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POLICY BRIEF

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THE CENTRE FOR RESEARCH ON FINANCIAL MARKETS AND POLICY®

Implications of Macroeconomic Stabilization Policies on Financial Intermediation

Executive Summary

Effective policies to stabilize macroeconomic conditions are essential for economic growth. In the context of this study, policymakers pursue these macroeconomic stability objectives by adjusting fiscal and monetary policy. Results show that monetary policy changes through CRR and CBR manipulation have a longer lasting impact on private sector credit compared to fiscal policy changes. Due to its direct impact on bank liquidity, CRR changes impact private sector credit more directly compared to variations in CBR. This implies that when macroeconomic stabilization is urgent, adjusting the CRR to influence private sector credit would be more useful. Meanwhile, fiscal policy, as illustrated through total government spending and revenues, tends to impact the quantum of private sector credit instantaneously. However, the impact is short-lived given the evolving nature of the sovereign's wallet. Further, the results show that prudent fiscal consolidation (raising government revenues or reducing government spending or a combination of both) support lending to the private sector.

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The Centre was established by the Kenya Bankers Association in 2012 to offer an array of research, commentary, and dialogue regarding critical policy matters that impact on financial markets in Kenya. The Centre sponsors original research, provides thoughtful commentary, and hosts dialogues and conferences involving scholars and practitioners on key financial market issues. Through these activities, the Centre acts as a platform for intellectual engagement and dialogue between financial market experts, the banking sector and the policy makers in Kenya. It therefore contributes to an informed discussion that influences critical financial market debates and policies.

1. Context and Importance of the problem

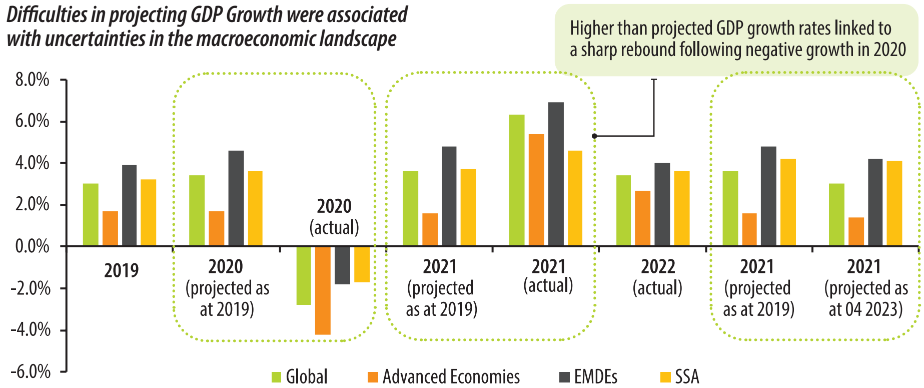
In recent times, the COVID-19 pandemic, the Russian-Ukraine war, and climate change shocks have been key sources of macroeconomic instability and have challenged the conduct of policymaking. Certainly, ensuring macroeconomic stability remains critical in contributing to sustainable economic growth and development. This stability is pursued through sound economic policies that help anchor private sector activity which is the greatest driver of economic growth in Kenya.

To achieve this, policymakers must define an attainable set of goals that target macroeconomic variables that are either in disequilibrium or can be 'manipulated' to promote macroeconomic stability.

According to the IMF, policymakers must first assess the appropriate policy stance to adopt given a set of circumstances either by tightening or easing fiscal and/or monetary policy and thereafter identify the instrument(s) needed to pursue the said policy stance. In this study macroeconomic stabilization policies are achieved through adjustments in fiscal policy (proxied by government spending and revenue) and monetary policy (proxied by the central bank rate and the cash reserve ratio).

This study specifically seeks to examine the impact of these macroeconomic stabilization policies on financial intermediation as proxied by private sector credit growth. The investigation is informed by evidence of crowding out effects in credit markets owing to increased government spending/reduced government revenues.

Figure 1: GDP growth projections and outcomes considering macroeconomic instability



Source: IMF, World Economic Outlook October 2019 and April 2023

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This is a result of commercial banks' dual role as the largest investors in government securities as well as the largest formal lenders to the private sector. The assumption here is that risk free lending to the government would result in a crowding out effect in credit markets thereby having significant consequences on private investments.

The central bank's influence on macroeconomic conditions is associated with adjustments of key policy rates as identified as the central bank rate (CBR) and the cash reserve ratio (CRR). This has far reaching implications on the financing conditions of the economy as well as on the availability of credit and commercial banks' willingness to assume specific risks. To this end, the study specifically seeks to understand the strength and significance of each of the policy mechanism to inform policymakers on the efficacy of each policy decision and its impact on the private sectors ability to contribute to the economy.

2. Methods and Results

Using aggregate bank level data, central bank data, government data and well as macroeconomic data between 2009 and 2023, the study established the impact of macroeconomic stabilization policies on financial intermediation as proxied by private sector credit.

The study finds:

Changes in monetary policy, through the manipulation of the central bank rate (CBR) and cash reserve ratio (CRR), have a longer lasting impact on private sector credit compared to changes in fiscal policy. That said, the transmission of this impact is lagged.

An increase in the CBR is intended to directly mitigate price pressures (inflation) by curtailing demand through increments in the price of credit. In Kenya, banks are required to provide a one (1) month notice when they intend to raise their base lending rates – to which will impact the price of credit (lending rates). This may explain why the IRF and VAR results reveal that the impact of the CBR shock occurs after one month.

Fiscal policy, as illustrated through total government spending and revenues, tends to impact the stock of private sector credit instantaneously. However, the impact is short-lived given the evolving nature of the sovereign's wallet.

The results clearly show that prudent fiscal consolidation (raising government revenues or reducing government spending or a combination of both) supports credit extension activities to the private sector.

Meanwhile, as high credit risks, as proxied by gross non-performing loans, remain an obstacle for bank credit extension to the private sector, banks should pay attention to reducing the levels of NPLs and improving the quality of the loan book. The study recommends that commercial banks must give more emphasis to credit risk evaluations.

3. Policy Inferences

- The study finds that the raising CRR may act as a kind of tax on the financial sector and may lead to financial disintermediation if it is calibrated excessively. Further its quantitative impact is questionable. The study recommends the use of CRR more so during times of monetary policy accommodation and pursued concurrently with CBR to strengthen monetary policy transmission.
- Government spending in Kenya is primarily recurrent in nature thus (potentially) resulting in direct crowding out of the private sector. However, the extent of crowding out depends on the financing of the spending either through government revenues or debt.
- The study finds that the impact of government spending on private sector credit requires further investigation given concurrent changes with respect to interest rates, the exchange rate, credit risk (just to mention a few) that may impact the extent of crowding out.
- Additionally on gross NPLs, the study found a passthrough of both fiscal and monetary policy to NPLs through several channels with changes in fiscal policy being most significant. The study recommends a phased approach to changes in fiscal policy as a result.
- Further, sound financial sector policies remain supportive of financial intermediation. This affirms the need for banks to maintain a healthy liquidity ratio which would prevent abrupt deleveraging which might improve credit supply to the private sector.

References

Implications of Macroeconomic Stabilization Policies on Financial Intermediation - Stephanie Kimani (2023).

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