The Central Bank of Kenya's Exchange Rate Policy

There has been an increasing interest by the public and media regarding the movement of the Kenya Shilling exchange rate in the recent past. Consequently, the number of commentators on the subject has risen. Discussions have focused on the *adequacy* of the existing foreign exchange reserves. A proper treatment of the subject must therefore begin with an understanding of the CBK's overall price stability mandate and the exercise of this mandate within a floating exchange rate regime and a liberalised capital account. In 1944, when the International Monetary Fund was founded, its main role was clearly defined to support countries facing temporary shocks in their balance of payments so that they did not have to make radical adjustments in the price of their currency. The existence of this facility gave rise to confidence in currencies leading to smoother international trade. This is indeed the role of foreign exchange reserves.

The CBK's primary responsibility is formulating and implementing monetary policy to achieve stability in the general price level, this includes the exchange rate which is the price of the Kenya Shilling expressed in other currencies. To realize the price stability objective the CBK uses a combination of indirect monetary policy tools or instruments such as Open Market Operations, and statutory requirements stipulated by law. These instruments include foreign exchange market operations. The CBK participates in the foreign exchange market mainly to acquire foreign exchange to service official debt, finance government imports, build its foreign exchange reserves, and, in times of volatility, buy or sell foreign exchange to stabilise the market. In this regard, foreign exchange reserves are also an indirect instrument of monetary policy and can be used for liquidity management. This is because buying or selling of foreign exchange injects or withdraws Kenya Shillings from the market.

The CBK therefore provides the policy environment on the exchange rate and cannot target a particular level or direction of the exchange rate. Some market segments have, on certain occasions, misrepresented the CBK's participation in the market as if it intended to defend a particular level or direction of change of the exchange rate. This is not true. CBK's participation in the foreign exchange market is usually aimed at stemming excessive volatility in the movement of the exchange rate. This is part of its price stability objective since the exchange rate is also a price. Supporting a specific level or direction of movement of the exchange rate in a liberalised foreign exchange market with an open capital account is neither sensible nor achievable. The Central Bank or the country for that matter, would not have the resources to support such a strategy in the face of a speculative attack. Once a country opts for a floating exchange rate with an open capital account, it cedes the power to defend a specific level or direction of the exchange rate.

To demonstrate this fact, in the early 1990s, the European Community operated the European Exchange Rate Mechanism, a semi-pegged currency system in which European Community member states pledged to maintain their exchange rates within certain bands to reduce volatility and achieve monetary stability. By so doing, they opened themselves to speculative attacks, forcing the respective governments to defend their currencies and subsequently causing heavy reserve losses. This scenario was later dubbed –"*you cannot lean against the wind*". Needless to say, the system was abandoned. This example confirms the futility of targeting a specific exchange rate while at the same time maintaining an open capital account. In our liberalised foreign exchange regime, the CBK allows the exchange rate to move in line with the fundamentals in the economy. One major factor that determines the demand and supply of foreign exchange in the country is the value of exports and imports of goods and services, which constitute the current account balance. A growing deficit in the current account signals that the exchange rate will in future depreciate due to reduced supply of foreign exchange in the market.

We now look at how the CBK uses its foreign exchange reserves. Section 26 of the CBK Act obligates the Bank to "*at all times use its best endeavours to maintain a reserve of external assets at an aggregate amount of not less than the value of four months imports as recorded and averaged for the last three preceding years*". There is no magic in the four month import cover number but rather convenience to enable the CBK to fulfil its role as and when required. The foreign exchange market activity of the CBK serves the greater monetary policy goal of managing liquidity in the banking system. Whenever the Central Bank buys foreign exchange, it is, in effect, injecting Kenya Shilling liquidity into the market. When it sells foreign exchange, it effectively mops up the local currency with the objective of achieving predetermined liquidity targets. Whether buying or selling foreign exchange, the Bank's market activity should be understood in terms of its broader policy goals of enhancing confidence and predictability of the value of the currency and providing ample liquidity to the banking system.

As mentioned, the overriding goal of monetary policy is maintaining price stability. Monetary policy is formulated in line with the inflation profile, given that this is the foremost threat to monetary stability in any country. Inflation can seriously undermine the value of the Kenya Shilling (exchange rate), causing exports to lose competitiveness and consequently decreasing earnings of foreign exchange. In the long-run, once the appropriate monetary policy stance for dealing with inflation has been established, the Central Bank deploys its instruments to manage liquidity along the predetermined path consistent with that monetary policy stance. This involves the mop up or injection of liquidity required, using either Repos, Term Auction Deposts or foreign exchange sales or purchases.

In most countries across the world, periods of economic or political uncertainty are characterised by potential investors postponing some of their planned investment in fixed irreversible assets. They instead prefer to a wait for the political cycle or the prevailing uncertainty to resolve itself. In the meantime, these potential investors will invest in short-term financial assets. The current market liquidity situation in the country is therefore the result of conscious and risk averse decisions by market participants. However, since the market fundamentals are right, monetary policy operations should work to manage such liquidity in the short term. The economic fundamentals remain healthy; hence the exchange rate is simply playing its role as an automatic stabiliser to smoothen any fluctuations.

Central Bank of Kenya
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