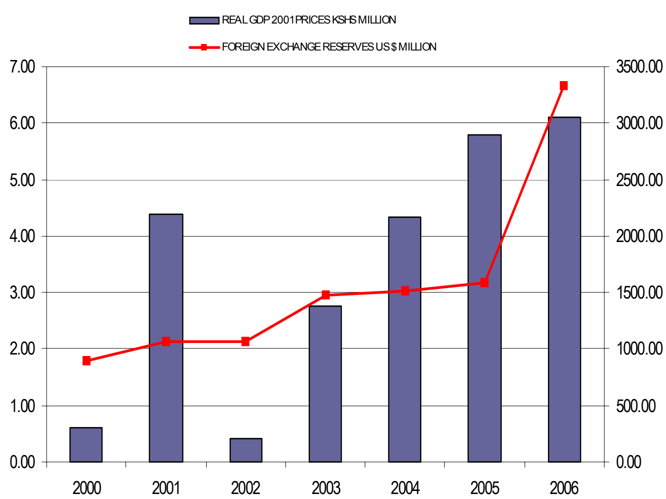



CENTRAL BANK OF KENYA

# Monetary Policy Statement

*Issued under the Central Bank of Kenya Act, Cap 491*

JUNE 2007

## Letter of Transmittal

Dear Honourable Minister,

I have the pleasure of forwarding to you the 20th 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 previous Statement for December 2006, the current economic developments, and outlines the monetary policy stance for the year to June 2008.

Prof. Njuguna Ndung'u
Governor

# MONETARY POLICY STATEMENT
# JUNE 2007

## TABLE OF CONTENTS

**Page**

## The Principal objectives 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 also seeks to:

- Formulate and implement foreign exchange policy;
- Hold and manage its foreign exchange reserves;
- License and supervise authorized dealers in the money market;
- Promote the smooth operation of payments, 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 Central Bank of Kenya formulates and conducts monetary policy with the aim of keeping inflation low and stable, thereby contributing to a favourable macroeconomic environment for economic growth and employment creation. Low and stable inflation facilitates higher levels of domestic savings and private investment and therefore leads to better economic outcomes including sustained high economic growth, higher real incomes and increased employment opportunities.

The Banks monetary policy is thus designed to achieve low and stable inflation and to accommodate economic growth.

### Instruments of Monetary Policy

The CBK pursues its monetary policy objectives using the following instruments:

- **Open Market Operations** whereby the CBK either buys or sells 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 from commercial banks through repurchase order agreement (Repos) , and withdraws money when it sells them.

- **Standing Facilities** which the CBK, as lender of last resort, provides secured short-term loans to commercial banks on an overnight basis at a 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 CBK every eight weeks. Commercial banks facing temporary liquidity needs may also rediscount their Treasury bills holdings at the CBR.

- **Reserve Requirements,** which is the proportion of commercial banks' deposits to be held as cash reserve requirement (CRR) at the CBK in accordance with the law. 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 been maintained at 6 percent of commercial bank deposits since July 2003.

- **Foreign Exchange Market Operations** whereby the CBK either injects or withdraws liquidity by engaging in foreign exchange transactions. The participation by CBK in the foreign exchange market is in most cases geared to forestalling 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

World real GDP grew by 5.4 percent in 2006 compared with 5.1 percent forecast in the September 2006 World Economic Outlook. The prospects for the world economy remain good with output growth projected to moderate to 4.9 percent in 2007, marking the fifth year of sustained expansion linked in part to strong productivity growth. While output growth in the US has slowed down driven by a slackening in the housing sector, domestic demand in the other economic regions continues to remain robust.

Sub-Saharan Africa's economic expansion remains robust with real GDP growth expected to reach 6.2 percent in 2007 from 5.5 percent in 2006, mainly driven by strong oil revenues. Oil exports from the region are expected to increase as new production wells in Angola and Equatorial Guinea come on stream and the conflict in the Niger Delta gets resolved. Growth in oil importing countries in the region is projected to ease on expectations of a slow down in domestic demand in South Africa following tighter monetary policy. While the oil importing countries have been resilient to high international fuel prices supported by improved terms of trade on the non-fuel commodities as well as marked improvements in the policy environment, further reforms particularly in the area of trade liberalization are a prerequisite for sustained growth.

Kenya's economy grew by 6.1 percent in 2006 marking the fourth year of sustained expansion underpinned by a vibrant tourism sector, increase in building and construction, manufacturing and agricultural sectors as well as improved governance. Growth is projected to increase by between 5.8 percent and 6.5 percent in 2007, underpinned by growth in agriculture, tourism, manufacturing and the building and construction sectors. In line with the Vision 2030, the economic expansion is also expected to be sustained over the medium term supported by the ongoing reform measures in key sectors of the economy and prudent implementation of macroeconomic policies by the Government. A major risk to the economic outlook is high international oil prices, and adverse weather conditions.

In the previous monetary policy statement, the Bank had assessed the growth in money supply, M3 (the intermediate target) and reserve money (the operating target) to June 2007 and sought to limit the growth of reserve money to 12 percent to anchor inflation pressures and accommodate the projected economic activity. To improve the effectiveness of monetary policy, the Bank also took certain measures to clarify its policy intentions to the market in order to achieve the desired adjustment in monetary conditions.

However, both money supply and reserve money expansion continued to remain well above the desired level following significant buildup in net foreign assets (NFA) and net domestic assets (NDA) of the banking system. While there was evidence of easing inflation pressures from the beginning of the year with the 12 month overall inflation rate coming down from 15.6 percent in December 2006 to 5.9 percent in March 2007, and underlying inflation well within the 5 percent objective, the persistent rise in prices led to the view that inflation developments could be partly driven by monetary factors. In the Banks' policy review in March 2007 under the Poverty Reduction and Growth Facility (PRGF) arrangement ahead of the IMF Board meeting in April 2007, the shared view was for gradual monetary tightening to check inflation pressures. Money supply, M3 and reserve money were thus targeted to grow by 14 percent and 12 percent by the end of June and September 2007 respectively. Money supply and reserve money is targeted to grow by 12.7 percent by the end of June 2008.

The Bank also continued to implement measures intended to facilitate the achievement of its reserve money targets. These included enhanced efforts to improve the effectiveness of its open market operations - the main instrument of monetary policy - and to improve signalling of the monetary policy stance in the context of reserve money operating framework. In this regard, modifications were also made to the conduct of open market operations in June 2007 to allow for more flexibility in liquidity management.

Looking ahead, higher fluctuations in oil prices than for the other commodities pose a risk to inflation outlook arising from the likelihood of high international oil prices feeding into the prices of domestic commodities. The potential for high inflation to feed into higher price expectations is therefore a key concern for monetary policy.

Overall inflation in June 2007 picked up mainly reflecting higher prices in most categories of the index than in January 2006, partly reflecting the effects of tax measures in the 2007/08 budget. Nevertheless, the risks to price stability will be minimized by the continued implementation of prudent monetary policy in the year, and efforts being made by the Bank to improve policy operating procedures.

## INTRODUCTION

The 20th Monetary Policy Statement (MPS) for June 2007 is made pursuant to Section 4B of the CBK Act, and sets out monetary policy for the fiscal year 2007/08. The MPS is part of a wider set of publications that the CBK uses to explain monetary policy actions and outcomes.

The 20th MPS reviews implementation of monetary policy for the period December 2006 to June 2007, evaluates key macroeconomic indicators during the period while setting out the risks in the short term, and outlines the monetary policy strategy to be applied for the fiscal year 2007/08 in order to deliver on the Bank's principal objective of low and stable inflation.

The MPS is presented in three parts. Section one reviews the performance of monetary policy for the first half of 2007. Section two covers economic developments in the first half of 2007, and presents the outlook for the next one year to 2008 and in the medium term. The last section contains the monetary policy stance to be applied in the fiscal year 2007/08 and is expected to be part of the information that economic agents consider when forming expectations on monetary conditions and inflation. The section also summarizes both prospects and risks that could influence the outlook for inflation by the end of June 2008.

## MONETARY POLICY SINCE THE LAST STATEMENT OF DECEMBER 2006

### 1.1 Review of Recent Monetary Policy Stance

Monetary policy sought to contain end-period inflation to below 7 percent by limiting the growth in both reserve money and money supply, M3, to 14 percent by June 2007. In the second quarter of 2006, the trends of both headline and underlying inflation had been upward with underlying inflation rising above 5 percent in early 2007. The pick up of inflation over this period also coincided with rapid growth in money supply to more than 18 percent in June 2007. A gradual monetary tightening was thus adopted to avoid potential second-round effects on inflation without posing significant risks to the economy.

Economic growth was expected to be 6.1 percent in 2006/07, underpinned mainly by growth in agriculture, manufacturing, construction and tourism. The expansion in economic activity would be supported by ongoing structural reforms as well as improved infrastructure by the Government. The main elements of the monetary expansion path are summarized in Table 1.

**Table 1: Growth Targets for Key Aggregates for 2006/07**

| | Jun'06 Act. | Dec'06 Act. | Mar'07 Est. | Jun'07 Proj. |
|---|---|---|---|---|
| Reserve money (Ksh Billion) | 107.7 | 124.2 | 122.8 | 123.1 |
| NFA of CBK (Ksh Billion) | 159.5 | 159.2 | 170.8 | 175.7 |
| Memo: | | | | |
| Annual change in reserve money | 14.0 | 16.9 | 19.5 | 14.0 |
| Annual change in money supply (M3) | 16.0 | 17.8 | 14.0 | 14.0 |
| Real GDP growth | | | | 6.1 |
| Overall inflation | | | | 7.0 |

**Source: CBK**

Reserve money path was determined taking into account a build-up in net foreign assets of the CBK from Ksh 159.4 billion in June 2006 to Ksh 175.7 billion by the end of June 2007. This was to be achieved with continued improvement in the balance of payments position in 2006/07 allowing for purchases of foreign exchange.

Implementation of monetary policy in the first half of 2007 was anchored on quarterly targets for reserve money as has been the case. Monthly targets for reserve money (currency in circulation and commercial bank deposits at the Central Bank) were set consistent with the established quarterly targets. Following successful completion of the second review under the 2006/07 PRGF arrangement, and extension of the arrangement to November 20, 2007, performance on reserve money and Central Banks' NFA was also to be monitored against a performance benchmark for end-March 2007 and performance criteria for end-June 2007.

## 1.2 Performance of Monetary Policy Implementation to June 2007

Monetary policy was implemented through open market operations (OMOs) using repurchase order agreement securities (REPOs). Open market operations were guided by comparing the forecast and the target reserve money on a daily basis. In most occasions, the deviation of the forecast from target formed the basis for determining the daily amount of REPOs required to align monetary conditions to the desired path. Daily REPOs immediately absorb excess balances in commercial bank accounts held at the Central Bank, while the other component of reserve money - currency in circulation - is expected to flow back in the banking system over much longer time through interest rate adjustments by commercial banks following open market operations.

Between December 2006 and June 2007, the liquidity mopped up under OMO fell short of the amount required to align monetary conditions. The stock of securities under REPOs thus declined from 10.5 billion in January 2007 to Ksh 5.6 billion by April 2007, before increasing to Ksh 15.6 billion by the end of June 2007. This was, however, below Ksh 21 billion REPO stocks required to bring reserve money on track.

In order to enhance the effectiveness of monetary policy implementation, open market operations were modified to allow for more flexibility in liquidity management during the June 2007 meeting of the Monetary Policy Advisory Committee (MPAC). With effect from 15th

June 2007, OMOs have been conducted using REPOs whose tenors range from 3 days to 90 days compared with previous tenors of between 7 and 40 days. The lengthening of the tenures was important as it served to signal to commercial banks that REPOs were an alternative investment that could be used for matching their maturity profiles, while the shortening of the repo tenor reduced the period during which banks may be forced to hold excess balances to meet clearing obligations. A correction was also made to the CBR. Consequently, the level of the CBR rate was reviewed from 10 percent to 8.5 percent effective June 15, 2007 to align it with other short term money market interest rates, while at the same time retaining its original value. By July 17, 2007, the stock of outstanding repo holdings had increased from Ksh 15.6 billion at the end of June 2007 to Ksh 19.5 billion, while at the same time commercial banks minimised the excess balances they maintain at the CBK.

**Reserve Money**

Reserve money remained in excess of target between December 2006 and June 2007 as shown in Table 2. Reserve money increased from Ksh 124.2 billion in December 2006 to Ksh 126.5 billion by June 2007 and was above the June 2007 target of Ksh 123.1 billion by 3.4 billion. The excess reserve money was in both currency outside banks (Ksh 1.5 billion) and bank reserves (Ksh 1.9 billion). Currency outside banks fell significantly in January and February 2007, but picked up towards the end of the first quarter of 2007.

Reserve money in excess of target in June 2007 reflected REPO securities of Ksh 15.6 billion compared with Ksh 21 billion targeted to bring reserve money back on track arising from a lower mop-up in OMO, coupled with a draw down in Government deposits above what was projected. The decline in other assets (net) of the CBK partially contributed to offsetting excess reserve money.

**Table 2: Reserve Money Perfomance & Targets for 2006/07 (Ksh Billion)**

| | Reserve Money | | | Currency outside Banks | | | Banks Reserves | | |
|---|---|---|---|---|---|---|---|---|---|
| | Actual | Target | Dev | Actual | Target | Dev | Actual | Target | Dev |
| Jun-06 | 106.1 | 100.4 | **5.7** | 66.2 | 62.2 | **4.0** | 40.0 | 38.3 | **1.7** |
| Jul-06 | 108.4 | 102.6 | **5.8** | 68.0 | 63.5 | **4.5** | 40.4 | 39.1 | **1.3** |
| Aug-06 | 111.9 | 103.7 | **8.3** | 70.0 | 65.1 | **4.9** | 41.9 | 38.6 | **3.3** |
| Sep-06 | 113.2 | 106.9 | **6.3** | 70.5 | 66.0 | **4.5** | 42.7 | 40.9 | **1.8** |
| Oct-06 | 114.5 | 110.2 | **4.3** | 71.9 | 68.8 | **3.1** | 42.6 | 41.4 | **1.2** |
| Nov-06 | 117.3 | 112.0 | **5.3** | 74.2 | 69.8 | **4.4** | 43.1 | 42.2 | **0.9** |
| Dec-06 | 124.2 | 116.9 | **5.7** | 77.8 | 72.8 | **5.0** | 44.9 | 44.1 | **0.7** |
| Mar-07 | 122.2 | 122.8 | **- 0.6** | 76.5 | 77.4 | **- 0.9** | 45.7 | 45.4 | **0.3** |
| Jun-07 | 126.5 | 123.1 | **3.4** | 78.1 | 76.6 | **1.5** | 48.3 | 46.5 | **1.9** |

**Source: CBK**

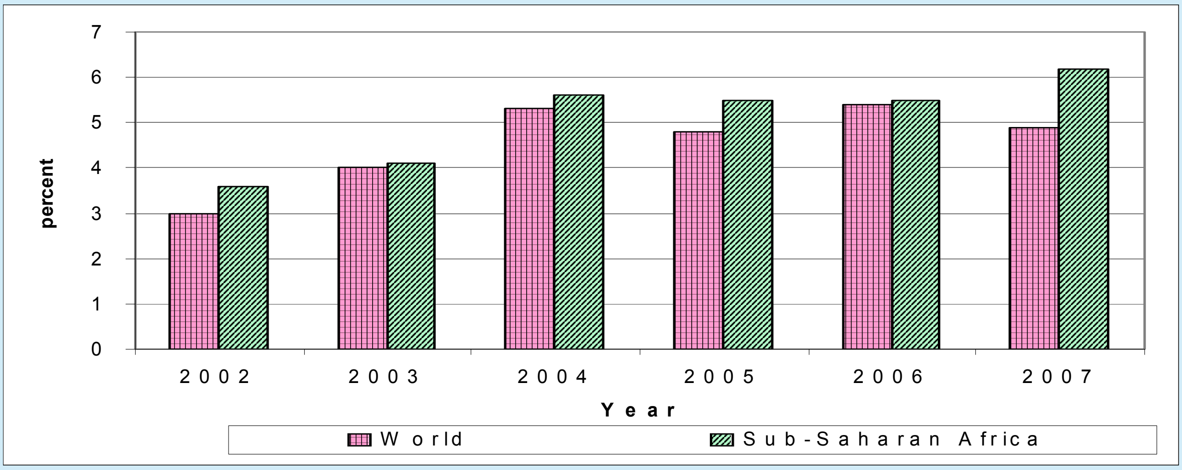
Performance on reserve money and unencumbered CBK NFA was also monitored against quantitative performance criteria for June 2007. At Ksh 169.4 billion, the adjusted unencumbered CBK's NFA was well within the target of Ksh 169.2 billion, while the target for reserve money was missed by Ksh 3.4 billion.

## ECONOMIC SITUATION AND OUTLOOK FOR 2008 AND MEDIUM TERM

### 2.1 The World Economy

World output is estimated to have grown by 5.4 percent in 2006 marking the fourth year of expansion according to the International Monetary Fund's World Economic Outlook (WEO) for April 2007 (Chart 1). The expansion is mainly in the Euro area boosted by strong domestic demand and in emerging market countries driven by investment and export growth. Part of the uncertainty on growth prospects for the world economy arising from inflationary pressures due to low spare capacity in oil production and high fuel prices have diminished. Nonetheless, there are emerging risks from rising food prices following increased demand for bio fuels.

**Chart 1: Global Economic Output (2002 - 2007)**




**Source: IMF World Economic Outlook**

Sub-Saharan Africa economies on the whole grew by 5.5 percent in 2006 and the growth rate is projected to increase to 6.2 percent in 2007. The increase reflects higher oil revenues as well as improved policy frameworks in the region. According to the WEO, new oil fields in Angola and Equatorial Guinea are expected to come to stream boosting oil production. Non-oil importing countries in the region will benefit from favourable terms of trade on the non-fuel commodities although this could be partially offset by a drop in metal prices for some countries.

### Outlook for 2007 and the Medium Term

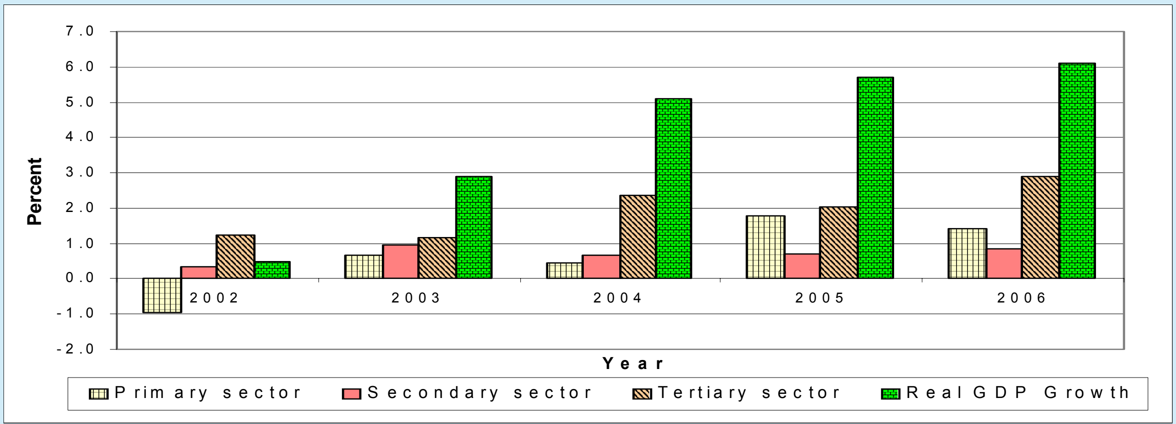
World output is expected to grow at a slower pace in 2007 and 2008. In 2007, real GDP growth is expected to moderate to 4.9 percent in line with the September 2006 WEO forecast. The slowdown in growth already taking place in the US economy following a slack housing market is also expected in the Euro area, as well as in emerging markets and developing countries, mainly reflecting policy tightening.

The economic outlook for Sub-Saharan Africa continues to remain positive reflecting sustained progress in the policy environment, improved terms of trade on non-fuel commodities as well as increased capital inflows. However, growth prospects in the region depend on developments in oil prices and the pace of global economic expansion through its impact on commodity prices. Sustaining the growth momentum in this region will depend more on the economic policy framework and to a lesser extent on socio-political developments.

## 2.2 Domestic Economy

Kenya's economy grew by 6.1 percent in 2006 an improvement from 5.7 percent and 5.1 percent in 2005 and 2004 respectively (Chart 2). The good performance in 2006 was attributed to good performance in tourism, building and construction, manufacturing, and agricultural sectors, reflecting macroeconomic stability. Favourable financial market conditions, increased access to credit and increased remittances have also been behind the positive trend in economic activity.

**Chart 2: Contribution to Real GDP Growth**




**Source: Kenya National Bureau of Statistics**

Growth in the agricultural sector slowed down from 7 percent in 2005 to 5.6 percent in 2006. Normal weather conditions and increased budgetary allocations contributed to a significant recovery in agricultural production compared with 2002 when agricultural output declined by 3.1 percent. The manufacturing sector grew by 6.9 percent in 2006 driven by increased production coupled with increased exports from the export processing zones. Normal weather conditions also led to improved supply of raw materials for the agro-based industries which had been adversely affected by the drought in early 2006. The tourism sector remained buoyant growing by 14.9 percent in 2006 compared with 13.3 percent in 2005 following sustained marketing campaigns especially to non-traditional markets. The recognition of the Maasai Mara as one of the Seven Wonders of the World and increased conference tourism boosted the tourism sector. The strong growth in the sector also had a positive spill-over effect on air transport and hotels and restaurants. Building and construction sector also picked up in 2006 supported by Government investment in infrastructure and increased spending on projects from the Constituency Development Fund.

Leading economic indicators for the first four months of 2007 indicate that the growth momentum will be sustained throughout the year.

### Projections for 2007/08 and the Medium Term

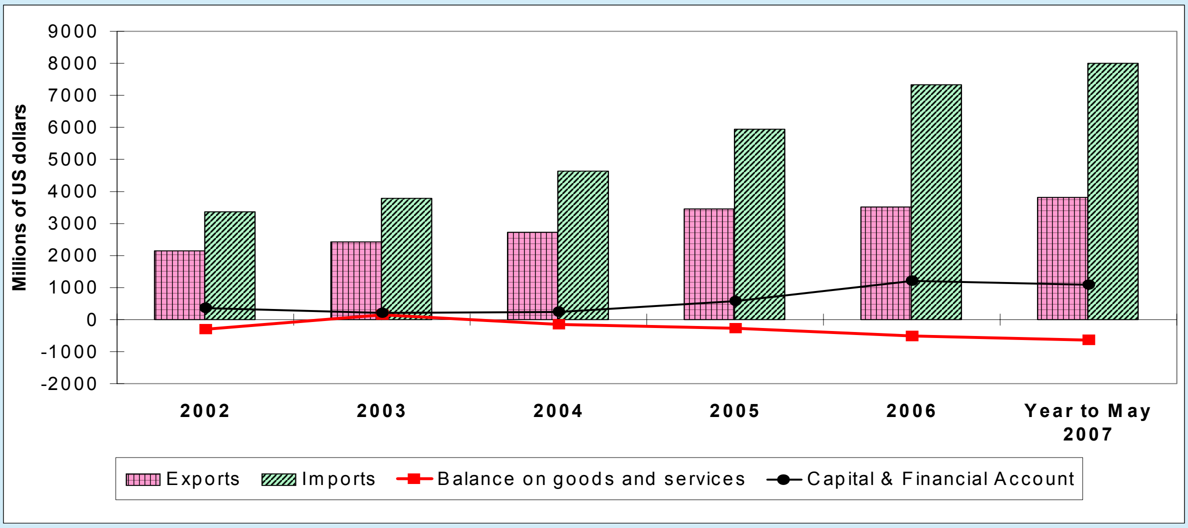
Growth in key sectors of the economy particularly agriculture, tourism, manufacturing and building and construction is expected to continue, both in 2007 and in the medium term, as envisaged in the vision 2030 outlook. The growth momentum will also be supported by improved economic performance in Kenya's trading partners. The outlook builds on increased investment, sustained structural reforms as well as increased outlays on infrastructural development. Real GDP is expected to grow by 6.6 percent in 2007/08, rising to 10 percent in 2011/12 under the Vision 2030 framework.

There are, however, some risks to the growth outlook which include high international oil prices. The deteriorating terms of trade arising from the high and volatile oil prices in the international market and high prices of other critical imported inputs may therefore undermine economic performance. While the Government has significantly increased budgetary allocations to the agricultural sector, natural calamities like drought and floods continue to be a challenge to the performance of the economy.

## 2.3 Balance of Payments

The surplus in the balance of payments declined from US$ 675 million in 2006 to US$ 431 million in the year to May 2007. This reflects a reduced surplus in the capital and financial account by US$ 124 million coupled with the widening of the current account deficit by US$ 121 million (Chart 3).

**Chart 3: Balance of Payments**




**Source: CBK**

The trade deficit widened from US$ 3,830 million in 2006 to US$ 4,187 million in the year to May 2007 reflecting 9.0 percent growth in merchandise imports to US$ 7,992 million compared with 8.7 percent growth in merchandise exports to US$ 3,805 million. The increase in the value of merchandise imports largely reflected increased imports of machinery and transport equipment and manufactured goods while the higher value of total exports reflected increased export values of tea, oil, manufactured goods, horticulture, raw materials and other miscellaneous exports.

The widening of the trade deficit was partially offset by higher receipts from services. The surplus in the services account improved to US$ 3,538 million in the year to May 2007 compared with US$ 3,302 million in 2006, mainly reflecting increased receipts from non-factor services. Net receipts from non-factor services increased reflecting improved performance of tourism and other Government and private sector services. Earnings from tourism rose from US$ 687 million in 2006 to US$ 811 million in the year to May 2007. The balance on the income account also improved reflecting higher interest earnings on official foreign exchange reserves and reduced interest payments on official foreign debt. Net receipts from current transfers also increased to US$ 1,852 million in the year to May 2007.

The surplus in the capital and financial account declined from US$ 1,204 million in 2006 to US$ 1,080 million in the year to May 2007 reflecting increased foreign asset holdings by commercial banks and reduced short term flows. Official medium and long-term financial flows however improved on account of reduced repayments of official foreign debt.

The overall surplus in the balance of payments was reflected in a build up in official and private foreign reserve assets. Gross official foreign exchange reserves thus increased from US$ 2,415 million, equivalent to 4.3 months of import cover (based on average imports for the three preceding years), at the end of December 2006 to US$ 2,723 million, equivalent to 4.4 months of imports cover, as at the end of June 2007. Foreign exchange reserve holdings by commercial banks also rose from US$ 916 million at the end of December 2006 to US$ 1,044 million at the end of June 2007.

### Projections for 2007 and the Medium Term

The deficit in the trade account is expected to widen further by the end of 2007 owing to high demand for imports of capital and intermediate goods to support increased domestic production. Although export volume growth will continue to lag behind import volume growth, exports are expected to pick up as agricultural output improves, supported by better weather conditions. The resulting wider deficit in the trade account will be partly offset by increased receipts from tourism, transportation, and current transfers (including external remittances).

To a large extent, the deficit in the current account will be financed by improved capital and financial inflows as the capital and financial account is expected to remain in surplus. Thus the overall balance of payments is expected to record a surplus of about US$ 561 million by December 2007.

Consistent with the expected overall improvement in the balance of payment, gross official foreign exchange reserves are projected to increase from US$ 2.4 billion in December 2006, equivalent to 4.3 months of import cover, to US$ 3.0 billion in December 2007 and to US$ 3.4 billion in December 2008, equivalent to 4.6 months of import cover.

## 2.4 Fiscal Developments

Government budgetary operations in the fiscal year 2006/07 resulted in an overall budget deficit including grants of Ksh 41.2 billion or 2.3 percent of GDP on commitment basis compared with Ksh 51.5 billion or 3.3 percent of GDP in the fiscal year 2005/06. As shown in Table 3, the deficit was much lower than the revised 2006/07 budget deficit of Ksh 67.9 billion or 3.7 percent of GDP. The performance of the budget compared to projections reflected significant growth in revenue. In addition, Government expenditure was lower than expected reflecting a decline in recurrent expenditure as a percent of GDP, as development expenditure increased in nominal terms to remain at 4.4 percent of GDP compared with the 2005/06 fiscal year. This is due to efforts by the Government to redirect spending from recurrent expenditure to physical infrastructure.

**Table 3: Central Government Fiscal Outturn (Ksh Billion)**

| | 2005/06 | Jul 2006-Jun 2007 | | 2007/08 | 2008/09 | 2009/10 |
|---|---|---|---|---|---|---|
| | Prov. | Prov. | Rev. Target | Proj. | Proj. | Proj. |
| **1. Total Revenue and Grants** | 331.3 | 379.2 | 415.5 | 469.2 | 528.9 | 601.6 |
| Total Revenue | 311.3 | 365.0 | 381.0 | 428.9 | 487.3 | 554.1 |
| **% of GDP** | 20.2 | 20.0 | 20.8 | 20.8 | 21.1 | 21.4 |
| Grants | 20.1 | 14.2 | 34.5 | 40.3 | 41.6 | 47.5 |
| **% of GDP** | 1.3 | 0.8 | 1.9 | 2.0 | 1.8 | 1.8 |
| **2. Total Expenditure** | 382.8 | 420.4 | 483.4 | 580.4 | 599.6 | 676.7 |
| Recurrent | 315.2 | 340.4 | 359.1 | 411.2 | 428.9 | 473.4 |
| **% of GDP** | 20.4 | 18.6 | 19.6 | 20.0 | 18.6 | 18.3 |
| Development | 67.7 | 80.0 | 124.3 | 169.2 | 170.7 | 203.3 |
| **% of GDP** | 4.4 | 4.4 | 6.9 | 8.2 | 7.4 | 7.9 |
| **3. Balance (commitment basis including grants)** | **-51.5** | **-41.2** | **-67.9** | **-111.2** | **-70.7** | **-75.1** |
| **% of GDP** | -3.3 | -2.3 | -3.7 | -5.4 | -3.1 | -2.9 |
| 4. Adjustment to cash | 15.0 | 6.5 | 0.7 | -1.5 | 0.0 | 0.0 |
| **3. Balance (cash basis including grants)** | **-36.5** | **-34.8** | **-67.2** | **-109.7** | **-70.7** | **-75.1** |
| **% of GDP** | -2.4 | -1.9 | -3.7 | -5.3 | -3.1 | -2.9 |
| 6. Statistical discrepancy | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| **7. Total Financing** | **36.5** | **34.8** | **67.2** | **109.7** | **70.7** | **75.1** |
| a. Net External | 1.2 | -3.8 | 16.2 | 39.8 | 27.7 | 33.6 |
| b. Net Domestic | 28.3 | 34.7 | 32.8 | 33.9 | 37.9 | 39.9 |
| c. Others* | 7.0 | 4.0 | 18.2 | 36.0 | 5.1 | 1.6 |

* Includes privatisation proceeds and securitisation of domestic arrears

**Source: Treasury**

The budgetary operations during the fiscal year 2006/07 required total financing of Ksh 44.3 billion. Out of this, Ksh 34.8 billion was required to finance the budget deficit; Ksh 3.8 billion to meet external debt repayments; and Ksh 5.6 billion to repay debt owed to the CBK. The financing requirement was met by borrowing Ksh 7.3 billion from commercial banks and Ksh 14.9 billion from non-banks, running down Government deposits at the Central Bank by Ksh 18.1 billion, while the sale of Government shares in Mumias Sugar Company as part of the privatization program realized Ksh 4.0 billion.

As a result of Government domestic borrowing operations during the fiscal year 2006/07, domestic debt increased from Ksh 357.8 billion at the end of June 2006 to Ksh 404.7 billion at the end of June 2007. However, the proportion of domestic debt to GDP dropped from 23.2 percent to 22.1 percent during the period due to the high GDP growth. During the period, Treasury bills decreased from Ksh 94.8 billion to Ksh 94.4 billion while Treasury bonds increased from Ksh 218.4 billion to Ksh 272.2 billion. The substantial rise in the stock of Treasury bonds during the fiscal year 2006/07 was partly attributed to the Ksh 20.0 billion bonds issued in June 2007 to National Bank of Kenya by the Government for the restructuring process.

**Outlook for Fiscal Year 2007/08 and the Medium Term**

Government revenue is projected to grow in nominal terms to Ksh 428.9 billion or 20.8 percent of GDP during the fiscal year 2007/08, reflecting improved growth prospects and continued implementation of tax policy reforms. In addition, external grants are projected to total Ksh 40.3 billion or 2.0 percent of GDP during the fiscal year. Government expenditure is projected at Ksh 580.4 billion or 28.2 percent of GDP during the fiscal year and will comprise Ksh 411.2 billion or 20.0 percent of GDP in recurrent expenditure and Ksh 169.2 billion or 8.2 percent of GDP in development expenditure. Consequently, overall budget deficit including grants is projected at Ksh 109.8 billion or 5.3 percent of GDP in the fiscal year. The higher deficit compared with that in the previous fiscal year largely reflects the substantial increase in development expenditure. The deficit will be financed through net external borrowing of Ksh 39.8 billion, net domestic borrowing totalling Ksh 33.9 billion and net privatization receipts amounting to Ksh 36.0 billion.

The net domestic borrowing requirement of 1.6 percent of GDP in the fiscal year 2007/08 is lower than the 1.9 percent of GDP in the fiscal year 2006/07 and is consistent with the medium-term target of 1.5 percent of GDP. Government revenue is expected to increase further from 21.1 percent of GDP in the fiscal year 2008/09 to 21.4 percent of GDP in the fiscal year 2009/10 while grants to GDP ratio is projected to ease to 1.8 percent of GDP during the period. Similarly, Government expenditure is expected to increase slightly from 26.0 percent of GDP to

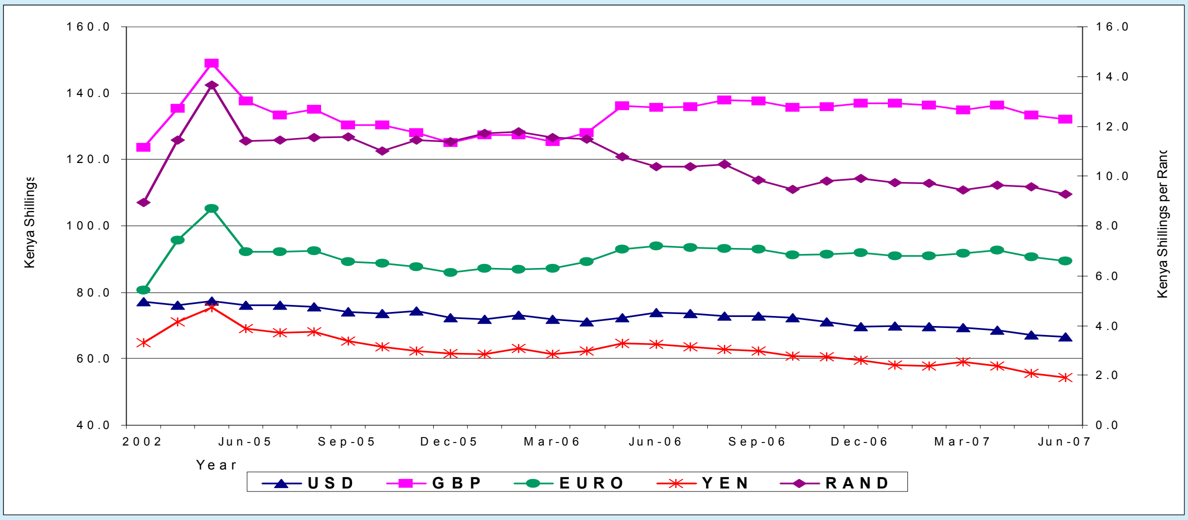
26.2 percent of GDP during the period. However, Government budget deficit on commitment basis is projected to fall from 3.1 percent to 2.9 percent during the period.

## 2.5 Exchange Rate

The Kenya shilling strengthened against major world currencies in the first quarter of 2007 after recording gains in the December 2006 quarter. The Kenya shilling appreciated against the US dollar by 4.7 percent in the first half of 2007 compared with 5.8 percent appreciation in the second half of 2006. The appreciation of the shilling against the US dollar reflects higher inflows into the domestic foreign exchange market, mainly from capital flows, export earnings and remittances, resulting in a surplus in overall balance of payments. The weakening of the US dollar in the international currency markets also amplified the appreciation of the shilling in the local foreign exchange market. The US dollar lost against the sterling pound and the Euro in the first half of 2007 by 1.4 percent and 3.2 percent, respectively. The shilling thus traded at an average of Ksh 66.6 against the US dollar in June 2007 compared with an average of Ksh 69.9 in January 2007.

Chart 4 shows that the Kenya shilling remained strong against the Sterling Pound in the first half of 2007 recouping losses in the second half of 2006. The shilling gained by 3.4 percent in the first half of 2007 compared with losses of 0.9 percent in the second half of 2006. The shilling also gained against the Euro and the Japanese Yen in the first half of 2007 by 1.7 percent and 6.6 percent, respectively.

**Chart 4: Kenya Shilling Exchange Rates Against Selected Currencies (2002-2007)**




**Source: CBK**

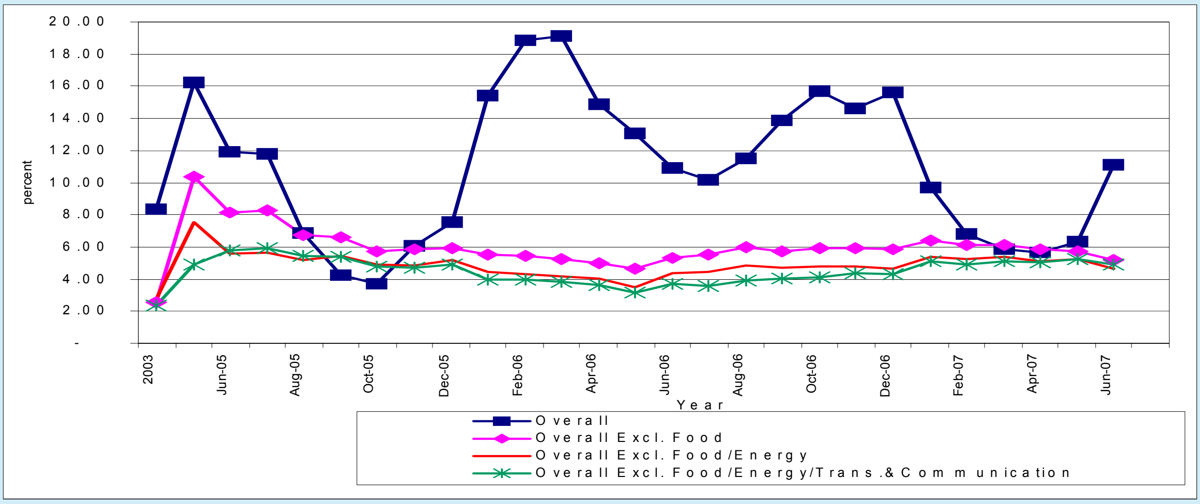
The Kenya shilling recorded mixed performance against the regional currencies in the first half of 2007, appreciating by 2.3 percent against the Tanzanian shilling and depreciating by 3.9 percent against the Uganda shilling.

As the CBK continues to pursue prudent monetary policy, and with stability being restored in the international foreign exchange market, it is expected that the shilling will remain stable in the medium term.

## 2.6 Inflation

Overall inflation fell from 15.6 percent in December 2006 to 11.1 percent in June 2007 (Chart 5). Between February and May 2007, overall inflation was below 7 percent reflecting a significant drop, particularly in inflation in the food and fuel and power component of the consumer price index to single digits.

**Chart 5: Inflation Rate (2003 - 2007)**




**Source: CBK**

In the last quarter of 2006, prices of items in the food and non-alcoholic drinks as well as the fuel and energy categories which account for over 50 percent of the composite index remained high. In particular, inflation in the food and non-alcoholic drinks index in the second half of 2006 ranged between 20 percent and 23 percent in part reflecting the impact of heavy short rains on the supply of vegetables. Inflation in the fuel and power category ranged between 12 percent and 14 percent reflecting high oil prices which persisted for most of 2006, which also had spill over effects on prices of goods and services in the transport and communication category.

The decline in food inflation from January 2007 to May 2007 follows normal weather conditions, while the decline in international oil prices in March 2007 coupled with Government intervention contributed to lower domestic pump prices during the same period. The recent increase in international oil prices is expected to put some pressure on domestic prices.

The increase in the overall price index in June 2007 occurred mainly in the food, alcohol and tobacco category. The increase in the food index by 15 percent in June 2007 compared with

June 2006 is due to sustained monthly increases in food prices from August 2006. The 8 percent inflation in the alcohol and tobacco category which was mainly due to increased beer and cigarette prices resulting from price adjustments following tax measures announced in the 2007/08 Budget, is expected to be a one time effect. At 11.1 percent, overall inflation was above the Government inflation objective of 5 percent at the end of June 2007.

Underlying inflation, which excludes the effects of food, fuel and energy, transport and communication, inflation was 4.9 percent in June 2007. It gradually increased from 4.9 percent in February 2007 to 5.2 percent in May 2007, before declining to 4.9 percent in June 2007 as shown in Table 4.

**Table 4: Consumer Price Index (June 2006 - June 2007)**

| | 2006 | | | 2007 | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Jun | Sep | Dec | Jan | Feb | Mar | Apr | May | Jun |
| **CPI** | 10.9 | 13.9 | 15.6 | 9.7 | 6.8 | 5.9 | 5.7 | 6.3 | 11.1 |
| Food & Drink | 14.9 | 20.0 | 22.6 | 11.8 | 7.2 | 5.7 | 5.5 | 6.7 | 15.0 |
| Alcohol & Tobacco | 6.5 | 9.2 | 7.0 | 6.0 | 5.6 | 5.6 | 5.1 | 6.6 | 8.0 |
| Clothing & Footwear | 2.8 | 3.1 | 3.0 | 3.4 | 3.6 | 3.7 | 3.8 | 4.0 | 3.3 |
| Housing | 4.8 | 4.7 | 6.0 | 7.3 | 6.9 | 7.3 | 7.2 | 7.1 | 5.8 |
| Fuel & Power | 11.4 | 11.9 | 13.5 | 12.8 | 11.5 | 10.9 | 10.5 | 8.6 | 8.5 |
| Household Goods & Services | 3.1 | 3.8 | 4.7 | 5.1 | 5.3 | 5.4 | 5.2 | 5.7 | 5.9 |
| Medical Goods & Services | 3.8 | 3.3 | 3.1 | 4.9 | 4.0 | 4.0 | 4.1 | 3.5 | 4.7 |
| Transport & Communication | 8.3 | 8.5 | 6.5 | 6.5 | 7.2 | 6.7 | 5.8 | 5.5 | 3.1 |
| Recreation & Education | 2.1 | 2.2 | 2.1 | 3.6 | 3.0 | 3.2 | 3.3 | 3.2 | 3.1 |
| Personal Goods & Services | 2.5 | 2.0 | 2.0 | 2.6 | 2.7 | 2.7 | 2.6 | 3.0 | 3.6 |
| **Underlying Inflation (various measures)** | | | | | | | | | |
| CPI excluding food | 5.3 | 5.7 | 5.9 | 6.4 | 6.1 | 6.1 | 5.9 | 5.7 | 5.2 |
| CPI excluding food and energy | 4.4 | 4.7 | 4.7 | 5.4 | 5.3 | 5.4 | 5.1 | 5.3 | 4.6 |
| CPI excluding food, energy and transport & communication | 3.7 | 4.0 | 4.3 | 5.1 | 4.9 | 5.1 | 5.0 | 5.2 | 4.9 |

**Source: CBK**

**Outlook in 2007/08 and the Medium Term**

The reserve money program for the next one year is targeted to achieve inflation of 5 percent by the end of June 2008. Successful implementation of the reserve money program is therefore expected to contain inflation pressures.

While there are concerns over the volatility of international oil prices, the stability in the shilling exchange rate which is expected to be sustained will help contain inflation pressures, particularly in the transport and energy sectors. A major risk to the outlook for inflation is uncertain weather conditions.

## 2.7 Monetary and Financial Markets Developments

**Money and Credit**

Money supply, M3, grew by 18.8 percent in the year to June 2007 compared with 16.1 percent in June 2006. The expansion in M3 was above the target growth of 14 percent for the June 2007 quarter. The expansion in M2 was however slower at 16 percent in June 2007 compared with 18 percent in June 2006. The slowdown in M2 growth was in quasi deposits which grew at 1.3 percent in June 2007 compared with 19.2 percent in June 2006.

M3 growth in the year to June 2007 was supported by a 25.2 percent increase in net foreign assets (NFA) and 16 percent increase in net domestic assets (NDA) of the banking system, reflecting increased private sector financial inflows and domestic credit respectively. The increase in net foreign assets accounted for 8 percent of the 18.8 percent expansion in M3 in June 2007 having increased from 7.1 percent a year ago. The growth in net domestic assets accounted for 10.9 percent of the M3 expansion, having increased from 9 percent in June 2006 (Table 5).

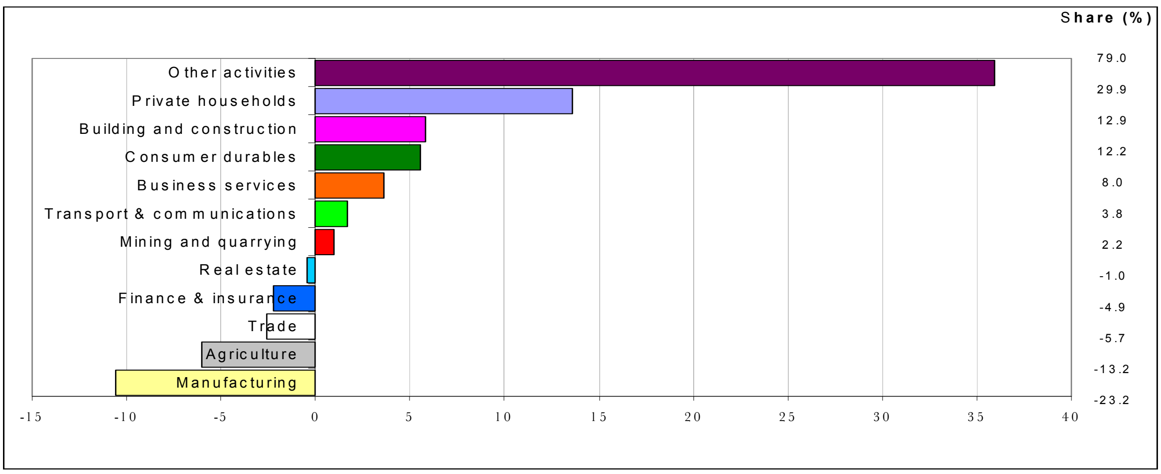
**Table 5: Contribution to Growth in Broad Money, M3 (percent))**

| | May-06 | Jun-06 | Sep-06 | Dec-06 | Mar-07 | May-07 | Jun-07 |
|---|---|---|---|---|---|---|---|
| Annual growth in M3 | 16.0 | 16.1 | 17.4 | 17.8 | 17.8 | 17.3 | 18.8 |
| Net Foreign Assets | 7.5 | 7.1 | 8.4 | 8.8 | 8.4 | 7.3 | 8.0 |
| Net Domestic Assets | 8.5 | 9.0 | 9.0 | 9.0 | 9.4 | 11.4 | 10.9 |
| Domestic Credit | 11.0 | 11.2 | 12.0 | 13.6 | 12.8 | 15.6 | 14.0 |
| Government (net) | 1.5 | 1.1 | 1.5 | 2.8 | 2.0 | 2.1 | 6.5 |
| Rest of the Economy | 9.5 | 10.1 | 10.5 | 10.8 | 10.8 | 13.5 | 7.6 |
| Other public sector | 0.3 | 0.4 | 1.2 | 1.2 | 1.1 | 0.7 | 0.0 |
| Private sector | 9.2 | 9.8 | 9.4 | 9.7 | 9.6 | 12.8 | 7.5 |
| Other Items (net) | -2.5 | -2.2 | -4.6 | -4.6 | -3.4 | -4.3 | -3.2 |

**Source: CBK**

Domestic credit grew by 16.3 percent in the year to June 2007 compared with 12.6 percent in June 2006. Credit to Government increased by 33.3 percent in the year to June 2007 compared with 5 percent in June 2006. The large increase in credit to Government, as earlier indicated, was due to the Ksh 20 billion Treasury bond issued to the National Bank of Kenya. Credit to the private sector grew by 11.6 percent in the year to June 2007 compared with 15 percent in June 2006. The larger share of private sector credit in the year to June 2007 as shown in Chart 6, went to private households (29.9 percent), building and construction (12.8 percent), consumer durables (12.2 percent), business services (8 percent), transport and communication (3.8 percent), and mining and quarrying (2.2 percent).

**Chart 6: Share of Credit to the Private Sector in twelve months to June 2007 (Ksh billion)**




**Source: CBK**

## Equity Market

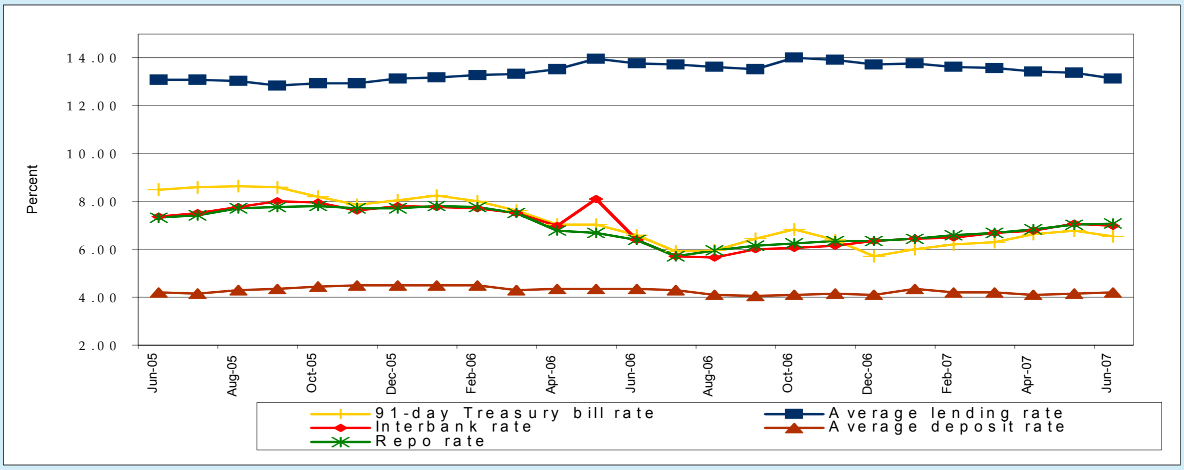
Compared to the second half of 2006, the equity market was on average subdued in the first half of 2007. The NSE 20 Share Index lost 500 points, moving from 5,645.7 in December 2006 to 5146.7 by end of June 2007, although the NSE peaked during the period to reach its highest in history at 6,161.5 points on January 12, 2007. Market turnover declined by 29 percent from Ksh 59 billion in the second half of 2006 to Ksh 41.9 billion in the first six months of 2007 owing to price declines that were recorded in February and March 2007 as market correction took place. Market capitalization declined by Ksh 47.7 billion from Ksh 791.6 billion in December 2006 to Ksh 743.9 billion in June 2007. Bond market trading however improved as bonds worth Ksh 41.5 billion were traded during the period compared with Ksh 21 billion traded in the last half of 2006. The improvement in bond trading followed declining interest rates in the longer term dated bonds and the decline in the 182 dated Treasury bill rate.

## Interest Rates

The CBR remained unchanged at 10 percent during the period under review since it was adjusted in August 2006. This signalled continued monetary tightening by the CBK. As a result, short term interest rates were on an upward trend during the period January 2007 to June 2007, with the 91 – day Treasury bill rate increasing from an average of 5.73 percent in December 2006 to 6.53 percent in June 2007. The average interbank rate increased from an average of 6.34 percent in December 2006 to 6.98 percent in June 2007, while the Repo rate increased from 6.34 percent in December 2006 to 7.08 percent in June 2007. The average 182-day Treasury bill rate, however, declined over the same period from 8.87 percent to 7.19 percent in June 2007.

Commercial banks average lending rates declined from 13.74 percent in December 2006 to 13.14 percent in June 2007. The overdraft rate declined from 13.91 percent to 13.20 percent in the first half of 2007, while the average deposit rate increased from 4.11 percent in December 2006 to 4.18 percent in June 2007. As a result, the spread between lending and deposit rates declined from 9.63 percent in December 2006 to 8.96 percent by June 2007. The decline in lending rates and the increase in deposit rates could be attributed to increased competition among commercial banks following a decline in government borrowing.

**Chart 7: Short term interest rates (Jun 2005 - June 2007)**




**Source: CBK**

## Outlook for 2007/2008 and the Medium Term

The interest rates are expected to remain stable in the medium term as they move towards the CBR rate, which is expected to signal monetary conditions in the economy. The stable interest rate will be supported by the continued implementation of prudent monetary policy by the Bank.

## 3. MONETARY POLICY FOR 2007/08

The monetary program set out in the December 2006 monetary policy statement was developed against a background of rapid expansion in both reserve money and broad money, at the time when both headline and underlying inflation were on an upward trend. In particular, there was a persistent increase in overall inflation largely reflecting sustained increases in food prices, particularly between November and December 2006. The concern of rising inflationary pressures was therefore key in developing the program as the acceleration in inflation coincided with acceleration in money supply growth.

While there were signs of improved short term inflation outlook beginning January 2007 onwards whereby overall inflation fell from 15.6 percent in December to 9.7 percent and 6.3 percent in January and May 2007 respectively, money supply growth in excess of target posed a risk to the medium term inflation outlook.

Monetary policy in 2007/08 will thus be directed towards securing low and stable inflation over the medium term. The monetary program targets reserve money growth of 12 percent at end-September 2007 and 12.7 percent at end-June 2008. This is expected to address the inflationary risk posed by fast growth in monetary aggregates. More effort will also be expended on enhancing the effectiveness of the Bank's indirect monetary policy instruments. Economic growth is projected to pick up from 6.1 percent in the fiscal year 2006/07 to 6.4 percent in the fiscal year 2007/08. Under the vision 2030 framework, growth is assumed to rise further as a result of the ongoing structural reforms, improved environment for business activities, and increased efficiency in the public sector.

Monetary policy seeks to contain end-period inflation to the Government's objective of 5 percent, by limiting the growth in reserve money to 12.7 percent and thus the growth of broad money to 12.7 percent by June 2007 (Table 6 and Appendix 2). Given the 5 percent inflation objective, the set expansion in money supply is in line with the expected growth in real GDP of around 6 percent in 2007.

**Table 6: Growth Target for Monetary Aggregates for 2007/08 - 2008/09**

| | Sep'07 | Dec'07 | Mar'08 | Jun'08 | Jun'09 |
|---|---|---|---|---|---|
| | | | | | |
| Reserve money (Ksh million) | 125.3 | 139.1 | 134.0 | 138.8 | 156.0 |
| NFA of CBK (Ksh million) | 182.9 | 189.42 | 196.4 | | |
| Memo: | | | | | |
| Annual change in reserve money | 12.0 | 10.0 | 11.1 | 12.7 | 12.8 |
| Annual change in broad money (M3) | 12.0 | 11.0 | 11.1 | 12.7 | 12.8 |
| Real GDP growth | | | | 6.4 | 6.5 |
| Overall inflation | | | | 5.0 | 5.0 |

* Revised projection

**Source: CBK**

There are potential short term risks to the monetary policy outlook. The unpredictable nature of international oil prices means that volatile movements in world crude prices will have an impact on domestic prices through increased energy prices, and through spill over effects on other goods and services. The monetary policy outlook also assumes normal weather patterns, and therefore a recurrence of drought conditions could lead to a spike in food prices contributing to inflationary pressures.

As emphasized in previous statements, the Bank will continue to monitor domestic and external developments so as to respond promptly to address emerging inflation pressures. As has been the case, the Banks' daily monetary operations will be geared towards aligning reserve money to target so as to deliver on the inflation objective.

# Appendix 1: Medium Term Macroeconomic Framework
# Selected Indicators (2005/06 - 2009/10)

| | 2005/06 | 2006/07 | 2007/08 | 2008/09 | 2009/10 |
|---|---|---|---|---|---|
| | Prov. | Est. | | Projections | |
| *Annual percentage change, unless otherwise indicated* | | | | | |
| **National account and prices** | | | | | |
| Real GDP | 5.9 | 6.3 | 6.4 | 6.4 | 6.5 |
| GDP per capita | 3.9 | 4.3 | 4.4 | 4.4 | 4.5 |
| CPI Index (eop) | 10.9 | 6.8 | 5.0 | 5.0 | 5.0 |
| **Money (end of period)** | | | | | |
| M3 (percent change) | 15.6 | 14.0 | 12.7 | 12.7 | 12.8 |
| Reserve money (percent change) | 14.0 | 14.0 | 12.7 | 12.7 | 12.8 |
| *In percentage of GDP, unless otherwise indicated* | | | | | |
| **Investment and saving** | | | | | |
| Investment | 18.1 | 18.4 | 23.2 | 24.7 | 26.2 |
| Central Government | 4.3 | 4.3 | 8.1 | 7.3 | 7.8 |
| Other | 13.7 | 14.2 | 15.1 | 17.4 | 18.5 |
| Gross National Saving | 16.0 | 15.9 | 20.7 | 21.7 | 22.9 |
| Central Government | 0.0 | 1.6 | 1.0 | 2.5 | 3.1 |
| Other | 15.9 | 14.3 | 19.7 | 19.1 | 19.8 |
| **Central government budget** | | | | | |
| Total revenue | 20.2 | 20.6 | 20.8 | 21.1 | 21.4 |
| Total expenditure and net lending | 24.8 | 23.4 | 28.2 | 26.0 | 26.2 |
| *of which* : wages and salaries | 7.3 | 7.0 | 7.0 | 6.6 | 6.5 |
| Interest payments | 2.7 | 2.3 | 2.5 | 2.3 | 2.2 |
| Development expenditures | 4.4 | 4.4 | 8.2 | 7.4 | 7.9 |
| Overall balance (commitment basis) excl. grants | -4.6 | -2.8 | -7.4 | -4.9 | -4.7 |
| Overall balance (commitment basis) incl. grants | -3.3 | -2.1 | -5.4 | -3.1 | -2.9 |
| Net external borrowing | 0.1 | -0.1 | 1.9 | 1.2 | 1.3 |
| Net domestic borrowing | 1.8 | 1.8 | 1.6 | 1.6 | 1.5 |
| Total donor support (grant & loans) | 1.9 | 1.4 | 4.2 | 3.7 | 3.9 |
| **Balance of payments** | | | | | |
| Exports value, goods and services | 26.8 | 24.4 | 24.6 | 25.7 | 26.4 |
| Imports value, goods and services | 35.5 | 33.3 | 33.3 | 34.7 | 35.5 |
| Current external balance, including official transfers | -2.1 | -2.6 | -2.5 | -3.0 | -3.3 |
| Current external balance, excluding official transfers | -2.3 | -2.5 | -2.6 | -3.0 | -3.3 |
| Gross international reserve coverage in months of next year | 3.2 | 3.4 | 3.9 | 4.1 | 4.3 |
| **Public debt** | | | | | |
| Nominal central government debt (end of period) | 45.9 | 40.0 | 40.3 | 39.3 | 38.2 |
| Domestic (gross) | 23.2 | 22.4 | 22.4 | 22.4 | 22.4 |
| Domestic (net) | 18.0 | 18.1 | 18.3 | 18.0 | 17.6 |
| External | 27.9 | 21.9 | 22.0 | 21.3 | 20.6 |
| **Memorandum items:** | | | | | |
| Nominal GDP (in Ksh millions) | 1543.9 | 1828.1 | 2059.1 | 2304.9 | 2584.8 |
| ICOR | 3.1 | 2.9 | 3.6 | 3.9 | 4.0 |

**Sources: CBK and Treasury**

# Appendix 2: Depository Corporations Survey June 2006-June 2008

| | 2006/07 | | | | | 2007/08 | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Jun-06 | Sep-06 | Dec-06 | Mar-07 | Jun-07 | Sep-07 | Dec-07 | Mar-08 | Jun-08 |
| | Act. | Act. | Act. | Act. | Act. | Proj. | Proj. | Proj. | Proj. |
| **Central Bank of Kenya** | | | | | | | | | |
| Net foreign assets 1/ | 159.5 | 162.1 | 159.2 | 171.4 | 174.2 | 182.9 | 189.5 | 198.1 | 206.2 |
| (in billions of U.S. dollars) | 2.2 | 2.2 | 2.2 | 2.3 | 2.4 | 2.5 | 2.6 | 2.7 | 2.8 |
| Net domestic assets | -51.8 | -49.8 | -35.1 | -49.2 | -47.7 | -57.7 | -50.4 | -60.9 | -63.6 |
| Net domestic credit | -37.0 | -22.2 | -9.8 | -21.1 | -16.8 | -27.4 | -18.9 | -31.0 | -32.5 |
| Government (net) | -15.8 | -10.4 | -7.1 | -8.8 | -3.5 | -3.6 | -3.7 | -3.8 | -3.9 |
| Advances to commercial banks | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Repos (liability to commercial banks (-)) | -23.4 | -13.9 | -4.9 | -14.6 | -15.7 | -26.1 | -17.6 | -29.7 | -31.1 |
| Private sector credit (CBK staff loans) | 2.2 | 2.2 | 2.3 | 2.3 | 2.3 | 2.3 | 2.4 | 2.5 | 2.4 |
| Other items (net; asset (+)) | -14.8 | -27.7 | -25.3 | -28.2 | -30.9 | -30.3 | -31.5 | -29.8 | -31.1 |
| Reserve money | 107.7 | 112.3 | 124.2 | 122.2 | 126.5 | 125.3 | 139.1 | 137.2 | 142.6 |
| Currency outside banks | 67.2 | 68.7 | 76.4 | 76.5 | 78.1 | 76.4 | 87.9 | 84.9 | 87.5 |
| Bank reserves | 40.5 | 43.6 | 47.8 | 45.7 | 48.3 | 48.9 | 51.2 | 52.3 | 55.1 |
| **Depository Corporations Survey** | | | | | | | | | |
| Net foreign assets 1/ | 191.6 | 205.1 | 217.6 | 232.5 | 239.8 | 253.8 | 261.0 | 270.4 | 279.2 |
| Net domestic assets | 413.9 | 427.0 | 442.0 | 452.5 | 479.7 | 454.1 | 487.4 | 515.4 | 535.9 |
| Domestic credit | 521.7 | 540.8 | 571.5 | 591.3 | 606.8 | 605.0 | 650.0 | 672.9 | 703.3 |
| Government (net) | 117.9 | 130.1 | 137.8 | 137.8 | 157.2 | 161.8 | 166.5 | 171.1 | 175.7 |
| Rest of the economy | 403.8 | 410.7 | 433.7 | 453.4 | 449.6 | 443.2 | 483.6 | 501.8 | 527.5 |
| Other public sector | 12.2 | 15.1 | 18.5 | 18.2 | 12.5 | 15.9 | 19.4 | 19.1 | 13.1 |
| Private | 391.6 | 395.6 | 415.2 | 435.2 | 437.1 | 427.3 | 464.2 | 482.7 | 514.4 |
| Other items (net; asset (+)) | -107.8 | -113.9 | -129.5 | -138.7 | -127.0 | -150.9 | -162.6 | -157.5 | -167.3 |
| M3 | 605.5 | 632.0 | 659.6 | 685.0 | 719.5 | 707.8 | 748.5 | 785.8 | 815.1 |
| Deposits in foreign currency | 83.5 | 94.3 | 105.7 | 108.7 | 114.3 | 123.3 | 124.6 | 125.8 | 134.6 |
| M2 | 522.0 | 537.7 | 553.9 | 576.3 | 605.3 | 584.5 | 623.9 | 660.0 | 680.5 |
| Currency outside banks | 67.2 | 68.7 | 76.4 | 76.5 | 78.1 | 76.4 | 87.9 | 84.9 | 87.5 |
| Deposits in shillings | 454.8 | 469.0 | 477.5 | 499.8 | 527.1 | 508.1 | 536.0 | 575.1 | 593.0 |
| Memorandum items: | | | | | | | | | |
| M3 growth (12-month percent change) | 16.1 | 17.4 | 17.8 | 17.8 | 18.8 | 12.0 | 13.5 | 14.7 | 13.3 |
| Reserve Money (12-month percent change) | 14.0 | 17.1 | 16.9 | 18.9 | 17.5 | 11.6 | 12.0 | 12.3 | 12.7 |
| Required reserve ratio (in percent) | 6.0 | 6.0 | 6.0 | 6.0 | 6.0 | 6.0 | 6.0 | 6.0 | 6.0 |
| Money multiplier (M3/reserves) | 5.6 | 5.6 | 5.3 | 5.6 | 5.7 | 5.7 | 5.4 | 5.7 | 5.7 |
| Program exchange rate (KSh/US$) | 73.88 | 73.88 | 73.88 | 73.88 | 73.88 | 73.88 | 73.88 | 73.88 | 73.88 |

**Source: CBK**

## APPENDIX 3: CHRONOLOGY OF EVENTS OF PARTICULAR RELEVANCE TO MONETARY POLICY AND INFLATION (2007

**2007**

| | |
|---|---|
| January 2007 | The CBK releases its nineteeth Monetary Policy Statement (Dec 2006) setting out the monetary program for the remainder of the FY 2006/07. |
| February 2007 | An IMF multi-topic mission visits the country. |
| March 2007 | The CBR reviewed and left unchanged. |
| May 2007 | The National Economic Social Council (NESC) convenes a workshop on the role of the Central Bank in economic transformation in the context of vision 2030. |
| | An IMF mission visits the country between May 16 and May 25 to discuss budget proposals for the FY 2007/08 and implementation of the monetary program. |
| June 2007 | The CBR is adjusted downwards from 10 percent to 8.5 percent. |
| | CBK's OMO modified to align it closer to market interest rates. |

## GLOSSARY OF KEY TERMS

### Overall Inflation

This is inflation measured by the movement of indices of all consumer price items of goods and services sampled by the Kenya National Bureau of Statistics.

### Underlying Inflation

This is inflation measured by movement of indices of all consumer price items of goods and services sampled by Central Bureau of Statistics other than food, energy, 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 CBK to gauge the influence of monetary policy on inflation.

### Reserve Money

These are CBK's monetary liabilities comprising currency in circulation (currency outside banks and cash held by commercial banks in their tills) 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 narrower and broader senses 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 savings deposits + certificates of deposits + deposits Liabilities of Non-Bank Financial Institutions (NBFIs) |
| M3 | M2 + residents' foreign currency deposits |

**Central Bank Rate (CBK)**

The rate of interest at which 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 act of buying or selling treasury bills in the secondary market by the Central Bank 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 the legally required position of commercial banks and nonbank financial institutions deposits 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.