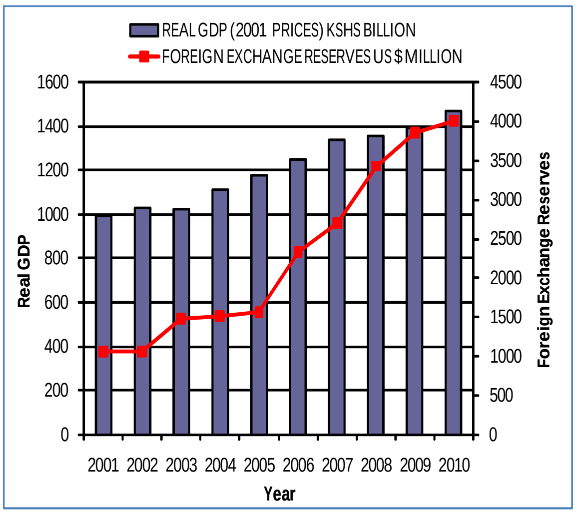

CENTRAL BANK OF KENYA

Monetary Policy Statement

Issued under the Central Bank of Kenya Act, Cap 491

JUNE 2011

Letter of Transmittal

Honourable Minister,

I have the pleasure of forwarding to you the 28th Monetary Policy Statement (MPS) of Central Bank of Kenya (CBK), pursuant to Section 4B of the Central Bank of Kenya Act. It covers the current economic developments and provides details of the monetary policy stance, for July 2011 to June 2012. The Statement also reviews the implementation of monetary policy from January to June 2011.

Prof. Njuguna Ndung'u, CBS
Governor

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The Principal Objectives of the Central Bank of Kenya

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;
3. Subject to (1) and (2) above, to support the economic policy of the Government, including its objectives for growth, and employment. Without prejudice to the generality of the above, the Bank shall:

- Formulate and implement foreign exchange policy;
- Hold and manage its foreign exchange reserves;
- License and supervise authorised foreign exchange dealers;
- Formulate and implement such policies as best to promote the establishment, regulation and supervision of efficient and effective payment, clearing and settlement systems;
- Act as banker and adviser to, and as fiscal agent of, the Government; and
- Issue currency notes and coins.

It follows therefore, that the CBK formulates and conducts monetary policy with the aim of keeping overall inflation at the Government target of 5 percent. Achieving and maintaining a low and stable inflation rate together with adequate liquidity in the market facilitates higher levels of domestic savings and private investment and therefore leads to improved economic growth, higher real incomes and increased employment opportunities.

The Bank's monetary policy is therefore designed to support the Government's desired growth in the production of goods and services and employment creation through achieving and maintaining a low and stable inflation.

Instruments of Monetary Policy

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

- **Open Market Operations (OMO):** Refers to actions by the CBK through purchases and sales of eligible securities to regulate the money supply and credit conditions. OMO can also be used to stabilise short term interest rates. When the Central Bank buys securities on the open market, it increases the reserves of commercial banks, making it possible for them to expand their loans and investments. To achieve the desired level of money supply, OMO is conducted using:
    - **Repurchase Agreements (Repos)** consist of the sale of eligible securities by the CBK to reduce commercial banks deposits held with it. **Reverse repos** are purchases of securities from commercial banks by the CBK during cases of tight liquidity in the market. Currently, repos have a fixed tenor of 7 days.
    - **Horizontal Repos** are transacted between commercial banks using government securities as collateral, and have negotiated tenors. Commercial banks short of deposits at the CBK borrow from banks with excess deposits on the security of an appropriate asset, normally Government securities. Horizontal repos help banks to overcome the problem of credit limits, thus promoting efficient management of interbank liquidity.
    - **Term Auction Deposits:** In extreme market conditions, the CBK acquires deposits from commercial banks at a price but with no exchange of security guarantee. The deposits are transferred to the CBK for a 7 day period after which they revert back to the respective commercial bank on maturity of the transfer agreement.

- **Central Bank Rate (CBR):** It is reviewed and announced by the Monetary Policy Committee (MPC) every two months and its movements, both in direction and magnitude, signals the monetary policy stance.

  These movements are reflected in changes in short-term interest rates. A reduction of the CBR signals an easing of monetary policy and a desire for market interest rates to move downwards. Lower interest rates encourage economic activities and thus growth. When interest rates decline, the quantity of credit demanded should increase.

The CBR operates through the market for repo securities. Efficiency of the repo and interbank markets is crucial for the transmission of monetary policy decisions. By fixing a single tenor (currently 7 days) for bills sold in the repo market, the MPC aims to sharpen the signalling process.

- **Standing Facilities:** The CBK, as lender of last resort, provides secured loans to commercial banks on an overnight basis at a penal rate over the CBR. The rules governing the operation of the CBK Discount Window are reviewed from time to time by the MPC.

- **The Cash Reserves Ratio (CRR):** The CRR is the proportion of a commercial bank's deposit liability which must be deposited at CBK at no interest, in accordance with the law. These deposits are held in the Cash Reserve Ratio (CRR) Account and are currently 4.75 percent of total bank deposit liabilities. The CBK can use the CRR as a liquidity management tool. A reduction in the CRR releases liquidity thus enhancing the capacity of commercial banks to expand credit. An increase in the CRR tightens liquidity and could also dampen demand driven inflationary pressures.

- **Foreign Exchange Market Operations:** The CBK can also inject or withdraw liquidity in the banking system by engaging in foreign exchange transactions. A sale of foreign exchange to banks withdraws liquidity from the system while the purchase of foreign exchange injects liquidity into the system. Participation by the CBK in the foreign exchange market is usually motivated by the desire to prevent excessive volatility in the rate at which the Kenya shilling exchanges against other foreign currencies, or to acquire foreign exchange to service official debt and build its foreign exchange reserves. The CBK does not participate in the foreign exchange market to defend a particular value of the Kenya shilling.

- **Licensing and Supervision of Financial Institutions:** The Bank uses the licensing and supervision tools to ensure the health and efficiency of the banking system.

- **Communications:** The increasing use of communications media ensures a wider dissemination of monetary policy decisions and background data thereby increasing the efficiency of information transmission. For example, the CBK website is an important source of up-to-date data on all aspects of the financial market including interest rates, exchange rates and results of auctions of government securities.

Legal Status of the Monetary Policy Statement

1. Section 4B (1) of the CBK Act 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 which shall:
    - i) Specify policies and the means by which the Bank intends to achieve its policy targets;
    - ii) State reasons for adopting such monetary policies and means; and
    - iii) Contain a review and assessment of the progress made in the implementation of monetary policy by the Bank during the period to which the preceding Monetary Policy Statement relates.
2. The Minister shall - by the law under subsection (1) 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.

3a. The Bank shall by law publish in the Kenya Gazette:
    - i) Its Monetary Policy Statement; and
    - ii) Its Monthly Balance Sheet.

3b. The Bank is further required to disseminate key financial data and information on monetary policy to the public.

4. 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

This Monetary Policy Statement (MPS) provides the policy stance for the 12-months between July 2011 and June 2012. The outcome of the monetary policy stance adopted in the first half of 2011 is also analysed.

Despite inflation and exchange rate shocks in the first half of 2011, economic recovery was sustained with a growth of 4.9 percent in the first quarter of 2011. This shows that economic performance is still within the range of the *Vision 2030* growth trajectory with the recovery of key sectors of the economy. However, underlying inflationary pressures pose a risk to this strong economic recovery. Exchange rate volatility attributed to Euro Zone and USA debt crises and balance of payments pressure have also given rise to risks although these have been moderated by benefits to exporters. Despite these challenges, private sector confidence in the economy has been sustained.

The main objective of the CBK is to formulate and implement monetary policy aimed at ensuring that the month-on-month overall inflation remains within the 2 percent band around the 5 percent target. The escalation of food and fuel prices witnessed in the first half of 2011 resulted in overall inflation surpassing and remaining above the Government target band between March and June 2011. However, the tight monetary policy stance adopted by the CBK has stopped the ratification of inflationary expectations. Consequently, a deceleration in inflation is expected in the next few months driven by the impact of the tight monetary policy stance on domestic prices, Government actions to lower or eliminate taxes on key food and fuel items, stabilisation of world oil prices, and expected improvement in food supply following the recent rains which were near normal in the food basket areas.

The exchange rate is also expected to stabilise by the end of the 2011 on account of increased foreign exchange inflows through tourism earnings in the third quarter of 2011 coupled with rising diaspora remittances and increase in short term capital inflows attributed to the rise in interest rates. Despite the pressure from servicing of Government external debt obligations, the CBK did not consider it appropriate to build-up foreign exchange reserves through purchases from the domestic foreign exchange market between May and June 2011 given that the turbulences generated internationally would have exacerbated the depreciation of the exchange rates.

The framework for monetary policy formulation and implementation is based on targets for net domestic assets (NDA) and net international reserves (NIR) as set in the Extended Credit Facility (ECF) programme which was mentioned in the previous MPS. In addition, the CBK is implementing a gradual tightening of monetary policy in order to balance policies for fighting inflation while at the same time implementing measures to facilitate credit expansion to support growth. Credit supply to productive sectors of the economy including agriculture has remained strong. The Monetary Policy Committee (MPC) therefore expects to continue with its stance of facilitating availability of adequate and affordable credit while at the same time ensuring that the credit expansion does not result in demand driven inflation.

The regular interactions between the MPC with financial and real sector institutions have enhanced the understanding of monetary policy transmission. The Bank will continue with these forums in the next 12-months by reaching out to more stakeholders to enhance moral suasion.

1. Introduction

This Monetary Policy Statement (MPS) presents the policy guidelines and broad targets for the Central Bank of Kenya (CBK) over the period July 2011 to June 2012. It also highlights the policy outcomes in the period January to June 2011.

Economic recovery in Kenya remains strong with a growth of 5.6 percent realised in 2010 and 4.9 percent in the first quarter of 2011. This indicates that economic performance is well on track towards achieving the *Vision 2030* trajectory with the recovery of key sectors of the economy. However, depressed rains slowed down agricultural output in the first quarter of 2011 to 2.7 percent from 5.7 percent over the same quarter in 2010. Inflationary pressures attributed to increases in food and fuel prices pose a risk to this strong economic recovery. Exchange rate volatility attributed to Euro Zone and USA debt crises and balance of payments pressure have also provided risks although these have been balanced by benefits to exporters. Despite these challenges, private sector confidence in the economy has been sustained.

The CBK is implementing a gradual tightening of monetary policy in order to balance policies for fighting inflation while at the same time implementing measures to facilitate credit expansion to support growth. Credit supply to productive sectors of the economy including agriculture has remained strong. The Monetary Policy Committee (MPC) expects to continue with its stance of facilitating availability of adequate and affordable credit while at the same time ensuring that the credit expansion does not result in demand driven inflation.

The framework for monetary policy formulation and implementation is based on targets for net domestic assets (NDA) and net international reserves (NIR) as set in the Extended Credit Facility (ECF) programme. In addition, the Bank also continues to monitor targets for key monetary aggregates such as broad money supply, M3. However, the Bank will continue to implement measures aimed at improving the effectiveness of monetary policy formulation and implementation. The Bank's participation in the foreign exchange market will continue to be guided by the need to accumulate and maintain foreign exchange reserves at or above the statutory level of four months of imports cover, purchase foreign exchange to meet the Government's external obligations, and ensure stability of the value of the Kenya shilling when there is excess volatility.

In order to improve the transparency of monetary policy formulation and implementation, the Bank continued with its regular interactions with stakeholders in the financial and real sectors, and timely release of relevant data so as to enhance the transmission of monetary policy signals.

2. Actions and Outcomes of Policy Proposals in the 27th Monetary Policy Statement

The overall aim of the Monetary Policy Statement for December 2010 (27th MPS) was to set targets that would ensure low and stable inflation, encourage growth and ensure long term sustainability of public debt. It also aimed at enhancing financial access within the economy as well as ensuring a continuation of the medium term research agenda. The following are therefore the outcomes of the policy proposals in the 27th Monetary Policy Statement:

a. Inflation

The primary objective of monetary policy formulation and implementation is price stability. Following the escalation of food and fuel prices between March and June 2011, overall inflation was above the target of 5 percent by more than 2 percentage points. Depressed rains in the first quarter of 2011 and political crises in the Middle East and North Africa (MENA) during the period resulted in significant rises in food and crude oil prices, respectively. Consequently, CBK provided a letter to the Minister for Finance following the release of the March 2011 inflation data and an additional letter in June 2011 as the inflation rate remained outside the target band for three consecutive months.

Despite the effects of supply side factors on overall inflation, non-food and non-fuel inflation category, which is where monetary policy has direct effect, remained below 7 percent in the period. High inflation levels as well as deflation tend to discourage investment and long term economic growth. Consequently, the Bank is required to strive to achieve the inflation target of 5 percent at all times while accounting for any deviations exceeding 2 percentage points in either direction.

b. Monetary Programme

The monetary aggregate targeting framework continued to guide the MPC in achieving its price target and supporting the Government's economic growth objectives. The 27th MPS projected reserve money (RM), net foreign assets (NFA) of the CBK, and broad money supply (M3) to increase from Ksh. 215.7 billion, Ksh. 258.9 billion and Ksh. 1,299.9 billion, respectively, in December 2010 to Ksh. 221.3 billion, Ksh. 264.7 billion, and Ksh. 1,411.7 billion in June 2011 (Table 1). These targets are consistent with those for NDA and NIR in the ECF programme. The programmed growth in money supply during the period was considered adequate to support economic growth through expansion of credit to private sector with no effect on demand driven inflation. Broad money supply, M3, remained generally within the set target as the monetary aggregate increased from Ksh. 1,271.6 billion in December 2010 to Ksh. 1,380.3 billion in June 2011. The growth in credit to private sector during the period was generally above target, rising from a stock of Ksh. 888.4 billion to Ksh. 1,043.0 billion in June 2011.

Table 1: Actual and Targeted Growth in Key Monetary Aggregates

	Dec-10	Jan-11	Feb-11	Mar-11	Apr-11	May-11	Jun-11
Actual Broad Money,M3 (Ksh Billion)	1,271.6	1,285.5	1,306.4	1,324.7	1,334.9	1,351.4	1,380.3
Target Broad Money,M3 (Ksh Billion)	1,299.9	1,318.6	1,337.1	1,355.6	1,374.5	1,393.0	1,411.7
Actual Reserve Money,RM (Ksh Billion)	222.6	208.3	209.8	209.4	213.1	209.4	219.3
Target Reserve Money,RM (Ksh Billion)	215.7	210.6	211.1	211.8	210.3	213.3	221.3
Actual NFA of CBK (Ksh Billion)	252.4	251.8	258.4	258.7	265.0	263.8	282.6
Target NFA of CBK (Ksh Billion)	258.9	260.3	261.1	261.9	262.8	263.6	264.7
Actual Credit to private sector (Ksh Billion)	888.4	905.1	929.6	954.5	979.4	1,003.8	1,043.0
Target Credit to private sector (Ksh Billion)	883.9	904.2	924.3	934.6	947.0	973.2	1,002.5
Memorandum Items							
12-month growth in actual RM (Percent)	22.4	16.1	19.7	18.0	20.1	7.9	4.3
12-month growth in actual M3 (Percent)	21.6	20.4	20.5	19.6	18.9	16.5	15.1
12-month growth in actual credit to private sector (Percent)	20.3	21.0	23.3	25.7	27.3	27.4	30.5

Source: Central Bank of Kenya

c. Developments in the Velocity of Money and the Money Multiplier

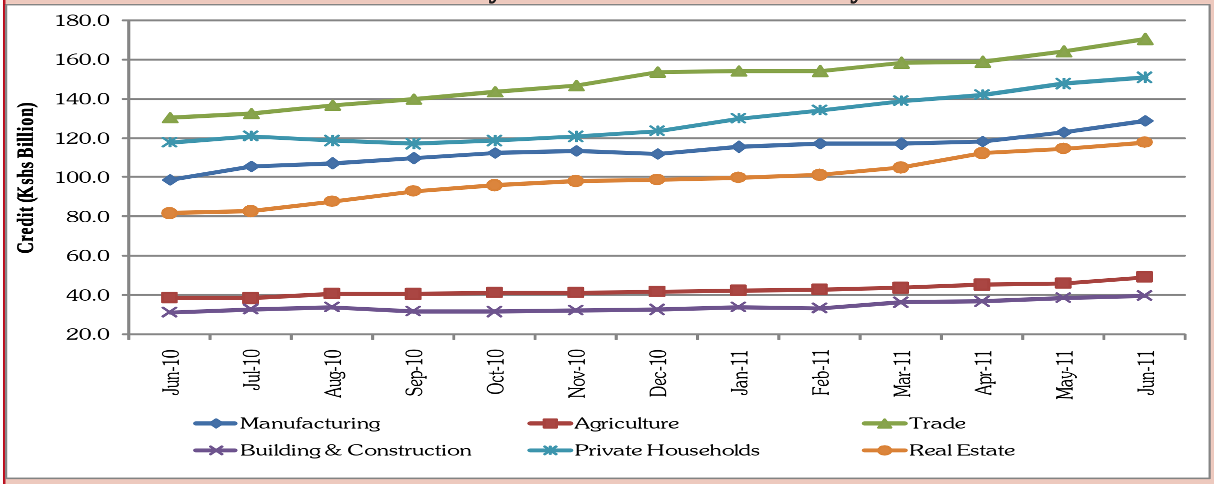
Stability of the velocity of money and money multiplier is necessary for the effectiveness of the traditional monetary programming framework. The velocity of money continued on a downward trend between December 2010 and June 2011, declining slightly from 2.01 to 1.97 in the period. This was driven mainly by financial innovations and structural changes in the economy. However, the money multiplier remained volatile during the period, rising from 5.71 to 6.29 between December 2010 and June 2011.

d. Credit to Private Sector

The Monetary Policy Committee (MPC) adopted a tight monetary policy stance in the first half of 2011 to rein in inflation and inflationary expectations, as well as stabilise the exchange rate. However, a gradual tightening stance was adopted to ensure that interest rates do not rise rapidly to slow down credit demand and economic activity. In this regard, the MPC raised the CBR by 25 basis points to 6.00 percent in March 2011 and to 6.25 percent in May 2011.

Private sector credit grew by Ksh. 66.0 billion and Ksh. 88.5 billion in the first and second quarters of 2011, respectively, driven by increased economic activity. Credit to the key sectors of the economy – agriculture, trade, real estate and manufacturing sectors – continued on an upward trend between December 2010 and June 2011 (Chart 1a).

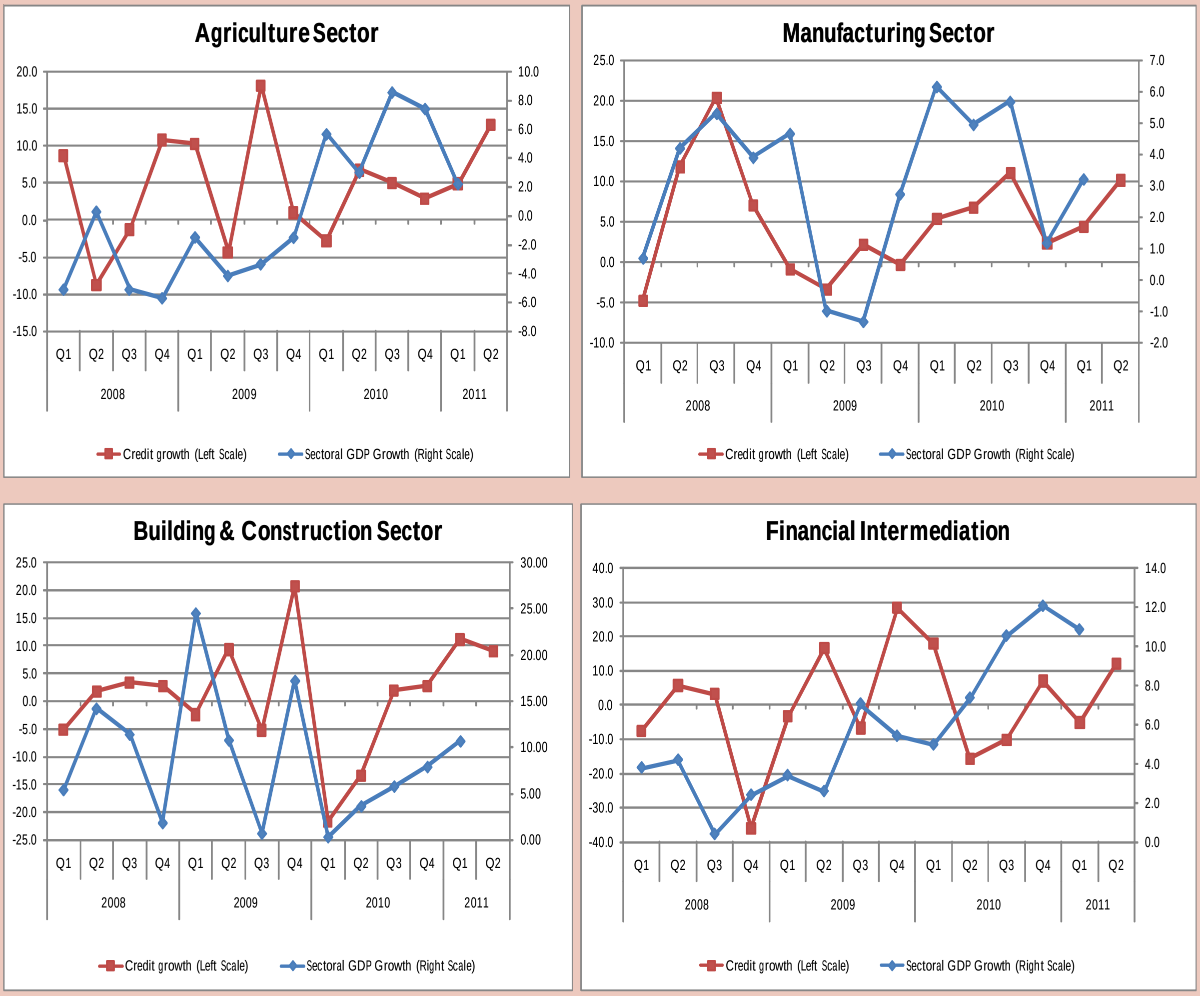
Chart 1a: Sectoral Credit to Key Sectors in the Economy



Source: Central Bank of Kenya

A graphical analysis of credit expansion and growth for the respective sector shows a positive link as established in previous analyses (Chart 1b).

Chart 1b: Growth in Real GDP and Sectoral Credit to Key Sectors

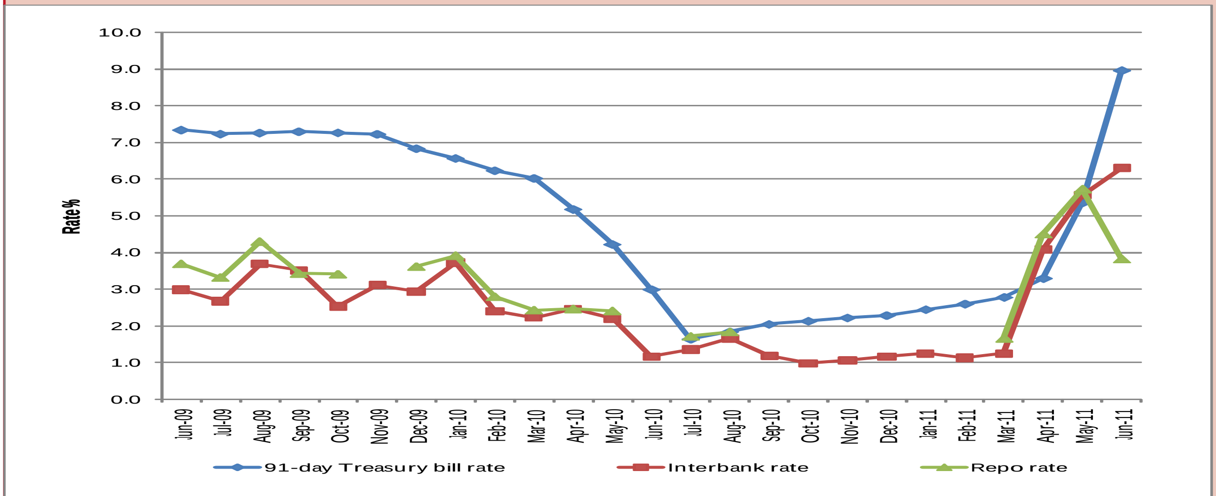


Source: Central Bank of Kenya & KNBS

e. Interest Rates and Liquidity

The evolution of short term interest rates between December 2010 and June 2011 was successfully coordinated by movements in the CBR. Specifically, as depicted by Chart 2, the average interbank rate averaged 1.21 percent between January and March 2011, but increased to average 5.33 percent between April and June 2011 following the tight monetary policy stance adopted by the MPC over the period. Mis-information around the availability of the CBK Discount Window resulted in a rise in the interbank rate above the Discount Window rate on 28th June 2011. The interbank rate increased from 6.25 percent on 27th June, 2011 to 7.08 percent on 28th June 2011 and maintained this upward trend to peak at 10.67 percent on 15th July, 2011. In view of this instability in the interbank market, the Bank considered that its first objective in the interest rate regime was to restore the statutory purpose of the CBR and remove arbitrage opportunities. Consequently, the CBK announced new measures to guide the operations of the CBK Discount Window but also provided liquidity through reverse repos to stabilise the interbank market.

Chart 2: Trends in Short Term Interest Rates



Source: Central Bank of Kenya

A similar trend was depicted by the interest rates on horizontal repos during the period. The volume of horizontal repos transacted to redistribute liquidity between banks increased slightly from Ksh. 7.0 billion in December 2010 to Ksh. 7.7 billion in June 2011. Despite the increase, the volume transacted through the instrument during the period averaged 3 percent of the total transactions of the interbank market. Commercial banks therefore still have room to improve on the uptake of the instrument in redistributing liquidity. The highest tenor transacted in the instrument remained at 91-days during the period. The number of banks participating in the market also increased with enhanced trading across all categories of banks. The Bank will continue to monitor the developments as the instrument was introduced to increase efficient short term liquidity management within the banking system. Government deposits at the CBK were more predictable – hence exerting less pressure on liquidity in the interbank market.

f. Impact of Fiscal Development on Liquidity

The Government domestic borrowing programme did not exert pressure on interest rates during the fiscal year 2010/11. Specifically, the net domestic borrowing decreased from Ksh 130.5 billion in the fiscal year 2009/10 to Ksh 90.4 billion in the fiscal year 2010/11. However, the Bank will continue to work closely with the Ministry of Finance to ensure that the borrowing programme does not cause inflationary monetary expansion or crowd out the private sector through an increase in interest rates.

g. Banking Sector Developments

The CBK continued to implement measures aimed at lowering transaction costs in the financial system as well as enhancing financial access. Expanding financial services in Kenya is evidenced by an increase in commercial banks' branch network from 740 at the end of 2007 to 1,102 in June 2011 (Table 2). All regions in the country have benefited from bank branch network expansion over the last four years. Similarly, the number of commercial banks ATMs more than doubled during the period to stand at 2,183 in June 2011.

The growth of the banking sector improved significantly between 2007 and June 2011. Gross loans of banks doubled to Ksh 1.08 trillion while total deposits increased to Ksh 1.41 trillion during the period. However, the potential for loan accounts to grow further remains as these stood at 2.1 million in June 2011 compared with 14.2 million deposit accounts. Some of the products and initiatives that have been used extensively by the sector include mobile-banking services and agency banking services.

The market has therefore continued to embrace financial deepening through enhanced financial innovations. The impact of financial innovations on the current monetary policy framework has been analysed and the results incorporated in the MPC decision process. Access to financial services as indicated by branch expansion, number of ATMs, deposit accounts and amounts mobilised through mobile phone banking services continues to expand. Accelerated mobile phone banking has resulted in a decline in the proportion of currency outside banks as a percentage of the total money stock.

Table 2: Banking Sector Developments

	2007	2008	2009	2010	May-11	Jun-11
1. Number of Branches	740	887	996	1,030	1,067	1,102
1.1. Rural branches	288	350	418	436	447	456
1.2. Urban branches	452	537	578	594	620	646
2. Number of ATMs	1,078	1,510	1,827	2,052	2,171	2,183
3. Gross loans (Ksh Million)	540,555	685,921	771,766	925,641	1,046,902	1,083,139
4. Gross deposits (Ksh Million)	758,480	936,003	1,065,405	1,276,089	1,386,841	1,412,841
5. Number of loan accounts	1,216,053	1,384,359	1,672,964	1,793,664	2,096,123	2,106,623
6. Number of Deposit Accounts	4,725,755	6,428,509	8,657,490	12,803,561	13,773,164	14,213,264
6.1. Micro-Deposit Accounts	4,123,432	5,795,734	8,001,585	12,026,566	12,957,715	13,365,472
6.2. Other Deposit Accounts	602,323	632,775	655,905	776,995	815,449	847,792

Source: Central Bank of Kenya

h. MPC Market Surveys and Stakeholder Forums

The MPC continued to conduct its bi-monthly MPC Market Surveys to understand market perceptions on key indicators of the economy including inflation, interest rates, exchange rates and growth. The results of these Surveys were shared with the market which continued to appreciate the importance of these surveys in the MPC decision-making process. The MPC also continued with regular meetings with chief executive officers (CEOs) of commercial banks to enhance the understanding of its decision-making process as well as obtain direct feedback from the CEOs.

The MPC held regular press conferences during which the background to the MPC decisions was explained. Since the start of MPC press conferences, a notable level of understanding by the market of economic issues has been observed. The regular interaction with the media was also aimed at shaping market expectations and reducing uncertainty thereby influencing actions of economic agents particularly with respect to anchoring medium and long-term demand driven inflation expectations. This has helped to enhance the Bank's credibility and transparency in the perspective of the public.

The Bank continued to participate in the quarterly economic round table discussion forums organised by the World Bank. The meetings provide a forum for key stakeholders in the country's economic management as well as development partners to discuss and share information on economic developments as well as the outlook.

i. Research Agenda

The Bank hosted the first seminar in January 2011 to review research papers that the MPC 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 following research papers were presented during the technical seminar: (a) demand for money function for Kenya; (b)monetary policy transmission mechanism in Kenya; (c) a framework for restructuring the CBR; (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 usage of financial services from different financial access strands in Kenya; and, (i) a dynamic model for inflation.

During the period, the Bank made significant progress towards the completion and implementation of its macroeconomic model. An external review of the model was conducted by internationally renowned researchers. In addition, preliminary output from the model was shared with the MPC during its Analytical and Technical Meetings. A book *Kenya: Policies for Prosperity* was launched by His Excellency the President in February 2011. The book is an outcome of intensive collaborative research between local and internationally accredited researchers under the coordination of Central Bank of Kenya and Oxford University. The book is expected to influence policy formulation and implementation and complement other Government development plans like the *Vision 2030* while also developing CBK's research capacity.

3. Financial and Economic Trends and Events (January to June 2011)

a. International Economic Environment

The June 2011 Update of the April 2011 IMF's *World Economic Outlook* shows that global growth accelerated from -0.6 percent in 2009 to 5.0 percent in 2010 (Table 3). This reflected improvements in growth of advanced economies and emerging and developing economies. The global economic recovery during the period was attributed to stimulus measures, improved

Table 3: Performance of the Global Economy

	Real GDP Growth (%)		Inflation (%)	
	2009	2010	2009	2010
World	-0.6	5.0	2.7	3.9
Advanced Economies	-3.4	3.0	0.1	1.6
United States	-2.6	2.8	-0.3	1.6
Japan	-6.3	3.9	-1.4	-0.7
Euro Area	-4.1	1.7	0.3	1.6
United Kingdom	-4.9	1.3	2.1	3.3
Other Advanced economies	-1.2	5.7	1.5	2.5
Emerging and developing economies	2.7	7.3	5.2	6.2
Sub-Sahara Africa	2.8	5.0	10.5	7.5
East African Community (Excl.Kenya)	5.4	5.5	11.8	7.2
Developing Asia	7.2	9.5	3.1	6.0
China	9.2	10.3	-0.7	3.3
India	6.8	10.4	10.9	13.2
Middle East and North Africa	1.8	3.8	6.5	6.9

Source: IMF World Economic Outlook (April 2011 and June 2011 Update) global financial conditions, and increased private consumption. Growth in the East African Community (EAC) countries excluding Kenya improved from 5.4 percent to 5.5 percent during the period. Consequently, the performance of Kenya's exports, comprising mainly of agricultural goods and tourism improved considerably. As expected, global growth attained an annualised rate of 4.3 percent in the first quarter of 2011. The performance of the global economy during the period was underpinned by the devastating impact of the earthquake and tsunami on the Japanese economy which disrupted industrial production, consumer sentiments and spending. Growth also slowed down in the USA during the first quarter of 2011 due to higher commodity prices, bad weather, and supply chain disruptions from the Japanese earthquake.

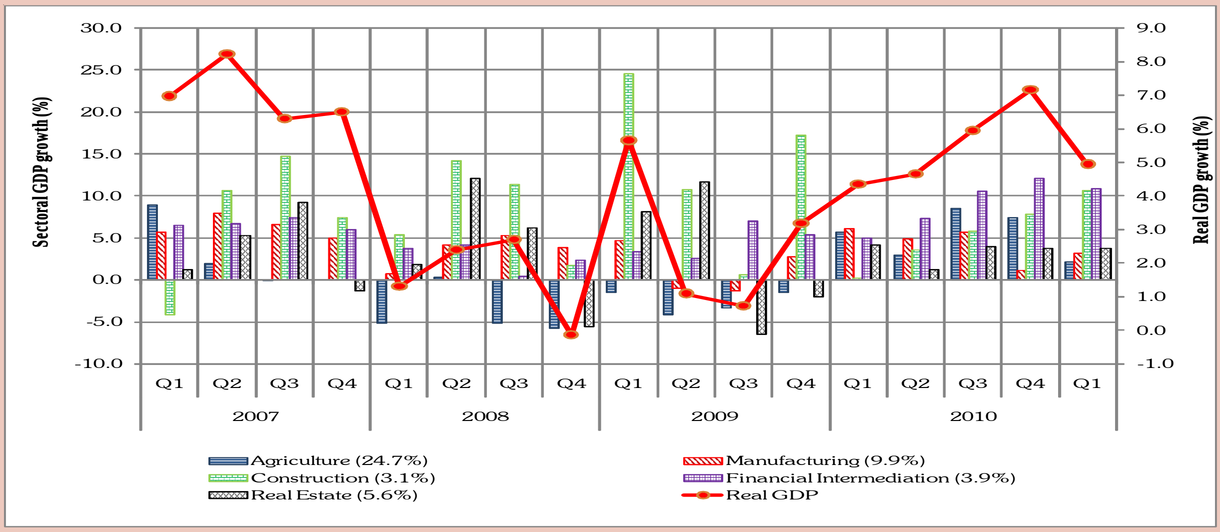
Global inflation increased from 2.7 percent in 2009 to 3.9 percent in 2010 due to higher commodity prices in response to strong global demand and supply shocks for selected commodities. Similarly, inflation for emerging and developing economies increased from 5.2 percent to 6.2 percent during the period. However, inflation declined during the period for Sub-Sahara Africa countries due to improved food supply and lower hydro energy costs. Following larger than expected increases in commodity prices, global inflation worsened from 3.5 percent in the last quarter of 2010 to 4.0 percent in the first quarter of 2011. Among emerging and developing economies, inflation pressures reflected a higher proportion of food and fuel in consumption as well as increased demand pressures.

b. Domestic Economic Environment

i. Economic Growth

Data from the KNBS shows that the economy expanded by 4.9 percent in the first quarter of 2011 up from 4.3 percent in a similar period in 2010, but lower than the 7.2 percent in the fourth quarter of 2010 (Chart 3).

Chart 3: Quarterly Sectoral GDP Growth Rates



Source: Kenya National Bureau of Statistics

Note: Long term average contribution of the respective sectors to growth are given in brackets

The performance of the economy in the first quarter of 2011 was attributed to strong performance of transport and communications (6.5 percent), financial intermediation (10.9 percent), and construction (10.7 percent) sectors.

The improved performance of the economy in the first quarter of 2011 was against the backdrop of depressed rains and high energy prices which slowed down growth. Agricultural output was particularly affected by the depressed rains. Shortage of fertilisers and seeds for key food crops aggravated the situation.

ii. Confidence in the Economy

Despite the shocks on the economy in the first half of 2011, confidence in the Kenyan economy was sustained. The confidence was partly attributed to the upgrading of the country's credit rating to 'B+ with stable outlook' by Fitch Ratings and implementation of the New Constitution with expectations for new and more effective institutional and governance structures. Other indicators showing sustained confidence in the economy are depicted in Table 4. The cumulative diaspora remittances increased from USD 642.0 million in the 12-months to December 2010 to USD 748.5 million in the 12-months to June 2011. Similarly, the 12-month cumulative tourist arrivals remained well over 1,000,000 in the first half of 2011.

Other important signals to investors included the overall decline in credit risk during the period. The MPC Market Surveys conducted in the period also pointed to sustained private sector confidence in the economy despite various shocks witnessed.

Table 4: Indicators of Declining Risk and Confidence in the Economy

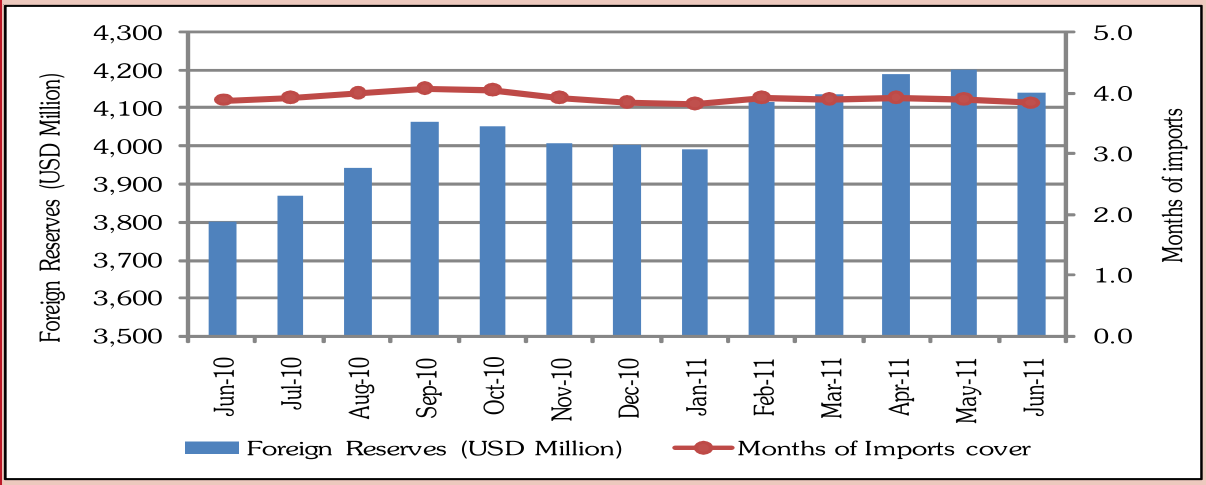
	Dec-10	Jan-11	Feb-11	Mar-11	Apr-11	May-11	Jun-11
12-Month Emigrant Remittances (USD Million)	642.0	661.2	675.6	694.8	712.2	729.2	748.5
NSE Index (Jan 1966 = 100)	4,432.5	4,464.9	4,240.2	3,887.1	4,029.2	4,078.1	3,968.1
12-Month Number of Tourist Arrivals	1,095,304	1,117,269	1,126,026	1,137,119	1,155,821	1,088,004	1,008,532
Net NPLs/Total Loans ratio (%)	1.56	1.51	1.44	1.43	1.36	1.28	1.31

Source: Kenya National Bureau of Statistics, NSE and CBK

iii. Foreign Exchange Market

Overall, the Bank continued to maintain a steady level of official foreign exchange reserves between December 2010 and June 2011 (Chart 4). Official foreign exchange reserves of the CBK increased slightly from USD 4,002 million in December 2010 to USD 4,142 million in June 2011. However, foreign exchange reserves averaged 3.89 months of import cover during the period, slightly lower than the statutory 4 months of imports. The build-up in official foreign exchange reserves in the first half of 2011 was through purchases of Euros and US Dollars. In addition, the Bank received SDR 65.1 million (equivalent of US$ 101.7 million) in January 2011 following successful negotiation of the Extended Credit Facility (ECF) programme. Despite the pressure from servicing of Government external debt obligations, the CBK did not consider it appropriate to build-up foreign exchange reserves through purchases from the domestic foreign exchange market between May and June 2011 given that there was turbulences generated internationally which affected the exchange rates.

Chart 4: Foreign Exchange Reserves

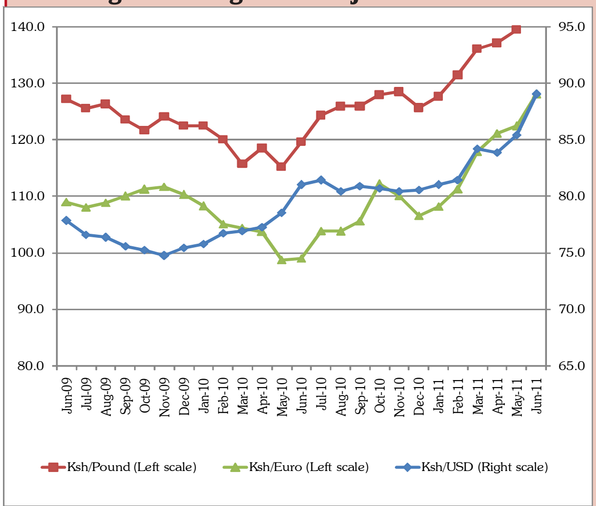


Source: Central Bank of Kenya

iv. Exchange Rates

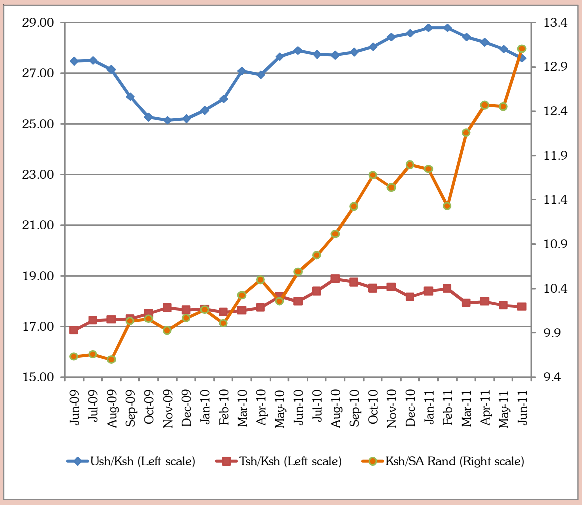
During the first half of 2011, international events continued to shift the values of currencies of Kenya's trading partners, affecting the value of the Kenya Shilling (Chart 5a and 5b). Despite policy actions taken to stabilise the exchange rate against the major currencies during the period, these currencies tended to respond in a coordinated manner before returning to reflect trends in the international financial markets. Generally, the Kenya Shilling weakened against the Sterling Pound, Euro and US dollar.

Chart 5a: Trends in the Kenya Shilling Exchange Rate against Major Currencies



Source: Central Bank of Kenya

Chart 5b: Trends in the Kenya Shilling Exchange Rate against Regional



Source: Central Bank of Kenya

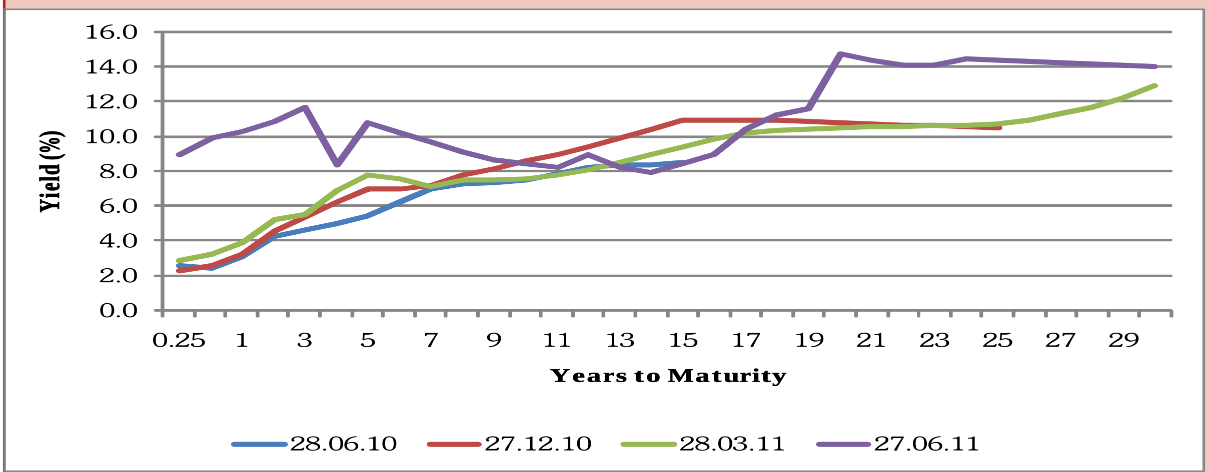
The debt crisis in Greece, political crisis in the Middle East and North Africa, balance of payments pressures emanating from increased imports of capital and intermediate goods, and speculative forces in the foreign exchange market between April and June 2011 resulted in weakening of the Shilling against major currencies. The exchange rate of the Kenya Shilling against the US dollar was also affected by reduced foreign exchange inflows from tea exports to Egypt and through the Suez Canal. However, increased foreign exchange inflows through immigrant remittances and tourism earnings supported the Shilling during the period.

On the regional front, the Kenya shilling strengthened against the Uganda and Tanzania shillings but weakened substantially against the South African Rand (Chart 5b). The Rand continued to strengthen globally due to higher commodity prices.

v. Yield Curve and Commercial Banks' Interest Rates

Following tight liquidity conditions in the market, overall yields on Government securities increased both at the short and long ends of the yield curve between December 2010 and June 2011 (Chart 6). However, yields on medium tenor (9 to 17 years) securities declined during the period due to increased liquidity of the instruments. The shape of the yield curve in June 2011 also reflected inflationary pressures in the country as well as uncertainty in the international financial markets due to the Greek and US debt crises.

Chart 6: Shift in the Kenya Government Bonds Yield Curve: June 2010 to June 2011

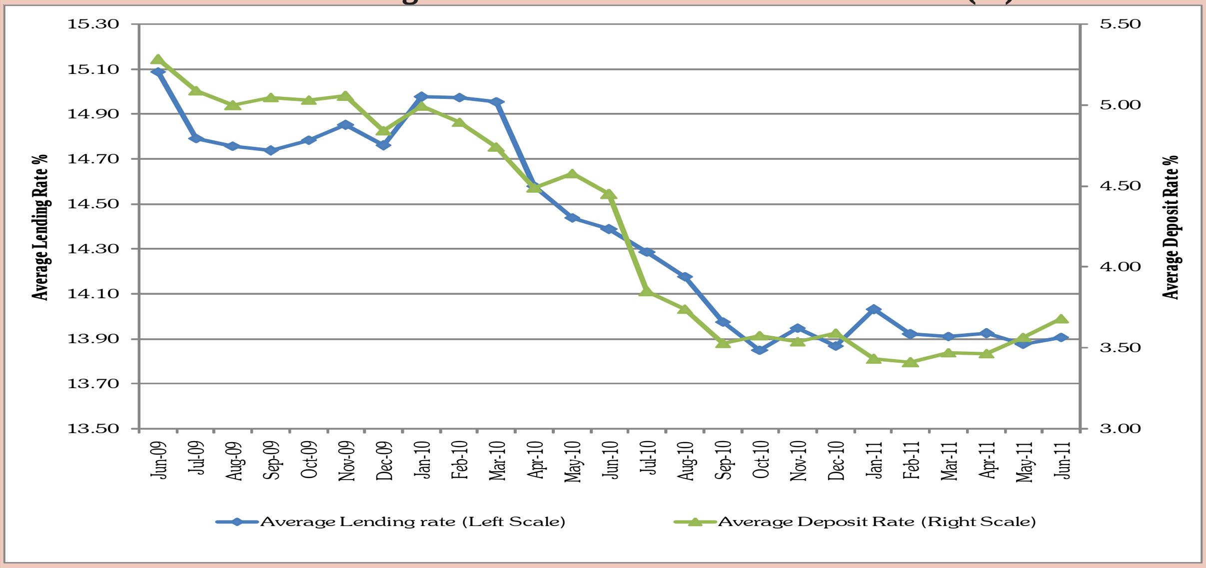


Source: Central Bank of Kenya

Following increased competition in the credit market, average commercial banks' lending rates remained virtually unchanged; averaging 13.93 percent between January and June 2011(Chart 7). The average commercial banks deposit rate increased slightly from 3.59 percent in December 2010 to 3.68 percent in June 2011 due to tight liquidity in the market. However, average commercial banks lending rates increased slightly from 13.87 percent to 13.91 percent within the same period. The interest rate spread declined slightly from 10.28 percent to 10.23 percent during the period.

Despite the operationalisation of Credit Reference Bureaus and progress by the Government in improving infrastructure in the country, commercial banks have cited various structural factors which have slowed down the transmission of monetary policy signals to the lending rates. The CBK is working with stakeholders to address the concerns and challenges around the collateral perfection process.

Chart 7: Trends in Average Commercial Bank Interest Rates (%)



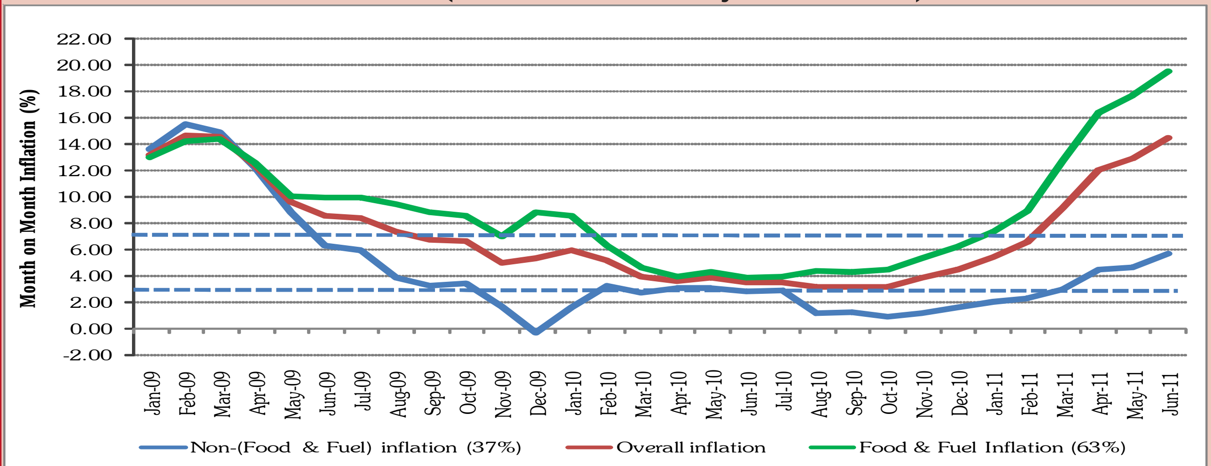
Source: Central Bank of Kenya

vi. Inflation

Overall inflation increased sharply from 4.51 percent in December 2010 to 14.49 percent in June 2011 (Chart 8). The prices of food and fuel, both of which are dependent on the level of supply, accounted for the largest proportion of the rise in inflation during the period. Food inflation increased from 7.84 percent to 22.51 percent while food and fuel inflation escalated from 6.19 percent to 19.54 percent during the period. The rapid increase in food inflation largely reflected a rise in the price of dry maize and maize flour. On the other hand, despite zero rating of taxes on certain fuels, including kerosene, the prices were adjusted upwards several times. Crude oil prices increased from USD 91.85 per barrel in December 2010 to a peak of USD 120.70 per barrel in April 2011 before falling to USD 112.15 per barrel in June 2011.

Despite the rise in overall inflation during the period, non-food-non-fuel inflation remained within the 5 percent target range. Specifically, non-food-non-fuel inflation increased from 1.56 percent in December 2010 to 5.65 percent in June 2011.

Chart 8: Trends in Inflation (CPI base February 2009=100)



Note: Numbers in brackets represent respective weights in the CPI basket.

Source: Kenya National Bureau of Statistics

vii. Fiscal and Public Debt Developments

Central Government budgetary operations during the fiscal year 2010/11 resulted in a deficit-to-GDP ratio of 4.55 percent on commitment basis (including grants) compared with 5.94 percent in the fiscal year 2009/10. The budget deficit in the fiscal year 2010/11 was within the programmed target of 6.81 percent of GDP on commitment basis. Gross public and publicly guaranteed debt increased slightly from 49.9 percent of GDP in December 2010 to 54.0 percent of GDP in June 2011. The weakening of the Shilling against major currencies resulted in a substantial rise in the debt stock during the period. Despite the rise in the debt stock, the public debt ratios were consistent with the thresholds set in the current Medium Term Expenditure Framework.

4. Outlook for the Monetary Policy Enviroment (July 2011 - June 2012)

a. Global Economy

The IMF projects the global economy to slow down temporarily in 2011 and grow by 4.3 percent before recovering to grow by 4.5 percent in 2012 (Table 5). The projected slowdown in growth in 2011 is attributed to subdued private consumption due to oil price spikes in previous periods which have reduced household real incomes. In addition, the effect of global supply disruptions from the Japanese earthquake and tsunami is still being felt especially in the United States. Recovery of growth in 2012 is expected to be driven by accommodative macroeconomic conditions, increased demand for consumer durables and investment, and the strong potential for growth in emerging and developing countries.

Emerging and developing countries are projected to grow by 6.6 percent in 2011 and 6.4 percent in 2012. Sub-Saharan Africa and East African Countries (excluding Kenya) are forecast to grow at 5.5 percent and 5.9 percent, respectively, in 2011 which is expected to boost trade in the region and Kenya's export sector.

Pressure on global inflation is expected to ease with a projection of 3.5 percent in 2012 from 4.6 percent in 2011 with most countries raising their policy rates to rein in inflationary pressures. Upward pressure on prices is expected to persist in 2011 due to pressure on food and energy prices.

Table 5: Outlook for Real GDP Growth and Inflation in 2011 and 2012 (%)

	Real GDP Growth (%)		Inflation (%)	
	2011	2012	2011	2012
World	4.3	4.5	4.6	3.5
Advanced Economies	2.2	2.6	2.2	1.7
United States	2.5	2.7	2.2	1.6
Japan	-0.7	2.9	0.2	0.2
Euro Area	2.0	1.7	2.3	1.7
United Kingdom	1.5	2.3	4.2	2.0
Other Advanced economies	4.0	3.8	3.3	2.4
Emerging and developing economies	6.6	6.4	6.9	5.3
Sub-Sahara Africa	5.5	5.9	7.8	7.3
East African Community (Excl.Kenya)	5.9	6.2	6.0	9.2
Developing Asia	8.4	8.4	6.0	4.2
China	9.6	9.5	5.0	2.5
India	8.2	7.8	7.5	6.9
Middle East and North Africa	4.2	4.4	10.0	7.3

Source: IMF World Economic Outlook (April 2011 and June 2011 Update)

b. Domestic Economy

i. Economic Growth

Despite the shocks on inflation and exchange rates in the first half of 2011, private sector confidence in the economy was sustained with a growth of over 5 percent expected in 2011. In addition, credit supply to productive sectors of the economy including agriculture is expected to remain strong. The CBK has been balancing policies for fighting inflation while at the same time implementing measures to facilitate credit expansion to support growth. The results of the MPC Market Perception Surveys on the performance of the economy conducted between January and June 2011 show sustained confidence. Respondents indicated that there would be increased levels of foreign direct investment with the implementation of the New Constitution. Enhanced investment in infrastructure, imports of capital equipment and emigrant remittances all continue to support a positive growth forecast. The projected growth in the global economy in 2011 is expected to increase the demand for Kenya's exports as well as the number of tourist arrivals in the country.

ii. Exchange rates

The exchange rate of the Kenya shilling against major currencies is expected to stabilise by the end of the third quarter on account of increased foreign exchange inflows through tourism earnings in the third quarter of 2011 coupled with rising diaspora remittances, increase in short term interest rates which are expected to attract short term capital inflows, and efforts by major European countries to address the debt crisis in the Euro Area. The resolution of the US debt ceiling still poses some questions of exchange rate re-alignment with declining credibility of the US Dollar. The recent depreciation in the exchange rate could ease balance of payments pressures from rising imports. However, high oil prices, strengthening of the US dollar in the global foreign exchange market, and Greek and USA debt crisis pose a risk on the strength of the Kenya Shilling.

iii. Interest rates

Pressure on short term interest rates is expected to persist in the next few months as the CBK implements a tight monetary policy to rein in inflation and stabilise the exchange rate. However, commercial banks lending rates are expected to remain stable in the second half of 2011 on account of lower credit risk with the operationalisation of credit reference bureaus, and economic growth which is expected to increase demand and competition for credit.

iv. Inflation

The tight monetary policy stance has stopped the ratification of inflationary expectations. A turn around in inflation is expected in the next few months driven by the impact of the tight monetary policy stance on domestic prices. Government actions to lower or eliminate taxes on key food and fuel items are expected to lower food and fuel prices; food imports are also expected to enhance domestic supply, both supported by stabilisation of world oil prices, and expected improvement in food supply following the recent rains which were near normal in the food basket areas. Inflation and inflationary expectations have not abated in the first half of 2011 due to supply side challenges on food and fuel. These factors may continue to be a challenge in the second half of 2011.

v. Fiscal Policy

The impact of the domestic borrowing programme for fiscal year 2011/12 has been analysed and is not a major threat to interest rates and debt sustainability. The enhanced expenditure on infrastructural projects in the country will continue to create employment and demand – hence supporting economic growth. Specifically, the development budget for the fiscal year 2011/12 is a significant proportion of the total budget.

5. Future Direction of Monetary Policy (July 2011 – June 2012)

During the 12-months to June 2012, monetary policy will focus on: setting targets which are consistent with objective of maintaining a low and stable inflation, encouraging growth and ensuring the long term sustainability of public debt; enhancing access to banking services; and, continuation with the medium term research agenda.

a. Monetary Programme and Foreign Exchange Reserves

The monetary targets for the fiscal year 2011/12 are based on the assumptions in the June 2011/11 Budget Strategy Paper which are presented in Annexes 1 and 2, and the ECF programme targets. The monetary targets for the fiscal year 2011/12 are presented in Table 6. In particular, broad money supply, M3, is set to grow by 15.9 percent by September 2011, 17.2 percent by December 2011, 16.7 percent by March 2012, and 16.0 percent by June 2012. Consequently, the NDA of the CBK is planned to increase from Ksh. -53.7 billion in September 2011, Ksh. -39.4 billion in December 2011 and to Ksh -56.2 billion in June 2012. This is expected to enable the Bank achieve the policy objective of maintaining overall inflation at the target of 5 percent and to anchor inflation expectations.

The monetary policy stance will ensure that short term interest rates remain stable. As a result, credit to the private sector is projected to grow by 28.7 percent in September 2011, 24.7 percent by December 2011, and by 15.1 percent in June 2012.

Table 6: Monetary Targets for the Fiscal Year 2011/12	Jul-11	Aug-11	Sep-11	Oct-11	Nov-11	Dec-11
Broad Money, M3 (Ksh Billion)	1,398.7	1,417.1	1,435.4	1,453.8	1,472.2	1,490.8
Reserve Money, RM (Ksh Billion)	222.8	222.0	224.9	233.0	229.2	247.5
NFA of CBK in Ksh Billion	272.0	275.7	278.3	281.1	283.8	286.9
NDA of CBK in Ksh Billion	-49.3	-53.7	-53.4	-48.0	-54.6	-39.4
12-month growth in RM (Percent)	11.5	10.5	7.2	7.4	2.3	11.2
12-month growth in M3 (Percent)	15.3	16.5	15.4	15.9	17.0	17.2
12-month growth in Credit to Private Sector (Percent)	30.3	29.2	28.7	25.7	24.5	24.7
12-month growth in Real GDP (Percent)						5.3
12-month overall Inflation (Percent)	5.0	5.0	5.0	5.0	5.0	5.0
	Jan-12	**Feb-12**	**Mar-12**	**Apr-12**	**May-12**	**Jun-12**
Broad Money, M3 (Ksh Billion)	1,509.1	1,527.3	1,545.5	1,564.1	1,582.3	1,600.7
Reserve Money, RM (Ksh Billion)	235.1	240.5	241.8	245.3	240.2	247.1
NFA of CBK in Ksh Billion	289.9	292.0	294.7	297.4	300.2	303.3
NDA of CBK in Ksh Billion	-54.8	-51.6	-52.9	-52.1	-60.0	-56.2
12-month growth in RM (Percent)	12.9	14.6	15.5	15.1	14.7	12.7
12-month growth in M3 (Percent)	17.4	16.9	16.7	17.2	17.1	16.0
12-month growth in Credit to Private Sector (Percent)	24.3	22.9	21.7	19.8	18.1	15.1
12-month growth in Real GDP (Percent)						5.7
12-month overall Inflation (Percent)	5.0	5.0	5.0	5.0	5.0	5.0

Source: Central Bank of Kenya

The Bank will continue to monitor developments with respect to the Monetary Targets and make any necessary reviews. The achievement of the targets set will however depend on stability in the international prices of oil, normal weather conditions, stability of the exchange rate, and commitment by the Government to operate within the domestic borrowing ceiling for fiscal year 2010/11. Monetary policy implementation will be based on monthly targets for NDA, reserve money and broad money supply M3 to be achieved through open market operations. The repos will be used to withdraw any excess liquidity in the banking system on a timely basis and where necessary reverse repos will be used to inject liquidity.

The strong seasonal demand for currency by the public has been built into the programme. In addition, the success of CBK's monetary policy measures to fight inflation will depend on the effectiveness of the institutions charged with the responsibility of managing the supply side of prices – more so adequate food supply.

b. Extending Access to Financial Services

The Bank will continue to support development of new products and innovations towards enhancing financial access as improvements in access to financial services have been shown to support economic growth. The Bank will recommend appropriate legislation aimed at ensuring that such innovations are regulated accordingly to enhance market confidence.

c. Measures to Enhance Market Efficiency

The Bank will continue to work with stakeholders in the banking and real sectors in order to enhance the monetary policy transmission mechanism. The Bank will hold the second Monetary Policy Public Forum in November 2011 and will also continue with similar initiatives aimed at engaging stakeholders and obtaining feedback on the impact of MPC decisions. Measures to enhance the uptake of Horizontal Repos among banks will also be implemented, while stakeholder forums with chief executive officers and Treasury Managers of banks will be held to obtain feedback and explain the background to MPC decisions. Furthermore, the MPC will continue to brief the market on its decisions through press conferences with the media.

d. Research Agenda

The Bank will finalise and post on the CBK website research papers prepared by its researchers and which were presented during the technical retreat held in January 2011. Work on the CBK model will also be finalised in the second half of 2011 with incorporation of comments from external reviewers. The Bank will also continue to work with the KNBS towards development of underlying inflation measures including tradable and non-tradable CPI measures.

ANNEX 1: MAIN MACROECONOMIC INDICATORS UNDERPINNING THE MEDIUM TERM FISCAL FRAMEWORK, 2009/10 – 2013/14

	2009/10	2010/11		2011/12		2012/13		2013/14	
	Actual	*Budget*	*BPS'11**	*BOPA'11*	*BPS'11**	*BOPA'11*	*BPS'11**	*BOPA'11*	*BSP'11**
	Annual percentage change, unless otherwise indicated								
National account and prices									
Real GDP	4.1	5.1	5.4	6.1	5.7	6.7	6.3	6.8	6.5
Real GDP per capita	2.2	2.2	2.5	3.2	2.8	3.7	3.4	3.9	3.6
GDP deflator	5.7	6.4	6.4	6.8	9.1	5.6	6.0	4.9	5.0
CPI Index (eop)	3.5	5.0	13.0	5.1	7.8	5.0	5.7	5.0	5.0
CPI Index (avg)	5.5	5.0	7.4	5.2	9.3	5.0	6.4	5.0	5.0
Money and credit (end of period)									
Net domestic assets	34.6	13.8	17.1	15.4	16.2	10.5	14.1	13.0	16.2
Net domestic credit to the Government	59.7	16.9	29.3	10.9	18.3	5.0	5.2	5.0	4.7
Credit to the rest of the economy	16.8	20.0	23.3	18.3	17.6	15.0	17.8	15.7	17.5
Broad Money, M3 (percent change)	26.2	14.0	17.0	17.7	16.5	14.9	17.4	14.9	17.7
Reserve money (percent change)	31.5	11.7	1.8	14.8	13.6	14.9	17.4	14.9	17.7
	In percentage of GDP, unless otherwise indicated								
Investment and saving									
Investment	19.5	21.1	22.3	25.1	23.4	26.5	24.8	26.6	25.3
Central Government	10.3	10.2	9.8	10.6	12.5	11.8	11.0	11.2	10.5
Other	9.3	10.9	12.6	14.5	10.9	14.6	13.8	15.4	14.7
Gross National Saving	12.1	15.5	13.8	18.6	15.5	20.6	17.6	21.4	19.0
Central Government	2.0	6.4	2.7	4.4	3.9	6.2	5.5	6.4	6.1
Other	10.1	9.1	11.1	14.2	11.6	14.4	12.1	15.0	12.9
Central government budget									
Total revenue	23.9	24.9	24.9	25.3	24.7	25.3	24.9	25.5	25.2
Total expenditure and net lending	32.2	33.1	32.0	31.8	33.5	31.3	31.0	30.7	30.2
of which : wages and salaries	7.1	6.9	7.3	7.1	7.0	7.1	6.9	7.1	6.9
Interest payments	2.6	2.7	2.6	2.7	2.6	2.6	2.8	2.6	2.3
Development expenditures	10.4	11.7	9.9	10.7	12.6	11.9	11.1	11.3	10.6
Overall balance (commitment basis) excl. grants	-8.4	-8.2	-7.2	-6.6	-8.8	-6.0	-6.1	-5.2	-5.0
Overall balance (commitment basis) incl. grants	-7.1	-6.8	-5.9	-5.3	-7.4	-4.7	-4.7	-3.9	-3.7
Primary budget balance	-4.5	-4.1	-3.3	-2.7	-4.8	-2.0	-1.9	-1.3	-1.4
Net external borrowing	0.8	3.0	1.4	1.9	3.6	3.2	3.3	2.4	2.5
External sector									
Exports value, goods and services	25.4	24.5	28.3	24.6	28.2	24.3	27.2	24.4	26.8
Imports value, goods and services	38.8	35.2	42.5	36.5	41.4	35.5	39.3	34.7	37.7
Current external balance, including official transfers	-7.4	-5.6	-8.5	-6.4	-7.9	-5.9	-7.2	-5.3	-6.3
Current external balance, excluding official transfers	-7.4	-5.5	-8.5	-6.4	-7.9	-5.8	-7.1	-5.2	-6.2
Gross international reserve coverage in months of next year imports (end of period)	3.2	3.2	3.1	3.8	3.2	4.2	3.6	4.4	3.8
Public debt									
Nominal central government debt (eop), gross	49.9	50.3	52.3	51.6	52.3	50.7	51.2	49.4	49.7
Nominal central government debt (eop), net	45.0	46.0	48.0	47.7	48.6	47.2	47.9	46.3	46.7
Domestic (gross)	26.9	27.1	28.4	28.8	28.4	27.1	26.6	25.6	24.9
Domestic (net)	22.0	22.9	24.1	24.9	24.7	23.6	23.2	22.5	22.0
External	23.0	23.2	23.9	22.8	23.9	23.6	24.6	23.7	24.7
Memorandum items:									
Nominal GDP (in Ksh billions)	2,458	2,767	2,761	3,075	3,184	3,463	3,589	3,879	4,011
Per capita income (Ksh)	62,787	67,344	68,572	74,249	76,889	81,352	84,294	88,639	91,674

Source: Ministry of Finance

BOPA = Budget Outlook Paper

BSP = Budget Strategy Paper

BPS = Budget Policy Statement

eop - End of period

avg - period average

* Updated

ANNEX 2: MONETARY SURVEY 2009/10 – 2013/14 (END OF PERIOD, Ksh BILLION)

	2009/10	2010/11	2011/12	2012/13	2013/14
	Act.	*Proj.*	*Proj.*	*Proj.*	*Proj.*
Central Bank of Kenya (CBK)					
Net Foreign Assets 1/	242.9	266.3	288.9	358.9	421.0
Net Domestic Assets	-32.6	-52.3	-45.7	-73.4	-85.1
Net credit extended	7.5	17.5	27.5	9.4	5.5
Net claims on Government	7.5	13.7	19.7	22.1	24.5
Claims on banks	0.0	3.8	7.8	-12.7	-19.0
Other assets, net	-41.9	-69.8	-73.2	-82.8	-90.6
Reserve money (RM)	210.3	214.0	243.2	285.5	335.9
Monetary Survey					
Net Foreign Assets (NFA) 1/	280.3	327.0	384.2	492.7	600.5
Central Bank (CBK)	242.9	266.3	288.9	358.9	421.0
Banks	37.4	60.7	95.3	133.9	179.5
Net Domestic Assets (NDA)	918.6	1,075.9	1,249.7	1,425.6	1,656.6
Domestic Credit	1,076.9	1,344.7	1,583.6	1,812.2	2,072.7
Claims on Government (net)	277.7	358.9	424.7	446.6	467.7
Central Bank	7.5	13.7	19.7	22.1	24.5
Banks	270.2	345.2	405.0	424.5	443.3
Claims on Private Sector	799.2	985.8	1,158.9	1,365.6	1,605.0
Other items (net)	-167.1	-268.8	-333.8	-386.7	-416.1
Broad Money (M3)	1,198.9	1,402.9	1,633.9	1,918.3	2,257.2
of which:					
Residents' foreign-currency deposits	165.2	193.3	225.2	264.4	311.1
Ratio of Foreign currency deposits/M3 (%)	13.8	13.8	13.8	13.8	13.8
Memorandum items:					
Reserve money annual percentage change	31.5	1.8	13.6	17.4	17.7
M3 Annual percentage change	26.2	17.0	16.5	17.4	17.7
Velocity (GDP/M3avg)	2.3	2.1	2.1	2.0	1.9
Multiplier (M3/RM)	5.7	6.6	6.7	6.7	6.7
Credit to private sector	16.8	23.3	17.6	17.8	17.5
Net Government borrowing	536.2	661.2	780.7	829.4	876.4
Banking sector	277.7	358.9	424.7	446.6	467.7
Non-banking sector	258.5	302.2	356.0	382.8	408.6

Source: Ministry of Finance

1/ At current exchange rate

ANNEX 3: CHRONOLOGY OF EVENTS OF PARTICULAR RELEVANCE TO MONETARY POLICY AND INFLATION (January – June 2011)

March 2011

a) The CBR was reviewed upwards from 5.75 percent to 6.00 percent marking a shift in monetary policy stance to address inflationary pressure and exchange rate instability.

b) Japan was hit by an earthquake and consequent tsunami that destroyed many manufacturing firms and affected export supplies in the global market.

May 2011

a) Banking Circular No. 3 of 2011 announced the establishment of the East Africa Cross Border Payment System (EAPS) developed in conjunction with Central Banks of EAC member states. This was directed at facilitating cross-border payments for trade in the East African region.

b) Banking Circular No. 4 of 2011 announced the upward revision of the CRR and the CBR from 4.50 percent and 6.00 percent to 4.75 percent and 6.25 percent, respectively.

c) The tenor for late repurchase agreements (repo) was reviewed from 7 days to 4 days at 100 basis points below the average for the morning repo rate.

d) Build-up in sovereign debt in a few countries in Europe caused debt default fears across Europe and the global economy. The crisis was worst experienced in Greece as the public protested the austerity measures taken by the Greek Government.

June 2011

a) Banking Circular No. 5 introduced an operational interest rate for the CBK Discount Window was to be reviewed from time to time and posted on the CBK Website by 9.00am. The initial accommodation through the Window was at 8.00 percent. In addition, use of funds from the CBK Discount Window for trade in the interbank market or for trading in foreign exchange was not allowed and stiff penalties were imposed on banks that would engage in these activities.

b) The sovereign debt crisis situation in Greece was brought under control with the Greek government managing to pass a package of new austerity measures and EU leaders pledging funds to support the country. This quelled uncertainty in financial markets across Europe.

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.

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 (OMO)

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

Repurchase Agreement (REPO)

REPOs/reverse repos are agreements between the CBK and commercial banks to purchase/sell Government securities from/to commercial banks at agreed interest rates (REPO rate) for a specified period with an understanding that the commercial bank will repurchase/resell the security from/to the CBK at the end of the period. The period can be limited by the CBK.

Horizontal REPO

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

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 Reserve Ratio (CRR)

This is the legally required position of commercial banks and non-bank financial institutions deposits held with the CBK. The CBK is empowered by the CBK Act to demand that a certain proportion of commercial banks' deposits be held as reserves at the CBK. The ratio currently stands at 4.75 percent.

Term Auction Deposits

A deposit product of the Central Bank of Kenya transacted with commercial banks under Open Market Operations through a competitive auction bidding system. Deposits are held to maturity and qualify for liquidity ratio purposes.