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

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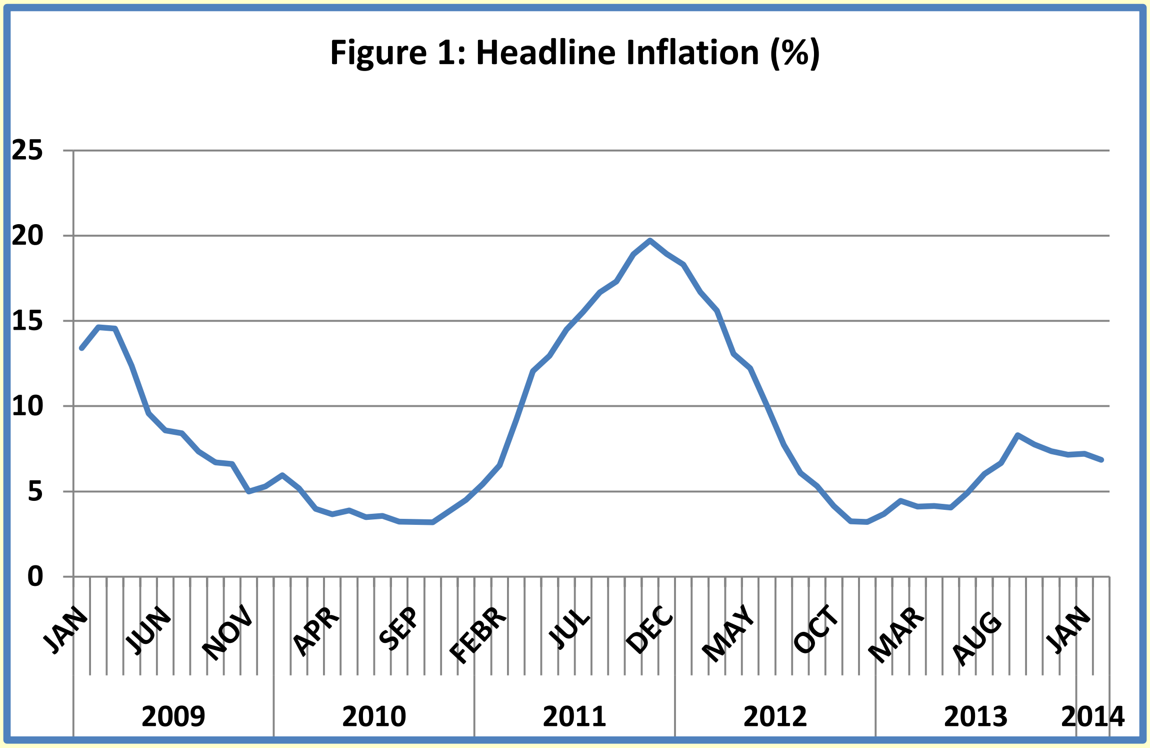
Monetary Policy Stance – A Sound Decision Signalling Policy Credibility

Highlights

- The Central Bank of Kenya's Monetary Policy Committee (MPC) decision to retain the Central Bank Rate (CBR) at 8.5 percent for the sixth consecutive time during its meeting of March 4, 2014 sent out an important message regarding its commitment to the stability mandate.
- The MPC's decision was evidently aimed at anchoring inflation expectations and is thus based on sound economic grounding.
- The short-term market outcomes have been favourable and largely speak to the positive outcomes of the CBK's monetary policy stance.
- We should not lose sight of potential downside risks from emerging markets and the Eurozone that could undermine the fragile global recovery and its attendant consequences to the domestic economy.

Introduction

The Central Bank of Kenya's Monetary Policy Committee (MPC) decision to retain the Central Bank Rate (CBR) at 8.5 percent for the sixth consecutive time during its meeting of March 4, 2014 sent out an important message regarding its commitment to the stability mandate. Like its previous decision, its decision was evidently aimed at anchoring inflation expectations and is thus based on sound economic grounding[1]. While the overall month-on-month inflation declined mildly from 7.21 percent in January 2014 to 6.86 percent in February 2014, it remains within the upper bound of the government's medium-term target of 5 percent [+ (-) 2.5 percentage points] – **Figure 1**.

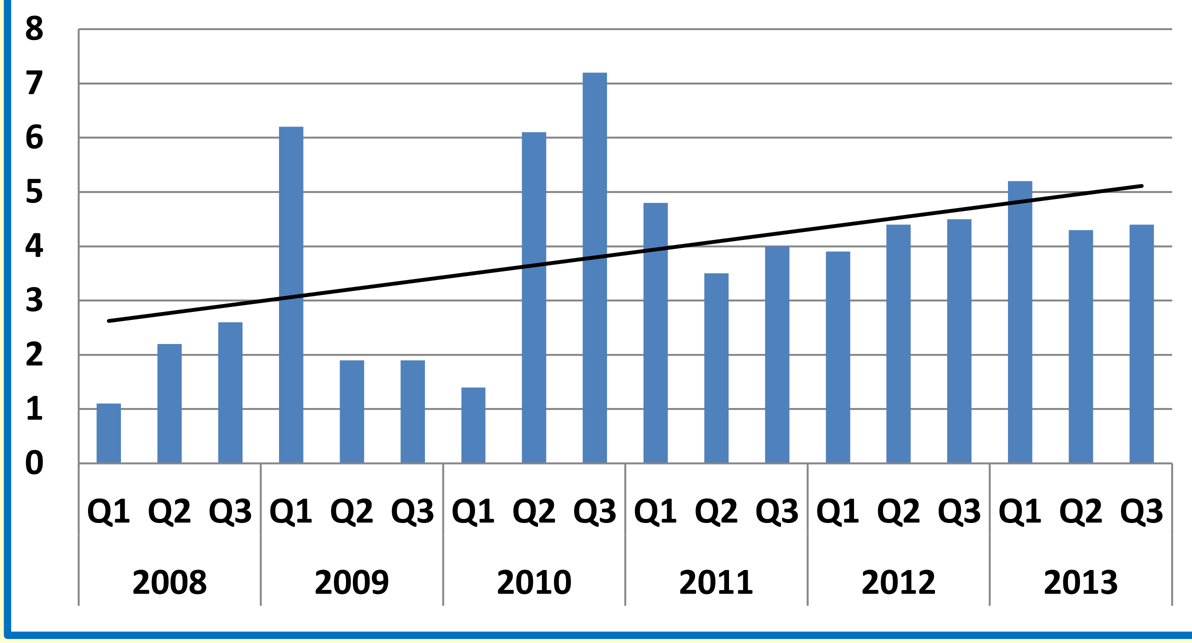


Source: The Kenya National Bureau of Statistics

The decision to hold the CBR was further bolstered by the desire to consolidate the gains on the monetary policy' success in stabilising the non-food-non-fuel inflationary pressure; indeed the private sector credit growth that the economy continues to experience from 2013 into the early parts 2014 has proven to be noninflationary, partly reflecting the fact that the economy's sluggish recovery is characterised by a positive output gap (**Figure 2**). This implies that there is scope for the monetary policy stance to remain accommodative without compromising stability but with an eye on the potential downside risks that stand on the way for an even more accommodative stance in the form of a lower CBR.

[1] See the Kenya Bankers Association Centre for Research on Financial Markets and Policy® *Research Note No.7. – 2014 (RN/7/14)* of January 16, 2014 that espouses this argument.

Figure 2 : Real GDP Growth Rate (%)

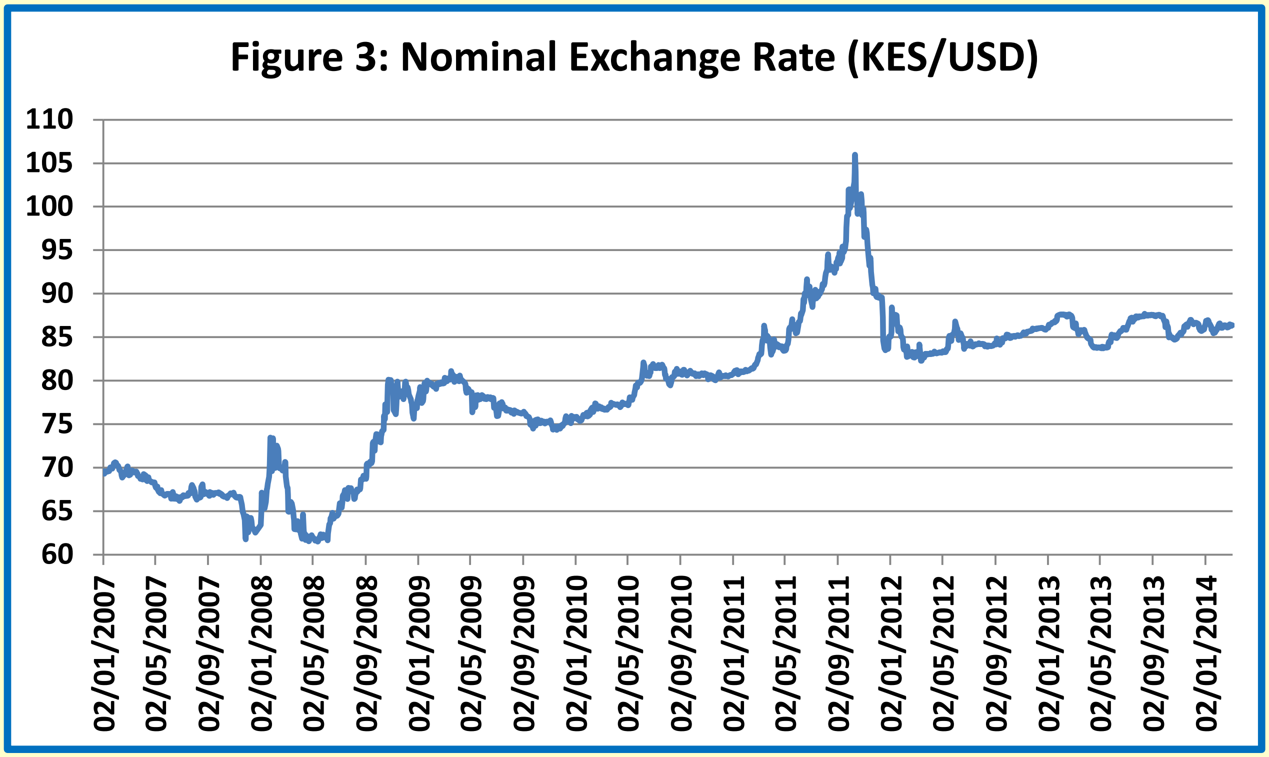


Source: The Kenya National Bureau of Statistics

A Basis for Optimism…

The short-run market outcomes have largely been positive and therefore a basis for optimism. The exchange rate has been stable (Figure 3) on the back of a mildly improving external position; as the MPC observes, the 12 months cumulative current account deficit narrowed from 10.45 percent equivalent of GDP in December 2013 to 8.09 percentage in February 2014. With the absolute value of the deficit being well above the economy's projected real output growth of 5.1 percent for 2014, the local currency could be expected to have a depreciation bias.

However, the increase in the amount of usable foreign exchange reserves from the December 2013 level of an equivalent of 4.32 months of import cover to an equivalent of 4.38 months of import cover in February 2014 will provide some cushion. Similarly, expectations buttressed by the USD 1.5 billion Eurobond to be issued in March 2014 may occasion a temporary appreciation of the local unit.



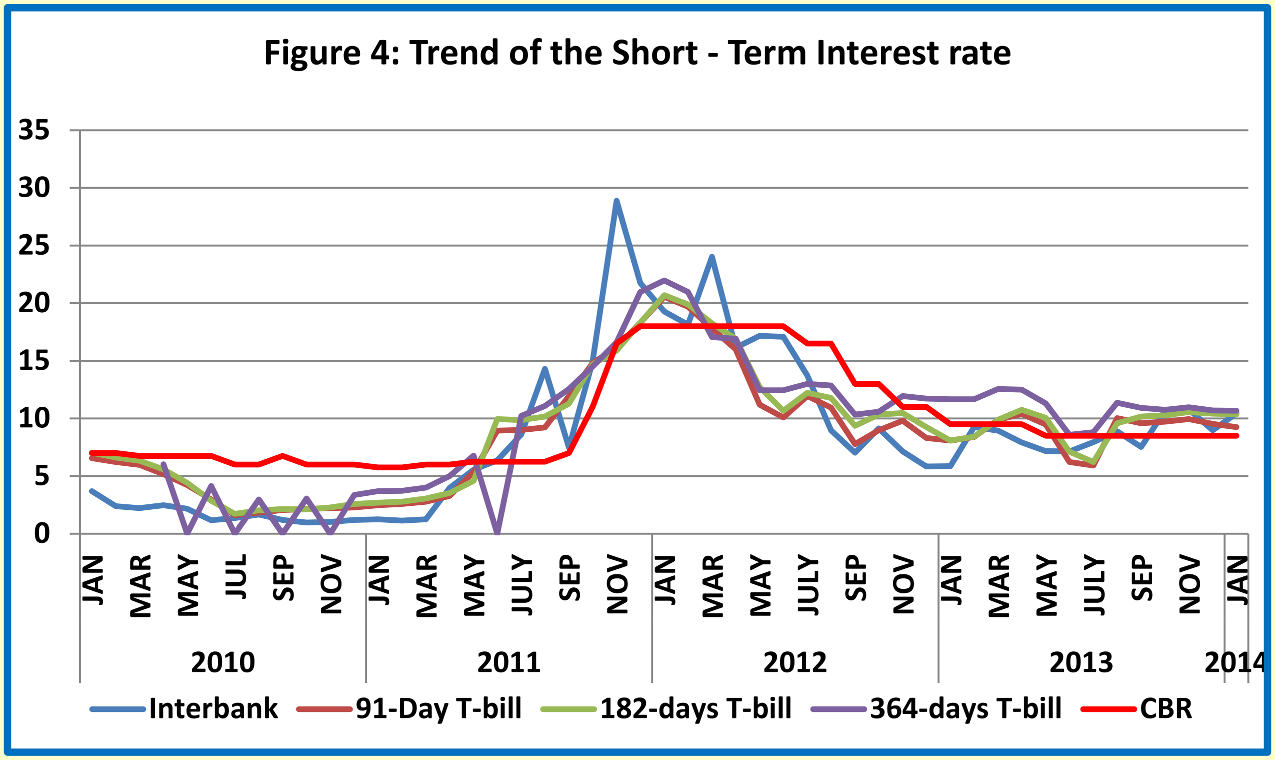
Source: Central Bank of Kenya

The interplay between the foreign exchange market and the money market on the back of the Eurobond will have an influence on the direction of the short-term interest rates. Although the short-term interest rates clearly track the CBR (Figure 4), the market rates are currently above the CBR if only marginally. With the CBR maintained at 8.5 percent, how the market plays out going forward could be a function of a number of 'Ifs' surrounding the Euro bond.

- If the entire USD1.5 billion is mobilised and USD 600 million is used to retire the government's short term syndicated loan, then the USD 900 million (equivalent to KES 77.4 billion) will be available for expenditure. The amount of foreign currency reserves available to the CBK will depend on what component of the syndicated loan loan will be channelled to off-shore accounts of lending principal banks or whether the funds will be channelled to their local subsidiaries; such reserves will also depend on whether the syndicated loan is rolled over. Furthermore the resources will mostly be expended in local currency as the government seeks to meet its local obligations, which therefore means that liquidity may increase by a magnitude that will depend on the foreign currency that will be available for expenditure.

- If the government uses the proceed to finance infrastructure projects as has explicitly been stated as a basis for this bond, then there will be increased liquidity that will have the potential of lowering interest rates at the risk of mounting depreciation pressure on the local currency. Given the potential destabilising effect of the currency depreciation, open market operations (OMO) to sterilise the liquidity may be inevitable given the MPC's comportment of seeking to entrench policy credibility of anchoring inflation expectations. This will have the potential implication of influencing an increase in interest rates.

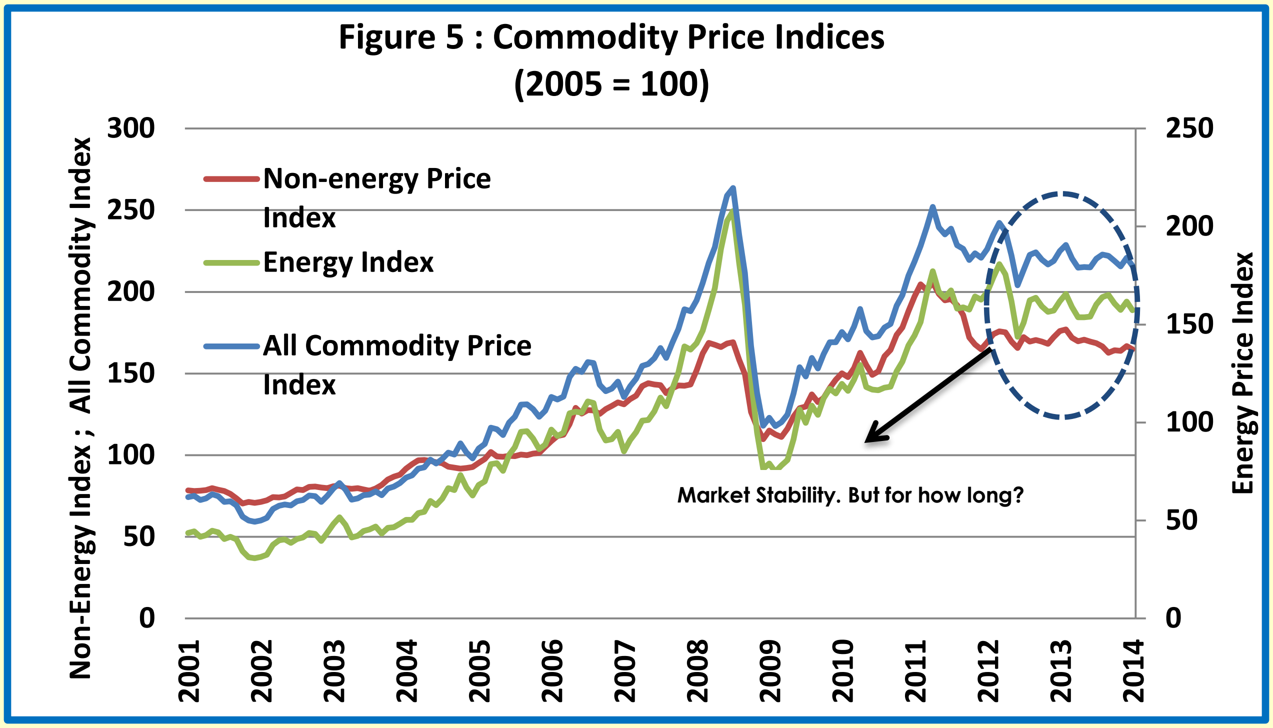
- If however the government seeks to utilise the proceeds to retire domestic obligations – and our conjecture is that there is a less disposition towards this option – then its effect will depend on which obligations are retired. In the event of those obligations being the overdraft with the CBK and the suspense account, then this move will be liquidity neutral. But in the event of the government utilising the proceeds to retire domestic debt, then there will be a liquidity increase that would necessitate OMO with the obvious influence on interest rates.



Source: Central Bank of Kenya

Overall, the effect on the Euro bond on inflation is likely to be neutral but with a potential of having mild pressure on interest rates increase.

Another basis for optimism is the fact that the international commodity prices appear to have stabilised (Figure 5). This implies that based on the recent past trend, the possibility volatility in the terms of trade could constrain further improvement in the current account is modest. The observed stability however needs to be weighted vis-à-vis the dynamic geo-political developments that are potentially upsetting.



Source: International Monetary Fund

… but Not an Excuse for Exuberance

It is apparent that the MPC is cautionary optimistic, highlighting that the global economic prospects look promising but downside risks – hinged on the effect of the United States monetary policy stance that has commenced on the tapering of quantitative easing on emerging markets financial markets, and on the geopolitical developments in Eastern Europe, Middle East and North Africa.

We argue that while the effect of these downside risks on the domestic markets has been at the worst mild as the MPC observes, it is imperative to ponder on the implications of such developments going forward given that the economy – like others in the continent are now more linked to the emerging economies than the developed economies. As a recent study indicates[2], Sub-Saharan Africa's business cycle has not only moved in the same direction as that of the rest if the world, but has also gradually drifted away from the G7 in favour of the so called BRICs – Brazil, Russia, India and China. Trade with the BRICs turns out to be the strongest driver of this shift. Therefore the challenges currently facing the emerging markets should not be seen as perpetually having mild potential adverse effects.

We further argue that based on recent evidence, the challenges of the emerging markets may be deep-rooted than merely representing market reactions to the US's tapering. There are arguments to the effect that differentials in market reactions to the tapering signal are an indication of the differences in macroeconomic fundamentals in those economies (Figures 6 and 7).

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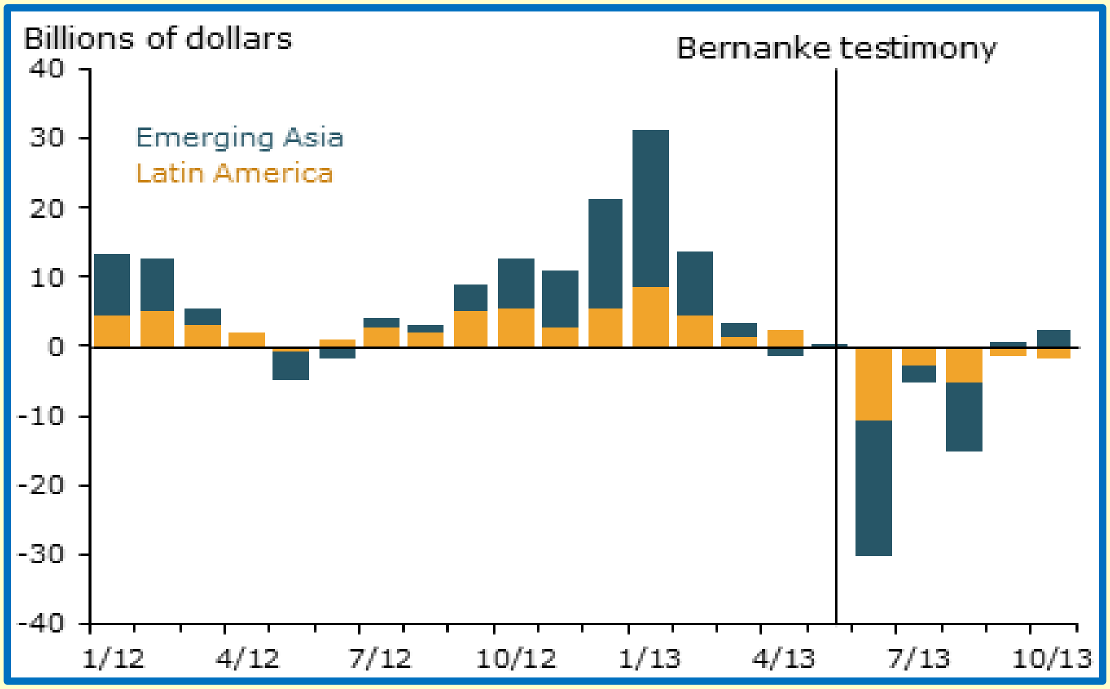
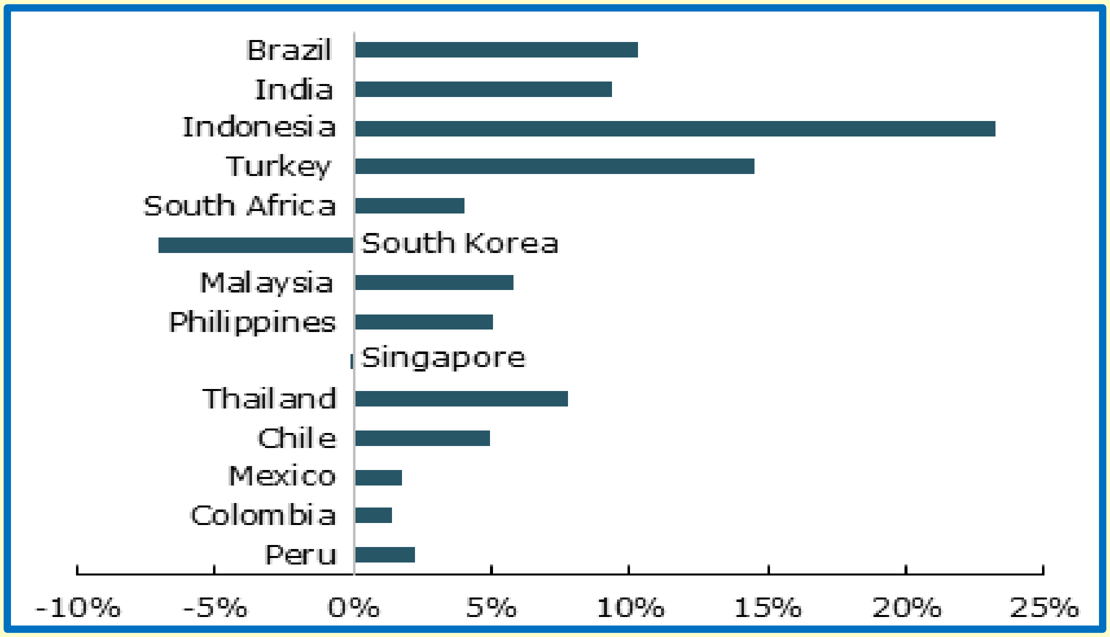
[2] See Oumar Diallo ; Sampawende J.-A. Tapsoba (2014), *"Rising BRICs and Changes in Sub-Saharan Africa's Business Cycle Patterns"*, IMF Working Paper No 14/35

Figure 6: Emerging Market Bond and Equity Fund Flows



Source: Powell (2013)[3]

Figure 7: Exchange Rate Depreciation, May to December 2013



Source: Nechio (2014)[4]

It is becoming clear that international capital inflows are related to external factors as well as to a country's internal conditions. As Nechio (2014) argues, monetary policies in developed economies affect investor decisions, although a country's domestic economic conditions also play a role in shaping investment flows. As advanced economies recover, conventional monetary policies will resume.

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[3] Powell, Jerome. 2013a. *"Advanced Economy Monetary Policy and Emerging Market Economies."* Speech at the Federal Reserve Bank of San Francisco 2013 Asia Economic Policy Conference, San Francisco, CA, November 4.

[4] Nechio, Fernanda (2014), *"Fed Tapering News and Emerging Markets"*, Federal Research Bank of San Francisco, Economic Letter, March 3.

The differences from one emerging market economy to another in the difficulties experienced when the Federal Reserve Board began to discuss scaling down asset purchases highlight the sensitivity of global investment patterns to domestic conditions. They demonstrate how important it is for emerging market countries to improve their domestic fundamentals as global monetary conditions return to normal. Therefore their recent market conditions that have necessitated monetary policy tightening to defend their respective local currencies should be seen as underlying fundamental weakness.

Further, the geopolitical development in Eastern Europe involving Russia and Ukraine could potentially upset not just the stability of the internal oil prices that we earlier observed, but stands to undermine the fragile Eurozone recovery and consequently the global economies' more towards attaining the pre-economic meltdown growth levels.

Conclusion

The foregoing analysis has pointed out that the decision by the CBK's MPC in its March 4, 2014 meeting to retain the CBR at 8.5 percent for six consecutive times is a signal of commitment to the stability mandate and that its decision was evidently aimed at anchoring inflation expectations and is thus based on sound economic grounding. While the short-term market outcomes have been favourable, we should not lose sight of potential downside risks from emerging markets and the Eurozone that could undermine the fragile global recovery and its attendant consequences to the domestic economy.

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