THE EXCHANGE RATE AND THE PERFORMANCE OF THE KENYA SHILLING

There has been an increasing debate in the media regarding the exchange rate and the performance of the Kenya Shilling. Discussions on this topic have centred on the recent weakening of the Kenya Shilling suggesting that this is a bad outcome for the economy. Some of these discussions have implied that the Shilling should always strengthen. However, this perception needs to be modified so that the market is properly informed and not misled by some commentators who have focused, indirectly, on their portfolio returns where the exchange rate plays a vital role. A competitive exchange rate ensures that the interests of both exporters and importers are balanced. In this regard, movements in the exchange rate serve to correct any imbalances in the market. The movement of the exchange rate cannot therefore be classified as good or bad if it is adjusting to economic factors.

1. ***What is the Central Bank's policy towards the exchange rate?***

   The proper context of this discussion must be premised on the understanding of the CBK's mandate of overall price stability within the framework of a floating exchange rate regime and a liberalised capital account. This policy setting means that the exchange rate adjusts – it weakens or strengthens – in line with economic factors including trade, production and investment in the economy. The CBK therefore provides the policy environment and does not target a particular level or direction of change of the exchange rate. It participates in the foreign exchange market as and when it is necessary to stem excessive volatility emanating from external shocks, or to cover a short-term shortage of foreign exchange liquidity in the market, or to effect Government external payments obligations, also when it is building its foreign exchange reserves to increase the months of import cover position. Moreover, whenever the Monetary Policy Committee (MPC) holds its bi-monthly meetings, it considers developments in the exchange rate market among other factors when deciding on the monetary policy stance to be adopted to deliver its price stability objective as well as macroeconomic stability.

   To put this matter in a different context, the financial market in Kenya currently transacts between USD 350 to 500 million a day, that translates to between USD 12 and 15 billion a month. The Central Bank endeavours to keep foreign exchange reserves equivalent to 4 months of import cover that is currently slightly over USD 4 billion. This therefore means that were the CBK to intervene in an attempt to hold the exchange rate at a particular level or move it towards a certain direction, its holdings of reserves would not last even a week.

2. ***What does a weak Shilling mean to Kenya?***

   There is a negative implication when the Kenya Shilling depreciates as this implies a higher cost in Shillings to finance imports. However, there is also a positive side to a weak Shilling as it means lower foreign prices for our exports; this increases the country's competitiveness in the world market, which improves our balance of trade position. Further, a weak Shilling promotes domestic investments that create employment and also discourages final consumption of luxury imports. All these are necessary to improve the current account balance and support economic growth. For instance, in 2011 there was a large current account deficit of about 11 percent of GDP, the exchange rate had to depreciate significantly to correct this imbalance in the economy. However, for a small, open, developing economy like Kenya that has a huge oil import bill, a protracted weakening of the Shilling may eventually cause inflationary pressures by knock-on effects through energy prices via consumption and production processes. This is not the case currently.

3. ***What does a strong Shilling mean for Kenya?***

   A strong Kenya Shilling reduces the competitiveness of our exports which could dampen economic growth. Kenyan exports become expensive abroad and imports become cheaper thereby discouraging domestic competitive industries as the share of foreign goods in our domestic market increases. Furthermore, a high interest rate which discourages domestic investment, which in turn impacts negatively on economic growth and employment, is generally associated with short-term inflows of foreign exchange which strengthens the Shilling. Strengthening the Shilling by short-term foreign exchange inflows increases the risk of exchange rate instability since these can be easily reversed.

   An appreciating currency is like a tax hike. It increases the burden on manufacturers of domestic goods while making imports cheaper domestically. This can lead to a recession as excess capacity can trigger layoffs. As the economy goes into a recession there would be a weak effective demand and the National Treasury would collect less tax revenue which would undermine the activities of the Government.

By now most readers must be asking what then is the desirable rate of exchange of the Shilling to the US Dollar? On a broader perspective with respect to this subject, a depreciation or appreciation of a currency is an adjustment process in response to the underlying fundamentals. Economists generally agree that a desirable exchange rate should be at a level that makes a country's export of goods and services competitive in the world market. A large proportion of the discussion on the exchange rate in the media has been at the level of discovering if the currency is misaligned – that is whether it is overvalued or undervalued. Recent analysis by the MPC shows that over the years the exchange rate is never misaligned beyond a range of about 5 percent and so we expect the exchange rate will move to correct for any imbalances in the long-run.

<u>CENTRAL BANK OF KENYA</u>