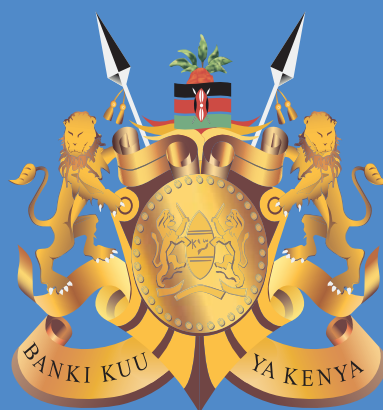


**FIFTH**

**BI-ANNUAL REPORT OF THE**

**MONETARY POLICY COMMITTEE**



**CENTRAL BANK OF KENYA**

**Issued under the Central Bank of Kenya Act, Cap 491**

**OCTOBER 2010**

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## **Letter of Transmittal to the Minister for Finance**

Honourable Minister,

I have the pleasure of forwarding to you the fifth bi-annual Monetary Policy Committee (MPC) Report in accordance with section 4D(6) of the Central Bank of Kenya Act. The Report outlines developments in the economy as well as the activities of the Committee in the six months to October 2010. The Minutes of all the Meetings of the MPC between May 2010 and October 2010 are attached to the Report for your information.



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

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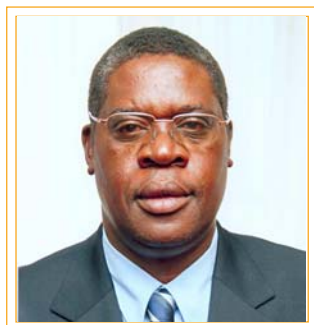
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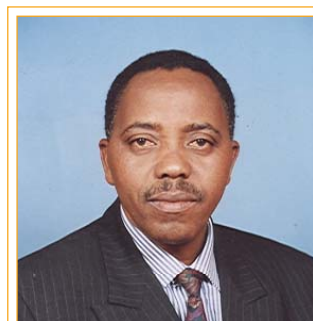
## Members of the Monetary Policy Committee



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



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



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



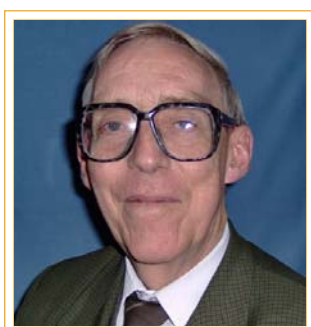
Mrs Sheila S.M.R. M'Mbijjew  
Member



Mr. Charles G. Koori  
Member



Dr. Rose W. Ngugi  
Member



Prof. Terry C. I. Ryan  
Member



Mr. Wycliffe Mukulu  
Member



Mr. John Birech  
Member

## EXECUTIVE SUMMARY

The fifth bi-annual report of the Monetary Policy Committee (MPC) covers the activities of the MPC in the six months to October 2010 and reviews Kenya's economic developments during that period. The MPC made significant steps towards completing its report on appropriate changes to the structure of its operations based on lessons from visits by members to selected central banks in 2009 and 2010. Preparation of the report was also informed by research based on best practice and comments from the Bank for International Settlements (BIS).

During the period between May 2010 and October 2010, there were several notable economic developments both on the domestic and international fronts. First, inflation remained low and stable within the Government's target of 5 percent on account of generally stable energy prices and lower communications costs compared with the prices in the previous six months. The lower communications costs were supported by price war in the mobile telephone service industry which was driven by competition for customers. Second, the MPC continued to track developments in the Greek debt crisis from late 2009 and their likely impact on the Kenyan economy and concluded that the direct impact was not significant.

The MPC continued to undertake bi-monthly market surveys that provided important input in the Committee's decision making process. In addition, bi-monthly meetings with chief executive officers of commercial banks provided the forum for the MPC to explain the background on its decisions and receive feedback. Furthermore, the first MPC public forum was held in August 2010, this provided a platform to obtain feedback on the impact of monetary policy decisions by the MPC on commercial banks and the real sector. The MPC also continued to analyse data on its weekly and monthly dashboards of key indicators which were updated regularly. In particular, the dashboards are an important complement to the set of indicators monitored through the MPC Indicator Table.

In general, this Report indicates that the growth momentum in the Kenyan economy is being supported by growth of credit to the private sector in line with the decisions of the MPC. In addition, both the inflationary pressures witnessed in the previous six months and the impact of the debt crises in some European countries continued to ease. The monetary policy stance that was not inflationary was maintained. In particular, the Bank's tools of liquidity management were sufficient to ensure that monetary expansion directed at supporting economic growth, neither posed any threat to inflation nor stifled the growth process by limiting the availability of liquidity. Although the Report presents data that is already in the public domain, additional analyses and information are included. Both the activities of the MPC and developments in the economic environment are covered by the Report.

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## 1. INTRODUCTION

The fifth bi-annual Report of the MPC covers the period from May to October 2010. The MPC continued to review developments in both the international and domestic economic environments during this period. The Committee noted continued improvement in the performance of key sectors of the economy such as agriculture, manufacturing, financial intermediation, tourism, and construction. This was partly attributed to improved confidence in the economy, credit expansion to the specific sectors, and increased agricultural activity coupled with the recovery of the global economy. The Committee also continued to work closely with the Kenya National Bureau of Statistics (KNBS) to produce, alongside the overall inflation measure, the non-tradable goods price indices which would be a better measure to re-evaluate the effectiveness of monetary policy implementation than the underlying inflation.

Significant recovery was witnessed in economic performance with improvements in the third quarter of 2010 compared to a similar period in 2009 following favourable weather conditions, increased liquidity in the banking system, and prudent macroeconomic management. Reliable rainfall distribution resulted in continued improvement in the performance of the agriculture sector relative to the performance of the sector in 2009. The generally steady oil prices and lower communications costs during the period also helped to ease inflationary pressures and resulted in a general downward trend in overall inflation. This will also provide a direct relation to real exchange rate profile in the economy.

The MPC pursued a monetary programme for the fiscal year 2010/2011 consistent with the provisions in the Government Budget presented by the Minister for Finance in June 2010. The key assumptions for the monetary programme include a real GDP growth rate of 5.1 percent (Budget Outlook Paper, 2009) by June 2011, a broad money supply (M3) expansion of 17.3 percent and reserve money decline of 2.1 percent in the fiscal year. The monetary programme incorporated a foreign exchange reserves build up to USD 4.35 billion by June 2011, equivalent to 4.20 months of imports compared with USD 3.78 billion or 3.89 months of imports at the end of June 2010.

The MPC made significant progress towards completing the report of its proposed structure which is expected to enhance its effectiveness in formulation and implementation of monetary policy. 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. Lastly, monetary policy decisions during the period continued to be informed by technical analysis of the overall economic environment on both the domestic and international fronts.

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## 2. ACTIVITIES UNDERTAKEN BY THE MPC

**Structure of the MPC** The structure of the MPC has continued to evolve as reported by the Committee in its previous bi-annual MPC Reports. Among other activities, the reports indicated how the MPC has continued to fulfil its legal mandate, undertaking its analytical work and visiting other MPCs around the world to study the effectiveness of their structures and relevance to the Kenyan situation.

The MPC had visited several central banks in the previous periods to learn more regarding any modifications in structure which it might adopt. These visits provided the MPC with a good understanding of the operational processes, structures and effectiveness of the monetary policy operations at these selected central banks. This understanding was then compared with the Kenyan model and used to propose modifications that were considered most appropriate to the structure so as to support the effective implementation of monetary policy in Kenya today.

Many of the non-legislative and purely process/procedures driven enhancements have already been implemented by the MPC. It is also worth noting that the proposed structure has been reviewed by the Bank for International Settlements and their feedback has been incorporated. The report provides recommendations on, among others, the appropriate size of the MPC, terms and appointment procedures, composition of the MPC, reporting structure, procedures at meetings, communication of the decisions, and production of statutory reports.

In July 2010, the MPC prepared a paper on monetary policy committee institutional frameworks which was presented during the 8<sup>th</sup> Meeting of Governors of the Association of African Central Banks, Eastern Africa Sub-region at the Central Bank of Comoros. Regional central banks had been tasked to prepare and share experiences on the institutional framework for monetary policy committee with respect to appointment, composition, degree of autonomy and other issues relating to the respective MPCs.

**Visit by the Tanzanian MPC** The Central Bank of Kenya MPC hosted the Tanzanian MPC between 26<sup>th</sup> and 28<sup>th</sup> July, 2010. The Tanzanian delegation was in the country to learn how the Kenyan MPC conducts its technical meetings. The delegation was led by the Governor of the Bank of Tanzania Prof. Benno Ndulu. The meetings provided a forum for sharing experiences by the two Committees in the formulation and implementation of monetary policy.

The visit by the Tanzanian delegation also provided an opportunity for the two Committees to exchange ideas and experiences with regard to the conduct of monetary policy at the time when the global economy was emerging from financial and economic crises.



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**Statutory  
Requirements**

In July 2010, the Minister for Finance restated, through a letter, the price stability target that should be maintained by the Central Bank of Kenya. The letter also indicated the actions to be taken by the Central Bank when the inflation target was not met. Section 4 (subsections 4, 5 and 6) of the CBK Act requires the Minister for Finance to specify, at least in every period of 12-months at the beginning of the financial year, the price stability target and economic policy to be undertaken by the Government. The letter specified an inflation target of 5 percent as measured by the 12-month change in the overall consumer price index (CPI) published by the KNBS. The letter requires that the Bank strives to achieve this inflation target at all times while accounting for any deviations exceeding 2 percentage points in either direction, in line with section 4B, 4C and 4D of the CBK Act. Notably, high inflation levels as well as deflationary levels tend to discourage investment and long term economic growth.

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

- a) The MPC held its thirteenth meeting on 20<sup>th</sup> May 2010. The Committee noted that economic recovery was on course with increased optimism for enhanced growth in 2010. However, to sustain the growth momentum towards achieving the *Vision 2030* growth trajectory, the economy still required supportive and appropriate fiscal and monetary policies. The lowering of commercial banks base lending rates and the introduction of new products signalled a positive response to the monetary policy stance.

The Committee noted that there was no threat of resurgent inflation from the demand or supply side as inflation was expected to decline and stabilise at low levels due to good rains. Further, the Committee noted improved confidence in the performance of the economy as evidenced by lengthened maturity of government debt from an average of 3.6 years in June 2009 to 4.3 years in May 2010. Improved confidence in the economy was also corroborated by the results of the MPC market perception survey and the World Bank Country Policy and Institutional Assessment for Kenya which had improved from 3.6 to 3.7 and was above the average provided by the International Development Association. This had improved the country's eligibility for concessional funding to the benefit of Government infrastructure development.

With inflation expectations anchored at a lower level and the upside risks to inflation low, the Committee concluded that the market needed more time to consolidate its operations within the current monetary policy stance. In this regard, the MPC decided to maintain the CBR at 6.75 percent.

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- b) The fourteenth MPC meeting was held on 28<sup>th</sup> July, 2010. The information analysed indicated that economic recovery was on course with increased optimism for enhanced growth in 2010. There were also increasing opportunities both internationally and domestically that could be taken advantage of. However, this could only be achieved by strengthening the capacity for private sector growth. To keep the momentum, the Committee was of the view that the economy still required supportive and appropriate fiscal and monetary policies. The Committee noted that commercial banks continued revising their base and lending rates downwards. New products and institutions had emerged including the Credit Reference Bureaus and budget lines for SMEs lending by the Ministry of Finance. Agency banking had taken off and therefore accessibility to financial services had been enhanced. All these considerations together with the growth optimism built a strong case for continued facilitation and provision of adequate and affordable credit.

The Committee was confident that the upside risks to inflation remained low with minimal pressure from international oil prices and the efforts to maintain adequate food supply through the Economic Stimulus Package. The prevailing confidence in the economy provided a firm foundation for growth in economic activities. This was demonstrated by the downward shift and levelling out of the Government securities yield curve and the recovery of the domestic stock market. The successful introduction of the 25-year Treasury bond provided another beacon to guide the financial sector to lengthen the tenors of its credit and debt instruments.

Given the low inflation risk, the strengthening growth profile and growing confidence in the economy, the MPC was of the view that commercial banks and the private sector needed a strong signal in order to provide them with information that overall downside risks were declining and that other factors such as the East African Common Market Protocol offered significant opportunities. The Committee therefore lowered the CBR by 75 basis points to 6.00 percent.

- c) The MPC held its fifteenth meeting on 23<sup>rd</sup> September 2010. The Committee's analyses and market feedback revealed that the perceptions of growth were strong while inflation and exchange rates remained generally stable. The Committee noted that, following its previous decisions, credit growth responded and bank lending rates had declined slightly. However, there was still scope for further reduction in the lending rates. Credit expansion was noted to be in line with the set targets. In particular, private sector financial access improved and this was coupled with a noteworthy growth in lending.

The Committee also considered the measures that would be necessary to improve the efficiency of the financial sector to support the growth of the economy. Among the factors that affect efficiency and which give rise to higher

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costs of capital include the challenges of realizing on collateral and the sufficiency of information of pricing risk. Furthermore, the Committee noted that the models used by the banking sector to price risk did not reflect a competitive market environment. The presence of excess reserves in the banking system signaled commercial banks' readiness to meet any surge in demand for liquidity. Hence, such an increase could be easily absorbed with no adverse impact on the interest rate structure. It was also observed that the factors influencing bank interest rate spreads had changed over time. These indicate a reduction in risk and therefore the capacity for banks to reduce their spreads. The Committee was confident that access to financial services continued to improve as was noted earlier.

In view of these developments, the Committee decided to hold the CBR at its prevailing level of 6 percent to consolidate the gains in the monetary policy stance. It would continue to explore ways of improving the transmission of monetary policy signals to other interest rates in the economy. This would include structural changes aimed at enhancing financial sector efficiency and interest rate adjustments. Consequently, the Committee recommended that Central Bank of Kenya explores ways to address alternative dispute resolution models and make data on cost of borrowing by individual banks more easily available.

#### **Research Activities**

During its previous meetings, the MPC had commissioned research studies aimed at providing insights on how to improve the formulation and implementation of monetary policy. These studies include: demand for money function for Kenya; monetary policy transmission mechanism in Kenya; a framework for restructuring the Central Bank Rate; output fluctuations and inflation in Kenya; efficiency and productivity of the Kenyan banking sector; access to private sector credit and economic performance; interest rate pass-through in Kenya; factors driving usage of financial services from different financial access strands in Kenya; and, a dynamic model for inflation. Significant progress was made towards finalising the studies during the period under review.

Notable progress was also made in the development of the CBK macroeconomic model during the period. Preliminary output from the model was shared with the MPC during its Analytical and Technical meetings.

#### **MPC Market Perception Surveys**

During the period covered by this report, the MPC continued undertaking bi-monthly surveys to capture the perceptions of the banking and private sectors on key economic issues including economic growth, inflation, direction of interest rates, exchange rates, awareness of the public on activities of the MPC and what banks consider as the determinants of interest rates spread. The sample of the private sector was drawn from sectors that contribute approximately 70

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percent to economic growth. The MPC continued to improve on the questionnaires and analysis during the period covered by this report in order to capture issues of interest to the Committee while, at the same time, incorporating comments from the key respondents in this exercise. It is worth noting that while the response rate of the survey questionnaires on banks has improved to 100 percent, the private sector also improved their participation in the survey across all the regions covered by the survey.

Results from the MPC Market Surveys complemented the findings from previous interest rates studies as credit risk, cost of funds and profit margins being highlighted as key determinants of the spread. However, analyses on available data indicated that credit risk and cost of funds that were cited as key drivers of the spread 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 small banks than the other banks. As shown in Table 1, the results of the May 2010 MPC Market Perception Survey indicated that most banks and private sector firms expected the economy to grow by between 3 to 5 percent in 2010. While the proportion of private firms that expected inflation to either remain the same or decline by 1 to 2 percent increased from 55 percent in May 2010 to 58 percent in September 2010, the proportion of banks that had the same perception declined from 84 percent to 62 percent over the same period. Banks cited movements in international crude oil prices as a major driver of inflation.

However, the MPC market perception survey results by September 2010 indicated a major shift and growing optimism for economic growth and lower inflation expectations by both banks and the private sector firms. Most banks and private sector firms in September 2010 expected the economy to grow by more than 4 percent with close to 10 percent indicating a growth of above 5 percent. Inflation was expected to either remain at the previous low level or decline by 1 to 2 percent, the exchange rate to strengthen, and interest rates to either remain at the same level or decline in the remainder of 2010. While over 65 percent of banks expected to reduce interest rates by more than 1 percent in the remainder of 2010, over 46 percent of the private sector firms expected to increase their demand for more credit by 1 to 10 percent (Table 1 and Table 2).

Generally, results obtained from these market perception surveys corroborated other measures of confidence in the economy and facilitated the MPC in understanding the perceptions of key stakeholders in the economy and hence formed an input in the Committee's decision process.

**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	Above 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
May-10	16	44	40	24	20	56		24	76		4	76	20	
Jul-10	25	62	14	21	28	51		17	69	14	14	75	7	4
Sep-10	38	44	18	68	9	23		9	82	9	6	59	26	9

Source: Central Bank of Kenya

**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	Above 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
May-10	45	18	37	28	43	29	5	53	33	9	15	30	25	30
Jul-10	28	28	44	26	21	48		17	66	17	7	33	33	27
Sep-10	42	32	26	42	21	32	16	21	63		7	47	46	

Source: Central Bank of Kenya

### Weekly and Monthly Dashboards

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.

### First MPC Public Forum

The MPC in collaboration with the Kenya Bankers Association (KBA) held its first Public Forum on August 10<sup>th</sup> 2010 at the Kenya School of Monetary Studies. The forum brought together key stakeholders from the public sector, media, academia, research institutions, financial and real sectors to discuss monetary policy issues, banking sector developments, financing of private sector activities and also develop public awareness on financial services. It also provided a platform to obtain feedback on the impact of monetary policy decisions by the MPC on commercial banks and the real sector. The theme of the forum was “*Lubricating the Economic Engine with Adequate and Affordable Credit*”.



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Presentations during the Forum were on: monetary and fiscal policy objectives; banking sector developments and economic growth; financial information flow and the media. The presentations were made by the MPC, Ministry of Finance, Equity Bank, KBA, Kenya Private Sector Alliance, Kenya Association of Manufacturers, Financial Sector Deepening Trust, and the Nation and Standard Media Groups. The following was agreed as the way forward and action plan by the concerned stakeholders in achieving the objectives of the Forum:

- a) In view of the prevailing favourable macroeconomic conditions, declining credit risk and improved liquidity conditions following easing of the monetary policy stance by the MPC, commercial banks should lower their lending rates further to enhance credit uptake by the private sector. The high cost of credit was highlighted by the non-bank private sector as a key obstacle for the sector to contribute fully to the country's growth target. It was also observed that credit uptake by the private sector could be enhanced by increasing access to financial services. Commercial banks were encouraged to be more transparent by disclosing the level of bank charges on loans. Increased flexibility of banking hours was also emphasised by SMEs as key to improving the performance of the sector.
- b) Commercial banks should strive to increase the maturity profile of loans to the private sector to meet the demand for long term financing by the private sector. It was noted that the prevailing maturity of loans, which stood at about three years, was an impediment to long term financing of private sector investment. Syndicate lending by banks was proposed as one way of mobilising long term deposits for long term lending. However, it was agreed that the private sector should ensure that projects for which long term loans are required are viable.
- c) SMEs should enhance their interactions with key stakeholders to facilitate their sector growth. It was noted that a major impediment to SMEs accessing credit from commercial banks was the lack of information on their operations derived from prudent record keeping. It was agreed that SMEs should provide such information to credit reference bureaus to enhance their credit ratings. Regular interactions with the media would also help to sensitise the public on the activities of the SMEs sector.
- d) The CBK, KBA and Financial Sector Deepening (FSD) should enhance financial education. It was noted that financial education would be required to build the capacity of SMEs and MFIs on how to develop and maintain records as well as financial reporting. Sensitisation of commercial banks on the need to adopt the annual percentage rate (APR) and development of a futures interest rate was also noted to be necessary. There is also need to build capacity on pricing risk by banks as most banks were noted not to have a convincing framework.

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- e) The CBK should make the MPC Forum an annual event as it was noted to have brought together key stakeholders involved in the country's economic policy formulation and implementation. Such forums are an important avenue for industry associations to advocate for an enabling environment for their growth. It was proposed that industry players should hold similar forums to discuss modalities for addressing challenges in their respective sectors.
  - f) The media should play its role as a partner in development through positive reporting on the economy. In most cases, it had been observed that the information content would carry a positive message while the heading was on the contrary. The media was also requested to dedicate a section on the SMEs in order to sensitise the public on the sector's activities. However, SMEs were challenged to generate news through improved performance and regular interaction with the media.
  - g) The Ministry of Finance should implement fiscal policy measures which would enhance the competitiveness of the country's exports in the region. The private sector was particularly concerned that the cost of goods and services was higher in Kenya compared to other countries in the region due to comparably higher taxation.
  - h) The Ministry of Finance should develop a mechanism for speeding up the local procurement process of the Government and ensure that suppliers of goods and services are paid on time. It was observed that continued improvement of the efficiency of the National Payments System by the CBK would also support this goal. Providers of financial services should also embrace innovation in order to improve access and efficiency in the sector.

### **Structure of MPC Meetings**

The MPC continued to implement measures aimed at enhancing its decision making process. Consequently, in July 2010, the MPC held a meeting with those who present at its Analytical and Technical Meetings. The purpose of the meeting was to enhance productivity of the various levels of MPC meetings given the time constraints, and also to continue the evolution of MPC policy formulation process. The modalities for achieving these objectives was identified to be through increasing confidence of presenters, providing broad guidelines of what the MPC expects at the three levels of meetings, and establishing a prioritised scheduling for effectiveness. Capacity building towards enhancing presentation skills was noted to be a core factor in improving the quality of presentations. In line with experiences from other countries, the following was agreed to distinguish between the three levels of MPC meetings.

- Analytical Meetings would provide a forum for researchers to present analytical work undertaken as well as views on the economy with the purpose of providing insights to inform policies. MPC members are free

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to give analytical and technical input during the Meetings.

- Technical Meetings would provide a forum for discussion by MPC members and researchers informing on what needs to be considered in making policy decisions arising from key developments in the market and observed relationships.
- The Main MPC Meeting would provide a forum for decisions to be taken informed by information that had previously been discussed and cleared as appropriate for decision making.

#### **Other MPC Activities**

- a) After every MPC Main meeting, the Committee held meetings with chief executive officers of commercial banks to share the results of the Market Perceptions Surveys and to obtain feedback on the data collection tool.
- b) The MPC also used the meetings to provide the background information to its previous decisions which is usually motivated by the content of the long press release. 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 to enhance the quality of the Short and Long MPC Press Releases.
- c) The MPC continued to monitor and prepare briefs on the status and impact of the evolution of the Greek debt crisis.
- d) 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.
- e) Various forums were organised with Treasury managers of commercial banks, investment banks and the media to obtain their perceptions on the economy.
- f) MPC members also participated in Market Leaders Forums which were organised on monthly basis by the Central Bank of Kenya to discuss market developments and new Treasury bond issues.
- g) The MPC worked with the KNBS on various data issues, in particular in the preparation of the Kenya Economic Survey for 2010.
- h) In October 2010, the MPC held a meeting with the IMF mission which was in the country to discuss the Memorandum of Economic and Financial Policies for the Extended Credit Facility arrangement with Government officials.



### 3. REACTIONS TO THE ECONOMIC ENVIRONMENT

This section reviews developments in the domestic economy, and outlines the major events with economic consequences that occurred during the period covering May 2010 to October 2010.

#### Kenya Economic Status and Financial Sector Developments

The provisional KNBS third quarter growth data for 2010 indicated that the economy grew by 4.97 percent in the 12-months to September 2010 relative to a similar period in 2009 up from 3.53 percent in the 12-months to June 2010 (Table 3).

**Table 3: 12-Month Economic Growth (percent)**

	2007				2008				2009				2010		
	to Mar	to Jun	to Sep	to Dec	to Mar	to Jun	to Sep	to Dec	to Mar	to Jun	to Sep	to Dec	to Mar	to Jun	to Sep
Real GDP	6.56	7.05	6.57	7.00	5.59	4.20	3.26	1.55	2.58	2.27	1.71	2.59	2.45	3.53	4.97
Agriculture	6.47	5.73	3.89	2.40	-0.75	-1.09	-2.43	-4.08	-3.21	-3.97	-3.52	-2.57	-0.73	1.52	4.05
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	3.91	5.06	3.03
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	2.80	4.58	6.84
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	8.04	0.86	3.61
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	9.79	11.66	14.86
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	6.83	10.50	13.82
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	-3.05	0.25	6.45
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	2.98	4.93	6.00

*Source: Kenya National Bureau of Statistics*

The improved performance of the economy in the third quarter of 2010 was attributed to favourable weather conditions, increased liquidity in the banking sector and prudent macroeconomic management. These factors encouraged a steady growth of the economy since the first quarter of 2010 leading to a turnaround in the performance of electricity, agriculture and water and tourism sectors. This had an indirect compounding impact on growth through knock-on effects on manufacturing, construction and services sector. In particular, agriculture, manufacturing, building and construction and financial services grew by 4.05 percent, 6.84 percent, 14.86 percent and 13.82 percent, respectively, in the year to September 2010. The performance of the financial sector during the period endorsed the MPC's active encouragement. Notably, a combination of Government expenditures on the Economic Stimulus Package programmes and infrastructure development through the development budget provided the economy with an additional thrust during the period.

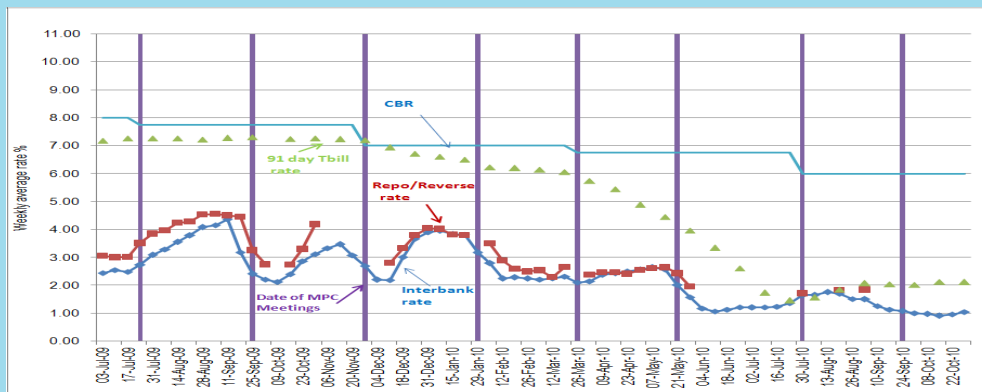
#### Monetary Policy Operations

The monetary programme continued to guide MPC decisions during the six months to October 2010. The effectiveness of the current monetary policy framework has been questioned by the MPC following recent financial innovations which had resulted in structural changes in the economy. Enhanced financial deepening resulted in a decline in the velocity of money and an increase in the money multiplier which must be relatively constant for efficacy in traditional monetary programming. Consequent on their volatility, the relationship between reserve money (the operational target) and broad money supply has not been easy to predict. This has rendered open market operations

under the current monetary targeting framework an inappropriate instrument in its traditional role.

The liquidity management activities during the period were aimed at taming the volatility in the interbank rate. Consequently, open market operations in the period were generally restricted to liquidity injections through reverse repos rather than mop ups. In the face of improved liquidity conditions in the market, reverse repo operations have only been periodic. As a result, the average repo rate declined from 2.54 percent at the end of April 2010 to 1.84 percent in October 2010. As shown in Chart 1, short term interest rates continued to decline during the period covered by this report in response to movements in the Central Bank Rate. In addition, credit to the private sector expanded by Ksh 95.11 billion between April and October 2010 compared with Ksh 57.91 billion in the previous six months. Furthermore, the credit expansion between April and October 2010 was mainly to key sectors of the economy including manufacturing, trade, agriculture and real estate.

**Chart 1: Short Term Interest Rates**



**Source:** Central Bank of Kenya

As shown in Table 4, reserve money remained consistently above target over the period covered by this Report as commercial banks were holding excess reserves. Since commercial banks were holding excess reserves, there was no threat of demand driven inflationary pressures.

**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	177.50	177.06	0.44	0.00	0.00	0.00	81.70	72.32	-9.39	0.00
May-10	194.12	179.40	14.72	0.00	0.00	0.00	56.88	74.21	17.33	0.00
Jun-10	210.25	181.40	28.85	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Jul-10	199.77	187.20	12.57	0.00	0.00	0.00	10.00	6.49	-3.51	0.00
Aug-10	200.97	182.76	18.21	0.00	0.00	0.00	8.00	3.62	-4.38	0.00
Sep-10	209.89	186.39	23.50	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Oct-10	216.99	189.48	27.51	0.00	0.00	0.00	0.00	0.00	0.00	0.00

**Source:** Central Bank of Kenya

Despite the success of open market operations in reducing the level of volatility in the interbank market, due to instability of the money multiplier and velocity of money, the link between reserve money and broad money supply has been unpredictable. Consequently, reserve money increased from Ksh 177.50 billion in April 2010 to Ksh 216.99 billion in October 2010. This was equivalent to a growth of 32.76 percent in reserve money in the year to October 2010 compared with a growth of 16.09 percent in the year to April 2010. However, broad money supply (M3) which was above target at Ksh 1,122.8 billion in April 2010 grew gradually and was within target in absolute terms by October 2010 at Ksh 1,254.5 billion. This reflected a growth of 24.70 percent in broad money in the year to October 2010 compared with a growth rate of 20.88 percent in the year to April 2010.

The major source of growth in money supply included expansion in credit to private sector which increased significantly from an annual growth of 15.72 percent in April 2010 to 21.50 percent in October 2010.

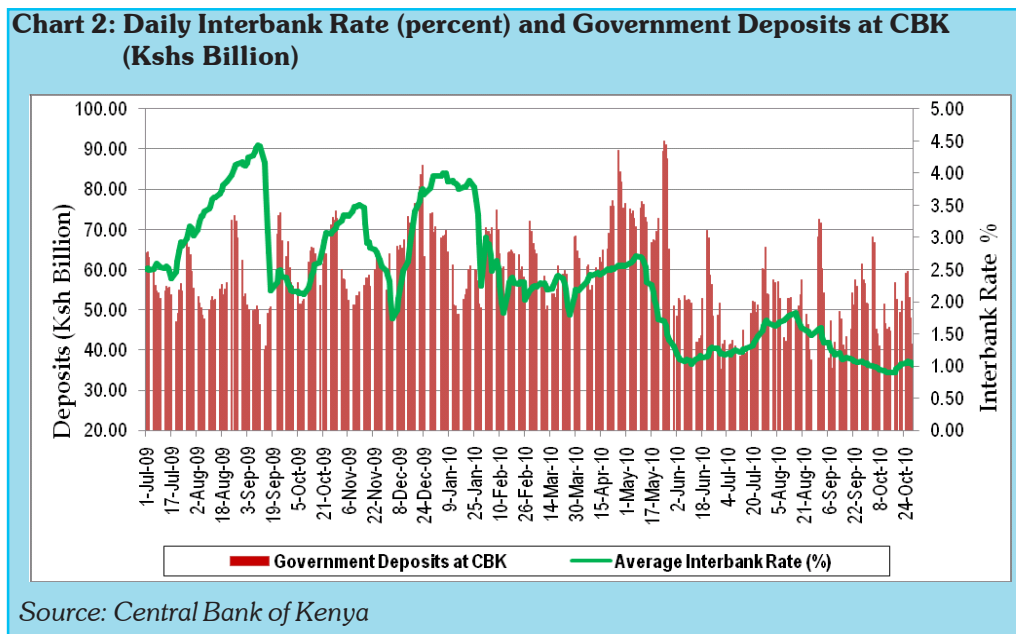
The MPC continued to encourage commercial banks to use Horizontal Repos during the period to improve access to liquidity and improve its distribution within the banking system. Consequently, the uptake of Horizontal Repos increased from Ksh 2,354.84 million in April 2010 to Ksh 12,696.30 million in October 2010. In addition, the average interest rate on a 7-day Horizontal Repo declined from 2.919 percent to 1.300 percent during the period. Increased use of the horizontal repo facility was facilitated by increased entry of banks into the Master Repurchase Agreements between themselves with more than 40 banks having enrolled by the beginning of May 2010. Despite these developments, there is scope for further development of the Horizontal Repos market. Horizontal Repos transactions accounted for an average of 5 percent of the total transactions in the interbank market during the period.

The movements in policy rates during the period were driven by country specific factors. In particular, a comparison of the policy rates with other countries indicates that while the MPC reduced the CBR from 6.75 percent in April 2010 to 6.00 percent in October 2010 to enhance credit expansion, the US Federal Reserve Bank, the Bank of England and the European Central Bank maintained their policy rates throughout the period at 0.25 percent, 0.50 percent and 1.00 percent, respectively. The US and UK policy rates remained unchanged to consolidate the impact of previous reductions to stimulate economic recovery.

### The Interbank Market

The target of monetary policy during the period was to remove the excessive volatility in the interbank rate. As shown in Chart 2, there is a positive correlation between interbank rates and the build-up of government deposits at the Central Bank. The average interbank rate has also been on a downward trend while the volatility in the rate was lower compared with that in the previous period. The average interbank interest rates were less volatile during the period June to October 2010 due to, among other factors, predictability of government deposits and seasonal requirements of the banking system particularly associated with payment of tax liabilities.

As Government deposits were drawn down with the start of the new financial year, interbank interest rates declined significantly in line with major increases in liquidity and coordination by the CBR signals.



### Banking Sector Developments

The performance of the banking sector remained strong and stable during the period covered by this report. Commercial banks gross deposits and loans grew by 12.30 percent and 12.63 percent, respectively, during the period to stand at Ksh 1,259.3 billion and Ksh 889.19 billion, respectively, at the end

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of October 2010. Credit risk continued to decline as the proportion of net non-performing loans to total loans declined from 2.55 percent in April 2010 to 1.82 percent in October 2010. In addition, credit expansion in the period was mainly to manufacturing, agriculture, mining and quarrying, real estate and business services which are key sectors of the economy. There were also significant developments towards enhanced financial inclusion with the number of commercial banks branches, number of ATMs, and number of registered providers of agency banking increasing significantly over the period covered by this report.

There were also legal and institutional changes aimed at developing the financial sector during the period. In particular, the innovations of mobile phone banking services took effect and implementation of guidelines on agent banking issued by the CBK were effected in May 2010. In addition, Credit Reference Bureaus were operationalised in July 2010 to maintain and provide banks with the credit history of borrowers. This is expected to reduce credit risk of banks significantly.

#### **Government Budget Operations**

The MPC continued to monitor developments in the budgetary operations of the Government and noted that fiscal operations were not exerting pressure on interest rates. In particular, central Government budgetary operations in the fiscal year 2009/10 resulted in a deficit of Ksh 157.9 billion on commitment basis compared with a deficit of Ksh 110.6 billion in a similar period of 2008/09. The deficit-to-GDP ratio increased from 4.6 percent to 6.2 percent on commitment basis, while the budget deficit on cash basis increased from 4.6 percent to 6.6 percent of GDP during the period. The budget deficit during the period was within the programmed target of 6.7 percent of GDP on commitment basis. However, due to temporary shortfalls in revenue collections and domestic borrowing during the period, Government overdraft at the Central Bank increased from Ksh 5.1 billion in June 2009 to Ksh 17.6 billion in June 2010, and further to Ksh 20.0 billion at the end of October 2010.

Since this Report covers the closure of the fiscal year 2009/10 and the budget for the fiscal year 2010/11, the MPC looked at the borrowing programme, debt sustainability, and foreign borrowing carefully. During the fiscal year 2010/11, Government revenue excluding external grants is estimated at Ksh 689.6 billion (24.9 percent of GDP), while external grants are estimated at Ksh 40.4 billion (1.5 percent of GDP). Government expenditure is estimated at Ksh 918.0 billion or 33.1 percent of GDP. The main components of expenditure include Ksh 592.5 billion (21.4 percent of GDP) in recurrent expenditure and Ksh 323.6 billion (11.7 percent of GDP) in development expenditure. The overall budget deficit including grants is, therefore, estimated at Ksh 188.0 billion (6.8 percent of GDP) in 2010/11. The deficit will be financed through net external borrowing of Ksh 82.7 billion (3.0 percent of GDP) and net domestic borrowing of Ksh 105.3 billion (3.8 percent of GDP). The MPC noted that the planned domestic borrowing in the fiscal year 2010/



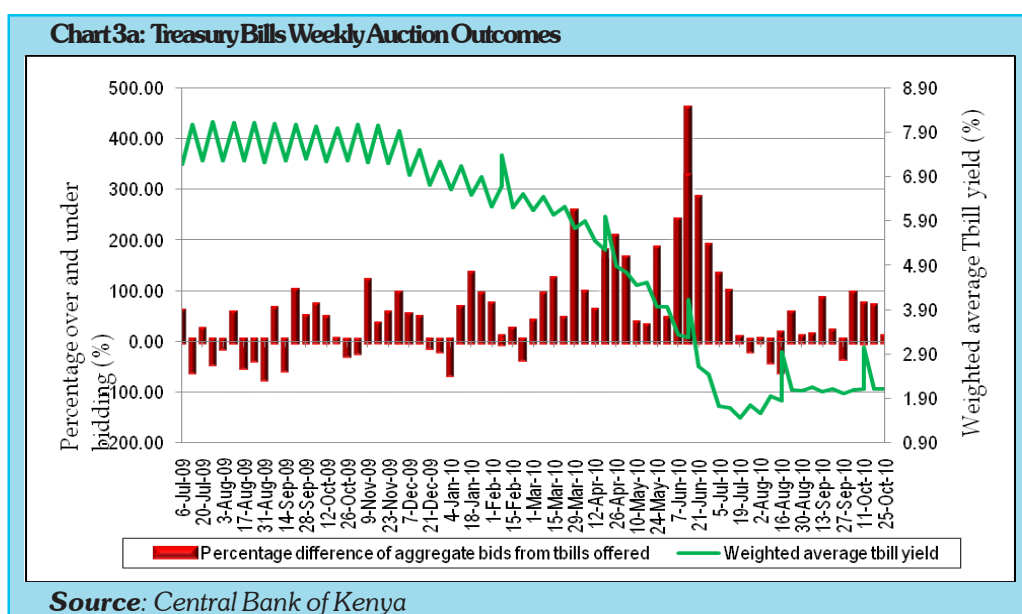
11 was lower than that for the previous fiscal year and was therefore not expected to exert pressure in interest rates.

### The Treasury Bill and Treasury Bond Market

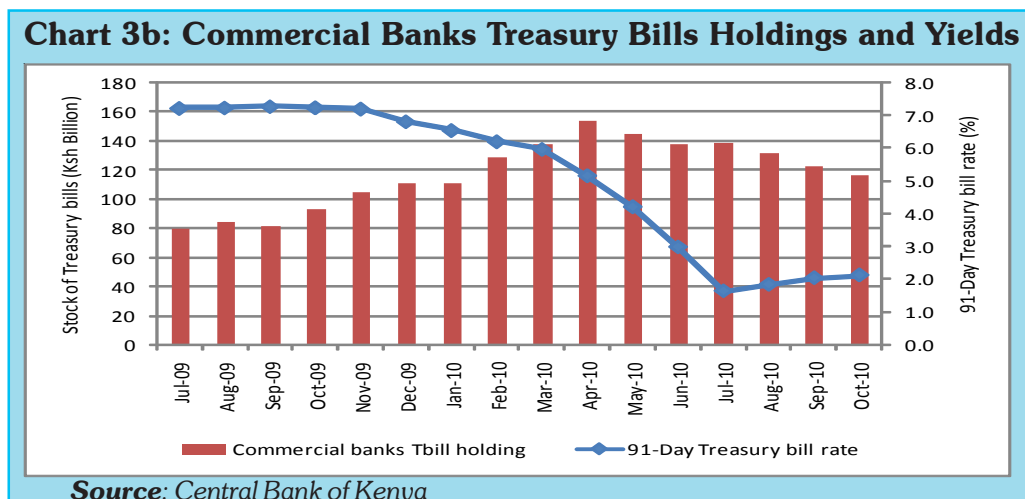
The stock of Treasury bills (excluding repos) declined from Ksh 176.13 billion at the end of April 2010 to Ksh 144.16 billion at the end of October 2010. However, the stock of Treasury bonds increased from Ksh 442.40 billion to Ksh 501.23 billion during the period. This reflects a shift in the Government debt profile as short term debt maturities were replaced with longer dated government paper borrowing to finance the budget deficit. In particular, the first 25-year Treasury bond amounting to Ksh 7.5 billion which was issued in June 2010 was oversubscribed by 361 percent. This was achieved due to increased confidence in the performance of the economy. The 25-year Treasury bond issue was re-opened in July 2010 and, again, was oversubscribed with a lower average interest rate.

As shown in Chart 3a, the steep decline in the yields on Treasury bills between April and June 2010 was largely driven by oversubscriptions on most of the issues of government securities following improved liquidity conditions. In particular, only four out of the twenty nine Treasury bills auctions in the period were undersubscribed while all Treasury bond issues were oversubscribed. Confidence in the longer-dated government paper was indicated by the lengthening maturity profile of domestic debt in the period. This is also an important development in ensuring the sustainability of domestic debt as more debt is held on longer term basis.

Auctions of Government securities during the period were conducted on weekly but alternating basis for the 91-day and 182-day Treasury bills, and on bi-monthly basis for the 364-day Treasury bills which explains the serated shape of the curve in Chart 3a.

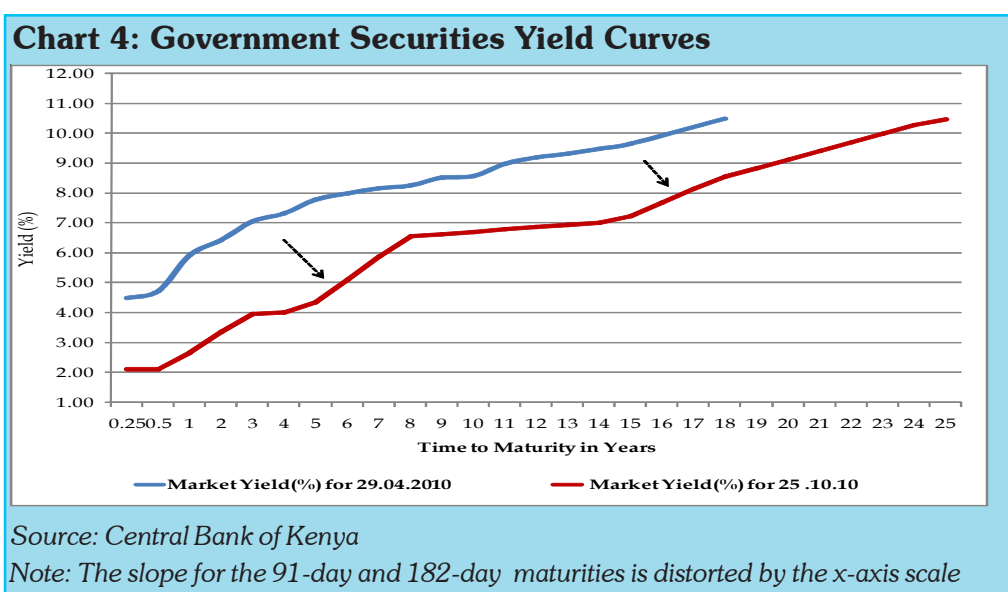


As shown in Chart 3b, commercial banks' holding of Treasury bills decreased between April and October 2010 following significant declines in the yield on Treasury bills. The commercial banks revised their portfolios of Government securities in favour of Treasury bonds where the availability of secondary trading provided a further attraction.



### Government Securities Yield Curve

The trend in short term interest rates was replicated by that in the longer term interest rates on riskless government paper as these declined steadily as indicated by a downward shift of the yield curve between April 2010 and October 2010 (Chart 4). This was attributed to adequate liquidity in the market occasioned 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 volumes traded and efficiency in trading especially of longer dated securities.



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### **Global Economic Developments**

An analysis of developments in the global economy revealed continued improvement in the global growth prospects. In particular, the October 2010 World Economic Outlook (WEO) projected the global economy to grow at 4.8 percent in 2010 against a previous forecast of 4.6 percent. Likewise, Sub-Saharan Africa growth forecast was revised upwards to 5.0 percent from 4.7 percent. The Euro Zone sovereign debt crisis appeared to be under control thereby restoring confidence in the Euro. The WEO revision of economic growth for both the Euro Zone and UK were lower and, this together with austerity measures being implemented could dampen demand for Kenya's exports. The outlook for the US economy showed a moderate improvement which was expected to support the global recovery. In addition, there were expectations that the global economic recovery was based on continued high growth in the BRICs (Brazil, Russia, India and China) economies which was expected to increase the demand for Kenya's exports.

The commencement of the EAC Common Market Protocol in July 2010 together with the expected economic growth of member states also opened new opportunities for Kenya. In the short term, this should expand the market for Kenya's manufactured exports while in the medium to long term this was expected to give rise to mobility of capital and labour. An analysis of inflation developments in Uganda, Tanzania and South Africa showed that inflation in these countries has been declining since June 2010 while interest rates, as measured by the 91 day Treasury bill rate, have increased except in South Africa. The exchange rate with respect to the Ugandan and Tanzanian shillings also remained stable.

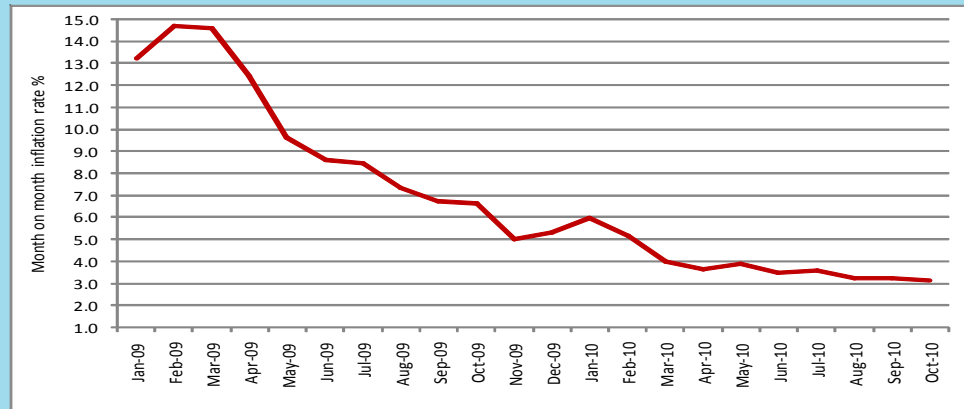
### **Developments in Inflation**

During the period covered by this report, overall 12-month inflation remained well within the target bands set by the Minister for Finance. The MPC worked closely with the KNBS towards producing tradable and non-tradable goods price indices. As shown in Chart 5, the 12-month overall inflation rate maintained a downward trend between May 2010 and October 2010.

In particular, overall inflation declined from 3.88 percent to 3.11 percent during the period on account of improved rainfall, reduction in the cost of communication due to price wars by mobile telephone service providers, and stable world oil prices. Price war by mobile telephone service providers resulted in a steep reduction in the 12-month communication inflation from 0.1 percent in April 2010 to -24.15 percent in August 2010.



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

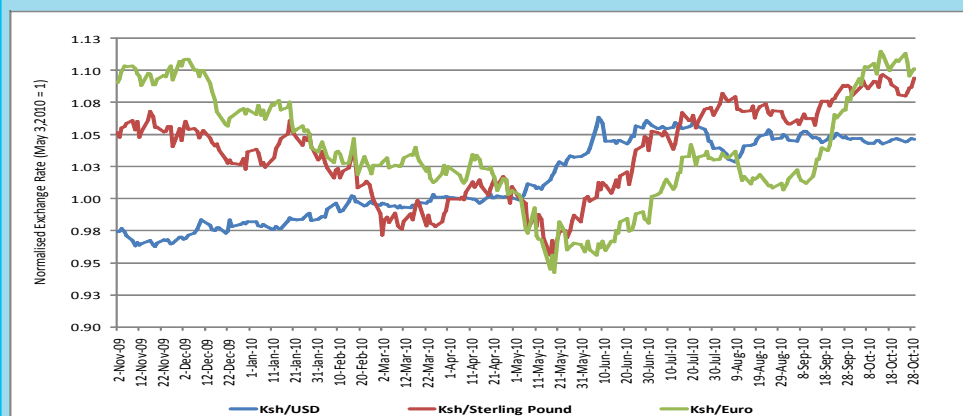


Source: Kenya National Bureau of Statistics and CBK

**Exchange Rate Management**

The Kenya Shilling weakened against the Sterling Pound and the Euro but remained fairly stable against the US dollar between May 2010 and October 2010 (Chart 6). These movements in exchange rates reflected a correction of the Euro and Sterling Pound towards the pre Greek debt crisis levels. Both the Euro and Sterling Pound had depreciated significantly in the international market as investors shifted their portfolios to the US dollar which was perceived safe at the peak of the Greek debt crisis between April and May 2010. Foreign exchange inflows from a variety of sources in the six months to October 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 between May and October 2010 compared with USD 53.90 million in the six months to October 2009. This shows that the developments in the global financial markets had a minimal impact on flows of immigrant remittances.

**Chart 6: Trends in Normalised Exchange Rates**



Source: Central Bank of Kenya

Note: The Kenya shilling exchange rates on 3<sup>rd</sup> May, 2010 were 77.16 per USD, 117.68 per Sterling Pound, and 102.15 per Euro.

Tourism also continued with its recovery beyond 2007 pre-crisis positions. A comparison of tourist arrivals shows that tourist arrivals through Nairobi and Mombasa averaged 76,911 and 14,467 per month, respectively, in the May-October 2010 period up from 68,459 and 11,439 per month, respectively, in the May-October 2009 period.

### Foreign Exchange Reserves

As shown in Table 5, the Bank continued to build-up foreign exchange reserves between May and October 2010 by purchasing USD 224.53 million from the domestic foreign exchange market. 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. The official foreign exchange reserves stood at USD 4,053.95 million at the end of the period which was equivalent to 4.06 months of import cover. This was slightly above the statutory 4 months of imports averaged over the last 36 months.

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

	Oct-09	Apr-10	May-10	Jun-10	Jul-10	Aug-10	Sep-10	Oct-10
<b>Gross Reserves</b>								
Official	3,810.42	3,805.39	3,755.36	3,798.58	3,867.97	3,942.28	4,062.77	4,053.95
Commercial Banks	1,536.24	1,319.02	1,279.00	1,210.69	1,287.42	1,103.79	1,078.08	1,215.72
Months of Imports cover (Based on 36 months cumulative imports)	4.13	3.95	3.87	3.89	3.94	4.00	4.08	4.06
<b>Foreign Exchange Transactions</b>								
Interbank purchases	82.00	115.50	75.00	35.57	6.50	75.46	32.00	0.00
Interbank sales	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00

Source: Central Bank of Kenya

The MPC advised the Central Bank to diversify purchases of foreign exchange reserves from the market to include the Euro and Sterling Pound. In the past, all purchases of foreign exchange were made in US dollars. The build-up in official foreign exchange reserves towards the end of October 2010 was therefore undertaken through purchases of both Euros and US dollars as the former depreciated against the local currency occasioned by the developments in the Greek debt crisis.

## 4. CONCLUSION

Overall, the MPC met its planned objectives between May and October 2010. During this period, it was observed that the monetary policy stance had been successful as indicated by a low and stable inflation regime, robust and broad based economic growth, and decreased volatility in the interbank rate. In addition, the CBR was effective in coordinating movement in short term interest rates. The Committee will continue to monitor developments in the domestic and global economy that may have either direct or indirect impact on the economy, while recommending, where necessary, appropriate measures to be taken.

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The low and stable inflation rates experienced during the period covered by this Report provide space for the MPC to continue with the monetary policy stance aimed at supporting growth through credit expansion. During the period, the Bank's tools of liquidity management were sufficient and the degree to which inflation affected the economy was mainly on the supply side.

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## 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. The impact of these inflationary spikes is supply side inflation. Demand driven inflation is affected by actual demand for money in the economy. The monetary authority has control over demand driven inflationary pressures.

**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 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.

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**Reserve  
Money  
Programme**

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

**Cash Ratio  
Requirement (CRR)**

This is the minimum ratio of cash balances (including deposits at CBK) of the total deposit liabilities of commercial banks and non-bank financial institutions maintained with the CBK as reserves. CBK fixes the ratio by law.