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

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Monetary Policy Stance – The Conundrum We Are Shy of Talking About!

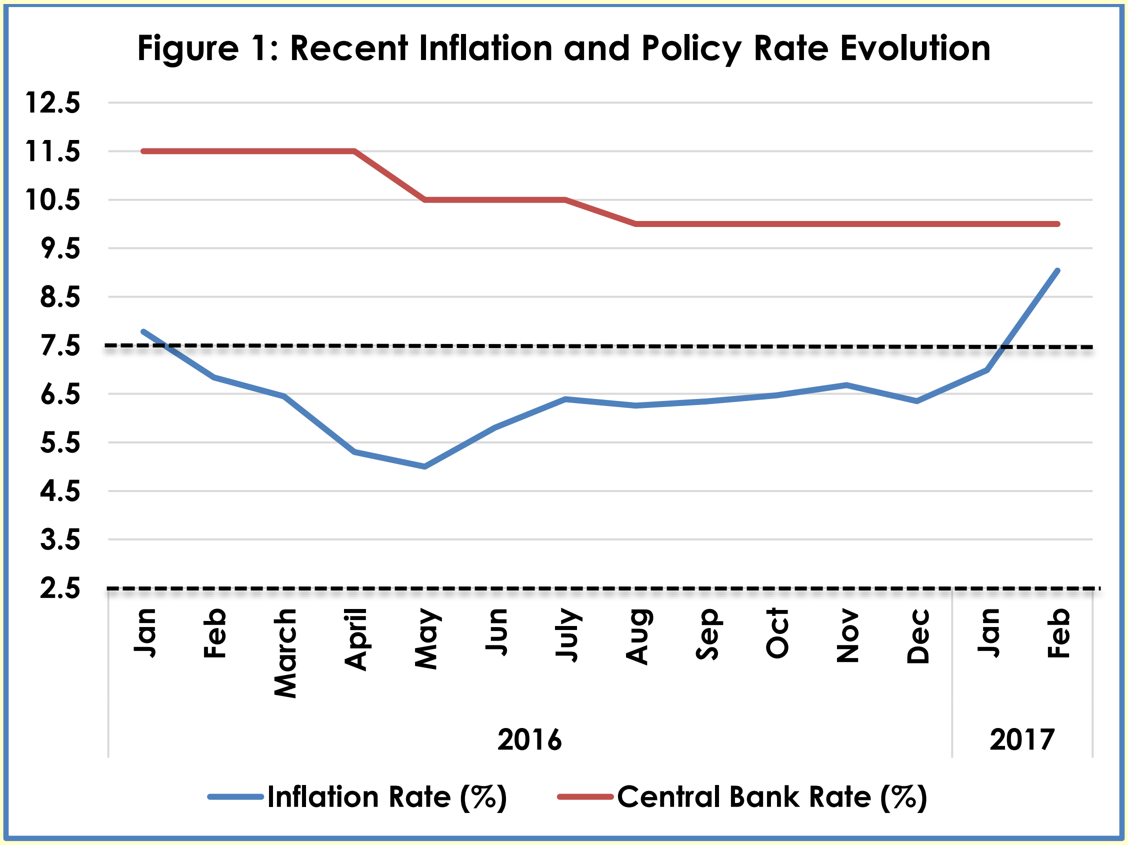
Highlights

- The decision by the Monetary Policy Committee, in its meeting of March 27, 2017, to maintain the CBR at 10.0 percent amidst the risks of inflationary pressure and substantial uncertainty at the local and international fronts is less about the need to offer relief to borrowers and more about a policy conundrum that is admitted only implicitly.
- To the extent that the MPC decision is based on the comfort that the core inflation is stable and therefore there is no basis for a change in policy stance given that demand pressure is muted, we argue that the Committee has turned a blind eye on what lessons recent history could offer. The dilemma though is that any change of stance towards tightening will stifle the economy that is already hit by declining credit to the private sector whose effect has been compounded by the capping of interest rates.
- Ultimately, the MPC has to confront the reality presented by the trilemma that it is impossible to have domestic monetary policy independence, control the exchange rates market instead of showing the policy influence through either demand or supply interventions, and have free capital flows; you can meet no more than two of these three objectives. The limits to its policy choices is evident in the sense that its apparent preference for rigidity both the money market prices and exchange rate must confront the reality of inflationary pressure. In the circumstances, something must give – if interest rates capping provided an incentive to let money market prices exceed the cap, and the monetary policy stance does not speak to the reality of inflation, then the exchange rate market must adjust.

Introduction

In its meeting of March 27, 2017, the Central Bank of Kenya's Monetary Policy Committee (MPC) came close to implicitly admiting the limits to monetary policy. The MPC retained the Central Bank Rate (CBR) at 10.0 percent onthe back of: (a) overall inflation being above the Government target, and the MPC forecasting that it will remain so in the medum term; (b) uncertainty – both local and international – abound; (c) the reality that interest rate capping law that came into effect September 2016 stand to compromise the effectiveness of monetary policy.

The monetary policy decision and the outlined underlying circustances begs the question: Are we living the Milton Freidman's 1968 moment[1]? Freidman said then that "Monetary Policy was a string. You can pull on it to stop inflation but you could not push on to halt a recesion". Not quite, we argue, when it comes to our recent inflation experience. Evidently, the monetary policy string cannot be pulled to stop inflation that has breached the 5 percent (**-/+**2.5 percetage points) target (**Figure 1**). And as we argue later though, like any string, monetary policy cannot be pushed to address imminent output growth challenges.



Source: KNBS; CBK

The MPC's argument for not changing the policy stance is that the hedline inflaiton is above target is predomitantly because of subtantial increases in food prices. In any case, contends the Committee, "the 3-months non-food-non-fuel inflation remained relatively stable, suggeting that demand pressures were muted".

[1]Firedman , Milton (1968), "The Role of Monetary Policy", *The American Economic Review*, Volume LVIII, No. 1, March. (https://wwz.unibas.ch/fileadmin/wwz/redaktion/witheo/lehre/2009_FS/vwl4/doc/chapter8/Friedman_AER1968.pdf)

We advance two lines of argument on why the MPC is confronted with a policy conundrum but wouldn't admit as much, at least not explicitly. Let's start by briefly examining the CBK's monetary policy objective of maintain a low and stable inflation rate over time as it is an indication of price stability. The target given to the central bank is the headline (overall) inflation and not core (non-food-non-fuel) inflation.

There is a compelling reason why the Central Bank of Kenya (CBK) is given a headline, and not a core, inflation target. It is simply because monetary policy of necessity has to connect the CBK with households and businesses who know price changes when they see them. In other words, households'most frequent visits to petrol station and grocery shops makes it hardly helpful for monetary policy credibililty if its stance appears to be based on a measure of prices movement that excludes items that form the essence of such visits.

But the MPC is clearly commited to the core inflation. Why is that the case? First, there is the argument that headline inflation is more volatile than core inflation and therefore if monetary policy reacts systematically to headline inflation the economy itself would become more volatile – an argument that has been refered to as "all hell would break loose".

Granted, headline inflation tends to be more volatile than a subset inflation measures that exclude the most volatile components. That by no means says anything about how policy should or should not react to movements in headline inflation. It is possible to have policy responses that appropriately take cognisance of the fact that price indices contain a certain level of volatility. In other words, the policy response can be optimized given the inflation index being targeted.

Second is the popular argument for focusing on core inflation is that it is a good and consistent predictor of future headline inflation[2]. The thrust of this argument is that it is normal for food and energy prices to push up headline inflation to levels well above its underlying trend and in contrast, core inflation tends to remain low and stable. In the circumstances, goers the argument, headline inflation tends to converge toward core inflation, thus high inflation is unlikely to persist as long as inflation expectations remain anchored.

This begs the question: How can inflation expectations be anchored when the headline inflation that is binding on households and businesses breaks away from the target? In our case, the answer, provided by the experience of the inflationary eposide of 2011/12 (**Figure 2**), is that they can't. The September 2011 – July 2012 period was characterised an inflationary trend that was erratic and on a clear upward trajectory; inflation outlook then was largely predicated upon food production and distribution, two aspects that are closely linked to weather (specifically floods that could potentially disrupt food production and distribution). Any inflation anchoring needs to be manifested in policy action. That policy action was then lacking.

The ensuing critique, prominently by an IMF research paper[3], was that the CBK was not quick to respond to the inflation surge of September 2010 to November 2011 and the policy reaction that came with a time lag entailed shocking the economy with a drastic monetary policy tightening of August 2011 to December 2011 – the Central Bank Rate (CBR) was over the short period hiked from 6.25 percent to 18.0 percent. This was truly when "all hell broke loose".

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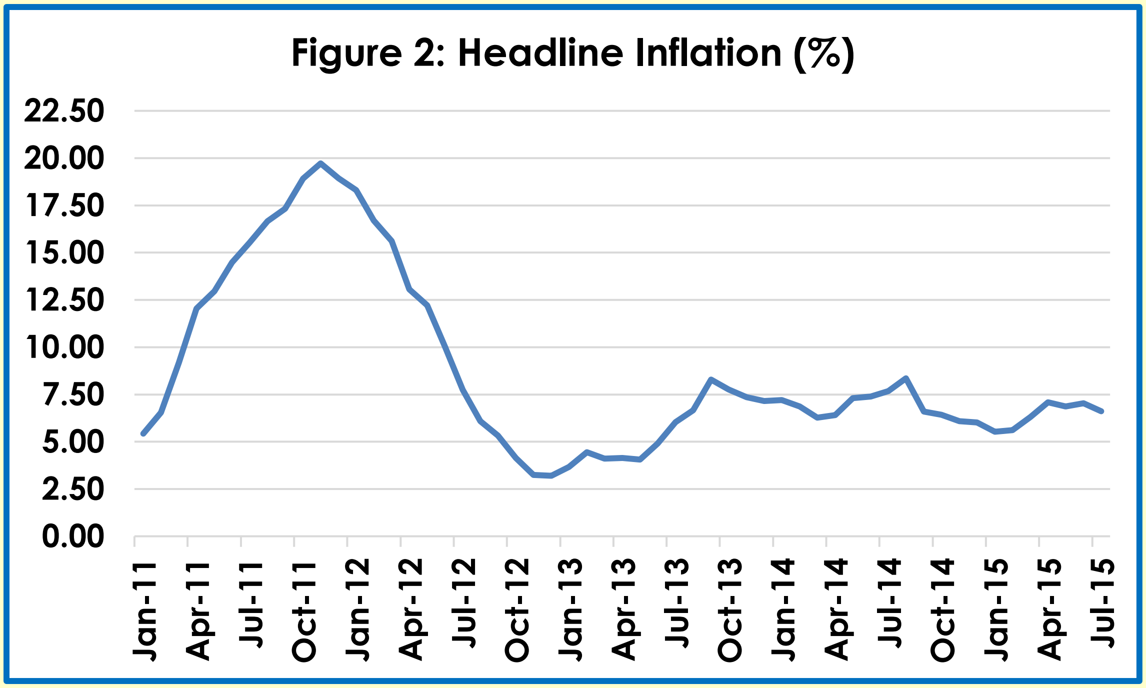
[2] See for instance Liu, Zheng and Weidner, Justin, (2011), "Does Headline Inflation Converge to Core?", *Federal Reserve Bank of San Francisco (FRBSF) Economic Letter*, August. (http://www.frbsf.org/economic-research/files/el2011-24.pdf)

[3] Andrle, Michal ; Berg, Andrew ; Morales, R. ; Portillo, Rafael ; and Vlcek, Jan (2013), "*Forecasting and Monetary Policy Analysis in Low-Income Countries: Food and non-Food Inflation in Kenya*", IMF Working Paper WP/13/61, March (https://assets.publishing.service.gov.uk/media/57a08a55ed915d3cfd0006ea/wp1361.pdf)



Source: KNBS

Has the MPC missed the lesson that maybe, as some could argue, "the core is rotten"[4]? The inflation climb-down from a high of 19.72 percent in November 2011 to 3.25 percent in November 2012 was accompanied a cautious policy approach – initially holding the CBR at 18.0 percent until July 2012 before the MPC took to an accommodative stance of easing the CBR to 16.5 percent and subsequently reducing it consistently to 8.5 percent by May 2013.

The period subsequent to May 2013 was interesting from a policy standpoint. For much of that period (precisely 2 years – between May 2013 and May 2015), the MPC didn't change its policy stance and held the CBR at 8.5 percent. It is easy to assume based on its public pronouncements that the MPC's view then was informed by a determination that inflation had been subdued. In any case it was within the target range and the IMF[5] was nearly on the verge of declaring victory in a broad context.

Therefore if the latest MPC decision is based on the comfort that the core inflation is stable and therefore there is no basis for a change in policy stance given that demand pressure is muted, then the Committee has turned a blind eye on what lessons recent history could offer. The dilemma though is that any change of stance towards tightening will stifle the economy that is already hit by declining credit to the private sector whose effect has been compounded by the capping of interest rates.

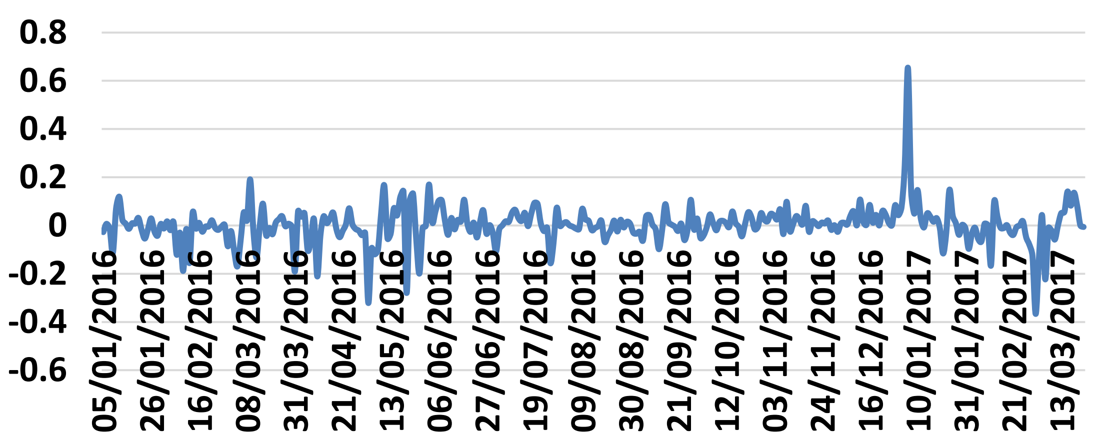
[4] Bullard James (2011), "Measuring Inflation: The Core Is Rotten", Federal Reserve Bank of st. Louis *Review*, July/August. (https://files.stlouisfed.org/files/htdocs/publications/review/11/07/bullard.pdf)
[5] IMF (2013), *"The Dog that Didn't Bark: Has Inflation Been Muzzled or was it Just Sleeping"*, Chapter 3 *World Economic Outlook – Hopes, Realities, Risks*, April

The Dilemma leading to a Trilemma - Mundell-Fleming's Indispensable Insights

While inflation is creeping upwards, the foreign exchange has remained stable (**Figures 3 and 4**). The MPC attributes the stability to the narrowing of the current account mainly due to low imports – even for plant and equipment meant to support the economy's productive capacity – but also by inflows from remittances, tourism and horticulture. The MPC also takes comfort in the adequacy of foreign exchange reserves as well as the Precautionary Arrangement with the IMF meant to provide a buffer against short-term shocks.

Figure 3: Nominal Exchange Rate

Figure 4: Nominal Exchange Rate Changes (KES/USD) - + (Depreciation; -(Appreciation)



Source: Central Bank of Kenya

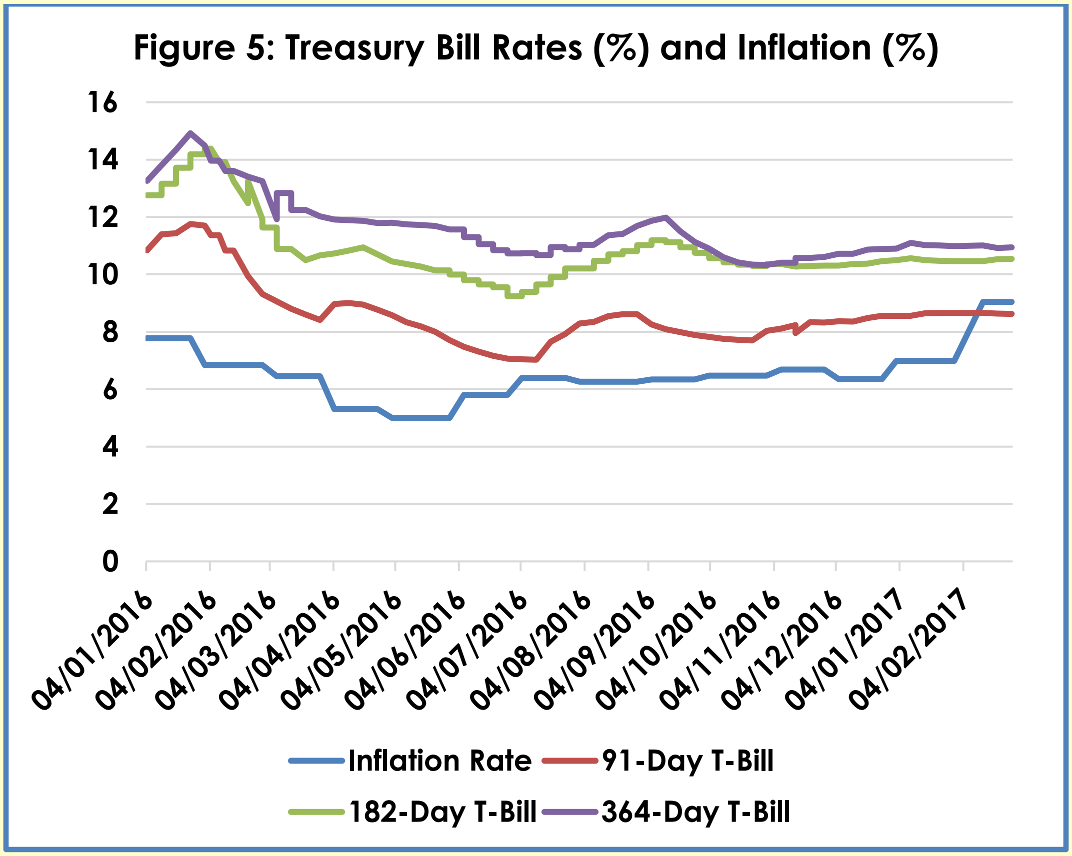
It is reasonable to assume that while there is stability in the foreign exchange market, the challenges that the capping of interest rates pose are limiting to the MPC's policy options of assuring broad stability. The stability that we note does not take away the fact that a manifestly flexible exchange rate should allow the exchange rate movement to provide the adjustment mechanism necessary for proper financial markets' functioning.

In other words the CBK must of necessity be committed to a flexible exchange rate such that it neither has a preferred level (or range) nor direction of adjustment as long as either direction is not characterised by volatility. This policy choice should be guided by the compelling thinking of economists Marcus Fleming and Robert Mundell who developed a model (the so-called Mundell-Fleming model of exchange rates) in 1962 which demonstrated that it is impossible to have domestic monetary policy independence, control the exchange rates market instead of showing the policy influence through either demand or supply interventions , and have free capital flows; you can meet no more than two of these three objectives – hence their findings being dubbed the "impossible trinity" or the "trilemma".

There is a challenge when you want to have all the three simultaneously, for the three are desirable but contradictory. If inflation is within the target range the CBK could seek to support growth by lowering the policy rates and the market rates follow in tandem, the ensuing resource outflow will but the currency under depreciation pressure that could be inflationary which will then force the MPC to take interest rates up again. If the policy choices is some level of control on the exchange rate and while money freely flow in and out of the economy, then that will be at the expense of having no control over interest rates (in other words no independent monetary policy).

If however the policy choice is some form of control on interest rate and almost limiting flexibility in the exchange rate, then the economy will have no control capital inflow and outflow. This is closer to what is prevailing in the economy at the moment. There are interest rate controls at two levels – one *de jure* (the capping of interest rates) and another implicit (imposed rigidity in the money market rates either in pursuit of fiscal sustainability sustenance or in an endeavour to obviate market distortions arising from risk-free rates being higher than the level of interest rate caps).

This portends another policy conundrum: inflationary pressure has seen the short-end of the money market move to the negative real interest territory (**Figure 5**). With inflation on the upward trend and not drawing any policy response on the one hand and a lid on interest rates on the other, it can only mean that pressure must come out somewhere. The pressure exit candidate is the foreign exchange market – which has no support that a tighter monetary policy could provide, and likely to be augmented by portfolio outflows is the negative interest rates regime becomes a norm.



The string can't be pushed

Even with the foregoing policy challenges, the decision by the MPC is in some quarters being positioned as relief for borrowers. This points to the limitations of having the CBR – a policy signalling rate that is operationalised using other market rates – as a base for capping interest rates. Noteworthy, the MPC's experiment of seeking to pursue an accommodative policy stance in September 2016[6] didn't achieve the stated purpose of spurring credit to the private sector, coming after the capping of interest rates and at a time when growth of such credit had been on a steady down trend. The subsequent MPC decisions have largely been a wait-and-see stances that have equally not seen the growth supporting intentions realised.

From close to 20 percent in January 2016, the growth of private sector credit has now "stabilized at 4.0 percent. The consequences on economic growth are obvious than many are willing to admit. According to a recent study[7], financial variables such as credit growth, stock prices and house prices have considerable predictive power for macroeconomic variables such as GDP. So credit trends are of no comfort even with a past attempted with a monetary policy support. House prices, according to the Kenya Bankers Association Housing Price Index are showing signs of softening, partly due to low credit expansion. Stock prices have taken a beating since August 2016 when the capping law was signed (**Figure 6**).

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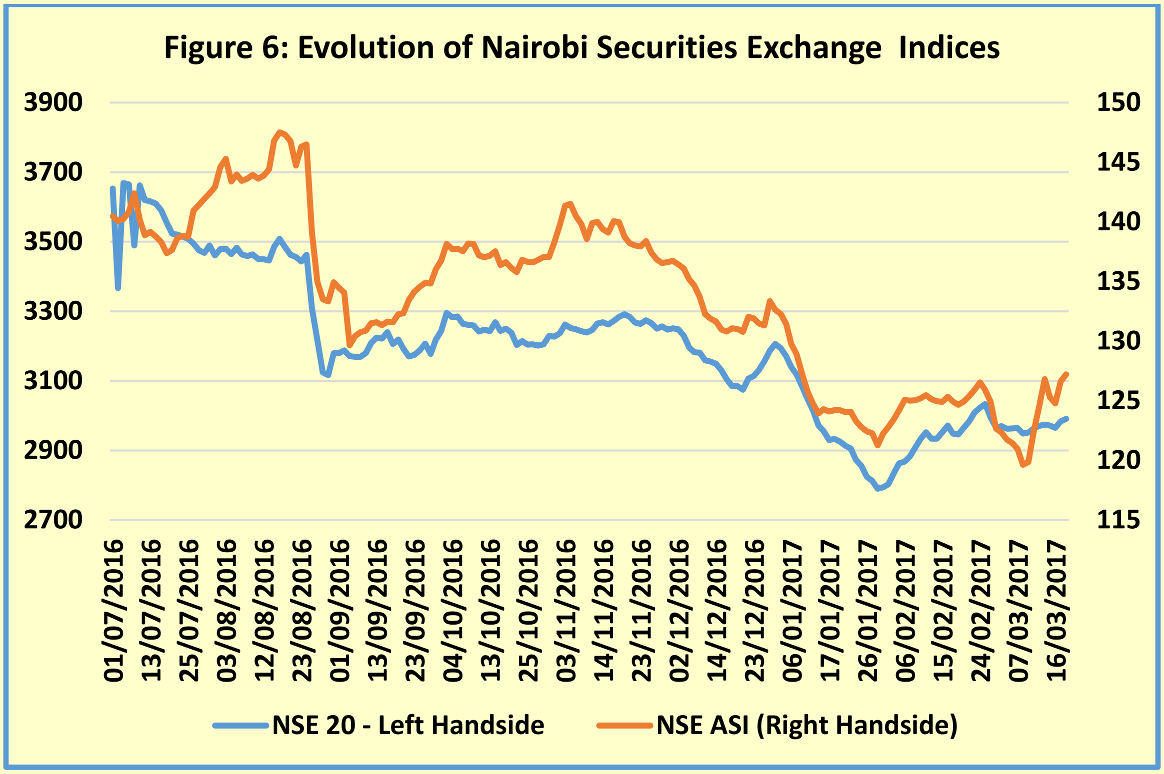
[6] See https://www.centralbank.go.ke/uploads/mpc_press_release/2012373677_MPC%20Press%20Release%20-%20Meeting%20of%20September%2020,%202016.pdf

[7] Chen, Sophia and Rachiere, Romain (2016), "Financial Information and Macroeconomic Forecasts", IMF Working Paper WP/16/251, December (https://www.imf.org/external/pubs/ft/wp/2016/wp16251.pdf)

So an accommodative monetary policy didn't help, and a tight one will make matters worse. For the MPC then, it is damned if you do, damned if you don't. The string just can't be pushed.



Source: NSE

Conclusion

We can surmise therefore that the MPC's decision to retain the CBR at 10.0 percent amidst the risks of inflationary pressure and substantial uncertainty at the local and international front is less about the need to offer relief to borrowers and more about policy conundrum that is admitted only implicitly.

To the extent that the MPC decision is based on the comfort that the core inflation is stable and therefore there is no basis for a change in policy stance given that demand pressure is muted, we argue that the Committee has turned a blind eye on what lessons recent history could offer. The dilemma though is that any change of stance towards tightening will stifle the economy that is already hit by declining credit to the private sector whose effect has been compounded by the capping of interest rates.

Ultimately, the MPC has to confront the reality presented by the trilemma that it is impossible to have domestic monetary policy independence, control the exchange rates market instead of showing the policy influence through either demand or supply interventions, and have free capital flows; you can meet no more than two of these three objectives. The limits to its policy choices is evident in the sense that its apparent preference for rigidity both the money market prices and exchange rate must confront the reality of inflationary pressure. In the circumstances, something must give – if interest rates capping provided an incentive to let money market prices exceed the cap, and the monetary policy stance does not speak to the reality if inflation, then the exchange rate market must adjust.

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