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

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# Monetary Policy Stance – Banking on the Forecast, but Blunting the Signal!

## Highlights

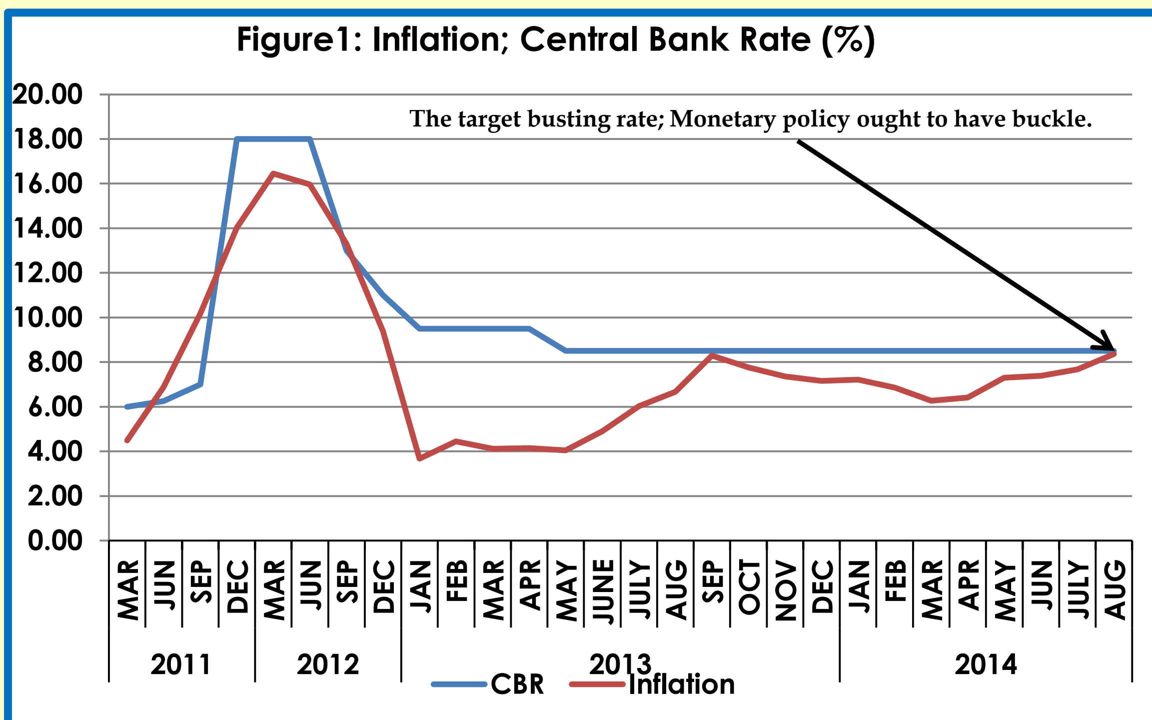
- The MPC has opted to retain the Central Bank Rate (CBR) at 8.5 percent for 9th consecutive meeting of September 3, 2014. Its justification is that there is no fundamental structural pressure on inflation and that the overshooting of the inflation target stems from the base effects of energy and food prices; therefore in MPC's forecast, inflation will dissipate in September 2014.
- We contend that this is an interesting, if controversial, policy stance for at least three reasons.
  - One, inflation has since July 2013 been sticky on the upper bound and not necessarily close to the medium target of 5 percent; this state of affairs speaks to the fundamental structural dynamics that may see inflation persisting above target for longer than the MPC projects.
  - Two, the foreign exchange pass-through effect on inflation is easily assumed away by the MPC at a time when the local currency is under depreciation pressure. Such pressure is unlikely to dissipate in the short-run.
  - Three, the MPC admits that there is a case for change of policy stance in its indication that it will "pursue a tightening bias in the money market through the CBK monetary policy operations". This presents a contradiction. If the MPC is seeking to pursue a policy stance with a tightening bias, then such stance should be signalled by the adjustment in the CBR. In any case, the Committee argues that the short term rates are aligned to the policy rate.
- In essence, the MPC is banking on its outlook while blunting the signalling effect of the CBR.

*"The tightening signal would be clearly justifiable not only on the account of inflation over-shooting the target but also as a necessary accommodation of the foreign exchange market that presently is under depreciation pressure. Such decision would be echoing the fact that the lessons of the costs of past delayed monetary policy action have filtered through into the money policy process."*

## Introduction

The 3rd September 2014 meeting of the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) was held on the back of inflation having busted the target range of 2.5 percent points on either side of the 5 percent target. The 8.36 percent inflation rate for August 2014 was not a sudden upshot; the inflationary momentum has been building since February 2014 even though over much of that time the inflation rate was within target (**Figure 1**). The upward trajectory in the inflation rate is partly attributable to new electricity tariffs that came into effect in August 2014 as well as shortage in the stable foods such as maize that has led to importation from Tanzania. Even then, the MPC has retained the CBR at 8.5 percent.

It is our view that the MPC was justified not just in maintaining the Central Bank Rate at 8.5 percent while inflation was within target but also for pointing out the downside risks that could influence inflation outlook. As we have consistently argued in three previous *Research Notes*[1], the MPC is ostensibly getting better at anchoring inflation expectations in its policy communication. With inflation now above target, the alluded commitment to ensuring that inflation remains within target underpins the expectations for not just the intention but a clear tightening signal in the form of an increase in the CRR.




***Source: Central Bank of Ken;, Kenya National Bureau of Statistics***

[1] January 16th, 2014, (*Research Note No 7*); March 6th, 2014 , (*Research Note No. 8*), May 5th 2014 (*Research ote No. 10*) and July 9, 2014, *Research Note No. 11*) all avalialble at www.kba.co.ke

As this *Research Note* will argue, the tightening signal would be clearly justifiable not only on the account of inflation over-shooting the target but also as a necessary accommodation of the foreign exchange market that presently is under depreciation pressure. We further argue that such decision would be echoing the fact that the lessons of the costs of past delayed monetary policy action have filtered through into the money policy process[2].

The MPC has opted to retain the CBR at 8.5 percent for 9th consecutive meeting. Its justification is that there is no fundamental structural pressure on inflation and that the overshooting of the inflation target stems from the base effects of energy and food prices; therefore in MPC's forecast, inflation will dissipate in September 2014.

We contend that this is an interesting, if controversial, policy stance for at least three reasons.

- One, inflation has since July 2013 been sticky on the upper bound and not necessarily close to the medium target of 5 percent; this state of affairs speaks to the fundamental structural dynamics that may see inflation persisting above target for longer than the MPC projects.
- Two, the foreign exchange pass-through effect on inflation is easily assumed away by the MPC at a time when the local currency is under depreciation pressure. As we argue in the next section, such pressure is unlikely to dissipate in the short-run.
- Three, the MPC admits that there is a case for change of policy stance in its indication that it will "pursue a tightening bias in the money market through the CBK monetary policy operations". This presents a contradiction. If the MPC is seeking to pursue a policy stance with a tightening bias, then such stance should be signalled by the adjustment in the CBR. In any case, the Committee argues that the short term rates are aligned to the policy rate.

In essence, the MPC is banking on its outlook while blunting the signalling effect of the CBR.

## Help from Abroad? Maybe Some other Time

The economy's account is manifestly weak. As we have argued previously, so long as the current remains in its weak state, the local currency will maintain the depreciation bias (**Figure 2**). The recent depreciation episodes coinciding with foreign exchange demand pressure from key importers necessitated market intervention by the CBK. While that on the one hand is testimony to the CBK's commitment to assuring stability, it on the other hand points to the fact that any depreciation persistence will signal the need for market correction in the form of relative price increase and therefore a slow down on imports.

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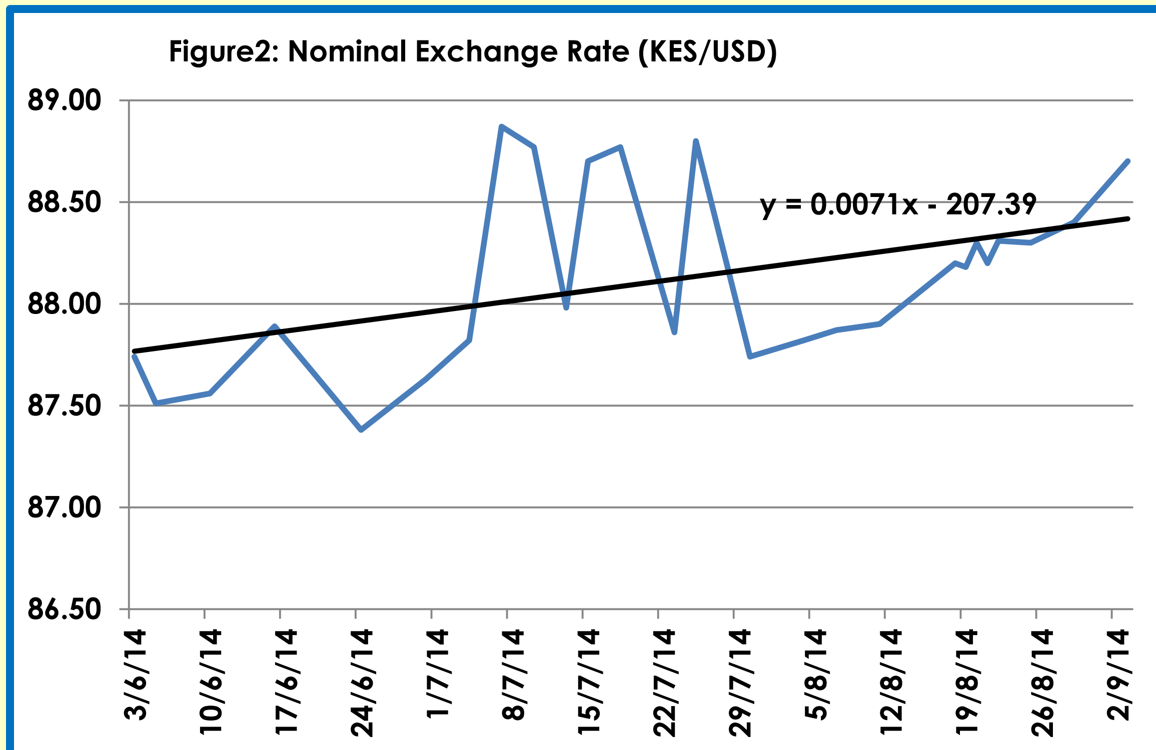
[2]See Andrle M., Andrew Berg A., R. Armando Morales R.A., Portillo R. and Jan Vlcek J. (2013), "Forecasting and Monetary Policy Analysis in Low-Income Countries: Food and non-Food Inflation in Kenya", *IMF Working Paper WP/13/61*, March
[https://www.imf.org/external/pubs/ft/wp/2013/wp1361.pdf]

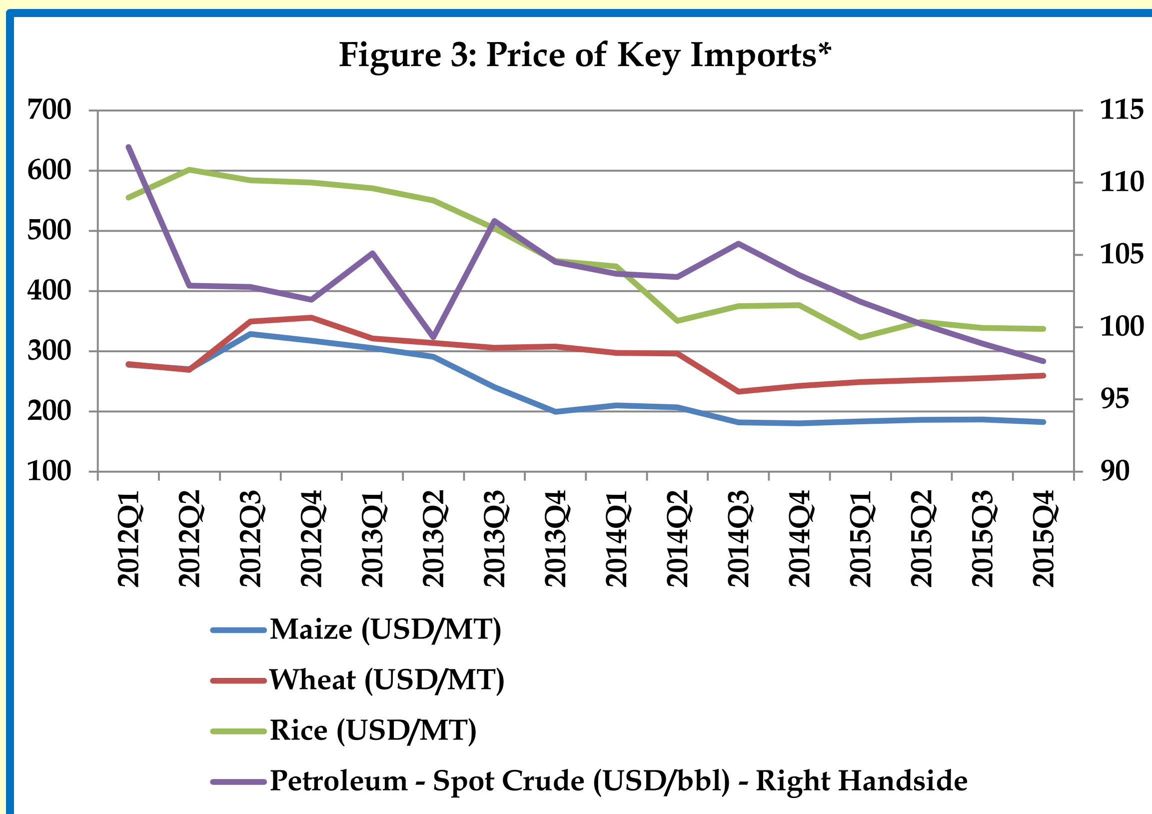



***Source: Central Bank of Kenya***

The success of the debut issue of the Euro bond drew near-euphoric expectations not just in terms of its likely impact on reducing the interest rates but also its possible effect of enabling the boosting of the currency stabilization capacity. As we pointed out in our Research Note No. 11, such expectations were clearly stretched more towards extreme optimism, an argument that early market outcomes vindicate.
The repairs to the current account will of necessity arise mainly from the exportable 'sector' of the economy; the ensuing boost of the foreign currency available in the market will at least lead to the plateauing of the foreign exchange trend. The domestic circumstances, especially the hit on the tourism sector arising from the perception of insecurity and the attendant effect of travel advisories from major sources of tourists, does not help the current account position.

Unfortunately, there is limited consolation from the global economy; expectation that a global rebound will reverberate towards local recovery – with the current account being the entry point – may seem far-fetched. The IMF's July 2014 update of the April 2014 *World Economic Outlook* almost pours cold water on any expectations of a quick rebound. According to the update, the global growth projection for 2014 has been marked down by 0.3 percent to 3.4 percent on account of both the legacy of the weak first quarter performance, particularly in the United States, and a less optimistic outlook for several emerging markets.

The IMF's less than optimistic stance is understandable. Downside risks that present the basis of concern abound. There is a possibility that the increased geopolitical risks – the Russia- Ukraine episode, the Syria and Iraq debacle as well as the merging developments in Libya – could lead to sharply higher oil prices. The IMF commodity price forecast presents a near term sharp rise in crude oil prices although it will dispute as move towards 2015 (**Figure 3**). This outlook does not factor in the geopolitical risks that may drag on for a while. There are financial market risks too; they include higher-than-expected U.S. long-term rates and a reversal of recent risk spread and volatility compression.




***Source: IMF; As Noted earlier, there is a likelihood of demand for food importation going into 2015***

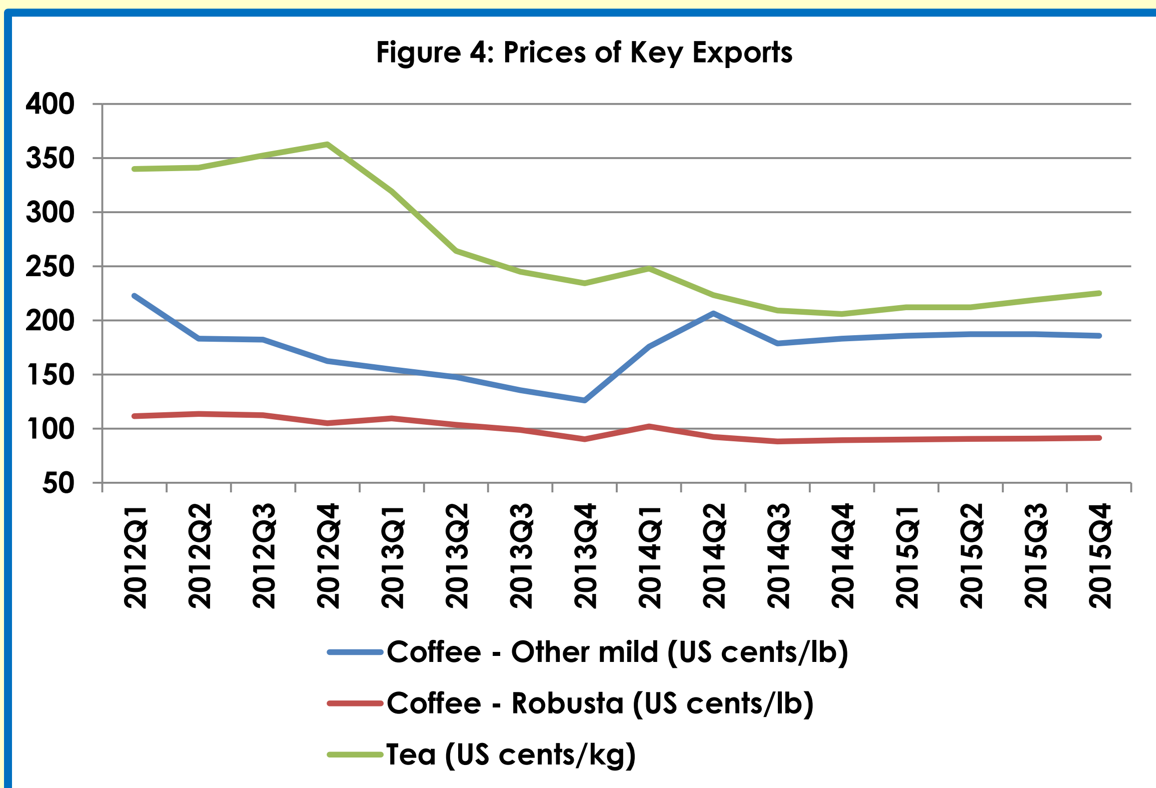
Ultimately, global growth could be weaker for longer, given the lack of robust momentum in advanced economies despite very low interest rates and the easing of other brakes to the recovery especially on the fiscal front. In some major emerging market economies, the negative growth effects of supply-side constraints and the tightening of financial conditions over the past year could be more protracted. On the emerging markets front, the focus has naturally been on the performance of the so-called BRICS – Brazil, Russia, India, China and South Africa – that now command a sizable share of the global economy.

It has downed on the managers of the China economy that the pre-global economic meltdown growth rates are not coming back soon. That is why they have resorted to interventions such as targeted policy measures to support activity in the second half of the year, including tax relief for small and medium enterprises, accelerated fiscal and infrastructure spending, and targeted cuts in required reserve ratios. As a result, growth in 2014 is projected to be 7.4 percent. For next year, although the outlook remains to an important extent a function of the government's target, growth is projected to moderate to 7.1 percent as the economy transitions to a more sustainable growth path.

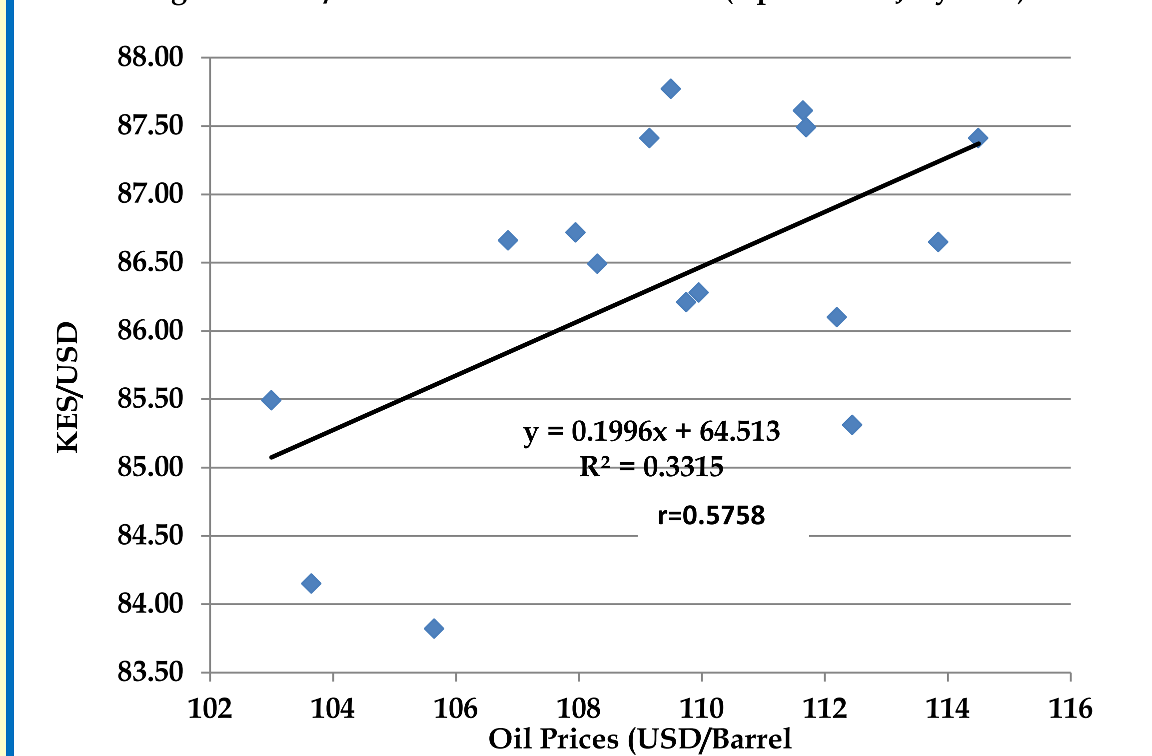
In India, growth has evidently bottomed out, and activity is projected to pick up gradually after the postelection recovery in business sentiment, offsetting the effect of an unfavorable weather on agricultural growth. In Brazil, tighter financial conditions and continued weakness in business and consumer confidence are holding back investment and dampening consumption growth. In Russia, investment is expected to remain weaker for longer, given geopolitical tensions. Growth in South Africa is expected to stay sluggish as a result of electricity constraints and labour conflicts.

The implication of the outlined global scenario could be seen from two fronts. First, the prices of Kenya's key exports are forecasted to largely be on a declining trend (**Figure 4**). It doesn't help that the East African economies have not signed an Economic Partnership Agreement (EPA) with the European Union (EU), implying that exports to the EU including horticulture produce may be uncompetitive.

Second, we see a fairly strong correlation between the international oil prices and the changes in the local currency's nominal exchange rate, albeit with a lag (**Figure 5**). International oil prices tend to filter into the local foreign exchange market, pointing to the argument that anticipated high oil prices are likely to be associated with a currency under depreciation pressure. This indirect relationship is an indication of how the Kenyan current account is sensitive to the dynamics in the international oil prices as well as how oil prices are of significant influence on the economy's current account.




***Source: IMF***




## Conclusion

The MPC in its meeting of September 3rd, 2014 decided to retain the CBR at 8.5 percent for its 9th consecutive meeting. Its justification is that there is no fundamental structural pressure on inflation and that the overshooting of the inflation target stems from the base effects of energy and food prices; therefore in MPC's forecast, inflation will dissipate in September 2014. We contend that this is an interesting, if controversial, policy stance for at least three reasons.

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