

CENTRAL BANK OF KENYA



“INNOVATIVE STRATEGIES ADOPTED BY AFRICAN COUNTRIES IN COPING WITH THE RECENT GLOBAL ECONOMIC RECESSION”

Speaking Notes for

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during the

**1ST ANNUAL INTERNATIONAL BUSINESS AND
MANAGEMENT (AIBUMA) 2010 CONFERENCE**

*Kenyatta International Conference Centre, Nairobi
Wednesday, 25th August, 2010*

Distinguished Guests,

Ladies and Gentlemen:

It is my pleasure to join you at this very auspicious occasion of the First Annual African International Business and Management Association Conference hosted by the University of Nairobi. I am deeply honoured to be with you today.

The theme of this conference is on innovation, the organisers invited me to talk on *"Innovative Strategies Adopted by African Countries in coping with the Recent Global Economic Recession"*. The world economic outlook seems brighter today than it was six months ago, even though many large economies are yet to emerge from the adverse effects of the crisis. But for the economies in the region, buffeted by other shocks, like Kenya, we need to develop stronger capacity for future growth. This can only be achieved by solving the binding constraints to growth.

The Genesis of the Global Financial Crisis

The global financial crisis originated in the sub-prime mortgage market in the USA and was traced to a decade of low interest rates in the USA which spurred liberal lending practices by commercial banks to the sub-prime market such that investors could essentially borrow money against such appreciating securities.

Consequently, commercial banks and mortgage financial institutions created products commonly referred to as mortgage backed securities, which were enhanced through underwriting guarantees by insurance companies. Investment banks repackaged and transformed these high-risk assets from financial institutions into tradable instruments that could be bought and sold in capital markets worldwide, thereby spreading the risk across the global financial system.

The securities derived from the housing mortgages were used by banks in the USA and elsewhere in the world, and later turned toxic. The rest of the outcome is known, but we need to draw some lessons on this financial crisis for the future. So coping is not enough, institutional reforms are critical for our economies.

The Initial Effects and the Knock on Effects

The impact of the financial crisis on African economies focussed on secondary effects. The initial effects were on exchange rate depreciation occasioned by non-resident outflows from the domestic equity and bonds markets. The US dollar was also perceived by investors as a safe haven. So, when global banks were not trading, its liquidity and hence value were affected. This was also followed by a slump in the

stock markets. Foreign exchange reserves also fell below the statutory level of four months of imports as these were used to cushion the market from extreme exchange rate volatility.

The third round effects of the financial crisis were economic in nature. These comprised of slowdown in exports (mainly horticultural) occasioned by reduced international demand, tourism, remittances and foreign direct investment. These effects also affected domestic economic activity and hence the economic slow-down took effect.

The Economic Stimulus and Financing Options

The financial crisis had direct effects on Kenya's development path. In fact, the impact was compounded by the political problems in the economy in 2008 while the effect of the drought later in the year worsened Kenya's economic performance. In addition, the crisis delayed the issuance of the sovereign bond factored in the budget. Kenya is among the few African countries with favourable sovereign risk rating by international rating agencies and whose entry in the international capital market would boost this rating and economic performance.

In view of the pervasive economic difficulties, the drought effects and displacement of persons following the political violence, Government expenditure patterns needed to be re-aligned to these new challenges in order to reverse the trend. There was a strong realization that a shilling spent on the poor and rural areas had a higher multiplier effect on the economy. There was also a desire and importance to bring back the growth trajectory to support growth as envisaged in the Vision 2030 development plan, and poverty reduction in order to diffuse the political tension.

Consequently, the fiscal year 2009/10 Government Budget was premised on the need to urgently overcome socio-economic challenges by stimulating growth and protecting jobs; reducing poverty; enhancing food security and protecting the poor. The Government launched a Ksh.22 billion economic stimulus programme for this purpose.

The Governments development budget was also enhanced with strong focus on infrastructure development. Project specific infrastructure bonds were successfully issued in the fiscal year 2009/10 to support infrastructure development.

Infrastructure bonds also give Kenyans an opportunity to invest while providing funds for infrastructure development that stimulate savings and investment, thus growth. In addition, this provided the Central Bank a chance to introduce new measures to develop the bond market and become a domestic source of long term finance. This would encourage corporate with strong balance sheets and others to issue their bonds.

The Domestic Policy Paradigm

The financial sector in African countries (outside the Republic of South Africa) emerged relatively unscathed from the global financial crisis due to limited integration with global financial markets. However banks had built up adequate liquidity and capital buffers following recent reform initiatives by African regulators and policy makers.

Notwithstanding the resilience of the African financial system, smart regulatory measures were instituted to shield the financial sector from local and global turbulences. More importantly these measures were intended to build strong institutions that could catalyse economic development.

The usual reaction after a crisis is to increase the level of regulation. But for us we have realized that better regulation is the best path and allows space for innovation.

Deliberate measures were taken to minimize regulatory arbitrage. For instance Kenya has in the past few years seen the emergence of financial conglomerates with interests in different financial sub sectors such as insurance, banking, capital markets and retirement benefits. Whereas these conglomerates facilitate “one-stop financial services” there is a risk of regulatory arbitrage as they are subject to different sectoral regulators, the Central Bank of Kenya (CBK) for banking, the Insurance Regulatory Authority (IRA) for insurance, the Capital Markets Authority (CMA) for capital markets and the Retirement Benefits Authority (RBA) for retirement benefits.

To mitigate this arbitrage risk and promote information sharing and supervisory co-ordination, the four domestic financial sector regulators entered into a Memorandum of Understanding in August 2009. The MOU provides for the sharing of information and supervisory co-ordination amongst the four regulators. A Joint Technical Committee oversees the implementation of the MOU and has already started work on the review of the regulators supervisory methodologies. This committee supports the Boards of the four regulators who jointly meet periodically to review progress in

the identified areas of co-operation. The MOU has seen the increased sharing of information amongst the four regulators which will promote stability of the Kenyan financial sector.

On the regional front, significant strides have been made towards the integration of the East African Community (EAC) consisting of Kenya, Uganda, Tanzania, Rwanda and Burundi. A Customs Union and Common Market are in place and preparatory work for a monetary union has recently commenced.

Financial institutions particularly Kenyan banks, have taken advantage of the EAC and are extending their footprint across the region. This is a welcome development that will serve to integrate regional financial markets. However regional banking groups may also lead to regulatory arbitrage risk given the different regulatory regimes faced by such groups. Different regulatory regimes also lead to increased compliance costs for these groups that may deter their expansion.

In light of this, the East African Central Banks entered into a Memorandum of Understanding in 2008 to facilitate information sharing and supervisory co-ordination of banking groups. Joint inspections amongst the five central banks are already being carried out to facilitate harmonization of supervisory methodologies. The EAC Central Banks are also working on reforms with regard to anti-money laundering, credit information sharing, microfinance, risk based supervision and adherence to international standards on bank supervision and accounting. When implemented across the five EAC countries, these reforms will reduce the risk of regulatory arbitrage and the compliance costs faced by regional banking groups.

In summary, the financial crisis was an opportunity for us but also a painful economic loss. But it has allowed us:

- To build space for strong institutions that define the appropriate incentive framework that encourages prudent behaviour;
- The Government protected development programmes and budgets in this time of crisis and so enable increased capacity for future growth – that is why resurgence of growth is visible today.
- To allow space for banks and other financial actors to introduce innovative products in the market;
- To create room for strong and stronger banks that will cover EAC; and finally,
- The Central Bank has taken measures to strengthen the financial sector through the introduction of new institutions and new proposals for reform:

- Credit Reference Bureaus (CRBs) – build information capital to solve information asymmetry
 - New models to reduce the cost of doing business – Agent Banking.
 - Required legislation to support National Payments System
 - Required legislation to support and enhance Deposit Protection Insurance
 - Financial Education Program (FEP)
- To increase the level of financial inclusion

Thank you