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Monetary Policy Stance – The Agony of the Signal

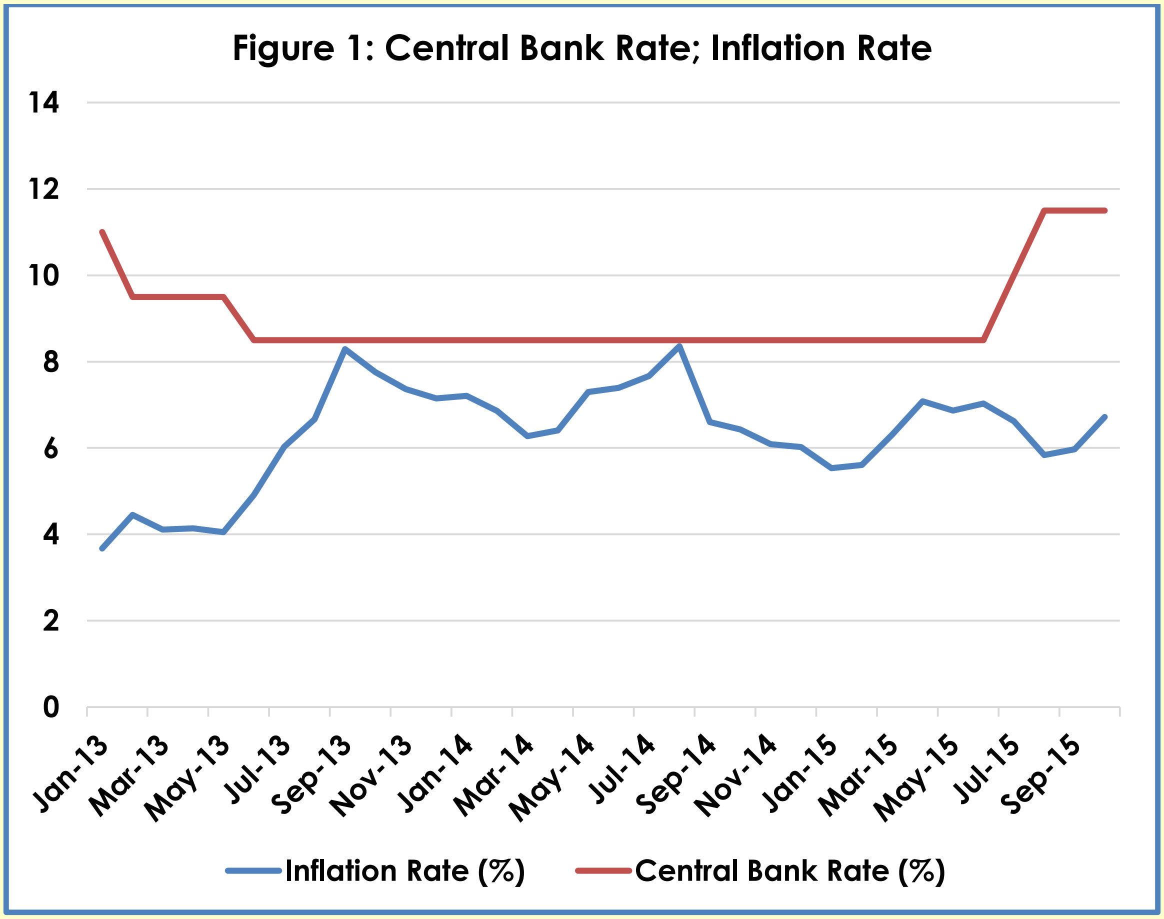
Highlights

- The Central Bank of Kenya's Monetary Policy Committee is exhibiting confidence that the monetary policy measures in place are appropriate to assure stability and anchor inflation expectations, hence retaining the CBR at 11.5 percent during its meeting of 17th November 2015.
- With there being a number of downside risks, the policy stance is implicitly a sustenance of the tightening bias although the CBK is keen to see money market rates come down. This reflects the agony of policy signalling.

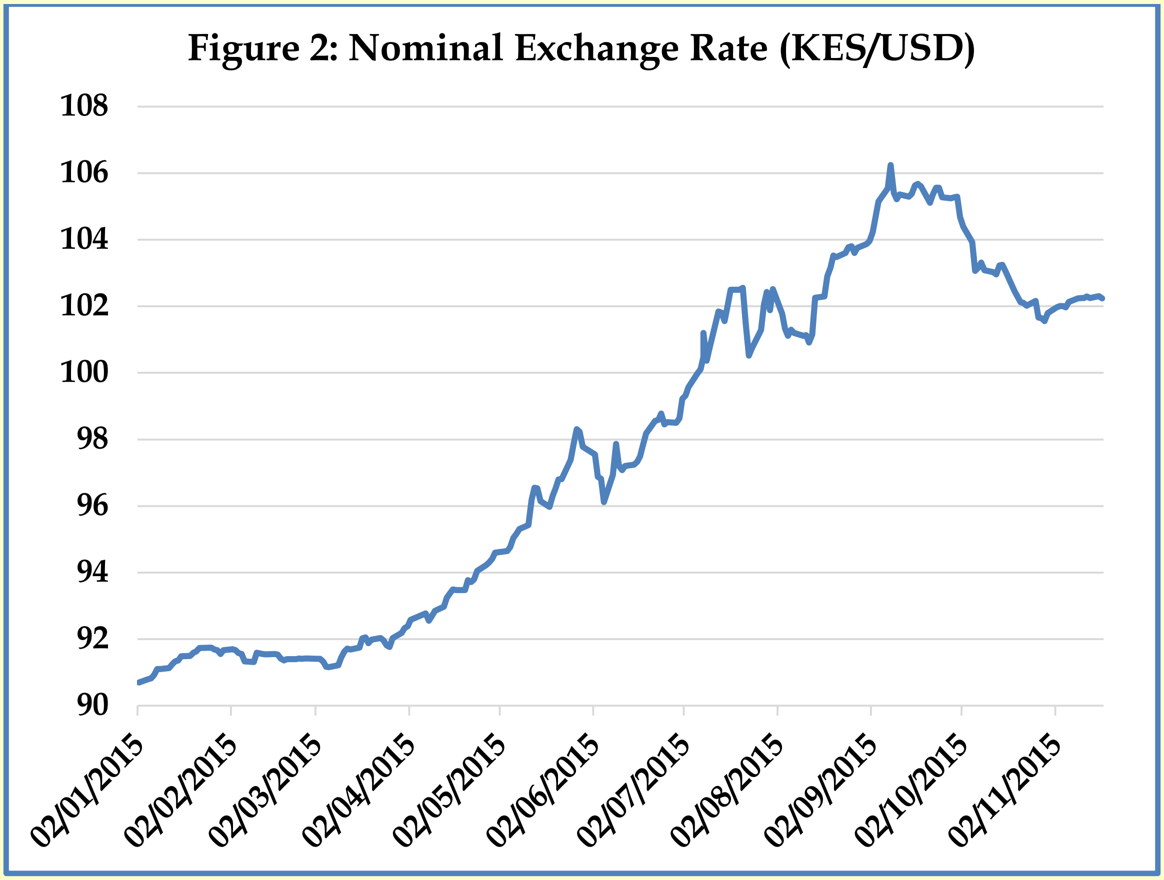
Introduction

The 17th November 2015 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 and not doing the fiscal policy bidding. When the MPC signalled the changed in policy stance from accommodative to tight in July 2015 through an increase in the Central Bank Rate from 8.50 percent to 10% in June 2015 and 11.50 percent by July 2015, a level at which it has since been maintained.

As **Figure 1** indicates, inflation was within target at the time of the change of the policy stance. This can only mean expectations of simultaneity of two effects: One, the MPC was of the view that pressure from a fast depreciating currency (**Figure 2**) could lead to the breaching of the targeted inflation range of 2.5 percentage points over (or below) the 5 percent medium term target. Two, the resumption of a rising interest rates regime will provide some support in the effort to stabilise the foreign exchange based on the assumption that the uncovered interest rates parity (UIRP) principle – where foreign resource inflows are attracted by positive interest rates differential – holds.



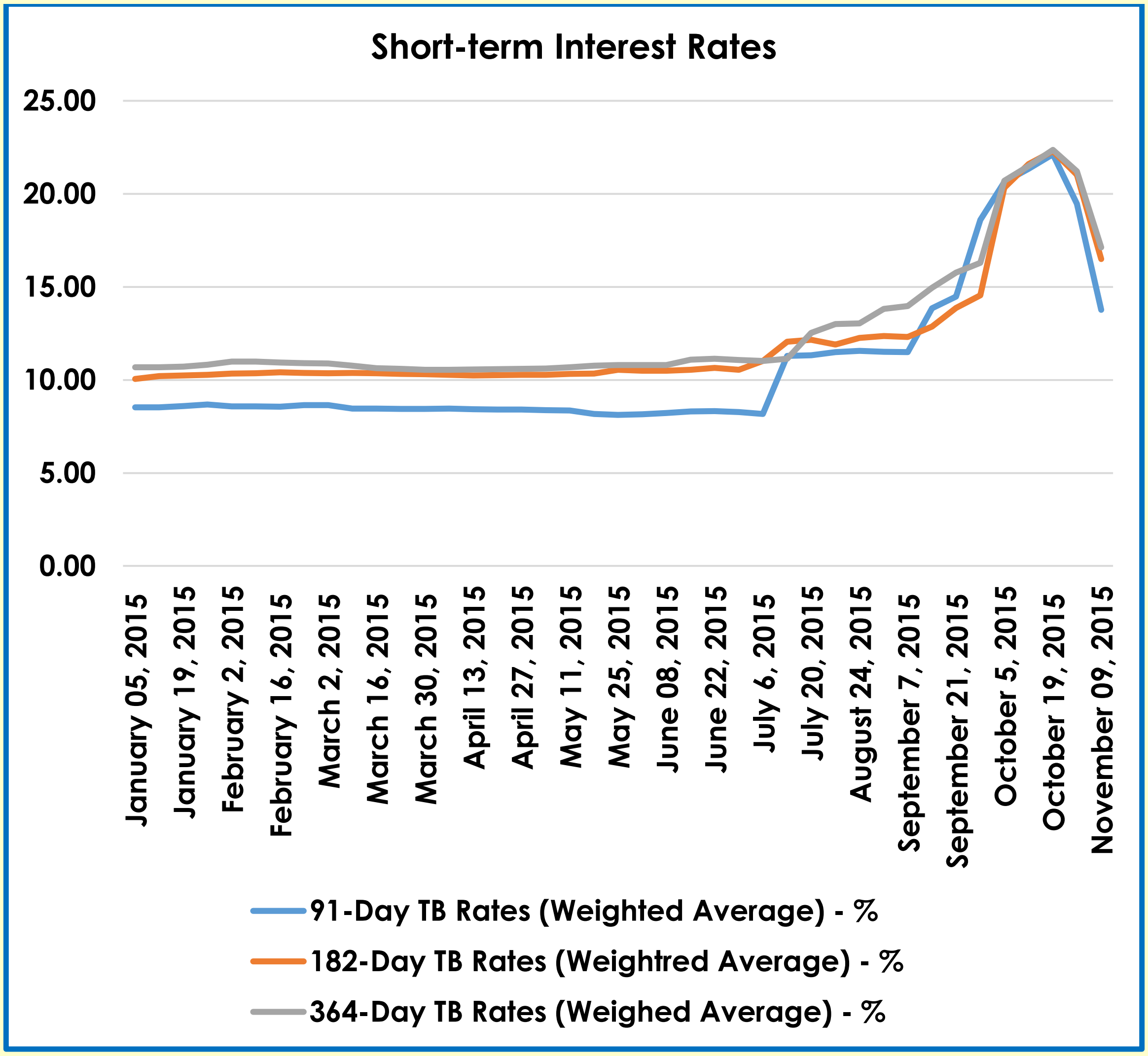
Source: KNBS; CBK



Source: CBK

Against that background, "urgent" resource requirement to fill the fiscal gap saw a steep rise in the Treasury bill rates (**Figure 3**). While superficially the high rates on fiscal instruments could be seen to be reinforcing the monetary policy tightening, it was in all respects 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 MPC explicitly acknowledges the need for continued strengthening of monetary and fiscal policy coordination towards supporting overall macroeconomic stability.

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 point towards a negative answer, thus providing the platform for an unintended mixed monetary policy signalling.



Source: CBK

The Eventual Calmness?

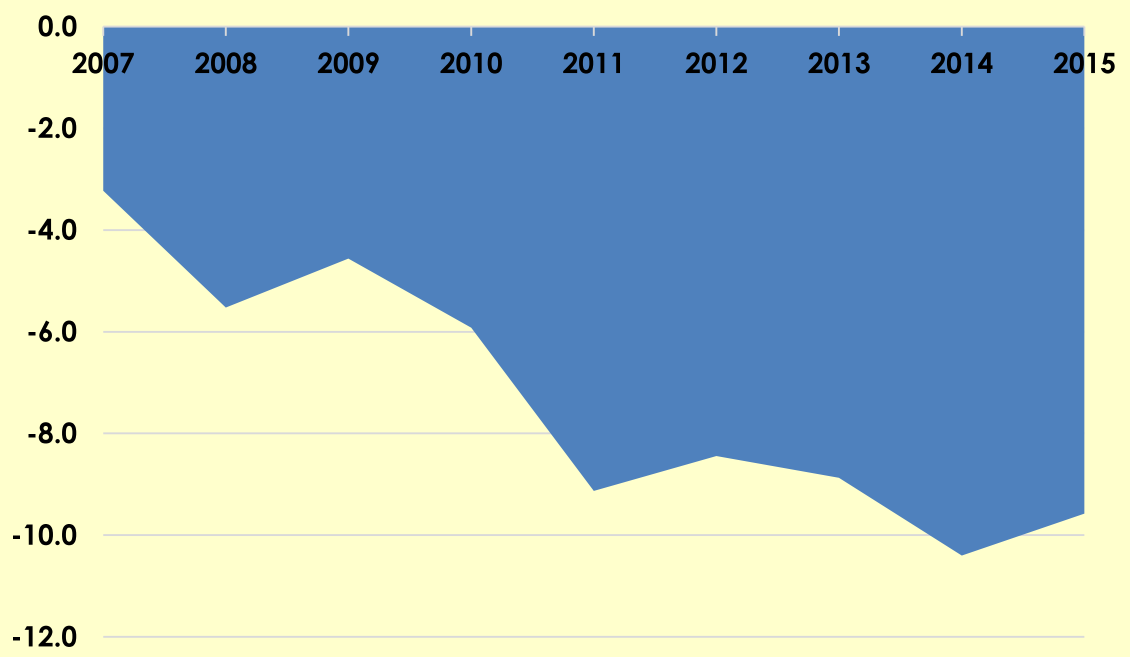
As could be observed, there has been relative calmness in the foreign exchange market over the past two months. This has largely been on account of the high interest rates as well as the CBK's intervention in the foreign exchange market when it deems that appropriate.

At the same time we are seeing a quick reversal of the short-term interest rates. There have been arguments that the steep rise was an over-reaction and therefore a reversal in the past three weeks is seen more as a correction than anything else.

Are we seeing calm before the storm? To be sure, one need to look at what has changed at the broad macroeconomic parameters. The projected fiscal deficit remains large and the measures being put in place are geared towards bringing the fiscal gap and not reducing it. The MPC gives a favourable review of the syndicated loan that was concluded by the National Treasury in November 2015, arguing that it will ease pressure on the government's domestic borrowing and interest rate; it is silent though on its implication on the foreign exchange market.

It is noteworthy that the stability in the foreign exchange market has seen some stability on account of the CBK's monetary policy operations. That the narrowing of the current account deficit is attributable to a lower import bill and not necessarily export inflows is a pointer to the challenges associated with the economy's international competitiveness. In any case, over the past decade or so the Kenyan currency has been appreciating in real terms. Furthermore, the external position as reflected in a current deficit in excess of an equivalent of 9 percent of GDP is still weak (**Figure 4**). 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. We contend that there is no symmetry in the current account narrowing on the basis of 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.

Figure 4: Current Account Balance (% of GDP)



Source: IMF

The CBK clearly has adequate foreign reserves, equivalent of 4.3 months of import cover, which – complemented by the Precautionary Arrangement with the International Monetary Fund (IMF) – provide buffer against short-term shocks. Nonetheless the MPC curiously indicates that the build-up of reserves was supported by purchase of foreign exchange from the market; in which case the very action will be seen to be putting the local unit under more pressure. Further, the CBK has been active in the foreign exchange market in the selling side to support the local currency especially when weaknesses started showing at the time short-term interest rates started decline.

Ultimately, the MPC is inadvertently not clearly signalling on the one extreme its comfort regarding the sustenance of the calm market conditions and the inhibitions of the fiscal policy on the other. This is on the back of the softening of the performance of the global economy; the uncertainty around the timing return to conventional monetary policy in the US and hence the risk of portfolio outflows with interest rates hike; and 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.

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 11.5 percent. With the highlighted of downside risks, the policy stance is implicitly a sustenance of the tightening bias although the CBK is keen to see money market rates come down. This reflects the agony of policy signalling.

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