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Research Note

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Economic recovery is on course, but lacking the necessary anchor of a stronger growth in credit..

Economic recovery is on course and inflation remains within the target range. However, risks to stronger growth and stable inflation are imminent. To anchor a stronger economic growth, the focus should be supporting a scale-up in credit supply by fast-tracking a system-wide implementation of risk-based pricing.

Highlights

The CBK Monetary Policy Committee meeting of **January 26, 2022,** is expected to provide guidance on the monetary policy stance to be adopted going forward. At the center of the anticipated policy decision would be four underlying macroeconomic developments:

- First, inflationary pressures have eased and remain within the 5±2.5% target range, but there are fears going forward of a further rise in global oil prices, given the strength of its pass-through to local fuel prices as well as knock-on effects on prices of other consumer goods;
- Second, is the notable recovery of the economy in 2021, driven by a strong resumption of activity in the services and industrial sectors attributed to the reopening of the economy. However, uncertainty continues to linger on whether the recovery would be sustained, given the lack of a clear foresight on the containment of the pandemic, the emerging seasonal investor jitters associated with general elections, as well as reliance on a few anchors of long-term growth;
- Third, the short-term interest rates have eased reflecting ample liquidity conditions, but lending rates remain sticky mirroring the challenges with effective pricing of risk by banks, which is associated with delays in the approvals - and thus implementation, of risk-based pricing models. This, coupled with the suspension of listing of negative credit information that is constraining customer credit assessment by banks, continue to impede a stronger growth in credit in the economy and limit the speed and magnitude of the economic recovery process; and
- Fourth, the widening of the current account deficit in part continues to exert pressure on the exchange rate to weaken; a trend now sustained since July 2021. This may pose risks on the overall price stability, going forward.

In view of the above developments, and an assessment of the balance of risks to the economy, a retention of the CBR at 7.00 percent is justifiable.

A further cut in the policy rate – seeking to support economic recovery, amidst the existing gridlock in the conversion of liquidity in the system to private sector credit, may not deliver the desired outcomes. On the contrary, a rate hike risks derailing the fragile recovery of the economy and widening of the the output gap.

In our view, to anchor a stronger economic growth, the focus should be supporting a scale-up in credit supply by fast-tracking a system-wide implementation of risk-based pricing.

Background

The **January 26, 2022,** meeting of the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) is much anticipated, as it is expected to set the monetary policy tone for the year, particularly following a remarkable global and domestic economic recovery in 2021. Nonetheless, the emergence of new variants of COVID-19 continues to define the uncertainty about how quickly the pandemic can be contained at a global level. Amidst these developments, policymakers globally continue to face the delicate balance between supporting the uncertainty-laced recoveries and mitigating volatilities in financial markets through policy rate adjustments. In this *Research Note*, we parade four arguments that are likely to be at the center of the anticipated MPC policy decision:

One, from a general price stability standpoint, inflationary pressures have eased and remain within the 5±2.5 percent target range, but there are jitters going forward. As **Figure 1a & 1b** indicate, overall CPI inflation has since October 2021 been on a downward trend, declining to 5.7 percent in December 2021, from 5.8 percent in November, driven by supply-side factors – mainly food inflation that eased to 9.1 percent from 9.9 percent over the same period. However, concerns remain on the path of fuel inflation, which steadied at above 10 percent following a rise from 9.6 percent in October 2021; echoing the evolution of global oil prices. Core inflation, which reflects changes in demand for consumer goods in the economy, remained flat, at 2.0 percent in December, though slightly up from 1.9 percent in November.

Across 2021, overall inflation remained within the target range, but its path in 2022 will depend on two critical developments. First, are the rallying global energy prices as global oil demand edges up following recoveries from the effects of the pandemic. The global energy prices, particularly for net importing countries, have demonstrated strong pass-through effects to local fuel prices. Second, is the evolution of the exchange rate that would characterize the impact of imported inflation on local consumer prices. On the back of these arguments and anchored on the rising global oil prices and their knock-on second-round effects on prices of other consumer goods, inflationary expectations going forward, in our view, are not well-anchored.

Figure 1a: CPI Inflation trends

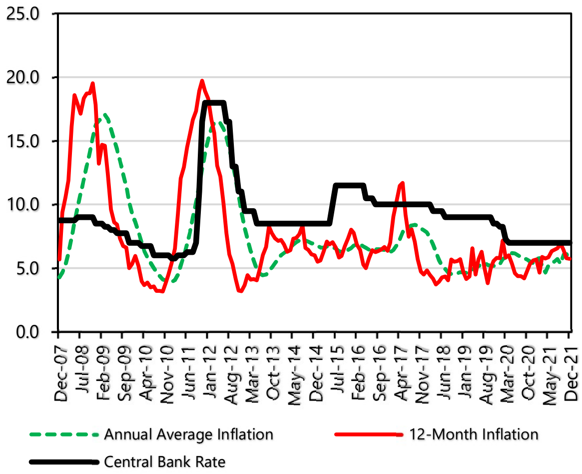
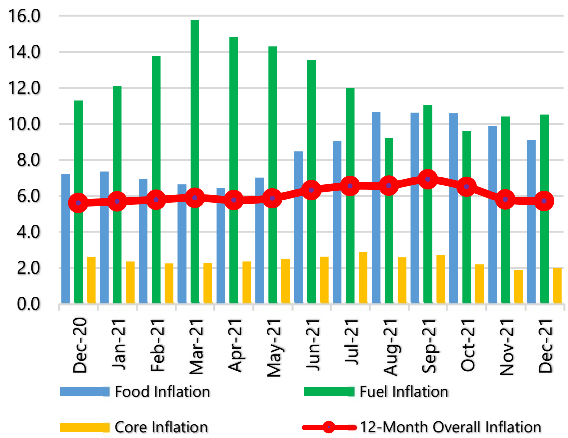


Figure 1b: 12-Month Inflation Rates, by Broad Categories (%)

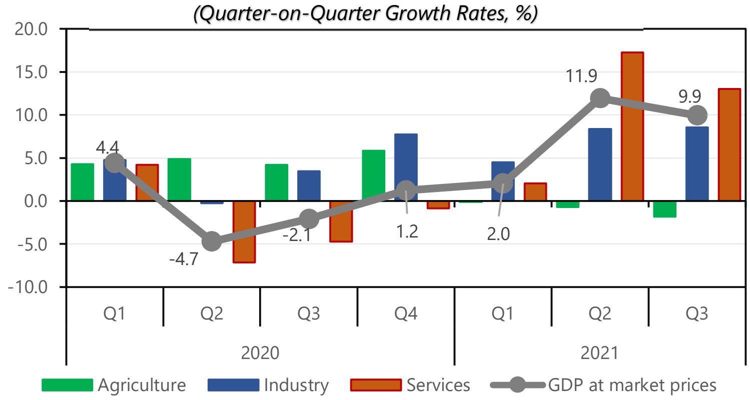


Source: *Central Bank of Kenya*

Second, there was a strong economic recovery in the first three quarters of 2021, driven by notable resumption of services and industrial activities. The latest data published by KNBS, shows that the economy in the third quarter of 2021 grew by 9.9 percent, compared to a contraction of 2.1 percent over a similar period in 2020. This was driven by a broad-based recovery in services – particularly transport & storage, education, accommodation & food services, and trade – and industrial activity (mainly construction and manufacturing). Over the first three quarters of 2021, real economic activity recovered by 7.9 percent from depressed levels in the first three quarters of 2020 (when it contracted by 0.8 percent) (**Figure 2**).

However, activity in the agriculture sector – which grew by 4.5 percent and supported the overall economy in the first three quarters of 2020, declined by 0.8 percent over the three quarters of 2021 largely reflecting the unfavourable weather conditions in the country in 2021. Projecting into 2022, the economy's recovery is expected to be sustained, albeit at a decelerated pace, as it repositions itself to its average long-term rate. This will be anchored by a sustained reopening of the economy and increased uptake of COVID-19 vaccines.

Figure 2. Real GDP Performance by Broad Categories
(Quarter-on-Quarter Growth Rates, %)



Source: *KNBS & Central Bank of Kenya*

However, a few downside risks are present. These include the continuing uncertainty on the containment of the pandemic amidst the emergence of new variants and related policy measures to be taken by countries, as well as the views taken by local and foreign investors in the country associated with the general elections later in the year.

Analyses of higher frequency indicators of economic activity, based on the Purchasing Managers' Index™ (PMI)[1] publication, show that economic growth in the fourth quarter of 2021 was strong. The December PMI index stood at 53.7 – higher than 53.0 recorded in November, with the increase reflecting sustained recovery of economic activity in the manufacturing sector between November and December (**Figure 3a**). The upturn was attributed to an increase in output as new orders picked up. In addition, the recovery in output continued to sustain growth in employment (**Figure 3b**), reflecting well-anchored demand and responsive business recovery plans. All in all, these indicators suggest that the private sector closed 2021 on a stronger footing and a renewed confidence in the economy's recovery towards the pre-pandemic levels.

Figure 3a. Trends in Overall PMI Index
Mirrors a sustained growth of economy month after month..

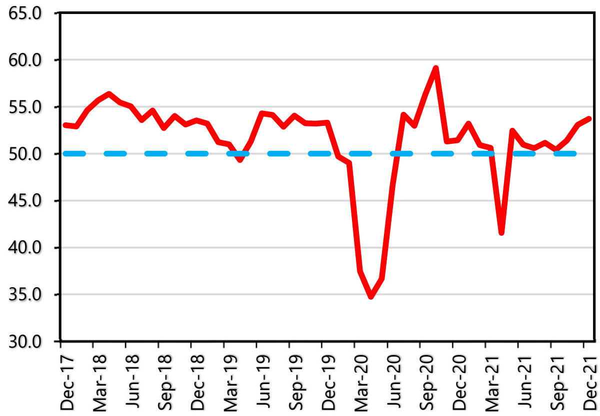
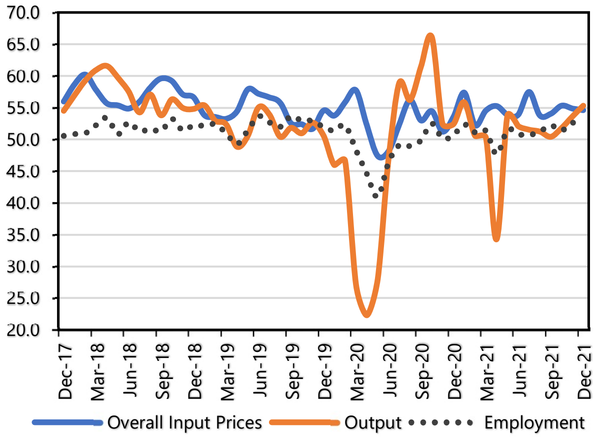


Figure 3b. Sub-components of PMI Index
Recovery in output pulling up employment levels..



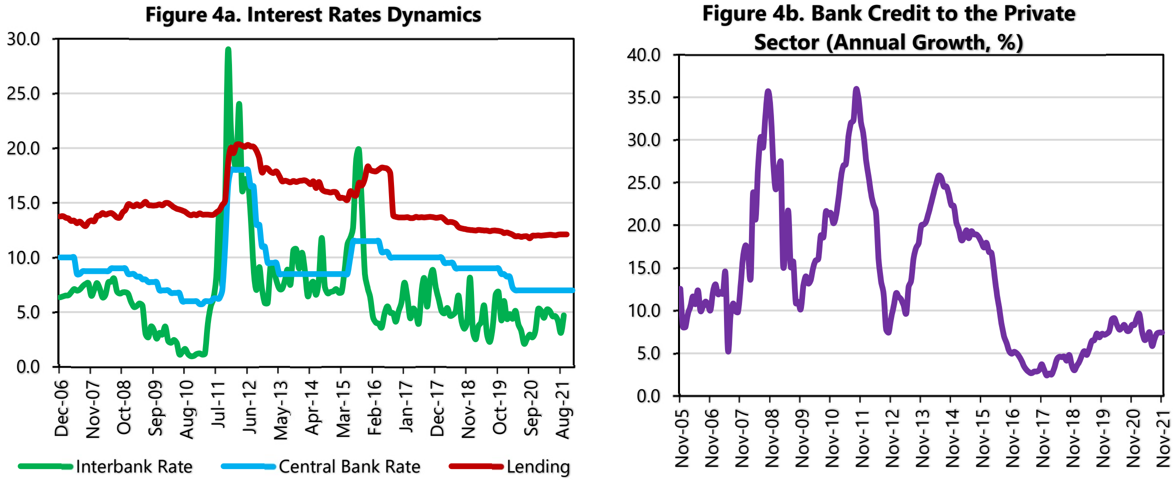
Source: *Stanbic Bank & IHS Markit*

Third, analyses of changes in interest rates amidst recovery of the economy, show minimal adjustments; reflecting stickiness in lending rates that continue to constrain credit supply in the economy. A few notable developments are evident. First, is the decline and divergence of the interbank rate from the Central Bank Rate, which reflects ample liquidity in the banking system. Second, contrary to the interbank rate movements, is the stickiness in commercial banks' lending rates (Figure 4a), which reflects challenges in the conversion of liquidity in the system to credit flow to the private sector. This is attributed to delays in the approvals and implementation of banks' risk-based pricing models. The sticky lending rates continue to disincentivize the supply of credit to the private sector (**Figure 4b**), thus dimming the effectiveness of the accommodative monetary policy stance adopted since April 2020.

[1] The composite Purchasing Managers' Index (PMI) is published by Stanbic Bank 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.

Third, the recent suspension[2] of listing of negative credit information with the credit reference bureaus is undermining credit assessment of customers by banks and further slowing down the supply of credit. Against these developments, the inflection phase of the credit market may be prolonged; thus, denying the economy an anchor to a stronger recovery.

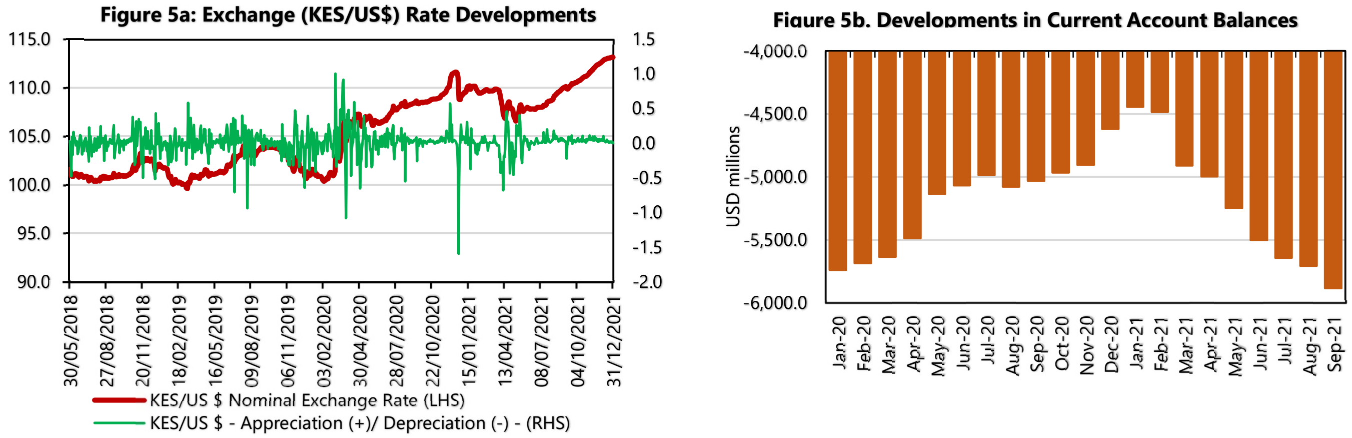
Figure 4: Interest Rates and Credit Market Developments



Source: *Central Bank of Kenya*

Fourth, developments in the balance of payments and the foreign exchange market have been manifested in a depreciated Shilling vis-a-vis the US dollar; a trend adopted since July 2021. As depicted in **Figure 5a,** the weakening trend of the Shilling exchange rate against the US dollar- the main trading and reserve currency, reflects a number of developments. First, is the consistent widening of the deficit in the current account of the balance of payments, in volume (as shown in **Figure 5b**) and as a ratio of GDP from 4.6 percent in 2020 to a projected 5.2 percent of GDP in 2021. At a broad level, a wider deficit reflects a stronger growth in foreign exchange expenditures on imports that outpaced the improvement in foreign exchange receipts from exports and remittances[3] during the period. The balances on the capital and financial accounts of the balance of payments did not match the widening current account deficit (**Figure 5c**). A worsening current account deficit would fundamentally exert pressure on the exchange rate to weaken, particularly within a flexible exchange rate regime.

Figure 5: Developments in the External Sector



Source: *Central Bank of Kenya*

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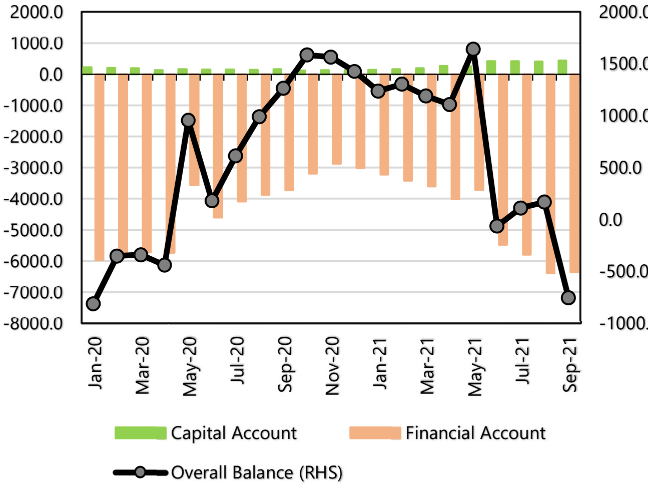
[2] https://www.centralbank.go.ke/uploads/press_releases/566112348_Press%20Release%20-%20Suspension%20of%20The%20Listing%20of%20Negative%20Credit%20Information%20for%20Borrowers.pdf

[3] Diaspora remittances rose from USD 309.8 million in September to USD 337.4 million in October, declined to USD 320.1 million in November and rose to all-time high of USD 350.56 million in December 2021.

Figure 5c: Developments in the Capital and Financial Account

...Movements in the capital & financial account, and the overall



Source: *Central Bank of Kenya*

Conclusion

The Monetary Policy Committee meeting of January 26 2022, is expected to announce the monetary policy stance to be adopted going forward. At the center of the anticipated policy decision are several notable underlying macroeconomic developments. First, is the evolution of inflation and risks from rallying global oil prices. Second, is the notable economic recovery from the depressing effects of the pandemic and the prevailing uncertainty on the containment of the pandemic. Third, is the stickiness in lending rates that reflects the challenges that banks face in effectively pricing risk, and their inability to conduct comprehensive customer credit assessments following the suspension of listing of negative credit information in late 2021. These developments continue to constrain growth in credit to support a stronger economic recovery. Finally, the sustained widening of the current account deficit continues, in part, to exert pressure on the exchange rate with detrimental implications on inflation going forward.

Against this backdrop, and the balance of risks, a retention of the CBR at 7.00 percent is justifiable. Any varied perspective on policy rate adjustments may deliver undesired outcomes. For instance, a rate cut – seeking to support economic recovery, amidst the existing gridlock in the conversion of liquidity in the system to private sector credit– may inadvertently introduce volatilities in the foreign exchange market. On the contrary, a rate hike risks derailing the fragile recovery of the economy and reopening of the output gap.

In our view, therefore, and to anchor a stronger economic growth, the focus should be supporting a scale-up in credit supply by fast-tracking a system-wide implementation of risk-based pricing.

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