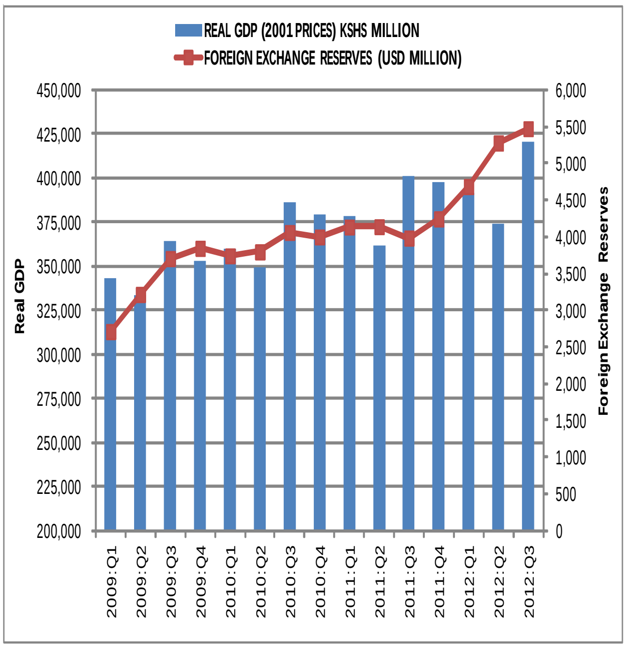

CENTRAL BANK OF KENYA

Monetary Policy Statement

Issued under the Central Bank of Kenya Act, Cap 491

DECEMBER 2012

Letter of Transmittal to the Minister for Finance

Dear Honourable Minister,

I have the pleasure of forwarding to you the 31st 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 July to December 2012, describes the current economic environment and outlook, and outlines the monetary policy stance for January 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 (TAD):** TAD 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.

  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.

- **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 severe 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 liability 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. 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 to acquire foreign exchange to service official debt and build its foreign exchange reserves. 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, through Prudential Guidelines to banks, 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 Chief Executive Officers of commercial banks through 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.

Legal Status of the Monetary Policy Statement

1. Section 4B (1) of the CBK Act requires the Bank to submit to the Minister or 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 from January to June 2013. It also reviews the outcome of the monetary policy stance adopted between July and December 2012.

The stance adopted by the Monetary Policy Committee (MPC) in the second half of 2012 contributed to the decline in inflation, exchange rate stability, and achievement of the targets in the monetary programme. Overall inflation declined from 10.05 percent in June 2012 to 3.20 percent in December 2012, reflecting an easing in food prices, stabilisation of world oil prices as well as easing demand pressure in the economy. Similarly, non-food-non-fuel inflation declined from 9.31 percent to 4.81 percent during the period. Both inflation measures were within the 5 percent Government medium-term target for overall inflation by the end of the period. The Central Bank of Kenya (CBK) foreign exchange reserves remained above the statutory requirement of an equivalent of 4 months of import cover thereby providing a cushion to the foreign exchange market against external shocks. In addition, improved liquidity management ensured stability in the interbank market while the Central Bank Rate (CBR) remained the pivot for all monetary policy operations.

Given the positive outcomes of a low and stable inflation rate and exchange rate stability, the MPC embarked on a gradual easing of the monetary policy stance in July 2012. The Bank has ensured that credit growth is consistent with the price stability objective. The policy stance from January to June 2013 will therefore be aimed at maintaining the overall inflation within the Government target. The Bank will also continue building its foreign exchange reserves in line with the statutory requirement.

During the period January to June 2013, monetary policy will seek to constrain the annual growth in broad money supply, M3, to 16.8 percent in January 2013, 18.4 percent by March 2013 and 16.1 percent by June 2013. The Net Domestic Assets (NDA) of the Bank is planned to decrease from Ksh -69.7 billion in January 2013 to Ksh -71.0 billion in March 2013 and further to Ksh -79.2 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 17.0 percent in January 2013, 16.5 percent in March 2013 and 16.8 percent in June 2013. The ECF targets for Net International Reserves (NIR) of the CBK are USD 4,490 million for March 2013 and USD 4,640 million for June 2013. The monetary policy stance will ensure that movements in the short-term interest rates are in line with the inflation objective.

Uncertainty over the full resolution of the eurozone problems and balance of payments pressures attributed to the high current account deficit remain the main risks to the macroeconomic outlook. Successful elections in March 2013 will enhance confidence in the economy and sustain the current macroeconomic stability. The CBK remains vigilant to any threats to macroeconomic stability and will take appropriate actions to maintain price stability.

Lastly, 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. This will enhance the transmission of monetary policy signals and coordinate market expectations.

1. Introduction

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

During the second half of 2012, the monetary policy stance adopted by the MPC resulted in the decline and flattening of inflation within the Government medium-term target of 5 percent, as well as exchange rate stability. The main threats to exchange rate stability remain the uncertainty over the full resolution of the eurozone problems and balance of payments pressures due to the high current account deficit. The current macroeconomic stability will be supported by successful elections in March 2013 through enhanced confidence in the economy. However, a notable outcome of the monetary policy stance was the reduction of demand for credit to finance private consumption and imports. Consequently, the proportion of exports financing imports stabilised during the period thereby moderating the pressure on the exchange rate.

Monetary policy formulation and implementation continues to be guided by 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, and credit to the private sector. 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 June 2012 MPS while Section 3 outlines the current economic environment and outlook for the period January to June 2013. Section 4 concludes by outlining the monetary policy stance for the period January to June 2013.

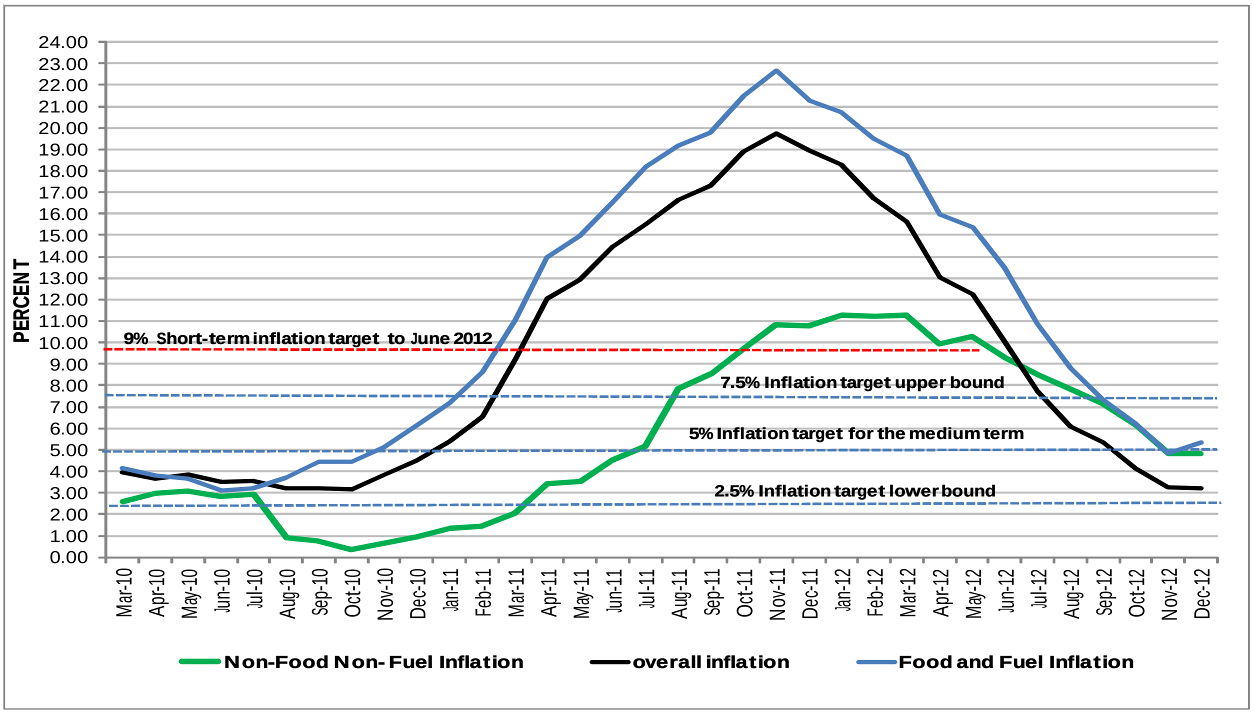
2. Actions and Outcomes of Policy Proposals in the June 2012 Monetary Policy Statement

The overall aim of the Monetary Policy Statement for June 2012 (30th MPS) was to set monetary policy targets that would ensure low and stable inflation, encourage growth and ensure long-term sustainability of public debt. It also aimed at enhancing financial access within the economy. Following a decline in the risks to the inflation outlook, the frequency of MPC meetings was also reviewed from monthly to bi-monthly in July 2012. The following are the outcomes of the policy proposals in the 30th MPS:

a. Inflation

Price stability remains the primary objective of monetary policy formulation and implementation. During the second half of 2012, both overall and non-food-non-fuel inflation declined and flattened within the Government medium-term target of 5 percent (Chart 1). The decline in inflation reflected a sustained decline in food prices, stabilisation of world oil prices and easing demand pressure in the economy. In particular, overall inflation declined from 10.05 percent in June 2012 to 3.20 percent in December 2012 while non-food-non-fuel inflation dropped from 9.31 percent to 4.81 percent.

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

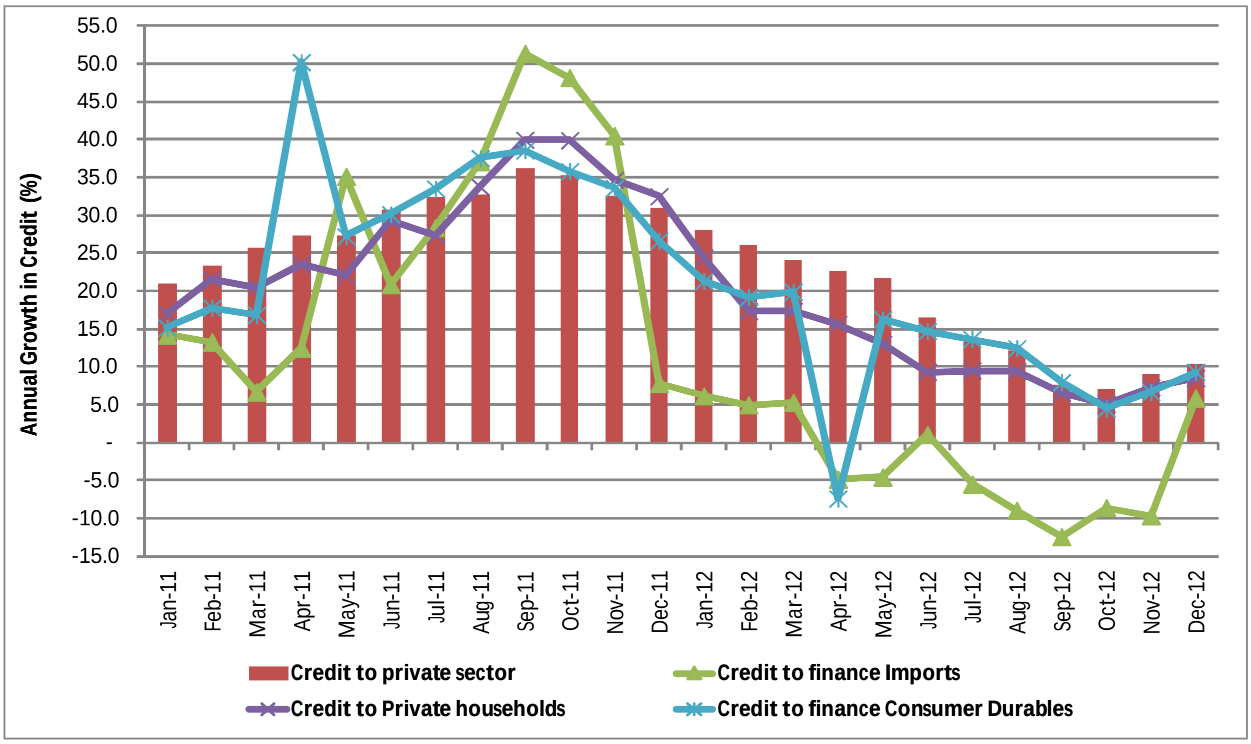


Source: Kenya National Bureau of Statistics and CBK

i. Credit to Private Sector

The gradual easing in the monetary policy stance adopted by the MPC from July 2012 was expected to support a non-inflationary credit expansion to the key sectors of the economy in the remainder of 2012 in order to stimulate economic activity. The slowdown in the annual credit growth in the first three quarters of 2012 had supported the decline in non-food-non-fuel inflation during the period. However, during the last quarter, growth in private sector credit at both the aggregate and sectoral levels reversed its downward trend and started rising in November 2012 (Chart 2). This was mainly attributed to the gradual reduction of the CBR from 18.0 percent to 13.0 percent by September 2012 and further to 9.5 percent by end of December 2012. Consequently, annual private sector credit growth increased from 7.12 percent in October 2012 to 10.42 percent in December 2012.

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



Source: Central Bank of Kenya

ii. Monetary Programme

The monetary programme targets were generally achieved during the second half of 2012 (Table 1). This is a reflection of the inflation outcome during the period. Monetary policy was conducted based on the monetary aggregate targeting framework in order to achieve the price stability 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

	Jun-12	Jul-12	Aug-12	Sep-12	Oct-12	Nov-12	Dec-12
Actual Broad Money,M3 (Ksh Billion)	1,594.7	1,612.6	1,638.2	1,670.9	1,702.5	1,740.2	1,727.3
Target Broad Money,M3 (Ksh Billion)	1,638.6	1,661.2	1,683.7	1,706.3	1,728.8	1,751.3	1,774.1
Actual Reserve Money (Ksh Billion)	257.3	257.4	250.2	259.0	250.4	279.7	293.6
Target Reserve Money (Ksh Billion)	251.8	255.0	254.1	257.4	264.8	264.6	279.5
Actual Net Foreign Assets of CBK (Ksh Billion)	330.5	322.8	341.6	349.5	351.3	364.3	364.1
Targets for Net Foreign Assets of CBK (Ksh Billion)	322.4	326.2	329.2	332.7	327.5	330.6	334.5
Actual Net Domestic Assets of CBK (Ksh Billion)	-73.2	-65.3	-91.4	-90.5	-100.8	-84.6	-70.5
Target Net Domestic Assets of CBK (Ksh Billion)	-70.6	-71.3	-75.1	-75.4	-62.7	-65.9	-55.0
Actual Credit to private sector (Ksh Billion)	1,213.2	1,224.0	1,228.7	1,237.3	1,252.3	1,265.7	1,283.9
Target Credit to private sector (Ksh Billion)	1,214.0	1,240.8	1,272.2	1,325.7	1,386.8	1,356.8	1,358.1
Memorandum Items							
12-month growth in actual RM (Percent)	16.7	15.6	8.4	9.7	6.7	14.0	15.1
12-month growth in actual M3 (Percent)	15.5	14.2	14.0	12.6	12.5	16.8	14.1
12-month growth in actual credit to private sector (Percent)	16.1	13.5	11.9	7.7	7.1	9.1	10.4

Source: Central Bank of Kenya

The velocity of money remained fairly stable at about 2.2 during the second half of 2012. However, the money multiplier remained unstable and oscillated between 5.9 and 6.8 during the period reflecting a notable rise in the cash in till of banks with improved liquidity conditions. The predictability of money demand has continued to be affected by the unstable money multiplier and general decline in the velocity of money in circulation.

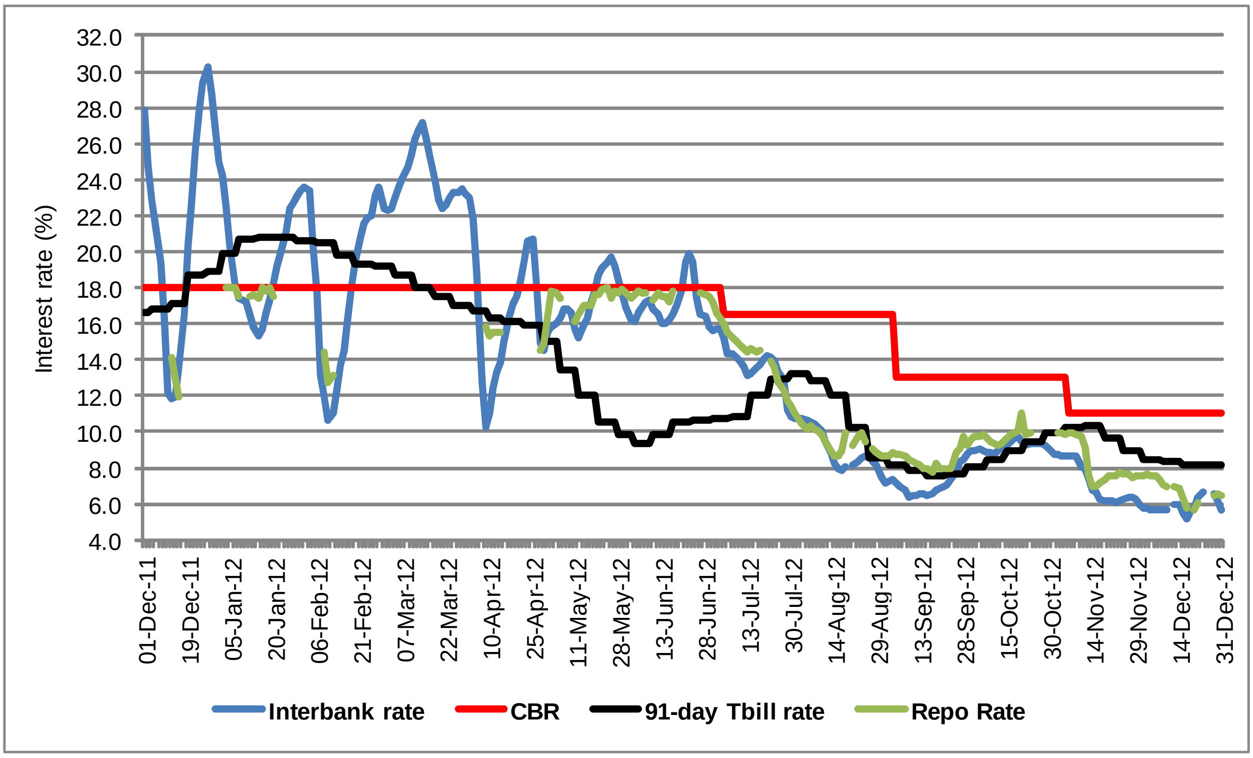
iii. Interest Rates and Liquidity

The gradual easing of the monetary policy stance coupled with Open Market Operations resulted in improved liquidity and stability in the interbank market in the second half of 2012. Consequently, short-term interest rates declined gradually during the period (Chart 3). The average interbank rate declined from 17.09 percent in June 2012 to 5.84 percent in December 2012. Similarly, interest rates on Treasury bills and bonds declined during the period. Improved liquidity conditions in the market reflected higher maturities of Government securities, reduced uptake of private sector credit due to higher interest rates, and the existing flexibility in liquidity management where banks are required to comply with the CRR based on monthly averaging as well as the provision that banks could overdraw their CRR account to a daily minimum of 3 percent of total deposits.

Reflecting improved liquidity conditions in the market, banks only accessed funds totalling Ksh 0.03 billion from the CBK Discount Window as a last resort in the second half of 2012 compared with Ksh 8.09 billion in the first half. This was also attributed to the high penal rate above the CBR on the CBK Discount

Window which encouraged banks to consider other sources of liquidity before seeking for funds from the Window.

Chart 3: Trends in Short-term Interest Rates (%)

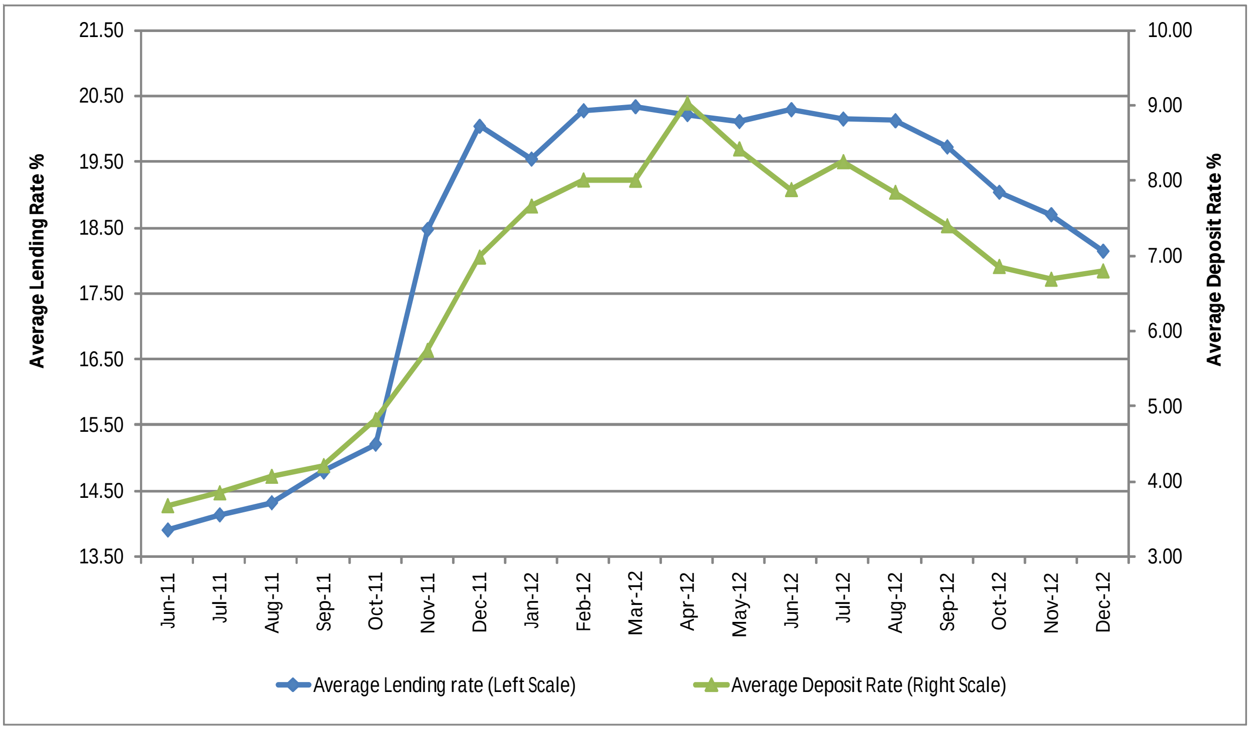


Source: Central Bank of Kenya

Consistent with the developments in short-term interest rates, average commercial banks' lending and deposit interest rates declined gradually between June and December 2012 (Chart 4). The average commercial banks lending rates decreased from 20.30 percent in June 2012 to 18.15 percent in December 2012 while the average deposit rates declined from 7.88 percent to 6.80 percent during the period. Consequently, the average ex ante interest rate spread declined from 12.41 percent to 11.34 percent in the period. Small banks had the lowest spread due to more competitive deposit rates during the period, while large banks had the highest spread.

The CBK has continued to work with the Kenya Bankers Association to provide avenues that reduce the cost of doing business for banks. Banks have integrated with mobile phone financial platforms and moved into the Agency Banking networks that have lowered transaction costs. Credit Reference Bureaus have also improved credit profiling process and lowered the costs of information search and risk. Despite these developments, lending interest rates have remained high suggesting that these cost reductions are yet to be fully transferred to bank customers.

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



Source: Central Bank of Kenya

b. Exchange Rates and Foreign Exchange Reserves

i. During the second half of 2012, the Kenya shilling exchange rate remained stable against the major world currencies but strengthened against the regional currencies (Chart 5a and 5b). The exchange rate against the US Dollar fluctuated within the narrow range of Ksh 83.90 and Ksh 86.07 in the second half of 2012 compared with a range of Ksh 82.27 and Ksh 88.44 in the first half. Exchange rate stability during the period was supported by improved liquidity management in the interbank market, continued build-up of foreign exchange reserves by the CBK that enhanced confidence in the market on the Bank's capacity to respond to external shocks, resilient foreign exchange inflows through diaspora remittances, and improved macroeconomic stability that resulted in confidence in the economy and increased purchases of equity by foreigners at the Nairobi Securities Exchange (NSE). Diaspora remittances remained resilient in 2012; they averaged USD 97.59 million per month and amounted to USD 105.7 million in December 2012.

In the region, the Kenya shilling strengthened against the South African Rand and Uganda Shilling but remained stable versus the Tanzanian shilling. The weakening in the Uganda Shilling was attributed to temporary suspension of budget support by the country's development partners, which reduced foreign exchange inflows into Uganda significantly. The South African Rand has generally weakened on account of the eurozone problems coupled with reduced foreign exchange inflows from exports of minerals due to prolonged labour unrests by miners.

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

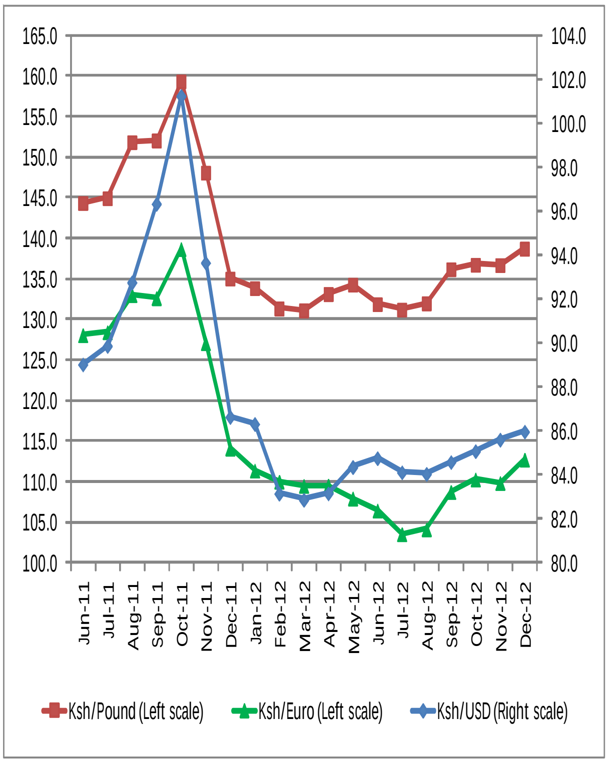
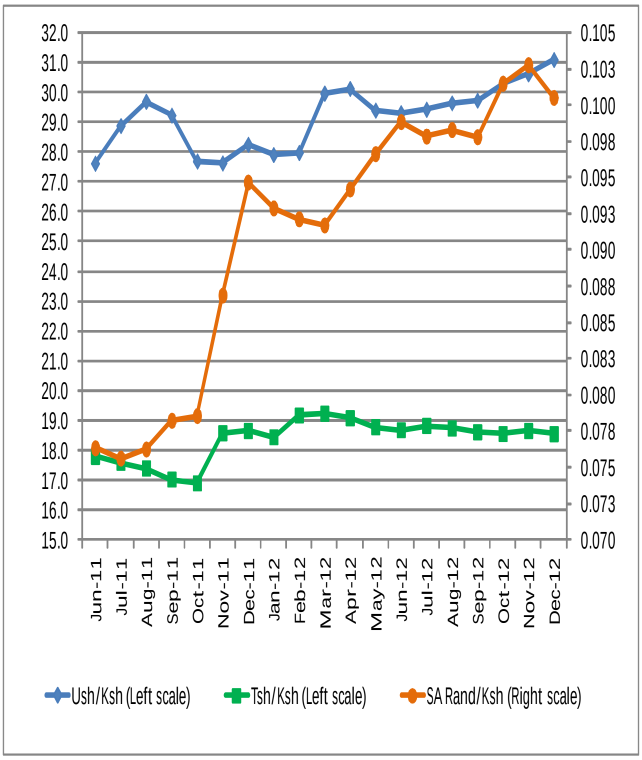


Chart 5b: Trends in the Kenya Shilling Exchange Rate against Regional Currencies

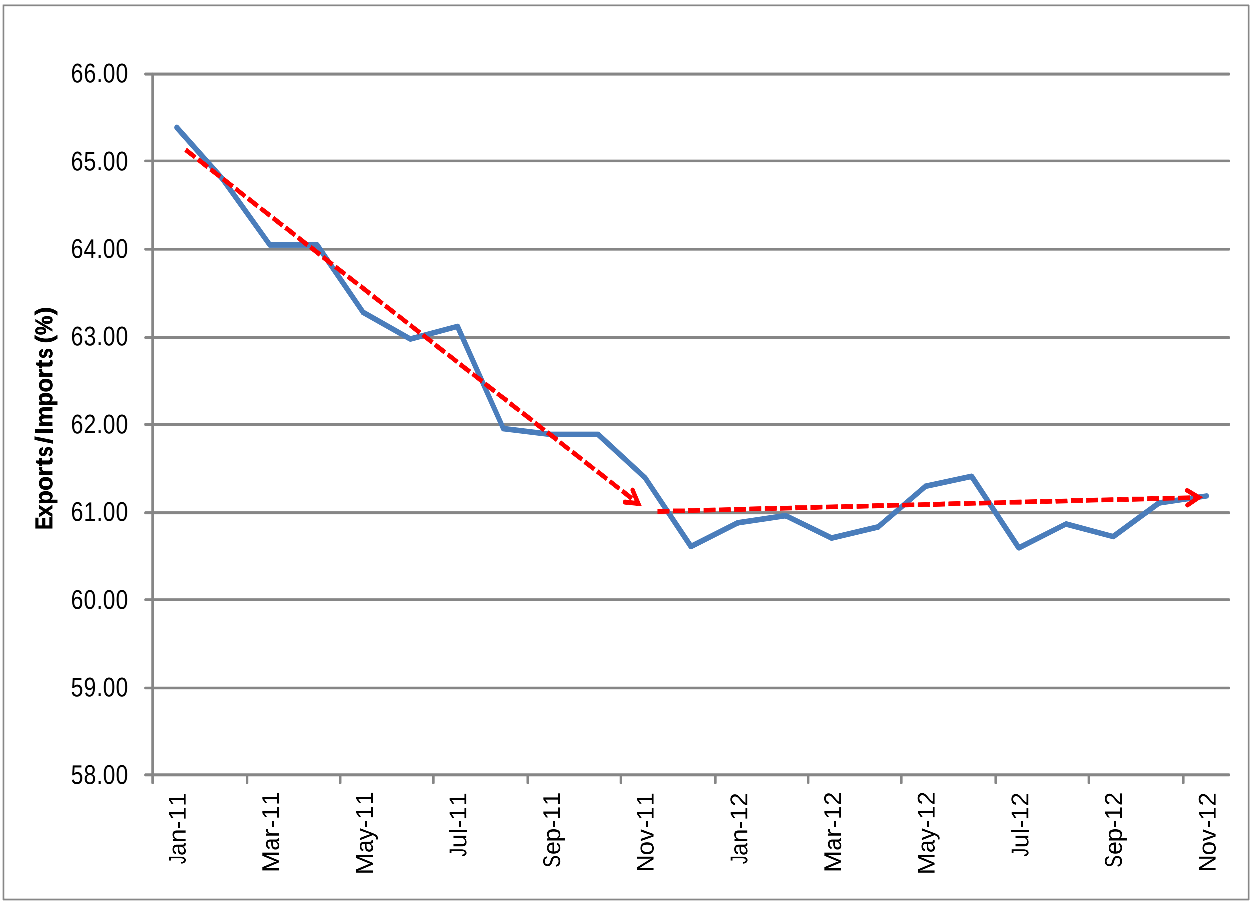


Source: Central Bank of Kenya

Although the total exports earnings continue to finance a higher proportion of total imports of goods and services, this proportion stabilised at about 61 percent in 2012 (Chart 5c). The downward trend witnessed in 2011 has terminated on account of the tight monetary policy stance adopted during the period that slowed down private sector borrowing to finance consumption related imports. This moderated the pressure exerted by a high import bill on the exchange rate.

However, the current account deficit estimated at about 10 percent of GDP by the end of 2012 remains high and has been exerting pressure on the exchange rate. The persistent problems in the eurozone have also been affecting exchange rate stability with a tendency for the Shilling to depreciate when the Euro comes under pressure.

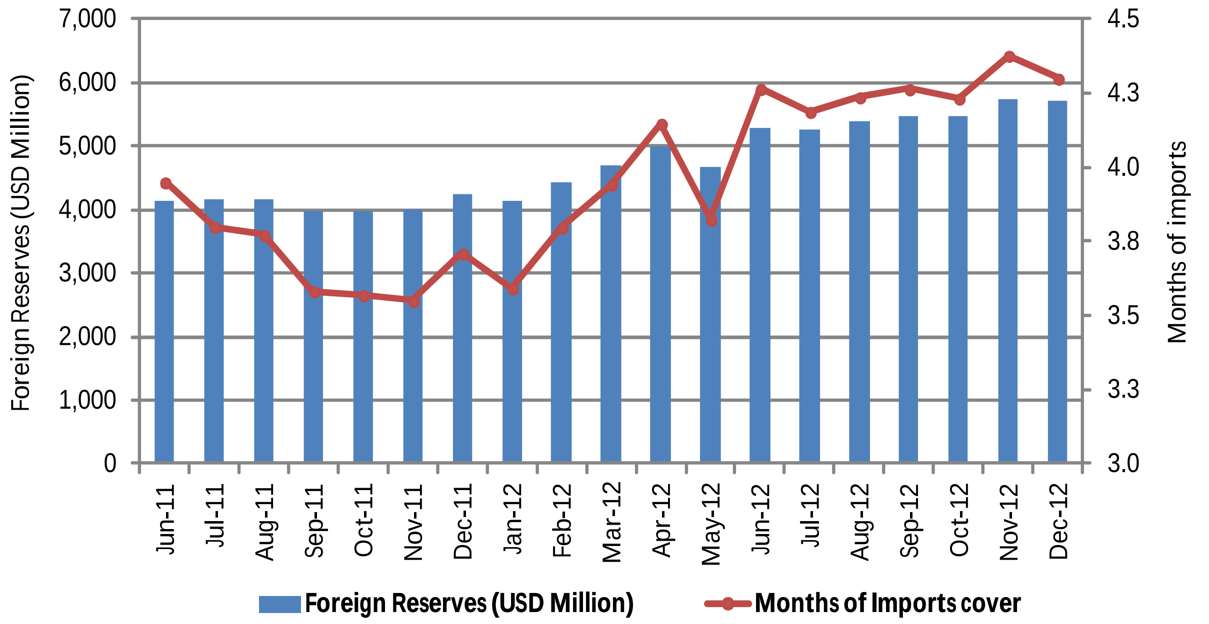
Chart 5c: 12-Month Cumulative Exports/12-Month Cumulative Imports (%)



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 5,262.6 million (4.25 months of import cover) in June 2012 to USD 5,680.6 million (4.31 months of import cover) in December 2012 (Chart 6). The build-up in reserves was supported by purchases of US Dollars amounting to USD 567 million during the period and receipts of an equivalent of USD 110.63 million disbursements in November 2012 from the IMF through the ECF programme. The build-up in reserves during the period continued to provide a cushion to the foreign exchange market against external shocks.

Chart 6: Foreign Exchange Reserves



Note: Months of import cover computed based on the average imports over the previous 36 months

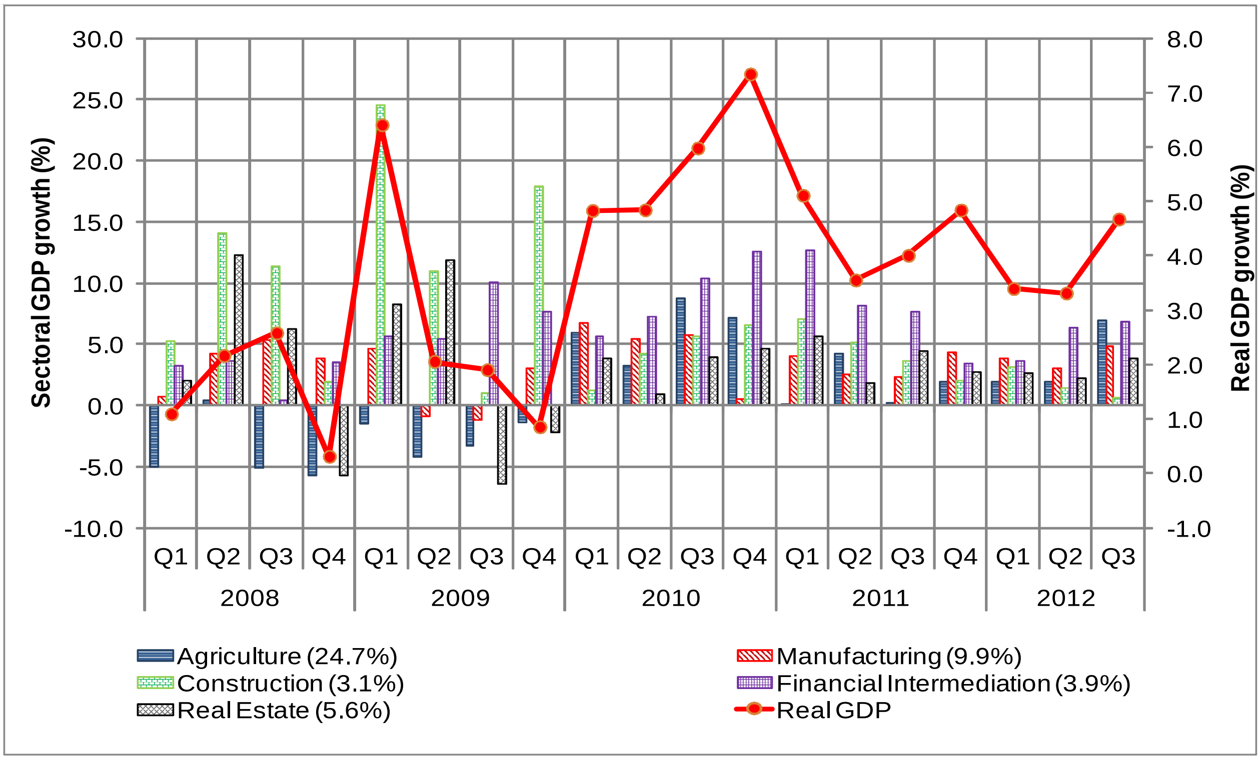
Source: Central Bank of Kenya

c. Economic Growth

Data from the Kenya National Bureau of Statistics (KNBS) shows that the economy registered a notable recovery in the third quarter of 2012 following improved macroeconomic stability characterised by a low and stable inflation, and robust agricultural sector performance due to improved rains (Chart 7). Economic growth in the quarter was 4.7 percent compared with 3.4 percent and 3.3 percent in the first and second quarters, respectively.

The growth performance was also partly attributed to a shift in the monetary policy stance in July 2012 when the MPC started easing its monetary policy stance to stimulate private sector credit growth to support economic activity. There were strong performances in the fishing, manufacturing, and transport and communication sectors during the period. However, growth decelerated in the construction, hotels and restaurants, and mining and quarrying sectors during the third quarter of 2012. Volatile world oil prices, security concerns in the country, and the persistent eurozone problems were the main impediments to a stronger growth recovery in 2012.

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 fiscal measures implemented by the Government in the first half of the Fiscal Year 2012/13 were consistent with the monetary policy objectives. In particular, the borrowing plan ensured that the build-up in domestic debt was consistent with the thresholds set in the Government Medium Term Debt Management Strategy. Consequently, the Debt-GDP-ratio declined from an estimated 47.5 percent in June 2012 to 46.4 percent in December 2012. Domestic borrowing activities were supported by comparably lower interest rates that prevailed during the period.

e. Banking Sector Developments

The CBK continued to implement measures aimed at enhancing the efficiency of the banking sector as well as financial inclusion. This is expected to enhance the monetary policy transmission mechanism. Commercial banks' branch network increased from 1,197 in June 2012 to 1,213 in September 2012 while the number of ATMs increased from 2,205 in 2011 to 2,381 in 2012. In addition, the Agency Banking model has taken root with the number of agents standing at 16,336, and having transacted Ksh 195.8 billion by December 2012. In addition the Bank licensed an additional deposit taking microfinance institution in November, 2012 to enhance financial access. Nairobi continued to establish itself as the financial hub for the region. The number of representative offices of large international banks opened in Nairobi stood at five by end of December 2012 while Kenyan banks had opened 269 branches outside Kenya.

As already indicated, mobile phone money transfers have continued to affect financial intermediation through reduction of transaction costs. The latest innovation is a mobile phone based facility introduced in November 2012 which allows borrowing and interest earning savings. The facility has already netted more than Ksh 1.0 billion in savings. Several banks have partnered with telecommunication companies to offer financial services on telecommunication platforms. Financial innovations have continued to change the design and conduct of monetary policy.

f. MPC Market Surveys, Stakeholder Forums and Communication

The MPC continued to conduct its bi-monthly Market Perception Surveys in the second half of 2012. The results of these surveys informed the monetary policy decisions during the period, and the results were shared with the commercial banks and other participants from the private sector. The coverage of the Market Survey captured respondents from Nairobi and around the CBK branches in Mombasa, Kisumu and Eldoret, and Currency Centres in Nakuru, Nyeri, and Meru. The MPC also continued to improve its communication initiatives to enhance understanding of monetary policy developments by the market. MPC Meetings throughout the period were followed by the release of a short version of the Press Release. The MPC also continued to simplify its Press Releases to make them more understandable and more focused to the public, media, financial sector and other stakeholders. The MPC Press Releases were also published in the widely circulating local dailies.

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

a. International Economic Environment

The global economy is projected to pick-up gradually from an estimated growth of 3.2 percent in 2012 to 3.5 percent in 2013 (Table 2). Although the ongoing policy actions by respective governments have lowered the crisis risks in the eurozone and the United States, only modest growth rates are projected.

However, sub-Saharan Africa and East African Countries (excluding Kenya) are forecast to grow at 5.8 percent and 6.1 percent, respectively, in 2013. Given that over 40 percent of Kenya's exports are to the East African region, the strong growth projection for the region is expected to benefit Kenya's export sector. Global inflation that eased from 4.9 percent in 2011 to an estimated 4.1 percent in 2012 is projected to decline further to 3.7 percent in 2013. This reflects the impact of the aggressive monetary policy measures implemented by most countries in 2011 and 2012 to rein in inflationary pressures and dampen exchange rate volatility.

Despite the projected positive outlook for the global economy in 2013, the eurozone continues to pose a large downside risk to this global outlook. In particular, the projections of prolonged stagnation in the eurozone indicate sustained risks to the region's recovery if the momentum for reform is not maintained. These developments could slowdown the performance of Kenya's tourism and horticulture exports and exert pressure on the exchange rate.

Table 2: Performance and Outlook for the Global Economy

	Real GDP Growth (%)			Inflation (%)		
	2011 Act.	2012 Est.	2013 Proj.	2011 Act.	2012 Est.	2013 Proj.
World	3.9	3.2	3.5	4.9	4.1	3.7
Advanced Economies	1.6	1.3	1.4	2.7	2.0	1.6
United States	1.8	2.3	2.0	3.1	2.0	1.8
Japan	-0.6	2.0	1.2	-0.3	0.0	-0.2
Euro Area	1.4	-0.4	-0.2	2.7	2.3	1.6
United Kingdom	0.9	-0.2	1.0	4.5	2.7	1.9
Other Advanced economies	3.3	1.9	2.7	3.0	2.5	2.4
Emerging and developing economies	6.3	5.1	5.5	7.2	6.1	6.1
Sub-Sahara Africa	5.3	4.8	5.8	9.7	9.1	7.1
East African Community (Excl.Kenya)	6.1	5.7	6.1	13.0	13.0	7.6
Developing Asia	8.0	6.6	7.1	6.5	5.0	4.9
China	9.3	7.8	8.2	5.4	3.0	3.0
India	7.9	4.5	5.9	8.9	10.2	9.6
Middle East and North Africa	3.5	5.2	3.4	9.7	10.4	9.1

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b. Domestic Economic Environment

i. Economic Growth

The Government Budget Policy Statement projects real GDP to grow by 5.6 percent in 2013 compared with a projection of 5 percent in 2012. This is expected to be driven by a stable macroeconomic environment, improved weather conditions that will stimulate agricultural production, as well as completion of key infrastructure projects in the roads and energy sub-sectors. Over the medium-term, growth is expected to pick up to over 6 percent. In addition, the MPC Market Perceptions Survey conducted in December 2012 showed sustained confidence in the economy due to stable macroeconomic environment, expected pick up in credit growth with the declining interest rates, expected recovery of the global economy, prospects for increased regional trade within the EAC countries which are projected to grow faster, and implementation of a devolved Government system are expected to spur growth in the counties. However, the slow recovery of the eurozone economies which are the main markets for Kenya's horticultural exports and insecurity have been noted to be the main risks to the growth outlook. Successful elections in 2013 will enhance investor confidence in the economy with a likely increase in capital inflows.

ii. Foreign Exchange Market

The exchange rate is expected to remain stable in the remainder of the fiscal year 2012/13 in spite of the continued pressure from the current account of the balance of payments. The monetary policy measures in place projected easing of imports of machinery and equipment towards the roads and energy sector infrastructure development, and sustained rise in foreign exchange inflows through foreign direct investment and diaspora remittances are the main factors expected to support exchange rate stability in 2013. In addition, less pressure is expected from food imports due to improvement in the weather conditions throughout the country which will boost food production. The MPC Market Survey for December 2012 corroborated this evidence of an expected stable exchange rate. However, the main risks to exchange rate remain the uncertainty over the full resolution of the eurozone problems and balance of payments pressures attributed to the high current account deficit.

iii. Inflation

Overall inflation is expected to remain within Government target bounds in the second half of the fiscal year 2012/13 on account of improved food supply and lower energy costs following good rains across the country, general stability in the exchange rate, and the monetary policy measures that have been put in place by the CBK. This inflation outlook is corroborated by the results of the December 2012 MPC Survey. However, the main risks to the inflation outlook include a likely increase in consumption related expenditure during the period around the March 2013 elections and volatile world oil prices. The delayed resolution of the eurozone problems could also result in exchange rate volatility with pass-through effects to domestic prices.

iv. Interest Rates

Interest rates are expected to decline gradually with the easing of the monetary policy stance by the MPC following the decline of inflation and improved liquidity conditions in the market. Sustained Open Market Operations by the CBK will also ensure stability of the interbank market interest rates around the CBR.

In addition, the MPC Market Perceptions Survey for December 2012 showed that lending rates were expected to decline gradually following the decline in inflation and inflation expectations and the sustained easing of monetary policy stance by the MPC coupled with enhanced engagements of the Bank with commercial banks through the KBA. The Bank has also continued to monitor developments in non-performing loans with a view to ensure that they do not affect the stability of the banking sector. The main risk to the outlook on interest rates is the international economic developments or supply side factors which could prompt additional measures by CBK to alleviate any adverse expectations with respect to inflation and /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.

vi. Confidence in the Economy

Various indicators show that confidence in the economy remains strong (Table 3). During the second half of 2012, the Standard & Poor's rating agency affirmed Kenya's rating at "B+ with a stable outlook" while Moody's assigned the country a "B1 rating with a stable outlook". This supported the Fitch Rating previously reported. The NSE-20 index over the period has shown that the stock market has remained buoyant with the foreign participation reaching an all-time high in December 2012.

The cumulative diaspora remittances continued to grow, rising from USD 1,080.8 million in the 12-months to June 2012 to USD 1,171.1 million in the 12-months to December 2012. Confidence in the banking sector will be enhanced following implementation of new Prudential and Risk Management Guidelines for banks that will strengthen corporate governance and business practices. Credit risk in the banking sector also remains low.

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

	Jun-12	Jul-12	Aug-12	Sep-12	Oct-12	Nov-12	Dec-12
12-Month Emigrant Remittances (USD Million	1,080.8	1,100.7	1,116.0	1,123.7	1,134.0	1,150.7	1,171.1
NSE Index (Jan 1966 = 100)	3,703.9	3,832.4	3,865.8	3,972.0	4,147.3	4,081.5	4,133.0
Gross NPLs/Total Loans ratio (%)	4.50	4.50	4.55	4.60	4.66	4.60	4.50

Source: Central Bank of Kenya

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

Monetary policy in the second half of the Fiscal Year 2012/13 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 second half of the Fiscal Year 2012/13 are based on the indicators in the updated Budget Policy Statement for 2012/13 that are presented in Annexe 1, and the ECF programme targets. The monetary targets for the period are presented in Table 4. Monetary policy will seek to constrain the annual growth in broad money supply, M3, to 16.8 percent in January 2013, 18.4 percent by March 2013 and 16.1 percent by June 2013. The Net Domestic Assets (NDA) of the Bank is planned to decrease from Ksh -69.7 billion in January, 2013 to Ksh -71.0 billion in March 2013 and further to Ksh -79.2 billion in June 2013. The NDA targets are consistent with the ECF programme for the period. However, the annual growth in credit to the private sector is projected at 17.0 percent in January 2013, 16.5 percent in March 2013 and 16.8 percent in June 2013. The ECF targets for Net International Reserves (NIR) targets of the CBK are USD 4,490 million in March 2013 and USD 4,640 million in June 2013. The monetary policy stance will ensure that movements in the short-term interest rates are in line with the inflation objective.

These monetary targets are expected to enable the Bank maintain overall inflation within the 5 percent Government target for the medium-term in order to anchor inflationary expectations. The CBK will also continue to build its foreign exchange reserves in line with statutory requirement in order to 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 remain stable 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 January to June 2013

	Jan-13	Feb-13	Mar-13	Apr-13	May-13	Jun-13
Broad Money, M3 (Ksh Billion)	1,758.5	1,777.0	1,795.6	1,814.5	1,833.0	1,851.8
Reserve Money, RM (Ksh Billion)	286.5	285.7	287.6	283.5	283.4	284.2
NFA of CBK in Ksh Billion	356.2	357.4	358.6	360.2	361.9	363.4
NDA of CBK in Ksh Billion	-69.7	-71.6	-71.0	-76.7	-78.4	-79.2
12-month growth in RM (Percent)	17.3	23.3	11.5	16.0	19.6	9.6
12-month growth in M3 (Percent)	16.8	18.1	18.4	18.1	17.4	16.1
12-month growth in Credit to Private Sector (Percent)	17.0	16.8	16.5	16.6	14.9	16.8
12-month growth in Real GDP (Percent)						5.4
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 and Treasury

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 the 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.

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 economy that would have a direct impact on food and fuel prices. In addition, the current macroeconomic stability will be supported by successful elections in March 2013 through enhanced confidence in the economy.

b) Measures to Extend Access to Financial Services and Enhance Market Efficiency

The Bank will continue to support development of new products and innovations towards enhancing financial access. Improvements in access to financial services has been shown to support economic growth. Appropriate legislation aimed at ensuring that such innovations are regulated accordingly to enhance market confidence will be identified and recomended. The monitoring of new financial derivatives in the market that could have adverse effects on market stability will be sustained.

Stakeholder forums with the banking and real sectors will be sustained in order to enhance the monetary policy transmission mechanism. Measures to enhance the uptake of Horizontal Repos among banks will also be identified and implemented, while stakeholder forums with Chief Executive Officers and Treasury Managers of banks will be held both to obtain feedback and to explain the background to MPC decisions. The MPC will also continue to brief the market on its decisions with a view to coordinate market expectations.

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	
	Act.	*Prov*	*BROP'12*	*BPS'13*	*BROP'12*	*BPS'13*	*BROP'12*	*BPS'13*
Annual percentage change, unless otherwise indicated								
National account and prices								
Real GDP	5.1	4.7	5.4	5.4	5.8	5.8	6.1	6.1
GDP deflator	7.8	12.5	9.2	9.2	6.8	6.8	6.6	6.6
CPI Index (eop)	14.6	10.1	0.6	6.0	5.5	5.5	5.0	5.0
CPI Index (avg)	6.8	16.1	5.9	5.9	6.0	6.0	5.0	5.0
In percentage of GDP, unless otherwise indicated								
Investment and saving								
Investment	20.2	19.8	20.6	20.5	22.4	22.2	23.6	23.4
Gross National Saving	11.1	10.4	11.9	11.9	14.1	14.0	16.5	16.2
Central government budget								
Total revenue	23.9	22.8	24.1	24.1	24.3	24.3	24.4	24.4
Total expenditure and net lending	29.4	28.9	32.0	32.0	29.5	29.6	29.2	29.2
Overall balance (commitment basis) excl. grants	-5.5	-6.1	-8.0	-8.0	-5.3	-5.3	-4.8	-4.9
Overall balance (commitment basis) incl. grants	-4.8	-5.6	-6.0	-6.0	-4.1	-4.2	-3.7	-0.4
External sector								
Exports value, goods and services	27.9	27.2	25.2	25.2	24.9	24.9	24.9	24.9
Imports value, goods and services	44.2	44.5	40.8	40.8	39.4	39.4	37.8	37.8
Current external balance, including official transfers	-9.1	-9.4	-8.6	-8.6	-8.3	-8.3	-7.2	-7.2
Public debt								
Nominal central government debt (eop), gross	53.4	49.8	49.9	49.9	47.4	47.5	45.9	46.0
Domestic (gross)	27.4	26.2	25.6	25.6	24.7	24.7	23.7	23.8
External	25.9	23.6	24.3	24.3	22.7	22.7	22.2	22.2
Memorandum items:								
Nominal GDP (in Ksh billions)	2,787	3,281	3,775	3,775	4,266	4,266	4,826	4,827
Nominal GDP (in US$ millions)	33,799	37,756	43,783	43,783	48,542	48,543	54,402	54,403

Source: Ministry of Finance

BPS = Budget Policy Statement

BROP = Budget Review & Outlook Paper

ANNEX 2: CHRONOLOGY OF EVENTS OF PARTICULAR RELEVANCE TO MONETARY POLICY (JULY – DECEMBER 2012)

Jul-12	a) The MPC reduced the CBR by 150 basis points from 18 percent to 16.5 percent.
	b) The MPC reverted to its bi-monthly meetings from the previous monthly meetings.
	c) The CBK purchased USD 90 million from the market to build its foreign exchange reserves.
	d) The CBK authorised Bank of China Ltd to establish a representative office in Kenya.
Aug-12	The CBK purchased USD 218 million from the market to build its foreign exchange reserves.
Sep-12	a) The MPC reduced the CBR by 350 basis points to 13.0 percent.
	b) The CBK purchased USD 52 million from the market to build its foreign exchange reserves.
Oct-12	The CBK purchased USD 115 million from the market to build its foreign exchange reserves.
Nov-12	a) The MPC reduced the CBR by 200 basis points to 11.00 percent.
	b) The CBK purchased USD 62 million from the market to build its foreign exchange reserves.
	c) CBK licensed Sumac DTM Ltd which became the eighth Deposit Taking Microfinance Institution in Kenya.
Dec-12	The CBK purchased USD 30 million from the market to build its foreign exchange reserves.

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