THIRD

BI-ANNUAL REPORT OF THE

MONETARY POLICY COMMITTEE

CENTRAL BANK OF KENYA

Issued under the Central Bank of Kenya Act, Cap 491

OCTOBER 2009

The Bi-Annual Report is prepared by the
Members of the Monetary Policy Committee.

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Letter of Transmittal to the Minister for Finance

Honourable Minister,

I have the pleasure of forwarding to you the third bi-annual Monetary Policy Committee (MPC) Report in accordance with section 4D(6) of the Central Bank of Kenya Act. The Report outlines developments in the economy as well as the activities of the Committee in the six months to October 2009. The Minutes of all the Meetings of the MPC between May 2009 and October 2009 are attached to the Report for your information

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

REPORT OF THE MONETARY POLICY COMMITTEE,

OCTOBER 2009

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Governor, Chairman

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Mr. Joseph K. Kinyua
PS, Treasury
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Mrs Sheila S.M.R. M'Mbijjewe
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Mr. Charles Koori
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Dr. Rose W. Ngugi
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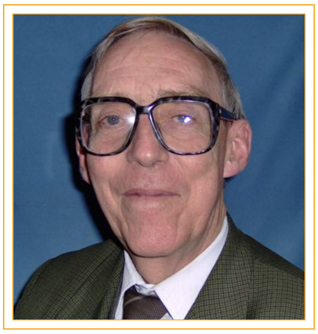


Prof. Terry C. I. Ryan
Member

Mr. Wycliffe Mukulu
Member

Mr. John Birech
Member

EXECUTIVE SUMMARY

The third bi-annual Report of the Monetary Policy Committee (MPC) highlights the activities of the MPC in the six months to October 2009 and also reviews Kenya's economic developments during the period. The MPC continued to update its report on an appropriate structure for its operations following visits by members of the Committee to the Bank of Ghana and the Reserve Banks of India and New Zealand. The updating process is being informed by lessons from these and previous visits.

Several important economic developments were witnessed both on the domestic and international fronts during the period between May 2009 and October 2009. First, overall inflation stabilised on account of lower food prices compared with the prices in the previous six months. Despite the easing in food inflation, drought conditions which prevailed continued to put pressure on food prices. The inflation process in Kenya therefore continued to be a supply side phenomenon. Second, the MPC continued to track the impact of the global financial crises on the Kenyan economy and concluded that the impact was less severe compared with overseas countries as well as its peers in the region.

A notable development during the period was the introduction of the bi-monthly MPC Market Surveys which have been an important input in the decision making process. Bi-monthly forums between the MPC and chief executive officers of commercial banks were also introduced to provide forums for the MPC to explain and get feedback on its decisions. The MPC also continued to analyse data that the Committee captures on the MPC weekly and monthly dashboards of key indicators which are updated regularly. The dashboards complement the set of indicators monitored through the MPC Indicator Table.

Overall this Report indicates that the growth momentum in the Kenyan economy is picking up while the high inflationary pressures witnessed in the previous six months and the impact of the global financial crises which was triggered in September 2008 continue to ease. The Central Bank of Kenya continued to engage in open market operations aimed at ensuring that monetary driven inflationary pressures did not occur. In particular, the Bank's tools of liquidity management were sufficient while inflation continued to be supply side phenomenon.

Although the Report presents data that are already public, additional analyses and information are included. The report covers the evolved structure of the MPC and the economic environment.

1. INTRODUCTION

The third bi-annual Report of the Monetary Policy Committee covers the period from May 2009 to October 2009. During this period, the country was faced with supply side inflationary pressures emanating from high poor weather related food prices and rising world oil prices, as well as the impact of the dissipating effect of the global financial crises.

Significant recovery was witnessed as economic performance improved in the first and second quarters of 2009 compared to the same quarters in 2008. However, overall economic growth in the third quarter was subdued on account of drought conditions that adversely affected agricultural activity, electricity and water sectors with indirect effects on the manufacturing sector. Despite this performance, hotels and restaurants recorded remarkable growth in the third quarter of 2009 as this period is considered mainly as a 'high season' for tourism. At first, drought conditions exerted upward pressure on food prices, but the short rains recorded in the second and third quarters of 2009 helped to ease the supply constraints enough to reduce food prices towards the end of the third quarter 2009. Consequently, overall inflation maintained a general downward trend in spite of increases in global crude oil prices.

The fiscal year 2009/2010 monetary programme was consistent with the provisions in the Government Budget presented by the Minister for Finance in June 2009. The key assumptions for the monetary programme were: real GDP growth rate of 3.1 per cent by June 2010 and a GDP Deflator of 10.1 percent which implied a broad money supply (M3) expansion of 14.5 percent and reserve money growth of 10.9 percent in the fiscal year. The country received disbursements of USD 200 million under the Exogenous Shock Facility (ESF) in September 2009, and USD 223 million SDR allocations from the IMF to cushion against the effects of the global financial crisis. Consequently, the MPC reviewed the projected growth in gross foreign exchange reserves from the earlier 3.6 months of import cover to 4.5 months of import cover by June 2010.

In order to gather the requisite information to inform development of an effective and efficient structure based on best practice, members of the MPC visited selected external central banks. In addition, the MPC continued to explore and improve its interface with the various departments of the Central Bank with the objective of ensuring positive interactions to ensure the timely flow of relevant information.

Lastly, monetary policy decisions during the period continued to be informed by careful analysis of the overall economic environment on both the domestic and international fronts.

2. EVOLVED STRUCTURE OF THE MPC

The Committee reported on the evolving structure of the MPC in the second bi-annual MPC report that covered six months to April 2009. The report also highlighted how the MPC had continued to fulfil its legal mandate, carried on with its analytical work and visited other MPCs around the world to look at the effectiveness of their structures and relevance to the Kenyan situation.

This, third MPC report that spans the last six months to October 2009, reports on the progress made with regard to the development of an appropriate MPC structure at a time when the global economy is in financial and economic crisis. The MPC continued with its visits to several central banks to learn more regarding an appropriate structure which it can adopt. The visits during the financial crisis also allowed the Committee to study how other MPCs were responding to the crisis. The effectiveness and capacity of the instruments being used by the various MPCs in the selected countries were also analysed.

Visits to other central banks

The members of the MPC visited the Bank of Ghana in June 2009, Reserve Bank of New Zealand in July 2009, and Reserve Bank of India in August 2009. As was the case for visits conducted in the preceding six months, the findings of the visits were aimed at informing the MPC on how to restructure its own to make it more effective and also to learn more on monetary policy formulation and operations. In this regard, the main objective of the visits was to understand the structures of the MPC in respective central banks and their effectiveness relative to their role, and how MPCs are staffed and supported. As is the case for Kenya, monetary policy in both central banks visited has the objective of ensuring price stability. Except for New Zealand where the governor makes all decisions on monetary policy, and in India where the committee is only advisory, the role of formulating monetary policy in Ghana is undertaken by a monetary policy committee. Policy interest rates are used in both countries to set the stance of monetary policy. The composition of the monetary policy committees in Ghana and India is quite similar to the Kenyan case where external members are allowed.

The MPC in Ghana uses the prime rate as the key policy rate to set the stance of monetary policy. The prime rate is a signalling rate that sets the tone for monetary policy stance. At the operational level, the repo rate is linked to the prime rate. This rate remains the main rate at which the central bank transacts business with the commercial banks. The level of interest rates is decided by the MPC. The membership of the MPC consists of seven members – five from the Bank of Ghana and two external members appointed by the Minister for Finance. The MPC meetings are chaired by the Governor of the Bank of Ghana.

The MPC at the Reserve Bank of New Zealand is an advisory organ to the Governor of the Reserve Bank of New Zealand and comprises of the Governor, Deputy Governors, and senior members of the economics/ research and financial markets departments as its agenda requires. The committee is chaired by the Deputy Governor responsible for monetary policy and meets weekly.

The Technical Advisory Committee (TAC) on monetary policy at the Reserve Bank of India (RBI) advises the RBI on the stance of monetary policy. The panel is headed by the RBI Governor while the three Deputy Governors are members. The Deputy Governor-in-charge of the monetary policy department is the Vice Chairman. Other members of the panel include the two members from RBI's Committee of the Central Board (CCB) and five external members. The tenure of TAC is two years while meetings are held once in a quarter to review the macroeconomic and monetary developments and to advise the central bank on its stance of monetary policy.

After the planned visit to the South African MPC, the Committee intends to share with the Ministry of Finance, the recommendations from the report of the MPC structure based on lessons from all the visits and survey of various models of MPCs.

Statutory Requireme-nts

The MPC is required by law to hold bi-monthly meetings. consequently, the MPC held three meetings during the period under review. An expansionary monetary policy was adopted during the period while efforts were also made to strengthen money market operations. The following are the key higlights of the MPC decisons in the period:

a) The MPC held its seventh meeting on 21st May 2009. The Committee noted that there was no visible threat of resurgent inflation from the demand and supply side as inflation was expected to decline due to the anticipated good rains. The Committee reiterated the need for ensuring low and stable inflation while providing adequate liquidity to support economic activity. Consistent with previous decisions to enhance liquidity management, the Committee provided a strategy to strengthen the operations of the repo market. As on a previous occasion where it had removed the possibility of overnight warehousing of deposits, the Committee wished to endorse this signal to encourage commercial banks to use the horizontal repo to redistribute liquidity. In this regard, the committee reviewed the CBR downwards by 25 basis points to 8.00 percent and the tenor for repo transactions to a single fixed 5 day. The two measures were not only aimed at improving liquidity distribution but also enhancing the potential for future economic activity.

b) The eighth MPC meeting was held on 22nd July 2009. The Committee noted that due to the existence of significant slack in labour market and capital capacity of the economy, there would be no inflationary threat from further credit expansion. The Committee was of the view that the 2009/10 fiscal budget had provided a much needed stimulus to support demand and stronger output growth without undermining fiscal sustainability. The key objective that guided the Committee's decisions was continued support to stimulation of economic growth process through enhanced access to credit until the economy goes back to its *Vision 2030* growth path. To achieve this objective and to provide guidance on the path of monetary policy over the next two months, the Committee reviewed the CBR downwards by 25 basis points to 7.75 percent, lowered the cash ratio to 4.5 percent and supported these decisions by reviewing the tenor on repo transactions by lengthening it to a single seven days.

c) During its ninth meeting held on 23rd September 2009, the Committee retained the CBR at 7.75 percent and the programmed growth rates of money to allow for the impact of its previous decisions to be fully absorbed by the economy. In reviewing the impact of its previous decisions and analysis on the existing evidence, the Committee was of the view that the financial system had sufficient liquidity to support growth. However, it noted the considerable impact of drought on the performance of the economy that had both fiscal and physical effects. The fiscal effects were seen in both the reallocation of funds to support those sectors adversely affected by the drought and a shortfall in revenue collection. On the physical side, there was a poor crop yield and increased livestock mortality. While crops were expected to recover more rapidly as a consequence of the onset of the October rains, livestock mortality was seen to have a long term impact on growth. The Committee also agreed to engage with the banking sector and explore on ways of improving the intermediation process so that the MPC's signals could be effectively transmitted to the various sectors of the economy.

Research Activities

The studies on the interest rates and inflation in Kenya were developed further and found to be more elaborate than initially envisaged. Preliminary results were shared and the studies are ongoing.

Interest Rates Spread

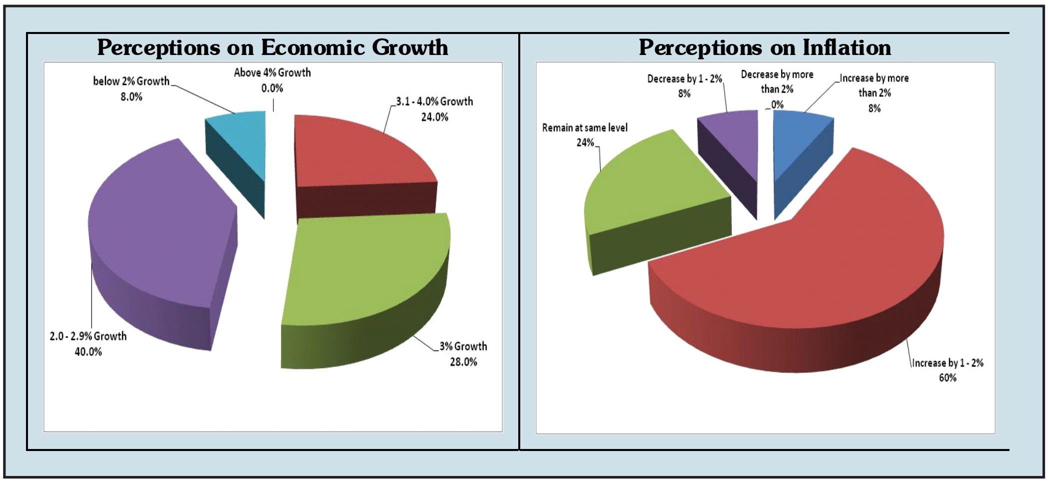
The MPC initiated studies on the interest rates spread to understand the underlying factors driving the level and the spread in Kenya. The study was motivated by the fact that high interest rates spread discourages savings and investment and that under such an environment the bank lending channel for monetary policy would be ineffective. There was therefore need to develop policies that would ensure a narrower interest rates spread by reducing lending rates and increasing return on deposits. The study used individual commercial banks data to capture bank specific factors. Preliminary results from the study indicated that the large spread in Kenya is determined by, among other factors, high non-performing loans, high operating costs, low level of competition, government borrowing and the level of liquidity in the market.

MPC Market Perception Surveys

During the period covered by this report, the MPC initiated bi-monthly MPC Surveys to capture the perceptions of the banking and private sectors on key economic issues including economic growth, inflation, direction of interest rates, exchange rates, awareness of the public on activities of the MPC and what banks consider as the determinants of interest rates spread. However, the first MPC Survey conducted in September 2009 focused only on commercial banks. Other private sector firms were incorporated in subsequent surveys. The MPC will improve on the questionnaires and analysis in subsequent surveys to capture issues of interest to the Committee while, at the same time, incorporating comments from the key respondents in this exercise. Results from the survey complemented the findings from the interest rates study as both the Treasury bill rates and the profit margins were highlighted as key determinants of the spread.

As shown in Chart 1, the results of the September 2009 MPC Market survey showed that most banks expected the economy to grow by 2–3 percent in 2009. However, most banks expected inflation to increase by 1– 2 percent in the remainder of 2009 from the 17.79 percent in July 2009 due to expectations for high energy prices and drought.

Chart 1: Perceptions By Banks on Economic Growth and Inflation in 2009



Source*: Central Bank of Kenya*

The results of these surveys facilitated the MPC in understanding the perceptions of key stakeholders in the economy and hence formed an input in the Committee's decision process.

Weekly and monthly dashboards were further developed

The MPC continued to monitor and analyse developments in the economy using the weekly and monthly dashboards of key economic indicators. The MPC is improving on the data quality and collection methods to ensure that the information captured effectively facilitates sound analyses and keeps the MPC well informed of the developments in the various sectors of the economy. The availability of high frequency data through the weekly dashboard enhanced policy formulation during the period covered by this report. Once good data quality has been assured and the collection method well established, the data in the MPC dashboard will be disseminated.

Other MPC Activities

a) The MPC continued to monitor and prepare briefs on the status and impact of the global financial crises on the Kenyan economy.

b) MPC members also participated in conferences and workshops both locally and internationally and contributed to creating awareness on monetary policy operations and collecting market reactions.

c) Forums were organised with diversified stakeholders including commercial banks, investment banks and the media to obtain their perceptions on the economy.

d) After every MPC meeting, the Committee held meetings with chief executive officers (CEOs) of commercial banks to share the results of the survey Market Perceptions Surveys and to obtain feedback on the data collection tool. The MPC also used the meetings to elaborate on the underlying factors that were considered in the previous MPC decision usually motivated by the content of the long press release. Meetings with CEOs and Market Perceptions Surveys were both initiated in September 2009

e) Press conferences to disseminate MPC decisions were used to enhance the Committee's communications strategy.

f) The MPC worked closely with Research Department and the Communications Committee of the Bank during the period.

3. REACTIONS TO ECONOMIC ENVIRONMENT

This section reviews developments in the domestic economy, and outlines the major events that occurred during the period covering May 2009 to October 2009.

Kenya Economic Status and Financial Sector Developments

The economy grew by 1.98 percent in the 12 months to September 2009 relative to the 12 months to September 2008 down from 2.84 percent in the 12 months to June 2009 (Table 1). The performance was attributed to the drought conditions that intensified in the third quarter of 2009 which adversely affected agricultural activity and electricity generation and with indirect constraints on growth in manufacturing sector. Agriculture, and electricity and water contracted by 3.22 percent and 2.89 percent, respectively, in the period. However, the overall positive growth in the economy was supported by growth in tourism, building and construction and transport and communication which grew by 17.66 percent, 9.86 percent and 3.95 percent, respectively in the period.

Table 1: 12-Month Economic Growth (Percent)

	2007				2008				2009		
	to Mar	to Jun	to Sep	to Dec	to Mar	to Jun	to Sep	to Dec	to Mar	to Jun	to Sep
Real GDP	6.74	7.41	7.04	7.10	5.05	3.49	2.61	1.69	2.80	2.84	1.98
Agriculture	6.41	5.64	3.71	2.02	-1.38	-2.16	-3.73	-5.15	-3.99	-4.01	-3.22
Transport & communication	9.18	9.27	10.99	15.07	12.60	8.34	5.52	3.11	4.20	5.63	3.95
Manufacturing	5.85	6.70	6.54	6.46	5.87	5.10	4.07	3.75	3.76	2.54	0.96
Tourism (Hotels and Restaurants)	16.33	22.22	19.32	16.32	-2.01	-17.72	-27.02	-36.11	-16.99	-3.49	17.66
Building and construction	3.06	4.21	7.54	6.85	8.85	9.57	9.00	8.31	14.23	13.56	9.86
Financial services	5.29	5.65	6.46	6.68	5.68	4.67	3.12	3.08	3.83	4.18	6.11
Electricity & Water	0.49	3.72	6.91	9.14	10.23	8.52	6.61	5.23	2.33	-0.31	-2.89
Trade	11.80	12.32	9.95	11.52	7.79	5.28	5.80	5.07	6.52	5.94	3.44

***Source**: Kenya National Bureau of Statistics*

Among the six key sectors identified in achieving the goals of the Vision 2030 development plan, tourism and financial services registered the highest growth in the 12-months to September 2009. The other sectors expected to drive growth are agriculture, manufacturing, trade and business process off shoring.

The Repo Market

The Central Bank drew down its repo stock in May 2009 as it sought to ensure that reserve money growth was within the programmed target (Table 2). The MPC continued to encourage the use of the Horizontal Repos during the period to improve access to liquidity and improve its distribution within the banking system. Consequently, the uptake of Horizontal Repos increased from Kshs. 174.5 million in April 2009 to Kshs. 1,781.8 million in

October 2009. In addition, the average interest rate on a 7-day Horizontal Repo fell from 5.65 percent to 4.00 percent during the period. The Term Auction Deposit facility was not used during the period.

Table 2: Performance of Average Reserve Money (Kshs billion)

	Reserve Money			OMO (REPO)			OMO (REVERSE REPO)			Repo stock
	Actual	Target	Deviation	Amount Posted	Actual Mop Up	Deviation	Amount Offered	Actual Injection	Deviation	
Jul-08	152.70	146.90	5.80	1.40	2.50	1.10	2.60	2.50	-0.10	9.40
Aug-08	154.36	148.27	6.09	1.12	2.83	1.71	1.14	1.15	0.01	11.07
Sep-08	154.03	152.29	1.74	2.61	2.35	-0.26	0.00	0.00	0.00	7.86
Oct-08	156.62	155.25	1.36	2.73	1.52	-1.21	0.00	0.00	0.00	3.26
Nov-08	160.55	161.17	-0.62	2.50	1.56	-0.94	0.00	0.00	0.00	4.38
Dec-08	160.89	170.72	-9.83	3.83	4.03	0.20	0.35	0.26	-0.09	10.52
Jan-09	156.46	168.56	-12.10	2.50	3.32	0.82	0.14	0.14	0.00	7.94
Feb-09	154.27	167.48	-13.20	1.73	2.08	0.35	0.16	0.18	0.03	5.70
Mar-09	154.78	164.23	-9.45	1.83	1.41	-0.42	0.00	0.00	0.00	3.87
Apr-09	154.25	164.57	-10.32	1.30	0.91	-0.39	1.90	1.68	-0.22	2.88
May-09	160.40	164.92	-4.52	0.10	0.11	0.01	4.30	2.92	-1.38	0.37
Jun-09	159.94	163.58	-3.64	0.00	0.00	0.00	1.23	1.15	-0.08	0.00
Jul-09	157.95	161.04	-3.09	0.00	0.00	0.00	2.04	1.63	-0.41	0.00
Aug-09	156.88	162.89	-6.00	0.00	0.00	0.00	2.45	1.41	-1.04	0.00
Sep-09	163.49	164.74	-1.26	0.00	0.00	0.00	0.42	0.39	-0.03	0.00
Oct-09	163.45	166.61	-3.16	0.00	0.00	0.00	1.51	0.88	-0.63	0.00

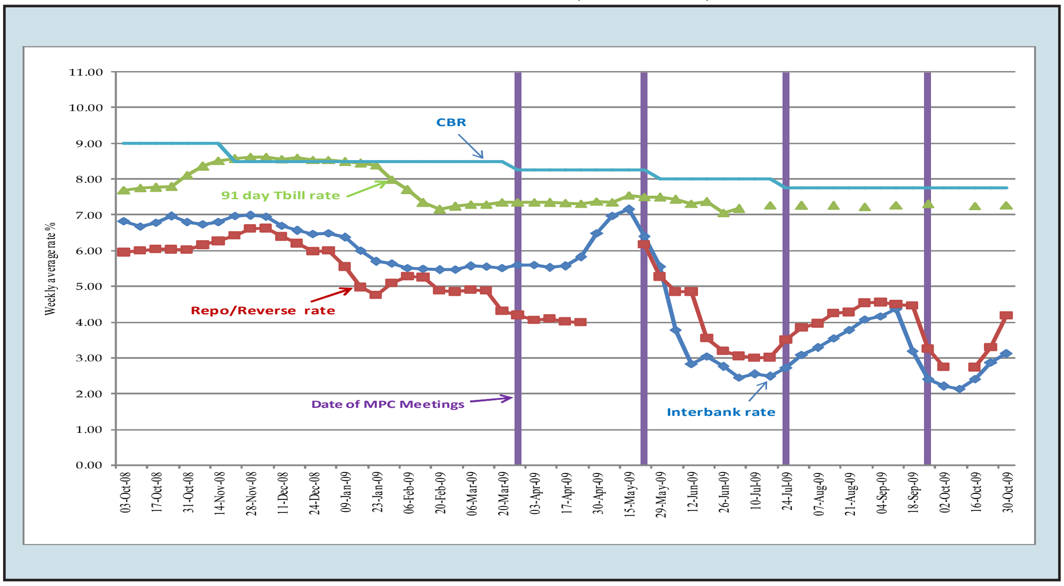
***Source**: Central Bank of Kenya*

Consistent with the decisions of the MPC which were mainly aimed at ensuring that banks had adequate liquidity to lend to the private sector, open market operations between May and October 2009 were generally restricted to liquidity injections rather than mop ups. Consequently, the average repo rate dropped from 6.18 percent to 3.41 percent during the period.

Liquidity management

The MPC reduced the CBR from 8.00 percent in May 2009 to 7.75 percent in October 2009 while the Bank of England and the European Central Bank maintained their policy rates at 0.25 percent and 0.50 percent set respectively in the period. The US and UK policy rates were maintained as signs of recovery in these countries were starting to be realised. The MPC considered reduction of the CBR to boosting credit growth in support of economic growth. As shown in Chart 2, short term interest rates continued to respond to monetary policy signals. The impact of this measure on the availability of credit was positive leading to a build up in credit to private sector by Kshs 32.55 billion over the period covered by this report. However, this build up in credit was mostly realised within the second quarter of 2009. Reserve money and broad money were below target over the period despite increasing from Kshs 160.4 billion and Kshs. 928.6 billion in May 2009 to Kshs 163.45 billion and Kshs 1,006.0billion in October 2009, respectively.

Chart 2: Short Term Interest Rates (Percent)



Source: *Central Bank of Kenya*

Developments in the Banking Sector

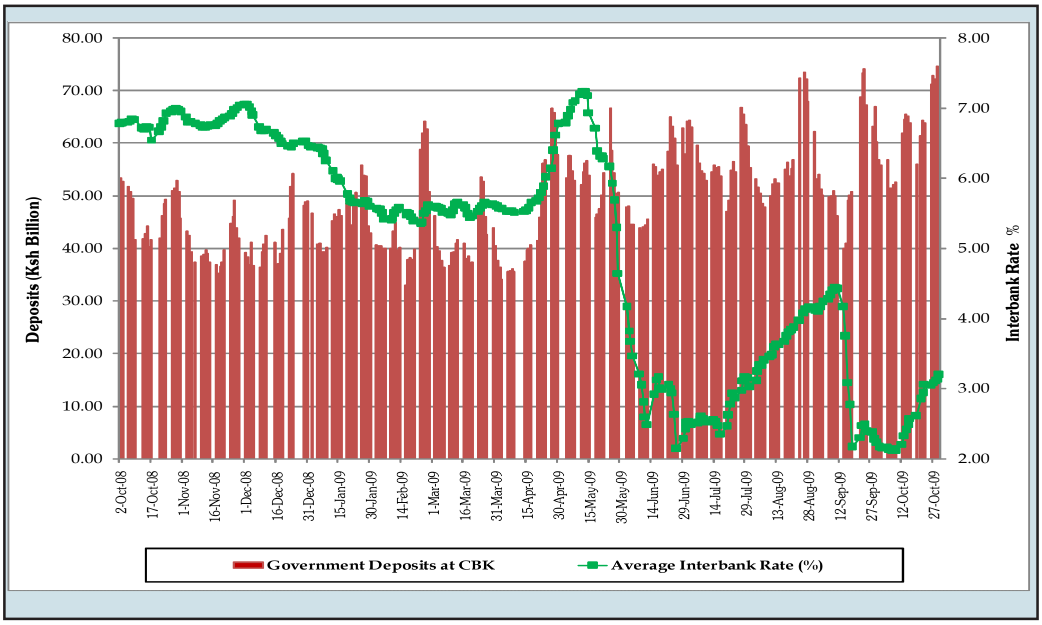
The performance of the banking sector remained strong and stable during the 12-months to October 2009 as indicated by stress tests conducted in the period. In particular, commercial banks gross deposits and loans grew by 10.4 percent and 11.2 percent during the period to stand at Ksh. 1,014.5 billion and Ksh 755.0 billion respectively at the end of October 2009. The proportion of net non-performing loans in total loans decreased from 3.3 percent in May 2009 to 2.9 percent in October 2009, indicating declining credit risk. In addition, credit to private sector grew by 6.5 percent in the six months to October 2009 with a large proportion going to manufacturing, energy and water, building and construction, trade, and mining and quarrying sectors.

Among the legal developments in the financial sector during the period included the implementation of guidelines stipulated in the Microfinance Act & Regulations of 2008 which the MPC considered would affect access to financial services. Consequently, the first microfinance deposit taking institution was licensed in May 2010. This was followed by introduction of agency banking and lengthening of the tenor for repos to 7 days in June and July 2009, respectively. The start time for repo trading was adjusted to 11.30 am in August 2009 to enable the Government to provide the CBK with the schedule of actual payments for the day. This development resulted in improved liquidity forecasting by ensuring predictability of Government payments. Other important developments include the proposal for introduction of credit reference bureaus in August 2009 and introduction of value capping for cheques in October 2009, which ensured that cheques for amounts over one million are paid through the Real Time Gross Settlement System (RTGSS).

The Interbank market

Chart 3 shows that the average rate in the interbank market was very volatile during the period under review. The MPC followed this closely and identified a strong positive correlation between interbank rates and the build up of Government deposits at the Central Bank. Once the deposits had been run down and the new financial year commenced, the interest rates dropped precipitously in line with the major increases in liquidity available and the signals from the MPC decisions. The MPC noted the seasonal requirements of the banking system particularly associated with payment of tax liabilities which caused periodic increases in demand and associated with increases in supply which might have inflationary implications.

Chart 3: Daily Interbank Rates (percent) and Government Deposits at the Central Bank of Kenya (Ksh Billion)



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

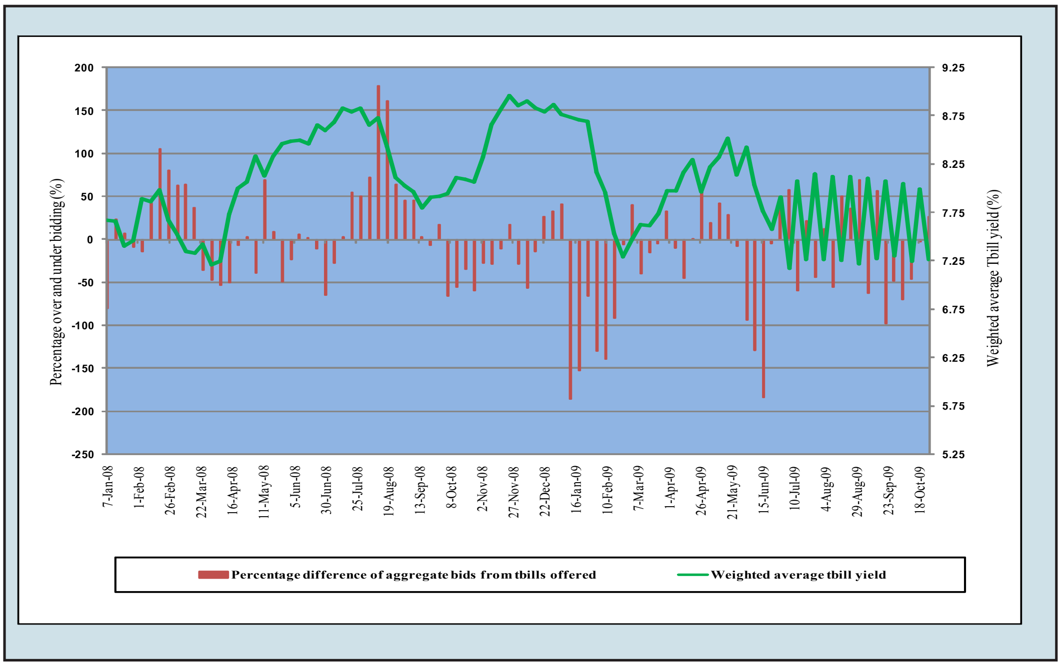
The Treasury Bill and Treasury Bond Market

The stock of Treasury bills (excluding repos) rose from Kshs. 105.0 billion at the end of April 2009 to Kshs. 133.6 billion at the end of October 2009. The stock of Treasury bonds increased from Kshs. 343.5 billion to Kshs. 389.9 billion during the period. The build up in government debt during the period was due to planned government domestic borrowing to finance the budget deficit.

Despite the introduction of alternating issues of 91 day and the 182 day Treasury bills on weekly basis in July 2009, the yields remained stable (Chart 4). Notably, only seven out of the twenty six Treasury bills auctions in the period were undersubscribed while all but two of the six bond issues were oversubscribed. Confidence in the longer-dated government paper was also indicated by the lengthening maturity profile of domestic debt in the period.

An important development in the issuance of government paper was witnessed in August 2009 with the introduction of the 364-day Treasury bill which is issued bi-monthly. The two issues of the 364-day Treasury bill were oversubscribed as it provided an additional investment channel at the short end of the yield curve. The yields on the Treasury bill also declined in the period. In addition, five Treasury bonds issues comprising of 2-year, 5-year, 15-year and 20-year benchmark bonds were re-opened during the period in order to increase the liquidity around these bonds.

Chart 4: Treasury Bills Weekly Auctions



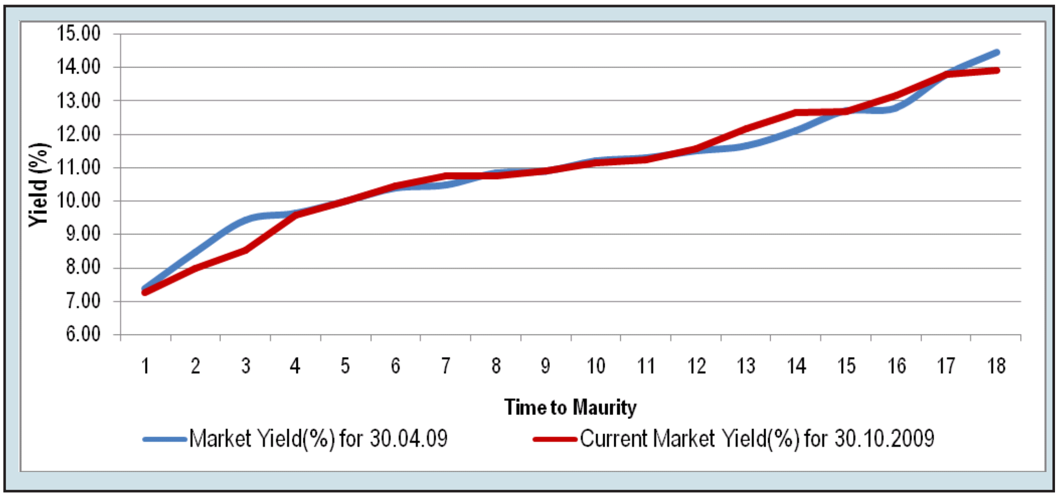
***Source**: Central Bank of Kenya*

Government Securities Yield Curve

The short end of the yield curve on government securities shifted downwards between April 2009 and October 2009. This was attributed to improved liquidity conditions in the market following reductions in the Central Bank Rate from 8.00 percent to 7.00 percent over the same period. Generally, the shape of the yield curve has improved even though the long end of the curve is still steeper than expected (Chart 5).

It is anticipated that the introduction of automated trading system in November 2009 will enhance efficiency in trading and result in decline in yields on the longer dated securities.

Chart 5: Government Securities Yield Curve (End of Month)



Source: *Central Bank of Kenya*

Update on the Global Financial Crisis

The MPC updated its first report on the Global Financial Crisis covered in the Second MPC Report, to the period from January 2009 to June 2009. It highlighted the evolution of the impact of the global financial crisis on the Kenyan economy. Some of the key issues that emerged were:

- There was clear evidence of an impact specifically in tourism due to lower holiday bookings and cancellations of chartered flights occasioned by the global financial crisis. Despite the cancellations, Kenya was reported to be faring better than its competitors; South Africa and Egypt due to its better image and position as a business hub. This therefore, meant that the country was placed in a stronger position to benefit from the rebound when it starts to be recorded. Related to the tourism sector was the hotels and restaurants subsector. It is reported that in the first quarter of 2009 the sub sector of hotels and restaurants recorded an impressive growth of 59%; indicating clear signs of recovery from the post-election disturbances.
- As in the previous MPC reports, there was clear evidence of an impact of the global financial crisis in the floriculture sector, on input costs, in the foreign exchange markets and with Bank credit. Inventory levels, the NSE and trading patterns had also been affected. In the latest bi-annual report to June 2009 on development of the global financial crisis, there are recorded bottoming-out of the recession in different sectors with trade ,hotels and restaurants and construction sector s recording 2.2 percent, 24.2 percent and 10.7 percent, respectively in the second quarter of 2009. Other sectors that had recorded positive growth in the first quarter, for instance agriculture and manufacturing, would have posted impressive growth rates if drought conditions in the second quarter had not occurred in most parts of the country.

- When compared to what had been experienced in Europe and even amongst its African peers such as Nigeria, South Africa, Ghana and Egypt, the Kenyan economic impact is not that severe. This is because the Kenyan economy is not dependant on a narrow commodity export and was not exposed to complex financial credit products. This was evidenced by the 2.4 percent growth in the second quarter of 2009 and with no strong statements on reductions in demand or jobs.
- The stock market was picking up with almost 50 percent investment coming from foreign investors. This indicated in part a return of confidence in the market and easing of effects of global economic crisis. There was a considerable upsurge in the bond turnover as the Government came into the market with the infrastructural bond. The NSE index has also started a climb from a low of around the 2800 in May 2009 to over 3000 by end of October 2009. 50% of the new investors into the market are foreign. However sentiment rather than logic in respect of company fundamentals has tended to lead the market and domestic investors take a short 6-12 month profit taking perspective. There is however concern over the 2009 Budget directive that requires all new investment by the NSSF to be made in Government securities.
- Horticulture was broken down into floriculture the largest sector, and vegetables and fruit. While the vegetables and fruit subsector recorded major drop in demand for the two products, the prices of floriculture after June 2009 in Dutch floral markets registered major increases boosting revenues for local exporters to Europe. It is also reported that many businesses in this subsector are aligning themselves back to this more stable base and negotiating flexible contracts n the direct sales markets.
- Except for the spike in December 2007 from the investment into Equity Bank by Helios Bank of the Netherlands and investment in Telkom Kenya Ltd by Orange of France, Foreign Direct Investment flows have remained fairly depressed but stable. This was the case prior to the global economic crisis and has not changed. Immigrant remittances as indicated earlier have remained fairly stable over the period covered by this report. There has been no clear evidence therefore that there has been an impact as a result of the global economic crisis.
- Kenya's official foreign exchange reserves also increased steadily from as low as equivalent to cover 3.31 months of imports in May 2009 to 4.13 months of imports by October 2009. The IMF SDR allocation equivalent to USD 200 million in June 2009 boosted the official reserves towards the statutory limits of 4 months of import cover. This is deemed to further boost investor-confidence in the economy and attract investors.

Review of activities related to inflation

The MPC hosted a seminar on inflation in August 2009. It had been noted that the inflationary pressures prevailing in the country at the time were associated with supply side shocks which include volatile oil prices, commodity prices and drought conditions. These shocks continued to pose a challenge to the achievement of the CBK's core mandate of price stability. In particular, the achievement of the inflation target was being constrained by increased volatility in food prices and other exogenous shocks. The seminar was therefore organised by the MPC to:

a) Review the country's inflation history and how weather conditions had affected food production and hence prices.
b) Review the sources, magnitude and structure of inflation in Kenya.
c) Suggest possible ways of addressing the food supply problem in Kenya, and

d) Deliberate on the possible action plan among key stakeholders to keep inflation low and stable.

Participants in the seminar were drawn from Ministries of Finance, Planning and Vision 2030, Trade, East African Community, Special Programmes and Agriculture; Kenya National Bureau of Statistics (KNBS), Kenya Agricultural Research Institute (KARI), Kenya Bankers Association (KBA), Federation of Kenya Employers (FKE), Kenya Association of Manufacturers (KAM), Central Organization of Trade Unions (COTU), National Cereals and Produce Board (NCPB), Central Bank of Kenya, KIPPRA, IPAR and Kenya Meteorological Department (MET).

The following was agreed as the way forward and action plan by the concerned stakeholders in achieving the objectives of the seminar:

- **Need to have the right measure of inflation**: It was agreed that for a start, KNBS will release new numbers of inflation for Nairobi based on the new basket and computed using the geometric mean methodology in October 2009. The new inflation data for Kenya would then be released thereafter in February 2010 after thirteen months of comparable data has been collected. This statistic will reflect new the consumer basket with new weights.
- **Undertake stakeholder education on the new inflation measure**: It was agreed that the Kenya Association of Manufacturers (KAM), would work with KNBS and CBK to communicate issues on the new measure of inflation with the private sector prior to its release.
- **Adopt uniform measures of inflation which can be explained**: It was agreed that the Monetary Policy Committee would work with KNBS to define and adopt uniform measures of inflation which would be reported by CBK and KNBS. The measures proposed to be explored for adoption are food inflation, core inflation, tradable goods inflation, non-tradable goods inflation and a national inflation which can be used to measure the cost of living.

- **Enhance partnerships among public institutions to promote food security**: It was observed that the relevant policies for enhancing food security were already in place and that the focus should now be on implementation rather than seeking for resources. Specifically, it was agreed that the Ministry of Agriculture implements the recommendations of Kenya Agricultural Research Institute on planning adequately for food production as well as diversifying food types in order to improve food security. It was proposed that the Ministry of Finance should consider expanding the coverage of food items for importation duty free to include wheat as a way of facilitating reduction in the prices of the commodity. On the other hand, the Ministry of Agriculture was requested to provide incentives to promote adoption of traditional food production and consumption by the public where many traditional foods were drought resistant.
- **Improve food storage to enhance food security**: It was agreed that there is need for the Ministries of Agriculture and of Finance to support implementation of the strategic plan of the National Cereals and Produce Board which will improve storage capacity for diverse food types and enhance food security. To enhance food security in the country, NCPB was in the process of establishing a Commodity Exchange that will promote efficient functioning of commodity markets in the region. The Commodity Exchange will boost price discovery for maize and other grains, improve transparency in the grain industry, reduce transaction costs, enhance management of risks through hedging, and ensure efficient management of warehousing in the region.
- **Implement reforms in the agriculture sector**: It was agreed that the Ministry of Agriculture should address the large number of pieces of legislation in the sector which are impediments to making the necessary reforms to improve food production, processing and storage. Consumer protection and property rights definition should also be observed.
- **Provide periodic data on weather**: It was agreed that the Meteorological Department provides stakeholders with monthly data on the weather as well as explanations on the implications of anticipated changes in weather conditions to enable farmers to prepare for such circumstances.

Important Steps in Improving the Inflation Measure in Kenya

The Kenya National Bureau of Statistics at the end of October 2009 released the consumer price indices based on a geometric rather than arithmetic mean. The new measure of inflation reflected a more realistic picture of overall price changes in the country that was devoid of any upward bias, which had been the case with the use of arithmetic mean methodology. As shown in Table 3, overall 12-month on month inflation eased from 9.57 percent in May 2009 to 6.60 percent in October 2009 on account of a drop in food and fuel and power inflation rates. Moreover, underlying inflation also declined from 7.43 percent to 5.17 percent over the same period.

The KNBS Integrated Household Budget Survey conducted in 2005/06 has provided new data on expenditure patterns which include new and relevant items such as airtime, mobile phones and computers. It also provided data which enabled the MPC to assist in establishing relevant Nairobi income groups for analysis. The new basket of goods and income groups are being used to create a new consumer price index using the geometric mean methodology. This will lead to a new inflation series in early 2010.

Table 3: Various Measures of Inflation (Percent)

	12-month overall inflation	12-month underlying inflation	"Food and non-alcoholic drink" inflation	Contribution of food inflation to total inflation	"Fuel and power" inflation	Oil prices $ per bbl	Middle/upper 12 month overall inflation
May-08	18.60	6.59	27.92	75.81	17.20	125.75	12.91
Jun-08	17.82	6.92	26.05	73.83	19.81	134.00	12.42
Jul-08	17.03	6.86	23.97	71.07	27.80	137.35	12.21
Aug-08	18.31	7.45	25.78	71.07	31.23	117.50	12.38
Sep-08	18.64	7.93	26.25	71.14	31.84	98.05	11.18
Oct-08	18.62	8.06	26.29	71.29	28.65	69.25	11.30
Nov-08	19.55	8.48	28.36	73.27	27.06	51.40	11.92
Dec-08	17.80	8.44	25.88	73.42	17.07	42.10	10.56
Jan-09	13.34	8.43	18.45	69.86	9.33	48.85	9.19
Feb-09	14.62	8.39	20.62	71.22	7.17	44.95	9.03
Mar-09	14.56	7.99	20.68	71.69	4.04	47.55	11.63
Apr-09	12.38	8.10	16.68	68.03	1.28	45.85	10.27
May-09	9.57	7.43	12.48	65.81	-2.37	60.15	8.58
Jun-09	8.57	6.70	11.39	67.13	-5.28	71.65	7.31
Jul-09	8.41	6.18	11.97	71.86	-9.69	66.95	7.13
Aug-09	7.34	5.64	10.70	73.64	-12.41	72.75	6.88
Sep-09	6.72	5.16	9.76	73.32	-12.19	69.10	6.07
Oct-09	6.60	5.17	9.24	70.66	-9.92	69.25	5.84

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

Since this report covers the activities of the MPC between May 2009 and October 2009, the inflation data reported reflect the old consumer basket under the new computational methodology. As pointed out, the new methodology application on the new consumer basket will be reflected in the new inflation series to be released in early 2010.

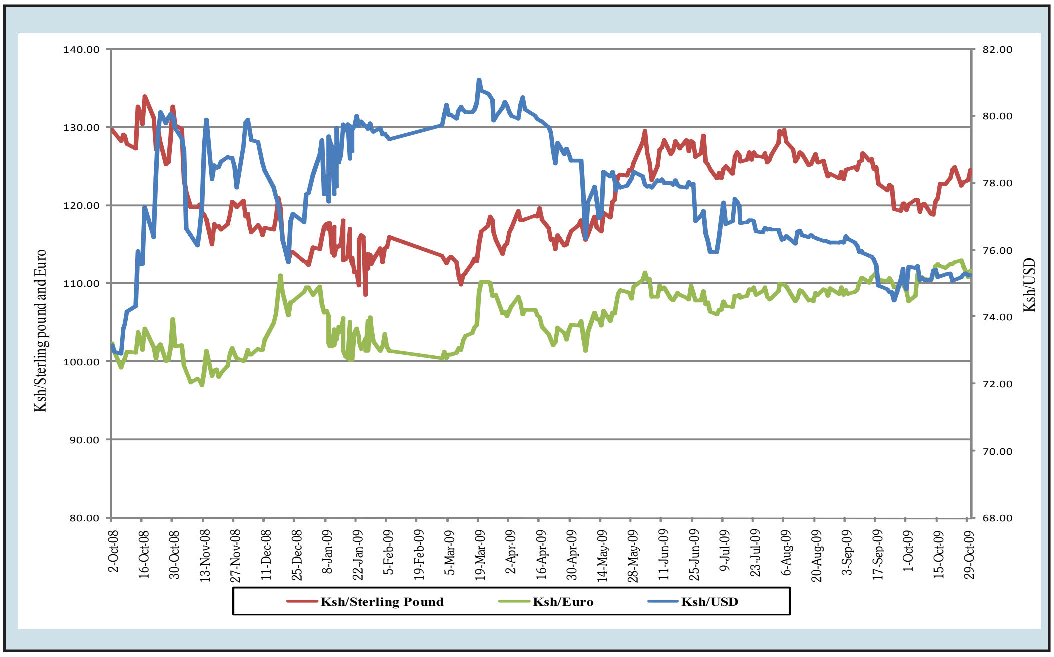
Exchange Rate Management

The Kenya shilling strengthened against the US dollar and Sterling pound between June and October 2009 (Chart 6). However, the Shilling weakened against Euro during the period occassioned by strengthening of the Euro against major currencies. The performance of the Kenya shilling against the US dollar during the period was largely attributed to the weakening of the latter in the global market against the Euro and Japanese Yen. The general stability in the exchange rate of the Kenya shilling against major currencies during the period was also attributed to significant increases in tourism earnings, diaspora remittances and earnings from tea exports.

Immigrant remittances averaged about USD 51.4 million during the period compared with USD 46.7 million in the six months to April 2009. This shows that the developments in the global financial crisis have had no impact on flows of immigrant remittances. Tourism also continued its recovery from the post election violence period towards pre-crisis positions.

Comparing the period from May 2009 to October 2009 and similar periods in 2007 and 2008, Nairobi returned rapidly to 2007 hotel occupancy level while the coast suffered slow recovery occasioned by the global financial crisis that may have led to cancelled chartered flights to Mombasa. In particular, tourist arrivals in the country averaged 79,893 per month in the May-October 2009 period up from an average of 63,212 over a similar period in 2008.

Chart 6: Trends in Exchange Rates of Major Currencies



Source: Central Bank of Kenya

Foreign Exchange Reserves

Between May 2009 and October 2009, the Bank continued to build up foreign exchange reserves by purchasing USD 469.75 million from the domestic foreign exchange market (Table 4). Despite the purchases of foreign exchange from the market, the exchange rate remained stable during the period mainly as result of increased foreign exchange inflows from tourism, earnings from tea exports and diaspora remittances.

Table 4: 12-Months Cumulative Balance of Payments (USD Million)

	Nov-08	Dec-08	Jan-09	Feb-09	Mar-09	Apr-09	May-09	Jun-09	Jul-09	Aug-09	Sep-09	Oct-09
Gross Reserves												
Official	2,869.33	2,875.46	2,768.85	2,744.85	2,713.87	2,887.74	2,928.94	3,219.46	3,215.85	3,591.02	3,707.96	3,810.42
Commercial Banks	1,654.11	1,765.32	1,579.27	1,609.52	1,606.54	1,732.54	1,441.03	1,602.15	1,614.29	1,534.33	1,527.18	1,536.24
Imports cover (36 months)	3.40	3.36	3.21	3.16	3.10	3.28	3.31	3.61	3.57	3.98	4.07	4.14
Interventions												
Interbank purchases	0.00	0.00	15.00	0.00	0.00	10.00	81.50	74.00	55.00	87.25	98.00	74.00
Interbank sales	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00

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

The foreign exchange reserves of the Central Bank had been run down somewhat during the early period of adjustment to the international financial crises. By October 2009, it was clear to players in the financial sector that there were only minimal risks in the sector in Kenya and hence the foreign reserves position started to improve. The Central Bank accumulated official foreign exchange reserves over the period covered by this report to USD 3,810.42 million by end of October 2009. This was equivalent to 4.14 months of import cover which was above the statutory minimum of 4 months of import cover.

4. CONCLUSION

Overall, the MPC met its planned objectives between May 2009 and October 2009. Despite the various high inflationary pressures witnessed during the period and the impact of the global financial crises, the economy maintained an upward growth trajectory. Furthermore, the Central Bank of Kenya was able to engage in open market operations aimed at ensuring that monetary driven inflationary pressures did not occur. In particular, the Bank's tools of liquidity management were sufficient and the degree to which inflation affected the economy was mainly on the supply side.

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 Kenya National Bureau of Statistics (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.

Underlying Inflation This is the overall inflation measure that excludes volatile components that include food, energy, transport and communications which are beyond the control of the CBK. Thus, the underlying measure is used by the CBK to gauge the influence of monetary policy on inflation.

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

Open Market Operation The act of buying or selling Treasury bills in the secondary market by the Central Bank in order to achieve a desired level of bank reserves. OMO is done in the context of an auction where commercial banks bid through the Reuters screen.

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 recognizes Government securities as collateral for borrowing. The instrument allows commercial banks without credit lines with other banks to access credit from the interbank 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).

Cash Reserve Requirement This is the legally required position of commercial banks and non-bank financial institutions deposits held with the CBK. The CBK is empowered by the CBK Act to demand that a certain proportion of commercial banks' deposits be held as reserves at the CBK. The ratio currently stands at 4.5 percent.

Term Auction Depposits A deposit product of the Central Bank of Kenya transacted with commercial banks under Open Market Operations through a competitive auction bidding system. Deposits are held to maturity and qualify for liquidity ratio purposes.