## APPENDIX I: LIST OF OFFICIALS THAT ATTENDED THE 4TH MEETING OF THE AACB EAST AFRICA SUBREGION

| SURNAME | OTHER NAME | CENTRAL BANK | POSITION | TEL. | E-MAIL |
|---|---|---|---|---|---|
| 1. KANIMBA | Francois | Banque Nationale du Rwanda | Governor | | |
| 2. SAMBILI (DR) | Edward | Central Bank of Kenya | Deputy Governor | | |
| 3. KASEKENDE (DR) | Louis | Bank of Uganda | Deputy Governor | | |
| 4. TOYI | Salvator | B.R.B. | Deputy Governor | | |
| 5. BARANSATA (Mrs) | Speciose | B.R.B. | Deputy Governor | | |
| 6. KONAN | Benard | AACB Secretariat | Executive Secretary | | |
| 7. KIPTOO **(Rapporteur)** | Christopher | Central Bank of Kenya | Senior Assistant Manager | 254-20-2863216 | Kiptoock@Centralbank.go.ye |
| 8. SEKAGILIMANA | Célestin | Banque Nationale du Rwanda | Directeur | 08306019 | Csekgilimana@.yahoo.fr |
| 9. MHANDO | Joseph | Bank of Tanzania | Director | 255-22-2119312 | jsmhando@hg.bot-tz.org |
| 10. KONAN | Bernard | Secrétariat ABCA | Secrétaire Exécutif | 221.839.0884 | bkonan@bceao.int |
| 11. MUSINGUZI (Dr) | Polycarp | Bank of Uganda | Executive Director & Economic Advisor to the Governor | 077 798 798 | pollymusing@yahoo.com |
| 12. SOTA | Bonaventure | B.R.B. | Responsable du Service | 22 2745 | sotabon@yahoo.fr |
| 13. NTIVUMBURA | Yves | B.R.B. | Responsable du Service | | ntivumburayves@hotmail.com |
| 14. KAMARIZA | Rose | B.R.B. | Conseiller de la Direction | 21 82 44 | rkamariza@hotmail.com |
| 15. NKURIKIYE | Consolate | B.R.B. | Responsable du Service | 22 27 32 | consonkuri@yahoo.fr |
| 16. NTAHOBARI | Adélaïde | B.R.B. | Responsable du Service | 22 2805 | ntahodel@yahoo.fr |
| 17. NIYONZIMA | Audace | B.R.B. | Cadre du Service des | 23 7941 | niyoauda@yahoo.fr |
| 18. NDAYISENGA | Paulin | B.R.B | Cadre du Service des | 837435 | ndayisepaul@yahoo.fr |
| 19. KABONEKE | Boniface | B.R.B | Cadre du Service des | 22 3873 | kaboboni@yahoo.fr |
| 20. NTINDEKURE | Médard | B.R.B. | Cadre du Service | 850865 | medntindek@hotmail,com |
| 21. NDAYIRORERE | Adélaïde | B.R.B | Cadre du Service | 945371 | ndayirorerea@yahoo.fr |

# A: KENYA'S RECENT EXPERIENCE IN MONETARY POLICY MANAGEMENT

## 1.0 Introduction

Kenya's monetary policy framework has evolved significantly since the establishment of the Central Bank of Kenya (CBK) in 1966. In its early years, the CBK pursued a passive monetary policy and was largely concerned with protection of Kenya's foreign exchange reserves and the allocation of credit to priority sectors like agriculture and small-scale indigenous businesses. The 1980s witnessed a more active interest rate policy involving a series of reviews aimed at maintaining rates positive in real terms. CBK also adopted a flexible exchange rate regime aimed in part at maintaining the competitiveness of the country's exports. Under this framework, monetary policy remained subordinated to defending the exchange rate rather than, for instance, fighting inflation. Thus the level of reserves assumed importance as the target variable for monetary policy.

In early 1990s, major economic indicators pointed at a downturn in economic activity. The government implemented drastic adjustment measures, including internal deregulation, removal of exchange controls, reduction in government spending, and liberalisation of interest rates. The deregulation of economic activities in early 1990s marked a major milestone in the conduct of monetary policy, changing its mandate from defending a particular exchange rate to achieving and maintaining price stability. The framework that was adopted was that of monetary targeting. Under this framework, the intermediate target for monetary policy is broad money (M3X)[1] while the operating target[2] is reserve money. The Central Bank has three main instruments through which it can affect monetary conditions in order to obtain suitable growth in the money supply. These are: the Open Market Operations (OMO), the Cash/Reserve Ratio Requirement and the Discount Rate.

Monetary policy is conducted in the context of a flexible exchange rate with no predetermined path or specific target range for the exchange rate, and of an open capital account. The CBK's current policy is to occasionally use monetary policy to counter large swings in the exchange rate, and to only intervene in the foreign exchange market to smooth short-term volatility, but not to influence the fundamental direction of exchange rate movement. Monetary policy implementation is anchored on annual targets for broad money and reserve money aggregates, which are reviewed every six months in the context of the Monetary Policy Statement and IMF-supported Poverty Reduction and Growth Facility (PRGF). Monthly targets are set consistent with the established inflation[3] and reserve objectives, and changes in the reserve money are monitored on a daily basis based on the CBK daily balance sheet and liquidity-forecasting framework.

## 2. Kenya's Recent Monetary Policy Experiences

Kenya's experience with monetary targeting is not very different from those of fellow African countries or even those of advanced countries such as Canada and Australia. The implementation of monetary targeting framework has brought to the fore various challenges:

### (i) Problem of controllability

[1] *Broad money M3X comprises currency outside banking institutions, term and non-term deposits held by the private and the public sectors (excluding central and local government) in banking institutions and residents' foreign currency deposits with local banks. The CBK also tracks the movements of other monetary aggregates, namely M1, M2, M3 and M3XT.*

[2] *Reserve money comprises currency in circulation and deposits of commercial banks and non-bank financial institutions at the Central Bank*

[3] *The objective of monetary policy currently pursued by the CBK is that of containing underlying inflation to below 5 percent.*

CBK over the recent years has no found it easy in dealing with several challenges related to controllability of monetary policy. These include:

(a) **Challenge of forecasting liquidity:** The CBK has had to contend with the challenge of forecasting liquidity within a short time period. The monetary policy operations are based on an analysis of the daily forecast of the sources of reserve money, some of which have proved elusive and tricky to forecast. The most problematic ones are transactions affecting government accounts at the CBK. While data on transactions relating to debt payments are fairly accurate and readily available, those on transactions relating to goods and services consumed by the Government are not. This is because the Treasury has not been able to put in place effective cash management and expenditure control systems.

(b) **Problem of Controlling Currency Outside banks:** CBK has experienced difficulties in immediately influencing excess reserves in form of currency outside banks -- one of the key component of reserve money in Kenya, and perhaps the case for other central banks in Africa. Influencing currency outside banks through OMO can only be affected by higher interest rates sustained over a long time, where the public will respond by reducing their currency holdings in favor of deposits. High seasonality in currency outside banks associated with the public's high demand for currency, especially during festivities and when inflation is high due to transient factors occasioned by adverse effects of drought on food inflation and/or rising world oil prices on fuel prices, has also constrained liquidity management using OMO. It would seem more reasonable, therefore, to focus on bank reserves only. This is because bank reserves, unlike currency in circulation, can be influenced by central banks in their short-term monetary operations. The inclusion of currency in circulation tends to complicate monetary operations. For example, in cases where expansion in reserve money is due to excess currency holdings, the central bank has no tool at its disposal to mop up the excess cash holdings by the public.

(c) **Problems of Distressed banks**: Targets for daily liquidity operations set in terms of bank excess reserve are affected by reserve held by distressed banks. These banks do no participate in Repo operations because of their nature of liquidity problems. A case in Kenya is that of a state-owned bank that sometimes holds excess reserves and which cannot be accessed by the CBK in its the daily liquidity operations.

(d) **Lack of Interest rate anchor:** The current monetary policy framework does not have an interest rate anchor as both the repo rate and the discount rates are linked to the treasury bill rate, which is influenced more by short-term government financial needs than by the monetary policy stance. To address this, CBK is set to launch a Bank Rate, which is expected to be the reference prime rate maintained by any bank, in respect of loans, advances, or other financial facilities granted to its customers. It would

be interesting to share experiences in this area, especially as countries consider developing monetary policy framework based on a short term interest rates as the operating target.

### (ii) Problem of Volatile Short-Term Interest Rates

CBK pursues a policy of market-determined interest rates. With short-term interest rates on government securities becoming negative in real terms in the recent one-year or so, the Bank was perceived as having deliberately kept nominal interest rate at low levels[4]. This was a misconception as forces of demand and supply determined money market interest rates. Like any market affected by structural inefficiencies, the Bank played its rightful role of guarding the system against any disruptive forces in the market, while letting the market determine the level of interest rates.

With effort to allow more credit to the private sector grow by maintaining interest rate low and stable and preserving the bond yield curve, CBK and market participants were concerned about the too sharp an increase in interest rates in the last quarter of 2004 may lead to financial instability and collapse of bond prices. While this has not happened, two key lessons could be drawn:

- How should interest rate risks be managed in a market-determined interest rates system where there is need to balance the objectives of monetary policy and allow adequate flow of credit to the private and government sector at reasonable rates without disrupting investment decision in the financial markets?

- For central banks allowing recourse to rediscount facilities of government securities, how should central banks guard against abrupt rediscounting when short-term interest rate rises sharply? Massive rediscounting could complicate liquidity operations.

**(iii) Problem of Managing Exchange Rate Volatility**

CBK's exchange rate policy is to allow the forces of demand and supply to determine the exchange rate in the interbank market for foreign exchange. The policy has served the economy well by absorbing any external shocks. The participation of CBK in the interbank market continued to be limited to smoothing short-term excessive volatility, effecting external debt payments and maintaining the target for net international reserves under the IMF-supported PRGF program.

The CBK intervened in August-September 2004 when speculative tendencies destabilized the movement in the exchange rate. At the time, speculators cashed in on fears of increased demand for foreign currency from oil importers occasioned by increased prices of oil in the international markets, implications of delayed donor inflows for budgetary support and anticipated import of food following the adverse impact of drought. While the overall depreciation of the Kenya shilling was moderated by the CBK intervention, there are concerns about the determination of timing and magnitude of any intervention.

**(iv) Problem of Inflexibility of Reserve requirement**

Some of the policy instruments that are used have constrained the conduct of monetary policy. The required reserve ratio, for instance, is relatively inflexible as a monetary instrument to use in the short run while, under the rediscount window, the CBK is obliged to supply the liquidity demanded and can only change the price.

[4] On a positive note, the low interest rates brought about some acceleration in private sector credit.

A related problem to this is that effective July 1, 2003, the CBK introduced changes to the specification of reserve requirement to include: lowering of the cash ratio level from 10 percent to 6 percent; abandoning of reserve averaging and creating two separate banks' clearing accounts -- cash ratio account with day-to-day maintenance requirement and clearing balance account; and inclusion of foreign currency deposits in the reserve base and denominating reserves on foreign currency deposits in domestic currency.

Commercial banks have expressed reservation on the denomination of reserves on foreign currency deposits in domestic currency. Instead, they have proposed to CBK to allow for denomination of reserves on foreign currency deposits in foreign currency. The CBK has resisted the proposal arguing that denominating reserves in domestic currency ensures that reserve money would not vary as the exchange rate varies. In the case of a depreciation of the shilling exchange rate, the reserve money would not expand, as it will be automatically accommodated as required reserve deposits in local currency terms. The motivation of the proposal by the banks is to place the onus of adjustment in case of the variation of the exchange rate on CBK. Consequently, the CBK has advised banks to spread their foreign currency holding denomination to other currencies so as to hedge against adjustment in case of any exchange rate variations.

## (v) Problems of Exogenous Shocks

Implementation of the current monetary program to June 2005 was disrupted mid-stream by unilateral modification by the IMF in the face of inflation pressure that emanated from rising oil prices.

- ***Issue 1:*** how should consultations between the IMF and central banks be improved to ensure nondisruptive implementation of monetary policy programs?

- ***Issue 2:*** what should be the appropriate monetary policy response to external shock (such as oil prices) for countries adopting a flexible exchange rate regime?

### (v) Problems of High Interest rates

Kenya's experience has shown that in spite of the financial reforms, interest rate spreads have persistently remained relatively high during the post-liberalized environment than during the pre-liberalized environment (Chart 1). The spreads have also remained relatively high when compared to other countries (Chart 2). Kenya's experience is not a typical.

Many countries failed to achieve the intended the liberalisation objective of achieving positive real interest levels as well as narrower spreads. The early and rapid liberalizations in the Latin American countries, of Argentina, Chile, Uruguay and Brazil led to different outcomes with regard to real interest rates. Real interest rates in Chile and Uruguay rose to positive levels and remained at high levels for many years whereas in Argentina and Uruguay, negative real deposit rates continued to for several years. In all cases, the spreads between lending and deposit rates widened. There was similar experience in many African countries such as Gambia, Benin, Cameroon, Cote d'Ivoire, Malawi and Nigeria.

**CHART 1: DEPOSIT AND BORROWING RATES & SREAD**

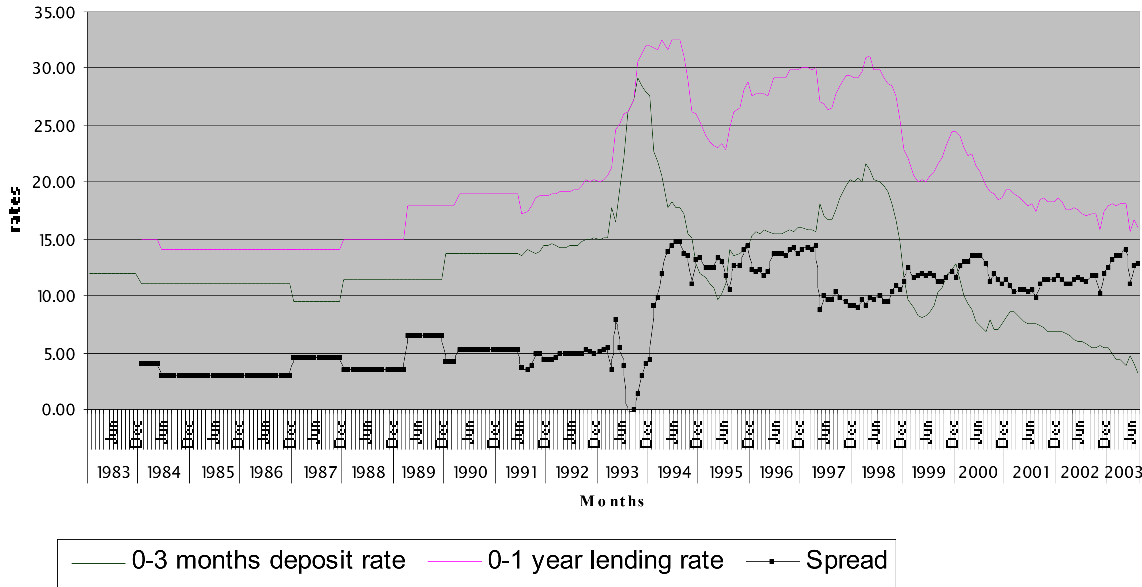
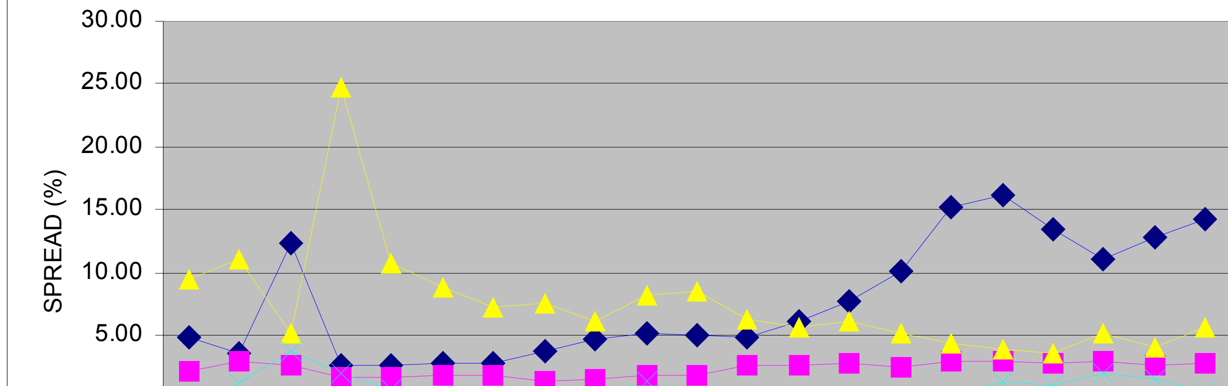



**CHART 2: INTEREST RATE SPREADS IN KENYA AND OTHER COUNTRIES**



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The failure of market forces to bring down interest rates and to harmonise the lending and saving rates has led to a lot of disillusionment in Kenya, culminating in the enactment of the Central Bank of Kenya Amendment Act No. 4 of 2001[5]. Many commentators have argued that the high spreads have been one of the major bottlenecks hindering Kenya's economic growth in Kenya. The debate that followed the judicial dispensation of the litigation surrounding the Central Bank of Kenya (Amendment) Act, 2000 remains a worrisome development and is likely to continue to destabilize not only the banking sector but the entire economy. The CBK believes that the way forward regarding the high interest rates problem is to streamline the operations of banking institutions so as to reduce their operational costs while also strengthening the judicial system in order to quicken the administration of commercial cases. In this context, the CBK is faced with the challenge of convincing Kenyans to support and hasten approval by Parliament of the Central Bank of Kenya (Amendment) Bill, 2001. The Bill seeks to repeal the section in the Central Bank of Kenya (Amendment) Act, 2000 that provides for the control of interest rates.

**(vi) Problems of Capital Flows/Instability in Money Demand Function**

In view of the increasing integration of the Kenyan economy in the world financial markets and the increasing importance of large and volatile international capital flows, Kenya may have reached the same stage now where the usefulness of the M3X-money supply as a target for monetary policy has been diluted to a point where some alternative anchor should be considered. We may soon see demise of money supply targeting to inflation targeting.

This concern is driven by the fact that there has been instability in the relationship between money supply and inflation - the ultimate objective of policy. The CBK has relied on a demand function both as a means to identify medium term targets for the supply of money but also to manipulate interest rates for the purpose of controlling liquidity in the economy. In the absence of a stable money demand function, monetary growth targets have tended to be inconsistent with developments in the real economy and interest rate targets have also been out of line with the planned growth of the money supply so that the targeted monetary aggregate have sometimes turned out not to be the appropriate reflection of total liquidity in the economy.

## APPENDIX III: MACRO-ECONOMIC PERFORMANCE AND CONVERGENCE CRITERIA UNDER THE AMCP

## Primary Criteria

| | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | AMCP Target | Time Frame for Achieving Criteria | Subregional Member | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | Remarks |

[5] *Section39 (1) of the CBK (Amendment) Act No. 4 of 2001 states that the maximum rate of interest which specified banks or specified institutions may charge on loans or advances shall be the 91-day Treasury Bill rate published by the Bank on the last Friday of each month, or the latest published 91-day Treasury Bill rate, plus four per-centum. Section 39(2) states that the minimum rate of interest which specified banks or specified institutions may pay o deposits held in interest earning accounts shall be seventy per-centum of the 91-day Treasury Bill rate published by the Bank on the last Friday of each month, or of the latest published 91-day Treasury Bill rate, plus four per-centum*

| | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1 | Overall budget deficit/GDP ratio (excluding grants) of less than 3 per cent | Target of < 5 %t should be achieved in stage II (2004-2008).<br><br>Target of < 3 % should be achieved in stage III (2009-2012) | Uganda | -1.7 | -1.67 | - | -1.23 | -6.7 | -2.6 | -13.0 | -11.2 | -11.2 | Most countries have not met this criterion. |
| | | | Kenya | -1.2 | -1.9 | -2.5 | -0.1 | 0.4 | -4.8 | -3.2 | -5.4 | -1.9 | |
| | | | Mauritius | - | -4.0 | 0.9 | -1.5 | -1.2 | 0.9 | -6.0 | -6.0 | - | |
| | | | Rwanda | -3.5 | -2.2 | -6.6 | -9.9 | -9.2 | -9.8 | -9.2 | -10.2 | -13.9 | |
| | | | Burundi | -3.0 | -4.9 | -3.8 | -3.4 | -5.9 | 1.6 | - | - | - | |
| | | | Ethiopia | -2.0 | -1.4 | -4.0 | -5.2 | - | - | - | - | - | |
| 2 | Inflation rate of less than 10 per cent | Under the original AMCP, inflation rate of less than 10 per cent should be achieved in stage II (2004-2008) | Uganda | 6.9 | 6.9 | - | 6.4 | 2.9 | 2.0 | 3.5 | 2.4 | 0.9 | Few countries have attained the criteria. |
| | | | Kenya | 8.4 | 6.6 | 9.8 | 5.5 | 5.2 | 5.5 | 2.7 | 2.8 | 3.5 | |
| | | | Mauritius | 6.8 | 6.8 | 6.9 | 6.9 | 4.2 | 5.4 | 6.3 | 5.15 | - | |
| | | | Rwanda (Overall) | - | 12.0 | 6.2 | -2.4 | 4.3 | 2.9 | 2.5 | 7.4 | 12.0 | |
| | | | Burundi (Overall) | - | 31.2 | 12.5 | 3.4 | 24.3 | 9.2 | -1.3 | 10.7 | 9.8 | |
| | | | Ethiopia | - | 2.4 | 2.6 | 7.9 | 0.7 | -8.1 | 1.5 | 23.2 | - | |

| | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 3 | Minimization of Central Bank financing of budget deficit. | Under the AMCP, member countries are expected to contain Central Bank financing of budget to less than 10 per cent during stage II (2004-2008) | Uganda | - | - | - | - | - | - | - | - | - | To be addressed in the proposed workshop on harmonization of concepts, methodologies and statistical frameworks |
| | | | Kenya | - | - | - | - | - | - | - | - | - | |
| | | | Mauritius | - | - | - | - | - | - | - | - | - | |
| | | | Rwanda | - | - | - | - | - | - | - | - | - | |
| | | | Burundi | - | - | - | - | - | - | - | - | - | |
| | | | Ethiopia | - | - | | - | - | - | - | - | - | |
| | External reserves of equal to or more than six months of imports of goods and services | Under the original AMCP, external reserves of equal to or more than 3 months of imports of goods and services should be achieved in stage II (2004-2008) and equal to or more than 6 months of imports of goods and services stage III (2009-12) | Uganda | 3.8 | 4.4 | 4.6 | 6.5 | 6.9 | 7.6 | 6.3 | 5.5 | 6.5 | Except Uganda and Mauritius, all other countries are yet to meet this criteria |
| | | | Kenya | 3.0 | 2.5 | 2.5 | 2.9 | 2.9 | 3.2 | 3.4 | 4.3 | 3.6 | |
| | | | Mauritius | 3.8 | 3.1 | 2.5 | 3.1 | 4.0 | 3.8 | 7.6 | 8.5 | - | |
| | | | Rwanda | 3.5 | 3.9 | 4.8 | 4.8 | 5.4 | 5.9 | 6.7 | 5.6 | 7.1 | |
| | | | Burundi | 12.1 | 9.6 | 4.5 | 4.4 | 2.6 | 1.5 | 4.6 | - | - | |
| | | | Ethiopia | 5.1 | 3.6 | 3.3 | 2.8 | 2.1 | 2.3 | 4.7 | - | - | |

**Secondary Criteria**

| | Original AMCP Target | Time Frame for Achieving Criteria | Sub-regional Member | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | Remarks |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Domestic fiscal receipts/GDP ratio of equal to or more than 20%. | | Uganda | - | - | - | - | - | - | 13.5 | 13.4 | 12.8 | |
| | | | Kenya | - | - | - | - | - | - | 22.2 | 22.9 | 19.9 | |
| | | | Mauritius | 8.8 | 10.9 | 9.7 | - | 20.9 | 18.4 | 18.5 | 20.3 | 20.3 | |
| | | | Rwanda | 16.6 | 17.0 | 15.8 | 16.4 | 10.1 | 11.7 | 12.4 | 13.0 | 13.5 | |
| | | | Burundi | 15.0 | 15.4 | 18.5 | 17.3 | 21.0 | 26.8 | 30.2 | - | - | |
| | | | Ethiopia | 18.0 | 20.7 | 21.6 | 17.0 | - | - | - | - | - | |
| | Salary mass/total domestic fiscal receipts ratio of less than 35%. | | Uganda | - | - | - | - | - | - | - | 42.7 | 39.4 | |
| | | | Kenya | 31.5 | 32.3 | 34.6 | 32.2 | 36.9 | 31.5 | 38.2 | 37.7 | 46.6 | |
| | | | Mauritius | - | - | - | - | - | - | 9.0 | 1.2 | - | |
| | | | Rwanda | - | - | - | - | 56.0 | 48.9 | 42.5 | 38.4 | 38.0 | |
| | | | Burundi | - | - | - | - | - | - | - | - | - | |
| | | | Ethiopia | - | - | - | - | - | - | - | - | - | |

| | Original AMCP Target | Time Frame for Achieving Criteria | Sub-regional Member | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | Remarks |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | The sourcing of minimum of 20% government investment capital from fiscal receipts. | | Uganda | - | - | - | - | - | - | - | - | - | |
| | | | Kenya | 20.1 | 18.2 | 19.3 | 16.3 | 10.4 | 15.7 | 12.2 | 19.3 | 17.4 | |
| | | | Mauritius | - | - | - | - | - | - | - | - | - | |
| | | | Rwanda | - | - | - | - | - | - | 2.2 | 2.8 | 3.0 | |
| | | | Burundi | - | - | - | - | - | - | - | - | - | |
| | | | Ethiopia | - | - | - | - | - | - | - | - | - | |
| | Interest rates – The maintenance of positive real interest rates | | Uganda | 4.8 | 6.1 | 9.1 | 9.4 | 16.0 | 6.8 | 13.4 | 21.4 | - | |
| | | | Kenya | - | - | - | 15.5 | 7.7 | 5.5 | 5.54 | -1.19 | -3.0 | |
| | | | Mauritius | 3.2 | 6.3 | 1.6 | 3.1 | 3.5 | 1.9 | 0.81 | -11.3 | - | |
| | | | Rwanda | 4.0 | 6.9 | 5.1 | 13.6 | 7.4 | 10.1 | 10.5 | 9.1 | 4.0 | |
| | | | Burundi | -21.2 | 2.4 | -0.5 | 8.6 | -10.3 | 4.8 | 16.8 | - | - | |
| | | | Ethiopia | 4.8 | 0.4 | 0.9 | -4.3 | 2.1 | 11.2 | -0.2 | - | - | |

| | Original AMCP Target | Time Frame for Achieving Criteria | Sub-regional Member | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | Remarks |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Maintenance of real exchange rate stability | | Uganda | - | - | - | - | - | - | - | - | - | To be addressed in the proposed workshop on harmonization of concepts, methodologies and statistical frameworks. |
| | | | Kenya | - | - | - | - | - | - | - | - | - | |
| | | | Mauritius | - | - | - | - | - | - | - | - | - | |
| | | | Rwanda | - | - | - | - | - | - | - | - | - | |
| | | | Burundi | - | - | - | - | - | - | - | - | - | |
| | | | Ethiopia | - | - | - | - | - | - | - | - | - | |