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Monetary Policy Stance – A Pre-emptive Strike or a Reactive Response?

Highlights

- Market expectations were unanimous that the decision of the Central Bank of Kenya's monetary Policy Committee (MPC)meeting of June 9, 2015 will send to an unambiguous signal of change in monetary policy stance; in essence it was not a case of whether the MPC will tighten monetary policy but rather one of to what extent will policy be tightened. So there was a manifest change of monetary stance as signalled by the MPC changing the policy signalling rate – the Central Bank Rate (CBR) – from 8.50 percent to 10 percent.
- The MPC's monetary policy tightening was inevitable – whether it be a pre-emptive stance given that inflation is still within the target range and therefore tightening will ensure it remains so or a reactive response given our past arguments that the recent MPC communication have not sounded the urgency for a change in stance.
- The switch of the CBK's messaging from "Managing Risks in the Monetary Policy Path" in its previous pronouncement in May 2015 to "Managing Market Expectations to Ensure Stability" is not a mere nuance. The sense of urgency demonstrated in its decision to tighten monetary policy is a total contrast from the "calmness" (at least on the surface) previously portrayed.
- There is no doubt that the developments in the foreign exchange market prompted not just the meeting but also the decision. As we argue, the MPC meeting was anything but ordinary, not least because it was held just after one month since the previous meeting. Granted, the MPC can hold as many meetings as "business" necessitates; but given the fact that the mandate of the Committee is to make decisions towards assuring market stability, any indication of a sense of urgency in having a meeting ahead of the normal schedule sends a clear signal that there is plenty to watch for in the market.
- Popular commentary has been that the upward adjustment of the CBR has targeted the stabilisation of the local currency. We argue that in the CBK's monetary policy framework, the exchange rate stabilisation is an intermediate policy target. In our view the judgment by MPC on the extent of tightening is such that inflation remains within the target range. The icing in this instance will be the support of such increase for the foreign exchange market.

Introduction

The monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) meeting of June 9, 2015 was anything but ordinary, not least because it was held just after one month since the previous meeting of May 6, 2015. Granted, the MPC can hold as many meetings as "business" necessitates; but given the fact that the mandate of the Committee is to make decisions towards assuring market stability, any indication of a sense of urgency in having a meeting ahead of the normal schedule sends a clear signal of aplenty "business" thanks this particular time to the happenings in the foreign exchange market.

Market expectations were unanimous on the fact that the decision of the MPC meeting will send a clear signal of change in monetary policy stance; in essence it was not a case of whether the MPC will tighten monetary policy but rather one of to what extent will policy be tightened. So there was a manifest change of monetary stance as signalled by the MPC changing the policy signalling rate – the Central Bank Rate (CBR) – from 8.50 percent to 10 percent.

As we have argued before, to indicate that the MPC has a tightening bias while leaving the CBR unchanged is in a way blurring the policy signalling tool. Indeed the MPC has in its previous three meetings explicitly indicated that it has a tightening bias while the CBR was held at 8.5 percent. Since May, the CBK has enhanced its monetary policy operations through raising its maximum acceptable bid rates for term auction deposits by 2.5 percentage points above the CBR. That the MPC now felt compelled to raise the CBR by 1.5 percentage points can only mean that "outsourcing" the signalling of policy has its own limits.

What is the trigger for this policy move? This *Research Note* seeks to argue that it cannot be about the actual inflation rate, which remains within the government target range – albeit sticky on the upper bound. It then means that the inflation outlook points towards the busting of the target unless "something" is done. The breaching of the inflation target range will arise from the effects of a depreciating currency that will manifest themselves in inflation by way of the pass-through effect via fuel (as the international prices resume an increasing but modestly slow pace) as well as imported consumer goods.

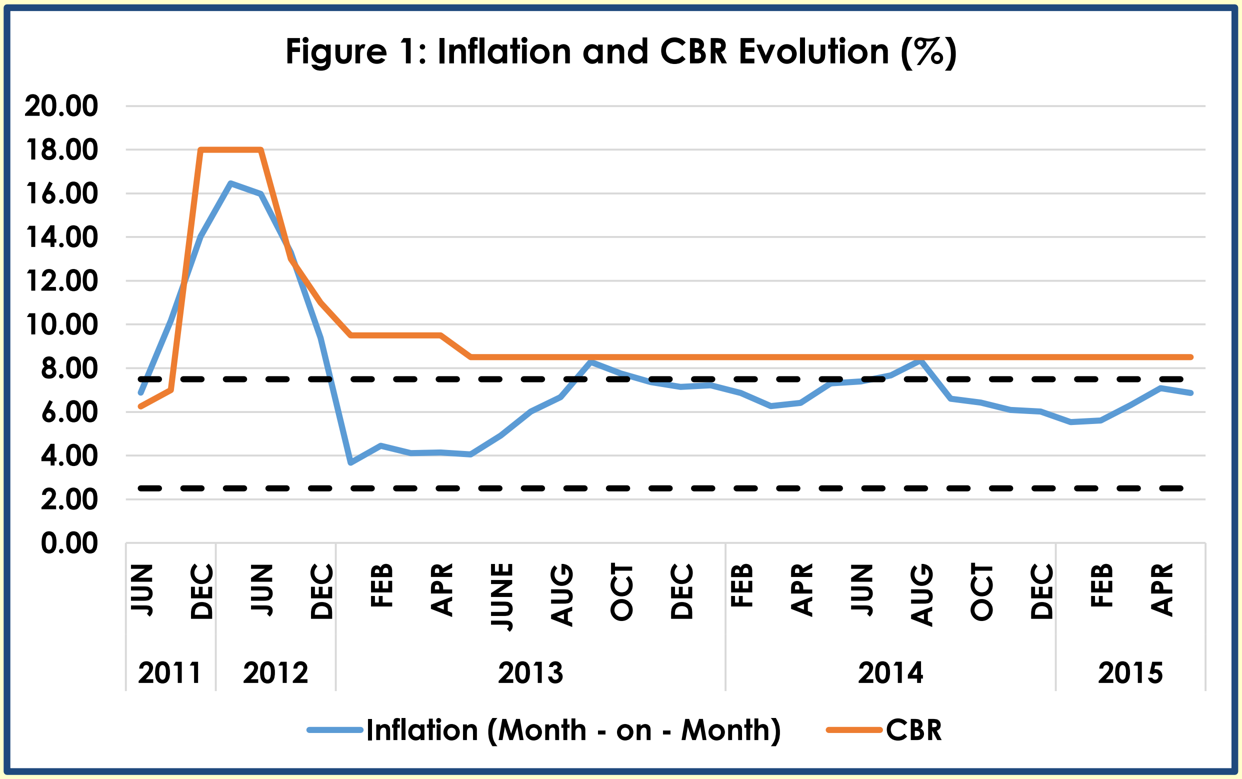
On the back of a very weak current account, the Kenyan currency – the Kenya shilling (KES) – should naturally be expected the have a depreciation bias. The less-than anticipated fast depreciation of the KES particularly against the US Dollar (USD) can only exacerbate the alluded effects on the economy's inflation outlook. With neither the evidently concerted foreign exchange market intervention by the CBK nor its declared tightening bias through market operations not yielding the desired effect of the KES's recent volatile demeanour, the MPC's hands were no doubt held towards the decision to deploy the CBR.

In essence, it could seem that the lessons of the 2011/12 market episodes of volatility accompanied by delayed policy action were never lost. In others words the famous worlds of John Maynard Keynes (A Tract of Monetary Reform (1924) that "… this long-run is a misleading guide to current affairs. In the long run we are all dead. Economists set themselves too easy, too useless a task, if in tempestuous seasons they can only tell us that when the storm is long past, the ocean is flat again".

This means that action was inevitable as inaction in anticipation that markets will – after turbulence – self-correct, would be a costly alternative. We argue thus based on our perspective that the MPC's express indication of the need to change policy course has been at best unclear otherwise lacking, even as recent as May 2015. We could argue that even the previous decision of May 2015 had a Bobby McFerrin's "don't worry, be happy'" feel. Indeed since May 2013, the MPC has maintained the CBR at 8.5 percent, implying that in its considered view the economic circumstances generally and the market conditions specifically have not provided justification for a change in monetary policy stance, until suddenly the foreign exchange market exposed the implicit weakness of not providing succinct forward guidance even if it is not necessary accompanied by a policy stance change – in any case forwards guidance is in no way a policy pre-commitment .

Inflation – Staying the Expectation Anchoring Cause?

As noted, the MPC has held steady the monetary policy stance since May 2013. Over that period, inflation has remained within the upper bound of the medium-term target of 5 percent [+ (-) 2.5 percentage points], except on two instances where month-on-month inflation rate has been above target (**Figure1**).

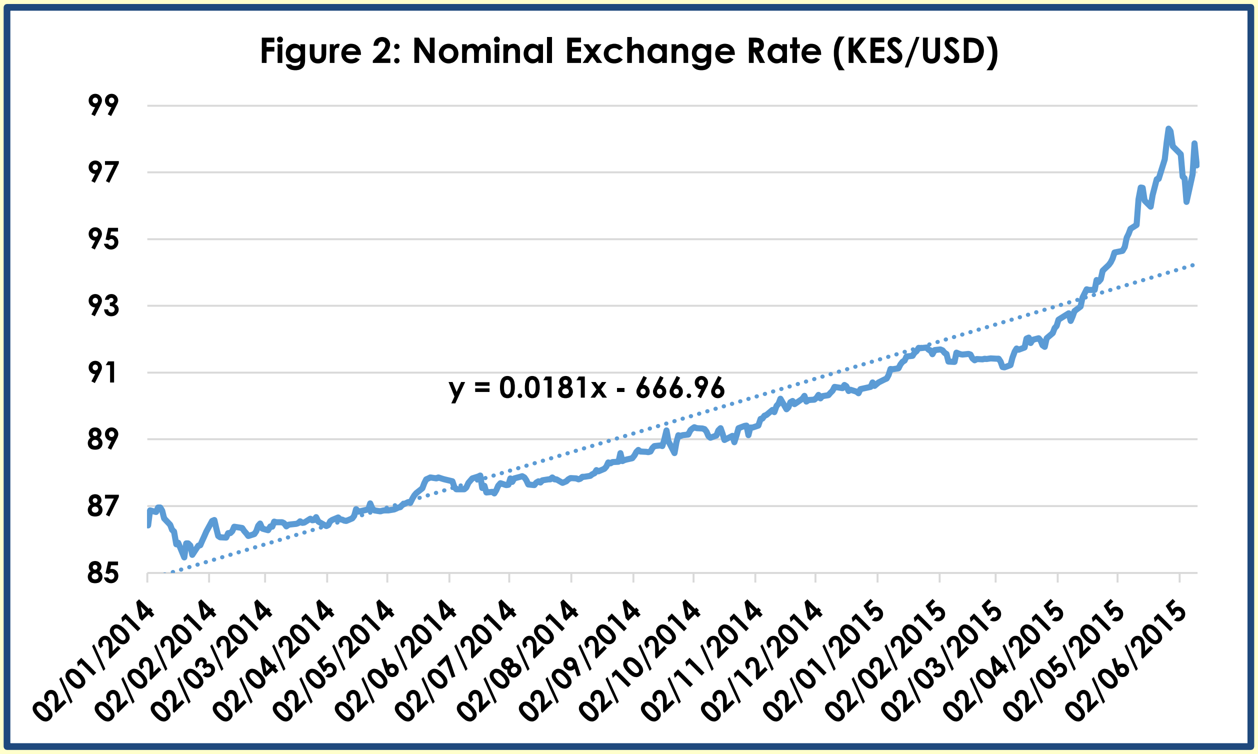


Source: CBK, Kenya National Bureau of Statistics

As is evident from Figure 1, there has been increasing inflationary pressure, with the inflation rate rising from 5.53 percent in January to 7.08 percent by April before marginally declining to 6.87 percent in May 2015. There are two revealing signals from the MPC that speak to the tipping point insofar as the policy stance is concerned. One is that the non-food-non-fuel inflation has been creeping up as the easing of inflation was purely on the support of lower food prices. The other is that the measure of broad money (so-called M3) as well as private sector credit have surpassed what the MPC considers to be the on-inflationary target.

Undoubtedly, the foreign exchange market situation was the trigger to the change in policy stance. As earlier noted, the exchange rate of the KES against the USD has remained under pressure (**Figure 2**) that is likely to manifest itself in inflation by way of the pass-through effect via fuel as well as imported consumer goods. Popular commentary has been that the upward adjustment of the CBR has targeted the stabilisation of the KES. We argue that in the CBK's monetary policy framework, the exchange rate stabilisation is an intermediate policy target – a means rather than an end.

In our view therefore, the judgment by MPC was that a 150 basis points increase will ensure that inflation remains within the target range. The icing in this instance will be the support of such increase on the foreign exchange market.



Source: CBK

Policy Cure – Any side effects?

As would be expected, the hiking of the CBR will provide a welcome breather for the KES and help abate inflationary pressure. But like any prescription a malady, the policy cure could come with at the very least a bad after-taste, at the worst some not-so-life-threatening side effects. The CBK's usable forex exchange reserves are equivalent to 4.26 months of imports cover; at the same time the economy has a precautionary facility with the International Monetary Fund (IMF) to provide cushion in the event of temporary shocks. The apparently cautious approach by the CBK to make foreign exchange market interventions implies that it is correctly seeking to deploy a mixture of instruments.

That monetary policy tightening is now part of the package needs to be seen in proper context. The policy stance will have the obvious consequence of stretching the already tight liquidity market. Even though this will put a strain on the economy's growth, the trade-off arising from the pursuit of stability is better seen as a short-term phenomenon.

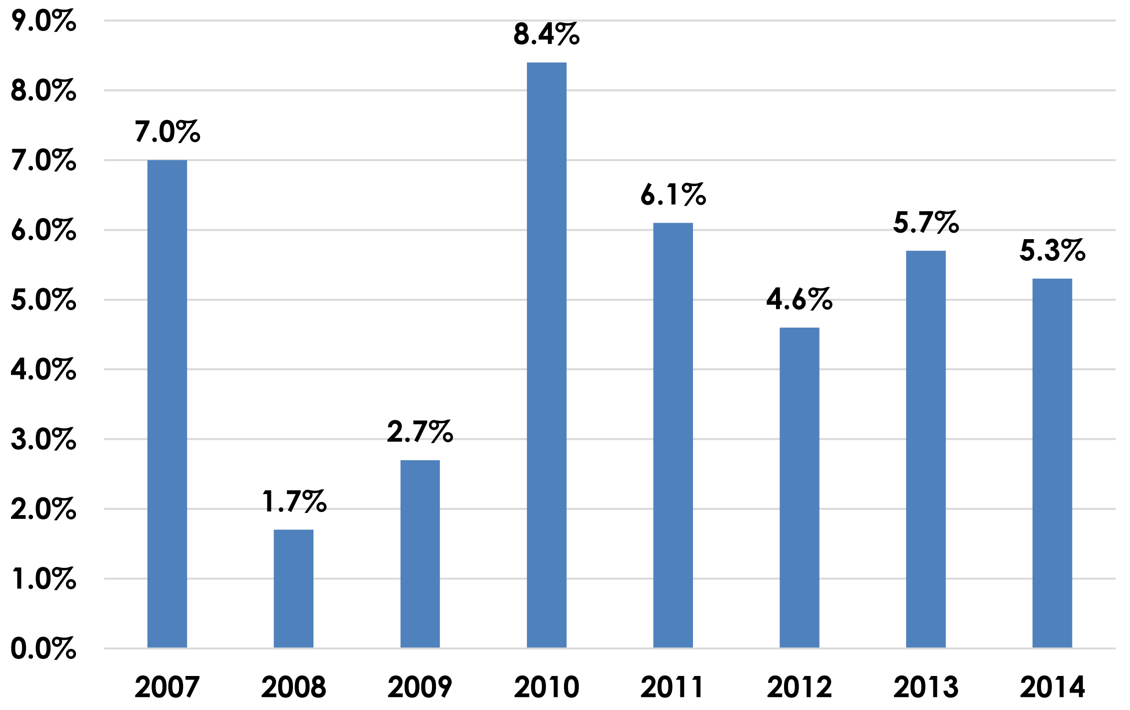
In the same vein, how the monetary policy stance plays out insofar as the external balance is concerned needs some deeper reflections. It is possible that due to policy lags, the pursuit of restoring external balance (the so-called balance of payment equilibrium) through the stabilisation of the exchange rate could end up distorting the internal balance (stable inflation rate) if the ensuing tight credit conditions leads to supply constrains that lead to inflationary pressure.

Further, there could be expectations that with a high interest rates regime, the positive interest rates differential between the domestic market and the international markets will attract resource inflows so long as the currency portrays some stability – the so called uncovered interest rates parity (UIRP).

It is worth noting that to stabilise the external balance through the UIRP channel its constraints. First, the capital market has been performing poorly as evidenced by the recent reclining trend of the key Nairobi Securities Exchange (NSE) indices. This is partly attributable to of the current dividend pay-out period with the foreign investors being net sellers rather than buyers of securities which has further exerted pressure on the shilling.

Secondly for external balance to be restored, the existing domestic rates of return should exceed the foreign rate of return to warrant any investment by foreigners. This calls for a substantial interest rates parity between the domestic rates and the foreign rates which could harm the economy as well through increased domestic cost of credit. The question then is whether the 150 basis points increase in the CBR is sufficient for the UIRP to obtain. In all these dynamics, the possibility of the economy's growth to break past the 6 percent level for 2015 from the 2014's 5.3 percent (**Figure 3**) is increasingly becoming remote.

Figure 3: Real GDP Growth



Source: Kenya National Bureau of Statistics

Any help from abroad?

The global economy presents mixed performance. The US economy seems to be gearing for a normalisation of its monetary policy, a move that is likely to cause jitters in the emerging markets. Eurozone registered a reversal in deflation trends in May 2015 after five months of deflation. The annual Inflation rates as at May 2015 stood at 0.3 percent albeit below the 2 percent European Central Bank (ECB) target; this instils hope for economic recovery after five months of stagnation. However, it's noteworthy that the reversal from deflation is largely underpinned by the quantitative easing programme by the ECB dating back to March 2015 when a 1.1 trillion Euros bond buying programme was kick-started with the goal of drawing back the economy on the rails of growth.

In addition the weak euro compared to the other world hard currencies bolstered exports from the Eurozone thus supporting the rebound in the Eurozone's economic growth. The return towards normal banking in Eurozone has also seen the banks return to lending again following the review of the assets quality in year 2014. Therefore we point out that the positive inflation may not be supported by the rise in the commodity prices given that the core commodities such as energy remain lower than they were before they commenced the recent declining trend.

Another noteworthy development was the conclusion of elections in the UK, where the possibility of a potential Britain exit from the European Union be interpreted to mean seems to have been ignored by the electorate – or even entertained if the Conservative victory could be seen as a sign of sympathy for such exit. This could be unnerving when combined with the challenges that Greece is facing regarding its external debt position.

On the emerging markets front, the contraction in the Russian economy in the future is inevitable given the lagged effect of monetary policy and the fiscal tightening underway in attempts to save the rouble from further depreciation. While India seems to be on the growth path, the other members of the BRICS group – especially Brazil and South Africa seem – to be struggling as China's growth is evidently slowing.

Conclusion

This *Research Note's* foregoing analysis this points to fact that the MPC's momentary policy tightening as signalled by the 150 basis points increase was inevitable and widely expected – whether it be a pre-emotive strategy given that inflation is still within the target range and therefore tightening will ensure it remains so or reactive response given our past arguments that the recent MPC communication past have not sounded the urgency of a change in stance.

The switch of the CBK's messaging from "Managing Risks in the Monetary Policy Path" in its previous pronouncement in May 2015 to "Managing Market Expectations to Ensure Stability" is not a mere nuance. The sense of urgency demonstrated in its decision to tighten monetary policy is a total contrast from the "calmness" (at least on the surface) previously portrayed.

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