EIGHTH
BI-ANNUAL REPORT OF THE MONETARY POLICY COMMITTEE

Central Bank of Kenya

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LETTER OF TRANSMITTAL TO THE MINISTER FOR FINANCE

Honourable Minister,

I have the pleasure of forwarding to you the eighth bi-annual Monetary Policy Committee (MPC) Report in accordance with section 4D (6) of the Central Bank of Kenya Act. The Report outlines the monetary policy formulation; developments in key interest rates, exchange rates and inflation; and other activities of the Committee in the six months to April 2012. Copies of MPC Press Statements and the Minutes of all the Meetings of the MPC between November 2011 and April 2012 are attached to the Report for your information.

Prof. Njuguna Ndung'u, CBS
Governor, Central Bank of Kenya

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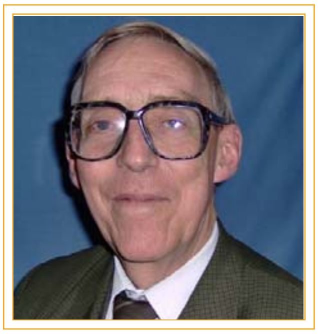

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EXECUTIVE SUMMARY

The eight bi-annual Report of the Monetary Policy Committee (MPC) reviews Kenya's monetary policy formulation and economic developments during the six months to April 2012. The primary objective of monetary policy formulation and implementation is price stability. In this regard, monetary policy operations in the six months to April 2012 were aimed at bringing down inflation to the Government short-term target of 9 percent in the fiscal year 2011/12.

The Report spans the period of turbulence in the foreign exchange market and high inflationary pressure. The impact of the drought conditions in 2011, and the political crisis in the Middle East and North Africa which was reflected in world oil prices were major contributors to the exchange rate volatility and inflationary pressures in the period. In addition, the sovereign debt crisis in Greece which had been cited in the previous MPC Report escalated with contagion effects in several major economies in the eurozone. The turbulence in the global financial markets was exacerbated by the US debt crisis which resulted in the downgrading of US credit ratings in mid 2011. These events affected the global economy and were therefore not unique to Kenya. Following these developments in the international financial markets, foreign exchange market players adopted new financing platforms and derivatives which enhanced the transmission of international events into Kenya's financial system. Besides these immediate effects, the MPC noted that a gradual weakening of the Kenya Shilling was inevitable for as long as the long-term changes in the fundamentals with respect to the balance of payments, and in particular, the widening current account deficit were not addressed. The current account deficit peaked at about 11.4 percent of GDP in April 2012, exerting pressure on the exchange rate. The eurozone debt crisis during the period also caused instability in currencies worldwide with the US dollar strengthening as the preferred reserve currency.

A tighter monetary policy stance and regulatory measures in the foreign exchange market were adopted by the CBK in the second half of 2011 to dampen the persistent inflationary pressures and stabilise the exchange rate. The MPC raised the Central Bank Rate from 6.25 percent at the beginning of September 2011 to 18 percent in December 2011. Regulatory measures adopted include: suspension of the use of Electronic Brokerage Systems (EBS) by banks; limiting the tenor of swaps and Kenya Shilling borrowing where offshore banks are involved to a tenor of not less than one year; limiting the tenor of swaps between residents to not less than seven days; reduction of the foreign exchange exposure ratio of core capital from 20 percent to 10 percent, and; introduction of a requirement that local banks obtain supporting documents for all transactions in the Nostro accounts of off-shore banks. Consequently, overall inflation eased gradually to 13.06 percent by April 2012 while the exchange stabilised. The decline in inflation was supported by a fall in food and fuel prices and an appreciation of the exchange rate. In addition, annual private sector credit growth declined from 35.2 percent to 22.6 percent between October 2011 and April 2012 reflecting easing of demand driven inflationary pressures. In addition, a slowdown in credit to finance imports eased pressure on the exchange rate. However, a persistently high current account deficit and world oil prices as well as the eurozone debt crisis remain potential risks to inflation and exchange rate stability.

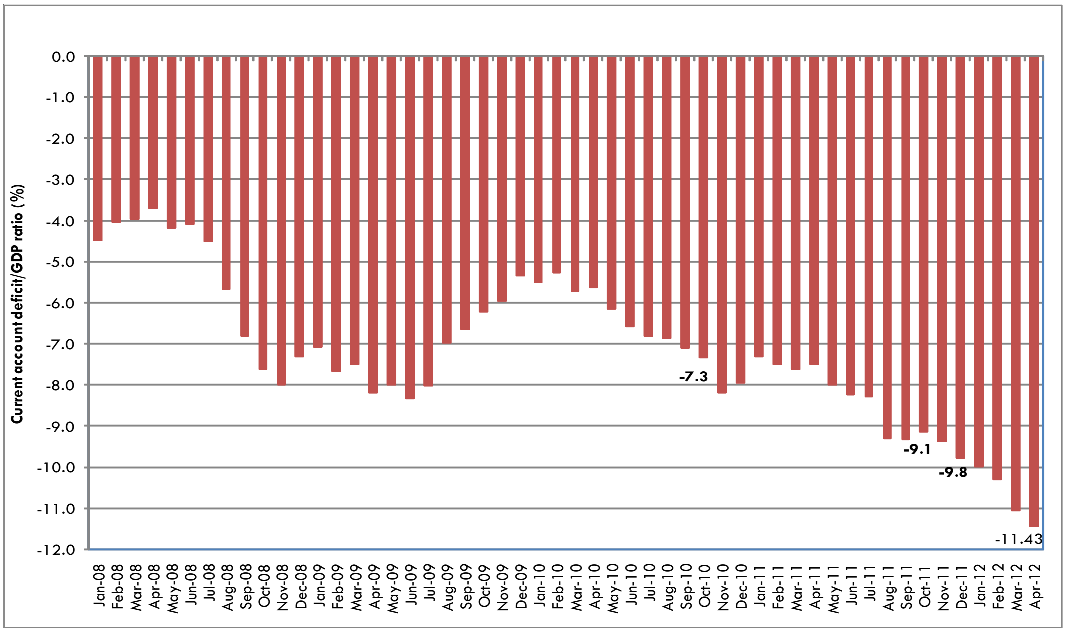
The MPC continued with its regular interactions with stakeholders in the financial sector and timely release of relevant data in order to enhance the effectiveness and transparency of monetary policy formulation and implementation.

1. INTRODUCTION

The eigth bi-annual Report of the MPC covers the period November 2011 to April 2012. It focuses on the factors which contributed to the inflationary pressures and exchange rate instability in 2011 and outlines the measures taken by the CBK to address these developments, and the impact of these measures. During the period, the monetary policy and regulatory measures adopted by the CBK delivered the desired outcomes of a gradual decline in inflation as well as exchange rate stability.

Inflation and exchange rate instability witnessed in 2011 were attributed to both domestic and international events. On the domestic scene depressed rainfall in the first half of 2011 resulted in a rise in food and energy prices. Persistently high current account deficits due to an increasing import bill and decline in foreign exchange earnings from major exports remains a structural problem in the economy as this is exerting pressure on the exchange rate. The current account deficit as a proportion of GDP increased from -7.3 percent in October 2010 to -9.1 percent in October 2011 and further to -11.4 percent in April 2012 (Chart 1). These developements indicate that the fundamentals have changed leading to pressure on foreign exchange reserves and the exchange rate given that exports of goods and services have been financing a smaller proportion of imports.

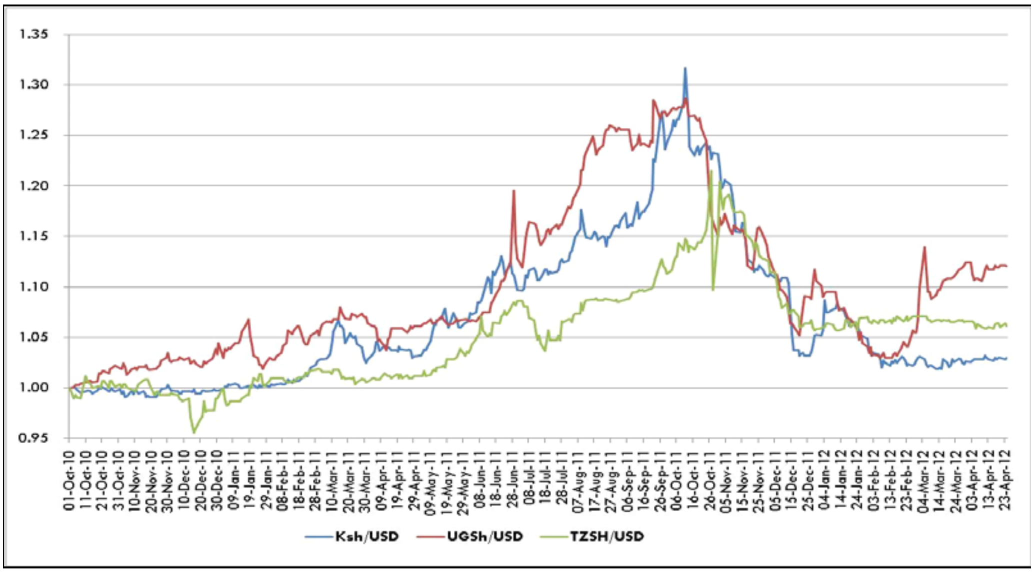
Chart 1: 12-Month Cumulative Current Account Balance (% of GDP)



***Source**: Central Bank of Kenya*

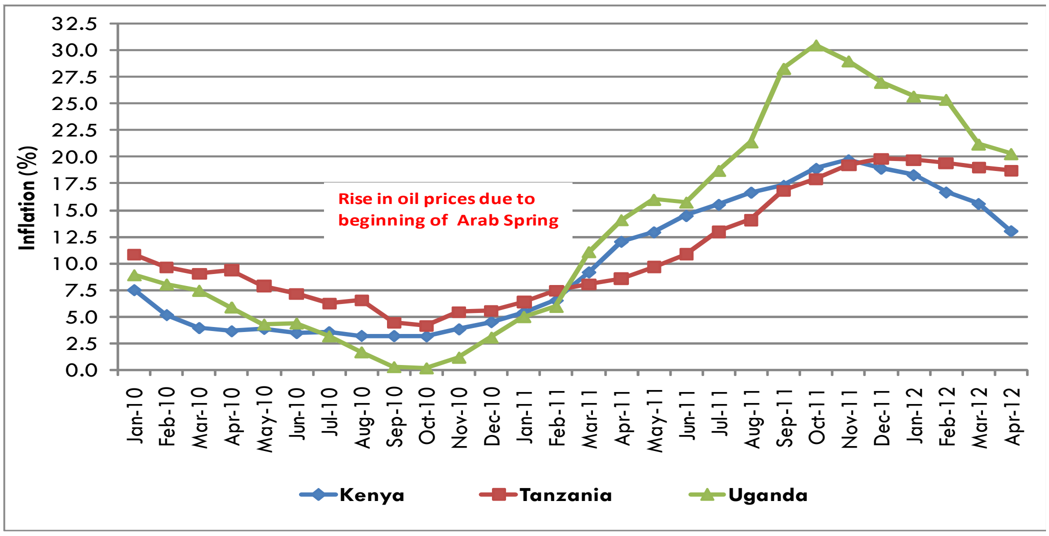
On the international scene, the political turmoil in the nations affected by the Arab Spring in North Africa and the Middle East from late 2010, along with the tension between the United States and Iran, drove up oil prices to record levels. Freight costs including insurance also increased with increased incidences of piracy and the threat of terrorist attacks. On the other hand, the Greek debt crises and risks of defaults on debt put pressure on the Euro. Consequently, investors shifted to the US Dollar and the depreciation of the Euro against the US Dollar. Global stock markets have also tumbled repeatedly on worries over Europe's debt crisis, while the euro continues to be exposed against the US dollar. Investor confidence reached panic levels with a series of sovereign credit downgrades of developed countries. The US lost its triple-A credit rating for the first time in its history, while Italy, France and Spain experienced several downgrades. The use of EBS for foreign exchange trading exacerbated the pressure on the Kenya Shilling to depreciate in 2011. These events had an impact on domestic prices and exchange rate stability globally in 2010 and 2011. In the East Africa Community region, these developments had adverse effects on countries with fully liberalised capital accounts and floating exchange rates, especially in October 2011 (Chart 2 and Chart 3). However, a combination of tight monetary policy and other coordinated regulatory measures in the region resulted in a significant strengthening of the Kenya Shilling and decline in overall inflation compared with those of other currencies in the region.

Chart 2: Normalised Exchange Rate of Regional Currencies against the USD (1st Oct 2010 = 1)



Source: *Websites of respective Central Banks*

Chart 3: 12-Month Overall Inflation in the Region (%)



***Source**: Websites of respective Central Banks*

The remainder of this Report is structured as follows. Section 2 provides highlights of the monetary policy formulation in response to threats during the period while Section 3 provides a discussion of outcomes on key economic indicators. Other activities of the MPC with relevance to monetary policy formulation and implementation are discussed in Section 4 while Section 5 concludes.

2. MONETARY POLICY FORMULATION

2.1 Monetary Policy Objectives and Targets

The formulation and implementation of monetary policy to achieve and sustain price stability in the economy is the main objective of the CBK. Price stability enhances investment thereby supporting economic growth and employment creation. The CBK therefore formulates monetary policy to achieve the inflation target set by the Minister for Finance. The Government short-term inflation target is 9 percent for the fiscal year 2011/12 while the medium term target is 5 percent. The Bank has adopted a monetary policy framework that targets monetary aggregates consistent with these inflation targets.

The relevance of the CBR as the guide for short-term interest rates and monetary policy operations was enhanced during the period covered by this Report. The movements in the CBR, both in direction and magnitude, signals the monetary policy stance, and are therefore reflected in changes in short-term interest rates.

Whenever the CBK is injecting liquidity in the market through a Reverse Repo, the CBR is the lowest acceptable rate. Similarly, whenever the Bank wishes to withdraw liquidity through a Vertical Repo, the CBR is the highest rate that the CBK pays on any bid received. Those banks utilising the CBK Overnight Window are charged the CBR plus a high penalty.

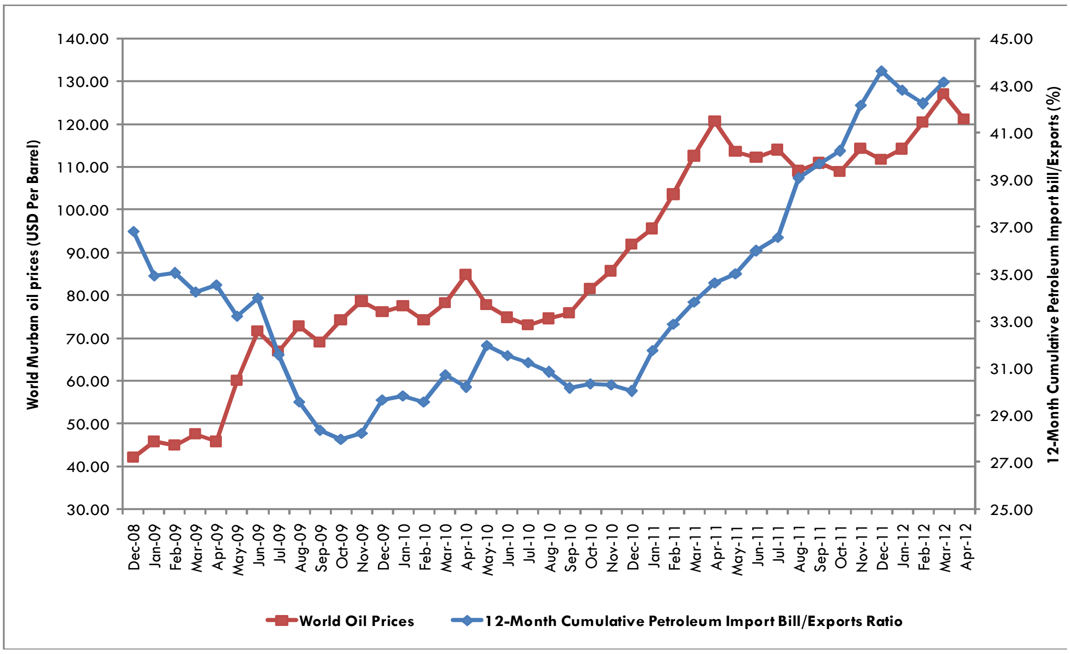
The MPC continued to pursue the monetary programme that was consistent with targets outlined in the Extended Credit Facility (ECF) where the Net International Reserves (NIR) and Net Domestic Assets (NDA) were the quantitative performance criteria measures. The NDA and NIR targets for December 2011 and March 2012 were met. The March 2012 targets for broad money supply (M3) growth were generally achieved while private sector credit growth continued to slow down. Following the conclusion of the third review of Kenya's economic programme in March 2012, the monetary programme performance criteria was revised to take account of recent economic developments and the externalisation of part of the fiscal net deficit financing via a syndicated foreign currency denominated loan of USD 600 million. The revised targets for NDA and NIR are Ksh -55.0 billion and USD 4,070 million, respectively, for June 2012.

2.2 Economic Environment

The economic environment in 2011 was characterised by high food and fuel prices and turmoil in the global financial markets all of which had a strong pass-through to inflation and caused exchange rate instability. In addition, structural weaknesses in the economy which have resulted in high current account deficits have persisted, exerting pressure on foreign exchange reserves and the exchange rate.

Murban crude oil prices remained above USD 100 per barrel in 2011 and peaked at USD 127.0 per barrel in March 2012 before easing slightly to USD 121.2 per barrel in April 2012. Consequently, the ratio of oil imports to total exports earnings which averaged about 30 percent up to December 2010 increased significantly to 43.2 percent by March 2012. This crowded out other essential imports and put pressure on the exchange rate to weaken (Chart 4). It also led to accumulation of imported inventory with traders expressing uncertainty in exchange rate movements.

Chart 4: World Oil Prices and Ratio of 12-Month Cumulative Petroleum Import Bill/Total Exports (%)



Source: *Central Bank of Kenya*

During the period from May to October 2011, the CBK conducted audits of all commercial banks' foreign exchange trading activities. The main drivers responsible for the increase in the level of activities during this period were identified as "reverse carry" deals, shortening of the tenor of currency swaps, the preference by Kenyans to hold their wealth in foreign currency and the use of EBS for foreign exchange trading. Reverse carry transactions allowed an off-shore financial institution with counter-party agreements with banks in Kenya to borrow Kenya shillings and buy and hold US dollars. Secondly, there was increased use of swap derivatives by banks to fund their short or long US Dollar or Kenya Shilling positions as a means of hedging their customers' requirements. Prior to the period of Kenya Shilling instability, the currency swap tenor was 60 to 90 days. However, given the volatility in the foreign exchange market, investors preferred shorter tenor swaps creating even more volatility. In addition, due to the weakening of currencies in other markets, most Kenyan exporters preferred holding their wealth in US dollars.

The audits also revealed that original foreign exchange platforms being used by the Kenyan Banks were "voice driven" which required foreign exchange brokers to transact over the phone. However, the new EBS allowed for the matching of orders on an electronic screen and had the advantage of speed and cost reduction and hence became more prominent. It was observed that the system exposed the market to a range of external players and allowed for a much higher level of activity in the market and was therefore contributing to the rapid activity in foreign exchange trading and volatility of the exchange rate.

2.3 Monetary Policy Committee Decisions and CBK Regulatory Measures

An enhanced monetary policy tightening was adopted by the MPC. In order to rein in inflation and dampen inflation expectations, it took the following measures: On 14th September 2011, the CBR was raised by 75 basis points to 7 percent and then on 5th October, 2011, it was raised by 400 basis points to 11.0 percent. On 1st November, 2011, the CBR was raised by 550 basis points to 16.5 percent and the Cash Reserve Ratio was raised to 5.25 percent from 4.75 percent, effective from 15th December, 2011. On 1st December, 2011, the CBR was raised to 18 percent. The CBK also enhanced its interventions through Open Market Operations (OMO) more actively from September 2011 to reduce the volatility in the interbank rate and bring it closer to the CBR. The OMO operations ensured consistency with the monetary policy stance.

In February 2012, the Government (working with the IMF) justified the augmented disbursements from the IMF amounting to USD750 million in three years. Consequently, official reserves have been boosted and pressure on the balance of payments eased. The need for the augmentation was because the balance of payments pressure was greater than had been predicted by the Government. Interventions through foreign exchange sales by CBK complemented other measures in stabilising the exchange rate and by managing expectations.

The tight monetary policy adopted by the MPC caused several banks to liquidate some of their foreign exchange holdings in order to meet their cash flow requirements. Between September and October 2011 when the exchange rate weakened rapidly, the CBK issued Banking Circulars (see Appendix) to curtail the potential for arbitrage. The Banking Circular, issued on 29th June 2011, announced stiff penalties for banks using funds from the CBK Window to trade in the interbank market. Subsequent Circulars imposed limits on the frequency and amounts that could be taken from the Discount Window. These measures are part of a continuous process but the activities are intense when there is a tight monetary policy. The guidelines were not violated by any of the banks. The guidelines which govern 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 high penalty. However, banks making use of this facility more than twice in a week are scrutinised to establish whether prompt corrective action is required.

The CBK introduced various regulatory measures in the second half of 2011 to contain the adverse effects on the exchange rate of the increase in the level of trading activities attributed to "reverse carry" deals, short tenor of currency swaps, and the use of EBS for foreign exchange trading. These were: a) suspension of the use of EBS by banks; b) limiting the tenor of swaps and Kenya Shilling borrowing where offshore banks are involved to a tenor of not less than one year; c) limiting the tenor of swaps between residents to not less than seven days; d) reduction of the foreign exchange exposure ratio of core capital from 20 percent to 10 percent, and; c) introduction of a requirement that local banks obtain supporting documents for all transactions in the Nostro accounts of offshore banks. These CBK measures which proved successful were replicated by Tanzania and Uganda through the policy coordination initiative for the region as they were facing similar challenges with foreign exchange trading derivatives from off-shore banks.

3. OUTCOMES ON KEY ECONOMIC INDICATORS

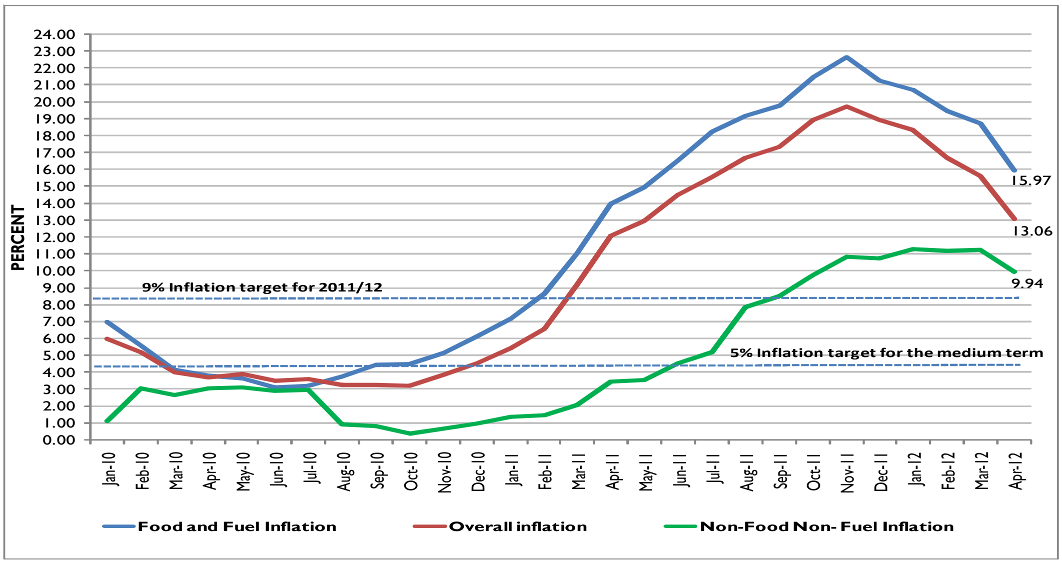
3.1 INFLATION

The monetary policy tightening adopted by the MPC in 2011 has delivered the desired outcome of a gradual reduction in overall inflation (Chart 5). The 12-month overall inflation declined from a peak of 19.72 percent in November 2011 to 13.06 percent in April 2012. In addition, non-food-non-fuel inflation which reflects the impact of the monetary policy stance being pursued which was 10.83 percent in November 2011 and 11.26 percent in March 2012 declined to 9.94 percent in April 2012.

Despite the decline in overall inflation during the period, underlying inflationary pressure from food and fuel prices prompted the MPC to maintain a tight monetary policy stance between December 2011 and April 2012. In particular, the overall 3-month annualised inflation increased from

7.65 percent in March 2012 to 9.22 percent in April 2012. Furthermore, although non-food-non-fuel inflation declined in April 2012, it was still above the Government short-term inflation target of 9 percent for the fiscal year 2011/12. The MPC identified the persistently high world oil prices and food prices as the main risks to the inflation outlook in 2012 assuming that the elections would be held in 2013.

Chart 5: 12-Month Inflation in Broad Categories (%)



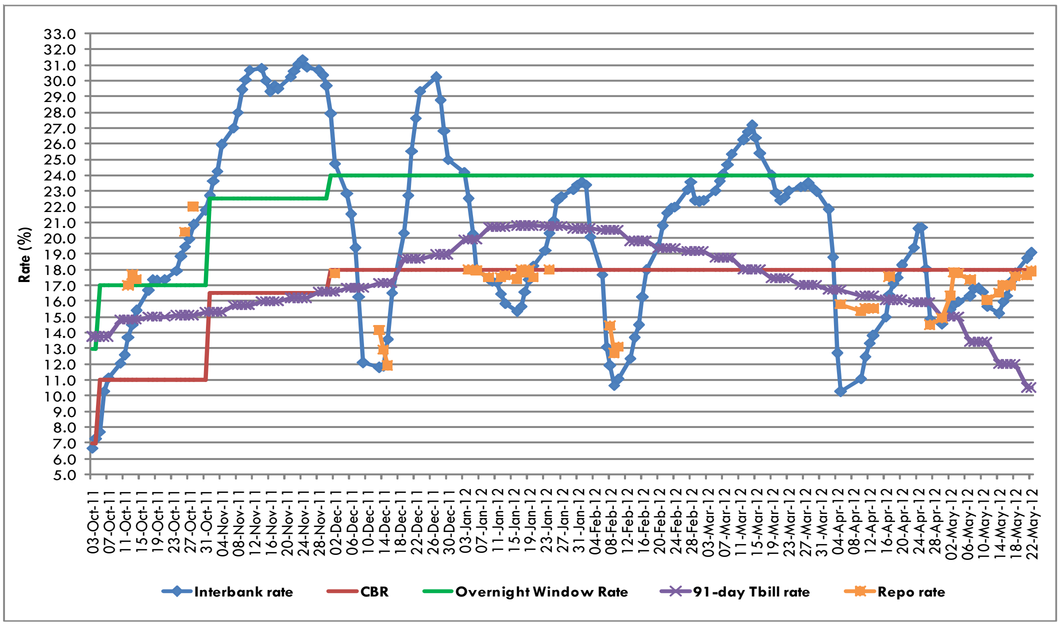
Source: *Kenya National Bureau of Statistics*

3.2 INTEREST RATES

3.2.1 Short Term Interest Rates

Short term interest rates rose rapidly between October and November 2011 following augmented tightening of monetary policy to curb inflation and stabilise the exchange rate (Chart 6). The interbank rate was volatile compared with the 91-day Treasury bill rate during the period. However, pressure on interest rates started easing in January 2012 following the decision by the Government to externalise an equivalent of USD 600 million of its planned domestic borrowing in the fiscal year 2011/12 through the Revised Budget. Consequently, Government fiscal operations did not exert upward pressure on interest rates. In addition, the CBK enhanced its monetary policy operations through use of vertical Repos from April 2012 in order to stabilise the interbank rate around the CBR. The CBK Discount Window rate was maintained at penal rate above the CBR during the period to ensure that it only serves as a last resort for banks.

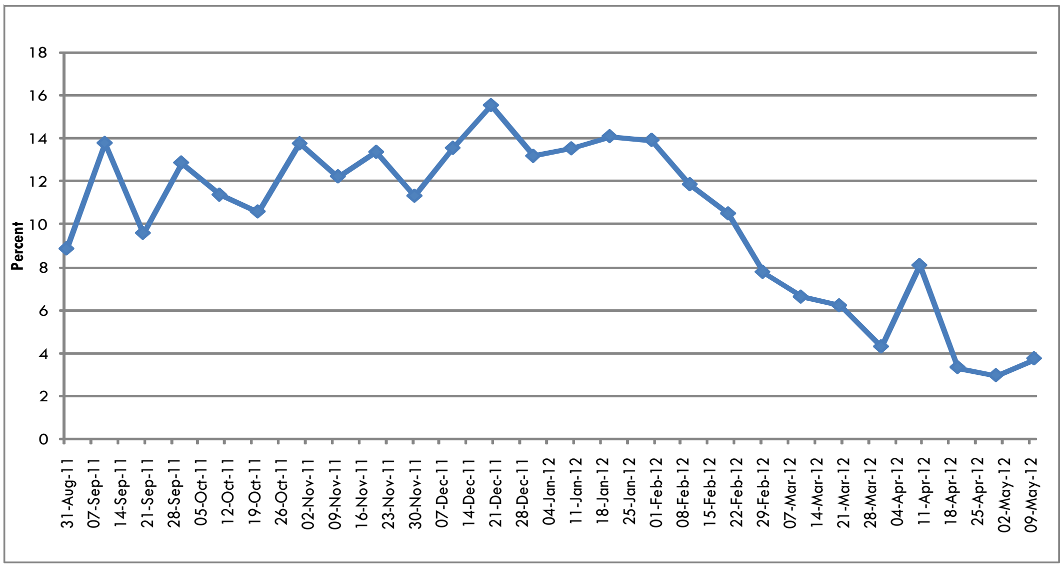
Chart 6: Trends in Daily Short Term Interest Rates (%)



***Source**: Central Bank of Kenya*

The monetary policy stance characterised by the rise in the cash ratio requirement to 5.25 percent by October 2011 and the step-wise increase in the CBR to 18 percent by December 2011 resulted in a significant tightening in liquidity conditions in the market. Consequently, banks resorted to liquiditating some of the their holdings of foreign assets – as mentioned earlier – to meet their daily liquidity demands (Chart 7).

Chart 7: Total Foreign Assets/Total Liquid Assets (%)



***Source**: Central Bank of Kenya*

3.2.2 Commercial Banks Interest Rates and Spreads

The rise in short term interest rates between October and December 2011 due to tight liquidity conditions was transmitted to the commercial banks interest rates (Table 1). The average commercial banks lending rates increased from 15.21 percent in October 2011 to 20.34 percent in March 2012 before dropping slightly to 20.22 percent in April 2012. The average deposit rates almost doubled in the period, rising from 4.83 percent to 8.56 percent due to an increase in the cost of funds and competition for deposits. Consequently, average interest rates spreads increased from 10.39 percent in October 2011 to 13.06 percent in December 2011 before declining to 11.18 percent in April 2012.

However, interest rate spreads have generally decreased since December 2011. Medium and Small banks have generally maintained competitive deposit rates and therefore had lower spreads. The decline in the interest rate spread between December 2011 and April 2012 was partly attributed to the impact of the measures announced by the Kenya Bankers Association in December 2011 to cushion borrowers from high interest rates as well as reduce the threat of accumulating non-performing loans. The CBK has also been working with the Kenya Bankers Association (KBA) to address the high spreads through the operationalisation of Credit Reference Bureaus and establishment of Currency Centers around the country. This has reduced credit risk levels and the operation costs of banks.

Table 1: Commercial Banks Interest Rates and Spreads (%)

	Lending rates				Deposit rates				Interest rates Spreads			
	All banks	Small banks	Medium banks	Large Banks	All banks	Small banks	Medium banks	Large Banks	All banks	Small banks	Medium banks	Large Banks
Mar-11	13.92	14.47	14.11	14.93	3.47	4.46	3.33	2.1	10.45	10.01	10.78	12.84
Apr-11	13.92	14.34	13.99	15.01	3.47	4.5	3.37	2.1	10.45	9.84	10.63	12.9
May-11	13.88	14.37	14.06	14.97	3.57	4.45	3.76	2.12	10.31	9.92	10.3	12.86
Jun-11	13.91	14.27	14.02	14.93	3.68	4.55	3.84	2.09	10.23	9.72	10.19	12.84
Jul-11	14.14	14.35	14.58	15.08	3.85	4.59	4.2	2.32	10.29	9.76	10.38	12.76
Aug-11	14.32	14.61	14.85	15.07	4.07	4.65	4.36	2.62	10.25	9.96	10.5	12.45
Sep-11	14.79	14.78	15.13	15.51	4.21	4.91	4.69	2.43	10.58	9.88	10.44	13.08
Oct-11	15.21	15.17	15.52	15.95	4.83	5.14	5.29	3.04	10.39	10.03	10.24	12.91
Nov-11	18.48	17.57	19.37	18.82	5.75	6.66	6.41	2.99	12.73	10.9	12.96	15.83
Dec-11	20.04	19.12	20.59	20.95	6.99	7.24	7.54	3.63	13.05	11.88	13.05	17.32
Jan-12	19.54	19.6	20.32	19.7	7.66	7.65	8.49	4.15	11.88	11.95	11.83	15.55
Feb-12	20.28	19.93	21.2	20.52	8.01	8.26	8.61	5.18	12.27	11.67	12.59	15.35
Mar-12	20.34	19.46	21.04	21.09	8.01	8.06	8.93	5.01	12.33	11.01	12.12	16.09
Apr-12	20.22	19.65	21.38	20.97	9.04	8.35	10.19	6.61	11.18	11.3	11.19	14.36

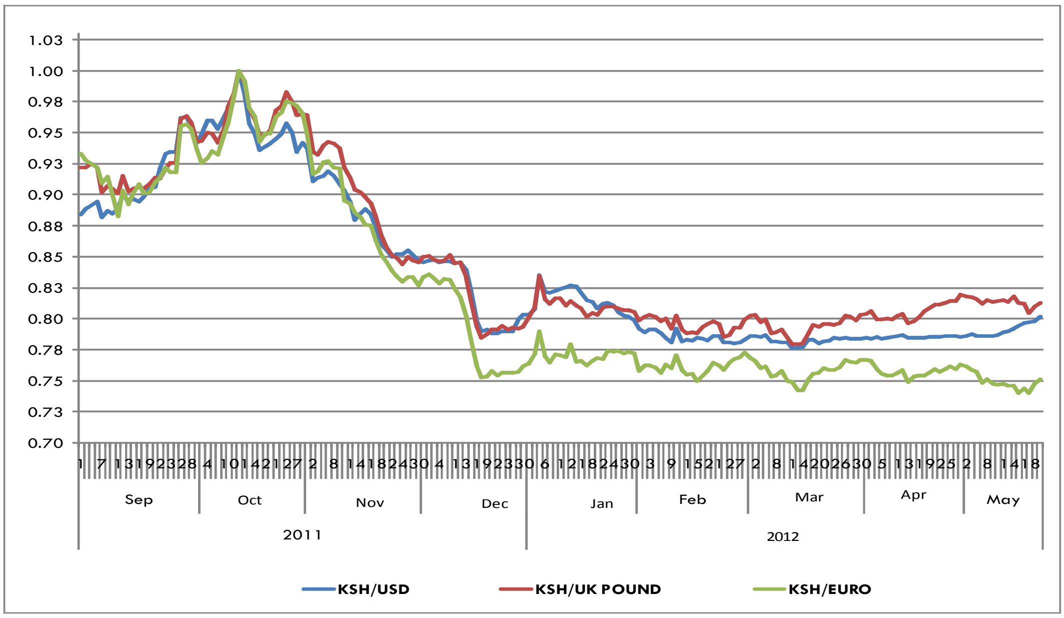
***Source**: Central Bank of Kenya*

3.3 EXCHANGE RATES

A combination of monetary policy and regulatory measures adopted by the MPC and CBK between October and December 2011 restored stability in the foreign exchange market (Chart 8). Consequently, the exchange rate of the Kenya Shilling against the US Dollar fluctuated within the narrow range of Ksh 82.27 and Ksh 83.93 between February and April 2012. The stability in the exchange rate during the period was surpported by increased short term capital inflows attributed to high yields on Government secuirites, the rising diaspora remittances that increased from USD89.76 million in January 2012 to USD103.98 million in February 2012 and further to USD106.40 million in March 2012, and an equivalent of USD111 million disbursements by the IMF under the ECF in April 2012 which increased the CBK's foreign exchange reserves position to USD 4,629 million (4.02 months of import cover).

The expected disbursement of the USD 600 million under the syndicated external loan in the first half of 2012 is expected to surpport the Kenya Shilling exchange rate. However, as indicated already the main risks to exchange rate stability and foreign exchange reserves remain the high international crude oil prices, high current account deficits and instability in the eurozone. These factors continue to pose a threat to both exchange rate stability and the continued easing of inflation pressure.

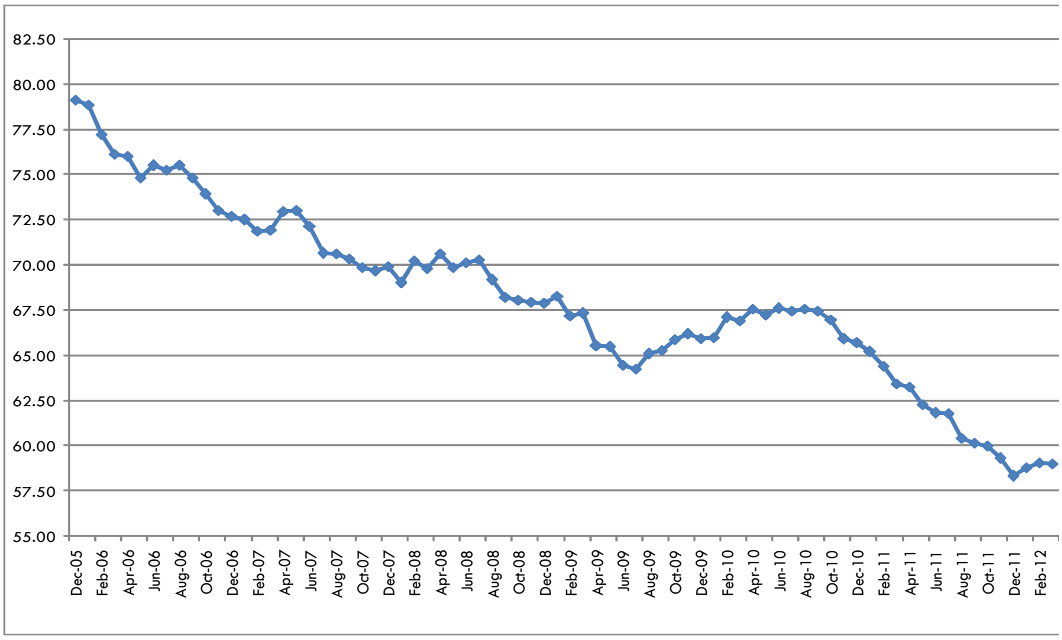
Chart 8: Normalised Exchange Rates of the Kenya Shilling Against Major Currencies (12th October 2011 = 1)



Source: ***Central Bank of Kenya***

The rapid depreciation of the exchange rate in 2011 was mainly a culmination of a structural problem in the economy where export earnings have been financing a decling proportion of imports leading to a widening current account deficit (Chart 9). The proportion of imports of goods and services financed by exports of goods and services dropped from cumulative and average of above 70 percent in 2006 to 58 percent in March 2012. Although a significant proportion of the total import bill from time to time is towards machinery and equipment and oil products which are growth enhancing, the rising imports relative to exports are exerting pressure on the exchange rate.

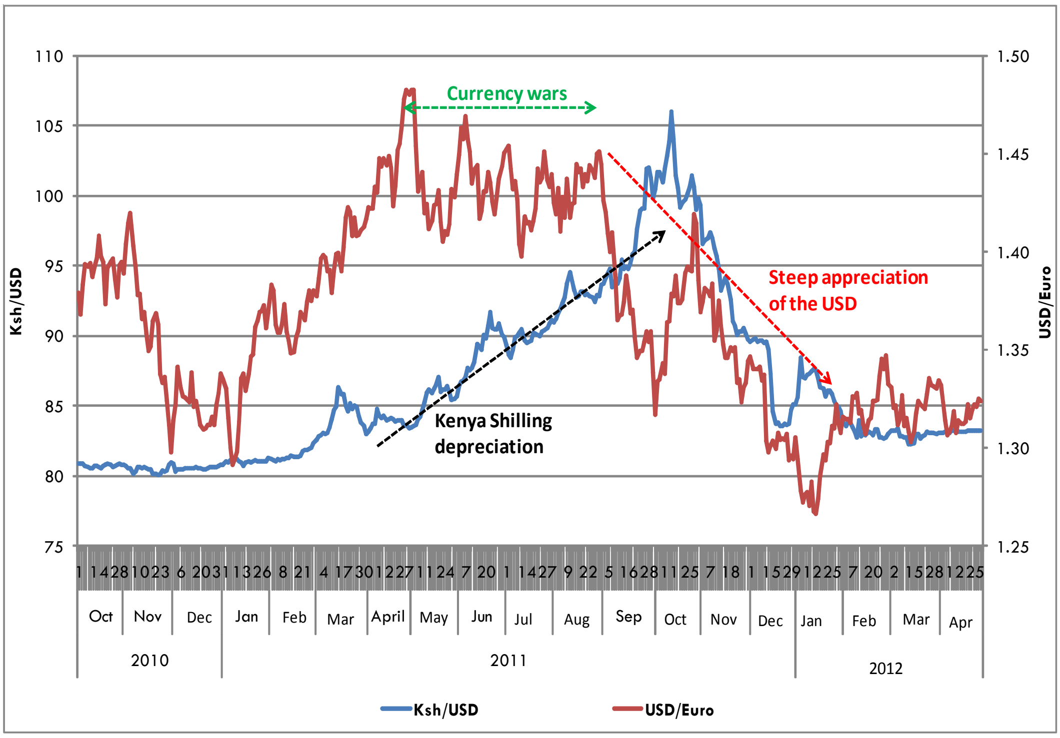
Chart 9: Declining Trend in Exports/Imports of Goods and Services Ratio (%)



***Source**: Central Bank of Kenya*

The depreciation in the exchange rate between April and October 2011 was exacerbated by the currency wars (Chart 10). The sudden steep weakening of the Kenya Shilling from September to 11th October 2011 was consistent with the sudden strengthening of the US Dollar in the global financial markets. The US Dollar became a safe haven in the global financial market. This increased the world demand for US Dollars. The result was increased sale of equity by foreigners at the Nairobi Securities Exchange (NSE) and commercial banks realigning their portfolio towards foreign assets.

Chart 10: Movements in the USD/Euro Cross Rates and the Ksh/USD Exchange Rate



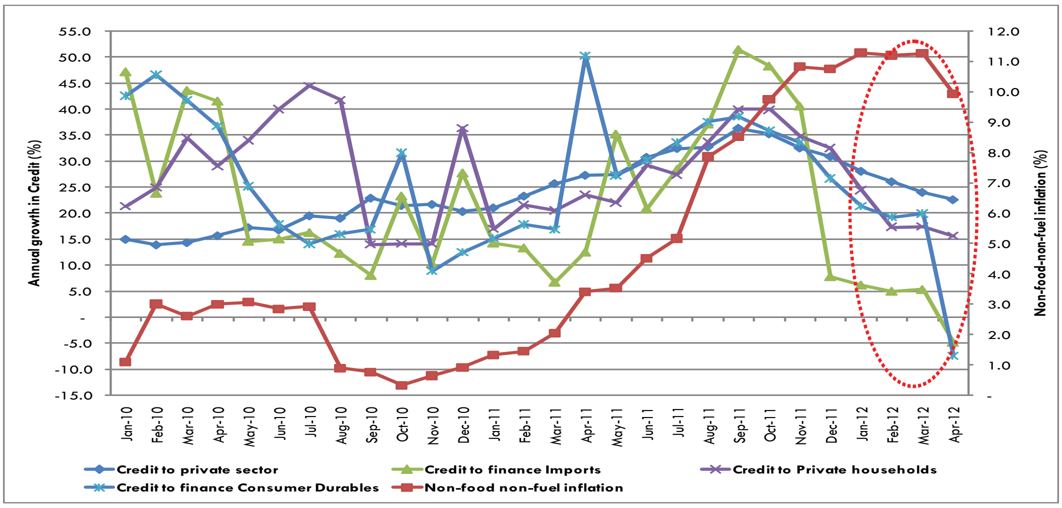
Source: *Central Bank of Kenya*

3.4 CREDIT TO PRIVATE SECTOR

The tight monetary policy stance adopted by the MPC since September 2011 gave rise to a gradual slowdown of the growth of overall annual private sector credit from 35.21 percent in October 2011 to 22.61 percent in April 2012 (Chart 11). Deeper analysis showed that annual credit growth to private households and financing consumer durables slowed down from 39.91 percent and 35.84 percent, respectively, to 15.67 percent and -7.37 percent, respectively, during the period.

Consequently, demand pressure on inflation eased as reflected in non-food-non-fuel inflation which was 10.83 percent in November 2011 dropping from 11.29 percent in January 2012 to 9.94 percent in April 2012. The slowdown in credit to finance imports during the period also eased pressure on the exchange rate.

Chart 11: Annual Growth in Private Sector Credit and Non-Food-Non-Fuel Inflation (%)



***Source**: Central Bank of Kenya*

4. OTHER ACTIVITIES OF THE MONETARY POLICY COMMITTEE

During the period covered by this Report, the MPC continued to hold stakeholder forums with Chief Executive Officers of commercial banks through the KBA Governing Council. A one day meeting format was adopted by the MPC from September 2011 given that the meetings were held on a monthly basis. The MPC also continued to improve on the information gathering processes through market perception surveys, and communication with key stakeholders on the MPC decisions. The MPC also consulted regularly with the IMF to enhance the effectiveness of implementation of monetary policy decisions.

5. CONCLUSION

The combination of policy responses and regulatory measures adopted by the CBK and the Government since 2011 has yielded the desired results of stabilising the exchange rate as well as easing inflationary pressures. The MPC will continue to monitor developments in the domestic and global economy that could have either direct or indirect impact on the economy, while recommending, where necessary, the appropriate monetary policy measures to be taken. However, there is need for a long term policy to support the export sector in order to increase foreign exchange inflows and augment foreign exchange reserves. This will ease pressure on the exchange rate, and domestic prices in general, in the long run.

APPENDIX: BANKING CIRCULARS ISSUED IN 2011

	Date	Banking Circular	Objective
1.	29th June 2011	Banking Circular No.5 of 2011 that revised the rules that guide the operations of the CBK Discount Window.	Set the discount window rate at 8% well above the CBR. Also announced that this rate would be reviewed from time to time and posted on the CBK website daily at 9.00 am. Announced stiff penalties for banks using funds from the CBK Window to trade in the interbank market.
2.	11th July 2011	Banking Circular No.6 of 2011 that reviewed guidelines on the use of CBK Discount Window	Banks lending in the interbank barred from accessing window funds on the same day In a week (Monday-Friday) banks were restricted to borrow from the window a maximum of their statutory cash reserves Window rate reviewed downwards to 6.25% from 8.00% Signaled banks to consider liquidating their Treasury bills, bonds or foreign currency positions prior to resorting to CBK Window
3.	28th July 2011	Banking Circular No.7 of 2011 that announced the MPC decision	CBR maintained at 6.25% Introduced weekly averaging on cash reserves instead of the daily and banks were allowed to deviate from the 4.75% provided the five-day average of 4.75% was met.
4.	12th August 2011	Banking Circular No.8 of 2011 that provided further guidelines on the CBK Discount Window	Any bank accessing funds from the CBK Window was not allowed to lend in the interbank market either on the same day or the following day. Window rate = CBR + (Average interbank rate for the previous day-CBR) + 3% Penalty Eligibility to access funds from the CBK window would be determined by among other things, an individual bank's foreign exchange trading behavior over the previous four trading days. Reverse repos were suspended until the stance on monetary policy was changed.
5.	26th August 2011	Banking Circular No.9 of 2011 that provided more guidelines on liquidity management and CRR	Reviewed the formula for Window rate to reflect market conditions by introducing a weight for the gap between average interbank rate and CBR and expanded the period for the average interbank rate component. (*Average period was not announced but was actually 2 days. CBR was the floor).* Expanded averaging of cash reserves from weekly to monthly but limited the deviation to a minimum of 3% failure to which penalties would be effected.
6.	15th September 2011	Banking Circular No.10 of 2011 that announced the MPC decision at a special MPC meeting held on 14 September 2011.	CBR adjusted upwards from 6.25% to 7.00% to rein in inflation and exchange rate instability.
7.	6th October 2011	Banking Circular No.11 of 2011 that announced the MPC decision of 5 October 2011	CBR adjusted upwards from 7.00% to 11.00% to tame inflationary pressure, stabilize exchange rate and re-establish a strong growth base. MPC meetings to be held monthly usually in the first week of the month until further notice.
8.	13th October 2011	Letter to Chief Executive Officers of commercial banks that extended foreign exchange guidelines	Reverse-carry transactions that had been introduced into the market, and were unrelated to economic activity, and which have not been utilised for domestic purposes were limited to a minimum tenor of one year. Foreign currency swaps involving Kenya shillings were limited to a minimum tenor of seven days. Reviewed downwards the foreign exchange exposure limits from 20% to 10% of core capital
9.	18th October 2011	Further clarifications on the letter dated 13th October 2011 to commercial banks	Clarified that foreign currency swaps and forward transactions involving Kenya shilling for non-resident financial institutions will be limited to a minimum tenor of one year.
10.	2nd November 2011	Banking Circular No.13 of 2011	Announced the decision of the MPC: CBR adjusted upwards from 11 to 16.5% to provide an enhanced monetary policy tightening stance – effective immediately. CRR adjusted upwards from 4.75% to 5.25% effective from 15th December, 2011
11.	2nd December 2011	Banking Circular No.14 of 2011	Announced the decision of the MPC: CBR adjusted upwards from 16.5% to 18.0% to provide an enhanced monetary policy tightening stance – effective immediately.

GLOSSARY OF KEY TERMS

Overall Inflation: This is a measure of inflation in the economy measured by the month-on-month movement of indices of all consumer price items of goods and services sampled by the KNBS. It is affected by commodity components in the market that may experience sudden inflationary spikes such as food or energy and may therefore not present an accurate picture of the current state of the economy.

Reserve Money: These are CBK's monetary liabilities comprising currency in circulation (currency outside banks and cash held by commercial banks in their tills) and deposits of both commercial banks and 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

Central Bank Rate (CBR): This is the lowest rate of interest that the CBK charges on loans to commercial banks. It is reviewed and announced by the Monetary Policy Committee at least every two months as part of its decisions. It is used by the commercial banks as a reference interest rate hence transmits to the financial sector and signals the CBK's monetary policy stance.

Cash Ratio Requirement (CRR): This is the minimum ratio of cash balances (including deposits at CBK) of the total deposit liabilities of commercial banks and non-bank financial institutions maintained with the CBK as reserves. The ratio is fixed by CBK as provided for by the law.

CBK Discount Window: The CBK Discount Window is a collateralised facility of last resort for banks. It has restrictive guidelines controlling access. The Discount Window plays a significant role in ensuring banking sector stability by offering overnight liquidity as a last resort.

Open Market Operations (OMO) : The act of buying or selling of government securities from or to commercial banks by the Central Bank in order to achieve a desired level of bank reserves. OMO is carried out in the context of an auction where commercial banks bid through the Reuters dealing system or by phone/fax.

Repurchase Agreement (Repo): Repos/reverse repos are agreements between the CBK and commercial banks to purchase/sell Government securities from/to commercial banks at agreed interest rates (REPO rate) for a specified period with an understanding that the commercial bank will repurchase/resell the security from/to the CBK at the end of the period. The period can be limited by the CBK.

Horizontal Repo: This is an interbank Repo instrument which recognises Government securities as collateral for borrowing. The instrument has a variable tenor and allows commercial banks without credit lines with other banks to access credit from the interbank market.

Interbank Market: The interbank market is a critical channel for distributing liquidity that reduces the need for banks to access the CBK Overnight Discount Window. However, since not all banks have credit lines with each other, it is not a perfectly operating market and therefore banks come to the Window as a last resort. The interest rates charged by banks reflect an individual bank's perception of the risk of the particular bank borrower and also the tightening liquidity in the market.

Reserve Money Programme: This is the desired movement in the reserve money operating target to achieve the money supply growth target (intermediate target) that is consistent with the inflation target (ultimate target).