RESEARCH NOTE NO.35. – 2018(RN/35/18)

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

March 15, 2018

Monetary Policy Stance – Resisting the Temptation to be "Accommodative"

Highlights

- The Central Bank of Kenya's Monetary Policy Commitee meeting of 19th March 2018 puts a spotlight on the committee's ability to strike a balance between three competing circumstance.
    - First are the competing viewpoints between expectations-based stance and fundamentals-based stance. The key issue here is whether monetary policy will change based on explicit guidance of recent past decisions and how they have influenced stability outcomes or whether the economic fundamentals – particularly output growth – will support a given policy stance.
    - Second is the view that monetary policy must face the glaring possibility of fiscal dominance, where fiscal policy forces the hand of a monetary policy stance.
    - Third is the necessary candour that both monetary policy signalling and transmission are clearly impaired by the prevailing legislation around credit pricing to the extent that any assumption of normalcy on the two aspects will obviously be limiting.
- We argue that if these considerations are brought to bear, then the Monetary Policy Commitee will likely maintain its stance as would be signalled by the retaining of the Central Bank Rate, the policy signalling rate, at 10.0 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 that is typocally earned and not endowed.

Introduction

As the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) prepares for its meeting of 19th March 2018, its clear that the policy stance being pondered must strike a balance between three broad considerations.

- First are the competing viewpoints between expectations-based stance and fundamentals-based stance. The key issue here is whether monetary policy will change based on explicit guidance of recent past decisions and how they have influenced stability outcomes or whether the economic fundamentals – particularly output growth – will support a given policy stance.
- Second is the view that monetary policy must face the glaring possibility of fiscal dominance, where fiscal policy forces the hand of a monetary policy stance.
- Third is the necessary candour that both monetary policy signalling and transmission are clearly impaired by the prevailing legislation around credit pricing to the extent that any assumption of normalcy on the two aspects will obviously be limiting.

If these considerations are brought to bear, then the MPC will likely maintain its stance during the forthcoming meeting as would be signalled by the retaining of the Central Bank Rate (CBR), the policy signalling rate, at 10.0 percent.

The MPC seeks to guide expectations through its interpretation of evidence as a necessary condition but not sufficient unless accompanied by clear articulation. In essence, communication has become a critical part of its monetary policy tool kit. Clarity of the MPC's communication, a measure of policy transparency, helps anchor inflation expectations.

As expressed in the MPC 22nd January 2018 communique, there is "room for accommodative monetary policy in the near term, as well as the risk of perverse outcomes"[1]. If that is interpreted as 'forward guidance', which in itself is not a policy pre-commitment, then it signals the extent to which the MPC needs to exercise caution on any temptation to change its policy stance. This *Note* argues so because nudging a perception normalcy through adoption of an accommodative stance must confront the possibility of the perverse outcomes, given the equal possibility of either of the two.

Nudging normalcy … and then manage the consequences?

The MPC has, as recent as in January 2018, portrayed itself as an exemplar of optimism on the state of the economy. Its real GDP growth outlook for 2018 is 6.2 percent, the most optimistic amongst all projections from credible institutions that include the International Monetary Fund, the World Bank, the National Treasury and a host of international commercial financing agencies.

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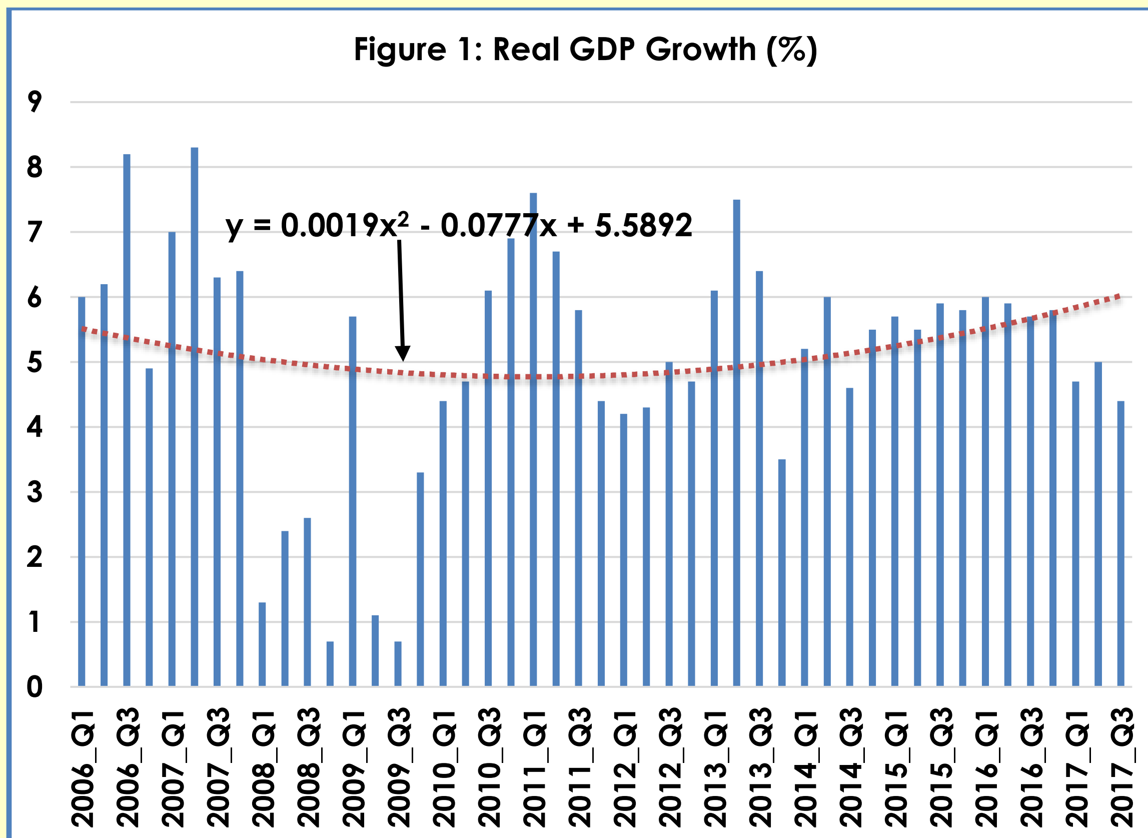
[1] See https://www.centralbank.go.ke/uploads/mpc_press_release/356588052_MPC%20Press%20Release%20-%20Meeting%20of%20January%2022,%202018.pdf

With the slowdown that the economy experienced in 2017 that has led to the estimated rate of output growth dipping to below 5.0 percent, it will take a drastic turn of events for the economy to quickly pick the growth slack and grow above its medium term trend (**Figure 1**). The MPC's outlook, which has been characterised as baseline, means a rebound of over 120 basis points.



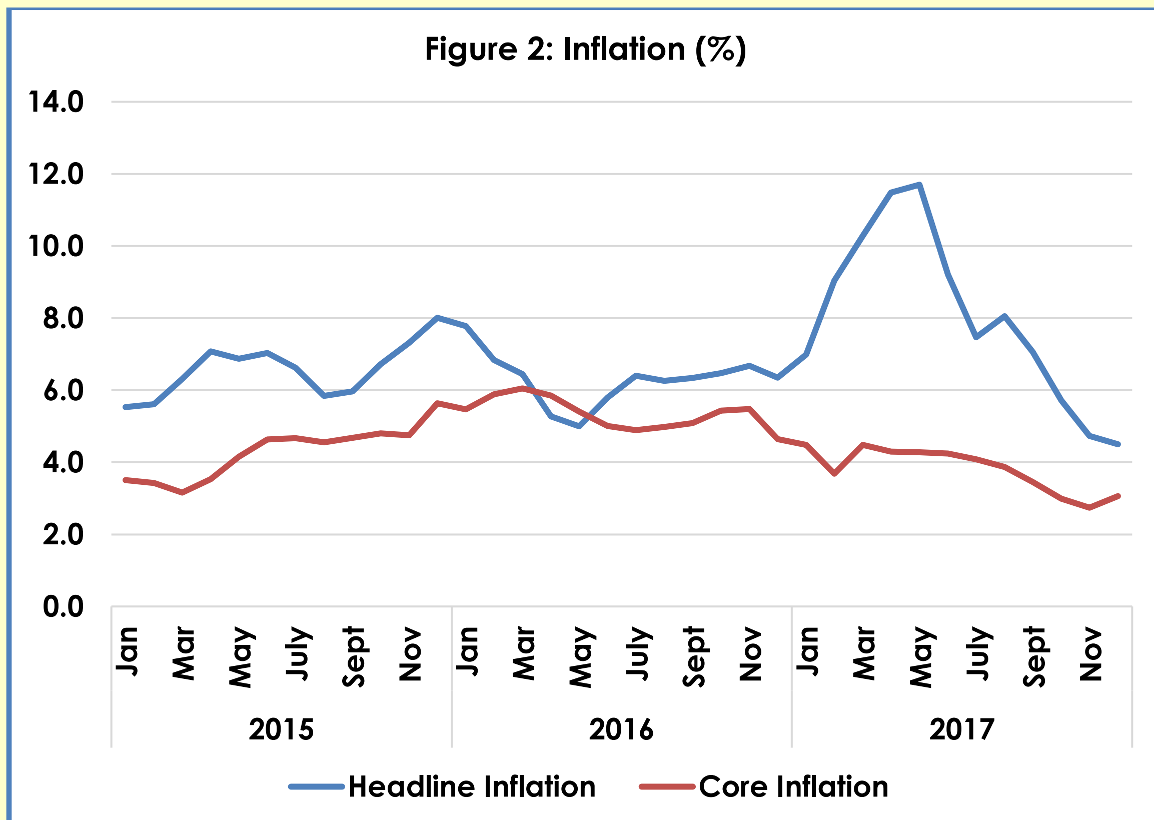
Source: Kenya National Bureau of Statistics

In the best of circumstances, any anticipated real GDP growth bounce back must of necessity be on the back of four factors. Let's consider those factors in turn.

- First, increase private sector investments needs to be on a positive trajectory. When the economy is operating at a negative output gap (meaning that its actual output falls short of its potential) it implies that firms are generally operating at excess capacity (meaning that their levels of operations are well below installed capacity). Intuitively, the priority of businesses is therefore to beef up capacity unitisation before additional capacity (i.e. investment) becomes a priority.

- Second, while the dynamics on the investment side represent the supply side of the equation, there has to be a corresponding demand side response. It is often assumed that a low and stable inflation promotes not just a predicable environment for planning and investment, but enabled households continued consumption that then feeds into investment requirements.

With the essence of monetary policy being the attainment of the low and stable inflation in line with the given target, it could be assumed that MPC has been successful ion realising that objective (**Figure 2**) – no wonder the already noted temptation that there is scope for an accommodative monetary policy" stance. It is worth testing this assumption.



Source: Kenya National Bureau of Statistics

By February 2018, monthly headline inflation was at 4.46 percent, marginally down from the December 2017 level of 4.5 percent. It is indisputable that the decline in headline inflation from a high of 11.7 percent in May 2017 to the target range, associated largely with food prices, has nothing with the monetary policy stance. It is purely a supply-side phenomenon, thus monetary policy lacks the appropriate tools tor its redress.

The core inflation (which excludes foods and fuel) – and which is not the target given to the CBK – has largely remain low. This signals subdued demand. Does this signal monetary policy success? Not necessarily, especially when you consider that there have been instance (as will be discussed later) when the MPC has attempted to stimulate demand in vain. The economy now finds itself at a corner where demand is subdued and, according to a recent survey, consumer confidence sagging.[2]

[2] See https://africabusinesscommunities.com/africadata/kenyas-latest-nielsen-consumer-confidence-report-indicates-decline/

It may therefore amount to a hasty verdict, if one is to conclude that inflation expectations are now well anchored as to justify the though is there being scope for an accommodative monetary policy stance. As we have learned from recent studies[3], the outlined inflationary story and monetary policy attitude easily portrays diversity of expectations. The anticipation may be that inflation expectations are "CBK- following" – where the outcome is as guided by the MPC pronouncements. The reality however could be that inflation expectations could be taking a "random walk" – as **Figure 2** seems to suggest.

- Third, there is a real possibility that the largely public-expenditure-led growth arrangement, which has arguably prevailed for well over two years, has run its full cycle. The typically large fiscal deficit, in instances over an equivalent of 9.0 percent of GDP has been associated with a rapid accumulation of public debt that is now in focus, having more than doubled over the past five years. That public debt is a matter of concern is in no doubt given that fiscal consolidation is now a compelling policy proposition.

  Little comfort can, for instance, be taken from the IMF-World Bank Debt Sustainability Analysis (DSA) observation that "Kenya's risk of external debt distress remains low, while overall public sector debt dynamics continue to be sustainable"[4] while (a) the same institutions are expressing concern on the economy's debt situation, and (b) the rating agencies are equally expressing concern[5]. It is therefore difficult to see how the MPC can nudge fiscal nomalcy, assume that there will be no influence of the fiscal state on its policy position.

- Fourth, the external position is anything but bubbling in health. As we have argued in the past, the closure of the economy's current account from its double digit deficit levels of GDP equivalent seen five years back to below 6.0 percent by end of 2017 is attributable more to the lower rate of growth of imports value than a vibrancy of exports. It is hardly surprising that the stand-by arrangement with the IMF remains critical[6].

  Granted, the local currency has remained largely stable (**Figure 3**) even as MPC projects that the current account deficit will widen as in 2017. The widening of the current account deficit is on the back of the rising oil prices in the international markets. While the recovery of the global economy has started gaining traction, the downside risks to the global economy of policy unpredictability – and especially the consequences of the US' imposition of new tariffs of 25 percent on steel and 10 percent on aluminium on all trading partners[7] – are worthy taking into account in any viewpoint on the state of the global economy.

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[3] e.g Hachem K., and Wu J. K. (2017), "Inflation and Social Dynamics", *Journal of Money, Credit and Banking*, Vol. 48, No. 8, pp. 1673 – 1714. December.

[4] See https://www.imf.org/external/pubs/ft/dsa/pdf/2017/dsacr1725.pdf

[5] See https://www.moodys.com/research/Moodys-downgrades-Government-of-Kenyas-issuer-rating-to-B2-and--PR_379217

[6] See http://www.imf.org/en/News/Articles/2018/03/13/pr1885-imf-executive-board-approves-6-month-extension-of-the-stand-by-arrangement-with-kenya

[7] See https://piie.com/blogs/trade-investment-policy-watch/trumps-steel-and-aluminum-tariffs-are-counterproductive-here-are

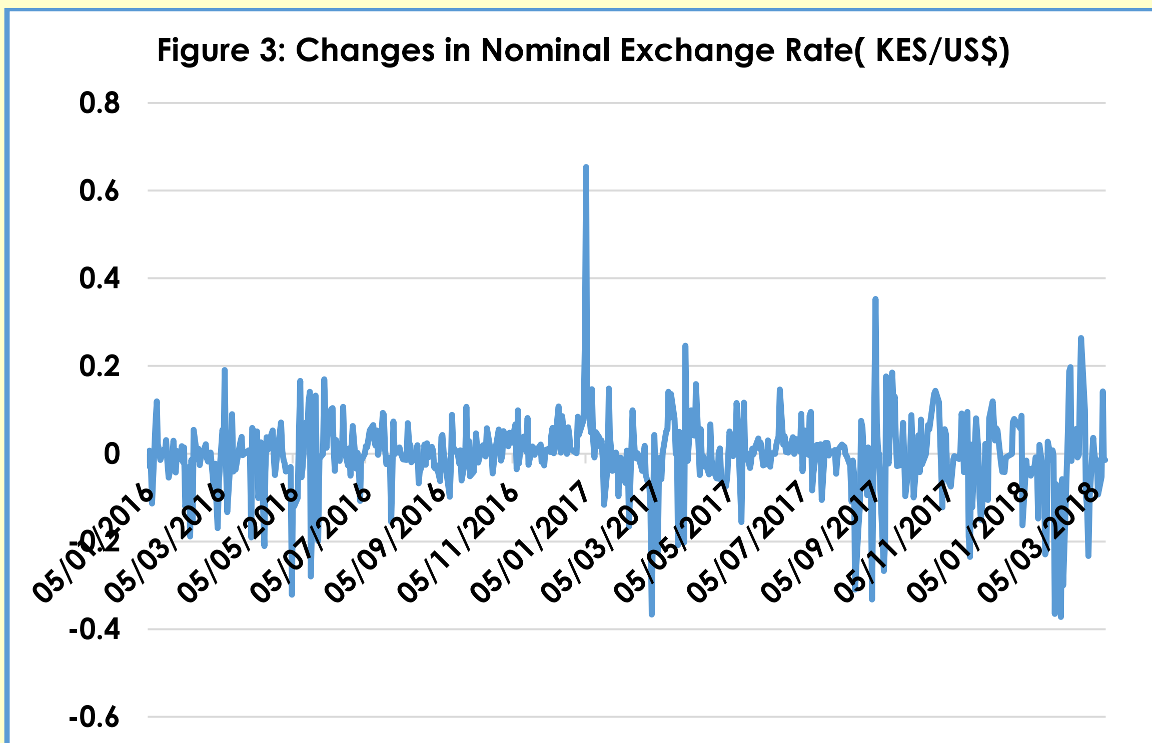

Figure 3: Changes in Nominal Exchange Rate(KES/US$)

Source: Central Bank of Kenya

Matters private sector credit – revisiting Sam Cooke and his "What-a-Wonderful-World"

As earlier alluded, there MPC has attempted to play the demand rejuvenating card through the easing of monetary policy with a view to supporting private sector credit uptake. Even with Sam Cooke's "don't-know-much-about-history" attitude, 20th September 2016 is recent enough to recall.

Amidst the anxiety as well as lack of clarity on the likely effects of the Banking (Amendment) Act 2016 that introduced caps to the lending rate and the minimum that commercial banks can pay for interest earning deposits, the MPC decided to lower the CBR by 50 basis points from 10.5 percent to 10.0 percent.

The reason for the MPC's policy move was its concern about "persistent slowdown in private sector credit". The private sector credit slowdown has persisted, and the MPC has subsequently maintained the CBR at 10.0 percent. The same – some could argue worse – conditions that made the monetary policy signal not pick traction in the private sector credit market are still prevailing.

If, as the MPC has recently stated, there is "room for accommodative monetary policy in the near term" is one side of the coin and "risk of perverse outcomes of the accommodative stance" is the other, then a toss of that coin will likely have a bias towards the latter. Private sector credit conditions, to the extent that the capping law uses the CBR as the base, could deteriorate as borrowers could be subjected more scrutiny.

The perverse outcome from a broader economic standpoint is easy to appreciate. The other undesirable outcome will be the implication on MPC's credibility by such a monetary policy move that leads to the exact opposite results. It is non-controversial to contend that monetary policy credibility is earned, not endowed. Therefore tempting as it may be, the MPC will have to incline towards excising caution and retaining the CBR at 10.0 percent.

Conclusion

The MPC meeting of 19th March 2018 puts a spotlight on the committee's ability to strike a balance between three competing circumstance.

- First are the competing viewpoints between expectations-based stance and fundamentals-based stance. The key issue here is whether monetary policy will change based on explicit guidance of recent past decisions and how they have influenced stability outcomes or whether the economic fundamentals – particularly output growth – will support a given policy stance.
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