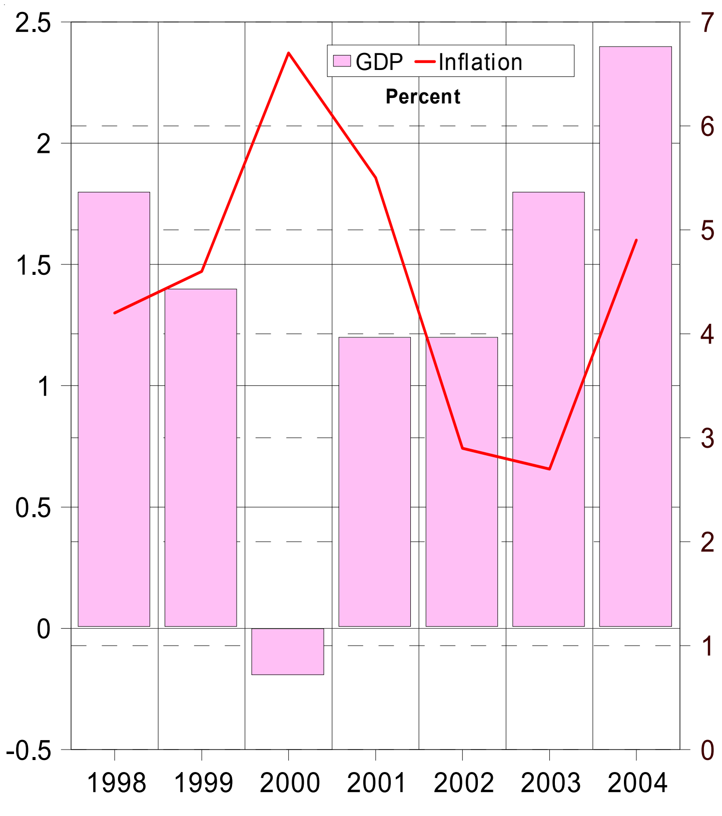


CENTRAL BANK OF KENYA

Monetary Policy Statement

Issued under the Central Bank of Kenya Act, Cap 491

December 2004

Letter of Transmittal

Dear Honourable Minister,

I have the pleasure to present to you the 15th edition of the Monetary Policy Statement of the Central Bank of Kenya, in accordance with Section 4B (1) of the Central Bank of Kenya Act, 1996. The Statement provides a review of monetary policy implementation and achievement against targets since the last *Statement* in June 2004. It also gives an overview of the performance of the economy. Finally, the Statement outlines the program for monetary policy through June 2005.

Yours Sincerely,

ANDREW K. MULLEI
Governor
Central Bank of Kenya

MONETARY POLICY STATEMENT
DECEMBER 2004

TABLE OF CONTENTS

Page

List of Tables

List of Charts

Appendices

Glossary

Legal Basis for the Publication of the Monetary Policy Statement

The Monetary Policy Statement is published in accordance with Part II Section 4B(1) of the Central Bank of Kenya Act, CAP 491. The law states that:

- The Bank shall at intervals of not more than six months, submit to the Minister a Monetary Policy Statement for the next twelve months which shall:

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

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

    - *Contain a review and assessment of the progress of the implementation by the Bank of monetary policy during the period to which the preceding policy statement relates.*

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

- *The Bank shall:*

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

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

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

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

Objectives of the Central Bank of Kenya

The CBK (Amendment) Act of 1996 provides the following objectives and functions of the Central Bank of Kenya.

- Primary objectives:
  - To formulate and implement monetary policy directed at achieving and maintaining price stability.
  - To foster solvency and proper functioning of a stable market based financial system.
- Secondary functions:
  - To formulate and implement foreign exchange policy.
  - To manage official foreign exchange reserves.
  - To license and supervise dealers in the money market.
  - To promote efficient payment, clearing and settlement systems.
  - To perform as banker, advisor and fiscal agent to the Government.
  - To issue currency notes and coins.

Importance of Maintaining Price Stability

- Maintaining price stability is crucial for a proper functioning of a market-based economy.

- Inflation control is not an end in itself, but rather, the means by which monetary policy contributes to overall economic performance.

- Inflation is undesirable for several reasons:

  - It makes some people worse off because their incomes do not rise as rapidly as prices do. The most hit are mainly pensioners whose incomes are fixed.

  - It hurts lenders and rewards borrowers since the changes in interest rates tend to lag behind inflation. The end result is that those who lend money buy less with what they receive now than what they would have bought at the time of lending.

  - It makes business planning difficult as since matching the cost of production with output price become elusive. The uncertainties that inflation creates can discourage investment, thus slowing economic growth.

  - It feeds on itself; one spiral of price increase leads to another. For example, when firms raise prices to cover rising costs, workers who see prices going up will ask for higher wages. If unchecked a vicious cycle may arise culminating in hyperinflation, a situation in which prices rise extremely rapidly.

What the Central Bank of Kenya Does to Ensure Price Stability

- The Central Bank of Kenya keeps the growth of the money stock at a level that is consistent with the target set for economic growth. The Bank also regulates the growth of broad money supply (M3X) to ensure that its availability does not create excess demand on goods and services pushing prices up.

- To manage the growth of money supply, the Bank targets the reserve money as the operating instrument. Reserve money comprises of liabilities of the Central Bank (currency in circulation and commercial banks' deposits at the CBK). A change in reserve money affects the base at which commercial banks can create credit in the economy.

- In deciding whether to expand or contract reserve money, the CBK takes into account a variety of economic and financial data. It also considers prospects of economic growth and whether inflation appears to be a problem. After reaching a decision on what monetary policy to pursue, the CBK executes the policy by employing a variety of instruments at its disposal. These instruments are outlined in the next section.

Instruments of Monetary Policy

- There are three major tools used by the Bank to implement monetary policy:

  - **Open Market Operations**: Through open market operations, the Bank buys or sells Kenya Government Treasury Bills, which are held already by commercial banks, in the secondary market in order to achieve a desired level of reserves money. The Bank injects money to the economy when it buys Treasury bills, and withdraws money when it sells the Treasury bills.

  - **Discount Window Operations**: The Bank, as lender of last resort, provides secured short-term loans to commercial banks on an overnight basis at a penalty rate known as discount rate, which is 3 percent above the Treasury bill rate. An increase/decrease in the discount rate discourages/encourages commercial banks from borrowing from the Central Bank window.

  - **Reserve Requirements**: The Central Bank is empowered by law to demand that a certain proportion of commercial banks' deposits be held as cash reserve requirement (CRR) at the Central Bank. An increase in CRR would reduce the capacity of commercial banks to extend credit. A reduction in the CRR enhances the capacity of commercial banks to expand credit. The CRR has remained at 6 percent of commercial bank deposits since July 2003.

  - **Foreign Exchange Market Operations:** the Bank effectively injects or withdraws liquidity by engaging in foreign exchange market transactions. In most cases, Central Bank participation in the foreign exchange market has not been geared to affecting domestic liquidity, although it can do so.

I. INTRODUCTION

The Kenyan economy continued to perform moderately well during 2004, with real GDP growing by 2.4 percent, up from 1.8 percent in 2003. The moderate growth performance benefited from a favourable international environment and recovery in domestic demand. The strong growth in Kenya's trading partners led to higher demand for Kenyan exports. Expansion in domestic demand was mainly driven by growth in agriculture, tourism, and transport and telecommunication services.

Inflation increased in the second half of 2004 due to rising food and fuel prices occasioned by the adverse effect of drought on food supply and sharp increase in world oil prices. Safety rules imposed in the transport industry also reduced the availability of transport and higher fares had a toll on inflation. Underlying inflation also increased, threatening to exceed the 5 percent target in October 2004 due to increased demand emanating from strong expansion of bank credit and the impact of the shilling depreciation in the third quarter of 2004. Inflationary pressures, however, started to ease in December 2004 with overall inflation declining to 16.3 percent from the peak of 19 percent in September.

The monetary program — designed in May/June 2004 and presented in the last *Statement* — was revised to take into account outcome of monetary and fiscal data for the June 2004 and developments in growth and inflation through September 2004. Broad money M3X, was targeted to grow by 8.9 percent in the year to December 2004 and 7.5 percent in the year June 2005, while reserve money expansion was targeted at 6.2 percent and 3.8 percent, respectively. This monetary program underpinning the IMF supported Poverty Reduction and Growth Facility (PRGF) was approved on December 20, 2004 following the successful completion of the First Review of the PRGF program that enabled Kenya receive a further US$76.9 million. The approval brought the total amount drawn to US$115.4 million, out of the total US$330 million expected to be drawn under the arrangement.

The economy is showing a steady recovery, supported by improved domestic demand and favourable external environment with world demand growing at over 4.5 percent. There are also signs of improved business conditions and a tapering off of inflationary pressures. The Bank, therefore, considers the current monetary program as appropriate and achievable and it will be maintained through June 2005.

II. MONETARY POLICY IMPLEMENTATION AND PERFORMANCE SINCE THE LAST STATEMENT IN JUNE 2004

Macroeconomic Objectives

One of the key pillars of the Government's Economic Recovery Strategy for Wealth and Employment Creation (ERS) is the restoration of economic growth within the context of a sustainable macroeconomic framework. Macroeconomic stability is a prerequisite for strong private sector-led economic growth. The Government has therefore set out to ensure that monetary and fiscal policies strongly support both growth and macroeconomic stability by aiming at:

- Raising economic growth, particularly real GDP growth to 2.7 percent in 2004/05 from 2.1 percent in 2003/04 (See Appendix Table 1).

- Maintaining low and stable inflation, with an average annual underlying inflation target of 5 percent by end-June 2005.

- Constraining net domestic borrowing of the Government to no more than 2.5 percent of GDP.

- Increasing international reserves from three months in 2003/04 to four months of import cover, as a cushion against external shocks.

Monetary Policy Management

In line with the above growth and broad macroeconomic objectives of the Government, the Central Bank designed its monetary program with an aim of containing underlying inflation below 5 percent. The inflation objective was achieved by targetting reserve money, with broad money (M3X) as the intermediate target, and open market operations as the main instrument. The cash ratio requirement (CRR) was kept at the 6 percent level set in July 2003. Moreover, the Bank continued to use a broad set of indicators to monitor inflationary pressures and to gauge the appropriateness of the monetary policy stance.

Monetary policy implementation was anchored on quarterly targets for broad money and reserve money aggregates reviewed every six months in the context of the Monetary Policy Statement.

Reserve Money Program

The reserve money path developed during the May/June 2004 discussion with the IMF and reported in the previous *Statement* is shown in Table 1. Reserve money was then projected to increase by 8.7 percent in the year to December 2004 and by 5.1 percent in the year to June 2005, consistent with projected necessary increase in money supply.

Table 1: Reserve Money Program*

	Jun'04	Sep'04	Dec'04	Mar'05	Jun'05
			Projection		
Reserve Money	**88.6**	**90.0**	**95.2**	**93.1**	**93.1**
Annual Change (percent)	3.6	10.1	8.7	7.5	5.1
Net Foreign Assets	87.6	91.3	93.0	96.7	98.1
Net Domestic Assets	1.0	-1.2	2.2	-3.6	-5.0

** As developed in May/June 2004*

Source: Central Bank of Kenya

Modifications made to the Reserve Money program

When the last *Statement* in June 2004 was published, monetary and fiscal data for end-June 2004 fiscal year were not available to be taken into account in the formulation of a firm 2004/05 monetary program. Moreover, the adverse impact of the drought and rising oil prices on growth and inflation had not been foreseen.

Following the September 2004 IMF Program Review discussions, the monetary program was updated to take into account the final June numbers and the revisions made on growth and inflation following the adverse effects of drought and rising oil prices. Broad money, M3X, was revised and targeted to grow by 8.9 percent and 7.5 percent in the year to December 2004 and June 2005, respectively as shown in Table 2. Similarly, reserve money was revised and targeted to expand by 8.5 percent and 5 percent compared with 8.7 percent and 5.1 percent in the earlier program. During the discussion, the monetary program was modified to include a ceiling on reserve money and an adjuster on excess/shortfall on currency outside banks against program target, instead of the ceiling on NDA in the previous program. This was intended to remove ambiguity in the program targets.

As the Bank embarked on the implementation of the updated program, further revisions were made on the reserve money program that was approved by the IMF Executive Board Meeting on Kenya's PRGF program on December 20, 2004. The revisions were motivated by the outcome of the September 2004 monetary and inflation data that exceeded target. Expansion of reserve money was revised downwards to 6.2 percent in December 2004 and 3.8 percent in June 2005 as shown in Table 2. Furthermore, the adjuster to the reserve money ceiling on excess/shortfall in currency outside banks was dropped, representing a further tightening of the monetary program.

Table 2: Revision made on the Reserve Money path through June 2005 (Ksh Billion)

	Sep'04	Dec'04		Mar'05		Jun'05	
	Act	Old**	New***	Old**	New***	Old**	New***
Reserve Money	89.9	94.9	93	94	93.3	94.7	93.7
Annual change	*9.8*	*8.5*	*6.2*	*8.5*	*7.7*	*5*	*3.8*
Currency outside Banks	56.1	59.7	57.9	58.4	57.7	58.4	57.7
Bank Reserves	33.8	35.2	35.1	35.6	35.5	36.4	36
Till Cash	7.2	7.1	7.2	7.1	7.3	7.2	7.3
Deposits	26.5	28.2	27.8	28.5	28.2	29.1	28.6
Required Reserves	25	25.9	26.3	26.4	26.7	27.1	27.2
Excess Reserves	1.6	2.3	1.6	2.1	1.5	2	1.5

*Figures may not add up due to rounding

**May/June 2004 program

*** Approved under the new PRGF program on December 20, 2004

Source: Central Bank of Kenya

Assessment of the Reserve Money Progam so far in 2004/05

Against the September 2004 ceiling of KSh 90.1 billion (based on May/June program), actual average reserve money at KSh 90.3 billion exceeded the target marginally. The December 2004 target of KSh 93 billion (based on the revised program) was exceeded by some KSh 4.7 billion, as actual average reserve money for December turned out to be KSh 97.7 billion. This was despite the Bank's intensified effort to withdraw liquidity from the banking system, which saw the repo rate rise to an average of 7.5 percent in December from an average of 2.5 percent in the first eleven months of 2004. Most of the deviation from target was in currency outside banks of Ksh 5.1 billion, as banks' excess reserves were below target by Ksh 0.4 billion.

Withdrawal of liquidity through open market operations was constrained by the more-than-envisaged high seasonality in currency outside banks associated with the public's demand for currency during the December festivities. The high inflation also caused the public to demand more currency to support transactions. It is normally difficult to immediately withdraw excess reserves in form of currency outside banks. This can only be affected by higher interest rates sustained over a long time, where the public will respond by reducing their currency holdings in favour of deposits.

Table 3: Performance of the Reserve Money so far in 2004/03 (Ksh billion)

	Sep'04		Dec'04	
	Actual	Target*	Actual	Target**
Reserve Money	**90.3**	**90.1**	**97.7**	**93**
Currency outside Banks	56.4	56	63	57.9
Bank Reserves	32.9	34.1	34.7	35.1
Net Foreign Assets	**76.4**	**80**	**82.7**	**74.4**
Net Domestic Assets of the CBK	10.7	-1.2	11.8	13.4

*May/June 2004 program.
** Approved benchmark under the new PRGF program on December 20, 2004.
*** Free Foreign exchange reserves for immediate use less foreign liabilities.

Source: Central Bank of Kenya

Regarding the target on net foreign asset (NFA) for the Central Bank, the benchmark for September 2004 was missed, but that for December 2004 was achieved. The NFA floor adjusted for shortfall in non-project external support and external privatisation receipts was targeted at Ksh 80 billion and Ksh 74.3 billion for September and December, respectively, compared with the actual of KSh 76.4 billion and Ksh 82.9 billion.

Overall, the reserve money benchmark ceiling for December 2004 was missed. However, this may not cause a serious problem in terms of the effect on broad money since reserve money is expected to revert on track in early 2005 when currency outside banks starts to correct itself to its normal trend.

Liquidity Management

In implementing the monetary policy, the Bank monitored developments in reserve money on a daily basis using the Central Bank liquidity-forecasting framework. Cumulative deviations in reserve money relative to monthly targets were used to guide the daily open market operations (OMO). The OMO desk undertook the desired policy actions through repos when withdrawing liquidity or reverse repos when injecting liquidity.

While the Bank continued to face difficulties in projecting liquidity due to inaccuracies in cash flow forecast of Government operations, liquidity forecasting is expected to improve in the months ahead as the

Government implements a more robust cash flow forecasting procedure.

Interest Rate Policy

The Bank continued to allow market-determined interest rates. With short-term interest rates negative in real terms for a greater part of 2004, the Bank was perceived as having kept nominal interest rate at low levels. This was a misconception as forces of demand and supply determined money market interest rates. Like any market affected by structural inefficiencies, the Bank played its rightful role of guarding the system against any disruptive forces in the market, while letting the market determine the level of interest rates. The Bank continued providing the necessary information on recent trends in economic and financial indicators to enable market participants make informed decisions. This was accomplished through the regular Weekly Bulletins, Monthly Economic Reviews, Statistical Bulletins and Annual Reports published by the Bank, as well as through Governor's speeches and press statements.

Commercial banks' lending rates declined marginally following the decline in short-term money market rates, but there remains scope for further narrowing of the lending-deposit margins. Evidence indicates that interest rates are to some extent influenced by structural inefficiencies in the banking system, including relatively high level of non-performing loans and administrative costs.

Exchange Rate Policy

The Bank continued with its policy of a flexible market-determined exchange rate. CBK participation in the market was limited to smoothing short-term excessive volatility, effecting external debt payments and maintaining the target for net international reserves under the IMF-supported PRGF program. The CBK intervened in August-September 2004 when speculative tendencies regarding fears of increased demand for foreign exchange occasioned by rising oil prices and food imports led to a sharp weakening of the shilling.

III THE CURRENT ECONOMIC SITUATION

External Environment

The world economy grew by 5 percent in 2004, up from 3.9 percent in the previous year. Much of the growth impetus was attributed to increased world trade volumes mainly owing to China's economic boom. The global recovery during the year was however moderated by the surge in world oil prices.

Kenyan exports, mainly to Uganda, Tanzania, United Kingdom, Netherlands and Pakistan, performed well in 2004 as export earnings grew by about 10.3 percent. This increase largely followed improved export prices of tea, coffee and horticulture, which rose by 3.2 percent, 4.6 percent and 29.7 percent, respectively in 2004 . The weakening of the shilling exchange rate in the second half of 2004 improved the profitability and international competitiveness of many Kenyan exporters.

Tourism services improved remarkably in 2004, despite the negative effects of the US travel advisories. Improved marketing strategies, security and higher incomes in source countries are the main factors behind the improvement in tourism performance. Most of the tourists were from Europe, followed by Africa, Asia and America.

Imports increased with the weakening of the exchange rate, rising oil prices and recovery in domestic economic activity. Overall, the current account balance deteriorated reflecting the combined effect of increased domestic activity and the weakening of the terms of trade.

Domestic Economic Conditions

The domestic economy has been growing at a moderate pace with real GDP estimated to have grown by 2.4 percent in 2004. Growth would have been higher were it not for adverse effects of the drought, high cost of crude oil and the slower disbursement of donor resources. The main sources of growth over the period were agriculture, tourism, and transport and telecommunication services. There was also evidence of increased consumption demand, fuelled by relatively low interest rates that allowed bank credit to households and companies to grow by 23 percent in 2004.

Growth in agriculture was mainly in horticulture, sugar and tea subsectors. Production of horticultural crops for export increased by 19.6 percent to 130,546 tonnes in the first ten months of 2004 from 109,148 tonnes in a similar period in 2003. Production of processed sugar increased by 16.9 percent to 422,629 tonnes from 361,684 tonnes, while tea output increased by 10.6 percent to 257,881 tonnes from 233,086 tonnes.

In the manufacturing sector, electricity consumption increased by 8.1 percent in the first ten months of 2004, while output of beer, sugar, soda ash, cement and cigarettes increased by 32.7 percent, 16.9 percent, 2.4 percent, 3.4 percent and 0.1 percent.

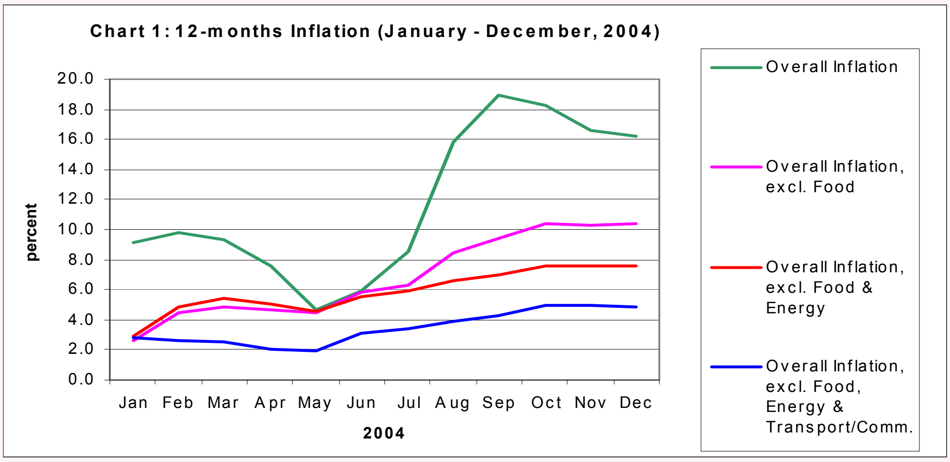
Growth in the services sector also improved with cargo handled by Kenya Ports Authority growing by 5.7 percent to 11.6 million tonnes in the first ten months of 2004 from 10.9 million tonnes in the corresponding period in 2003. Throughput by Kenya Pipeline Company increased by 9.6 percent. Mobile telephone services grew significantly with the two mobile service providers hosting about 3 million subscribers at the end of September 2004 compared with 1.6 million in June 2003, about 90 percent growth.

A major boost for growth in 2004 was provided by the tourism sector. Arrivals through the main entry points of Jomo Kenyatta International Airport (JKIA), Moi International Airport, Mombasa (MIAM) and by cruise ships increased by 23.1 percent in the first eleven months of 2004 to 601,207 from 547,314 in the same period of 2003. The improvement in arrivals was partly attributed to the intensified marketing campaigns and down grading of travel advisories by the US and UK in the course of 2004, following improvement in security in the country.

Low interest rates encouraged households to take on more debt, which has been evidenced in high expansion of household credit growth. Over the past two years, businesses have generally been optimistic about economic prospects. Strong recovery in business investment has, however, been constrained by lower public investment, as the pace of execution of the development budget has been well below the budgeted level.

Inflation

Inflationary pressures increased in the second half of 2004. The 12-month overall inflation, which had eased to 4.7 percent in May from 9.1 percent in January, accelerated to 19 percent in September, before easing to 16.3 percent in December (Chart 1). The sharp pick up in overall inflation during the third quarter of 2004 mainly reflected increased prices of basic foods following shortfalls in food supply occasioned by the adverse effects of drought and the high international prices of crude oil. However, following the onset of the short rains in late October 2004, the supply of basic food items, particularly green groceries, improved resulting in a gradual easing of the 12-month overall inflation to 16.3 percent by December 2004.



The 12-month underlying inflation, measured as overall inflation excluding food, energy and transport prices, also rose, threatening to exceed the 5 percent target. It edged up from 2 percent in May 2004 to 5 percent and 4.9 percent in November and December 2004, respectively. Much of the increase in underlying inflation partly reflected the impact of the remnants of transitory factors associated with increased oil prices and partly due to the depreciation of the shilling exchange rate and consumption pressures emanating from expansion of bank credit to the private sector.

Table 4: Annual growth rates in Broad Monetary Aggregates (Percent)

	Reserve Money		Monetary Aggregates			
			M3	M3X		M3XT
	Actual	Target	Actual	Actual	Target	Actual
2003						
Mar	11.0		9.9	11.7		13.1
Jun	11.2		9.3	10.9		12.1
Sep	4.1	0.1	10.3	9.6	9.7	9.6
Dec	-1.1	-5.5	12.7	11.7	6.4	9.3
2004						
Mar	3.0	-4.1	11.9	12.7	7.3	10.0
Jun	5.5	-5.4	12.3	12.9	7.1	9.3
Sep	**9.8**	**9.4**	**12.6**	**14.6**	**14.5**	**11.0**
Nov	7.2	4.5	9.9	13.0	11.5	11.3
Dec	**11.7**	**6.2**	**8.3**	**12.1**	**8.9**	**10.7**

Source: Central Bank of Kenya

Monetary Aggregates

Broad money, M3X[1], expanded by 12.1 percent in the year to December 2004 compared with 11.7 percent a year earlier, and 8.9 percent target (Table 4). The overall liquidity as measured by M3XT (M3X plus non-bank holding of government securities), grew by 10.7 percent compared with 9.3 percent in the year to December 2003.

[1] M3X comprises currency outside banks, demand deposits and time and savings deposits (including foreign currency deposits of residents) with the financial system. Monetary policy has focused on the behavior of the broader monetary aggregate rather than M3, mainly due to the stable relationship with nominal economic activity.

Table 5: Annual growth in domestic credit extension (Percent)

	Government (net)	Private sector	
		Actual	Target
Dec-02	21.9	4.8	
Mar-03	29.6	5.9	
Jun-03	31.1	5.2	
Sep-03	27.9	5	4
Dec-03	23.1	6.9	3.6
Mar-04	17.9	9.5	5
Jun-04	10.1	12.3	4.8
Sep-04	**4.6**	**17.8**	**13.2**
Nov-04	-1.5	19.9	17.1
Dec-04	2.0	**23.3**	**15.4**

Source: Central Bank of Kenya

The expansion in M3X was mainly supported by 9 percent increase in net domestic assets (NDA) of the banking sector. The contribution of net foreign assets (NFA) to the expansion of M3X was 3.1 percent. The increase in NDA mainly reflected an increase in private sector credit, as contribution of credit to government slowed down.

Credit

Credit to the private sector increased significantly from 6.9 percent in 2003 to 23.3 percent in 2004 (Table 5). The increase exceeded the target of 15.4 percent for December 2004. Much of the increase in credit was in personal loans following the decline in interest rates and increased competition amongst commercial banks to lend to the private sector.

Banking system credit to government grew less rapidly at 2 percent in 2004, compared with 23.3 percent increase a year earlier. The decline in banking sector credit to government reflected reduced domestic borrowing by the government during the first half of financial year 2004/05.

Interest Rates

Interest rates on the three-month Treasury bill, which had declined to below 1 percent in September 2003, rose sharply to about 8 percent by end-December 2004. Much of the increase occurred in the last quarter of the year, as market participants became jittery on the direction of the interest rates. While fears about the sustainability of low rates had emerged, the correction that happened during November – December was mainly driven by market expectations that rates were expected to be moved to a particular level. There were also fear that the Government domestic borrowing was expected to rise after several months of undersubscription in the primary auction market for government securities.

Following the downwards revision of the reserve money target for December 2004 quarter in November to tighten the monetary policy stance in view of the September 2004 monetary data exceeding target and inflationary pressures threatening to exceed the 5 percent target, open market operations were intensified. As a result, the repo rates rose to about 10 percent by the end of December 2004. As liquidity in the banking system became tight, interbank rates followed suit rising to about 9 percent.

Meanwhile, average lending rate for commercial banks, which had declined by about 6 percentage points to 12.3 percent in September 2004 from 18.3 percent in December 2002, started rising in tandem with short-term money market rates towards the end of December.

Exchange Rates

The Central Bank remained committed to a market driven exchange rate, intervening only to smoothen excessive fluctuations in the exchange rate. The Bank intervened in August-September 2004 when speculative tendencies destabilised the movement in the exchange rate. At the time, speculators cashed in on fears of increased demand for foreign currency from oil importers occasioned by increased prices of oil in the international markets, implications of delayed donor inflows for budgetary support and anticipated import of food following the adverse impact of drought.

The overall depreciation of the Kenya shilling was moderated, following the Bank's intervention in the foreign exchange market and the positive assessment of the economy by the IMF on the conclusion of PRGF Review in September 2004.

Fiscal Developments

Preliminary estimates indicate that over the first half of the financial year 2004/05, the Government made domestic debt repayment amounting to 0.2 percent of GDP against the programmed domestic borrowing of 1.5 percent of GDP for the year. Revenue performance was well on track, buoyed by improvement in tax administration, measures to curb tax evasion in petroleum sector and positive response to tax amnesty offered to previous defaulters. Expenditures are expected to remain well below expectations in view of slower disbursement of donor financing.

Towards the end of 2004, there was evident inability of raising funds domestically to support the budget with issues of Government paper attracting less than 50 percent of tender. This was partly attributed to speculation among market players on movement of interest rates. However, the situation has improved since the beginning of 2005, with subscription reaching about 100 percent.

IV MACROECONOMIC OUTLOOK FOR 2005

Economic recovery is expected to sustain its upward trend with real GDP projected to reach 3 percent by December 2005 up from 2.4 percent in 2004. Activity in the sectors that performed well in 2004 — namely, agriculture, telecommunications, manufacturing and tourism — is expected to increase further, buoyed by the implementation of fiscal reforms agreed under the PRGF program.

On the external front, a competitively determined shilling exchange rate, resumption of peace in the horn of Africa and implementation of the Common External Tariff in the East Africa Community and other liberal trade arrangements within the region and internationally as well as the robust growth in Kenya's main trading partners are also expected to promote export led growth. Global markets remain uncertain about the near-term path of the US dollar, in the face of the US large fiscal and current account deficits, as well as high and volatile oil prices occasioned by strong global demand coupled with supply constraints in the oil producing countries.

Inflation Outlook and Monetary Policy

Based on projections, it is assessed that inflation pressures which intensified in the second half of 2004 due to rising food and fuel prices as well as more-than-programmed expansion of broad money will steadily drop as conditions improve. The decline in interest rates, which resulted in bank credit to the private sector expanding by more than programed, has reversed. This is expected to put a brake on the expansion of bank credit. Tighter monetary policy will, however, need to be continued to damped any inflationary pressure over the medium term. Moreover, the recent favourable weather and stability in crude oil prices are expected to stabilise food and fuel prices, resulting in lower overall inflation to single digits by December 2005.

Underlying inflation is expected to remain within target in the next twelve months with the continued implementation of prudent monetary policy. In addition, the recent increase in interest rate and the inflows related to IMF and other donors are expected to hold the exchange rate firm against major trading currencies thereby stabilising import prices.

Monetary Policy strategy for 2004/05

In implementing the program set out in Table 2, the monetary policy objectives of the Bank will continue to be geared to maintaining low and stable inflation to ensure macroeconomic stability, while supporting the broad macroeconomic objectives of the Government. The inflation objective will be pursued largely through reserve money targeting, with broad money (M3X) as the intermediate target and open market operations as the main instrument. The Bank will also use other instruments as outlined in *page vii*, while continuing to use a broad set of indicators to monitor inflationary pressures and to gauge the appropriateness of the monetary policy stance.

The Bank will sterilise, on a timely basis, any excess liquidity, thereby leaving interest rates to be determined by market forces. The Bank will continue to implement a flexible exchange rate system, intervening in the foreign exchange market only to meet the net foreign assets target under the program and to smooth disruptive short-term fluctuations.

V. CONCLUSION

The Statement has reviewed the monetary policy implementation and performance against target since the last *Statement* in June 2004. It has also provided an overview of the current economic situation, which forms the basis of adoption of the outlined monetary policy program through June 2005.
Since the publication of the last Statement in June 2004, several modifications were made to the reserve money program to take into account the following important developments:

- Outcome of June 2004 monetary and fiscal developments;

- Revisions of growth prospects following the adverse impact on drought and rising oil prices.

- Revision of domestic budgetary financing given the shortfall and delay in donor funding; and

- Outcome of monetary and inflation developments as at end of September 2004 that exceeded target.

There is evidence that the Kenyan economy performed moderately well in 2004, with real GDP growing by 2.4 percent, up from 1.8 percent in 2003. The moderate performance benefited from a favourable world economy in which growth averaged 4.5 percent and also from recovery in domestic activity, driven mainly by growth in agriculture, tourism, manufacturing, and transport and telecommunication services. There is also evidence of a pickup in consumption demand, buoyed by the relatively low interest rates that saw private sector credit increase by 23 percent in 2004. Inflationary pressures that emerged have started easing, with dissipation of the adverse effects of drought, decline in world oil prices and correction of interest rate and the capital inflows related to IMF and other donors that are expected to keep the exchange rate stable.

Economic recovery is expected to gain momentum, with real GDP projected to expand to 3 percent in 2005. Sectors that performed well in 2004, namely, agriculture, telecommunications, horticulture and tourism, are expected to register further improvement, buoyed by implementation of fiscal reforms pursued by the Government under the IMF-supported PRGF program. Growth in the world economy is expected to remain strong, thereby supporting export led growth.

With inflation expected to remain within the desired range, the CBK has found it appropriate to continue, through June 2005, with the current monetary policy stance. Underpinning the IMF supported PRGF program approved in December 20, 2004 following the successful First Review. Banking system liquidity management, mainly via open market operations, will be geared towards achieving the agreed monetary program. The CBK will also continue to use a wide range of indicators to monitor inflationary pressures and to gauge the appropriateness of the monetary policy stance going forward.

Appendix Table 1: Meduim-Term Macroeconomic framework, 2003/04-2007/08

	2003/04	2004/05	2005/06	2006/07	2007/08
Real Sector					
Nominal GDP, KSh billion	1,162	1,301	1,423	1,533	1,651
Real GDP growth	2.1	2.7	3.2	3.6	4.0
CPI inflation (end of period)	5.9	5.0	3.5	3.5	3.5
Savings/GDP	11.7	9.6	10.6	13.3	15.2
Investment/GDP	13.2	14.1	16.3	18.5	19.5
External Sector					
Current Account (% of GDP)	-1.5	-4.5	-5.7	-5.2	-4.3
Overall balance (US$ million)	214	-3	-91	-15	117
Official reserves (US$ million)	1,399	1,520	1,649	1,750	1,858
Months of import coverage	3.1	3.1	3.1	3.2	3.1
NPV of external debt ratio	27.4	27.3	27.1	26.8	26.1
Money and Credit					
(Annual % change)					
Net Domestic Assets	12.2	7.3	10.1	9.2	7.8
Net Credit to Government	9.9	8.9	6.1	2.1	0.4
Credit to Private Sector	13.1	8.1	13.3	10.9	9.7
Broad Money (M3X)	12.9	7.5	6.9	6.9	7.0
Reserve Money	5.5	3.8	6.8	7.0	7.0
Fiscal Sector (% of GDP)					
Total Revenue	21.7	21.4	21.1	21.9	22.9
Total expenditure and net lendin	23.5	25.5	28.6	28.8	28.8
Overall balance, excl. grants	-1.7	-4.1	-7.5	-6.9	-5.9
Overall balance, incl. grants	-0.3	-2.5	-3.5	-3.5	-2.9
Net domestic borrowing	0.8	2.5	2.1	0.7	0.1
Financing gap	0.4	0.0	0.4	1.4	2.2
Total donor support (grants & lo	2.4	3.3	6.0	5.7	4.7
Domestic Debt/GDP	22.2	22.3	22.5	21.7	20.3

Source: Central Bank of Kenya

Appendix Table 2: Monetary Survey 2003- 2007

	Jun-03	Jun-04	Sep-04	Dec-04	Mar-05	Jun-05	Jun-06	Jun-07
	Act	*Act*	*Act*	*Act*	*Proj*	*Proj*	*Proj*	*Proj*
Central Bank of Kenya								
Net foreign assets 1/	81.5	86.7	79.8	89.4	84.5	95.7	98.9	103.0
Net domestic assets	4.0	3.6	10.0	11.6	8.8	-2.0	1.1	4.0
Net domestic credit	7.7	11.2	14.3	18.0	13.3	2.7	6.1	9.2
Other items (net)	-3.7	-7.7	-4.3	-6.4	-4.5	-4.8	-5.0	-5.2
Reserve money (RM)	**85.5**	**90.2**	**89.9**	**101.0**	**93.3**	**93.7**	**100.1**	**107.1**
Currency outside banks	49.7	55.7	56.1	63.0	57.7	57.7	61.7	66.0
Bank reserves	35.8	34.6	33.8	38.0	35.5	36.0	38.3	41.0
Banks								
Net foreign assets 1/	22.9	33.1	37.2	37.0	35.3	33.5	27.3	22.2
Reserves	35.8	34.6	33.8	38.0	35.5	36.0	38.3	41.0
Credit to CBK	8.4	6.1	5.0	2.9	7.3	18.3	16.6	14.1
Net domestic assets	302.6	343.9	354.5	367.5	365.5	363.3	400.1	438.0
Domestic credit	367.4	412.6	428.5	447.3	443.3	445.0	494.7	536.5
Other items (net)	-64.8	-68.7	-74.0	-79.8	-77.8	-81.7	-94.6	-98.4
Total deposits	369.7	417.8	430.4	445.4	443.6	451.1	482.3	515.3
Monetary survey								
Net foreign assets 1/	104.4	119.8	117.0	126.3	119.7	129.2	126.2	125.3
Net domestic assets	315.1	353.6	369.5	382.1	381.5	379.6	417.8	456.1
Domestic credit	383.6	430.0	447.8	469.3	463.9	466.0	517.3	559.7
Government (net)	124.2	136.6	136.0	131.0	146.6	148.8	157.9	161.2
Rest of the economy	259.3	293.4	311.8	338.2	317.3	317.2	359.5	398.5
Other items (net)	-68.5	-76.3	-78.3	-87.2	-82.3	-86.5	-99.6	-103.6
M3X	**419.4**	**473.4**	**486.5**	**508.4**	**501.3**	**508.8**	**544.0**	**581.4**
Memorandum items:								
(In Percent of Annual Change)								
M3X	10.9	12.9	14.5	12.1	8.8	7.5	6.9	6.9
Reserve Money	11.2	5.5	9.8	15.4	7.7	3.8	6.8	7.0
Currency outside banks	5.9	12.0	13.4	13.5	5.2	3.6	7.0	7.0
Domestic credit	12.2	12.1	14.5	15.8	11.7	8.4	11.0	8.2
Government (net)	31.1	9.9	4.6	-2.0	8.3	8.9	6.1	2.1
Rest of the economy	4.9	13.1	19.4	24.6	13.4	8.1	13.3	10.9
Multiplier (M3X/RM)	4.9	5.2	5.4	5.0	5.4	5.4	5.4	5.4
Reserve cover, in months of ir	2.9	2.8	2.6	2.8	2.7	3.0	3.0	3.1

Note:

1/ Constant Kenya shilling per U.S. dollar exchange rate prevailing on September 30, 2001 (Ksh 78.95 per US dollar)

Source: Central Bank of Kenya

Appendix 3: Chronology of events of particular relevance to monetary policy and inflation

<u>2004</u>

June	The Central Bank of Kenya released its fourteenth Monetary Policy Statement, setting out the monetary program to be pursued in the financial year 2004/05 (July-June).
August/September	An assessment of the impact of the drought indicated that the 2.7 percent real GDP growth estimate for 2004 might not be attained. Consequently, real GDP growth estimate was lowered to 2.4 percent
September 13-24	Following availability of firm monetary and fiscal data for June 2004 and the discussion with the IMF Mission on the First Review Under the PRGF program, the monetary program was tightened.
November/December	With the monetary and inflation outcome for September 2004-quarter exceeding target, the monetary program was further tightened.
December 20	The IMF Executive Board approved the First Review under the Poverty Reduction and Growth Facility (PRGF) arrangement.

GLOSSARY

Overall Inflation

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

Underlying Inflation

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

Reserve Money

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

Money Supply

The sum of currency outside banks and deposit liabilities of commercial banks.

Deposit liabilities are defined in the narrower and broader sense as follows: narrow money (M1), broad money (M2), and broader money (M3, M3X and M3XT). These aggregates are defined as follows:
M1= Currency in circulation plus demand deposits.
M2 = M1 plus quasi-money (time and savings deposits).
M3 = M2 plus other deposits issued by nonbank financial institutions (savings and loan association, mortgage finance institutions etc.).
M3X = M3X plus residents' foreign currency deposits.
M3XT = M3 plus nonbank holding of government securities (a measure of overall liquidity).

Discount Rate

The rate of interest the Central Bank charges on loans it extends to commercial banks facing temporary liquidity shortfalls. The discount rate is currently set at 3 percentage points above the 91-day Treasury bill rate applicable to the last auction.

Open Market Operations (OMO)

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

Repurchase Agreement (REPO)

This is an instrument used in OMO. Repos are agreements by the CBK to purchase/sale 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 reserve money (operating target) to achieve the money supply growth target (intermediate target) that is consistent with the inflation target (ultimate target).

Cash Reserve Requirement

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