Shopping Mall Economics: A note on the value of the Kenya shilling

Is the Kenya shilling overvalued or not? According to the IMF it is currently overvalued by 17 percent. In an unusually combative response to his former employer the Central Bank governor says that is only off-kilter by 5 percent and accuses the IMF of making Kenya a “guinea pig in its new approach.” The offensive claim, contained in the IMF’s latest report on the country dated October 2018, states as follows:

> “The EBA-lite methodology for the exchange rate suggests that the external position is weaker than fundamentals. The current account approach shows that the current account deficit (both actual and cyclically adjusted) are above the norm (the CA gap is -2.5 percent), suggesting an overvaluation of about 17.5 percent of the real exchange rate. This can only marginally be explained by the policy gap. The REER approach also shows a similar-size of overvaluation, equivalent to about 18.0 percent. Again, the policy gap is marginal. Given the continued appreciation of the real exchange rate, the external position is assessed to be weaker than fundamentals. Regarding the last approach, the external sustainability approach, it was not possible to use it as the international investment position data is not yet produced by the authorities.”

This needs a fair amount of disambiguation. EBA is a needless acronym that stands for external balance approach for exchange rate assessment. The methodology is described in an IMF paper published in 2013 as an update of a previous methodology known as CGER. CGER is another needless acronym for consultative group for exchange rate assessment. This EBA thing appears to be what the CBK governor is referring to as a new approach.

The methodological spat is a red herring. Economic models are tools, not oracles. What we have here is workmen quarrelling over tools. Our top three economic mandarins are former IMF staffers. Surely, as former colleagues, they can sit together with their colleagues and their models and converge on an assessment as to whether the shilling is overvalued or not?

The IMF refers to three methodologies: the Real Effective Exchange Rate (REER), the current account and external sustainability approach. Of the three, the REER is the most intuitively understandable and also the one for which we have data. But what is this animal the REER?

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Suppose bananas are retailing at KSh 100 shillings a bunch in Kenya. The Kenya/Uganda shilling exchange rate is one to ten. At this exchange rate and banana price, 20 percent of bananas are coming from Uganda. Suppose price of Kenyan bananas goes up to KSh 125 a bunch (e.g. because of increase in taxes), and exchange rate remains the same. Ugandans can continue to sell bananas in Kenya profitably at KSh 100 while many Kenyan producers cannot. In fact, Ugandans are likely to hike their price to let us say KSh.110 making Kenya an even more profitable market than their home market. Uganda bananas will flood the market and put Kenyan producers who are not profitable at Ksh. 110 out of the banana business. For the market to remain at the old equilibrium (i.e. 20/80 Uganda/Kenya market share) requires Kenya shilling to fetch USh. 8.00 so that to get USh. 1000 as before, the Ugandans will also have to sell their bananas at KSh125.

Its readily apparent that if our domestic prices go up faster than those of our trading partners, then foreign goods will keep becoming cheaper. But you cannot tell by just looking at the dollar shilling exchange rate. We need to factor in the price movements with every trading partner. The REER is an index that combines the relative exchange rate and price movements of all our trading partners.

If the REER is rising, our goods are becoming more expensive. We can expect to import more and export less. If this happens our trade deficit will widen. If the trade deficit continues to widen, we run the risk of defaulting on our international obligations in particular debt service and repatriation of profits and capital. This is where the IMF comes in. The IMF's mandate is to maintain international financial stability. The IMF is a financial cooperative whose job it is to ensure members do not run into external payments difficulties, and to bail them out when they do, in order to keep global finance and commerce going.

The spat between the IMF and the CBK is therefore about our external creditworthiness. The key indicator for this is the current account balance. The current account balance has two components: trade and income. The trade account I have already mentioned. The income account consists of payments for "factor services" such as interest (use of capital), labour (e.g. for services of Kenyan troops abroad) and another component we call unrequited transfers (meaning money we have not earned) such as diaspora remittances, grant aid and such like. The external account in turn, has a third component, the capital account where, as the name suggest, we record investment transactions.

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This is how it works. Kenya Airways buys an aircraft using a foreign loan. The aircraft is entered in the trade account as an import and simultaneously in the capital account as a capital inflow. The following day it ferries passengers from Lagos to Dubai. The income is recorded in the trade account as a service export. At the end of the month it remits repayment on the loan. The interest is recorded in the income account as a factor service payment and the principal is in the capital account as a capital outflow.

The net of the current account and the capital account are added together to give the overall balance. An increasing overall deficit depletes foreign reserves, while a surplus leads to a build up of reserves. Current account surpluses mean that a country's savings exceed its investment; it can, therefore, export capital, like China. A current account deficit means that a country is investing more than its savings, in other words, it is importing capital (either debt, FDI, remittances, grants etc).

The country's creditworthiness thus depends not just on trade but also on other financial flows, that are determined by factors other than trade competitiveness, both economic and non-economic. Complicated stuff.

Both the IMF and CBK agree that the shilling has appreciated, but they disagree on the magnitude. The IMF also implies that the appreciation is a reflection of policy action while the CBK maintains that it is a reflection of market forces. The IMF view translates to accusing the CBK of misleading the public by espousing a monetary policy that claims to target inflation, while in practice it is actually targeting the exchange rate. The IMF's "smoking gun" is the fact that the NEER has flatlined for the past six years (see Chart).

Recently the IMF re-classified the Kenya shilling from a “floating” (meaning market determined) to “other managed arrangement.” This means the IMF is convinced that the Central Bank is propping up the shilling. What reason would the Central Bank prop up the shilling especially if it undermines the country’s competitiveness and solvency?

Foreign currency debt exposure is one reason. The interest payments on the first Eurobonds issued in 2015 ($185 million a year) has increased by KSh 3 billion, KSh 16 billion to KSh 19 billion on account of the depreciation of the shilling. Translate that to the total interest payments this year which are in the order of $1.4 billion dollars. The shilling has weakened by about three shillings to the dollar since the beginning of the financial year. The total interest payments this year which are in the order of $1.4 billion. This translates to a KSh 4 billion squeeze on a government that is already living way beyond its means. The last thing the Treasury wants to hear is that the shilling should be trading at about 120 to the dollar.

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Another reason is pressure to keep low interest rates. Interest rate is the policy instrument in an inflation-targeting monetary policy regime such as we claim to have. Central Banks are given statutory independence over the conduct of monetary policy to insulate them from such pressure so that they can raise interest rates when they need to, even when it is politically costly for the government of the day. Parliament’s capping of interest rates two years ago is ample demonstration that political pressure on Central Banks is real.

Keeping interest rates artificially low puts pressure on the exchange rate. A weakening currency creates inflationary pressures, which is what the Central Banks are mandated to control in the first place. The Central Banks end up trying to meet incompatible objectives, low interest rates, low inflation and a stable currency.

This is precisely what happened from mid-2009 to September 2011. The Central Bank bent over backwards to accommodate the government's economic stimulus meant to respond to both the post-election violence and the global financial crisis. Interests rate were driven to the floor. From mid-2010 to mid-2011 the benchmark 90-day Treasury bill rate was kept below 3 percent. The IMF's charts show how this ended— with a very hard landing. The shilling which had been propped up at about 80 to the dollar, started unravelling in April peaking at KSh100 to the dollar in September. The Central Bank was forced to jack up interest rates in a hurry. By the end of 2011, the T-bill rate was heading to 20 percent.

The IMF seems to believe that, left to market forces, the shilling will depreciate in real terms. The IMF's REER chart covers eight years, from 2010 to 2017. A longer timespan does not necessarily support this contention (see Chart). My chart goes back to the beginning of the liberalized regime in 1994. What do we see? The shilling has been appreciating in real terms since it was liberalized. Overall it has appreciated 157 percent, by 9 percent per year on average. This could mean that the Government has been propping up the shilling all these years, or that market forces are not working the way the IMF expects.

Many Kenyans have observed that we have become an importing country. One also hears policymakers lamenting that we are losing our markets in the region and blaming all manner of things. There is no mystery to it.

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But is the Central Bank propping up the shilling? That we cannot be able to tell that easily. There are lots of moving parts. It can also be on account of some trading partners manipulating their currencies: China, for example, is regularly accused of maintaining an artificially weak currency. China has a big weight in our REER and it's been growing over time.

The ultimate question is whether it is sustainable. There are two parts to this, financial and economic. The widening trade deficit has been plugged by remittances and portfolio inflows (money flowing into the stock exchange and government securities), not all of it honest money, and lately, government commercial borrowing, the ubiquitous eurobonds and syndicated loans. As long as these keep flowing, the show can go on.

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The economics is a different story. This is the shopping mall economy. It is not good for employment and equity. It is not good for employment, or equity, or sustainable growth. It is part of the answer to the question that Kenyans keep asking: why they are told the economy is growing and they are not feeling it. This is the shopping mall economy. How long can we keep that going? Your guess is as good as mine. Governments are known to manipulate currencies and to distort financial markets generally. The IMF is known to (a) have more faith in market forces than warranted and (b) get the workings of those market forces wrong. What to do?