**Central Banking**

**Formation and structure of the Central Bank of Kenya (From** [**www.centralbank.go.ke**](http://www.centralbank.go.ke)**)**

The Central Bank of Kenya was established in 1966 through an Act of Parliament - the Central Bank of Kenya Act of 1966.

The establishment of the Bank was a direct result of the desire among the three East African states to have independent monetary and financial policies. This led to the collapse of the East Africa Currency Board (EACB) in mid 1960s. Under the Central Bank of Kenya Act, the responsibility for determining the policy of the Bank, other than the formulation of monetary policy, is given to the Board of Directors. The Monetary Policy Committee of the Bank is responsible for formulating monetary policy.

The Board of Directors of the Bank consists of eight members:-

* the Governor, who is also its chairman
* the Deputy Governor, who is the deputy chairman
* the Permanent Secretary to the Treasury who is a non-voting member
* five other non- executive directors

All members are appointed by the President to hold office for a term of four years and are eligible for reappointment once, provided that a Board member shall hold office for not more than two terms. The executive management team comprises the Governor, the Deputy Governor and fifteen heads of department who report to the Governor. The Bank operates from its head office in Nairobi and has branch offices in Mombasa, Kisumu, Nakuru and Eldoret. The Bank also owns the Kenya School of Monetary Studies (KSMS) which is headed by an executive director answerable to the Governor.

**Mandate of the bank**Section 4 of the Central Bank of Kenya Act states the core mandate of the Bank as follows:

(1) The principal object of the Bank shall be to formulate and implement monetary policy directed to achieving and maintaining stability in the general level of prices;

(2) The Bank shall foster the liquidity, solvency and proper functioning of a stable market- based financial system; and

(3) Subject to (1) and (2), the Bank shall support the economic policy of the Government, including its objectives for growth and employment.

The other objectives of the Bank are enumerated under Section 4A of the Act, and empower the Bank to :-

* Formulate and implement foreign exchange policy
* Hold and manage its foreign exchange reserves;
* License and supervise authorized dealers;
* Formulate and implement such policies as best promote the establishment regulation and supervision of efficient and effective payment, clearing and settlement systems;
* Act as banker and adviser to, and as fiscal agent of the Government; and
* Issue currency notes and coins.

In pursuit of the above outlined mandate, the Central Bank operations are organized into the following functional areas:

* [Monetary policy](http://www.centralbank.go.ke/monetary/Default.aspx)
* [Notes and Coins](http://www.centralbank.go.ke/Currency/Default.aspx)
* [Bank Supervision](http://www.centralbank.go.ke/financialsystem/Default.aspx)
* [Treasury securities](http://www.centralbank.go.ke/securities/Default.aspx)
* [Publications and Research](http://www.centralbank.go.ke/publications/Default.aspx)
* [National Payments System](http://www.centralbank.go.ke/nps/Default.aspx)
* [Deposit Protection Fund](http://www.centralbank.go.ke/dpfb/Default.aspx)

In this course, we focus on monetary policy, bank supervision, and deposit protection.

**Monetary Policy**

The Central Bank’s principal object is formulation and implementation of monetary policy directed to achieving and maintaining stability in the general level of prices. The aim is to achieve stable prices – that is low inflation - and to sustain the value of the Kenya shilling. Following amendments to the law, Section 4 paragraph (4) provides that the Minister for Finance may by notice in writing to the Bank set the price stability targets of the Government.   
  
**Inflation**   
As is the case the world over, a central bank exists in a country to safeguard the value of its currency in terms of what it can purchase. When prices of goods and services in an economy keep on rising, the value of these goods and services that the currency can purchase –exchange for- diminishes. This leads to loss in value of the currency. Monetary policy is the main tool used in the preservation of the value of the currency in an economy. It involves the control of liquidity circulating an economy to levels consistent with growth and price objectives set by the Government. The volume of liquidity in circulation influences the levels of interest rates, and thus the relative value of the local currency against other currencies. It is the responsibility of the Monetary Policy Committee to formulate the monetary policy of the Central Bank of Kenya. Maintaining price stability is crucial for a proper functioning of a market-based economy. It encourages long-term investments and stability in the economy. Low and stable inflation refers to a price level that does not adversely affect the decisions of consumers and producers. Price stability is a precondition for achieving a wider economic goal of sustainable growth and employment. High rates of inflation lead to inefficiency in a market economy and, in the medium to longer term, to a lower rate of economic growth. Movements in the general price level are influenced by the amount of money in circulation, and productivity of the various economic sectors, the Central Bank of Kenya regulates the growth of the total money stock to a level that is consistent with a predetermined economic growth target as specified by the Government and outlined in its Monetary Policy Statement  
  
There are three major tools the Bank uses to implement monetary policy:

1. **Open Market Operations:** Through open market operations, the Bank buys or sells securities in the secondary market in order to achieve a desired level of Bank reserves. Alternatively, the Bank injects money into the economy through buying securities in exchange for money stock. As the law of supply and demand takes effect to determine the cost of credit (interest rates) in the money market, money stock adjusts itself to the desired level. This process influences availability of money in the economy.
2. **Discount window operations:** The Bank, as lender of last resort, may provide secured short-term loans to commercial banks on overnight basis at punitive rates, thus restricting banks to seek funding in the market resorting to Central Bank funds only as a last solution. The discount rate is set by the Central Bank to reflect the monetary policy objectives.
3. **Reserve Requirements:** The Central Bank is empowered by the law to retain a certain proportion of commercial banks' deposits to be held as non-interest bearing reserves at the Central Bank. An increase in reserve requirements restricts commercial banks ability to expand bank credit and the reverse is regarded as credit easing.

In addition, Quantitative easing (Part of assignment 2), and advance interest rate commitments are increasingly being used as monetary policy tools.

The policy of a central bank attempting to stimulate the economy by buying long-term securities is called quantitative easing. It is useful in extreme economic conditions when interest rates (on discount window operations have fallen to near zero).

**Open Market Operations versus Other Policy Tools**

Open market operations have several benefits that other policy tools lack: control, flexibility, and ease of implementation. Because the central bank initiates open market purchases and sales, it completely controls their volume. Discount loans depend in part on the willingness of banks to request the loans and so are not as completely under the CBK’s control. Open market operations are flexible because the CBK can make both large and small open market operations. Often, dynamic operations require large purchases or sales, whereas defensive operations call for small purchases or sales. Other policy tools lack such flexibility. Reversing open market operations is simple for the CBK. For example, if the CBK decides that its open market sales have made reserves grow too slowly, it can quickly authorize open market purchases. Discount loans and reserve requirement changes are more difficult to reverse quickly. The CBK can implement its open market operations rapidly, with no administrative delays. All that is required is for the trading desk to place buy or sell orders with the primary dealers. Changing the discount rate or reserve requirements requires lengthier deliberation.

The [Monetary Policy Committee (MPC)](http://www.centralbank.go.ke/monetary/monetaryPolicyCommittee.aspx) of the Bank sets the rate of interest at which the Central Bank charges on loans to commercial banks. This rate referred to as the Central Bank Rate (CBR). The rate signals the monetary policy stance of the Bank.

**Monetary Policy Committee**

**Role and Legal Status**The Monetary Policy Committee is the organ of the Central Bank of Kenya responsible for formulating monetary policy. The Committee was formed vide Gazette Notice 3771 on 30th April 2008 replacing the hitherto Monetary Policy Advisory Committee (MPAC)   
**Membership**The membership of the MPC is as follows:

* The Governor, who is the chairman;
* The Deputy Governor, who is the deputy chairman;
* Two members appointed by the Governor from the Bank. One being a person with executive responsibility within the Bank for monetary policy analysis (Director of Research Department) and the other is a person with responsibility within the Bank for monetary policy operations (External Payments and Reserves Management);
* Four external members who have knowledge, experience and expertise in matters relating to finance, banking, fiscal and monetary policy, who are appointed by the Minister for Finance. Currently these members are: Prof. Terry C. I. Ryan, Ms. Sheila M’Mbijjewe, Prof. Francis Mwega and Mrs. Farida Abdul.
* The Permanent Secretary, Ministry of Finance, or his designated alternate as representing the Treasury. The Treasury representative is a non-voting member o the committee.  
    
  Each external member of the Committee serves for a term of three years which is renewable once.   
  **Meetings**The Chairman of the MPC convenes a meeting of the Committee at least once every two months and will convene an additional meeting if requested in writing by at least four members. The quorum for meetings of the Committee is five members, one of whom must be the Chairman or Vice-Chairman. The decisions of the Committee in these meetings are communicated to the public through Press Releases from the Chairman.   
  **Statutory Requirements**At least once every six months the Committee prepares and submits a report to the Minister for Finance with respect to its activities. The Minister presents the Report to the National Assembly. In addition, the MPC is responsible for preparation of the bi-annual Monetary Policy Statement of the Bank. The Committee is supported by a secretariat, responsible for the information flow between itself and the rest of the Departments of the Bank.

GOALS OF MONETARY POLICY

Most economists and policymakers agree that the overall aim of monetary policy is to advance the economic well-being of the population. Although there are many ways to assess economic well-being, it is typically determined by the quantity and quality of goods and services that individuals can enjoy. Economic well-being arises from the efficient employment of labor and capital and the steady growth in output. In addition, stable economic conditions—minimal fluctuations in production and employment, steady interest rates, and smoothly functioning financial markets—are qualities that enhance economic well-being. The CBK has set six *monetary policy goals* that are intended to promote a well-functioning economy:

(1) Price stability,

(2) High employment,

(3) Economic growth,

(4) Stability of financial markets and institutions,

(5) Interest rate stability, and

(6) foreign-exchange market stability.

The central banks try to set monetary policy to achieve these goals.

**The conduct of monetary policy**

Monetary Targeting and Monetary Policy

The central bank’s objective in conducting monetary policy is to use its policy tools to achieve monetary policy goals. But the CBK often faces trade-offs in attempting to reach its goals, particularly the goals of high economic growth and low inflation. To demonstrate the problem, suppose the CBK, intending to spur economic growth, uses open market purchases to lower the target for the discount rate and to cause other market interest rates to fall. Open market purchases also increase the monetary base and the money supply. Lower interest rates typically increase consumer and business spending in the short run. But a larger money supply can potentially increase the inflation rate in the longer run. So, a policy that is intended to achieve one monetary policy goal (economic growth) may have an adverse effect on another (low inflation).

The CBK faces another problem in reaching its monetary policy goals. Although it hopes to encourage economic growth and price stability, it has no direct control over real output or the price level. Interactions among households and firms determine real output and the price level. The CBK can influence the price level or output only by using its monetary policy tools—open market operations, discount policy, reserve requirements, and interest on bank reserves. But these tools don’t permit the CBK to achieve its monetary policy goals directly.

The CBK also faces timing difficulties in using its monetary policy tools. The first obstacle preventing the CBK from acting quickly is the *information lag*. This is the CBK’s inability to observe instantaneously changes in GDP, inflation, or other economic variables. If the CBK lacks timely information, it may set a policy that doesn’t match actual economic conditions, and its actions can actually worsen the problems it is trying to correct. A second timing problem is the *impact lag*. This is the time that is required for monetary policy changes to affect output, employment, or inflation. Changes in interest rates and the money supply affect the economy over time, not immediately. Because of this lag, the CBK’s actions may affect the economy at the wrong time, and the CBK might not be able to recognize its mistakes soon enough to correct them. One possible solution to the problems caused by the information lag and impact lag is for the CBK to use targets to meet its goals. Targets partially solve the CBK’s inability to directly control the variables that determine economic performance, and they reduce the timing lags in observing and reacting to economic fluctuations. Unfortunately, targets also have problems, and some traditional targeting approaches have fallen out of favor at the CBK during the past.

**Using Targets to Meet Goals**

Targets are variables that the CBK can influence directly and that help achieve monetary policy goals. Traditionally, the CBK has relied on two types of targets: *policy* *instruments*—sometimes called *operating targets*—and *intermediate targets*. Although using policy instruments and intermediate targets is no longer the favored, reviewing how they work can provide some insight into the difficulties the CBK faces in executing monetary policy.

**Intermediate Targets**

Intermediate targets are typically either monetary aggregates, such as M1 or M2, or interest rates. The CBK can use as an intermediate target either a short-term interest rate, such as the interest rate on Treasury bills, or a long-term interest rate, such as the interest rate on corporate bonds or residential mortgages. The CBK typically chose an intermediate target that it believed would directly help it to achieve its goals. The idea was that by using an intermediate target—says, a monetary aggregate such as M2—the CBK had a better chance of reaching a goal such as price stability or full employment, which is not directly under its control, than it would if it had focused solely on the goal. Using an intermediate target could also provide feedback on whether its policy actions were consistent with achieving the goal. For instance, from statistical studies, the CBK might have estimated that increasing M2 at a steady rate of 3% per year was consistent with its goal of price stability. If M2 was actually growing by 6%, the CBK would know immediately that it was on a course to miss its long-run goal of price stability. The CBK could then use its monetary policy tools (most likely open market operations) to slow M2 growth to the target rate of 3%. Hitting the M2 intermediate target had no value in and of itself. It would simply help the CBK to achieve its stated goals.

**Policy Instruments or Operating Targets**

The CBK controls intermediate target variables, such as the mortgage interest rate or M2, only indirectly because private-sector decisions also influence these variables. The CBK would therefore need a target that was a better link between its policy tool and intermediate targets. Policy instruments, or operating targets, are variables that the CBK controls directly with its monetary policy tools and that are closely related to intermediate targets. Examples of policy instruments include the discount rate and reserves. Most major central banks use interest rates as policy instruments.

The Figure below shows the traditional approach of using policy instruments and intermediate targets to reach its goals. For the targeting approach we have just outlined to be effective, the links between policy tools and policy instruments, between policy instruments and intermediate targets, and between intermediate targets and policy goals must be reliable. Over time, however, some of these links have broken down. For example, prior to 1980 in the USA, there was a fairly consistent link between increases in the rate of growth of M1 and M2 and, after a lag of roughly two years, an increase in the inflation rate. This link made some economists argue that the Fed should concentrate on a monetary aggregate as its intermediate target. Unfortunately, the link between changes in the money supply and changes in inflation has been erratic since 1980. The growth of the money supply has varied widely, while the inflation rate has varied much less. In general, in recent years, many economists and policymakers no longer believe that a stable relationship exists between the alternative intermediate targets and the Fed’s policy goals.

**INDEPENDENCE OF THE CENTRAL BANK**

An independent central bank is free to pursue its goals without direct interference from other government officials and legislators. Most economists believe that an independent central bank can more freely focus on keeping inflation low.

**Arguments for CBK Independence**

The main argument for CBK independence is that monetary policy—which affects inflation, interest rates, exchange rates, and economic growth—is too important and technical to be determined by politicians. Because of the frequency of elections, politicians may be shortsighted, concerned with short-term benefits without regard for potential long-term costs. The short-term desire of politicians to be reelected may clash with the country’s long-term interest in low inflation. Therefore, the CBK cannot assume that the objectives of politicians reflect public sentiment. The public may well prefer that the experts at the CBK, rather than politicians, make monetary policy decisions. Another argument for CBK independence is that complete control of the CBK by elected officials increases the likelihood of political business cycle fluctuations in the money supply. For example, those officials might pressure the CBK to assist the Treasury’s borrowing efforts by buying government bonds, which would increase the money supply and fuel inflation.

**Arguments against CBK Independence**

The importance of monetary policy for the economy is also the main argument against central bank independence. Supporters of this argument claim that in a democracy, elected officials should make public policy. Because the public can hold elected officials responsible for perceived monetary policy problems, some analysts advocate giving the president and parliament more control over monetary policy. The counterargument to the view that monetary policy is too technical for elected officials is that national security and foreign policy also require sophisticated analysis and a long time horizon, and these functions are entrusted to elected officials. In addition, critics of CBK independence argue that placing the central bank under the control of elected officials could confer benefits by coordinating and integrating monetary policy with government taxing and spending policies. Those who argue for greater parliamentary control make the case that the CBK may not always used its independence well.

**Review questions**

* 1. Adam Posen, a member of the Bank of England’s Monetary Policy Committee was quoted as arguing in a speech that:

“Central banks’ purchases of government debt . . . far from undermining their independence . . . should enhance their credibility. . . . Mr. Posen said, . . . “What matters for our independence is our ability to say no and to mean it, and to be responsible about when we choose to say yes.”

a. Why might purchasing government debt be seen as undermining a central bank’s independence?

b. What actions does a central bank need to have the independence to say “no” to? Why might a central bank sometimes want to say “yes” to these actions?

* 1. What is the Board of Governors? How many members does it have, and who appoints them?
  2. What is the monetary policy Committee? Who are its members?