

SECTION 1. Macroeconomic processes and regional economies management

Enock T. Nyorekwa (South Africa), Nicholas M. Odhiambo (South Africa)

Monetary policy regimes and economic performance in Kenya

Abstract

This paper provides an overview of Kenya's economic, monetary and financial reforms – since its independence in 1963. In particular, the paper assesses the respective monetary policy frameworks, and the associated economic performance from 1963 to date (July 2014). It also explores the challenges facing the performance of monetary policy. Kenya has undergone a number of reforms since its independence – shifting from direct monetary policy to indirect monetary policy in the 1990s – as an important part of the IMF structural adjustment programs. In 2011, a monetary policy framework that targets monetary aggregates consistent with government inflation targets was adopted, with the Central Bank Rate (CBR) as the main instrument. The findings of this paper show that while monetary policy was largely inactive in the 1960s and the early 70s; as in many other developing countries, the associated macroeconomic performance exhibited by high growth rates, the balance of payment surplus, and the low inflation during this period, has not been fully replicated. The study also found that, although Kenya's financial sector is currently regarded as one of the most developed in sub-Saharan African countries, like many other emerging economies, the sector still faces a number of challenges. These challenges include: the intricacies associated with rapid financial innovations, the pursuance of multiple objectives, and the recent rising trend of domestic debt.

Keywords: Kenya, monetary policy, macroeconomic performance.

JEL Classification: E42, E52, E58.

Introduction

Kenya, which attained independence in 1963, has historically been, and still is, the largest economy in the East African Community¹ in terms of its GDP size. Post-independence has been associated with significant economic and financial reforms, which in part explain the momentous levels of economic and financial development, manifested in higher levels of economic growth, low and stable inflation, positive trade balances, and a significant growth in money supply and private sector credit, as shares of GDP (Swamy, 1994; Killick and Mwega, 1990). Since independence, it has undertaken a number of reforms: in particular, a shift from direct monetary policy controls to indirect monetary policy in the 1990s, when the structural adjustment policies of liberalizing the exchange rate and the capital accounts were fully rolled out. In 2011, the Central Bank of Kenya (CBK) adopted a flexible monetary-targeting regime, where both short-term interest rates and reserve money serve as operational targets (Andrle et al., 2013; Kinyua, 2001).

In the first decades after independence, monetary policy was passive, primarily because inflation was low and stable; growth averaged 6.7% per annum; and the balance of payment surplus, except in 1967 and 1969, was registered. In the next decade, Kenya encountered a number of domestic and exogenous shocks: in particular, the collapse of the Bretton

woods system of fixed exchange rates in 1971, the oil shock in 1973/74, the positive boom of high coffee prices in 1975, and the drought in 1979 – as well as a second oil crisis in early 1980. These, except the coffee price boom, had negative far-reaching effects on growth, inflation and the balance-of-payments position (Killick and Mwega, 1990).

Monetary policy continued to operate through the direct measures until the early 1990s, in particular because of credit restrictions, fixed cash ratios, and liquid asset ratios, as well as the setting of minimum deposit and maximum lending rates. Elements of fiscal dominance² were prevalent in the late 1970s. The fixed exchange rate prevailed until the early 1980s, when the crawling peg exchange-rate system anchored to a basket of currencies was adopted; and full liberalization of the exchange rate was not attained until the early 1990s (Kinyua, 2001).

Post-liberalization prudent economic policies and reforms (including that of the monetary policies) have since contributed to moderate to the strong macro-economic and financial performance; exhibited by modest growth rates associated with significant levels of financial development – in terms of private sector credit and the money supply respective shares of GDP (Cheng, 2006; Were and Tiriongo, 2012).

While conventional arguments favor the transition to inflation targeting by using interest rates as the operational target, the effectiveness of any monetary

© Enock T. Nyorekwa, Nicholas M. Odhiambo, 2014.

¹ The first EAC in the 1960s comprised Uganda, Kenya and Tanzania. The current EAC is comprised of 5, Rwanda and Burundi along with the original three.

² It occurs where the fiscal policy is too strong, and such that macro-variables are sensitive to changes in the fiscal policy.

framework would depend on the strength and reliability of the of monetary transmission mechanisms, because the reform of the monetary policy frameworks alone would not necessarily lead to more effective monetary policies, when the transmission mechanism is weak (Opolot et al., 2013). Successful and effective implementation of monetary policy would depend most importantly on the Central Bank's independence and transparency in effectively communicating the formulation of the monetary policy actions. This enhances the credibility of the Central Bank, ultimately influencing any public expectations (Mishra et al., 2012).

In addition, conventional monetary policy effectiveness depends on other factors, but not limited to: a nation's strong linkage with the external financial markets, a floating exchange rate regime, a large and competitive formal financial sector, highly developed money, bond, and stock markets, highly liquid markets for real assets, such as housing, and a strong institutional environment (Opolot et al., 2013).

Well-functioning secondary markets help the Central Bank influence the value of financial market variables, such as the interbank market interest rate and the money stock. Competition in the banking sector is necessary, if changes in the policy rates are to have an impact on market rates; banks in a non-competitive market might not pass on any changes in the policy rates for the lending or deposit rates of customers. The existence of long-term bonds is a prerequisite for the establishment of a market-based term structure; it also helps to hedge uncertainty about future short-term rates (Christensen, 2011).

A strong institutional environment that leads to enforcement and effective application of the laws leads to low intermediation costs. Finally, a substantial degree of international financial integration is required to influence the arbitrage between domestic and foreign financial assets (Mishra et al., 2012).

Empirical studies reveal that monetary policy transmission mechanisms tend to be weaker in LICs than they are in more developed economies, primarily because the afore-mentioned factors are partially or fully absent (Mishra et al., 2010). Kenya is no exception; and this paper provides an overview of its economic, monetary and financial reforms since its independence in 1963. In particular, it assesses the respective monetary policy frameworks, and the associated economic performance from 1963 to date (July 2014). It also highlights the respective challenges facing the performance of the current monetary policy.

The rest of the paper is organized as follows: Section 1 outlines the main features of Kenya's monetary regime and its associated economic performance from 1963 to 1985. Section 2 explores the monetary policy environment from 1986 to date (July 2014). The associated economic and financial performance, including the financial structure, is presented in section 3. Final section provides a summary and the policy implications of this paper.

1. Economic and monetary performance (1963-1985)

Post-independence monetary policy was controlled by the East Africa Currency Board (EACB)¹ that also served Uganda and Tanzania. That was until 1966, when the EACB broke down, leading to the creation of the Central Bank of Kenya (CBK) by an Act of Parliament – the Central Bank Act (CAP 481); and the Central Bank was mandated to execute all functions of the Kenyan monetary system. The monetary policy thereafter was conducted through direct controls: domestic credit was the intermediate target and the minimum reserve requirement was fixed at 12.5% of the commercial banks' deposit liabilities in 1969. Interest rates were controlled, exchange rates fixed; and the CBK held the significant shares of the foreign exchange, since the Bank had taken custody of the foreign exchange in 1967 (Kinyua, 2001).

The strong macroeconomic performance exhibited by high growth rates, and the positive balance of payments led to the low inflation rate that was recorded in the 1960s. Despite recording a negative real GDP growth rate in 1970, the real GDP averaged 4.7% between 1963 and 1970; the inflation rate was stable, and low at an average of 2%; and a balance of payments surplus was recorded: except in 1967 and 1969 (See Table 1 in Appendix).

The high growth rates were arguably largely driven by the high savings rates and the high level of investments, coupled with significant national expenditure at an average rate of 99% of GDP in the 1960s. Despite inflation rates being low and stable, money and quasi-money (M2) as a percentage of GDP grew from 9% in 1961 to 30.6% in 1970 (see Table 1 in Appendix)

In the 1970s, however, the economy faced a number of shocks: the collapse of the Bretton Woods system of fixed exchange rates in 1971; the oil shock in 1973/74 and the drought in 1979, as well as the positive boom of high coffee prices in 1975 (Killick and Mwegu, 1990).

¹ Formed in 1919, its offices were based in London and the East African shilling was pegged against the British pound. Its offices were transferred to Nairobi in 1960.

These shocks – except for the coffee price boom – had far-reaching effects on the economy. This was manifested in a worsening balance of payments, a dwindling real GDP growth rate, and double-digit inflation (Killick and Mwega, 1990). The latter could arguably be attributed to the increased share of M2, as a share of GDP, and the persistent high share of national expenditure, as a percentage of GDP – over 100 % (see Table 1 in Appendix).

A number of measures were undertaken in the early 1970s; the monetary policy that was largely inactive in the 1960s was now subject to a number of changes. The liquidity ratio requirement was changed a couple of times in the 1970s, starting with the liquidity ratio being raised to 15% in 1972 – on top of removing the cash ratio. The 15% liquidity ratio requirement was further extended to cover the Non-Bank Financial Institutions (NBFIs) in 1974; and the Treasury bill was increased from nearly zero to 6%. Moral suasion was also used as an instrument, thereby subjecting commercial banks to reduce their lending to the import sector and foreign-owned firms (Kinyua, 2001).

There was also a shift from the Kenyan shilling alignment with the US dollar to the Special Drawing Rights (SDR) in 1975. This marked the first step of engaging with the IMF to reverse the economic trend, and to mitigate any domestic and external shocks (Kinyua, 2001). Interest rates remained controlled; elements of moderate financial repression remained – exhibited by the continued fixing of the exchange rate, increased government borrowing from the commercial banks, and moral suasion practices (Killick and Mwega, 1990).

In 1979, the IMF and Kenya agreed on the first structural adjustment loan; but no actual disbursements were made until 1980, when the balance of payments support was necessary, in order to mitigate any related consequences of the second oil shock. The respective structural reforms were introduced. These were aimed at removing the controls on prices, trade and credit, while driving structural reforms to address the supply-side shocks. The reforms also targeted fiscal and monetary policy, including the rationalization of expenditure, adopting a more flexible exchange rate, and reducing controls on trade and credit (Swamy, 1994).

At the dawn of 1980s, most of the economic indicators were discouraging; especially when compared to the economic performance in the post-independence decade. In particular, the period between 1981 and 1983 yielded a poor economic performance; the current deficit, as a share of GDP, was 12.5% in 1981; inflation increased to over 20%

in 1982; the real GDP declined to 1.3% in 1983; and the debt-service ratio increased to over 25%. This prompted Kenya to approach the IMF for a second adjustment Loan in 1982 (Swamy, 1994).

As part of the IMF adjustment program in 1982, it was agreed to increase the controlled interest rates, to ensure that the positive or nearly positive real interest rates would continue going forward. The interest rate spread was also reduced to 2.3% in 1982, from an average rate of 4.8% in 1980. From 1982, a crawling peg exchange-rate system, anchored to a basket of currencies, was adopted. Monetary policy continued to operate through the direct measures, in particular using credit restrictions, fixed cash ratios, and liquid asset ratios, as well as the setting of a minimum deposit and maximum lending rates (Swamy, 1994).

Economic performance remained subdued between 1982 and 1984, despite a slight improvement; inflation eased to 10% in 1984; growth remained between 1% and 2%. Domestic credit as a share of GDP hardly increased; the interest rate spread marginally improved; money supply as share of GDP remained stagnant at 28-29%; and the real interest rates remained negative. The dismal economic performance was partly attributed to the attempted military takeover of the government in 1982, as well as the recurring drought in 1984, and dwindling investment (Killick and Mwega, 1990).

Post-independence monetary policy was largely passive in the first decade after independence. The main monetary tools were credit controls and the imposition of ceilings: particularly on commercial banks. The passive monetary policy, coupled with an expansionary fiscal policy, periodic droughts and the oil crisis in part led to inflationary pressures over the years. The interest rates remained administered and negative in real terms over the period; and the exchange rate was fixed until the early 1980s. Despite the ongoing financial repression, there were increased levels of financial deepening; the money supply (M2), as a share of GDP, increased from just 4% at independence to 27% in 1985; but had reached 30% in the late 1970s (Kinyua, 2001; Killick and Mwega, 1990).

2. Economic and monetary performance (1986 to June 2014)

The year of 1986 heralded the dawn of major reforms agreed under the new Structural Adjustment Programs (SAPs) integrated into the macro-economic management policies. The SAPs aimed mainly at reducing inflation, increasing sectorial efficiency, and restoring the sustainable balance of payments. In particular, the SAP reforms *inter alia*,

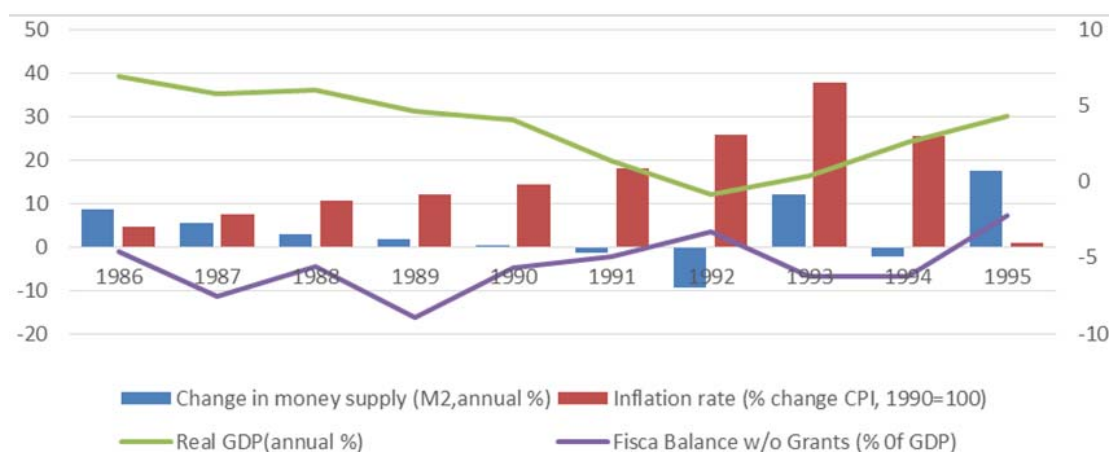
included the liberalization of prices and marketing systems; financial sector policy reforms; international trade regulation reforms; the restoration of fiscal discipline; the divestiture and privatization of parastatals and civil service reforms (Rono, 2002).

The financial sector policy reforms aimed, in part, at increasing the competition in the financial sector, and at increasing the range of financial instruments *via* an expanded financial infrastructure. It also targeted the deregulation of interest rates, improving the overall process of financial intermediation, mobilization, and the allocation of resources (Rono, 2002).

In addition to short-term government securities, the treasury bonds were introduced in 1986; the cash ratio was re-introduced, at the rate of 6%; and the liquidity ratio was raised to 20% (Nyamwogo and Ndirangu, 2013). While 1986 is regarded as the

crucial point for the key reforms, it was associated with a financial crisis – with a couple of NBFIs defaulting on their obligations. Inflation, which had eased to just 2.5% in 1986, increased again to double digits in 1986, and continued to rise through to the mid-1990s (see Figure 1). The high inflation rates rendered the real interest rates negative, despite the attempt to raise the interest rates. For example, the raising of the savings rate to 12.5% and 15% in 1989 and 1990, respectively, was not enough to attain positive real interest rates.

Economic growth, however, picked up, and grew at an average rate of 5% between 1986 and 1990, higher than the first half of the 1980s. Intriguingly, high levels of financial deepening were achieved at the post-independence period, despite the financial repression from the early 1960s being sustained through to the mid-1990s.



Source: World Development Indicators, 2013.

Fig. 1. Selected economic indicators (1986-1995)

However, despite the major reforms, most of which did not take place until the early to mid-1990s, the 1990s became the true era of key reforms actualization. Initial important steps to liberalize the foreign exchange market began in the same year, adopting a dual exchange rate in 1990, which entailed tracking the official exchange rate and the market rate available. Complete liberalization of the exchange rate was achieved only in October 1993, when the exchange rate was allowed to become market-determined (Maehle et al., 2013).

Further steps were undertaken in 1994, with the relaxation of all the restrictions on current account transactions, including the removal of all export taxes, and allowing exporters to retain 100% of their foreign exchange proceeds in foreign exchange accounts. In addition, restrictions on outward investments and inward investments were removed in 1994 and 1995, respectively, marking the

complete removal of the quantitative controls on the capital accounts (O’Connell et al., 2010).

The liberalization reforms were continued into the 1990s; the lending rate and the maximum interest rate spread were fully harmonized by 1990: for both banks and NBFIs. Liquidity ratios were harmonized later in July 1995 at 25%. In 1991, the first step in liberalizing the interest rates was implemented – with the first auctioning of treasury bills in the primary market. The method of treasury bid auctioning was reformed further in 1993, with the volumes to be sold in the primary market auctions¹ contingent upon the Central Bank’s determination of fiscal needs and the prevailing monetary circumstances.

Following the increased government borrowing associated with government expenditure related to

¹ The CBK determined the volumes on the weekly auctions.

the elections in 1992, large quantities of treasury bills¹ were issued to curb the inflationary spiral – subsequently leading to high interest rates and the associated negative impact on private investments (Kinyua, 2001).

Domestic credit to the private sector, as a share of GDP, started to weaken in 1992 (see Figure 2). The lowering of maturities restricted eligible securities, as collateral for overnight loans such as treasury bills and bonds. Treasury bills maturity halved; while the Treasury bonds terms were reduced to 45 days or less (Ngugi, 2001).

Prior to 1996, monetary policy had multiple objectives, which were often inconsistent with the maintenance of low and stable inflation. Thereafter, the CBK act was amended, clearly defining the narrowed mandate of the monetary policy, as well empowering the Central Bank with more autonomy². Price stability was defined as the primary objective, with the ultimate aim of promoting the long-term goal of economic growth. The other objectives included: the promotion of liquidity, exchange rate stability, and ensuring financial stability. The amendment of the Act also mandated the CBK to shift from targeting broad money M3 to targeting broader money M3X and MXT³, as an intermediate target. The actual transition to broader aggregates happened only in 1998 (Kinyua, 2001).

In addition, the reserve money consisting of currency in circulation and bank reserves kept at the CBK served as an operating target. In addition to the OMO, the cash ratio and the reserve requirement, rediscount facilities and a lender-of-last resort facility were implemented (Kinyua, 2001).

The *de jure* monetary targeting remained in place until 2011. Faced with the inflation spiral in 2011, the CBK in September that year moved to adopt short-term interest rates as the main operational target, while retaining the monetary targeting framework (Andrle et al., 2013).

The Central Bank Rate (CBR)⁴ is used as a reference rate for pricing monetary-policy operations. A

¹ Fiscal costs associated with sale of the treasury bills rose rapidly, the domestic interest payments accounting for 93% and 90% of end period for 1992/93 and 1993/94 respectively (IMF, 1995).

² Prior to 1996, the Minister for Finance had exclusive authority over the CBK Board of Directors and could overrule monetary policy without any restraint.

³ M3 is defined as currency in circulation, term, and non-term domestic deposits held with banks and NBFIs. M3X as M3 plus foreign currency deposits (FCDs) held by residents, whereas M3XT is M3X plus holdings of government paper by the non-bank public.

⁴ Set and announced monthly by CBK's monetary policy committee. The CBR serves as a reference for interbank rates and repo rates.

number of other monetary instruments including: the open-market operations (OMO), standing facilities (as a lender of the last resort), required reserves, foreign market operations, licensing, and the supervision of commercial banks and the communication of bank decisions were used to achieve the monetary stance (Berg et al., 2013).

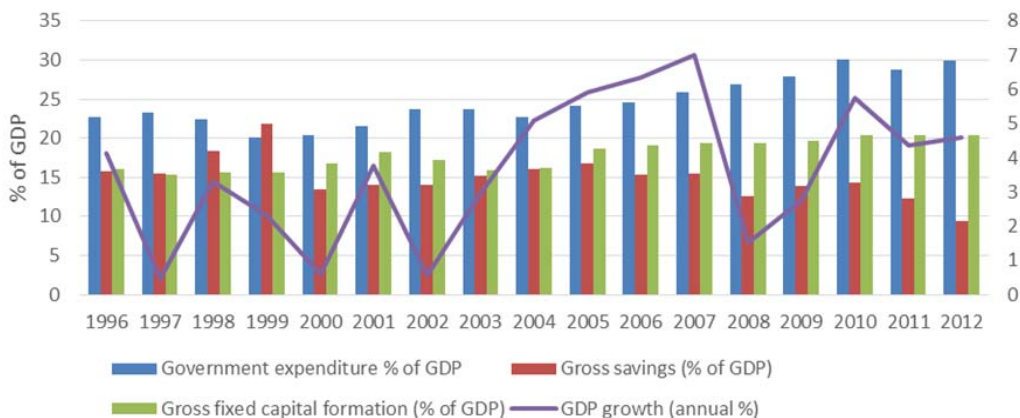
In November 2013, Kenya signed the East African Monetary Union Protocol. All the partner States were expected to conclude the ratification of the Protocol by July 2014. A monetary affairs committee is currently in place – with the aim of harmonizing both monetary and exchange rate policies in line the agreed macroeconomic convergence criteria. Performance convergence criteria, which include a headline-inflation target of maximum 8%, a fiscal deficit, including grants as a percentage of GDP of 3%, present value of public debt, as a percent of GDP of utmost 50%, and a foreign-exchange reserve cover of at least 4.5 months of import value. From 2024 onwards, a single currency was mandated to be adopted, provided at least three partner states met the performance target for at least three consecutive years (CBK, 2013).

The Council of Ministers is still expected to implement a 10-year road map, based on a single currency (CBK, 2013). However the unharmonized fiscal policies especially in regard with the agreed macroeconomic convergence criteria will weaken the monetary union effectiveness. The convergence criteria aims to ensure that the countries have fairly the same economic structure (Morales, 2012).

Since the mid-1990s, the Kenyan economy has experienced mixed financial and economic performance. The economy grew at moderate rates; and this was largely supported by stable significant levels of gross savings, government's growing expenditure, and investments. Government expenditure, as a share of budget, increased from 23% in 1996 to 29% in 2012; gross fixed capital formation, as a share of GDP, increased by 4 percentage points; while gross savings, as a share of GDP, dwindled by 6 percentage points over the same period, thereby implying that the savings investment gap had widened (See Figure 2).

Despite the Kenyan economy remaining the biggest economy in the EAC region, its growth has been inferior to the Sub-Saharan average and to that of the EAC countries, with the exception of Burundi (IMF WEO, 2014).

Previously, it had served as a reference for interest rate for the CBK's overnight-lending facility.



Source: World Development indicators, 2013.

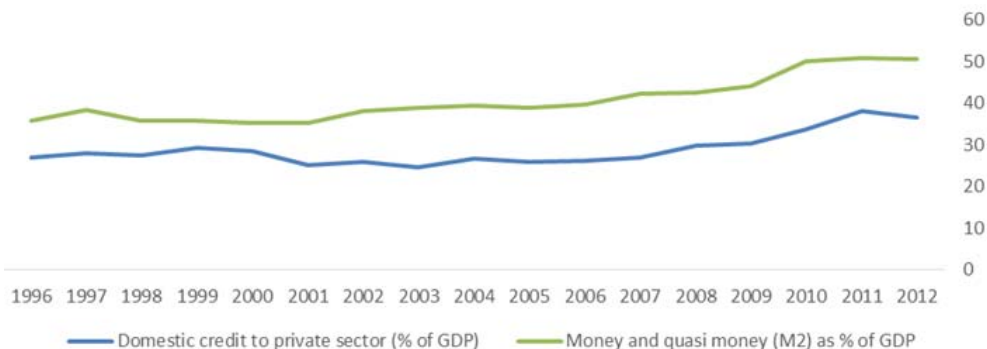
Fig. 2. Selected economic indicators (1996-2012)

However, the Kenyan economy has, since the mid-1990s, enjoyed tremendous levels of financial developments: domestic credit to private sector, as a share of GDP, increased from 27% in 1996 to almost 37% in 2012; and M2 as a share of GDP, increased by 15% over the same period to 50% of GDP (see Figure 3). The increase in private sector credit and money supply have been associated with modest levels of inflation; and in particular, inflation was below the CBK medium target of 5% only twice over that entire period (see Figure 4).

particular, two global episodes of increases in global food and energy prices have been experienced. The first was in 2007/08, coinciding with the global financial crisis; and the second was in the period of 2010/11 – with food and energy prices soaring (Berg et al., 2013).

The economy has, in the recent past, been susceptible to the global economic shocks; in

Kenya just like many LICs has encountered dominant supply shocks over the demand shocks. The supply shocks tend to increase the likely conflict between output and inflation. In regimes of inflation targeting, lower inflation will occur at the cost of output especially when the supply shocks are dominant (Adam et al., 2010).



Source: World Development Indicators, 2013.

Fig. 3. Selected financial depth indicators (1996-2012)



Source: World Development Indicators, 2013.

Fig. 4. Inflation trends (1996-2012)

Intriguingly, the liberalization of interest rates, and the resultant increased financial deepening have not lowered the interest rates, or their spread. The spread instead increased to double-digit figures. This reflects largely on the increase in lending rates and the reduction in savings deposit rates.

The high Treasury bill rates eased to lower than the lending rate from 2003 onwards and to lower than half the 1993 rate of 55.7% (CBK, 2013). The latter is partly because of the reinforced Central Bank independence in 1996, and the limited use of T-bills for fiscal operations.

3. Financial structure

The effectiveness of monetary policy instrument depends on the strength and reliability of the monetary transmission mechanisms. The channels through which monetary policy affects aggregate demand depend on a country's financial structure (Mishra et al., 2010). Kenya has enjoyed significant levels of financial deepening – which has in part contributed to its fairly large financial sector relative to those in the EAC region. Significant banking sector growth has been recorded over the last two decades, with the total banking deposits as a share of GDP growing to from 27% in 1996 to 33% in 2012 (Nyamwogo and Ndirangu, 2013). By the end of 2013, the Kenyan financial system comprised 43 commercial banks with branches, 1 mortgage finance company, 9 representative offices of foreign banks, 9 deposit-taking micro-finance institutions, 112 foreign-exchange bureaux, and 2 credit reference bureaux (CBK, 2013).

The insurance sector included 154 insurance brokers, 23 medical insurance providers and 4,205 insurance agents. The commercial banking sector continued to dominate the financial sector; and as of the end of 2012, the assets of the pension sector, micro-finance banks, and the insurance sector accounted for just 38% of the total commercial banking sector (KIPRA, 2013).

Kenya's banking sector remains solid; in particular, the commercial Banks remain well-capitalized above the minimum regulatory capital adequacy requirement, and well-buffered to withstand any shocks¹. In the year to June 2013, the regulatory tier 1 capital to risk-weighted assets increased to 23 per cent from 21.9 per cent in the previous year; while the ratio of total regulatory capital to risk-weighted assets rose from 20.7 per cent to 24.3 per cent. This

was facilitated by total capital to total gross assets increasing to 17.1% from 16.3%. The banks remained liquid, with sound profitability, as shown by the return to assets. The asset quality, however, registered a decline, primarily because of an increase in the non-performing loans, as a share of the total assets, increasing by 0.8% to 5.3% in June 2013 (CBK, 2013).

The Kenyan formal banking system, however, is dominated by the few banks, with the large 6 banks accounting for 51.4% of the commercial bank's assets, 50.2% of the customer deposits, and 61.8% of the pre-tax profits; and it had a market share of 52.39% (CBK, 2013). This in part could weaken the bank lending and interest channel because the monetary policy actions may not be fully transmitted to changes in the credit availability, loan rates and deposit rates (Mishra et al., 2012).

Sensational growth of financial innovation in particular, with mobile technology and new financial instruments and services, has been recorded. The growth in mobile money services has been exponential since its launch in March 2007; with the number of transactions growing to about 65 million transactions in August 2013, and the value increasing to about Ksh 160bn (Nyamwogo and Ndirangu, 2013). The number of adults at 11.5 million, using mobile phone financial services, is more than double the 5.4 million that make use of the banks (FinAccess, 2013).

The ATMs were also introduced in the late 1990s. They have increased to more than the number of commercial bank branches by 2006, at 540 ATMs; and thereafter, they grew at an even faster rate to 2487 in December 2013. Agency banking launched in 2010 has also seen tremendous growth; the number of contracted agents had grown to 19,649 agents and facilitated over 58.6 million transactions worth Ksh 310.5 billion (CBK, 2013). The Real Time Gross Settlement (RTGS) since its introduction has enjoyed steep growth in both volume and value of transactions, especially from 2009. By February 2014, the total value of transactions stood at Kshs 137,543,981 (CBK, 2013).

The growth in financial innovations and in the banking sector has been associated with increased financial access over the years. According to Fin Access Survey (2013), Kenya's financial access has evolved since 2006 with the proportion excluded from financial access reducing from 39% in 2006 to 25% in 2013. In addition, Kenya's financial access is the highest in the EAC region (see Table 2).

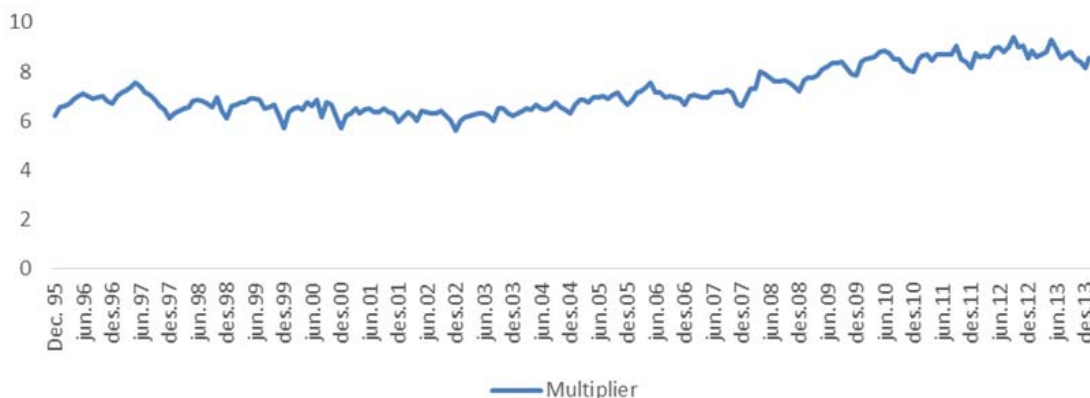
¹ Measured by the ratio of Core Capital and Total Capital to Total Risk Weighted Assets is 8.0 per cent and 12.0 per cent, respectively.

The impressive financial innovations, however, have tended to make the performance of monetary policy complex – by increasing the volatility money multiplier, and consequently, the instability¹ of money demand (Nyamwongo and Ndirangu, 2013; and Noyer, 2007). Figure 5 shows that the money multiplier (M3/RM) has risen over the years, and has been volatile, which may compromise, in particular, the Reserve Money Program (RMP).

Table 2. Financial access in the EAC (percentages)

Country	Formal	Informal	Excluded
Kenya 2013	67	8	25
Uganda 2013	39,4	30,6	30
Burundi 2012	13	14	73
Tanzania 2009	16	27	57
Rwanda 2012	42	30	28

Source: Fin Access Survey, 2013.



Source: Central Bank of Kenya.

Fig. 5. Money multiplier (M3/RM)

Conclusion

Kenya has been transformed from a directly controlled monetary policy to indirect monetary policy by using the reserve money as an operational target since the early 1990s. The 1990s transitional reforms included, but were not limited to, the liberalization of the exchange rate and capital accounts, and the amendment of the CBK Act in 1996, thereby clearly defining the monetary policy mandate. In November 2011, the Central Bank of Kenya (CBK) adopted a new monetary policy framework that gives more prominence to its policy interest rate, while retaining a monetary policy framework that targets monetary aggregates consistent with the inflation target. This paper provides an overview of Kenya’s economic, monetary and financial reforms – since its independence in 1963. In particular, the paper assesses the respective monetary policy frameworks, and the associated economic performance from 1963 to date (July 2014). It also explores the

challenges facing the performance of monetary policy. The study finds that while monetary policy was largely inactive in the first decade after independence, the Kenyan economy enjoyed the strongest economic performance of high growth levels when compared with the post-independence era. Structural adjustment reforms and post-liberalization policies have since yielded modest economic performance and reasonable macro-stability. This has, in part, led to significant structural and financial developments, in particular leading to increased innovations in the financial markets and the economy at large. The study also found that, although Kenya’s financial sector is currently regarded as one of the most developed in Sub-Saharan African countries, like many other emerging economies, the sector still faces a number of challenges. These challenges include: the intricacies associated with rapid financial innovations, the pursuance of multiple objectives, and the recent rising trend of domestic debt.

References

1. Adam, C. et al. (2010). Building a Monetary Regime for the 21st Century. In C. Adam, P. Collier & N. Ndirangu (Eds.), *Kenya: Policies for Prosperity*, Oxford: Oxford University Press.
2. Andrle, M.A. et al. (2013). Forecasting and Policy Analysis Systems in Low Income Countries: The Role of Money Targeting in Kenya, *International Monetary Fund Working Paper*, Washington, D.C.
3. Berg, A. et al. (2013). The Monetary Transmission Mechanism in the Tropics: A Narrative Approach, *IMF Working Paper*.
4. Central Bank of Kenya (2013). *Annual Financial stability report*, June.

¹ The presence of a stable money demand function enhances the ability of monetary authorities to reach predetermined monetary growth targets if price stability is the main objective.

5. Central Bank of Kenya (2013). *Annual report*. Available at: <https://www.centralbank.go.ke/index.php/cbk-annual-reports>.
6. Central Bank of Kenya (2013). *Annual supervision report*. Available at: <https://www.centralbank.go.ke/index.php/bank-supervision-reports>.
7. Central Bank of Kenya (2013). *Annual Financial stability report*, June. Available at: <https://www.centralbank.go.ke/index.php/news/378-financial-2013-report>.
8. Cheng, K. (2006). A VAR analysis of Kenya's monetary policy transmission mechanism: how does the central bank's REPO rate affect the economy? *IMF Working Paper* WP/06/300.
9. Christensen, V.B. (2011). Have monetary transmission mechanisms in Africa changed? *BIS Papers* No 56.
10. International Monetary Fund (2014). *Regional Economic Outlook: Sub-Saharan Africa*, Washington D.C. April.
11. Kenya Institute for Public Policy Research and Analysis (KIPPRA). (2013). *Kenya Economic Report: Creating an Enabling Environment for Stimulating Investment for Competitive and Sustainable Counties*.
12. Killick, T. and Mwega, F.M. (1990). Monetary policy in Kenya 1967-1988, *Overseas Development Institute Working paper*, 39
13. Maehle, N. et al. (2013). Exchange Rate Liberalization in Selected Sub-Saharan African Countries – Successes, Failures, and Lessons, *IMF*, WP/13/32.
14. Mishra, P. et al. (2010). Monetary Transmission in Low Income Countries, *IMF Working Papers* 10/22.
15. Mishra, P. et al. (2012). Monetary Transmission in Low-Income Countries: Effectiveness and Policy Implications, *IMF Economic Review*, 60, 270302.
16. Morales, R. (2012). Monetary Policy Harmonization in the East African Community. In H. Davoodi (Ed.), *The East African Community after Ten Years. Deepening Integration*, International Monetary Fund.
17. Nyamongo, E. and Ndirangu, L. (2013). *Financial Innovations and Monetary Policy in Kenya*, MPRA Paper No. 52387.
18. Ngugi, R.W. (2001). An empirical analysis of interest rate spread in Kenya, *African Economic Research Consortium research paper*, 106, May.
19. Noyer, C. (2007). Financial Innovation, Monetary Policy and Financial Stability, *Spring Conference of the Bank of France/Deutsche Bundesbank, Eltville, Germany*, April.
20. O'Connell, S. et al. (2010). Capital Mobility, Monetary Policy, and Exchange Rate Management in Kenya. In Adam, Collier and Ndung'u, eds. (2010) *Kenya: Policies for Prosperity*, Oxford University Press, pp. 172-210.
21. Opolot, J. et al. (2013). *Financial architecture and monetary policy transmission mechanisms in Uganda*, Bank of Uganda working paper No. 02/2013.
22. Rono, K.J. (2002). The impact of the structural adjustment programmes on Kenyan society, *Journal of social development in Africa*, 17 (1).
23. Swamy, G. (1994). *Kenya Structural Adjustment in the 1980s*, the World Bank, Chief Economists Office, Africa Regional Office.
24. Were, M. and Tiriongo, S. (2012). *Central Bank's Response to Economic Crises from a Developing African Economy Perspective*, Central bank of Kenya, May.

Table 1. Selected economic indicators in 1960s

Years	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980
Domestic credit to private sector (% of GDP)	...	12.3	11.8	13.2	13.7	13.8	12.6	14.6	12.9	12.7	15.1	17.4	16.5	21.9	21.9	21.8	21.7	22.3	27.6	27.3	29.5
GDP growth (annual %)	...	-7.8	9.5	8.8	5.0	2.0	14.7	3.4	8.0	8.0	-4.7	22.2	17.1	5.9	4.1	0.9	2.2	22.3	27.6	27.3	29.5
Gross domestic savings (% of GDP)	17.1	16.8	16.5	16.0	17.2	15.1	20.2	19.3	20.2	20.8	23.6	17.4	20.2	24.5	18.5	13.5	20.9	27.0	20.0	16.4	18.3
Gross fixed capital formation (% of GDP)					12.4	12.8	14.7	18.7	18.5	18.0	19.7	22.7	21.8	20.5	19.1	20.2	20.0	21.0	25.1	19.2	18.3
Gross national expenditure (% of GDP)	102.6	98.4	98.1	96.9	95.8	99.3	98.5	100.9	99.9	98.6	100.8	106.6	102.1	101.3	107.2	104.7	99.3	96.6	109.8	101.7	106.4
Inflation, consumer prices (annual %)		2.5	3.1	0.7	-0.1	3.6	5.0	1.8	0.4	-0.2	2.2	3.8	5.8	9.3	17.8	19.1	11.5	14.8	16.9	8.0	13.9
Money and quasi money (M2) as % of GDP		3.9	4.4	4.4	4.3	5.4	22.7	23.7	24.0	26.4	30.6	29.7	28.5	30.5	25.7	27.4	28.2	32.8	34.5	34.4	29.9
Interest rate spread (lending rate minus deposit rate, %)												5.5	5.5	5.5	5.2	4.9	4.9	4.9	4.9	4.9	4.8