CENTRAL BANK OF KENYA

The Thirteenth Monetary Policy Statement

Issued under the Central Bank of Kenya Act, Cap 491

DECEMBER 2003

MONETARY POLICY STATEMENT
DECEMBER 2003

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I. INTRODUCTION

Programme Overview

This 13th Monetary Policy Statement, articulates and provides an assessment of the assumptions underlying the poverty reduction and growth facility (PRGF) programme for the twelve months to June 2004. It reviews progress in the implementation and performance of the monetary policy programme for the six months to December 2003, in the context of its stated objectives. Finally, taking into account the developments in the preceding period, it proposes the monetary policy implementation path considered appropriate for the next 12 months to June 2004.

The Central Bank of Kenya[1] is implementing a monetary programme built into the country's broad economic strategy and supported by the three-year Poverty Reduction and Growth Facility (PRGF) approved by a IMF Executive Board on 21st November 2003. The monetary programme underlying the current IMF/Government of Kenya PRGF was initiated and developed during a series of IMF Mission negotiations that took place between May and October 2003. The programme is designed to provide the basis for strong economic and employment growth, and poverty reduction by taking into account and ensuring containment of the potential effects of Kenya's macroeconomic vulnerabilities.

The monetary programme for the twelve months to June 2004 sought to target underlying inflation at 3.5%, being the average rate achieved by Kenya's trading partners, and to support accelerated growth in real gross domestic product (GDP) from 1.1% in 2002 to 1.9% by the end of December 2003 and to 3.5% by the end of December 2004. Towards this end, it programmed money supply to increase by 7.1%, and reserve money to decline by 5.4% by June 2004. The programme further envisaged gross foreign exchange reserves at U.S. dollar value equivalent of 2.8 months of imports of goods and non-factor services based on a projection of imports for twelve months in 2004/05. Finally, the programme also assumes a domestic deficit-financing requirement of Ksh 30 billion for the period. On the budget front, the programme built in a budget deficit of Ksh 48bn with the domestic financing capped at Ksh 19.8bn. Immediately following the approval of the PRGF programme on 21 November, 2003, the CBK embarked on its implementation.

The monetary performance criteria and benchmarks under the PRGF programme are set with respect to the components of reserve money; namely, the net domestic assets (NDA) and net foreign assets (NFA) of the Central Bank. The NDA has been set at a maximum (ceiling) average of Ksh -1,237 million as a benchmark for September, 2003, Ksh 2,026 million as performance criteria for December 2003, Ksh –7,167m as a benchmark for March 2004 and Ksh –13,238m as performance criteria for June 2004. Similarly, the NFA was set at a minimum (floor) of Ksh 75,921m as benchmark for end September 2003, Ksh 77,562m as performance criteria for end December 2003, Ksh 83,878m as benchmark for end March 2004 and Ksh 90,105m as performance criteria for end June 2004.

The PRGF programme also provides for adjusters to the above performance targets to take care of deviations from programmed levels in 3 areas namely, donor budgetary flows, non-bank holdings of Government securities and the foreign component of privatization proceeds.

Over the six months to December 2003, the Central Bank of Kenya reviewed the monetary programme three times to accommodate new developments in the economy. In the first review of July 2003, real GDP growth, which had been set to accelerate from 1.1% in 2002 to 2.3% in 2003 and to 3.5% in 2004, was revised to conform to the projections indicated in the Minister's Budget Speech for the FY 2003-04. The programme was reviewed again in early August 2003. GDP growth, which had been estimated at 2.3%, was revised downward to 1.9% p.a. to take into account delays in resumption of donor support and the adverse effects of travel advisories on the tourism sector. However, economic growth for 2004 was maintained at 2.6%. The third review was contained in the final PRGF signed in November 2003.

With sustained implementation of the economic reforms underlying the PRGF Programme, economic growth is expected to rise further in 2004 to reach the programmed level of 2.6%, while the government's commitment to sustained implementation of agreed reforms is expected to further unlock pledged financial resources from a wide range of multilateral and bilateral creditors and strengthen implementation of Economic Recovery Strategy for Wealth and Employment Creation. The recent rescheduling of debt owed to the Paris club creditors has boosted availability of additional resources for development. Sustained implementation of the reforms is expected to improve confidence of both domestic and foreign investors in the management of the economy and lead to a pick up in economic activity in the medium term.

Overall, the future performance of the fiscal operations will largely depend on the Government's ability to restrain expansion in expenditures and to meet revenue targets. The flow of external disbursement both of grants and loans will impact on the success of fiscal policy especially with respect to domestic financing. In addition, given that the joint IMF and World

Bank staff assessment of the programme is yet to take place, the Government is likely to see delays in the release of the expected budgetary support from development partners. This may increase pressure on domestic borrowing thereby undermining the domestic financing targets.

The remainder of this Monetary Policy Statement is organized into six sections. The section following this overview presents the legal basis for the publication of the Monetary Policy Statement. Section 2 reviews the implementation status of the first half of the current Monetary Policy Programme for July 2003 - June 2004 and current and future economic prospects. Section 3 projects the monetary programme for the twelve months to December 2004, while Section 4 provides conclusions.

Legal Basis for the Publication of the Monetary Policy Statement

The legal basis for publishing the Monetary Policy Statement is provided for in Part II Section 4B(1) of the Central Bank of Kenya Act, CAP 491. It states:

- 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:

  - *Specify the policies and the means by which the Central Bank intends to achieve the policy targets;*

  - *State reasons for adopting such policies and means;*

  - *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.*

- *The Minister shall lay every statement submitted under section (1) before the appropriate committee of the National Assembly not latter than the end of the subsequent session of Parliament after the statement is submitted.*

- *The Bank shall:*

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

  - *Disseminate key financial data and information on monetary policy to the public.*

- *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.*

To comply with the above provisions, the Central Bank produces a rolling monetary policy formulation and implementation framework every six months. By regularly communicating its monetary policy stance through these Statements, the Central Bank enables various agents to make informed economic decisions. Such shared knowledge about monetary policy enhances macroeconomic stability which underpins economic activity.

II. REVIEW OF MONETARY POLICY IN THE TWELVE MONTHS TO DECEMBER 2003

Programme Formulation

The monetary programme for the twelve months to June 2004 initially sought to target underlying inflation[2] at 3.5%, this being the estimated average rate achieved by Kenya's trading partners, and to support growth in real gross domestic product (GDP) from 1.1% in 2002 to 1.9% by the end of December 2003 and further to 3.5% by the end of December 2004. The programme also targets gross foreign exchange reserves at U.S. dollar value equivalent of 2.8 months of imports of goods and non-factor services, based on a projection of imports for twelve months in 2004/05. Further the programme level of foreign exchange reserves[3] was compared to the satisfactory level based on actual imports of the last three years. Finally, the programme also assumed a domestic deficit financing requirement of Ksh 30 billion for the period.

Monetary Policy Instruments

In the formulation of the programme, the Bank continued to depend on the following monetary policy instruments for implementing the Monetary Policy Programme in the year ending December 2003, Open Market Operations (OMO), Minimum Cash Ratio requirement of 6% of banks' deposit liabilities, and lender of last resort window.

Programme Reviews and Implementation

During the six months to December 2003, the Bank reviewed the monetary programme three times to accommodate new developments in the economy. In the first review of July 2003, real GDP growth, which had been set to accelerate from 1.1% in 2002 to 2.3% in 2003 and to 3.5% in 2004 was revised to conform with the projections adjusted in the Minister's Budget Speech for financial year 2003-04.

In line with the Minister's pronouncements in the Budget Speech for FY 2003/04 the cash ratio was adjusted by the Bank from 10% to 6%, and this freed about Ksh 8.1bn to commercial banks that was expected to stimulate lending to the private sector. By mid August, however, it became apparent that the freed funds had instead been accumulated by the commercial banks in their clearing accounts at the Central Bank, (which they had been required to open separately from their frozen cash ratio accounts), to manage their daily inter-bank settlements. To accommodate the observed excess reserve holdings averaging 2.3% of the M3X over and above the cash ratio requirement of 6%, the programme was reviewed again in early August 2003. Furthermore, GDP growth which had been estimated at 2.3% was revised downward to 1.9% p.a. due to delays in resumption of donor support, and to take into account the adverse effects of travel advisories by the United Kingdom and the United States governments and subsequent suspension of commercial flights from the two countries to Kenya which had far reaching effects on the tourism sector. However, economic growth for 2004 was maintained at 2.6%.

The PRGF Programme

The Central Bank of Kenya, in December 2003, adopted and implemented the monetary programme underlying the PRGF programme that had been initiated and formulated during the May-June 2003 IMF mission visit and finalized in the negotiations that took place between September and October 2003. The monetary programme was, designed to provide the basis for strong economic and employment growth and poverty reduction by taking into account and ensuring containment of the potential effects of Kenya's macroeconomic vulnerabilities. It targeted money supply to increase by 7.1% and reserve money to decline by 5.4% to June 2004. The expansion in money supply was deemed adequate to accommodate 1.9% real GDP growth, 3.5% underlying inflation target and foreign exchange equivalent reserves of about 2.8 months of next years imports. On the budget front, the programme built in a budget deficit of Ksh 48bn with the domestic financing capped at Ksh 19.8bn.

Programme Performance Review

Money Supply

Money supply measured across the three aggregates, namely M3[4], M3X[5] and M3XT[6] as shown in Table 1, overshot their respective monthly targets from July through December, 2003. M3X, the intermediate target for monetary policy, increased by 12.1% thereby exceeding the 6.4% target growth over the twelve months. Inspite of the fairly rapid expansion of M3X, however, domestic inflation did not accelerate as domestic demand remained largely subdued as evidenced by underlying (monetary based) inflation which remained at 2.6%.

Table 1: Percentage Changes in Selected Monetary Aggregates

	RM		M3		M3X		M3XT		DRM	DM3	DM3X	DM3XT
	Act.	Targ.	Act.	Targ.	Act.	Targ.	Act.	Targ.	Percentage Points of Change			
Dec, 02	11.8	4.9	8.8	6.8	10.2	6.5	12.8	10.3	6.9	2	3.7	2.5
Jan, 03	13.4	13.1	10.8	9.6	12.7	9	13.8	10	0.3	1.2	3.7	3.8
Feb	11.7	10.6	9.6	9.3	10.8	8.9	11.7	9.5	1.1	0.3	1.9	2.2
Mar	11	8.1	9.9	9.5	11.7	9.1	13.1	12.3	2.9	0.4	2.6	0.8
Apr	8	7.7	7.7	8.1	9.7	7.9	11.9	11.9	0.3	-0.4	1.8	0
May	9.4	5.7	8.5	8.1	10.6	7.9	12.8	12.8	3.7	0.4	2.7	0
Jun	10.8	6.6	9.3	7	10.9	7	12.4	11.8	4.2	2.3	3.9	0.6
July	-2.9	-4.2	11.7	8.8	11.7	7.5	13	12.8	1.2	2.9	4.2	0.1
Aug	9.8	12.1	9.3	8.5	8.9	8.2	10.1	8.8	-2.3	0.8	0.7	1.3
Sep	4.1	10	10.3	9.5	9.6	9.1	9.6	8.8	-5.9	0.7	0.6	0.8
Oct	15.8	11.5	12.2	9.6	12.5	8.9	11.1	8.8	-11.5	-9.6	-8.9	-8.8
Nov	10.4	10.4	11.9	9.3	12	8.1	9.9	9.4	10.4	11.9	12	9.9
Dec.	-1.1	-5.5	13.2	7.3	12.1	6.4	9.6	8.7	-1.1	13.2	12.1	9.6

Source: Central Bank of Kenya

Reserve Money

The performance of reserve money is summarized in Table 2 below. It can be observed that except for July and December 2003, reserve money[7], was on average, contained within respective targets during the period under review. The excess reserves observed in July and December 2003 was attributed to the inability of the pre-budget programme scenario to anticipate excess reserves that emerged with the new cash ratio regime.

Table 2: Reserve Money Performance January to December, 2003 /1 (Ksh M)

	2003											
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
1. Liabilities												
Reserve Money												
Actual	85910	85361	84492	83638	84442	87637	81733	85528	85283	85770	88351	89512
Target	83274	81590	81895	81152	80948	81951	79593	86946	86471	86039	89042	83574
Deviation (Ksh. m)	2636	3771	2597	2486	3494	5686	2140	-1418	-1188	-268	-692	5938
(%)	3.17	4.62	3.17	3.06	4.32	6.94	2.69	-1.63	-1.37	-0.31	-0.78	7.11
2. Assets												
Net Foreign Assets												
Actual	73427	78639	79858	80770	82888	81259	80269	81156	84316	86143	85806	85882
Target	78280	78815	79350	79885	80919	81690	84021	76332	75964	78162	76337	89763
Deviation (Ksh. m)	-4853	-176	508	885	1970	-430	-3752	4824	8353	7981	9469	-3881
Net Domestic Assets												
Actual	12484	6722	4634	2868	1554	6377	1464	4371	967	-372	2545	3630
Target	4994	2775	2544	1267	29	261	-4428	10614	10507	7877	12705	-6189
Deviation (Ksh. m)	7490	3947	2089	1601	1525	6116	5892	-6242	-9540	-8249	-10161	9819

1/ Monthly Averages
Source: Central Bank of Kenya

Commercial banks held excess reserves in their clearing account throughout the six months to December, 2003. This was unlike in the past when they economised on balances held at the Central Bank to strictly those required under the cash ratio regime. From July 1, 2003 balances held under the cash ratio account were frozen throughout the cash ratio cycle such that a bank facing a cash shortage for clearing could either access the more expensive Central Bank liquidity support facilities at the overnight window, or the interbank market. To manage settlement risks, commercial banks, on average, held Ksh 6.6bn per month between July and December 2003 in their clearing accounts. The liquidity released through maturing CBK repurchase agreements (Repos) was also partly invested in government Treasury bills and bonds. Commercial banks held excess reserves throughout the six months to December 2003, as shown in Table 3, partly for precautionary purposes. It was also found that a weak financial intermediation by banks resulted from a number of factors:

- The high stock of non-performing loans (NPLs) that have characterised the banking system in Kenya continued to constrain banks from aggressive lending. In a bid to avoid future recurrence of serious NPLs in their loan portfolios, banks exercised extreme caution in credit extension, laying emphasis on authentic and easily realizable collateral securities.

- There was uncertainty created by the controversy ridden Central Bank (Amendment) Act 2000 “Donde Act” that required lending and deposit rates to be indexed to the Treasury bill rate. As a result of the uncertainty and contingent risks, commercial banks remained cautious in credit extension for fear of financial repercussions were the proposed amendments to take effect.

- The anticipated economic recovery was slow and having grown by an estimated 1.5% by December 2003, did not generate sufficient demand for credit. However, credit to private sector expanded by 6.9%, which was significantly higher than 4.8% over similar period the previous year.

Table 3: Excess Reserves of Commercial Banks and NBFIs a the Central Bank 1/ (Ksh M)

		Banks Deposits at Central Bank		
		Total	Required	Excess
2002	Jan	24616	25509	-892
	Feb	24756	25439	-683
	Mar	24844	25410	-567
	Apr	24932	25641	-708
	May	25075	25744	-669
	Jun	25290	25999	-709
	Jul	25723	26435	-712
	Aug	26052	26776	-724
	Sep	26226	27034	-808
	Oct	26364	27201	-838
	Nov	26602	27355	-753
	Dec	26508	27497	-989
2003	Jan	27142	27788	-646
	Feb	28118	27965	153
	Mar	28269	28108	161
	Apr	28199	28470	-271
	May	30081	28469	1612
	Jun	31652	28499	3153
	Jul	27346	20709	6637
	Aug	29226	21034	8193
	Sep	28764	21064	7699
	Oct	28610	21194	7416
	Nov	28407	21693	6714
	Dec	26284	22140	4144

1/ Calendar month averages

The cash ratio and cash ratio administration were reviewed on 1st July 2003. The cash ratio was lowered from 10% monthly average subject to 8% daily minimum, to 6% daily minimum. The cash ratio balances were frozen and therefore no longer accessible to depository institutions. The deposit base was widened to include residents' foreign currency denominated deposits. Commercial banks opened clearing accounts for daily settlement of business in the clearing house.

PRGF Quantitative Financial Performance Criteria

The monetary performance criteria and benchmarks under the PRGF programme were set with respect to the components of reserve money, namely, the net domestic assets (NDA) and net foreign assets (NFA) of the Central Bank. The NDA was set at a maximum (ceiling) average of Ksh -1,237 million as a benchmark for September, 2003; Ksh 2,026 million as performance criteria for December 2003, Ksh –7,167m as a benchmark for March 2004 and Ksh –13,238m as performance criteria for June 2004. Similarly, the NFA was set at a minimum (floor) of Ksh 75,921m as benchmark for end September 2003, Ksh 77,562m as performance criteria for end December 2003, Ksh 83,878m as benchmark for end March 2004 and Ksh 90,105m as performance criteria for end June 2004.

The closely related net domestic financing (NDF) of the Central Government performance criterion, under the Treasury, was set with respective quarterly targets of Ksh 12.2 bn for end December 2003, Ksh 19.0bn for end March 2004 and Ksh 19.8bn for end June 2004.

Programme Adjusters

The Technical Memorandum of Understanding (TMU) underlying the PRGF programme provided for adjusters to the above performance targets to take care of deviations from programmed levels in three areas namely: donor budgetary flows, non-bank holdings of Government securities and the foreign component of privatization proceeds. Subsequent consultations between the Bank and the IMF held in February 2004, led to a revision of the TMU that inter alia, excluded the adjustment for non-bank holding of Government securities.

NDA Performance

The Central Bank achieved the Monetary Programme NDA target for the December 2003 and March 2004 quarters as shown in the Table 4 below. The CBK took very aggressive measures to mop up liquidity beginning November 2003 onwards. The Bank enhanced and diversified its Open Market Operations in January 2004 to include a one-year repurchase Treasury bill designed to raise Ksh 15 bn at 3.5% interest, that was a 0.5% margin above market yield on one-year bonds. This effort, coupled with the adjustments made to accommodate the shortfalls in donor budgetary support, resulted in the success of the programme indicated above. This success notwithstanding, the Bank experienced major difficulties in its open market operations.

Table 4: Summary of NDA Performance, Ksh M

		Sept 2003**	Dec 2003***	Mar 2004**	June 2004***
1	Program Target	-1,237	2,026	-7,167	-13238
2	Shortfall in non project budget support	2,789	5,378	12,442	19,506
3	Shortfall in non bank public holding government securities	5,176	15,170	15,299	
4	Adjusted Program Target (1+2+3)	6,728	22,106*	20,574	6,268
5	Actual NDA	967	3,670	858	
6	Deviation (4-3)	-5761	-18,436	-19,706	
	Performance Criteria met	Yes	Yes	Yes	-

* Kshs.22,106m is the max. equivalent allowed adjuster of USD 280 million in the programme. The actual of Kshs 22,574m is higher than Kshs.22,106m

** Benchmark dates

*** Test dates

Source: Central Bank of Kenya

NFA Performance

The monetary programme was successful with respect to the NFA target for end December 2003 NFA and end March 2004 quarters by significant margins as shown in Table 5. The observed success in the NFA benefited from purchases of foreign exchange from commercial banks as well as from donor inflows for budget support.

Domestic Inflation

Domestic inflation remained stable at low rates into the second half of the year 2003 as shown in Table 6. The twelve-month underlying inflation for July through December 2003 ranged between 2.3% and 2.6% against a

Table 5: Summary of NFA Performance, Ksh M

		Sept 2003*	Dec 2003**	Mar 2004*	June 2004**
1	NFA Program Target	75,921	77,562	83,878	90,105
2	Shortfall in non project budget support	2,789	5,378	12,442	19,506
3	Adjusted Program Target (1+2)	73,132	72,184	71,436	70,599
4	NFA Actual (unencumbered)	78,784	82,452	80,707	
5	Deviation (4-3)	5,652	10,268	9,271	
6	Performance met	Yes	Yes	Yes	-

* Benchmark dates

** Test dates

Source: Central Bank of Kenya

target of 3.5%. The Central Bank of Kenya was, therefore, on course in its pursuit for a low and stable general level of prices. Furthermore, the monthly changes in the underlying consumer price index fluctuated at about zero; ranging between a low of –0.25% and a high of 0.12%, respectively. Apart from the prudent monetary policy actions[8] that the Bank continued to take, the following other factors contributed to the evolution of domestic inflation during the second half of the year 2003:

- An appreciation of the domestic currency *vis-a-vis* international hard currency in June, 2003 mainly due to positive sentiments on the economy checked the inflation pressure that came with imports;

- Reduction in the price of electricity following the downward adjustment by Kenya Power and Lighting Company of the fuel and foreign exchange tariffs in June 2003;

- Lowering of selected Excise Duties and Value Added Tax (VAT) as provided for in the Government Budget for the Financial Year 2003/04; and

- Favourable weather conditions that led to an increase in the supply of and hence a reduction in the market price of vegetables.

The overall inflation outlook over the next twelve months is expected to be stable. Favourable weather conditions and stable crude oil prices are expected to give rise to a slower rate of increase in food prices and other CPI prices. Over the longer-term, most conditions also seem favourable for the containment of underlying inflation which is expected to remain within the 3.5% target in the next twelve months. These actions include the up-turn in global economic recovery, sustained implementation of sound macroeconomic policies and disciplined fiscal policies by Government, and prudent monetary policy stance by the Bank. Inflows related to IMF and other donors are expected to hold the exchange rate firm against major trading currencies.

Table 6: Inflation in Kenya, January - December 2003

		Overall Inflation	Overal Inflation Excluding Food	Overall Inflation Excluding Food and Energy	Food
2003	Jan	6.40	4.00	2.70	8.50
	Feb	7.50	4.40	3.00	10.20
	Mar	10.10	4.50	3.10	15.00
	Apr	11.60	4.20	3.20	18.10
	May	14.90	4.00	2.80	24.50
	Jun	13.70	4.00	2.80	22.20
	Jul	10.90	3.30	2.40	17.70
	Aug	8.30	3.30	2.50	12.80
	Sep	7.90	3.00	2.60	12.40
	Oct	9.10	2.80	2.60	14.70
	Nov	9.00	2.70	2.30	14.60
	Dec	9.30	2.60	2.30	13.80

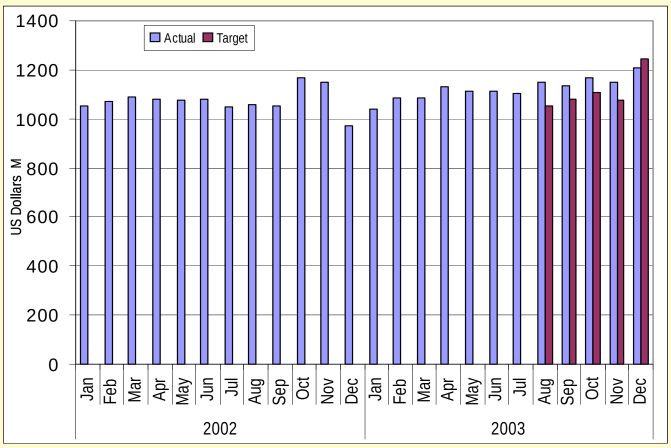
Source: Central Bank of Kenya

Foreign Exchange Reserves

The Central Bank has generally met its statutory reserves level, equivalent to 4.0 months imports cover over the last three years. It also met the programmed reserves level, equivalent to 2.8 months of imports cover, which over the next three years is valued at constant US dollar/Kenya shilling exchange rate of Ksh 78.95 that prevailed as at the end of September 2001. The Bank's reserves in both statutory and programmed levels were achieved through both interbank purchases and donor program financing during the July to December 2003 period. The Bank's gross reserves increased from US$ 1.1bn or 3.4 months of import cover in December 2002 to US$ 1.5bn or 4.2 months of import cover in December 2003 as shown in Table 7. Purchases from the inter-bank were possible with improvement in the country's overall balance of payments surplus to US$ 460m during the year compared to US$ 65m during 2002, reflecting US$ 642m surplus in the capital and financial account against US$ 183m deficit in the current account.

Table 7: Gross Foreign Exchange Reserves of the Central Bank in USm

		Actual	Target
2002	Jan	1053	
	Feb	1072	
	Mar	1090	
	Apr	1080	
	May	1077	
	Jun	1079	
	Jul	1048	
	Aug	1059	
	Sep	1055	
	Oct	1169	
	Nov	1148	
	Dec	972	
2003	Jan	1042	
	Feb	1087	
	Mar	1084	
	Apr	1133	
	May	1112	
	Jun	1114	
	Jul	1103	
	Aug	1151	1051
	Sep	1134	1079
	Oct	1169	1107
	Nov	1148	1077
	Dec	1206	1245



Source: Central Bank of Kenya

Macroeconomic Developments

Real Economic Growth

The monetary program pursued under the PRGF arrangement assumed as already discussed, a rise in the real Gross Domestic Product (GDP) growth from 1.1% as at the end of 2002 to 1.3% for the end of 2003 and 2.6% by December 2004. The growth objective for 2003 was therefore exceeded as the real GDP grew by 1.5% as at the end of December 2003. The modest economic recovery was attributed to the positive impact of improvements in political and economic governance underlined by intensified fight against corruption; stable macroeconomic environment manifested in low inflation, falling interest rates, stable shilling exchange rate, and resumption of donor support, following the signing of IMF PRGF programme.

The modest economic growth in 2003 occurred largely in agriculture, and in the services sectors such as telecommunications and financial services. In agriculture, coffee deliveries increased by 34.6% in 2003 compared with a decline of 16.6% in 2002, following improved crop husbandry, while horticultural crop exports increased by 10.0% following expansion to new export markets besides Europe. Tea output, though less dramatic, also grew by 2.3% in 2003 from a decline of 2.6% in 2002. Similarly, pyrethrum and sisal production grew by 4.8% and 13.2% respectively compared with declines of 20.6% and 4.6% in 2002. The improvement in tea and pyrethrum production reflected favourable weather conditions in key growing areas. Sisal production, on the other hand, grew largely due to the reopening of some estates that had been closed.

The telecommunications sector recorded significant growth in the mobile telephone services. By end 2003, active mobile phones totaled 1,954,034 compared with 975,500 in June 2002. Cargo handled through the Port of Mombasa also increased by 13.0% while throughput by Kenya Pipeline Company rose by 7.4% in 2003, reflecting increased use of the two facilities. In the financial sector, banking institutions recorded a 65.9% increase in pre-tax profits to reach Ksh 14.6bn in 2003 from KSh 8.8bn in 2002.

With sustained implementation of the economic reforms underlying the IMF's PRGF Programme economic growth is expected to rise further in the year 2004 to reach the programmed level of 2.6% with the government's commitment to sustained implementation of agreed reforms it is expected to further unlock pledged financial resources from other multilateral and bilateral creditors and strengthen implementation of Economic Recovery Strategy for Wealth and Employment Creation. The recent rescheduling of debt owed to the Paris club creditors has boosted availability of additional developmental resources. A sustained implementation of the reforms is expected to improve confidence of both

Fiscal Policy Developments

domestic and foreign investors in the management of the economy and lead to a pick up in economic activity in the medium term.

The Government fiscal operations registered an impressive performance in the first half of the fiscal year 2003/04. The budget deficit on a commitment basis was Ksh 1.8bn or 0.2% of GDP compared with a target of Ksh 5.7bn or 0.6% of GDP. On a cash basis, the deficit was Ksh 4.6bn against a target of Ksh 6.4bn. The good fiscal performance was attributable largely to lower expenditures than planned and also due to significant inflows of grants. During the review period the Government expenditure totalled Ksh 123.7bn while total revenue and grants amounted to 121.9bn.

While Government revenues fell below the target by Ksh 11.1bn, mainly as a result of underperformance of non-tax revenue, the total expenditure incurred during the period was Ksh 15.0bn below the target. The low expenditures is attributed to three factors, namely, the low revenue inflows which hampered timely release of exchequer requests to line ministries, delays in donor programme support which constrained development expenditure by Ksh 6.7bn from the targeted Ksh 21.6bn and Government suspension of awards of new contracts, and suspension of payment of existing contracts, as well as suspension of procurement of goods and services without prior Treasury approval between May 2003 and September 2003.

The fiscal operations from July to December 2003, consequently, resulted in a domestic financing requirement of Ksh 21.1bn. The entire financing requirement of Ksh 21.1bn was mobilised from commercial banks through issuance of Treasury bills and bonds. This level of borrowing was required to finance net repayment of external debt totalling Ksh 2.5bn, repayment of debt due to non- bank institutions totalling Ksh 6.6bn and build up of Government deposits at the Central Bank by Ksh 9.3bn.

Domestic borrowing resulted in the stock of Treasury bonds increasing from Ksh 161.5bn in June 2003 to Ksh 178.4bn in December 2003, while Treasury bills (excluding Repos) decreased from Ksh 78.7bn to Ksh 76.7 bn. The Treasury bond sales were not only meant to finance the Government deficit and repay external debt but also to restructuring policy so as to lengthen the domestic debt maturity.

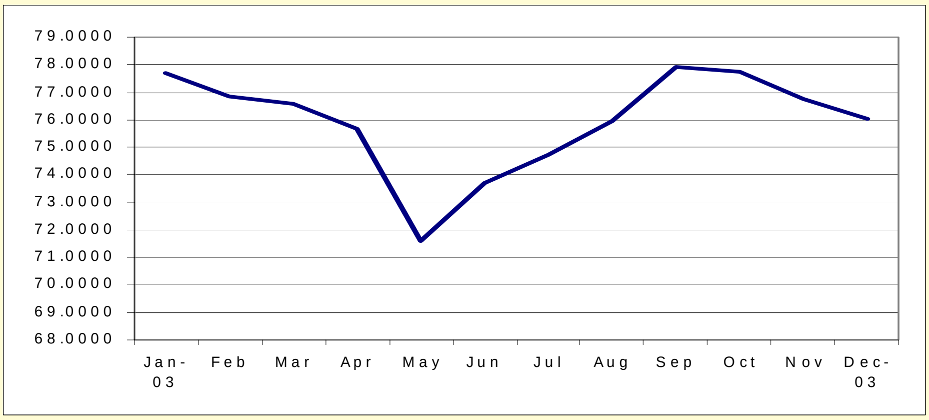
Exchange Rate Developments

The Kenya shilling which continued to be determined by market forces, had a mixed performance against key currencies as shown in Table 8 and Chart 2. While it depreciated significantly against the Pound Sterling and the Euro, it remained relatively stable and well within the programmed exchange of Ksh 78.95 against the U.S dollar. From an average of Kshs 118.31/Pound Sterling in 2002 the shilling weakened to exchange at 124.13/ Pound Sterling in 2003. Similarly, from an average of Ksh 74.44/Euro in 2002, the shilling weakened to exchange at Kshs 85.87/Euro in 2003. From

Table 8: Kenya Shilling Exchange Rates

	Ksh/$	Ksh/£	Ksh/Yen	Ksh/EUR	Ksh/SDR
Jan-03	77.7175	125.6618	65.7833	82.6033	103.7975
Feb	76.8410	123.8360	64.3315	82.7773	105.3075
Mar	76.5826	121.1663	64.5394	82.6666	104.9227
Apr	75.6564	119.1798	63.1407	82.1815	102.1251
May	71.6074	116.1869	61.1661	82.8175	100.7329
Jun	73.7223	122.5313	62.3393	86.0762	104.3089
Jul	74.7473	121.4666	62.9864	85.0436	104.5206
Aug	75.9602	121.1184	63.9348	84.7004	105.1989
Sep	77.9042	125.4598	67.6909	87.4757	108.7944
Oct	77.7651	130.4129	70.9720	91.0154	111.3762
Nov	76.7375	129.6012	70.2667	89.7756	109.5698
Dec-03	76.0194	132.9265	70.4957	93.2828	111.5559
Annual Average	**75.9384**	**124.1290**	**65.6372**	**85.8680**	**106.0175**

Chart 2: Kenya Shilling US$ Exchange Rate



Source: Central Bank of Kenya

an average of 78.73/US dollar in 2002, the shilling strengthened to exchange at an average of Kshs 75.94 in 2003.

Interest Rate Developments

Interest rate s declined in the six months to December 2003 as shown in Table 9. The downward trend reflected excess liquidity in the money market on account of the reduction in the cash ratio to 6% in July 2003 from 10% monthly average previously. Although the review of the cash ratio administration meant that funds held under the cash ratio were no longer available for intra day settlement among commercial banks as under the former cash ratio regime, the gradual redemption of Treasury bills held by commercial banks under open market repurchase arrangements implied excess liquidity in the short end of the money market. Consequently, the 91-day treasury bill declined through downward pressure from competitive bidding by investors at the weekly Treasury bill auctions. The inter-bank market rate remained depressed, falling from 1.6% in June 2003 to 0.8% in December. At the shorter end of the interest rate structure, the average rate on the 91-day Treasury bill also fell from 3% in June 2003 to a low of 0.8% in September before rising to 1.5% in December 2003. Among other key commercial bank interest rates, the average lending rate declined from 15.7% to 13.5%, while the average deposits rate fell from 4.8% to 3.3% over the same period. On account of these developments, the average

Table 9: Trends in Key Interest Rates Dec 02-Dec 03 in %

	Dec	Mar	June	July	Aug	Sep	Oct	Nov	Dec
Treasury bill** 91days	8.38	6.24	3.0	1.5	1.18	0.83	1.00	1.28	1.46
182 days	8.79	6.64	4.12	2.9	2.12	1.35	1.61	1.88	2.09
Average Lending Rate	18.34	18.49	15.73	15.30	14.81	14.82	14.75	14.07	13.47
Overdraft	18.56	17.26	14.93	14.43	14.96	14.31	14.13	14.02	13.74
Interbank rate	8.69	6.23	1.62	0.5	0.43	0.54	0.69	0.73	0.81
Average Deposit rate	4.75	3.99	4.84	4.49	3.37	3.07	3.13	3.32	3.27
3 - months deposits	5.42	4.44	4.69	3.96	3.23	2.50	2.56	3.17	2.97
Savings	3.47	3.28	3.07	1.79	1.72	1.44	1.43	1.44	1.38
Treasury bonds									
1 Year		-	8.37	11.75	-	-	-	10.45	3.85
1.5 Year		14.50	-	-	-	-	-	-	-
2 Years	13.11	7.24	12.99	8.37	12.19	-	13.45	6.18	7.91
3 Years	8.05	11.84	8.03	12.47	-	10.95	6.26	12.33	2.24
4 Years		-	13.25	9.16	-	12.50	14.00	-	10.07
5 Years	14.00	14.50	14.00	-	13.70	14.50	11.95	6.51	14.00
6 Years		14.25	-	14.00	-	14.25	4.73	11.50	-
7 Years						13.75	-	-	-
8 Years							12.50	-	-
9 Years								12.75	-
10 Years									13.25

Source: Central Bank of Kenya

interest rate spread declined from 10.9 percentage points in June 2003 to 10.2 percentage points by December 2003.

Interest rates on other longer dated Government securities also declined in tandem with the fall in the 91 days Treasury bill rate during the six months to December 2003. The declining yields on Government securities reduced the attractiveness of this investment outlet to non-bank investors, and were edged out by competitive bidding of commercial banks from the market. As a result, the stock of government securities at cost held by non-bank investors fell to Ksh 116,080m by end December 2003 from Ksh 122,730m by end June while that of commercial banks increased to Ksh 133,126m in December 2003 from Ksh 109,419m in June 2003.

III. MONETARY PROGRAMME OUTLOOK

Programme Objectives and Assumptions for 12 months to June 2004.

Considering the performance achieved in the six months to December 2003 and the path through June 2004 that was charted out in the June 2003 Monetary Policy Statement, and the programme pursued under the PRGF, it will be found prudent that the monetary policy programme to be pursued during the next twelve months be kept broadly unchanged from that pursued during the last six months to December, 2003. Consistent with the PRGF Programme, therefore, the objectives of the Monetary Programme for the year through December 2004 are to:

1. Achieve and sustain underlying annual inflation at 3.5% so as to support an estimated 2.6% real gross domestic product growth for the year;

2. Build up international reserves at the Central Bank of Kenya to 3 months of import cover by December 2004 from 2.8 in December 2003;

3. Reduce government domestic financing from Kshs 19.8bn in the FY 2003/04 budget by Kshs 9.1bn in repayment during the financial year 2004/05 with a half of the repayment expected in the six months to December 2004.

4. Ensure continued stability of banking system institutions through effective supervision.

Monetary Policy Programme Outlook

The monetary programme for the calendar year 2004 as shown in Table 10 below is based on the assumptions that over the coming year,

- the underlying inflation will be contained at 3.5% per year;
- real gross domestic product will grow by 2.6%;
- and bank reserves at the Central Bank of Kenya will be consistent with the prevailing cash ratio regime.
- net foreign assets of the Central Bank will increased by 17.4% by June 2004

Broad Money Supply

Consistent with the above target projections,money supply, M3X, is programmed to grow by 8.1% from 6.4% projected during 2003. M3X expansion envisaged in 2004 remains lower than the actual 12.1 % growth realised in 2003 which was above its respective target of 6.4%. The monetary expansion in 2004 will be supported by increases in net foreign assets and net domestic assets as shown in Table 10. The expansion in

NDA is envisaged to ease to 3.2% in 2004 compared with 7.4% in the program for 2003 and compared with an actual growth of 13.2% in 2003. The deceleration reflects an expected 24% net repayment by Government of its outstanding credit to the banking system. Meanwhile, credit to the private sector is projected to increase by 12% compared with 6.9% growth in 2003. The projected expansion in commercial bank credit to the private sector is consistent with the emerging pick up in the economic recovery and

Table 10: Monetary Programme for Dec 2003 - Dec 2004 Ksh M 1/

	2003					2004				
	Dec-02 Act.	Mar-03 Act.	Jun-03 Act.	Sep-03 Act.	Dec-03 Act.	Dec-03 Proj	Mar (Proj)	Jun (Proj)	Sep (Proj)	Dec (Proj)
1. Monetary Survey										
Money supply (M3X)	406,009	408,817	419,419	424,704	453,348	431,956	438,529	449,299	451,887	466,882
Annual % Change	10.2	11.7	10.9	9.6	11.7	6.4	7.3	7.1	6.4	8.1
Net Foreign Assets	102,150	104,537	104,352	107,434	109,519	105,516	111,608	117,613	123,445	130,043
Annual % Change	8.7	9.5	7.5	10.8	7.2	3.3	6.8	12.7	14.9	23.2
Net Domestic Assets	303,859	304,280	315,067	317,270	343,829	326,441	326,921	331,686	328,441	336,840
Annual % Change	10.7	12.4	12.0	9.3	13.2	7.4	7.4	5.3	3.5	3.2
2. Central Bank Balance Sheet										
Reserve money	88,453	84,113	85,494	81,849	87,512	83,574	80,696	80,854	83,990	89,226
Annual % Change	11.8	11.0	11.2	4.1	(1.1)	(5.5)	(4.1)	(5.4)	2.6	6.8
Net Foreign Assets	70,274	79,136	81,482	84,115	85,621	83,101	89,417	95,644	101,476	108,791
Annual % Change	(7.1)	1.9	4.7	10.4	21.8	18.3	13.0	17.4	20.6	30.9
Net Domestic Assets	18,179	4,977	4,012	(2,266)	1,891	473	(8,721)	(14,790)	(17,486)	(19,565)
Annual % Change	416.4	(364.1)	(521.7)	(193.5)	(89.6)	(97.4)	(275.2)	(468.6)	671.6	(4,232.8)

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

Source: Central Bank of Kenya

the observed shift in business focus by commercial banks towards private sector lending.

Reserve Money Growth

Growth in reserve money will remain the operating target for implementing monetary policy. The target is envisaged to be up by 6.8% unlike the target for 2003 which was set to decline by 5.5%. Actual decline was however lower at 1.1%. As an indicator of the consistency in the reserve money program with the expansion in broader domestic liquidity, the monetary programme accommodates an increase in the money multiplier from 5.18 in December 2003 to 5.23 in December, 2004.

Monetary Policy Instruments

The Central Bank shall continue to depend on the following monetary policy instruments for implementing the Monetary Policy Programme in the year ending December 2004:

- Open Market Operations (OMO);
- Minimum Cash Ratio Requirement of 6% of banks' deposit liabilities; and
- Conditions of access to lender of last resort window

The above monetary policy instruments have proved to be effective. The Bank also has the technical and organizational capacity to fully utilize the efficacy of the instruments in realizing the monetary policy objectives.

Prospects for Fiscal Policy Objectives

The future performance of the fiscal operations will depend largely on the Government's ability to restrain increase in expenditures and to meet revenue targets. The flow of external disbursement both of grants and loans will determine the success of fiscal policy especially with respect to domestic financing. Based on performance so far in the year, it appears that the net domestic financing targets may be difficult to achieve with non-tax revenue shortfall already large. In addition, given that the joint IMF and World Bank staff assessment of the programme is yet to take place. The Government is likely to see delays in the release of the expected budgetary support from development partners. This is expected to put pressure on domestic borrowing.

CONCLUSIONS

Lessons in Programme Implementation from previous period

- There were difficulties in mopping up what appeared as excess liquidity under the PRGF monetary programme. Inevitably, a shortfall in programmed external budgetary support had to be covered by the Government accessing more than programmed domestic financing and thus making it difficult to mop.

- In the course of implementing the monetary programme interest rate, especially at the shorter end of the interest rate structure, declined in line with the fall in the 91 days Treasury bill rate. The decline in commercial bank lending rates was not as large as in the money market rates, but gave a modest boost to credit growth to the private sector. While credit to the private sector increased in nominal terms, accelerating from 4.8% in the year to December 2002 to 6.9% in the year to December 2003, the expansion remained below the overall inflation rates in the year to December 2003.

- Credit to the private sector will need to increase in real terms to meaningfully support the envisaged economic recovery. The decline in interest rates alone is not a sufficient condition for economic recovery. Easing interest rates, however, ought to be sustained to encourage more borrowing by the private sector as other structural factors that continue to discourage private sector investment are simultaneously addressed.

Challenges in implementing the proposed programme

- The Central Bank liquidity mop up operations were complicated by the fact that the projected reserve money path did not fully accommodate the changes induced by the review of the cash ratio administration from 1st July 2003. The separation of the commercial bank's cash ratio account from clearing accounts necessitated the holding of excess balances for settlement purposes. By not factoring the latter, the PRGF reserve money targets underestimated the desired reserve money under the revised cash ratio regime. In implementing this programme, the Central Bank could not access the excess reserves implied by the programme because commercial banks needed them same for settlement purposes. Furthermore, as already indicated the shortfall in external budgetary support aggravated the situation as its use was accommodated by the allowance for increased domestic financing.

- The Central Bank and the IMF PRGF programme review mission will have to assess the impact of the cash ratio regime introduced in July 2003 on the demand for reserve money and hence the money multiplier. Specifically, the programme will need to accommodate holding of precautionary balances by commercial banks in support of their daily settlement in the Clearing House. At the same time, a more realistic projection will have to be sought on the external budgetary support to be build into the monetary programme.

- Credible projection of GDP growth over the programme period remains a daunting challenge for programme formulation. A good projection is required of the growth path to ensure consistency of the money supply and reserve money under the programme with what the economy actually needs to support its activities without imparting undue pressure on inflation.

After proper assessment and review of the basis of the PRGF programme, stable macroeconomic environment that is conducive to the realisation of the key objectives of the programme, including the envisaged economic recovery is possible.

Endnotes

1. For brevity purposes, the Central Bank of Kenya is also simply referred to as "Bank". This is consistent with the interpretation given in Part I of the Central bank of Kenya Act, CAP 491.

2. The Underlying inflation concept is used in this case. Unlike the Overall Domestic Inflation Measure that incorporates the often highly volatile prices of food and energy, the Underlying Inflation Measure excludes prices of the two items. In so doing, domestic price stability is defined in terms of a customer price index that is not subject to transitory demand and supply shocks.

3. The valuation of the foreign exchange reserves is to be done at Kshs 78.95 to the US$, the exchange rate that prevailed as at end September 2001.

4. M3 denotes broad money that is comprised of currency outside Banking Institutions and all private and other public sector holdings of Demand Deposits, Savings and Time Deposits. It excludes Central and Local Government deposits with banking institutions.

5. As noted earlier, M3X denotes broader money that is comprised of M3 and residents 'Foreign Currency Deposits with local banks.

6. M3XT denotes broader money that is comprised of M3X and non-banking public holding Government securities.

7. Reserve money comprises banking institutions' deposits with the Central bank of Kenya and currency in circulation. As the basis for domestic credit creation in the banking industry, reserve money constitutes the monetary policy operations target.

8. The Bank confined expansion of reserve money below targets for the months of August through November 2003.

9. See for instance, CBK, (July, 2003), Monthly economic Review, pg. 6.