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

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Monetary Policy Stance – A justifiable Pause

Highlights

- On the back of inflation declining from 7.0 percent in June 2015 to 6.6 percent in July 2015, and the Kenya shilling starting to manifest signs of stabilisation, the Central Bank of Kenya's Monetary Policy Committee (MPC) in its meeting of August 5, 2015 decided to hold the Central Bank Rate (CBR) at 11.5 percent.
- This *Research Note* argues that the MPC's decision is justifiable as it demonstrated MPC's confidence in its recent past decisions that need time to yield the desired outcome. A decision any other way could have been as counterproductive as it could have been counterintuitive – counterproductive given the slow trickling in of evidence of the efficacy or otherwise of its recent past decisions thus a further tightening could signal panic that would be costly, and counterintuitive because the CBK's has in its recent decisions and pronouncements been backed by persuasive logic especially with regard to the foreign exchange market.

Introduction

The Central Bank of Kenya (CBK), like other central banks that pursue similar monetary policy frameworks, does not make policy pre-commitment. That is why its Monetary Policy Committee (MPC) gives itself flexibility in all matters within its mandate and especially the frequency of review of its previous decisions. In particular, nearly all its public pronouncements subsequent to a decision of its intentions to "continue to monitor any emergent risks from the external and domestic fronts that may impact on price stability". In other words if circumstances so dictate, the MPC could review the efficacy of its prior decisions and any emergent evidence of a likely impact on price stability – the primary mandate of the CBK – as frequently as it deems necessary.

This is the context in which the MPC meeting of August 6, 2015 – which follows in quick succession three previous meetings of May 6, 2015, June 9, 2015 and July 7, 2015 but unlike these meetings decided to hold the policy rate at 11.5 percent – should be seen[1]. More frequent meetings by the MPC is not an unprecedented occurrence even in the not-so-distant past. Between September 2011 and July 2012, the MPC held monthly meetings. The next meeting has been set for September 2015, a clear indication that frequent meetings are not necessarily emergencies, if by emergence one means a hurriedly convened meeting based on some surprise information that requires urgent and drastic policy intervention. This *Research Note* grounds its perspectives about the latest decisions by the MPC on the similarities and indeed differences between the circumstances then and now that warranted frequent decision reviews.

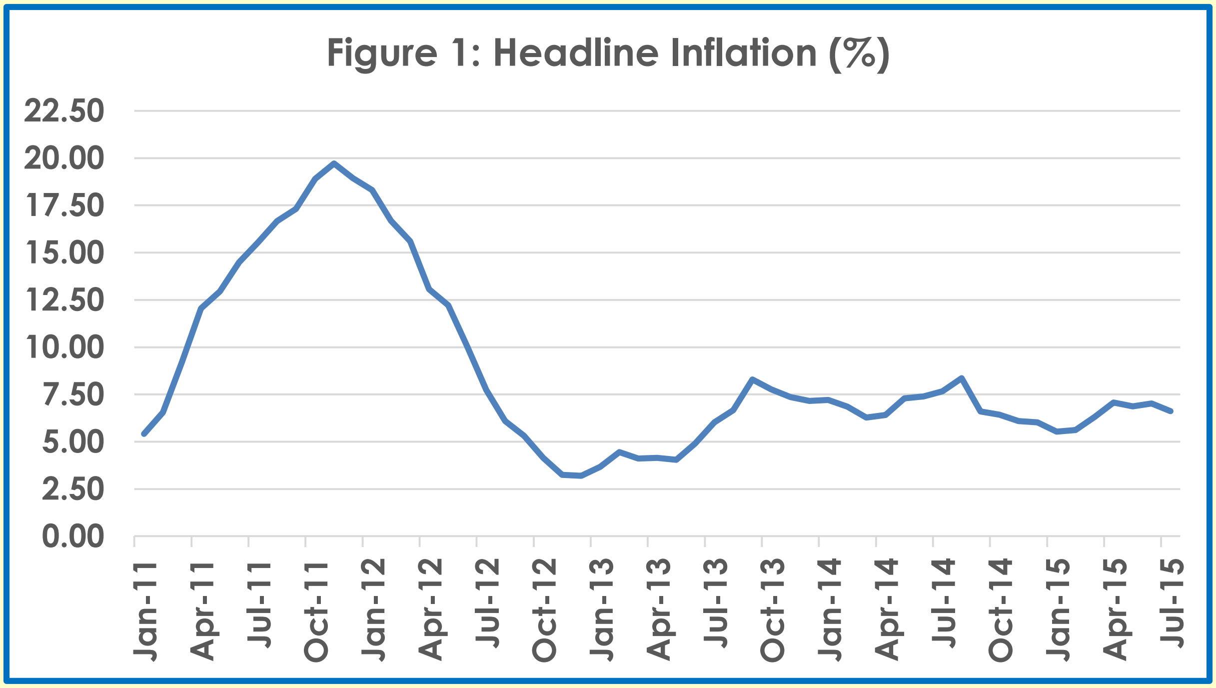
The starting point is a look at the prevailing macroeconomic stability conditions in line with the CBK's mandate as reflected by the headline inflation rate. As Figure 1 shows, the September 2011 – July 2012 period was characterised by high inflation while during the current period inflation has largely been within the medium-term target range of 5 percent +(-) 2.5 percentage points – although it evidently has an upper bound bias.

The policy response to the observed inflationary picture has been markedly different. It is reasonable to assume that the CBK's monetary policy is aimed at anchoring inflation expectations around the medium-term target. In the case, such as Kenyan's during the 2011-2012 period, where the inflation trend was erratic but largely on a clear upward trajectory and inflation outlook is largely predicated upon food production and distribution, two aspects that are closely linked to weather (specifically floods that could potentially disrupt food production and distribution), such anchoring needs to be manifested in policy action.

That policy action was then lacking. The ensuing critique, prominently by an IMF research paper[2], was that the CBK was not quick to respond to the inflation surge of September 2010 to November 2011 and the policy reaction that came with a time lag entailed shocking the economy with a drastic monetary policy tightening of August 2011 to December 2011 – the Central Bank Rate (CBR) was over the short period hiked from 6.25 percent to 18.0 percent.

[1] Ordinarily, the MPC holds its meetings after every two months. Any more frequent meetings have been widely perceived as emergency sessions – admittedly though, the perception of "emergency" gives the wrong impression of some surprise information that requires urgent and drastic policy intervention.

[2] Andrle, Michal ; Berg, Andrew ; Morales, R. ; Portillo, Rafael ; and Vlcek, Jan (2013), "*Forecasting and Monetary Policy Analysis in Low-Income Countries: Food and non-Food Inflation in Kenya*", IMF Working Paper WP/13/61, March



Source: Kenya National Bureau of Statistics

The inflation climb-down from a high of 19.72 percent in November 2011 to 3.25 percent in November 2012 was accompanied a cautious policy approach – initially holding the CBR at 18.0 percent until July 2012 before the MPC took to an accommodative stance of easing the CBR to 16.5 percent an subsequently reducing it consistently to 8.5 percent by May 2013.

The period subsequent to May 2013 has been interesting from a policy standpoint. For much of that period (precisely 2 years – between May 2013 and May 2015), the MPC didn't change its policy stance and held the CBR at 8.5 percent. It is easy to assume based on its public pronouncements that the MPC's view was informed by a determination that inflation had been subdued. In any case it was within the target range and has remained there to-date – except for 2 incidences in September 2013 and August 2014; and the IMF[3] was nearly on the verge of declaring victory in a broad context.

The question that this *Research Note* poses and explores is: is the CBK's latest policy stance an implicit signal of leaning from the past and therefore respond proactively? The answer is traceable to the development in the foreign exchange market under different inflation circumstances – depreciation of the local currency (in instances exhibiting volatility) under high inflation conditions (2011 – 2012) and under low inflation but with the threat of busting the range on account of foreign exchange-pass-through effect (the current episode).

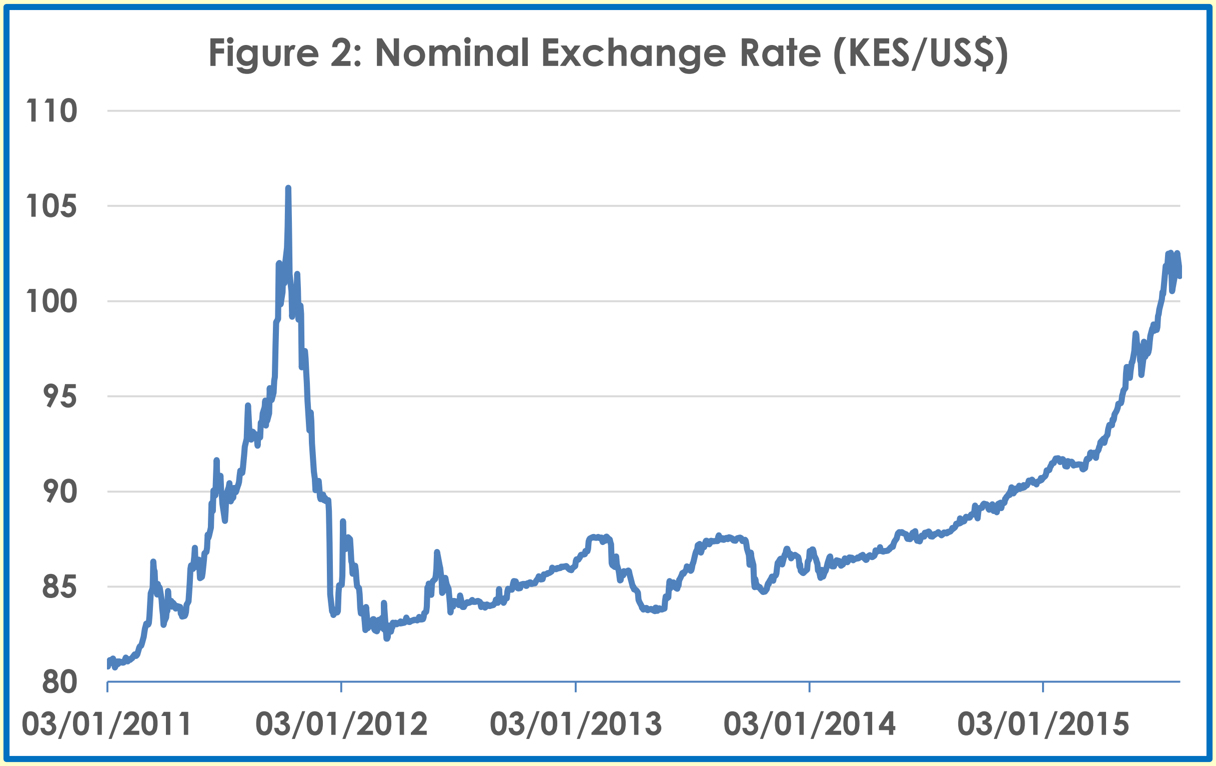
Based on the available evidence, it is clear that the decision by the MPC to hold the CBR at 11.5 percent is justifiable as it demonstrated MPC's confidence on its recent past decisions that needs time to yield the desired outcome. As this *Research Note* will seek to argue, a decision any other way could have been as counterproductive as it could have been counterintuitive – counterproductive given the slow trickling in of evidence of the efficacy or otherwise of its recent past decisions thus a further tightening could signal panic that would be costly, and counterintuitive because the CBK's has in its recent decisions and pronouncements been backed by persuasive logic especially with regard to the foreign exchange market.

[3] IMF (2013), *"The Dog that Didn't Bark: Has Inflation Been Muzzled or was it Just Sleeping"*, Chapter 3 *World Economic Outlook – Hopes, Realities, Risks*, April

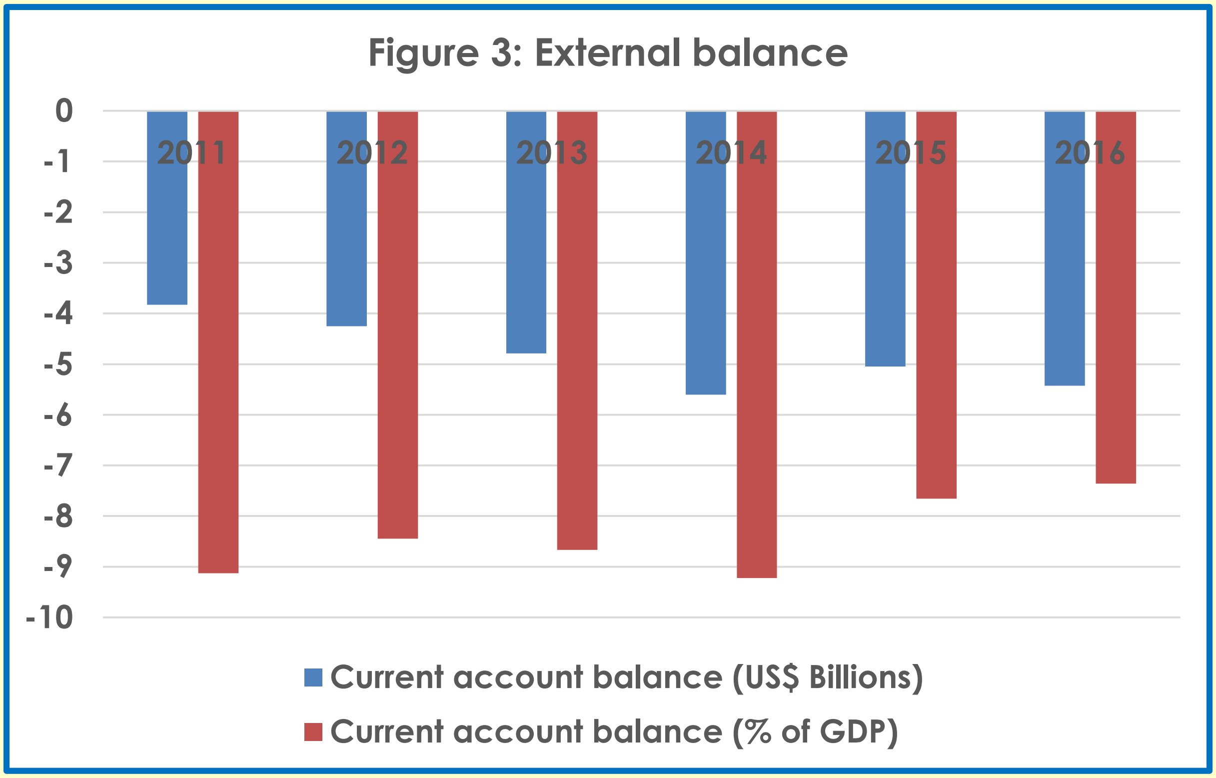
The shilling "under siege"?

As Figure 2 indicates, the economy has had two recent episodes of sustained depreciation of the Kenya shilling (KES) vis-à-vis major international currencies and especially the US dollar (US$). Both episodes have been characterised by incidents of market volatility; they have in equal measure been characterised by calls on the CBK to "do something" to come to the KES's rescue. Expectations of what the CBK can and/or should do depends on who is making the call, with there being two extremes. On the one hand are those who imagine that the CBK has the power, capacity and mandate to "do something" beyond the only logical expectation of preventing volatility in the foreign exchange mandate. They only look at the story that Figure 2 tells – that the KES is "under siege".

On the other hand are those whose expectations are shaped by an understanding that the KES may be "under siege" on account of a weak external position; therefore all the CBK can do is deploy instruments at its disposal to obviate volatility while at the same time ensuring that the depreciation trend does not lead to inflation spiralling out of control. They look at the story as told by Figure 2 and Figure 3 that shows a weak current account positon that underlies the depreciation trend.



Source: Central Bank of Kenya



Source: IMF World Economic Outlook Database; 2016 Figures are projections

Mundell-Fleming thinking carries the day

As we have argued before[4], the MPC is evidently aware of the policy options available to it on the back of the fact that as long as the fundamentals remain weak, the KES will remain under depreciation pressure. This can be inferred from the current account deficit that has been widening on account of weak exports and an increasing import bill on account of external inputs towards capital expenditure. Imports towards infrastructure investments are obviously desirable as they enhance the economy's future capacity to generate export goods; they however have the same effect on the current exchange rate as any other imports.

Further, the MPC is manifestly comfortable with a flexible exchange rate such that it neither has a preferred level (or range) nor direction of adjustment as long as either direction is not characterised by volatility. This policy choice 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 1962 that demonstrated that it is impossible to have domestic monetary policy independence, control the fixed 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".

Much of the agitation about the Kenyan currency – as for instance observed during the July 27, 2015 appearance by the Governor of the CBK who is also the chairperson of the MPC before a committee of the Kenyan Congress – is to the effect that the currency should be managed in a manner that it doesn't fluctuate beyond a certain (arguably arbitrarily imposed) upper or lower limit so as to have predictability of the export and import prices. The same agitation could be seen in the desire to have

[4] See for Instance the Kenya Bankers Association Centre for Research on Financial Markets and Policy® Research Note NO.18. – 2015 (RN/18/15) of July 9, 2015 (http://www.kba.co.ke/images/stories/RN%20No%205%202015.pdf).

some level of management of interest rates so as to keep borrower happy without upsetting savers. But then we have the noble desire to let money flow in and out of the economy without causing too much disruption.

There is a challenge when you want to do all these simultaneously, for the three are desirable but contradictory. Assume that for the period November 2012 and subsequently when inflation has been within the target range the CBK decides to support growth by lowering the policy rates and the market rates follow in tandem, the ensuing resource outflow will but the currency under depreciation pressure that could be inflationary which will then force the MPC to take interest rates up again. If the policy choices is some level of control on the exchange rate and let money freely flow in and out of the economy, then that will be at the expense of having no control over interest rates (in other words no independent monetary policy. If however the policy choice is some form of control on interest rate an exchange rate, then the economy will have no control capital inflow and outflow.

So the choice is two of the three options, and Kenya has advisedly chosen a free exchange rate and independent monetary policy while foregoing any influence on resources flow in and out of the economy. Now that the US's Federal Reserve – the central bank – has indicated the possibility of an interest rate hike before the end of this year, this is likely to put further pressure on the KES. The message that the CBK is implicitly putting across in the face pressure from the legislative arm of government[5] is that it cannot manage the exchange rate; it can only deploy instruments to avoid market volatility. The only addendum one can make to that message could be that experience shows that flexible exchange rates are more resilient in the face shocks and are better able to distribute the cost of adjustment between the external and domestic economy.

A pipe wrench as a tool in play?

It is clear that the MPC is keen to extract liquidity from the financial system especially when it started emerging that money supply and credit growth was mounting pressure on inflation[6]. The tightening bias that has characterised the MPC's stance, while targeting to address and obviate potential inflationary pressure emanating from the exchange rate, has augmented the CBK's direct intervention in the foreign exchange market.

It is on this account that the latest MPC pronouncement observes relative stability in the foreign exchange market in the few days preceding its decision to hold the CBR at 11.5 percent – although it interestingly observes that the measures of its previous meetings are yet to be fully transmitted into the economy. In order to further support the foreign exchange stabilisation measures, the CBK has reiterated its requirement – in line with the prudential guidelines – that the limit on the overall foreign exchange exposure as measured by spot mid-rates and shorthand methods should be 10 percent of a bank's core capital (overall and intra-day). It is evident that the pipe wrench tool will remain deployed in form of open market operations with a tightening bias, and the tight liquidity is already showing as all the short-term interest rates are all trending upward (Figure 4) – with some such as the inter-bank rate trend up at a very fast rate.

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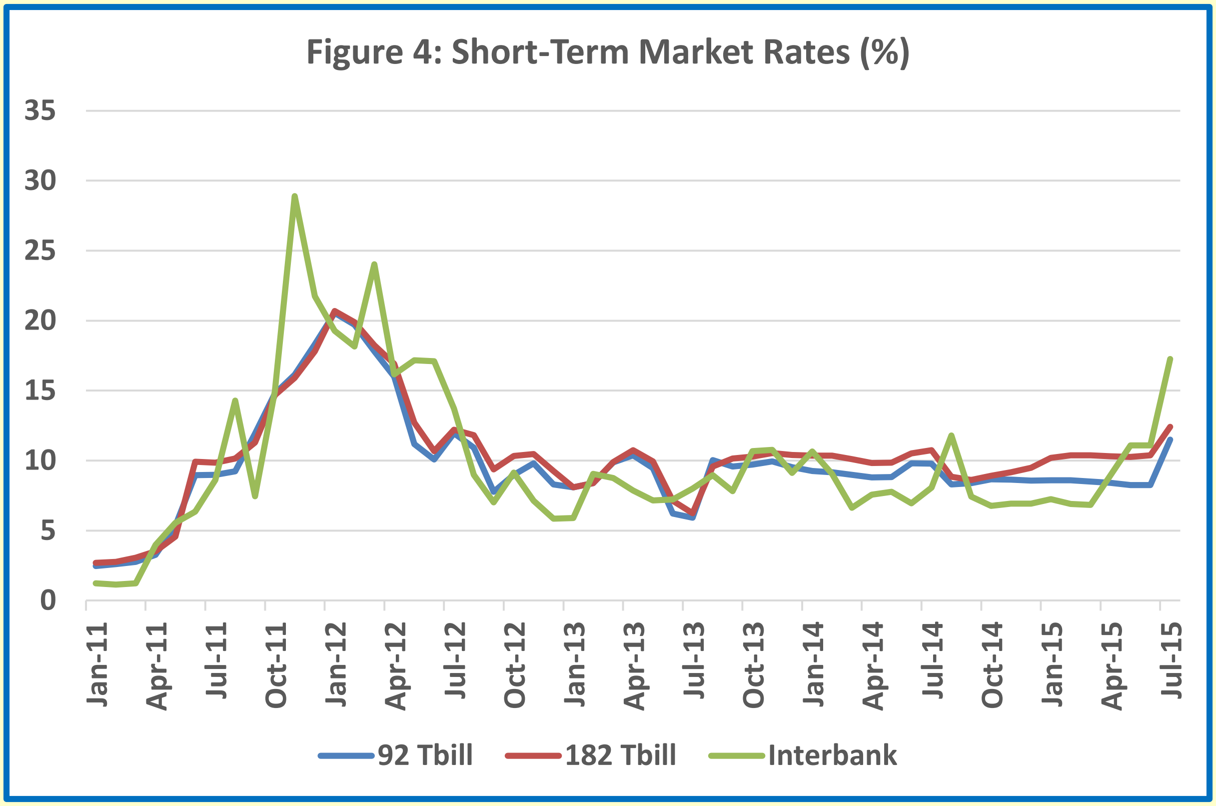
[5]This is the spirit of the CBK Governor's indication that the KES's depreciation is not entirely in control of the central bank - http://www.businessdailyafrica.com/Njoroge-says-shilling-fall-now-beyond-CBK-control/-/539552/2811236/-/xag8mjz/-/index.html

[6]This principally informed the chance of monetary policy stance in June 9, 2015. See https://www.centralbank.go.ke/images/docs/MPC%20Press%20Releases/MPC_press_release_-_9_June_2015_3.pdf



Source: Central Bank of Kenya

Conclusion

Based on the foregoing analysis, we argue that the decision by the MPC to hold the CBR at 11.5 percent is justifiable as it demonstrated MPC's confidence on its recent past decisions that need time to yield the desired outcome. A decision any other way could have been as counterproductive as it could have been counterintuitive – counterproductive given the slow trickling in of evidence of the efficacy or otherwise of its recent past decisions thus a further tightening would signal panic that would be costly, and counterintuitive because the CBK's has in its recent decisions and pronouncements been backed by persuasive logic especially with regard to the foreign exchange market.

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