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Monetary Policy Divergence in Advanced Economies: Implications for Lesotho

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Outline

1. Introduction

In the immediate aftermath of the Great Financial Crisis of 2007-8, the global economic environment was plagued with high levels of uncertainty and the substantial downward revision of medium-term economic growth prospects in advanced economies. Conventionally, given such periods of economic downturn, a bank would employ expansionary monetary policy to increase the supply of money into the economy and thus stimulate investment and consumer spending. For instance, in the United States (US), the Federal Reserve System (FED) when faced with an economic slowdown would traditionally adopt an accommodative monetary policy stance that involves three things; (i) lowering of the federal discount rate , (ii) lowering the level of reserve requirements and (iii) the purchase of securities through open market operations. These measures lead to declines in money market interest rates such as commercial bank lending rates which in turn encourage investment spending by firms; labour market tightening, and a rise in aggregate demand. However, following the 2007-8 financial crisis, a number of central banks, especially those from advanced economies such as the US, had policy rates that were close to what was historically considered as the zero lower bound (ZLB). This meant that the effectiveness and indeed the feasibility of orthodox expansionary monetary policies would have to be reassessed.

Mindful of the challenge of monetary policy effectiveness given the ZLB, central banks from advanced economies resorted to making use of unconventional monetary policies (UMPs) to breathe life into their ailing economies. These UMPs involved the introduction of concepts such as quantitative easing (QE) in conjunction with what came to be known as negative interest rate policies (NIRPs). Owing to the fact that most of the world's economies were facing downturns during this time, the global monetary policy landscape was generally synchronised and widely understood to be accommodative. This was certainly the case, up until September 2014 when the FED Federal Open Market Committee (FOMC) published its policy normalisation principles and plans.

The aim of this article is to provide an overview of the monetary policy divergence in advanced economies from 2015 to date and discuss its implications for Lesotho, a small open market economy with a fixed exchange rate regime. The rest of the paper is organised as follows; Section 2 explores the monetary policy landscape in advanced economies from 2015 to 2018. Section 3 presents implications of monetary policy divergence on Lesotho. Section 4 concludes.

2. Monetary Policy Landscape in Advanced Economies from 2015 to 2018

In September 2014, the FED FOMC mulled over ways to normalize its monetary policy stance together with its securities holdings given QE. The deliberations resulted in the publication of the FED policy normalisation principles and plans in the same month. Subsequent to that, in December 2015, the FED raised the federal funds rate for the first time in nine years.

1 In the broadest sense, the aftereffects of severe financial crises share three characteristics. First, the asset market collapses. Second, the level of output declines while the level of unemployment increases. Third, the real value of government debt increases dramatically.

2 The FED is the central bank of the US.

3 The discount rate is the interest rate charged to commercial banks and other depository institutions on loans they receive from their regional Federal Reserve Bank's lending facility--the discount window.

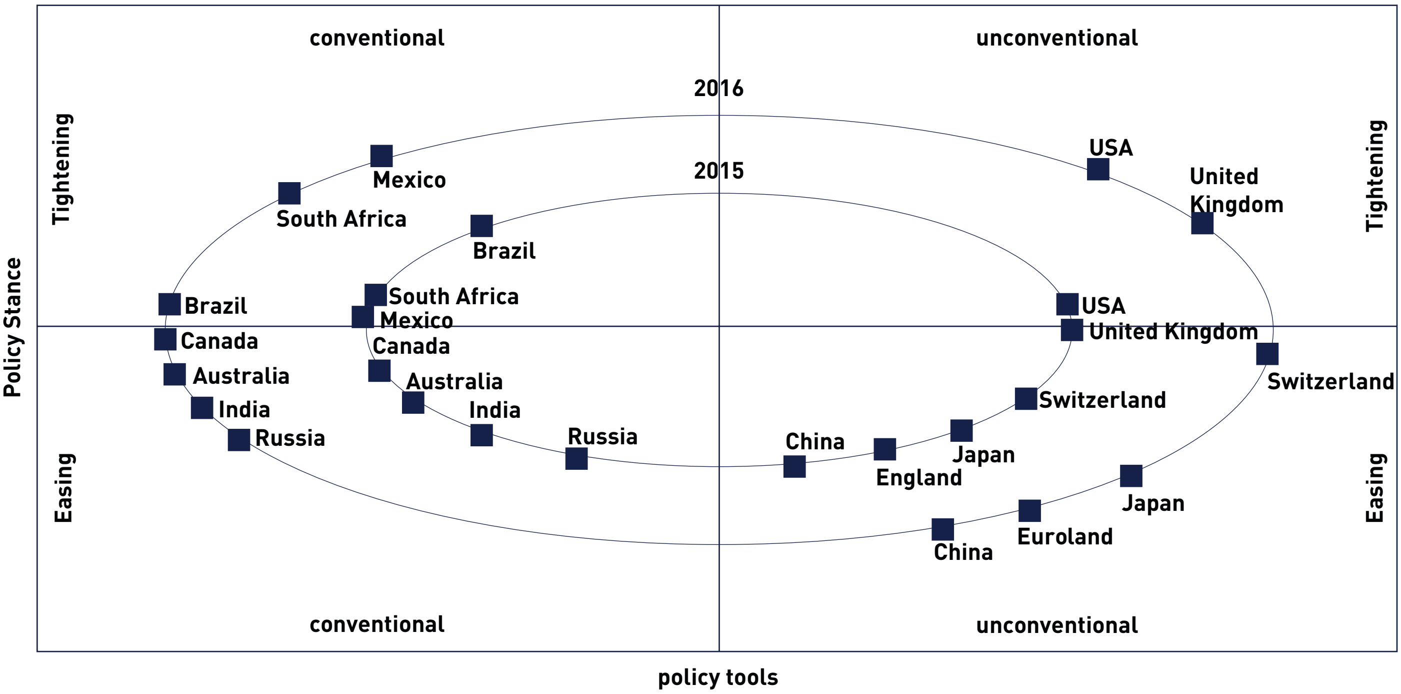
4 These are the amount of funds that a depository institution must hold in reserve against specified deposit liabilities.

5 This is the rate that is used by a central bank to implement or signal its monetary policy stance.

6 Quantitative easing or as it is sometimes called; large-scale asset purchases, is an expansionary monetary policy whereby a central bank attempts to stimulate the economy and increase liquidity through purchases of predetermined amounts of government bonds or other financial assets.

This move signalled two things; (i) a move away from ultra-low (nearly 0%) interest rates that had taken root since the 2007/08 financial crisis period, and (ii) the clear departure or divergence of the US (among developed countries) from the so called synchronised and loose global monetary policy stance that had been prevailing. Figure 1 offers an illustration of these two points.

Figure 1: Global Central Bank Monetary Policy Landscape – 2015 vs 2016



Source: Allianz Global Investors

From Figure 1, 2016 can also be characterised as having exhibited divergence in monetary policy among developed countries. The difference this time around was that the US was joined by the United Kingdom (UK), through the Bank of England's (BoE's), normalisation path. This meant leaving behind the likes of the European Central Bank (ECB), the Bank of Japan (BoJ) and the Swiss National Bank (SNB) to name a few. It is worth noting that in 2016 both the FED and the BoE did not start scaling back their asset purchase programmes. This continued to render them in unconventional monetary policy territory despite gradual normalisation of the policy rate. The global monetary policy landscape among advanced economies remained broadly unchanged and asynchronised throughout 2017 with the US maintaining a normalisation path while also taking steps towards unwinding the size of its balance sheet. The balance sheet taper signalled the start of the FED's gradual reversal of QE, leaving behind the likes of the BoJ and the ECB. At the time of this article (March 2019), the FED raised rates to between 2.25% and 2.5% in their December 2018 meeting. During the same time, the ECB announced that they would not be continuing with QE into 2019 . However, unlike the FED, the ECB does not expect to raise rates until the summer of 2019. In the meantime, the BoJ has maintained an unchanged accommodative monetary policy stance, one characterised by LSAP and negative interest rates.

[7] The FED funds rate target range was increased from 0 – 0.25% to 0.25 – 0.5%.

3. Implications of Advanced Economy Monetary Policy Divergence on Lesotho

The transmission of monetary policy decisions from advanced economies to other countries is usually through two broad channels; the price channel and the quantity channel (the capital flows channel). In the case of Lesotho (a small open economy that operates under a fixed exchange rate regime), monetary policy developments in advanced economies are transmitted to it indirectly via their influence on the Republic of South Africa. To fully appreciate the indirect impact of changes in the monetary policy stance of developed economies such as the US on Lesotho, it is important to briefly discuss Lesotho's monetary policy regime. Table 1 presents the monetary policy regime, operational target, intermediate target, ultimate target and monetary policy instruments of the Central Bank of Lesotho (CBL).

Table 1: The Monetary Policy of the Central Bank of Lesotho

Monetary Policy Regime	Operational Target	Intermediate Target	Ultimate Target	Monetary Policy Instruments
Exchange rate targeting (fixed exchange rate regime; maintain a 1 to 1 peg with the South African Rand)	Monetary Base	One to One parity (loti-rand) ensured by keeping a minimum level of net international reserves (NIR)	Price Stability	• Open Market Operations (Sale and Repo of Tbills) • Standing facility (intraday loan facility, Lombard facility) • Minimum Reserves Requirement.

The CBL follows a fixed exchange rate monetary policy regime where the ultimate objective of price stability is achieved by influencing the operational target and maintaining a level of net international reserves (NIR) that supports the parity between the Lesotho Loti and the South African Rand (ZAR). The exchange rate parity between the Loti and the Rand is crucial for Lesotho's price stability since the bulk of Lesotho's inflation is imported from South Africa. Monetary policy decisions from advanced economies affect Lesotho indirectly through the country's close relationship with South Africa.

As an example, loose monetary policy from the FED, ECB and BoJ at the end of 2008 as characterised by very low rates (close to / beyond the ZLB) and Large Scale Asset Purchase (LSAP) programmes / QE were transmitted to South Africa through the price and quantity channels.

[8] The ECB intends to continue reinvesting, in full, the principal payments from maturing securities purchased under the asset purchase proramme (APP) for an extended period of time past the date when it starts raising the key ECB interest rates, and in any case for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation.

[9] The price channel acts a transmission channel through any or all of following three ways; policy interest rate setting among central banks, global bond markets, and currency depreciation or appreciation.

Starting from a couple of years before the crisis, net capital flows into South Africa as a percentage of GDP increased to 4.9 per cent in 2005 and continued to grow to a peak of 7.6 per cent of GDP in 2007 before declining to 4.2 per cent of GDP in 2008 and down to 2.6 per cent of GDP by 2010, which this was still higher than the -1.2 per cent of GDP recorded in 2003. The relative increase in net capital flows over the 2003 to 2010 period sparked a rise in the demand for Rands and thus an appreciation of the ZAR against the dollar. Consequently, this also meant an appreciation in Lesotho's Loti against the US dollar. At the end of July 2009, the Rand, and hence the Loti, appreciated from 10.00 at the end of 2008 to 7.90 against the US dollar. Against this background, Table 2 provides a brief outline of the advantages and disadvantages of an appreciation of the domestic currency against the US dollar.

Table 2: Advantages and Disadvantages of Domestic Currency Appreciation against the US dollar

Advantages	Disadvantages
• An improvement in the terms of trade. • Reduction of import costs from the rest of the world and softening of domestic inflationary pressures. • Reduction in cost of US dollar denominated external debt service.	• Loss of export price competitiveness. • Worsening of the trade balance. • Increased likelihood of job losses in the export market. • Negative impact on domestic growth prospects.

Considering the prevailing monetary policy normalisation in the US (rising interest rates and tightening of the FED balance sheet), the likely impact is a reversal of hot money flows into EMEs like South Africa back to the US as it seeks higher returns back home. Such capital outflow will translate in a depreciation of the domestic currency, the Rand (and by extension, the Loti) against the US dollar. Consequently, this further manifests itself in the form of heightened upside risks to domestic inflation and increased debt service costs of dollar denominated debt. The decline in the international reserve position of countries such as Lesotho due to service external debt obligations and increased import costs in the wake of an appreciated US dollar stands to be moderated by foreign exchange inflows supported by price competitiveness in the export market.

4. CONCLUSION

The apparent global monetary policy divergence in advanced economies exemplified by a normalisation of interest rates in the US presents policy uncertainty for Lesotho, a small open economy with close ties to a more developed regional neighbour, South Africa. This necessitates close monitoring of the monetary policy developments from the US but more importantly, those of South Africa in order to offer a timely and suitable domestic policy reaction.

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