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Monetary Policy Stance: A Justifiable Pause

Highlights

- Under the current circumstances, an accommodative monetary policy stance is justified. We argue that notionally so long as inflation remains anchored within the target range and real interest rates remain positive, monetary policy has easing scope.
- Policy easing however needn't be an end in itself; the demand injection needs to be matched by supply side measures without which policy efficacy will remain inhibited. If indeed further easing is an option, then the pace has to take into account the disadvantages of expending all the ammunition on the back of significant uncertainty.

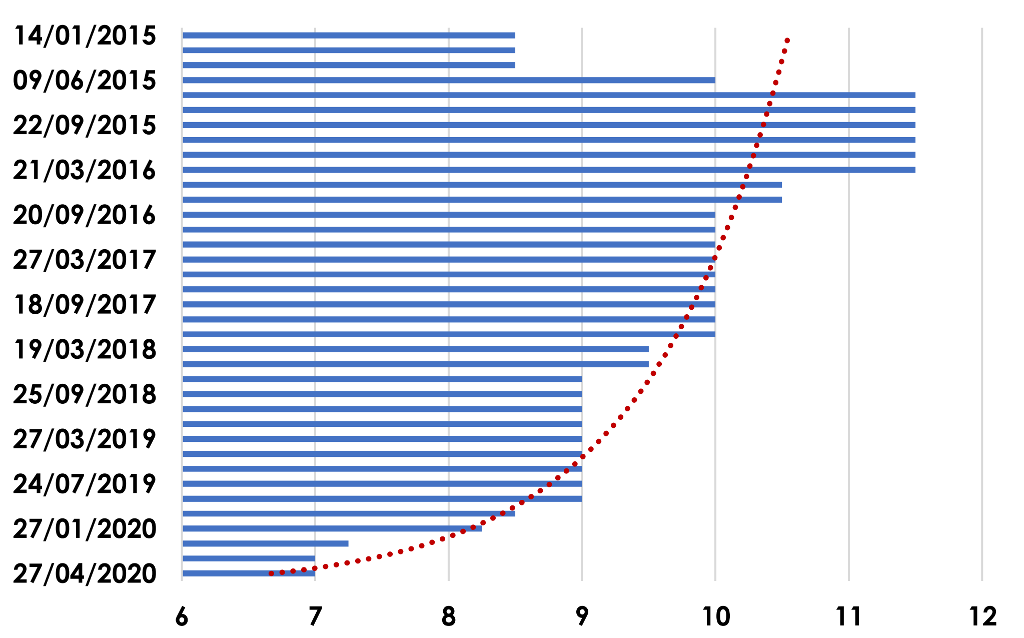
Introduction

The Central Bank of Kenya's monetary policy response to the economic shock arising from the Coronavirus (COVID-19) outbreak has been swift. The monthly meetings of its Monetary Policy Committee (MPC) point to the justifiable policy vigilance meant to support the economy navigate the shock. On the back of such response is the acknowledgement that the economic slowdown that has already been manifested in a drastic downward review of output growth forecasts has both demand side and supply side dimensions. In that lies the scope for monetary policy potency towards addressing demand-side aspects as well as limitations inherent in its inability to address supply-side aspects.

The MPC meeting of May 27, 2020, concluded that "the policy measures adopted in March and April were having the intended effect on the economy and are still being transmitted". The MPC thus elected to retain the Central Bank Rate (CBR) – the policy signalling rate – at 7.0 percent, observing that the current accommodative monetary policy stance remains appropriate.

This *Research Note* observes that over the past four years, monetary policy has had an accommodation bias (**Figure 1**). Instances of quick easing – for instance, the 100 basis points' reduction in the CBR in May 2016 and the easing cycle of 2020 in response to the pandemic – is underpinned by the need to inject more credit demand. Assessment of the policy efficacy especially during the 2016 – 2019 period when interest rates were controlled – was that the credit market remained largely unresponsive to the price signal with the growth of the banking system's claims to private sector stuck at a single-digit level.

Figure 1: Central Bank Rate (%)



Source: CBK

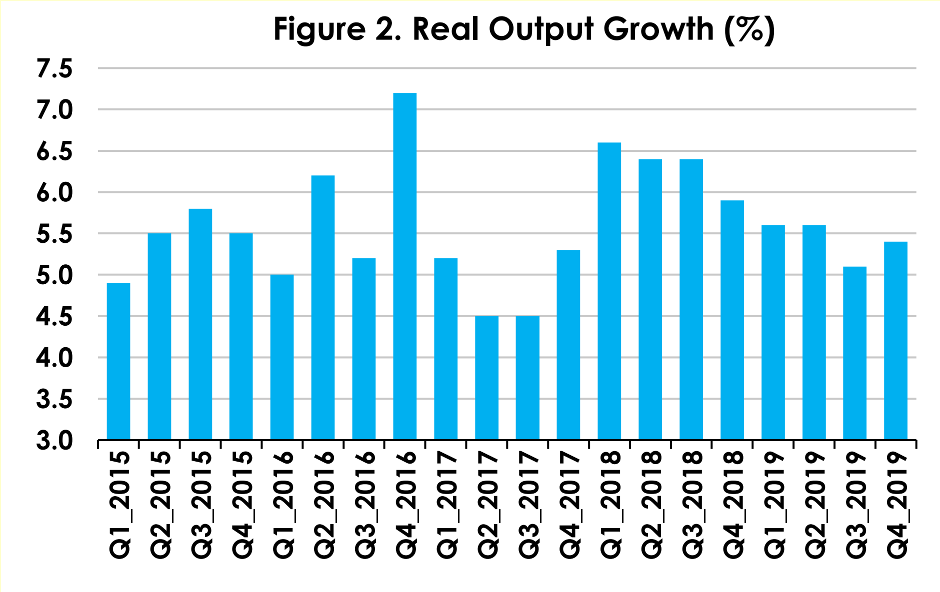
Under the current circumstances, an accommodative monetary policy stance is obviously justified. Given the policy transmission lags that the MPC expressly recognizes, it's worth reflecting on two forward-looking questions: Is there scope for further easing of monetary policy? If yes, what would be the ideal pace of such easing?

We argue that notionally so long as inflation remains anchored within the target range and real interest rates (nominal interest rates adjusted for inflation) remain positive, then monetary policy has an easing scope. Policy easing, however, needn't be an end in itself; the demand injection needs to be matched by supply-side measures without which policy efficacy will remain inhibited.

If indeed, further easing is an option, then the pace has to take into account the disadvantages of expending all the ammunition on the back of significant uncertainty. That is why the MPC has often followed any quick easing with relatively more tapered moves. While under the current circumstances it is difficult to have a clear forecast on how the economy and markets outcomes will play out and therefore have a basis for policy anticipation, we can point out areas to watch.

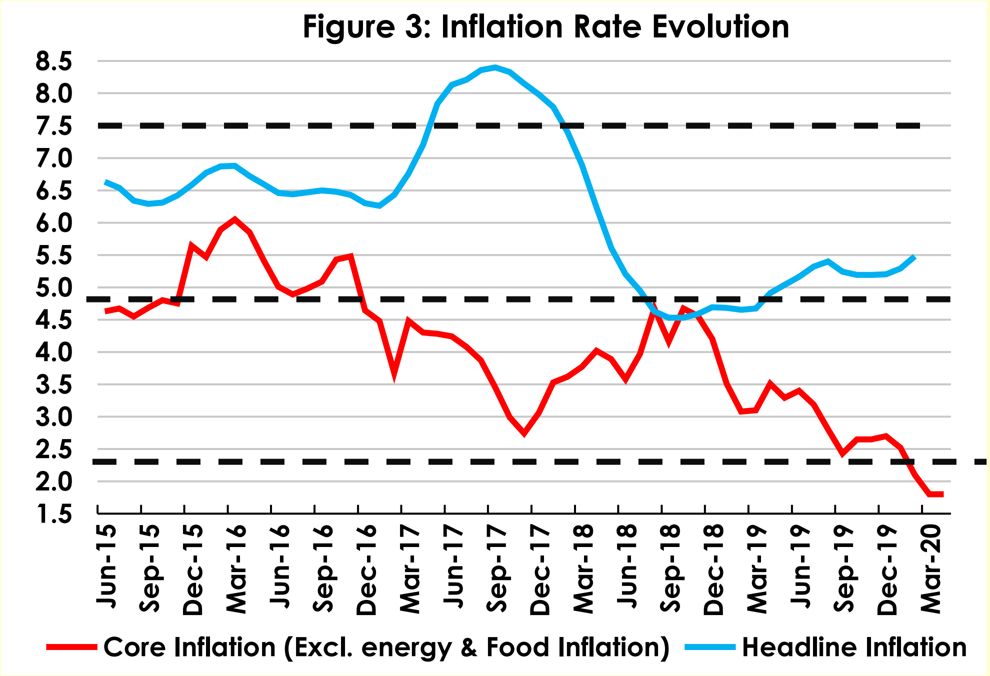
Being on the lookout

The first one is on the broad output performance. The COVID-19 has had an unprecedented impact on the global as well as the domestic economy. As **Figure 2** shows, the economy entered 2020 with more considerable economic slack. The negative output gap is expected to widen significantly as real output growth is projected to be much lower than anticipated at the end of 2019. In 2019, the economy grew by 5.4 percent compared to 5.9 percent in 2018, partly reflecting a softening of household spending, constrained private sector credit growth, and slowing export growth. Taking the growth picture into consideration, monetary policy could be expected to remain accommodative.



Source: KNBS

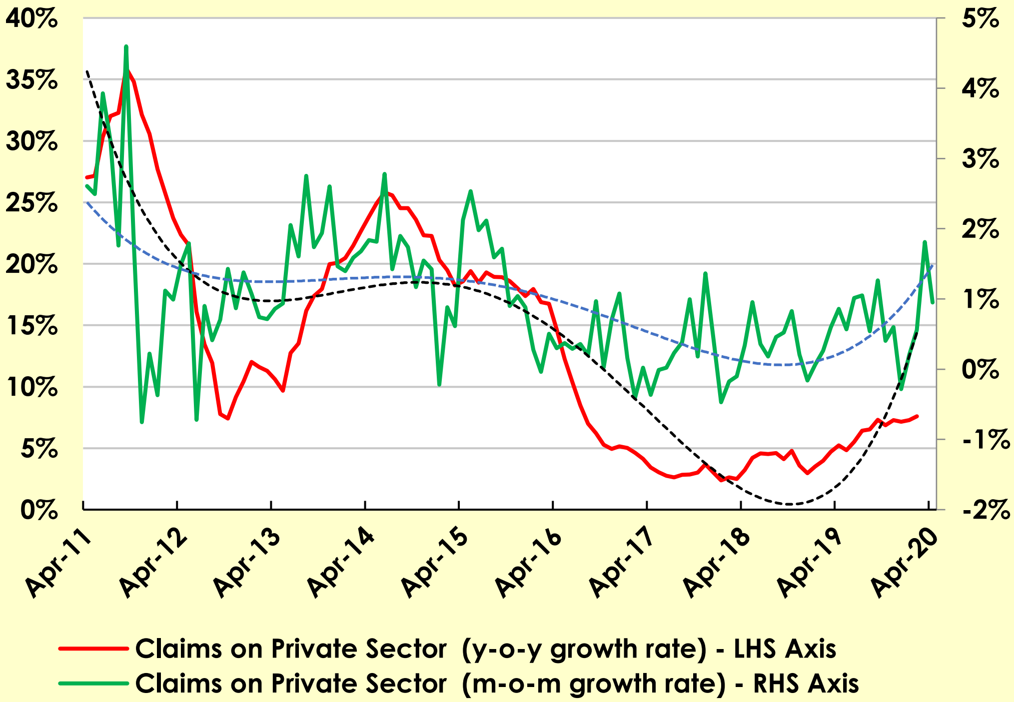
The second is inflation. As **Figure 3** shows, inflation is well within the government target range of 5±2.5 percent, albeit with an upper bound. Even so, overall inflation rate edged upwards by 0.10 percentage points from 5.50 percent in March to 5.60 percent in April mainly due to an increase in prices of food and non-alcoholic, electricity and cooking gas, which outweighed the decrease in the cost of kerosene, and also an increase in the transport prices. On the other hand, core inflation continues to exhibit stickiness to the downside. In April it stabilized at 1.8 percent recorded in March, sustaining a fourth consecutive month of a downward trend. With the core inflation – a measure of demand-side inflationary pressures – remaining low, monetary policy would be expected to remain sufficiently accommodative as a platform for spurring demand.



Source: CBK

The third is the trajectory of credit to the private sector. As at April 2020, the balance of credit granted by commercial banks to the private sector grew by a nominal annual rate of 9.0 percent, an increase of 0.1 percentage points compared to the 8.9 percent growth in March (**Figure 4**). The marginal increase in lending was supported by the various policies put in place to support access to credit and loan repayments by customers that are distressed because of COVID-19.

Figure 4. Private sector credit and growth rate (percentage change)

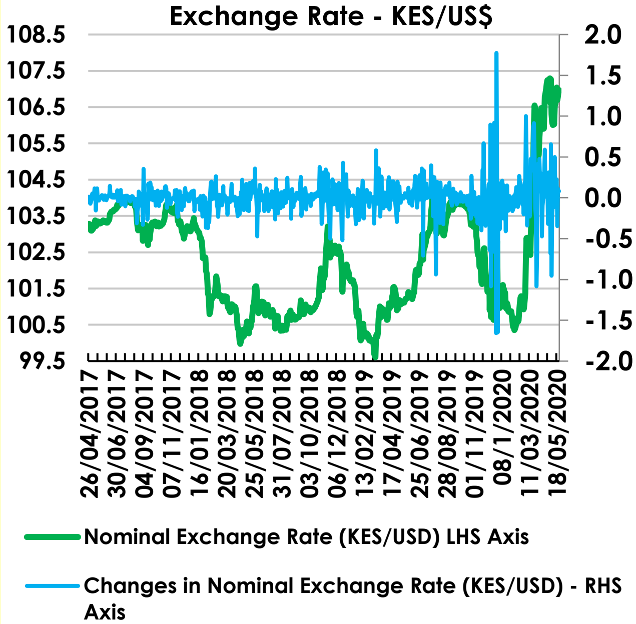


Source: CBK

As one considers the three arguments above, it is worth taking a keen look at both the foreign exchange market as well as the international oil prices, both of which have implications on the domestic economy's stability. The Kenya shilling has in the recent past few months been on a depreciating path against the US dollar (**Figure 5)**. Even though the depreciation has not translated to higher prices, perhaps due to a low pass-through effect, it is worth taking a keen look on how this evolves going forward especially if the trend is sustained on the back of rising risk aversion leading to capital outflows as has recently been the case.

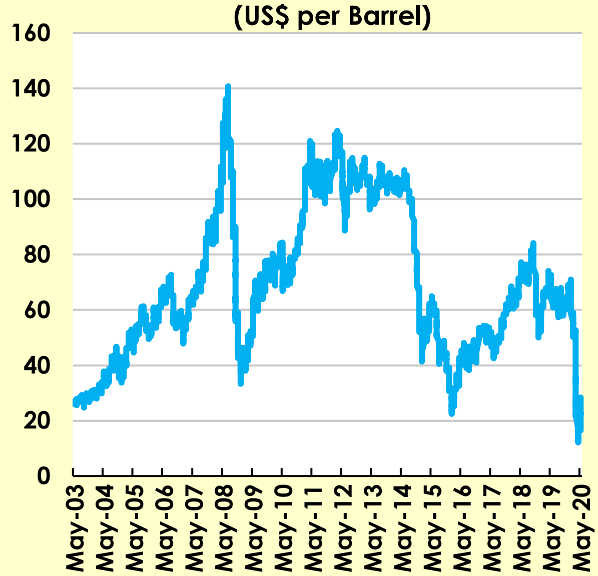
Oil prices in the first quarter of 2020 plummeted mainly on account of a price war between Saudi Arabia and Russia, raising supplies while demand has been feeble since the outbreak of Coronavirus (**Figure 6**). While the prices are expected to remain low, a slow recovery is possible as suspended economic activity resumes.

Figure 5. Changes in Nominal Exchange Rate - KES/US$



Source: CBK

Figure 6. Daily OPEC Basket Prices (US$ per Barrel)



Source: OPEC

Conclusion

Under the current circumstances, an accommodative monetary policy stance is justified. We argue that notionally so long as inflation remains anchored within the target range and real interest rates remain positive, monetary policy has easing scope. Policy easing, however, needn't be an end in itself; the demand injection needs to be matched by supply-side measures without which policy efficacy will remain inhibited. If indeed further easing is an option, then the pace has to take into account the disadvantages of expending all the ammunition on the back of significant uncertainty

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