RESEARCH NOTE NO.37. – 2018(RN/37/18)

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

May 25, 2018

Monetary Policy Stance – The Inevitability of a Pause

Highlights

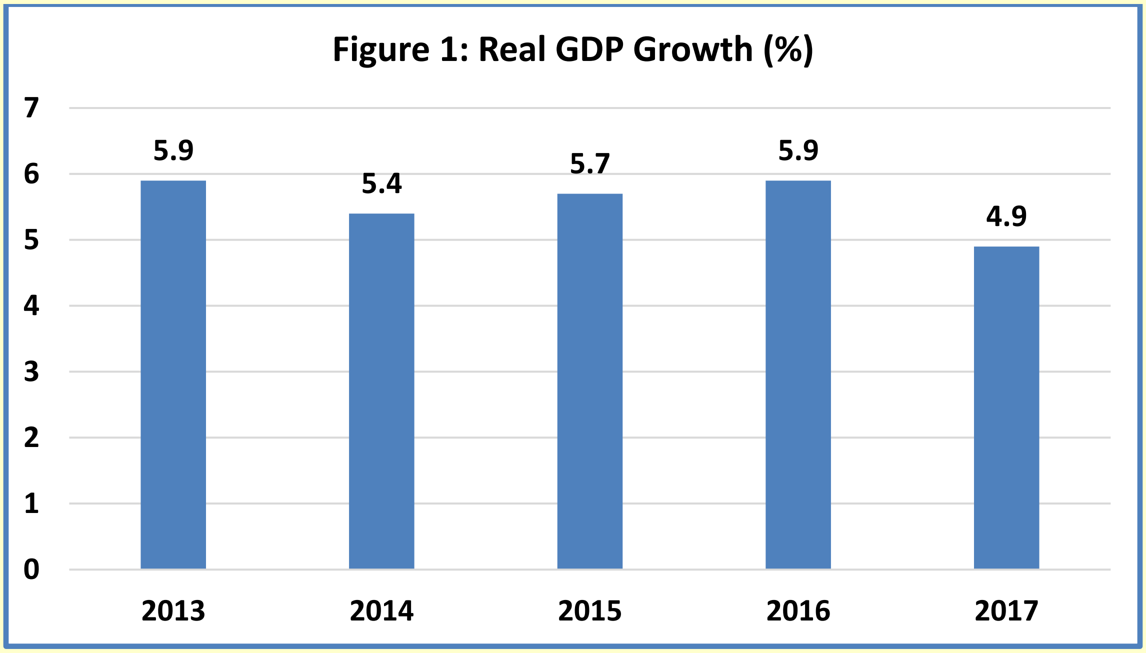
- As the Central Bank of Kenya's Monetary Policy Committee (MPC) meets on May 28, 2018 it is clear that the resumption of an accommodative stance in March 2018 was more of the easing window being kicked open than an opportunity of an open easing widow being seized.
- The various downside risks – especially the fast rising oil prices that stands to filter into domestic inflation and potentially falter further closure the economy's external and the geopolitical developments that stand to undermine the global economic outlook – are difficult to ignore.
- Therefore a case for a pause in monetary policy stance is compelling.

Introduction

As the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) meets on May 28, 2018, there is every reason for the market to watch its decision keenly. For one, the MPC's previous surprise decision to lower the Central Bank Rate (CBR) by 50 basis points was a clear indication of the Committee's desire to conduct creative monetary policy – acknowledging the risk of perverse outcomes while hoping that there was scope for easing monetary policy stance "in order to support economic activity"[1].

It is worth recalling the MPC's concern that "the prevailing uncertainties, including the impact of the interest rate caps on the effectiveness of monetary policy"[2]. The fact that the monetary policy stance was changed during the previous MPC meeting puts a spotlight on the plausibility of the implicit assumption that normalcy has resumed and therefore monetary policy will support economic activity.

It is true that economic activity needs some impetus. The real GDP growth of 4.9 percent in 2017 is the weakest over the past five years (**Figure 1**). The prerequisites for the realisation of the projected real growth of 5.5 percent for 2018 include (a) continued macroeconomic stability (b) demand for credit by the private sector picking (c) fiscal policy adjusting to the consolidation platform that rationalises expenditure and enhances revenue mobilisation in a manner that supports both investment and consumption.



Source: KNBS

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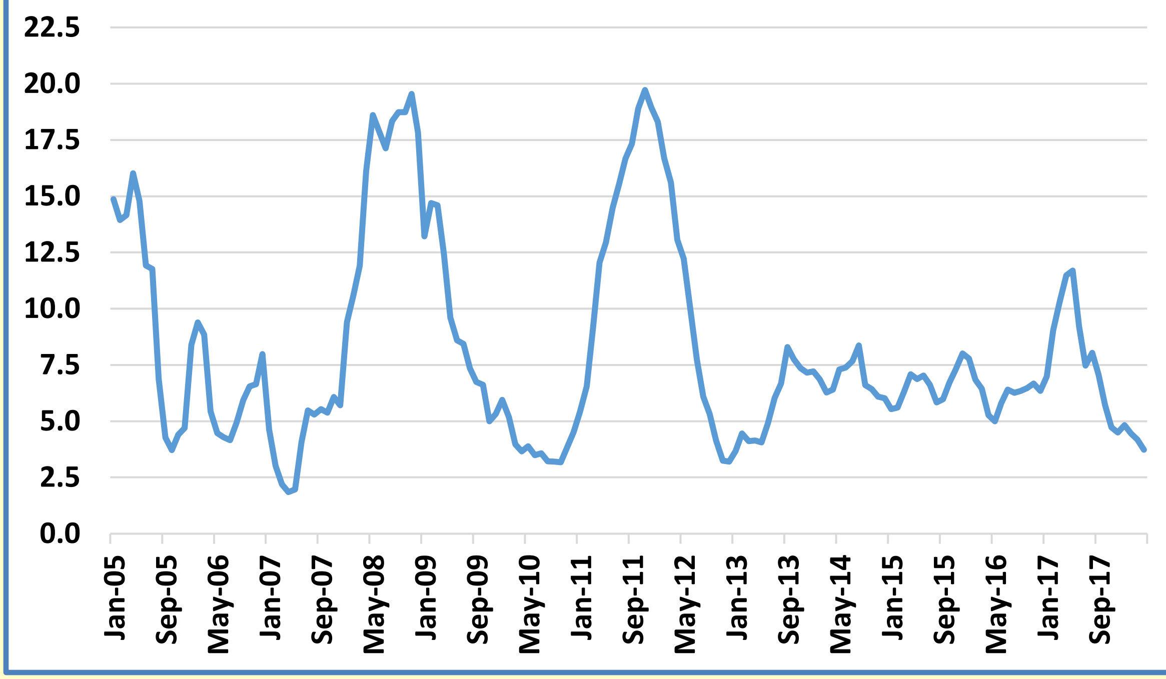
[1] See March 19, 2018 MPC decision (https://www.centralbank.go.ke/uploads/mpc_press_release/986102954_MPC%20Press%20Release%20-%20Meeting%20of%20March%2019,%202018.pdf)

[2] See March 27, 2018 MPC decision (https://www.centralbank.go.ke/uploads/mpc_press_release/808712593_MPC%20Press%20Release%20-%20Meeting%20of%20March%2027,%202017.pdf)

It is true, too, that inflation is now within the official target range (**Figure 2**). In the recent past, the MPC has argued that inflation being within the Government target range in the near term is ***mainly*** due to expectations of contained food prices following improved weather conditions.

Noteworthy, as the MPC sees its inflation outlook with a near term lens, it is convinced that inflation expectations are well anchored even – we could add – as such expectations hang on a thin thread of food supply. The steep climb in inflation from 5 percent in May 2016 to 11.7 percent in May 2017 was substantially driven by food prices; the subsequent decline to 3.7 percent in April 2018 must confront fiscal policy proposals in form of taxes that will have direct effects prices in the Consumer Price Index (CPI) basket.

Figure 2: Twelve-Month Inflation (%)



Source: KNBS

At the core of this ***Research Note*** is the question: is the MPC in the mood of another policy experiment? As we have argued[3], the resumption of an accommodative stance in March 2018 was more of the easing window being kicked open than an opportunity of an open easing widow being seized. It is arguably critical that an assessment of the perverse outcomes, if any, of the previous decision as well as the incorporation of new risks that are now evident, before any chance in policy stance is considered.

The inevitable pause, we argue, preludes the jigging of monetary policy towards supporting economic activity, through assuring stability upon which its influence on the credit market will ultimately be realised.

[3] See (1) http://www.kba.co.ke/downloads/RN%20No%202%202018.pdf (2) http://www.kba.co.ke/downloads/RN%20No%203%202018.pdf

Towards a new "optimal"

As the law regulating interest rates approaches its second year, commercial banks have apparently aligned their business models generally and the pricing frameworks specifically, the credit market is settling at:

- The short-term, secured loans; credit is essentially in favour of large, well-established businesses while Micro, Small-sized enterprises (MSMEs) and households have limited access.
- A state where recovery of growth of bank credit to the private sector is at best minimal.
- A heightened level of sensitivity to risk as non-performing loans as a share of gross loans remain at double digit level.
- A state where there is private sector – public sector competition for resources on the back of the latter remaining relatively more attractive.

The CBK finds itself in a place where it has to rejig its monetary policy towards a new "optimal". As is typically the case, the key channel for monetary policy transmission – the so-called credit channel – is such that the MPC will pursue the achievement of stabilisation mandate through influencing the interest rates, thus aligning the private sector incentives to stability through the price of credit. The distortions on this channel are well known[4], thus assuming a seamless transmission is limiting.

It gets more interesting. The MPC is at an interesting juncture where the other channel – the so-called expectations channel – is such that announcements or information disclosure on its views in economic fundamentals as a way of market expectations management has to depend on two things:

- The clarity and consistency of the explicitly stated information.
- The extent to which the implicit signal that accompanies the adjustment of the CBK's monetary instruments in line with the CBR changes is consistent with the broader stability mandate.

Cognisant of the limitations to monetary policy as already alluded, it is interesting to imagine – but debatable on the realism of the expectation – that monetary policy on its own can address the persistent slowdown in private sector credit from banks. Evidently, the MPC has in the past hinged its view on the expectation that the tweaking of its monetary policy stance towards accommodation will spur credit expansion.

That plays into the second aspect where the CBK has explicit intention to "put in place measures to sustainably bring down the cost of credit and improve liquidity management". This is undoubtedly a noble objective whose achievement, especially the sustainability dimension, requires progressive interventions at the policy and structural level.

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[4] See, among others, CBK (2018) - https://www.centralbank.go.ke/wp-content/uploads/2018/03/Interest-Rate-Caps_-March-2018final.pdf

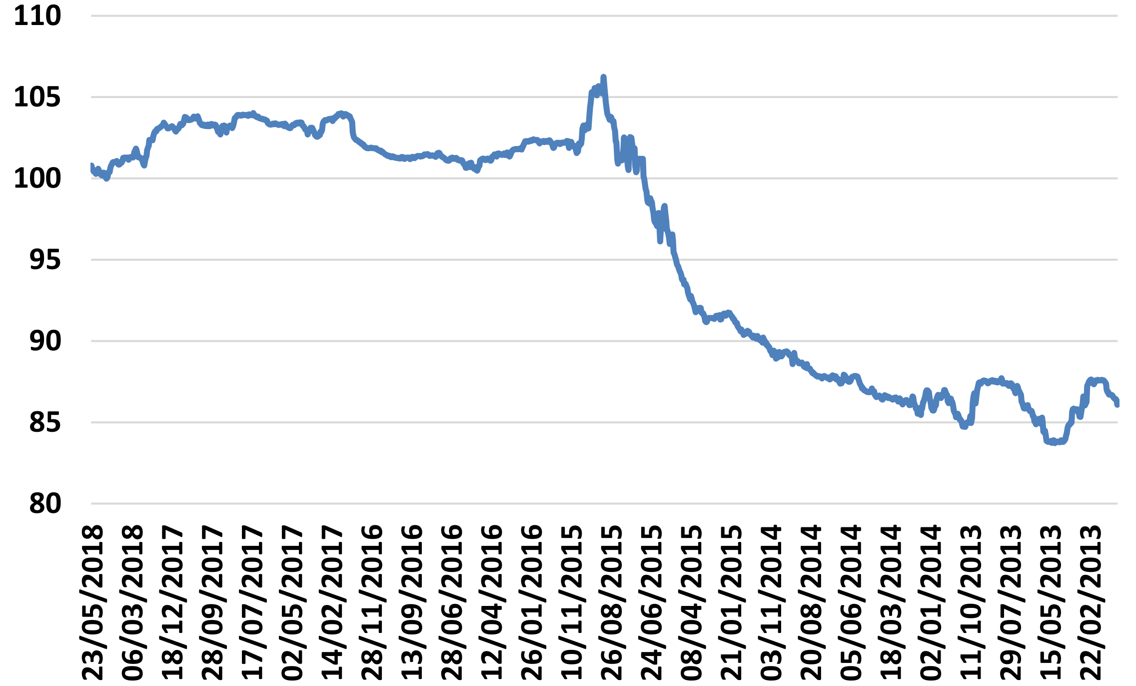
The wider public and the political class, both categories having a downward bias when it comes to interest rates trend, have seen the first round of its expectations met. How successful this objective will be significantly depends on the extent to which Government domestic borrowing is managed. As already hinted, lending to government under the current environment is very attractive – and the cost to the economy is seen in the crowding out effect.

The Downside Risks

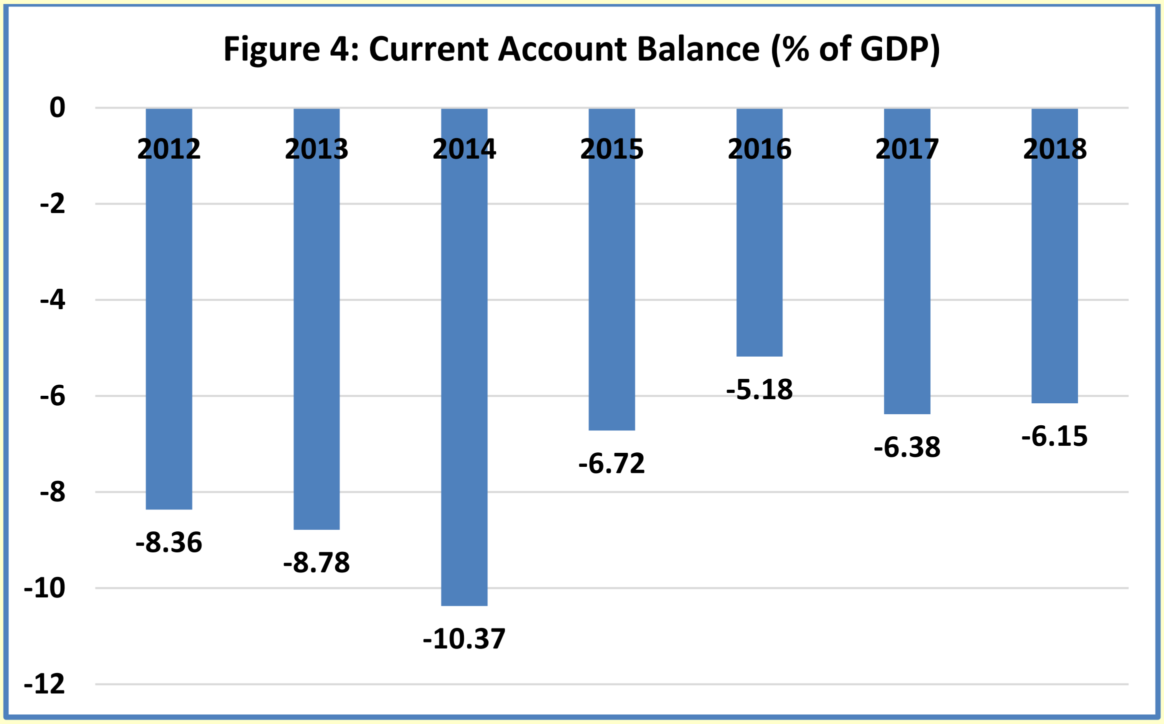
The only explanation one can proffer for a further monetary policy easing can only be if the macroeconomic conditions are attuned to the policy intention such that there are no circumstances – market anxiety or other downside risks – that can persuade a pose.

It can be acknowledged based upon **Figure 2** that the inflation rate is at the right place, but debatable whether inflation expectations are well anchored. It can be acknowledged too that the foreign exchange market has been stable (**Figure 3**) on the back of the expected improvement in the economy's external position (**Figure 4**).

Figure 3: Nominal Exchange Rate (KES/USD)



Source: CBK



Source: IMF – WEO (April 2018)

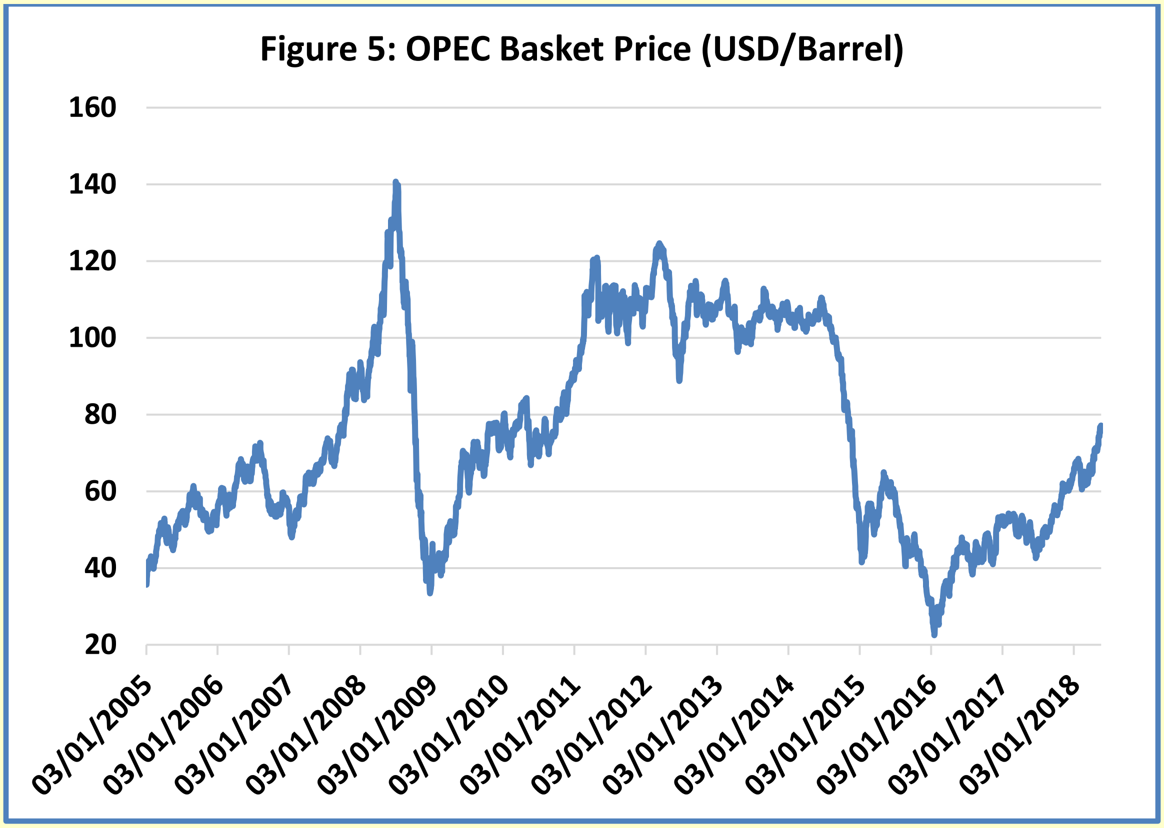
While the foreign exchange market and the external position gives a positive feeling, it is important to reflect on:

- The asymmetric effect of the closing of the capital account - when arising from reduced rates of imports versus rising exports; we are seeing more of the former.
- The masked costs to stability as could be read from the CBK market interventions.
- The fact that the foreign exchange reserves critically need augmenting by the IMF standby programme is telling.

Whereas typically the central bank's decisions are assumed to be backed by a set of information that is superior to that of the private sector, the signalling of policy is impaired by the limiting assumption on the price responsiveness of credit. Given as it is that the credit's response to the last policy signal has been largely muted, it is critical that the decision is given more time; this is more so the case considering that the past decision was anticipated to come with the possibility of perverse outcomes.

Further, the ever evolving global geopolitics add to the level of uncertainty on the extent to which global economic recovery is entrenched. The trade war threats, the Iranian deal quandary, the developments in Israel-Palestine regarding the new US Embassy in Jerusalem and what it means to peace in the region, the crises in Syria and the Korean Peninsula have complicated the global economic outlook.

The anxiety around oil supply disruptions accompanied by OPEC supply cuts have seen oil price increases pick momentum to the extent of its filtering into domestic inflation being real (**Figure 5**).



Source: OPEC

Conclusion

The outlined discussions point to three inferences:

- The resumption of an accommodative stance in March 2018 was more of the easing window being kicked open than an opportunity of an open easing widow being seized.
- The various downside risks – especially the fast rising oil prices that stands to filter into domestic inflation and potentially falter further closure the economy's external and the geopolitical developments that stand to undermine the global economic outlook – are difficult to ignore.
- A case for a pause in monetary policy stance is compelling.

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