THE FIFTH MONETARY POLICY STATEMENT

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OBJECTIVES OF THE CENTRAL BANK OF KENYA

The Central Bank of Kenya objectives are laid down in the Central Bank of Kenya Act:

Principal Objectives

1. The first principal objective shall be to formulate and implement monetary policy directed to achieving and maintaining stability in the general level of prices

2. The second principal objective shall be to foster the liquidity, solvency and proper functioning of a stable market based financial system

Secondary Objectives

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

1. Formulate and implement foreign exchange policy

2. Hold and manage its foreign exchange reserves

3. License and supervise authorised dealers in the money market

4. Promote the smooth operation of payments, clearing and settlement systems

5. Act as a banker and adviser to, and as fiscal agent of the Government; and

6. Issue currency notes and coins

LEGAL REQUIREMENT FOR THE PRODUCTION OF MONETARY POLICY STATEMENT

This statement has been prepared in accordance with the requirements of the Central Bank of Kenya Act, Section 4(B) which is reproduced below:

"4B.(1) The Bank shall at intervals of not more than six months, submit to the Minister a monetary policy statement for the next twelve months which shall –

(a) specify the policies and the means by which the Bank intends to achieve the policy targets;

(b) state the reasons for adopting such policies and means;

(c) contain a review and assessment of the progress of the implementation by the Bank of monetary policy during the period to which the preceding policy statement relates.

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

(3) The Bank shall –

(a) cause –

(i) every monetary policy statement submitted under subsection (1); and

(ii) its monthly balace sheet to be published in the Gazette; and

(b) 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."

1. INSTRUMENTS OF MONETARY POLICY

The policy of the Central Bank will continue to be directed towards maintaining price stability and specifically containing inflation at below 5% over the next twelve months.

To contain the build up of inflationary pressures, the Bank will maintain monetary policy restraint. Accordingly, the growth of money supply will be kept consistent with the performance of the real sector in the next twelve months.

The Bank will also continue to implement prudential measures to further stabilise the banking system and thereby enhance efficiency in the transmission mechanism for monetary policy. The Bank will therefore apply the revised Banking Act including imposing financial penalties for non-compliance and enforcing the the revised capital requirements. To improve confidence in non-cash business transactions, appropriate legislation will be put in place to prosecute drawers of bouncing cheques.

In the conduct of monetary policy, the Bank will use cash ratio requirement, open market operations and discounting facilities to manage expansion of credit and money supply. The conduct of monetary policy will be as follows:

- Commercial banks will continue to maintain a specified minimum cash ratio by holding deposits at the Central Bank equal to an appropriate proportion of their deposit liabilities.
- The Bank will buy and sell Treasury bills, or any other stipulated Government paper, from time to time in the open market as appropriate conditions of the market may require.
- The Central Bank will, as lender of last resort, provide financial facilities to commercial banks without compromising the objective of price stability.

The conduct of monetary policy in terms of target setting for expansion of domestic credit and money supply will take into account the developments in the Government budget and the balance of payments outcome during the twelve months to December 2000.

2. MONETARY DEVELOPMENT IN THE LAST TWELVE MONTHS

The Bank maintained tight monetary policy stance with a view to achieving single digit inflation, specifically below 5% in the twelve months to December 1999. The expansion of money supply remained within target with (M3) rising by 2.6% in the twelve months to December 1999 while the broader money supply (M3XT) rose by 7.7% in the same period. The sources of increase in money supply during the period were as follows:

- The balance of payments recorded a surplus of US$ 91.3m equal to shs 5.7bn and thus the change in the foreign assets of the banking system contributed 72.6% of the increase in money supply during the twelve months.

- Lending by the banking system as measured by the net domestic assets of the banking system, increased by shs 2.1bn which was equal to 27.4% of the increase in money supply, and was made up as follows:

  – Lending to the Goverment declined by shs 2.2bn or 2.4% reflecting the decline in Government borrowing from the Central Bank as Government borrowing from comercial banks increased during the twelve months.

  – The banks' lending to the parastatals and other public entities increased by 16.6%.

  – Private sector credit from the commercial banks increased by 8.9% in the twelve months compared with an increase of 7.4% in the twelve months to December 1998.

While the increase in money supply (M3) decelerated almost throughout the twelve months, the increase in broader money supply (M3XT) defined to include short-dated Treasury paper and foreign currency deposits held by the private sector, accelerated during the last half of the period. Furthermore, the Central Bank had to adjust the target on the growth of money supply downwards as more information on economic performance in the real sector became available and showed slack growth in gross domestic product.

3. INFLATION

Inflation was generally on a rising trend mainly due to the lagged effect of the depreciation of the shilling which occurred during the twelve months, and the shortfalls in basic foods supply. The pass-through effect of increase in fuel prices also affected the domestic prices of most consumer items. As a result, the underlying month-on-month inflation rose to 7.6% in December 1999 from 4.9% in July. The underlying average annual inflation however moderated to 5.1% from 5.7% in July 1999 (Table 1 and Chart 1).

INFLATION

TABLE 1: UNDERLYING INFLATION

1999	Jul	Aug	Sep	Oct	Nov	Dec
Month-on-month	-0.6	6.9	7.2	8.2	8.3	8.0
Average annual	1.8	1.9	2.2	2.6	3.0	3.5

TABLE 2: OVERALL INFLATION

1999	Jul	Aug	Sep	Oct	Nov	Dec
Month-on-month	4.9	5.9	6.6	6.6	7.3	7.6
Average annual	5.7	5.4	5.3	5.2	5.1	5.1

CHART 1:UNDERLYING INFLATION

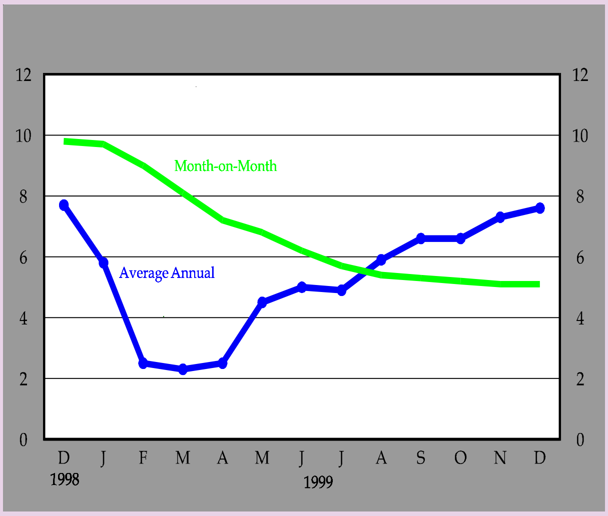
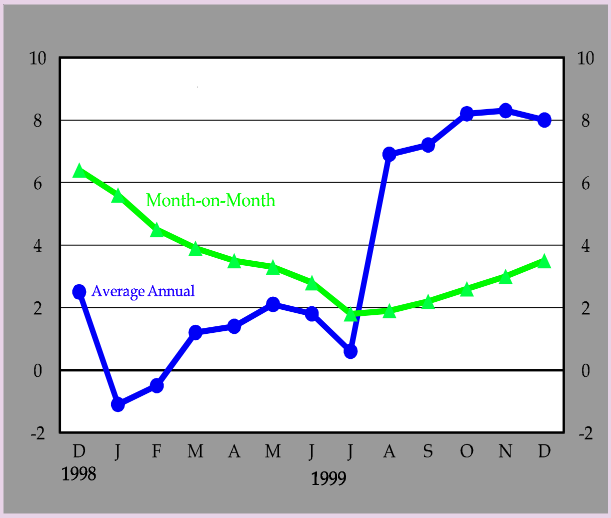


CHART 2: OVERALL INFLATION



Source: Central Bank of Kenya

Shortfalls in the supply of basic foods and the depreciation of the shilling exerted pressure on prices during the twelve months, but because of the tight stance of monetary policy maintained during most of the period the impact of the shilling depreciation and the shortfall in some items of food supply remained under control and inflation remained within single digits. The overall month-on-month inflation accordingly rose to 8.0% in December 1999 from negative 0.6% in July 1999 while the overall average annual inflation rose to 3.5% in December from 1.8% in July (Table 2 and Chart 2).

4. STABILITY IN THE BANKING AND FINANCIAL SYSTEMS

The banking sector was more stable during 1999 than 1998. Only one non-bank financial institution experienced severe financial distress. Restructuring of one bank continued during the year while one which was under statutory management was re-opened in August, 1999. To further strengthen the banking sector, the Central Bank took the following actions:

(a) An institution under distress was immediately put under statutory management to stop a further run.

(b) Depositors' committees were formed to assist statutory managers in restructuring banks under statutory management.

(c) Bank Supervision Department was strengthened to enhance closer surveillance aimed at detecting banking problems early enough so as to take preventive action.

(d) Guidelines for risk classification of loans were revised and issued to facilitate better credit risk assessment.

(e) The Bank continued to encourage formation of credit reference and credit rating agencies in order to enhance credit risk assessment. The first credit reference bureau was launched in February 1999 and a credit rating agency has also started operations.

(f) A circular in respect of borrowing by Directors of Banking institutions requiring their loans to be at commercial rates was issued.

(g) A system of vetting Directors and Chief Executives of banks prior to being appointed was implemented.

(h) The Banking Act was amended to give the Central Bank power to remove directors, levy penalties and enforce regulations.

(i) The disclosure of the financial performance was enhanced as a way of ensuring better market discipline. The banks are now required to publish non-performing loans as well as facilities to directors.

5. EXCHANGE RATES

The shilling regained stability during the second half of 1999 after weakening through the first half of the year from shs 61.8 to the US dollar in January to shs 73.6 to the dollar in June (Table 3 and Chart 3). Thereafter, the shilling remained stable trading at shs 73.1 to the US dollar in July and at shs 73.9 in December. Overall, the shilling weakened against all the major currencies over the twelve months in 1999:

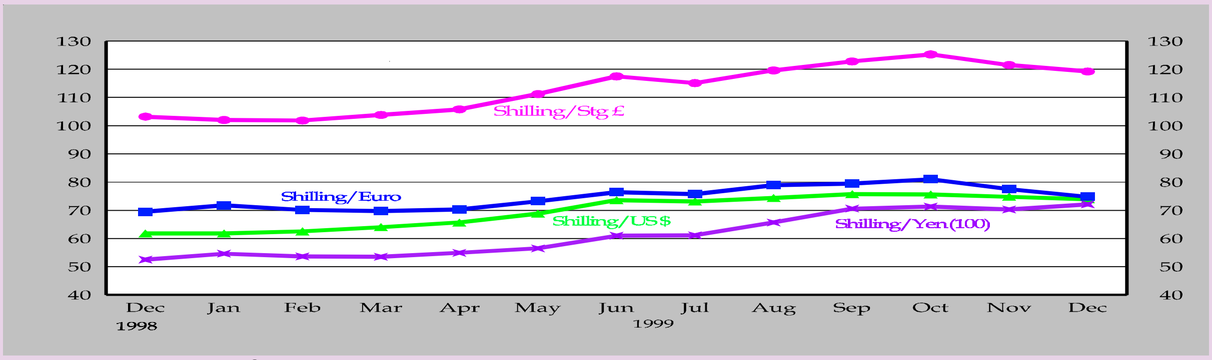
- It weakened against the US dollar and Pound Sterling by 16.4% and 13.6%, respectively to exchange at shs 70.3 and shs 113.8 in 1999 compared with shs 60.4 and shs 100.0 in 1998.
- Against the Euro and the Japanese yen, the shilling weakened by 10.5% and 34.5% to trade at shs 74.9 and shs 62.2 in 1999 compared with shs 67.8 and shs 46.2, respectively in 1998.

SHILLING EXCHANGE RATE AGAINST MAJOR CURRENCIES

TABLE 3

1999	Jul	Aug	Sep	Oct	Nov	Dec
US $	73.1	74.4	75.7	75.6	74.8	73.9
STG £	115.1	119.6	122.8	125.3	121.5	119.3
EURO	75.7	78.9	79.5	81.0	77.5	74.9
YEN(100)	61.1	65.7	70.6	71.3	71.3	72.1

CHART 3



Source: Central Bank of Kenya

The weakening of the shilling against the major currencies in 1999 reflected partly the decline in export receipts due to the relatively low prices for coffee and tea and partly due to lagged effect of the fall in interest rates particularly the interest on the 91-day Treasury bill which fell from 23.9% in 1998 to 13.3% in 1999 on average.

The Bank built-up its foreign exchange holdings from US$ 701m held in July 1999 to US$ 791m at the end of December 1999. At US$ 791m the foreign exchange reserve holdings of the Bank covered about 3.1 months of imports and were above the holdings twelve months earlier but remained below the desired target of US$ 800m by the end of the fiscal year 1999/2000.

6. INTEREST RATES

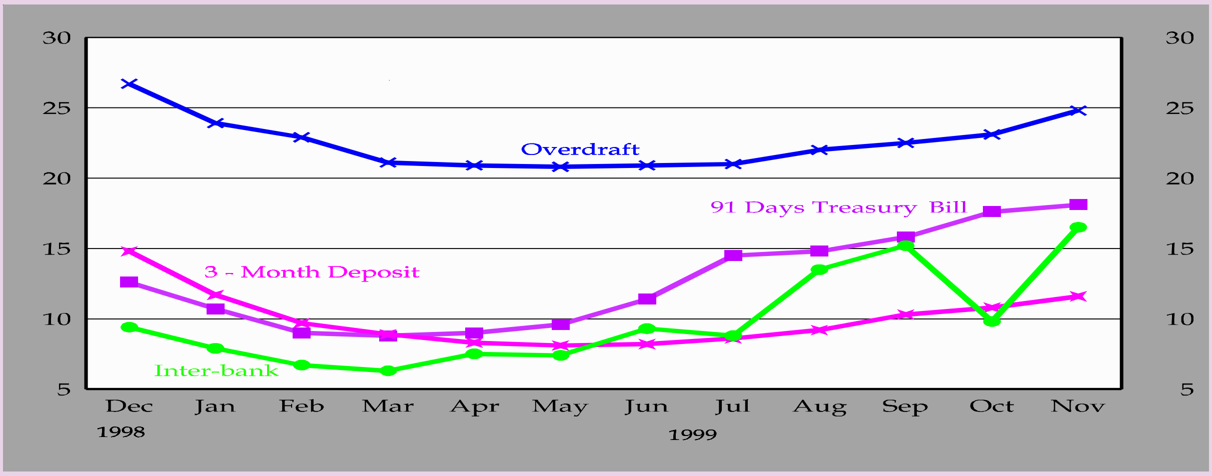
The interest rates on average fell over the twelve months to December 1999 compared with the outcome in the twelve months to December 1998, with the average of interest rates on the 91-day Treasury bill falling from 23.9% in 1998 to 13.3% in 1999 (Table 4 and Chart 4).

INTEREST RATES (%)

TABLE 4

1999	Jul	Aug	Sep	Oct	Nov	Dec
91-day Treasury Bill	14.5	14.8	15.8	17.6	18.1	20.0
Overdraft	21.0	22.0	22.5	23.1	24.8	
3-Month Deposit	8.6	9.2	10.3	10.8	11.6	
Interbank Borrowing	8.8	13.5	15.6	9.8	16.5	13.0

CHART 4



Source: Central Bank of Kenya

The fall in interest rates occurred during the first half of the twelve months. The rates however remained on a rising trend in most of the second half of the period. The interest rate on the 91-day Treasury bill reached 20% in December 1999 compared with 13% in December 1998 and 8% in April 1999. Meanwhile, the lending interest rate as represented by the overdraft interest rate fell from around 28% in December 1998 to about 25% in December 1999. The trend of the three-months deposit interest rate followed that of the 91-day Treasury bill falling most of the first half of the twelve months from around 15% to reach 12% in December 1999 having fallen to around 8% in June 1999. The interbank rate at the short-end of money market fell to about 6% in the first quarter of the twelve months but rose to about 17% in December. The interest rate trend reflected the adjustment of the stance of monetary policy whenever this became necessary during the twelve months.

7. MONETARY POLICY IN THE TWELVE MONTHS TO DECEMBER 2000

(a) The Target on Money Supply

The objective of monetary policy in the coming twelve months to December 2000 will be to contain inflation to below 5%. With prospects of pick-up in economic activity in the coming twelve months, the supply of money will be guided to increase by no more than 8% during the period using **cash ratio**, **Open Market Operations** and **discount and overnight lending by the Central Bank as lender of last resort**.

The source of the expansion in money supply during the twelve months and their details are as outlined in Table 5 below.

TABLE 5: MONEY SUPPLY AND ITS SOURCES (SHS BN)

	1998	1999		2000	Annual
	Dec. (Act.)	Jun. (Act.)	Dec. (Proj.)	Dec. (Proj.)	Change (%)
1. Money Supply (M3) = (2+3)	303.8	309.8	311.6	335.3	7.6
2. Net Foreign Assets	42.4	40.0	48.1	59.0	14.7
3. Net Domestic Assets	261.4	269.8	263.4	285.3	8.3
Government borrowing from:	90.1	96.9	87.9	94.4	17.4
Commercial Banks	63.1	66.1	62.2	78.7	26.5
Central Bank	27.0	30.8	25.7	15.7	-38.9
Private sector borrowing	260.6	277.7	284.3	314.0	10.4
Other items net	-89.3	-104.8	-108.8	-123.0	13.1

Source: Central Bank of Kenya

The target increase in money supply will be adjusted as appropriate in the course of the twelve months. The target will be revised upwards should economic activity turn out to grow faster than the expected 2.5% and vice versa.

- Balance of payments is expected to improve accordingly during the coming twelve months, and about 7.9% of the increase in money supply is expected to be supported by foreign exchange build-up of shs 1.9bn during the period.
- The lending by the banking system, that is, the net domestic assets of the banking system, is also expected to pick-up folowing recovery in

the economic activity during the twelve months and support 92.1% of the increase in money supply.

- The increase in the net domestic credit of the banking system will partly reflect an increase of 7.4% in the Government borrowing from the banking system, wholly from the comercial banks as borrowing from the Central Bank is expected to fall during the twelve months.
- The lending to the private sector including lending to the parastatals and other public entities is expected to increase by 10.4% during the period.

(b) Strengthening of the Banking and Financial Systems

To further stabilise the banking system, the Central Bank, in consultation with the Ministry of Finance, will take the following actions during the year 2000:

(i) Further strengthen Bank Supervision Department through training and equipment.

(ii) Apply the revised banking law including levying monetary penalties for non-compliance where appropriate.

(iii) Encourage the Government to fully divest itself from the banking industry.

(iv) Enforce the revised capital requirements which have been enacted into law.

(v) Enforce the provisions of Building Societies Act in order to harmonise the operations of the building societies with banking institutions.

(vi) Put in place appropriate legislation to prosecute authors of bouncing cheques.

(vii) Propose enactment of legislation that will facilitate passage of information on loan defaulters to the credit reference bureaus, in order to encourage banking institutions to use credit reference agencies.

(viii) Develop regulatory framework for micro-finance business in collaboration with stakeholders in the micro finance industry.