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Monetary Policy Stance: Just the Right Level of Accommodation

Highlights

- As the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) meets in November 27, 2018, we consider the current monetary policy stance to be accommodative enough, thus further easing will potentially trigger downside risks from other markets – notably the foreign exchange market – with attendant stability challenges.
- Holding the decision to CBR at the current rate of 9.0 percent – a policy decision we consider justifiable – will send a clear message of a stance that makes a delicate balance between competing risks, limitations and opportunities.

Context

When in the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) meets in November 27, 2018, its decision on the Central Bank Rate (CBR) will have to take into take on board an evaluation of its recent past decisions – at least its past five decisions – and emerging downside risks. The explicit signal of the MPC, based on its communiques, is that its policy objectives are largely being met.

The monetary policy easing cycle seen in the of the lowering the CBR in March 2018 from 10.0 percent to 9.5 percent and further to 9.0 percent in July 2018 can only be assessed as successful if the signal is picked by the credit market – even if it is with a reasonable time lag – and the risk of perverse outcomes from the easing as recognised by the policy committee being avoided.

Under ideal conditions, the entry of the accommodative monetary policy cycle could seem appropriate. But ideal is often a special case, not the norm. That special case is characterised by:

- appropriate monetary conditions as could be read from the interbank rates; but as its evident the segmentation in the interbank market is often masked if one is to merely look the price and not the structure;
- fiscal consolidation picking momentum, thus obviating the dominance government budgetary resource requirement; but if consolidation of leaning more towards increase revenue, some of which entailing tax measures withy inflationary implication, requires a nuanced perspective. In any case, Revenue shortfalls that persisted during 2017/18 fiscal year, put the consolidation plans at risk
- the output gap (the difference between actual output and potential output) remaining negative, thereby giving scope for non-inflationary growth; but we see a disconnect between growth that the output and expenditure sides of the economy's GDP – for instance, a bumper maize harvest that feeds into high output lowering inflation, but the maize farmer is subjected to delayed payments.

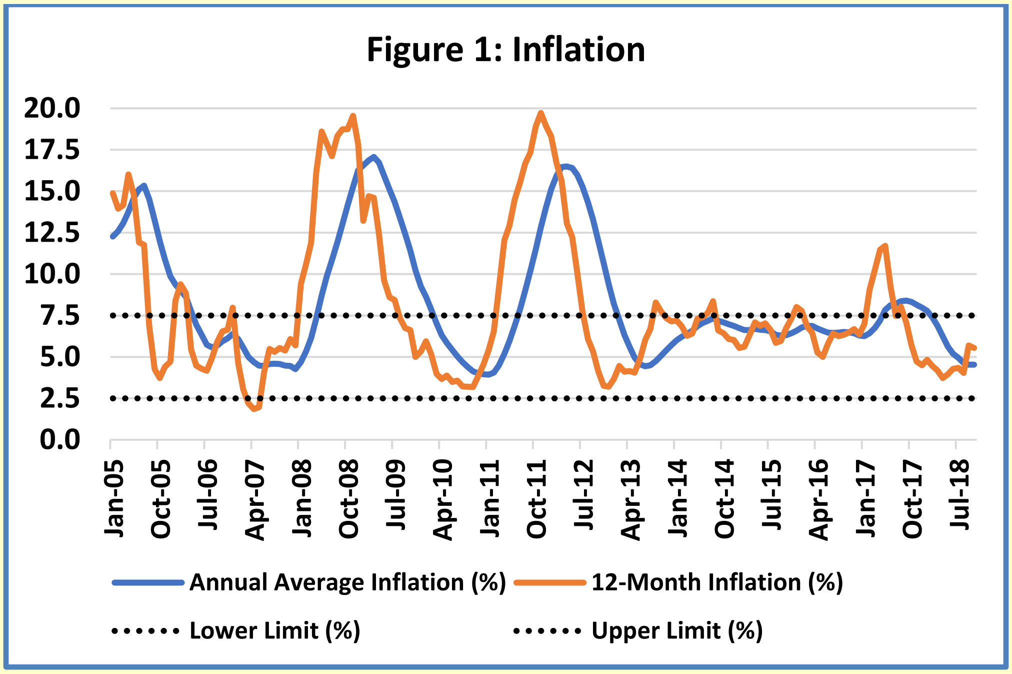
If the intention of the accommodative monetary policy stance is to trigger private sector credit, then the objective has to a large extent been unrealised. It's worth mentioning though that there hasn't been a further deterioration of the private credit conditions since the commencements of the easing. That is not to say that the credit has noticeably turned the corner; it rather points to the market potentially in some low equilibrium trap.

The recognition that the credit market challenges are not a monetary policy problem means the panacea cannot be entirely monetary policy. With interest rates capping in 2016, the signalling ability of the CBR was dented; thus, re-establishing the signalling role of the CBR requires the removal of the controls. Until then, the cost of the interest rate controls via the remains high – in some estimated being in the range of ¼ – ¾ percentage points of GDP[1].

Is there scope for further easing of policy in the immediately term? The answer, we argue, first lies in the acknowledgement of the above-mentioned constraint to monetary policy framework. Further easing means lowering the maximum interest rate that banks can charge under the interest rate caps, a move that could ration a greater share of high risk - high return borrowers. In essence, the effect will be tighter, not looser, credit conditions. The impact, if any, of the cut on bank lending since the commencement of the easing cycle is not yet clear. Under the circumstances, a pause in the CBR is justifiable.

[1] *See IMF (2018) - https://www.imf.org/en/Publications/CR/Issues/2018/10/23/Kenya-Staff-Report-for-the-2018-Article-IV-Consultation-and-Establishment-of-Performance-46301*

Second, the well-known imperfections in the monetary policy transmission mechanism even in the best of circumstances would persuade a pause [2]. Even with inflation now within the target range (**Figure 1**) – albeit with an upper bound bias - it can be argued that the allure for further easing need to factor in the could emerge from the foreign exchange market as well as external vulnerabilities.



Source: Kenya National Bureau of Statistics

In this *Research Note*, we make arguments that the current monetary policy stance remains accommodative enough and that further easing will potentially trigger downside risks from other markets – notably the foreign exchange market – with attendant stability challenges. Essentially, holding the decision to CBR at the current rate of 9.0 percent will send a clear message of a stance that makes a delicate balance between competing risks, limitations, and opportunities.

Inflation is on Target – An Allure for Further Easing?

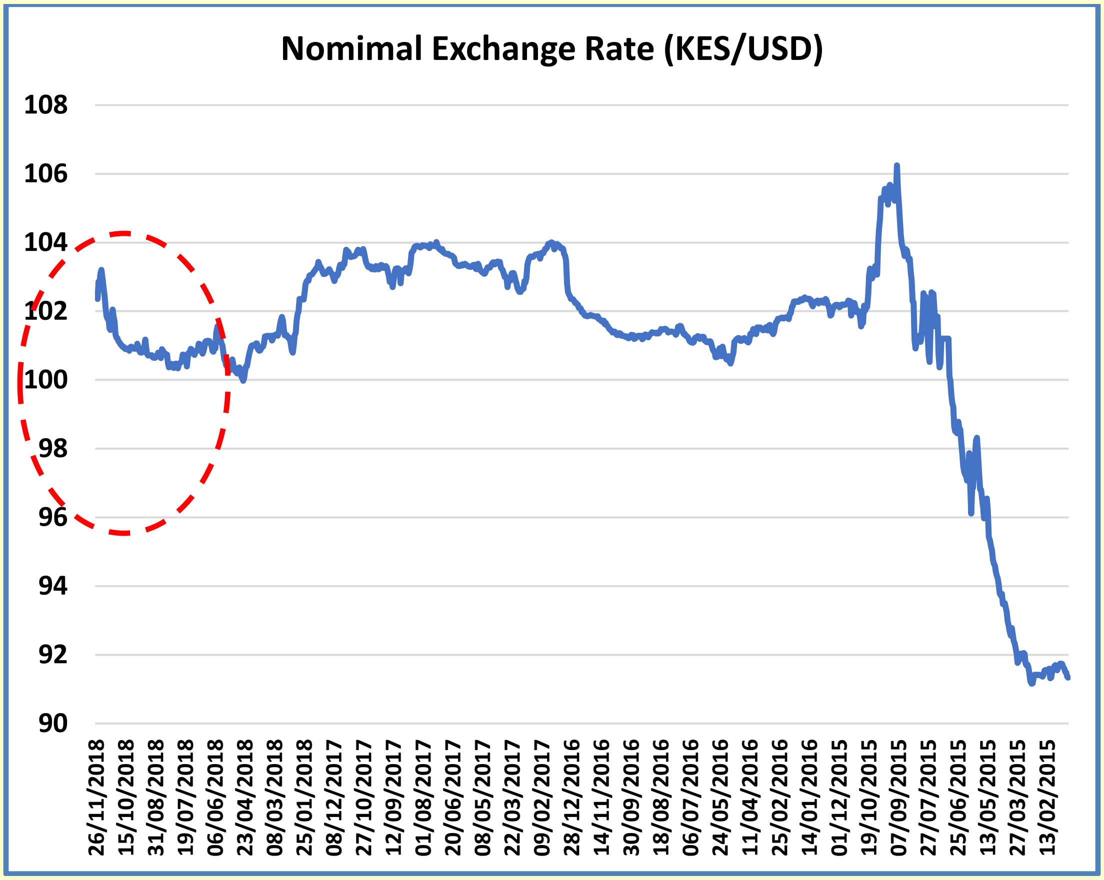
As already observed, the MPC's decision will partly hinges on the fact that inflation is now back to target. For this be a demonstrating a policy outcome and thus, in MPC-speak an entrenchment of the strive to "anchor inflation expectations and enhance the credibility of its policy stance", there is need for some context on how that sets the tone for the near-future monetary policy decisions. We highlight four areas:

First, the economy's growth is picking some momentum from last year's performance even though the growth projections range from conservative (lower 5.0 percent) to very optimistic (lower 6.0 percent). If sustained, the consequence will be the narrowing the output gap. While that in itself will not be been a source of inflationary pressure in the immediate to medium term, coming at a time of an accommodative monetary policy stance, it could be a strong pointer to the argument that

[2] Davoodi, H. R., Dixit S., and Pinter G., (2013), "*Monetary Transmission Mechanism in the East African Community: An Empirical Investigation*", IMF Working Paper WP/13/39, February (https://www.imf.org/external/pubs/ft/wp/2013/wp1339.pdf); and Mishra P. and Montiel P., 2013, "*How effective is monetary transmission in low-income countries? A survey of the empirical evidence*", Economic Systems 37, 187–216

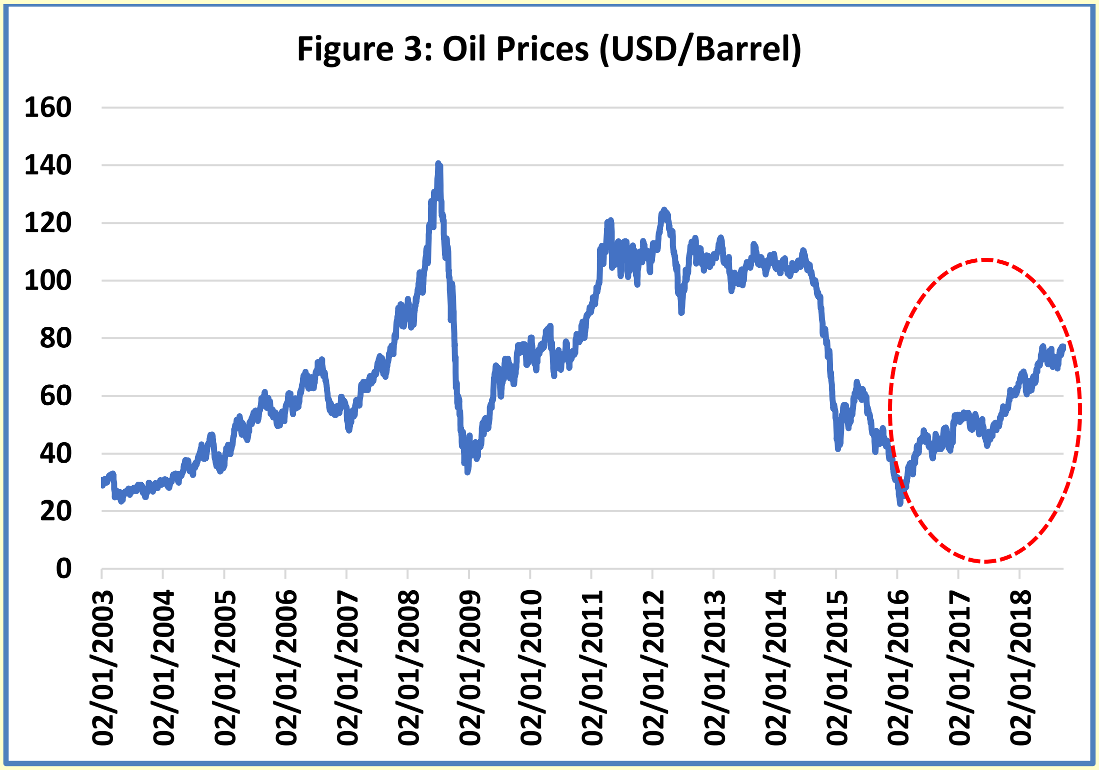
the MPC's intention to enhance the credibility of its policy stance will necessitate a careful watch on when further easing has run its course, at least for now.

Second, the observed foreign exchange market stability is confirmed by the MPC. The prevailing market conditions follow aggressive central Bank interventions in the form of market participation. With monetary policy in an accommodative posture, the recent depreciation pressure (**Figure 2**) makes the case for a pause in the CBR rendering support; a further easing will likely heighten the pressure on the local currency.



Source: Central Bank of Kenya

The narrowing of the current account deficit has been attributed to improved diaspora remittances and weakening of imports; some respite from the easing of international oil prices after a steep climb in the recent past (**Figure 3**) need to be given due consideration to obviate any policy move that will compromise market stability.



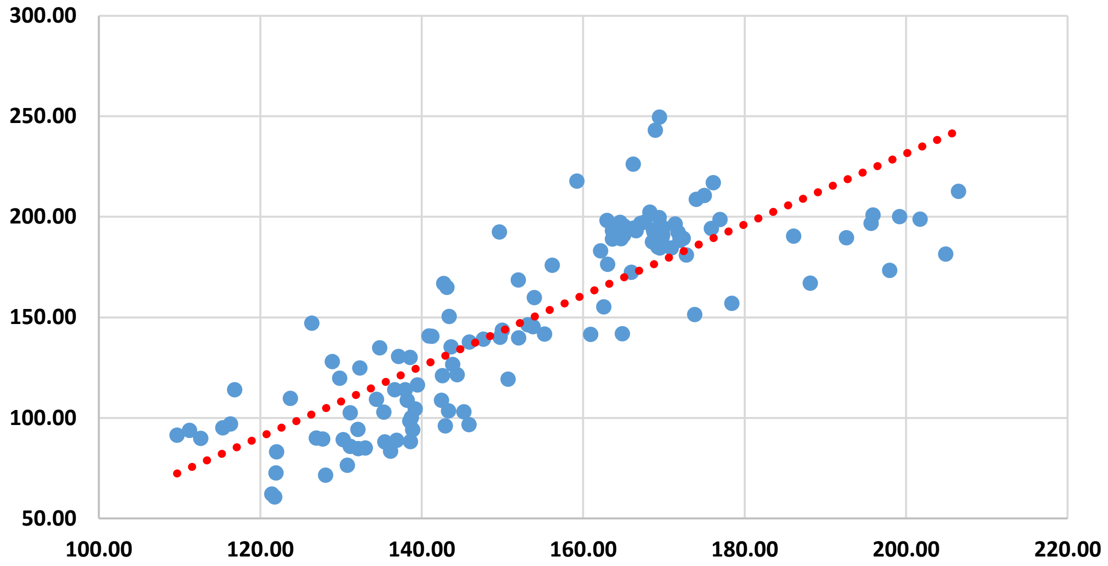
Source: OPEC

Three, the projected narrowing of the economy's current account needs to be seen on the back of the global economic circumstances are far from rosy. The IMF's World Economic Outlook for October 2018 is optimistic but very cautious about the state of the global economy. This is on the back of the ongoing trade wars and geopolitical developments and the implication of the developments around Brexit. All these influence global demand and supply conditions.

Alongside the easing of oil prices has been the easing of prices of other commodities, notably some of Kenya's exports – coffee and tea. Thus, while the reduction in oil prices as observed is beneficial in terms of its easing the economy's import bill, such reduction need to more than compensate for the reduction in export revue given the strong co-movement of commodity prices (**Figure 4**).

Four, the 2018/19 fiscal programme has to some extent been embedded with proliferation of tax proposals which, if enacted, will have inflationary implications. It remains to be seen whether a reduction in domestic borrowing requirement will sustainably be realised; this is especially so given constrained revenue collections by the Kenya Revenue Authority (KRA).

Figure 4: Association Between Non-Fuel and Fuel(Energy) Price Indices



Data Source: IMF

Conclusion

In this *Research Note*, we make arguments that the current monetary policy stance remains accommodative enough, thus further easing will potentially trigger downside risks from other markets – notably the foreign exchange market – with attendant stability challenges. Holding the decision to CBR at the current rate of 9.0 percent, a policy decision we consider justifiable, will send a clear message of a stance that makes a delicate balance between competing risks, limitations and opportunities.

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