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Monetary Policy Stance – The Quandary

Highlights

- The predictability of the Central Bank of Kenya's Monetary Policy Committee's decision to hold the CBR at 10.0 percent in its May 29, 2017 meeting was largely due to the policy dilemma that it can barely admit is binding. Nothing illustrates that dilemma better than the fact that:
    - One, a tighter monetary policy has no fire power to counter inflationary pressure;
    - Two, an accommodative monetary policy, which conceptually cannot be justifiable amidst inflation pressure, cannot spur momentum in the sagging private sector credit expansion.
- On the back of this dilemma, the Monetary Policy Committee resorts to giving hope; unfortunately hope is not a policy tool.

Introduction

The Central Bank of Kenya's recent conduct of monetary policy has been interesting than many are willing to admit. The policy stance as expressly signalled by its Monetary Policy Committee (MPC) decisions regarding the Central Bank Rate (CBR) brings out two aspects, both of which speaking to the limits that confront monetary policy in the current market circumstances.

The first aspect is that the pause in the monetary policy stance – reflected in the CBR being retained at 10.0 percent in five consecutive MPC meetings held since September 2016 – is largely involuntary. This is especially so post-February 2017 when inflation broke loose from its official 2.5 percent – 7.5 percent target range. Before then, MPC's decisions were meant to "anchor inflation expectations"[1].

Subsequently though, the core messaging has been that the non-food-non-fuel (NFNF) inflation, usually a reflection of demand pressure, is muted. In other words, the MPC is sending a message that the "core" (as the NFNF inflation is referred to) is just fine. The MPC is sending a message too that if the core is fine, then monetary policy has to give way for other interventions – policy or otherwise – to help address inflationary pressure.

The second aspect, which draws from the first, is that the MPC's communication of its policy intentions is characterised by less candour, hence the compelling need for some decoding that will lead us to the viewpoint that it is confronted more by a policy dilemma (damned if I change stance, damned if I don't change the stance) than the challenge of a policy balancing act amongst the short run to medium term trade-offs of stability and growth.

Discreetly, anchoring inflation expectations has left the scene and the void is filled by "recent rains and interventions by Government are expected to provide some relief"[2]. At the very least, this is the closest one can come to drawing on the 1923 wisdom of John Maynard Keynes[3] that "economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us than when the storm is long past the ocean is flat again".

As this *Research Note* argues, the predictability of the MPC's decision to hold the CBR at 10.0 percent in its May 29, 2017 meeting was largely due to the policy dilemma that it can barely admit is binding. Nothing illustrates that dilemma better than the fact that:

- One, a tighter monetary policy has no fire power to counter inflationary pressure;
- Two, an accommodative monetary policy, which conceptually cannot be justifiable amidst inflation pressure, cannot spur momentum in the sagging private sector credit expansion.

On the back of this dilemma, the MPC resorts to giving hope. Whilst painting a very unclear – even contradictory – message regarding the overall state of private sector credit, the MPC is hopeful that the dampened private sector growth expectations will be more than compensated by the public expenditure programme targeting infrastructure. This motivates the question: how far will the public expenditure-led growth take the economy amidst what we have previously described as a "policy conundrum"[4]?

[1] See MPC communique of January 30, 2017.
[https://www.centralbank.go.ke/uploads/mpc_press_release/239547611_MPC%20Press%20Release%20-%20Meeting%20of%20January%2030,%202017.pdf]

[2] See MPC communique of May 29, 2017.
[https://www.centralbank.go.ke/uploads/mpc_press_release/1017399013_MPC%20Press%20Release%20-%20Meeting%20of%20May%2029%202017.pdf]

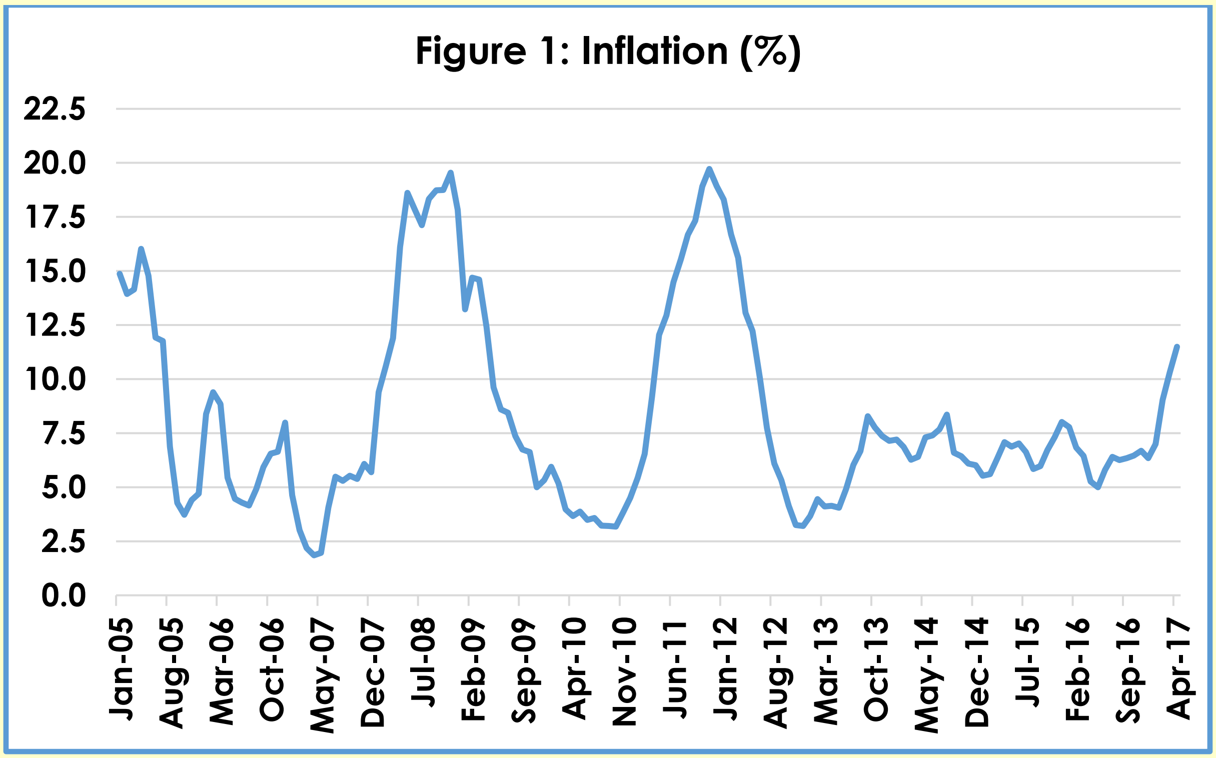
[3] Keynes, J.M (1923), *A Tract on Monetary Reform*.
[4] See http://www.kba.co.ke/downloads/RN%20No%202%202017.pdf

Revisiting old fights?

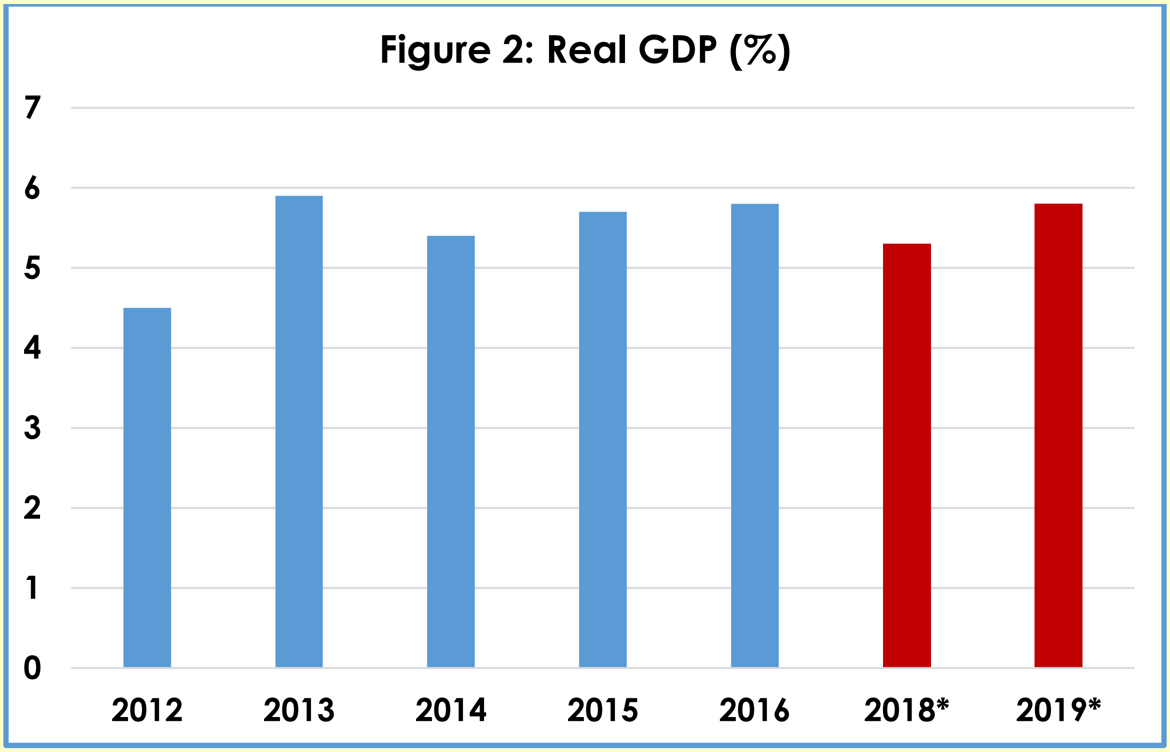
It is a fact that inflation in Kenya is now well above the official target (**Figure 1**). The MPC's forecast is that "overall inflation is expected to remain above the Government target range in the near term due to elevated prices of some food items". But the MPC is emphatic that" the prevailing monetary policy stance has reduced the threat of demand driven inflation". Its message is clear: when it comes to inflation, we have a supply problem and not a demand problem. And the MPC is right.

We argue though than the problem is bigger than that. Our contention here is that the paradox of scarcity amidst growth is not being confronted. If the economy's output growth – which has variedly been described as resilient, robust or even strong depending on the describer and/or audience – is on a positive trajectory (**Figure 2**), why do we have food shortages that have necessitated fiscal interventions?

The MPC has an answer: it is all about "the ongoing public infrastructure development". If this "will continue to spur growth", then there is the uncomfortable assumption that the multiplier effect of such investments will spur production with a time lag, for infrastructure is not an output but an input into production.



Source: Kenya National Bureau of Statistics



*Source: Kenya National Bureau of Statistics (Economic Survey 2017); *IMF Projections*

Figures 1 and 2 tell an interesting story. On the inflation front, we are by no means in an unprecedented space; even in the recent past (January 2008 – August 2009), March 2011 – July 2012) we have had inflation spiralling out of target, only to revert back after some painful policy decisions. During these past inflationary incidences, economic growth has been mixed; not being strong (the post 2007/2008 politically inflicted economic damage), and being relatively better (2011/12) output performance that represented a rallying amidst global challenges post the global financial crisis.

Just as has been the assertion in advanced economies that inflation has been conquered (and the bigger threat has been deflation), we can say that the period August 2012 to January 2017 was characterised by the inflation target being met and the CBK seeking to entrench its inflation expectations' anchoring credentials.

If in the current circumstances we have projected growth amidst production and inflationary challenges, is this an in invitation to revisit the old inflation-economic growth nexus debate? Not necessarily because, when one takes a longer term perspective, high inflation is associated with low growth and the end of such a high inflation is associated with high growth[5].

How about re-opening the debate on what is the appropriate level of the inflation target? There are those who have attempted to have the a discussion that seem to make the case for "moderate" inflation and how that relates to growth, conforming the challenge of determining what could be universally defined as "moderate" and ending up concluding that such pursuit could be misguided[6].

Even if we were to entertain a conceptually appealing argument that target differentials are necessary deepening on the level of development of an economy – and in effect the extent of

[5] See for instance Bruno, M. and Easterly, W. (1998)," Inflation crises and long-run growth", *Journal of Monetary Economics* Vol 41, pp. 3 - 26; [https://williameasterly.files.wordpress.com/2010/08/18_easterly_bruno_inflationcrisesandlongrungrowth_prp.pdf]

[6] Such thoughts are debunked by, for instance, Marty A.L. and Thornton, D. L. (1995), "Is There a Case for "Moderate" Inflation?", *Review*, Federal Reserve Bank of St. Louis, July/ August. [http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.174.2446&rep=rep1&type=pdf]

monetary policy sophistication – any levels of inflation thresholds in the double digit levels are detrimental for growth; some studies have estimated such threshold to be 1 percent to 3 percent for developed economies and 7 percent to 12 percent for developing economies, above which inflation is detrimental for growth[7].

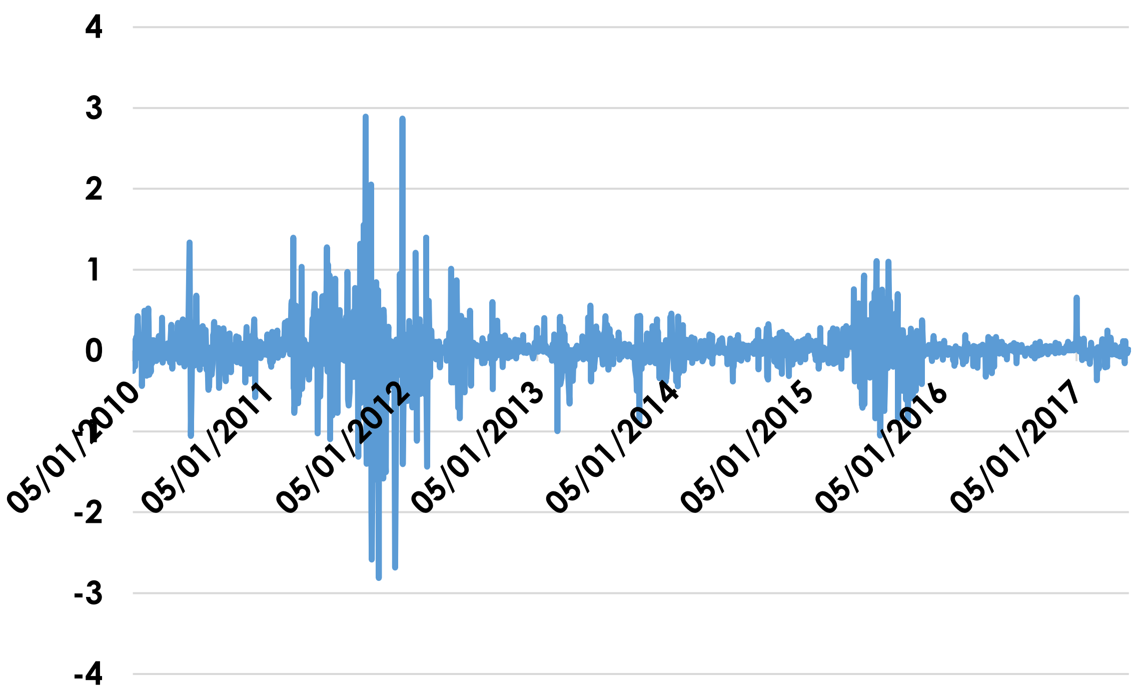
It is as much delusional therefore to imagine that as an economy we can tolerate double digit inflation as it is to imagine that time will sort things out; "for in the long run we are all dead", meaning that the policy dilemma and paradox already outlined need not only be acknowledged but confronted. The question then is: where do we start from?

Strong External Balance: Can we say the same of the Domestic Balance?

A good starting point is to have a balanced view regarding the overall stability from both the external and domestic front. The MPC posits, correctly, that the foreign exchange market has remained stable (**Figure 3**); it points put to both the adequacy of foreign reserves and the narrowing of the current account deficit.

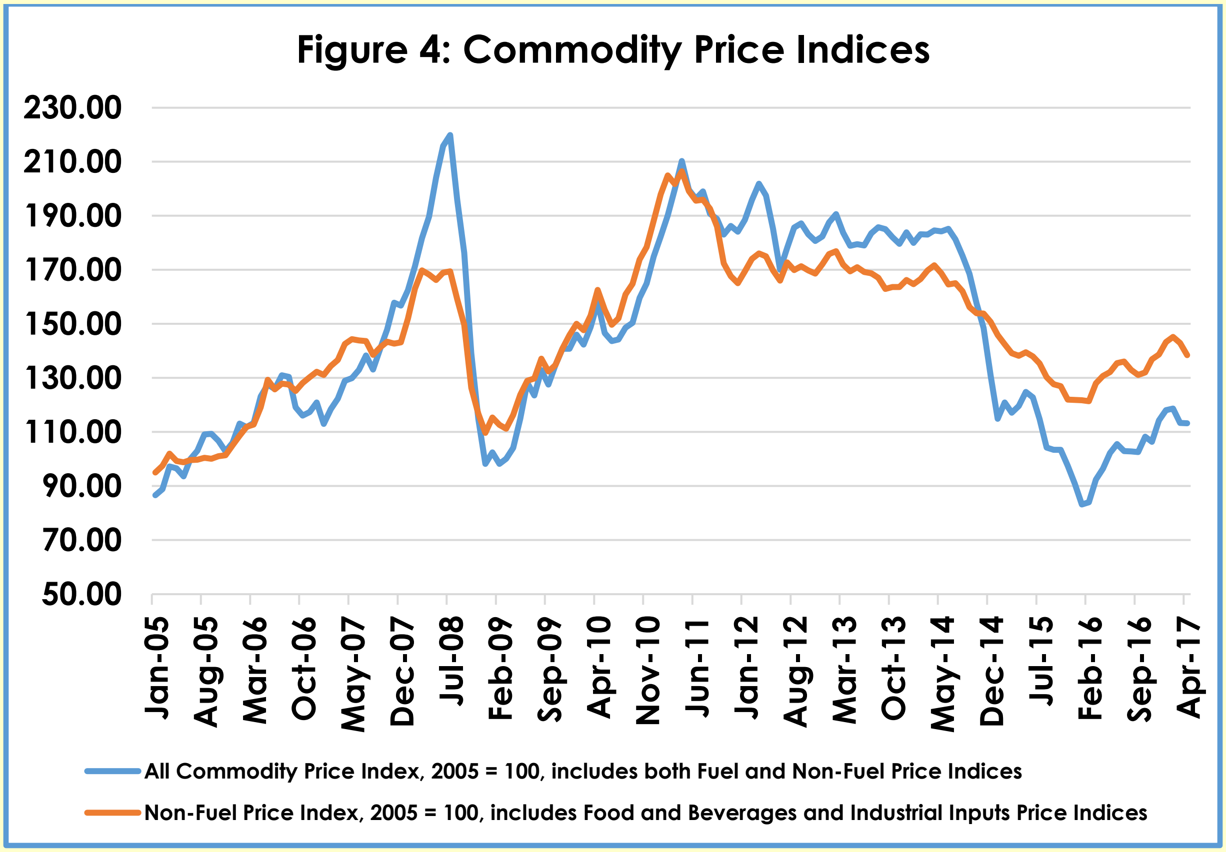
Even as this is the case, the MPC acknowledges the external risks associated with policy uncertainties underpinned by global geopolitics. We would add to this the fact that the recovery of the commodity prices will take a while before hitting the 2011 – 2014 levels (**Figure 4**).

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



Source: CBK

[7] See Khan M. S. and Senhadjil. A. S. (2000), "Threshold Effects in the Relationship between Inflation and Growth", *IMF Working Paper* WP/00/110, June. [https://www.imf.org/external/pubs/ft/wp/2000/wp00110.pdf]



Source: IMF

Just as the external balance and the attendant risks are of immediate policy concern, the domestic balance is as critical as it is the other side of the same coin[8]. The predictability of the government borrowing programme and the stability of the yield curve as acknowledged by MPC are necessarily but far from sufficient in assuring the external-domestic balance.

The distortionary effect of the interest rate capping on the yield curve – as the lower end of the curve is not in the negative real yield territory and the upper end of capped negates the advantages that come with the yield curve stability; stability is not synonymous to being static, for the latter is what the interest rate capping prescribes.

Without this balanced view even the MPC's promise that "stands ready to take additional measures as necessary", meant to imply that even amidst its hands clearly tied by the policy quandary it is still doing something, may be a pursuit in vain.

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[8] This argument is well developed in Stanley Fischer, S and Easterly, W. (1990), "The Economics of the Government Budget Constraint", *The World Bank Research Observer* vol. 5. No. 2, July pp. 127 – 142. [http://www1.worldbank.org/publicsector/pe/pfma06/easterly.pdf]

Conclusion

From the foregoing, we can see not just a policy challenge but an economic quagmire that one policy measure cannot untangle. Thus, the predictability of the MPC's decision to hold the CBR at 10.0 percent in its May 29, 2017 meeting can be seen as being largely due to the policy dilemma that it can barely admit is binding. If there was enough candour, then the MPC could have come close to the *so-what-do-you-expect-us-to-do* moment. Its lack thereof means that the MPC can only resort to preaching hope, which hope has never been a policy tool.

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