SIXTH

BI-ANNUAL REPORT OF THE

MONETARY POLICY COMMITTEE

CENTRAL BANK OF KENYA

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

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

Honourable Minister,

I have the pleasure of forwarding to you the sixth 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 2011. The Minutes of all the Meetings of the MPC between November 2010 and April 2011 are attached to the Report for your information.

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

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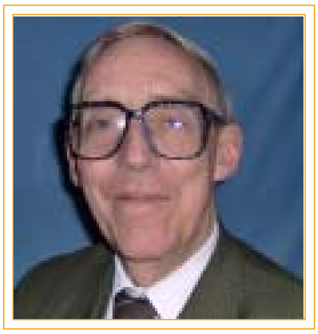

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Mr. John Birech
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EXECUTIVE SUMMARY

The sixth bi-annual Report of the Monetary Policy Committee (MPC) covers the activities of the MPC in the six months to April 2011 and reviews Kenya's economic developments during the period. There were notable economic developments both in the domestic and international environment over the period November 2010 to April 2011. First, on the domestic front, despite the various shocks which buffeted the economy in 2010, a strong performance of the agricultural sector contributed significantly to the overall economic growth of 5.6 percent in 2010. The agricultural sector grew by 6.3 percent in 2010. The persistent drought during most of the period resulted in supply-side inflationary pressures that increased food prices. Second, the rise in international crude oil prices also exerted pressure on energy prices in the domestic market with pass through effects on other commodity prices. Consequently, overall inflation exceeded the Government's target of 5 percent by more than 2 percentage points between March and April 2011. However, lower costs of communication eased the pressure on overall inflation as price wars in the mobile telephone service industry reduced the prices of telephone calls.

Other external economic developments that impacted on the Kenyan economy included political instability in the Middle East and North African (MENA) countries. This had an adverse impact on the supply of oil in the international markets, and obstruction of trade channels through the Suez Canal with consequential increases in insurance costs. Further, among the countries affected by the instability was Egypt which is one of Kenya's leading destinations for tea exports. In addition, Japan, a major development and trading partner which had been on a recovery path, suffered a severe setback following an earthquake and tsunami that triggered a temporary closedown of some of their key manufacturing firms. The MPC analysed the build-up in inflationary pressures arising from increasing food and oil prices and increased volatility in the exchange rate. Exchange rate fluctuations were being driven by increasing speculation due to expectations of shortages due to oil price increases and political turbulence in the MENA region.

The MPC has implemented a new monetary framework since March 2011 consistent with targets agreed under the Extended Credit Facility (ECF) programme which had been negotiated between the Government of Kenya and the IMF in January 2011. The resources under the ECF programme are mainly aimed at balance of payments support. Concerning liquidity management, activities in the interbank market during the period were directed at ensuring stability in the interbank market and supporting growth in private sector credit. However, the MPC continued to monitor developments in inflation to ensure that demand driven inflationary pressures did not ensue. As inflationary pressure started to build-up mainly due to cost push effect of oil prices and food supply constraints, the volatility on the exchange rate has also increased. The MPC, in a policy response to these forces, raised the CBR in March 2011 to ease pressure on the exchange rate and send a signal to the market that inflationary pressure should not be factored in pricing structures.

The MPC continued to undertake bi-monthly market perception 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 MPC hosted the first seminar to review research papers that the Committee had commissioned in previous periods. The research papers were reviewed by leading scholars and international experts and thus, once completed will form an important basis for drawing policy insights. The MPC also continued to analyse data on its weekly and monthly indicator tables of key variables which were updated regularly. In particular, these were an important complement to the set of indicators monitored by the MPC.

The economic growth data for 2010 indicated that the growth of the economy was achieved through enhanced macroeconomic stability, increased credit expansion to the private sector, low inflationary pressure and improved weather conditions. The MPC continued to pursue policies that would support credit expansion to finance increased economic activity while at the same time monitoring developments in inflation to ensure that there were no demand-driven inflationary pressures. The Committee also continued to monitor developments in the domestic and global economy that may have either a direct or indirect impact on the economy. Appropriate recommendations were made on the measures to be taken. 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.

1. INTRODUCTION

The sixth bi-annual Report of the MPC covers the period from November 2010 to April 2011.The MPC continued to review developments in both the domestic and international economic environment during this period. The performance of the economy virtually doubled from that in 2009 to register a growth of 5.6 percent in 2010. This growth was supported by several factors including macroeconomic stability, increased credit expansion to key sectors of the economy and improved weather conditions. In particular, the sectors that supported the strong performance of the economy included agriculture, electricity and water, trade, and financial services which recorded growth rates of 6.3 percent, 9.9 percent, 7.8 percent and 8.8 percent, respectively in the 12-months to December 2010. This was also supported by improved confidence in the economy coupled with improvements in the global economy.

However, in the first quarter of 2011, there were several developments in the domestic and external environments that posed downside risks on the performance of the economy. First, on the domestic front, the persistent drought conditions during most of the period exerted supply side inflationary pressure and resulted in increases in food prices. Second, the rise in international crude oil prices also exerted pressure on energy prices in the domestic market with pass through effects onto other commodity prices. This resulted in inflation surpassing the Government's target of 5 percent. However, lower costs of communication eased the pressure on overall inflation as price wars in the mobile telephone service industry resulted in lower telephone calling charges. Other external economic developments that adversely impacted on the Kenyan economy included political instability in the MENA countries which had an adverse impact on the supply of oil in the international markets, and obstruction of trade channels through the Suez Canal. In addition, the oil supply distortions related to the developments in the MENA region induced anticipation for further oil shortages in the international markets. This triggered speculative behavior in the domestic foreign exchange market as traders anticipated increased demand for foreign currency to finance the increasing oil import bill.

The MPC has been implementing a new monetary programme since March 2011 consistent with targets agreed under the Extended Credit Facility programme which had been negotiated between the Government of Kenya and the IMF in January 2011. The programme outlines new assumptions and targets where the net domestic assets (NDA) and net international reserves (NIR) are the quantitative performance criteria measures. An NDA ceiling is set as the operating target in place of the reserve money to address the weaknesses of unstable velocity and money multiplier identified in the old monetary programme. However, the MPC recognises that the use of NDA as part of daily liquidity management should be supported by use of other variables such as the monetary base (reserve money), short term interest rates, liquidity distribution in the banking sector and deviations of broad money from target. The key assumptions of the monetary programme include a decline in NDA from Ksh -46.7 billion in November 2010 to Ksh -50.0 billion in June 2011 and increase in the NIR floor from USD 3,329 million to USD 3,515 million over the same period.

The MPC pursued avenues to enhance monetary policy formulation and implementation during the period. In particular, the Committee hosted a technical seminar in January 2011 to review research studies that it had initiated in previous periods. The research papers were reviewed by renowned scholars and international experts. The MPC also continued to explore its interface with the various departments of the Central Bank with the objective of improving the flow of information. Lastly, monetary policy decisions during the period continued to be informed by technical analyses of the overall economic environment on both the domestic and international fronts.

2. ACTIVITIES UNDERTAKEN BY THE MPC

Statutory Requirements

Section 4 (sub sections 4, 5 and 6) of the CBK Act requires the Minister for Finance to specify, at the beginning of the financial year, the price stability target and economic policy to be undertaken by the Central Bank of Kenya. In this regard, the Deputy Prime Minister and Minister for Finance specified in July 2010, through a letter to the Central Bank of Kenya, an inflation target of 5 percent as measured by the 12-month change in the overall consumer price index (CPI) published by the Kenya National Bureau of Statistics (KNBS). The letter required 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 sections 4B, 4C and 4D of the CBK Act. Also indicated were the actions to be taken by the Central Bank when the inflation target was not met. High inflation and deflationary levels tend to discourage investment and long term economic growth. In this regard, CBK provided a letter to the Minister following the release of the March 2011 inflation data which showed that inflation was above target by more than 2 percentage points. The CBK would thereafter be required to write an additional letter to the Minister if the inflation rate remains outside the target band for three consecutive months.

As required by Section 4D of the CBK Act, the MPC held three bi-monthly meetings between November 2010 and April 2011. During this period, MPC decisions were mainly aimed at enhancing credit expansion in order to support economic growth since there was minimal threat of demand-induced inflation. However, the MPC decision in March 2011 was aimed at fighting inflation threats as well as stabilising the exchange rate. The following are the key highlights of the MPC meetings held during the period:

a) The MPC held its sixteenth meeting on 25th November 2010. The Committee analysed the reaction of the market to its previous decisions and noted that medium sized banks had registered the largest reduction in lending rates in response to CBR signals and had benefited from their initiatives in expanding access to financial services especially to small and medium enterprises. On growth and inflation, the Committee analysed available information and concluded that while there were minimal upside risks to demand-driven inflation, there was increased economic activity in agriculture, construction, manufacturing and financial sectors indicating higher economic growth prospects. The Committee also recognised that financial sector deepening and increased financial innovations had a strong bearing on increasing access to financial services, supporting higher economic growth and reducing poverty. On this front, savings accounts had increased and quasi-banking outlets had been opened through the agency banking framework.

The Committee also noted that there was increased confidence in the economy. The country's credit rating by *Standard & Poors* had been revised upwards from B to 'B+ with a stable outlook' and its policy and institutional quality as reported by World Bank's Country Policy and Institutional Analysis (CPIA) had improved. These endorsed expectations of high economic growth and low risks on inflation reflected in the MPC Market Perception Surveys. The Committee therefore decided to maintain the level of CBR at 6.00 percent to further consolidate the gains of the previous policy stance and to sustain stability in the course of the structural transformations in the financial sector.

b) The seventeenth MPC meeting was held on 27th January 2011. During the meeting, the MPC examined key macroeconomic indicators for the first three quarters of 2010 which showed that there was strong and broad based economic recovery driven by agriculture, trade, manufacturing, and the information and communications technology (ICT) sectors. In addition, the potential for higher growth in the future was being supported by an environment of low and stable inflation with negligible inflationary threats in the immediate outlook. This was corroborated by evidence of increasing imports of intermediate inputs and capital goods that enhance the capacity of the economy to grow. In response to previous MPC decisions, the Committee noted that short term interest rates were low and stable and that volatility in the interbank interest rate had reduced, implying improvement in liquidity management. Further, credit to the private sector was increasing and well distributed to the key sectors of the economy. Despite these developments, the Committee established that there was scope for enhancing availability and affordability of credit without posing a threat on inflation. On developments in the banking sector, the Committee analyzed the risk profile, stability indicators and stress test results and concluded that the sector was stable and able to withstand plausible shocks and that credit risk, as measured by the ratio of net non-performing loans to total loans, was improving. On financial inclusion frontiers, the Committee noted that there was expanded footprint of financial intermediation services that was enhancing access to financial services by the unserved and underserved population.

The Committee concluded that its monetary policy stance had been successful in delivering a low and stable inflation regime and decreased volatility in the interbank market besides supporting the economic growth process. In addition, the CBR had been effective in coordinating movement in short term interest rates. In order to provide the impetus for enhanced economic growth, the MPC concluded that private sector investment needed to be supported with more affordable credit through reductions in lending rates. The Committee therefore decided to lower the CBR by 25 basis points to 5.75 percent.

c) The MPC held its eighteenth meeting on 22nd March 2011 to evaluate performance of the economy and review its monetary policy stance. In particular, the Committee analysed the implications of domestic and external shocks on the economy. On the domestic scene, the Committee noted the impact of the prolonged dry weather conditions and the forecast of adequate but poorly distributed rainfall during the year. Externally, the instability in the MENA region had raised downside risks, pushed up oil prices, reduced tea exports to Egypt and increased freight insurance charges for trading through the Suez Canal. In addition, Japan, a major development and trading partner which had been on a recovery path, suffered a severe setback following an earthquake and tsunami that triggered a temporary closedown of some of their key manufacturing firms. Due to these developments, the Committee analysed the build-up in inflationary pressure emanating from increasing food and oil prices and increased volatility in the exchange rate. The exchange rate fluctuations were being driven by increasing speculation that was mainly as a result of expectations of shortages due to oil price increases and political turbulence in the MENA region. However, available economic indicators and growth expectations from the MPC market perception survey by banks and non-bank private sector firms still showed no threat to the growth targets set in the 2010/11 Budget.

In view of these developments, the Committee concluded that the changing international environment warranted a revision of the domestic policy stance. The persistent inflationary pressure and the instability in the exchange rate raised the concern of the MPC and called for a change in the monetary policy stance. In this regard, the MPC decided to tighten the monetary policy stance by raising the CBR from 5.75 percent to 6.00 percent. This reflected a shift in the monetary policy stance in order to send the signal that temporary shocks such as exchange rate volatility and seasonal food shortages should not be allowed to persist and be factored into pricing structures. The tightening was expected to provide a solution to inflationary pressures and stabilize the exchange rate while still protecting economic activity. The monetary policy stance was also in line with the then expected unwinding of the Economic Stimulus Package by the Government.

Research Activities

As outlined in the Fifth MPC Report, the MPC commissioned research studies in collaboration with the Research Department of the Central Bank that were aimed at providing insights to the formulation and implementation of monetary policy. In January 2011, the MPC hosted a technical retreat to review progress on the studies. The Committee invited renowned scholars and experts in research to review the studies, which once completed, will be available for reference. The studies that were reviewed include: a) Demand for Money Function for Kenya; b) Monetary Policy Transmission Mechanism in Kenya; c) A Framework for Restructuring the Central Bank Rate; d) Output Fluctuations and Inflation in Kenya; e) Efficiency and Productivity of the Kenyan Banking Sector; f) Access to Private Sector Credit and Economic Performance; g) Interest Rate Pass Through in Kenya; h) Factors Driving the Usage of Financial Services from Different Financial Access Strands in Kenya; and i) A Dynamic Model for Inflation.

MPC Market Perception Surveys

The MPC undertook three Market Perception Surveys in the period covered by this report. As with previous MPC Market Surveys, the objective of the Surveys was to capture perceptions and expectations of the banking and non-bank private sector on key economic issues including economic growth, inflation, direction of interest rates, exchange rates, demand and supply of credit to the private sector. They also covered the awareness by the public of the activities of the MPC, and what banks considered to be the key determinants of their interest rate spreads. While all banks were surveyed, the sample of private sector firms was drawn from sectors that contributed approximately 70 percent to GDP from the Nairobi, Mombasa, Kisumu and Eldoret regions. Therefore, results obtained from these Market Surveys provided strong insights to the MPC on the level 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 making process. The Committee continued to improve on the questionnaires and analyses during the period in order to capture issues of interest to it while at the same time incorporating comments from respondents in this exercise. The response rate of banks remained at 100 percent while that of the private sector improved to over 70 percent of the sampled firms which were well distributed across the country. Also, of note was the fact that most of the banks have developed an interest in the Survey results and were incorporating the findings in their planning processes.

As shown in Tables 1 and 2, the results of MPC Market Perception Surveys indicated that in November 2010, 85 percent of banks and 81 percent of private sector firms expected the economy to grow by between 5 and 5.6 percent in 2010. In March 2011, 60 percent of banks and 71 percent of non-bank private sector firms had revised their expectations for growth in 2011 upwards to between 5.7 and 6 percent. Banks and private sector firms sampled cited a number of reasons for their increased optimism on the performance of the economy, including ; improved regional trade and opportunities in South Sudan; stable macroeconomic environment; increased investor confidence with improving accountability; increased public investment in infrastructure; political stability; Government and private sector support to Small and Medium Size Enterprises (SMEs); and lower lending rates that were encouraging the private sector to borrow and finance investment.

On inflation, 88 percent of banks and 71 percent of the private sector firms in November 2010 expected inflation to either remain the same or increase by 1 to 2 percent in the remainder of 2010. By March 2011, 100 percent of banks and 98 percent of private sector firms expected inflation to increase by 1 to 2 percent in 2011. The reasons cited for the shift in expectations on inflation reflected supply side constraints occasioned by dry weather conditions and oil price increases due to the political crises in the MENA region.

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	5	5-5.6	5.7-6	Above 6	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
Nov-10	42	46	12	61	33	6		3	12	39	46				33	58	9
Jan-11	89	4	7	25	21	54					28.6	60.7	10.7		32	39	29
Mar-11	100			16	8	76				4	36	56	4		12	60	28

Source: Central Bank of Kenya

Expectations on the direction of the exchange rate of the Kenya shilling against the US dollar (USD) showed that in November 2010, 61 percent of banks and the same proportion of non-bank private sector firms, expected the exchange rate to strengthen. These expectations, however, had shifted by March 2011 with 76 percent of banks and 71 percent of private firms expecting the exchange rate to weaken. They cited rising demand for the USD associated with increasing costs of imports as the main factors driving their expectations for the exchange rate to depreciate further.

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	5	5-5.6	5.7-6	Above 6	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	
Nov-10	35	36	29	61	33	6			19	50	31			23	46	23	8
Jan-11	56	20	24	48	32	20			18		28	40	16	5	48	24	23
Mar-11	74	24		23	6	71					29	59	12	12	29	47	12

Source: Central Bank of Kenya

Note: *Perceptions between January and November 2010 relate to 2010 and those in January and March 2011 relate to 2011.*

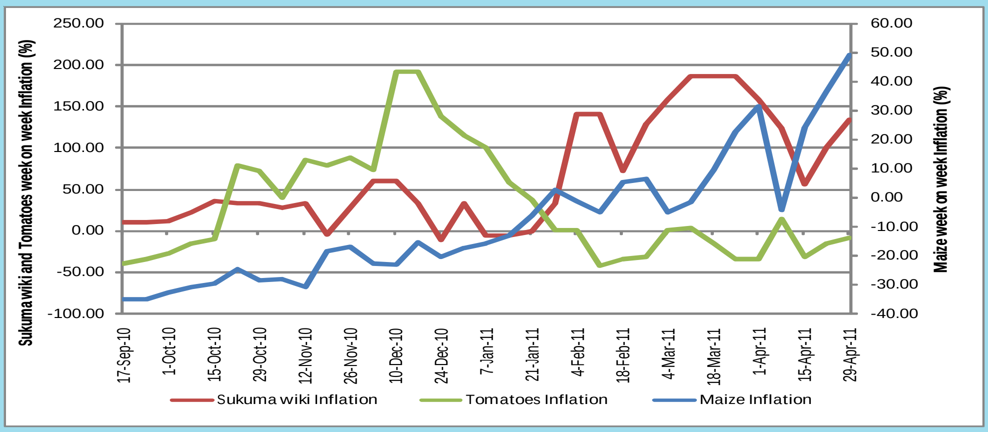
It is worth noting that while banks generally expected interest rates to remain stable between November 2010 and the first half of 2011, the proportion of private sector firms that expected to increase their demand for credit by 1 to 10 percent increased from 23 percent to 47 percent over the same period.

Weekly and Monthly Indicator Tables

The MPC continued to monitor and analyse developments in the economy using the MPC Indicator Table, and weekly and monthly indicators of key economic variables. The Committee expanded the coverage, improved on the content, enhanced data quality and the collection methods so as to ensure that the information captured effectively facilitated sound analyses and provided the MPC with a data-based window to examine the developments in the various sectors of the economy. Among the notable developments in the MPC Indicator Table and the weekly indicator table were the development and inclusion of an indicative monthly bond trading index. These data provided additional information on the extended market structure of benchmark bonds and facilitated the MPC in analyzing movements and shifts in the yield curve while comparing the performance of the benchmark bonds in the secondary market.

The availability of high frequency data through the weekly indicator table 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 more and better data. In addition, the MPC was able to monitor developments in food prices in Nairobi over the period covered by this report by capturing the weekly wholesale prices of food in Nairobi as published by the Ministry of Agriculture in its market intelligence report. The data on wholesale food prices has enabled the MPC to track closely movements in food prices which are the main drivers of inflation in Kenya. For instance, Chart 1 shows developments in the prices of maize, tomatoes and Kales (*Sukuma wiki*). The movements in the weekly index were found to be strongly correlated with the food component of the overall CPI basket.

Chart 1: Development in week on week Food Inflation (December 19th 2008=100)



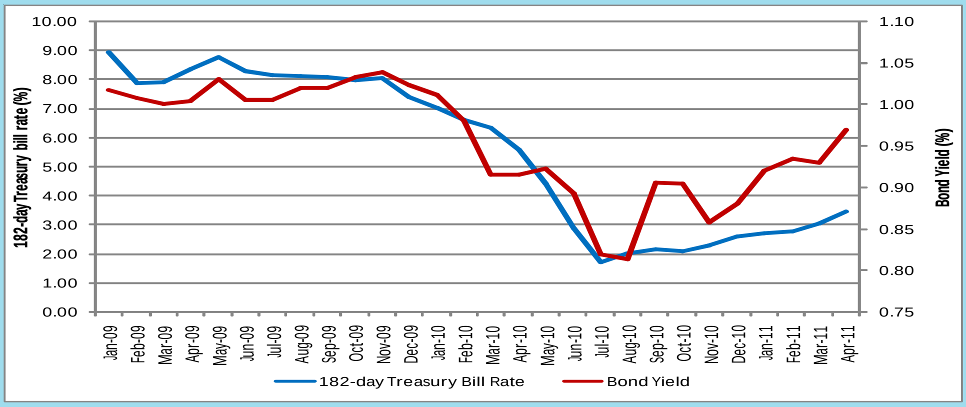
Source: Ministry of Agriculture average food prices in Nairobi Market

Development of the Bond Trading Index

Until recently, the MPC had been monitoring developments in the secondary market for bonds using an old bond trading index based on trading between January and March 2005. The index has served the MPC well given that the Nairobi Stock Exchange (NSE) has just embarked on the development of its bond index. The bonds index developed by the MPC provided a good measure of trading activity at the secondary market for bonds particularly before the introduction of bonds with tenors over 10 years in August 2006. With an increased number of longer-dated bonds, a change in the weights became necessary since the old framework was rendered inappropriate. In this regard, the MPC developed a new bond index that reflects the trading of bonds used in the development of the Government securities yield curve. The new bond index was generated using secondary trading data of bonds and fixing the seven months period between December 2007 and June 2008 as the base period. The objective of the index is to generate a single statistic capturing the shifting nature of both the prices and the bonds traded. This records how yields in bond portfolios appear to be assessed by secondary market trading participants.

Since this index is a measure of investor choice, its reciprocal can be regarded as a yield and can be compared with the yields received by investors on Treasury Bills. Chart 2 below compares the average yield on bonds with the average monthly 182-day Treasury bill yield. This shows that participation by investors in the domestic bond market with a view to trade the bonds appear to base their decisions on perceived returns of short term securities such as the 182-day Treasury bills. This indicates, in part, that these investors trade the bonds they purchase within the first 6 months of the life of the bond, or investors in the bond market seem to switch between holding bonds and Treasury bills in their portfolios based on prevailing yields similar to performance of the 182-day Treasury bill interest rate.

Chart 2: Current Bond Yield (%) [Jan 2009 - April 2011]



Source: CBK and NSE

Enhanced Communication Strategy

The MPC enhanced its strategy of communicating monetary policy decisions and other measures or issues of interest. This was achieved through press releases of monetary policy decisions, press conferences, briefs on outcomes and direction of the policy and significant changes in key financial sector variables such as exchange rates. A notable development in the communications strategy during the period covered by this report was the standardisation of the format of the MPC Press Release. The regular interactions with the market was particularly critical in restoring confidence and fostering stability of the market and defusing uncertainty occasioned by both domestic and the international developments. Moreover, it helped to enhance the Bank's credibility and transparency in the perspective of the public. The regular communication was also intended to help shape market expectations and reduce uncertainty thereby influencing actions of economic agents particularly with respect to anchoring medium and long-term demand driven inflation expectations.

On matters of mutual interest between the MPC and the Bank's stakeholders, the MPC initiated articles for the *CBK Newsletter* which when finalised will be posted on the Bank's website. While these articles will provide information to the market on emerging concerns in the wake of volatilities and shocks to the economy, they will also enhance market understanding of the conduct of monetary policy and shape market expectations towards desired outcomes. Future articles will also provide speedy responses to the market on CBK's policy stance and quick analyses on topical issues hence complementing research work. The completed articles included:

a) Report of the first MPC public forum;
b) Noisy traders and Kenya shilling exchange rate behavior;
c) Drivers of inflation in Kenya;
d) Microanalysis of commercial banks interest rates in Kenya;
e) Competition in the mobile telephony industry in Kenya: nature and price implications;
f) Structural characteristics of the banking sector in Kenya which are slowing down the transmission of monetary policy signals to lending rates;
g) International economic outlook and implications for Kenyan economy;
h) Changing perceptions from the MPC market surveys and implications to the economy.

Other MPC Activities

a) During the period covered by this report, 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. The MPC also used the meetings to elaborate on the underlying factors that were considered in the previous MPC decision 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 improve on its communication in terms of simplicity, clarity and understandability of the press releases.

b) The MPC continued to monitor developments related to the European debt markets and political crises in the MENA region. The MPC analysed the possible impact of these crises on the Kenyan economy and considered these new developments in its monetary policy decision process.

c) MPC members also participated in conferences, workshops, economic forums, World Bank Economic Round-Table breakfast meetings and other stakeholder meetings, and contributed to discussions and creating awareness on monetary policy operations and collecting market reactions.

d) Various meetings were held with treasury managers of commercial banks, investment banks and the media to obtain their perceptions on the economy. The MPC also participated in the monthly Market Leaders Forums which were organised by the Bank to discuss market developments and new Treasury bond issues.

e) The MPC worked closely with the KNBS in the preparation of the Kenya Economic Survey for 2011 and continues to improve on the tradables and non-tradables price indices.

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 November 2010 to April 2011. It thereby provides the wider backdrop and environment within which the MPC's activities and decisions elaborated above were undertaken.

Kenya Economic Status and Financial Sector Developments

The Economic Survey for 2011 released by the KNBS provided information on economic performance for the year 2010 and the fourth quarter of that year (Table 3). The strong performance of the agricultural sector - with a growth of 6.3 percent - had contributed significantly to the overall economic growth of 5.6 percent in 2010. The economy had been projected to grow at 5 percent in 2010. The financial intermediation sector grew at 8.8 percent which was the highest ever recorded by the sector. The overall growth of the economy in the fourth quarter of 2010, at 6.9 percent, indicated that the economy was on a high growth trajectory prior to the international economic and domestic shocks. The growth was broad based across most of the sectors of the economy. However, growth in some sectors such as manufacturing had decelerated.

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	to Dec
Real GDP	6.58	7.08	6.61	6.99	5.54	4.13	3.18	1.54	2.60	2.29	1.80	2.63	2.35	3.22	4.61	5.55
Agriculture	6.49	5.77	3.94	2.40	-0.80	-1.14	-2.48	-4.08	-3.26	-4.25	-3.78	-2.58	-0.92	0.67	3.83	6.33
Transport & communication	9.00	8.91	10.54	15.07	13.09	9.27	6.59	3.04	6.31	5.05	6.58	6.41	4.33	6.34	4.76	5.86
Manufacturing	5.98	6.81	6.30	6.28	5.01	4.12	3.84	3.53	4.49	3.14	1.45	1.26	1.77	3.40	5.38	4.41
Tourism (Hotels and Restaurants)	16.16	21.93	19.05	16.31	-0.61	-17.75	-27.67	-36.10	-1.97	18.54	30.71	42.82	6.02	-1.49	0.52	4.22
Building and construction	3.09	4.33	7.81	7.32	9.62	10.56	9.77	8.24	12.51	11.66	8.58	12.36	6.96	5.15	6.50	4.50
Financial services	5.23	5.52	6.33	6.65	5.89	5.20	3.45	2.69	2.65	2.32	3.97	4.61	5.00	6.21	7.11	8.79
Electricity & Water	-0.04	3.36	6.72	9.10	9.90	7.97	6.12	5.28	3.72	3.23	1.37	-3.04	-4.23	-3.32	1.74	9.91
Trade	10.73	10.29	7.99	11.32	11.68	9.66	8.64	4.78	1.95	0.75	0.21	3.86	5.11	6.61	6.96	7.79

Source: *Kenya National Bureau of Statistics*

The improved performance of the economy in 2010 was achieved in an environment of enhanced macroeconomic stability, increased credit to the private sector, low inflationary pressure and improved weather conditions. The sectors that supported the strong performance of the economy include agriculture, electricity and water, trade, and financial services which recorded growth rates of 6.3 percent, 9.9 percent, 7.8 percent and 8.8 percent, respectively in the 12 months to December 2010. The strong growth performance in 2010 and diverse distribution through the productive sectors within the economy is a testimony of the quality of macroeconomic policies adopted during the year.

Further analysis of the growth data showed that while agriculture and related sectors such as electricity and water were supported by favorable weather conditions, the performance of the financial services sector was significantly boosted by prudent management of liquidity that facilitated expansion in credit to the private sector. For instance, credit to private sector increased by Ksh 151.2

billion in 2010 compared with an increase of Ksh. 89.9 billion in 2009. The performance of agriculture, water and electricity and financial services sectors had compounding effects on the overall performance of the economy as they provided positive knock-on effects on manufacturing and building and construction sectors which recorded growth rates of 4.4 percent and 4.5 percent, respectively 2010. This was also corroborated by enhanced confidence in the economy with the adoption of the new constitution.

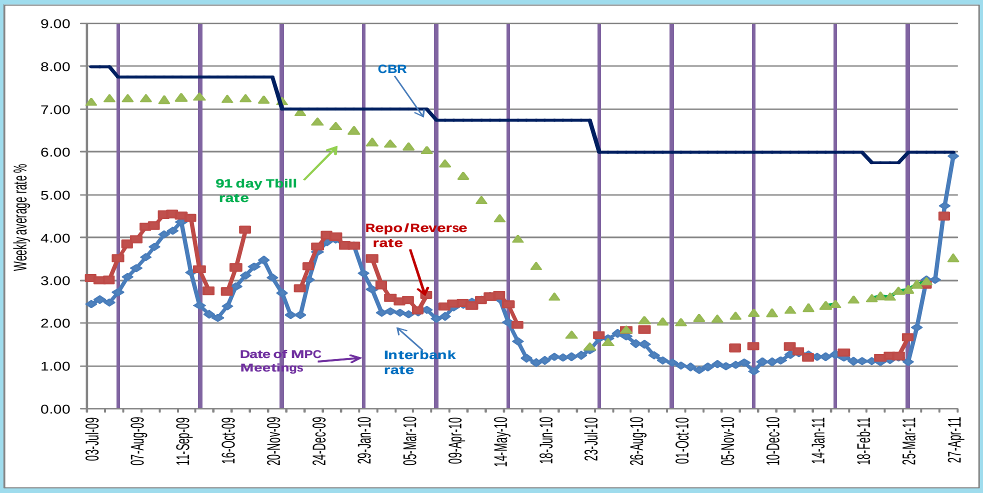
Monetary Policy Operations

In the previous MPC Report, the Committee acknowledged the inappropriateness of the traditional monetary programming in predicting the relationship between reserve monetary (operational target) and broad money supply in the face of structural changes that have occurred in the financial system. Notably, there have been increased financial innovations that have deepened the financial sector and as a result caused a decline in the velocity of money and an increase in the money multiplier.

In January 2011, the Kenya Government successfully negotiated with the IMF a three year Extended Credit Facility (ECF) which will see the country receive an SDR 328.68 million loan (equivalent to US$ 508.7 million) in balance of payments support. These resources were aimed at facilitating build up in foreign exchange reserves. Consequently, a new monetary programme has been put in place to guide monetary policy operations. The access to ECF funds will be over a three year period. SDR 65.1 million (24 percent of quota) equivalent of US$ 101.7 million was made available on approval in January 2011. Two additional disbursements of SDR 43.4 million (16 percent of quota) each, will be accessed during the first year of the programme, following the March 31, 2011 and the June 30, 2011 reviews. The MPC recognises that the use of NDA as part of daily liquidity management should be supported by use of other indicators such as monetary base, short term interest rates, liquidity distribution in the banking sector and deviations of broad money from target. Broad money supply, M3, that was on target at Ksh 1,254.49 billion in October 2010 increased to Ksh. 1,331.3 billion in April 2011 which was generally within the target range. The major source of growth in money supply included expansion in credit to private sector which increased significantly from an annual growth of 24.7 percent in October 2010 to 27.2 percent in April 2011.

Concerning liquidity management, activities in the interbank market during the period were directed at ensuring stability in the interbank market. Between November 2010 and January 2011, open market operations were generally restricted to liquidity injections to support growth in private sector credit. However, the Committee continued to monitor developments in inflation to ensure that demand driven inflationary pressures did not ensue. As a result, the average reverse repo rate declined from 1.43 percent in November 2010 to 1.23 percent in January 2011 while the average interbank rate fluctuated between 1.01 percent and 1.24 percent during the same period (Chart 3) over the same period. However, as inflationary pressure started to build-up and volatility on exchange rate increased, the MPC, in March 2011 raised the CBR. This measure was aimed at easing pressure on the exchange rate and sending a signal to the market that inflationary pressure should not be factored in pricing structures. In this regard, the Bank commenced mop-up of excess liquidity in the banking system through open market operations. Consequently, the interbank rate and the repo rate increased to 5.94 percent and 4.55 percent by end of April 2011 from 1.04 percent and 1.42 percent, respectively, at the beginning of November 2010.

Chart 3: Trends in Short Term Interest Rates



Source*: Central Bank of Kenya*

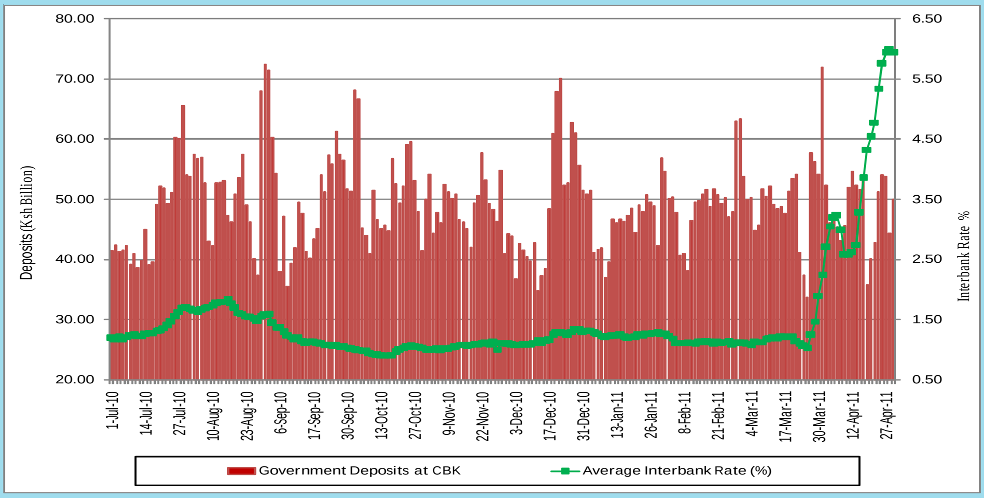
The MPC also continued to improve access to liquidity and its distribution within the banking system. In episodes of skewed liquidity distribution within the banking system, the MPC encouraged commercial banks to use Horizontal Repos. Consequently, Horizontal Repos transactions amounted to Ksh 12,696.30 million in October 2010 compared with Ksh 10,242.5 million in April 2011. The slight reduction in activity in the Horizontal Repos market during the period reflected a downward shift in the supply of funds. As a result, the average interest rate on Horizontal Repos increased from 2.26 percent in October 2010 to 5.33 percent in April 2011.

The movements in international policy rates during the period covered by this report were driven by country-specific factors. In particular, an analysis of policy rates in other countries indicates that while the US and UK policy rates remained unchanged, the Reserve Bank of South Africa reduced its policy rate from 6.00 percent to 5.50 percent in November 2010 to enhance credit expansion for growth. Similarly, the Kenyan MPC reduced the CBR from 6.00 percent in October 2010 to 5.75 percent in January 2011 to support credit expansion. However, during its March 2011 meeting, the MPC noted increasing inflationary pressures emanating from rises in the prices of food and crude oil coupled with increased volatility in the exchange rate. In this regard, the Committee raised the CBR to 6.00 percent in March 2011. China and India had also previously made successive reductions in their policy rates but shifted their monetary policy stance by increasing their policy rates. These countries cited increased inflationary pressures emanating from rising food and oil prices.

The Interbank Market

Large build-ups of Government deposits at the Central Bank of Kenya had been shown in previous periods to create tight liquidity conditions in the market and consequential volatility in the interbank rate. Chart 4 shows improved stability in the interbank market for most of the period covered by this report as the predictability of Government deposits improved. The distribution of the liquidity in the market was enhanced through use of horizontal repos.

Chart 4: Daily Interbank Rate (percent) and Government Deposits at CBK (Kshs Billion)



Source: Central Bank of Kenya

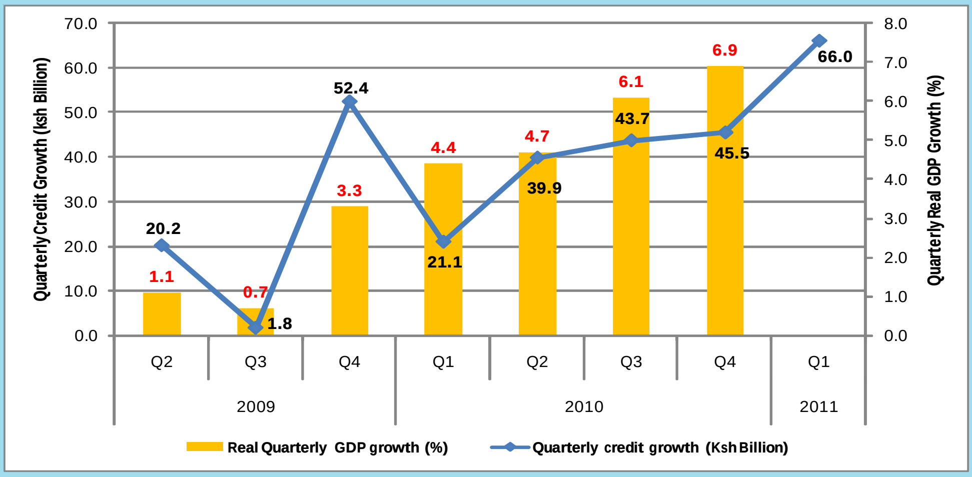
The average interbank rate remained relatively stable over most of the period covered by this report. This is attributable to success in liquidity management and enhanced predictability of government deposits. However, towards the end of March 2011 following the shift from accommodative to a tighter monetary policy stance, interbank market interest rates increased substantially. The MPC continues to monitor developments in the interbank market and explore avenues to reduce any excessive volatility. In particular, reverse repos were used to inject liquidity in the banking system during periods of large tax payments and payments by investors in Government securities which created liquidity shortages in the market.

Banking Sector Developments

The banking sector remained strong and stable in the period covered by this report. In particular, commercial banks gross deposits and loans grew by 18.8 percent and 28.7 percent, respectively, to stand at Ksh 1,348.6 billion and

Ksh 1,015.7 billion, at the end of the April 2011. Credit risk, as measured by the ratio of net non-performing loans to total loans, declined from 1.6 percent in November 2010 to 1.4 percent in April 2011. Credit to private sector in the year to April expanded by 27.2 percent compared with 21.7 percent in the year to November 2010. Chart 5 shows a strong positive correlation between credit to private sector and real GDP growth. Consequently, the strong credit expansion in the first quarter of 2011 is an indication of strong growth performance.

Chart 5: Quarterly Growth in Real GDP and Expansion of Credit to Private Sector (Percent):



Source: Central Bank of Kenya

Financial Inclusion Initiatives

The Bank continued to underscore its commitment to fostering an environment conducive for a robust, inclusive and efficient financial system. The monetary policy environment has embraced new financial products and initiatives that emerged from enhanced information communication and technology. These products have not only enhanced financial deepening but also increased access to financial services by a majority of Kenyans who were previously unbanked or under-banked.

The expanding financial services to Kenyans are evidenced by an increase in commercial banks branch network from 1030 in September 2010 to 1072 in March 2011. Rural branches increased by 15 compared with an increase of 27 for the urban branches over the period. Some of the products and initiatives that have been used extensively by the sector include mobile-banking services and agency banking services. Three additional deposit taking microfinance institutions licensed in the period also enhanced the spread of financial services to the rural areas.

Other financial inclusion initiatives that were explored by the Bank included the establishment of currency centres in strategic regions of the country. This was motivated by the desire to limit risks associated with transportation of currency and cut down on operational costs which would be reflected in the cost of credit.

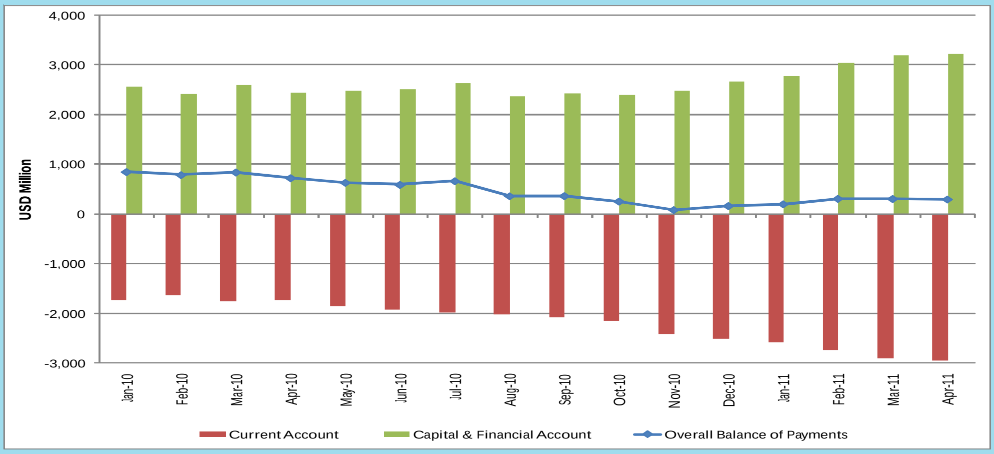
The Bank opened two currency centres located in Nakuru in December 2010 and Meru in February 2011; increasing the total number of currency centres to three. The Nakuru currency centre serves 14 commercial banks with 48 branches transacts about 3.61percent of national transactions. Cumulatively, all currency centres transact 19.82 of the national currency transactions.

While the establishment of currency centers continues to help in alleviating pressure on the operations of the CBK branches, they also reduce some of the structural bottlenecks that have hindered the achievement of lower lending rates. Other than providing currency services, the CBK currency centres continue to facilitate small investors in the rural areas to invest in Government securities, thus improving financial inclusion. For instance, during the issue of Government of Kenya Savings Development Bond in February 2011, currency centers promoted awareness on the bond.

Balance of Payments

The overall balance of payments position improved on account of the Capital and Financial Account balance which grew to USD 3,234 million in the year to April 2011 from USD 2,447 million in the year to April 2010. The improvement in the Capital and Financial Account during the period was attributed to increased private financial inflows associated with the purchase of an aircraft by Kenya Airways in November 2010 as portfolio and other official flows remained relatively stable. However, the Current Account deficit in the year to April 2011 widened to USD 2,937 million from USD 1,723 million in a similar period in 2010 (Chart 6).

Chart 6: Developments in Balance of Payments (12-Month Cumulative)



***Source**: Central Bank of Kenya and KNBS*

The widening of the Current Account deficit during the period was attributed to an increase in imports of oil (by 26.9 percent), chemicals (27.2 percent), manufactured goods (22.7 percent), machinery and transport equipment (26.0 percent), and other commodities for home use (2.7 percent). However, the improvement in the Capital and Financial Account more than offset the widening Current Account deficit to yield an overall surplus in the balance of payment.

Government Budget Operations

In the fiscal year 2010/11 to April 2011, the MPC continued to analyse developments in the budgetary operations of the Government. The Committee noted that the operations were not exerting pressure on interest rates. In particular, Central Government budgetary operations in the year to April 2011 resulted in a deficit of Ksh 105.4 billion on commitment basis compared with a deficit of Ksh 108.5 billion in a similar period in the fiscal 2009/10. Consequently, the deficit-to-GDP ratio declined from 4.3 percent in the fiscal year 2009/10 to April 2010 to 3.9 in the fiscal year 2010/11 to April 2011 on commitment basis. Similarly, the budget deficit on cash basis declined from 4.6 percent to 3.7 percent over the same period. This 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, the Government's overdraft at the Central Bank increased from Ksh 20.0 billion in October 2010 to its limit of Ksh 22.9 billion in April 2011.

During the period, Government borrowing as a proportion of total domestic credit remained at about 24 percent. This coupled with the improved liquidity in the market was expected to ensure that the Government domestic borrowing requirement would not exert pressure on short term interest rates as the monetary policy stance was tightened. The borrowing programme was also designed to increase the maturity profile of domestic debt, hence reducing the concern on interest rate risk and domestic debt sustainability.

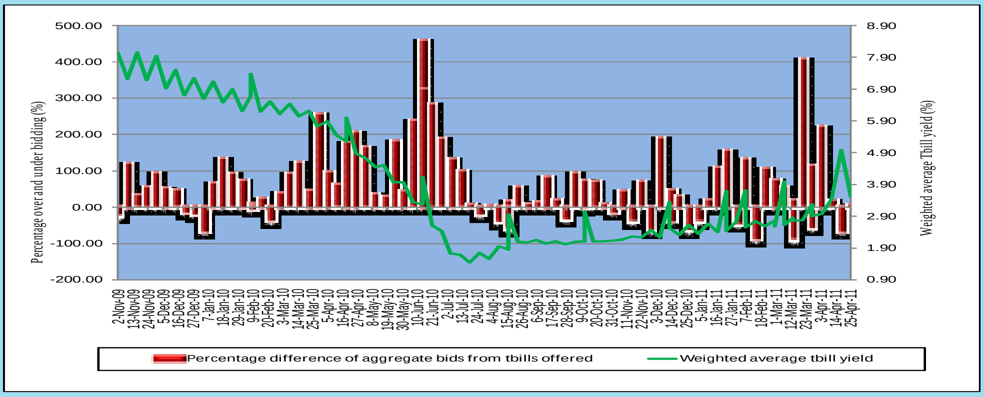
The Treasury Bill and Treasury Bond Market

The stock of Treasury bills (excluding repos) declined from Ksh 133.8 billion at the end of November 2010 to Ksh 101.9 billion at the end of April 2011. However, the stock of Treasury bonds increased from Ksh 511.1 billion to Ksh 563.5 billion during the period reflecting a shift in the debt profile as short term debt maturities were replaced with longer dated Government paper. In particular, a notable development in the bonds market included the issue of a 30-year Government of Kenya Savings Development Bond in February 2011 which was oversubscribed by 87.0 percent at an average interest rate of 12.96 percent. The bond was aimed at increasing the stock of national savings and developing the market for bonds with a strong bearing on improving the reliability and the shape of the yield curve. The bond was re-opened in March 2011 and was oversubscribed again, by 44.10 percent though at a higher average interest rate of 13.52 percent.

Chart 7a shows a gradual increase in the yields of Treasury bills between November 2010 and April 2011.This was largely driven by reduced oversubscriptions, compared with the previous period. In particular, eleven out of the thirty three Treasury bills auctions in the period were undersubscribed while all Treasury bond issues were oversubscribed. Compared with the previous period, the increase in the under subscriptions on Treasury bills was attributed to low yields. However, the oversubscriptions on the Treasury bond auctions reflected confidence in the longer-dated paper and lengthening of the maturity profile of Government debt in the period. This indicated a stronger position on the sustainability of Government debt.

Auctions of Government securities between November 2010 and February 2011 were conducted on weekly but alternating basis for the 91-day and 182-day Treasury bills, and on a monthly basis for the 364-day Treasury bills. However, this framework was changed with the re-introduction of weekly auctions for 91-day Treasury bills in March 2011, and fortnightly issues of 182-day Treasury bills while the frequency for the 364-day Treasury bills remained the same. This was motivated by the need to enhance the efficiency in the issuance of the securities in financing of the budget deficit.

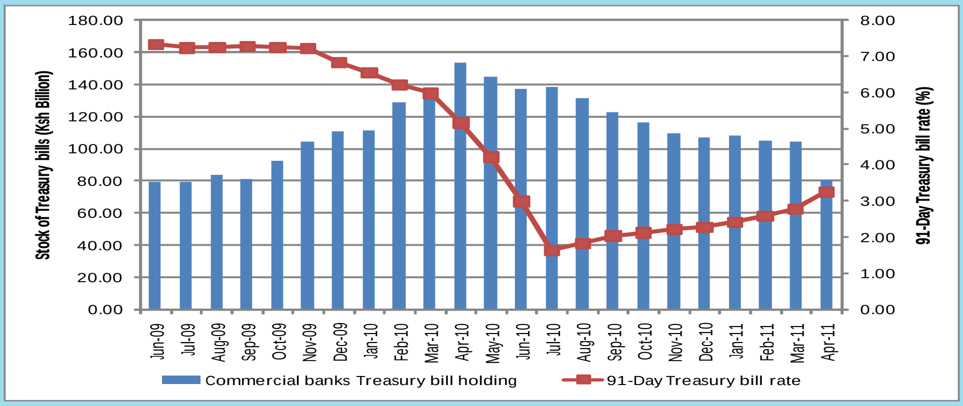
Chart 7a: Treasury Bills Weekly Auction Outcomes



Source: Central Bank of Kenya

As shown in Chart 7b, commercial banks' holding of Treasury bills decreased between November 2010 and April 2011 as yields on Treasury bills remained low in real terms. The commercial banks revised their portfolios of Government securities in favour of Treasury bonds.

Chart 7b: Commercial Banks Treasury Bills Holdings and Yields



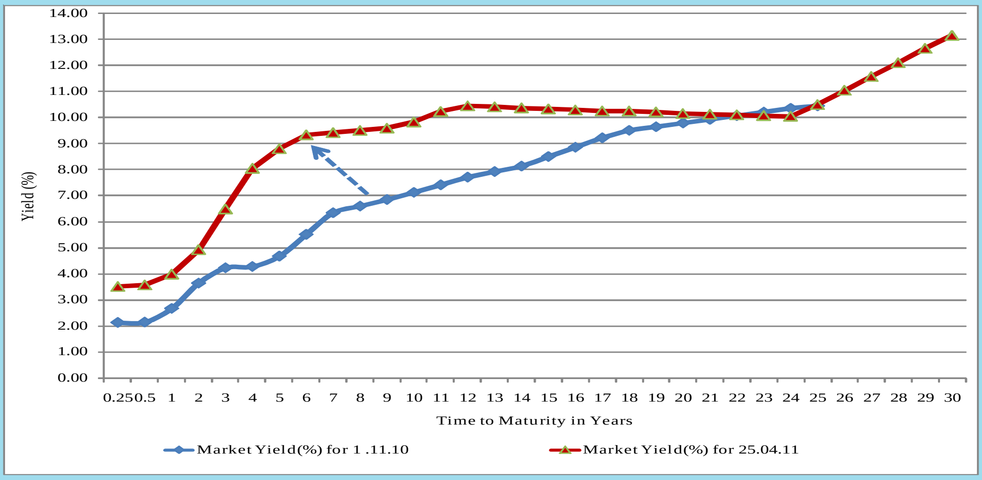
***Source**: Central Bank of Kenya*

Government Securities Yield Curve

As shown in Chart 8, the Government securities yield curve shifted upwards between November 2010 and April 2011. This was attributed to a number of factors, key among them included: change in liquidity conditions in the market occasioned by a shift in monetary policy stance adopted by the MPC in March

2011 to reduce pressure on inflation and volatility in exchange rate; and changes in inflationary expectations as drought conditions and political instability in oil-supplying MENA region persisted. In an environment of both internal and external shocks, the Committee continues to monitor developments in the yield curve as it explores appropriate interventions to mitigate the adverse impact of the shocks.

Chart 8: Government Securities Yield Curve



Source: Central Bank of Kenya

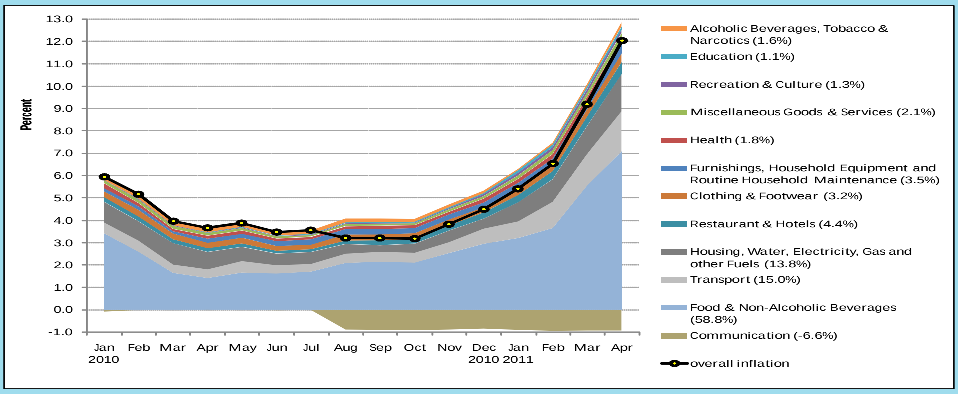
Global Economic Developments

The IMF's World Economic Outlook (WEO) for April 2011 revealed that the global economy grew by 5.0 percent in 2010; strongly supported by the growth in emerging and developing economies. It projected improvements in global economic prospects with the world economy expected to grow by 4.4 percent in 2011 against an earlier forecast of 4.2 percent in October 2010. Despite this, the forecast for growth in sub-Saharan Africa in 2011 remained unchanged at 5.5 percent between October 2010 and April 2011. However, it identified rising food and commodity prices and political instability in the MENA region as some of potential downside risks to growth in sub-Saharan Africa and other developing regions. In addition, the 2011 growth projection for the Euro Area was revised downwards from 1.5 percent in October 2010 to 1.3 percent in April 2011. Generally, the expectations for higher global economic growth were based on projections of strong performance of the BRICS (Brazil, Russia, India and China and South Africa) economies. With these expectations, Kenya's exports to these countries are projected to improve to levels that would compensate the likely reduction in exports to the Euro Area.

Development in Inflation

The April 2011 inflation data released by the Kenya National Bureau of Statistics (KNBS) showed that inflation increased from 3.18 percent in October 2010 to 9.19 percent in March 2011 and further to 12.05 percent in April 2011. Consequently, overall inflation surpassed the target band of 5.0 percent plus or minus 2 percent set by the Ministry of Finance. Further analysis on the drivers of inflation showed that the surge in inflation was mainly as a result of increase in food and fuel related costs (Chart 9). In particular, food and non-alcoholic beverages accounted for 58.8 percent of the overall inflation in April 2011 as transport and housing (including electricity, water, gas and Kerosene) explained for 15.0 percent and 13.8 percent, respectively. However, increased competition in the communication sub-sector with the entry of an additional service provider dampened inflationary pressure as its contribution to inflation was a reduction by 6.6 percent in April 2011.

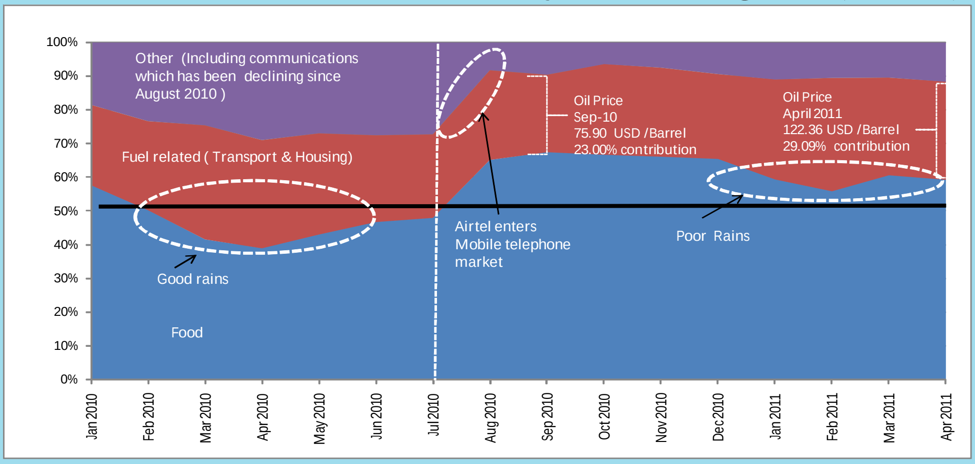
Chart 9: Contribution to Inflation by Board Categories (Percent)



Source: Kenya National Bureau of Statistics and CBK

As shown in Chart 10, the contribution of food to overall inflation between November 2010 and April 2011 was above 50 percent as fuel-related transport and housing (including kerosene) contributed on averaged about 29 percent over the same period. Whilst the surge in food prices was directly related to depressed rains through much of the country between October and November 2010, increases in fuel prices were as a result of political instability in the MENA region that resulted in an upward pressure in international Murban crude oil prices from USD 81.5 per barrel in October 2010 to USD 122.4 per barrel in April 2011. Other factors that contributed to increase in inflation include instability in the exchange rate that increased the cost of imported goods.

Chart 10: Contribution to Inflation by Broad Categories (Percent)



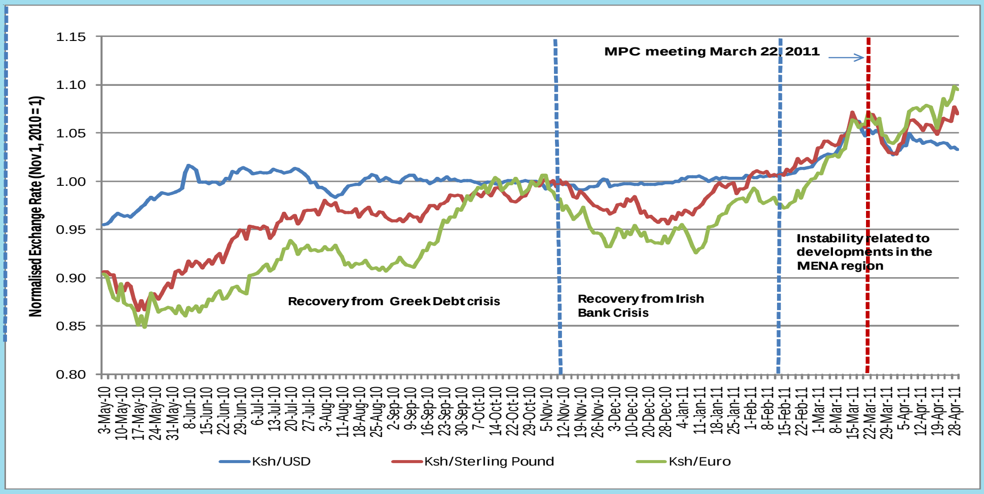
***Source**: Kenya National Bureau of Statistics*

Exchange Rate Management

The Kenya shilling on average weakened against the USD, the Sterling Pound and the Euro between November 2010 and April 2011 (Chart 11). The MPC Report for October 2010 had reported the correction of the exchange rate following the Greek debt crisis that had resulted in the Euro and Sterling Pound depreciating significantly in the international foreign exchange market. However, the onset of the Irish banking crisis restarted a flight to the USD which was, like during the Greek crisis, again perceived as safe. This led to stability in the USD as the Euro and Sterling Pound depreciated. By February 2010 as the impact of the Irish banking crisis dissipated, the political instability in the MENA region caused instability in the exchange rate that was associated with increased speculative behavior in the domestic foreign exchange market. In particular, traders in the market anticipated increased demand for the foreign currency to finance a larger oil import bill as international crude oil prices surged. In addition, oil supply constraints due to political turmoil in the MENA region exacerbated the depreciation.

However, foreign exchange inflows from a variety of sources in the six months to April 2011 continued to dampen the volatility in the exchange rate. In particular, the first tranche of foreign exchange inflows through the Extended Credit Facility successfully negotiated in January 2011 of USD 101.7 million eased the pressure on the shilling as it also facilitated build up in official reserves. Immigrant remittances remained steady at an average of USD 61.7 million over the same period.

Chart 11: Trends in Normalised Exchange Rate



Source: *Central Bank of Kenya*

Note*: The Kenya Shilling exchange rates on 1st November 2010 were 80.75 per USD, 129.80 per Sterling Pound and 113.01 per Euro.*

Foreign Exchange Reserves

As shown in Table 4, the Bank continued to maintain a steady level of official foreign exchange reserves between November 2010 and April 2011 by purchasing USD 116.1 million from the domestic foreign exchange market. This, compared with purchases of USD 224.5 in the previous six-months period, resulted in a slowdown in purchases that was associated with increased instability in the exchange rate that was driven by external developments. The supply of foreign exchange in the market was supported by steady inflows from exports of goods and services including tourism and Diaspora remittances. The official foreign exchange reserves therefore stood at USD 3,981.2 million at the end of the period which was equivalent to 3.7 months of import cover and thus below the statutory requirement of the value of 4 months of imports averaged over the last three years.

Table 4: Developments in Foreign Exchange Reserves (USD Million)

	Apr-10	Nov-10	Dec-10	Jan-11	Feb-11	Mar-11	Apr-11
Gross Reserves							
Official	3,805.39	4,006.87	4,001.68	3,991.90	3,940.18	3,993.89	3,981.19
Commercial Banks	1,319.02	1,149.00	1,120.84	1,070.54	1,363.55	1,316.49	1,233.66
Imports cover (36 months)	3.95	3.70	3.66	3.60	3.64	3.73	3.72
Foreign Exchange Transactions							
Interbank purchases	115.50	41.98	48.71	8.00	10.91	6.46	0.00
Interbank sales	0.00	0.00	0.00	0.00	0.00	0.00	0.00

Source: Central Bank of Kenya

The MPC continued to advise the Bank to diversify purchases of foreign exchange from the market to include the Sterling Pound and the Euro, as the Committee monitored movements in the exchange rates. The build-up in reserves during the period covered by this report was therefore conducted through purchases of USD, Euros and Sterling Pounds based on their movements against the local currency.

4. CONCLUSION

The activities of the MPC between November 2010 and April 2011 were directed at ensuring stability in the interbank market and inflation within the target of 5 percent. This was to be achieved through adoption of appropriate monetary policy stance that would also support credit expansion necessary for enhanced growth of the economy. The CBR was effective in coordinating movements in the short term interest rates. However, towards the end of the period covered by this report, there were both domestic and external shocks that triggered inflationary pressures and instability in the exchange rate. While the domestic shocks emanated from the persistent drought conditions that resulted in supply side inflationary pressure, the external shocks were related to increase in international crude oil prices that were associated with political instability in the oil-producing MENA region.

The MPC also observed increased instability in the exchange rate that resulted from increased speculative behavior by foreign exchange traders occasioned by the anticipation of increased demand for foreign exchange to finance higher oil import bill. In recognition of the impact of these shocks on the economy, the MPC changed the monetary policy stance in March 2011 in order to stabilise the exchange rate and ensure that persistent inflationary pressure was not considered permanent and factored in pricing structures.

The MPC was of the view that the Bank's tools of liquidity management were sufficient and the degree to which inflation affected the economy was mainly on the supply side. The Committee however, continues 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.

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 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 (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.