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Monetary Policy Stance – Economics Justifiably Carries the Day!

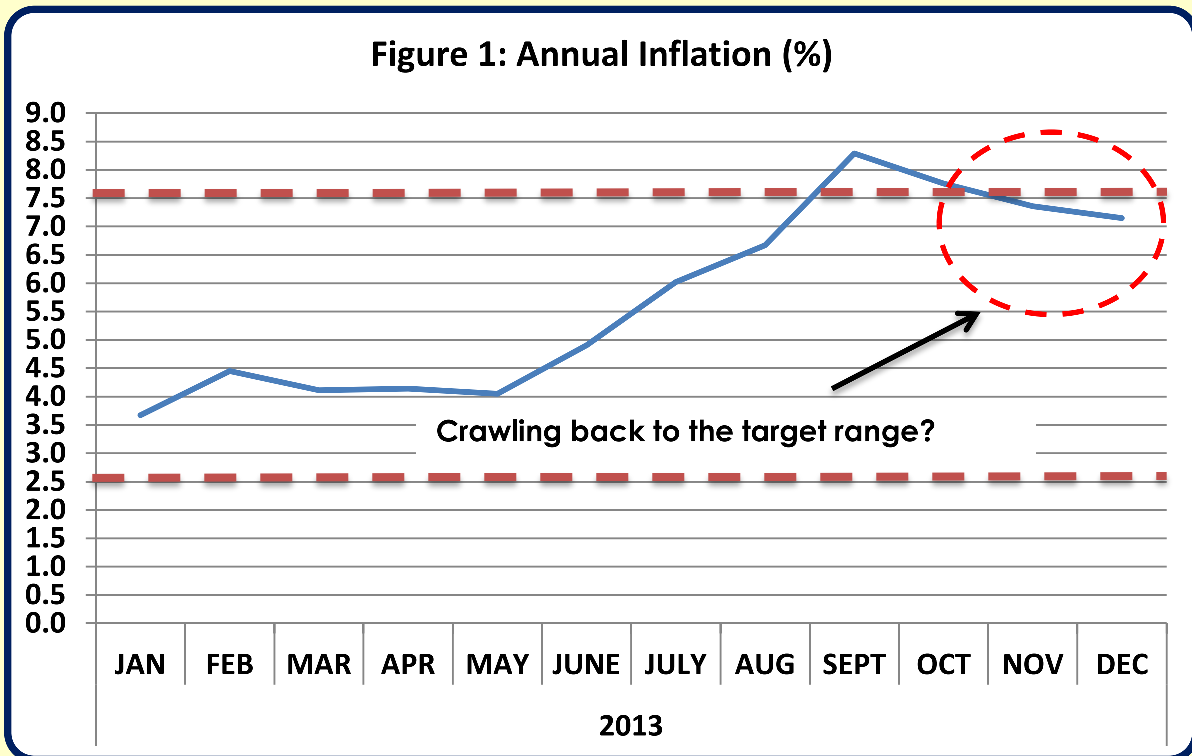
Highlights

- The Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK), in its first meeting of 2014 held on January 14, 2014, was confronted with two scenarios that are not equally compelling.
    - One scenario is to play the populist card and lower the signalling rate – the Central Bank Rate (CBR) – to suit the wide expectations in that regard.
    - The other scenario is to treat the fact that a mild reduction of inflation rate in December 2013 back to the target range of 2.5 percent to 7.5 percent does not amount to a trend and therefore hold the CBR at 8.5 percent with a view to entrenching the credentials of anchoring low inflation expectations.
- The latter scenario, arguably the compelling one, carried the day. The MPC decided to hold the CBR at 8.5 percent for the fifth consecutive time with a view to anchoring a stable monetary policy path.
- As this *Research Note* argues, while there are a number of positive market outcomes that informed the decision to hold the CRB at 8.5 percent, the MPC's follow-through in terms of vigilance on potential risks on price stability will have to take on board the interplay between domestic and international factors.
- On the domestic front, it has to be appreciated that the tightening liquidity conditions as signalled by all the key short term rates – treasury bill rates and inter-bank rates – being higher than the CBR would mean that the scope for lending rates reducing without further monetary policy easing will be as unjustifiable as the possibility of such easing being desirable.
- On the international front, the challenges of the of the emerging markets on the back of a feeble global recovery should not be wished away or even assumed to be mitigated by a potential robust growth in the sub-Saharan economy. The very circumstances stand to undermine the growth of the African economy and therefore negate the possible stabilising benefits that could be anticipated.
- The decision by the MPC is therefore a show of determination to consolidate the CBK's credentials of focusing its monetary policy on anchoring inflation expectations. It represents a welcome resistance to a populist policy stance that may appear to be supporting the feeble growth recovery but which may end up undermining a stable environment against which sustained recovery could be bolstered.
- While acknowledging a number of positive outcomes, some of which attributable to monetary policy, the MPC needs to appreciate that there are a number of domestic and external risks – not less the fiscal policy outcomes that seem to drag growth and the challenges of emerging markets' economies – that should form part of the follow-thoughts by the MPC in its policy vigilance.

> *"It is noteworthy that a large part of the past seven years, the treasury bill rates and the inter-bank rates have largely been below the CBR, except during the tight monetary policy period of late-2011 to mid-2012. We are now seeing a picture where these rates are moving above the CBR, which will be a pointer to tight market liquidity conditions.*
>
> *Even if the MPC was of the view that the situation will rectify itself in the near future, the expectation of a further reduction in lending rates will remain largely unmotivated until such rectification materialises – whether that will be through a further fine-tuning of the monetary operations framework or from an improvement in public expenditure that will see government deposits in the CBK steadily decline."*

Introduction

The Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK), in its first meeting of 2014 held on January 14, 2014, was confronted with two scenarios that are not equally compelling. One scenario is to play the populist card and lower the signalling rate – the Central Bank Rate (CBR) – to suit the wide expectations in that regards. The other scenario is to treat the fact that a mild reduction of inflation rate in December 2013 back to the target range of 2.5 percent to 7.5 percent does not amount to a trend (***Figure 1***), therefore hold the CBR at 8.5 percent with a view to entrenching the credentials of anchoring low inflation expectations.



Source: Kenya National Bureau of Statistics

It is clear that the latter scenario, arguably the compelling one, carried the day. The MPC decided to hold the CBR at 8.5 percent with a view to anchoring a stable monetary policy path. It is easy to fathom why that was the case. As we have argued in the past (see for instance KBA, 2013[1]), any move away towards resisting the temptation to directly boost growth when there are potential downside risks on stability is welcome.

Ordinarily if inflation has retreated back to the target range as observed, and its outlook is stable, then monetary policy could be carefully deployed to spur the economy's growth momentum. In any case, the accommodative monetary policy stance that has prevailed since July 2012 has been praised as growth boosting (World Bank, 2013)[2]. But the CBK's current monetary policy

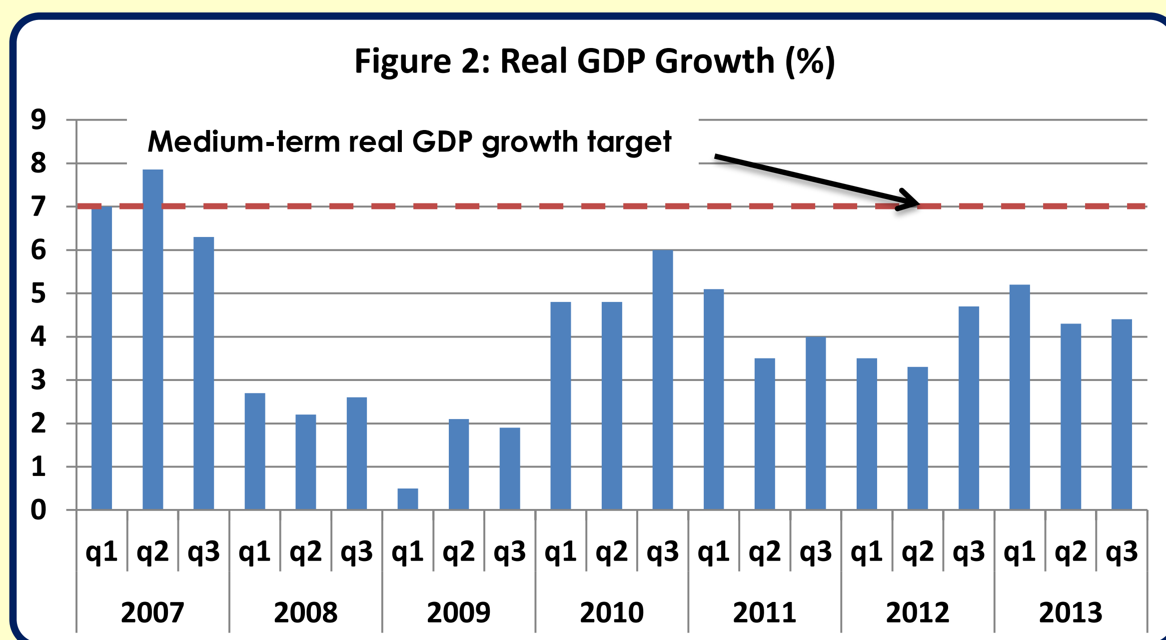
[1] Research Note No. 5 – 3013 (RN/5/13), "*Monetary Policy Stance – Eventualy it is all about Inflation*!", November 7; KBA Centre for Research on Financial Markets and Policy.

[2] See World Bank (2013), "*Kenya Economic Update: Reinvigorating Growth with a Dynamic Banking Sector*", Nairobi, Kenya. (http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2013/12/12/000442464_20131212144249/Rendered/PDF/832670WP0Kenya0Box0382083B00PUBLIC0.pdf)

framework does not explicitly indicate its inflation forecast beyond mere outlook hints and an implicit indication of reliance on the MPC survey on inflation expectations.

But there are limits beyond which monetary policy can boost growth, especially if fiscal policy is seen to be a drag on account of challenges associated with government spending during the transition period to a fully functional devolved system. It is evident that the efforts to stimulate the economy through an accommodative monetary policy was constrained by limited liquidity in the banking system that was largely attributed to government deposit accumulation at the CBK and in a few banks where the government held deposits outside of the CBK (World Bank, 2013).

Consequently the growth trend for the year 2013 (***Figure 2***), while in some circles is considered commendable but not strong enough given that it was below potential, was notable if only for the fact that it was characterised by regular downward revisions of its outlook. A projected 5 percent real output growth for 2013 is therefore admittedly the optimistic case.



Source : Kenya National Bureau of Statistics

As this *Research Note* will argue, while there are a number of positive market outcomes that have informed the decision to hold the CRB at 8.5 percent, the MPC's follow-through in terms of vigilance on potential risks on price stability will have to take on board the interplay between domestic and international factors. In essence, the need to consolidate the credible policy position of anchoring low inflation expectations necessitates that the positive comportment of the MPC be countered by a hawk-eyed attitude towards potential downside risks.

The "hidden" Pockets of Turbulence

Domestic

As can be seen from ***Figure 2***, the economy's growth performance has not scaled back to the pre-global economic meltdown levels. Indeed, the attainment of the medium term growth target of 7 percent would necessitate a rapid swing in output expansion. The trend that we observe, and the most realistic outlook points to a gradual climb to 6 percent real GDP growth by 2014/15 fiscal year at the best case scenario.

While the real economy will expand on account of favourable weather (to support agriculture), continued investment in infrastructure to support service and industry, and macroeconomic policy boost – both fiscal and monetary – to support effective demand at household and firm level, the financial sector will continue to play its role in providing the required funding.

With the evident output gap – the difference between actual growth performance and potential growth level – there is scope for credit expansion that is not inflationary. As the CBK's credit report of September 2013 indicates and as confirmed by the MPC, the number of loan applications and consequently the actual credit extension continues to increase. By the end of November 2013 credit had increased by 20 percent from the same period in 2012.

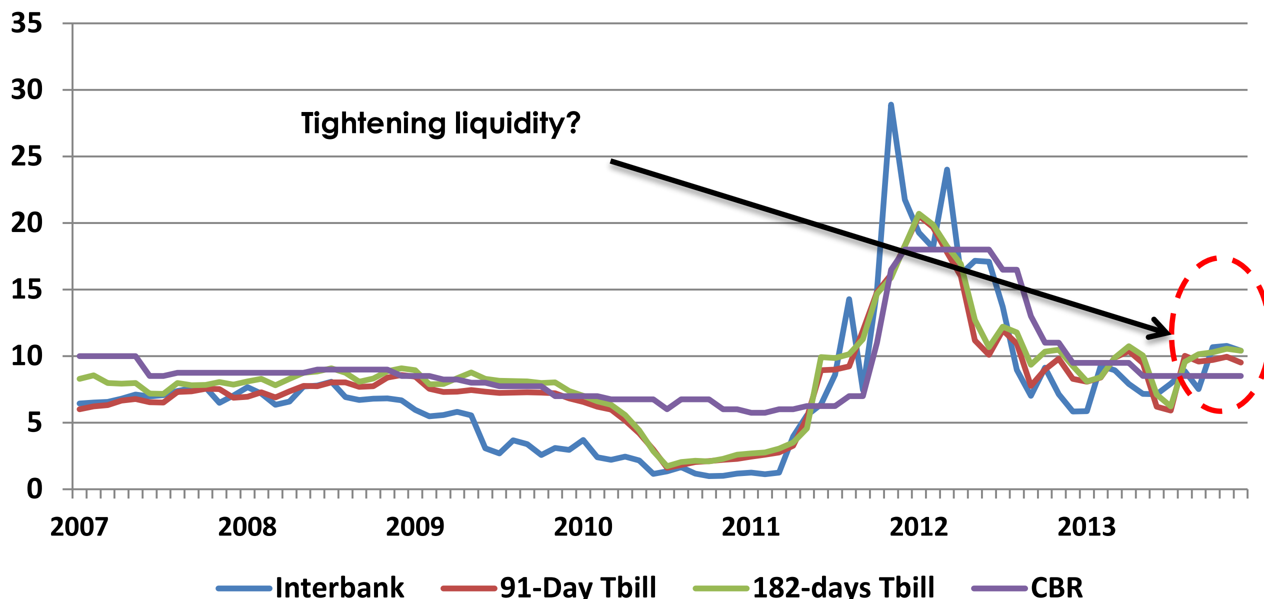
The positive posture of the MPC regarding a number of market outcomes is an implicit indication that the influence of monetary policy is taking root. With inflation now at the single digit target after a recent reverting after an overshoot, the CBK has scope to remain accommodative in its monetary policy stance in line with inflation expectations. It is worth appreciating thought that an accommodative monetary policy stance does not always necessarily mean a reduction in the CBR, nor does a less accommodative stance necessarily imply a tightening.

The fact that there has been a decline in market interest rate – however gradual – signals that low inflation expectation may be entrenching itself. It is in this context that we see the latest MPC decision to be refreshing given that it exemplifies the fact that the monetary policy gains so far have not inculcated complacency on the part of the CBK. In the process this implicitly points towards a policy stance characterised by no rapid reductions in the policy signalling rate that could upset the gains on the inflation front as well as put the exchange rate market under undue pressure.

The CBK has continued to complement the CBR's signalling with its framework for monetary operations as a means to guide market expectations. While as already observed, and the MPC acknowledges, the average lending rates have gradually declined from an average of about 20% in 20123 to the 2013 avegare level of 16.8 percent, it is the MPC's considered view that there is scope for further lending rates reduction as well as increase in deposit rates. We argue the validity that such view has to be tested against the implication of the prevailing short-term interest rates regime.

It is true that for a while now the short-term interest rates have been aligned to the CBR (***Figure 3***). It is noteworthy that a large part of the past seven years, the treasury bill rates and the inter-bank rates have largely been below the CBR, except during the tight monetary policy period of late-2011 to mid-2012. We are now seeing a picture where these rates are moving above the CBR, which could be a pointer to tight market liquidity conditions.

Even if the MPC was of the view that the situation will rectify itself in the near future, the expectation of a further reduction in lending rates will remain largely unmotivated until such rectification materialises – whether that will be through a further fine-tuning of the monetary operations framework or from an improvement in public expenditure that will see government deposits in the CBK steadily decline.

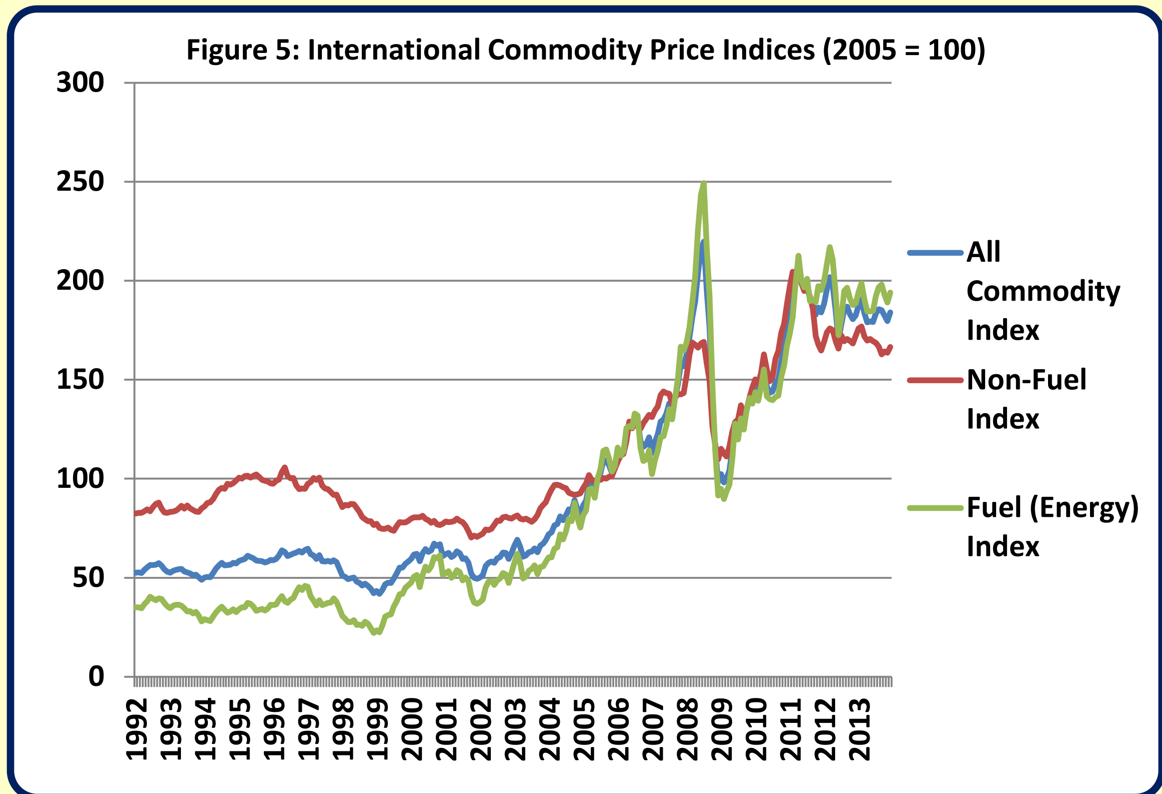


Source: CBK

As the MPC observes, the foreign exchange market has remained stable since its previous decision (***Figure 4***). That the CBK has adequate reserves, equivalent to 4.32 months of import cover as at the end of December 2013, is an indication that there is scope for market intervention where necessarily in the event of market volatility. As we have argued, the monetary policy stance is supportive of a stable exchange rate, but it needs support from the improvement in the fundamentals – especially the current account position – given that the build-up in reserves is arising from support by the International Monetary Fund (IMF) and the CBK's participation in the foreign exchange market.

Source: CBK

Among the positive outcomes that the MPC takes into account in its decision is the fact that the 12-month cumulative current account deficit as a proportion of GDP improved from 10.5 percent in December 2012 to 8.5 percent in November 2013. This is a welcome development even though, as we have argued in the past[3], it is hard to see the drivers of a confident posture on the quick return to a sustainable current account position merely on account of faster balance of payment data flow. The true test of a return to a sustainable external position will be on how, as a non-oil commodity exporter, we will navigate the high international commodity prices (***Figure 5***) – and especially whether our exports, combined with remittances will more than compensate for the high but stable oil prices.



Source: IMF

International

The view that the global economic recovery will recover in 2014, albeit with strong qualifications that it will not result in a quick return to pre-2008 levels and will remain uneven has gained traction as the year commences. Even though the Euro Zone has been the bane, a number of emerging markets have should serious vulnerability whose possible adverse impact may not be more than compensated by the anticipated robust performance of sub-Saharan Africa as the MPC argues.

Take the case of how a number of emerging market economies have been on a rollercoaster since the U.S. Federal Reserve announced May 2013 the eventual tapering of its asset purchase program. This is a pointer to how susceptible these economies remain to economic conditions outside their borders. Much of the market movements so far have been short term in nature but the end game is not a secret – interest rates in advanced economies will eventually go up, reducing the cheap external financing they have benefited from until now. It is as well then that the Kenyan government is timing the issuance of its inaugural Sovereign bond now.

[3] The MPC's communication during its decision Indicated that the efforts of the CBK, the IMF and the Kenya National Bureau of Statistics has improved the quality and speed of delivery of balance of payment data. See Research Note No. 5 – 3013 (RN/5/13), "*Monetary Policy Stance – Eventualy it is all about Inflation*!", November 7; KBA Centre for Research on Financial Markets and Policy

There is more to the only external factor weighing on the growth prospects of emerging markets. There is also little evidence that another commodity boom will boost the fortunes of commodity exporters, given the stability that we are seeing in international commodity prices over the past two years (***Figure 5***). In short, the supportive external environment that propelled emerging markets during the pre-crisis years has either already died down or, in the case of easy external financing, will do so soon. Given that these factors have been estimated to have the impact of potentially slashing as much as one percentage point of the combined GDP growth of these systemically important economies, it implies that it will have an influence over the momentum of the global economy's recovery and in turn the growth of sub-Saharan Africa.

Conclusion

The decision by the MPC to leave the CBR at 8.5 percent for the fifth consecutive time is a show of determination to consolidate the CBK's credentials of focusing its monetary policy on anchoring inflation expectations. It represents a welcome resistance to a populist policy stance that may appear to be supporting the feeble growth recovery but which may end up undermining a stable environment against which sustained recovery could be bolstered.

While acknowledging a number of positive outcomes, some of which attributable to monetary policy, the MPC needs to appreciate that there are a number of domestic and external risks – not less the fiscal policy outcomes that seem to drag growth and the challenges of emerging markets' economies – that should form part of the follow-thoughts by the MPC in its policy vigilance.

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Comments on this *Research Note* can be forwarded to the Centre's Director at research@kba.co.ke or josoro@kba.co.ke

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