Central Bank of Kenya

Curriculum Vitae

Joseph K. Kinyua

Joseph K. Kinyua began his career as an assistant lecturer at Nairobi University. He joined the Central Bank of Kenya in 1980 and worked his way through the ranks, from an economist to director of Research. Mr Kinyua also worked as an economist on a fixed term appointment with the International Monetary Fund during 1985-1990, after which he returned back to the Central Bank.

He was appointed Financial Secretary to the Treasury in June 1995, a position he held until July 1999 when he rejoined the Central Bank of Kenya as Director of Financial Markets. Since October 2000 he has been the Chief Economist of the Central Bank of Kenya.

Mr Kinyua has also served as a director on several Boards of State Corporations. He is currently a member of the Advisory Committee of the African Economic Research Consortium.

He holds BA (Econ.) and MA (Econ.) degrees from Nairobi University.

E-mail: kinyuajk@centralbank.go.ke

Acknowledgements

I am thankful to members of the Economic Affairs Division of the Reserve Bank of Malawi for their wonderful comments and suggestion. In particular, I would like to thank Mr. P W Mamba, Mr. C Msosa, Mr. M Khomba and Mr. R Wiyo. However, the views expressed in this paper are mine and do not necessarily reflect those of the Reserve Bank of Malawi or the people mentioned herein. Any errors and shortfalls, therefore, are my responsibility.

Levie Jeremiah Sato
Monday, 28 May, 2001

MONETARY POLICY IN KENYA: EVOLUTION AND CURRENT FRAMEWORK

Joseph K. Kinyua[1]

Central Bank of Kenya
P O Box 60000
Nairobi, Kenya
kinyuajk@centralbank.go.ke

Abstract

Prior to economy-wide reforms in early 1993, monetary policy evolved under a highly regulated economic and financial set-up with uncoordinated approaches, strategies, and instruments. It was therefore difficult to find any thread of coherent monetary policy that attempted to control events, especially under a fixed exchange rate regime. Significant changes in the institutional framework, operating procedures and instruments have taken place since 1993, culminating in a more elaborate conduct of monetary policy. This has helped contain inflation and establish a viable external payments position in Kenya. Considerations for further refinement in operating procedures in the face of changing financial and economic environment are currently in progress.

Key words: Monetary policy; domestic credit control; balance of payments; inflation; exchange rate; monetary aggregates.

1 The author is Chief Economist and Director of Research at the Central Bank of Kenya. The views expressed in this paper are those of the author and do not in any way represent the official position of the Central Bank of Kenya. I wish to thank my staff in the Research Department for the assistance in the preparation of this paper. The paper was written for presentation at the conference on Monetary Policy Frameworks in Africa, 17-19 September 2001, Pretoria, South Africa.

1. INTRODUCTION

The Central Bank of Kenya (CBK), like most other central banks around the world, is entrusted with the responsibility of formulating and implementing monetary policy directed at achieving and maintaining low inflation as one of its two principal objectives; the other being to maintain a sound market-based financial system[2]. Since its establishment in 1966, the CBK has essentially used a monetary-targeting framework to pursue the inflation objective. The use of this monetary policy strategy has been and continues to be based on the presumption that money matters, that the behaviour of monetary aggregates has a major bearing on the performance of the economy, particularly on inflation. Econometric studies done to investigate the link between inflation and monetary expansion have established and lent credence to the strong link between inflation and money supply in Kenya (Mwega, 1990; Durevall & Ndungu, 1999).

Although the monetary policy framework has essentially remained the same over the past 35 years, the CBK has been continuously refining its monetary policy operations and procedures in order to enhance efficiency and effectiveness in delivering its objectives in a changing financial and economic environment. Thus, following the persistent failure of monetary policy to deliver on its inflation objective in the late 1980s and the early 1990s, the CBK effected significant changes to monetary policy implementation procedures, including the introduction of new instruments. The radical changes effected included the shift towards using indirect instruments of monetary control by introducing open market operations (OMO) and by liberalising interest rates and the shilling exchange rate.[3] Thus, the monetary policy framework has become more specific with respect to the inflation objective being pursued and the instruments used to achieve it. Before then, monetary policy in Kenya was sparingly used as a tool of economic management because of the pervasive controls covering almost all economic activities, including the banking sector. Monetary policy, under the regime of direct controls, was more preoccupied with reacting rather driving monetary developments. This was of course not unique to Kenya; control was then the fashionable approach to economic policy management in most developing countries.

To analyse how the conduct of monetary policy has evolved in Kenya, it has been classified into two distinct periods, that is, the period between 1966 and 1992 when Kenya was pursuing a somewhat fixed exchange rate; and the period after 1993 to date when the country adopted a floating exchange rate.[4]

This paper traces the evolution and nature of the CBK monetary policy framework as follows. The next section describes how monetary policy was managed between 1966 and 1992. Section Three discusses aspects of the current monetary policy framework following the adoption of a more formal approach since 1993, including operational procedures, institutional arrangements, and the instruments available to the Bank. Section Four outlines the challenges that the CBK faces in managing monetary policy within the present framework, and Section Five concludes the paper.

2. EVOLUTION OF MONETARY POLICY UNDER A FIXED EXCHANGE RATE

In this section we review how monetary policy evolved under the fixed exchange rate regime pursued during 1966 – 1992. To get a better perspective of the role monetary policy played in the process of Kenya's development during this period, the discussion is broken into the formative years of central banking, and the period 1970 to 1992.

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2 Central Bank of Kenya Amendment Act, 1997

3 CBK (Amendment) Bill, 2000 approved by Parliament on July 26, 2001 has, however, reintroduced control on interest rates.

4 For a summary of the evolution of monetary policy in Kenya, see Appendix 1.

2.1. Monetary policy in the formative years of central banking 1966 – 1970

The Central Bank of Kenya (CBK) was established in 1966 under the Central Bank Act (CAP 481), 1966. The Act assigned to the CBK the statutory objectives "to assist in the development and maintenance of a sound monetary and credit, and banking system in Kenya, conducive to the orderly and balanced economic development of the country and the external stability of the currency".[5] The Bank was also required to maintain a desirable level of foreign exchange computed as equal to at least four months of imports cover averaged over the last three years.

With such broadly defined objectives referring only obliquely to price stability, the CBK tended to underpin its monetary policy strategy with controls on interest rates and the volume of credit expansion by banking institutions as its operational targets, and money supply growth as its intermediate target. The operational targets were communicated to banks through guidelines issued from time to time. There were, however, no explicit penalties for non- compliance.

Thus during 1966 – 1970, the CBK pursued a rather passive monetary policy partly because the Bank had not then acquired sufficient experience in the management of monetary policy. What was more important, the Kenyan economy had no serious macroeconomic problems to contend with during this period. The economy grew at rates around 8 per cent annually while inflation remained below 2 per cent. Apart from 1967 and 1969, both the country's balance of payments and the budget recorded substantial surpluses during this period.

It should be noted that the CBK focused its efforts during the formative years largely on laying down the necessary infrastructure for the effective management of monetary policy. The Bank consolidated its role as the major holder of foreign exchange following the centralization of the custody of foreign exchange with the Bank in 1967. In the same year, the Bank introduced a liquidity ratio, requiring commercial banks to maintain initially 12,5 per cent of their deposit liabilities in a liquid form. This requirement was not as much an instrument of credit control as an instrument intended to create a captive market for government Treasury bills in order to support government fiscal operations. Even then, most of the Treasury bills were held by the CBK, which, in effect, amounted to printing money.

The first challenge to the CBK came in 1967 when the pound sterling, to which the shilling was pegged, was devalued by 14,3 per cent, occasioning the first balance of payments crisis since independence in 1963. At the time, the Bank did not consider it an exchange rate problem. It viewed it as essentially a temporary problem that did not require any devaluation. Indeed, there was an improvement in 1968 and the balance of payments reverted to a surplus. As a result of this improvement and the increase in domestic credit by 27 per cent in the year, growth in the money supply accelerated from 8 per cent in 1968 to about 19 per cent in 1969.

Thus, Kenya passed through its first decade of independence with virtually no active monetary policy intervention, first under the East African Currency Board and then the fledgling CBK. During the early years the CBK relied mainly on moral suasion. It enlisted the support of banking institutions through regular meetings with the chief executives of banks to explain the thrust of monetary policy initiatives. Being the regulator of commercial banks and non-bank financial institutions, the CBK had some influence in this regard. However, without a clear focus on inflation and appropriate sanctions on the one hand, and lacking both a relevant and supportive fiscal policy on the other, this framework could not ensure that inflation was contained at consistently low levels.

5 Before 1966, matters relating to monetary management were handled by the East African Currency Board which also served Uganda and Tanzania.

2.2 Monetary policy during 1970 – 1980

Kenya entered her second decade of independence with major difficulties that threatened her ability to sustain the commendable 6-8 per cent annual economic growth she had enjoyed in the 1960s. The country had to confront emerging and severe constraints on the balance of payments, particularly following the collapse of the Bretton Woods system of fixed exchange rates in 1971, and the oil crises of 1973. Economic growth slowed down in 1971-1975, and the balance of payments and domestic prices came under increasing pressure. After consecutive surpluses over the previous three years to 1970, the overall balance of payments moved into a deficit of 362 million shillings in 1971 and inflation climbed to 7,0 per cent from 2,6 per cent in 1966. These adverse developments were largely attributed to a sharp expansion in domestic credit that had occurred in the previous two years and resulted in much higher imports in 1970/71. The reduction in net capital inflows also contributed to the weakening of the balance of payments in 1971.

The Bank took a number of measures aimed at containing credit expansion and at helping to curb imports. These measures included the imposition of a minimum cash ratio of 5 per cent on commercial banks in 1971, in addition to the liquidity ratio requirement of 12,5 per cent put in place in 1969. The cash ratio was, however, removed and the liquidity ratio was raised to 15,0 per cent in February 1972. Commercial banks and non-bank financial institutions (NBFIs) were also instructed by the CBK to reduce their lending for financing imported consumer durables by specified amounts between July and October 1971. The shilling exchange rate was also devalued following the devaluation of the US dollar.

As a result, domestic credit growth rate declined to 12,2 per cent per year during 1971/72 from 30,2 per cent in 1970. The balance of payments in turn improved over the two years to register surpluses of 196 million shillings in 1972 and 199 million shillings in 1973, while inflation declined to average 4,0 per cent per year from 7,0 per cent in the previous year. This was despite the onset of the oil crisis in 1973. There were, however, fears that economic growth was likely to slow down in the coming year as credit to the private sector had risen by only 5 per cent in 1971 compared with an increase of 36,5 per cent in 1970. In order to maintain the growth momentum, the Bank in 1972 instructed commercial banks to increase their lending to the private sector by no more than 12 per cent for the whole year and directed that priority be given to requests for loans to the agricultural sector, small African enterprises and exporters.

In anticipation of balance of payments difficulties and pressure on domestic prices following the 1973 oil crisis, the Bank in October 1973 restricted commercial bank lending to foreign-controlled companies to no more than 60 per cent of such company's capital, if at least 50 per cent of the equity in the company was owned by Kenyan nationals. The limit was even lower for the wholly foreign-owned companies. This restriction was relaxed in 1974 to allow such lending to be made available to foreign-controlled companies engaged in agriculture, manufacturing, export trade and tourism. The requirement that commercial banks lend 12 per cent to the private sector still remained in force from 1973 to 1975. In addition, the 15 per cent minimum liquidity requirement was extended to cover NBFIs in 1974. Measures were also taken to substantially reduce government borrowing from the banking system in fiscal years 1973 and 1974,[6] and the minimum deposit rate and prime borrowing rate were raised in 1974 for the first time since independence to 5 per cent and 8 per cent respectively from 3 per cent and 7 per cent. Similarly, the Treasury bill rate was raised to over 6 per cent from under 1 per cent.

Although growth in both domestic credit and money supply slowed down considerably between 1973 and 1975, partly as a result of these efforts, the balance of payments reverted to deficits in 1974 and 1975 and inflation accelerated to average 15,5 per cent per annum from 4 per cent in 1974. At the same time, economic growth slowed down to 2,5 per cent annually. This deterioration in the macroeconomic environment was symptomatic of the measures being insufficient to offset the adverse effects of the external factors.

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6 Fiscal year runs from July 1 to June 30.

In an effort to arrest the deterioration in the balance of payments, contain pressures on domestic prices and stimulate economic activity, the Bank took a number of additional measures in 1975. These included the re-alignment of the Kenya shilling from the US dollar to the Special Drawing Rights (SDR) and devaluing it by 10,8 per cent. The shift of the currency peg was intended to stabilise the value of the shilling from undesirable fluctuation in a world of floating exchange rates. The SDR happened to be the most stable of the internationally accepted currencies at the time.[7] While a tight credit stance was to be maintained, it was considered necessary to channel more credit to agriculture in view of its significant contribution to the overall national economy. In this context, commercial banks were in 1975 instructed to increase their outstanding credit to agriculture to 17 per cent of their deposit liabilities by June 1976. By the end of 1975, this ratio was 14 per cent compared with 10 per cent in 1974.

During the period 1976/77, Kenya's terms of trade improved by over 60 per cent, primarily following substantial increases in world prices of coffee and tea. At the same time, the capital account remained fairly strong. As a result of these developments, the overall balance of payments improved to record substantially large surpluses. The foreign exchange reserves held by the Bank rose sharply from US$ 172 million in 1975 to US$ 529 million in 1977.

All the gains from the higher coffee and tea prices were passed on to producers, thereby substantially raising their incomes and correspondingly government revenue. In recognition of the potential impact on monetary and credit expansion and the threat posed to domestic prices, efforts were made to limit the monetary impact of higher incomes from coffee. The minimum liquidity ratio of banks and NBFIs was raised in July 1976 from 15 to 18 per cent; the maximum lending rate was raised to 10 per cent; and growth in total domestic credit was to be limited to 21 per cent in 1976/77. Limits were also set on government borrowing from the banking system during the period, including the restriction on local borrowing by foreign-controlled companies imposed in 1973.[8]

These measures had little effect on domestic credit and monetary expansion. For instance, banks increased their domestic credit extension by 29,0 and 44,3 per cent in 1976 and 1977, respectively, compared with 15 per cent in 1975. This was largely due to the continued large borrowing by the government to finance its large budget deficit as its expenditure outstripped the pace of revenue increases. Consequently, the increase in money supply accelerated from 17,1 per cent in 1975 to 24,1 and 46,8 per cent in 1976 and 1977, respectively. Despite this substantial monetary expansion, inflation eased over the two years to an average of 12 per cent per year from 15 per cent in 1975. Moreover, the economy recovered on account of higher incomes from coffee and tea, to grow at 5,6 and 8,6 per cent in 1976 and 1977, respectively.

The CBK, conscious of the lagged effects of monetary expansion on inflation, was concerned about the excessive monetary expansion in 1976/77 and the likelihood of the trend continuing into 1978 as banks and NBFIs remained awash with liquidity. In this regard, the Bank increased the liquidity ratio raising it from 18 to 20 per cent in January 1978 and the cash ratio was re-imposed on commercial banks at 4 per cent in May of the same year. In addition, the discounting rate was raised from 6,0 to 7,5 per cent. Following these measures, commercial banks' liquidity position became tight necessitating a lowering of the liquidity ratio back to 18 per cent and the cash ratio to 3 per cent six months later. However, banks were instructed to limit their credit extension to the private sector to 18 per cent per annum and government borrowing was to be reduced substantially. These measures were reinforced in December 1978 by non-interest-bearing special deposits imposed on imports. The measure was accompanied by additional exchange control restrictions. As the banks' liquidity position remained tight, the Bank had to further reduce the minimum liquid assets ratio requirement to 16 per cent by mid-1979.

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7 The SDR comprised 16 currencies of countries contributing over 1% of the total world exports. The weights assigned to each currency in the basket depended on the country's share in total exports modified in the light of the currency weight in the world economy.

8 This restriction was removed in 1997 as part of actions the government was taking then to encourage industrialization.

The impact of these measures was hardly felt in 1978. The balance of payments reverted to a deficit in the year, reflecting mainly the sharp drop in world prices of coffee and tea as well as a substantial increase in imports. Inflation remained high at around 12 per cent. A significant improvement was, however, realised in 1979 in the balance of payments when a 1,414 million shillings surplus was realised on account of reduced imports accompanied by increased net capital inflows. Inflation also eased to around 8 per cent. Despite attempts in 1980/81 to liberalize imports, devalue the shilling exchange rate and raise interest rates, these improvements were short-lived. In the three years to 1982, the balance of payments worsened to large deficits and inflation accelerated to double digits with growth in real domestic product averaging 3,2 per cent per annum. This followed the second oil shock and a highly expansionary stance in fiscal policy, owing mainly to a sharp increase in government expenditures. Throughout the fiscal years 1979 – 1982, the budget deficit averaged 8 per cent of GDP per annum and was principally financed by borrowing from the banking system. These large budget deficits and the inevitable large borrowing from the banking system marked the beginning of a rough course for the Bank's management of monetary policy. While the use of monetary policy before 1979 had yielded reasonable results, it thereafter proved less effective largely because of the non-supportive fiscal policy.

In an attempt to redress the rising domestic and external imbalances and restore stability, the government tightened fiscal policy in the fiscal years 1983 and 1984, significantly reducing the borrowing from the banking system. The increase in credit to the private sector also slowed down to around 8 per cent. Consequently, total domestic credit and money supply also increased less rapidly rising on average at 10,5 and 8,0 per cent per annum, respectively, over this period. Partly as a result of these developments, the overall balance of payments turned into surpluses in 1983/84 and inflation declined to 14,6 and 9,1 per cent in 1983 and 1984, respectively, from 22,1 per cent in 1982.

The improvement in the economy during 1983/84 was short-lived. In 1985, the balance of payments reverted to a deficit and inflationary pressures intensified, partly due to the rapid expansion in credit, especially to the government, following a weakened budgetary position. Thanks to another coffee boom, the situation improved in 1986 when the overall balance of payments turned into another large surplus. But because the budget was not tightened in the fiscal year 1986, government borrowing continued to increase. As a result, total domestic credit and money supply rose rapidly by 35,1 and 32,5 per cent, respectively. Inflation, however, declined to about 6,0 per cent in the year.

By 1985 it had become clear to the Kenya government that the economic difficulties the country faced were more structural in nature and, as such, in addition to the stabilization measures, it called for far-reaching structural reforms in the economy. As part of a comprehensive economic and financial programme, a number of reform measures intended to enhance the effectiveness of monetary policy were put in place from 1986.[9] New government debt instruments, that is, Treasury bonds of one-, two-, and five-year maturities, intended mainly for monetary policy purposes,[10] were introduced in 1986 and the cash ratio for commercial banks was reintroduced at 6 per cent in December 1986. A more flexible management of the exchange rate was adopted and significant liberalisation of other areas of exchange and trade systems was undertaken. Perhaps a more significant reform was the liberalisation and complete decontrol of interest rates in July 1991 and the introduction of open market operations in the same month.

Despite the increase in the number of monetary policy instruments available to the CBK, the fluctuations in the growth of domestic credit and the money supply persisted. Domestic credit and money supply expanded much faster than expected in most years between 1987 and 1991. This partly reflected the effect of the expansionary fiscal policy, which made it necessary for the government to resort to more borrowing from the banking system to finance its burgeoning budget deficits. This made the Bank's task of managing monetary policy even more difficult.

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9 See Sessional Paper No1 of 1986 on Economic Management for Renewed Growth.

10 Funds raised using these instruments, contrary to the original intention, were used to finance government operations

In summary, it is clear from this analysis that the monetary policy framework from the 1970s to the 1980s, though targeting the monetary aggregates, had its scope constrained by the fixed exchange rate policy Kenya pursued then. The CBK could not pursue an independent monetary policy as the overly expansionary fiscal policy that it accommodated, conflicted with the fixed exchange rate regime of the 1970s and 1980s. Consequently, the credit targets pursued were rarely met. It is also important to emphasize that domestic credit guidelines, as a way of containing monetary expansion, suffered severe drawbacks, such as the following:

- The guidelines applied to commercial banks only and not to other deposit-taking financial institutions. Thus, to evade the stringent limitation, non-bank financial institutions (NBFIs), some of which were owned by commercial banks, proliferated in the late 1970s and early 1980s at the expense of effective monetary control. Attempts were made but with limited success to bring NBFIs into the ambit of CBK monetary control.
- Commercial banks misreported their credit extension operations, particularly credit relating to the agricultural requirement.
- Credit guidelines were hardly observed partly because there were no sanctions to enhance compliance.
- The approach requiring banks to expand credit by some specified rate per month/year was inequitable as it forced both the efficient and inefficient banks to expand their balance sheets at the same rate irrespective of their capabilities, initiative, and business acumen and prospects.

Monetary policy cannot therefore be considered to have been effective in the 1970s and 1980s. Brough and Curtin (1981) in their study on fiscal and monetary policy in Kenya argue that "they did not find any thread of coherent monetary policy attempts to control events rather than be controlled by them".[11] In fact, in areas where positive monetary policy could have been helpful, particularly in controlling the balance of payments, the Government tended to substitute non-monetary policy prescriptions. Thus, rather than allowing the money supply to contract during the periods of balance of payments deficits, policy efforts were directed mainly towards controlling imports directly by means of administrative controls under the Exchange Control Act.

3. CURRENT MONETARY POLICY FRAMEWORK

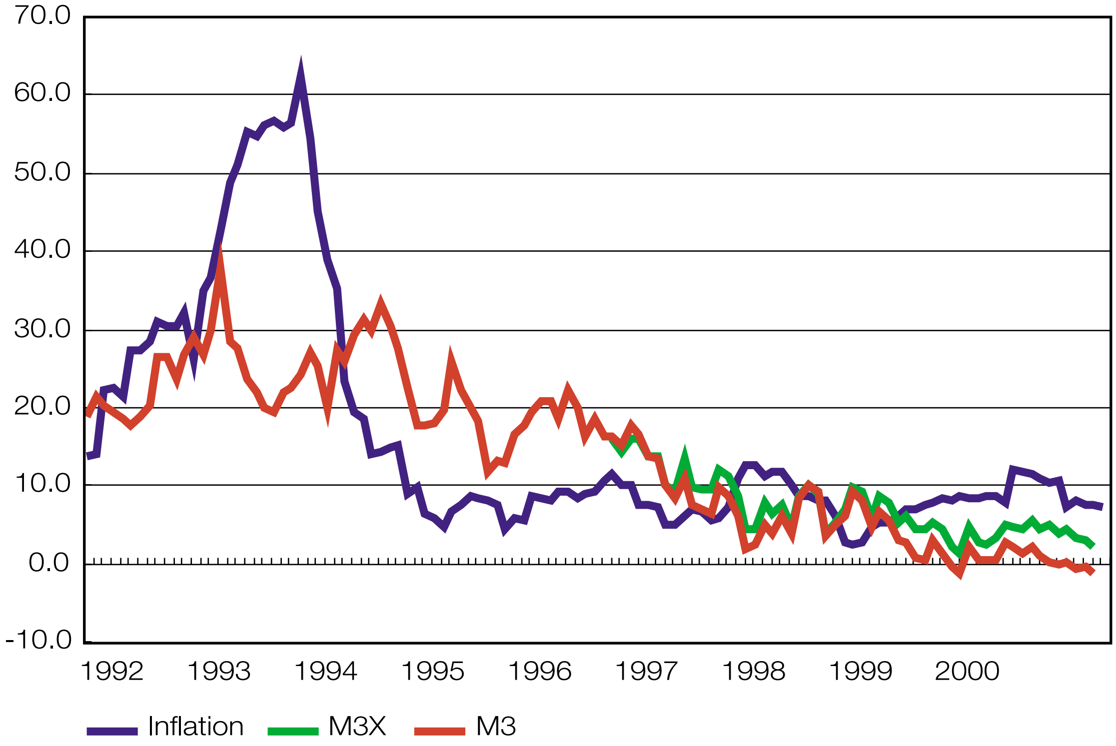
3.1 From direct to indirect procedures

In 1993, the Government adopted a comprehensive economic reform programme initially under an IMF monitored arrangement that does involve provision of financial support and then later supported by an IMF Enhanced Structural Adjustment Facility. Under this economic programme, the Government initiated a wide-ranging effort to reform its role in the economy, tackling at the same time fiscal, monetary, structural and external issues. There was a general sense of crisis about Kenya's economic policy at the time, based on concerns that the country's economic performance had persistently deteriorated.

The high inflation and near-collapse of the shilling in 1990 – 1993 largely reflected a collapse of fiscal and monetary policy in the face of the first multiparty elections in 1992 after Kenya regained her multiparty democracy (Chart 1). Money supply growth reached 34 per cent in 1991 compared with the 9 per cent target, buoyed by the CBK's excessive accommodation of distressed banks. Fiscal policy did not help either. The government budgets were in large deficits of 10 – 11 per cent of GDP in the 1991/92 and 1992/93 fiscal years, largely financed with CBK monies. It is noteworthy that anomalies in the Central Bank Act allowed the Minister for Finance to override the decisions of the CBK's Board of Directors, including those on monetary policy without restriction. In effect, the Bank had only limited authority on monetary policy management.

[11] Brough and Curtin (1981), Growth and Stability: An Account of Fiscal and Monetary Policy, in Killick .T. (Ed.) Papers on the Kenyan Economy, Page 40.

Chart 1: Growth in money supply and inflation



As far as monetary performance went, for the first time Kenya experienced inflation close to 70 per cent and growth hit a low of 0,2 per cent in 1993. The country lost its forex, being left with a bare minimum of a week's imports cover in early 1993. The shilling weakened so much that people were reluctant to use it as a medium of exchange, preferring to use foreign currencies such as the US dollar to transact business. As noted in Section 2, monetary policy before 1996 had multiple and varied objectives, which were seldom clearly specified, and only rarely consistent with the achievement of low inflation.

Against this background, it was therefore necessary to give the CBK authority to manage monetary policy, if the country expected to manage to bring inflation back to single-digit levels. The Central Bank Act was amended substantially in 1996, narrowing the mandate of the CBK to that of maintaining price stability and fostering liquidity, solvency and the proper functioning of a stable market-based financial system. The operational autonomy also necessitated clear provision for accountability and transparency. The Act in this regard requires the CBK to submit to the Minister for Finance, within every six months, a monetary policy statement which: (i) specifies the policies and instruments to apply to achieve policy targets in the next twelve months; (ii) states the rationale for the policies and instruments mix; (iii) contains an assessment of progress with the implementation of monetary policy in the immediate twelve months to which the previous statement relates. The Minister, in turn, is required to table the monetary policy statement to the parliamentary committee that deals with economic matters. Moreover, the central bank is required to disseminate key financial data and information on monetary policy to the public.

The salient features of the new framework now include a more precise definition of the CBK's mission as the maintenance of price stability and the fostering of liquidity, solvency and proper functioning of a stable market-based financial system. Perhaps the most important feature of the current framework is the tenure of office for the Governor. This was important if the Governor was to firmly pursue the price stability objective. Section 14 of the 1996 Act sets out the procedure which is required to be followed to remove the Governor from office, making it difficult for the appointing authority to move in that direction without very persuasive reasons and reasons that can stand up in a court of law.

Another important development that requires to be mentioned is the shift from the use of M3 to broader aggregates M3X and M3XT. Until 1998, the conduct of monetary policy had focused on the behaviour of the broad monetary aggregate, M3. This aggregate includes currency in circulation and term and non-term domestic deposits held with banks and NBFIs. The stability of the relation between M3 and nominal GDP came into question, as the banks and non-banking institutions engaged in large-scale portfolio shifts between deposits, government paper, and foreign-currency-denominated deposits (Chart 2). The shifts appeared as a response to either actual or perceived changes in the relative rates of return of these financial assets, as well as to other factors related to the sophistication of the local market participants, the openness of the capital account, the perception of Kenya in the eyes of international financial investors and the perceived liquidity of government paper. In the process of these shifts, the velocity of M3 changed, thereby reducing the usefulness of this aggregate as a guide for monetary policy.

As a result, the CBK changed to focus on the much broader monetary aggregate, M3X and M3XT. M3X is defined as M3 plus foreign currency deposits (FCDs) held by residents, whereas M3XT is M3X plus holdings of government paper by the non-bank public. The inclusion of FCDs in the definition of money follows the relative expansion in the holding of FCDs by residents after liberalisation and their domestic currency value after the recent large depreciation of the shilling against the US dollar. For instance, at the end of December 1997 immediately after the weakening of the shilling in the third quarter of 1997, the growth of M3 was 9,8 per cent and that of M3X, which include FCDs held by residents, reached 11,9 per cent. Since the Bank had targeted M3 at the time, the growth of liquidity was understated, resulting in looser-than-warranted monetary conditions, with increased pressure on inflation and balance of payments performance (Chart 3).

Chart 2: GDP/Money supply ratios, 1972-2000

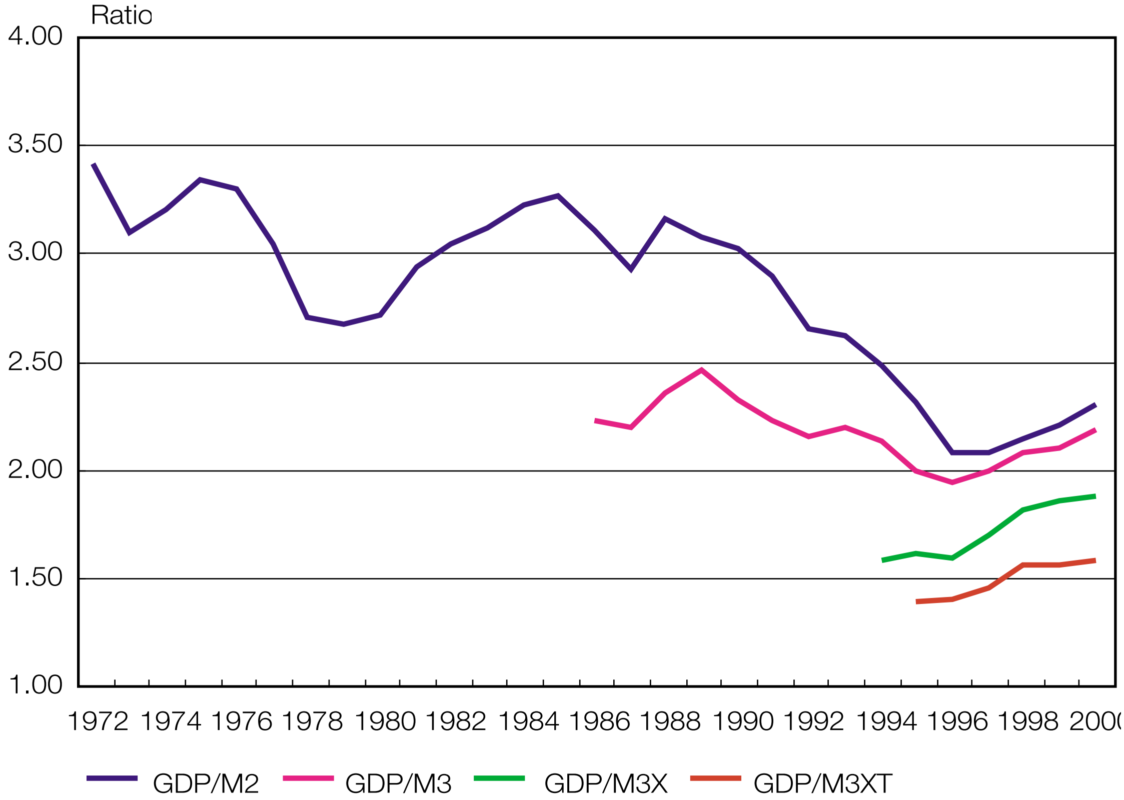
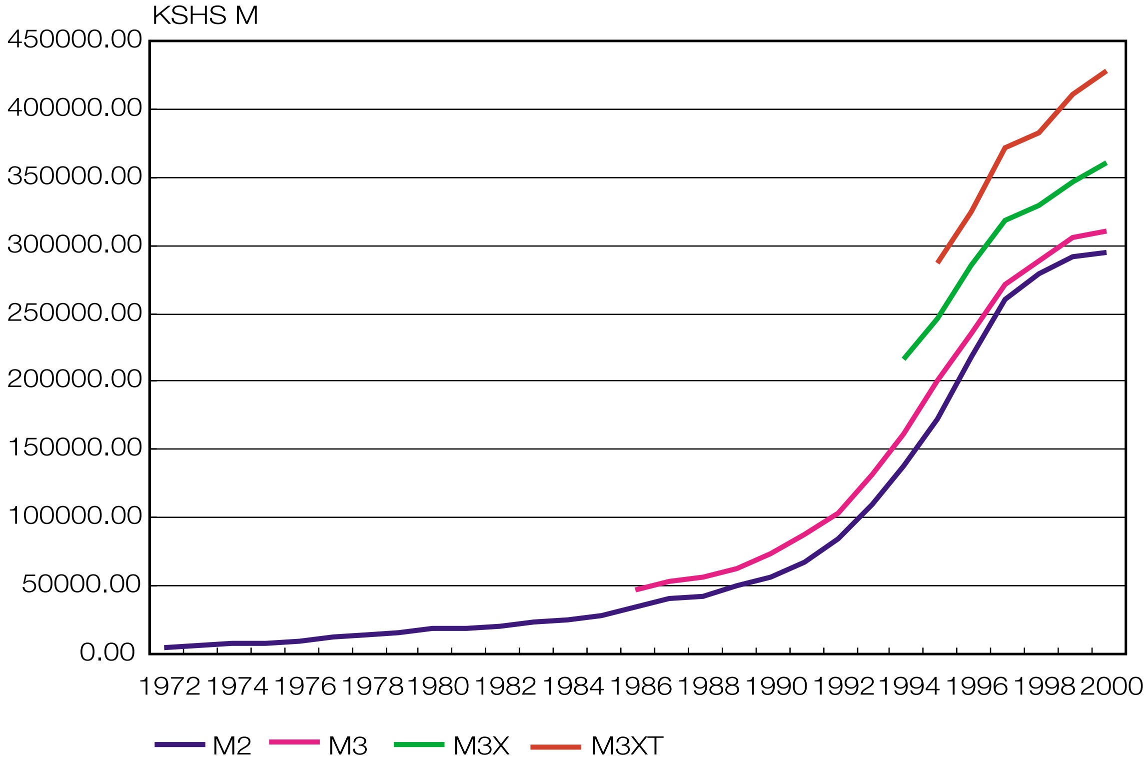


Chart 3: Money supply aggregates, 1972-2000



The monitoring of a much broader monetary aggregate, M3XT, arose from the fact that the short-dated 91-day Treasury bills had characteristics close to those of term deposits with commercial banks both in terms of the maturity structure and liquidity, the latter supported by the availability of a ready rediscounting facility at the CBK for banks and the non-banking public. A measure of liquidity in the economy that did not include government paper could then understate the liquidity held by the non-banking public, and thus lead to the setting up of monetary targets that were inconsistent with the inflation objective.

3.2 Operational procedures

Under the current framework, the CBK sets both the inflation target and the instruments to ensure the realization of its objectives. In formulating the monetary programme to implement for a specific period the Bank starts by estimating the demand for money consistent with the target rate of inflation and GDP growth. This forms the basis for setting the desired path for monetary growth to which the actual money supply had to conform during the policy implementation stage.

With the long delays in getting the information needed for the effective control of broad monetary aggregates, the CBK formulates its monetary policy implementation strategy on the basis of the reserve money or base money, which is more readily available as it is a liability of the CBK. The CBK, therefore, designs a reserve money programme consistent with the desired money supply expansion. Thus, the CBK closely monitors developments in the reserve money, taking appropriate monetary policy actions whenever undue deviations are observed.

3.3 Institutional arrangement

The formulation of monetary policy in Kenya is delegated to a Monetary Policy Committee (MPC) of the CBK whose members comprise senior staff of the Bank who are responsible for monetary policy analysis and monetary policy operations. The MPC meets once in a month to review and determine the reserve money programme for the next three months. This monthly meeting allows the

CBK to take into account the latest information on the economy and to reflect on whether it is necessary to change the stance of monetary policy currently in force. It should be noted that the deliberations of the MPC are not published.

The decisions of the MPC are effected by a Monetary Policy Operations Committee (MPOC) which meets every day at 08:45 for 30 minutes. The MPOC considers the forecasted daily liquidity position against the target reserve money, on the basis of which it recommends the necessary action, either to mop up or inject liquidity. The forecast involves estimating movements in the government accounts at the CBK, the bank's forex transactions and transactions related to CBK operations as a lender of last resort. It should be noted that the MPOC does not make the final decision. It only recommends to the Governor what it considers the appropriate actions for the day given its assessment of the liquidity situation. The Governor makes the final decision on the matter.

3.4 Instruments

The CBK manages monetary conditions in the economy using the following instruments:

(i) **Open Market Operations (OMO).** The CBK engages in repurchase (repo) and reverse repurchase agreements under OMO with a view to mopping up liquidity and injecting liquidity into the banking system, respectively. Decisions to offer repos are, as already indicated, made on a daily basis on account of the perception of the tightness of monetary conditions and deviation from targets. The OMO desk electronically requests bids, and investing banks state the amount and the price or interest desired. The CBK uses the marginal pricing approach to adjudicate on any repo issue. OMO operations are conducted as repurchase agreements with commercial banks. The tenures traded under Repos range between one week and two months. Care is taken not to trade in long-dated repos to avoid direct competition with the primary auction for the 91-day Treasury bills, which is held weekly to raise funds for government use. OMO operations are restricted to commercial banks as the participating institutions and transactions are two-way.

(ii) **The cash ratio requirement.** The cash ratio requirement has been used on occasion by the CBK to tighten or loosen monetary conditions. The last time the ratio was changed was on October 1, 2000, when it was lowered from 12 per cent to 10 per cent. Banks have to fulfil the ratio twice a month: in the middle and at the end of every month. The ratio is determined as the average amount of deposits and liabilities of a bank (or a non-bank financial institution) with the CBK over a 15-day period ending in the middle and at the end of every month to the amount of domestic currency deposits held with the bank by residents and non-residents on the last working day of the penultimate month through the middle of each month, and on the last day of the previous month thereafter.

(iii) **Rediscount facilities.** Banks can approach the CBK and rediscount their holdings of government paper without limit at a price determined by the Bank on a daily basis. The rediscount rate in recent times has been maintained at 3 percentage points above the last Treasury bill auction rate. There were two main rediscounting windows, until their merger into one in late 2000 in order to harmonize the cost of accommodation to banks. The windows available to borrowers were the Lombard window and the lender-of-last-resort window. The Lombard window permitted a bank to borrow from the CBK up to 5 per cent of its paid-up capital at a cost equal to the interest rate in the last Treasury bill auction plus 3 percentage points. Collateral had to be in the form of government paper maturing within 91 days or paper quoted on the Nairobi Stock Exchange. The lender-of-last resort window allowed a bank to borrow funds from the CBK in excess of the 5 per cent of its paid-up capital available under the Lombard facility but at a higher cost – at 5 percentage points above the last Treasury bill auction rate. The required collateral was the same as for the Lombard facility.

4. CURRENT CHALLENGES

Although the monetary-targeting framework has worked well for Kenya with inflation maintained at satisfactory levels, developments in the economy and the financial system during the recent past have tended to weaken the thrust of using monetary aggregates as policy targets, especially when instability in money velocities blurs the relationship between monetary aggregates and GDP. In Kenya, the weak relationship has been manifested in excessive fluctuations in short-term interest rates.

The challenge of forecasting liquidity within a short time period continues to be a major constraint to the effective implementation of open market operations in the current monetary policy framework. CBK monetary policy operations are based on an analysis of the daily forecast of the sources of reserve money, some of which have proven elusive and tricky to forecast. The most notorious ones are transactions affecting government accounts in the CBK. Though transactions relating to debt payments are fairly accurate and readily available, the same is not the case with transactions relating to payment for goods and services consumed by the Government. The reasons for this are because Treasury on its part has not been able to put in place effective cash management and expenditure control systems. Therefore, efforts to improve forecasting of government transactions will require co-operation from Treasury.

The most important challenge the CBK has faced and continues to face is political rather than economic. The Bank's success in reducing inflation, and then maintaining it within the single-digit level in the past seven years, has been associated by some critics with a high cost in terms of unemployment and poverty. To quote the Governor of the CBK, the Bank has been accused of "pursuing price stability rather dogmatically while it ought to be focusing more on enhancing economic growth, especially given the current level of poverty in the country". Though it is true the country is going through these problems, there is no empirical evidence to suggest that unemployment and poverty reached the current levels entirely because of monetary policy or that they would have been entirely avoided if monetary policy had been different. Indeed, the critics of the CBK's focus on inflation argue further that because of what they perceive as the excessive tightness of monetary policy, interest rates have remained high, making it even more difficult for investment to take place and therefore to create the much-needed jobs. With this wrong perception, Kenya has reversed the liberalisation of interest rates achieved in 1991. If the President assents to the Bill that was approved by Parliament on 26 July 2001, the CBK will be required to regulate both the deposit and lending rates. So the issue of how to educate the public and even the local academics on the relative importance of low inflation is and will remain a major challenge to the CBK for the foreseeable future.

5. CONCLUSION

It was not until the early 1990s that the conduct of monetary policy in Kenya changed significantly in terms of the institutional framework, operating procedures and instruments. The changes were precipitated by the economy-wide reforms undertaken by the Government, which necessitated the adoption of indirect measures in the operation of monetary policy. Prior to these reforms, monetary policy had evolved under a highly regulated economic and financial set-up with uncoordinated strategies, approaches and instruments.

Although the challenges facing the current framework have remained substantial, refinements, especially in terms of monetary policy instruments, were undertaken to cope with the changing economic and financial environment. Consideration of the further refinement of the current framework is still necessary.

The success of the current monetary policy framework will continue to depend on a supportive fiscal policy. While the build-up of government deposits over time has assisted in the sterilization effort, the CBK must continue broadening its policy instruments to ensure an adequate mop-up without fiscal support.

The CBK should also embark on a path of confidence building among the citizenry in its record of price stability. This has proved an important asset among the more successful central banks towards reshaping the inflationary expectations of the business community and the banking fraternity at large.

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Period	Macroeconomic environment	Monetary Policy Framework	Intermediate targets	Monetary Policy Instruments
1966-70	No serious macro-economic problems, save or balance of payments deficit experienced in 1967 and 1969: - Growth averaged 8% - Inflation was low at 2% - Government budget was was in surplus	Domestic credit control under a fixed exchange rate regime	Domestic credit	Minimum liquidity ratio fixed at 12,5% of commercial banks deposit liabilities
1971-75	- Balance of payments difficulties experienced, especially after the first oil crisis in 1973/74 - Inflation pressures emerge, reaching 15,5% in 1975	Domestic credit control under a fixed exchange rate regime	Domestic credit	- Required reserve (cash ratio) imposed at 5%, but later removed in 1972. - Liquidity ratio raised to 15% - Devaluation of the shilling exchange rate - Moral suasion: commercial banks instructed to reduce lending to import sector and foreign-controlled firms and, instead, increase lending to agriculture, export trade, tourism and agro-agro-based manufacturing.
1976-77	- Balance of payments surpluses following commodity boom brought about by high coffee and tea prices - Incipient inflationary pressures arising from commodity boom	Domestic credit control under a fixed exchange rate regime	Domestic credit	- Minimum liquidity ratio raised to 18% - Interest rates control imposed with maximum lending rate fixed at 10%
1978-84	- Spill over of liquidity arising from commodity boom of 1976/77 threatens a balance of payments deficit and inflationary pressures - GDP growth started to slow down towards the end of this period - Government budget deficit reached 8% of GDP	Domestic credit control under a fixed exchange rate regime	Domestic credit	- Initially, to stem excess liquidity, minimum liquidity ratio was adjusted to 20% and required reserve ratio re-imposed at 4%. - Discount rate increased to 7.5% from 6.0% - Later, towards the end of the period when liquidity eased, iquidity and required ratio requirements were reduced to 16% and 3%, respectively.
1985-92 6%	- Continued weak budgetary position puts pressure on balance of payments and inflation	Domestic credit control under a flexible exchange rate regime	Domestic credit and money supply (M2)	- Open Market - Operation through Treasury bond of one, two and five year maturities - Required reserve ratio was raised to Current level at 10% - Interest rate deregulated in 1991
1993 to date	- Persistent balance of payments problems and structural constrains necessitated economic and Financial deregulation - Excess liquidity injected in the run-up to multi-party democracy in 1992.	Base-money targeting under a floating exchange rate system	Broader monetary aggregates: Initially M3, and later M3X	- Required reserve ratio raised to the statutory limit of 20% by 1995 - Active Open Market Operation – Primary and secondary operations - Use of rediscount facilities at the CBK - Foreign exchange interventions