SECOND

BI-ANNUAL REPORT OF THE

MONETARY POLICY COMMITTEE

CENTRAL BANK OF KENYA

Issued under the Central Bank of Kenya Act, Cap 491

APRIL 2009

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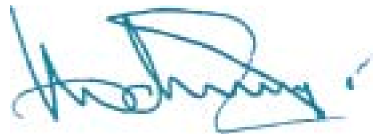
Letter of Transmittal to the Minister for Finance

Honourable Minister,

I have the pleasure of forwarding to you the second 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 April 2009. The Minutes of all the Meetings of the MPC between November 2008 and April 2009 are attached to the Report for your information.



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

REPORT OF THE MONETARY POLICY COMMITTEE,

APRIL 2009

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Members of the Monetary Policy Committee

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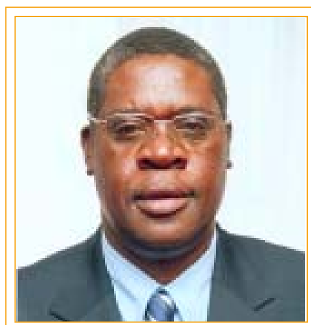

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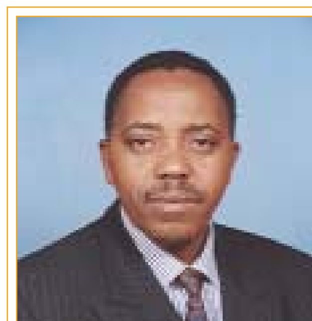

Mr. Joseph K. Kinyua
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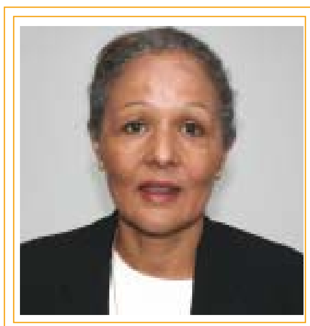

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Mr. Charles Koori
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Dr. Rose W. Ngugi
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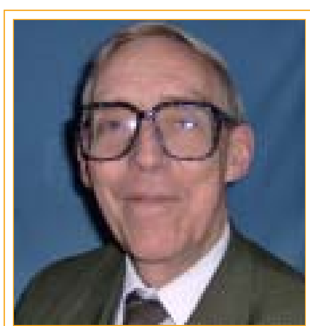

Prof. Terry C. I. Ryan
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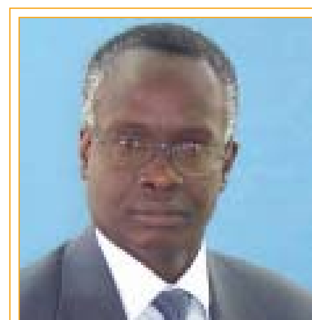


Mr. John Birech
Member

EXECUTIVE SUMMARY

This is the second bi-annual report of the Monetary Policy Committee (MPC) which highlights the activities of the MPC in the six months to April 2009 as well as providing a review of the developments in the Kenyan economy during the period. During the period, the MPC made significant progress towards the development of an appropriate structure for its operations. The process was informed by lessons from visits by the Kenyan MPC to selected external central banks.

Several important economic developments were witnessed both in the domestic and international fronts during the period between November 2008 and April 2009. First, the overall inflation stabilised on account of lower world oil prices compared with the prices in the previous six months. Despite the easing in food inflation, the drought conditions which prevailed continued to put pressure on food prices. The inflation process in Kenya therefore continued to be 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 to overseas countries as well as its peers in the region.

In an effort to ensure that developments in the economy were monitored closely and effectively, the MPC developed the weekly and monthly dashboards of key indicators which are updated and analysed regularly. The dashboards will complement the set of indicators monitored through the MPC Indicator Table. Although the report presents data that is already public, additional analyses and information are included. The report covers the evolved structure of the MPC, the economic environment and also outlines some of the responses by the MPC to periodic requests from the market and public.

Overall the report indicates that the Kenyan economy is resilient to both internal and external shocks having weathered the high inflationary pressures witnessed in the previous six months and the impact of the global financial crises which triggered in September 2008. The Central Bank of Kenya was also 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 is affecting the economy lies more on the side of supply.

Prof. Njuguna Ndung'u
Chairman, Monetary Policy Committee

1. INTRODUCTION

The second bi-annual Report of the Monetary Policy Committee covers the period from November 2008 to April 2009. During this period, the country was faced with supply side inflationary pressures emanating from high food prices as well as the impact of the global financial crises which was triggered by sub-prime lending in the United States.

Significant recovery was witnessed as economic performance improved in the first quarter of 2009 compared to that in the fourth quarter of 2008. The performance of the economy in the first quarter of 2009 was on account of improved growth in the transport and communication, trade, manufacturing and building and construction in the period. However, drought conditions impacted negatively on agricultural production and electricity and water. Consequently, food prices remained high in spite of a general downward trend in world oil prices.

The reserve money targets in the monetary programme for 2008/09 were reviewed downwards in December 2008 following the decision of the MPC to reduce the cash ratio rate from 6 to 5 percent. This decision was aimed at ensuring that commercial banks had adequate liquidity to lend to the private sector in order to stimulate economic growth.

Members of the MPC visited selected external central banks to gather the necessary information on developing their own effective and efficient structure based on best practice. The MPC continued to explore 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.

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

In the first six monthly report of the MPC to October 2008 the Committee reported on the initial evolution of the structure of the MPC. This included the appointment and composition of the committee, their legal mandate, the meeting structure, interactions with stakeholders and work done. It was mentioned at that time that the Kenyan MPC intended to continue to study the structure of MPCs in other countries to understand and assess

their effectiveness.

During the period November 2008 to April 2009, which is the period covered by this report, the MPC has 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 suitability to the Kenyan market. It should be mentioned here that this is a very opportune time to be carrying out these studies as the global economy is in a financial and economic crisis. This therefore allows the Committee to study the MPC structures in other countries as they are under strain. The Committee is also able to look at the effectiveness and capacity of the instruments being used by the various MPCs during these turbulent times.

Visits to other central banks

In the six months to April 2009 the MPC visited the Bank Negara of Malaysia in March 2009, the Riksbank Bank of Sweden and the Bank of England both in April 2009. On the whole, these visits were study based missions of three to four days. They revolved around understanding the structures of the respective central banks in particular countries and how the MPC's operations relate to this. The Committee then studied the effectiveness of the structure relative to its role. The choice of countries to visit was determined by the desire to understand a range of models whilst at the same time confining the choice to a model that will have some relevance to the Kenyan market.

The Riksbank of Sweden has the oldest and most liberal MPC. Its MPC reports directly to parliament and not through the presiding Government. The Swedish model whilst being very effective in Sweden, took time to develop and at this stage Kenya may not yet be ready for such an advanced structure. However, in Sweden, the Committee was able to learn a lot about simplifying the structure of the central bank and its communications. These areas are still being studied.

Bank Negara Malaysia is a much more formal central bank with the MPC members all made up of executives within the bank employment and a controlled way of communicating with stakeholders. However, the Malaysian model was strong in the way it was able to create instruments that drive economic growth. The Bank Negara is also unapologetic when it takes strong measures to protect the country's economy or financial sector.

The Bank of England model was the basis for the existing MPC structure in Kenya. It combines the structures of the liberal Riksbank of Sweden and the more formal structure of the Bank Negara of Malaysia. It was interesting to note the complexities of the English model with the required relationships

between the Central Bank, the Treasury and the Financial Services Authority. Like Kenya, it has the benefit of the MPC containing external members which provide the benefit of their independence and varied experience. The analytical reports presented to the Kenyan MPC during their visit to the Bank of England were found to be effective and have therefore been adopted by the MPC.

The Committee still intends to visit the South African MPC which is the only one so far known to have an annual open day to interact with its stakeholders. The Committee has also included in its plans the need for a seminar in December 2009. At this seminar, the Committee will assess the lessons from these visits and prepare a report on what it deems to be the best MPC structure for Kenya.

Statutory Requirements

a) The MPC held its fourth Meeting on 1st December 2008. During the meeting, the MPC noted the anticipated demand for liquidity during the festive period and the Government's intention to issue infrastructure bonds. The Committee therefore reduced the cash ratio requirements (CRR) from 6 percent to 5 percent which was backed by a reduction in the Central Bank Rate (CBR) from 9.0 percent to 8.5 percent. These measures were aimed at enhancing liquidity in the banking system and supporting the economic recovery process.

b) The fifth MPC meeting was held on 30th January 2009. The Committee retained the CBR at 8.5 percent to allow for the impact of its previous decisions to be fully absorbed by the economy. In addition, the Committee was also to provide better mechanisms to overcome the intermediation inefficiencies in the financial sector which had constrained the full benefits from being realized more rapidly and effectively. This included establishing the true marginal cost of funds, the banks' degree of market power and the biases of discriminative lines of credit.

c) During its sixth meeting held on 20th March 2009, the MPC noted that the most important consideration for enhanced access to liquidity would be through operationalisation of the horizontal repo. It was therefore agreed to implement an immediate instrument. The Committee also reduced the tenor for repos to a minimum of 5 days but this would be implemented after monitoring the performance of the instrument after release of the banking circular. This decision was backed by a reduction in the CBR by 25 basis points from 8.50 percent to 8.25 percent per annum. This would provide an appropriate signal to the banking sector that interest rates, both bid rates on securities and lending rates to customers should ease.

Research Activities

The studies on the National Payments System (NPS) and inflation were developed further and found to be more elaborate than initially envisaged. Preliminary results were shared and the studies are ongoing.

Payment systems

An efficient payment system is a prerequisite for sound financial sector as it improves access to financial services and reduces transaction costs. The MPC had intended to undertake a comprehensive study of the payments system. This was deferred so that it could be undertaken concurrently by a review being undertaken by the National Payment Systems Committee. In the meantime, the MPC in recognising the importance of the payment system, has recommended certain measures to be taken that would be aimed at rationalising payment infrastructure and therefore lowering transaction costs. One of these measures is the interconnectivity of the ATM network in the country.

Whilst it is recognised that technology is going to play a major role in financial services intermediation the model currently in use in the country which has seen duplication of expensive technology which invariably leads to high transaction cost that are invariably passed onto the customer. The number of ATMs grew by 40 percent from 1,078 at the end of 2007 to 1,510 at the end of 2008. However, the number of ATMs in the country has more than doubled over the last three years. These ATMs are operated by two independent Switches in addition to other multiple switches operated by many banks. This technology is expensive and managing ATMs is a complex and expensive undertaking. This model is expensive and invariably the cost is passed onto the users. There is a need to review the current model and encourage interconnectivity. Core models are where there is partnership between the Government, industry and technology providers. The MPC is therefore encouraging the interconnectivity of ATMs as a channel for lowering transaction costs.

Weekly and monthly dashboards were developed

The MPC developed the weekly and monthly dashboards of key economic indicators in January 2009 to facilitate close monitoring of developments in the economy. At the moment, the dashboards are for internal use only by the MPC. However, the information in the dashboards will be disseminated in future after improvement of the data quality and collection methods.

Lessons learnt from the Safaricom IPO

The lessons learnt from the Safaricom IPO in April 2008 were shared with key stakeholders including Treasury, Capital Markets Authority and Nairobi Stock Exchange. The key lesson learnt is the liquidity challenge posed to the overall banking system if there is concentration of the liquidity in a small number of receiving banks. The second lesson from the Safaricom IPO was that payment for shares in advance resulted in refund challenges hence the need to adopt the payment on allocation option as an alternative.

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.

3. REACTIONS TO ECONOMIC ENVIRONMENT

This section reviews developments in both the global and domestic economy. It outlines the major events that occurred during the period covering November 2008 to April 2009.

Kenya Economic Status and Financial Sector developme-nts

The economy grew by 2.76 percent in the first quarter of 2009 relative to the first quarter in 2008 up from 1.67 percent in the fourth quarter of 2008. The first quarter of 2008 had been seriously affected by drought and the post election disturbances (Table 1). The improved performance of the economy in the first quarter of 2009 was attributed to growth in the transport and communication, trade, manufacturing and building and construction which grew by 4.08, 6.52, 3.88 and 14.23 percent, respectively in the period. The improved performance of the economy in the first quarter of 2009 was also attributed to a lower base in the first quarter of 2008. However, drought conditions impacted negatively on agricultural production and electricity and water. Agricultural production contracted by 3.95 percent during 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
Real GDP	6.72	7.42	7.12	7.15	5.00	3.40	2.61	1.67	2.76
Agriculture	6.41	5.64	3.71	2.02	-1.38	-2.16	-3.73	-5.15	-3.95
Transport & communication	9.18	9.27	10.99	15.07	12.60	8.34	5.52	3.11	4.08
Manufacturing	5.85	6.70	6.54	6.46	5.87	5.10	4.07	3.75	3.88
Tourism (Hotels and Restaurants)	16.33	22.22	19.32	16.32	-2.01	-17.72	-27.02	-36.11	-16.99
Building and construction	3.06	4.21	7.54	6.85	8.85	9.57	9.00	8.31	14.23
Financial services	5.29	5.65	6.46	6.68	5.68	4.67	3.12	3.08	3.83
Electricity & Water	0.49	3.72	6.91	9.14	10.23	8.52	6.61	5.23	2.37
Trade	11.80	12.32	9.95	11.52	7.79	5.28	5.80	5.07	6.52

Source: Kenya National Bureau of Statistics

Concerning developments in the financial sector, some of the legal developments included the implementation of guidelines stipulated in the Microfinance Act & Regulations of 2008 which took effect from November 2008. During the same period, the Governors of the central banks of the East African countries signed a Memorandum of Understanding on banking cooperation.

The Repo

As shown in Table 2, the Central Bank drew down its repo stock between November 2008 and April 2009 as it sought to ensure that reserve money growth was within the programmed target. The MPC moved to accelerate the adoption of the Horizontal Repo in March 2009 which was aimed at improving access to and distribution of liquidity in the banking system. Horizontal Repo is the instrument that banks use to borrow from each other.

Whilst in the case of interbank the borrowing is done on open lines (without collateral), the Horizontal Repo requires that the borrowing institution provide government securities as collateral. The open line favours the larger and stronger banks and distorts the market in their favour. Although there had been a slow uptake, a pick-up has began. The first Horizontal Repo transactions after operationalisation occurred in April 2009. Two transactions amounting to Kshs 302.5 million were recorded.

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

	Reserve Money			OMO (REPO)			OMO (REVERSE REPO)			OMO (TAD)	
	Actual	Target	Deviation	Amount Posted	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		27.26
May-08	146.70	144.00	2.70	4.40	8.10	3.70	5.20	4.50	-0.70	11.80	26.21
Jun-08	149.10	144.20	4.90	2.80	4.70	1.90	5.60	5.60	0.00	43.60	23.96
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

Source: Central Bank of Kenya

Liquidity management

The MPC, like the western monetary authorities, was concerned that liquidity should not be constrained by declining confidence in the financial sector. While the Bank of England and the European Central Bank cut their policy rates by 1.5 percent and 0.5 percent, respectively, in December 2008, the MPC reduced the CBR by 0.5 percent and lowered the CRR by 1.0 percent. The CBR was lowered further by 0.25 percent to 8.25 percent in March 2009 mainly to support increased economic activity in the country.

The impact of these measures on the availability of credit to the private sector in April 2008 was somewhat undermined by the delayed passage of the Supplementary Budget Estimates through Parliament in April 2008 which caused an excessive build up of Government deposits in the Central Bank.

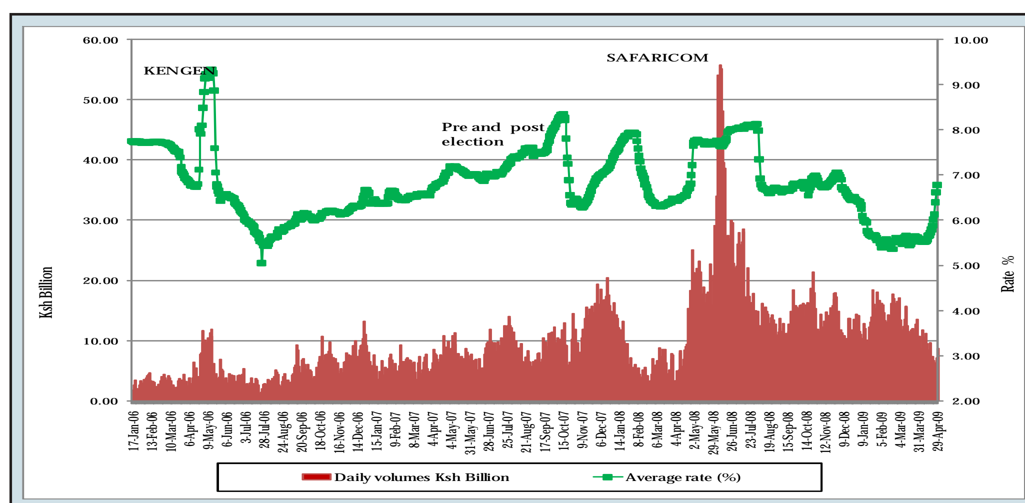
As can be noted in Table 2, reserve money was consistently below target during the period, falling from Kshs 160.55 billion in November 2008 to Kshs 154.25 billion in April 2009. Reserve money therefore grew by 4.03 percent in the year to April 2009 compared with the targeted growth of 13.65 percent. Similarly, broad money supply (M3) grew by 7.49 percent in the year to April 2009 which was much lower than the programmed 17.1 percent. The annual growth in credit to private sector slowed down from 32.9 percent in November 2008 to 14.5 percent in April 2009.

The Interbank market

The period covered by this report is one that showed continued volatility in the interbank market both with respect to quantities and prices (Chart 1). A close analysis of the data indicates that the early part of the period was one in which the supply of loanable funds in the banking system increased considerably causing the rates to fall. This period was followed, during the early part of 2009, by stabilisation of both volumes and prices. But towards the end of the period, liquidity started to become tight with the contraction of supply of loanable funds pushing the rates back up.

Throughout the period the demand for liquidity appeared to be relevantly stable and hence prices and quantities were responding to changes in bank liquidity. There was no noticeable impact of Treasury's borrowing nor were the changes in interbank liquidity reflected in the Nairobi Stock Exchange which would have reacted to investors blocking funds into equity.

Chart 1: Interbank Daily Volumes and Average Rates



Source: Central Bank of Kenya

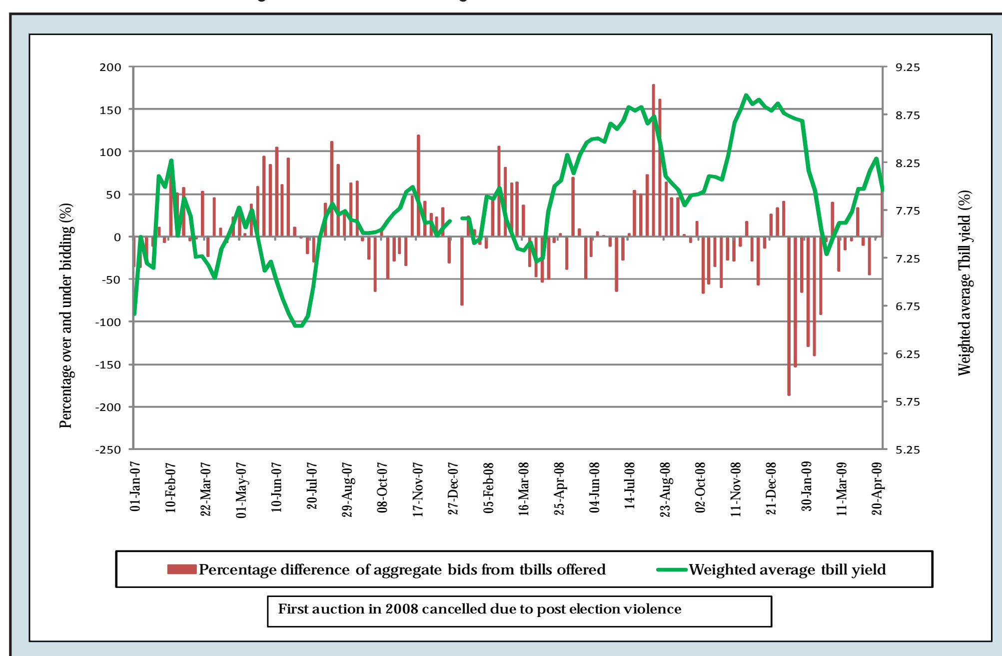
The Treasury Bill Market

During the six months to April 2009, the MPC analysed the Government's borrowing programme observing the build up of the stock of outstanding Treasury bills and bonds. The stock of Treasury bills rose from Kshs 125.3 billion at the start of November 2008 to Kshs 138.9 billion at the end of April 2009. Over the same period, the stock of bonds grew from Kshs 320.9 billion to Kshs 343.5 billion. The build up in government debt was partly due to an upward review of the government domestic borrowing requirements from Kshs. 54.5 billion to Kshs. 84.5 billion in the fiscal year 2008/09.

Both the 91 day and the 182 day Treasury bill yield rates did not depict any trend since the advent of the global financial crisis in September 2008 (Chart 2). This continued to early December when the rates fell rapidly. Notably, eight out of the twenty six auctions in the period were undersubscribed while all but one of the seven bond issues was oversubscribed. This was seen to indicate confidence in the future and a consequential preference for longer-dated papers. The strategy of reopening previously under-subscribed bond issues introduced in April was welcomed by the market.

During the same period, the minimum Treasury bills bid was also reduced from Kshs. 1,000,000 to Kshs. 100,000 to promote participation by small investors in the risk free government securities. The reduction in the minimum threshold for investment in Treasury bills has seen a reasonable increase in the number of applicants for investing in the securities.

Chart 2: Treasury Bills Weekly Auction Performance



Source: Central Bank of Kenya

Update on the Global Financial Crisis

The MPC prepared its first report on the Global Financial Crisis in December 2008. This report covered the period from September 2007 to December 2008. Part 1 of the original report dealt with the origins of the crisis and outlined the structure of the Kenyan economy. Part 2 then dealt with what impact the crisis has had on the Kenyan economy. This was analyzed by tracking key data such as tourist arrivals, input costs, exports of flowers and vegetables, Government revenues, remittances, FDI flows, exchange rates etc.

Understanding the impact of the global financial crisis was made somewhat more difficult as it was mixed with the residual effects of the post election violence that had hit the country in the first three months of 2008 and the significant Safaricom IPO that affected the financial markets in the period prior to that covered by this Report (April to October 2008). It is therefore difficult to be precise on how much of the observed changes were due to the violence; the IPO or how much were due to the onset of the global financial crisis.

The MPC was however to continue monitoring the global situation and particularly the concern with respect to possible “W” shaped recoveries or high levels of inflation as the large amounts of liquidity injected into the various economies begin to be felt.

Review of the Kenyan Banking Sector

The MPC reviewed data relating to the performance of the Banking Sector. The purpose of this review was to understand the market's perception of the Kenyan Banking Sector as well as obtain an in-depth understanding of the performance of the sector in the last ten years to 2008. The analyses are based on in-house information as well as results of the Banking Survey for 2009.The highlights of the analyses are as follows:

a) The banking sector in Kenya has witnessed a growth in banking institutions of over 100 percent over the last ten years. This covers most areas of the banks' business such as deposits, loans and advances, interest income, fees and commissions, expenses etc. In comparison, interest on deposits declined by 24 percent during the period. This was seen to be as a result of the impact of the "Donde Bill" when most banks converted their savings accounts into transaction accounts to avoid the law that mandated interest payments on savings accounts. Many accounts therefore ceased to be interest earning. At 74 percent, large banks accounted for the largest customer deposit market share in December 2008. Similarly, large banks received 90 percent of the interest paid market share.

b) The top ten banks' dominance of the banking sector is very evident. Whereas the whole sector grew by more than 100 percent in the ten years, this is strongly skewed in favour of the top ten banks which grew by over 200 percent with the remaining 33 banks growing by about 15 percent in the period. In the case of growth of cash balances with CBK and interest on loans and advances the 33 smaller banks had declining balances. This supported the CBK focus on encouraging the smaller banks to merge to be more effective and stronger market players.

c) Profit after tax in the banking sector grew by 747 percent in the last ten years. However, the top ten banks witnessed a growth of about 1000 percent in profits as the remaining 33 banks saw a growth of 71 percent.

d) Losses on lending declined by 38 percent in this period while the proportion of lending to total assets stood at 54 percent in December 2008. However, the ratio of non-performing loans to total loans and the proportion of the cost to income ratio decreased to 7 and 56 percent, respectively. It is distressing to note that fees and commissions increased by 224 percent in the last ten years with the smaller banks driving this increase.

The main conclusion from the above analyses of the banking sector over the last ten years is that Kenyan banking sector is stable, strong and thriving. There have been great improvements in key indices in this sector over the last ten years due to de-politicising of banks, the use of technology, the

introduction of strong local players and overall effective supervision. However, the MPC noted that the key concerns that remained and which require further improvement were:

a) Despite a 130 percent increase in deposits, interest paid on customer deposits has been falling. This could discourage the savings culture in Kenya.
b) Fees and commission revenues have increased by 224 percent in the ten years representing the second highest increase after profitability. This was particularly evident with the smaller banks that may be over-reliant on this income base.
c) The analyses identified the need for more understanding of the cost base of banks and questioned why interest on lending by smaller banks declined despite a 47 percent increase in lending.

Exchange Rate Management

In mid September 2008, the major west economies entered a period of financial turmoil. Initially it was purely a financial crisis directly impacting banks which had unwisely invested in derivatives based on the supply of mortgages in the USA. This financial crisis soon converted to a full blown economic crisis as balance sheet value of major corporations collapsed. International Stock Exchanges downturned steeply and companies started laying off workers. By early 2009 all the indications were that the developed world was entering a serious recession and growth forecasts were revised downward drastically.

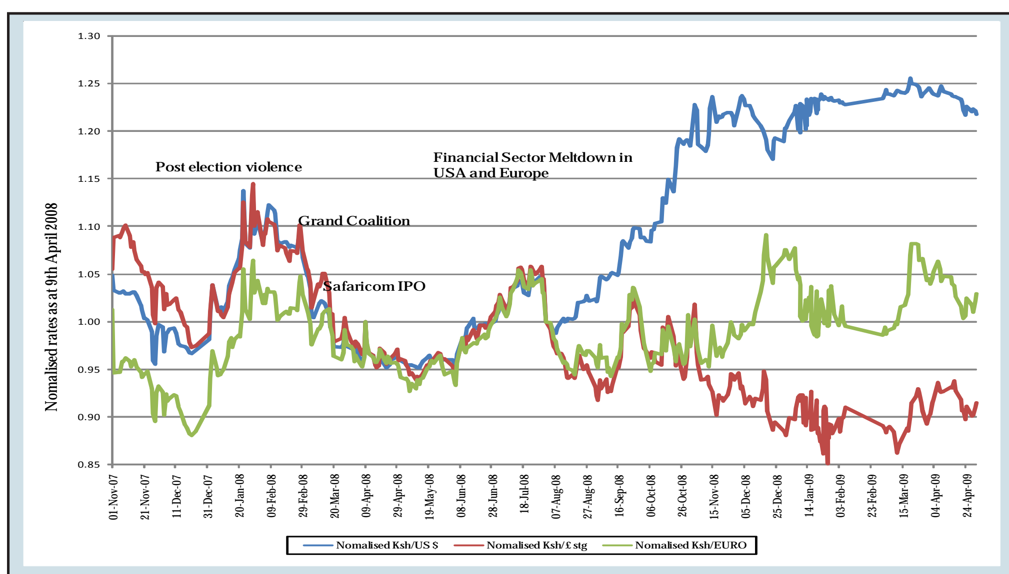
A careful survey of the Kenyan financial sector was undertaken indicating the seven banks which were subsidiaries of international banks were not exposed to the toxic assets that were affecting banks abroad. However, economic developments that accompanied the crises started to impact on Kenya's exchange rate market (Chart 3). This came through both the capital and current accounts of the balance of payment. Initially, CBK used its foreign exchange reserves as the appropriate support for short term shortfall in the current account since capital account inflows were somewhat curtailed. Nevertheless one of the critical components in that account did not turn out as initially expected.

Diaspora remittances averaged about USD 46.7 million during the period showing no downturn. Generally, the remittances maintained their level throughout which probably was a consequence of the Kenyans in the Diaspora being well qualified and therefore were not exposed to downsizing as the recession progressed.

Again, contrary to expectations, tourism continued its recovery from the post election violence period. Nairobi returned rapidly to an acceptable hotel occupancy level while the coast suffered from the normal off-season's downturn rather than from any European recession. In particular, tourist arrivals in the country averaged 75,538 per month in the period up from an average of 63,212 in the previous six months.

On the other hand, horticulture, particularly floriculture, was seriously affected by the recession in Europe.

Chart 3: Normalised Exchange Rates



Source: Central Bank of Kenya

Foreign Exchange Reserves

Between November 2008 and April 2009, the Bank commenced to build up foreign exchange reserves by purchasing USD 25 million from the domestic foreign exchange market against the backdrop of a fairly stable exchange rate (Table 3). Despite the purchases of foreign exchange from the market, the exchange rate has remained fairly stable due mainly to stable inflows.

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 April 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.

Table 3: 12-Months Cumulative Balance of Payments (in USD millions)

	Nov-08	Dec-08	Jan-09	Feb-09	Mar-09	Apr-09
Gross Reserves						
Official	2,869.33	2,875.46	2,768.85	2,744.85	2,713.87	2,887.74
Commercial Banks	1,654.11	1,765.32	1,579.27	1,609.52	1,606.54	1,732.54
Imports cover (36 months)	3.40	3.36	3.21	3.16	3.10	3.28
Interventions						
Interbank purchases	0.00	0.00	15.00	0.00	0.00	10.00
Interbank sales	0.00	0.00	0.00	0.00	0.00	0.00

Source: Central Bank of Kenya

The difficulty of measuring and maintaining price stability

The MPC worked together with the Kenya National Bureau of Statistics (KNBS) so as to improve the quality of analysis of the cost of living in Kenya. The existing Consumer Price Index (CPI) is derived from a 1997 update of the 1993/94 Household Budget Survey. Therefore, it is seriously defective in representation of consumer behaviour in 21st century. New products such as mobile phones and laptop computers have started to figure in household expenditure while other products are no longer on the shelves in the supermarkets being superseded by imports in the current liberalized regime.

Other defects arising from the computation methodology where noted to introduce an upward bias. Furthermore, efforts to establish a policy relevant index through an underlying inflation statistic were seen to be frustrated having to remove a large proportion of the surveyed products. The outcome of this discussion has been a commitment to draw on the Kenya Integrated Household Budget Survey of 2005/06 to produce a relevant basket while exploring less biased measures of computation.

As shown in Table 4, overall month on month inflation eased from 29.36 percent in November 2008 to 26.07 percent in April 2009 on account of a drop in food and fuel and power inflation rates. However, underlying inflation edged up slightly during the period.

Table 4: 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
Jan-07	9.67	5.15	11.80	67.12	12.80	54.85	5.34
Feb-07	6.81	4.92	7.20	56.41	11.50	58.75	4.76
Mar-07	5.87	5.13	5.70	50.35	10.90	62.10	3.43
Apr-07	5.66	5.03	5.50	50.45	10.50	67.60	3.14
May-07	6.33	5.22	6.70	55.45	8.60	68.40	4.51
Jun-07	11.00	4.90	15.00	75.65	8.50	69.70	7.44
Jul-07	13.56	5.46	18.90	78.31	8.70	73.70	9.04
Aug-07	12.37	5.06	17.20	78.00	7.00	71.75	8.27
Sep-07	11.72	5.34	16.10	76.60	6.30	78.55	10.10
Oct-07	10.55	5.41	14.03	73.83	5.90	81.80	10.15
Nov-07	11.83	5.30	15.72	74.10	5.70	91.75	9.80
Dec-07	12.03	5.25	15.86	74.10	5.70	90.60	9.61
Jan-08	18.22	5.07	24.62	78.42	10.60	92.25	9.63
Feb-08	19.13	6.64	24.91	74.92	14.10	95.10	10.14
Mar-08	21.83	6.98	28.82	76.61	15.60	102.20	12.51
Apr-08	26.63	6.54	36.81	81.25	15.40	109.35	14.59
May-08	31.54	7.24	44.21	82.53	17.90	125.75	17.53
Jun-08	29.26	7.60	40.06	80.28	20.06	134.00	16.01
Jul-08	26.50	7.61	35.06	77.15	27.03	137.35	14.95
Aug-08	27.58	8.23	36.35	76.66	30.80	112.41	14.68
Sep-08	28.23	8.59	37.16	76.65	31.57	96.85	13.58
Oct-08	28.43	8.67	37.63	77.14	28.79	69.16	14.27
Nov-08	29.36	9.10	39.44	78.68	26.87	49.76	15.48
Dec-08	27.72	9.04	37.48	79.54	17.99	38.60	13.97
Jan-09	21.87	8.89	28.90	78.07	10.17	41.54	12.96
Feb-09	25.09	8.67	33.93	81.44	8.86	41.41	13.34
Mar-09	25.86	8.75	34.90	82.17	6.07	45.78	17.28
Apr-09	26.07	9.95	34.63	80.58	4.30	50.20	16.33

Source*: Kenya National Bureau of Statistics.*

4. RESPONSES TO PERIODIC REQUESTS

Foreign Exchange Reserves

The current legislation requires the Central Bank to use its best endeavours to hold the equivalent of four months imports cover measured as the average imports over the previous three years. This legislation was seen to be a hangover from the period of foreign exchange control which dominated international thinking in the 1970s. At that time concerns with respect to the balance of payments were generally focused on the current account since controls applied to both the imports permitted and access to foreign exchange. Exchange rates were not freely determined and hence the legislation was merely to ensure that those who invested in the country had some assurance of being able to obtain foreign exchange to sustain their activities. These controls gave rise to serious distortions ranging from overstocking of inventory to multiple applications for import licenses in the hope of getting some quota.

In the late 1980s liberalisation of the balance of payment came to be seen as a more efficient way of obtaining growth since market determined exchange rates would ensure that sectors of the economy that were most competitive got the scarce foreign exchange. Unfortunately, the period was also dominated by those who were obtaining economic rents from a continuation of the diregist regime. The current account still remained the focus since export expansion was seen to be the route to development. It was only the late 1990s that the capital account became liberalized internationally and exchange rates became flexible. In consequence, mobile, international capital moved into countries with unexploited investment opportunities and later, short term, hot money took advantage of international interest rate differentials. Increasing sophistication of international financial institutions meant that real time transactions, which became available through the computer revolution, restricted arbitrage possibilities.

In view of the changed world circumstances the Committee reviewed the purposes for which the country should hold foreign exchange reserves. It considered that the current legislation was an anomaly and that it would be more appropriate to hold reserves that were tied to six different goals.

(a) The government international debt liability, both in interest and redemption, which could be obtained from debt analysis;

(b) Periodically the country is exposed to food shortfalls as a consequence of weather patterns. Holding foreign exchange in reserve to cover imports of grain would be cheaper than storing the grain domestically with the concomitant costs incurred in having to roll over the strategic reserves;

(c) In order to maintain the reputation of the Kenya shilling as a respectable currency, a variable amount would need to be held so as to ensure those involved in Kenya's import-dependent industries as well as exporters would not be penalised by foreign banks and business by requiring them to pay foreign currency up front. This purpose is clearly allied to the present legislation without being associated to a four month figure. This reserve would need to be larger in times of insecurity than at times of stable trade;

(d) Since the Government requires various things from abroad in the course of its normal operations and the Central Bank is responsible for providing the foreign exchange of these purchases, some amount of foreign reserves would be necessary. This amount would be associated with the time-frame of revenues and expenditure envisaged by the Treasury;

(e) Although it would be an inappropriate policy to try defending a particular exchange rate, the Central Bank should hold itself ready to intervene in the foreign exchange market if there were any exceptional turbulence in rates. This should not be a response to any speculation that the Kenya shilling is either under or overvalued;

(f) In view of the international Accounting Standards, any foreign exchange held by any concern is valued at the current exchange rate in its balance sheet. In consequence, the profits or losses of institutions are affected by the magnitude of foreign exchange assets and the movements of the rate of exchange. The Central Bank, despite the fact that it has no intention of realising its foreign assets, has been subject to criticism for making losses on reserves when in fact it has built up its foreign exchange reserves internationally. This distorts the interpretation of Central Bank activity;

Monetary Approach to Balance of Payments

Continuing with analysis of implications of the balance of payment, the Committee initiated an examination of the implications of domestic fiscal policy to see whether changes in the net foreign assets were driving movements in the current and capital account rather than the other way round. The outcome of this analysis is expected in the course of the next six months; it is based on the Monetary Approach to the Balance of Payment which had been a matter of analytical concern among professional economists in the 1970s. The expectation is that the change in economic regimes worldwide would have reduced the degree to which domestic fiscal events would affect the balance of payment.

Monetary Programme

The monetary programme was seen to need revision as data became available suggesting that the economic growth in the fourth quarter would be low due to a combination of poor weather and the expanding impact of the international financial crisis which was developing into a second round of damaging downturns.

Build up in warehouse Inventory

One of the indicators of the health of the economy is the growth of investment. Among the types of investments that can be considered is the investment in inventory. The Committee considered that this indicator needed careful analysis since an investment in inventory (ex post) could be an outcome of an unintended accumulation of stocks due to reduced domestic demand. In that case, it would be an adverse indicator, but if the accumulation of inventory was due to expectations by businessmen of an expanded demand it would have positive implications.

A third aspect of inventory accumulation would arise from speculators anticipating a rise in international prices or a curtailment of access to foreign exchange to acquire import. Since the Committee had data that showed warehouse inventory was increasing over time, it was necessary to investigate the nature of this increment so as to interpret the data more accurately. Analyses as conducted which showed that a significant proportion of the increase of inventory was inputs to export processing zones operations which were suffering from cut backs in AGOA demands.

Consumer Price Index

As mentioned earlier, the inflation data being prepared by the Kenya National Bureau of Statistics has traditionally been calculated as an arithmetic mean of price relatives. This, so-called Carli index is easy to interpret but unfortunately fails to fulfil a number of axioms which are necessary for a good index. Amongst others it gives significant weight to outlying observations and does not allow for a return to the same index when prices fall.

The Committee examined the implications of changing to a geometric mean, as the mode of computation, this so-called Jevons index, which satisfies the mathematical axioms and also spreads the effect of outliers. A Jevons index will always lie below a Carli index but not always by the same amount. The Committee was shown how sensitive these indices are to changes. It was, furthermore, noted that the current KNBS index is based on a 1997 update of a 1993/4 household budget survey. This basket of goods is significantly defective for a number of reasons:

(a) Its relates to the pre-liberation era and hence many consumer products were not licensed to enter which might have been competitive with domestic products;
(b) A major technical revolution has occurred in the interim bringing in mobile phones, laptop computers and a variety of electronic based equipment. These products are within the budget of many of the consumers;

The Committee continued to work with the KNBS data, but its measure of underlying inflation, which is meant to be the policy relevant measure that reacts to monetary expansions or contractions, relates to such a small component of the consumption basket (food, fuel and transport are all excluded).In this regard, the MPC felt that a non-tradable index should be developed.

The Kenya Integrated Household Budget Survey which was conducted in 2005/06 updated the income distribution as well as the consumption basket. This new data set will be used for the generation of a new inflation index using the Jevons methodology.

Relations with CBK Board

The Monetary Policy Committee sensitised the Central Bank Board on its work. In view of the executive character of the MPC's decisions, the Board needed to have comfort that the quality of underlying analysis did not jeopardize the Central Bank's overall responsibilities. Members of the Board attended the Technical Meeting in advance of the Policy Meeting.

Access to the Government Securities Market

The Committee was concerned that access to the risk-free Treasury bill market was significantly restricted by the high minimum scale of bid that would be considered. By lowering the threshold it was considered that new, small investors would be mobilised to take advantage of these assets. The degree to which individuals and smaller non-institutional bodies would be drawn into this market would be an important adjunct to bringing financial intermediation to the economy at large

5. CONCLUSION

Overall, the MPC met its intended objectives during the period spanning the six months to April 2009. Significant progress was made towards the development of an appropriate structure for its operations. The process was informed by lessons from visits by the Kenyan MPC to selected external central banks.

Furthermore, this report indicates that the Kenyan economy is resilient to both internal and external shocks having weathered the high inflationary pressures witnessed in the previous six months and the impact of the global financial crises which peaked in September 2008.

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 is affecting the economy lies more on the side of supply.

GLOSSARY OF KEY TERMS

Overall Inflation
This is the total 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 areas of the market which 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 inflation that is currently measured by indices of all consumer price items of goods and services sampled by KNBS excluding food, energy, transport and communications which are susceptible to volatile price movements 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 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 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 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 Reserve Requireme-nts	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.
Term Auction Deposits	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.

NOTES