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Monetary Policy Stance: The hidden Trade-offs

Highlights

- The Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) lowered the Central Bank Rate (CBR) to 8.25 percent during its Meeting of January 27, 2020. This follows the decision of November 25, 2019 when the MPC followed through with an accommodative stance in line with its earlier "forward guidance", lowering the Central Bank Rate (CBR) by 50 basis points from 9.00 percent to 8.50 percent.
- This Research Note argues that the inflection phase of the credit market that we are in presently may be prolonged. The policy choices – both fiscal and monetary – will likely influence the path of the market in the near to medium term. It is however critical to watch the developments on the fiscal policy front. Even with express commitment on fiscal consolidation, it remains only prospective until it reveals itself in terms of noticeable and sustained reduction in deficit levels.
- The expectations that the credit market will positively respond to an accommodative policy stance is predicated on the argument that the repeal of the interest rate capping law comes with an element of immediacy regarding the flexibility of the pricing of credit. Any expectations on the efficacy of the MPC decision can benefit from an injection of the reality that even with the supposed flexibility in credit pricing, lending rates rigidity is a conceivable possibility. With that comes the possibility that even with the right trajectory, the rate of credit expansion to the private sector will remain slow at best and government securities are still a competing alternative.
- Ultimately, the MPC's decision to continue with an accommodative stance that could be characterized as aggressive based on the observation that the effect of the initial lowering of the CBR are still tentative at a time when a further lowering is effected has hidden trade-offs. On the one hand we have credit market whose expansion could be slow at best, otherwise unresponsive, to the MPC signal especially at a time when the fiscal consolidation path is not clear. On the other hand, there is the argument by the MPC that amidst "elevated" global uncertainties, and "potential risks to food supply" there is still room for further monetary policy accommodation. These two opposing positions put the spotlight on monetary policy credibility.

Introduction

The Central Bank of Kenya's Monetary Policy Committee (MPC) intent on steering monetary policy back to its effective state following the removal of interest rates controls through the repeal of the Banking Act in November 2019. As in its previous meeting of November 25, 2019, the MPC's meeting of January 27, 2020, was intended to signal its policy intentions in a manner that supports macroeconomic stability as a platform for output growth.

With stability as the principal mandate, the MPC is seen to be directly supporting growth through influencing the cost of credit once it demonstrates that sustainable stable market conditions are safeguarded. In anticipating the MPC's reaction function parameters, we go beyond looking at the set of macroeconomic outcomes and provide perspectives on the past decisions and how they filter into the market's response to policy.

In November 25, 2019, the MPC followed through with an accommodative stance in line with its earlier "forward guidance", lowering the Central Bank Rate (CBR) by 50 basis points from 9.00 percent to 8.50 percent. The MPC has lowered the CBR further to 8.25 precedent during its Meeting of January 27, 2020.

While taking the comfort that stable macroeconomic conditions were in place, the MPC hinged its "forward guidance" and the eventual policy decisions on – among others – "the ***prospective*** tightening of fiscal policy which would provide scope for accommodative monetary policy", the core question for monetary policy is whether a signal on the pricing of credit will be sufficient to inject demand impetus in the economy.

Consistent with our past argument, we observe that the inflection phase of the credit market may be prolonged by two factors. One, while the policy choices – both fiscal and monetary – will likely influence the path of the market in the near to medium term, it is critical to watch the developments on the fiscal policy front. Even with express commitment on fiscal consolidation, it remains only prospective – as the MPC reckons – until it reveals itself in terms of a noticeable and sustained reduction in deficit levels.

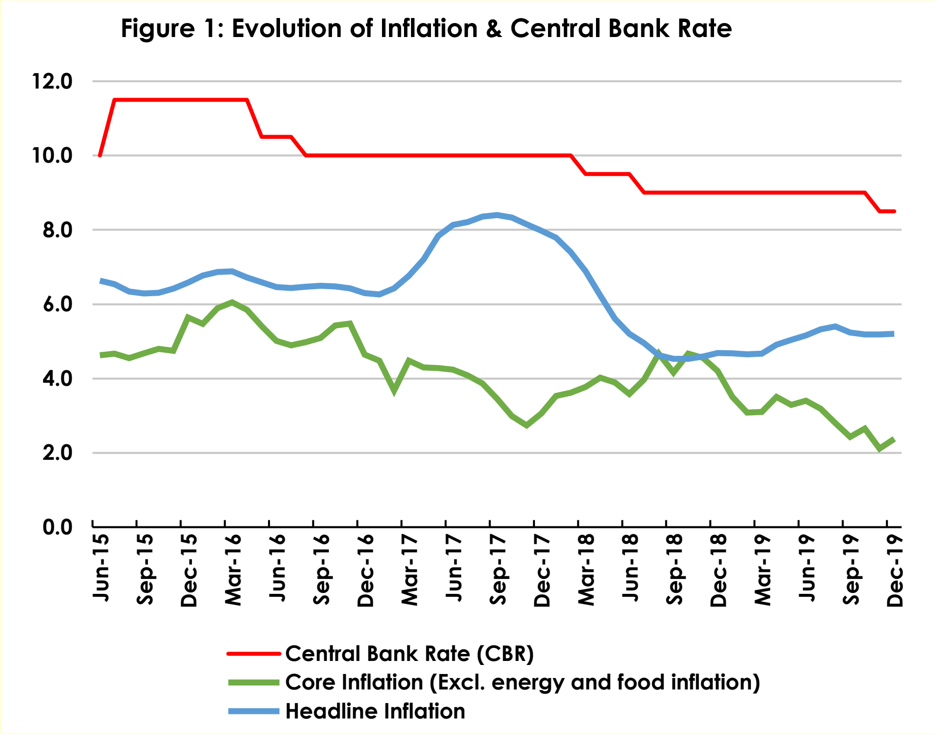
Two, the expectations that the credit market will positively respond to an accommodative policy stance is predicated on the argument that the repeal of the interest rate capping law comes with an element of immediacy regarding the flexibility of the pricing of credit. Just before the lowering the CBR in November 2019, private sector credit grew by 6.6 percent. By the end of 2019, the rate of private-sector growth had increased by a paltry 0.5 percent to 7.1 percent.

A key inference from these two factors on the expectations of the efficacy of the MPC lowering the CBR in two consecutive meetings can benefit from an injection of the reality that even with the supposed flexibility in credit pricing, lending rates rigidity is a conceivable possibility. With that comes the possibility that even with the right trajectory, the rate of credit expansion to the private sector will remain slow at best and government securities are still a competing alternative.

Ultimately, the MPC's decision to continue with an accommodative stance that could be characterized as aggressive based on the observation that the effect of the initial lowering of the CBR is still tentative at a time when a further lowering is effected has hidden trade-offs. On the one hand, we have a credit market whose expansion could be slow at best, otherwise unresponsive, to the MPC signal especially at a time when the fiscal consolidation path is not clear. On the other hand, there is the argument by the MPC that amidst "elevated" global uncertainties, and "potential risks to food supply" there is still room for further monetary policy accommodation. These two opposing positions put the spotlight on monetary policy credibility.

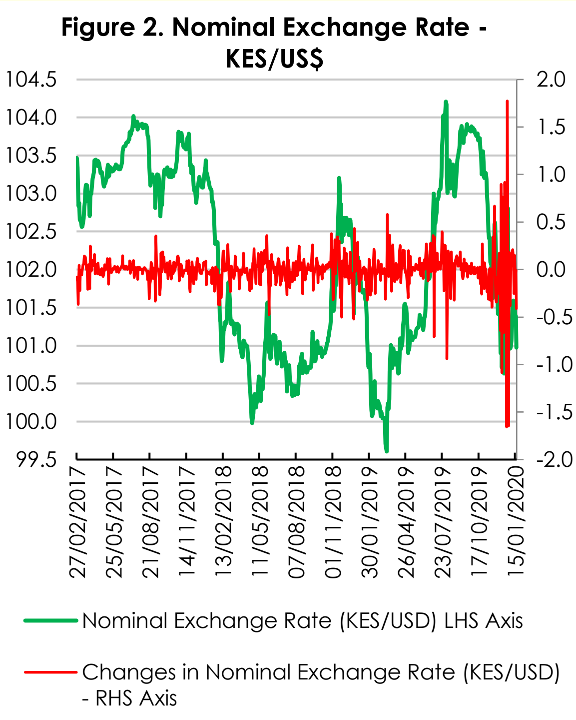
Macroeconomic Stability

From a stability standpoint, it is evident that: (a) inflation is within the target range, (b) the foreign exchange market is stable. As **Figure 1** indicates, inflation remains within the target, albeit with signs of upward bias as it historically remains more on the upper bound of 5.00 percent to 7.50 percent. Inflationary pressure is mainly emanating from the supply-side, for demand-driven inflationary pressures has remained muted. Even with inflation expectations remaining well anchored, monetary policy has to a large extent been justifiably conservative. But now the conservative stance has given way to an aggressive accommodation as already noted.



Source: CBK

Figure 2 shows the broad stability in the foreign exchange market. This has had a contributory effect in inflation in the form of a low pass-through effect. The observed stability and its outlook need to be taken in the context of the extent to which it is buttressed by the state of the economy's external position and the policy instruments available to the CBK to sustain it. It is worth noting that the economy's current deficit continues to close (**Figure 3**). Whereas domestic demand conditions will have an influence on imports demand, a weak global economy will likely have a toll on exports. Elevated uncertainty surrounding trade and geopolitics as the IMF notes in its October 2019 *World Economic Outlook* may put a strain on global demand.



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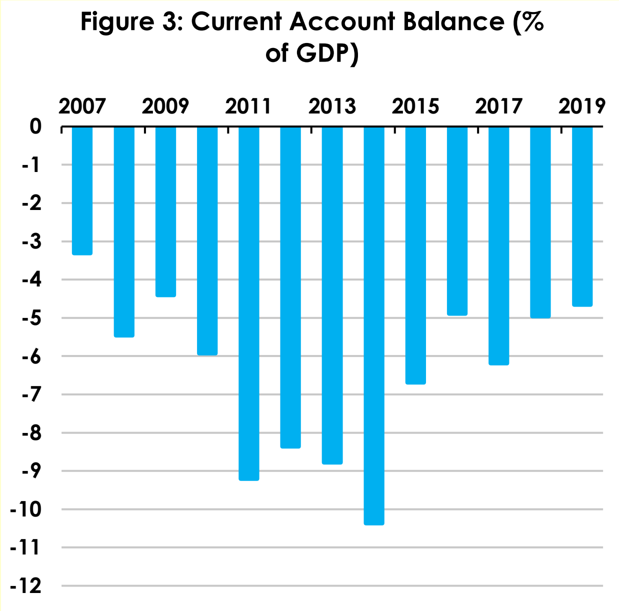
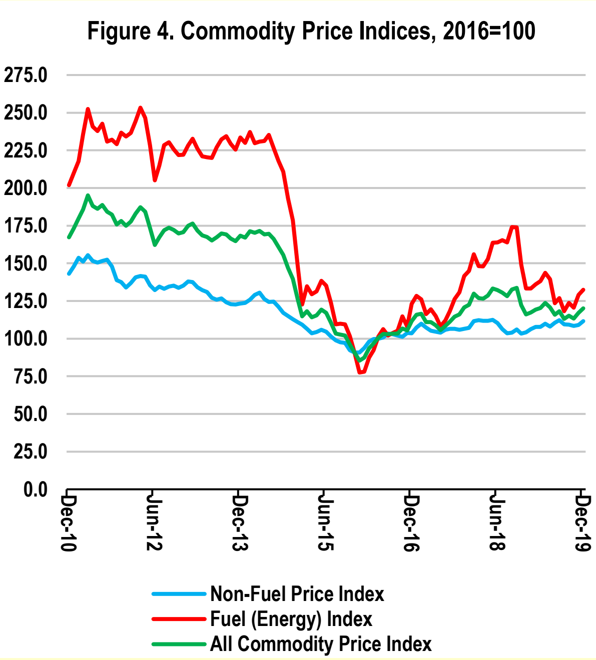
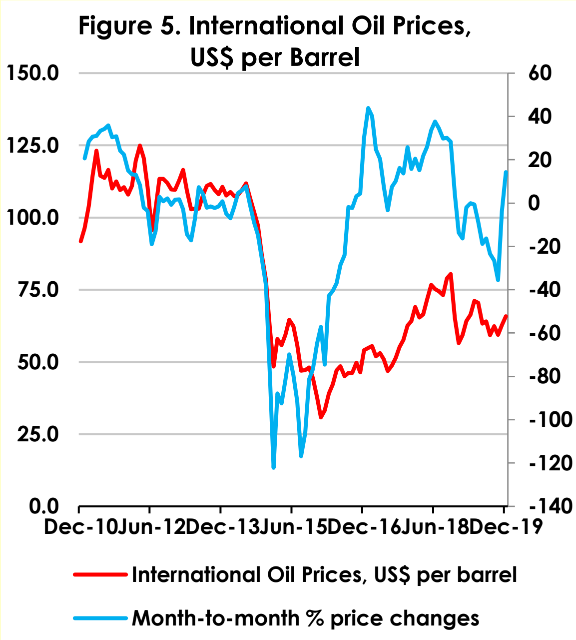


Source: World Bank WDI database

The MPC is evidently taking the comfort in the foreign exchange reserves adequacy, with the reserves currently estimated to be an equivalent of 5.2 months of import cover. It's worth acknowledging though that the quantum of foreign exchange reserves is important but so is the source, for different sources have different multiplier effects on the domestic economy. It is evident that the build-up of the reserves is from diaspora remittances as the export earnings have not been that strong.

With the elevated uncertainty and the associated downside risks, developments at the global front will ultimately play into the domestic economy. Signals of commodity prices rising are evident (**Figure 4]** and so are oil prices (**Figure 5**) with oil prices standing at USD 59.37 in October before rising to USD 62.74 in November and further to at USD 65.86 in December 2019. This trend is likely to be sustained in the near-term to the detriment of oil importers





Source: IMF

The Growth Story

With the stable macroeconomic environment outlined above, it is plausible to argue that there is scope to deploy monetary policy to support growth. While the economy is growing at a rate that could be characterised as strong (**Figure 6**), it's clear that the scope for fiscal programmes to continue being a growth driver is limited as fiscal consolidation becomes a priority. Similarly, enterprises are operating at excess capacity (limited or no demand for additional investments) and households' expenditure ability is constrained.

These two factors point to an economy with a negative output gap that superficially means an accommodative monetary policy will not compromise macroeconomic stability. The deployment of such an accommodative stance need not be unqualified, as already argued. The recent evidence of slowed economic activity point to weak demand. With the real GDP growth of 5.1 percent in the third quarter of 2019 and is the lowest since the fourth quarter of 2017. Clearly, this points to an economy operating at excess capacity and thus the need to stimulate economic activity.

Further, the private sector credit is still trapped in a low equilibrium position (**Figure 7**). The revival of private sector growth must be seen in light of both the supply and demand-side interactions. Whereas the supply-side may be willing to provide credit, the demand side remains weak as the economy is operating at excess capacity and household demand is weak.

Figure 6. Real Output Growth (%)

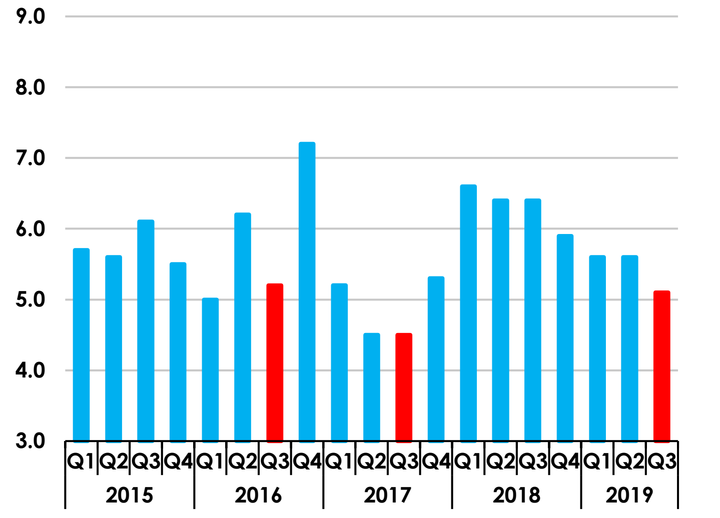
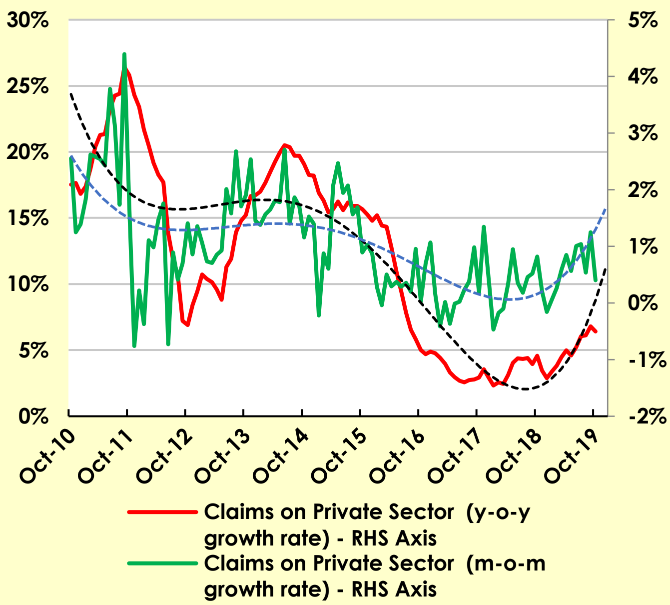


Figure 7. Private sector credit and growth



Source: KNBS

Source: CBK

Conclusion

The above arguments reinforce the inference that the inflection phase of the credit market may be prolonged. The policy choices – both fiscal and monetary – will likely influence the path of the market in the near to medium term. It is, however, critical to watch the developments on the fiscal policy front. Even with express commitment on fiscal consolidation, it remains only prospective until it reveals itself in terms of a noticeable and sustained reduction in deficit levels.

The expectations that the credit market will positively respond to an accommodative policy stance is predicated on the argument that the repeal of the interest rate capping law comes with an element of immediacy regarding the flexibility of the pricing of credit. Any expectations on the efficacy of the MPC lowering the CBR in two consecutive meetings can benefit from an injection of the reality that even with the supposed flexibility in credit pricing, lending rates rigidity is a conceivable possibility. With that comes the possibility that even with the right trajectory, the rate of credit expansion to the private sector will remain slow at best and government securities are still a competing alternative.

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