

Interest Rate Management and Monetary Policy in Kenya

Introduction

The Economic Recovery Strategy (ERS) for the period 2003-2007 emphasizes on the role of the private sector as the engine for economic growth, while the Investment Programme (2003) points out the need to enhance private sector investment. In the ERS, the government emphasizes the need to achieve an interest rate structure that promotes financial savings and ensures efficient allocation of the same. To meet these objectives, bank interest rates should reflect the true cost of capital in order to enhance mobilization and efficient allocation of financial capital. Consequently, management of the liberalized interest rates must be strengthened. The Central Bank of Kenya has the responsibility to manage the liberalized interest rates. However, the effectiveness of doing so depends on operations of the monetary policy and the competitiveness of the financial sector. In this regard, the government proposes various monetary policy reforms to enable the Bank gain independence, public confidence and become more effective.

The financial sector in Kenya has marginally gained the expected outcome in the post-liberalization period. The sector, for example, is characterized by high lending rates, which are undesirable for investment growth. Low deposit rates, which become negative in real terms when there is slight inflation, sustain a wide interest spread, which reflects inefficiency in the financial sector.

This policy brief is based on three studies carried out by KIPPRA, namely: *Understanding interest rate structure in Kenya*; *Determinants of interest rate spread in Kenya*;

and *Monetary policy operations in Kenya*. The studies are a response to proposals made in the ERS aimed at revamping the monetary policy especially as it relates to interest rate management.

Main Findings

a) *Interest rate structure*

Table 1 shows a kink around June 2003 when interest rates drastically declined following implementation of changes in interest rates management by the government. While low lending rates are desirable to enhance investment by the private sector, the declining interest rates settle at a comparatively high level. Deposit rates drop significantly but become negative in real terms as inflation ensues. The low deposit rates are sustained by limited competition in the financial asset market, especially with low Treasury bill rate and declining currency-deposit ratio, which does not put any pressure on banks to raise the deposit rate to maintain the ratio. Therefore, the deposit rate is very low and this, to some extent, has led to a wide interest spread.

The spreads between maturities of banking sector interest rates make it difficult to determine the risk structure in the market. For example, the maturities of deposit rates portray a U-shaped relationship while the lending rates reveal an inverted U-shape, which makes it impossible to determine whether it is profit maximization motive or maturity preferences that drives the behavior of banking institutions. Consequently, this hinders the response of banking institutions to monetary policy actions.

	Under inflation	Overall inflation	Deposit rate	Lending rate	Real deposit rate	Real lending rate	Spread	Inter-bank rate	Treasury bill rate
Jan-03	2.6	2.5	4.7	19.0	2.2	16.2	14.3	9.0	8.4
Feb-03	2.7	3.0	4.4	18.8	1.4	15.4	14.4	7.1	7.8
Mar-03	2.8	3.6	4.0	18.5	0.3	14.3	14.5	6.2	6.2
Apr-03	2.9	4.5	4.1	18.6	-0.5	13.4	14.5	5.9	6.3
May-03	3.0	5.7	3.7	18.5	-1.8	12.2	14.8	5.7	5.8
Jun-03	3.0	6.6	4.8	15.7	-1.6	8.5	10.8	1.6	3.0
Jul-03	3.2	7.3	4.5	15.3	-2.6	7.4	10.8	0.5	1.3
Aug-03	3.3	7.9	3.4	14.8	-4.1	6.4	11.4	0.4	1.2
Sep-03	3.4	8.4	3.1	14.8	-4.8	6.0	11.7	0.5	0.8
Oct-03	3.5	9.0	3.1	14.8	-5.4	5.4	11.7	0.7	1.0
Nov-03	3.6	9.5	3.3	14.1	-5.6	4.2	10.8	0.7	1.3
Dec-03	3.6	9.8	3.3	13.5	-5.9	3.4	10.2	0.8	1.5
Jan-04	2.7	10.0	3.12	13.5	-6.3	3.1	10.4	0.8	1.6
Feb-04	2.7	10.2	2.47	12.7	-7.0	2.2	10.2	0.9	1.6
Mar-04	2.6	10.1	2.32	13.1	-7.0	2.8	10.8	1.3	1.6
Apr-04	2.5	9.7	1.98	12.7	-7.1	2.7	10.7	1.7	2.1
May-04	2.5	8.8	2.22	12.6	-6.1	3.4	10.3	2.1	2.9
Jun-04	2.5	8.2	2.2	12.2	-5.5	3.7	10.0	1.3	2.0

Source: Central Bank of Kenya Monthly Economic Reviews

The money market interest rates show significant relationships among them. For example, the rediscount and discount window rates are defined as Treasury bill rate plus a premium, which reflect on monetary policy action. With a tight monetary policy, the premium charged is high, discouraging the use of such markets by commercial banks in liquidity management. In such a situation, pressure is exerted on the interbank market such that there is an indicated positive relationship between the monetary policy signal and the interbank rate. Interbank rate is generally lower than discount window rate but higher than the repurchase agreements (REPO) market rate, indicating a deliberate effort by the Central Bank of Kenya to maintain its position as a lender of last resort as banks use the interbank market as a priority in their liquidity management. The REPO rate level encourages growth of the secondary market for government securities.

b) Financial intermediation

The interest rate spread is wide despite the efforts made to narrow it (Figure 1). For example, the revision of cash ratio downwards to reduce the implicit cost that feeds into the spread led to a marginal decline in the interest spread. When interest spread is decomposed into the *prime spread* (base lending) and the *credit risk spread*, results show that credit risk constitutes 89% of the spread while the prime spread constitutes 11%. This implies that decline in prime rates only narrows the interest spread marginally. For significant gains in

narrowing the spread to be made, the credit market must attain a significant level of competitiveness.

In summary, the factors that explain the wide interest rate spread in Kenya include:

(i) Inefficiency in the credit market where presence of non-performing loans signals credit risk to which the banks respond by charging a high premium, which keeps the lending rates high.

(ii) Capital requirements, where results support the argument that when capital ratio is endogenously determined to protect against credit risk, it results in high interest spread as the cost of holding such is borne by customers.

(iii) The burden of operational costs, which is shared with bank customers.

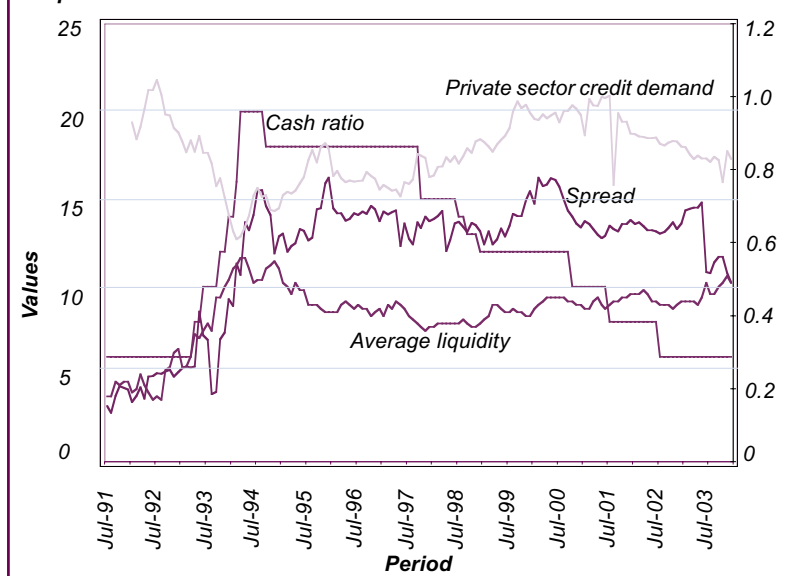
(iv) Excess liquidity; when banks hold liquid assets, this reduces the liquidity risk premium. However, if the opportunity cost of holding idle reserves is high, banks tend to maintain wide spreads. This explains why banks sustain a high spread despite the reduced cash ratio.

c) Commercial banks interest rates and monetary policy operations

An unstable financial sector weakens the monetary policy transmission mechanism, constraining the effectiveness of monetary policy actions. Commercial banks' interest rates trace monetary policy actions with a lag and less proportionately. For example, all interest rates rise with tight monetary policy and take a general downward trend as monetary policy is relaxed. When penalties on the discount window and the overnight lending are increased, banks lending rates rise to reflect the increased cost of liquidity management. Furthermore, high statutory requirements push interest rates up as they represent an implicit tax and therefore a cost to the banks.

Banks have for some time now invested heavily in Treasury bills as the credit market became more risky. This has earned them substantial revenue but at the expense of their intermediation role. Presently, the government is making the Treasury bill market

Figure 1: Relationship between cash ratio, interest spread, liquidity and private sector credit demand



unattractive to banks by keeping a very low Treasury bill rate. While this is appropriate in promoting financial intermediation, banks profitability and the stability of the banking sector is threatened in the short run. Such a move requires that efforts be made to enhance the competitiveness of the credit market.

d) Monetary authority independence

The independence of the Central Bank of Kenya and the level of confidence the public has with it is important for effectiveness of monetary policy operations. The proportionate share of government borrowing from the Bank dropped drastically from 56% between 1991 and 1996 to 38% between 1997 and 2004. There is a positive link between the government borrowing from the Bank and the level of inflation, therefore supporting the argument that financing government deficit through borrowing from the Central Bank is inflationary, and makes it difficult for the Bank to meet its goal.

The government has for some time now used the Treasury bill rate as a signaling interest rate for monetary policy actions. However, given that to some extent this interest rate reflects on the fiscal policy operations, the signals may distort monetary policy objectives. Having a signaling interest rate that is independent of fiscal operations would enhance the

position of the Central Bank of Kenya in managing interest rates.

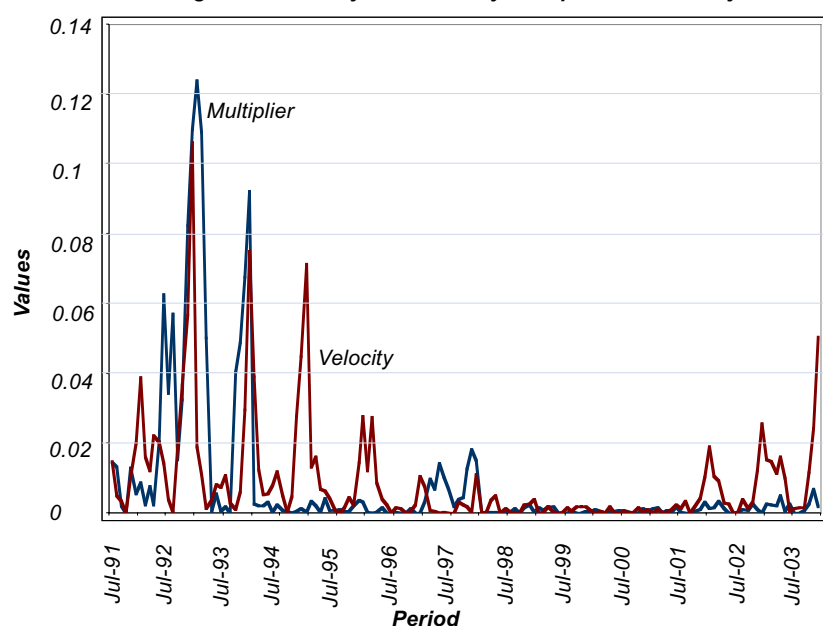
e) Reserve money programme

While the ultimate goal of monetary policy is to ensure price stability, monetary authorities adopt varying monetary policy rules. In Kenya, the monetary authority uses the monetary target framework to manage liquidity. For this framework to work effectively, it requires a strong and reliable relationship between the goal variable (inflation) and the targeted aggregate (reserve money). It also requires a stable money velocity and money multiplier. Further, the monetary authority

should have control over the monetary aggregates. For example, it is argued that while the monetary authority can control the narrow monetary aggregates, it may not be the case with broader monetary aggregates. Central Bank of Kenya uses the reserve money framework and has shifted from the narrow monetary aggregates (M2) to broader monetary aggregates (M3X).

There is a positive relationship between reserve money and inflation. However, the responsiveness of inflation to reserve money is low, an indication of weakening relationship. The money multiplier and velocity show instability. For example, although some stability was indicated immediately after the changes implemented in 1996/97, this was not sustained (Figure 2). A positive relationship is indicated between inflation, the volatility of multiplier, and the velocity, implying that a weak monetary framework makes it difficult for monetary authority to achieve its goal variable. The money demand function indicates a money-income elasticity of 0.79 and money-interest rate elasticity of negative 0.18. When there is dis-equilibrium in the money market, the real money demand adjusts by 40%. Further, the stability of money demand function changes over time, an indication that monetary authority temporarily loses on liquidity management. This means that assumptions that support the monetary framework are weakening, reflecting developments in the economy and the financial system.

Figure 2: Volatility in the money multiplier and velocity



Conclusions and policy recommendations

Sustainability of an attractive interest rate structure with effective monetary policy operations depends on the developments in the money market, the relationship between fiscal and monetary policy operations and competitiveness of the banking sector. This calls for the need to sustain a comprehensive reform process for the financial sector by:

- ◆ Enhancing the competitiveness of the credit market in order to keep the credit risk low and therefore narrow the interest rate spread substantially. This could involve restructuring the balances of banking institutions facing high non-performing loans; strengthening the institutional structure of information capital to ensure timely, accurate and reliable information, and facilitate information

sharing; restructuring of failing banks to enhance competitiveness; and tightening the enforcement of financial contracts by undertaking legal reforms and strengthening the capacity of commercial courts.

- ◆ Supporting efforts aimed at rationalizing the operational costs by individual banks. Although in the short-run customers bear part of the restructuring costs, reduced operational costs sustain narrow interest spread in the long-run. Rationalization through closing up branches, though, may raise the proportion of the population with no access to financial services.

◆ Encouraging development of capital and money market by strengthening the institutional structures, including the trading system, to reduce the transaction period and expansion of the financial assets basket. This will allow for diversification of risk among investors and enhance competitiveness in the financial market. Competitiveness in money market will bring down the cost of liquidity management by banks and enhance the effectiveness of monetary policy.

- ◆ Establishing a signaling interest rate that has no direct relationship with fiscal operations. This will allow the monetary policy to give signals specific to its objectives. However, because the Central Bank of Kenya uses Treasury bill securities in its monetary programme, a good cash management system at the Treasury will enhance liquidity management by giving the monetary programme a better forecast.

About KIPPRA Policy Briefs

KIPPRA policy briefs are aimed at a wide dissemination of the Institute's policy research findings. The findings are expected to stimulate discussion and also build capacity in the public policy making process in Kenya.

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