CENTRAL BANK OF KENYA

# CBK NEWSLETTER

*Keeping you informed*

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**INSIDE THIS ISSUE**





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The CBK Newsletter is published quarterly by the Central Bank of Kenya, Communications Office.

## *Message from the Governor*

I am pleased to present this inaugural edition of the CBK Newsletter.

The Central Bank is committed to improving communication, not only with the financial market players, but also with the general public. This is aimed at providing timely data and sharing information as the Bank performs its core mandate of steering the Kenyan economy and financial markets. Guided by our belief that effective communication with the public enhances transparency and fosters predictability and policy effectiveness, the Central Bank has expanded its communication channels by introducing this quarterly Newsletter. We believe besides communication, the CBK Newsletter will support information process and decision making.

In 2009, the Bank re-launched its website with more enriched information as a first step towards wider communication with the public. CBK has noted significant response and interest from its audience. This newsletter therefore aims to buttress this role of communicating to the public by providing news and information that will help promote understanding of the Central Bank's responsibility.

The Bank aims to use the Newsletter as an avenue of providing regular news on new products, exchange rates, government securities among other activities that CBK is engaged in. The newsletter will also carry opinion articles and commentaries on issues affecting the general public, such as commercial banks lending rates and the introduction of Credit Reference Bureaus (CRBs). It is my hope that you will use the feedback opportunity provided through this and future editions of this quarterly Newsletter to share ideas with us so that we can enhance our mutual understanding. This way, we will be able to improve the understanding and effectiveness of Kenya's monetary policy and financial stability, thereby drawing us closer to the national goal of economic development geared towards our vision of being a newly industrialized and prosperous nation.

**PROF. NJUGUNA NDUNG'U**

## Credit Information Sharing to be effected from 31st July, 2010

The Banking (Credit Reference Bureau) Regulations, 2008 were published in July 2008 and came into operation on 2nd February 2009. The Regulations, which provide for the licensing and supervision of Credit Reference Bureaus (CRBs) by the Central Bank, create a closed user group for credit information sharing for institutions licensed under the Banking Act. A closed user group means that only institutions licensed under the Banking Act, namely, commercial banks, mortgage finance companies and non-bank financial institutions will be able to source information from licensed CRBs. The Regulations govern the operations of banking sector CRBs and have provisions on a customer's rights which include access to at least one free credit report annually. The Regulations also outline the responsibilities of institutions and CRBs as well as provide for the oversight of CRBs by CBK. The Regulations compel the sharing of information on non-performing loans but also allow for the sharing of information on performing loans.

CBK has since licensed one CRB, Credit Reference Bureau Africa Limited, while three other applications from Metropol Credit Reference Bureau Limited, Compuscan Kenya Limited and Credit Check Limited are at various stages of being processed. The introduction of CRBs in our financial landscape is an effort to encourage sharing of information by institutions so as to reduce the incidences of serial defaults by bank customers as well as minimise the incidences of non-performing loans. Credit information sharing will allow banks to distinguish between good and bad borrowers. Credit Information sharing will also present customers with the opportunity to negotiate for good credit terms when one has a good credit record. This means that the introduction of CRBs will inculcate a culture of observing credit terms. SMEs and individual borrowers stand to benefit greatly from the introduction of CRBs since they will be able to use their credit histories as collateral unlike in the past when they were constrained from accessing credit by lack of physical collateral.

The information to be shared by CRBs can either be positive or negative. Positive information includes bills paid when due, timely repayment of loans and advances, maintaining steady employment, and clean public records. Negative information includes late or defaulted payments on outstanding loans and advances, bankruptcy, fraud, foreclosures on collateral held by lenders, loss of employment, misapplication of borrowed funds, unpaid cheques and standing orders due to insufficient funds.

This information will be exchanged by banks on a monthly basis.

*Coming together, sharing together,*
*working together, succeeding together*
*- Unknown*

## Anti-Money Laundering Act passed

The Proceeds of Crime and Anti-Money Laundering Act, 2009 (Act No. 9 of 2009) ("AML Act") was passed by Parliament in December 2009 and came into operation on June 28, 2010. The AML Act is quite comprehensive in that it criminalizes the offence of money laundering; establishes the Financial Reporting Centre; stipulates anti-money laundering obligations for Reporting Institutions; establishes an Assets Recovery Agency including its powers and functions and also establishes the Criminal Assets Recovery Fund. The Act also has extensive and elaborate procedures for both Civil and Criminal Forfeiture and international assistance in investigations and proceedings. The enactment of the AML Act will provide Kenya with the requisite legal and institutional framework to tackle the problem of money laundering in the country. Some key highlights of the AML Act include: Money laundering is an offence punishable with up to fourteen years imprisonment and a fine of up to five million shillings; Persons intending to convey monetary instruments in excess of USD 10,000 or its equivalent in any currency to or from Kenya will be required to report the particulars of such conveyance to authorised personnel; Reporting Institutions will be required to report suspicious transaction and cash transactions above USD 10,000 or its equivalent in any currency to the Financial Reporting Centre. They will also be required to verify their customers' identity, establish and maintain customer records as well as establish and maintain internal reporting procedures.

## Domestic Tourism Survey

The Central Bank of Kenya, Ministry of Tourism, Kenya National Bureau of Statistics (KNBS), and Kenya Tourism Board (KTB) are conducting a domestic tourism survey. The Tourism Satellite Account (TSA) Project for Kenya started with a feasibility study in 2002 funded by UNDP with technical assistance provided by the United Nations World Tourism Organization (UNWTO).The study identified gaps in the tourism statistics system for Kenya and recommended an inbound and outbound tourism expenditure survey, diagnosis of the domestic tourism in Kenya and establishment of an institutional framework for implementation of the survey.

The first phase of the Inbound and Outbound Tourism Expenditure Surveys was implemented in 2004 (April and October) covering key entry points into Kenya, i.e. Jomo Kenyatta International Airport, Moi International Airport, Lunga Lunga, Namanga, Malaba, Isebania and Busia.

**Tourism Survey Account**

- Is a standard framework for organizing statistical data on tourism.
- Is a powerful instrument for designing economic policies related to tourism development.
- Measures the contribution of tourism to GDP.
- Provides credible data on the impact of tourism and the associated employment.
- Provides data on impact of tourism on the Balance of Payments.
- Provides information on Tourism Human Resource characteristics.

The 20-day domestic tourism survey started on 7th June 2010. The Central Bank was represented in the Technical Committee of the TSA by two officers from the Research department.

Tourism Satellite Account (TSA) is a statistical instrument designed to measure tourism related goods and services according to international standards of concepts, classifications and definitions which allow for valid comparisons with other industries and eventually from country to country and between groups of countries.

## Association of African Central Banks Governors meet

The Central Bank of Kenya (CBK) as the Chair of the AACB, Eastern Africa sub-region, hosted the 9th Annual meeting in Nairobi on 14th July, 2010. The objective of the AACB is to promote co-operation in monetary, banking and financial spheres in Africa. To achieve this objective, AACB has been implementing the African Monetary Cooperation Programme (AMCP) since 2002. The aim of this programme is to put in place, at the end of a successful convergence process, a common currency and a common Central Bank at the continental level by 2021.

The meeting reviewed the progress on the implementation of the AMCP by the Eastern Africa sub-region countries in 2009, macroeconomic performance against the AMCP targets and the status of execution of the decisions of the 8th meeting of Governors of the sub-region held in Moroni, Comoros. The meeting was attended by seven Central Banks, namely Central Bank of Kenya, Bank of Mauritius, National Bank of Rwanda, Bank of Uganda, Bank of the Republic of Burundi, Central Bank of Comoros and the Bank of Tanzania.

*Team Player: One who unites others toward a shared destiny through sharing information and ideas, empowering others and developing trust.*

*Dennis Kinlaw*

# Proper handling of Kenyan Currency

The Central Bank of Kenya has adopted a Clean Currency Policy aimed at ensuring that currency circulating in Kenya is unsoiled and properly handled at all levels of its life cycle. The drive towards a clean currency policy has been necessitated by the fact that currency in circulation represents the face of a country and for that reason, it is paramount that as a country we must ensure that we only have the best currency in circulation. Secondly, printing and minting currency is not only expensive but also imposes an extra burden on the tax payer. Improper handling of currency depreciates the banknotes and coins faster than they ought to and as a result, the Central Bank will have to replace these currencies with new ones.

So, how do we go about handling our currency properly? The answer to this question could elicit several responses, most of which will be based on individual perceptions. However, not subjecting our currency to any form of deliberate damage would first and foremost ensure that the lifespan of our currency is not only prolonged but that it is appropriately kept. We have witnessed cashiers who jot their balancing numbers on the banknotes, hopefuls who put down their names or contacts on banknotes wishing that one day it will return to them or that a mate could contact them and then there are those that write a letter to pay a debt and affix some currencies on the letter by stapling. Folding, crumpling or shoving bank notes into the pockets without care, greatly damages them. These are just illustrations of how we deliberately damage our currencies. Common as these illustrations may seem, they shorten the lifespan of the currencies and thus become an expense to the country for their replacement.

**Bad handling of currency**

**Good handling of currency**

Therefore to effectively ensure that these currencies are properly handled and that the clean currency policy is effectively implemented, we urge all people who handle money, including public transport industry players, to avoid folding or crumpling the notes as this drastically increases their wear and tear.

Liquids, detergents and chemicals are known to have an adverse effect on banknotes when in contact. Genuine banknotes in circulation have some security features which clearly distinguish them from counterfeits. However, these features are washed away partially or completely when in contact with liquids especially those with detergents or chemicals. Simple checks such as emptying the pockets before a laundering process will ensure that the notes are not subjected to this kind of damage.

As a parting shot, we encourage all currency users to handle this precious commodity with a second thought. Avoid keeping the currencies in one's socks and shoes, close to our hearts and those dug out savings spots. We advise the public to invest in wallets, simple as they may be. For the public transport industry, investment in money pouches may be a good idea to ensure that the currencies are not only handled well but also for their security.

The Bank will continue striving towards improvement of cleanliness of currency in circulation by having a continuous withdrawal process of unfit notes and supply of clean currency. Under the laws of the land as described in the Penal Code Cap 63 Chapter **36,** improper currency handling which could lead to its mutilation is punishable.The specific provisions state as follows:-

**367A.** Any person who wilfully and without authority or excuse defaces, tears, cuts or otherwise mutilates any currency note shall be guilty of an offence and shall be liable to imprisonment for a term not exceeding three months or to a fine not exceeding two thousand shillings or to both.

**Sec. 368** Any person who deals with any coin in such a manner as to diminish its weight with intent that when so dealt with, it may pass as coin, is guilty of a felony and is liable to imprisonment for seven years.

**Sec. 369** Any person who melts down, breaks up, defaces by stamping thereon any name, word or mark, or uses otherwise than as currency any coin current for the time being in Kenya is guilty of a misdemeanour and is liable on conviction to a fine not exceeding eight thousand shillings or to imprisonment for six months or to both.

## CBK Spreads Its Outreach

The Nyeri Currency Centre serves the Mt Kenya region and occupies part of the Kenya Commercial Bank, Nyeri Branch premises. The response to this initiative by commercial banks and the general public in the region has been very encouraging. Mr Paul Tikani, Divisional Director Operations, KCB applauded the Central Bank for setting up the Centre. He said, "as a result of opening this Centre, our cost of transporting cash to Nairobi has reduced drastically. KCB has 22 branches in this region and each branch makes about 5 trips in a month at an estimated cost of Kshs. 40,000 per trip. This is commendable", he said. One KCB customer remarked that he was now being issued with cleaner notes than before.

Over the last six months in which the Centre has been operational, the number of banks using the service has increased from the initial 2 to 11 institutions.The second and third Currency Centres in Nakuru and Meru are expected to be operational by end of this year.

## Monetary Policy

One of the principal objectives of the Central Bank of Kenya (CBK) is to formulate and implement monetary policy directed to achieving and maintaining stability in the general level of prices. The responsibility for formulation of monetary policy is vested on the Monetary Policy Committee of the Bank. The CBK formulates and implements monetary policy with the aim of keeping inflation low and stable. This policy is designed to support higher levels of domestic savings and private investment, which in turn facilitate realization of better economic outcomes including improved and sustainable economic growth, higher real incomes and increased employment opportunities. The CBK pursues its monetary policy objectives through the following instruments:

1. **Open Market Operations (OMO):** Refers to actions by the CBK to vary the amount of commercial banks' deposits held with it in relation to the statutory requirement. Change in these deposits impact on the rate of interest at which credit is provided which in turn affects the growth of deposits held with commercial banks (which is the dominant component of money supply) and ultimately domestic

*Continued on page 6*

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prices. To achieve the desired level of money supply, OMO is conducted using the following instruments:

- o **Repurchase Agreements (Repos)** – Which consist of the sale or purchase of eligible securities by the CBK to reduce or augment commercial banks excess deposits held with it. Reverse repos are purchases of securities from commercial banks by the CBK during periods of tight liquidity in the market. Horizontal Repos are transacted at the commercial banks level. Commercial banks short of deposits at the CBK borrow from banks with excess deposits on the security of appropriate assets, mostly government securities. The instrument helps banks overcome the problem of credit limits, thus promoting efficient management of interbank liquidity.
- o **Term Auction Deposits** – The CBK acquires deposits from commercial banks at a price but with no exchange of security guarantee. The deposits are transferred to the CBK for a 7 day period after which they revert to the respective commercial bank on maturity of the transfer agreement.

2. **Central Bank Rate (CBR):** This is the rate of interest that the CBK charges on loans to commercial banks. It is reviewed and announced by the Monetary Policy Committee (MPC) at least every two months and its movements are a signal of the intended direction of the change of money interest rates.
The direction and magnitude of movements of the CBR signal the monetary policy stance of the Bank. This signal is first operationalised through movements of the short term interest rates. When interest rates decline, the quantity of credit demanded increases.
A reduction of the CBR signals an easing of monetary policy and a desire for market interest rates to move downwards. Lower interest rates encourage economic activities and thus growth. When interest rates decline, the quantity of credit demanded increases assuming other factors remain the same.
The efficiency of the OMO and interbank markets is crucial for the transmission of monetary policy decisions. By fixing a single tenor for bills sold or bought in the repo market, the monetary authority aims to sharpen the signaling process. At present, there is a fixed 7 day tenor for bills used in the repo market.

3. **Standing Facilities:** The CBK, as lender of last resort, provides secured loans to commercial banks on an overnight basis at an interest rate equal to the CBR.

4. **Required Reserve (RR):** The Required Reserve stipulated under Section 38 of the CBK Act is the proportion of a commercial bank's deposit liability which is held at the CBK. These deposits are held in the Cash Reserve Ratio (CRR) Account. The CBK uses the RR as a direct instrument for monetary policy. If the CRR is lowered, part of the blocked deposits initially mobilized by commercial banks would be availed to the banks and hence enhance their capacity to expand credit.

5. **Foreign Exchange Market Operations:** The CBK can also inject liquidity into or withdraw it from the banking system by engaging in foreign exchange transactions. A sale of foreign exchange to banks withdraws liquidity of local currency from the system while the purchase of foreign exchange injects liquidity into the system. Participation by CBK in the foreign exchange market is commonly motivated by the desire to prevent excessive volatility in the rate at which the Kenya shilling exchanges against other foreign currencies, to acquire foreign exchange to service official debt and build its foreign exchange reserves or for liquidity management. The credibility of the Kenya shilling as an internationally respected currency ensures that correspondent banks provide trade credit at convenient terms.

# The Regulatory Role of The Central Bank of Kenya

The Central Bank of Kenya was established pursuant to the CBK Act enacted in 1966. The principal objectives of CBK are set out in the Act as being to:-

1. Formulate and implement monetary policy directed to achieving and maintaining stability in the general level of prices.
2. Foster the liquidity, solvency and proper functioning of a stable market-based financial system.
3. Support government economic policies.

The focus of this article is on the second objective of fostering financial stability. CBK currently regulates banks, financial institutions (non-bank financial institutions whose principal difference with banks is that they do not operate current accounts), mortgage finance companies licensed under the Banking Act and Foreign Exchange Bureaus licensed under the CBK Act. In May 2008, the Microfinance Act became operational bringing Deposit Taking Microfinance (DTM) Institutions under the regulatory purview of the Central Bank. The Banking (Credit Reference Bureau) Regulations, 2008 were also published in July 2008. The Regulations have empowered CBK to license and oversee Credit Reference Bureaus (CRBs). CBK also regulates Building Societies licensed under the Building Societies Act. The mandate of the Bank currently covers 43 Commercial Banks, two Mortgage Finance Companies, 2 DTMs, 130 Foreign Exchange Bureaus and 1 Credit Reference Bureau (CRB).

How does CBK regulate and supervise the institutions under its purview? A "cradle to death'' regulatory and supervisory lifecycle is followed to ensure the stability of institutions and protection of depositors funds. At the ''cradle (birth)'', due diligence of license applications is conducted. The due diligence focuses on the viability of proposed institutions and the character ofthe proposed shareholders, directors and senior officers. The overarching objective of CBK's gate keeping role is to mitigate the risk of potentially unsound institutions entering the financial system.

During the life of an institution, CBK monitors the ongoing operations of institutions through a combination of onsite and offsite surveillance. Onsite surveillance involves the physical presence of CBK supervisory staff at institutions to validate their risk management frameworks. Offsite surveillance relies on submission of returns by institutions to the Central Bank. These returns whose frequency ranges from daily, fortnightly, monthly to quarterly are analysed and institutions requiring closer attention are identified.

Where institutions run into difficulties arising from insolvency and/or loss of market/depositor confidence, the Central Bank has to contain the potential systemic risk to the rest of the sector. This is usually done by the appointment of a Statutory Manager by the Central Bank. The Manager seeks to restructure the institution and put it back on a recovery path. Where the initiatives of the Statutory Manager do not bear fruit, the Central Bank has to ensure the orderly exit of the institution by placing it under liquidation by the Deposit Protection Fund Board (DPFB). It is however important to note that DPFB protects each depositor in the case of liquidation up to a maximum sum of Kshs. 100,000.

How does one know that an institution is under the regulatory ambit of CBK? Institutions licensed by the Central Bank are required to prominently display their licenses in their places of business. You can also access the Central Bank of Kenya website, www.centralbank.go.ke for directories of licensed institutions. This is but a flavour of CBK's regulatory mandate and in coming issues we shall delve into more details and current developments in this front.


**Kenya School of Monetary Studies, Ruaraka host to the CMI offices.**

# Hosting the COMESA Monetary Institute (CMI): A big win for Kenya

In October, 2009 the COMESA Committee of Governors of Central Banks ratified the decision for the Central Bank of Kenya to host the COMESA Monetary Institute (CMI) at the Kenya School of Monetary Studies (KSMS), Ruaraka, Kenya. Besides high level diplomacy among the regional Central Bank Governors, the win for Kenya followed months of intense competition and evaluation among the Central Banks in the COMESA region. This short article examines what hosting the COMESA Monetary Institute means for Kenya in general and the Central Bank of Kenya in particular, drawing from the experience of the European System.

The COMESA Monetary Institute, set to become operational in the course of 2010 will among other things monitor implementation of the Monetary Cooperation Programme and the harmonization of regulation of financial markets in the region. The COMESA Monetary Cooperation Programme is aimed at establishing a common monetary area with greater monetary stability in order to facilitate economic integration efforts and to provide sustained economic development of the sub-region with the ultimate objective of establishing a COMESA Monetary Union. Ultimately, the CMI will undertake technical preparatory work and sensitisation for the issue of a single currency and setting up of a common Central Bank for the region. This initiative is within a broader vision for the African Continent as was articulated in the Abuja Treaty of 1991 that envisaged the creation of Regional Monetary Unions that would ultimately merge to create a single African Central Bank and currency.

The establishment of a monetary union brings about a number of benefits which include among others: elimination of exchange rate risks within the region, reduction of costs in respect to cross border commerce; savings in currency conversion costs; deepening of financial markets than can be achieved under an individual member state; provision of opportunity for improvements in monetary policy management and enhancement of economies of scale in central banking thereby increasing the chances for real resource saving. Besides, there are other broader benefits associated with deeper integration, such as, increased trade, increased financial flows, employment and poverty reduction. For instance, already at the level of a Customs Union, COMESA region is increasingly becoming a very important destination for Kenya's exports, which on average takes up about 33 percent of the value of all exports from Kenya.

In addition, if the European system example is anything to go by, the European Monetary Institute (EMI) established in 1994, translated into the current European Central Bank (ECB) in 1998. The ECB inherited not only an executive body of preparatory work but also the whole EMI infrastructure, including a body of staff which had been prepared to undertake its studies at the ECB. This greatly helped the ECB to make the Euro system operational and enable change over to the Euro within a few months (Seven months). In this regard, hosting the CMI strategically places Kenya in a better position politically to bargain for the common COMESA Central Bank to be established in Kenya, when that time comes. Like in the European Union where the road to the Euro was from the onset entrusted to a Committee of Governors of Central Banks (in May 1964) after coming up with the first proposal for economic and monetary union in 1962, the COMESA Committee of Governors have set the stage for further monetary and financial integration of the region, by establishing the COMESA Monetary Institute.

It should be acknowledged that the road to a single currency for COMESA member countries will not be without challenges. It will require member countries to give up their autonomy in issuing and managing their national currencies. Member countries will also be required to cede cultural and sovereignty aspects they attach to their respective currencies. In a region with some of the worst conflicts and political instability, this supranational institutional arrangement will call for strong political will and serious compromises from all levels in the integration process. Since the Treaties of Rome in 1958 however, the experience of the EU suggests that monetary integration will not be without varying degrees of success and progress alternated with set backs. With the current world wide trend towards regional economic integration, there is very little choice for Africa in general and COMESA in particular, but to pursue deeper and faster economic integration.

*The establishment of a monetary union brings about a number of benefits which include among others: elimination of exchange rate risks within the region, reduction of costs in respect to cross border commerce, saving in currency conversion costs, deepening of financial markets than can be achieved under an individual member state, provides an opportunity for improvements in monetary policy management and enhancement of economies of scale in central banking increasing the chances for real resource saving.*

In a nutshell, the hosting and the expected establishment of the CMI is no mean achievement for the region and Kenya, in particular. The support and unity of purpose from all Government departments and agencies during the process of bidding and evaluation to host the CMI in Kenya, is highly commendable. However, this is just the beginning and such support will continuously be required if the Central Bank of Kenya is to deliver a CMI that meets members' expectations and drive the region to the next level of monetary and financial integration, that is, the level of a COMESA Monetary Union under a common Central Bank.

## Understanding Government Borrowing from Domestic Markets

The Central Bank as a Fiscal Agent of the Government of Kenya, has been mandated under the Internal Loans Act and the Central Bank of Kenya Act to raise domestic debt on behalf of the central Government. As Advisor to and Fiscal Agent of the GoK, CBK issues Government Securities, maintains the debt registrar, and makes all payments of interest and principal to investors (lenders). The Government Borrowing Programme details how CBK intends to raise the overall targeted amount in a Fiscal Year for the Government based on the latter's borrowing needs identified in the Cash Plan. The Programme takes into consideration all redemptions (at face value), new borrowing on net basis (at cost) and secondary market development initiatives – implementation of benchmark bonds program. It is reviewed regularly to reflect changes in borrowing targets relative to performance. It also reflects government borrowing strategies and objectives. The reason for domestic borrowing is to take care of shortfalls in revenue relative to expenditure – Financing Gap at the start of the FY or Supplementary Budget, financing development infrastructure projects and also for domestic markets development.

**ECONOMICS MADE EASY**

## Who is an Economist?

*An **economist** is a professional in the field of economics, the social science that examines how individuals and societies use scarce resources to satisfy unlimited wants. Central to the discipline of economics is the concept of choice, which necessitates a clear understanding of the concept of opportunity costs of one action and not the other. An economist conducts research and provides theories on all elements of society and the economy. In conducting research, an economist uses, analyses and syntesizes both quantitative and qualitative data and based on the research results, provides policy advice to policy makers in various economic fields. The essence of the social science is to recommend policy strategies to policy decision makers geared towards enhancing economic development.*

The truth is, by the time you swung out of the parking lot to join the city's ever increasing traffic this morning, you had made a myriad of economic decisions. Those decisions influence your expenditure patterns, and they are the basis for your personal economic policy.

Economics is basically about the choices we make daily in the face of the scarce financial resources at our disposal. Someone has said, *'the mouth never has enough to eat'* hence the perennial quest for more and more. But then the more we want, the less the ability to obtain these things. Whether it's choosing between buying salt and sugar, *ugali* and *matoke*, Datsun or Nissan, truth be told, we can't have them all. We have to choose one over the other and the choice is influenced by the size of our wallets. These decisions, however mundane, are economic decisions.

Of course there are fellows who read more in an attempt to unravel the causes and determinants of spending patterns.They have gained the necessary analytical tools, indeed the intellectual wherewithal to interpret the relationship between production, distribution and consumption, among other things. For their sweat, they have earned themselves a coveted title called '**ECONOMIST**'. You may not be familiar with the entire 'right' parlance to sufficiently engage in an animated discussion on the credit crunch. You may not describe a recession in the insider's lingua. The latest hype on sub-prime mortgage crisis may sound like balderdash. But understand this friend; the choices you made at the traffic jam and the resulting actions you took to save your little world from economic implosion are legitimate ECONOMIC decisions.

What! I hear you cry. Yes, that's right; professional titles aside, the moment you make spending decisions dictated by scarce economic resources, you are already in Economists' turf.

## Understanding Bonds

Simply put, a bond is a formal loan contract between lender (investor) and borrower (issuer) where the latter agrees to repay borrowed money with interest at fixed intervals according to the terms of the contract (Prospectus). The issuer is usually a Government (or its agency) and/or a large corporation which requires huge sums of money (capital) to finance certain operations and/or projects. On one hand, Governments or their agencies use bonds proceeds to finance their operations, specified infrastructural/developmental projects such as building roads, bridges, railway lines, and social programs. Companies on the other hand issue bonds to raise funds for expansion of their core business and to facilitate reach to larger markets.

The money lent by investors to the issuer of a bond is the *principal* or *face value* or *par value*. It is also the amount of money the bond holder (investor) will get back once it matures. By the privilege of investors lending money to the issuer, they get to earn 'something extra' referred to as a *coupon rate* which is received in form of interest payments made at predetermined rates and schedules. The date on which the issuer must repay the borrowed amount is the *maturity* date. The period between bond issuance (bought by investors) and maturity (repaid by issuer or retired) is referred to as the *life* of the bond. Bonds are fixed income securities because investors know the exact amount of cash they will get as coupons (interest) during a bond's life and the final value (face value) if they hold the bonds to maturity. As an example, let's assume that you invest Ksh 100,000 in a 10-year bond that pays fixed interest (coupon) of 5% p.a. The initial investment of Ksh 100,000 is the face value which you receive at the end of 10 years. You would then collect before tax interest payments of Ksh 5,000 (coupons) in each of the10 years if you hold it till maturity. If this bond pays interest semi-annually, then you would receive Ksh 2,500 before tax, every six months until maturity.

There are various types of bonds based on features or characteristics, type of issuer or markets where they are issued. Depending on your investment goals, tax situation and risk tolerance levels, you may choose from municipal, government, corporate, mortgage-backed, asset backed or international bonds/securities. Within each broad bond market sector, you will find securities with different issuers, credit ratings, coupon rates, maturities, yields and other features which offer varied risk-return levels.

Anything that has to be bought or sold has a price tag. The price of a bond depends on its *yield*, which measures the rate of return to the holder of the bond. The price moves in opposite direction from that of the yield. When you buy/sell the bond at par price, the yield is equal to the interest rate (coupon).

## CALENDAR OF EVENTS

**Monetary Policy Committee** meeting to take place on 28th July 2010.

**The First Monetary Policy Committee Public Forum** to take place on 10th August 2010, at Kenya School of Monetary Studies

## *DID YOU KNOW?*

The three pillars of Monetary Policy are?

- Price stability
- Sound financial system
- Reliable payments systems

You can get security details of Bank Notes on the CBK website

Link:
**http://www.centralbank.go.ke/currency/securityfeatures.aspx**

# Q and A - Currency Operations & Branch Administration

*Quite often, members of public raise questions about Kenyan currency notes and coins. Joyce Yego spoke to the Director, Currency Operations Branch and Administration on some of these issues. Excerpts.*

**QHow does Central Bank of Kenya procure currency notes and coins?**
**A** From the onset, currency production handling is a national security issue. Nevertheless, in procuring currency notes and coins, the Central Bank first determines the quantity of notes required by averaging the demand for each denomination in the past three years, then loads it to the projected increased demand.

Central Bank has been procuring its banknotes from De La Rue Currency and Security Print Limited and the coins from the Royal Mint of UK.

**Q Who decides on what security features should appear on the currency?**
**A** This is usually done by a technical team within the Currency Department in consultation with the management of the Bank. The department also gauges the threat of counterfeits that has been obtained at the time.

**Q With worn out notes, are members of the public free to visit the Central Bank of Kenya offices for replacement?**
**A** Yes. Genuine worn out, soiled, and burnt notes may be replaced at any Central Bank Branch country wide through the Banking office. The same service is also rendered by Commercial Banks. However, for these pieces of notes to qualify for replacement, they must be more than half their original sizes.

**Q What criteria is used to decide on the size of currency and coins?**
**A** The size of notes is usually determined by technological possibility. You will notice that the size of the notes has progressively been reducing mainly due to cost implications, without, of course, compromising any required features. Consideration for the visually challenged is also taken into account when deciding on the size of the notes.

**Q What influences the introduction or phasing out of a currency?**
**A** It is influenced mainly by demand. Other influencing factors include:-

- Purchasing power of any denomination
- Strength of the economy
- Counterfeiting
- Corruption
- Value

**Q How does the Bank decide on the quantities of currency to produce?**
**A** The quantity of currency is dependent on the demand while taking into account production lead times for the orders. It is also determined by strategic reserves to be held which act as buffer stocks in case of any unforeseen demands and technicalities in production.

**Q How does Central Bank of Kenya decide on which denominations to produce, i.e, is it possible to have a 70 or 80 shilling note?**
**A** The major factors influencing the denomination mix for any country includes simplicity to transact with the currency and common acceptability of the same. However, there are global tools such as the D-Metric model used in currency operations that assist in the determination of denomination mix for circulation.