CENTRAL BANK OF KENYA

Keynote Address

by

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during the

PUBLIC DEBT, FISCAL POLICY AND FORWARD LOOKING MONETARY POLICY

at the

2^{ND} ANNUAL RESEARCH SEMINAR OF THE KENYA SCHOOL OF MONETARY STUDIES RESEARCH CENTRE

Kenya School of Monetary Studies, Nairobi

Tuesday, 18th November 2014

Invited Guests;

Chairman of the Central Bank of Kenya Board of Directors;

Members of the Monetary Policy Committee;

Researchers;

Distinguished Guests;

Ladies and Gentlemen:

Good Morning. It gives me great pleasure to be here this morning at the official opening of the Research Seminar on '**Public Debt, Fiscal Policy and Forward Looking Monetary Policy**' organized by the Research Centre at KSMS.

As you are aware this is the second time we are gathered here to discuss the research findings of our researchers. A look at the papers in today's program shows that they are as a result of collaborative effort of researchers in the Bank and other esteemed institutions. Collaborative and comprehensive research is key to good policy advice work.

Ladies and Gentlemen, the title of this research seminar touches on a very important and current topic. Looking globally, a number of countries are going through a time of hardship. Public debt is a real economy problem when not sustainable. When public debt is unsustainable, it creates a debt overhang problem with the effect that the private sector believes the government will raise taxes in future to pay the public debt. The effect is on private investment since the private sector acquires a waiting option and finally, these effects slow down growth. Thus, the most important challenge to debt sustainability and this will restore growth trajectory to dislodge the market from this waiting option.

To achieve this objective many difficult and far-reaching decisions have to be taken. Against this backdrop, forums such as this one are essential for sharing ideas. After all, scientific research is a central pillar of good decision-making. Therefore, I would like to thank the Kenya School of Monetary Studies for organising this event.

Why *public debt, fiscal policy and forward looking monetary policy*? My starting point is to draw our attention to the principal objective of macroeconomic policy, which is to achieve sustainable economic growth in a context of macro stability. To achieve this, monetary and fiscal policies have to play their roles and their success is largely dependent on how they anchor public expectations.

Ladies and gentlemen, there are interesting studies on fiscal policy and economy growing with debt; and monetary policy and fiscal dominance. They come to interesting conclusions, but the most important is policy coordination.

Why is policy coordination important?

- Monetary policy is about short-run decisions on the direction of prices, and affects nominal variables; while fiscal policy affects real variables.
- It makes it easier for policy makers to achieve their stated policy objectives in a coherent and efficient manner.
- Ensures commitment to mutually agreed upon objectives, thus helping to eliminate the problem of time inconsistency in the design of policy.
- It enhances the credibility, anchors public expectations, ensures sustainability of fiscal and monetary policies, thus promoting macroeconomic stability.

Ladies and gentlemen, to ensure success of policy coordination we need either of the following:

- A continuous interaction between the fiscal and monetary authorities to decide jointly on aspects relating to policy design and implementation, or;
- A set of rules and procedures that minimize the need for frequent interaction.

But we know all these, why was the EU zone not successful?

As noted by **Sargent** and **Wallace** in their famous article "*Some unpleasant monetarist arithmetic*", 'tighter money today leads to higher inflation not only eventually but starting today'. The paradox for tight monetary policy and heavy debt expansion will lead to economic stagnation, Eddie Buffie has demonstrated this for a number of countries in this region. Moreover, **ladies and gentlemen**, the lack of credibility of the overall policy framework caused by the long-term inconsistency of such mix in signals diminishes the effectiveness of monetary policy.

Our experience with fighting inflation in Kenya suggests that inflation may be occasioned by demand side as well as supply side factors. Monetary policy uses interest rate as an instrument to fight inflation and anchor inflationary expectations. Fiscal policy on the other hand raising debt domestically and using a mix of debt instruments drives the domestic interest rate structure. How policy makers coordinate and consolidate their efforts not only affects expectations concerning future policies and outcomes but can also affect the outcome of economic activity.

Ladies and gentlemen, several papers that link fiscal policy, monetary policy and inflation have been lined up for presentation today. As you listen to the presentations and the discussions, it is important that we filter the conclusions first to reach to the frontier of this subject matter and provide renewed thinking in the policy arena. The recommendations of these papers should fit in the policy dialogue and policy making process to support growth and employment as envisaged in Vision 2030 in Kenya.

As I conclude, I would like to thank all the participants present. I hope the issues addressed in today's contributions will provide the basis for a rewarding discussion.

Once again— you are all very welcome!

It is my pleasure to declare this workshop officially open.

Thank you