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Monetary Policy Stance – Anchoring Stability

Highlights

- As anticipated, the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) retained the Central Bank Rate (CBR) at 8.5 percent in its meeting of February 26, 2015.
- By its decision, the MPC is sending a clear message that there is a compelling case for the compelling need to anchor stability as a prerequisite to sustainable economic growth
- The plummeting of international oil prices has been a big factor in the domestic inflation outcome. We argue that the prices may be turning the corner now.
- The depreciation of the KES is to some extent attributed to the external factors mainly the effects of the resurgent USD following the end of the quantitative easing the federal government. Nonetheless, the fundamentals to support any other stance other than a mildly depreciation bias are lacking.

Introduction

The Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) meeting of February 26th 2015 takes place earlier than the usual two months before such meetings are usually held. The previous meeting was held in January 14, 2015. Whereas the MPC can meet as frequently as "business" may demand, frequent meetings or early scheduling from the norm can mean any of two things: either there are market swings that portent volatility, therefore necesitating policy intervention or there is some unique adminsitative/governance developments that necessiate a meeting.

A look at the market since the last MPC meeting points to no drastic market movements. In any case the market – if we were to take inflation as the gauge – is tending, albeit gradually, to move towards the median target of the 5 percent headline inflation rate. Indeed inflation has been trending downwards largely on account of a fall in energy prices (see **Figure 1**).

It therefore means that the MPC has been necessitated by the fact that the current CBK Governor's tenure is coming to an end and this could be a transitioning meeting to the next head of the central bank. If this is the sole purpose of the meeting, then two issues come to mind:

- One, the governor's tenure is fixed, therefore the markets have factored in that inevitability. Any market movements in response to changes in that office cannoly be felt *ex post*.
- Two, the change in leadership at the CBK, indeed at the MPC does not mean or necessiate a change in policy stance and/or policy regime. The inflation target, as given by the National Treasury, remains as before; the monetary policy framework that the CBK has built over time as it seeks to transition into a formal inflation targeting regime remains in place; the delpyment of monetary policy instruments – in line with the *instrument independence* where there is no *goal independence* – remains as before.

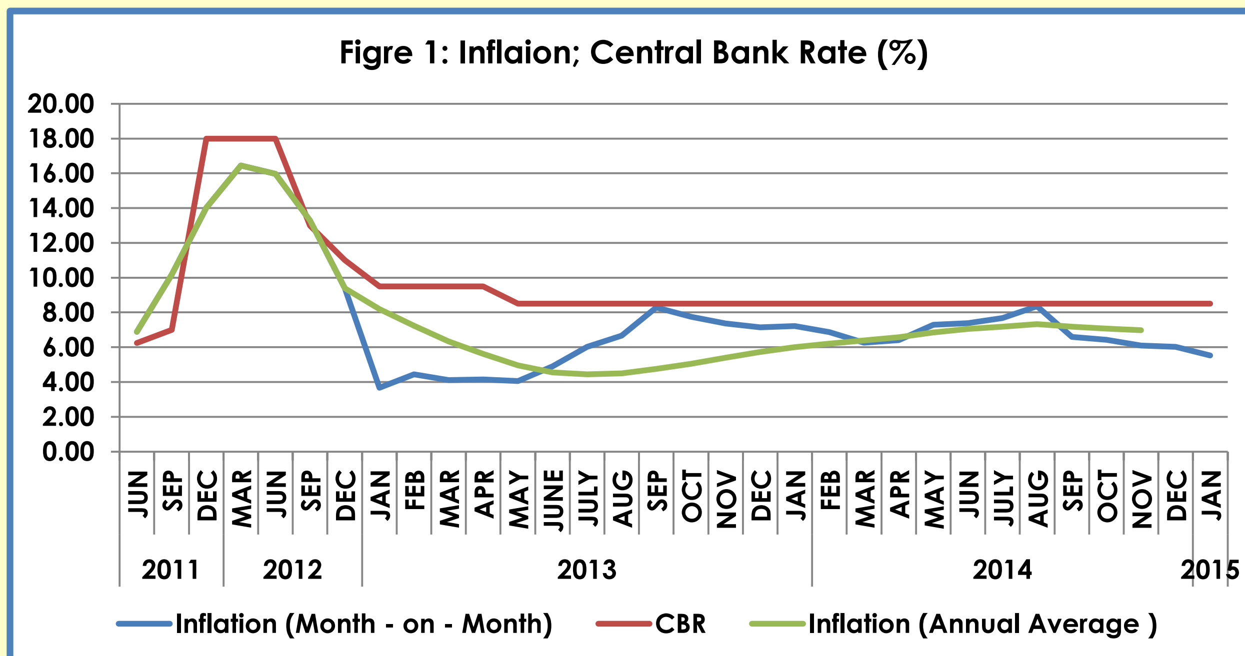
This *Research Note* is by no means suggesting that the comportment, style and intellectual inclination of the incumbent of the the governor's office doesn't matter; it certainly does to the extent that such leadership manifests itself in how clear a signal it sends to the market in matters of policy articulation – commonication being a policy tool. Instead we argue that the transititioning message in the balance of all factors – market conditions and expectations – the thurst of monetary policy should be embedded in:

- One, the compelling need to anchor stability as a prerequisite to sustainable economic growth; in this case, if there as clear signs volatility or stability the respective appropriate policy action should be to pursue a tight stance or an accomodative stance – whichever is approoriate as justfied my evidence;
- Two – which is linked to the first message – the need to resisting the temptation to an activist policy stance with a view to promoting growth through a bias towards an accomodative stance when evidence may either not be clear, or a bias towatds a tight stance at the slisghtest market 'provication' that may not be an signal of impending volatility. In essence, the evidence must be compelling to justifiy a given policy stance.

That is why this *Note* concurs with the reasoning and decision of the MPC in retaining the Central Bank Rate (CBR) at 8.5 percent. The MPC's decision reinforces our past arguemnts (see for instance the KBA Research Centre's ***Research Note No. 14*** *of January 16, 2015*) that the MPC is alive to the fact that inflation expectations need to be anchored and therefore it is premature to change the monetary policy stance as signalled by the CBR unless stability is firmly enthrenched.

Inflation is clearly on a mild declining trend but still remains in the upper bound of the government's 5 percent medium term target as at the end of January 2015 at 5.3 percent. The effects of energy prices have already filtered into these inflation numbers so a futher drastic decline from this front is

unlikely. A clear commitment to anchoring inflation expectations is reflected by the monetary policy's stance on the back of the trend of the inflation rates that we observe.



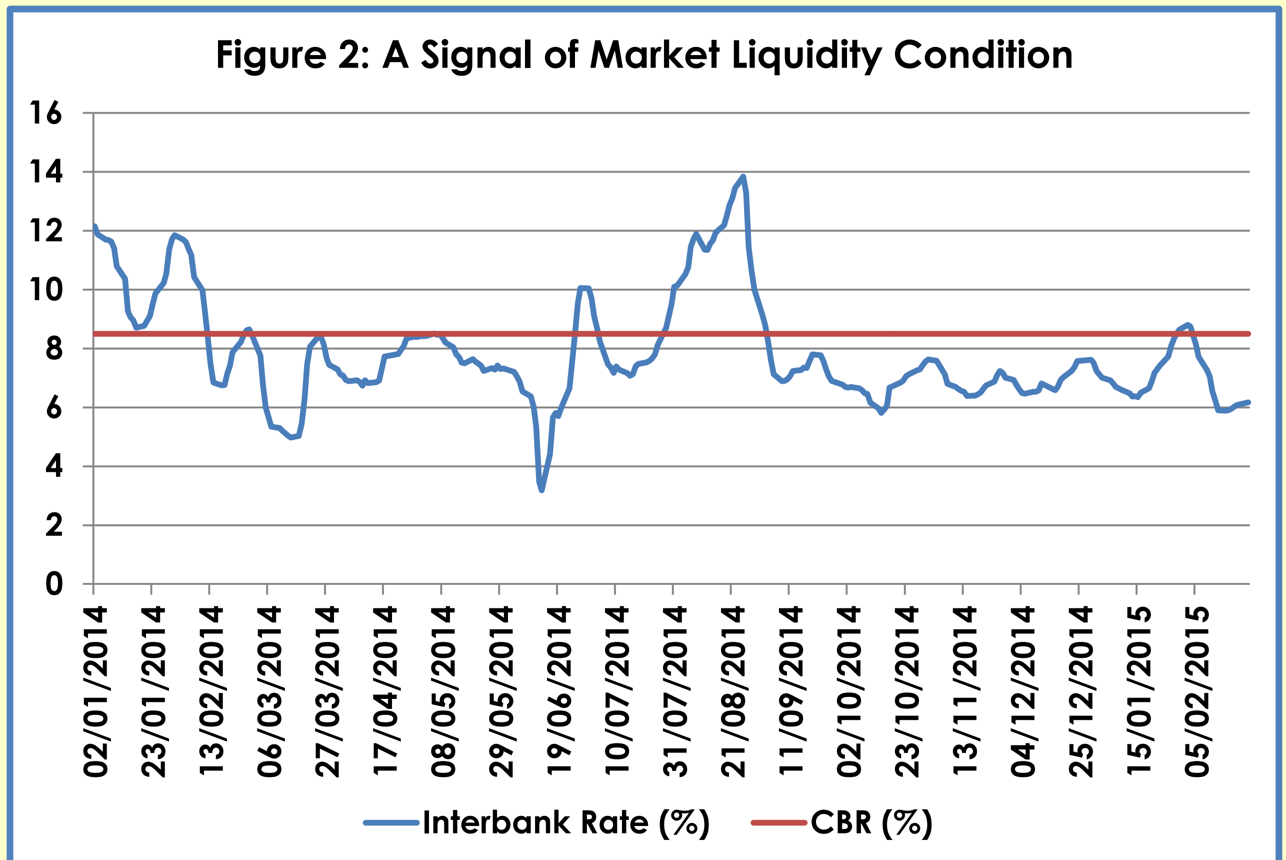
Source: Central Bank of Kenya, KNBS

The Financial Markets

There is every indication that the money market is not constrained by liquidity. As **Figure 2** indicates, the fact that the inter-bank rates have consitently remained below the policy rate since September 2014 is an indication that there is adequate market liquidity. At the same time, there has been a slight reduction in the Treasury bill rates on the back of the government's external borrowing programme that has influenced the extent of resort to the domestic money market. Indeed the Treasury Bill Rates, while often oscilating around the CBR, have remained higher than the inter-bank rates.

Will these money market characteristics translate into lower rates going forward? It all depends on the market competition dynamics and positioning. In the banking industry for instance, the deposits rates for banks relying more on wholesale funds have been under upward pressure. With the credit expansion that the CBK's *Credit Officer Surveys* report largely accounted for by consumer loans, credit for trade and SME manufacturing, it is possible that the banks with wide branch etworks – and therefore relatively lower deposit rates – are keen to offer more competitive rates for wholesale depoits which they then can pass on to the SMEs and households while maintaining good spreads.

Furthermore, the CBK is likely to remain active in its open market operations as one of the mechanisms of ensuring stability in the foreign exchange market, the other being active participation in the foreign exchange market. So long as the Kenya shilling remains under depreciation pressure on account of the economy's weak current account position, the scope of a significant reduction in interest rates in the near future remains constrained. Consequently, the trend of lending rates will remain downward but gradual at best.

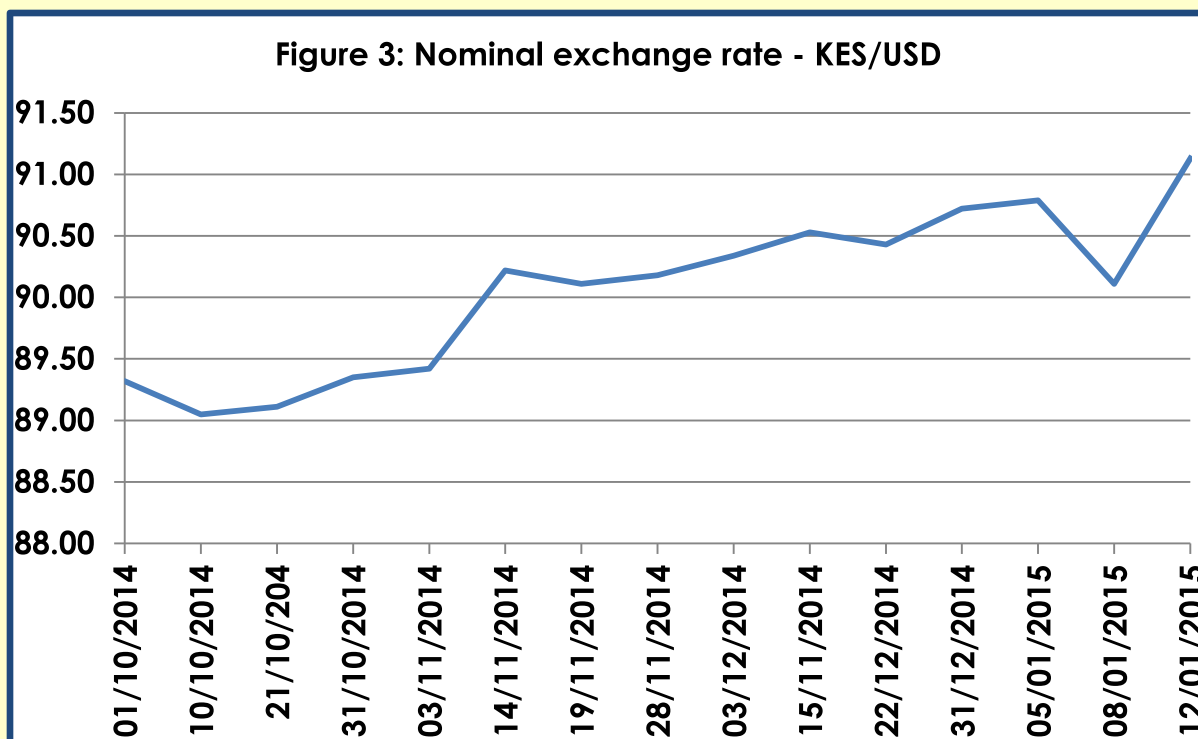


Source: Central Bank of Kenya

The CBK has made it explicit, and rightly so, that the nominal exchange rate is a monetary policy tool[1]. As already noted, the interest rates outlook is somewhat connected to developments in the foreign exchange market. Indeed, so long as the Kenya shilling (KES) remains under depreciation pressure on account of the economy's weak current account position, the scope of a significant reduction in interest rates in the near future remains constrained.

It is interesting that the MPC has often indicated in its recent past meetings that a largely stable foreign exchange market, albeit with any depreciation owes it more to a strengthening USD than a weakening KES. This is just one perspective. The KES has clearly been under depreciation bias for the entire of quarter four of 2014 (**Figure 3**). We acknowledge that the depreciation is to some extent attributed to the external factors mainly the effects of the resurgent USD following the end of the quantitative easing the federal government.

[1] See https://www.centralbank.go.ke/index.php/news/403-the-nominal-exchange-rate-as-a-tool-of-monetary-policy



Source: Central Bank of Kenya

It is clear that the fundamentals to support any other stance other than a mildly depreciation bias are weak. The current account is still weak; that is why as we have noted before all the accommodations to stabilizing the currency that supports the MPC's position are clearly anything but an improvement in the fundamentals.

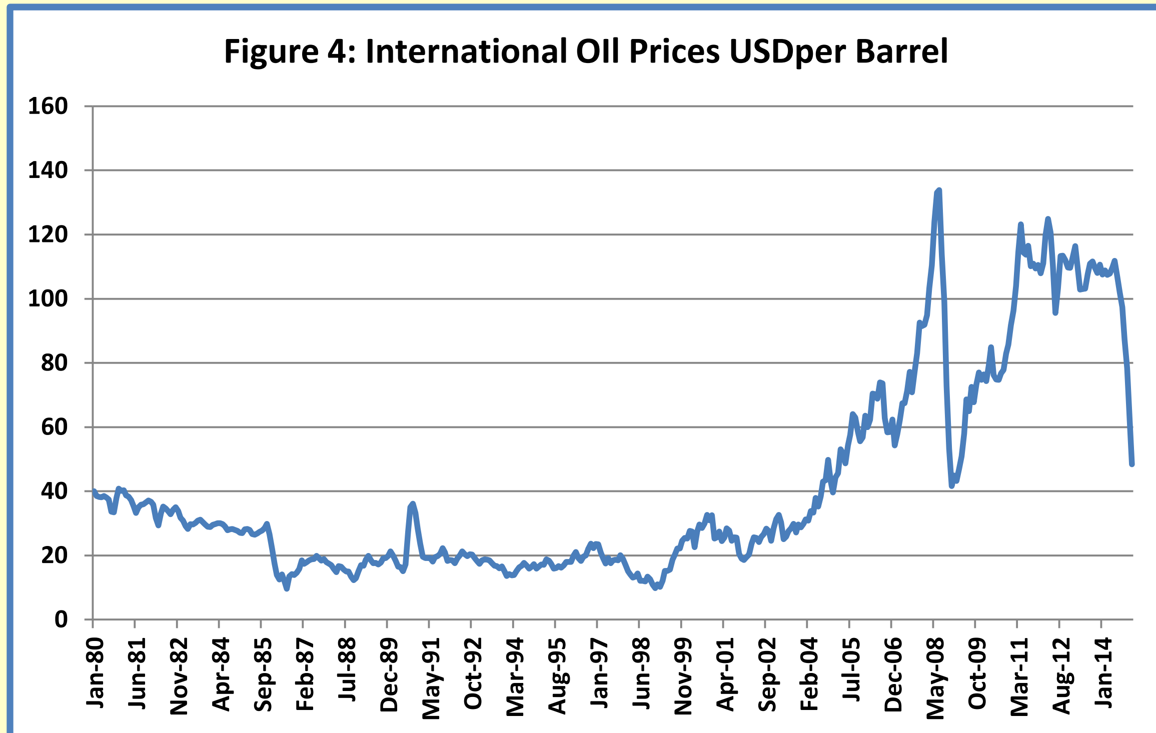
First, the foreign currency reserves have received a boost from the initial issuance and the later re-opening of the sovereign bond. We argue that this is a case of the fiscal policy offering monetary policy a helping hand. Given that the bond proceeds are meant for government investment programs, it means therefore that the level of reserves arising thereof could be fluctuating depending on utilization. Further accommodation is available from an approved International Monetary Fund (IMF) facility that can allow the CBK to draw down as need arises towards ensuring foreign exchange market stability; that there is such facility means that weaknesses in the fundamentals are evident.

Second, there is a clear boost from diaspora remittances and increased net purchase of equities in the Nairobi Securities Exchange (NSE). We contend that taking a forward-looking stance will entail factoring in the likely implication of the unclarity surrounding the introduction and implementation of of capital gains tax on the trend of foreign participation in the NSE.

The Oil Prices Hitting the Bottom?

As we have previously noted, the inflation trend that we see has largely been attributed to oil prices plumetting. The global economics of oil have taken a shift from the ordinary. As at the end of year 2014, the oil market experienced a market glut with the supply overshooting global demand. Low demand for oil is 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 tumble that has been observed in the recent past, unexpected as it may seem, was in the circumstances inevitable.

We argue though that such drastic market movements are unprecedented (see **Figure 4**). Admittedly, the upswings and downswing in oil prices may be representing an overshooting and undershooting respectively above/below some level that meets the producers and consumers desires[2]. The market is therefore bound to correct, and as the IMF indicates in its latest commodity prices forecast, such correction may have begun.



Source: IMF Database

Weak Global and Emerging Economies Growth Prospects

The global and emerging markets growth prospects remain weak. While the US and the UK are the drivers of the moderate recovery that is currently observed the Eurozone is now formally in deflation hence dampening any possibility of economic growth for the member country. Further, the ongoing political developments around the support or lack thereof for Greece only builts to that uncertanity. For the emerging economies, growth prospects in majority of these economies for the year 2015 have been revised downwards. For Brazil, the third quarter for 2014 registered negative growth with shrinking exports' revenues, widening trade deficits as well as the sliding consumer confidence. In India, investment environment remains weak mainly attributed to the high corporate tax and rigid fiscal policy. The people's Bank of China has reduced its benchmark interest rates for the first time since June 2012 in attempts to spur up the weakening growth. The worst hit is Russia with a serious depreciation bias of its currency despite the interventions by the central bank. In addition, the service sector is experiencing contraction. This presents a weakening bias for the BRICs economies which is likely to trickle down to the less developed economies.

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[2] See http://www.businessdailyafrica.com/Opinion-and-Analysis/What-leads-to-a-plunge-in-global-oil-prices/-/539548/2632996/-/i3j56gz/-/index.html

Conclusion

As we anticipated, the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) retained the Central Bank Rate (CBR) at 8.5 percent in its meeting of February 26, 2015. The MPC is to send out a clear message that it is keen to anchor inflation expectations; therefore the mild downward ticking of inflation does not justify a chance in monetary policy stance. To the extent that the Kenya shilling is under depreciation pressure on account of weak fundamentals, the scope for significant interest rates reduction in the near term is curtailed.

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