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Monetary Policy Stance – Threading the Thin Line

Highlights

- The Monetary Policy Committee (MPC of the Central Bank of Kenya (CBK) decisions are often keenly watched; its meeting of January 22 2018 hasn't received any different treatment.
- Indeed, the focus is keener given that the monetary policy framework has its core signalling instrument – the Central Bank Rate (CBR) – obviously constrained by the interest rates regulating law, the downside risks on broad price stability are obvious, and there are popular expectations (but short-term in orientation) that the MPC has to "stop playing safe" and set the tone for the year on the back of slow growth of bank credit to the private sector.
- The tone has been set in the MPC decision to hold the CBR at 10.0 percent, which decision speaks to the desire by the Committee to thread cautiously – some would argue helplessly – on the back of a conundrum arising from the interest rate capping law.

Introduction

All decisions of the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) are often keenly watched. Its meeting of January 22, 2018 hasn't received any different treatment. If anything, the focus is keener given that the monetary policy framework has its core signalling instrument – the Central Bank Rate (CBR) – obviously constrained by the interest rates regulating law, the downside risks on broad price stability are obvious, and there are popular expectations (but short-term in orientation) that the MPC has to "stop playing safe" and set the tone for the year on the back of slow growth of bank credit to the private sector.

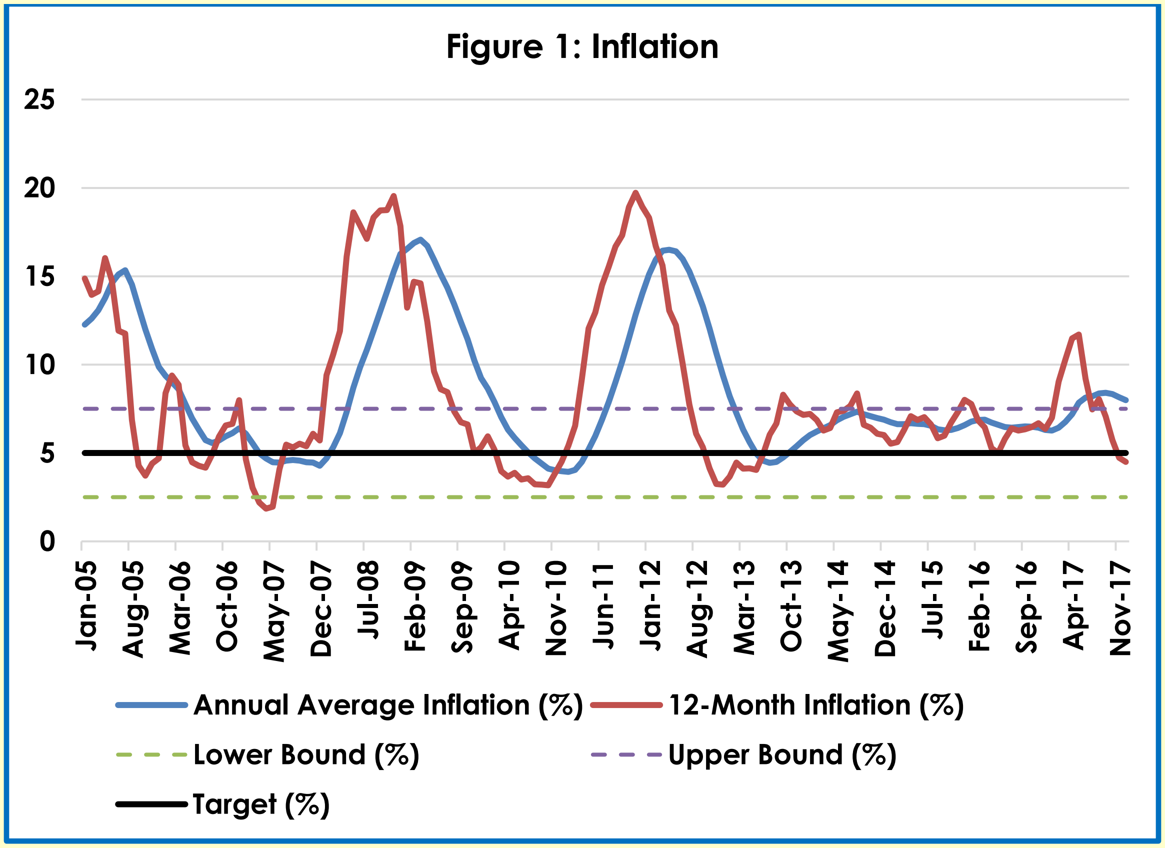
Being as it is that monetary policy decisions are many things to many people – to some an opportunity to address the issue of cost of credit and set the economy on a recovery path, to others a chance to provide clarity on the price stability mandate is primary to entrenching stability as a platform for sustainable growth – the stability-growth nexus has trade-offs which, albeit short term, that could be taken to conflicts in policy objectives.

This *Research Note* argues for the conundrum that the interest rates capping presented to the monetary policy conduct gives the MPC little opportunity to adjust policy levers even when confronted with low credit demand on the back of abating inflation. Even though not explicitly stated, the decision to hold the CBR at 10.0 percent speaks to the MPC's policy dilemma.

Traces of the dilemma are evident in the admission that there is scope for an "accommodative monetary policy" but risks of "perverse outcomes" are also manifest[1]. A rushed prognosis of the inflationary trend could erroneously entice the move towards an accommodative stance as could be signalled by a reduction of the CBR.

As **Figure 1** shows, month-on-month overall inflation has declined from a high of 11.7 percent in May 2017 to 4.5 percent cent in December 2017 principally through lower food prices reflecting improved supply of key food items. While at its current level the inflation rate is within the Government target range, its past erratic demeanour makes it far from being anchored as its forward evolution may well be purely a function of supply side challenges and not any action on the part of the monetary authority.

[1] See thenMPC Comminique of January 22, 2018 (https://www.centralbank.go.ke/uploads/mpc_press_release/356588052_MPC%20Press%20Release%20-%20Meeting%20of%20January%2022,%202018.pdf)



Source: Kenya National Bureau of Statistics

By recognising the potential of perverse outcomes the MPC is advisedly threading a thin line cautiously. Through its policy actions, the MPC is has taken due cognisance of the risks to macroeconomic stability associated with energy prices, and the possibility that limited fiscal space could make the cost of a further subsidy of maize meal high.

The Oil Story

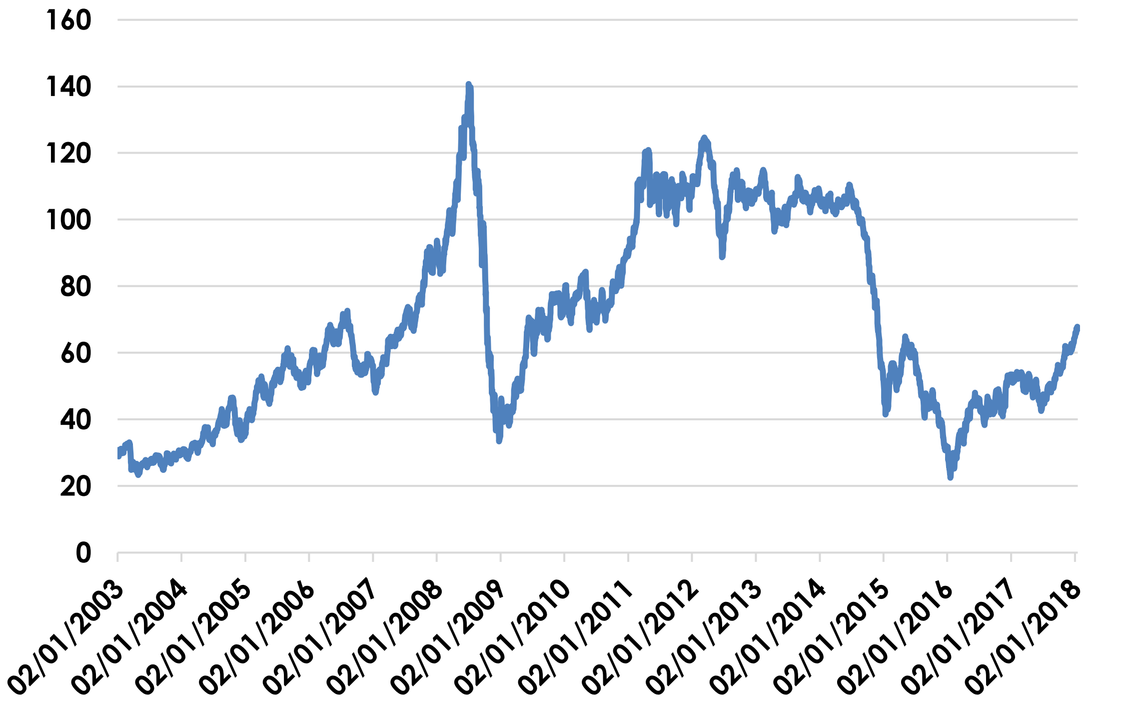
It is obvious that the low international oil prices have in the past been part of the reasons for instances of good inflation fortunes. Evidently, the global economics of oil has taken a shift away from the ordinary as prices take an upward trajectory (**Figure 2**). As at the end of the year 2014, the oil market experienced a market glut with the supply overshooting global demand. Low demand for oil was mainly attributed to weak world economic activity especially in the emerging economies, increased inefficiency, and the growing shift to other fuels in pursuit of green economy.

The price rise that has been observed in the recent past, unexpected as it may seem to many, was in the circumstances inevitable. We highlight the following lessons from the oil prices increase.

- The economics of oil globally has currently taken a new shift away from the ordinary. It is now evident that oil prices are not only determined by the market forces of demand and supply, but rather by the market expectations. Therefore, the decision by the OPEC for instance to cut down production will definitely spike oil prices. We also note that from the new development in the oil market, the oil market will remain subject to the geopolitical shocks whose absence would make the market less vulnerable to shocks. Future price expectations will of necessity factor in the view that OPEC seems to have addressed its past divided positions insofar as output targets are concerned.

- The past tumble in the oil market adversely affected oil producing economies with serious currency depreciations as well as worsening fiscal balances. The promise of price recovery will boost their growth performance, catalyze growth in economies linked to them and consequently augment the demand momentum that will potentially keep the prices high.
- For the non-oil producers, the rising oil prices are detrimental as it will negate the beneficial effects of low prices in the form of their boost to gross domestic product growth through reduced cost of production, low inflation as well as reduce oil import bills. According to the IMF estimates, for every USD10 a barrel fall in oil prices raises the world growth by 0.2 per cent. Thus cheaper oil is an adrenalin to world growth through the fuel injection in the world's circular flow of income. It is estimated that a USD 40 price cut shifts approximately USD 1.3 trillion from the producers to consumers; the rising process thus stands to negate these positive attributes of low prices.

Figure 2: OPEC Reference Basket Price (USD/Barrel)



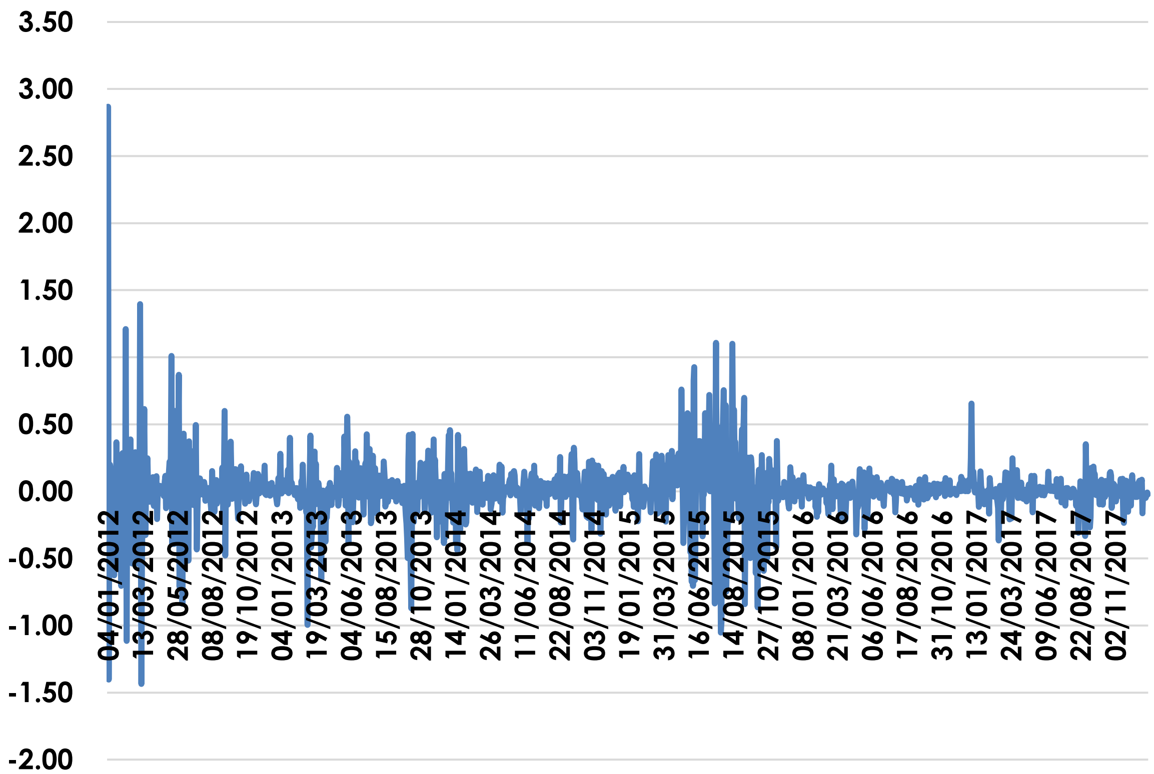
Source: OPEC

We could therefore infer that the effects of the oil prices are characterized by mixed fortunes. We see a direct adverse effect to the local economy in form of its potential inflationary consequences as the local energy sector regulator reviews prices upwards; but higher prices could support recovery in some key markets, especially the producer economies that have suffered from limited diversification on the face of low prices.

The Foreign Exchange Market – Some Comforting Stability…

Households, firms and the government can take comfort in the prevailing stable nominal exchange rate (**Figure 3**) given the arising cushioning on inflation and to some extent the external public debt. Even with the conceptually clear connection between interest rates and exchange rate, the price lever is not available for the MPC's management of the exchange rate market; instead there is an evident reliance on the quantity lever. The CBK's foreign exchange reserves that provide a buffer for obviating any market volatility presently stand at about USD 7 billion (4.7 months of import cover) and are augmented by the Precautionary Arrangements with the IMF, equivalent to USD1.5 billion.

Figure 3: Changes in Nominal Exchange Rate (KES/USD)



Source: Central Bank of Kenya

The sustenance of the nominal exchange rate stability will be assured by strong fundamentals. It is acknowledgeable that the economy's current account has been improving, closing from a deficit of over 10 percent equivalent of GDP to the current level of 6.2 percent and projected to close further. We have argued before that the extent of the narrowing of the current account is as important as the process.

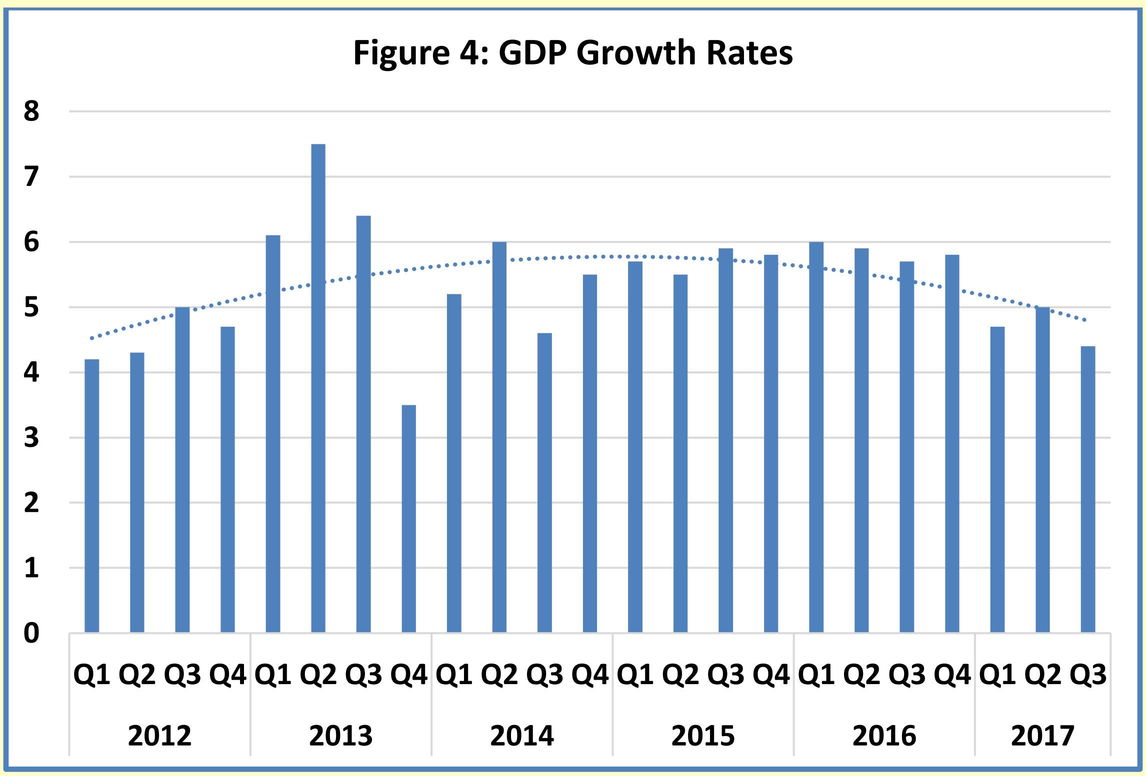
The economy's current account has in the recent past years benefited from low international oil prices; but that window is – as argued above – slowly closing. If the projected further narrowing of the current account will be triggered more by less imports than more exports, then the implication is that the vibrancy of the economy's exports is yet - or even anticipated - to materialize.

Therefore even the obvious boost that the CBK foreign exchange reserves get from diaspora remittances and increased net purchase of equities in the Nairobi Securities Exchange (NSE) and portfolio flows wil remain succepstability to sentiments and global economic cycles.

…and Some Optimism on Global and Emerging Economies Growth Prospects

It is noteworthy that the economy's current account position would benefit from the early indications that the global and emerging markets growth prospects are gradually strengthening. Looking at the emerging economies, growth prospects in majority of these economies for the year 2017 and 2018 are being revised upward.

Arguably therefore, the global economic weaknesses are slowly giving way for an entrenched broad-based recovery. But even then, there is a sense of uncertainty with regard to the U.S. economic policies, the post-Brexit resolution, and the pace of monetary policy normalization in advanced economies. Of interest to us is how the global hand will help in the recovery of the Kenyan economy that – even when described as resilient – is still susceptible and therefore unable to pick quick momentum from the 2017 slowdown (**Figure 4**).



Source: Kenya National Bureau of Statistics

Conclusion

The Monetary Policy Committee (MPC of the Central Bank of Kenya (CBK) decisions are often keenly watched; its meeting of January 22 2018 hasn't received any different treatment.

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