Central Bank of Kenya

MONETARY POLICY FRAMEWORKS IN A CHANGING FINANCIAL LANDSCAPE:

KENYA'S EXPERIENCE

Central Bank of Kenya

AACB CONTINENTAL SEMINAR

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Nairobi, Kenya

PRESENTATION OUTLINE

A. **Introduction**

B. **Financial landscape in Kenya**

C. **Outcomes of changing financial landscape**

D. **Improvements in the Monetary policy framework**

2

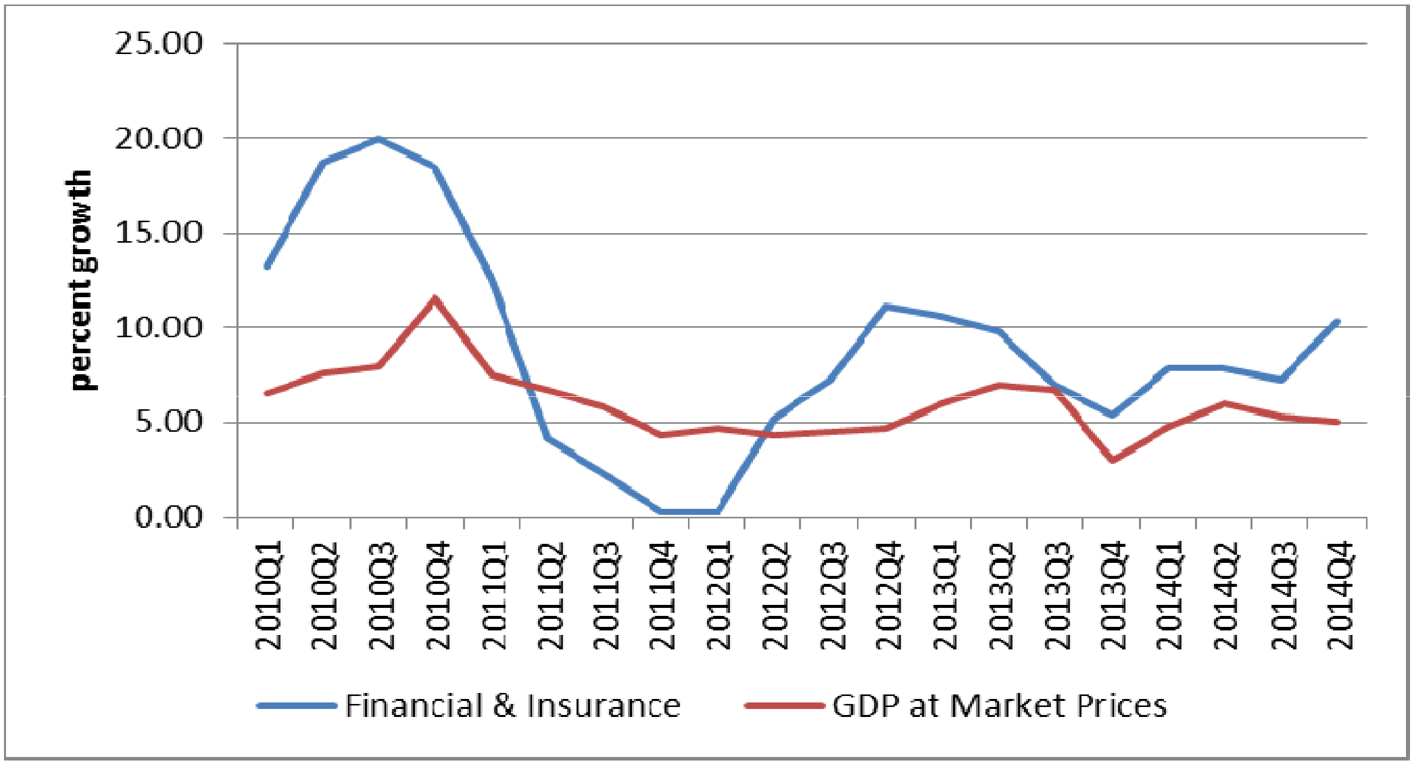
1. MONETARY POLICY FRAMEWORK

1. Macroeconomic stability a key pillar of achieving the growth targets in the *Vision 2030*
2. The CBK Monetary Policy goal – maintain the Government's price stability - inflation target of 5% with a 2.5% band
3. The monetary policy framework :
   - Monetary policy framework is based on targets of Net International Reserves (NIR) and Net Domestic Assets (NDA) as the quantitative performance criteria measures
   - Net Domestic Assets of the CBK is the operational target while broad money supply (M3) is the intermediate target
   - Given a floating exchange rate regime, its implications on the open capital account of the balance of payments and the likely impact on money supply is considered in the monetary programme
   - The level and movement of the Central Bank Rate (CBR) signals the monetary policy stance
   - Monetary policy instruments include Open Market Operations (Repos including Reverse Repos, and Term Auction Deposits), Cash Reserve Ratio, and Foreign Exchange Market operations

THE CENTRAL BANK RATE WORKS THROUGH DIFFERENT CHANNELS

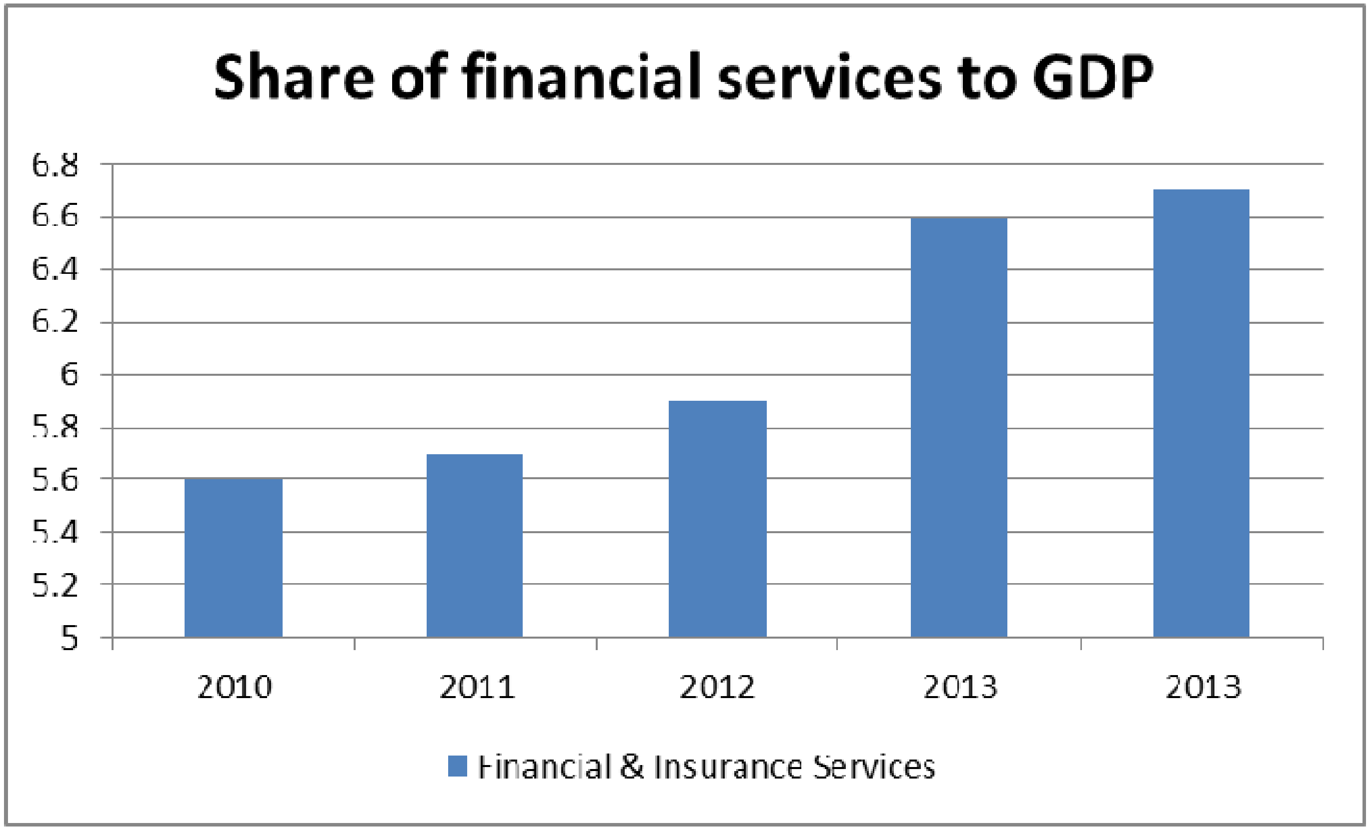
- The CBR forms the base for all monetary policy operations; this has enhanced clarity and certainty in monetary policy operations
- Effectiveness and efficiency of transmission mechanisms depend on the stability of the money demand function
- Expanding financial inclusion in Kenya has resulted in unstable money multiplier and velocity of money both of which undermine predictability of demand for money
- Interest rate and exchange rate channels are the main channels of monetary policy transmission in Kenya – but expectations channel also becoming significant with increasing Central Bank communications and transparency backed by bi-monthly MPC Market Surveys
- The MPC's communications strategy has ensured a wider dissemination of monetary policy decisions, and enhanced the efficiency of information transmission

GROWTH OF THE FINANCIAL SECTOR HAS OVERTAKEN OTHER MAJOR SECTORS OF THE ECONOMY



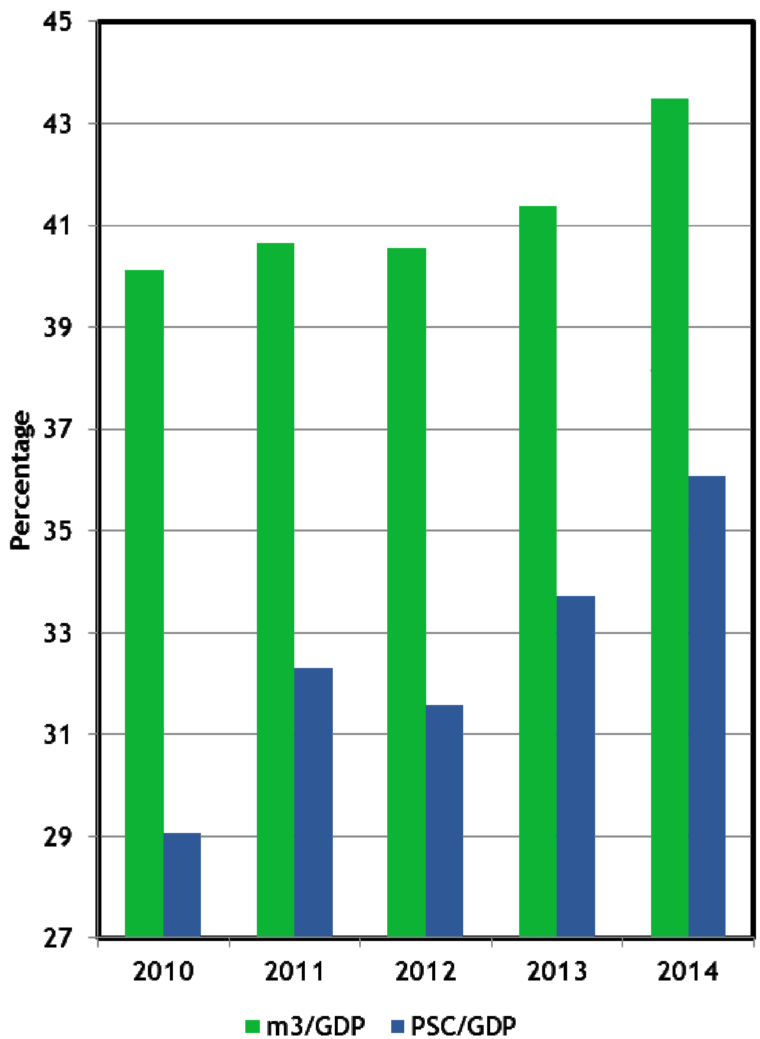
- **Financial landscape has changed significantly**
- **Following major financial innovations the financial sector has grown above GDP.**

…AND THE FINANCIAL SECTOR'S SHARE TO GDP HAS INCREASED



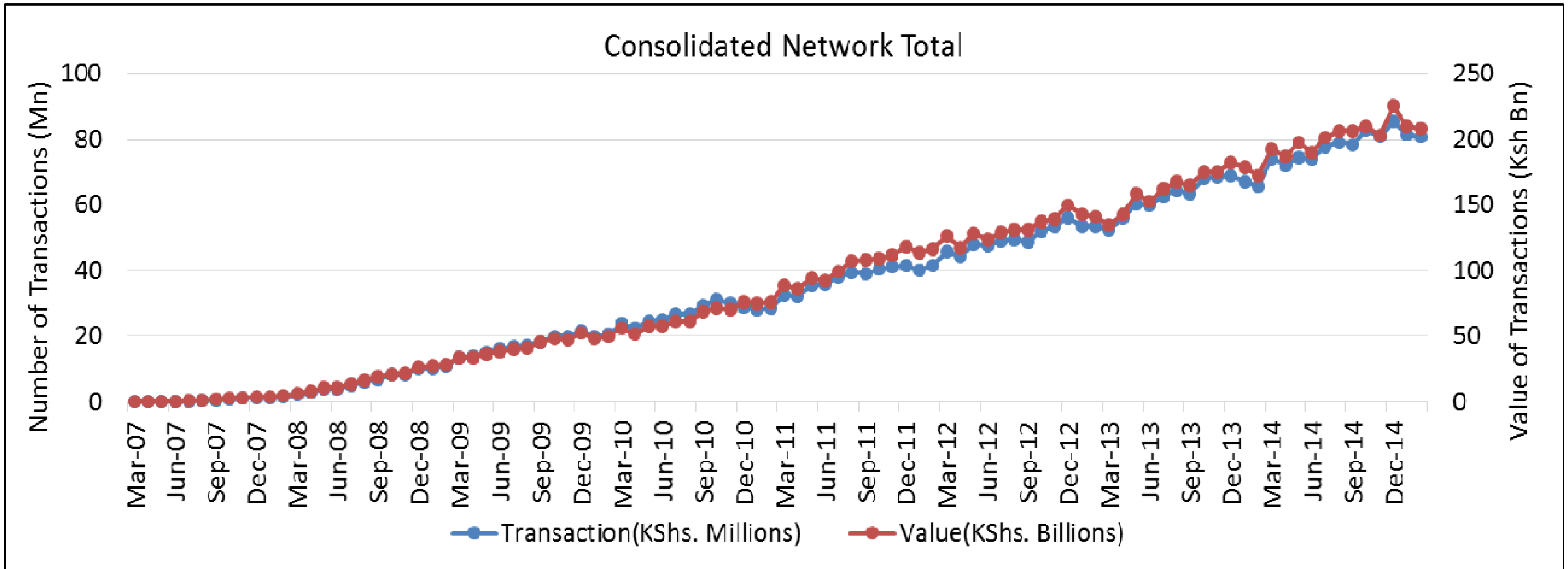
- The share of financial intermediation in GDP has grown since 2008.

FINANCIAL DEVELOPMENT INDICATORS HAVE ALSO GROWN



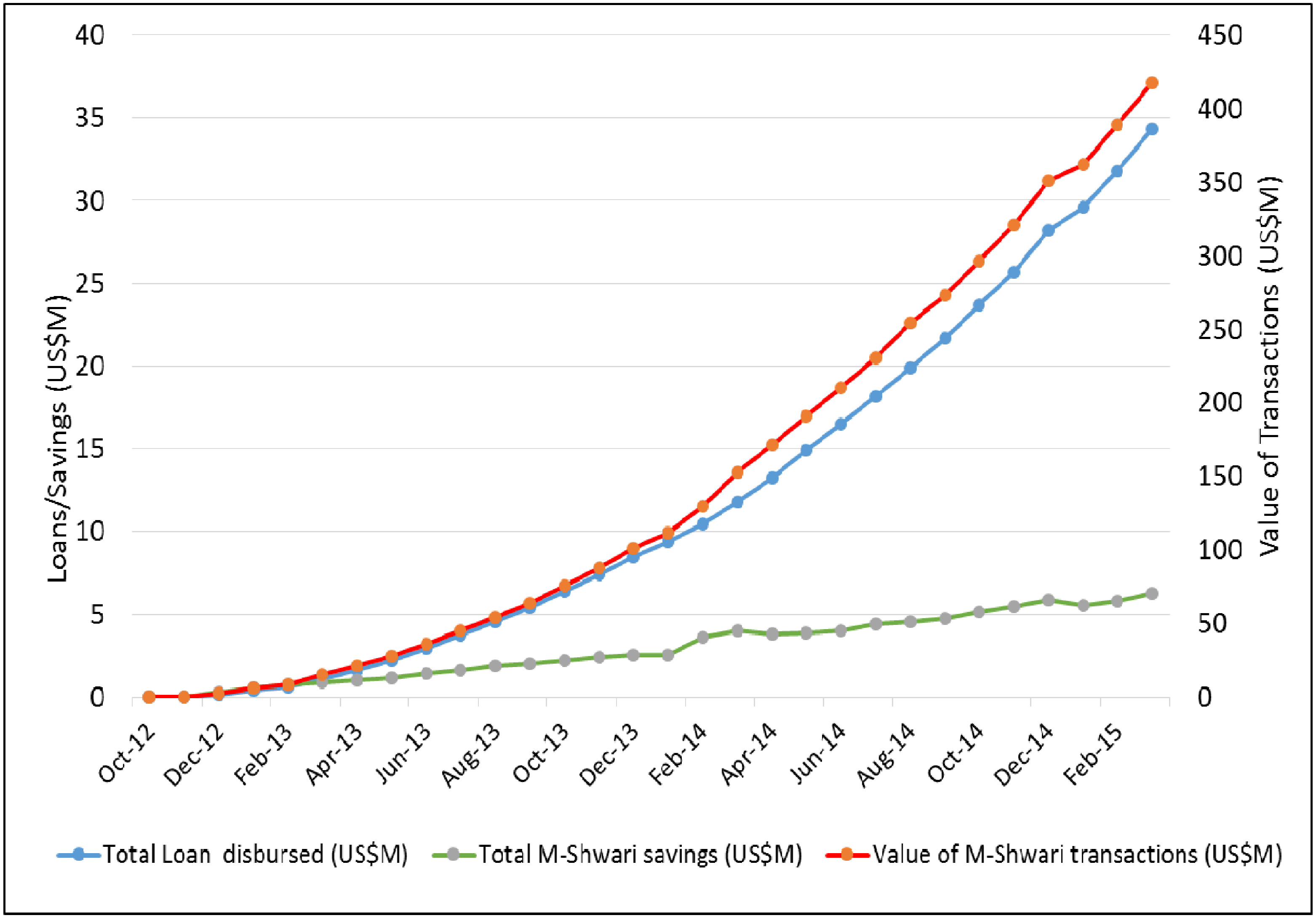
- The degree of monetization has remained high since 2010 and continues to grow. In relation to GDP:
  - Credit to private sector stood at 29% 2010 rising to 36% in 2014.
  - Broad money has remained above 40% of GDP and continues to rise.

THESE IMPROVEMENTS HAVE BEEN SUPPORTED BY FINANCIAL INNOVATIONS:
1.) MOBILE PHONE FINANCIAL SERVICES TRANSACTIONS



- Mobile Phone Network operations commenced in March 2007. In February 2015 the number of mobile phone financial services subscribers reached 25.5 million compared to 18.8 million in February 2011.
- In 2014, mobile phone money transactions in Kenya were valued at USD26.98 billion, which would represent 45 percent of the country's GDP.
- Average size of transactions per customer has been increasing (from USD40.7 (Ksh.2,866) in February 2008 to USD89.4 (Ksh.8,176.3) in February 2015)
- The National Payments Systems (NPS) Act, 2011 and NPS Regulations, 2014 provide the enabling legal and regulatory framework for use of electronic payment services.
- Corporates, private and public sector partnerships have encouraged the use of the facility in new and diverse ways of making payments.

PERFORMANCE OF M-SHWARI IN KENYA AS AT APRIL 2015 USD $ MILLION (CONVERSION FACTOR: KSH 86 TO 1US$)



3) OTHER INNOVATIONS

- **Enabling regulatory environment and reforms to improve efficiency in the financial market by Central Bank of Kenya (CBK) has led to increasing demand for new financial services.**

  - **Credit Reference Bureaus (2008)**
    - Reducing cost of doing business - Build information capital, reduce information search costs and the problems associated with information asymmetry; and extending credit based on financial identity. This allows change in the collateral technology in use.

  - **Currency Centers**
    - Reducing cost of doing business and largely Cash-in-Transit costs for banks and their branch networks across regions. (3 currency centres have been established- **Nyeri (2009), Nakuru (2010) and Meru (2011)).**

  - **Consumer Protection (2013) and Deposit Protection**
    - That encourages transparent disclosure, fair treatment, dispute resolution and financial education/awareness and costs.
  - **Islamic financial services (including Shariah compliant banking) (2008)**
    - Diversification of market products lowers the per unit cost

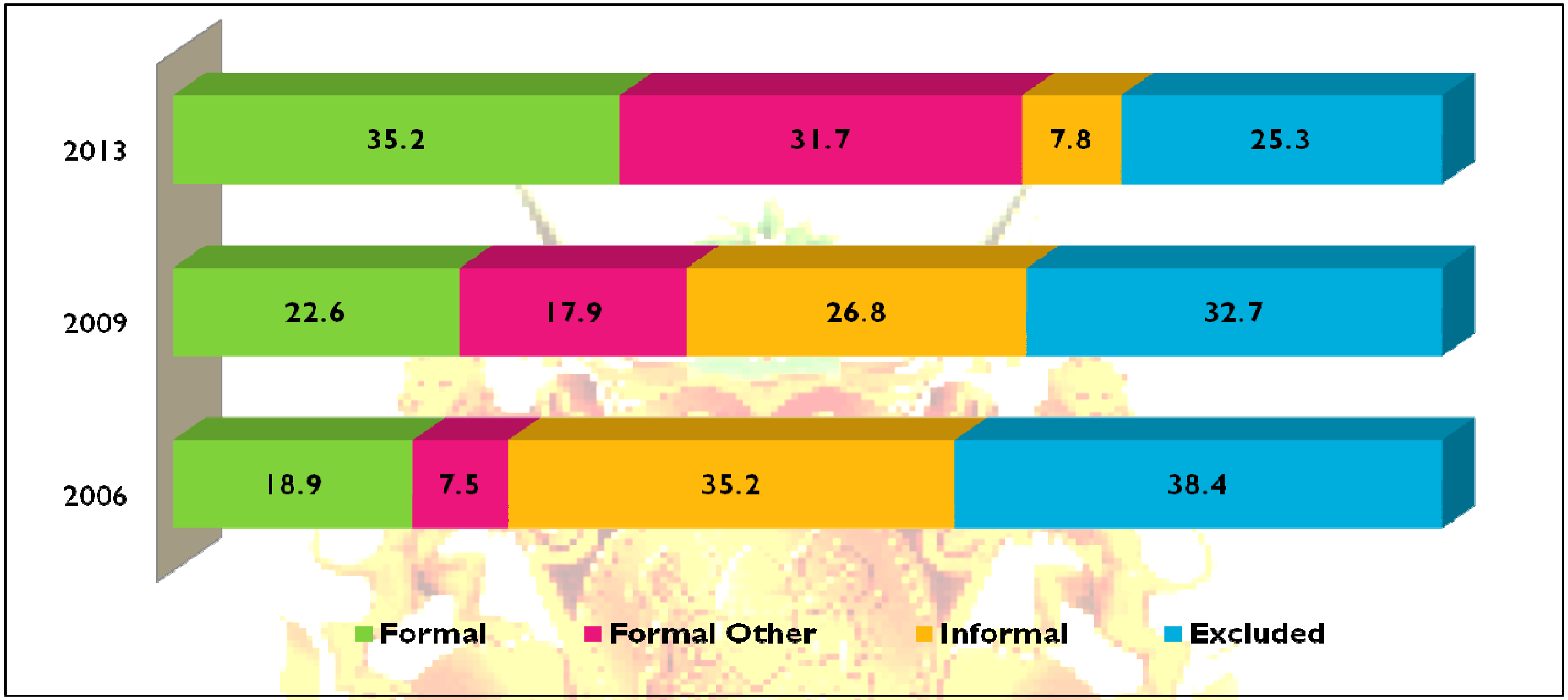
- **Establishment of an Automated Clearing House (ACH)**
  - ACH processes 2.5 million transactions per month (Electronic Fund Transfers & Cheques) valued at Kshs 246 billion.
  - Cheque Truncation introduced in 2011 to enhance efficiency in processing of cheques – Clearing cycle reduced to T+1 (day) from T+3 (days).

- **Deposit Taking Microfinance Institutions (DTMFIs)**
  - Focus on rural and peri-urban areas where financial inclusion is lowest - closer reach to low income segments. Introduced in 2008 (year) DTMFIs have grown to 10 micro finance banks (MFBs) with 98 branches.

- **Agent Banking (Dec 2012)**
  - Entails turning non-bank outlets into financial services providers to enable third parties to offer limited financial services. Lowers cost of doing business

- **Newly licensed players in the financial markets also include:**
  - Money Remittance Providers (2013).
  - Representative office (2008)

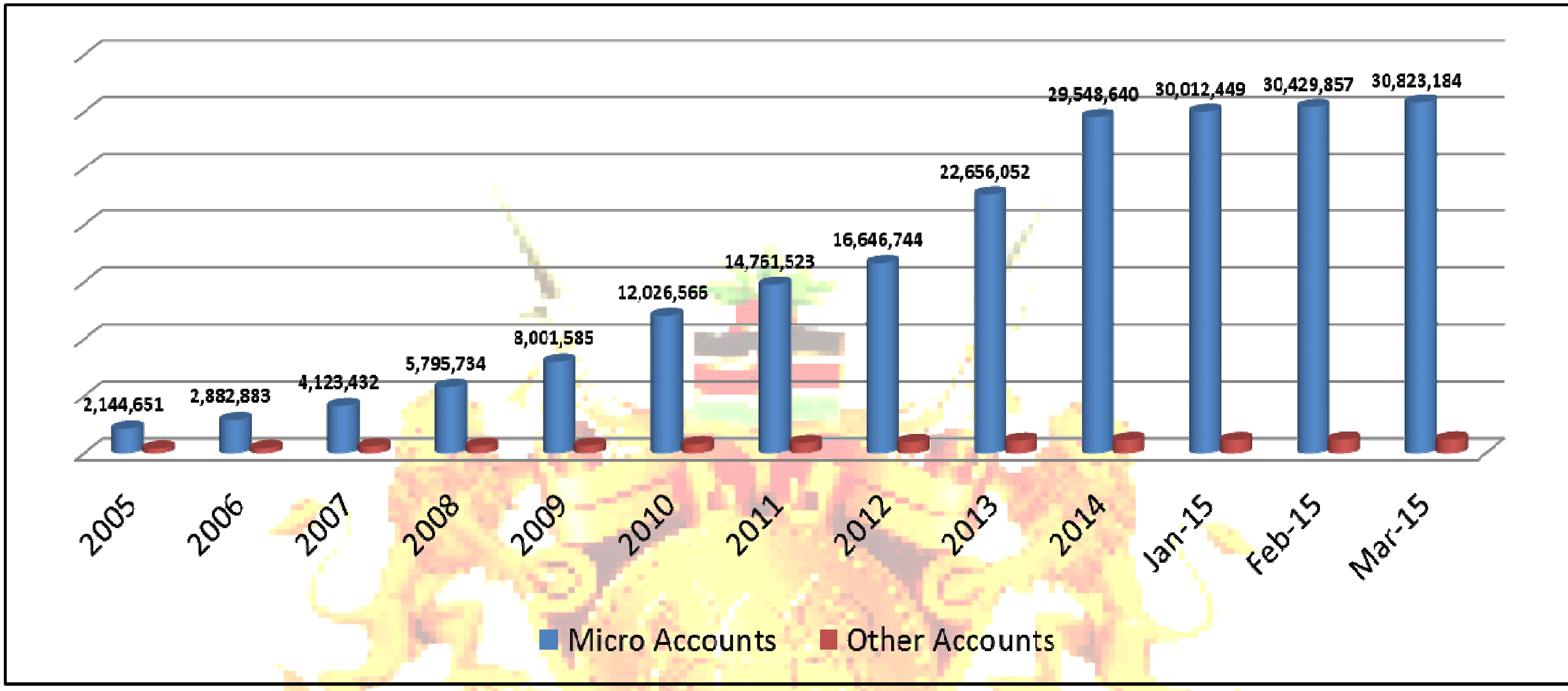
FINANCIAL INNOVATIONS HAVE IMPROVED FINANCIAL ACCESS IN KENYA SINCE 2006



Source: Financial Access Surveys: 2006, 2009 & 2013

- ✓ 67 per cent of Kenyans can access financial services.
- ✓ About 7.8 per cent are served by informal financial services.
- ✓ 25 per cent of the population are still excluded.

…AND THE NUMBER OF BANK ACCOUNTS HAVE GROWN SINCE 2005

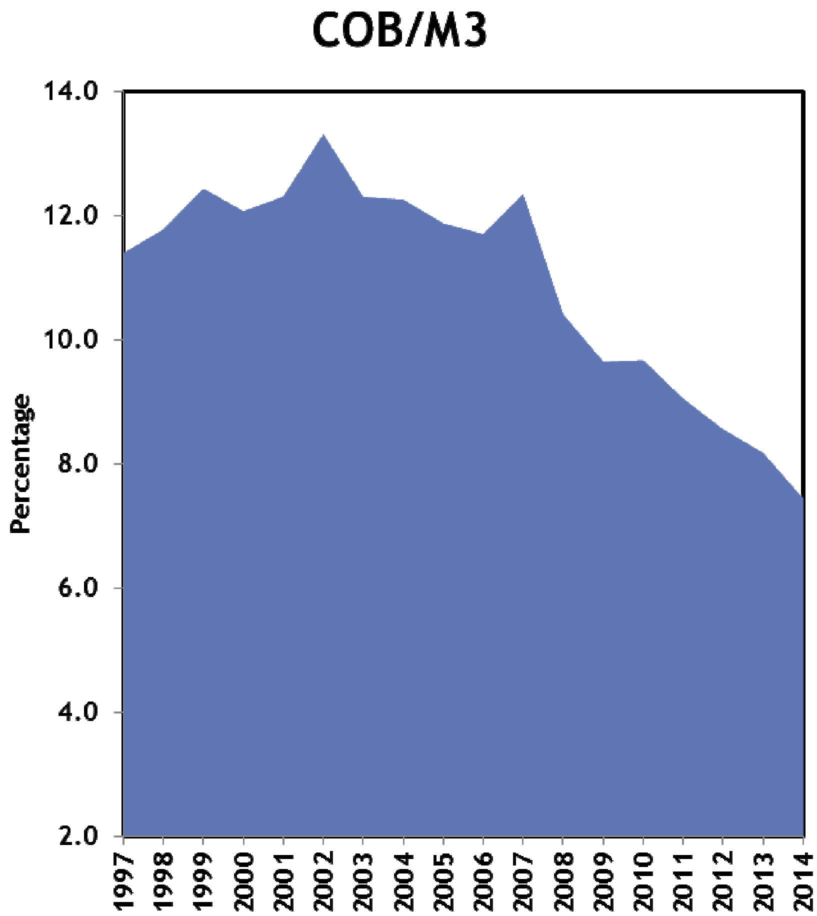


- Deposit accounts have increased from 2.5 million in 2005 to over 32 million in March 2015.
- **Micro accounts** have increased by over 1,337% from about 2.14 million accounts in 2005 to about 30.82 million accounts in March 2015. Micro-accounts balances are up to Ksh.100,000 and are fully covered by Deposit Protection Fund.
- Growth attributable to reduced costs of maintaining micro accounts and financial market access; mobile banking, agent banking, increased branch outlets solving physical distance problem.

…AND EFFICIENCY IMPROVED

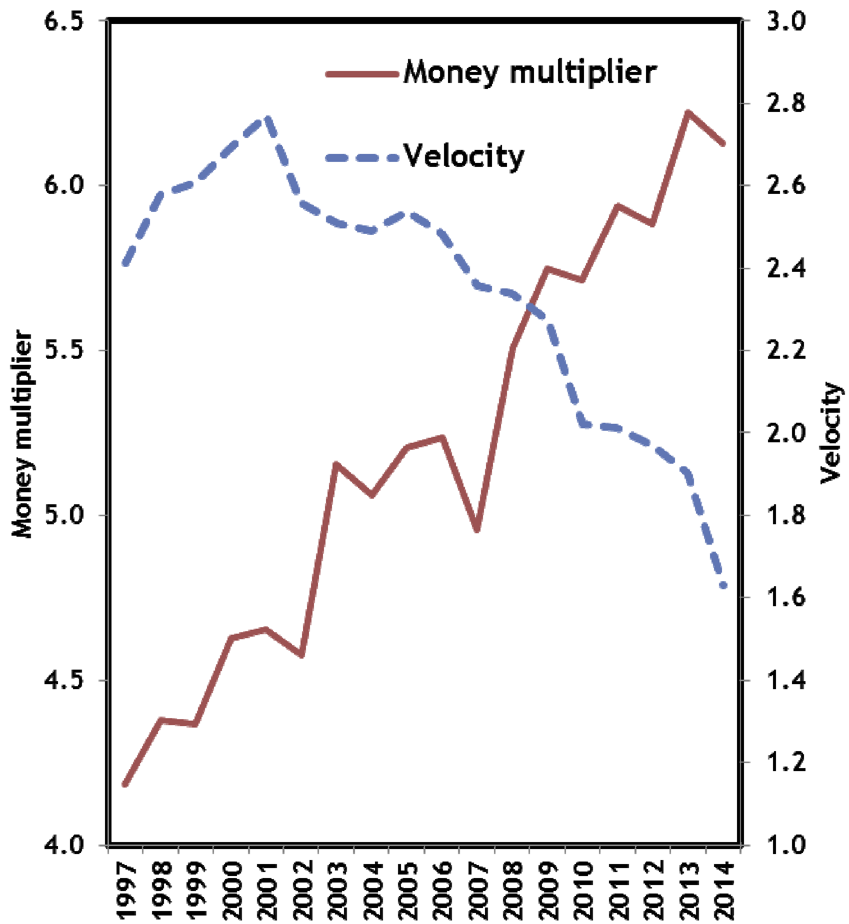
- Financial innovation increases the efficiency of the financial system:
  - ✓ Improves efficiency of the financial system in providing funds for business activities - a positive effect on long-term economic growth.
  - ✓ Supports credit market development making it easier for banks to hedge credit risk, manage maturity and credit mismatches thereby enhancing financial system stability.
  - ✓ Facilitates monetary policy operations.

THE TRANSMISSION OF MONETARY POLICY HAS IMPROVED



- **Improved access to financial services has led to reduction in currency outside and hence informality in the banking sector**.
- …has improved transmission of monetary policy

BUT THESE FINANCIAL INNOVATIONS HAVE COME WITH IMPLICATIONS IN THE CONDUCT OF MONETARY POLICY



- With financial deepening and innovations, velocity of circulation has been falling while money multiplier has been rising…

- Consequently , the relationship between monetary aggregates has not been stable

- Financial developments including mobile phone money innovations have played a significant role in the decline in the velocity of money since 2007.

- The decline in velocity implies Kenyans are becoming “cash light”,

…MONETARY TARGETING FRAMEWORK IS THEREFORE UNRELIABLE

- The money multiplier has been rising in Kenya since 2007 evidence of financial innovation
- Declining velocity and unstable money multiplier imply that the money demand function is unstable which has implications for monetary policy framework and instruments
- Rising money multiplier – financial innovation – shows the relationship between monetary aggregates is unstable – **monetary policy framework should change**

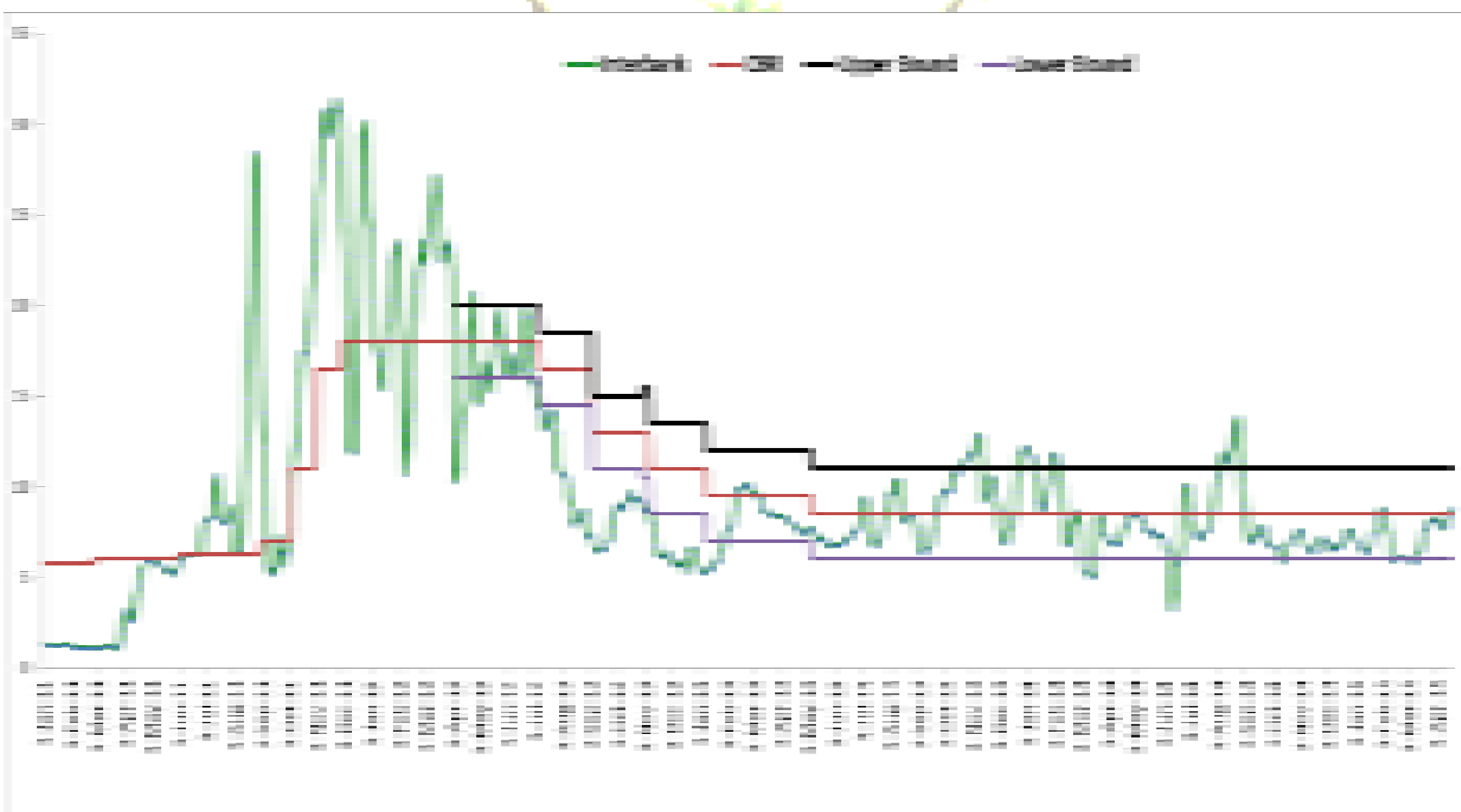
..AND THEREFORE THE BANK HAS CONTINUOUSLY IMPROVED ITS MONETARY POLICY FRAMEWORK

- **Flexibility introduced in the monetary targeting framework**
  - NDA and NIR of the Central Bank were introduced as intermediate targets since January 2011
  - The economic programme 2015 has Net Domestic Assets (NDA) as the indicative target and Net International Reserves (NIR) as the quantitative performance criteria. This programme is supported by a precautionary facility of the IMF (the SBA/SCF arrangement)
- **Introduction of the CRR averaging requirement for commercial banks in August 2011 to improve liquidity management.**
  - Banks required to observe 5.25% on average during the maintenance cycle with a daily floor of 3%
- **Introduction of longer dated term auction deposits to expand the array of monetary policy instruments. Currently maturities range include 14, 21 and 28 days.**

⊙ Modification of the monetary policy operating framework:

- Introduction of the CBR corridor in April 2012 to minimize volatility in the interbank rate and align it with the CBR ;
- CBR is the reference rate for pricing monetary policy operations
- The interbank rate has become the operating target for monetary policy

EVOLUTION OF INTERBANK RATES



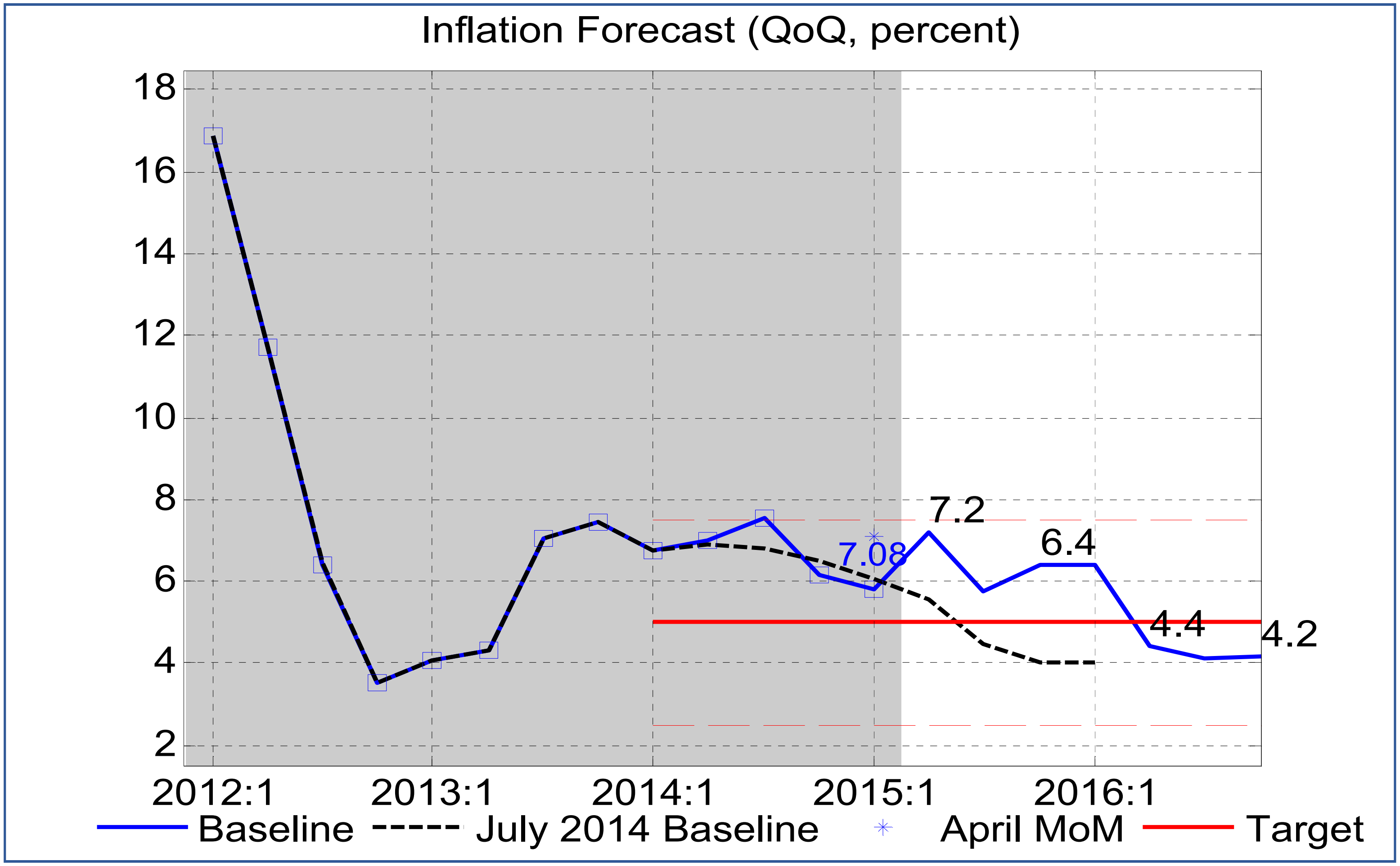
IN ADDITION THE BANK HAS STARTED TRANSITIONING TO FORWARD LOOKING MONETARY POLICY REGIME

- The government economic programme with the IMF has committed to inflation targeting.
  - The agreed performance criteria is inflation target of 5% with a corridor of ± 2.5
- To effectively monitor this criteria the bank has invested in:
  - Forward looking inflation forecasting frameworks – Forecasting and Policy Analysis System –FPAS.

THE NEXT STEPS…

1. The monetary policy framework has delivered price stability – but the supply side is a threat and financial innovation and development is a benefit
2. Transition to an explicit inflation targeting framework for Kenya is necessary but will require internal institutional build-up at the CBK:
   - Enhance the inflation forecasting capabilities
   - Capacity to survey and analyze inflation expectations and similar means of information gathering so that CBR anchors these expectations properly and appropriately
   - Continue with institutional and money market reforms that are important to enhance the monetary policy transmission process and the monetary policy instruments
   - Develop strong capacity for monetary policy operations to support the MPC decisions
   - Macro-prudential supervisory capabilities
3. But external institutional challenges persist:
   - The creation of buffers to support the supply side of the economy – reserves for food, oil and foreign exchange would provide an intervention mechanism for moderating overall inflation
   - Commodity exchanges/or receipt warehousing will also encourage surpluses to be generated in the sector to enhance productivity and the food buffers

AN EXAMPLE OF OUTPUT FPAS



- Actual inflation rate was 7.08% in April 2015.
- Inflation for 2015Q2 is projected to edge upwards to 7.2% nearing the upper bound of the government medium term target of ±2.5 of 5 %.
- Inflation is expected to gradually come down in Q3 of 2015 to 6.4% nearer to the Medium term target of 5%.

THANK YOU