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Monetary Policy Stance – Quick at Declaring Positive Traction?

Highlights

- As widely expected, the Central Bank of Kenya's Monetary Policy Committee (MPC) held the policy rate at 11.5 percent during its meeting of September 22, 2015. The decision is justified by the fact that inflation is within the target rage and pointing towards the 5 percent. That the month-on-month non-food-non-fuel inflation seems has resumed the right path is a pointer to the effects of the recent past MPC decisions being transmitted to the economy.
- It can however be argued that the MPC is not sufficiently articulate in its recognition of the risks that could potentially be derailing its policy intentions. Notably, the MPC sees no risk – or at the very least it does not make it explicit – that there are domestic fiscal policy challenges, especially those linked to the industrial action by a section of the public service and expenditure programmes that may be confronted by funding constraints.

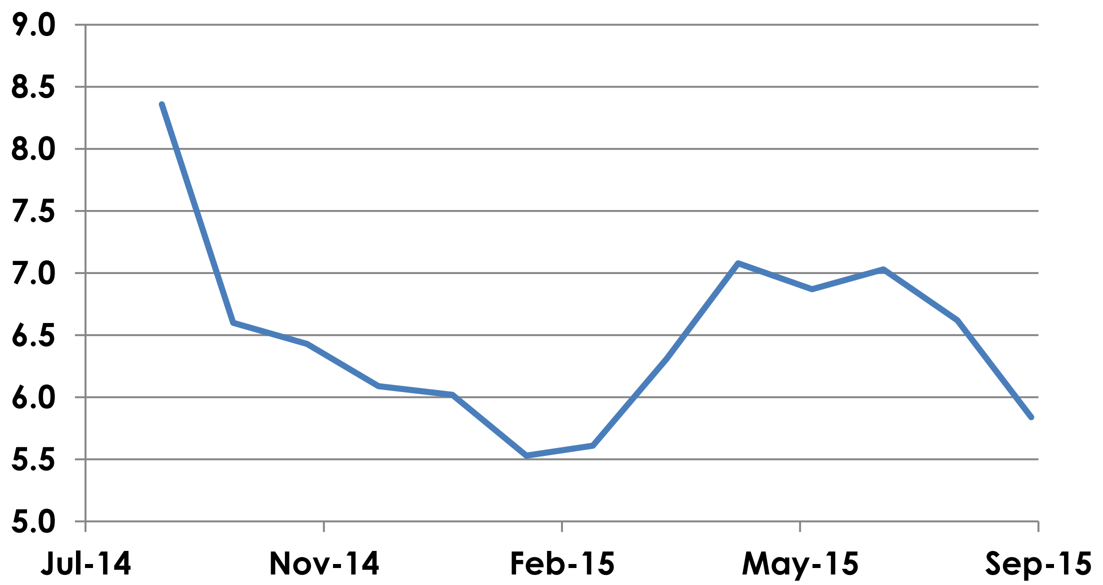
Introduction

The September 22, 2015 meeting of the Monetary Policy Committee (MPC) was admittedly a delicate navigation. Coming before the release of the September 2015 inflation numbers, the decision to hold the Central Bank Rate (CBR) at 11.5 percent in two consecutive meeting implies two things:

- One is that the MPC is confident that its previous decisions, especially the quick tightening of stance as reflected in the consecutive increase of the CBR from 8.5 percent that prevailed until June 9, 2015 when it was increased to 10.0 percent and subsequently to 11.5 percent in July 5, 2015, are yielding the desired effect.
- The other is that MPC's inflation outlook as implied by its communique is such that the economy is headed to its medium term target of 5 percent, which is necessary for anchoring stability expectations.

As is evident from the recent trend (**Figure 1**), the attaining of the inflation target is predicated on both supply and demand conditions – then former being outside the control of the MPC and the latter being a function of its careful deployment of monetary policy instruments. The question that this Research Note poses is: is the MPC being overly sanguine about the efficacy of its recent past decisions?

Figure 1: Overall Inflation Rate (%)



Source: KNBS

To be sure of whether or not we are seeing a MPC that is keen to quickly declare positive traction of its policy stance, first it is worth noting that the decision to retain the CBR at 11.5 percent could have been anticipated and justifiably so. The month-on-month non-food-non-fuel inflation seems has resumed the right path. At the same time, the holding of the CBR does not signal an accommodative stance given that the short end of the money market is experiencing tight liquidity as manifested in the inter-bank rates and other short-tenor rates being consistently higher than the policy rate.

We could therefore argue that the message the MPC is sending is that the risks of appearing to be enthusiastic in the tightening are asymmetric: a premature hike would be damaging than a slight wait. In that case the September 2014 inflation numbers could be vindicating the decision if they are within target or justify a review in the next decision meeting.

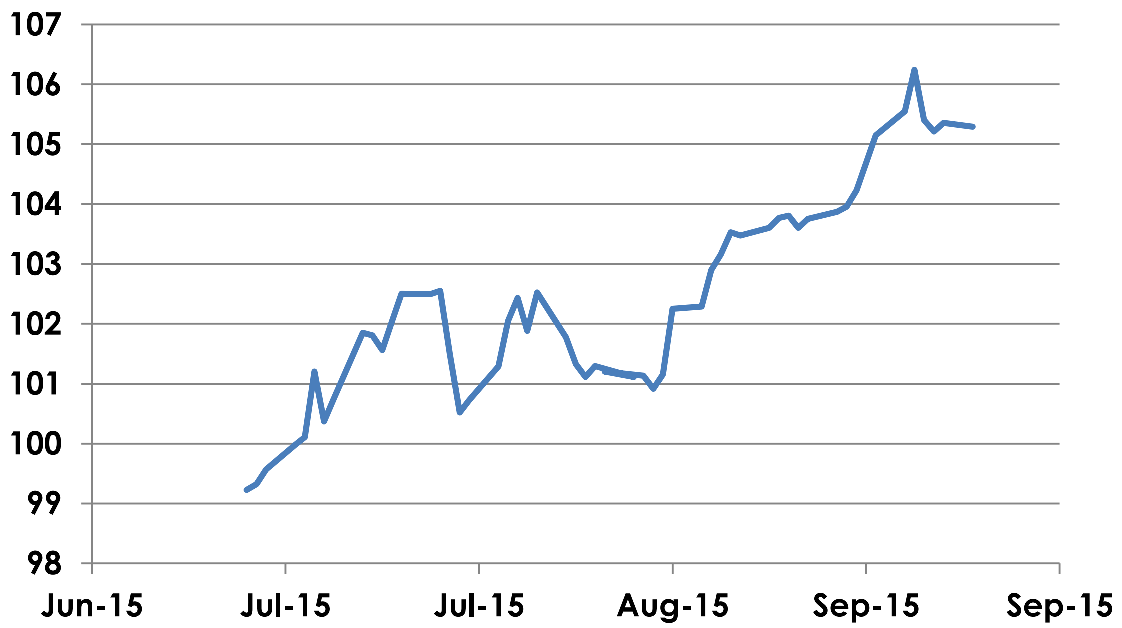
All the reasons for the comfort?

We have argued in the past the MPC is a master of its own calendar, choosing to meet as frequently as once every month – typically its meetings are held after every two months – as was the case over the last four months. It is notable that its September 2015 meeting was on account of an implicit indication of its scheduling to obviate a perception that had been created in its previous three meetings that the MPC was on an emergency mode.

With no such indication in its latest statement, the MPC contrasts itself with those economists John Maynard chastised for setting themselves "too easy, too useless a task, if in tempestuous seasons they can only tell us, that when the storm is long past, the ocean is flat again". That the MPC has been decisive as reflected in the recent 300 basis points increase in the CBR has been positively acknowledged.

Does that mean that the ocean is nearly flat, now that the MPC has not committed to a meeting in October 2015 and therefore implying that we could be back to a review meeting after every two months? The exchange rate, which has exhibited volatility over the past two months (**Figure 2**), is somewhat stable – although some critics assert that it is only less volatile. As the MPC indicates tight liquidity and direct market interventions have helped calm the storm. The CBK can therefore take the comfort that its foreign exchange reserves of USD 6,183 million and the precautionary facility with the IMF will provide adequate short-term cover against any foreign exchange market shocks.

Figure 2: Nominal Exchange Rate (USD/KES)



Source: CBK

The positive picture that one could paint from the policy proactivity on the part of the MPC could be easily marred by a lost opportunity to be succinct about a number of risks.

- First, it is evident that the monetary policy stance could be credited for the moderating demand pressure that has seen non-food non- inflation change course. It is the ensuing tight liquidity that has moderated demand for credit. That makes it interesting for the MPC to observe that tight liquidity (its deliberate policy strategy) and credit risk (the intended consequence) pose a risk to the banking sector. At the very least, the MPC's comminucation about liquidity risks ought to be have been clearly linked to market management issues and in particular the efficiency issues on the inter-bank market
- Second, the manifestation of the tight market liquidity is in the short term market rates being above the CBR. It is less than clear whether MPC sees an anomaly in such rates, especially the inter-bank rate and the 91-day Treasury bill rates, not just being above the CBR but in instances clearly breaking away. If indeed this is an indication of consistency with the monetary policy stance, then the MPC needs to pronounce itself on the Kenya Banks Reference Rate (KBRR) – the common lending benchmark – which has remained 9.87 percent since July 7, 2015.
- Three, it is not clear why MPC could see liquidity and credit risks emerge from largely local conditions – some of which policy related – requiring that its response to be "closely monitor the (banking) sector in view of the risks posed by the volatility in the global markets".
- Fourth, it is inescapable that the MPC rights sees the potential risks from the global developments but assumes await – for it makes no mention of it – then potential challenges to monetary policy and the broader economic performance posed by the risk ofthe domestic fiscal challenges. It is obvious that the expansionary fiscal policy is already encountering hurdles arising from labour industrial action that is taking a toll on public service industry. Whether the wage bill, which adds to the recurrent expenditure, increases to an already strained fiscal budget remains to be seen; but the effect of the strikes and the tightened liquidity will lead to poor third quarter growth rate; this is a risk worth recognising.

Conclusion

As widely expected, the MPC held the policy rate at 11.5 percent during its meeting of September 22, 2015. The decision is justified by the fact that inflation is within the target rage and pointing towards the 5 percent. That the month-on-month non-food-non-fuel inflation seems has resumed the right path is a pointer to the effects of the recent past MPC decisions being transmitted to the economy.

It can however be argued that the MPC is not sufficiently articulate in its recognising the risks that could potentially be derailing its policy intentions. Notably, the MPC sees no risk – or at the very least it does not make it explicit – that there are fiscal policy challenges, especially those linked to the industrial action by a section of the public service

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