

## Table of Contents

|  | Page |
|--|------|
| 1. Objectives of the Central Bank .....                                    | 2    |
| 2. Legal Requirement for Production of Monetary Policy<br>Statements ..... | 3    |
| 3. Recent Monetary Developments .....                                      | 4    |
| 1.1 Money and Credit .....   | 4    |
| 1.2 Shilling Exchange Rate .....   | 5    |
| 1.3 Interest Rates .....   | 6    |
| 4. Banking Sector Stability .....  | 7    |
| 2.1 Overview.....  | 7    |
| 2.2 Further Measures to Strengthen Stability .....                         | 7    |
| 5. Inflation .....   | 8    |
| 3.1 Recent Developments.....   | 8    |
| 3.2 Outlook .....  | 8    |
| 6. Monetary Policy for the Next One Year .....                             | 9    |
| 4.1 Policy Objective.....  | 9    |
| 4.2 Monetary Programme .....   | 9    |
| 4.3 Instruments of Monetary Policy .....                                   | 10   |

## **OBJECTIVES OF THE CENTRAL BANK OF KENYA**

The Central Bank of Kenya objectives are laid down in the Central Bank of Kenya Act as:

### **Principal Objectives**

1. The first principal objective shall be to formulate and implement monetary policy directed to achieving and maintaining stability in the general level of prices
2. The second principal objective shall be to foster the liquidity, solvency and proper functioning of a stable market based financial system

### **Secondary Objectives**

Without prejudice to the generality of the above two principal objectives, the Bank's secondary objectives shall be to:

1. Formulate and implement foreign exchange policy
2. Hold and manage its foreign exchange reserves
3. License and supervise authorised dealers in the money market
4. Promote the smooth operation of payments, clearing and settlement systems
5. Act as a banker and adviser to, and as fiscal agent of the Government; and
6. Issue currency notes and coins

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## **LEGAL REQUIREMENT FOR THE PRODUCTION OF THE MONETARY POLICY STATEMENT**

This statement is made pursuant to Section 4(B) of the Central Bank of Kenya Amendment Act 1996, which states that:

- “4B.(1) The Bank shall at intervals of not more than six months, submit to the Minister a monetary policy statement for the next twelve months which shall -
- (a) specify the policies and the means by which the Bank intends to achieve the policy targets;
  - (b) state the reasons for adopting such policies and means;
  - (c) contain a review and assessment of the progress of the implementation by the Bank of monetary policy during the period to which the preceding policy statement relates.
- (2) The Minister shall lay every statement submitted under subsection (1) before the appropriate committee of the National Assembly not later than the end of the subsequent session of Parliament after the statement is so submitted.
- (3) The Bank shall –
- (a) cause –
    - (i) every monetary policy statement submitted under subsection (1); and
    - (ii) its monthly balance sheet to be published in the Gazette; and
  - (b) disseminate key financial data and information on monetary policy to the public.
- (4) In subsection (2), the expression “appropriate committee” means the committee of the National Assembly appointed to investigate and inquire into matters relating to monetary policy.”

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## 1. RECENT MONETARY DEVELOPMENTS

### 1.1 Money and Credit

Money supply, M3X, broadly defined to include currency held by the non-banking public and resident deposits both in local currency and foreign currency held with local banks, increased by shs 15bn or 4.4% in the year to November 2000. The money supply expansion was supported by shs 26.8bn build up of net foreign assets (NFA) by the Central Bank and commercial banks which more than offset the decline in their net domestic assets (NDA). The NFA build up reflected mainly external inflows associated with the Poverty Reduction and Growth Facility (PRGF) arrangements concluded in July 2000.

NDA of the banking system declined by shs 11.8bn or 4.1% during the year to November 2000, reflecting:

- Shs 18.3bn or 21.4% fall in other domestic assets of the banking system. The fall reflected both a build-up of capital and reserves and an increase in other liabilities over other assets of commercial banks.
- Shs 1.2bn or 1.5% reduction in net credit to Government. Net credit from Central Bank to the Government declined by shs 4.5bn, thus wholly offsetting an increase of shs 3.3bn in credit from commercial banks and NBFIs. This reflected build up in government deposits.
- Shs 7.7bn or 2.6% increase in credit to the private and other public sectors by commercial banks. Growth in bank credit to the private sector fell short of the expected 5% growth. This is partly attributed to the low demand for credit occasioned largely by the poor economic growth performance.

## 1.2 Shilling Exchange Rate

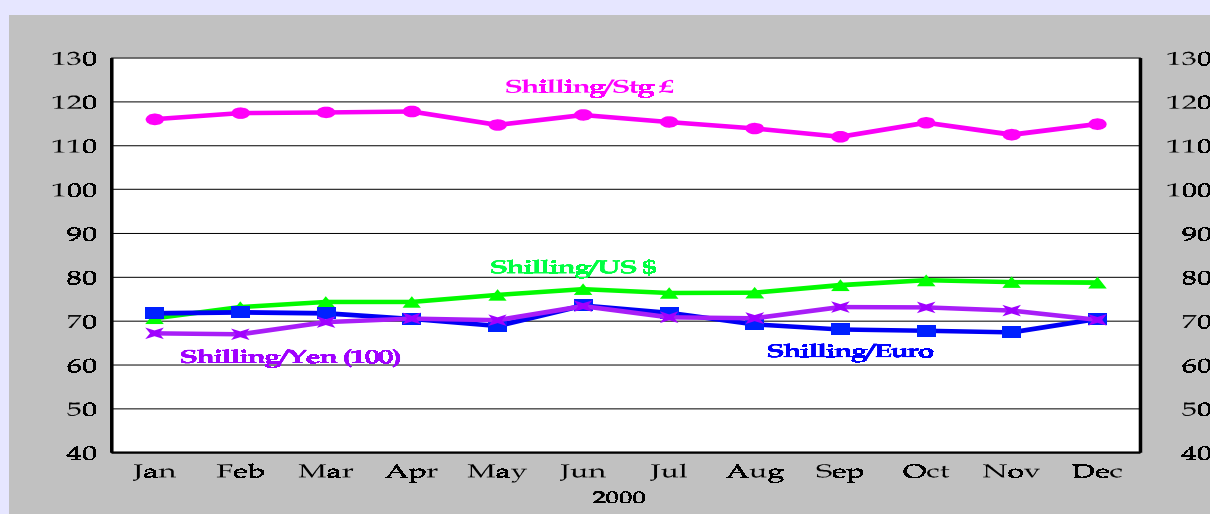
After remaining generally stable in the first half of Year 2000, the shilling experienced mixed performance during the second half of the year. It weakened to trade at shs 78.8 against the US dollar in December 2000 from shs 77.3 in June 2000. Meanwhile, it gained against the other principal currencies, notably, the Pound Sterling, the Euro and the Japanese yen to exchange at shs 114.9, shs 70.5 and shs 70.3 in December 2000 compared with shs 117.0, shs 73.6 and shs 73.4 in June 2000, respectively (Table 1 and Chart 1).

The weakening of the shilling against the US dollar in the second half of 2000 mainly reflected reduced forex receipts relative to their demand. Export receipts from horticulture, tea and coffee declined during the period under review. The fall in horticulture and tea export earnings was due to the current drought while coffee export earnings were adversely affected by the decline in international coffee prices. The adverse supply-side effects were further compounded by the strong foreign exchange demand for energy and food-related imports. Meanwhile, the strengthening of the shilling against the Pound and the Euro reflected the weakening of those currencies against the US dollar in the international currency markets.

**Table 1: Shilling Exchange Rate against the Major Currencies**

| 2000     | Jun   | Jul   | Aug   | Sep   | Oct   | Nov   | Dec   |
|----------|-------|-------|-------|-------|-------|-------|-------|
| US \$    | 77.3  | 76.4  | 76.5  | 78.2  | 79.3  | 78.9  | 78.8  |
| STG £    | 117.0 | 115.4 | 113.9 | 112.0 | 115.2 | 112.5 | 114.9 |
| EURO     | 73.6  | 71.9  | 69.3  | 68.1  | 67.8  | 67.4  | 70.5  |
| YEN(100) | 73.4  | 70.9  | 70.7  | 73.2  | 73.1  | 72.4  | 70.3  |

**Chart 1**



Source: Central Bank of Kenya

### 1.3 Interest Rates

Interest rates generally declined in the twelve months to December 2000 in line with the downward trend in the 91-day Treasury bill rate (Table 2 and Chart 2). The fall in interest rates partly reflected the excess liquidity in the domestic money market as demand for bank credit remained subdued due to the depressed economic growth, and partly reflected the reduction of the cash ratio requirement for banks from 12% to 10% effected in October 2000.

Interest rates evolved as follows:

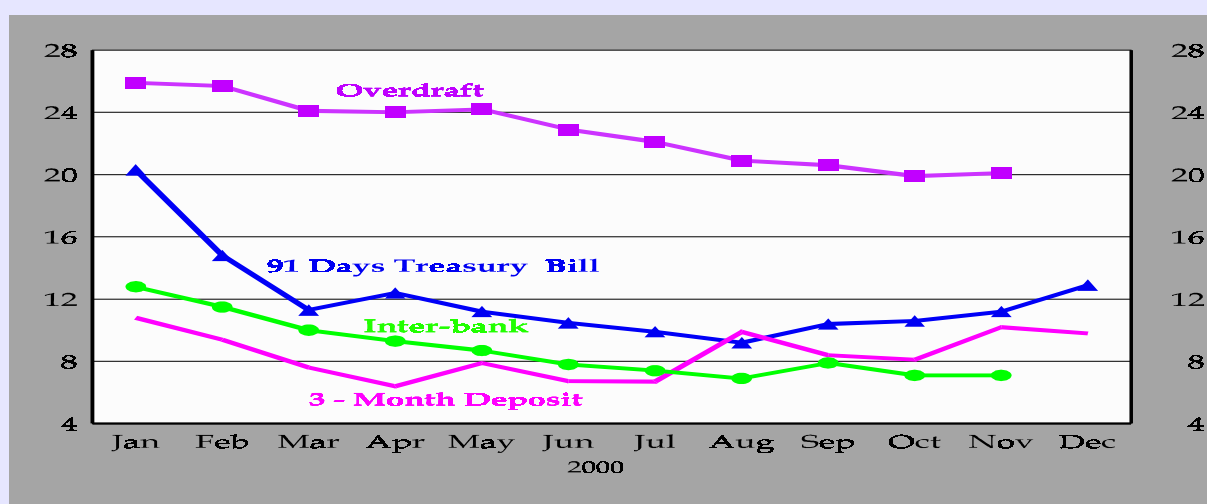
- Interest rates on the 91 –day Treasury bill fell to an average of 12.9% in December 2000 from 20.0% in December 1999.
- The lending rate as represented by the overdraft rate, fell from 25.6% in December 1999 to 20.1% in November 2000.
- The three months deposit rate offered by commercial banks fell from 12.3% in December 1999 to 7.1% in November 2000.
- The rate on savings deposits placed with commercial banks fell from 6.2% in December 1999 to 4.4% in November 2000.
- The overnight interbank rate fell to 9.9% in December 2000 from 13.0% in December 1999.

**Table 2: Interest Rates (%)**

| 2000                 | Jul  | Aug  | Sep  | Oct  | Nov  | Dec* |
|----------------------|------|------|------|------|------|------|
| 91-day Treasury Bill | 9.9  | 9.2  | 10.4 | 10.6 | 11.2 | 12.9 |
| Overdraft            | 22.1 | 20.9 | 20.6 | 19.9 | 20.1 |      |
| 3-Month Deposit      | 7.4  | 6.9  | 7.9  | 7.1  | 7.1  |      |
| Interbank Borrowing  | 6.7  | 9.9  | 8.4  | 8.1  | 10.2 | 9.9  |

\*Provisional

**Chart 2**



Source: Central Bank of Kenya

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## **2. STABILITY OF THE BANKING SECTOR**

### **2.1 Overview**

The banking sector remained relatively stable in the second half of Year 2000. Two previously closed banks, were reopened in January and April 2000. However, one commercial bank and a non-bank financial institution that were under statutory management were finally placed under liquidation in September 2000. The first half-year results indicate a slightly improved profitability for the sector in the Year 2000.

Measures undertaken in the Year 2000 by the Central Bank to further strengthen the banking sector included the following:

- (a) Issuing in July 2000 of a guideline on the enforcement of banking laws and prudential regulations. The guideline outlines various enforcement actions that the Central Bank of Kenya would take for violations noted during on-site inspections and off-site surveillance.
- (b) Strengthening of the foreign exchange exposure regulation by setting it at 20% of core capital of institutions. Moreover, the forex exposure was redefined to take into account off-balance sheet items denominated in foreign currency.

### **2.2 Further Measures to Strengthen Banking Stability**

For the next twelve months to December 2001, the Central Bank will continue to pursue policies put in place during the year 2000 to ensure the sector remains stable. These include:

- (i) Further strengthening of Bank Supervision Department through training of personnel and automation of the work processes.
- (ii) Proposing amendments to Building Societies Act in order to harmonise the operations of building societies with banking institutions.
- (iii) Formulating legislation to facilitate operation of Credit Reference Bureaus.
- (iv) Developing regulatory framework for micro-finance business.
- (v) Working closely with the three East African Central Banks to harmonise banking legislation and supervisory practices within the region.

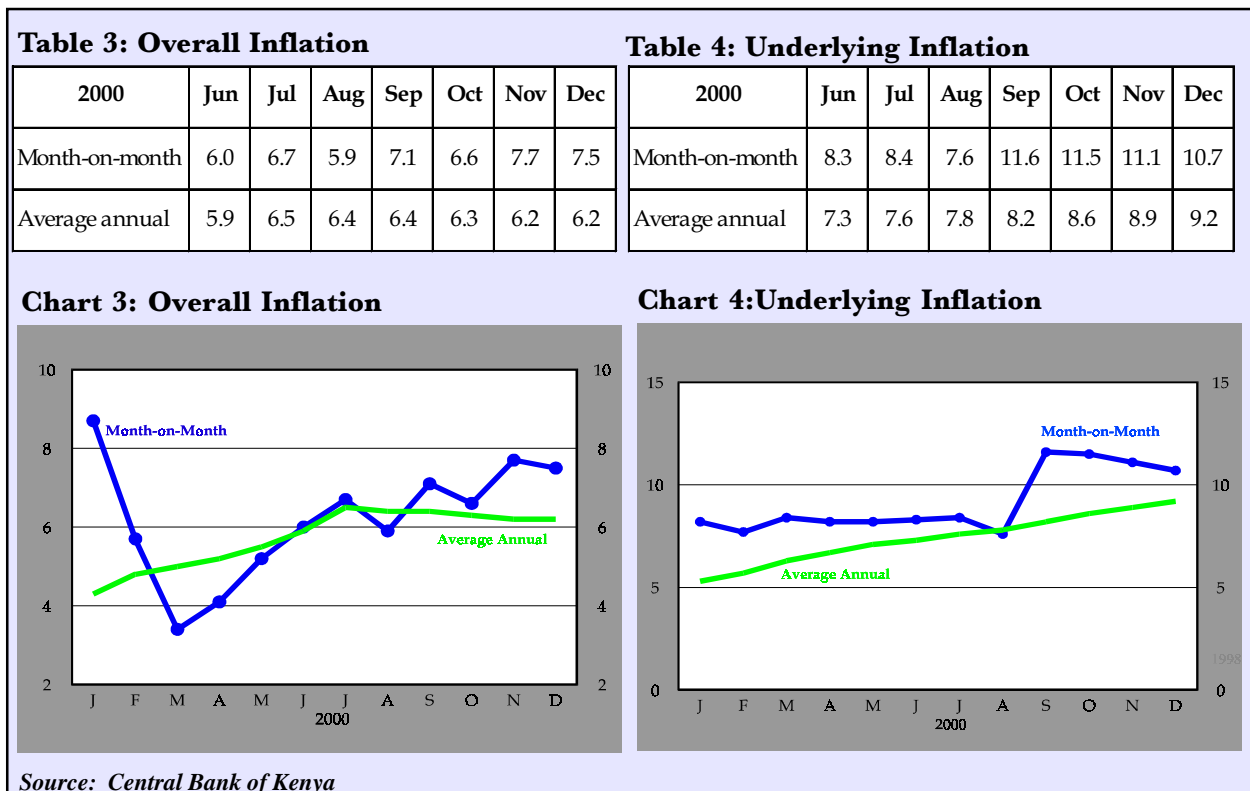
### 3. INFLATION

#### 3.1 Recent Developments

After remaining within a satisfactory range in the eight months of the Year 2000, inflation edged up to double digits in the last four months of the year mainly due to the effects of the depreciation of the shilling and the increased cost of crude oil in the international market. The overall month-on-month inflation increased to 7.5% in December 2000 from 5.9% in August. In the same period, the underlying month-on-month inflation rose to 10.7% from 7.6%, while the underlying average annual inflation increased from 7.8% to 9.2% (Tables 3 and 4 and Charts 3 and 4). However, the overall average annual inflation eased to 6.2% from 6.4% reflecting the improved supply of foodstuff during the second half of the year.

#### 3.2 Outlook

Our forecasts indicate that in the absence of monetary restraint, the upward trend in the underlying inflation is likely to continue in the months ahead. This reflects delayed effects of the depreciation of the shilling and the subdued production of goods and services in the economy.



## 4. MONETARY POLICY FOR THE NEXT ONE YEAR TO DECEMBER 2001

### 4.1 Policy Objective

The aim of monetary policy in Year 2001 is to continue to underpin sustainable growth in income and employment in Kenya by containing inflation to the desired 5% target. As already noted, prospects are strong for inflation to continue rising in the months ahead. This suggests that firmer monetary conditions than prevailed through the December quarter are appropriate.

### 4.2 Monetary Programme

To attain the 5% underlying inflation target and accommodate the expected 2% growth in real economic activity in the Year 2001, the Central Bank will contain the increase in the money supply, M3X, to around shs 25.9bn or 7.0% in the year (Table 5). Reserve money, the basis for the money supply expansion process, is programmed to increase by 1.1% in the year to December 2001.

|                                    | 1999        | 2000        | 2001         |              | Annual Change (%) |
|------------------------------------|-------------|-------------|--------------|--------------|-------------------|
|                                    | Dec. (Act.) | Dec. (Est.) | Jun. (Proj.) | Dec. (Proj.) |                   |
| <b>1. Money supply (M3X)=(2+3)</b> | 345.9       | 365.0       | 375.6        | 390.9        | 7.0               |
| 2. Net foreign assets              | 54.5        | 81.5        | 76.4         | 85.2         | 4.5               |
| 3. Net domestic assets             | 291.4       | 283.5       | 299.3        | 305.7        | 7.8               |
| Government borrowing from:         | 84.1        | 78.9        | 75.8         | 74.6         | -5.5              |
| Commercial banks                   | 58.4        | 56.4        | 57.8         | 57.8         | 2.6               |
| Central Bank                       | 25.7        | 22.5        | 18.0         | 16.7         | -25.7             |
| Private sector credit              | 285.6       | 295.0       | 323.6        | 329.5        | 11.7              |
| Other domestic assets net          | -78.3       | -90.4       | -100.2       | -98.3        | 8.7               |
| <b>4. Reserve Money</b>            | 79.0        | 77.7        | 75.5         | 78.6         | 1.1               |
| Currency outside banks             | 42.9        | 46.3        | 41.4         | 46.1         | 1.0               |
| Bank reserves                      | 36.1        | 31.4        | 34.0         | 32.4         | 3.1               |

The projected expansion in the money supply in the year reflects the following:

- An increase of shs 3.7bn or 4.5% in the banking system net foreign assets (NFA). The build up will be wholly in the Central Bank foreign reserves which is to increase from the current 3.1 months cover of imports to 3.3 months by end of December 2001.

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- Expansion in credit to the private sector of shs 34.5bn or 11.7%.
  - A projected shs 4.3bn net reduction in government indebtedness to banking system in line with the Government intentions of reducing domestic debt as stated in the Poverty Reduction and Growth Strategy Paper.
  - A reduction of shs 7.9bn in other net domestic assets of the banks.

### 4.3 Instruments of Monetary Policy

The Bank will continue to use open market operations, including repurchase agreements (repos), required reserve ratio and rediscount policy to regulate domestic credit and money supply in the economy. In addition, the Bank will continue to supplement these instruments with discounting facilities to provide needed liquidity to the economy.

- **Open Market Operations (OMO):** The Bank will, from time to time, buy and sell Treasury bills or any other stipulated Government paper in the open market to affect the level of reserves in the domestic money market as monetary conditions require.
- **Repurchase Agreement (Repos):** The Bank will engage in repurchase and reverse repurchase agreements with a view to regulate liquidity in the banking system to ensure it is in line with the economy's requirement. Decisions on repos will be made on a daily basis in line with daily forecasts of banks' liquidity position relative to the set targets.
- **Required reserve ratio:** The requirement that commercial banks hold a specified minimum cash deposits at the Central Bank relative to their deposit liabilities will be maintained.
- **Rediscount facilities:** As the lender of last resort, the Central Bank will, through its rediscount window, provide liquidity to commercial banks but in a manner that will not compromise the adopted monetary policy stance for Year 2001.