Policy Brief

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The Future of Monetary Policy Regime in Kenya

Monetary policy is one of the key macroeconomic policy tools that are used to influence macroeconomic variables by regulating monetary aggregates and/or terms and availability of credit in the economy. Its implementation captures the behaviour of monetary authority as it reacts to changes in an economy's macroeconomic environment. The reactions of the monetary authority are influenced by the goals of monetary policy, which include: price and output stability; exchange rate stability and establishing a stable financial system. The mandate of formulating and implementing monetary policy in Kenya is vested in the Central Bank of Kenya. It is mandated to formulate and implement monetary policy to achieve and maintain stability in the general level of prices. Determining how the Bank has reacted over time to different macroeconomic environments, and to what extent these actions were consistent with monetary policy objectives, is important for the future evolution of monetary policy. Understanding how the policy has been implemented, and recognizing the constraints faced, is important for any new monetary policy initiatives. Being an important macroeconomic management tool, achieving and maintaining price stability would enable economic agents to make business decisions with more certainty.

Implementation of Monetary Policy in Kenya

The implementation of monetary policy during the first decade after independence in 1963 was rather passive, and identifying the monetary policy stance during that period is often difficult. This was basically because of two issues. The first decade formed inception of the Central Bank of Kenya and therefore it dealt more with capacity building issues. Secondly, and more importantly, the economy was growing rapidly at an average rate of 8% per annum, and with an inflation rate of below 2%, there were no serious macroeconomic imbalances to deal with. However, during the second decade, macroeconomic disturbances ensued, following the collapse of the Bretton Woods System of fixed exchange rates in 1971, the oil price crises of 1973, and the coffee boom of 1976/77. To counter the macroeconomic imbalances arising from these shocks, the Bank adopted a restrictive monetary policy by imposing a cash reserve ratio of 5% in 1971, increasing minimum liquidity ratio from 12.5% in the late 1960s to 18% in 1976 and further to 20% in 1978. It is noteworthy that in the first two decades of independence, the Central Bank of Kenya relied more on direct instruments of monetary control, key of which were credit ceilings on commercial banks' lending and interest rates controls.

In mid 1990s, the government recognized that the economic difficulties faced were structural in nature and therefore initiated market-oriented reforms within the framework of structural adjustment programmes. This marked the transition in the practice of monetary policy from reliance on direct instruments to the use of indirect measures of monetary control. Accordingly, Kenya adopted a flexible managed exchange regime and interest rate controls were removed. In addition, indirect instruments of monetary policy such as open market operations (OMO) were gradually introduced. The 1990s decade was, however, characterized by double-digit inflation rates due, partly, to excessive monetary expansion that funded the first multi-party elections in 1992 and the Bank's accommodation of financially troubled banks. The macroeconomic instability experienced during this period, coupled with persistent external payments problems and structural constraints, necessitated a re-examination of the effectiveness of monetary policy. Efforts to enhance the effectiveness of monetary policy were partly achieved through the enactment in 1996 of the Central Bank of Kenya Act amendment. The amendment fortified the Bank's mandate over price stability and ensured stability of the financial sector.

This policy brief is based on KIPPRA Discussion Paper No. 58 on Monetary Policy Reaction Function for Kenya, whose objective was to estimate a monetary policy reaction function for Kenya. The study sought to understand whether the Central Bank of Kenya, in its reaction to macroeconomic changes, reacted consistently and in a systematic way or randomly.

ırther amendments on the Act were mainly aimed enhancing the supervisory role of the Central ınk over the financial system.

› achieve the principal objective of monetary ›licy of price stability, the Bank operates a onetary policy under a monetary programming amework that includes monetary aggregates quidity and credit) targets that are consistent with given level of economic growth, and inflation. In ›me cases, these targets have been made public in ıe monetary policy statements. The targets are sually reviewed under the IMF's Poverty Reduction nd Growth Facility (PRGF). According to the bi-nnual monetary policy statements, the current ıonetary policy programme was approved in 2003 nd runs to June 2008. The Bank's objective for the scal year 2005/06, for instance, was aimed at chieving an inflation rate of 5% by June 2006. To chieve this, reserve money was targeted to expand y at most 6.3% by June 2006. The programmed rowth in reserve money was to support a growth ı liquidity of 10%, which was enough to support a % non-inflationary expansion in economic ctivities. In the meantime, external payments osition was expected to improve and allow net ›reign assets (NFA) to increase to Ksh 108.6 billion y June 2006. The implementation of the monetary rogramme for the fiscal year 2005/06 was based n quarterly reserve money targets. The rogramme set a ceiling for reserve money and a oor for NFA at the Central Bank in December 2005 › allow for the adjustment of any shortfall of rogrammed budgetary support.

:urrent Issues on Monetary Policy

n analysis of the response of the Central Bank of enya to changes in the macroeconomic nvironment reveals that the monetary rogramme is principally focused on the monetary olicy objective of attaining and maintaining price tability. The Central Bank of Kenya has not used ıonetary policy to stabilize output. Monetary olicy instruments such as reserve money and omestic credit have not been used consistently to tabilize output. Ideally, monetary policy should chieve and maintain economic stability in terms of utput and prices. Indeed, the Bank has cknowledges that "...a tighter monetary policy is ursued when economic performance is forecast to low down while an expansionary monetary policy ; put in place when the economy is forecast to erform well."[1] Therefore, instead of undertaking hort-term stabilization of output, monetary policy as been pro-cyclical.

urther analysis of the Bank's reaction to exchange ate movements reveals lack of focus on exchange ate stabilization. This is not surprising since, ccording to various monetary policy statements,

The Central Bank of Kenya has not used monetary policy to stabilize output. Monetary policy instruments such as reserve money and domestic credit have not been used consistently to stabilize output. Ideally, monetary policy should achieve and maintain economic stability in terms of output and prices.

the Central Bank has adopted a policy of allowing exchange rate to be determined by forces of demand and supply and only intervenes to smoothen erratic movements.

With regard to coordination of fiscal and monetary policy, coordination at the programming level is apparently adequate. This is because macroeconomic assumptions such as overall inflation target and fiscal targets are set in collaboration with the Ministry of Finance and Treasury. In the actual implementation, however, fiscal policy has tended to dominate monetary policy in the determination of market interest rates. Analysis reveals that movements in the T-bills rate largely depend on government borrowing, yet the Treasury–bill rate is a key determinant of other market interest rates.

As discussed above, monetary policy in Kenya consists of a monetary aggregate target. The rationale for using the monetary aggregate target is that there exists a stable demand for money relationship that depends on overall economic activity and price level. Consequently, liquidity is expanded at a level considered to be consistent with a given rate of economic expansion and price level target (usually underlying inflation at below 5%). The demand for money function can be quite unstable especially in an economy where the financial sector is registering remarkable growth. In addition, Kenya has been able to register remarkable macroeconomic stabilization since the beginning of this decade. Recent revisions to national statistics reveal that Kenya's economy has been growing faster and its size about 5% greater than earlier estimates. This implies that a single shilling was supporting a larger volume of transactions than assumed in the monetary policy programme. Consequently, growth in monetary aggregates can be erratic and thus provides limited information as a guide to setting monetary policy.

Future Directions of Monetary Policy in Kenya

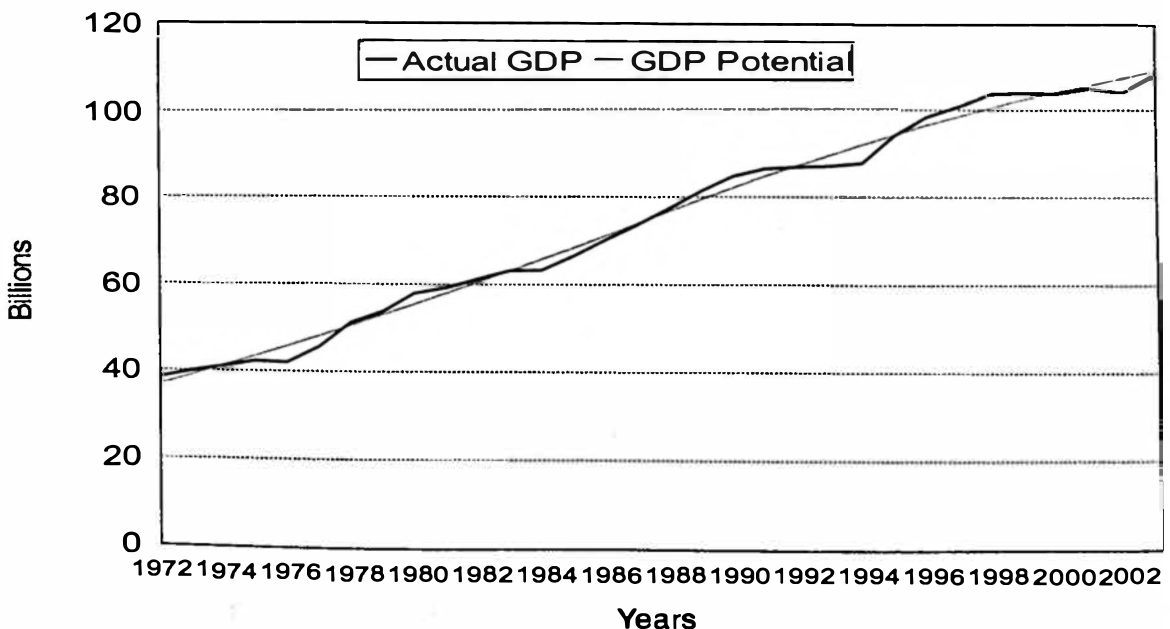
The Central Bank of Kenya continues to focus on price stability, defined as maintaining underlying inflation below 5% since June 1997. The Bank has made considerable achievement in this direction, given the double-digit inflation levels that prevailed in the early 1990s. Average annual underlying

inflation, which excludes food, energy, transport and communication, has since 1997 registered single digit inflation rates. However, there are two challenges. The first lies in the different definitions of underlying inflation by the Central Bureau of Statistics and the Central Bank of Kenya. The Bureau excludes food and non-alcoholic drinks from overall inflation. The Bank, in addition to food and non-alcoholic drinks, also excludes fuel, power as well as transportation and communication of goods and services. This has been recognized and work is currently underway to harmonize and improve its measurement. The second challenge is that despite the fact that the average annual underlying inflation still falls within target, annual average headline inflation has been consistently way above it, for example hitting 18.9% in February 2006. A good measure of underlying inflation should predict overall inflation and be closely linked to monetary policy.

The current practices tend to suggest that the Central Bank of Kenya is in a transition phase towards adopting an inflation targeting monetary policy framework. This is because a common feature with countries using this monetary policy framework is the definition of the inflation target. The Bank announces a target inflation rate not to be exceeded. If the Bank moves towards this direction, important practical questions relate to the precise numerical target, whether it should be a band or a point, and how the target should be calculated. To facilitate this policy framework, there may be need to develop a model for forecasting the inflation target.

Should output stabilization be considered in Kenya, deviations between actual Gross Domestic Product (GDP) from its potential would provide important signals for monetary policy. In essence, the Central Bank of Kenya would use monetary policy to try and stabilize short-run growth.

The Central Bank of Kenya Act, CAP 491, gives a single objective to monetary policy directed to achieving and maintaining stability in the general level of prices. As already mentioned, from various monetary policy statements, this price stability is defined as an underlying inflation at 5%. Ideally, monetary policy should be directed at both price and output stabilization. However, as mentioned above, analysis reveals that the Bank does not pay any significant attention to stability in short-term growth. The figure below reveals deviations between actual and potential output[2] of the economy, implying that monetary policy could have been more accommodative whenever the potential of the economy to grow was higher than the actual growth but without undermining price stability. Although it is widely recognized that the primary objective of monetary policy is price stability, in the US, for example, monetary policy has a dual mandate; that is, price stability and full employment. In the European Union (EU) and England, monetary authorities pursue a singular but hierarchical mandate in that other goals can be pursued once the price stability objective has been achieved. Should output stabilization be considered in Kenya, deviations between actual



Gross Domestic Product (GDP) from its potential would provide important signals for monetary policy. In essence, the Central Bank of Kenya would use monetary policy to try and stabilize short-run growth.

The intensified efforts by members of the East African Co-operation towards greater integration that would culminate into a monetary union imply that actions of the Central Bank of Kenya to formulate and implement monetary policy would be gradually ceded to a monetary union. Developments in this direction should be monitored.

Policy Recommendations

In the recent past, the government has been undertaking measures to enhance monetary policy outcomes by, among other things, enhancing the autonomy of the Central Bank, formation of a Monetary Policy Advisory Committee and, lately, the introduction of a Central Bank Rate. Despite these efforts, there are still challenges to be addressed as discussed below.

Limit dominance of fiscal policy over monetary policy

Monetary and fiscal policy formulation and implementation need to be well coordinated to facilitate effective realization of macroeconomic policy objectives. The Kenyan experience shows that although fiscal and monetary policy coordination is done at the programming level, in actual practice there has been fiscal policy dominance. This weakness has been recognized, leading to the introduction of a Central Bank Rate to limit fiscal policy dominance.

It is still too early to evaluate the effectiveness of the CBR. However, its success will depend on: Fiscal discipline, availability of alternative sources of funds for commercial banks, and competition in the banking sector, which would ensure that market interest rates are more responsive to the Central Bank Rate. Lack of fiscal discipline may induce unsustainable fiscal deficits and put excessive pressure on the market. This is because the government is a key player in the domestic securities market, such that excessive movements in the T-Bill rates will affect other asset prices.

Consider revising the mandate of monetary policy

As noted above, analysis of monetary policy reveals that output stabilization has not been a goal of monetary policy in Kenya. This may not be surprising since, according to the Central Bank Act, monetary policy has a singular objective in terms of achieving and maintaining stability in general level of prices. A review of Central Banking legislation in most countries reveals that the objective of monetary policy is singular but hierarchical. This implies that monetary policy can support other economic policy objectives as long as it does not jeopardize the goal of price stability. However, in the case of the US, for example, monetary policy has the dual mandate of ensuring price and output stability. There is need therefore for Kenya to consider the revision of monetary policy objective. However, it would either require reformulation of the monetary programming framework or amending section 4(1) of the Central Bank of Kenya Act to include a provision for other economic policy goals, perhaps in a hierarchical order.

Notes

[1] Central Bank of Kenya (2000), "The practice of monetary policy in Kenya", p5, Nairobi: Central Bank of Kenya.

[2] The potential GDP path is not the full employment path. It accommodates rigidities due to structural and institutional constraints in the economy.

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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