

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

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## Monetary Policy Stance: A Sort-of Pause Before Correction?

### 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) 8.5 percent in its July 9, 2013 meeting was justified by the argument that inflation is within the target range and previous decisions need time to work through the economy.
- 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 sustaining a recovery momentum and in the process narrowing the output gap – the difference between the economy's actual real growth level and its potential level. While that in itself has evidently not been a source of inflationary pressure, coming at a time of an accommodative monetary policy stance, it could be a strong pointer to the argument that monetary policy easing has completed running its course.
  - The feel-good- factor that prevailed in the foreign exchange market during the first quarter of 2013 is evidently waning as the reality of a weak external position creeps in. There is a limit beyond which good policy intentions and sentiments have to give way for weak fundamentals that will occasion the inevitable market correction in form of nominal exchange rate depreciation that we currently observe.
  - 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 in the narrow sense of the Eurozone challenges and their implication on the general price stability.
- We therefore observe that the decision by the MPC to hold the CBR at 8.5 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 MPC's 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.

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*"The MPC is a sympathetic evaluator of its policy achievements to the extent of blurring the articulation of its objective as well as its underlying framework. As a consequence, clarity on the monetary policy transmission mechanism is jeopardised".*

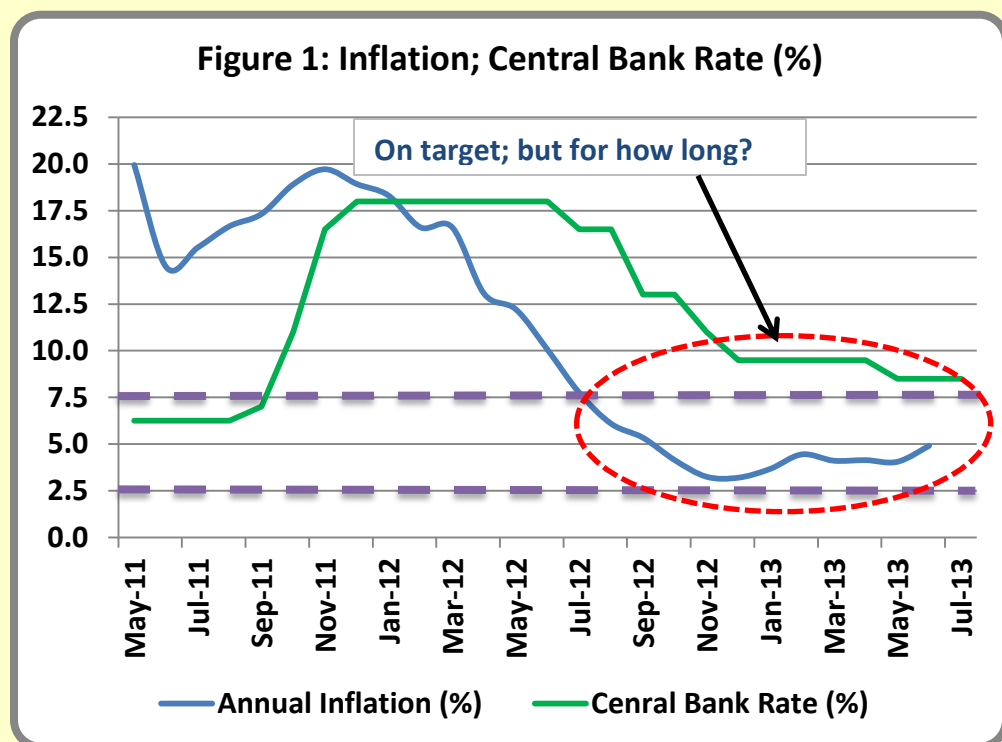
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## Introduction

When the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) decided to retain the Central Bank Rate (CBR) at 8.5 percent on account of providing time for its previous decisions to work through the economy, it sent out two signals – one explicitly and the other inadvertently.

The explicit signal is that the MPC decisions are meeting the policy objective. The inadvertent signal is that there are imperfections in the monetary policy transmission mechanism such that the effect of its decisions as would be manifested by market prices reaction – especially money market prices – are realised with a time 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 will argue that the scope for a further reduction in the CBR is clearly limited considering that inflation – much as it is within the target range – is now gradually turning the corner to assume an upward trajectory (**Figure 1**).



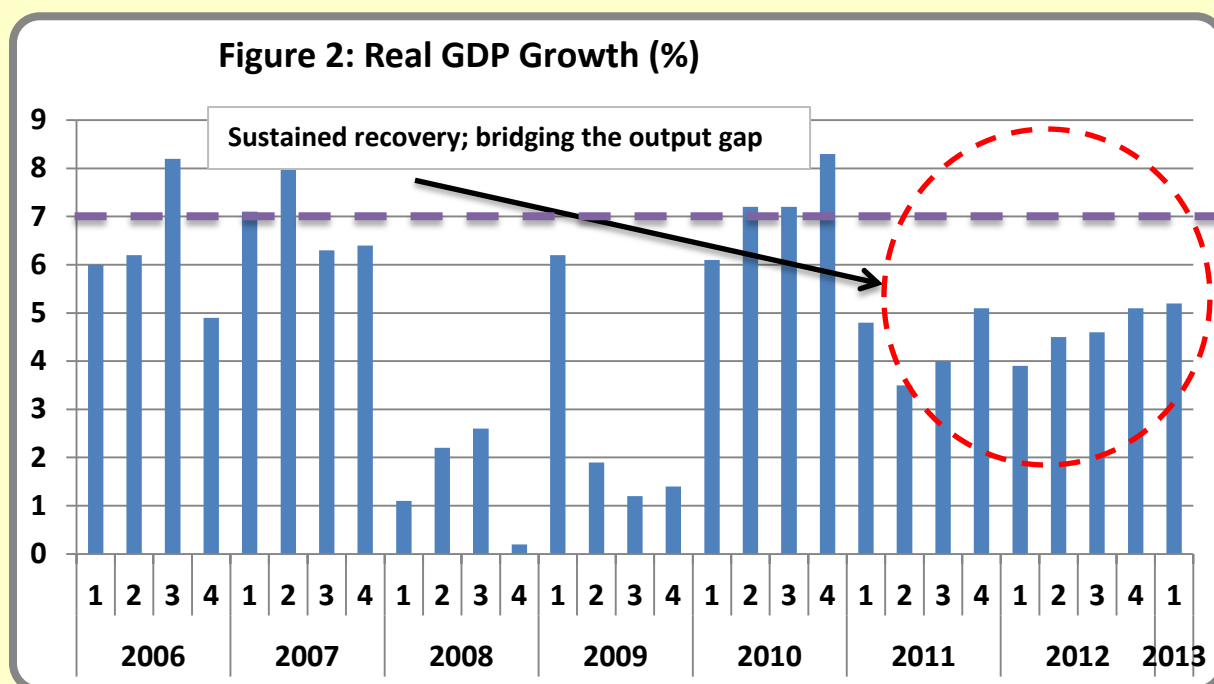
Source: CBK, Kenya National Bureau of Statistics

In addressing this question, this *Research Note* seeks to pursue a line of argument that highlights the observation that the MPC is a sympathetic evaluator of its policy achievements to the extent of blurring the articulation of its objective as well as its underlying framework. As a consequence, clarity on the monetary policy transmission mechanism is jeopardised.

## On Target - But for How Long?

As already observed, the MPC's latest decision hinges on the fact that inflation is on target. While it is a fact that inflation is within the 2.5 percent – 7.5 percent range, how that 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 noteworthy that the economy's growth is sustaining a recovery momentum (**Figure 2**) and in the process narrowing the output gap – the difference between the economy's actual real growth level and its potential level.



Source: Kenya National Bureau of Statistics

If we take the Government's 7.0 percent medium term real growth target as an approximation of the economy's potential output expansion rate, then the observed growth trajectory implies the dwindling output gap. While that in itself has evidently not been a source of inflationary pressure, coming at a time of an accommodative monetary policy stance, it could be a strong pointer to the argument that monetary policy easing has completed running its course.

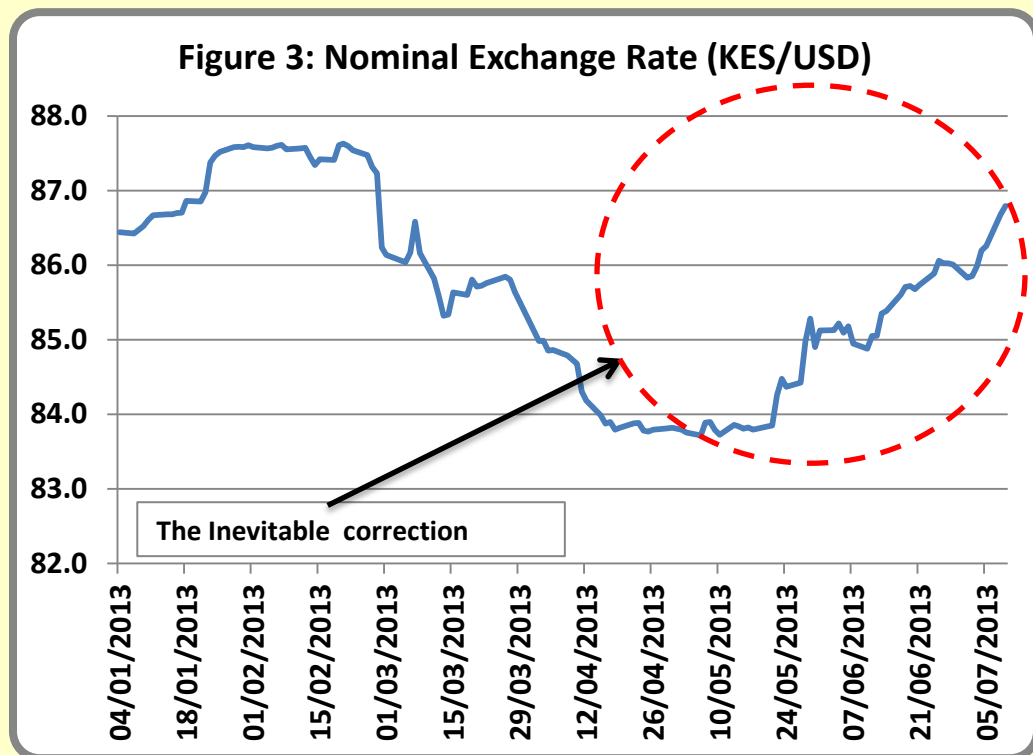
In any case, the growth momentum that has seen the economy register real growth of 5.2% during the first quarter of 2013 hardly implies sustained food abundance – where if the opposite scenario was to prevail, it would obviously be inflationary on account of the fact that the economy's growth may increase households' effective demand at a time of constrained food supply<sup>1</sup>.

Second, it is worth acknowledging that the feel-good-factor that prevailed in the foreign exchange market during the first quarter of 2013 is evidently waning as the reality of a weak external position creeps in. Then, we observed that the prevailing market confidence rested on three factors: one, the successful conclusion of the general elections in March 2013; two, the

<sup>1</sup> The inflationary pressure that persisted during the October 2010 – November 2011 was on the back of sustained economic growth whose momentum, as public expenditure (especially infrastructure development) fuelled household demand at a time of constrained food supply.

increase in the usable foreign exchange reserves significantly due to the USD 108.5 million disbursement by the International Monetary Fund (IMF) under the Extended Credit Facility (ECF); and three the CBK's foreign exchange market participation.

It is interesting that the MPC observes stability in the foreign exchange market, but only after looking at the nominal exchange rate in compartments! The MPC notes that the exchange rate fluctuation in May 2013 was in the KES 83.72 – KES 84.88 per US Dollar range and in June it was in the range of KES 85.29 – KES 86.06 per US Dollar. We argue that there is a limit beyond which good policy intentions and sentiments have to give way for weak fundamentals that will occasion the inevitable market correction in form of nominal exchange rate depreciation that is seen for the entire period (Figure 3).

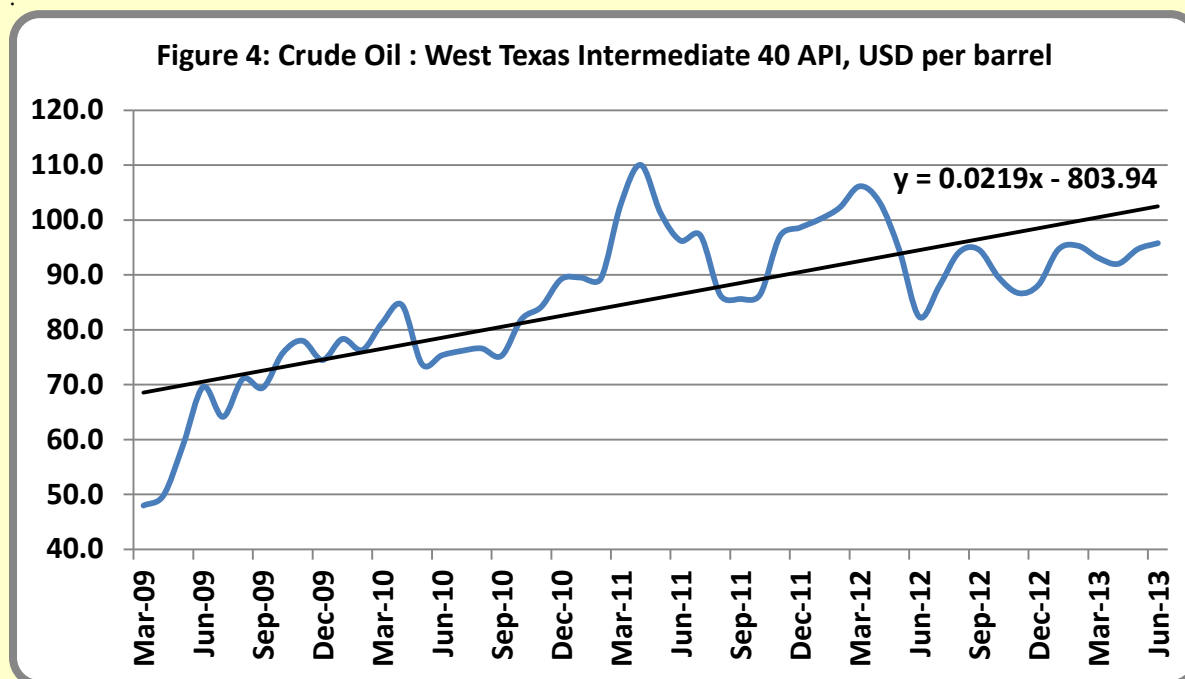


Third, the fact that the MPC bases its short-run stable inflation outlook on “declining international oil prices coupled with non-inflationary credit growth” is quite telling considering that it further observes that one of the key risks that have a bearing on the international oil prices is the instability in Middle East and North Africa (MENA). There is concurrence in the current analysis of the international oil market that a price of less than USD 100 per barrel may not be sustainable in the current circumstances.

We argue that while the international oil prices seem to have ebbed from a high of USD 110 per barrel and USD 106 per barrel in April 2011 and March 2012 respectively, the current circumstances may drive the market towards that level (Figure 4). One, the American Petroleum Institute recently reported a drop in supply by 9.4 million barrels per day. This decline, considered the biggest in more than 10 years, is assumed to have taken traders by surprise, triggering the sharp upside price breakout. The rapidly tightening supplies could mean the start of a long uptrend.

Two, the unrest in Egypt is the second key reason why crude oil prices are rising, with speculators fearing a disruption in supply because of the lack of stability in the region. The speculators are betting the political turmoil will lead to a disruption in the transportation of nearly 2.4 million barrels

per day of oil considering that Egypt, although a non-oil producer, is strategically located in the oil transportation corridor. The likely outcome of the oil market circumstances, coupled with our earlier observations on the foreign exchange market, paints a picture of Kenya's short run inflation outlook that far is from concurring with the MPC's sanguine conjecture.



Four, the global economic circumstances are far from rosy and the MPC seems to acknowledge that fact albeit in the narrow sense of the Eurozone challenges and their implication on the general price stability. We note that the IMF, in its post-April 2013 growth forecast undertaken in July 2013, trimmed its global output growth projections from 3.3 percent to 3.1 percent on account of not just the recession-struck Europe but also because of the emerging markets woes; this is the fifth time the IMF has reviewed downwards its global growth projections, pointing to the fact that the recovery momentum still remains feeble.

It didn't help that the US's Federal Reserve appears to have miscommunicated its policy intention by hinting at "tempering" its Quantitative Easing programme in the process prompting a sharp reaction from markets both in the developed and emerging economies that saw an upsurge in interest rates; its subsequent clarification didn't seem to result in a correction. It didn't help either that there is a drive by, among others, the Bank for International Development, for a monetary policy shift into a tightening stance in some economies that have not realised full entrenchment of recovery<sup>2</sup>.

These circumstances hint at the possibility of the benefits of reducing the level of domestic borrowing requirement in the 2013/14 fiscal year compared to the 2012/13 fiscal year in favour of a Eurobond – an aspect that MPC observes to be mitigating potential interest rates pressure – being adversely offset by the likely increase in the cost of such external borrowing. Furthermore, recent studies have been questioned by the suitability of the first time issuance of Eurobond to financing infrastructure projects in Africa<sup>3</sup>.

<sup>2</sup> See the 83rd *Bank for International Settlement Annual Report*; June 23, 2013; the IMF seems to be inclined towards an exact opposite view.

<sup>3</sup> See for instance IMF, 2013, *World Economic and Financial Surveys - Regional Economic Outlook: Sub-Saharan Africa*, May

Further, the 2013/14 fiscal programme is embedded with proliferation of tax proposals which, if enacted, will have inflationary implications. In particular, proposals regarding value added tax (VAT) on items that feature prominently in the consumer price index (CPI) basket has already drawn public backwash. The challenge is compounded by the wage demands amongst a section of the public service that is likely to put pressure on the Government wage bill, and consequently the overall fiscal position. It therefore remains to be seen whether a reduction in domestic borrowing requirement will be realised.

### 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 continue to monitor the outcome of the key macroeconomic aggregates, implementation of the new fiscal programme as well as any emergent risks to ensure that the policy stance continues to deliver price stability".

It is clear that the CBK cannot commit to future policy – and nobody expects it to. All it can do is signal its character given the inherent difficulty in momentary 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 give-away 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<sup>4</sup>. 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.

In the East African region, particularly in Kenya and Uganda, where the conduct of monetary policy has been undergoing some fine-tuning, the CBK's monetary policy framework contrasts that of the Bank of Uganda (BOU) in some significant manner. In July 2011, the BoU adopted an inflation targeting "lite" monetary policy framework, in which the BoU announces publically a policy interest rate every month to signal the monetary policy stance. The framework is forward looking, with the policy rate set on the basis of a forecast of inflation intended to anchor expectations. The BOU includes its inflation forecast for the next one to one and half years in its monetary policy statement.

With the kind of leeway that the CBK has inculcated in its framework, it is not clear whether it is the signalling rate – the CBR – that the market should keenly watch or it is some measure of money supply; indeed, even with the MPC clearly basing its policy signalling on the CBR it indicates, for instance in its *10<sup>th</sup> Bi-Annual Report*, that the CBK has adopted "a monetary policy framework that targets money supply on a quarterly basis".

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 target towards either reflecting demand or investment impetus. All this points towards conclusions by recent studies that

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<sup>4</sup> See Kenya Bankers Association Centre For Research on Financial Markets, 2013, *Policy Research Note 2* (RN/2/13), May

even when central banks in low income countries are declaring monetary policy victories, there is a dire need of streamlining policy conducts, for enhancing the effectiveness of monetary policy in such countries is a critical challenge<sup>5</sup>. 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 reflection 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 8.5 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.

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<sup>5</sup> 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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