The Conduct of Monetary Policy in East Africa In A Changing Policy Environment

A Memorial Lecture In Honour of Prof Francis Mwega

By

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Outline

- **Conduct of Monetary Policy in East Africa**
  - **largely Successful**
  - **Remarkably similar across countries – regional coherence**
- **Recent Striking Changes in the Behaviour of Monetary Aggregates and prices in East Africa**
  - Sharp slow down of Monetary Growth
  - Sharp Slow Down Of Private Sector Credit Growth;
  - Sharp fall in money market rates - reflected in treasuries
- **What Explains theses Changes?**
- **How Have East African Central Banks responded to these changes?**
- **What are the key risks to macro stability in the Near and Medium Term?**

I. Conduct of Monetary Policy in the EAC Largely Successful

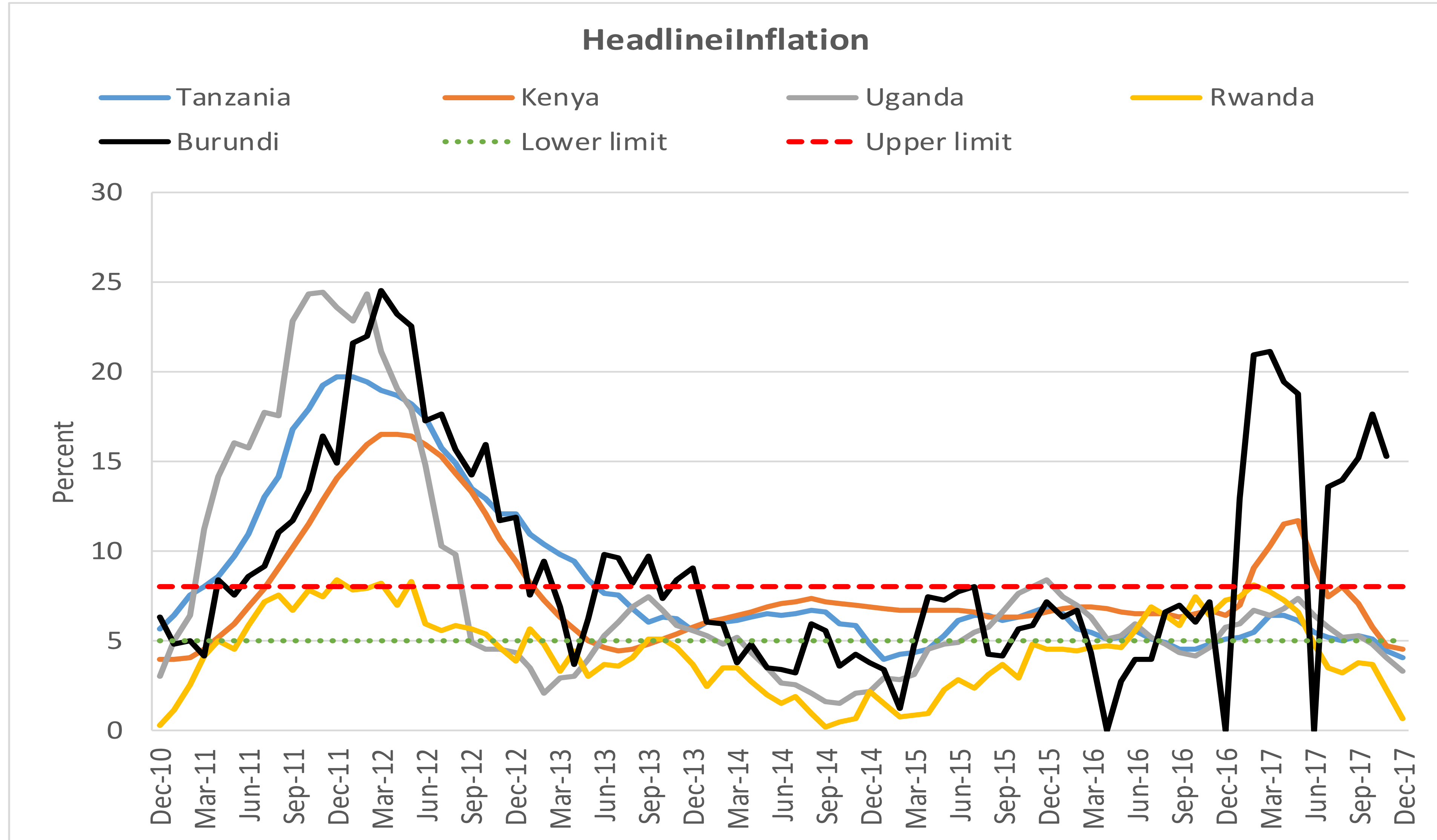
Two key sets of indicators for measuring such success

- **The first relates to achievement of the core mandates of the central banks - price stability**
  - **Inflation for domestic prices**
  - **Exchange rates for price of tradables**

- **Secondly, Success is also deduced from ability to ride through major shocks to enable the economies continue on a path of sustained growth after brief disruption**

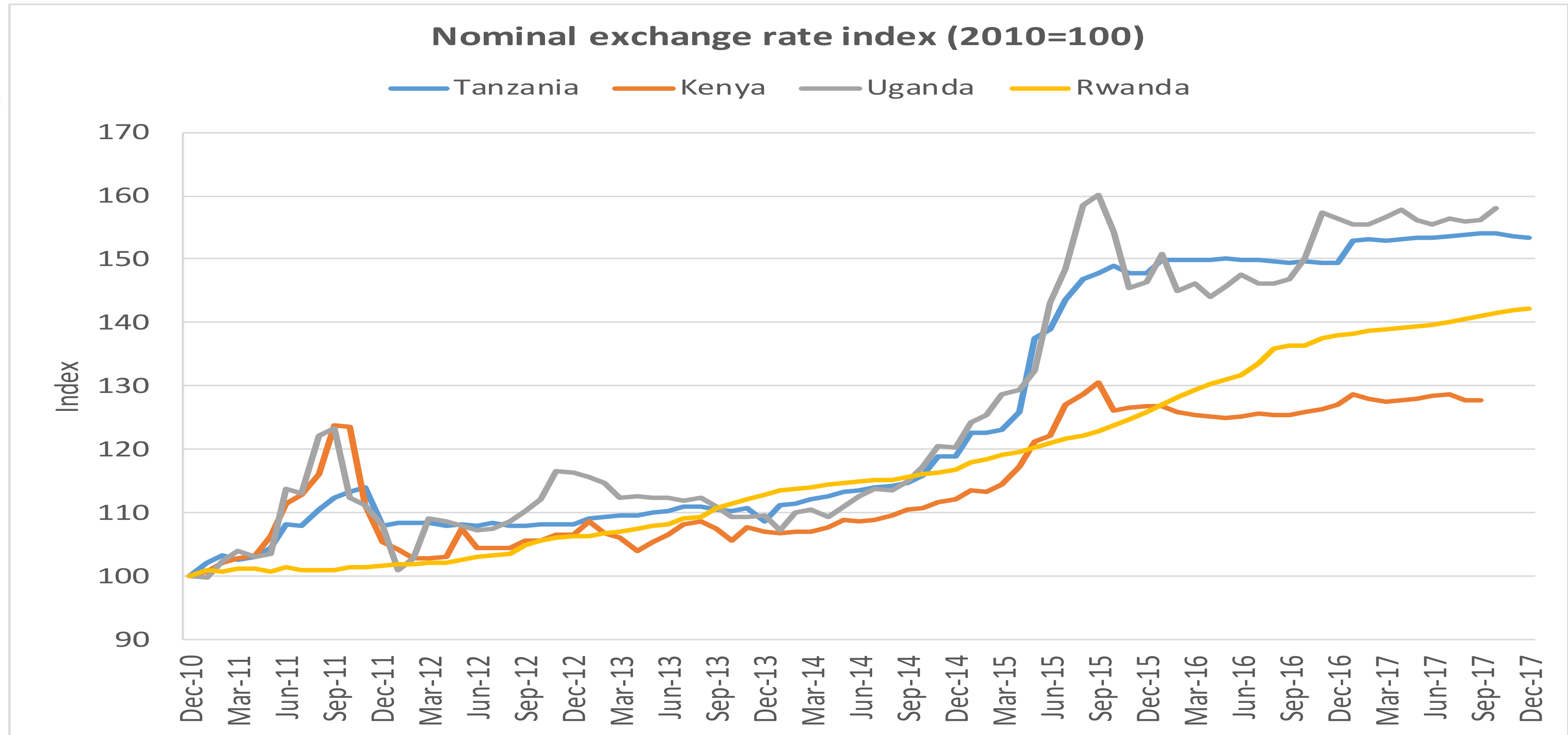
Inflation trends in selected EAC countries

Since 2013 Inflation rates have remained subdued and within EAC convergence band save for Burundi recently, mainly due to successful conduct of monetary policy helped along by stability of oil prices, and improved food supply



Nominal exchange rate index – Reasonably Stable save for Corrections For Shocks

- Reasonably stable path with correction for shocks
- Real effective Exchange rates Stable
- Larger correction in countries purs-uing more flexible exch rate regime



Real GDP performance in selected EAC countries

Real GDP Growth in EAC Countries

Percent

	2008	2009	2010	2011	2012	2013	2014	2015	2016
Burundi	4.9	3.8	5.1	4.0	4.4	4.9	4.5	-3.9	0.9
Kenya	0.2	3.3	8.4	6.1	4.6	5.7	5.3	5.6	6.0
Rwanda	11.1	6.3	7.3	7.8	8.8	4.7	7.0	6.9	6.0
Tanzania	5.6	5.4	6.4	7.9	5.1	7.3	7.0	7.0	7.0
Uganda	10.4	6.9	8.2	5.9	3.2	4.7	4.9	5.5	4.8

Sources: African Economic Outlook, 2017 and National Bureau of Statistics

- **Growth in the region was strong and robust supported by public investment in infrastructure, favourable commodity prices, subdued global oil prices and favourable weather condition.**
- **Growth in the region has remained resilient to shocks, quickly recovering after each shock – with robust macrostability**

EAC QUARTERLY GDP GROWTH

Percent

Country	2013				2014				2015				2016				2017		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Uganda	3.4	4.6	3.9	4.1	5.8	7.0	1.4	8.4	5.7	5.6	6.2	5.3	4.1	2.9	1.2	2.0	3.9	6.5	7.5
Rwanda	4.5	7.7	2.7	4.1	7.4	5.9	10.5	6.7	8.0	9.3	8.1	10.0	8.9	7.5	5.4	2.4	1.7	4.0	8.0
Kenya	6.1	7.5	6.4	3.5	5.2	6.0	4.6	5.6	5.8	5.6	6.1	5.5	5.3	6.2	5.7	6.1	4.7	5.0	4.4
Tanzania	6.2	5.9	7.3	9.7	7.8	9.8	5.7	4.4	6.5	6.5	6.8	8.2	6.9	8.5	6.6	5.5	5.7	7.8	6.8
EAC Average	**5.1**	**6.4**	**5.1**	**5.3**	**6.6**	**7.2**	**5.5**	**6.3**	**6.5**	**6.8**	**6.8**	**7.3**	**6.3**	**6.3**	**4.7**	**4.0**	**4.0**	**5.8**	**6.7**

Sources: National Bureau of Statistics

Managing Shocks for Sustained Macrostability

- **Since 2008 the region managed to ride through three major shocks with consequence on macrostablity**
  - **Global Financial Crisis (2009) – the biggest shock with impacts transmitted through a spike in exchange rates (heightened by speculative attacks) and through a global economic recession**
  - **The Euro Crisis (2011/12) again transmitted mainly through spike in exchange rates and its impact on lengthening the period of recovery from GFC recession**
  - **Commodity Price Collapse (2014/15) with its effect transmitted mainly via pressure on exchange rates**
- **Judging from the short duration of stress from each shock – short lived inflationary and exchange rate spikes and quick recovery of growth – Management of shocks was quite successful**.

Remarkable Similarity Across Countries in the Path of Monetary Aggregates and Price Indicators Across the Region

It is not by accident – the region is on a path to Monetary Union and the Central banks via MAC have actively coordinated approaches and action

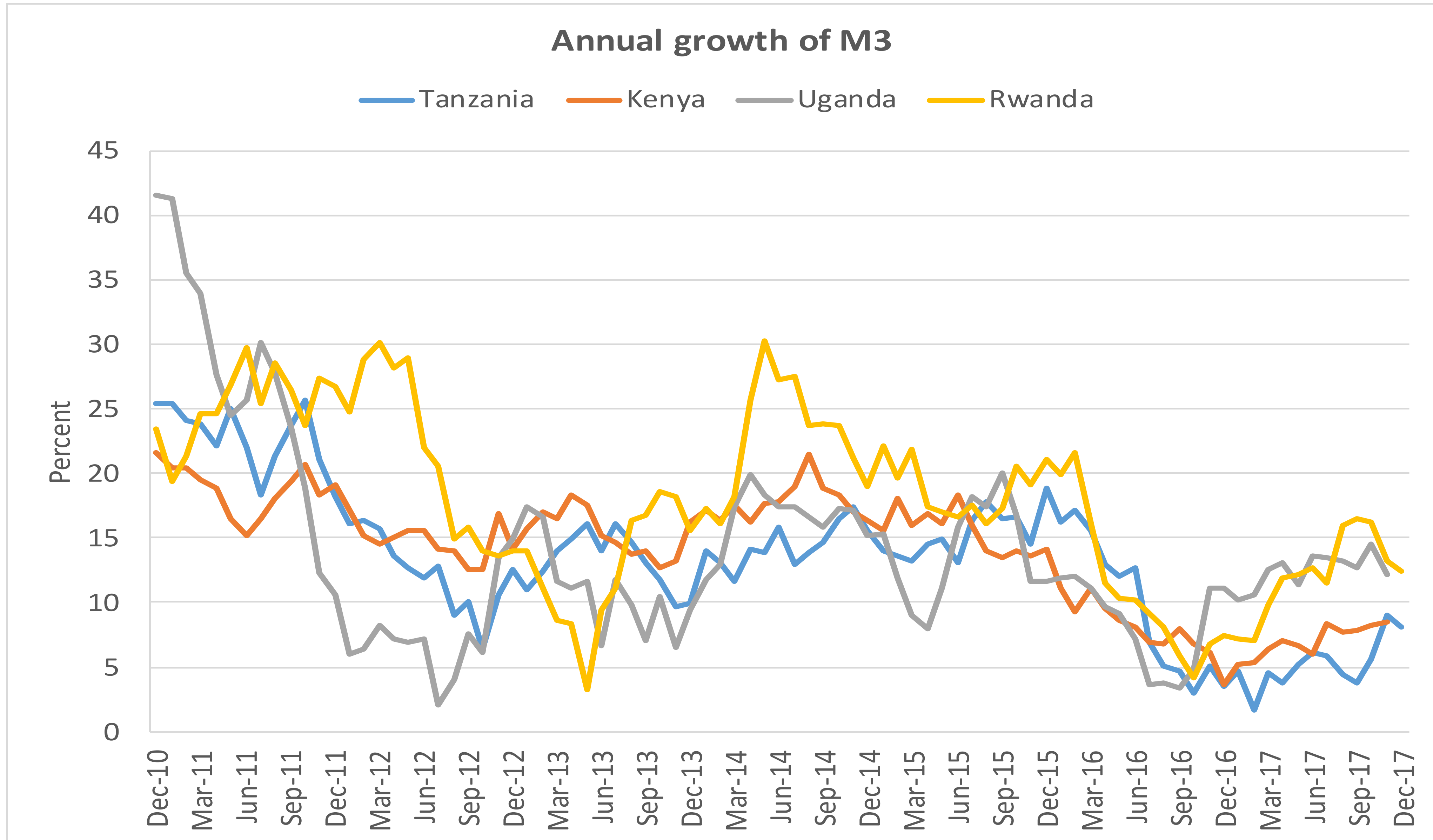
- **Harmonization in the approaches to the conduct of monetary policy has strengthened over time.**
- **Coordination of responses to common shocks e.g. Global Financial Crisis 2009**
- **Cross border operations of regional and international banks has necessitated coordination in regulation and handling of common challenges.**
- **Exchange of information and data has facilitated this coordination**

II. Recent Significant Developments in the Path of Monetary Aggregates and Prices

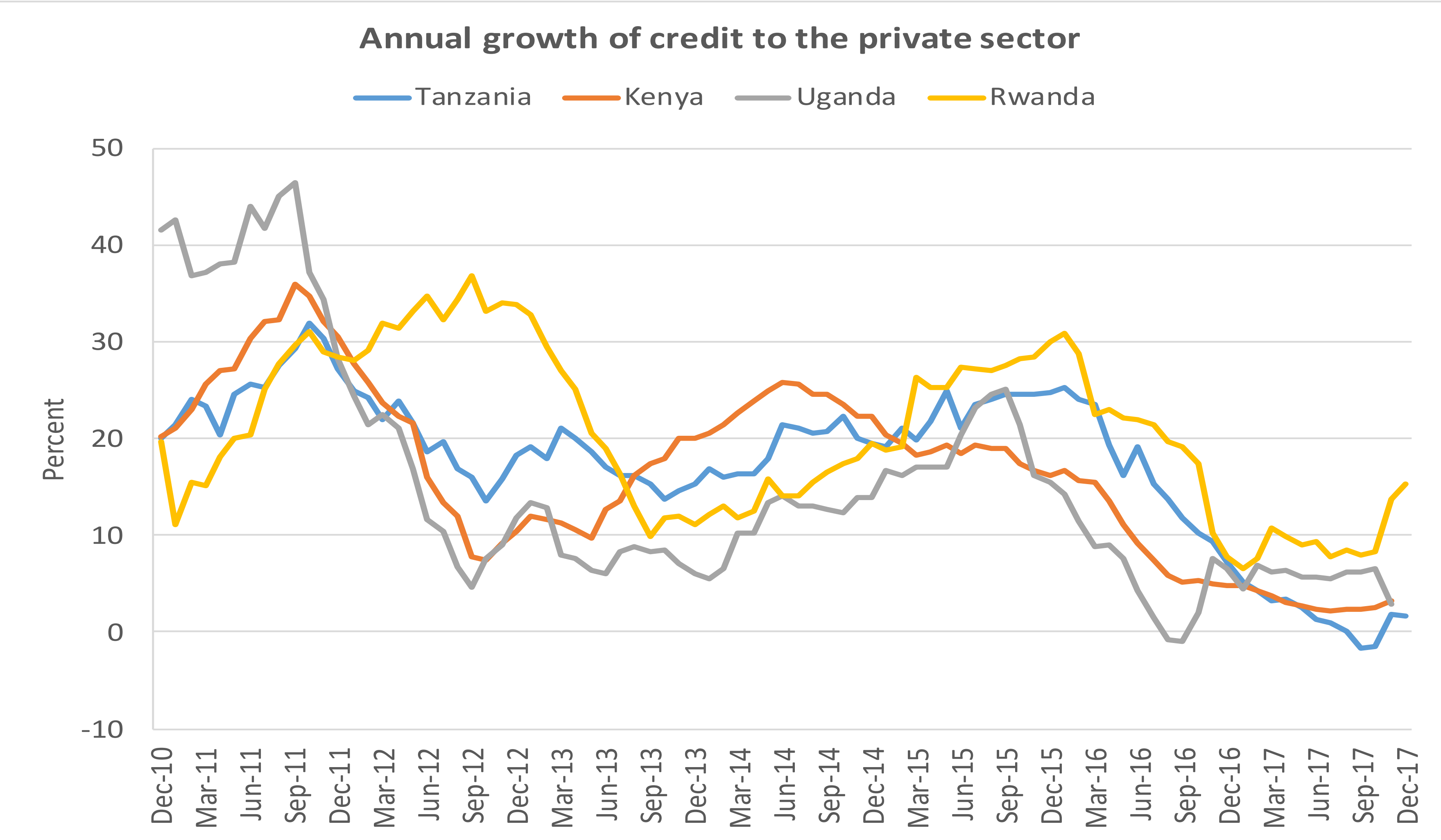
- **Sharp slow down of Growth Rates of all Monetary Aggregates**
- **A Virtual Collapse of growth of Credit to the Private Sector – mainly driven by a spike in the risk premium as indicated by spikes in Non-performing loans across the region**
- **Sharp decline in yields in the market for treasuries a key benchmark for other financial prices**
- **But lending Rates stayed strikingly stable or rose widening the gap between treasuries and lending rates in most countries**

EAC money supply Growth Trends

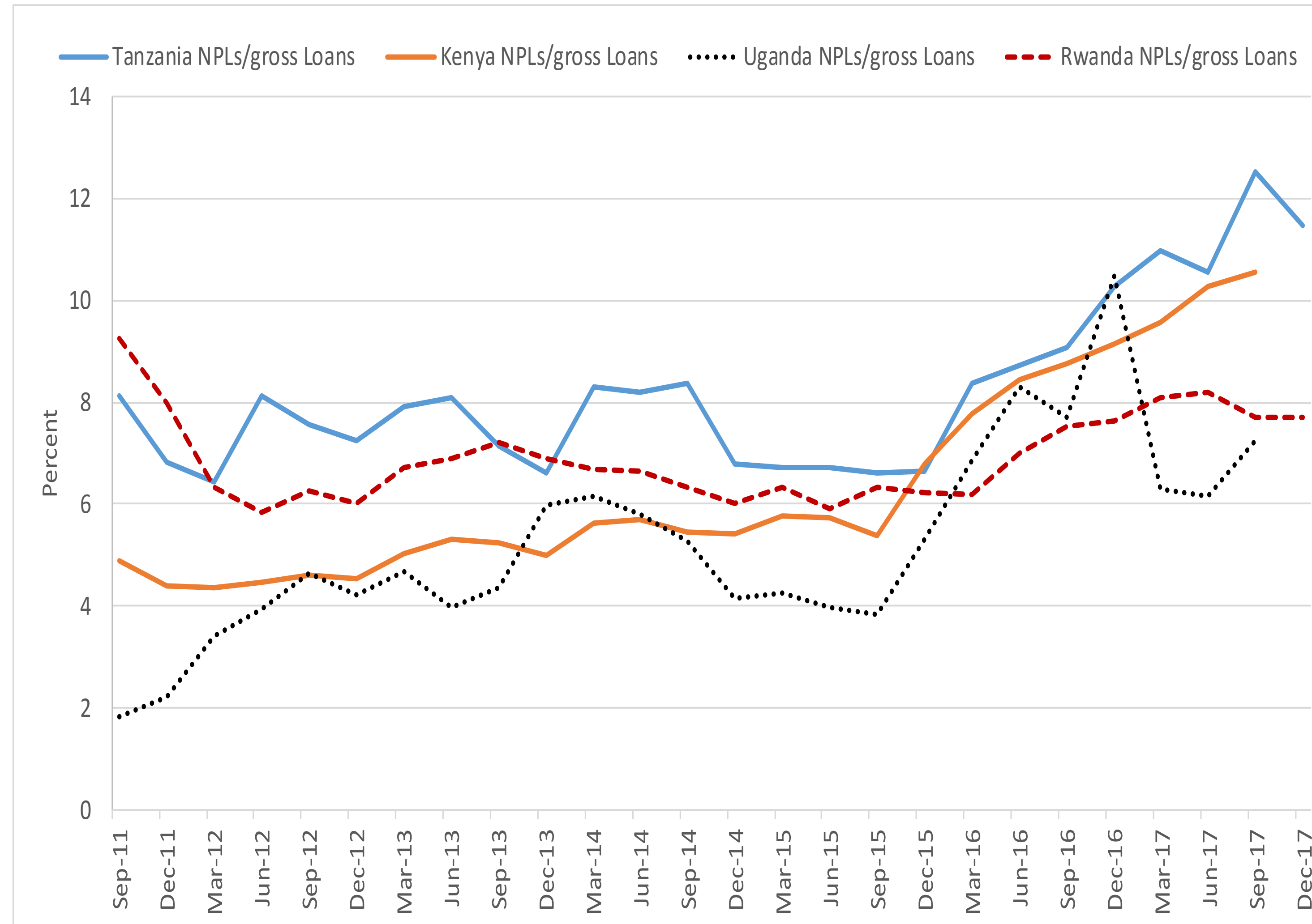
- **Growth of money supply tracks Inflation reasonably well**
- **It has now begun to pick up in some of the EAC countries after sharp deceleration over the last two years**



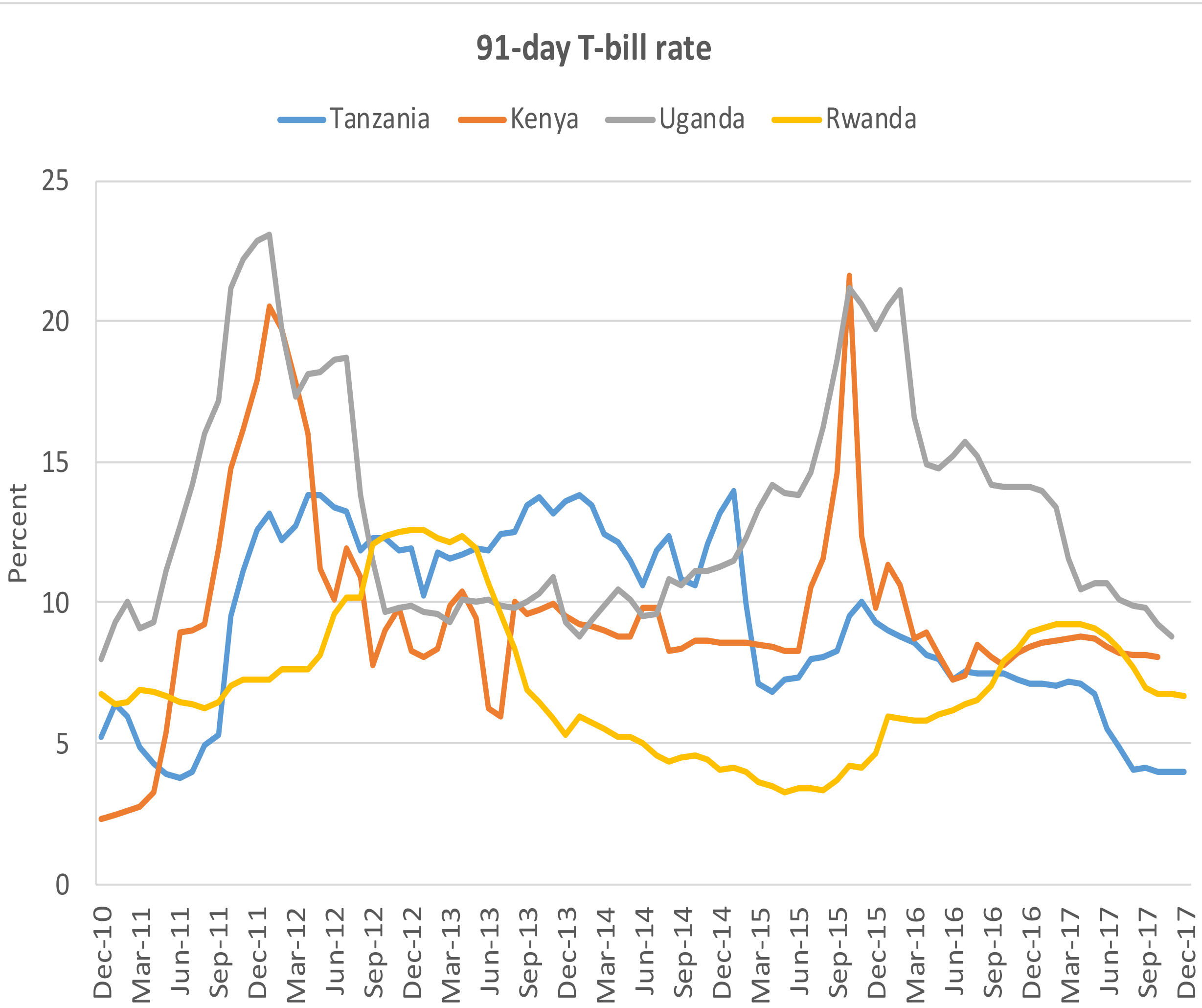
Growth of Credit to the Private sector has slowed down sharply

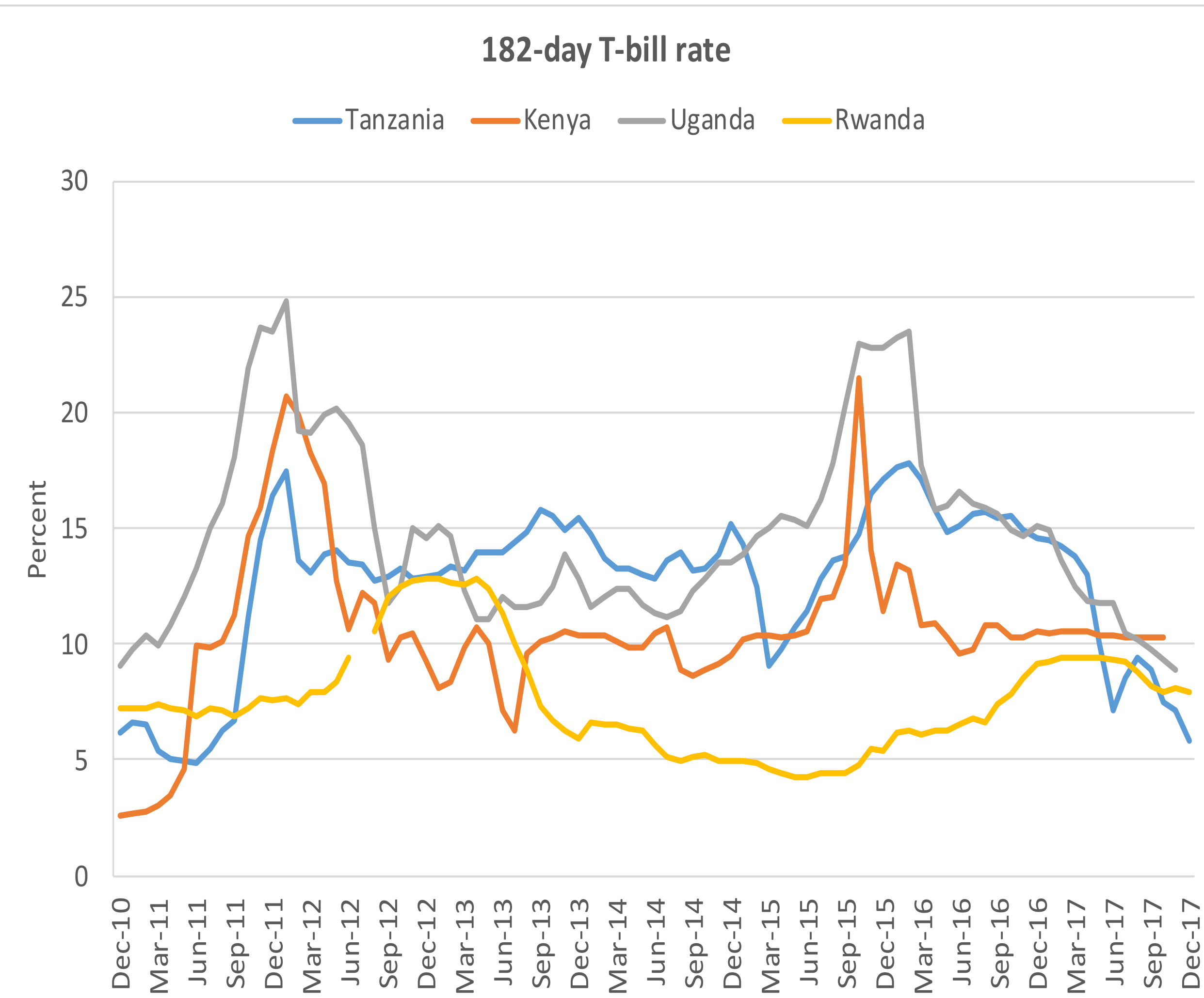


Sharp Rise in NPLS Has Raised Risk Premium



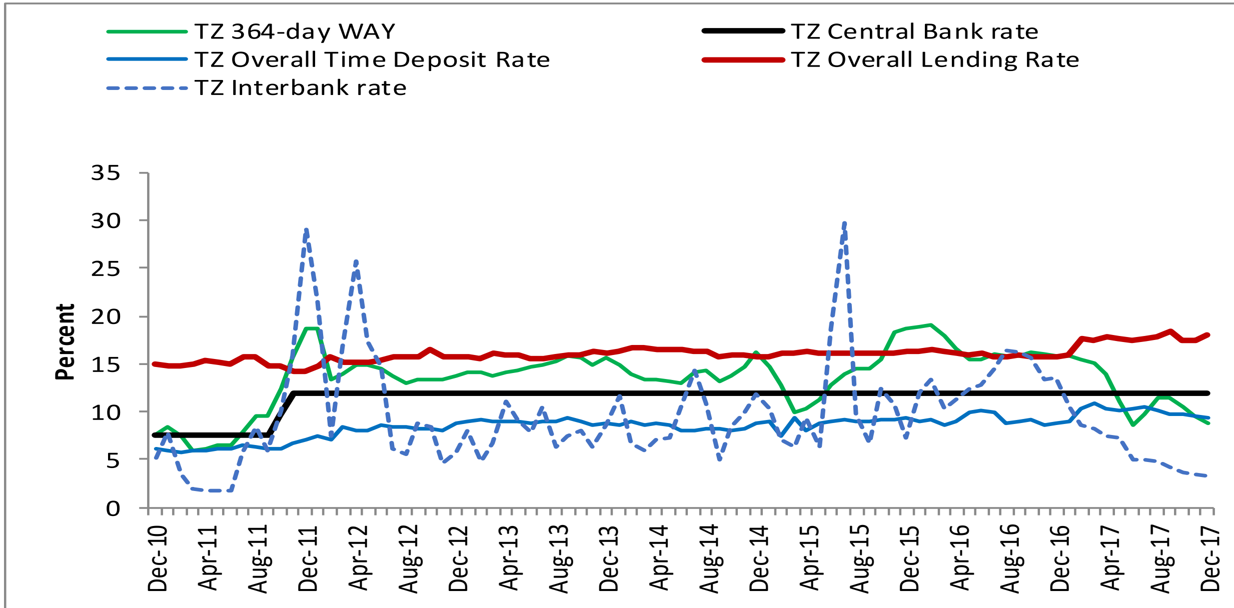
EAC money market interest rates Declined Sharply Reflecting Flight to Safety of Government Paper

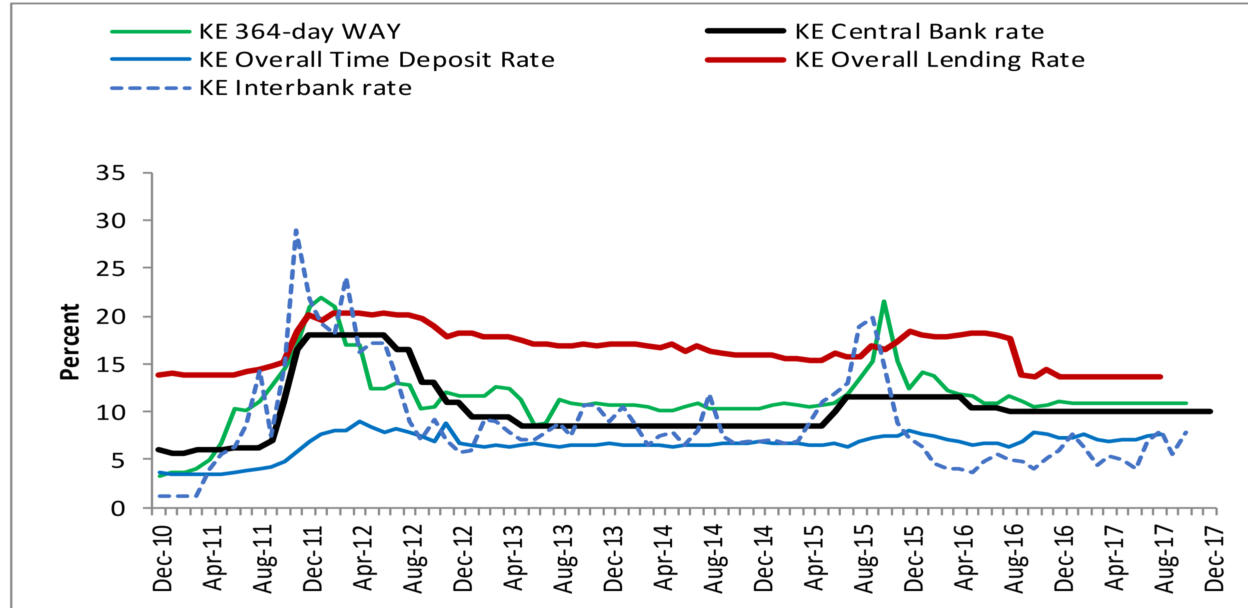


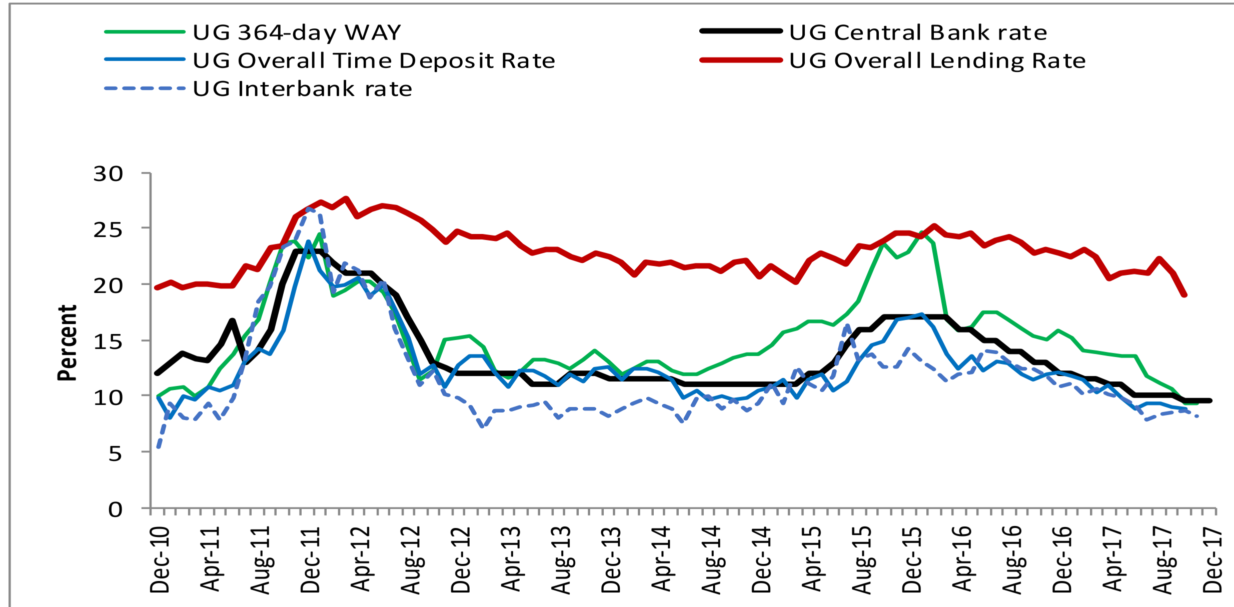


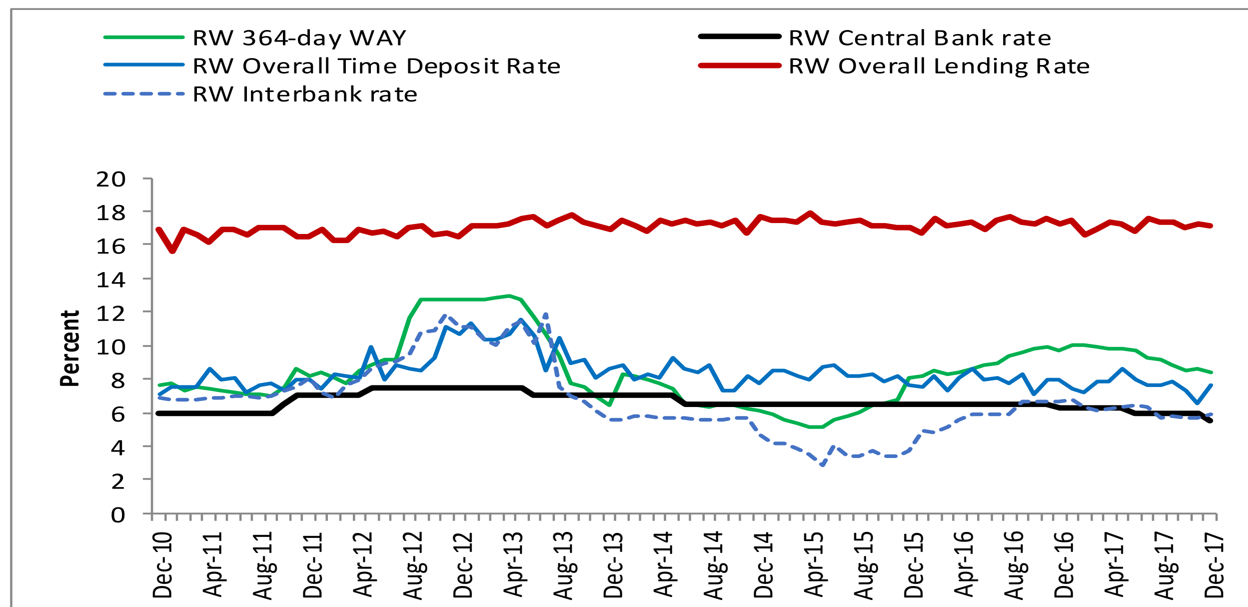
- **Countries in the EAC which are more open to global market, experience relatively large swings in money market interest rates e.g. Uganda**

EAC money market and commercial banks interest rates









But Lending Rates Have stayed Stubbornly High

- **Notwithstanding sharp decline in interbank cash market rate and Treasuries' market rates lending rates have stayed stubbornly high. In Tanzania they even rose slightly. In Kenya they moved down but not significantly.**
- **To a large extent this is due sharp rise in NPLS raising risk premiums**
- **Risk-adjusted rates followed suit or stayed stubbornly above declining cost of funds or declining market rates**

The Gap between Lending Rates and market Rates Has Widened

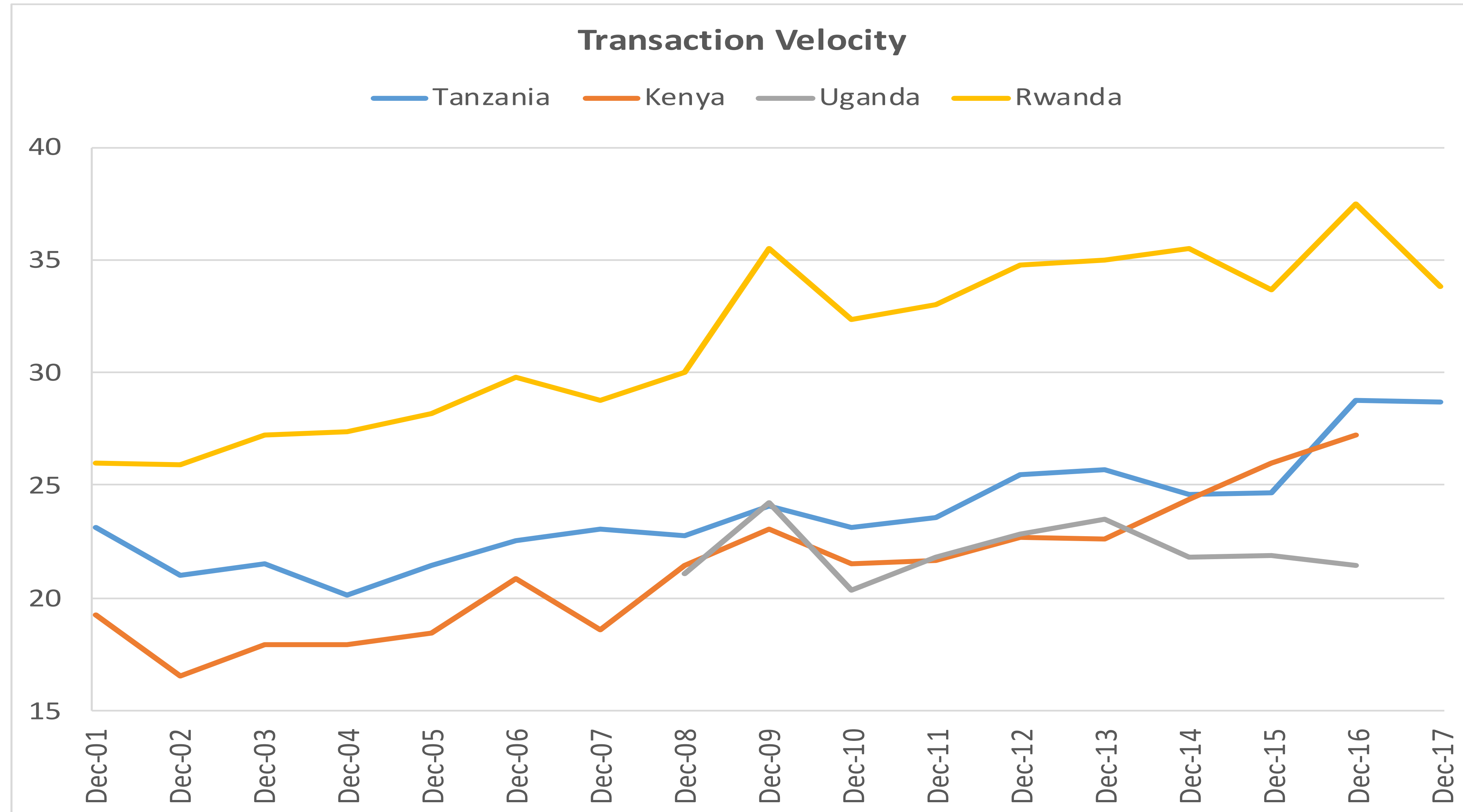
- **Interbank Cash market rates have fallen sharply in line with with Central Bank easy monetary policy – Response from banks has been to use this position to lend to Governments or accumulate liquidity in the form of excess reserves in the Central Banks**
- **With high NPLS banks have**
  - **slowed down credit to the private sector**
  - **Lent more to each other driving rates down**
  - **Increased demand for govt paper, way beyond govt needs (heavy oversubscriptions driving maket rates down.**

III. Major Changes Impacting the Conduct of Monetary Policy

- **More Frequent Supply Side shocks with exogeneous impact on Inflation**
- **Sharp Rise in Transaction Velocity of Circulation with the advent of mobile Money**
- **Dilution of Fiscal Dominance**
- **Changes in the approach to conducting monetary policy – From Targeting Quantities to Targeting Prices**

Transaction velocity of money in the EA Region

- **The impact of slow growth in monetary aggregates was partly reduced by rising transaction velocity of money associated with ongoing financial innovations and technological dividend**



The main Imperatives of Monetary Policy Implementation have changed significantly

- **In 2008 when I became Governor of the Bank of Tazania – our main preoccupation was mopping up liquidity from the system to reduce Inflationary pressure.**
- **Fiscal dominance = Govt busy injecting via spending foreign savings and the Central Bank mopping up excess liquidity arising from this**
- **Currently fiscal Dominance significantly diluted**
  - **Government greater reliance on domestic revenue means enhanced neutrality in monetary effects of govt operations – withdraw liquidity when collecting Revenue and injecting liquidity when spending it**
  - **Significant proportion of foreign savings – via grants or loans spent on big projects meant leakages via imports of goods and services and fees**
  - **Loans given in kind – i.e. with no cash transfer for big projects also meant less liquidity injections**
  - **Central Banks have been pushed to rely more on their own instruments to provide liquidity e.g. via repos, purchase of forex from the market etc – depth and efficacy of financial markets key challenges for effectiveness of transmission mechanisms**

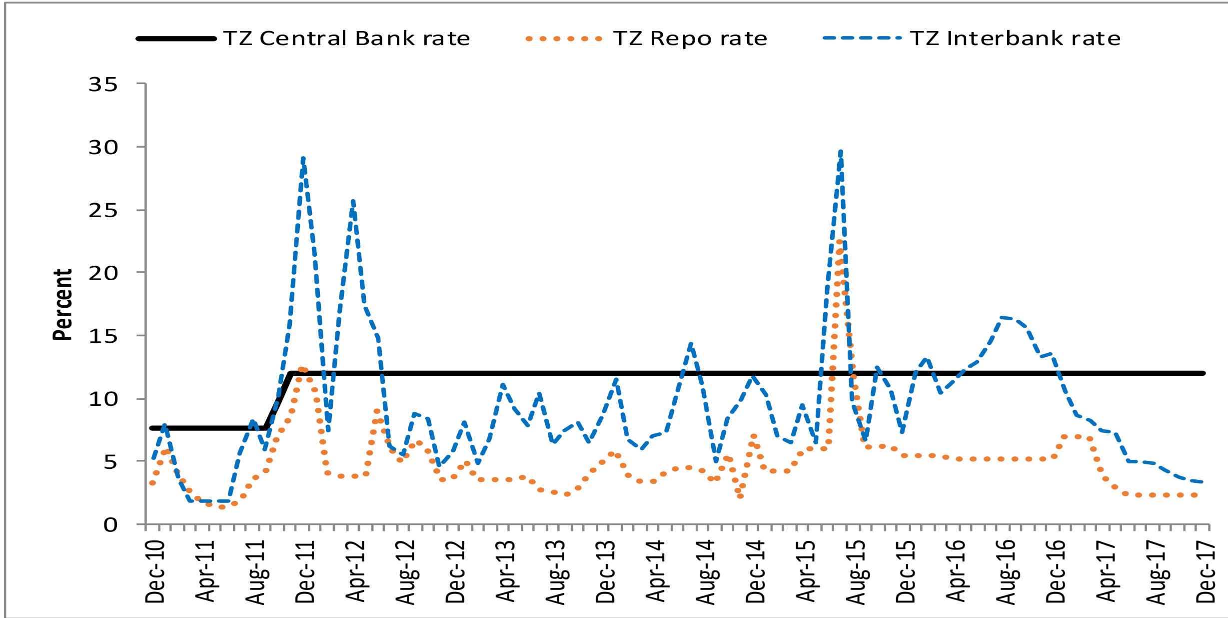
Fiscal Operations Much less Liquidity Injecting

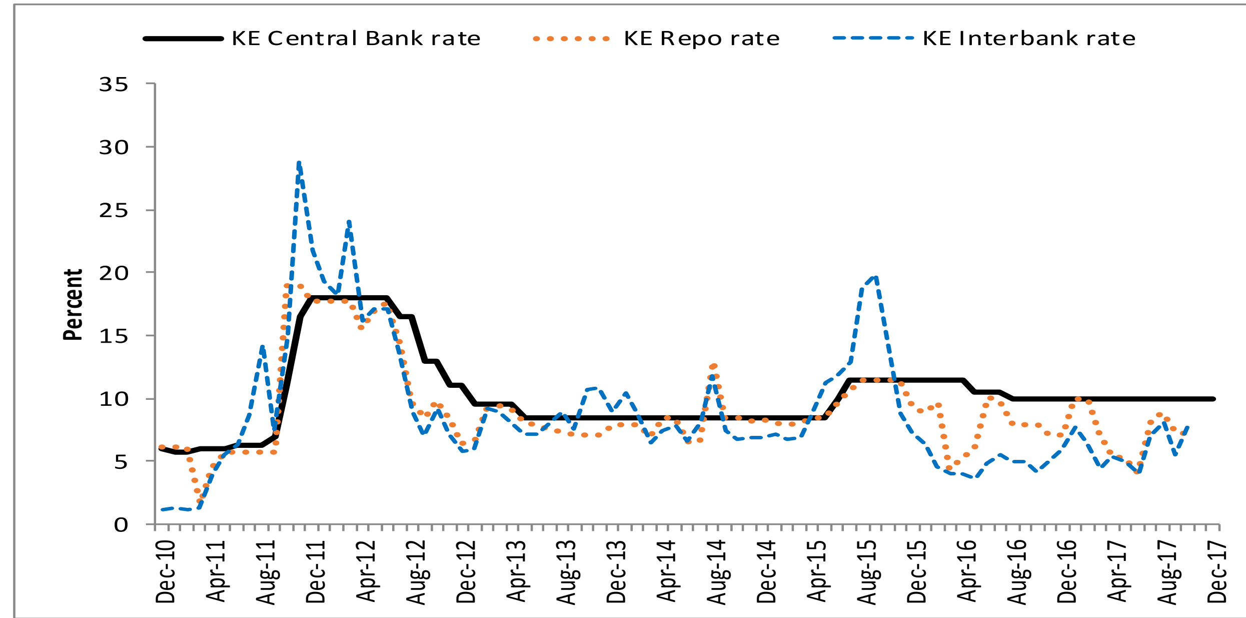
- **Sharp decline in liquidity injecting financing as donor budget support sharply decreased, and non-concessional borrowing also slowed down with increase in the cost of borrowing**
- **Loans given in kind are not-liquidity injecting – many Chinese-funded infrastructure loans are in that form (Rail in Kenya; Gas pipeline in Tanzania)**
- **Dominance of large infrastructure projects in the development budget – where foreign firms dominate in securing contracts= means large leakages in the multiplier effects**
- **As the share of development budget rises these leakages become more pronounced**

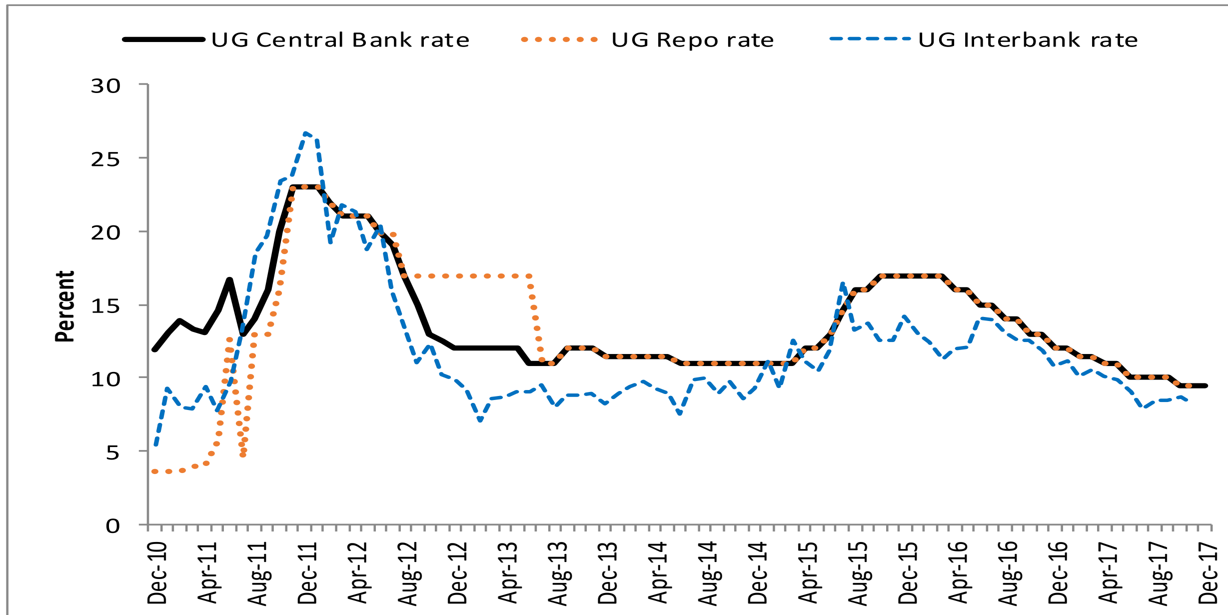
Those countries that have shifted to price-based conduct of monetary Policy Policy Rate tracks Markets better

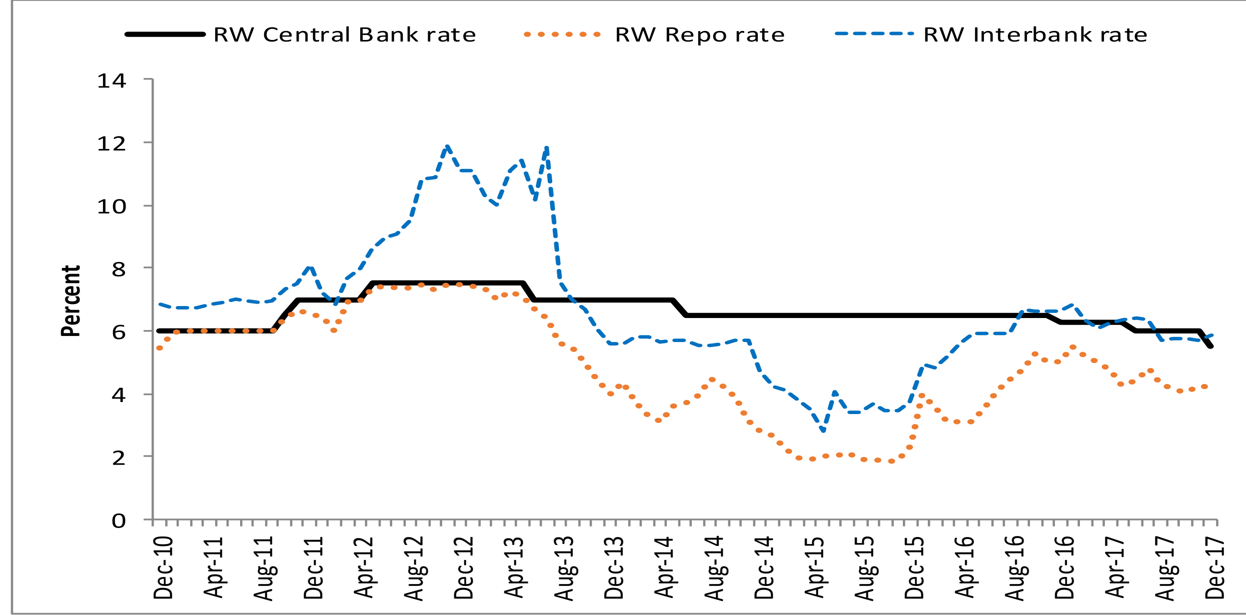
- They use policy rates more actively
- They track short term rates more accurately
- But not long term rates

EAC Policy rates and short-term money market interest rates









IV. Major Macrostability Risks Going Forward

- **Independence of Central Banks to pursue price stability and protect the value of the local currency**
- **Tendency to fix interest rates, a key price of monetary policy blunts efficacy of monetary policy transmission**
- **Debt Sustainability / Debt distress**
  - **Unsustainable levels of borrowing**
  - **Risks from Currency mismatch in major borrowing for infrastructure big push (borrowing for non-tradable services**
  - **Risks from Maturity mismatch for major infrastructure investment**
- **End of Quantitative Easing in US to be followed by Europe**

Rising Challenges to Central Bank Independence

- **Notwithstanding the fact that independence/autonomy of central bank independence is enshrined in Constitutions and Law there are frequent operational challenges to this independence**
- **Interest rate controls and directed credit – most frequent pressure in the region – more on this in the next slide**
- **Rising capital inadequacy and dependence on fiscal subventions will undermine autonomy and separation of fiscal and monetary policy mandates**
  - **Almost a decade of very low returns/yields to central bank foreign investment due to quantitative easing have eroded capital adequacy of central banks and exposed them to risk of dependence on subventions**

Deliberate Policy Interventions to Promote Credit by Lowering Rates Unfruitful

- **Tying lending rates to policy rates is at best tenuous. Objectives of policy rates are related to price stability – while capping interest rates targets affordability of lending rates**
- **It is also likely that those who least can afford high interest rates may be skewed out of credit market by higher risk assessment rather than simply interest rates – e.g. those who benefited for unsecured credit – e.g. Mkesho, Mpawa**
- **Interest Controls are not new, they were tried across the region in the past, and the ensuing rationing of credit at set rates disproportionately skewed out those who were targeted most for help driving them to loan sharks**
- **Interventions that target reduction of risk premium or requirements for expensive collateral – e.g. credit scoring system based on mobile telephony and mobile money usage – would be most effective solutions instead.**

Debt Sustainability Challenges – Are we borrowing too much?

- **Based on DSA carried out for each of the East African member countries External debt and Total public debt are broadly within the acceptable int'l thresholds and EAC limit of PV of debt at 50%**
- **None is currently already at risk of distress**
- **Nevertheless recent build up has been rapid with higher cost and shorter maturities as non-concessional borrowing increased faster than debt stock**
- **PV of Kenya's total public debt ratio to GDP has approached the 50% mark (although there are disputes for discount rate for domestic debt) and could breach the threshold for sustainable debt**

The Risks from Currency Mismatch

- **The Greater risk is that from currency mismatch (liquidity risk)**
- **Loans for large infrastructure projects (transport, power, water communications) are contracted in foreign currency and have to be repaid in the same**
- **But revenue streams from these investments are in local currency and servicing to a large extent depends on growth of export sector.**
- **Unless these investments accelerate growth of exports, a country may face challenges in externalizing debt service even if there is enough revenue from these investments**
- **Hope lies in getting oil and gas exports to start flowing early to boost foreign exchange earnings**

The Risks of Maturity Mismatch

- **Some debts start getting repaid even before investment is complete**
- **This is particularly the case for debt contracted in the capital markets – usually medium term in maturity**
- **This mismatch in timing leads to a "solvency" risk – no revenue available to service the debt**
- **Large and lengthy gestation period projects = such as standard gauge railway if funded this way could spell out such risk for the countries concerned**
- **This is particularly troublesome if debt has to be rolled over at higher cost.**

End of Quantitative Easing and Rise in interest Rates

- **USA is already moving full steam to reversal while Europe is winding down QE. Two major impacts are worrisome vis a vis macrostability**
- **Reversal of capital flows back to USA and Europe to take advantage of higher returns and reduced risks – likely to engender**
  - **significant pressures on and volatility of exchange rate and**
  - **tightening of liquidity particularly if foreign currency denominated deposits decline and subdues liquidity injection via inflows of foreign savings**
- **Initial large negative effect on central bank income via revaluation losses as price of its foreign assets decline with rise in interest rate - engendering inadequacy of capital and thraeat central bank independence.**

Concluding Remarks

- The conduct of monetary policy in the region has been overall successful
- Part of this success can be attributed to letting Central Banks pursue its mandates unencumbered
- Sustaining this success will partly depend on
  - Protecting the independence of central banks to implement its mandate
  - Improve accountability of central banks for its actions – including more effective communication of its activity
  - Stronger capacity and flexibility to manage response to shocks
- Let us sustain regional coordination and coherence of policy and action in response to shocks and in this era of cross-border banking.