FIRST

BI-ANNUAL REPORT OF THE

MONETARY POLICY COMMITTEE

CENTRAL BANK OF KENYA

Issued under the Central Bank of Kenya Act, Cap 491

OCTOBER 2008

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

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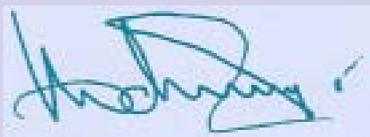
Letter of Transmittal to the Minister for Finance

Honourable Minister,

I have the pleasure of forwarding to you the first bi-annual Monetary Policy Committee 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 during the first six months of its existence. The Minutes of all the meetings of the MPC between April 2008 and October 2008 are attached to the Report for your information.



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

REPORT OF THE MONETARY POLICY COMMITTEE, OCTOBER 2008

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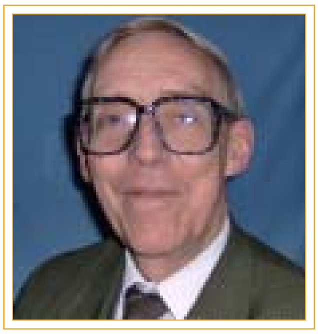

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Mr. Wycliffe Mukulu
Member

Mr. John Birech
Member

EXECUTIVE SUMMARY

This, first bi-annual report of the Monetary Policy Committee (MPC) commences with a section showing how this new Committee relates to its predecessor the Monetary Policy Advisory Committee (MPAC). The change in legislation which gave rise to the Committee's terms of reference also altered its membership and mandate.

The period between May 2008 and October 2008 witnessed several major developments – both domestic and international - which occupied much of the Committee's time and effort. Highlighted in the report is the Initial Public Offer (IPO) of Safaricom which had major ramifications on the liquidity of the banking system. The global financial crisis which peaked in September 2008 was analysed but clearly its major implications relate to a later period beyond October 2008.

The report presents data that is in the public realm, however the Committee has gone out of its way to provide additional insights. Of particular significance are the annual sectoral growth rates which have had implications on inflation. The post election violence clearly falls outside the period under analysis but its implications are to be found in various sections of this report. The section of the report on the structure of the Kenyan Economy indicates the areas in which policy intervention in the financial sector might be relevant. In particular, the magnitude of the informal sector membership demonstrates the degree to which micro-finance will become more important in the Committee's later work.

Overall the report chronicles the efficiency of various financial markets and the health of the financial sector. It demonstrates that the Central Bank's tools of management are adequate and that the degree to which inflation is affecting the economy lies more on the side of supply than through monetary driven demand.

Prof. Njuguna Ndung'u
Chairman, Monetary Policy Committee

1. INTRODUCTION

This, the first report of the Monetary Policy Committee, spans the period from May 2008 to October 2008. This period was affected by major events both within Kenya and in the rest of the world. The first was the Safaricom IPO and the second the major turbulence in the international financial markets triggered by sub-prime lending in the United States.

The domestic economy was recovering from the post election violence which had adversely affected economic performance. Not only was growth negative but inflation rose sharply largely due to the increases in food prices arising from the shortages caused by the inability to transport food effectively in the first quarter of the year. Furthermore, world oil prices rose to record heights and this also spilt over into domestic cost push or supply side inflationary pressure.

Kenya had completed its programme with the IMF and commenced work on developing a new framework for monetary policy. Within this background, the monetary programme was redesigned after analysis to explore the policy signaling mechanism.

Besides this wide variety of policy considerations, the Monetary Policy Committee had to work out its own modalities of functioning since it had no precedent to go by. It explored its interactions with the various departments of the Central Bank, guided by the need for positive interactions to ensure the timely flow of relevant information. In particular the MPC reappraised the interaction of its predecessor institution, the Monetary Policy Advisory Committee, with the Research Department.

Decisions with respect to the Central Bank Rate (CBR) were informed by careful analysis of the overall environment of the Kenyan economy both domestically and internationally as impacted by the global environment - particularly as seen in our trading partners.

2. APPOINTMENT OF THE MPC

The Monetary Policy Committee was appointed by Gazette Notice 3771 on 30th April 2008 to serve for three years as required by the Central Bank of Kenya Act. The appointment followed widespread consultation between the Treasury and CBK to ensure that the requisite skills were embodied in the personnel appointed. The fact that the external personnel had all been members of the erstwhile Monetary Policy Advisory Committee safeguarded historical memory and familiarity with the modalities of working with the Central Bank.

Unlike the Monetary Policy Advisory Committee, the Monetary Policy Committee is executive with responsibility for policy formulation. The CBK Act identifies areas of commitment for the MPC, which include price stability, the exchange rate and the overall health of the economy.

While the Monetary Policy Advisory Committee members were paid a retainer by the Central Bank, the members of the Monetary Policy Committee are part-time employees devoting half of their working hours to Central Bank matters. They operate from within the Bank, have their own secretariat which obtains data / information from various departments. The MPC also can commission relevant studies to analyse and answer policy questions. Their approach is proactive within the Bank.

A critical departure from the past, is that the Monetary Policy Committee works directly with the Chairman and Vice Chair who are the Governor and Deputy Governor by law, providing them with executive briefs on matters of particular concern to it. In part, these briefs arise from the fact that the appointed – as opposed to ex-officio members have an exposure to the wider financial market and academia. This provides insights with respect to analysis and structural inelasticities. This can best be seen in the Safaricom IPO Report which mixed both formal economics and the institutional characteristics. This IPO had a major impact on the Kenyan economy and it was important to learn from lessons that it taught us.

The Committee has adopted a flexible approach to its own agenda. It not only responds to the Central Bank's requirements, but rather tracks international events which impinge on the Kenyan economy at large. In order to strengthen this structure, the Central Bank and MPC members will visit some pre-identified central banks in other countries to learn from their experience.

3. EVOLVED STRUCTURE OF MPC

Introduction The genesis of the MPC was the Government of Kenya's undertaking to support the efforts of the Central Bank of Kenya's policy initiatives with the creation of a Monetary Policy Committee, in line with best practice in other parts of the world.

By Gazette Notice 5756 of July 2005 the Government appointed six non executive members to the newly formed Monetary Policy Advisory Committee (MPAC). The six comprise two women. Four are economists and two senior members of the financial sector in Kenya. In addition to these six members, the MPAC also consisted of the Governor of the Central Bank of Kenya (Chairman of the MPAC), the Deputy Governor and a representative of the Treasury. Following their formal appointment the Committee set to work by defining its role and deliverables and set a structure for the effective execution of its functions.

It was agreed that in compliance with the legal mandate of the MPAC, a formal meeting to review the Central Bank Rate (CBR) would be held every two months and that a statement of the outcome of that meeting would be provided to the Board for release to the press soon after. It was also agreed that the MPAC was required to provide the Minister of Finance with a bi-annual report on the monetary policy strategy. This report would be presented by the Minister to Parliament. The Committee was of the view that in order to stay up to date with events in the economy, and to carry out the relevant research, it would meet informally twice per month to discuss issues and set policy direction. These informal meetings commenced on 3rd May 2007. Based on international practice, the MPAC created an indicator table. The items in this table are considered to be vital economic indicators of the health, or otherwise, of the Kenyan economy. With over 150 items that were continuously updated, the indicator table informed the Committee's deliberations.

Work done by the MPAC

The first and most pressing issue that was required to be determined was whether the CBR should be a signaling or pricing instrument. After much debate and consideration of the wording of the law, it was agreed that it would be a signaling instrument.

The next matter of significance was the structure in which monetary policy is implemented. The monetary programme is determined jointly by the Treasury and the Central Bank of Kenya. Yet the MPAC was responsible for advising on its implementation. It was agreed that there was a need to understand the working arrangement within the Central Bank and the models and assumptions under the monetary policy programme. On reviewing this structure the Committee raised issues with the framework which tended to be susceptible to distortions.

The MPAC was provided with a Secretariat from the Research Department of the Central Bank of Kenya which was responsible for co-coordinating, providing up-to-date information on the economy and staff and facilities for research. The previously mentioned indicator table was classified into segments. These segments covered the following areas: the real economy, public finance, the external sector, the money and banking sector, public debt and financial and capital markets.

Consideration was also given to stakeholders and how best to communicate with them. In particular it was important that they understood the concept and purpose of the CBR. This required that the stakeholders understood the information provided and also how best to process it.

It was also considered useful for the MPAC members to carry out some study tours to other countries to assess the effectiveness of the MPAC / MPC in those countries and therefore improve on the structure that they were developing.

During the life of the MPAC various studies were carried out on the Currency Outside of Banks, the Exchange Rate, the Money Multiplier, the Transmission Mechanism of Monetary Policy, the Impact of the Microfinance Act, and inflation and growth. In addition meetings were held with the IMF, The Nairobi Stock Exchange and the Chief Economist of the World Bank. In August 2007 a retreat was held in Naivasha to review the various studies.

Besides the above stated work, the MPAC also reviewed the effectiveness of the repo (repurchase agreement operation) in managing liquidity and the direction of monetary policy. As a result of this work several changes were made to the repo and a horizontal repo was proposed for the market.

The MPAC was able to meet its legal obligations and provided the Bi-Annual reports as required. They also held their formal meeting every two months and deliberated on the CBR given the state of the Kenyan economy. These meetings were followed with a formal statement by the Central Bank. The format of these meetings and the statements that were subsequently issued were designed and revised during this period.

In June 2007 it became evident that the Government now wished to re-engineer the MPAC into a fully functioning MPC with responsibility for the implementation of monetary policy. This was legislated for in the 2007 Finance Act. The existing MPAC finalized their outstanding reports and completed work that had been commenced. They also prepared a paper advising on the best structure for the MPC.

The Next Development; the MPC

The last role of the MPAC was therefore to study other MPAC/MPC operating around the world and advise on a suitable structure for the Kenyan MPC. The MPAC consulted with and studied the MPAC/MPC operating in the UK, South Africa, Botswana and New Zealand. It had also requested data from Malaysia but was unable to obtain the data on time. However, it was able to meet with the Deputy Governor of the Bank of Sweden and discuss the structure and responsibilities of the Swedish Monetary Policy Committee.

What became evident from this study was that the Kenyan structure was in fact ahead of other markets in many respects. Most monetary committees were advisory and were made up of individuals working within their respective Central Banks. Their MPCs/MPACs were therefore an extension of existing job descriptions. In this sense they lacked the independence of a fully functional monetary policy committee. Sweden had the most independent Monetary Policy Committee which is elected by, and reports directly to the Swedish Parliament. The Bank of England had a modified version of the Swedish model and was more in line with what was envisaged by the Kenyan legislation. It was this model that secured the best base for the Kenya MPAC to study and examine as a future structure of the new Kenyan MPC. The roles and responsibilities of the English MPC are more or less the same as those designed for Kenya. In the UK the MPC included external members drawn from the academia, the Union movement and Business. They are identified with respect to their expertise in a particular aspect of the economy. They have three year contracts that are renewable, they operate independently while expressing their views freely. It is believed that for the MPC to retain its independence that they should not interact with the Treasury and only for the purpose of understanding each other's views do they meet with the Board of the Central Bank. They achieve this by a set formal meetings every quarter. The Minister of Finance appoints the MPC.

In a report to the Governor of 21st December 2007, the last role of the MPAC was to provide him with recommendations for the structure of the new MPC. This covered the research resources, reporting lines, secretariat, communication, and interaction with stakeholders.

The MPC

By Gazette Notice 3771 on 30th April 2008, the MPC was appointed to serve for three years as required by the Central Bank of Kenya Act. The fact that all the four external members appointed to the MPC were previously members of the MPAC allowed for continuity.

An informal meeting was held with the Governor (as Chairman) and MPC members in May 2007. At this meeting, the legal appointment of the MPC was discussed and the role and responsibilities considered. In addition, it was agreed that this job has a much bigger role than that of the MPAC and therefore would require at least 50 percent of a member's working time. It was therefore expected that the MPC members would spend a considerable amount of their working hours at the Central Bank of Kenya. It was also agreed at that meeting that the MPC would have two working meetings every week so as to ensure it remains up to date with financial market and economic issues, as well as coordinating its work.

The first formal meeting of the MPC was held on 9th June 2007 during which the Committee reviewed the state of the economy and noted highlights of the MPC Economic Indicator Table. The details of the meetings of the MPC are given below but here it is sufficient to note that the meeting focused on the pressures in the economy from the Safaricom IPO and its consequential effects on liquidity; the meeting commissioned studies to understand the persistence of high inflation and the impact of the financial crisis undermining the developed economies.

The MPC carried out the following work in the period under review.

- Review of the 2007/08 National Budget;
- Determination of the CBR and reviews of the impact of the CBR decisions;
- Prepared a comprehensive report on the Safaricom IPO;
- Continual review and reporting on the state of the economy including pending or pertinent current and future events and their likely impact on it;
- Commissioned inflation and stability studies;
- Reviewed the 2008 Annual Economic Survey;
- Review of the Vision 2030 development plan;
- Preparation of the MPC strategic work plan;
- Review of the current Government and IMF monetary programme;
- Dealing with ad hoc requests from the Governor's office;
- Finalisation of the last report of the MPAC;
- Conducted stakeholder meetings;
- Attendance and presentation to stakeholders;
- Monitoring and reporting on the Global financial crises;
- Monitoring and interpreting exchange rate movements;
- Monitoring and interpreting interest rate movements and balance of payments dynamics;
- Monitoring of inflation rates and considering reformation of computational modalities;
- Monitoring of market liquidity

While this is not a comprehensive list it does give a good indication of the working of the MPC from May to October 2008 - the first six months of its existence.

4. THE ECONOMIC STATUS AND FINANCIAL SECTOR DEVELOPMENT

The establishment of the MPC came at a time when the economy was feeling the aftermath of the post-election violence and the advent of the Safaricom IPO which saw liquidity shifts in the financial sector. At the same time the economy felt the impact of the rising oil prices. The incipient international financial crisis was yet in the making. These factors which saw heightened uncertainty, skewed distribution of liquidity in the financial sector, rising energy and transport costs and volatility in exchange rates dictated the decision making process of the Monetary Policy Committee over the succeeding months. The MPC decisions were generally aimed at restoring and sustaining confidence in economic activities.

Economic Growth with Internal and External Shocks

Sustaining public confidence was a major focus as the economy experienced external and internal shocks that saw a decline in output in key sectors, that were adversely affected by displacement of farmers and workers, and rising production costs especially energy and transport costs. Consequently, the output gap widened and inflation reached a high of 31%. The highest in a decade. But computational problems with the index gave rise to an upward bias.

The first quarter of the year saw the economy at its lowest economic growth since 2003 with the post-election violence halting many of the areas of the economic activities. This was a temporary shock as the economy rebounded in the second quarter (Table 1). Among the sectors that were adversely affected was the agricultural sector which saw a negative growth in the first quarter. Because of this, the economy experienced food shortages and a threat to lay-off workers to reduce costs. Given that the economy relies heavily on the agricultural sector for its food supply, employment and exports, a quick recovery of the sector was desirable.

Tourism is always very sensitive to the political situation and hence the sector saw a significant decline in the tourist arrivals particularly at Mombasa. Building and construction was not significantly affected, an indication that there was confidence in the future of the economy. Similarly there was a continued build up of imported inventories.

Although the economy was facing significant challenges, no revisions were made to the monetary programme. This indicated that the economy was encountering merely a temporary shock. There were significant deviations of reserve money from its target growth in the first quarter of the year but with the initiation of the sale of Safaricom IPO, the gap narrowed.

Table 1: 12-Month Economic Growth by Sector (percent)

	2007				2008		
	to Mar	**to Jun**	**to Sep**	**to Dec**	**to Mar**	**to Jun**	**to Sep**
Real GDP	6.90	7.60	7.00	7.00	4.80	3.50	2.40
Agriculture	6.40	5.80	3.90	2.30	-0.80	-0.60	-1.80
Transport & communication	9.10	8.90	10.00	14.90	11.80	7.20	3.80
Manufacturing	5.80	6.70	6.40	6.20	5.00	3.80	1.80
Tourism (Hotels and Restaurants)	17.80	24.60	21.40	16.30	-5.40	-20.10	-31.90
Building and construction	3.10	4.40	7.80	6.90	11.20	17.40	22.60
Financial services	6.00	5.80	6.20	6.40	6.60	7.20	6.80
Electricity & Water	0.50	3.80	7.00	9.20	10.20	8.40	6.40
Trade	11.70	12.10	9.70	11.50	8.20	6.20	6.00

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

Liquidity Management with the Safaricom IPO

The Safaricom IPO was oversubscribed by a factor of over four, and diverted temporarily more than 20 percent of the total money supply. The banking sector witnessed significant shifts in deposits which resulted in a skewed distribution of liquidity in favour of the receiving banks at the expense of the rest of the commercial banks. As shown in Table 2, the CBK therefore participated in Open Market Operations (OMO) both to mop-up (from banks with liquidity) as well as to inject liquidity (to assist banks without liquidity). This therefore provided support for banks that were experiencing liquidity shortfalls and mopped liquidity from banks with excess reserves. The mop-up operations of the Central Bank, however, was constrained by the Ksh 34.9 billion worth of repurchase agreements securities at the disposal of CBK. The Bank, therefore, introduced the Term Auction Deposit Facility (TAD) to the market as an additional OMO instrument on 30th April 2008. The TAD facility was active in May and June 2008 when it was used to mop up a total of Ksh 11.8 billion and Ksh 43.6 billion in these months respectively.

Repo market

The Central Bank had earlier sold foreign exchange worth $100m for monetary policy purposes. This was occasioned by the REPO office exchanging its stock of repo securities of $30m in February, $50m in March and $20m in April 2008. This complemented efforts of the Bank to mop up liquidity from the market.

The liquidity shifts in the banking sector saw an increased demand in the interbank market. Drawing on experience during the KENGEN IPO in April / May 2006, receiving banks agreed to an informal cap on the interbank rate of 1 percent below the CBR to prevent escalation of interest rates. The banks also agreed to open up credit lines beyond their normal customers. As shown in Chart 1, both the interbank rate and volumes traded rose especially with the opening of IPO in April. For the months of the IPO (till late July) volumes in excess of Ksh 20 billion were common compared with the previous experience of Ksh 5-7 billion daily.

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

	Reserve Money			OMO (REPO)			OMO (REVERSE REPO)			OMO (TAD)	
	Actual	Target	Deviation	Desired Mop Up	Actual Mop Up	Deviation	Amount Offered	Actual Injection	Deviation	Term Auction Deposits (Total)	Repo stock
Jan-08	150.90	138.20	12.70	3.90	4.50	0.60					17.80
Feb-08	148.90	137.20	11.70	6.30	7.40	1.10					33.30
Mar-08	150.40	139.20	11.20	8.40	6.60	-1.80					30.50
Apr-08	147.60	143.70	3.90	8.00	6.20	-1.80	4.00	3.60	-0.40		27.30
May-08	146.70	144.00	2.70	4.40	8.10	3.70	5.20	4.50	-0.70	11.80	26.20
Jun-08	149.10	144.20	4.90	2.80	4.70	1.90	5.60	5.60	0.00	43.60	24.00
Jul-08	152.70	146.90	5.80	1.40	2.50	1.10	2.60	2.50	-0.10		9.40
Aug-08	154.40	148.30	6.10	1.10	1.10	0.00	1.10	1.10	0.00		11.10
Sep-08	154.00	152.30	1.70	2.60	2.40	-0.20	0.00	0.00	0.00		7.90
Oct-08	156.60	155.30	1.30	2.70	1.50	-1.20	0.00	0.00	0.00		3.30

Source: *Central Bank of Kenya*

Central Bank Rate (CBR)

The CBR was raised from 8.75 percent to 9.00 percent on 5th June 2008 in response to the changing liquidity situation arising from the Safaricom IPO. The rate remained unchanged in the 6th August 2008 and 29th September 2008 meetings.

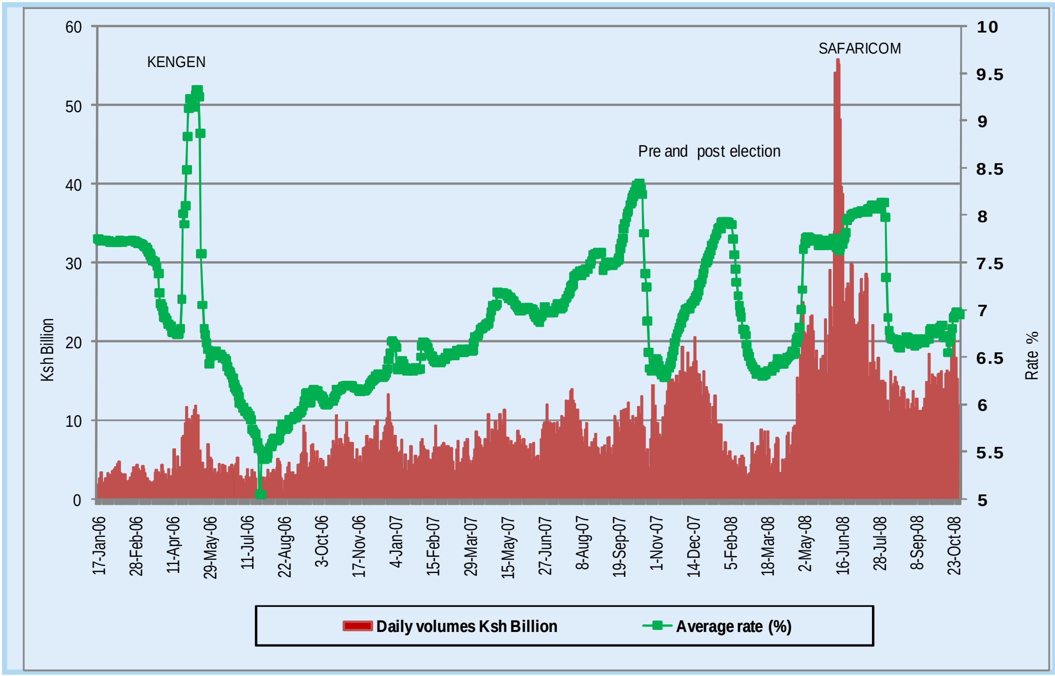
The Interbank Market

With the removal of the cap in early July while repo rates declined, the receiving banks proceeded to push the interbank rate up only to find a rapid fall off in volumes demanded since the Central Bank was providing an alternative source of support. As will be noted, the interbank rate then followed the repo rate down but the volumes seem to have established a new plateau above Ksh. 10 billion.

The banks having recourse to the interbank market changed significantly in the period covered by this report. During the IPO, it was the small banks which had temporarily lost some of their deposit base but from July onwards, it was the large banks which accounted for more than 70 percent of the volume loaned.

In an effort to deepen the market, the horizontal repo was launched on 12th September 2008. Consequently, commercial banks undertook the signing of agreements among themselves. A pilot survey was undertaken to inform the process adequately before it was officially launched.

Chart 1: Interbank daily Volumes and Interest Rates



Source: Central Bank of Kenya

Treasury bill market

The Treasury bill market saw a declining trend in the level of subscription with a shift in preference for short term returns. The expectation for the investors was that they would receive a high return on their investment as had been experienced during the KENGEN IPO. The banks with their customer deposits coming down had very little to invest in Treasury bills. The banks which were holding liquidity preferred the interbank and repo market. It is noteworthy that in addition to the withdrawal of deposits, banks also lent money to investors to facilitate their participation in the IPO.

As a result of the IPO tying up liquidity, there was a significant impact on subscriptions for Treasury bills. While the initial period of 2008 saw a subscription rate of 97 percent, during the IPO the subscription rate declined to an average of 69 percent.

In order to interpret the behaviour in the Treasury securities market, the Committee noted that it is important to understand competing products' characteristics since those entering the market have them in mind.

a) Treasury bills: both 91 day and 182 day, count toward bank's liquidity ratio. They can be discounted at the penalty window in the Bank.

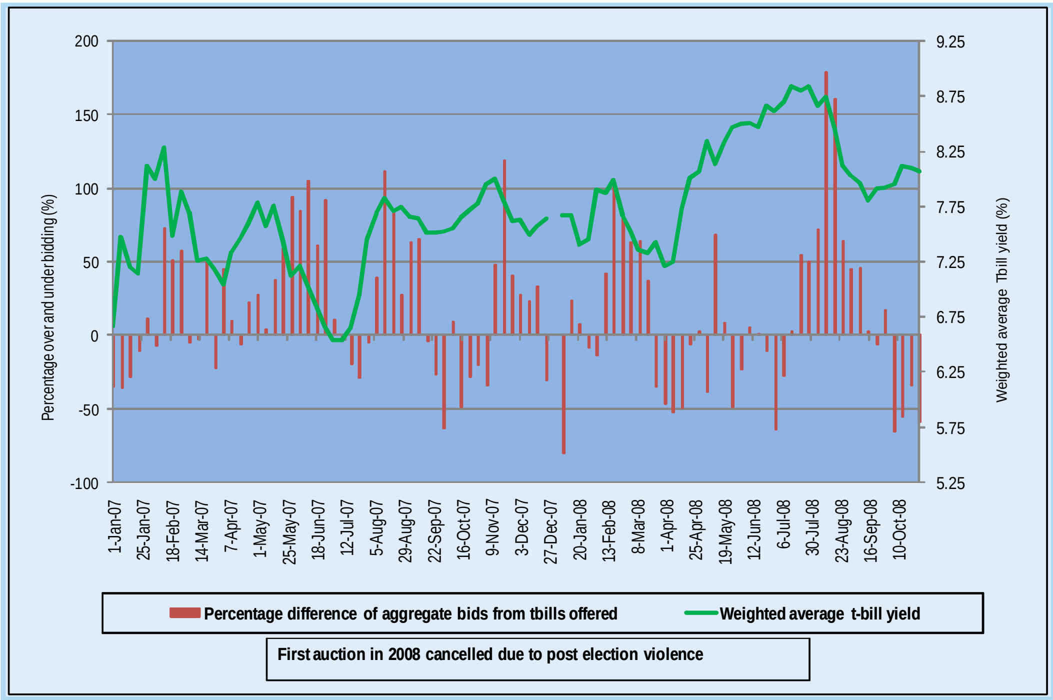
b) Treasury bonds have various maturities and coupon rates. They can be in the Nairobi Stock Exchange or the secondary market hence, do not lock up liquidity.

c) Special bonds cannot be traded. These are mainly issued to clear pending bills.

d) Repo bills are offered for sale – usually daily – from the stock held by the Bank. Those bidding quote a price and tenor. The minimum tenor is 3 days to avoid warehousing surplus cash overnight. The maximum tenor is 90 days.

The short end of the yield curve therefore comprises of the interbank overnight rate, the repo rate and the 91 day Treasury bill yield. Those with loanable funds, given their knowledge of their time-bound liquidity requirements, bid as noted in the chart below. Where there is an excess demand for funds i.e. underbidding, the average rates tend to rise, equally when there is an excess supply of loanable funds the rates fall (Chart 2). The actual supply of loanable fund relate to many factors such as: the imminence of a tax-due date, an alternative such as an IPO, investment outlets and inflation.

Chart 2: Treasury Bills Weekly Auction Performance



Source: Central Bank of Kenya

The International Financial Crisis

There are various questions that can be usefully asked in reviewing the present international, financially-triggered economic crisis. Firstly, how did the institutions and instruments develop? And secondly, at what point did abuse enter? The third question is of a more nuts and bolts nature, the modalities of meltdown.

The Origins of the Crisis

The first question requires a philosophical and historical answer. In the early 1970s when the world was emerging from one of its periodic dollar shocks, the zeitgeist was to encourage liberal laissez-faire capitalism by either removing or reducing controls. In that era development banks separated themselves from the rigors of Central Banks' supervision.

In order for liberalised markets to function efficiently two major requirements were to reduce risk and curtail uncertainty. To achieve these, derivatives came to prominence as devices for spreading risk while rating agencies undertook the verification of the credibility of potential investments.

The stage was now laid for abuse. If the rating agencies failed to detect on a timely basis deterioration in risk products then, when they did signal, it was more in the nature of a massive step down than an adjustment. Likewise, the phenomenon of layered derivatives made it more and more complex to actually evaluate either the risk being underwritten or the economic health of whatever realities underpinned the paper assets. Like a massive Ponzi Scheme as long as new buyers of new paper could be found, the self advertisement of profitability swept the financial sector away from reality and it was only when the viability of that underlying reality was questioned that the pyramid scheme collapsed with inevitable losses.

The mundane mechanics of the way in which the present crisis grew in the matrix of instruments and institutions just discussed, is straight forward. A downturn in the US economy in January 2001 led to a perfectly normal policy response: lower interest rates to stimulate investment. As would be expected, housing finance was indeed one of the most active areas. The mortgage finance corporations took increased risk because they knew they could layoff most of it through derivatives – mortgage backed assets (MBA). Less stringent standards were applied to assess a borrower's ability to repay and down payments were reduced as it was assumed that loans would be protected by the increasing property values. An oversupply of houses resulted instead in falling property prices.

The rating agencies had been rating the MBA as A or A+ and hence finance houses from banks and insurance companies to pension funds had bought into them. Furthermore, the unsupervised investment banks continued issuing more complex derivatives making reality more remote. So widespread were these practices hence the collapse, when it came, spread rapidly and internationally.

The Structure of the Kenya Economy

Any time that one tries to describe the structure of the Kenyan economy, one is trapped by the abundance of data that describes the activity of about 10 percent of the work force. The other 90 percent is more sketchily depicted in case studies and anecdotes. This division is normally presented as the formal and informal sectors.

Some approaches to structural analysis rely on sectoral contributions to the Gross Domestic Product; others seek to allocate labour to occupations. Some even try to disaggregate revenue contributions arguing that taxation data provides insights into the structure of an economy. This report is less ambitious. It rather follows a logic that monetary policy should impinge on people's welfare and therefore it is where the people are and what they do that best describes the economy's structure for our purpose.

In 2007, some 9.5 million were identified as employed (including self employment). This total does not include an estimated 7 million occupied in informal agricultural and pastoral pursuits. Of the 9.5 million, 1.9 million were in the formal sector. Since 2003, when the economy started to recover, formal sector employment has grown by 10.1 percent while the informal sector's contribution to employment grew by 30.8 percent. Within the formal sector the private sector contributed 1.3 million jobs - growing from 1.1 million in 2003. Within the public sector's 625,300 employees some 192,200 were in Central Government and 234,600 in the Teachers Service Commission. Between the public and the private sectors 349,900 were in agriculture and forestry. The private sector employs roughly another 100,000 teachers.

The informal sector employment is split – 61 percent rural and 39 percent urban (bearing in mind that urban centres can be as small as 5,000 people or less than 1,000 families).

These numbers can be backed with other macroeconomic data but they do not change the picture: Kenya is primarily a rural, agro-based economy with a small minority directly interfacing with the developed world. Such high profile industries as tourism have very little penetration to the vast majority of Kenyans. While education and access to the rapidly multiplying modes of social communication will undoubtedly give rise to cultural change it is most unlikely that international economic turbulences will have little more effect than the great Depression of the 1930s. In that economic disaster, it was the immigrant communities – who were the analog of the present formal sector – who suffered.

Given the essentially rural nature of Kenya's economy recent developments in telephony have enabled many to start considering more commercially oriented activity: the information uncertainty has been reduced. Furthermore, access to funds and outlets to mobilise resources have expanded significantly. All these developments which have lowered transactions costs are themselves independent of world economic events.

Maintaining Price Stability

The Monetary Authority has, as its primary responsibility the maintenance of stable prices. However, it can only effectively influence demand pull inflation which reflects on too much money in the economy relative to goods and services available. But containing money supply growth has only a limited effect on supply or cost push factors which have permanent effects on prices. The period under review experienced a significant increase in inflation moving from 12.03 percent in December 2007 to 31.54 percent in May 2008 which was the highest in the past decade (Table 3). The rise in the overall inflation was attributed mainly to food and oil prices which are supply driven.

Table 3: Various Measures of Inflation (percent)

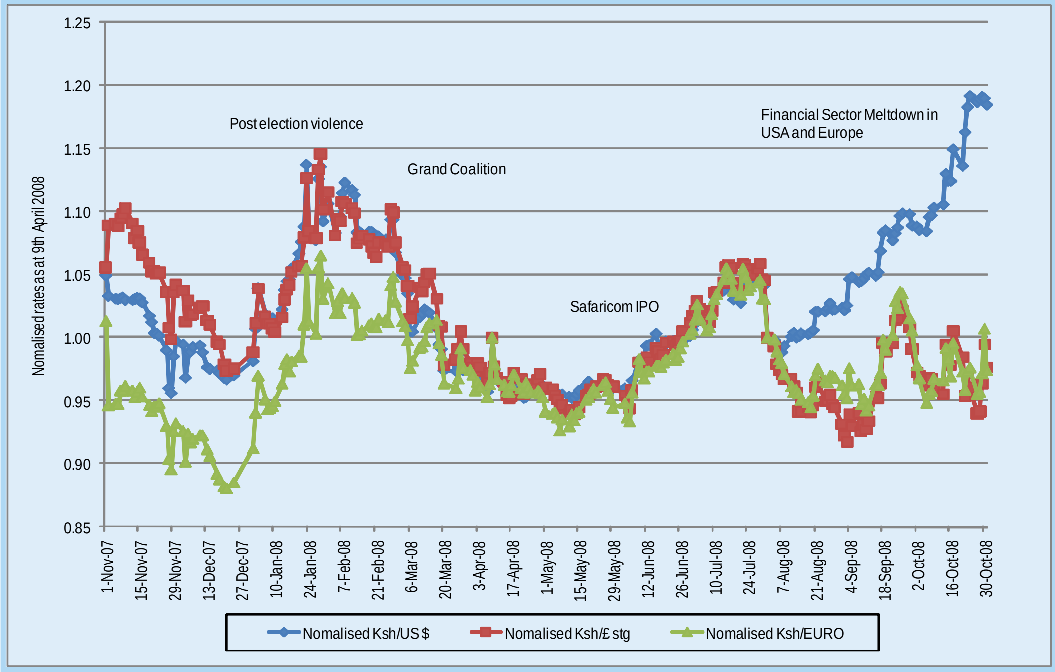
	12-month overall inflation	12-month underlying inflation	"Food and non-alcoholic	Contribution of food inflation to	"Fuel and power" inflation	Oil prices $ per bbl	Middle/upper 12 month overall inflation
Jan-07	9.67	5.15	11.80	61.37	12.80	54.85	5.34
Feb-07	6.81	4.92	7.20	53.49	11.50	58.75	4.76
Mar-07	5.87	5.13	5.70	49.18	10.90	62.10	3.43
Apr-07	5.66	5.03	5.50	49.28	10.50	67.60	3.14
May-07	6.33	5.22	6.70	53.42	8.60	68.40	4.51
Jun-07	11.00	4.90	15.00	68.16	8.50	69.70	7.44
Jul-07	13.56	5.46	18.90	70.45	8.70	73.70	9.04
Aug-07	12.37	5.06	17.20	70.37	7.00	71.75	8.27
Sep-07	11.72	5.34	16.10	69.35	6.30	78.55	10.10
Oct-07	10.55	5.41	14.03	67.16	5.90	81.80	10.15
Nov-07	11.83	5.30	15.72	67.10	5.70	91.75	9.80
Dec-07	12.03	5.25	15.86	66.54	5.70	90.60	9.61
Jan-08	18.22	5.07	24.62	68.22	10.60	92.25	9.63
Feb-08	19.13	6.64	24.91	65.75	14.10	95.10	10.14
Mar-08	21.83	6.98	28.82	66.67	15.60	102.20	12.51
Apr-08	26.63	6.54	36.81	69.82	15.40	109.35	14.59
May-08	31.54	7.24	44.21	70.79	17.90	125.75	17.53
Jun-08	29.26	7.60	40.06	69.13	20.10	134.00	16.01
Jul-08	26.50	7.62	35.10	66.80	27.00	137.35	14.95
Aug-08	27.58	8.23	36.35	66.57	30.80	117.50	14.68
Sep-08	28.24	8.59	37.16	66.47	31.57	98.05	13.57
Oct-08	28.43	8.67	37.63	66.83	28.79	69.25	14.27

Source: Kenya National Bureau of Statistics

Exchange Rate Management

The movements in exchange rates reflected both internal and external factors. For example, the market witnessed significant depreciation of the shilling against major currencies in response to the post election violence (Chart 3). The situation changed as the shilling appreciated during the Safaricom IPO with huge inflows of foreign currency (or preference for the local currency) as the purchase of the IPO was underway. However, the situation changed when the IPO started trading at the stock market, the shilling depreciated as the market witnessed an outflow of capital increasing the demand for currency.

Chart 3: Exchange Rates (Normalised to 1 on 9th April, 2008)



Source: Computations based on data from Central Bank of Kenya

As the world witnessed the meltdown in US economy, the first round effects were experienced with the dollar appreciating against other major currencies. As a result the economy felt a significant depreciation of the shilling against the dollar. However, the situation was compounded by speculative behavior among banking institutions. These threatened the international competitiveness as the real exchange rate appreciated.

The CBK responded by selling $50m to reduce the rate of depreciation (Table 4). The sale was done in two batches, $20m in September and $30 in October 2008. The Central Bank has continued to use its bear endevours as required by the Act to maintain four month average import cover. The commercial banks dominated the share of the official exchange rate reserves increasing from about 25 percent in January-March to 40 percent in June-July period when the IPO inflows were prevalent.

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

	Jan-08	Feb-08	Mar-08	Apr-08	May-08	Jun-08	Jul-08	Aug-08	Sep-08	Oct-08
Gross Reserves										
Official	3522.00	3460.00	3422.00	3390.00	3435.00	3445.00	3439.00	3263.00	3151.00	2928.00
Commercial Banks	1055.00	1090.00	1321.00	1587.00	1809.00	2341.00	2177.00	2023.00	1861.00	1807.00
Imports cover (36 months)	4.98	4.80	4.68	4.58	4.56	4.53	4.41	4.11	3.97	3.55
Interventions										
Interbank purchases	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Interbank sales	0.00	30.00	50.00	20.00	0.00	0.00	0.00	0.00	20.00	30.00

Source: Central Bank of Kenya

Expanded Space for Access to Financial Services

The MPC noted that the mushrooming M-Pesa services are revolutionising the money transfer service product using technological innovation. The services are provided to the non-banked with partial access to financial services. The Committee therefore noted that it is important to watch the implications of these developments on the money velocity, an important component in the monetary programme framework. An immediate area to consider is the prudential regulations to guide the operations of the money transfer services.

Commercial Banks' Inter Rates

Commercial bank lending rates have implications on the amount of loans borrowed by the private and public sector and therefore the expansion of economic activities with investment growth. During the period, some banks revised their base lending rate arguing for the need to maintain their profit margin in the face of rising inflation and retain a positive interest earning in real terms. However, as they became convinced that their action would feed into the inflationary pressure through increased cost of fund, some of them rescinded the decision. Consequently, the overall lending rate declined from 14.06 percent in June 2008 to 13.66 percent in September 2008 (Table 5). A major factor that threatened the loans market was the post-election violence which challenged repayment of loans as economic performance was uncertain.

Table 5: Commercial Banks Interest Rates

	Jan-08	Feb-08	Mar-08	Apr-08	May-08	Jun-08	Jul-08	Aug-08	Sep-08	Oct-08
AVERAGE DEPOSIT RATE (percent)										
Overall Weighted Rate	4.37	4.37	4.35	4.41	4.45	4.48	4.54	4.65	4.62	4.65
Demand	1.37	1.37	1.37	2.04	2.28	1.45	1.33	1.57	1.53	1.39
0-3months	5.10	5.11	5.21	5.10	5.14	5.18	5.24	5.39	5.19	5.39
Over 3months	6.28	6.28	6.11	6.42	6.50	6.55	6.70	6.88	6.94	6.82
Savings	1.72	1.70	1.72	1.71	1.71	1.70	1.67	1.68	1.73	1.74
AVERAGE LENDING RATE (percent)										
Overall Weighted Rate	13.78	13.84	14.06	13.91	14.01	14.06	13.90	13.66	13.66	14.12
Corporate rate	12.32	12.28	12.84	12.76	12.80	12.81	12.97	12.76	12.89	13.25
Business rate	14.30	14.62	14.53	14.56	14.52	14.55	13.39	13.57	13.34	14.33
Personal rate	15.78	16.02	15.72	15.34	15.51	15.47	15.65	15.51	15.45	15.2
Spread	9.41	9.47	9.72	9.50	9.56	9.58	9.37	9.01	9.04	9.47

Source: *Central Bank of Kenya*

5. MPC MEETINGS

During the first six months of its existence the Monetary Policy Committee reviewed the Central Bank Rate (CBR) guided by the economic situation and the liquidity position in the market. Efforts were made to ensure that the market remained liquid and that the monetary policy supported the economic growth process. Following each meeting, the MPC prepared a summary Press Release giving the CBR decision and a limited background to the decision. But within 48 hours, the MPC issued a comprehensive Press Release which provided a detailed overview of key development that affected monetary policy and therefore informed the decision by the

Committee. These critical examinations of the economic environment have been provided to the press every two months.

First Meeting, 5th June 2008

The key factors considered in making the decision at the first meeting in June 2008 included the following. The rising inflation, which was predominately driven by factors outside of monetary control; the skewed distribution of liquidity in the market following the Safaricom IPO; the government's role in the economic restoration process and finally the fiscal dynamics as the government entered a new fiscal year with enlarged demands on its resources.

The Monetary Policy Committee raised the CBR from 8.75 percent to 9.0 percent and set itself to monitor the Safaricom IPO liquidity so as to assess its impact on both the real and nominal economy. In addition it agreed to monitor the exchange rate effects as well as the oil price. Although outside the Central Bank control, it was noted that these changes have an impact on the balance of payments and will have a knock on effects on the money supply.

Second Meeting, 6th August 2008

The second meeting held in August 2008 noted the pre-emptive actions that the Bank was taking to cushion the instability in the financial sector that might have arisen due to significant movements of liquidity in the banking system. A development resulting from the unprecedented and massive IPO had in a developing economy. The Bank's flexibility in its monetary policy operations and the carefully determined guidance of the financial markets during this period provided the economy with necessary liquidity and unprecedented leadership in the financial sector. This ensured financial stability and provided lessons for the future management of monetary policy not only for Kenya but other monetary authorities elsewhere which might experience similar episodes. As the sector returns to normalcy, the Committee expects the Bank to redirect its focus and resources on taming inflation which still remains at unacceptable levels.

The Committee concluded that the stance adopted at its previous meeting was still valid. It therefore retained the CBR at 9 percent indicating a continued need for tightened liquidity. The Committee requested the Bank to use other instruments at its disposal to help ease the inflationary pressure in the economy.

Third Meeting, 29th September 2008

At its third meeting in September 2008, while considering what action to chart monetary policy to meet the Bank's objectives for the near future, the Committee took note of the developments in the domestic and international markets as discussed previously. It took comfort in the fact that there was no liquidity overhang in the system as the Bank was on its reserve money path. Despite these remarkable achievements, the Committee was still of the view that the levels of inflation are unacceptably high albeit driven by factors beyond its control. In addition there was inflationary pressure in the economies of Kenya's trading partners which together with the instability in the financial system in the US, Europe and elsewhere meant that, there was both a need for analysis of the mode in which international events transmit to Kenya's economy as well as a sensitive early warning system to allow timely decisions.

Despite the positive news on economic performance from the second quarter data, the Committee noted the imminent downside risks to growth and the upside risks to inflation. The Committee was to continue monitoring economic and financial developments and act as needed to promote sustainable economic growth and price stability. Going forward, the Committee evaluated the instruments at the Bank's disposal and was satisfied with their availability and scope to ease inflationary pressures. Using the open market operations, the Bank could still tighten monetary policy. By doing that, domestic assets could become more attractive to domestic and foreign investors. A tightened monetary policy environment would also help dampen depreciation fears and stabilise the exchange rates movements.

Considering the balance of prospects and risks the Committee decided to retain the CBR at 9 percent. At this rate the Central Bank was to deepen its open market operations to effectively manage market liquidity. It was also to continue to vigilantly monitor the international developments and their possible impacts on the domestic market.

Planned Activities for the Next Six Months

The immediate challenge in the next six months is the impact of the global financial crises on the domestic economy. Monetary policy must remain focused on supporting the growth process and efforts to cushion the economy. Among the proposed ways forward with the global financial crises include coordination of policies at both the local and regional level. For monetary policy the following are crucial issues which will be considered. Each of these will be backed by informal meetings with knowledgeable stakeholders so as to ensure that decisions based on these studies will be well informed.

As the economies move towards regional integration it means that the effectiveness of the monetary policy will depend on the coordination of the policy issues. Thus it will be important to relook at the monetary policy operations in Kenya and the region at large and the activities that need to be taken into consideration. Thus in the analysis of the monetary policy framework focus will be the operations of monetary policy now and the support that it would give to the development process and the issues at the regional level.

Money Market Deepening

The money market operations will be significant to support for example the infrastructure bond. The option of sustaining low interest rates will be important and also the confidence in risk preference especially for the long term bonds. Structuring of the Government debt is crucial.

Financial Sector Stability

The success of monetary policy depends on the ability to transmit the signals correctly. A major factor to consider is the stability of the financial sector and the future developments and how they facilitate the operations of monetary policy. There is a lot of technological development in the market and taking pro-active actions will be crucial. It is important to re-think the financial structure we intend to have in the future and implications of a financial hub to the monetary policy operations.

Payment System

Payment system effectiveness and efficiency determine the ability of the monetary authority to monitor the operations in the financial sector, the current experience with the global financial crises and the capital movements, the issues of transfers from outside and inside the country, and money laundering.

Interest Rate structure & Spread

Interest rates are still a major factor that continues to keep the investors on their toes. The spread on interest rates is a challenge and therefore needs to be continually monitored.

Commun-ication Channel

For the MPC to be effective, it is necessary that the private sector is fully informed on the rationale of its decisions. This can be done effectively by informal meetings with the stakeholders and interactions with the media. Among the stakeholders, the relevant Parliamentary committees are critical. Private sector meetings will be held with groups with common interests rather than larger groups which can easily lose critical focus.
At the time of the preparation of the Central Bank's submission to Treasury for consideration for incorporation in the annual budget, the MPC will view institutional/Legal considerations as well as directions on macro valuables which would support its monetary targets to attain economic ends.

The MPC will take a pro-active role with respect to the media rather than merely reacting to information being provided by the press, radio and television.

Supportive Actions by Other Agencies

To address high inflation and accelerate economic growth the Government has initiated various policy actions:

a. **Treasury and Ministry of Energy**

- The Government has used moral suasion to persuade oil companies to respond to the decline in the world oil prices;
- The Ministry of Finance has reduced VAT on petroleum products;
- Electricity tariffs have been reviewed with a view to making power affordable;
- The National Oil Corporation will expand its outlets so as to offer an advantage of concessional prices and increased competition in the oil distribution industry;
- Increase import quota for National Oil Corporation to about 30 percent;
- Increase capacity of strategic oil reserves to smooth out supply of petroleum products;
- Diversification to other sources of energy such as bio-fuel and increase geothermal expansion.

b. **Ministry of Agriculture**

- Funding from African Development Bank (ADB) to import fertilisers to be distributed at competitive prices by National Cereals and Produce Board (NCPD) –expected to lower cost push inflation;
- Importation of cereals including maize to smooth supply and to moderate prices;
- Provide seeds and fertilisers to farmers;
- Price reduction and waiver of taxes on foodstuff prices.

6. CONCLUSION

This, the first report of the Monetary Policy Committee which spans the period from May to October 2008 has been eventful. It covers the Kenyan economy in a period of post election violence, the largest IPO in the history of the country and the gathering storm of a global financial crisis. During this period the MPC commenced the process of setting its procedures and structures to facilitate its operations to meet its mandate. This process of evolution ensures that the MPC is both effective, has the greatest impact, and will continue for some time. The MPC has plans in early 2009 to visit the central banks of appropriate countries to learn more about their MPCs' mandates and how this is effected, to assess their responses to the global financial crisis and to understand their management of sovereign and infrastructural bonds.

During this period the MPC has been pro-active in its advise, guidance, analysis and reporting on major events affecting the Kenyan economy. In particular, it was able to guide and advise on the Safaricom IPO, the issues surrounding the persistence of high levels of inflation, and the likely impact of the global financial crisis. The Government sovereign bond and infrastructural bonds, levels of inflation and its computation, the balance of payments, exchange rates and the global financial crisis are likely to continue to be the Committee's main focus in the short to medium term.

GLOSSARY

Downturn

An economy has been on a relatively stable upward trend and encounters a shock which negatively destabilizes the trend. The expectation is that the economy will revert to the trend as the shock dissipates. A drought or earthquake for example could cause a downturn in a healthy economy.

Recession

The fundamental framework of the economy is disrupted causing businesses to cease re-ordering inventory. There may be temporary business closures while management teams assimilate the new economic environment.

Depression

Businesses go bankrupt and workers are laid off. The economy risks entering a low income trap where poverty curtails savings which would have been necessary for investment to stimulate a recovery.