RESEARCH NOTE NO.33. – 2017 (RN/33/17)

Kenya Bankers Association Centre for Research on Financial Markets and Policy®

November 23, 2017

Monetary Policy Stance – Too Many Moving Parts Ought to Persuade a Pause

Highlights

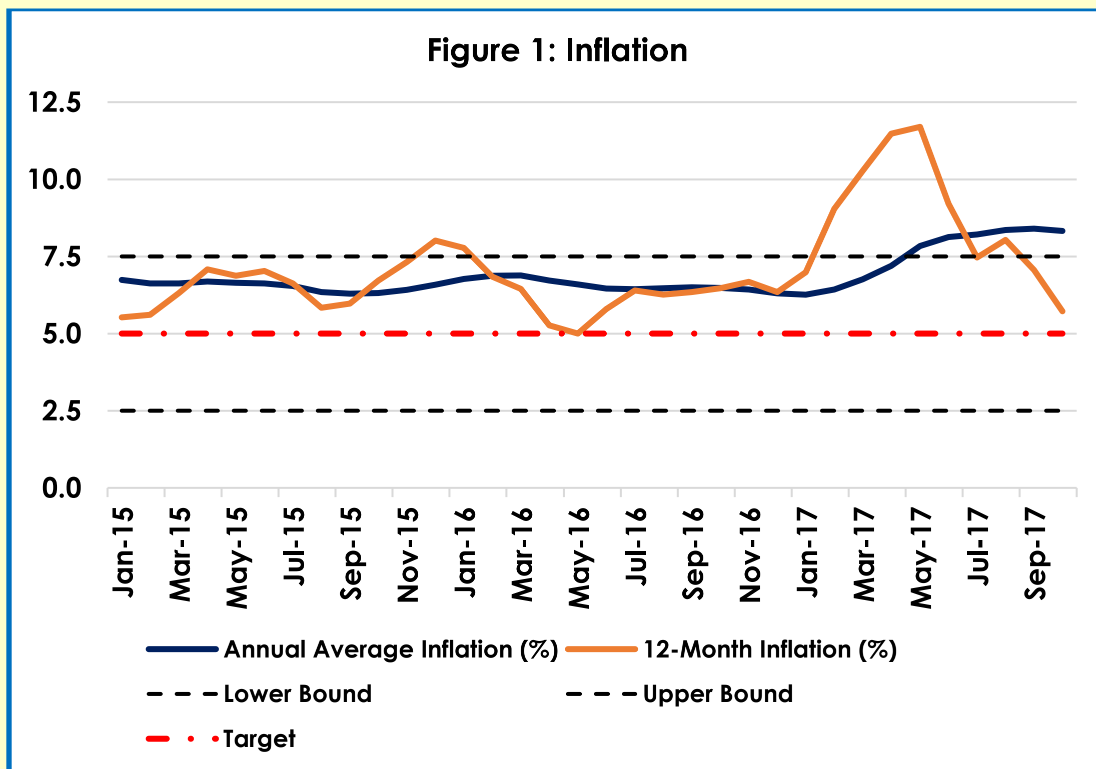
- The November 23, 2017 meeting of the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) has to confront two scenarios, one not compelling and the other persuasive. It can choose the populist but less persuasive scenario and lower the policy signalling rate – the Central Bank Rate (CBR) – to suit some expectations that 12-month inflation has now trended into the target range. In so doing monetary policy would signal the intention of seeking to support growth. In the circumstances this policy move is unlikely to meet its intentions.
- The other scenario is to treat the fact that a mild reduction of inflation rate back to the target range of 2.5 percent to 7.5 percent does not provide sufficient ground for a chance in the monetary policy stance. Due consideration has to be given to the myriad downside risks, most prominently:
  - The softening of real GDP growth as evidenced by the downward revision of output growth forecasts;
  - The risk of public debt distress;
  - The possibility of fiscal dominance on the back of dwindling bank credit to the private sector;
  - The creeping up of international oil prices; and
  - The realisation that the foreign exchange market stability comes at a cost especially at a time of political anxiety causes a binding constraint to all markets but more so financial markets.
- With the too many moving parts, we argue, a pause in the monetary policy stance as would be signalled by the holding of the CBR at 10 percent is persuasive.

Introduction

The November 23, 2017 meeting of the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) has to confront two scenarios, one not compelling and the other persuasive. One scenario is to play the populist card and lower the signalling rate – the Central Bank Rate (CBR) – to suit some expectations that 12-month inflation has now trended into the target range (**Figure 1**); in so doing monetary policy would signal the intention of seeking to support growth.

This *Research Note* doesn't suffer hindsight bias but instead seeks to argue that policy expectations have not realised when that card has been played - the most recent such act was the MPC decision of September 20, 2016 that, against all odds, elected to be explicitly accommodative as a way of spurring credit. As we argued then[1], the policy intentions were not realised, at the very least not even with a lag of one year, for growth of credit to the private sector is nearly grinding to a halt.

The other scenario is to treat the fact that a mild reduction of inflation rate back to the target range of 2.5 percent to 7.5 percent does not provide sufficient ground for a chance in the monetary policy stance. Due consideration has to be given to the myriad downside risks, most prominently the softening of real GDP growth as evidenced by the downward revision of output growth forecasts, the risk of public debt distress, the possibility of fiscal dominance on the back of dwindling bank credit to the private sector, the creeping up of international oil prices, and the realisation that the foreign exchange market stability comes at a cost especially at a time of political anxiety causes a binding constraint to all markets but more so financial markets. With the too many moving parts, we argue, a pause in the monetary policy stance as would be signalled by the holding of the CBR at 10 percent is persuasive.



Source: Kenya National Bureau of Statistics

[1] See *Research Note* NO. 2 6. – 20 1 6 (RN/ 2 6 /1 6) September 21, 2016 (http://www.kba.co.ke/downloads/RN%20No%205%202016.pdf)

Weak Growth that Monetary Policy (on its own) will not Remedy

It is clear that Kenya's output growth is fast softening. Even the perpetual optimistic such as the International Monetary Fund (IMF) have revised downwards the economy's growth forecasts. In its October 2017 *World Economic Outlook* (WEO), the IMF for instance projects a real GDP growth of 5.0 percent for 2017 compared to 2016's 5.8 percent real growth. This is a substantial revision from its October 2016 WEO's growth projection of 6.1 percent.

Given its small-open-economy status – therefore without systemic importance, Kenya's downward revision interestingly comes at a time when the global economy's prospects are looking up. The October 2017 WEO asserts that there will be a global upswing in economic activity, with global growth projected to rise to 3.6 percent in 2017 and 3.7 percent in 2018[2]; this growth that has been characterised as broad-based with upward revisions in the euro area, Japan, emerging Asia, emerging Europe, and Russia would more than offset downward revisions for the United States and the United Kingdom.

The foregoing is therefore a pointer to the fact that Kenya's growth challenges are largely stemming from domestic conditions. One such condition is the state of the private sector credit – where it will take utter deniability to assume away the nexus between private sector and economic performance, even as there remains a healthy debate regarding the magnitude of elasticities (the extent of change in real output growth arising from a one percentage change in credit growth).

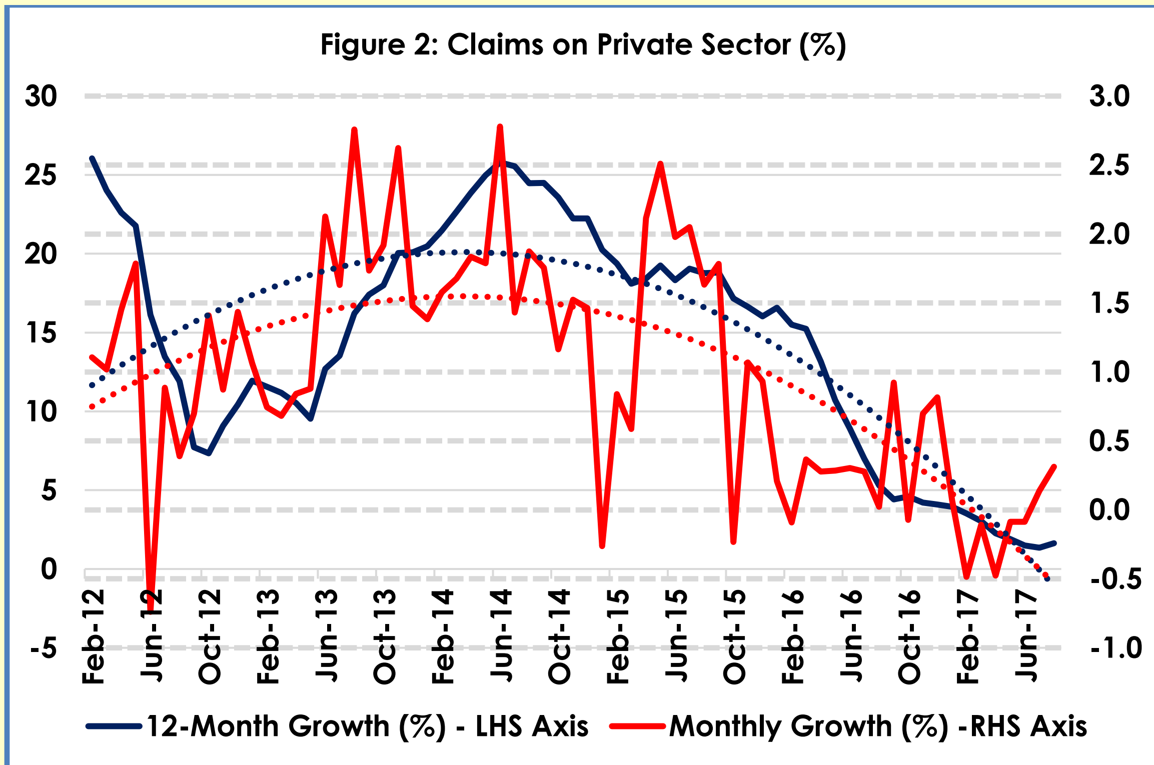
As **Figure 2** ad **Figure 3** show, there is a fairly strong association between credit growth to the private sector and the economy's real output growth. If we assume that the economy's full employment level of real output growth – often taken as the medium term target – is about 7 percent, the economy would be operating at a negative output gap (difference between actual and potential real growth).

Under such circumstances, it is possible to possible to increase credit without triggering demand-driven inflation. But at the core of the snail speed of private sector credit expansion is the muted demand as confirmed in monetary policy pronouncements over the past one year. Subdued demand filters into supply such that firms operate at less than installed capacity. The implication is therefore that demand for credit is more towards boosting excising capacity utilisation than towards capacity expansion.

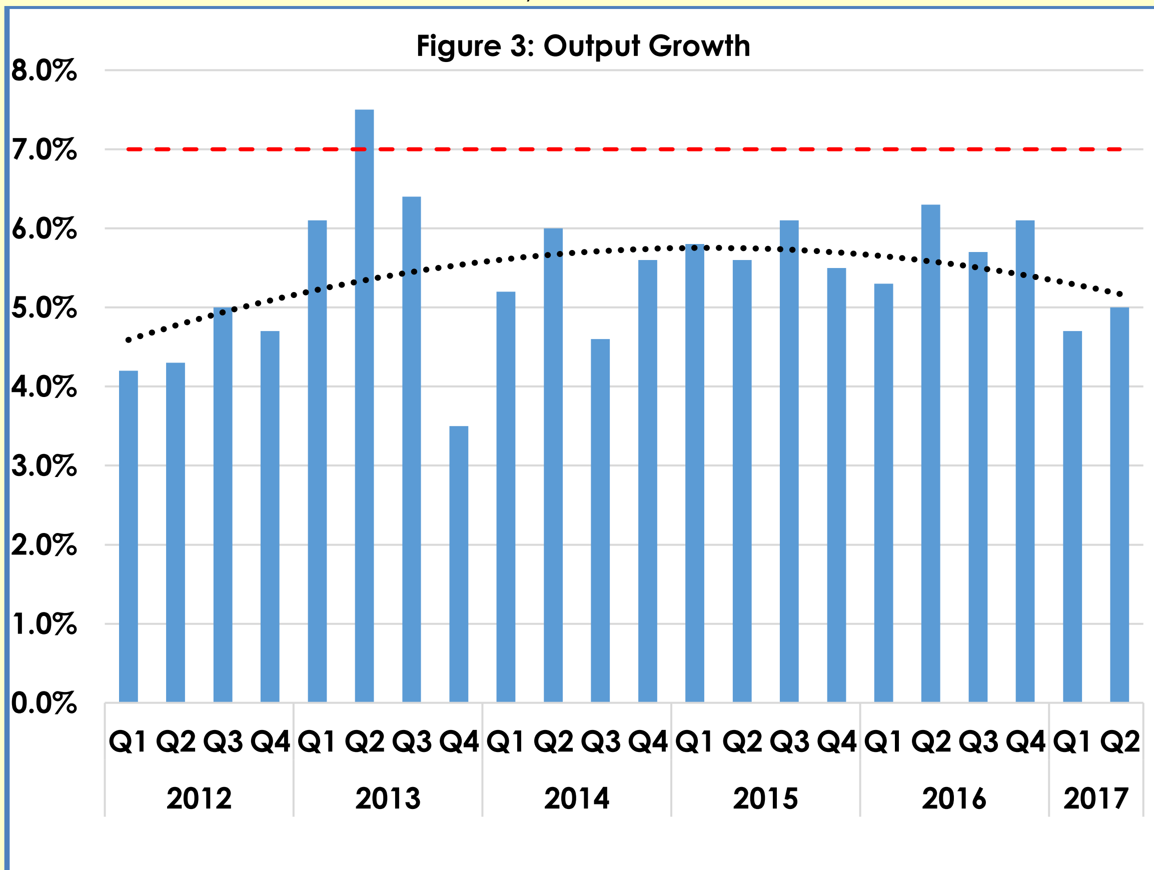
The monetary policy toolkit is suited for addressing demand-side challenges and not supply-side challenges. That means therefore that any policy adjustment towards spurring credit expansion remains constrained, even more so cognisant that the Banking (Amendment) Act 2016 restricts free pricing of credit risk. The policy conundrum presented above has a contributory effect on the downward revision of the economy's growth near-term forecast.

---

[2] IMF (2017), WEO – October; (http://www.imf.org/en/Publications/WEO/Issues/2017/09/19/world-economic-outlook-october-2017)



Source: Central Bank of Kenya

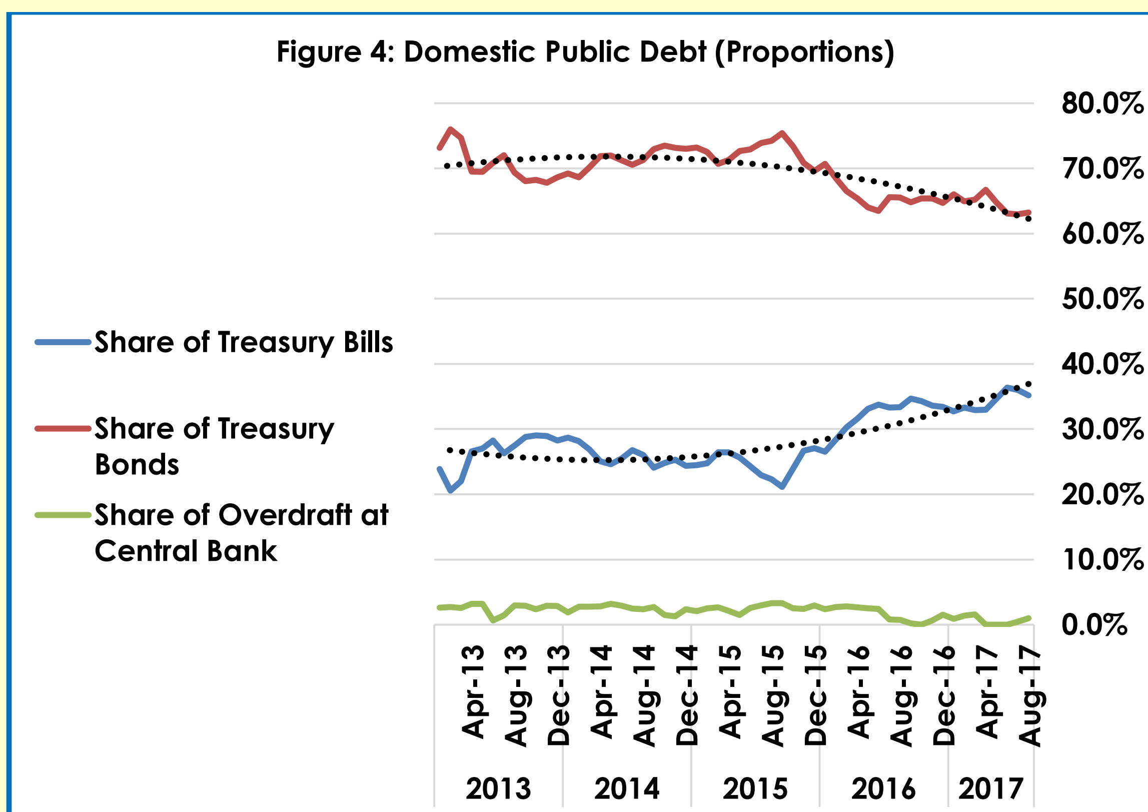


Source: Kenya National Bureau of Statistics

The obviously limiting assumption that the economy will continue to growth regardless of the observed association between credit to private sector ignores the fact that if such growth is driven by fiscal policy then it is likely to hit a limit beyond which that very policy will become a growth drag.

If there is an expansionary fiscal policy as the economy is suffering from weak demand, then either the economy is set to realise the benefits of such policy with a longer time lag; it would be presupposed that the expansionary fiscal policy is investment-leaning more than it is consumption- inclined. But then there is a possibility – inferring from the reducing trend in the tenor of the domestic borrowing instruments (**Figure 4**) – that public expenditure could be consumption leaning, in which case asking why that hasn't boosted demand is a legitimate question – is it perhaps "the missing money riddle"[3] ?

Figure 4: Domestic Public Debt (Proportions)



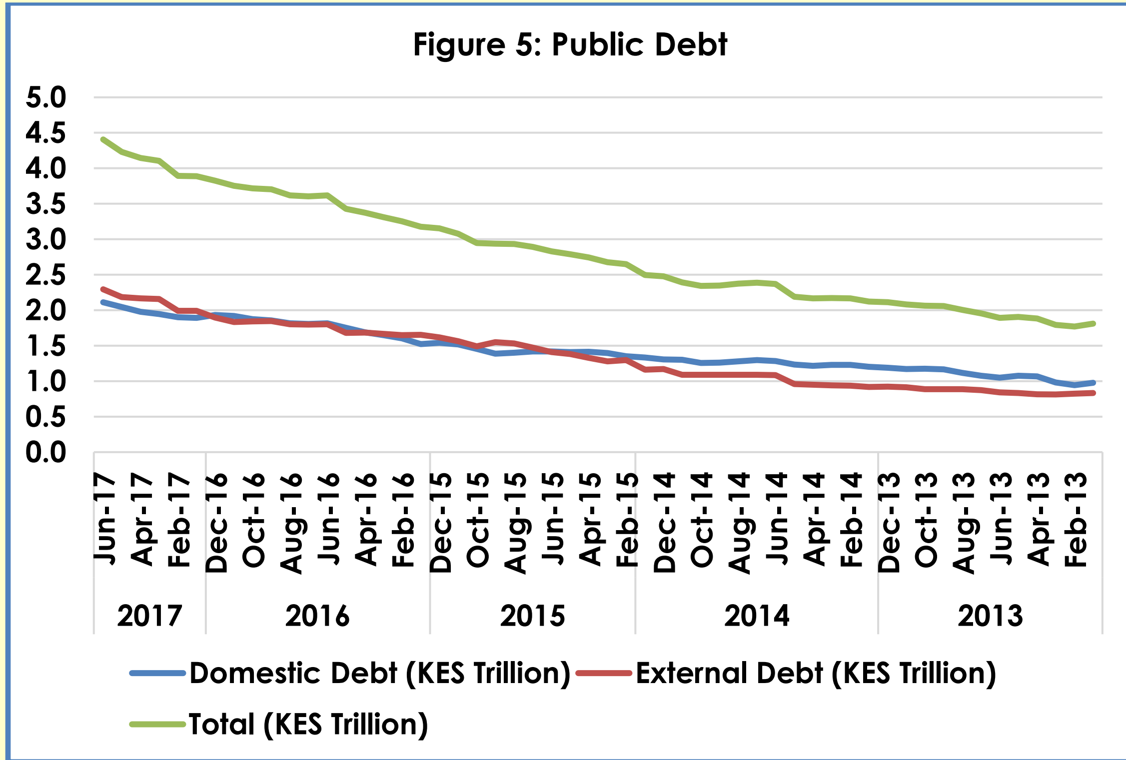
Source: Central Bank of Kenya

The evolution of public debt over the past five years has now brought to the fore the concerns regarding the possibility economy approaching debt distress levels. The stock of debt has more than doubled over the period, hitting a historic level of over KES 4 trillion equivalent (**Figure 5**). If this stock of debt has evolved with reduced tenors, then the challenge is not merely the stock itself (outstanding amounts) but also the flows (how the reduced tenors put a strain the repayment ability at any given time).

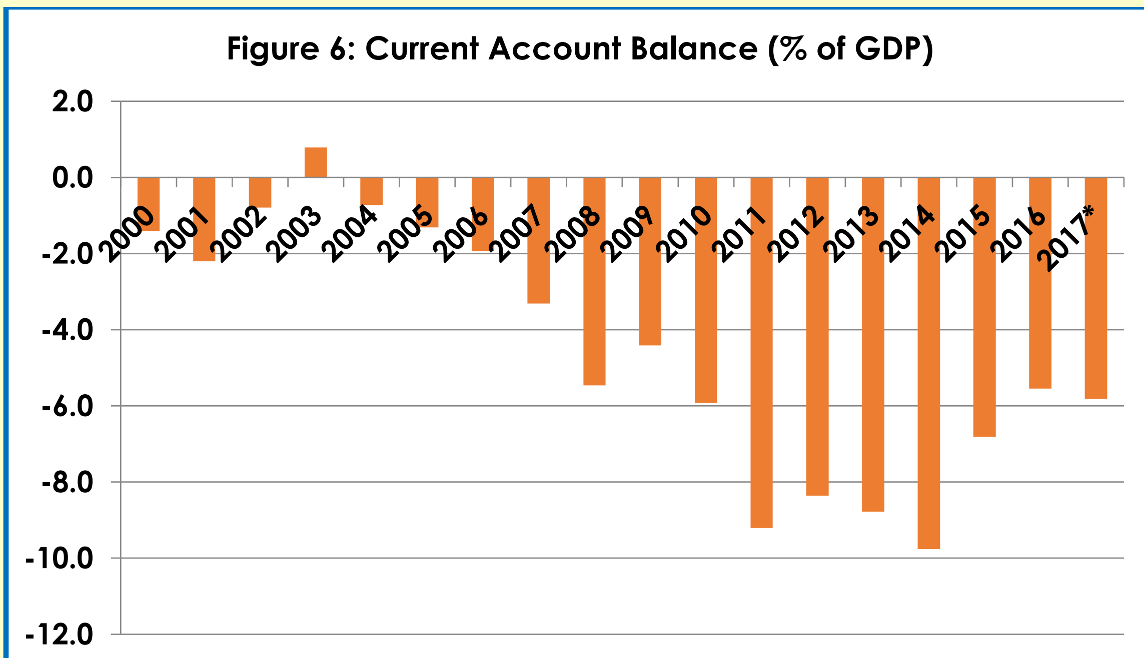
Furthermore, as external debt doubles, the current account balance is narrowing (**Figure 6**), meaning that the as the reliance on foreign resources to fill the domestic savings gap (the difference between investment requirements and domestic gross savings) reduces, public external borrowing is on the rise; this is a form of crowding out of international intermediation.

[3] See https://en.wikipedia.org/wiki/Missing_dollar_riddle

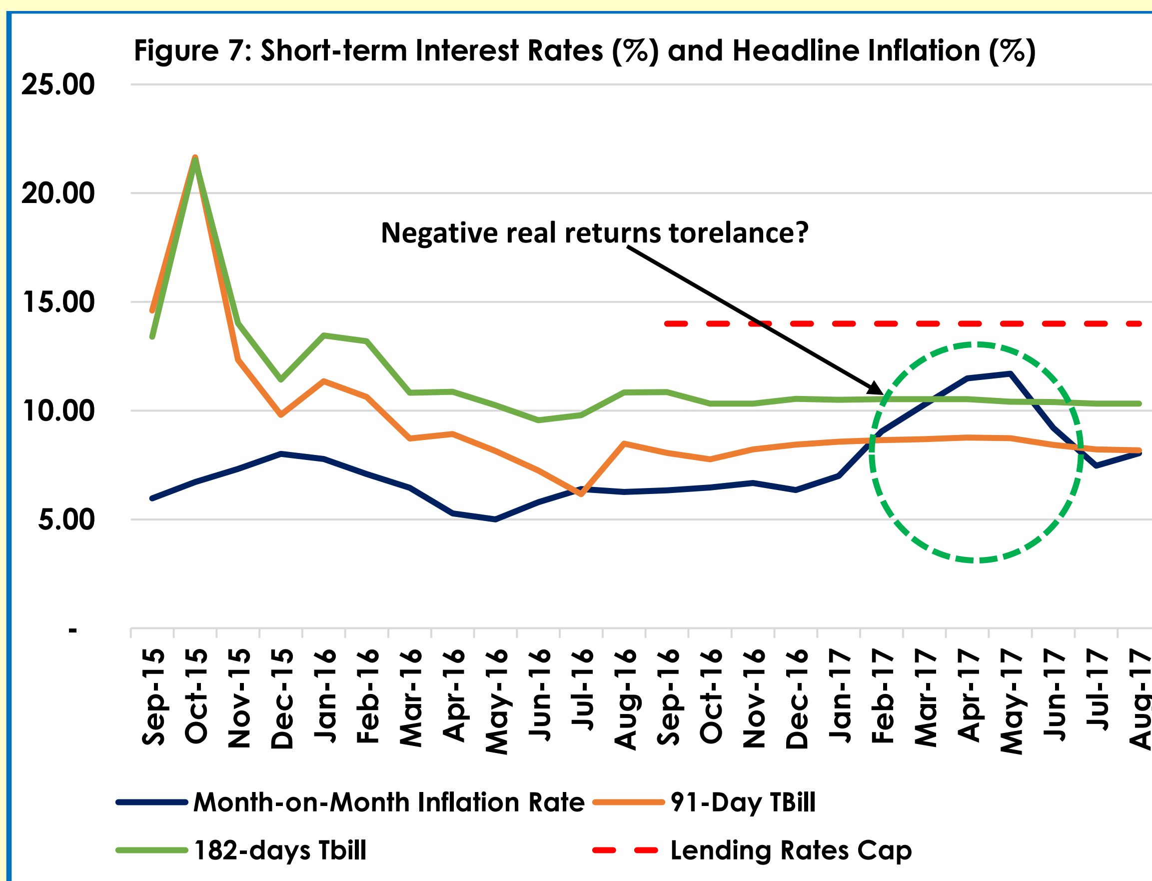
But that is half the story. The other half is that crowding out is even more evident at the domestic front; and it is happening through the quantity channel (actual resource shift from private sector to public sector) as, for instance banks as willing to lend to government at negative real returns (**Figure 7**)) than through the price channel (where government borrowing severely influences the lending rates, hence credit to the private sector) given the current interest rate capping regime.



Source: Central Bank of Kenya



Source: IMF



Source: Central Bank of Kenya

Watching the Shilling as Oil Prices Commence the Rise

The MPC would be expected to sustain the effort of maintain foreign exchange market stability. That the CBK has adequate reserves is an indication that it has scope for market intervention where necessarily in the event of market volatility. The hawk-eyed stance on the currency stability that has seen the local unit remaining largely stable (**Figure 8**) could help ameliorate the challenges of ballooning external debt, albeit as a sub-optimal strategy. This is especially so given that it is difficult to assure debt sustainability largely through currency management. In any event the economy's balance of payment (BOP) position necessitates the support of the IMF in the form of the IMF's stand-by facility.

If the foreign exchange market has to be stable almost at whichever cost, then such costs would of necessity need to have the compensatory effect of the rising oil prices (**Figure 9**). The June 2014 – January 2016 plunge in oil prices substantially helped repair the economy's weak current account position. The effects price resurgence that has since emerged needs to be countered by a stable currency (at least not a weakening currency). How that stability is realised requires a combination of policy tools, and not a bias towards market interventions; this calls for caution in a change in monetary policy especially if it would entail premature easing.

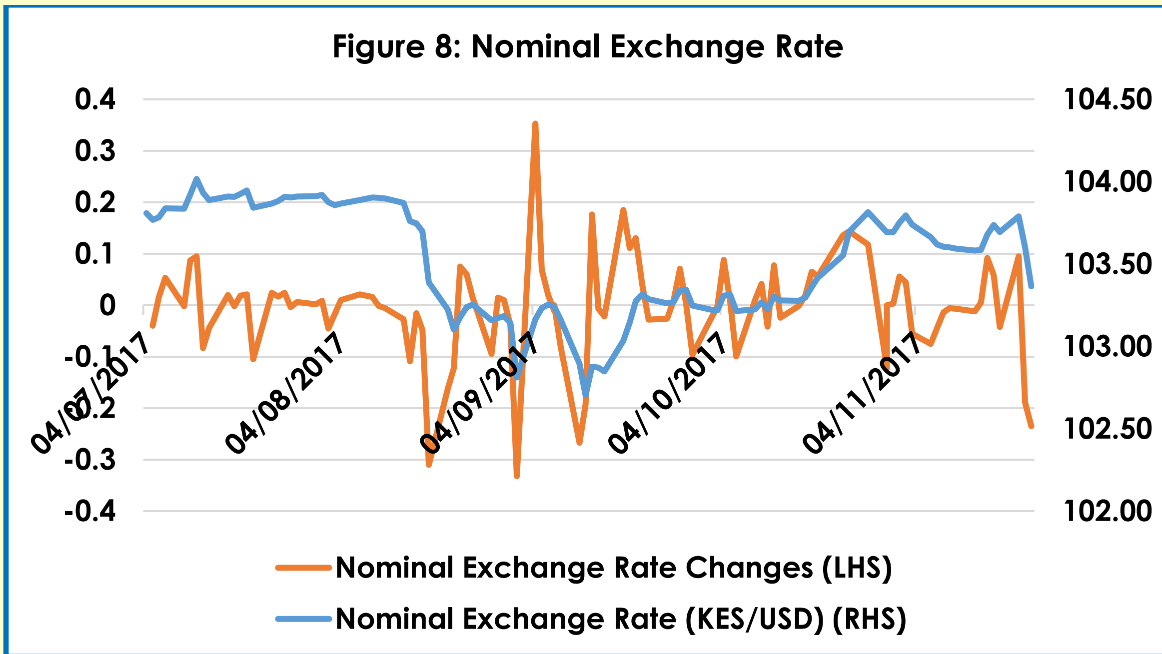


Figure 8: Nominal Exchange Rate

Source: Central Bank of Kenya

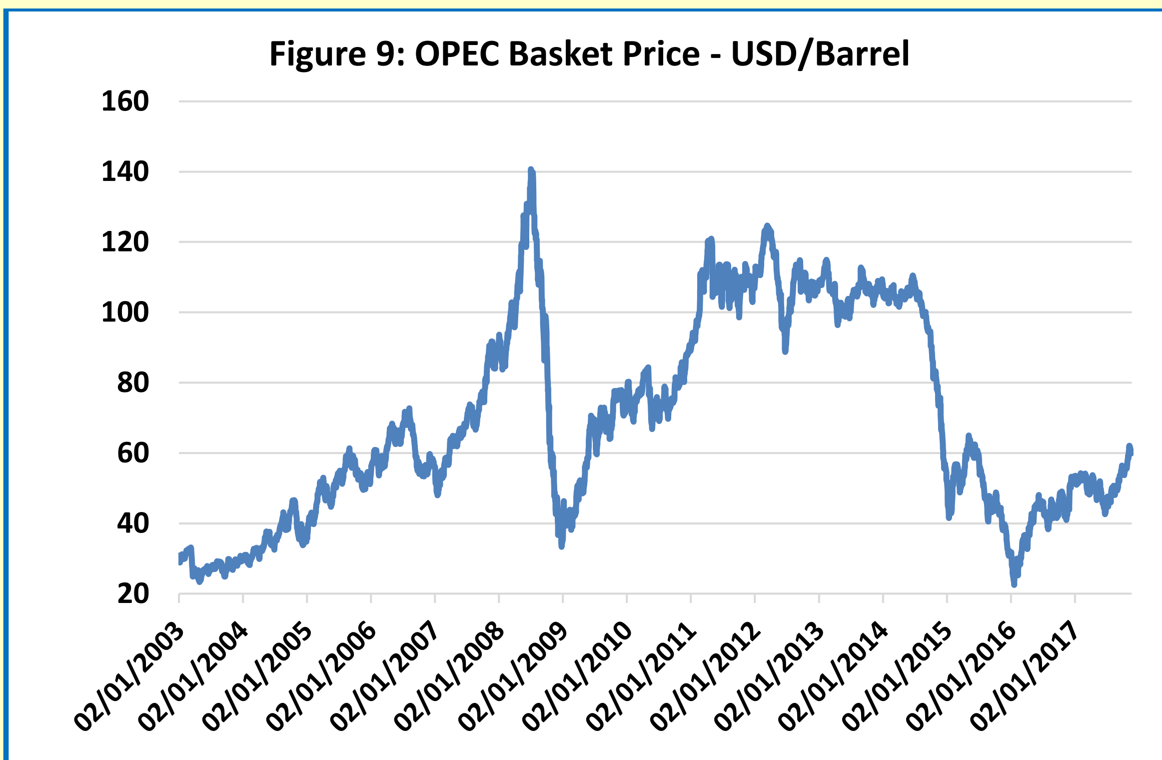


Figure 9: OPEC Basket Price - USD/Barrel

Source: OPEC

Conclusion

From the foregoing, this *Research Note* argues that the November 23, 2017 meeting of the MPC has to confront two scenarios, one not compelling and the other persuasive. It can choose the populist but less persuasive scenario and lower the policy signalling rate – the CBR – to suit some expectations that 12-month inflation has now trended into the target range. In so doing monetary policy would signal the intention of seeking to support growth. In the circumstances this policy move is unlikely to meet its intentions.

The other scenario is to treat the fact that a mild reduction of inflation rate back to the target range of 2.5 percent to 7.5 percent does not provide sufficient ground for a chance in the monetary policy stance. Due consideration has to be given to the myriad downside risks, most prominently:

- The softening of real GDP growth as evidenced by the downward revision of output growth forecasts;
- The risk of public debt distress;
- The possibility of fiscal dominance on the back of dwindling bank credit to the private sector;
- The creeping up of international oil prices; and
- The realisation that the foreign exchange market stability comes at a cost especially at a time of political anxiety causes a binding constraint to all markets but more so financial markets.

With the too many moving parts, we argue, a pause in the monetary policy stance as would be signalled by the holding of the CBR at 10 percent is persuasive.

This *Research Note* is a publication of the Kenya Bankers Association Centre for Research on Financial Markets and Policy®. The Centre was established by the Kenya Bankers Association in 2012 to offer an array of research, commentary, and initiate dialogue on critical policy matters that impact the financial sector. Through these activities, the Centre acts as a platform for intellectual engagement between experts on financial markets, banking industry players and policy makers.

The views expressed in this *Research Note* do not necessarily represent those of the Members of the Kenya Bankers Association. The content of this publication is protected by copyright law. Reproduction in part or whole requires express written consent.

Comments on this *Research Note* can be forwarded to the Centre's Director at research@kba.co.ke or josoro@kba.co.ke

©Kenya Bankers Association 2017