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Monetary Policy Stance – The Juggling Game

Highlights

- The Central Bank of Kenya's Monetary Policy Committee meeting of March 27, 2019 could as well convey its typical positivity while sprinkling a dose of downside risks, mainly external. We make three arguments in this *Research Note*:
    - First, it will be stretching to assume normalcy in the environment against which the policy decision will be taken. The limitations of monetary policy ought to be acknowledged.
    - Two, the economy has a growth conundrum that monetary policy on its own cannot unravel.
    - Three, the perverse outcomes of the recent accommodative policy stance are discernible from the growth of credit to the private sector that is now stuck at low single digit levels and not heeding the policy nudging.
- The justifiable decision in the MPC is therefore to hold the CBR at 9.00 percent. The neutral stance will be an implicit sign that as the evidence of perverse outcomes become clear, the digging has to stop.

Introduction

Under normal circumstances, monetary policy is an important lever that can influence the course of the economy. In the immediate to medium term a given monetary policy stance can propel the economy towards its optimal level of performance on account of its ability to manage demand conditions.

The ability to do so is often analogised as a car whose speed the monetary policy committee (MPC) – the driver – manages through pressing the accelerator or brake pedal (which is interesting the same pedal called the policy signalling rate that is either increased, decreased or left unchanged).

But even when the circumstances are normal, the car has never been perfect analogy. And as we argue in this *Research Note*, our circumstances are anything but normal. Thus, any monetary policy action has to be a juggling game.

First the car. A real-world driver has a better information set – knowing the exact speed of the car and the state of the road – than a policy policymaker seeking to keep the economy from veering off the road or getting it back to the road. There are leading indicators at hand; but that is to cover for the sometimes long time lags before actual information – especially the actual rate of growth of the economy – is available.

Then there the issue of how the policy signalling rate may not be aligned to private sector expectations especially regarding investments of a longer-term nature being hinged on a pedal that has a short-term orientation.

Expectations on monetary policy are shaped by different things. Whenever the MPC of the Central Bank of Kenya (CBK) holds its scheduled meetings those with strong views (meant to at the very best shape the policy outcome, at the very least influence market expectations) have in the recent past taken a narrow view of seeing the policy decision as singularly meant to offer reprieve to borrowers.

There is no reason to imagine that populism often gives way to realism; therefore, popular expectations of the decision by the CBK's MPC in its meeting of March 27, 2019 will not be any different. Commentary, especially amongst punditry in the Business Media corp, will predictably link the decision to the cost of credit with at best limited attention to the whether such cost will help the credit market get back to the road from where it has over the past three years veered off.

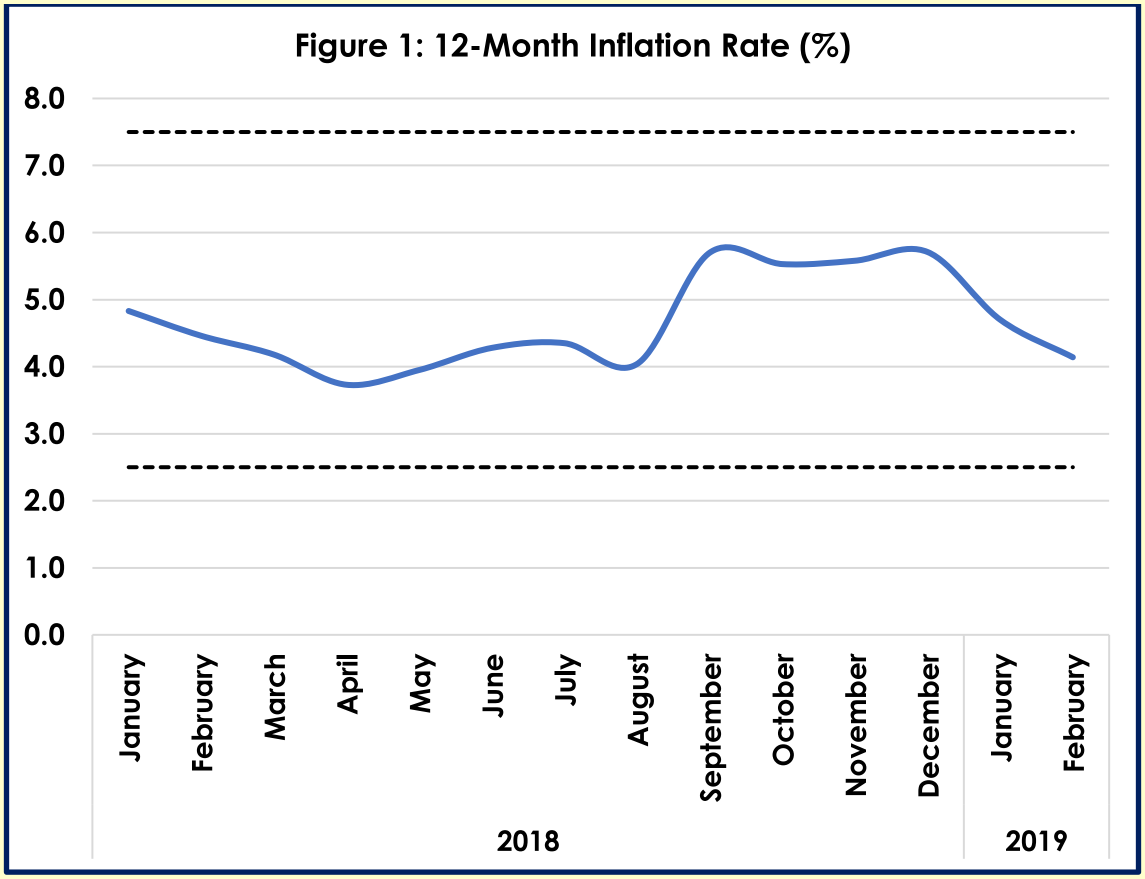
Such viewpoint inadvertently underpins the notion that all is well and that monetary policy under the present credit pricing regime characterised by interest rates capping law that came into effect in September 2016 can still come to the rescue of the credit market. In the process the fact that the signalling effect of monetary policy is forward looking missed.

If the car analogy is not perfect, so is the assumption that monetary policy conduct is on the back of conditions that depict normalcy. As this *Note* argues, whilst it is tempting to assume normalcy, there is every reason to exercise caution. Therefore, in the juggling game, the monetary policy that stands to pass the test of realism will be to hold the central bank rate (CBR) at its current level of 9.00 percent.

The Temptation

It is clear that the MPC keenly watches the trend of inflation as a basis for determining that its past decisions have influenced expectations and that it is anchored to the targeted range. As **Figure 1** indicates, headline inflation is within target range.

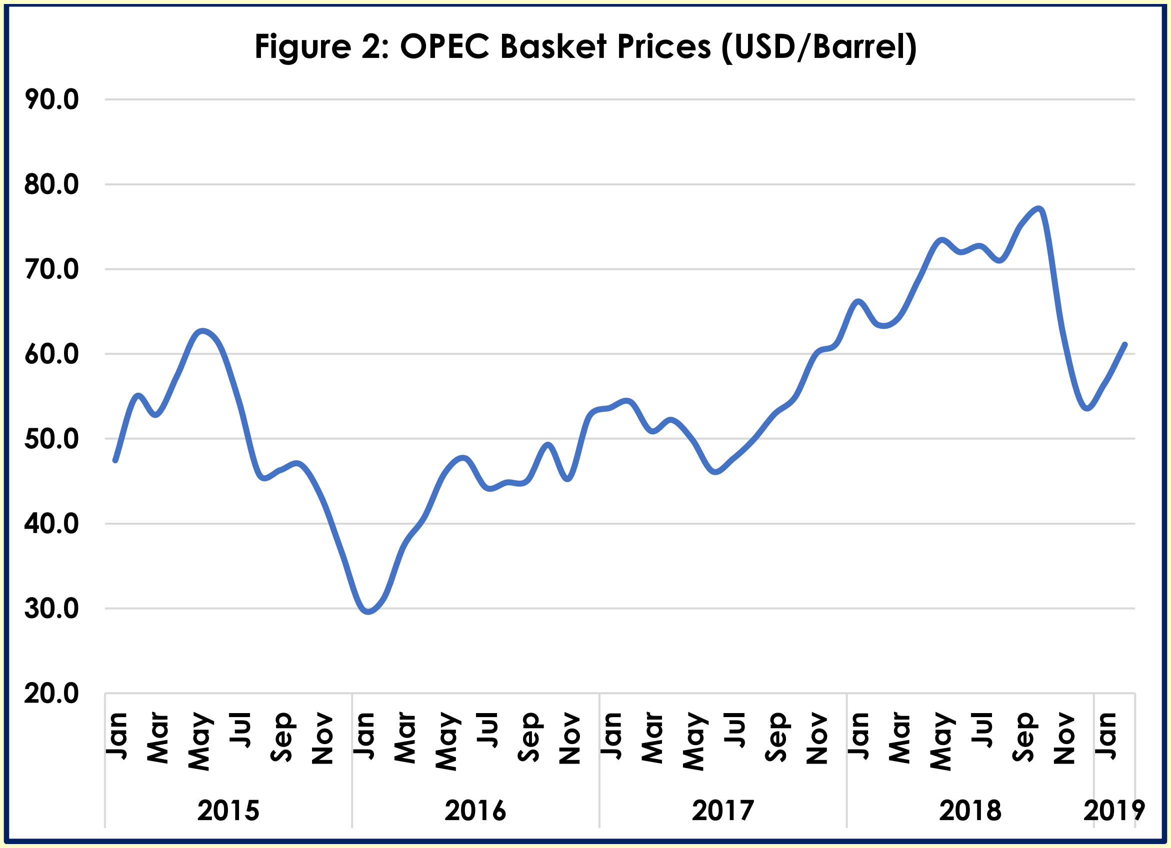
The inflation trend is in many respects supply leaning, being driven substantially by the food component of the consumer price index (CPI). Against the background of low demand as could be inferred from the non-food-non-fuel inflation, the low inflation is a sign of adequate food supply.



Source: Kenya National Bureau of Statistics

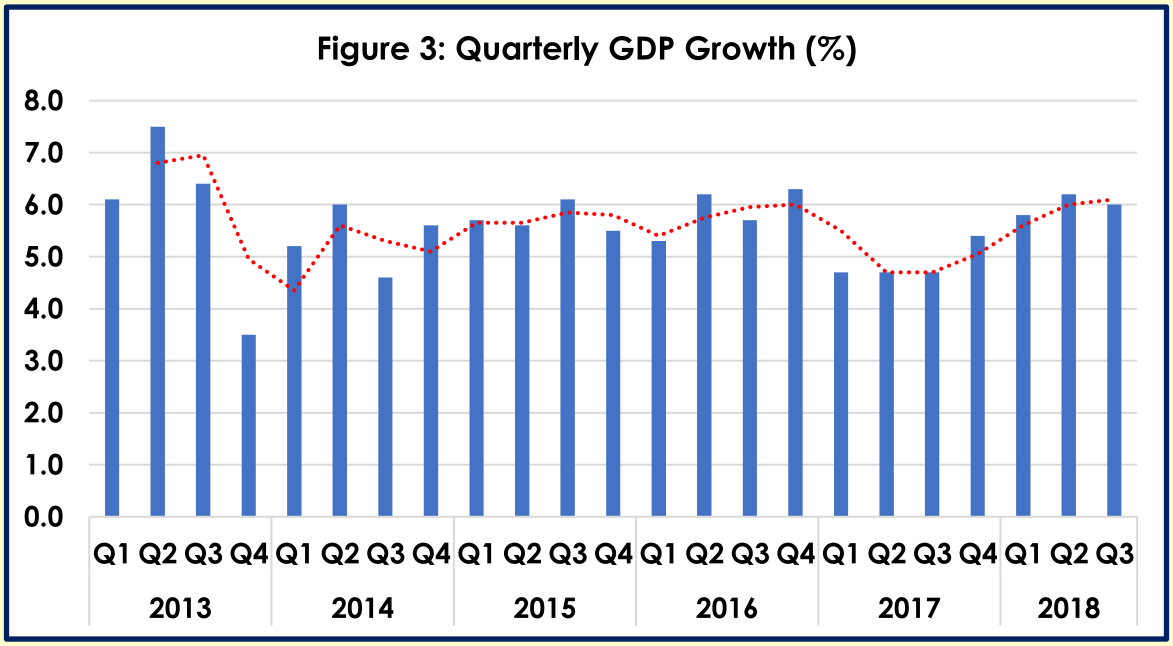
It is evident that tradable goods have had a muted effect on inflation especially considering that the pass-through effect of imports is on the back of a stable currency. At the same time, while the international oil prices have taken an upward trajectory moving from USD54 per barrel in December 2018 to about USD 61 per barrel by the end of February (**Figure 2**), it worth watching whether the trend will be sustained.

While the trend may well be sustained given the commitment of organisations such as the organisation of petroleum exporting countries (OPEC) committing to output cuts (supply side conditions), its pace towards the high of USD 77 per barrel seen in October 2018 will be influenced by the projected slowdown of the global economy that may affect demand (demand side conditions).



Source: OPEC

With the macroeconomic environment exhibiting stability, the other attribute that can tempt a conjecture of normalcy is real output performance. **Figure 3** demonstrates a growth trend that anchors a bullish growth outlook. Arguably, the outlook is too optimistic to the extent of being unrealistic.



Source: Kenya National Bureau of Statistics

The fact that the real output trend is positive and the outlook for 2019 is aligned to the trend, an argument that the economy's output gap – the difference between actual growth and potential growth – is fast narrowing is emerging. Espousing such argument requires some further perspectives if it has to hold ground.

First, when the negative output gap is shrinking, one needs to look at whether that is accompanied by heightened demand and therefore potential for demand-driven inflation going forward. As alluded, weak demand-fed inflation is apparent.

Secondly, if indeed the growth output trajectory is the underpinning rationale why the output gap is narrowing, then the closure presents a conundrum as it happens on the back of a continual dwindling of the rate of the rate of growth of credit to the private sector by banks.

Third is that the expansionary fiscal policy is at the centre of growth, then there is a missing explanation as to why it is not stimulating demand. Even on the back of the government embarking on fiscal consolidation, concerns around management and usage of public funds, while legitimate, demonstrates how the effects of fiscal policy are seen with the expenditure lens without a balance of equally seeing it from a revenue mobilisation lens.

It is an open question whether the fiscal consolidation will be realised on the back of tax revenue targets being consistently missed and the expenditure rationalisation leaning towards the cutting of non-recurrent expenditure.

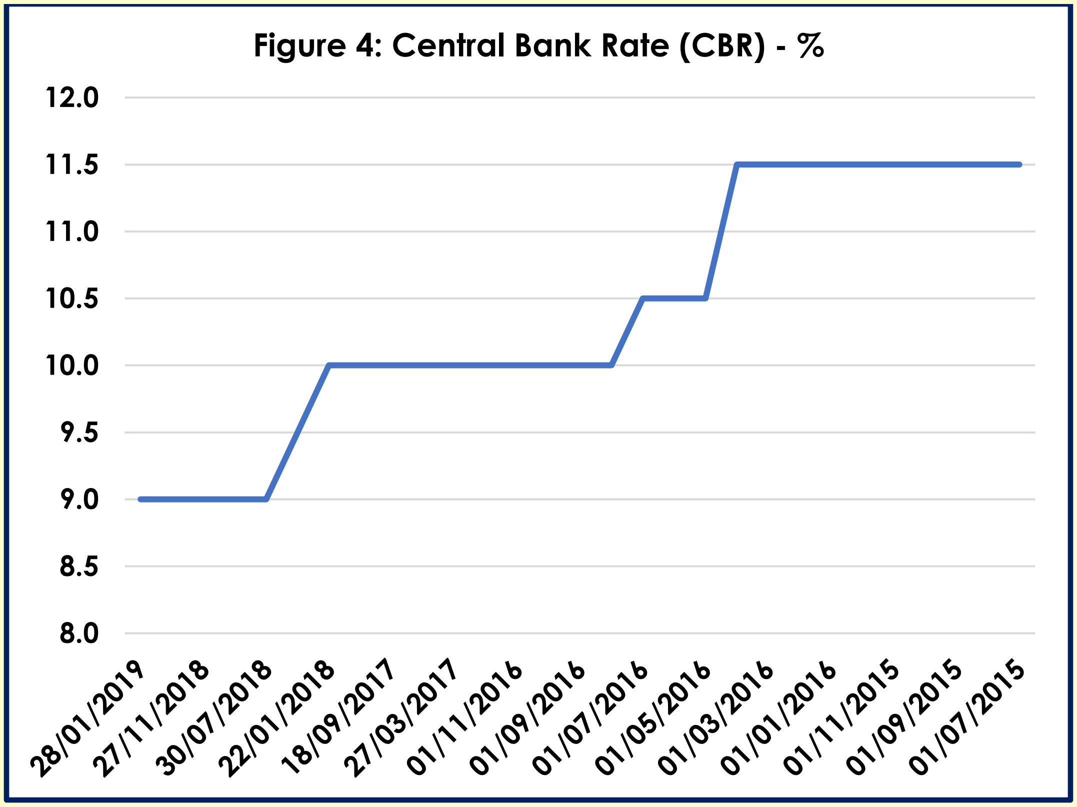
Is this an invitation for monetary policy to come to the rescue? The answer lies in acknowledging the limitations of monetary policy in our case such that its deployment amounts to staking its credibility with limited commensurate return in terms of policy objective being realised. It doesn't help that the external environment is worth watching, and the MPC has had its eyes trained on the developments on that front.

The last six months have been increasingly challenging for the global economy, leading to the International Monetary Fund (IMF) being extremely cautious in its outlook and therefore being keen in reviewing regularly its *World Economic Outlook*. The changes are to a large extent the result of greater volatility and uncertainty, and they present a higher risk for the global economy in 2019.

The effects of the US-China trade war have started being felt, and they are spilling over to both developed and emerging markets. This is taking place when China is showing clear signs of growth slowdown; for an economy that is now systemically important, that has implications on the global economic performance. Further, there are all signs that Brexit is not likely to be smooth. The ramifications are likely to be binding across the European Union and therefore not restricted to the United Kingdom.

Not for Lack of Trying

Even with acknowledged limitations, monetary policy has been in play over the last two years. The easing cycle seen over the period has solely been aimed at restoring vibrancy in the credit market; the neutral stance in between the accommodative monetary policy period are meant to allow time for the intentions of decisions to fully transmitted. The easing was observably emphatic in 2016 and 2018 (**Figure 4**).



Source: Central Bank of Kenya

The MPC has been crystal clear about its policy intentions. On September 20, 2016, the concern was the sustained reduction in the rate of private sector credit growth, thus the need to offer some acceleration power. The fact that the market didn't respond was lost in the further accommodative stances although the subsequent decisions we qualified with the observation that they may lead to perverse outcomes.

As should be obvious, the continued decline of the rate of private sector credit growth is a pointer to the perverse outcomes and an invitation to evaluate the assumptions that such outcomes have violated. Let's step back to September 2016.

The MPC's decision to signal a reduction in interest rates came only a week after the new banking law comes to effect. The new law had delivered a reduction in lending rates in a magnitude way higher that the CBR reduction. That the MPC was compelled to signal a further reduction can only mean that in its view the first round of reduction is not adequate to spur credit growth.

In hindsight, there was a glaring contradiction in expectations management in the sense that the MPC is sized of the need for time to assess the impact of the new law, and it says as much. At the same time, Committee assumes a credit demand function that is very price sensitive even in circumstances of market anxiety. In view of the observed contradiction was an obviously limiting assumption.

While typically the central bank's decisions are assumed to be backed by a set of information that is superior to that of the private sector, the signalling of policy is impaired by the contradiction and the limiting assumption on the price responsiveness of credit. The expectations management therefore is blurred.

To the wider public and the political class, the MPC decision have been seen as a decisive demonstration of the delivery of the desired low cost of credit. To the financial sector however, the decision comes at a time of adjustment and have Somewhat unsettle the ability to efficiently transmit policy signal.

Amidst the policy limitations, growth conundrum and external constraints as motivated above, the justifiable decision in the MPC meeting of March 27, 2019 is to hold the CBR at 9.00 percent. The neutral stance will be an implicit sign that as the perverse outcomes become clear, the digging has to stop.

Conclusion

The Central Bank of Kenya's Monetary Policy Committee meeting of March 27, 2019 could as well convey its typical positivity while sprinkling a dose of downside risks, mainly external. We make three arguments in this Research Note: First, it will be stretching to assume normalcy in the environment against which the policy decision will be taken. The limitations of monetary policy ought to be acknowledged. Second, the economy has a growth conundrum that monetary policy on its own cannot unravel. Three, the perverse outcomes of the recent accommodative policy stance are discernible from the growth of credit to the private sector that is now stuck at low single digit levels and not heeding the policy nudging. The justifiable decision in the MPC is therefore to hold the CBR at 9.00 percent. The neutral stance will be an implicit sign that as the perverse outcomes become clear, the digging has to stop.

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