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November 23, 2019

Monetary Policy Stance: A Choice at the Inflection Phase of the Credit Market

Highlights

- The meeting of the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) of November 25, 2019 will undoubtedly draw keen attention for two reasons. One, it will be following the repeal of the Banking Act to remove the interest rate caps that were introduced in 2016. Two, it follows the MPC's 'forward guidance' in the previous meeting leaning towards an "accommodative monetary policy in the near term".
- We make two arguments.
    - One, the credit market is at an inflection phase and the policy choices – fiscal and monetary – will likely influence the path of the market in the near term. Amidst obvious fiscal challenges even as the Government is committing to fiscal consolidation, it is tempting to assume that monetary policy will pick up the slack in supporting growth by stimulating credit.
    - Two, the plausibility of the assumption that the credit market will respond to an accommodative policy stance is predicated on the argument that the removal of the interest rate caps comes with an element of immediacy regarding the flexibility of credit pricing.
- ***Taken together, these two arguments need to take on board the reality of the popular expectations of rigidity of interest rates even without caps.*** With that, it's possible that the counterintuitive nature of the credit market not responding to the policy signal may still be binding in the immediate term. ***Therefore, even on the back of broader macroeconomic stability, a monetary policy pause during the market inflection phase seems reasonable.***
- If the MPC decides to follow through on the accommodative route, that will mean that it has weighed the trade-offs between the possibility of, on the one hand, a non-responsive credit market at a time when the fiscal consolidation path is not clear and, on the other, the need to maintain policy credibility whereby its signal is picked and transmitted. Should the current circumstances work towards lengthening the transmission lag period, then the MPC's decision will be presumed to mean that such lengthening is not a cost to its policy credibility.

Introduction

The meeting of the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) of November 25, 2019, will undoubtedly draw keen attention for two reasons. One, it will be the first MPC meeting following the repeal of the Banking Act to remove the interest rate caps that were introduced in 2016. Two, the MPC decision will provide a clear signal of the monetary policy stance on the back of the 'forward guidance' in the previous meeting leaning towards "accommodation"[1].

There is a connection, albeit not obvious, between these two factors; and it is in that connection that the validity of the November 25, 2019 decision is hinged. The thread that links the two is in the circumstances under which monetary policy is expected to be effective. Under the capped interest rates environment that prevailed for nearly three years, monetary policy was muzzled as confirmed by – among many studies – the CBK (2018)[2]. While the effect of interest rate capping first on monetary policy and second on the credit market were *a priori* expected to be negative, monetary policy apparently gave the new dispensation a benefit of the doubt; an accommodative stance was taken immediately the capping law came into effect.

As the CBK (2018) observes:

> *"On September 20, 2016, the MPC, in its regular meetings, noted that inflation was expected to decline but had concerns with the slowdown in credit to the private sector. Consequently, it decided to reduce the CBR by 50 basis points to 10.0 percent with the anticipation of reversing the declining trend. However, credit to the private sector continued to decline leading one to conclude that the monetary policy action produced counterintuitive results… a loosening on monetary policy yielding unexpected decline in credit to the private sector".*

The repeal of the Banking Act to remove the caps in the interest rate charged on credit came after the MPC had given the 'forward guidance' regarding its amenability for an accommodative stance, contending that "the prospective tightening of fiscal policy which would provide scope for accommodative monetary policy in the near term". As we argued in a *Research Note* of September 23, 2019[3], "it remains to be seen whether the path towards fiscal consolidation is straightforward or slippery and whether that is the appropriate grounding for forward guidance".

Against that backdrop, the questions that this *Research Note* will seek to answer is: is the grounding sufficient for the MPC to follow through with its 'near-term' shift to an accommodative stance? Will such shift, coming soon after the removal of the interest rate caps lead to an appropriate response from the credit market?

We make two arguments. One, the credit market is at an inflection phase and the policy choices – fiscal and monetary – will likely influence the path of the market in the near term. Amidst obvious fiscal challenges even as the Government is committing to fiscal consolidation, it is tempting to assume that monetary policy will pick up the slack in supporting growth by stimulating credit. Two, the plausibility of the assumption that the credit market will respond to an accommodative policy stance is predicated on the argument that the removal of the interest rate caps comes with an element of immediacy regarding the flexibility of the pricing of credit.

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[1] https://www.centralbank.go.ke/uploads/mpc_press_release/928263182_MPC%20Press%20Release%20-%20Meeting%20of%20September%2023,%202019.pdf

[2] https://www.centralbank.go.ke/wp-content/uploads/2018/03/Interest-Rate-Caps_-March-2018final.pdf

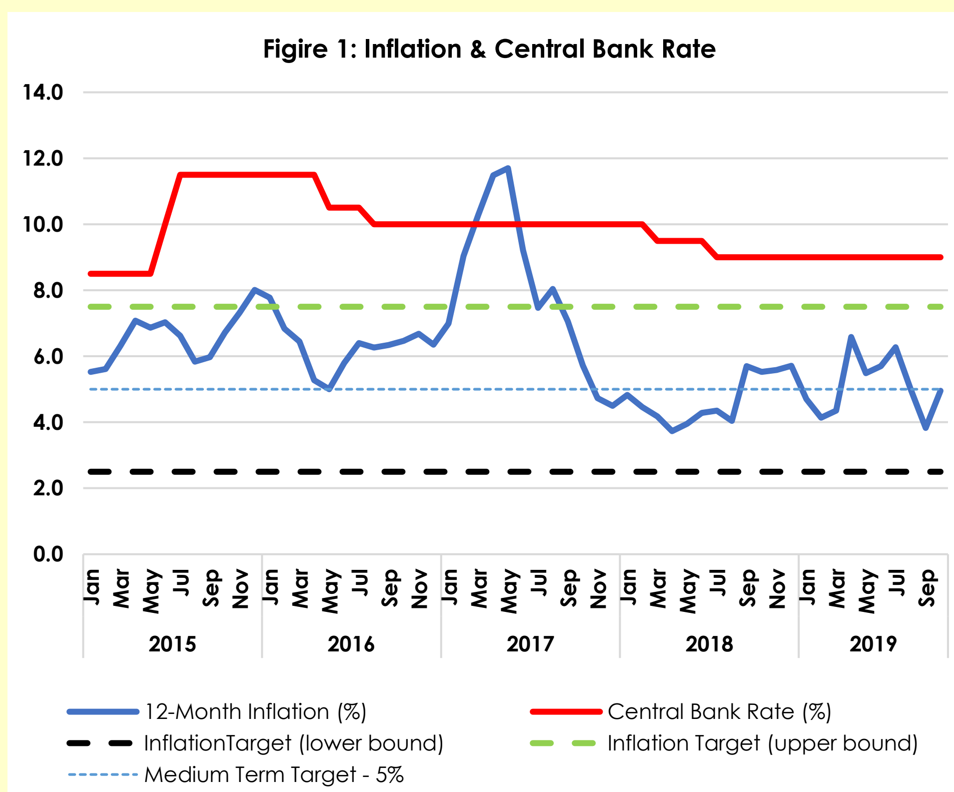
[3] https://www.kba.co.ke/downloads/RN%20No%204%202019.pdf

Taken together, these two arguments need to take on board the reality of the popular expectations of rigidity of interest rates even without caps. With that, it's possible that the counterintuitive nature of the credit market not responding to the policy signal may still be binding in the immediate term. ***Therefore, even on the back of broader macroeconomic stability, a monetary policy pause during the market inflection phase seems reasonable.***

If the MPC decides to follow through on the accommodative route, that will mean that it has weighed the trade-offs between the possibility of, on the one hand, a non-responsive credit market at a time when the fiscal consolidation path is not clear and, on the other, the need to maintain policy credibility where its signal is picked and transmitted. Should the current circumstances work towards lengthening the transmission lag period, then the MPC's decision will be presumed to mean that such lengthening is not a cost to its policy credibility.

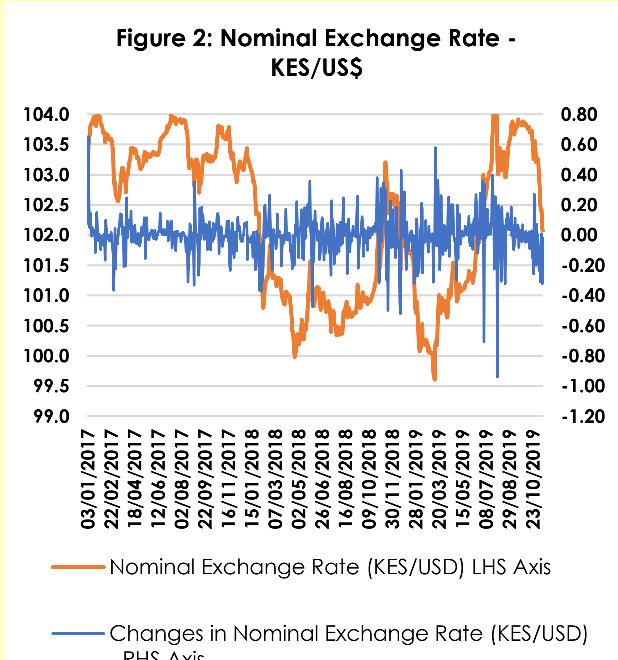
First, Macroeconomic Stability…

As the MPCs ponder on its policy decision, its eyes are clearly trained on the core mandate of maintaining macroeconomic stability, for its such stability that growth is anchored. From a stability standpoint, it is evident that: (a) inflation is within the target range, (b) the foreign exchange market is stable. As **Figure 1** indicates, inflation remains within the target, albeit with signs of upward bias as it historically remains more on the upper bound of 5.00 percent to 7.5 percent. Inflationary pressure is mainly emanating from the supply-side, for demand-driven inflationary pressures has remained muted. Even with inflation expectations remaining well anchored, monetary policy has to a large extent been justifiably conservative.



Source: CBK

Figure 2 shows the broad stability in the foreign exchange market. This has had a contributory effect in inflation in the form of at worst low pass-through effect. The observed stability and its outlook need to be taken in the context of the extent to which it is buttressed by the state of the economy's external position and the policy instruments available to the CBK to sustain it. It is worth noting that the economy's current deficit continues to close (**Figure 3**). Whereas domestic demand conditions will have an influence on demand for imports, a weak global economy will likely have a toll on exports. Elevated uncertainty surrounding trade and geopolitics as the IMF notes in its October 2019 *World Economic Outlook*[4] may put a strain on global demand.



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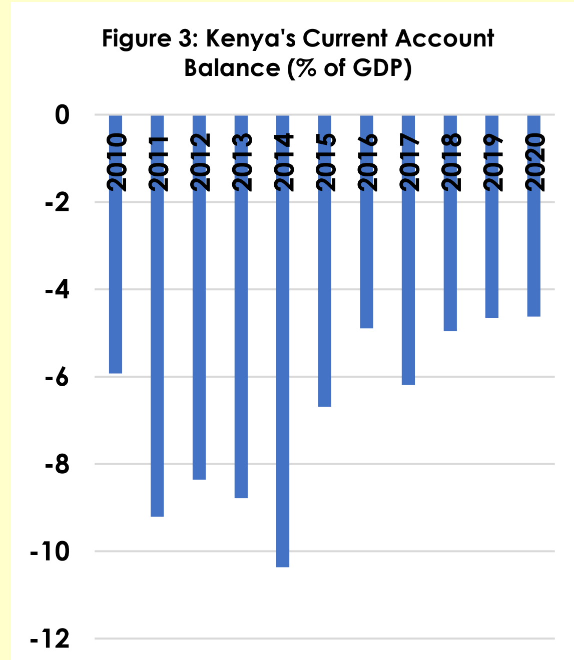
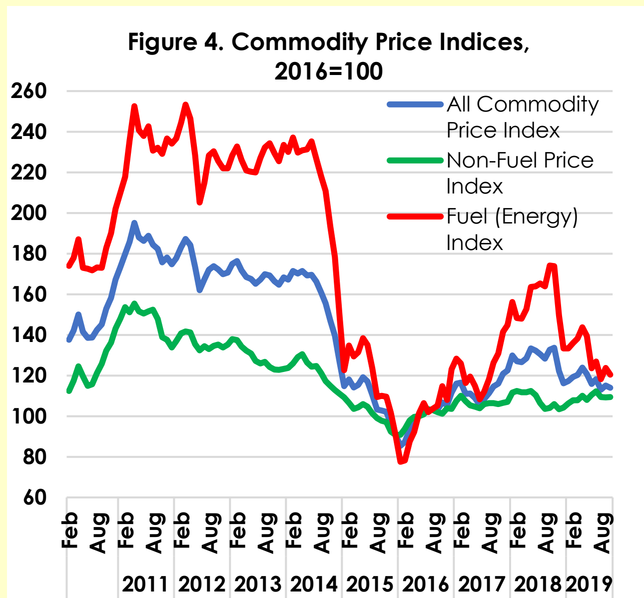
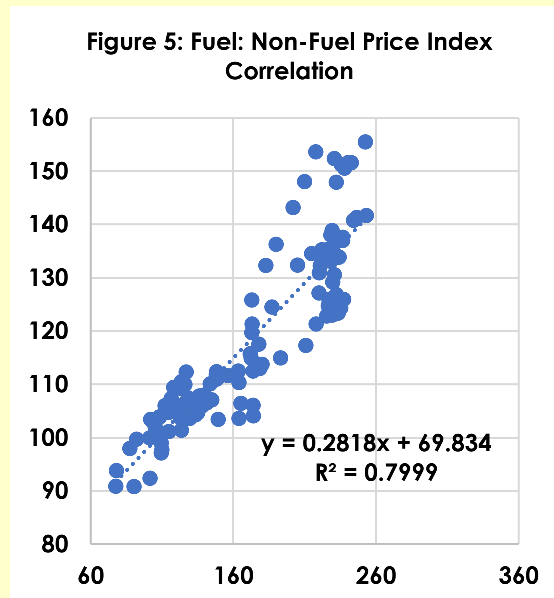


Source: IMF

The MPC could take the comfort of the foreign exchange reserves adequacy which are an equivalent of 6 months of import cover. It should be acknowledged though that the quantum of foreign exchange reserves is important but so is the source, for different sources have different multiplier effects on the domestic economy. It is evident that the build-up of the reserves is from diaspora remittances as export earnings are not that strong. Even as oil prices keep a declining trend (**Figure 4**) and therefore supporting savings of import costs and the observed low inflation though minimal oil prices pass-through effect, Kenya's commodity export earnings are likely to be subdued given the strong association between fuel and non-fuel commodity prices (**Figure 5**).

[4] https://www.imf.org/~/media/Files/Publications/WEO/2019/October/English/text.ashx?la=en



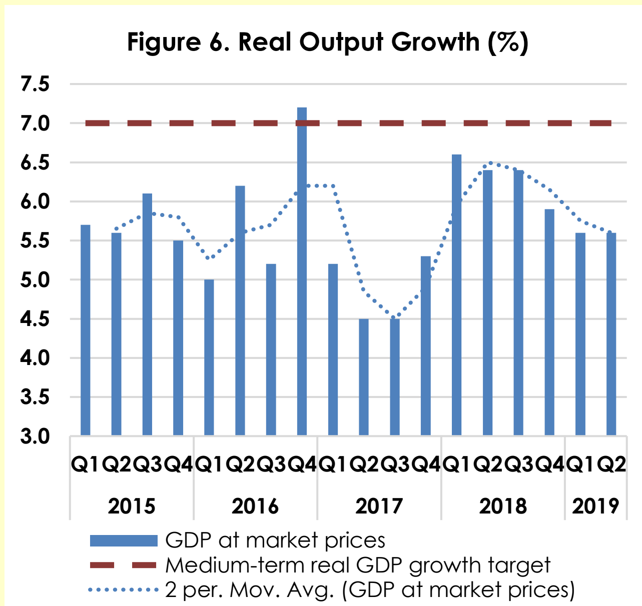


Source: IMF

…And then Growth.

With the stable macroeconomic environment outlined above, it could be argued that there is scope to deploy monetary policy to support growth. While the economy is growing at a rate that could be characterised as strong (**Figure 6**), it's clear that: (a) the scope for fiscal programmes to continue being a growth driver is limited as fiscal consolidation becomes a priority, (b) enterprises are operating at excess capacity (limited or no demand for additional investments) and households' expenditure ability is constrained (our earlier observation of subdued core inflation). These two factors point to an economy with a negative output gap that superficially means an accommodative monetary policy will not compromise macroeconomic stability.

The key question to ask is: will monetary policy do the trick of taking the economy on the path of closing the output gap, especially post the repeal of the Banking Act to remove interest rate caps? To be sure, one must take into account that the credit market being trapped in a low equilibrium position (**Figure 7**) has both a demand and supply angle. The alluded excess capacity and weak household demand point to the possibility of limited effective credit demand even on the back of banks willing to avail funding in a non-controlled credit pricing regime.



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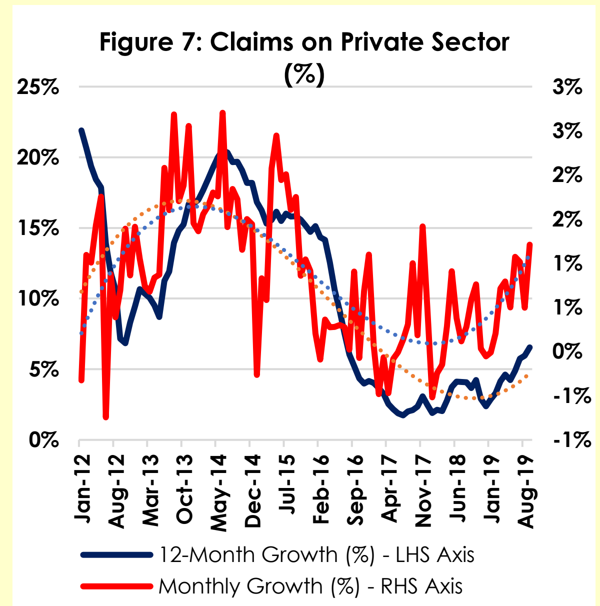

Source: CBK

We see the credit market to be at an inflection phase and the policy choices – fiscal and monetary – will likely influence the path of the market in the near term. Amidst the already noted obvious fiscal challenges even as the Government is committing to fiscal consolidation, it is tempting to assume that monetary policy will pick up the slack in supporting growth by stimulating credit. The plausibility of the assumption that the credit market will respond to an accommodative policy stance is predicated on the argument that the removal of the interest rate caps comes with an element of immediacy regarding the flexibility of the pricing of credit.

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Conclusion

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