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Monetary Policy Stance: *Forward Guidance* on a Near Term Accommodative Stance?

Highlights

The decision by the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) meeting of September 23, 2019 to hold the CBR at 9.00 percent was justifiable. It is clear that the MPC's decision hinged crucially on the fact that inflation is on target, thus demonstrating the strive to "anchor inflation expectations".

"It remains to be seen whether the path towards fiscal consolidation is straightforward or slippery and whether that is the appropriate grounding for forward guidance".

How that has buttressed the MPC's latest decision needs to be taken in context if only to bring out the proper perspective 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.

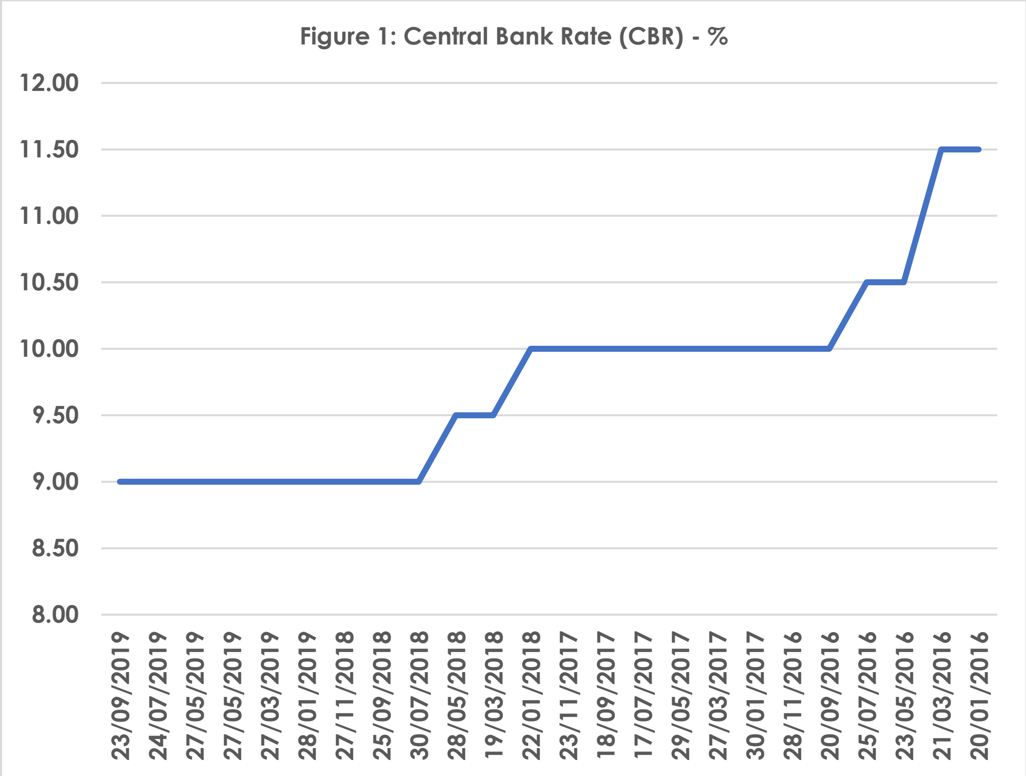
- One, as the economy's growth momentum picks, one has to be clear how that plays out with regard to the output gap – difference between full potential and actual growth – and how that relates to inflation expectations.
- Two, while stability is evident in the foreign exchange market, there is need to 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, remains to be seen whether the path towards fiscal consolidation is straightforward or slippery and whether that is the appropriate grounding for forward guidance. This is crucially so given the MPC's indication that "the prospective tightening of fiscal policy" would provide scope for "accommodative monetary policy in the near term"

Introduction

So what does the decision by the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) meeting of September 23, 2019 to retain the Central Bank Rate (CBR) at 9.00 percent signal? The answer is two fold: there is an explict signal and an inadvertent signal.

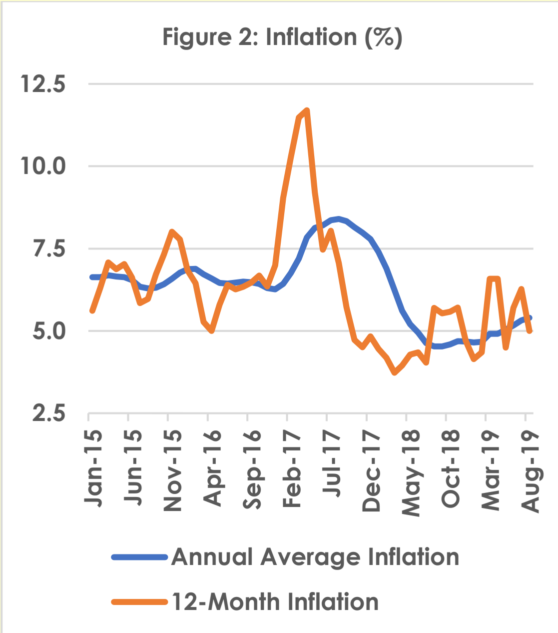
Let' start with the explicit signal. Since March 2019, the MPC's stance could be characterised as having an acomodative bias (**Figure 1**). The stance has on the one hand been supported by the key stabiity indicators being within target. On the other hand though, the stance underlies the case of a slack in demand at both househods level (as manifest in subdued non-food non-fuel inflation) and at enterprises level (as manifest in subdued growth). The fact that the policy rate has been held at 9.00 percent since Setpember 2018 would be infered to indicate that the MPC policy decisions are meeting their objetive.

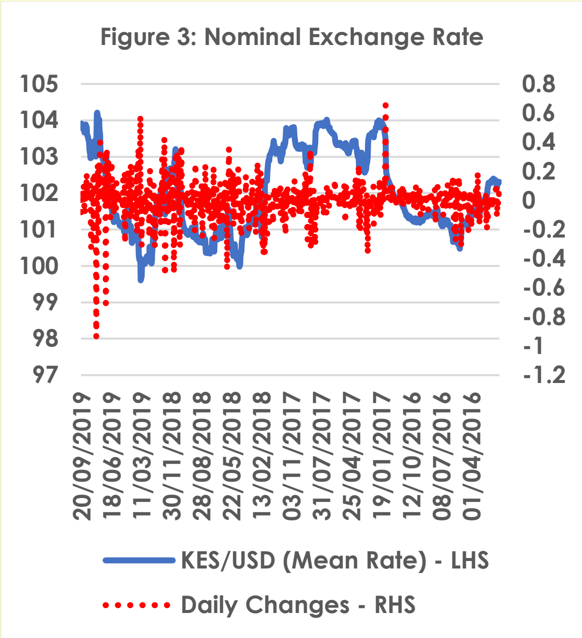
The inadvertent signal is that any expectations on a change in policy stance will have to acknowldege the known imperfections in the monetary policy transmission mechanism[1] such that the effect of its decisions as would be manifested by market prices reaction – especially money market prices – are 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 since inflation is within target (**Figure 2**) and the exchange rate market is *largely* stable (**Figure 3**).



Source: CBK

[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





Source: KNBS; CBK

An inference on the MPC's inflation forecast – albeit not a numerical one – is that past inflationary pressure that led to the target being surpassed were to dissipate by within one quarter. The tone of the latest MPC communique is such that the earlier inflation outlook has been accurate. Indeed the MPC indicates that the recent increase in international oil prices will at best exert "moderate upward pressure on fuel inflation, but with limited pass-through effect on inflation".

In this *Research Note*, we seek to make arguments around the immediate future implications of these policy messaging strategy. ***Our key observation is that the MPC is giving some forward guidance regarding its next policy decision by asserting that "the prospective tightening of fiscal policy" would provide scope for "accommodative monetary policy in the near term".***

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 perspective 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 momentum remains positive, although demand remains weak. If this is sustained, the consequence will be the narrowing of the output gap – the difference between the economy's actual real growth level and its potential level. 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 currency status that has been described as appropriately accomodative[2] has run its course.

[2] IMF (2018) https://www.imf.org/en/Publications/CR/Issues/2018/10/23/Kenya-Staff-Report-for-the-2018-Article-IV-Consultation-and-Establishment-of-Performance-46301

Second, the foreign exchange market stability that we have witnessed over the recent past few months is confirmed by the MPC. The sustenance of the stable streak will hinge on how the broader economic dynamics play out towards the further closure of the current account deficit to an equivalent of 4.5 percent by end of 2019 from 5.0 percent in 2018. The narrowing of the current account deficit has been attributed to improved diaspora remittances and export; but we have to keep an eye on the rising of oil prices.

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 April 2019. The IMF observes that the risks to the global outlook remain tilted to the downside and relate to ongoing adjustments in the global economy on the back of the trade between the US and China that is spilling into investment slowdown, geopolitical developments that potentially point to market volatility, and the uncertainty around the Brexit.

Four, the 2019/20 fiscal programme is framed around taking the economy on a fiscal consolidation path yet it could potentially be influenced by constrained revenue collections by the Kenya Revenue Authority (KRA). With the private sector enterprise operating at excess capacity and tax revenue capacity consequently inhibited, it remains to be seen whether the expectations of fiscal consolidation is a realistic proposition.

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 manner that could help shape policy expectations. As is often the case, the MPC gives itself a window to change gears in its observation that " it remains vigilant on possible effects of the increase in uncertainties in the external environment".

It is clear that the MPC cannot pre-commit to future policy decision – and we cannot logically expect it to do so. All it can do is signal its character given the inherent difficulty in monetary policy conduct to lock in a future policy stance. That however is no excuse for not setting the platform for the immediate future policy position.

Forward guidance, which in our case appears to be explicit in the latest MPC communique in its assertion "the prospective tightening of fiscal policy" would provide scope for "accommodative monetary policy in the near term", is not a give-away but a sign of a critical input to guiding market expectations. It will be interesting though that we are potentially looking at the possibility of front-loading monetary policy in anticipation of a fiscal consolidation that may be constrained.

The implied confidence in the MPC's inflation outlook where it projected the easing of inflationary pressure is a good pointer towards its likely policy direction; so anybody expecting a change in stance by end of 2019 need to start seeing how this fits into the hinging of the near term policy stance on the prospective fiscal policy outcome. 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.

Conclusion

The decision by the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) meeting of September 23, 2019, to hold the CBR at 9.00 percent was justifiable. It is clear that the MPC's decision hinged crucially on the fact that inflation is on target, thus demonstrating the strive to "anchor inflation expectations".

How that has buttressed the MPC's latest decision needs to be taken in context if only to bring out the proper perspective 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.

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- Three, the global economy remains weak and this has implications on the domestic economy generally and the financial markets in particular.
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