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MPC retains status quo, cites well-anchored inflation expectations **27th Nov, 2018**

- As broadly expected, the MPC in its final meeting of this year elected to hold the key policy rate at 9.0%, citing the combination of well-anchored inflation expectations and a narrowing output gap.

- Inflation eased slightly to 5.5% in October from 5.7% a month earlier. In November, however, pressure from the lagged effects of higher oil prices, some second round effects of the recent tax measures and lower base effects could see inflation rise to about 5.9%.

- The prognosis from the policy body suggests that inflation should remain within the statutory target band, grounds enough for sustaining the current posture into 2019. Effects of recent exchange rate depreciation should be offset by fairly low food inflation as well as lower fuel prices after Brent crude fell sharply to $60/barrel.

- The MPC downplayed the recent exchange rate volatility, painting a “balanced” market characterized by a declining current account deficit which it projects to narrow further to 5.2% of GDP by year-end from 5.3% in September and significantly below 6.4% a year earlier.

- The shilling has been on the back foot depreciating to 102.80 against the US dollar on increased demand from 100.85 when the MPC met two months ago. Pressure on the shilling has been attributed largely to deteriorating shilling sentiment mostly due to the country’s fiscal fragilities.

- While the tone of the statement suggests that the pressure on the shilling may be transitory, the persistent global dollar strength, widening interest rate differentials for dollar-shilling and souring emerging and frontier markets sentiment may add to the shilling’s vulnerabilities. This may necessitate continued intervention to keep the local unit supported.

- Indeed, the foreign exchange reserves remain strong at $8.03Bn (5.3 months import cover). However, their continuous depletion amid rising global economic uncertainty and heavy upcoming external debt obligations may keep the market on the edge. This is on a backdrop of elevated public finance management concerns with plans to issue fresh Eurobonds aggravating sentiment around debt sustainability. Yields on Kenya’s Eurobonds have on average risen by 160bps over the last two months.

- The economic sentiment remains fairly bullish, the slow private sector credit growth, 4.4% in October, remains a major headwind. The committee continued to underscore the consequences of the interest rate cap on the transmission of policy signals, particularly by delaying and reducing the impact of the policy actions on growth.

- All said, the retention of status quo should see persistence of the recent market trends. Short-term rates will continue to ease gradually on increased liquidity allocation towards government securities, underlined by the banking sector’s liquidity ratio of 48.9%. Meanwhile, the exchange rate could witness more volatility in the interim although short-term liquidity squeeze may offer some support.