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Research Note

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The monetary policy stance remains appropriate, but a sustainable economic recovery would be anchored by a stronger growth in credit.

While economic recovery continues, its sustainability would be anchored on a stronger growth in credit. To unlock credit, this does not call for a further cut in the policy rate, but a faster leap towards an environment where its pricing mechanism would need to reflect the evolution of risk in the market.

Highlights

The **November 29, 2021** meeting of the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) is expected to keep the CBR at 7.00% as the appropriate policy stance underpinned by a number of developments:

- The economy depicts strong recovery driven by some normalization of the services sector as the effects of the pandemic continue to wane with the easing of containment measures and increased vaccinations. However, higher frequency indicators and sentiments from businesses followed on monthly basis point to uncertainty on the future path of the recovery and thus the need for stronger anchors.
- Inflation eased marginally in October, largely driven by a slight decline in fuel inflation. However, inflationary threats remain with the sustained rise in global oil prices, the depreciating currency, and drought conditions in most parts of the country that may elevate food prices.
- Developments in the external sector show widening deficits on both the current and financial accounts of the balance of payments. This changes in an environment of a flexible exchange rate regime, imply a weakening of the currency; a phenomenon evident since July 2021. While this is an automatic adjustment, concerns would be the inflationary pressure that may emanate from a weaker currency, going forward.
- While the average interbank rate remained sustained below the Central Bank rate- pointing to ample liquidity in the market, concerns remain on the stickiness of the lending rate. The minimal changes on the lending rate, that fail to mimic the market credit risk changes, is a reflection of the lenders' inability to effectively price credit that has been ocassioned by a slow pace in the approvals and implementation of risk-based pricing frameworks. This continues to deny the economy a stronger supply of credit, that is a neccesary condition for a stronger and sustainable recovery of the economy.

Against this background, we sustain our argument for maintaining the policy stance, while watching out for inflationary threats. This note, however, renews our call for a faster leap towards the approval and implementation of risk-based pricing models that would unlock private sector loans and anchor a stronger economic recovery.

Background

The MPC's policy scenarios, particularly amidst the notable recovery in the economy in 2021, would be defined to a large extent by the need to strike a balance between supporting a stronger economic recovery and minimizing any threats to price stability in the near to medium term. Policy monitors will be keen to see the decision adopted by the MPC with the sustained inflationary threats that call for a stay on policy stance and/or perhaps a signal for an upward adjustment in interest rates in the near-term, in tandem with global sentiments. In essence, and as was considered by the policy organ's September Press Release, the threats to inflation remain real anchored on the steady increase in global oil prices.

In this Research Note, we make four arguments that are likely to be at the centre of the policy decision anticipated on 29th November 2021:

First, the economy depicted a strong recovery in the first half of 2021 driven by some normalization of the services sector as the effects of the pandemic continue to wane with the easing of containment measures and increased vaccinations. During the second quarter of 2021, the economy registered a strong recovery, growing by 10.1% which was driven by rebounds in industrial activities and services. This strong growth, compared with a meagre 0.7% in the first quarter of 2021, was on the back of a continued easing of COVID-19 pandemic containment measures. The performance of agriculture; the sector that supported the economy during the first half of 2020, remained muted in the first half of 2021, as services regained its strong contribution to economic activity towards the pre-pandemic levels (**Figure 1a**).

Higher frequency economic indicators for the third quarter of 2021, as depicted by trends in the composite PMI index[1] (see **Figure 1b**) showed month-after-month improvements in economic activity- rising to the highest level in five months in October. However, firms exhibited some uncertainty on whether the growth momentum would be sustained. As such, there were evident volatilities in business orders and expectations on future output were not well anchored.

Figure 1a. Real GDP performance by broad categories (Quarter-on-quarter growth rates, %)

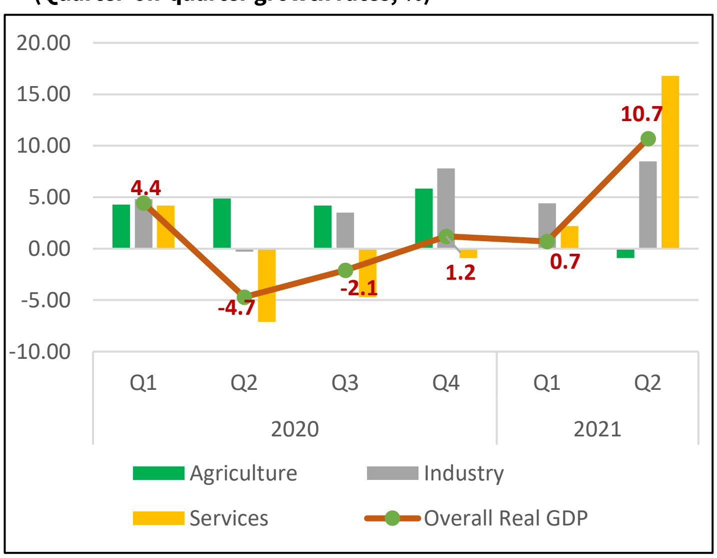
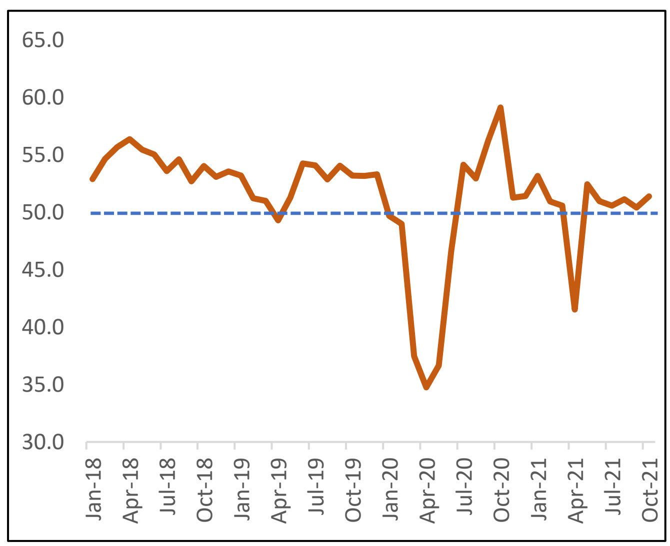


Figure 1b. Trends in overall PMI index



Source: *CBK, Stanbic Bank & IHS Markit*

[1] The composite Purchasing Managers' Index (PMI) is published by Stanbic Bank on a monthly basis and measures changes in 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.

Second, inflation eased marginally in October, largely driven by a slight decline in fuel inflation. Overall CPI inflation stood at 6.45% in October 2021, easing slightly from 6.91% in September and largely comparable with 6.57% in August (**Figure 2**). While fuel inflation declined from 11.1% in September to 9.6% in October (**Figure 3**), food inflation remained high and steady at 10.6% between September and October reflecting food supply constraints on account of the drought conditions experienced in some parts of the country. Inflationary risks, however, remained escalated as global oil prices continued to edge upwards; rising from US$77.13 in September to US$ 84.43 per barrel in October 2021 (**Figure 4**).

Figure 2: CPI Inflation trends

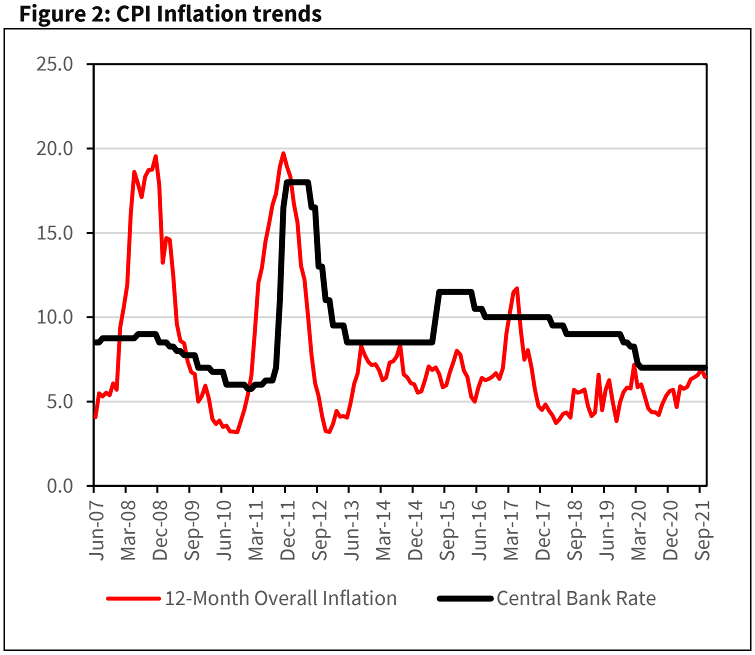
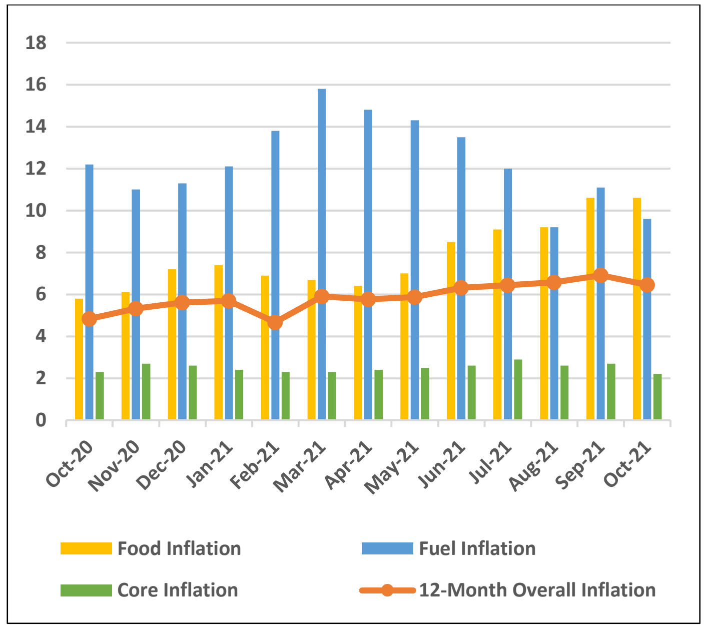
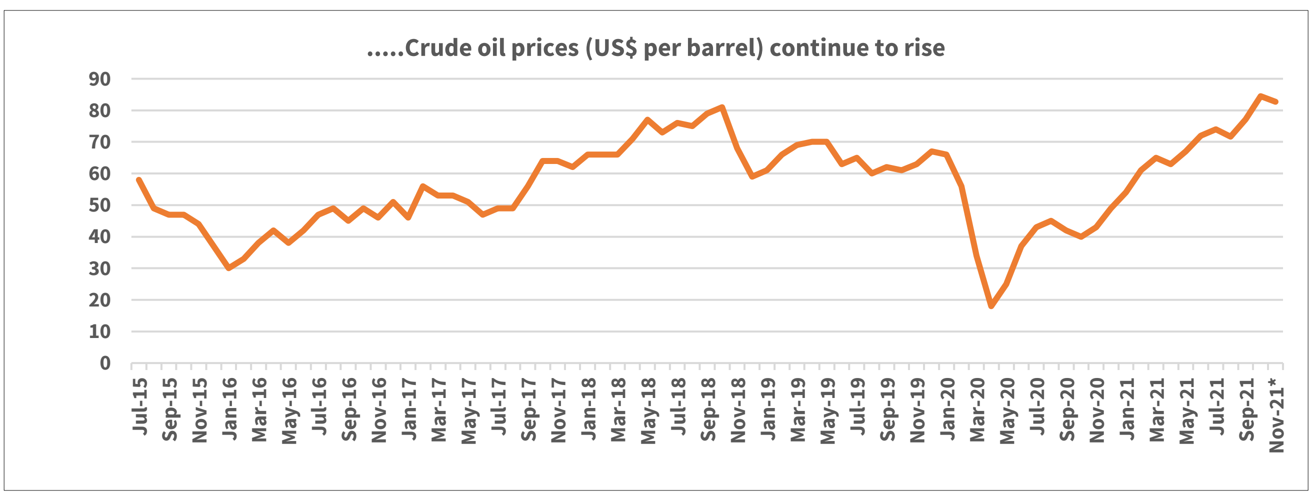


Figure 3: Inflation by broad categories (12-month rates, %)



Source: *KNBS & Central Bank of Kenya*

Figure 4: Developments in global oil prices



Source: *Abu Dhabi Oil Company*

Third, the average interbank rate has remained low and consistently below the central bank rate, reflecting ample liquidity in the market, but lending rates have been sticky. Changes in the lending rate have been minimal; a phenomenon attributed strongly to the existing challenges in the pricing of loans that have persisted even beyond the repeal of interest rate caps in November 2019 (**Figure 5a**). Consequently, growth in private sector credit has remained within the single-digit level (**Figure 5b**). Going forward, two main concerns linger. First, is the slow transition towards a pricing environment that reflects market risk development. Second, is the recent suspension[2] of listing of negative credit information with the credit reference bureaus that is likely to undermine credit assessment of customers and thus slow the supply of credit.

Figure 5: Interest rates and Credit Market Developments

Figure 5a. Interest Rates Dynamics

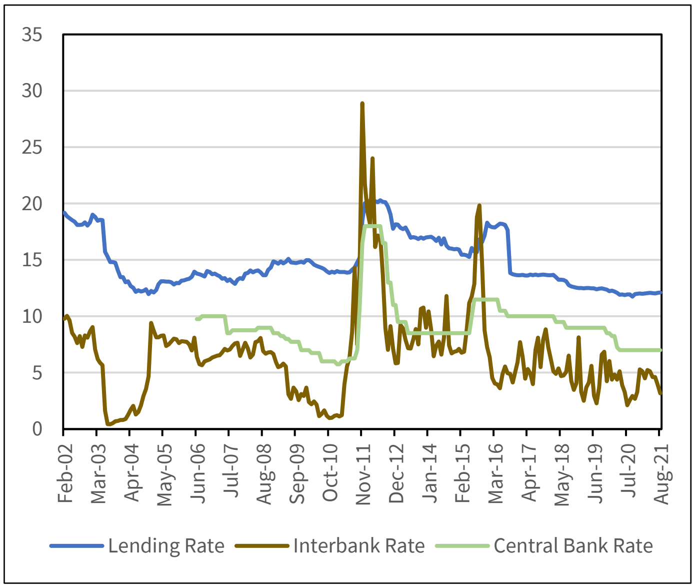
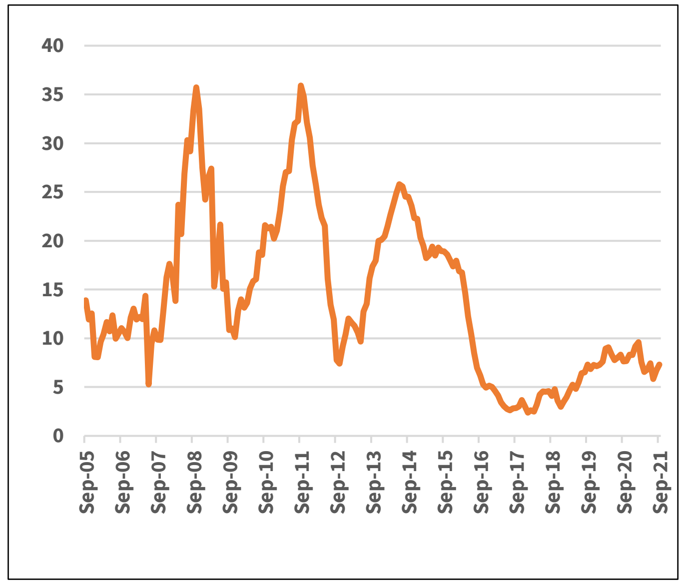


Figure 5b. Evolution of Private Sector Credit (12-Month Growth, %)



Fourth, is the weakening trend that the Shilling picked against the US dollar, particularly from July. The exchange rate weakening. as shown in **Figure 6a**, was driven mainly by fundamentals, as the current account deficit widened to 5.6% of GDP in the 12-months to September 2021 compared to 5.0% of GDP in the 12 months to September 2020, without a corresponding improvement in the capital and financial account (**Figure 6b & 6c**). The current account movement was on account of a faster increase in imports of goods and services that outpaced the growth in receipts from exports and remittances. Diaspora remittances rose to USD309.8 million in September and further to USD 337.4 million in October 2021 compared to USD 263.1 million in October 2020, reflecting a 28.2% increase month-on-month. The official foreign exchange reserves have remained strong, at USD 8,873 million, equivalent to 5.42 months of import cover as of November 18. These developments imply that the market demand for foreign exchange, which is consistent with the ongoing economic recovery, surpassed its supply resulting in a weakening shilling; an automatic adjustment typical in a flexible exchange rate regime.

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

Figure 6: Developments in the external Sector

Figure 6a: Exchange (KES/US$) rate developments

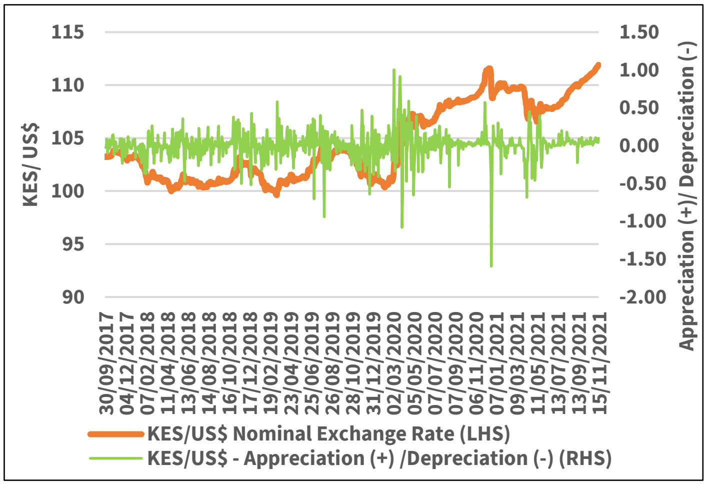


Figure 6b. Developments in the 12-month Current Account Balances

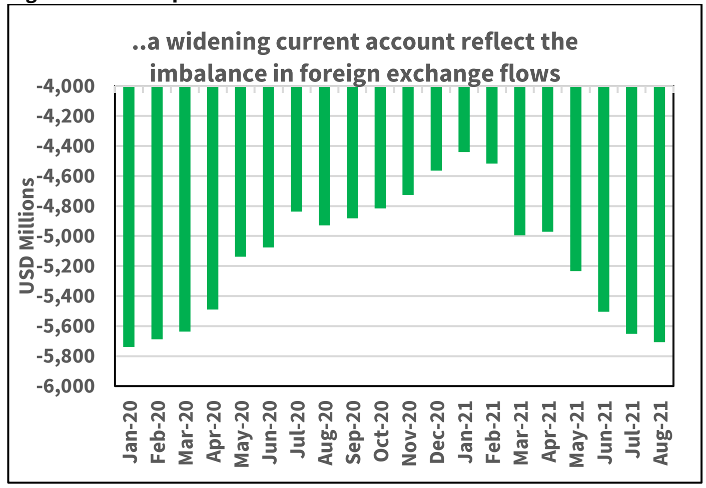
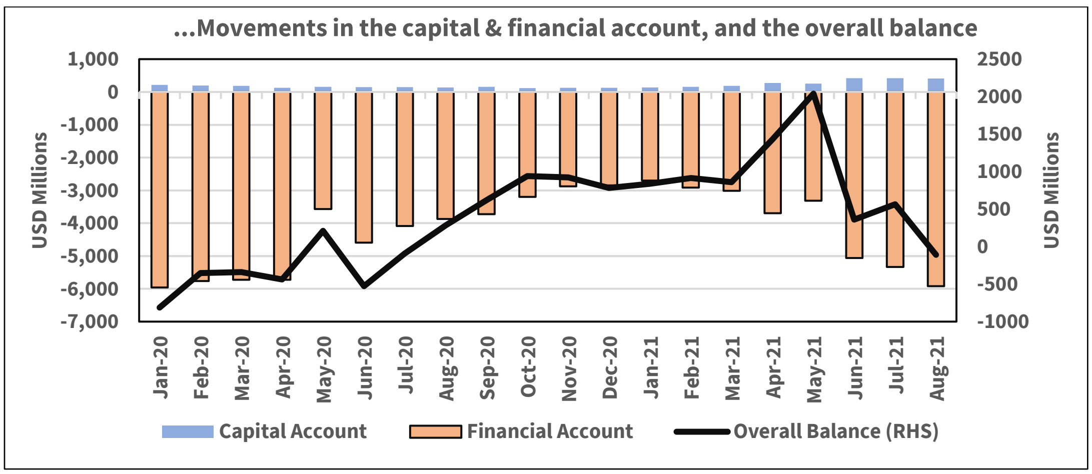


Figure 6c: Developments in the Capital and Financial Account (12-month Cumulative balances)



Conclusion

At its meeting scheduled on 29th November 2021, the Monetary Policy Committee's decision is expected to be anchored on a number of considerations. First, is the notable recovery in the economy from the adverse effects of the pandemic and its containment measures, while acknowledging the uncertainty that continues to prevail. Second, are the sustained threats to inflation from the persistent rise in global oil prices, drought conditions in some parts of the country and the weakening currency. Third, is the flattening out in the growth of private sector credit that reflects challenges that lenders continue to face in their efforts to effectively price loans, amidst ample liquidity in the market; and fourth, is the widening deficits in current and financial accounts of the balance of payments that continue to exert pressure on the exchange rate to weaken.

These developments point to the need to maintain the policy rate at 7.00% and explore avenues to unlock a faster recovery of the economy. In our view, a faster growth in credit would be achieved through increased supply of credit to the private sector supported by the extensive adoption of risk-based pricing frameworks.

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