DRAFT REPORT OF 4TH MEETING OF GOVERNORS OF THE ASSOCIATION OF AFRICAN CENTRAL BANKS (AACB), EASTERN AFRICA SUB-REGION

BUJUMBURA, BURUNDI

FEBRUARY 25, 2005

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1. Introduction

1.1. The 4th meeting of Governors of the Association of Africa Central Banks (AACB), East Africa Sub-Region was held on February 25, 2005 in Novotel Hotel, Bujumbura, Burundi. It was hosted by Banque de la Republique du Burundi.

1.2. The purpose of the meeting was to, among other agenda items, review progress of the sub-region in the implementation of the African Monetary cooperation programme (AMCP).

1.3. Mr. Salvator Toyi, Governor of the Banque de la Republique du Burundi, chaired the meeting.

2. Attendance

2.1. The meeting was attended by Governors and officials from the following member Central Banks:

i. Banque de la Republique du Burundi ;
ii. Central Bank of Kenya;
iii. Bank of Uganda;
iv. Banque Nationale du Rwanda;

2.2. Bank of Tanzania attended the meeting as an observer. The Executive Secretary of the AACB Secretariat also attended the meeting. The list of Governors and officials from member Central Banks who attended the meeting is attached as **Appendix 1.** Also included in the list are the representatives of Bank of Tanzania and the AACB Secretariat.

2.3. Except for Bank of Mauritius, which sent its apology, the following member central banks were absent:

i. Bank of Eritrea
ii. Central Bank of Seychelles
iii. Banque Centrale de Djibouti
iv. Central Bank of Ethiopia.

3. Opening Remarks

3.1. Mr. Salvator Toyi, Governor of the Banque de la Republique du Burundi, officially opened the meeting. In his opening remarks, Governor Toyi welcomed all delegates to Burundi, in its capital, Bujumbura. He observed that the 4th meeting of Governors was taking place at a crucial moment for the country of Burundi.

3.2. Governor Toyi further told the meeting that after more than 12 years of socio-political conflicts, Burundi was heading to lasting peace based on democracy, politico-economic good governance, thanks to the efforts made by its people, the Sub-region and the international community. He informed the meeting that on February 28, 2005 a ballot on the adoption of the Burundi constitution will be held and that other consultations aimed at providing the country with democratically elected institutions are planned in the First Semester 2005.

3.3. Finally, Governor Toyi thanked fellow Governors for having entrusted him and the Bank of the Republic of Burundi, with the responsibility of the position of chairman

of AACB Eastern Africa-Sub-region on July 27, 2004 Yaounde, Cameroon. He promised to do all his best to built on the excellent work already achieved by his predecessors and thus ensue that the goals of monetary cooperation in the sub-region are achieved. He particularly singled Dr. Andrew Mullei, Governor of the Central Bank of Kenya for the work he achieved during his term.

4. Adoption of Agenda

4.1. The meeting adopted the following agenda:

i. Opening Session

ii. Adoption of Agenda

iii. Consideration of the report of the 3rd Meeting of the AACB Eastern Africa Sub-region

- Confirmation and adoption of report
- Matters Arising

iv. Exchanges of Experiences in Monetary Policy Management

v. Progress Towards Implementation of the African Monetary Cooperation Programme (AMCP) by member central banks

vi. Capital Account Liberalization: The Experience of Uganda and Kenya

vii. Preparation of the 2005 Symposium on Bank Supervision Basle II Agreement

viii. Any Other Business (A.O.B).

5. Consideration of Report of 3rd Meeting of Committee of Governors of the AACB Eastern Africa Sub-Regional Committee Held on July 27, 2004 in Yaounde, Cameroon

5.1. The Governors considered and adopted the report of the 3rd meeting of Governors of AACB East Africa.

5.2. Matters Arising:

5.2.1. Experience of Kenya on the causes of high interest rate spreads

- Since the meeting of Governors in Yaounde did not have an opportunity to discuss the paper on *Experience of Kenya on the causes of high interest rate spreads*, it was agreed that the paper be presented to the next meeting of the sub-region.

5.2.2. **Support for Burundi and Rwanda to join the East Africa Community (EAC)**

- The Governors reiterated their support for both Burundi and Rwanda to join EAC;

- They mandated the current chair of the Sub-region to consult with the EAC Secretariat on the matter and to request that both countries be invited to future Monetary Affairs Committee (MAC) Meetings as observers.

5.2.3. **Low Participation of Fellow Governors in the Meetings of the Sub-region**

- Governors emphasised the need to enhance efforts to sensitise the inactive members of the sub region and enlist their commitment both to the AACB and Sub regional Monetary Cooperation Programme.

5.2.4. Workshop on Harmonization of Concepts, Statistical Frameworks and Methodologies

- The meeting recalled that the AACB Assembly of Governors held in Cameroon in July 2004 decided that harmonization of concepts and methodologies as well as the statistical frameworks of the AMCP should first be done at the sub-regional level before continental harmonization of the same is done.

- The meeting also recalled that the *CBK promised to host a meeting of the subregion in Mombasa, Kenya*. The *chairman was mandated with the task of liaising with Governor Mullei on* the promise.

- The meeting recalled that Bank of Uganda was mandated to take the lead in examining the convergence criteria of the AMCP so as to facilitate the discussion during the proposed workshop.

6. Exchange of Experiences in Monetary Policy Management

6.1 The Governors shared experiences on the management of monetary policy among member states. The summaries of each country's presentations on monetary policy experiences are attached as **Appendix II.** The following salient features emerged from the discussions:

(i) **Problems of Exogenous Shocks:**

- The meeting observed that exogenous shocks, particularly those arising from bad weather and increase in oil prices have complicated monetary policy management in all member states.

- Bank of Uganda informed the meeting that the World Bank has done some work on how to mitigate the impact of such exogenous shocks not only on monetary policy but also on farmers and the poor. In particular, the meeting was informed that the World Bank is in the process of developing a fund that will act as a lending facility as well as a signal to donors on the need to support countries facing exogenous shocks. The size of support from the fund will be based on the size of the shocks that the respective countries face. *Governors agreed that more information on this facility be obtained from the Executive Directors of the Africa*

Group I Constituency of the World Bank. Bank of Uganda was asked to take the lead on this issue.

(ii) **Problem of large donor inflows:**

- **Relatively large donor inflows in Uganda have complicated monetary policy management**. Because the foreign inflows have been high relative to the level of domestic absorption, government fiscal operations have led to excessive liquidity of a structural nature that need to be sterilised. *BOU, however, does not have enough sterilization instruments.* This situation has lead to a massive use of treasury bills that in turn has led to increased interest rates, hence causing crowding out of the private sector in the credit market.

- *Governors observed that a lack of sterilization instrument was one problem but an even bigger problem is the design of the monetary programs by member states.* Governors observed that the IMF *has often understated the velocity of money supply in the design of monetary program under the PRGF*. They further observed that although research that has been done by some of the IMF experts has acknowledged this problem, the Fund has not made much progress to correct this problem. *In this respect, Governors observed that there was need for some realism among central banks and IMF missions in the design of monetary policy programs*.

- The Governors also observed that the IMF in its designs of financial programs for African countries often insist on countries pursuing low figure of budget deficit (excluding grants) to GDP. They also noted that the current criterion under the AMCP of targeting a low figure of budget deficit (excluding grants) to GDP is too tight for many countries. They indicated that the structure of many African countries will not allow them to meet the criteria. They therefore *called upon the IMF to increase the fiscal space* and *for the AMCP to change the criteria from excluding grants to including grants*. They therefore called upon the experts to revisit the criteria by way of undertaking a study that will indicate the appropriate budget deficit for countries absorbing large donor inflows. *The purpose of such a study will be to reconcile the two conflicting positions of achieving Millennium Development Goals (MDGs) while at the same time pursuing low budget deficit to GDP ratio.*

(iii) **Problem of controllability:** Central banks of member countries have over the recent years found it difficult dealing with several challenges related to controllability of monetary policy targets. These include:

(a) Challenge of forecasting liquidity:

- Most member central banks have had to contend with the challenge of forecasting liquidity within a short time period. The monetary policy operations are based on an analysis of the daily forecast of the sources of reserve money, some of which have proved elusive and tricky to forecast.

- The most problematic ones are transactions affecting government accounts at the central banks. While data on transactions relating to debt payments are fairly accurate and readily available, those on transactions relating to goods

and services consumed by the Government are not. This is because most Treasuries of member countries have not been able to put in place effective cash management and expenditure control systems.

(b) Problem of Controlling Currency Outside banks:

- The four member central banks that presented their reports have experienced difficulties in immediately influencing excess reserves in form of currency outside banks. Influencing currency outside banks through OMO can only be affected by higher interest rates sustained over a long time, where the public will respond by reducing their currency holdings in favor of deposits.

- High seasonality in currency outside banks associated with the public's high demand for currency, especially during festivities and when inflation is high due to transient factors occasioned by adverse effects of drought on food inflation and/or rising world oil prices on fuel prices, has also constrained liquidity management using OMO.

- The meeting observed that under these circumstances, it would seem more reasonable, therefore, to focus on bank reserves only. This is because bank reserves, unlike currency in circulation, can be influenced by central banks in their short-term monetary operations. The inclusion of currency in circulation tends to complicate monetary operations.

(c) Problems of Distressed banks:

- Targets for daily liquidity operations set in terms of bank excess reserve are affected by reserve held by distressed banks. These banks do no participate in Repo operations because of their nature of liquidity problems.

- A case in Kenya is that of a state-owned bank that sometimes holds excess reserves and which cannot be accessed by the CBK in its the daily liquidity operations.

(d) Lack of Interest rate anchor:

- The meeting observed that the current monetary policy frameworks in member central banks do not have interest rate anchors. In the case of Kenya, for instance, both the repo rate and the discount rates are linked to the Treasury bill rate, which is influenced more by short-term government financial, needs than by the monetary policy stance.

- To address this, CBK is set to launch a Bank Rate, which is expected to be the reference prime rate maintained by any bank, in respect of loans, advances, or other financial facilities granted to its customers.

- BOU indicated the issue of developing an interest rate that signals the monetary policy stance is under discussion in Uganda. BOU indicated that it had invited IMF to give technical advice on an appropriate bank rate.

- Governors observed that the major challenge that must be met in order to realize success in the implementation of a Bank rate is to ensure that the prevailing fiscal stance is supportive of that Bank rate. Additionally, the transmission channels of financial markets must be strong unlike the current situation in many member countries were transmission channels are weak. Many commercial banks in the region, for instance, still carry huge non-performing loans. Governors indicated that they were following keenly how successful the Bank rate that the *CBK is currently developing given the current state of infrastructure and fiscal stance in Kenya!*

(e) Problem of Volatile Short-Term Interest Rates:

- The meeting noted that short-term interest rates in all the member central banks represented have been experienced.

- This has tended to create uncertainties in the economic environments of the respective countries and thus may have affected investments.

(iv) Problem of Managing Exchange Rate Volatility:

- Exchange rate policies for the four member central banks present in the meeting are market based, implying that forces of demand and supply determine the exchange rates in the respective interbank foreign exchange markets.

- The policy has served the economy well in all countries by absorbing any external shocks. The participation of central banks in the interbank market continued to be limited to smoothing short-term excessive volatility, effecting external debt payments and maintaining the target for net international reserves under the IMF-supported PRGF program.

- There are concerns about the determination of timing and magnitude of any intervention. This was observed as a problem for many countries of the subregion. Central banks have been criticised for either action, moving in too quickly or too slowly or even moderate!

(v) Problem related to inclusion of foreign currency deposits in calculation of reserve requirement:

- Except in the case of Burundi, foreign currency deposits are included in the calculation of reserve requirement. This has attracted resistant from commercial banks on grounds that it increases their exposure to exchange rate losses.

- The commercial banks have expressed reservation on the denomination of reserves on foreign currency deposits in domestic currency during calculation of reserves and have often requested to be allowed to denominate reserves on foreign currency deposits in foreign currency in the calculation of reserve requirement.

- The member central banks, however, resisted the proposal arguing that denominating reserves in domestic currency ensures that reserve money would not vary as the exchange rate varies. In the case of a depreciation of the shilling

exchange rate, for instance, the reserve money would not expand, as this will be automatically accommodated as required reserve deposits in local currency terms.

- The motivation of the proposal by the banks in Kenya, for instance, is to place the onus of adjustment in case of the variation of the exchange rate on CBK. Consequently, the CBK has advised banks to spread their foreign currency holding denomination to other currencies so as to hedge against adjustment in case of any exchange rate variations. This is a challenge to many central banks in the subregion.

(vi) Problems of High Interest Rates:

- Kenya's experience has shown that in spite of the financial reforms, interest rate spreads have persistently remained relatively high during the post-liberalized environment than during the pre-liberalized environment. The spreads have also remained relatively high when compared to other countries. Kenya's experience is not a typical. Other central banks in the sub-region have also experienced similar trends.

- The meeting was informed that the failure of market forces to bring down interest rates and to harmonise the lending and saving rates in Kenya, led to a lot of disillusionment among Kenyans, culminating in the enactment of the Central Bank of Kenya (Amendment) Act No. 4 of 2001. In effect, the Act sought to reintroduce interest rate controls. This Act, has however, been repealed in a new Central Bank of Kenya (Amendment) Act that came into being in December 2004.

- Governors observed that the problem of high interest rate spreads is rampant among member states of the subregion. They observed that the high spreads in most countries are due to inefficiencies in the banking sector in addition to inadequate competition. They observed that as long as the government borrowing continues to be a feature in the local money markets, then it will be very difficult to reduce the spreads since most banks find it a relatively risk free avenue of investments.

- Governors observed that they have a role to advise the Government though the relevant ministers such as those of finance on the need for government to reduce their reliance on domestic borrowing. They also observed that member countries should endeavour to develop bank rates that are independent from the Treasury bill rates that are driven by behaviour of government borrowing.

- Governors were informed by BOU that the World Bank was undertaking a pilot study that attempts to indicate areas where government can reduce budget deficits and hence the amount of domestic borrowing. These involves excluding well functioning parastatals from the exchequer.

- BOU was asked to give the lead on the issue of increasing fiscal space and design of monetary programs. This will include writing to the Executive Directors of the Africa group I of the World Bank for frequent briefs on fiscal space developments. The meeting agreed that the CBK would share its paper on

experiences with interest rates spread problem with fellow members during the next meeting of the Sub-region.

(vii) Problems Instability in Money Demand Function:

- Governors observed that strong and stable money demand functions are necessary for the success of the monetary targeting framework of monetary policy, which most member states currently use. They stressed the fact that in the absence of a stable money demand function, monetary growth targets will often be missed because close control is either not possible, or would require undesirable movements in the policy instruments.

- In this respect, Governors observed that central banks of member states may tend towards inflation targeting framework in the future so as to take full control of inflation. This policy change will, however, be dependent on the respective economies meeting certain conditions which include: Providing the Central Bank with instrument independence and a mandate to achieve inflation target; Having a well developed financial markets as well as capital markets; Attaining strong fiscal position and entrenched macroeconomic stability; Having a clear and well understood transmission mechanism with a sound methodology for devising inflation targets and; Having improved accountability and credibility of the Central Bank.

(viii) **Low Depth and Competition of the financial sector:**

- The low depth and competition of financial sector are still some of the main challenges of central banks of respective member countries.

- In the case of Uganda, for instance, the low depth and competition of the financial sector is rendering the interest rate transmission channel of monetary policy ineffective.

- Recent developments, however, indicate that the sensitivity between Repo rates and the interbank rates is improving.

7. Capital Account Liberalization: The Experience of Uganda and Kenya

7.1. Kenya and Uganda presented papers to the committee of experts on their experiences of capital account liberalization. A summary of each presentation is provided below:

7.2. Capital Account Liberalization: *The Uganda Experience*

(i) The move onto a fully liberalized capital account in Uganda was realized in July 1997. It is then that Uganda, among other things, allowed free flow of capital between Uganda and the rest of the world, permitted both residents and non-residents to hold foreign exchange denominated accounts in the domestic banking system and permitted residents to hold foreign exchange denominated accounts and instruments outside the country.

(ii) Ever since the initiation of the reform process in 1987, inflows into Uganda have to a large extent increased.

(iii) Following the capital account liberalization, Uganda has suffered periods of instability in the foreign exchange market:

- The instability in the foreign exchange market has usually manifested itself in widened trading margins, sustained pressure on the exchange rate to either appreciate or depreciate. To a large extent, this instability has been associated with trade-related-flows arising from shifts in terms of trade. Other important factors have included the seasonality of coffee export-related inflows and changing perceptions of market participants on the sustainability of the reform process.

- Just like most other liberalized markets, the foreign exchange market has been subjected to movements triggered off byrumors and speculation. The bubbles have usually been short lived but without doubt, causing losses to investors, creating uncertainty in the market and denting the credibility of the central bank. The single most important effect of large inflows has been the appreciation of the exchange rate plus the associated erosion of export competitiveness.

(iv) A related consequence of capital account liberalization has been the holding of local currency deposits relative to foreign exchange deposits in the domestic banking system:

- By June 1997, the foreign exchange accounts held by residents amounted to 12.8% of broad money (M3). One year after the liberalization of the capital account, this ratio increased to 14.4% and further rose to 17.9% and 23.4% as at end-June 1999 and April 2000 respectively.

- It is difficult to disassociate the exchange rate developments from the observed shift from shilling denominated accounts to dollar denominated ones, although speculative tendencies could have a hand in the enhanced preference for foreign deposits throughout this period. This added another degree of complexity in management of liquidity as intermediation is allowed both in shillings and foreign currency assets and liabilities.

(v) Another development is the increased role of the private sector in spearheading investment given the low domestic savings ratios. Following the liberalization, Uganda has experienced increased levels of private sector investments.

(vi) Increased foreign exchange inflows under a liberal capital account have presented challenges to stability in the foreign exchange market and the management of liquidity:

- In the period prior to capital account liberalisation, both fiscal and monetary policy instruments were used to combat any disruptive effects of capital inflows. In the recent past, however, monetary policy instruments have borne the largest burden of adjustment associated with disruptive effects of capital inflows. This has mainly been through increased issuance of

government and Bank of Uganda securities and adjustment of margins on the policy rates.

- Monetary management has also been complicated following shifts in portfolio behavior by both the banks and non-bank public. This largely lies in the ability of the residents holding foreign accounts to have unlimited freedom in what they can do with such resources thereby increasing the scope for speculation. Such asituation tends to complicate monetary management in an environment where authorities have limited instruments

(vii) Liberalization of the capital account created new forms of risks for the domestic banks, which they had little experience in managing.The large accumulation of short-term foreign liabilities by banks was a major source of distress in the problem banks. To the extent that capital inflows were channelled through the banking system, there was substantial increase in the volume of financial resources at risk. In some cases, this created currency mismatch and transfer of exchange rate risk into credit risk.

(viii) The challenges that Uganda faces as a result of capital account liberalisation are largely associated with the seasonality of export receipts and the associated speculative behaviour making the management of the exchange rate difficult:

- The problem is further complicated by the unlimited purchases and holding of foreign exchange by both residents and non-residents. Transactions relating to unfounded letters of credit, private sector debt and panic behaviour are normally a source of problems. To the extent that the monetary authorities are constrained by availability of enough instruments to contain speculative behaviour of individuals and firms, exchange rate management under a liberal capital account is made difficult. This tends to cause a herd behaviour resulting in reduced transactions as agents opt to withhold sales of foreign exchange from the market, while at the same time buyers bring forward purchases as depreciation pressures are reigning. The converse is true when there are appreciation pressures.

- The resulting volatility in the exchange rate exposes firms that have taken unhedged positions in foreign exchange, e.g. firms that have opened letters of credit or borrowed from external sources. There is, therefore, need to develop instruments to deal with private sector (non-bank) exposure and this could probably be done through commercial banks advising their clients. Education on issues such as currency matching of assets and liabilities, fully covering L/C's, etc would be a positive step.

7.3. Capital Account Liberalization: *The Kenyan Experience*

(i) Capital account liberalisation in Kenya has been part and parcel of a series of economic reforms the country has gone through since early 1990s:

- The climax of measures to liberalize the capital account was reached in 1995 when parliament passed the Bill for the repeal of the Exchange Control Act.

- Since then, non-residents are formally permitted to invest in local money market instruments and repatriate their capital and income earned from such investment as treasury bills, treasury bonds, bearer bonds, government stocks, negotiable certificates of deposits (CD's) and commercial paper.

(ii) Restrictions on outward investments from Kenya have been completely removed:

- Commercial banks are, however, required to inform the Central Bank on all outward investments in excess of US$500,000 for statistical purposes only.

- Restrictions on inward foreign direct investments were removed to a large extent. Foreign companies and individuals were allowed to invest up to a maximum of 40% and 5%, respectively for shares listed at the stock exchange.

- Further liberalization of the capital account was undertaken in 2002 when both non-resident companies and individuals were allowed to invest up to a maximum of 75% of any share issued at the Nairobi Stock Exchange. The remaining 25% was reserved for domestic investors.

(iii) The basic goal of the Kenyan government in opening up the capital account has been *to encourage the import of foreign capital* and *technology*, and to *a smaller extent protect the interests of local economic players*. Thus, the cap of 75% on foreign ownership of foreign invested enterprises ("FIEs") listed at the Nairobi Stock exchange (NSE) was meant to achieve this goal. This explains why Kenya has been reluctant to allow both non-resident companies and individuals to invest up to a 100% of any share issued at the Nairobi Stock Exchange, thus making Kenya's capital account completely liberalized. Consultations among various stakeholders are still going on in Kenya on whether to remove the remaining capital account restrictions.

(iv) Kenya's experience with capital account liberalization has been mixed. While capital account liberalization has generally been beneficial, it also has had disadvantages:

a) **Composition of capital flows**: The liberalization of the capital account in Kenya has affected the composition of capital flows:

  o Net official inflows have generally been on a declining trend, although this decline has been as a result of the country being on an aid embargo rather than due to capital account liberalization per se;

  o Private long-term capital inflows, which were negative around 1993-94, have increased to positive levels;

  o Short-term capital inflows (including net errors and omissions), which were very low in 1993 started rising in 1994 and remained the dominant type of capital inflow since then

The shift to short-term flows is a challenge considering that these flows are easily reversible. Short-term capital inflows have been associated with

high interest rates that prevailed during the period just after liberalization, owing to the mop-up of excess liquidity by the CBK.

b) **Real Exchange Rate Misalignments**. The high interest rate regime that followed liberalization led to increased short-term inflows. The increase in short-term capital inflows led to appreciation of the Kenya shilling, implying deterioration in the country's international competitiveness. During most of the period of liberalized capital account, the Kenya shilling was, in real terms, generally overvalued, implying deterioration in the country's international competitiveness. The misalignments have, however, reduced overtime.

c) **Excessive volatility in foreign exchange market**. An associated consequence of capital account liberalization is that it has tended to invite speculative money flows due to information imperfections that have sometimes made domestic foreign exchange markets excessively volatile and hence drive exchange rates away from values consistent with their underlying macroeconomic fundamentals:

- The macroeconomic implications of even temporary exchange-market failures are great enough to warrant corrective actions. In this respect, the CBK has under the circumstances of exchange rate excessive volatility intervened in the foreign exchange market to stabilise the exchange rate. The CBK intervened in the foreign exchange market on 33 different times between 1995 and end of 2004. The intervention currency in all cases has been in the US dollar. The CBK has had to undertake sterilization measures in all these periods in order to prevent the intervention in the foreign exchange market from changing the amount of bank reserves from levels consistent with established monetary policy goals.

- The sterilization process has been costly because the interest rate the CBK earns on its holdings of securities issued by foreign governments is lower than the market real rate of interest CBK has had to pay on its outstanding liabilities. Furthermore, sterilization keeps domestic real rates relatively high, encouraging more capital to flow to the domestic economy and resulting in a need for even more intensive sterilization activity. It also hampers the country's international competitiveness as it leads to appreciation of the real exchange rate.

d) **Rise in Foreign Currency Deposits.** A related outcome of capital account liberalization has been increasing holdings of foreign currency deposits (FCDs) relative to local currency deposits in the domestic banking system:

- Following the move in February 1994 to permit Kenyan residents with foreign exchange earnings (including non export earnings) to hold foreign currency deposits (FCDs) in commercial banks, there has been substantial growth in FCDs over time. FCDs increased from Ksh 72 million in September 1992 to Ksh 78.8 billion by December 2004.

- As a proportion of broad money supply, M3X, the share rose from 4.2% in December 1994 to 13.5% in December 2004, indicating that foreign currency denominated deposits have, within the span of a decade, become an important component of the country's money supply.

- The loans and advances in foreign currency by banks increased from Ksh. 19.5bn (or 8.1% of total credit to the private sector) in December 1997 to Ksh 45.6bn (or 13.8% of total credit to the private sector) in December 2004. The rapid growth in resident's FCDs is partly due to credit expansion.

- The exclusion of resident' FCDs from the cash ratio deposit base may have provided banks with an avenue for credit disintermediation. This problem was, however, resolved in July 2003 when the computation of cash ratio was changed to include holdings of FCDs by commercial banks as part of harmonization of monetary policy operations within EAC. The CBK is faced with the challenge of whether to allow the calculation of cash ratio to also be based on in foreign currency in addition to local currency.

e) **Low Savings, Investments and hence Growth**. Despite the liberalization of its capital account, Kenya's economic performance weakened over the last decade. Of significance is the decline in savings and investments as a proportion of GDP. As a consequence to decline in savings and investments, Kenya's economic growth declined. The challenge facing Kenya currently is how to mobilize savings and investments, without which higher economic growth cannot be achieved.

7.4. **Capital Account Liberalization: *The Case of Rwanda and Burundi***

(i) Rwanda and Burundi have just finished liberalizing the current accounts. They are however yet to liberalize their capital accounts.

(ii) The socio-political and economic situation in both countries does not favour immediate capital account liberalization. Efforts are, however, underway to open up the capital accounts in both countries.

(iii) The executive secretary informed the meeting that in West Africa, the liberalization of the capital account has already begun but is still also slow. He further indicated that the measures of assessment of the stage reached in liberalization have been set up by the member states

7.5. Lessons from the Presentation of Kenya and Uganda in Capital Account Liberalization

(i) Governors noted that recent events, in particular, the debt crisis in Mexico (1994-95), Asia (1997-98), Brazil (1998-99) and more recently Argentina (2000) have demonstrated, that financial liberalization has its dangers. The events have demonstrated how treacherous world capital markets can be, and posed several dilemmas to policy makers in economic management. Financial

liberalization should therefore be accompanied by implementation of appropriate policies to limit excess volatility and related problems and to contain their potentially damaging effects. They urged countries that are yet to liberalize to exercise caution as the undertake capital account liberalization.

(ii) Governors observed that capital account liberalization has the advantage that it brings discipline in the market. They observed that a liberalized capital account tends to cause speculations that in turn result in frequent portfolio shifts as market participants interprets available information. Those that interpret information correctly gain but those who misinterpret such information often occur substantial losses. Because of this, Governors observed that market participants often try to minimize risks by exercising discipline. Governors also observed that the speculations associated with liberalized capital accounts tend to bring problems of volatility of the exchange rate and this in turn often complicates monetary policy management, as central banks have to undertake sterilization.

(iii) Governors observed that with a liberalized capital account, it is essential that the member central banks ensure that commercial banks accurately report their foreign currency exposures and comply with exposure limits, and that banks' pursue prudent exchange rate risk management policies. This would mean additional capital for commercial banks as they indulge in more foreign exchange transactions. The regulators must also ensure that banks' liquidity management takes cognizance of the potential volatility in short-term foreign borrowing.

(iv) Governors observed that sound macroeconomic policies are essential for maintaining financial stability particularly in countries with liberalized capital. They also observed that recent experience highlights the fact that macroeconomic stability, while necessary, is not sufficient for financial stability, which also requires sound financial sector policies that minimise financial risk through adoption of sound risk management by market participants themselves. In this respect, Governors indicated that:

a) Rigorous prudential supervision and regulation combined with careful design of the lender-of-last-resort facility to limit the scope and incentives for financial market participants to take on excessive risk

b) Banks and non-bank financial intermediaries must manage their balance-sheet risks prudently.

c) Corporate borrowers must recognize and manage risks appropriately, which requires a strong system of corporate governance.

d) Any tendency to take on excessive risk can be contained through market discipline facilitated by the adoption of best-practice accounting, auditing, and disclosure standards.

e) Banks should develop in-house models with which to manage risk, and the national authorities can refer to these when calculating risk weights for capital requirements by, for instance, Basle Capital Accord. But where risk-management techniques are underdeveloped or significant financial market

distortions exist, there is an argument for additional prudential measures to identify and discourage excessive short-term, especially foreign-currency-denominated, borrowing that could jeopardize systemic stability.

f) Governors observed in today's age of modern information and communications technologies, capital account liberalization and financial liberalization are inevitable. The countries of the East Africa Sub-region should therefore strive to minimize the risks and maximize the substantial benefits from participating in the open world economic system.

8. Progress Towards Implementation of the AMCP by Member Central Banks

Member central banks present in the meeting presented their progress reports in the implementation of the quantitative macroeconomic convergence criteria in the second phase (2004 – 2008) of the AMCP:

(a) Progress Made With Respect to the Primary Criteria

(i) Overall Budget Deficit (Excluding Grants) Target as % of GDP

- Under the AMCP, member countries are supposed to achieve Budget deficit (excluding grants) /GDP ratio not exceeding 5 per cent at the end of stage II (2004-2008) and Budget deficit (excluding grants) /GDP ratio not exceeding 3 per cent by end of stage III (2009-2012);

- Except Kenya, all countries that reported their performance did not attain the overall budget deficit target of below 5.0% of GDP (Appendix III);

- Member countries, however, still have time to meet the criteria since stage II of the AMCP begins in 2004 and ends in 2008.

(ii) Inflation target

- Under the AMCP, member countries are expected to attain single digit inflation rates during the second stage (2004-2008) and less than 3 per cent inflation rates by the end of stage III (2009-2012);

- Kenya and Uganda were the only countries whose underlying inflation rates were within single digit inflation rates required to be attained by each member country by end of stage II (Appendix III).

- Unlike Kenya and Uganda that report underlying inflation rates, Rwanda and Burundi report overall inflation rates. While Burundi attained single digit inflation in 2004, Rwanda did not following drought related factors. As in the case of Kenya where overall inflation rose from 9.8% in 2003 to 11.6% in 2004, the increase in inflation in all countries to double-digit level mainly reflected the combined effect of the increases in food prices and petroleum pump-prices. Food prices rose due to reduced food supplies following drought, while the petroleum prices increased because of the rising world prices for oil.

(iii) Minimization of Central Bank financing of budget deficit.

- Under stage II of the AMCP, Central Bank financing of budget deficits should not exceed 10% of previous year's tax revenue. All countries are expected to have eliminated Central Bank credit to Government by end of stage III (2009-2012);

- Uganda does not finance budget deficits using overdrafts from the central banks;

- The Kenya Government financing of the deficit from Central Bank overdraft is by law limited to no more than 5% of the latest audited Government gross recurrent revenue. In fiscal year 2002/2003, the implied amount of overdraft was Ksh 8.3bn compared with actual overdraft amounting to Ksh 4.3bn. In 2003/04, however, the actual Government overdraft at the CBK rose to Ksh 9.2 billion. This was also within the statutory limit Ksh 9.23.billion in fiscal year 2003/04;

- Central Bank financing of budget deficits in Burundi are expected to be within the statutory requirement of 10% of previous year's revenue. Due to the conflicts, however, Burundi has often flouted the statutory requirement;

- While Rwanda has maintained central bank financing of budget deficits within the statutory requirement of not more than 11% of previous year's revenue, the effective overdraft was 0.9% 0f previous year's revenue in 2004.

(iv) External Reserves of Equal to or More than Six Months of Imports of Goods and Services

- Under the AMCP, member countries are expected to attain foreign exchange reserves equivalent to or greater than 3 months of imports during the second stage (2004-2008) and 6 months of imports of goods and non-factor services during stage III (2009-2012);

- All the countries that submitted their reports recorded external reserves/import cover of at least 3 months of imports of goods and non-factor services as required during the second stage (2004-2008) of the implementation of the AMCP;

- Uganda, however, achieved foreign exchange reserves worth 6.5 months of imports of goods and non-factor services. This was above the target of 6 months of imports of goods and non-factor services required to be met during stage III (2009-2012).

(b) Progress Made With Respect to the Secondary Criteria

(i) Elimination of Domestic Arrears and Non-accumulation of New Ones

- Information on whether countries succeeded in elimination of domestic arrears and non-accumulation of new ones was unavailable except in the case of Kenya, Rwanda and Uganda;

- During the fiscal year 2003/04, Kenya reduced the stock of pending bills by about Kshs 3.5 billion, implying that on a cumulative basis, no new domestic arrears were accumulated. Kenya government policy is not to accumulate any new arrears but instead progressively reduce outstanding ones;

- During the year 2004, Rwanda substantially reduced the arrears that had, over the past years, been accumulated;

- Uganda has not completely eliminated accumulation of arrears. Uganda government policy is not to accumulate any new arrears but instead clear outstanding ones by fiscal year 2008/09.

(ii) Domestic fiscal receipts/GDP ratio of equal to or more than 20%.

- In the year 2003/04, domestic fiscal receipts as a percentage of GDP in Kenya dropped below the required ceiling of 20% to stand at 17.72% from 22.9% in 2003;

- Uganda, Burundi and Rwanda did not also satisfy the criteria of attaining domestic fiscal receipts/GDP ratio of equal to or more than 20% during fiscal year 2004. The three countries achieved domestic fiscal receipts/GDP of 12.8%, 19.9% and 13.5%, respectively. This was mainly due to low tax base particularly for countries emerging from long periods of war such as Burundi and Rwanda.

(iii) Wage bill to total tax revenue ratio of less than 35%.

- All countries surpassed the wage bill to domestic revenue target ratio of 35% during the year 2004. Burundi, Kenya, Uganda and Rwanda recorded wage bill as a percentage of fiscal receipts of 47.9%, 46.64%, 39.4% and 38.0%, respectively.

(iv) Public investments financed from internal resources to minimum of 20%.

- Government investment capital as a percentage of fiscal receipts in Kenya rose declined to 17.4% in 2004 from 19.3% in 2003.

- Rwanda recorded investment capital as a percentage of fiscal of 3.0% in 2004.

- Uganda and Burundi did not report on their performance on this criterion.

(v) Real Exchange Rate Stability to be Maintained by Each Country.

- The currencies of Kenya, Rwanda and Uganda appreciated in real terms in 2004, reflecting both developments in domestic and international conditions.

- Burundi currency, however, depreciated in real terms during year 2004.

(vi) The Maintenance of Positive Real Interest Rates

- Real interest rates were positive for Uganda, Burundi and Rwanda in 2004. In the case of Kenya, however, only lending rates were positive in real terms, reflecting excess liquidity in the banking sector

- The interest rates, however, remained broadly market determined in all the countries.

(c) Outstanding Challenges

(i) Governors observed that the issue of harmonization of concepts and methodologies as well as the statistical frameworks need to be revisited in order ensure timely and comparable national statistics: In particular, there is need to:

- Revisit the issue of whether to target budget deficits excluding grants or including grants

- Reach consensus on appropriate concept of inflation – whether underlying or overall- and how it is computed

- Agree on what real exchange rate stability means and wheter it should really be one of the critetia. Can the appreciating currencies of member countries receiving huge donor inflows be said to be unstable?

- Reach agreement on appropriate measure of import cover – is it months of imports of goods alone or impoerts of goods and non-factor services?

(ii) The extent of ownership of the AMCP program by Sub-regional member central banks, RECs and other stakeholders is still low. This is explained by the low participation of member central banks in both the subregional and continental AACB meetings.

(iii) The timetables of the various RECs remain inconsistent with that of the AMCP. Notable progress has, however, been made in respect of COMESA whose monetary cooperation program has been changed to be in line with the AMCP.

9. Progress on Harmonization of Concepts, Methodologies and Statistical Frameworks

9.1. The meeting observed that the issue of harmonization of concepts, methodologies and statistical frameworks requires more time to deliberate on all the many aspects involved.

9.2. The meeting also observed that the harmonization of concepts, methodologies and statistical frameworks involves not only member central banks but also other stakeholders such as the Central Bureau of Statistics and Ministries of Finance / National Planning and Development.

9.3. In this respect, the Governors decided that the matter be handled as a substance item in form of a workshop where major stakeholders will also be invited. In the meantime member countries should do preliminary work that should culminate into a workshop. Alternatively, a questionnaire could be designed and send to member states. The results of the survey will then be discussed n the workshop.

10. Any Other Business (A.O.B)

10.1. The Governors observed that that the issue of timing of the implementation of AMCP should not be mixed up with the issue of harmonization of concepts, methodologies and statistical frameworks. In this respect, Governors recommended that a workshop on harmonization of concepts, methodologies and statistical frameworks under the AMCP should be organized at some future date at the continental rather than subregional level.

10.2. Bank of Rwanda was elected to be the vice chair of the Sub-region during the tenure of Bank of Burundi as the chair of the technical meetings. Governors congratulated Bank of Rwanda for being elected to the position of the vice chair of the sub region.

10.3. Governors expressed thanks and gratitude to Bank of Burundi for good hospitality accorded to them and their officials in addition to the excellent facilities provided to facilitate the successful conduct of the meetings.

11. List of Decisions to Governors

(i) Member central banks should continue to meet regularly to share experiences/lessons and challenges in the implementation of the AMCP;

(ii) The sub-region should intensify efforts to enhance ownership of the AMCP by member central banks and other stakeholders. In this respect:

- The current chairman of the sub-region was mandated to undertake physical contacts with his fellow Governors of the subregion in order to find an urgent solution to the problem of the low participation in the sub-regional meetings.

- Key in this endeavour is for the chairman to make efforts to sensitise the inactive members of the sub region and enlist their commitment both to the continental AACB and Sub regional Monetary Cooperation Programme.

- The current chair will also have to send the reports of recent events within the region including those of the 3rd and 4th meetings of the subregion.

- The Governors recommend to the Bureau of Governors to mandate the AACB Secretariat to organize a continental workshop on harmonization of concepts, methodologies and statistical frameworks;

(iii) Workshop on harmonization of concepts, methodologies and statistical frameworks of the AMCP should:

- Be held in June 2005 at a venue to be communicated by the chairman of the sub-region.

- Should precede the meeting of experts that will prepare the sub-region's draft report on the implementation of AMCP to be presented to the 2005 Assembly of Governors scheduled to be held in July 2005 in Accra, Ghana.

- In the meantime member countries should do preliminary work that should culminate into the workshop. Additionally, a questionnaire could be designed and send to member states. The results of the survey will then be discussed during the workshop.

- Bank of Uganda mandated to take the lead in examining the convergence criteria of the AMCP so as to facilitate the discussion during the proposed workshop in Mombasa.

- The AACB Secretariat should make efforts to organize a continental workshop on harmonization of concepts, methodologies and statistical frameworks.

(iv) A study should be undertaken by the committee of experts of the subregion on the appropriate budget deficit for countries absorbing large donor inflows. *The purpose of such a study will be to reconcile the two conflicting positions of achieving Millennium Development Goals (MDGs) while at the same time pursuing low budget deficit to GDP ratio.*

(v) Member states, which do not participate in the sub-regional committee meeting, should at least make an effort to send reports of their performance in the implementation of the AMCP as well as other agenda items. Such reports should be send to both the current chair of the central bank and the host country of the meeting. This will make future meetings of the subregion to be more effective in assessing progress of the subregion;

(vi) The current chair of the Sub-region to consult with the EAC Secretariat and request that both Burundi and Rwanda should be invited to future Monetary Affairs Committee (MAC) Meetings as observers.

(vii) The paper on *Experience of Kenya on the causes of high interest rate spreads* circulated to the 3rd meeting of Governors of the subregion held at BEAC on July 27, 2004 should be presented to the next meeting of the sub-region. Further sharing of experiences of member countries in the liberalization of their respective account capital should also be undertaken.

(viii) During ordinary meetings of Assembly of Governors of the AACB, the respective chairmen of the AACB sub-regions should present the reports of the different sub-regions.

(ix) Member states that have not yet liberalized their account capital accounts are encouraged to make extra efforts to reach that goal. For the countries that have already liberalized and for those in the process of liberalizing, efforts should be made to minimize the problems associated with globalisation. These include:

- Designing and implementing sound macroeconomic policies;
- Promoting strong systems of corporate governance through adoption of best-practice accounting, auditing, and disclosure standards;
- Practising prudential financial institution supervision and regulation combined with careful design of the lender-of-last-resort facility to limit the scope and incentives for financial market participants to take on excessive risk should be embraced by each member central bank, and;
- Encouraging to develop in-house models with which to manage risk, and which the national authorities can refer to when calculating risk weights for capital requirements by, for instance, Basle Capital Accord

(x) Efforts should be stepped up to reconcile the timetables of the Regional Economic Communities (RECs) with the proposed AMCP. This will ensure the attainment and maintenance of macroeconomic convergence among the sub-regions within the prescribed timeframe.

(xi) Governors should mandate the current chair of the Sub-region to consult with the EAC Secretariat and request that both Burundi and Rwanda should be invited to future Monetary Affairs Committee (MAC) Meetings as observers..

(xii) During ordinary meetings of Assembly of Governors of the AACB, the respective chairmen of the AACB sub-regions should present the reports of the different sub-regions;

(xiii) The current chairman of the sub-region should get in touch with his colleagues to remind them to pay their contributions of 2005, the previous arrears and to ratify the revised statutes of the AACB.

Signed

MR. SALVATOR TOYI
Chairperson of AACB Eastern Africa Subregion / Governor of the Board of Banque de la Republique du Burundi (BRB)
February 25, 2005

APPENDIX I: LIST OF OFFICIALS THAT ATTENDED THE 4TH MEETING OF THE AACB EAST AFRICA SUBREGION

	SURNAME	OTHER NAME	CENTRAL BANK	POSITION	TEL.	E-MAIL
1.	KANIMBA	Francois	Banque Nationale du Rwanda	Governor		
2.	SAMBILI (DR)	Edward	Central Bank of Kenya	Deputy Governor		
3.	KASEKENDE (DR)	Louis	Bank of Uganda	Deputy Governor		
4.	TOYI	Salvator	B.R.B.	Deputy Governor		
5.	BARANSATA (Mrs)	Speciose	B.R.B.	Deputy Governor		
6.	KONAN	Benard	AACB Secretariat	Executive Secretary		
7.	KIPTOO **(Rapporteur)**	Christopher	Central Bank of Kenya	Senior Assistant Manager	254-20-2863216	Kiptoock@Centralbank.go.ye
8.	SEKAGILIMANA	Célestin	Banque Nationale du Rwanda	Directeur	08306019	Csekgilimana@.yahoo.fr
9.	MHANDO	Joseph	Bank of Tanzania	Director	255-22-2119312	jsmhando@hg.bot-tz.org
10.	KONAN	Bernard	Secrétariat ABCA	Secrétaire Exécutif	221.839.0884	bkonan@bceao.int
11.	MUSINGUZI (Dr)	Polycarp	Bank of Uganda	Executive Director & Economic Advisor to the Governor	077 798 798	pollymusing@yahoo.com
12.	SOTA	Bonaventure	B.R.B.	Responsable du Service	22 2745	sotabon@yahoo.fr
13.	NTIVUMBURA	Yves	B.R.B.	Responsable du Service		ntivumburayves@hotmail.com
14.	KAMARIZA	Rose	B.R.B.	Conseiller de la Direction	21 82 44	rkamariza@hotmail.com
15.	NKURIKIYE	Consolate	B.R.B.	Responsable du Service	22 27 32	consonkuri@yahoo.fr
16.	NTAHOBARI	Adélaïde	B.R.B.	Responsable du Service	22 2805	ntahodel@yahoo.fr
17.	NIYONZIMA	Audace	B.R.B.	Cadre du Service des	23 7941	niyoauda@yahoo.fr
18.	NDAYISENGA	Paulin	B.R.B	Cadre du Service des	837435	ndayisepaul@yahoo.fr
19.	KABONEKE	Boniface	B.R.B	Cadre du Service des	22 3873	kaboboni@yahoo.fr
20.	NTINDEKURE	Médard	B.R.B.	Cadre du Service	850865	medntindek@hotmail,com
21.	NDAYIRORERE	Adélaïde	B.R.B	Cadre du Service	945371	ndayirorerea@yahoo.fr

APPENDIX II: COUNTRY EXPERIENCES IN MONETARY POLICY MANAGEMENT

A: KENYA'S RECENT EXPERIENCE IN MONETARY POLICY MANAGEMENT

1.0 Introduction

Kenya's monetary policy framework has evolved significantly since the establishment of the Central Bank of Kenya (CBK) in 1966. In its early years, the CBK pursued a passive monetary policy and was largely concerned with protection of Kenya's foreign exchange reserves and the allocation of credit to priority sectors like agriculture and small-scale indigenous businesses. The 1980s witnessed a more active interest rate policy involving a series of reviews aimed at maintaining rates positive in real terms. CBK also adopted a flexible exchange rate regime aimed in part at maintaining the competitiveness of the country's exports. Under this framework, monetary policy remained subordinated to defending the exchange rate rather than, for instance, fighting inflation. Thus the level of reserves assumed importance as the target variable for monetary policy.

In early 1990s, major economic indicators pointed at a downturn in economic activity. The government implemented drastic adjustment measures, including internal deregulation, removal of exchange controls, reduction in government spending, and liberalisation of interest rates. The deregulation of economic activities in early 1990s marked a major milestone in the conduct of monetary policy, changing its mandate from defending a particular exchange rate to achieving and maintaining price stability. The framework that was adopted was that of monetary targeting. Under this framework, the intermediate target for monetary policy is broad money (M3X)[1] while the operating target[2] is reserve money. The Central Bank has three main instruments through which it can affect monetary conditions in order to obtain suitable growth in the money supply. These are: the Open Market Operations (OMO), the Cash/Reserve Ratio Requirement and the Discount Rate.

Monetary policy is conducted in the context of a flexible exchange rate with no predetermined path or specific target range for the exchange rate, and of an open capital account. The CBK's current policy is to occasionally use monetary policy to counter large swings in the exchange rate, and to only intervene in the foreign exchange market to smooth short-term volatility, but not to influence the fundamental direction of exchange rate movement. Monetary policy implementation is anchored on annual targets for broad money and reserve money aggregates, which are reviewed every six months in the context of the Monetary Policy Statement and IMF-supported Poverty Reduction and Growth Facility (PRGF). Monthly targets are set consistent with the established inflation[3] and reserve objectives, and changes in the reserve money are monitored on a daily basis based on the CBK daily balance sheet and liquidity-forecasting framework.

2. Kenya's Recent Monetary Policy Experiences

[1] *Broad money M3X comprises currency outside banking institutions, term and non-term deposits held by the private and the public sectors (excluding central and local government) in banking institutions and residents' foreign currency deposits with local banks. The CBK also tracks the movements of other monetary aggregates, namely M1, M2, M3 and M3XT.*

[2] *Reserve money comprises currency in circulation and deposits of commercial banks and non-bank financial institutions at the Central Bank*

[3] *The objective of monetary policy currently pursued by the CBK is that of containing underlying inflation to below 5 percent.*

Kenya's experience with monetary targeting is not very different from those of fellow African countries or even those of advanced countries such as Canada and Australia. The implementation of monetary targeting framework has brought to the fore various challenges:

(i) Problem of controllability

CBK over the recent years has no found it easy in dealing with several challenges related to controllability of monetary policy. These include:

(a) **Challenge of forecasting liquidity:** The CBK has had to contend with the challenge of forecasting liquidity within a short time period. The monetary policy operations are based on an analysis of the daily forecast of the sources of reserve money, some of which have proved elusive and tricky to forecast. The most problematic ones are transactions affecting government accounts at the CBK. While data on transactions relating to debt payments are fairly accurate and readily available, those on transactions relating to goods and services consumed by the Government are not. This is because the Treasury has not been able to put in place effective cash management and expenditure control systems.

(b) **Problem of Controlling Currency Outside banks:** CBK has experienced difficulties in immediately influencing excess reserves in form of currency outside banks -- one of the key component of reserve money in Kenya, and perhaps the case for other central banks in Africa. Influencing currency outside banks through OMO can only be affected by higher interest rates sustained over a long time, where the public will respond by reducing their currency holdings in favor of deposits. High seasonality in currency outside banks associated with the public's high demand for currency, especially during festivities and when inflation is high due to transient factors occasioned by adverse effects of drought on food inflation and/or rising world oil prices on fuel prices, has also constrained liquidity management using OMO. It would seem more reasonable, therefore, to focus on bank reserves only. This is because bank reserves, unlike currency in circulation, can be influenced by central banks in their short-term monetary operations. The inclusion of currency in circulation tends to complicate monetary operations. For example, in cases where expansion in reserve money is due to excess currency holdings, the central bank has no tool at its disposal to mop up the excess cash holdings by the public.

(c) **Problems of Distressed banks**: Targets for daily liquidity operations set in terms of bank excess reserve are affected by reserve held by distressed banks. These banks do no participate in Repo operations because of their nature of liquidity problems. A case in Kenya is that of a state-owned bank that sometimes holds excess reserves and which cannot be accessed by the CBK in its the daily liquidity operations.

(d) **Lack of Interest rate anchor:** The current monetary policy framework does not have an interest rate anchor as both the repo rate and the discount rates are linked to the treasury bill rate, which is influenced more by short-term government financial needs than by the monetary policy stance. To address this, CBK is set to launch a Bank Rate, which is expected to be the reference

prime rate maintained by any bank, in respect of loans, advances, or other financial facilities granted to its customers. It would be interesting to share experiences in this area, especially as countries consider developing monetary policy framework based on a short term interest rates as the operating target.

(ii) Problem of Volatile Short-Term Interest Rates

CBK pursues a policy of market-determined interest rates. With short-term interest rates on government securities becoming negative in real terms in the recent one-year or so, the Bank was perceived as having deliberately kept nominal interest rate at low levels[4]. This was a misconception as forces of demand and supply determined money market interest rates. Like any market affected by structural inefficiencies, the Bank played its rightful role of guarding the system against any disruptive forces in the market, while letting the market determine the level of interest rates.

With effort to allow more credit to the private sector grow by maintaining interest rate low and stable and preserving the bond yield curve, CBK and market participants were concerned about the too sharp an increase in interest rates in the last quarter of 2004 may lead to financial instability and collapse of bond prices. While this has not happened, two key lessons could be drawn:

- How should interest rate risks be managed in a market-determined interest rates system where there is need to balance the objectives of monetary policy and allow adequate flow of credit to the private and government sector at reasonable rates without disrupting investment decision in the financial markets?

- For central banks allowing recourse to rediscount facilities of government securities, how should central banks guard against abrupt rediscounting when short-term interest rate rises sharply? Massive rediscounting could complicate liquidity operations.

(iii) Problem of Managing Exchange Rate Volatility

CBK's exchange rate policy is to allow the forces of demand and supply to determine the exchange rate in the interbank market for foreign exchange. The policy has served the economy well by absorbing any external shocks. The participation of CBK in the interbank market continued to be limited to smoothing short-term excessive volatility, effecting external debt payments and maintaining the target for net international reserves under the IMF-supported PRGF program.

The CBK intervened in August-September 2004 when speculative tendencies destabilized the movement in the exchange rate. At the time, speculators cashed in on fears of increased demand for foreign currency from oil importers occasioned by increased prices of oil in the international markets, implications of delayed donor inflows for budgetary support and anticipated import of food following the adverse impact of drought. While the overall depreciation of the Kenya shilling was moderated by the CBK intervention, there are concerns about the determination of timing and magnitude of any intervention.

[4] On a positive note, the low interest rates brought about some acceleration in private sector credit.

(iv) Problem of Inflexibility of Reserve requirement

Some of the policy instruments that are used have constrained the conduct of monetary policy. The required reserve ratio, for instance, is relatively inflexible as a monetary instrument to use in the short run while, under the rediscount window, the CBK is obliged to supply the liquidity demanded and can only change the price.

A related problem to this is that effective July 1, 2003, the CBK introduced changes to the specification of reserve requirement to include: lowering of the cash ratio level from 10 percent to 6 percent; abandoning of reserve averaging and creating two separate banks' clearing accounts -- cash ratio account with day-to-day maintenance requirement and clearing balance account; and inclusion of foreign currency deposits in the reserve base and denominating reserves on foreign currency deposits in domestic currency.

Commercial banks have expressed reservation on the denomination of reserves on foreign currency deposits in domestic currency. Instead, they have proposed to CBK to allow for denomination of reserves on foreign currency deposits in foreign currency. The CBK has resisted the proposal arguing that denominating reserves in domestic currency ensures that reserve money would not vary as the exchange rate varies. In the case of a depreciation of the shilling exchange rate, the reserve money would not expand, as it will be automatically accommodated as required reserve deposits in local currency terms. The motivation of the proposal by the banks is to place the onus of adjustment in case of the variation of the exchange rate on CBK. Consequently, the CBK has advised banks to spread their foreign currency holding denomination to other currencies so as to hedge against adjustment in case of any exchange rate variations.

(v) Problems of Exogenous Shocks

Implementation of the current monetary program to June 2005 was disrupted mid-stream by unilateral modification by the IMF in the face of inflation pressure that emanated from rising oil prices.

- ***Issue 1:*** how should consultations between the IMF and central banks be improved to ensure nondisruptive implementation of monetary policy programs?
- ***Issue 2:*** what should be the appropriate monetary policy response to external shock (such as oil prices) for countries adopting a flexible exchange rate regime?

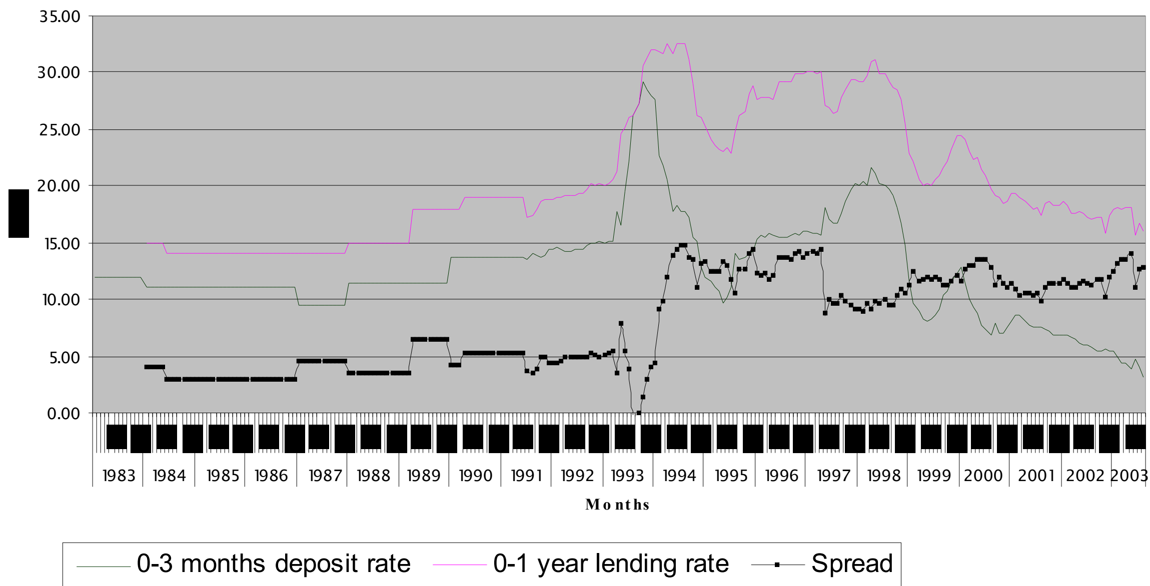
(v) Problems of High Interest rates

Kenya's experience has shown that in spite of the financial reforms, interest rate spreads have persistently remained relatively high during the post-liberalized environment than during the pre-liberalized environment (Chart 1). The spreads have also remained relatively high when compared to other countries (Chart 2). Kenya's experience is not a typical.

Many countries failed to achieve the intended the liberalisation objective of achieving positive real interest levels as well as narrower spreads. The early and rapid liberalizations in the Latin American countries, of Argentina, Chile, Uruguay and Brazil led to different outcomes with regard to real interest rates. Real interest rates in Chile and Uruguay rose to positive levels and remained at high levels for many years whereas in Argentina and Uruguay, negative real deposit rates continued to for several years. In all cases, the

spreads between lending and deposit rates widened. There was similar experience in many African countries such as Gambia, Benin, Cameroon, Cote d'Ivoire, Malawi and Nigeria.

CHART 1: DEPOSIT AND BORROWING RATES & SREAD



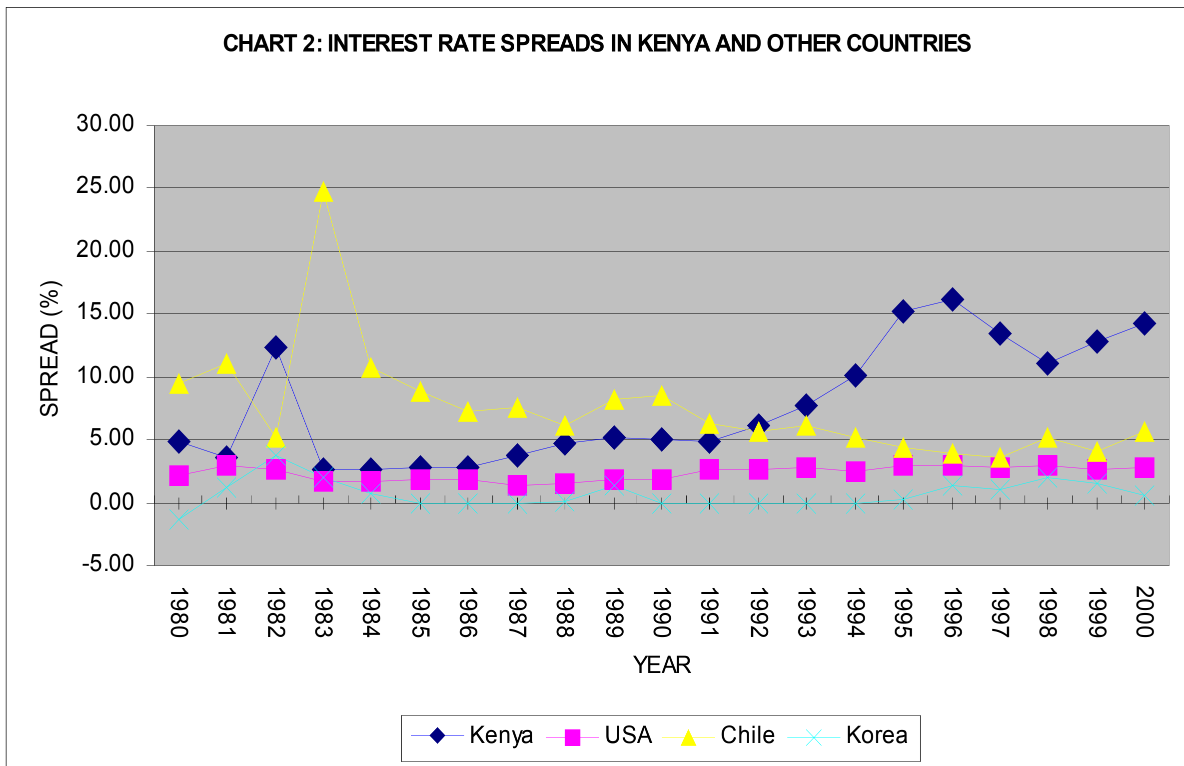


CHART 2: INTEREST RATE SPREADS IN KENYA AND OTHER COUNTRIES

The failure of market forces to bring down interest rates and to harmonise the lending and saving rates has led to a lot of disillusionment in Kenya, culminating in the enactment of the Central Bank of Kenya Amendment Act No. 4 of 2001[5]. Many commentators have

[5] *Section39 (1) of the CBK (Amendment) Act No. 4 of 2001 states that the maximum rate of interest which specified banks or specified institutions may charge on loans or advances shall be the 91-day Treasury Bill rate published by the Bank on the last Friday of each month, or the latest published 91-day Treasury Bill rate, plus four per-centum. Section 39(2) states that the minimum rate of interest which specified banks or specified institutions may pay o deposits held in interest earning accounts shall be seventy per-centum of the 91-day Treasury Bill rate published by the*

argued that the high spreads have been one of the major bottlenecks hindering Kenya's economic growth in Kenya. The debate that followed the judicial dispensation of the litigation surrounding the Central Bank of Kenya (Amendment) Act, 2000 remains a worrisome development and is likely to continue to destabilize not only the banking sector but the entire economy. The CBK believes that the way forward regarding the high interest rates problem is to streamline the operations of banking institutions so as to reduce their operational costs while also strengthening the judicial system in order to quicken the administration of commercial cases. In this context, the CBK is faced with the challenge of convincing Kenyans to support and hasten approval by Parliament of the Central Bank of Kenya (Amendment) Bill, 2001. The Bill seeks to repeal the section in the Central Bank of Kenya (Amendment) Act, 2000 that provides for the control of interest rates.

(vi) Problems of Capital Flows/Instability in Money Demand Function

In view of the increasing integration of the Kenyan economy in the world financial markets and the increasing importance of large and volatile international capital flows, Kenya may have reached the same stage now where the usefulness of the M3X-money supply as a target for monetary policy has been diluted to a point where some alternative anchor should be considered. We may soon see demise of money supply targeting to inflation targeting.

This concern is driven by the fact that there has been instability in the relationship between money supply and inflation - the ultimate objective of policy. The CBK has relied on a demand function both as a means to identify medium term targets for the supply of money but also to manipulate interest rates for the purpose of controlling liquidity in the economy. In the absence of a stable money demand function, monetary growth targets have tended to be inconsistent with developments in the real economy and interest rate targets have also been out of line with the planned growth of the money supply so that the targeted monetary aggregate have sometimes turned out not to be the appropriate reflection of total liquidity in the economy.

B: MONETARY POLICY EXPERIENCE BURUNDI

The Bank of the Republic of Burundi is by laws charged with the responsibility of formulating and maintaining monetary stability and the pursuit of credit and exchange policy propitious to the harmonious development of the country's economy. To reach these goals, the Central Bank exerts its action on the monetary basis, which is the operational objective of the monetary policy. In this way, it has 3 indirect instruments of monetary regulation namely: the market of treasury certificates; the system of refinancing and; the policy of compulsory reserves. Below is a decription of each of them:

(a) **The market of Treasury Certificates.** The Bank of the Republic of Burundi has set a primary market of Treasury Certificates since 1998. The issuing takes place each fifteen days. The procedure used for tenders is that of multiple interest rates and the allocations are held according to a method called "DUTCH" method. This market has undergone changes. With terms of 12 months at the beginning which returned to 6 months later, the expiries are today limited to 1 month (≃ 90% of issued titles) and to 3 months (≃10% of issued titles), since the public has preferred these short term expiries. In fact, the management of treasury is easier in the short term than in the mid or long term. The Bank of the Republic endorses the risk of

Bank on the last Friday of each month, or of the latest published 91-day Treasury Bill rate, plus four per-centum

unpayment by the State at the end of expiry. The Bank of the Republic of Burundi also buys the unadjudged part of the allocations which often varies between 60% and 70% of the offered amounts. In the final analysis, these purchases constitute a kind of advance/loan to the Stak which is flexible for the BRB, allowing the avoidance of negotiating new conventions of budgetary deficit financing by the State caused by repayment of long duration. Initially, the average changeable rates of interest on the Treasury Certificates of the four consecutive issuing served as reference rate since the refinancing rate depended on it.

a. Inferior limit : y* + 0,5% (per cent)
b. Superior limit : y* + 2,75% (per cent)
c. Where Y* stands for the average changeable of average rates of interest for the last four issuing of Treasury Certificates at one month.

Today, taking into account the functioning conditions of the market of Treasury Certificates, the rate given on the Certificates is no longer the reference for the determination of the refinancing rate. The BRB put its belongings on tap to the rate on which it retook them, that is, the average weighted rate from the auctions. The bank is today witnessing a certain interest from the subscribers for that facility. The market of the Treasury Certificate is open to the public. However, financial institutions can be allowed to tender only if they are not refinanced by the Central Bank. This measure has been set up by the BRB to avoid the arbitration risk consecutive to the fact that the refinancing rate is below the rate used on the market of Treasury Certificates. It should be precised that since August 2003, the Central Bank has revised its monetary policy in lowering the rates of Treasury Certificates. For that, the Central Bank estimates, according to the conditions of the time, the ceiling acceptable rate for each term and at each issuing.

(b) The system of refinancing -The refinancing constitutes the Central plan of action of the monetary policy and uses three main elements namely the rate, the ceilings and the guarantees. From the time it was disconnected from the average rate from the auctions of the Treasury Certificates, the refinancing rate is set in a discretionary way taking into account the objective of the monetary policy. From 1 December, 2003, it changed from 15,5% to 14,5%. The flexible management of the refinancing rate is going to continue in periodically adjusting it to the evolution of the inflation rate in order to render the positive the real rates of interests.

Concerning the ceilings, il has been instituted in 2000, in order to put an end to automaticity of the refinancing which remained for a long time at the initiative of financial institutions. The ceilings Lave first been set on a term basis. Then, they have been reduced to one month from January 2003. The levels of those ceilings are also determined in relation to the objectives of the monetary policy and, today, they are individualised. That's why the Central Bank is thinking of replacing it by the system of inviting for bids for cash injection. The system requires the setting up of monetary planning which implies the insertion of the monetary policy within a provisional macroeconomic framework. Lastly, the system of refinancing centers on guarantees. These are made of credits/assets which fulfill the liberation conditions. The Central Bank is planning to render more rigorous the liberation criteria in introducing a decote system to protect itself against the refinancing of unperformant loans.

C: MONETARY POLICY EXPERIENCE IN RWANDA

The mission of the National Bank of Rwanda is by law charged with the responsibility of formulating and carrying our the monetary policy in order to preserve the value of the currency and to ensure its stability. Monetary policy instruments used by the National Bank of Rwanda have evolved through time according to the orientations of the Government's

economic policy. Before 1990, the National Bank of Rwanda had a policy based on the direct control of the credit/loan. The beginning of the first structural adjustment programme in November 1990 started the progressive introduction of indirect instruments of monetary policy.

The year 1995, corresponding to great economic reforms, marked a decisive turning point. Since then, the National Bank of Rwanda has a policy of regulating the bank cash in using indirect instruments.In this way, besides the classical instruments, namely the rate of the compulsory reserve and the rate of refinancing, the indirect monetary policy has been characterized by the creation, in August 1997, of a monetary market. This market, with the interventions of the National Bank on the exchange market, has become the essential instrument of the regulation of the bank liquidity.

Moreover, within the framework of that monetary market, titles of treasury bonds are issued for the needs of the financing of the budgetary deficit as well as for monetary policy. The monetary policy based on indirect instruments has allowed participants on the monetary market to determine freely their rates of interests. The final goal of the monetary policy being to ensure the price stability, the Government development programme aims at the inflation rate and economic growth (real GDP) in relation to the foreseeable trends of supply and Demand.

Since inflation is not a directly controllable variable, the National Bank of Rwanda uses a monetary aggregate (M2) on an intermediary variable of control, basing itself on the hypothesis that if this aggregate is mastered, inflation will also be so (mastered), this hypothesis is founded on the monetarist theory stating the inflation is a monetary phenomenon and consequently, there exists a correlation between currency and inflation. In this way, the choice of the money in circulation has to be compatible with the fixed levels of the real GDP and inflation, according to the currency quantitative relation which determines the general level of liquidity in the economy.

The conduct of the monetary policy by the National Bank of Rwanda uses indirect instruments in order to influence the monetary basis.To carry out its monetary policy, the National Bank of Rwanda uses :

1. **The ratio of compulsory reserves -** compulsory reserves are the proportion of customers' deposits in RWF and in oreign currencies that commercial banks have to keep in the National Bank. These reserves constitute a guarantee for customers but also serve the needs of monetary policy. he level of the ratio of the compulsory reserves is determined by the National Bank of Rwanda, it has varied in these last years, from 12% in 1997 to 8% today.

2. **The rate of refinancing -** the rate or refinancing is a cost of funds obtained by banks from the National ank or Rwanda through the allowance wicket/post. This wicket provides necessary resources to banks, which didn't satisfy the needs of the interbank market. This wicket use a penalizing rate and shows the role of the National Bank as lender of last resort. This rate has repeatedly been revised, and it was between 9.63% (in 2001) and 14.5% (today).

3. **The interventions on the monetary market** - The interventions on the monetary market concern the over all transactions Between the National BANK OF Rwanda and the banking system about short term liquidity. These operations are conducted by cash exchanges through the mechanisms of inviting for bids for liquidity injection, sale or

purchase of titles (Treasury bonds) and the sale or purchase of foreign currencies on the exchange market. The aim of these operations is to increase bank treasuries if necessary or reduce it in case of excess.

Functioning of the current monetary market in Rwanda

4. **Interbank market -**The National Bank remains the center of the interbank market where its interventions consists of balancing the market. The borrowing and lending operations are held at negotiated rates between financial Institutions Today, the interbank market it made of 6 commercial banks ad 2 financial Institutions.

5. **Intervention of the National Bank of Rwanda on the monetary market**. The National Bank can intervene on the monetary market in injecting liquidity in relation to the evolution of liquidity and the operational objective of the monetary policy. Thus, it organises invitation for bids allowing it to face the tender conditions for participants. The National Bank of Rwanda, in a meeting of the committee of Monetary policy and exchange chaired by the Governor determines, each week, the amount of central money it is willing to give or put to the monetary market. On Friday and Monday, or any other time judged convenient, it invites for bids analysed at 12h00 o'clock by an ad hoc committee. The participants must indicate in their tenders the amount to borrow (to lend) and corresponding rates classified in the decreasing (increasing) order of rates round at 1/16 of the percentage. After analysis, the National Bank informs the participants of the retained amounts and of the average weighted rate of the bid. The borrowed/lent amounts are credited on their respective accounts open in the National Bank of Rwanda at the operation date. At the expiry, those account are debited with the capital of the loan increased in the interests.

6. **Issuing Treasury Bonds**. The Treasury bonds are negotiable titles representing the credits to the state. They one issued by the National Bank of Rwanda, as a financial agent of the State, in thin the framework of financing the budgetary deficit and the management of the public debt or for he needs monetary policy. The issuing of Treasure bonds is done by adjudication means, the basis of the competition being the suggested prices by the tenderers. Tenderness other than banks present in competitive offers for which a part of the total issuing is reserved and announced to the public during the adjudication announcement. They will be served in that limit, to the average weighted rates of competitive offers.

D: Experiences of Monetary policy in Uganada

1. Like a number of Sub-Saharan countries, Uganda shifted from direct to indirect monetary policy control as part of the financial sector liberalization process undertaken under the Structural Adjustment Programs. There is growing consensus that direct controls on interest rates and credit have been abandoned because they led to misallocation of resources and inefficiency in financial intermediation with knock-on effects for savings mobilization, investment, and economic growth.

2. Monetary policy in Uganda is set within the context of the macroeconomic objectives of achieving real economic growth and maintenance of price stability as defined by Government from time to time. Consistent with this, monetary policy is designed with a view of achieving the target on inflation while providing adequate credit to the private

sector to sustain the desired economic growth and improve the balance of payments, given an underlying set of assumptions.

3. In the past, the capacity of the Bank of Uganda to manage monetary policy, regulate and supervise financial institutions had been greatly undermined by Government when the authority for licensing banks was vested with the Ministry of Finance. Realizing the need to rationalize the activities of the central bank, the Bank of Uganda Act of 1966 was amended as per the Bank of Uganda Statute of 1993, empowering Bank of Uganda (BOU) as the only monetary authority in Uganda, with the autonomy to formulate and implement monetary policy. BOU was also empowered to supervise and regulate the financial institutions under the Financial Institutions Statute of 1993. Autonomy has proven to be a fundamental strength for the BOU in the recent successful re-privatisation of Uganda Commercial Bank Ltd (UCBL).

4. Uganda adopted a market-based monetary policy regime effectively in 1993, when Government realized that an efficient financial sector with an effective banking system is essential to support and foster its stabilization and adjustment program. One of the program's overall and long-term objectives was to deepen and broaden the financial system and to establish an efficient system of resource mobilization that would offer a greater variety of instruments to borrowers and savers in an increasingly liberal and market-oriented environment. Components of this program included: reform of the legal and regulatory framework of the banking system, reducing financial repression by liberalizing interest rates and eliminating credit controls, restructuring commercial banks, establishing freedom of entry into and procedures for orderly exit from the banking industry, instituting the transition from direct to indirect monetary policy, developing financial markets, including treasury bill markets and other money markets, improving the financial infrastructure including bank supervision, the payments system, auditing, and accounting.

5. Starting in 1993, the BOU adopted the Reserve Money Program (RMP) as the operating framework to facilitate indirect monetary control [Jebuni, Musinguzi and Stryker (2004), Musinguzi, Obwona and Stryker (2000,2001), Musinguzi and Katarikawe (2001), Musinguzi, Kihangire and Opondo (1999), Katarikawe and Sebudde (1999)]. Open market-type operations conducted through treasury (and central bank bills before they were phased out when repos were introduced) are the major monetary policy instruments. The RMP is a policy-oriented but quantity-based projection of a central bank's balance sheet. In determining the demand for base money, BOU follows three steps:

   5.1. The ultimate macroeconomic objectives are defined in terms of quantitative targets on real GDP growth rate, inflation, and the import cover;

   5.2. Broad money growth for M2 and other components of the monetary survey are projected, consistent with the macroeconomic objectives with assumptions for velocity. This makes broad money supply the intermediate target;

   5.3. The growth of base money is then projected to be in line with the broader monetary aggregates and inflation. The annual growth target is converted into monthly targets that reflect seasonality in the money demand. From the monthly targets, the desired levels for daily movements are worked out.

6. On the supply side, factors affecting base money are divided into two categories: autonomous (non-discretionary) factors that are not directly under the control of the

central bank and policy factors driven by discretionary actions of the central bank. For a particular week, the out-turn of base money is compared with the desired level and the gap dictates the direction of monetary policy bearing in mind developments in the prospective supply of base money and other macro-economic variables (inflation, exchange rates, and interest rates). Thus, the RMP has guided monetary policy for some time now.

7. At times, when there were fears that fiscal operations would lead to liquidity injections that would not be easily sterilized by available monetary policy instruments, the fiscal authorities would postpone and cut down on expenditures in favor of macroeconomic stability. Second, the reduction of inflation in the early 1990s was a relection of the commitment of His Excellency the President of Uganda Yoweri Kaguta Museveni when he declared in early 1990s that **Inflation is Indiscipline**. Using the Reserve Money Program, the monetary and fiscal authorities have successfully contained inflationary pressures and significantly lowered and stabilized inflationary expectations through championing sound and consistent policies. Later in the discussion , however, I will argue that this success - containing inflation in low and stable single-digit levels- still begs the question: At what cost was inflation tamed in terms of interest rate and exchange rate volatilities?

8. There are two interrelated concerns since the 1990s have previously cropped up on the day-to-day use of the RMP:

   8.1. Deciding how quickly a deviation in base money from the target (or desired level) should be corrected;

   8.2. Deciding on an appropriate mix of both RMP-based forecasts and forecast of a wider array of leading real economic indicators- such as headline and underlying inflation, the departure of the Equilibrium Real Exchange Rate Path from the actual Real Exchange Rate Path, momentum of nominal exchange rate change and exchange rate margins, M2 and M3 growth, real economy indicators or their proxies including the index of industrial production, export and import volumes, prime and overall lending rates and margins, private sector credit growth, the fiscal operations - in case conflicting signals arise.

9. Other things being equal, the gap between the out-turn and desired levels would give the direction of monetary policy stance: ease if base money is below desired, tighten monetary policy if base money is above desired, and leave monetary policy unchanged/neutral if base money is in line with desired levels. However, in the current situation of structural changes in the financial and non-financial sectors which cause volatilities in velocity and the money multiplier, any action would have to be strongly supported by empirical analysis of developments in other indicators, especially of the real economy. If such movements call for ease in policy while developments in other indicators show the contrary, a policy-oriented analysis of both the RMP-based forecasts and forecasts of Key Leading Real Economic Indicators may help to resolve the conflict in signals. In any case, easing monetary policy under such conditions may be inappropriate as it would fuel rather than contain inflation. In the short run, because of the innovations partly brought about by the liberalization process, the relationships between money, prices, and other indicators, as captured in the instabilities in the money multiplier and its components and in velocity, tend to become hard to predict, thus complicating the conduct of monetary policy [Musinguzi and Katarikawe (2001)].

10. In terms of the overall macroeconomic objectives, the RMP has helped to determine an appropriate monetary policy stance that delivers low and stable single-digit inflation. Such inflation pays as it guides economic agents to make rational decisions, lengthens the planning horizon, reduces uncertainty, safeguards against eroding the purchasing power of a currency, facilitates the savings-investment process, stabilises business expectations, and enhances real GDP growth and poverty reduction prospects.

11. But the effectiveness of the RMP in indirect monetary control has also been undermined by a number of factors: problems in forecasting autonomous factors affecting base money, especially net government operations, the instability of the money multiplier, weak interest rate sensitivity, high levels of commercial banks' excess reserves, and inefficient financial intermediation. In addition, a wider array of indicators including the fundamentals of the Equilibrium Real Exchange Rate (ERER) do not lend themselves to easy and timely measurement. The lumpy nature and timing of donor resources for Government's Poverty alleviation programs and the wide-ranging implications has been a subject of immense discussion within the Bank of Uganda, and between BOU and Government and donors, and a recent IMF MFD Mission was called in by the Governor to address, inter alia, the twin problems of interest rate and exchange rate volatilities, the appropriateness of the RMP and the policy instrument mix. We still face the challenge of eliminating these volatilities.

12. Uganda is a major recipient of donor funds in form of grants and loans to finance public investment programs and for budget support. To date, net donor financing accounts for nearly 10 percent of GDP, or, when expressed as a ratio to total expenditures, now amounts to about 48 percent. Using Net Treasury Bills and sales of dollars in the Inter-bank Foreign Exchange Market, the Bank of Uganda has actively mopped up liquidity injections recently arising from government expenditure of poverty reducing donor resources through increased net sale of dollars in the foreign exchange market. The BOU is also employing Repurchase Agreements (repos) and reverse repos for liquidity management to smooth out the forward-looking base money supply path around the desired or programmed base money demand path to keep both annual headline and underlying inflation in low and stable single-digit levels.

13. This has had the impact of appreciating the nominal and real exchange rate sharply at the expense of export sector competitiveness. The other alternative would have been to actively use open market-type operations using significantly stepped up net Treasury Bill issues, resulting into higher and volatile interest rates which would further squeeze the private sector credit growth. This would adversely affect the real economy growth now below the earlier buoyant levels of 7%. Consequently, there is a need to determine the extent to which the increased donor inflows have *crowded in* the private sector by ascertaining the productivity gains, cost of doing business by the private sector, the increased absorptive capacity, and poverty reduction resulting from increased government expenditures and the effectiveness of poverty-reducing donor resources. There is a need to determine whether the *crowding in* of the private sector more than offsets the loss of export sector competitiveness created by intermediating the donor inflows in the foreign exchange market, and whether the current framework can sustain development in the long run.

14. The timely and accurate measurement of the productivity gains in Uganda and output gap derived from actual output and potential output remains an uphill task. In particular, in the face of exogenous shocks, it is important but difficult to simulate the short-run, medium-term, and long-run effects of the output gap and ERER. Yet **Shadow or Fully-**

Fledged Inflation Targeting still relies on timely, accurate, comprehensive and sufficiently disaggregated real economy data. The application of the RMP in guiding monetary policy actions has improved immensely through weekly liquidity forecasting. There is still a lot to be done by the liquidity forecasting taskforce or the 'Friday Prayer Breakfast' to improve the fiscal forecasts, even in the context of the RMP and the Government Cashflow especially in the already identified areas of government cheques and automatic releases, and the empirical research on the pattern and seasonality of forecasting errors. And with more recent ongoing collaboration between EAST AFRITAC, UBOS and BOU, production of monthly real sector indicators or their proxies and quarterly GDP should assist to check the reliability of the liquidity forecasts and reduce the forecasting errors. In the absence of timely and comprehensive quarterly data on GDP by expenditure from the Uganda Bureau of Statistics (UBOS), only an eclectic approach between the refined Reserve Money Program which has been successful in delivering low and stable single-digit inflation in Uganda and a shadow inflation-targeting framework can be planned for at this stage, as the national accounts and labour market data demands imposed by the latter methodology will have to be satisfied first, and that is why we shall still be stuck with a refined RMP for some time. I will now proceed to show that Inflation Targeting is not a total panacea either [see Willen Duisenberg (2003)] and there is still hope in a **significantly refined RMP which delivers the same objective of maintaining low and stable single-digit inflation but at a cost.**

15. The Strategic Policy Way Forward

15.1. The debate above on Monetary Targeting versus Inflation Targeting is not new at all and the monetary economics literature in academic institutions and developed central banks such as the US Federal Reserve System and the Bank of England on the subject using the actual experiences of 1979 (for the USA) and 1980s (for the UK) is very rich. The Pinpoint Monetary Targeting debate took centre-stage at an international policy conference, see Williamson's (1983) intelligent discussion of IMF Conditionality. It was also the central theme at the recent 2003 Basle BIS meetings.

15.2. Limitations of inflation targeting in the region arise from:

- Weak monetary policy transmission mechanisms.
- Lack of timely, accurate and high frequency data, especially GDP by expenditure approach.
- Lack of appropriate forecasting models.
- The inability of the central banks to undertake independent monetary policy decisions. Weak fiscal positions.
- Narrow range of monetary policy instruments.

- In view of the above limitations, it is premature to move to inflation targeting. In the meantime, the current monetary policy frameworks should be strengthened while at the same time laying the foundation for inflation targeting in the medium term.

- A phased approach for inflation targeting be adopted and implemented as follows:

Phase 1: Formalize use of available information

- Improve information flow especially in the real sector.
- Using available data, estimate the monetary policy transmission mechanism.
- Decide on key issues such as:
- Increasing transparency and accountability through publications and the media;
- Adopting the core measure to guide monetary policy actions and/or communicate with the public;
- Adopting escape clauses to address volatilities associated with inflation in developing countries;
- Inform the public in advance to make accountability easier and further build credibility.

Phase 2: Adopting a formal forecasting framework

- Design system of generating timely and high frequency real sector data including GDP by expenditure approach.

- Develop a simple forecasting model to assist in policy simulation.

- Based on the model, start a shadow inflation-targeting framework.

Phase 3:

- Adopting a fully fledged inflation targeting framework.

- Build capacity through training of staff particularly in macroeconomic modelling and forecasting."

16. **Conclusion.** As a strategic policy and methodological way forward, BOU strongly recommends a practical and effective implementation of the above phased approach to Shadow Inflation Targeting for the medium-term, while simultaneously refining further the current Reserve Money Program along the lines discussed in the foregoing *but not abandon it now*, while efforts need to be stepped up to build up timely, reliable, comprehensive, and sufficiently disaggregated national accounts.

APPENDIX III: MACRO-ECONOMIC PERFORMANCE AND CONVERGENCE CRITERIA UNDER THE AMCP

Primary Criteria

	AMCP Target	Time Frame for Achieving Criteria	Subregional Member	1996	1997	1998	1999	2000	2001	2002	2003	2004	Remarks
1	Overall budget deficit/GDP ratio (excluding grants) of less than 3 per cent	Target of < 5 %t should be achieved in stage II (2004-2008). Target of < 3 % should be achieved in stage III (2009-2012)	Uganda	-1.7	-1.67	-	-1.23	-6.7	-2.6	-13.0	-11.2	-11.2	Most countries have not met this criterion.
			Kenya	-1.2	-1.9	-2.5	-0.1	0.4	-4.8	-3.2	-5.4	-1.9	
			Mauritius	-	-4.0	0.9	-1.5	-1.2	0.9	-6.0	-6.0	-	
			Rwanda	-3.5	-2.2	-6.6	-9.9	-9.2	-9.8	-9.2	-10.2	-13.9	
			Burundi	-3.0	-4.9	-3.8	-3.4	-5.9	1.6	-	-	-	
			Ethiopia	-2.0	-1.4	-4.0	-5.2	-	-	-	-	-	

2	Inflation rate of less than 10 per cent	Under the original AMCP, inflation rate of less than 10 per cent should be achieved in stage II (2004-2008)	Uganda	6.9	6.9	-	6.4	2.9	2.0	3.5	2.4	0.9	Few countries have attained the criteria.
			Kenya	8.4	6.6	9.8	5.5	5.2	5.5	2.7	2.8	3.5	
			Mauritius	6.8	6.8	6.9	6.9	4.2	5.4	6.3	5.15	-	
			Rwanda (Overall)	-	12.0	6.2	-2.4	4.3	2.9	2.5	7.4	12.0	
			Burundi (Overall)	-	31.2	12.5	3.4	24.3	9.2	-1.3	10.7	9.8	
			Ethiopia	-	2.4	2.6	7.9	0.7	-8.1	1.5	23.2	-	
3	Minimization of Central Bank financing of budget deficit.	Under the AMCP, member countries are expected to contain Central Bank financing of budget to less than 10 per cent during stage II (2004-2008)	Uganda	-	-	-	-	-	-	-	-	-	To be addressed in the proposed workshop on harmonization of concepts, methodologies and statistical frameworks
			Kenya	-	-	-	-	-	-	-	-	-	
			Mauritius	-	-	-	-	-	-	-	-	-	
			Rwanda	-	-	-	-	-	-	-	-	-	
			Burundi	-	-	-	-	-	-	-	-	-	
			Ethiopia	-	-		-	-	-	-	-	-	

	External reserves of equal to or more than six months of imports of goods and services	Under the original AMCP, external reserves of equal to or more than 3 months of imports of goods and services should be achieved in stage II (2004-2008) and equal to or more than 6 months of imports of goods and services stage III (2009-12)	Uganda	3.8	4.4	4.6	6.5	6.9	7.6	6.3	5.5	6.5	Except Uganda and Mauritius, all other countries are yet to meet this criteria
			Kenya	3.0	2.5	2.5	2.9	2.9	3.2	3.4	4.3	3.6	
			Mauritius	3.8	3.1	2.5	3.1	4.0	3.8	7.6	8.5	-	
			Rwanda	3.5	3.9	4.8	4.8	5.4	5.9	6.7	5.6	7.1	
			Burundi	12.1	9.6	4.5	4.4	2.6	1.5	4.6	-	-	
			Ethiopia	5.1	3.6	3.3	2.8	2.1	2.3	4.7	-	-	

Secondary Criteria

	Original AMCP Target	Time Frame for Achieving Criteria	Sub-regional Member	1996	1997	1998	1999	2000	2001	2002	2003	2004	Remarks
	Domestic fiscal receipts/GDP ratio of equal to or more than 20%.		Uganda	-	-	-	-	-	-	13.5	13.4	12.8	
			Kenya	-	-	-	-	-	-	22.2	22.9	19.9	
			Mauritius	8.8	10.9	9.7	-	20.9	18.4	18.5	20.3	20.3	
			Rwanda	16.6	17.0	15.8	16.4	10.1	11.7	12.4	13.0	13.5	
			Burundi	15.0	15.4	18.5	17.3	21.0	26.8	30.2	-	-	
			Ethiopia	18.0	20.7	21.6	17.0	-	-	-	-	-	

	Original AMCP Target	Time Frame for Achieving Criteria	Sub-regional Member	1996	1997	1998	1999	2000	2001	2002	2003	2004	Remarks
	Salary mass/total domestic fiscal receipts ratio of less than 35%.		Uganda	-	-	-	-	-	-	-	42.7	39.4	
			Kenya	31.5	32.3	34.6	32.2	36.9	31.5	38.2	37.7	46.6	
			Mauritius	-	-	-	-	-	-	9.0	1.2	-	
			Rwanda	-	-	-	-	56.0	48.9	42.5	38.4	38.0	
			Burundi	-	-	-	-	-	-	-	-	-	
			Ethiopia	-	-	-	-	-	-	-	-	-	
	The sourcing of minimum of 20% government investment capital from fiscal receipts.		Uganda	-	-	-	-	-	-	-	-	-	
			Kenya	20.1	18.2	19.3	16.3	10.4	15.7	12.2	19.3	17.4	
			Mauritius	-	-	-	-	-	-	-	-	-	
			Rwanda	-	-	-	-	-	-	2.2	2.8	3.0	
			Burundi	-	-	-	-	-	-	-	-	-	
			Ethiopia	-	-	-	-	-	-	-	-	-	

	Original AMCP Target	Time Frame for Achieving Criteria	Sub-regional Member	1996	1997	1998	1999	2000	2001	2002	2003	2004	Remarks
	Interest rates - The maintenance of positive real interest rates		Uganda	4.8	6.1	9.1	9.4	16.0	6.8	13.4	21.4	-	
			Kenya	-	-	-	15.5	7.7	5.5	5.54	-1.19	-3.0	
			Mauritius	3.2	6.3	1.6	3.1	3.5	1.9	0.81	-11.3	-	
			Rwanda	4.0	6.9	5.1	13.6	7.4	10.1	10.5	9.1	4.0	
			Burundi	-21.2	2.4	-0.5	8.6	-10.3	4.8	16.8	-	-	
			Ethiopia	4.8	0.4	0.9	-4.3	2.1	11.2	-0.2	-	-	
	Maintenance of real exchange rate stability		Uganda	-	-	-	-	-	-	-	-	-	To be addressed in the proposed workshop on harmonization of concepts, methodologies and statistical frameworks.
			Kenya	-	-	-	-	-	-	-	-	-	
			Mauritius	-	-	-	-	-	-	-	-	-	
			Rwanda	-	-	-	-	-	-	-	-	-	
			Burundi	-	-	-	-	-	-	-	-	-	
			Ethiopia	-	-	-	-	-	-	-	-	-	