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Monetary Policy Stance: Hitting the Pause Button, Again

Highlights

- As the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) meets on November 26, 2020, this *Research Note* leans towards a monetary policy stance that remains accommodative without necessarily adjusting the signaling rate – the Central Bank Rate (CBR).

- We do so while fully cognizant of;

  a) The economy's fragile growth position, especially on the back of sizeable negative output gap – as characterized by a 5.7 percent contraction in economic growth in the second quarter of 2020;

  b) Benign inflation outlook, which albeit edging upwards, remains well within the government's 5±2.5 percent.

  c) Despite an existing policy stance that is accomodative, bank lending remains stuck in loan gear an indication that credit demand is not price constrained, rather the demand side remains weak. Credit to the private sector growth in September and October grew 7.63 percent and 7.66 percent year-on-year respectively, edging further downwards from an 8.3 percent growth recorded in August.

  d) A shilling that, while coming coming under pressure and thus on a depreciation trend, could still be characterised as being stable.

- On account of the first two observations, the need to stimulate the economy is evident.

- However, an accomodative stance is unlikely to move the bank lending needle, as is already evident from a credit growth being characterised by further contraction on the back of asset quality deterioration.

- Lastly, on account of the fact that the shilling is under immense pressure, a number of downside risks exists, as as long as the shilling remains under on its current depreciation bias, a monetary policy stance attuned to further easing is off the table.

Introduction

When the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) meets on November 26, 2020, its policy signal will have to take on board an 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 signalled by the trend and level of the Central Bank Rate (CBR) remains accommodative. The issue that the MPC could grapple with is whether further easing is justified or not based on its ability to spur economic activity.

In its September 29, 2020, MPC meeting the CBK observes:

> *"The package of policy measures implemented since March were having the intended effect on the economy and will be augmented by implementation of the fiscal measures in the FY2020/21 Budget. Thus, the MPC elected to retain Central Bank Rate (CBR) – the policy signalling rate – at 7.0 percent, observing that the current accommodative monetary policy stance remains appropriate".*

In this *Research Note*, we argue that the sustenance of the current accommodative stance is justified for two reasons. 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, especially on the back of sizeable negative output gap – the difference between actual growth and potential growth – as characterised by a 5.7 percent contraction in economic growth in the second quarter of 2020;

(b) The benign inflation outlook, which albeit edging upwards, remains well within the government's 5±2.5 percent.

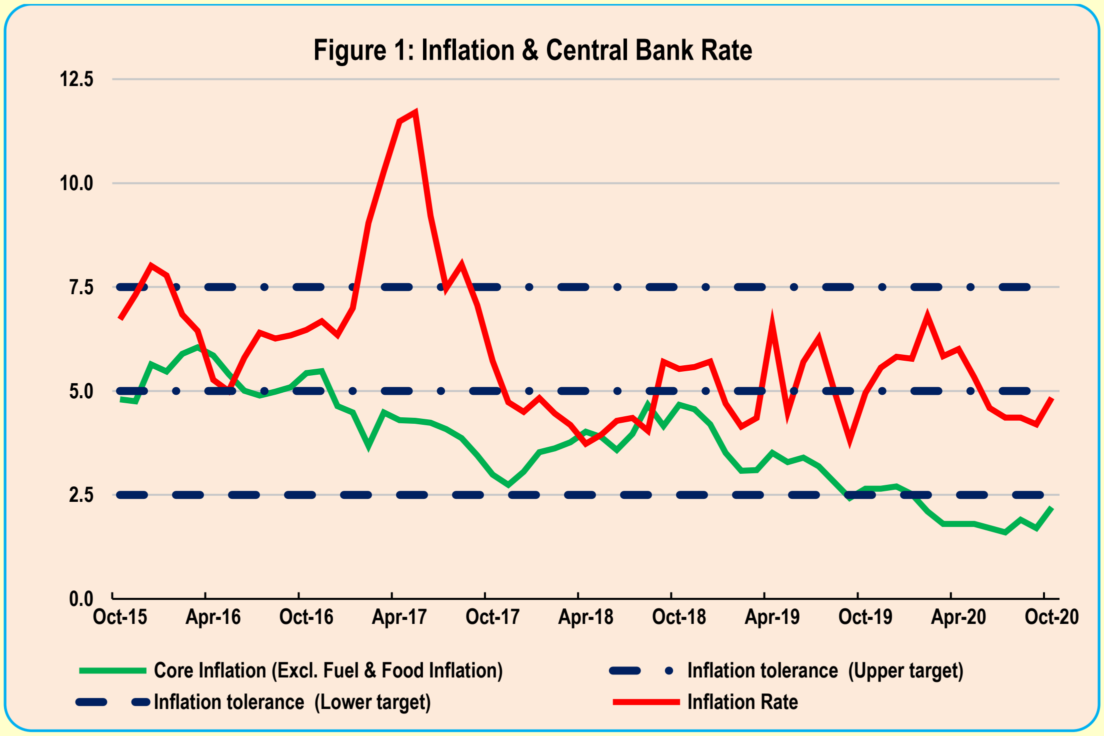
On account of the above observations, the need to stimulate the economy is evident. However, this *Research Note* leans towards a monetary policy stance that remains accommodative without necessarily adjusting the signaling rate – the Central Bank Rate (CBR) on account of two factors;

i) Bank lending remains stuck in loan gear, and already contractionary as evident from the sustained two-month a credit growth contraction on the back of asset quality deterioration thus a policy stance attuned to further accommodation is unlikely to move the bank lending needle, and thus stimulate economic growth.

   Credit to the private sector growth in September and October grew 7.63 percent and 7.66 percent year-on-year respectively, edging further downwards from an 8.3 percent growth recorded in August reinforcing the fact under the current policy stance, credit demand is not price constrained, as we have argued in previous *Research Notes*; instead, the demand side remains weak.

ii) On account of the fact that the shilling is under immense pressure, a number of downside risks exist, and as long as the shilling remains under on its current depreciation bias, a monetary policy stance attuned to further easing is off the table.

As the MPCs ponder on its policy decision, its eyes are trained on the core mandate of maintaining macroeconomic stability, for its such stability that growth is anchored. From a stability standpoint, it is evident that: (a) inflation is within the target range, (b) the foreign exchange market is stable, albeit on characterised by a depreciation of the shilling. As **Figure 1** indicates, price pressures have been kept at bay with inflation remaining sticky but to the upside. Consumer prices increased by 0.6 percent leading to month-on-month inflation to slightly increase to 4.8 percent in October 2020 from 4.20 percent in September but remain well within the government's 5±2.5 percent target level.



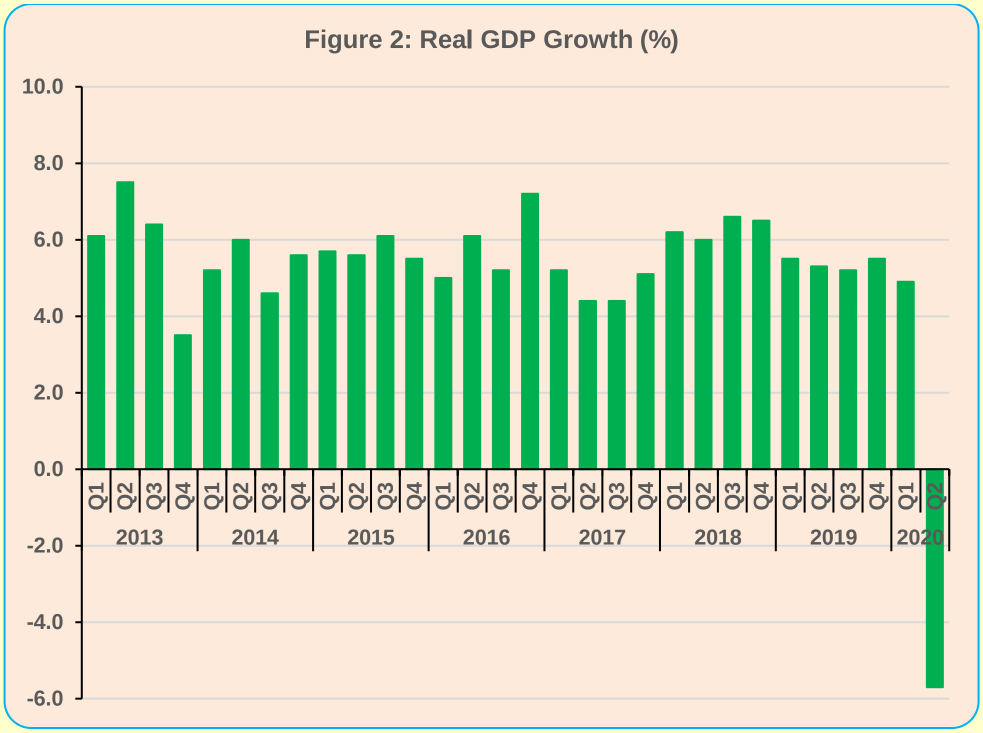
Source: CBK

Core inflation again edged upwards from 1.70 percent in September 2020, to 2.2 percent in October 2020. Food inflation rose from 5.2 percent in September to 5.8 percent in October, and fuel inflation also edged upwards from 10.7 percent to 11.4 percent over the same period. Likely, inflation's stickiness and the fact that inflation edged up to 4.8% in October is one of the reasons behind our argument for the continuation of the current monetary stance even if the MPC acknowledges that the increase was mainly driven by non-core inflation, where monetary policy is not effective.

Long Road to Recovery?

The current economic situation remains dire amid the coronavirus pandemic. During the second quarter of 2020, economic growth continued to lose momentum, contracting by 5.7 percent compared to a 4.9 percent growth in the first quarter of 2020 (**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.

Undoubtedly, the economic slack in the third quarter and the rest of the year is likely to persist as the second wave of infections continue to impact of sentiments and thus weighing on confidence. As such, demand constraints are likely to persist, unless the fiscal policy comes in strong – but fiscal policy has its constraints given that tax revenue mobilisation of adversely affected by the weak economic conditions and the scope for increased public debt is dwindling by the day.



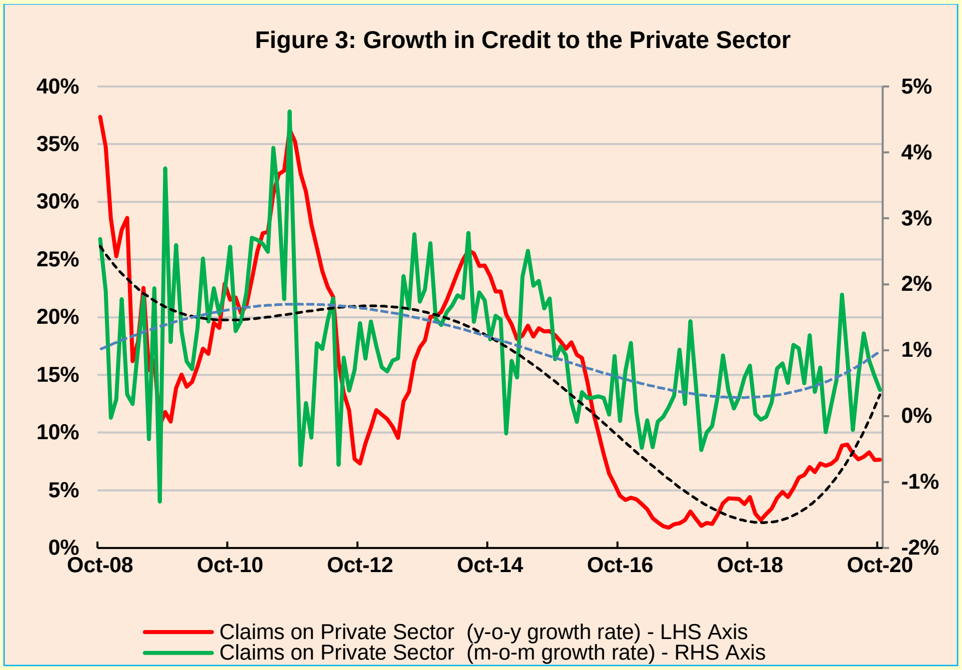
Source: KNBS

This outlook, characterised by an economy best describe as fragile, despite the fact that some early indications of a rebounding economy in the third quarter suggests that a lot of heavy lifting is necessary to narrow the now sizeable negative output gap and bring the economy back on the positive territory must be done.

While the economy needs some support, will the monetary policy do the trick? Absolutely not! It's fiscal policy to the rescue of the economy, an inference we deduce from the CBK's MPC's statement in September that "*the package of policy measures implemented since March were having the intended effect on the economy and will be augmented by implementation of the fiscal measures in the FY2020/21 Budget*".

A rate cut unlikely to move the bank lending needle, and thus no respite for growth

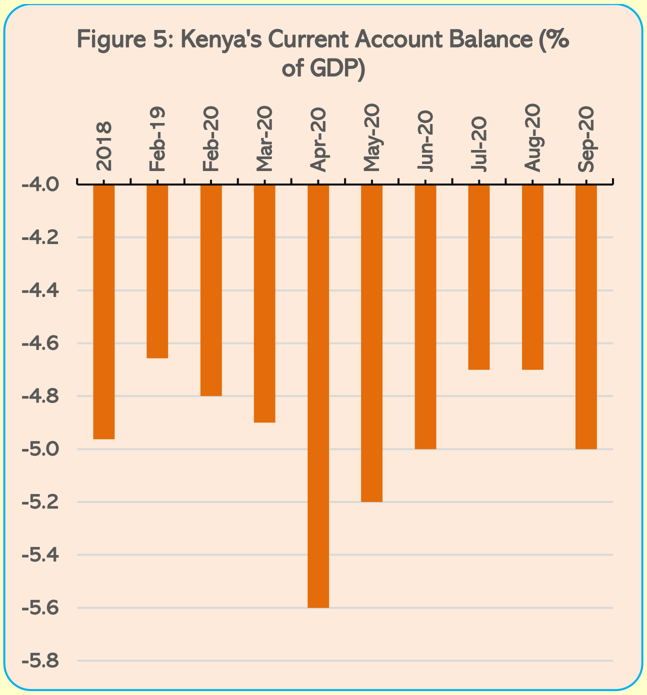
Thus, while the pursuit of a balanced growth approach will be ideal, the public sector impetus will, of necessity take the lead. There is limited momentum – on account of the alluded weak demand - for private sector credit to pick. As **Figure 3** shows, the credit markets have been in flux despite the monetary policy being accommodative since 2016. The 125-basis points reduction in the CBR since January 2020 has not translated into a noticeable change in the credit growth trend. Bank lending remains stuck in loan gear with loan growth posting a mere 7.63 percent and 7.66 percent in September and October respectively compared to an 8.3 percent growth in August 2020.

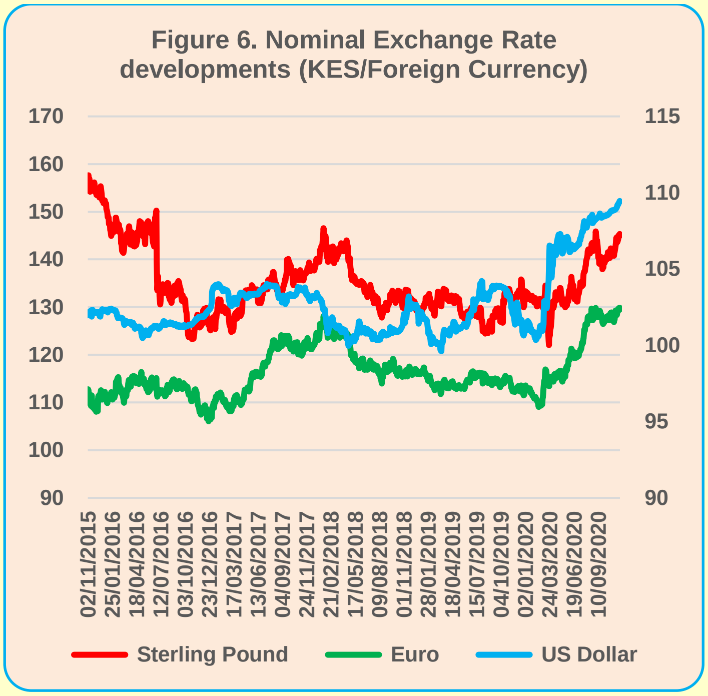


Source: CBK

At the Core, the Shilling's Stability

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 as **Figure 5** shows 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).



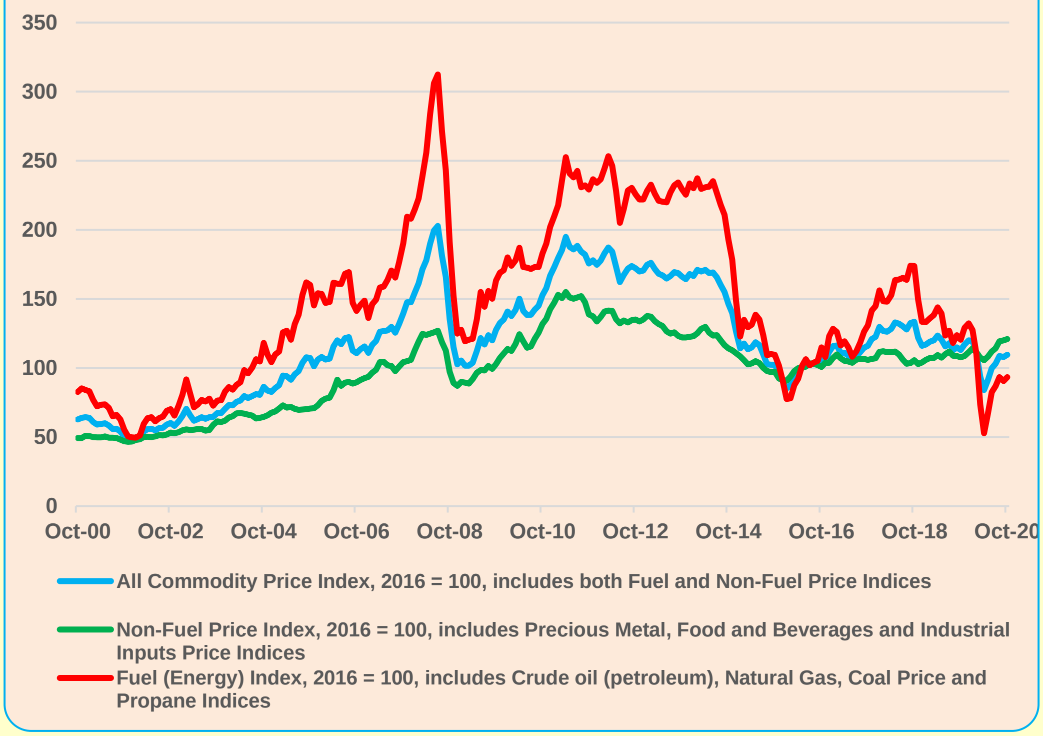


Source: CBK

Even if the MPC is to take comfort on foreign currency reserves adequacy of more than 4.87 months equivalent of import cover), it must contend with the fact that the creation of the reserves is largely muted mostly on the back of sub-optimal level exports and remittances, as well as muted portfolio, flows after exhibiting an exit bias. Thus, any monetary policy stance attuned to further easing in support for the local currency by way of interest rate adjustment – if any is needed – is off the table on account of the assumption that the uncovered interest rates parity (UIRP) principle – where foreign resource inflows are attracted by positive interest rates differential – is in play can for now be ruled out.

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

Figure 5: Global Commodity Prices



Source: Central Bank of Kenya

Conclusion

As MPC meets on November 26, 2020, the argument for holding the CBR at 7.0 percent is in the current circumstances more compelling. Ultimately, the MPC must of necessity search for policy signalling clarity that ensures the sustenance of the calm market conditions.

As such, we argue that the sustenance of the current accommodative stance is justified for two reasons. 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, especially on the back of sizeable negative output gap – as characterised by a 5.7 percent contraction in economic growth in the second quarter of 2020; (b) benign inflation and within the 5±2.5 percent and inflation expectations being well anchored.

Thus, on account of the above observations, the need for policy nudging to further stimulate the economy is limited on account of the fact that credit demand is not price constrained, and that any yielding of the monetary policy stance attuned to further easing implies that any support for the local currency by way of interest rate adjustment is off the table.

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