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Monetary Policy Stance – The Case for Resisting the Temptation to Change the Policy Stance

Highlights

- As the Central Bank of Kenya's Monetary Policy Committee (MPC) meets on July 30, 2018 there could be an allure to change its policy stance towards further accommodation as could be signalled in a reduction in the Central Bank Rate (CBR).
- We argue that to hold the CBR will be a more persuasive decision. We do so being fully aware that the MPC could try to justify a rate cut on the observation that (a) its past decision has not had any perverse effects – if anything it is gaining traction in the credit market (b) Inflation is within target. These two factors, we contend, run into attribution challenges.

Introduction

As the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) meets on July 30, 2018 the key question in the mind of policy watchers should be: what signal will the Committee be sending in the event of a stance change, whichever direction that may be? The answer depends partly on the interpretation of MPC's read of the economic data and partly on what guidance the MPC wants to give – explicitly or implicitly – regarding its policy evolution beyond the immediate term.

We have argued[1] in the recent past that the MPC decision in March 19, 2018 to lower the Central Bank Rate (CBR) by 50 basis points from 10 percent to 9.5 percent was a policy experiment. The explicit indication then was that the decision could lead to perverse outcomes while hoping that there was scope for easing monetary policy stance "in order to support economic activity"[2].

We have also argued[3] that the MPC has been inclined to seeing normalcy in its policy making environment to the extent of negating its apt observation that "the prevailing uncertainties, including the impact of the interest rate caps on the effectiveness of monetary policy"[4]. It is worth asking: have the perverse outcomes been avoided, thus rendering the accommodative monetary policy effective?

This *Research Note* will make the argument that assuming the March 2018 MPC decision to lower the CBR and the retention of the CBR in May 2018 is an indication of monetary policy effectiveness, and therefore a harbinger for a further reduction, will amount to asymmetric attribution – where any downside outcome is deemed beyond the control of policy but any resemblance of calmness is credited to policy.

In making the argument, we take cognisance of three issues. First is the interplay between the economic performance and outlook on the one hand and inflation expectations on the other. Second is the interplay between fiscal policy and monetary policy. Third is the extent to which the downside risks influence the monetary policy decision.

The Growth and Inflation Story

It is obvious that the MPC, through its pronouncements and decisions, is keen to play its hand on matters beyond macroeconomic stability; the Committee is keen to support growth. It is easy to see why. There is near unanimity that the performance of the economy in 2017 was the weakest we have seen in the recent past – at least over the past five years. The assumption therefore is that the economy is in need of a policy jolt.

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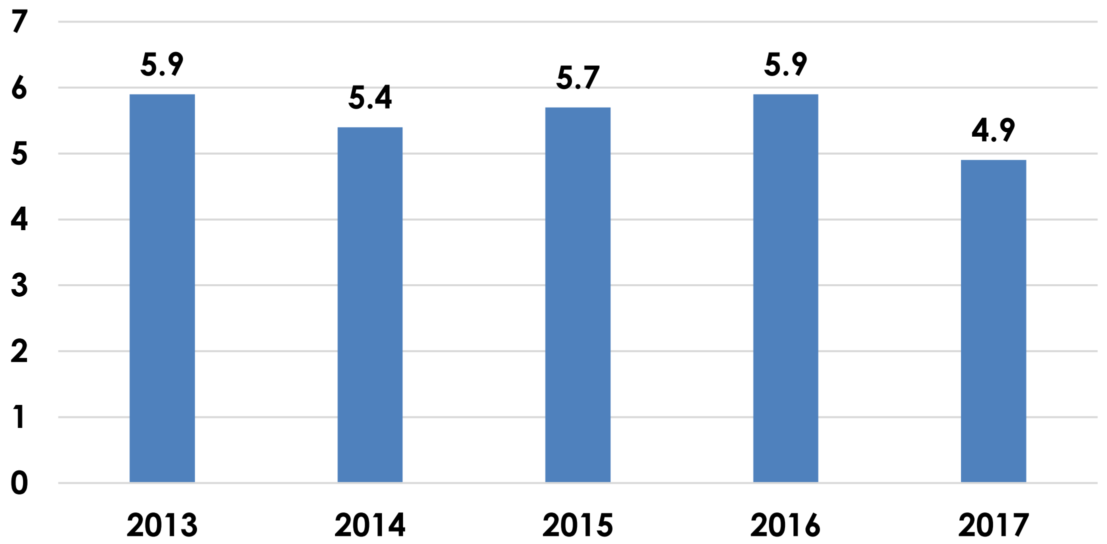
[1] See here (http://www.kba.co.ke/downloads/RN%20No%203%202018.pdf)
[2] See March 19, 2018 MPC decision (https://www.centralbank.go.ke/uploads/mpc_press_release/986102954_MPC%20Press%20Release%20-%20Meeting%20of%20March%2019,%202018.pdf)
[3] See here (http://www.kba.co.ke/downloads/RN%20No%204%202018.pdf)
[4] See March 27, 2018 MPC decision (https://www.centralbank.go.ke/uploads/mpc_press_release/808712593_MPC%20Press%20Release%20-%20Meeting%20of%20March%2027,%202017.pdf)

The fact that the economy has been on a stable or positive growth trajectory hardly blinds us of the fact that the core driver has been public sector investments, mainly in infrastructure. Unlike growth driven by private sector vibrancy, especially if it is characterised by investments, a public expenditure-led growth injects vulnerabilities to the economy if it leads to debt accumulation.

It is an easy argument to make that the space for pumping up more debt slack is getting thinner by the day. Instead, the private sector has more slack to pick up more debt; but credit is flowing in the opposite direction as two recent studies confirm[5]. That businesses are operating at excess capacity seems to be almost the norm. The sequencing of private credit recovery will start with working capital financing until optimal capacity utilisation that will usher demand for investments credit. How then will output growth break the slow pace of 2017 (**Figure 1**) and pick to 5.5 in real terms in 2018?

Figure 1: Real GDP Growth (%)

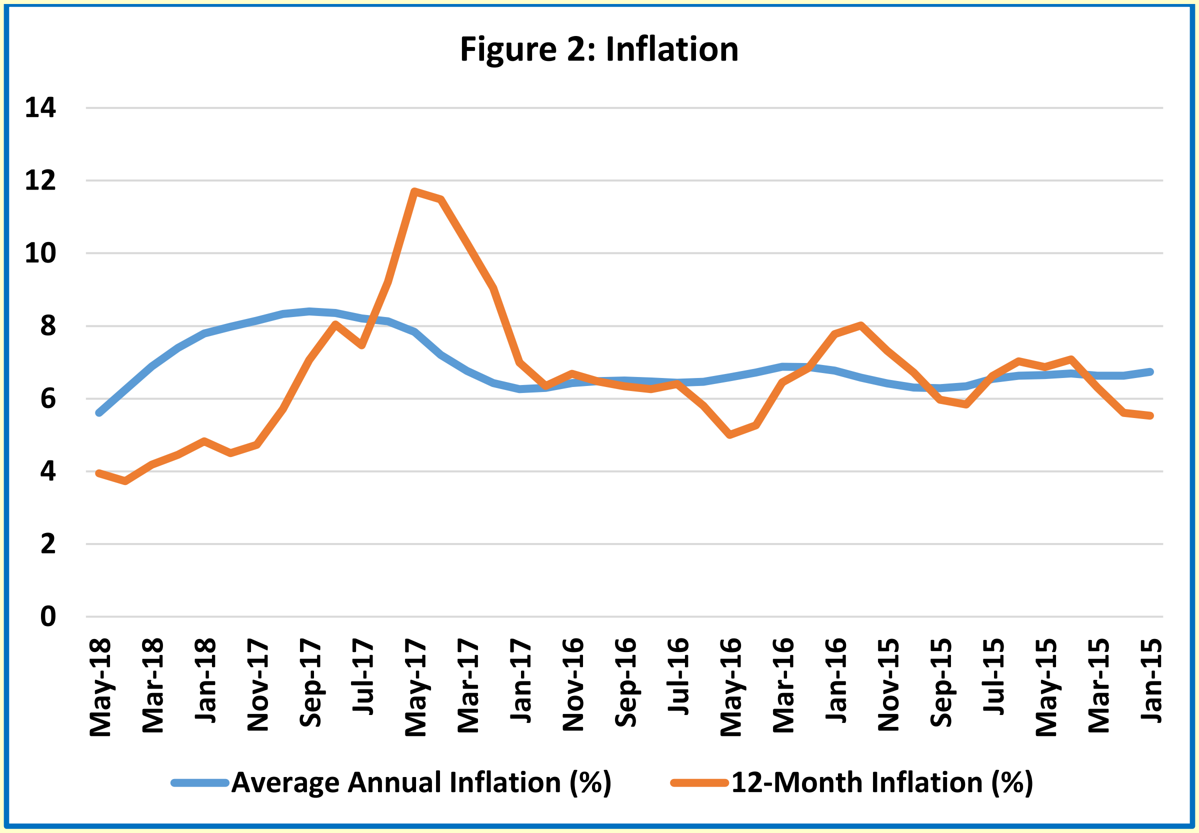


Source: KNBS

First, any resemblance of credit market recovery is a signal that the economy is turning the corner. But for one to ascribe any recovery in credit growth – which still remains very modest – to monetary policy action, one has to control other factors such as the different political environment that what was prevailing at a similar period last year. This will therefore, take one away from the attribution aspects to the contribution aspect of monetary policy of the whole equation.

If we take growth out of the question and assume that the MPC is looking at its mandate from a narrow sense of the price stability objective, then the inflationary trend (**Figure 2**) is a pointer to the growth slack that exists in the economy which can be filled with more credit without the risk of undermining stability.

[5] See and KBA Working Paper No. 17 (here: http://www.kba.co.ke/downloads/WPS%2018.pdf) and KBA Working Paper No. 19 (here: http://www.kba.co.ke/downloads/WPS%2019.pdf)



Source: KNBS

While it is true that inflation is now within the official target range, in the recent past, the MPC has argued that inflation being within the Government target range in the near term is mainly due to expectations of contained food prices following improved weather conditions. That is a correct argument to make.

The steep climb in inflation from 5 percent in May 2016 to 11.7 percent in May 2017 was substantially driven by food prices; the subsequent decline to 3.7 percent in April 2018 must confront fiscal policy proposals in form of taxes that will have direct effect on prices in the Consumer Price Index (CPI) basket. Just as was the case during the high inflation, the traction of monetary policy for supply-side constraints is at best limited.

Ultimately, therefore, both growth – and the view that there hasn't been any adverse effects of the March 2018 decision – and the low inflation trajectory that has not taken into account the July 2017 inflation data and that is largely food-driven, shouldn't be read as an opportunity for further policy monetary accommodation. Taken together with the other, mainly but not exclusively external down side risks highlighted subsequently, a continued policy pause seems the most reasonable policy decision.

Vulnerabilities

Amidst cautions of optimism, the global economy is wobbly. According to the IMF's World Economic Outlook (WEO)[6] of April 2018, the global economic upswing that commenced around mid – 2016 is now broader and stronger. Advanced economies are expected to continue to expand above their potential growth rate over the next two years. Emerging and developing economies on their part will realise increased growth before it levels off.

The report adds, though that global growth can be more durable if policy makers are proactive, thus potentially obviating the next downturn. But as is the case in any good projection that must be buttressed by assumptions whose reasonableness has to be validated, the IMF's WEO didn't have to wait long before a revision was effected in July 2018. The message now while the global economy's growth is still strong, it is less even, more fragile, and under threat.

Economies in the Euro Zone, Japan, and the United Kingdom have experienced slow growth. Even in the US where output continues to grow faster than the potential and job creation is still robust, thanks in large part by recent tax cuts and increased government spending, the long cyclical recovery will run its course and the effects of temporary fiscal stimulus will wane. All these are not the critical pain points that calls for vigilance.

One are of potential pain is the policy direction of the Federal Reserve, an institution that is critical in global financial developments. Going by the strong US employment and firming inflation, the Fed is likely to sustain its interest rates hiking over the next two years; its monetary policy stance is likely to be tighter than that of other advanced economies.

One effect of such policy move will be the strengthening the US dollar. The dollar has been on an appreciation trend since the commencement of the second quarter of 2018. More critically, the financial conditions facing emerging and frontier economies are increasingly becoming somewhat more restrictive. While some could argue that these financial conditions are relatively benign when taken in a historical context, if the Fed were to tighten faster than is currently expected, a broader range of countries could feel more intense pressures.

The bigger threat is likely to emerge from the current trade tensions. The United States has initiated trade actions affecting a broad group of countries, and now faces retaliation or retaliatory threats from China, the European Union, its North Atlantic Free Trade Area (NAFTA) partners, and Japan, among others. The likely effect of all these will likely be on the waning market confidence, with knock-on effect on asset prices, and investment with the attendant threat to global growth.

There are good reasons why this should be of concern for anybody projecting Kenya's growth, at least in the near term. To the extent that emerging markets literally dragged the global economy in a positive sense during the global economic meltdown such that as the US and the rest of the so-called G7 were at best crawling while some of the emerging

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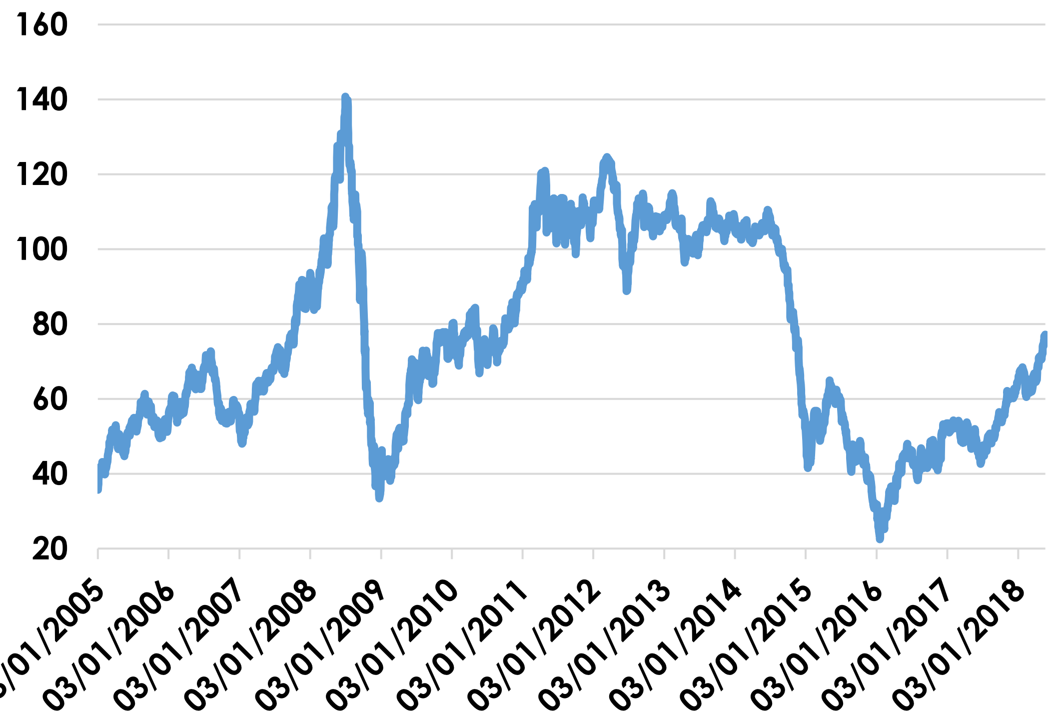
[6] See IMF – WEO, April 2018 (here: http://www.imf.org/en/Publications/WEO/Issues/2018/03/20/world-economic-outlook-april-2018)

market economies – especially China – registered robust performance implies that they are now systemically very important.

It is worth noting that Kenya's ties to the Sub-Saharan Africa are strengthening, and arguably becoming stronger than those to the rest of the world. As a recent study confirms[7], Sub-Saharan Africa's business cycle has not only moved in the same direction as that of the rest of the world, but has also gradually drifted away from the G7 in favour of the so called BRICs – Brazil, Russia, India and China. Trade with the BRICs turns out to be the strongest driver of this observed shift. Therefore the challenges currently facing the emerging markets as outlined should be seen as having potential adverse effects that could be more than mild.

Beyond trade, global developments are playing into the local economy. Supply disruptions and geopolitical tensions have helped raise oil prices (**Figure 3**), benefiting emerging oil exporters such as Russia and Middle Eastern suppliers but harming importers such as India, Kenya and other net importers.

Figure 3: OPEC Basket Price (USD/Barrel)



Source: OPEC

It is possible that the rising oil prices will feed into Kenya's import bill and jeopardise the projected further closing of the economy's current account. It is possible too that if the oil prices, augmented by the fiscal measures in form of taxes on consumables including oil products, filters into inflation, then the hand of the Central Bank of Kenya (CBK) will be moved towards monetary policy tightening.

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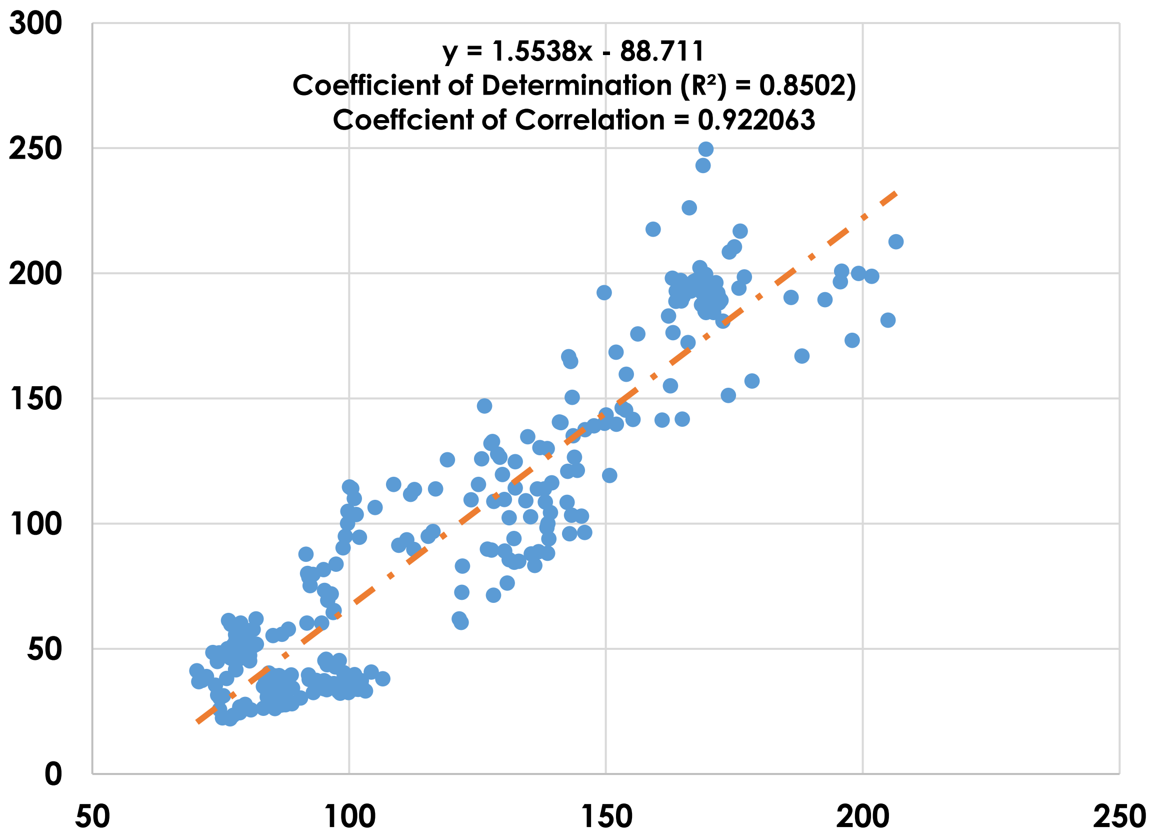
[7] Oumar Diallo ; Sampawende J.-A. Tapsoba (2014), "*Rising BRICs and Changes in Sub-Saharan Africa's Business Cycle Patterns*", *IMF Working Paper No 14/35.*

Even then, it could be observed that the increase in oil prices is not all gloom and doom. Then fact that there is a very strong association between oil and non-oil prices (**Figure 4**) simply means that some of the Kenyan exports will benefit from rising prices. In essence, the two effects could offset each other.

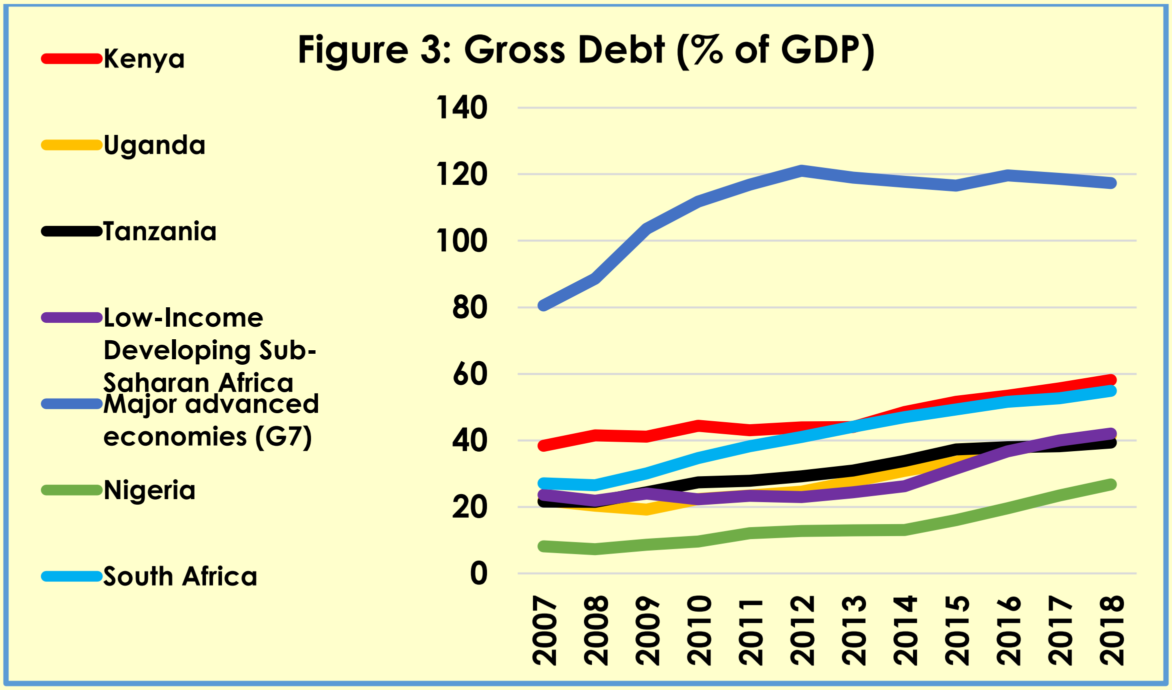
Figure 4: Association between Fuel (Energy) Index and Non-Fuel Price Index (Jan 1992 - June 2018); 2005 = 100



Source: IMF

If all the other parameters are exogenous, then the levers for growth influence are in the macro policy. Fiscal policy remains expansionary, even with the promise – now looking like a wish - of fiscal consolidation. Unless either expenditure gives (or we now have a presidential directive that ceases all new projects) or revenue mobilisation is enhanced (and we can argue that the difficulties for that are manifest in the tax measures that could be counterproductive and counterintuitive to economic growth), public debt will be the resort.

As already alluded, the scope for increased public debt is evidently small. The economy's debt as a share of output, while substantially below that of advanced economies, is well above the regional partners and emerging markets such as South Africa (**Figure 5**. It is the characteristics of the debt, not merely the absolute amount that is a source of worry. It is increasingly commercial, and the average tenor is decreasing. That means the amount of resource requirement for debt service is higher to the extent of eating into resources that could be channelled into social services.



Source: IMF Fiscal Monitor

For what it is worth, a distress should not be seen only in default but can be signalled by the opportunity cost in terms of what social priorities could be forgone as the economy meets its debt obligations. Does this then leave the task of boosting growth in the hands of the CBK through monetary policy conduct?

It is Apparent that the CBK is keen to ensure that market liquidity in the financial system, when not inflationary, is a boost to the sagging credit growth. The accommodative policy bias doesn't seem to have led to the private sector credit growth to pick. Taking all the above into account, it is highly probable that the economy's performance prospects could be good; but vigilance on the downside risks, both local and external, is critical in guiding monetary policy.

Conclusion

Based on the foregoing, we can conclude that to hold the CBR will be a persuasive decision. We do so while fully aware that the MPC could try to justify a rate cut on the observation that (a) its past decision has not had any perverse effects – if anything it is gaining traction in the credit market (b) Inflation is within target. These two factors, as we have argued, run into attribution challenges.

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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