RESEARCH NOTE NO.38. – 2018(RN/38/18)

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

September 24, 2018

Monetary Policy Stance – A balancing Act Between A Calm Surface and Stormy Undercurrents

Highlights

- As the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) meets on September 25, 2018 for its fifth time this year, the judgment call will essentially be a juggling act between a calm surface and stormy under currents. If the easing wave persists and it further lowers the central bank rate (CBR) then its eyes are squarely trained on the surface; if it taken on board the stormy undercurrents, it will hold the CBR. The need to hold is, in our view, more persuasive.

Calm on the surface….

As the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) meets on September 25, 2018 for its fifth time this year, the judgment call will essentially be a juggling act between a calm surface and stormy under currents.

It is obvious that the MPC has been on an accommodative mood. Its decision to lower the CBR by 50 basis points in July 2018 is confirmation that the dovish stance – where it is either a lowering or holding of the policy signalling rate – represents the policy path as informed by both market and economic conditions.

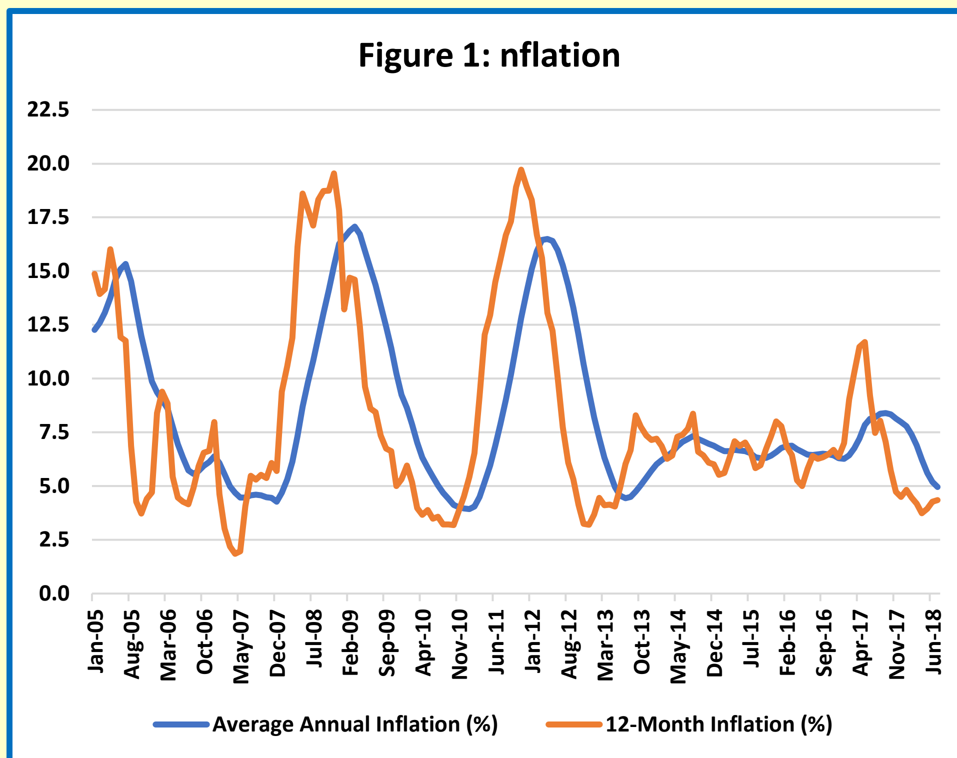
Explicitly, the MPC is exuding confidence at two levels:

- One, is the articulation that inflation expectations are well anchored (see MPC statement[1]). The MPC is equally bullish about the economy's prospects, indicating that they are "growth prospects were improving". It is obvious that inflation trend is within the official target range (**Figure 1**). Is that an indication that inflation expectations are well anchored? The answer, as we subsequently argue, is on the fiscal policy implications on the conduct of monetary policy.

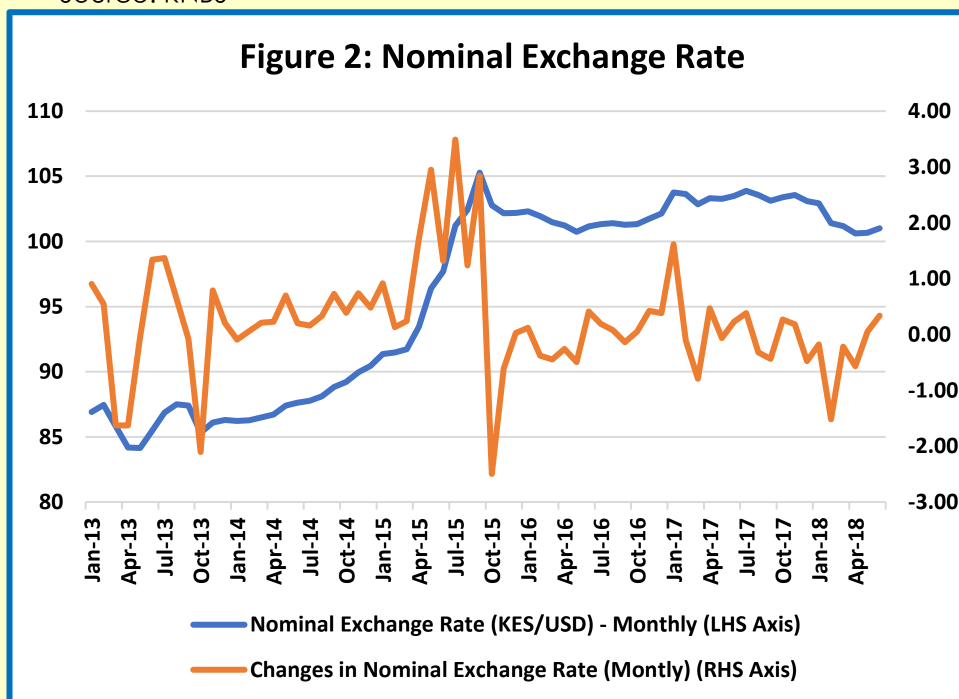
- Two, the foreign currency market, specifically nominal exchange rate market, has exhibited a sense of stability (**Figure 2**). This has the obvious consequence of easing the pass-thought effect on inflation. Is that confirmation that we need not worry about the relative price? The answer, as we subsequently argue, depends on how the external position of the economy behaves on the back of a trade war and what the lapse of the IMF program with Kenya – specifically the standby facility which the MPC has in the past consistently indicated to be an extra buffer – for the market.

- Three, the credit market that has been constrained and almost crawling to a halt could be picking a signal from the past monetary policy decisions and appropriately responding. Is this in any way an indication that all is back to normal, and that the credit market will – even on the back of a controlled interest rates regime – run with the monetary policy signal? The answer, as we subsequently argue, depends on whether the monetary policy can navigate the ambiguity of whether it is procyclical (being accommodative when it is explicitly buoyant about the state of the economy) or it is countercyclical (being accommodative as a means of spurring the slow rate of private sector).

[1] https://www.centralbank.go.ke/uploads/mpc_press_release/1411998543_MPC%20Press%20Release%20-%20Meeting%20of%20July%2030,%202018.pdf



Source: KNBS



Source: CBK

…and stormy undercurrents

The outlined factors need to be seen in the context of how they stand on the back of potential undercurrents. Let's start with the fiscal policy.

The past MPC communiques – at least over the past five years – give no inkling on how the fiscal policy stance has a bearing on monetary policy decision. The underlying message is therefore that either the two main macro policies are in harmony (we have our doubts) or there is no fiscal dominance[2] (but we see a real possibility of there being such dominance).

The tax measures of the fiscal year 2018/2019 have a direct implication on consumer products that form part of the basket upon which the consumer price index (CPI) – for instance value-added tax (VAT) on petroleum products. This happens on the back of eroded household disposable incomes.

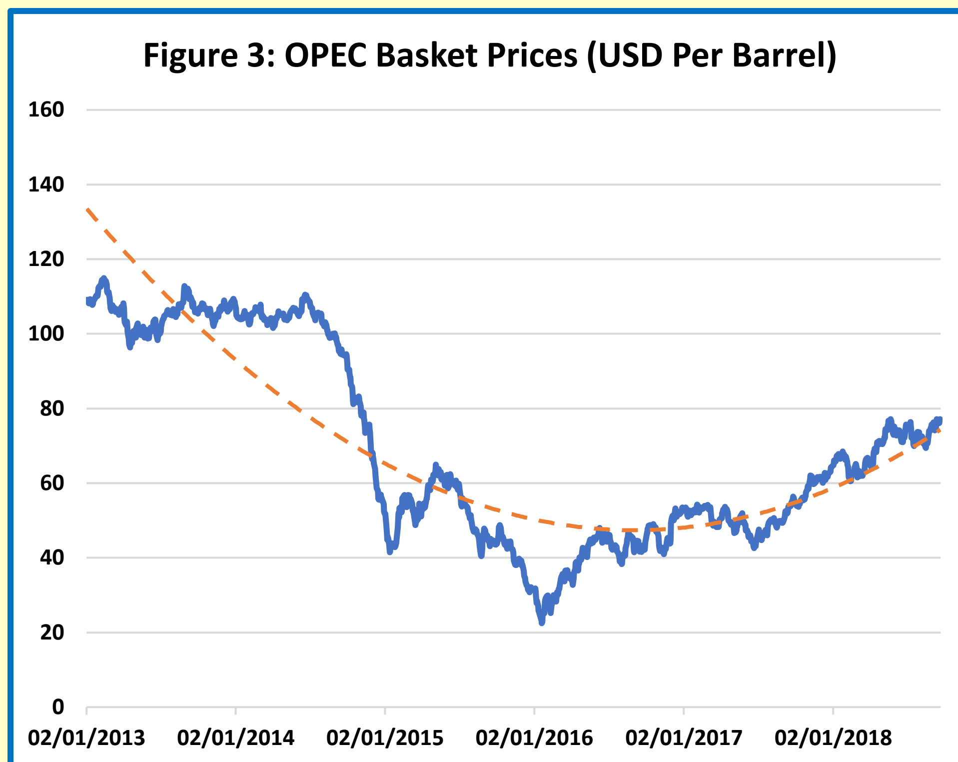
It will be interesting to see whether the MPC maintains the view that inflation expectations remain anchored. With the level and structure of public debt now being in focus, it will be interesting too to see whether the "improving growth prospects" remain MPC's official forecast given the call for austerity (this lowering the momentum of public-sector led growth), constrained household expenditure, and the state where enterprises are operating at excess capacity.

The second area of focus is the economy's external position. The CBK projects that the economy's current account deficit will continue to close. It will be interesting to see how this plays out given that the international oil prices are now on a clear upward trajectory (**Figure 3**). If supply conditions tighten, then we haven't seen the end of the oil prices rally. That plays into negating the extent to which the current account will close, as well as raise the possibility of oil prices via the oil prices pass-through effect; will inflation expectations remain anchored? We argue not.

It is equally clear that the global trade war is now in progress and that is likely to undermine the global economic outlook. That means that if as an economy we anticipated at the very best a vibrancy, and at the very least a recovery, of our exports, then the case for reviewing our outlook is compelling. This leaves the strong diaspora remittances as a dominant source of the CBK's foreign currency reserves.

We argue that while the quantum of the reserves is important, it is critical that its source be seen in the context of potential multiplier effect to the domestic economy. So, diaspora remittances shouldn't be seen to as being symmetrical to earnings from exports.

[2] This happens when fiscal decisions as could be manifested in the levels of fiscal deficit and public debt unduly undercuts the intentions of monetary policy to promote macroeconomic stability



Source: OPEC Data

A reflection on how the external position of the economy will play out in the foreign exchange market need to be seen against the context of (a) the CBK having adequate foreign exchange but with a recognition that if the closure of the current account is hampered by low export momentum, then the relative price need so adjust (b) market expectation as would be driven by the IMF programme – more so the standby facility, which the IMF has consistently indicating to be an extra buffer to the CBK's otherwise adequate reserves – will evolve going forward.

The third area is a critical reflection on the broader implications of the apparent easing cycles that the MPC has taken. We look at these implications from advanced economies emerging economies developing economies context. It is noteworthy that during the global financial crisis of 2008-09, central banks in both advanced and emerging market economies lowered policy rates to cushion the adverse shock and to spur economic activity.

Because the reductions in rates were widespread and occurring more or less at the same time, it might have gone unnoticed that for EMEs in general, this was an unusual development. This is notable because historically, emerging markets economies had to raise interest rates during crises to contain capital flight and defend the value of their currencies.

In other words, their monetary policies had traditionally been procyclical rather than countercyclical as in the advanced economies. An argument can be made that in so doing, emerging markets have been denying themselves of one key policy tool limit large cyclical and welfare-reducing swings in economic activity. On that account alone, the MPC's easing cycle could be seen to be countercyclical, and therefore it the right direction.

But there is a sense of ambiguity if the monetary policy stance is seen as procyclical while the MPC is of the view that the economy's growth prospects are strong, meaning its eyes need to be trained on downside risks to stability and not on the business cycles that it deems to be in the right direction.

Furthermore, the apparent countercyclical policy stance on the back of the highlighted weaknesses on the external economy is to be seen as a deprivation of oneself the foreign exchange stabilisation tool and therefore relying on expectations management and quantitative interventions that ordinarily have a limit.

Kenya's monetary policy framework is of the inflation-targeting type, more price based than quantity based. With a more flexible exchange rate, the necessity to defend a particular value of the domestic currency and increased the ability of monetary policy to focus more on inflation and growth objectives is removed.

The stability in the foreign exchange market, itself a good thing, need to be seen from a cost-benefit perspective; it if comes with the perception of being seen as a certain value being defended then it takes the momentum away from the monetary policy framework eventually acquiring the attractive countercyclical attributes. In any case, with interest rate rigidity occasioned by the capping law that has undermined monetary policy and an open capital account, the adjustment on the foreign exchange market is desirable.

In other words, we cannot run away from the fact that our exchange rate framework is guided by the compelling thinking of economists Marcus Fleming and Robert Mundell who developed a model – the so called Mundell-Fleming model of exchange rates - in early 1960s that demonstrated that it is impossible to have domestic monetary policy independence, a managed exchange rates, and have free capital flows; you can meet no more than two of these three objectives – hence their findings being dubbed the "impossible trinity" or the "trilemma"

Conclusion

As the MPC meets on September 25, 2018 for its fifth time this year, the judgment call will essentially be a juggling act between a calm surface and stormy under currents. If the easing wave persists and it further lowers the central bank rate (CBR) then its eyes are squarely trained on the surface; if it taken on board the stormy undercurrents, it will hold the CBR. The need to hold is, in our view, more persuasive.

This *Research Note* is a publication of the Kenya Bankers Association Centre for Research on Financial Markets and Policy®. The Centre was established by the Kenya Bankers Association in 2012 to offer an array of research, commentary, and initiate dialogue on critical policy matters that impact the financial sector. Through these activities, the Centre acts as a platform for intellectual engagement between experts on financial markets, banking industry players and policy makers.

The views expressed in this *Research Note* do not necessarily represent those of the Members of the Kenya Bankers Association. The content of this publication is protected by copyright law. Reproduction in part or whole requires express written consent.

Comments on this *Research Note* can be forwarded to the Centre's Director at research@kba.co.ke or josoro@kba.co.ke

©Kenya Bankers Association 2018