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

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Monetary Policy Stance – The Search for Signalling Clarity

Highlight

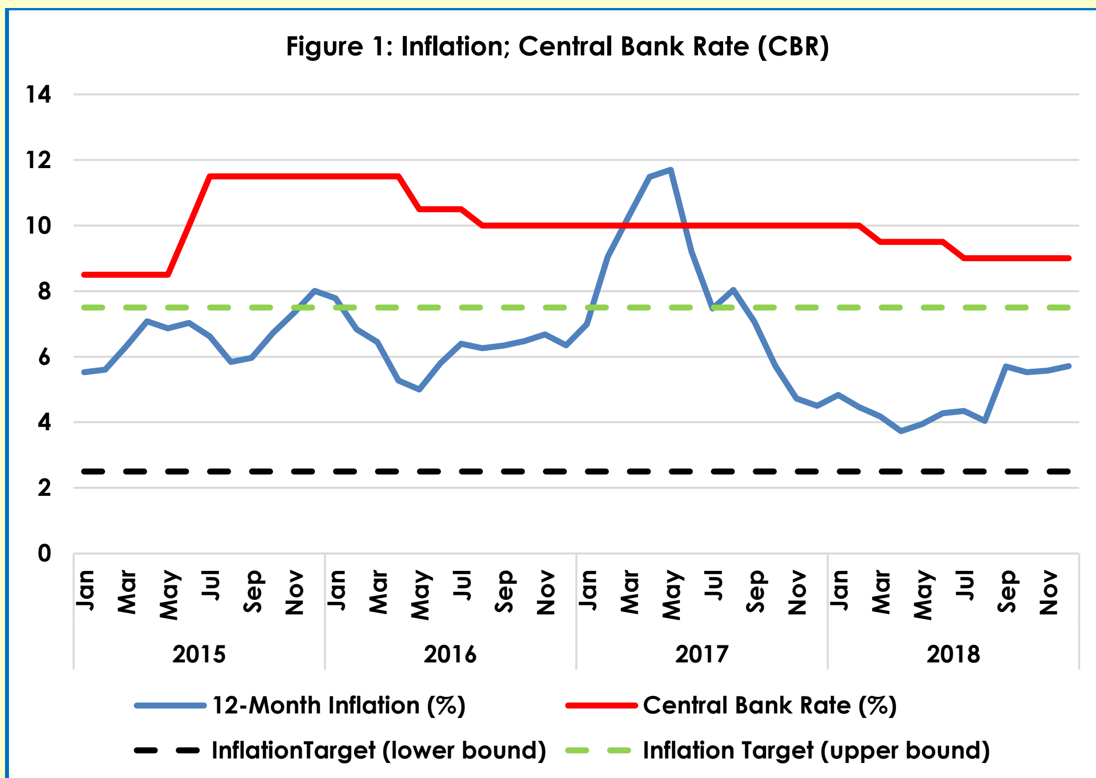
The Central Bank of Kenya's Monetary Policy Committee meeting of January 28, 2019 could exude confidence that the monetary policy measures in place are appropriate to assure stability and anchor inflation expectations. On that basis, and taking on board the numerous downside risks, a retention of the CBR at 9.00 percent will be justifiable. Any other stance will present a dilemma of the clarity of the policy signal.

Introduction

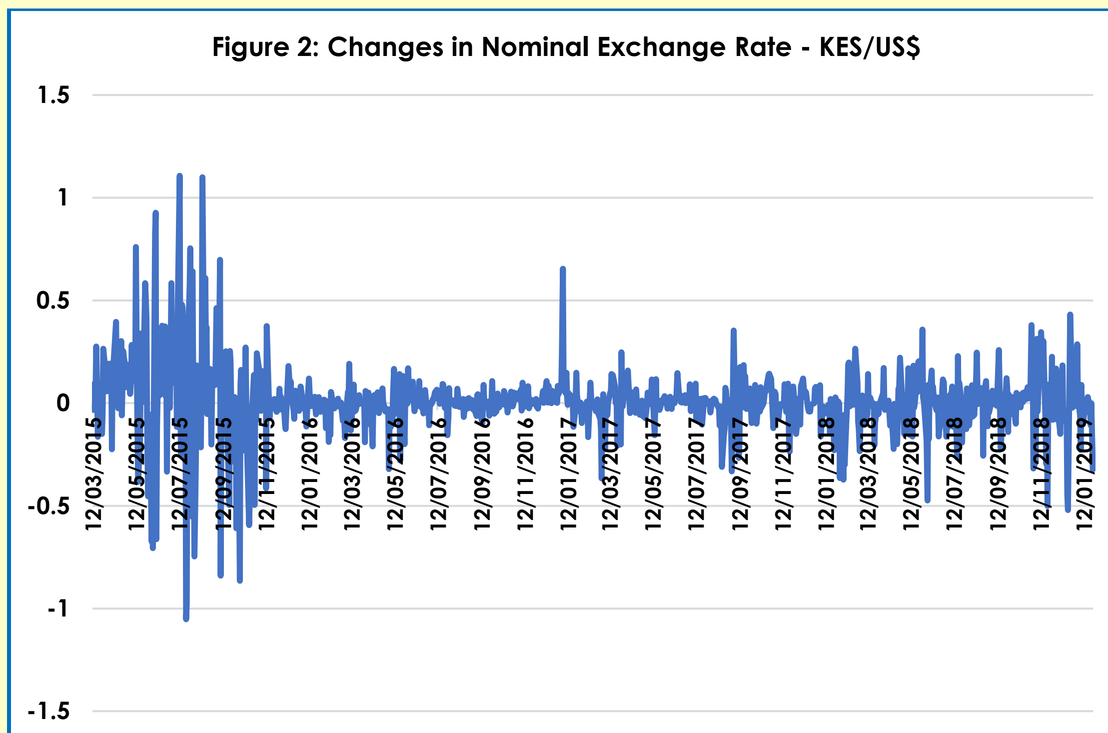
The 28th January 2019 meeting of the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) is important in at least two respects. One is that it will set the monetary policy tone for the year on the back of anticipated improvement in output growth but characterised by subdued consumer confidence and low investment demand. The other is that it will be a test for policy signalling clarity given the implicit tension between the projected strong economic performance and the seemingly constrained businesses and households that underlies a disconnect that is seldom acknowledged.

As **Figure 1** indicates, inflation has since September 2018 been within target. The monetary policy stance has gradually shifted from neutral (neither accommodative nor restrictive) during the time of transitioning from an inflationary spike (January 2917 to August 2018) to a more accommodative one. We see a motivation of expectations of simultaneity of two effects.

On the one hand, the MPC could take the view that there will be comfort of a stable nominal exchange (**Figure 2**) that would support inflation remaining within the targeted inflation range of 2.5 percentage points over (or below) the 5 percent medium term target. On the other hand, the neutral monetary policy stance's gradual yielding to an accommodative one implies that any support for the local currency by way of interest rate adjustment – if any is needed – is off the table; in essence the assumption that the uncovered interest rates parity (UIRP) principle – where foreign resource inflows are attracted by positive interest rates differential – is in policy play can for now be ruled out.



Source: KNBS; CBK

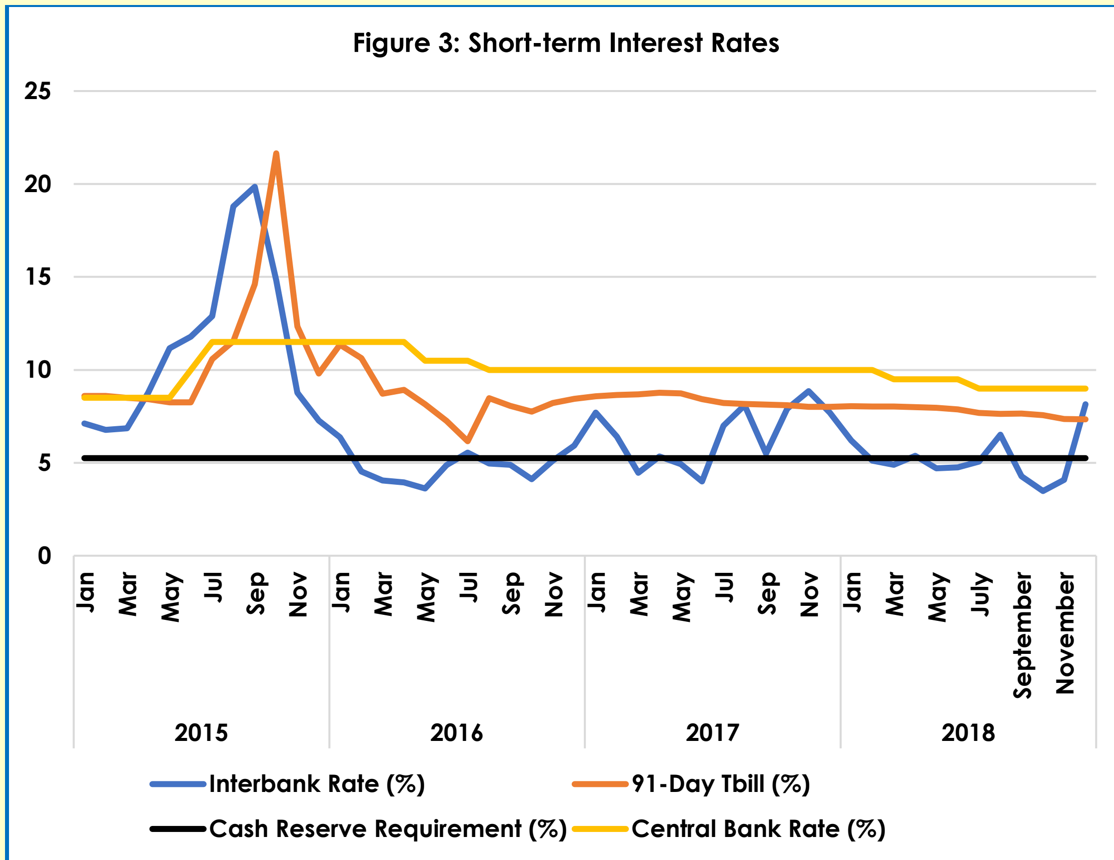


Source: CBK

The fiscal policy is undoubtedly on the radar on account of the government's resource requirement to fill the fiscal gap even on the back of the "fiscal consolidation" promise of the 2018/19 budget. This implies that fiscal policy has an influence on liquidity and consequently the short-term interest rates. Since the Banking (Amendment) Act, 2016 that capped lending rates, the short-term interest rates have been stable and consistently below the CBR – the monetary policy signalling rate and the capping benchmark (**Figure 3**).

While superficially the stable interest rates on fiscal instruments could be seen to be reinforcing the monetary policy stance, it is in many respects masking a policy conflict that buttressed some level of fiscal dominance – where the fiscal policy action forces the hand of the monetary policy. The fiscal–monetary policy conflict in the current credit pricing regime is seen more from the quantity channel (resource allocation away from the private sector, thus negating any simulating effect of an accommodative monetary policy) than from the price channel.

Therefore, the case for strengthening of monetary and fiscal policy coordination towards supporting overall macroeconomic stability remains strong. The question that this *Research Note* poses is: are we seeing the state of macro policy tending towards normalisation? We argue that all the evidence points towards a negative answer, thus providing the platform for an unintended mixed monetary policy signalling.



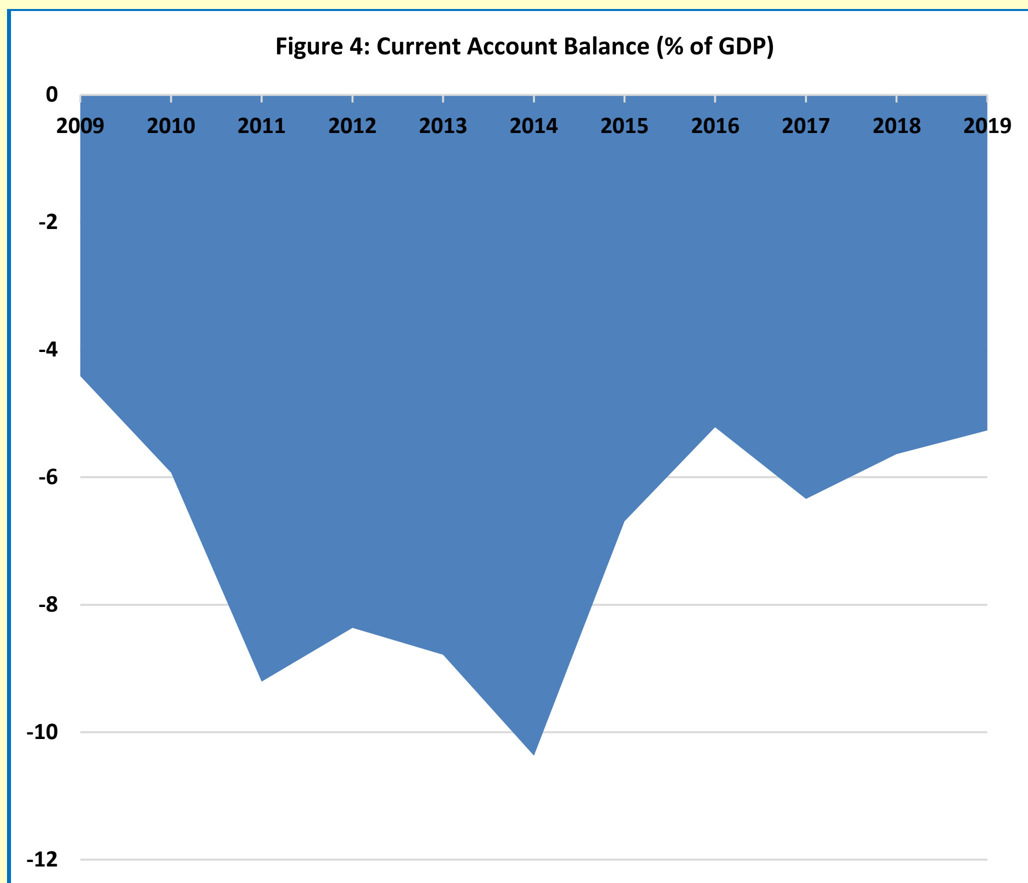
Source: CBK

The Calmness – What's it Hiding?

The broadly calm domestic market environment highlighted above could misleadingly tempt an assumption of policy normalcy. As already noted, the foreign exchange market has been stable on the back of calm money markets. Financial market calmness is hardly economic nirvana. Could we be seeing calm before the storm? To be sure, one need to look at what has changed at the broad macroeconomic parameters. Even with the promise of consolidation, the projected fiscal deficit remains large and the measures being put in place are geared more towards bridging the fiscal gap than to substantially reduce it.

The challenges are not entirely concentrated on the domestic balance. The external balance deserves an equally careful scrutiny. Superficially, the economy's narrowing current account deficit reflects good tidings (**Figure 4**). That the narrowing of the current account deficit leans more towards a lower import bill than vibrancy of export inflows is a pointer to the challenges associated with the economy's international competitiveness. That is why we could argue that to look at the narrowing as an end in itself without looking at the process will only serve a short-term purpose.

As we have contended in the past, there is no symmetry in the current account narrowing based on imports declining and the narrowing on account of exports rebounding; the latter obviously reflects a rejuvenation of growth in the exportable and therefore an indication of improvement in competitiveness.

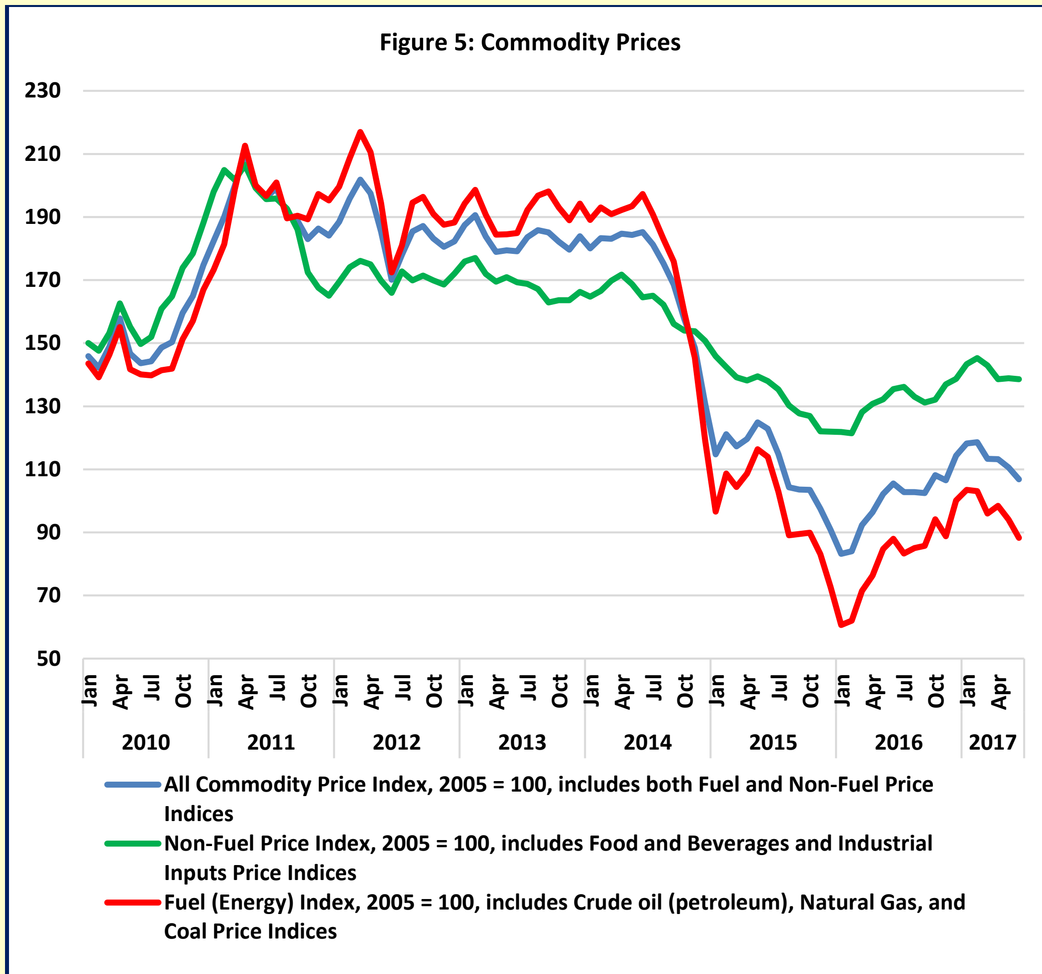


Source: IMF

The MPC could take comfort of foreign exchange foreign reserves adequacy even without the Precautionary Arrangement with the International Monetary Fund (IMF). Nonetheless the true test of such adequacy will be if the CBK has to resort to the build-up of reserves by way of purchase of foreign exchange from the market; in which case the very action would put the local unit under pressure.

Ultimately, the MPC must of necessity search for policy signalling clarity if on the one extreme it takes comfort in the sustenance of the calm market conditions and on the other bring to bear considerations of the possible inhibitions of the fiscal policy. Beyond that there are several downside risks to be considered. One is that while a reduction in international oil prices will provide some reprieve, Kenya's commodity exports could also be subject to softening process given that commodity prices track each other (**Figure 5**). The two effects may offset each other insofar as the effect on the current account is concerned.

Furthermore, the performance of the global economy is subject to softening on the back of a trade war between the US and China; the uncertainty around the timing return to conventional monetary policy in the US and hence the risk of portfolio outflows with interest rates hike; then fact that the risks for emerging markets are not simply slow growth but debt challenges that seem to be on the move initially from the US to the Eurozone and now to emerging markets; and the risks associated with a messy Brexit.



Source: IMF

Conclusion

The MPC could exhibiting confidence that the monetary policy measures in place are appropriate to assure stability and anchor inflation expectations. On that basis, and taking on board the numerous downside risks, a retention of the CBR at 9.00 percent will be justifiable. Any other stance will present a dilemma in the implied policy signal.

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