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Amidst inflationary and economic growth trade-offs, the need to maintain policy stance is justified

Amidst two heavily competiting trade-offs, between dampening inflationary expectations and supporting economic recovery that continues to face headwinds, warrant a maintainance of the policy stance.

Highlights

At its meeting scheduled for ***March 29, 2022***, the Central Bank of Kenya's Monetary Policy Committee (MPC) faces two significant policy trade-offs.

- On the one hand, the need to dampen expectations of higher inflation on the back of rising global commodity prices- mainly oil- and a relatively weaker shilling that is anchored on fundamentals;
- On the other, the need to boost private sector growth to anchor a stronger and sustainable economic recovery. The economic recovery in 2022 faces new headwinds from the geopolitical tensions associated with the Russia-Ukraine conflict and the domestic political risks. Here, the focus should be dealing with the challenges that lenders continue to face, particularly with regard to the existing inability to effectively price risk;
- On hindsight, we take note of the strides made in the approvals of risk-based credit pricing frameworks for banks, and call for a faster leap towards its market-wide adoption.
- We also take note of the sustained uncertanty in financial markets driven by the delayed containment of COVID-19 at global level, and escalated by the geo-political developments associated with the Russia-Ukraine conflict.

In our view therefore, and consistent with global trends, most probable reviews of policy rates would lean upwards to deal with rising inflationary expectations and dampen currency depreciation. But to signal the need to support the fragile economic recovery - from the adverse effects of the pandemic- the CBR should be kept unchanged at 7.00% reflecting a maintenance of an accommodative policy stance.

Background

At its meeting on ***March 29, 2022***, the MPC faces glaring policy tradeoffs. The meeting would be held on the backdrop of the ongoing Russia-Ukraine conflict which has heightened uncertainty and geo-political tensions, with sizeable implications for global and domestic economies. Global growth is expected to be dented on the back of economic sanctions imposed on Russia and the resultant disruptions to trade. This is expected to be compounded in the domestic market by the perennial risks associated with electioneering. Higher inflationary pressures across the globe are imminent with the rising commodity prices. These developments, therefore, call for a delicate balancing act by the MPC. In this *Research Note*, we make four arguments that are likely to be at the center of the policy decision anticipated on March 29, 2022:

First, the global economic recovery is expected to slowdown in 2022 on account of the ongoing Russia-Ukraine conflict. The spillovers of a weak global economy on the domestic economy are also imminent through several channels, including weak export growth, reduced business and investor confidence, heightened uncertainty, and the likely impact of capital outflows from emerging markets as financial conditions tighten in advanced markets.

Higher frequency economic indicators, as depicted by trends in the Purchasing Managers' Index™ (PMI),[1] showed some recovery in economic activity in Kenya in February from a dip in January. The composite index rose by 5.3% to 52.9 in February from 47.6 in January 2022, suggesting an expansion of private-sector economic activity after losing momentum in the previous month (**Figure 1a**). However, the evolution of the sub-indices registered mixed patterns (**Figure 1b**). In February, while there was increased optimism for growth in future output and a continued recovery in export orders, input and output prices rose – effectively indicating a rise in inflationary expectations in the near term.

Figure 1a. Trends in Overall PMI Index
Mirrors a recovery in activity in February from a dip in January

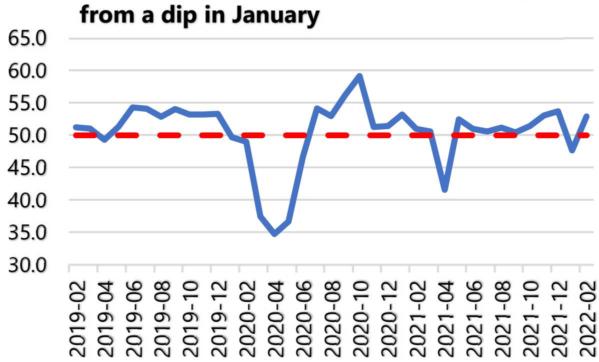
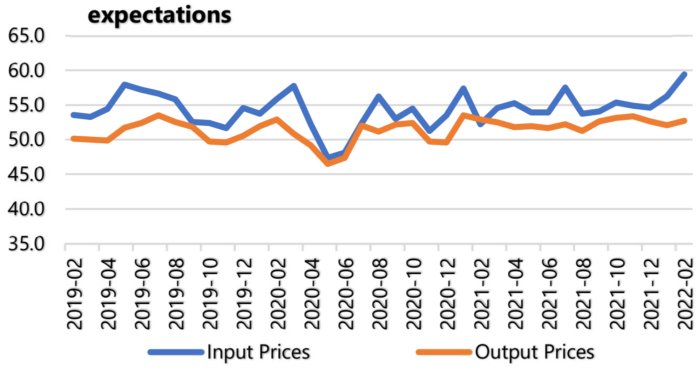


Figure 1b. Sub-components of PMI Index
Rising input and output prices reflect inflationary expectations



Source: *IHS Markit*

Second, despite easing overall inflation in February, inflationary expectations are imminent, mainly on the back of rising global oil prices. Overall inflation eased to its lowest in 16 months in February and was within the 5±2.5% government target range (**Figure 2a**), to stand at 5.1% down from 5.4% in January, driven by a decline in food and fuel prices on a month-on-month basis. In particular, as food and fuel inflation respectively eased to 8.7% and 6.5% from 8.9% and 8.1% in January, core inflation - a reflector of the demand-driven inflationary pressure, remained largely unchanged at 2.1%. Despite the stable inflation, expectations of rising prices are imminent, given the escalating global commodity prices (mainly oil) triggered by the Russia invasion of Ukraine and the sanctions imposed on Russia. Picking up from the global supply disruptions, the Murban oil prices short up drastically in recent weeks, from USD 94.21 on 17th February to USD 130.24 per barrel by 9th March 2022 **(Figure 2b)**. The pass-through of rising international prices

[1] The composite Purchasing Managers' Index (PMI) for Kenya is published by IHS Markit on a monthly basis and measures changes in economic activity and business conditions between two successive months. An index measure above 50.0 signals an improvement in business conditions and below 50 reflects a deterioration. The PMI is generated from a survey of firms in the manufacturing sector.

to domestic inflation through increased fuel prices in the coming months is expected with the upward revision of domestic pump prices[2] from March 14th.

Figure 2a: Consumer Price Index (CPI) Inflation Trends

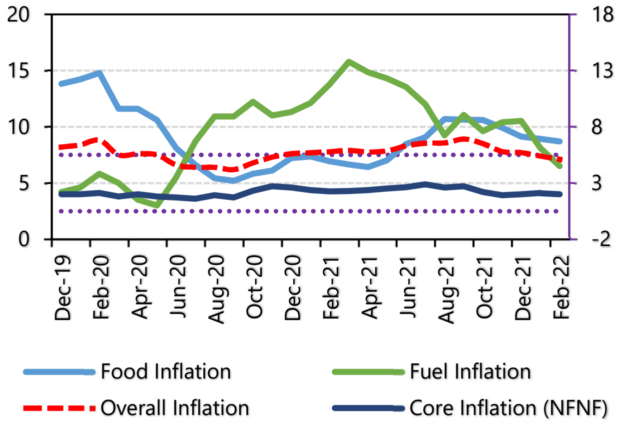
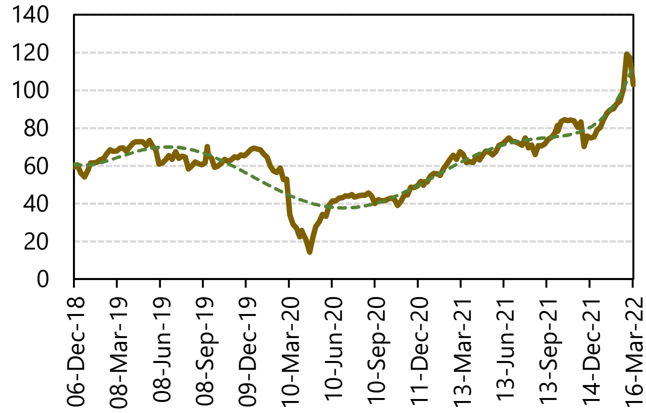


Figure 2b: Evolution of Murban oil prices (US$ per barrel)



Source: *Central Bank of Kenya, Oilprice.com*

Third, credit growth remains muted, largely reflecting the existing challenges with effective pricing of risk. Private sector credit rose on a month-on-month basis by 8.6% in December 2021 (**Figure 3a**) - the highest in nine months - driven by credit to finance consumer durables (that grew by 15.0%), transport and communication sector (14.3%), manufacturing (13.1%), business services (9.5%) and trade (8.5%). Overall credit growth remains within the single digit level underpinned by the existing challenges in the pricing of loans. Consequently, lending rates have remained sticky amidst changing market conditions and evident responsiveness of other market interest rates (**Figure 3b**).

Albeit slowly, the increasing adoption of risk-based pricing for the industry is noted, with about 27% of the industry loan portfolio having transitioned to risk-based pricing environment by mid March. A faster transition of the industry to risk-based pricing of loans is expected to boost credit supply and uptake by the private sector in the near to medium term. However, the suspension[3] of listing of negative credit information continues to undermine credit assessment of customers and dampen prospects for increased credit supply.

Figure 3a: Growth in claims to the private sector remains muted

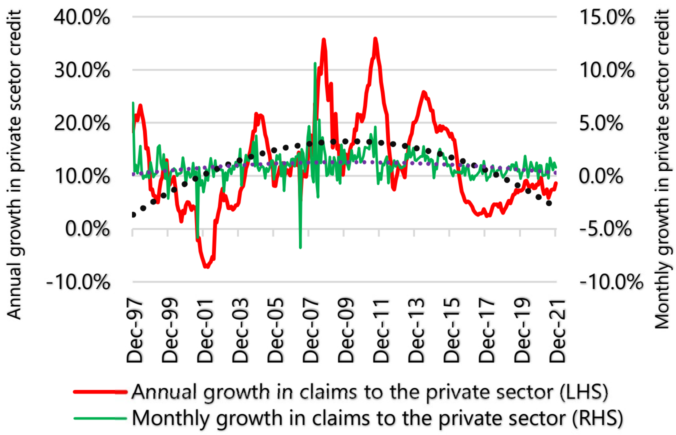
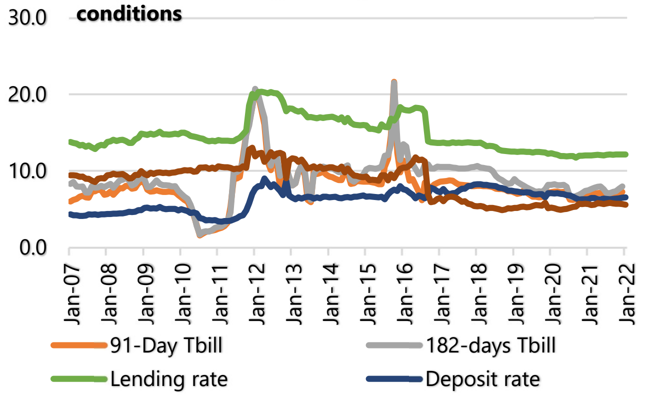


Figure 3b: Interest rate dynamics: Yields on private sector bank loans remain sticky, while other market yields adjust to market conditions



Source: *Central Bank of Kenya*

[2] See EPRA (March 2022). Maximum retail petroleum prices in Kenya for the period 15th March to 14th April 2022 https://www.epra.go.ke/maximum-retail-petroleum-prices-in-kenya-for-the-period-15th-march-to-14th-april-2022/

[3] https://www.centralbank.go.ke/uploads/press_releases/566112348_Press%20Release%20-%20Suspension%20of%20The%20Listing%20of%20Negative%20Credit%20Information%20for%20Borrowers.pdf

Fourth, is the weakening trend that the Shilling picked against the US dollar, driven by a worsening in the fundamentals. The weakening Shilling relative to the US dollar (as shown in **Figure 4a**), can be attributed to a widening current account deficit (as a percentage of GDP) (**Figure 4b**), a decline in foreign exchange reserves (**Figure 4c**), and rising jitters in global financial markets as the Russia-Ukraine conflict escalates. As shown in **Figure 4b**, the current account deficit widened to 5.4% of GDP in the 12-months to December 2021 compared to 4.6% of GDP in a similar period in 2020. The ongoing Russia-Ukraine conflict will further deteriorate Kenya's current account position; with the expected disruptions to Kenyan export flows to the two countries (**Figures 4d and 4e**). Notably, the worsening in the current account position has lacked a corresponding improvement in the capital and financial account, leading to a weaker overall balance of payments position (**Figure 4f**).

In addition, the official foreign exchange reserves volume has been on a declining trend **(Figure 4c)** and stood at USD 7,979 million (or 4.88 months of import cover) by March 17, which despite being above the CBK's statutory requirement of 4 months approaches the EAC region's 4.5 months limit of import cover. Declines in official reserves may weaken market confidence in its ability to quell any short-term volatilities, and thus may trigger expectations of a further weakening in the currency, particularly in an environment of uncertainty and global markets volatilities. The ongoing conflict between Russia and Ukraine, may compound the pressure for the Shilling to weaken by elevating market volatilities as a result of the sanctions imposed on Russia that continue to constrain their participation in global markets. The growing possibility of advanced markets tightening their monetary policy stance, may also exert more pressure on the Shilling to weaken, if they trigger significant reversals of capital flows from emerging and frontier markets. Pressure on the Shilling to weaken, particularly when it is driven by fundamentals, portends additional inflationary pressures. This development, considered on its own merit, would call for a tightening of the monetary policy.

Figure 4a: Exchange Rate (Ksh/USD) Developments

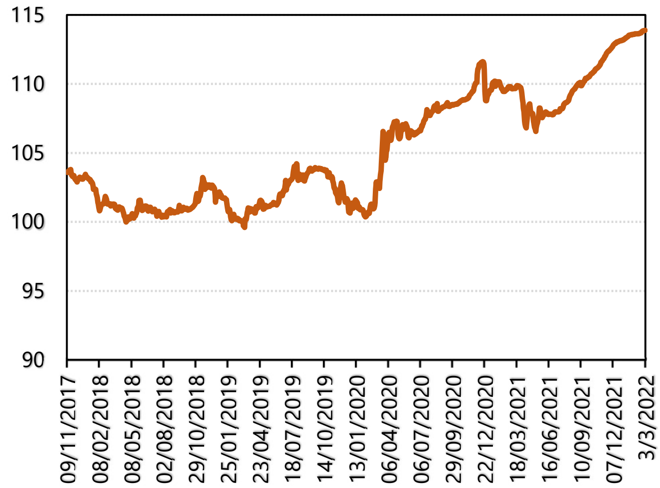


Figure 4b: Developments in Current account deficit (% of GDP)

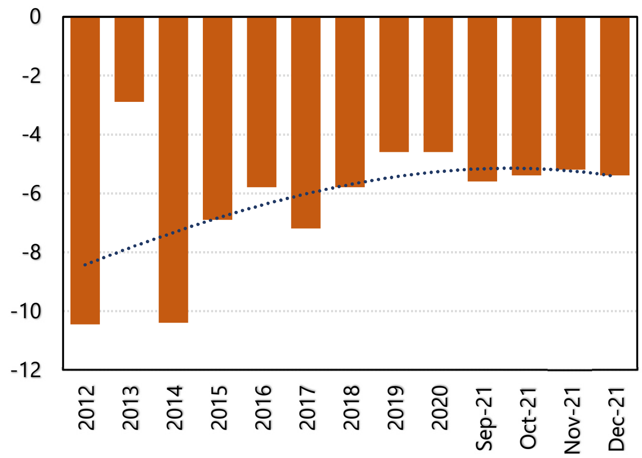


Figure 4c: Official Foreign Exchange Reserves

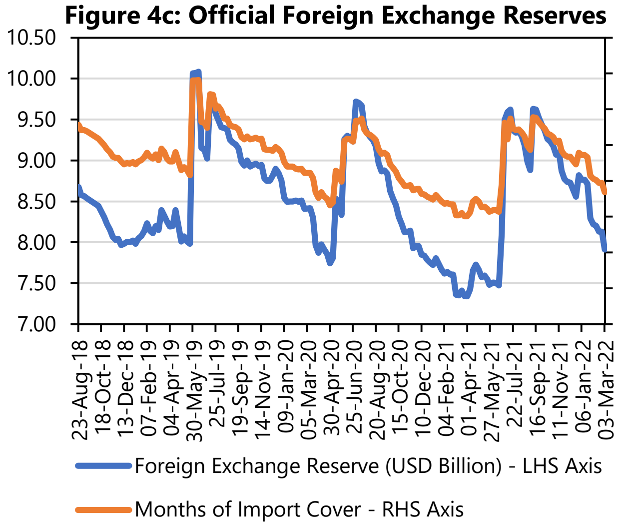


Figure 4d: Kenya-Russian Federation Trade Relations

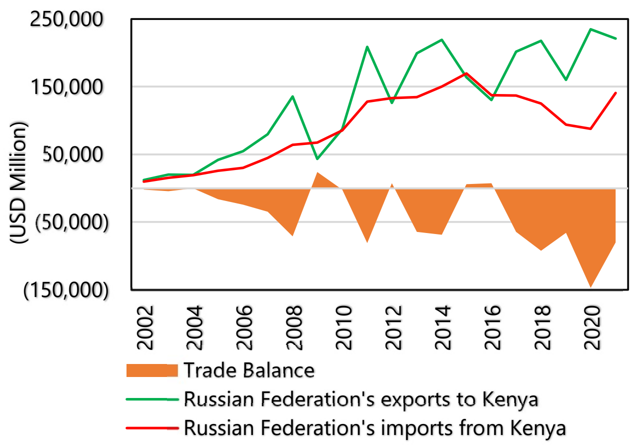


Figure 4e: Kenya-Ukraine Trade Relations

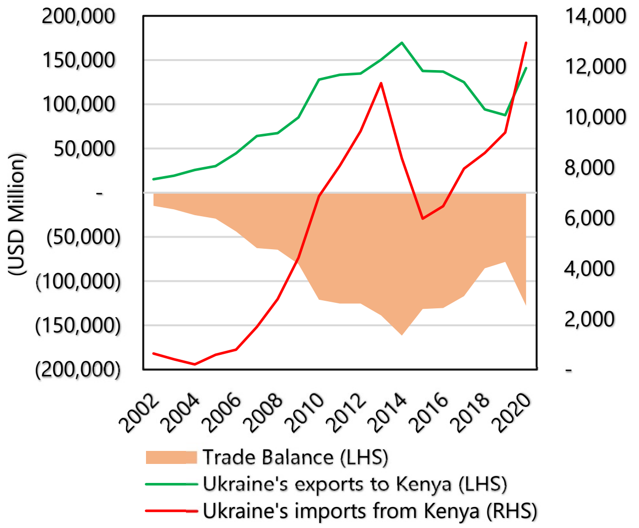
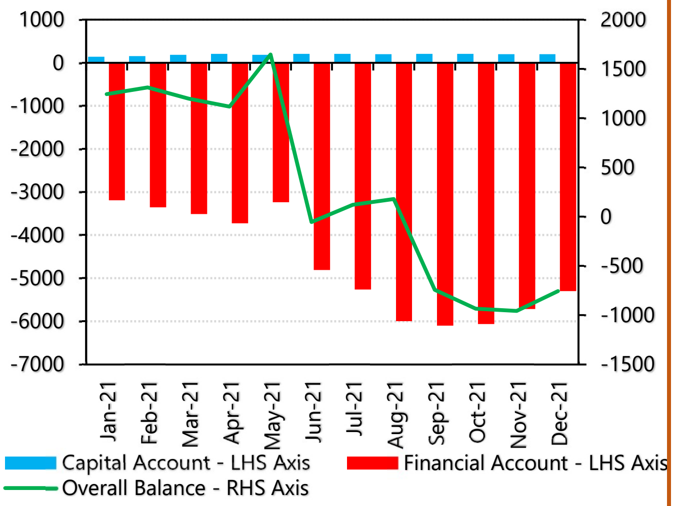


Figure 4f: Developments in the Capital and Financial Account



Source: *CBK, KNBS, and ITC Trade Map*

Conclusion

At its meeting scheduled on ***March 29, 2022***, the Central Bank of Kenya's (CBK) Monetary Policy Committee (MPC) faces two significant policy tradeoffs.

- On the one hand, while the current inflationary pressures, expectations point to rising inflation in the near term, driven by rising oil prices, and tht weakening shilling relative to the US dollar; and

- On the other, the need to support the fragile economic recovery from the adverse effects of the pandemic, which would be well anchored on a stronger growth in private sector credit. The current muted private sector credit growth, that is attributed to stickiness in lending rate, reflects challenges that lenders face in their efforts to effectively price credit amidst ample market liquidity. Therefore, in our view, faster growth in credit would be achieved with market-wide adoption of risk-based pricing frameworks.

On the back of the outlined developments, we view that the MPC is likely to retain the accommodative stance, by maintaining the CBR at 7.00%. However, pressure to adjust the policy rate upwards in the near term continues to build-up with rising inflation expectations and a sustained weakening of the Shilling relative to the US dollar.

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.

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