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Monetary Policy Stance – The Tactical Pause

Highlights

- The Central Bank of Kenya's Monetary Policy Committee meeting of September 18, 2017 decision to retain the CBR at 10 percent is more of a tactical pause on the back of substantial un-clarity and uncertainty. Underlying the pause is a two-edged signal, one being obvious and other less so.
- The obvious signal is that the policy stance is meant not to upset the current pricing of credit. This would make sense under normal conditions when such pricing is unregulated and the market is devoid of supply and demand weaknesses. The conditions are however anything but normal. Weak supply has been inflationary. Weak demand is underkying private sector distress that has seen credit to private sector almost grind to a halt.
- The less obvious, but certainly more interesting, signal is that there is a lot of uncertainty with a bearing on market stability and overall economic performance. The uncertainty arise mainly, but not entirely, from the political stalemate linked to the 2017 General elections. The external position is weaker than we are willing to admit; the current account position could be disguising the true state of the external situation. The state of public debt and its sustainability is increasingly becoming part of that vulnerability. Under the circumstances, patience on the part of the MPC in changing the policy stance is logical.

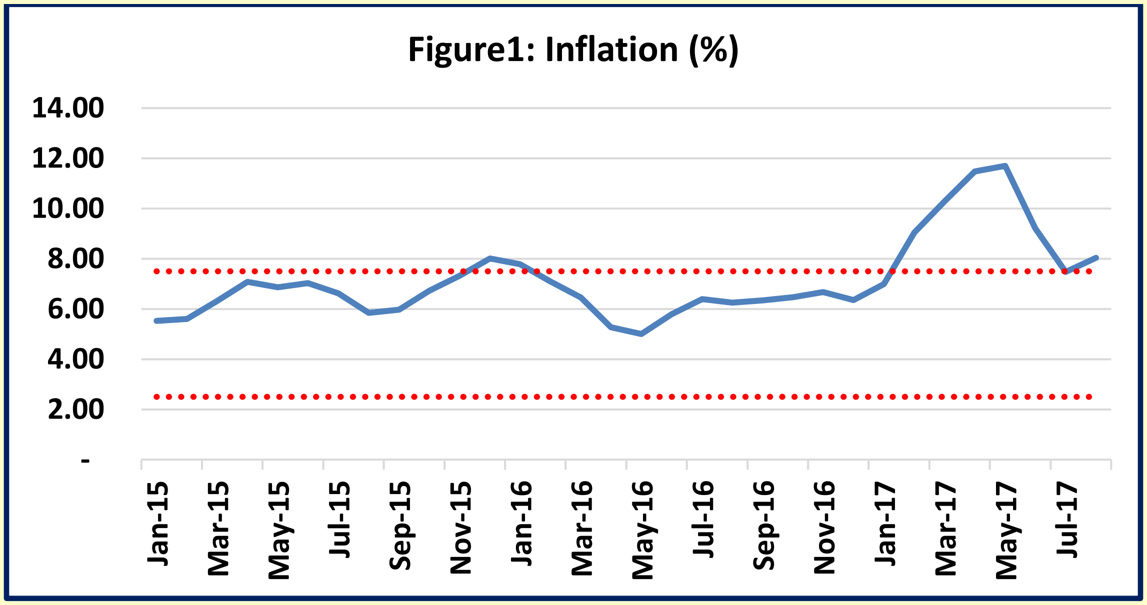
Introduction

When an economic policy decision – especially monetary policy – is predictable, then ordinarily a combination of two factors must be at play. One is that the underlying framework is well understood such that the policy move would be anticipated from the outcome of the primary policy target – in this case overall inflation. The second is that the intentions of monetary policy will not have any inhibitions arising from either a disjointed transmission mechanism or a distortionary effect of other existing policies, or even both.

Predictably, the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) had to hold the Central Bank Rate (CBR) – the policy signalling rate – at 10 percent. Is it on account of the outlined factors? This *Research Note* argues that such decision, which is reflective of *stance patience* given that the CBR has been retained at that level in the MPC's previous six meetings, is more of a tactical pause on the back of substantial un-clarity and uncertainty. Underlying the pause is a two-edged signal, one being obvious and other less so.

Let's start with the obvious signal. The policy stance is meant not to upset the current pricing of credit, whose capping since the 2016 Banking (Amendment) Act is based on the CBR. Under normal circumstances, this would imply that the MPC is happy with the market outturn upon which it is deploying its policy instruments. In other words, the decision would be implying that there is no pressure on price stability as measured by inflation. Evidence cannot collaborate such view.

As **Figure 1** shows, overall inflation – which has largely remained within the target rate of 2.5 percent and 7.5 percent until February 2017 – hardly gives a predicable path that can assure the anchoring of expectations. After the food-related spike that saw inflation hit a high of 11.7 percent in May 2017, the fiscal interventions in form of stable food subsidy saw the pressure ease as it declined to 7.47 percent in July 2017, then rising to 8.04 percent in August 2017.



Source: KNBS

The inflationary pressure has been more on the supply side and therefore the monetary policy tools have no potency in addressing it. The non-food-non-fuel (NFNF) – core – inflation has remained low. This can only mean therefore that the MPC has to give the supply side interventions a chance.

The less obvious, but certainly more interesting, signal is the inference of what low core inflation means from a broader market dynamics consideration. If the supply side is constrained as could be inferred from the food shortages that have occasioned inflationary pressure, and demand is weak given the low core inflation, the implications are such that:

- One, the Milton Freidman's 1968 moment[1] is real, in the paraphrased sense of "monetary Policy being a string that you can pull on it to stop inflation but you could not push on to halt a recession". If it weren't, then the MPC experiment of reducing the policy rate in September 2016 with the hope that it will spur momentum in the expansion of private sector would have worked; it didn't.

- Two, which is linked to the first implication, the clear softening of the economy that is sandwiched by both demand and supply weakness is now playing into the real economic outlook downgrades. With the monetary policy's obvious incapability to address supply side channels, the clear signs that the economy's real GDP growth may not sustain an upward trajectory – and expecting a real growth of even 5 percent in 2017 represents a sign in exuberant optimism – is confirmation that supply-side intervention to support growth has its limits.

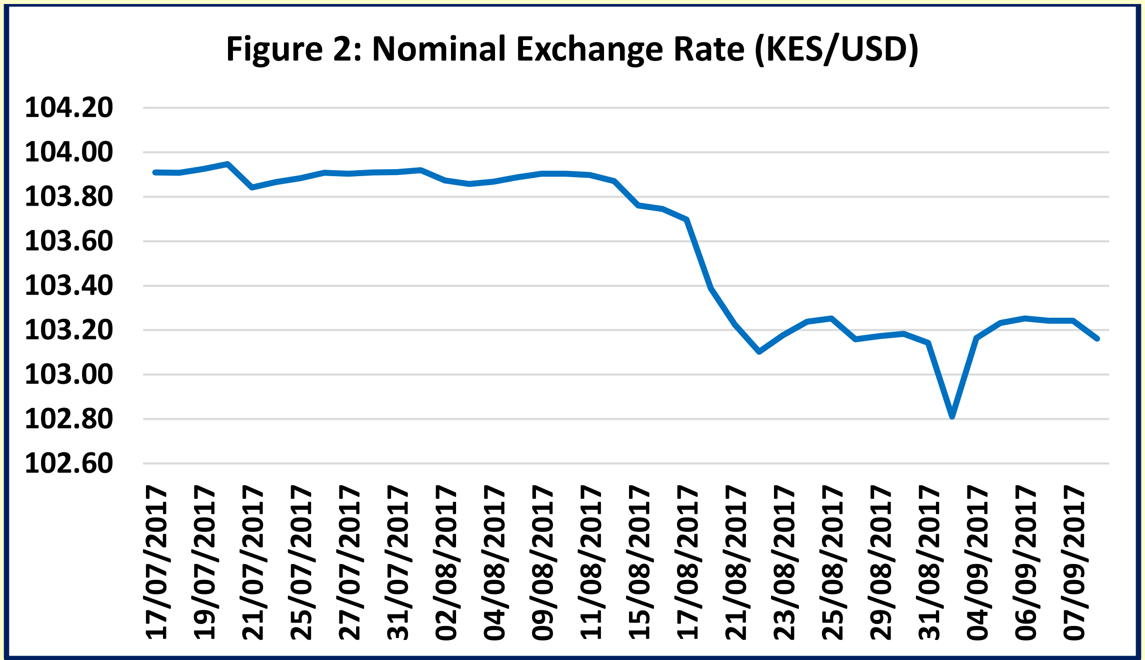
As we subsequently argue, the weaknesses of pulling of the fiscal string have started showing at both the domestic and integrational front, which weaknesses are now amplified by the political stalemate over the 2018 General Elections and its immediate market implications as well as what it means for the medium term.

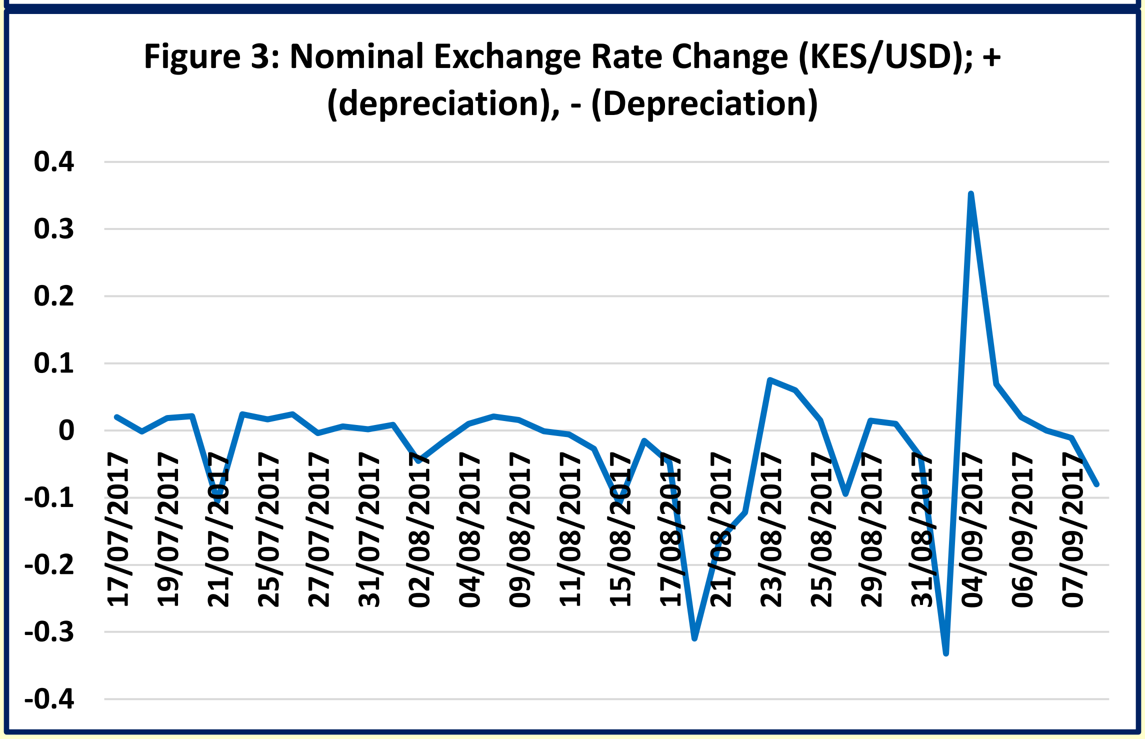
The external sector – vulnerable than we choose to admit?

The MPC has always taken the comfort in a stable foreign exchange rate market. It can be argued that such stability (**Figures 2 and 3**) speaks more to the vigilance of the CBK that is backed by foreign exchange reserves than a robustly healthy balance of payment position. The adequacy of foreign exchange reserves, presently estimated at slightly below 5 months equivalent of imports of goods and services as well as an International Monetary Fund (IMF) stand-by facility means that the CBK is able to make market interventions as required to obviate any volatility.

In essence, if stability in the foreign exchange market is assured by the monetary authority's hawk-eyed approach, then it can mean that the external position is either in need of continued support or the exchange rate – being a relative price – may need some adjustment that will amount to a correction.

[1] Friedman, Milton (1968), "The Role of Monetary Policy", *The American Economic Review*, Volume LVIII, No. 1.

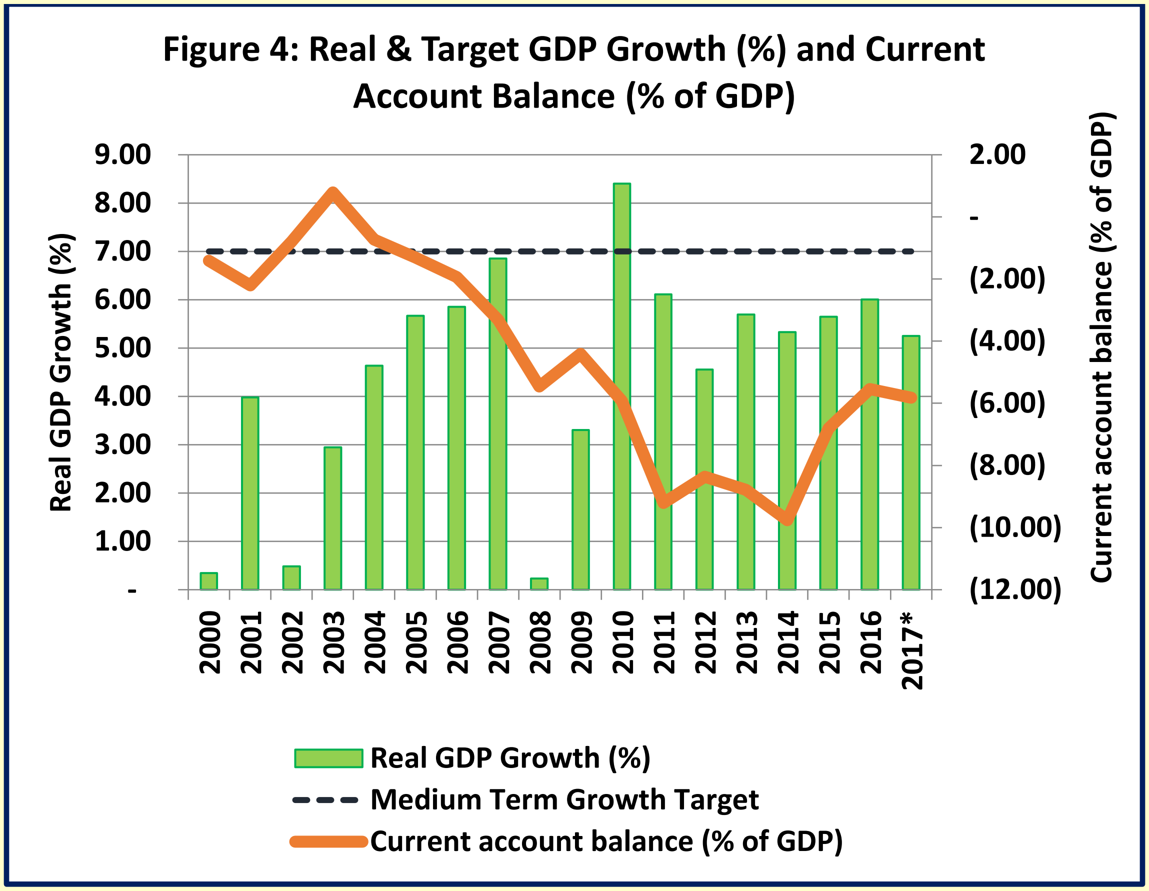




Source: Central Bank of Kenya

The foreign exchange market developments are against the background of the gap between the government's medium term real growth rate target of 7 percent and actual growth widening (**Figure 4**). Under normal circumstances, the widening of such gap would mean that there is scope for private sector credit expansion that is non-inflationary. But the circumstances are anything but normal. Demand pressure, as already noted, is almost muted, meaning that there is no scope for a monetary policy stimulus especially under the circumstances of a regulated interest rate regime.

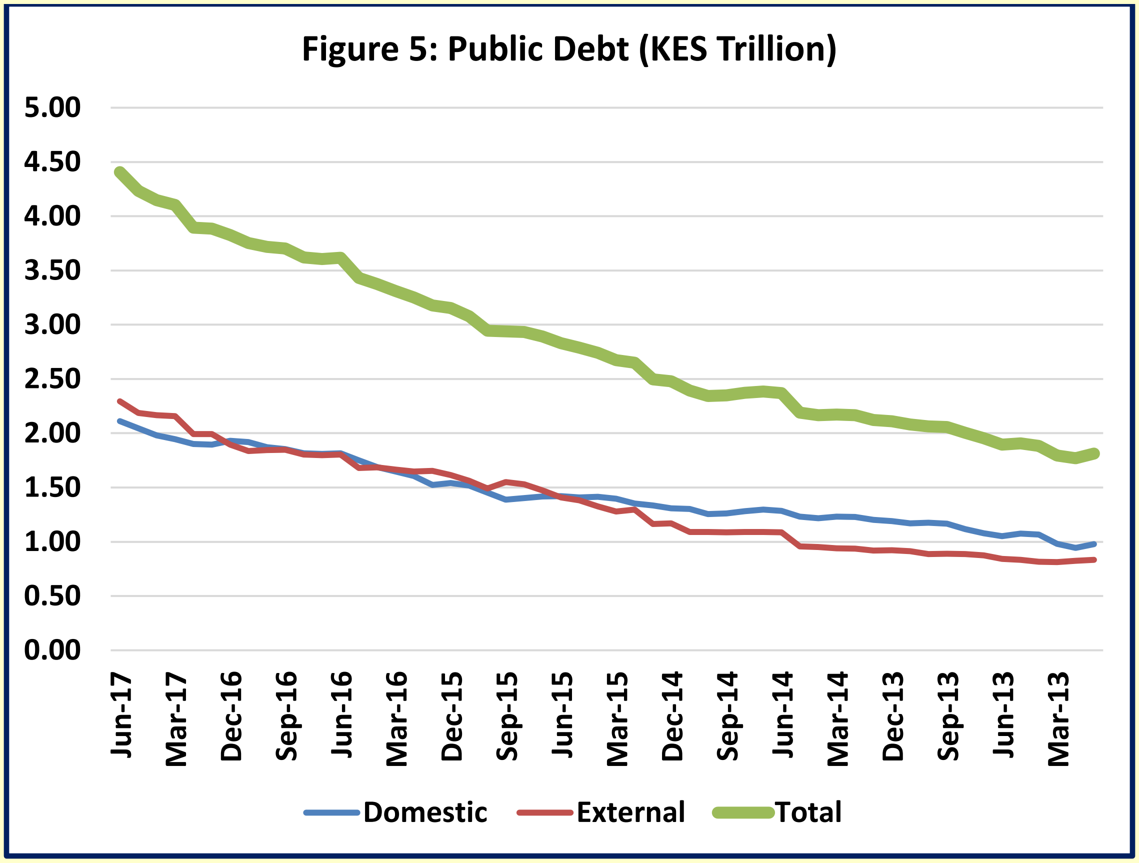
The earlier alluded demand-supply softening has seen private sector credit expand at a weakening pace, and if unabated will head towards the shrinking territory. With that state of affairs, the real GDP growth outlook of 5 percent in 2017 is easily the best case scenario. It doesn't help that political uncertainty and its attendant implications of foreign direct investments as well as portfolio flows will see the realistic growth case being even more worrying.



Source: IMF World Economic Outlook Database (July 2017)

Over the past five years the current account has narrowed, largely due to a low import bill than on a robust export regime – the low international oil prices have helped lower the import bill; the week global economy that dampened the price of commodities (Kenya's core exports) underpinned the export market weaknesses.

The narrowing of the current account implies the reduction in the extent to which the economy's domestic savings gap is filled by foreign savings. But as **Figure 5** shows, over the five years, public debt has more than doubled – give that domestic and foreign debt are of equal proportion, then it means that much of the foreign capital intermediation is towards public programmes and less towards direct support of private sector initiatives. It also means that the weak credit to the private sector is manifest from both the domestic and foreign front.



Source: Central Bank of Kenya

With the economic weaknesses outlined it is increasingly becoming necessary not to ask wither the economy is debt suitable but instead to ask for how long it will remain debt sustainable. The fiscal position, which has attracted protracted calls for consolidation, is now manifesting its challenges on the external sector, hence our argument that the economy may be having external vulnerabilities than we are willing to admit.

Conclusion

The MPC's inevitable decision of retaining the CBR at 10 percent is more of a tactical pause on the back of substantial un-clarity and uncertainty. Underlying the pause is a two-edged signal, one being obvious and other less so.

The obvious signal is that the policy stance is meant not to upset the current pricing of credit. This would make sense under normal conditions when such pricing is unregulated and the market is devoid of supply and demand weaknesses. The conditions are anything but normal. Weak supply has been inflationary. Weak demand is underkying private sector distress that has seen credit to private sector almost grind to a halt.

The less obvious, but certainly more interesting, signal is that there is a lot of uncertainty with a bearing on market stability and overall economic performance. The uncertainty arise mainly, but not entirely, from the political stalemate linked to the 2017 General elections. The external position is weaker than we are willing to admit; the current account position could be disguising the true state of the external situation. The state of public debt and its sustainability is increasingly becoming part of that vulnerability. Under the circumstances, patience on the part of the MPC in changing the policy stance is logical.

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