RESEARCH NOTE NO.36. – 2018(RN/36/18)

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

March 20, 2018

Monetary Policy Stance: "Let's Try This One More Time; Who Knows, It May Work"

The Bliss

This *Research Commentary* is a follow-up to the Kenya Bankers Association Centre for Research on Financial Markets and Policy® *Research Note*[1] of 15th March, 2018 that argued the case for resisting the temptation to change monetary policy towards easing.

Not to be pre-empted, the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) has decided to change its monetary policy stance. In its meeting of 19th May 2018, the MPC decided to lower the Central Bank Rate (CBR) by 50 basis points to 9.50 percent.

There are two aspects to the decision, both interesting in equal measure. One is the explicit basis of the attempted accommodative stance. The other is what the decision hides. The intentions of the MPC decision are crystal clear. It states that there is "scope for easing its monetary policy stance in order to support economic activity"[2]. This is a summation of the MPC's diagnosis that all is getting on just fine, and that its policy move will fuel the momentum that is already picking. That is all good, if only it can be convincing.

For the MPC, it cannot be anything but a bliss.

- For one, the MPC observes that "inflation is expected to be within the Government target range in the ***near term*** mainly due to expectations of contained food prices following improved weather conditions". But even as the MPC sees its inflation outlook with a near term lens, it is convinced that inflation expectations are well anchored within the government target range.

- What's more, the external sector is doing just fine as the MPC sees it. That is what can be inferred from its projecting of the narrowing of the current account of the economy's balance of payment is closing even as the oil prices are rising. In other words, the MPC sees a vibrant export regime – tea and horticulture – supported by increased remittances.

  It is curious though that the CBK foreign exchange reserves, described to be at an all-time high of USD8.8 billion (5.9 months of import cover), up from USD7.1 billion (4.7 months of import cover) in January 2018, offer adequate buffer against short

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[1] See http://www.kba.co.ke/downloads/RN%20No%202%202018.pdf

[2] See https://www.centralbank.go.ke/uploads/mpc_press_release/986102954_MPC%20Press%20Release%20-%20Meeting%20of%20March%2019,%202018.pdf

term shocks in the foreign exchange market and yet the recent extended of then precautionary arrangement with the International Monetary Fund equivalent to USD989.8 million is considered an absolute necessity.

What is the source of the upshot in the foreign exchange reserves? It obviously is not export vibrancy. That is clearly a MPC assumption. All we know is that the Government has in the recent been in the Eurobond market and, **boom!**, the reserves are at an ***all-time high*** – a phrase laden with a sense of exuberance. It thus must be a case of celebrating reserves, source notwithstanding.

- Further, the MPC choses to see two countervailing messages in the private credit market while there is actually one clear message. Private sector credit growth continued its downward roll, rising by 2.1 percent in the 12 months to February 2018, slightly lower than the 2.4 percent in December 2017.

  According to the MPC, the slowdown in credit growth was on account of loan repayments in the transport and communication sector but lending to manufacturing, real estate, and trade remained relatively strong. The clear message, we argue, is that the so-described "strong" credit growth doesn't compensate for the loan portfolio shrinkage from the commercial banks' loan portfolio.

The Bikini

Aaron Levenstein was right when he observed thus: "Statistics are like bikinis. What they reveal is suggestive, but what they conceal is vital." The same can arguably be argued of the MPC's latest monetary decision. As anticipated in the 15th March 2018 *Research Note*, the hardly surprising sense of optimism on the part of the MPC says as much as it conceals.

- If real output growth has to rebound in, then growth credit to the private sector must of necessity turn the corner. The 'desire' to do something is clear. What is concealed is implicit assumption that any policy move towards an accommodative stance will unlock credit growth. The MPC's candour to "do something" that was observed on 20th March 2016 is, to a discerning eye, this time round camouflaged.

  Then, the Committee was "concerned about the persistent slowdown in private sector credit growth. The MPC ***therefore*** decided to lower the CBR by 50 basis points to 10 percent"[3]. That policy experiment didn't help. Now the MPC has less candour, with its decision seeking to, ambiguously, support economic activity given that the economic output is below its potential level. The 50 basis points reduction of the CBR to 9.50 percent could well end up being a blunt tool targeted at "economic activity" rejuvenation.

[3] See https://www.centralbank.go.ke/uploads/mpc_press_release/2012373677_MPC%20Press%20Release%20-%20Meeting%20of%20September%2020,%202016.pdf

- Once the 20th September 2016 experiment didn't yield the expected results, the MPC concern shifted. By 27th March 2017, the concerned was about the then prevailing uncertainties, including the impact of the interest rate caps on the effectiveness of monetary policy[4]. Then as now, inflation was within target; the exchange rate was stable; the global economic situation was characterised by largely the same set of downside risks. Are the interest rate caps any less binding on money policy effectiveness now than it was a year ago?

  To be sure, there are two new elements to the experiment. One is that the banking industry has commenced on a new asset classification regime (IFRS9) that requires more aggressive recognition of potential loan losses. The other is that the ratio of gross non-performing loans (NPLs) to gross loans is now perching at the double digit level. How an accommodative policy would be expected to spur "economic activity" – if that is read as triggering private sector uptake under these circumstance is as interesting as it is counterintuitive.

- Duly acknowledging that the MPC "stands ready to take additional measures as necessary", when (if?) the experiment proves to have negative effects will point towards the Committee's policy credibility credentials, an argent made in earlier-referred *Research Note*.

  Beyond that, the MPC is trying to take a clear break from its recent past history where policy decisions with the potential of offering invaluable lessons are long forgotten. In that case, the usual reference to past decisions – even without specificity of when they were made – as a way of tracking their traction and sending a clear message of a consistent though process is missing.

  The concealed message is that the MPC is opening a new line of thought on monetary policy communication as a "policy" tool. The implied message though is that "let's try this one more time; who knows, it may work". In the circumstances, the expected results are not guaranteed, and 'constructive ambiguity' has gotten its groove back.

[4] See https://www.centralbank.go.ke/uploads/mpc_press_release/808712593_MPC%20Press%20Release%20-%20Meeting%20of%20March%2027,%202017.pdf

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Comments on this *Research Note* can be forwarded to the Centre's Director at research@kba.co.ke or josoro@kba.co.ke

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