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# Monetary Policy Stance – The Policy Signalling Agony!

## Highlights

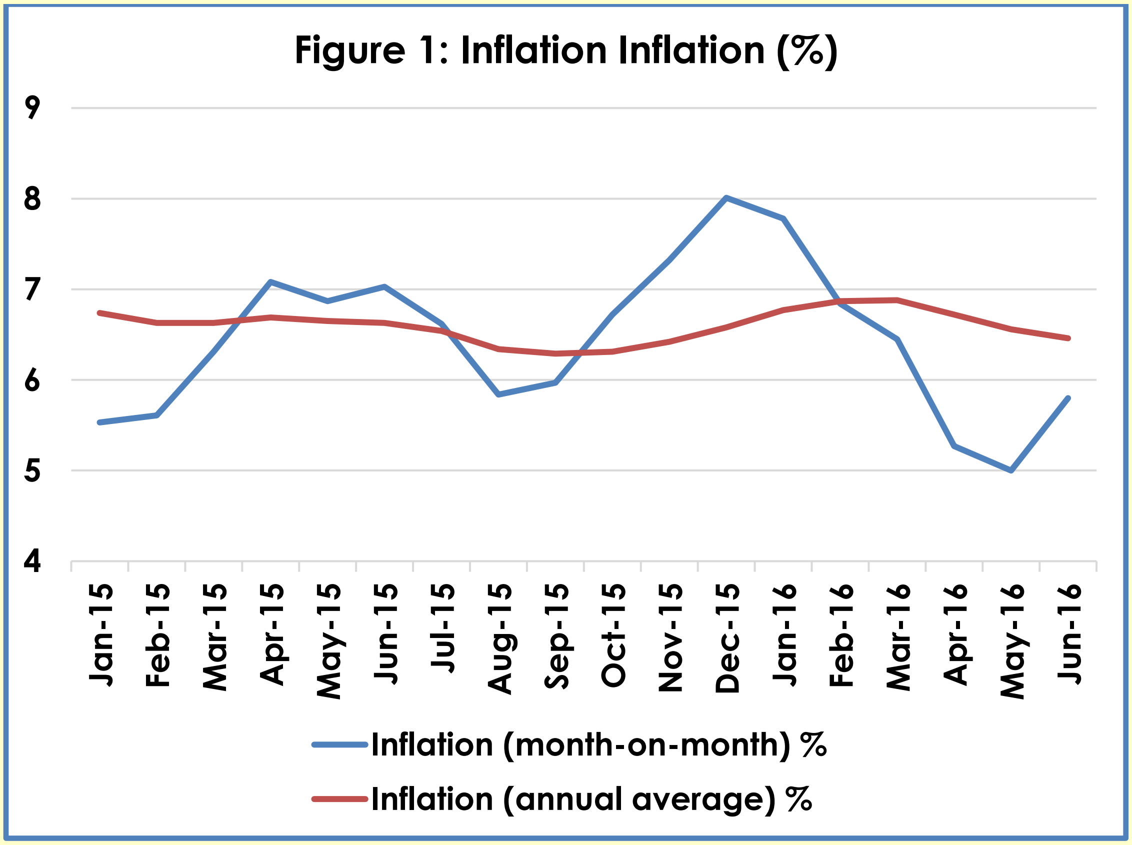
- The Central Bank of Kenya's Monetary Policy Committee is desirous of anchoring inflation expectations, the reason why in its meeting of July 25, 2016 culminated in the decision to retain the Central Bank Rate (CBR) at 10.5 percent. On the back of rising inflation, albeit within the target range, this represents no change in the overall policy stance.
- The Committee however reviewed the Kenya Banks Reference Rate (KBRR,) the common benchmark for floating rate credit pricing, and lowered it from 9.78 percent to 8.90 percent rate, effective from the date of the meeting. In essence the Committee is comfortable with a lower lending rates without adjusting the policy signalling rate. This is the evidently the agony of signalling.

## Introduction

The July 25, 2016 meeting of the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) was expected to provide a clear signal that monetary policy is aimed at anchoring inflation expectations. That was demonstrated nn the decision by yhe MPC to hold the Central Bank Rate (CBR) at 10.5 percent.

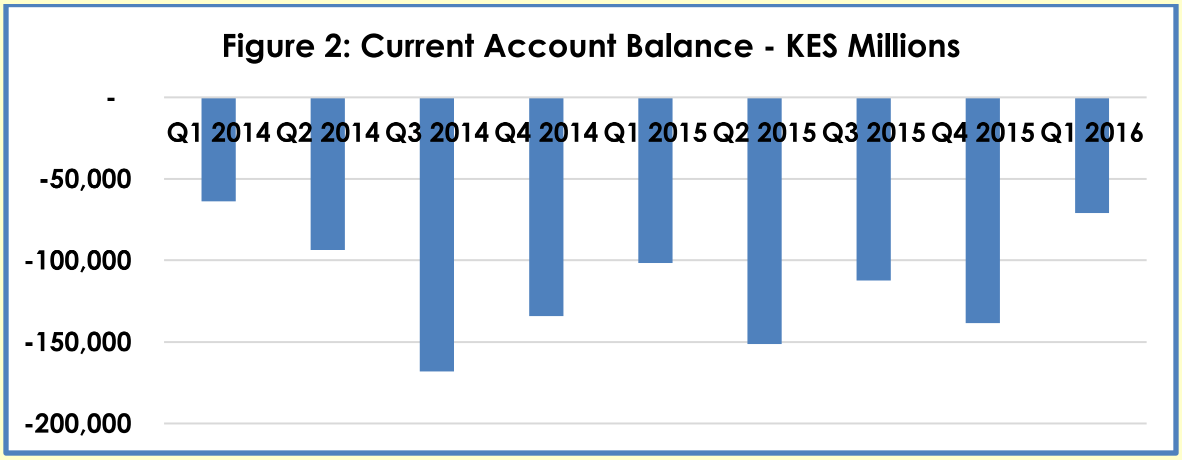
As **Figure 1** indicates, inflation was within target range. The month by month inflation rate that had peaked in January 2016 at 7.78 percent dropped to a low of 5 percent in May but rose to 6.6 percent in June 2016. This increase was largely attributed to pressure from some basic food items. Month-on-month non-food-non-fuel (NFNF) inflation declined to 5.0 percent in June from 5.4 percent in May.

The 3-month annualised NFNF inflation fell to 3.3 percent in June from 5.2 percent in May 2016, indicating that there were no significant demand pressures in the economy. We can surmise that the decision by the MPC to review the Kenya Banks Reference Rate (KBRR,) the common benchmark for floating rate credit pricing, and lowered it from 9.78 percent to 8.90 percent was undeppjed by the view that there is limited demand pressure and therefore no risk of demand-drioven inflation linked to the credit market.

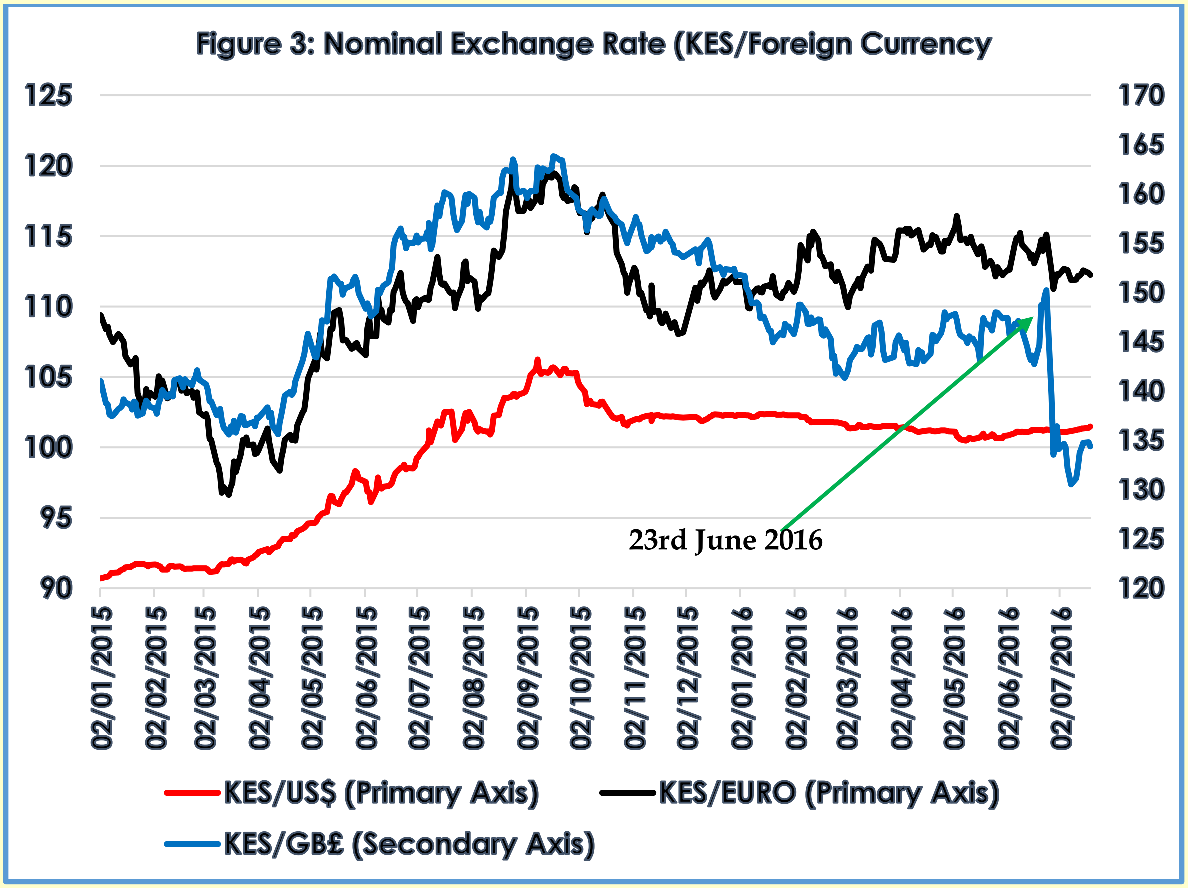



*Source: KNBS*

The inflationary trend observed above was on the back of the foreign exchange market remaining stable. On the one hand this was a reflection of a narrower current account deficit (**Figure 2**) due to a lower import bill, improved tea and horticulture exports, and strong diaspora remittance. On the other hand it manifested the support by the CBK that closely monitored the market before and after the U.K. vote to leave the European Union (Brexit) - **Figure 3**.




*Source: KNBS*




*Source: CBK*

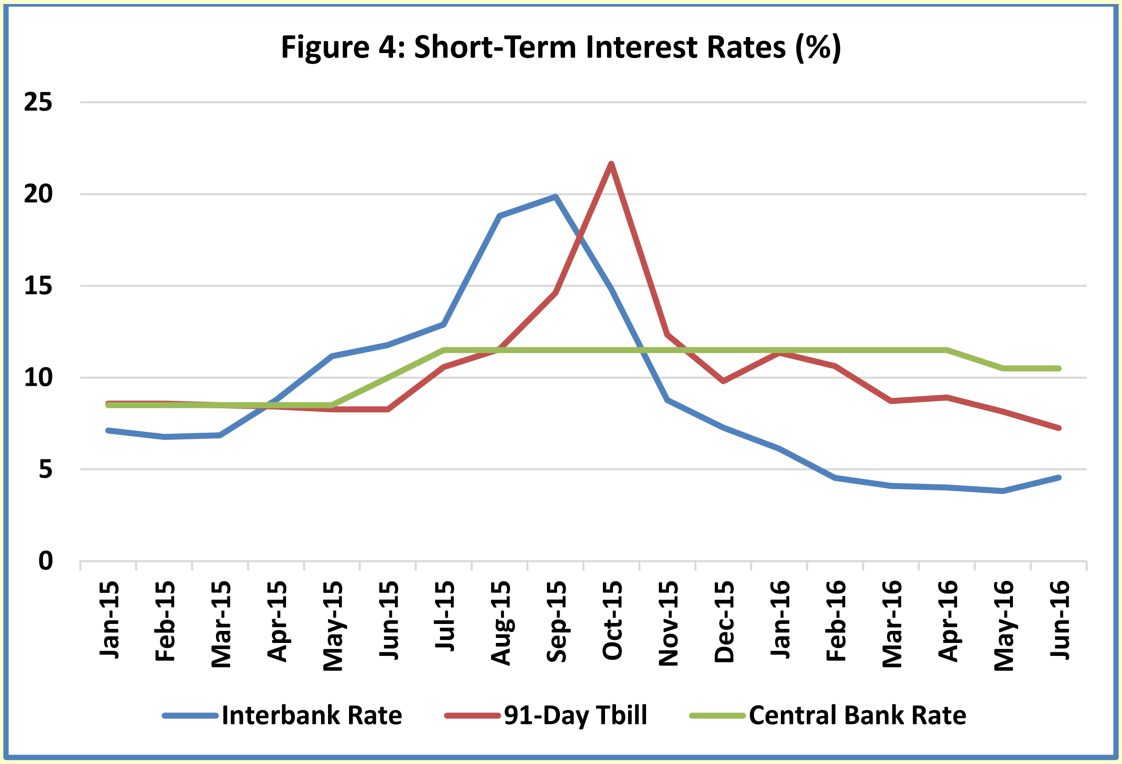
The ability of the CBK to bolster the foreign exchange market stability is suppprted by the adequacy iof foreign exxhange reserves, presently at USD7. 8 billion (5.1 months of import cover) up from USD7.7 bilion by end of May 2016. The reserves, together with the Precautionary Arrangements with the International Monetary Fund (IMF) continue to provide adequate buffers against short-term shocks.

## Calmness through and through?

The MPC is up-beat about the state of the economy. In its assessment, the performance can be characterised as strong, with a real growth of 5.9 percent in the first quarter of 2016, compared with 5.0 percent in a similar period of 2015. The MPC is equally up-beat about the fiscal stance by the Government. The Committee notes that the 2016/17 fiscal year budget statement provides for additional resources towards infrastructure investment, security, and irrigation projects, which should continue to improve the business environment and lower food prices in the medium term. The budget also provided additional measures to address the high cost of credit,including use of movable assets as collateral, setting up of an electronic collateral registry, and the ongoing digitisation of land registries.

Notably, the MPC is concerned about the possibilty of interest rates regulation through a proposed capping. This, in the MPC's view would lead to inefficiencies in the credit market, promote informal lending channels, and undermine the effectiveness of monetary policy transmission. We nonetheless see one risk that the MPC doesn't highlight: the substantial fiscal deficit (estmated at an equivalent of over 9 percent of GDP). It is possible that all the programmed expenditure may not be realised – given absoprtion challenges. But if you take into account political considerations surrounding the forthcoming general elections where previous pledges have to be delivered, the likely outcome is an endeavour to push the proposed expenditure as much as possible.

That will only mean that the fiscal demeanor will be one of seeking to mobilise "urgent" resource requirement to fill the fiscal gap. The calm that is seen in the short-term money market (**Figure 4**) would consequently be revered. While superficially the high rates on fiscal instruments, if temporary, could be seen to be reinforcing the monetary policy stance towards stablity in the medium term, it would in some respect be masking a policy conflict that buttressed some level of fiscal dominance – where the fiscal policy action forces the hand of the monetary policy. That is why the case for continued strengthening of monetary and fiscal policy coordination towards supporting overall macroeconomic stability is compelling.




*Source: CBK*

## The Brexit "fear"

The initial view of the economic effects of the Brexit has been that it is more a regional issue than a global one. That has informed the perspective, by for instance *The Economist* (2016)[1], that any downward review of the growth forecast on account of the Brexit is "markedly for Britain, materially for Europe, and modestly for the world". Formal analyses by, for instance IMF, (2016)[2] confirm this view and asserts that Brexit represents a materialisation of a key downside risk for the world economy.

While the Brexit is still unfolding, the ensuing uncertainty – hinged on direction the exit process and anxiety regarding possible political fallout – has occasioned a downward review of the global economic outlook by 0.1 percent for 2016 and 2017. Just like *The Economist* (2016), the IMF (2016) contends that the negative effect will concentrate in advanced Europe, with the impact elsewhere being at worst muted.

While the effect on the real economy could be muted or, even where it to noticeable, comes with a time lag, asset prices respond rapidly. The view that the Kenyan market took soon after the verdict of the Brexit vote manifested itself in the dipping of the GB£ against the KES while the exchange rate vis-à-vis the US$ and the Euro remained stable (**Figure 3**).

We can therefore argue that the low interest rate regime that may be prolonged by the Brexit is not likely to have short-term influence on the exchange rate even when it could influence portfolio flows to the economy.
The key inference arising from that observation is that markets are unlikely to suffer the possibility of carrying the risk of turmoil in the event of future policy changes monetary policy normalising, like was

[1] *The Economist*, July 2nd – 8th 2016.
[2] IMF (2016), *World Economic Outlook* Update, July 19th.
[http://www.imf.org/external/pubs/ft/weo/2016/update/02/pdf/0716.pdf ]

the case in major merging market when the US hinted that it will scale down on Quantitative Easing (QE) – what has been referred to as the Taper Tantrum (see Neely, 2014)[3].

We by no means suggest that there is limited possibility of market turmoil; our argument though is that such occurrence (if at all) cannot be pinned solely, even substantially, on Brexit and the macro policy it has induced. If at this stage the envisaged effect of the Brexit on growth to Kenya – just like other markets and the global economy – is not expected to be substantial, and the market reaction in a negative manner beyond the immediate response is likely to be mild, then why should the Brexit be an issue of concern to Kenya and the EAC economy? We argue that the Brexit could trigger attitudes towards integration with implications on the EAC pace and thrust.

## Conclusion

The MPC is exhibiting confidence that the monetary policy measures in place are appropriate to assure stability and anchor inflation expectations, hence retaining the CBR at 10.5 percent. With the highlighted of downside risks especially those linked to the fiscal stance, it is interesting that the MPC decided to lower the KBRR while retaining the CBR. This reflects the agony of policy signalling.

[3] Neely, C. J. (2014) "Lessons from the Taper Tantrum", *Economic Synopses*, Federal Reserve Bank of St. Louis, January 17. [https://research.stlouisfed.org/publications/es/14/ES_2_2014-01-28.pdf ]

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