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Monetary Policy Stance – The Signalling Getting Better?

"Increasingly the MPC's messaging is improving and the thrust of its signalling addresses stability before any other aspect within the purview of the CBK's mandate. While the short-term market outcomes have been deemed favourable, we should not lose sight of potential downside risks from emerging markets and the Eurozone that could undermine the fragile global recovery and its attendant consequences to the domestic economy. A good balance tween the positive outcome and the downside risks should guide expectations on the future monetary policy stance".

Highlights

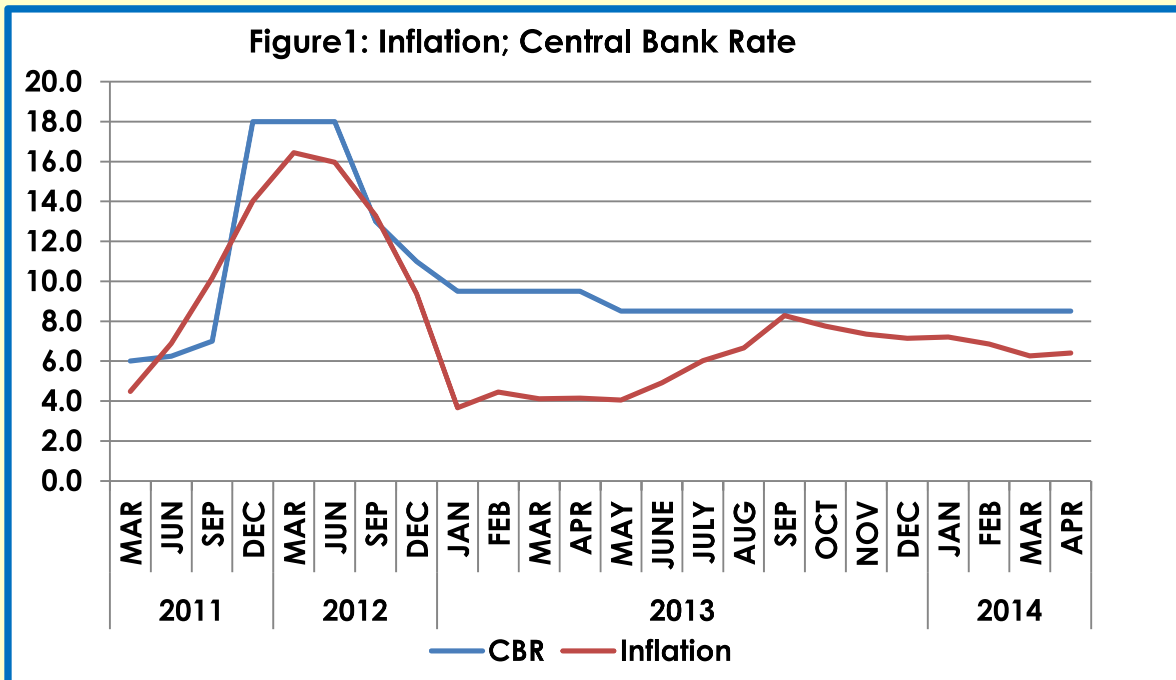
- The Central Bank of Kenya's Monetary Policy Committee (MPC) decision to retain the Central Bank Rate (CBR) at 8.5 percent for the seventh consecutive time during its meeting of April 30, 2014 sent out a clear message regarding its commitment to the stability mandate and low expectation anchoring.
- The MPC's decision was evidently aimed at anchoring inflation expectations and is thus based on sound economic grounding.
- The short-term market outcomes have been favourable and largely speak to the positive outcomes of the CBK's monetary policy stance.
- We should not lose sight of potential downside risks from emerging markets and the Eurozone that could undermine the fragile global recovery and its attendant consequences to the domestic economy.
- Therefore a good balance tween the positive outcome and the downside risks should guide expectations on the future monetary policy stance.

Introduction

The Central Bank of Kenya's Monetary Policy Committee (MPC) has in its past seven meetings retained the policy rate – the Central Bank Rate (CBR) – at 8.5 percent. The latest decision of 30th April 2014, just like the previous six, has been manifestly motivated by the desire to anchor inflation expectations and therefore ensure sustainable macroeconomic stability as a growth promoting strategy. Evidently, inflationary pressure has been mild and the rate if the consumer price index change has been within the government's target range of 2.5 percent and 7.5 percent (**Figure 1**).

While it could be tempting for the MPC to seek to spur the economy's fragile recovery through the pursuance of a more accommodative monetary policy stance, the downside risks to stability arising from both domestic and external circumstance have been persuasive enough to motivate a cautious stance. It is ostensible that the MPC is sold to the idea that the inflation – growth trade-off is only a short term phenomenon[1].

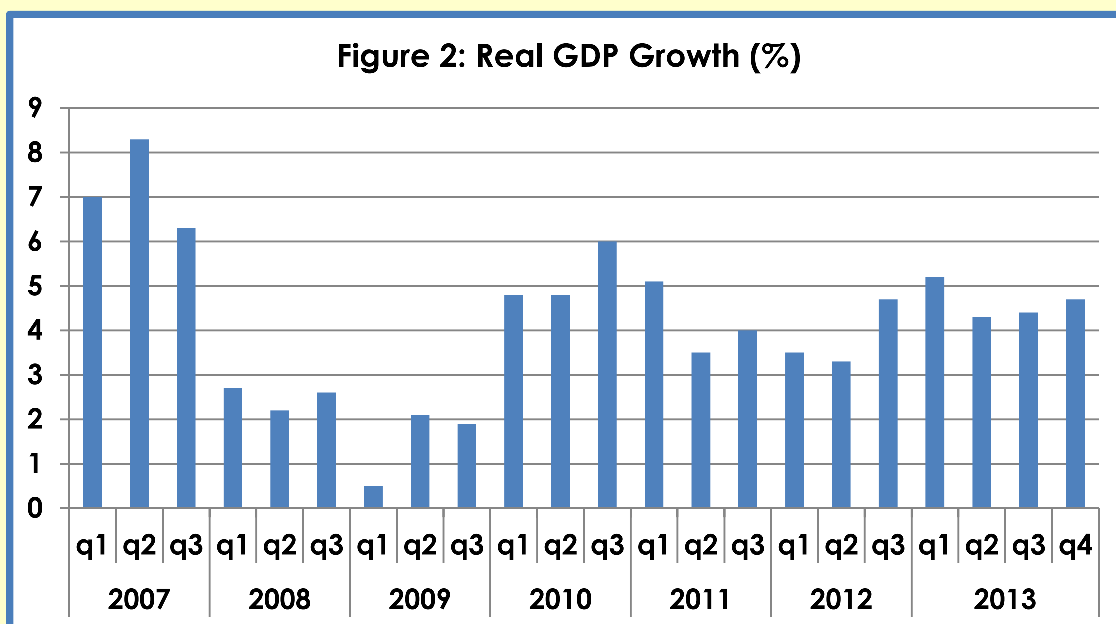
The fact that inflation has remained on the upper level of the medium term target thus underpinning the decision to hold the CBR at 8.5 percent, therefore imply that the monetary policy stance for the past one year, should not be construed as a tightening bias on the part of the MPC. In any case, a justifiable less accommodative monetary policy stance is by no means the same thing as a tight stance. Should the above inflation outcome be seen as a monetary policy achievement? The answer could well be on the affirmative given that the underlying inflation – the non-food-non-fuel, which measures the impact of the monetary policy stance – has been low and therefore supportive of stable inflation; indeed the month-on-month non-food-non-fuel inflation declined from 4.98 percent in March 2014 to 4.53 percent in April 2014.



Source: Central Bank of Kenya

[1]The empirical determination that the trade-off between inflation and output (low inflation being associated with high unemployment because the underlying tight monetary policy has a low growth causal effect) – the so-called Phillips curve – is at the worst a short-run phenomenon underpins the possible rationale for the focus on price stability on the part of the MPC as opposed to an activist stance that may later prove to be counter-productive.

The stability in monetary policy stance mirrors the stability in the money market pricing, an attribute that translated into sustained increase in demand for credit and expansion in the banking industry assets for the year to end of 2013. Given the feeble growth in other key sectors such as tourism, manufacturing and agriculture, the financial sector expansion - especially in the banking industry - did not translate into the a robust overall performance of the economy. Real output expansion has remained below 5 percent (Figure 2), implying that the economy is growing well below its potential. On this account, our observation that the monetary policy needs not have any tightening bias, is justified. On the same account then, the explicitly worry by the MPC that expansion in private credit would potentially trigger demand pressure or adverse inflationary expectations may be an overstatement.



Source: Kenya National Bureau of Statistics

External Environment – Outsourcing Stability?

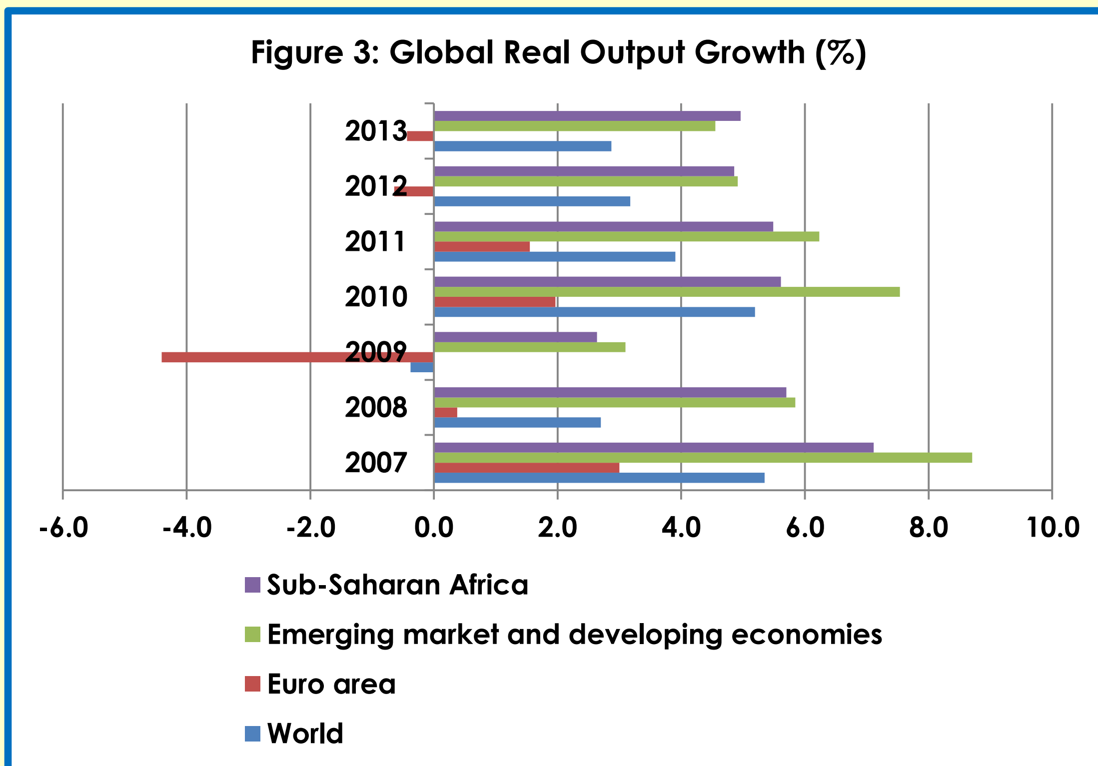
There is an apparent upbeat comportment in the MPC's assessment of the global economy in its noting of the projected upward trend in output growth. The IMF's *World Economic Outlook* (April 2014) projects a 3.6 percent global output growth in 2013 compared to 2013's 3.0 percent real growth. The Eurozone, which by the end of 2013 was still in the red, is likely to register positive growth in 2014; and Sub-Saharan growth will remain strong, albeit with the backing of few resource rich economies that continue to benefit from the commodity price boom (**Figure 3**).

Based on the expected global economic recovery, the MPC hinges stability in the exchange rate that is currently observed (**Figure 4**) on increased exports. The committee too assumes that the volatility in the currency and money markets arising from the United States tapering off of the economic stimulus will be limited. While on these two respects the MPC's premises sound credible, the depreciation pressure that the Kenya shilling has been subjected to in the recent is a signal that the market is factoring in other factors beyond external growth and policy. We can point out four factors currently playing a role on the weakening bias of the local unit whose supporting fundamentals, while improving, still remain weak.

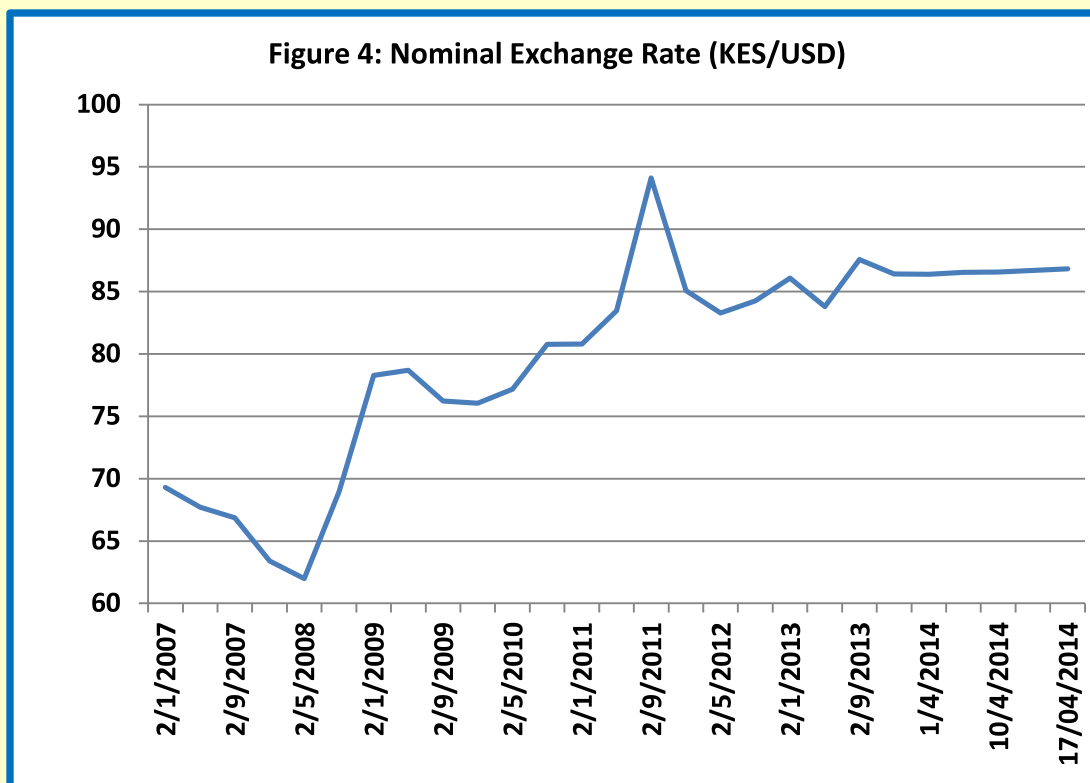
- One, the Euro zone recovery may well be an interim outcome given that demand remains weak, contrary to MPC's observation that domestic demand is picking and consequently driving the region's recovery. If it were true that demand is picking, then the European Central Bank (ECB) will not be sending string signals that it will pursue a quantitative easing equivalent strategy in the Euro zone. There are deflationary prospects at the Euro zone with inflation being below the 2 percent target. With the Euro area being a key export market for Kenya's exports, a

competitive entry strategy will necessitate an increase in the local relative price – which is essentially a gradual depreciation of the local unit that does not portent volatility.

- Two, the clear signals that in the recent past developing countries are shift their commercial ties from the G7 in favour of BRICs has its implications. This is especially so when China, the biggest of the BRICs, has posted the slowest in 18 months during the first quarter of 2014; the market is obviously factoring this in its expectations formation.
- Three, notwithstanding the Kenyan economy's public debts being certified as sustainable, institutions such as the IMF are sending coded signals that with massive external and internal borrowing in quest to finance infrastructure, and the still weak current account position, the exchange rate stability can only be viewed as short term and its whose sustenance rests on the external support. Since the market volatility of late 2011 and early 2012, the IMF's balance of payment support equivalent to KES 65 billion has helped boost the economy's foreign exchange reserves.
- Four, the anticipated debasing of Kenya's GDP in September 2014 debasing of Kenya's GDP would have implications if it yields a status for the economy that pushes it out of the concessional lender threshold.



Source: IMF



Source: Central Bank of Kenya

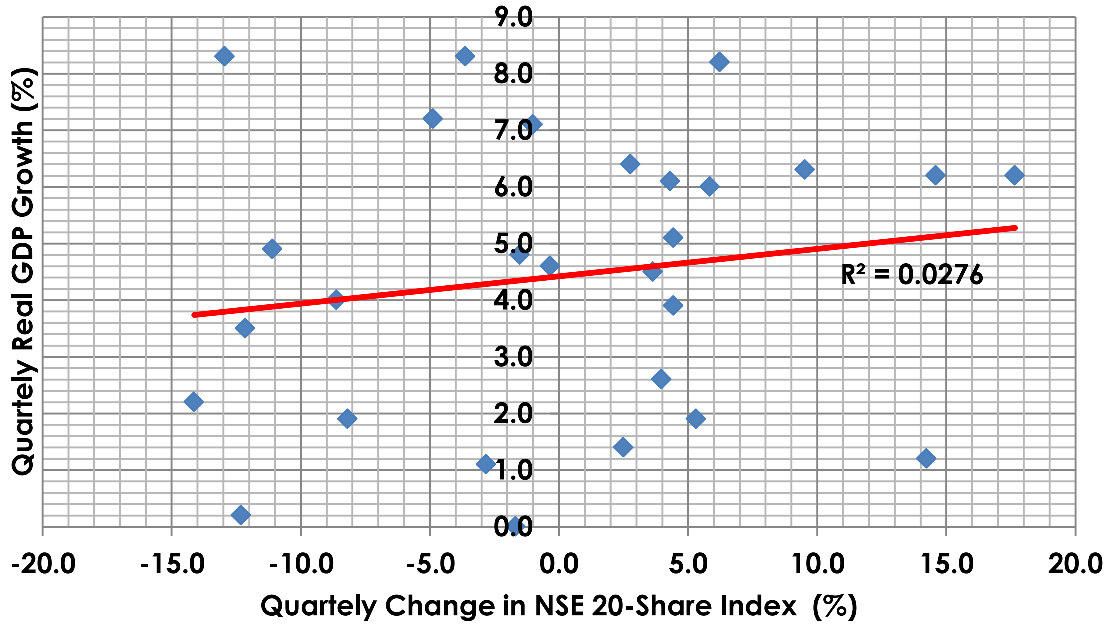
Economic Confidence – Our Version of Krugman's "Confidence Fairy"?

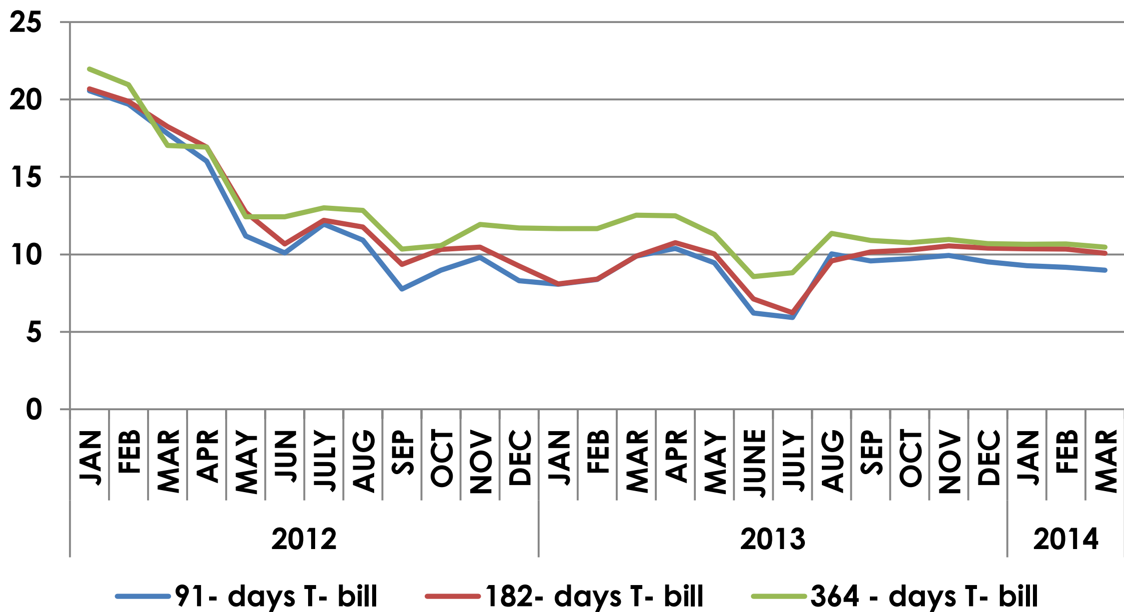
One of the MPC's measures of the confidence in the economy is the performance of the Nairobi Securities Exchange (NSE) as measured by the evolution of the NSE-20 share index. The index's upward trend from 4,9433.44 in March to 4,945.98 is in the MPC's view a signal of strong confidence in the economy. The equally positive trend in diaspora remittances is its other measure of confidence, the implicit assumption being that part of these remittances end up in the bourse as well as in the formal financial markets and therefore can be intermediated. These two measures need to be nuanced.

- First, part of the remittances are channelled towards household consumption support, thus will continue flowing regardless of the level of confidence in the economy;

- Second, the relationship between the evolution of the NES-20 share index and the economy's performance is tenuous, otherwise very weak, given the low depth of our capital market (**Figure 5**).

Nonetheless, the fact that there is an element of external participation in the NSE and that the remittances are positively flowing has given the CBK an additional policy lever for stabilisation other than interest rates. The stability in the money markets observed in the recent past (**Figure 6**) can partly be attributed to the comfort in positive expectations of external resource flows.





Source: Central Bank of Kenya

Conclusion

The foregoing analysis has highlighted that fact that the decision by the CBK's MPC in its April 30, 2014 meeting to retain the CBR at 8.5 percent for seventh consecutive times is a signal of commitment to the stability mandate and that its decision was evidently aimed at anchoring inflation expectations. Increasingly the MPC's messaging is improving and the thrust of its signalling addresses stability before any other aspect within the purview of the CBK's mandate. While the short-term market outcomes have been deemed favourable, we should not lose sight of potential downside risks from emerging markets and the Eurozone that could undermine the fragile global recovery and its attendant consequences to the domestic economy. Therefore a good balance tween the positive outcome and the downside risks should guide expectations on the future monetary policy stance.

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