KENYA BANKERS ASSOCIATION
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Macro – Imbalances and Bank Lending: A Case of Kenya's Banking Industry

Executive Summary

Macroeconomic imbalances- which arise from unexpected events that disrupt normal functioning of an economy and lead to a sudden and substantial impact on key macroeconomic indicators have gained tremendous attention since the global financial crisis of 2007/2008. Kenya's macroeconomic landscape, albeit largely stable, has in the recent past exhibited substantial macroeconomic imbalances that call for a deeper examination given the economic challenges they pose. We examine the effect of macroeconomic imbalances on bank lending with emphasis on the exchange rate movement, inflation differential and fiscal deficit. Bank lending is modelled by gross loans and advances, assets quality and risk appetite. The panel GMM model results show that the Kenya shilling depreciation increased bank lending, improved asset quality and increases risk appetite. Inflationary pressures increased bank lending, worsens asset quality and leads to risk aversion. Lastly, fiscal deficit reduces bank lending, improves asset quality and increases risk appetite. This study's findings support bank behaviour during the study period- where the single obligor limits may not have been a consideration given low lending toward capital expenditure. The study found out that uncertainty with regard to policy makers' response to macro-imbalances impairs decision making by economic agents. Thus, it is important for policy makers to provide forward guidance on their possible action path. Additionally, the National Treasury needs to adhere to the fiscal path that it tables every fiscal year. Overall, commercial banks and other business enterprises require predictable guidance from the policy makers to aid in strategy formulation and balance sheet optimization decisions.

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1. Context and Importance

Macro-imbalances have been documented to have adverse effects on the banking industry mainly through the bank credit channel, with lending sharply declining. However, we note that the effect of the macro-imbalances on the banking industry performance is diverse and dependent on several factors and so are the transmission channels. Additionally, the size and the structure of the economy is a major factor here in determining the macroeconomics imbalances – banking industry performance nexus. Moreover, empirical literature largely has consensus that macro imbalances have adverse effect on the bank lending. However, there is evidence inconclusiveness on the findings regarding the effect of inflationary pressures on bank lending.

In the Kenyan context, there is scanty and limited empirical work on the impact of macro – imbalances on the bank lending. Existing studies in this area fail to provide empirical analysis into specific macro – variables imbalances and bank lending but rather provide a general examination of the relationship between banks performance and macroeconomic factors.

This calls for empirical research on this topical issue in the Kenyan context amid the heightened macro-imbalances in Kenya in the recent past. Moreover, adverse impact stemming from macroeconomic shocks and its consequent effect on banking industry performance underpins the crucial need for this empirical study.

2. Methods and Results

The study covers 33 commercial banks for Q42020 – Q12024 period. Generalized Method of Moments regression technique is applied to model this macro imbalances-bank performance nexus. Bank performance is measured by bank lending, assets quality and bank risk appetite. The study focuses on three key macro-imbalances namely: exchange rate movement, inflation and fiscal deficit. Further, the study controls for the effect of bank level factors mainly: bank core capital, excess liquidity and bank size, while the effect of economic growth is controlled for in the study. The results indicate that macro imbalances have significant effect to bank lending, banks asset quality and bank's risk appetite, although the effects are dynamic. More specifically, the study established that:

Shilling depreciation increases bank lending, improves asset quality and increases risk appetite.

- Increased bank lending following shilling depreciation infers to increased Kenya shilling conversion equivalent as well as increased overall value of imported raw materials that need to be financed by local corporates and other enterprises hence more borrowing.
- Positive effect on asset quality which could be explained by an increase in the denominator in quarters when growth in value of loan accelerated in tandem with currency depreciation.
- Increased bank risk appetite on the backdrop of shilling depreciation means that banks earn more foreign exchange trading income during periods of exchange rate volatility.

Inflation increases bank lending, worsens asset quality and leads to risk aversion.

- Increased bank lending during periods of high inflation points toward bank customers borrowing more as they factor in higher commodity prices.
- The negative effect of inflation on asset quality implies tight monetary policy stance, hence, tight credit standards, resulting in loan repayment challenges.
- Increased inflation saw a rise in bank risk aversion, with a preference for investment in government paper.

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Fiscal deficit reduces bank lending, improves asset quality, but increases risk appetite

- Increased domestic borrowing which the study uses to measure the government fiscal deficit leads to private sector crowding out effect with a higher balance sheet allocation toward government paper.

- Increased government domestic borrowing could improve the asset quality if such borrowing is deployed in for example payment to suppliers and pending bills which in turn improves private sector loans repayment.

- Increased opportunities from government domestic borrowing leads to more bank investment in government securities as the government seeks to finance the deficit domestically.

3. Policy Recommendations

The key policy issues arising from the study are:

- Based on the study findings that uncertainty with regard to policy makers' response to macro-imbalances impairs decision making by economic agents. Thus, it is important for policy makers to provide forward guidance on their possible action path, for example the monetary policy committee communication by the Central Bank of Kenya.

- Moreover, with the negative effect of fiscal deficit on private sector lending, the need for fiscal discipline is underscored, especially at the national government level, given the already constrained fiscal space.

- Additionally, the National Treasury needs to adhere to the fiscal path that they provide guidance to every fiscal year. Notably, targets on fiscal consolidation path, domestic and external borrowing.

- In practice, commercial banks and other business enterprises require predictable guidance from the policy makers to aid in better projections or forecasts for strategy formulation.

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