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Monetary Policy Stance – Eventually it is all about Inflation!

"On the back of weak external circumstances it is hard to see the drivers of a sanguine posture on the quick return to a sustainable current account position merely on account of faster balance of payment data flow. But that seems to be the MPC's comportment with the indication that a recomputed series of the current account deficit has yielded an "improvement" of the current account deficit from an equivalent of 10.45 percent in December 2012 to 7.5 percent in September 2013."

Highlights

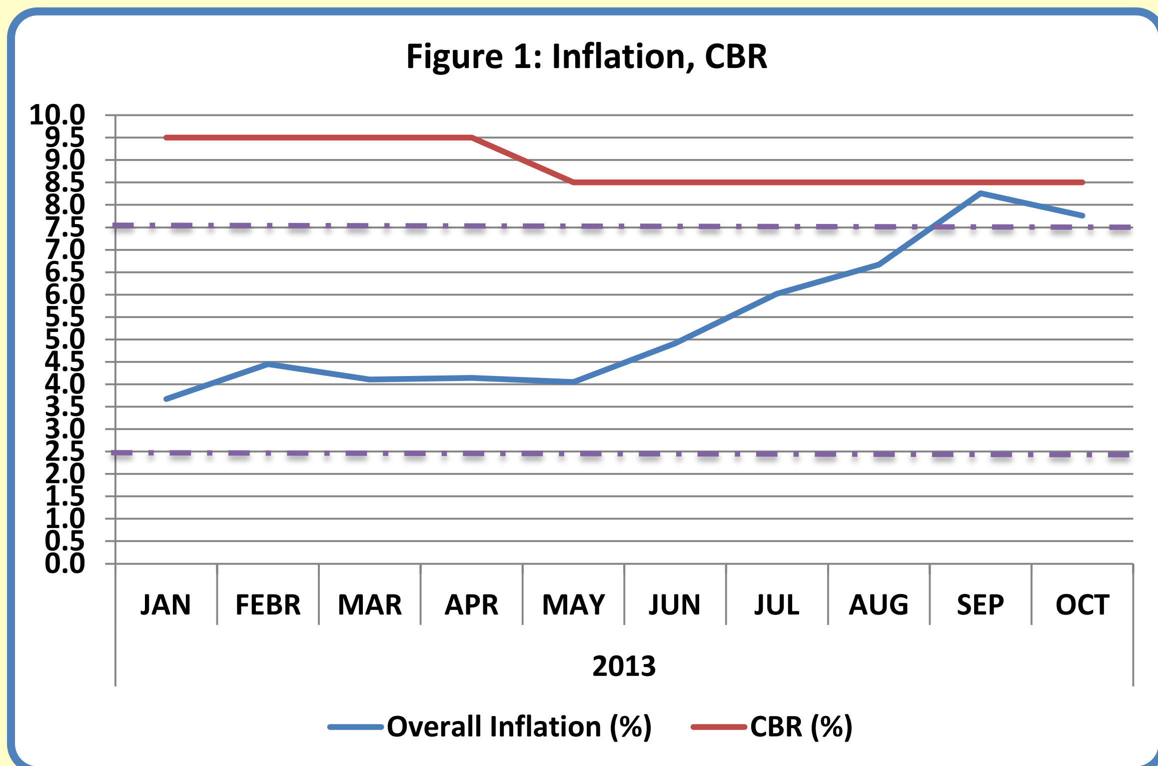
- The decision by the MPC to leave the CBR at 8.5 percent for the fourth consecutive time represents an eventual and welcome return of the monetary policy focus to anchoring inflation expectations. This stance is a clear departure from the previous signals of temptation to directly nudge economic growth.
- Even with that renewed focus, the MPC seems to be content with the economy's external position through its indication that the current account position is in the sustainable range. This stance seems to fly in the face of the prevailing global and domestic market conditions.
- This *Research Note* argues that the correction in the external position will have to be triggered by real exchange rate depreciation in view of the weak export base and a current account that is largely funded by short-term portfolio flows. We argue that the perception of improvement in the current account deficit position needs to be seen in the correct perspective:
    - One, on the back of a stable money market environment the only correction mechanism for the current account position towards the attainment of a sustainable position can be through real exchange rate depreciation.
    - Two, it is clear that in view of the observation of slow investments and a weak export earnings base, the current account deficit is largely funded by short term flows that carry the big risk of quick reversal. This casts doubt on the sustainability of the stable foreign exchange. Ultimately, the reprieve to inflation by way of moderating the pass-through effect of imported inflation may seem to be a short-term phenomenon.
- Ultimately, even though the inflation outlook may reflect a benign position at the moment, it draws attention to the fact that a sustainable return to the medium term target may be drawn out, an outcome that may not augur well for the restoration of the economy's recovery momentum. The challenge may be compounded by domestic risks, such as those related to weather and other supply-side shocks that could alter the inflation outlook dynamics.

Introduction

For the fourth consecutive time, the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) decided to leave the Central Bank Rate (CBR) unchanged at 8.5 percent during its meeting of 5th November 2013. All the while, the prevailing circumstances at each decision point have been changing.

When the MPC lowered the CBR by 100 basis points from 9.5 percent to 8.5 percent in May 2013, the implicit message was that the economy's recovery was gaining noticeable traction. The lowering of the rates was therefore meant to provide the necessary momentum to entrench the economy's climb to the pre-global financial crisis growth rate.

Subsequently, however, it is becoming clear that the economy's projected real growth of 5.8 percent for 2013 is unlikely to be realised. Instead a real growth of 5 percent could be the best case scenario. In the meantime, inflation that was within target but showing a clear increasing trend is now above target (**Figure 1**).



Source: KNBS; CBK

As this *Research Note* will argue, now that the MPC is training its eyes on the right target of anchoring inflation targets, it needs not lose sight of the domestic and external risks that could upset the stable market conditions[1]. The basis of our argument is two factors that the MPC highlights as positive outcomes of the market since its previous decision.

[1] The KBA Centre for Research on Financial Markets and Policy has consistently argued in three previous *Research Notes* [***Research Note No. 2 - 2013 (RN/2/13), Research Note No.3 – 2013 (RN/3/13) and Research Note No. 4 – 2013 (RN/4/13)***] that there is need to revise the signalling strategy by the MPC from implicitly backing growth to focusing on anchoring inflation expectations.

- One factor is the observed decline in overall inflation from 8.29 percent in September 2013 to 7.76 percent. We argue that an event does not amount to a trend and circumstances may lead to inflation remaining above target well into 2014.

- The second factor is the recognition that the moderation of inflation can partly be attributed to the strengthening of the Kenya Shilling against major currencies therefore that provided the cushioning from the pass-through effects of imported inflation. We argue that the reprieve should be seen against the still weak external circumstances that may stand on the way to a sustainable current account position.

Potential Risks – Ours has never been a 'Robinson Crusoe' Economy!

As a small-open economy, Kenya's macroeconomic stability is as much a function of external circumstances as it is of domestic supply and demand conditions. As recent analyses have confirmed (e.g. IMF, 2013[2]), global headwinds have moderately lowered Sub-Saharan Africa's growth in 2013, although the pace is expected to pick up in 2014. The softer outlook for 2013 for Sub-Saharan Africa, which mirrors our earlier observation of a revised outlook Kenya, is on the back of an adverse external environment characterized by rising financing costs, less dynamic emerging markets[3].

At the same time, we are seeing less favourable commodity prices in the international markets, slower investments even when the CBK's credit survey for the quarter ending September 2013 indicates an increase in credit, and weakening consumer confidence on the jostling of the VAT measures even when the CBK argues that the implementation of the VAT act in September 2013 had a one-off impact on inflation. Equally important are the domestic risks, such as those related to weather and other supply-side shocks that could alter the inflation outlook dynamics.

The local circumstances that we outline are a reflection of the global economic circumstances. After sluggish growth in 2013, the global economy is expected to pick up in 2014. The extent of the pick is however continually revised downwards. The IMF's October 2013 *World Economic Outlook* (WEO) projects a world output growth of 2.9 percent and 3.6 percent in 2013 and 2014, respectively, a more subdued than in the April 2013 issue, which projected the world economy to grow 3.3 percent in 2013 and 4.0 percent in 2014.

In the circumstances, to assume that Kenya's performance will defy regional and international conditions will be farfetched. That by no means presupposes only adverse circumstances, for the prospects seem mixed if one is to keenly watch the global developments.

- One, even with the much publicized recent Government shut-down, the U.S. economy has continued to recover in a fundamental way that at some point that its central bank indicated in May 2013 that they would consider starting a tapering of their program of monetary stimulus beginning in 2014. However, in its September meeting, the Federal Open Market Committee decided to maintain its level of stimulus unchanged for the time being in view of renewed fiscal risks and other domestic news.

- Two, while Europe appears to be finally out of a formal recession, it is growing more slowly than projected earlier in the year. But Japan seems to be responding well to policy stimulus, but could still lose momentum in 2014 as the stimulus diminishes.

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[2] See IMF, 2003, *Regional Economic Outlook, Sub-Saharan Africa*, October.

[3] See KBA Centre for Research on Financial Markets and ***Policy Research Note No. 4 – 2013 (RN/4/13),*** **September 2013.**

- Three, as earlier alluded, China and other emerging market economies that have become increasingly important in the global economy and for Sub-Saharan Africa in particular, have shown signs of slowing down.

External Position – Does a change in the flow of numbers mean a change in the circumstances?

On the back of the back of the weak external circumstances as outlined above, it is hard to see the drivers of a sanguine posture on the quick return to a sustainable current account position merely on account of faster balance of payment data flow[4]. But that seems to be the MPC's comportment with the indication that a *recomputed* series of the current account deficit has yielded an "*improvement*" of the current account deficit from an equivalent of 10.45 percent in December 2012 to 7.5 percent in September 2013.

The observed "improvement" needs to be seen in its correct perspective. For one, the circumstances on the global environment are a pointer to the fact that if there has been any improvement in the current account position of the economy, then it is definitely not arising from a boom in exports. Further, the appreciation of the Kenya shilling that seems to fit a cyclical behaviour observed in the year (**Figure 2**) can only mean that price elastic exports are losing competitiveness.

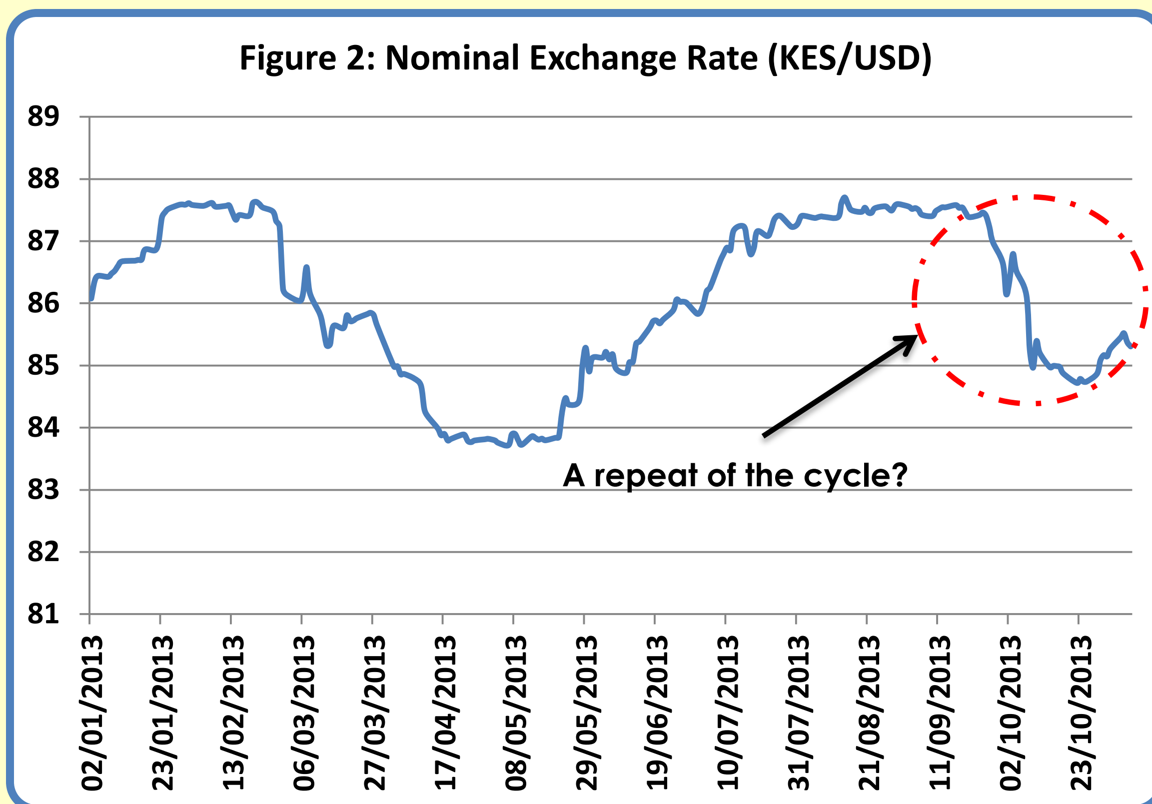
These factors can only mean two things:

- One, on the back of a stable money market environment – which the MPC correctly observes to be prevailing – the only correction mechanism for the current account position towards the attainment of a sustainable position can be through real exchange rate depreciation. And that depreciation is to be sustained until the current account attains a 5 percent equivalent of GDP. How quick that happens will depend on the rate of depreciation. But the prevailing circumstances are the exact opposite, which casts some doubts as to whether we are seeing a real improvement in the current account position or an accounting improvement.

- Two, It is clear that in view of our observation of slow investments and a weak export earnings base, the current account deficit is largely funded by short term flows that carry the big risk of quick reversal. This casts doubt on the sustainability of the stable foreign exchange rate market conditions at the very worst and the appreciation stance of the local currency at the very best. Ultimately, the reprieve to inflation by way of moderating the pass-through effect of imported inflation may seem to be a short-term phenomenon.

Therefore, even though the inflation outlook may reflect a benign position at the moment, it draws attention to the fact that a sustainable return to the medium term target may be drawn out, an outcome that may not augur well for the restoration of the economy's recovery momentum.

[4] The MPC Indicates that the efforts of the CBK, the IMF and the Kenya National Bureau of Statistics has improved the quality and speed of delivery of balance of payment data.



Soruce: CBK

Conclusion

The decision by the MPC to leave the CBR at 8.5 percent for the fourth consecutive time represents an eventual and welcome return of the monetary policy focus to anchoring inflation expectations. This stance is a clear departure from the previous signals of temptation to directly nudge economic growth. Even with that renewed focus, the MPC seems to be content with the economy's external position through its indication that the current account position is not in the sustainable range. This stance seems to fly in the face of the prevailing global and domestic market conditions. We argue that the adjustment in the external position will have to be triggered by real exchange rate depreciation in view of the weak export base and a current account that is largely funded by short-term portfolio flows.

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