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Monetary Policy Stance: A Justifiable Defence of Policy Credibility

Highlights

- The decision by the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) meeting of March 21, 2016 to hold the CBR at 11.5 percent was justifiable and that any other stance could have compromised prudency that the CBK is keenly deploying as it seeks to anchor inflation expectations and enhance policy credibility.
- It is clear that the MPC's decision hinged crucially on the fact that inflation is now back to target, thus demonstrating the strive to "anchor inflation expectations and enhance the credibility of its policy stance". How that has buttressed the MPC's latest decision needs to be taken in context if only to bring out the proper context on how that sets the tone for the near-future monetary policy decisions. We highlight four areas of key consideration to avoid missing that context.
    - One, as the economy's growth momentum picks, one has to be clear how that plays out with regard to the output gap – difference between full potential and actual growth – and how that relates to inflation expectations.
    - Two, while stability is evident in the foreign exchange market, there is need to closely watch the external position (especially the current account) so as to have a grounded view with regard to the sustenance of the stable market conditions.
    - Three, the global economy remains weak and this has implications on the domestic economy generally and the financial markets in particular.
    - Four, itremains to be seen whether a reduction in domestic borrowing requirement will sustainably be realised; this is especially so considering that the revised budget estimates currently under consideration by the National Assembly lean more towards expenditure reduction, thus likely to encounter political headwinds as the country heads towards general elections in 2017.

"The MPC's decision to hold the CBR was a representation of policy prudence that any other stance could have compromised".

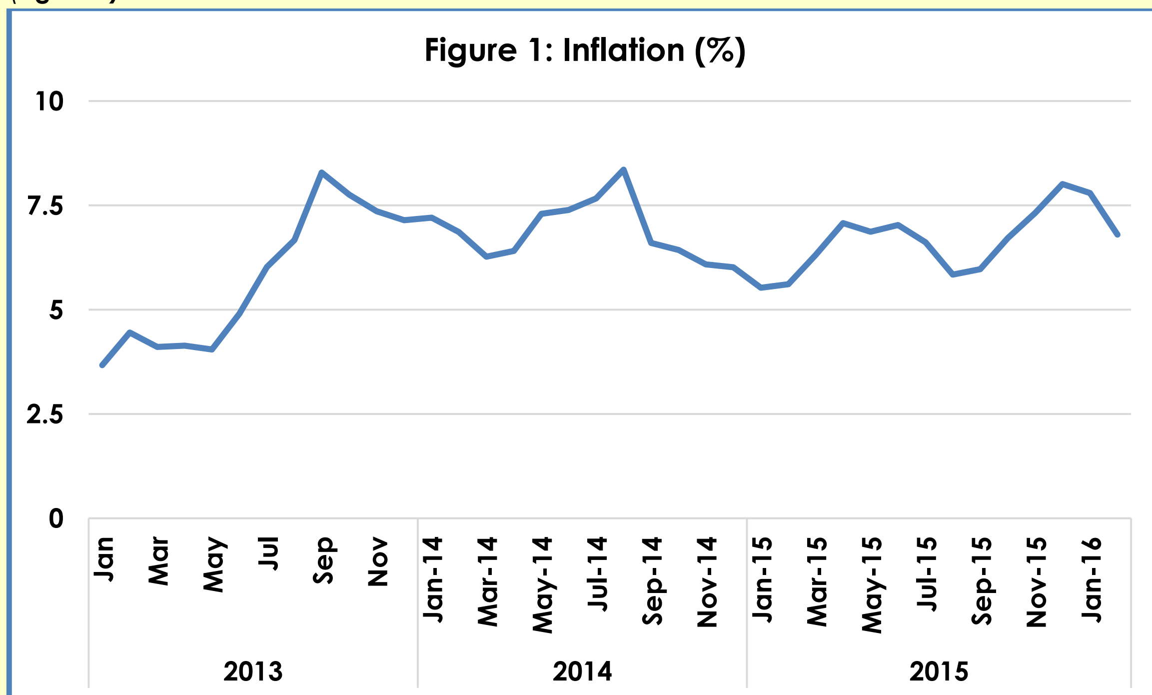
Introduction

When in the the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) meeting of March 21, 2016 the decision was to retain the Central Bank Rate (CBR) at 11.5 percent, two signals – one explicitly and the other inadvertently – are evident.

The explicit signal is that the MPC decisions over the recent past ten months are meeting the policy objective. The signalling of the change of stance in June 2015 by way of increaing the CBR from 8.5 percent to 10.0 percent and subsequently to 11.5 percent in July 2015 has been a clear demonstration of the CBK's readiness to act in defence of monetary policy credibility. The CBR has been retained at that level for six consecutive meeting.

The inadvertent signal is that any expectations on a change in policy stance will have to acknowldege the known imperfections in the monetary policy transmission mechanism[1] such that the effect of its decisions as would be manifested by market prices reaction – especially money market prices – are realised with a time lag. That is why the MPC had to lean, arguably rightly so, against popular but unlitigated expectations that the CBR needed to be lowered.

To the extent that inflation at 6.8 percent in February 2016 represented has revertion to the government's 5.0 percent (+-2.5 percent) target after a two month breach (December 2015's inflation rate of 8.0 percent and January 2016's rate of 7.8 percent) the MPC's decision to hold the CBR was a representation of policy prudence that any other stance could have compromised (**Figure 1**).



Source: Kenya National Bureau of Statistics

[1] Davoodi, H. R., Dixit S., and Pinter G., (2013), "*Monetary Transmission Mechanism in the East African Community: An Empirical Investigation*", IMF Working Paper WP/13/39, February (https://www.imf.org/external/pubs/ft/wp/2013/wp1339.pdf); and Mishra P. and Montiel P., 2013, "*How effective is monetary transmission in low-income countries? A survey of the empirical evidence*", Economic Systems 37, 187–216

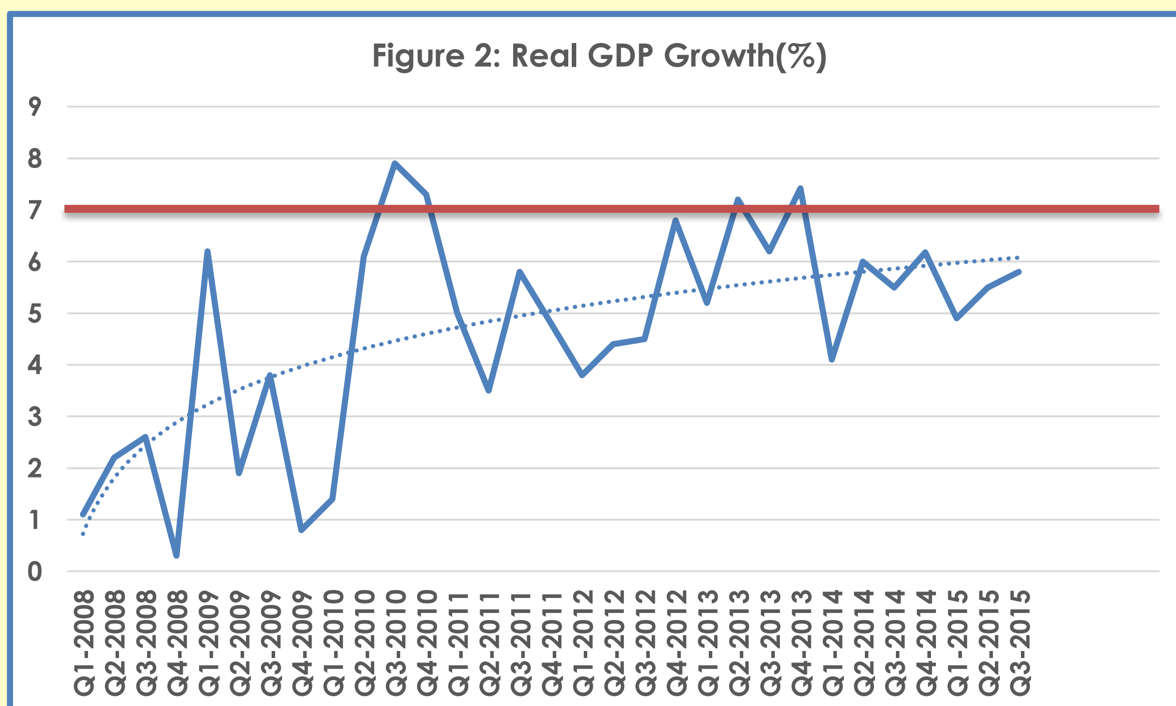
In the January 2016 meeting, the MPC gave its most explict – albeit not numerical – inflation forecast, indicating that the basis of the inflationary pressure that lead to the target being surpassed were to dissipate by April 2016. The tone of the latest MPC communique is such that the ealier inflation outlook has been accurate. In this *Research Note*, we seek to make arguments around the immediate future implications of these policy messaging strategy.

On Target – A Guide to the Near-Future Policy Stance?

As already observed, the MPC's latest decision hinges crucially on the fact that inflation is now back to target, thus demonstrating the strive to "anchor inflation expectations and enhance the credibility of its policy stance". How that has buttressed the MPC's latest decision needs to be taken in context if only to bring out the proper context on how that sets the tone for the near-future monetary policy decisions. We highlight four areas of key consideration.

First, the economy's growth is picking momentum (**Figure 2**). If this is sustained, the consequence will be the narrowing the output gap – the difference between the economy's actual real growth level and its potential level. If we take the Government's 7.0 percent medium term real growth target as an approximation of the economy's potential output expansion rate, then the observed growth trajectory implies that the output gap will dwindle over time.

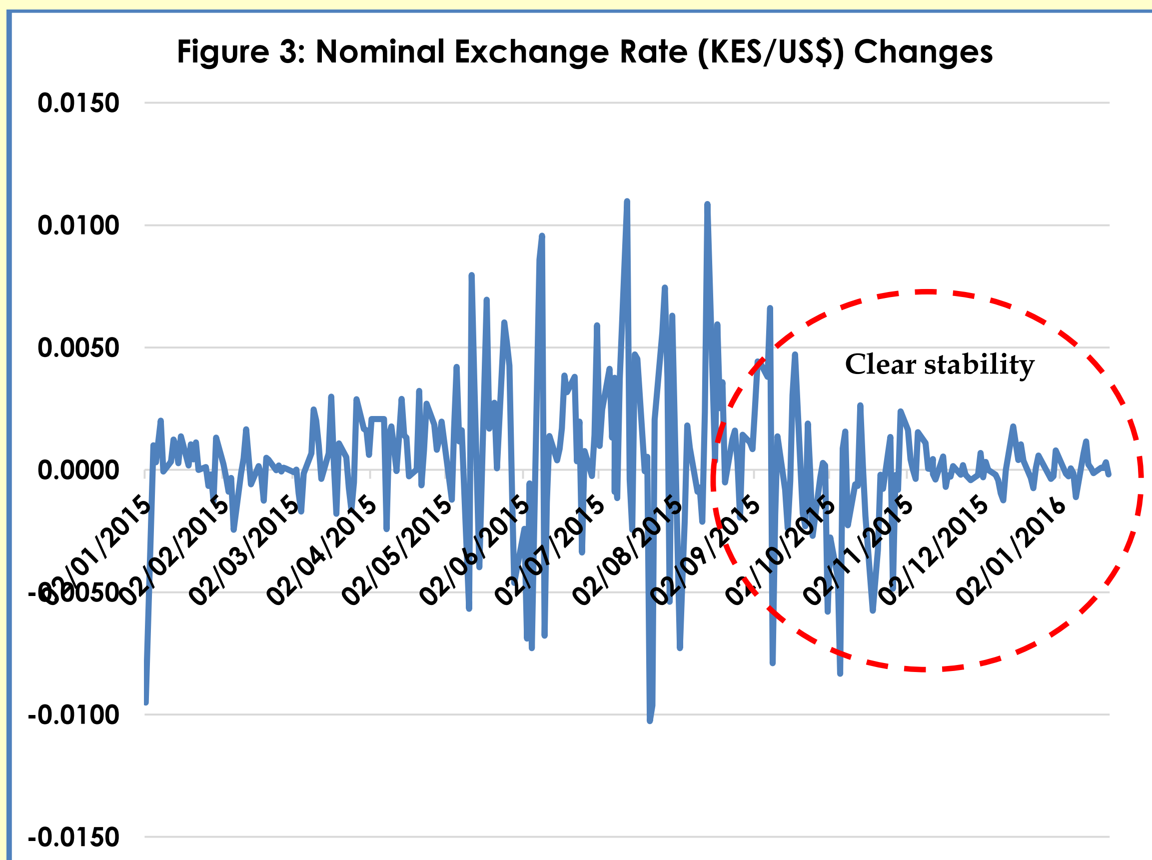
While that in itself has evidently not been a source of inflationary pressure, coming at a time of expectations of the resumption of an accommodative monetary policy stance, it could be a strong pointer to the argument that the MPC's intention to enhance the credibility of its policy stance will necessitate a careful watch on when easing has run its course and when to keep a keen eye on a stance with a tightening bias. It coud seem that now and the near future endears itself to the latter scenario.



Source: Kenya National Bureau of Statistics

Second, the foreign exchange market stability that we have witnessed over the recent past few months (**Figure 3**) is confimed by the MPC. While the prevailing market conditions follow an aggressive central Bank interventions – both in terms of market participation and monetary policy tightening – towards restoration of stability, the sustenance of the stable streak will hinge on how the broader economic dynamics play out towards the repiar of the external position (current account deficit).

The mild narrowing of the current account deficit has been attributed to improved diaspora remmitances and export earnings at time when lower oil prices have lessed the fuel import bill. The evidently adequate foreign exchange reserves (equivalent of 4.7 months of import cover, up from 4.5 months in January) coupled with the US$1.5 billion IMF precautionary facility approved in March 14, 2016 gives the comfort against short-term shocks. The IMF facility's approval signfies that the overall macroeconomic policy stance is in the right direction; any changes (even on the monetry policy front)have to be persuasively motivated to obviate compromising the gains made.



Source: Central Bank of Kenya

Three, the global economic circumstances are far from rosy and the MPC seems to acknowledge that fact. The IMF has just revised its global economic outlook . The IMF is now explicitly pessimistic about the state of the global economy than it was in October 2015. According to the IMF, the global growth, currently estimated at 3.1 percent in 2015, is projected at 3.4 percent in 2016 and 3.6 percent in 2017, a more gradual trend than its October 2015 World Economic Outlook (WEO), especially in emerging market and developing economies.

The IMF observes that the "risks to the global outlook remain tilted to the downside and relate to ongoing adjustments in the global economy: a generalized slowdown in emerging market

economies, China's rebalancing, lower commodity prices, and the gradual exit from extraordinarily accommodative monetary conditions in the United States. If these key challenges are not successfully managed, global growth could be derailed". Unlike the past, were we have argued that the MPC has tended to almost understatement this risk, the apparent policy caution reflects that the external challenges are on its radar. The fact that the US's Federal Reserve appears to have slowed the pace of its stride towards a conventional monetary policy stance is a signal that there are soft patches both in the US and global conomy that policy makers from developing and emerging markets need to keenly be aware of. These include the dangers of deflation that stands to derail a return to policy nomalcy.

Four, the 2015/16 fiscal programme has to some extent been embedded with proliferation of tax proposals which, if enacted, will have inflationary implications. The challenge is compounded by the wage demands amongst a section of the public service that could put pressure on the Government wage bill, and consequently the overall fiscal position. It therefore remains to be seen whether a reduction in domestic borrowing requirement will sustainably be realised; this is especially so considering that the revised budget estimates currently under consideration by the National Assembly lean more towards expenditure reduction, thus likely to encounter political headwings as the country heads towards general elections in 2017. This is on the back of constrained revenue collections by the Kenya Revenue Authority (KRA).

Towards Aiding Clarity

The factors that we outline above buttress our view that the pronouncements of the MPC have to be carefully considered in a maner that could help shape policy expectations. As is often the case, the MPC gives itself a window to change gears in its general, if standard, remark that "it will continue to monitor developments and will use instruments at its disposal to mainain overall price and financial sector stability". It is clear that the CBK cannot commit to future policy – and we cannot logically expects it to. All it can do is signal its character given the inherent difficulty in monentary policy conduct to lock in a future policy stance. This is however no excuse for not setting the platform for the immediate future policy position. Forward guidance, which in our case appears to be at best limited, is not a give-away but a sign of a maturing monetary policy framework.

The implied confidence in the MPC's inflation outlook in January 2016 where it projected the easing of inflationary pressure by April 2016 was a good pointer towards Its likely policy direction; so anybody expecting a change in stance even before April must have missed this signal. There are clear advantages arising from the MPC's signal being clearly read by the market – and that could entail the policy statements being as clear as is logically possible in providing some form of forward guidance.

The main advatange is that the MPC, if it hints on its forecast of the target variable (inflation in this case), will help shape inflation expectations of private agents; it is reasonable to assume that the central bank's forecating error will be lower than that of private agents, therefore if appropriately guided it will lead to private agents producing more accurate forecasts. In an environment characterised by imperfect information – and one where the information set of the central bank is different (and sometimes richer) from that of private agents, a clear forward signal will aid the understanding of the policy maker's view of the appriopriateness of the policy stance. Ultimately, this will support expectations anchoring.

Conclusion

The decision by the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) meeting of March 21, 2016 to hold the CBR at 11.5 percent was justifiable and that any other stance could have compromised prudency that the CBK is keenly deploying as it seeks to anchor inflation expectations and enhance policy credibility.

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