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Monetary Policy at the turn of Financial Markets: A Forerunner or Follower?

Executive Summary

This policy Brief seeks to establish whether the monetary policy stance of Central bank of Kenya (CBK) at the turn of financial markets is pre-emptive or a cleanup. It makes the argument that there is a dynamic interaction among key financial market prices that is not necessarily at the prompting of monetary policy. This points to how financial markets are pre-emptive, and the monetary authority playing catchup. Such sequencing comes with the possibility of monetary policy reacting to market movements more than markets responding to monetary policy signal, underlying the tension between monetary policy and fiscal policy. It further contends that the direct connection between the CBK's policy signal and the inter-bank rate justifies the CBK's interest rate corridor around the former. That is however a necessary but not sufficient framework for efficient policy signalling and transmission unless it is accompanied by measures to address inter-bank market segmentation as well as those that can injects vibrancy in the horizontal repo market. Finaly, the positioning of the foreign exchange policy in support of monetary policy objectives is encumbered by the small-open-economy attributes that limits the assumption that full flexibility is sufficient for full effectiveness.

1. Introduction and Context

In the conduct of monetary policy, central banks keenly watch financial markets' behaviour just as markets watch central banks' policy signals. Even as the two parties watch each other, they are driven by different motivations. Monetary policy conduct as implied by the reaction function is the public good that macroeconomic stability proffers. The financial firms' response function is motivated by the perceived implication of monetary policy on the profitability agenda.

The conventional argument underpinning the interaction between central banks and financial sector actors – especially banks, which are the direct conduit of monetary policy transmission – is that the feedback loop between monetary policy reaction and the markets' response presupposes a sequencing that runs from the former to the latter.

That however does not rule out the possibility of monetary policy decisions responding to financial markets' actions and not necessarily pre-empting them. On that account, this Policy Brief aims to test whether monetary policy is a forerunner or a follower especially at the turn of markets. We explore the issue in the context of Kenya, a small open economy with a liberalized capital account that underpins a floating exchange rate regime, and a price based monetary policy framework.

The contextualisation of our assessment is based on three considerations. The first one is that both the short end of the money market and the foreign exchange market are often a step ahead of the Central Bank Rate (CBR) – the policy signal – when markets are making major turns **(Figure1).**

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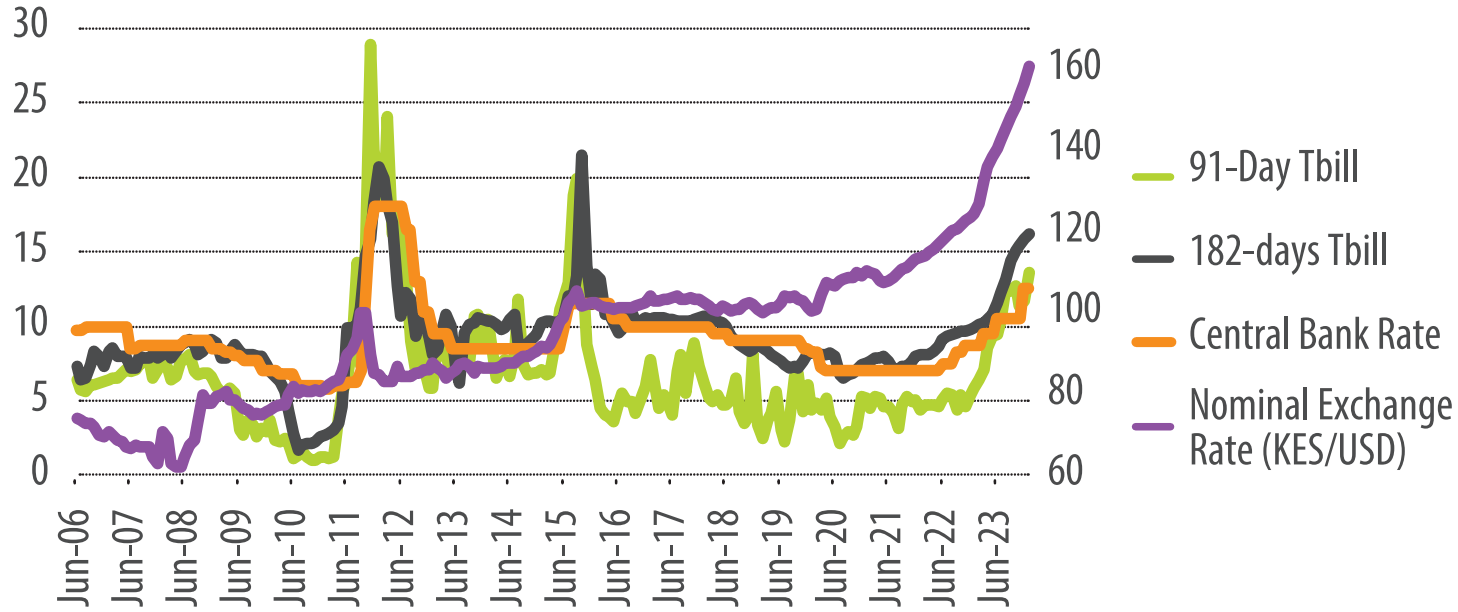
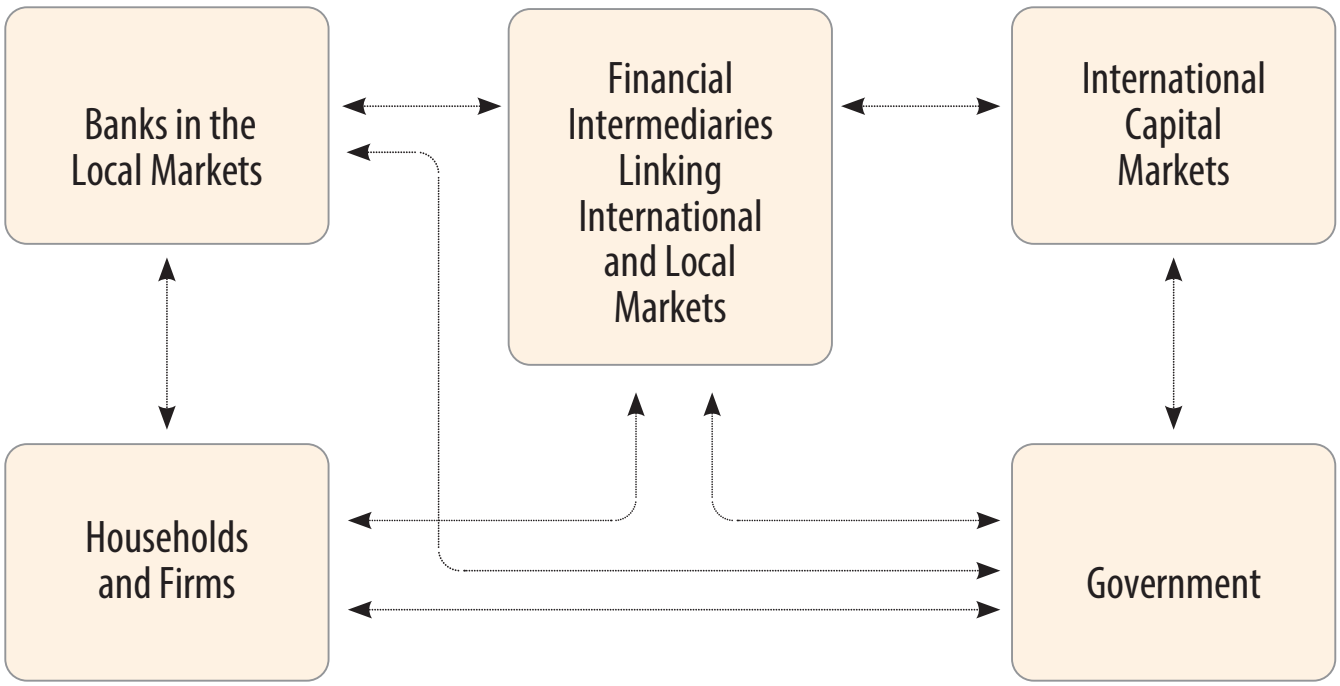
Figure 1: ***Short-term Rates (%) and Nominal Exchange Rate***



Source: ***CBK***

The second one is that formalizing the understanding of monetary policy conduct with the small open economy attributes necessitates the appreciation of the intricate connection between the domestic and international financial markets as illustrated in **Figure 2**. The connection, a priori, reveals itself in the quantities involved in the flow and the prices in the form of interest rate and exchange rate.

Figure 2: ***Domestic- International Financial Markets Interaction***



The third one is that the monetary policy conduct towards balancing savings and investments has an influential international dimension. Based on historical trend, we contend that the Feldstein – Horioka Puzzle (Felstein and Horioka, 1980) where high correlation between domestic rates of investment and savings point to limited financial integration – has some relevance to Kenya **(Figure 3: A**). The external savings inflows to fill the domestic savings gap amidst limited financial integration are an exact equivalent of the economy's current account balances **(Figure 3: B)**.

Figure 3:A - Gross national savings (% of GDP) : Total Investments (% of GDP) Association; 1990 - 2023

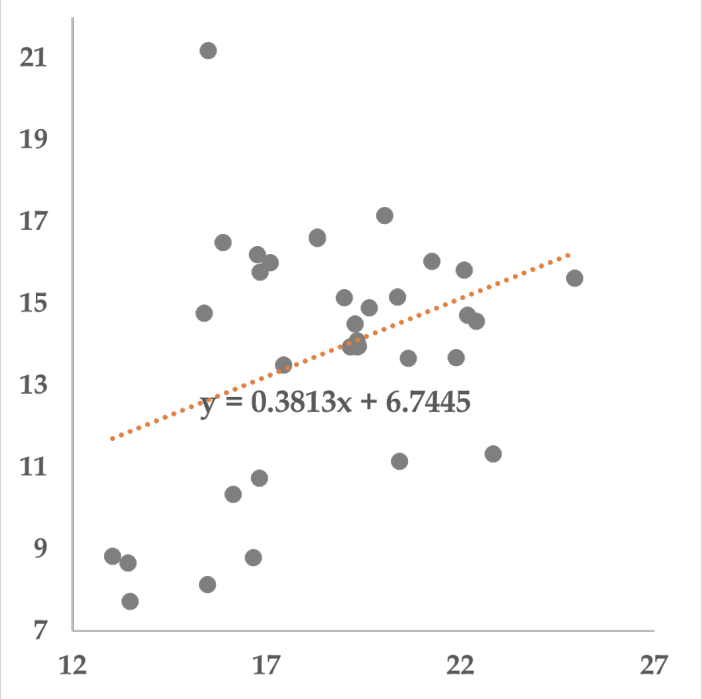
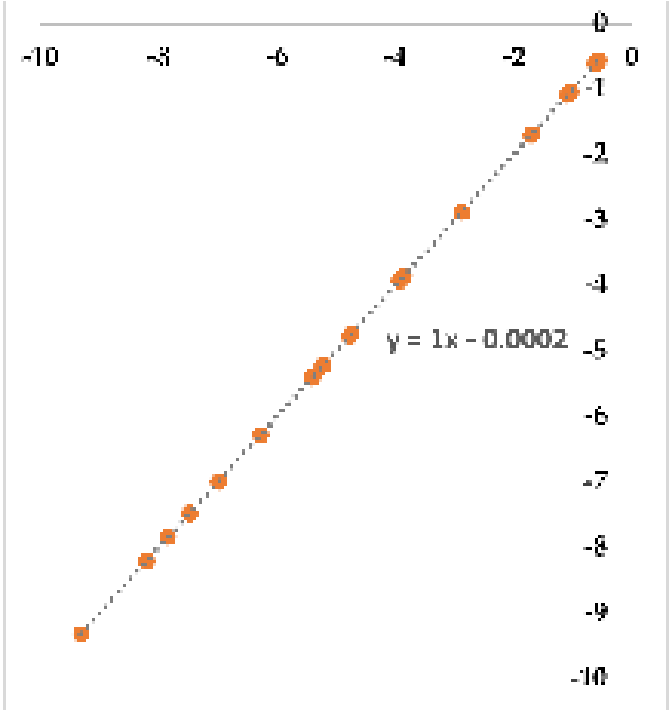


Figure 3:B - Current Acount Balance (% of GFP) : Savings Gap (% of GDP) Associaiton; 2000 - 2023



Ultimately, the extent to which public finance occasions market turns and forces the hand of monetary policy is pertinent. Contextualising monetary policy based on the foregoing will enable an appreciation of whether the monetary policy by the Central Bank of Kenya (CBK) at the turn of markets is pre-emptive or a cleanup.

2. Empirical Findings

The aforementioned three considerations underscore the need to modify the Taylor-rule (Taylor, 1993), that takes monetary policy to be determined by the two gaps namely the output gap (actual output less its potential) and inflation gap (actual inflation less the target). The modification, meant to address the limitations of a rule-based monetary policy framework, entails the estimation of the policy signal rate in a manner that takes on board the previous decision on the policy signal, a measure of output, the nominal exchange rate (defined as amount of local currency per unit of the US dollar), inflation gap (the actual inflation less the target), real return on treasury bill rates, and asset prices, specifically equities of listed corporations. We control for exogenous factors namely the foreign riskfree rate and the local -international interest rate differential.

Our analysis uses monthly data from December 2013 to June 2024 from the CBK, the Kenya National Bureau of Statistics (KNBS) and the Federal Reserve Economic Data (FRED). Beyond having a full dataset for the empirical model for the period, we are able to cover various shocks with implication on monetary, including the 2016 – 2019 interest rate capping regime, banking sector reforms in line with the post-global financial crisis regulatory measures, progress in the modernization of monetary policy from money to inflation targeting, and the COVID-19 pandemic. We deploy the Structural Vector Autoregression SVAR process due to its usefulness in studying the transmission of policies and shocks.

Four key findings arise from the foregoing analysis.

- First, while a change in monetary policy stance has an effect on the interbank rate, the intermediation prices of deposit rates and lending rates are hinged on the 91-day treasury bill rates. In essence, the deposit rates respond to changes in the treasury bill rates and then triggers a change in the lending rates. The implication is that the market could respond to movements in the treasury bill rates whether or not that change has a direct link to a chance in the monetary policy stance.

- Second, it is instructive that exchange rate matters for monetary policy conduct, not just from the pass-through effect on inflation but also from the fact that it is connected to developments in the money market. It is not obvious though whether monetary policy signalling has an influence on the direction that the foreign exchange market takes.

- Third, as could be anticipated a priori, the effect of monetary policy on inflation has lag effects. We are cognisant that other factors besides demand pressure – such as supply constraints – may affect inflation in the initial lags but in a transitory manner. Its therefore feasible that monetary policy influence will be observed in the second-round effects of a rise in inflation rather than the transitory effects that could be self resolving. This resonates with the sticky prices argument.

- Fourth, equity prices seem to matter in monetary policy conduct, not necessarily because they respond to monetary policy but because monetary policy responds to their movements.

3. Conclusion and Policy Implications

Our analysis showcases how monetary policy conduct in a small open economy such as Kenya is nuanced from that of advanced systemic markets with deep financial markets.

- In the former case, the financial conditions such as the driver of stock prices, banking sector lending standards, the trend of bond yields in secondary markets, are important in shaping monetary policy formulation and effectiveness. The interaction among the key market prices, not necessarily at the prompting of monetary policy, is a pointer to how financial markets are pre-emptive and the monetary authority playing catchup.
- In the latter case, the global economic conditions that occasioned monetary authorities to raise policy rates in 2022 and commence policy accommodation in 2024 were accompanied by market movements in anticipation of regime turns.

The above inferences have implications on policy and market conduct.

- The possibility of monetary policy responding to market movements more than markets respond to monetary policy signal underlies the tension between monetary policy and fiscal policy. The 91-day treasury bill rates are as revealing about the market liquidity conditions as they are about the state of fiscal policy. Banks would likely attune their profit maximisation agenda as influenced by the pricing of deposits and credit in line with the 91-day treasury bill rates than what the CBR signals.
- The direct connection between the CBR and the inter-bank rate provides justification for the CBK's interest rate corridor around the former. This however is a necessary but not sufficient framework for efficient policy signalling and transmission unless it is accompanied by measures to address inter-bank market segmentation and inject vibrancy in the horizontal repo market.
- The positioning of the foreign exchange policy in support of monetary policy objectives is encumbered by the small open economy attributes that limits the assumption that full flexibility is all that is required for full effectiveness.

References

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