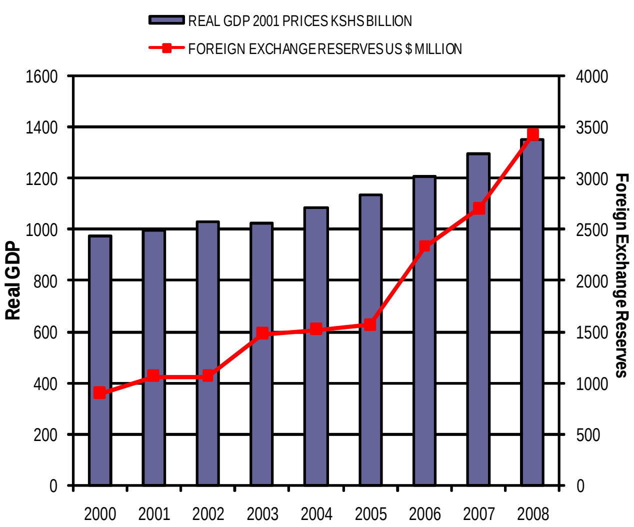

CENTRAL BANK OF KENYA

Monetary Policy Statement

Issued under the Central Bank of Kenya Act, Cap 491

DECEMBER 2008

Letter of Transmittal

Dear Honourable Minister,

I have the pleasure of forwarding to you the 23rd Monetary Policy Statement (MPS) of Central Bank of Kenya (CBK), pursuant to Section 4B of the Central Bank of Kenya Act. The Statement reviews the implementation of monetary policy from July to December 2008. It also covers the current economic developments and outlines the monetary policy stance for the short and medium term.

Prof. Njuguna Ndung'u

Governor

MONETARY POLICY STATEMENT
DECEMBER 2008

TABLE OF CONTENTS

Page

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

The principal objectives of the Central Bank of Kenya 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, the Bank shall support the economic policy of the Government, including its objectives for growth and employment. Without prejudice to the generality of the above, the Bank also seeks to:

- Formulate and implement foreign exchange policy;
- Hold and manage its foreign exchange reserves;
- License and supervise authorized 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.

The CBK formulates and conducts monetary policy with the aim of keeping inflation low and stable, thereby contributing to a favourable macroeconomic environment for sustainable economic growth and employment creation. Low and stable inflation facilitates higher levels of domestic savings and private investment and therefore leads to better economic outcomes including improved economic growth, higher real incomes and increased employment opportunities.

The Bank's monetary policy is thus designed to support the economic growth and employment objectives of the Government through achieving low and stable inflation.

Instruments of Monetary Policy

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

- **Open Market Operations (OMO):** Through this instrument the CBK implements monetary policy by controlling the money supply. To achieve the desired level of money supply, OMO is conducted using the following instruments:

  - ***Repurchase Agreements (Repos)*** – The CBK uses repos to withdraw liquidity by selling eligible securities to commercial banks, or reverse repos to inject liquidity by buying eligible securities from commercial banks.
  - ***Term Auction Deposits*** – The CBK uses Term Auction Deposits to withdraw liquidity from the banking system. In this case no securities are involved as in the case of repos.

- **Standing Facilities:** The CBK, as lender of last resort, provides secured loans to commercial banks on an overnight basis at a rate known as the Central Bank Rate (CBR). The value of the CBR is based on the average of the interbank and the Repo rates plus a margin to be determined and announced by the Monetary Policy Committee of the CBK at least every two months.

- **Reserve Requirements (RR):** The Required Reserve is the proportion of commercial bank's deposit liability held at the CBK in accordance with the law. These deposits are held in an account known as Cash Reserve Ratio (CRR) Account. The CBK uses this as a direct instrument for monetary policy. An increase in CRR reduces the capacity of commercial banks to extend credit. A reduction in CRR enhances the capacity of commercial banks to expand credit.

- **Foreign Exchange Market Operations:** The CBK can either inject or withdraw liquidity in the banking system by engaging in foreign exchange transactions. A sale of foreign exchange to banks or the public withdraws liquidity from the system while the purchase of foreign exchange injects liquidity into the system. Participation by CBK in the foreign exchange market is commonly motivated by the desire to forestal excessive volatility in the foreign exchange rate movements or when the Bank is building its foreign exchange reserves. The Bank also uses it's foreign exchange reserves to meet the Government's external obligations - hence it carries amounts that vary for the purpose.

- **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 every two months as part of its decisions.

  The CBR signals the monetary policy stance. The Bank sends policy signals to the market through the CBR. A reduction of the CBR signals the easing of monetary policy and a desire for market interest rates to move downwards. Lower interest rates enhance economic activities and thus growth. When lending rates decline, demand for credit rises. This enhances the intermediation role of commercial banks while making the market more liquid through credit creation.

  CBR is a policy rate that is operationalised through the repo market. As such, efficiency of the repo and interbank market is crucial for transmission of monetary policy decisions. By fixing a single tenor for repo market, the monetary authority expects to sharpen the signalling process.

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 the 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 is required by the law under subsection (1) 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.

3a. The Bank is required by law to 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 fthe National Assembly appointed to investigate and inquire into matters relating to monetary policy.

Executive Summary

This 23rd Monetary Policy Statement proposes an accommodative monetary policy stance to support the recovery process and counteract threats of adverse effects of the global economic downturn. It seeks to enhance efficiency of the financial sector and support financial deepening and development. Faced with both external and internal shocks, the recovery process has slowed down and resuscitating economic activities will require significant support in providing an enabling environment with adequate liquidity backed by a low cost of funds. It also means facilitating mobilisation of adequate resources.

What started in September, 2008 as a global financial crisis turned into a global economic downturn. While the full impact of the magnitude of the global effects is yet to be determined, the fact that Kenya is a small economy makes it vulnerable to many adverse effects. The Bank will take advantage of the crisis to deepen reforms and strengthen the institutional structure at this time which is crucial in solidifying the domestic economy. The Central Bank is thus proposing measures to promote efficiency in operations of the financial sector.

Many countries have responded to the global crisis by putting in place measures cushioning their economies from the adverse effects of the shocks buffeting their economies. The measures have included lowering of interest rates and injecting significant liquidity into the market. Lower interest rates abroad might induce short term capital inflows to developing countries like Kenya. The effects of such inflows might be devastating to Kenya's macroeconomic stability. Conscious measures to lower interest rate differential between Kenya and other countries would lessen the destabilizing consequences which would arise from short term capital inflows.

The inflationary pressure on the domestic economy has been easing with the fall of international oil prices and further easing is expected with good long rains. With the economy clear of any liquidity overhang, the Central Bank will be supporting the establishment of an enabling environment to boost economic activities by providing adequate liquidity and maintaining low interest rates contingent on inflationary expectations remaining low.

To attain the Vision 2030 objective of financial deepening, the Bank intends to take measures to facilitate improved returns to investors and depositors. This will build on significant efforts that the banking sector has made in mobilising deposits. The Bank will create an enabling environment to enable diversification of the financial asset basket in an effort to support financial deepening and development.

The main challenge for the Central Bank in the immediate future will be to pursue a monetary policy keeping in view the downside risk of slowing economic activity as external conditions stabilise after a steep deterioration. As such, ensuring that the current high inflation does not become a permanent feature in the economy will require a balancing of concerns about inflation with the need to ensure an adequate flow of credit to the real sector. In this regard, ensuring an interest rates structure that supports economic growth without compromising the inflation goal will be vital. A caveat however, is that inflation computation will in the future be following the international best practices of both computation and reporting which will affect the data for targeting.

I. INTRODUCTION

This is the first Monetary Policy Statement (MPS) since the Monetary Policy Committee (MPC) became operational. The MPC has come to grips with its mandate particularly since its first meeting in June 2008, assessing the way in which policies are translated to actions and the transmission of those actions to desired results. From the outset, the MPC has filled a big gap that existed.

The structure of this MPS is firstly a review of the implementation and outcome of policies proposed in previous MPSs; secondly, it assesses the environment in which the proposals presented will be required to operate and finally, the proposals in December 2008. The background to this Monetary Policy Statement reflects the residuals of the January 2008 disturbances, the response to the distortion consequences of the Safaricom IPO liquidity distribution, the global financial crisis and the domestic food crisis due to inadequate November rains.

2. CONDUCT OF MONETARY POLICY

2.1 Policy proposals in June 2008

The deep concern in setting up the monetary programme in June, 2008 was the increasing inflationary pressure emanating from increasing prices of food, international oil and commodities prices. Thus, the main objective was to pursue a tight monetary policy to anchor inflation expectations and guard against second round effects from increases in food and fuel prices. This was achieved through limiting growth in reserve money and also broad money.

2.2 Policy actions taken

The previous Monetary Policy Statement promised a tightening of monetary policy in dealing with the liquidity effects of the Safaricom IPO. Thus, in the 1st meeting of the Monetary Policy Committee (MPC) on 5th June 2008, the CBR was reviewed upward to 9.00 percent from 8.75 percent and retained at that level in the subsequent two meetings in August and late September of 2008. The situation was reappraised in the December 2008 meeting in the light of the deteriorating external environment which threatened to spill over domestically. As such, the MPC lowered the cash reserve ratio by 100 basis points from 6.00 to 5.00 percent and simultaneously reduced the CBR by 50 basis points from 9.00 to 8.50 percent. The MPC was of the view that while the liquidity targets were being met, the economy was experiencing a slowing recovery which was mainly attributed to supply-side constraints. The injected liquidity was considered non-inflationary and essential to support expanded economic activities.

2.3 *Market response to the actions taken*

During the initial period (July-September 2008) the major concern for the MPC was to ensure that the market cleared the Safaricom IPO liquidity concerns which had affected a few banks. Later, September-December, the major factor that dominated the period under review was the global financial crisis that had been triggered by sub-prime mortgages in the US. Analysis has been conducted to explore the degree to which the recessionary effects will be propagated in Kenya.

a) Economic growth

Provisional data for the first quarter of the period under review (July-September 2008) indicated a significantly lower than expected economic growth of 2.46 percent when compared to 3.52 percent in the March-June 2008 quarter, signifying a slow down of economic recovery. The second quarter (October-December 2008) continued to show a slow recovery. This resulted from a weaker global economic outlook which was having a negative impact on Kenya's foreign exchange markets, the equity market and the real economy (tourism and lower export orders) while remittances fell from the Safaricom related peak. However, there was no evidence of liquidity shortage to the private sector. At that point, it was becoming clear that the target set for economic growth in 2008/09 of 5.8 percent was not achievable. As data was slow to come in, it is difficult to assess the full impact of the monetary stimuli announced by the MPC at the beginning of December 2008.

From September 2008, the world economies were experiencing the financial crisis that threatened to engulf a majority of their economies in recession. This forced many analysts to revise growth projections significantly downwards. For example, USA and UK economies shrunk by 3.8 percent and 1.8 percent respectively in the fourth quarter of 2008 (IMF projections). Africa real GDP growth rate was expected to decline from 6.2 percent to 4.6 percent in 2009, while the East Africa growth rates are projected to fall from 8.4 percent in 2007 to 6 percent in 2009 (AfDB projections). The story was not different for the Asian tigers. Singapore and South Korea saw their economies shrink by 3.7 percent and 3.4 percent in the fourth quarter of 2008 respectively.

b) Inflation

Inflation remained above 20 percent. For effective monetary policy programming, the Central Bank analysed sources of inflation to separate the supply and demand aspects. The analysis showed that there was no liquidity overhang, but instead inflationary pressure being generated through the food component as a result of distributional effects and poor harvests after the disruptions in cultivation and inadequate rain earlier in the year. Fuel inflation which had generated high inflationary pressure in the June-August period eased significantly with the decline in oil price inflation from 31.57 percent in September to 17.99 percent in December, 2008. The Nairobi low income group experienced a significantly higher inflation compared to the middle and upper income groups.

The anticipated short term risks materialised when oil prices accelerated during mid year causing disruptions to the macroeconomy through fuel shortages as well as delayed changes in pump prices.

c) Liquidity position

Central Bank met its monetary targets which are consistent with a low inflation target during the period November to December 2008 as the actual reserve money was less than the set targets. However, as the economic performance was lower than programmed in the Bank's monetary operations, the perceived tightness did not hurt the economy but reduced the monetary overhang in the financial system which could have been inflationary. The monetary programme was reviewed to reflect the reduction in cash ratio while the growth assumptions were maintained given that the slowdown in the economy was perceived as temporary shock. As the shock took longer than anticipated, this called for a further review of the monetary programme to take into consideration the developments in the real sector.

d) The commercial banks' interest rates

With the inflationary pressure and the global financial crisis, commercial banks became more risk averse based on the expectation that the economic outlook would deteriorate. The banks revised their base lending rates upwards arguing for the need to maintain their profit margin in a higher inflationary environment, and weed out projects and clients whose projects could not weather the shocks buffeting the economy. However, as they became convinced that the outlook did not turn out as bleak as their projections, the clamour for higher rates abated. Consequently, there were only minimal increases in lending rates especially after September 2008. This was also accompanied by minimal increases in the deposit rates.

e) Financial growth and stability

In 2008, bank deposits surpassed a trillion shillings. The increased mobilization of deposits that saw an average of 15 billion per month was attributed to the expansionary strategy adopted by banks and the entry of Islamic banking products. Average liquidity stood at 37 percent compared to the statutory minimum of 20 percent. The Total Capital to Total Risk Weighted Assets Ratio for the sector stood at 18.9 percent, which was above the statutory minimum of 12 percent.

The financial sector showed no long term deterioration due to the international events. Non-performing loans as a proportion of total loans continued to decline from 7.13 percent in June 2008 to 7.05 percent in December 2008. This was supported by a slightly lower improvement taking into consideration provisions. The June ratio of 2.36 percent increased to 2.53 percent in December 2008.

f) The exchange rate

The movement in the exchange rate generally reflected external factors. As the world witnessed the meltdown in the US economy, the first round effects were experienced with the dollar appreciating against other major currencies. As a result, the Kenya felt a significant depreciation of the shilling against the dollar between September and December 2008. The situation was compounded by speculative behavior among banking institutions. The CBK responded by selling $50 million to cushion excessive volatility in the shilling in September (US$20 million) and October, 2008 (US$30 million).

g) Fiscal developments

During the first half of the 2008/09 financial year, the market for Government securities was generally undersubscribed, partly reflecting the tight liquidity conditions and the spill-over of the impact of the global financial crisis on the domestic financial markets. The 91-day Treasury bill interest rates edged up by 90 basis points from 7.741 percent on 1st September to 8.623 percent on 1st December 2008. With the policy action that saw the injection of liquidity into the market, the Treasury bill rate reduced slightly by 9 basis points to 8.537 percent on 29th December 2008. By year end the MPC actions had not taken full effect in the financial system. While initially the subscriptions exceeded the tender amounts, the seasonal effects of the festive season led to significant under-subscriptions. Thus, by December 2008, domestic borrowing was running below target by KSh 23.3 billion. Indeed, during this period the Exchequer had to meet the debt redemptions through ordinary revenues and overdraft from the CBK.

h) International rating

The positive rating of the country signaled an improved environment and restored confidence in the economy. On 3rd November 2008 Standard & Poors upgraded Kenya's rating to B stable for both the long and short sovereign debt, FitchRatings in January 2009 also upgraded Kenya to B stable from B negative.

3. FINANCIAL AND ECONOMIC OUTLOOK AT DECEMBER 2008

3.1 Global economy

Central Bank kept track of the unfolding international financial and economic instability that is evolving into a global economic downturn. The world economy appears to be undergoing an unusually sharp and synchronized downturn driving several countries into what looks like prolonged recession. As a small open economy, Kenya is not immune to the impact of the global economic downturn. However, the magnitude of how different African economies will be affected will depend on the structure of their economies and their type of commodity dependence. Kenya is primarily a rural, agro-based economy with only a small minority of the population directly interfacing with the developed world. The main sectors likely to feel any significant impact as the crisis intensifies through the second round effects include tourism and commercially oriented agriculture such as horticulture, tea and coffee. Other effects will be felt through foreign exchange volatility, intermediate input price volatility and also the credit and trade restrictions from counterpart banks and firms abroad. The Kenyan economy will also be affected (and impacted) by the type of strategies being adopted by the major world economies. The bank bailouts and stimulus packages being put in place and implemented by these economies will influence the relative domestic vis-à-vis international interest rates and affect the flow of short term capital. Such flows may cause macroeconomic instability if not managed appropriately. In summary, the indirect effects of this global financial crisis pose a significant threat to Kenya's development agenda and Vision 2030 goals.

3.2 Domestic market

a) Economic growth

The forecasted global economic downturn implies that the recovery of the domestic economy will be slower than projected, mainly as a result of both domestic and external shocks. Treasury has already revised its growth rate targets for 2008/09 and 2009/10 to between 3.0 and 3.1 percent. The recent data from the Leading Economic Indicators shows a recovery from the post election disrupted first quarter growing at a significantly lower rate than was generally programmed. However, a number of indicators continue to show that business is still improving relative to 2007. Tea and cement, which are significant indicators of economic activity, show positive growth. However a rebound from the poor performance in 2008 is contingent on good rains, the severity of the global economic crisis, and how flexible the economy will be in order to withstand the shocks and return to its growth path. As such, the downside risks to growth remain high. The economic outturn will have implications on the monetary targets set for the period.

b) Inflation

Inflation is expected to continue easing in the coming period with the drop in oil prices and low interest rates which feed into the cost of capital. To some extent, however, this will also depend on the amount of rainfall received in the March-May 2009 long rain period easing the food inflation. Backed by research conducted in the Central Bank, it is clear that liquidity injections have not contributed to any inflationary pressure. The MPC expects the pass-through effects of the oil price and the exchange rate instability transmitting to inflationary pressure in the next six months to be insignificant.

In addition, it is expected that KNBS will soon be releasing a new CPI series that takes into consideration the computational problems that have been experienced thus far. As the new methodology takes cognisance of a wider basket and moderates the impact of highly volatile prices, the new series is expected to report lower inflation rates than those compiled using the current basket and methodology. The new inflation numbers will be comparable with those of Kenya's trading partners.

Given the factors above, the inflation outlook is positive as the oil and commodity prices are expected to remain low. Similarly, the monetary overhang's threat to the financial system is also expected be low. However since food continues to be a large weight in the new basket (about 40%), the outlook to food affected inflation remains uncertain at best. However the upside risks to underlying inflation are low.

c) Exchange rate

The global economic crisis is causing the monetary authorities in the United States, the United Kingdom and the Eurozone to take measures to cushion their economies from severe negative macroeconomic effects. This is causing high exchange rate volatility as misaligned currencies respond to relative interest rates which are themselves moving to reflect domestic liquidity and risk perceptions in those countries.

Appropriate policies to be pursued in Kenya should be those that maintain the international credibility of the Kenya Shilling. A significantly under-valued shilling while beneficial to the export sector and growth, might encourage massive short term capital inflows exposing the country to significant macroeconomic risks should a reversal occur. On the other hand should the currency not adjust and the shilling gets over-valued, the undesirable effect of lowering import costs could be accompanied by the deleterious effects of lower revenue for Kenya's exports which could eventually choke growth.

The challenge in the future is going to be how to strike a balance for the economy and maintain interest rate differentials beneficial to the economy and reducing macroeconomic risks associated with overvalued or undervalued exchange rates. The Central Bank will continue to strive to have a market driven but stable exchange rate backed up by an adequate foreign exchange reserve level.

d) Market liquidity

The Central Bank will continue to monitor the liquidity situation in the banking system and, where necessary provide adequate liquidity to the market to support economic activity. The Bank has several instruments at its disposal to ensure enough liquidity is available to the market. This commitment by the Bank was demonstrated in December 2008 when it used the cash ratio instrument to inject liquidity into the system. Reserve money targets will be reviewed to accommodate these developments including a reduction in the bank reserve target and an increase in the money multiplier. Should the recovery process be slower or faster than forecasted, the MPC will revise its targets to be consistent with the growth and inflation outcomes in its consideration in the monetary programme.

e) Financial deepening

Financial deepening remains a challenge in this economy. Although the expansionary strategy adopted by banks has seen significant outreach, the lower end of the market is yet to be served sufficiently. The finalisation of the regulatory framework for Micro Finance Institutions (MFIs) in early 2009 is expected to usher in deposit-taking MFIs which will generally serve the lower end of the market. This will enhance the reach of the financial sector while deepening the products available to the wider community.

While the banking sector remains sound, the major challenge that the monetary authority is facing is the speed with which the policy signals are internalised by the sector. This is generally attributed to inefficiencies in the intermediation process. The full implementation of the proposed institutional reforms in the sector is expected to improve operational efficiency. The Bank has identified the Horizontal Repo instrument and lowered the Treasury bill threshold to improve intermediation and efficiency of the banking system.

Deepening of the interbank market is still key in the transmission mechanism of monetary policy. While the introduction of the horizontal repo was expected to play a key role in enhancing the efficiency of the interbank market, it has not been fully operationalised. The horizontal repo is supposed to enable banks, including those without credit lines, to access credit from other banks through the interbank market. This will deepen money markets through enhanced efficiency in the interbank market.

In December 2008, the Central Bank announced the reduction of the Treasury bill bid threshold to KSh100,000 which was effect from 1st January 2009. The main objective was to enable small savers to diversify their financial asset basket with a risk free asset that they previously were not able to access easily and thus to stimulate their savings rate. A challenge though in realising this policy change is accessing the Treasury bill market at minimal transaction costs. The CBK will in future develop an agency programme to reach the micro investors.

Notable also is the expanded space for access to financial services with the mushrooming of mobile banking services. This has revolutionised money transfer service products using technological innovation. The services are provided to the non-banked with partial access to financial services. The Bank has recognised the contribution of these services but will continue to analyse the impact of such developments and their implications on the money velocity which is an important component of the monetary programme framework.

f) Fiscal development

By the end of December 2008, the Government had raised 48 percent of its targeted budget revenue and 35 percent of the proposed domestic borrowing. As a result there was pressure to catch up on the Treasury's domestic borrowing programme in the subsequent two quarters before the end of the year.

The first domestic infrastructure bond is to be launched in February 2009 through which the Government intends to raise KSh18.5 billion to cater for infrastructure development. While that may not have significant implications on the Government debt, it may support some shifts in liquidity in the financial market.

4. FUTURE DIRECTION OF MONETARY POLICY

The main challenge for the Bank and MPC will be to pursue a monetary policy keeping in view the downside risk of slowing economic activity as external conditions stabilise after a steep deterioration. To ensure that the current high inflation does not become a permanent feature in the economy, it will be paramount for the Bank to balance concerns about inflation with the need to ensure an adequate flow of credit to the real sector. In this regard, ensuring an interest rates structure that supports economic growth without compromising the inflation goal is vital. In addition, the Committee will continue monitoring closely the exchange rate movements of currencies that compete with Kenya in its export markets and implementating the imperative of the current exchange rate policy of maintaining external competitiveness and exchange rate stability.

Specifically, in line with the key responsibilities of the Central Bank, this Monetary Policy Statement proposes the following:

In maintaining price stability;

- The monetary authority will ensure that market liquidity is managed in such a manner as to minimise any demand-driven inflation while at the same time, ensuring that there is adequate liquidity to support growth of economic activities and ease the supply constraints.
- The monetary authority will support an interest rate regime that will nurture faster economic recovery towards the Vision 2030 growth path. In doing so the CBK expects a reduction in cost of funds that feeds into the cost of doing business which has in the past caused high inflation.
- The Bank will take steps to moderate volatility in foreign exchange rates so as to maintain confidence and promote productive activities, without necessarily defending the exchange rate, but building foreign exchange to counter any shocks that would promote exchange rate instability.

The Bank is expected to foster liquidity, solvency and proper functioning of a stable, market-based financial system. In this regard, the Bank proposes to;

- Continue implementing the on-going institutional reforms to enhance efficiency in the banking sector.
- Review the reserve money programme to take into consideration the slowing economic recovery process and enable a proper tracking of the impact of policy actions with respect to efficiency of both the markets' and economy's responses.
- Operationalise the horizontal repo market in order to facilitate deepening of the interbank market.

In support of economic policy on growth and unemployment, the bank will;

- Monitor second round effects of the global recession and support growth and employment by pursuing an exchange rate policy that balances the interest of both exporters and importers. Complementarity of policies will enhance efficiency and create employment.

- Ensure that the private sector has access to adequate financing while not being crowded out by fiscal obligations.

In formulating and implementing foreign exchange policy, the bank will

- Continue pursuing the present open economy policies which have stood Kenya in good stead throughout the transformational period of development and move towards the implementation of the convergence criteria for the creation of an effective, prosperous Eastern Africa Community.
- Strive to maintain adequate foreign reserves that will enable the Bank play its role in facilitating debt and other Government payments, exchange rate management, liquidity management and preserve investor confidence.

Finally to promote the establishment, regulation and supervision of efficient and effective payment, clearing and settlement systems, the Bank aims to work towards lowering transaction costs by strengthening institutional frameworks.

Annex 1: Main Macroeconomic Indicators Underpinning the Medium-Term Fiscal Framework, 2007/08-2011/12

		Medium-Term							
	2007/08	2008/09		2009/10		2010/11		2011/12	
	Prov.	*Budget*	*BOPA'09*	*BSP'08*	*BOPA'09*	*BSP'08*	*BOPA'09*	*BSP'08*	*BOPA'09*
Annual percentage change, unless otherwise indicated									
National accounts and prices									
Real GDP	3.5	5.8	3.6	6.9	4.6	6.8	5.2	6.8	6.0
Real GDP per capita	0.6	2.9	0.7	4.0	1.7	3.9	2.3	4.0	3.1
GDP deflator	12.1	11.1	12.8	5.2	10.7	4.3	6.0	4.2	4.6
CPI Index (eop)	29.3	7.5	13.2	5.0	8.8	5.0	5.9	5.0	5.0
CPI Index (avg)	18.5	16.9	19.7	6.5	10.9	5.0	6.8	5.0	5.0
Terms of trade (-deterioration)	-4.5	-7.0	-0.9	-0.9	0.3	0.4	-1.2	0.2	-0.5
Money and credit (end of period)									
Net domestic assets	16.1	17.9	17.6	19.8	13.1	18.5	9.5	16.0	11.4
Net domestic credit to the Government	-15.1	14.8	11.8	12.1	8.5	10.8	11.6	11.5	11.4
Credit to private sector	28.2	16.3	15.1	16.7	14.1	16.2	13.3	16.2	13.7
Broad Money, M3 (percent change)	18.7	17.1	16.9	17.0	15.2	16.1	14.4	16.2	14.3
Reserve money (percent change)	18.2	16.2	15.2	16.5	14.7	16.1	14.4	16.2	14.3
In percentage of GDP, unless otherwise indicated									
Investment and saving									
Investment	15.7	22.3	18.0	23.8	20.3	24.8	21.6	23.5	22.7
Central Government	6.6	8.6	7.7	8.3	7.9	8.6	8.0	9.4	8.2
Other	9.1	13.7	10.3	15.6	12.4	16.2	13.6	14.2	14.5
Gross National Saving	8.3	15.3	9.3	17.5	13.5	18.9	15.7	18.0	18.2
Central Government	1.7	1.6	2.2	2.8	3.0	3.2	3.0	3.7	3.1
Other	6.6	13.7	7.0	14.6	10.4	15.7	12.7	14.2	15.1
Central Government budget									
Total revenue	22.0	21.4	22.1	21.7	21.6	21.8	21.7	21.8	21.8
Total expenditure and net lending	27.2	28.3	27.6	27.2	26.6	27.3	26.8	27.6	27.0
of which: wages and salaries	7.4	6.8	7.0	6.6	6.5	6.4	6.5	6.4	6.5
Interest payments	2.4	2.4	2.5	2.3	2.4	2.4	2.5	2.4	2.4
Development expenditures	6.7	8.5	7.8	8.4	8.0	8.7	8.1	9.5	8.3
Overall balance (commitment basis) excl. grants	-5.2	-6.9	-5.5	-5.5	-5.0	-5.5	-5.1	-5.7	-5.2
Overall balance (commitment basis) incl. grants	-3.4	-5.4	-4.1	-3.9	-3.5	-3.6	-3.4	-3.6	-3.4
Net external borrowing	0.3	1.2	1.1	1.5	0.4	1.4	1.0	1.4	1.0
Infrastructure bonds	0.0	0.8	2.3	0.8	2.0	0.8	1.1	0.8	1.1
Net domestic borrowing	-0.7	1.5	2.4	1.1	1.4	0.9	1.9	1.0	1.9
Total external support (grant & loans)	2.4	3.6	3.5	3.8	3.0	4.0	3.6	4.3	3.8
Balance of payments									
Exports of goods and non-factor services	25.2	23.1	26.0	23.7	26.3	24.2	27.7	24.8	28.7
Imports of goods and non-factor services	39.0	36.0	40.8	35.7	38.7	35.6	38.7	35.8	38.1
Current external balance, including official transfers	-7.4	-7.0	-8.7	-6.3	-6.9	-5.9	-5.9	-5.6	-4.5
Current external balance, excluding official transfers	-7.5	-7.0	-8.7	-6.3	-6.9	-5.9	-5.9	-5.6	-4.5
Gross international reserve coverage in months of next year forecast imports	3.2	3.4	3.1	3.5	3.2	3.6	3.5	3.9	3.8
Public debt									
Nominal Central Government debt (eop), gross	44.3	43.1	44.8	40.4	43.7	42.5	43.4	40.1	43.1
Nominal Central Government debt (eop), net	39.5	38.8	40.6	36.2	39.5	38.3	39.2	35.9	38.9
Domestic (gross)	21.9	21.0	20.8	20.6	19.4	20.2	19.3	20.0	19.3
Domestic (net)	17.2	16.8	16.6	16.4	15.2	16.0	15.1	15.7	15.1
External	22.4	22.0	24.0	19.8	24.3	22.3	24.1	20.1	23.8
Memorandum items:									
Nominal GDP (in Ksh billions)	1,967	2,393	2,299	2,690	2,663	2,993	2,970	3,332	3,294
Nominal GDP (in US$ millions)	29,946	35,580	31,229	39,204	32,852	42,775	34,829	46,686	37,618
Per capita income (US$)	793	916	804	981	822	1,041	848	1,105	890

Source: Ministry of Finance

BOPA = Budget Outlook Paper

BSP = Budget Strategy Paper

Annex 2: Monetary Survey 2007/08 - 2011/12 (end of period, in KSh Billion

	2007/08	2008/09	2009/10	2010/11	2011/12
	Act.	*Medium term projection*			
Central Bank of Kenya (CBK)					
Net Foreign Assets 1/	202.6	222.5	266.9	336.5	402.8
Net Domestic Assets	-49.6	-46.3	-64.9	-105.4	-138.6
Net credit extended	-30.2	26.4	32.0	13.7	-0.7
Net claims on Government	-27.7	-25.3	-23.4	-20.5	-17.4
Claims on banks	-2.5	51.7	55.4	34.2	16.7
Other items (net)	-28.9	-72.8	-96.9	-119.1	-138.0
Reserve money (RM)	152.9	176.1	201.9	231.0	264.1
Monetary Survey					
Net Foreign Assets (NFA) 1/	291.3	336.7	401.8	495.7	590.5
Central Bank (CBK)	202.6	222.5	266.9	336.5	402.8
Banks	88.7	114.2	134.9	159.2	187.7
Net Domestic Assets (NDA)	549.4	646.1	730.7	799.9	890.8
Domestic Credit	701.8	803.1	908.1	1,025.9	1,161.9
Claims on Government (net)	133.4	149.1	161.8	180.7	201.2
Central Bank	-27.7	-25.3	-23.4	-20.5	-17.4
Banks	161.1	174.4	185.2	201.2	218.6
Claims on Private Sector	568.3	654.0	746.3	845.2	960.7
Other items (net)	-152.4	-157.0	-177.4	-226.0	-271.0
Broad Money (M3)	840.7	982.8	1,132.5	1,295.6	1,481.3
of which:					
Residents' foreign-currency deposits	124.7	157.2	181.2	207.3	237.0
Ratio of foreign currency-deposits in M3 (%)	14.8	16.0	16.0	16.0	16.0
Memorandum items:					
Reserve money annual percentage change	18.2	15.2	14.7	14.4	14.3
M3 Annual percentage change	18.7	16.9	15.2	14.4	14.3
Velocity (GDP/M3 eop)	2.3	2.3	2.4	2.3	2.2
Velocity (GDP/M3 avg)	2.5	2.5	2.5	2.4	2.4
Multiplier (M3/RM)	5.5	5.6	5.6	5.6	5.6
Credit to private sector (Annual % growth)	28.2	15.1	14.1	13.3	13.7

Source: Ministry of Finance and Central Bank of Kenya

1/ At current exchange rate

ANNEX 3: CHRONOLOGY OF EVENTS OF PARTICULAR RELEVANCE TO MONETARY POLICY AND INFLATION (July-December 2008)

1. International oil prices peaked at US$ 147.27 per barrel in July 2008

2. In September 2008, the subprime mortgage crisis escalated to global dimensions including collapse of investment banks.

3. The Bank launched the horizontal repo facility to encourage competitive trading in the interbank market on 9th September 2008.

4. In December 2008, the minimum size of bids for Treasury bills was lowered from KSh1,000,000 to KSh100,000.

5. The MPC reduced the cash reserve ratio from 6.00 to 5.00 percent on 1st December 2008.

GLOSSARY OF KEY TERMS

Overall Inflation

This is the total 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 areas of the market which 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.

Underlying Inflation

This is inflation measured by indices of all consumer price items of goods and services sampled by KNBS excluding food, energy, transport and communications which are susceptible to volatile price movements beyond the control of the CBK. Thus, the underlying measure is used by the CBK to gauge the influence of monetary policy on inflation.

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 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 Requirement

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 5 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.