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Monetary Policy Stance: A Temptation to Juice up Growth?

Highlights

- In leaving the Central Bank Rate (CBR) unchanged at 8.5 percent during the 3rd September 2013 meeting, the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) was very clear on its justification: the positive market outcomes since its July 2013 meeting outweigh the downside risks and that there is no demand-driven inflationary pressure to warrant a change in the policy stance.
- As this *Research Note* argues, inadvertently or otherwise, there is an element of cherry-picking of risks to justify a decision with the potential cost being the inevitability to shock the system when the clearly downplayed risks crystallise. This is seen in four key respects:
  - One, the possibility of inflation overshooting the target in the very near term is now evident and is contrary to the MPC's "stable short-run outlook". If this fact has not escaped the MPC, then it can only mean that the implicit stance is one of 'crossing the bridge when we reach there'.
  - Two, the best bet for the MPC in ensuring stability in the foreign exchange market is hinged on the medium term conjecture that the initiatives by the government to attract foreign investors and expansion in trade markets will result in increased foreign exchange "'in the future". But there is a risk that the MPC does not even acknowledge it exists: *the BRICS hitting the wall!* The brics – as the economies of Brazil, Russia, India, China, and by some reckoning, South Africa – depicted a tendency of fast growth for some time until it was assumed that they could grow in their sleep – regardless of what happens in the rest of the world.
  - Three, the path of the international oil prices remains slippery than the MPC is willing to acknowledge.
  - Four, it remains to be seen whether lessons have been learned from past episodes of delayed policy response. Such learning can only take place if there is an appreciation that there is a cost to a delayed policy response if such response will entail shocking the system by a drastic adjustment. It may be important to seek to juice up the economy during politically opportune moments. But that has its costs. In view of the circumstances, the prospects of economy's real growth hitting the target of 5.6 percent for 2013 seem less likely by the day.
- We therefore see the policy decision as a missed opportunity on the part of the MPC to assert its policy credibility credentials. We surmise that in the prevailing circumstances, a slightly less accommodative monetary policy stance- which does not necessarily amount to a tightening – will have been justified for it could have sent the signal of vigilance on the part of MPC to secure stability.

  While it is tempting to seek to juice growth because that may be one of the ways of fending off medium term inflation, the policy decisions may end up frustrating the very growth if they make it inevitable to shock the system so as to have stability.

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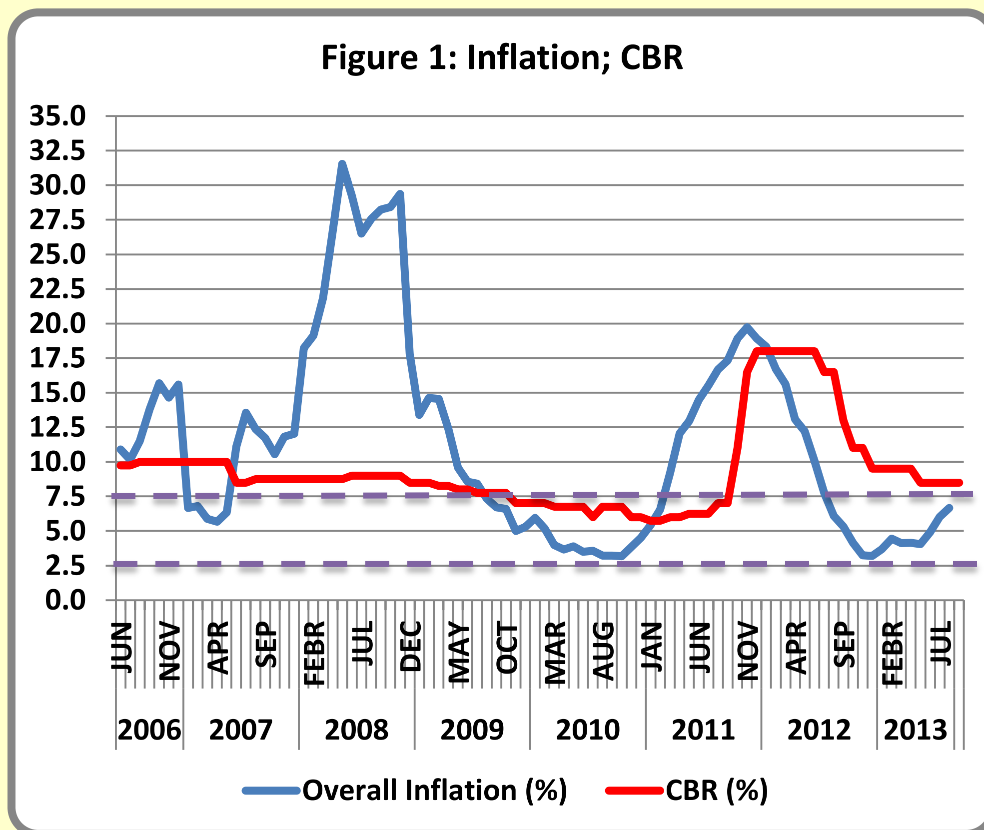
Introduction

The Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) decided on its meeting of 3rd September 2013 to leave the Central Bank Rate (CBR) unchanged at 8.5 percent. The MPC was very clear on its justification of non-revision of its policy stance. Its core argument was that the positive market outcomes since its July 2013 meeting clearly outweigh the downside risks and that there is no demand-driven inflationary pressure to warrant a change in the policy stance.

Admittedly, this is an interesting decision if only in confirming the MPC's credentials of consistency in pursuance of a short-run growth-promoting agenda. But at what cost? As this *Research Note* argues, inadvertently or otherwise, there is an element of cherry-picking of risks to justify a decision with the potential cost being the inevitability to shock the system when the clearly downplayed risks crystallise.

It is true that by MPC's decision time inflation was within range of 2.5 percent on either side of the government's medium term target of 5 percent (**Figure 1**). But as we have consistently argued in the past, there needs to be be a difference in attitude when inflation is within target but on a declining trend from when it is within target but with a clearly consistent rising trend. The MPC has been confronted with both scenarios in the recent past, the former obtaining between July 2012 to December 2012 and the latter in the subsequent period.



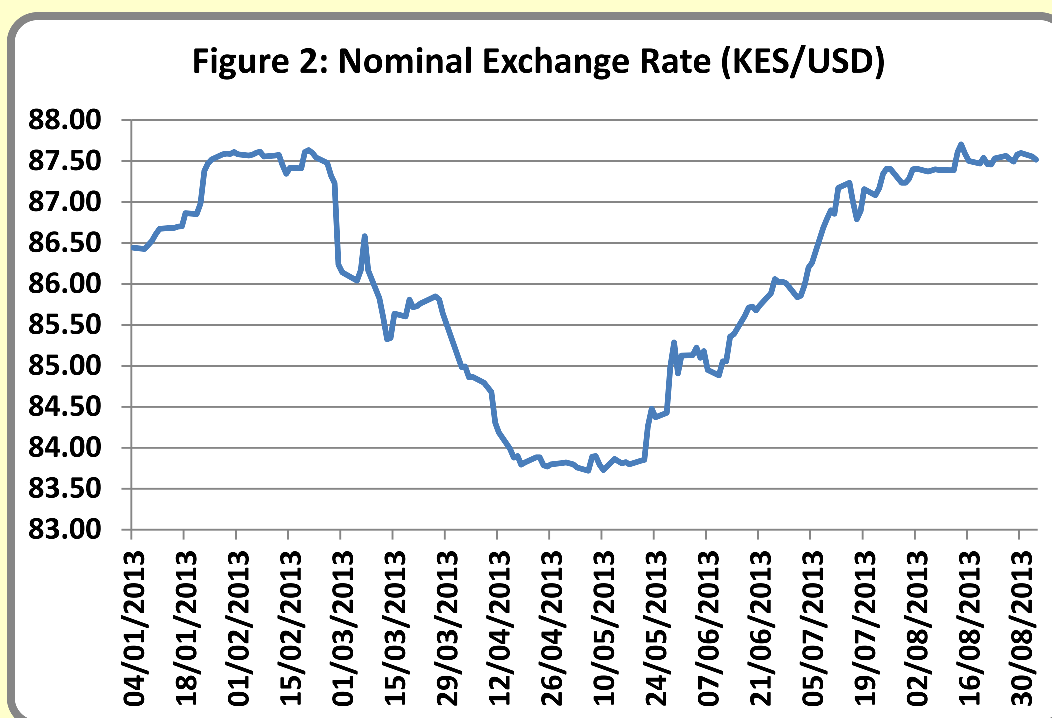
Source: KNBS; CBK

The possibility of inflation overshooting the target in the very near term is now evident and is contrary to the MPC's "stable short-run outlook". If this fact has not escaped the MPC, then it can only mean that the implicit stance is one of 'crossing-the-bridge-when-we-reach-there'. And it is easy to see how the MPC has cut itself some sizable slack in this respect by asserting that "it will continue to monitor the key macroeconomic aggregates and any emergent risks that may impact on price stability".

Beyond its inflation outlook which, as we have alluded, even against all odds the MPC assumes to be stable in the near term, we see sanguine attitude whose realism needs to be established. In the MPC's considered view, all is well in the foreign exchange market; the government borrowing programme has been within target and therefore not exerting pressure on interest rates; and the "strong" confidence in the economy as reflected by the activities at the Nairobi Securities Exchange can only mean that the projected growth target of 5.6 percent is attainable. In short we are depicted to be living in the world of musician Bobby McFerrin and the official mantra may as well be "*Don't Worry, Be Happy*".

The Bobby McFerrin Stance – How Realistic?

When you consider the period July–August 2013 as the MPC has, you observe a sense of stability in the foreign exchange market. Which the market conditions buttressed by a weak external position characterised by a current account deficit equivalent to about 10 percent of GDP, the relativestability is more a function of the depreciation trend that commenced in May 2013 (**Figure 2**) starting to constrain imports as opposed to the export impetus picking.



Source: CBK

The best bet for the MPC in ensuring stability in the foreign exchange market is hinged on the medium term conjecture that the initiatives by the government to attract foreign investors and expansion in trade markets will result in increased foreign exchange "'in the future". We call this a conjecture advisedly; the MPC does not define the future against which it hinges stability in the foreign exchange market.

It is the endeavour by the MPC to hinge its market stability expectations on expansion in trade markets that brings out the fact that some clear risks are being downplayed. These are principally the external risks. The only external risks that the MPC explicitly acknowledges are the challenges of the Euro zone and the Middle East and North Africa Challenges; in the case of the latter it is only to the extent that it influences the price of oil.

But there is a bigger risk that the MPC does not even acknowledge it exists: *the BRICS hitting the wall!* The *BRICS* – as the economies of Brazil, Russia, India, China, and by some reckoning, South Africa – depicted a tendency of fast growth for some time until it was assumed that they could grow in their sleep – regardless of what happens in the rest of the world.

Unfortunately that attitude led to a bubble of complacency that is now being popped brutally. As observed by *The Economist* (July 27th – August 2013), these economies are experiencing the great deceleration and even though that may not necessarily imply the beginning of a burst, it is a turning point for the world economy.

The challenges of the brics did not emerge with the US's Federal Reserve Bank signalling the intention of re-looking its monetary policy stance in its tapering talk. Soft patches started being observed as far back as October 2012. Prior to that period and subsequent to the beginning of the global economic crisis, conventional wisdom divided the world into two: the *BRICS* and the "sick" (the EU and the US).

But then, it is now emerging that for all the talk about decoupling, the *BRICS* are affected by the weak Western economies. In other words, the MPC is looking at the leading emerging markets in its "expansion in trade markets" observation as the refugee in repairing the current account. Unfortunately, this comes at a time when the brics are also looking sick.

The MPC is sending the signal that the usable foreign exchange reserves currently at an equivalent of 4.11 months of import cover will adequately allow the CBK to intervene as appropriate in the event of volatility. The sense of foreign exchange stability that we earlier observed meant that if there were any market interventions by the CBK, they were mild. But this does not take away the fact that the current account is increasingly relying on short-term capital inflows, and this has attendant risks in the event of a reversal.

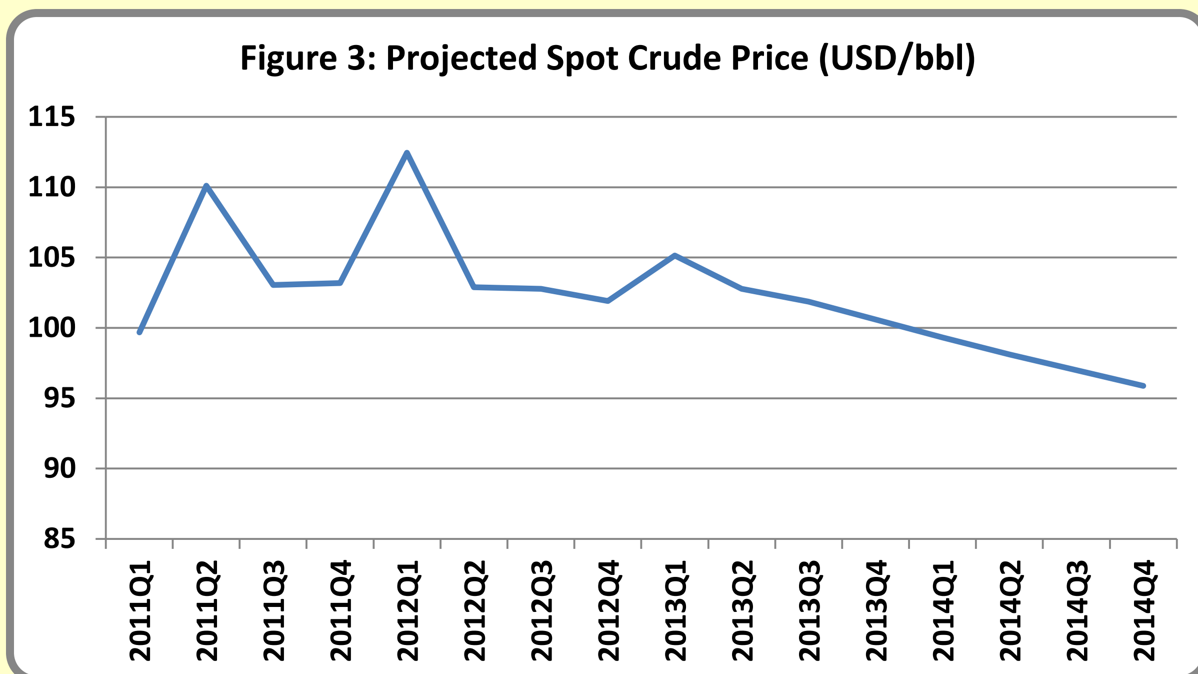
In another respect, the MPC's inadvertent penchant to be implicitly backward looking as opposed to giving forward guidance without necessarily giving away the game has tended to shroud in the money market. The MPC's indication that the "government domestic borrowing programme was within target and was therefore not driving or exerting pressure on interest rates" needs to be considered alongside the fact that while delayed government expenditure as the new government was settling in may have resulted in tight liquidity, the resumption of expenditure may be accompanied by challenges of meeting government revenue collection targets.

Therefore, to assume away the possibility of a simultaneous domestic adjustment at the fiscal front and the external adjustment in view of the global developments we outline above will be sweeping a major risk under the carpet. Similarly, the argument that the new VAT measures will contribute only to mild short-term inflation has to confront the fact that the implementation has seen drastic price increases in basic commodities even beyond the tax measure – in instances opportunistically – and clearly inflation expectations.

While the MPC acknowledges the instability in the Middle East and North Africa as stands to contribute to an increase in domestic fuel prices, the full potential impact needs to be appreciated. Some forecasts of the international oil prices (**Figure 3**) indicate a stable – even mildly declining – regime in the range of USD 95 – USD 100 per barrel. It is difficult to countenance such forecast when you consider the shifting geo-political dynamics in the Middle East.

The prospect of Western military intervention in Syria is one reason why the forecast may be overly ambitious, but not the only one. A combination of strikes and sabotage has hurt Nigerian, Iraqi and Libyan oil production. And the amount of "spare capacity" in oil output—a gauge of future price movements—is at its lowest level since 2008. On the local front, the Energy Regulatory Authority has

increased the pump price and there are all indications that the consumer will be forced to subsidize the inefficient refinery in Mombasa. All this will be inflationary.



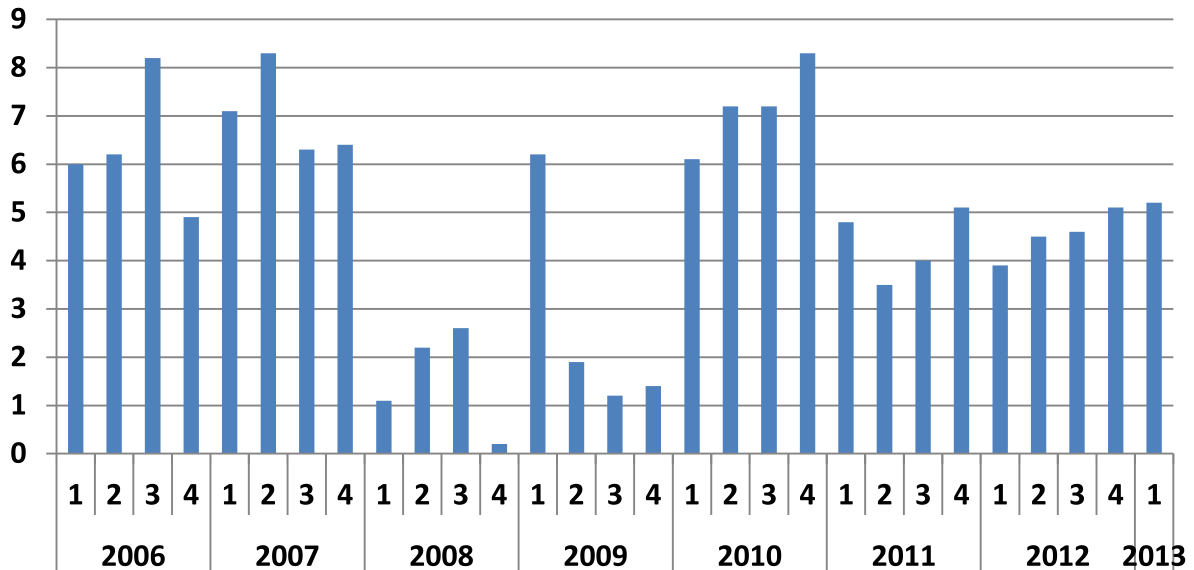
Source: IMF

Learn From Recent History? Which History?

With the MPC indicating that "it will continue to monitor the key macroeconomic aggregates and any emergent risks that may impact on price stability", we can only assume that to be an indication of its willingness to make a quick response in the event of those risks becoming more probable. But that can only be an assumption that needs to be tested against arguments that we have fronted above to the effect that the inflationary momentum may be building under MPC's watch.

What is at stake is policy credibility. We have been in such a spot in the past. As **Figure 1** shows, during the period February 2011 – August 2011 when inflation sharply rose from 5.75 percent to 16.7 percent, the CBR was in the 5.75 percent – 6.25 percent level. This was arguably a clear policy misstep whose correction necessitated a drastic tightening by way of drastic increase in the CBR and restricted use of the discount window. Those who share our view hasten to add that the policy communication was not clear, a fact that manifested itself in an even large increase in the inter-bank rate during the time.

It remains to be seen whether lessons have been learned. Such learning can only take place if there is an appreciation that there is a cost to a delayed policy response if such response will entail shocking the system by a drastic adjustment. It may be important to seek to juice up the economy during politically opportune moments. But that has its costs. In view of the circumstances, the prospects of economy's real growth trajectory seen in **Figure 4** being maintained and the target of 5.6 percent for 2013 being hit seem less likely by the day. That is why there has to be a recognition that a slightly less accommodative monetary policy stance does not necessarily amount to a tightening but stands to send the signal of vigilance to secure stability.



Source: KNBS

Conclusion

In justifying the decision to hold the CBR at 8.5 percent, the MPC noted that inflation has remained within the target range. As we argue above, there are a number of major risks that the MPC ignored, not least the fact that even within the target range inflation is strongly establishing an increasing trend and will soon overshoot the target.

We therefore see the policy decision as a missed opportunity on the part of the MPC to assert its policy credibility credentials. Markets are usually forward looking, responding to what the policy maker is expected to do and not what the policy maker does. We surmise that in the prevailing circumstances, a slightly less accommodative monetary policy stance- which does not necessarily amount to a tightening – will have been justified for it could have sent the signal of vigilance on the part of MPC to secure stability.

While it is tempting to seek to juice growth because that may be one of the ways of fending off medium term inflation, the policy decisions may end up frustrating the very growth if they make it inevitable to shock the system so as to have stability.

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

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