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POLICY BRIEF

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THE CENTRE FOR RESEARCH ON FINANCIAL MARKETS AND POLICY®

Fiscal and Monetary Policy Interaction During Economic Shocks: A Wedge or Bridge for Bank Profitability?

Executive Summary

This policy brief assesses the implications of fiscal and monetary policy interactions on the profitability of banks in Kenya, highlighting four key points: banks' profit-seeking behavior amid expansionary fiscal and tightening monetary policies can increase economic instability; a persistent positive differential between government borrowing interest rates and real GDP growth leads to rising debt-to-GDP ratios; Kenya has shifted towards a balanced debt mix, reducing fluctuations between domestic and external debt; and global shocks affect Kenya's money and foreign exchange markets differently compared to advanced economies like the US. The brief suggests that the interplay between fiscal and monetary policies, especially during economic shocks, significantly influences banks' profit-seeking behaviors and risks. It emphasizes the need to consider these interactions in strategic planning to ensure financial stability, underscoring that stable financial systems can mask underlying risks, potentially leading to sudden instability as seen in past financial crises.

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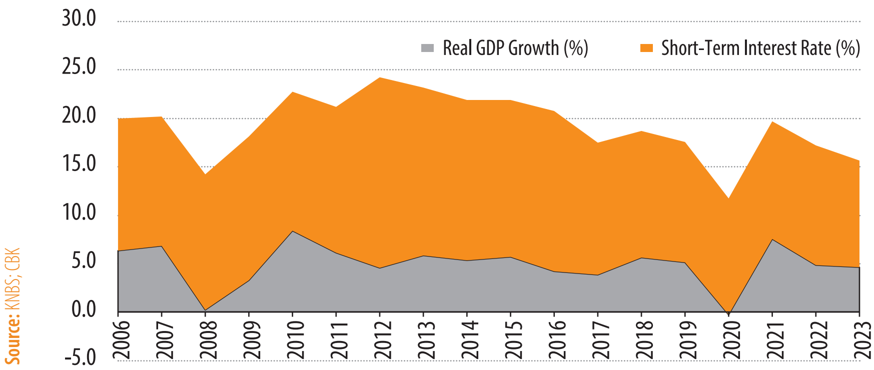
1. Introduction and Context

The understanding of how economic shocks adversely affect market outcomes and consequently change the landscape for financial sector profit seekers is seldom esoteric. Nor is the acknowledgment that the policy response towards restoring stable financial and macroeconomic environment often comes with short-term tradeoffs. It is however not obvious whether the adjustment of financial sector players' profit seeking behavior is informed more by the adverse outcomes or by the inevitable macroeconomic policy response.

As a contribution towards the understanding of the adjustment to shocks, this policy brief provides as assessment of the implication of the fiscal policy–monetary policy interaction on the profitability of banks in the context of Kenya. The assessment is undertaken on thw back of four sets of stylized facts:

- **Stylized fact 1:** Banks' pursuit of profit amid both expansionary fiscal and tightening monetary policies can lead to increased risk-taking behavior, potentially pushing the economy towards instability.
- **Stylized fact 2:** So long the different between interest rate of government borrowing (r) and real output growth (g) is consistently positive, the debt-to-GDP ratio will continue rising (**Figure 1**).

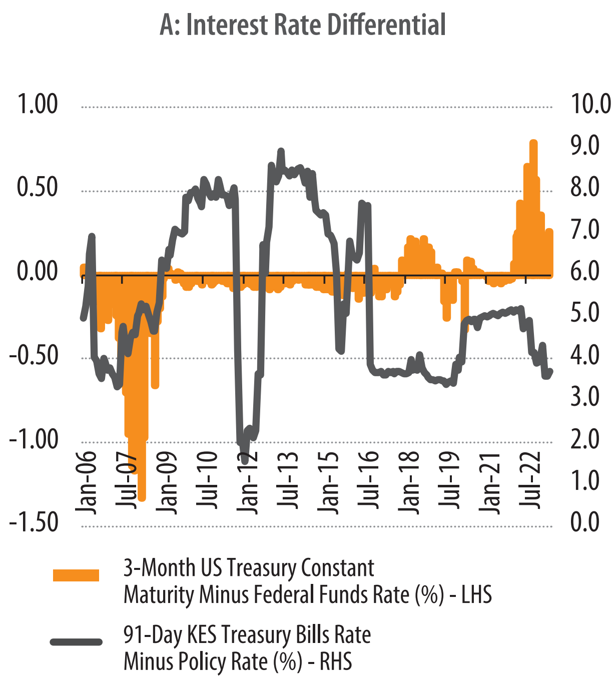
Figure 1: Kenya's r-g>0

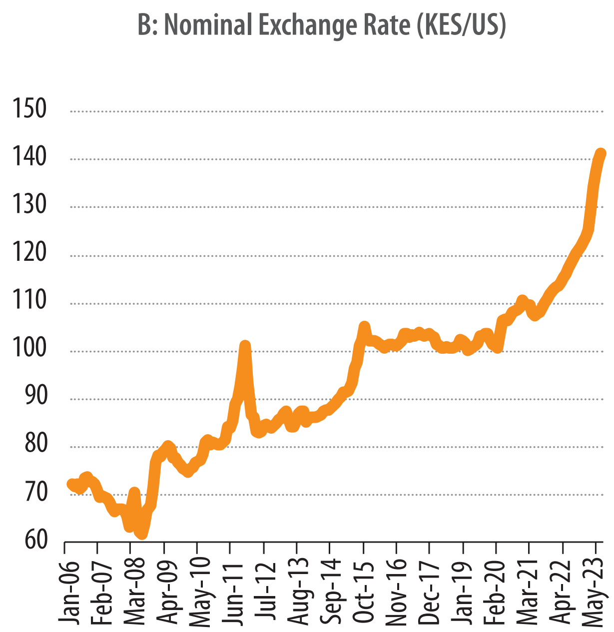


- **Stylized fact 3:** The sustained public debt accumulation over the past two decades has been characterized by a shift in the debt mix from the obvious swings between domestic debt and external debt that portent some substitution effect to a more stable balance of proportionality.
- **Stylized fact 4:** The extent to which global shocks have played into both money markets and foreign exchange markets in Kenya is a stark contrast to that of advanced markets such as the US (**Figure 2**).

1. FSD Africa
2. Kenya Mortgage Refinance Company

Figure 2: **Interest Rate Differential and Exchange Rate**





Source: Federal Reserve Economic Data (FRED); CBK.

The insights we offer in this brief are less about how banks make profit, an area that has attracted considerable interest. They are instead more about risks masked by the perception of financial stability that does not fully acknowledge the possibility that the interaction between monetary and fiscal policy could be approaching the boundaries of the "region of stability".

According to BIS (2023), the consistency of the combination of fiscal policy and monetary policy to macroeconomic and financial stability points to a system operating within the region of stability. Within the region, any tension that may arise between the two policies will remain manageable. When the policies tend towards the boundaries of the region of stability, it implies that they are encroaching on each other in a manner that compromises macro-financial stability.

In the Kenyan context, the interaction between fiscal and monetary policies plays a pivotal role in shaping banks' profitability in several ways.

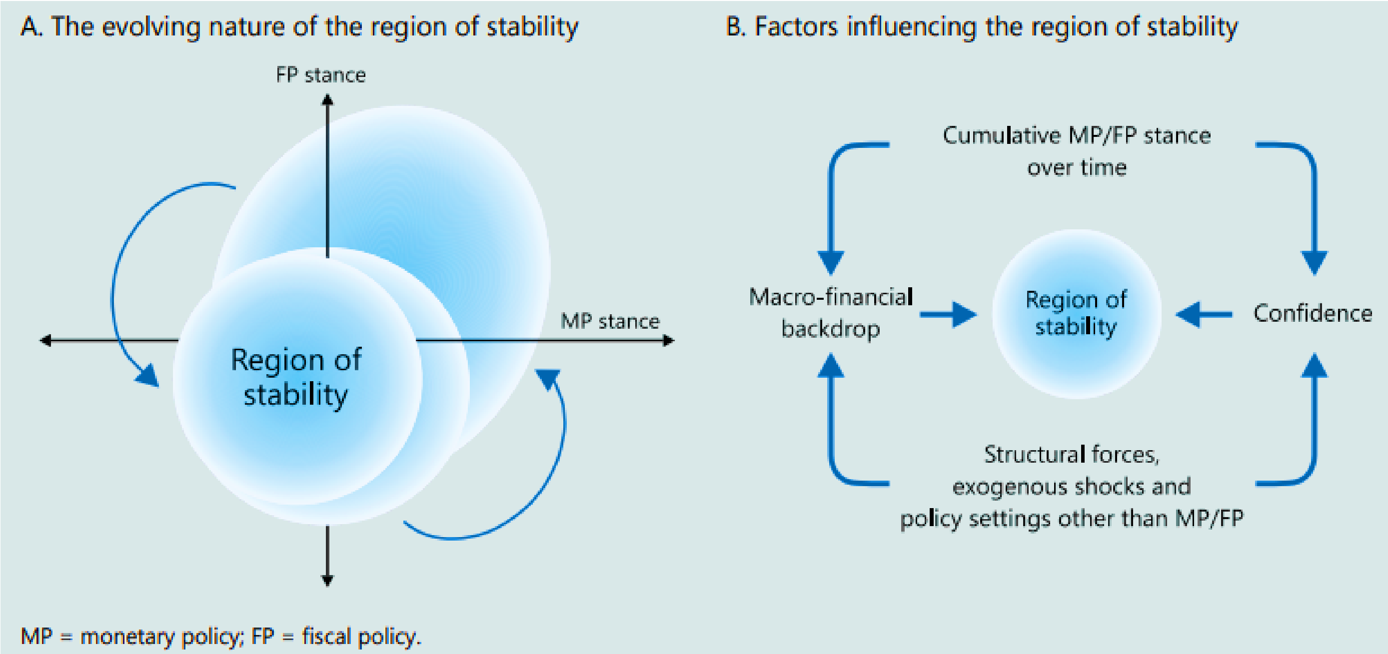
- Firstly, while there is a semblance of independence between monetary and fiscal policy frameworks, they are intricately interconnected.
- Secondly, despite fiscal policy intending to be countercyclical, Kenya's economic optimism often leads to instances of both acyclical and procyclical policies.
- Lastly, the Kenyan banking landscape occasionally experiences "Minsky moments", (Minsky, 1982) characterized by prolonged financial stability followed by sudden bank failures, such as those witnessed in the 2015-2016 period. Additionally, the segmentation of the interbank market between small and big banks highlights challenges in liquidity distribution, further exposing banks' profit-seeking behavior amidst financial stability.

The strong connection between monetary and fiscal policy in the case of Kenya underpins the profit seeking behavior by banks more that is often examined. The analytical void of this connection, especially when the economy is subject to shocks, disguises the underlying risks arising from the risk-taking attitude as shaped by the prevailing macroeconomic policy stances. On the fiscal side, the difficult trade-off between economic support and fiscal sustainability rarely features in bank profitability analyses. Nor does the appreciation that the effects of monetary policy on stability that is suggested to exist through the risk taking channel whereby monetary expansions induce more risk.

The blind spot on the implication of these interactions incapacitates the embedding of the "region of stability" as illustrated in **Figure 3** in the strategic view on banks' profitability.

"Expansionary fiscal policy positively affects bank profitability, similar to tightening monetary policy suggesting that banks' profit- seeking behavior is more responsive to policy adjustments than underlying economic conditions.

Figure 3: Region of Stability



Source: BIS (2023)

We contend that even under the best of circumstances, the deployment of macroeconomic policy to address benign market dislocations is a balancing act. When the balance is tested by shocks, the intention of fiscal and monetary policies is ideally to minimize cyclical fluctuations. However, minimization is often not a neat process, hence the recent plethora of studies calling for a rethink of macroeconomic policy.

The financial systems, and more so banks, are at the center of the rethink. Evident from the 2007 – 2009 global financial, the behavior of financial institutions is core for the stability of the macroeconomic system. Equally, the state of the macroeconomic system has a bearing on behavior of financial institutions, especially considering the latter's inherent active profit seeking attribute. The feedback loop between macroeconomic stability and financial stability motivates a focus on the banks' profitability for two linked reasons.

- One, inspired by Hyman Minsky's financial instability hypothesis (Minsky, 1982), a robust banking system could be endogenously transformed into fragility on account of prolonged periods of stable years motivating enhanced risk-taking behavior in pursuit of profit maximization).
- Two, when banks are riding the wave of good financial returns on the back of stable periods, it is easy for the boundaries of the region of stability to be elusive to the extent of only being apparent ex post. As BIS (2023) asserts, banks could portray stability, until suddenly they are not.

2. Empirical findings

Using panel models, we analyze macro policies' impact on bank profitability in Kenya from 2003-2022, covering major economic shocks including the global financial crisis. Both monetary and fiscal policies significantly influence bank profitability, showcasing their interconnectedness. Our findings reveal that: -

- First, expansionary fiscal policy positively affects bank profitability, similar to tightening monetary policy suggesting that banks' profit-seeking behavior is more responsive to policy adjustments than underlying economic conditions. The interplay between the two policies is characterized by the influence on profitability stemming from their contrasting stances. Banks' profitability is positively influenced by an expansionary fiscal policy, with a similar influence associated with a tightening monetary policy.
- Second, exchange rate being the connecting variable between fiscal policy that has a strong nexus external markets through borrowing and monetary policy are positively associated with bank profitability.
- Third, considering that monetary policy's disposition to frequent finetuning, its interaction with bank specific variables reveals that the coefficient on the interaction between monetary policy and bank size has a negative influence on ROA and a positive one on ROE. The mixed influence is counterbalanced with the characteristics of efficiency, ability to diversify and capacity to leverage, all pointing to a positive influence of a tighter monetary policy on profitability.
- Fourth, the positive influence of an expansionary monetary policy on bank profitability hinges on banks' efficiency. This can be inferred from the fiscal policy and bank specific attributes, with the profitability of banks being negatively influenced by fiscal policy if they have a high loan to assets ratio.

Further analysis, based on a threshold analysis further reveals that: -

- One, the optimal capital adequacy threshold, measured as the ratio of total capital to total risk weighted assets, is 20.02 with its lower level at 19.12 and the upper level at 22.32. This points to the possibility of capital adequacy increasing over time to its optimal level as banks take risks in pursuance of profitability. However, the degrees of maneuver above the optimal threshold are narrow.
- Two, the optimal asset quality thresholds measured by the share of non-performing loans to gross loans is 25.85%, with its upper level at 32.05% and the lower level at 17.69%. The negative relationship between asset quality and profitability points to the risk of approaching even the lower threshold.

3. Conclusion and policy implications

This Policy Brief highlight how Kenyan banks' pursuit of profitability amidst an expansionary fiscal policy and tightening monetary policy poses risks that could destabilize the economy. Even under different policy mixes, where fiscal policy is conservative and monetary policy is accommodative, the same risk-taking behavior persists, as seen in both advanced and emerging economies. This suggests that banks' profit-seeking behavior is more reactive to policy adjustments during shocks rather than underlying economic conditions, emphasizing the importance of regulatory attitudes towards profitability and risk-taking.

In response to these observations, two key policy considerations emerge. Firstly, during periods of economic shocks, it is crucial to ensure that banks maintain sufficient capital buffers to withstand downturns. This includes establishing a safety corridor beyond required capital buffers to allow for countercyclical measures, along with fine-tuning stress-testing frameworks to optimize capital adequacy and asset quality thresholds. Secondly, fostering a stable funding mechanism, supported by the Central Bank of Kenya (CBK), becomes essential. While profitability may persist, implementing a conservative dividend policy can complement regulatory measures around capital adequacy and interbank funding sources, thus enhancing overall stability.

These policy considerations aim to prevent scenarios where the boundaries of economic stability are breached ex post, leading to sudden instability within the banking system. This resonates with broader concerns highlighted by the IMF in 2023, where shifts from prolonged low-interest rates to higher regimes have sparked market jitters and renewed focus on banking stability. By addressing these considerations, regulators can better navigate economic shocks and promote a more resilient banking sector in Kenya.

References

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