Governor

BANKI
KUU YA
KENYA

CENTRAL
BANK OF
KENYA

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11th June, 1997

Hon. Musalia W. Mudavadi, E.G.H, M.P.
Minister for Finance,
Ministry of Finance
THE TREASURY

Dear Sir,

I have the pleasure to present to you the First Monetary Policy Statement in accordance with section 4B of the Central Bank of Kenya (Amendment) Act, 1996.

The statement reviews Kenya's monetary policy performance over the past one year and outlines the stance to be adopted in the coming twelve months from July 1997 to June 1998.

Yours sincerely,

MICAH CHESEREM
GOVERNOR

CENTRAL BANK OF KENYA

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CENTRAL BANK OF KENYA

THE FIRST MONETARY POLICY STATEMENT- JUNE 1997

1. INTRODUCTION

This statement is made to the Minister for Finance according to Section 4B of the Central Bank of Kenya (Amendment) Act, 1996 which states that:

" 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.

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".

2. GOVERNMENT BORROWING FROM THE CENTRAL BANK

The amendment grants greater independence to the Central Bank of Kenya (CBK) and essentially ensures that the task of managing the supply of money in the economy is kept separate from that of spending. It also removes the pressure to finance Government operations by recourse to direct borrowing from the Central Bank. Excessive direct borrowing by the Government from the Central Bank has been the major cause of monetary expansion and hence inflation in the past.

Government borrowing from the CBK, outstanding as at 30 June, 1997 shall be treated in accordance with Section 18(3) of the CBK Act, which provides that:

(a) The total amount of advances made under this section outstanding at anytime shall not exceed five per centum of the gross recurrent revenue of the Government as shown in the Appropriation Accounts for the latest year for which those Accounts have been audited by the Controller and Auditor-General provided that this subsection shall not apply in respect of advances made by the Bank to the Government prior to the commencement of this section.

(b) Any advance made by the Bank to the Government which is outstanding at the commencement of this section shall be deemed to be a loan granted by the Bank to the Government on such terms and conditions as may be determined by the Bank in consultation with the Minister.

The net borrowing as at 30 June, 1997 is forecast to be about shs 38 billion made up as follows:

	Shs. Billion
Gross Paymaster General Account	136
Less: Deposits from sales of Treasury Bills	98
Net indebtedness to CBK	38

It has been agreed between the Treasury and the Central Bank that the debt will be converted as follows:

	Shs. Billion
Treasury bills 50%	19
Treasury bonds 50%	19
Net indebtedness to CBK	38

Future borrowings will be dealt with in accordance with Section 18(3) of the Central Bank of Kenya Act which limits Government's borrowing from the Bank in any one year to 5% of gross recurrent revenue as shown in the Appropriation Accounts for the latest year which have been audited by the Controller and Auditor-General.

For 1997/98 financial year, the maximum borrowing shall be shs 6 billion, computed as follows:

	Shs. Billion
Recurrent Revenue stated in the latest Audited Accounts (1994/1995)	119
The 5% of which is	6

The borrowing limit will be adjusted during the year upon availability of a more upto date audited accounts.

All borrowing shall be fully securitised.

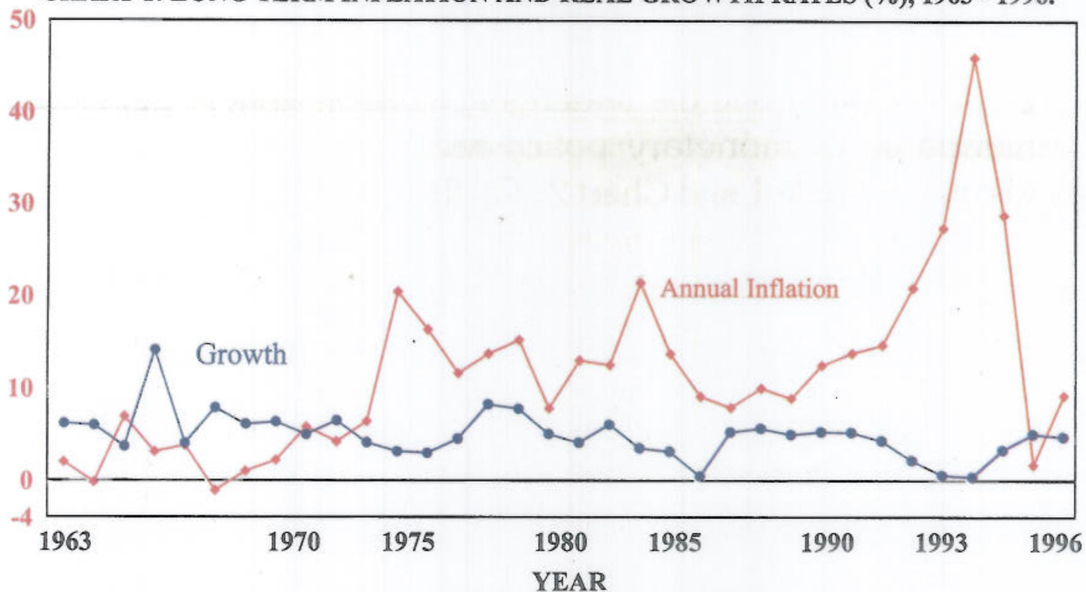
3. OBJECTIVES OF MONETARY POLICY

Monetary policy operations in the next twelve months, from July 1997 to June 1998, will be conducted in accordance with the Central Bank of Kenya amended Act which states that the principal object of the Bank shall be to formulate and implement monetary policy directed to achieving and maintaining price stability, that is, low and stable rates of inflation. A low inflation policy is not an end but rather the means through which monetary policy fundamentally contributes to good economic performance.

Monetary policy, geared towards maintaining price stability, is capable of supporting a meaningful and lasting economic growth. It gives Kenyans the confidence that the money they hold will retain its value over time and helps markets work efficiently in promoting better use of available resources. Successful monetary policy prevents inflation from being a major factor in the decision-making of businesses and consumers.

The damage which a loose monetary policy can inflict on an economy has been evident in Kenya's economic performance over the years as shown in Chart 1. The higher the inflation rate the lower the gross domestic product (GDP) growth.

CHART 1: LONG TERM INFLATION AND REAL GROWTH RATES (%), 1963 - 1996.



Source: Central Bureau of Statistics and CBK computations

Prudent monetary policy mitigates damage that inflation inflicts on the performance of the economy. Inflation adversely affects the growth in production of goods and services, creation of employment and income distribution by:

- increasing uncertainty and weakening the confidence of investors on the profitability of long term business ventures;

- weakening the effectiveness of prices and the market framework in the economy. This introduces distortions that create incentives for Kenyans to engage in non-productive speculative activities such as buying property instead of holding financial assets whose values are prone to erosion by inflation. This means less financial savings will be available to finance investment;

- tending to unfairly "tax" the poorer members of the society like fixed income pensioners and wage earners. As their money buys fewer and fewer goods and services, they become more and more anxious of their financial insecurity. Those sophisticated enough to cushion themselves with speculative acquisition of such assets as houses, jewellery and hoarding of foreign currency prosper. This breeds envy that reduces social harmony and could eventually create civil unrest.

4. INFLATION IN THE YEAR TO MAY 1997

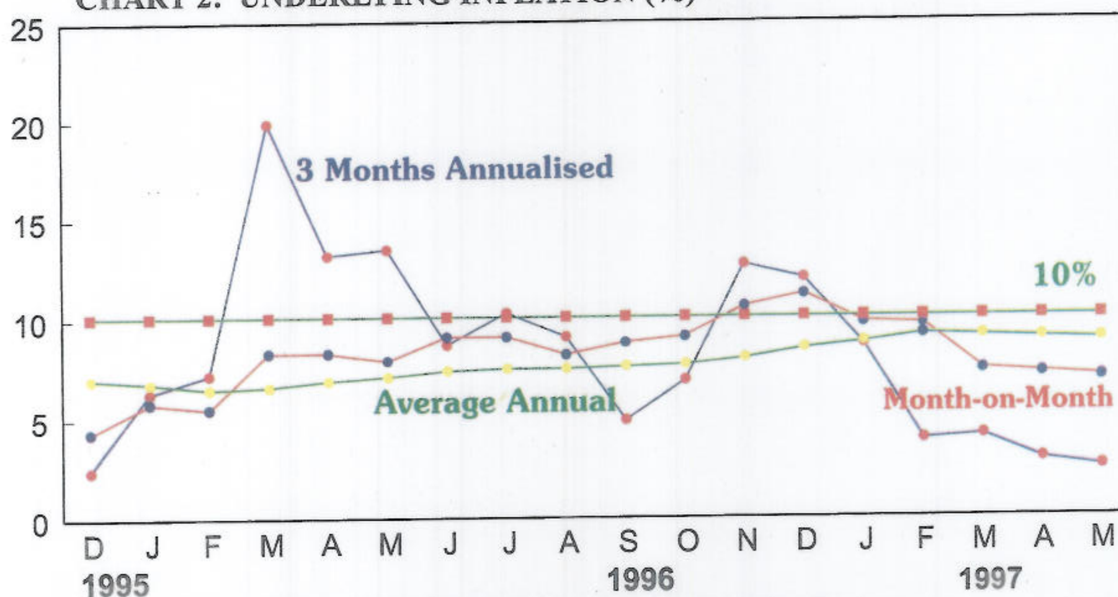
The developments in the underlying inflation (that is, inflation that is amendable to monetary policy measures) since June 1996 are indicated in Table 1 and Chart 2. On the whole, the underlying inflation has been kept at single digits with tight fiscal and monetary policies that have slowed down the expansion in the money supply. The strengthening of the shilling by keeping the prices of imports down throughout 1996 and first half of 1997 also helped reduce the underlying inflation. Underlying inflation has been declining since January 1997.

TABLE 1: UNDERLYING INFLATION (%)

Inflation Measure	1996			1997	
	May	Sep	Dec	Mar	May
1. Month-on-Month	7.8	8.7	11.1	7.3	6.9
2. Average Annual	7.0	7.5	8.4	9.0	8.8
3. 3 Months Annualised	13.4	4.8	11.8	4.0	2.4

Source: Central Bureau of Statistics and CBK computations

CHART 2: UNDERLYING INFLATION (%)



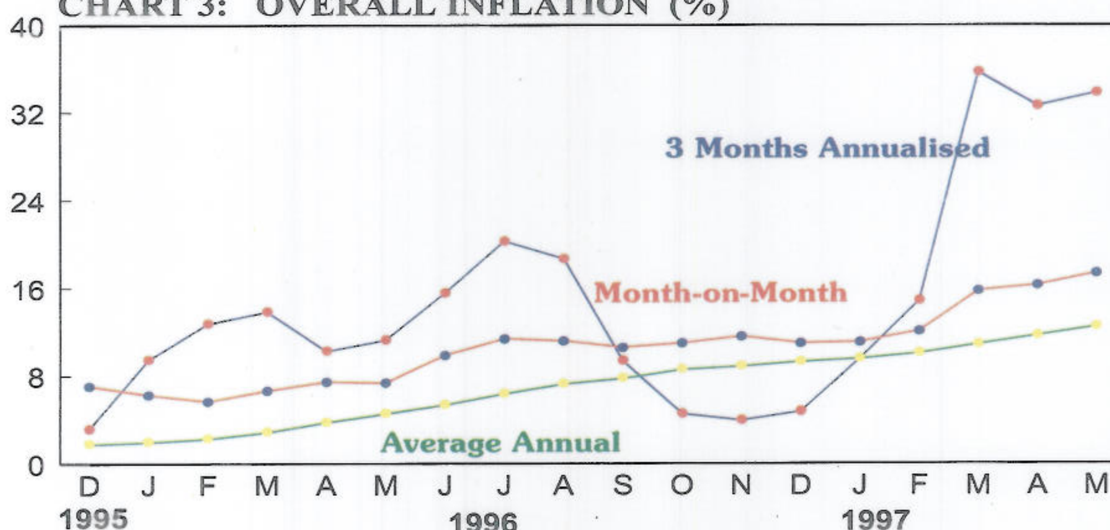
Source: Central Bureau of Statistics and CBK computations

On the other hand, the overall inflation, that is, inflation taking into account both policy and non-policy factors, continued to rise but at a slower pace than in the early part of the year (Table 2 and Chart 3). The overall inflation was driven mainly by the delayed effects of the recent severe drought.

TABLE 2: OVERALL INFLATION (%)

Inflation Measure	1996			1997	
	May	Sep	Dec	Mar	May
1. Month on Month	7.1	10.4	10.8	15.6	17.2
2. Average Annual	4.4	7.6	9.1	10.7	12.3
3. 3 Months Annualised	11.1	9.2	4.6	35.6	33.7

Source: Central Bureau of Statistics and CBK computations.

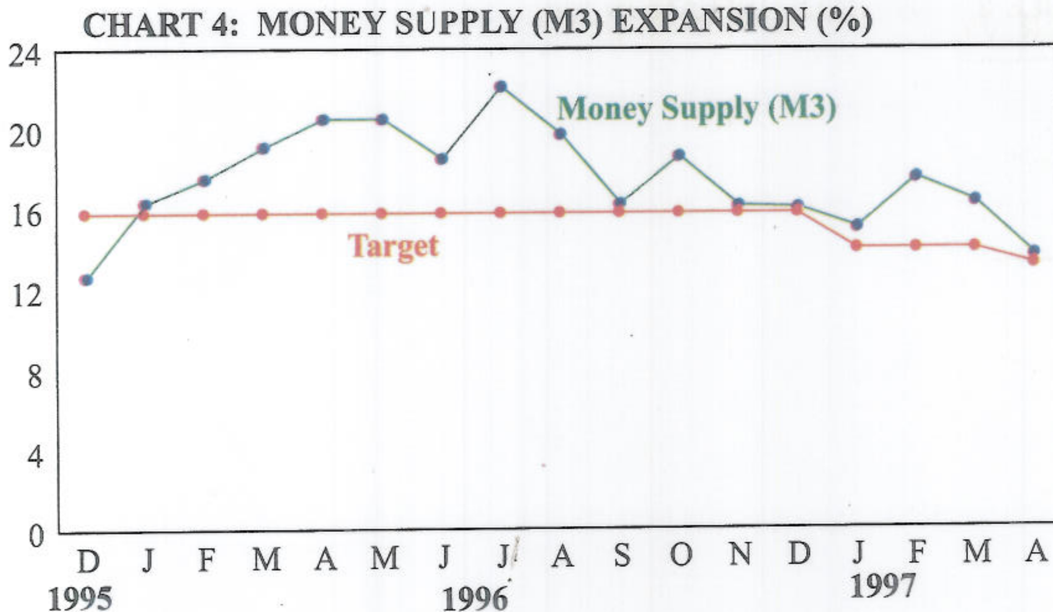


Source: Central Bureau of Statistics and CBK computations

5. FACTORS BEHIND INFLATION IN THE YEAR TO MAY 1997

The decline in underlying inflation resulted from a slow down in money supply expansion, especially since November 1996. The slow down in the money supply contained aggregate demand, thus dampening inflationary pressures. Continued strengthening of the shilling against other currencies throughout 1996 and early 1997 also helped reduce the inflationary pressures through reduced shilling import prices.

The growth in the money supply was restrained and brought down from 18.4% in June 1996 to 13.5% in April 1997. The expansion has thus been kept close to target (Chart 4).



Source: Central Bank of Kenya and CBK computations

Government borrowing from the Central Bank was the main source of money supply expansion in the past. However, between May 1996 and April 1997 and in spite of the Government continuing to borrow from domestic sources to meet the rolling-over of large domestic debt, the bulk of which was in treasury bills, the increase in the money supply mainly arose from:

- an increase of 14.5% in borrowing by the private sector from the banking system. The increase though modest historically, was still faster than what was required to support non-inflationary growth in production.

- net inflow of foreign exchange of shs 24.5 billion. The Central Bank held shs 27 billion of the increase in net foreign assets while commercial banks reduced their holdings by shs 3 billion.

6. MONETARY POLICY MANAGEMENT IN THE YEAR TO MAY 1997

To contain expansion in money supply, the Bank issued more treasury bills whenever excess liquidity threatened resurgence in inflation and instability in the shilling exchange rate. In this regard, the Bank intervened several times during the year in the domestic money and foreign exchange markets. It issued treasury bills to contain the expansion of the money supply and even more bills to pre-empt more money supply arising from its intervention in the foreign exchange markets.

7. INFLATION TARGET FOR THE YEAR TO JUNE 1998

Monetary policy in the next twelve months to June 1998, will seek to contain the underlying inflation at single digits. Critical to achieving the low single digit inflation objective, will be the observation of the limit on Government borrowing from Central Bank to no more than 5% of the most recent audited Government gross recurrent revenue according to Section 46(3) of the amended Central Bank of Kenya Act. The most recent audited Government revenue are those for 1994/95 in which the ordinary revenues were shs 119 billion, 5% of which translates to shs 6 billion. This limit will ease the task of managing the money supply by eliminating excess Government borrowing, the main monetary injection channel.

To confine inflation to single digit rates in the year to June 1998, the Central Bank will ensure that the expansion of money supply (M3), that is, currency outside banking institutions plus the deposits of both the private and other public sectors with the institutions, eases from 13.5% in April 1997 to no more than 11% in the year to June 1998.

8. MONETARY POLICY INSTRUMENTS

The Central Bank will pursue price stability through the regulation and control of the money supply in the economy. The Bank will do this by continuously monitoring and indirectly managing the expansion of money supply using:

- interest rates on treasury bills
- discount rate on lending to commercial banks
- the exchange rate
- the cash ratio requirement on banking institutions

Exchange and interest rates will remain market determined. Central Bank participation in the foreign exchange and domestic money markets, will be gradual and smooth to prevent disruptive movements in exchange and interest rates. The infrastructure for effective intervention in the markets by the Bank has been in place and operational for over two years. In particular:

- procedures for transactions in treasury bills, bonds, and foreign exchange have been established.
- Open Market Operations (OMO) arrangements have been set up in the Bank.
- Repurchase Agreements (Repos) facilities are also available in the Bank to supplement Primary issues, that is, new issues of treasury bills and issues through outright Open Market Operations.
- The cash ratio requirement has also been extended to include all banking institutions.

Use of these instruments will be supported by prudent Government budgetary operations given the limit on Government borrowing from the Central Bank. Government borrowing from the domestic financial markets has been integrated into the financial programme for the next twelve months to June 1998:

- the money supply target envisages an expansion of around 11% in total bank credit to the economy by the end of June 1998. Lending to the private sector and other public sector, however, is expected to increase by 18% in the next twelve months, to June 1998. The

lending to private and other public sector had expanded by 14.5% in the year to April 1997 and will be allowed to accelerate to the higher rate to support growth as much as inflation objective permits.

- Government borrowing from domestic sources is expected to decline, thereby reducing the current shs 128 billion domestic debt stock by at least shs 10 billion by the end of June 1998.
- the Central Bank will seek to maintain foreign exchange reserves sufficient to cover both four months of imports and manage stability in foreign exchange market through June 1998.

9. OUTLOOK

The Central Bank of Kenya monetary policy in the next one year, beginning July 1997, will be aimed at lowering inflation. This is the best contribution the Central Bank can make to both economic growth and improved distribution of income. Strict application of tight fiscal policy, especially aiming at a surplus in the budget, will be a determining factor in obtaining desired results. Thus effective management of the underlying inflation, particularly confining it to single digits target at the end of June 1998, will be facilitated by the implementation of the amended Central Bank of Kenya Act (1996).

June , 1997

GLOSSARY

Average-annual inflation	-	The average of month-on-month inflation over the last twelve consecutive months.
Banking System	-	The Central Bank as well as commercial banks and nonbank financial institutions that operate under the Banking Act.
Cash Ratio	-	This is the ratio of the cash commercial banks and NBFIs hold with CBK to the deposits the public hold with the institutions. The institutions are required by the Bank to hold with CBK on a fortnightly basis an average of 18% and at no time less than 15% of the deposits the public hold with them.
Domestic Money Market	-	A market in which money is borrowed and lent for a short period among banking institutions.
Excess Liquidity	-	Liquidity over and above that required to support growth in production of goods and services. It can also mean liquidity over and above cash required for cash ratio purposes.
Financial System	-	Banking system and all other institutions that provide financial services.
Foreign Exchange Market	-	A market network in which foreign currencies such the US dollar, the Pound sterling, the Japanese yen and the Deutschemark are transacted among banks and between banks and the general public.

Government borrowing from CBK -	All the lending the Bank has made to the Government in forms of overdraft, Treasury bills, and Treasury bonds.
Inflation -	Change in the general level of prices, normally expressed on a one year basis as a percent of the previous period's price level.
Liquidity -	Means for instantly paying for goods and services.
Monetary Policy -	Objectives and actions relating to the management of the money supply in the economy.
Money Supply -	Currency, that is notes and coin, held by the public outside the commercial banks and NBFIs plus all deposits the public hold in the institutions.
Month-on-Month inflation -	Inflation over a period of twelve months.
Open Market Operations (OMO) -	An arrangement for sales and purchases of Government and other eligible securities such as treasury bills by the Central Bank in the money market for purposes of managing the money supply.
Other Public Sector -	Local Government, public and parastatal entities.
Pay Master General Account -	This account, well known as the PMG, is the main account at the Central Bank into which all Government revenues are deposited and out of which all payments are made.

Term		Definition
Price Stability	-	A condition in which the general price level remains unchanged or changes in relatively small predictable magnitudes.
Primary Market	-	A market in which initial issue of financial instruments is made.
Private Sector	-	The whole economy excluding Central and Local Governments.
Repurchase Agreement (REPOs)	-	An arrangement for buying and selling securities mainly among banks including the Central Bank, in which the seller undertakes to buy back the instrument on a specific date.
Three-months annualised Inflation	-	The month-on-month inflation that would be generated if inflation in the last three months were maintained throughout the year.
Treasury Bills	-	A short term borrowing instrument issued by the Treasury through the Central Bank as a fiscal agent of the Government. It is currently available in maturities of 28, 91 and 182 days.
Treasury Bonds	-	A medium term borrowing instrument issued by the Treasury through the Central Bank as a fiscal agent of the Government. It is currently available as a one year floating interest rate bond.
Underlying Inflation	-	Change in the general price level that excludes changes in prices of food and any other once-and-for all price change. Underlying inflation essentially reflects the influence of monetary expansion on prices.