RESEARCH NOTE NO.28. – 2017 (RN/28/17)

Kenya Bankers Association Centre for Research on Financial Markets and Policy®

January 31, 2017

Monetary Policy Stance: Confidence in the Pause, Limited in the Signalling Candour

Highlights

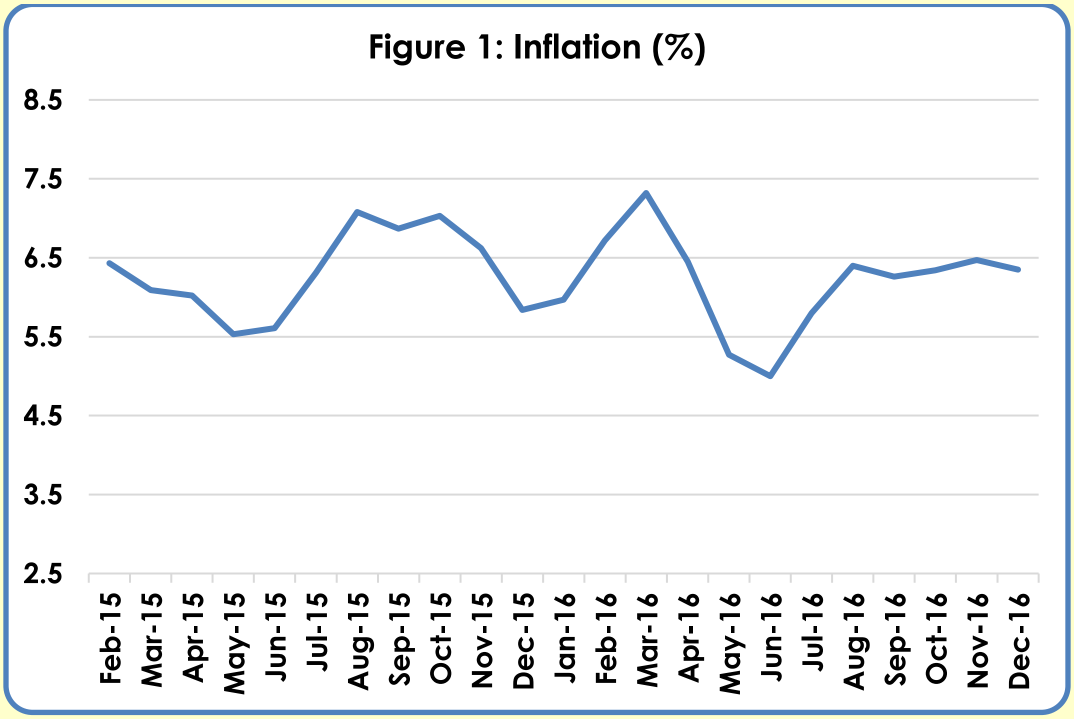
- The largely anticipated decision by the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) to hold the Central Bank Rate (CBR) 10.0 percent in its January 30, 2017 meeting was justified by the argument that inflation is within the target range.
- While the MPC's decision appears reasonable on the basis of the current circumstances, it needs to be nuanced if only to bring out the proper context on how it sets the tone for future monetary policy decisions. We highlight four underpinning factors.
    - The economy's growth is deemed robust even when there are a number of undercurrents that undermines such characterisation.
    - The feel-good-factor that prevailed in the foreign exchange market could be masking vulnerabilities in the economy's external position.
    - The path that the international oil prices are taking is more slippery than the MPC is willing to acknowledge.
    - The global economic circumstances are far from rosy, a fact that the MPC seems to acknowledge, albeit the broader view being that the global economy is poised to do better in 2017.
- We therefore observe that the decision by the MPC to hold the CBR at 10.0 percent as justified by the Committee's argument that inflation is within the target range and previous decisions need time to work through the economy was anticipated. While on that account the MPCs decision seems justified, its assessment of the immediate term risks on price stability and other macro parameters are of less candour. Consequently, this reflects the MPC's inability, or unwillingness, to provide forward guidance in its monetary policy signalling.

Introduction

When in its meeting of January 30, 2017 the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) decided to retain the Central Bank Rate (CBR) at 10.0 percent on account of seeking to anchor inflation expectations, it sent out two signals – one explicitly and the other inadvertently.

The explicit signal is that the MPC previous decisions are meeting the policy objective, at least insofar as stability is concerned. The inadvertent signal is that there are imperfections in the monetary policy transmission such that the effect of its decisions as would be manifested by market prices reaction – especially in the credit market – are realised with a lag.

To the extent that inflation remained within the government target of 5 percent (±2.5 percent), the MPC's decision to hold the CBR was largely anticipated. In this *Research Note*, we argue that evidence points towards the need for a tighnening signal – not neccesarily commencement of tightening but the candour on the part of the MPC that downside risks present an opportunity for forward guidance that is necessary to anchor inflation expectations (**Figure 1**).



Source: CBK, Kenya National Bureau of Statistics

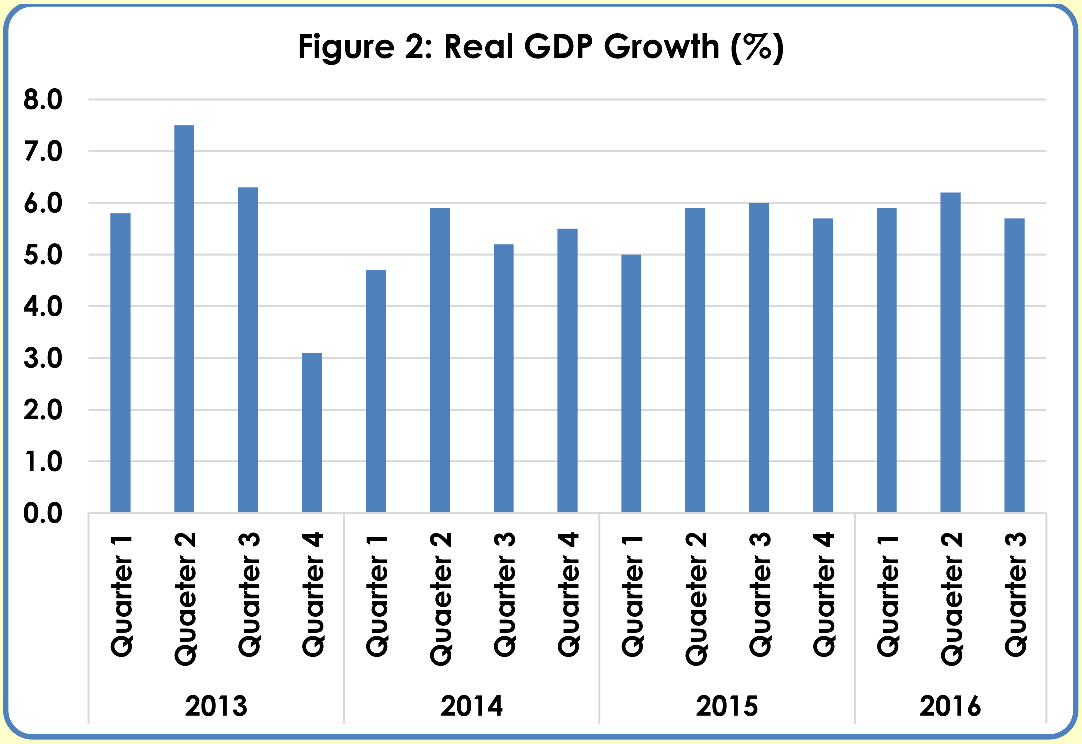
The thrust of this *Note's* arguments is that the understandable focus on the CBR not just as a policy signaling rate but also the base for deposit and lending rates determination as tended to blur the persuasive view that its (the CBR's) review is as important as the underlying justification. It is the justification that forms the basis for expectations formation.

We therefore evaluate the MPC's decision against its four key observations: one, on the back of the prevailing dry weather conditions, food and electricity prices are expected to remain elevated; two, all is well in the foreign exchange market and by extension the economy's external position; three there is no sufificient evidence to take a view on the impact of the recent interest rate capping; and four, the economy's overal performance remains robust at least as evident from the performamce of the third quarter of 2016.

On Target - But for How Long?

As already noted, the MPC's latest decision hinges on the fact that inflation is on target although it has stubbornly stuck on the upper bound of the target range. With that in mind, how it has buttressed the MPC's latest decision needs to be nuanced if only to bring out the proper context on how that sets the tone for future monetary policy decisions. We highlight four underpinning factors.

First, it is observable that economy's growth, while positive, has been consistently below the 6 percent projection that is seldom attained (**Figure 2**). Interestingly, such rosy forecasts have been a basis for government revenue and expenditure projections. The MPC notes that the observed growth arises from "the prevailing macroeconomic stability, public investment in infrastracture, lower energy prices, and the recovery in the tourism sector".

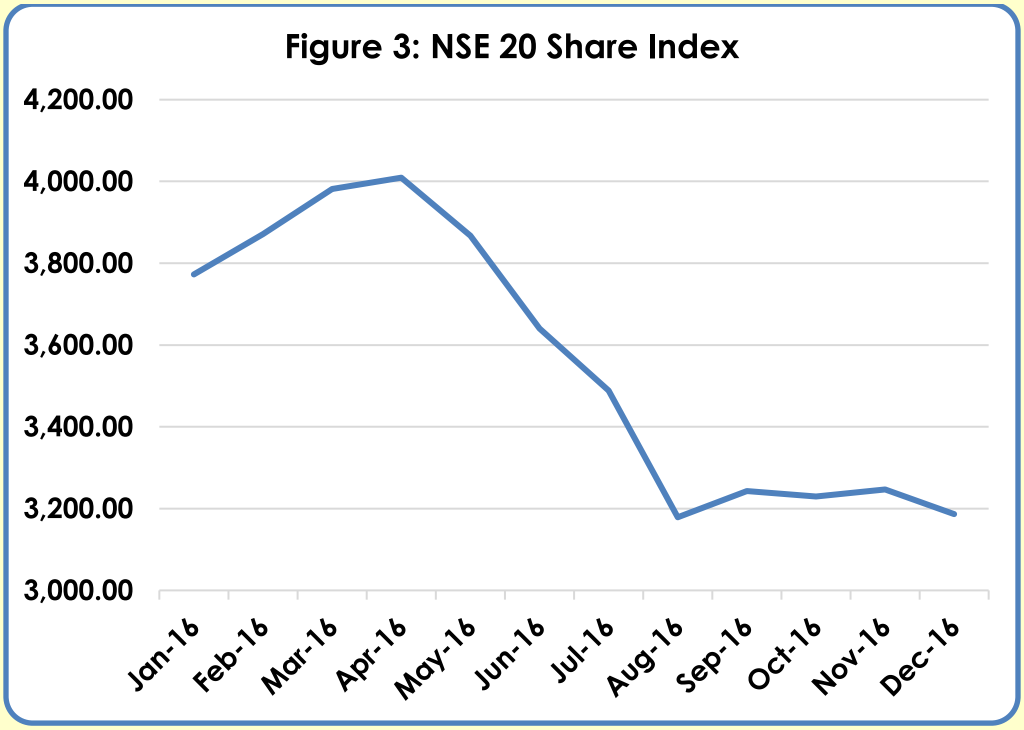


Source: Kenya National Bureau of Statistics

The outlined drivers of growth seem not to be reconcilled with the business sentiments. Let's start with the fact that credit expansion to the private sector has plummeted to the extent that its effect on the economy – even as MPC is seeking for adequate evidence should be obvious. Recent studies[1] inform us that financial variables such as credit growth, stock prices and house prices have sufficient predictive power in the near to medium term.

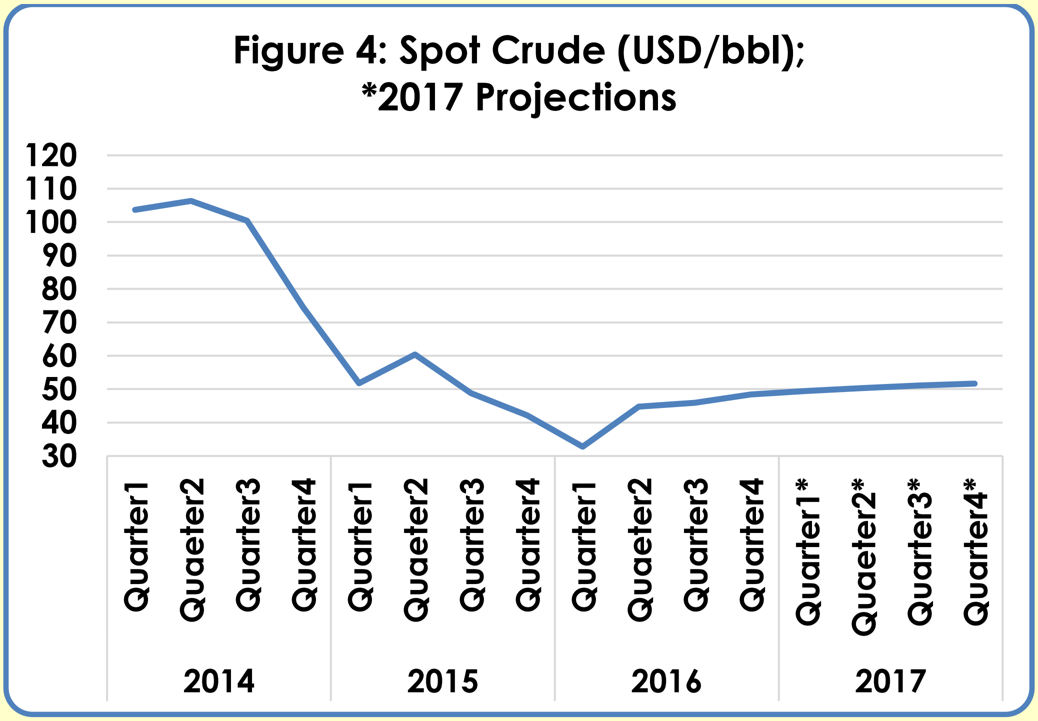
From a normal of double digit growth in 2015 to a stabilisation at 4.3 percent in Decemner 2016, credit growth to the private sector should be a pointer to the likelihood of the private sector to drag the economy's peformance. The Kenya Bankes Association Housing Price Index (KBA-HPI) indicates that house prices have in the recent past been rising at modest rates at best. Furthermore evidence from the Nairobi Securities Exchange (NSE), previously a common feature in the MPC's evidence for strong economic performance but not any more, points towards a steady decline as the key market index has been on a downward trajectory (**Figure 3**).

[1] Chen, S and Ranciere, R. (2016), "Financial Information and Macroeconomic Forecast", *IMF Working Paper* WP/16/251, December.



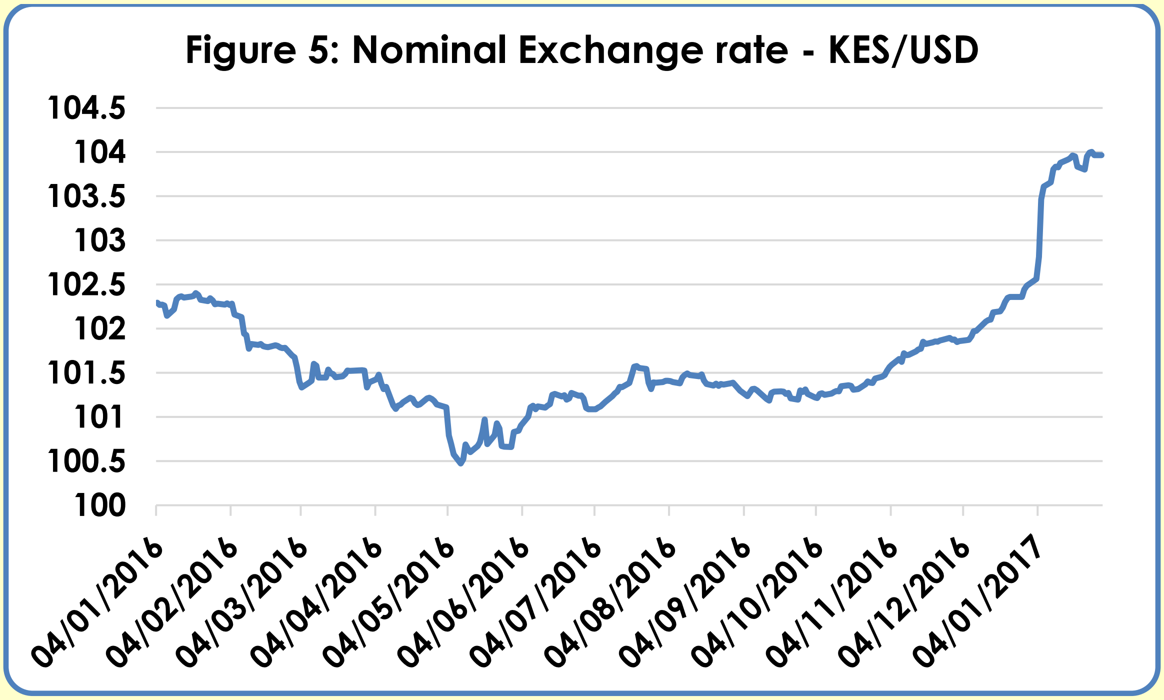
Source: NSE

It is clear that the era of cheap oil prices is coming to an end. With Organization of Petroleum Exporting Countries (OPEC) signaling the desire for lower output as a way fo boosting prices, the price of oil per barrel is projected to remain above USD 50 for 2017 (**Figure 4**). Any impetus on growth arising from low prices that have prevailed in the recent past is diminished.

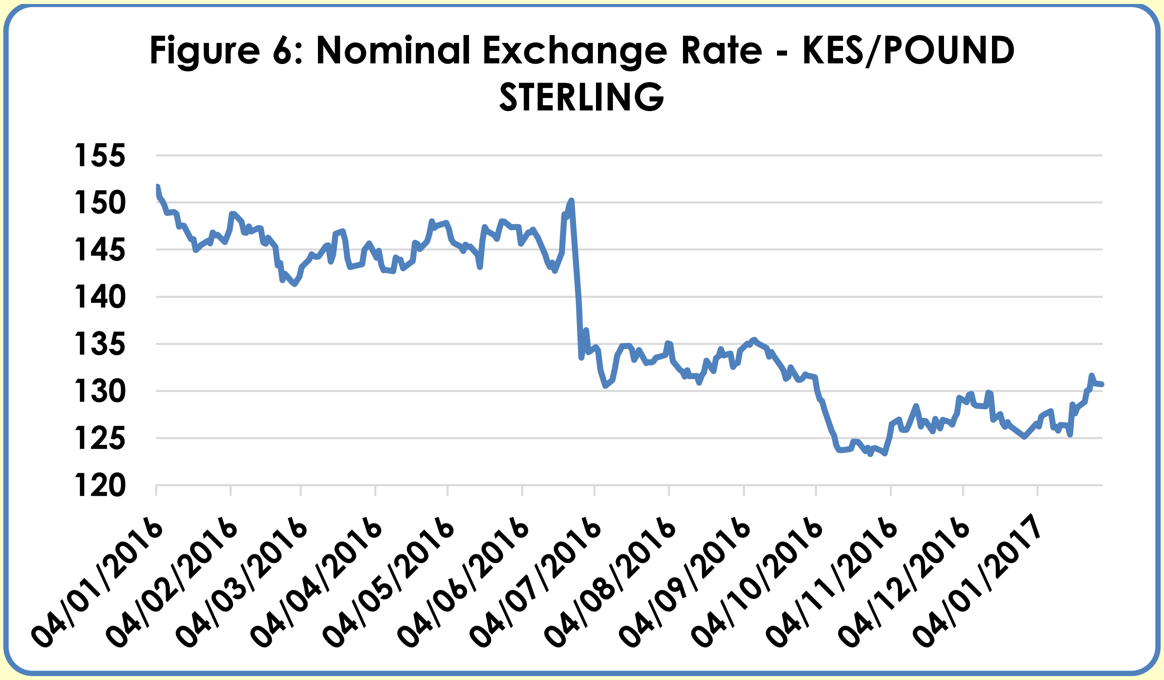


Source: IMF

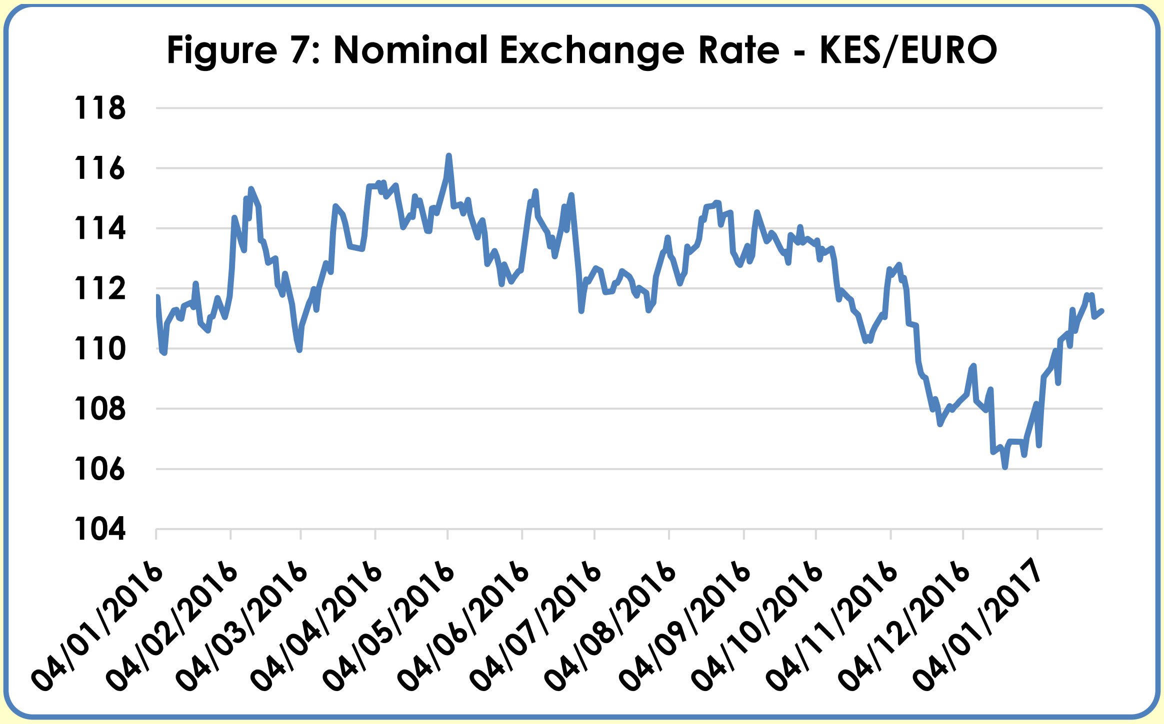
Second, there is an obvious feel-good-factor on the part of the MPC when it comes to the foreign exchange market; its core message is that the market is stable and such stabillity is anchored on strong fundamentals – the narrowing of the current account deficit, even when arising largely from less imports including machinery, the amount of foreign exchange reserves and the comfort of the Precautionary Arrangment with the IMF. Even with that the local currency has been under depreciation pressure (**Figures 5,6 and 7**), even though that does not necesarily amount to volatility. This points to a depreciation bias that is counter to the noted feel-good-factor.



Source: CBK



Source: CBK



Source: CBK

Third, when you take into account the fact that the foreign exchange, oil and food prices often have both a short term and long term relationship then the picture illustrated above could guide on the possible inflation and therefore monetary policy direction. If the MPC sticks to the objective is anchoring inflation expectations, then explicit confidence in the outcome as well as a hint on the outlook of the target variables admitedly reflects an understatement of the downside risks.

Fourth, the global economic circumstances are far from rosy and the MPC seems to acknowledge that fact albeit with a sense of optimism that global growth is expected to pick in 2017. We note that the IMF, in its October 2016 growth forecast undertaken trimmed its global output growth projections on account of not just the recession-struck Europe but also because of the emerging markets woes; this points to the fact that the recovery momentum still remains feeble.

One's Own Sympathetic Evaluator?

The limited consideration of the factors that we outline above buttress our view that the pronouncements of the MPC have not explicitly set the tone for the immediate future policy stance. We note though that the Committee has given itself an entry window in its general, if standard, remark that "it will closely monitor developments in the domestic and global economies, and stands ready to take additional measures as necessary".

We are not lost on the fact that the MPC cannot commit to future policy – and nobody expects it to. All it can do is signal its character given the inherent difficulty in monetary policy conduct to lock in a future policy stance. This is however no excuse for not setting the platform for the immediate future policy position. Forward guidance, which in case appears to be at best limited, is not a giveaway but a sign of a maturing monetary policy framework.

While the MPC makes it clear in its latest pronouncement that its policy objective is price stability, we have argued in the past that its signals have not been crystal clear – in instances leaning towards keenness to direct support for growth at the risk of stability. The blurred clarity can be traced to the recent evolution of the CBK's monetary policy framework. In October 2011, the CBK adopted a monetary policy framework that gave greater prominence to the role of its policy rate in guiding its liquidity operations. In this framework, containing inflation is a key priority in the setting of policy, but the inflation forecast currently plays no explicit role, and only the Government's 5 percent medium-term inflation target is cited in the monetary policy statement, leaving the CBK with significant flexibility to change its objectives.

When the MPC is keen on tracking, even targeting credit expansion without segregating household credit and business credit, it once again blurs the intention of such a target towards either reflecting demand or investment impetus. All this points towards conclusions by recent studies that even when central banks in low income countries are declaring monetary policy victories, there is a dire need for streamlining policy conducts that will enhance the effectiveness of monetary policy in such countries[2]. It is with that lens that we surmise the MPC's overall observation that its monetary policy measures continue to deliver desired results as a reflcetion of one being one's sympathetic evaluator.

Conclusion

From the foregoing analysis, we observe that the decision by the MPC to hold the CBR at 10.0 percent as justified by the Committee's argument that inflation is within the target range and previous decisions need time to work through the economy was anticipated. While on that account the decision seems justified, its assessment of the immediate term risks on price stability and other macro parameters are of less candour. Consequently, this reflects the MPC's inability, or unwillingness, to provide forward guidance in its monetary policy signalling.

[2] See Prachi Mishra and Peter Montiel, 2013, *"How effective is monetary transmission in low-income countries? A survey of the empirical evidence"*, Economic Systems 37, 187–216

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