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**High Interest Rates and the Risks to Economic  
Growth**

**Discussion Paper**

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### **DISCLAIMER**

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## 1.0 Introduction

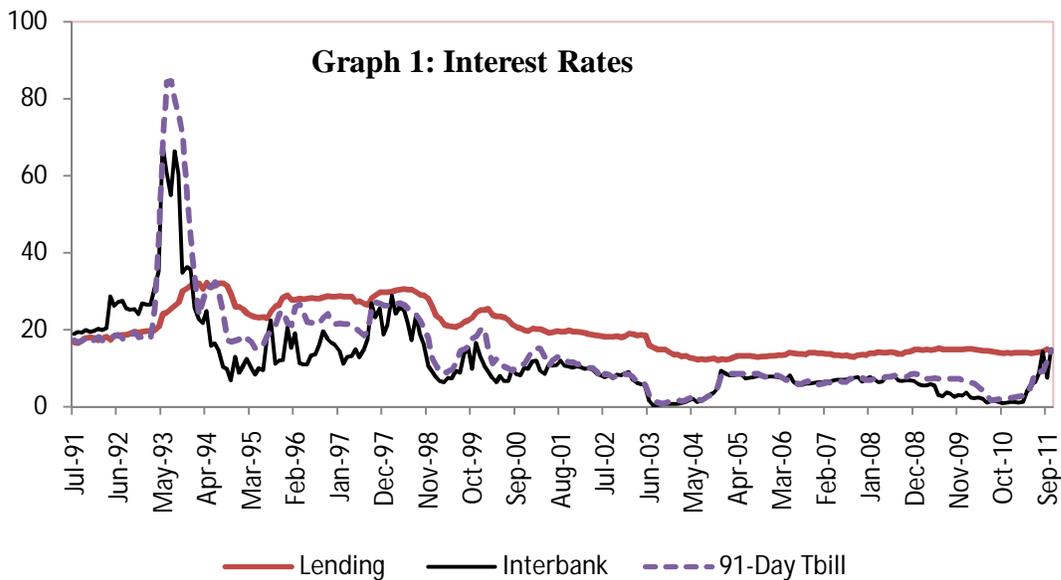
Recent movements in interest rates, inflation and exchange rates present real dangers to economic stability. The economy has endured steep inflationary pressures and exchange depreciation for about 9 months in 2011. This started with the buildup in inflationary pressures early in the year, then the onset of exchange rate depreciation around April 2011, and the recent rise in interest rates. Notably, inflation rose from 4.51 in January to 19.7 percent by November 2011. Kenya's shilling depreciated from about Ksh. 81 to Ksh. 101 to the US dollar in October 2011. To address these problems the Central Bank of Kenya (CBK) belatedly increased the Central Bank Rate (CBR) to 11 percent in October 2011. On November 1, 2011 the CBK again raised the CBR rate to 16.5 percent from 11 percent. Banks in their characteristic style increased their lending to between 20 and 25 percent. While the primary goal of these shock measures was to address inflationary pressures and the weakening of the Kenya shilling, the results are mixed and uncertain. Truly, the exchange rate has appreciated to trade at about Ksh. 89-90 to the US dollar but inflation rose to 19.7 percent in November 2011. The largely cost-push and supply side inflationary pressures could not ease up with these monetary policy measures, so the CBK on December 1, 2011 once again increased the CBR to 18 percent.

Officially driven interest developments are not unprecedented in Kenya, but the use of the CBR as a signal for monetary policy is fairly recent. This is the first time that the CBR is being used actively to address inflationary pressures. What is not clear is the size of CBR change that can have real effect of reducing money supply in the economy. It is quite apparent that only large increases in the CBR (for example 7 percent increase in the CBR in just two months) may have an effect on inflation and exchange rates. The recent raise in the CBR now presents another danger to the economy. There is little doubt that banks will have another round of interest rate increases which could easily breach the 30 percent level. Primarily, high interest rates are likely to curb business investments and innovation, rising interest rates could also increase loan defaults in the banking system and bank vulnerability, high interest could also drive the cost-push inflation due to medium term increase in prices associated with higher costs of business financing.

We can also contrast the current high interest rates and previous episodes of high interest rates. Notably, 1992-95 high interest rates were associated with macroeconomic mismanagement and bank failures and not formal monetary policy operations that we are seeing today. We believe that there are alternative measures to dealing with the problem of high inflation and weak shilling away from the use of harmful measures such as sharp interest rate increases. These measures are discussed towards the end. First, we provide a background on historical trends in interest rates, and then provide a short review of recent macroeconomic instability and measures used to address it.

## 2.0 Historical Interest Rate Trends

Kenya's interest rates were fairly stable before 1990s due to a combination of price controls and banking controls in the country. Interest rate volatility quickly set in after 1992 multiparty elections. Together with runaway inflation, sharp rise in interest rates were noted in most of 1993. Treasury bills interest rates at one time reached 84.67 % in July 1993 and the interbank rate exceeded 68 percent in March 1993 (See Graph 1). The lending rate also rose steadily, exceeding 30 percent for the period October 1993 to October 1994. Lending rates remained above or close to 30 percent through September 1998, but declined in 1999. The rates peaked again at 24 percent in November 1999 and that was the highest rate that preceded a decade of low and stable interest rates. Indeed the lending rates remained within 12 and 16 percent through September 2011 causing a huge expansion in credit to the private sector, rising government debt appetite, and growth in the economy.

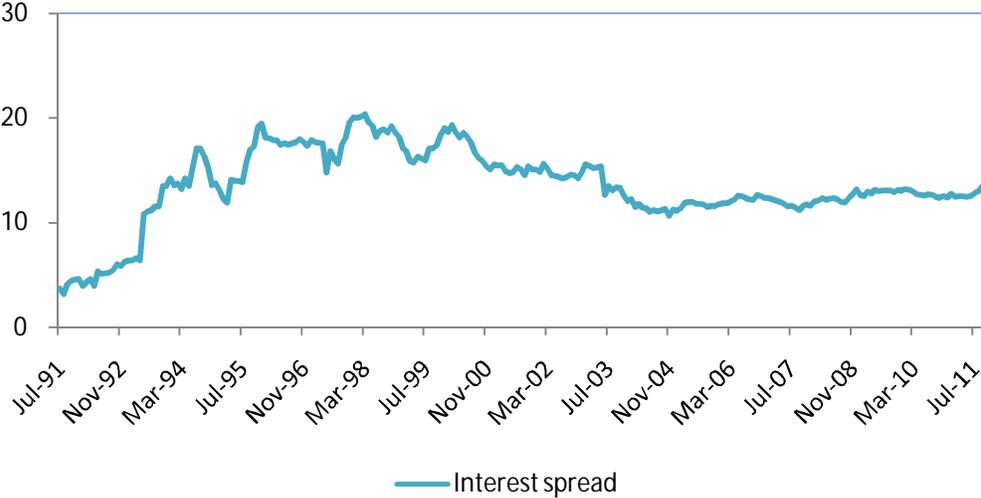


Some interesting finding can also be found in the trend of interest rate spreads in Kenya. Graph 2 shows that the spreads were narrower prior to 1992 due to a period of marked economic controls in the economy. The spreads that time were a mere 4-5 percent. But, macroeconomic problems associated with excessive growth of money supply and the Goldenberg scandal contributed to a subsequent wide interest rate spreads. For example, the spreads rose to 17 percent by December 1994, and reached 20 percent by November 1995. The spreads only declined after the 2002 elections. The new government had just taken office and keen to grow the economy under the ERS, the government reduced cash reserve ratios (CRR) sharply leading to a fall in interest rates and rate spreads. Due to the reduction of CRR, lending rates fell from about 18 percent in December of 2002 to close at 13.7 percent in December 2003. From Graph 2, we can easily establish a major structural shift to lower interest rates (12-14 percent) from mid-2003 to part of

2011. Thus, we can see some distinct pattern: low spreads during times of state controls; large spreads of about 18 to 20 percent in times of economic turmoil; and modest spreads of 12 to 14 percent during times of relative economic stability.

Recent CBR increase has caused banks to adjust their rates from an average of 15 percent to about 24 percent. For some banks, actual lending rates are about 30 percent. As seen in Graph 1, the last time the rates were this high was in early and mid 1990s. The current average spreads at these rates, about 18 to 22 percent, are also similar to those of the most volatile times in 1990s.

**Graph 2: Interest Rate Spread**



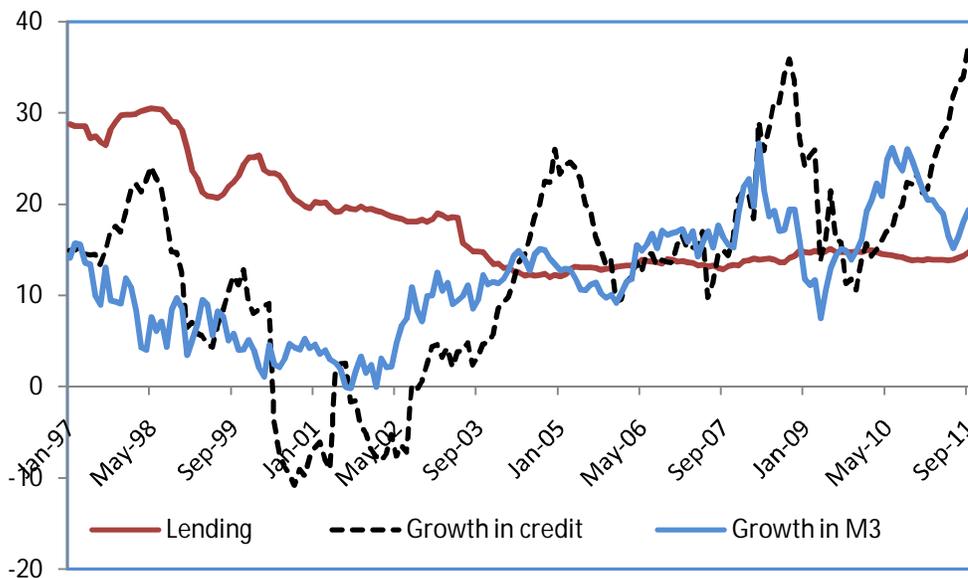
**3.0 Monetary Expansion and Interest Rates**

Graph 3 shows the monthly growth in credit, growth in money supply and lending interest rates for the period 1997 to 2011. The graph shows a dramatic collapse of the credit growth in the period 2000 to 2002 followed by a sustained rise in 2003. The sustained rise in monetary base (M3) and subsequent decline in the lending rates from early 2003 through 2005 partly explains the unprecedented growth in banking sector credit to the private sector. The lending rates largely stabilized at about 12-15 percent during this period. Even though lending rates variations remained within narrow margins, we can see marked volatility in the monetary base accompanied by sharp fluctuations in the growth of private sector credit towards the 2007 general elections. Due to large inflows in foreign assets in December 2007, money supply growth accelerated to 26.67 percent by March 2008. Money supply dipped sharply to 7.49 percent in April 2009 during the Global Financial Crisis.

It is quite apparent that credit expansion follows similar trend as that of growth in money supply. But, credit expansion appears to lag money growth by about 3-4 months. Still, due to increased

liquidity in the market, credit to the private sector still remained high and at one time reached 35 percent in September 2008. The process, and the somewhat synchronized movements between money supply growth and credit expansion, repeats again between April 2009 and the third quarter of 2010. This corresponds to the monetary and fiscal spending associated with the Economic Stimulus Package that was one of the primary tools used to fight-off the negative effects of the Global Financial Crisis.

**Graph 3: Monetary Expansion and Growth of Credit**



#### 4.0 Discussion: High Interest Rates and Spreads

The analysis above shows clearly that the country went through a long and sustained period of low interest rates from 2003 to October 2011. The CBK unexpectedly raised the CBR to 16.5 percent on November 1, 2011 from 11 percent, then again to 18 percent after exactly one month. This was a total reversal of interest rate regime in Kenya since 2003. According to the CBK, this rate increase is designed to reduce inflation through slowing down consumption spending. Whether this will have the expected results will depend on the proportion of inflationary pressures caused by money supply. The rate increase is also expected to reduce the pressure on the Kenya shilling exchange rate. However, external factors such as the Euro debt crisis could still keep the shilling exchange rate under pressure. High rates could also attract unreliable short term capital or hot money.

Under the present economic conditions, the current interest rate policy could cause sharp contractions in growth and worsen unemployment and poverty situation. High interest rates lead

to fall in business profits, fall in investment, which inevitably leads to lower economic growth, worsening unemployment situation, and poverty. High interest rates could also prevent establishment of new businesses. For instance, if a startup raises capital at say 20 % interest rate, it would need to charge larger margins than this to service the loan and stay afloat. The current economic conditions, particularly unpredictable monetary policies, uncertainties in the economy, high cost of production, and other risks in the country (such as uncertainties associated with 2012 elections and the war in Somalia) could work to curtail stable investment flows.

High interest rates may also lead to higher market prices associated with rising costs of production (also known as cost-push inflation). This happens when companies increase their mark ups to compensate for costly bank financing. This is a special case where rising interest rates could reduce the effectiveness of monetary measures to tame inflation. Thus, supply constraints such as food supply problems or cost-push related drivers of inflation such as high fuel prices could keep inflation high and potentially lead to a more worrisome scenario of high inflation and low growth. High interest rates may also have some income distribution aspects. For example, high interest rates could disproportionately affect the middle class who ordinarily are less affected by supply side inflation. If this effect comes through, then depressed middle class consumption demand could sharply undo employment gains and poverty reduction efforts since 2003.

Since interest rates are likely to slow economic growth (including causing unemployment, rising poverty) it could only be hoped that inflation will decline. Alternatively, high interest will also have negative effect on the banking sector. For instance, already the interbank lending is about 30 percent and quite unstable. This implies that some banks are accessing operational funds at very high rates. In addition, the recent increase in the cash reserve ratio will further strain banks and probably affect their profitability.

The high interest rates have also brought to the fore the unusually wide interest rate spreads in Kenya's banking system. Recent information shows that savings rates are about 2 percent while banks base lending rates have reached 20-25 percent in November 2011. Indeed, the interest rate spreads widen whenever base lending rates go up guaranteeing banks supernormal profits. Notice, that historical spreads were as high as they are today during economic turmoil of 1990s (Graph 3). Further, customer deposits constitute about 75 percent of banks lent funds. Thus, in a way banks tend to make more money during economic volatility when everyone doesn't.

Why do banks hold large spreads? A Financial Sector Deepening report (2009<sup>1</sup>) notes some of the causes of large bank spreads in Kenya as: one, high proportion of non-performing loans (this

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<sup>1</sup> FSD (2009). Costs of Collateral in Kenya: Opportunities for Reform, Financial Sector Deepening, Nairobi, Kenya, September 2009.

problem has largely declined with the resolution of NBK debts); two, Kenyan banks appetite for high profits; three, high cost of collateral due to weak registries, difficult and sluggish judicial processes, and recently corruption in the lands sector; and four, high labour costs of Kenyan banks (for example, the net interest generated by a typical Kenyan bank worker is half that of emerging economies).

## **5.0 Policy Options**

Recent actions of the CBK represent a major shift in interest rate policy, which could have dire effects on Kenya's economy. For about 8 months the CBK had a window of opportunity to redress the problem of rising inflation and weakening Kenya shilling. But, monetary policy intervention came belatedly with the increase in the CBR rate to 11 percent. Before full transmission of this measure, the CBK again raised the CBR to 16.5 percent in November 2011. Once again monetary authority has increased the CBR to 18 percent, which is expected to cause sky high lending rates. Some questions still linger about Kenya's dramatic 2011 economic problems and policy response by government. For example, was there adequate assessment of the impact of each CBR raise before another one was considered? Why, for instance, was the rate increased by a massive 5.5 percent from 11 to 16.5 percent within a month given that supply driven inflation was expected to decline with improved harvests during the period December 2011 to February 2012. In addition, what are the real costs of giving up the growth objective to achieve the inflation objective? Why was fiscal policy not used to help curb domestic demand?

As noted above, huge private sector credit and government development spending has contributed to Kenya's growth since 2003. Still, according to Vision 2030, economic growth, poverty reduction and employment creation remain the core pillars of Kenya's economic development. For these reasons any shock therapy through curbing credit expansion in a low income country like Kenya, where youth unemployment is rampant, where 50 percent of population lives below the poverty line, and where the government requires massive resources to fund an election year budget and cater for devolved governments, is highly misadvised.

Given that part of the triggers of rising inflation and exchange rate depreciation could remain and even worsen (for example global food prices will remain high, the Euro area debt crisis is yet to be resolved) it is most advisable to take moderate and conservative interventions especially of monetary nature so as not to throw the economy into a recession. An important balance need to be made: contain inflationary pressures while ensuring affordable credit to the private sector and to the government. In any case, we still need to protect government's budget program and also ensure a banking sector that can lend profitably without the risk of loan defaults. At the same time, a balance should also be found to ensure that savers earn a reasonable return on their funds. All this is possible in an environment of stable interest rates, stable inflation and exchange rates.

Stability of inflation and exchange rates cannot be achieved through disproportionate and destabilizing interest rates increase. At the moment, we cannot rule out further CBR increases above 18 percent. Is the country ready to pay the price of falling growth, high unemployment, rising labour union pressures, poverty, inability of government to borrow for its operations, high loan defaults and bank weaknesses? In light of all this, following are some plausible alternatives to redress the situation and stabilize Kenya's economy:

1. Allow fiscal policy to work. Interest rate increases could be avoided if some aspects of import demand (for example raising tariffs) and domestic demand (reducing government consumption) are handled by the Treasury. The ministry of finance could use tariffs to curb the so called "unessential imports". This will reduce unrestrained use of monetary policy instruments.
2. Undertake only moderate interventions whenever interest rates reach historically high levels. Treasury bill interest rates close to 20 percent are historically quite high. Monetary contraction instruments such as the CBR should be used sparingly under such circumstances regardless of the rate of inflation. In addition, our analysis shows that monetary interventions lag growth of credit by a few months. Thus, the second 16.5 percent CBR increase should have been allowed to take effect.
3. Protect domestic investments and job creation. To support local businesses and create employment, the interest rates should be at meaningful levels. A reduction in the CBR is therefore suggested.
4. Take measures to reduce the interest on government borrowing and ensure public debt is sustainable. High interest rates occasion high borrowing and debt rollover costs for the government. With treasury bills and bonds above 15 percent, the costs of government borrowing are quite high relative to expected returns.
5. Protect the welfare of depositors by reducing bank spreads. Since direct controls of interest rates are risky, this can be done by setting the deposit rate as a given proportion of a banks base lending rate. Such a measure would promote savings, encourage long term financing, and promote innovation and consolidation in the banking system associated with narrower spreads, among other benefits.