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Monetary Policy Stance – The Bobby McFerrin "Don't Worry, Be Happy" Signal

Highlights

- The Central Bank of Kenya's Monetary Policy Committee (MPC) seeks to spur credit expansion through signalling a 50 basis points reduction in the Central Bank Rate (CRB). The decision is hinged on the MPC's judgement that inflation expectations are well anchored and stability in both the money and exchange rate markets is well established.
- This *Note* weighs the MPC's balance between assuming normalcy and thus resume an accommodative monetary policy on one end and the inclination to imply that its decision to lower the policy rate will spur credit growth amidst market anxiety. We argue that under normal circumstances, it is easy to see scope for policy easing. The current circumstances are far from normal. We contend that:
    - MPC's decision to signal a reduction in interest rates comes only a week after the Banking Amendment Act 2015 came into effect. There is a need to balance between achieving normalcy in the banking sector following the enactment of the new law, and spurring credit growth within the productive sectors of the economy. The new law has delivered a reduction in lending rates in a magnitude way higher that the CBR reduction. The new law has delivered a reduction in lending rates in a magnitude that is substantially higher than the CBR reduction. That the MPC was compelled to signal a further reduction can only mean that in its view the first round of reduction is not adequate to spur credit growth. If that is the case, then there is a glaring contradiction in expectations management in the sense that the MPC is seized of the need for time to assess the impact of the new law.
    - The MPC assumes a credit demand function that is very price sensitive even in circumstances of market anxiety. In view of the observed contradiction it will be limiting to make such assumption.
    - While 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 contradiction and the limiting assumption on the price responsiveness of credit. The expectations management therefore is blurred. To the wider public and the political class, the MPC decision is seen as a decisive demonstration of the delivery of the desired low cost of credit. To the financial sector however, the decision comes at a time of adjustment and could unsettle the ability to efficiently transmit policy signal.
- Broadly, the MPC decision is at the very least contradictory, otherwise counterintuitive.

Introduction

The Central Bank of Kenya's Monetary Policy Committee (MPC) meeting of September 20, 2016 has arguably drawn the most attention than all before it. The meeting is the first since the coming into effect of the Banking (Amendment) Act 2016 that introduced caps to the lending rate and the minimum that commercial banks can pay for interest earning deposits. The MPC decided to lower the Central Bank Rate (CBR) by 50 basis points from 10.5 percent to 10 percent.

The wide attention on the MPC decision is buttressed by the fact that the Central Bank of Kenya (CBK) has, pursuant to the new law, determined that the CBR is the base rate upon lending rates are caped and the floor of interest paid to qualifying accounts is based. Ordinarily, the CBR is the MPC's signalling rate that – if changed – is operationalised through the Repo market or other Open Market Operations (OMO).

As commercial banks have just commenced aligning their business models generally and the pricing frameworks specifically, we argue that the CBK finds itself in a place where it has to commence rejigging its monetary policy towards a new "optimal". Typically 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 MPC now finds itself 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: (a) the clarity and consistency of the explicitly stated information (b) 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.

In this *Note*, we subject the decision of the MPC to an assessment on account of its intention from both the credit channel and the expectations channel perspective. The evaluation will seeks to answer two questions:

- One, how valid is the MPC's assumption that a reduction of the CBR by 50 basis points will lead to a reversal of the declining credit trend?
- Two, whose expectations is the MPC seeking to manage through its latest policy signal?

These questions are easily motivated by the MPC's key observations underpinning its decision. First is the concern about "persistent slowdown in private sector credit". Evidently, the MPC hinges its view on the expectation that the tweaking of its monetary policy stance towards accommodation will spur credit expansion. In the same breath, the MPC observes that the CBK is monitoring the impact "new [Banking] law on monetary policy and the overall economy".

The possible new adverse consequences of the new law, which has seen the lending rates drastically come down, is the shrinkage of credit to the market segment whose risk profile is well above the 4 percent cap. The impact of the new law will come with a time lag, yet the MPC envisions – amidst all the unclarity about the new law that is posing implementation challenges – that the credit market needs a monetary policy stimulus to reverse the declining trajectory.

Second is the CBK's 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. 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 – through the new law and now through the MPC policy signal that must trigger a new capping rate and interest earnings compensation floor.

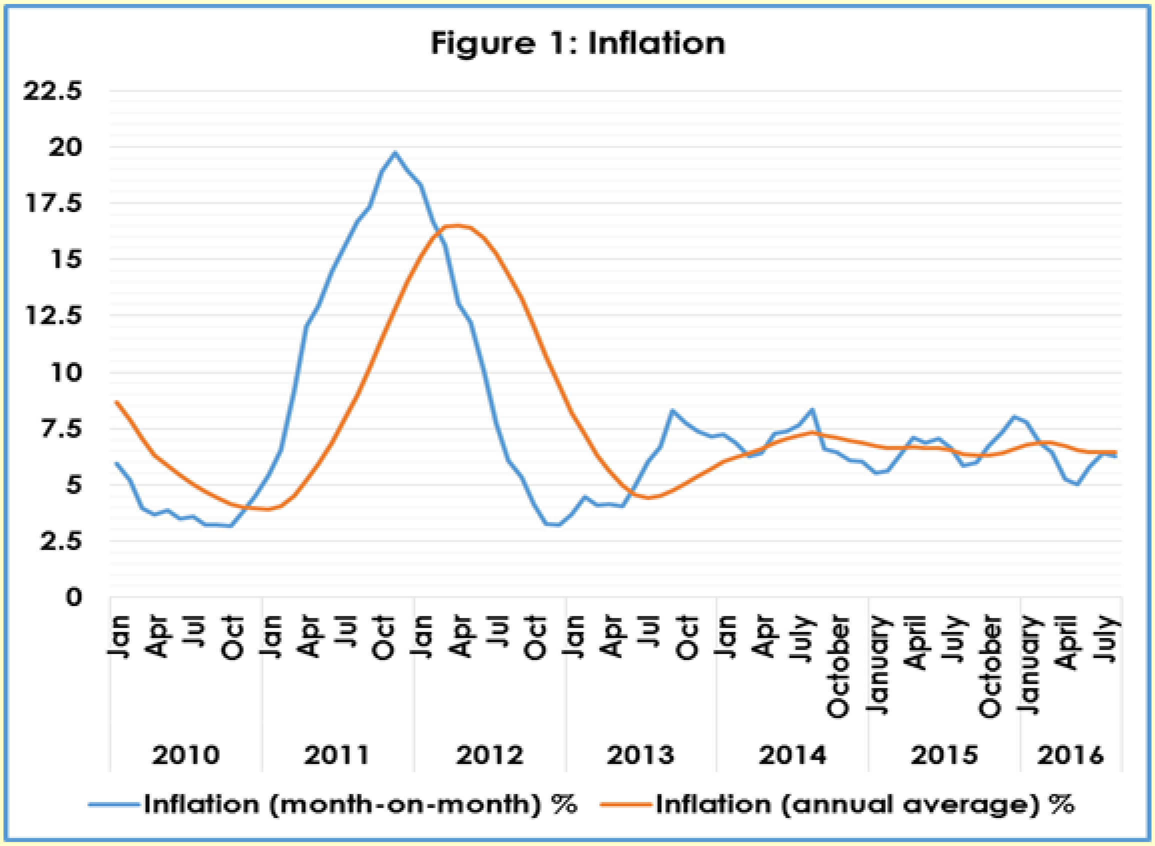
The missing piece of the puzzle however is how the MPC is managing the expectations of the financial system through which monetary policy is transmitted. This is especially so given that even before the system gets to grips the implementation the new law and all its unclarity, it is under pressure to make further adjustments.

Assume "normal" market conditions

The only explanation one can proffer for a change of monetary policy stance is that the macroeconomic conditions are attuned to the policy intentions. In other words, there are no circumstances – market anxiety or other downside risks – that can persuade a pose, even if amounting to "err on the side of caution".

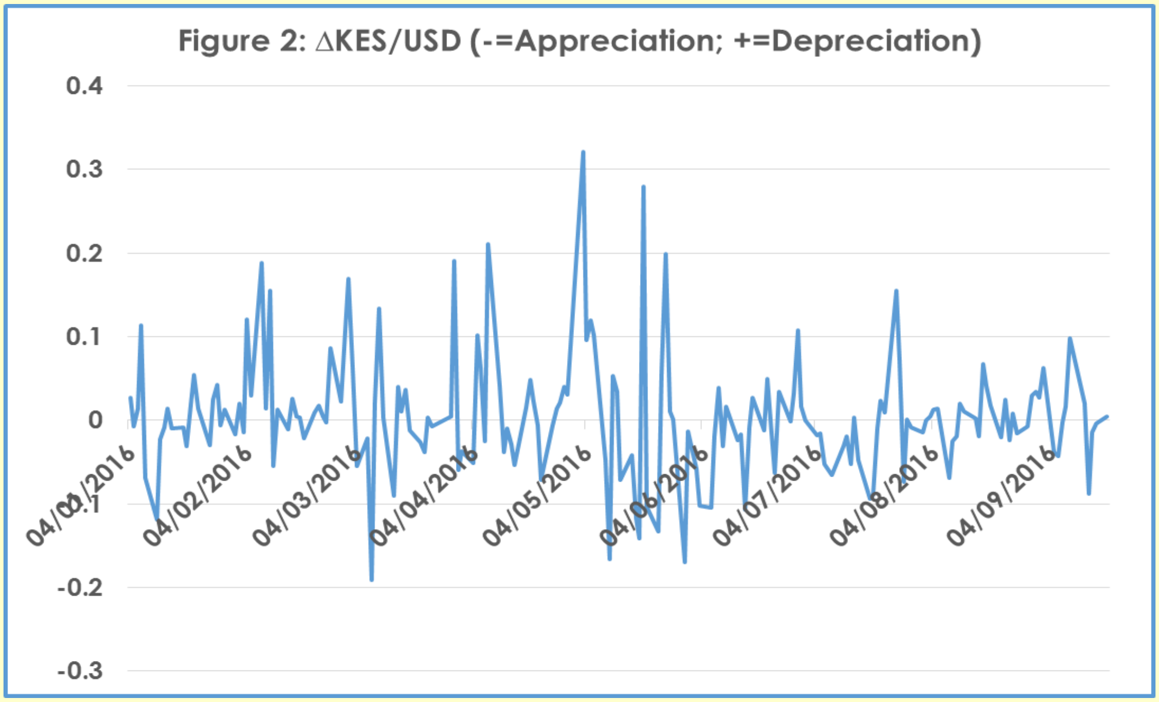
The evidence before the MPC that informed its September 20, 2016 decision to lower the Central Bank Rate (CBR) by 50 basis points can be summarised as follows:

First, the MPC is sending the message that inflation expectations are well anchored. It is clear that inflation has reverted to the target range, declining from a peak of 7.8 percent in January to 6.5 percent in August 2016 (**Figure 1**). The MPC's previous decision hinted at its inflation forecast through its indication that the inflationary pressure would dissipate. That inflation has taken the observed trend is somewhat a vindication of the MPC's short-term outlook. Inflation however consistently remains on the upper bound of the target range. 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.



Source: Kenya National Bureau of Statistics

Second, the MPC has taken the view that broadly the financial markets are stable as manifested in the key prices of exchange rate and interest rate. The domestic circumstances have undoubtedly supported the observed inflation outcome. Equally important though has been the eventual stabilisation of the foreign exchange market (**Figure 2**). 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.



Source: Central Bank of Kenya

When the MPC expressed concern about the likely implication on private sector credit, upon which it eases monetary policy, it could be inferred that it is seeking to protect its positive view of the performance of the real economy. The 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 seems to be signalling that there is for easing of monetary policy while continuing to anchor inflation expectations.

It could be argued that even with the implicit assumption of normal market conditions, the MPC's communique 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.

It could further be argued that the noticeable progress in the restoring of confidence in the banking system while critical support need to go 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. The new law and the pressure from the new policy stance stands to delay a return to normalcy and stands to undermine the intentions to reverse the decline in credit growth.

In a Bobby McFerrin – “don’t worry, be happy” economy, the MPC’s desired outcome of improved credit growth would be achieved through a policy rate reduction. In the real world though, where the now evident reduction in credit growth cannot be ascribed to interest rate alone, it is difficult to see how that outcome will be realised based on the policy action. The policy outcome sheds a spotlight on three aspects.

One, the MPC’s decision to signal a reduction in interest rates comes only a week after the new banking law comes to effect. As already observed, the new law has delivered a reduction in lending rates in a magnitude way higher that the CBR reduction. That the MPC was compelled to signal a further reduction can only mean that in its view the first round of reduction is not adequate to spur credit growth. If that is the case, then there is a glaring contradiction in expectations management in the sense that the MPC is sized of the need for time to assess the impact of the new law, and it says as much.

Two, the MPC assumes a credit demand function that is very price sensitive even in circumstances of market anxiety. In view of the observed contradiction it will be limiting to make such assumption.

Three, 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 contradiction and the limiting assumption on the price responsiveness of credit. The expectations management therefore is blurred. To the wider public and the political class, the MPC decision is seen as a decisive demonstration of the delivery of the desired low cost of credit. To the financial sector however, the decision comes at a time of adjustment and could unsettle the ability to efficiently transmit policy signal.

Conclusion

The MPC declares that there is compelling evidence to support the case for lowering the CBR, thereby signalling a shift to an accommodative policy stance.

- First, inflation expectations are well anchored;
- Second, broadly the financial markets are stable as manifested in the key prices of interest rates and exchange rates.
- Third, and as could be indirectly inferred, the performance of the real economy reflecting a trending in the right direction, thus needs to be supported through an accommodative monetary policy that will boost credit expansion.

We weigh the MPC's balance between assuming normalcy and thus resume an accommodative monetary policy on one end and the inclination to imply that its decision to lower the policy rate will spur credit growth amidst market anxiety. Under normal circumstances, it is easy to see scope for policy easing. The current circumstances are far from normal. That makes the MPC decision at the very least contradictory, otherwise counterintuitive.

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