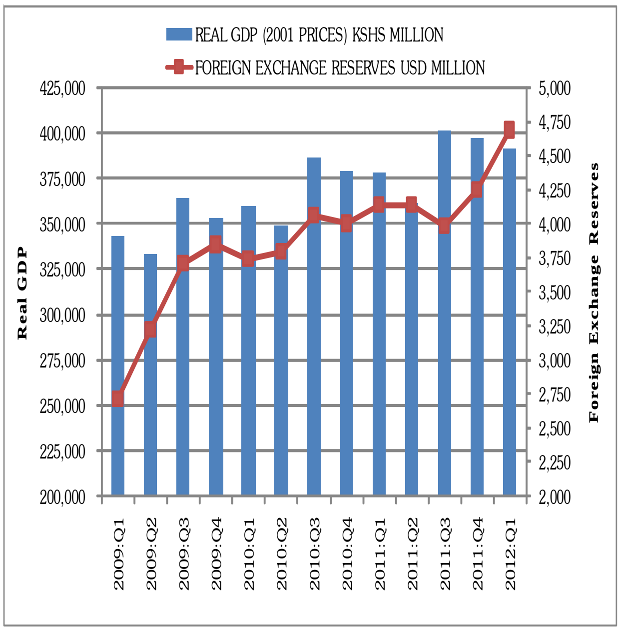

CENTRAL BANK OF KENYA

Monetary Policy Statement

Issued under the Central Bank of Kenya Act, Cap 491

JUNE 2012

Letter of Transmittal to the Minister for Finance

Honourable Minister,

I have the pleasure of forwarding to you the 30th Monetary Policy Statement (MPS) of Central Bank of Kenya (CBK), pursuant to Section 4B of the Central Bank of Kenya Act. It reviews the outcome of the monetary policy stance in the period January to June 2012, describes the current economic environment and outlook, and outlines the monetary policy stance for July 2012 to June 2013.

Prof. Njuguna Ndung'u, CBS
Governor

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The Principal Objectives of the Central Bank of Kenya

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;

(3) Subject to (1) and (2) above, to support the economic policy of the Government, including its objectives for growth, and employment.

Without prejudice to the generality of the above, the Bank shall:

- Formulate and implement foreign exchange policy;
- Hold and manage Government foreign exchange reserves;
- License and supervise authorised foreign exchange 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.

The CBK therefore formulates and conducts monetary policy with the aim of keeping overall inflation at the Government's medium-term target which is currently 5 percent. The achievement and maintenance of a low and stable inflation rate together with adequate liquidity in the market facilitates higher levels of domestic savings and private investment, and therefore leads to improved economic growth, higher real incomes and increased employment opportunities.

The Bank's monetary policy is therefore designed to support the Government's desired growth in the production of goods and services and employment creation through achieving and maintaining a low and stable inflation.

Instruments of Monetary Policy

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

- **Open Market Operations (OMO)** refers to actions by the CBK through purchases and sales of eligible securities to regulate the money supply and the credit conditions in the economy. OMO can also be used to stabilise short-term interest rates. When the Central Bank buys securities on the open market, it increases the reserves of commercial banks, making it possible for them to expand their loans which increase the money supply. To achieve the desired level of money supply, OMO is conducted using:

    - **Repurchase Agreements (Repos):** Repos entail the sale of eligible securities by the CBK to reduce commercial banks' deposits held in CBK. Currently, Repos (often called Vertical Repos) have a fixed tenor of 7 days. Reverse Repos are purchases of securities from commercial banks by the CBK during periods with tighter than desired liquidity in the market. The late Repo, sold in the afternoon, has a 4-day tenor and is issued at an interest rate 100 basis points below the Repo on that day.

    - **Term Auction Deposits:** These are used in extreme market conditions when the securities held by the CBK for Repo purposes are exhausted or when CBK considers it desirable to offer longer tenor options. The CBK acquires deposits through a transfer agreement from commercial banks at a price but with no exchange of security guarantee. Currently, the deposits are transferred to the CBK for a 14, 21, or 28 day period after which they revert back to the respective commercial banks' on maturity of the transfer agreement.

- **Central Bank Rate (CBR)**: The level of the CBR is reviewed and announced by the Monetary Policy Committee (MPC) at least every two months and its movements, both in direction and magnitude, signals the monetary policy stance. The CBR is the base for all monetary policy operations in order to enhance clarity and certainty in monetary policy implementation. Whenever the Central

Bank is injecting liquidity through a Reverse Repo, the CBR is the lowest acceptable rate by law. Likewise whenever the Bank wishes to withdraw liquidity through a Vertical Repo, the CBR is the highest rate that the CBK will pay on any bid received.

Movements in the CBR are reflected in changes in short-term interest rates. A reduction of the CBR signals an easing of monetary policy and a desire for market interest rates to move downwards. Lower interest rates encourage economic activities and thus growth. When interest rates decline, the quantity of credit demanded should increase.

Efficiency of the repo and interbank markets is crucial for the transmission of monetary policy decisions. By fixing the tenor for bills sold in the repo market, the MPC aims to sharpen the signalling process. The CBK monitors, but does not intervene, in the overnight interbank money market which is conducted by the banking industry.

- **Standing Facilities**: The CBK, as lender of last resort, provides secured loans to commercial banks on an overnight basis at a penal rate that is over the CBR. The rules governing the operation of the CBK Discount Window are reviewed from time to time by the Bank. Currently, banks utilising the CBK Overnight Window are charged the CBR plus a penalty. Moreover, banks making use of this facility more than twice in a week are scrutinised to establish whether prompt corrective action is required.

- **The Cash Reserves Ratio (CRR)**: In accordance with the law, the CRR is the proportion of a commercial bank's deposit liabilities which must be deposited at CBK at no interest. These deposits are held in the CRR Account. The ratio is currently 5.25 percent of the total bank domestic and foreign currency deposit liabilities of the previous month. To facilitate commercial banks' liquidity management, commercial banks are currently required to maintain their CRR based on an average from the 15^{th} of the previous month to the 14^{th} of the current month and a minimum CRR of 3 percent on a daily basis. A reduction in the CRR releases liquidity thus enhancing the capacity of commercial banks to expand credit. An increase in the CRR tightens liquidity and could also dampen demand-driven inflationary pressures.

- **Foreign Exchange Market Operations**: The CBK can also inject or withdraw liquidity in the banking system by engaging in foreign exchange transactions. A sale of foreign exchange to banks withdraws liquidity from the system while the purchase of foreign exchange injects liquidity into the system. Participation by the CBK in the foreign exchange market is usually motivated by the need acquire foreign exchange to service official debt and build its foreign exchange reserves where the statutory requirement is to use the Bank's best endevours to maintain a foreign reserves equivalent to a three year average of four months' import cover.

The CBK does not participate in the foreign exchange market to defend a particular value of the Kenya shilling but may intervene to stabilise excess volatility in the exchange market. The following regulatory measures have been introduced to support stability of the exchange rate:

i. Limiting the tenor of swaps and Kenya Shilling borrowing where offshore banks are involved to a tenor of not less than one year.
ii. Limiting the tenor of swaps between residents to not less than seven days.
iii. Reduction of the foreign exchange exposure ratio of core capital from 20 percent to 10 percent.
iv. Requirement that local banks obtain supporting documents for all transactions in the Nostro accounts of offshore banks.
v. Suspension of the use of Electronic Brokerage System by banks.

- **Licensing and Supervision of Financial Institutions**: The Bank uses the licensing and supervision tools to ensure the health and efficiency of the banking system; this includes vetting potential managers for suitability both with respect to qualifications and character.

- **Communication**: The increasing use of communication media ensures a wider dissemination of monetary policy decisions and background data thereby increasing the efficiency of information transmission. The regular interaction between the MPC and the Kenya Bankers Association (KBA) has ensured that monetary policy decisions and their underlying logic are transmitted to the banking sector. The CBK website is an important source of up-to-date data on all aspects of the financial market including interest rates, exchange rates and results of auctions of government securities.

- Horizontal Repos are transacted between commercial banks on the basis of signed agreements using government securities as collateral, and have negotiated tenors and yields. Commercial banks, short of deposits at the CBK, borrow from banks with excess deposits on the security of an appropriate asset, normally Government securities. Horizontal repos help banks to overcome the problem of credit limits, thus promoting efficient management of interbank liquidity. They are not strictly monetary policy instruments but modes of improving liquidity distribution under CBK supervision.

Legal Status of the Monetary Policy Statement

1. Section 4B (1) of the CBK Act 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 which shall:

    i. Specify policies and the means by which the Bank intends to achieve its policy targets;
    ii. State reasons for adopting such monetary policies and means; and
    iii. Contain a review and assessment of the progress made in the implementation of monetary policy by the Bank during the period to which the preceding Monetary Policy Statement relates.

2. The Minister shall - by the law under subsection (1) - 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.

3a. The Bank shall - by law - publish in the Kenya Gazette:

i) Its Monetary Policy Statement; and
ii) Its Monthly Balance Sheet.

3b. The Bank is further required to disseminate key financial data and information on monetary policy to the public.

4. In subsection (2), the expression "appropriate committee" means the committee of the National Assembly appointed to investigate and inquire into matters relating to monetary policy.

Executive Summary

This Monetary Policy Statement provides the policy stance for the period between July 2012 and June 2013. It also reviews the outcome of the monetary policy stance adopted between January and June 2012.

A combination of the tight monetary policy stance and regulatory measures adopted by the Bank supported with fiscal measures by the Government reduced inflationary pressures and stabilised the exchange rate in the first half of 2012. Consequently, overall inflation declined from 18.93 percent in December 2011 to 10.05 percent in June 2012. A significant drop in food and fuel prices during the period supported the decline in inflation. World crude oil prices declined significantly during the period following reduced global demand attributed mainly to the instability in the eurozone. Demand driven inflationary pressures continued to ease during the period as reflected in the decline in private sector credit growth. In order to enhance liquidity management and the effectiveness of the monetary policy measures taken, the Bank continued to review monetary policy operations. Specifically, the role of the CBR as the base for all monetary policy operations was enhanced.

Balance of payments pressures and their potential effect to the exchange rate remain major risks to the inflation outlook. The persistent instability in the global financial markets due to the debt crisis in the eurozone continues to present potential risks to the exchange rate, and inflation. The Bank will continue to ensure that credit expansion is consistent with the inflation objective. In order to anchor inflation expectations, the Bank's monetary policy stance from July 2012 to June 2013 will therefore be aimed at achieving and maintaining the overall inflation at 5 percent in the medium term. The Bank will also continue building its foreign exchange reserves towards achieving the statutory requirement in order to enhance the country's ability to absorb shocks that affect the foreign exchange market.

Monetary policy during the period July 2012 to June 2013 will therefore, seek to constrain the growth in broad money supply, M3, to 17.2 percent by December

2012 and 16.5 percent by June 2013. The Net Domestic Assets (NDA) of the Bank is planned to decrease from Ksh. -25.0 billion in December 2012 to Ksh -40.0 billion in June 2013 which is consistent with the Extended Credit Facility (ECF) programme targets for the period. However, the annual growth in credit to the private sector is projected at 15.8 percent in December 2012 and 16.8 percent in June 2013. The Net International Reserves (NIR) targets for the CBK are USD 4,160.0 million in December 2012 and USD 4,260.0 million in June 2013 which is consistent with the ECF programme targets for the period. The monetary policy stance will ensure that short-term interest rates continue their gradual downward trend in line with the decline in inflation.

In order to enhance the transmission of monetary policy signals and coordinate market expectations, the Bank will continue with its regular interactions with stakeholders in the financial and real sectors, including the Kenya Bankers Association, and timely release of relevant data.

1. Introduction

This Monetary Policy Statement (MPS) presents the policy guidelines and broad targets for the CBK over the period July 2012 to June 2013. It also presents the policy outcomes in the period January to June 2012.

Inflation continued to decline while exchange rate stability was sustained in the first half of 2012. These developments were attributed to the monetary policy and regulatory measures adopted by the Bank coupled with Government fiscal measures. However, relative exchange rate movements continue to be driven mainly by developments in the eurozone. In addition, the persistent balance of payments pressure from a rising import bill relative to export earnings remains a threat to exchange rate stability.

The framework for monetary policy formulation and implementation continued to follow the Government's programme as reflected in the Extended Credit Facility (ECF) programme where targets for Net Domestic Assets (NDA) and Net International Reserves (NIR) are the operational parameters. The Bank also continues to monitor targets for key monetary aggregates such as broad money supply, M3. The Bank's participation in the foreign exchange market will continue to be guided by the need to accumulate and maintain foreign exchange reserves at or above the statutory level of four months of import cover as well as purchasing foreign exchange to meet the Government's external obligations, and ensuring stability of the value of the Kenya shilling.

The rest of this policy statement is organised as follows. Section 2 reviews the outcome of the monetary policy stance proposed in the December 2011 MPS while Section 3 outlines the current economic environment and outlook for the period July 2012 to June 2013. Section 4 concludes by outlining the monetary policy stance for the period July 2012 to June 2013.

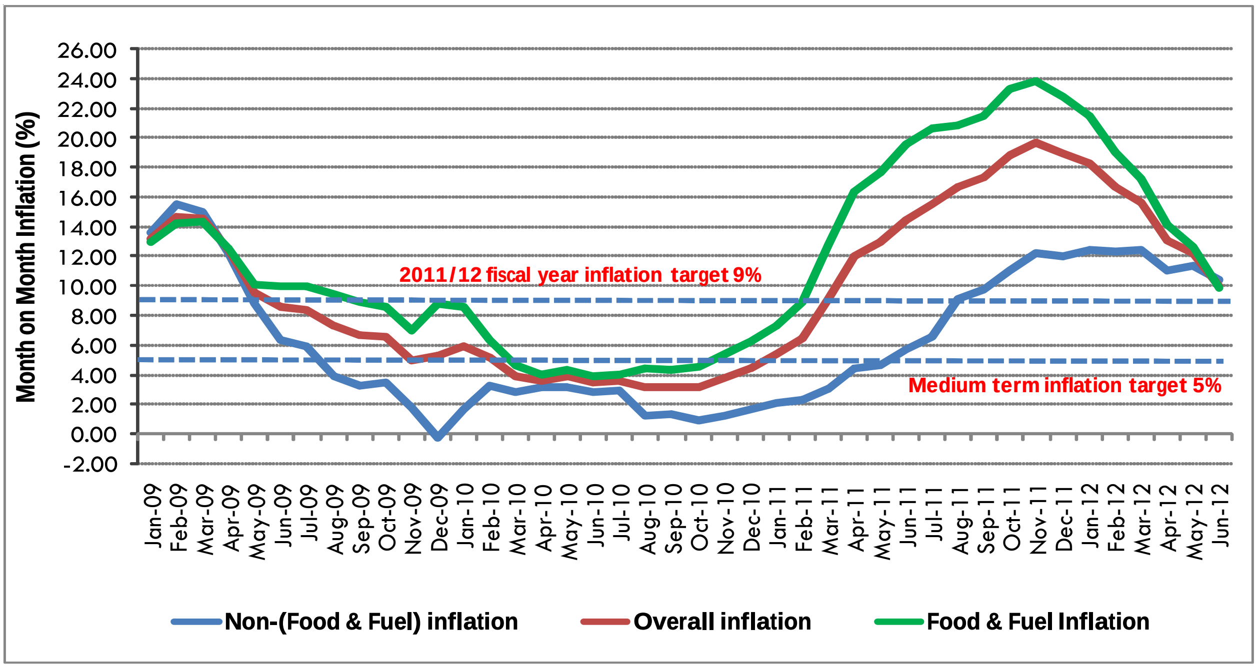
2. Actions and Outcomes of Policy Proposals in the 29th Monetary Policy Statement

The overall aim of the Monetary Policy Statement for December 2011 (29th MPS) was to set monetary policy targets that wouldensure low and stable inflation, encourage growth and ensure long-term sustainability of public debt. It also aimed atenhancing financial access within the economy. The Monetary Policy Committee (MPC) continued with onthly meetings to ensure close monitoring of the changing economic environment. The following are the outcomes of the policy proposals in the 29th Monetary Policy Statement:

a. Inflation

The primary objective of monetary policy formulation and implementation is price stability. During the period January to June 2012, inflation continued to decline gradually towards the Government short-term target of 9 percent to June 2012 (Chart 1). Overall inflation remained above the medium-term target of 5 percent throughout the period but declined faster than envisaged in the June 2012 Budget Strategy Paper. Overall inflation declined from 18.93 percent in December 2011 to 10.05 percent in June 2012. Inflation remained above target due to high food and fuel prices during most of the period. Non-food-non-fuel inflation also declined during the period but remained above target indicating demand driven inflationary pressures.

Chart 1: Trends in Inflation (CPI base February 2009=100)

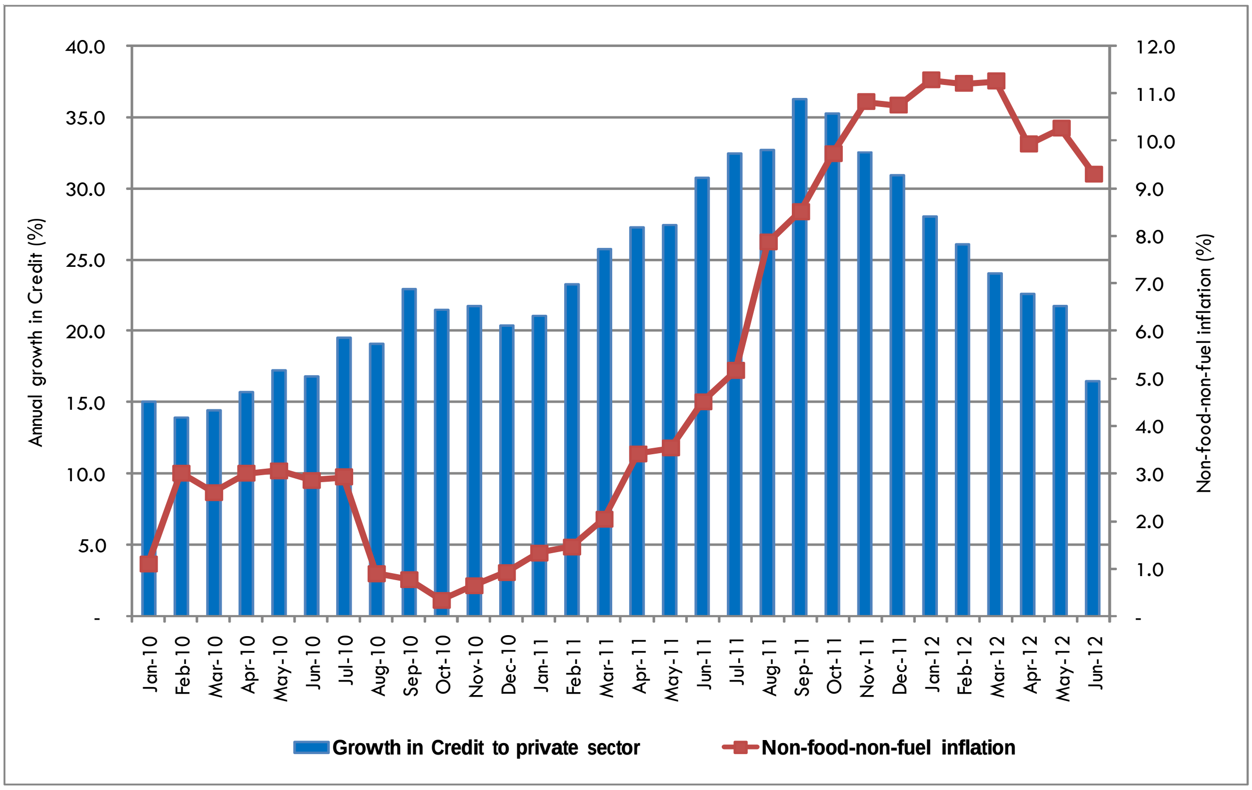


Source: Kenya National Bureau of Statistics

i. Credit to Private Sector

The annual growth in private sector credit at both the aggregate and sectoral levels slowed down in the first half of 2012 as an outcome of the tight monetary policy stance adopted by the MPC (Chart 2). The MPC retained the CBR at 18.00 percent in period. Private sector credit expansion slowed down from Ksh 118.1 billion in the last half of 2011 to Ksh 54.1 billion in the first half of 2012. Consequently, the demand driven inflationary pressures exposed by non-food-non-fuel inflation, eased during the period.

Chart 2: Annual Growth in Private Sector Credit and Inflation (%)



Source: Central Bank of Kenya

ii. Monetary Programme

Consistent with the inflation outcome in the first half of 2012, the monetary programme targets were generally achieved (Table 1). The Bank continued to conduct monetary policy based on the modified monetary aggregate targeting framework as it worked towards achieving its price target. The targets pursued under the framework are consistent with those for NDA and NIR in the ECF programme.

Table 1: Actual and Targeted Growth in Key Monetary Aggregates

	Dec-11	Jan-12	Feb-12	Mar-12	Apr-12	May-12	Jun-12
Actual Broad Money,M3 (Ksh Billion)	1,514.2	1,505.8	1,504.8	1,517.1	1,536.3	1,561.6	1,595.0
Target Broad Money,M3 (Ksh Billion)	1,528.0	1,542.6	1,557.0	1,558.6	1,585.5	1,611.9	1,638.6
Actual Reserve Money (Ksh Billion)	255.0	244.1	231.7	257.9	244.5	237.0	259.3
Target Reserve Money (Ksh Billion)	249.3	236.8	241.9	241.7	245.6	240.9	251.8
Actual Net Foreign Assets of CBK (Ksh Billion)	258.7	249.9	267.8	291.1	312.8	299.6	340.4
Targets for Net Foreign Assets of CBK (Ksh Billion)	295.8	296.0	295.0	288.4	309.0	315.5	322.4
Actual Net Domestic Assets of CBK (Ksh Billion)	-3.7	-5.7	-36.2	-33.2	-68.3	-62.6	-81.1
Target Net Domestic Assets of CBK (Ksh Billion)	-46.5	-59.2	-53.1	-46.7	-63.3	-74.6	-70.6
Actual Credit to private sector (Ksh Billion)	1,162.7	1,159.0	1,171.8	1,183.7	1,200.9	1,222.3	1,216.8
Target Credit to private sector (Ksh Billion)	1,138.5	1,150.8	1,148.6	1,182.7	1,165.8	1,174.9	1,214.0
Memorandum Items							
12-month growth in actual RM (Percent)	12.0	13.7	15.3	16.1	15.3	15.0	14.2
12-month growth in actual M3 (Percent)	19.1	17.1	15.2	14.5	15.1	15.6	15.5
12-month growth in actual credit to private sector (Percent)	30.9	28.0	26.0	24.0	22.6	21.8	16.5

Source: Central Bank of Kenya

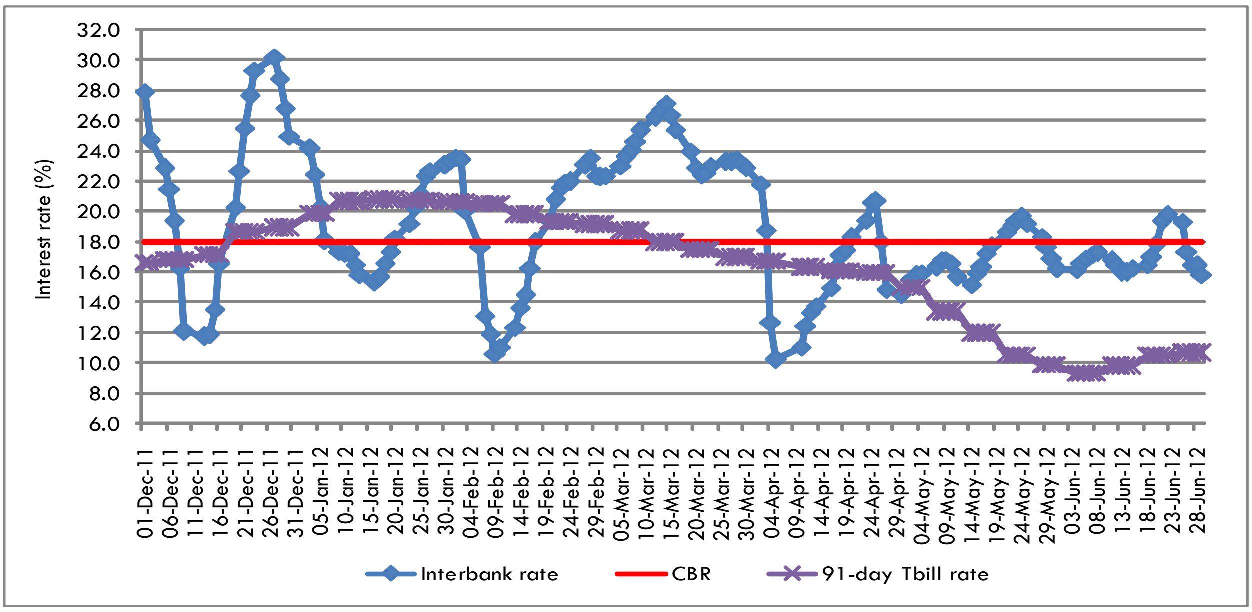
In the long-term, expanding financial inclusion in the country has resulted in an unstable money multiplier and reduced velocity of money circulation both of which have undermined predictability of demand for money leading to adverse outcomes. The money multiplier was generally on an upward trend rising from 5.94 to 6.15 between December 2011 and June 2012. However, the velocity of money remained fairly stable in the period although it rose slightly in June 2012.

iii. Interest Rates and Liquidity

Despite the tight monetary policy stance maintained by the MPC in the first half of 2012, short term interest rates were generally on a downward trend due to improved liquidity conditions. However, as shown in Chart 3, the CBR continued to coordinate movements in the short term interest rates during the period. Enhanced Open Market Operations by the Bank restored stability in the interbank market interest rates. The interbank rate fluctuated between a narrow range of 15.84 percent and 19.89 percent in June 2012 compared with a range of 11.79 percent and 30.23 percent in December 2012.

The improved liquidity conditions in the market were mainly attributed to the decision by the Government to externalise an equivalent of USD 600 million of its planned domestic borrowing in the fiscal year 2011/12. Interest rates on Treasury bills declined significantly following this development. The flexibility in liquidity management by banks through the requirement that they comply to CRR based on monthly averaging as well as the provision that banks could draw their CRR account to a daily minimum of 3 percent of total deposits also contributed to the improved liquidity. In addition, in order to moderate the effect of the increased cost of funds, commercial banks continued to offload some of their holdings of foreign exchange and Government securities while several banks also resorted to commercial offshore borrowing to supplement customer deposits.

Chart 3: Trends in Short Term Interest Rates (%)

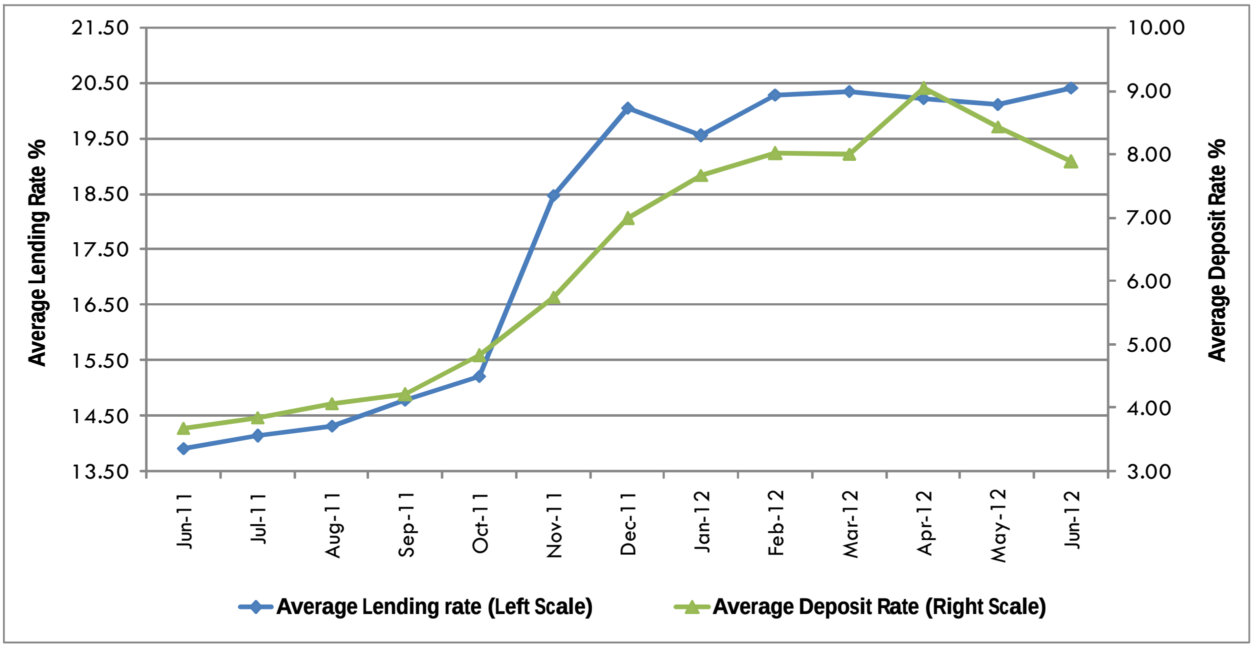


Source: Central Bank of Kenya

Average commercial banks' lending and deposit interest rates remained fairly stable between December 2011 and June 2012 after rising sharply in the last half of 2011 following tight liquidity in the market (Chart 4). This is a reflection of the impact of measures announced by the Kenya Bankers Association (KBA) to protect borrowers from high interest rates following adoption of a tight monetary policy stance by CBK. The average commercial banks lending rates increased from 20.04 percent in December 2011 to 20.41 percent in June 2012. The average deposit rates rose from 6.99 percent to 7.88 percent during the period due to an increase in the cost of funds and competition for deposits.

As a result, the average interest rate spread declined from 13.05 percent in December 2011 to 12.52 percent in June 2012 following a noteworthy increase in deposit rates largely as an outcome of small and medium size banks seeking to retain and attract depositors. Hence, they had lower spreads compared with large banks. In June 2012, small banks had a spread of 12.45 percent; medium banks a spread of 12.07 percent; and large banks 16.12 percent. The CBK has been working with the KBA to address the high spreads. The operationalisation of Credit Reference Bureaus and establishment of currency centres around the country has reduced credit risk levels and the operation costs of banks. The CBK will continue to work with stakeholders to address the concerns and challenges around the collateral perfection process.

Chart 4: Trends in Commercial Bank Interest Rates (%)



Source: Central Bank of Kenya

b. Exchange Rates and Foreign Exchange Reserves

i. The foreign exchange market stabilised in the first half of 2012 following implementation of both monetary policy and regulatory measures by the MPC and CBK, respectively (Chart 5a and 5b). As a result, the exchange rate of the Kenya Shilling against the US Dollar fluctuated within the narrow range of Ksh 83.64 and Ksh 86.12 in June 2012 compared with a range of Ksh 83.52 and Ksh 89.83 in December 2012. Exchange rate stability during the period was supported by increased short-term capital inflows attributed to high yields on Government securities, the rising diaspora remittances that averaged about USD 100 million per month between January and June 2012, and an equivalent of USD111 million disbursements by the IMF under the ECF in April 2012 and disbursement of the USD 600 million under the syndicated external loan in June 2012.

In the region, the Kenya shilling strengthened against the South African Rand, and Uganda and Tanzanian shillings. The significant weakening in the Rand was attributed mainly to the turmoil in the eurozone.

Chart 5a: Trends in the Kenya Shilling Exchange Rate against Major Currencies

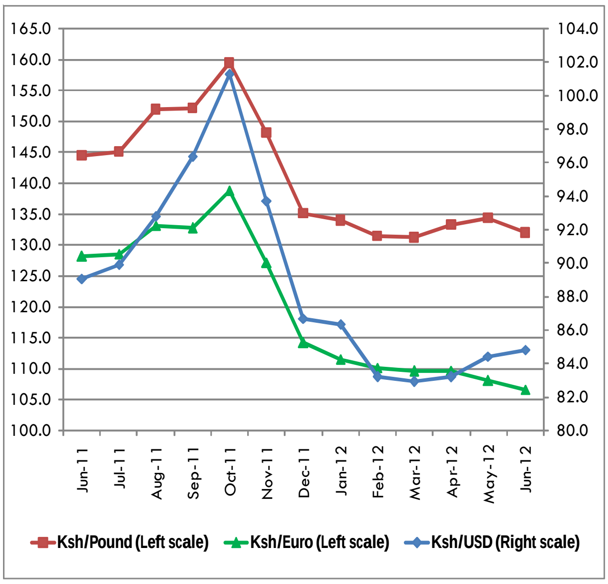
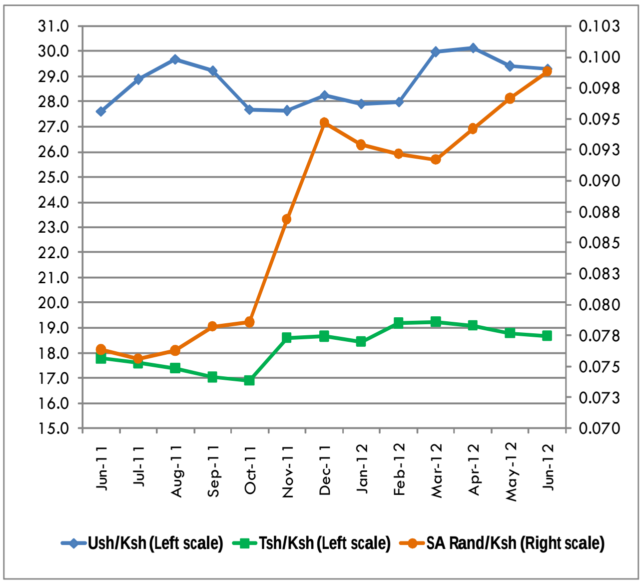


Chart 5b: Trends in the Kenya Shilling Exchange Rate against Regional Currencies



Source: Central Bank of Kenya

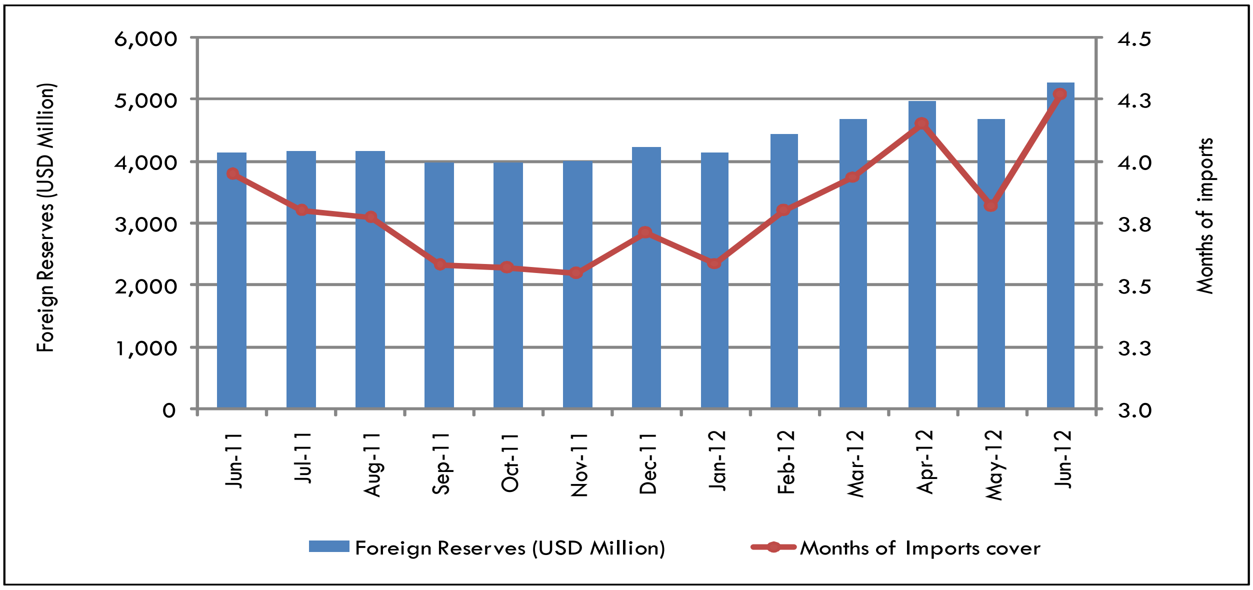
Given the current structure of the economy where export earnings have been financing a rising import bill, the Kenya Shilling is vulnerable to external shocks (Chart 5c). The current account deficit increased from 9.78 percent of GDP in December 2011 to an estimated 11.4 percent of GDP in June 2012, exerting pressure on the exchange rate. The eurozone debt crisis during the period also caused instability in currencies worldwide with the US dollar strengthening as the preferred reserve currency.

Chart 5c: 12-Month Cumulative Exports/12-Month Cumulative Imports (%)

Source: Central Bank of Kenya and Kenya National Bureau of Statistics

ii. The level of official foreign exchange reserves held by the CBK increased from USD 4,248 million (3.71 months of import cover) in December 2011 to USD 5,283 million (4.27 months of import cover) in June 2012 (Chart 6). The build-up in foreign exchange reserves during the period was attributed to purchases of US Dollars amounting to USD 844.5 million, receipt of an equivalent of USD 111 million disbursements under the ECF programme, and disbursement of the USD 600 million under the syndicated external loan in June 2012. These foreign exchange receipts were however partly offset by sales of foreign exchange amounting to USD 346 million undertaken to stabilise the exchange rate during the period.

Chart 6: Foreign Exchange Reserves



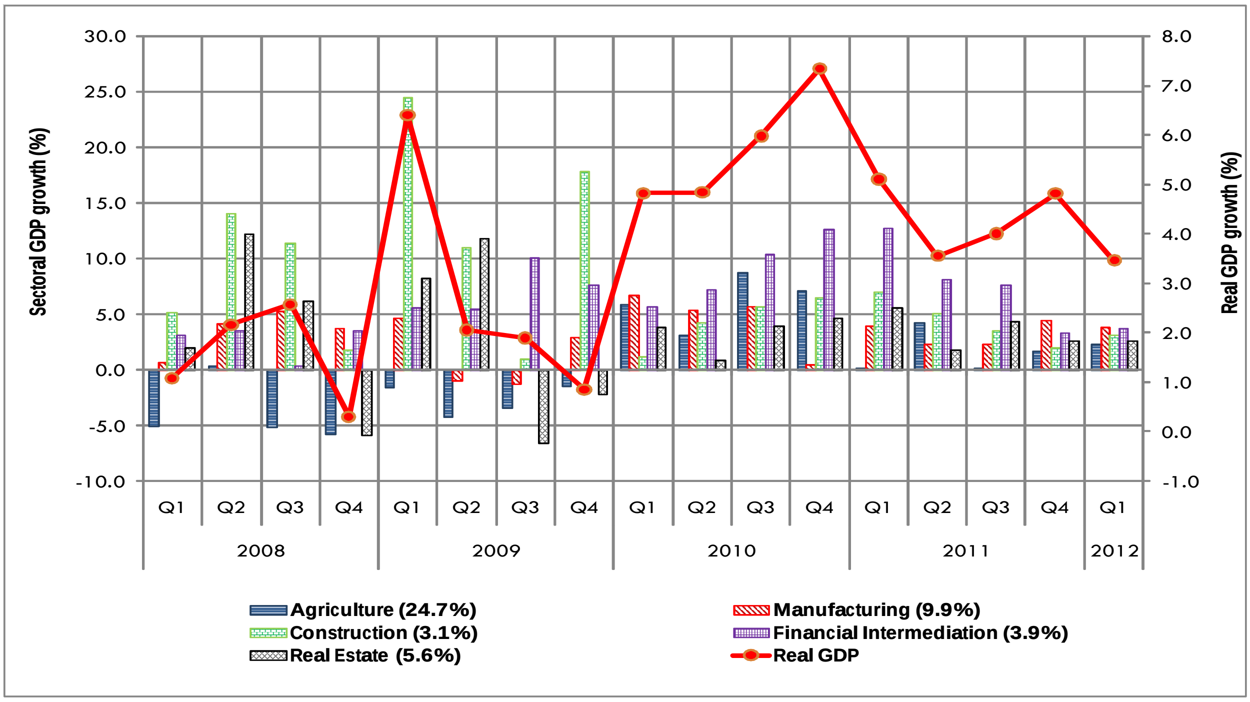
Source: Central Bank of Kenya

c. Economic Growth

Data from the Kenyan National Bureau of Statistics (KNBS) shows that the economy grew by 3.5 percent in the first quarter of 2012 down from 5.1 percent in a similar period in 2011 (Chart 7). The economy remained resilient to register positive growth in the face of domestic and external shocks witnessed in the second half of 2011 and first quarter of 2012. The decline in the performance of the economy in the first quarter of 2012 was attributed to high energy prices following persistently high oil prices, delay in the onset of the rains, and high interest rates following adoption of a tight monetary policy stance by the MPC.

Agriculture and manufacturing sectors registered growths of 2.3 percent and 3.8 percent respectively. The agriculture sector suffered from a severe frost in January 2012 which affected tea and horticulture sub-sectors. Transport and communication and wholesale and retail trade sectors contributed significantly to the overall growth with growth rates of 5.9 percent and 5.1 percent respectively.

Chart 7: Selected Quarterly Sectoral GDP Growth Rates



Source: Kenya National Bureau of Statistics

Note: *Long term average contribution of the respective sectors to real GDP are given in brackets*

d. Fiscal Developments and Debt

The Bank's pursuit for price stability during the period was supported by close collaboration with the Ministry of Finance to ensure coordination between fiscal and monetary policies. Following the externalisation of an equivalent of USD 600 million of the planned domestic borrowing in the fiscal year 2011/12, the Government domestic borrowing programme did not exert pressure on interest rates in the first half of 2012. As a result, net domestic borrowing decreased from Ksh 91.7 billion in the fiscal year 2010/11 to Ksh 76.0 billion in the fiscal year 2011/12 and was also below the budget target of Ksh 119.5 billion for the period. Similarly, the public debt ratios for the period were consistent with the thresholds set in the June 2012 Medium Term Debt Management Strategy.

e. Banking Sector Developments

Financial markets development is core in enhancing the monetary policy transmission mechanisms. In this regard, the CBK continued, between January and June 2012, to implement measures aimed at lowering transaction costs in the financial system as well as enhancing financial access. Commercial banks' branch network increased from 1,161 in 2011 to 1,197 by June 2012 while the number of commercial banks' ATMs increased from 2,205 to 2,291. In addition, the Agency Banking model has taken root with the number of agents standing at 12,054 by June 2012.

Mobile phone platforms began integrating with banking platforms in 2009 where customers can use their phones to transfer/withdraw money from their bank accounts. This set the stage for mobile phone money transfers to start affecting financial intermediation. Several banks have partnered with telecommunication companies to offer financial services on telecommunication platforms. As already indicated, these financial innovations have changed both the design and conduct of monetary policy.

f. MPC Market Surveys and Stakeholder Forums

The Bank held regular interactions with stakeholders in the financial and real sectors to enhance the effectiveness and transparency of monetary policy formulation and implementation so as to coordinate market expectations. It also constantly updated its website with the release of timely and relevant data. The MPC held regular forums with the Kenya Bankers Association. In February 2012, the Bank made a submission to the Parliamentary Select Committee on Finance and Trade on the factors behind the weakening of the Kenya Shilling in the second half of 2011 and the actions taken by the Bank.

The MPC continued to improve on the information gathering processes through market perception surveys and communication with key stakeholders on the MPC decisions. Bi-monthly MPC Market Surveys were conducted to understand market perceptions on key indicators of the economy including inflation, interest rates, exchange rates and growth.

3. The Current Economic Environment and Outlook for July 2012 to June 2013

a. International Economic Environment

The growth of the global economy is projected to slow down from 3.9 percent in 2011 to 3.5 percent in 2012 due to the instability in the eurozone, and a weaker external environment, capacity constraints and policy tightening in emerging market economies. However, sub-Saharan Africa and East African Countries (excluding Kenya) are forecast to grow at 5.4 percent and 5.8 percent, respectively, in 2012 (Table 2). However, the global economy is projected to recover and register a projected growth of 3.9 percent in 2013. This growth is expected to benefit Kenya's export sector given that a large proportion of Kenya's exports are to the region. Pressure on global inflation is expected to ease in 2012 and 2013 reflecting the impact of aggressive monetary policy measures implemented by most countries to rein in inflationary pressures and dampen exchange rate volatility.

The uncertainties in the global financial markets due to the debt crisis in the eurozone remain the main risks to the international economic environment. These could slowdown the performance of tourism and horticulture in particular. Furthermore, the geo-political risks associated with oil movement through the Straits of Hormuz could interrupt the crude oil supply and thus affect fuel prices globally. The consequence of these risks could be seen in Kenya through an increase in exchange rate volatility and potential weakening of the Kenya Shilling.

Table 2: Performance and Outlook for the Global Economy

	Real GDP Growth (%)		Inflation (%)	
	2011 Act.	2012 Proj.	2011 Act.	2012 Proj.
World	3.9	3.5	4.9	4.1
Advanced Economies	1.6	1.4	2.7	1.9
United States	1.7	2.1	2.1	1.3
Japan	-0.7	2.0	-2.0	-0.2
Euro Area	1.4	-0.3	2.7	2.0
United Kingdom	0.7	0.8	4.5	2.4
Other Advanced economies	3.2	2.6	3.3	2.4
Emerging and developing economies	6.2	5.7	7.1	6.2
Sub-Sahara Africa	5.1	5.4	8.2	9.6
East African Community (Excl.Kenya)	6.6	5.8	8.5	14.8
Developing Asia	7.8	7.3	7.0	5.1
China	9.2	8.2	5.5	3.3
India	7.2	6.9	10.6	8.6
Middle East and North Africa	3.5	4.2	9.9	7.6

IMF World Economic Outlook (April 2012 and July 2012 Update)

b. Domestic Economic Environment

i. Economic Growth

The economy is projected to remain resilient during the fiscal year 2012/13 and register positive growth. In addition, the MPC Market Perceptions Survey conducted in June 2012 showed sustained confidence in the economy. An improved economic environment with lower inflation and exchange rate stability, large investment in infrastructure, expected pick-up in private sector credit growth with declining interest rates, and increased regional trade within the East African Community countries are the main factors expected to drive growth. However, the subdued global economy and volatile crude oil prices are the main risks to the growth outlook.

ii. Foreign Exchange Market

The exchange rate is expected to remain stable in the fiscal year 2012/13 in spite of the continued pressure from the current account of the balance of payments. The monetary policy and regulatory measures in place coupled with increased foreign exchange inflows from diaspora remittances and tourism are the main factors expected to support exchange rate stability. Demand for credit to finance imports is expected to continue declining, and short term capital inflows to increase due to the higher interest rates. In addition, less pressure from food imports due to improvement in the weather are expected to support the Kenya shilling. The MPC Market Survey for June 2012 corroborated this evidence of an expected stable exchange rate. However, risks on exchange rate stability mainly revolve around the instability in the eurozone.

iii. Inflation

Inflation is expected to continue declining in the fiscal year 2012/13. The inflation outlook, which is corroborated by the June 2012 MPC Market Survey results, is attributed to the CBK monetary policy measures in place, lower energy costs and improved food supply due to better rainfall across the country together with the stable exchange rate should also lower prices and hence inflation. However, volatile crude oil prices and uncertainty in the resolution of the eurozone debt crisis could result in exchange rate volatility with pass-through effects to domestic prices.

iv. Interest Rates

The expected continued decline in inflation in the fiscal year 2012/13 is projected to dampen pressure on interest rates. There are expectations for a gradual easing in the tight monetary policy stance adopted in the second half of 2011 to rein in inflationary pressures. In addition, the MPC Market Perceptions Survey for June 2012 showed that lending rates were expected to decline with inflation coming down, a stable exchange rate, and the ongoing moral suasion by KBA and CBK. Most commercial banks have also expressed sensitivity to the impact of any threat of an accumulation of non-performing loans. The main risk to the outlook on interest rates is to the international economic developments or supply side factors which could prompt additional measures by CBK to alleviate any adverse expectations with respect to inflation or exchange rate movements.

v. Fiscal Policy

The fiscal measures announced by the Government during the Budget Statement for the fiscal year 2012/13 are consistent with monetary policy objectives. The borrowing plan should ensure that domestic debt remains within the thresholds set in the Medium Term Debt Management Strategy. In addition, enhanced expenditure on infrastructural projects in the country continues to create employment and demand. However, the main risks to the fiscal outlook are the likely increase in expenditures to finance preparations for the forthcoming elections.

vi. Confidence in the Economy

The country's policy environment remains strong. The latest Country Policies and Institutional Assessment (CPIA) rating of 3.8 by the World Bank places Kenya fourth overall in Sub-Saharan Africa in terms of policy reform and institutional quality. Table 3 shows other indicators of sustained confidence in the economy. The cumulative diaspora remittances continued to grow, rising from USD 891.4 million in the 12-months to December 2011 to USD 1,080.8 million in the 12-months to June 2012. Similarly, the 12-month cumulative tourist arrivals remained over 1,000,000 during the period. Other key signals to investors included a relatively lower credit risk and strong recovery of the stock market during the period.

Table 3: Indicators of Declining Risk and Confidence in the Economy

	Dec-11	Jan-12	Feb-12	Mar-12	Apr-12	May-12	Jun-12
12-Month Emigrant Remittances (USD Million)	891.4	916.7	960.0	994.8	1,020.3	1,053.2	1,080.8
NSE Index (Jan 1966 = 100)	3,205.0	3,224.9	3,303.8	3,366.9	3,546.7	3,650.9	3,703.9
12-Month Number of Tourist Arrivals	1,264,926	1,261,231	1,265,561	1,263,433	1,266,530	1,263,332	1,280,618
Net NPLs/Total Loans ratio (%)	0.82	0.87	0.72	0.69	0.66	0.77	0.83

Source: Kenya National Bureau of Statistics and CBK

4. Future Direction of Monetary Policy (July 2012 – June 2013)

During the fiscal year 2012/13, monetary policy will focus on: setting monetary targets which are consistent with the objective of achieving and maintaining a low and stable inflation, encouraging growth, and ensuring the long-term sustainability of public debt; and, enhancing access to banking services in order to improve the monetary policy transmission to the benefit of economic growth.

a) Monetary Programme and Foreign Exchange Reserves

The monetary targets for the fiscal year 2012/13 are based on the indicators in the June 2012/13 Budget Strategy Paper which are presented in Annexe 1, and the revised ECF programme targets. The monetary targets for the period are presented in Table 4. In particular, broad money supply, M3, is set to grow by 17.2 percent in December 2012 and 16.5 percent by June 2013.

The NDA of the CBK is planned to increase from Ksh. -75.4 billion in September 2012, to Ksh. -55.0 billion in December 2012 before falling to Ksh. -64.7 billion in June 2013. The NDA targets for the period are consistent with the ECF programme targets. Annual growth in credit to the private sector is projected at 15.8 percent in December 2012 and 16.8 percent in June 2013. Similarly, the Net Foreign Assets (NFA) of CBK is projected at Ksh 334.5 billion in December 2012 and Ksh 346.6 billion in June 2013. The NIR targets are USD 4,241.5 million in December 2012 and USD 4,387.7 million in June 2013 which are consistent with the ECF programme targets for the period.

These monetary targets are expected to enable the Bank achieve the policy objective of bringing down overall inflation to the 5 percent in the medium-term in order to anchor inflation expectations. The planned build-up in foreign exchange reserves will enhance the country's capacity to absorb shocks that impact the foreign exchange market. The monetary policy stance will ensure that short-term interest rates continue to decline gradually with inflation, which will encourage growth and ensure the long-term sustainability of public debt. The Bank will also continue to enhance the effectiveness of its monetary policy instruments with regard to speed and magnitude of impact.

Table 4: Monetary Targets for the Fiscal Year 2012/13

	Jul-12	Aug-12	Sep-12	Oct-12	Nov-12	Dec-12
Broad Money, M3 (Ksh Billion)	1,661.2	1,683.7	1,706.3	1,728.8	1,751.3	1,774.1
Reserve Money, RM (Ksh Billion)	255.0	254.1	257.4	264.8	264.6	279.5
NFA of CBK in Ksh Billion	326.2	329.2	332.7	327.5	330.6	334.5
NDA of CBK in Ksh Billion	-71.3	-75.1	-75.4	-62.7	-65.9	-55.0
12-month growth in RM (Percent)	14.5	10.1	9.0	12.9	7.9	9.6
12-month growth in M3 (Percent)	17.6	17.2	15.0	14.2	17.6	17.2
12-month growth in Credit to Private Sector (Percent)	14.9	16.0	14.8	16.4	16.3	15.8
12-month growth in Real GDP (Percent)						5.2
Medium-Term 12-month overall Inflation (Percent) Target	5.0	5.0	5.0	5.0	5.0	5.0

	Jan-13	Feb-13	Mar-13	Apr-13	May-13	Jun-13
Broad Money, M3 (Ksh Billion)	1,796.7	1,819.0	1,841.3	1,864.1	1,886.4	1,908.9
Reserve Money, RM (Ksh Billion)	268.1	275.2	274.7	279.6	274.9	281.9
NFA of CBK in Ksh Billion	338.3	341.3	344.8	339.6	343.2	346.6
NDA of CBK in Ksh Billion	-70.3	-66.0	-70.1	-60.0	-68.2	-64.7
12-month growth in RM (Percent)	9.8	16.6	13.6	13.8	14.1	12.0
12-month growth in M3 (Percent)	19.3	18.7	18.1	17.6	17.0	16.5
12-month growth in Credit to Private Sector (Percent)	15.0	15.9	15.4	18.6	16.9	16.8
12-month growth in Real GDP (Percent)						5.5
Medium-Term 12-month overall Inflation (Percent) Target	5.0	5.0	5.0	5.0	5.0	5.0

Source: Central Bank of Kenya

The Bank will continue to monitor developments with respect to the Monetary Targets and make any necessary reviews. The achievement of the targets set will depend on stability in the international prices of oil, normal weather conditions, and continued commitment by the Government to operate within the domestic borrowing ceiling for fiscal year 2012/13. Monetary policy implementation will be based on monthly targets for NDA, RM and broad money supply, M3, to be achieved through Open Market Operations. The Repos and Term Auction Deposits will be used to withdraw any excess liquidity in the banking system on a timely basis and where necessary Reverse Repos will be used to inject liquidity. In addition, the success of CBK's monetary policy measures to fight inflation will depend on the effectiveness of the institutions charged with the responsibility of managing the supply side of prices that is ensuring adequate food and fuel supply.

b) Extending Access to Financial Services

The Bank will continue to support development of new products and innovations towards enhancing financial access as improvements in access to financial services that have been shown to support economic growth. Appropriate legislation aimed at ensuring that such innovations are regulated accordingly to enhance market confidence will be recommended. The Bank will also continue to monitor any new financial derivatives in the market.

c) Measures to Enhance Market Efficiency

The Bank will continue to work with stakeholders in the banking and real sectors in order to enhance the monetary policy transmission mechanisms. It will also continue with initiatives aimed at engaging stakeholders and obtaining feedback on the impact of MPC decisions. Measures to enhance the uptake of Horizontal Repos among banks will also be implemented, while stakeholder forums with Chief Executive Officers and Treasury Managers of banks as well as the CBK Board of Directors will be held both to obtain feedback and to explain the background to MPC decisions. Furthermore, the MPC will continue to brief the market on its decisions with a view to coordinate market expectations.

d) Enhancing the Effectiveness and Efficiency of CBK Operations

The implementation of monetary policy will be enhanced by the operationalisation of the institutional changes introduced by the Government, through the Ministerial Budget Statement for the fiscal year 2012/13. This introduced the positions of a non-executive Chairman of the CBK Board and a second Deputy Governor.

ANNEX 1: MAIN MACROECONOMIC INDICATORS UNDERPINNING THE MEDIUM TERM FISCAL FRAMEWORK, 2010/11 – 2014/15

	2010/11	2011/12			2012/13			2013/14			2014/15	
	Prov.	*Budget*[1/]	*BROP'12*	*BPS'12*	*BPS'11*[1/]	*BROP'12*	*BPS'12*	*BPS'11*[1/]	*BROP'12*	*BPS'12*	*BROP'12*	*BPS'12*
	Annual percentage change, unless otherwise indicated											
National account and prices												
Real GDP	5.0	5.7	4.9	4.8	6.3	5.5	5.5	6.5	5.8	5.9	6.3	6.3
GDP deflator	7.3	9.1	13.1	13.4	6.0	10.5	11.3	5.0	6.5	7.1	5.4	5.6
CPI Index (eop)	14.6	7.8	8.9	11.0	5.7	7.9	8.0	5.0	5.6	5.6	5.0	5.0
CPI Index (avg)	6.9	9.3	15.1	16.0	6.4	9.5	9.8	5.0	6.3	6.3	5.0	5.0
Terms of trade (-deterioration)	-5.4	-2.5	-1.1	-2.0	-2.8	-0.3	0.5	-1.3	-0.2	1.8	0.7	1.2
	In percentage of GDP, unless otherwise indicated											
Investment and saving												
Investment	21.3	23.4	21.2	22.6	24.8	22.5	23.6	25.3	24.4	24.4	25.1	25.2
Central Government	7.8	12.5	9.7	9.5	11.0	9.4	9.8	10.5	9.6	9.6	10.2	9.8
Other	13.5	10.9	11.5	13.1	13.8	13.0	13.8	14.7	14.8	14.8	14.9	15.3
Gross National Saving	10.6	15.5	12.2	11.5	17.6	15.6	14.9	19.0	18.9	17.1	20.8	19.1
Central Government	2.7	3.9	3.8	3.3	5.5	4.1	3.9	6.1	4.9	5.2	5.6	5.8
Other	7.9	11.6	8.4	8.2	12.1	11.5	11.0	12.9	13.9	11.9	15.2	13.3
Central government budget												
Total revenue	24.1	24.7	23.5	24.0	24.9	24.0	24.7	25.2	24.2	24.9	24.5	25.1
Total expenditure and net lending	29.3	33.5	29.6	30.3	31.0	29.9	30.7	30.2	29.5	29.8	29.6	29.7
Overall balance (commitment basis) excl. grants	-5.2	-8.8	-6.1	-6.3	-6.1	-5.9	-6.0	-5.0	-5.2	-4.9	-5.1	-4.6
Overall balance (commitment basis) incl. grants	-4.5	-7.4	-4.7	-4.8	-4.7	-4.6	-4.5	-3.7	-3.9	-3.8	-3.7	-3.5
Primary budget balance	-1.8	-4.8	-2.2	-2.2	-1.9	-1.4	-1.8	-1.4	-1.4	-1.4	-1.4	-1.3
Net domestic borrowing	3.0	3.8	1.7	1.9	1.4	2.0	2.8	1.2	1.1	2.6	1.2	1.5
Total external support (grant & loans)	2.4	5.7	3.6	3.6	4.3	4.6	3.9	4.0	3.8	3.3	4.2	3.3
External sector												
Exports value, goods and services	27.8	28.2	27.8	27.0	27.2	26.2	24.9	26.8	26.3	24.7	26.4	24.5
Imports value, goods and services	44.3	41.4	42.0	43.2	39.3	37.7	37.8	37.7	36.2	35.9	34.9	34.1
Current external balance, including official transfers	-10.8	-7.9	-8.9	-11.1	-7.2	-6.8	-8.7	-6.3	-5.5	-7.3	-4.3	-6.1
Public debt												
Nominal central government debt (eop), gross	53.6	52.3	49.8	50.0	51.2	47.8	47.8	49.7	46.7	45.2	45.5	44.4
Nominal central government debt (eop), net of deposits	48.8	48.6	45.8	45.9	47.9	44.3	44.3	46.7	43.6	42.1	42.7	41.7
Domestic (gross)	27.6	28.4	24.9	25.1	26.6	23.4	24.1	24.9	21.9	23.9	20.7	22.8
Domestic (net)	22.7	24.7	20.9	21.0	23.2	19.9	20.7	22.0	18.8	20.8	18.0	20.1
External	26.1	23.9	24.9	24.9	24.6	24.4	23.7	24.7	24.8	21.3	24.7	21.6
Memorandum items:												
Nominal GDP (in Ksh billions)	2,773	3,184	3,292	3,295	3,589	3,836	3,866	4,011	4,321	4,383	4,837	4,916
Nominal GDP (in US$ millions)	33,627	38,316	37,844	37,917	43,056	44,386	44,735	47,812	48,947	49,642	54,267	55,159

Source: Ministry of Finance

BPS = Budget Policy Statement

BROP = Budget Review & Outlook Paper

1/ Updated in June 2011

ANNEX 2: CHRONOLOGY OF EVENTS OF PARTICULAR RELEVANCE TO MONETARY POLICY (JANUARY –JUNE 2012)

Jan-12	a) The MPC retained the CBR at 18 percent during its meeting on 11th January, 2012.
	b) Commercial banks continued to adjust their portfolios in view of the tight monetary policy stance adopted by the MPC. Banks sold foreign exchange totalling USD 56 million to the CBK. However, the CBK sold USD 105 million during the month to stabilise the exchange rate.
Feb-12	a) The MPC retained the CBR at 18 percent during its meeting on 1st February, 2012.
	b) The CBK Governor made a submission to the *Parliamentary Select Committee on the Decline of the Kenya Shilling against Foreign Currencies* explaining the factors behind the weakening of the Kenya Shilling in the second half of 2011 and the actions taken to address the situation.
Mar-12	a) The MPC retained the CBR at 18 percent during its meeting on 6th March, 2012.
	b) The discovery of commercially viable oil deposits in the Turkana area of Kenya was announced by the Government.
Apr-12	a) The MPC retained the CBR at 18 percent during its meeting on 4th April, 2012.
	b) The Financial Reporting Centre was operationalised to deal with issues of money laundering.
May-12	a) The MPC retained the CBR at 18 percent during its meeting on 3rd May, 2012.
	b) The Kenya Deposit Insurance Act replaced the Deposit Protection Fund Act.
	c) The CBK sold USD 164.0 million to stabilise the exchange rate following instability in the foreign exchange market attributed to the escalation in the eurozone crisis.
Jun-12	a) The MPC retained the CBR at 18 percent during its meeting on 5th June, 2012.
	b) The CBK sold USD 76 million to stabilise the exchange rate following instability in the foreign exchange market attributed to the escalation in the eurozone crisis.

GLOSSARY OF KEY TERMS

Overall Inflation

Overall inflation is a measure of inflation in the economy calculated as the weighted year-on-year movement of indices of all consumer price items of goods and services sampled by the Kenya National Bureau of Statistics. The inflation measure is affected by the commodity components in the market that may experience sudden inflationary spikes such as food or energy. It may therefore not present an accurate picture of the current state of the economy, nor does it purport to measure the cost of living.

Reserve Money

Reserve Money is computed as the 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 non-bank financial institutions held with the CBK. However, it excludes Government deposits.

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 + deposit Liabilities of Non-Bank Financial Institutions (NBFIs)

M3 M2 + residents' foreign currency deposits