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THE CENTRE FOR RESEARCH ON FINANCIAL MARKETS AND POLICY®

Macroeconomic Imbalances Evolution and Their Effect on Bank Intermediation Cost in Kenya

Executive Summary

Overtime, the linkage between macroeconomic development and banking industry has been extensively examined. In the recent past, it can be deduced that the 2007-2009 global financial crisis revealed the necessity for the countries to identify and contain risks to the financial system. The study examines effects of macro imbalances on the banking sector performance in Kenya from the financial intermediation cost perspective for 2020q4 – 2024q1 period. Employing dynamic panel GMM model, the study finds that inflation pressures above the upper bound target, external debt unsustainability, monetary policy tightening and current account deficit to GDP ratio lead to increase in the intermediation cost. The findings call for need to anchor the inflation rate below the upper bound target, exercise prudence fiscal measures, effective application of the monetary policy instruments and development of a matrix of interlinkages between the macro – imbalances.

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1. Context and Importance

Overtime, the linkage between macroeconomic development and banking industry has been extensively examined. In the recent past, it can be deduced that the 2007-2009 global financial crisis revealed the necessity for the countries to identify and contain risks to the financial system. As a result, any central banks adopted the use of prudential tools and established macroprudential policy frameworks to promote financial stability. However, much are the effects of the macroeconomic imbalances on the banking industry. Banks undertake a critical role in financial intermediation process. In undertaking financial intermediation, its notable that the cost and efficiency of intermediation plays a crucial role in determining the depth and breadth of the banking system. Kenya boasts of a fairly well-developed financial sector that is bank – led. Similarly, Kenya's macro – economic landscape albeit largely stable has in the recent past exhibited substantial macro – imbalances that call for an in-depth examination given the economic challenges they pose.

Kenya's financial sector has far – reaching effects on the real economy. Mainly, the sector remains key in financing macro imbalances through financing government fiscal deficit. This has a repo effect on the financial intermediation cost. The adverse effect of the high cost of financial intermediation in the banking industry cannot be overemphasized. High intermediation cost amplifies shocks that affect banks' net worth. High intermediation cost makes it costlier for banks to fund themselves, a reduction in net worth weakens the supply of credit and reduces the economy's output. Moreover, high intermediation cost amplifies the effect on output of capital-destruction shocks, commonly studied in the literature on financial crises. This persistence comes from banks' funding costs rising alongside credit spreads, implying banks' net worth is rebuilt very slowly in contrast to models with a leverage constraint.

Furthermore, the increase in fragility due to scarcer net worth gives banks an incentive to demand more liquid assets hence generating a countercyclical liquidity premium. The effects are therefore likely to be amplified during heightened shocks arising from macro – imbalances. Therefore, against this backdrop of the adverse effects of high intermediation cost on the banking industry, an examination into macro – imbalances effects on intermediation cost is underscored. Therefore, against this backdrop, this study seeks to bridge the research gap by examining the macro imbalances in recent time in Kenya and how these imbalances affect bank lending for Q42020 to Q12024 period that has been characterized by high depreciation of the Kenya shilling, very narrow fiscal space amid high debt burden as well as reasonably high inflation rate and interest rates.

2. Methods and Results

The study covers 33 commercial banks for 2020Q4 – 2024Q1 period. Generalized Method of Moments regression technique is applied to model effect of macro imbalances on the cost of financial intermediation. Within the model, the cost of financial intermediation is measured by the bank Net Interest Margin. The study focuses on three key macro-imbalances namely: inflation, fiscal distress, current account deficit and Central Bank Rate. Further, the study controls for the effect of bank level factors mainly: bank core capital, bank risk aversion, bank credit risk and bank size. Further the effect of economic growth is controlled for in the study. The results indicate that macro imbalances have significant effect on the cost of financial intermediation. More specifically, the study established that:

- **Inflationary pressures lead to increase in the cost of financial intermediation.** High inflation leads to factoring out of the inflation in the market pricing thus leading to inflation adjusted prices. Thus, the lending rates with rise with the rise in the inflation rate. Notably also, the interest expense is likely to rise as the corporate deposits attract higher deposit rates to account for inflation as the corporate depositors seek for higher real return from their deposits.

- **The effect of fiscal distress has positive effect on the cost of financial intermediation.** The finding suggests that with a high debt service to revenue ratio, the government is faced with a very narrow fiscal space. As such since debt service to revenue ratio is a measure of external debt sustainability, the government is prompted to borrow more perhaps in the domestic market when faced with external debt sustainability challenges. This triggers the rise in the cost of financial intermediation in the domestic market.

- **The current account deficit has a positive effect on the net interest margin though insignificant.** The finding could be reflecting how the deficit is funded. The deficit is mainly funded from the export's earnings and remittances from the capital account. However, the insignificance of the current account deficit in the cost of financial intermediation could be informed by the fact that the ratio has been relatively stable for the period under that study.

The study finds inflation and fiscal distress increase financial intermediation costs (NIM), while the current account deficit has a minor impact. Bank-level factors and economic growth were controlled.

3. Policy Recommendations

The key policy issues arising from the study are:

- The significant positive effect of inflationary pressures on intermediation cost call for the need to anchor the inflation within the target bound as much as policy through various monetary policy instruments. Further, is the need to consider the effect inflation rate on the short – term and long – term market rates and the transmission mechanism since the market tend to fact in the inflation in pricing of credit and assets prices in the long run. There is therefore the need for the monetary policy authority to strive to anchor the inflation rate below the 7.50% upper bound target.
- The negative effect of fiscal deficit on private sector lending is an evidence for private sector crowding out effect. Therefore, in order to spur private sector lending there is need for exercising fiscal prudence on the government side. The need for fiscal discipline is underscored given the already constrained fiscal space.
- Thirdly, banks need to consider the macroeconomic developments and projections in their lending decisions. To this effect, commercial banks need to revise their credit models regularly as the macroeconomic developments may warrant to factor in much of the macroeconomic uncertainties as possible.

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