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Monetary Policy Stance – Still Hamstrung!

Highlights

- When policy decisions are as predictable as the Central Bank of Kenya's Monetary Monetary Policy Committee's have lately become, then either of two factors are at play: the policy framework is transparent and robust enough such that when confronted with objective evidence a certain decision is logically anticipated; or there are undercurrents that have hamstrung a change in the policy stance.

- Just like in the preceding five meetings since September 20, 2017 that have retained the Central Bank Rate (CBR) at 10.0 percent, the decision of the MPC meeting scheduled for July 17, 2017 will in all probability be the same. This has less to do with a predictable framwork but more to do with a hamstrung ability to change the stance.

Introduction

When policy decisions are as predictable as the Central Bank of Kenya's Monetary Policy Committee's have lately become, then either of two factors are at play: the policy framework is transparent and robust enough such that when confronted with objective evidence a certain decision is logically anticipated; or there are undercurrents that have hamstrung a the ability to change the the policy stance.

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What is at play here? Is it the former or ther latter that carries the day? The answer requires a step back and careful thinking about the monetary policy thinking process.

In anticipating the decision of the Monetary Policy Committee (MPC) one needs to take into account the motivations of the policy makers. Under normal circumsnances, there are three considerations that should underpin the decision. First is the need to make a move that addresses deviations of inflation from the target – especially when the target has been overshot. Second is the desire to make a policy decision that workd towards reconciling output and its potential. Third, and often implicit, is the pursuit of a stable interest rate regime, either in terms of interest rate smoothing or stability around a certain level.

So are the circumstances normal? On the inflation front, the answer is to the negative. There is no denying the fact that the inflationary process is understoon; there is pressure from the food compoment while the non-food-non-fuel remains muted. But as we have argued before, there are good reasons why the Central Bank of Kenya (CBK) is given a headline (overall inflation target and not just the core inflation (one that excludes the non-food-non-fuel component)[1].

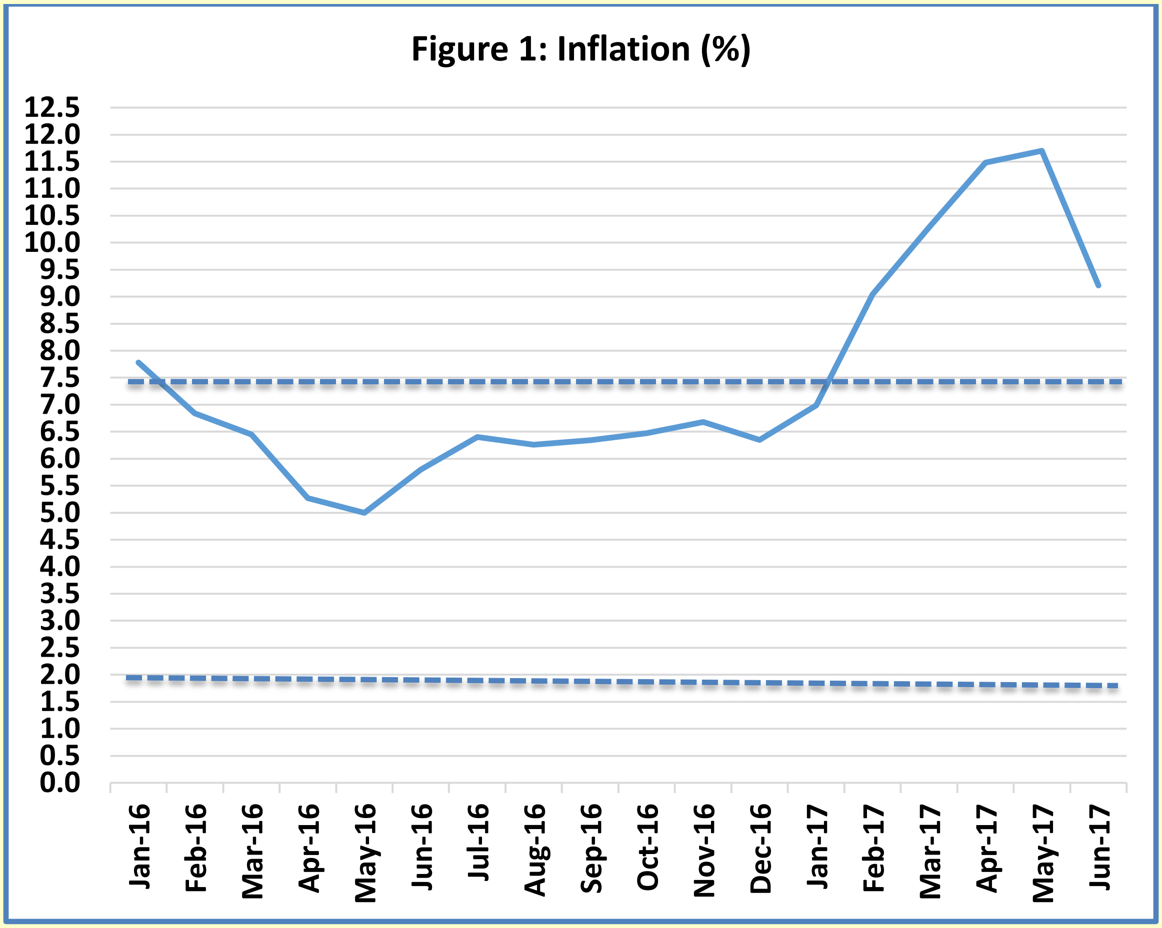
The argument we make is that if monetary policy is to have a "human face" then its target should be the price changes that households and businesses are confronted with; these prices who know price changes when they see them. These changes are wirnessed in household's most frequent visits to petrol station and grocery shops. Therefore monetary policy credibililty is on trial it its target is a measure of prices movement that excludes items that form the essence of such visits.

For nearly half a year now, inflation has been well above the official target of 5.0 percent plus a 2.5 percentage points above/below the target (**Figure 1**). Over that period, the MPC has been consitent that core inflation is under control (no matter that it is not the official target). There has been another level of consistency on the part of the MPC that many have not noticed; over that period it has dropped the public proclamation that its decisions are meant to anchor inflation expectations – a standard parlance meant to signal the commitment to the official inflation target.

Since the MPC cannot anchor a sub-set of inflation, then It could well cut the pretense to normalcy and wait for food inflaiton to subside, thus playing to the witty John Maynard Keynes's witty quip on economists setting themselves *"too easy, too useless a task if in tempestuous seasons they can only tell us than when the storm is long past the ocean is flat again"*[2].

[1] *See KBA Centre for Research on Financial Markets and Policy Research Note No.* 29 of March 28, 2017 http://www.kba.co.ke/downloads/RN%20No%202%202017.pdf

[2] Keynes, J.M (1923), A Tract on Monetary Reform.

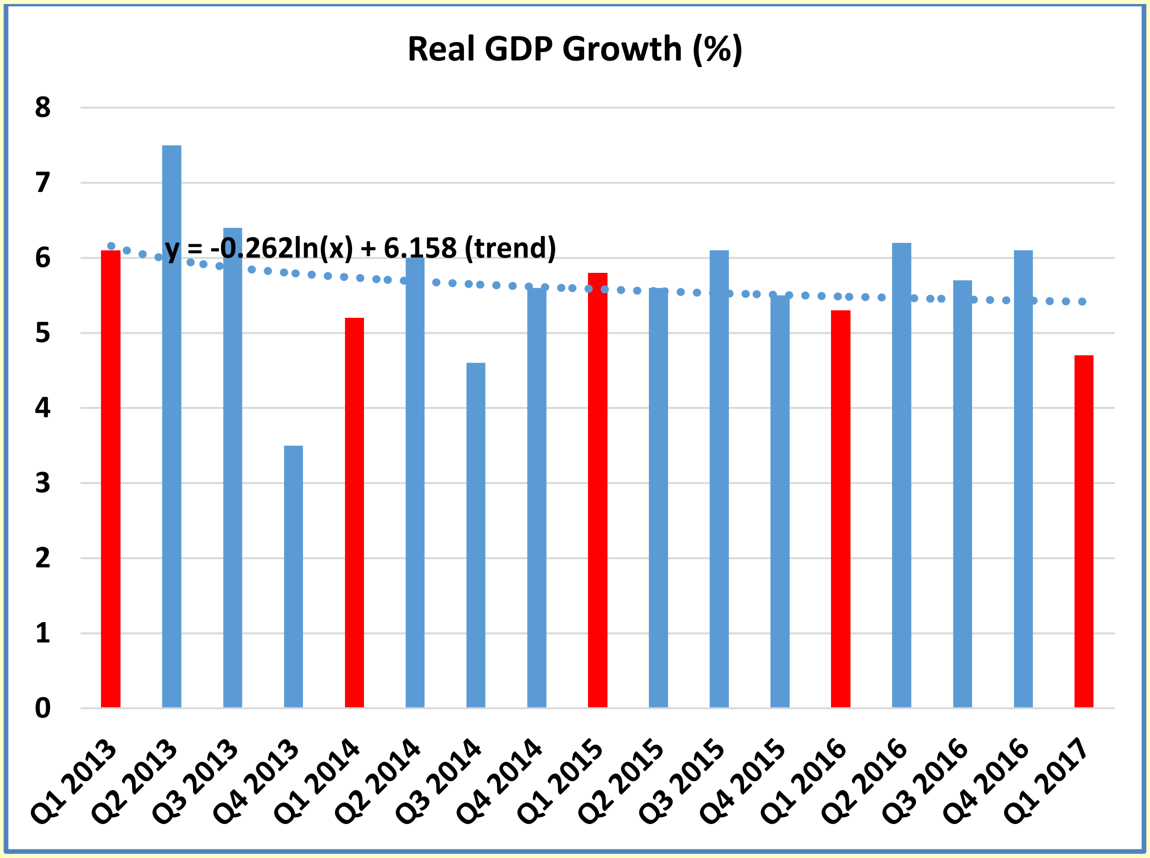


Source: Kenya National Bureau of Statistics

So if normalcy, at least in the sense of expectations on monetary policy stance, cannot be ascribed to the period February – July 2017 if solely charged on inflation behaviour, then the persuasion of then MPC decision could be sought at the output growth and/or interest rates stability front. And how is that playing out?

Output Growth – Positivity Merely a Whim?

As the MPC meets on to ponder on its July 2017 decision, the latest output growth numbers look anything but rosy. The real GDP growth of 4.7 percent for the first quarter of 2017, is the lowest compared to corresponding quaters since 2013 (**Figure 2**). Activity in the agriculture, forestry and fishing sector were considerably subdued. There was deceleration in growth of financial intermediation owing largely to a slowdown in credit uptake. Electricity supply also experienced a deceleration arising from the adverse impact of the shortage of rain. The drag of these key sectors on overall growth performance would not be offset by the positive performance of the wholesale and retail trade; real estate; transport and Storage; and information and communication.



Source: Kenya National Bureau of Statistics

The observed growth trajectory is in large measure below trend. For the past decade, an annual medium term GDP growth rate of at least 6.0 percent has been projected but never attained. Under normal circumstances, an accomodative monetary policy will be supportive. But as is incresasingly becoming clear, the circumstances are anything but normal.

There is a non-ambiguous conclusion that high inflation has a negative effect on medium and long term growth given that such inflation impedes efficient resource allocation since it obscures the signalling role of relative prices, an important guide to efficient economic decision making. Therefore inferences backed by evidence point towards a relationship where stable and on-target inflation is related to positive income growth.

As already noted, inflation is off target and the policy stance is largely one of a "wait-and-see-whe-it-reverts- to-target". This is an indication that even if it was the MPC's desire to intervene towards getting output growth towards its trend, the scope is constrained. It is neither able to live to the price stabilisaiton agenda nor will it be able to stimulate credit expansion through an accmodatiove policy.

Eyes on the Ball? Which Ball?

As ealier noted, since September 2016, the MPC has maintained the CBR at 10.0 percent. This hardly implies that the economic circumstances generally and the market conditions specifically have not provided justification for a change in monetary policy stance. The policy stance coincides with gthe interest rates capping regime that came into effect through the 2016 amedment of the Banking Act.

It is obvious that the non-responsive monetary policy is involuntary. In any case, the pursuit of a stable interest rates regime is not an explicit objective of monetary policy; and if it were, recent studies have confirmed that such preference will be self defeating as it will create a less stable interest rates environment than the case without such preference[3]. Furthermore, even the desire to have the interest rates stabise around a given level – in this case the CBR – has its own challenges, not least the distortionary effects of the interest rate capping, as well as the imperfections in the inter-bank market and therefore the limited signaling ability of the inter-bank price as confirmed in a recent our recent study[4].

Even amidist these challenges, the MPC would of ncessity be training its eyes on a number of potentially undermining undercurrents.

The first one is the potential of the fiscal position to be dominant to the extent of forcing a government monetary policy stance. This undercurrent is linked to the ambitious fiscal budget estimated at for the fiscal year 2017/18. In all intent and purpose, this is meant to be stimulating growth in the Keynesian sense – increase in government expenditure at a time when there is no scope for monetary stimulation – that we observe to be lacklustre. A deeper reflection on the implication of this unprecedented budget – both from an expenditure point of view and from a funding point of view – on monetary policy will be critical.

The CBK has in the past been quick to allay any insinuations about fiscal dominance – where an expansionary fiscal policy will necessitate monetary policy tightening as a counter to obviate inflationary pressure – indicating that the two macro-policies of monetary and fiscal are aligned towards the common objective of promoting growth without compromising stability.

Evidence may seem to be vindicating the CBK's position with regard to fiscal expenditure influencing monetary policy insofar as it could potentially be inflationary. We cannot make a similar argument though when it comes to the funding side, especially cognisant that the revenue base is an ambitious real growth outlook of the economy that clearly is at odds with the trend observed above.

The implication is that the tax base may be overstated as we earlier alluded and therefore the possibility of increased domestic borrowing to meet the expenditure needs cannot be ruled out.

The second one is the potential complacency with regard to the economy's external position. It is hard to deny the good fortunes associated with lower oil prices that the global economy has experienced. But it is worth acknowledging the geopolitical risks stand to undermine stability in the international oil market. It is true that the economy's import bill has benefitted from the plummeting oil prices; but the key question remains: have the prices turned the corner?

As the end of 2014 the world experienced a glut in the oil market due to decreased American demand for imported oil on account of increased their domestic production, and a weak world economy. With the Saudi Arabia's production hitting ten million barrels per day, the glut in the world oil market could remain for a while.

Nonetheless, oil prices seem to have bounced in the first quarter of 2015 as the prices of crude oil rally. This is being driven by increased demand, driven partly by the momentum from previous low prices; however the pace of the rally (not the direction of the trend) could be checked by the somewhat gloomy recovery prospects of the global economic performance - which nonetheless does not represent a decline but a less-than-buoyant recovery.

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[3] Alstadheim, R., and Roisland, O (2017), "When Preference for a Stable Interest Rate Becomes Self-Defeating", *Journal of Money, Credit and Banking*, Vol 49. No. 2 – 3, pp. 293 -415. March April.

[4] See Osoro J. and Muriithi D. (2017), "The Interbank Market in Kenya: An Event-Based Stress Analysis Based on Treasury Bill Market", *European Scientific Journal* Vol.13, No.16, pp. 1857- 7431, June.

The third one is the foreign exchange market which, whle stable, would be a source of rigidity that would reveal itself in other markets and consequently the pace at which the curent account balance repairs itself.

Conclusion

From the foregoing analysis, this *Research Note* makes a deduction that the MPC may seek to position its decision to maintain the policy stance in a manner that sugegsts calmness on the surface that understates the extent by which its current and recent past decisions are hamstrung. We argue that to the extent that the MPC policy decision is easy to predict and that decision being to hold the CBR at 10.0 percent either of two factors are at play: the policy framework is transparent and robust enough such that when confronted with objective evidence a certain decision is logically anticipated; or there are undercurrents that have hamstrung the ability to change the the policy stance. Evidence leans towards the latter.

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