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# The Central Bank of Kenya Legal Framework Review – A Modern Central Bank in the Making?

## Highlights

- This *Research Note* provides a critical examination of the "Draft Central Bank of Kenya Bill 2014". The analysis acknowledges the progressive aspects of the provisions of the Draft Bill. In the same measure, it highlights the limitations and contradictions in the Draft Bill's provisions, whose review it calls for. In particular, it seeks the consideration of the following areas:
  - Given the apparent leaning of the Central Bank of Kenya (CBK) towards a Taylor rule type of monetary policy conduct, the Draft Bill could demonstrate creativity by legally entrenching a formal inflation targeting framework where such conduct is clearly amenable.
  - The Draft Bill could ambitiously and boldly make pronouncements of a rule type with regard to goal setting to avoid a scenario of dynamic inconsistency and inflation bias emanating from the National Treasury.
  - In an endeavor to enhance monetary policy formulation and implementation framework, the Draft Bill explicitly stipulates the timeframe for price stability goal setting but is silent on the timeframe for realizing the goal is not; we argue that it should explicitly address that asymmetry.
  - Monetary policy transparency and accountability through detailed disclosure and National Assembly testimonies is all good; it is however not sufficient unless the Draft Bill is explicit on the aspect of sanctions in the event of failure to meet the target – even if it is by way of sharp questioning or even public reprimand and risk loss of reputation of the holder of the Governor's office.
  - The Draft Bill should address the potential of the National Treasury compromising the CBK's instrument independence. This is with regard to the provision that the CBK "shall, after consultation with the National Treasury, determine and implement the exchange rate policy". If the Monetary Policy Committee (MPC) has to be fully accountable for monetary policy conduct, then the National Treasury need not be consulted in the *implementation* of the exchange rate policy. The National Treasury has the authority to choose the exchange rate regime, and its choice is one of free market determination; in the spirit of the CBK's instrument independence and accountability, that is where its role with regard to foreign exchange management should end.
  - Finally, the Draft Bill should address itself to potential compromise on accountability and independence in monetary policy conduct arising from governance provisions – particularly the role of the Chairman of the Board of Directors who is not the Governor. If the MPC, and indeed the Governor, is accountable to the public through the National Assembly:
    - then it is contradictory to expect the Governor's performance evaluation initiated by chairman of the Board; If the MPC has the responsibility of formulating monetary policy, and the CBK's Board of Directors has the responsibility of determining policies of the CBK other that formulation and implementation of monetary policy, it is clearly contradictory for the Draft Bill to have provisions that (a) require the governor to be accountable to the Board on matters of monetary policy (b) compromise instrument independence by requiring Board approval on monetary policy instrument, particularly Open Market Operations (OMO).

  It is therefore evident that the creation of a structure where the Governor and the Chairman of the Board of Directors are different is as controversial as it is unprecedented in central banks with efficient monetary policy conduct and seamless operations; and we call for its review.

## Introduction

The National Treasury has published a "Draft Central Bank of Kenya Bill 2014" (subsequently the Draft Bill) that apparently seeks to lay the foundation for a modern central bank. There is no doubt that a modern central bank whose policies and practices conform to those of major central banks that oversee progressive banking sectors and economies is critical if Kenya's economic aspirations as pronounced by Vision 2030 are to be realized.

The fact that the National Treasury has opted for a complete review of the legal framework underpinning the operations of the Central Bank of Kenya (CBK) as opposed to piece meal amendment proposals is evidence enough of the ambition to entrench macroeconomic economic stability, and consequently sustainable growth, on a solid framework. The objective of this *Research Note* is to evaluate that ambition based on the specifics of the Draft Bill.

This *Research Note's* broad assessment is that the Draft Bill makes a number of progressive proposals in respect to monetary policy conduct – the CBK's core policy. The potential positive gains from these proposals however stand to be negated by a number of contradictions arising from the broader governance proposals as well as blurred aspects of the CBK's independence insofar as policy conduct is concerned.

In the next section, we give perspectives on the principal objectives of the CBK as stated in the Draft Bill and how the crafting of the bill will influence their realization. This is followed by an analysis of the monetary policy conduct in the context of accountability and transparency. Subsequently, we evaluate the issue the of CBK's independence against the Draft Bill's proposal on Governance, especially focusing on the role of the Chairman of the Board of Directors and that of the Governor. We conclude by delineating contradictory areas that have a bearing on the CBK's ability to effectively accomplishment of its core mandate.

## Mandate

The mandate of the CBK is embedded in its core objective. The Draft Bill states that objective as being "to formulate and implement monetary policy directed towards achieving and maintaining domestic stability in the general price level". Although the CBK has two other objectives, they are pursued without prejudice to the price stability mandate. The second objective of the CBK is, without prejudice to the core objective, "fostering and maintaining a stable financial system" while the third objective is "supporting the economic policy of the Government – including the objective of growth and employment" without prejudice to the price and financial stability objectives.

The hierarchy of the objective is crystal clear – general price stability being higher than financial stability, which is higher than the objective supporting the government's role with regard to growth and employment[1]. This is a largely mainstream ranking of these objectives backed by experiences elsewhere that draw from rigorous empirical determination of the efficacy of a central bank in delivering on its mandate.

In particular, the determination that the trade-off between inflation and output (low inflation being associated with high unemployment because the underlying tight monetary policy has a low growth causal effect) – the so-called Phillips curve – is at the worst only a short-run phenomenon underpins the rationale for the focus on price stability as the primary objective of the central bank.

[1] Section 6 of the Draft Bill.

We take cognizance of the literature that point to the fact that whereas central banks may have more than one objective, and some of them may assign equal weighting to the objectives, sometimes there are instances of inconsistency in the objectives[2]. The shift that we see triggered by strong empirical evidence that high inflation has distortionary effects on private agents in regard to investment, savings and production, and ultimately slower growth as it is associated with high variability is assumed to be the basis for the ranking of the CBK's objectives.

While that may be the case, the fact that the CBK has the third explicit objective of "supporting the economic policy of the Government" calls for pause to critically consider the implication of such objective in the context of its consistency with the primary objective of price stability. We buttress that critical examination by the consideration that the CBK does not set the inflation target.

Indeed, the Draft Bill states that the Cabinet Secretary, National Treasury, "shall specify at least every 12 months, the price stability target in consultation with the [Central] Bank and economic policies to be to be taken by the Government"[3]. The implicit assumption here is that the National Treasury (or the CBK) has made a determination of the optimal level (or range) of the price stability target.

Whereas the plausibility of such assumption may be a matter of conjecture, it is clear that the setting of the stability target – while agreeably is the mandate of the Government and not the CBK – in line with the stating of the Draft Bill implies that there is room for it to be changed fairly frequently. It could be a pointer to the so-called "dynamic inconsistency and inflation bias" problem. As this *Note* points out in the next section, it could also lead to accountability challenges on the part of the CBK.

Dynamic inconsistency arises when there is a difference between the policy announced by a central bank and the prevailing policy carried out by the central bank after the public has made decisions based on the expectations of the announced policy. Hypothetically, if the CBK announces that it will target a level of inflation given by the National Treasury and the public engages in contracts based on that announcement, nothing takes away the incentive of the CBK to renege on that promise and seek to attain a higher output through producing surprise inflation.

Once the public realizes this, its response will be an adjustment in inflation expectations upwards, consequently limiting the realization of the desired output gain; in any case no output gain may be realized at all if the underlying wage and price rigidities do not allow complete adjustments in both the goods and labour markets. In essence, the rationality of the economic agents will end up creating inflation bias in response to a policy regime that may have an incentive to deviate from the pre-announced position.

Inflation bias could also arise from the National Treasury's incentive to inflate, not necessarily with a view to boost growth – and consequently lower unemployment – but in pursuance of government budget financing considerations. If the National Treasury finances part of its budget deficit by way of money creation – so-called signiorage – or lowers its real liabilities – so-called inflation tax –, that will be a signal of an incentive to announce a lower inflation target that will induce a higher demand for real balances but then subsequently choose a higher inflation rate. As already observed, this dynamic inconsistency subjected to rational agents will engender inflation bias.

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[2] See Fischer, S. (2004), *IMF Essays from a Time of Crisis*, MIT Press, Cambridge Massachusetts; and Khan, M.S. (2010), *The Design and Effects of Monetary Policy in Sub-Saharan African Countries*, Peterson Institute for International Economics Working Paper Series WP 10-11, July.

[3] Section 4 of the Draft Bill.

In view of the above, the issue of "rules versus discretion" not just on the part of the CBK but also on the part of the National Treasury with regard to the former's core objective of price stability is arguably critical. We do not see any bearing of this in the Draft Bill. The typical focus of economists on this aspect has been on *instrument rules* where it has been either rules around growth in money supply or interest rate rule (so-called Taylor rule); the jury is still out regarding which of these rules is more successful.

The Draft Bill outlines aspects of open market operations (OMO) and credit operations – aspects with an influence on money supply, but not in a rule demeanor[4]; the Draft Bill, too, proposes that the Central Bank Rate – which it defines as "a policy rate used to determine the monetary policy stance" – be the lowest rate of interest the CBK charges on loans to banks; this sheds little clarity as to whether it is leaning more towards a monetary policy framework with an interest rates rule[5].

Where there seems to be consensus, but unfortunately without any implicit input to the Draft Bill, is the notion that if rules can apply to instruments they can also apply to targets. A case in point is the inflation thinking around the inflation targeting monetary policy regime. Given the apparent leaning of the CBK towards a Taylor rule type of monetary policy conduct, the Draft Bill could demonstrate creativity by legally entrenching a formal inflation targeting framework where such conduct is clearly amenable. The Bill could even be more ambitious and bold by making pronouncements of a rule type with regard to goal setting to avoid a scenario of dynamic inconsistency and inflation bias emanating from the National Treasury[6].

## Monetary Policy Conduct

The above discussion on the mandate of the CBK as spelled out on the Draft Bill provides the grounding for discussion on the monetary policy conduct. The Draft Bill outlines several functions of the CBK in furtherance of its three objectives[7]. Whereas many of the specified functions are geared towards addressing operational issues, the formulation and implementation of monetary policy can be singled out as the core policy function.

The Monetary Policy Committee (MPC), its composition and mandate as stipulated in the Draft Bill is largely in line with how similar committees in leading central banks are constituted and mandated[8]. Furthermore, the executive focus on monetary policy has been enhanced through the creation of offices of two deputy governors, one of which office's responsibilities are monetary policy and banking sector stability[9].

The Draft Bill makes two progressive stipulations with regard to the aspects of transparency and accountability. One of the stipulations is that besides the publication of a statement on the decision of the MPC and the underlying rationale[10], the minutes of the Committee before the end of 10 weeks from the day of the meeting unless such publication shall impede or frustrate the achievement of the decision's intentions[11]. This allows for an enhanced basis of expectations formation regarding the conduct of monetary policy; this transparency is a good basis for

[4] Section 18 of the Draft Bill.
[5] Sections 2 and 18 of the Draft Bill.
[6] While acknowledging the spirit of Section 89 with regard to government's financing of the budget and the restrictions therein, we argue that there is too much discretion on the part of the National Treasury in setting the stability goal to the extent that it could potentially engender fiscal dominance in monetary policy conduct.
[7] Section 7 of the Draft Bill.
[8] Section 10 of the Draft Bill.
[9] Section 49 of the Draft Bill.
[10] Section 14 of the Draft Bill.
[11] Section 15 of the Draft Bill.

ascertaining the reaction function of the MPC members, as has been the case in jurisdictions where there is such practice[12].

The second stipulation is that the MPC shall submit the monetary policy statement to the National Assembly and the CBK Governor may on request by the National Assembly or by own initiative be heard by the National Assembly on matters to do with monetary policy[13]. This is an enhanced accountability compared to the practice where the Governor simply submits the monetary policy report to the Cabinet Secretary of the National Treasury.

The progressive stipulations notwithstanding, the Draft Bill misses out on two aspects that can enhance the monetary policy formulation and implementation framework. One, while the timeframe for stipulating the price stability goal is explicitly stated[14], the timeframe for realizing the goal is not; we argue that it should.

Two, the transparency and accountability through disclosure and National Assembly testimonies is all good; it is however not sufficient unless the Draft Bill is explicit on the aspect of sanctions in the event of failure to meet the target – even if it is sharp questioning like the case of the US's Federal Reserve Board Chairman or even public reprimand and risk loss of reputation of the holder of the Governor's office.

## Autonomy (or is it Independence?) – Squaring out with Governance Provisions

In line with international best practice, the Draft Bill provides for the CBK's autonomy in the legal context[15]. It is a fact the central banks are part of the government; it may therefore be a misnomer to imagine that they are autonomous in the strict sense. To have a good perspective of what this autonomy entails, the common nomenclature of central bank independence – meaning somewhat a part of government – needs some nuancing. The nuance is with regard to the distinction between goal independence and instrument independence.

Where the central bank has a goal that is imprecisely defined implies that it has goal independence; the other extreme is where the central bank's goal are precisely defined. The instrument independence in the latter case is where the central bank with a precisely defined goal has the power to conduct monetary policy toward attaining the goal[16]. The provisions of the Draft Bill give the CBK instrument independence and not goal independence[17]. We however see two respects with which the CBK's instrument independence stands to be compromised by the provisions of the Draft Bill.

One respect is where such compromise would arise from the National Treasury. This is with regard to the provision that the CBK "shall, after consultation with the National Treasury, determine and implement the exchange rate policy[18]. Based on the economic logic concerning the interaction between exchange rates, we argue that monetary and exchange rate policies cannot be

[12] Harris, N.M and C. Spencer (2009), *The Policy Choices and Reaction Function of Bank of England MPC Members*, Southern Economic Journal, 76 (2): 482 – 499, conclude that policy decisions tend to be insider biased (staff members of MPC)
[13] Section 13 of the Draft Bill.
[14] Section 4 of the Draft Bill.
[15] Section 4 of the Draft Bill.
[16] It's noteworthy that if a central bank is bound by monetary rules or is required to finance government deficit, then it does not have instrument independence.
[17] Central banks where there has been successful inflation targeting – e.g. Reserve Bank of New Zealand and its pioneering role in inflation targeting – have such regimes.
[18] Section 24 (2) of the Draft Bill.

independent; under a floating exchange rate, which the Draft Bill provides, monetary policy affects exchange rate and vice versa.

Therefore if the MPC has to be fully accountable for monetary policy conduct, then the National Treasury need not be consulted in the *implementation* of the exchange rate policy. The National Treasury has the authority to choose the exchange rate regime, and its choice is one of free market determination[19]; in the spirit of the CBK's instrument independence and accountability, that is where its role should end.

The other respect is where the Draft Bill has governance provisions – particularly the role of the Chairman of the Board of Directors who is not the Governor – that clearly compromise both independence and accountability of the MPC in monetary policy conduct.

- If the MPC, and indeed the Governor, is accountable to the public through the National Assembly as earlier discussed, then it is contradictory to expect the Governor's performance evaluation initiated by chairman of the Board[20];
- In the MPC has the responsibility of formulating monetary policy[21], and the CBK's Board of Directors has the responsibility of determining policies of the CBK other that formulation and implementation of monetary policy[22], it is therefore clearly contradictory for the Draft Bill to have provisions that (a) require the governor to be accountable to the Board on matters of monetary policy[23] (b) compromise instrument independence by requiring Board approval on monetary policy instrument, particularly OMO[24].

It is therefore evident that the creation of a structure where the Governor and the Chairman of the Board of Directors are different is as controversial as it is unprecedented in central banks with efficient monetary policy conduct and seamless operations. The provision for such separation – even if only from a monetary policy conduct perspective - should therefore be reconsidered. In any case the Governor cannot be accountable to a Board and its Chairman whose accountability is not explicitly specified and yet the same Governor is accountable to the Public through the National Assembly.

## Conclusion

The preceding sections of this *Research Note* provide a critical examination of the Draft Central Bank of Kenya Bill 2014. In the analysis we acknowledge the progressive aspects of the provisions of the Draft Bill. In the same measure, we highlight the limitations and contradictions in the Draft Bill's provisions, whose review we call for. In particular, we are seeking the consideration of the following areas:

- Given the apparent leaning of the CBK towards a Taylor rule type of monetary policy conduct, the Draft Bill could demonstrate creativity by legally entrenching a formal inflation targeting framework where such conduct is clearly amenable.
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- In an endeavor to enhance monetary policy formulation and implementation framework, the Draft Bill explicitly stipulates the timeframe for price stability goal setting but is silent on the timeframe for realizing the goal is not; we argue that it should address that asymmetry.

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[19] Section 24 (1) of the Draft Bill.
[20] Section 43 (2. g) of the Draft Bill.
[21] Section 10 of the Draft Bill.
[22] Section 34 of the Draft Bill.
[23] Section 47 of the Draft Bill.
[24] Section 18 of the Draft Bill.

- Monetary policy transparency and accountability through detailed disclosure and National Assembly testimonies is all good; it is however not sufficient unless the Draft Bill is explicit on the aspect of sanctions in the event of failure to meet the target – even if it is by way of sharp questioning or even public reprimand and risk loss of reputation of the holder of the Governor's office.
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