

THE INDEPENDENCE OF THE CENTRAL BANK OF KENYA:

A REVIEW OF THE LEGAL FRAMEWORK

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Declaration

This thesis is my original work and has not been presented for the award of a degree in this or any other university.

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This thesis has been submitted with my approval as the University Supervisor.

Njaramba Gichuki

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Date : _____

Dedication

This work is dedicated with love and affection to my husband Alois, my son Mosi and my daughter Sanaa who have supported me in my journey of education by allowing me to follow my academic dream.

Acknowledgement

I thank my husband for greatly supporting my desire to complete my studies and the encouragement he has given me in pursuing my studies.

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CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND

Central Bank Independence refers to the freedom of monetary policymakers from direct political or governmental influence in the conduct of policy¹. The principle of Central Bank Independence or autonomy concerns itself with direct control that a government has over the functions and decisions taken by a central bank. Central Bank Independence can either be absolute where a central bank enjoys complete freedom from government influence or control or may be none existent where the central bank is dependent on the government. Elgie R. states that the extent of autonomy of a central bank can be viewed as follows:-

“A completely independent central bank would be one which was free from government intervention across the whole set of political indicators ; it would have the full range of monetary policy instruments at its disposal ; and it would be able to use all of these instruments without any government restriction. By contrast a completely dependent central bank would be one which was subject to unbound government intervention across the set of political indicators ; and it would either have no monetary policy instruments at its disposal or it would be subject to absolute government restriction on all those that it was able to use.”²

In his analysis Elgie R. looks at two key dimensions of independence of a central bank, that is the institutional and functional independence of a central bank. These dimensions of autonomy relate to the control or power that the government has over the central bank through its involvement in decisions taken by the central bank as well as the use of the monetary policy instruments by the institution. The overall degree of autonomy will therefore depend on the extent of government intervention, number of monetary instruments at the bank’s disposal and the level of government

¹ http://people.ucsc.edu/~walshc/Mypapers/cbi_newpalgrave.pdf. Accessed on 7th September 2012,p.1. This is an article by Walsh, C. E. titled “Central Bank Independence” and prepared in December 2005 for the New Palgrave Dictionary, .

² Elgie, R. (1998) “Democratic Accountability and Central Bank Independence: Historical and Contemporary, National and European Perspectives”, *West European Politics*, Volume 21 (3), p. 56..

restrictions on the use of the instruments of monetary policy³. The level or degree of a central bank's autonomy can therefore be looked at in two extremes where on one hand the central bank is seen as an arm of government and is subject to control by the minister under whose docket the central bank falls under, that is a dependant central bank and on the other hand a central bank that is controlled by technocrats completely independent of government direction, that is an independent central bank⁴.

There are various factors that affect the degree of independence a central bank enjoys but in most instances the level or degree of independence is dependent on the institutional structure of the central bank. Whereas central banks conduct similar functions⁵ across various nations their levels of independence differ substantially⁶. The institutional structure may either be formal, that is as found in the enabling statute or may be informal such as the societal preferences of the institution⁷. To measure the extent of autonomy of central banks, scholars have looked at indicators of independence that can be found in the laws or documents creating the central bank (formal independence) or at other indicators that lie outside the law such third party preferences such as in the financial sector or international requirements (informal independence).

The principle of central bank independence has been at the centre of legal reform in many countries which seek to amend the laws on central banking to increase the degree or the level of autonomy of their respective central banks⁸. Central bank Independence gained momentum

³ Ibid.

⁴ www.bankofengland.co.uk/publications/Pages/speeches/2000/speech95.aspx. Accessed on 1st October 2012. This speech was delivered by the Rt Hon. Eddie George Governor of the Bank of England at the South East Asia, New Zealand, Australia (SEANZA) Governors' Symposium, Colombo on 26th August 2000, p. 403.

⁵ A central bank can be defined as a public institution that manages a country's currency, the supply of money and interest rates (A definition from Sullivan, A. and Sheffrin, S. M. (2003) *Economics : Principles in Action*, Pearson Prentice Hall, New Jersey, p. 254). From this definition it is clear that the main role played by a central bank is that of managing the monetary policy in an economy.

In an article titled "What are the functions of a Central Bank", Sinha, A sets out the functions of a central bank as banker to the government, banker to bank, clearing agent, and lender of last resort. (www.preservearticles.com, accessed on 16th October 2012).

⁶ William, B. (1998) "A Political Explanation of Variations in Central Bank Independence", *The American Political Science Review*, Volume 92, Issue 2, p. 1.

⁷ Debelle, G. (1996) "Central Bank Independence: A Free Lunch?" *International Monetary Fund Working Paper*, Number WP/96/1, p.17.

⁸ http://people.ucsc.edu/~walshc/Mypapers/cbi_newpalgrave.pdf. Accessed on 7th September 2012, p.5.

particularly because of the performance of the German economy as a consequence of the model adopted by the Bundesbank as well as the empirical evidence that showed that there was a direct link between increased central bank autonomy and reduced levels of inflation⁹. A high level of central bank independence is considered as one of the factors required by a country to achieve price stability or low inflation and governments are for this reason motivated to enhance the autonomy of their central bank. Available literature on central bank independence indicates that there is a relationship between the level or degree of independence a central bank enjoys and the economic performance of a country¹⁰. Kenya for instance has recently introduced amendments to the Central Bank of Kenya Act¹¹ through the Finance Act, Number 4 of 2012¹². These amendments have been motivated by a need to increase the independence of the Central Bank of Kenya. The amendments sought to increase the process of appointment of the top management by introducing mechanisms of transparency in the appointment process. In addition the Constitution of Kenya 2010 does recognize the principle of an autonomous Central Bank as it provides that the Central Bank of Kenya shall not be under the direction or control of any person in the exercise of its powers or in the performance of its functions¹³.

As mentioned here above the institutional design of a central bank determines the degree of independence of a central banks and one aspect of the institutional design of a central bank is the relationship the institution has with the government. A study of the historical foundations of early central banks shows that the early central banks were closely tied to their respective governments particularly as a source of financing to the government in times of financial distress¹⁴. Walsh C. E states that:-

⁹ Debelle, G. (1996) "Central Bank Independence: A Free Lunch?" *International Monetary Fund Working Paper*, Number WP/96/1, p.1.

¹⁰ Eijffinger, S.C. W. and De Hann, J. (1996) "The Political Economy of Central Bank Independence" *Special Papers in International Economics*, , Department of Economics, Princeton University, Princeton, New Jersey , Number 19, p. 1.

¹¹ Chapter 491, Laws of Kenya.

¹² Kenya Gazette Supplement No. 35 (Acts No.4) , 2nd May 2012.Number 4 of 2012

¹³ Article 231 (3).

¹⁴ Bordo, M.D. and Schwartz A.J. (2002) "Charles Goodhart's Contributions to the History of Monetary Institutions", *NBER Working Paper Series*, No. 8717, p.9 .

“The historical, legal and de facto relationship between a country’s government and its central bank is complex, involving many different aspects. These include but are not limited to, the role of government in appointing (and dismissing) members of the central bank governing board, the voting power (if any) of the government on the board, the degree to which the central bank is subject to budgetary control by the government, the extent to which the central bank must lend to the government and whether there are clearly defined policy goals established in the central bank’s charter”¹⁵.

It is these aspects of the relationship between a government and a central bank that are at the centre of determining the extent to which a central bank can be independent. Due to the subsisting relationship between government and its central bank there is a need to draw the rules of engagement that will yield the desired balance of power and control that the government wields over the central bank and affording the central bank an enabling environment in which it can execute its mandate as prescribed in its constituent instrument or charter. A concern has been raised as to the extent to which government can relinquish its control over monetary policy noting that government and the legislature are responsible for accounting to the electorate for the performance of monetary policy. While there is great justification for creating an independent central bank there still remains a challenge of how government can limit the powers of the central bank to avoid the country suffering from a rogue central bank. The answer to this concern can be found in allowing the government residual powers to act in exceptional cases. It is stated that even the most independent of central banks face some government control and the most dependant central banks enjoy some degree of freedom and therefore no central bank can be said to be absolutely independent¹⁶.

There are convincing arguments for an independent central bank some based on political justifications as well economic reasoning. Among the political justifications for an autonomous central bank is that central banking is a technical discipline¹⁷ that requires management by competent personnel who shall be held accountable for their decisions and by enhancing the

¹⁵ http://people.ucsc.edu/~walshc/Mypapers/cbi_newpalgrave.pdf. Accessed on 7th September 2012, p.3.,

¹⁶ Elgie, R. (1998) “Democratic Accountability and Central Bank Independence: Historical and Contemporary, National and European Perspectives”, *West European Politics*, Volume 21 (3), p. 57..

¹⁷ www.bankofengland.co.uk/publications/Pages/speeches/2000/speech95.aspx. Accessed on 1st October 2012. This speech was delivered by the Rt Hon. Eddie George Governor of the Bank of England at the South East Asia, New Zealand, Australia (SEANZA) Governors’ Symposium, Colombo on 26th August 2000, p. 403.

independence of the central bank the technocrats would be provided with the required resources to conduct their affairs with minimal interference from government or politicians who may be motivated by realizing short term gains dictated by the electoral cycles¹⁸. An economic justification would be that greater independence yield better monetary policy performance. It is on the basis of these benefits of an independent central bank that a number of countries moved to amend the law relating to their central banks. The legal instruments, as a tool of institutional design, providing for the independence of a central bank should therefore insulate the central bank from political pressure that may be exerted on the central bank or its officials.

In Kenya , the Central Bank of Kenya Act sets out the legal framework within which the Central Bank of Kenya operates and thereby determines the Bank's structures of legal independence and the extent of autonomy. The Central Bank of Kenya is mandated by the Central Bank of Kenya Act, Chapter 491, section 4(1) o secure the monetary policy¹⁹ of the state as well as act as the government's fiscal agent and thereby plays a pivotal role in the economy of the country and it is imperative that the operations of the central bank be governed by a robust legal framework to ensure that the economy of the country is administered pragmatically. To achieve the successful implementation of the Central Bank's mandate, the institution must be seen to exercise autonomy in the execution of its responsibilities. The autonomy of the Central Bank is premised on the degree to which the underlying legal framework supports such independence. This type of independence can also be referred to as formal independence as it is based on the law.

The Central Bank of Kenya Act has undergone a number of amendments since independence and Kenya like many countries has sought to increase the independence of its central bank through legal reforms to the bank's primary legislation²⁰.

In addition to the recent amendments effected to the Central Bank of Kenya Act by the Finance Act, Number 4 of 2012, the Central Bank (Amendment) Bill, 2012 seeks to introduce further

¹⁸ Kibmer, F., and Wagner, H. (1998) "Central Bank Independence and Macroeconomic Performance: A survey of the evidence", Lehrstuhl für Volkswirtschaftslehre, insb. Makroökonomik Fachbereich Wirtschaftswissenschaft, Fern Universität Hagen, p.3.

¹⁹ Monetary policy relates to the supply of money, which is controlled via factors such as interest rates and reserve requirements for banks. For example, to control high inflation, policy-makers (usually an independent central bank) can raise interest rates thereby reducing money supply. For instance monetary policy is formulated at the beginning of each year on the basis of known or estimated data about money supply, economic developments and financial flows including in particular the budgetary position, treasury funding and inward and outward flows on the current and capital accounts of the Central Bank.

²⁰ Elgie, R. (1998) "Democratic Accountability and Central Bank Independence: Historical and Contemporary, National and European Perspectives", *West European Politics*, Volume 21 (3), p. 53.

amendments to the Central Bank of Kenya Act. These amendments relate primarily to the governance structures of the Central Bank of Kenya and they seek to introduce mechanisms through which the top management of the bank can be appointed in a competitive and transparent manner. The amendments referred to here above demonstrate the country's efforts to reform the existing legal framework on central banking in Kenya however the existing legislation does not provide adequate measures and controls to safeguard the autonomy of the Central Bank of Kenya and this paper shall look at the Act with a view to identifying the available avenues of enhancing the legal independence of the Bank.

1.2 STATEMENT OF PROBLEM

The legal framework in Kenya on central banking does not guarantee the Central Bank of Kenya a desirable level of independence within which to execute its objectives. The Constitution of Kenya, 2010 provides for the independence of the Central Bank of Kenya by providing that the Bank shall not be under the direction or control of any person or authority in the exercise of its powers or in the performance of its functions²¹. The provisions of the Central Bank of Kenya Act, on the other hand, are in conflict with the provisions of the Constitution since the Act grants the Finance Minister power to direct and control the monetary institution in respect of formulating and implementing monetary policy.

The Central Bank of Kenya Act limits the independence of the Central Bank by granting the Finance Minister power to influence the execution of the Bank's mandate and in particular the principal object of formulating and implementing monetary policy with a view to maintaining price stability²². This influence is, for instance exercised through the Minister's ability to specify the price stability target of the government²³, the Minister's powers to specify at least in every period of twelve months the price stability target in consultation with the Bank²⁴, the requirement for regular consultations on monetary policy between the Minister and the Bank²⁵ and the

²¹ Article 231(3).

²² The Central Bank of Kenya Act, Chapter 491, Section 4 (1).

²³ Section 4 (4) (a).

²⁴ Section 4 (5).

²⁵ Section 4C (1).

Minister's powers to direct the Bank to adopt and implement monetary policy as the Minister may specify pursuant to Section 4C (2) of the Central Bank of Kenya Act.

A number of amendments have been made to the central banking law in Kenya to increase the independence of the Central Bank of Kenya for instance the latest amendment through the Finance Act, Number 4 of 2012 which introduced amendments that dealt primarily with the governance aspects of the institution. The amendments sought to make the process of appointment of the top management and of the Board of Directors of the Bank transparent and competitive as well as introducing the position of the Chairperson of the Board. There are further proposed amendments to the Central Bank of Kenya Act by way of the Central Bank (Amendment) Bill, 2012 (which is yet to be passed) that seeks to provide clarity on the appointment procedures introduced by the Finance Act, 2012.

While effort has been made in strengthening the independence of the Central Bank of Kenya, the amendments are not sufficient and the existing legal framework on central banking in Kenya is in need of review since the government has some control over the Bank which diminishes the independence of the Central Bank of Kenya and in turn the effectiveness of the institution especially in matters to do with monetary policy for which the Central Bank should be held accountable .

The Governor of the Central Bank of Kenya appeared before the Public Accounts Committee (PAC) in early 2012 to explain the depreciation of the Kenyan Shilling in 2011 when it traded at Kenya Shilling 107 to the United States dollar. The depreciation was blamed on a late intervention by the Central Bank of Kenya. In this instance the Governor was also accused of lowering the Central Bank lending rate and thereby enabling commercial banks to borrow heavily from the Central Bank for speculative purposes which were blamed for inflationary pressure on the economy as well as high interest rates²⁶. The value of the Kenyan currency and the level of inflation are the primary responsibility of the Central Bank by virtue of its mandate to formulate and implement monetary policy however in this particular instance it is not clear why the Bank or the Governor of the Central Bank of Kenya failed to take timely remedial action²⁷. The findings of

²⁶ Section 36 (4) of the Central Bank of Kenya Act provides that it is the mandate of the Bank to publish the lowest rate of interest it charges on loans to specified banks and that this rate shall be known as the Central Bank Rate.

²⁷ www.marsgroupkenya.org . Report of the Parliamentary Select Committee on the decline of the Kenya Shilling against foreign currency. Accessed on the 1st October 2012.

the Parliamentary Select Committee on the causes for the decline of the shilling included indecisiveness and inaction on the Central Bank of Kenya as well as failure of the Governor of the Central Bank of Kenya to act in good time²⁸. A recommendation of the Parliamentary Select Committee was that the Governor be investigated by a Tribunal to determine his competency to continue in office²⁹. While calls were made for the Governor to step down from office, there is need to interrogate the legal framework in which the Central Bank of Kenya and its officers are required to operate. Concern may be raised as to the suitability of the current Governor but key to the issues raised as a cause for the decline of the value of the shilling is the legal framework³⁰ within which the institution is required to execute its mandate as well as other political/economic factors outside the Act that may influence the work of the Central Bank of Kenya.

The existing legal framework on central banking in Kenya does not guarantee the Central Bank of Kenya a high degree of independence since the Central Bank Act grants the Finance Minister power to interfere with the formulation and execution of monetary policy as provided by both the Constitution and by the Central Bank of Kenya Act.

The independence of a central bank is determined by the circumstances prevailing within the jurisdiction under review and any proposed legal reform should be based on the needs and requirements of a particular country. The legal structure adopted in one country may not yield the desired level of independence in another as one size does not fit all and therefore legal reform must consider the political / economical factors that influence policy and legal reform. It is with this in mind that the legal framework in Kenya shall be reviewed with a view to proposing reform that will increase the independence of the Central Bank of Kenya in particular in the arena of monetary policy where the Act grants powers to the Finance Minister to direct the monetary policy to be pursued by the Bank.

1.3 RESEARCH OBJECTIVES

1.3.1 General Objective

²⁸ Ibid.pp.106-107.

²⁹ Ibid.p.110.

³⁰ Ibid.pp.111-112.

The objective of this research is to identify the factors that determine the formal independence of the Central Bank of Kenya in the execution of its role of formulating and implementing monetary policy.

1.3.2 Specific Objectives

- i. To review the provision of the Constitution of Kenya, 2010 and the Central Bank of Kenya Act, Chapter 491 to examine the legal framework which incorporates the Bank and the extent to which the Act provides for the different aspects of the autonomy of the Bank namely the institutional independence, the functional independence, the personal independence and the financial independence of the Bank;
- ii. To identify the factors that are required to increase the independence of the Central Bank of Kenya in light of the political, legal and economic environment of the Central Bank of Kenya.
- iii. To identify possible areas of legal reform that can be adopted to enhance the independence of the Central Bank of Kenya.

1.4 RESEARCH QUESTIONS

The research will seek to answer the following questions:-

- i. To what extent does the Central Bank of Kenya Act, Chapter 491 provide for the independence of the Central Bank of Kenya;
- ii. Are the amendments introduced by the Finance Act, Number 4 of 2012 to the Central Bank of Kenya Act, Chapter 491 as well as the proposed further amendments contained in the Central Bank (Amendment) Bill, 2012 sufficient to safeguard the independence of the Central Bank of Kenya?
- iii. What degree of independence is desirable for Kenya's Central Bank as an institution that contributes to a developing country's economy?

1.5 SIGNIFICANCE OF THE STUDY

The research will provide an understanding of the factors that influence the independence of the Central Bank of Kenya and determine the extent to which the Central Bank of Kenya Act provides or limits the independence of the bank specifically in the formulation and implementation of monetary policy.

The findings of the research will also inform legislators and other stakeholders on the aspects of the central banking law that require amendment so as to increase the autonomy of the Central Bank of Kenya. The findings of the research will inform decisions regarding formulating legislation and policies that would enhance the independence of the Central Bank of Kenya to a level that would positively influence economic performance of Kenya.

1.6 THE SCOPE OF THE STUDY

In reviewing the legal framework that determines the legal independence of the Central Bank of Kenya, the study will focus on the Constitution of Kenya, 2010 and the Central Bank of Kenya Act, Chapter 491 as the significant legislation impacting the operations of the Central Bank.

The scope of the research will be to review in particular the Central Bank of Kenya Act provisions on monetary policy formulation and implementation against the provisions of the Constitution on the degree of autonomy required by the bank to manage monetary policy in Kenya.

1.7 LIMITATIONS OF THE STUDY

Due to the sensitivity of the operations of the Central Bank of Kenya the research will be based on writings, research materials and findings by other researchers as the officers at the Central Bank of Kenya are not at liberty to provide information on the operations and decisions of the Bank.

1.8 LITERATURE REVIEW

Central banking is a technical discipline that requires the input of technical experts dedicated to monitoring the functions of the central bank on a daily basis. The complexity of central banking particularly as far as monetary policy is concerned is related to shocks from the economy, international influences, uneven and variable lag between implementing a monetary policy action and when the effects are felt as well as technological innovations in the financial industry³¹. It is this complexity of central banking that motivates politicians to delegate the role of formulating and implementing monetary policy to central bankers.

The delegation of monetary policy to the central bank however raises a question as to the extent or degree of such delegation since the government ultimately remains accountable to the public regarding the performance of monetary policy since the central banker is not appointed by the public³². The question therefore is how to structure the central bank institution to grant the institution a desirable degree of independence while at the same time granting powers to the government to intervene in cases requiring government action. Government intervention is necessary to the monetary policy role played by the central bank since government holds democratic responsibility over all the functions of a central bank and it is this democratic accountability that demands that the government retains some residual powers over monetary policy. The residual powers granted to government should have defined limits so as not to water down the independence of the central bank. This also means that the degree of independence of a central bank cannot be absolute³³.

To execute its mandate effectively a central bank requires a degree of independence from government since politicians suffers from an inflationary bias which leans on achieving short terms benefits of monetary policy while the central banker is focused on ensuring the long term benefits of monetary policy as well as safeguarding the public's welfare. Elgie R. states that:-

³¹ William, B. (1998) "A Political Explanation of Variations in Central Bank Independence", *The American Political Science Review*, Volume 92, Issue 2, p. 2.

³² Elgie, R. (1998) "Democratic Accountability and Central Bank Independence: Historical and Contemporary, National and European Perspectives", *West European Politics*, Volume 21 (3), pp. 53-54.

³³ *Ibid.* p.56.

“In order to eliminate the propensity towards short term electorally motivated business cycles governments have ceded monetary policy making powers to unelected central bankers.”³⁴

This justification for an independent central bank suggests that although democratic accountability for monetary policy lies with government, there is a case for the appointment of an independent central banker as a solution to the inflationary bias problem posed by the politician and thereby achieving monetary or price stability.

Literature on achieving monetary stability suggests that price stability can be achieved by increasing the independence of the central bank. Increasing the independence of the central bank is considered as an element of the institution’s design so as to achieve price stability³⁵. Such independence can be achieved by adopting either of the following strategies³⁶:-

a) Legislative strategy

Independence is achieved through law and the mandate of the central bank is clearly stipulated in the constituent document.

In this form of strategy the legislature is able to control the extent of independence of the central bank by amending the law on central banking by either increasing or decreasing the control that the government has over the central bank³⁷.

This essentially means that a central bank which in most cases is a creature of statute such as the Kenyan Central Bank cannot be absolutely independent since the legislature has the power to determine the extent of the independence of the Bank by using their legislative powers to either increase or decrease the independence of the Bank.

³⁴ Ibid. pp.54-55

³⁵ Persson, T. and Tabellini, G. (1993) “Designing Institutions for Monetary Stability” *Carnegie-Rochester Conference Series on Public Policy* Volume 39, p.54.

³⁶ Ibid.

³⁷ Eijffinger, S.C. W. and De Hann, J. (1996) “The Political Economy of Central Bank Independence” *Special Papers in International Economic* Number 19, May 1996, Department of Economics, Princeton University, Princeton, New Jersey, pp 10-11.

b) Contracting Strategy

Independence is achieved by structuring a contract between the government and the central bank where the government is the principal and the central bank is the agent. The objectives of the central banker are stipulated in the contract and penalties prescribed for failure to meet the objectives³⁸.

The government may for instance assign instrument independence to the central bank and the contract with the central bank stipulates the manner in which the independence delegated to the central bank can be used or alternatively the contract stipulates an inflation target to be met by the central bank and the manner in which this target shall be met left to the central banker³⁹.

The contracting strategy creates accountability on the part of the central banker as it prescribes a scorecard against which the central bank shall be evaluated. The public can therefore use the scorecard to measure the effectiveness of the central bank while at the same time removing the element of goal shifting by government which is done in most instances to meet the interests of the politicians.

The Reserve Bank of New Zealand has adopted a contracting strategy to managing its monetary policy by having the Governor of the Central Bank enter an agreement with the Finance Minister in which the two agree the policy targets the central bank shall pursue during the term of office of the Governor. This agreement forms a basis for the removal of the Governor should the Central Bank not achieve the terms of the contract⁴⁰.

c) Targeting Strategy

The government imposes explicit inflation targets and makes the central bank leadership explicitly accountable for its success in meeting the established targets⁴¹.

³⁸ Ibid, p.10.

³⁹ Ibid, p.11.

⁴⁰ Knight, R. L. "Central Bank Independence in New Zealand" in Downes,P. and Vaez- Zadeh,R. (eds.) (1991) *The Evolving Role of Central Banks* , International Monetary Fund (IMF), Washington p.143.

⁴¹ Eijffinger, S.C. W. and De Hann, J. (1996) "The Political Economy of Central Bank Independence" *Special Papers in International Economic* Number 19 , May 1996, Department of Economics, Princeton University, Princeton, New Jersey, p.11.

The Kenyan legislation for instance provides that the Finance Minister may specify the price stability target that the government wishes the Central Bank to achieve⁴² which means that goal independence rests with the government.

The strategy adopted by a country is dependent on the circumstances of that particular country since that will determine the success of the strategy adopted. In a country where for instance there is a high regard for the law, then the legislative strategy may be adopted since what is prescribed by the law and shall be implemented.

Legal reform has been adopted in Kenya as one avenue of enhancing central bank independence through various amendments to the Central Bank of Kenya Act however available literature has not addressed the degree to which the law grants independence to the Central Bank of Kenya in view of the ministerial powers granted by the Kenyan Act or whether the strategy adopted by Kenya of assigning only instrument independence to the Central Bank of Kenya is desirable in the execution of the Bank's mandate of maintaining price stability.

1.8.1 Justification for Central Bank Independence

i. Economic Performance

A key justification for enhancing central bank autonomy has been that a higher degree of central bank independence enables a country to manage inflation or price stability and therefore its economic performance. In the 1970s industrialized countries were faced with high inflation and one of the measures taken to manage the economic crisis was to increase the impact of monetary policy measures by enhancing the independence of their respective central bank⁴³. While there may be other causes of inflation within a country such as political instability, it is presumed that all other factors being held constant central bank independence can positively contribute to low inflation within an economy.

Research conducted on the relationship between central bank independence and inflation suggests that there is a relationship between the two. Otmar Issing states that:

⁴² Section 4 (4) (a), Central Bank of Kenya Act, Cap. 491.

⁴³ Vasile, D. and Tiberiu, S. (2012) "Central Bank Independence", *Theoretical and Applied Economics*. Vol. 19, No. 8 (573) pp. 97-102.

“What evidently holds true is that the higher the degree of independence of a central bank, the lower is, as a rule, the average rate of inflation, and the smaller are the fluctuations in a country’s price movements⁴⁴.”

Most countries have moved towards having more independent central banks so as to position the country for economic improvement and this is demonstrated by legal reform in their respective central banking law. Every government that comes into power will invariably be measured against economic performance and the effect of its policies towards achieving economic excellence and increasing the central’s independence is one avenue for improving the economic performance of a country. The question however is the degree to which each country is able to transfer monetary policy control to its central bank.

ii. **Credibility of the Central Bank**

Godfrey Uzonwanne examines the research conducted by Bowles and White⁴⁵ in which they posit that there is a rising demand for an increase in central bank independence. In their analysis, Bowles and White indicate that there is pressure on governments to increase the level of independence of their central bank which is a player in determining economic growth in a country. Other than the labour market Bowles and White also state other players in determining the independence of a central bank are politicians and international actors such as the World Bank and the IMF which impose conditions of economic policy on developing countries. Their findings generally are that central banks are highly politicized institutions as they are run by technocrats who try to maintain strong political backing⁴⁶.

⁴⁴Issing, O. (1993) “*Central Bank Independence and Monetary Stability*”, The Institute of Economic Affairs, Occasional Paper 89, p.14.

⁴⁵ Bowles, P., and White, G. (1994) “Central Bank Independence: A Political Economy Approach”, *The Journal of Development Studies*. Vol. 31, No. 2 pp. 235-264.

⁴⁶ Uzonwanne, G. C. (2011) “The Political Economy of Central Bank Independence and the Challenges for Development in African Economies”, University of Central Lancashire, Preston, United Kingdom, pp.11-12.

Enhancing the independence of the central bank will increase the credibility of the institution since the influence of government over central bank decisions will be reduced and pronouncements by the central bank will be acted upon by the public⁴⁷.

A solution to the credibility problem of the central bank is through agreeing the policies that are to be implemented by the bank in the long term so as to remove the temptation to change the goals in the future without just cause thereby dealing with the time inconsistency problem⁴⁸.

Increasing the credibility of the bank will mean that economic decisions can be taken in the long run as the risk of surprise changes in the future shall be reduced thus dealing with the time inconsistency problem that shall be described later in this paper.

The temptation by politicians to create an economic boom in the short term particularly closer to elections so as to please the electorate is one justification for having an independent central bank that will pursue the long term policies it has committed to as opposed to short term strategies that may have negative effects on the economy in the long term.

While credibility of the central bank refers to the bank standing by the policies it set out to achieve, this does not mean that the bank should be rigid in its approach to monetary policy for instance and should be alive to the dynamics of the economy as well as financial innovations which may change the underlying assumptions that were taken in setting a particular monetary policy.

A number of legal reforms have been introduced in the Kenyan central banking law, as has been the case in other countries in the developed world however the available literature does not speak to the weaknesses of the Kenyan legislation in as far as insulating the Central Bank of Kenya from direction by the Finance Minister is concerned. Further the available literature does not

⁴⁷ Kibmer, F., and Wagner, H. (1998) "Central Bank Independence and Macroeconomic Performance: A survey of the evidence", Lehrstuhl für Volkswirtschaftslehre, insb. Makroökonomik Fachbereich Wirtschaftswissenschaft, Fern Universität Hagen, Diskussionbeitrag Number 255, p.6.

⁴⁸ In the Report of an Independent Panel Chaired by Eric Roll (1993) titled *Independent and Accountable. A New Mandate for the Bank of England* published by The Centre for Economic Policy Research, p.13 time inconsistency is defined as "The phenomenon called time inconsistency reflects the fact that a policy stance which is best today will become undesirable when that future arrives. The standard solution to the time inconsistency problem is to find a pre commitment today that will prevent any future succumbing to temptations that will by then exist. By making the central bank credible the bank will be forced in the future to stand by what was promised today".

address the manner in which the Finance Minister can be held to account for the directives issued to the Central Bank of Kenya if at all such directives are necessary.

1.8.2 Forms of Central Bank Independence

Central Bank independence has various dimensions namely the institutional independence, functional independence, personal independence and financial independence.

Institutional or political independence can be defined as the ability of a central bank to remove political influence in defining its policy objectives and can also be referred to as goal independence while functional or instrument independence can be defined as the ability of the central bank to freely implement policy using the monetary instruments in pursuit of a monetary goal⁴⁹. Political independence has also been defined as the ability of the central bank to select its policy objectives without influence from government⁵⁰ while a central bank that is given control over the levers of monetary policy and allowed to use them is said to have instrument independence⁵¹. The United Kingdom's Bank of England for instance lacks goal independence as inflation targets are set by the government and the Bank is then granted instrument independence to achieve the goals set by the government⁵².

Personal independence on the other hand deals with the independence of the officers of the central bank such as the Governor of a central bank⁵³ while financial independence relates to a central bank's ability to finance government expenditure either directly or indirectly through central bank credits⁵⁴.

⁴⁹ Walsh, C. E. "Central Bank Independence", New Palgrave Dictionary, (2005), p.3.

⁵⁰ Alesina, A. and Summer, H. L. (May 1993) "Central Bank Independence and Macro Economic Performance: Some Comparative Evidence" *Journal of Money, Credit and Banking*, Vol.25, No. 2, p. 153.

⁵¹ Fischer, S. (1995) Central Bank Independence Revisited "*The American Economic Review*" p.202.

⁵² http://people.ucsc.edu/~walshc/Mypapers/cbi_newpalgrave.pdf. Accessed on 7th September 2012,p.3. This is an article by Walsh, C. E. titled "Central Bank Independence" and prepared in December 2005 for the New Palgrave Dictionary .

⁵³ Eijffinger, S.C. W. and De Hann, J. (1996) "The Political Economy of Central Bank Independence" *Special Papers in International Economic* Number 19, May 1996, Department of Economics, Princeton University, Princeton, New Jersey, p.2.

⁵⁴ Ibid.

The independence of a central bank must be considered in terms of the four forms of independence as all these forms contribute to the ultimate degree of independence that a central bank enjoys.

1.8.3 Measuring Independence

A number of indices have been developed to measure central bank independence both from a legal/formal perspective as well as an informal perspective.

1.8.3.1 Formal Independence

The legal or formal authority of a central bank can be determined by reviewing the charter or the legislation creating the respective central bank⁵⁵. The Legal Variables Aggregate Unweighted (LVAU) indicator developed by Cukeirman, Webb and Neyapti⁵⁶ is of interest in measuring legal independence as it focuses on legal characteristics that should be contained in the constituent document of a central bank namely:-

- i. Appointment, dismissal and legal term of office of the Governor of the central bank. A central bank would be viewed as being more independent if the appointment of the Central Bank Governor or Chief Executive should be done by the board of the governing board and not the Finance Minister or any other state officer;
- ii. The institutional location of the final authority for monetary policy and the procedure for conflict resolution between government and central bank. The independence is said to be higher depending on the extent to which policy decisions are made independently of government involvement;

⁵⁵ Presnak, M. "Central Bank Independence in Sub-Saharan Africa: An analysis , 1960-1989" pp. 39-56
http://www.iwu.edu/polisci/res_publica/2005/Res_Publica_Book_05_presnal.pdf, Accessed on 5th October 2012.

⁵⁶ Cukierman , A., Webb, S. B., and Neyapti, B. (1992) "Measuring the Independence of Central Bank Independence and its Effect on Policy outcomes" *The World Bank Economic Review*, Vol. 6 No. 3, pp. 393 -398. In the research by Cukeirman, Webb and Neyapti the index that was developed to determine formal independence was derived from factors contained in the respective central bank legislation of seventy two (72) countries from both the developed and developing countries.

- iii. The importance of price stability in comparison to other objectives of the central bank. Higher independence is achieved if the charter of the central bank provides that price stability is the sole or primary goal of monetary policy; and
- iv. Stringency and universality of limitations on the ability of the government to borrow from the central bank. Independence is greater if there are limitations on the ability of government to borrow from the central bank⁵⁷.

The index by Cukierman was subsequently interrogated by Atcharyachanvanich⁵⁸ who proposed a legal enforcement index as a way of modifying the Cukierman's index. In Cukierman's index it was found that legal independence does not play a significant role in developing countries. Atcharyachanvanich's research studied a number of developing countries in both long term and short term bases and applied changes in values across time rather than using absolute values at a given point in time and developed a legal enforcement index which would then enhance the legal framework to achieve a higher degree of independence for developing countries. To compare the degree of level of enforcement five dimensions were identified as follows ; (i) clarity of monetary objective; (ii) accountability of a central bank board in implementing monetary policy; (iii) transparency of conducting monetary policy ; (iv) balance coordination among the directors in a central bank board; and (v) contingency measures against instability⁵⁹.

The study by Atcharyachanvanich is more relevant to the present research since it places some focus on the developing countries such as Kenya as opposed to other studies that have been conducted with focus on the developed world noting also that in Atcharyachanvanich 's study the Central Bank of Kenya was found to have a relatively high degree of autonomy with relatively low degree of legal enforcement.

The legal enforcement index is instrumental in evaluating the legal framework adopted by a country's government in promoting central bank autonomy and it will be important to consider whether Atcharyachanvanich findings in his study conducted in 2003 on legal enforcement in Kenya are still true.

⁵⁷ Ibid.

⁵⁸ Waranya, A. (2003) "The Legal Central Bank Independence and Macroeconomic Performance: An Empirical Study on Eighteen Developing Countries in the 1990s" *Forum of International Development Studies*, Vol.23 pp. 201-221.

⁵⁹ Ibid.

1.8.3.2 Informal Independence

Informal or behavioral independence is identified from other factors outside the legal framework. The research by Cukeirman, Webb and Neyapti⁶⁰ also sought to identify factors that could be said to contribute to the informal independence of central bank. These factors include informal arrangements with governments, quality of bank personnel and personal characteristics of the key individuals at the Bank. A detailed review of the index developed for this purpose revealed that it was not a true indicator for each country and there was therefore need to look at each country independently.

The research by Megan Presnak⁶¹ suggests that one must consider the political context in which a central bank exists. The reality of the manner in which central bank independence is embraced in developing countries is different from what is stipulated in statute and other measures of determining the degree of independence have been developed such as the turnover of the central bank governor vis a vis the tenure established by the charter of the central bank.

Another factor to be considered in determining the degree of independence of central banks in developing countries is the foundations of the central banks. A large number of the central banks in developing countries emerged after the respective countries gained independence from their colonial masters. The Central Bank of Kenya for instance emerged from the former East African Community Central Bank. The economic environment at the time of independence is seen as a factor to consider in evaluating the effectiveness of a central bank since at the time of independence new governments took economic policies of redistribution and populist spending and left no or little room to the central banks to carry out their mandate⁶².

In the Kenyan context great steps have been taken in reforming the central banking law to increase the independence of the Central Bank of Kenya and the indicators for legal independence that are found suitable for the developed world could be used to measure the autonomy of the Central Bank of Kenya.

⁶⁰ Cukierman , A., Webb, S. B., and Neyapti, B. (1992) "Measuring the Independence of Central Bank Independence and its Effect on Policy outcomes". *The World Bank Economic Review*, Vol. 6 No. 3, pp. 393 -398.

⁶¹ Presnak, M. "Central Bank Independence in Sub-Saharan Africa: An analysis , 1960-1989" pp. 39-56
http://www.iwu.edu/polisci/res_publica/2005/Res_Publica_Book_05_presnal.pdf, Accessed on 5th October 2012.

⁶² *Ibid.* p.44.

1.8.4 Objections to Central Bank Independence

Whereas it can be said that a high degree on central bank independence is desirable there are those who argue that this extent of autonomy can reduce the accountability of the central bank and therefore advocate for granting government goal independence and the central bank exercising instrument independence⁶³.

The basis for this objection is twofold namely:-

i. Lack of Democratic Accountability

In this instance it is argued that monetary policy should be determined by those who have been democratically elected for instance members of parliament who will be accountable to the electorate⁶⁴. Central bank independence and democratic accountability can be implemented through:-

- a) defining the principle objective of the central bank in its constituent document;
- b) defining specific targets for the central bank , for instance target range for inflation for a given duration;
- c) defining the extent of statutory independence in the constituent document;
- d) giving the minister of finance overriding power over the central bank; and
- e) appointment of bank officials who would not be obligated to answer to the direction of their appointing authority⁶⁵.

As mentioned here above democratic accountability on the part of government can be achieved by the legislature using its law making power to control the independence of the central bank and therefore no central bank can be absolutely independent so long as the monetary institution is a creature of the law subject to parliamentary control.

⁶³ Eijffinger, S.C. W. and De Hann, J. (1996) "The Political Economy of Central Bank Independence" *Special Papers in International Economic* Number 19 , May 1996, Department of Economics, Princeton University, Princeton, New Jersey, pp 15-21.

⁶⁴ Ibid.

⁶⁵ Ibid.p.16.

The important question to be addressed in the discussion on central bank independence is the extent to which the central bank is under the control of government through the powers granted to the Finance Minister and where government control is warranted whether mechanisms are in place to hold the government accountable for the policies adopted by it or directives issued to a central bank⁶⁶.

ii. Potential damage to policy coordination

In this case it is argued that there needs to be coordination of economic policies by government and therefore the central bank as the monetary policy institution should be under the control of government which determines fiscal policy⁶⁷. Such coordination however does not mean that the government should also have control over monetary policy since this can be achieved through consultations between the government and the central bank while at the same time reserving the Bank's ability to challenge government on actions that may hamper implementation of its monetary policy mandate.

1.9 THEORETICAL FRAMEWORK

Theoretical models used to study central bank independence look at the effects of central bank autonomy on inflation and output⁶⁸. This means that the models used to study central bank independence look at its influence on inflation with a view to reducing actions that would otherwise increase inflation as well as increasing productivity within a certain economy. Modern theories on central bank independence attribute the bias towards inflation to firstly, the dynamic inconsistency of monetary policy and secondly the revenue motive of the inflation tax⁶⁹.

⁶⁶ In the Report of an Independent Panel Chaired by Eric Roll (1993) titled *Independent and Accountable. A New Mandate for the Bank of England* published by The Centre for Economic Policy Research, p.16 the panel recommended that institutional arrangements must be put in place to deal with the democratic accountability required of government on monetary policy which meant that the government should be held accountable for its decisions on through a transparent process in which the government must justify its position on monetary policy it is to prescribe for implementation by the central bank.

⁶⁷ Eijffinger, S.C. W. and De Hann, J. (1996) "The Political Economy of Central Bank Independence" *Special Papers in International Economic* Number 19, May 1996, Department of Economics, Princeton University, Princeton, New Jersey, p.18.

⁶⁸ Debelle, G. (1996) "Central Bank Independence: A Free Lunch?" *International Monetary Fund Working Paper*, Number WP/96/1, p.1,

⁶⁹ Fischer, S. (1995) Central Bank Independence Revisited "The American Economic Review" p.201.

The dynamic inconsistency problem is defined as the inconsistency between the optimal policies that a policy authority would announce if its announcements were believed by the public and the policies the authority would carry out once the public has acted on the basis of those expectations⁷⁰. The revenue motive of the inflation tax can be explained as the benefit that a policy maker would derive from surprise inflation.

The two main strands of theory that inform the debate on central bank independence are the political agency theory also known as the principal agent approach and the conservative central banker approach also the interest group theory⁷¹.

1.9.1 Political Agency Theory

This theory (which may also be referred to as the theory of delegation) stipulates that there is rationale for politicians to delegate certain authority to technocrats such as an independent banker who is given a long term contract which in turn gives the central banker an incentive to put more effort in policy making issues rather than an elected politician⁷². In this model the politician is the principal and the central banker the agent and therefore this delegation theory is also referred to as the principal-agent theory. Under this theory the inflationary bias problem is resolved by structuring a contract that penalizes the central banker if he were not to execute the mandate of his office in line with the terms of the contract⁷³.

In this theory monetary policy is delegated to the central banker with the intention that their efforts shall result in better policy and in the end better social welfare. The disadvantage of delegating is that the public will suffer from the mistakes of central bankers whom they did not appoint or may not be able to remove from office. It is therefore critical that the capabilities of the candidate be ascertained at the time of hiring to minimize this cost to the public⁷⁴.

The theory of delegation rests on the following factors:-

⁷⁰ Eijffinger, S.C. W. and De Hann, J. (1996) "The Political Economy of Central Bank Independence" *Special Papers in International Economic* Number 19, May 1996, Department of Economics, Princeton University, Princeton, New Jersey, p.1.

⁷¹ Fischer, S. (1995) Central Bank Independence Revisited "*The American Economic Review*" p.201.

⁷² Gauti B. E. and Le Borgne E. (2010) "A Political Agency Theory of Central Bank Independence", *Journal of Money, Credit and Banking*, Vol. 42 Issue 4 pp. 647-677.

⁷³ Fischer, S. (1995) Central Bank Independence Revisited "*The American Economic Review*" p.201.

⁷⁴ Ibid.

- i. Complexity of the task;
- ii. Level of rent that the officer holder derives from managing it; and
- iii. The ability of the politician to find a suitable candidate for the position⁷⁵.

1.9.2 Interest Group theory

This theory seeks to answer the question why politicians and interest groups such as players in the private sector would clamor for an independent central bank. Under this approach a conservative central banker is appointed to manage inflation at socially acceptable levels⁷⁶. Under this theory *“the central bank has to be independent to ensure that its preferences rather than those of society determine monetary policy in a context in which pre-commitment to optimal (low inflation) policy is impossible”*⁷⁷.

The financial sector is an interest group that for instance supports price stability and in turn central bank independence as this sector stands to benefit from a stable economy⁷⁸. Kathleen McNamara states the following about the financial sector:-

*“According to Posen monetary policy is driven by a coalition of political interests in society, because a central bank will be prepared to take a strong anti-inflation line only when there is a coalition of interests politically capable to sustain such a political stance. In industrial countries, the financial sector represents such a sector.”*⁷⁹

Changes in a country’s financial system will have an impact of a nation’s inflation levels and inflation will have a negative impact on the profits to be made by banks for instance in the financial sector who will therefore be keen on ensuring that the inflation levels are predictable.

⁷⁵ Ibid. p.4.

⁷⁶ Fischer, S. (1995) Central Bank Independence Revisited *“The American Economic Review”* p.201.

⁷⁷ Ibid, p.202.

⁷⁸ Posen, A.S. (1995) “Declarations Are Not Enough: Financial Sector Sources of Central Bank Independence”, *NBER Macroeconomics Annual*. Vol. 10 pp 253-275.

⁷⁹ De Haan, J. and Kooi, W.J. (2000) Does Central Bank Independence Really Matter? New Evidence For Developing Countries Using A New Indicator” *Journal of Banking and Finance* Volume 24 p. 645.

In addition the financial sector has access to the elected officials in government as well as the senior officer in the central bank and can influence the decisions of this entity based on the financial information they have or the advice they can give on monetary policy. In some countries the financial sector does contribute to the appointment of the directors of the central bank such as in the United States where the financial sectors contributes to the nomination of directors. Central bank monetary policy decisions are not always devoid of political considerations and are at times responses to political realities that determine the autonomy and the power of the central bank⁸⁰.

The degree of autonomy can be looked at in terms of the political system's discipline of legislating and its centralization of policy execution. The political systems discipline is the extent to which a government's top elected officials can get the legislature to pass their initiatives without alteration while political systems centralization looks at the manner in which day to day policy is set⁸¹.

The interest group theory by Geoffrey P. Miller is premised on the rent extraction motivation which suggests that politicians have a strong incentive to create unanticipated inflation from time to time as this unravels interest group deals. Many political deals are in most cases tied to nominal price levels and will use their positions to influence the value of the currency in exchange for rent in the form of political support. To check this, an independent central bank is used to control inflation since they can resist control from political pressure⁸².

This study shall focus on the political agency theory of central bank independence as a basis for undertaking an analysis of the formal independence of the Central Bank of Kenya. The paper shall look at central bank autonomy in the background of the central banker as an agent of the government. In the study the central bank is considered an institution created by the legislature, that is created by the politicians.

⁸⁰ Posen, A.S. (1995) "Declarations Are Not Enough: Financial Sector Sources of Central Bank Independence", *NBER Macroeconomics Annual*. Vol. 10 pp 253-275.

⁸¹ *Ibid.* p.259.

⁸² Miller, G. P. (1998) "An Interest-Group Theory of Central Bank Independence" *Journal of Legal Studies*, Vol. 27 pp 433- 453.

1.10 HYPOTHESIS

The research shall be guided by the following hypothesis:-

- i. The legal/formal independence of the Central Bank of Kenya is inadequate.
- ii. The independence of the Central Bank of Kenya is influenced by political/ economic/ social factors.

1.11 RESEARCH METHODOLOGY

The research will be based on literature review of various published and notable journals (academic and scholarly) on the subject of the independence of central banks as well as a review of available legislation of comparative institutions and in particular the Central Bank of Kenya Act, the Bundesbank Act and the Central Bank of Nigeria Act.

1.12 RESEARCH STRUCTURE

This is the manner in which the paper shall seek to address the research questions posed here above.

1. Chapter Two:- Central Banking and the place of Central Bank Independence

In this chapter the research shall examine the concept of central banking independence in the backdrop of the available theories of central bank autonomy and establish the basis for the need to have an independent central bank. This chapter shall establish a justification for central autonomy as well as discuss the various forms of independence. The chapter shall also examine the methodology of measuring formal central bank independence and this methodology shall be applied in chapter three of this paper to determine the extent to which the Central Bank of Kenya Act provides for autonomy the institution.

2. Chapter Three: - The principle of central bank autonomy in the Central Bank of Kenya Act.

In this Chapter the research shall focus on the Kenyan legislation creating the Central Bank of Kenya in particular how the law has provided for a structure for the independence of the institution. In this chapter the research shall seek to examine whether the current model of the Central Bank of Kenya is sufficient to guarantee the institution a desirable degree of independence. This chapter shall draw from the methodology of measuring central bank autonomy identified in chapter two.

3. Chapter Four: - Comparative Study: The Bundesbank of Germany and the Central Bank of Nigeria.

In this chapter comparisons shall be made with other models adopted in like institutions to establish what has worked effectively in other jurisdictions with comparable political economic environment. Comparison shall be made of a country in the developed world and in a developing country such as Kenya.

4. Chapter Five: - Recommendation and case for reform.

Based on the review in the previous chapters the research shall seek to draw conclusions on the effectiveness of our existing legal framework and policy and make recommendations that can be implemented to resolve weaknesses identified in our law on central banking.

CHAPTER TWO

CENTRAL BANKING AND THE PLACE OF CENTRAL BANK INDEPENDENCE

2.1 INTRODUCTION

In this chapter, central banking independence as a principle governing the institution on central banking shall be examined with a view to establishing a basis for the creation of a highly independent central bank.

The various types of central bank independence are also explained.

The chapter shall also examine the methodology of measuring various types of central bank independence from a formal perspective.

2.2 DEFINITION OF CENTRAL BANK INDEPENDENCE

Charles Goodhart defined central bank independence as the right to change the key operational instrument without consultation or challenge from Government⁸³.

Central bank independence refers to the freedom of monetary policy makers from direct political or governmental influence in its conduct of policy⁸⁴.

From the foregoing definitions of central bank independence it can be said that it is the insulation of a central bank from pressures of day to day political activity.

⁸³ Ibid. p.15.

⁸⁴ http://people.ucsc.edu/~walshc/Mypapers/cbi_newpalgrave.pdf. Accessed on 7th September 2012, p.1. This is an article by Walsh, C. E. titled "Central Bank Independence" and prepared in December 2005 for the New Palgrave Dictionary,

2.2.1 Political Agency Theory of Central Bank Independence

Central banks across a number of countries are vertically subordinated to the legislature which represents the diverse interests of the public⁸⁵. As stated in chapter one⁸⁶, the legislature who hold democratic accountability for monetary policy are compelled to delegate the role of central banking to experts who can monitor the functions of the bank closely and on a full time basis.

To remove the inflationary bias of government, monetary policy is delegated to an independent and “conservative” central banker. Conservative meaning a central banker who is averse to inflation as compared to government since (s) he places a greater weight on price stability than government does⁸⁷.

In the theory of central bank independence a contracting model of monetary policy is adopted where the principal (government) enters into a contract with the agent (central banker) in which the objectives of the central banker are specified and penalties are prescribed for failing to meet the objectives. It is assumed that the contract shall be executed and that the principal shall not change the terms of the contract since it will be costly to the government to do so⁸⁸.

For the contracting model to be successful the central banker must be held accountable for achieving their objectives and this will at the same time motivate the central banker to take corrective measures to counter any adverse economic changes that will prevent them from meeting their objectives.

The theory of delegation fits well with the requirement for government to account to the electorate since the central bank is seen as merely the agent of the government. The government does not relinquish its responsibility over monetary policy but merely delegates the role to the central banker who must remain accountable to the government for his/her actions. Further any

⁸⁵ Waller C.J. and Walsh, C.E. (1996) “Central Bank Independence, Economic Behaviour and Optimal Term Lengths”, *The American Economic Review*, Volume 36 Issue 5, pp.73-74.

⁸⁶ pp..31-32.

⁸⁷ Berge, H., De Haan, J. and Eijffinger, S.C. W. (2001) “Central Bank Independence: An update of Theory”, *Journal of Economic Surveys*, Volume 15, Number 1, p. 3.

⁸⁸ Fischer, S. (1995) “Modern Approaches to Central Banking”, *National Bureau of Economic Research Working Paper Series*, Working Paper Number 5064, p. 40.

power granted to the central banker is premised under the law creating the central which law the government has ultimate control.

2.2.2 Justification for Central Bank Independence

A key justification for enhancing central bank autonomy has been that a higher degree of central bank independence enables a country to manage inflation or price stability. For example, in the 1970s industrialized countries were faced with high inflation and one of the measures taken to manage the economic crisis was to increase the impact of monetary policy measures by enhancing the independence of their respective central bank⁸⁹.

Otmar Issing states the following on the economic justification for central bank independence;

*“As has so often been the case in economics, interest in the idea of independence for the central bank originated in economic trends , in particular in a world –wide acceleration of inflation and the question how this problem could be mastered”.*⁹⁰

Other than the economic basis set out here above the following reasons have been put forward for establishing independent central banks namely:-

i. Inflationary bias of monetary policy.

Central bank independence is viewed as a means to deal with political pressure on central banks to realize high inflation rates that may not be beneficial to the economy or the public but only to the politicians. The high inflation rates are seen as an avenue by politicians to raise revenue / rents and is considered an inflationary bias which arises from dynamic inconsistency. Geoffrey P. Miller refers this as the rent extraction motivation for inflation wherein government may favour monetary expansion and the associated price level changes that increase with money supply especially in the period immediately before an election in order to increase economic activity, raise employment and create a strong, if temporary sense of well being for the electorate. The

⁸⁹ Vasile, D. and Tiberiu, S. (2012) “Central Bank Independence”, *Theoretical and Applied Economics*. Vol. 19, No. 8 (573) pp. 97-102.

⁹⁰ Issing, O. (1993) “*Central Bank Independence and Monetary Stability*”, The Institute of Economic Affairs, Occasional Paper 89, p.11.

disadvantage of this preference is that inflation has few welfare benefits since the real cost of inflation includes the distortion of economic activity, the cost of repricing real assets according to a change in nominal price level, the costs of the effort people have to undertake to avoid losing the value of their financial claims and in the case of very high inflation, social demoralization⁹¹.

Dynamic inconsistency is defined as the inconsistency between the optimal policies that a policy authority would announce if its announcements were believed by the public and the policies the authority would carry out once the public has acted on the basis of those expectations⁹².

The credibility of a monetary policy would also be premised on time inconsistency problem which is that a policy would be time inconsistent when a future policy decision that forms part of an optimal plan formulated at an initial date is no longer optimal at the time the policy is implemented, although no relevant information is provided.

Since economic decisions are made based on expectations of future monetary policy and assuming that the monetary policy can influence the inflation rate, any unexplained changes in monetary policy in the future may create more inflation that was not anticipated⁹³.

As stated in chapter one⁹⁴ the problem of time inconsistency can only be cured by making the central bank a credible institution. Economic decisions are premised on the value of money and therefore the public will make decisions premised on what they anticipate to be the inflation as indicated by the respective central bank. If the indicators of the central bank are subject to unexplained changes then the public will not rely on statements of the central bank as they will tend to suffer financially from surprise inflation.

Dependant central banks would be more susceptible to carrying out policies that would not meet the expectations of the public and thereby raising a credibility issue of the central bank. A

⁹¹ Miller, G. P. (1998) "An Interest-Group Theory of Central Bank Independence", *Journal of Legal Studies* Vol. 27, p. 436.

⁹² Fischer, S. (1995) "Modern Approaches to Central Banking", *National Bureau of Economic Research Working Paper Series*, Working Paper Number 5064, p. 32.

⁹³ Kibmer, F. and Wagner, H. (1998) "Central Bank Independence and Macroeconomic Performance: A survey of the evidence", *Lehrstuhl für Volkswirtschaftslehre, insb. Makroökonomik Fachbereich Wirtschaftswissenschaft, Fern Universität Hagen*, Diskussionbeitrag Number 255, p.6.

⁹⁴ p.31.

monetary policy for instance would be credible if the private sector believes that it shall be carried out.

To deal with the inflationary bias problem of monetary policy the independence of the central bank must be enhanced so as to give it credibility.

ii. Empirical Relationship between central bank independence and price stability.

The evidence on the costs of inflation and the relationship between inflation and growth suggests that countries benefit from being inflation averse. Independent central banks produce, on average, lower inflation, both in terms of level and variability as well as generate lower output variability⁹⁵.

Literature suggests that inflation and central bank independence are negatively correlated and has no doubt prompted governments to consider enhancing the autonomy of the central banks⁹⁶.

iii. Visible benefits of independent central banks to economies with highly independent central banks.

The success of the Bundesbank of Germany and that of the German economy bears provides proof that central bank independence plays a pivotal role in economic success. The relative autonomy of the Bundesbank is often seen as evidence that central bank independence can function as an effective device for assuring price stability since Germany has one of the best post World War II inflation record among the industrial countries⁹⁷.

2.3 INSTITUTIONAL DESIGN OF A CENTRAL BANK

In establishing a central bank a government must consider the extent or degree to which the institution shall be autonomous. The political agency theory suggests that the politician prefers delegating to a central bank who shall dedicate their time to the function of monetary policy. A

⁹⁵ Gaudi B. E. and Le Borgne E. (2010), "A Political Agency Theory of Central Bank Independence", *Journal of Money, Credit and Banking*, Vol. 42 Issue 4 pp. 647-677.

⁹⁶ Eijffinger, S.C. W. and De Hann, J. (1996) "The Political Economy of Central Bank Independence" *Special Papers in International Economic* Number 19, May 1996, Department of Economics, Princeton University, Princeton, New Jersey , p. 1.

⁹⁷ *Ibid.* p. 1.

concern that the government must deal with is the accountability of the institution to the government and in turn the legislature which is democratically accountable to the electorate for the performance of the monetary policy institution.

While delegating to an agent solved the time inconsistency problem of inflation there is also a danger that the agent may not implement the directions of the government⁹⁸ and it is therefore important that the law or instrument creating a central bank puts in place mechanisms for checking the powers granted to the central bank. Such mechanisms will therefore water down the autonomy of the central bank but shall give the government authority to conduct official oversight or informal interactions with the central bank⁹⁹. As stated in chapter one¹⁰⁰ a government may adopt various strategies to achieve independence of its central bank among them the legislative strategy or the contractual strategy.

The strategies adopted by a government set the platform upon which the extent to which a central bank is independent. For instance if a targeting strategy is adopted whereby the government retains goal independence and sets the price stability targets, the central bank in such a case will be controlled in its operations by the targets set by the government. Such a target will also create an accountability mechanism whereby the central bank shall be held accountable for the achievement of the inflation rate set by the government¹⁰¹. The targeting strategy would give the central banker discretion to determine how to achieve the price stability target through the manipulation of the instruments of monetary policy thereby giving the central bank clarity on the extent to which it can act while at the same time maintaining some control by the government. The disadvantage of this strategy would be that the government may take advantage of the power to set targets to push for a government agenda that may not advance the interests of the public¹⁰². The decision to grant independence to a central bank shall rest on the degree to which the

⁹⁸ McNamara, K. R. (2002) "Rational Fictions: Central Bank Independence and the Social Logic of Delegation", *West European Politics*, Volume 25 (1), p. 55.

⁹⁹ Ibid.

¹⁰⁰ pp. 21-22.

¹⁰¹ Persson, T. and Tabellini, G. (1993) "Designing Institutions for Monetary Stability" *Carnegie-Rochester Conference Series on Public Policy* Volume 39, p.54.

¹⁰² Ibid. 72.

politician is willing to delegate power to an unelected person based on the prevailing circumstances in a country.

2.4 TYPES OF CENTRALBANK INDEPENDENCE

Central bank independence has various dimension namely the institutional independence, functional independence, personal independence and financial independence.

2.4.1 Institutional Independence

This is also referred to as goal independence which can be defined as the ability of a central bank to remove political influence in defining its policy objectives¹⁰³.

Institutional independence therefore means that the central bank is at liberty to set the policies of monetary policy it wishes to pursue without having to refer to the government for approval.

This independence is premised on the basis that the central banker has expertise in the field of central banking and that he will act in the best interests of the of the public. The central bank has the right to set its own policy goals, whether inflation targets, control of the money supply, or maintaining a fixed exchange rate. The United Kingdom's Bank of England for instance lacks goal independence as inflation targets are set by the government and the Bank is then granted instrument independence to achieve the goals set by the government¹⁰⁴.

2.4.2 Functional Independence

This is also referred to as instrument independence which can be defined as the ability of the central bank to freely implement policy in pursuit of monetary goal¹⁰⁵. A central bank has

¹⁰³ Walsh, C. E. "Central Bank Independence", New Palgrave Dictionary, (2005), p. 3.

¹⁰⁴ Ibid. p. 3.

¹⁰⁵ Ibid. p. 3.

instrument independence when it has full discretion and power ¹⁰⁶to deploy monetary policy to attain its goals.

The central bank has the independence to determine the best way of achieving its policy goals, including the types of instruments used and the timing of their use. This is the most common form of central bank independence where by the government sets the price stability targets and the central bank assigned the roles of formulating and implementing a policy that would achieve the government's inflation target. In the case of the Bank of England the inflation target for instance is announced in the Chancellor's annual budget speech to Parliament but the central bank has autonomy in the manner in which the inflation target shall be achieved¹⁰⁷.

2.4.3 Personal Independence

Personal independence on the other hand deals with the independence of the officers of the central bank such as the Governor of the Central Bank. This is also referred to as management independence. The personal independence of the central bank refers to the influence the government has in appointment procedures. It is not feasible to exclude government influence completely in appointments to a public institution such as the central bank however the level of influence may be determined by criteria such as government representation in the board of the central bank and government influence in the appointment procedures, terms of office and dismissal of the governing board of the bank¹⁰⁸.

Under this type of independence the central bank also has the authority to run its own operations (appointing staff, setting budgets, and so on.) without excessive involvement of the government. The other forms of independence are not possible unless the central bank has a significant degree of management independence.

One of the most common statistical indicators used in the literature as a determinant of central bank independence is the "turn-over-rate" of central bank governors. If a government is in the

¹⁰⁶ Fischer, S. (1995) "Modern Approaches to Central Banking", *National Bureau of Economic Research Working Paper Series*, Working Paper Number 5064, p. 41.

¹⁰⁷ Ibid. p. 3.

¹⁰⁸ Eijffinger, S.C. W. and De Hann, J. (1996) "The Political Economy of Central Bank Independence" *Special Papers in International Economic* Number 19, May 1996, Department of Economics, Princeton University, Princeton, New Jersey , p. 2.

habit of appointing and replacing the governor frequently, it clearly has the capacity to micro-manage the central bank through its choice of governors. Personal independence can be achieved by guaranteeing the tenure of office of the bank's senior officers such as the Governor¹⁰⁹.

2.4.4 Financial Independence

Financial independence relates to the central bank's ability to finance government expenditure either directly or indirectly through central bank credits¹¹⁰. This independence may also be referred to as the economic independence of the central bank.

The economic independence of a central bank arises from the ability of the central bank to determine its own expenditure and is not subject to limitation say by Government. If a central bank for instance relies on government funding then its policies may be influenced by government by the manner in which the budgetary control is exercised¹¹¹.

2.5 MEASURING INDEPENDENCE

Measuring the degree of independence of a particular central bank is in most cases pegged to the formal independence of the central bank which can be discerned from an analysis of the charter of the central bank.

In determining whether a central bank is independent or otherwise, measurements of central bank independence have been proposed by writers such as Alesina, Grilli, Masciandaro and Tabellini (GMT Index)¹¹², Eijffinger and Schaling, Cukierman. The most commonly used measurement

¹⁰⁹ Ibid. p. 26.

¹¹⁰ Ibid. p.2.

¹¹¹ Downes, P. and Vaez-Zadeh, R. "The Evolving Role of Central Banks", (1991) Central Banking Department *International Monetary Fund (IMF)*, Washington, p. 433.

¹¹² This index was developed by Vittorio Grilli, Donato Masciandaro and Guido Tabellini and is referred to as the GMT Index.

index is that developed by Cukierman, Webb and Neyapti which is based on four legal characteristics of formal independence¹¹³.

In determining the independence of a central bank Cukierman, et al propose that one should look at whether the Governor of the Central Bank is appointed by the Board of Directors of the central bank, whether policy decisions are made independently of government involvement, whether the charter of the bank specifically states that the sole responsibility of the bank is to maintain price stability and what limits exist in the law as far as lending to government is concerned¹¹⁴. These are the four main parameters of the index developed by Cukierman and in each parameter there are various matters that are reviewed to determine the extent of the independence of a central bank.

In the first parameter which mainly deals with the appointment of the Governor (Chief Executive Officer) the following issues are examined:-

i. Length of term of office of the Governor

The tenure of the Governor indicates the independence of the institution if the term of appointment is longer than that of the electoral cycle in a country.

ii. The entity delegated to appoint the Governor

The process of appointing the Governor would be considered more independent if the Governor was appointed by a non-government entity for instance perhaps by the Board of Directors of the central bank.

iii. The provisions of the legislation on the dismissal of the Governor

The dismissal procedure would be considered as being independent if the dismissal is conducted by an entity other than the government or its officials or perhaps by the Board of Directors of the central bank if it was the appointing authority.

¹¹³ Walsh, C. E. "Central Bank Independence", New Palgrave Dictionary, (2005) p. 4.

¹¹⁴ Ibid. pp. 4-5.

iv. The ability of the Governor to hold other office.

A central bank would be considered as more independent of the Governor is prohibited from holding other offices that may cause a conflict in the execution of his responsibilities at the central bank¹¹⁵.

The second parameter that is considered by Cukierman is the role played by a central bank in monetary policy formulation. In this instance one would be required to look at the provisions of the legislation to determine:-

i. The entity responsible for monetary policy formulation

The index proposes that a central bank would be considered more independent if the responsibility for monetary policy formulation rested with the central bank as opposed to the Government. In cases where the central bank merely advises government on monetary policy then the independence of such a central bank would be considered as low.

ii. The rules to be applied to resolve conflicts in monetary policy between the central bank and the Government.

In the event of a conflict between the Government and the Central Bank on the monetary policy formulated by the central bank, the independence of the central bank would be higher if the central bank was granted the final word on the monetary policy so developed by the relevant legislation. Where the final word rests with the executive branch of government then the independence of the central bank in this context would be considered as low.

iii. The participation of the Central Bank in formulating the Government's Budget

¹¹⁵ Arnone, M. Laurens, B.J. and Segalotto, J.F. (2006) "Measures of Central Bank Autonomy: Empirical Evidence for OECD, Developing and Emerging Market Economies", *IMF Working Paper*, Number 06/228, p.5.

Where the central bank is involved in the formulation of the budget then the independence of the central bank would be considered as high since such participation not only reflects cooperation between the fiscal and monetary authorities but also provides an avenue for the two avenues to develop policies that will not be in conflict. The level of government expenditure is a significant determinant of the fiscal environment of a country and the central bank would be in a position to advise the government on the effects of government spending on the monetary policy the central bank seeks to implement in a given period¹¹⁶.

The third parameter to be considered is the importance that the central bank places on the objective of monetary policy.

Where the object of price stability is stated as being the primary objective of the central bank such a central bank is considered as having more independence.

The central banking legislation should provide for the primacy to the role played by the central bank in monetary policy. Monetary stability should be seen as the most important objective of the central bank as this is considered as the most important function of the central bank and once this is defined by statute it becomes easier to determine the success of a central bank as its focus shall be on monetary policy. A number of statutes provide for a number of objects for the central bank but do not specifically state that the primary function of the central bank is to deal with monetary stability. Where such clarity is not provided then the government can take up the role of monetary policy and relegate the central bank to performing other functions such as issue of currency and supervising the financial institutions¹¹⁷.

Lastly the independence of a central bank can be discerned from the limits placed on the government on borrowing from the central bank.

Independence is greater if there are limitations on the ability of government to borrow from the central bank. Limiting the growth of government debt from the central bank affects the independence of the central bank since such limits make lending to the government credible and

¹¹⁶ Ibid.

¹¹⁷ Ibid.

sustainable since the debt does not curtail the ability of the central bank to conduct monetary policy¹¹⁸.

Legal limits on lending to Government placed in the law should be specific as to the total amount that the Government can borrow from their respective central bank in terms of the total outstanding debt as compared to government revenue and secondly defining limits of the debt the government can borrow from all possible sources available to it. Such legal limits will remove elements of discretion in determining how much to lend as well as assist the public to vet the amount of actual central bank debt to the government and avoid financing through circumvention of the law¹¹⁹.

In this instance one should consider the following issues:-

i. Whether the central bank is allowed to make advances to government

Where lending to government by a central bank is not allowed then in such a case the central bank would be considered as being more independent. Since the government may need to borrow from the central bank then the law must specify the limits of such advances or the manner in which the limit can be determined if not specified by the law for example as a percentage of government revenue.

ii. Whether the government is required to provide security for the monies borrowed from the central bank.

Where the government is required to provide security for advances made to it by the central bank then the central bank would be considered as being more independent as compared to a case where government was not required to provide security.

¹¹⁸ Leone, A. "Effectiveness and Implications of Limits on Central Bank Credit to Government", in Downes, P. and Vaez- Zadeh, R. (eds.) (1991) *The Evolving Role of Central Banks*, International Monetary Fund (IMF), Washington, p. 390.

¹¹⁹ *Ibid.* p. 381.

iii. The authority granted power to determine the terms to govern the advance to government.

This should include the maturity of the loans, the applicable interest rates and the limits on the amount to be borrowed.

Where the legislation places the authority on the central bank to determine the terms of the advances or specifically stipulates that the manner in which advances are to be made to the government should be in line with the prevailing market terms then such a central bank would be considered as more independent than where the authority was with the Government or was not specified by the law leaving room for abuse.

iv. The restrictions placed on the central bank in participating in the primary market for government securities such as treasury bills and bond.

Where a central bank is prohibited from participating in the primary market for government securities this is an indicator for high independence which means that the government cannot raise funds by selling its treasury bills to the central bank or compelling the central bank to purchase the same¹²⁰.

These legal indicators of independence will be explored in the next chapter where a review of the legal framework on the Central Bank of Kenya will be done.

2.6 CONCLUSION

The main concern for every government is to ensure economic growth and social welfare which would not be realized in an environment that has inflation. On average economic performance is better in countries with independent central banks and one avenue of managing inflation is by having a monetary authority that is independent since the central bank is managed by technical experts who will deal with the counter cyclical effects of inflation without other motivation that politicians may have.

¹²⁰ Arnone, M. Laurens, B.J., and Segalotto, J.F. (2006) "Measures of Central Bank Autonomy: Empirical Evidence for OECD, Developing and Emerging Market Economies", *IMF Working Paper*, Number 06/228, p. 5.

A review of the history of central banking demonstrates that there is a need for central banks particularly for purposes of ensuring a stable currency which is the economic basis for central bank independence.

The theories on central banking that is the delegation theory and the interest group theory in my view lead to the same conclusion that the underlying reason for central bank independence is economic stability since by strengthening the monetary institution is the desire of the government as well as the players in the financial sector.

The independence of a central cannot however be absolute since the legislature have power to amend the statute that grants the central bank autonomy and we cannot therefore talk about absolute independence but establish a degree of independence for each central bank that meets the requirements of each country.

The degree of independence for every central bank will depend on the political –economic environment in which the central bank will operate and a one size fits all methodology cannot be adopted but rather an analysis of the economic development status of the country, the type of political regime in place will be key in determining the extent to which reforms should be undertaken to achieve a desirable degree of independence.

It has been stated in various literature that whereas independence can be established from the charter of the central bank in practice however the actual independence of the central bank will be premised on the will of the government to uphold the law that grants the central bank independence.

“Where the rule of law is not embedded in the political culture of a country it will be difficult to match legal independence to practical independence as is observed in developing countries”¹²¹.

¹²¹ Ibid. p. 5

CHAPTER THREE

THE PRINCIPLE OF CENTRAL BANK AUTONOMY IN THE KENYAN LEGAL FRAMEWORK

3.1 INTRODUCTION

The focus of this chapter is the Kenyan legislation creating the Central Bank of Kenya with a view to understanding the manner in which the existing law safeguards the independence of the institution.

The most widely available indices of central bank independence refer to the level of independence as specified in the law¹²². In chapter two¹²³ we have considered the legal parameters that are considered in the index developed by Cukierman and these four legal indicators shall be considered while reviewing the Kenyan legal framework on central banking to determine the extent to which the Kenyan law promotes central bank autonomy.

The main parameters to be considered shall be the appointment, dismissal and legal term of office of the Governor of the Central Bank, the institutional location of the final authority for monetary policy and the procedure for conflict resolution between government and bank, the importance of price stability in comparison to other objectives of the Central Bank and the stringency and limitations on the ability of the government to borrow from the central bank.

¹²² Cukierman, A. (2006) "Central Bank Independence and Monetary Policy Making Institutions: Past, Present and Future" *Working Paper of the Central Bank of Chile*, Number 360 p. 3.

¹²³ pp.45-48.

3.2 APPOINTMENT OF THE GOVERNOR AND THE BOARD OF DIRECTORS

3.2.1 The Governor

i. Appointment

Section 13 of the Central Bank of Kenya Act provides for the appointment of a Governor as the Chief Executive Officer of the Central Bank. The Governor is to be appointed by the President through a transparent and competitive process and with the approval of Parliament to hold office for an initial term of four (4) years and would be eligible for re appointment for a further term of four years.

The process of appointing the Governor was amended by the Finance Act, 2012 since prior to this amendment the legislation provided that the Governor would be appointed at the behest of the Head of State. This previous practice was changed to bring in the need for a vetting process in the appointment of the Governor of the Central Bank which means that criteria would be established for a suitable candidate for the position. Thereafter the person selected for appointment would have to be approved by Parliament as part of their democratic accountability responsibility¹²⁴.

This new process of appointment in my view introduces transparency in the appointment of the Governor since the appointment is not left entirely to the President and hence increased the independence of the individual so appointed since he will not hold any allegiance to the Head of State who appointed him/her.

ii. Tenure

The concern with the present legislation on the appointment of the Governor is the tenure of the four years which means that in every electoral cycle the position of the Governor has to be reviewed. Considering that the government of the day is not the Government that appointed the Governor there is a high likelihood that a new government would be inclined to appoint a new Governor who will be considered as being sympathetic to the policies of the existing

¹²⁴ Section 13 (1), Central Bank of Kenya Act.

Government. In a study conducted on the optimal term length for the appointment of a central bank governor, Christopher J. Waller and Carl E. Walsh state the following:-

“Longer terms serve to insulate the central bank from political pressures and help mitigate the policy uncertainty that arises from the turnover of political leadership”¹²⁵.

The term “longer terms” should in this context be considered as a term of appointment that is longer than the electoral cycle of the legislature for example. This tenure is desirable since the governor is not influenced by the desire to get reappointed where the tenure is say for four years subject to extension. While there is an advantage in providing for assessment of the conduct of the governor after the initial term of appointment this benefit is outweighed by the impact that reappointment has on the conduct and in part the independence of the Governor since he/she will want to act in a manner that will guarantee him reappointment which in most instances will mean that the governor may succumb to the pressures of the government in power. Research has shown that the one term appointment with the eligibility for reappointment causes the Governor to act in an inflationary manner particularly during election periods¹²⁶.

While the reappointment process allows the public an opportunity to remove a governor who fails to implement desired monetary policy more weight should be placed on the desire to remove partisan behavior of the governor to ensure his reappointment. Additionally should the governor fail to execute his mandate appropriately or as prescribed by the government then the law provides a mechanism for the removal of the governor on grounds of incompetence. It therefore appears that with legislation providing for an exit mechanism should the agent act outside his mandate then the principal can remove the governor even before the expiry of his initial tenure. This allowance therefore means that even where the law provides a long tenure for the governor he can only be dismissed for specific reasons which are tied to the management of monetary policy and not on political reasons such as allegiance to the government of the day. This in my view introduces accountability both on the part of the Governor as far as executing his mandate is concerned and on the government in terms of ensuring that the right person for the job is appointed to the position of governor.

¹²⁵ Waller, C. J. and Walsh, C. E. (1996) “Central-Bank Independence, Economic Behaviour and Optimal Term Lengths”, *The American Economic Review*, Volume 86 Issue 5 p.1140.

¹²⁶ Ibid.

Looking at Cukierman's index on the tenure of the Governor it therefore appears that the independence of the Central Bank of Kenya is weakened by the tenure of four (4) years and should be increased perhaps to be longer than the five (5) year electoral cycle in Kenya.

iii. Dismissal

The Central Bank of Kenya Act provides for removal of the Governor once the matter of his removal has been considered by a Tribunal that has been appointed by the President¹²⁷. The process of removal of the Governor promotes the independence of the Governor in the execution of his/her responsibilities since the Governor is not under threat of removal by the President. The procedure in the Act requires that the President be guided in his decision by the opinion of a tribunal which introduces transparency and independent in the removal process. To this extent the Kenyan law enhances the independence of the Central Bank of Kenya.

iv. Other Offices

The Governor is prohibited from holding other offices while acting in the Central Bank of Kenya. Any exception to this would be on the basis that the appointment would be beneficial to the interests of the Central Bank and advances the objects of the Central Bank¹²⁸.

The disqualification from holding other offices is necessary to ensure that there are no conflict of interest arising by virtue of other responsibilities held by the Governor and Governor is required to dedicate his time to the affairs of the Central Bank to ensure the success of the institution.

3.2.2 The Board of Directors

The Central Bank of Kenya Act provides that the Board shall comprise of a Chairperson, Governor of the Central Bank, The Permanent Secretary to the Treasury and five (5) other non-executive directors appointed by the President with the approval of Parliament and shall hold office for a period of 4 years, and being eligible for reappointment for a further term of four (4) years¹²⁹.

¹²⁷ Section 14, Central Bank of Kenya Act.

¹²⁸ Section 14 and 15, Central Bank of Kenya Act.

¹²⁹ Section 11, Central Bank of Kenya Act.

Section 11 of the Central Bank of Kenya Act was amended by Section 45 of the Finance Act of 2012 by introducing the position of the Chairperson of the Board of the Directors. Previously the Chairperson of the Board of Directors was the Governor of the Central Bank of Kenya.

Section 11 (2) of the Central Bank of Kenya Act was amended by Section 45 of the Finance Act of 2012 by requiring that the appointment of the five non-executive directors of the Central Bank be by the President with the approval of Parliament. Initially these appointments were the prerogative of the President without the need to consult Parliament.

The current provisions of the law on the appointment of the members of the board introduces transparency in the appointment process since the appointment requires scrutiny of the candidates through a vetting process which should ensure that those appointed shall serve the best interests of the institution. The process also provides that the appointment of the directors shall be approved by Parliament which is a deviation from the previous practice of the appointment only by the President. The approval by Parliament also introduces a second opportunity for the review of the proposed directors and therefore making the process more rigorous and obtains democratic approval.

3.2.3 Personal Independence

The Central Bank of Kenya Act, Number 15 of 1966 provided that the Board of Directors would comprise of the Governor, the Deputy Governor, the Permanent Secretary to the Treasury (or in his absence an official of the Treasury nominated by the Minister of Finance) and four Directors¹³⁰.

The 1966 Act provided that Board meetings could only be held if the quorum of the meeting comprised of the Treasury representative and where special circumstances required, the Governor with the concurrence of the Treasury Representative would make decisions that were binding on the Bank without a formal meeting of the Board. A meeting of the Board would thereafter be called to report such a decision to the Board¹³¹.

¹³⁰ Section 11, Central Bank of Kenya Act, Number 15 of 1966.

¹³¹ Section 12 (2) and (5), Central Bank of Kenya Act, Number 15 of 1966.

Further the Governor and the Treasury Representative had a right to suspend a vote of the Board and refer the matter to the Minister of Finance for a final decision on the vote¹³².

A reading of the first legislation on Central Bank of Kenya indicates that the independence of the Central Bank of Kenya was limited to the extent that Government was greatly involved in the affairs of the Central Bank. This could be explained by the transition of the Central Bank from the East African Currency Board to the Central Bank of Kenya. This transition period required that the Central Bank be in tune with Government policy of a new and independent state Kenya having just obtained independence from its colonial masters.

The Central Bank of Kenya (Amendment) Act, 1996 amended the Board Constitution by making the Treasury Representative a non-voting member of the Board and further providing for non-executive directors hence decreasing the influence of the Treasury Representative in the decisions of the board and from a governance perspective increased the independence and impartiality of the Directors by requiring them to be non-executives¹³³.

In making the Treasury representative a no voting member of the Board of the Central Bank, this amendment required that the Treasury provide the Central Bank with the Government position on the policy to be adopted by the Central Bank so as harmonize the fiscal and monetary policy positions taken by the two entities. The import of this amendment was to enhance the autonomy of the Central Bank in the Board decisions. Direct government influence and control was removed in the decision making process of the Board of Directors thereby enhancing the independence of the Central Bank.

The amendments introduced by the Finance Act, 2012 sought to further increase the governance of the Board by creating the position of the Chairperson of the Board who would take the position of a non-executive and independent director as is the case in a commercial entity/enterprise. This position was initially held by the Governor who in essence would be sitting in judgment of his own actions contrary to best practice in governance of organizations¹³⁴.

¹³² Section 12 (6), Central Bank of Kenya Act, Number 15 of 1966.

¹³³ Section 5, Act Number 9 of 1996.

¹³⁴ Section 45, Act Number 4 of 2012.

Prior to the 2012 amendment the Governor was the Chairperson of the Bank's Board of Directors which in essence meant that an Executive Director was also the Chairperson of the Board which is not the best practice in corporate governance requirements. Secondly as both the Chief Executive Officer and the Chairperson, the Governor's objectivity in decision making would be compromised since he would be called upon to determine whether his actions as the Governor (that is the performance of the Central Bank) is appropriate or otherwise. The Chairperson should be a non-executive person who is not involved in the day to day affairs of the Bank and can be able to provide proper guidance to the Central Bank.

While the Finance Act 2012 also introduced transparency in the manner in which the Governor and the two (2) Deputy Governors are to be appointed by requiring that the selection be through a transparent and competitive process, the Amendment did not prescribe the qualifications that would be considered for the appoints and in addition did not prescribe the manner in which the Chairperson of the Board is to be appointed¹³⁵.

The Central Bank of Kenya (Amendment) Bill, 2012 proposes further amendments to the Central Bank of Kenya Act by increasing the number of the non-executive directors to eight (8) in place of the present five (5), requiring that the Chairperson be appointed by the President with the approval of Parliament upon selection through a transparent and competitive process and finally by introducing a criteria for the suitability of the persons to be appointed as Governor and Deputy Governor by prescribing that the Governor and Deputy Governors shall be fit and proper persons of recognized professional standing and over ten years' experience at senior management level in the field of economics, banking, finance, law or other fields relevant to the functions of the Central Bank. The term "fit and proper" shall mean possessing all the attributes to be taken into account in determining the suitability of a person to be appointed as Governor, including the person's general probity, competence and soundness of judgment for the fulfillment of the responsibilities of office and the diligence with which the person is likely to fulfill those responsibilities.

An analysis of the law on personal independence of the Central Bank of Kenya shows that there has been a change to introduce better governance structure particularly by introducing the position of the Chairperson in place of having the Governor acting as the chairperson of the board.

¹³⁵ Ibid.

The Chairperson is considered as an independent and non-executive director who would be able to provide the Board of the Bank proper direction in light of his independence from the day to day affairs of the Central Bank.

The concern with the extent of the independence of the Chairperson would in practice be determined by the information that is made available to the Board of Directors by the management of the Central Bank of Kenya. The direction the decisions of the Board and that of the Chairperson would be dictated by the information that is tabled by the Governor who are engaged in the day to day affairs of the Central Bank and may be inclined to table only the information that will enable them achieve certain approvals from the Board.

Whereas great effort has been made to enhance the personal independence of the Central Bank of Kenya the provisions of the Act limit the personal independence of the Central Bank in terms of the tenure of the members of the Board as well as that of the Governor and the Deputy Governor.

3.3 THE IMPORTANCE OF PRICE STABILITY IN COMPARISON TO OTHER OBJECTIVES OF THE CENTRAL BANK.

3.3.1 Objectives of the Central Bank of Kenya

Section 4 (1) of the Central Bank of Kenya Act provides that the primary objective of the Bank is to formulate and implement monetary policy directed at achieving and maintaining stability in the general level of prices.

Secondary objectives shall be to foster liquidity; solvency and proper functioning of a stable market based financial system as well as supporting the economic policies of the Government including the objectives for growth and employment.

Section 4 further provides that the Minister may by notice in writing specify the price stability targets of the government and the economic policy to be taken by the government.

The Central Bank of Kenya was created by the Central Bank of Kenya Act, Number 15 of 1966 (after the dissolution of the East Africa Currency Board). The 1966 Act defined the objectives of the Central Bank of Kenya as: to regulate the issue of notes and coins; to assist in the development and maintenance of sound monetary credit and banking system, the external stability of the currency and to serve as the banker and financial adviser to the Government. The

function of the Central Bank was not clearly defined and the Act was amended by Act Number 9 of 1996¹³⁶. Section 2 of Act Number 9 of 1996 prescribed the principal object of the Bank as being the formulation and implementation of monetary policy. The amendment obviated the generality of the objects of the Bank hence making the mandate of the Bank specific. Njaramba Gichuki states that the amendments to the objects of the Bank were indicative of a shift in the main object of the Bank and therefore its role as a monetary policy authority¹³⁷.

The Central Bank Act presently designates price stability as the primary role of the Central Bank of Kenya however while this is the case the Act further goes to provide for Ministerial powers that may influence the manner in which the Central Bank would carry out its mandate. The Central Bank of Kenya Act gives the Government through the Finance Minister power to set the price stability target or the inflation target. In the Kenyan context therefore goal independence is held by the Government¹³⁸.

The Act then provides that the Central Bank shall formulate and implement monetary policy in line with the target prescribed by Government¹³⁹. This essentially means that instrument independence is granted to the Central Bank by the Act but this independence is limited by the powers granted to the Finance Minister and the Cabinet to prescribe monetary policy where they disagree with the monetary policy set by the Central Bank of Kenya¹⁴⁰.

The Ministerial powers as earlier mentioned appear to be in conflict with the provisions of the Constitution on independence as aforementioned and this in my view is an area for reform in the Kenyan legislation on central banking.

3.3.2 Monetary Policy

Section 2 of Act Number 9 of 1996 introduced Section 4B of the Act on Monetary Policy statements to be issued by the Bank at regular intervals. The Monetary Policy statements are to be

¹³⁶ Section 2, The Central Bank of Kenya (Amendment) Act, 1996.

¹³⁷ Gichuki, N. (2011) *Law of Financial Institutions in Kenya*, Law Africa, Nairobi, p.4.

¹³⁸ Section 4 (4), (5) and (6) of the Central Bank of Kenya Act.

¹³⁹ Section 4 B of the Central Bank of Kenya Act.

¹⁴⁰ Section 4C of the Central Bank of Kenya Act.

submitted to the Minister of Finance clearly specifying the policies and the measures by which the Bank intends to achieve the said policy targets, the reasons for adopting such policies and a review of the progress of the implementation of the monetary policy covered by the preceding policy statement.

The Minister is then required to lay the monetary policy statement before the appropriate committee of the National Assembly that is appointed to investigate and inquire into matters relating to monetary policy.

Further Section 4C of the Act provides that there shall be regular consultations in monetary policy between the Minister and the Bank and where the Minister is not satisfied that the monetary policy adopted by the Bank is in tandem with the principal object of the Bank he may direct that the monetary policy proposed by the Bank be withheld and the Minister shall prescribe the monetary policy to be implemented for a specified duration.

The Act also grants the Bank power to determine the interest rates in the economy by requiring the Bank to publish the lowest rate of interest (Central Bank Rate) it charges banks for advances to the specified institutions¹⁴¹ as well the manner in which the Bank would regulate the supply of money in the economy through open market operations with the approval of the Board of Directors¹⁴².

The provisions of the Central Bank Act on the manner in which the monetary policy is to be formulated and implemented is subject to abuse particularly by the government through the requirement that the Central Bank of Kenya must consult with the Finance Minister on a regular basis while the same Act stated that the primary mandate of the monetary institution is to manage price stability. While there is need for fiscal and monetary policy to be harmonized it is not clear why the Bank should consult with the Finance Minister on a regular basis unless this consultation is an avenue of seeking the approval of the Minister to adopt certain monetary policy.

In the Kenyan context, the Minister has the powers to set the inflation target¹⁴³ which is to be obtained by the Central Bank through formulating and implementing and appropriate monetary

¹⁴¹ Section 36 (4) Central Bank of Kenya Act.

¹⁴² Section 38 (1) Central Bank of Kenya Act.

¹⁴³ Section 4 (4) Central Bank of Kenya Act.

policy. By setting the price stability targets the Finance Minister gives the Government position on what it expect or plans to achieve in terms of monetary policy and prescribes the agenda to be pursued by the implementing agent, the Central Bank of Kenya.

The Act then presupposes that the Central Bank shall then be at liberty to use its instruments of monetary policy freely to achieve the target that has been set by the Government or the Finance Minister by specifying that the primary objective of the Central Bank is to pursue price stability. This means that the Central Bank would use the powers granted to it under the Act to achieve the price stability target set by the Government. The mandate of the Central Bank is already specified by the Finance Minister and any monetary policy formulated must be aligned to the price stability target.

The Central Bank Act by providing overriding powers to the Finance Minister in suspending the monetary policy adopted by the Central Bank appears take away instrument independence from the Central Bank. To this extent the independence of the Central Bank of Kenya is therefore limited. The powers reserved by the Finance Minister should for instance be limited to instances where the economic environment has changed rendering the monetary policy formulated by the Central Bank unrealistic.

If the Central Bank was to formulate a monetary policy that is against the price stability target prescribed by the Finance Minister then such a situation would call for disciplinary measures against the management of the institution and would require the intervention of the Finance Minister in formulating monetary policy.

In the absence of prescribed special circumstances where the Finance Minister or Government can intervene in monetary policy formulation then such legislation would be open to abuse by government and water down the independence of the Central Bank particularly considering the challenges proposed by the political agency theory as described here above¹⁴⁴.

3.3.2.1 Monetary Policy Committee

The Central Bank of Kenya (Amendment) Act, 2004 which came into force on the 1st August 2005 amended the 1966 Act by creating the Monetary Policy Advisory Committee. The amendment introduced section 4D that sets out the mandate of the Monetary Policy Committee as

¹⁴⁴ p.41.

formulating monetary policy. The creation of this specialized Committee within the Act demonstrated the importance of the primary objective of the Central Bank of monetary stability.

The members of the committee are the Governor of the Central Bank (the Chairman of the Committee), the Deputy Governors (deputies to the Chairman), two members appointed by the Governor from among the staff of the Central Bank (one with executive authority in monetary policy analysis and the other with responsibility for monetary policy operations), four other members who have knowledge, experience and expertise in matters relating to finance, banking, fiscal and monetary policy (appointed by the Minister of Finance to hold office for a term of three years with eligibility for one additional term) and the Permanent Secretary to the Treasury (or his representative) who shall be a non-voting member¹⁴⁵ .

The Chairman is required to convene a meeting of the committee once every two months and shall cause a report of the Committee to be submitted to the Minister every 6 months detailing the activities of the Committee and the Minister shall lay a copy of the report before the National Assembly¹⁴⁶.

In presenting the report of the Committee to the Finance Minister and Parliament the Central Bank is seen to be informing the Government on its efforts in implementing the monetary policy it had formulated as well as inform Government on any activities that may hamper the achievement of the monetary policy objectives or price stability targets prescribed by Government.

Other than the two staff members of the Central Bank appointed by the Governor, the other members of the Committee are appointed by the President (Governor and Deputy Governor) and the Minister for Finance.

The appointment procedure of the MPC members is premised on the appointment by Government since the members are appointed by the executive which in essence is similar to the appointment of the Board of Directors of the Bank.

¹⁴⁵ Section 4D (2) Central Bank of Kenya Act.

¹⁴⁶ Section 4 D (5) Central Bank of Kenya Act.

If the appointments to the MPC are made by the executive then one could presuppose that the interests and concerns of the government would be considered in the deliberations of the MPC and therefore the need to consult with the Finance Minister would be diminished.

3.3.3 Instrument versus Goal Independence

Section 2 of Act Number 9 of 1996 also defined the government's power to prescribe the price stability targets that the Central Bank of Kenya was to pursue. Sections 4 (4) and (5) required the Minister for Finance to give notice in writing to the Bank, at least in every 12 months specifying the price stability targets in consultation with the Bank.

The present Central Bank of Kenya Act provides the Bank with instrument independence since it is given the mandate to prescribe monetary policy as well as implement the same with a view of achieving price stability that may be prescribed by the Minister for Finance. The provision that allows ministerial direction on the level of inflation demonstrates that goal independence in Kenya rests with the Government.

There is however a limitation to extent to which the Bank can freely utilize the instrument of monetary policy since Section 4C allows the Minister to prescribe monetary policy for a period of 6 months where he together with the Cabinet are of the view that the monetary policy adopted by the Bank is inconsistent with the principal object of the Bank. In this instance the Bank shall upon receipt of a directive from the Minister for Finance adopt and implement the monetary policy that is prescribed by Government.

The power granted to the Minister under this section does not state or define what shall be considered as exceptional cases requiring the intervention of the Minister or that the Minister shall be required to make a basis for the directive given that is contrary to the position taken by the Central Bank.

Further the section does not specify what action is to be taken or which monetary policy is to be adopted after the expiry of the period specified in the directive by the Minister. Is the Central Bank then required to implement the "undesirable" monetary policy that Minister did not find appropriate?

The Monetary Policy Committee created by Section 4D is deemed to have the required expertise in formulating monetary policy and its membership also comprises of the Permanent Secretary to

the Treasury who is deemed to represent and protect the interests of Government in the formulation of monetary. There is in my view no need for further recourse to the Minister of Finance or to the National Assembly Committee on issues of Monetary Policy if the Committee on Monetary Policy is presumed effective in executing its mandate.

The section in its current condition provides for room for misuse by the Minister as it does not task the Minister to justify the basis for disagreeing with the Central Bank nor does the Act create a mechanism for accountability for the directive so given by the Minister.

In view of the disposition of government to create inflation one would deem it prudent to ensure that the exercise of such powers as provided in Section 4C is within defined limits so as to check the Minister's ability to make directives that may not yield long term benefits to the economy.

The power to the Minister grants the government a final say on the issue regardless of any conflict between the Bank and the Minister on the issue of monetary policy and this limits the autonomy of the Bank in exercising its function as monetary authority in as much as the Act prescribes that the Bank is granted the responsibility of formulating and implementing monetary policy.

Additionally, the requirement to place the monetary policy statement before the committee also demonstrates a degree of interference in the mandate of the Bank in regard to Monetary Policy. While the Committee is required to look at the proposed monetary policy, there is no provision as to what would happen in the event the House committee disagreed with the proposed Monetary Policy.

In my view the involvement of the Minister and the Committee is unwarranted and if at all the intervention is necessary there exists a gap in the manner in which a conflict between the Central Bank and the Minister or the appropriate House Committee would be resolved noting that the ultimate responsibility for monetary policy lies with the Central Bank of Kenya.

3.4 MINISTERIAL POWERS AND DECISION MAKING AT THE CENTRAL BANK OF KENYA

The finance minister will in most jurisdictions oversee the functions of the central bank. The powers that the minister of finance holds will include agenda control as well as discretionary

authority. In his capacity as the Minister of Finance he can limit the policy or proposals that are tabled before the Cabinet and the legislature which means that the minister can control the information that is presented to the Cabinet or the legislature on matters of monetary policy. By controlling the information on monetary policy the governor can indirectly determine the decisions taken by Cabinet say on monetary policy. The discretionary power granted to the minister on the other hand allows the minister to choose policies without the explicit approval of the legislature¹⁴⁷. These powers of the finance minister as provided for in the Central Bank of Kenya Act have a direct impact on monetary policy decision taken by the cabinet and legislature and in turn the autonomy of the central bank.

3.4.1 The institutional location of the final authority for monetary policy and the procedure for conflict resolution between government and bank

As stated here above¹⁴⁸ while the Central Bank of Kenya Act grants instrument independence to the Central Bank of Kenya, the same Act also grants the Finance Minister and the Cabinet power to set monetary policy where the policy set by the central bank is not acceptable. This provision of the Act gives the finance minister and the cabinet control over monetary policy and it therefore appears that the final decision on the monetary policy to be implemented is that approved by the Finance Minister. This provision of the Act is in conflict with the provision of the Constitution on the independence of the central bank more so where the powers to the Minister or the Cabinet are not limited or checked to ensure that the powers are not abused.

Section 50 of the Central Bank of Kenya Act provides that the Bank is required to advise the Minister on any matter which in its opinion is likely to affect the achievement of the principal objects of the Bank as specified in Section 4 of the Act. This section read together with the provisions on the Minister's powers on monetary policy shows that the Central Bank is subservient to the Minister of Finance as far as the implementation of its mandate is concerned.

The Act does not prescribe a mechanism for resolving a conflict between the Minister and the Central Bank which leaves the Minister with the final authority even in matters of monetary policy. Where for instance the Finance Minister and the Cabinet determine that the monetary

¹⁴⁷ William, B. (1998) "A Political Explanation of Variations in Central Bank Independence", *The American Political Science Review*, Volume 92, Issue 2, p. 3.

¹⁴⁸ p.75.

policy adopted by the central bank is not in line with the price stability target set by the Minister/government there is no room for representations by the central bank to explain or set a basis for adopting a particular strategy prior to the Minister of Finance prescribing the monetary policy to be implemented by the central bank say to the cabinet or the legislature on whom final responsibility for monetary policy lies. In a situation where there is a conflict between the policy formulated by the central bank and the position taken by the finance minister there should be the involvement of the legislature in determining the appropriate monetary policy to be adopted unless the circumstance do not allow for the intervention of the legislature in which case such exceptional circumstances should be clearly set out in the law.

Functional independence of the bank is curtailed particularly in the case of formulation and implementation of monetary policy in view of the powers granted to Minister of Finance.

3.5 ABILITY OF THE GOVERNMENT TO BORROW FROM THE CENTRAL BANK

3.5.1 Government as a client of the Central Bank of Kenya

The Act provides that the Central Bank of Kenya shall act as the fiscal agent of the Government. Section 46 of the Central Bank of Kenya Act provides that the Bank may direct advance to the Government for purposes of offsetting fluctuations between the receipts from the budgeted Revenue and payments of Government. Advances made to the Government shall be secured with negotiable securities issued by the Government which mature not later than twelve (12) months, bear interest at market rate and be made solely for the purpose of providing temporary accommodation to the Government. The total amount outstanding at any time shall not exceed 5 % of the gross recurrent revenue of the Government as shown in the Appropriation Accounts for the last year.

In this respect the transactions between the Central Bank and the Government appear to be at arm's length and the functional independence of the Bank as far as advances to government are concerned.

3.6 CONCLUSION

A critical analysis of the amendments made to the Central Bank of Kenya Act since 1966 shows that great strides have been made to increase the independence of the Bank however there is need for further amendments in the realm of formulation and implementation of monetary policy (functional independence) , governance (personal independence) and resolution of conflict between the view of the Bank and Government especially on matters to do with monetary policy which should be the jurisdiction of the Central Bank of Kenya.

The role by the Central Bank in monetary policy should be enhanced to remove any interference by government (dynamic inconsistency) and thereby giving credibility that the Central Bank proposes to implement. Since the Act has delegated instrument independence to the Bank then limits on the exercise of the tools of monetary control should be removed as the intervention by the Minister is considered unnecessary.

The index by Cukierman is interrogated by Atcharyachanvanich¹⁴⁹ who proposes a legal enforcement index as a way of modifying the Central Bank Independence Index developed Cukierman. In Cukierman's index it is found that legal independence and actual independence differs in developing countries and pursuant to an analysis of short and long term benefits of central bank independence a legal enforcement index was developed.

To compare the degree of level of enforcement five dimensions were identified as follows:-

- (i) Clarity of monetary objective;
- (ii) Accountability of the Central Bank Board in implementing monetary policy;
- (iii) Transparency of conducting monetary policy ;
- (iv) Balance coordination among the directors in the Central Bank board; and
- (v) Contingency measures against instability.

¹⁴⁹ Waranya, A. (2003) "The Legal Central Bank Independence and Macroeconomic Performance: An Empirical Study on Eighteen Developing Countries in the 1990s" *Forum of International Development Studies*, Vol. 23 pp. 201-221.

The legal enforcement index is instrumental in evaluating the legal framework adopted by a country's central bank in respect of the extent to which the law provides for mechanisms that allows for enforcement of the dimensions in the Atcharyachanvanich index and these shall be explored in Chapter Five which shall deal with recommendations on legislative and policy reform.

CHAPTER FOUR

COMPARATIVE STUDY: THE BUNDESBANK OF GERMANY AND THE CENTRAL BANK OF NIGERIA

4.1 INTRODUCTION

The focus of this chapter is to review the central banking law in Germany and Nigeria respectively while making a comparison between the legislation in each of the two countries with the provisions of the central banking law in Kenya.

The research has sought to look at the central banking law of Germany as it is lauded as having one of the most independent central banks in the developed world¹⁵⁰ as well as analyze a central bank in a developing country.

4.2 THE BUNDESBANK OF GERMANY

As stated earlier herein¹⁵¹ one of the justifications given by many countries for moving to an independent central bank regime is the success of the German central bank especially in managing the price stability in the country.

More importantly the model of central banking in Germany was set as the benchmark for all the countries wishing to join the European Union and was the guiding principle behind the provisions of the Maastricht Treaty in regard to the European Central Bank system (“ESCB”)¹⁵². The Deutsche Bundesbank is an integral part of the European System of Central Banks and participates in the performance of the ESCB’s tasks as stated in Section 3 of the Bundesbank Act.

¹⁵⁰ Issing, O. (1993), p. 9.

¹⁵¹ Chapter 2, p.37.

¹⁵² Arnone, M., Laurens, B.J. and Segalotto, J.F. (2006) “Measures of Central Bank Autonomy: Empirical Evidence for OECD, Developing and Emerging Market Economies”, *IMF Working Paper*, Number 06/228, p. 5.

The Bundesbank was created in 1957 replacing the Bank deutscher Lander (BdL) which was created by the Allied Military Governments in Germany. The Bank deutscher Lander had the role of coordinating the Lander central banks in each of the states occupied by America, France or Britain. The occupying powers in Germany at the time created an Allied Banking Commission which retained veto powers over the policies of the Bank deutscher Lander¹⁵³.

The Bundesbank's structure follows the pattern of federalism as there are regional offices in certain specified areas and are headed by a President who is subject to the authority of the Executive Board¹⁵⁴. The regional offices all act the main administrative branches of the Bundesbank, representatives of their economic circumstances and as listening posts for representative public opinion¹⁵⁵.

4.2.1 Objectives of the Bundesbank

4.2.1.1 The importance of price stability in comparison to other objectives of the Central Bank

The Bundesbank is considered one of the more independent central bank's since the law mandates the Bank to safeguard the currency of the country¹⁵⁶.

“In pursuing this objective, it is often regarded as the central bank with “a relative maximum of independence.”¹⁵⁷

Section 3 of the Bundesbank Act¹⁵⁸ provides that the primary objective of the Bundesbank shall be to maintain price stability.

¹⁵³ Kennedy, E. (1991) *“The Bundesbank Germany's Central Bank in the International Monetary System”*, Pinter Publishers Limited, London, p. 12.

¹⁵⁴ Section 8 of the Bundesbank Act, 1957.

¹⁵⁵ Kennedy, E. (1991) *supra*. pp. 18-19.

¹⁵⁶ Tietmeyer, H. “The Role of an Independent Central Bank in Europe”, in Downes, P. and Vaez- Zadeh, R. (eds.) (1991) *The Evolving Role of Central Banks*, International Monetary Fund (IMF), Washington p. 179.

¹⁵⁷ *Ibid*.

¹⁵⁸ The version of the Bundesbank Act referred to in this study is a translation prepared by the Deutsche Bundesbank for the convenience of English-Speaking readers and is not the official text of the Act.

This objective is supported by the institutional design of the Bundesbank which first obtains formal insulation from political influence and secondly by articulating an inflation target annually as well as establishing a target for growth of the key monetary aggregate¹⁵⁹.

The Act further provides other tasks that shall be performed by the Bundesbank which shall include holding and managing the foreign reserves of the country, arranging and executing domestic and cross border payments and contribute to the stability of payment and clearing systems.

From the foregoing provision the Bundesbank Act appears to first designate the primary objective of the Bank as maintaining price stability. The Act further goes to set out three (3) other functions to be played by the Bank which are key to the role played by the Bank as a monetary authority.

The Act is worded to specifically state the mandate of the Bundesbank so that the roles to be played by the Bank are explicit and can be measured against the stated objectives.

The provision of the Bundesbank on the principle objective of the Bundesbank is not as explicit as the provision in the Central Bank of Kenya Act which clearly refers to monetary policy as a key objective of the Central Bank of Kenya.

Further section 4 (3) states that in the event of a conflict between the role of the Central Bank of Kenya as a monetary authority and its role to support the economic policy of the Government then the objective of price stability would prevail. This provision therefore further enforces the dominant position that price stability should have in the objectives of the Central Bank of Kenya and should also direct the Central Bank of Kenya in making a decision when faced with a fiscal problem from Government.

The difference between the provisions of the Bundesbank Act and the Central Bank of Kenya Act in relation to the objectives of the two banks is that the Bundesbank has limited roles as a central bank compared to the Central Bank of Kenya which performs additional roles such as supervision of commercial banks.

¹⁵⁹ Clarida, R. H. and Gertler, M. "How the Bundesbank Controls Monetary Policy" in Romer, C. D., and Romer, D. H., (eds.) (1997) Reducing Inflation: Motivation and Strategy, University of Chicago Press, Chicago, pp. 363- 412.

The clarity of the objectives of the Central Bank of Kenya is however watered down by the influence that the Government has over monetary policy as described here above and thereby curtailing the independence of the Central Bank of Kenya.

4.2.1.2 Monetary Policy

Section 13 of the Bundesbank Act provides that the Bundesbank shall advise the Federal Government on monetary policy issues of major importance and shall furnish the Government with information on request.

The wording of this section suggests that the role of the Bundesbank is to formulate and implement monetary policy and then advise the Government. It appears that the Government does not play a role in the formulation of monetary policy. The Government may only invite the President of the Bundesbank to attend its deliberations on important monetary policy issues¹⁶⁰. By this requirement it appears that while the President of the Bundesbank may be called upon to attend the meetings of Government on monetary policy his position would be as advisor and not for purposes of being controlled to adopt any other monetary policy that the government considers suitable.

By virtue of this provision the Bundesbank is deemed to have control over monetary policy and the government's direct role appears to be prohibited by Section 12 of the Act.

There is a great difference in the structure adopted by the Bundesbank on monetary policy as compared to the Kenyan scenario where the Finance Minister is permitted to specify the price stability targets to be pursued by the Central Bank as well as issue directives of the monetary policy to be implemented by the Central Bank of Kenya.¹⁶¹

A criticism that is leveled against the provisions of the German central banking law in regard to monetary policy is that the Act does not specify the means by which the Bank shall execute its mandate as a monetary authority. The determination of goals for the Bank for instance is not

¹⁶⁰ Section 13 (2) of the Bundesbank Act.

¹⁶¹ Section 4 C (2), Central Bank of Kenya Act.

provided for as well as the manner in which the goals of the Bank shall be met¹⁶². The Act leaves the decision about what maintaining price stability is to the Bank.

4.2.1.3 Institutional versus Functional Independence

The Bundesbank appears to have both institutional and functional independence since the Bank seems to be free as an institution to determine the monetary policy it shall pursue and it is also free to determine the manner in which it shall apply the instruments of monetary policy without instruction from the Government.

By granting the Bundesbank autonomy on monetary policy the central bank has been able to pursue monetary policy with great success in managing inflation in Germany. It also ensures that there is no room for abuse of government influence in determining monetary policy which has been the case in developing countries.

4.2.2. Ministerial Powers and decision making at the Bundesbank

4.2.2.1 The institutional location of the final authority for monetary policy and the procedure for conflict resolution between government and bank

The Bundesbank Act provides at Section 12 that,

“In exercising the powers conferred on it by the Act, the Deutsche Bundesbank shall be independent of and not subject to instruction from the Federal Government.”

This section of the Act describes the relationship between the Bank and the Federal Government which basically provides that the Bundesbank shall act without direction or interference from the Government. The final authority on decision of the Bundesbank particularly on monetary policy rests with the Bundesbank and even in cases of conflict, the Bundesbank would prevail if the matter is within its statutory mandate.

It is this provision in the German central banking law that guarantees the Bundesbank independence from Government as it specifically provides that the Bank shall not receive any instruction from Government. It should be noted however that the independence of the

¹⁶² Kennedy, E. (1991) “The Bundesbank Germany’s Central Bank in the International Monetary System”, Pinter Publishers Limited, London, p. 22.

Bundesbank could be said to be limited by the people who are appointed to manage the affairs of the Central Bank since the appointment is political as mentioned herein.

This is a provision that is not seen in many central banking laws hence providing an environment in which the Bank acts free from government interference.

The wording in section 12 of the Bundesbank Act is almost similar to the provision of the Constitution of Kenya 2010¹⁶³ which provides that the Central Bank of Kenya shall not be under the direction or control of any person in the exercise of its powers or in the performance of its functions. In amending its Constitution, Kenya recognized the importance of an independent central bank so as to be able to make economic gains. However, while the principle of autonomy is upheld in the Supreme law of the country, the main legislation on central banking in Kenya does not provide for this autonomy thereby making a case for reform of this legislation.

Section 4 (3) of the Central Bank of Kenya Act therefore falls short of the requirement of granting the Central Bank of Kenya power to make its own decisions particularly in the domain of monetary policy due to the Ministerial powers granted by the Central Bank of Kenya Act. The provisions of the Central Bank of Kenya Act give the final authority on monetary policy on government even where the Central Bank may hold a different and justifiable view from that of Government.

4.2.3 Appointment of the Governor and Board of Directors

4.2.3.1 The Board of Directors

Section 7 of the Bundesbank Act provides that the governing body of the Bundesbank shall be the Executive Board of the Bundesbank and comprises of the President, the Deputy President and four other members who must have relevant professional qualification. The members of the board shall be appointed for a term of 8 years and shall deliberate under the Chairmanship of the President or the Deputy President.

The members of the Executive Board are appointed by the President of the Federal Republic of Germany. The President, the Deputy President and one member of the board shall be nominated by the Federal Government while the other three members shall be nominated by the Bundersrat,

¹⁶³ Article 231 (3).

(that is the Upper House of Parliament representing the federal states) in agreement with the Federal Government. The Bundesrat may make nominations to the Federal Government for the office of Deputy President.

The tenure of office of the members of the Executive Board is considerably long compared to the electoral cycle in Germany and therefore the chances of the government of the day to change the members of the Board are minimized. The tenure of appointment is an indicator of the personal independence of the central bank since the longer the tenure of office of the appointees compared to the length of the electoral cycle the less the likelihood that the government of the day will be tempted to appoint someone who would be influenced by the Government in power. In the Kenyan scenario the appointment of the non-executive directors has been staggered so that the members of the Board shall be appointed at different times so that the respective expiry dates of the members' terms of office shall fall at different times¹⁶⁴.

Roland Sturm has said the following about the tenure of the Executive Board:-

“There is no doubt that the major aim of the provision of the Bundesbank Act which gives the members of the Central Council a period of at least eight years in office , namely to decouple the timing of the selection of top officials of the Bundesbank from the calendar of parliamentary elections , has been achieved. Newly-elected governments on the Federal Republic have never had a chance to hand the bank over to their supporters in order to secure political obedience”¹⁶⁵.

The structure of appointment of the Bundesbank board is different from Kenya since although the appointments to the Board are by the President of the country, in the German case the President and Deputy President and one member of the Board are nominated by the Government while the other three members are nominated by the Upper House of Parliament that represents the federal states. We see a role played by Parliament in the appointment of the members of the Board whereby half the board is appointed through nomination by the Government and the other half appointed through nomination by the Upper House of Parliament. Parliament is involved in the

¹⁶⁴ Section 11 (3), Central Bank of Kenya Act.

¹⁶⁵ Kennedy, E. (1991) “The Bundesbank Germany’s Central Bank in the International Monetary System”, Pinter Publishers Limited, London, p. 16.

appointment process through nomination of suitable candidates as opposed to the Kenyan scenario where the appointment is done by the President with the approval of Parliament.

The other significant difference in the Executive Board (Germany) and the Board of Directors (Kenya) is that the Board of Directors in the Kenyan situation has a Chairperson who is not the Chief Executive Officer of the central bank. The position of a non-executive Chairperson introduces independence in the manner in which the Board operates as the Chairperson is not involved in the day to day activities of the central bank and would bring more value to the decisions of the Board as well as the governance of the Central Bank since he/she does not take an executive role in the affairs of the Central Bank of Kenya.

To this extent the model adopted by Kenya is superior in the sense that it introduces independence in the decision making process by having the position of an independent Chairperson¹⁶⁶. This however does not mean that the Executive Board of the Bundesbank is devoid of independence considering that the Act also provides that the Bank which includes its Board shall not be subject to the direction of Government. With this statutory provision it can be deduced that there would be no need to have a non-executive Chairperson on the Executive Board of the Bundesbank although best practice dictates that the Chief Executive Officer of an organization should not also hold the position of the Chairperson in its board of directors.

Another notable difference in the Boards of the two Banks is that the Kenya Central Bank has the Permanent Secretary to the Treasury (or his representative) who is a non- voting member. The Bundesbank board has no representation from Government in the Board which must be by virtue of the provision in the Bundesbank Act that disallows government involvement in the business of the central Bank.

4.2.4 Ability of the government to borrow from the Central Bank

4.2.4.1 Government as a client of the Bundesbank

¹⁶⁶ The Prudential Guidelines issued by the Central Bank of Kenya for Institutions licensed under the Banking Act, CBK/PG/02, pp. 32-33 requires that the Chairperson of a bank's Board of Directors shall always be a non-executive director. Independent non-executive directors must comprise the majority of the non-executive directors serving on the board. This is to ensure that the non-executive directors who should form a majority would render the necessary independence to the Board from the executive arm of the banking institution and help mitigate any possible conflict of interest between the policy making process and the day to day management of the institution.

If this structure of Boards for commercial banks assists the bank to arrive at better decisions then it follows that the Central Bank Board should assume a similar structure so as to enhance its structure.

The Bundesbank Act sets limits on direct central bank credit to the government. The law allows government paper to be acquired by the central bank in the course of open market operations that is for monetary policy purposes and not for the account of the Bundesbank.

The legislation places a cash advance limit of Euro 25 Billion¹⁶⁷ through the issuance of liquidity paper by the Government.

To the extent that the legislation provides for a limit on the amount that the government can borrow directly from the Bundesbank then the Central Bank can be considered financially independent.

4.2.5 Conclusion

A comparison of the provisions of the German central banking law and the Kenyan equivalent suggests that the Kenyan legislation has sought to mirror the tenets of the German law in particular the provision of the Kenyan Constitutions which mirrors almost word for word the Bundesbank Bank Act, section 12.

The process of appointing the members of the Board of the German Central Bank appears to be more rigorous as it involves the two Houses of its National Assembly. The involvement of the legislature in the appointment procedure is greater but appears to be politicized as compared to the process in Kenya which seeks to remove political control or influence in the appointment of the Governor or the Board Members.

The position of Chairman of the Board of Directors in German appears to be what existed in Kenya prior to the 2012 Amendment¹⁶⁸. While this model may be considered to be unsatisfactory from a governance perspective one can also take the view that the Bundesbank operates in an independent environment and therefore the Governor who acts without control from Government can also sit as the Chairperson of the Board of Directors.

The autonomy of the Bundesbank appears to be higher compared to the Kenyan central bank mainly due to the involvement of the Government in the formulation of monetary policy.

¹⁶⁷ Section 42 of the Bundesbank Act.

¹⁶⁸ Act Number 4 of 2012.

4.3 THE CENTRAL BANK OF NIGERIA

The law on central banking in Nigeria is contained in the Central Bank of Nigeria Act, 2007¹⁶⁹ which repealed the 1991 Act. The purpose of the new legislation was primarily to increase the efficiency of the Bank as well as the independence of Bank. The Central Bank of Nigeria took over from the West African Currency Board and was created by the 1958 Central Bank Act which came into effect on the 1st July 1959¹⁷⁰.

4.3.1 Objectives of the Central Bank of Nigeria

4.3.1.1 The importance of price stability in comparison to other objectives of the Central Bank

The Central Bank of Nigeria Act provides at section 2 for the five principal objects of the central bank namely to ensure monetary and price stability, issue legal tender, maintain external reserves to safeguard the international value of the legal tender currency, to promote a sound financial system in Nigeria and to act banker and advisor to the Federal Government on economic and financial matters.

The Act refers to monetary and price stability as one of the many objectives of the Central Bank and does not give prominence to this object in this section of the Act.

The Act however highlights the role of maintaining stability at section 1 (3) as one of the reasons for granting the Central Bank of Nigeria independence. In this section 1 (3) we may presume that the stability being referred to is price stability but a reading of the section in its entirety gives an understanding that the independence that is granted to the Central Bank of Nigeria is that required to execute its objectives under the 2007 Act as well as other Acts which give the central bank authority to act such as the Banks and Other Financial Institutions Act¹⁷¹.

¹⁶⁹ Commencement date being 25th May 2007.

¹⁷⁰ History of the Central Bank of Nigeria, www.cenbank.org accessed on 15th November 2012.

¹⁷¹ The 2007 Act introduced Section 1 (3) in an attempt to increase the independence of the central bank as this provision did not exist in the earlier legislation. Section 1 (3) provides “*In order to facilitate the achievement of its mandate under this Act and the Banks and Other Financial Institutions Act, and in line with the objective of promoting stability and continuity in economic management , the Bank shall be an Independent Body in the discharge of its functions*”.

The importance of price stability in the Nigerian context does not appear to be high since the object of price stability is merely put together with the other objects of the Bank.

The Kenyan legislation as compared to the Nigerian Act gives prominence to the object of price stability as it provides specifically that the principal object of the Central Bank of Kenya shall be to formulate and implement monetary policy and other objects of the Central Bank of Kenya are considered as secondary objectives.

From the foregoing analysis it can be deduced that the Nigeria legislation does not give clarity on the importance of price stability as a principle object for the Central Bank of Nigeria and is therefore one of the many objectives of the Bank.

4.3.1.2 Monetary Policy and the Monetary Policy Committee

Section 12(3) of the Central Bank of Nigeria Act provides that formulation of monetary policy and credit policy be determined by the Monetary Policy Committee¹⁷². A periodic report is required by the Board of Directors of the Central Bank of the Committee's meetings and activities¹⁷³.

Similar to the Kenyan legislation, the 2007 Act¹⁷⁴ also grants the Central Bank of Nigeria power to determine the interest rates in the economy by requiring the Bank to publish the monetary policy rate¹⁷⁵ as well the manner in which the Bank would regulate the supply of money in the economy through open market operations¹⁷⁶.

From an analysis of the provisions in this Act on monetary policy it appears that the final authority in setting and implementing the monetary policy to be pursued by the central bank lies with the Central Bank itself.

¹⁷² Section 12 provides, "*In order to facilitate the attainment of the objective of price stability and to support the economic policy of the Federal Government there shall be a Committee of the Bank known as the Monetary Policy Committee*".

¹⁷³ The Second Schedule to the Act on the Proceedings of the Monetary Policy Committee.

¹⁷⁴ Section 35, Central Bank of Nigeria Act.

¹⁷⁵ The monetary policy rate is the baseline interest rate upon which other interest rates are pegged.

¹⁷⁶ Section 28, Central Bank of Nigeria Act.

The Act does not provide for reporting mechanisms to the Minister of Finance on issues of monetary policy as is the case in Kenya nor does it grant the Minister of Finance power to intervene in matters of monetary policy and it can be presumed that the Central Bank of Nigeria has both the goal and instrument independence. The Governor of the Central Bank of Nigeria is nevertheless required to appear before the National Assembly semi-annually to report on the activities of the Central Bank in respect of monetary policy.

This provision of the Act seems to suggest that the Governor would report directly to the National Assembly on matters to do with monetary policy and that direct involvement in the formulation and implementation of monetary policy rests with the Central Bank of Nigeria¹⁷⁷.

4.3.2 Ministerial Powers and decision making at the Central Bank of Nigeria

4.3.2.1 The institutional location of the final authority for monetary policy and the procedure for conflict resolution between government and bank

As stated here above the Nigeria Central Bank Act does not endow the Minister of Finance powers in as far as monetary policy is concerned as is the case in Kenya.

The Governor of the Central Bank of Nigeria is however required to appear before the National Assembly at semi-annual hearings to report on the activities, objectives and plans of the Board with respect to monetary policy¹⁷⁸. This reporting gives the National Assembly an opportunity to interrogate the Bank's views on monetary policy as part of their democratic accountability role.

The Act also requires the Governor to keep the President informed of the affairs of the Bank including a report on its budget as well as make a formal report and presentation on the activities of the Bank and the performance of the economy to the relevant committees of the National Assembly¹⁷⁹.

¹⁷⁷ Section 8 (4) Central Bank of Nigeria Act.

¹⁷⁸ Section 8 (4) (a) Central Bank of Nigeria Act.

¹⁷⁹ Section 8 (5) (a) and ((b) Central Bank of Nigeria Act.

The reporting structure on monetary policy in Nigeria first lies with the Board of Governor (which also plays a role of formulating and implementing exchange rate policy¹⁸⁰) and the Board through the Governor reports to the National Assembly or an appropriate committee of the National Assembly. The reports to the President are for information purpose and not for consultation purpose as is the case with the Kenyan legislation which provides for regular consultation.

In this regard the final decision making authority on monetary policy in Nigeria appears to lie with the Central Bank of Nigeria.

4.3.3 Appointment of the Governor and Board of Directors

The Board of the Central Bank of Nigeria comprises of the Governor (also the Chairman of the Board), four Deputy Directors, the Permanent Secretary to the Ministry of Finance, five other directors and the Accountant General of the Federation.

The appointment of the Governor and four deputy governors shall be done by the President with the confirmation of the Senate and such appointment shall be for an initial term of 5 years subject to reappointment for a further term of 5 years¹⁸¹.

The non-executive directors shall be appointed by the President subject to confirmation by the Senate for a term of four years subject to reappointment for a further term of four years. In making the appointment the President is required to have regard to a fair representation of the financial, agricultural, industrial and commercial interests and the principle of federal character¹⁸².

The difference between the appointment process of the Nigeria board and the Kenya board is that the Kenyan legislation provides for transparency in the appointment process. In the Kenyan

¹⁸⁰ Section 6 (3) (c) Central Bank of Nigeria Act.

¹⁸¹ Section 8 Central Bank of Nigeria Act.

¹⁸² Section 10, Central Bank of Nigeria Act.

context it envisaged that those seeking appointment to the Central Bank Board will go through some form of vetting and not merely get appointed by the President.

In this regard the Kenyan process of appointment enhances the personal independence of the Board and the top management of the Bank as compared to appointment by the President with the approval of Parliament (Kenya) or the Senate (Nigeria).

There is also a concern with the person holding the position of the chairperson of the central bank in Nigeria which is similar to what existed in the Kenyan context prior to the 2012 amendments. In the Nigerian case the Governor is also the Chairperson of the Board of Directors and such a setting can limit the independence of the decisions taken by the board since it is chaired by an executive director.

4.3.4 Ability of the government to borrow from the Central Bank

4.3.4.1 Government as a client of the Central Bank of Nigeria

The Central Bank of Nigeria Act provides that the Bank may make advances to the Federal Government to meet temporary deficits in its budget revenue at such rates of interest as the Bank may determine¹⁸³.

The total amount of such advances shall not exceed 5% of the previous year's actual revenue of the Federal Government¹⁸⁴.

The Act further goes to stipulate sanctions against the Federal Government for failing to repay the advances before the expiry of the Federal Government's year in which the advance was made by specifying that the Central Bank shall not make advances to the Government in subsequent years¹⁸⁵.

¹⁸³ Section 38 (1) Central Bank of Nigeria Act.

¹⁸⁴ Section 38 (2), Central Bank of Nigeria Act.

¹⁸⁵ Section 38 (3) (a), Central Bank of Nigeria Act.

The provisions of the Nigeria legislation places limits on the amounts that can be advanced to the Federal Government. The short coming of this provision is that it does not specify the manner in which the interest rate chargeable on this advances shall be determined.

Like the Kenyan legislation the Act which specifies that the advances shall bear interest at market rate the Nigeria legislation should specify the manner in which the interest rate can be determined to avoid arbitrariness in setting the interest rate.

As indicated here above the provision on the repercussions for non-payment of advances to Government in the Nigeria legislation is an aspect of the legislation that the Kenyan Central Bank could borrow as it further enhances the independence of the Central Bank in terms of determining whether to advance to Government or not.

4.3.5 Conclusion

The evolution of central banking law in Nigeria has led to the enhancement of the instrument independence of the Central Bank of Nigeria which has in turn increased the operational efficiency of the central bank in terms of its ability to achieve its objective of price stability¹⁸⁶.

A major difference between the Central Bank of Nigeria and the Central Bank of Kenya is the manner in which matters of monetary policy are handled. The National Assembly in Nigeria has role to play in the manner in which monetary policy is implemented and is not left to the Finance Minister as is the case with the Kenyan legislation. An advantage of having the involvement of Parliament in monetary policy by way of periodic reports means that the legislature are in tune with the development of monetary policy in the country as required of them in their role of democratic accountability as opposed to leaving the matter in the hands of one person and or the Cabinet.

¹⁸⁶ Nnanna, O. J. (Dr.) "Monetary Policy Framework in Africa: The Nigerian Experience", (2001) Central Bank of Nigeria, Abuja, p.11.

4.4 CONCLUSION

An analysis of the two models reveals that there are strengths that the Kenyan legislation can adopt. For instance, although the German law seeks to protect the central bank from improper political influence, the Federal Government still plays a role in the appointment of the Executive Council. This power to appoint may affect the independence of the appointees. To ensure that the independence of the appointees is not watered down the Bundesbank Act enhances the personal independence of the Executive Council by providing for a long tenure in office that is not similar to the electoral cycle. The length of the term of office is an attribute of the German model that Kenya can borrow.

The Central Bank of Nigeria like the Bundesbank enjoys some autonomy in setting the monetary policy in the country as the Act does not provide for Government or Ministerial involvement as is the case in the Kenyan legislation. This monetary independence is another attribute of the two models that can be adopted by Kenya.

Lastly the limits on Government borrowing from the Central Bank of Nigeria is another area that Kenya legislation can emulate although it is not clear whether the provisions of the law are complied with strictly in practice. This may be an area of further research.

CHAPTER FIVE

CONCLUSION AND CASE FOR REFORM

5.1 INTRODUCTION

The law on central banking in Kenya has been successful in some respects in granting the Central Bank of Kenya some degree of autonomy.

A review of the four aspects of formal independence shows that the objective of the Bank is clearly specified and the limits of borrowing by Government are well defined. There is however a case for enhancing the independence of the Central Bank of Kenya in regard to the functional independence of the central bank as far as government involvement is concerned as well as in the appointment process of the members of the Board and the top management of the Bank.

This chapter shall propose amendment to aspects of the law that would further increase the independence of the Central Bank of Kenya.

5.2 RECOMMENDATIONS FOR REFORM

5.2.1 Monetary Policy Independence

The Central Bank of Kenya Act provides that the Central Bank of Kenya has the principal object of maintaining price stability. However the Act further goes to provide that the role of maintaining monetary policy shall in some respects be subject to the intervention of the Minister of Finance and the Cabinet.

This structure does not guarantee the Central Bank of Kenya autonomy since the Bank does not have full control over the monetary policy it is to formulate or implement. As stated earlier the Central Bank of Kenya is granted instrument independence that is the ability to formulate and implement monetary policy while the Government determines the general goal of monetary policy by setting the price stability targets. This structure of monetary policy appears to give the Central Bank of Kenya power to determine the means of achieving the price stability target set by Government but this independence is limited by allowing the Minister and the Cabinet to

prescribe monetary policy for a period of six (6) months in situations that are described by the Act as being exceptional.

Having studied other models of central banking a number of governments prefer a model where goals on price stability are controlled by Government and the means of achieving the target is left to the central bank since monetary policy outcomes are still the responsibility of the government irrespective of the delegation to a specialized institution such as the central bank. The concern is that in Kenya while instrument independence is granted to the Central Bank of Kenya, this independence is constrained by the powers reserved by the Minister (and the Cabinet) which appear to be broad. This concern in the Kenyan context is first that the term “exceptional” is not defined and secondly it is not stated who is to bear responsibility for the outcome of the short term monetary policy prescribed by government.

I. Institutional and Functional Independence

Monetary policy control may either be in terms of granting the Central Bank of Kenya autonomy in setting the entire monetary policy to be pursued by the Bank, that is both the institutional and functional independence where by the monetary policy target and the means of achieving the target is left to the Central Bank of Kenya or the alternative where monetary autonomy can be limited to only the functional independence wherein the government sets the monetary policy targets and the Central Bank left to determine the manner in which the target set by government is set .

The Constitution of Kenya seeks to grant the Central Bank of Kenya full autonomy where the monetary authority is free from the directive of any party either in terms of setting the monetary policy or the implementation of the same. The present prescribes that price stability targets should be set by the Finance Minister and to the extent that this target is a matter of Government policy for which ultimate responsibility shall be held by the executive then this provision can remain in the legislation.

The concern that needs to be addressed is the control that the Finance Minister has pursuant to section 4C which are widely drafted and should be amended. The directives to be given by the Finance Minister or Cabinet should be within defined limits such as the instances when they can determine that monetary policy formulated by the Central Bank is not in line with the price stability targets prescribed by Government.

The wording of Section 4C is to the effect that the Minister may suspend the implementation of monetary policy where “*he is of the opinion that the monetary policy adopted by the Bank is inconsistent with the principal object of the Bank*”.

This provision grants wide powers to the Minister (Cabinet) without specifying what can be considered as not being in line with the principal object of Central Bank. If this section would perhaps refer to the Central Bank not formulating monetary policy that is in line with the price stability target prescribed by Government then the powers granted to the Minister would be acceptable since it is likely that one can determine, based on prevailing market parameters that a particular monetary policy can either achieve the price stability target or not.

A further justification for granting instrument independence to the Central Bank of Kenya is that the Bank is to be measured and judged by a policy it has formulated it would be pragmatic for the Bank to set a monetary policy that rhymes with the fiscal environment. Granting the Central Bank independence does not mean that the Bank would act in isolation and completely ignore the fiscal position in the country but it would require that both authorities cooperate. It should also be noted that the monetary policy to be established by the Central Bank should be flexible since the real economic conditions may dictate that the Central Bank adopts a different strategy of monetary policy to deal with the countercyclical nature of the economy.

II. Central Bank Accountability and Transparency

The Central Bank of Kenya through the Governor can be required to present its intended monetary policy and report on the implementation of proposed monetary policy to Parliament at predetermined times so that democratic control over monetary policy is not eroded while at the same time holding the Central Bank of Kenya accountable to the monetary policy it proposes to implement. Reporting to Parliament will also enhance the capacity of Parliament to call on Government to answer on questions regarding fiscal policy that may hamper the implementation of monetary policy. This model has been adopted by the Central Bank of Nigeria Act where the Governor is required to appear twice a year to give a report to the National Assembly.

The Governor should be required to present the Monetary Policy that the Central Bank of Kenya considers as appropriate for the country given the existing and forecasted economic environment as well as the means of achieving the monetary policy having due consideration to the economic policies of the Government. Where the fiscal policies adopted by Government inhibit the success of the Central Bank of Kenya in pursuing its monetary objective then this should also be reported

to Parliament so that failure to meet the set monetary objectives are also explained to Government.

This model of monetary policy independence will mean that the Central Bank of Kenya will be accountable to Parliament for a policy it has itself formulated without the interference of other bodies.

To maintain the democratic accountability of Government over monetary policy instances where such intervention is required should be specifically stated in the statute and the mechanism of determining accountability for monetary policy proposed by Government prescribed. Establishing the circumstances when Government can intervene in monetary policy will incorporate transparency in the manner such intervention shall be effected. If the Government considers that the monetary policy adopted by the Central Bank of Kenya is not in line with objective of price stability, the reasons for such conflict should be specified and tabled by the Minister of Finance before Parliament by a statutory instrument for approval in place of Cabinet approval.

This procedure together with the periodic reporting by the Governor on matters of monetary policy to Parliament shall mean that Parliament will be continuously appraised of the monetary policy of the country and shall bear the ultimate responsibility of monetary policy and will be as opposed to relegating the function to a parliamentary committee.

III. Parliamentary Committee

Section 4B (4) of the Central Bank of Act defines the term “appropriate committee” as the Committee of the National Assembly appointed to investigate and inquire into matters relating to monetary policy.

This powers granted to this committee are in my view insufficient to assist Parliament in executing its responsibility over monetary policy since the committee only acts “after the event”. This means that the committee is either relegated to investigating failures of monetary policy or is merely notified of decisions on monetary policy after the Finance Minister has made a determination on a matter of monetary policy. For instance section 4 (6) (b) requires that the Minister of Finance lay a copy of the notice in which he/she has specified the price stability target before the appropriate committee of the National Assembly and section 4 B (2) of the Central Bank of Kenya Act requires the Finance Minister to lay the monetary policy prepared by the Central Bank before the appropriate committee of the National Assembly.

These provisions of the Central Bank of Kenya Act do not seem to require any debate or discussion by the Committee on the documents before it. It appears that their role is merely to note the contents of the documents.

The committee could be assigned a greater role in administering monetary policy by hearing the Governor regularly on matters of implementation of monetary policy. This regular appearances before the House Committee will ensure that both Parliament (through the Committee) and the Central Bank are always in tune with economic reality of monetary policy as the Central Bank will be required to explain its positions before the House Committee. The regular appearance before the Committee will also form a basis upon which Parliament can act to intervene in monetary policy in the so called “exceptional cases” as the hearings will inform Parliament on the monetary policy adopted by the Central Bank and where the committee finds that the monetary policy is in conflict with the primary object of the Central Bank it may recommend to Parliament to utilize its powers to suspend the monetary policy proposed by the Central Bank. The Committee should be mandated to make a report to Parliament on its assessment of the monetary policy being implemented by the Central Bank.

While this may not be an area of legal reform a practice can be developed that is in line with the above proposal so as to give the Committee more influence in matters of monetary policy as well as increasing the capacity and knowledge to deal with matters of monetary policy which is key to the economic growth of the country.

IV. Consultation with Government on Monetary Policy Issues

Section 4 C (1) of the Central Bank Act provides for regular consultation between the Finance Minister and the Central Bank. This section is silent as to what should happen in the event of a dispute over the monetary policy adopted by the Central Bank. This section together with section 4 C (2) which gives the Minister powers to suspend monetary policy demonstrates that the consultation is for purposes of obtaining approval of the Minister on the monetary policy.

The independence of the Central Bank of Kenya could be further enhanced if this provision was removed from the Act as it provides room for the Minister to justify his involvement in the monetary policy making process. This provision waters down the independence of the Central Bank if its intention is to obtain the approval of the Minister on monetary policy. If the consultation is merely to harmonize fiscal and monetary policy then the consultation would be appropriate.

The Central Bank should not be under any obligation to consult the Minister on matters regarding the formulation and implementation of monetary policy once the price stability targets have been prescribed by Government. Any consultations need not be legislated in the manner presently prescribed by the Act unless the same specifically refer to obtaining clarity on the price stability target prescribed by the Executive.

The Central Bank is a specialized institution that has competent staff to formulate monetary policy and have the resources required determining whether the monetary policy adopted will appropriately meet the requirements of the country. There is therefore no justification for the consultation with the Finance Minister (or Treasury) whose mandate is fiscal policy.

5.2.2 Personal Independence

The independence of the Central Bank of Kenya institutional, functional or financial is tied to the independence of the people in the managerial positions of the Bank. Like any corporate entity an institution is a good as its people. Whereas great strides can be made in enhancing the institutional independence of the Central Bank if the personal independence of the Bank is not similarly strengthened then the Bank may not be successful in achieving its mandate.

i. Tenure of Office

While the Finance Act 2012 and the proposed Central Bank of Kenya (Amendment) Bill, 2012 seek to introduced transparency in the manner in which the Chairperson, Governor and the two (2) Deputy Governors are to be appointed by requiring that the selection be through a transparent and competitive process, the amendments have not dealt with the issue of the tenure of office appropriately.

The tenure of the Governor who is the Chief Executive Officer of the Bank remains four years subject to an extension of a further term of four years. This term in my view limits the independence of the Central Bank considering the electoral cycle in Kenya is five years and this means that every Parliament can change the management of the monetary authority.

The tenure of the Governor should be longer than the four years if he/she is to oversee the successful implementation of monetary policy which by its very nature takes a long term view in

terms of yielding visible benefits for the country. Further as stated in chapter 3¹⁸⁷ the tenure of the governor should remove the element of reappointment as this provides room for the government to influence the governor's conduct who would wish to be reappointed and therefore act in the interests of the existing government. I would suggest an eight (8) year term with no eligibility for reappointment. This tenure is similar to that of the Director of Public Prosecution¹⁸⁸ and the Controller of Budget¹⁸⁹ under the new Constitution. Such tenure would give the Governor security in terms of the time he/she will be office and will not feel bound or pressured by the government of the day. The decisions of the Governor would be premised solely on the objects of the Central Bank and with accountability to Parliament.

Should the eight year term be considered as too long then consideration can be given to the contracting model in New Zealand where by the Finance Minister and the Governor enter into an appointment agreement stipulating the means by which the success of the Governor shall be measured and failure to meet the agreed targets would result in the removal of the Governor. The targets can be time bound during the tenure of the Governor and subject to review periodically so as to assess whether the Governor is on track to achieve the terms of the agreement. This proposal is in line with the performance contracting model adopted by the Government of Kenya for officers in Government and which form a basis for the appraisal of the government officials. It should be noted that such agreement should specify the circumstances when the Governor shall not be held accountable for the failure to meet the set targets as not all factors are within his control.

ii. Appointment Process

The Central Bank of Kenya Act proposes a competitive process for the appointment of the Bank's Board. The Act does not however specify the manner in which the process shall become transparent and competitive. The Act for instance does not suggest the body or entity that is to conduct the vetting so as to refer the suitable candidate to the President for appointment as is the

¹⁸⁷ p.68-69.

¹⁸⁸ Article 157 (5), Constitution of Kenya, 2010.

¹⁸⁹ Article 228, Constitution of Kenya, 2010.

case in the Judiciary where the Judicial Service Commission recommends the Chief Justice as well as the Deputy Chief Justice for appointment by the President¹⁹⁰.

To the extent the vetting process is not clearly defined by the statute there appears to be a limitation to the success of this process producing independent and unbiased candidates for the position of Governor, Deputy Governors and the members of the Board of Directors.

The process adopted should introduce independence in the process of receiving applications, vetting of applications and interviewing the candidates. This may call for the appointment of an external consultant or a Committee comprising of individuals who have not connection to the Central Bank to undertake the exercise to remove any element of interest in the person so appointed.

iii. Composition of the Board of Directors

The Central Bank of Kenya (Amendment) Bill, 2012 proposes to increase the number of non-executive directors appointed to the Central Bank Board to eight (8) as opposed to the current five (5).

The increase in the number of non-executive directors does not increase the independence or the efficiency of the Board. No justification can be given to a bloated Board of Directors especially in view of the new position of the Chairperson, a non-executive member of the Board and the removal of the Deputy Director in the composition of the Board.

The existing constitution of the Board of Directors is sufficient since the number of non-executive directors is greater than the executive Directors. There is only one executive director that is the Governor out of a total eight (8) board members noting that the Permanent Secretary to Treasury is a non-voting member of the Board.

The constitution of the Board should be enhanced by ensuring that the mix of skills and expertise on the Board is sufficient to guarantee soundness of the decisions of the Board which in turn translated to the independence of the Central Bank.

¹⁹⁰ Article 166 (1) (a), Constitution of Kenya, 2010.

5.3 CONCLUSION

Central banks have for a long time been struggling with the role of maintaining a sound banking system and have recently begun amending their respective legislation so to focus on the object of price stability as well as enhancing the independence of their respective central bank so as to achieve the primary object of the central bank as was the case in Nigeria which enacted a new central banking law. It should be noted that the changes in legislation in most cases follow the stage of economic development of a country¹⁹¹.

Central bank independence has been deemed as a necessary element in central banking since political leadership have a tendency to pursue short term monetary objectives so as to enhance their chances of re-election as well as change the policy even after making pronouncements on policy and thereafter changing them giving rise to surprise inflation. Monetary policy on the other hand is considered to be long term in nature and therefore should be placed in the hands of a central banker whose attitude is to avoid inflation as well as bring credibility to the monetary policy that is announced by the central bank.

To deal with the time inconsistency problem of monetary policy and to build credibility in the central bank institution, formal legislation has been one avenue of addressing the establishment of independence in the central bank thereby leading to a number of countries amending their respective laws on central banking.

In the Kenyan context we have ascertained that the object of price stability is clearly stated in the central banking law but the pursuit of this primary object is watered down by the powers given to the Finance Minister over monetary policy as well as the limitation on personal independence of the management of the central bank by virtue of their tenure in office.

Proposals have been made to enhance the degree of independence of the Central Bank of Kenya having considered other models of central banking in Germany and Nigeria which seem to have legislation that gives their respective central banks autonomy particularly on monetary policy issues.

¹⁹¹ Arnone, M., Laurens, B.J. and Segalotto, J.F. (2006) "Measures of Central Bank Autonomy: Empirical Evidence for OECD, Developing and Emerging Market Economies", *IMF Working Paper*, Number 06/228, p.16.

The Kenyan legislation by virtue of the provisions of the Constitution recognizes the importance of having an independent central bank and it is left to the legislators to revise the substantive central banking law in Kenya to reflect the intention of the Constitution.

Legislative reform will however not be sufficient in guaranteeing the Central Bank of Kenya independence since a change in political culture will also be required to achieve a suitable environment for the central bank in Kenya. Central Banks do not operate in a political vacuum and cannot separate themselves completely from Government control that may either be direct or indirect or from the political process¹⁹². The Government has a range of methods of exerting influence on the central bank regardless of the legal provisions and there is therefore a need for change in the manner in which the law is enforced. Transparency and accountability in monetary policy is important in achieving a change in the political culture. Atchariyachanvanich, W. (2003) proposes a legal enforcement model in which transparency and accountability are enshrined in the central banking law of developing countries in particular. He states,

“The degree of central bank independence should be accompanied by compatible level of accountability and transparency. While these legal enforcing mechanisms may well be embedded in the central bank law of industrialized countries, they are still insufficient in the case of developing countries”¹⁹³.

It is in considering the legal enforcement model that this paper has proposed transparency and accountability in the manner in which Government can involve itself in monetary policy in Kenya by involving Parliament in the decision making process where monetary policy is concerned.

In enhancing the independence of the Central Bank of Kenya it should be noted that the Government will still maintain control over the Central Bank through its legislative authority and should remain accountable for monetary policy through Parliament which hold democratic responsibility. Secondly, there should be a clear mandate to the Central Bank of Kenya for which it should be held accountable for and where government intervention is necessary. A mechanism for transparency and accountability should be provided for and lastly conflicts between government and the central bank should be resolved in a transparent manner that should involve

¹⁹² Beddies, C. H.,(2000) “Selected Issues Concerning Monetary Policy and Institutional Design for Central Banks: A Review of Theories”, *IMF Working Paper*, Number WP/00/140, p.4.

¹⁹³ Waranya, A. (2003) “The Legal Central Bank Independence and Macroeconomic Performance: An Empirical Study on Eighteen Developing Countries in the 1990s” *Forum of International Development Studies*, Volume 23. p.206.

Parliament which holds the ultimate responsibility for monetary policy as proposed in the recommendation for reform.

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