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Monetary Policy Stance – A "Wait-and-See" Decision?

Highlights

- The Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) in its meeting of May 6, 2015 decided to retain the Central Bank Rate (CBR) at 8.50 percent. Based on the fact that inflation is at 7.08 percent is still within the medium term target range albeit with an upward trajectory, a change in monetary policy stance by the MPC would have not been justified. So the MPC's decision to retain the CBR is arguably well founded.
- However, any forward guidance that one could read from the MPC's indication that it will pursue a tightening bias is not well anchored given the positivity of the committee on both price and foreign exchange stability amidst the pressure on both fronts in the recent past. In essence, the tightening bias signal is not clearly articulated by the MPC.
- This *Research Note* argues that the MPC is seeking to position its latest decision and the overall monetary policy stance on "Managing Risks in the Monetary Policy Path" in a manner portraying a calmness on the surface that understates the potentially destabilising undercurrents. We argue so based on the observations that:
    - One, confidence in the economy that the MPC states "remains strong "could be at odds with evidence as presented by the *2014 Economic Survey* by the Kenya National Bureau of Statistics (KNBS);
    - Two, the implications of the fiscal policy stance going forward on monetary policy could be at best understated, otherwise ignored;
    - Three, to portray tight market liquidity as temporary given the fiscal position and the explicit indication by MPC to be having a tightening bias is a perspective that is hard to reconcile.
    - Four, to exude confidence about the foreign exchange market while silent about the clearly weak external position and an economy that has steadily lost international competitiveness is a reflection of optimism that may not be well grounded.

Introduction

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The monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) meeting of May 6, 2015 was held on the back of expectations that the policy signalling rate [the Central Bank Rate (CBR)] will be retained at 8.50 percent but market circumstances will necessitate at the very least a clear and unambiguous signal – akin to forward guidance – of the need for change in the monetary policy stance. Such market expectations are underpinned by both market outcomes and the filter-through from fiscal policy anticipation on the back of a proposed KES2.2 trillion budget.

The expectations were nonetheless to confront the reality that the economy's recovery is not strong enough as reported by the Kenya National Bureau of Statistics (KNBS). The MPC delivered on one front: retaining the CBR. It however, perhaps in conformity with the conventional but unwritten central banking doctrine of "constructive ambiguity", was less than clear in signalling its stated "tightening bias".

As this *Research Note* argues, the delicate balance for the MPC is to seek to entrench the inflation expectations anchoring credentials and tighten policy if evidence so justifies only that it will happen at a time of weak economic performance that may need a boost from a monetary policy that is anything but tight. As we have argued before, there is no trade-off between stability and growth; so the case for the MPC not changing its policy stance on the back of evidence that stability is being breached at a time when real economic growth is not showing a consistent upward trend may be hard to make.

The question we explore then is: is the evidence for breaching the stability overwhelming? The search for answer is trained on three areas.

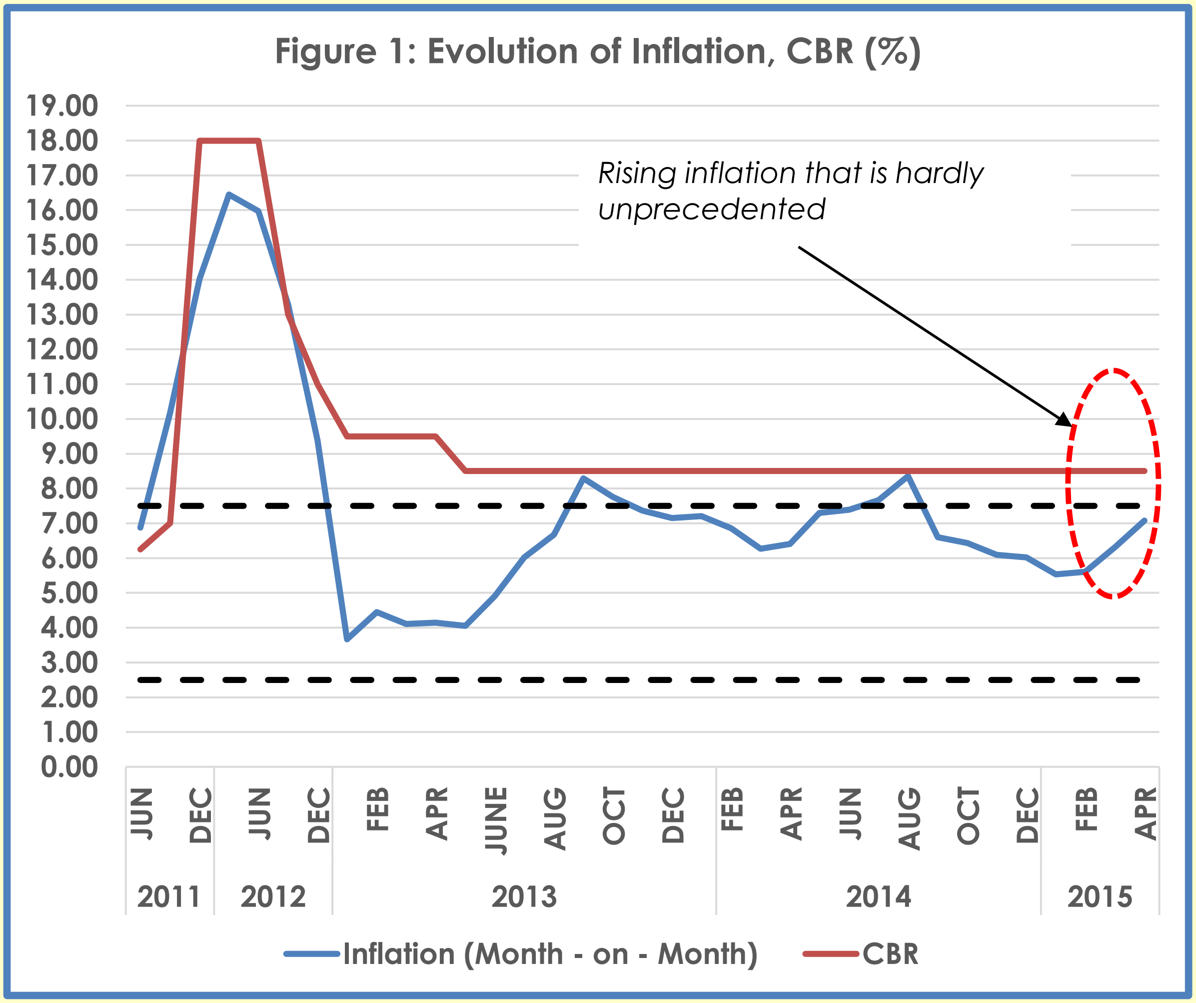
- One, there is need to look at the inflation trend vis-à-vis the official medium-term target of 5 percent [+ (-) 2.5 percentage points].
- Two, we need to critically examine the market outcomes – foreign and money markets – to establish whether the pass-through effects to inflation justifies monetary policy caution – where caution points towards tightening to forestall inflation target breaching.
- Three, a careful analysis of the external circumstances with a bearing on local markets will be important. The global economic performance – especially the emerging markets and the Euro zone – has a beaning on the economy's current account evolution which feeds to the foreign exchange dynamics. Perspectives on the international oil market will inform expectations on its impact on inflation.

Inflation – Eyes on the Ball?

Since May 2013, the MPC has maintained the Central Bank Rate (CBR) – the policy signalling rate – at 8.5 percent, implying that the economic circumstances generally and the market conditions specifically have not provided justification for a change in monetary policy stance. As **Figure 1** indicates, we have had two instances where month-on-month inflation rate has been above target. But largely, inflation has remained within the upper bound of the medium-term target of 5 percent [+ (-) 2.5 percentage points].

Since the beginning of 2015, we have observed an increasing inflationary trend from 5.53 percent in January to 7.08 percent by April. This is by no means unprecedented given that on the two occasions that the upper bound inflation target has been breached (September 2013 and August 2014), there has been a quick reversion towards the 5 percent target.

Unlikely popularly claimed, this is perhaps a vindication of the MPC's judgment in not falling into seeking to change policy stance towards a clear tightening "at the slightest provocation"; and as we have indicated in past perspectives we are increasingly seeing the CBK's confidence in its inflation forecasting prevailing (KBA Centre for Research on Financial Markets and Policy, 2014)[1]. Much of the rise in the inflation rate lately evident has been attributed to an increase in food prices due to the erratic rain in the first quarter that has eroded the downward pressure on the inflation rate arising from the decline in the world oil prices.



Source: Kenya National Bureau of Statistics & Central Bank of Kenya

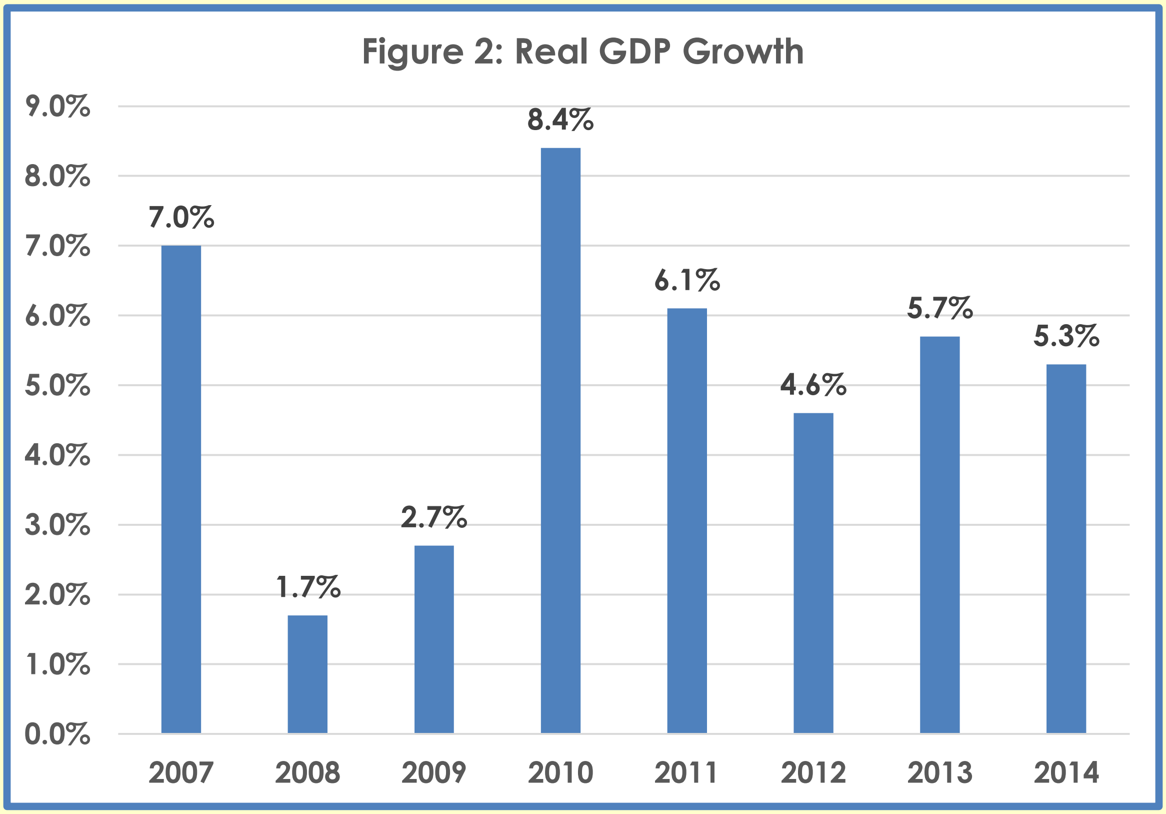
Undercurrents – Are they critically undermining?

It is evident that the MPC is increasingly improving its communication as a signalling tool to support its decisions with regard to the CBR as a way of indicating monetary policy stance. Progressively, the message has been that the core basis of its decision is anchoring inflation expectation on the target. Based on the foregoing discussion on the recent trend on inflation, it is reasonable to assume that the MPC will still have its eye set on anchoring the inflation expectations.

But then there are other competing expectations that the CBK has to manage, particularly the messaging around the fact that a focus on stability is growth enhancing, and therefore that any slowdown should not trigger an accommodative monetary policy stance if that will be at the

[1] http://www.kba.co.ke/images/stories/RN%20No%206%202014.pdf

expense of stability. As **Figure 2** shows, the economy's expansion as reflected in the real GDP growth rate has been anything but robust; the rate of growth in 2014 of 5.3 percent represents a decline from the previous year's growth rate of 5.7 percent.



Source: Kenya National Bureau of Statistics

There is a non-ambiguous conclusion that high inflation has a negative effect on medium and long term growth and that such inflation impedes efficient resource allocation since it obscures the signalling role of relative prices, an important guide to efficient economic decision making. Therefore inferences backed by evidence point towards a relationship where stable and on-target inflation is related to positive income growth.

In essence, the CBK's hand in ensuring that the growth trajectory is sustainable upward – and not the erratic picture presented in Figure 2 – is to stick to the stabilisation agenda and ignore any disruptions of playing a growth activist. The implication therefore is that the MPC's focus will remain on the vulnerabilities that any of at least three (potential) undercurrents may occasion.

- ***A Potentially Dominant Fiscal Position?***

The first potential undercurrent is linked to the ambitious fiscal budget estimated at about KES2.2 trillion for the fiscal year 2015/16. In all intent and purpose, this is meant to be stimulating growth in the Keynesian sense – increase in government expenditure at a time when there is no scope for monetary stimulation – that we observe to be lacklustre. A deeper reflection on the implication of this unprecedented budget – both from an expenditure point of view and from a funding point of view – on monetary policy will be critical.

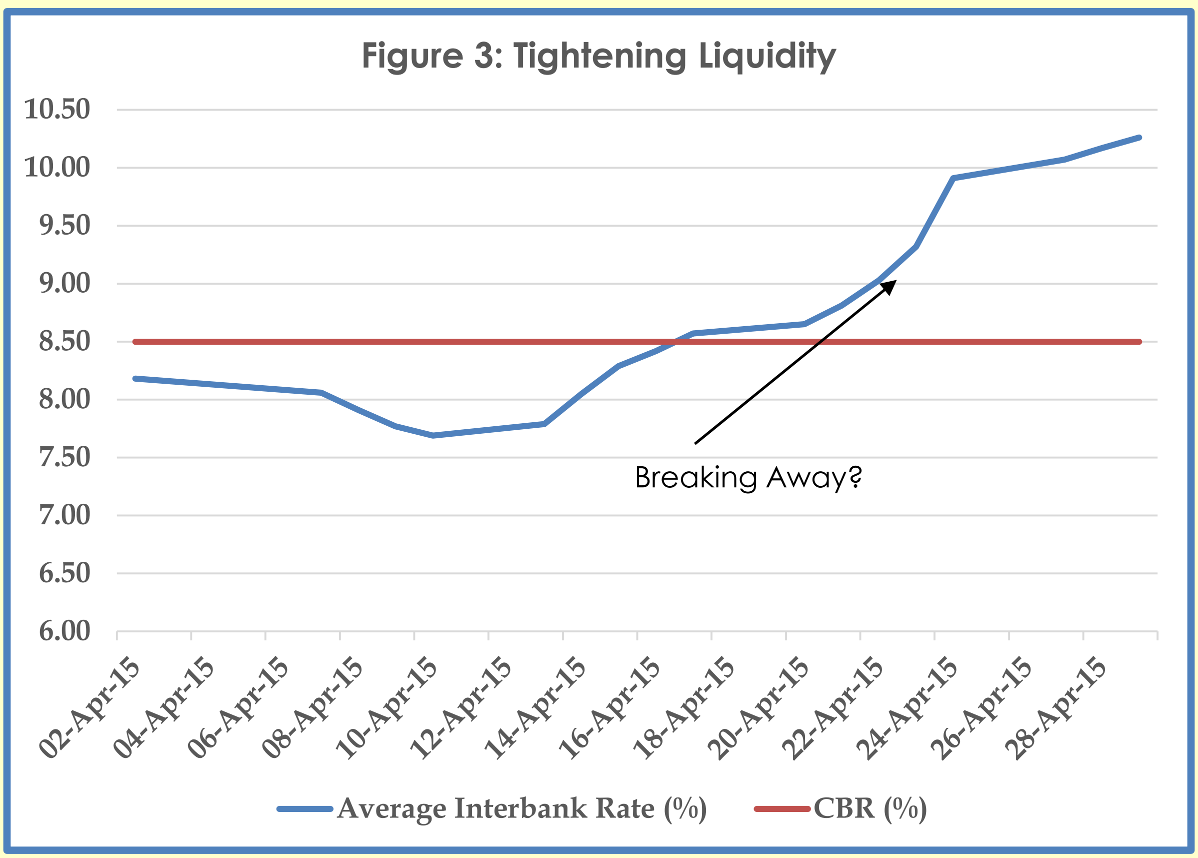
The CBK has in the past been quick to allay any insinuations about fiscal dominance – where an expansionary fiscal policy will necessitate monetary policy tightening as a counter to obviate inflationary pressure – indicating that the two macro-policies of monetary and fiscal are aligned towards the common objective of promoting growth without compromising stability.

Evidence may seem to be vindicating the CBK's position with regard to fiscal expenditure influencing monetary policy insofar as it could potentially be inflationary. We cannot make a similar argument though when it comes to the funding side, especially cognisant that the revenue base is an ambitious real growth outlook of the economy that is over 6 percent and clearly at odds with the trend observed above.

The implication is that the tax base may be overstated as we earlier alluded and therefore the possibility of increased domestic borrowing to meet the expenditure needs cannot be ruled out. The MPC makes two interesting observations. One is that the government's borrowing programme for the 2014/15 is consistent with monetary policy and has not crowded out private sector credit; the other is that tight liquidity occasioned partly by the CBK's open market operations (OMO) and temporary Government deposits build-up at the CBK.

We argue that these observations need to be put to perspective. The first observation is in no way a forecast on the fiscal outcome for 2015/16. In any case, when it comes to borrowing needs and that filters into market liquidity conditions, timings critical. The fiscal year 2014/15 is coming to an end when liquidity in the market is fast tightening as **Figure 3** reflects with inter-bank rates fast rising above the CBR. How this feeds into the commencement of 2015/16 fiscal year in July 2015 is a matter that should interest MPC; we see little evidence that it does.

One the second observation, an expansionary fiscal policy could necessitate that sustained OMO is carried into the next fiscal year; it doesn't help that there are still absorption challenges that remain unaddressed thus will on occasion lead to Government deposit build-up at the CBK; therefore such build-up being temporary as the MPC observes could well be a matter of conjecture.



Source: Central Bank of Kenya

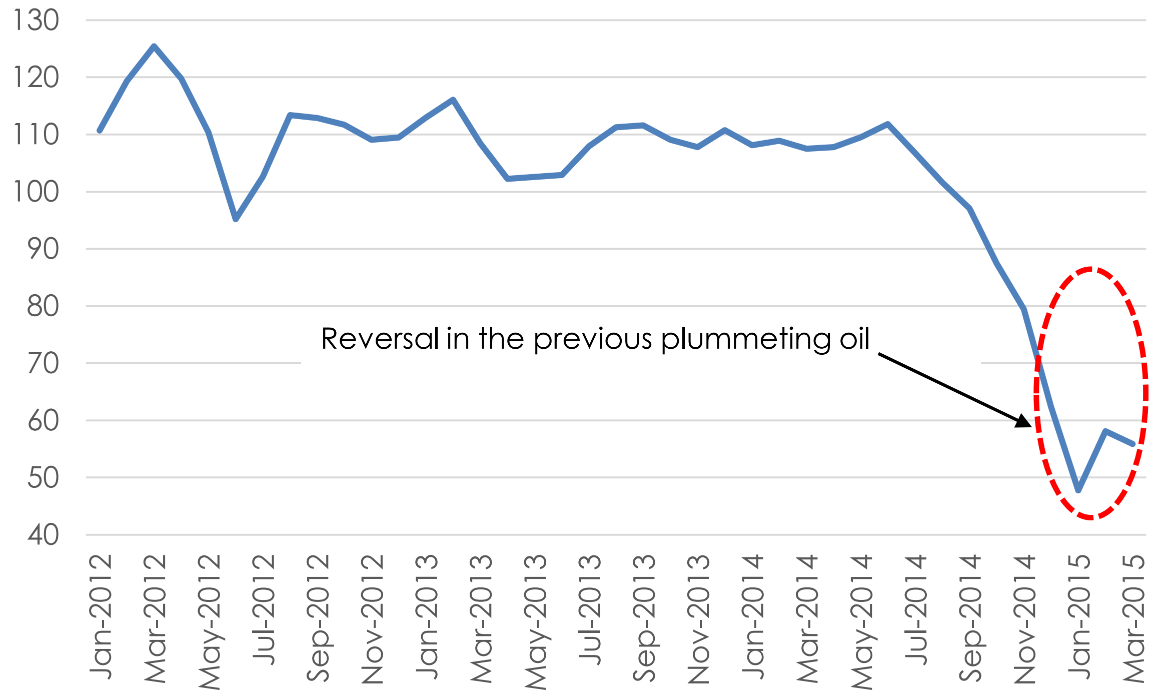
- ***Perpetual partying on account of favourable oil prices?***

The MPC explicitly recognises the good fortunes associated with lower oil prices that the global economy has experienced, but at the same time reckoning – and rightly so – that geopolitical risks stand to undermine stability in the international oil market. It is true that the economy's import bill has benefitted from the plummeting oil prices (**Figure 4**); but the key question remains: have the prices turned the corner?

As the end of 2014 the world experienced a glut in the oil market due to decreased America demand for imported oil on account of increased their domestic production, and a weak world economy. With the Saudi Arabia's production hitting ten million barrels per day, the glut in the world oil market could remain for a while. Moreover the political mayhem in Yemen that has seen rivalry among the world oil producers; - Saudi against the Iran is a clear indication of lack of agreement to cut down on the world oil production any soon.

Nonetheless, oil prices seem to have bounced in the first quarter of 2015 as **Figure 4** signals as the prices of crude oil rally. This is being driven by increased demand, driven partly by the momentum from previous low prices; however the pace of the rally (not the direction of the trend) could be checked by the somewhat gloomy recovery prospects of the global economic performance - which nonetheless does not represent a decline but a less-than-buoyant recovery.

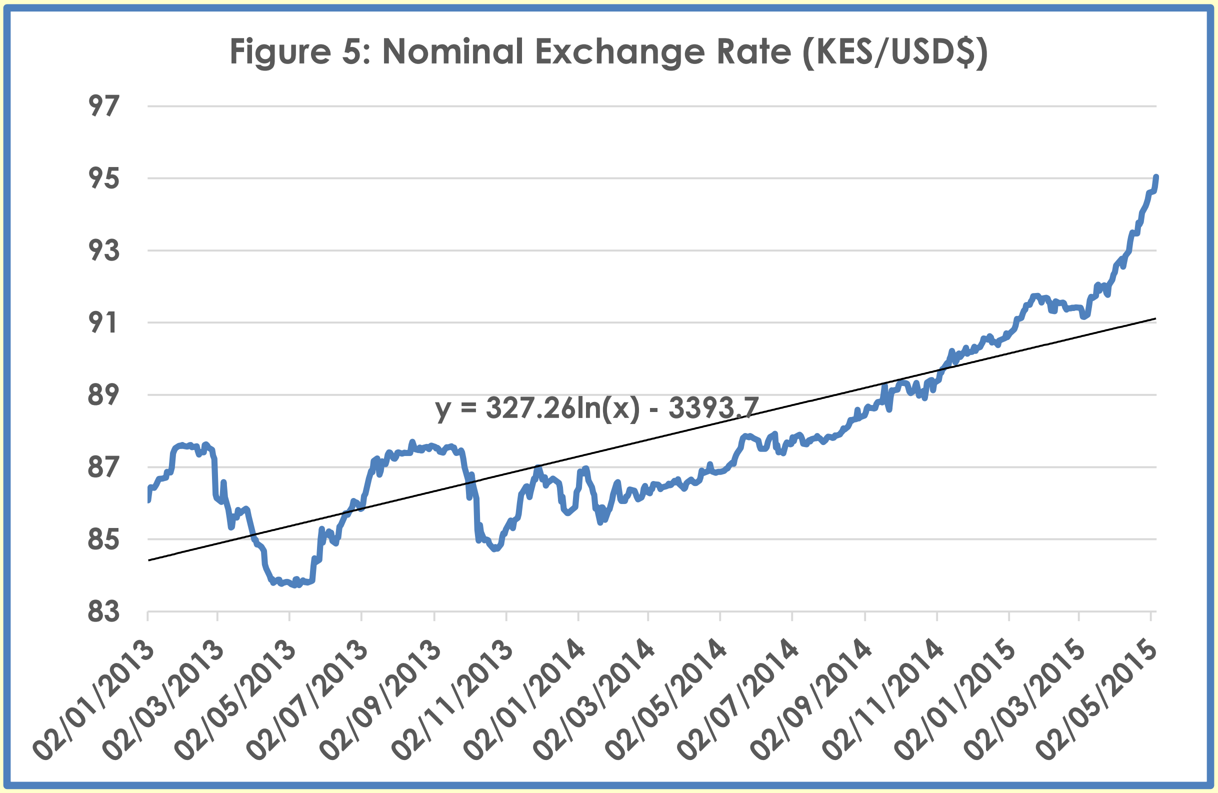
Figure 4: Brent Spot Price FOB (US$per Barrel)



Source: Brent

- ***Foreign exchange market – throwing sand in the gears?***

It is evident that the shilling has for a while had a depreciation bias (**Figure 5**); lately though the deprecation pressure is causing anxiety – if public commentary that depicts desperation is at all a guide. The MPC acknowledges that the local unit is under pressure but argues, for instance, that its nominal exchange rate against the US Dollar (US$) as depicted by **Figure 5** is more about the US$ strengthening on the back of "enhanced, but seasonal, demand for foreign exchange by local corporate sector largely associated with dividend and profit remittances". That is why the MPC exudes the confidence that the usable foreign exchange reserves equivalent to 4.4 months and the precautionary facility from the International Monetary Fund (IMF) will provide a cushion for the foreign exchange market against any temporary volatility.

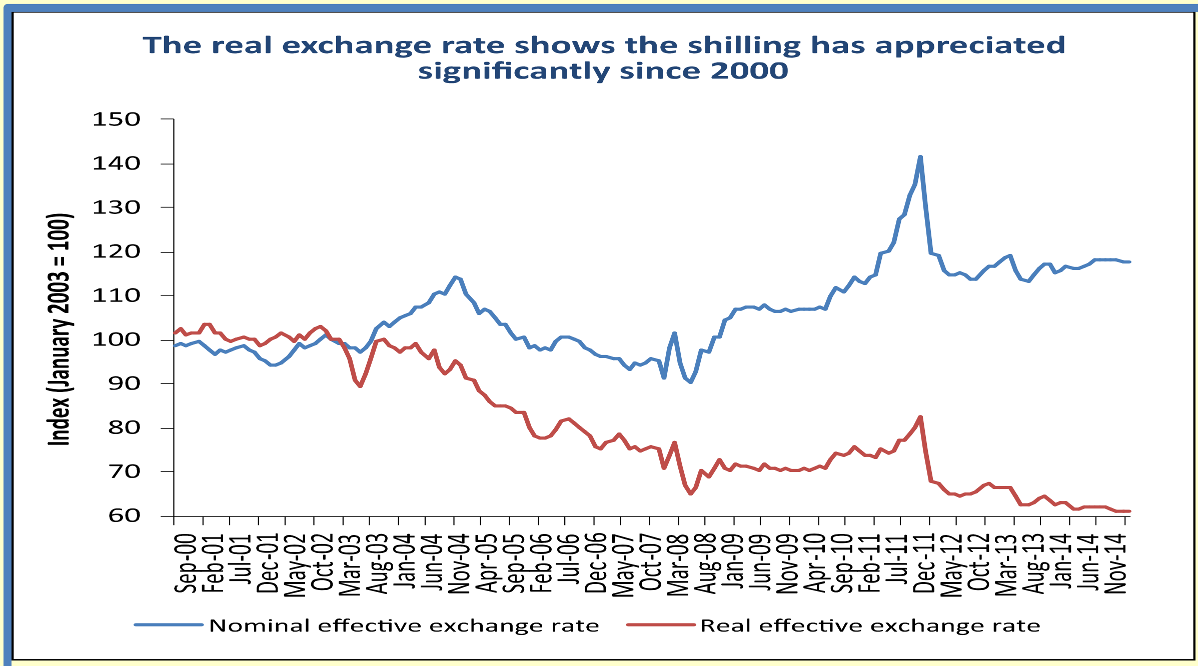


Source: Central Bank of Kenya

There is more to the foreign exchange market than apparently the MPC would want to be explicit about. There are indications that the Kenyan currency has substantially appreciated in real terms over the past decade (**Figure 6**) – see the real effective exchange rate trend; in other words the country has been losing competitiveness in the international market, a fact that is evident in the weak external position (current account deficit). The fact that the economy had to seek the IMF precautionary support is further confirmation of the weak external position.

The nominal depreciation that is depicted in both **Figure 5** and **Figure 6** is one of the corrections to the external imbalance, and the CBK can only do its part in ensuring that this inevitable position is not volatile. But the consequences are obvious: it could erode the gains from cheap commodity import (especially oil); and it could lead to further inflationary pressure given the strong exchange rate pass-through effect that has been empirically confirmed.

Figure 6: Real Exchange Rate Appreciation



Source: Central Bank of Kenya.

The economy's weak external position takes little conform from the fact that the global economy's recovery as we have alluded is fragile; the IMF"s latest Worl Economic outlook for June 2014 confirms as much.

Conclusion

From the foregoing analysis, this *Research Note* makes a deduction that the MPC is seeking to position its latest decision and the overall monetary policy stance on "Managing Risks in the Monetary Policy Path" in a manner portraying a calmness on the surface that understates the potentially destabilising undercurrents. We argue so based on the observations that:

- One, confidence in the economy that the MPC states "remains strong "could be at odds with evidence as presented by the 2014 Economic Survey by the KNBS;
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- Four, to exude confidence about the foreign exchange market while silent about the clearly weak external position and an economy that has steadily lost international competitiveness is a reflection of optimism that may not be well grounded.

Ultimately, based on the fact that inflation is at 7.08 percent is still within the medium term target range albeit with an upward trajectory, a change in monetary policy stance by the MPC would have not been justified. So the MPC's decision to retain the CBR at 8.50 percent is arguably well founded. However, any forward guidance that one could read from the MPC's indication that it will pursue a tightening bias is not well anchored given the positivity of the committee on both price and foreign exchange stability amidst the pressure on both fronts in the recent past. In essence, the tightening bias signal is not clearly articulated by the MPC. All these point towards a wait-and-see stance.

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