RESEARCH NOTE NO.24. – 2016 (RN/24/16)

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

May 24, 2016

Monetary Policy Stance: The Delicate Balancing Act Packaged As Victory Signal

Highlights

- The evidence before the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) that informed its May 23rd 2016 decision to lower the Central Bank Rate (CBR) by 100 basis points from 11.50 percent to 10.50 percent rate can be summarised as follows:
  - First, inflation expectations are well anchored;
  - Second, broadly the financial markets are stable as manifested in the key prices of interest rate and exchange;
  - Thirdly, and as could be indirectly inferred, the performance of the real economy reflecting a trending in the right direction, albeit modestly.
- This *Research Note* weighs the MPC's balance between a quick declarations of victory thus resume an accommodative monetary policy on one end and the inclination to remain cautious as could be signalled by the holding of the rate on the other. Under normal circumstances, it is easy to see scope for policy easing. We argue that circumstances have not entirely normalised, notwithstanding the evident gains. That is why a quick declaration of policy victory should have given way for caution.

Introduction

The evidence before the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) that informed its May 23rd 2016 decision to lower the Central Bank Rate (CBR) by 100 basis points from 11.50 percent to 10.50 percent rate can be summarised as follows: First, inflation expectations are well anchored; second, broadly the financial markets are stable as manifested in the key prices of interest rate and exchange; thirdly and as could be indirect inferred, the performance of the real economy reflecting a trending in the right direction, albeit modestly.

Based on the consideration of these factors, the MPC's view is simply that the traction of its previous decision is manifest in the market stability and should thus be reinforced by CBR reduction so as to push the economy forward. Granted, the explicit mandate of the MPC is stability; but stability is not an end in itself for it is meant to underpin sustainable real output growth.

The dual-directional feedback where growth supports supply and thus leads to abatement of inflationary pressure arising from supply-constraint on the one hand and stability providing a platform for forward investment planning and therefore embedding growth on the other hand are implicitly at play in the MPC decision. That is why the MPC arrives at the conclusion that "there is space for easing of monetary policy while continuing to anchor inflation expectations".

This *Research Note* seeks to weigh the MPC's balance between a quick declarations of victory thus resume an accommodative monetary policy on one end and the inclination to remain cautious as could be signalled by the holding of the rate on the other. This will entail a careful examination of the evidence basic the decision, contrasting it with the timing of the adoption of the tight stance (June 2015 and then July 2015) and the subsequent retention of the CBR at 11.50 percent for 10 consecutive months.

We argue that the MPC's communique provides an argument that leans towards optimism that supports the new stance. That it explicitly acknowledges only one major risk (the ever softening global economic performance) while at the same time discounting its potential effect on the economy (seeing better prospects for Kenya's exports, as its trading partners are expected to remain robust) cements that optimism. Admittedly, this is a gross understatement of that risk.

We further argue that the noticeable progress in the restoring of confidence in the banking system while critical needs support beyond surveillance. The weaknesses in – indeed the segmentation of – the interbank market is one area that necessitates a multiple policy interventions. The scope of monetary policy accommodation that the MPC determined could well be underpinned by implicit assumption of normal circumstances where the key risk should be any circumstance that stands to set loose the inflation expectations anchor; but that could be a limiting assumption.

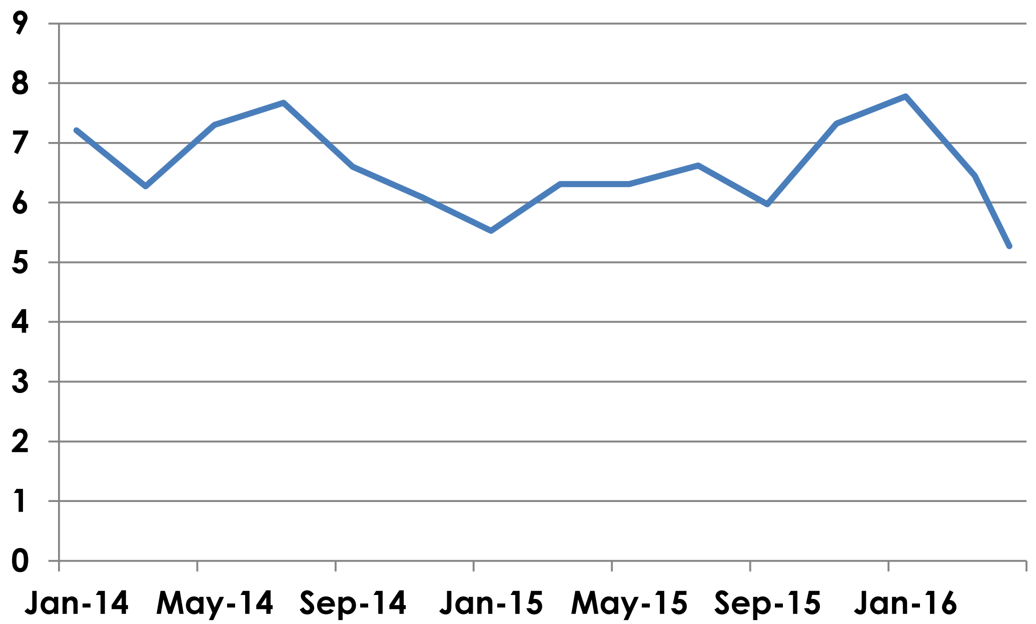
Inflation: "We told you so"!

It is clear that inflation has reverted to the target range, declining from a peak of 7.8 percent in January to 5.3 percent in April 2016 (Figure 1). As we previously argued[1], the MPC's previous decision hinted at its inflation forecast through its indication that the inflationary pressure would dissipate by April. That inflation has taken the observed trend is somewhat a vindication of the MPC's short-term outlook.

[1] See *KBA Centre for Research on Financial Markets and Policy (2016); Research Note No. 22 – 2016 (RN. No.22/2016.* [http://www.kba.co.ke/images/stories/rn%20no%201%202016.pdf]

Part of the account for the decline is the reduction in food and fuel prices, and part of it is attributable to easing of the non-food-non-fuel components of the Consumer Price Index (CPI) – therefore signalling limited demand pressure. While the latter characteristic is pointer to the adoption of the tight monetary policy stance in the second half of 2015 gaining traction, we later contend that the easing of policy may mean a declaration of quick victory on the part of the MPC.

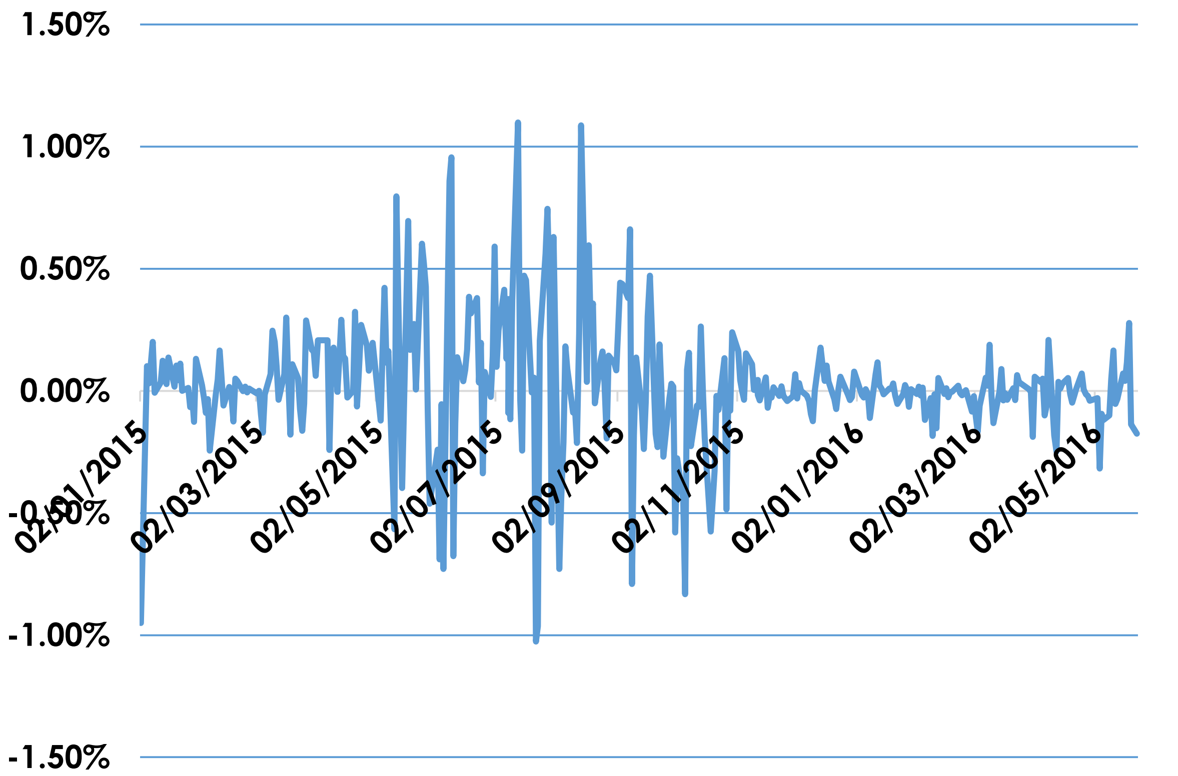
Figure 1: Rate of Inflation (%)



Source: Kenya National Bureau of Statistics

The domestic circumstances have undoubtedly supported the inflation outcome. Equally important though has been the eventual stabilisation of the foreign exchange market (see Figure 2 for the period from late **November 2015**). This has led to the substantial realisation of the benefits of low international oil prices, a situation hitherto compromised by foreign exchange instability on the back of a general depreciation (Figure 2 before **November 2015**). The MPC takes the comfort in the amount of foreign currency reserves, equivalent of 5 months of import cover (USD7.7 billion) as at the end of April 2016 compared to 4.7 months of import cover (USD 7.3 billion) as at the end of March 2016.

Figure 2: Nominal Exchange Rate Movement (USD/KES)



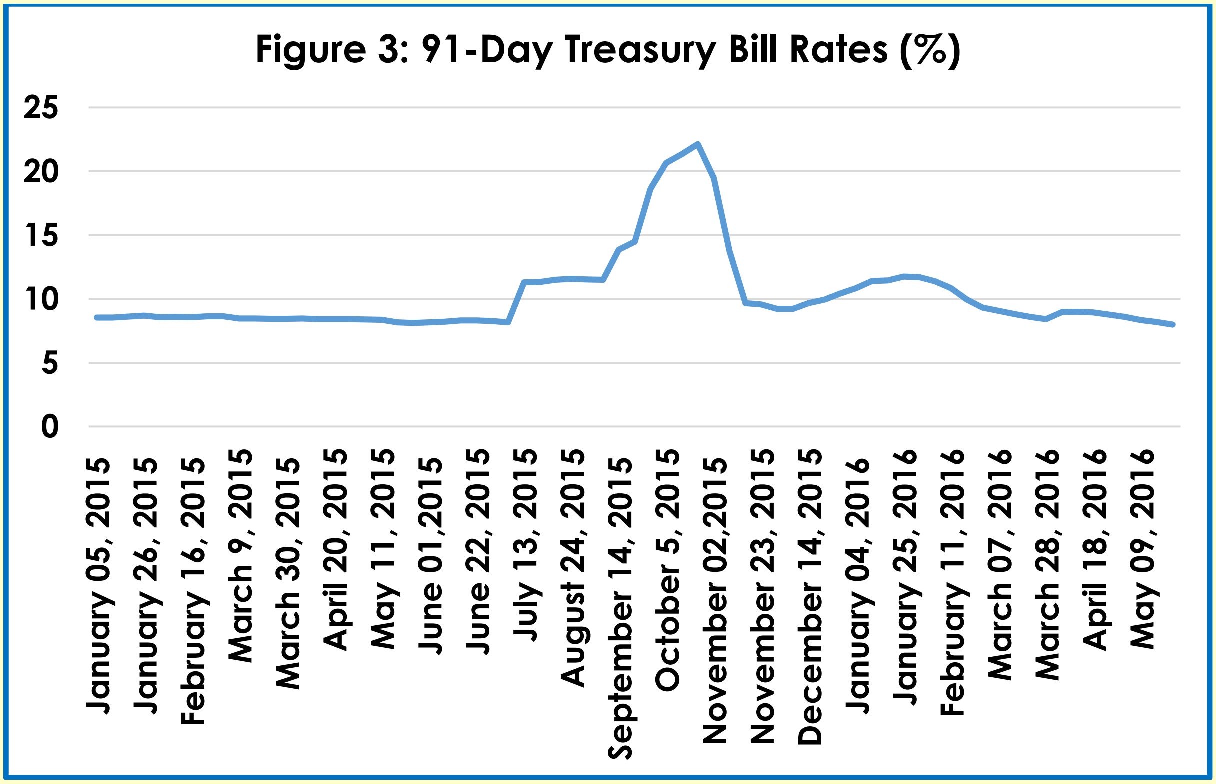
Source: Central Bank of Kenya

Dark Corners

There is some degree of resemblance of a tranquil money market similar to the broader stability seen in the declining of inflation towards the 5 percent target and a calm foreign exchange market. Subsequent to the turbulent September – October 2015 when the Treasury Bill rates spiked in response to government resource needs on the back of missed revenue targeted, the market is much calmer now (**Figure 3**).

The MPC is sanguine that that the monetary and fiscal policies are now in harmony. The MPC is optimistic too that the government fiscal deficit can only narrow in the 2015/16 fiscal year, and consequently ease pressure on interest rates. The chemistry between the two arms of macro policy may be portraying a sense of synchrony; nonetheless there are pointers to a dark corner on the fiscal front.

The fiscal year 2015/16 fiscal year was based on an unrealistically ambitious real GDP growth of nearly 7 percent. The real growth of 5.6 percent for 2015, which the MPC describes as strong, is a signal that the revenue base for the expected narrowing budget deficit is severely constrained; if any confirmation was needed of such constraint then the Kenya Revenue Authority provides in its serially missing revenue targets. This puts the burden of narrowing the budget deficit, and therefore support MPC's expectations, on expenditure reduction; how heavy that burned is depends on whether there is meaningful scope to cut expenditure during the budgeting cycle the combines with the general election year.



Source: Central Bank of Kenya

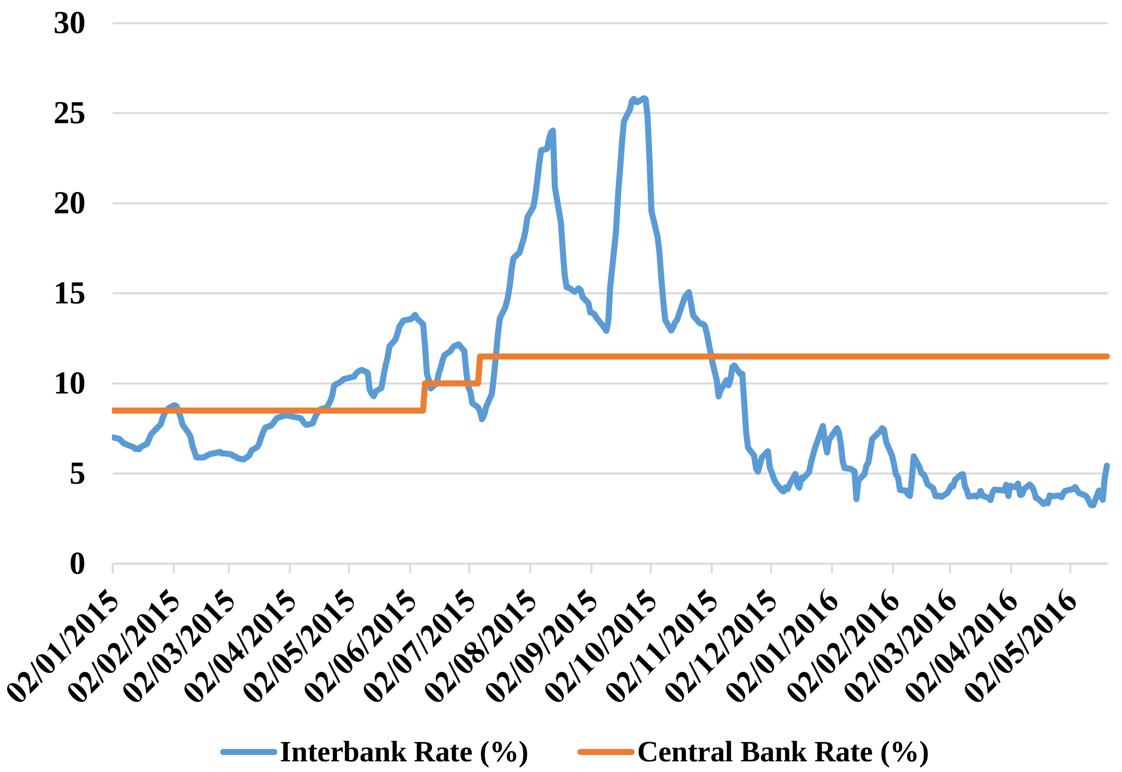
The other possible dark corner where danger of money market instability could loom from is the assumption that the evident enhanced confidence in the banking sector with the quick re-opening of Chase Bank and more stringent enforcement of asset classification that has led to gross non-performing loans being 8.2 percent in April 2016 being seen as quick road to full confidence. Even the MPC reckons that such assumption is far-fetched. As the MPC acknowledges, liquidity risks abound in the financial system.

With that acknowledgement, the CBK in April 11th 2016 introduced a liquidity support framework for commercial and microfinance banks that comes under liquidity pressures arising from no fault "of their own" and will avail the facility "for as long as is necessary to return stability and confidence to the financial sector".

That the CBK has opened this liquidity window speaks to good economics on the part of the lender-of last resort. That economics sees an inter-bank market characterised by banks with surplus liquidity having market power while illiquid banks have weak outside options that allow surplus banks to ration lending to them (see **Figure 4** for evidence of the challenges of the interbank market). This is a sign of an inefficient inter-bank market and the CBK's decision on liquidity is meant to ameliorate this inefficiency[2].

[2] See Walther Ansgar (2016), Joint Optimal Regulation of Bank Capital and Liquidity, *Journal of Money Credit and Banking,* Vol 48, No. 2-3; pp.415 – 448.March – April.

Figure 4: The Inter-bank Market Dillema



Source: Central Bank of Kenya

The sharp decline in the interbank rate subsequent to Dubai Bank and Imperial Bank being out under receivership in August 14th 2015 and October 13th 2015 respectively is not a reflection of liquidity abundance but a sign of flight from a segment of the market that is liquidity constrained. That is why the interbank rate has drifted away from the CBR. By the time Chase Bank was put under a one year receivership in April 7th 2016, the interbank market was at its ebb and the CBK liquidity to address the market confidence challenge. This begs the question: is a liquidity framework the only policy lever?

A cautious argument can be made that monetary policy could have a peripheral role; that role is not necessarily to adjust the policy rate towards where the inter-bank rate is stuck[3]. As widely accepted, monetary policy is an imprecise tool, even an inappropriate one, for addressing financial stability issues. That is not to say it should lend a hand by temporarily remaining higher than price stability objectives necessitate. It could lend such hand if costs are smaller than benefits.

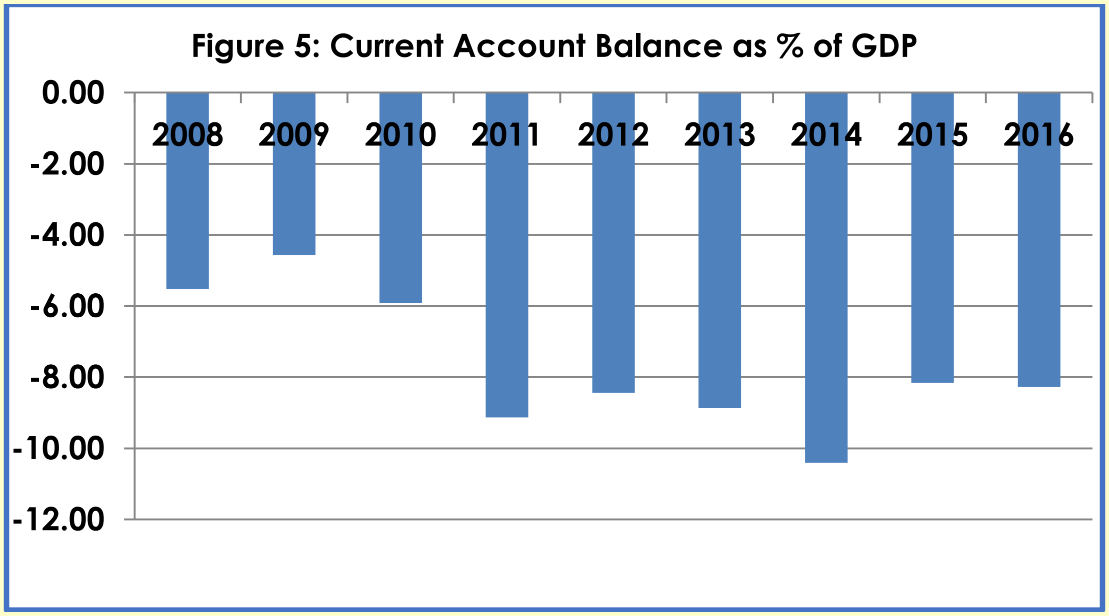
Costs, often short term, arise in the form of lower output and inflation. Benefits materialize mainly in the medium term, as financial risks are mitigated, though effects are more uncertain. While this by no means calls for a hawkish stance in our case, it similarly doesn't necessarily make a near activist stance any better. The two potential dark corners we highlight point to the possibility of the MPC declaring "mission accomplished" a bit soon in the move towards an emphatic accommodative monetary policy. In any case, given the observed sipke in non-performing loans, the monetary policy accomodation is unlikely to trigger credit expansion as both lenders and borrowers have heightened levels of caution.

---

[3] See IMF 2015, *Monetary Policy and Financial Stability*, Staff Report, September. [http://www.imf.org/external/np/pp/eng/2015/082815a.pdf]

External Position: “Danger from Abroad? Which Danger?”

As earlier pointed out, MPC explicitly takes cognisance of the weaknesses on the global economic front. Weakness are evident not just in the advanced economies, but also in emerging market economies that have strong linkages to Kenya. That the MPC anticipates strong performance in Kenya’s major regional trading partners even amidst the global weakness is the basis of the expectations that the current account deficit will continue to narrow, a view shared with projections from, for instance, the IMF (**Figure 5**). The only problem with the view though is that even those regional trading partners are not projected to do that well. Growth weakened markedly in Sub-Saharan Africa in 2015, to 3.5 percent – the lowest level in 15 years. The slowdown is expected to continue into 2016, with the IMF projecting a 3.0 percent—roughly half the rate Africa has grown accustomed to.



Source: IMF World Economic Outlook Database; 2016 figures are projected

Conclusion

The evidence before the CBK’s MPC that informed its May 23rd 2016 decision to lower the CBR by 100 basis points from 11.50 percent to 10.50 percent can be summarised as follows:

- First, inflation expectations are well anchored;
- Second, broadly the financial markets are stable as manifested in the key prices of interest rate and exchange;
- Thirdly and as could be indirectly inferred, the performance of the real economy reflecting a trending in the right direction, albeit modestly.

We weigh the MPC’s balance between a quick declarations of victory thus resume an accommodative monetary policy on one end and the inclination to remain cautious as could be signalled by the holding of the rate on the other. Under normal circumstances, it is easy to see scope for policy easing. The circumstances have not entirely normalised, notwithstanding the evident gains. That is why a quick declaration of policy victory should have given way for caution.

This *Research Note* is a publication of the Kenya Bankers Association Centre for Research on Financial Markets and Policy®. The Centre was established by the Kenya Bankers Association in 2012 to offer an array of research, commentary, and initiate dialogue on critical policy matters that impact the financial sector. Through these activities, the Centre acts as a platform for intellectual engagement between experts on financial markets, banking industry players and policy makers.

Comments on this *Research Note* can be forwarded to the Centre's Director at research@kba.co.ke or josoro@kba.co.ke