Research Note

May 24, 2022

RESEARCH NOTE NO.61 – 2022 (RN/62/22)

Tighten monetary policy stance to rein in on rising inflationary expectations and support market and macroeconomic stability in the near term

Highlights

As the Monetary Policy Committee (MPC) of CBK meets on 30th May 2022, the Committee would be weighing between supporting the fragile economic recovery and reigning in on rising inflationary expectations. In this regard, a number of arguments are expected to underpin the Committee's policy decision:

- Upward inflationary pressure has continued to build up on account of three factors: rising oil and food prices, as well as the direct impact of a weaker currency via imported inflation. The three forces driving inflation continue to underpin expectations of higher inflation in the near term, strong enough not to be ignored. In addition, the need to rein in on inflationary expectations, particularly coming from the expected knock-on effects of rising oil prices on the prices of virtually all other commodities, should capture the attention of policymakers implementing forward-looking monetary policy.
- The strong economic recovery registered in 2021 is expected to moderate in 2022 due to poor weather conditions in the first quarter particularly in the bread-basket regions, the depressing effects of higher oil and other imported commodity prices on manufacturing and other heavily energy-dependent sectors, and the seasonal depressed business activity associated with periods of electioneering.
- With respect to credit extension, the prevailing elevated credit risk, coupled with the rising inflationary pressure, implies that credit growth is at risk of being constrained further, unless a stronger market-wide transition to risk-based environment is achieved so that bank credit is effectively priced to reflect risk conditions.
- The external sector imbalances are projected to worsen, exposing the economy's vulnerability to global market developments and the resultant policy measures taken by advanced economies to raise interest rates. The implications of this fundamental development on the domestic foreign exchange market is a continued weakening of the Shilling exchange rate. This calls for a policy action to avert the destabilizing effects of the exchange rate weakening on price stability, going forward.

Given the above consideration, we call on the MPC to consider tightening the monetary policy stance to rein in on inflationary expectations and avert the destabilizing effects of a further weakening of the shilling on the macroeconomy. While the current drivers of inflation are largely supply-side factors, persistently higher oil prices would knock-on other commodities and the second-round effects would demand a stronger policy action to tame. Failure to effect this – at this point- risks demanding stronger policy action in the near term, notwithstanding the destabilizing effects of this on the macroeconomy.

Inflationary expectations are not well anchored. There is need to tighten monetary policy stance to rein in on inflationary expectations and support macroeconomic stability in the near-to medium term.

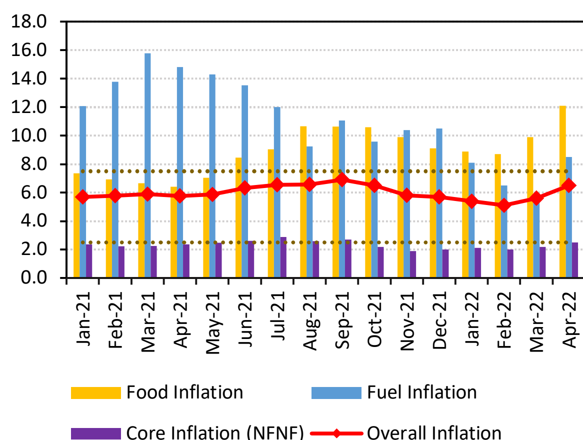
Background

On **30th May 2022**, market attention would be drawn to the decision that the MPC would take given the competing need of supporting the fragile economic recovery on one hand and maintaining market and price stability on the other, amidst the elevated downside risks from global and domestic developments. Thus, in this *Research Note*, we present five arguments that are likely to anchor the MPC policy decision:

First, the inflationary pressure has continued to build up, driven by food and fuel price increases, elevated Non-Food-Non-Fuel (NFNF) inflation, as well as imported inflation (**Figure 1**). Overall inflation has been on an upward trajectory since December 2021 when it stood at 5.8 percent to 6.5 percent in April 2022. This has been driven primarily by higher fuel inflation that edged up from 5.8 percent in March to 8.5 percent in April- reflecting the successive March and April upward pump price adjustments by the Energy and Petroleum Regulatory Authority (EPRA)[1]. Food price inflation also rose to 12.1 percent in April from 8.7 percent in February reflecting the adverse impact, in the first quarter, of the unfavorable weather conditions across the country on short-season food supplies.

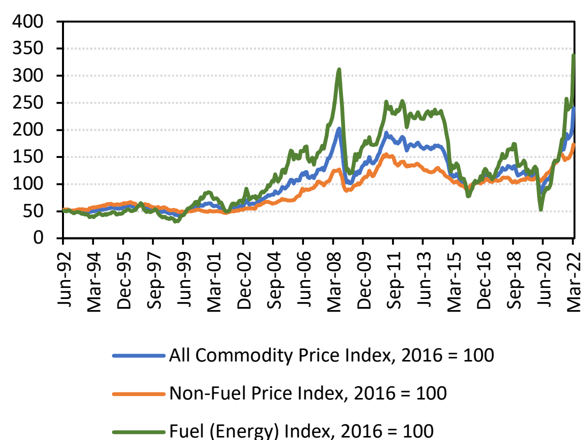
In addition, global commodity (both fuel and non-fuel) prices have been on the rise (**Figure 2**), as a result of the prolonged global supply disruptions. This continues to drive up inflationary expectations and threaten price stability across the globe. As a mitigation, policymakers particularly in key advanced economies, have raised interest rates. In the domestic market, inflationary expectations are elevated and the attendant adverse effects on other macroeconomic factors, such as investment and real economic performance, are looming.

Figure 1: Inflation trends



Source: *CBK*

Figure 2: Evolution of commodity prices



Source: *IMF Commodity price database*

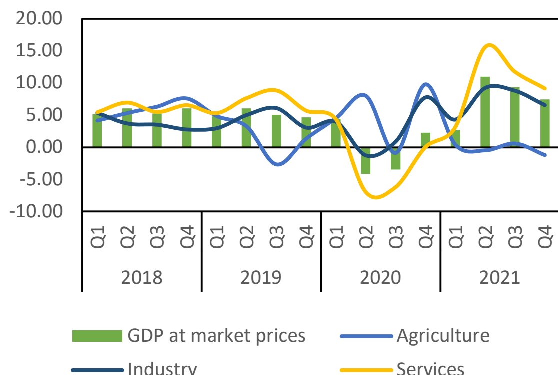
Second, the strong economic recovery registered in 2021 risks being slowed down in 2022 by the adverse effects of the unfavorable weather, higher oil prices and seasonal political risks. In 2021, Kenya's GDP rose by 7.5 percent driven by recoveries in the industrial activity and services sector, from an overall 0.3 percent contraction in 2020 **(Figure 3)**. Despite the recovery, there are emerging downside risks for growth in 2022. First, is the unfavorable weather conditions particularly in the bread-basket regions in the first quarter, which may spell lower harvests later in the year. Second, is the depressing effects of higher oil and other imported commodity prices on manufacturing and other heavily energy-dependent sectors such as automobiles, and consumer durables. Third, the ongoing electioneering process could potentially slowdown business activities as investors typically adopt a wait-and-see approach to their investment decisions.

Other developments that have an implication on the domestic economic outturn is the performance of the global economy. The global economic growth for 2022 has been revised down by 0.8 percentage points to 3.6 percent from the January 2022 projection[2], as a result of rising uncertainty on account of the upsurge in global inflation outturn and outlook, and the potential spillover effects of the imposed sanctions on Russia.

[1] See Energy and Petroleum Regulatory Authority (EPRA) https://www.epra.go.ke/maximum-retail-petroleum-prices-in-kenya-for-the-period-15th-may-to-14th-june-2022/
[2] See the April 2022 World Economic Outlook Report: https://www.imf.org/en/Publications/WEO/Issues/2022/04/19/world-economic-outlook-april-2022

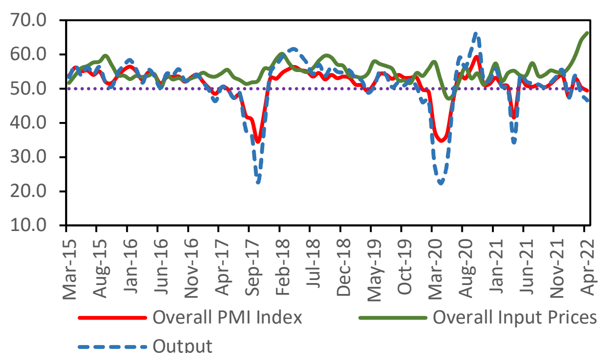
Evidently, some of the risks have materialized in the local economy. At the start of the second quarter of 2022, a notable slowdown in economic activity is shown by the composite Purchasing Managers' Index (PMI) that, in April, fell below the 50-mark for the first time in 2022 (**Figure 4**). The April PMI index dropped to 49.5 from 50.5 in March reflecting a decline in economic activity that was associated with marked increases in input prices, fuel costs and other living expenses. Forward-looking, the PMI report shows that business confidence in April dropped to a record low for the second successive month amid concerns over rapid price inflation and reduced client spending.

Figure 3: Sectoral and aggregate GDP Growth rates (%)



Source: *KNBS*

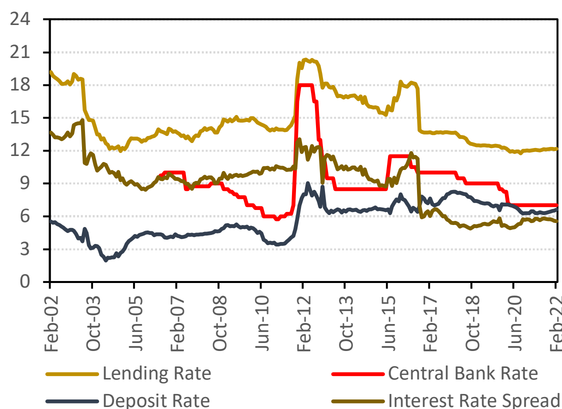
Figure 4: Evolution of the Purchasing Managers index



Source: *IHS Markit*

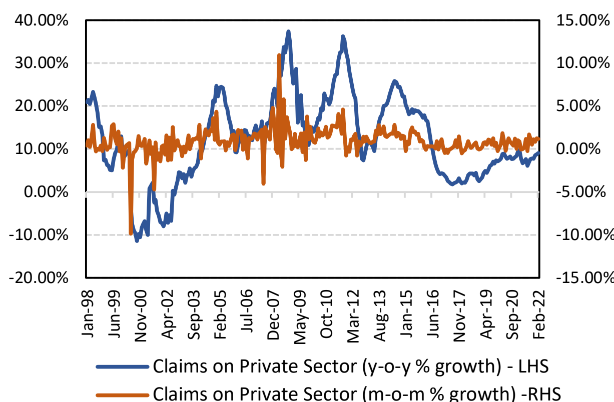
Third, the prevailing elevated credit risk, coupled with the rising inflationary outcomes and expectations, implies that credit growth is at risk of being constrained further. The ongoing challenge that has kept banks' lending rate somewhat unchanged (**Figure 5**) is associated largely to the lenders' inability to effectively price risk amidst the elevated credit risk- with the ratio of gross non-performing loans to gross loans edging up to 14.0 percent in February from 13.1 percent by the end of 2021. The existing slow approvals of risk-based pricing model proposals by banks continue to constrain lending (**Figure 6**) and remains a concern for the industry. Going forward, any efforts to boost credit extension to the private sector, and support the fragile economic recovery, requires as a necessary and sufficient condition, a stronger shift in the pricing conditions/frameworks to allow effective pricing of risk. This will provide an incentive for banks to price-in risk and unlock credit to the private sector.

Figure 5: Interest rates developments (%)



Source: *CBK*

Figure 6: Growth in claims on private sector (%)

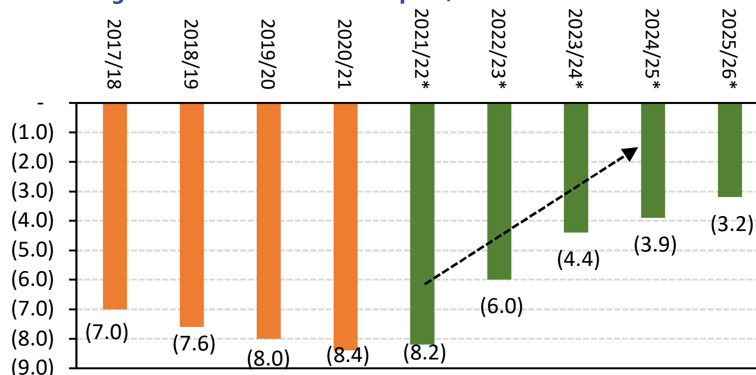


Source: *CBK*

Fourth, fiscal consolidation may not be realizable with potential slowdown in economic activity amidst government expenditure pressures. There is a reported effort to address debt vulnerabilities through a gradual fiscal consolidation targeting enhanced revenue mobilization, expenditure rationalization and prudent management of public debt. Consequently, the fiscal deficit is projected to decline from 8.2% of GDP in the Financial Year 2021/2022 to 3.9% by end 2024/2025 **(Figure 7)**.

There are, however, some downside risks to the realization of these targets, including the constrained transmission of monetary policy (given the deceleration in private sector credit) - that would call for fiscal policy to provide the much-needed reprieve, and the evident slowdown in economic activity that may depress government revenues and require additional borrowing given the growing expenditure demands to finance contracted infrastructure projects and the post-Covid recovery strategy. Moreover, there are evident challenges in offshore borrowing with the tightening of financial market and borrowing conditions in the global markets following the normalization of monetary policy in most developed markets.

Figure 7: Fiscal consolidation path, Fiscal deficit % of GDP

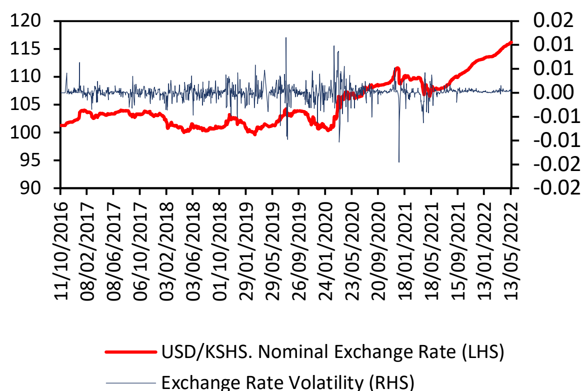


Source: *The National Treasury*

Fifth, the external sector imbalance is projected to worsen, exposing the economy's vulnerability to global market developments and the resultant policy measures taken by advanced economies. As an outcome of a widening current account deficit (**Figure 9**), the Shilling exchange rate to the US dollar has weakened overtime (**Figure 8**). The Shilling exchange rate weakening has been exacerbated by the excess demand of the US dollar - anchored majorly on the recovery of economic activity that has called for more imports, rising fuel import bill, and net sell-offs at the local stock market, amidst dwindling supply of foreign exchange as recovery of exports remained slow.

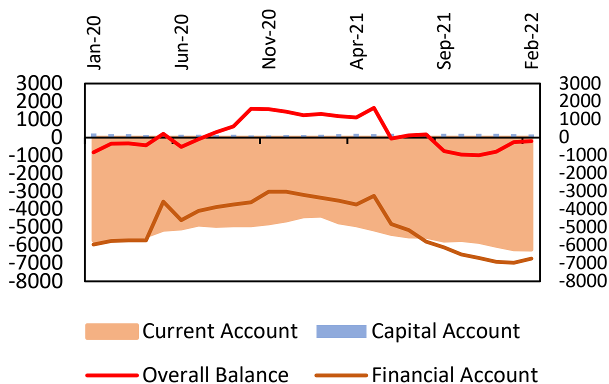
The implication of a depreciated currency is two-pronged. First, is the direct knock-on effect on inflation via higher prices (in local currency) of imported goods. Second, is its implication for economic growth, particularly when it is not benefiting exporters as is the case at the moment with the slow recovery in export volumes. The current depreciation of the shilling would constrain imports of goods and services – most of which are intermediate in nature, and thus pull back economic recovery. Under these circumstances – that have a bearing on both price stability and economic growth adversely, the need to take policy action to quell the depreciation is warranted. This is particularly important at this time when leading economies have raised interest rates to deal with rising inflation – a move that would worsen the interest rate differential and trigger capital and portfolio flows out of the country.

Figure 8: Exchange rate developments (USD/KSH)



Source: *CBK*

Figure 9: Developments in the Balance of payments



Source: *KNBS*

Conclusion

The decision of the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) from its meeting on 30th May 2022 is much anticipated to shift gears and direct the market towards sustained price and market stability. Higher inflation outcomes are being driven primarily by food and oil prices. The potential persistence of higher food and fuel prices are likely to generate second-round effects on other commodity prices and fuel higher overall inflationary pressure in the near term. In addition, the weakening exchange rate is likely to compound imported inflationary pressure that is already in place as a result of the increases in the global commodity prices. Higher inflationary pressure -left unattended - risks undermining economic recovery in the near to medium term.

In our view, recognizing that monetary policy is a short-term macroeconomic stabilization tool, and to avert higher inflationary pressure and its consequent depressing effects on economic recovery, there is need to tighten monetary policy via a raise in the policy rate. This would signal a tightening of financial conditions, ease the exchange rate weakening and avert more macroeconomic instabilities in the short term. Failure to effect this, at this point, risks calling for a higher magnitude raise in the policy rate in the near future with its attendant effects of market instabilities.

This *Research Note* is a publication of the Kenya Bankers Association Centre for Research on Financial Markets and Policy®. The Centre was established by the Kenya Bankers Association in 2012 to offer an array of research, commentary, and initiate dialogue on critical policy matters that impact the financial sector. Through these activities, the Centre acts as a platform for intellectual engagement between experts on financial markets, banking industry players and policy makers.

The views expressed in this *Research Note* do not necessarily represent those of the Members of the Kenya Bankers Association. The content of this publication is protected by copyright law. Reproduction in part or whole requires express written consent.

Comments on this *Research Note* can be forwarded to research@kba.co.ke

©Kenya Bankers Association 2022