CENTRAL BANK OF KENYA

The Eleventh Monetary Policy Statement

Issued under the Central Bank of Kenya Act, Cap 491

December 2002

Monetary Policy Statement December 2002

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OBJECTIVES OF THE CENTRAL BANK OF KENYA

Principal Objects of the Bank

The principal objects of the Bank as laid down in the Central Bank of Kenya Act shall be to:

(i) formulate and implement monetary policy directed to achieving and maintaining stability in the general level of prices; and

(ii) foster the liquidity, solvency and proper functioning of a stable market-based financial system.

Secondary Objects of the Bank

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

(i) formulate and implement foreign exchange policy;

(ii) hold and manage its foreign exchange reserves;

(iii) license and supervise authorised dealers in the money market;

(iv) promote the smooth operation of payments, clearing and settlement system;

(v) act as a banker and adviser to, and as fiscal agent of the Government; and

(vi) issue currency notes and coins.

LEGAL BASIS FOR THE PUBLICATION OF THE MONETARY POLICY STATEMENT

This Statement is made pursuant to Section 4(b) of the Central Bank of Kenya Act, which states that:

(i) 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.

(ii) 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.

(iii) The Bank shall:

  (a) cause every monetary policy statement submitted under subsection (1) and its monthly balance sheet to be published in the Gazette; and

  (b) disseminate key financial data and information on monetary policy to the public.

(iv) In subsection (ii), the expression ‘appropriate committee’ means the committee of the National Assembly appointed to investigate and inquire into matters relating to monetary policy.

1. Implementation of Monetary Policy for the Twelve Months to June 2003

1.1 Key Elements of the Policy

Inflation control remained the key focus of monetary policy

The monetary policy stance adopted during the twelve months to June 2003 aimed to contain inflation at below 5%. The policy stance was designed to allow real gross domestic product (GDP) to increase from 1.2% in 2001, to 1.8% in 2002, and 2.8% in 2003.

The impetus for higher growth in domestic output was expected to come from the agricultural sector. Good growth performance of agriculture would in turn spill over to the other sectors through their strong linkages with agriculture. The expected upturn in agriculture hinged on continuation of the favourable weather conditions that prevailed in 2001. With adequate rains in most parts of the country, agricultural production had increased substantially while hydro-electric power supply had normalized. These developments impacted favourably on manufacturing and services sectors.

A stable macroeconomic environment was forecast throughout the year. Interest rates had been downward since July 2001 and expected to stabilize at lower levels over the program period. In addition, the shilling exchange rate had remained relatively stable, and economic fundamentals pointed to continued stability in the period ahead. Various tax measures introduced in the budget for fiscal year 2002/03, in particular reduced duty and VAT rates on raw materials, machinery and other intermediate inputs were expected to impact favorably on domestic output.

Furthermore, the expected restoration of relations with the IMF in the early part of the fiscal year 2002/03 had revived hopes for the release of external budgetary support from Kenya's principal development partners. This was critical for the restoration of business confidence, which had continued to decline since the suspension of the IMF support in late 2000.

On external sector, the monetary program had assumed US $ 99m build up in the Central Bank's unencumbered gross foreign exchange reserves by June 2003 from US $ 900m in June 2002. The envisaged reserve build up was to comprise the purchase of foreign exchange from the local inter-bank market. Foreign reserves were forecast at about 3.4 months cover of imports of goods and non-factor services. Meanwhile, domestic financing of the budget deficit was expected to decline to Ksh 33bn from Ksh 38.9bn in the year to June 2002. The reduction in domestic financing was to ease pressure on domestic interest rates and free resources to support production in the private sector.

Economic growth scaled down as investor confidence declined

Consistent with strong indications that the pace of economic growth had slackened considerably due to deteriorating investor confidence, the Central Bank reviewed the monetary program in November 2002. The slackening economic growth was also attributed to general unfavourable factors, including the perceived uncertainty associated with the general elections held in late December 2002, failure to restore external financial support from our main development partners, and poor infrastructure facilities, particularly the dilapidated road network, inefficient telecommunications and the high cost of electric power. With the GDP growth estimated at 0.7% per annum in the first eight months of 2002, the growth forecast for 2002 was scaled down from 1.8% to 1.2%.

Taking into account the revised forecasts for real GDP growth, as well as inflation and foreign exchange targets, money supply (M3X)[1] growth was programmed to accelerate from 6.5% in the year to December 2002 to 7% in the year to June 2003 (Table 1). Reserve money[2], which forms the basis of monetary expansion, was projected to increase by 4.9% in the twelve months to December 2002, and accelerate thereafter to 6.6% in the year to June 2003.

TABLE 1: MONETARY PROGRAMME FOR JUN 2002 - JUN 2003 (Ksh m)

	2002			2003	
	Jun Act	Sep Act	Dec (Proj)	Mar (Proj)	Jun (Proj)
1. Monetary Survey					
Money supply (M3X)/2	378,276	387,365	392,291	399,424	404,856
	(6.7)	(8.4)	(6.5)	(9.1)	(7.0)
Net Foreign Assets/2	97,040	96,992	98,432	99,887	102,075
	(6.4)	(4.6)	(4.7)	(4.7)	(5.2)
Net Domestic Assets/2	281,236	290,374	293,859	299,537	302,781
	(6.7)	(9.7)	(7.1)	(10.7)	(7.7)
2. Central Bank Balance Sheet					
Reserve money/2	76,881	78,589	83,010	81,895	81,951
	(10.9)	(5.0)	(4.9)	(8.1)	(6.6)
Net Foreign Assets/2	77,832	76,165	77,744	79,350	81,690
	(16.5)	(4.1)	(2.8)	(2.2)	(5.0)
Net Domestic Assets/2	-951	2,424	5,266	2,544	261
	(-138.0)	(-172.0)	(49.8)	(-235.0)	(-127.4)

1/ Actuals end-months, and expected monthly averages for CBK balance sheet projections
2/ Figures in parentheses represent annual percentage changes.
Source: Central Bank of Kenya

[1] Broad money supply, M3X, is the intermediate target of Central Bank monetary policy. M3X is defined to include currency held by the non-bank public and Kenya shilling and foreign currency denominated deposits of the non-bank private sector.

[2] Reserve money comprises deposits of banking institutions held with the Central Bank, plus currency in circulation.

1.2 Progress in Implementation of Monetary Policy, July - December 2002

Reserve money was slightly ahead of target

The Bank closely monitored and used deviations in reserve money from the desired path to guide daily decisions on monetary policy operations. Except for July 2002, reserve money exceeded the targets during the period under review (Table 2). The excess reserve money originated from net domestic assets (NDA) of the Bank as the net foreign assets (NFA) remained below monthly targets. Furthermore, within the NDA the excess reserve money was due to substantial rundown of government deposits and use of overdraft facility at the Central Bank beyond indicative program levels. Over the period, the liquidity mop up operations conducted by the Bank could not access the liquidity injections through the Government budgetary operations, which were translated as currency held by the non-banking public.

TABLE 2: PERFORMANCE OF RESERVE MONEY, DEC 2001 - DEC 2002 (Ksh m)

	2001	2002						
	Dec	Jun	Jul	Aug	Sep	Oct	Nov	Dec
1. Liabilities								
Reserve Money								
Actual	78,082	77,285	77,892	79,051	79,228	78,995	82,207	86,152
Target	76,627	76,000	78,575	78,719	77,769	76,657	78,600	83,010
Deviation	1,455	1,285	-683	332	1,459	2,337	3,607	3,142
%	1.90	1.69	-0.87	0.42	1.88	3.05	4.59	3.78
2. Assets								
Net Foreign Assets								
Actual	75,146	77,628	76,962	75,657	76,065	75,463	73,021	70,848
Target	72,912	76,268	78,797	78,914	79,156	79,368	80,048	77,744
Deviation	2,234	1,360	-1,835	-3,257	3,091	3,906	-7,027	-6,895
Net Domestic Assets								
Actual	2,936	-343	930	3,393	3,163	3,532	9,186	15,303
Target	3,715	-268	-222	-195	-1,387	2,711	-1,448	5,266
Deviation	-779	-75	1,152	3,588	4,550	6,243	10,634	10,037

Source: Central Bank of Kenya

Growth in virtually all monetary aggregates accelerated

Largely reflecting the expansionary reserve money path, broader domestic liquidity measured by money supply, M3X, exceeded monthly targets over the second half in 2002. M3X growth accelerated from 6.7% in June to 10.2% in December 2002 and was well above the 6.5% target. A significant share of the monetary expansion was attributed to growth in domestic credit to both the Government and the private sectors, and to a lesser extent to a build up in net foreign assets held by commercial banks. Between July and December 2002, net credit to Government increased by Ksh 13.8bn or 14.6% and accounted for 50.0% of the Ksh 27.7bn monetary expansion, while credit to the private sector expanded by Ksh 9.1bn or 3.7%, representing 32.8% of the of the growth in money supply. Over the period under review, credit extended to the private sector by the banking institutions rose steadily by 7.4% annually.

TABLE 3: EVOLUTION OF SELECTED MONETARY AGGREGATES (ANNUAL PERCENTAGE CHANGES)

	RM		M3		M3X		M3XT	
2001	Act.	Targ.	Act.	Targ.	Act.	Targ.	Act.	Targ.
December	1.8	2.4	2.5	5.7	2.3	5.3	6.1	10.3
2002								
January	3.4	2.8	2.0	7.3	0.0	5.4	4.3	9.1
February	4.4	2.7	4.4	8.6	3.1	7.0	7.3	10.4
March	8.2	2.2	3.9	6.9	2.1	5.2	5.7	8.4
April	2.5	2.8	4.2	5.3	2.0	3.4	6.3	7.4
May	8.0	5.7	6.1	5.9	4.8	4.6	7.5	6.8
June	10.9	9.7	8.5	6.4	6.7	4.9	8.4	6.3
July	16.7	10.4	8.7	4.7	7.6	4.4	8.6	5.7
August	5.0	6.6	11.3	5.6	10.9	5.2	11.6	8.5
September	12.6	5.3	8.1	5.2	8.4	4.8	11.4	9.0
October	6.9	6.3	7.2	1.2	7.0	1.5	10.6	7.4
November	8.7	6.4	8.4	1.6	9.6	1.9	15.8	6.5
December	11.8	4.9	8.8	6.8	10.2	6.5	12.8	10.3

Source: Central Bank of Kenya

Inflation remained subdued

Inflation remained well below the 5% target during the second half of 2002. The overall 12-month inflation eased from 2.2% in July 2002 to 1.8% in August and September before rising, respectively, to 2.7% and 4.1% in November and December 2002. The 12-month underlying inflation, which excludes food and energy prices, declined from 2.0% in July 2002 to 1.4% in September but rose to 2.0% and 2.4%, respectively, in November and December 2002.

TABLE 4: INFLATION (%)

	2001					2002						
	Jan	Mar	Jun	Sep	Dec	Jan	Mar	Jun	Sep	Oct	Nov	Dec
Overall												
12-month/[3]	12.0	9.5	4.6	3.1	1.8	0.4	1.9	2.8	1.8	1.9	2.7	4.1
Annual average/[4]	10.2	10.7	10.1	8.1	5.8	4.8	3.5	2.3	1.8	1.7	1.7	1.9
Underlying												
12-month	5.9	5.2	5.4	5.5	5.0	4.1	4.1	3.7	1.7	1.8	1.9	2.7
Annual average	5.2	5.3	5.4	5.4	5.5	5.3	5.1	4.6	3.7	3.4	3.1	2.9

Source: Central Bank of Kenya

[3] The rate of change in the CPI over the same month in the previous year, sometimes referred to as the "annual" rate of change.

[4] Percentage change in the average CPI for the last 12 months over the average CPI for the previous 12-month period.

Inflation remained subdued and well under control during the review period largely due to the sustained implementation of a prudent monetary policy and the judicious approach towards stabilizing the shilling exchange rate. An upward trend in domestic prices, however, emerged during the last quarter of 2002, notably in the prices of basic food items such as maize products and green groceries, and costs of housing and petroleum products. The temporary seasonal increase in household demand during the December festivities and the general election period also contributed to the modest inflationary pressures.

2 MONETARY POLICY DURING 2003

2.1 Current Economic Situation

2.1.1 Inflation

As shown above, inflation was successfully confined within the 5% target throughout the second half of 2002. The success in keeping inflation at the desired level was attributed to the sustained implementation of a prudent monetary policy supported by the skillful management of the shilling exchange rate.

2.1.2 Domestic Output

Recovery pace remains modest

Leading economic indicators for the first ten months of 2002 show that the economy continued to recover during the year, though at a slower pace than envisaged. Real GDP is estimated to have grown by 0.9% in 2002 compared with the original forecast of 1.2% for the year. The slowdown in economic recovery during the period reflected lowered investor confidence associated with the perceived uncertainties that surrounded the general election period, delay in the restoration of external financial support and the high cost of transacting business in the country. The factors that continue to impede development on business include the dilapidated road network that continues to impact adversely on the distribution system, inefficient telecommunications network, and the high incidence of corruption, amongst others. The performance of the key sectors during the period was as follows:

- Activity in the agricultural sector was supported by strong production of horticultural crops for export, sugarcane and food crops except maize and livestock. Production of other crops such as coffee, tea, pyrethrum and sisal, however, declined.

- Manufacturing was supported by the easing of restrictive policies within the East African Community (EAC) and COMESA and the opening of the textiles market in the United States through the African Growth and Opportunities Act (AGOA).

- The vibrant investment in cellular phone network continued to be the main driving force in the telecommunications sector.

- Bad and doubtful debts remained the main impediment in the financial sector, while tourism suffered adversely from the perceived uncertainty during the period leading to the general elections and from deterioration in the global political environment.

2.1.3 Outlook

Despite weakened outlook for global economic recovery, the country's growth momentum is projected to accelerate to 3.0% in 2003. The prospect for the accelerated economic recovery has been attributed to renewed investor confidence in the economy after both peaceful general elections and transition period, expected reduction in the cost of transacting business through renewed commitment by the Government to fight corruption and to implement key reforms in various sectors of the economy, and the real prospects for resumption of donor support in 2003. Moreover, increased access to external markets accruing from the reduction of restrictive trade practices by the country's major trading partners will continue to boost economic activity, in general, and the manufacturing sector, in particular.

Temporary and seasonal influences on domestic prices such as the increase of prices of petroleum and related products, coupled with shortages of goods and services that are likely to emanate from the effects of the expected heavy rains on the already inefficient transportation and distribution network, are expected to exert upward pressure on prices in the short-run. The pressure on prices is, however, expected to be moderated by the Bank's continued commitment to pursue a prudent monetary policy and a stable shilling exchange rate regime.

2.2 Monetary Programme for January - December 2003

2.2.1 Objectives

Monetary policy to continue focusing on inflation control

During the year, the Central Bank will continue to pursue, as in the previous year, a monetary policy that aims to contain inflation within 5% while supporting the projected 3.0% economic growth. The Central Bank will also build its unencumbered gross foreign exchange reserves to US $1.2bn by December 2003 from US $0.9.bn as at end December 2002. In view of the additional expenditure expected from new financial commitments that include provision of universal primary education and affordable general health care, the Government projects a rise in the domestic financing to Ksh 57bn from the initial estimate of Ksh 32.6bn for the year to June 2003. With current donor pledges at Ksh 10.3bn, the Government is expected to finance the balance of Ksh 46.7bn from domestic sources.

Notwithstanding the planned measures to maximise revenue collection by sealing loopholes in tax collection and reducing wasteful spending by curbing corruption, demand for Government services is expected to expand through to the next financial year. Consequently, the budget deficit during financial year 2003/2004 is expected to stagnate at Ksh 57bn, with expected external financing of Ksh 17.1bn or 30% of the budget deficit and domestic financing of Ksh 39.9bn.

The Government will depend more on the non-bank sector for domestic borrowing. With the share of Central Bank net lending to Government in net domestic credit being stable in the 8-10% range, and the share of banks net lending declining gradually from 40.5% in December 2002 to 33.3% by December 2003, the share of the non-bank sector lending will rise from 51.5% in December 2002 to 58.8% by December 2003. The declining share of bank financing is expected to encourage banks to accommodate the credit demands by the private sector in order to support the programmed expansion in domestic output.

Broad money supply set to expand by 7.4% during 2003

2.2.2 Monetary Programme Outlook

Consistent with the projected economic growth, inflation target, budget deficit financing by banking institutions and foreign exchange reserve target, broad money M3X is programmed to increase by 9.2% in the year to December 2003. The monetary expansion will be supported by increases of 7.0% in the NDA and 15.8% in the NFA. With bank lending to Government declining from 21.9% growth in December 2002 to 1.4% in December 2003, the NDA expansion will largely reflect bank lending to the private sector. The latter is programmed to accelerate from 4.9% growth to 9.3% over the same period. Meanwhile, the expansion in the NFA will be wholly in Central Bank holdings with purchases from commercial banks and inflows from donor budgetary support as well as drawing from the IMF balance of payments support.

TABLE 5: MONETARY PROGRAMME FOR DEC 2002- DEC 2003/1 (Ksh m)

	2002				2003			
	Mar (Act)	Jun (Act)	Sep (Act)	Dec (Act)	Mar (Proj)	Jun (Proj)	Sep (Proj)	Dec (Proj)
1. Monetary Survey								
Money supply (M3X)	366,051	378,276	387,365	406,009	412,018	420,029	430,353	443,536
Annual % change	2.1	6.7	8.4	10.2	12.6	11.0	11.1	9.2
Net Foreign Assets	95,440	97,040	96,992	102,150	106,053	115,788	116,686	118,316
Annual % change	6.6	6.4	4.6	8.7	11.1	19.3	20.3	15.8
Net Domestic Assets	270,611	281,236	290,374	303,859	305,966	304,242	313,668	325,220
Annual % change	0.6	6.7	9.7	10.7	13.1	8.2	8.0	7.0
2. Central Bank Balance Sheet								
Reserve money	75,779	76,881	78,589	88,453	87,387	88,129	90,876	97,018
Annual % change	8.2	10.9	12.6	11.8	15.3	14.6	15.6	9.7
Net Foreign Assets	77,663	77,832	76,165	70,274	74,878	84,613	85,511	87,142
Annual % change	23.0	16.5	4.1	(7.1)	(3.6)	8.7	12.3	24.0
Net Domestic Assets	(1,884)	(951)	2,424	18,179	12,509	3,516	5,365	9,876
Annual % change	(127.3)	(138.0)	(172.0)	416.9	(763.9)	(469.6)	121.4	(45.7)

1/ Actuals end-months, and expected monthly averages for CBK balance sheet projections

Source: Central Bank of Kenya

Current monetary policy framework and instruments to remain

2.2.3 Monetary Policy Instruments

The Bank will continue to manage monetary policy using the monetary targeting framework with reserve money (RM) as the operating target. In tandem, the Bank will use the current instruments to influence the reserves of the banking institutions. In this regard, the Central Bank will during the year continue to:

- Buy and sell Treasury bills or any other stipulated government paper, from time to time, in the open market through repurchase agreements with a view to influencing the level of bank reserves.

- Require commercial banks to hold specified minimum cash deposits at the Central Bank, currently equivalent to 10% of their deposit liabilities.

- Provide, as a lender of last resort, liquidity to commercial banks but in a manner that will not compromise the monetary policy stance adopted for the year.

3 Conclusion

Price stability and structural reforms key to the recovery process

Sustained implementation of a prudent monetary policy by the Central Bank coupled with a relatively sound fiscal policy stance has enabled the economy to enjoy a stable macroeconomic situation for some years now. Despite this, the economy has continued to perform well below expectations. A major challenge is, therefore, to translate the stable macroeconomic environment into tangible and sustainable economic growth. It is imperative, therefore, that while a stable macroeconomic environment is important, the ultimate remedy lies in addressing the deep-seated structural impediments that continue to make the 'cost of doing business' in the economy exorbitantly high. On its part, the Central Bank will strive to ensure that low and stable inflation and a sound banking system are maintained. While the Central Bank is committed to playing its part, it is equally vital that all other stakeholders effectively play their part.