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Monetary Policy Stance: A Test on Creativity

Highlights

- The circumstances against which the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) meets on Monday, March 23, 2020, are unprecedented. The COVID-19 pandemic has simultaneously unleashed three challenges namely constrained demand, interrupted supply, and trodden confidence.
- There is no arguing with the fact that the CBK's monetary policy has remained accommodative. A case for further accommodation under the current circumstances can be made. However, the nature of accommodation has to manifest creativity if it's to be effective. Lowering the Central Bank rate (CBR) and transmitting the accommodative stance through the credit market will on its own not do it.
- Acknowledging the limitations of the conventional tools, additional supportive measures will be worth considering. We propose three such measures:
    - One, lowering the cash reserve requirement (CRR).
    - Two, creative deployment of the "lender of last resort" facility to allow financial institutions access the window at rates that are not punitive.
    - Three, synchronising fiscal and monetary policies beyond the broader aggerate targets by considering (a) a review of the Government overdraft with the central bank, and the incremental amount targeted towards supporting health sector interventions (b) a deliberate CBK balance sheet growth – not necessarily as radical as Quantitative Easing (QE) – through the purchase of a "special treasury bond" whose proceeds could be ring-fenced to support distressed businesses.

Introduction

The circumstances against which the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) meets on Monday, March 23, 2020, are unprecedented. The COVID-19 pandemic has simultaneously unleashed three challenges namely constrained demand, interrupted supply, and trodden confidence.

Whilst the MPC's toolkit is attuned to demand challenges, it could be argued that any of its policy moves should of necessity seek to address confidence issues while aligning itself to other agencies' interventions to address both demand and supply issues.

There is no arguing with the fact that the CBK's monetary policy has remained accommodative. It is debatable though whether the objective of the accommodative stance have been realised or the stance is still wiggling its way through the transmission line.

There is near unanimity that the MPC should sustain, even more, be aggressive with, the accommodative stance. In these circumstances, this *Research Note* aligns itself with the viewpoints for more accommodative monetary policy. We, however, argue that it has to be a creative accommodative stance, for the credit channel that the Central Bank Rate (CBR) signals will on its own not do it.

We therefore fully acknowledge the limitations of the conventional tools and proffer some suggestions of additional measures to consider. Like in other jurisdictions, the lowering of the CBR is assumed to filter to the economy through the credit market.

The presupposition of such a policy move is that it will enhance the affordability of funds hence promote uptake. With the disruptive nature of the COVID-19 pandemic, demand even from households and businesses that considered creditworthy is low. That can only mean that monetary policy via the credit channel is only effective at the margins.

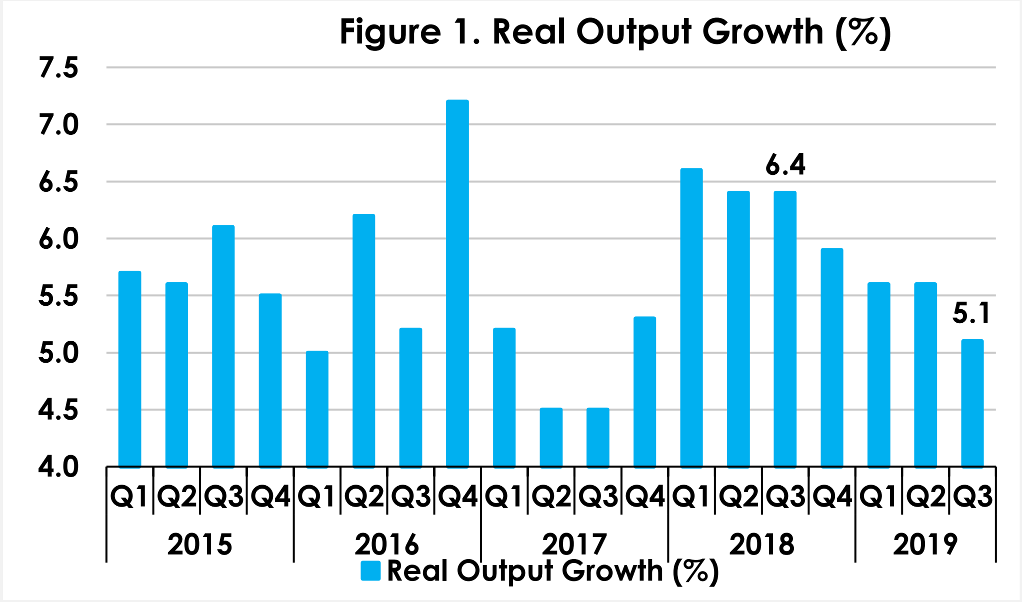
Therefore, while the MPC may consider stimulating the economy through a rate cut amidst muted economic activity, any move it makes should be by way of instilling market confidence of its readiness to act to support a rebound of economic activity once the epidemic is contained. That will require the consideration of additional supportive measures. We prose three such measures:

- One, lowering the cash reserve requirement (CRR). This is the proportion of banks' total deposits at the CBK at no interest rate. The CRR, presently at 5.25 percent is a tool that the CBK uses to adjust the amount of money in the market.
- Two, creatively deploying the "lender of last resort" facility. That will mean a keenness to modify the so-called "*Bagehot conditions*" – *the central bank's disposition to (a) lend without limit (b) to solvent but illiquid financial market player (c) against good collateral (d) at high rates* – through relaxing the rate of interest paid by the financial market players accessing the window. The essence of such modification will be to support liquidity distribution.

- Three, synchronising fiscal and monetary policies beyond the broader aggerate targets by considering (a) the legal mechanisms of increasing the Government overdraft with the central bank, and the incremental amount targeted towards supporting health sector interventions (b) a deliberate CBK balance sheet growth – not necessarily as radical as *Quantitative Easing* (QE) – through the purchase of a "special treasury bond" whose proceeds could be ring-fenced to support distressed businesses.

Confidence Booster

It is evident that the COVID-19 pandemic has battered confidence at household and business level. The timing wouldn't have been bad. As **Figure 1** shows economic growth appears to have slowed recently, with the economy expanding by 5.4 percent in the first three quarters of 2019 compared to a 6.3 percent growth in 2018 partly reflects a softening of household spending, constrained private sector credit growth, and slowing export growth.



Source: Kenya National Bureau of Statistics

Over the next coming quarters of the year, the locust invasion and the COVID-19 pandemic will engender a deterioration of economic conditions. Some of the initial mitigation measures such as the readiness of the banking industry to restructure existing loans offer important support[1], but only to those that have credit obligations. The proceeds proposed "special treasury bond" would potentially allow the national government to offer direct support to enterprises – especially small and medium firms – that may not be having any credit facilities with banks to navigate the current shock.

It is undeniable that many working households – now confronted with the possibility of losing their jobs and therefore their incomes – have no social safety buffers. Even then they

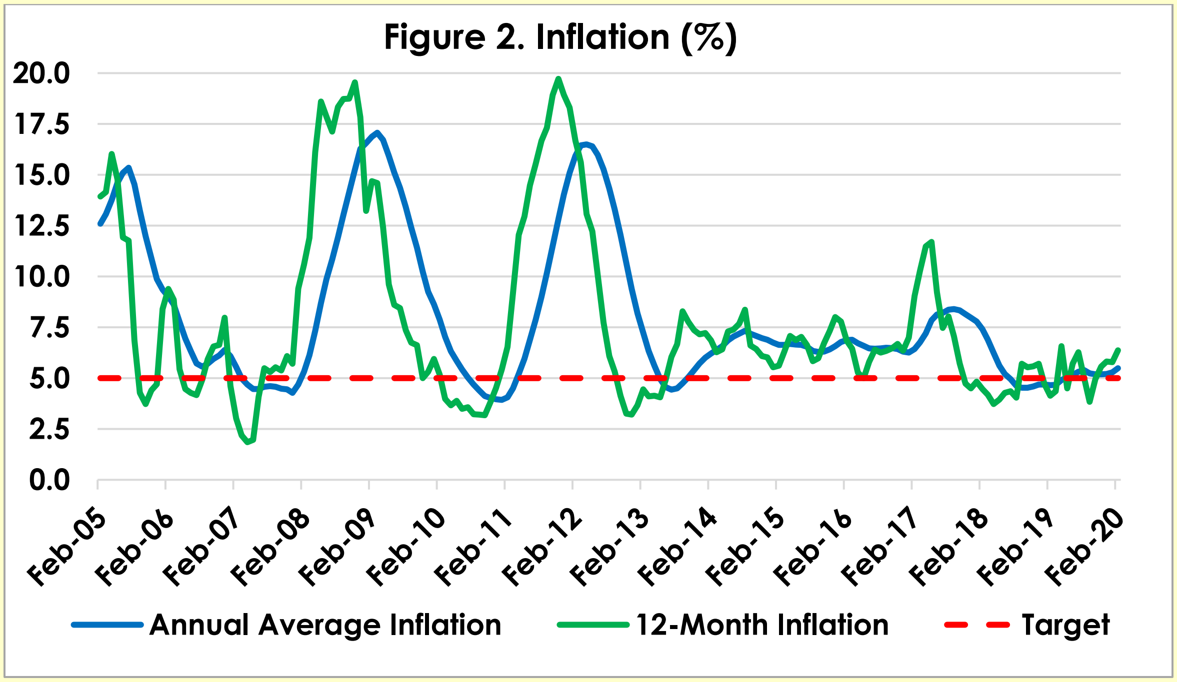
[1] See https://www.centralbank.go.ke/uploads/press_releases/1908080057_Press%20Release%20-%20Emergency%20Measures%20to%20Mitigate%20the%20Adverse%20Economic%20Effects%20on%20Bank%20Borrowers%20from%20the%20Coronavirus%20Pandemic.pdf

still have obligations with banks, including mortgages. In the same vein, many MSMEs are very vulnerable and could collapse if they are not supported. For both the workers and MSMEs, the Government would consider designing support programmes to complement the remedial restructuring by banks as already noted.

Acknowledging its budgetary constraints and bearing in mind its medium-term fiscal targets under the fiscal consolidation stance, the Government can apply as appropriate measures that other countries have used under similar circumstances: tax breaks; rental and tax rebates for commercial property; tax credits for SMEs whose turnover drops beyond a certain threshold.

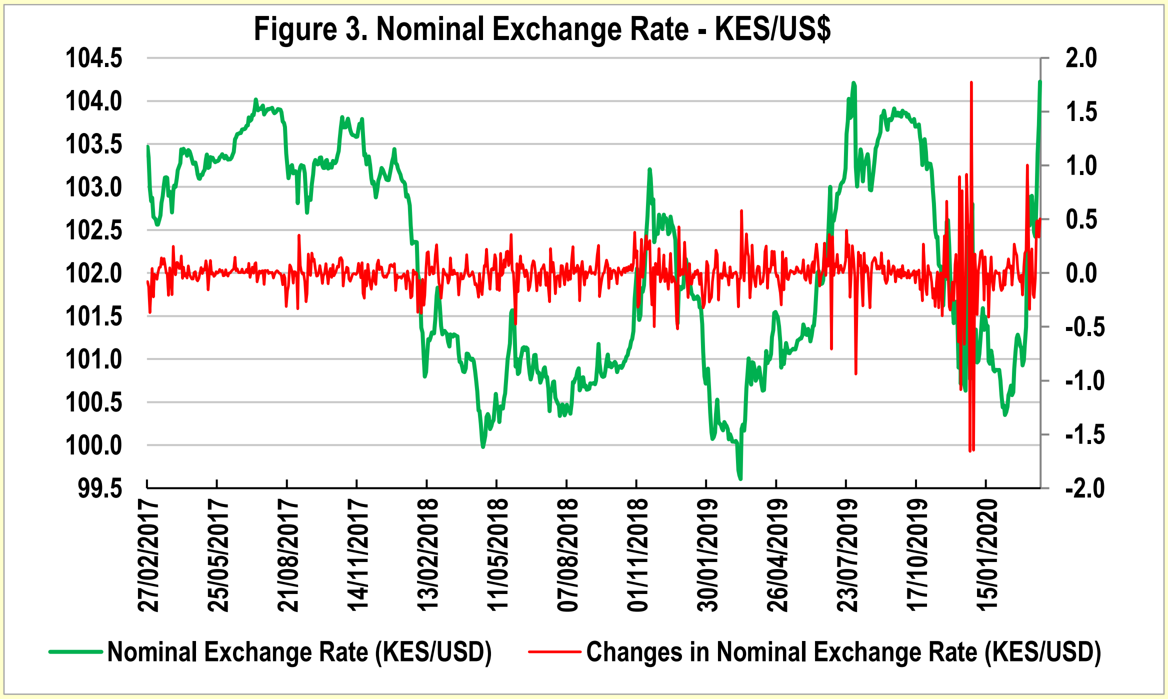
Amidst all that, the production and supply disruptions will have implications on the cost of living. As **Figure 2** shows, despite being with the government's medium-term target of 5±2.5 percent there has been upward pressure on inflation. The 12-month inflation rose to 6.37 percent in February from 5.78 percent in January 2020 while the annual average inflation rose from 5.29 percent in January to 5.48 percent in February 2020.

The increase in inflation has been largely driven by a surge in food price inflation, an increase in the housing, water, electricity, gas and other fuels' index, as well as a rise in the prices of petrol, diesel and airfares and its outlook, remains highly uncertain in the next few quarters as the pressures are of a supply-side nature.



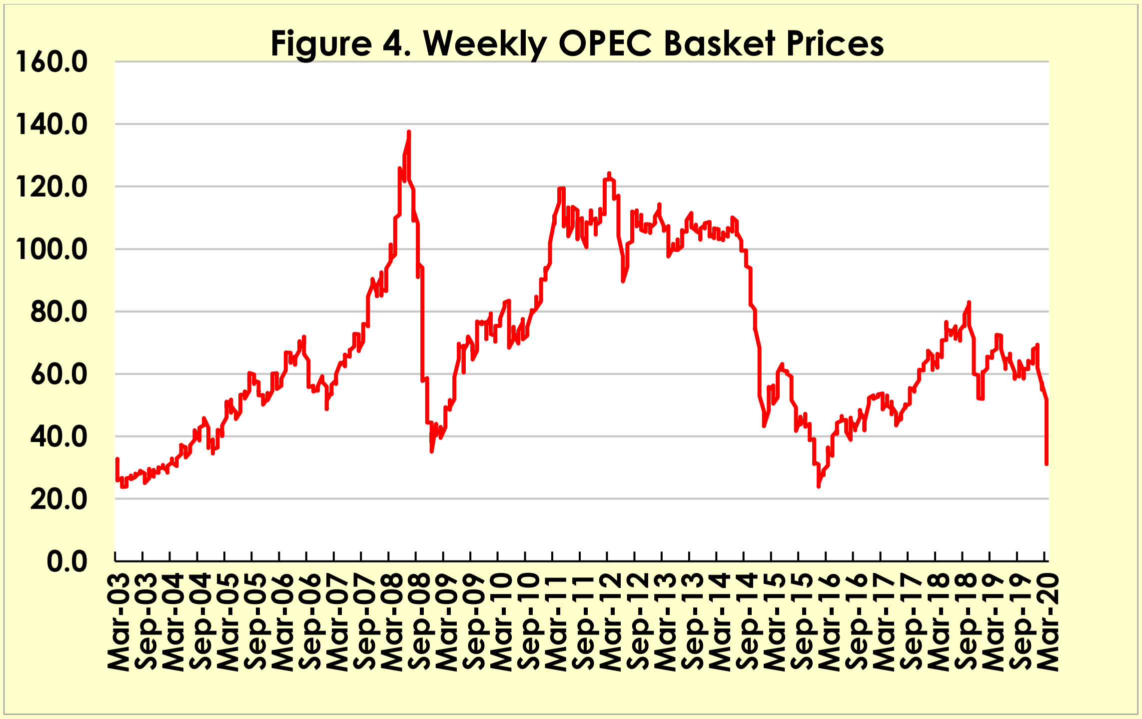
Source: Kenya National Bureau of Statistics

It doesn't help that the external sector is now weak and the local currency has depreciated (**Figure 3**). The heightened demand that followed the CBK's move to beef up its reserves through purchases from the market at this time of weaknesses in the global economy has seen the currency depreciate in the recent past few weeks. It remains to be seen whether the MPC will maintain its comfortable comportment concerning the exchange rate market dynamics, cognisant that the local unit has largely been stable over the past three years.



Source: Central Bank of Kenya

Similarly, oil prices have plummeted largely on account of a price war between Saudi Arabia and Russia, raising supplies as consumption falls as demand for fuel remains hit by the outbreak of Coronavirus (**Figure 4**). Whereas decline oil prices are usually beneficial to oil-importing countries, the circumstances are different and not a reprieve in muting inflationary pressures as the benefits of low oil prices does not translate to increased activity through reduced cost of production during these disruptive times.



Source: OPEC

Conclusion

There is no arguing with the fact that the CBK's monetary policy has remained accommodative. A case for further accommodation under the current unprecedented circumstances can be made. However, the nature of accommodation has to manifest creativity for it to be effective. Lowering the CBR and transmitting the accommodative stance through the credit market will on its own not do it.

Additional supportive measures will be necessary. We propose three such measures:

- One, lowering the cash reserve requirement (CRR).
- Two, creative deployment of the "lender of last resort" facility to allow financial institutions to access the window at rates that are not punitive.
- Three, synchronising fiscal and monetary policies beyond the broader aggerate targets by considering (a) a review of the Government overdraft with the central bank, and the incremental amount targeted towards supporting health sector interventions (b) a deliberate CBK balance sheet growth – not necessarily as radical as Quantitative Easing (QE) – through the purchase of a "special treasury bond" whose proceeds could be ring-fenced to support distressed businesses.

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