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Monetary Policy Stance: A harbinger of Activism?

Highlights

- The May 7, 2013 decision by the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) to reduce the Central Bank Rate (CBR) by 100 basis points from 9.5 percent to 8.5 percent was based largely on an evidently optimistic stance on the state of the economy.
- The policy decision motivates two broad questions:
  - One, beyond the decision itself, whose consequences this *Research Note* seeks to highlight, does the MPC's supporting pronouncements give a clear signal on the CBK's monetary policy conduct going forward?
  - Two, does it matter that the popular expectations amongst market analysts before the MPC's decision was for a CBR reduction, and now that the wish has been granted, is the intention of the CBK's policy stance unambiguously aimed at price stability or there is a deliberate keenness – for better or worse – to seek to promote short-run economic growth?
- We argue that a decision by the MPC to hold the CBR at 9.5 percent could have been easy to justify if entrenching price stability was manifestly at the core of its monetary policy thrust. The decision to lower the CBR by 100 basis points is only justifiable if the considerations are very short-term. Given the short-term orientation of the decision, we contend that the signalling effect of the current policy decision on the future monetary policy conduct is not as clear as should be. Furthermore, it doesn't help that the policy decision is widely perceived to be leaning more towards growth promotion than stability promotion.

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Introduction

The May 7, 2013 decision by the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) to reduce Central Bank Rate (CBR) by 100 basis points from 9.5 percent to 8.5 percent motivates two broad questions:

One, beyond the decision itself, whose consequences this *Research Note* seeks to highlight, does the MPC's supporting pronouncements give a clear signal on the CBK 's monetary policy conduct going forward?

Two, does it matter that the popular expectations amongst market analysts before the MPC's decision was for a CBR reduction, and now that the wish has been granted, is the intention of the CBK's policy stance unambiguously aimed at price stability or there is a deliberate keenness – for better or worse – to seek to promote short-run economic growth?

To address these questions let us begin by outlining, and contextualising, the key factors that the MPC indicates were underlying its decision.

- First, inflation rate – at 4.14 percent in April 2013 from March 2013's 4.11 percent – is contained within the Government's medium term target of 5 percent and is supported by a stable exchange rate and declining international oil prices. It is worth noting that Kenya's inflation rate has since December 2012 bottomed out; that the MPC notes an increase in non-food-non-fuel inflation from 4.18 percent in March 2013 to 4.28 percent in April 2013 confirms the inflation bottoming out, but most importantly sends a signal that the MPC is indifferent on the trend's direction so long as inflation is within the target range. We argue that being within the target inflation range deserves as much consideration as the speed and direction of approach of the target inflation range.
- Second, the stable – even mildly appreciating – exchange rate is one of the buttresses of the low and stable inflation. Under normal circumstances, such state in the foreign exchange market will support a monetary policy stance that is increasingly more accommodative. But the circumstances are far from normal, for even the MPC's account for the stable foreign exchange market is very telling.

  Market confidence justifiably rested on the successful conclusion of the General Election in March 2013. Further, there was an increase in the usable foreign exchange reserves from an equivalent of 3.78 months of import cover in March 2013 to an equivalent of 4.25 months of import cover in April 2013, with the USD 108.5 million disbursement by the International Monetary Fund (IMF) under the Extended Credit Facility (ECF) and the CBK's foreign exchange market participation noticeably contributing to the build-up. This is a pointer to the reality that the foreign exchange market is short-term in orientation and leans heavily on market sentiments than fundamentals. Even the MPC acknowledges, in one of the **only** two main risks it points out[1], that there is a balance of payment pressure emanating from the high current account deficit – currently at more than 11 percent of GDP.

- Third, there is optimism galore as could be seen in MPC's tone and demeanour. It acknowledges stability in the commercial banking industry even as the industry players pursue their ambitious growth agenda and claims credit for stability in short-term interest rates, rightly attributing growth to the declining trend in average lending rates; it says all is fine on the public domestic borrowing front; it reports an upbeat stance as reflected in the increase in the Nairobi Securities Exchange (NSE) 20-share index during the January – April 2013 period, resilience in remittances, and the broad optimism expressed in the MPC *Market Perception Survey* of April 2013.

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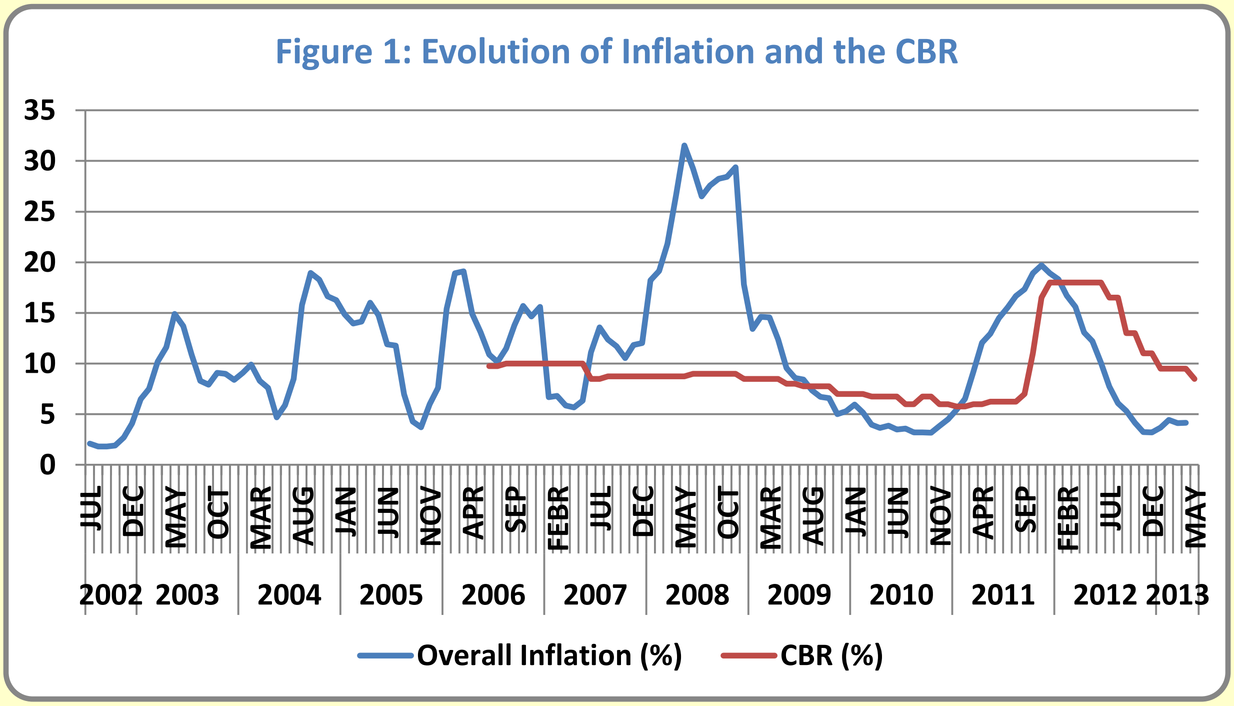
[1] The other risk that the MPC highlights is the challenge associated with the Eurozone crisis. The MPC's explicit indication that this risk is mitigated by the strong growth in Kenya's main regional trading partners implicitly assumes that the Eurozone challenge is not binding on these economies.

While a negative comportment by the MPC may be a market constraint, the positive demeanour needs to be properly contextualised. While the MPC does not – and perhaps is not expected to – commit on its outlook on the stability of the short-term interest rates, it is limiting to assume away the implication on interest rates arising from the inability of the Kenya Revenue Authority (KRA) to meet revenue targets during the 2012/13 fiscal year and the fact that, even with that inability, its revenue targets have been upped by nearly 22 percent in 2013/14 fiscal year. In essence, there could be a recalibration of market perceptions. And so long as there is total silence on the issue of sustainability of the market circumstances, we are inclined to infer that realism could easily be traded for optimism.

How Clear is the Policy Signal?

The MPC explicitly states that its decision to reduce the CBR by 100 basis points is aimed at "consolidating monetary policy gains". There is no doubt that there have been monetary policy gains over the past two years as could be manifested by the CBK's tightening stance that followed the sharp inflation increase in the period September 2010 – November 2011, and the subsequent accommodative stance as inflation ebbed to single digit level in the period December 2011 – November 2012 (**Figure 1**). Indeed, the IMF report on the 5th Review under the ECF published in April 2013 seems to imply that expectations of low inflation have taken hold[2].

While that may be the case, this *Research Note* argues that it is one thing to observe the gains but quite another to consolidate the gains, with the difference hinged on the market perception of policy consistence. As earlier observed, and as Figure 1 confirms, it is clear that inflation has bottomed out. We observed too that even within the target inflation range, it matters from which direction and at what speed the target is being attained. What **Figure 1** clearly confirms is the fact that for over one decade, the economy has not experienced a sustained low level of inflation; a declining inflation trend is followed by a quick reversal. That the MPC is ready to lower the CBR now can only point to the inference that this time round the situation may be different.



Source: CBK, Kenya National Bureau of Statistics; *The CBR was introduced in June 2006

[2] IMF (2013), "*Kenya: Fifth Review Under the Three-year Arrangement Under the Extended Credit Facility and Request for a Waiver and Modification of Performance Criteria*", April, 1.

But is the situation really that different this time around? We form our view on the issue on the guiding of a recently published study by the IMF[3] which points to the fact that in advanced economies as well as more developed emerging markets' economies, inflation over the past decade has not only been remarkably stable, but has become less responsive to changes in economic slack. This implies that in these economies, longer-term inflation expectations have become more firmly anchored.

Therefore, so long as inflation expectations remain anchored, an accommodative monetary policy is unlikely to have inflationary consequences. We cannot be that confident in the Kenyan case where the inflation trend is as erratic as we observe, and where – as the MPC explicitly states – 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).

On the back of the critique[4] 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, we have argued in the past[5] that any MPC policy decision – such as that that of March 13, 2012 that retained the CBR at 9.5 percent on account of evidence of inflation changing trend – represents a policy correction. It is on this basis that we consider the latest decision to reduce the policy rate in the circumstances that we highlight to be a lost opportunity for entrenching policy consistency, and therefore a blur to the signal of the future policy direction.

Popular Expectations Carried the Day; So what?

The implication of the MPC's decision to lower the CBR may seem obvious: the market's response has to be seen in reducted interest rates. To the extent that interest rates are forward-looking prices, it matters how the market expectations have been engendered. Before the MPC decision, popular commentary was that the CBR could come down on account of the stable markets – foreign exchange, goods and services, and money markets – and the general upbeat stance, factors that we earlier considered in proper perspective.

The more formal views on the anticipated MPC decision ranged from extremely casual to extremely pre-emptive. In the former extreme is, for instance, a commentary by Standard Bank Research[6] that ambushes its readership with a non-motivated conclusion on the anticipated CBR reduction; in the latter extreme is the IMF's official position that "with firmer expectations of low inflation, there is scope for further monetary easing, although the Central Bank of Kenya will need to remain vigilant to the risk of possible adverse shocks or a reversal of capital flows"[7].

What is telling about the IMF's position is the fact that the study that critiques the CBK's past monetary policy stance gives input to its 5th Review of Kenya under ECF, and the MPC seems to have taken half the counsel on the scope for further policy accommodation, and not the caution that stems from the study; in other words, damn the study that is encumbered by the usual disclaimer of opinion!

Against the above background, the MPC's reduction of the CBR is widely perceived – at the very least going by the popular media coverage – as serving the objective of promoting economic growth. It is true that the economy needs to scale its way back to its pre-global economic meltdown growth rate (**Figure 2**); it is equally true that the economy was picking its growth momentum even during the tight monetary policy regime. As real growth picks, the output growth gap – difference between full potential

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[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

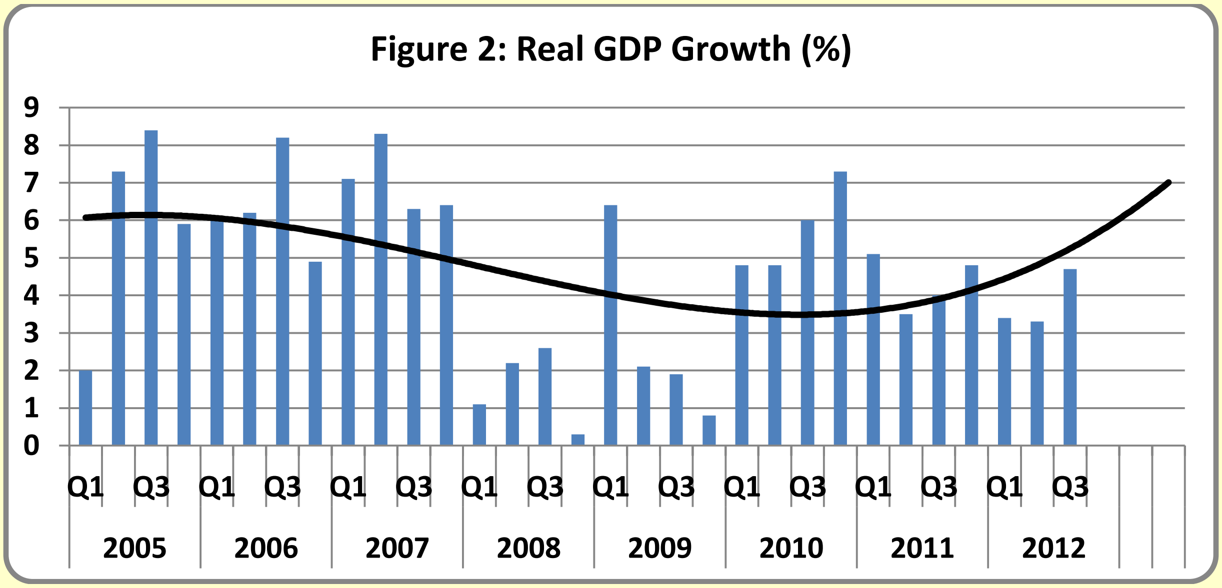
[4] Andrle, Michal ; Berg, Andrew ; Morales, R. ; Portillo, Rafael ; and Vlcek, Jan (2013), "Forecasting and Monetary Policy Analysis in Low-Income Countries: Food and non-Food Inflation in Kenya", *IMF Working Paper* WP/13/61, March

[5] Kenya Bankers Association Centre for Research on Financial Markets and Policy (2013), "Monetary Policy Stance: Qualified Optimism" *Research Note No. 1 (RN/1/13/*, March 14.

[6] Standard Bank (2013); Africa Research Strategy – Kenya: Trade Idea; "Taking Away Bond Investor's Bowl", April 29.

[7] IMF (2013) Press Release No. 13/125 "IMF Executive Board Completes Fifth Review under the ECF Arrangement for Kenya and Approves USD 108.5 Million Disbursement; April 14.

growth and actual growth – is gradually dwindling. With the loose inflation expectations anchoring that we earlier highlighted, an even more accommodative monetary policy stance as implied by the MPC's decision stands to be potentially inflationary.



Source: Kenya National Bureau of Statistics

With the now acknowledged improved CBK-Treasury coordination, it is imperative to ask whether the CBK should take the lead role in promoting growth. The Treasury's Budget Review and Outlook Paper (BROP) – Medium Term Expenditure Framework (MTEF) for 2012/14 – 2015/16 – provides insights on the CBK's envisaged role. It envisages a fiscal policy that aims to strike a balance between supporting growth – indeed public expenditure especially infrastructure expansion has provided growth momentum – and continued fiscal consolidation that provides room for implementation of decentralisation.

If the growth momentum is maintained, then the external position will improve gradually and the current account deficit will be about 5 percent by 2017. The role of the CBK in this case is to pursue a monetary policy that will deliver stable inflation around the range of 5 (+/-2.5) percent. In essence, pursuit of stability as a growth enhancing strategy is not meant to give way to monetary policy activism that popular expectations seem to engender.

Conclusion

The foregoing analysis leads to the overall observation that a decision by the MPC to hold the CBR at 9.5 percent could have been easy to justify if entrenching price stability is at the core of the monetary policy thrust. The decision to lower the CBR by 100 basis points is only justifiable if the considerations are only short-term. That such is the stance, and that the MPC indicates that it will continue to monitor the macroeconomic aggregates as well as any emerging risks with a view to responding as it deems appropriate, will only imply that the signalling effect of the current policy decision on the future monetary policy conduct is not as clear as should be. Furthermore, it doesn't help that the policy decision is widely perceived to be leaning more toward growth promotion than stability promotion.

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