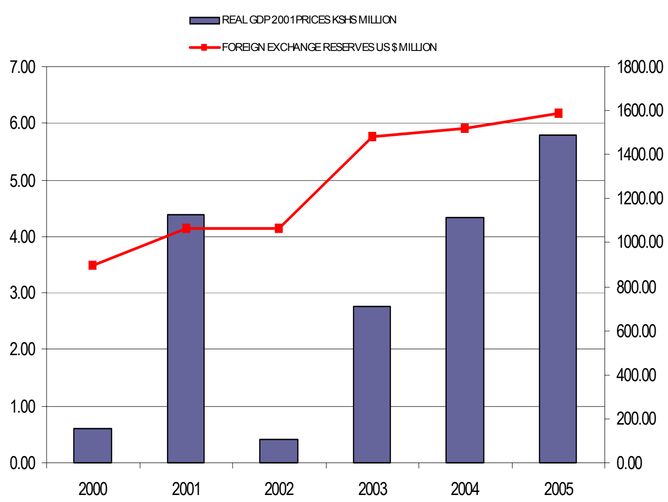


CENTRAL BANK OF KENYA

Monetary Policy Statement

Issued under the Central Bank of Kenya Act, Cap 491

December 2006

Letter of Transmittal

Dear Honourable Minister,

I have the pleasure of forwarding to you the 19th edition of the Monetary Policy Statement of the Central Bank of Kenya, pursuant to Section 4B of the Central Bank of Kenya Act. The Statement reviews the implementation of monetary policy since the previous Statement for June 2006, and the current economic developments. It also outlines the monetary policy stance for 2007.

Jacinta W. Mwatela

Ag. Governor

MONETARY POLICY STATEMENT DECEMBER 2006

TABLE OF CONTENTS

The Principal objectives of the Central Bank of Kenya (CBK) are:

1. To formulate and implement monetary policy directed to achieving and maintaining stability in the general level of prices.
2. To foster the liquidity, solvency and proper functioning of a stable market-based financial system.

Without prejudice to the generality of the above, the Bank is required to:

- Formulate and implement foreign exchange policy;
- Hold and manage its foreign exchange reserves;
- License and supervise authorized dealers in the money market;
- Promote the smooth operation of payments, clearing and settlement systems;
- Act as banker and adviser to, and as fiscal agent of the Government; and
- Issue currency notes and coins.

Objectives of Monetary Policy

The CBK's monetary policy is aimed at achieving and maintaining price stability. The CBK, in consultation with the Government, defines price stability as the containment of inflation below 5 percent.

Price stability raises economic well being by reducing uncertainty about the future inflation expectations. Lower inflation rates provide a good basis for higher long-term economic growth rates.

Instruments of Monetary Policy

The CBK pursues its monetary policy objectives using the following instruments:

- **Open Market Operations** whereby the CBK either buys or sells Treasury bills and any other eligible securities to achieve a desired level of money in the economy. The CBK injects money to the economy when it buys Treasury bills from commercial banks through repurchase order agreement (Repos) , and withdraws money when it sells them.

- **Standing Facilities** which the CBK, as lender of last resort, provides secured short-term loans to commercial banks on an overnight basis at a rate known as the Central Bank rate (CBR). The rate is based on the average of the interbank and the Repo rates plus a margin to be determined and announced by the Central Bank every eight weeks. Commercial banks facing temporary liquidity needs may also rediscount their Treasury bills holdings at the CBR.

- **Reserve Requirements,** the proportion of commercial banks' deposits to be held as cash reserve requirement (CRR) at the CBK in accordance with the law. An increase in CRR reduces the capacity of commercial banks to extend credit. A reduction in the CRR enhances the capacity of commercial banks to expand credit. The CRR has been maintained at 6 percent of commercial bank deposits since July 2003.

- **Foreign Exchange Market Operations** whereby the CBK either injects or withdraws liquidity by engaging in foreign exchange transactions. The participation by CBK in the foreign exchange market is in most cases geared to forestalling speculative tendencies rather than influencing domestic liquidity, although it has the scope to do so.

Monetary Policy Statement

1. The CBK Act Section 4B requires the Bank to submit to the Minister for Finance, at intervals of not more than six months, a Monetary Policy Statement for the next twelve months.

2. The Minister is required by the law to lay every Statement submitted under subsection (1) before the appropriate committee of the National Assembly not later than the end of the subsequent session of Parliament after the Statement is so submitted.

3. The Bank is required by the law to publish in a Gazette:
   i) Its monthly balance sheet; and
   ii) Its Monetary Policy Statement.

4. The Bank is further required to disseminate key financial data and information on monetary policy to the public stating the following:

   i) Policies and the means by which the Bank intends to achieve the monetary policy targets;
   ii) Reasons for adopting such monetary policies and means; and
   iii) Progress made in the implementation by the Bank of monetary policy during the period to which the preceding Monetary Policy Statement relates.

5. In subsection (2), the expression "appropriate committee" means the committee of the National Assembly appointed to investigate and inquire into matters relating to monetary policy.

EXECUTIVE SUMMARY

World real GDP growth is expected to ease from 5.1 percent in 2006 to 4.9 percent in 2007, marking the fourth year of expansion. However, high fuel prices and inflationary pressures emanating mainly from low spare capacity pose a significant risk to growth prospects.

Economic expansion in sub-Saharan Africa remains robust following increased oil production in several oil producing countries. Oil importing countries in the region have showed resilience to high international fuel prices supported by improved terms of trade on the non-fuel commodities as well as marked improvements in the policy environment. Real GDP growth in sub-Saharan Africa is, therefore, expected to reach 6.3 percent in 2007 from 5.2 percent in 2006.

Kenya's economy is expected to sustain its growth momentum in 2007. Real GDP is expected to be 6 percent in 2007 underpinned by growth in agriculture, tourism, manufacturing and the telecommunications sector. The economic expansion is also expected to be sustained over the medium term supported by the ongoing reform measures in key sectors of the economy.

The main short-term risk to the monetary policy outlook for 2006/07 identified in the previous statement when money supply, M3, and reserve money were expected to grow by 10 percent was the pick up in underlying inflation from June 2006 onwards. In particular, while underlying inflation continued to remain below target, its increase posed a risk to the medium term inflation trend. In addition, there was also a likelihood of prevailing high international oil prices feeding into the prices of domestic commodities.

However, as international oil prices eased and the exchange rate remained stable in part anchoring inflation expectations, overall inflation picked up from 10.2 percent in July 2006 to 15.6 percent in December 2006. While remaining within the 5 percent target, underlying inflation also started to increase from July 2006 onwards.

The Bank therefore made some revisions to the monetary policy outlook in November 2006. The management of inflation expectations formed the main consideration of the monetary policy stance in 2007. When assessing the risks to price stability, consideration was given to the fact that the pick up in inflation from July 2006 in part reflected the effects of the drought in the fourth quarter of 2005 which had not fully dissipated as earlier thought, as well as inadequate distribution of some food items to deficit regions. Incoming data so far shows a deceleration in overall inflation in January 2007 mainly reflecting significantly lower increases in the food index than in January 2006.

Nonetheless, to avoid high inflation becoming embedded in the inflationary process, the growth in money supply, M3, and reserve money to June 2007 has been limited to 12 percent. In order to enhance the effectiveness of monetary policy implementation, the Bank has also taken measures aimed at clarifying its policy intentions to the market to achieve the desired adjustment in monetary conditions. Meanwhile, economic growth in the year to June 2007 is expected to be stronger than projected in the previous monetary policy statement.

There are risks to monetary policy in the short term expected to emanate from both external and domestic developments. The potential for high inflation to feed into higher price expectations is of concern. A related risk arises from potential increases in international crude oil prices, particularly following security concerns in the Middle East. The risks to price stability will, however, be minimized by the continued implementation of prudent monetary policy in the year.

INTRODUCTION

The 19th Monetary Policy Statement (MPS) for December 2006 is made pursuant to Section 4B of the Central Bank of Kenya (CBK) Act. The MPS sets out monetary policy for 2007. The MPS is part of a wider set of publications that the CBK uses to explain monetary policy actions and outcomes.

The 19th MPS reviews implementation of monetary policy for the period June 2006 to December 2006, evaluates economic conditions in the context of possible risks in the short term, and outlines the monetary policy strategy to be applied in 2007 in order to deliver on price stability.

The MPS is presented in three parts. Section one reviews the performance of monetary policy for the second half of 2006. Section two covers economic developments in the second half of 2006, and presents the outlook for 2007 and the medium term. The last section contains the monetary policy stance to be applied in 2007 and summarizes both prospects and risks that could influence the outlook for inflation in 2007, and is intended to affect the manner in which economic agents form expectations on inflation.

1. MONETARY POLICY SINCE THE LAST STATEMENT OF JUNE 2006

1.1 Review of Recent Monetary Policy Stance

Monetary policy has been directed towards attaining and maintaining 5 percent inflation by June 2007. The monetary policy was consistent with the reduction in inflation by the end of June 2006. Overall inflation had eased to 10.9 percent in June 2006 following the onset of the long rains in the second quarter of 2006. Therefore, the supply of regular food stuffs improved leading to a deceleration in the food and non-alcoholic drinks index, which constitutes over 50 percent of the composite index. While underlying inflation had started to increase, it remained well below 5 percent.

Real GDP was expected to grow by 5.8 percent in 2006/07, underpinned mainly by growth in agriculture, manufacturing, construction and tourism. The expansion in economic activity would be supported by ongoing structural reforms as well as improved macroeconomic conditions. Given the 5 percent inflation objective, the expansion in money supply, M3, and reserve money was set at 10 percent by June 2007. The main elements of the monetary expansion path are summarized in Table 1.

Table 1: Growth Targets for Key Aggregates for 2006/07 Monetary Programme

	Jun'06	Sep'06	Dec'06	Mar'07	Jun'07
	Act.	Projection			
Reserve money (Ksh million)	107.7	106.9	116.9	113.7	116.6
NFA of CBK (Ksh million)	151.6	144.2	148.8	156.9	162.2
Memo:					
Annual change in reserve money	14.0	11.5	10.1	10.6	10.0
Annual change in extended broad money	16.0	12.1	11	10.8	10.0
Real GDP growth					5.8
Overall inflation					5.0

Source: Central Bank of Kenya

Reserve money path factored in build-up in net foreign assets of the CBK from Ksh 151.6 billion in June 2006 to Ksh 162.2 billion by the end of June 2007. This was to be achieved from continued improvement in the balance of payments position in 2006/07.

Implementation of monetary policy in the second half of 2006 was anchored on quarterly targets for reserve money. Monthly targets for reserve money were set consistent with the established quarterly targets.

1.2 Performance of Monetary Policy to December 2006

Monetary policy was implemented through open market operations using repurchase agreement order securities (REPOs). Forecasts for reserve money, comprising commercial bank deposits at the CBK and currency in circulation, were generated. The daily deviation of the forecast reserve money from target formed the basis for the amount of repos required to be sold or bought to align monetary conditions to the desired path. Daily repos immediately absorb excess liquidity of commercial banks and are also expected to cause banks to attract the cash held by the public, as banks offer higher deposit rates.

Following monetary expansion, both of money supply and reserve money in excess of targets and an upward trend in underlying inflation, the Bank undertook measures to manage liquidity and inflationary pressures. In particular, the CBK intensified monetary policy operations through the sale of repos to commercial banks. In line with the monetary policy operations, the Bank also reviewed the Central Bank Rate (CBR) from 9.75 percent to 10 percent in August 2006.

By December 2006, however, the stock of outstanding repo securities had declined from Ksh 23.4 billion in June 2006 to Ksh 4.9 billion, as commercial banks redeemed their holdings with the Central Bank. Withdrawal of excess liquidity through open market operations was also constrained by higher than expected cash held by the public particularly in December 2006.

Reserve Money

Reserve money remained above the monthly targets between June 2006 and December 2006 as shown in Table 2. Reserve money increased from Ksh 106.1 billion in June 2006 to Ksh

122.6 billion by December 2006. The excess reserve money was in cash outside banks (Ksh 5.0 billion) and bank reserves (Ksh 0.7 billion). Cash outside banks trended upwards during the period under review. The excess of cash outside banks from target narrowed in October 2006 but widened thereafter through December 2006 in line with seasonality experienced during the festivities.

Table 2: Reserve Money and Targets for 2006/07 (Ksh Billion)

		Reserve Money			Currency outside Banks			Banks Reserves		
		Actual	Target	Dev	Actual	Target	Dev	Actual	Target	Dev
2006	Jun	106.1	100.4	**5.7**	66.2	62.2	**4.0**	40.0	38.3	**1.7**
	Jul	108.4	102.6	**5.8**	68.0	63.5	**4.5**	40.4	39.1	**1.3**
	Aug	111.9	103.7	**8.3**	70.0	65.1	**4.9**	41.9	38.6	**3.3**
	Sep	113.2	106.9	**6.3**	70.5	66.0	**4.5**	42.7	40.9	**1.8**
	Oct	114.5	110.2	**4.3**	71.9	68.8	**3.1**	42.6	41.4	**1.2**
	Nov	117.3	112.0	**5.3**	74.2	69.8	**4.4**	43.1	42.2	**0.9**
	Dec	122.6	116.9	**5.7**	77.8	72.8	**5.0**	44.9	44.1	**0.7**
2007	Mar		115.5			71.7			43.8	
	Jun		120.6			75.4			45.2	

Source: Central Bank of Kenya

The increase in reserve money in December 2006 was supported by increased net foreign assets (NFA) of the Central Bank, as net domestic assets (NDA) declined reflecting a build up of Government deposits. NFA increased by Ksh 38.7 billion in the year to December 2006, largely due to interbank forex purchases made by the Bank.

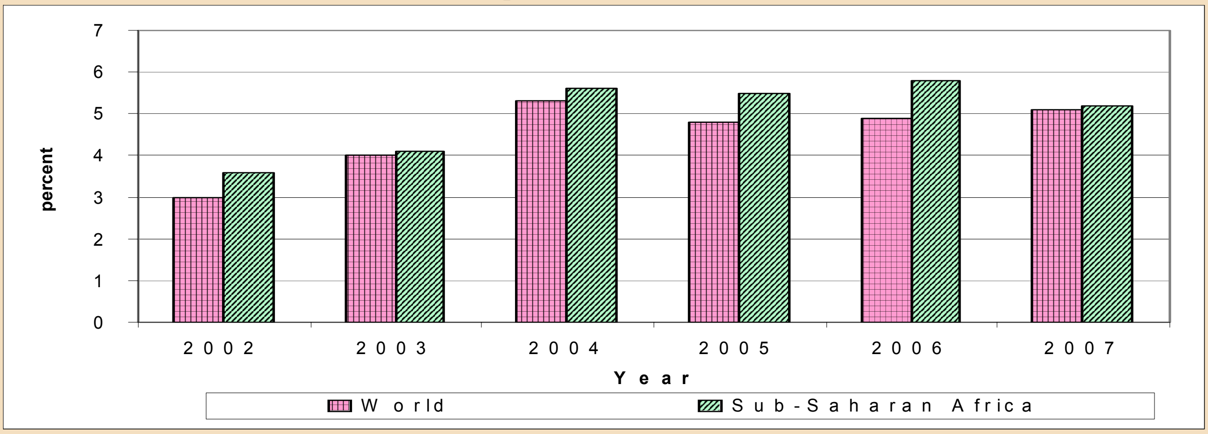
The Bank, however, encountered difficulties in sterilizing liquidity arising from the foreign exchange purchases from commercial banks. By December 2006, outstanding repo securities had declined from Ksh 23.4 billion in June 2006 to Ksh 4.9 billion, as commercial banks redeemed their holdings with the Central Bank most of which was turned into cash held by the public particularly in December 2006.

2. ECONOMIC SITUATION AND OUTLOOK FOR 2007 AND MEDIUM TERM

2.1 The World Economy

World output is projected to have grown by 5.1 percent in 2006, according to the International Monetary Fund's World Economic Outlook (WEO) for September 2006 (Chart 1). The expansion is broad based with impressive growth being maintained in emerging market countries as well as low income countries in Africa.

Chart 1: Global Economic Output (2000 - 2007)



Source: IMF World Economic Outlook

GDP in Sub-Saharan Africa is estimated to have grown by 5.2 percent in 2006 and expected to increase to 6.3 percent in 2007. The increase reflects strong policy stance and a pick up of growth in oil exporting countries particularly Nigeria. According to the IMF's World Economic Outlook (WEO) new oil fields in Angola and Equatorial Guinea are expected to come on stream, further boosting oil production. Oil importing countries in the region have shown resilience to high fuel prices to register improved economic performance on account of favourable terms of trade on the non-fuel commodities.

Outlook for 2007 and the Medium Term

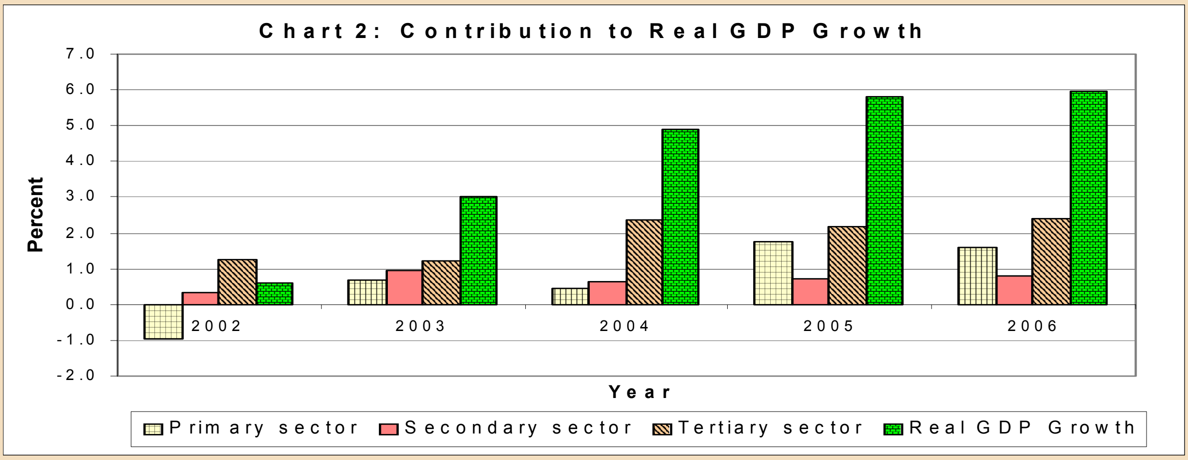
World output is expected to moderate to 4.9 percent growth in 2007. Rising inflationary pressures coupled with low spare oil capacity pose a risk to global expansion. Although investment in new oil production and diversification into alternative energy sources is already taking place, the restoration of spare capacity is only expected in the long term.

The economic outlook for Sub-Saharan Africa remains positive. However, growth prospects in the region are hinged on the developments in oil prices as well as export performance which relies on the pace of global economic expansion.

2.2 Domestic Economy

Kenya's economy is projected to have grown by 6 percent in 2006. The good performance was underpinned by vibrant tourism, increased activity in building and construction, manufacturing, agriculture sectors and improved governance. Stable interest rates and market determined exchange rate continue to provide a conducive macroeconomic environment for investment. In particular, remittances from abroad increased as well as public spending on development projects.

Chart 2: Contribution to Real GDP Growth



Source: Central Bureau of Statistics

Leading economic indicators show improved performance in key sectors of the economy in 2006. Increased agricultural output in the second half of 2006 mitigated the drought-related decline in output in the first half. The manufacturing sector achieved significant growth in 2006 despite the negative impact of drought on agro-based manufacturing. Strong export demand, coupled with tax incentives in the 2006/07 budget also contributed to the growth of the manufacturing sector estimated at 6.8 percent in 2006. Tourism remained buoyant following marketing campaigns especially to non-traditional markets, and improved security. This resulted in 14 percent tourist arrivals growth in the first ten months of 2006. The strong growth had a positive spill-over effect on air transport and hotels and restaurants.

The expansion in economic activity is reflected in increased electricity consumption which rose by 5.5 percent in the January – October 2006 period while total local electricity generation increased by 5.2 percent over the period. Completion of Sondu Miriu project towards the end of 2007 is expected to add 60.0 million KWH to the national grid system. Plans are also underway to construct a third geothermal plant in Olkaria while exploration is ongoing in lakes Naivasha, Bogoria and Baringo and its environs.

Projections for 2007 and the Medium Term

The economic recovery in the last four years is expected to continue both in 2007 and in the medium term as envisaged in the vision 2030 outlook. The growth momentum will be supported by increased credit to private sector for investment in the productive sectors. The outlook builds on the various structural reforms implemented in the recent past and continued sectoral growth in tourism, transport and communication, manufacturing and building and construction. The ongoing liberalization in telecommunications, energy, and transport is expected to boost growth in these sectors.

There are, however, some downward risks to the growth outlook that include infrastructural constraints particularly the high cost and supply of electricity, roads, and ICT which have a negative impact on export competitiveness. Equally, the deteriorating terms of trade resulting from the high and volatile oil prices in the international market and high prices of other critical imported inputs could undermine economic performance. Natural calamities like drought and floods continue to be a challenge to the performance of the economy.

2.3. Balance of Payments

The balance of payments surplus eased from US$ 839 million in the year to June 2006 to US$ 784 million in the year to November 2006 following increased merchandise imports. The deficit in the current account widened by US$ 366 million as the surplus in the capital and financial account increased by US$ 311 million (Chart 3).

Chart 3: Balance of Payments

Source: Central Bank of Kenya

The balance of trade deficit widened from US$ 3,096 million in the year to June 2006 to US$ 3,763 million in the year to November 2006. Merchandise imports grew by 14.2 percent, to US$ 7,168 million in the year to November 2006, largely reflecting increased imports of oil, manufactured goods and machinery and transport equipment. Merchandise exports grew by 7.1 percent to US$ 3,405 million during the same period and reflected increased export earnings from tea, horticulture, manufactured goods and raw materials.

The trade deficit was offset by higher receipts from services. The surplus in the services account was US$ 2,868 million in the year to November 2006 compared with US$ 2,568 million in the year to June 2006 and was attributed to other government and private sector services. Earnings from tourism, however, declined from US$ 638 million in the year to June 2006 to US$ 622 million in the year to November 2006.

The surplus in the capital and financial account rose from US$ 1,368 million in the year to June 2006 to US$ 1,679 million in the year to November 2006 due to increased short term financial inflows. Official medium and long-term financial flows also improved during the period under review and reflected reduced official foreign debt repayments.

Following improved overall balance of payments, gross official foreign exchange reserves increased from US$ 2,353 million, equivalent to 4.8 months of imports cover, at the end of June 2006 to US$ 2,415 million, equivalent to 4.5 months of imports cover (based on average imports for the three preceding years) as at the end of December 2006. Foreign exchange reserves holdings by commercial banks also rose from US$ 556 million, at the end of June 2006 to US$ 916 million, at the end of December 2006.

Projections for 2007 and the Medium Term

The balance of trade deficit is expected to widen further in the coming year with continued strong demand for imports of capital and intermediate goods to support increased domestic production. Export volume growth is also expected to pick up as agricultural output recovers from the drought experienced in the earlier part of 2006. Export volume growth is, however, not expected to match that of import. The wider trade deficit will be partly offset by increased receipts from tourism, transportation, and current transfers, particularly external remittances.

To a large extent, the deficit in the current account will be financed by improved capital and financial inflows as the capital and financial account is expected to remain in surplus. Thus the overall balance of payment is projected to have a surplus of US $350 million by the end of December 2007.

Following the expected surplus in the overall balance of payment, the gross official foreign exchange reserves are projected to increase from US$ 2.4 billion in December 2006, equivalent to 4.5 months of imports cover to US$ 2.8 billion in December 2007 and to US$ 3.1 billion in December 2008, equivalent to 4.7 months of imports cover.

2.4 Fiscal Developments

Government budgetary operations in the first half of the fiscal year 2006/07 resulted in an overall budget deficit on commitment basis of Ksh 23.5 billion or 1.4 percent of GDP compared with Ksh 15.4 billion or 1.1 percent of GDP in a corresponding period of the fiscal year 2005/06. As shown inTable 3, the deficit was lower than the target of Ksh 33.9 billion or 2.0 percent of GDP for the period. The performance of the budget during the period was attributed to a substantial growth in tax revenue coupled with lower than budgeted Government expenditure.

Table 3: Central Bovernment Fiscal Outturn (Ksh Billion)

	2005/06	Jul 2006-Dec 2006		2006/07	2007/08	2008/09
	Prov.	Prov.	Target	Proj.	Proj.	Proj.
1. Total Revenue and Grants	333.7	163.7	194.0	403.8	413.8	461.3
Total Revenue	313.6	158.8	180.7	375.4	373.6	415.9
% of GDP	20.1	9.6	10.9	21.2	19.1	19.3
Grants	20.1	4.9	13.2	28.4	40.2	45.3
% of GDP	1.3	0.3	0.8	1.6	2.1	2.1
2. Total Expenditure	376.5	187.1	227.9	461.2	499.5	543.9
Recurrent	316.2	157.6	175.6	338.3	362.1	390.7
% of GDP	20.2	9.5	10.6	19.1	18.5	18.1
Development	60.3	29.5	52.2	122.9	137.4	153.2
% of GDP	3.9	1.8	3.2	6.9	7.0	7.1
3. Balance (commitment basis including grants)	**-42.8**	**-23.5**	**-33.9**	**-57.4**	**-85.7**	**-82.6**
% of GDP	-2.7	-1.4	-2.0	-3.2	-4.4	-3.8
4. Adjustment to cash	6.3	-10.5	0.0	0.0	0.0	0.0
3. Balance (cash basis including grants)	**-36.5**	**-34.0**	**-33.9**	**-57.4**	**-85.7**	**-82.6**
% of GDP	-2.3	-2.1	-2.0	-3.2	-4.4	-3.8
6. Statistical discrepancy	0.0	-7.5	0.0	0.0	0.0	0.0
7. Total Financing	**36.5**	**26.5**	**33.9**	**57.4**	**85.7**	**82.6**
a. Net External	1.2	-0.8	-0.4	9.7	24.5	26.8
b. Net Domestic	28.3	27.2	21.8	29.5	25.7	18.1
c. Others*	7.0	0.0	12.5	18.2	35.6	37.7

* Includes privatisation proceeds and securitisation of domestic arrears

Source: Treasury

The fiscal operations in the first half of the fiscal year 2006/07 resulted in a financing requirement of Ksh 27.2 billion. This level of borrowing was required to finance a budget deficit of Ksh 26.5 billion and to repay external debt of Ksh 0.8 billion. The Ksh 27.2 billion financing requirement was sourced as follows: Ksh 5.6 billion from the Central Bank; Ksh 11.8 billion from commercial banks; Ksh 6.6 billion from non-banks; and, Ksh 3.3 billion through draw down of Government deposits at the Central Bank. The financing operations resulted in a net drawdown of Government accounts at the Central Bank by Ksh 8.8 billion in the first half of the fiscal year 2006/07. The domestic borrowing operations in the first half of the fiscal year 2006/07 resulted in an increase in domestic debt from Ksh 357.8 billion at the end of June 2006 to Ksh 385.1 billion at the end of December 2006. During the period, Treasury bills increased from Ksh 94.8 billion to Ksh 96.7 billion while Treasury bonds increased from Ksh 218.4 billion to Ksh 238.0 billion, as investors preferred longer dated instruments.

Outlook for 2007 and the Medium Term

Government revenue (including grants) is projected to rise from Ksh 333.7 billion or 21.4 percent of GDP in the fiscal year 2005/06 to Ksh 403.8 billion or 22.8 percent of GDP in the fiscal year 2006/07. Similarly, Government expenditure is projected to increase from Ksh 376.5 billion or 24.1 percent of GDP in the fiscal year 2005/06 to Ksh 461.2 billion or 26.0 percent of GDP in the fiscal year 2006/07. The overall budget deficit including grants, therefore, is projected to rise from Ksh 42.8 billion or 2.7 percent of GDP to Ksh 57.4 billion or 3.2 percent of GDP during the period. This is expected to be financed through net external financing totalling Ksh 9.7 billion, privatisation proceeds of Ksh 18.2 billion and domestic borrowing of Ksh 29.5 billion.

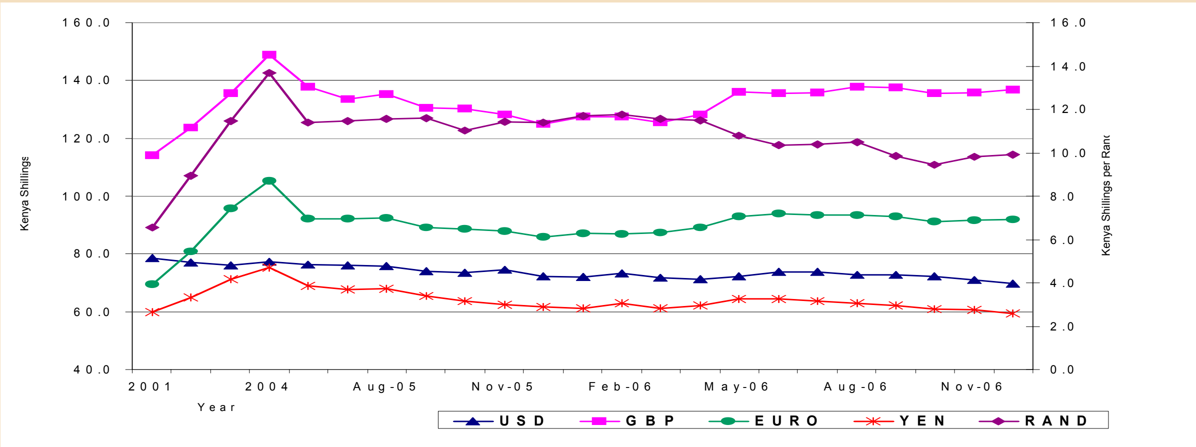
Government revenue (including grants) is projected to grow steadily, boosted by the growth of the economy and continued tax policy reforms. Tax revenue collection is expected to rise from 19.1 percent of GDP in the fiscal year 2007/08 to 19.3 percent in the fiscal year 2008/09 while grants to GDP ratio are projected to remain at 2.1 percent during the period. Similarly, Government expenditure is expected to increase but remain stable as a percent of GDP. However, Government net domestic financing is expected to fall from Ksh 29.5 billion in the fiscal year 2006/07 to below Ksh 20.0 billion by the fiscal year 2008/09 while external financing is projected to increase.

2.5 Exchange Rate

The Kenya shilling appreciated against the US dollar by 5.8 percent in the second half of 2006 after depreciating by 2.6 percent in the first half of the year. The appreciation of the shilling against the US dollar reflected in part the international weakening of the US dollar. The US dollar lost by 7.0 percent and 3.9 percent against the Sterling Pound and the Euro, respectively, between June and December 2006. The shilling was also buoyed by continued foreign exchange inflows from the export sector and capital inflows. The shilling thus traded at 69.6 against the US dollar in December 2006 compared with Ksh 73.88 in June 2006.

The Sterling Pound remained strong vis-à-vis the Kenya shilling throughout 2006 as shown in Chart 4. The depreciation of the Kenya shilling against the Sterling Pound was, however, less pronounced in the second half of the year during which the shilling lost by 0.9 percent compared with 6.4 percent depreciation in first half of the year. The shilling on the other hand recouped its losses against the Euro and the Japanese Yen from June 2006 onwards and gained by 2.1 percent and 7.7 percent against the Euro and the Japanese Yen, respectively. The Kenya shilling remained strong against regional currencies between June and December 2006, appreciating by 2.9 percent and 9.1 percent against the Uganda and Tanzania shillings, respectively. As the CBK continues to pursue prudent macroeconomic polices and maintain market determined exchange rate, it is expected that the shilling will remain stable in 2007.

Chart 4: Kenya Shilling Exchange Rates Against Selected Currencies (2001-2006)

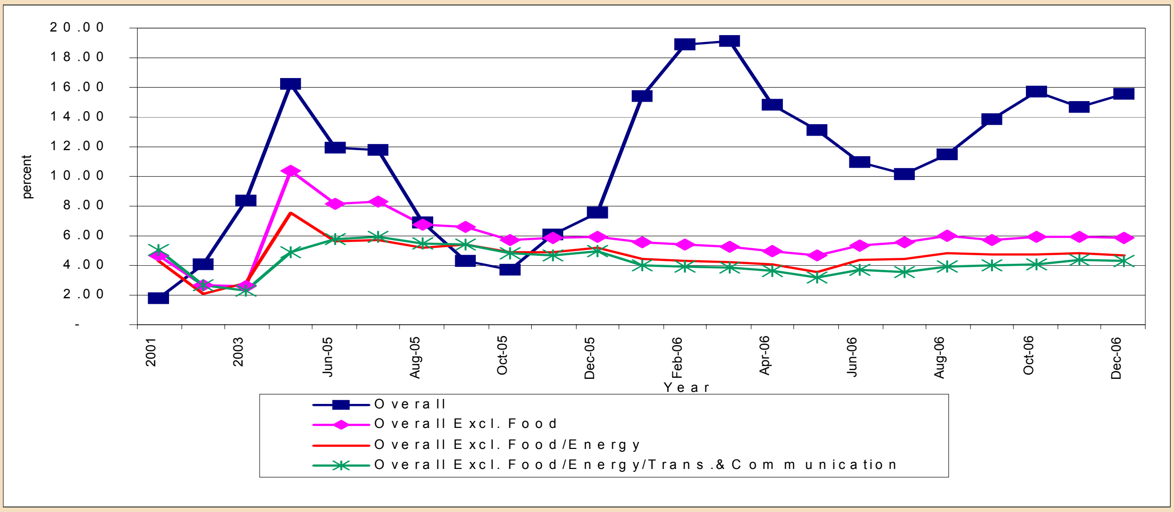


Source: Central Bank of Kenya

2.6 Inflation

Overall inflation increased from 10.2 percent in June 2006 to 13.9 percent and 15.6 percent in the September and December quarters, respectively (Chart 5). Over the past two quarters, there was acceleration in food and non alcohol prices as well as the fuel and energy prices which account for over 50 percent of the composite index. Inflation in the food and non-alcoholic drinks in the second half of 2006 ranged between 20 and 23 percent, while that of the fuel and power category ranged between 12 and 14 percent.

Chart 5: Inflation Rate (2001 - 2006)



Source: Central Bank of Kenya

The effects of the 2005 drought which spilled over into the first quarter of 2006 dissipated in the second quarter leading to a significant drop in inflation in the food category. In December 2006, there was a marked increase in the prices of sugar, tomatoes, onions, and wheat flour in part, reflecting the impact of heavy rains on the supply of vegetables. The re-emergence of persistent price increases particularly in the food index suggests supply obstacles, mainly the inadequate distribution of food to deficit regions. While there have been declines in international oil prices, lower domestic petrol prices are yet to be experienced.

Despite recent high levels of overall inflation, underlying inflation remains below 5 percent, albeit moving towards the target. The underlying measure of inflation which excludes food, energy, transport and communication categories of goods and services from the CPI, increased from 3.7 percent in June 2006 to 4.3 percent in December 2006 as shown in Table 4.

Table 4: Consumer Price Index (June 2006 - December 2007)

	2006						
	Jun	Jul	Aug	Sep	Oct	Nov	Dec
CPI	10.9	10.2	11.5	13.9	15.7	14.6	15.6
Food & Drink	14.9	13.5	15.5	20.0	23.0	21.1	22.6
Alcohol & Tobacco	6.5	6.7	8.0	9.2	9.3	8.8	7.0
Clothing & Footwear	2.8	3.1	3.1	3.1	2.8	2.8	3.0
Housing	4.8	4.3	5.1	4.7	5.1	5.9	6.0
Fuel & Power	11.4	12.8	13.7	11.9	13.5	13.0	13.5
Household Goods & Services	3.1	3.0	3.1	3.8	3.9	4.4	4.7
Medical Goods & Services	3.8	3.1	3.0	3.3	3.4	4.1	3.1
Transport & Communication	8.3	9.3	9.8	8.5	8.2	7.1	6.5
Recreation & Education	2.1	2.0	2.2	2.2	2.2	2.0	2.1
Personal Goods & Services	2.5	2.3	2.1	2.0	2.0	1.8	2.0
Underlying Inflation (various measures)							
CPI excluding food	5.3	5.5	6.0	5.7	6.0	5.9	5.9
CPI excluding food and energy	4.4	4.4	4.8	4.7	4.8	4.8	4.7
CPI excluding food, energy and transport & communication	3.7	3.6	3.9	4.0	4.1	4.4	4.3

Source: Central Bank of Kenya

Stability of the Kenya shilling exchange rate coupled with declining international oil prices contributed to partly anchoring inflation expectations. In January 2007, inflation decelerated to 9.7 percent reflecting lower price increases in the food, alcohol, fuel and power categories of goods and services

Outlook in 2007 and the Medium Term

Inflation is expected to remain stable in 2007. The stability in the shilling exchange rate is expected to be sustained in 2007. While there are concerns over the sustainability of global oil supplies, lower international oil prices in the short term which have so far dropped below US $ 60 per barrel, coupled with the weakening of the US dollar, will help contain inflationary pressures particularly in the transport and energy sectors.

Continued implementation of the adopted monetary policy stance will contribute to dampening underlying inflationary pressures. In particular, the projected reserve money growth is expected to accommodate underlying inflation of below 5 percent. However, a major risk to the outlook for inflation is the effect of uncertain weather conditions on food supply.

2.7. Monetary and Financial Markets Developments

Money and Credit

Money supply, M3, grew by 17.9 percent in 2006 compared with 10.2 percent in 2005. The expansion in M3 was above the projected growth of 11 percent for the December 2006 quarter. Broad money, M2, which is M3 excluding foreign currency deposits increased by 16.7 percent in 2006 compared with 9.7 percent in 2005.

The contribution of net foreign assets of the banking system to monetary expansion increased from 7.4 percent in 2005 to 9.0 percent in 2006, reflecting increased private capital inflows. Net domestic assets of the banking system accounted for 8.9 percent of the expansion in M3 in 2006, having increased from 2.8 percent in 2006 as shown in Table 5.

Table 5: Contribution to Growth in Broad Money, M3 (percent))

	Jun-05	Sep-05	Dec-05	Mar-06	Jun-06	Sep-06	Dec-06
Annual growth in M3	11.0	11.3	10.2	12.5	16.0	17.4	17.9
Net Foreign Assets	5.0	6.1	7.4	6.5	7.1	8.1	9.0
Net Domestic Assets	6.0	2.9	2.8	6.0	8.9	9.4	8.9
Domestic Credit	10.7	5.4	4.9	8.2	11.3	11.7	13.6
Government (net)	-2.1	-5.1	-2.0	-0.2	1.1	2.2	2.8
Rest of the Economy	12.8	10.5	6.9	8.4	10.2	9.5	10.9
Other public sector	0.2	-0.1	0.2	0.1	0.4	0.8	1.2
Private sector	12.6	10.6	6.7	8.3	9.9	8.7	9.7
Other Items (net)	-4.7	-2.5	-2.1	-2.3	-2.4	-2.4	-4.7

Source: Central Bank of Kenya

Domestic credit grew much faster, by 15.5 percent in 2006 compared with 5.3 percent in 2005. Credit to the private sector grew by 15.1 percent in 2006 compared with 10.4 percent in 2005 in line with increased economic activity. Most of the credit expansion was to transport and communication (46.9 percent), consumer durables (39.4 percent), business services (32.3 percent), mining and quarrying (31.7 percent), building and construction (28.5 percent), and manufacturing (10.9 percent) as shown in Table 6.

Table 6: Credit to Private Sector

	2005		2006		Annual	
	December Ksh bn	Share (%)	December Ksh bn	Share (%)	Change Ksh bn	percent
Credit to Private Sector	**364.5**	**73.1**	**419.5**	**72.9**	**54.9**	**15.1**
Agriculture	33.0	6.6	32.3	5.6	-0.7	-2.2
Manufacturing	63.3	12.7	70.2	12.2	6.9	10.9
Trade	51.6	10.4	56.4	9.8	4.8	9.3
Building and construction	26.8	5.4	34.4	6.0	7.6	28.5
Transport & communications	27.1	5.4	39.9	6.9	12.7	46.9
Finance & insurance	32.2	6.5	25.5	4.4	-6.8	-20.9
Real estate	24.6	4.9	24.5	4.2	-0.2	-0.7
Mining and quarrying	2.4	0.5	3.2	0.6	0.8	31.7
Private households	46.6	9.3	50.4	8.8	3.8	8.3
Consumer durables	9.4	1.9	13.1	2.3	3.7	39.4
Business services	34.6	6.9	45.8	8.0	11.2	32.3
Other activities	12.8	2.6	23.9	4.2	11.1	86.1

Source: Central Bank of Kenya

Equity Market

There was improved activity at the Nairobi Stock Exchange (NSE) in the second half of 2006. The NSE 20 Share Index gained 1,385 points, moving from 4,260.5 points in June 2006 to 5,645.6 points by December 2006. Market capitalization increased from Ksh 623.2 billion in June 2006 to Ksh 791.6 billion in December 2006. Meanwhile, market turnover increased from Ksh 35.9 billion in the first half of 2006 to Ksh 59 billion in the second half.

The improvement in most key indicators followed increased traded shares associated with three initial public offers (IPOs) and a number of share splits, coupled with unprecedented share price increases in most counters. Bond turnover, however, declined during the period under review from Ksh 23.8 billion in the six months to June 2006 to Ksh 10.3 billion in the six months to December 2006. The decline in bond turnover could be attributed to the improved performance in the equity market that led investors to divest from the fixed income securities.

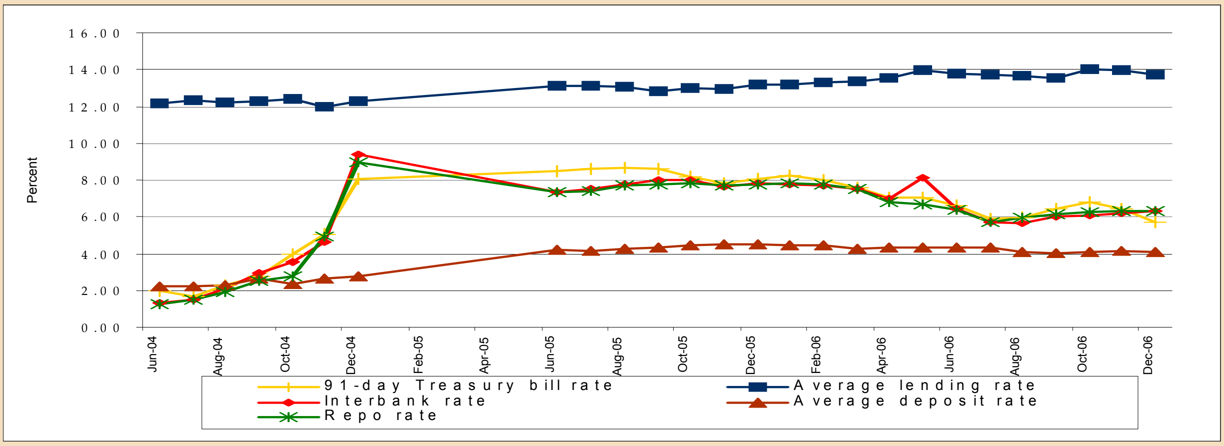
Interest Rates

Short-term interest rates continued to drop in the second half of 2006, with the 91-day Treasury bill rate declining from 6.6 percent by end of June 2006 to 5.7 in December 2006. However, before declining in December 2006, the rate increased to 6.8 percent in October 2006, reflecting in part, response of short term interest rates to CBK's upward revision of the CBR in August 2006 from 9.75 percent to 10 percent. In subsequent reviews, the CBR was left unchanged.

The average 182-day Treasury bill rate, however, remained unchanged over the same period at 7.3 percent. The average interbank rate declined from 6.4 percent in June 2006 to 6.3 percent in December 2006.

Commercial banks lending rates remained stable at 13.7 percent in the second half of 2006, while the average deposit rate declined from 4.4 percent in June 2006 to 4.1 percent in December 2006. As a result, the spread between lending and deposit rates increased from 9.4 percent in June 2006 to 9.6 percent by December 2006.

Chart 6: Short term interest rates (Jun 2004-Dec 2006)



Source: Central Bank of Kenya

Outlook for 2007 and the Medium Term

With interest rates continuing to be determined by the market, continued implementation of prudent monetary policy is expected to consolidate interest rate stability.

3 MONETARY POLICY FOR 2007

When the June 2006 Monetary Policy Statement was published, there were signs of improved short term inflation outlook, mainly as a result of the decline in food prices following the onset of the long rains in the second quarter of 2006. However, from July 2006 onwards both overall and underlying inflation started to increase.

The increase in inflation in the food index has taken place when the impact of the drought in late 2005 appeared to have dissipated, while domestic fuel prices are yet to adjust to declining international oil prices. Nonetheless, second round effects have so far been limited by recent appreciation in the exchange rate. Even then, the upward drift in underlying inflation remains a risk as monetary conditions have not turned out as expected. Of concern has been the growth in money supply, M3, which ranged between 15 percent and 18 percent in the second half of 2006.

The path for money supply and reserve money for 2007 has been revised to minimise possible risks to the medium term trend in inflation arising from high inflation expectations in the short term while at the same time accommodating higher prospects for growth. Economic growth is expected at 6.1 percent in 2006/07. In particular, the ongoing improvement in physical infrastructure by the Government coupled with increased investments in capital goods and machinery is expected to reinforce the growth momentum.

Monetary policy seeks to contain inflation to 5 percent, by limiting the growth in reserve money to 12 percent and thus the growth of broad money to 12 percent by June 2007 (Table 7 and Appendix 2). Given the 5 percent inflation objective, the set expansion in money supply is in line with the expected growth in real GDP of around 6 percent in 2007. A slowdown is expected in credit growth over the next year. Credit to Government by the banking system is expected to range from 7 percent to 14 percent and that of credit to the private sector from 10 percent to 13 percent.

Table 7: Growth Target for Monetary Aggregates for 2007

	Mar'07	Jun'07	Sep'07	Dec'07	Jun'08
Reserve money (Ksh million)	115.5	120.6	122.6	131.5	134.0
NFA of CBK (Ksh million)	162.7	172.2	184.2	186.1	196.8
Memo:					
Annual change in reserve money	12.4	12.0	9.1	10.0	11.1
Annual change in extended broad	12.5	12.0	10.0	11.0	11.1
Real GDP growth		6.1			6.0
Overall inflation		5.0			5.0

* Revised projection

Source: Central Bank of Kenya

While the Bank expects to be successful in managing inflationary pressures, there are potential short term risks to monetary policy outlook. More specifically, high and volatile energy prices as well as uncertain weather conditions remain a major concern for overall inflation. A key risk on the demand side for monetary policy implementation is higher demand for cash as the main channel for effecting payments.

As emphasized in previous statements, the Bank will continue to monitor developments so as to respond promptly to any emerging pressures. The Banks daily monetary operations will be geared towards aligning reserve money to target so as to deliver on the inflation objective.

Appendix 1: Macroeconomic Framework (2004-2008)

	2004	2005	2006	2007	2008
Real Sector					
Nominal GDP, Ksh billion	1,278.4	1,458.1	1,674.5	1,884.3	2,101.4
Real GDP growth	4.9	5.8	6.0	6.0	6.0
CPI inflation (end of period)	8.9	11.4	8.0	5.0	5.0
Savings/GDP	15.9	15.1	16.2	17.0	17.2
Investment/GDP	17.4	17.5	19.2	20.5	21.2
External Sector					
Current Account (% of GDP)	-0.3	-2.6	-3.2	-3.6	-4.2
Overall balance (US$ million)	129.5	-88.5	209.5	276.0	384.5
Official reserves (US$ million)	1,493.0	1,970.0	2,494.0	2,804.0	3,141.5
Months of import coverage (next year's imports)	2.7	3.0	3.5	3.5	3.6
Money and Credit					
(Annual % change)					
Net Credit to Government	-2.0	-7.7	12.8	9.7	2.6
Credit to the rest of the economy	25.7	10.3	16.3	9.5	13.7
Extended Broad Money (M3)	13.2	13.2	17.9	11.0	11.1
Reserve Money	15.5	5.1	16.9	10.0	10.4
Fiscal Sector (% of GDP)					
Total Revenue	21.3	20.7	20.6	21.4	21.6
Total expenditure and net lending	22.7	23.5	25.0	25.8	26.3
Overall balance, excl. grants	-1.4	-2.8	-4.5	-4.5	-4.7
Overall balance, incl. grants	-0.1	-1.6	-3.3	-3.2	-3.3
Net domestic borrowing	0.1	0.7	1.8	2.0	1.6
Financing gap	0.2	0.0	0.0	0.0	0.0
Total donor support (grants & loans)	2.2	2.0	2.2	3.2	4.3
Domestic Debt/GDP	20.1	18.3	18.2	18.7	18.4

Sources: Central Bank of Kenya and Ministry of Finance

Appendix 2: Depository Corporations Survey June 2005-June 2007

	Jun-05	Sep-05	Dec-05	Mar-06	Jun-06	Sep-06	Dec-06	Mar-07	Jun-07
	Act.	Act.	Act.	Act.	Act.	Act.	Act.	Proj.	Proj.
	(In Billions of Kenya Shillings)								
Central Bank of Kenya (CBK)									
Net foreign assets 1/	95.7	106.1	114.6	127.3	151.6	155.7	152.6	164.2	173.7
Net domestic assets	-1.2	-10.2	-8.3	-24.5	-44.0	-43.4	-28.4	-48.6	-53.2
Net domestic credit	1.7	3.3	0.5	-13.2	-37.0	-22.2	-9.8	-33.6	-37.5
Other items (net)	-2.9	-13.4	-8.9	-11.3	-7.0	-21.2	-18.6	-15.0	-15.7
Reserve money (RM)	94.4	95.9	106.2	102.8	107.7	112.3	124.2	115.5	120.6
Currency outside banks	59.3	59.3	66.3	64.2	67.2	68.7	76.4	71.7	75.4
Bank reserves	35.1	36.6	40.0	38.6	40.5	43.6	47.8	43.8	45.1
Banks									
Net foreign assets 1/	52.8	51.5	49.4	51.7	34.3	45.9	62.4	39.7	41.1
Reserves	35.1	36.6	40.0	38.6	40.5	43.6	47.8	43.8	45.1
Credit to CBK	5.3	5.1	5.3	20.8	23.4	13.9	4.9	25.5	29.5
Net domestic assets	374.2	391.5	404.6	412.4	445.8	466.4	475.4	480.2	493.7
Domestic credit	459.2	473.3	492.9	512.3	539.5	553.1	580.6	579.3	596.5
Other items (net)	-85.0	-81.8	-88.3	-99.9	-93.6	-86.7	-105.2	-99.1	-102.7
Total deposits	467.5	484.6	499.2	523.4	544.0	569.8	590.4	589.2	609.4
Monetary survey									
Net foreign assets 1/	148.4	157.6	164.0	179.0	186.0	201.6	214.9	203.8	214.8
Net domestic assets	378.3	386.4	401.5	408.6	425.3	436.9	451.9	457.1	470.0
Domestic credit	466.3	481.6	498.7	519.9	525.9	544.8	575.8	571.2	588.4
Government (net)	112.3	118.8	122.2	125.9	117.9	130.1	137.8	132.8	134.2
Rest of the economy	354.0	362.8	376.5	394.0	408.0	414.7	437.9	438.4	454.2
Other public sector	10.3	10.6	12.0	11.7	12.2	15.1	18.5	12.1	12.6
Private	343.7	352.2	364.5	382.2	395.8	399.6	419.5	426.3	441.6
Other items (net)	-88.0	-95.3	-97.1	-111.3	-100.6	-107.9	123.9	-114.2	-118.4
M3	526.8	543.9	565.5	587.6	611.2	638.5	666.8	660.9	684.9
Memorandum items:									
	(In Percent of Annual Change)								
M3	11.3	11.8	10.2	12.5	16.0	17.4	17.9	12.5	12.0
Reserve Money	4.7	6.7	5.1	9.8	14.0	17.1	16.9	12.4	12.0
Currency outside banks	6.6	5.7	5.7	10.7	13.3	15.8	15.3	11.7	12.2
Domestic credit	7.8	7.1	5.3	9.0	12.8	13.1	15.5	9.9	11.9
Government (net)	-19.3	-13.8	-7.7	-1.0	5.0	9.5	12.8	5.5	13.8
Rest of the economy	20.6	16.4	10.3	12.6	15.2	14.3	16.3	11.3	11.3

Source: Central Bank of Kenya

APPENDIX 3: CHRONOLOGY OF EVENTS OF PARTICULAR RELEVANCE TO MONETARY POLICY AND INFLATION (2006)

2006

January 2006	The Central Bank of Kenya releases its seventeeth Monetary Policy Statement (December 2005), setting out the monetary policy for the remainder of the financial year 2005/06 (January-June).
May 2006	An IMF mission visits the country to follow up on the discussions reached during the June 2005 Mission, to enable completion of discussion on the Second Review of the IMF-supported PRGF program.
June 2006	The Central Bank Rate (CBR), the rate the CBK charges on its overnight lending facility to commercial banks, is launched at 9.75 percent.
July 2006	The Central Bank of Kenya releases its eighteenth Monetary Policy Statement (June 2006), setting out the monetary program for 2006/07.
August 2006	The CBR is revised upwards from 9.75 percent to 10 percent.
October 2006	The CBR is reviewed and left unchanged at 10 percent.
November 2006	IMF mission visits the country for the article 4 consultation and discussions on the Second Review of the IMF-supported PRGF program.
December 2006	The CBR is reviewed and left unchanged at 10 percent.

GLOSSARY OF KEY TERMS

Overall Inflation

This is inflation measured by the movement of indices of all consumer price items of goods and services sampled by the Central Bureau of Statistics.

Underlying Inflation

This is inflation measured by movement of indices of all consumer price items of goods and services sampled by Central Bureau of Statistics other than food, energy, transport and communications. These items are excluded because they are susceptible to transient effects that are in most cases beyond the control of the CBK. Thus, the underlying measure is used by the Central Bank to gauge the influence of monetary policy on inflation.

Reserve Money

These are CBK 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 nonbank financial institutions held with the CBK.

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
	M1 + time and savings deposits + certificates of deposits + deposits
M2	Liabilites of Non-Bank Financial Institutions (NBFIs)
M3	M2 + residents' foreign currency deposits

Central Bank Rate

The rate of interest the Central Bank lends to commercial banks. It is determined and announced by the Central Bank every eight weeks, based on the average of the interbank and Repo rates plus a margin.

Open Market Operations (OMO)

The Central Bank's act of buying or selling treasury bills in the secondary market in order to achieve a desired level of currency in circulation and bank reserves. OMO is done in the context of an auction where commercial banks bid through the Reuters screen.

Repurchase Agreement (REPO)

This is an instrument used in OMO. 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 to the CBK at the end of the period.

Reserve Money Program

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

Cash Reserve Requirement

This is the legally required balances of commercial bank and nonbank financial institutions held with the CBK. The Central Bank is empowered by the Act to demand that a certain proportion of commercial banks' deposits to be held as reserves at the Central Bank. The ratio currently stands at 6 percent.