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

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Monetary Policy Stance: A Pause, But still Accommodative

Highlights

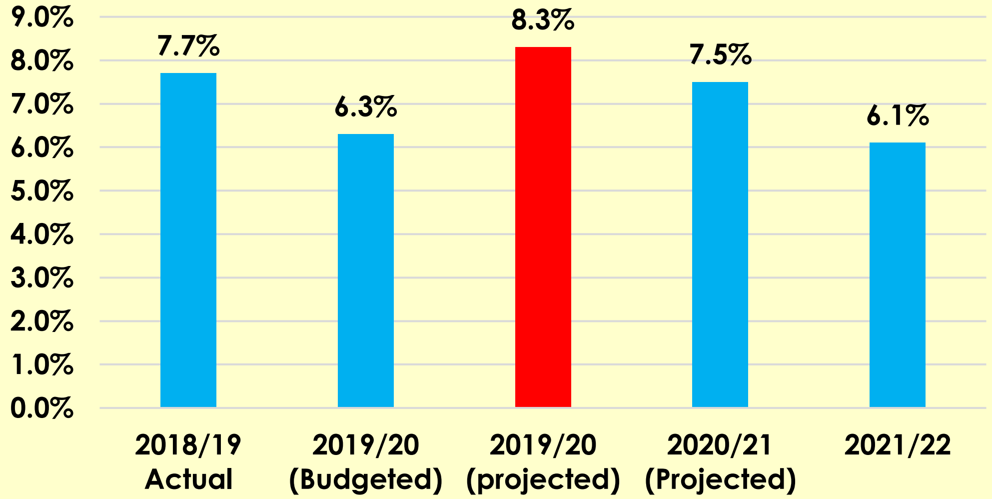
- Will a further easing of financial conditions as reflected in the monetary policy stance necessarily translate to increased demand and therefore spur economic activity? Considering the prevailing macroeconomic conditions, can the evidence of compete transmission of the previous monetary policy decisions discernible? With the pandemic still evolving – and with limited clarity on how it will pan out – any answer to these questions will be tentative.
- This *Research Note* leans towards a monetary policy stance that remains accommodative without necessarily adjusting the signaling rate – the Central Bank Rate (CBR). Holding the CBR at its current level of 7.00 percent as was the case in the Central Bank of Kenya's Monetary Policy Committee meeting of June 25, 2020 will allow for the economy to obviate any downside risks associated with unanticipated perverse outcomes of a further accommodation on the back of a constrained but still expansionary fiscal policy.

Introduction

As the Monetary Policy Committee (MPC) of the Central Bank of Kenya held it's now monthly meetings on June 25, 2020, it was clear that its policy stance under the current circumstances could only be accommodative. Evidently, the recent MPC policy actions are intended to cushion the economy from the adverse effects of the pandemic, albeit in a complementary manner to other government policy measures.

The fiscal policy on its part – as signalled by June 11, 2020, Budget Statement – has remained expansionary in posture. Even amidst constrained fiscal space occasioned by dwindling revenue prospects, the financial resource requirement to support the economy bedevilled by the unabated COVID-19 pandemic remain high. With fiscal consolidation obviously, and justifiably, taking a back seat as the fiscal deficit widens **(Figure 1**), it is critical to reflect on how – or whether - the two major macro policies are in rock-step.

Figure 1: Fiscal Deficit (% of GDP)



Source: National Treasury

The sense of urgency in macroeconomic policy, especially on the part of the MPC, is obvious. With the nature and magnitude of the impact of the COVID-19 shock, and especially the fact that its transmission is multi-pronged, any expectations of the efficacy of policy to enable the economy reverse its decline is akin to steering the Titanic; the captain knows where the ship ought to go and expends every effort to align it in that direction.

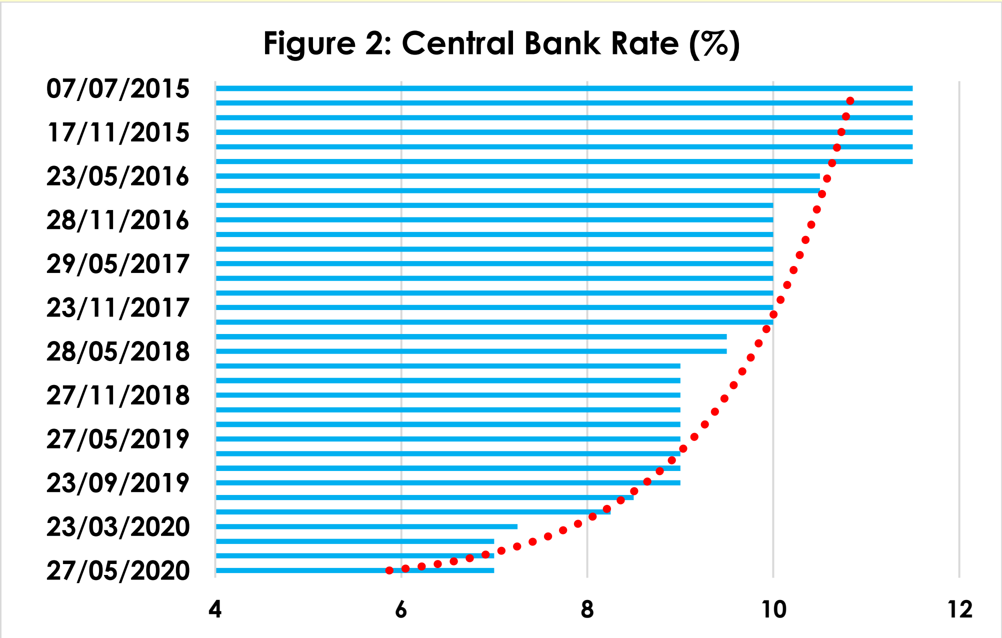
Whilst many unknowns remain, the economy is undoubtedly not forecasted to be heading to the eventual destination of the Titanic. The policy mix at play is expected to provide the necessary stabilisation. What is not clear though is whether more of the same ingredients of the policy will see the economy show signs of turning the corner.

As the MPC, therefore, met to review the traction of its recent past decisions that can be characterised as overtly accommodative (**Figure 2**), it's worthy pondering on several questions, but notably the following: Will the further easing of financial conditions as reflected in the monetary policy stance necessarily translate to increased demand and therefore spurred economic activity? Considering the prevailing macroeconomic conditions, can the evidence of complete transmission of the previous monetary policy decisions discernible?

With the pandemic still evolving – and with limited clarity on how it will pan out – any answer to these questions will be tentative. This Research Note nonetheless proffers two sets of arguments.

- One, if the efficacy of monetary policy is seen in the context of attaining macroeconomic stability as could be inferred from inflation being within the target range, it is tempting to argue that the MPC decisions are meeting the primary objective. That implies that the risks to stability by a further accommodative stance have low risks of upsetting stability agenda. While such an argument has its merits, it needs the qualification that demand remains weak; thus, the accommodative stance has not necessarily triggered more credit uptake.
- Two, if credit demand remains weak on account of businesses operating at excess capacity and households are lacking effective demand, then resource allocation will likely follow the monetary policy – fiscal policy interplay. Banks will see opportunity in lending to the government in view of the wider fiscal deficit; this may push the economy into a vicious cycle that the crowding-out effect at the centre of such resource allocation may trigger.

This Note leans towards a monetary policy stance that remains accommodative without necessarily adjusting the signal rate – the Central Bank Rate (CBR). Holding the CBR at its current level of 7.00 percent as was the case in its June 2020 meeting will allow for the economy to obviate any downside risks associated with unanticipated perverse outcomes of a further accommodation on the back of a constrained but still expansionary fiscal policy.



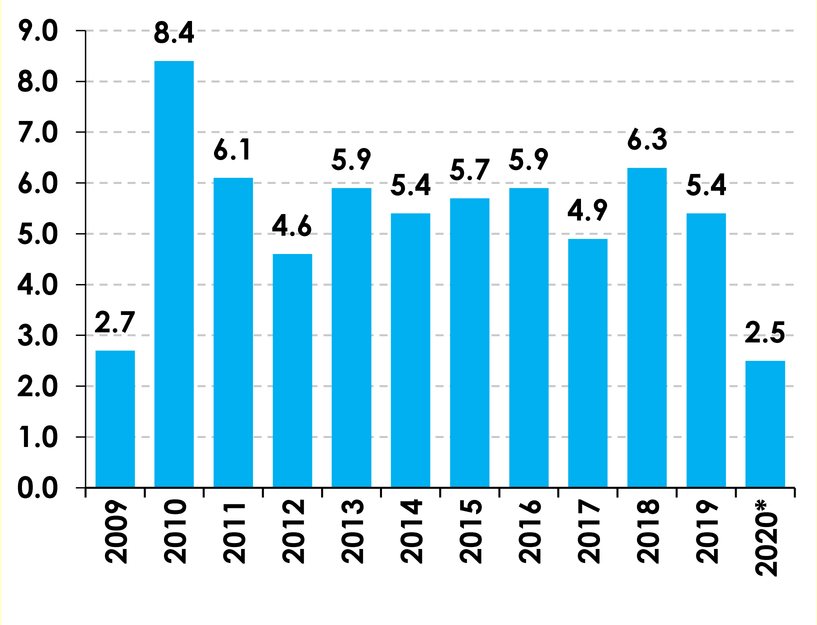
Source: CBK

The slowdown follows the shock…

The economy's output growth before the COVID-19 pandemic has been characterised as strong, even when it had started showing sights of slowdown in 2019 compared to 2018 (**Figure 3**). It is abundantly clear now that the earlier projections of a GDP growth of 5.8 percent for 2020 is not attainable; indeed, even the 2.5 percent forecast may well be very optimistic in the circumstances.

That means that the possibility of the economic slack widening over time is real. That is on account of the measures adopted to contain the spread of the virus leading to a partial shutdown of non-essential economic activities, delivering simultaneous shocks to supply and demand. The negative output gap is a pointer to the possibility of not having an accommodative monetary policy at limited risk of upsetting macroeconomic stability. While such an argument has its merits, it needs the qualification that demand remains weak; thus, the accommodative stance has not necessarily triggered more credit uptake.

Figure 3. Real Output Growth (%)



Source: KNBS & BPS (2020)

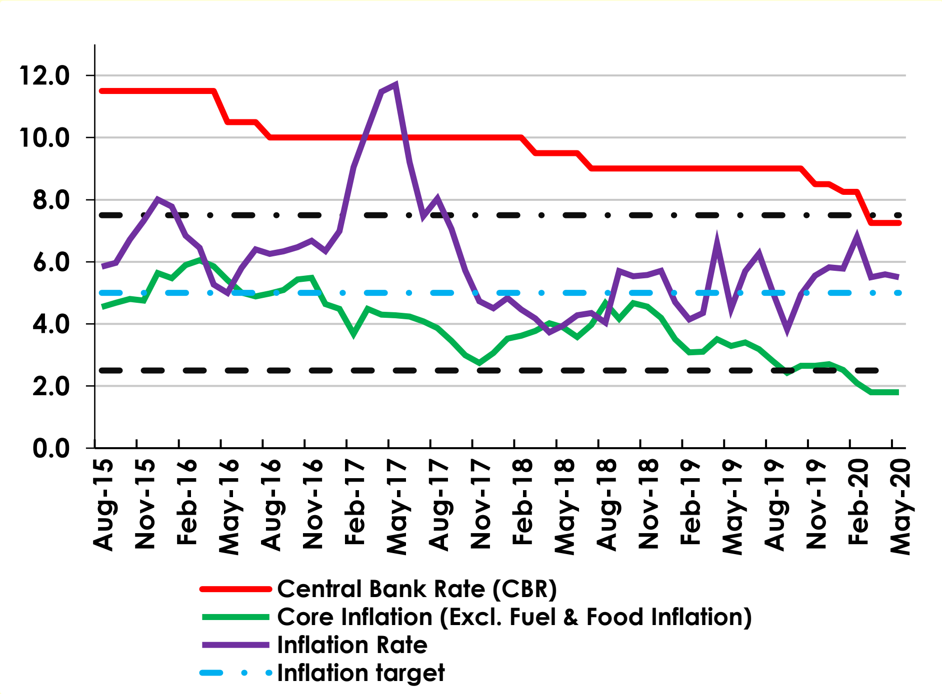
As noted, credit demand is weak on account of businesses operating at excess capacity and households are lacking effective demand. We face the possibility of resource allocation likely following the monetary policy – fiscal policy interplay. Banks will see opportunity in lending to the government in view of the wider fiscal deficit; this may push the economy into a vicious cycle that the crowding-out effect at the centre of such resource allocation may trigger.

… but macroeconomic stability is evident.

The economy's inflation dynamics reflect an interesting interplay between demand and supply conditions of the economy. Overall inflation – while remaining on the upper bound of the target range, core inflation remains sticky and below the lower range (**Figure 4**). The decline in overall inflation from 6.80 percent in February 2020 to 5.5 percent in May 2020 is attributed to the slowdown in food inflation and fuel inflation to 10.60 percent and 3 percent respectively in May from 11.6 percent and 5.6 percent in April 2020, an indication of muted supply-side pressures. Core inflation is sticky at 1.80 percent for three consecutive months, suggesting that no demand-side pressures exist as aggregate demand is depressed.

The observed inflation trend is supported by two factors. One, the stability of the exchange rate albeit characterised by depreciating trend in the recent months; and two lower oil prices buttress the stable inflation outlook. Under normal circumstances, this would support a more accommodative stance. The current circumstances are far from normal, for aggregate demand is muted even as the CBR has been lowered in the recent past months. Whether further easing of monetary policy will nudge enterprises and households to bring forward their future spending plans and hence spurring aggregate demand remains an open question.

Figure 4: Evolution of Inflation & Central Bank Rate



Source: CBK

Amid the uncertainty associated with the outbreak of the coronavirus, enterprises and household's decision-taking inertia has been amplified and demand is muted, a clear suggestion that the economy may have simply run short of "marginal" consumers who can be encouraged to spend. In addition, financial distress among enterprises and households will cause the share of banks' non-performing loans (NPLs) to rise, weighing on bank capital and potentially clogging the bank lending channel of monetary policy.

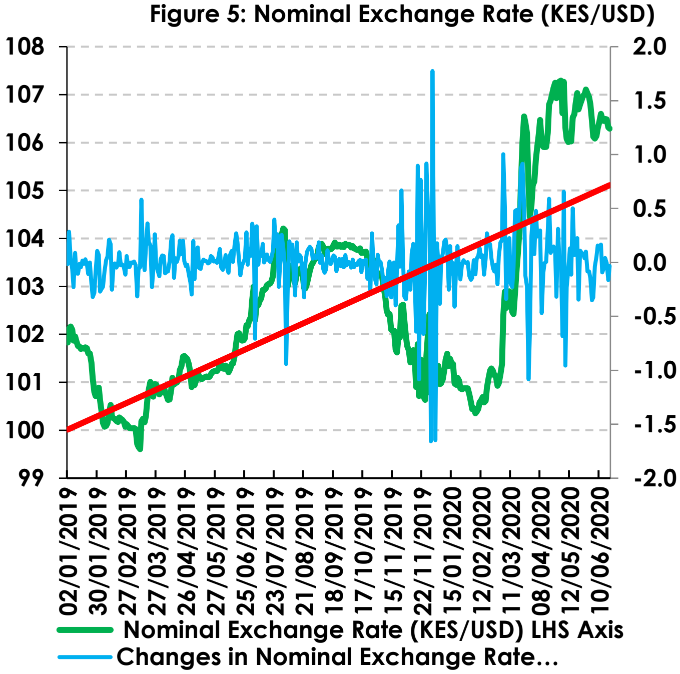
Exchange rate developments

As already observed, while the shilling has been broadly stable, albeit, with a general depreciating trend (**Figure 5**), on account of the economy's external position weakness attributable to a global economy. The slowdown of remittances, which increasingly had been a significant contributor to the economy's foreign exchange reserves, has had a contributory effect on the weak external position. However, the recent increase in the CBK usable foreign exchange reserves remains adequate at USD 9,278 million (5.58 months of import cover) as of June 18 further supporting the shilling's stability. Even so, the compensatory effect of reduced oil import bill due to lower prices provides a cushion to the depreciating trend.

Further, the strong association between international oil prices and the changes in the local currency's nominal exchange rate (**Figure 6**) plays an integral role in influencing the economy's current account deficit estimated at 4.9 percent of GDP (as of March 2020). The attribute of international oil prices filtering into the local foreign exchange market points to the fact that the lower oil prices are likely to be associated with currency stability and hence maintenance of the current account deficit albeit temporarily.

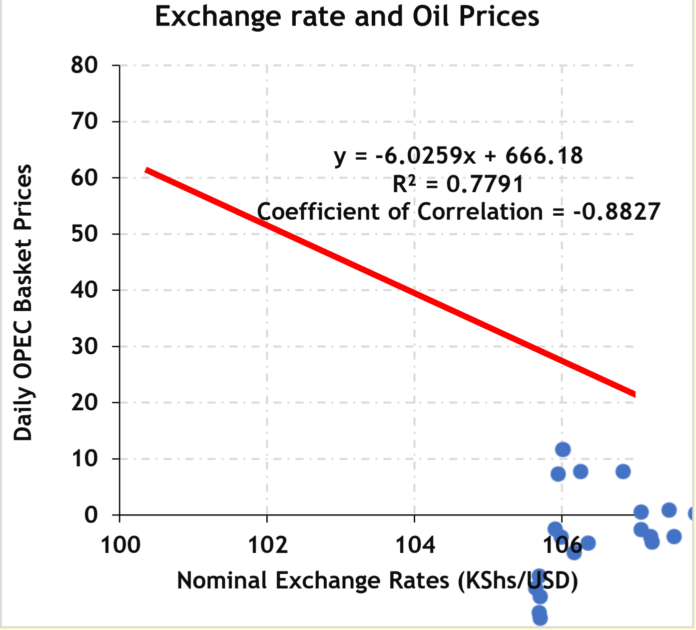
But since the economy is a net commodity exporter and commodity prices tend to depict strong co-movement, the current account deficit is projected to widen to about 5.8 percent by the end of 2020.

Figure 5: Nominal Exchange Rate (KES/USD)



Source: CBK

Figure 6: Correlation between Exchange rate and Oil Prices



Source: Cumputed based on CBK & OPEC Data

Conclusion

Will a further easing of financial conditions as reflected in the monetary policy stance necessarily translate to increased demand and therefore spur economic activity? Considering the prevailing macroeconomic conditions, can the evidence of complete transmission of the previous monetary policy decisions discernible? With the pandemic still evolving – and with limited clarity on how it will pan out – any answer to these questions will be tentative.

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