Letter of Transmittal to the Minister for Finance

Dear Honorable Minister,

I have the pleasure of presenting to you the 18th edition of the Monetary Policy Statement of the Central Bank of Kenya, pursuant to Section 4B of the Central Bank of Kenya Act. The Statement reviews the implementation of monetary policy since the issuance of the preceding Statement for December 2005, provides an overview of the current economic developments and outlines the appropriate monetary policy stance to be adopted over the next one year to June 2007.

Jacinta W. Mwatela

Ag. Governor

MONETARY POLICY STATEMENT
JUNE 2006

TABLE OF CONTENTS

Page

The Principal objects of the Central Bank of Kenya (CBK) are:

1. To formulate and implement monetary policy directed to achieving and maintaining stability in the general level of prices.

2. To foster the liquidity, solvency and proper functioning of a stable market-based financial system.

Without prejudice to the generality of the above, the Bank is required to:

- Formulate and implement foreign exchange policy;

- Hold and manage its foreign exchange reserves;

- License and supervise authorized dealers;

- Formulate and implement such policies as best promote the establishment, regulation and supervision of efficient and effective payment, clearing and settlement systems;

- Act as banker and adviser to, and as fiscal agent of the Government; and

- Issue currency notes and coins.

Objectives of Monetary Policy

The CBK's monetary policy is aimed at achieving and maintaining price stability. The CBK, in consultation with the Government, defines price stability as the containment of inflation below 5 percent.

Price stability raises economic well being by reducing uncertainty about the future inflation expectations. Evidence indicates that countries with lower inflation rates tend to have higher long-term economic growth rates.

Instruments of Monetary Policy

The CBK's uses the following instruments in pursuit of its monetary policy objectives:

- **Open Market Operations** whereby the CBK either buys or sells Government Treasury bills and any other eligible securities to achieve a desired level of money in the economy. The CBK injects money to the economy when it buys Treasury bills, and withdraws money when it sells them.

- **Standing Facilities** whereby the CBK, as lender of last resort, provides secured short-term loans to commercial banks on an overnight basis at rate known as the Central Bank rate (CBR). The rate is based on the average of the interbank and the Repo rates plus a margin to be determined and announced by the Central Bank every eight weeks. Commercial banks facing temporary liquidity needs may also rediscount their Treasury bills holdings at the CBR.

- **Reserve Requirements** whereby the CBK is empowered by law to stipulate a proportion of commercial banks' deposits to be held as cash reserve requirement (CRR) at the CBK. An increase in CRR reduces the capacity of commercial banks to extend credit. A reduction in the CRR enhances the capacity of commercial banks to expand credit. The CRR has remained at 6 percent of commercial bank deposits since July 2003.

- **Foreign Exchange Market Operations** whereby the CBK effectively injects or withdraws liquidity by engaging in foreign exchange transactions. CBK participation in the foreign exchange market in most cases is geared to arresting speculative tendencies rather than influencing domestic liquidity, although it has the scope to do so.

Monetary Policy Statement

1.The CBK Act Section 4B requires the Bank to submit to the Minister for Finance, at intervals of not more than six months, a Monetary Policy Statement for the next twelve months.

2. The Minister is required by the law to 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 is required by the law to publish in a Gazette:
    i) Its monthly balance sheet; and
    ii) Its Monetary Policy Statement.

4. The Bank is further required to disseminate key financial data and information on monetary policy to the public stating the following:

    i) Policies and the means by which the Bank intends to achieve the monetary policy targets;
    ii) Reasons for adopting such monetary policies and means; and
    iii) Progress made in the implementation by the Bank of monetary policy during the period to which the preceding Monetary Policy Statement relates.

5. 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.

EXECUTIVE SUMMARY

The world economy is expected to grow by 4.9 percent in 2006, despite increases in international oil prices. The move towards energy efficient industries and energy saving methods of production, has contributed to reduced impact of rising oil prices on the world economy. The global economy is expected to sustain the growth momentum into 2007.

The outlook for Sub-Saharan Africa remains positive with growth of 5.8 percent projected in 2006 underpinned by high commodity prices, sound macroeconomic policies and ongoing structural reforms.

The Kenyan economy has continued to benefit from a stable macroeconomic environment with real GDP expected to grow by between 5.5 percent and 6 percent in 2006. The setback to agricultural production in the first quarter of 2006, following the drought in the last quarter of 2005, proved transitory with leading indicators showing recovery in the output of the affected sectors.

The Bank's assessment of the economic outlook as presented in the December 2005 Statement was that underlying inflation would remain within the 5 percent target, while the outcome on overall inflation would be affected by upward pressures arising from international oil prices and the drought experienced in late 2005. As a result of the drought related food shortages, overall inflation rose to 19.1 percent in March 2006, but thereafter eased to 10.9 percent by the end of June 2006.

Meanwhile, underlying inflation, which is a better indicator of the monetary policy stance, has generally been on a downward trend. The effects of pressures from rising prices of crude oil appear to have been limited with underlying inflation remaining below target. This points to the fact that long term inflation expectations have been anchored relatively well.

The Monetary policy stance in the fiscal year 2006/07, will take into account the favourable inflation outlook with money supply, M3, and reserve money expected to grow by 10 percent. The path of reserve money for 2006/07 will be influenced by a build up in gross international reserves by the Bank following expectations of a continued surplus in the capital and financial account of the balance of payments. In this respect, the Bank will continue to absorb any excess liquidity from the market to ensure price stability.

Despite the current favourable economic conditions, the Kenyan economy faces short term risks associated with both domestic and external factors. On the international scene, the risk of inflationary pressures arising from sustained high oil prices continues to be of concern, a situation which could be worsened by the emerging geopolitical uncertainty particularly in the Middle East. With respect to the risks arising from the domestic front, the recent increase in underlying inflation indicates higher inflation expectations. However, with continued implementation of a prudent monetary policy, the effects of this increase will be minimized. The success of the adopted monetary policy stance in the coming year will also depend on stability of the exchange rate, and the Governments' commitment to live within the domestic finance envisaged in the 2006/07 budget.

INTRODUCTION

The 18th edition of the Monetary Policy Statement (MPS) for June 2006 is published pursuant to Section 4B of the Central Bank of Kenya (CBK) Act. The MPS sets out the monetary policy stance adopted by the Bank over the fiscal year 2006/07 and is subject to semi-annual reviews. The Statement is an integral part of the Bank's communication to the public of it's monetary policy. In addition, the CBK publishes other related documents including the weekly bulletin, the monthly economic review and the annual report, which explain monetary policy actions and Performance.

The statement reviews implementation of monetary policy for the period December 2005 - June 2006, assesses the current economic conditions and outlook, and outlines the monetary policy strategy over the next one year to June 2007.

The MPS is presented in three parts. Section one reviews the performance of monetary policy for the period ending June 2006. Section two of the statement covers economic developments in the second half of fiscal year 2005/06, and the outlook for fiscal year 2006/07, and the medium term. The last section contains the monetary policy stance adopted for fiscal year 2006/07 and summarizes both prospects and risks affecting inflation over the next year and is intended to guide expectations of economic agents regarding future inflation trends.

1 MONETARY POLICY SINCE THE LAST STATEMENT OF DECEMBER 2005

1.1 Review of Recent Monetary Policy Stance

In the previous statement, overall inflation was expected to reduce to 5 percent by June 2006, as the Bank continued to consolidate monetary policy gains achieved in the recent past. In terms of economic activity, GDP growth was expected to be sustained with improvements in agriculture, tourism and in general more optimism on the prevailing economic environment. These factors explained the continuation of the monetary policy stance adopted at the beginning of the financial year 2005/06, with modifications made to the reserve money path to accommodate the strong accumulation of foreign exchange reserves in the last quarter of 2005 and the anticipated financing of drought relief operations.

Nonetheless, the Bank continued to be cognisant of further upward pressures on inflation expectations emanating from food shortages following the drought and increasing international oil prices, developments on the fiscal position with respect to drought financing in the event that international assistance was not forthcoming, and, developments in the exchange rate.

While inflation had started to pick up by the time the December 2005 statement was published, and as the first quarter of 2006 progressed, there were signs of easing food prices particularly following the onset of the rains in early April. In addition, high oil prices did not seem to eventually affect overall inflation. However, minimal increases were observed in the prices of the other sub-categories of the consumer price index. Underlying inflation, which excludes the direct effects of movements in both food and energy prices, remained below the target implying that the potential for rising inflation expectations was limited.

The relative stability of the exchange rate during the reference period also contributed to anchoring inflation expectations. In addition, with short term interest rates relatively stable, the Bank considered it prudent to implement the monetary policy stance revised in early 2006 that accommodated a strong accumulation of foreign exchange reserves by the Bank and the anticipated domestic financing of drought relief operations. The expansion of reserve money and money supply was therefore limited to 7.6 percent and 10 percent respectively by June 2006. The main elements of the monetary program are summarized in Table 1 below.

Table 1: Growth Targets for Key Aggregates for 2005/06 Monetary Programme

Table 1: Growth Targets for Key Aggregates for 2005/06 Monetary Programme

	Dec'05	Mar'06	Jun'06	Sep'06	Dec'06
	Act.	Projection			
Reserve money (Ksh million)	106.4	101.4	101.6	103.5	110.5
NFA of CBK (Ksh million)	114.8	112.4	110.8	114.9	114.1
Memo:					
Annual change in reserve money	5.6	8.3	7.6	7.9	4.0
Annual change in extended broad money	10.7	9.9	10.0	9.5	10.4
Real GDP growth			5.0	5.1	5.1
Overall inflation			5.0	5.0	5.0

Source: Central Bank of Kenya

Monetary policy in the financial year 2005/06 continued to be directed towards achievement of 5 percent target for inflation by June 2006. The inflation objective was pursued by targeting reserve money expansion of no more than 7.6 percent by June 2006. The growth in reserve money was consistent with 10 percent growth in money supply, and was adequate to support the projected 5 percent non-inflationary expansion in economic activities. The balance of payments was expected to improve further, allowing for a build up in net foreign assets of the CBK to Ksh 110.7 billion by June 2006.

Implementation of the monetary program for the remainder of the financial year 2005/06 was anchored on quarterly targets of reserve money. A ceiling on reserve money and a floor on usable net foreign assets of the Bank were determined for every quarter. Monthly targets for reserve money were set consistent with the established quarterly targets.

1.2 Performance of the Monetary Policy to June 2006

Implementation of monetary policy in the year to June 2006 was through daily monitoring of reserve money. The Bank used the liquidity forecasting framework to monitor on a daily basis the level of reserve money against set targets. In most occasions, policy operations entailed mopping of excess liquidity that was in the money market. This was achieved through open market operations by sale of repurchase agreement (REPOs) securities to commercial banks. As a result, the securities held by commercial banks with Central Bank increased to an average of Ksh 24,859 million in June 2006 from Ksh 9,293 million in December 2005.

Reserve Money

Reserve money increased to Ksh 106.1 billion in June 2006 from Ksh 105.2 billion in December 2005, surpassing the target of Ksh 101.6 billion by Ksh 4.5 billion. (Table 2) The excess in reserve money was largely in currency outside banks amounting to Ksh 4.1 billion. Bank reserves exceeded target by only Ksh 0.4 billion.

Table 2: Reserve Money (RM) Performance and Targets for 2005/06 (Ksh billion)

	2005	2006					
	Dec	Jan	Feb	Mar	Apr	May	Jun
RM (Target)	101.1	101.4	101.4	101.4	101.6	101.6	101.6
Average RM (Actual)	105.2	103.9	102.8	103.3	104.5	104.5	106.1
Deviation	4.1	2.5	1.4	1.9	2.9	2.9	4.5
of which:							
Excess Currency outside	3.7	4.4	3.6	4.2	2.3	3	4.1
Excess bank reserves	0.4	-1.9	-2.2	-2.3	0.5	-0.1	0.4

Source: Central Bank of Kenya

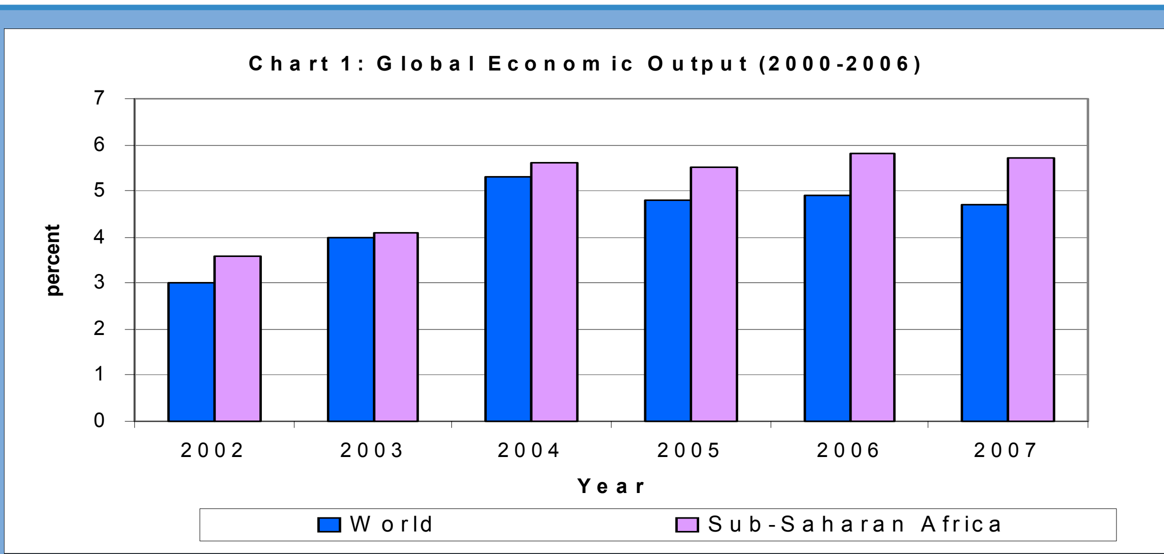
Net Foreign Assets of the CBK

Net Foreign Assets (NFA) of the Central Bank were the main source of reserve money expansion. NFA increased to Ksh 148.5 billion in June 2006 from Ksh 113.2 billion in December 2005. The increase in net foreign assets was from interbank purchases for purposes of meeting the statutory 4.0 months of imports and receipt of budgetary support from the external donors. As a result, net foreign assets targets were surpassed by wide margins during the period under review.

2. ECONOMIC SITUATION AND OUTLOOK FOR 2006 AND MEDIUM TERM

2.1 The World Economy

Despite higher oil prices and natural disasters, expansion of the world economy in 2005 continued to exceed expectations on account of improved financial market conditions and favourable macroeconomic policies, according to the International Monetary Fund's World Economic Outlook (WEO) for April 2006. The world economy is estimated to have grown by 4.8 percent in 2005 compared with 5.3 percent in 2004 as shown in Chart 1. The expansion is becoming more broadly based with remarkable performance being recorded also among emerging market countries.



Source: IMF World Economic Outlook

In sub-Saharan Africa, GDP growth is estimated at 5.5 percent in 2005 compared with 5.4 percent expansion in 2004. The increase reflects continued positive effects of earlier policy reforms and a pick up of growth in oil exporters, particularly Nigeria. On the other hand, oil importing countries in the region continued to show resilience to high oil prices following price increases in non-fuel commodities, improved macroeconomic stability and ongoing structural reforms.

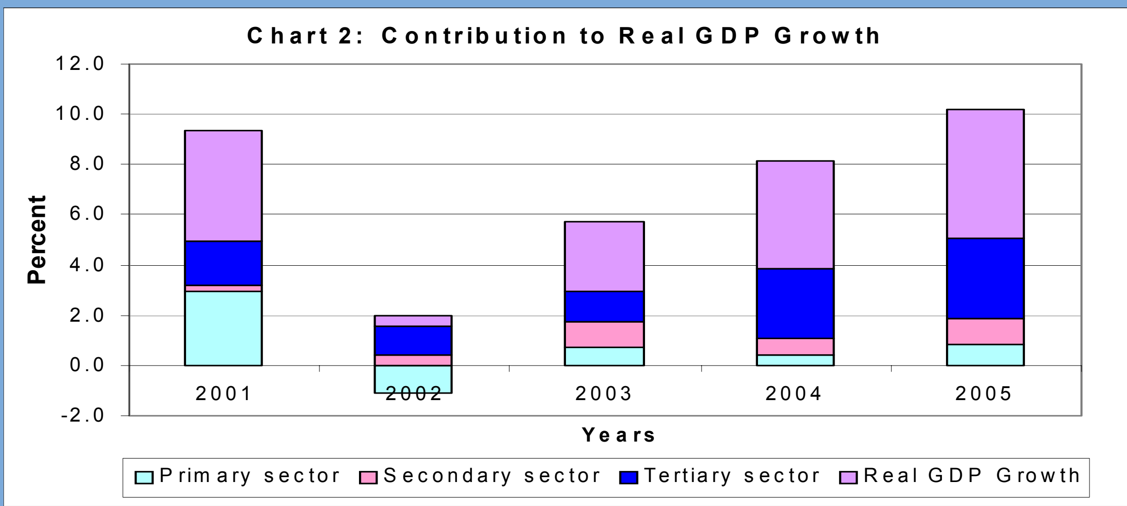
Outlook for 2007

World output growth is expected at 4.9 percent and 4.7 percent, in 2006 and 2007 respectively. Adverse effects of high and volatile oil prices, mainly driven by concerns about future supply, are expected to be offset by robust global industrial production and a resilient services sector.

Economic outlook for Sub-Saharan Africa remains positive with 5.8 percent growth projected in 2006 underpinned by high commodity prices, improved macroeconomic policies and structural reforms in some countries. However, growth prospects for the region particularly the oil importing countries will be undermined by the softening demand for non-oil commodities, higher energy prices and weather.

2.2 Domestic Economy

The economy grew by 5.8 percent in 2005 compared with 4.9 percent in 2004 as shown in chart 2. There was improved performance in various sectors particularly tourism, telecommunications, energy and construction. Credit conditions remained supportive for businesses and facilitating expansion of spending in capital goods. In addition, stability in interest rates and in the macroeconomic environment contributed to the favorable performance of the economy in 2005. The Kenyan economy is expected to continue to perform well with economic growth projected at 5.8 percent in the financial year 2006/07 supported by improved weather conditions expected to boost performance of the agricultural sector.



Source: Central Bureau of Statistics Economic Survey

The expansion in economic activity is reflected in the increased demand for electricity whose consumption increased by 5.5 percent in the first quarter of 2006 while cargo transported through the Kenya Railways rose by 10.5 percent over the same period.

Tourism remained buoyant as stepped up marketing and improved security resulted in increased tourist arrivals by 13.6 percent in the first quarter of 2006. However, growth in the agricultural sector, particularly tea, horticulture, and coffee slowed down in the first quarter of 2006 due to drought. The effect of the drought on these sub sectors has proved to be minimal with output increasing from April 2006 according to leading indicators.

In addition, there was increased demand for imported intermediate inputs for the manufacturing sector while improved performance in the building and construction sector was demonstrated by a 9.5 percent expansion in cement consumption in the first quarter of 2006 compared with 8.7 percent increase in a similar period of 2005.

Projections for financial year 2006/07 and the medium term

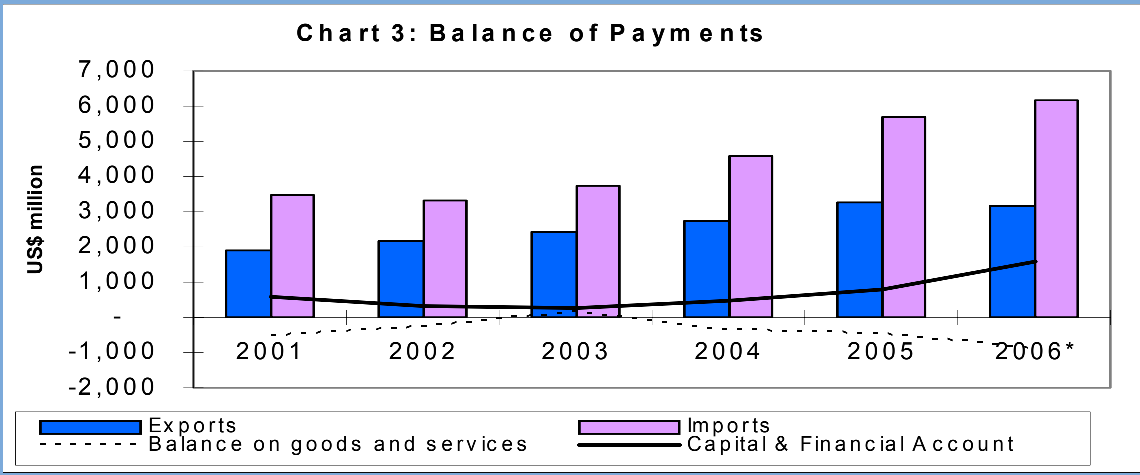
The growth momentum is expected to be sustained through 2006 supported by increased credit to private sector for investment in the productive sectors. Liberalization in ports, telecommunications, energy, and the concessioning of the Kenya Railways is expected to boost growth in these sectors. Successful resolution of armed conflicts in the neighboring countries and particularly the reconstruction underway in Southern Sudan is expected to enhance business opportunities for the Kenyan investors in the medium term.

The upward trend in the economy may, however, be undermined by the deteriorating terms of trade resulting from the high and volatile oil prices in the international market and high prices of other critical imported inputs. In addition, poor infrastructure and high cost of power may further increase the cost of doing business and negatively affect export competitiveness. Other risks include delays in implementation of reforms, that create uncertainties and loss of confidence of investors in the business environment.

2.3 Balance of Payments

The external sector was characterized by rapid expansion of merchandise imports, widening current account deficit, a capital and financial account surplus which easily financed the current account deficit, and, a significant accumulation of international reserves. In the year ended May 2006, the surplus in the balance of payments increased to US$ 782 million from US$ 187 million in the year to June 2005 due to increased private sector financial inflows (Chart 3). The capital and financial account surplus therefore increased by US$ 1,160 million while the current account deficit widened by US$ 564 million. The widening of the current account deficit reflected a larger deficit on trade in goods.

The trade deficit widened to US$ 3,130 million in the year ended May 2006 from US$ 2,252 million in the year to June 2005. Merchandise imports grew by 17.7% to US$ 6,264 million in the year to May 2006 compared with 2.1% growth in merchandise exports to US$ 3,135 million during the same period. There was increased spending on imports of oil and machinery and transport equipment. The increase in imports is broadly consistent with the pace in domestic



Source: Central Bank of Kenya

spending. Export earnings improved on account of increased export volumes primarily in tea, coffee, horticulture, oil and manufactured goods to the country's main trading partners.

Increased outflows from the trade account were partially offset by higher net inflows into the services account of US$ 2,045 million in the year to May 2006 compared with US$ 1,732 million in the year to June 2005. The improvement in the services account reflected increased inflows on account of transportation services, tourism and current transfers. Earnings from tourism improved to US$ 625 million in the year to April 2006 from US$ 522 million in the year to June 2005.

The surplus in the capital and financial account rose to US$ 1,867 million in the year to May 2006 from US$ 707 million in the year to June 2005 due to increased private sector financial inflows. Demand from foreign investors for domestic assets, particularly in the equity market , has driven gross capital inflows in the recent past. Official medium and long-term financial flows, however, worsened by US$ 72 million during the reference period following increased amortization of official foreign debt.

Following the improvement in the overall balance of payments position, gross official foreign exchange reserves increased to US$ 2,253 million, equivalent to 4.6 months of imports cover (based on average imports for the three preceding years) as at the end of May 2006, from US$ 1,587 million, equivalent to 3.9 months of import cover, at the end of June 2005. Foreign exchange reserves holdings by commercial banks however declined to US$ 698 million, at the end of May 2006, from US$ 740 million, at the end of June 2005. By the end of June 2006, accumulated gross official reserves stood at approximately US$ 2.3 billion, which is equivalent to 4.7 months of import cover.

Projections for financial year 2006/07 and the medium term

The deficit in the current account is expected to continue widening as the performance of merchandise exports continues to lag behind growth in imports. Higher imports, particularly of oil, machinery and transport equipment and other intermediate goods are anticipated, commensurate with expectations of higher economic growth. Continued economic expansion in Kenya's trading partners is, however, expected to support further improvement in export earnings.

The services sector has had good performance with services exports, including tourism, rising steadily since October 2005. The improvement in the services account is thus expected to slow down the deterioration of the current account.

The improvement in the capital and financial account following expected strong inflows of private and official capital would offset the deterioration of current account deficit. As a result, the overall balance of payments is expected to record a surplus of around US$ 500 million in the fiscal year 2006/2007.

Following improved balance of payments, the gross official foreign exchange reserves are projected to increase to US$ 2.6 billion in June 2007 and to US$ 3 billion in June 2008, equivalent to 4.9 months of imports cover, up from US$ 2.3 billion in June 2006, equivalent to 4.7 months of import cover.

2.4 Fiscal Developments

During the fiscal year 2005/06, Government fiscal operations resulted in an overall budget deficit of Ksh 55.2 billion, equivalent to 3.5 percent of GDP, on commitment basis compared with a surplus of Ksh 1.0 billion, equivalent to 0.1 percent of GDP in fiscal year 2004/05 (Table 3). The overall deficit mainly reflected an increase in Government expenditure, and was within the limit of 3.5 percent of GDP, for the period.

Cumulative Government revenue collection and receipts of external grants during the period amounted to Ksh 327.8 billion, and was lower than the Ksh 360.7 billion target for the period. The under-performance in revenue collection was attributed to hitches during the implementation of the new customs computer system (simba 2005) which affected collection of custom duties. The strike by oil marketers following the requirement that they pay petroleum taxes upfront also affected petroleum taxes, contributing to lower than expected performance in revenue collection. However, when compared with collections in the previous fiscal year which totalled Ksh 304.7 billion, revenue collection and receipts of external grants improved by 7.6 percent during the period as a result of the good performance of the economy.

Government expenditure during the fiscal year 2005/06 amounted to Ksh 383.0 billion, or 24.5 percent of GDP, which was within the Ksh 415.1 billion target for period. The decision by the Government to cut expenditure on operations and maintenance following lower than expected revenue collections during the period, led to lower expenditures. Net financing of the budget deficit during the period amounted to Ksh 37.3 billion compared with a target of Ksh 51.7 billion. Net domestic financing of the deficit amounted to Ksh 28.4 billion while net foreign financing was a net repayment of Ksh 1.8 billion. In addition, the Government received privatisation proceeds totalling Ksh 7.0 billion from the KenGen IPO.

Table 3: Central Government Fiscal Outturn (Ksh Billion)

	2004/05 Prov.	2005/06 Prov.	2005/06 Target	2006/07 Proj.	2007/08 Proj.
1. Total Revenue and Grants	304.7	327.8	360.7	403.8	413.8
Total Revenue	289.8	308.0	325.6	375.4	373.6
Grants	14.9	19.8	35.1	28.4	40.2
2. Total Expenditure	303.7	383.0	415.1	461.2	499.5
Recurrent	258.1	314.8	328.2	338.3	362.1
Development	45.6	68.2	86.9	122.9	137.4
3. Balance (commitment basis including grants)	**1.0**	**-55.2**	**-54.4**	**-57.4**	**-85.7**
% of GDP	0.1	-3.5	-3.5	-3.2	-4.4
4. Adjustment to cash	0.4	17.6	2.8	0.0	0.0
3. Balance (cash basis including grants)	**1.4**	**-37.7**	**-51.7**	**-57.4**	**-85.7**
% of GDP	0.1	-2.4	-3.3	-3.2	-4.4
6. Statistical discrepancy	-5.9	-0.4	0.0	0.0	0.0
7. Total Financing	**-7.3**	**37.3**	**51.7**	**57.4**	**85.7**
a. Net External	-0.6	1.8	5.7	9.7	24.5
b. Net Domestic	-6.7	28.4	36.6	29.5	25.7
c. Others*	0.0	7.0	9.3	18.2	0.0
d. Financing Gap	0.0	0.0	0.0	0.0	35.6

* Includes privatisation proceeds and securitisation of domestic arrears

Source: Treasury

In the Supplementary Budget estimates for the fiscal year 2005/06, the Government revised its budget estimates for the fiscal year. The new estimates took into account increased expenditure on drought related expenses. Government revenue and receipts of grants for the financial year 2005/06 are projected at Ksh 360.7 billion while expenditure is projected at Ksh 415.1 billion. This implies a budget deficit of Ksh 51.7 billion or 3.3 percent of GDP on cash basis, which is expected to be financed through net external borrowing totalling Ksh 5.7 billion, net domestic borrowing totalling Ksh 36.6 billion, privatisation proceeds totalling Ksh 7.3 billion from the KenGen IPO and expenditure arrears securitisation financing amounting to Ksh 2.0 billion.

Projections for the fiscal year 2006/07 and the medium term

For the fiscal year 2006/07, Government revenue is targeted at Ksh 375.4 billion which is equivalent to 21.4 percent of GDP. The revenue collection will largely be supported by the on-going improvements in tax and customs administration. Total Government expenditures in the fiscal year 2006/07 are projected at Ksh 461.2 billion which is equivalent to 26.4 percent of GDP. As a proportion of GDP, expenditures are expected to remain unchanged from that in the fiscal year 2005/06. Recurrent expenditures are projected to grow by 7.6 percent to stand at Ksh 338.3 billion. However, as a share of GDP, recurrent expenditure is projected to fall to 19.3 percent from 20.1 percent in the fiscal year 2005/06. Development expenditure is projected to rise to Ksh 120 billion from Ksh 86.9 billion in the previous fiscal year. In terms of GDP, development expenditure will increase from 5.6 percent to 6.8 percent, which is consistent with the core requirement of the Economic Recovery Strategy.

The overall budget deficit including grants for the fiscal year 2006/07 is therefore projected at Ksh 57.4 billion or 3.2 percent of GDP and will be financed through net external financing of projects amounting to Ksh 9.7 billion, privatisation proceeds amounting to Ksh 18.2 billion and domestic borrowing totalling Ksh 29.5 billion.

2.5 Exchange Rate

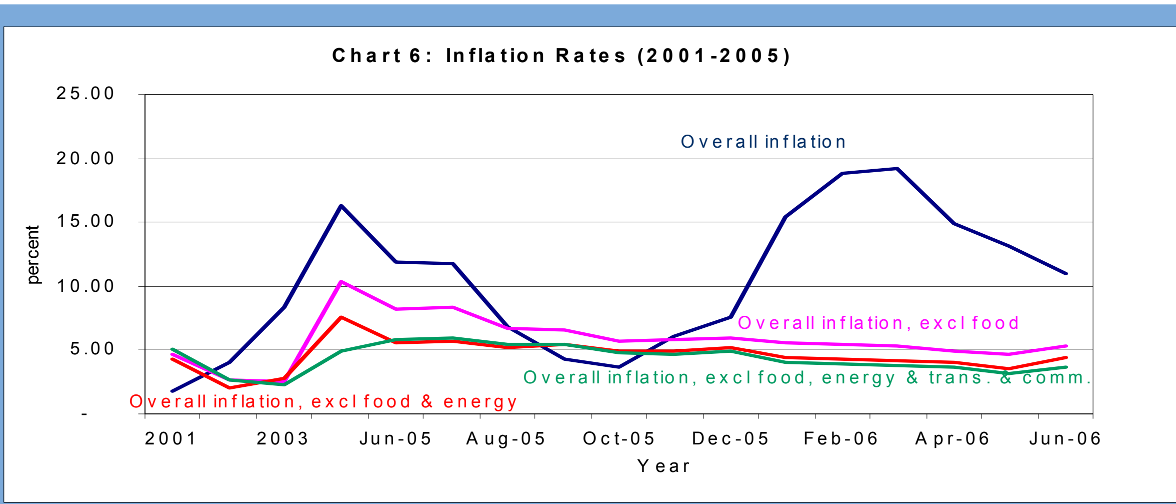
The appreciation of the Kenya shilling experienced in the second half of 2005 continued through the first quarter of 2006. It was driven by continued foreign exchange inflows from the export sector and capital inflows supported by relatively attractive domestic interest rates. The strength of the shilling, however, eased in May and June 2006 following a pick up in corporate demand mainly from oil importers.

The Kenya shilling thus depreciated against major currencies in the first half of 2006. Against the US dollar, the shilling lost by 2.1 percent to close at Ksh 73.9 at the end of June 2006 from Ksh 72.4 at the beginning of 2006. The shilling also lost against the Sterling Pound by 8.5 percent, by 9.4 percent against the Euro and by 4.5 percent against the Japanese Yen. The weakening of the shilling against the Sterling Pound, the Euro and the Japanese Yen reflected the strengthening of these currencies against the US dollar. The Kenya shilling ,however, maintained its strength against regional currencies, appreciating by 0.4 percent and 5.3 percent against the Uganda and Tanzania shillings, respectively. As the CBK continues to pursue a prudent monetary policy and maintain a market determined exchange rate, it is expected that the shilling will remain stable in 2006 and in the medium term.

2.6 Inflation

Overall inflation ended up higher in the first half of 2006 than in the second half of 2005 (Chart 6). The higher inflation mainly reflected rising food prices due to the drought experienced in the last quarter of 2005. In particular, overall month-on-month inflation reached a peak of 19.1 percent in March 2006 before moderating to 14.9 percent in April 2006 and further to

10.9 percent by the end of June 2006. Average annual inflation remained high in the first quarter of 2006 before falling to 11.2 percent in June 2006.



Source: Central Bank of Kenya

The decline in overall inflation by the end of June 2006 reflected a significant drop in inflation in the food category particularly of vegetables, and the non-alcoholic drinks category which account for 50.5 percent of the overall CPI. While the food and non-alcoholic drinks inflation fell to 14.9 percent in June 2006 from 18.9 percent in May 2006, six out of ten inflation categories increased in June 2006 largely due to price adjustments following new tax measures announced in the budget for fiscal year 2006/07.

Underlying inflation , as measured by the consumer price index excluding the direct effects of price movements in food, energy and transport and communication sub indices, declined to 3.18 percent in May 2006 from 3.66 percent in April 2006, before picking up to 3.68 percent in June 2006 (Table 4). The CBK excludes food and non-alcoholic drinks index from the overall Consumer Price Index (CPI) because food prices are influenced by weather conditions while fuel and power inflation is affected by weather conditions as well as movements in international crude oil prices. Transport and communications index includes items such as petrol and diesel whose prices largely reflect oil price developments in the world market. The pick up in underlying inflation in June 2006 to 3.68 percent reflects price adjustments arising from the fiscal year 2006/07 budget statement. Increased levy in particular, had an indirect effect on other categories affected by higher fuel and transport costs. Nonetheless, underlying inflation continues to remain below target of 5 percent.

Table 4: Consumer Price Index (2005-2006)									
	2005			2006					
	Jun	Sep	Dec	Jan	Feb	Mar	Apr	May	Jun
CPI	11.9	4.3	7.6	15.4	18.9	19.1	14.8	13.1	10.9
Food & Drink	14.7	2.6	8.8	22.6	28.6	29.0	21.7	18.9	14.9
Alcohol & Tobacco	9.7	8.9	9.2	9.9	9.6	10.2	8.8	8.7	6.5
Clothing & Footwear	4.3	3.7	3.1	2.4	2.0	2.0	1.5	1.6	2.8
Housing	6.4	6.0	5.5	3.9	3.9	3.8	4.5	3.4	4.8
Fuel & Power	28.7	14.6	11.2	13.1	13.2	12.6	11.0	12.3	11.4
Household Goods & Services	7.2	6.5	4.7	4.1	3.7	3.4	2.9	2.6	3.1
Medical Goods & Services	5.7	6.5	5.3	4.5	5.2	5.2	4.2	5.3	3.8
Transport & Communication	4.5	5.7	6.5	7.0	6.4	6.3	6.4	5.4	8.3
Recreation & Education	4.2	4.0	4.3	3.2	3.6	3.0	2.9	2.0	2.1
Personal Goods & Services	3.4	3.2	4.0	3.2	3.2	3.0	2.8	2.4	2.5
Underlying Inflation (various measures)									
CPI excluding food	8.2	6.6	6.0	5.5	5.4	5.3	5.0	4.7	5.3
CPI excluding food and energy	5.6	5.4	5.2	4.5	4.3	4.2	4.1	3.5	4.4
CPI excluding food, energy and transport & communication	5.8	5.4	4.9	4.0	3.9	3.8	3.7	3.2	3.7

Source: Central Bank of Kenya

While energy prices have been rising for a second year in a row, the pressures appear not to have generated second round effects as reflected by movements in underlying inflation. Unlike overall inflation, underlying inflation has been low in the first quarter of 2006 fluctuating between 3.0 percent and 4.0 percent, relative to the second half of 2005 whereby underlying inflation fluctuated between 4.7 percent and 6.0 percent. The appreciation of the shilling has contributed to containing the pass through of high international oil prices to domestic energy prices. In addition, the stability in the exchange rate has also helped in dampening inflation expectations.

Projections for 2006/07 and the medium term

Overall inflation is expected to decline further with food prices declining following long rains in March-May 2006. Increased supply of basic foodstuffs is therefore expected to further moderate the food and non-alcoholic drinks index which accounts for more than 50 percent of the overall CPI. The prevailing macroeconomic conditions as manifested by stable domestic interest rates and the shilling exchange rates are expected to support realization of stable inflation.

While there are expectations of low and stable inflation in view of the expected decline in food prices, continued implementation of prudent monetary policy and the expected continuation of macroeconomic stability, high international oil prices continue to pose a challenge to the realisation of stable prices. Monetary policy will be geared towards consolidating the gains achieved so far and ensuring that inflation expectations are well anchored in order to prevent one off increases from becoming embedded in the inflationary process.

2.7 Monetary and Financial Markets Developments

Money and Credit

Broad money, M3, accelerated from 11.0 percent a year ago to 16 percent in the year to June 2006 (Table 5). At 16 percent, the expansion in M3 was above the 10 percent target for the June 2006 quarter. Meanwhile, the expansion in M2 accelerated from 8.6 percent in June 2005 to 18 percent in June 2006 , reflecting a build up in demand deposits following the KenGen share issue.

The increase in M3 was supported by the expansion in the banking systems' net foreign assets and net domestic assets which contributed 7.1 percent and 8.9 percent respectively. The increase in net foreign assets of the banking system reflected a strong surplus in the capital and financial account of the balance of payments.

Table 5: Contribution to Growth in Broad Money, M3 (percent)

	Dec-04	Mar-05	Jun-05	Sep-05	Dec-05	Mar-06	Jun-06
Annual growth in M3	13.2	13.4	11.0	11.3	10.2	12.5	16.0
Net Foreign Assets	3.1	5.0	5.0	6.1	7.4	6.5	7.1
Net Domestic Assets	10.0	8.4	6.0	2.9	2.8	6.0	8.9
Domestic Credit	14.8	13.2	10.7	5.4	4.9	8.2	11.3
Government (net)	-0.6	-2.1	-2.1	-5.1	-2.0	-0.2	1.1
Rest of the Economy	15.4	15.2	12.8	10.5	6.9	8.4	10.2
Other public sector	1.1	0.5	0.2	-0.1	0.2	0.1	0.4
Private sector	14.3	14.7	12.6	10.6	6.7	8.3	9.9
Other Items (net)	-4.8	-4.7	-4.7	-2.5	-2.1	-2.3	-2.4

Source: Central Bank of Kenya

Reserve money increased by 14 percent in the year to June 2006 from 4.7 per cent in a similar period to June 2005, and 7.6 percent target for the June 2006 quarter. The increase in reserve money was mainly in currency outside banks. Net foreign assets of the CBK supported the increase in reserve money reflecting purchases made by the Bank for reserves build up to the statutory 4.0 months of imports cover in addition to inflows for budgetary support from bilateral institutions.

Domestic credit grew much slower with credit to private sector decelerating to 15.2 percent in June 2006 from 20.9 percent a year earlier. While credit to the private sector represented a slowdown, the increase in the year was consistent with improved economic prospects. Most of the private sector credit expansion was to mining and quarrying (47.8 percent), transport and communication (33.4 percent), building and construction (31.4 percent), business services (28.1 percent), and agriculture (17.5 percent) as shown in table 6.

Table 6: Credit to Private Sector						
	2005		2006		Annual	
	June Ksh bn	Share (%)	June Ksh bn	Share (%)	Change Ksh bn	percent
Credit to Private Sector	**343.7**	**73.7**	**395.8**	**75.3**	**20.9**	**15.2**
Agriculture	29.5	6.3	34.7	6.6	10.7	17.5
Manufacturing	67.3	14.4	71.1	13.5	26.6	5.6
Trade	51.5	11.0	57.7	11.0	4.1	12.0
Building and construction	23.7	5.1	31.1	5.9	21.9	31.4
Transport & communications	26.7	5.7	35.6	6.8	38.7	33.4
Finance & insurance	30.6	6.6	29.7	5.6	30.6	-2.9
Real estate	23.6	5.1	25.7	4.9	19.0	8.8
Mining and quarrying	2.1	0.4	3.1	0.6	4.0	47.8
Private households	46.3	9.9	45.4	8.6	60.0	-2.0
Consumer durables	9.2	2.0	11.8	2.2	37.4	28.0
Business services	32.6	7.0	41.7	7.9	49.5	28.1
Other activities	0.7	0.1	8.3	1.6	-95.1	1143.2

Source: Central Bank of Kenya

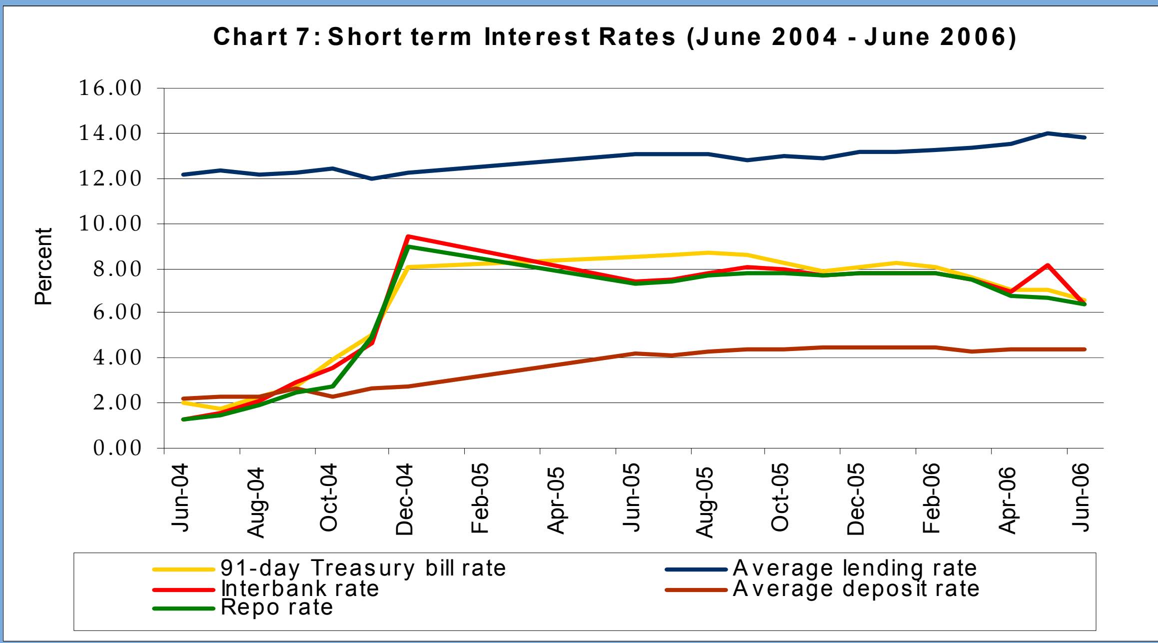
Equity Market

Activity at the Nairobi Stock Exchange improved in the 2005/2006 financial year. The NSE 20 Share Index gained 287.5 points, moving from 3973.04 in December 2005 to 4260.49 by the end of June 2006.

Market turnover increased over the same period, from Ksh 24.0 billion in December 2005 to Ksh 35.9 billion in June 2006. During the period under review, the Government offered for sale 659 million shares in KenGen which pushed market capitalization to Ksh 623.2 billion in June 2006 from Ksh 462.5 billion in December 2005. Increase in the volume of shares traded, coupled with increase in share prices for most stocks as a result of improved corporate financial returns, contributed to the increase in turnover and rise in the NSE 20 share index.

Interest Rates

Short-term interest rates as shown in Chart 7 continued to ease downwards in the first half of 2006 with the average 91-day Treasury bill rate declining to 6.60 percent by end of June 2006, from 8.07 percent in December 2005. Similarly, the average 182-day Treasury bill rate declined from 8.49 percent in December 2005 to 7.32 percent in June 2006.



Source: Central Bank of Kenya

The average interbank rate declined from an average of 7.79 percent in December 2005 to 6.41 percent in June 2006. However, before declining in June 2006, the rate increased sharply to 8.12 percent in May 2006 reflecting a temporary shock to the interbank market following the initial public share offer by KenGen. The requirement for prospective investors to pay upfront for the shares, and for all the funds to be deposited in one bank drained liquidity in most banks. As a result, commercial banks resorted to the interbank market to cover for the liquidity shortfalls.

The recent decline in short term interest rates reflects high levels of liquidity in the market following an increase in short term capital inflows.

Commercial banks lending rates increased to 14.0 percent in May 2006 from 13.5 percent in the previous month. The average deposit rate remained virtually unchanged at 4.36 percent in May 2006 compared with 4.38 percent in December 2005. The average deposit rate has been very stable varying between 4.0 percent and 4.5 percent between May 2005 and April 2006. Following increased lending rates, the interest rate spread was generally higher between January and May 2006 compared with the last half of 2005.

Outlook for 2006/07

Interest rates are expected to remain stable with continued implementation of prudent monetary policy and a sustainable fiscal position.

The measure taken to strengthen the implementation of monetary policy with respect to the Central Bank Rate (CBR) is expected to further consolidate interest rate stability. At this stage, the CBR is set in accordance with Section 36(4) of the Central Bank of Kenya Act, which requires the Central Bank to publish the minimum interest rate at which it lends to commercial banks. It is based on an eight-week moving average of the repo rate and the interbank rate plus a margin.

3 MONETARY POLICY FOR 2007

Monetary policy in financial year 2006/07 will continue to be directed towards attaining and maintaining inflation rate of 5 percent. While taking into account the delayed effects of monetary policy actions on the economy, a careful assessment of both the current economic conditions and the outlook for inflation has been undertaken.

On the basis of incoming data on inflation and economic activity, the main factors that contributed to the favourable economic performance in 2005 are expected to prevail in 2007. Some of the structural impediments to growth identified in the previous statement have also been addressed. In particular, the reconstruction of key road networks is well underway. Interest rates are relatively low and growth in private sector credit continues to be in line with improved macroeconomic stability. Despite the concerns of higher world oil prices, economic growth is expected to strengthen further to 5.8% in 2006/07.

The outlook for inflation has improved with overall inflation easing down to 10.9 percent by the end of June 2006. However, the continued increase in international oil prices could put some upward pressures on underlying inflation reflecting the pass through of higher energy prices to domestic fuel prices. Underlying inflation increased by the end of June 2006, mainly reflecting price adjustments following the 2006/07 Budget statement.

The risks to price stability form the major consideration of the stance of monetary policy in 2007. As indicated in Table 7 and Appendix 2, which set out the monetary policy stance for 2007, broad money supply, M3, is set to grow by 10 percent by June 2007. To achieve the policy objective of bringing inflation to the target of 5% and to anchor inflation expectations, reserve money is programmed to expand by 10 percent in 2007. With stable interest rates, credit to the private sector is expected to range between 10 and 12 percent.

Table 7: Growth Target for Monetary Aggregates for 2006

	Jun'06	Jun'06*	Sep'06	Dec'06	Mar'07	Jun'07
Reserve money (Ksh million)	101.6	106.0	106.9	117	114.0	116.6
NFA of CBK (Ksh million)	110.8	142.0	144.9	150.5	158.5	164.1
Memo:						
Annual change in reserve money	7.6	12.3	11.5	10.1	10.9	10.0
Annual change in extended broad money (M3)	10.0	12.3	12.0	11.0	11.1	10.0
Real GDP growth	5.0	5.0				5.8
Overall inflation	5.0	5.0				5.0

Source: Central Bank of Kenya

The reserve money path takes into account a build up in gross international reserves by the Bank to reflect expected strong surplus in the capital and financial account. In addition, provisions have been made to the reserve money path to accommodate strong demand for currency by the public.

The Bank will continue to monitor developments and make necessary adjustments as may be warranted in order to contain possible risks to price stability in 2007 and over the medium term. However, sustaining the monetary policy stance will depend on the following factors:

- Stability in the international prices of oil;
- Stability of the exchange rate particularly following the recent decline in interest rates; and
- Commitment by the Government to live within the domestic borrowing ceiling for fiscal year 2006/07.

Monetary policy implementation will be anchored on monthly targets for reserve money to be achieved through open market operations. As in the past, changes in the reserve money will be monitored on a daily basis based on the Banks daily balance sheet and liquidity-forecasting framework, with repos used to withdraw any excess liquidity in the banking system on a timely basis and vice versa. The Bank will limit its participation in the foreign exchange market to smoothening out any erratic movements in the exchange rate, meeting external obligations of the Government, and to maintaining the statutory import cover.

Appendix 1: Medium-Term Macroeconomic Framework (2003-2007)

	2003	2004	2005	2006	2007
Real Sector					
Nominal GDP, KSh billion	1,289	1,467	1,659	1,840	2,016
Real GDP growth	4.1	5.5	5.7	6.0	6.3
CPI inflation (end of period)	8.9	11.4	8.0	4.3	3.5
Savings/GDP	15.9	14.9	15.2	15.6	15.5
Investment/GDP	17.4	17.1	18.0	19.4	20.2
External Sector					
Current Account (% of GDP)	-0.7	-2.9	-3.4	-4.4	-5.2
Overall balance (US$ million)	136	144	428	436	390
Official reserves (US$ million)	1,493	1,878	2,363	2,778	3,196
Months of import coverage	2.8	2.8	3.1	3.5	3.6
Money and Credit					
(Annual % change)					
Net Credit to Government	-1.0	-2.0	-6.8	13.1	9.0
Credit to Private Sector	24.4	25.7	10.3	10.7	13.6
Extended Broad Money (M3)	13.2	13.2	10.2	11.0	10.0
Reserve Money	15.5	15.5	5.1	10.1	7.7
Fiscal Sector (% of GDP)					
Total Revenue	21.2	21.1	21.1	21.4	21.8
Total expenditure and net lending	22.6	24.4	26.4	26.3	26.1
Overall balance, excl. grants	-1.4	-3.4	-5.3	-4.9	-4.2
Overall balance, incl. grants	-0.1	-1.6	-3.3	-3.1	-2.1
Net domestic borrowing	0.1	0.8	1.9	1.5	1.1
Financing gap	-0.2	0.0	0.0	0.0	0.5
Total donor support (grants & loans)	2.0	2.4	3.3	3.9	4.4
Domestic Debt/GDP	22.4	23.1	22.8	22.5	21.7

Source: Central Bank of Kenya and Ministry of Finance

Appendix 2: Depository Corporations Survey June 2005 - June 2007
(in Ksh billion, unless otherwise indicated)

	Jun-05	Sep-05	Dec-05	Mar-06	Jun-06	Sep-06	Dec-06	Mar-07	Jun-07
			2005/06					2006/07	
	Act.	*Act.*	*Act.*	*Act.*	*Proj.*	*Proj.*	*Proj.*	*Proj.*	*Proj.*
Central Bank of Kenya									
Net foreign assets 1/	95.7	106.1	114.8	127.3	142.0	144.9	150.5	158.5	164.1
Net domestic assets	-1.1	-10.2	-8.6	-24.5	-36.0	-38.0	-33.5	-44.6	-47.5
Net domestic credit	-3.2	3.3	0.5	-13.2	-24.6	-26.6	-22.7	-33.2	-36.1
Other items (net)	2.1	-13.4	-9.1	-11.3	-11.3	-11.3	-10.8	-11.3	-11.3
Reserve money (RM)	94.6	95.9	106.2	102.8	106.0	106.9	117.0	114.0	116.6
Currency outside banks	59.3	59.3	66.3	64.2	66.8	66.9	73.9	70.9	73.6
Bank reserves	35.2	36.6	40.0	38.6	39.2	40.0	43.0	43.1	43.0
Other Depository Corporations									
Net foreign assets 1/	52.8	51.5	49.4	51.7	51.7	51.7	51.7	51.7	51.7
Reserves	35.2	36.6	40.0	38.6	39.2	40.0	43.0	43.1	43.0
Credit to CBK	5.3	5.1	5.3	20.8	32.5	34.9	31.2	42.1	45.3
Net domestic assets	369.1	391.3	404.6	412.4	401.4	415.5	427.9	445.3	437.5
Domestic credit	459.2	473.3	492.9	512.6	513.2	529.6	546.6	569.6	570.1
Other items (net)	-90.1	-82.0	-88.3	-100.2	-111.7	-114.1	-118.7	-124.3	-132.6
Total deposits	467.5	484.6	499.2	523.4	524.8	542.1	553.8	582.1	577.5
Deposits in shillings	383.1	394.4	408.2	428.7	428.7	445.0	455.7	483.1	477.5
Deposits in foreign currency	84.4	90.2	91.0	94.7	96.1	97.1	98.1	99.0	100.0
Depository Corporations Survey									
Net foreign assets 1/	148.4	157.6	164.2	179.0	193.6	196.6	202.1	210.2	215.7
Net domestic assets	378.3	386.4	401.3	408.6	398.0	412.4	425.6	442.8	435.3
Domestic credit	466.3	481.6	498.7	520.2	521.0	537.8	555.1	578.4	579.2
Government (net)	112.3	118.8	122.2	126.2	131.4	134.8	138.2	141.6	145.0
Rest of the economy	354.0	362.8	376.5	394.0	389.7	403.1	416.9	436.8	434.2
Other items (net)	-87.9	-95.2	-97.3	-111.6	-123.1	-125.4	-129.5	-135.6	-143.9
M3	526.8	543.9	565.5	587.6	591.6	609.0	627.7	653.0	651.1
Memorandum items:									
(In Percent of Annual Change)									
M3	11.3	11.8	10.2	12.5	12.3	12.0	11.0	11.1	10.0
Reserve Money	4.8	6.7	5.1	9.8	12.3	11.5	10.1	10.9	10.0
Currency outside banks	6.6	5.7	5.7	10.7	12.6	12.8	11.6	10.4	10.1
Domestic credit	8.4	7.1	5.6	9.0	11.7	11.7	11.3	11.2	11.2
Government (net)	-17.8	-13.8	-6.8	-0.7	17.0	13.4	13.1	12.2	10.4
Rest of the economy	20.6	16.4	10.3	12.6	10.1	11.1	10.7	10.9	11.4

APPENDIX 3: CHRONOLOGY OF EVENTS OF PARTICULAR RELEVANCE TO MONETARY POLICY AND INFLATION (JANUARY – JUNE 2006)

2006

January 2006	The Central Bank of Kenya released its seventeeth Monetary Policy Statement (December 2005), setting out the monetary program to be pursued for the remainder of the financial year 2005/06 (January-June).
May 2006	An IMF mission visits the country to follow up on the discussions reached during the June 2005 Mission, to enable completion of discussion on the Second Review of the IMF-supported PRGF program.
June 2006	The current practice of setting the overnight lending rate of the Central Bank as the latest 91-day Treasury bill rate plus 3% is discontinued. Instead, the overnight lending rate, which is the same as the Central Bank Rate (CBR) will now be based on the average of the interbank and the Repo rates plus a margin to be determined and announced by the Central Bank every eight weeks. The CBR is set in accordance with Section 36(4) of the Central Bank of Kenya Act, which requires the Central Bank to publish the minimum interest rate at which it lends to commercial banks.

GLOSSARY OF KEY TERMS

Overall Inflation

This is a measure of movement of indices of all consumer price items of goods and services sampled by the Central Bureau of Statistics.

Underlying Inflation

This is a measure of consumer price movements in goods and services other than food, energy and transport and communications. These items are excluded because they are susceptible to transient effects that are in most cases beyond the control of the CBK. Thus the underlying measure is used by the Central Bank to gauge the influence of monetary policy on inflation.

Reserve Money

These are CBK monetary liabilities comprising currency in circulation (currency outside banks and till cash held by commercial banks) and deposits of both commercial banks and nonbank financial institutions held with the CBK.

Money Supply

Money supply is the sum of currency outside banks and deposit liabilities of commercial banks. Deposit liabilities are defined in the narrower and broader sense as follows: narrow money (M1); broad money (M2); and extended broad money (M3). These aggregates are defined as follows:

M1	Currency outside banking system + demand deposits
M2	M1 + time and saving deposits + certificate of deposits + deposits Liabilities of Non-Bank Financial Institutions (NBFIs)
M3	M2 + resident's foreign currency deposits

Central Bank Rate

The minimum rate of interest the Central Bank lends to commercial banks. It is determined and announced by the Central Bank every eight weeks, based on the average of the interbank and Repo rates plus a margin

Open Market Operations (OMO)

The Central Bank's act of buying or selling Government treasury bills in the secondary market in order to achieve a desired level of currency in circulation and bank reserves. OMO is done in the context of an auction where commercial banks bid through the Reuters screen.

Repurchase Agreement (REPO)

This is an instrument used in OMO. REPOs are agreements between the CBK and commercial banks to purchase/sell government securities from/to commercial banks at agreed interest rate (REPO rate) for a specified period with an understanding that the commercial bank will repurchase/resell the security to the CBK at the end of the period.

Reserve Money Program

This is the desired expansion in the reserve money operating target to achieve the money supply growth target (intermediate target) that is consistent with the inflation target (ultimate target).

Cash Reserve Requirement

This is an amount of legally required balances of commercial bank and nonbank financial institutions held with the CBK. The Central Bank is empowered by the Act to demand that a certain proportion of commercial banks' deposits to be held as reserves at the Central Bank. The ratio currently stands at 6 percent.