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Monetary Policy Stance – The Stability Precedent

"The short-termism in popular expectation on the implication of holding the policy rate while marginally changing benchmark lending rate is single-eyed in perspective in the sense that the import of staying the monetary policy stance is totally eclipsed by the unmotivated expectation to imply that sufficient conditions are in place for a substantial lowering of the cost of credit."

Highlights

- As widely anticipated, the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) retained the Central Bank Rate (CBR) at 8.5 percent in its meeting of 14th January 2015. During the same meeting, the MPC announced a 59 basis points reduction of the Kenya Banks Reference Rate (KBRR) from 9.13 percent to 8.54 percent.

- The marginal reduction of the KBRR that was accompanied by the maintenance of the CBR at 8.5 percent sends out two messages that ought to be clear, but are necessarily not, as they are counter to populist expectations:
    - One is that the CBK's MPC is alive to the fact that inflation expectations need to be anchored and therefore it is premature to change the monetary policy stance as signalled by the CBR.
    - The other is that the money market conditions have been characterised by slight reduction in the Treasury bill rates on the back of the government's external borrowing programme that has influenced the extent of resort to the domestic money market. It is clear that the CBK will remain active in its open market operations as one of the mechanisms of ensuring stability in the foreign exchange market, the other being active participation in the foreign exchange market. So long as the Kenya shilling (KES) remains under depreciation pressure on account of the economy's weak current account position, the scope of a significant reduction in interest rates in the near future remains constrained. Consequently, the trend of lending rates will remain downward but gradual at best.
- The plummeting of international oil prices has been a big factor in the domestic inflation outcome. We infer though that the effects of the oil prices are characterized by mixed fortunes. We see a direct benefit to the local economy in form of the effect on inflation; but the lower prices could hamper recovery in some key markets, especially the Eurozone which now has to fight deflation.
- The depreciation of the KES is to some extent attributed to the external factors mainly the effects of the resurgent USD following the end of the quantitative easing the federal government. Nonetheless, the fundamentals to support any other stance other than a mildly depreciation bias are lacking. The current account is still weak; that is why all the accommodations to stabilizing the currency that supports the MPC's position are clearly anything but an improvement in the fundamentals. It doesn't help the economy's current account position considering that the global and emerging markets growth prospects remain weak.

Introduction

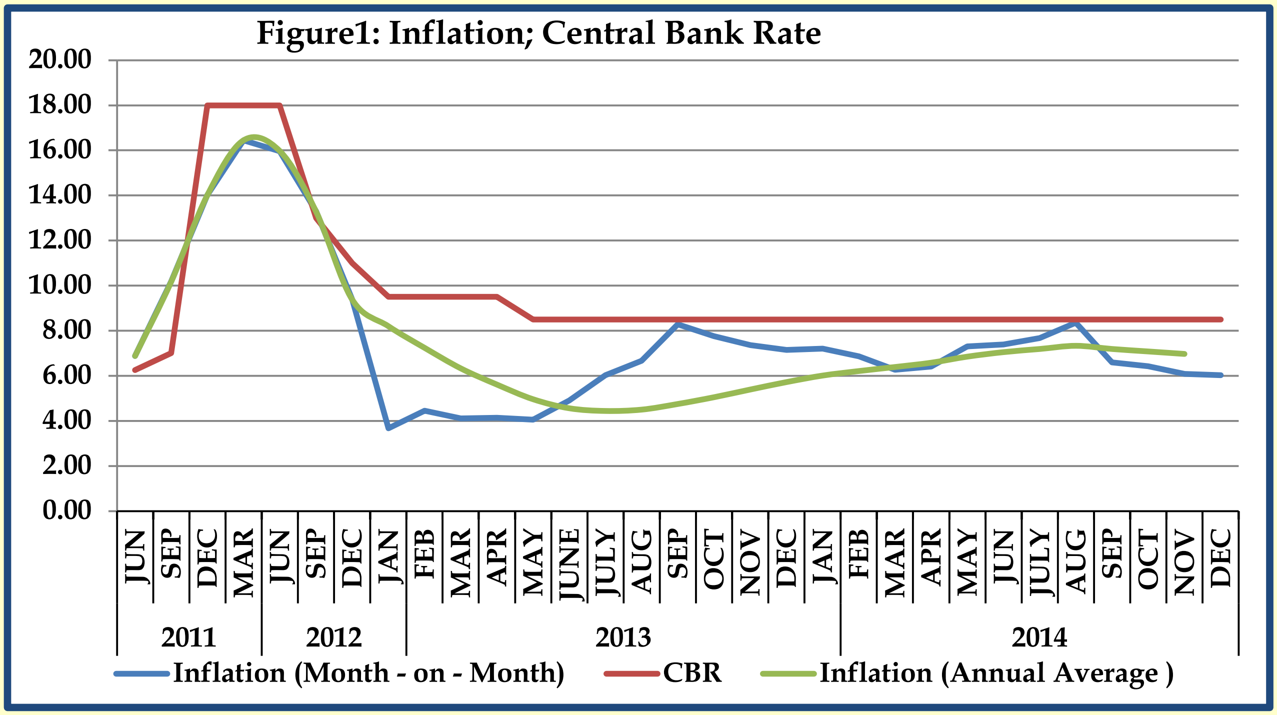
As widely anticipated, the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) retained the Central Bank Rate (CBR) at 8.5 percent in its meeting of 14th January 2015. During the same meeting, the MPC announced a 59 basis points reduction of the Kenya Banks Reference Rate (KBRR) from 9.13 percent to 8.54 percent.

Predictably, the short-termism in popular expectation on the implication of holding the policy rate while marginally changing benchmark lending rate is single-eyed in perspective in the sense that the import of staying the monetary policy stance is totally eclipsed by the unmotivated expectation to imply that sufficient conditions are in place for a substantial lowering of the cost of credit. Therefore this *Research Note* argues that the marginal reduction of the KBRR that was accompanied by the maintenance of the CBR at 8.5 percent sends out two messages that ought to be clear, but are necessarily not, as they are counter to populist expectations:

- One is that the CBK's MPC is alive to the fact that inflation expectations need to be anchored and therefore it is premature to change the monetary policy stance as signalled by the CBR.

- The other is that the money market conditions have been characterised by slight reduction in the Treasury bill rates on the back of the government's external borrowing programme that has influenced the extent of resort to the domestic money market. It is clear that the CBK will remain active in its open market operations as one of the mechanisms of ensuring stability in the foreign exchange market, the other being active participation in the foreign exchange market. So long as the Kenya shilling remains under depreciation pressure on account of the economy's weak current account position, the scope of a significant reduction in interest rates in the near future remains constrained. Consequently, the trend of lending rates will remain downward but gradual at best.

As the MPC acknowledges, inflation may be on a mild declining trend but still remains in the upper bound of the government's 5 percent medium term target. A clear commitment to anchoring inflation expectations is reflected by the monetary policy's stance on the back of the trend of the inflation rates (**Figure 1**) where the month-on-month inflation rates have been on downward trend from 6.43 per cent in October to 6.09 and 6.02 percent in November and December respectively, the lowest inflation rate for the year. Similar trend is observed for the annual average inflation rate that stood at 6.98 percent in December from a high of 7.33 per cent in August 2014.



Source: Central Bank of Kenya

It is noteworthy that the fall in the month-on-month inflation rates is attributed to the declining oil prices from the global market which is beginning to spill over to the non-oil-producing countries. In our context though, the pressure from food prices increase curtailed the extent of overall inflation decline.

The Oil Story

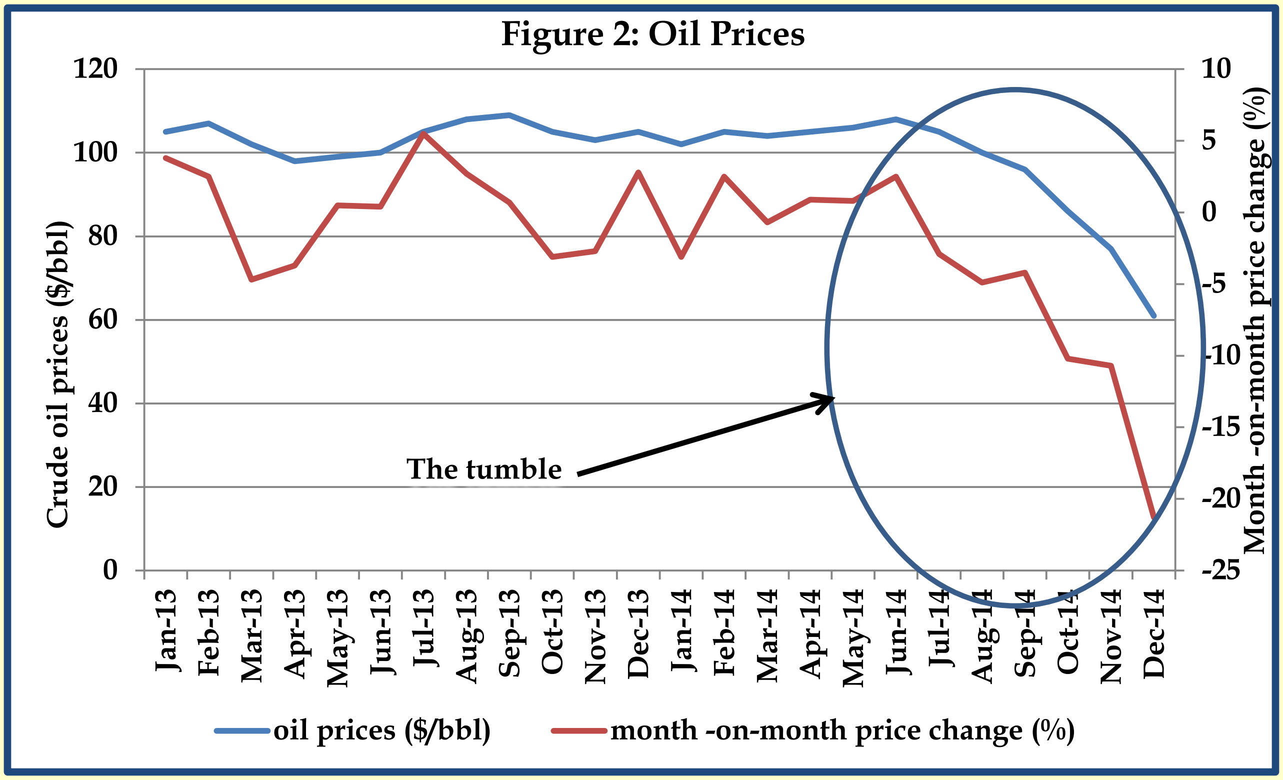
As we note above, the good inflation fortunes to a substantial extent owe it to oil prices. Evidently, the global economics of oil have taken a shift from the ordinary. As at the end of year 2014, the oil market experienced a market glut with the supply overshooting global demand. Low demand for oil is mainly attributed to weak world economic activity especially in the emerging economies, increased inefficiency, and the growing shift to other fuels in pursuit of green economy. The price tumble that has been observed in the recent past (**Figure 2**), unexpected as it may seem, was in the circumstances inevitable. We highlight the following lessons from the tumbling oil prices.

- The economics of oil globally has currently taken a new shift away from the ordinary. It is now evident that oil prices are not only determined by the market forces of demand and supply, but rather by the market expectations. Therefore, the decision by the OPEC for instance to cut down production will definitely spike oil prices. We also note that from the new development in the oil market, oil market will remain subject to the geopolitical shocks whose absence would make the market less vulnerable to shocks. While OPEC seems divided and that decision has not been forthcoming in the recent price episode, any future price expectations will of necessity factor that in.

- The recent tumble in the oil market has adverse effects to the oil producing economies with serious currency depreciations as well as worsening fiscal balances. The value of the Russian rouble is already at the plunge depreciating significantly against the U.S dollar. In Nigeria, the Naira is already facing weakening bias in addition to interest rates being on an upward trend. In Venezuela, the fiscal deficits are on the rise to the extent of the economy close to defaulting its national debt. In Nigeria and Venezuela the social unrests experienced complicate the situation further. The case for diversification of economic activity is easily made.

- For the non-oil producers, the declining world oil prices are beneficial to their economies. These economies can leverage on the dropping prices to boost on the gross domestic product growth through reduced cost of product, low inflation as well as reduce oil import bills. According to the IMF estimates, for every USD10 a barrel fall in oil prices raises the world growth by 0.2 per cent. Thus cheaper oil is adrenalin to world growth through the fuel injection in the world's circular flow of income. It is estimated that a USD 40 price cut shifts approximately USD 1.3 trillion from the producers to consumers.

- Despite the cheap oil prices having the likelihood of boosting world economic growth, there is the negative news to the Euro zone in form of the region now being in a deflation following the Euro crisis. The European Central Bank ECB is already devising policies to surge up inflation and promote growth in the region. However, the low oil prices counters these policies since low oil prices imply low inflation rates. Despite the mild improvements recorded in Germany and Spain; Italy, the third largest economy in the zone continues to slow down while France, the second largest economy in the Euro zone has not been growing considerably. In addition, the looming political tension in Greece amid the upcoming elections in January 2015 further dampens the prospects of recovery in the Euro zone in the near future.



Source: IMF Database

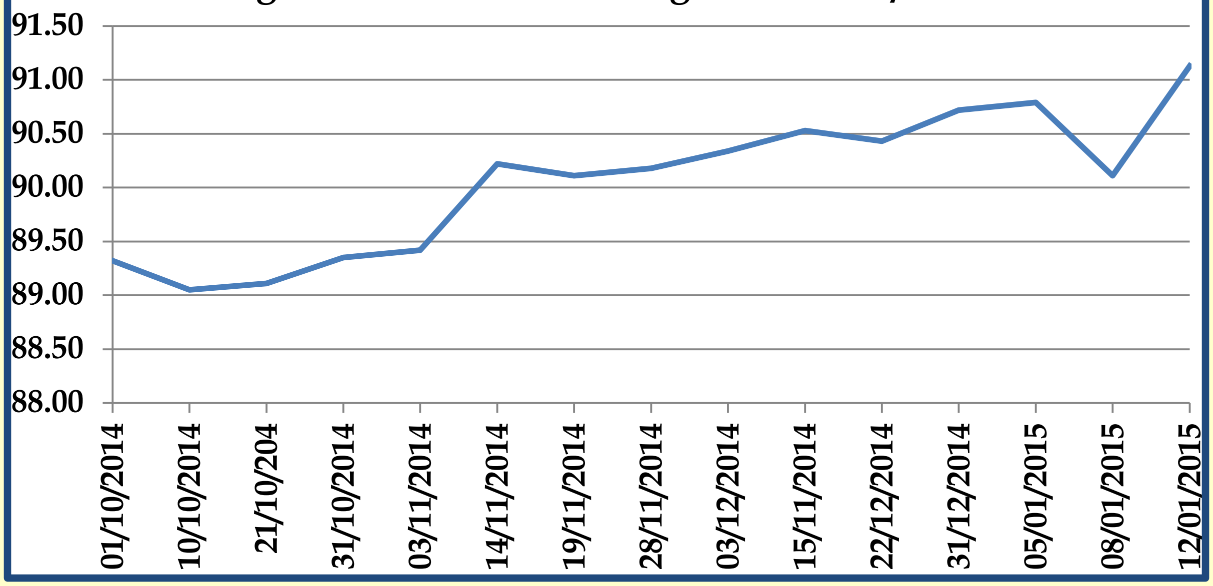
We could therefore infer that the effects of the oil prices are characterized by mixed fortunes. We see a direct benefit to the local economy in form of the effect on inflation; but the lower prices could hamper recovery in some key markets, especially the Eurozone which now has to fight deflation.

The Foreign Exchange Market – A Helping Fiscal hand…

As we pointed out in the introduction, the interest rates outlook has a clear connection to the developments in the foreign exchange market. Indeed, so long as the Kenya shilling (KES) remains under depreciation pressure on account of the economy's weak current account position, the scope of a significant reduction in interest rates in the near future remains constrained. It is interesting that the MPC sees a largely stable foreign exchange market, albeit with any depreciation arising more from a strengthening USD than a weakening KES.

The MPC's position is in our view part of the story, and in any case needs to be seen in a nuanced perspective. The KES has clearly been under depreciation bias for the entire of quarter four of 2014 (**Figure 3**). We acknowledge that the depreciation is to some extent attributed to the external factors mainly the effects of the resurgent USD following the end of the quantitative easing the federal government.

Figure 3: Nominal exchange rate - KES/USD



Source: Central Bank of Kenya

The other side of the story is that the fundamentals to support any other stance other than a mildly depreciation bias are lacking. The current account is still weak; that is why all the accommodations to stabilizing the currency that supports the MPC's position are clearly anything but an improvement in the fundamentals:

- The foreign currency reserves have received a boost from the initial issuance and the later re-opening of the sovereign bond. We argue that this is a case of the fiscal policy offering monetary policy a helping hand. Given that the bind proceeds are meant for government investment programs, it means therefore that the level of reserves arising thereof could be fluctuating depending on utilization. Further accommodation is available from an approved International Monetary Fund (IMF) facility that can allow the CBK to draw down as need arises towards ensuring foreign exchange market stability; that there is such facility means that weaknesses in the fundamentals are evident.

- There is a clear boost from diaspora remittances and increased net purchase of equities in the Nairobi Securities Exchange (NSE). We contend that taking a forward-looking stance will entail factoring in the likely implication of the introduction of capital gains tax on the trend of foreign participation in the NSE.

…but Weak Global and Emerging Economies Growth Prospects

It doesn't help the economy's current account position considering that the global and emerging markets growth prospects remain weak. It is true, and the MPC points as much, that the US and the UK are the drivers of the moderate recovery that is currently observed. But as we have already indicated, the Eurozone is now formally in deflation hence dampening any possibility of economic growth for the member country. Further, the ongoing political developments - speculations on Grexit (Greece exit from the Euro zone membership) and Brexit (Britain's exit from the EU) - have not been helpful in building market confidence.

Looking at the emerging economies, growth prospects in majority of these economies for the year 2015 have been revised downwards. For Brazil, the third quarter for 2014 registered negative growth with shrinking exports' revenues, widening trade deficits as well as the sliding consumer confidence. In India, investment environment remains weak mainly attributed to the high corporate tax and rigid fiscal policy. For China, the people's Bank of China has reduced its benchmark interest rates for the first time since June 2012 in attempts to spur up the weakening growth. The worst hit is Russia with a serious depreciation bias of its currency despite the interventions by the central bank. In addition, the service sector is experiencing contraction. This presents a weakening bias for the BRICs economies which is likely to trickle down to the less developed economies.

It is now clear that the weaknesses in these economies are deeply entrenched and that the weakening of the key emerging markets currencies after the indication that the US's Federal Reserve Board was to embark on the tapering its Quantitative Easing Program was in sense a tantrum; that is why the US bond rates have come down to the pre-tapering indication levels while the emerging markets currencies are still on the depreciating trend (**Figure 4**). Therefore as we have argued before, help from abroad is likely to be limited at best.

Figure 4: Emerging Markets Soft Underbelly

Source: Federal Reserve Bank of St. Louis

Conclusion

As widely anticipated, the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) retained the Central Bank Rate (CBR) at 8.5 percent in its meeting of 14th January 2015 while during the same meeting the MPC announced a 59 basis points reduction of the Kenya Banks Reference Rate (KBRR) from 9.13 percent to 8.54 percent. The MPC is to send out a clear message that it is keen to anchor inflation expectations; therefore the mild downward ticking of inflation does not justify a chance in monetary policy stance. To the extent that the Kenya shilling is under depreciation pressure on account of weak fundamentals, the scope for significant interest rates reduction in the near term is curtailed.

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