SEVENTH

BI-ANNUAL REPORT OF THE

MONETARY POLICY COMMITTEE

CENTRAL BANK OF KENYA

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

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Letter of Transmittal to the Deputy Prime Minister and Minister for Finance

Honourable Minister,

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

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

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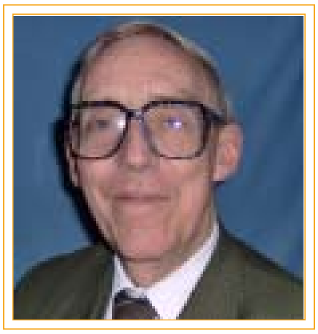

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EXECUTIVE SUMMARY

The seventh bi-annual Report of the Monetary Policy Committee (MPC) reviews Kenya's monetary policy formulation and economic developments during the six months to October 2011. A combination of both domestic and international economic developments during the period determined the conduct of monetary policy to achieve the Bank's overall mandate of price stability. These developments resulted in an escalation of inflationary pressure and exchange rate volatility, thereby jeopardising the economy's recovery from the adverse effects of the global financial crisis.

On the domestic scene, inflationary pressures peaked in response to increasing food prices and a strong pass-through of persistently high international oil prices. However, a strong domestic demand mainly driven by a rapid expansion in private sector credit during the six months to October 2011 also contributed to the inflationary pressures. Overall inflation increased from 12.05 percent in April 2011 to 18.91 percent in October 2011, and exceeded the revised Government target of 9 percent for the fiscal year 2011/12 and the medium term target of 5 percent throughout the period. Exchange rate depreciation also exerted pressure on inflation. The exchange rate of the Kenya Shilling against the US Dollar depreciated from Ksh 83.89 to Ksh 101.39 between April 2011 and October 2011. The depreciation of the Shilling against major currencies was attributed mainly to the build-up in the current account deficit due to a rise in imports of machinery and transport equipment necessary for the economic recovery process as well as uncertainty in the global financial markets that was caused by the debt crisis in the eurozone. This gave rise to currency wars as countries sought to maintain the competitiveness of their respective exports. Despite persistence of these domestic and external shocks, the economy remained resilient with real GDP growth averaging 4.2 percent in the first three quarters of 2011 from 4.9 percent in a similar period of 2010.

The MPC undertook a gradual tightening of monetary policy to rein in inflationary pressures and stabilise the exchange rate by raising the Central Bank Rate (CBR) from 6.00 percent in May 2011 to 7.00 percent in September 2011. In addition, the Cash Reserve Ratio (CRR) was raised from 4.50 percent to 4.75 percent during the period to reinforce the monetary policy stance. However, following persistence of the inflationary and exchange rate pressures for longer than was earlier anticipated, the MPC augmented the tightening of monetary policy in October 2011 by raising the CBR further to 11.00 percent. This upward adjustment of the CBR was expected to provide a signal to banks that interest rates should rise and therefore reduce the expansion in credit to private sector. At the same time, the MPC also reviewed the monetary policy operations of the Central Bank with a view to enhancing liquidity management and the effectiveness of the monetary policy measures that had been taken. These included measures to restrict access to the CBK Overnight Discount Window by commercial banks, and review of foreign exchange guidelines.

Going forward, the priority for monetary policy remains the control and stabilisation of inflation and inflationary expectations. The pursuit and attainment of these goals will ensure that the economic growth base is protected. The regular meetings and interactions between the MPC and key stakeholders were sustained to enhance the effectiveness of the transmission mechanism of monetary policy. The ongoing coordinated efforts by the Government to address the shortfalls on the supply side of the economy are expected to signal relief in the build-up of inflationary expectations and exchange rate pressures.

1. INTRODUCTION

The seventh bi-annual Report of the MPC covers the period May to October 2011. This period was characterised by persistent inflationary pressures and exchange rate volatility mainly attributed to both domestic and external shocks on the economy. Consequently, these developments had a strong impact on the conduct of monetary policy and thus the achievement of the Bank's overall mandate of price stability during the period.

High food and fuel prices contributed to a build-up in inflation to double digits between May 2011 and October 2011 compared with the low and stable single digits witnessed in a similar period of 2010. The food Consumer Price Index (CPI) index and increased from 129.9 in May 2011 to 140.4 in October 2011 while the fuel CPI index (comprising of transport and housing items) increased from 120.6 to 127.1 during the period. The increase in fuel inflation during the period was mainly attributed to high world oil prices (Murban) which remained above USD 100 per barrel. In addition, the exchange rate depreciation and volatility witnessed during the period exerted upward pressure on inflation. Consequently, overall inflation exceeded the Government's target of 9 percent in the fiscal year 2011/12 and 5 percent for the medium term. A combination of enhanced tightening of monetary policy and the implementation of additional measures to improve liquidity management by banks, and to guide the operations of the CBK Discount Window and foreign exchange market was therefore necessary as the Bank sought to achieve its core manadate of price stability.

In order to shape market expectations, it is important to understand the perceptions of the market on major macroeconomic variables. In this regard, the regular MPC market perception surveys were therefore important inputs in the Committee's decision making process. Other important forums include the regular interactions between the MPC with Chief Executive Officers of commercial banks. A comprehensive and up-to-date database of key economic indicators provided the base for informed MPC decisions. In this regard, the MPC continued to analyse high frequency data on its weekly and monthly indicators tables of key variables.

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

2. MONETARY POLICY FORMULATION

The principle objective of the CBK is to formulate and implement monetary policy directed to achieving and maintaining stability in the general level of prices in the economy. The price stability objective is necessary for enhancing investment and supporting economic growth and employment creation. In this regard, the CBK formulates monetary policy to achieve the inflation target set by the Minister for Finance. The inflation target for the fiscal year 2011/12 is 9 percent while that for the medium term is 5 percent. In the pursuit of this objective, the Bank has adopted a monetary policy framework that targets monetary aggregates consistent with the Government inflation target. The main instrument of monetary policy is the CBR which is reviewed and announced at least every month. The movements in the CBR, both in direction and magnitude, signals the monetary policy stance. These movements are reflected in changes in short-term interest rates. The monetary policy stance, as signalled by the movements in the CBR, is operationalised through open market operations, changes in cash reserve requirements at CBK, foreign exchange transactions, and the CBK Standing Facility (CBK Overnight Discount Window).

The MPC continued to pursue the monetary programme that was consistent with targets outlined in the Extended Credit Facility where the Net International Reserves (NIR) and Net Domestic Assets (NDA) were the quantitative performance criteria measures. The targets for NDA and NIR were set at USD 3,515 million and Ksh -49.9 billion, respectively, in June 2011 and USD 3,125 million and Ksh -40.0 billion, respectively, for December 2011. The actual outturn for NIR and NDA in June 2011 and October 2011 was within the set performance criteria targets. Consistent with the NIR and NDA targets, broad money supply (M3) annual growth was projected to decelerate from 16.8 percent in June 2011 to 15.9 percent in October 2011. However, following increased domestic credit to the private sector arising from increased domestic demand, annual growth in M3 accelerated from 15.2 percent to 20.8 percent during the period.

The MPC had intially adopted a gradual tightening of monetary policy to rein in inflationary pressures and stabilise the exchange rate by raising the Central Bank Rate (CBR) from 6.00 percent in May 2011 to 7.00 percent in September 2011. In addition, the Cash Reserve Ratio (CRR) was raised from 4.50 percent to 4.75 percent during the period to reinforce the monetary policy stance. However, following the unusual persistence of these inflationary and exchange rate pressures longer than was earlier anticipated, the MPC enhanced the tightening of monetary policy in October 2011 by raising the CBR further to 11.00 percent. The upward adjustment of the CBR was also expected to provide a signal to banks that interest rates should rise and therefore reduce expansion in credit to private sector. Consequently, the annual growth in private sector credit slowed down from 36.3 percent in September 2011 to 35.2 percent in October 2011 after accelerating rapidly from 27.4 percent in May 2011.

The MPC also reviewed monetary policy operations of the Bank between May 2011 and October 2011 with a view to enhancing liquidity managment and the effectiveness of the monetary policy measures that had been taken. These included measures to restrict access to the CBK Discount Window by banks, and review of foreign exchange guidelines. To facilitate commercial banks' liquidity management, the MPC decided that the banks maintain their Cash Reserve Ratio (CRR) based on a 30 day average with a floor of 3 percent. In order to establish the pivotal role of the CBR the MPC announced a new Monetary Policy Framework whereby all Central Bank Market Operations would be based on the Central Bank Rate (CBR) in order to enhance clarity and certainty. In this regard, all Central Bank injections of liquidity through Reverse Repo would be priced such that the CBR will be lowest acceptable rate. Likewise, CBK withdrawals of liquidity through vertical Repos would be priced such that the CBR will be the highest rate. Banks utilising the CBK Overnight Window would also be charged the CBR plus a high penalty while usage of the facility more than twice in a week would prompt the CBK to request for remedial actions. Lastly, the Bank agreed with Central Banks in the East Africa Community region to ensure that policy actions directed at dealing with the shocks on the economy were coordinated.

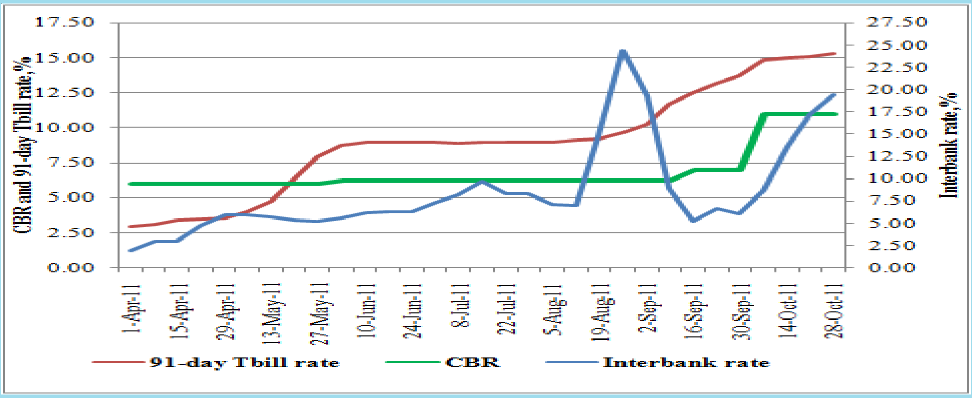
3. DEVELOPMENTS IN KEY ECONOMIC INDICATORS

3.1 INTEREST RATES

Short term interest rates increased gradually between May 2011 and October 2011 in line with the tight monetary policy stance adopted by the MPC since March 2011. Open market operations during the period were therefore generally restricted to liquidity tightening consistent with the monetary policy stance. Following the rise in the CBR to 11 percent in October 2011, the interbank rate increased rapidly from 2.23 percent in March 2011 to 21.77 percent in October 2011 indicating tight liquidity and structural factors in the market (Chart 1). The CBK occasionally provided liquidity to the market through reverse repos in order to stabilise the interbank rate.

The average 91-day Treasury bill rates also increased from 2.77 percent to 5.25 percent during the period. The upward pressure on short term interest rates was transmitted to the longer term commercial banks lending rates which increased, on average, from 13.92 percent to 14.79 percent in the period. As banks competed for deposits to ease liquidity constraints, the average deposit rates in the banking system increased, from 3.47 percent to 4.21 over the same period.

Chart 1: Weekly Average Short Term Interest Rates

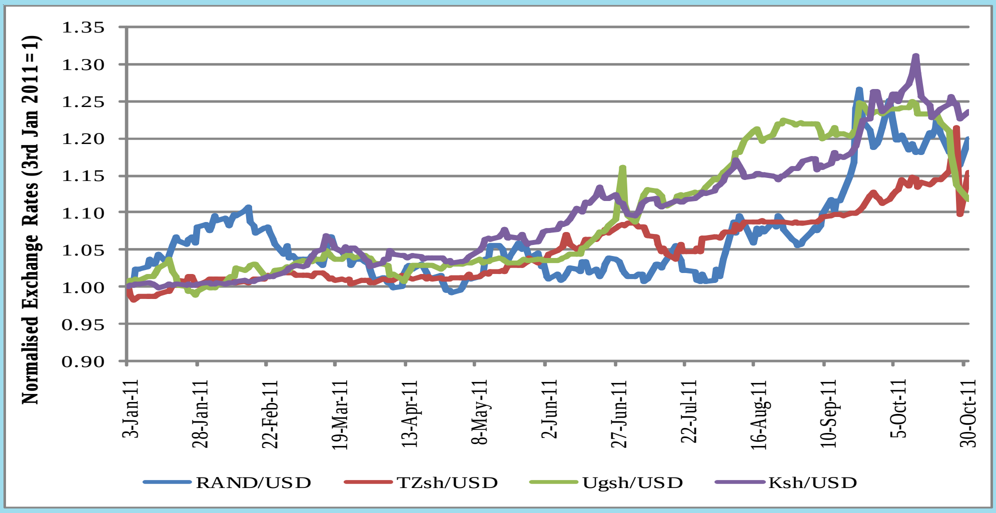


Source: Central Bank of Kenya

3.2 EXCHANGE RATES

The foreign exchange market witnessed signifcant volatility between May 2011 and October 2011 reflecting general volatility in the global financial markets as well as increased demand for foreign exchange to finance imports. As a result, the Kenya Shilling, like other currencies in the region and other global markets, weakened substantially. For instance, against the US Dollar, the Shilling depreciated from an average of Ksh 84.20 in March 2011 to Ksh 101.39 in October 2011, which is equivalent to 20.42 percent depreciation (Chart 2).

Chart 2: Currency Exchange Rates against the US dollar



Source: Central Bank of Kenya

The depreciation of the Kenya Shilling during the period was attributed to a number of reasons. First, following escalation of the eurozone debt crisis, there was uncertainty and a deterioration of the global financial markets. This resulted in strengthening of the US Dollar globally as investors shifted their portfolios to the currency which was perceived as a safe haven. Second, the persistence of the political instabilities in the Middle East and North African region constrained supply of crude oil in the international markets resulting in increases in the price of oil. These developments resulted in increased demand for US Dollars to finance oil imports thus creating pressure on the exchange rate. Specifically, the fuel import bill rose from 19.2 percent of the total cost of imports in January 2011 to peak at 31 percent in August 2011 thereby exerting pressure on the current account and available foreign exchange.

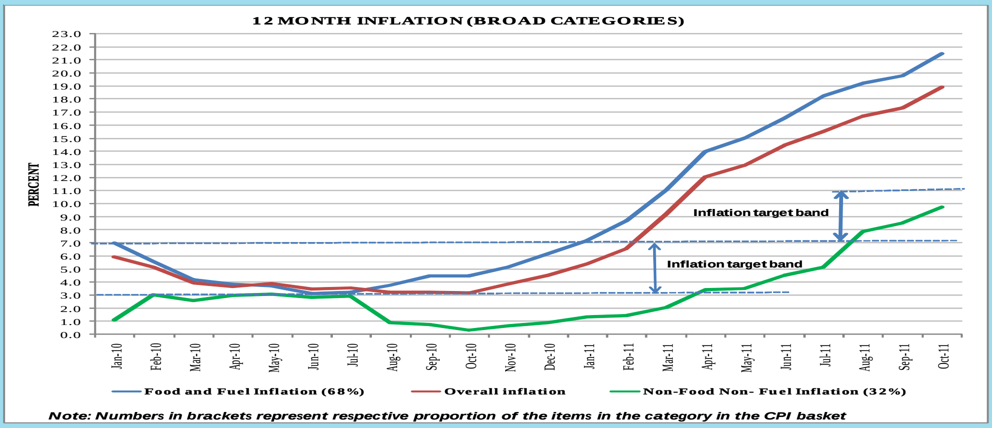
Third, the increase in imports of machinery and transport equipment which are key inputs for the manufacturing sector caused a build-up in the current account deficit from 9.1 percent of GDP in March 2011 to 12.8 percent of GDP in October 2011. This, without a compensating increase in capital inflows, exerted pressure on the exchange rate to depreciate. Given that most of Kenya's imports are price in-elastic, the increase in the global commodity prices and delays in the resolution of the debt crisis in the eurozone caused speculation in the foreign exchange market, thereby exacerbating the weakening in the exchange rate.

3.3 INFLATION

Inflationary pressures persisted over the period covered by this Report with overall inflation rising from 9.19 percent in March 2011 to 18.91 percent in October 2011. The rise in inflation was mainly attributed to increase in food and fuel inflation from 11.04 percent to 21.47 percent in the period. These items represent 68 percent of the items surveyed in the CPI basket. The rest of the items in the basket recorded a slower build-up in inflation from 2.05 percent to 9.75 percent over the same period (Chart 3). While the former reflects supply constraints on food and increased international crude oil prices, the latter represents inherent build-up in demand pressures in the economy. In addition, volatility in the exchange rate partly contributed to the inflationary pressure by exacerbating the pressure.

In recognition of the macroeconomic challenges brought about by the adverse effects of high oil prices and food shortages, and the need to tame inflation and inflationary expectations and to support the economy's growth base, the Minister for Finance specified a revised price stability target of 9 percent for the fiscal year 2011/12 but the inflation target of 5 percent remains the medium term objective.

Chart 3: Developments in Overall Inflation



Source: KNBS and Central Bank of Kenya

4. OTHER ACTIVITIES OF THE MONETARY POLICY COMMITTEE

During the period covered by this Report, the MPC continued to hold stakeholder forums with Chief Executive Officers of commercial banks through the Kenya Bankers Executive Council. In addition, following escalation of inflation and exchange rate volatility, the MPC held a meeting with the Parliamentary Committee on Finance, Planning and Trade in October 2011 to provide explanations.

MPC Meetings were held monthly from September 2011; hence a one day meeting format was adopted. These meetings were preceded by a technical session. Consequently, explicit Analytical and Technical Meetings were not held. The MPC continued to improve on the information gathering processes through market perception surveys, and communication with key stakeholders on the MPC decisions. The MPC also participated actively in the Economic Roundtable forums organised by the World Bank and consulted regularly with the IMF to enhance the effectiveness of implementation of monetary policy decisions.

5. CONCLUSION

The MPC will continue to monitor developments in the domestic and global economy that could have either direct or indirect impact on the economy, while recommending, where necessary, the appropriate monetary policy measures to be taken.

GLOSSARY OF KEY TERMS

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

Reserve Money: These are CBK's monetary liabilities comprising currency in circulation (currency outside banks and cash held by commercial banks in their tills) and deposits of both commercial banks and non-bank financial institutions held with the CBK. However, it excludes Government deposits.

Money Supply: Money supply is the sum of currency outside banks and deposit liabilities of commercial banks. Deposit liabilities are defined in narrower and broader senses as follows: narrow money (M1); broad money (M2); and extended broad money (M3). These aggregates are defined as follows:

M1	Currency outside banking system + demand deposits
M2	M1 + time and savings deposits + certificates of deposits + deposit Liabilities of Non-Bank Financial Institutions (NBFIs)
M3	M2 + residents' foreign currency deposits

Central Bank Rate (CBR): This is the lowest rate of interest that the CBK charges on loans to commercial banks. It is reviewed and announced by the Monetary Policy Committee at least every two months as part of its decisions.

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

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

Horizontal Repo: This is an interbank Repo instrument which recognises Government securities as collateral for borrowing. The instrument 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 Ratio Requirement (CRR): This is the minimum ratio of cash balances (including deposits at CBK) of the total deposit liabilities of commercial banks and non-bank financial institutions maintained with the CBK as reserves. The ratio is fixed by CBK as provided for by the law.