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

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Monetary Policy Stance – Staying the Tightening Course

Highlights

- Inflationary pressure on the back of the pass-through effect from a fast depreciating currency has underpinned the decisive stance of monetary policy tightening by the MPC in its decision of July 7, 2015. The MPC increased the CBR by a further 150 basis points, having increased it by a similar magnitude in its June 9, 2015 decision. In a short one month, the MPC has tightened its monetary policy stance by 3 percentage points signalling a desire to restore macroeconomic stability at all costs.
- Contrary to the popular view the unambiguous tightening signals the desire to "rescue" the local currency that is subject to sustained depreciation pressure, the monetary policy stance remains primarily aimed at containing inflation within target. In essence the MPC's focus is anchoring inflation expectations. Consequently, while the nominal exchange rate – Kenya shilling (KES) versus major international currencies matters, it's the implication of the continued depreciation of the local unit on inflation that forces the MPC's hand in showing its hawkish credentials.
- Even with all the hype about the exchange rate dynamics and perceptions about the CBK's "powers" to intervene, it is clear that as long as the fundamentals remain weak, the KES will remain under depreciation pressure. It is equally clear that the CBK is manifestly comfortable with a flexible exchange rate such that it neither has a preferred level (or range) nor direction of adjustment so long as either direction is not characterised by volatility.
- As was expected the MPC was to review the KBRR upwards. The MPC revised upwards the KBRR from 8.54 percent as set in January to 9.87 percent. With the MPC having hiked the CBR by 300 basis points in less than one month, it is interesting – even curious – that the KBRR was increased by a 133 basis points. This calls for a closer look at the mechanics around the KBRR, especially the continued reliability of its computation parameters.

Introduction

Expectations on policy – especially monetary policy – are shaped by different things. Whenever the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) holds its scheduled meetings those with strong views (meant to at the very best shape the policy outcome, at the very least influence market expectations) have in the recent past been oscillating between why it has to be an emergency[1] to why it has to be about the MPC leadership[2].

When the MPC CBK met in July 7, 2015 to review market developments since its monetary policy stance changing meeting of June 9, 2015 there was a clear fixation by many on the change of guard at the helm of the central bank and what that is imagined to portend to policy. Fortunately for the MPC, the focus was on the sustenance of a stance aimed squarely at core mandate of assuring stability and the committee came out hawkish in its delivery of a further 150 basis points increase in the Central Bank Rate (CBK) – the policy signalling rate. At the same time, it augmented its liquidity management by introducing a 3-day Repo.

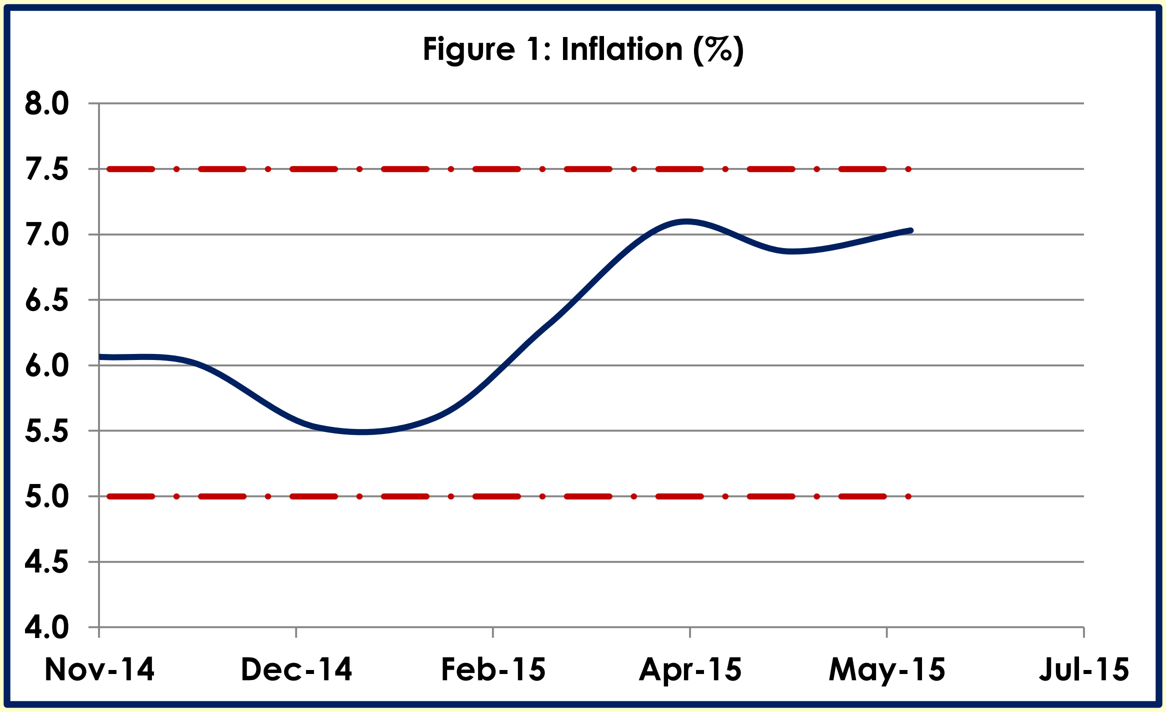
Therefore in a short 4 weeks – the MPC's decision to change policy stance having taken place on the June 9, 2014 with a 150 basis points hike in the CBK – the committee has increased the CBK by 3 percentage points. It is clear that in the absence of any new compelling evidence to persuade a decision to the contrary, a clear unambiguous stance of monetary policy tightening by the MPC was inevitable.

The question that this *Research Note* seeks to answer is: Is the MPC been seeking to – as widely believed – to rescue the shilling? The simple answer is that while the nominal exchange rate – Kenya shilling (KES) versus major international currencies, especially the US Dollar (USD) that is the dominant reserve currency – matters, it's the implication of continued depreciation on inflation that forces the MPC's hand in a given policy direction.

In its latest move, the MPC adduces evidence that inflation is stuck on the upper bound and is projected to burst the target range unless appropriate policy response is put in place (**Figure1**). The headline inflation rose past the 7 percent mark in June 2015 from the previous month's 6.9 percent. The rise in the overall inflation was mainly driven by the non-food-non-fuel inflation, which has risen steadily over the last three months from 3.53 percent in April 2015 to 4.15 percent in May 2015 to 4.52 percent in June 2015.

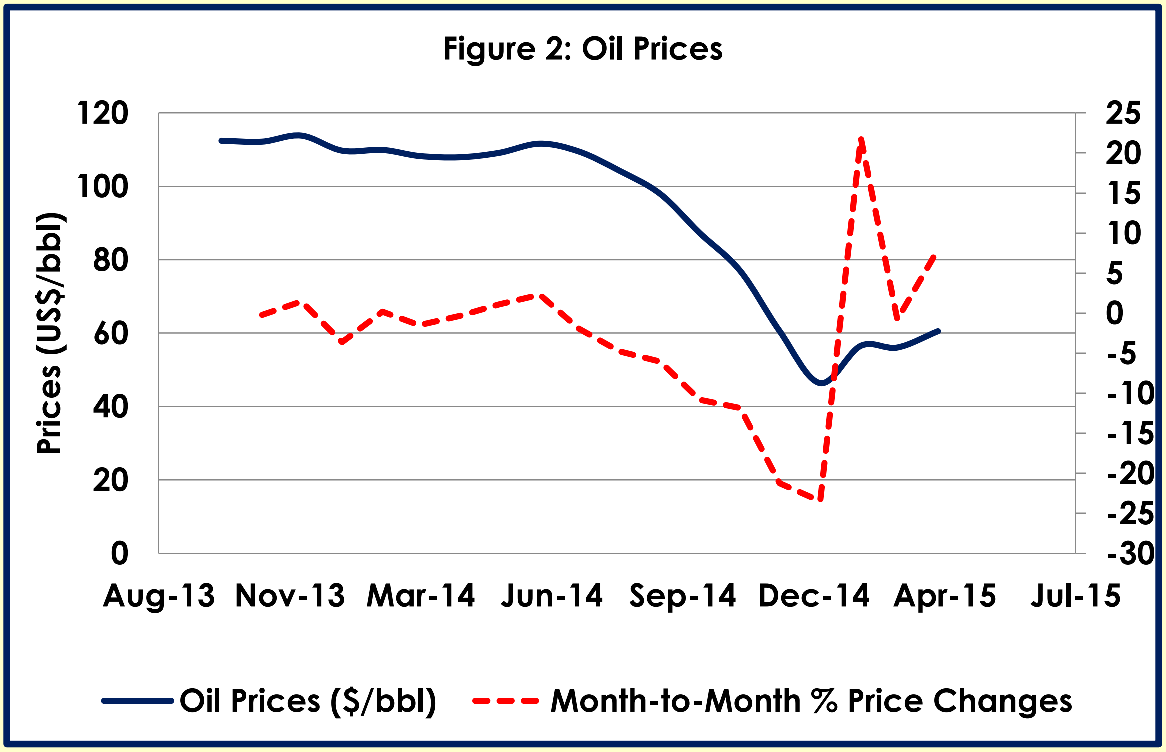
[1] There was a popular, but erroneous, assumption that the MPC meeting of June 9, 2015 was all out the measures that would be out in place to "rescue" the depreciating Kenya shilling. The correct view, which we espouse in the Kenya Bankers Association Centre for Research on Financial Markets and Policy® Research Note NO.17. – 2015 (RN/17/15) of June 11, 2015 http://www.kba.co.ke/images/stories/RN%20No%204%202015.pdf , was that the thrust of the MPC decision was the implication of the fast-depreciating currency on the inflation target.

[2] Popular commentary, especially amongst punditry in the Business Media corp, has been that the taking change in leadership at the CBK and effectively MPC, will clam the market – the assumption being that the period that he CBK didn't have a substantive head was volatile on account of that fact alone; that is an obviously limiting assumption.



Source: Kenya National Bureau of Statistics

It is evident that the tradable goods have had a noticeable effect on inflation especially occasioned by the pass-through effect of imports on the back of the depreciating KES, Kenya being a net importer of inputs to the production process. World oil prices have taken an upward trajectory moving from USD46.4 per barrel at the beginning of the year to about over USD 60 per barrel by the end of April (**Figure 2**) and subsequently showing signs of a sustained mildly rising; this has fed into the cost of energy and locally manufactured products, thus contributing to the change in the non-food-non-fuel inflation.



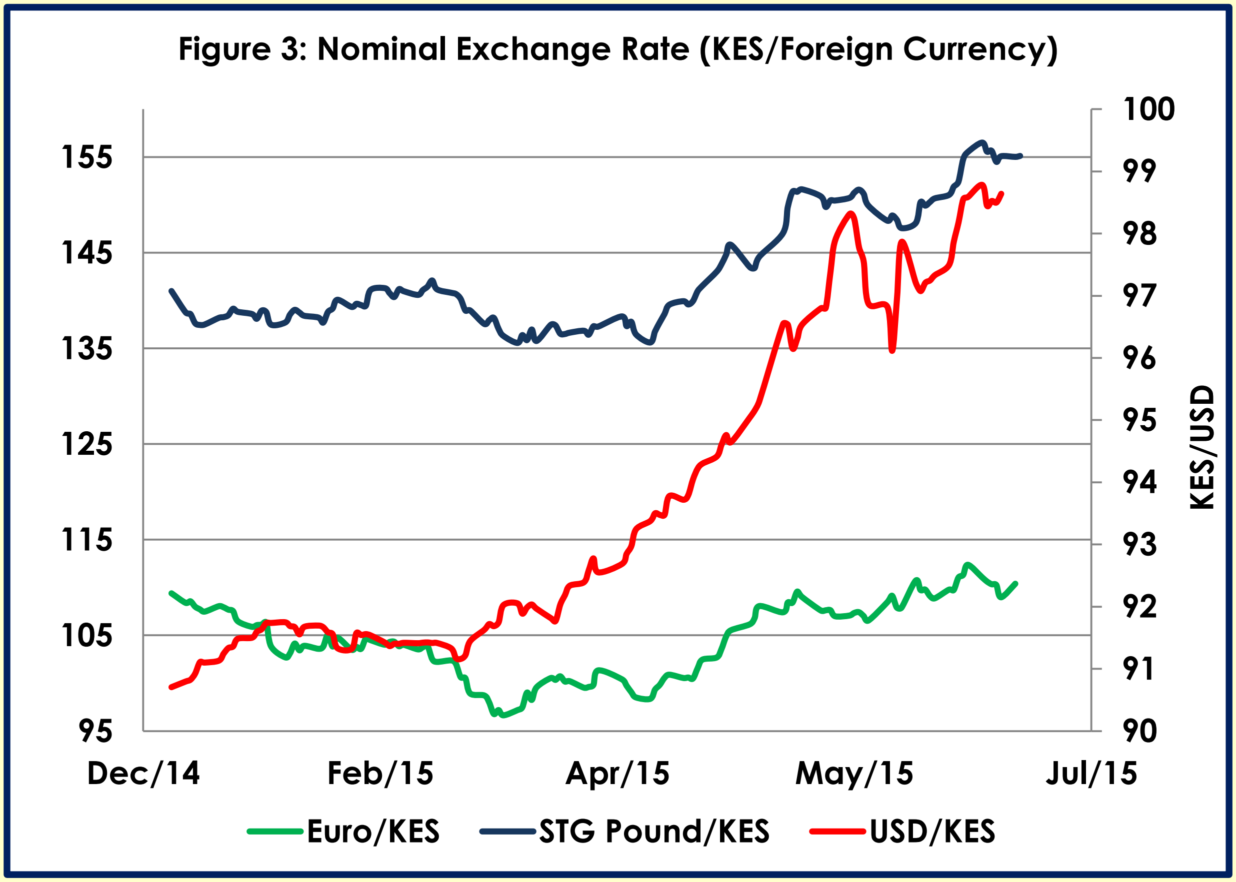
Source: Brent

The External Sector. The "Soft Under-Belly"?

Even with all the hype about the KES, two things are clear. One, as long as the fundamentals remain weak, the KES will remain under depreciation pressure. As the MPC notes, the current account deficit has been widening on account of weak exports and an increasing import bill on account of external inputs towards capital expenditure.

Imports towards infrastructure investments are obviously welcome as they enhance the economy's future capacity to generate export goods; they nonetheless have the same effect on the current exchange rate as any other imports. Two, the CBK is manifestly comfortable with a flexible exchange rate such that it neither has a preferred level (or range) nor direction of adjustment so long as either direction is not characterised by volatility.

The unrelenting pressure that the KES has been experiencing is seen across all key hard currencies (**Figure 3**). It therefore implies that the MPC's indication that the depreciation of the KES is more a reflection of the appreciation of the USD than it indicates the local weaknesses needs a correct contextualisation given that the KES has been on a losing streak against the pound sterling and even the Euro, albeit not as fast as against theUSD .



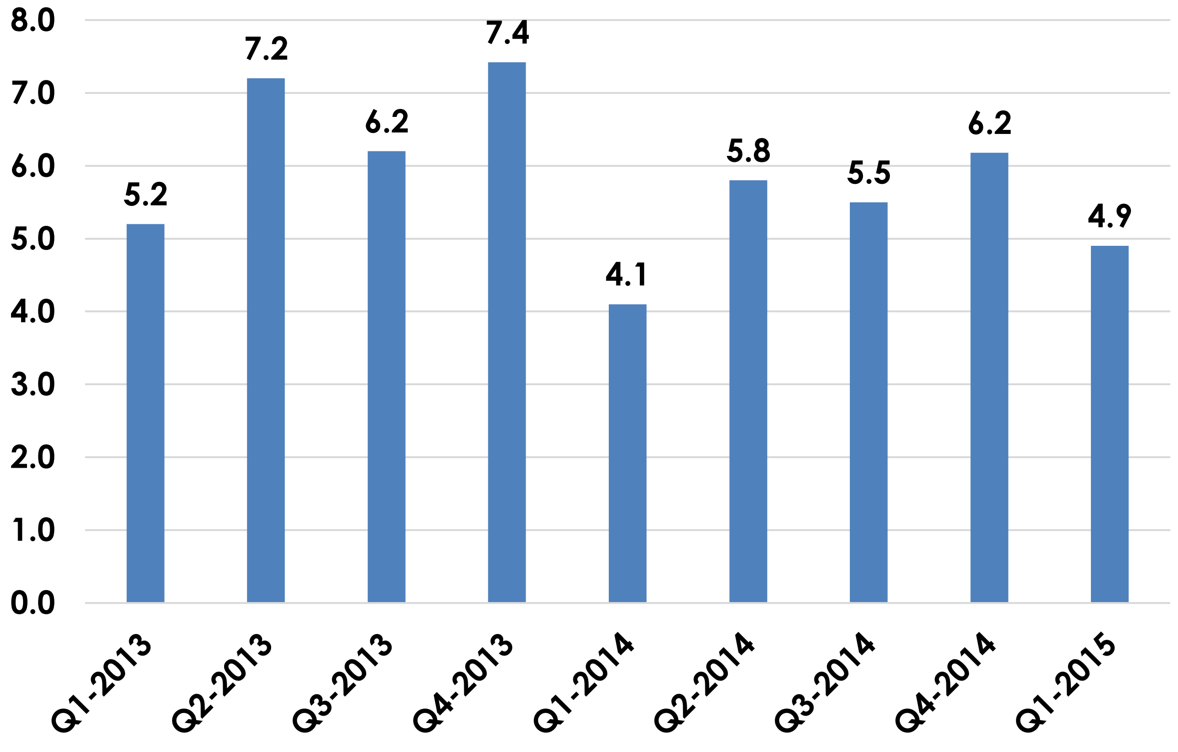
Source: CBK

Is the respite on the KES going to come from a recovery of exports or a further depreciation to an extent of being a discouragement of imports? Theoretically, a depreciating currency – if its trend is aligned with the real effective exchange rate (an index that measures the movement of the nominal currency vis-à-vis that of major trading partners adjusted for inflation) depreciation – will mean that the economy's exports are gaining competitiveness. Even if that were to happen, the nature of Kenya's exports (coffee, horticulture, etc.) which are largely price inelastic will mean that any price competitiveness will not translate into more of their consumption increase.

This can only mean therefore that the picking up of exports will correspond to the general recovery of the economy. Unfortunately the recovery has been feeble. The economy's real growth for 2014 was 5.3 percent, having declined from the previous year's 5.7 percent. Growth for the first quarter of 2015 at 4.9 percent confirmed the weak performance (**Figure 4**). What is even more interesting is the indication by the MPC that growth in broad money (so-called M3) and credit to the private sector has been above the target beyond which they are potentially inflationary.

These two variables 'rate of growth has been on the declining trend in the recent past; that they are at the inflationary threshold means that the economy's output gap – difference between actual growth and potential growth – is negative but narrowing fast at a level that is undesirable. Therefore respite on the current account from robust recovery seems remote as the CBK's information set conveys, albeit indirectly, an important signal about economic outlook that is counter to other projections such as that of the National Treasury that could be unjustifiably bullish. The tightening monetary policy stance will in itself be a slowing, but necessary effect on the fact of inflationary pressure.

Figure 4: Quarterly Real GDP Growth (%)



Source: Kenya National Bureau of Statistics

The Global economy: Another Source of Weakness?

The last six months have been increasingly challenging for the global economy, leading to the International Monetary Fund (IMF) being extremely cautious in its outlook and therefore being keen in reviewing regularly its *World Economic Outlook*. The changes are to a large extent the result of greater volatility and uncertainty, and they present a higher risk for the global economy in 2015. The rapid decline in oil prices (though picking up now), quick adjustments in exchange rates (with the US dollar appreciating and weakening of most other currencies, notably the euro), and the new quantitative easing program of the ECB are just a few examples of the economic factors at play. In addition, there is increased geopolitical uncertainty related to the Russia-Ukraine and Middle East conflicts, as well as increased concern about the economic and political future of the Euro Area and European Union with Greece taking the centre stage.

The Eurozone experienced a positive start to the year (having been on a deflation trend on the better part of 2014) with a GDP growth of 0.4 percent in Quarter one of 2015 being driven majorly by the domestic demand. Despite the growth trajectory, the Eurozone is likely to take a hit from the yet to be solved Greece crisis. Greece became the first developed country to default on the IMF, on a debt of USD 1.7 billion, which means that it is cut from accessing IMF resources until the debt is paid. The country is now seeking a further Euro 29 billion from European Union; however this request is likely to be subjected to be tougher conditions than the ones earlier rejected by Greece.

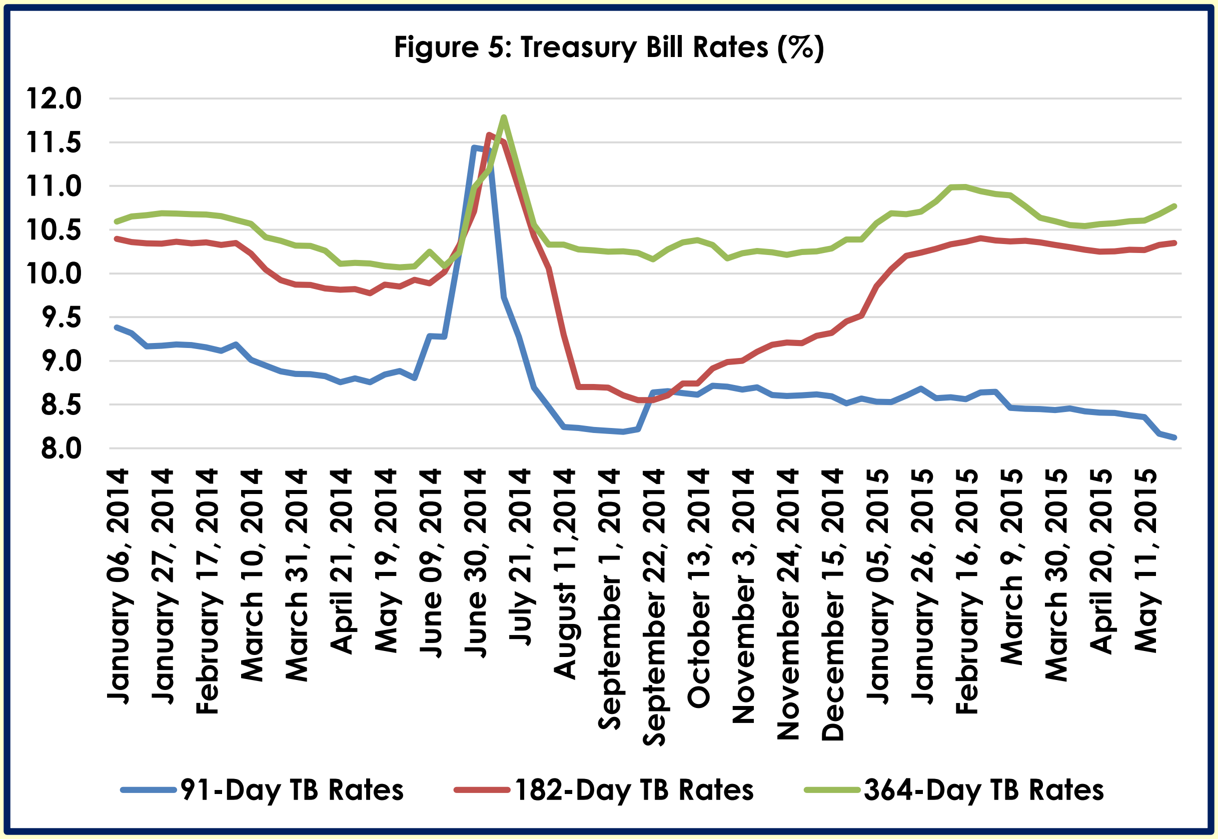
Although Asia region was stable in first quarter of 2015, with GDP expanding at the previous quarter's annual rate of 6.2 percent; this growth is slight below the expected 6.3 percent. In fact, most of the economies in the region fared worse compared to the previous quarter as China, the region's driving force, is experiencing a stock market clash that could be the economy's weaknesses. Besides India (the *I* in the BRICS), the rest of the so-called BRICS (Brazil, Russian, China and South Africa) have been on a struggling streak.

The KBRR Review – A Closer Look!

As was expected the MPC was to review the floating loans' pricing benchmark, the Kenya Banks Reference Rate (KBRR). The MPC revised upwards the KBRR from 8.54 percent as set in January to 9.87 percent. With the MPC having hiked the CBR by 300 basis points in less than one month it is interesting, even curious, that the KBRR was increased by a 133 basis points. This calls for a closer look at the dynamics around the KBRR.

The KBRR was launched at 9.13 percent in July 8, 2014 and revised downwards marginally to 8.54 in January 14, 2015, and the latest review saw its increase to 9.87 percent. Looking at this movement, it is tempting to assume that the market has been stable with adequate liquidity. The reality however is different. As we have observed, there has been volatility in the market – especially the foreign exchange market. It is possible that the MPC's decisions on CBR are keenly premised on how it influences the KBRR (being a key component with a 50 percent weight) as much as they are on the stability considerations.

It is evident that the money market has distortions especially relating to the 91-day Treasury bills, which constitute the other 50 percent of the KBRR computation. The fact that the 91-day Treasury bill rates have taken a trend that is clearly at odds with other short end rates points towards the market distortion (**Figures 5**). It is easy to see the temptation to artificially exert downward pressure on the KBRR when market/economic conditions that it increases. As expected, the July 2015 review was a marginal increase given the change in policy stance that is arguably drastic but against a distorted 91-day Treasury bill market.



Source: CBK

At the time of conceptualising the KBRR's crafting there was a proposal that instead of one rate, a weighted average of various tenors be used. The countered by the CBK which carried the day was that the various short-end interest tenors, especially the 91-day and 182-day Treasury bill rates are strongly correlated. And this made sense prior to the introduction of the KBRR (**Figure 6**). Given what we have observed regarding the divergence in trend between the 91-day Treasury bill rates and other short-end rates, the strong correlation argument is hard to sustain. Indeed, the correlation between the 81-day Treasury bills rate and the 182-day Treasury bills rate subsequent to September 2014 has not only been weak, but also negative (**Figure 7**)

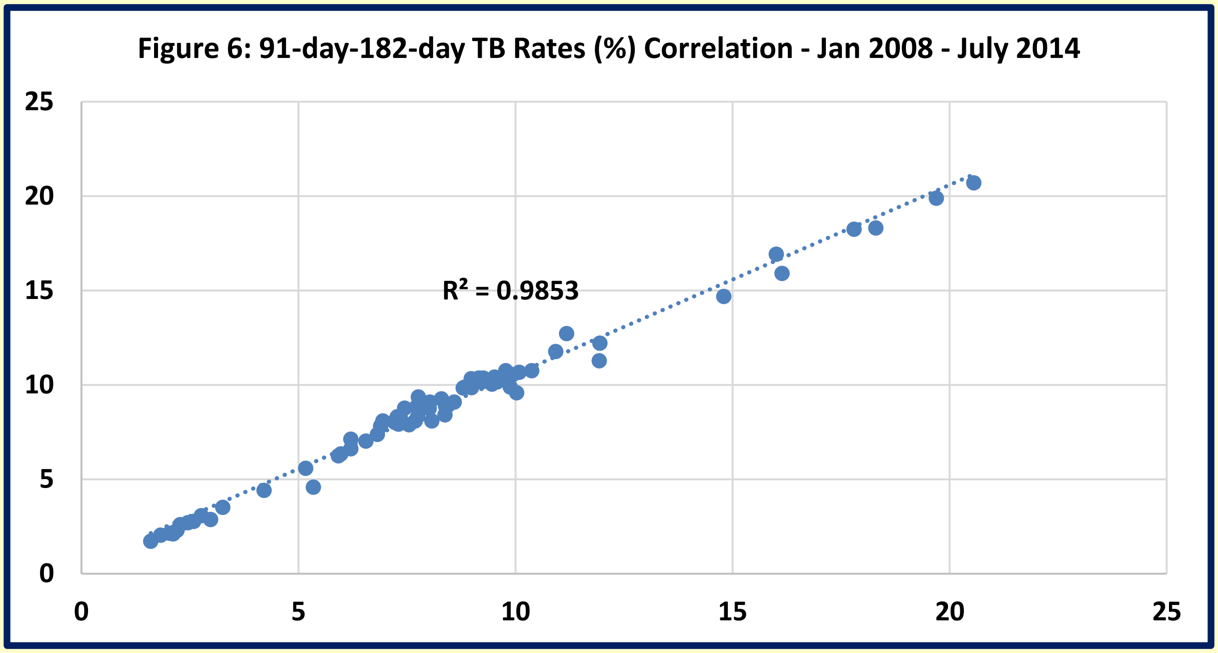


Figure 6: 91-day-182-day TB Rates (%) Correlation - Jan 2008 - July 2014
25
20
15
10
5
0
0
5
10
15
20
25
$R^2 = 0.9853$

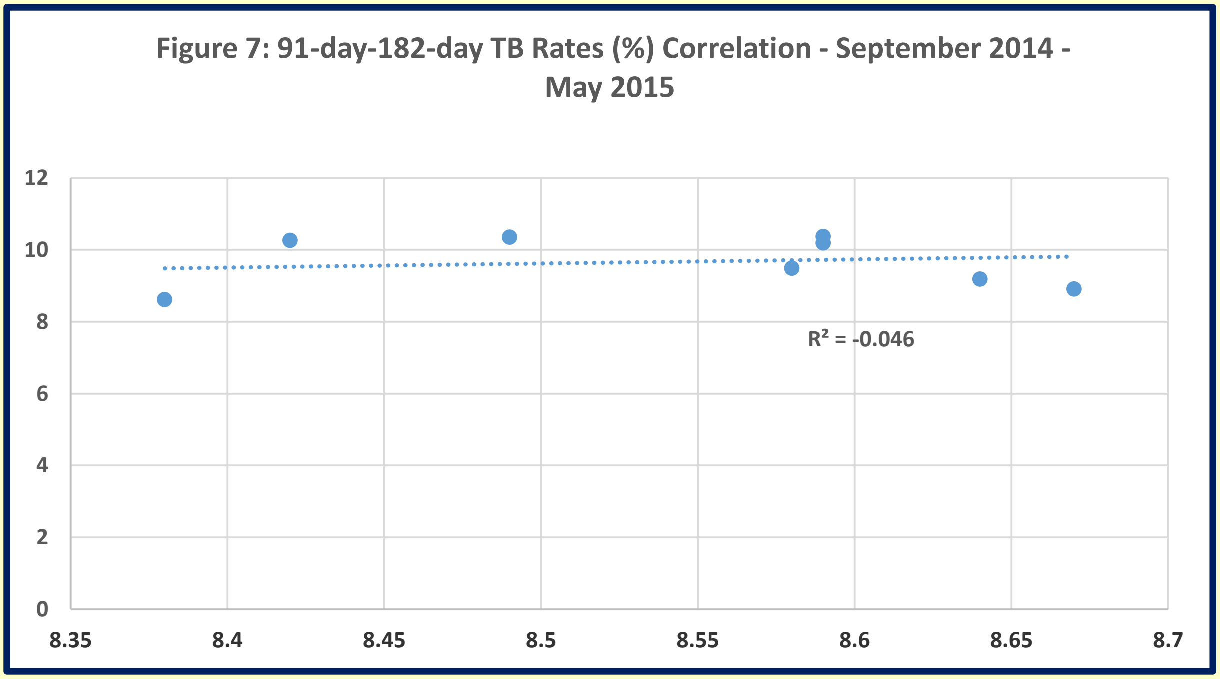


Figure 7: 91-day-182-day TB Rates (%) Correlation - September 2014 - May 2015
12
10
8
6
4
2
0
8.35
8.4
8.45
8.5
8.55
8.6
8.65
8.7
$R^2 = -0.046$

Conclusion

Inflationary pressure on the back of the pass-through effect from a fast depreciating currency has underpinned the decisive stance of monetary policy tightening by the MPC in its decision of July 7, 2015. The MPC increased the CBR by a further 150 basis points, having increased it by a similar magnitude in its June 9, 2015 decision. In a short one month, the MPC has tightened its monetary policy stance by 3 percentage points signalling a desire to restore macroeconomic stability at all costs.

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