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Monetary Policy Stance – Waiting for the Sky to Clear!

Highlights

- The Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) in its meeting of November 28, 2016 decided to hold the Central Bank Rate (CBR) at 10 percent. The decision was underpinned by three considerations: one, inflation is within the Government target range; two, the foreign exchange market exhibits stability; and three, the fiscal policy – monetary policy coordination is providing the necessary support to market stability.
- Under normal circumstances, the decision to hold the rates would have been expected. But the circumstances are anything but normal, and the MPC acknowledges that there is a lot of unclarity in the air at the domestic and international front. That is why at the very least some form of analytical clarity could have helped shape market expectations.
- With all the focus that the MPC is presently drawing, the interest is not just on the direction of change (if at all) in policy but also on the consistency of the thought process. By that measure, the latest MPC decision departs from the previous one where an accommodative stance amidst uncertainty meant to spur credit expansion to the private sector flopped. The latest policy decision could admittedly be seen as an implicit correction of the previous decision.

Introduction

The Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) in its meeting of November 28, 2016 decided to hold the Central Bank Rate (CBR) at 10 percent. The MPC's decision is hinged on three key considerations. One, inflation is within the Government target range; two, the foreign exchange market exhibits stability; three, the fiscal policy – monetary policy coordination is providing the necessary support to market stability.

Under normal circumstances, the decision to hold the rates would have been expected. But the circumstances are anything but normal, and the MPC acknowledges that there is a lot of unclarity in the air at the domestic and international front. That is why at the very least some form of analytical clarity – akin to forward guidance, which in itself should not be seen as a pre-commitment – could have helped shape market expectations.

As this *Note* will argue, the fact that CBR is not merely a policy signalling rate given that it is now the base upon which – under the amended Banking Act – lending rates are capped and interest-earning deposits rates are determined is reason enough for the MPC to wean itself of the conventional but unwritten central banking doctrine of "constructive ambiguity".

In other words the justified policy decision to retain the CBR at 10 percent needed to provide the required clarity that will obviate the MPC walking onto the Keynes's 1923 critique that "economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is past the ocean is flat again"[1].

In the new dispensation of interest rates regulation, and on the back of the CBK's decision to settle on the signalling rate as the capping and deposit pricing base instead of another rate such as one through which the policy signal is operationalised, the MPC decisions are keenly watched. The keen eye is not just on the direction of change (if at all) but also on the consistency of the thought process. By that measure, the latest MPC decision departs from the previous one in one significant way.

In September 2016 the MPC was concerned that the slowdown in the rate of credit expansion to the private sector from double digit levels to single digit levels posed "***a risk to economic growth"***[2]. This was the basis of the MPC decision to lower the CBR by 50 basis points even when the rates had been brought down by two weeks earlier by over 400 basis points through legislation. The MPC now observes that ***"the slower credit growth witnessed over the last several months was found to be largely an outcome of structural factors in the banking sector rather than monetary policy. However, there is no evidence that this is***

[1] Keynes, J. M., (1923), *A Tract on Monetary Reform,* Ch. 3

[2] MPC Press Release of September 20, 2016 (https://www.centralbank.go.ke/uploads/mpc_press_release/2012373677_MPC%20Press%20Release%20-%20Meeting%20of%20September%2020,%202016.pdf)

having a negative effect on economic growth"[3]. In essence, in two month times, the clear evidence of the risk of slow credit growth to growth that prompted a policy move has turned to an evidence searching process. This begs the cliché question: does the absence of evidence mean evidence of absence?

In the meantime, the MPC is of the view that the stability in the foreign exchange market is an outcome of the narrowing of the current account deficit and the support of the strong foreign exchange reserve position. We argue that the narrowing of the current account deficit needs to be seen in the context of the asymmetric nature of the contribution of the lower imports and the higher exports to that narrowing. We argue too that the foreign exchange stability cannot be entirely attributed to the narrowing of the current account; the CBK's presence on the market partly plays a role.

The core argument of this *Research Note* is that the delicate balance for the MPC is to seek to entrench the inflation expectations anchoring credentials and policy as appropriately as possible. It has to do so though at a time when the state of the economy is weaker than it is willing to explicitly admit but could be interfered from its demeanour to lend a helping hand even when it is clear that the 1968 wisdom of Milton Friedman[4] is at play here – that monetary policy is a string: you pull it to stop inflation but you cannot push on it to halt the dwindling economic fortunes that domestic and external uncertainties begets.

Inflation – Eyes on the Ball?

The MPC has generally been reviewing the CBR in a manner that is aligned to the realisation of the inflation target range. As Figure 1 indicates, inflation has largely been within target, but mainly remaining within the upper bound of the medium-term target of 5 percent [+ (-) 2.5 percentage points. In instances where the target has been breached (e.g. September 2013 August 2014 and December 2015), there has been a quick reversion towards the target range. Much of the rise in the inflation rate lately evident has been attributed to an increase in food prices due to the erratic rain in the first quarter that has eroded the downward pressure on the inflation rate arising from the decline in the world oil prices.

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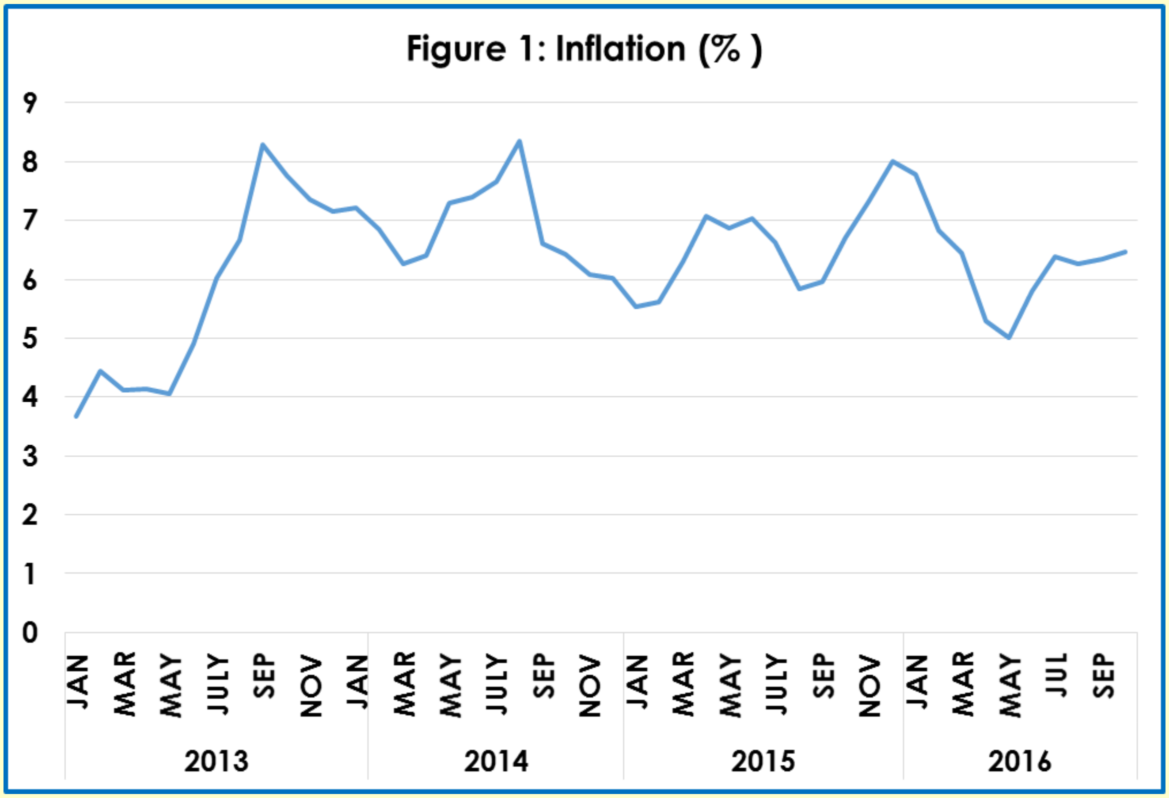
[3] MPC Press Release of November 28, 2016 (https://www.centralbank.go.ke/uploads/mpc_press_release/1127537557_MPC%20Press%20Release%20-%20Meeting%20of%20November%2028%202016%20(4).pdf)

[4] Freidman. M. (1968), "The Role of Monetary Policy", *The American Economic Review*, Vol. LVIII, No. 1. March.



Source: KNBS

While the observed success in ensuring that inflation remains with target is better analysed when all the potential undercurrents that could critically undermine stability are considered. As we have argued in past Research Notes, high inflation has a negative effect on medium and long term growth and that such inflation impedes efficient resource allocation since it obscures the signalling role of relative prices, an important guide to efficient economic decision making.

Inferences backed by evidence point towards a relationship where stable and on-target inflation is related to positive income growth. This implies that the MPC's focus remains to be on the vulnerabilities that any of at least two (potential) undercurrents may occasion.

- ***A potentially dominant fiscal position.*** The first potential undercurrent is linked to the ambitious fiscal budget for the fiscal year 2016/17. The intention of the budget is to stimulate growth in the Keynesian sense – increase in government expenditure at a time when there is no scope for monetary stimulation. A deeper reflection on the implication of this unprecedented budget – both from an expenditure point of view and from a funding point of view – on monetary policy will be critical.

  The CBK has in the past been quick to allay any insinuations about fiscal dominance – where an expansionary fiscal policy will necessitate monetary policy tightening as a counter to inflationary pressure – indicating that the two macro-policies of monetary and fiscal are aligned towards the common objective of promoting growth without compromising stability.

Evidence may seem to be vindicating the CBK's position with regard to fiscal expenditure influencing monetary policy insofar as it could potentially be inflationary. We cannot make a similar argument though when it comes to the funding side, especially cognisant that the revenue base is an ambitious real growth outlook of the economy at about 6 percent and clearly likely to be undermined by the low rate of credit expansion. The dilemma here is that it will not be easy to stimulate credit based on price (interest rate) channel alone as credit to private sector nosedived on the back of a low interest rates regime occasioned by a legislative measure. The MPC's September 2016 experiment in this direction must have led to the same conclusion.

- ***The external position.*** The current account narrowing on account of less imports (even capital goods) is not as desirable as where such narrowing is arising from increased exports. The global trade remains substantially subdued as the IMF's World Economic Outlook of October 2016 confirms.

  Besides the narrowing of the current account, it is clear that the CBK has been in the market to assure foreign exchange stability (Figues 2); while the foreign exchange reserves remain adequate, market interventions are never perpetual and without constraints.

Figure 2: Nominal Exchange Rate (KES/US$)

Source: CBK

The economy's weak external position takes little comfort from the fact that the global economy's recovery is fragile; the IMF's *Worl Economic outlook* for October 2016 confirms as much. The economy is obviously not isolated from the rest of the world; on that account, any hint that the Kenyan economy will be excemptted from the down side risks emanating from the weaker global economy would be a pointer to a policy position based on the state of the economy that is weaker than the policy maker may be willing to explicitly admit but could be interfered from its demeanour to lend a helping hand. Admittedly therefore the decision to hold the CBR is better seen as a correction from the September 2016 stance.

Conclusion

The MPC's decision to hold the CBR at 10 percent was underpinned by three considerations: One, inflation is within the Government target range; two, the foreign exchange market exhibits stability; three, the fiscal policy – monetary policy coordination is providing the necessary support to market stability.

Under normal circumstances, the decision to hold the rates would have been expected. But the circumstances are anything but normal, and the MPC acknowledges that there is a lot of unclarity in the air at the domestic and international front. That is why at the very least some form of analytical clarity could have helped shape market expectations.

With all the focus that the MPC is presently drawing, the interest is not just on the direction of change (if at all) in policy but also on the consistency of the thought process. By that measure, the latest MPC decision departs from the previous one where an accommodative stance amidst uncertainty meant to spur credit expansion to the private sector flopped. The latest policy decision could therefore admittedly be seen as an implicit correction of the previous decision.

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