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The Conduct of Monetary Policy in Central Banks after the Global Financial Crisis

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The consensus that guided the conduct of monetary policy around the world before the financial crisis of 2007-2009 was that central banks could greatly contribute to growth and financial stability by delivering price stability which was fairly vindicated by developments before the crisis. The scope and scale of the crisis revealed the inadequacy of the conventional instruments of monetary policy as central banks had to resort to unconventional measures including: quantitative easing; broadening and lowering of the quality of financial instruments eligible as collateral for accessing central bank loans; executing various forms of lender-of-last resort measures to bail out troubled banks; and purchase of securities to improve liquidity. These measures were complimented by government intervention through provision of credit to troubled industries.

In view of the challenges to monetary policy brought about by the crisis, this paper identifies three main areas of intervention that are relevant to Sub-Saharan Africa (SSA) countries namely: the role of monetary policy in the post crisis economic conditions; ways of improving the link between micro- and macro-prudential policies; and designing appropriate framework of managing cross-border spillover effects.

The role of monetary policy in the post crisis economic conditions

First, maintaining price stability remains the central focus of monetary policy after the crisis, but this “single

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policy goal" view was greatly challenged during the crisis. As a result, many central banks have been given more explicit role of maintaining financial stability after the crisis. Second, the capital outflow from emerging and developing countries to advanced economies that followed the gradual implementation of "tempering" policy to exit from the unconventional policy measures has seen central banks in emerging and developing countries employing a variety of measures to limit the impact on exchange rates and domestic financial system. To manage these surges in capital flows, central banks in SSA may need to establish a collective self-insurance by pooling reserves to ease the impact of large sudden flows.

Maintaining price stability remains the central focus of monetary policy after the crisis, but this "single policy goal" view was greatly challenged during the crisis.

Third, the prolonged low interest rates that preceded the crisis and perpetuated by the policies employed to address it can increase the propensity of economic agents to engage in excessive risk taking and could impair financial intermediation. Central banks in SSA need to balance between maximizing output growth and minimizing excessive risk taking needs so as to mitigate the risk of surges in capital outflows.

Fourth, the fiscal response to the crisis led to substantial increase in fiscal deficits and debt which may become unsustainable in the future particularly if interest rates rise from current levels. For monetary policy, there is a potential for emergence of fiscal dominance that could pose risk to central banks' operational independence and undermine monetary policy objectives. It is important for monetary policy framework to include a program of improving communication to public on central bank independence and improve transparency in setting monetary policy targets and actions.

Fifth, the use of unconventional measures to deal with liquidity needs during the crisis highlights the need to review liquidity management framework to maintain stable monetary conditions. Central banks may expand eligible collateral and incentivize counterparts to hold and use these financial instruments and design flexible liquidity management tools, such as special term deposits, foreign exchange swap facilities and reverse repos where these instruments have not been used. Similarly, the banks should be encouraged to adopt flexible instruments to facilitate liquidity in the money market.

Sixth, as most central banks in SSA countries contemplate or implement programs for adopting inflation targeting, they should be mindful of the challenges encountered in application of traditional monetary policy nominal anchors, especially at the times of turmoil. The discussion about moving away from monetary targeting to inflation targeting regime should not completely ignore the information content of money to future inflation. Equally important, there is need to continue developing the financial markets to increase the interest rate sensitivity so as to improve the conduct of monetary policy and increase resilience of the markets to shocks.

Seventh, while the general consensus in economic literature is that low and stable rate of inflation is desirable for promoting economic growth, there is need to establish the desirable level of inflation and whether it is symmetrical across countries. This question is critical in maintaining a balance between inflation and output, as reduction of inflation rate to low levels is associated with output loss, while frequent changes of inflation targets can also lead to "time-inconsistency problem". As shown in some literature the desirable rate of inflation may be higher than the 5% or below that has been applied in SSA. Central banks may need to consider setting inflation targets as a long-term goal of monetary policy and determine their short-term targets based on prevailing economic conditions.

Improving the link between micro-prudential policies and macro-prudential policies

There is need to link micro- and macro-prudential policies. The crisis has shown that monetary policy and financial stability are intrinsically intertwined, underscoring the need for coordination between monetary and macro-prudential policies to ensure stability of inflation, output and financial sector.

Designing appropriate framework of managing cross-border spillover effects

The crisis highlighted the importance of cooperation among central banks to maintain proper functioning of the financial sector. One approach involves formalizing and strengthening cooperation and coordination among central banks and other financial institutions to manage cross-border spillover effects. Another is to design an integrated surveillance and mechanisms of enforcement of monetary policy cooperation and coordination amongst partner states. Finally, cooperation and coordination can be done through agreements on a set of economic and monetary (financial) indicators, and an effective mechanism for ensuring compliance.

(Full paper available in the Bank of Tanzania website: www.bot.go.tz))

Appropriate Threshold Level of Inflation for Economic Growth: Evidence from the Three Founding EAC Countries

Nicas Yabu and Nicholaus Kessy

The implementation of the macro-economic convergence criteria in the East African Community is the realization by the partner states that a successful and sustainable monetary union requires a prior economic convergence. One of the EAC primary convergence criteria is the ceiling on headline inflation of 8 percent for which each partner state is to achieve by 2021 and sustain thereafter. Implicit in the target for inflation is the achievement of high economic growth since the two are fundamental macroeconomic objectives of most economies. However, in the economic literature, there is considerable debate on the nature of inflation and growth relationship; with increasing agreement that high inflation has negative effects on long-term economic growth. The objective of the study was to establish whether or not achieving of the primary convergence criteria of the ceiling on headline inflation of 8 percent supports economic growth in three founding EAC member countries, Kenya, Tanzania and Uganda.

The EAC convergence criterion of the single rate of headline inflation is consistent with high economic growth in the three EAC partner states.

The paper utilized a non-linear model form of quadratic function to estimate the threshold level or the turning point above which inflation exerts a negative effect on economic growth. Panel estimation in the form of random effect model was used to estimate average inflation rate for all three member states, while Seemingly Unrelated Regression (SUR) was used to estimate inflation rate for each EAC country separately.

Findings from random effect model indicated that for the three EAC economies, the rate of inflation beyond 8.46 percent has negative and significant impact on economic growth. However, findings from the SUR model indicated that for individual economies, the threshold rate of inflation for Kenya, Tanzania and Uganda were 6.77 percent, 8.80 percent and 8.41 percent, respectively. The implication for monetary policy is that policy makers need to continue putting effort in achieving and maintaining single level of inflation for the EAC member states to support economic growth.

(Full paper available in the Bank of Tanzania website: www.bot.go.tz))

Contract Farming Schemes in Tanzania: Benefits and Challenges

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In many developing countries, contract farming is typically encouraged on the ground that such arrangements, among others, tend to strengthen market linkages between smallholder farmers and buyers, improve farmers' incomes through various mechanisms including access to markets, higher prices, as well as access to new technologies. Nevertheless, mixed views have been expressed in Tanzania by some smallholder farmers and politicians that the schemes have not adequately benefited farmers including in raising their incomes, access to new technology and credit. This study examines whether or not contract farming has improved farmers' economic and social welfare, the extent to which contract farming has solved access to market constraints, and challenges in managing contract farming.

The study used both qualitative and quantitative approaches, and applied cross sectional data with a sample size of 904 smallholder farmers. A structured questionnaire was used to solicit key information from farmers, while information from crop buyers and marketing boards were collected using checklist questions. Crops covered in the study were cotton in Mara, Simiyu, Mwanza, Tabora, Kigoma, Geita, Kagera and Shinyanga regions; sisal in Tanga; sugarcane in Morogoro; and tobacco in Ruvuma, Mbeya, Katavi and Iringa regions. The findings suggest the following:

Farm size

Small-holder farmers expressed mixed feelings on the impact of contract farming in improving their economic and social welfare, as well as market access.

Farm size for tobacco increased after joining contract farming, while differences were recorded for the case of sugarcane. As for cotton, no significant differences were observed in farm size before and after farmers joined contract farming schemes. Majority of the cotton farmers indicated that they cultivated

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farms of less than 5 acres per annum. Nonetheless, no comparison could be made for sisal as there were no sisal smallholder farmers before the start of the contract farming. On average a sisal farmer cultivated a farm of 4.5 hectares.

Use of modern technology and access to credit

The majority of cotton, sisal and sugarcane contracted farmers use improved technology than smallholder farmers outside the schemes. The use of hand hoe was predominant in tobacco farming. With respect to sources of finance, majority of smallholder farmers used own funds in crop production. Access to loans from buyers and financial institutions was still a problem, and this has constrained expansion of crop production. As for commercial banks, the key deterrent factors were related to collateral requirements, long screening procedures and high interest rates.

Crop production

The findings indicated that tobacco and sugarcane production rose after the introduction of contract farming scheme. Nevertheless, for sugarcane, the increase was in favour of smallholder farmers in Kilosa and Kilombero districts as smallholder farmers in Mvomero district experienced a 26 percent decrease in the similar period. Most of respondents in cotton pointed out that they did not experience differences in production largely due to delay of inputs, low quality seeds, lack of credit and payment delays. No comparison could be made for sisal farmers in this aspect as there were no smallholder farmers before the start of the contract farming and no sales had been recorded under the outgrower scheme. On average a smallholder farmer produced 9.1 tonnes of sisal annually.

Economic and social welfare

The impact on farmers' economic and social welfare was also mixed. The study findings on tobacco growers indicated an increase in real incomes, as well as access to better health services, shelter and education for their children. While there was no before and after comparisons in sisal, smallholder farmers reported that contract farming had provided them extra incomes that enabled them to access better health services and shelter as well as send their children to good schools. Overall, sugarcane farmers recorded a decline in real incomes after joining the scheme, driven by a fall in real incomes of outgrowers in Mvomero district, which more than offset the increase in real incomes of farmers from Kilosa and Kilombero districts. Outgrowers in Mvomero district also indicated that contract farming did not enable them to access better health services, improved shelter and better education their children. Meanwhile, there was no statistically significant change in real incomes of majority of cotton growers after joining contract farming schemes except in Simiyu and Mara regions where findings indicated a modest rise in real incomes. Also, most of cotton farmers suggested that contract farming had not made them better off in accessing better health services, improved shelter and better education for their children.

Market access and Other Challenges

Access to market is no longer a problem to the majority of respondents except for sugarcane where most respondents indicated that market is still a problem due to oversupply of sugarcane. The main concerns for most of respondents were on low prices offered and payment delays by buyers. Overall, contract farming schemes have not adequately assured smallholder farmers of crop buying prices before commencement of planting season as stipulated in the Contract Farming Act, 2013.

Some of the respondents were not aware of their contractual obligations while others were not satisfied with information flow from the buyers to the famers. Also, majority of the respondents complained that buyers did not abide by contractual obligations. Such a situation points to weak contract enforcement mechanism. Other challenges include:

- Low accounting knowledge and inadequate contract negotiation skills of farmers' representatives.
- Poor record keeping by smallholders farmers.
- Inactive marketing boards in overseeing contract enforcement and education to smallholder farmers for them to understand their contractual rights and obligations.
- Poor transport infrastructure in the areas surrounding the schemes which increases the cost of production.
- Disease outbreaks and weather dependence of most crops in the absence of crop insurance schemes increase the risk of loan default, causing financial institutions to shy away from lending to agriculture.
- Lack of transparence in crop grading and price setting arrangements contribute to low prices to farmers' produce.

Policy Recommendations

The study makes a number of policy recommendations, comprising: availing and facilitating smallholder farmers access to long-term sources of finance; establishment of crop insurance schemes; contract enforcement by the government, through relevant crop boards; improvement of transport infrastructure to areas surrounding the schemes; establishment of irrigation schemes; establishment of competitive environment for the cash crops; and stepping up public awareness on the significance of contract farming particularly in raising incomes and welfare of smallholder farmers.

(Full paper available in the Bank of Tanzania website: www.bot.go.tz))

Assessing the Intra-SADC Trade in Goods and Services

Nicas Yabu

One of the objectives of regional integration is to expand trade and boost economic growth among member states. However, since the establishment of the Southern African Development Community (SADC) in 1992, the economies of member states have remained relatively small and economic growth performances have not been robust enough to enable member countries to trade among themselves. For example, intra-Asia trade and intra-EU trade account for more than 50 percent of their total trade. This study investigated the extent of trade within SADC member states and identified factors affecting intra-regional trade.

The study used the relative measure of trade intensity to measure export and import shares within member states and gravity model to identify factors affecting intra-SADC trade flows. The findings indicated that the share of intra-SADC exports averaged to 31.3 percent between 2008 and 2012 with Swaziland recording the largest share of 97.5 percent, while Seychelles had the smallest share of 2.4 percent. Meanwhile, the share of intra-SADC imports averaged to 35.0 percent in the same period with Lesotho recording the largest share of 92.4 percent, while South Africa had the smallest share of 3.7 percent. It was found that other SADC countries export and import most of their goods and services to and from South Africa. Generally, findings indicated that SADC as a region trades more with countries outside the region.

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Findings from the gravity model indicated that intra-trade flows within SADC region significantly depend on GDP, per capita income, the value of manufacturing, foreign direct investment, financial development, infrastructure development, stable exchange rate, and low inflation rate. It is recommended that SADC countries put more effort in investing in infrastructure to facilitated trade flows among themselves, remove non-tariff trade barriers as well as adopting export diversification strategy by identifying priority products, in which each country has a comparative advantage.

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