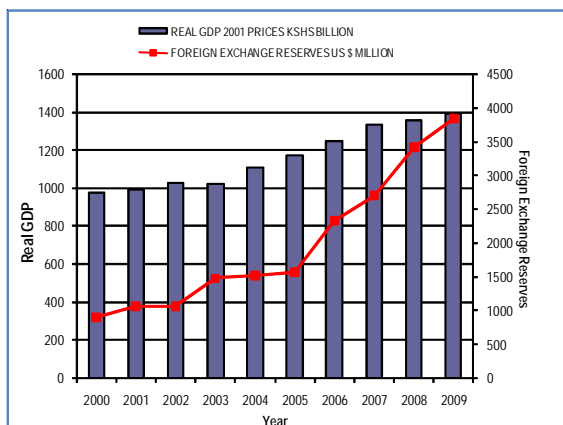




CENTRAL BANK OF KENYA

Monetary Policy Statement

Issued under the Central Bank of Kenya Act, Cap 491



JUNE 2010

Letter of Transmittal

Dear Honourable Minister,

I have the pleasure of forwarding to you the 26th 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 outlines details of the monetary policy stance for June to December 2010. The Statement also reviews the implementation of monetary policy from January to June 2010.



Prof. Njuguna Ndung'u, CBS
Governor

MONETARY POLICY STATEMENT

JUNE 2010

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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 target level given by the Minister for Finance, of 5 percent. Achieving and maintaining a low and stable inflation rate 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 through a stable macroeconomic environment for sustainable economic growth.

The Bank's monetary policy is thus designed to support the 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

CBK pursues its monetary policy objectives through the following instruments:

- **Open Market Operations (OMO):** Refers to actions by the CBK to vary the amount of commercial banks' deposits held with it in relation to the statutory requirement. Change in these deposits impact on the rate of interest at which credit is provided which in turn affects the growth of deposits held with commercial banks (which is the dominant component of money supply) and ultimately domestic prices. To achieve the desired level of money supply, OMO is conducted using the following instruments:
 - **Repurchase Agreements (Repos)** – Which consist of the sale of eligible securities by the CBK to reduce or augment commercial banks excess 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, mostly Government securities. Horizontal repos help banks to overcome the problem of credit limits, thus promoting efficient management of interbank liquidity.
 - **Term Auction Deposits** – 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 days period after which they revert back to the respective commercial bank on maturity of the transfer agreement.
- **Central Bank Rate (CBR):** This is the rate of interest that the CBK charges on loans to commercial banks. 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 increases. 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 and signals. 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 the CBR.
- **Required Reserves (RR):** The Required Reserve is the proportion of a commercial bank's deposit liability which is held at the CBK in accordance with the law. These deposits are held in the Cash Reserve Ratio (CRR) Account. The CBK uses the RR as a liquidity management tool. A reduction in the CRR releases liquidity thus enhancing the capacity of commercial banks to expand credit.
- **Foreign Exchange Market Operations:** The CBK can also inject or withdraw liquidity into or from the banking system through foreign exchange transactions. A sale, through auction, of foreign exchange to banks 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 driven by three objectives. The first is intervention in order to prevent excessive volatility in the rate at which the Kenya shilling exchanges against other foreign currencies. The second objective is to build foreign exchange reserves to service official debt and meet other Government external obligations. Finally, accumulation of foreign exchange reserves provides a buffer to protect the market in case of international financial crises. In this regard, the law requires the Bank to endeavour to hold foreign exchange reserves equivalent to a minimum of four months of imports averaged over the last three years. The credibility of the Kenya shilling as an internationally respectable currency ensures that correspondent banks provide trade credit at convenient terms.
- **Licensing and Supervision of Financial Institutions:** The Bank uses the licensing and supervision tools to ensure the health and efficiency of the banking system.
- **Communication Strategy:** The increasing use of the media for communications 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 interest rates, exchange rates and results of auctions of government securities as well as on the monetary policy stance.

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 to June 2011. It focuses particularly on the period July to December 2010. It also highlights the outcome of the policy stance adopted in the first half of 2010.

The economy showed recovery from the international financial crises and the drought conditions witnessed in 2009 to register a strong performance in the first and second quarters of 2010. Economic recovery was driven mainly by a stable macroeconomic environment with both low inflation and a downward review of interest rates by most commercial banks which stimulated credit expansion to key sectors of the economy. The impact on the economy of the Economic Stimulus Package which was implemented throughout the fiscal year 2009/10 was also positive.

An important development in the general area of monetary policy formulation and implementation has been the release of the new inflation data derived from the 2005/06 Integrated Household Budget Survey. The new CPI basket has de-emphasized the vulnerability to fluctuations in food prices, and also ensured that Kenya's inflation measure is comparable to that of its trading partners.

Price stability remains the main objective of the CBK and therefore the Bank continues to formulate and implement monetary policy aimed at ensuring that demand driven inflation does not pose a threat. Similarly, the Bank continues to explore and propose the use of appropriate monetary policy tools to support economic growth through affordable credit to the private sector and, consequently, address any supply side inflation. In the event of any imported inflation through exchange rate volatility, this would be addressed through the use of the Bank's unencumbered foreign exchange reserves.

The effective transmission of monetary policy signals to commercial banks lending interest rates have been hampered by structural factors. The Bank will therefore continue to explore ways of improving the transmission of the signal to other interest rates in the economy including structural changes aimed at enhancing financial sector efficiency and interest rate adjustments. As first steps towards solving these problems, the Central Bank will work with other institutions to identify alternative dispute resolution models, and by making data on cost of borrowing by individual banks more easily available. However, while these efforts are going on, the effects of which may take some time to be felt, banks have both the duty and scope to see how lending rates can be adjusted downwards, spreads reduced, and services expanded to enhance financial inclusion.

1. Introduction

This Monetary Policy Statement (MPS) presents the policy guidelines for the Central Bank of Kenya (CBK) over the period July to December 2010 and broad targets for the six months from January to June 2011. It also provides an analysis of the policy outcomes in the first half of 2010.

The economy witnessed a notable recovery in the first half of 2010. The effects of the global financial crisis and drought conditions witnessed in the second half of 2009 had dampened the recovery of the economy from the impact of the post election crisis in December 2007. The CBK has enhanced its support to the country's economic growth by formulating and implementing policies aimed at expanding credit growth to key sectors of the economy.

The challenges of the current framework for implementing monetary policy through reserve money management have increased the Bank's efforts to explore other frameworks involving targeting of alternative monetary aggregates. The Bank's participation in the foreign exchange market will be to build and maintain foreign exchange reserves at or above what is needed to cover four months of average imports, and buy foreign exchange to meet the Government's external obligations. The reserves are also used to intervene in the foreign exchange market to stabilise the value of the Kenya shilling when it is excessively volatile.

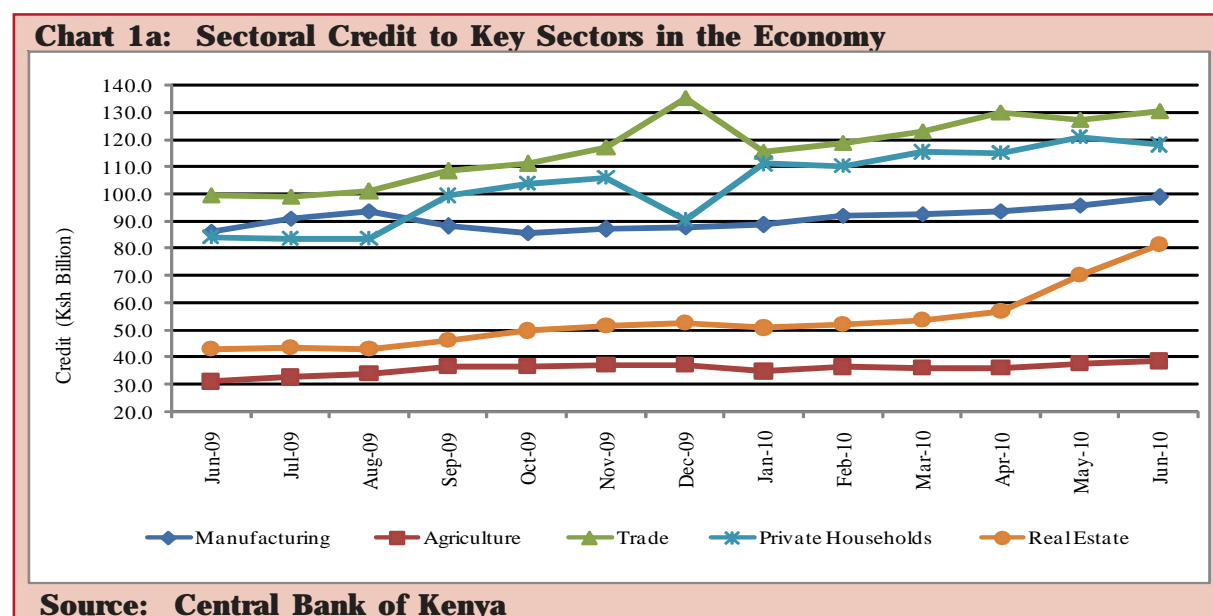
In order to address the slow transmission of monetary policy signals to the real sector, the Bank will continue its interactions with stakeholders and the release of relevant data so as to address the still unacceptably high lending rates that, in part, are a consequence of the non-competitive character of the banking industry. There are also structural difficulties in enforcing contracts, inappropriate definitions of property rights, and lack of dispute resolution mechanisms. This has hindered the creation of an effective and competitive financial system. This will also improve the transparency of monetary policy formulation and implementation by the Bank. An outcome of this should be to improve access to financial services.

Following the introduction of the new CPI measure, the Bank will work with the Kenya National Bureau of Statistics (KNBS) on the production of a non-tradable CPI index. Other countries have found that this is the relevant CPI measure that is expected to reflect monetary policy actions and it responds appropriately to monetary policy signals in the domestic economy.

2. Actions and Outcomes of Policy Proposals in the 25th Monetary Policy Statement

a. Credit to Private Sector

The main policy of the Monetary Policy Committee (MPC) in the first half of 2010 was to facilitate the financial sector's expansion of credit to key sectors of the economy in order to support economic growth. During its meeting on 23rd March, 2010, the Monetary Policy Committee lowered the CBR by 25 basis points to 6.75 percent in order to stimulate an increase in private sector credit necessary to sustain the growth momentum. It noted with satisfaction that the overall economic activity increased in both the first and second quarters of 2010 with private sector credit growing by Kshs. 20.9 billion and Kshs. 40.8 billion, respectively, in the two quarters. In particular, demand for credit increased with improved weather conditions which had a positive impact on agricultural production and manufacturing. Credit to the key sectors of the economy – agriculture, trade, real estate and manufacturing sectors – maintained an upward trend between January and June 2010 (Chart 1a).



The policies formulated by the MPC in the first half of 2010 to support growth through credit expansion were informed by the positive correlation between sectoral growth in private sector credit and real GDP growth in the particular sectors (Chart 1b). Specifically, it can be seen that sectors that drive growth should also demand more credit. Their share of credit in the period under review increased significantly.

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



Source: Central Bank of Kenya

b. Interest Rates and Liquidity

The signals which monetary policy transmitted to the economy were successful in that they led to a decline in short term interest rates comprising of the interbank, repo and Treasury bill rates. Commercial banks absorbed this information, as can be seen through the decline in the horizontal repo and commercial banks' lending rates. However, the decline in commercial banks' lending rates was slow and almost insignificant as the average lending rates declined from 14.78 percent in October 2009 to 14.39 percent in April 2010.

During the six months to June 2010, uptake of Horizontal repos as an instrument for redistributing liquidity among banks increased. The volume transacted through the instrument increased from Kshs. 2.6 billion in December 2009 to Kshs. 6.0 billion in June 2010. The instrument became more active both in terms of the variety of tenors at which they have traded as well as an increasing cross-section of banks participating. Usage of the instrument was more prevalent during temporary build-ups in Government deposits at the CBK which created shortfalls in liquidity in the interbank market. However, the Bank is exploring modalities to enhance uptake of the instrument as it still accounts for a very small proportion of interbank transactions.

c. MPC Market Surveys and Stakeholder Forums

Bi-monthly MPC Market Surveys were conducted to obtain market expectations on the performance of the economy. The results of these surveys were an important input in the MPC decision process. The MPC also held meetings with Chief Executive Officers (CEOs) of commercial banks in February, April and June 2010 so as to improve the perception and interpretation of the signalling process of its decisions but more importantly, to explain the background information that led to monetary policy decisions and also the Bank's expectations from commercial banks. The meetings provided a forum for the MPC to explain to the CEOs the background to its decisions as well as obtain feedback from the commercial banks.

d. Auctions of Government Securities

The Bank continued with efforts to improve the efficiency in the Treasury bill auctions, as well as to lengthen the maturity profile of domestic debt. In particular, a new auction framework was put in place in February 2010 to make the auction of government securities more efficient and transparent to stakeholders. This also ensured that government debt was procured at the lowest cost. It would also encourage and improve competitive bidding by investors. In the new auction method, the cut-off rate is defined as the weighted average of the accepted bids.

The first 25-year Treasury bond was introduced in June 2010 to lengthen the maturity profile of domestic debt as well as to accommodate the interest of long term investors such as pension funds and insurance companies. The uptake of this bond was encouraging and was reflected very well in the yield curve.

e. Banking Sector Developments

Significant efforts aimed at lowering transaction costs in the financial system as well as enhancing financial access were made between January and June 2010. Three approaches have been adopted. The first was creation of new institutions, second, creation of new initiatives, and finally, improvement of cash in transit services for commercial banks.

The first credit reference bureau for information sharing was licensed in February 2010 to offer banking sector credit information sharing services. This will improve credit risk management as banks will now be able to submit credit information and request for, and obtain, credit references on potential or existing customers. Borrowers would also use their credit information history as a form of collateral in negotiating for cheaper loans. This will help change and transform the collateral technology to support both the banked and unbanked in Kenya. A second set of institutions, licensed in April 2010, is the deposit

taking microfinance institutions to undertake community as well as nationwide deposit taking microfinance business. This will improve financial reach of the microfinance sector through mobilisation and intermediation of public deposits at micro levels.

The second set revolves around new initiatives to reduce the costs of rolling out branch networks to the unbanked and under-banked. This is through the agent banking model. Agent banking was introduced in May 2010 following issuance of guidelines by the CBK. Under this model, financial institutions licensed by CBK are permitted to contract third parties to provide certain banking services on their behalf. Both agent banking and the innovation of M-KESHO in May 2010 have improved access to financial services by Kenya's bankable population.

The final case in this period is to improve the cash in transit services and reduce costs of banks accessing cash from the Central Bank. Through a partnership with Kenya Bankers Association, Currency Centres have been introduced. The first phase was to see Currency Centres operational in Nyeri, Nakuru and Meru. The Nyeri Currency Centre, located at the Kenya Commercial Bank branch, is already operational and is serving 88 branches of commercial banks in the region.

f. Impact of Fiscal Developments on Liquidity

The Bank enhanced reverse repo operations in April and May 2010 to address interbank liquidity tightness occasioned by accumulation of Government deposits at CBK mainly from taxes and reduced expenditures. With an appropriate implementation framework for disbursement of funds under the Treasury's Fiscal Stimulus Package in place, absorption of funds improved after March 2010. Use of reverse repos and horizontal repos dampened the increase in interbank rates following liquidity shortages created by the build up in Government deposits at the CBK.

The fiscal year 2010/11 Government budget read in June 2010 was heavily inclined towards infrastructure development with 11 percent of the entire budget being allocated to the development vote. Notably, domestic borrowing requirement in the 2010/11 budget at Kshs 105.3 billion (3.8 percent of GDP) is lower than the Kshs 126.0 billion (5.1 percent of GDP) in the fiscal year 2009/10 revised budget suggesting less pressure on domestic interest rates. The MPC proposes to work closely with the Ministry of Finance on the time-based borrowing targets which should neither threaten any inflationary monetary expansion nor crowd out the private sector by bidding up interest rates. Finally, of importance is the continued support of the infrastructure bond programme to enhance the Government's effort to finance domestic infrastructure.

g. Inflation

The KNBS successfully completed work on and launched, in February 2010, the new CPI index based using the geometric mean methodology applied to the new, more relevant basket of goods. The geometric mean used in this new index is the international best practice being recommended by the International Labour Organisation (ILO) and has been used on the old consumer basket since October 2008. The effect of the new measure has been to reflect the true inflation rate for Kenya that is also in line with that of its neighbours and trading partners like South Africa. The new measure reduced the vulnerability to volatile prices on some food products and the price instability was moderated. Inflation levels have generally remained below 5 percent target level in the review period.

h. Monetary Programme

The MPC focussed its efforts to attain the inflation target and support the Government's economic growth target by targeting money supply in its monetary programme. As shown in Table 1, the 25th MPS had envisaged reserve money (RM) and broad money supply (M3) to increase from Kshs 174.5 billion and Kshs 1,036.4 billion, respectively, in December 2009 to Kshs 181.4 billion and Kshs 1,106.6 billion in June 2010. This planned growth in money supply during the period was considered adequate to support economic growth through expansion of credit to private sector. The programmed monetary expansion was not expected to affect inflation as the inflation process has generally been driven by supply side factors but importantly, these supply side factors, have been short run in nature.

Overall, broad money supply, M3, remained within the set target as the monetary aggregate increased from Kshs 1,045.7 billion in December 2009 to Kshs 1,198.9 billion in June 2010. Credit to private sector increased from Kshs 738.3 billion in December 2009 to 799.2 billion in June 2010, which was 7.00 percent below target.

Table 1: Actual and Targeted Growth in Key Monetary Aggregates

	Dec-09	Jan-10	Feb-10	Mar-10	Apr-10	May-10	Jun-10
Actual Broad Money,M3 (Ksh Billion)	1,045.7	1,067.3	1,084.3	1,107.9	1,122.8	1,159.6	1,198.9
Target Broad Money,M3 (Ksh Billion)	1,036.4	1,048.0	1,059.6	1,071.2	1,080.3	1,093.3	1,106.6
Actual Reserve Money,RM (Ksh Billion)	182.0	179.5	175.3	177.5	177.5	194.1	210.3
Target Reserve Money,RM (Ksh Billion)	174.5	173.4	175.2	175.9	177.6	179.4	181.4
Actual NFA of CBK (Ksh Billion)	222.8	220.5	216.8	218.1	226.0	230.2	242.9
Target NFA of CBK (Ksh Billion)	232.9	238.0	242.9	247.9	224.2	231.4	239.2
Actual Credit to private sector (Ksh Billion)	738.3	747.8	754.0	759.3	769.5	787.9	799.2
Target Credit to Private sector (Ksh Billion)	806.4	721.4	730.1	815.6	758.9	771.9	859.4
Memorandum Items							
12-month growth in actual RM (Percent)	9.1	17.7	15.4	14.2	16.1	21.0	32.1
12-month growth in actual M3 (Percent)	16.0	19.2	20.5	22.3	20.9	24.9	26.3
12-month growth in actual credit to private sector (Percent)	13.9	15.0	14.0	14.4	15.7	17.3	16.8

Source: Central Bank of Kenya

3. Financial and Economic Trends and Events (January – June 2010)

a. International Economic Environment

The July 2010 Update of the April 2010 IMF's World Economic Outlook shows that global real GDP growth declined from 3.0 percent in 2008 to -0.6 percent in 2009 (Table 2). The performance of the global economy in 2009 was attributed largely to contractions of advanced economies and slowdown in growth rates of emerging and developing economies due to effects of the financial crisis in 2008. The contraction in demand for exports from the developed countries had a major impact on some developing economies. Developing Asia and sub-Saharan Africa grew by 6.9 percent and 2.2 percent, respectively, in 2009 down from 7.7 percent and 5.6 percent, in 2008. Similarly, growth in the East African Community (EAC) countries excluding Kenya slowed down from 7.7 percent in 2008 to 5.1 percent in 2009. The volcanic eruption in Iceland in April 2010 and Greek Crisis which started in December 2009 have slowed down growth of the global economy in 2010.

Slowdown in demand and increase in excess capacity in the advanced economies resulted in slowdown in inflation from 3.4 percent in 2008 to 0.1 percent in 2009. Similarly, inflation for emerging and developing economies declined from 9.2 percent to 5.2 percent during the period. Consequently, world inflation decreased from 6.0 percent to 2.7 percent in the period.

Table 2: Performance of the Global Economy

	Real GDP Growth (%)		Inflation (%)	
	2008	2009	2008	2009
World	3.0	-0.6	6.3	2.7
Advanced Economies	0.5	-3.2	3.4	0.1
United States	0.4	-2.4	3.8	-0.3
Japan	-1.2	-5.2	1.4	-1.4
Euro Area	0.6	-4.1	3.3	0.3
United Kingdom	0.5	-4.9	3.6	2.2
Other Advanced economies	1.7	-1.2	3.8	1.5
Emerging and developing economies	6.1	2.5	9.2	5.2
Sub-Sahara Africa	5.6	2.2	11.6	10.6
East African Community (Excl. Kenya)	7.9	5.1	14.4	12.0
Developing Asia	7.7	6.9	7.4	3.1
China	9.6	9.1	5.9	-0.1
India	6.4	5.7	8.3	10.9
Middle East and North Africa	5.1	2.4	13.5	6.6

Source: World Economic Outlook (April/July 2010)

The impact of the slowdown in global economy on the domestic economy was reflected in the reduction in demand for Kenya's exports from Kshs 5,040 million in 2008 to Kshs 4,502 million

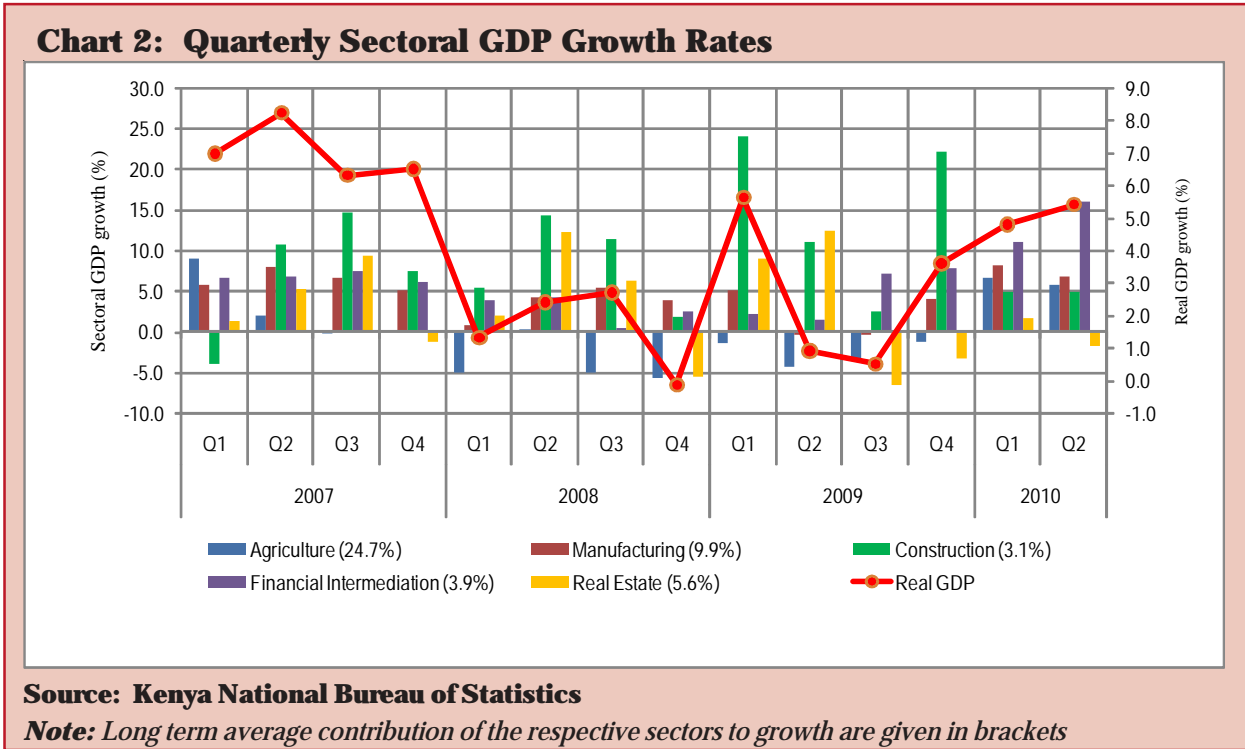
in 2009. Other sectors that were adversely affected by the global financial crises included tourism and activity at the stock market. The MPC has, since 2008, pursued monetary policy directed at supporting economic recovery to the pre-crisis levels. The MPC will continue to monitor developments in the global economy and their likely impact on the economy as we move from a fragile to a strong recovery of economic activity.

b. Domestic Economic Environment

i. Economic Growth

Data from the KNBS shows that the economy grew by 5.4 percent in the second quarter of 2010 relative to the second quarter in 2009, and up from 4.8 percent in the first quarter of 2010 (Chart 2). The improved performance of the economy in the second quarter of 2010 was driven mainly by agriculture, manufacturing, construction, and financial intermediation sectors, which accounted for 60 percent of the growth. These sectors grew by 5.8 percent, 6.8 percent, 18 percent, and 16 percent, respectively in the second quarter of 2010.

This performance was realised in an environment of macroeconomic stability characterised by low inflation and declining interest rates, improved production of cheaper electricity, and improved agricultural production. Agriculture contributing about 24.7 percent to GDP is expected to be supported by reliable rainfall across the country and low cost of credit.



ii. Confidence in the Economy

Confidence in the Kenyan economy remained high in the period under review. As shown in Table 3, diaspora remittances increased from USD 45.1 million in January 2010 to USD 56.3 million in June 2010 and have averaged over USD 50.0 million per month. The NSE index ranged between 3,565.3 and 4,339.3 in the period. The increased participation by foreign investors at the Nairobi Stock Exchange increased the activity at the bourse. The number of tourist arrivals through Nairobi and Mombasa was affected by cancellations of travel due to the volcanic eruption in Iceland in April 2010. However, the trend in tourist arrivals was upwards in May and June 2010. The monthly cement production, which is an important proxy for economic activity in the country, increased significantly from 285,923 metric tonnes in January 2010 to 339,948 metric tonnes in June 2010.

In addition, the ratio of net non-performing loans to total loans has been on downward trend indicating a declining credit risk. The declining credit risk will be accelerated with the operationalisation of the credit reference bureau in July 2010. Further, the MPC Market Surveys conducted in the period as well as reports from renowned research institutions in the country all pointed to increasing investor confidence.

Table 3: Indicators of Confidence in the Economy

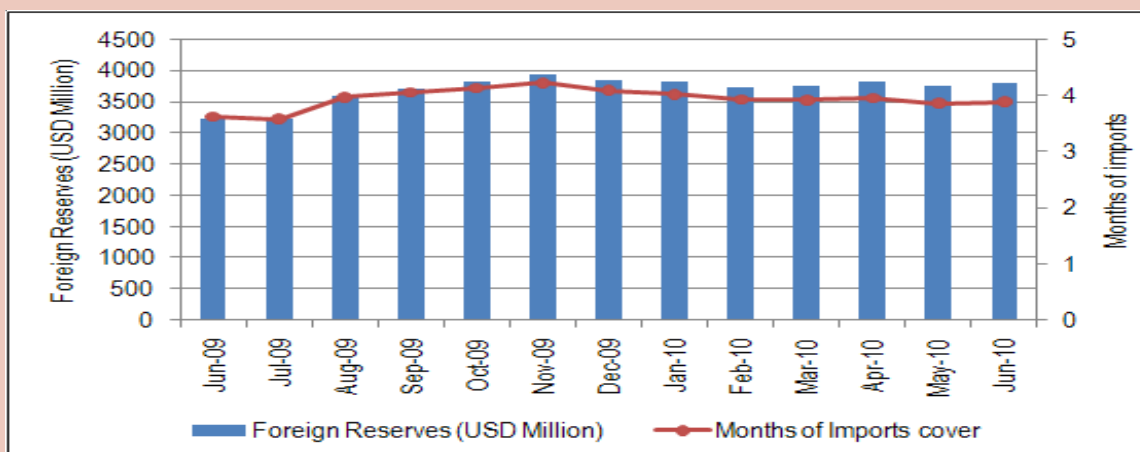
	Jun-09	Dec-09	Jan-10	Feb-10	Mar-10	Apr-10	May-10	Jun-10
Emigrant Remittances (USD Million)	46.3	56.3	45.1	46.4	52.3	52.7	51.2	52.5
NSE Index (Jan 1966 = 100)	3,294.6	3,247.4	3,565.3	3,629.4	4,072.9	4,233.2	4,241.8	4,339.3
Cement Production (Metric Tonnes)	282,016.0	292,769.0	285,923.0	262,261.0	294,765.0	290,477.0	291,258.0	339,948.0
Number of Tourist Arrivals	69,059.0	99,261.0	93,314.0	91,954.0	86,668.0	63,755.0	67,817.0	79,472.0
Net NPLs/Total Loans ratio	2.91	2.90	2.93	2.67	2.56	2.55	2.48	2.27

Source: Kenya National Bureau of statistics & CBK

iii. Foreign Exchange Market

As depicted in Chart 3, official foreign exchange reserves of the CBK decreased slightly from USD 3,847 million (4.1 months of imports cover) in December 2009 to USD 3,799 million (3.9 months of imports cover) in June 2010. The drawdown in reserves during the period was on account of revaluation losses on the Euro and Sterling Pound following weakening of the two currencies against the US dollar due to impact of the financial crisis on the Euro Zone. However, the official foreign exchange reserves remained within the range of the statutory requirement of 4.0 months of imports cover between February and June 2010.

Chart 3: Foreign Exchange Reserves



Source: Central Bank of Kenya

iv. Exchange Rates

The exchange rate of the Kenya Shilling against major currencies had mixed trends between December 2009 and June 2010 (Chart 4a). Following the Greek Crisis, the Euro and Sterling Pound weakened significantly against US dollar which was a safe haven currency during the crisis. Consequently, the Shilling strengthened significantly against the Euro and Sterling Pound, but weakened against the US dollar. However, following increased global demand for US dollars in June 2010, the Shilling depreciated against major international currencies to exchange at Kshs 81.0, Kshs 98.9, Kshs 119.6 and Kshs 89.2 per US dollar, Euro, Sterling Pound, and 100 Japanese Yen, respectively. However, regionally, the Kenya Shilling strengthened against the Uganda Shilling but remained stable against the Tanzania Shilling during the period (Chart 4b).

Chart 4a: Trends in the Kenya Shilling Exchange Rate

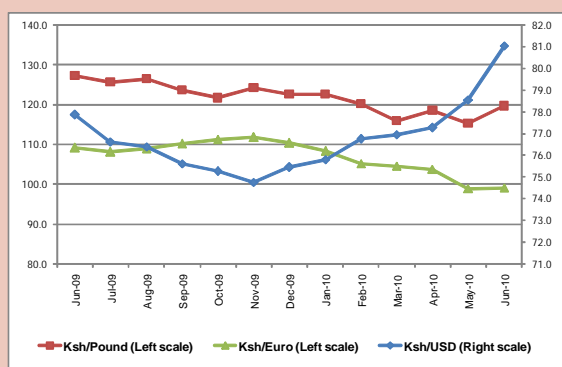
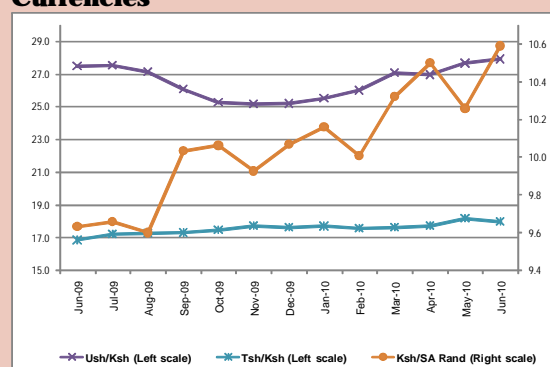


Chart 4b: Trends in the Kenya Shilling Exchange Rate against Regional Currencies

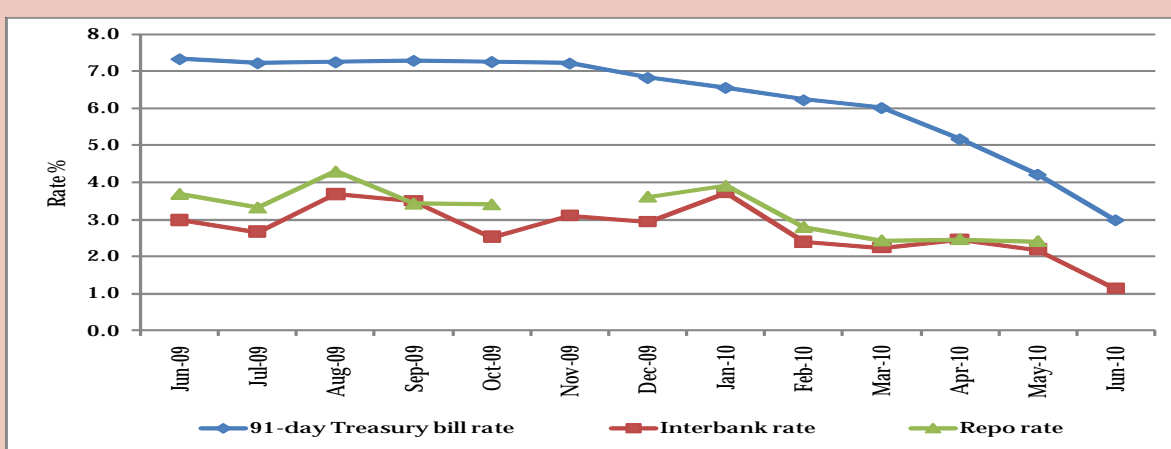


Source: Central Bank of Kenya

v. Interest Rates

As shown in Chart 5a, short term interest rates – interbank, repo and 91-day Treasury bill rates – responded to monetary policy signals by declining between December 2009 and June 2010. The reduction in the CBR to 6.75 percent in March 2010 was successful in bringing down the short term interest rates significantly in the period. Reverse repos were used extensively between December 2009 and May 2010 with average interest rates ranging between 3.9 percent and 2.4 percent in the period. The average interbank and 91-day Treasury bill rates declined from 2.9 percent and 6.8 percent, respectively, in December 2009 to 1.1 percent and 3.0 percent, respectively, in June 2010.

Chart 5a: Trends in Short Term Interest Rates



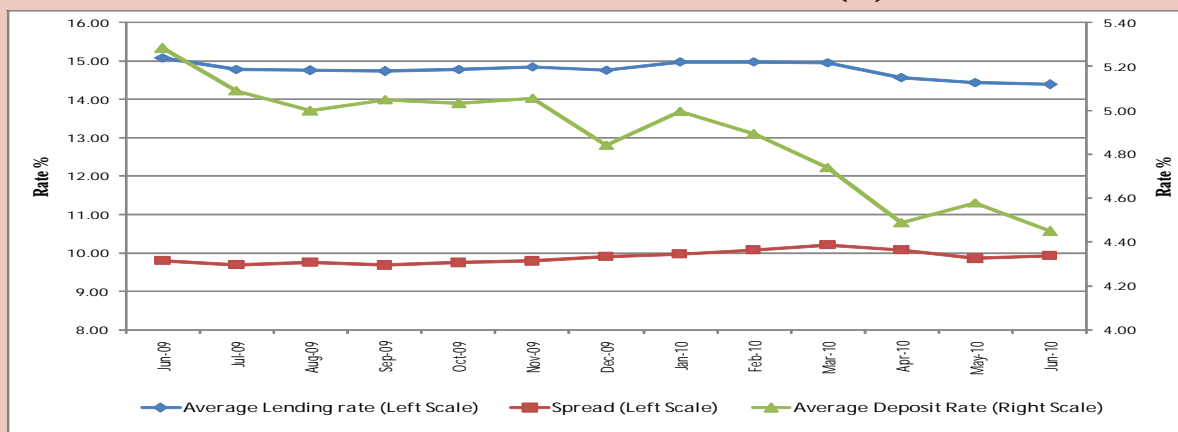
Source: Central Bank of Kenya

The average commercial banks deposit rate declined from 4.8 percent to 4.5 percent while the average lending rate declined from 14.8 percent to 14.4 percent between December 2009 and June 2010 (Chart 5b). However, the interest rate spread remained virtually unchanged at 9.9 percent during the period following proportionate reductions in the lending and deposit rates.

The transmission of the signals from short term interest rates to commercial banks lending rates is slow because it works through commercial banks' portfolio in the intermediation process but the CBK does believe that the speed is also hampered by structural factors in the financial sector.

Results of MPC Market Surveys conducted during the period showed that cost of funds, Treasury bill rates and inflation were the main determinants of the high interest rate spreads in banks. However, these factors have been declining although this has not affected the spreads.

Chart 5b: Trends in Commercial Bank Interest Rates (%)

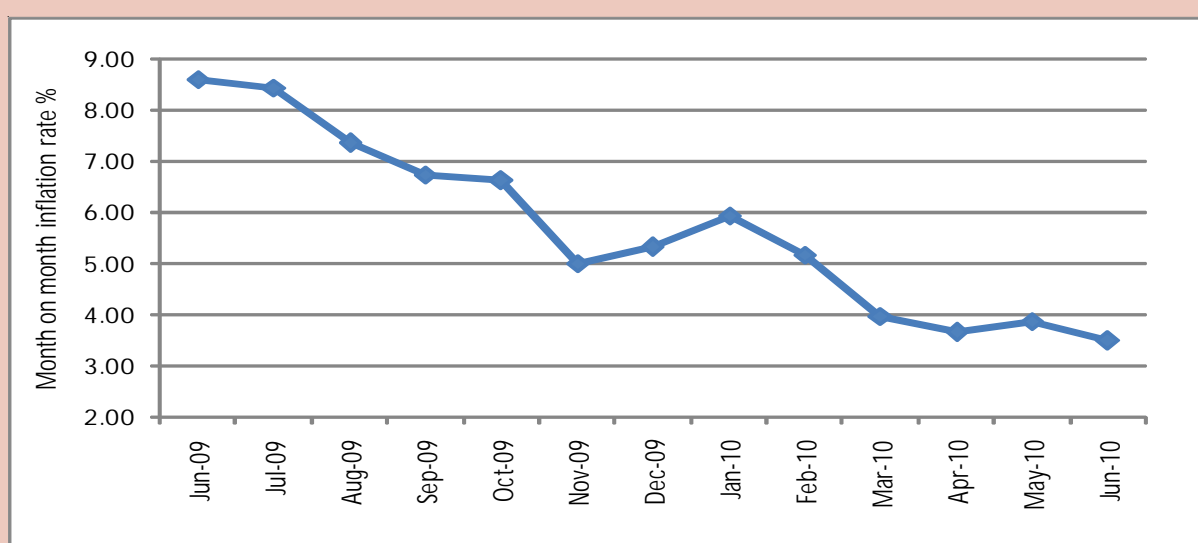


Source: Central Bank of Kenya

vi. Inflation

Overall inflation rates, based on the new CPI basket of goods, declined between December 2009 and June 2010 (Chart 6). In particular, overall inflation declined from 5.3 percent in December 2009 to 3.5 percent in June 2010. The decline in the inflation levels was attributed to easing of food prices following a return of the rains as well as a decline in oil prices which resulted in lower fuel prices. Considering that money supply over this period had grown by 14.7 percent, the decline in inflation suggests that the credit to private sector was channelled to economic activity with growth potential and contributed to growth rather than to inflation.

Chart 6: Trends in Inflation (Geometric Mean CPI)



Source: Kenya National Bureau of Statistics

vii. Fiscal and Public Debt Developments

During the fiscal year 2009/10, Central Government budgetary operations resulted in a deficit-to-GDP ratio of 6.2 percent on commitment basis compared with 4.6 percent in 2008/09. Despite the increase, the budget deficit during the period was within the programmed target of 6.7 percent of GDP on commitment basis. Similarly, public and publicly guaranteed debt increased from 44.0 percent of GDP in June 2009 to 45.4 percent of GDP in December 2010, and further to 47.1 percent in June 2010. The public debt ratios are consistent with the thresholds set in the current Medium Term Expenditure Framework, but this sudden surge was attributed to the Economic Stimulus in 2009/10 Budget to support the growth capacity of the economy after it was hit by various shocks in the fiscal year 2008/09.

4. Outlook for the Monetary Policy Environment (July - December 2010)

a. Global Economy

The IMF projects the global economy to recover strongly to grow by 4.6 percent and 4.3 percent in 2010 and 2011, respectively (Table 4). Growth is expected to be driven mainly by increased industrial production and trade, and improved consumer confidence. Growth in 2010 is projected at around 6.8 percent in the emerging and developing countries, and 2.6 percent in the advanced countries. In particular, sub-Saharan Africa and East African Countries (excluding Kenya) are forecast to grow at 5.0 percent and 5.3 percent, respectively, in 2010. The expected adoption of the East African Community Common Market Protocol in July 2010 will boost trade in the region.

The inflation level for the world economy is projected to fall to 3.9 percent in 2010 and 3.2 percent in 2011. The low levels of capacity utilisation and well anchored inflation expectations should contain inflation in developed countries. However, in emerging and developing economies, inflation is expected to increase to 6.2 percent in 2010 before falling to 5.0 percent in 2011.

Table 4: Outlook for Real GDP Growth and Inflation in 2010 and 2011 (%)

	Real GDP		Inflation	
	2010 (Projection)	2011 (Projection)	2010 (Projection)	2011 (Projection)
World	4.6	4.3	3.9	3.2
Advanced Economies	2.6	2.4	1.5	1.3
United States	3.3	2.9	2.1	1.7
Japan	2.4	1.8	-1.4	-0.5
Euro Area	1.0	1.3	1.1	1.3
United Kingdom	1.2	2.1	2.7	1.6
Other Advanced economies	4.6	3.7	2.3	2.2
Emerging and developing economies	6.8	6.4	6.2	5.0
Sub-Sahara Africa	5.0	5.9	8.0	6.9
East African Community (Excl. Kenya)	5.3	5.1	8.2	6.6
Developing Asia	9.2	8.7	5.9	3.7
China	10.5	9.6	3.1	2.4
India	9.4	8.4	13.2	5.5
Middle East and North Africa	4.5	4.8	6.5	6.4

Source: World Economic Outlook (April and July 2010)

a. Domestic Economy

i. Economic Growth

The projected growth in the global economy in 2010 and 2011 is expected to increase the demand for Kenya's exports as well as the number of tourist arrivals in the country. Results of the MPC Market Perception Surveys on the performance of the economy conducted between January and May 2010 show increasing confidence in the attainment of the Government's economic growth target of between 4.5–5 percent in 2010. In particular, respondents indicated that there would be increased levels of foreign direct investment with the expected adoption of the New Constitution. In addition, imports of capital equipment and emigrant remittances, together with the upturn in the Nairobi Stock Exchange activity, all continue to support a positive growth forecast.

ii. Exchange rates

The exchange rate of the Kenya Shilling against major currencies is expected to remain stable in the second half of 2010 on account of an expected increase in foreign exchange inflows from tourism, recovery of the global economy, agriculture exports (horticulture, tea, and coffee), diaspora remittances, and increase in foreign investor confidence at the NSE. However, high oil prices, developments in the Euro zone economies following the Greek debt crisis, and recovery of the US economy pose a risk on the strength of the Kenya Shilling. The impact of the exchange rate movements on official reserves will depend on the currency composition of the reserves as the economy moves forward.

iii. Interest rates

Interest rates are expected to remain stable in the second half of 2010 on account of economic recovery which is expected to increase demand and competition for credit, lower inflation rates, and the high liquidity in market which is expected to result in a decline in the short term interest rates and interest rates on Government securities. On the other hand, banking the unbanked has increased liquidity in the banking sector significantly. This shows that upward pressure on interest rates is unlikely.

iv. Inflation

Inflation is expected to remain stable in the second half of 2010 on account of increased agricultural production following good rains, increased flow of goods and services in the EAC region with the adoption of the EAC Common Market Protocol, and projections for stable world oil prices. The CBK's perceptions survey revealed that the business community and financial sector were not anticipating significant changes in inflation in 2010. Similarly, the interest rates structure and the business community seem to have anchored the inflationary expectations at low levels.

v. Fiscal Policy

The ongoing expenditure on infrastructural projects will enhance employment and consumer expenditure to stimulate economic growth. In addition, the fiscal year 2010/11 budget has provided for expenses on implementation of the new constitution. Tax revenue collection between July and December 2010 is expected to improve with the continuing improvement in economic performance. Furthermore, the current domestic borrowing programme is not a major threat to interest rates and debt sustainability. The borrowing programme for the financial year 2010/11 will be agreed on and incorporated in the monetary programme.

5. Future Directions of Monetary Policy (July-December 2010)

The direction of monetary policy during the last six months of 2010 will be concentrated on three areas. The first will be setting targets that are compatible with the responsibilities of maintaining a low and stable inflation, encouraging growth and ensuring the long term sustainability of public debt. The second relates to enhancing the variety of modes of extending banking services within the economy including payment systems, while the third is a continuation with the medium term research agenda.

5.1 Monetary Programme and Foreign Exchange Reserves

The monetary targets for 2010/11 are based on the assumptions in the June 2010/11 Budget Strategy Paper which are presented in Annexes 1 and 2. The monetary targets for the fiscal year 2010/11 are presented in Table 5a and Table 5b.

In particular, broad money supply, M3, is set to grow by 25.7 percent by September 2010, and 22.6 percent by December 2010. Reserve money is planned to expand by 14.0 percent in September 2010 and by 11.3 percent in December 2010. This is expected to enable the Bank achieve the policy objective of bringing inflation to the target of 5 percent and to anchor inflation expectations. The monetary policy stance will stabilise short term interest rates, therefore, credit to the private sector is projected to grow by between 17.9 percent and 21.3 percent between July and December 2010.

Table 5a: Monetary Targets for the First Half of 2010/11

	Jul-10 Targ.	Aug-10 Targ.	Sep-10 Targ.	Oct-10 Targ.	Nov-10 Targ.	Dec-10 Targ.
Broad Money, M3 (Ksh Billion)	1,212.7	1,226.4	1,240.2	1,253.9	1,267.7	1,281.6
Reserve Money, RM (Ksh Billion)	187.2	182.8	186.4	189.5	195.6	202.6
NFA of Central Bank of Kenya (Ksh Billion)	246.2	250.2	254.0	258.1	261.9	266.0
12-month growth in RM (Percent)	18.5	16.5	14.0	15.9	9.8	11.3
12-month growth in M3 (Percent)	24.6	24.6	25.7	24.6	24.0	22.6
12-month growth in Credit to Private Sector (Percent)	17.9	17.3	19.0	18.7	21.3	19.9
12-month growth in Real GDP (Percent)						4.5
12-month overall Inflation (Percent)	5.0	5.0	5.0	5.0	5.0	5.0

Source: Central Bank of Kenya

Table 5b: Monetary Targets for the Second Half of 2010/11

	Jan-11 Targ.	Feb-11 Targ.	Mar-11 Targ.	Apr-11 Targ.	May-11 Targ.	Jun-11 Targ.
Broad Money, M3 (Ksh Billion)	1,300.3	1,318.8	1,337.3	1,356.1	1,374.6	1,405.9
Reserve Money, RM (Ksh Billion)	198.6	199.2	200.0	198.6	201.6	205.9
NFA of Central Bank of Kenya (Ksh Billion)	270.4	274.3	278.1	281.9	285.7	289.8
12-month growth in RM (Percent)	10.7	13.6	12.7	11.9	3.9	-2.1
12-month growth in M3 (Percent)	21.8	21.6	20.7	20.8	18.5	17.3
12-month growth in Credit to Private Sector (Percent)	20.9	21.7	25.0	26.7	25.2	26.6
12-month growth in Real GDP (Percent)						5.1
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 attainment 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 reserve money 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.

However, there are challenges to monetary policy in the coming period, but more so on the framework in use and before a new framework is put in place. There are three challenges: First, due to financial inclusion via mobile telephone services, the financial depth has changed the direction of velocity of money to decline swiftly. Second, this form of financial innovation increased the money multiplier significantly. The current monetary policy framework assumes that both velocity and money multiplier are stable. Finally, the use of technological platform for financial services has brought into the banking sector the currency that was outside the banking system. This is good for financial deepening but has also created a structural change in the economy. The CBK has to learn to live with excess liquidity in the banking sector which, fortunately, is not inflationary. This changes the terrain of monetary policy formulation and implementation in Kenya.

5.2 Extending Access to Financial Services

Significant progress towards enhancing financial inclusion in Kenya has been made following the introduction of agent banking and mobile phone 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 would be beneficial to economic growth and poverty reduction. In addition, appropriate legislation (National Payments Systems Bill) will be brought to Parliament aimed at ensuring that such innovations are regulated accordingly to enhance market confidence.

The Bank has also established a Development Banking Committee (DBC) to explore avenues through which development banking products can be introduced into the market. This was necessitated by: (a) the current credit market structure of commercial banks that focuses more on short term loan maturities; (b) the problem of “the missing middle” in which the demand of term loans by SMEs is not met by the current loan structures of the commercial banks; (c) the moribund character of development financial institutions; (d) the existing opportunities available for long term financing from bilateral and multilateral financial institution; and, (e) the wide scope of developing bonds market to be a source for long term finance. The DBC is expected to complete its work in the six months to December 2010, and provide appropriate recommendations for implementation.

5.3 Measures to Enhance Market Efficiency

The Bank will hold the First Monetary Policy Forum on 10th August, 2010 which will bring together key stakeholders to discuss monetary policy issues, banking sector developments, financing of private sector activities and develop public awareness on financial services. It will also provide a platform to obtain feedback on the impact of monetary policy decisions on commercial banks and the real sector. The Forum will therefore be part of a wider scheme of measures to enhance the transmission mechanism of monetary policy from the short term interest rates to the commercial banks lending rates.

The Bank will work with stakeholders in the banking sector to operationalise and support the work of credit reference bureaus in order to reduce credit risk in the credit market. Measures to enhance the uptake of Horizontal Repos among banks will be implemented, while stakeholder forums with CEOs and Treasury Managers of banks will be held to ensure information flows freely.

5.4 Research Agenda

During the six months to December 2010, the Bank expects to finalise, for peer review, various research studies necessary to inform policy decisions. These studies include those on the transmission mechanisms of monetary policy and a demand for money function in Kenya. These studies will establish both the length of the lag from the signal to outcome and the stability of the demand for money and therefore its predictability. In light of technological developments, these set of papers are crucial to inform policy making.

The anticipated production by the KNBS of tradable and non-tradable CPI indices in the course of the next six months will require significant research to incorporate the new data into existing models. International best practice in developing economies, in general, recommends the use of a tradable goods inflation index as a requirement for understanding how international events convert into domestic outcomes.

Finally, the volume “Kenya: Policies for Prosperity”, developed by the CBK and Oxford University in the United Kingdom, will be finalised by end of December 2010. This will support the overall picture of the *Kenya Vision 2030* policy terrain and interpret the totality of policies for the future of the Kenyan economy.

**ANNEX 1: MAIN MACROECONOMIC INDICATORS UNDERPINNING
THE MEDIUM TERM FISCAL FRAMEWORK, 2007/08 – 2012/13**

	2007/08	2008/09	2009/10	2010/11		2011/12		2012/13	
			Prov.	Budget	Proj.	BSP'10	Proj.	BSP'10	Proj.
<i>Annual percentage change, unless otherwise indicated</i>									
National account and prices									
Real GDP	4.3	2.1	3.8	5.1	5.4	6.0	6.1	6.4	6.7
Real GDP per capita	1.3	0.2	1.9	2.2	2.4	3.1	3.2	3.5	3.7
GDP deflator	8.6	9.3	6.7	6.4	6.9	5.7	6.8	6.4	5.6
CPI Index (eop)	29.3	8.6	3.5	5.0	5.0	5.0	5.1	5.0	5.0
CPI Index (avg)	18.5	12.7	5.5	5.0	4.7	5.0	5.2	5.0	5.0
Terms of trade (-deterioration)	-2.4	4.8	5.8	-4.3	-3.0	-2.1	-4.1	-0.3	-1.8
Money and credit (end of period)									
Net domestic assets	14.0	26.5	34.8	13.8	13.2	9.6	13.3	10.5	12.5
Net domestic credit to the Government	-15.1	30.3	59.7	16.9	14.1	12.8	12.5	10.5	7.3
Credit to the rest of the economy	26.0	22.5	16.8	20.0	15.8	15.8	16.2	16.6	16.4
Broad Money, M3 (percent change)	18.7	13.0	26.2	14.0	15.1	14.4	15.4	15.5	15.6
Reserve money (percent change)	18.2	4.6	31.5	11.7	7.5	12.7	12.6	13.8	15.6
<i>In percentage of GDP, unless otherwise indicated</i>									
Investment and saving									
Investment	19.6	19.9	22.2	21.1	23.7	21.8	24.5	22.7	25.9
Central Government	6.6	7.5	8.8	10.2	10.3	9.1	10.6	8.9	11.2
Other	13.0	12.4	13.3	10.9	13.5	12.7	13.9	13.8	14.7
Gross National Saving	13.5	12.9	15.7	15.5	17.0	17.3	17.3	19.0	18.4
Central Government	1.7	2.4	1.6	6.4	2.9	5.6	5.0	5.6	6.3
Other	11.9	10.5	14.1	9.1	14.1	11.6	12.3	13.5	12.1
Central government budget									
Total revenue	22.1	22.4	22.7	24.9	25.2	24.6	25.0	24.5	25.1
Total expenditure and net lending	27.4	27.7	30.1	33.1	32.7	31.2	31.0	29.6	30.4
<i>of which: wages and salaries</i>	7.5	6.9	7.2	6.9	7.3	6.8	7.1	6.8	7.1
Interest payments	2.5	2.4	2.6	2.7	2.8	2.9	2.6	2.9	2.6
Development expenditures	6.7	7.6	8.9	11.7	10.3	10.3	10.7	9.7	11.3
Overall balance (commitment basis) excl. grants	-5.3	-5.2	-7.4	-8.2	-7.4	-6.6	-6.0	-5.1	-5.3
Overall balance (commitment basis) incl. grants	-3.5	-4.4	-6.5	-6.8	-6.3	-5.0	-4.7	-3.5	-4.0
Net external borrowing	0.3	0.6	0.8	3.0	1.9	2.0	2.0	1.8	2.4
Infrastructure bonds	0.0	0.9	0.0	1.1	1.1	0.6	0.8	1.0	1.6
Net domestic borrowing	-0.7	3.2	5.5	3.8	4.4	1.9	2.8	1.8	1.5
Total external support (grant & loans)	2.5	2.4	2.5	5.2	3.8	4.2	4.0	3.6	3.3
External sector									
Exports value, goods and services	26.8	26.4	25.8	24.5	25.6	24.7	24.6	25.1	24.2
Imports value, goods and services	39.7	40.1	38.6	35.2	38.2	34.0	37.3	33.3	37.0
Current external balance, including official transfers	-6.0	-7.0	-6.5	-5.6	-6.7	-4.5	-7.2	-3.7	-7.5
Current external balance, excluding official transfers	-6.2	-6.9	-6.4	-5.5	-6.7	-4.5	-7.2	-3.6	-7.4
Gross international reserve coverage in months of next year imports (end of period)	3.5	3.3	3.5	3.2	3.6	3.6	3.6	4.0	3.8
Public debt									
Nominal central government debt (eop), gross	44.6	48.4	50.6	50.3	51.2	49.3	50.6	48.1	49.8
Nominal central government debt (eop), net	39.8	43.3	45.6	46.0	46.8	44.4	45.5	43.1	44.6
Domestic (gross)	22.0	23.7	27.1	27.1	28.5	27.2	29.0	26.5	28.0
Domestic (net)	17.3	18.6	22.1	22.9	24.0	22.3	24.0	21.4	22.8
External	22.5	24.7	23.5	23.2	22.7	22.2	21.5	21.6	21.8
Memorandum items:									
Nominal GDP (in Ksh billions)	1,953	2,176	2,410	2,767	2,713	3,102	3,075	3,510	3,464
Per capita income (Ksh)	51,749	56,593	61,545	67,344	67,379	73,410	74,251	80,805	81,374
Nominal GDP (in US\$ millions)	28,618	29,695	30,804	35,973	34,065	39,840	38,106	44,524	42,474
Per capita income (US\$)	758.3	772.5	786.8		845.9		920.2		997.7
Population (millions)	37.7	38.4	39.2		40.3		41.4		42.6
Population growth rate	2.9	1.9	1.8		2.9		2.8		2.8

Source: Ministry of Finance

BOPA = Budget Outlook Paper

BSP = Budget Strategy Paper

Budget Outlook Paper, 2009

ANNEX 2: MONETARY SURVEY 2007/08 – 2012/13 (END OF PERIOD, KSH BILLION)

	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
	<i>Act.</i>	<i>Act.</i>	<i>Act.</i>	<i>Projection</i>		
Central Bank of Kenya (CBK)						
Net Foreign Assets 1/	202.6	208.8	241.9	275.5	322.0	390.1
Net Domestic Assets	-49.6	-48.8	-31.6	-49.5	-67.6	-96.1
Net credit extended	-23.1	-8.6	7.5	-5.0	-10.7	-26.4
Net claims on Government	-27.7	-23.5	7.5	13.4	19.4	23.3
Claims on banks	4.5	15.0	0.0	-18.4	-30.1	-49.7
Other assets, net	-28.9	-42.8	-41.9	-44.5	-56.9	-69.7
Reserve money (RM)	152.9	159.9	210.3	226.0	254.4	294.0
Monetary Survey						
Net Foreign Assets (NFA) 1/	291.3	268.0	279.3	339.3	413.6	514.6
Central Bank (CBK)	202.6	208.8	241.9	275.5	322.0	390.1
Banks	88.7	59.2	37.4	63.8	91.6	124.5
Net Domestic Assets (NDA)	539.3	682.3	919.7	1,041.1	1,179.3	1,326.2
Domestic Credit	691.7	857.9	1,076.9	1,242.7	1,432.8	1,634.8
Claims on Government (net)	133.4	173.9	277.7	316.9	356.6	382.5
Central Bank	-27.7	-23.5	7.5	13.4	19.4	23.3
Banks	161.1	197.4	270.2	303.5	337.2	359.2
Claims on Private Sector	558.3	684.0	799.2	925.9	1,076.2	1,252.3
Other items (net)	-152.4	-181.9	-167.1	-201.6	-253.5	-308.6
Broad Money (M3)	840.7	950.2	1,198.9	1,380.4	1,593.0	1,840.8
of which:						
Residents' foreign-currency deposits	124.7	138.2	165.2	190.2	219.5	253.7
<i>(ratio of FX deposits/M3)</i>	<i>14.8%</i>	<i>14.5%</i>	<i>13.8%</i>	<i>13.8%</i>	<i>13.8%</i>	<i>13.8%</i>
Memorandum items:						
Reserve money annual percentage change	18.2	4.6	31.5	7.5	12.6	15.6
M3 Annual percentage change	18.7	13.0	26.2	15.1	15.4	15.6
Velocity (GDP/M3eop)	2.3	2.3	2.0	2.0	1.9	1.9
Velocity (GDP/M3avg)	2.5	2.4	2.2	2.1	2.1	2.0
Multiplier (M3/RM)	5.5	5.9	5.7	6.1	6.3	6.3
Credit to private sector	26.0	22.5	16.8	15.8	16.2	16.4
Resident FX deposits (billions of US\$)	1.9	1.8	2.0	2.4	2.7	3.1
Net Government borrowing	335.3	404.3	535.6	654.4	774.8	853.2
Banking sector	133.4	173.9	277.7	316.9	356.6	382.5
Non-banking sector	201.8	230.4	257.9	337.5	418.2	470.7

1/ At current exchange rate

Source: Ministry of Finance and Central Bank of Kenya

ANNEX 3: CHRONOLOGY OF EVENTS OF PARTICULAR RELEVANCE TO MONETARY POLICY AND INFLATION (January – June 2010)

- February 2010**
- a) Implementation of a new auction framework for Government securities.
 - b) Introduction of the geometric mean in computation of the Consumer Price Index (CPI) using the new CPI basket of goods.
 - c) Licensing of the first credit reference bureau to offer banking sector credit information sharing services in Kenya.
- April 2010**
- Licensing of the second deposit taking microfinance institution to carry out nationwide deposit taking microfinance business.
- May 2010**
- a) Guidelines on agent banking issued by the CBK became effective.
 - b) Innovation of M-KESHO to provide mobile banking services.
- June 2010**
- Issuance of the first 25-year Treasury bond to lengthen further the maturity profile of domestic debt.

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.

Underlying Inflation

This is the overall inflation measure that excludes volatile components that include food, energy, transport and communications which are 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/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 Requirement (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 4.5 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