



MONETARY POLICY AND THE TRANSITION TOWARDS INFLATION TARGETING

*A Presentation at the High Level Conference on Kenya's Economic
Successes, Prospects and Challenges, Norfolk-Fairmont Hotel, Nairobi,
17-18 September, 2013*

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September 17, 2013



Introduction

Three Messages:

1. To Show the Policy Development: Economic Take-off Requires Paradigm Shift
 2. Institutional Reforms and Institutional Capacity Requirements – Institutions Define Clear Rules and Appropriate Incentives
 3. Match Policy Transformations and Reforms with Dynamics of the Market and the Economy
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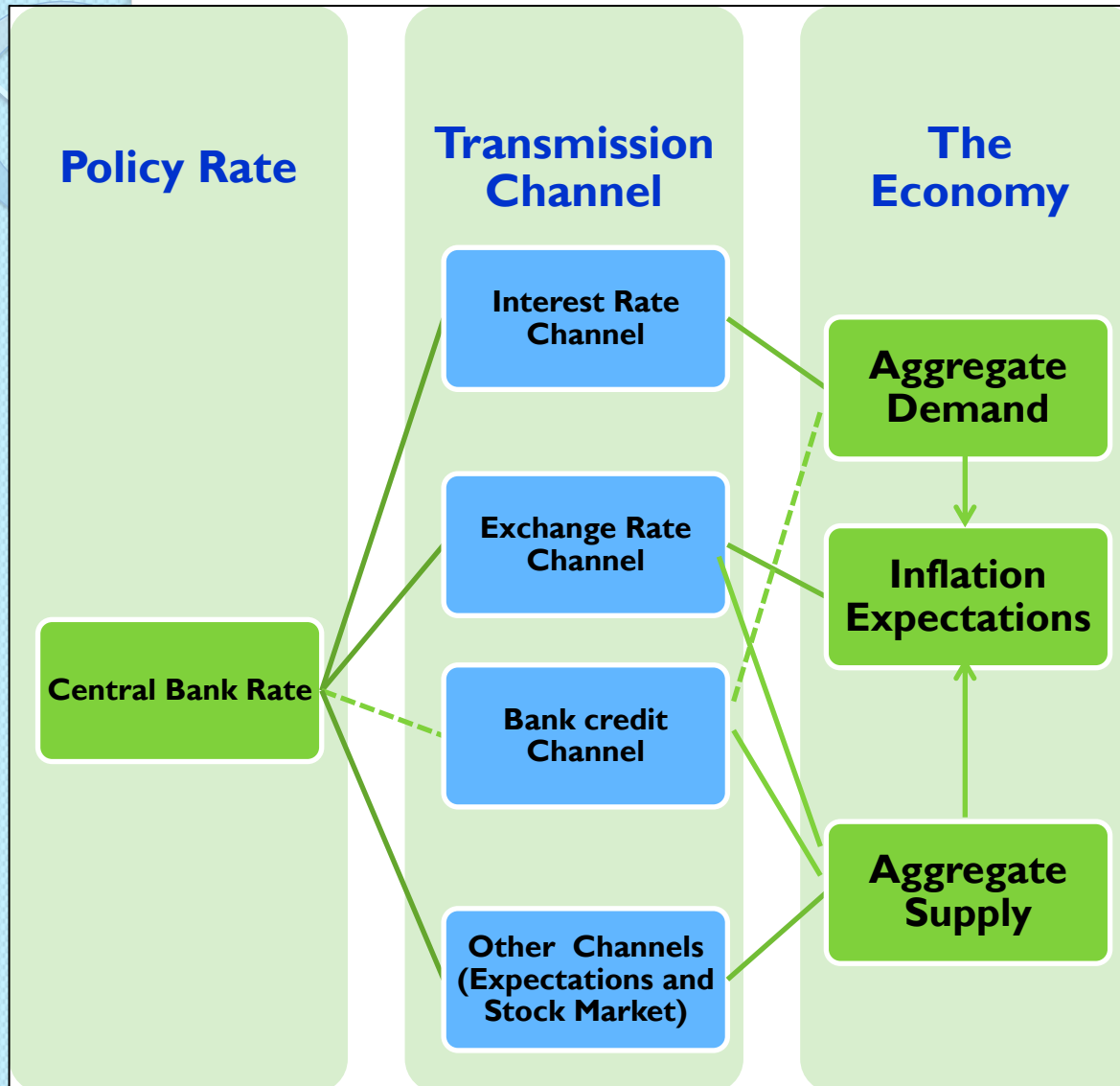


1. Monetary Policy Framework

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

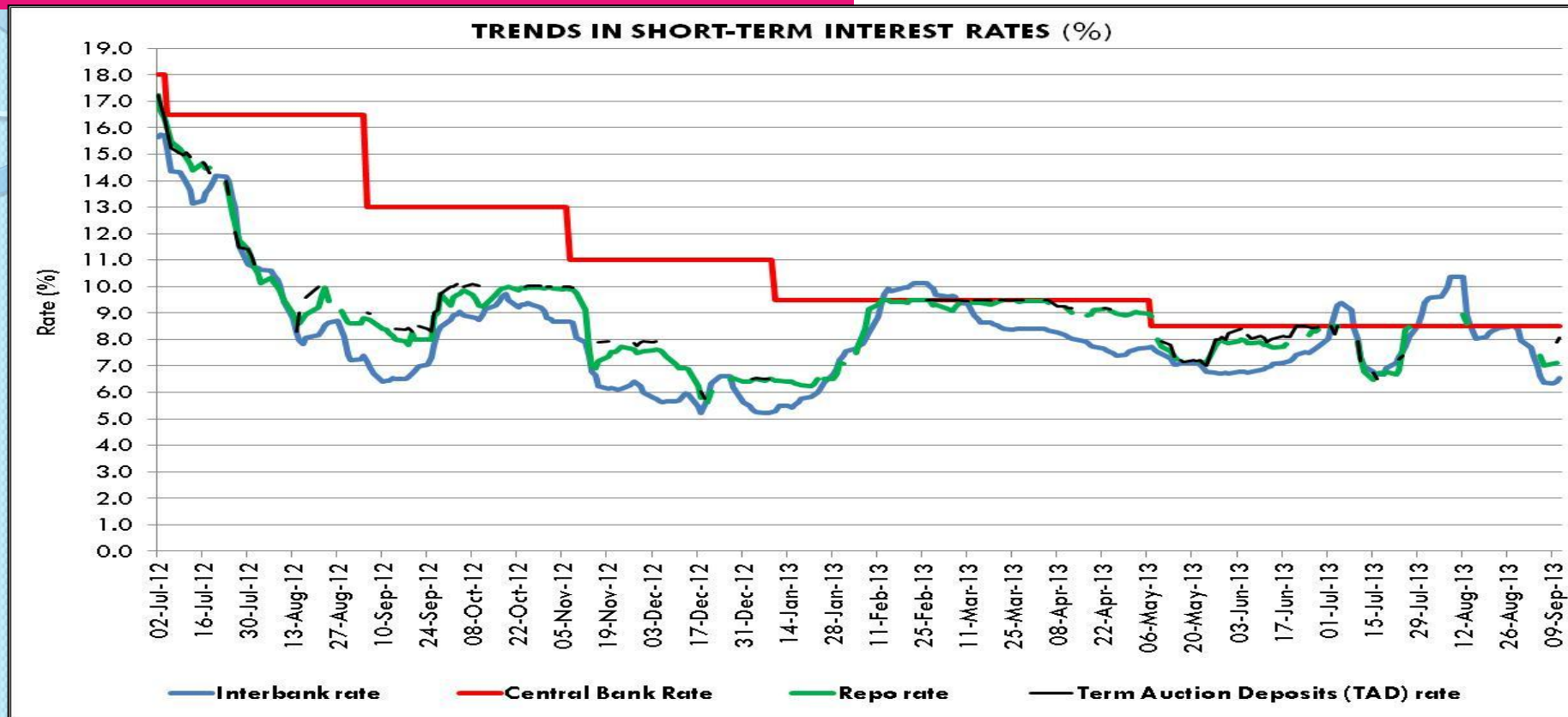
1.1 Monetary Policy Transmission Mechanism

The Central Bank Rate Works Through Different Channels



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

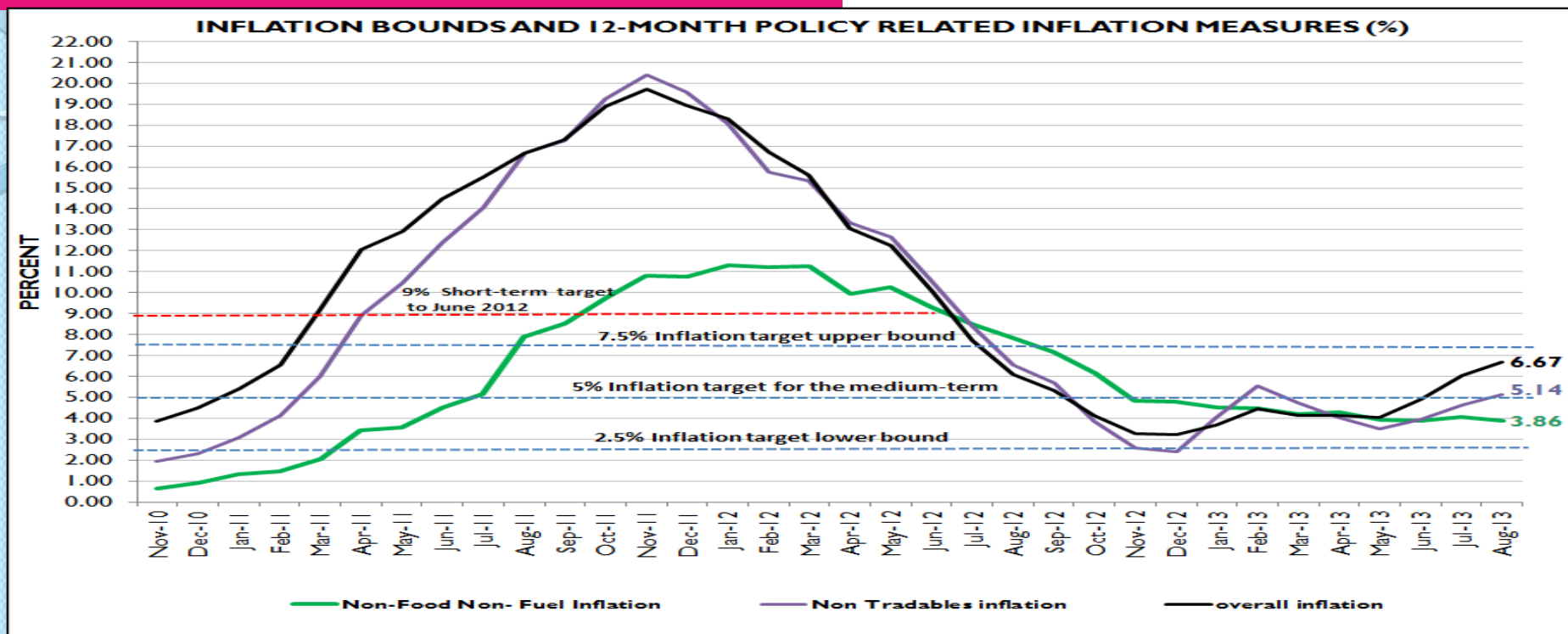
1.2 Monetary Policy - So Far has Delivered Results: The Central Bank Rate Co-ordinates Movements in Short-term Interest Rates



Source: Central Bank of Kenya

- Movements in short-term interest rates are aligned to the CBR and Open Market Operations have supported stability in the interbank market

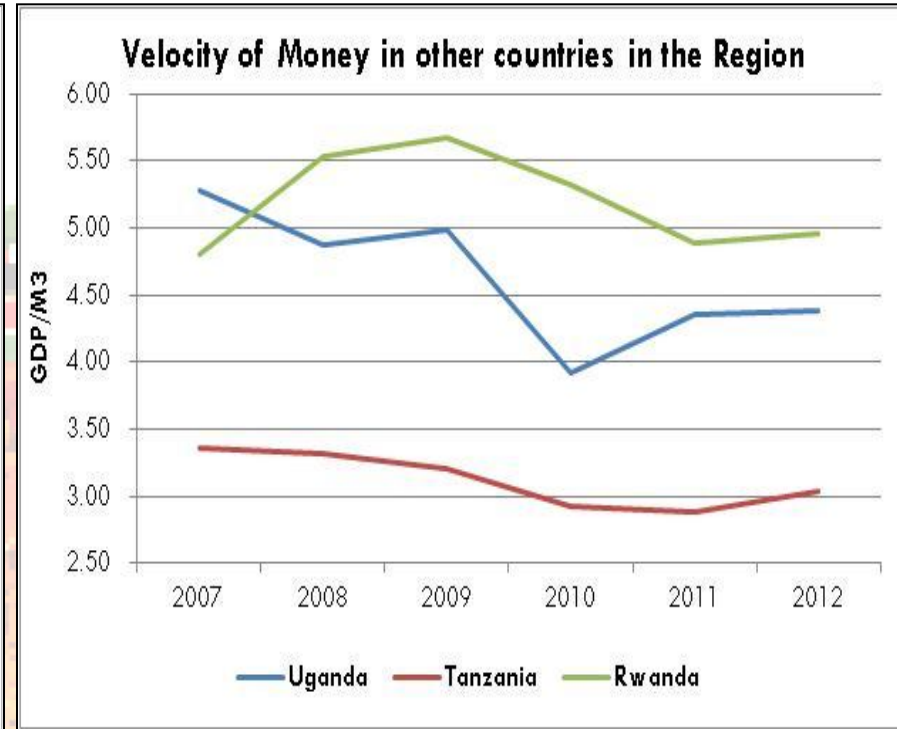
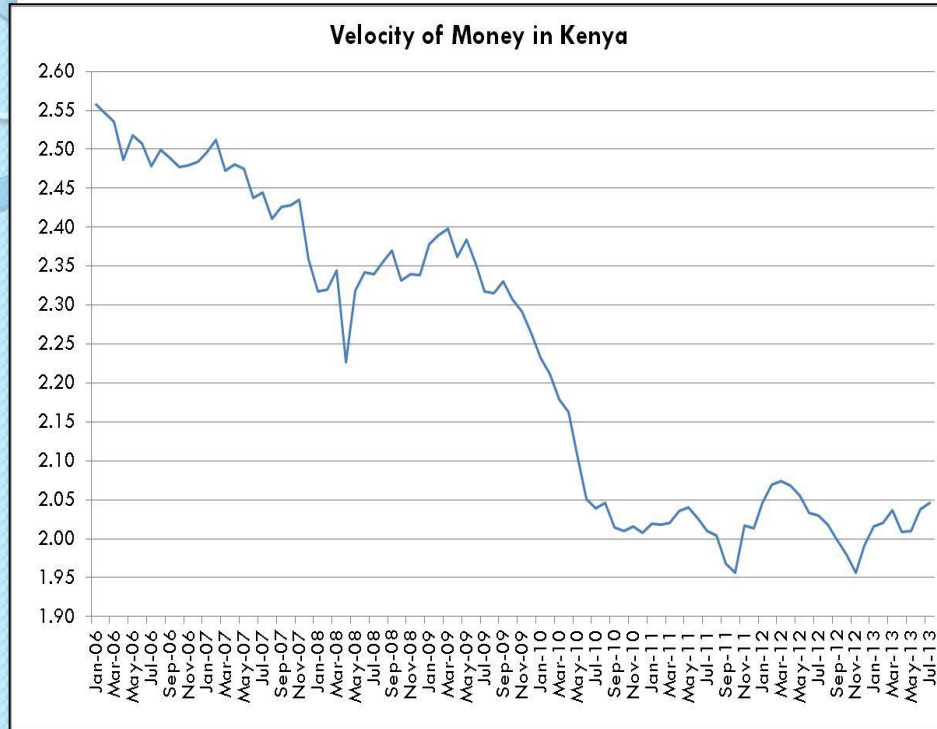
1.3 Inflation Outcomes: Inflation Within the Target Band but There are Risks



Source: Kenya National Bureau of Statistics & Computations by Central Bank of Kenya

- Overall and non-food-non-fuel month-on-month inflation rates have remained within the allowable margin of 2.5 percent on either side of the Government's medium-term target of 5 percent
- Overall inflation peaked at 19.7 percent in November 2011. Fuel prices have remained high with world oil prices remaining persistently above USD100 per barrel
- The CBK tightened monetary policy to prevent the supply shocks that affected domestic prices being ratified thereby creating a higher plateau of domestic prices

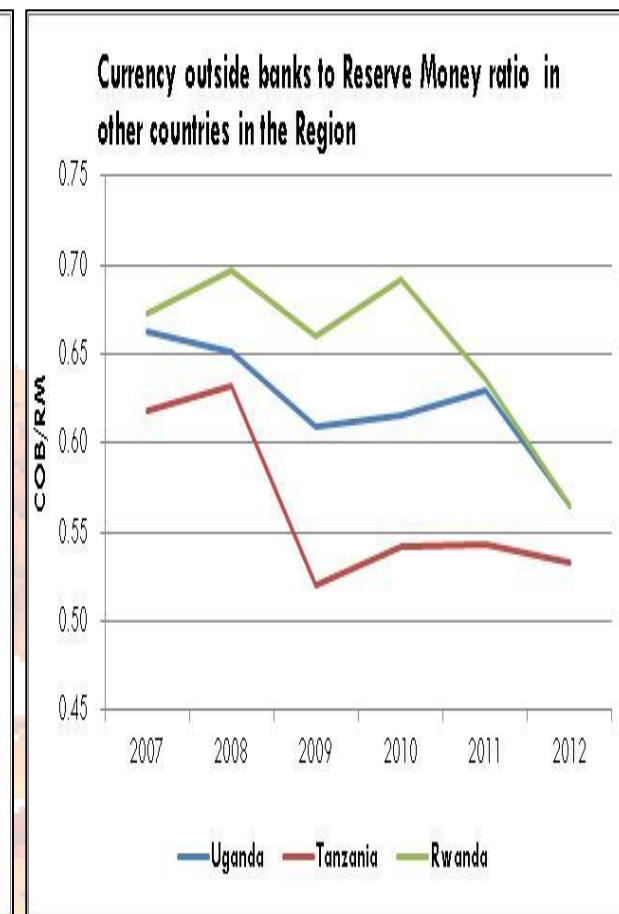
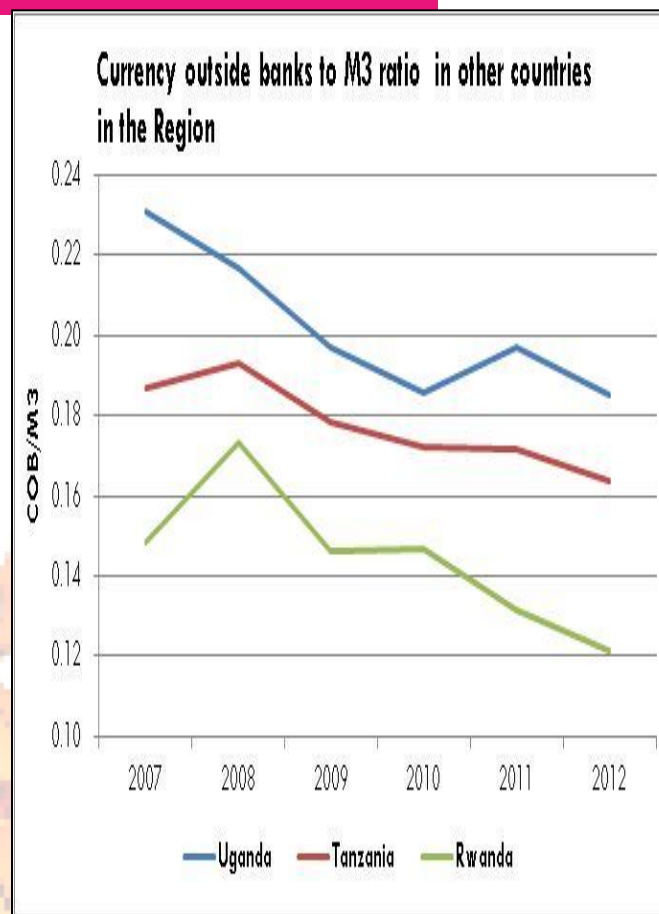
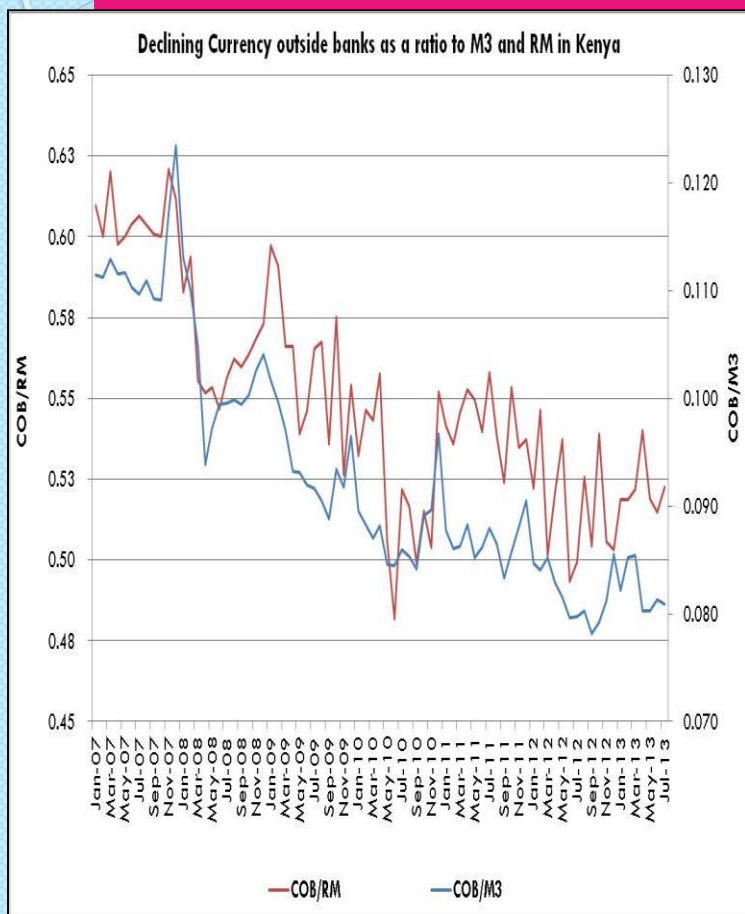
2. Financial Development has been Evident: *Financial Innovations – Velocity of Money has Declined*



Source: Websites of respective country Central Banks

- Velocity of Money in Kenya declined and has now stabilised at a lower level which is an indication of greater financial depth. A similar trend observed in the region but the decline was comparably lower
- Financial developments including mobile phone money innovations have played a significant role in the decline in the velocity of money since 2007
- The decline in velocity implies Kenyans are becoming “cash light”, therefore, money is mostly “inside money” which can support the improvements in the transmission mechanism for monetary policy

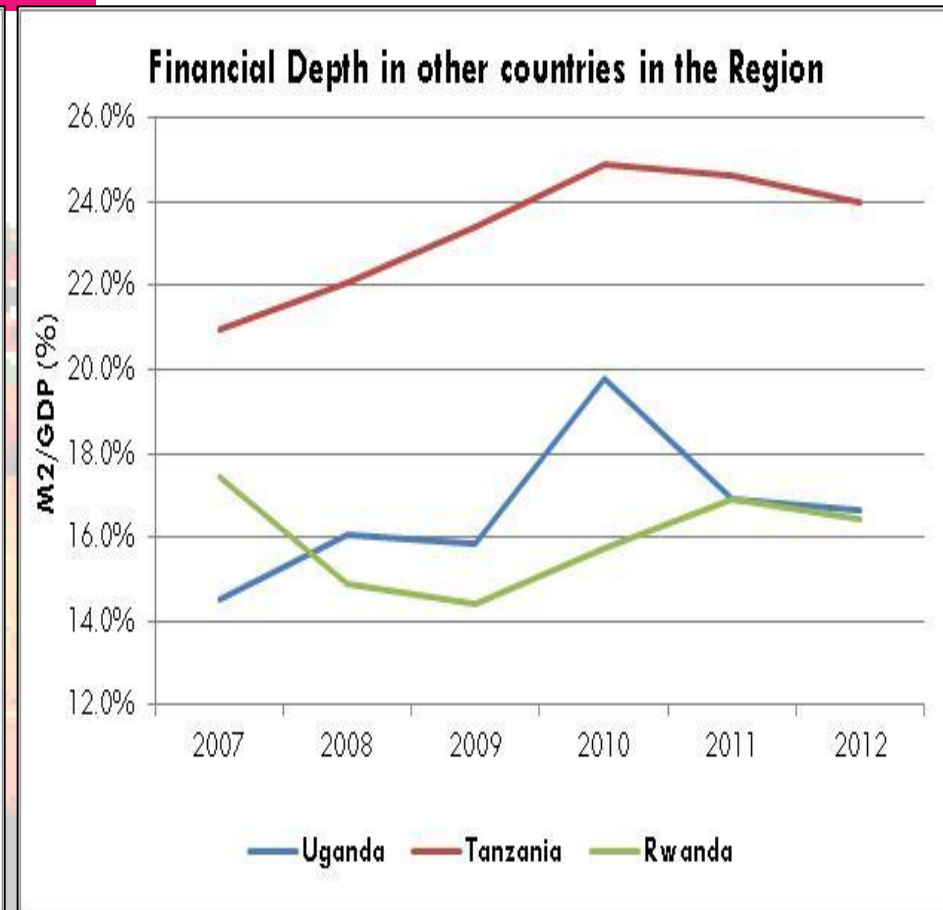
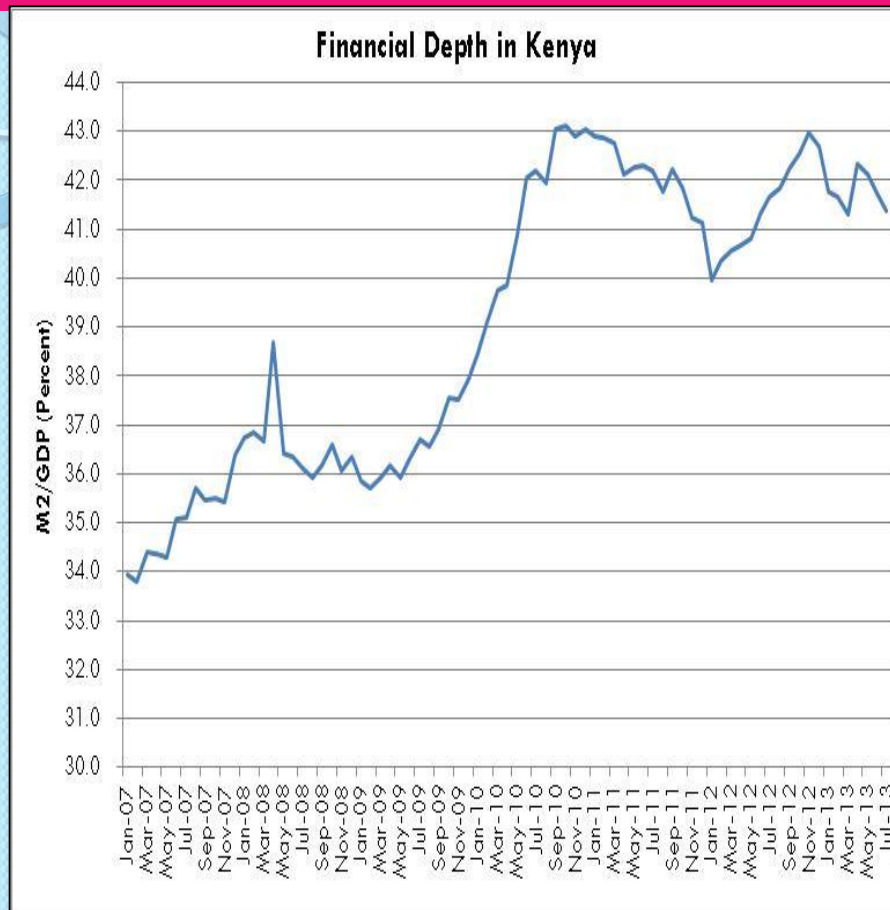
2.1 Financial Development has been Evident: Currency Outside the Banking System has Declined



Source: Websites of respective country Central Banks

- A declining ratio of currency outside banks to M3 and Reserve Money (RM) has been observed in the region. But a much faster decline has been more sustained in Kenya

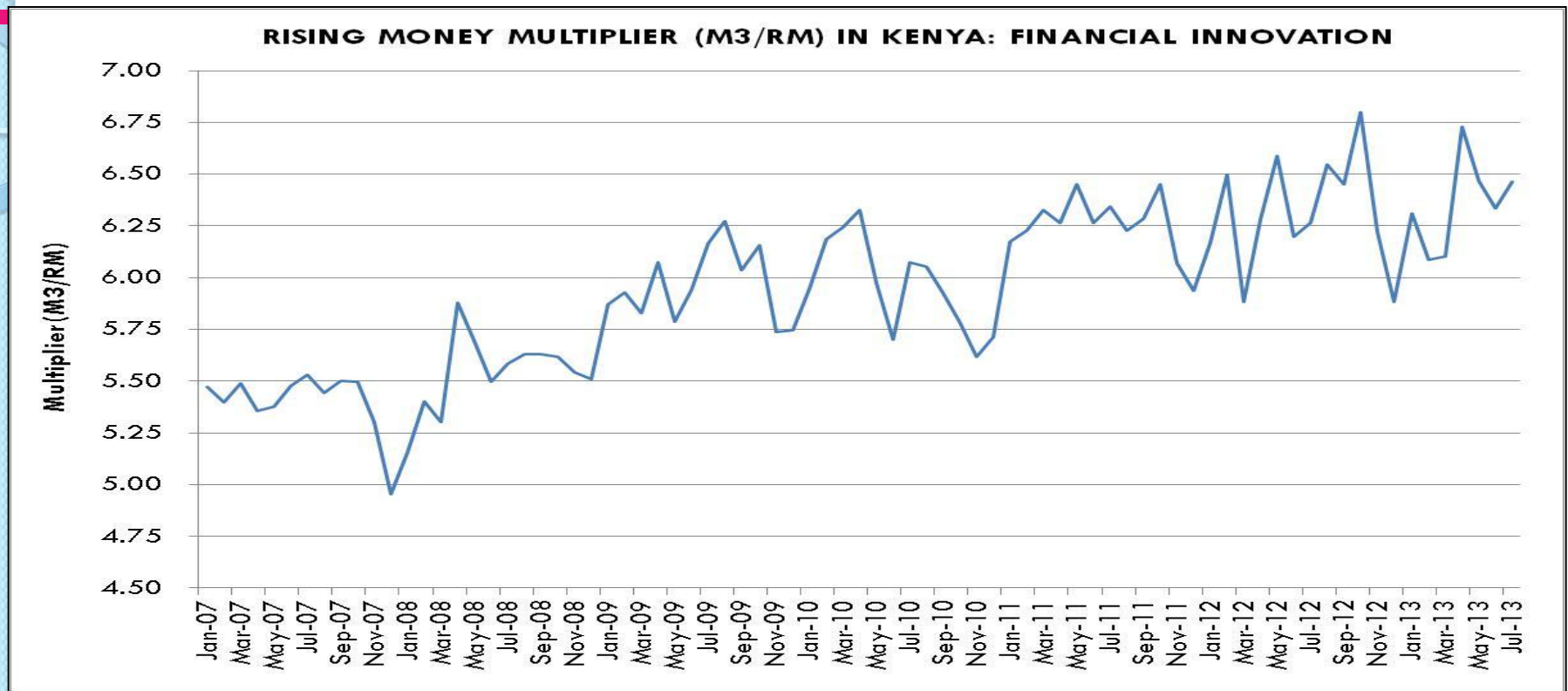
2.2 Financial Development has been Evident: *Financial Depth also Evident*



Source: Websites of respective country Central Banks

- Financial depth (proxy:M2/GDP) has been increasing in the region, but more pronounced in Kenya

2.3 Financial Development has been Evident: *Money Multiplier has been Volatile and Rising*



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



3. Towards Inflation Targeting

- With these financial developments, Inflation Targeting (IT) is supposed to build credibility and anchor public expectations about the future of inflation
 - 1. **Has benefits:**
 - Grants more flexibility to monetary policy
 - Lowers the economic cost of monetary policy failures
 - Limits time-inconsistency problems
 - Easy to communicate
 - 2. **But has challenges:**
 - Offers little discretion to policy
 - May constrain growth
 - Has pre-conditions
 - Difficult to work with when supply shocks dominate
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4. The Next Steps...

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