CENTRAL BANK OF KENYA

Remarks by

PROF. NJUGUNA NDUNG'U
GOVERNOR
CENTRAL BANK OF KENYA

at

A MEETING OF THE ACTUARIAL SOCIETY OF KENYA

………. Hotel, Nairobi
March 16, 2009

REMARKS BY THE GOVERNOR A MEETING OF THE ACTUARIAL SOCIETY OF KENYA – MARCH 16TH 2009

Chairman of the Actuarial Society of Kenya;

Members of the Actuarial Society of Kenya;

Distinguished Guests;

Ladies and Gentlemen:

It is both a pleasure and honour for me to speak here on a very topical and timely issue in Kenya and I look forward to a lively and informative discussion. My talk will focus on what monetary policy can do in providing support for economic development in Kenya.

Let me start out by being clear on what I think we mean by "monetary policy"- which I will take to mean the actions which are taken by central banks with a view to influencing the quantity, cost and availability of money in the economy. These measures consequently define the direction of the ultimate objectives of economic policy.

The Central Bank of Kenya (CBK) was established in 1963 to replace the then East African Currency Board (ECB). The ECB purely dealt with the issuance of local currency for the East African countries (Kenya, Uganda and Tanganyika).

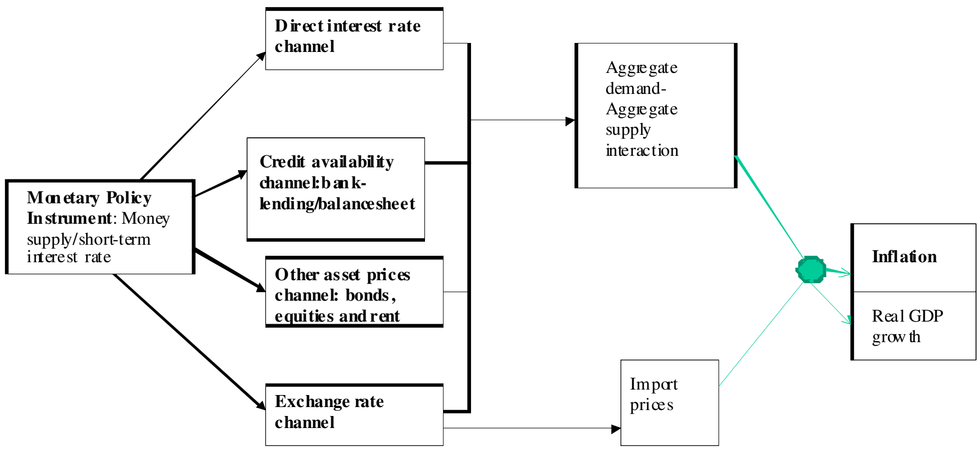
CBK's current principal objective is formulation and implementation of monetary policy directed to achieving and maintaining stability in the general level of prices. This function is consistent with low stable inflation. The second principal objective is to foster the liquidity, solvency and proper functioning of a stable market-based financial system. This is achieved through its oversight function over commercial banks and non bank financial institutions.

Like other central banks in the world, the CBK performs other functions including promoting an efficient national payments and settlement system; issuance of currency; provision of banking services to commercial banks and Government; fiscal agent; management of the country's foreign exchange reserves and promoting the economic development agenda of Government, including its objectives for growth and employment.

CBK's monetary policy strategy is aimed at aligning the growth of broad money (M3) to the target growth of real GDP (or total output of goods and services) and the inflation rate. The ultimate target is inflation and broad money is the intermediate target. The CBK impacts on these targets via an operating target called reserve money. The reserve money comprises of CBK's liabilities that include currency in circulation and deposits of commercial banks held with it (partly to facilitate interbank settlements and partly for overall liquidity management).

In achieving its objectives, the CBK uses several monetary policy instruments which include repurchase agreements (repos), reverse repos, term auction deposits, and overnight lending to commercial banks, the Central Bank Rate (CBR) and cash ratio. The repurchase agreements with commercial banks are designed to fine tune interbank money market liquidity to ensure that the operating target is achieved, while the CBR is purely a signalling rate which indicates the direction to which interest rates ought to move. The cash ratio is a direct credit control instrument, which works by enhancing or reducing the ability to create credit out of a given deposit base.

Monetary policy decisions are transmitted into changes in real GDP and inflation through four channels: interest rate channel, credit availability channel (bank-lending channel and balance sheet channel), exchange rate channel and other asset prices channel. There are strong indications that recent inflationary pressures are not associated with money supply growth but largely reflect supply side shocks emanating from drought and rigidities in the food distribution networks. The trend of overall inflation mirrors trend of the food inflation component in the consumer price index (CPI) basket. This however, does not mean the risk for money based inflation is cleared. As a nation we have lived through such phases before.



Monetary policy in any country matters and poorly designed monetary policy strategies can result in costly economic crises. The Asian crisis of 1997 and the collapse of the Argentina Currency Board arrangement of 2001 are stark reminders that poorly designed monetary policy can cause economic problems.

Monetary policy can best contribute to economic growth over the medium-term through its price stability function. Low and stable inflation is consistent with a broadly stable macroeconomic environment, with an effective communication strategy. Price stability improves the ability of the price system to spread information about how resources are to be allocated to areas where they benefit the citizens (through increased output and employment). In a market economy like Kenya, it is the task of the price system to communicate information, for instance about household preferences and, therefore provide signals to maximize efficiency in the employment of the factors of production. Thus, inflation can affect the wellbeing of the poor by influencing long-run growth and by influencing the distribution of income.

- High inflation creates uncertainty, generates expectations of future macroeconomic instability and distortionary policies, disrupts financial markets, and creates high effective tax rates on capital.
- It discourages investment of all types: physical capital accumulation, human capital accumulation, innovation, research and development, and foreign direct investment and technology transfer. As a result, it can retard growth.
- High inflation may lower work effort and lead to rent seeking. This can also erode a country's average standard of living.
- Inflation and macroeconomic volatility may harm some sectors of the economy disproportionately. For example, inflation may be particularly harmful to simple manufacturing or export-oriented industries. Depending on the relative position of the workers in these industries, this can either increase or decrease inequality.
- Finally, price stability is particularly beneficial for the political cohesion of society, because inflation brings about an undemocratic redistribution of economic resources.

It is because of the above that the "Economic Recovery Strategy for Wealth and Employment Creation" (ERS) for the period 2003-2007 and the current Medium Term Plan (2008-12) under Vision 2030 are partly anchored on macroeconomic stability. The Medium Term Plan 2008-12 is the first phase of Vision 2030. The Kenya Vision 2030 envisages that financial services will play a critical role by providing better intermediation between savings and investments. This will assist the mobilisation of investment funds that are required to implement the projects of Vision 2030. The CBK is working to improve intermediation efficiency in the banking system in support of Vision 2030 goals.

In recognition of the pivotal role of macroeconomic stability, the Central Bank took steps at the end of last year to facilitate availability of liquidity and reduction in interest rates by lowering the cash ratio from 6% to 5% and lowering the CBR from 9 % to 8.5 %. The policy measures were intended to ease liquidity tightness in the money market (indicated by a protracted rise in the short term interest rates and declining volumes of interbank trading). The measures provided the signal and the basis for increased interbank trading at lower interest rates.

Besides the task of safeguarding price stability, CBK is also responsible for the country's national payment system. The proper functioning of a modern economy requires that payments be carried out in a safe and efficient way. In order for payment systems to function, it is important that financial stability is maintained, through proper risk management practices in the banking sector. There are close connections between the responsibility of CBK for price stability and its responsibility for financial system stability. In order for the Central Bank's policy instruments to have the desired effect on interest rate formation, it is important that the national payment systems function efficiently and securely, since monetary policy instruments operate via the payment systems. Price stability can further be threatened by financial imbalances and by financial instability. At the same time a monetary policy focused on price stability *per se* reduces the risk for financial instability. Thus, price stability and financial stability are both required to create conducive conditions for economic growth, and CBK plays an important role in achieving both goals.

Other no less important features of macroeconomic stability include low and stable interest rates and stable exchanges rates. Low, positive and stable interest rates promote savings mobilization and investment which is positively correlated with economic growth. A stable exchange rate is a critical component in the decision making process of economic agents. Unstable exchange rates introduce uncertainty that affect decision. Kenya has a managed float exchange rate regime, with interventions purely for smoothening out unwarranted exchange rate fluctuations.

In conclusion, an appropriate monetary policy is a pre-condition for economic development in Kenya and without it our aspiration for economic development as stated in Vision 2030 will be severely impaired. Under the ERS 2003-2007, economic growth recovered from near stagnation in 2002 to 7 percent in 2007. The recovery process reversed in 2008 owing to effects of the post election violence, high global commodity prices, drought, and the global financial crisis. Even under these harsh conditions, the CBK is still keen to provide an enabling macroeconomic environment characterized by price stability and low market determined interest rates and market determined stable exchange rates.

Thank you very much for your attention.