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POLICY BRIEF

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THE CENTRE FOR RESEARCH ON FINANCIAL MARKETS AND POLICY®

Monetary-Fiscal Policy Interdependence and Pricing Dynamics: Empirical Estimation of Fiscal Dominance in Kenya

Executive Summary

Persistent inflation and Kenyan Shilling depreciation against major currencies, notably the US dollar, have sparked concerns about maintaining low inflation and currency stability. Traditionally, governments control inflation by reducing spending and increasing taxes, but these measures could be unpopular and ineffective for economic stimulation. Instead, the central bank manages inflation through monetary policy, aiming for price stabilization. Recent fiscal stimuli and subsequent reversals, coupled with growing public borrowing and discussions about dollarization, prompted this study to address concerns regarding fiscal dominance and potential interference by the central government with the Central Bank of Kenya's monetary policy. Findings suggest that monetary policy alone struggles to control inflation, expansionary fiscal policies fuel inflation and raise interest rates, and indications of fiscal dominance exist. The brief recommends coordinated monetary and fiscal policies to achieve price stability and economic growth effectively.

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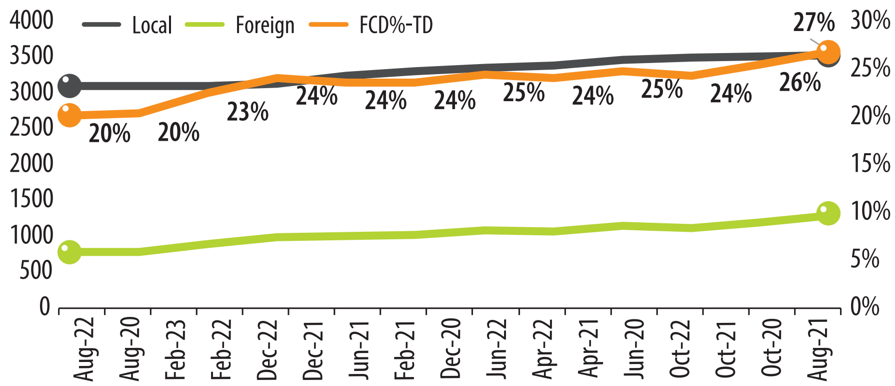
1. Context and Importance of the problem

Kenya pursues an inflation targeting (IT) regime just like many other developing economies due to its proven resilience but there developing evidence that IT regimes are no better than countries pursuing other non-inflation policies (Thornton ,2016). In fact, Thornton (2016) asserts that the less technically demanding monetary regime of currency pegging remains an attractive regime option for policymakers in developing countries. Most of these economies that pursue a non-inflation regime are usually exchange rate targeters. However, the downside of the non-inflation targeting regime economies is that they are thought to be always in fear of floating exchange rates since exchange rate depreciation would lead to high costs of servicing their external debts and therefore fiscal authority end us using the central banks to target real exchange rate stabilizing over inflation and this would in itself be a recipe for fiscal dominance. In fact, Strong & Yayi (2021) and Taiebnia et. al, S. H (2020) argued that fiscal dominance in Africa takes many forms that range from direct financing of government debt by central banks and commercial banks, to interfering with monetary policy by putting pressure on the central banks to keep interest rates low or to intervene in the foreign exchange markets to limit currency depreciation and lower debt servicing costs. This phenomenon can be unpleasant and bring macroeconomic instability and high inflation (Hooley et al. 2021).

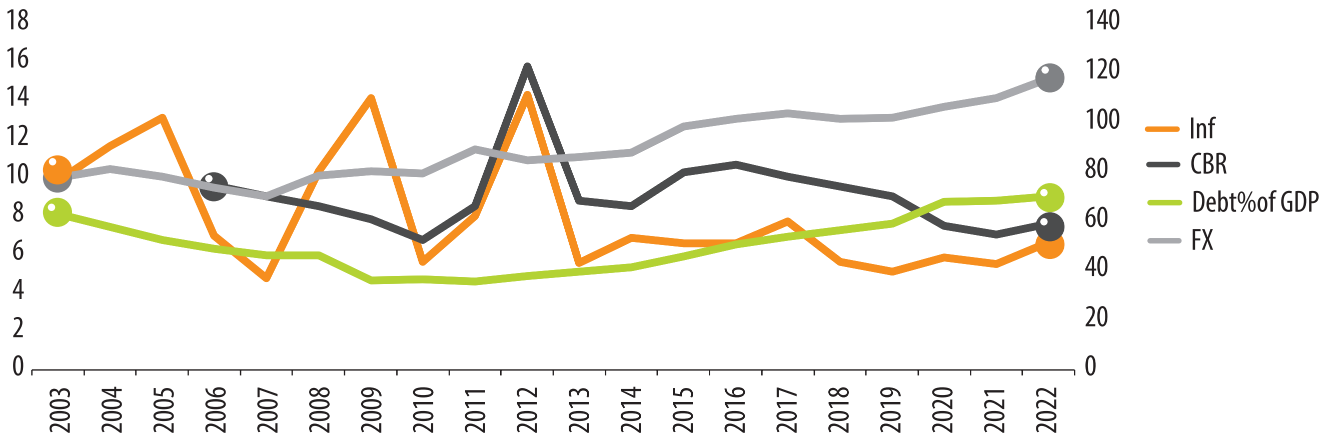
In 1992, there was considerable money supply growth to finance the first multi-party elections with Broad money (M2) growing by about 1500 basis points from from 21% percent in the 12-month period ended December 1991 to 36 percent in March 1993 (IMF, 1995). By 1993, market liquidity had grown considerably, the Kenya Shilling (KES) slumped, and dollarization heightened. Later that year, a contractionary monetary policy was implemented in an attempt to mop up excess liquidity, to stabilize the KES, and to address dollarization. By late 1993 and early 1994, the contractionary policy saw a tremendous increment in interest rates with the Treasury bill rate at some point rising beyond 55% (Ndung'u,1999). While there is no evidence of large dollarization in Kenya, The **Figure 1** shows a large increase in the share of foreign currency deposit liabilities in the country from 20% in June 2020 to 27%. This is a significant increase in just about 3 years.

Figure 1: Trends of deposit liabilities as proxy for dollarization in Kenya



Source: Central bank of Kenya

Figure 2: Trends of Key Variables in Kenya (2003- 2022); FX is (KES-USD)



Source: Central bank of Kenya

However, as indicated **Figure 2** public debt to GDP has increased from about 36.69 % in 2009 to about 70% in 2022 with inflation seemingly moving in the same direction as the Central Bank rate. We also see that the Foreign Exchange rate seemingly moves in the same direction as the public debt movement. According to Central Bank of Kenya reports, inflation has moved from 5.41% in December 2020 to 7.95% in December 2022 and about 8.68% in July 2023.

While there have been successes of monetary policy in Kenya since the 1990's and the introduction of the Central Bank Rate (CBR) and operational challenges of anchoring the overnight interbank rate to the policy rate with the overnight interbank rate experiencing Large and persistent deviations from the CBR hence, there have been notable target misses even after the introduction of inflation targeting. This included a disconnected CBR from the money market rates thereby undermining the credibility of the inflation target (IMF, 2015). However, during the 2020 Covid-19 pandemic demonstrated that monetary policy does not always control inflation on its own and fiscal policy interplay is needed stabilize inflation (IMF 2023, El-Khishin & Kassab,2021). This is because increasing public debt has led to increasing the possibility of fiscal dominance in which public deficits do not respond to monetary policy.

Just before the 2022 elections and especially during the Covid-19 period, the Kenyan government had introduced subsidies with highly moderated inflation, but public debt rose to 64% of the GDP but fiscal deficit narrowed to 6.3% of GDP due to increased revenue collection (AFDB, 2023). However, after the 2022 elections , When Kenya's current administration took office, price subsidies were removed causing an increment in consumer prices (in ways that the typical monetary policy tool, interest rates, was not able to immediately control), new/additional taxes were imposed (fiscal policy), and public-sector borrowing increased (fiscal policy) at a time when some previous debt (such as a tranche of the Eurobond 2018) were maturing, causing a drastic fall in the value of the KES.

Given the recent fiscal stimulus to the economy and the subsequent reversal thereof, uncontrolled government spending, the rising public borrowing and sentiments about dollarization of the Kenyan Economy, many concerns and questions have been raised if the central government is undermining Central Bank of Kenya in influencing monetary policy to accommodate cost of debt servicing or fiscal sustainability at the expense stabilizing prices rates through market activity. These concerns rotate around high inflation and foreign exchange fluctuations. This paper, therefore, will be centered on fiscal and monetary policy interconnection and its role on pricing dynamics particularly inflation, Lending rates and exchange rate.

2. Methods

Using monthly data between January 2010 and December 2022, the study applies econometric models to specify and estimate how monetary and fiscal policy affect pricing dynamics in Kenya. The analytical approach that was adopted allowed an interpretation of the probabilistic effects of the policies on the pricing dynamics. For the ease of evaluation of the effectiveness and appropriateness of fiscal and monetary policies, the specified model includes fiscal and monetary policy instruments, namely, the central bank rate for monetary policy and government spending and public debt for fiscal policy. The 91-day Treasury bills rate was employed as double-edged sword due its ability to be used as both monetary (liquidity and money supply control) or fiscal (extent of borrowing by the government).

3. Study Findings

The empirical assessment of this paper leads to three broad insightful conclusions. First, monetary policy is not fully effective in controlling and stabilizing prices especially inflation; two, expansionary fiscal policy is not only inflationary but leads to higher interests' rates as well and three: there exists traces of fiscal dominance even though it does not appear to very high form of high fiscal dominance.

Results from the study revealed that monetary policy shocks impacted foreign exchange (17%) more than inflation (2.5%) and Lending rates (10%) a clear indication that monetary policy is largely manifested through foreign exchange. This result would imply that the central bank's real target is exchange rate stabilizing over inflation with debt servicing costs in mind. Expansionary Fiscal policy shock on the other hand, is clearly inflationary from both public borrowing and government spending as manifested through inflation rates while also leading to increased lending rates. The study results further revealed that there exist traces of fiscal dominance even though it does not appear to very high form of high fiscal dominance. While CBK explicitly commits to a market-determined forex rate based on market activity, results from this study reveal otherwise. Although this is not primarily a monetary policy concerns but rather stems from the desire of seeking to assure fiscal sustainability and hence this would be a pointer of the monetary policy direction towards stabilizing the Kenyan currency. This is a signal of some level of fiscal dominance.

4. Policy Recommendations

A positive interplay between monetary policy and fiscal policy has many benefits to economic growth and price stability than we can fathom. Therefore, this study findings evoke several implications for policy. First, there is need to re-examine government spending with a view to effectively reducing budget deficit by reducing unnecessary expenditures while increasing revenue collection from all available channels. By cutting spending, the economy can benefit from reduced interest rates. Direct spending towards development projects like infrastructure or social-economic projects like education and health which have a higher impact on human capital. In addition, government spending should also be directed to productive sectors that support or influence growth. Second, the government should reduce domestic borrowing through the central bank or directly from commercial banks as this not only crowds out investments but leads to increases taxes, push up interest rates because markets often end up becoming nervous about governments ability to repay and most important could interferes with monetary policy. Third, there is need to review emergence of dollarization in Kenya both transactional and financial which could be a recipe for inflation and local currency instability. Four, there is also the need to review the monetary regime with a view of establishing if there is necessity to a regime change towards currency pegging which remains attractive option to some policymakers in developing and emerging economies. Finally, the paper suggests review of fiscal policy and establish if there is a need for a Fiscal Policy Committee (FPC) within the National Treasury to mimic the Monetary policy Committee.

References

Lidiema C., 2024. "Monetary-Fiscal Policy Interdependence and Pricing Dynamics: Empirical Estimation of Fiscal Dominance in Kenya", KBA Working Paper Series (WPS/085/2024).

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