Research Note No. RN/01/23.

"Together for a better banking environment"

Monetary Policy Stance
Steering the Economy to Sustained Recovery

November 20, 2023

Highlights

"The MPC's careful policy calibration is key to entrenching its policy objective of maintaining price stability. The simultaneity of domestic and external imbalances characterizes the state of play that the NBR has to navigate".

- The Monetary Policy Committee (MPC) of the National Bank of Rwanda (NBR) undertakes the fourth review of its monetary policy stance in 2023 on the back of sluggish global recovery, elevated inflation feeding into the tight monetary policy stance amongst major central banks, and evolving geopolitical risks in Europe and the Middle East.
- The MPC's tight monetary policy stance since February 2022 remains appropriate and supportive of the Rwanda's emergent economic recovery. The monetary policy stance acknowledges the long transmission lags, implying that further policy adjustment requires an assessment of the extent of effect of the recent past decisions.
- Under the current circumstaces, there is no scope to adjust monetary policy towards accommodation. However further tightening would only be triggered by clear evidence of second-round inflation effects of the risks emanating from concerns around food supply, continued exchange rate depreciation with a possibility of stronger passthrough effect, and a blurry oil prices outlook.
- The tight monetary policy has a role in steering the economy to a sustained recovery. The role is complementary to sector level policies as well as a slower pace of fiscal consolidation in the short run that is considered necessary to support recovery generally, and specifically from climate-related challenges.
- Although lending rates have marginally increased as monetary policy remains tight, they have generally been sticky. With a comfortable spread between the lending rate and less risky government securities, and given the low level of Non-Performing Loans (NPLs), banks are sufficiently incentivized to increase lending to the private sector. Therefore, the market outturn corresponding to the current monetary policy stance allows banks to play a role in entrenching the economy's emergent recovery.

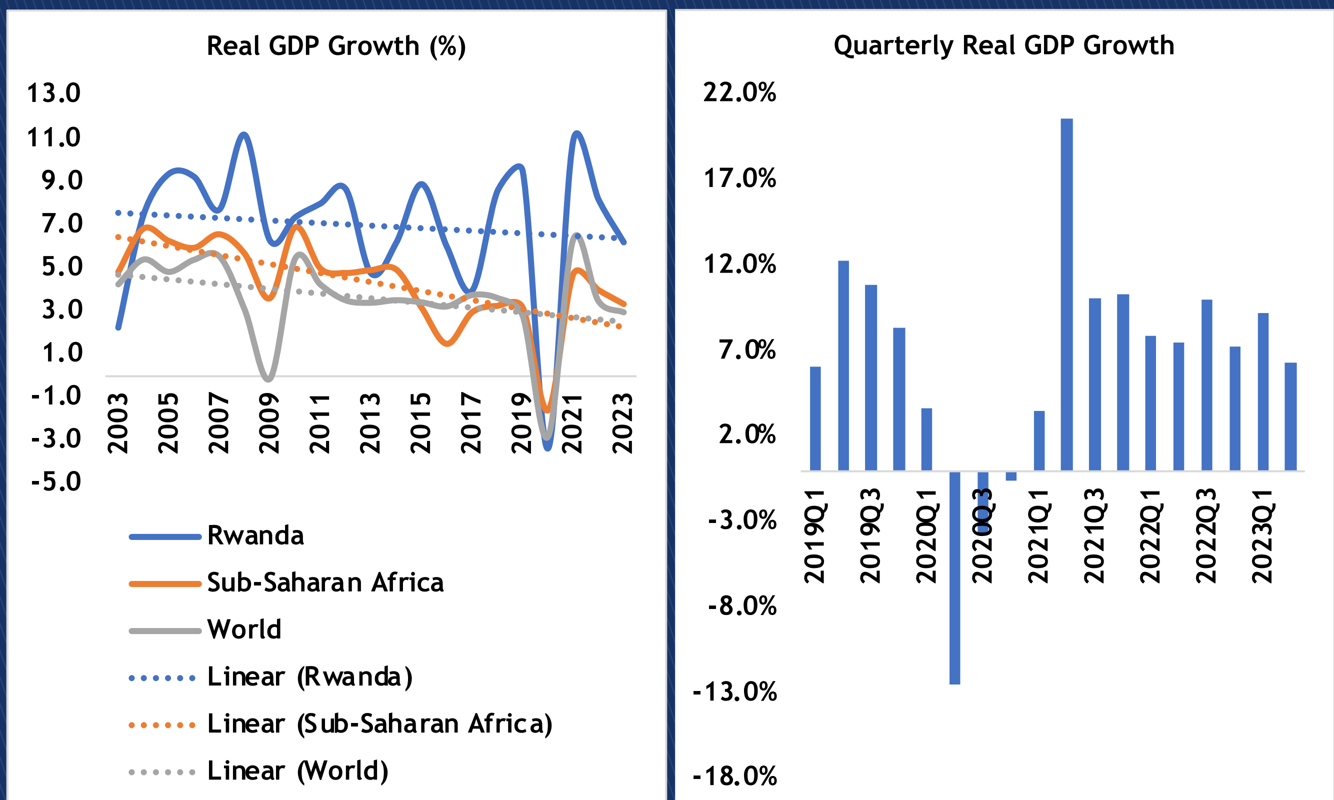
Background

The fourth quarter of 2023 meeting of the Monetary Policy Committee (MPC) of the National Bank of Rwanda (NBR) is held on the backdrop of the Rwandan economy showing strong signs of recovery. Like many small-open economies that are subjected to spillover effects from sluggish global recovery, elevated inflation feeding into the tight monetary policy stance amongst major central banks, and evolving geopolitical risks in Europe and the Middle East[1] , Rwanda's recovery is still emergent.

This Research Note argues that the NBR's monetary policy stance, complementing other macroeconomic and sector level policies, has a critical role in steering the economy to a sustained recovery. The MPC's careful policy calibration is key to entrenching its policy objective of maintaining price stability by keeping headline consumer price inflation in the 2% - 8% band. The simultaneity of domestic and external imbalances characterizes the state of play that the NBR has to navigate.

Three sets of evidence point to the extent to which sustenance of the emergent recovery has to confront a set of binding constraints. First, while the post 2020 rebound of economic performance is evident, the view that reversion of the economy's real GDP growth to its long-term trend is still tentative. **Figure 1** shows that: (i) Rwanda's real GDP growth closely tracks that of both the global economy and Sub-Sharan Africa; (ii) the economy's growth rate has consistently remained higher than that of the both global economy and Sub-Saharan Africa; and (iii) the economy exhibits stable real quarterly growth over the 2021 Q3 – 2023 Q2 period, although it remains to be seen whether the growth stability will persist.

Figure 1: Real Output Growth

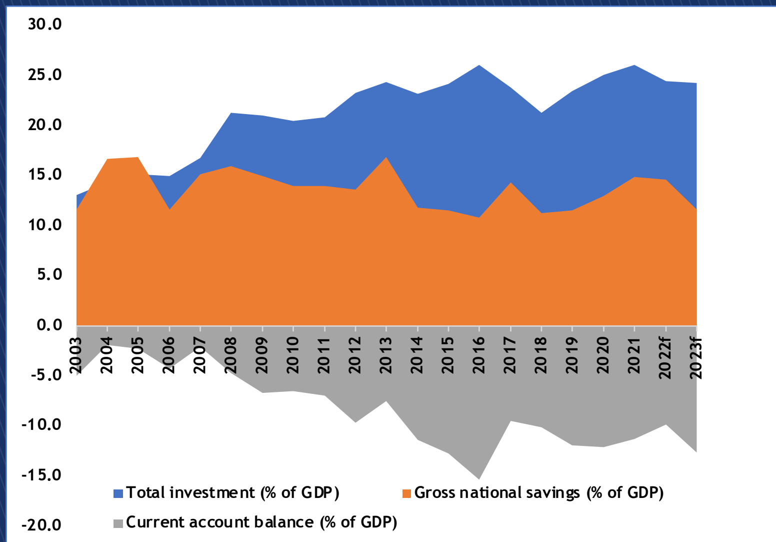


Source: National Institute of Statistics of Rwanda (NIRS), IMF WEO Database

[1] See IMF (2023), ***Regional Economic Outlook: Sub-Saharan Africa – Light on the Horizon?*** October.

Second, the interplay between the sluggish recovery of the global economy on the one hand and the gap between domestic savings and investments – so called savings gap – on the other has revealed itself in a current account deficit that has widened over time. Figure 2 illustrates that the current account deficit, which is an equivalent of the economy's savings gap, is core to the expectations on how NBR's monetary policy stance will strive to balance the external and domestic dimensions to macroeconomic stability.

Figure 2: Savings Gap and Current Account Balance



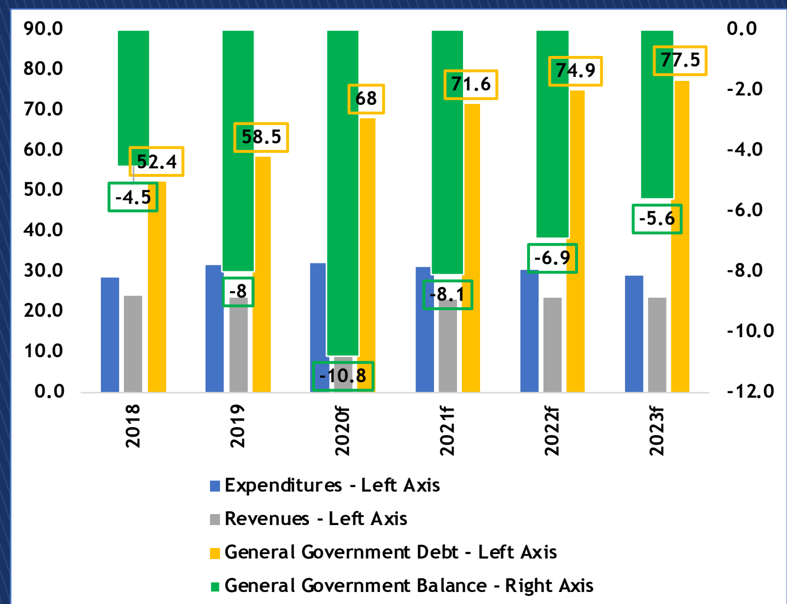
Source: IMF WEO Database

Under the current circumstances, the projected widening of the current account deficit, estimated at 12.7% equivalent of GDP by the end of 2023, has the obvious implication of revealing itself in the deprecation pressure on the Rwandan Franc (FRW) again major currencies. This view is asserted by the MPC[2] and accounts for market expectations with regard to the near-term state of the foreign exchange market.

Beyond the near-term, the economy's external balance has an important intertemporal dimension. Superficially, the widening trade deficit reflects growth in imports more than offsetting growth in exports. Contextually though, the fact that importation of capital goods is picking momentum reflects the extent to which domestic economic activity is gradually solidifying. It also points to the extent to which the economy's emergence from the external shocks is accompanied by the compelling need to build capacity for future resilience through capital investment.

Third, the domestic balance is characterized by fiscal deficit levels that have necessitated fiscal consolidation given that such levels have resulted in public debt accumulation that has risen from an equivalent of 52% of GDP in 2028 to an estimate of 78% of GDP in 2023 (Figure 3). The role of fiscal policy in entrenching recovery ought to be acknowledged. Arguably, a slower pace of consolidation is tenable[3]. Just like the widening current account deficit is, as observed, associated with the immediate pressure in the foreign exchange market while simultaneously accompanied by capacity enhancement through imports to support capital formation, the fiscal stance balances both immediate needs and the compelling long-term requirements.

Figure 3: Selected Fiscal Indicators (% of GDP)



Source: National Institute of Statistics of Rwanda (NISR), World Bank and IMF

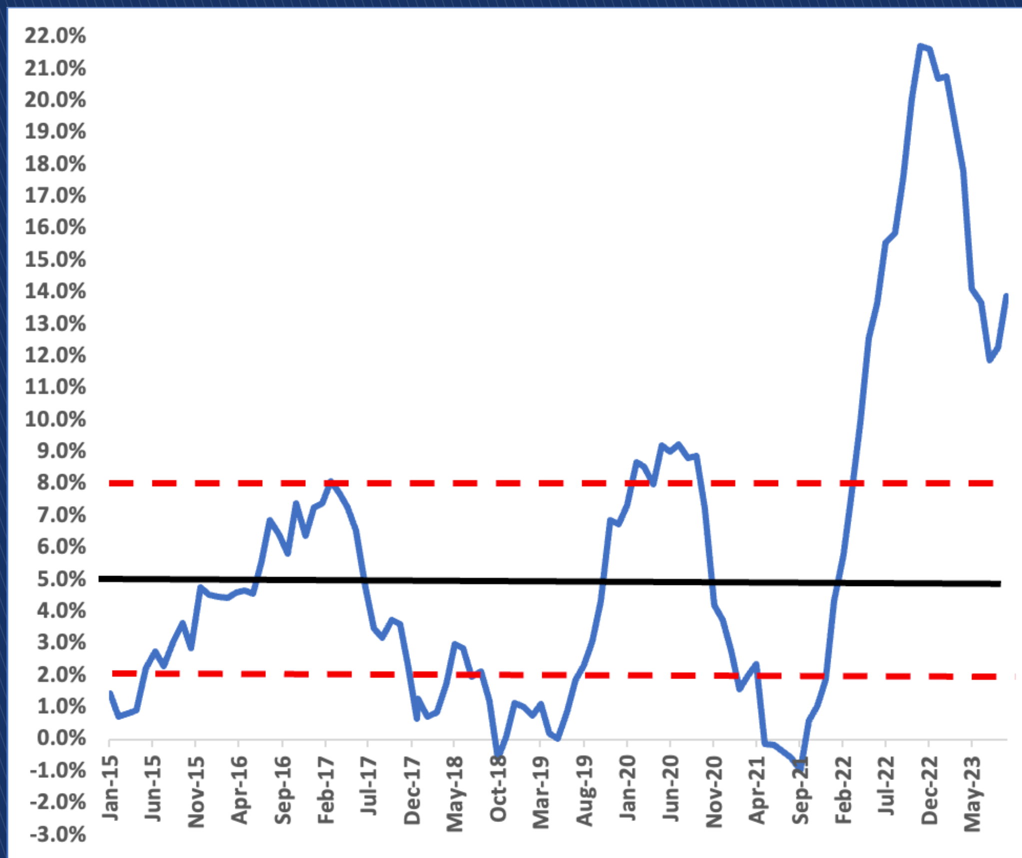
[2] See for instance the NBR (2023), ***Monetary Policy Report, August***
[3] IMF (2023), Press Release shares the same viewpoint, ***https://www.imf.org/en/News/Articles/2023/10/30/pr23367-rwanda-imf-reached-staff-level-agreement-second-reviews-pci-rsf-2023-article-iv-consultation***

The focus of the fiscal authority going forward is the safeguarding of fiscal and external sustainability through timely reforms to broaden the domestic tax base, improve tax compliance, rationalization of expenditure with emphasis on continuous enhancement of public investment efficiency. The NBR's independent conduct of monetary policy is aligned to the fiscal stance given that both policies are geared towards supporting recovery anchored on both external and domestic sustainability.

Macroeconomic Stability

Against the foregoing background, the NBR's monetary policy is focused on the medium term year on year inflation target of 5% with a 2% - 8% band. Figure 4 indicates that inflation is still above MPC target, albeit trending towards it. The spike in inflation from a low of -0.9% in September 2021 to a pick of 21.6% in December 2022 was accompanied by appropriate tightening of monetary policy, with a tacit acknowledgement that monetary policy tools will address the demand-side attributes of inflation - so-called core-inflation that excludes the food and energy components – and in the process influence the overall inflation.

Figure 4: Year-on-year Inflation



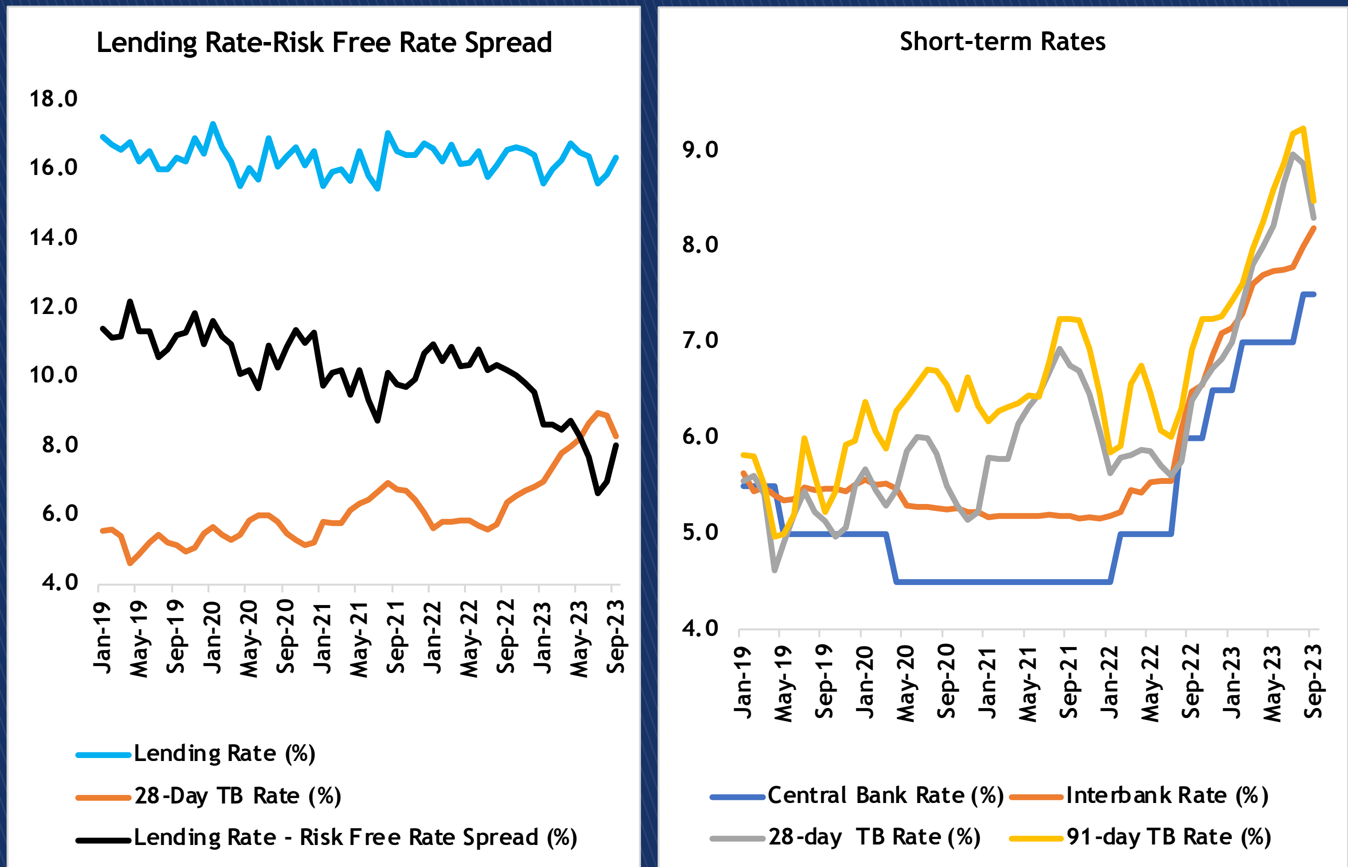
Source: National Institute of Statistics of Rwanda (NISR)

The MPC's change of policy stance from accommodative to tight is signaled by the increase in the Central Bank Rate (CBR) from 4.5% in January 2022 to 7.5% in August 2023 with the corresponding effect of aligning the short-term interest rates (Figure 5). Noteworthy, although lending rates have marginally increased, they have generally been sticky in the 15% - 17% range even under a tight monetary policy stance.

With a comfortable spread between the lending rate and less risky government securities and given the low level of Non-Performing Loans (NPLs)[4] that reflects good quality assets in the banking system, banks are sufficiently incentivized to increase lending to the private sector. Therefore, the market outturn corresponding to the current monetary policy stance allows banks to play a role in entrenching the economy's emergent recovery.

[4] NBR (2023), ***Quarterly Financial Stability Committee Meeting Press Release***, August. ***[FSC_Press_Release__August_2023-_English_version.pdf]***

Figure 5: Central Bank Rate and Market Rates



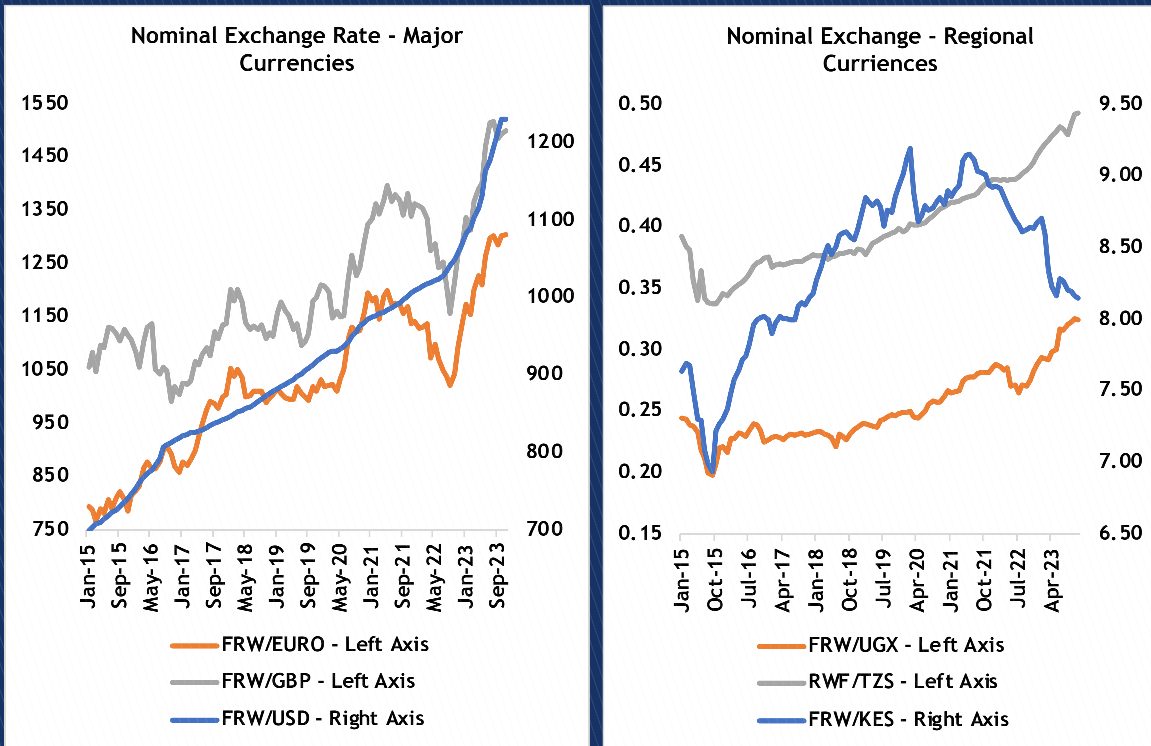
Source: National Bank of Rwanda (NBR)

The forward-looking nature of NBR's monetary policy necessitates that the MPC considers key variables that will influence inflation outlook. One of the variables is the exchange rate. The exchange rate dynamics are key in informing the outlook. On the back of the weak external position, the local currency has been subjected to deprecation pressure against key international currencies (US Dollar (ESD), Euro and Pound Sterling (GBP) as shown in Figure 6. The FRW however has been stable against regional currencies [Uganda Shillings (UGX and Tanzania Shilling (TZS)] and appreciating against the Kenya Shilling (KES).

The flexible exchange rate policy is considered an essential shock absorber that supports the economy's external adjustment. Considering that economies such as Rwanda have noticeable exchange rate pass through to inflation[5], the implication of continued depreciation of the RFW against major currencies is a factor in shaping inflation expectations. To contribute towards improving monetary policy transmission, the exchange rate as a policy lever need strengthening in terms of market development, especially the inter-bank foreign exchange market, as well as the enhancement of the framework for market interventions meant to obviate volatility.

[5] See, for instance, Hitayezu, P and Nyalihama, C (2019), "Exchange rate pass-through to consumer prices in Rwanda: A re-examination", ***BNR Economic Review***, Vol 14. pp. 77 – 111.; February. ***[BNR_Economic_Review_Vol_14 (1).pdf]***

Figure 6: Nominal Exchange Rate



Source: National Bank of Rwanda (NBR)

The other variable is the cost of energy, especially international oil prices. As an economy that relies on imported oil, Rwanda's inflation is directly exposed to changes in international fuel prices. Figure 7 shows the historical cyclicality of international oil prices as influenced by the demand supply dynamics. While the oil increases are a 2 years – 3 years episodes depending on the underlying cause, the declines are much faster, but not long-lasting.

The latest spike that saw the prices rise from USD12 dollars/barrel before the COVID Pandemic and the Russian Ukraine War to a high of USD128/barrel by March 2022 fed into the inflationary pressure experienced in Rwanda. While the prices gradually came down in the March 2022 – March 2023 period, the trough price in the latest decline is higher than some of the past peaks, and a gradual increasing trend is observed. The oil prices outlook is blurred by the continued Russian-Ukraine war and the geopolitical tension in the Middle East whose evolvement is unclear.

Figure 7: OPEC Reference Basket (USD per Barrel)

Source: OPEC

Macro policy perspectives

Inflation remains above target, the declining trend notwithstanding. On that account, the tightening stance is deemed appropriate. The downside risks from from concerns around food supply, continued exchange rate depreciation with a possibility of stronger than anticipated passthrough effect, and a blurry oil price outlook compels the evident MPC vigilance.

The tight monetary policy stance acknowledges the long transmission lags, implying that further policy adjustment requires an assessment of the extent of effect of the recent past decisions. While there is at best limited scope for policy to adjust towards accommodation, further tightening would only be necessitated by clear evidence of second-round inflation effects of the downside risks.

Even on the back of limited policy space, a slower pace of fiscal consolidation in the short run is considered necessary to support recovery generally and more specifically from climate-related challenges. Progress on the Rwanda – IMF program in the form of Policy Coordination Instrument (PCI) and Resilience and Sustainability Facility (RSF) provides a framework for continued fiscal consolidation, credible monetary policy, and further exchange rate adjustment to support the rebuilding of buffers, manage inflation, ensure debt sustainability.

The focus on resilience and sustainability against the backdrop of climate risks provides an opportunity for the financial sector to build a portfolio of green assets and embed climate friendly business practices. The pioneering Sustainability Linked Bond by Development Bank of Rwanda (BRD)[6] showcases the potential of Rwanda's financial system, and the banking industry that dominates the system, to support the economy's sustainable development. The strategic direction of the NBR to re-orient the market towards long-term issuances will be supportive of local currency corporate issuance by both bank and non-bank corporations, some of which having a green dimension. Part of that strategy entails the development of the yield curve that presently is flat and therefore skewing the market towards the short end[7] .

[6] See BRD (2023), Sustainability Linked Bond Prospectus. ***[SLB-Bond-Prospectus.pdf (brd.rw)]***
[7] See Yield Curve, October 2023. ***[Yield_curve_end_August_2023 (3).pdf]***

Conclusion

Amidst sluggish global recovery, elevated inflation feeding into the tight monetary policy stance amongst major central banks and evolving geopolitical risks in Europe and the Middle East, Rwanda's recovery is still emergent. The NBR's tight monetary policy stance that has persisted since February 2022 remains appropriate. As the NBR's MPC makes this year's final review of its money policy decisions, this Research Note argues that the tight monetary policy stance acknowledges the long transmission lags, implying that further policy adjustment requires an assessment of the extent of effect of the recent past decisions.

It is not contestable that there is currently no scope for policy to adjust towards accommodation. However further tightening would only be triggered by clear evidence of second-round inflation effects of the risks emanating from food supply, continued exchange rate depreciation with a possibility of stronger than anticipated passthrough effect, and a blurry oil prices outlook. The tight monetary policy stance has a critical role in steering the economy to a sustained recovery. The role is complementary to sector level policies as well as a slower pace of fiscal consolidation in the short run that is considered necessary to support recovery generally, and more specifically from climate-related challenges.

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