
Monetary Policy Statement June 2002

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OBJECTIVES OF THE CENTRAL BANK OF KENYA

Principal Objects of the Bank

The principal objects of the Bank as laid down in the Central Bank of Kenya (Amendment) Act, 1996 shall be to:

- (i) formulate and implement monetary policy directed to achieving and maintaining stability in the general level of prices; and
- (ii) foster the liquidity, solvency and proper functioning of a stable market-based financial system.

Secondary Objects of the Bank

Without prejudice to the generality of the above two principal objects, the Bank's secondary objectives shall be to:

- (i) formulate and implement foreign exchange policy;
- (ii) hold and manage its foreign exchange reserves;
- (iii) license and supervise authorised dealers in the money market;
- (iv) promote the smooth operation of payments, clearing and settlement system;
- (v) act as a banker and adviser to, and as fiscal agent of the Government; and
- (vi) issue currency notes and coins.

LEGAL BASIS FOR THE PUBLICATION OF THE MONETARY POLICY STATEMENT

This Statement is made pursuant to Section 4(b) of the Central Bank of Kenya (Amendment) Act, 1996, which states that:

- (i) The Bank shall at intervals of not more than six months, submit to the Minister a monetary policy statement for the next twelve months which shall:
 - (a) specify the policies and the means by which the Bank intends to achieve the policy targets;
 - (b) state the reasons for adopting such policies and means;
 - (c) contain a review and assessment of the progress of the implementation by the Bank of monetary policy during the period to which the preceding policy statement relates.
- (ii) The Minister shall 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.
- (iii) The Bank shall:
 - (a) cause every monetary policy statement submitted under subsection (1) and its monthly balance sheet to be published in the Gazette; and
 - (b) disseminate key financial data and information on monetary policy to the public.
- (iv) In subsection (ii), the expression ‘appropriate committee’ means the committee of the National Assembly appointed to investigate and inquire into matters relating to monetary policy.

1. IMPLEMENTATION OF MONETARY POLICY FOR THE TWELVE MONTHS TO DECEMBER 2002

1.1 Key Elements of the Policy

Inflation control remains the key focus of monetary policy

Monetary policy for the twelve months to December 2002 was designed to contain inflation under 5%, while sustaining the economic recovery that commenced in 2001. At the time of formulating the monetary policy for 2002, real gross domestic product (GDP) growth for 2001 had been estimated at 0.8% and was projected to accelerate to 1.4% in 2002.

A combination of a number of positive developments are expected to contribute to the envisaged increase in the pace of economic recovery in 2002. **First**, the favourable weather conditions for most part of 2001 has resulted in adequate rains being experienced in most parts of the country. This has in turn led to substantial improvement in agricultural production while the normalization of electric power supply has supported economic activity in manufacturing and services sector. **Second**, the stability in the interest rates and their downward trend since July 2001, continues to provide a boost to investment. **Third**, the expected resumption of relations with the IMF early in the fiscal year 2002/03 revived hopes for the restoration of external budgetary support from Kenya's principal development partners. **Fourth**, the shilling exchange rate has remained relatively stable, while the economic fundamentals point to continued stability in the period ahead.

The monetary policy for 2002 further incorporated a build-up of US\$ 70m in the Bank's unencumbered gross foreign exchange reserves to US\$ 1,008m. Taking into account the expected real GDP growth, as well as the inflation and foreign exchange targets, money supply (M3X)¹ was programmed to increase 4.9% in the year ending June 2002 before picking up to an annual rate of 6.1% by December 2002 (Table 1). Reserve money², which forms the basis of money creation, was projected to grow 4.7% by June and 7.1% by December 2002.

¹ Broad money supply, M3X, is the intermediate target of Central Bank monetary policy. M3X is defined to include currency held by the non-bank public and Kenya shilling and foreign currency denominated deposits of the non-bank private sector.

² Reserve money comprises deposits of banking institutions held with the Central Bank, plus currency in circulation.

TABLE 1: MONETARY PROGRAMME FOR JUN 2001 - DEC 2002 (Ksh m)

	Jun-01 (Act)	Sep-01 (Act)	Dec-01 (Proj)	Mar-02 (Proj)	Jun-02 (Proj)	Dec-02 (Proj)
1. Monetary Survey						
Money supply (M3X)	352160	367882	376927	374565	369589	400020
Net Foreign Assets	89185	92962	90155	92778	93512	97184
Net Domestic Assets	262976	274431	286771	281787	276077	302836
2. Central Bank Balance Sheet						
Reserve money	71617	72503	76627	75253	74974	82287
Net Foreign Assets	66881	70065	72912	75534	76268	79930
Net Domestic Assets	4736	2438	3715	-281	-1295	2357

Source: Central Bank of Kenya

1.2 Progress in Implementation of Monetary Policy, January - June 2002

*Reserve
money slightly
ahead of
target*

The Bank continued to closely monitor and use deviations in reserve money from the target to guide its daily monetary operations. Save for January 2002, reserve money exceeded the set targets during the period under review by a monthly average of 1.7% (Table 2). The excess reserve money largely reflected the substantial increase in the net foreign assets (NFA) of the Bank coupled with a substantial drawdown of government deposits at the Bank beyond the indicative programme levels. The excess liquidity was partly offset by the Bank's mop-up operations through its Repo transactions with commercial banks. The stock of Repo Treasury bills, consequently, rose from Ksh 19.6bn in December 2001 to Ksh 27.5bn in June 2002, thereby containing the net domestic assets (NDA) of the Bank within the set target.

TABLE 2: PERFORMANCE OF RESERVE MONEY, DEC 2001 - JUN 2002 (Ksh m)

	2001	2002					
	Dec	Jan	Feb	Mar	Apr	May	Jun
1. Liabilities							
Reserve Money							
Actual	78082	76349	75911	76278	76076	76883	77285
Target	76627	76400	75800	75253	75025	75500	76000
Deviation	1455	-51	111	1025	1051	1771	1285
2. Assets							
Net Foreign Assets							
Actual	75146	74800	75765	76971	77842	77474	77628
Target	72912	73078	73127	75534	75504	75965	76268
Deviation	2234	1722	2638	1437	2338	1531	1360
Net Domestic Assets							
Actual	3937	1548	146	-693	-1766	-591	-343
Target	3715	3322	2673	-281	-479	-466	-268
Deviation	222	-1774	-2527	-412	-1287	-125	-75

Source: Central Bank of Kenya

Growth in virtually all monetary aggregates remained subdued

It is worth noting that although reserve money has been above target in the period under review, money supply remained well below the target growth rates for virtually all the months (Table 3). Furthermore, the money multiplier of both M3 and M3X remained fairly stable at 4.3 and 4.9, respectively. Analysis of the factors affecting money supply during this period show that the contraction in bank credit granted to the private and other public sectors was a key factor and that monetary policy was not as such overly restrictive.

TABLE 3: EVOLUTION OF SELECTED MONETARY AGGREGATES (ANNUAL PERCENTAGE CHANGES)

	RM		M3		M3X		M3XT	
	Act.	Targ.	Act.	Targ.	Act.	Targ.	Act.	Targ.
Dec '01	1.8	2.4	2.5	5.7	2.3	5.3	6.1	10.3
Jan '02	3.4	2.8	2.0	7.3	0.0	5.4	4.3	9.1
Feb '02	4.4	2.7	4.4	8.6	3.1	7.0	7.3	10.4
Mar '02	8.2	2.2	3.9	6.9	2.1	5.2	5.7	8.4
Apr '02	2.5	2.8	4.2	5.3	2.0	3.4	6.3	7.4
May '02	8.0	5.7	6.1	5.9	4.8	4.6	7.5	6.8
Jun '02	10.9	6.1	8.5	6.4	6.7	4.9	8.4	6.3

Source: Central Bank of Kenya

Over the period under review, credit extended to the private sector by the banking institutions fell steadily by an annual rate of 3.4%. The contraction in bank credit to the private sector reflected the persistently low demand for credit due to the slow pace of economic recovery occasioned by the persistently low investor confidence. The uncertainty arising from the Central Bank of Kenya (Amendment) Act, 2000 also adversely affected the performance of banking institutions lending operations. Meanwhile, money supply expanded more rapidly in June 2002 than previously envisaged.

Inflation remained under control

It is encouraging, however, to note that in the year to June 2002 inflationary pressures have remained under control (Table 4).

TABLE 4: INFLATION (%)

	2001						2002					
	Jan	Mar	Apr	Jun	Sep	Dec	Jan	Feb	Mar	Apr	May	Jun
Overall												
12-month ³	12.0	9.5	9.0	4.6	3.1	1.8	0.4	1.1	1.9	0.9	1.7	2.8
Annual average ⁴	10.2	10.4	10.8	10.1	8.1	5.8	4.8	4.1	3.5	2.8	2.4	2.3
Underlying												
12-month	8.3	7.5	7.0	6.7	6.5	5.1	3.0	2.8	3.4	3.4	3.5	2.9
Annual average	6.8	7.1	7.2	7.1	6.8	6.7	6.2	5.8	5.5	5.2	5.0	4.6

Source: Central Bank of Kenya

³The rate of change in the CPI over the same month in the previous year, sometimes referred to as the "annual" rate of change.

⁴Percentage change in the average CPI for the last 12 months over the average CPI for the previous 12-month period.

Overall inflation remained within the lower end of the single digit range during the period under review. Based on the new CPI⁵, the 12-month overall inflation declined steadily in the year to June 2002, falling from 4.6% in June 2001 to 2.8% in June 2002. The 12-month underlying inflation, defined as overall inflation excluding food prices, also maintained a declining trend. Although the underlying inflation was slightly higher than the overall, what is encouraging is that it also remained within the single digit range, falling from 6.7% in June 2001 to 5.1% by December 2001, and further to 2.9% in June 2002.

The easing of inflationary pressures during the year to June 2002 reflected the sustained prudent monetary policy, relatively stable shilling exchange rate and lower prices of food commodities following increased production occasioned by the favourable weather conditions.

2. MONETARY POLICY FOR THE TWELVE MONTHS TO JUNE 2003

2.1 Current Economic Situation

2.1.1 Inflation

As already noted, inflation remained under control through the year to June 2002 due to the continued implementation of prudent monetary policy coupled with lower food prices and a stable shilling exchange rate.

2.1.2 Domestic Output

Information released by the Central Bureau of Statistics show that real GDP expanded by 1.2% in 2001. Although lower than originally expected, performance in 2001 was

⁵ The Central Bureau of Statistics launched the new consumer price index (CPI) in April 2002. The main features of the new CPI include the use of a more recent Urban Household Budget Survey (UHBS) conducted in 1993/94 than the one based on the 1982 UHBS; a new base period of October 1997; and a wider geographical coverage comprising Nairobi and twelve other urban towns with populations in excess of 10,000. The old CPI was based on data collected only in Nairobi. More importantly, rent and other housing costs are obtained through regular monthly surveys and not imputed as was the case in the past. The new index further incorporates new basket weights and a revised menu of commodities in line with changes in income and consumption patterns that have taken place. In addition, it provides for the replacement of goods that cease to be traded in the market.

Agriculture and tourism the driving force behind the recovery

encouraging when compared with the 0.2% decline recorded in 2000. The recovery was mainly attributed to the favourable weather conditions that led to improved agricultural production. Furthermore, electric power supply normalized and facilitated modest improvement in manufacturing and services sector. Preliminary production data for the key economic sectors for the first five months of 2002 indicate that the modest economic recovery has persisted. Real GDP is estimated to have increased by an annualised rate of 0.6% during this period compared with 0.3% growth in the corresponding period of 2001. The recovery was mainly in the following sectors:

- Agriculture, which grew by an estimated 0.5% in the five months to May 2002 compared to a decline of 1.0% in similar period in 2001. Increases were recorded in the production of sugarcane, horticultural products, maize and beans. However, production of the major export crops, coffee and tea, declined.
- The communications sub-sector, which provided a growth impetus following liberalization of the cellphone sub-sector.
- Trade, restaurants and hotels sector that grew by 0.7%, up from 0.1% rate of growth in the previous year.
- The manufacturing sector, which recovered and grew by 0.4% compared with a decline of 1.4% in the previous year.

2.1.3 Outlook

The economy is projected to grow by 1.8% in 2002. The higher growth is envisaged to emanate particularly from the agricultural sector. The upturn in agriculture is in turn expected to support recovery in the other sectors of the economy. Growth is also expected to be enhanced by various tax measures introduced in the fiscal year 2002/03 budget, particularly the reduction in duty and VAT rates on raw materials, machinery and other intermediate inputs. The pace

Recovery pace remains modest

of recovery is, however, expected to remain modest in the medium term due to the persistent weak investor confidence, and the high cost of domestic production partly arising from infrastructural weaknesses.

Govt. domestic borrowing expected to decline

On the fiscal front, the Government is expected to reduce its borrowing from the domestic sources in fiscal year 2002/03 to about Ksh 33bn from Ksh 39.8bn in fiscal year 2001/02.

Inflation projected to remain low

Inflation is forecast to remain subdued in the year to June 2003. This expectation is premised on the fact that the Central Bank will continue to implement prudent monetary policy in line with real sector developments.

2.2 Monetary Policy for July 2002-June 2003⁶

2.2.1 Objectives

Monetary policy to continue focusing on inflation control

The Central Bank will continue to implement monetary policy aimed at containing inflation at below 5%, while supporting the projected economic growth of 1.8% in 2002 and 2.8% in 2003. In addition, the Central Bank aims to retain its unencumbered gross foreign exchange reserves at about US\$ 1.0bn in June 2003, more or less the same level as in June 2002.

TABLE 5: MONETARY PROGRAMME FOR JUN 2002-JUN 2003/1 (Ksh m)

	2002				2003	
	Jun Act	Jul (Proj)	Sep (Proj)	Dec (Proj)	Mar (Proj)	Jun (Proj)
1. Monetary Survey						
Money supply (M3X)/2	378,276 (6.7)	369,831 (4.4)	368,245 (3.2)	376,890 (2.3)	390,354 (6.6)	395,356 (6.2)
Net Foreign Assets/2	97,040 (6.4)	96,430 (6.2)	96,718 (4.4)	97,926 (4.2)	100,200 (5.0)	103,199 (8.3)
Net Domestic Assets/2	281,236 (6.7)	273,401 (3.7)	271,527 (2.8)	278,964 (1.7)	290,153 (7.2)	292,157 (5.5)
2. Central Bank Balance Sheet						
Reserve money/2	76,881 (10.9)	78,575 (10.4)	77,769 (11.4)	81,489 (3.0)	83,974 (10.8)	84,053 (10.1)
Net Foreign Assets/2	77,832 (18.1)	78,797 (15.4)	79,156 (8.2)	80,470 (6.4)	82,873 (6.7)	86,000 (10.8)
Net Domestic Assets/2	-951 (-127.9)	-222 (-106.7)	-1,387 (-58.8)	1,019 (-71.0)	1,101 (-158.4)	-1,947 (-50.6)

1/ Actuals end-months, and expected monthly averages for CBK balance sheet projections

2/ Figures in parentheses represent annual percentage changes.

Source: Central Bank of Kenya

⁶ The programme assumes no resumption of IMF financial support.

Broad money supply set to expand by 6.2% in Fy 2002/03

Current monetary policy framework and instruments to remain

2.2.2 Monetary Programme

In line with the projected economic growth rate and the inflation and foreign exchange reserves targets, broad money supply (M3X) is expected to increase by 6.2% in the year to June 2003. This monetary expansion will be supported by growth in both NFA and NDA of the banking system of 8.3% and 5.5%, respectively (Table 5). The increase in the NDA reflects mainly an expansion of 8.0% in bank credit to the private sector.

2.2.3 Monetary Policy Instruments

The Bank will continue to manage monetary policy using the monetary targeting framework with reserve money as its operating target. In addition, the Bank will continue to use the instruments that are currently available to influence the reserves of the banking institutions. In this regard, the Central Bank will during the year continue to:

- Buy and sell Treasury bills or any other stipulated government paper, from time to time, in the open market through repurchase agreements with a view to influencing the level of bank reserves.
- Require commercial banks to hold a specified minimum cash deposit at the Central Bank, currently equivalent to 10% of their deposit liabilities.
- Provide, as a lender of last resort, liquidity to commercial banks but in a manner that will not compromise the monetary policy stance adopted for the year.

Price stability and structural reforms key to the recovery process

3. CONCLUSION

It is notable that sustained implementation of a prudent monetary policy by the Central Bank, coupled in tandem with a relatively sound fiscal policy, has enabled the country to enjoy a stable macroeconomic situation for some years now. However, despite this, the economy has continued to perform below expectations, posing a major challenge as to how to translate the macroeconomic stability into tangible developmental outcomes. This demonstrates clearly that, while a stable macroeconomic environment is necessary, the solution to the challenges facing Kenya's economy lies in addressing the structural constraints that continue to hinder the recovery process. Therefore, unless other stakeholders play their part effectively and efficiently, the economic recovery will remain weak. On its part, the Central Bank will continue to ensure that inflation remains low and stable, and that the banking system remains sound.