

CENTRAL BANK OF KENYA

ITS EVOLUTION, RESPONSIBILITIES AND ORGANIZATION

PARLIAMENT
OF KENYA
LIBRARY



THE CENTRAL BANK OF KENYA HEADQUARTERS, NAIROBI



060
CBK

CENTRAL BANK OF KENYA

ITS EVOLUTION, RESPONSIBILITIES AND ORGANIZATION



KENYA NATIONAL ASSEMBLY
Accession: 10013376

Call No: 060 CBK



SEPTEMBER, 1986

CONTENTS

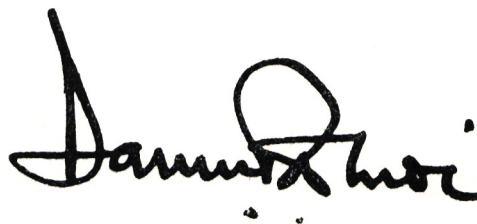
	PAGE
MESSAGE FROM HIS EXCELLENCY THE PRESIDENT	(iii)
MESSAGE FROM THE MINISTER FOR FINANCE	(iv)
PREFACE BY THE GOVERNOR	(v)
INTRODUCTION	1
CHAPTER 1: ECONOMIC DEVELOPMENTS IN KENYA	5
Overview	5
Agriculture	5
Manufacturing	6
Domestic Investment	6
Employment	6
Consumer Prices	6
Budgetary Developments	7
External Debt	7
Domestic Debt	8
Balance of Payments	8
Money and Banking	11
Money and Quasi-money	12
Domestic Credit	12
Interest Rates	13
CHAPTER 2: OBJECTIVES AND FUNCTIONS OF THE CENTRAL BANK OF KENYA	22
Provision of Banking Services to Commercial Banks	22
Provision of Banking Services to the Government	25
Management of Public Debt	27
CHAPTER 3: FOREIGN EXCHANGE AND EXCHANGE CONTROL OPERATIONS OF THE CENTRAL BANK OF KENYA	30
Foreign Exchange Operations	30
Exchange Rate Operations	31
Forward Exchange Cover	34
Relations with International Financial Institutions	35
Exchange Control Operations	35
CHAPTER 4: SUPERVISORY FUNCTION OF THE CENTRAL BANK OF KENYA	39
Bank Inspections	40
Financial Condition of the Licensed Bank and Non-bank Financial Institutions	41
Capital Structure	41
Deposit Liabilities	41
Borrowings, Profit and Loss	41

	Cash and Bank Balances	42
	Investment and Advances	42
	Bad and Doubtful Debts	42
	Foreign Exchange Business and Exchange Control	43
	Banking Operations	43
	Reports and Returns	43
	Other Supervisory Tools	43
CHAPTER 5:	DEVELOPMENTS IN KENYA BANKING LEGISLATION	44
	The Banking Ordinance of 1910	44
	The Banking Ordinance of 1956	44
	The Central Bank of Kenya Act, 1966	45
	The Banking Act of 1968	46
	Amendments to Banking Legislation 1972-1984	47
	The 1985 Amendments to the Banking Act	48
	Licensing of Banks and Financial Institutions	48
	Capital Requirements	48
	Prohibited Business	49
	Deposit Protection Fund	50
	Other Amendments	51
CHAPTER 6:	ROLE OF THE CENTRAL BANK IN THE MANAGEMENT OF THE ECONOMY	52
	Targets of Monetary Policy	53
	Instruments of Monetary Control	54
	Exchange Rate Policy	55
	External Assets Policy	57
	Retrospect and Prospects	59
CHAPTER 7:	DEVELOPMENTS IN THE STRUCTURE AND CAPITAL OF THE CENTRAL BANK OF KENYA	
	Organization Structure of the Bank	61
	Staff Development and Training	64
	Management of the Central Bank	66
	Capital, Reserves and Accounts of the Central Bank	66

**MESSAGE FROM
HIS EXCELLENCY THE HON. DANIEL T. ARAP MOI, C.G.H., M.P.,
PRESIDENT OF THE REPUBLIC OF KENYA
AND COMMANDER-IN-CHIEF OF THE ARMED FORCES**

The Central Bank of Kenya commenced operations on 14th September, 1966. Its establishment was a major step towards our independence in monetary affairs. Since that time, the Bank has expanded both in staff and in the diversity of its functions. Today, it is one of the vital institutions in the management of our national economy.

On this occasion of its Twentieth Anniversary I want to thank the Bank's management and staff for their devotion to service which has enabled the Central Bank of Kenya to make such a significant contribution to the economic growth and stability of our country.

A handwritten signature in black ink, appearing to read 'Daniel T. Arap Moi', with a large loop at the end.

D. T. ARAP MOI,
THE PRESIDENT,
REPUBLIC OF KENYA

STATE HOUSE,
NAIROBI.
September, 1986.

**MESSAGE FROM
THE MINISTER FOR FINANCE
HON. PROFESSOR GEORGE SAITOTI, E.G.H., M.P.**

The Twentieth Anniversary of the Central Bank of Kenya is a significant occasion in the history of Kenya's economic development. In the last twenty years, the Central Bank of Kenya, in collaboration with the Treasury, has played a major role in the formulation and conduct of Kenya's monetary policy and overall economic management. The Bank will continue to play an even more prominent role in the future as the demands of the economy and the financial sector in particular become more complex and diversified.

On this happy occasion of its Twentieth Anniversary I would like, therefore, to congratulate the directors and staff of the Central Bank of Kenya for the efficient manner in which they have discharged their responsibilities.


MINISTER FOR FINANCE

THE TREASURY,
SEPTEMBER, 1986.

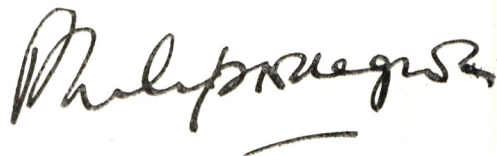
PREFACE

Since its establishment in September, 1966, the Central Bank of Kenya has carried out its policy and administrative functions, in addition to acting as the national centre for collection of data and general information in the field of money and banking with steadily increasing competence. The Bank has disseminated information on its policies and activities on a regular basis through its Annual Reports, the Quarterly Economic Review, and the Central Bank of Kenya Staff Papers.

The evolution of the Central Bank over the years has created a need to improve further public understanding of the objectives, functions, and operations of the Bank and the manner in which they have been carried out during the past twenty years of its existence. I have much pleasure, therefore, on the occasion of the Bank's Twentieth Anniversary, to release to the public this special book which describes the functions and operations of the Bank in various fields since its establishment in 1966.

During the first twenty years of the existence of the Bank, a comprehensive structure of financial organizations has been established and continues to develop, thereby contributing to the growth of Kenya's economy. As can be expected in any country, there are bound to be some inadequacies as well as weaknesses in the financial structure but these are problems of youth and growth; they are issues to be tackled in the years ahead.

I hope that the financial community and the general public will find this book useful.



PHILIP NDEGWA,
GOVERNOR.

CENTRAL BANK OF KENYA
September, 1986.

INTRODUCTION

As we celebrate the 20th anniversary of the Central Bank of Kenya, we also mark the 23rd year of Kenya's independence as a nation. However, these milestones do not mean that we have now come-of-age or reached maturity. Both the nation and the Central Bank are in fact still relatively young, and while we have certainly cut our teeth on some difficult issues, much growth, development and learning still lie ahead.

This book describes the objectives and operations of the Central Bank. The Bank, like other central banks around the world, is an institution like no other in the country. It is a creation of government with unique functions, such as managing the currency issue. Some of its responsibilities have a formal legal basis, while others have been acquired in a *de facto* way; and the ways in which it has exercised its powers have evolved and changed over the years, in some cases substantially, because of changes in the economy itself and in the approaches to public administration. To do its job effectively, the Bank needs to keep in close touch with developments in all sectors of the economy, and considerable resources are devoted to monitoring and analyzing these. This also means that the Bank is well placed to provide informed public commentary on economic developments, and continual efforts are therefore made to improve and extend the Bank's publications to help enhance public understanding. The most recent innovation in this respect has been the introduction of the "Staff Papers" series of publications.

This book continues that approach. It aims to describe both the role and

the operations of the Central Bank, and how these have evolved over the last 20 years. The objective is to provide the general reader with some insights into what the Bank does, and why; and thereby to help to dispel some of the mystique which surrounds it. The Bank, is dedicated to pursuing the national interest, and it is important that its operations should be widely understood and, where necessary, debated.

However, the book is a short one: its aim is to be informative rather than authoritative. Inevitably the coverage of developments in Kenya and within the Central Bank is selective and not comprehensive. Other sources should be consulted for a fuller discussion of many of the topics: a bibliography of some of the main references on Kenya and the Central Bank is included in the book.

Kenya's economic experience prior to independence was not dissimilar to that of other colonies: production activities were rather narrowly based and had a strong agricultural bias, with the choice of specific commodities dictated by local conditions, the demands of the colonizing power, and the preferences of the settlers concerned. Infrastructural and human development were generally given little more than the minimum attention required to achieve the rather narrow objective of producing these commodities and sending them to the developed world.

To some extent, the winds of economic change had started to blow before (or in anticipation of) independence. The change to self-government generally involved accelerating trends which had already started to emerge, and altering the emphasis given to diffe-

rent objectives, but there were few radical changes in the approach to economic policy. Kenya is still, in fact, substantially dependent on the same small range of primary commodity exports as it used to be. Significant growth has occurred in the manufacturing, distribution and service sectors, but this has not led to any great diversification of the export mix. It has, in some cases, involved significant import substitution, but not always efficient import substitution.

Development of the financial sector has been particularly marked. The financial system plays a key role in the development process, through facilitating the efficient conduct and settlement of economic transactions, through the provision of advice and specialized financial services to businesses and individuals, and through mobilizing savings and directing these to profitable investment areas. Broadly speaking, there have been two phases in this development since independence: the 1960s were a period of rapidly increasing monetization of the economy (reflected in a strong rise in the ratio of the money supply to G.D.P.) and increased use of financial intermediation (shown by a rapid decline in the proportion of the money supply accounted for by the currency issue). In the 1970s these ratios stabilized, although the share of the non-monetary economy in G.D.P. continued to decline significantly. The most notable feature of the 1970s and 1980s has been the considerable diversification of the financial system particularly in the latter part of the period. In particular, there has been rapid growth in the number of institutions (both banks and non-banks, domestic and foreign), significant improvements in the branch penetration of the in-

stitutions, (in particular into the rural areas), some broadening of the range of financial services available, and presumably-increased competition. Considerable progress has also been made by financial institutions in achieving the aim of Kenyanization (both in ownership and staffing), although some local manpower skills are still in short supply.

Studies have noted that this institution-building has given Kenya a high degree of depth in its financial system for its stage of development and it is certainly true that for all areas of the economy both access to and the quality of financial services have improved significantly. However, an important qualification is that the institution development process has not been matched by corresponding development in financial markets for securities. Kenya's financial system will not reach true maturity until there are active primary and secondary markets for government and private debt securities, and also for equity securities. The government and the Central Bank are increasingly turning their attention to the best means to facilitate this third phase of market development, and a number of changes, both regulatory and institutional, will be necessary.

Perhaps, the largest growth and development has occurred in the government sector. In part, this has reflected the much greater emphasis being given to improvements in, for example, the health and education systems. However, it also resulted from the belief that the government's economic objectives could best be pursued by a substantial amount of direct involvement in investment and infrastructural development, in production of goods and services. Associ-

ated with this was the aim of building up a large, professional, and well-educated public service. However, the emphasis is now starting to change in this area, away from direct involvement and more towards creating the right environment for private sector activities to flourish. This is a major underlying theme of the government's Sessional Paper No. 1 of 1986 on Economic Management for Renewed Growth. In addition, the government has made it very clear that it will be increasingly scrutinizing the activities of government departments and parastatals to ensure that it is getting good value for money from them.

Underlying these changes to the orientation of economic policy, which are now gaining momentum, is the growing realization throughout the nation that the economic environment is likely to remain difficult for the foreseeable future. The first decade of independence was marked by strong growth in real output, albeit from a very low base, but since 1973 the pattern has been more uneven. In fact, per capita real output has declined in all but two of the last seven years, and in 1985 was little more than 2 per cent above the 1973 level. The main constraint on growth in recent years, as in most other developing countries, has been the balance of payments, which has shown a weakening trend due to deteriorating terms of trade and stagnant or declining export volumes, only partly offset by significant reductions in import volumes. The ultimate sources of this weakness can be partly attributed to unfavourable developments in overseas markets for primary commodities, developments which owe a good deal to restrictive trade policy actions by developed countries as well as to changes in the

structures of both demand and supply for these commodities. These developments may be of a long-term nature. However, domestic conditions have also contributed to the deterioration in the balance of payments, and it is now vital that some dynamism be restored to production activities in general, and to export production and efficient import substitution in particular. The changes in the policy environment are recognition that the welfare of the general population can be noticeably improved only through a resumption of rapid but sustainable economic growth.

Against this background, the role of the Central Bank has evolved considerably over its first 20 years. Its essential objectives have not changed—these are to maintain the external and internal value of the currency and to maintain stability in the financial system. Nor has there been any significant change in its relationship with the government—while the Central Bank of Kenya Act gives the Bank considerable formal independence, in practice in Kenya (as in many other countries) it has been accepted that the design and implementation of financial policies are best achieved through continual consultation and co-ordination amongst the different arms of government.

What has changed over the years is the choice of techniques to implement monetary policy, and the increasing complexity involved in achieving satisfactory monitoring and supervision of financial institutions in order to help ensure their stability.

These developments are discussed more fully in later chapters. However, some essential features of the monetary policy framework can be drawn

out as an overview. For most of its history the Bank has relied on direct controls of one sort or another to influence the behaviour of financial institutions. The most important controls have been "price" controls—in particular, the exchange rate and (minimum/maximum) interest rates. These "price" controls, however, were revised only infrequently as economic conditions changed. The ability of the Bank to exercise firm control over the quantities of money and credit was therefore significantly constrained. As a result there have been extremely large fluctuations in money and credit growth rates over the years, with consequent effects on inflation, real activity and the balance of payments. It is impossible to control money and credit aggregates, as well as interest rates and the exchange rate, for any more than a short period. The Bank nevertheless made efforts to achieve quantitative monetary control, through supplementary instruments such as liquidity and cash ratios, import deposits and direct controls on credit growth. These measures have, predictably, been only partly successful, and they have also had an uneven impact on the financial system and other sectors of the economy.

The situation is now changing. The exchange rate has progressively been administered more flexibly as time has passed, but both exchange control and various trade policy measures are still required to support exchange rate

policy, and the Central Bank is still the residual supplier of foreign exchange to the market. Movements in the balance of payments can therefore still have a substantial domestic monetary impact.

Increased flexibility in interest rates has been foreshadowed, and this is necessary, in particular, to give the Bank a greater ability to offset any unwanted monetary influences arising from developments in the balance of payments or the budget through market operations of one sort or another. Greater flexibility in interest rates will help to ensure the success of such operations, will contribute substantially to the development of the financial markets required to implement them, and will ensure that the effects of monetary policies are spread quickly and equitably throughout the financial system, rather than being concentrated at particular points. There should now be sufficient competition in the financial system to ensure that financial institutions will not be able to use increased interest rate flexibility to take undue advantage of their customers.

These are developments for the future, and while the changing approach will need to be studied carefully and implemented cautiously, it will also need to proceed with determination if the fruits are to be realized.

CHAPTER 1—OVERVIEW OF ECONOMIC DEVELOPMENTS IN KENYA

During the past twenty years, the economy of Kenya enjoyed satisfactory performance. Growth in real output averaged 5.0 per cent, substantially higher than the 2.2 per cent average for African developing countries. Population rose at an annual average rate 3.9 per cent, and consumer prices at an average rate of 10.1 per cent. Investment, as a per cent of G.D.P., fluctuated in a range of 18 to 30 per cent. Savings, as a percentage of G.D.P., remained stable at an average rate of 18.9 per cent. On the external front, the current account deficit of the balance of payments averaged around 6.5 per cent of G.D.P. varying with movements in both the volume and the terms of trade. The money supply grew at an average annual rate of 16 per cent between 1970 and 1985, although there were some marked fluctuations in growth rates during the period. Trends in the international economic environment, together with variations in domestic weather conditions, dictated, to a large extent, the tempo of activity during the review period. Charts 1-8 in addition to Tables 1-4 in the appendix provide statistical information on the major economic developments during the period.

Agriculture

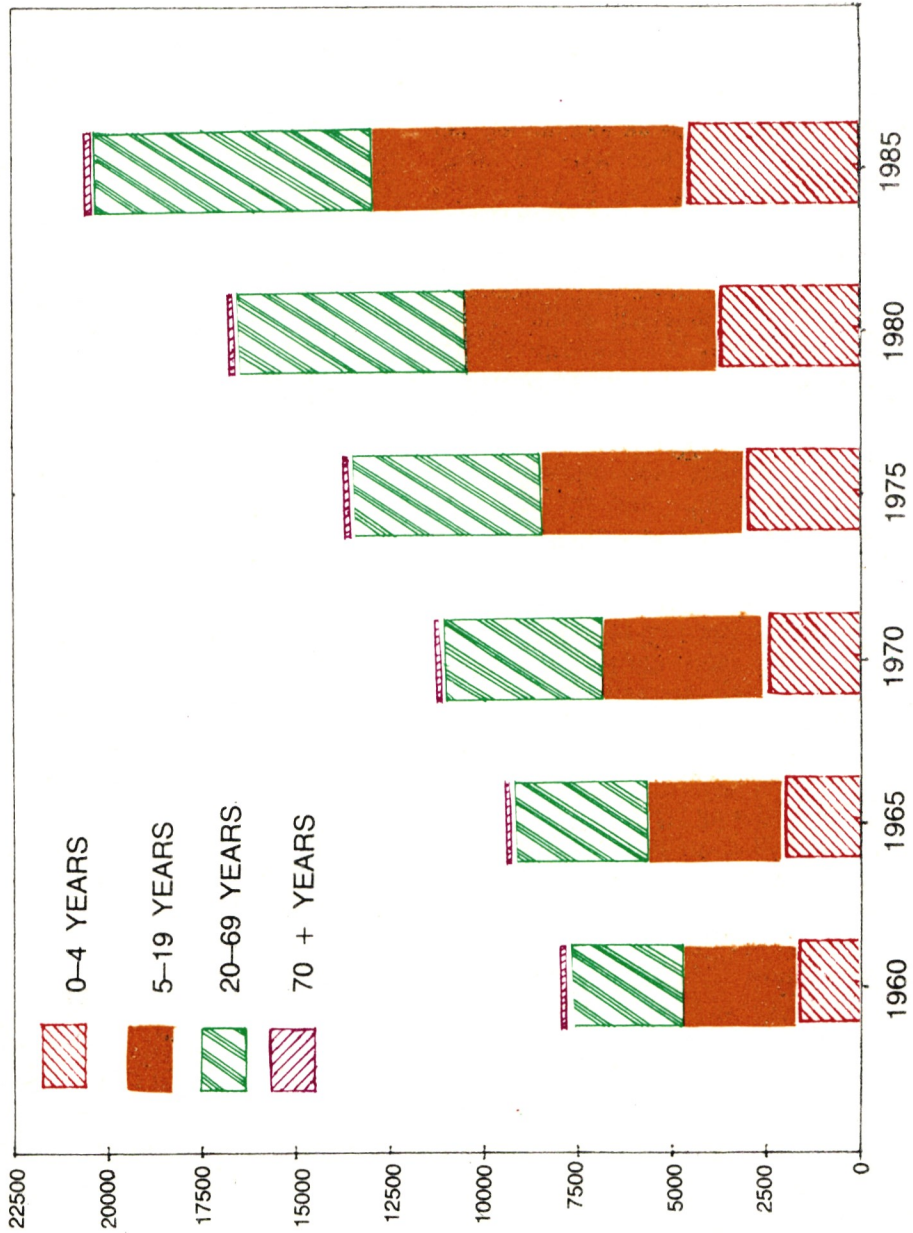
Growth in real output was spearheaded by developments in the agricultural sector whose share in G.D.P. averaged 33 per cent between 1970 and 1985. Agricultural output reached a record level of 41 per cent of G.D.P. in 1977 following an upsurge in coffee and tea prices which encouraged production. Since that time, however, the share of agricultural output has followed a downward trend, moving from 36 per cent of G.D.P. in 1978 to 30 per cent by the end of 1985.

The decline was especially sharp in fiscal year 1979/80 and again in 1984 due to severe drought and unfavourable developments in the international prices for agricultural commodities. Real growth rates in agriculture, forestry and fishing did, however, remain positive except in 1979 and 1980 when they were negative, reflecting the devastating effect of drought during those years.

Although there has been increases in agricultural producer prices, the prices of agricultural inputs increased at a faster rate than agricultural commodity prices between 1980 and 1984. As a result the terms of trade of agriculture declined during the period. The volume of agricultural exports grew by 4.5 per cent per year with tea and coffee volumes growing at average rates of 7 and 4.3 per cent per year respectively. The livestock sector was heavily influenced by drought conditions and the intake of the Kenya Meat Commission thus tended to stagnate. In order to promote maize and wheat production, the government established, in early 1980, the Seasonal Credit Scheme under which farmers with at least four hectares of maize and wheat under cultivation would receive loans at concessional rates through government financed institutions for purchase of material inputs. In May, 1986, the Seasonal Credit Scheme was replaced by the Guaranteed Minimum Return (G.M.R.) scheme.

The government's efforts in supporting agriculture were focussed on the streamlining of marketing and pricing policies for agricultural products and on the provision of adequate storage facilities. Incentives in the agricultural sector were maintained in

Chart: 1
KENYA'S POPULATION 1960-1985 IN '000s



Source: United Nations World Population Prospects.

the context of yearly reviews of producer prices. Producer prices for maize and wheat, for example, were raised by 82 and 64 per cent respectively in the four years ended in 1984. The increases helped provide crop surpluses in 1982 and 1983, allowing for some exports and the build-up of a strategic grain reserve.

Manufacturing

The manufacturing sector which accounts for 13 per cent of G.D.P. and about 14 per cent of total wage employment, grew at an annual average rate of 7 per cent between 1966 and 1985; with the fastest growth occurring during the 1970 through 1980 period. There was a marked slow-down in growth after this period, stemming from increased oil prices and the consequent costlier imported inputs, and from drought which increased the cost of domestic raw materials. In addition, the collapse of the East African Community in the mid-1970s resulted in a loss of market for manufactured products, causing a slow-down in output. Despite the drought effects of 1979/80 and 1984/85, the manufacturing sector grew at an annual rate 4.4 per cent between 1980 and 1985. Manufacturing activity was dominated by food processing, petroleum refining, metal, transportation and beverage industries. Though production in the manufacturing sector was generally influenced by import-substitution policies, there was a policy re-orientation during the period towards elimination of inefficient import substitution through increased trade liberalization and reduced tariff protection.

Domestic Investment

Domestic investment averaged 26.3 per cent of G.D.P. between 1967 and

1985. Due to favourable investment conditions, the period 1975 through 1980 experienced healthy growth in investment, rising from 18.2 per cent of G.D.P. to 30.1 per cent in 1980. After 1980, however, gross investment tended to decline, reaching 18.5 per cent of G.D.P. by 1985. This decline was occasioned by a general growth in domestic consumption which increased at an annual growth rate of 10.9 per cent. Domestic consumption increased by 24 per cent in 1985 alone. Investment activity was concentrated on rehabilitation and expansion of existing plants rather than on new investment.

Wage Employment

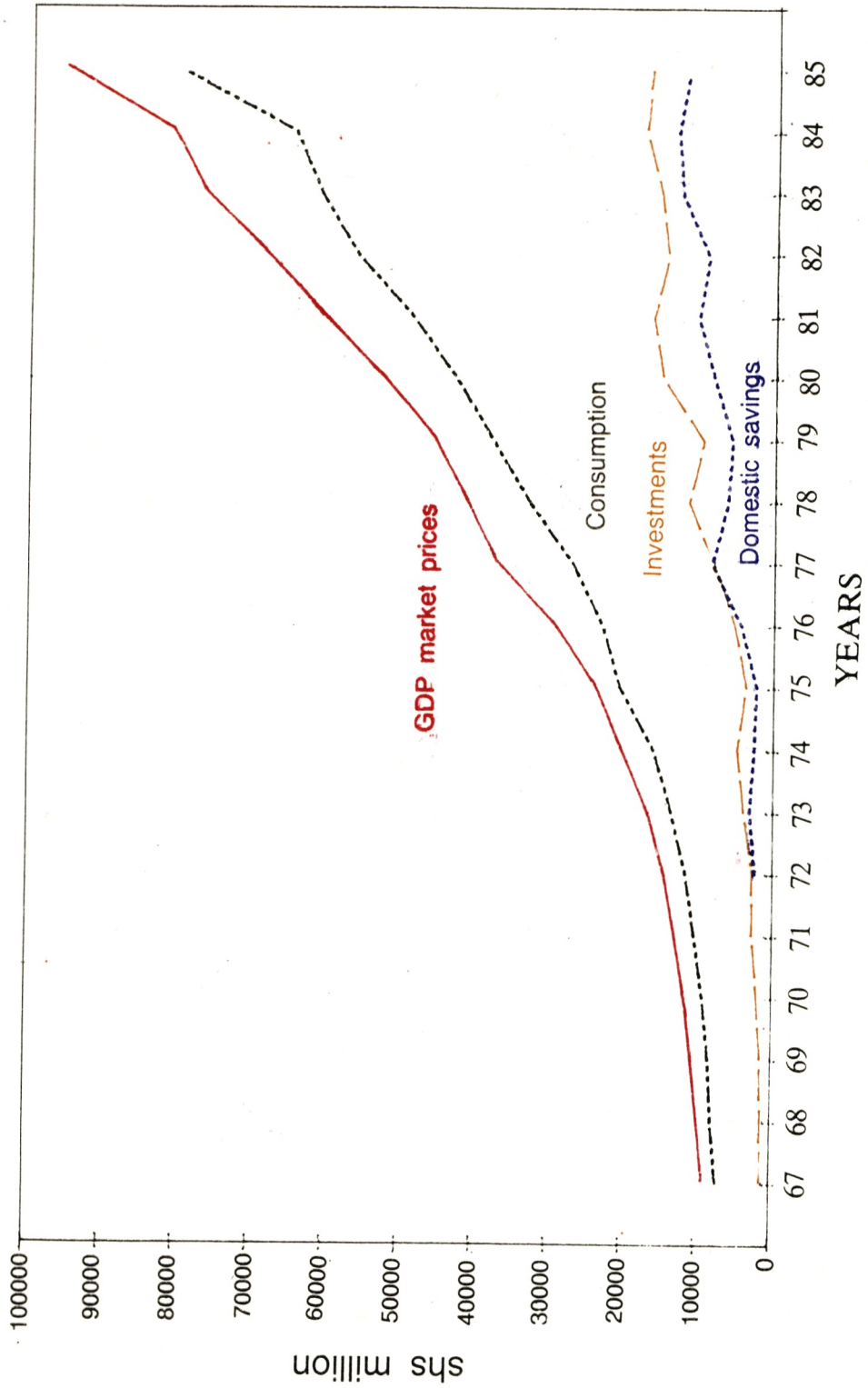
Wage employment grew at 3.4 per cent per year on average between 1967 and 1985, rising from 596,400 persons in 1967 to 1,174,400 persons in 1985. Public sector employment grew faster at 5.4 per cent per year while private sector employment grew at 2.1 per cent per year.

The more rapid growth in the public sector arose mainly from employment in public corporations which in 1980 rose by 28 per cent. In 1985 private sector employment increased by 4 per cent while public sector employment grew by 6 per cent. The government continued to pursue a cautious stance in permitting wage increases in private sector. The wage guidelines formulated aimed at containment of inflationary pressures, and minimizing disincentives to employment creation.

Consumer Prices

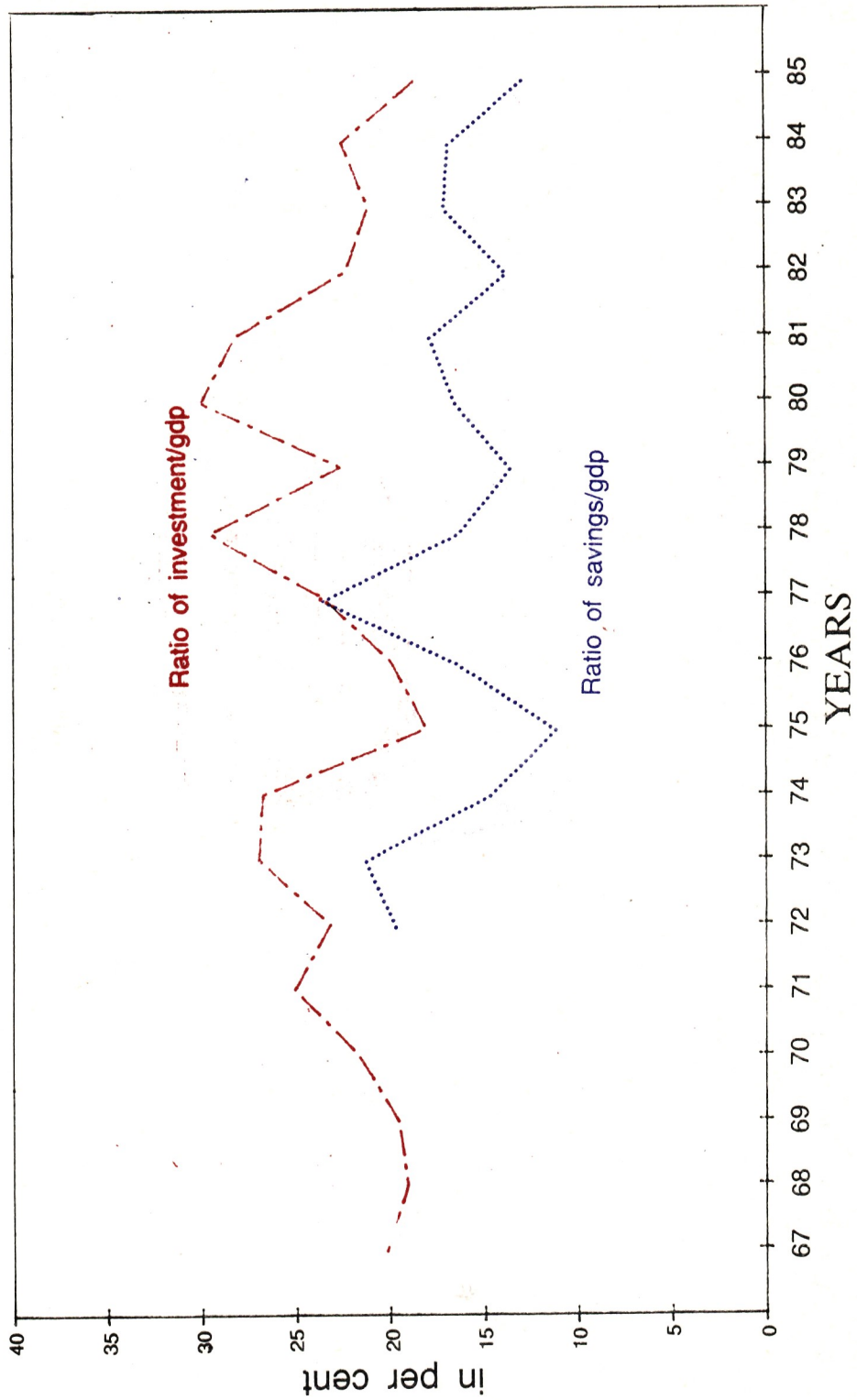
Prior to 1981, Kenya maintained specific price controls on 23 basic consumer items, and discretionary price controls on other items which required that manufacturers and trad-

Chart: 2
GDP, INVESTMENTS, CONSUMPTION AND
DOMESTIC SAVINGS



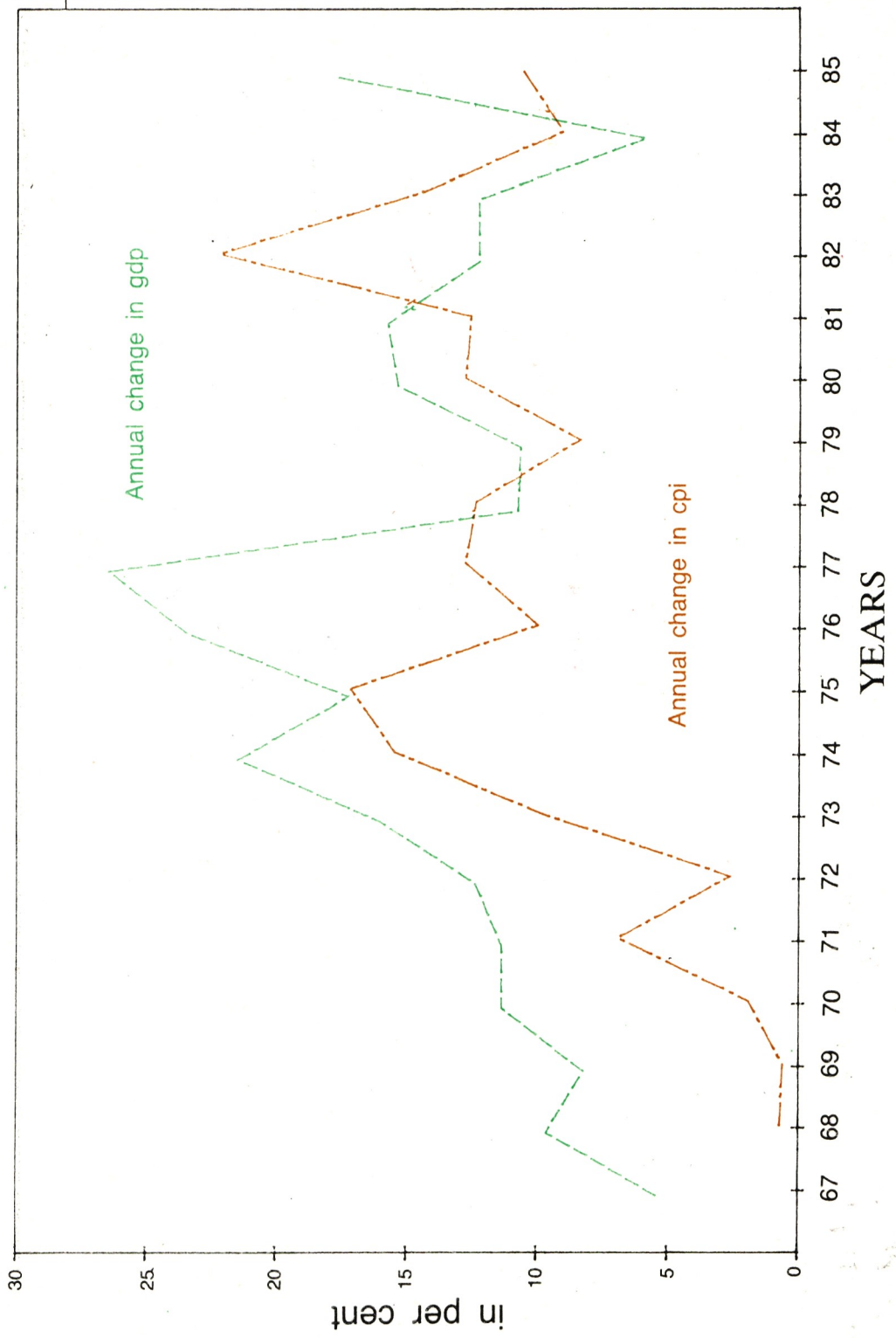
Source: Central Bureau of Statistics.

Chart: 3
RATIO OF INVESTMENT AND SAVINGS TO
GDP



Source: Central Bureau of Statistics, Statistics

Chart: 4
ANNUAL CHANGE IN GDP & CPI 1967-1985



Source: Central Bureau of Statistics.

ers obtain approval from the price controller prior to adjusting their prices. In spite of the controls, however, consumer price inflation rose steadily from 1.6 per cent in 1967 to 12.6 per cent in 1981. In 1982 prices escalated further in line with increases in energy costs, to reach a peak inflation rate of 22.3 per cent. There was also a general increase in food prices during that year. Between 1983 and 1985, the government followed a restrained monetary policy stance which resulted in a decline in the inflation rate to 14.5 per cent in 1983 and 10.7 per cent in 1985.

Budgetary Developments

The budget deficit, as a per cent of G.D.P., averaged 5.5 per cent for the central government and 5.7 per cent for the general government between 1972 and 1983. However, due to improved revenue collection and strict expenditure controls, the budget deficit has declined in recent years falling from a peak of 9.5 per cent of G.D.P. in 1980/81 to 5.1 per cent of G.D.P. in 1984/85. Between 1972 and 1982, total revenue for the general government was steady at an average of 22.9 per cent of G.D.P. while total expenditure minus repayments rose from 27 per cent of G.D.P. to 34 per cent. The level of grants remained persistently low at an average of 0.6 per cent of G.D.P. In 1979/80, total revenue increased from shs 12,603m to shs 22,018m in 1984/85 (see Table 2). There was a sharp growth in the level of external grants between 1983/84 and 1984/85 due to increased donor support following the devastating drought effects of 1984.

In spite of the growth in revenue during 1984/85, however, the budget deficit increased by 35 per cent to shs 4,638m due to substantial increase in

capital expenditure by the government. This large deficit was financed by shs 939m from external sources and by shs 3,699m from domestic sources. As well as making efforts to reduce budgetary deficits, the government financed a greater portion of the budget through the relatively less inflationary non-bank credit. Between 1980/81 and 1984/85, government sales of Treasury bills to non-banks increased substantially. As a result, the share of non-bank financing of the budget deficit rose from 19 per cent in 1980/81 to 64 per cent in 1980-85.

External Debt

Kenya accumulated a substantial amount of external debt between 1975 and 1985. By the end of 1985 public and publicly guaranteed debt had reached shs 50,619m compared with shs 2,775m in 1970. Including I.M.F. debt, the debt service as a ratio of exports of goods and services rose from 5.4 per cent in 1975 to 31.8 per cent in 1985, while interest payments rose from 8.6 per cent of exports of goods and services to 17 per cent. In 1985, central government external debt amounted to shs 30,850m of which I.M.F. debt was shs 7,391m. Multilateral lenders accounted for 48 per cent of total external debt in 1984 compared with just 30 per cent in 1980. At the same time, there was reduction in exposure to international commercial banks as the level of commercial borrowing declined from 30 per cent of total external debt in 1981 to 17 per cent, reflecting the repayments of two Euro-currency loans totalling US \$315m which were contracted in 1979 and 1981. The level of bilateral loans fell from 48 per cent in 1980 to 29 per cent of total external debt in 1984. The bulk of the country's debt was contracted on concessionary

terms. There was a steady growth in private non-guaranteed debt which rose from shs 625m in 1970 to shs 6,616m in 1983.

Domestic Debt

Outstanding domestic debt, excluding short-term borrowings, grew at an average annual rate of 15.3 per cent, rising from shs 1,760m in 1972 to shs 12,840m in 1985. Reflecting a sharp increase in the government deficits, domestic debt increased sharply by 36 per cent in 1978 and by 49 per cent in 1983. The large deficits during these years were occasioned by a sharp increase in government expenditure. There was also an increase in non-defence expenditure associated with higher petroleum costs, and emergency expenditure related to the importation and distribution of maize and wheat for drought relieve during 1979/81.

After 1983, the entire increase in domestic deficit financing took the form of Treasury bills. As a result the proportion of long-term domestic debt to total debt fell from 45 per cent in 1980 to 30 per cent in 1985.

Balance of Payments

Since 1967, Kenya's external position has exhibited sharp fluctuations, caused mainly by movements in the terms of trade. A combination of other factors have also been at work, among them extreme climatic variations, severe external shocks, unstable export prices, and a growing debt service burden accompanied by a general decline in concessional capital inflows. Adjustment programmes were therefore undertaken from time to time to eliminate payments disequilibria and restore external viability.

The measures taken invariably included pursuit of domestic price stabil-

ity to improve the climate for investment, control of budget deficits to curb inflationary pressures and to ensure that more productive resources were channelled into the private sector, maintenance of realistic exchange and interest rates to improve the allocation of resources and promote growth, and continual review of government expenditure, both current and capital, to ensure that resources were productively employed.

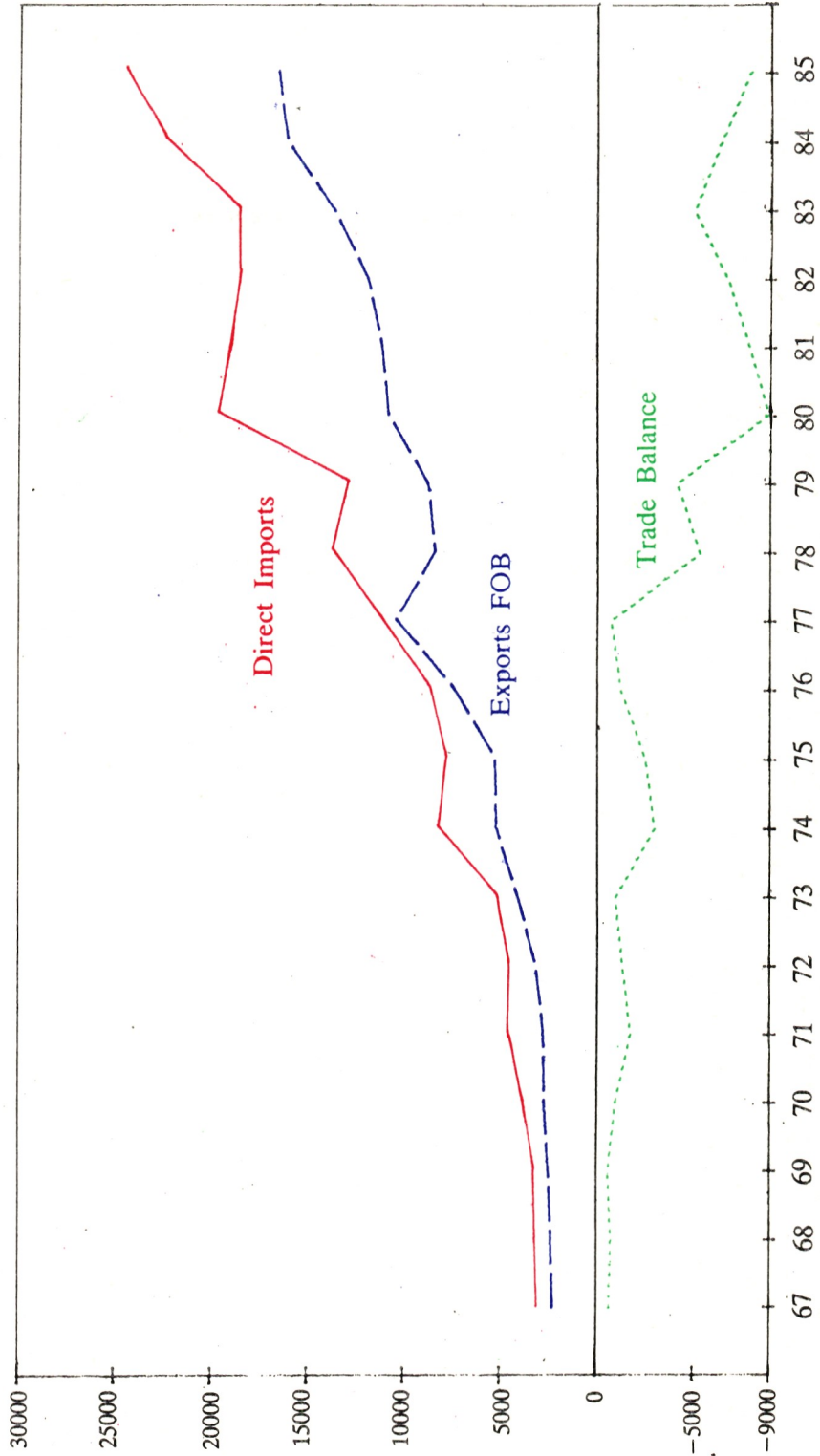
Between 1967 and 1985, the current account deficit of the balance of payments averaged 6.5 per cent of G.D.P. The deficits were sustainable up to 1969 as they could be financed by capital inflows during the period. However, after 1970, several balance of payments crises emerged.

The first major balance of payments difficulty surfaced in 1974 following the first round of sharp increases in the price of crude oil. There was a large deterioration in the terms of trade with import prices rising by 61 per cent over 1973 while export prices rose by only 30 per cent.

The current account deficit worsened from shs 934m in 1973 to shs 2,240m in 1974, reflecting substantially higher import values. As a result, the overall balance moved from a surplus of shs 234m in 1973 to a deficit of shs 442m in 1974, as shown in Table 3.

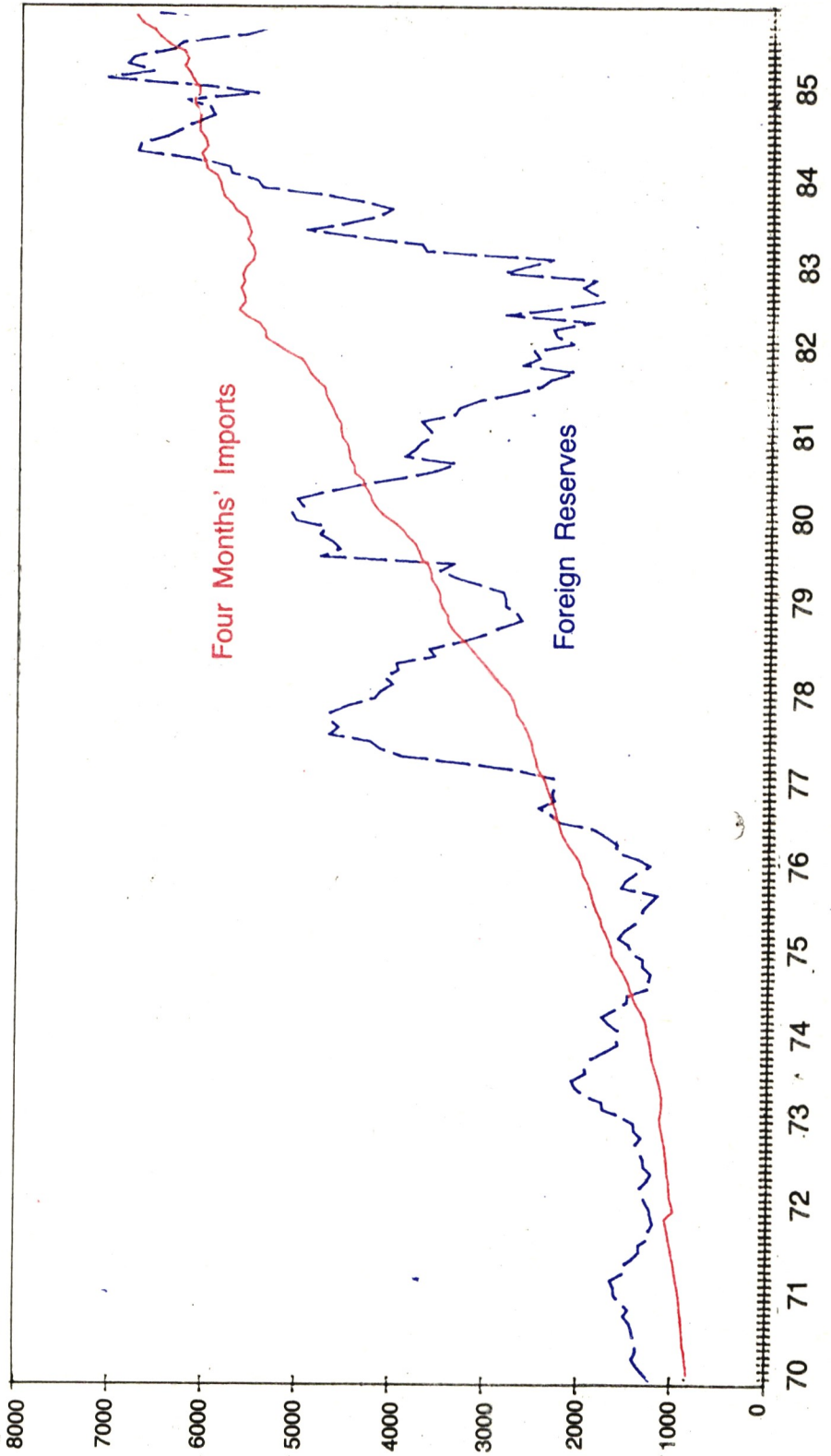
In reponse to the large deterioration in the balance of payments in 1974, the government instituted measures to restrain import demand and, in 1975, the current account improved substantially. Subsequently, an improvement in the terms of trade led by sharply rising prices in the world markets for coffee and tea, the balance of payments improved further in 1976 and 1977 registering a record surplus of shs 2,249m in 1977.

Chart: 5
FOREIGN TRADE—SUMMARY (shillings million)



Source: Kenya Customs & Excise Department, Annual Trade Report.

Chart: 6
FOREIGN RESERVES AND STATUTORY GUIDE
OF FOUR MONTHS' IMPORTS (AVERAGE)
(shillings million)



Source: Central Bank of Kenya and Customs & Excise Department.

The second major balance of payments difficulty occurred in 1978. During this year, world coffee and tea prices fell sharply and there was a large increase in import demand resulting from the export boom of 1976/77. Consequently, the terms of trade deteriorated by 25 per cent, leading to a massive deficit on the current account. This deficit, partly offset by a large increase in government long-term borrowing, resulted in an overall balance of payments deficit of shs 1,558m.

The introduction of an advance import deposit scheme and the subsequent fall in import demand, offset a further deterioration in the terms of trade in 1978. The current account deficit therefore improved from 12.4 per cent of G.D.P. in 1978 to 8.2 per cent of G.D.P. in 1979. There was, consequently, an improvement in the overall balance of payments to a surplus of shs 1,431m. The improvement in 1979 was also attributed to higher long-term and short-term capital inflows as importers of certain goods were required to negotiate 90-180 days credit from their foreign suppliers.

In 1980, the country suffered severe balance of payments difficulties: the terms of trade deteriorated by 9 per cent owing to steep rise in oil prices and to a further decline in coffee and tea prices; and export volumes declined due to the effect of drought which reduced agricultural output. In addition, foreign exchange reserves declined sharply due to heavy import payments following the relaxation of the import deposit scheme. As a result, the basic balance recorded a large deficit of shs 2,512m.

In view of a precipitous decline in the level of foreign exchange reserves following these developments, the

Central Bank slowed down the approvals of foreign exchange allocations in late 1980 through a new import system which was introduced to facilitate licensing of imports on a priority basis. Further, as part of the strategy to increase non-traditional exports, the government decided with effect from July, 1980 to revise the Export Compensation Scheme which had been in existence since 1975, by raising the rate of compensation from 10 to 20 per cent. There was also an attempt to increase the competitiveness of Kenya exports through the depreciation of the Kenya shilling in February, 1981, from Kshs 9.66 to the S.D.R. to Kshs 10.15 to the S.D.R.

In 1981, the current account deficit of the balance of payments declined to 11.1 per cent of G.D.P. from 12.5 per cent of G.D.P. in 1980. The improvement, resulting from a substantial reduction in the value of imports, occurred despite a further deterioration in the terms of trade. The decline in import values reflected substantially lower government imports and a decline in import demand as domestic stocks were reduced. The volume of merchandise exports also declined reflecting a sharply lower volume of petroleum exports and a decline or stagnation in tea and other exports. The terms of trade worsened further through a 3 per cent increase in export prices against an 11 per cent rise in import prices.

There was also a decline in all categories of capital inflows resulting from lower disbursement of public long-term loans, a sharp drop in suppliers' credits, and the absence of drawings from the structural adjustment loan which had bolstered capital inflows in 1980. As a result, the balance of payments deficit stood at shs 1,985m in

1981, of which shs 275m was financed by net purchases from the I.M.F. Gross official reserves declined to shs 2,575m, equivalent to six weeks of imports.

In 1982, the country faced difficult balance of payments problems exacerbated by global recession. The economy suffered from a weak export sector and a highly restrictive import system. The growth of agricultural output remained below its trend level in part because of the difficult weather conditions in the early 1980s. The terms of trade worsened further by 4 per cent. There was, nevertheless, an improvement in the basic balance from a deficit of shs 2,844m in 1981 to a deficit of shs 2,480m.

During the period 1983/84, the country experienced balance of payments surpluses which boosted official reserves from the equivalent of about 1.5 months of imports in 1981/82 to about 3 months of imports by the end of 1984. These developments were attributed to strengthened export performance arising from an increase in tea exports and from strong gains in receipts from non-traditional exports.

The domestic and external policies in place during 1983/84 allowed for the liberalization of the import regime and the external payments system. They also allowed for the withdrawal of the advance import deposit scheme in January, 1983. Further, the payment of outstanding external remittances of profits, dividends and fees for 1981 and 1982 were effected. In June, 1983, a new import system was put in place to facilitate the easy flow of imports.

The new Five-year Development Plan, which was announced for imple-

mentation beginning with the 1984/85 fiscal year provided the necessary impetus and success prospects for the adjustment efforts made in 1983/84. The plan aimed at a viable balance of payments position in the medium term, strengthening export performance and gradually improving the growth of real G.D.P. The plan also recognized the need to generate additional domestic resources for development and to maintain the overall budget deficit at a sustainable level, while ensuring adequate domestic financing for the rest of the economy.

The growth prospects envisaged in early 1984, however, suffered a major set-back with the emergence of a serious drought in mid-1984. The "long-rains" failed to come and agricultural output collapsed. In addition to the sharp decline in grain, tea and coffee output, the livestock herd was decimated and dairy production severely disrupted. There was, consequently, enormous pressure on the budget and on the balance of payments. The government responded swiftly to the crisis by seeking increased donor support and by borrowing on commercial terms. As a result of the imports requirements for drought relief, the current account deficit of the balance of payments rose from 2.3 per cent of G.D.P. in 1983 to 3.6 per cent in 1984.

In 1985, the current account deficit of the balance of payments worsened in absolute terms but remained unchanged in relation to G.D.P. at 3.6 per cent. This reflected, in part, the sharp increase in food imports following the drought in 1984 and the decline in tea and petroleum exports which resulted from a fall in world prices for the two commodities. There was, in

addition, a decline in total capital inflows. Although the economy enjoyed a recovery in the service sector with tourism, transportation and inflows of official grants offsetting some of the current account deficit, there was, nevertheless, an overall balance of payments deficit of shs 1,719m.

The adjustment programme for 1985 aimed at providing balance of payments support within a framework designed to maintain the underlying monetary and budgetary deficit at sustainable levels in the medium term. The programme aimed at reducing the fiscal and external current deficits to about 4 per cent of G.D.P. in 1986. It also provided for a real growth rate of about 5 per cent in 1986 rising to 6 per cent by 1990. The inflation rate was to be contained within 6-7 per cent per year throughout this period while domestic credit policies were to be adjusted in accordance with these objectives.

The balance of payments outlook for 1986 is for a further narrowing of the current account deficit as the terms of trade are expected to swing in Kenya's favour. The value of petroleum imports is expected to fall substantially due to lower prices while coffee export receipts are expected to increase substantially over those of 1984 due to the increase in world coffee prices. Though the increases in receipts appear to be less marked than those in the 1976/77 coffee boom, there will nevertheless be significant short-term benefits for the balance of payments and also for the economy as a whole.

Money and Banking

The principal instruments of monet-

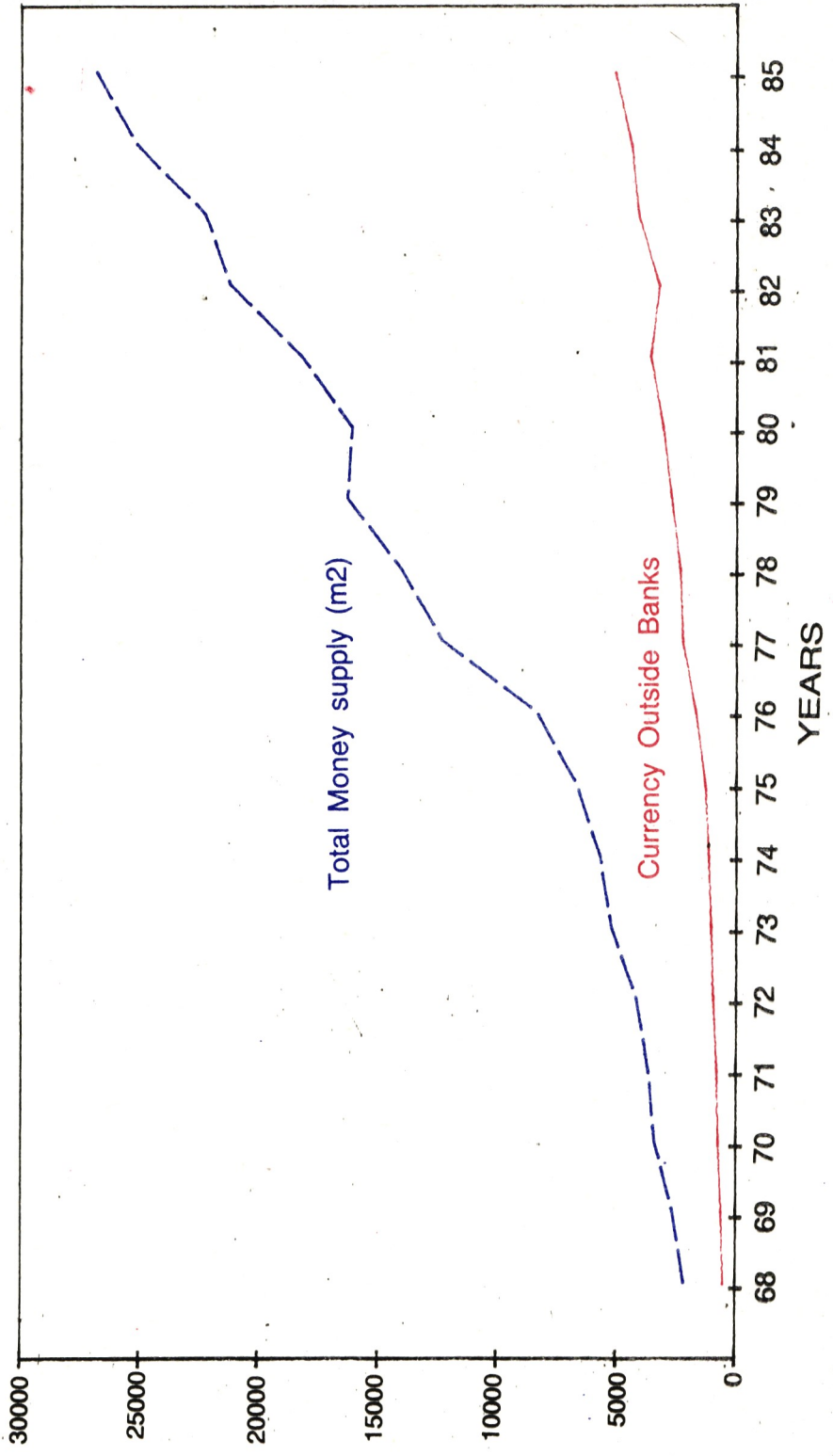
ary and credit control used by the monetary authorities in Kenya were minimum cash and liquidity ratios, quantitative ceilings on the overall credit expansions of commercial banks, and guidelines for the sectoral allocation of credit. Limitations on the amount of domestic borrowing allowed to foreign-controlled companies were also used. Beginning in early 1979, the Bank also used advance import deposits which by September, 1979, were equivalent to 5 per cent of the stock of money and quasi-money at the start of the year. The import deposit scheme was withdrawn in 1983.

When compared to other developing countries, the Kenyan economy is well monetized in relation to its level of development. At the end of 1985, total financial assets which include currency outside banks, deposits of the banking system and government securities were 67 per cent of G.N.P. This reflects financial depth greater than that prevailing in many countries with higher levels of per capita income.

Growth in banking system deposits has on average been slower than that of non-banks' deposits. Between 1967-85, banking system deposits grew at an average annual rate of 16.0 per cent while non-bank financial institutions deposits recorded a higher growth rate of 25.8 per cent. This was largely due to the interest rates differential between banks and non-banks which enabled non-bank financial institutions to offer higher interest rates on deposits than banks.

The financial system continued to expand with the opening of new private banks and non-bank financial

Chart: 7
MONEY AND QUASI-MONEY
(shillings million)



Source: Central Bank of Kenya.

institutions. At the end of June, 1986, the system consisted of the Central Bank, 24 commercial banks with a network of 419 branches. Non-bank financial institutions stood at 50 with a network of 89 branches. The system also includes 32 building societies, 52 insurance companies, 64 hire purchase companies, a post office savings bank, 10 development finance institutions, private pension plans and over 900 savings and credit co-operative societies. Most of this growth in the financial system has occurred in the period 1980-1985, when 9 banks and 31 non-bank financial institutions were licensed.

Money and Quasi-money

Between 1967 and 1985, the growth in money and quasi-money averaged 15.8 per cent per year reflecting, in part, continued expansion and diversification of the financial system. The most rapid growth since the 1977 "coffee boom" was in 1982 when the money supply increased from shs 18,364m in December, 1981 to shs 21,324m in December, 1982, thereby contributing to the record increase in consumer prices of 22.3 per cent during that year. After 1982, growth in the money supply was reduced to more prudent levels through ceilings on overall credit expansion. Between December, 1982 and the end of 1985 the annual average growth rate was only 8.1 per cent per year. The low rate of growth in the money supply helped to limit the growth in inflation, notwithstanding the rapid growth in credit expansion (see Table 4).

Much of the expansion in the money stock was in the quasi-money component which grew at an average annual rate of 18.0 per cent per year between

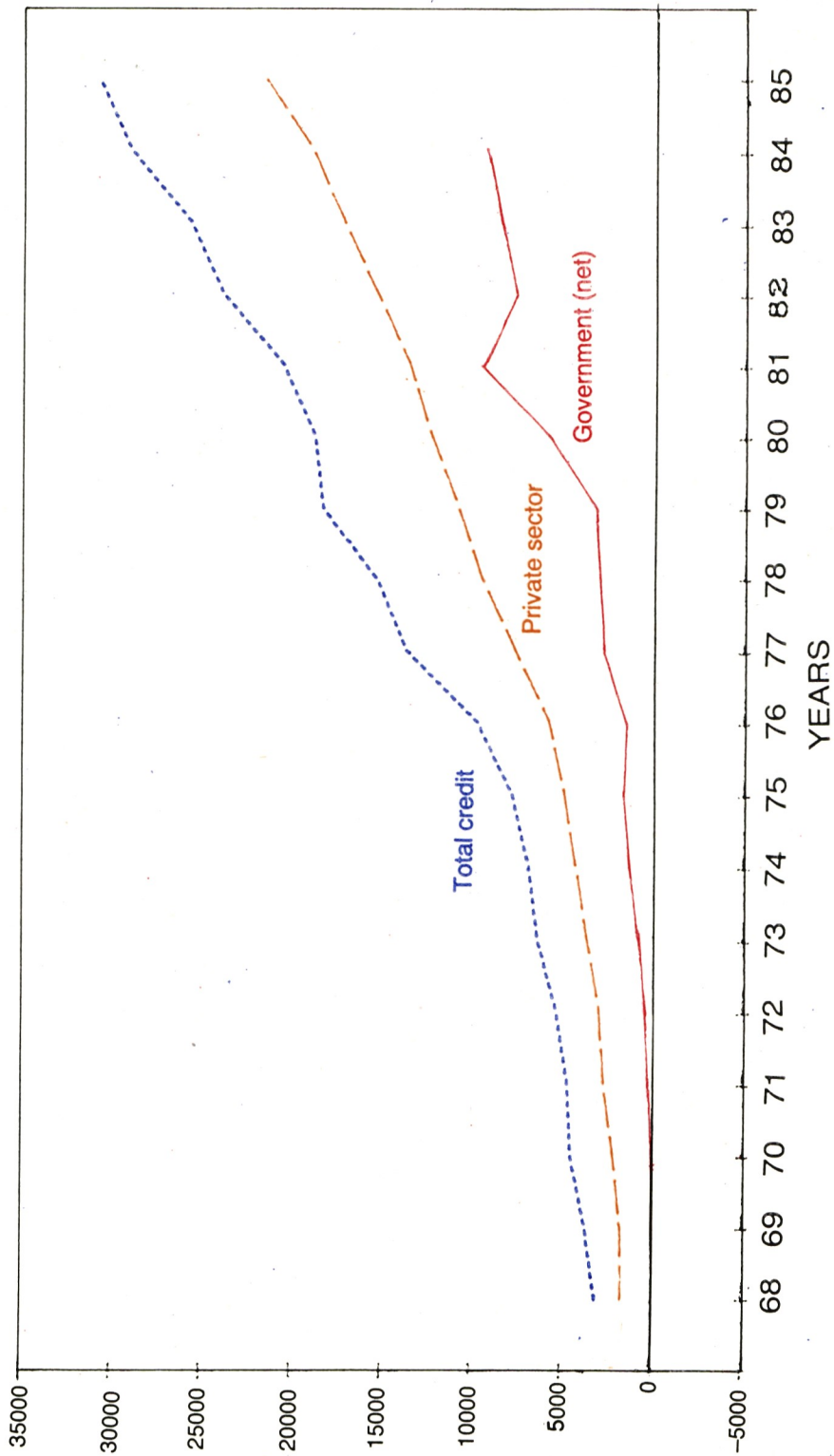
1967 and 1985. Currency outside banks plus demand deposits grew at a more moderate rate of 14.8 per cent. In 1985, quasi-money grew by 12.6 per cent while demand deposits and currency outside banks, which had expanded by 9.8 per cent in 1984, grew by only 2.9 per cent.

Domestic Credit

Domestic credit grew rapidly, rising from shs 1,268m in 1967 to shs 31,380m in 1985. Government credit policy encouraged lending to priority sectors such as agriculture and manufacturing. Credit from non-bank financial institutions expanded more rapidly than that provided by commercial banks. Lending by non-bank financial institutions which stood at shs 242m in 1967, grew on average at the rate of 24.3 per cent per annum to stand at shs 12,094m in 1985. In comparison, commercial bank lending grew at a slower annual rate of 16.4 per cent from shs 1,360m in 1967 to shs 20,900m in 1985. As a result the share of non-bank financial institutions' lending rose from 15.1 per cent in 1967 to 36.7 per cent in 1985.

As indicated in Table 4, the government continued to receive budgetary support from the banking system particularly the Central Bank. At the end of 1985, bank credit to the government as a proportion of total domestic credit was 30.5 per cent compared to 1.6 per cent in 1969. Outstanding banks credit to the government in 1985 stood at shs 9,750m, out of which the Central Bank lent 84.5 per cent. Since 1982, there has been a slow-down in bank credit to government. The slow growth in recent years reflects the cautious stance in fiscal policy of limiting aggregate demand in order to reduce internal

Chart: 8
DOMESTIC CREDIT
(shillings million)



Source: Central Bank of Kenya.

and external pressures while at the same time allowing sufficient credit to the private sector.

Interest Rates

Up to 1980, the Central Bank's policy on interest rates aimed at keeping interest rates as stable as possible. However, because of the spiralling inflation which followed the 1973/74 oil price increases, interest rates became negative in real terms. In 1981, the Bank adjusted interest rates upwards by about 2.0-2.5 percentage points in a bid to bring the rates to positive real levels. This action raised the discount rate to 12.5 per cent during that year while the Treasury bill rates and the lending rate averaged 7.6 and 12.8 per cent respectively. By end of 1985, the discount and lending rates rose to 13.9 and 14.0 per cent respectively from their 1981 levels. Deposit and lending rates charged by non-bank financial institutions have traditionally been higher than those quoted by commercial banks and this is reflected in the differential in the Central

Bank's interest rate controls. In 1983, the Central Bank began to re-inforce its surveillance over financial institutions, especially non-banks, with the aim of securing closer compliance with monetary policy requirements, in particular the methods used in computing interest charges.

At the end of June, 1985, the Central Bank's minimum lending rate was 11 per cent. The discount rate was 12.5 per cent with advances against Kenya Government securities being charged 12 per cent. The maximum lending rate chargeable by the commercial banks and the non-bank financial institutions was 14 and 19 per cent, respectively and the minimum deposit rate for both the commercial banks and the non-bank financial institutions was 11 per cent. While the interest rate differential between banks and non-bank financial institutions was kept under review to ensure competition on equitable terms, the policy intention was to move towards interest rates determined by market forces.

CHAPTER 2—OBJECTIVES AND FUNCTIONS OF THE CENTRAL BANK OF KENYA

The objectives and functions of the Central Bank of Kenya are set out in the Central Bank of Kenya Act of 1966. The Act prescribes that the principal objects of the Bank shall be to regulate the issue of notes and coins, to assist in the development and maintenance of a sound monetary, credit and banking system in Kenya conducive to the orderly and balanced economic development of the country and the external stability of the currency, and to serve as banker and financial adviser to the government.

The specific functions of the Central Bank of Kenya may be summarized as follows: the first function concerns the provision of banking services to the government and commercial banks and includes the issue of currency. The second function deals with services rendered to the government as fiscal agent, i.e. financing of budgetary deficits and managing the government debt. It also deals with services rendered to commercial banks, i.e. short-term loans; advances, and rediscounting of bills. The third function concerns the external financing services rendered by the Central Bank which include the management of foreign reserves, administration of exchange controls, carrying out transactions with international monetary institutions, and managing the exchange rate of the Kenya shilling. The fourth function involves the supervision of commercial banks and non-bank financial institutions; and the fifth function is concerned with the role played by the Central Bank in management of the economy. These functions will be considered in that order in this and the subsequent chapters of this book.

Provision of Banking Services to Commercial Banks

A principal responsibility of any central bank is to supply bank-notes and coin to the economy. To discharge this responsibility satisfactorily, a central bank ensures that there are always adequate stocks of notes and coins and that there is a satisfactory distribution system. The first stage in these arrangements is for a central bank to estimate the demand for the various denominations of currency notes and coin. This involves making forecasts of requirements for notes and coins and ordering supplies in good time before the existing stocks are exhausted. The next stage is the actual printing of the currency—a task undertaken using skills that make it very difficult for others to reproduce it accurately. This means that the materials used, the designs, and the actual manufacture of the currency require special expertise, sophisticated machinery and a high level of security.

The Central Bank has the sole right to issue notes and coin in Kenya. The first major task the Central Bank had to face when it was established was therefore the issue of the new Kenyan currency notes and coin to the general public on the 14th September, 1966. The task required careful planning and preparation for the new currency, design, description and denominations. The services of a number of financial intermediaries were used, and strict security arrangements were necessary to ensure orderly exchange. It was vital to secure the confidence of the public in the new currency. Initial issues of the new currency notes were made to all commercial banks well in advance of 14th September, 1966 at

Nairobi, Mombasa and Kisumu. To assist the banks during the early period of exchange, the initial drawings were made on suspense accounts subject to their liquidation within two months of the formal date of issue. The new currency notes comprised the following denominations: shs 5, shs 10, shs 20, shs 50 and shs 100. The new notes were issued through the commercial banks against the exchange of the East African Board currency notes. By 30th June, 1967, the Central Bank had exchanged shs 300 million of the East African currency notes, whilst its own notes in circulation amounted to shs 360 million.

The new national coinage of Kenya was released to the general public on the 10th April, 1967, in denominations of 5 cents, 10 cents, 25 cents, 50 cents, shs 1 and shs 2. The 25 cents and shs 2 pieces were new denominations and did not prove to be popular as had been hoped. They were subsequently withdrawn from circulation.

In order to save the public any inconvenience, the East African Currency Board notes were allowed to remain legal tender until the 14th September, 1967 and coins until the 1st April, 1969 after which they ceased to be legal tender. However, they continued to be exchanged at the bank at par until 31st December, 1972, when they were finally demonetized. From 1967 to 1985 the structure of the Kenya currency remained virtually unchanged, except that between 1973 and 1980 there were no issues of shs 50 note. Over time, however, the purchasing power of all denominations became eroded by inflation to the extent that the present highest denomination note of shs 100 is no longer of sufficient value for some transactions. This development led to a substantial increase in the turnover

of shs 5 and shs 100 notes and a reduction in their average lifespan. In order to reduce the costs of replacing worn out and torn notes, the bank introduced a new shs 5 coin in October, 1985 to gradually replace the existing shs 5 note. Arrangements were also being made to introduce before the end of 1986 shs 200 note to take over some of the transactions performed by the shs 100 note.

Most of the movements of currency from the Central Bank to the public and vice-versa take place through commercial banks. Currency flows from the commercial banks to the public when for example the government and other employers pay wages and salaries to their workers, and the marketing boards and other traders buy farm produce from farmers. The commercial banks obtain the currency they need from the Central Bank by either drawing down their deposits or by selling some of their monetary assets like Treasury bills to it. Later on, when farmers and workers use the cash to buy the goods they need from traders, the currency returns to the commercial banks when traders repay the loans they might have taken from commercial banks to stock up goods in their shops earlier, or when they deposit the currency in their commercial bank accounts. Similarly, when farmers and workers deposit their savings in their commercial bank accounts, there is a return flow of currency to commercial banks. The commercial banks return to the Central Bank any excess amount of currency which they do not require and thus build up their deposits. In this process, new or clean notes and coin go out from the Central Bank and dirty and worn out currency returns to it. In practice these inflows and outflows are all going on at the same time and, although there are

fluctuations, the amount of currency in circulation tends to be fairly stable, around a steadily growing trend because of growth in volume of transactions resulting from real growth in the economy, monetization of the economy and price increases. The amount of currency in circulation increased from shs 481m in December, 1967 to about shs 6000m in June, 1986.

Direct movements of currency between the Central Bank and the public also take place when those who receive payments by cheques from the government come to the Central Bank to cash them or those who have to make payments to the government towards taxes or other revenue pay them to the Central Bank. Since notes and coins are deposited in bulk by commercial banks, the Central Bank maintains notes and coin counters whose duty is to count all the deposited notes or coins as declared by the commercial banks at the time of depositing. After checking, the notes are sorted into clean and unserviceable, and bundles of each category are then made. The clean notes are reissued while the others are destroyed.

Apart from operating current accounts for the commercial banks, the Central Bank also provides them with other important facilities. One of these facilities is giving credit to commercial banks in time of need in accordance with the provisions of sections 35 and 36 of the Central Bank of Kenya Act. The Bank extends credit to commercial banks in two ways: first, by rediscounting, i.e. purchasing at less than face value bills of exchange, promissory notes or other eligible instruments; and secondly, by granting loans or advances against collateral of credit instruments referred to or negotiable security issued or guaranteed by the government.

The Bank is specifically authorized to extend short-term credit to commercial banks, in order to provide them with cash for three main purposes, namely, (i) when they need such credit as a result of their having financed the export or import of goods or their transportation within Kenya, (ii) storage of non-perishable goods and products which are duly insured or deposited under conditions assuring their preservation in authorized warehouses or in other places approved by the Bank, and (iii) when they need it because of their lending for agricultural or industrial production. The maturity period of the credit instruments from the time they are purchased by the Bank and the fixed periods of the loans and advances generally cannot exceed 6 months. However, if the Bank finds it to be in the interest of national economy, it may accept credit instruments relating to agricultural and industrial production with maturity period of up to 9 months.

Before a commercial bank is granted any credit facility by the Central Bank it must demonstrate that the liquidity shortage facing it is of a temporary nature and not a structural problem which may arise due to under-capitalization. For this purpose, the Bank, generally does not extend credit to commercial bank in excess of its capital and unimpaired reserves. Furthermore, for a loan to be extended, a 10 per cent margin between the amount of loan applied for and value of financial instrument securing the loan is required. Other factors that the Bank considers include the general financial condition of the commercial bank and the factors that led to the liquidity shortage.

Unlike credit to government, credit extended to commercial banks is not subject to any ceilings in the Act. The

reason is that the amount of such credit, and the terms and conditions on which it is given, are important instruments of monetary policy and hence are matters to be determined by the Central Bank from time to time in the light of the needs of the particular situation that exists and at the time. The provisions in the sections relating to credit operations are, therefore, of an enabling nature, i.e. they state the manner in which different types of credit can be given, leaving it entirely to the Central Bank to determine the general terms and conditions under which it extends credit to commercial banks and the rates of interest it will charge them. These rates form an integral part of the interest rate policy of the Central Bank.

Another important service rendered by the Central Bank to commercial banks is the running of the Clearing House mechanism. The Nairobi Bankers Clearing House which is located in the premises of the Central Bank is not a department of the Central Bank: it is a common facility of the member banks. It was established to provide a convenient medium for presentation and settlement of financial instruments such as cheques, drafts, payment orders drawn on or payable to other members. Before the Clearing House was established banks in Nairobi were settling their net receipts or payments once a month through courier service. The Central Bank took over the running of the Clearing House in Nairobi on 16th November, 1966. A similar arrangement also exists in Mombasa, where the branch of the Central Bank has been operating the Clearing House for the main branches of commercial banks in Mombasa and coast region since January, 1977.

Membership of the Clearing House is open to any bank which abides by

the established rules of the Clearing House. Membership may be withdrawn if in the opinion of the Central Bank a member has not acted in the best interests of the Clearing House or in accordance with the established rules. Every member of the Clearing House is required to maintain sufficient funds in its account with the Central Bank to meet the net amount due to other members. When a member's account has insufficient funds, settlement with other members is rendered impossible and the membership to the Clearing House, inevitably, has to be suspended until sufficient funds are available in the account. The Clearing House is presided over by an inspector appointed by the Central Bank assisted by a representative elected by member banks.

Provision of Banking Services to Government

The Central Bank is by law required to serve as banker to the government and to act as its fiscal agent. In these capacities, the Central Bank is required, amongst other things, to perform the following duties—

- (a) to be the official financial depository of the government, i.e. to accept deposits and effect payments on behalf of the government;
- (b) to maintain and operate special accounts for the government;
- (c) as agent of the government, to administer the public debt, i.e. to effect the issuance, payment of interest on, and redemption of bonds and other securities of the government;
- (d) to pay, remit, collect or accept for deposit or custody, funds in Kenya or abroad on behalf of the government;
- (e) to purchase, sell, transfer or accept for custody, cheques,

bills and other securities for the government;

- (f) to purchase, sell, transfer or accept for custody gold or foreign exchange on behalf of the government.

To discharge its responsibilities under these provisions, the Central Bank maintains, on behalf of the Treasury, the Exchequer Account, into which all revenue is deposited, and the Paymaster-General Account, out of which all payments are made. The annual budget of the government is essentially a forecast of the revenues which the government expects to receive during the financial year and the expenditures it will incur on normal administration as well as in carrying out various development activities. There are many items in the budget which can be forecast quite accurately. But there are a number of others where the actual performance can differ from the budget forecast in varying degrees due to factors beyond the control or foresight of the government. Consequently, the final budget outturn may be quite different from the forecast and where, as happens frequently, unexpected expenditure exceeds revenues, it sometimes becomes necessary for the Central Bank to provide the finance for the excess.

Apart from this overall problem for the budget over the financial year as a whole, temporary deficits or surpluses also arise during the financial year itself, because of the different timing of revenue and expenditure flows. Imbalances of both types are reflected immediately in the government's account at the Central Bank and so it is in a position to draw the attention of the Treasury to them. For this pur-

pose, there are five types of government accounts namely, Recurrent Revenue, Development Revenue, Recurrent Expenditure, Development Expenditure, and certain miscellaneous deposits and expenditures for special funds created in the budget. All ministries and government departments have Recurrent and Development Expenditure Accounts.

As regards revenue, all receipts due to the government of Kenya are paid into a Consolidated Fund which forms the credit side of the Exchequer Account and from which no monies are drawn except when authorized by an Act of Parliament or by a Vote on account passed by the National Assembly. When the Treasury releases funds to the various spending units according to the votes sanctioned for them, the Exchequer Account is debited and the account of the ministry, or department concerned in the Paymaster-General Account is credited with the funds released to it. The Paymaster-General Account is debited when expenditures are made by the respective ministries or departments. The Central Bank can then watch the expenditures by these organizations and warn them as well as the Treasury in good time before the funds are exhausted.

The Central Bank works out every day the overall position of the government by totalling the credits and debits recorded in all government accounts during the day. If the net result is a surplus it is added to the previous day's position, and if it is a deficit, it is subtracted from the position. The daily position is notified to the Treasury as soon as it is established.

Lending by the Central Bank to the government is governed by a special

set of provisions because of the important ways in which such lending can influence the money supply. These provisions allow the Central Bank to give to the government all types of credit, i.e. short-term, as well as medium- and long-term. However, both the forms in which credit can be given and the extent of credit in these forms are subject to ceilings laid down in the statute.

Short-term credit to the government can be in two forms, i.e. direct advances, and purchase of Treasury bills with a maturity of less than 12 months from the date of issue. Medium and long-term credit can only be in the form of negotiable securities, i.e. those securities which can be bought and sold in a market and which mature later than 12 months from the date of issue. Other forms of credit such as term loans are not allowed. The underlying idea is that the Central Bank should be able to conduct open market operations by using these securities in order to influence the money supply—hence the requirement that the securities should be negotiable if they are issued by the government and negotiable and guaranteed by the government if issued by public authorities. No other type of credit can be given by the Central Bank to the government either directly or indirectly.

There are certain limits regarding credit from the Central Bank to government. In the original Central Bank Act of 1966, the total outstanding credit by the Central Bank to the government at any time was limited to shs 240 million. Within this overall limit, the value of securities which were to mature later than 12 months from the date of acquisition or acceptance as security by the Bank was not to

exceed shs 60 million at any one time or 25 per cent of allowable credit.

The provisions in section 48 of the Act were amended in 1972 so that the Central Bank's direct advances to the government may not at any time exceed 25 per cent of gross recurrent revenue of the government as shown in the Appropriation Accounts for the latest year for which such accounts have been audited by the Controller and Auditor-General. The Recurrent Revenue of the government is defined to include revenue from taxes, customs, excise, export and other duties, fees, rents, profits and income from any investment or undertaking but to exclude proceeds from grants or loans, or any form of borrowing, whether short or long-term.

Management of the Public Debt

As fiscal agent for the government, the Central Bank has the responsibility of managing the domestic public debt by which is meant the debt the government has incurred locally in the form of marketable (i.e. negotiable) securities. The Central Bank is not required to handle other forms of borrowing by the government, such as through direct loans from private parties. These are looked after by the Treasury. Management of the public debt involves issuing government securities, making periodic payments of interest on them, registering transfers, and rolling over and redeeming the securities. In addition, the Central Bank manages "sinking funds" on behalf of the Treasury. The sinking funds are created by the Treasury for the purpose of meeting redemption expenses at maturity of some of the stocks. The money for these funds is contributed by the Treasury semi-annually and the Central Bank in turn invests it in

appropriate stocks (or other paper) to enable the loans to be paid at the time of redemption of the stocks.

Government securities issued by the Central Bank can be grouped under two broad categories: short-term, and medium or long-term, securities. Short-term securities consist of Treasury bills with maturities of up to 90 days, and tax reserve certificates. The minimum holding for an investor in Treasury bills is shs 100,000. The Central Bank ensures that the amounts of Treasury bills offered for tender are subscribed at reasonable rates of discount. The Central Bank may also participate in tenders to maintain rates at a desired level. The Central Bank also contributes to the marketability of the bills by its willingness to rediscount them for the holder at $\frac{1}{8}$ per cent. above the ruling average discount rate. The Central Bank invites tenders once a week from those intending to purchase these bills and allots them to the highest bidders. This method ensures that the government gets short-term finance at the lowest possible cost.

Tax reserve certificates, are available to those who wish to make financial provision for tax payment in the future by savings currently. This form of investment is useful to tax payers since they earn tax free interest on such savings and, having made such a provision, do not have to worry when the collector calls. The advantage to the government is that tax revenue is received in advance. However, they have been rather insignificant in terms of volume and value.

As regards medium and long-term securities, the management of government stock was taken over by the Central Bank in 1966. The Central

Bank, undertook to handle on behalf of the Treasury, new subscriptions, keep the register of holders and service the issues. Subsequently, the Central Bank took over the task of servicing all previous issues of the government.

The issuing and redeeming of government stocks is a continuous process. Issues are made when funds are required by the Treasury, and redemptions or conversions fall on the date when stocks mature. The amount of finance the government desires to raise through the issue of securities is worked out at the time of preparing the annual budget. The major investors, such as the National Social Security Fund, are consulted as to the investment they are likely to make and the shares of the total amount likely to be raised through securities (which forms part of Development Revenue) from the various types of investors, the commercial banks and the Central Bank are worked out.

The Central Bank advises the Treasury on the maturities into which the total amount should be split and the appropriate interest rates for the maturities. Generally, three maturities are offered: up to 5 years; between 5 and 10 years; and over 10 years. The Central Bank actively watches the progress of the issues to ensure that the budget expectations are fulfilled as far as possible by switching the original allocations if necessary. If, in spite of this, there is a shortfall in the subscription to the issues, it has to be made good by the Central Bank—either by taking up the balance of the issue, or short-term lending to the government.

In the 1986/87 budget, the government announced the introduction of two new medium and long-term securities aimed at offsetting the ex-

cessive money supply injection that was expected to arise from the balance of payments surplus. The government proposed to offer to the public, as well as commercial banks, on a voluntary basis, the opportunity to invest excess liquidity in these securities: One with a maturity of 2 years, and the other with a maturity of 5 years. The first security was intended for a broader spectrum of investors, i.e. commercial banks, financial institutions and individuals, while the second was primarily designed for insurance companies and

other institutions such as pension funds. While in the case of medium- and long-dated stocks both the coupon rate and the price at which the stocks are sold are fixed in advance, these new Treasury bonds will be sold at prices determined by bids in a competitive auction process. This has the advantage of allowing investors to determine the yields or effective interest rate on the bonds, which are necessary to achieve the required level of sales.

CHAPTER 3—FOREIGN EXCHANGE AND EXCHANGE CONTROL OPERATIONS OF THE CENTRAL BANK

The foreign exchange and exchange control operations of the Central Bank of Kenya are activities designed to enable the Central Bank carry out its responsibilities of maintaining an adequate level of external assets; administering laws relating to controls on imports, exports, foreign exchange transactions, and administering payments agreements between Kenya and other countries.

Foreign Exchange Operations

Historically, central banks have held reserves of external assets in order to safeguard the value of their currency. Statutes of many central banks require them to hold reserves of such external assets at least equal in value to some fixed percentage of total currency issued by them or to aim at a certain target of foreign currency in relation to a country's imports. Central banks hold these reserves to act as a buffer against adverse movements in the country's balance of payments with the rest of the world, and to maintain confidence of external solvency. All central banks have thus to pay careful attention to both the composition and the overall level of their reserves.

Transactions in foreign exchange take place throughout the year. Business houses and marketing boards engaged in agriculture, industry and trade as well as private individuals sell goods and services to people overseas and also buy from them. All this involves receipts or payments which may be immediate or accruing at some future date. These transactions take place through the banking system. The transactions relating to the general public are carried out by commercial

banks and those of the government by the Central Bank. However, sometimes commercial banks are also called upon to execute some government transactions for reasons of convenience. On the Kenyan side, any party having to make a payment abroad pays the shilling equivalent to its commercial bank and asks it to pay the corresponding foreign currency amount to the creditor abroad. Similarly, when any party is to receive payment from abroad, the commercial bank receives the foreign exchange while the Kenyan party receives the equivalent in shillings. This is because, under the Exchange Control Act, only parties authorized by the Central Bank to handle transactions in foreign exchange can maintain foreign currency balances and make payments out of them or receive payments into them. Generally, only commercial banks are authorized to maintain such balances, for the purpose of handling foreign exchange transactions which have been approved under exchange control.

The amount of foreign balances that commercial banks may hold are set by the Central Bank at a level sufficient to enable them to carry out their day-to-day business. Any excess is sold to the Central Bank and any shortfall is made good by the Central Bank, in exchange for shillings. The reason for this strict control is to conserve use of the reserves and limit speculation against the shilling by the commercial banks. Similarly, whenever the government receives foreign exchange by way of external assistance, it sells the foreign exchange to the Central Bank against local currency. When the gov-

ernment makes a foreign payment, it purchases the required amount of foreign currency from the Central Bank and settles the equivalent in local currency against its account. The Central Bank then makes the foreign exchange payment from its foreign exchange holdings.

In this way the Central Bank acquires and holds in its reserves of external assets all foreign exchange which is not immediately required for making payments by the public or the government. This foreign exchange is held by the Central Bank in various forms, i.e. current account balances with banks abroad which normally do not earn any interest; interest yielding fixed term deposits; Treasury bills; or any other instruments that are available in foreign money markets.

The Central Bank has to decide from time to time how much should be held in cash or assets which can easily be turned into cash, i.e. liquid form, and how much should be invested in higher yielding but less liquid form. The purpose is to achieve the best possible return on these substantial assets, whilst still ensuring that foreign exchange will be readily available to meet the country's foreign exchange payments as and when they fall due.

Although interest rates are normally higher in money markets of countries with weak currencies than in those with strong currencies, the Central Bank keeps a watch on developments in important foreign exchange and money markets to determine its investment stance, bearing in mind the need to distribute its foreign exchange investments into currencies and instruments that maximize the overall return on investment, including any changes in capital values of the investments.

An aspect of importance in managing Kenya's official reserves is the requirement that the Central Bank use its best endeavours to maintain a reserve of external assets at an aggregate amount of not less than the value of four months imports as recorded and averaged for the last three preceding years.

Keeping to the target is not easy, particularly in times of balance of payments problems. It then becomes a matter of public policy to decide how much foreign exchange should be allocated for imports or for other essential services. Another factor which is taken into account is the availability of finance from external sources such as equity capital, loan finance, and grants which make a large and growing contribution to Kenya's external means of payments.

Exchange Rate Operations

The term "exchange rate" refers to the price at which one currency is exchanged for another currency. In Kenya, the rate at which commercial banks buy or sell foreign currencies for shillings from or to their customers as well as the rates at which foreign exchange transactions are conducted with the government are fixed by the Central Bank. For this purpose, first a central value for the shilling is fixed in terms of the S.D.R. or any other chosen currency, e.g. the pound sterling, or the US dollar. Currently, a number of countries quote the value of their currencies against a basket of currencies—the S.D.R. is one such basket. If the value is in terms of a currency, the Central Bank then fixes the shilling rates for buying or selling that currency. The rates for buying or selling of foreign currencies by com-

mercial banks from or to their customers are then fixed in relation to the rates issued by the Central Bank.

The precise level at which the value of domestic currency is fixed is of vital importance to the economy of a country, because it becomes the basis for fixing the exchange rates of the country's currency in terms of other currencies, e.g. Kenya shilling in terms of the US dollar, pound sterling, French franc, etc. Once the exchange rates are fixed in this manner, exporters who sell their goods in foreign currency then know how much they expect to make in Kenya shillings. Similarly, importers can work out their costs in local currency of different items they import.

If the value of domestic currency is fixed at a level which importers find it highly profitable to import, a nation's foreign reserves can be reduced as more imports are attracted and exports discouraged. Hence, central banks endeavour to fix their currency value at levels that would avoid such consequences. Generally, the practice is to attempt to give some preference to exports and domestic producers, i.e. to encourage exports and discourage imports. The extent of such preference has to be moderate because other countries may be adversely affected and hence retaliate.

When the Central Bank of Kenya commenced operations in foreign exchange in 1966, it adopted rates used by the East African Currency Board, i.e. shs 19.994 per pound sterling when buying from banks and shs 20.012 per pound sterling when selling sterling to them. The underlying central relation was that shs 20 equalled £1. Subsequently, the value of the shilling was

fixed in terms of gold at shs 1=0.124414 grams. This was done in such a manner that it maintained the central relation between the shilling and the pound sterling of shs 20=£1. The rates for the shilling and all other currencies were worked out from this central relation using the rates between sterling and other currencies in the London foreign exchange market. The central banks of Tanzania and Uganda, both of which preceded the Central Bank of Kenya, adopted the same practice. As a result, the three central banks worked out banking arrangements amongst themselves such that transactions in each other's currencies were at par (i.e. they bought and sold the shilling amongst themselves at a common rate).

With the value so fixed, the relation between the shilling and the US dollar was fixed at shs 7.14286 = 1US dollar because the US Treasury maintained the value of the dollar at 35 dollars to 1 troy ounce of gold. In November, 1967, when sterling was devalued by 14.3 per cent, Kenya, together with Uganda and Tanzania, decided to maintain unchanged the par value of the shilling in terms of gold. This left the dollar/shilling rate intact, while the sterling/shilling relation changed to reflect the devaluation of the pound.

The system of fixing currency values in terms of gold was created in 1944 as part of the Bretton Woods arrangement which had three main elements; the par values, convertibility of currencies, and freedom from payments restrictions. The main feature of the Bretton Woods system was existence of a settlement asset which was freely acceptable, and that could also serve as a reserve asset. The supply of gold which previously served as a reserve

and settlement asset, proved inadequate for the purpose of facilitating international transactions. As a result the US dollar was designated to supplement gold reserves.

The functioning of this arrangement depended on two important conditions: first, the willingness of the US government to accumulate dollar liabilities in order to provide liquidity to finance expansion in international trade and investment; and second, the willingness of countries with balance of payments surplus to accumulate dollars as reserve assets. Countries with persistent balance of payments deficits were supposed to make macro-economic adjustments without changing their exchange rates. These conditions could not be sustained for long.

By late 1950s there was growing realization that the functioning of the par value system was threatened by two problems: first, attempts by the major industrial countries to use demand management macro-economic policies failed to solve their balance of payments problems. Second, there was demand for international liquidity, which could not be satisfied by accumulation of US dollar liabilities. Furthermore, countries with balance of payment surplus became increasingly wary of accumulating dollar reserves, and desired an asset that was free from monetary policies of another country. In order to resolve this issue discussions began in September, 1963, but it was not until April, 1968 that a final agreement was reached on a scheme to create Special Drawing Rights (S.D.R.s). The first allocation of S.D.R.s under the new scheme involved S.D.R. 9.3 billion over the three years 1970-72. Kenya received S.D.R. 15.6 million. The second

allocation of about S.D.R. 13.3 billion took place over 1979-81. Kenya, again received S.D.R. 7.2 million, raising the total cumulative allocation to S.D.R. 22.8 million. The distribution of S.D.R.s is based on members' quotas in the Fund.

S.D.R.s are not tangible money like notes or coin. They are book entries to facilitate settlement between participating members of I.M.F. or transactions between members and the Fund or authorized institutions such as the World Bank, African Development Bank, etc. The S.D.R. is also widely used as a unit of account in private and official transactions because of its relative stability when compared to other currencies.

When the first allocation of S.D.R.s took place in 1970, the value of S.D.R. was set to a fixed quantity of gold equal to the par value of the US dollar. Following the devaluation of the US dollar in 1971, the parity of the S.D.R. and the dollar ended as the S.D.R. appreciated against the dollar. After 1973 par values were no longer observed and the dollar as well as other major currencies floated freely and since the shilling was linked to the dollar, its exchange rate followed suit. In order to give the S.D.R. a measure of relative stability that was lacking in other currencies, the Fund decided with effect from 1st July, 1974 to value the S.D.R. on the basis of a standard basket of 16 currencies. The currencies were selected from countries whose international trade averaged 1.0 per cent of world trade over the period 1968-72. These were, the US dollar, deutschemark, pound sterling, French franc, Japanese yen, Canadian dollar, Italian lira, Netherlands guilder, Belgium franc, Swedish krona, Australian

dollar, Spanish peseta, Norwegian krona, Danish krona, Austrian schilling and South African rand. In 1978, the Danish krona and the South African rand were replaced with the Saudi Arabian riyal and the Iranian rial. Effective from 1st January, 1981 the number of currencies in the S.D.R. basket was reduced to five, i.e. the US dollar, deutschemark, pound sterling, Japanese yen and the French franc.

Until October, 1975, the Central Bank retained the relation between the shilling and the US dollar with marginal variations from time to time. However, as time progressed this was found unsuitable because of a sharp upward movement in the exchange rates between the US dollar and other currencies. Hence in October, 1975 the S.D.R. was chosen as the basis for determining the value of the shilling in terms of other currencies. To fix the shilling value in terms of other currencies, the Central Bank obtains daily the US \$/S.D.R. rates from the International Monetary Fund and the rates between the US dollar and other currencies from the Federal Reserve Bank of New York.

Forward Exchange Cover

Since the exchange rates between currencies fluctuate, Kenyan businessmen who expect to receive or pay foreign exchange at some future date and who do not wish to take the risk of exchange loss (or gain) can safeguard their position by obtaining forward cover for future transactions. The cover is in the form of a contract between a businessman and a commercial bank. The contract stipulates that a commercial bank would buy or sell a certain amount in foreign currency against shillings from or to a businessman on the stated date at an exchange rate

fixed at the time of making the contract. In making such contracts, commercial banks have to be very careful that they themselves are not placed in a position where they might sustain a heavy loss because of unfavourable movements in exchange rates between the time the contract is signed and its date of settlement.

If demand from importers buying foreign currency at a future date equals the supply of the currency by exporters at that date, then there is no risk for commercial banks because they can set off their forward sales against their forward purchases. However, this seldom happens. The commercial banks therefore need a safeguard against such contingencies and obtain cover from the Central Bank on lines similar to what the banks provide to their customers.

The forward foreign exchange market in Kenya commenced on 11th December, 1967. Initially, the Central Bank dealt exclusively in sterling in spot and forward markets, but the US dollar was included in the forward foreign exchange dealings in September, 1968. Since then, the deutschemark has been added to the currencies in which the Central Bank deals forward, and the maximum contract period has been extended to six months from the initial three months. Forward deals in other currencies can be arranged in other foreign exchange markets against a forward purchase of US dollars, pound sterling or deutschemarks from the Central Bank of Kenya.

As the exchange risk in foreign transactions with clients is taken over by the Central Bank, it is, of course, necessary that the Central Bank should be compensated for assuming

the risk. This compensation takes the form of a premium or discount over the ruling spot rate of exchange. The rates of "premium" or "discount", which are technically quoted by the Central Bank as "forward margins", are based on international market conditions depending on such factors as the forces of demand and supply for the currencies concerned, the differentials in ruling interest rates, inflation rates, and the general political and economic conditions in the countries involved. Interest rate differentials are, however, the most dominant single factor in determining forward margins.

Relations with International Financial Institutions

In its role as manager of foreign exchange reserves, the Central Bank of Kenya maintains correspondent relations with foreign central banks and commercial banks in those financial centres where warranted by the volume of business and the financial services available. The Central Bank opens accounts with reputable banks and operates current accounts for day-to-day settlements and receipts, and securities accounts for investments such as short-term deposits, government Treasury bills, and other long-term paper.

The Central Bank also maintains accounts of international institutions such as the International Monetary Fund, the World Bank Group, the European Economic Community Development Fund, and other aid agencies. On a regional basis, the Central Bank maintains accounts with regional central banks for operating reciprocal banking facilities. The reciprocal banking arrangements are to be taken over by the clearing house based in

Harare, Zimbabwe (recently established as part of the Preferential Trade Area institutions) where the Central Bank of Kenya maintains a settlement account to cater for regional trade.

Exchange Control Operations of the Central Bank

Under section 30 of the Central Bank of Kenya Act, the Central Bank is required to administer any law relating to exchange control that may be in force at any time in Kenya. The Exchange Control Act provides that the Minister for Finance retains the overall supervisory powers.

Restrictions of some kind or another on foreign exchange transactions by Kenya residents have been in existence for over half a century. In the early 1920s, there were quite restrictive exchange control rules regarding transactions between Kenya, which was then a part of the sterling area, and the rest of the world. Transactions within the sterling area were, however, free from restrictions. Since in those days people in Kenya had very few transactions outside the sterling area, the stringency of these restrictions was not felt by many people or businesses.

Local legislation providing specifically for exchange control was introduced in 1951 and the main provision of the current Exchange Control Act have been inherited from it. Again, the 1951 statute controlled transactions with non-sterling countries only. By leaving remittances to sterling area free of control, Kenya began to experience strong pressure on its reserves after independence in 1963. A number of people at that time decided to take out all their assets or transfer large amounts of funds to other sterling area

countries like the United Kingdom, Canada, Australia, India, Pakistan, etc. The impending break-up of the East African Currency Board in 1965 greatly increased such activity because of fears about the new currencies. In June, 1965, it became necessary to impose exchange control on transactions with sterling area countries other than Tanzania and Uganda, which also took similar action. Exchange control restrictions were extended to the two neighbouring countries in August, 1977 after the collapse of the East African Community.

The Exchange Control Act and the subsidiary legislation and rules and regulations made under it together form one of the most important means for economic management in Kenya. The Act provides that all transactions involving foreign exchange are prohibited unless permitted directly by the Central Bank of Kenya or indirectly through the authorized dealers. Such transactions include: the purchase, sale, borrowing or lending of foreign currency (and gold) and the maintenance of balances in foreign countries; payment to non-residents or into these accounts in Kenya; export of any financial instrument or bill of exchange, e.g. cheques, currencies, drafts, travellers' cheques, securities and gold; transfer of securities between non-residents and residents, and holdings of foreign securities; exports of goods to countries outside Kenya.

In administering the Act, the Central Bank considers applications from parties wishing to enter into these types of transactions in the light of the Government's policy, and approves or rejects them, or calls for further information before giving a final deci-

sion. According to the provisions of the Exchange Control Act, the exportation of goods of any class to any place outside Kenya is prohibited unless the Central Bank gives its consent. These powers have been delegated to the Commissioner of Customs on certain conditions, e.g. he can only allow the exportation of goods which are going to be sold abroad if he is satisfied that the sale proceeds of the goods will be received within a specified period; and that payment will be made in foreign exchange. Established exporters may register themselves with the Central Bank. Registered exporters are not required to obtain pre-shipment approvals from the Central Bank, but are, however, required to account for proceeds of sale to the exchange control.

Export documents (CD3 forms) are channelled through the commercial banks which retain copies of these forms, the original one being released to the exporter for the purpose of clearing the goods with the customs authorities. One of the copies is sent to the Central Bank by the exporter's bank to give the Central Bank notice of an impending export. When the goods have been cleared through customs, the custom's copy is sent to the Central Bank. When the proceeds of the sale of the goods are received, a certificate to that effect is prepared by the exporter's bank and again dispatched to the Central Bank. The three documents are then matched and retained as a record of satisfactory export performance. The Central Bank also checks to ensure that not only does the country get a fair return for the goods, but in particular that the money is actually received within a reasonable time.

Under the exchange control law, no resident, be it an individual or a private or public institution, can borrow foreign currency without the consent of the Central Bank. While borrowing by the government does not require exchange control consent, the Central Bank is duly informed of it; borrowing by other parties requires the express prior approval of the Central Bank. Borrowing by government corporations require Treasury's approval. The main concern of the Central Bank in this area is to satisfy itself about the purpose for which the loan is being raised and other tasks and conditions of the loan including the interest rate that is being charged, and the repayment periods. One of the major considerations in foreign borrowing is to spread the repayment period of the loans over as long a period as possible.

Residents who, in one way or another, become entitled to foreign exchange cannot retain it themselves, but are required to sell it to authorized dealers and receive shillings in return. Non-residents visiting Kenya are required to pay their hotel and other bills in foreign exchange.

The appropriate ministries in the government determine the desirability of foreign investment to be allowed in the areas of economic activity they are concerned with. The Central Bank then ensures that the investment is made by the foreign parties in an approved manner, e.g. cash or new machinery. Borrowing from local banks by resident companies with foreign ownership beyond certain levels require prior approval by the Central Bank.

The bulk of foreign exchange pay-

ments are made in respect of imports of goods. The total amount to be spent on imports in any financial year and the broad priorities for imports of different categories of goods are decided by the government. The Central Bank is entrusted with the task of allocating foreign exchange to import licences. To give effect to these decisions, and under current arrangements exchange control procedures are devised by the Central Bank to ensure not only that the goods so authorized for importation come into the country, but also that the price paid for them is in accordance with market prices for such goods in international markets.

In order to ensure that contractual requirements in price, quantity and quality are met, the Central Bank, in consultation with the government, has made arrangements with the General Superintendence Company (S.G.S.) to check and make comparisons. S.G.S. is charged with the responsibility of conducting price comparisons as well as quality and quantity inspection before certain range of goods are shipped to Kenya. When these requirements are met, a "Clean Report of Findings" is issued which enables local banks in Kenya to effect payment to the suppliers abroad. When a "Non-Negotiable Report of Findings" (N.N.R.F.) is issued, commercial banks cannot effect payment as the report is not negotiable.

A resident wishing to engage the services of a non-resident individual or institution must get prior approval of the exchange control before entering into an agreement to pay for the services. Such services include management, consultancy, and technical services. Dividends due to non-resident investors are freely remitted

to them provided they arise out of foreign investment which came in by an approved manner and accrue from trading profits. Applications for foreign exchange for all other purposes are examined by the Central Bank to establish the purpose and the amounts involved and decisions are taken in the light of the prescribed criteria.

In 1965 the Exchange Control Investigations Branch was established for the purpose of enforcing the Exchange Control Act (Cap. 113 Laws of Kenya). Since then the branch has established offices in Mombasa,

expanded considerably and it has now Maundi and Kisumu. The investigations branch ensures that funds due from abroad are properly received without delay and also enforces restrictions imposed by the Act in relation to gold, foreign currency, imports and exports procedures. Officers attached to the branch monitor activities along the borders with a view to gathering intelligence information relating to smuggling of foreign currency and local currency. Also, the officers inspect all tourist hotels and lodges and check on their mode of accepting and disposing foreign currency.

CHAPTER 4—SUPERVISORY FUNCTION OF THE CENTRAL BANK OF KENYA

The supervisory powers conferred on the Central Bank of Kenya are contained in the Banking Act which came into effect on 3rd June, 1969 replacing the Banking Act of 1956. As indicated in Chapter 5 the Banking Act has been amended several times in order to meet the needs of monetary authorities in the conduct of monetary policy and to give the Central Bank legal powers in performance of its various functions. The Banking Act is, however, mainly designed to help safeguard customers' deposits in commercial banks and other financial institutions for a number of inter-related reasons.

First, many people who carry out financial transactions through a bank maintain a deposit account which means that they assume the role of bank creditors and become linked with the fortunes of their bank. This contrasts with most other retail business, where customers simply pay for goods or services and never become creditors of the firms. Secondly, deposit safety is related to such factors as the capital in a bank and the condition and market value of its assets, including loans and securities. Investigation of these factors is too complex and costly for individual depositors. Moreover, even if it was possible to establish that a bank's assets relative to its liabilities were adequate, the condition could change quickly because many bank assets and liabilities are highly liquid. Since banks continually add new creditors, the relative amount of capital and other factors protecting depositors do fluctuate. A third reason for depositor protection is that much of the information needed to evaluate the condition

of a bank is confidential and unavailable to the public.

Bank depositors thus have greater difficulty in protecting their interests than creditors of other types of businesses. While depositors could conceivably combine their efforts in evaluating banks and other financial institutions, the task would still be difficult and costly.

The difficulty faced by the ordinary depositor in establishing whether his money is safe or not is one reason why banks and other financial institutions are particularly vulnerable to crises of confidence. These crises have occurred in a number of countries, and have shown that, once depositors lose confidence in the safety of their deposits because of facts, rumours, or any other reason, a "run" on the institution concerned can develop very quickly.

The difficulties involved in bank crisis management have led most countries to look for preventive measures which attempt to ensure that "run" on banks do not arise. In Kenya, preventive measures have two dimensions: first, the Central Bank supervises banks and other institutions, in order to identify problems of management or financial condition so that they can be remedied before they reach the point of crisis. Secondly, a deposit protection scheme has been introduced, so that individual depositors do not have to fear for the ultimate safety of their deposits, even if a crisis of some sort does emerge. There are also procedures for orderly management of bank failures. These

measures should be understood as intended to prevent systemic failure of the whole financial system (which would have serious consequences for the operation of the economy) and to protect individual depositors. They should not be understood as guaranteeing against the failure of individual banks or other institutions. Neither are they intended to protect the management, shareholders or creditors (other than depositors) of those institutions. The fact that the Central Bank does supervise an institution does not limit in any way the duties of shareholders, directors and managers to ensure that prudent procedures and appropriate management practices are followed. Scrutiny by the Central Bank is a complement to these, not a substitute for them. And, as international experience has shown, it cannot be assumed that Central Bank supervision will always identify potential failures before they occur, particularly when fraud is involved.

The Central Bank discharges its supervisory responsibilities for depositor protection through a programme of on-site inspections, and by periodic monitoring of the capital, profit and loss, as well as the liquidity, of commercial banks and other financial institutions. Annual audit reports on licensed banks and financial institutions are also submitted to the Central Bank for review.

Bank Inspections

The power of the Central Bank to conduct on-site inspections of licensed banks and financial institutions is spelt out in section 19 of the Banking Act. The purpose of these inspections is to ascertain that operations are safe and sound with due regard to the interests

of depositors, and to determine conformity with the relevant laws, rules and regulations governing these operations. A comprehensive written report is prepared by the Central Bank during each inspection for submission to the directors of the institutions under inspection. A close follow-up is conducted to ensure that any needed corrections identified during an inspection are initiated as deemed necessary by the Central Bank.

The inspections carried out by the Central Bank are based on actual on-site visits to the banking premises of the respective institutions as stipulated in the Act. During an on-site visit, Central Bank inspectors review and comment on the organizational set-up of each institution visited, the delegation of functions, the roles of policy and operating staff and management controls. The inspection exercise focuses on the board of directors, its composition and functions, the frequency of board meetings, the nature of business discussed and the records kept. Inspectors look for possible conflict between the board and the day-to-day management, how authority is exercised at the board level, and for lower management, and whether the activities are co-ordinated. The general qualification of the board members and their knowledge of the institution's financial matters are noted. Areas of weakness are pointed out.

Committees of the institution and their activities are looked into to determine their usefulness and performance in the various functions for which they are responsible. The chief executive officer's experience in banking is examined, along with his incumbency, terms of appointment, discretionary powers and how effectively they are discharged. His capability to co-ordinate the various activities is

appraised. Other executives' relationship with the chief executive is examined by interviewing them. Other areas examined are the assignments and functions of executive staff, and their capabilities and experience. Manpower development, recruitment, training and development of staff in relation to their experience and qualifications are examined in detail. Efforts on Kenyanization, etc. are areas that are looked into and, where shortcomings exist, these are pointed out to the management.

Financial Condition of the Licensed Banks and Financial Institutions

During an inspection tour, Central Bank inspectors ascertain the consolidated condition of the institution, in terms of assets and liabilities, as compared with the last inspection carried out. The growth of items such as capital and reserves, deposits, advances and profits is examined over a period of say three years to indicate whether there has been improvement or decline. Important operational ratios are examined, including the percentage of capital reserves to deposits; percentage of investments in government obligations to deposits and also to total investments; the advances/deposit ratio; and provisions for bad and doubtful debts to capital and reserves.

The ratios are assessed with a view to determining in which direction a bank or a financial institution is going. The ratios assist the inspectors to make a proper assessment of the financial health of the institution concerned.

Capital Structure

Capital adequacy is important to the

banking industry and, in this connection, the Central Bank inspectors appraise the paid-up capital or assigned capital in relation to total deposit liabilities. This examination serves several purposes. In the first instance, the law requires maintenance of capital at a minimum of 7.5 per cent of deposits. Secondly, the law stipulates that loans to one person or institution should not exceed 100 per cent of capital or 5 per cent of deposit liabilities. This limitation is based on the principle that it is prudent to diversify lending risks. Capital structure is therefore examined to determine compliance with the law. A listing of ownership is also examined and details as to how the capital is employed in the business.

Deposit Liabilities

Deposits of the institution are examined by Central Bank inspectors to determine the sources, and the increases or decreases over a period of say five years. Developments in terms of customer service improvements, new branches, interest rates paid and other terms are studied. A breakdown of deposits and their maturities is examined since deposits are indicators of the institution's growth orientation and it is necessary to determine whether an institution is relying on narrow sources for deposits. Since the spread of deposits across maturities determines the stability of the deposits, it is an area that inspectors also look at closely.

Borrowings, Profit and Loss

Borrowing from the Central Bank, local and external banks, financial institutions and the money market is examined in terms of frequency, authority for such borrowings' records,

and/or the purposes for these borrowings. The profit and loss accounts are also examined in order to identify profits and losses since the last inspection and to work out the profit to capital ratio. Details of returns and expenditure performances are examined to detect any deviation from the laid down procedures. The budgeting procedures, controls and variations are appraised and comments made as to dividend payments. The trend of the income/expenditure account is examined in detail in order to establish the trends, identify factors that are responsible for the behaviour of profits and bring out any weaknesses such as loose controls on expenditure, heavy loads of debts, indulgence in uneconomic practices, losses suffered on account of frauds, theft or malpractices by dubious book-keeping methods. Examination is also carried out on profits arising out of the sale or revaluation of assets.

Cash and Bank Balances

An inspection is carried out to establish the adequacy of cash, the adequacy of security arrangements, cash limits, insurance of cash in vaults and cash in transit and reconciliation of cash accounts. Other related examinations deal with the cash ratio and inter-bank lending.

Investments and Advances

Inspectors devote close attention to the investment portfolio of a bank or a financial institution. Section 10 of the Banking Act places some limits on investments, and conformity with the law is checked. The yield of the investment portfolio is examined and ratios worked out. A complete breakdown analysis is done as to the interest rate, cost, book value, market value,

appreciation/depreciation in value and maturity distribution of the various investments.

Various categories of advances are examined. These include bills purchased and discounted by amounts and maturities. Direct advances are examined in terms of appraisal of loan applications, sanctioning procedures for new loans and renewals, discretionary powers, borrowings by foreign controlled companies, etc. Loans examination is done so that prescribed limits as stipulated in the Act are adhered to.

The distribution pattern is also examined in terms of credit extended to the priority sectors of the economy—namely agriculture, exports, tourism, etc. Concentration of lending to a few borrowers is viewed as a dangerous practice and the examiners are required to look at this aspect very closely. Loans to directors and their related interests are listed and examined to see that they are all secured. Other areas examined in advances are disbursement supervision, periodic reviews and credit reports, security offered, security documentation, and insurance cover on securities.

Bad and Doubtful Debts

Any loans that are considered as bad or doubtful get special attention during inspections. Comments on the adverse features of these loans are made and appropriate provisions recommended. Classification is done, and a special mention of them is made in the reports.

Foreign Exchange Business and Exchange Control

Inspectors examine the institution's

awareness of its role as an authorized dealer in foreign exchange. Correspondent bank accounts are examined and remittances checked against exchange control approvals in order to detect any remittances made without exchange control authority. Savings remittances by non-residents are examined to check whether they conform to the regulations. External accounts authorities are checked and any irregular remittances and doubtful dealings are sighted and reported as necessary. Foreign exchange business involving bills, drafts, import payments, purchases and sales of foreign currency and export receipts are examined as necessary to establish conformity with the rules and regulations.

Banking Operations

Areas of operations that are examined include accounting systems and controls, book-keeping, general ledgers and subsidiary balancing and reconciliation of all records, and updating. Opening and closing of accounts, dormant accounts, staff accounts, cash controls, cash limits, rules of access to restricted areas and adherence to them, customer services, space, cleanliness and other physical conveniences are all looked at, and commented on, as appropriate.

Reports and Returns

Licensed banks and financial institutions are required to submit to the Central Bank liquidity returns as at the 10th, 20th and the last day of each month. Other returns required by the Central Bank include those relating to capital, profit and loss, and the level of lending to the agricultural sector. Additionally, commercial banks and financial institutions are required to

submit a monthly statement of assets and liabilities to the Central Bank.

With recent computerization in the Central Bank, it has become possible to speed up the tabulation and integration of the various returns so that irregular patterns are quickly detected and immediate attention paid to them. This off-site review supplements the detailed work of field inspectors which is normally done on a staggered basis, often once a year or every other year. During such extended periods between inspections, many things could happen, often without detection by or notice to the Central Bank. With off-site reviews based upon more frequent reports and returns, the Central Bank is able to maintain a current profile on the various institutions.

Other Supervisory Tools

In extreme cases, the Minister may revoke a licence if the licensee ceases to carry on business in Kenya or goes into liquidation or is wound up or otherwise dissolved: or if it fails to comply with the Banking Act, the Central Bank of Kenya Act or the Exchange Control Act, or any rules, regulations, orders or directions issued under any of those Acts. Besides possible revocation of a licence by the Minister for Finance, the Banking Act also gives the Central Bank authority to commission external audit firms which meet certain standards to carry out an audit and upon completion of their audit to certify as to the institution's compliance with laws, rules and regulations.

CHAPTER 5—DEVELOPMENTS IN BANKING LEGISLATION

The financial sector in Kenya is guided by five principal Acts of Parliament: the Companies Act, the Hire Purchase Act, the Building Societies Act, the Banking Act and the Central Bank of Kenya Act. The Companies Act is relevant in so far as businesses need to register their names with the Registrar of Companies before they start to operate. After registration each business enterprise is required to apply for a licence as specified in the Act controlling or regulating the type of financial business intended to be operated. In recent years, the distinction between the types of business performed by various financial institutions has tended to disappear, particularly the activities of building societies, the non-bank financial institutions and banks. Banks have expanded their services while other financial institutions have made inroads into activities that were primarily being performed by banks. Despite this development, the Central Bank of Kenya Act and the Banking Act remain the legal basis of the financial sector.

The banking business differs from other business activities in that its prosperity depends on public confidence. Whereas, a failure of ordinary business can be filled by another businessman, the failure of a bank has far more reaching consequences. It does not only cause problems for the failed bank and its depositors, but can also cause problems for other banks. Monetary authorities have therefore found it necessary to amend banking legislation in order to regulate the activities of banks and maintain the delicate public trust in the financial system.

The Banking Ordinance, 1910

The Banking Ordinance of 1910 was the first legislation enacted in Kenya to regulate activities of banks which existed at that time. Although the ordinance was not very elaborate when compared to the present legislation, it contained the basic provisions which form the basis of current banking law such as licensing of banks, inspection and disclosure of certain information to the public. In particular, banks were required to deposit with the Governor of the Protectorate Settlement deeds, memorandum and articles of association before they could commence business. The Governor was also given legal powers to order an inspection of a bank if asked by a shareholder with more than 25 per cent of shares or a depositor holding more than 50 per cent of deposits, and to approve external auditors appointed by the banks. Banks were required to publish their half-yearly statement of assets and liabilities at close of business on 30th June, and 31st December, each year. In addition they were required within 30 days (60 days for banks with head office outside the Protectorate) after 31st December, each year, to file in the Office of Registrar of Companies a list of shareholders, their chairmen and directors. This information was accessible to the public by paying a small fee.

The Banking Ordinance, 1956

After 1910, the banking industry expanded slowly, but steadily. By 1958 there were 9 banks and 3 non-bank financial institutions. In 1916 the National Bank of South Africa, started operations. It amalgamated with two other banks in 1926 to form the Bar-

clays Bank (D.C.O.). Other banks that followed were Nederlandsche Handel-Maatschappij (now A.B.N.) in 1951; Bank of India and Bank of Baroda in 1953; Habib Bank (Overseas) Ltd. in 1956; and the Ottoman Bank and the Commercial Bank of Africa in 1958. The earliest non-bank financial institutions to be established were Diamond Trust Company in 1946, Credit Finance Corporation in 1955 and National Industrial Credit in 1959. Savings and Loans (Kenya) was established in 1949 to do the business of mortgage lending. It was followed in the same business by East African Building Society in 1959.

The non-bank financial institutions operated generally under the Money Lenders Ordinance of 1933. In order to cope with the increased number of banks and the emerging non-bank financial institutions, Banking Ordinance, 1910 was repealed and the Banking Ordinance, 1956 enacted. Opportunity was also taken to enact the Building Societies Act, 1956.

Among the main provisions of the revised legislation was first, the creation of an office of the Registrar of Banks. The Registrar of Banks was given powers to license a bank or to revoke its licence if in his opinion, the conduct of the bank was not in public interest. Those banks that were in operation before the commencement of the Banking Ordinance, 1956 were automatically granted licences. Broadly, the registrar assumed the functions that previously were performed by the Governor of the Protectorate such as licensing and ordering of regular inspection of banks.

Other provisions that represented major departures from the previous

legislation were: first, introduction under section 4 of the minimum capital required to open a bank. The registrar was allowed to grant banking licences only to companies that had paid-up capital of more than shs 2 million; the second provision was creation of a reserve fund. Banks incorporated in the colony and outside the colony (unless in the opinion of the Registrar the aggregate of reserves of such a bank were adequate) were required to maintain a reserve fund and transfer to the fund, every year, not less than 25 per cent of their net profits until the amount of the reserve fund was equal to the paid up capital.

In order to protect the integrity of a bank's management, the new law prohibited appointment as a director or involvement in the management of a bank any person who became bankrupt, or was involved as a director or in the management of a bank that had failed. Persons who had been convicted to a term of imprisonment for an offence related to moral turpitude were also prohibited from holding office in a bank. Contravention of that provision was an offence punishable by imprisonment for a term not exceeding three years or a fine not exceeding shs 10,000 or both such fine and imprisonment.

The Central Bank of Kenya Act, 1966

After independence in the early 1960s each East African country desired accelerated development for its people. This also meant a need to have a responsive and active monetary policy to supplement other economic policies. The East African Currency Board, which to a lesser extent had performed the role of monetary authority, suffered serious deficiencies

that made its operations incompatible with needs of the newly independent nations. In particular, the Currency Board was passive to external shocks, and lacked discretionary powers to influence or regulate the activities of commercial banks and non-bank financial institutions such as expansion of credit.

As the weaknesses of the Currency Board became increasingly apparent, a debate was taking place as to whether a common central bank was the suitable replacement for the Currency Board or whether each of the three East African countries should establish its own central bank. In the end, the desire to have independent monetary and financial policies favoured establishment of separate central banks in Kenya, Uganda and Tanzania. The Act of Parliament establishing the Central Bank of Kenya obtained Presidential assent on 24th March, 1966, but it was not until 14th September, 1966 that Central Bank formally opened for business.

The Banking Act, 1968

Following the establishment of the Central Bank of Kenya, with powers to regulate the lending activities of banks and financial institutions it became necessary to revise the provisions of the Banking Act in order to harmonize it with the Central Bank of Kenya Act, and to lay down a foundation for future expansion of the banking industry. This was achieved through enactment of the Banking Act, 1968 which came into force on 3rd June, 1969.

First, the Banking Act abolished the office of the Registrar of Banks and transferred the functions previously

performed by the registrar to the Minister for Finance and the Central Bank. The responsibility to license banks and financial institutions including the revocation of such licences was according to sections 4, 5 and 6 vested on the Minister. Under sections 19 and 20 the Central Bank was allocated the responsibility of inspecting banks and financial institutions including issuing of directions to a bank or a financial institution whose affairs were found during an inspection to be detrimental to the interests of depositors or the institution. Another function that was transferred to the Central Bank was approval of auditors appointed by the banks and financial institutions.

The Banking Act, 1968, introduced some new provisions not covered by the previous legislation. A distinction was made in section 2 between a bank and a financial institution for the first time. In addition, the minimum capital requirements to open a financial institution were made more liberal than for banks. Whereas the minimum capital to start a locally incorporated bank was maintained at shs 2 million, the requirement for a financial institution was specified at shs 500,000.

Another new provision which represented a major development in banking legislation under sections 10, 11 and 12 was prohibition of banks and financial institutions from lending to any single person or institution more than 5 per cent of its deposit liabilities or 100 per cent of the sum of its paid-up capital and unimpaired reserves. Both banks and financial institutions were barred from lending against security of its shares and to allow any credit to be outstanding in respect of their employees without adequate security. Under sections 11

and 12 banks were further restricted in their trading activities and lending against immovable property. In particular banks were not permitted to engage in their account in wholesale or retail trade including import and export trade. These restrictions did not apply to financial institutions.

Finally the Banking Act, 1968 required both banks and financial institutions to maintain a minimum holding of liquid assets to be determined by the Central Bank from time to time. At that time liquid assets were defined as (i) Kenyan notes and coin, (ii) balances held at Central Bank, (iii) net balances with banks in Kenya, (iv) net balances with banks abroad, (v) Kenya Treasury bills, or (vi) such other assets as the Minister may determine. This requirement provided the Central Bank with additional instrument of monetary control.

Amendments to the Banking Legislation 1972-1984

In the period 1972 to 1984, the Banking Legislation was revised a number of times. The most important changes made included the amendment of section 48 of the Central Bank of Kenya Act in 1972 which enabled the Central Bank lending to the government to be flexibly determined. The previous fixed limit of shs 240 million proved inadequate to finance an expanding government budget. The amendment raised the limit of government borrowing from the Central Bank to 25 per cent of its gross recurrent revenue.

The next major amendment to the banking legislation was in 1980 via the Finance Act and Miscellaneous Amendment Act No. 10. The amend-

ment to the Banking Act raised the minimum capital required to open a locally incorporated bank from shs 2 million to shs 5 million and a financial institution from shs 0.5 million to shs 1.0 million. In case of a bank and a financial institution incorporated outside Kenya the minimum capital requirements were respectively raised from shs 10 million to shs 50 million and from shs 1.5 million to shs 5.0 million. The Central Bank of Kenya Act was also amended on several parts including addition to the power of the President to vary or suspend the par value of the shilling.

In 1982, the Banking Act was amended by raising the minimum capital required to open a bank or financial institution. For a locally incorporated bank and financial institution, the minimum paid-up by capital were raised to shs 10 million and shs 5 million respectively. Those incorporated outside Kenya had their minimum capital raised to shs 100 million for a bank and shs 50 million in case of a financial institution. This revision in capital requirements was necessitated by increase in number of banks and financial institutions which had began to emerge.

The other two major amendments to banking legislation occurred in 1984. Previously, building societies were exempted from the provisions of the Banking Act. Over time, however, their business operations had extended to activities traditionally performed by banks. The Central Bank Act was therefore amended in section 39A to empower the Central Bank to determine interest rates charged by the building societies and to inspect them. In December, 1984, Presidential assent was given to amendment of the

Banking Act to enable the Central Bank to remove and appoint managers of a bank or financial institution whose affairs were not being conducted in the interest of depositors or the institution.

The 1985 Amendments to the Banking Act

The 1985 amendments to the Banking Act were the most comprehensive since the Banking Act came into force in 1969. Those amendments were designed to remove weaknesses in the previous legislation, and to give more legal powers to the monetary authorities and to broaden the responsibilities and the coverage of institutions under the revised legislation. The main areas covered in the amendments of 1985 are discussed below.

Licensing of Banks and Financial Institutions

Before the amendments, persons wanting to start a bank or a non-bank financial institution or to open a branch, applied for a licence directly to the Minister for Finance. This procedure was found unsatisfactory. The new amendment requires an application to open a branch or to start a new institution to be channelled to the Minister through the Central Bank. The introduction of this amendment became necessary because the Central Bank is well-equipped to advise the Minister regarding the requirements listed in section 5 of the Banking Act. In particular, the Central Bank has access to the inspection reports, liquidity and other returns, and due to its daily contact with the financial system, it is in a better position to gauge the convenience and needs of the public to be served. The change was also necessary in order to institutionalize application procedures and to make it

possible to call for uniform information in all cases. The new procedure of applying through the Central Bank would among other things expedite the consultation process specified in section 24 of the Banking Act.

Capital Requirements

Two considerations influenced the decision to raise capital requirements in 1985. First, capital levels in Kenya were low when compared to other countries. Second, the low level of capital required to open a bank or non-bank financial institution was considered to be partly responsible for the rapid increase in the number of financial institutions. Monetary authorities felt that more adequate capital was necessary in any growing business and particularly so in banking business. Adequate capitalization was also regarded useful as a safeguard against mismanagement of an institution.

In order to make the directors and shareholders of banks and non-bank financial institutions carry risk proportionate to that borne by depositors and creditors, section 7 of the Banking Act was amended in 1985 to incorporate three main provisions. One of the main changes was the raising of minimum capital required to start a bank or a non-bank financial institution. For a locally incorporated bank the minimum capital was raised to shs 15 million and shs 150 million in case of a bank incorporated outside Kenya. Similarly, the paid-up capital required to start a non-bank financial institution was raised to shs 7.5 million for local institutions and shs 75 million for those incorporated outside Kenya. This amendment ensures that those wishing to do banking business have adequate capital of their own. Both banks and financial institutions were given up to

16th May, 1987 to increase their paid-up or assigned capital.

In order to ensure that adequate capitalization was maintained at all times, and also adjusted automatically proportionate to the increase in deposits, gearing ratio was raised from 5 to 7.5 per cent. Institutions were given up to 16th May, 1988 to build-up their capital and reserves. After that date it will be an offence for a bank or financial institution to operate with a lower gearing ratio. In addition to this provision the Central Bank, in consultation with the Minister, was empowered to prescribe minimum ratios that banks and financial institutions should maintain between paid-up capital and unimpaired reserves on one hand and their assets on the other.

The other important provision to strengthen the capital base of banks and financial institutions was re-introduction of a statutory reserve fund. The reserve fund was to be built-up from net profits. As long as the reserve fund was less than paid-up capital, institutions were required to transfer 12.5 per cent of their net profits each year to the reserve fund. After the level of the statutory reserves was equal to the paid-up capital, institutions were required to transfer each year not less than 10 per cent of their net profit to the reserve fund. This requirement was necessitated by the fact that a number of institutions were declaring dividends or issuing bonus shares even where real profits had not been made. Furthermore a number of institutions were also declaring dividends without making adequate provisions for bad and doubtful debts. This situation was dangerous because without adequate provisions for bad debts, one large or a few loan defaults could precipitate a

financial crisis for the involved institutions.

In order to minimize the possibility of capital erosion through improper declaration of profits, and inadequate provision for bad and doubtful debts, the amendments to the Banking Act specifically provided for investment of all moneys belonging to the statutory reserves fund into government securities or other securities authorized by the Central Bank not later than six months after the end of the financial year. Profits or losses will not be declared before adequate provision for bad and doubtful debts was made. Finally, auditors appointed by banks and financial institutions were required to ascertain compliance with the provisions of the Banking Act and the Central Bank of Kenya Act.

Prohibited Business

Section 10 of the Banking Act prohibits banks and non-bank financial institutions from granting unsecured advances and credit facilities to its employees or their relatives more than shs 10,000. Previously, this restriction was not sufficiently explicit about the status of the directors of the institutions and their related interests. In order to protect the interest of depositors and creditors, the law was amended to explicitly prohibit directors of banks and non-bank financial institutions from granting themselves, their relatives and their associated businesses unsecured advances and credit facilities. In addition subsection 10 (4) was added to make all directors of such institutions to be liable jointly and severally to indemnify the bank or financial institution against any loss arising from granting advances, loans or credit facilities which are unsecured or not fully secured. Furthermore it is

now a criminal offence for an institution to contravene these requirements. This provision was important to guard against abuses by directors, who failed to honour their obligations, particularly in cases where they ceased to be directors making it necessary for banks and financial institutions to make huge provisions for bad and doubtful debts.

Before the 1985 amendment to the Banking Act, section 11 of the Banking Act, on the prohibition of investment in immovable property or lending against security of immovable property, could only be applied to banks. The purpose of prohibiting banks from undertaking certain businesses was to ensure safety of customers' deposits against speculative investments. Since there was little restriction on trading activities of non-bank financial institutions, they used the opportunity to engage in speculative investments—thereby putting at risk the customers' deposits entrusted with them. The 1985 amendments to the Banking Act therefore closed this loophole by restricting the trading activities of non-bank financial institutions as well.

Specifically, the non-bank financial institutions were barred from acquiring, or holding any part of share capital or have direct interest in a financial, commercial, industrial or other undertakings where the value of the financial institutions' interest would exceed 25 per cent of the sum of its paid-up capital and unimpaired reserves, except shareholding in a corporation established for the purpose of promoting development and approved by the Minister and also in the case where the financial institutions took interest in satisfaction of a debt due to it. In such a situation, the financial

institution will be expected to dispose of the interest within a period determined by the Central Bank. Financial institutions were also barred from acquiring immovable property such as land, except for the purpose of development of their own premises or staff houses. This restriction was necessary to prevent customers' deposits being tied in non-liquid investments.

Another development which necessitated the 1985 amendments to the Banking Act was vertical ownership in financial enterprises, i.e. an institution owned another financial institutions or had controlling interest, and in nearly all cases, had the same directors. In those financial enterprises which initially started as non-banks, they began to set-up their own banks. Partly, this development was to enable them access to the interest free current account deposits as non-banks are not permitted to operate chequing accounts. Whereas there is nothing sinister about this situation, inspection reports revealed that parent companies had a tendency of incurring large unsecured overdrafts with their subsidiary banks. In addition, these activities also complicated management of monetary policy. The law was therefore amended by introducing section 11B which prohibit a licensed financial institution in Kenya from owning directly or indirectly equity shares in a bank. Financial institutions which were in this situation before the amendment were given up to 16th May, 1988 to liquidate their holdings in banks or to reverse these arrangements in order to comply with the amendments in law.

Deposit Protection Fund

The most fundamental change in

banking environment brought about by the 1985 amendments was the provision for establishment of a Deposit Protection Fund to strengthen the banking industry. The rapid increase in the number of institutions in the industry brought with it increased risks of failure, and therefore potential loss to depositors. The fund aims at protecting the interest of depositors, particularly small depositors who may be unable to evaluate the financial condition of an institution. The other objectives of the fund are: (i) to promote public confidence in the banking system by limiting runs on banks, and; (ii) to set a mechanism for liquidating the assets and paying off the liabilities of failed banks and financial institutions.

All deposit taking banks and financial institutions licensed to carry on banking in Kenya are required to contribute to the fund, by paying an appropriate amount annually which is deemed to be adequate for the successful operations of the fund. Building societies which accept deposits are also to be contributors to the fund. The rate of contributions to the fund is not expected to exceed 0.4 per cent of the average of the bank's or financial institution's total deposit liabilities. The revised Banking Act provides that the assessment rate may be increased for any bank or financial institution whose affairs are conducted in a manner detrimental to its own interests or those of its depositors. The maximum deposits to be covered by the fund will be shs100,000 and will consist of the aggregate credit balance of any accounts maintained by a customer at a bank or financial institution, less any liability of the customer to the bank or financial institution. The fund is to be run by a board responsible for for-

mulation of policy and for management and control of the fund. The board consists of the Governor of the Central Bank as chairman, and the Permanent Secretary to the Treasury as one of the members.

Other Amendments

Two other amendments were made in 1985: first to deal with maintenance of necessary information and records; and secondly to streamline the operations of representative offices of foreign banks and financial institutions. In the past, the Central Bank had faced problems in trying to investigate the activities of some banks and financial institutions because information was not readily available or records were not maintained. This situation undermined the effectiveness of the Central Bank in its inspections and supervisory function. The 1985 amendments therefore empowered the Central Bank to order a bank or financial institution to maintain books, records or information as may be considered necessary, in addition to those currently being maintained.

Previously, the representative offices of foreign banks and financial institutions operated without any control. After the 1985 amendments, these representative offices will now be required to be licensed by the Minister for Finance. In addition, the Minister may require these offices to furnish him with such information as he may direct. Further, the Minister may order a representative office closed if in his opinion the representative office has engaged in banking or financial business contrary to the terms of its licence.

CHAPTER 6—ROLE OF THE CENTRAL BANK IN THE MANAGEMENT OF THE ECONOMY

The Central Bank of Kenya participates actively in general economic management of the country. However, its role is more specific in the determination and management of monetary policy. Monetary policy in Kenya covers all actions by the Central Bank and the government which influence the quantity, cost, and availability of money and credit in the economy. The aims of the Central Bank in conducting monetary policy are compatible with those of the government. Both the Central Bank and the government seek to promote economic well-being of the country by striving to achieve high economic growth and employment, relative stability in the domestic price level, and a viable balance of payments position. In an overall sense, the Central Bank's conduct of monetary policy endeavours to ensure that the money supply is adequate to support growth of productive activities while, at the same time, administering the supply of money in a way that minimizes inflationary pressures and balance of payments difficulties.

The powers conferred on the Central Bank to discharge monetary policy and the manner in which it operates in supplying the ultimate means of payments to the economy have been described in Chapter 2 of this book. This chapter is devoted to a discussion of the manner in which the Central Bank carries out its responsibility of promoting the achievement of credit and exchange conditions conducive to the rapid but non-inflationary growth of the Kenyan economy.

Article 4 of the Central Bank of Kenya Act which enjoins the Central

Bank to endeavour to maintain "a sound monetary credit and banking system conducive to the orderly and balanced economic development of the country"—and to ensure "external stability of the currency" provides the basis for monetary policy. Thus, in formulating and pursuing monetary policy, the Central Bank ensures that the level of credit obtaining in the economy does not impose excessive strains on available resources. At the same time, the Central Bank ensures that monetary policy provides general environment in which savings can be accumulated to the maximum extent possible and utilized to support productive investment. The Bank also seeks to promote an environment that makes foreign investment in Kenya attractive.

In order to fulfil the requirement of maintaining a sound monetary and credit system, the Central Bank must devise practical criteria by which it can readily establish whether monetary stability is being reasonably maintained or not, so that remedial action can be taken whenever necessary. The practice adopted by the Central Bank is to set targets for the increase in domestic credit of the banking system and to contain growth in the money supply to a level consistent with the attainment of credit targets. While the maintenance of a sound monetary and credit system is directly related to the attainment of external stability of the currency, there are certain independent considerations that make the latter a fundamental requirement for orderly economic development.

The most important element of the Central Bank's role in maintaining

external stability of the currency is to formulate and maintain an appropriate exchange rate for the Kenya shilling. Unless foreigners have confidence in the domestic value of the shilling, they cannot be expected to save large amounts and hold their savings in the form of financial assets in Kenya. Local business also need assurance that the external value of the shilling is realistic, and will be kept reasonably stable, so that they can make their long-term production and investment decisions in confidence. The maintenance, both of an appropriate level of the exchange rate and external stability of the currency value, have therefore been among the Central Bank's objectives in the field of domestic monetary policy since its inception.

A supplementary measure applied by the Central Bank to help maintain external stability of the currency is to manage the country's external receipts—such as loans, grants, and export receipts—and payments made for exchange of goods and services with the rest of the world, and ensure that these are broadly in balance. In this regard, the Central Bank takes action to ensure, in particular, that there is no excessive downward pressure on the country's foreign reserves.

Targets of Monetary Policy

In the implementation of monetary policy the Central Bank makes extensive use of quantitative monetary targets as objectives of policy. There are advantages in using this approach. One of them is that the targets give the public a clear idea of what to expect. Secondly, the best way of giving a clear indication of thrust of monetary policy is to state quantitative aims for the rate of expansion of one or more of

the monetary aggregates. The growth of monetary aggregates, properly related to the circumstances of the time, is perhaps the best indication of monetary conditions, and targets set in terms of monetary aggregates are useful in providing checkpoints against which current developments can be compared and monitored.

Several factors affect desirable monetary targets. Some of these concern the pace of inflation and the state of the balance of payments, and how these might influence the rate of monetary expansion. One purpose of announcing monetary targets is to serve notice that excessive increases in domestic costs are bound to come up against resistance. If people believe that the money supply is going to be expanded to accommodate any rise in costs and prices, however fast, inflationary fears are likely to be increased. If, on the other hand, people are convinced that the rate of growth of the money supply will be held within well-defined limits, this helps to reduce inflationary expectations.

In the process of implementing monetary policy, the Central Bank usually states monetary aims for the period immediately ahead, normally a year, in the form of targets for the domestic component of credit expansion. There are two good reasons for choosing a domestic credit expansion target rather than a money supply one in the Kenyan context. First, an excessive growth of domestic credit is usually associated with a worsening balance of payments, both directly, if liquidity leaks abroad, and indirectly, if the excessive growth undermines external confidence. The second consideration is that it is the domestic element of credit expansion that is most directly

under the control of the Central Bank. To focus attention on domestic credit expansion as a control variable is the best means of ensuring that the domestic financial situation is kept under the proper degree of restraint, especially when the balance of payments is in serious deficit.

Instruments of Monetary Control

The Central Bank has a number of instruments of monetary control which it has employed on various occasions, as conditions have indicated, since its establishment in 1966. The most important of these instruments is the minimum liquid assets ratio which is stipulated in section 18 of the Banking Act. It was first imposed on commercial banks at 12½ per cent in December, 1969, and extended to other financial institutions in June, 1974. (Liquid assets are defined as cash in the tills of banks, balances of banks with the Central Bank, Treasury bills and net inter-bank balances in Kenya and abroad). The minimum liquidity ratio has been altered several times since 1972, mainly to influence lending behaviour, and has been 20 per cent since January, 1983.

The Central Bank may also require commercial banks to maintain minimum cash balances with it against their total deposit liabilities though the maximum prescribed balances may not exceed 20 per cent of total deposit liabilities. This stipulation is contained in section 38 of the Central Bank of Kenya Act. The first use of this instrument by the Central Bank was made in late 1971 when commercial banks were required to deposit at the Central Bank 5 per cent of their net deposit liabilities. The primary objective was to reduce the banks' free cash base and hence curb their capacity to give loans

and advances. This measure was rescinded in early February, 1972 after demonstrating its powerful impact. The instrument was used again by the Bank from 1978 to April, 1981 (the ratio was 4 per cent until July, 1978, when it was reduced to 3 per cent).

Another instrument is that of selective credit control. Since its establishment, the Central Bank has devoted much effort towards qualitative credit control in order to encourage those areas of economic activity considered essential or of high priority (especially agriculture), and to discourage those which are of lower priority. The Central Bank has effected this policy by issuing special directives in respect of loans, advances or investments made by commercial banks. The Central Bank is authorized under its statute to impose limits on any category of loans, advances or investments made by commercial banks.

Interest rates can be used in various ways, e.g. raising deposit rates to encourage savers to place their savings with banks and other institutions, raising interest rates on bank loans to discourage their use for purposes which have a low return or are contrary to national economic policy as well as controlling the growth of the money supply, and reducing rates to encourage the use of bank loans for purposes of a high priority.

It had been official policy in Kenya since independence to follow a "low interest rate policy" in order to encourage investment, and to protect the small borrower. In addition, the Central Bank held the view that stability in interest rates was an important factor in promoting development. It was felt that frequent changes in interest rates

would lead to uncertainty in repayments, which could discourage new investment and add to confusion in the credit market. The Central Bank maintained that interest rates were not to be given too much emphasis in the demand management of the economy. In the Kenyan context, allocation schemes seemed to work much better and faster in supplementing instruments of monetary control such as liquidity and cash ratios. Certain rigidities seemed to exist within the Kenyan banking system which tended to hinder the smooth operation of the interest rate mechanism.

The above considerations do not imply that interest rates were not used at all as a monetary policy tool in Kenya. Changes in interest rates were made at appropriate times not only for purposes of monetary control but also to protect savers and borrowers alike. From the inception of the Central Bank, interest rates were not altered until mid-1974 when the minimum rate on time and savings deposits was raised from 3 to 5 per cent and the lending rate raised from 7 to 8 per cent.

Since 1983, the role assigned to interest rates within the monetary policy framework has been significantly modified. Interest rates are now considered to be one of the main instruments of controlling monetary conditions in the country, and greater interest rate flexibility can help to achieve monetary control and an appropriate allocation of financial resources in a way which is considerably more efficient and equitable than could be achieved using the complex set of regulations which have been in force in the past. As a result, there has

been a general increase in interest rates since 1983 and most interest rates are now positive in real terms, i.e. they exceed the rate of inflation. The Central Bank has initiated this upward movement in interest rates in order to contain inflationary pressures, to promote savings, rationalize use of credit and indirectly assist in management of balance of payments. The Bank expects to continue to maintain positive real interest rates as well as using interest rate policy more actively to promote monetary stability and economic growth.

Exchange Rate Policy

The use of the exchange rate as an instrument of monetary policy has been controversial since the inception of the Central Bank. While the issues involved in the debate have at times not been clearly spelt out, it should suffice to note that exchange rate policy seeks to ensure balance of payments equilibrium in the sense that the demand for imports is met through exports and the inflow of foreign capital. Whenever there are persistent differences between foreign receipts and payments over a long period, it is obvious that the exchange rate and domestic policies are not compatible with developments in the external sector. The situation then calls for changes in either or both types of policies. The exact details of the corrective actions required differ from case to case depending upon the causes of such a disequilibrium. The discussion below gives examples of various situations which called for changes in the exchange rate.

In November, 1967, the pound sterling to which the shilling had always been pegged in the past was devalued

by 14 per cent against the US dollar. The monetary authorities in Kenya decided not to follow the pound sterling. There are also two important points to be made about this policy action. The first is that it was taken in conjunction with the monetary authorities of Tanzania and Uganda. A uniform exchange rate policy was in practice considered to be an important feature of the East African Community, since exchange rates within the region could thereby be kept stable, and trade conducted in confidence. Indeed, as the years passed the exchange rate came to be the only common element of policy in the community and hence a matter of increasing symbolic importance. Second, it was felt that devaluation would lead to an undesirable increase in domestic prices at a time when the healthy balance of payments situation in Kenya, in 1966 and the early part of 1967, did not provide positive arguments in favour of a devaluation. But it was also recognized that an appreciation of the shilling would have harmful effects upon the earnings of the agricultural sector and perhaps also upon the level of economic activity.

After November, 1967, the effective exchange rate of the Kenyan shilling remained almost exactly constant until the middle of 1971. This interlude of calm was to be brought to an end, once again, by events outside Kenya's borders. In August, 1971, the tension between the relative values of the world's major trading currencies which had been increasingly apparent since 1967 came to a head. Concerned about a persistent loss of gold reserves, the United States suspended the convertibility of its dollar into gold, imposed a 10 per cent surcharge upon imports,

and demanded a realignment of the exchange rates of the major trading currencies. For a time, these currencies, including the sterling, were allowed to "float" against the dollar and inevitably most of them floated upwards.

The Central Bank, at first, maintained the parity of the shilling with sterling which contributed to an appreciation of the shilling's effective exchange rate by about 1 per cent in the third quarter of 1971. The Tanzanian authorities decided in August, 1971 to maintain the value of their currency in terms of the dollar rather than sterling. The East African shillings were therefore no longer at par, and an important symbol of unity between the three countries of East Africa was in danger of disappearing. There followed urgent consultations between the authorities of the three countries, as a result of which the Kenya and Uganda shillings were also pegged to the US dollar rather than sterling.

In October, 1975, the exchange rate of the shilling was again changed, and the arrangement for fixing it was again modified. The peg was switched from the US dollar to the S.D.R. at the rate of shs 9.66 per 1 S.D.R. from the existing rate of shs 8.61675 per 1 S.D.R. The S.D.R. was considered to be a more stable alignment than any single currency unit. The exchange rate of the shilling was further changed in 1981 when it was devalued twice, by 5 per cent in February, 1981 and 15 per cent in September, 1981 when it was fixed at shs 11.95 per 1 S.D.R.

In December, 1982, it was decided to adopt a flexible exchange rate policy aimed at maintaining a competitive value of the shilling, by pegging the

shilling to a standard basket of currencies which are important in Kenya's external trade. These currencies included the US dollar, pound sterling, deutschemark, Japanese yen, and the French franc. This decision was based on the fact that in the current regime of floating exchange rates, the value of other currencies in terms of the shilling fluctuates on a daily basis due to changes in trends in economic activity in both Kenya and its trading partners, as well as to sizeable changes in the value of major foreign currencies. The adoption of the basket was designed to reduce the undesirable appreciations or depreciations of the shilling exchange rate in terms of specified currencies.

In adopting an appropriate basket of currencies, it was decided to use trade weights which reflected the bulk of Kenya's trade mix. Traded goods and tourist receipts were added together to obtain the trade share of the currencies which were included in the basket. A basket representing a complete country trade mix would in some ways have been preferred, but the advantages would have been relatively modest and did not appear to outweigh the administrative disadvantages. Accordingly, a short list of countries that capture the bulk of the volume of Kenya's trade was adopted for use. The trade weights are adjusted on a regular basis as need arises.

External Assets Policy

The Central Bank is required by section 26 of the Central Bank of Kenya Act to do its best to maintain a reserve of external assets, of an aggregate amount not less than the value of four months' imports, as recorded and averaged for the last three preceding years.

The maintenance of adequate international reserves by the Central Bank is considered as an essential part of monetary policy because reserves provide the means to ensure continued and uninterrupted flow of development inputs such as imported raw materials, spare parts, and capital equipment. If international reserves fall below a certain level, the Central Bank usually adopts policies of restraint to ensure a return to a target level. If, on the other hand, they rise above a certain level, it is usually recognized that they represent investment in foreign financial assets that are likely to be less productive than some domestic investments.

Examples of external assets policy actions since the inception of the Central Bank have been as follows: the first period was immediately following the devaluation of the pound sterling in November, 1967; the second period comprised most of 1971 and 1972; the third period commenced from the quadrupling of oil prices in December, 1973 and ran to the middle of 1975, while the fourth phase comprised 1978 through 1980. In all these phases excessive credit creation caused heavy outflows of foreign exchange largely through imports.

To stem the foreign exchange drain in the first period, commercial banks were directed in November, 1967 to borrow from their head offices before they resorted to the Central Bank. Inter-bank lending was prohibited, and facilities for forward cover for foreign exchange were introduced for the first time in the country's history.

During the second phase covering 1971 and 1972, selective credit controls were imposed in July, 1971 upon bank

lending which were aimed particularly at lending for hire purchase. By the middle of November, 1971, it became clear that this measure was having little impact upon the gathering foreign exchange crisis. The Central Bank then directed commercial banks to place 5 per cent of the value of their deposit liabilities on special deposit, in effect, raising the statutory minimum liquidity ratio from 12½ per cent as imposed towards the end of 1969 to 17½ per cent. This measure placed a binding constraint on lending by the majority of commercial banks and brought the expansion of credit to the private sector to an abrupt end. But it became apparent at once that the new credit restrictions were falling most severely upon small borrowers, and those whose security was less well established.

Furthermore, it was clear by the end of 1971 that restriction of bank credit to the private sector would not be sufficient by itself to prevent foreign reserves falling to the minimum target level, because the large credit expansion to the public sector which had been set in motion by the expansionary budgets of 1970/71 was still gaining momentum. Therefore aggregate monetary restriction was replaced, in January, 1972, by direct restriction of imports; foreign exchange purchases for transactions on current account were made subject to license, and quota limitations were imposed upon a wide variety of imports.

In the third phase covering the period December, 1973 to the middle of 1975, i.e. the oil crisis period, the following measures were instituted. First, expansion of credit to the private sector, which in the fiscal year ended June, 1974 had been allowed to reach

50 per cent of total domestic credit, was restricted to no more than 12 per cent for the period June, 1974 to June, 1975. It was, however, stipulated that the credit needs of the agricultural sector, small African enterprises, and finance for industrial raw materials, were to be met in full. Secondly, the 15 per cent liquidity ratio which had previously applied only to commercial banks was extended to non-bank financial institutions. Thirdly, the interest rate structure was adjusted with the minimum rate on time and savings deposits being raised from 3 to 5 per cent, and the maximum lending rate from 7 to 8 per cent.

Fourthly, import procedures were tightened, and steps were taken to encourage foreign controlled companies to turn more to overseas markets for their financial needs. The maximum rate of interest imposed earlier on foreign loans was lifted to enable companies to raise overseas finance at rates appropriate in foreign markets. The effective ceiling on interest rates for import credit acceptable to exchange control was increased from 9 to 11 per cent. Local borrowing by companies with over 15 per cent non-resident participation was further restricted except for those in priority sectors such as agriculture, manufacturing, exports and tourism. It was further considered appropriate to permit remittance of dividends against audited accounts only; the remittance of interim dividends overseas was discontinued.

In the fourth phase which covered the period 1978 to 1980, an advance import scheme was instituted. The import deposit scheme required a six-month, non-interest bearing refundable deposit equivalent to either 25 or

100 per cent of the cost and freight value depending upon the category of imports. Certain items were exempted from these requirements including raw materials, machinery, and government imports. Originally the scheme covered about half of Kenya's imports, but the coverage was later reduced to about a quarter of imports. Restrictions were also imposed on dividend remittances: companies with equity held by non-residents were not allowed to remit dividend of more than 10 per cent of equity capital and/or reserves.

Sales of tickets to Kenya residents for non-government travel abroad were made subject to prior approval of the Central Bank. Originally ticket applications had to be accompanied by a cheque of shs 2,000 in the case of air travel and shs 1,000 in case of travel by sea. Later, these fees, which were to be returned if the applications were not approved, were changed to 10 and 5 per cent of the values of the tickets respectively. The fee required did not apply to students and residents travelling for medical reasons.

The import deposit scheme was an emergency measure aimed at discouraging luxury imports and reducing stocks in the economy. The scheme was liberalized substantially in November, 1979 when the import deposit requirement of 100 per cent was reduced to 50 per cent, and that of 25 per cent to 10 per cent, except for imports of passenger motor-cars and textiles. The scheme was abolished in January, 1983.

Retrospect and Prospect

It will be clear from the description of past events that, even in the short

span of 20 years, there has been a good deal of change and development in the approach to monetary policy, even though the basic objectives have not changed. These developments have been caused by a number of factors—notably the growing size, penetration, sophistication and diversity of the domestic financial system, and the great changes which have occurred in the field of international trade and finance. The pace of change and development is unlikely to slacken in the foreseeable future, and the challenge now is built on past experience in a way which ensures that monetary policy continues to make the best possible contribution to economic growth and stability.

In this process, it will be important not to lose sight of some fundamental interrelationships and constraints, all of which can be illustrated from the Central Bank's first 20 years. First, monetary policy cannot be used to achieve a number of incompatible goals. In particular, it is necessary that target for the exchange rate, the level of interest rates, the balance of payments position, and the rate of domestic monetary expansion should be mutually consistent. If they are not, then it will only be possible to achieve one goal at the expense of another. For example, in periods where interest rates are fixed at too low a level, there will be a tendency for monetary and credit growth to be unduly rapid and for the balance of payments position to deteriorate, eventually forcing a review of the exchange rate.

Secondly, it is clear that the growing diversity and sophistication of the financial system will have a number of implications for the conduct of monetary policy. For example, there are

signs that direct controls such as ratio requirements, interest rate controls, exchange controls and lending guidelines are gradually becoming less effective as policy instruments. The greater complexity of the economy means that they are more easy to avoid or evade, and successive attempts to modify them to close loopholes generally have only limited success, and it also means that the controls quickly become difficult to understand. The judgements required by bureaucrats in administering controls fairly and in the national interest are becoming increasingly difficult, and it can be hard to change the policy stance quickly to meet changing circumstances. It seems inevitable that Kenya, like many other countries, will move towards placing less reliance on such instruments, moving instead towards more market based intervention to achieve policy goals. A number of moves along these lines were foreshadowed in Sessional Paper No. 1 of 1986, where they were integrated with similar policy proposals in other sectors. The Bank looks forward to playing an active part in implementing this framework within its own areas of responsibility.

Thirdly, it must be recognized that there is always likely to be a conflict between growth and stability objectives in the short-term. On a number of occasions in the past, stringent monetary policy actions have been

used to help restore a sustainable balance of payments position or to rein potentially explosive inflation. These actions have constrained domestic growth for a period, but it has to be understood that there can be no prospect of rapid economic growth in the long-term in an environment of galloping inflation and/or the chronic accumulation of external debt. Accordingly, such periods of restraint are sometimes essential in spite of their short-term costs. Such costs can best be kept to a minimum by ensuring that policy instrument settings do not get seriously out-of-line with the fundamental forces facing the economy, and by taking remedial action at the first sign of trouble rather than waiting until it is too late. Good analysis and research are vital in order to do this successfully, and the Central Bank is very conscious of its responsibilities in this respect.

Clearly, the Central Bank cannot be complacent about its conduct of monetary policy over the first 20 years. The international environment is a challenging one, and the domestic environment is also changing both rapidly and radically as the economy matures. Monetary policy will need to continually adapt as this process continues, but the fundamental objectives of maintaining a sound financial system and stability in the value of the currency will not alter.

CHAPTER 7—DEVELOPMENTS IN THE STRUCTURE AND CAPITAL OF THE CENTRAL BANK OF KENYA

The Central Bank of Kenya was legally established on 24th March, 1966 when the Central Bank of Kenya Act received Presidential assent. It was not, however, until 14th September, 1966 that the Central Bank was officially opened by the late President, Mzee Jomo Kenyatta and the first Kenya currency notes released for circulation to the public.

The Central Bank began its operations in a modest building, the former Army Records Office on Lt. Tumbo Avenue, now known as Herufi House. It took over the functions hitherto performed by the East African Currency Board, in addition to the new responsibilities specified in the Central Bank of Kenya Act. At that time, it had 60 staff members composed of 38 Kenyans and 22 expatriates. The first Governor, Dr. Leon Baranski, was seconded to the Central Bank by the International Monetary Fund. The appointments of Mr. D. N. Ndegwa, as Governor designate, and Mr. A. Abdallah, as Deputy Governor, were made in December, 1966, Mr. Abdallah took up his appointment in January, 1967, while Mr. Ndegwa became the first African Governor in May, 1967. By the end of the first year, staff had increased to 148, of whom 24 were expatriates.

The rapid expansion in the establishment reflected the inevitable growth of the Central Bank's functions and responsibilities. As early as November, 1966, the Central Bank took over the Bankers Clearing House and Kenya Government Accounts from the National and Grindlays Bank. In March, 1967, the Bank took over the management and control of

foreign exchange from the Treasury and sixteen months later, on 1st July, 1968, it took over responsibility for the issue and management of Kenya Government Treasury bills, the administration of government funded debt and the management of the sinking fund. Around the same period, an inspection office was set up to enable the Central Bank to exercise its powers of surveillance and supervision over the country's financial system, as provided under the Banking Act of 1968.

Organizational Structure of the Central Bank.

After a few years of operation, it became evident that Herufi House could not adequately cater for the needs of the Central Bank. Consequently, a plot was acquired for construction of bigger premises and moves initiated to plan a new headquarters building commensurate with the Central Bank's physical and functional expansion. Construction work on the new headquarters building commenced in August, 1970 and was completed in September, 1972. The building was officially opened by the late President, Mzee Jomo Kenyatta on 1st December, 1972. By that time the total staff had grown to 222 and the organizational structure that had evolved up to that time was composed of the following departments:

Office of the Governor.—Research Department, Foreign Department and Internal Audit.

Chief Banking Manager's Department.—Banking Office, Currency Office and National Debt Registry.

Exchange Control Departments.—Exchange Control Office and Banks Inspection Office.

Secretary's Department.—Accounts Office, Estates Office and Administration/Staff Training Office.

In September, 1973, the annual meetings of the I.M.F./I.B.R.D. and their affiliates were held in Nairobi, the first time for such meetings to be held in Africa. The Bank joined hands with other institutions of the government in organizing the meetings and ensuring that they were a success. On 12th December, of the same year, Kenya celebrated her Tenth Anniversary of Independence. To commemorate the historic event, the Bank issued a special coin of shs 5.

14th September, 1976 was the Central Bank's tenth anniversary. However, celebrations marking this important event were held during Jamhuri week in December, 1976 to coincide with the country's independence celebrations. The highlight of the celebration was a presentation by the Governor to the late President, Mzee Jomo Kenyatta, a silver die of Kenya notes representing all the four denominations.

As early as 1968, the Central Bank had purchased a plot on State House Crescent to construct flats for middle management staff. Construction of the flats began in January, 1975 and they were ready for occupation in July, 1976, in time for official opening as part of the Central Bank's tenth anniversary celebrations. Of the original 60 employees who joined the Bank at inception, 24 still remained in service: 20 men and 4 women. Special

certificates of services were issued to all of them as pioneers of central banking in Kenya. To mark the occasion, a special booklet entitled "The First Ten Years" was published for circulation to the public.

As the economy continued to grow at an impressive pace, it was considered necessary to establish a branch of the Central Bank outside Nairobi. Mombasa was selected as the most appropriate site, partly as the second largest urban centre, but mainly because of its importance as the country's gateway for the bulk of external trade. Construction of the branch building began in February, 1975 and was completed in March, 1977. By 30th June, 1977 the branch, with a complement of 120 staff members, had taken over the functions formerly entrusted to the Kenya Commercial Bank. Other matters handled by the branch included exchange control with supporting services from Accounts, Audit, Estates and Administration Sections. The broad supervision of the branch was entrusted to the chief banking manager with the branch manager in charge of the day-to-day operations. Mombasa branch building was officially opened by the late President, Mzee Jomo Kenyatta on 12th January, 1978.

By early 1978, the structure of the Bank was re-organized as follows:

Office of the Governor.—Research Department, Foreign Department and Inspection Office.

Chief Banking Manager's Department.—Banking Office, Currency Office, General Office and National Debt Registry.

Exchange Control Department.—Imports Office, Exports Office, Investments Office, General Office and Audit Office.

Secretary's Department.—Estate Office and Administration Office.

In response to a shortage of housing in Mombasa, the Central Bank acquired a plot in Mombasa for accommodation of middle management staff. Construction work at the Tudor Estate began in October, 1978 and was completed by September, 1979, when the high class flats were ready for occupation. The official opening of the flats was performed by the Governor in November, 1979.

On 12th October, 1979, the Central Bank was honoured by the visit of H.E. the President, Hon. Daniel T. arap Moi. During this occasion, H.E. the President was presented with special golden and silver coins issued by the Central Bank to commemorate the first anniversary of his installation as President and Commander-in-Chief of the Armed Forces of the Republic of Kenya. During the same month, the local banking community launched the Kenya Institute of Bankers. The Governor of the Central Bank was appointed patron of the institute while the Deputy Governor was elected its first Chairman.

In May, 1980, the Central Bank hosted the first teaching seminar mounted by the African Centre for Monetary Studies on "Foreign Exchange Management". The seminar was attended by senior staff drawn from 22 member central banks out of 31 members of the Association of African Central Banks.

On 1st April, 1981, the Bank took over the operation of the Kisumu Currency Centre which had hitherto been administered on an agency basis by the Kenya Commercial Bank. An initial complement of 38 staff was posted to the centre. The centre is housed in leased premises belonging to the Kenya Commercial Bank but by February, 1986, plans were at an advanced stage to open a branch in Kisumu to cater for the growing needs of central banking services in western Kenya.

On 24th July, 1981, the Governor, accompanied by the Deputy Governor and all board members, called on H.E. the President at State House, Nairobi to present the Nyayo bank-notes for shs 5, 10, and 20 before they were released for circulation to the public alongside the existing issues. The new notes bore the portrait of H.E. the President and were released for circulation on 30th July, 1981. The Nyayo coins had been released earlier.

By the time the Central Bank celebrated its 15th anniversary in September, 1981, the staff establishment was 1,286, with 1,083 staff at head office, 164 in Mombasa branch, and 39 at Kisumu Currency Centre. Of this number, 60 members of staff who had joined the Bank at inception still remained in service.

At the end of December, 1982, Mr. D. N. Ndegwa, who had been Governor of the Central Bank since May, 1967 retired after 16 years of service. Mr. Philip Ndegwa was appointed as the new Governor. Two years later, Mr. Ahmed Abdallah, who had served the Central Bank as Deputy Governor for 18 years retired to take up an

appointment as Alternate Executive Director of the International Monetary Fund. Mr. E. C. Kotut, formerly the Managing Director of the Kenya National Trading Corporation, was appointed Deputy Governor.

A major re-organization in the structure of the Central Bank took place in July, 1984, and resulted in the creation of a number of new departments and divisions. Following the 1986 amendments to the Banking Act, a Deposit Protection Division was created in the Banks Supervision Department to administer the newly-established Deposit Protection Fund. The Central Bank also decided to computerize its operations and a Computer Services Unit was set up to hasten the process. The library services of the Central Bank were brought under the umbrella of the Research Department.

The organizational structure of the Bank in July, 1986 was then as follows:

Office of the Governor.—Legal Division, Board Secretariat, Security Division, Internal Audit Division, Information Processing and Public Information.

Administration Department.—Personnel Management Division, Staff Training and Development Division, Estates Management Division and Purchasing and Supplies Division.

Banking Department.—National Debt Registry, Banking Division, Development Division.

Banks Supervision Department.—Deposit Protection Division, Inspection and Supervision Division.

Currency Department.—Currency Division, and Branch Administration Division.

Exchange Control Department.—Imports Division, Exports Division, Investments Division, General Division and Exchange Control Audit Division.

Finance and Planning Department.—Accounts Division, Salaries Division, Budget and Budgetary Control Division and Organization and Methods (O&M) Division.

Foreign Department.—Planning Division, Operations Division.

Research Department.—Domestic Economy Division, External Finance Division, Statistics Division and Library Services Section.

Another important development in the internal management of the Central Bank was the establishment in 1983 of a number of committees to run its affairs on a day-to-day basis. The committees, chaired by the Deputy Governor and advisory to the Governor, include the following: the Appointments, Promotion and Disciplinary Committee; Capital Projects Committee; Computer Steering Committee; Staff Housing Loans Committee; Investments of Foreign Currency Committee; Training Committee; and Tender Committee.

Staff Development and Training

During the early period of its operations, the Central Bank relied heavily on in-service training provided with the assistance of a training officer from the International Monetary Fund, while at the same time utilizing other

appropriate training opportunities both locally and overseas. Today, with a fully fledged Training Division, the Central Bank sponsors more than 150 members of staff for training annually to both local and overseas institutions. Since 1970, many senior officers have attended a variety of specialized courses offered by the I.M.F. Institute in Washington D.C., and commercial and central banking courses in India, Pakistan, Britain, Italy, Switzerland, the United States and other countries. In addition, the Central Bank is closely associated with other central banks and international (financial) institutions in Africa and elsewhere where staff members are sent for seminars and attachments in specialized areas. A number of staff have also been sponsored overseas for specialized postgraduate training in universities abroad so as to acquire the management techniques needed in a changing environment.

As far as local training is concerned, the Central Bank has continued to sponsor staff for supervisory, administrative and management courses organized by local institutions such as the Kenya Institute of Administration and the Kenya Institute of Management, as well as to other inter-regional training institutions, particularly the Eastern and Southern African Management Institute in Arusha, Tanzania. Lately, the Central Bank has started organizing in-house courses for supervisory and other cadres and refresher courses for secretarial staff. The Central Bank has also encouraged staff to improve themselves in every way they can by introducing an incentive scheme whereby staff members are refunded half the tuition fees incurred in pursuing recognized professional courses, in addition to awarding in-

cremental credits on completion of such courses.

More recently, the Central Bank has been engaged in an exercise designed towards promoting professionalism in providing its services to the public. The aim of training has thus been geared towards giving staff adequate motivation to acquire additional technical skills, professional qualifications and improve their proficiency in discharging their duties. In this connection, the Central Bank introduced a new promotion criteria in May, 1985 as part of its terms of service which specified the minimum requirements to be met before a member of staff could be promoted from one grade to another. The criteria specified the minimum age and period in the grade, the training courses which should be attended while in the grade, as well as the desirable working cross-experience needed while working within the relevant departments in the Central Bank. In addition, the Bank introduced in March, 1986, the publication—"Central Bank of Kenya—Staff Papers". The aims of the publication are to make available on *ad hoc* basis some of the work and thinking of the Bank staff on monetary and financial matters. The publication will also give staff opportunity to develop their literary qualities.

In order to inform staff of their rights and obligations as Central Bank employees, a booklet containing the staff rules and regulations was compiled and issued to all members of staff in May, 1981. In addition, the Pension Scheme of the Central Bank is fully operational with 13 pensioners and 9 dependent families enjoying benefits from the fund. The fund is administered by the Central Bank under the

general direction of the Board of Trustees. The Central Bank remains committed to providing medical facilities to its employees and their registered families and has one of the best Medical Benefit Scheme in the country. The Bank runs a fully-fledged medical clinic for welfare of its staff members.

Management of the Central Bank

Responsibility for determining the policy of the Central Bank is given by the Central Bank of Kenya Act to the Board of Directors. The Board consists of seven members—the Governor, who is also its Chairman, the Deputy Governor, who is deputy chairman, the Permanent Secretary to the Treasury, and four other directors. All members are appointed by the President to hold office for a term of four years and are eligible for reappointment. The present board members are the Governor, Mr. Philip Ndegwa, the Deputy Governor, Mr. Eric C. Kotut, the Chief Secretary and Head of the Civil Service, Mr. S. Nyachae, the Permanent Secretary to the Treasury, Mr. H. M. Mule, and Messrs. M. K. Cheserem, T. C. J. Ramtu and T. Kaloki. The board is required by law to meet not less than once in every two months.

According to section 13 of the Central Bank of Kenya Act the Governor shall be the chief executive officer of the Bank and, subject to the general policy decisions of the Board, shall be responsible for the management of the Bank, including the organization, appointment and dismissal of the staff in accordance with the general terms and conditions of service established by the Board. The Governor is also authorized to incur expenditure for the Bank within the administrative budget

approved by the Board. He is also the Bank's principal representative and spokesman.

Capital, Reserves and Accounts of the Central Bank

The authorized capital of the Central Bank is shs 26m fully subscribed and held entirely by the Permanent Secretary to the Treasury on behalf of the Kenya Government. The Central Bank is also required to establish and maintain a General Reserve Fund into which is paid, at the end of each financial year, one-fourth of annual profits of the Central Bank, as long as the fund is less than the authorized capital of the Central Bank. That requirement was fulfilled at the end of the 1970/71 financial year when the balance of the General Reserve Fund was shs 26m, the same as the authorized capital. The Act was amended in 1978 to allow for a variable proportion of the annual profits of the Central Bank to be transferred to the General Reserve Fund, the exact size being determined by the Board of Directors in consultation with the Minister for Finance.

There is also a special account called the Revaluation Account which holds profits or losses that arise from changes in the exchange rate between the Kenya shilling and other foreign currencies in which the Central Bank holds its foreign assets or liabilities and also changes in the shilling price of gold if gold is included in either of them. These changes can occur as a result either of Kenya altering the exchange rate for the shilling or other countries altering the rates for their currencies. The purpose of having a special account for holding the profits or losses due to these changes is to

isolate them from the Central Bank's general profits and their distribution. Since exchange rates can move either way, the balance in Revaluation Account fluctuates from time to time and is generally of a fairly small magnitude.

The financial year of the Bank is the same as the government's fiscal year. Within three months after the close of the financial year, i.e. at 30th September, the Bank is required to submit to the Minister for Finance a report on the Bank's operations throughout that year, together with the balance sheet and profit and loss accounts certified by auditors appointed by the Bank and approved by the Minister for Finance. The annual report contains a review of financial and economic situation in the country as well as policy changes and operations pursued during the year. After submission to the Minister, the report is thereafter published. In addition to the annual report and accounts, the Bank is also required to publish a statement of its assets and liabilities every month and a copy submitted to

the Minister for Finance.

Further References

1. The Central Bank of Kenya Act, 1966.
2. The Banking Act, 1968.
3. Annual Reports—Central Bank of Kenya.
4. Staff Papers—Central Bank of Kenya
5. Economic Surveys—Central Bureau of Statistics.
6. Statistical Abstracts—Central Bureau of Statistics.
7. Development Plans—Government Printer.
8. Sessional Paper No. 1 of 1986—Economic Management for Renewed Growth. Government Printer, July, 1986.

TABLE 1: MAJOR ECONOMIC INDICATORS 1967-1985

	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
Population (Millions)	10.1	10.5	10.9	11.5	11.9	12.4	12.9	13.4	13.9	14.4	14.9	15.5	16.1	16.7	17.3	18	18.8	19.5	20.2
Wage Employment ('000)	9,595	606.4	627.2	644.5	679.7	719.8	761.4	826.3	819.1	875.5	902.9	911.5	972.3	1,005.8	1,024.3	1,046	1,093.3	1,119.7	1,174.4
G.D.P. (shs m)—Current market prices	8,751	9,555	10,383	11,556	12,860	14,447	16,761	20,343	23,846	29,433	37,198	41,164	45,532	52,512	60,772	68,215	76,505	80,922	95,265
G.D.P. (shs m) (1982 Prices)—																			
Factor cost	26,850	28,934	30,878	32,956	35,022	37,266	39,838	40,640	41,132	43,632	47,460	50,624	52,556	54,302	57,529	58,892	60,700	61,268	63,796
Investment (shs m)	1,777	1,842	2,045	2,522	3,243	3,359	4,534	5,464	4,342	5,885	8,825	12,213	10,325	15,784	17,176	15,291	16,207	18,318	17,651
Domestic Savings (shs m)	NA	NA	NA	NA	NA	2,873	3,598	3,024	2,730	4,847	8,825	6,843	6,291	8,772	11,024	9,569	13,233	13,816	12,364
Money Supply (shs m)	2,047	2,301	2,748	3,505	3,770	4,295	5,356	5,819	6,814	8,455	12,413	14,118	16,396	16,208	18,364	21,324	22,365	25,242	26,929
B.O.P. Current A/c (shs m)	-414	-282	-48	-350	-796	-486	-934	-2,240	-1,698	-698	228	-5,106	-3,726	-6,574	-6,722	-5,212	-1,778	-2,932	-3,386
External Debt Service Payments (shs m)*	140	128	137	134	143	178	247	279	388	506	959	1,146	1,472	1,849	2,788	4,105	5,328	6,554	7,697
Exports of Goods and Services (shs m)	2,600	2,842	3,076	3,416	3,638	4,090	5,072	7,144	7,138	9,434	13,004	11,862	12,002	15,066	15,474	16,940	19,592	22,874	24,226
Financial Year	1966/67	1967/68	1968/69	1969/70	1970/71	1971/72	1972/73	1973/74	1974/75	1975/76	1976/77	1977/78	1978/79	1979/80	1980/81	1981/82	1982/83	1983/84	1984/85
G.D.P. F.Y. (shs m)	—	9,173	9,989	10,969.5	12,208	13,653.5	15,004	18,552	22,094.5	26,639.5	33,315.5	39,181	43,348	49,022	56,642	64,493.5	72,360	78,713.5	88,093.5
Budget Deficits (shs m)	301	294	374	434	632	733	1,026	721	1,367	1,924	1,574	2,182	2,713	2,094	5,366	4,289	2,243	3,450	4,458
	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
Annual Growth Rate in Population	3.8	4.0	3.8	5.5	3.5	4.2	4.0	3.9	3.7	3.6	3.5	4.0	3.9	3.7	3.6	4.0	4.4	3.7	3.6
Annual Growth in Wage Employment	2.1	1.5	3.4	2.8	5.5	5.9	5.8	8.5	-0.9	6.9	3.1	1.0	6.7	3.4	1.8	2.1	4.5	2.4	4.9
Annual Growth in G.D.P.	5.4	9.6	8.2	11.3	11.3	12.3	16.0	21.4	17.2	23.4	26.4	10.7	10.6	15.3	15.7	12.2	12.2	5.8	17.7
Annual Growth in G.D.P. (1982 Prices)	4.0	7.8	6.7	6.7	6.3	6.4	6.9	2.0	1.2	6.1	8.8	6.7	3.8	3.3	5.9	2.4	3.1	0.9	4.1
Annual change in C.P.I.	—	0.7	0.6	1.9	6.9	2.6	9.8	15.5	17.2	10.0	12.8	12.4	8.4	12.8	12.6	22.3	14.5	9.1	10.7
Ratio of Investment/G.D.P.	20.3	19.2	19.7	21.8	25.2	23.3	27.1	26.9	18.2	20.0	23.7	29.7	22.7	30.1	28.3	22.4	21.2	22.6	18.5
Ratio of Savings/G.D.P.	NA	NA	NA	NA	NA	19.9	21.5	14.9	11.4	16.5	23.7	16.6	13.8	16.7	18.1	14.0	17.3	17.1	13.0
Annual Growth in Money Supply	—	12.4	19.4	27.5	7.6	13.9	24.7	8.6	17.1	24.1	46.8	13.7	16.1	-1.1	13.3	16.1	4.9	12.9	6.7
Ratio of B.O.P. Current Account/G.D.P.	-4.7	-2.9	-0.5	-3.0	-6.2	-3.4	-5.6	-11.0	-7.1	-2.4	0.6	-12.4	-8.2	-12.5	-11.1	-7.6	-2.3	-3.6	-3.6
Ratio of External Debt Service Payments/Exports of Goods and Services	5.4	4.5	4.5	3.9	3.9	4.4	4.9	3.9	5.4	5.4	7.4	9.7	12.3	12.3	18.0	24.2	27.2	28.7	31.8
Budget Deficits/G.D.P. F.Y.	—	3.2	3.7	4.0	5.2	5.4	6.6	3.9	6.2	7.2	4.7	5.6	6.3	4.3	9.5	6.7	3.1	4.4	5.1

Source: Central Bureau of Statistics (Economic Surveys), Treasury and Central Bank Calculations, KEDRES, World Bank Debt Tables.

*Includes Government and Government Guaranteed Debts.

TABLE 2: BUDGET OUTTURN 1978/79—1984/85
(Shillings million)

	1978/79	1979/80	1980/81	1981/82	1982/83	1983/84	1984/85
Revenue	10,212	12,220	14,338	15,737	16,768	18,548	20,445
Grants	266	383	451	886	1,126	997	1,572
Revenue and Grants	10,478	12,603	14,789	16,623	17,894	19,545	22,017
Recurrent Expenditure	9,502	10,372	13,984	15,031	16,156	17,131	19,136
Development Expenditure	4,450	4,699	5,733	6,350	4,464	6,225	6,647
Total Expenditure	13,952	15,073	19,717	21,381	20,620	23,356	25,783
Adjustment*	+761	-376	-439	+469	+483	+361	-692
Overall Balance**	-2,713	-2,094	-5,366	-4,289	-2,243	-3,450	-4,458
Financing	2,713	2,094	5,366	4,289	2,243	3,450	4,458
External	865	1,091	2,764	1,108	1,236	715	939
Domestic	1,848	1,002	2,602	3,181	1,007	2,735	3,519
Banks	1,323	-116	1,574	1,694	-120	675	729
Non-banks	525	1,118	1,028	1,487	1,127	2,060	2,790
Memorandum Items							
Financing as per cent of the deficit							
External	32	52	52	26	55	21	21
Banks	49	-5	29	39	-5	20	16
Non-banks	19	53	19	35	50	59	63
Deficit as a per cent of G.D.P.	6.3	4.3	9.5	6.7	3.1	4.4	5.1

Source: Central Bureau of Statistics, Treasury and Central Bank calculations.

*A positive adjustment implies additional uncatagorized revenue. A negative adjustment implies additional uncatagorized expenditure.

**A negative balance indicates the deficit.

TABLE 3: BALANCE OF PAYMENTS, 1966-1985
(Shillings million)

	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
Imports (cif)	2,270	2,332	2,416	2,416	3,050	3,924	3,720	4,380	7,696	7,220	8,158	10,586	14,498	13,696	19,892	19,436	18,799	18,581	22,371	24,387
Exports (fob)	1,736	1,580	1,678	1,804	2,040	2,098	2,410	3,290	4,522	4,648	6,224	9,364	7,368	7,710	9,360	9,496	10,198	12,316	14,903	15,480
TRADE BALANCE:	-534	-752	-738	-612	-1,010	-1,826	-1,310	-1,090	-3,174	-2,572	-1,934	-1,226	-7,110	-5,988	-10,532	-9,940	-8,601	-6,265	-7,468	-8,907
Service Account Net of which: Government transfers	400	338	456	564	660	1,030	824	156	934	874	1,236	1,454	2,004	2,262	3,958	3,218	3,389	4,487	4,536	5,521
CURRENT ACCOUNT:	-134	-414	-282	-48	-350	-796	-486	-934	-2,240	-1,698	-698	-228	-5,106	-3,726	-6,574	-6,722	-5,212	-1,778	-2,932	-3,386
Capital Account:																				
Private long-term	20	80	180	260	326	340	306	628	832	294	462	960	1,176	1,550	1,108	1,426	1,290	1,239	1,540	1,597
Government corpora- tions	66	62	-8	18	96	58	4	22	166	242	100	-10	-108	-22	26	324	300	294	-25	-158
Government long-term	216	80	150	126	162	-74	302	330	436	612	710	728	2,292	2,262	2,926	2,128	1,142	1,147	1,430	184
Short-term	-256	102	-204	-456	-262	60	44	112	282	230	148	370	136	1,286	994	848	328	491	734	102
Capital Account (net)	46	324	118	-52	322	384	656	1,092	1,716	1,376	1,420	2,048	3,496	5,076	5,056	4,726	3,060	3,171	3,679	1,718
Basic balance	168	-192	40	356	234	-472	126	46	-806	-550	574	1,906	-1,746	64	-2,512	-2,844	-2,480	902	13	-1,770
Errors and omissions	84	-60	164	110	66	-75	10	76	82	-14	-15	-27	52	81	72	11	56	-35	34	-57
Overall balance	-4	-150	0	10	38	-488	180	234	-442	-334	707	2,249	-1,558	1,431	-1,446	-1,985	-2,096	1,358	781	-1,725
FINANCING:																				
Changes in official reserves	NA	-74	-491	-51	-351	330	-179	-190	259	-79	-873	-1,925	1,508	-2,073	1,005	1,209	-357	-2,535	-806	-532
Use of fund credit	NA	0	0	0	56	0	0	0	280	382	159	-361	44	541	425	622	2,246	1,264	-32	2,104
Changes in other liabilities	NA	224	491	41	257	-158	-1	-44	-97	-31	7	37	6	32	-53	1	129	100	59	153
Counterpart to S.D.R. allocations	NA	0	0	0	0	0	0	0	0	0	0	0	0	69	69	153	78	13	0	0
Reserves	+90	614	1,165	1,216	1,567	1,237	1,416	1,606	1,347	1,426	2,299	4,214	2,716	4,789	3,784	2,575	2,982	5,467	6,275	6,807
G.D.P. (Current prices)	NA	8,751	9,595	10,383	11,556	12,860	14,447	16,761	20,343	23,846	29,433	37,198	41,164	45,532	52,512	60,772	68,215	76,505	80,922	95,265
Current A/c as per cent of G.D.P.	NA	-4.73	-2.94	-0.46	-3.03	-6.19	-3.36	-5.57	-11.01	-7.12	-2.37	0.61	-12.40	-8.18	-12.52	-11.06	-7.64	-2.32	-3.62	-3.55

Source: Economic Surveys, and Central bank's Annual Reports.

TABLE 4: MONETARY SURVEY (shillings million)

	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
Foreign Assets:																			
Monetary Authority	614	762	1,216	1,567	1,237	1,416	1,606	1,347	1,426	2,299	4,224	2,716	4,762	3,744	2,508	2,899	5,467	6,275	6,589
Commercial Banks	174	159	157	180	157	117	222	304	372	407	334	373	516	555	706	627	609	632	640
Gross Foreign Assets	788	921	1,373	1,747	1,394	1,533	1,827	1,651	1,798	2,706	4,558	3,088	5,279	4,299	3,214	3,526	6,076	6,907	7,229
Foreign Liabilities:																			
Monetary Authority	4	4	8	8	7	14	5	271	656	844	520	571	1,158	1,514	2,474	4,985	5,678	5,691	7,779
Commercial Banks	229	96	117	140	178	181	273	400	480	413	413	388	533	520	440	561	626	813	814
Gross Foreign Liabilities	233	100	125	148	185	196	278	671	1,136	1,257	933	960	1,691	2,034	2,914	5,545	6,303	6,504	8,594
Net Foreign Assets	555	821	1,248	1,599	1,208	1,338	1,549	980	662	1,449	3,625	2,129	3,588	2,265	300	-2,019	-227	404	-1,364
Domestic Credit to:																			
Government	-69	-22	47	30	102	347	478	910	1,440	1,761	1,617	2,909	3,123	3,333	5,878	9,682	7,829	8,720	9,570
Private and Other Public	1,337	1,308	1,370	1,840	2,498	2,672	3,380	4,044	4,722	5,592	7,462	9,363	10,713	12,265	13,499	15,365	17,238	19,057	21,811
Total Domestic Credit	1,268	1,286	1,417	1,870	2,599	3,019	3,858	4,954	6,162	7,353	9,079	12,272	13,835	15,599	19,378	25,047	25,067	27,777	31,380
Other Items Net	-224	-194	-82	-36	-63	-62	-51	-115	-11	-348	-290	-283	-1,027	-1,655	-1,314	1,704	-2,475	-2,939	-3,087
Money and Quasi-Money																			
Currency outside banks	422	469	570	697	740	894	982	1,086	1,235	1,625	2,182	2,305	2,673	3,032	3,569	3,724	4,083	4,370	5,038
Demand Deposits	1,021	1,141	1,356	1,714	1,848	2,136	2,880	2,930	3,305	4,049	6,245	6,996	7,964	6,868	7,537	9,628	9,848	10,933	10,703
Quasi-Money	604	690	821	1,095	1,181	1,265	1,494	1,803	2,274	2,780	3,986	4,817	5,759	6,308	7,259	7,972	8,435	9,939	11,188
Total Money + Quasi-Money	2,047	2,301	2,748	3,505	3,770	4,295	5,356	5,819	6,814	8,455	12,413	14,118	16,396	16,208	18,364	21,324	22,365	25,242	26,929
Annual Change in Percent																			
Domestic Credit	1	10	32	39	16	28	28	28	24	19	23	35	13	13	24	29	0	11	13
Government (net)**	68	311	-35	236	241	38	90	58	22	-8	80	7	7	76	65	-19	11	10	10
Private and Other Public Sector	-2	5	34	36	7	26	20	17	18	33	25	14	14	10	14	12	11	14	14
Money and Quasi-Money	12	19	28	8	14	25	9	17	24	47	14	16	-1	13	16	5	13	7	7

Source: Central Bank of Kenya: Economic and Financial Reviews.

*Excludes Parastatals.