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Introduction

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

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Monetary Policy Stance: Staying Put

> *"With the credit market at an inflection point, any policy rate adjustment in the current circumstances is counter-productive, with trade-offs deriving from such being otherwise a 'reversal rate", meaning that its effect on lending is contractionary.*

Highlights

- As the Central Bank of Kenya's Monetary Policy Committee meets on September 29, 2020, the critical question in the mind of policy watchers is: is the MPC likely to stay put on its current policy stance, or is it likely to ease further and if so by magnitude?
- We make three arguments.
  - (i) Expectations for additional monetary stimulus to support the fragile state of the economy – albeit with signs of recovery beginning to emerge – given that inflation is within target, and inflation expectations well anchored, the case of easing remains;
  - (ii) Currency remains a crucial part of the consideration for the MPC, and its continued weakening albeit not characterised by high volatility portends a downside risks and thus help consolidate the need for a continuation of the current policy stance;
  - (iii) With the credit market still at an inflection point, any reduction in the policy rate in the current circumstances is counter-productive, with the trade-offs deriving from such a reduction being seen as a '*reversal rate*', meaning that such reduction in the policy rate becomes contractionary for lending and thus economic growth.
- We argue that if an appreciation of above three issues is brought to bear in totality, then the Committee has limited choice other than to stay put as would be signalled by the retaining of the Central Bank Rate, the policy signalling rate, at 7.0 percent.

Introduction

The MPC's policy considerations this year, amidst the challenging economic environment occasioned by double-tragedy – locust invasion and the Covid-19 pandemic – has been the most closely watched given that its policy levers can and has been attuned to reduce the slack in the economy

As the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) meets on September 29, 2020, the critical question in the mind of policy watchers is: is the MPC likely to stay put on its current policy stance, or is it likely to ease further and if so by magnitude? The answer depends partly on it's reading of the economic data, often backwards-looking, but also an infusion of market expectations, if only to supplement the former with a forward-looking view.

In this *Research Note*, we make three arguments that the Committee is likely to train its eyes on as it prepares to announce its policy stance;

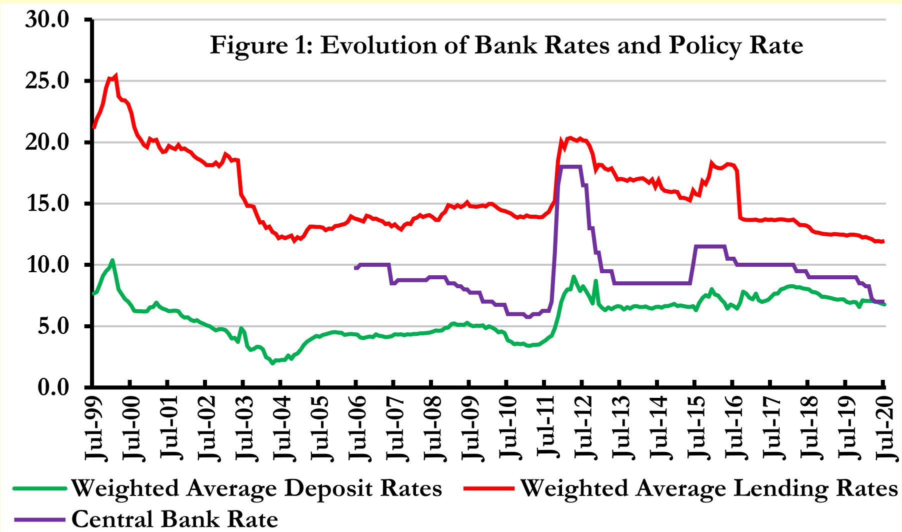
(i) With expectations for additional monetary stimulus to support the fragile state of the economy still lingering – even with signs of recovery beginning to emerge – grounded by the fact that inflation remains within target and expectations well anchored[1];

(ii) Currency remains a crucial part of the consideration for the MPC, and its continued weakening albeit not characterised by high volatility portends a downside risks and thus help consolidate the need for a continuation of the current policy stance;

(iii) With the credit market still at an inflection point, any reduction in the policy rate in the current circumstances is counter-productive, the trade-offs deriving from such being seen as a '*reversal rate*'[2], meaning that such reduction in the policy rate has two opposing forces. On the one hand, it is associated with capital gains on assets with long-term fixed-rate coupon payments; on the other hand, it squeezes the net interest margins and thus compressing the yield per unit of liability employed, on the back of a weakening asset quality base.

We argue that if an appreciation of above three issues in totality is brought to bear, then the Committee has limited choice other than to stay put as would be signalled by the retaining of the Central Bank Rate, the policy signalling rate, at 7.0 percent.

This *Research Note* makes the observation that monetary policy has had an accommodative bias, and transmission to bank rates has accelerated in the recent months as the pass-through of rate cuts to gains traction as **Figure 1** shows.



Source: Central Bank of Kenya

[1] https://www.centralbank.go.ke/uploads/mpc_press_release/603807985_MPC%20Press%20Release%20-%20Meeting%20of%20July%2029%202020.pdf

[2] Markus K. Brunnermeier and Yann Koby (2019), "*The Reversal Interest Rate*", IMES Discussion Paper Series 2019-E-6. (https://www.imes.boj.or.jp/research/papers/english/19-E-06.pdf)

Even so, the growth of the banking system's claims to private sector stuck has seen little changed since the onset of the pandemic and remains stuck at a single-digit level, likely due to softer demand for new loans, led by the heightened uncertainty in the current environment. As such, some businesses may be reluctant to take on new debt, as this uncertainty affects their expectation of future revenue and so their ability to repay debt.

As the expectations for additional monetary stimulus to support the fragile state of the economy still lingering – even as signs of recovery beginning to emerge –, and supported by the assessment that inflation is stable and expectations well anchored, and thus the need to unclog the credit lines further.

Such argument must appreciate the fact that the credit market is still at an inflection point. As such, any reduction in the policy rate in the current circumstances is counter-productive, with the trade-offs deriving from such a reduction should be seen as being a '*reversal rate*', meaning that such reduction in the policy rate becomes contractionary for lending and thus economic growth.

On the one hand, while the reduction in the policy rate is associated with capital gains on assets with long-term fixed-rate coupon payments, on the other hand, it squeezes the net interest margins and thus compressing the yield per unit of liability employed, on the back of a weakening asset quality base consequently filtering into the risk attitude, and a readjustment in the loan portfolio growth, with a view to adhering to both the regulatory and shareholder expectations.

Economic Growth: Disconnected and now Reconnected?

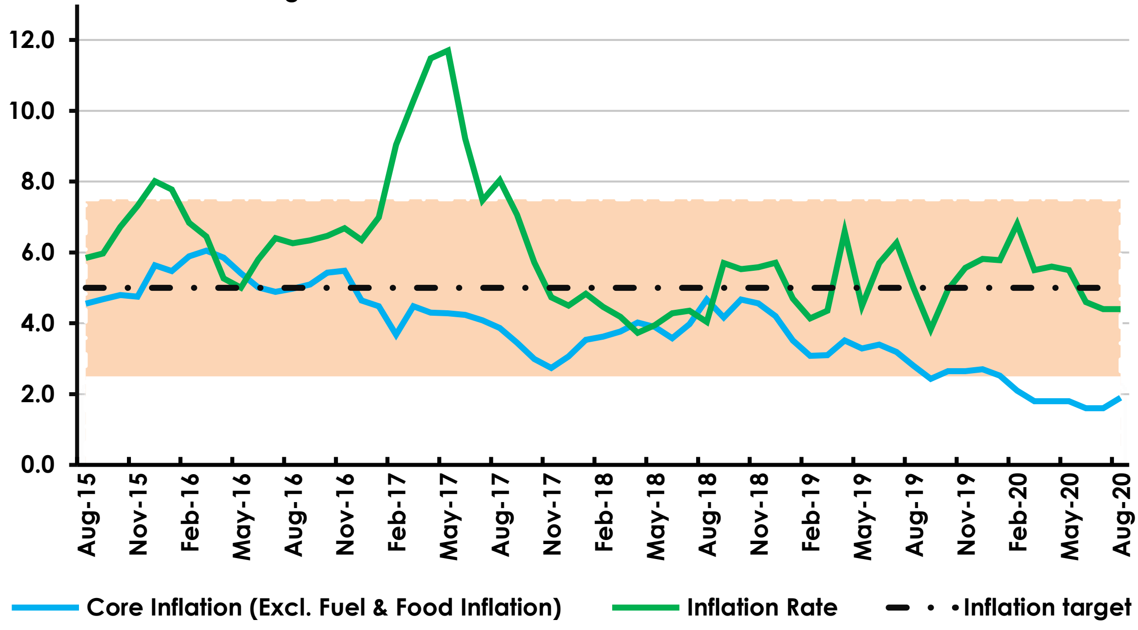
As it entered the year 2020, the economy was characterised by considerable economic slack, and battered by the locust invasion and the Covid-19 pandemic, the negative output gap substantially widened as household spending softened, production declined, export growth squeezed amidst weakening global demand, and households and enterprises stalling any investment decisions. In a bid to ameliorate any further deterioration of economic conditions, swift policy action – both on the fiscal and monetary front – was pursued. Since then high-frequency indicators, proxies for GDP, albeit still characterised by mixed performance, bright spots remain and with signs of economic recovery in the second quarter compared to the first quarter where the economy grew at 4.9 percent. On that front, and without the benefit of an examination of the other factors that we explored further in the next sections, the case of staying put on the current monetary policy stance is much more compelling if only to allow itself to continue monitoring the economic developments before taking further action.

Macroeconomic Stability

As pointed to above, the disconnected economic fundamentals showing signs of being reconnected, from a stability standpoint, two things are evident that:

- First, as **Figure 2,** price pressures remain stable with August inflation at 4.4 percent, well within the government's target of 5±2.5 percent, and reflects the subdued demand in the economy. Core inflation, on the other hand, edged upwards in August to 1.90 percent from 1.60 percent where a two-month sticknesss had characterised it since June. Food and fuel inflation also edged upwards in August compared to July this year. And with the inflation stable and inflation expectations remaining well anchored, monetary policy has, to a large extent been justifiably accommodative and remains justifiably so in the current inflation-economic growth environment.

Figure 2: Evolution of Inflation & Central Bank Rate



Source: Central Bank of Kenya

- Second, and as one considers the stability of consumer prices, it is also worth taking a keen look at the developments of both the foreign exchange as well as international oil prices, both of which has implications on the domestic economy's stability. As **Figure 3** shows, the Kenyan shilling has continued to weaken against the US dollar, albeit not highly volatile. It is also worth examining the evolution of oil prices, which matter more for fuel inflation. Further as **Figure 4** shows is also worth appreciating that higher oil prices exert direct pressures on fuel inflation but also indirectly on core inflation through higher transportation costs as well as on the shilling given that Kenya is a net importer.

Figure 3: Exchange Rate (KES/USD)

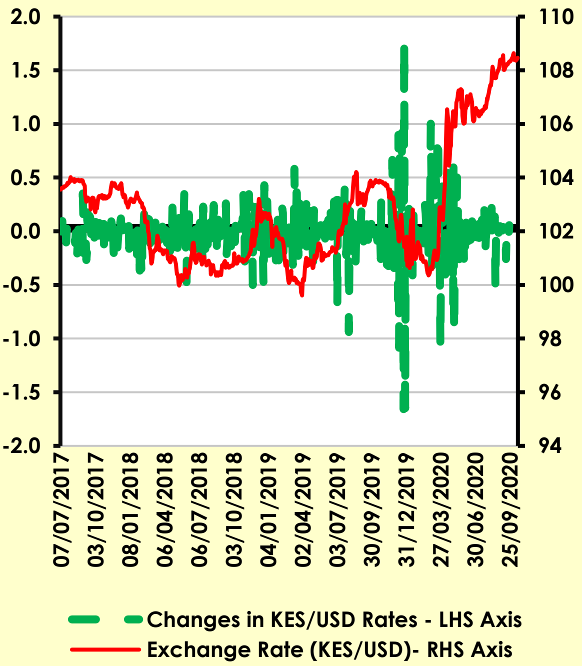
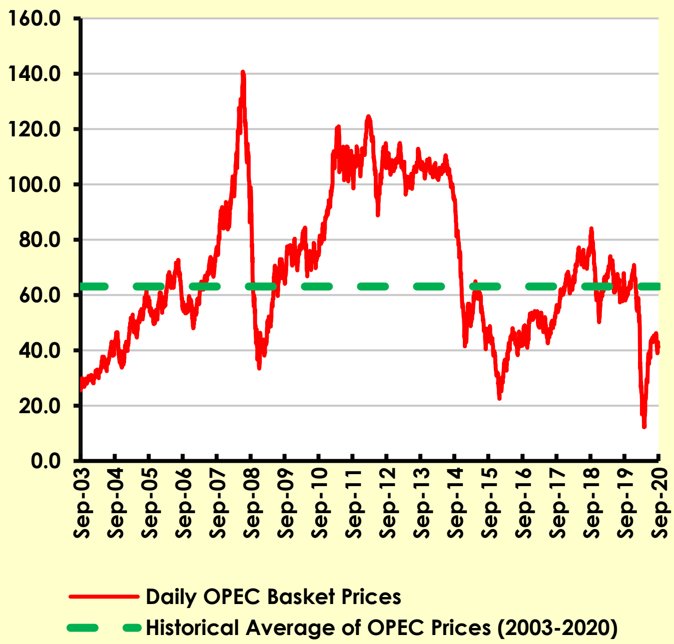


Figure 4. Daily OPEC Basket Prices



Source: Central Bank of Kenya, OPEC

While the stable inflation outlook and the need to further stimulate demand could provide the MPC with a window to justify and follow through with an accommodative stance, such a move would potentially exacerbate financial market instability, notably FX market volatility, which would likely worsen if the policy rate stance becomes even more accommodative thus upsetting the prevailing macro-stability.

Conclusion

The MPC meeting of September 29 2020, puts a spotlight on the Committee's ability to strike a balance between three competing circumstances.

(i) Expectations for additional monetary stimulus to support the fragile state of the economy – albeit with signs of recovery beginning to emerge – given that inflation is within the target, and inflation expectations well anchored, the case of easing remains;

(ii) Currency remains a crucial part of the consideration for the MPC, and its continued weakening albeit not characterised by high volatility portends a downside risks and thus help consolidate the need for a continuation of the current policy stance;

(iii) With the credit market still at an inflection point, any reduction in the policy rate in the current circumstances is counter-productive, with the trade-offs deriving from such a reduction being seen as a '*reversal rate*', meaning that such reduction in the policy rate has two opposing forces.

We argue that if these considerations are brought to bear, then the MPC will likely maintain its stance as would be signalled by the retaining of the CBR, the policy signalling rate, at 7.0 percent. In so doing, the MPC could have voted for its policy credibility. Any temptation to pursue an accommodative stance that would lead to perverse outcomes puts into jeopardy such credibility.

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