RESEARCH NOTE NO.22. – 2016 (RN/22/16)

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

January 21, 2016

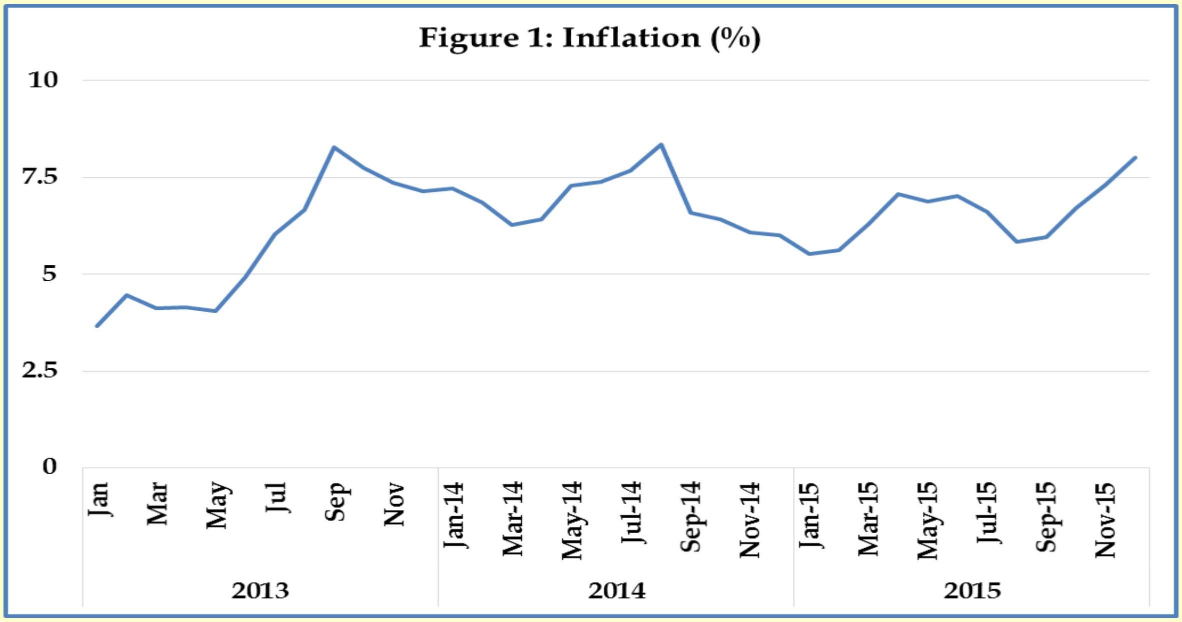
Monetary Policy Stance – All about Faith in the Forecast?

Highlights

- The decision by the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) in its meeting of January 20th, 2016 to retain the CBR at 11.5 percent while the inflation target is now breached was premised on the argument that there is no fundamental structural pressure on inflation, with the current pressure expected to dissipate by April 2016. The MPC has clearly banked on the faith on its inflation forecast.
- This *Research Note* argues that there is an inadvertent shrouding of the signalling of the policy decision decision: retention of the CBR when the inflation target range has been busted in contrast to the June – July 2015 tightening as signalled by the increase in the CBR even though inflation was within target.
- We argue that both domestic and external risks have been understated. The foreign exchange market stability premised on recovery of the current account position understates the risk the shaky recovery of the global economy – and more so the softening of the key emerging markets – could be undermine the market. The domestic money market could end up being undermined by the fact that the projected fiscal deficit remains large and the measures being put in place are in larger odds geared more towards bridging the fiscal gap and then reducing it. It doesn't help that the political environment is switching towards an electioneering mood.

Introduction

The 20th January 2016 meeting of the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) was held on the back of inflation having busted the target range of 2.5 percent points on either side of the 5 percent target. The 8.01 percent inflation rate for December 2015 was far from being a sudden upshot; we observe a build-up in the inflationary momentum since August 2015 even though over much of that time the inflation rate was within target, albeit on the upper bound (**Figure 1**). The upward trajectory in the inflation rate is partly attributable to food-related price increases as well as the coming into effect of the new excise tax on alcoholic beverages on December 1st 2015. Noteworthy, the non-food-non-fuel inflation has also been on an increasing trend.

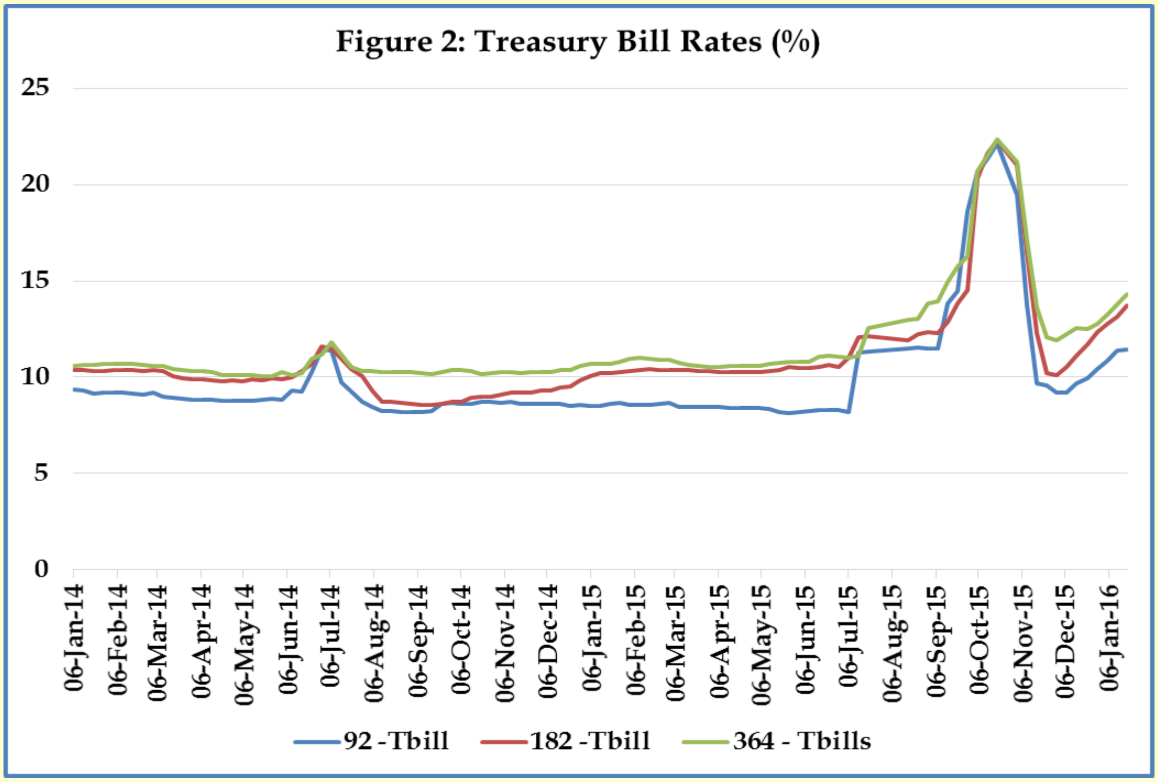


Source: Kenya National Bureau of Statistics

On the back of the above observation, the MPC's decision to hold the Central Bank Rate (CBR) – the policy signalling rate – at 11.5 percent and retain the Kenya Banks'Referebce Rate (KBRR) – the common credit pricing benchmark – at 9.87 pecent underpins three interesting observations.

- First, when the MPC explicitly signalled a change in its monetary policy stance in June 2015 by way of increasing the CBR from 8.5 percent to 10.0 percent and then to 11.5 percent in July 2015, inflation was within the target range. During that time, there was volatility in the foreign exchange market; presumably, it was the MPC's considered view that if the local currency is not supported through a tightening of monetary policy, the exchange rate pass-through effect to inflation will compromise the inflation target.
- Second, with the foreign exchang market stable but the inflation target breached, the MPC has decided to retain the the policy signalling rate. This could imply one of two things: either the MPC is sangunine about its inflation outlook (in any case it indicates that the current inflationary pressure would diapate by April 2016) or it feels sufficiently comfortable that both domestic and international circumstances do not justify the signalling of a change in stance even on the back of a target breach. Granted, there have been past episodes of target breach followed by a revertion to the targetd range – for instance in September 2013 and August 2014 both of which periods were characrised by the CBR being maintained at 8.5 percent. The true test of how compelling the MPC attitude is insofar as the anchoring of inflation expectations is concernbed is on how best it guides the market to read the signal of its intention; in other words to hold the policy signalling rate when inflation target is observed in the the breach could be telling of a "wait-and-see" approach to signalling.

- Third, by retaining the KBRR at 9.87 percent the MPC was implicitly pointing to a determination that since the last review of July 2015, the two components that determine the pricing benchmark have not mader any movements to justfity a change either way. As already noted, the CBR (one of the components) has been twice reviewed upwards. As we note, the 91-day treasury bills rate (the other compoment) has taken the demeanor of a bouncing ball (**Figure 2**): fast spiking (September 2015 – October 2015), fast tumbling (reacing the low ebb by Mid-November 2015); on their way up, albeit not as fast (sunsequent to November 2015). The market behaviour therefore does not point in the directioin of rention but towards an upward review of about 100 basis points.



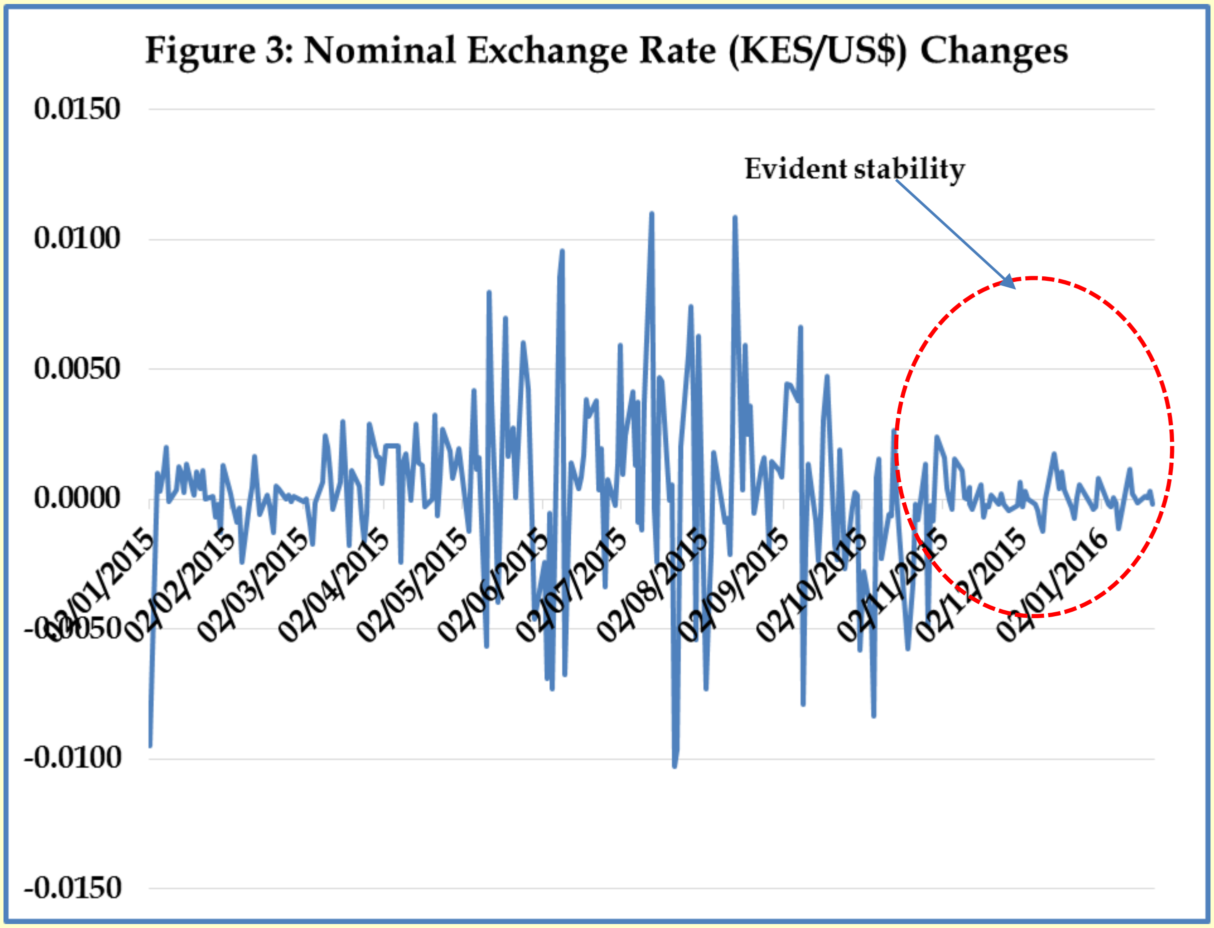
Source: Central Bank of Kenya

With the above three observations, this *Research Note* is grappling with a question that could erroneously be taken as trivial: what monetary policy stance does the latest MPC decision present? We have argued in the past[1], the MPC is ostensibly getting better at anchoring inflation expectations in its policy communication. With inflation now above target, the alluded commitment to ensuring that inflation remains within target underpins the expectations for not just the intention but a clear signal; that seem to be blurred by the eposides of tightening – justifiable as it remained – while inflation was within target and holding while inflation is above target.

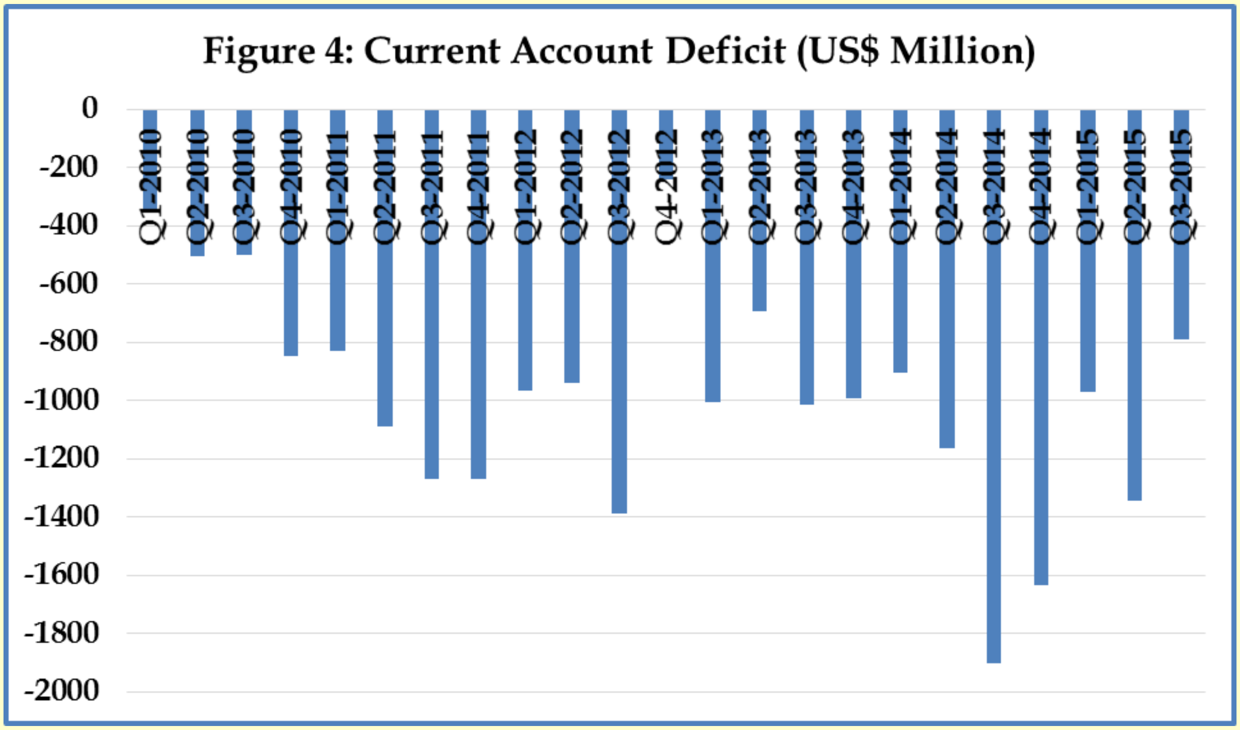
[1] See for instance, *Research Note No 12* of September 2014 (http://www.kba.co.ke/images/stories/RN%20No%206%202014.pdf)

Is the ocean now all calm?

It is evident that the foreign exchange market is manifesting stability (**Figure 3**), and the MPC notes as much. The current account has narrowed (**Figure 4**), although admittedly not sufficient enough to on its own entrench stability and move the foreign exchange market from the depreciation biased position. That is why, even with the foreign exchange reserves at a respectable USD 7 billion (equivalent of 4.5 months of import cover), the Precautionary Arrangement with the International Monetary Fund (IMF) remains necessary.



Source: Central Bank of Kenya



Source: Central Bank of Kenya

The basis for the MPC's comfort that the foreign currency market is stable on the backing of the narrowing current account deficit and despite the rise in the US interest rates and the slowdown of the Chinese economy needs further scrutiny. The MPC states that l a lower import bill for petroleum products and a recovery in earnings from tourism, tea and coffee have supported the current account deficit narrowing.

We contend that the narrowing as an end in itself without looking at the process will only serve a short-term purpose. We argue that there is no symmetry in the current account narrowing on the basis of imports declining and the narrowing on account of exports rebounding; the latter obviously reflects a rejuvenation of growth in the exportable and therefore an indication of improvement in competitiveness. This is where the weak external environment argument comes in.

The IMF has just revised its global economic outlook[2]. The IMF is now explicitly pessimistic about the state of the global economy than it was in October 2015. According to the Fund, the global growth, currently estimated at 3.1 percent in 2015, is projected at 3.4 percent in 2016 and 3.6 percent in 2017, a more gradual trend than its October 2015 *World Economic Outlook (WEO)*, especially in emerging market and developing economies.

The IMF observes that the "risks to the global outlook remain tilted to the downside and relate to ongoing adjustments in the global economy: a generalized slowdown in emerging market economies, China's rebalancing, lower commodity prices, and the gradual exit from extraordinarily accommodative monetary conditions in the United States. If these key challenges are not successfully managed, global growth could be derailed". The MPC's therefore position portrays an understatement of this risk.

[2] See http://www.imf.org/external/pubs/ft/weo/2016/update/01/index.htm

On the domestic front, the MPC seems to exude confidence on the Government borrowing programme such that it seem limited possibility of such borrowing being a constraint to market liquidity. As already observed (**Figure 1**), interest rates have started looking upward. This should be a signal for a more nuanced look at the fiscal position. We argue that the projected fiscal deficit remains large and the measures being put in place are in larger odds geared more towards bridging the fiscal gap and then reducing it. In there, therefore, could be another understated risk. It doesn't help that the political environment is switching towards an electioneering mood. Even the strong third quarter rate of 5.8 percent does not take away the fact that the annual average growth will likely end up being below trend; thus the revenue base remains undermined.

Conclusion

The decision by the MPC to retain the CBR at 11.5 percent while the inflation target is now breached is premised on the argument that there is no fundamental structural pressure on inflation, with the current pressure expected to dissipate by April 2016. The MPC has clearly banked on the faith on its inflation forecast.

This *Research Note* argues that there is an inadvertent shrouding of the signalling of the policy decision: retention of the CBR when the inflation target range has been busted in contrast to the June – July 2015 tightening as signalled by the increase in the CBR even though inflation was within target.

We argue that both domestic and external risks have been understated.

- The foreign exchange market stability premised on recovery of the current account position understates the risk the shaky recovery of the global economy – and more so the softening of the key emerging markets – could be undermine the market.
- The domestic money market could end up being undermined by the fact that the projected fiscal deficit remains large and the measures being put in place are in larger odds geared more towards bridging the fiscal gap and then reducing it. It doesn't help that the political environment is switching towards an electioneering mood.

Time will tell whether faith on the forecast will stand the test of time.

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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