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

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Monetary Policy Stance: Qualified Optimism

Highlights

The decision by the Central Bank of Kenya's Monetary Policy Committee (MPC) in its March 12, 2013 meeting to retain the Central Bank Rate (CBR) at 9.5 percent was as much a response to inflationary trend having hit the trough and now commencing a mild peak as it was a signal that economic recovery is gaining traction.

The MPC decision is not only justified, but it sends a clear 'watch' signal in the event that price stability is at risk. We however argue that even with a general cautious stance, the MPC portrays a more sanguine posture on both the markets and the state of the economy than evidence could justify:

- While the foreign exchange market has largely been stable, the economy's weak external position that buttresses a general depreciation bias is not given prominence;
- The effect of the high international oil prices, while acknowledged, is downplayed;
- There is an implicit assumption that non-inflationary credit expansion will be sustained; this could be limiting given the ambitious government expenditure proposals promised during the March 2013 election campaigns that have not been matched by resource mobilisation proposals, and the potentially high initial funding requirements for the devolved government system.
- The potential effects of a substantial increase in electricity tariffs if an application by the Kenya Power and Lighting Company to the Energy Regulatory Commission is approved, has not been factored into the inflation outlook.

While the MPC maintains that its core focus is price stability, its optimistic posture that somewhat overshadows some critical domestic risks to a stable inflation outlook points to the possibility of a strive to balance between supporting economic recovery and entrenching price stability.

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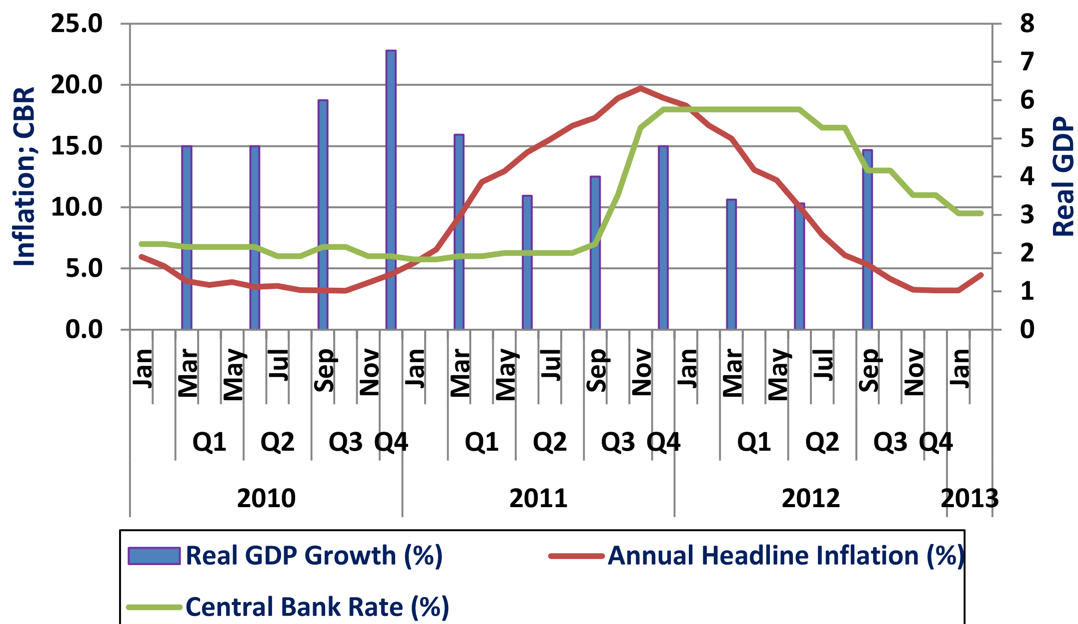
Introduction

The decision by the Monetary Policy Committee (MPC) of the Central Bank Kenya (CBK) in its March 13, 2013 meeting to maintain the Central Bank Rate (CBR) at 9.5 percent represents a pause that follows four consecutive reductions in response to abating inflationary pressure. While on the one hand the MPC's decision represents a reaction to the rate of inflation attaining its trough in November–December 2012 period and now mildly commencing the peak, it could on the other hand be a signal that the economy's recovery is somewhat gaining traction (**Figure 1**).

It is evident that the tight monetary policy for the period September 2011 to June 2012 was a key driver of the disinflation in much of 2012, with supply forces playing a lesser role. This success – realised though the monetary policy effects more than offsetting the domestic price shocks – provided scope for pursuance of an accommodative monetary policy stance in form of the CBR reduction from 18 percent in June 2012 to the current level of 9.5 percent.

In this *Research Note*, we argue that on account of domestic as well as international factors, the CBK's policy decision to halt further reduction of the CBR even when inflation is within the de facto target of 5(+/-2) percent is justified, not less because it portrays a stance meant to correct past policy missteps. But we further argue that even with a general cautious stance, the MPC portrays a more sanguine posture on both the markets and the state of the economy than evidence could justify.

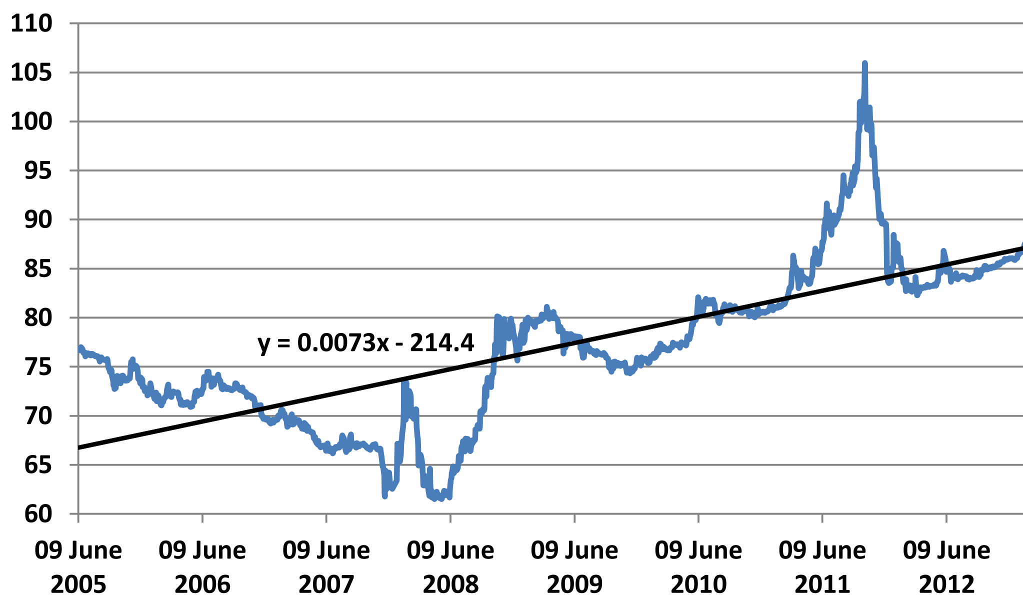


Source: *KNBS; CBK*

A Basis for Caution

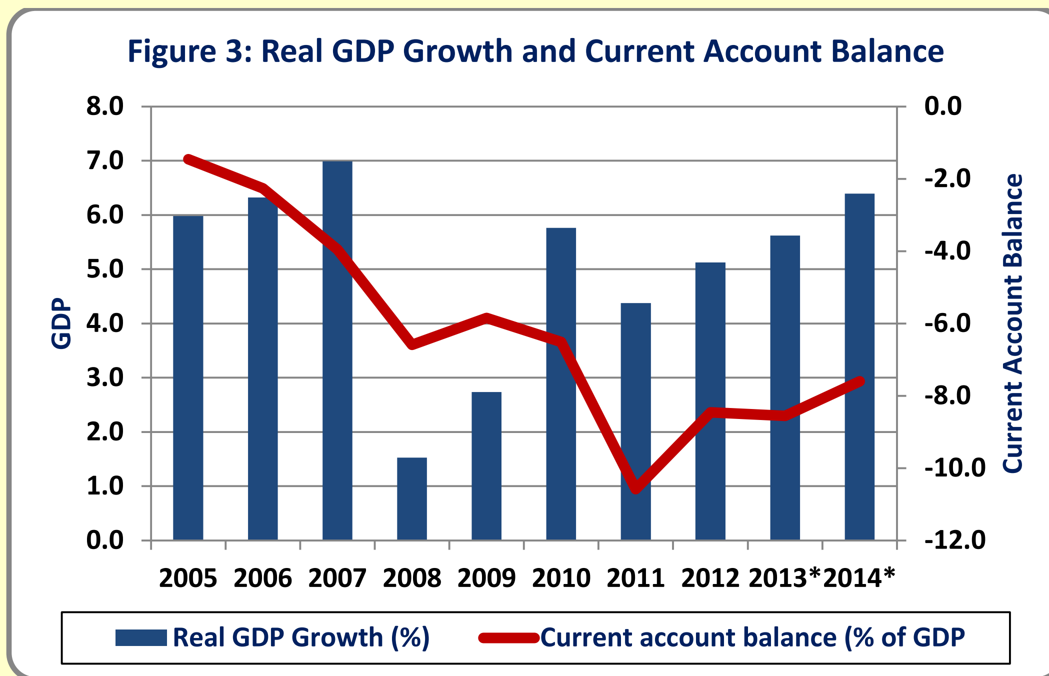
The CBK's monetary policy is formally anchored on reserve money targeting. However, the prominence of net domestic assets has been on the increase; the CBK's attention on short-term interest rates has equally been on the rise. With the economy's managed float, the exchange rate market partly manifests the CBK's role as the government's banker as the level of market liquidity arising from foreign exchange purchases could indicate; it partly reflects the magnitude of official foreign exchange flows.

While the MPC correctly observed that the foreign exchange market has in the recent past been largely stable, the Kenya shilling (KES) has maintained a general depreciating trend (**Figure 2**). This on account of the economy's external position remaining weak, with the fragile real output growth that is yet to achieve the 2008 levels being on the back of a current account deficit exceeding an equivalent of 8 percent of GDP (**Figure 3**).Inevitably, the KES has a depreciation bias and its stability in the recent past has hinged on liquidity management and foreign exchange operations, as well as public expectations' management[1].



Source: CBK

[1]See Njuguna Ndung'u (2013), "CBK Keen on Price Stability, not forex reserves", *Business Daily*, Friday March 8th.



*Source: IMF World Economic Outlook Database (October 2012), *=projections*

The case for non-inflationary credit expansion can be made based on the market liquidity conditions. For one, the rate of real GDP growth has largely been below trend. At the same time, the liquidity build-up during the accommodative monetary policy regime has seen the interbank rates remain below the CBR since April 2012 (**Figure 4**) while a downward shift in the yield curve has been observed in the past six months.

Demand for credit has evidently been positively responsive to the prevailing interest rates. The interbank rate has consistently declined from a high of 29 percent in November 2011, attaining the single-digit level by July 2012 and subsequently sustaining the declining trend (**Figure 5**); the interbank rate has closely been tracked by the 90-day Treasury Bill rate. The international money markets – especially the US – have been characterised by a near-zero interest rates regime since 2008; given the low inflation expectations in these markets, the interest rates regime is meant to stimulate demand and consequently promote output recovery.

The positive interest rate differential (as, for instance, depicted in **Figure 5**) between the local short-term interest rates and short-term rates in the international markets is likely to spur portfolio flows (or at the very least reverse portfolio outflows) given the prevailing post-election positive sentiments[2]. Coupled with inflows to the equities market, the foreign resource inflows are expected to provide mild support to the stability of the foreign exchange market without necessarily leading to a reversal of the earlier observed depreciation bias.

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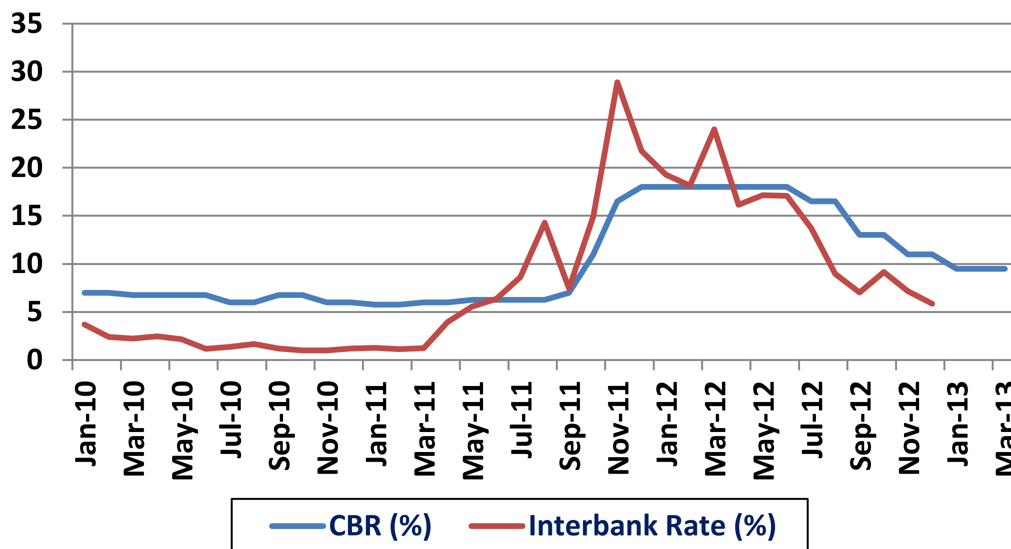
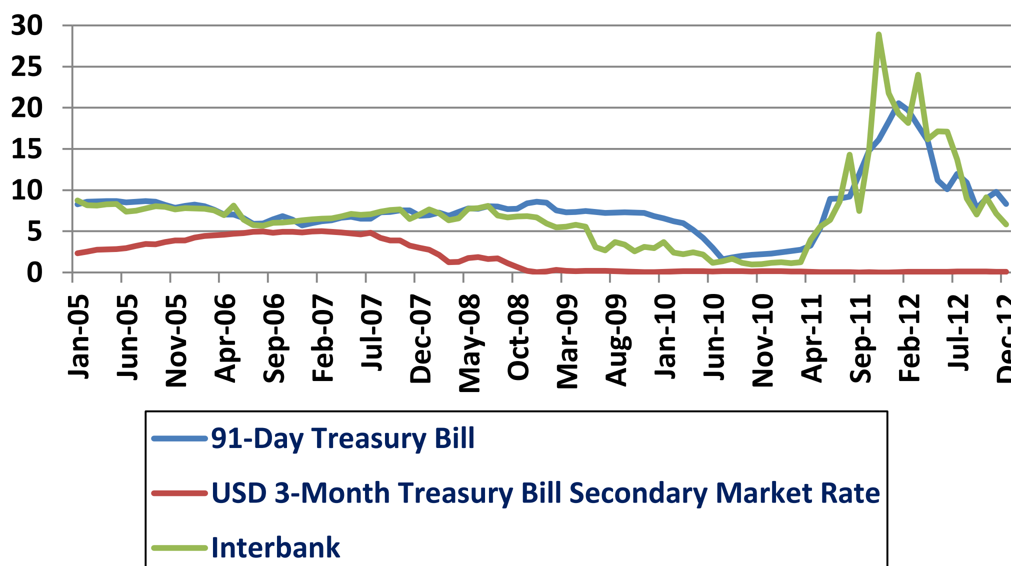
[2]On account of the peaceful March 4, 2013 elections, Fitch Ratings has maintained Kenya's B+ sovereign rating, with a stable outlook. The rating's affirmation is however qualified by a caution of the political risks that still prevail.



Source: CBK

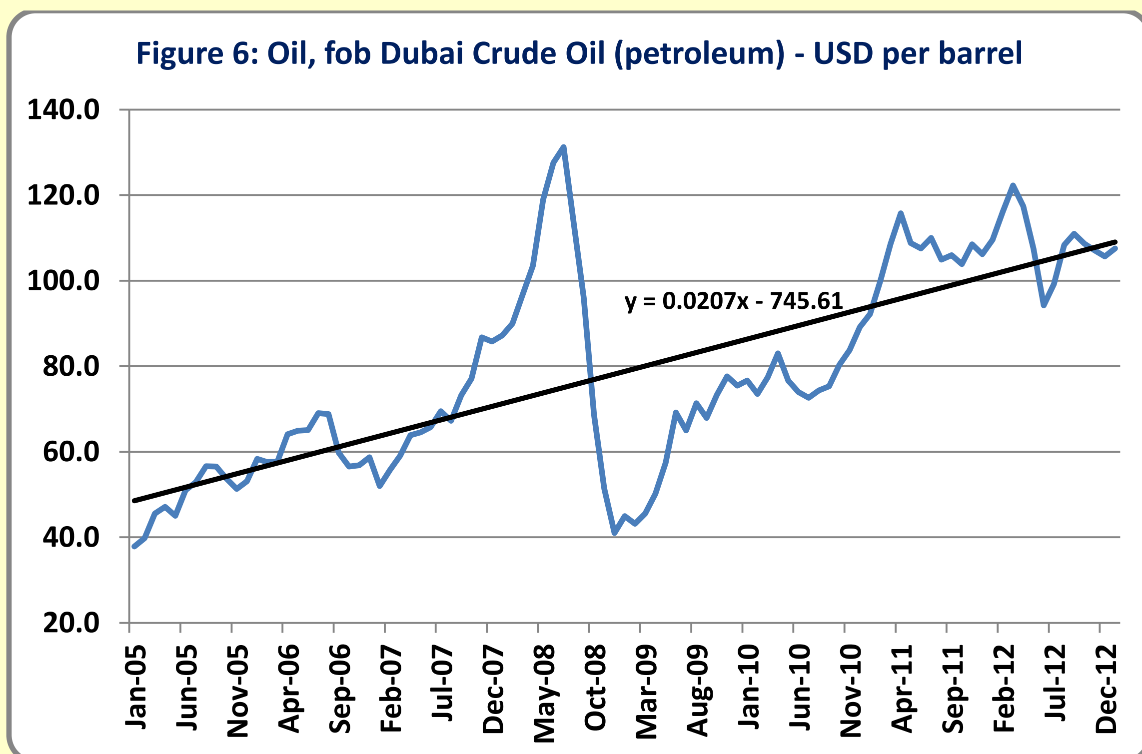


Source: CBK; Board of Governors of the Federal Reserve System

The MPC has projected "low and stable" short term inflation on account of non-inflationary credit expansion and predicted weather conditions. While we share the view that these factors could provide respite to potential inflationary pressure, we consider MPCs submission that they are expected to offset the impact of international rising prices to be quite ambitious. In any case, the upward trajectory of oil prices (**Figure 6**) is one of the risks to macroeconomic outlook that the MPC highlights.

Furthermore, the inflation outlook needs to be tempered with two more considerations.

- One; there is an application by the Kenya Power and Lighting Company to the Energy Regulatory Commission for Tariff increase which, if approved, will see the non-fuel tariffs increase initially by 21 percent, then by 9 percent, 4 percent and 11 percent in July 2013, July 2014 and July 2015 respectively. The proposed tariff increase, which will augment the automatic fuel levy adjustment, is likely to have inflationary implications.
- Two; notwithstanding the market liquidity status the implicit assumption of sustainable low interest could be limiting in view of the implications of the ambitious government expenditure proposals promised during the March 2013 election campaigns that have not been matched by resource mobilisation proposals, and the potentially high initial funding requirements for the devolved government system.



Source: IMF Primary Commodities Prices Database

The Correction

While the MPC largely remained upbeat in its motivation of the decision to keep the CBR at 9.5 percent, the committee took cognisant – and rightly so – of the risks to the macroeconomic outlook. These risks include the upward trajectory of international oil prices and weak global economic outlook on the back of a slow US recovery and a stagnating Eurozone economy.

That the MPC is keenly watching the macro-aggregates to ensure that their dynamics do not compromise price stability is an implicit, and welcome, signal that the CBK will respond fast so as to entrench the stability and establish policy credibility. This policy stance – which has been evident since the commencement of the tightening stance in September 2011 – contrasts with the lagged response that characterised the prior period, particularly during the period February 2011 – August 2011 when inflation sharply rose from 5.75 percent to 16.7 percent while the CBR was in the 5.75 percent – 6.25 percent level (**Figure 1**). This was arguably a policy misstep whose correction necessitated a drastic tightening by way of drastic increase in the CBR and restricted use of the discount window; a critique of this policy stance extends to the fact that its communication was not clear, a fact that manifested itself in an even large increase in the inter-bank rate during the time (**Figure 4**)[3].

Conclusion

The decision by the MPC in its March 12, 2013 meeting to retain the CBR at 9.5 percent was as much based on the need to give time for the previous MPC decisions to work through the economy (as the committee indicates) as it was an implicit signal that risks that could upset price stability are increasingly becoming evident (as this *Research Note* argues).

While the MPC maintained that its core focus is price stability, its sanguine posture that somewhat overshadowed some critical domestic risks to a stable inflation outlook – e.g. a potential rise in energy tariffs, and the fiscal challenge that may upset the low interest rate regime – points to the possibility of a strive to balance between supporting economic recovery and entrenching price stability.

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[3]See 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

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