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Monetary Policy Stance: The Merits of a Pause

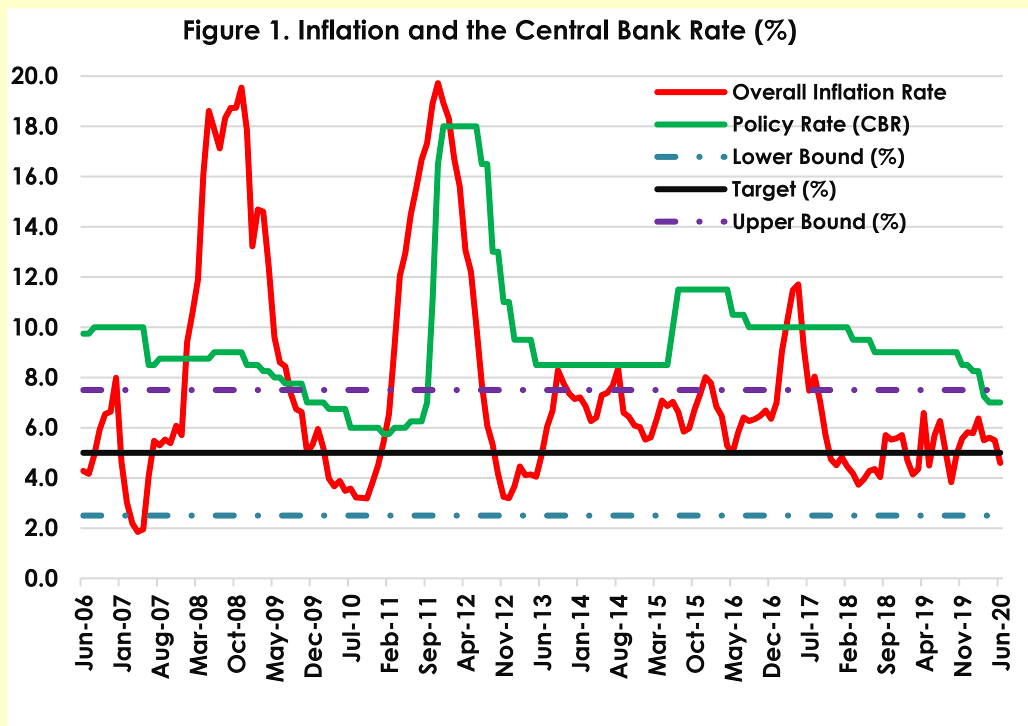
Highlights

- As the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) meets on July 29, 2020, the argument that holding the CBR at 7.0 percent is under the current circumsnances justifiable. A further monetary policy easing, as would be signaled by the lowering of the CBR, can only be desirable if it works its way through market expectations to ignite credit update.
- Obviously, credit demand is presently not price constrained. Instead, the prevailing weak effective demand implies that even lower rates have limited capacity to spur credit. Further easing of monetary policy when its influence on credit demand is muted, and the deterioration of banks' asset quality on the back of a fragile economy will trigger portfolio rebalancing in favour of government securities.
- The fact that the Kenya Shilling is under depreciation pressure points to the possibility of a further easing either driving market sentiments towards a futher depreciation or amounting to the giving away of the price channel for currency stablilizaiton.
- Beyond exchange rates, the recent rise in commodity prices is playing into the domestic economy. The oil prices staging an upside reversal on the back of strong co-movement in non-fuel and fuel prices, no doubt, will contribute to a build-up of inflationary pressures in the near-term.

Introduction

When the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) meets on June 29, 2020, its policy signal will have to take on board evaluation of its recent past decisions as well as an assessment of the current economic outlook but more importantly the near-term outlook. As it is, the MPC policy stance as signaled by the trend and level of the Central Bank Rate (CBR) remains accommodative. The issue that the MPC could grapple with is whether or not further easing is justified based on its ability to spur economic activity.

This *Research Note* will make the argument that holding the CBR at 7.0 percent is under the current circumstances justifiable. We do so while fully cognizant that the MPC could weigh the merits of a possible rate cut on the basis of (a) the economy's fragile growth position that may need policy nudging; (b) Inflation being benign and well within the government's target of 5±2.5 percent range (**Figure 1**).



Source: CBK & KNBS

A further monetary policy easing, as would be signaled by the lowering of the CBR, can only be desirable if it works its way through market expectations to ignite credit update. Obviously, credit demand is presently not price constrained. Instead, the prevailing weak effective demand implies that even lower rates have limited capacity to spur credit. That limitation is taken together with three other factors:

(i) One, a further easing of monetary policy when its influence on credit demand is muted, and the deterioration of bank's asset quality on the back of a fragile economy will trigger portfolio rebalancing in favour of government securities.

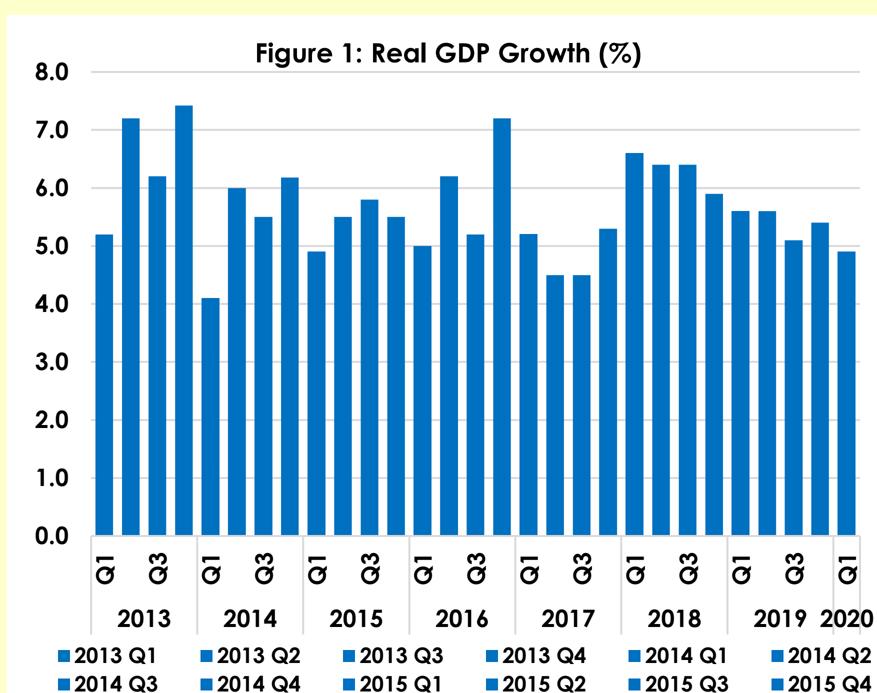
(ii) Two, with the effectiveness of domestic channels (the credit channel) waning, the prominence of the external channels (the exchange rate) will be critical in influencing the monetary policy stance. The fact that the Kenya shilling is under depreciation pressure points to the possibility of a further easing either driving

market sentiments towards a further depreciation or amounting to the giving away of the price channel for currency stabilization.

(iii) Third, beyond exchange rates, the recent rise in commodity prices is playing into the domestic economy. The oil prices staging an upside reversal on the back of strong co-movement in non-fuel and fuel prices will, no doubt, contribute to a build-up of inflationary pressures in the near-term.

Long Road to Recovery?

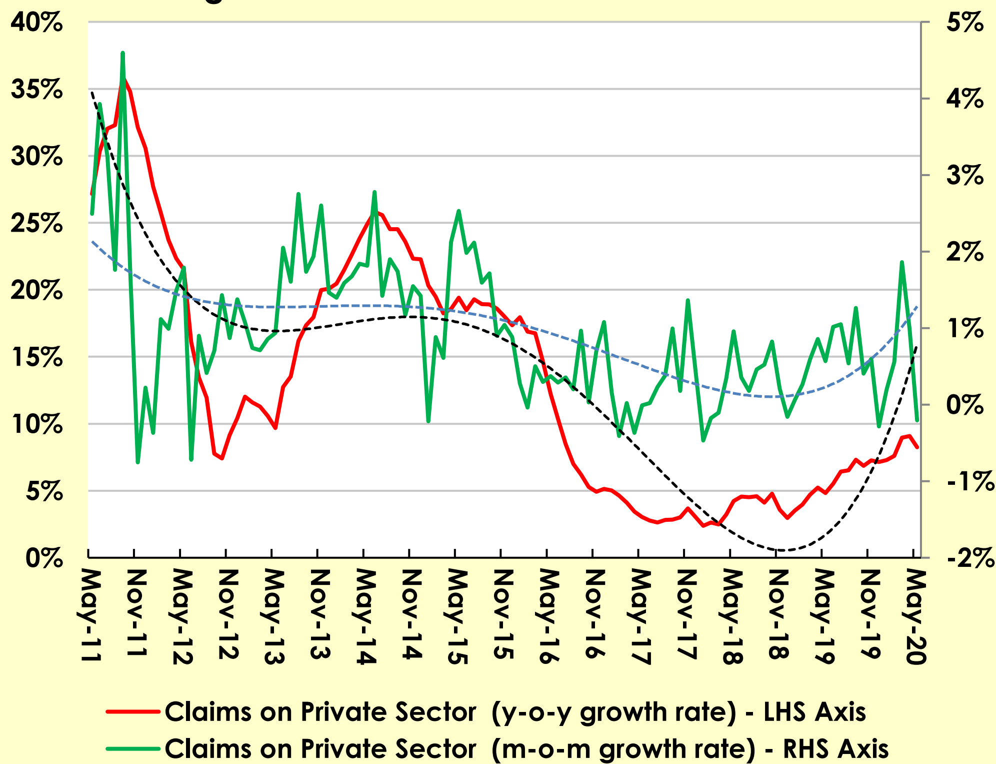
The current economic situation remains dire amid the coronavirus pandemic. During the first quarter of 2020, economic growth continued to lose momentum, growing at 4.9 percent compared to 5.6 percent in a similar period in 2019 (**Figure 2**). The consistent, almost quarter to quarter slowdown since the first quarter of 2018, speaks to the extent to which the coronavirus pandemic is worsening the economic fragility.



Source: KNBS

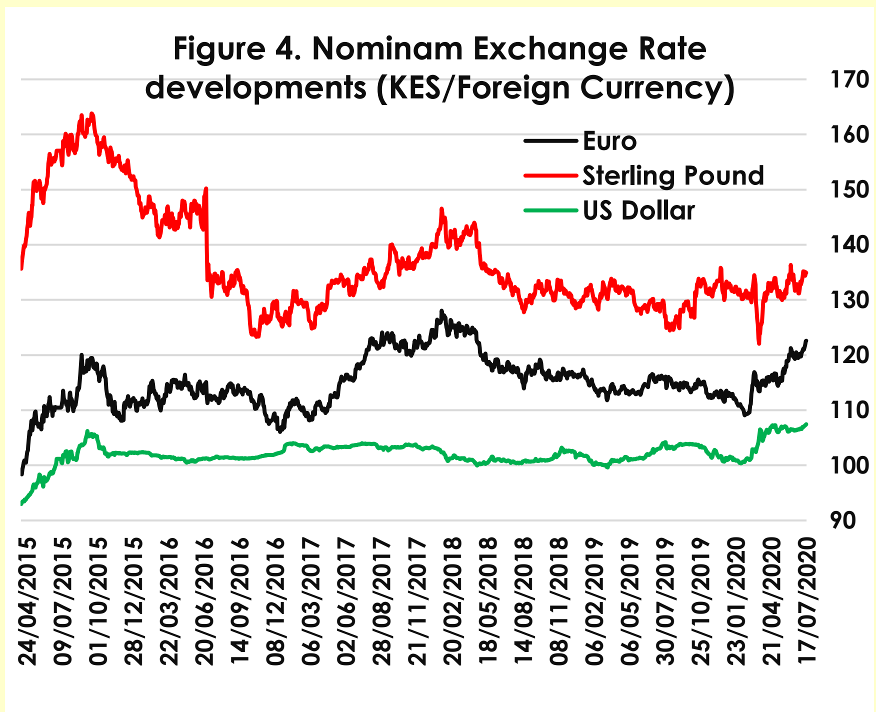
Undoubtedly, the economic slack in the second quarter and the rest of the year will persist. Even as containment measures put in place to address the current pandemic are being gradually lifted, the forward and backward linkages of economic activity will at best be repaired gradually, offering respite to the supply-side constraints. However, demand constraints could persist, unless the fiscal policy comes in strong – but fiscal policy has its constraints given that tax revenue mobilization is adversely affected by the weak economic conditions and the scope for increased public debt is dwindling by the day.

While the pursuit of a balanced growth approach will be the ideal, the public sector impetus will, of necessity take the lead. There is limited momentum – on account of the alluded weak demand - for private sector credit to pick. As **Figure 3** shows, the credit markets have been in flux despite monetary policy being accommodative since 2016. The 125-basis points (bps) reduction in the CBR since January 2020 has not translated into a noticeable change in the credit growth trend, with the rate of such growth still being stuck at a single-digit level.



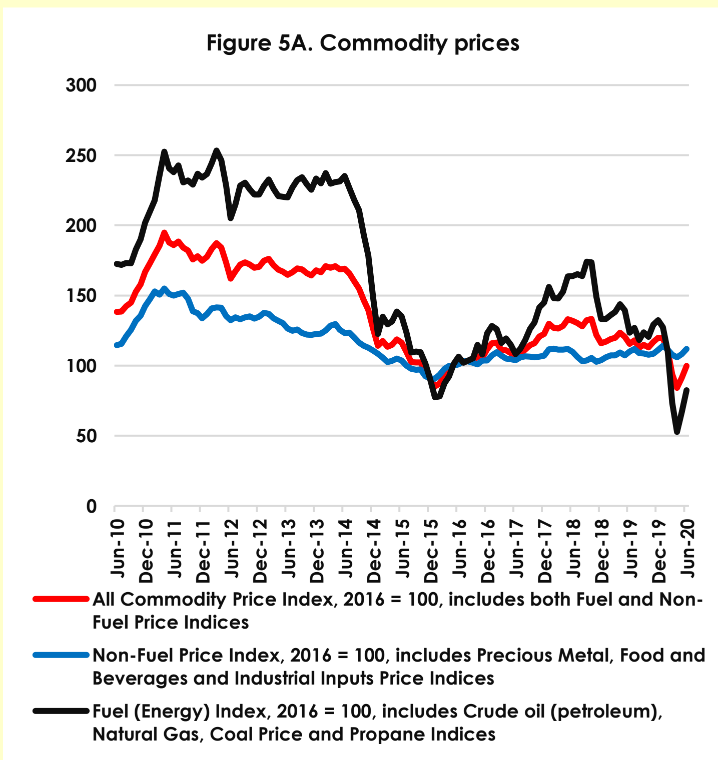
Source: CBK

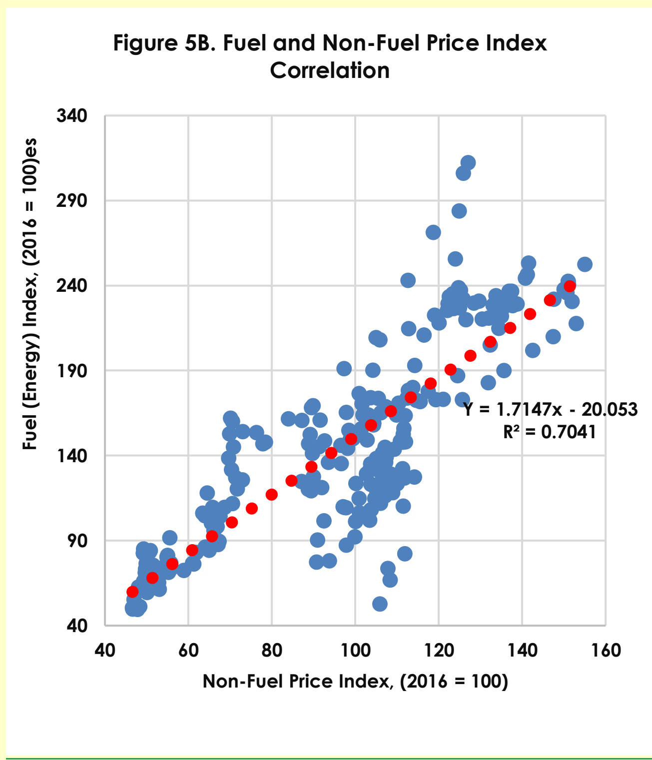
The observed weak economy that reflects the global economic challenges is slowly revealing itself in the fragile external position. The depreciating currency (**Figure 4)** arising out of the demand and supply dynamics on the back of the weak current account position means that the blending on market interventions to forestall instability will have to balance between quantity-based mechanisms (based on the amount of reserves available) and price-based mechanisms (based on what direction policy wants to steer interest rates). Even if the MPC was to take comfort on foreign currency reserves adequacy of more than 5 months equivalent of import cover), it has to contend with the channel of creation of those reserves. It has to be borne in mind that exports and remittances are in a sub-optimal level muted and portfolio flows are exhibiting an exit bias.



Source: CBK

On the back of the outlined developments in the foreign exchange market, the recent rise in commodity prices (**Figure 5A**) is likely to play into the domestic economy. Oil prices are gradually reversing the sharp decline seen in the recent past few months. The strong co-movement in non-fuel and fuel prices, as inferred from its positive correlation (**Figure 5B**), will contribute to a build-up of inflationary pressures in the near-term.





Source: IMF Commodity database & Authors computations

Conclusion

As MPC meets on July 29, 2020, the argument that holding the CBR at 7.0 percent is under the current circumstances justifiable. A further monetary policy easing as would be signaled by the lowering of the CBR can only be desirable if it works its way through market expectations to ignite credit update.

Obviously, credit demand is presently not price constrained. Instead, the prevailing weak effective demand implies that even lower rates have limited capacity to spur credit. Further easing of monetary policy when its influence on credit demand is muted, and the deterioration of banks' asset quality on the back of a fragile economy will trigger portfolio rebalancing in favour of government securities.

The fact that the Kenya Shilling is under depreciation pressure points to the possibility of a further easing either driving market sentiments towards a further depreciation or amounting to the giving away of the price channel for currency stabilization. Beyond exchange rates, the recent rise in commodity prices is playing into the domestic economy. The oil prices staging an upside reversal on the back of strong co-movement in non-fuel and fuel prices, no doubt, will contribute to a build-up of inflationary pressures in the near-term.

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