FOURTH

BI-ANNUAL REPORT OF THE

MONETARY POLICY COMMITTEE

CENTRAL BANK OF KENYA

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APRIL 2010

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Enquiries concerning the Report should be addressed to:

Monetary Policy Committee Secretariat,
Central Bank of Kenya,
P.O. Box 60000-00200 Nairobi, KENYA

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Letter of Transmittal to the Minister for Finance

Honourable Minister,

I have the pleasure of forwarding to you the fourth 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 2010. The Minutes of all the Meetings of the MPC between November 2009 and April 2010 are attached to the Report for your information.

Prof. Njuguna Ndung'u, CBS

Governor, Central Bank of Kenya

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Members of the Monetary Policy Committee

Prof. Njuguna Ndung'u (CBS)
Governor, Chairman

Dr. Hezron O. Nyangito
Deputy Governor, Vice-Chairman

Mr. Joseph K. Kinyua (CBS)
PS, Treasury
Treasury Representative

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Member

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Member

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Member

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Member

Mr. John Birech
Member

EXECUTIVE SUMMARY

The fourth bi-annual Report of the Monetary Policy Committee (MPC) highlights the activities of the MPC in the six months to April 2010 and also reviews Kenya's economic developments during the period. The MPC continued to update its report on the appropriate structure for its operations following the visit by members of the Committee to the Reserve Bank of South Africa. Preparation of the report is informed by research based on best practise, as well as lessons from visits to selected central banks.

Several important economic developments were witnessed both on the domestic and international fronts during the period between November 2009 and April 2010. First, a new measure of inflation based on a new basket, new weights and the geometric mean computation methodology was introduced. Inflation stabilised on account of lower food prices compared with the prices in the previous six months. This was supported by short rains towards the end of the third quarter of 2009 that enhanced agricultural activity. Second, the MPC continued to track the impact of the global financial crises on the Kenyan economy and concluded that the impact was less severe compared with overseas countries as well as its peers in the region.

The MPC continued to undertake bi-monthly market surveys that were introduced in September 2009.The surveys have provided important input in the Committee's decision making process. In addition, bi-monthly meetings with chief executive officers of commercial banks provided fora for the MPC to explain and get feedback on its decisions. The MPC also continued to analyse data that the Committee captured on the MPC weekly and monthly dashboards of key indicators which are updated regularly. The dashboards complement the set of indicators monitored through the MPC Indicator Table.

Overall this Report indicates that the growth momentum in the Kenyan economy is picking up while both the high inflationary pressures witnessed in the previous six months and the impact of the global financial crises which was triggered in September 2008, continue to ease. The Central Bank of Kenya continued to engage in open market operations aimed at ensuring that monetary driven inflationary pressures did not occur. In particular, the Bank's tools of liquidity management were sufficient to ensure that monetary expansion directed at supporting economic growth did not pose any threat to inflation nor did it have the growth process short of liquidity. Although the Report presents data that is already public, additional analyses and information are included. The Report covers both the activities of the MPC and developments in the economic environment.

1. INTRODUCTION

The fourth bi-annual Report of the MPC covers the period from November 2009 to April 2010. During this period, the MPC reviewed developments in both the global and domestic economic environments. The Committee noted the recovery in the major sectors of the economy as a consequence of improvements in agricultural activity coupled with the dissipating effect of the global financial crises.The Committee also welcomed the release of the new inflation series in February 2010 by the Kenya National Bureau of Statistics (KNBS) using a geometric mean methodology. The new series is based on a new basket of goods and services, an updated income distribution and new weights reflecting both population movements and change in consumption patterns since 1994.

Significant recovery was witnessed in economic performance with improvements in the fourth quarter of 2009 compared to the same period in 2008. The recovery in the agriculture sector following the end of drought conditions was particularly noteworthy since this sector had constrained its growth in the third quarter of 2009. The short rains that followed the drought also helped to ease inflationary pressures from food and resulted in a general downward trend in overall inflation. This was also aided by steady global crude oil prices.

The monetary programme of the fiscal year 2009/2010 was consistent with the provisions in the Government Budget presented by the Minister for Finance in June 2009. The key assumptions for the monetary programme were: real GDP growth rate of 3.1 per cent by June 2010 and a GDP Deflator of 10.1 percent which implied a broad money supply (M3) expansion of 14.5 percent and reserve money growth of 10.9 percent in the fiscal year. With respect to Kenya's foreign exchange reserves, the country received disbursements of USD 200 million under the Exogenous Shock Facility (ESF) in September 2009, and USD 223 million SDR allocations from the IMF to cushion the adverse effects of the global financial crisis. Consequently, the MPC reviewed the projected growth in gross foreign exchange reserves from the earlier 3.6 months of import cover to 4.1 months of import cover by June 2010.

The MPC completed study visits aimed at informing the development of an effective and efficient structure based on best practice, by visiting the Reserve Bank of South Africa in February 2010. The MPC also continued to explore and improve its interface with the various departments of the Central Bank with the objective of improving information flow.

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. EVOLVING STRUCTURE OF THE MPC

The Committee reported on the evolving structure of the MPC in the second and third bi-annual MPC reports which covered the six-month periods to April and October 2009, respectively. The reports also highlighted how the MPC had continued to fulfil its legal mandate, conducted its analytical work and visited selected MPCs around the world to study their structures and relevance to the Kenyan situation.

This, fourth MPC report which spans the last six months to April 2010, reports on the progress made with regard to the development of an appropriate MPC structure at a time when the global economy is emerging from financial and economic crises. The MPC has previously visited several central banks to learn more regarding any modifications in structure which it might adopt. The visits during the financial crisis also allowed the Committee to study how other MPCs were responding to the crisis. The effectiveness and capacity of the instruments being used by the various MPCs in the selected countries were also analysed.

Visits to other central banks

The members of the MPC visited the Reserve Bank of South Africa (RBSA) in February 2010. As was the case with visits conducted previously, the findings of the visits were aimed at informing the MPC on how to restructure its structure to make it more effective and also to learn more on monetary policy formulation and operations. During the visit, the MPC studied the RBSA's MPC structure and its effectiveness relative to its role, as well as the structure of the MPC meetings. In addition, the MPC learnt how RBSA conducts its public fora as part of its communication strategy.

Unlike the Kenyan MPC, in RBSA the Commitee is wholly internal and its membership comprises the Governor, three deputy Governors anf four senior officials from the core departments. The Ministry of Finance sets the inflation target which is communicated to the RBSA through an established technical committee on inflation that draws its members from the reserve bank and the Ministry of Finance. Notably, the director of bank supervision at RBSA is an MPC member and reports to both the Governor and the Minister for Finance.

The structure of MPC meetings at the RBSA is somewhat similar to that at CBK. Ten days to the main meeting, the MPC holds a series of meetings with the modelling team to discuss assumptions of the model, as well as with departments that prepare the documentations for the meeting. During the MPC meeting, presentations cover international economy, international markets, domestic financial markets, monetary aggregates and public finance, national economy including survey information, forecasts from the macroeconomic model on inflation and output, report from the registrar of banks on banking issues and financial stability indicators.

On the communication strategy at the RBSA, the media is informed of the Reserve Bank's activities through a full calender of its events that is released in advance. However, there is a media blackout on MPC proceedings ten days ahead of the meeting and 'silence is broken' on the day of the MPC main meeting when the MPC holds a press conference purely for the MPC decision.The Governor is the spokesperson of the MPC but other members can speak if called upon.The press conference is held on the day of the MPC main meeting.

The MPC at the RBSA also holds MPC public fora annually to sensitise the public on MPC issues and present monetary policy reviews. These fora are held once in each province. Each MPC member is allocated a province. Furthermore, the MPC also pays visits to industries and key agricultural counties to get first hand feedback on the perfomance of the economy.

Following the MPC visits various central banks, the MPC will finalise and share with the Ministry of Finance, recommendations on modifications to the existing structure of the Kenyan MPC. The report will be based on lessons from all the visits and a survey of various models in use internationally.

Statutory Requirements

Section 4D of the CBK Act requires the MPC to hold bi-monthly meetings. Consequently, the MPC held three meetings between November 2009 and April 2010. During this period, MPC decisions were aimed at enhancing credit expansion in order to support growth since demand induced inflation was noted to pose no threat. The following are the key highlights of the MPC decisions in the period:

a) The MPC held its tenth meeting on 24th November 2009. The global economy was showing signs of recovery but prospects remained highly uncertain. Growth data obtained from the KNBS also showed that the domestic economic recovery was fragile. In this regard, the Committee was of the view that the existing accomodative monetary policy needed to be sustained to stabilize expectations and strengthen both the fiscal and monetary support that was being provided.

   The Committee also welcomed the release of new inflation series as a better measure to address its statutory requirements of ensuring price stability. Further, the MPC undertook to work with the KNBS to develop core inflation and inflation of non-tradables goods measures which were expected to provide different options for looking at market behaviour in an open economic environment. In an environment where the upside risks to inflation were low, the Committee agreed that stimulating economic activity was critical in the short term.

   The Committee noted that banks were holding adequate liquidity which could be absorbed by the private sector as the economy emerged from the slowdown. Although the existing market conditions pointed to falling credit risk in the banking sector, lending rates seemed not to respond as expected. For this reason, enhancing credit availability at lower cost became a key focus for the Committee's decision. To achieve this objective, the Committee reviewed the Central Bank Rate (CBR) downwards by 75 basis points to 7.00 percent.

b) The eleventh MPC meeting was held on 26th January 2010. The Committee noted that monetary policy signals were transmitting to short term interest rates (interbank rate, the repo rates and Treasury bill rates) which were declining. In view of the positive response from the market on the use of CBR as a means of signalling movements in short term interest rates, the Committee considered its exisiting level of 7.00 percent to be appropriate to consolidate the gains from monetary policy.

   However, it was noted that although signals from the CBR to the short term interest rates had worked, their impact was not being transmitted to the real sector through a response in lending rates. The Committee therefore asked the Central Bank to explore ways through which development banking products could be introduced into the market. Such products would enhance the monetary policy transmission mechanism and lengthen the maturity profile of commercial bank term loans.

c) During its twelfth meeting held on 23rd March 2010, the Committee noted that the economic recovery process had gained momentum on account of the Treasury's Economic Stimulus Package and credit growth to the private sector. However, the Committee observed that the cost of credit was constraining further expansion in borrowing by the private sector and thus, economic recovery was not as fast as it was hoped. The MPC also noted that there were no upside risks to inflation and that inflation was no longer a key determinant of the interest rate structure. Further, cost of funds and credit risk which had earlier been identified as major constraints to credit supply were easing.This therefore would provide space for lower interest rates. The Committee noted that the yield curve for government securities had levelled out thereby providing a good benchmark for pricing long term debt and loan products. This had created an environment for banks to be innovative, thereby developing long term products that diversified sourcing for appropriate and adequate growth finance.

   Based on this information and analyses, the Committee decided to lower the CBR by 25 basis points to 6.75 percent.The Committee was of the view that the direction and magnitude of movements in the CBR would send the appropriate signals to the market; as inflation was not a significant threat, and that the policy stance aimed to stimulate the supply of credit that would support economic growth and anchor inflationary expectations.

Research activities

The various research studies commissioned by the MPC in the previous six months were updated to capture the new inflation series released by the KNBS. These studies include those on the demand for money function, term structure of interest rates, determinants of interest rate spreads in Kenya, and a dynamic model for inflation. Preliminary results of these studies were shared during MPC Analytical and Technical Meetings.

MPC Market Perceptions Surveys

The MPC continued to improve on the analyses and data capturing framework for its bi-monthly Market Surveys. In particular, the surveys were extended to cover the non-bank private sector in November 2009 while private sector firms in Mombasa, Kisumu and Eldoret were included in January 2010. Further, respondents in the surveys have gradually shifted from junior to senior officials of banks, which was in line with MPC's emphasis to CEOs during their joint meetings.This has improved the quality of information gathered and the analysis thereof.The surveys captured the response by the market to MPC signals, and perceptions of banks and the non-bank private sector on issues such as economic growth, inflation, direction of interest rates and exchange rates. The awareness of MPC decisions as well as perceptions on determinants of interest rates spread were also captured by the surveys.

Results from the MPC Market Surveys complemented the findings from the interest rates study as cost of funds, credit risk and the Treasury bill rates were highlighted as key determinants of the spread. However, analyses on available data indicated that these factors had been declining overtime, yet banks had not responded by reducing their spreads. The surveys also showed that profit margins were a more significant determinant of the spread among foreign owned banks than in locally owned banks. Over the period covered by this Report, the results of the market perception surveys conducted showed that most commercial banks expected inflation to remain low and stable, the exchange rate of the Kenya Shilling against the US dollar to strengthen, and economic growth to improve from 2-3 percent in 2009 to 4.5-5 percent in 2010 (Table 1).

Table 1: Changes in perceptions of banks (percent of response)

	Inflation			Ksh/USD Exchange rate			Economic Growth %			Interest rates			
	Increase by 1-2%	Remain the Same	Decline by 1-2%	Strengthen	Remain the same	Weaken	2-3	3-4.5	4.5-5	Decline by more than 2%	Decline by 1-2%	Remain the Same	Increase by 1-2%
Sep-09	60	24	16	48	28	24	68	24		52	44		
Nov-09	33	30	37	45	48	7	56	22		33	50	17	
Jan-10	14	45	41	50	32	18		41	59	53	47		
Mar-10	15	60	25	50	32	18		40	60		45	50	5

Source: Central Bank of Kenya

Similarly, the non-bank private sector exhibited expectations similar to those of banks on inflation and economic growth, while they expected the exchange rate to remain stable in the remainder of 2009 and first half of 2010. Perceptions on their demand for credit also shifted from expectations of growth between 1-10 percent to between10-20 percent over the same period. The expected increase in demand for credit, as viewed by the private sector, was to be achieved in an environment of low inflation and stable exchange rate (Table 2). The results of these surveys were an important input in the Committee's decision process .

Table 2: Changes in perceptions of non-bank private sector (percent of response)

	Inflation			Ksh/USD Exchange rate			Economic Growth %			Demand for credit			
	Increase by 1-2%	Remain the Same	Decline by 1-2%	Strengthen	Remain the same	Weaken	2-3	3-4.5	4.5-5	Decline	Remain the Same	Increase by 1-10%	Increase by 10-20%
Sep-09	60	24	16	48	28	24	68	24					
Nov-09	20	20	60	22	78		90	10					
Jan-10	18	64	18	30	40	30		73	27	17	17	66	
Mar-10	38	52	10	19	48	33		86	14		33	17	50

Source: Central Bank of Kenya

Data capture and analyses

The MPC continued to monitor and analyse developments in the economy using the weekly and monthly dashboards of key economic indicators. The MPC also continued to improve on the content, data quality and collection methods to ensure that the information captured effectively facilitates sound analyses and keeps the MPC well informed of the developments in the various sectors of the economy. The availability of high frequency data through the weekly dashboard enhanced policy formulation during the period covered by this Report. In this regard, the MPC worked closely with CBK staff to raise analytical insights as it requested for more and better data.

Other MPC activities

a) The MPC continued to monitor the impact of the global financial crises on the economy and the evolution of the Greek debt crisis.

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) Fora were organised with a diversified pool of stakeholders including commercial banks, investment banks and the media to obtain their perceptions on the economy.

d) After every MPC meeting, the Committee held meetings with chief executive officers of commercial banks (CEOs) to share the results of the Market Perceptions Surveys. The MPC also used the meetings to elaborate on the underlying factors that were considered in the previous MPC decision. Discussions in the meetings were guided by the content of the long press releases. Meetings with CEOs and Market leaders, both initiated in the previous period, were carried forward through the period covered by this Report.

e) Press conferences to disseminate MPC decisions were used to enhance the Committee's communications strategy. In this regard, the MPC worked closely with the communications committee of the Bank.

f) The MPC Meetings in January and March 2010 were held in Kisumu and Mombasa, respectively, in order to introduce MPC members to the Bank's branch operations.

3. REACTIONS TO THE ECONOMIC ENVIRONMENT

This section of this Report reviews developments in the domestic economy, and outlines the major events with economic consequences that occurred during the period covering November 2009 to April 2010.

Kenya Economic Status and Financial Sector Developments

The KNBS released the third quarter of 2009 growth data in December 2009 and the fourth quarter data in May 2010, at the same time as the release of the 2010 Annual Economic Survey. As shown in Table 3, however, the 12-month provisional real GDP growth improved to 2.6 percent in the fourth quarter of 2009 from 1.7 percent in the third quarter. The sectors driving growth in the fourth quarter of 2009 were transport and communication, manufacturing, tourism, building and construction and financial services. The agricultural sector also registered improved performance following improved rainfall in the fourth quarter of 2009.

However, the 2010 first quarter data on growth was not available to the Committee in April 2010, the final month covered by this Report. The Committee had nevertheless, been looking at other indicators and, discussing with the KNBS, hence, it had a satisfactory assessment of the likely 2010 first quarter performance. It was noteworthy that the slowdown in agricultural output, while having the expected depressing effect on growth, nevertheless did not dry up the momentum of the other sectors. In particular, the construction sector continued to boom while the wholesale and retail sector benefited from a continued recovery of tourism. Notably, research towards developing a forecasting framework for economic growth continues, but as yet has no meaningful input to the MPC's decision process.

Table 3: 12-Month Economic Growth (Percent)

	2007				2008				2009			
	to Mar	to Jun	to Sep	to Dec	to Mar	to Jun	to Sep	to Dec	to Mar	to Jun	to Sep	to Dec
Real GDP	6.56	7.05	6.57	7.00	5.59	4.20	3.26	1.55	2.58	2.27	1.71	2.59
Agriculture	6.47	5.73	3.89	2.40	-0.75	-1.09	-2.43	-4.08	-3.21	-3.97	-3.52	-2.58
Transport & communication	8.99	8.90	10.54	15.07	13.08	9.26	6.60	3.09	6.51	5.37	6.89	6.43
Manufacturing	5.98	6.83	6.31	6.28	4.98	4.07	3.79	3.53	4.59	3.41	1.93	2.00
Tourism (Hotels and Restaurants)	16.17	21.92	19.05	16.30	-0.58	-17.71	-27.63	-36.11	-2.19	18.21	30.41	42.83
Building and construction	3.10	4.35	7.83	7.32	9.62	10.56	9.76	8.24	12.40	11.64	9.07	14.08
Financial services	5.23	5.52	6.33	6.65	5.96	5.31	3.56	2.69	2.27	1.61	3.28	4.61
Electricity & Water	0.57	3.80	6.96	9.13	10.00	8.14	6.31	5.38	3.47	2.69	0.84	-3.12
Trade	10.70	10.25	7.94	11.31	11.83	9.93	8.90	4.78	1.38	-0.51	-1.75	1.48

Source: Kenya National Bureau of Statistics

The Repo Market

The monetary programme continued to guide MPC decisons during the six months to April 2010. Consistent with the decisions of the MPC which were mainly aimed at ensuring that banks had adequate liquidity to lend to the private sector, open market operations in the period were generally restricted to liquidity injections rather than mop ups. Consequently, the average repo rate dropped from 4.19 percent to 2.50 percent during the period.The Central Bank drew down its repo stock in May 2009 as it sought to ensure that reserve money growth was within the programmed target (Table 4).

Table 4: Performance of Average Reserve Money (Kshs Billion)

	Reserve Money			OMO (REPO)			OMO (REVERSE REPO)			Repo stock
	Actual	Target	Deviation	Amount Posted	Actual Mop Up	Deviation	Amount Offered	Actual Injection	Deviation	
Jan-09	156.46	168.56	-12.10	2.50	3.32	0.82	0.14	0.14	0.00	7.94
Feb-09	154.27	167.48	-13.20	1.73	2.08	0.35	0.16	0.18	0.03	5.70
Mar-09	154.78	164.23	-9.45	1.83	1.41	-0.42	0.00	0.00	0.00	3.87
Apr-09	154.25	164.57	-10.32	1.30	0.91	-0.39	1.90	1.68	-0.22	2.88
May-09	160.40	164.92	-4.52	0.10	0.11	0.01	4.30	2.92	-1.38	0.37
Jun-09	159.94	163.58	-3.64	0.00	0.00	0.00	1.23	1.15	-0.08	0.00
Jul-09	157.95	161.04	-3.09	0.00	0.00	0.00	2.04	1.63	-0.41	0.00
Aug-09	156.88	162.89	-6.00	0.00	0.00	0.00	2.45	1.41	-1.04	0.00
Sep-09	163.49	164.74	-1.26	0.00	0.00	0.00	0.42	0.39	-0.03	0.00
Oct-09	163.45	166.61	-3.16	0.00	0.00	0.00	1.51	0.88	-0.63	0.00
Nov-09	169.15	167.82	1.33	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Dec-09	175.52	172.66	2.86	0.00	0.00	0.00	2.90	2.80	-0.10	0.00
Jan-10	175.15	173.81	1.34	0.00	0.00	0.00	1.00	1.10	0.10	0.00
Feb-10	173.35	174.55	-1.20	0.00	0.00	0.00	2.30	2.20	-0.10	0.00
Mar-10	176.23	175.69	0.54	0.00	0.00	0.00	1.80	1.40	-0.40	0.00
Apr-10	177.05	177.06	-0.01	0.00	0.00	0.00	3.50	3.60	0.10	0.00

Source: Central Bank of Kenya

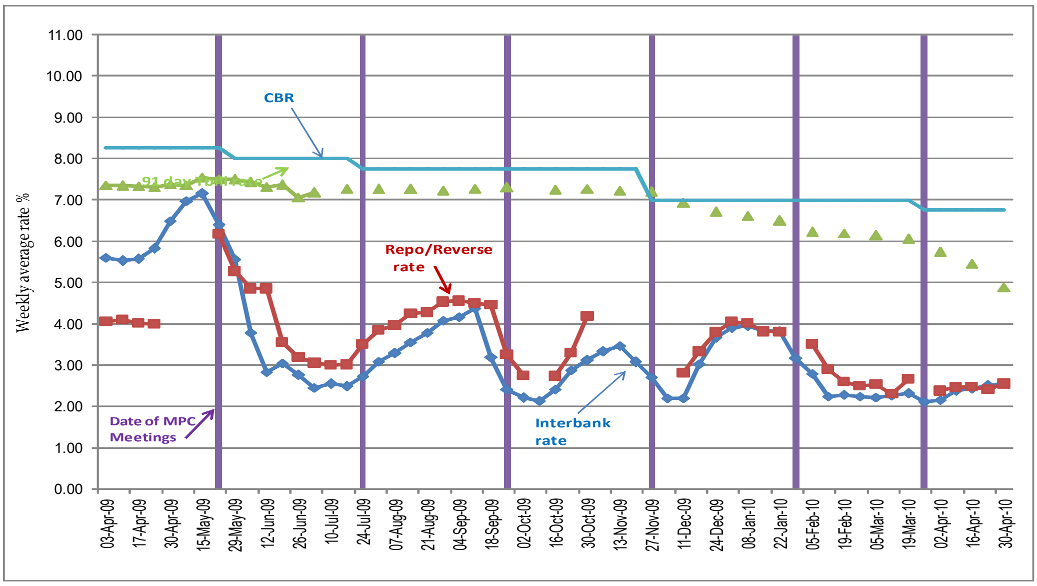
Reserve money remained below target over the period covered by this Report despite increasing from Kshs 163.45 billion in October 2009 to Kshs 177.05 billion in April 2010. However, broad money supply (M3) increased from Kshs 1,006.0 billion in October 2009 to Kshs 1,122.80 billion in April 2010, and was generally within target in absolute terms during the period. However, reserve money and money supply grew by 16.1 percent and 20.9 percent in the year to April 2010 against targets of 16.2 percent and 16.6 percent, respectively. The major source of growth in money supply included growth in credit to private sector which increased significantly from an annual growth of 10.95 percent in November 2009 to 15.72 percent in April 2010.

The MPC also continued to encourage the use of Horizontal Repos during the period in order to improve distribution of liquidity within the banking system. Consequently, the uptake of Horizontal Repos increased from Kshs. 1,781.8 million in October 2009 to Kshs. 2,354.8 million in April 2010 while the average interest rate on a 7-day Horizontal Repo declined from 4.00 percent to 2.92 percent. By April 2010, the MPC noted that more than 40 banks had signed the Master Repurchase Agreements (MRAs) between themselves on the use of the horizontal repo facility.

A comparison of the policy rates with other countries indicates that while the MPC reduced the CBR from 7.75 percent in October 2009 to 6.75 percent in April 2010 to enhance credit expansion, the US Federal Reserve Bank, Bank of England and the European Central Bank maintained their policy rates through out the period at 0.25 percent, 0.50 percent and 1.00 percent, respectively. The US and UK policy rates remained unchanged during the period as signs of recovery in these countries were starting to be realised.

As shown in Chart 1, short term interest rates continued to respond to monetary policy signals. At the same time, credit to the private sector expanded by Kshs 47.73 billion between October 2009 and April 2010. In addition, credit expansion in the period was mainly in key sectors of the economy.

Chart 1: Short Term Interest Rates



Source: Central Bank of Kenya

Banking sector Develop-ments

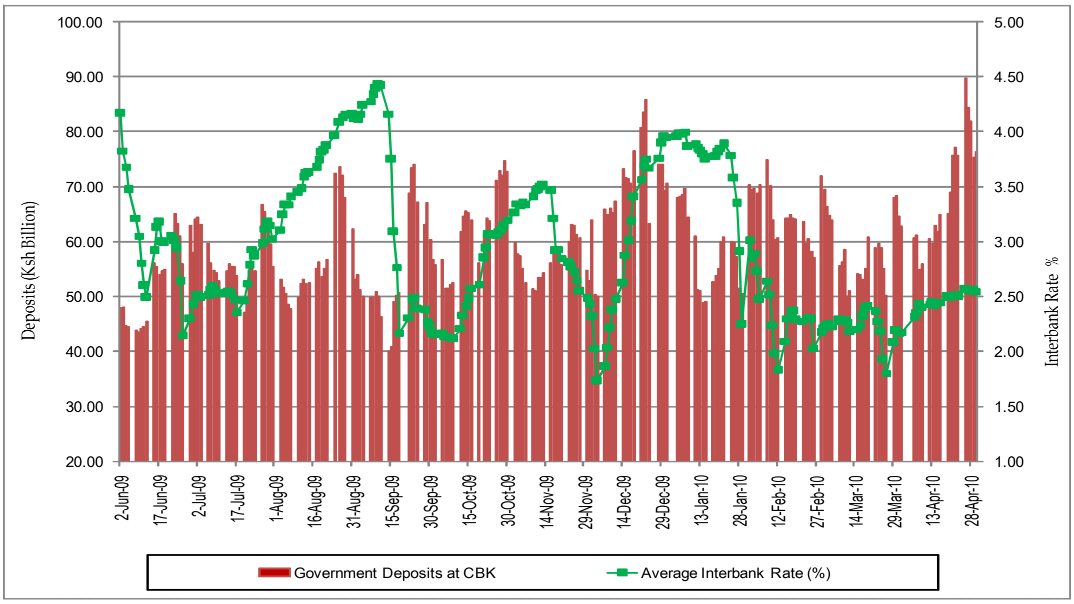
The performance of the banking sector remained strong and stable during the 12-months to April 2010. In particular, commercial banks gross deposits and loans grew by 12.53 percent and 5.89 percent, respectively, during the period to stand at Ksh. 1,141.6 billion and Ksh 799.5 billion, respectively, at the end of April 2010. The proportion of net non-performing loans to total loans decreased from 2.47 percent in November 2009 to 2.43 percent in April 2010, indicating declining credit risk. In addition, credit to private sector grew by 6.94 percent in the six months to April 2010 with a large proportion going to manufacturing, trade, mining and quarrying, private households, business services, transport and communication,and real estate sectors.

There were also legal and institutional changes aimed at developing the financial sector during the period. These included the implementation of guidelines stipulated in the Microfinance Act and Regulations of 2008; agency banking facilities in June 2009, introduction of value capping in October 2009; the passage of the Anti-Money Laundering Act in December 2009; and licensing of the first credit reference bureau in February 2010. The MPC considers these developments a significant step that would improve access to financial services.The introduction of value capping ensured that cheques for amounts over one million shillings would be paid through the Real Time Gross Settlement System (RTGSS). This has enhanced the safety and efficiency of the payments system and significantly reduced transaction costs associated with huge payments.

The Inter-bank Market

The average interest rate in the interbank market was volatile, but on a downward trend, during the period under review (Chart 2).

Chart 2: Daily Interbank Rate (percent) and Government Deposits at CBK (Kshs Billion)



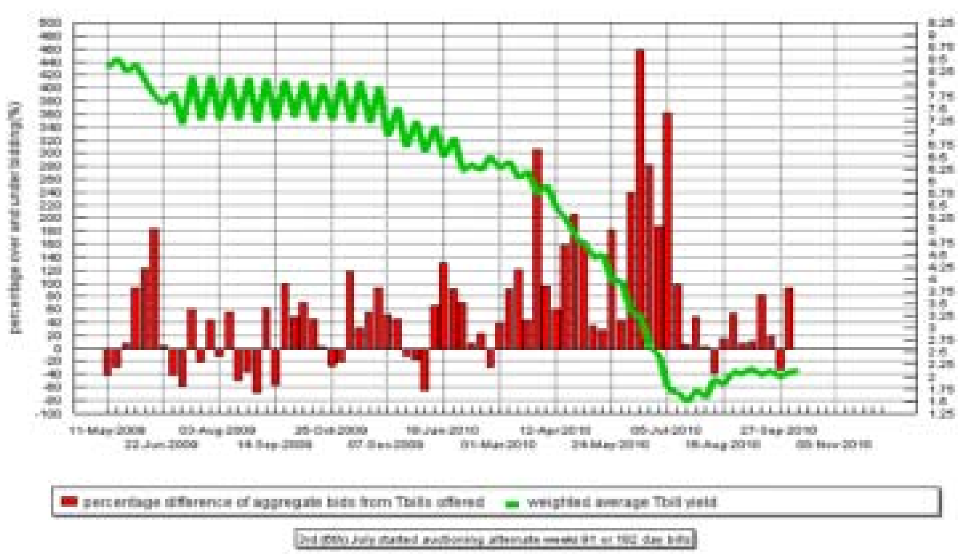
Source: Central Bank of Kenya

Analyses carried out by the MPC during the period showed a strong positive correlation between interbank rates and the build-up of Government deposits at the Central Bank. The MPC also noted that the average interbank interest rates had significantly become less volatile due to, among other factors, increased predictability of government deposits. Once the Government deposits had been drawn down and the new financial year commenced, the interest rates dropped significantly in June 2009 in line with the major increases in liquidity available and the signals from the MPC decisions. The MPC also noted the seasonal requirements of the banking system particularly associated with payment of tax liabilities which caused periodic increases in demand.Such surges needed to be closely monitored as they are likely yo have inflationary implications.

The Treasury Bill and Treasury Bond Market

The stock of Treasury bills (excluding repos) rose from Kshs. 137.7 billion at the end of November 2009 to Kshs. 176.1 billion at the end of April 2010. The stock of Treasury bonds increased from Kshs. 381.0 billion to Kshs. 442.4 billion during the period. The build-up in Government debt during the period was attributed to planned domestic borrowing to finance the budget deficit. As shown in Chart 3, the decline in the yields on Treasury bills was largely driven by oversubscriptions on most of the issues of government securities following improved liquidity conditions. In particular, only six out of the twenty nine Treasury bills auctions in the period were undersubscribed while all Treasury bond issues were oversubscribed. In order to take advantage of the low interest rates, the government stepped up domestic borrowing in February to March 2010. Confidence in the longer-dated government paper was also indicated by the lengthening maturity profile of domestic debt in the period. The ratio of bonds to bills in the total stock of debt remained steady at 70:30 over the period, indicating a low risk of huge government debt falling due in the short term.

Chart 3: Treasury Bills Weekly Auction Outcomes

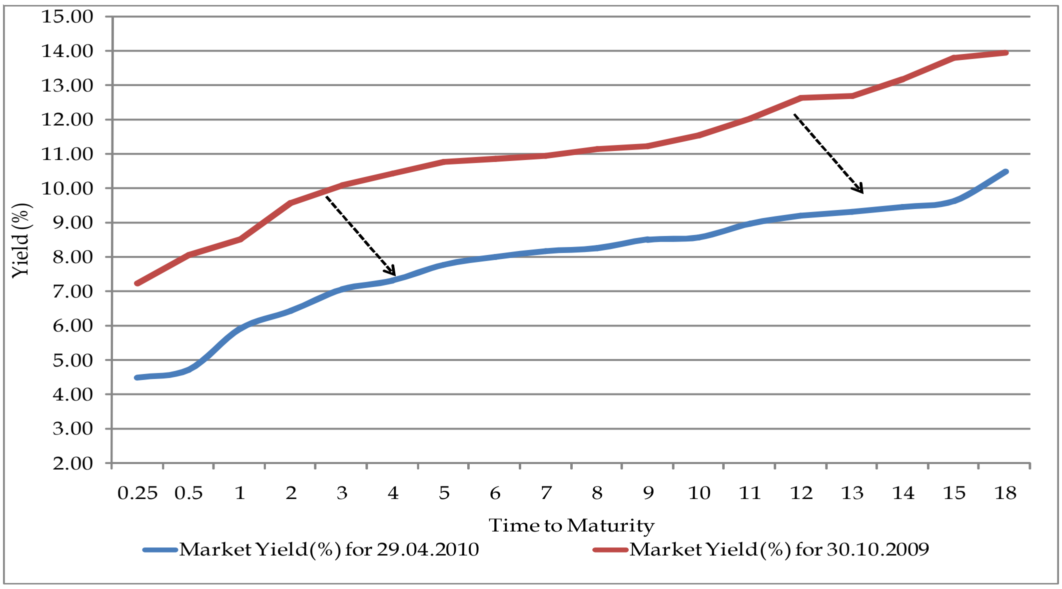


Source: Central Bank of Kenya

Govern-ment Securities Yield Curve

As with the short term interest rates, the longer term interest rates on riskless government paper declined steadily as displayed by a downward shift of the yield curve between October 2009 and April 2010 (Chart 4). Not only did the curve move downwards but it also flattened out slightly except for the very long tenor securities. This was attributed to adequate liquidity in the market occassioned by the expansionary monetary policy adopted by the MPC to enhance credit expansion in order to support economic growth, and increased confidence on the outlook of economic growth and inflation.Therefore, the Committee was satisfied with the improvements in the shape of the yield curve. This shift could,in part, be attributed to the introduction of the automated trading system in November 2009 that enhanced efficiency in trading especially of longer dated securities.

Chart 4: Government Securities Yield Curve



Source: Central Bank of Kenya

Global Economic Develop-ments

The international economic climate changed significantly early in December 2009 when Greece announced the likelihood of it defaulting on its debt. Prior to this, the Euro had been strengthening relative to the US dollar since the effects of the subprime mortgage financial and economic crises had began to wane.This had encouraged risk taking behaviour among participants in the foreign exchange market. These crises had several waves commencing in September 2008. However, earlier MPC Reports have indicated that Kenya weathered these economic storms satisfactorily.

The implications of the Greek crisis internationally were that those who had shifted to the Euro as an appropriate currency for storing wealth suddenly found themselves with a rapidly depreciating currency hence they offloaded them and purchased US dollars reversing the roles. The Euro (and Sterling

Pound) depreciated rapidly while the US dollar strengthened. As far as Kenya's trade is concerned, horticulture continued to be depressed throughout the period although there were some minor gains due to the selling in the Dutch Auction in Euros. Quantities remained low due to depressed European demand. On the other hand, immigrant remittances quickly recovered to their customary USD 50–55 million range indicating that Kenyans in the diaspora continued to see remittances as the best use of their resources. Coffee and tea marketed in US dollars and Sterling Pounds, respectively, continued to show un-trended but depressed results. Nevertheless, on services account, tourism continued its strong recovery from the post election violence period and both Mombasa and Nairobi were showing results - seasonally adjusted - better than pre-2007 elections.

The MPC concluded that it would continue monitoring the evolution of international economy while carefully reviewing the price wars as Europe and the United States sought to retain markets. Through the period under review, India and China continued to retain their positions as major trading partners despite the latest data showing no major changes in terms of trade volumes.

It would seem that the European and American economic turbulence has not had a significant impact on the East African Community economies since Kenya's exports in the region have continued to grow significantly. The South African Rand has strengthened slowly against the Kenya Shilling although demand for South African imports has continued unabated. However, the tourism sector, which was reported to have grown by an impressive 42.8 percent in the fourth quarter of 2009, continues to perform well. Due to the slow economic recovery in Europe, which is the main destination for Kenya's horticultural produce, recovery in exports of these commodities has been slow. Nevertheless, exporters generally are benefiting from the loss of value of the shilling against the US dollar.

Developments on Inflation

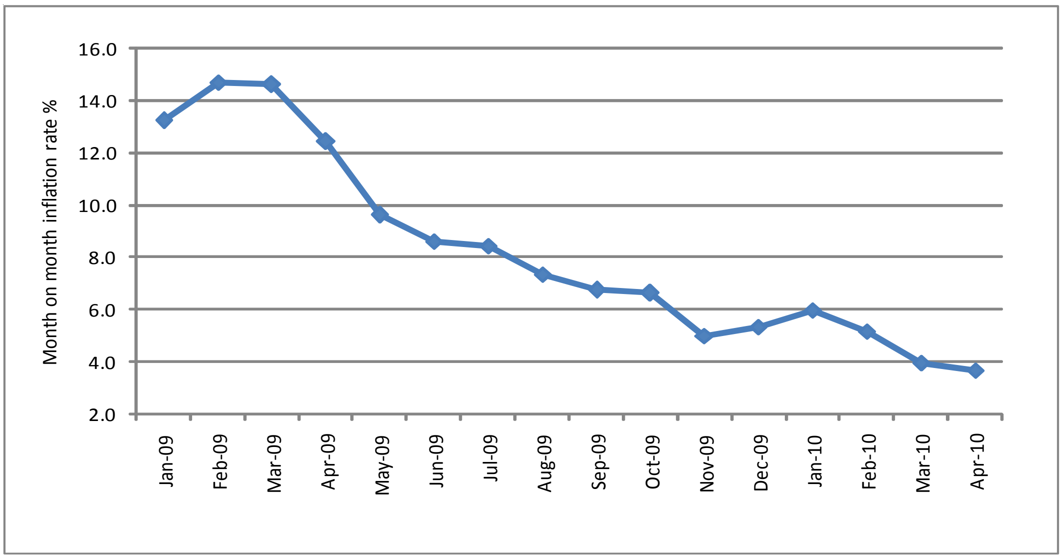
As was pointed out in the third MPC Report, the KNBS had produced a geometric mean computed price index in October 2008, and that this therefore, resulted in production of the first geo-mean inflation data in October 2009. The geo-mean computation significantly revised the previously computed, biased, arithmetic mean series. Since the prime target of monetary policy decisions is controlling inflation, the Committee considered it necessary to work together with the KNBS in producing a long data series.This would allow for econometric analysis and later facilitate updating of inflation forecasting models. Because of the non-linear character of the transition from an arithmetic measure to a geometric measure, it was necessary to use alternative ways of chaining (linking) the previous indices to these new measures. Since on various occasions in the past inflation had been negative, the possibility of using logarithmic transformations was ruled out and quadratic functions were found to be satisfactory. By January 2010 there was already an acceptable long series generated of a compatible geometric mean index.This, nevertheless, still embodied the old consumer basket and allied weights.

In February 2010 the KNBS published the first observation of inflation using the new consumer basket with new weights. These, 234 items, were drawn from the Kenya Integrated Household Budget Survey of 2005/06. This new, more relevant weighting, showed a significant shift from food dependence, while introducing a number of new products. The most significant of the new products introduced relate to new technologies ranging from the acquisition of computers and mobile phones to the mobile telephone call charges. Furthermore, the new index subdivided the previous Middle/ Upper Index into separate Middle and Upper Indices. The proportion of Lower Income continued to be similar to the preceding CPI. Provincial indices were now being generated replacing the more limited, urban indices in the preceding analysis.

Since the KNBS released the indices rather than an inflation series (there were only 13 months of data), the Committee explored ways of chaining this series in a more conventional manner since it was a geometric index to the geo-index which it had previously produced based on October 2005. The Committee noted there was no insipient inflationary threat. The Committee considered that the new index provided a more valid target to assess the implications of monetary policy but thought that it still showed vulnerability to international events beyond Kenyan control. It therefore commenced discussions with the KNBS on the preparation of a more appropriate measure along the lines of a non-tradable goods index which would be better than the old underlying inflation measure.

As shown in Chart 5, the 12-month overall inflation rate maintained a downward trend between October 2009 and April 2010. In particular, overall inflation declined from 6.6 percent to 3.7 percent during the period on account of improved rainfall and stable world oil prices.

Chart 5: 12-Month Overall Inflation Rate (Percent)



Source: Kenya National Bureau of Statistics and CBK

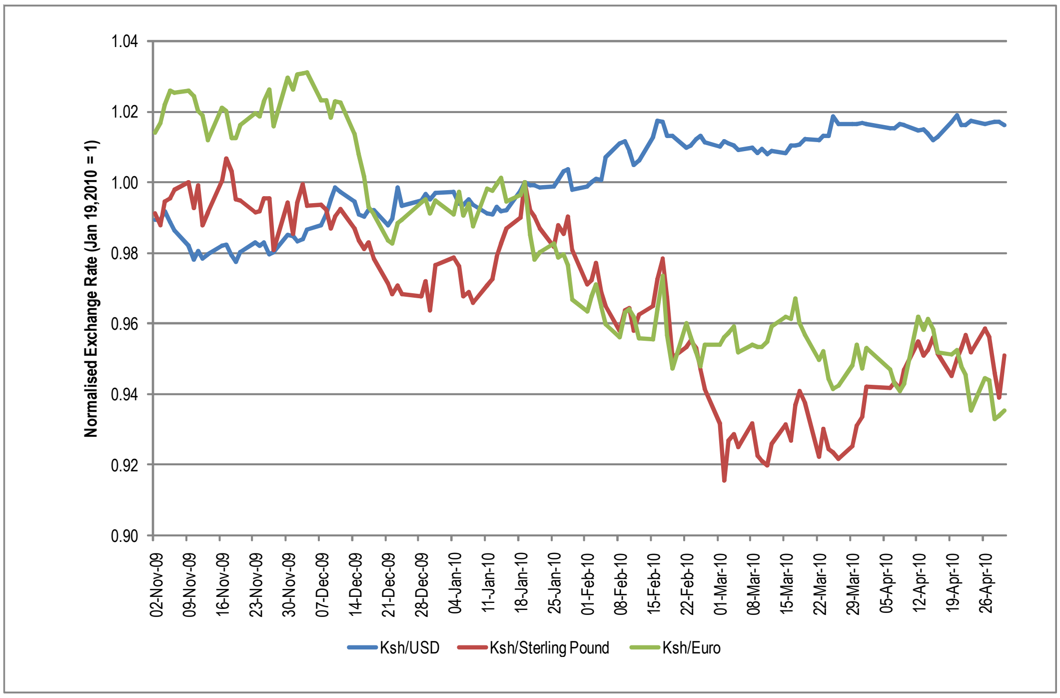
Exchange Rate Management

As shown in Chart 6, the Kenya Shilling weakened against the US dollar but strengthened against the Euro and the Sterling Pound between November 2009 and April 2010. These movements in exchange rates reflected developments in the international foreign exchange markets that were largely driven by the effects of the Greek debt crisis on the Euro. The resultant strengthening of the US dollar against the Euro and the Sterling Pound during the period accelerated the weakening of the Shilling against the US dollar.

However, inflows of foreign exchange from a variety of sources in the six months to April 2010 continued to support the exchange rate of the Kenya Shilling against the US dollar. In particular, immigrant remittances averaged about USD 50.18 million during the period compared with USD 51.34 million in the six months to October 2009. This shows that the global financial crisis did not have a significant impact on flows of immigrant remittances.

Tourism also continued with its recovery beyond 2007 pre-crisis positions. A comparison of tourist arrivals in the period from November 2009 and April 2010 to a similar period in the previous year shows that tourist arrivals through Nairobi and Mombasa averaged 64,954 and 21,548 per month, respectively, in the November 2009 to April 2010 period up from 56,055 and 19,484 per month, respectively, in the November 2008 to April 2009 period.

Chart 6: Trends in Normalised Exchange Rates



Source: Computations based on data from Central Bank of Kenya

Note: *The Kenya shilling exchange rates on 19th January, 2010 were 76.05 per USD, 124.82 per Sterling Pound, and 109.50 per Euro.*

Foreign Exchange Reserves

Between November 2009 and April 2010, the Bank continued to build up foreign exchange reserves by purchasing USD 332.35 million from the domestic foreign exchange market (Table 5). Despite the purchases of foreign exchange from the market, movements in the exchange rate during the period were mainly determined by developments in the international currency markets. This was amid steady inflows of foreign exchange from tourism, other export earnings and diaspora remittances as mentioned earlier.

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 2010, there were signs of increased build-up in the stock of foreign exchange reserves as the Central Bank made relatively large purchases from the domestic foreign exchange market. At the end of the period, the official reserves stood at USD 3,805.39 million which was equivalent to 3.96 months of import cover. The official foreign exchange reserves was slightly below the statutory 4 months of imports due to an increasing import bill.

Unlike in the past, the build up in official reserves towards the end of the period covered by this report was driven by purchases of both Euros and US dollars as the former depreciated against the local currency occassioned by the developments in the Greek debt crisis.

Table 5: Developments in Foreign Exchange Reserves (USD Million)

	Apr-09	Jun-09	Aug-09	Oct-09	Nov-09	Dec-09	Jan-10	Feb-10	Mar-10	Apr-10
Gross Reserves										
Official	2,887.74	3,219.46	3,591.02	3,810.42	3,934.28	3,847.39	3,809.54	3,722.55	3,744.62	3,805.39
Commercial Banks	1,732.54	1,602.15	1,534.33	1,536.24	1,386.66	1,216.63	1,469.84	1,531.78	1,443.02	1,319.02
Imports cover (36 months)	3.28	3.61	3.97	4.13	4.23	4.09	4.02	3.93	3.92	3.96
Foreign Exchange Transactions										
Interbank purchases	10.00	74.00	79.25	82.00	62.00	24.00	13.00	35.85	68.00	129.50
Interbank sales	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00

Source: Central Bank of Kenya

4. CONCLUSION

Overall, the MPC met its planned objectives between November 2009 and April 2010. There are signs of strong recovery in the economy supported by growth in credit to private sector and recovery in the global economy. The Committee will continue to monitor developments in the Euro zone economies following the Greek debt crisis and any other development that may have either direct or indirect impact on the economy, while recommending, where necessary, appropriate measures to be taken.

The low and stable inflation rates provide space for the MPC to continue with expansionary monetary policy in order to support growth through credit expansion. The Central Bank of Kenya was able to engage in open market operations aimed at ensuring that monetary driven inflationary pressures did not occur. In particular, the Bank's tools of liquidity management were sufficient and the degree to which inflation affected the economy was mainly on the supply side.

GLOSSARY OF KEY TERMS

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

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

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

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

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

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

Open Market Operations
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 rate (REPO rate) for a specified period with an understanding that the commercial bank will repurchase/resell the security from/to the CBK at the end of the period. The period can be limited by the CBK.

Horizontal Repo
This is an interbank REPO instrument which recognizes Government securities as collateral for borrowing. The instrument allows commercial banks without credit lines with other banks to access credit from the interbank market.

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

Cash Ratio Requirement
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 in law by CBK.