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Monetary Policy Stance – The Case for Holding the Policy Rate

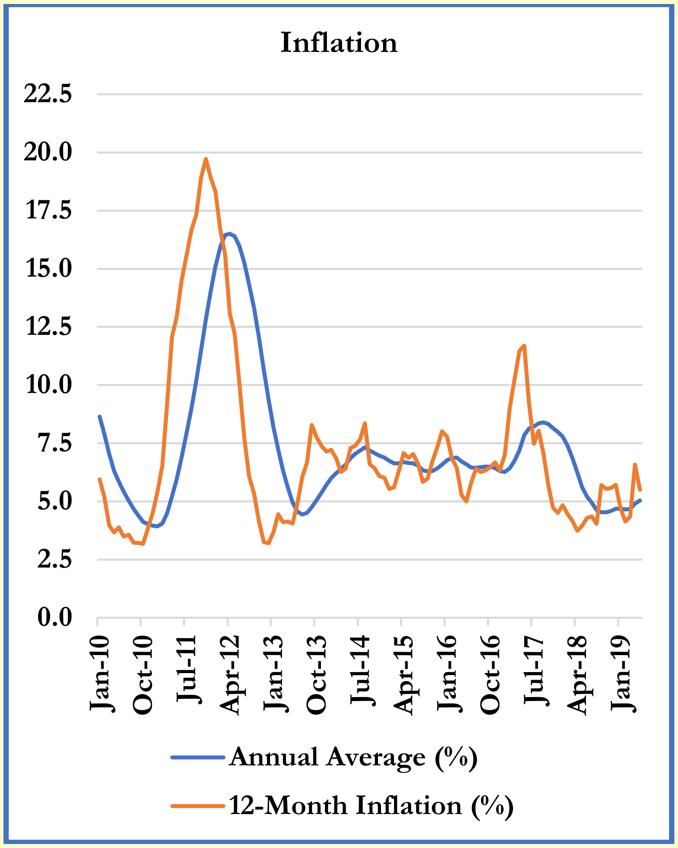
Highlights

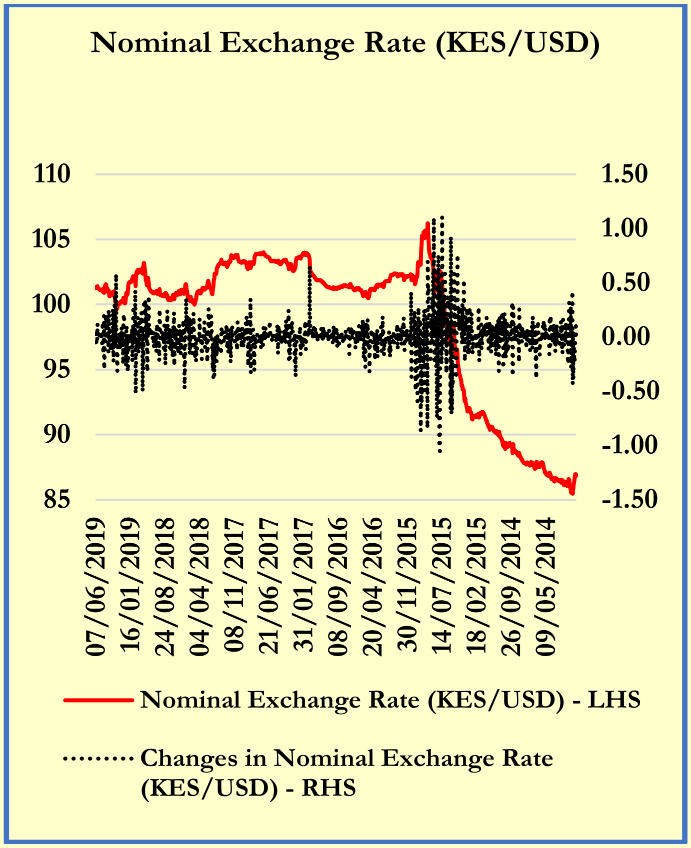
- *The backdrop against which the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) met on July 24, 2019 represents a stark contrast domestic optimism and external pessimism. The domestic conditions are characterized by stability on the back of positive output performance. That has not necessarily been accompanied by buoyant demand at both household and enterprise levels. The external environment remains wobbly. In the circumstances, the decision by the MPC to holds the Central Bank Rate CBR) at 9.0 percent is appropriate.*

Introduction

The backdrop against which the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) met on July 24, 2019 represents a stark contrast domestic optimism and external pessimism. The domestic conditions are characterized by stability on the back of positive output performance. Inflation is within the target range, hence the MPC's confidence that expectations are well anchored; the exchange rate depicts overall stability (**Figure 1**). Real GDP growth of 5.6 percent by the end of the second quarter represents a positive trajectory, albeit being lower than that of a corresponding period last year.

Figure 1: Macroeconomic Stability





Source: KNBS; CBK

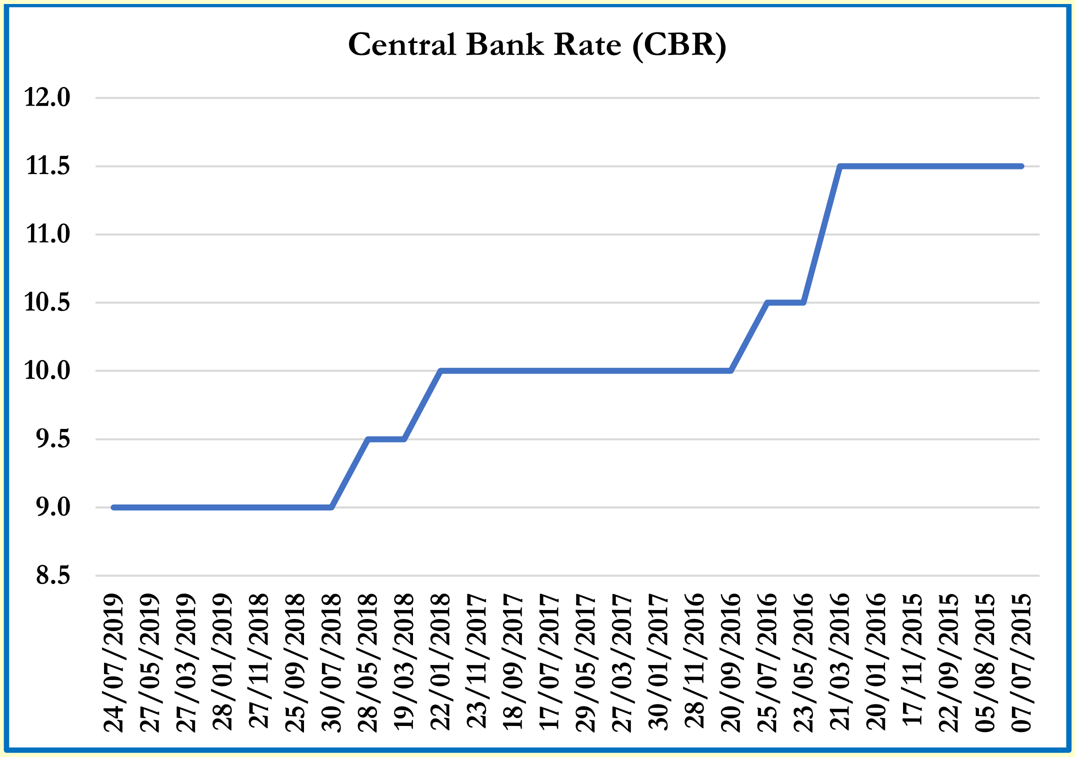
The observed stability and positive output growth sentiments should ideally reflect itself in strong households and enterprise demand. But that is hardly the situation. Weak household demand is reflected in the near-muted core inflation. The inflationary expectations as would be inferred from the MPC's position is linked to food prices as would be influenced by weather conditions, and energy costs as influenced by electricity prices on the back of reduced reliance on expensive power sources.

Subdued demand is equally evident on the enterprise side. While the credit market has remained slow on the back of the challenges associated with the Banking (Amendment) Act 2016 (supply side), the deteriorating quality of bank assets reflects weaknesses at enterprise level that affects their ability to meet financier's obligations. With the ratio of gross nonperforming loans (NPLs) to gross loans stood at 12.7 percent in June compared to 12.9 percent in April (MPC data), it could seem that recovery efforts by banks are yielding positive results. The broader picture though is that the current NPLs position presents a progressive build-up that reflects the fact that enterprises are operating sub-optimally (KBA, 2019[1]).

Assume Normalcy

Under normal circumstances, weak demand is addressed by a monetary policy that is accommodative. It could be argued that the MPC's stance has largely been accommodative (**Figure 2**) and described as appropriately so (IMF, 2018[2]). But even those who deem the policy to be appropriate accommodative are quick to add that the CBR "has lost its signaling role as interest rate controls have weakened the link between the CBR and bank lending and deposit rates".

Figure 2: Monetary Policy Stance



Source: CBK

It is clear therefore that the assumption of normalcy is limiting, and this is implicitly acknowledged by the MPC in its past decisions where any further accommodation is accompanied by the caution of potential adverse effects. On that basis, the appropriateness of the monetary policy decision will be judged upon:

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[1] KBA (2019), State of the Banking Industry Report (https://www.kba.co.ke/downloads/State%20of%20Banking%20Report%20200618%20(web).pdf)

[2] https://www.imf.org/en/Publications/CR/Issues/2018/10/23/Kenya-Staff-Report-for-the-2018-Article-IV-Consultation-and-Establishment-of-Performance-46301

a. not upsetting the macro-stability even when the ability to stimulate demand is constrained;
b. the ability to support market stability as could be reflected in for instance the foreign exchange market (to obviate volatility) as well as money markets (to ensure that it doesn't signal price movements that can affect cost funds for government – the fiscal policy angle).

The MPC's stance has so far remained appropriate on both accounts, and cognizant of the alluded limitation arising from the blurred signaling ability of the CBR. The fiscal policy angle to the MPC stance could be inferred from the fact that the stability, and consequently growth, objective is sustainably realized if the two key macro policies are in harmony.

Arguably, if monetary policy is sufficiently accommodative then the fiscal policy is sufficiently expansionary - albeit on the back of a move towards fiscal consolidation. Our read of the 2019/20 fiscal year budget leads to three observations:

a. The path to full realization of the fiscal consolidation targets will be slower than projected. The revenue targets – consistently missed in previous projections – still face the same challenges, and more so now that the private sector is facing demand challenges as already outlined.
b. Whilst the ideal strategy of fiscal consolidation is a balance between enhanced revenue mobilization and expenditure rationalization, the initial strategy is apparently expenditure leaning. Government expenditure has been a key growth driver, this any expenditure cuts – especially of investment type – will undermine the economy's capacity enhancement.
c. Based on the above two, the Government will remain active in the market. The cost of doing so has to be borne in mind especially as the issue of public debt and its sustainability remains in the fore.

Ultimately, the domestic circumstances need a careful watching, thus the case for MPC's holding its position. The external environment needs even a more careful watching.

A Wobbly Global Economy

The worries about the global economy are getting louder by the day. The IMF's flagship publication, the World Economic Outlook (WEO), had expressed its gloomy projection of the global economy in its April 2019 edition. Its latest update (July 2019[3]) represents a further downward revision of its growth outlook. At the center of this review is the global trade conditions in view of the trade war between the US and China.

Just as the trade war will affect output, it too is likely to affect global financial flows to the disadvantage of emerging and frontier countries. The initial filtering of the trade war into the financial markets is by way of how markets perceive US producers with significant exposure to Chinese markets and the reflect that in stock market valuations.

[3] https://www.imf.org/en/Publications/WEO/Issues/2019/07/18/WEOupdateJuly2019?cid=em-COM-123-39218

As Cerutti et. al., (2019) observe, the equity price performance of US companies with high sales to China underperformed relative to US businesses exposed to other international markets, after tariffs linked to the USD 34 billion retaliation list by China were implemented. They note that the performance gap narrowed at the beginning of 2019 with a potential trade truce but reopened again after the US tariff increase to 25 percent on the USD 200 billion list was announced.

Arguably, the biggest influence of the trade war on financial flows is hinged on the likely policy response to market behavior. The Federal Reserve has clearly changed course from the anticipated rate hikes in 2019, instead holding the rates in March and June 2019. The reason for that is the gloomy global economic outlook pinned on the inability of the US and China to strike a deal regarding the ongoing trade war. Beyond the equities market the of pain the trade war could be inferred from the decline in the 10-year US Treasury yields as investors anticipate a rate cut and flee for safety (**Figure 4**).

Figure 4: 10-Year US Treasury Constant Maturity Rates

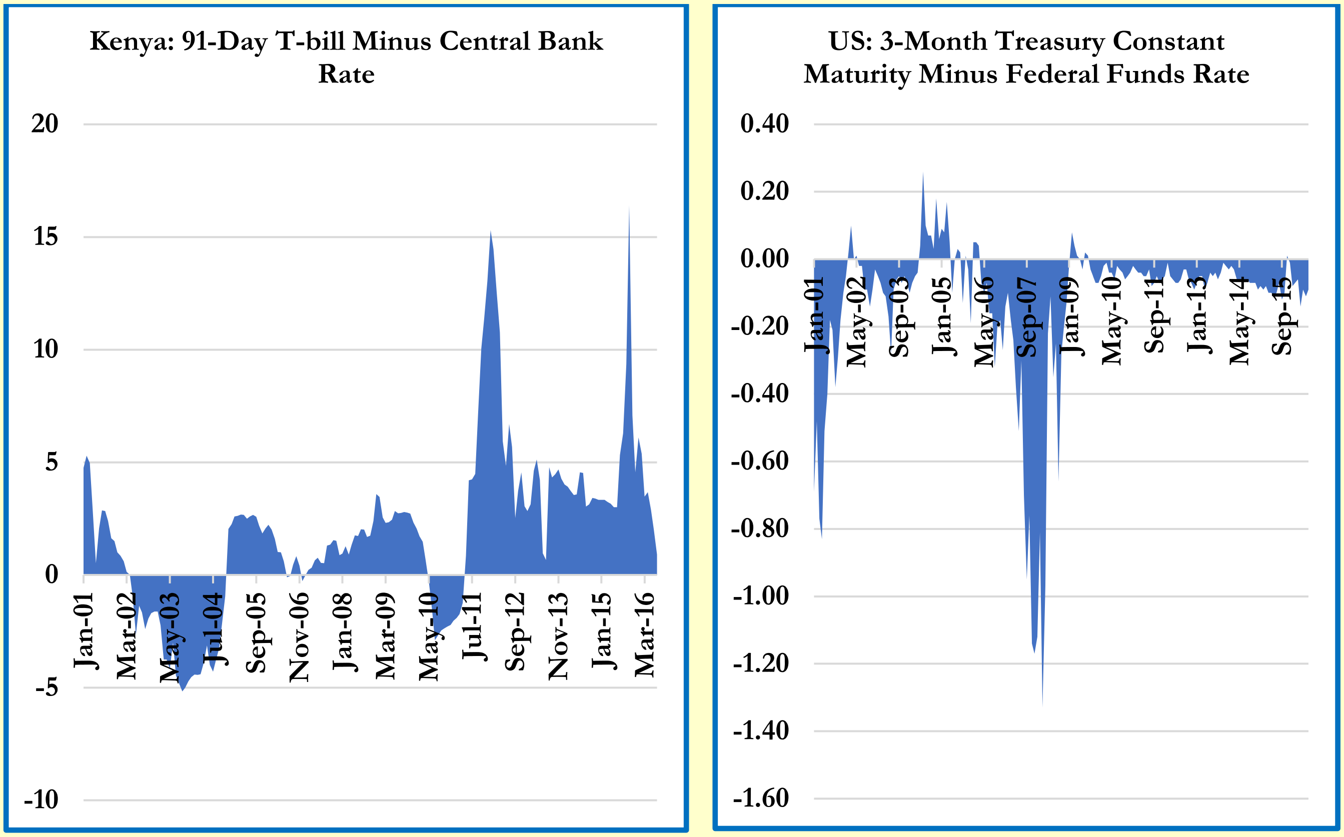
Source: Federal Reserve

The response of the Fed is to be seen in the context of the debate as to whether it responds in a manner that gives the notion that its monetary policy stance is influenced by traders – and politicians too seeking a rate cut – or it should stick to a policy direction as would be informed only by the backward-looking economic date that moves slowly.

If the Fed listen to the markets even as it looks at the hard data on growth and inflation, then we are seeking a possibility of a lower interest rates regime – which prevails too at the Eurozone as signaled by the European Central Bank (ECB) in the face of economic challenges in Europe as well as the Bank of England (BOE) in the face of uncertainty over Brexit as a new admiration takes over.

Does this them imply that the trade-war triggered low interest rates regime will lead to portfolio flows to emerging as well as frontier markets as was the case during the 2007 – 2008 global financial crisis and the subsequent period? Superficially, it you take the largely positive short-term spreads between market rates and policy rates in the case of a frontier market such as Kenya compared to the spreads for the same tenor of market rates versus policy rates that are largely negative (**Figure 5**), then you could expect resource flows to the former from the latter.

Figure 5: Interest Rate Spreads



Source: Central Bank of Kenya; Federal Reserve

However, the clearer picture is seen by looking beyond the superficial implication of positive interest rates differential in favour of emerging and frontier markets. In particular, the role that China will play in the global financial markets going forward is important to appreciate. Just a China is stamping its authority in its influence on the global output, its stature in the global financial space is now noticeable.

Effective October 1, 2016, the Chinese renminbi (RMB) met the criteria for inclusion in the IMF's Special Drawing Rights (SDR) basket – joining the USD, the euro, the Japanese yen, and the British pound sterling. The SDR basket is reviewed every five years, or earlier if necessary, to ensure that it reflects the relative importance of currencies in the world's trading and financial systems.

Most notably, China is systematically embedding itself into the global financial markets in a manner that will influence overseas investment, improved liquidity, better governance, and a lead to broader range of instruments. There is a deliberate endeavor to include Chinese stocks and bonds in several global financial-market indices. As Chinese securities are added, investors seeking to match or surpass the returns of the indices will adjust their portfolios to include Chinese stocks and bonds. Thanks to these benchmark-driven asset managers, China's portfolio flows. Are being globalized.

Over the past half a decade, foreign ownership of Chinese government bonds has quadrupled (Chen, Drakopoulos and Goel, 2019)[4]. Ownership of onshore equities has also increased but remains low compared with other emerging markets. As Chen, et.al (2019) argue, this trend of rising foreign ownership is likely to accelerate further.

Evidence to that effect is in the move in April 2019, to include two types of Chinese bonds in the Bloomberg Barclays Global Aggregate Index—local currency-denominated bonds issued by the central government and by state-owned policy banks such as China Development Bank. It is anticipated too that there will be an inclusion of Chinese bonds and equities into FTSE and JP Morgan indexes, a move that will substantially boost portfolio inflows into the economy.

These developments have the real possibility of seeing investors reducing the purchases of other emerging-market assets as they undertake portfolio rebalancing to reflect China's inclusion. This will be especially so in cases where benchmark-driven holdings constitute a significant amount of their foreign debt.

Cognizant that benchmark-driven investors tend to be more sensitive to changes in global financial conditions than other investors, their greater role in international finance may mean that external shocks propagate to medium-sized emerging and frontier market economies faster than in the past.

All said, the case for a careful watch of the global scene is compelling. And as we do so, and especially as we reflect on how it filters into the local economy, its makes sense to hold the monetary policy stance as the MPC did in its latest meeting.

Conclusion

The backdrop against which the MPC met on July 24, 2019 represents a stark contrast domestic optimism and external pessimism. The domestic conditions are characterized by stability on the back of positive output performance. That has not necessarily been accompanied by buoyant demand at both household and enterprise levels. The external environment remains wobbly. In the circumstances, the decision by the MPC to holds the Central Bank Rate CBR) - the policy signaling rate - at 9.0 percent is appropriate.

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[4] Chen, S., Drakopoulos, D., and Goel R (2019), *"China Deepens Global Finance Links as It Joins Benchmark Indexes".* https://blogs.imf.org/2019/06/19/china-deepens-global-finance-links-as-it-joins-benchmark-indexes/

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