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Monetary Policy Stance: Accommodative Bias; Choked Transmission

Highlights

- The decision by the MPC to lower the CBR by 25 basis points to 7.0 percent during its meeting of April 29, 2020 sends the signal that in the circumstances, monetary policy ought to remain – appropriately so – accommodative. Even then, the simultaneity of the economic challenges arising from demand and supply conditions experiencing a "sudden-stop" type of scenario portends a dilemma. Contrary to the popular commentary that a lower CBR amounts to "cheap loans" and therefore more credit demand, the broadly volatile and uncertain environment works towards choking the transmission mechanism.
- The overall stable macroeconomic environment masks a mixed picture that presents a paradox. Inflation is within target and in the MPC's assessment inflation expectations remain well anchored. The MPC is evidently taking comfort in the fact that "demand pressures are expected to remain muted". The essence of a simultaneously accommodative monetary and fiscal policies is to boost demand at household and enterprise level in view of the disruptions in the labour market as well as other markets. *This begs the question: is the projected muted demand an indictment of both policies or is it a pointer to the complexities that come with trying to address a non-conventional problem with conventional tools?*
- Ultimately, with the plethora of downside risks resulting in a sharp downward revision in projected output growth, the challenge of closing the negative output gap – the difference between actual growth and potential growth – remains enormous.

Introduction

The Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) sustained its accommodative stance by lowering the Central Bank Rate (CBR) by 25 basis points to 7.0 percent during its meeting of April 29, 2020. While the lowering of the CBK is less aggressive compared to the 100 basis points reduction in March 2020 that was also accompanied by the lowering of the Cash Reserve Ration (CRR) from 5.25 percent to 4.25 percent, it sends the signal that in the circumstances, monetary policy ought to remain – appropriately so – accommodative.

In the MPC's assessment, the decisions of March 2020 "continue to be transmitted through the economy". So, the further reduction in the CBR could be seen as additional "sugar" that comes as new set of information point to a directional – not magnitude – consensus that the economy's growth will take a hit.

Any assessment of the sufficiency or lack thereof of this policy move needs to be seen in the context that while monetary policy is agile – and the decision by the MPC to be meeting monthly during the pandemic reflects that agility – it can only be complementary. As this *Research Note* argues, there are many moving parts and players who unavoidably need to be in synch. With that comes the apparent challenge of synchronizing many actors in the face of complex policy trade-offs.

Chocking

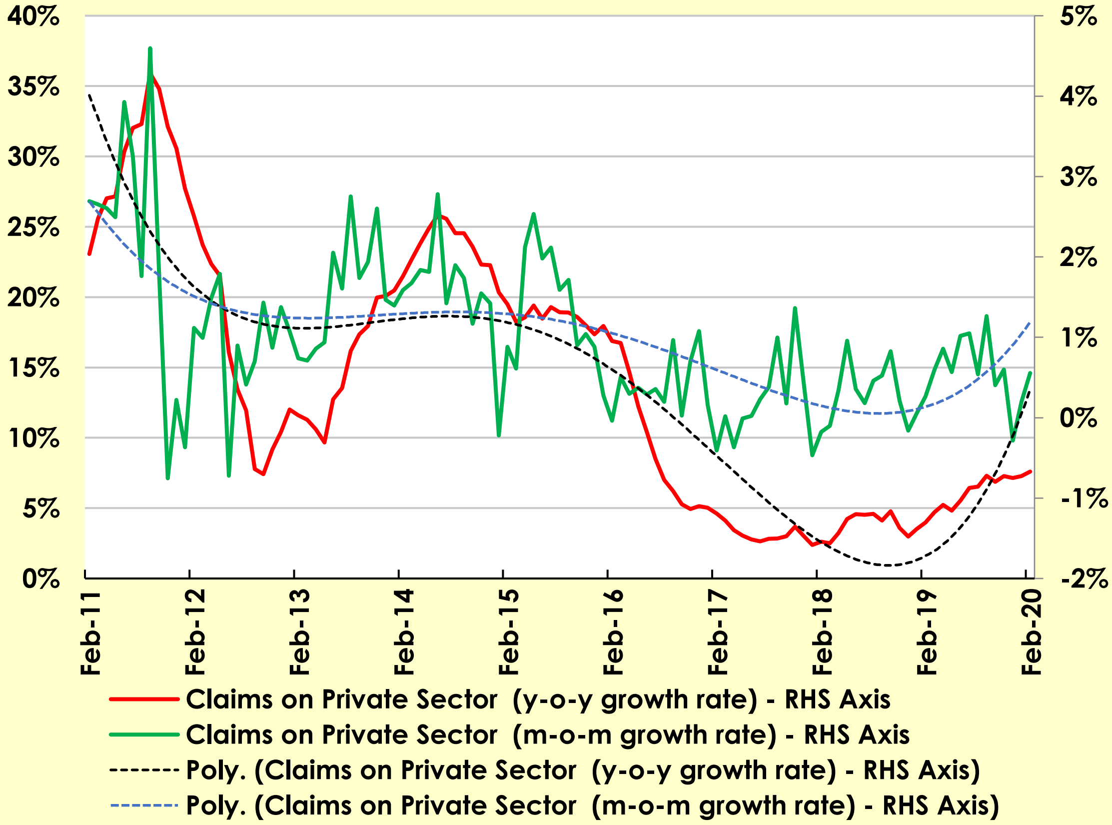
If the limitations of monetary policy – acting on its own – are acknowledged, implying therefore that it is only effective at the margins, then the fiscal policy move should be seen as an important lever. The MPC estimates the fiscal impulse from the accommodative measures by the government so far at an equivalent of 2 percent of the economy's output in the fiscal year 2019/20. Even with the double injection, the projected economic downturn points to three notable, but not necessarily obvious, aspects that this *Note* highlights.

- One, the simultaneity of the economic challenges arising from demand and supply conditions experiencing a "sudden-stop" type of scenario portends a dilemma. Contrary to the popular commentary that a lower CBR amounts to "cheap loans" and therefore more credit demand, the broadly volatile and uncertain environment works towards choking the transmission mechanism.

  When the levels of Non-Performing Loans (NPLs) remain elevated – and projected to rise, asset quality tends to override the urge for new asset creation. The MPC attributes the marginal reduction of NPLs as a share of gross loans from 12.7 percent in February 2020 to 12.5 percent in March 2020 to "strong growth in loans relative to NPLs). We contextualize this as an argument about relativity, not necessarily a signal that demand for credit is on a rebound.

The 8.9 percent growth in credit to the private over a 12 months period to March 2020 while commendable given the recent history (see **Figure 1**) is still a lagging indicator. The Month-on-Month credit growth numbers that swing from positive to negative and back, and that has largely been seen in the past three years in the -1 percent to 1 percent range reflects the swings that uncertainty – whether policy or economic circumstances – will remain a significant influence on credit provision and uptake going forward.

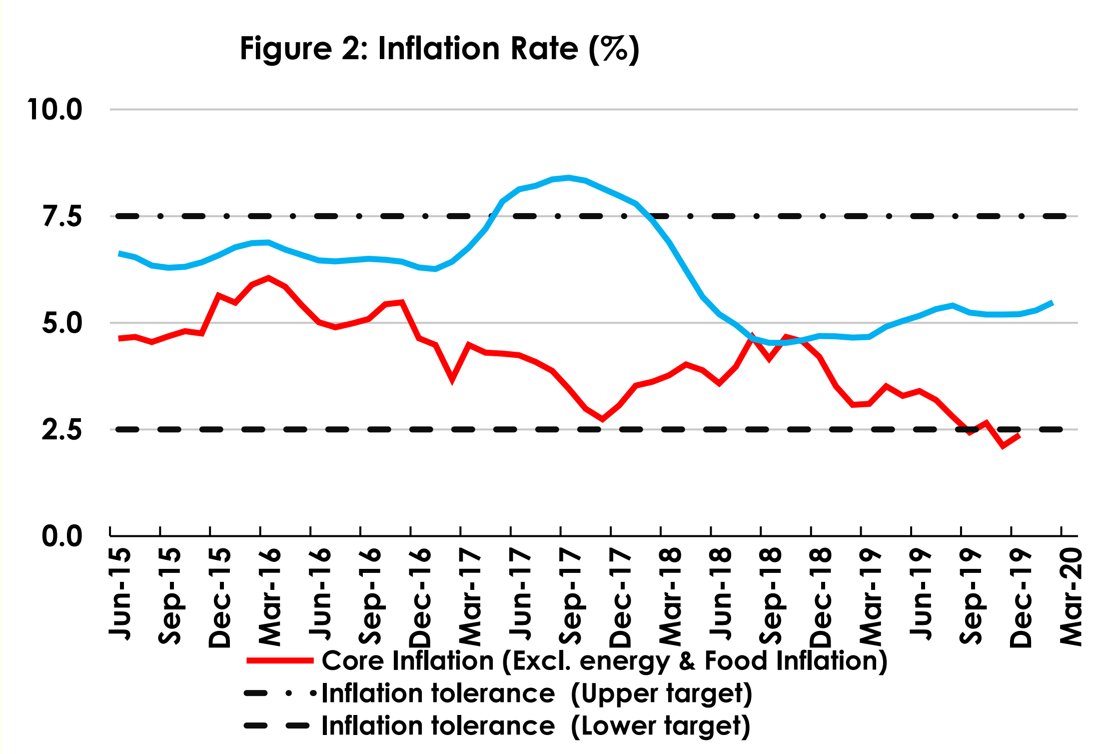
Figure 1. Private sector credit and growth rate (% change)



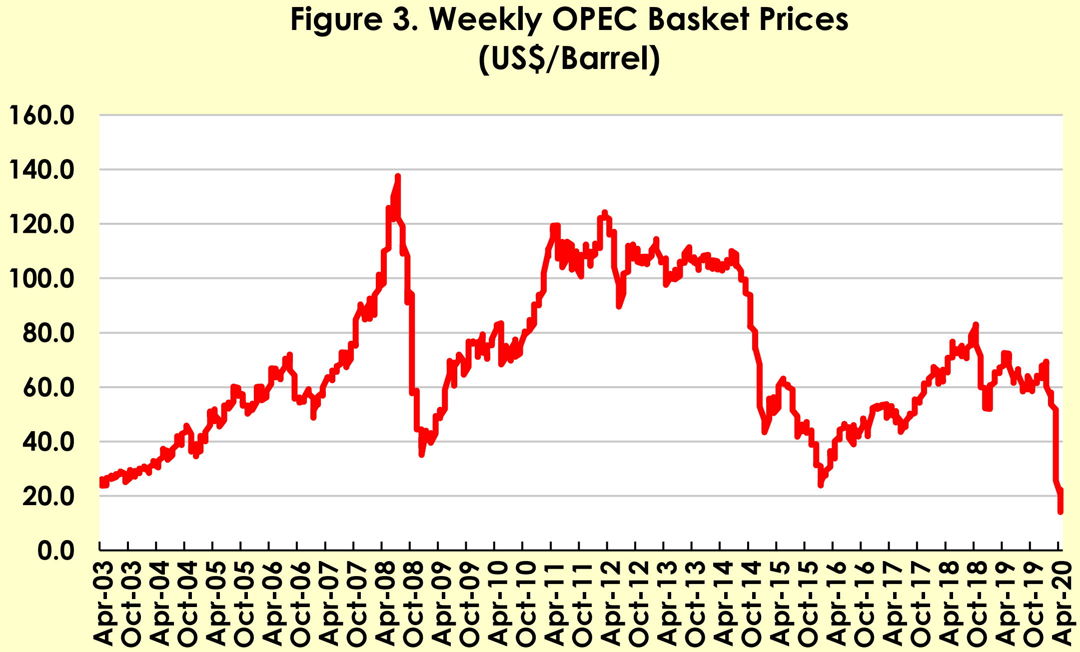
Source: CBK

- Two, the overall macroeconomic stability picture is mixed. One the one hand, overall inflation remains within the target range (see **Figure 2**) and in the assessment of the MPC is a representation of its well-anchored inflation expectations. This is largely attributable to domestic conditions as well as the low international oil prices (see **Figure 3**). The MPC is evidently taking comfort in the fact that "demand pressures are expected to remain muted".

  This arguably presents a paradox. The essence of a simultaneously accommodative monetary and fiscal policies is to boost demand at the household and enterprise-level in view of the disruptions in the labour market as well as other markets. *This begs the question: is the projected muted demand an indictment of both policies, or is it a pointer to the complexities that come with trying to address a non-conventional problem with conventional tools?*



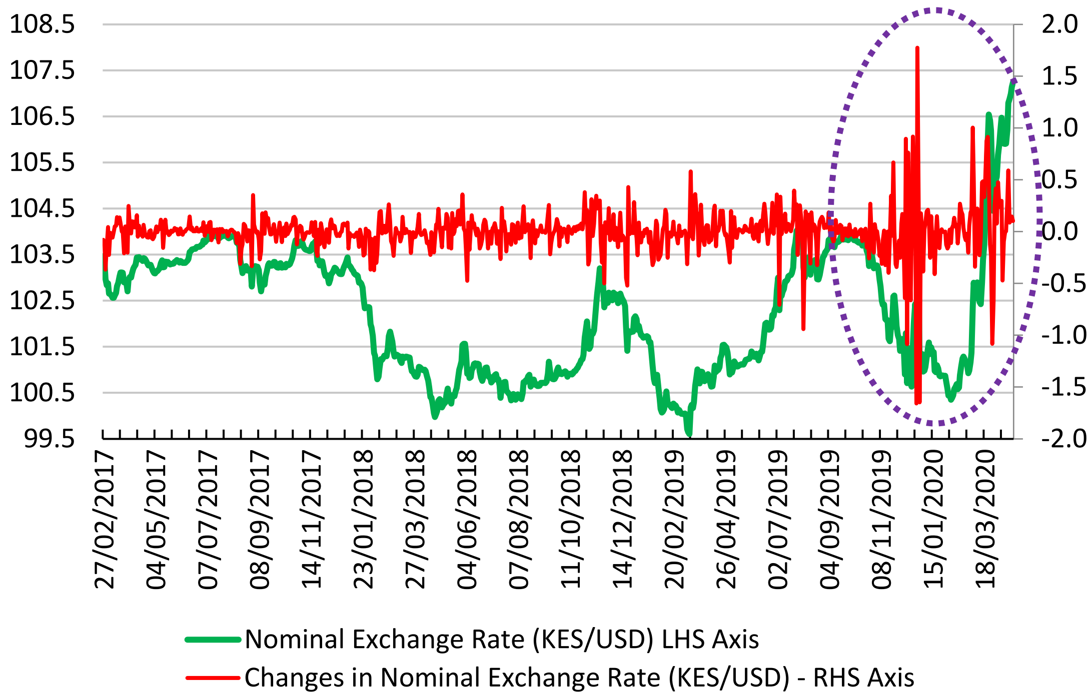
Source: CBK



Source: OPEC

On the other hand, the exchange rate – a relative price – depicts a foreign exchange market under pressure. As the MPC observes, global financial markets continue to experience volatility as reflected in the drastic downturn in both asset and commodity prices. The flight to the US dollar has seen it appreciate vis-à-vis many currencies. The Kenyan unit is no exception and has been subjected to depreciation pressure in recent months (see **Figure** 4).

Figure 4. Nominal Exchange Rate (KES/USD)



Source: CBK

The CBK keenly watches the market to smoothen out any episodes of volatility and respond to the secondary effects of currency movements filtering through to inflation. If the recent trend is, however, sustained, its ramifications are wider than implications on monetary policy; it will squeeze the fiscal policy space from the angle of external debt obligations.

- Three, given the downside risks resulting in a sharp downward revision in projected output growth, the challenge of closing the negative output gap – the difference between actual growth and potential growth – remains enormous.

Conclusion

The decision by the MPC to lower the CBR by 25 basis points to 7.0 percent during its meeting of April 29, 2020, sends the signal that in the circumstances, monetary policy ought to remain – appropriately so – accommodative. Even then, the simultaneity of the economic challenges arising from demand and supply conditions experiencing a “sudden-stop” type of scenario portends a dilemma. Contrary to the popular commentary that a lower CBR amounts to “cheap loans” and therefore more credit demand, the broadly volatile and uncertain environment works towards choking the transmission mechanism.

The overall stable macroeconomic environment masks a mixed picture that presents a paradox. Inflation is within target and in the MPC’s assessment inflation expectations well anchored. The MPC is evidently taking comfort in the fact that “demand pressures are expected to remain muted”. The essence of a simultaneously accommodative monetary and fiscal policies is to boost demand at the household and enterprise-level in view of the disruptions in the labour market as well as other markets. This begs the question: is the projected muted demand an indictment of both policies, or is it a pointer to the complexities that come with trying to address a non-conventional problem with conventional tools?

Ultimately, with the plethora of downside risks resulting in a sharp downward revision in projected output growth, the challenge of closing the negative output gap – the difference between actual growth and potential growth – remains enormous.

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