THE SIXTH MONETARY POLICY STATEMENT

Table of Contents

Page

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 THE 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 balance 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 Central Bank will continue to focus its monetary policy on maintaining price stability and specifically containing inflation at below 5% over the next twelve months.

Monetary policy restraint will be kept by the Bank to contain inflationary pressures. The growth of money supply will be kept in line with the expected performance of the real sector taking into account the inflation target of less than 5% by the end of the next twelve months.

Prudential measures will continue to be implemented to ensure that the banking system remains stable and efficient. Improved stability of the banking system is expected to further enhance efficiency in the transmission mechanism for monetary policy. The Bank will therefore rigorously apply the Banking Act including imposing financial penalties for non-compliance and enforcing the stipulated capital requirements. To improve confidence in non-cash business transactions, appropriate legislation will be put in place to prosecute drawers of bouncing cheques and those who indulge in cheque kiting.

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 be required 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 from time to time buy and sell Treasury bills, or any other stipulated Government paper, 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 June 2001.

2. MONETARY DEVELOPMENTS 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 June 2000. As a result, the expansion of money supply remained within target with (M3) rising by 1.9% in the twelve months to June 2000 while the broader money supply (M3XT) rose by 7% in the same period. The sources of increase in money supply during the period were as follows:

- Net foreign assets (NFA) of the banking system increased by shs 17.6bn, which was threefold the increase in money supply during the twelve months.

- Lending by the banking system as measured by the net domestic assets (NDA) of the banking system, fell by shs 11.7bn. The decline was wholly in the other domestic assets which reflected enhanced provisioning for bad debts by banks and non-bank financial institutions (NBFIs) as follows:

  – Lending to the Government increased by shs 3.4bn or 3.6% reflecting the increase in Government borrowing from the commercial banks as Government borrowing from the Central Bank declined during the twelve months.

  – The banks' lending to the other public entities, including local Government authorities and parastatals, fell by 13.7%.

  – Lending to the private sector, which was largely from commercial banks, increased by 9.8% in the twelve months.

While the increase in money supply (M3) decelerated almost throughout the twelve months, the increase in broader money supply (M3XT) defined to include, M3, 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 real gross domestic product.

3. INFLATION

Inflation was generally upward in the first half of 2000 mainly due to the lagged effects of the depreciation of the shilling and shortfalls in basic food supplies over the last twelve months. Increased cost of fuel products also affected the domestic prices of most consumer items. Underlying month-on-month inflation rose to 9.0% in June 2000 from 7.6% in December 1999. The underlying average annual inflation also increased from 5.1% in December 1999 to 8.0% in June 2000 (Table 1 and Chart 1).

INFLATION

TABLE 1: UNDERLYING INFLATION

2000	Dec	Jan	Feb	Mar	Apr	May	Jun*
Month-on-month	7.6	8.2	7.7	8.4	8.2	8.2	8.0
Average annual	5.1	5.3	5.7	6.3	6.7	7.1	7.3

TABLE 2: OVERALL INFLATION

2000	Dec	Jan	Feb	Mar	Apr	May	Jun*
Month-on-month	8.0	8.7	5.7	3.4	4.1	5.2	5.8
Average annual	3.5	4.3	4.8	5.0	5.2	5.5	5.8

CHART 1:UNDERLYING INFLATION

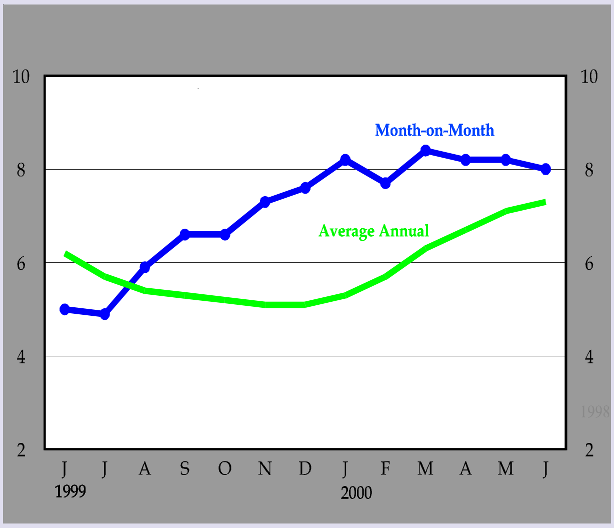
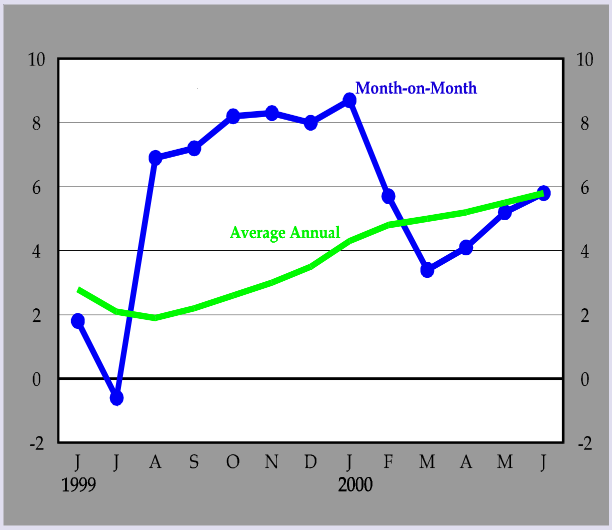


CHART 2: OVERALL INFLATION



***Provisional**

Source: Central Bank of Kenya

However, the tight stance of monetary policy maintained during most of the period kept the impact of the shilling depreciation and the shortfall in some items of food supply under control. As a result, inflation was tamed within single digits. The overall month-on-month inflation eased to 5.8% in June 2000 from 8.0% in December 1999. The overall average annual inflation however accelerated from 3.5% in December to 5.8% in June 2000 (Table 2 and Chart 2).

4. STABILITY IN THE BANKING AND FINANCIAL SYSTEMS

The banking sector was relatively stable in the first six months of year 2000. Two banks, previously under statutory management, re-opened in January and April 2000, while one which was under statutory management was placed under liquidation in May 2000. One commercial bank and one non-bank financial institution remain under statutory management. To further strengthen the banking sector, the Central Bank took the following actions:

(a) All banking institutions and their external auditors are now required to liase with Central Bank of Kenya before publishing financial results so as to agree on the figures for provisions for bad and doubtful debts. This is to ensure that institutions make adequate provisions. The published accounts must also conform to International Accounting Standards.

(b) Boards of directors are required to eliminate all remaining positions of executive chairmen in order to improve on corporate governance by separating the duties of the Board and Management.

(c) In the last one year, Central Bank of Kenya has been presenting inspection findings to boards of directors of various institutions. To further improve the process and to adopt a uniform approach, all institutions have been advised to be preparing for a special board meeting to specifically discuss the inspection findings within one month of the receipt of the inspection report. This is to ensure that all board members are well informed and prepared for the meeting with the Central Bank.

(d) Following the amendment of the Banking Act in 1999 all sections of the Act, that previously referred to capital and unimpaired reserves, were replaced by core and supplementary capital. The redefinition of capital and capital requirements was adopted in order to be in line with the Basle Capital Accord and International Supervisory practices on measurement of capital adequacy. Guidelines and regulations were revised and issued such that each institution shall at all times maintain the following:

(i) a core capital of not less than eight per cent of total risk adjusted assets plus risk adjusted off balance sheet items;

(ii) a core capital of not less than eight per cent of its total deposit liabilities; and

(iii) a total capital (core plus supplementary) of not less than twelve per cent of its total risk adjusted assets plus risk adjusted off balance sheet items.

5. EXCHANGE RATES

The shilling weakened during the first half of 2000 after remaining relatively stable through the second half of 1999 (Table 3 and Chart 3). In June 2000, the shilling traded at shs 77.3 compared with shs 70.7 in January 2000. The performance of the shilling against other major currencies was as follows:

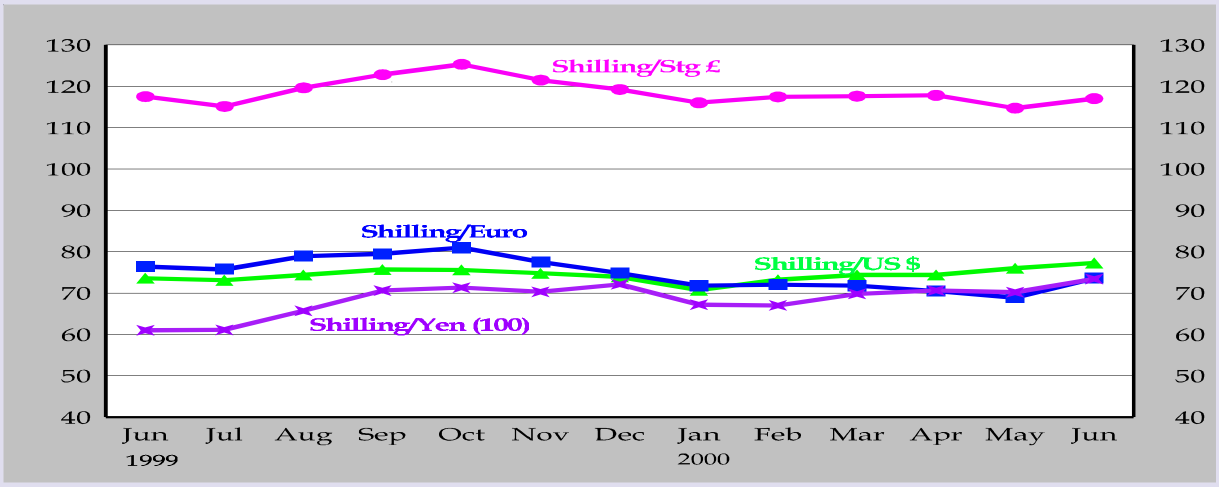
- It weakened against the Pound Sterling by 0.9% to exchange at shs 117.0 in June 2000 compared with shs 116.0 in January 2000.
- It also weakened against the Euro and the Japanese yen to exchange at shs 73.6 and shs 73.4, in June 2000 compared with shs 71.8 and shs 67.2 in January 2000.

SHILLING EXCHANGE RATE AGAINST THE MAJOR CURRENCIES

TABLE 3

2000	Jan	Feb	Mar	Apr	May	Jun*
US $	70.7	73.2	74.4	74.4	76.0	77.3
STG £	116.0	117.4	117.6	117.8	114.7	117.0
EURO	71.8	72.0	71.8	70.5	68.9	73.6
YEN(100)	67.2	67.0	69.8	70.6	70.2	73.4

CHART 3



*As at 21st June 2000.

Source: Central Bank of Kenya

The weakening of the shilling against the major currencies in 2000 so far reflected in part the decline in export receipts particularly from tea due to the current drought, and partly due to response to interest rates on Government paper which fell from 20.3% in January 2000 to 10.3% in June 2000.

The Bank built-up its foreign exchange holdings from US$ 791m held in December 1999 to US$ 802m at the end of June 2000. At US$ 802m the foreign exchange reserve holdings of the Bank covered about 3.3 months of imports and were about US$ 145m higher than the holdings in the comparable twelve months earlier.

6. INTEREST RATES

On average, interest rates fell over the twelve months to June 2000 from the average level that they were in the twelve months to June 1999 with the average interest rate on the 91-day Treasury bill falling from 11.4% in June 1999 to 10.6% in June 2000 (Table 4 and Chart 4).

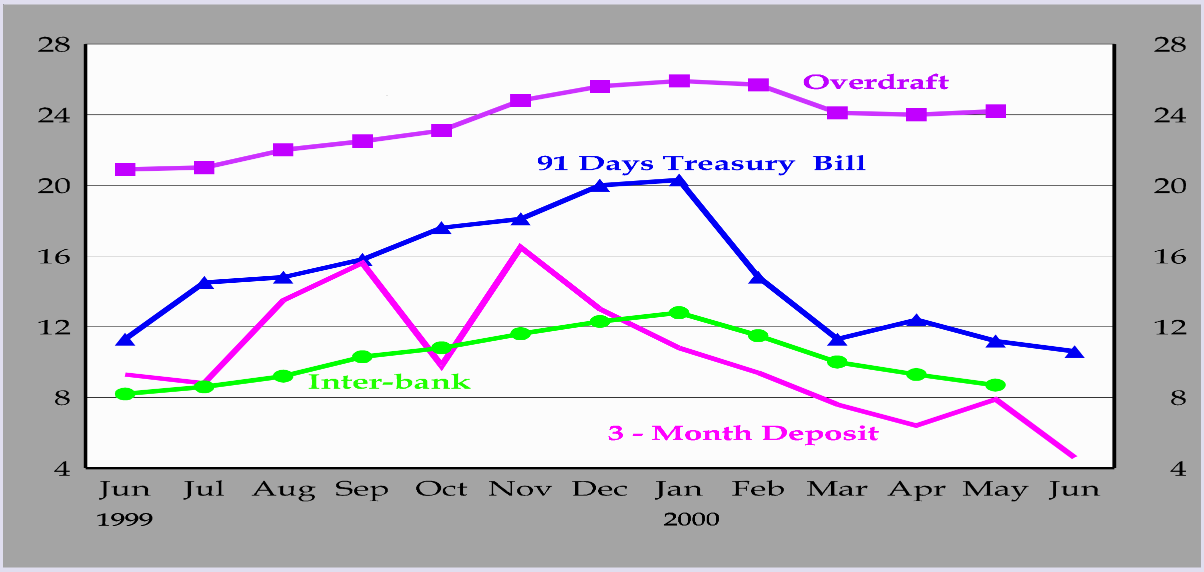
INTEREST RATES (%)

TABLE 4

2000	Jan	Feb	Mar	Apr	May	Jun
91-day Treasury Bill	20.3	14.8	11.3	12.4	11.2	10.6
Overdraft	25.9	25.7	24.1	24.0	24.2*	24.2*
3-Month Deposit	12.8	11.5	10.0	9.3	8.7*	8.7*
Interbank Borrowing	10.8	9.4	7.6	6.4	7.9	4.6

*Provisional

CHART 4



Source: Central Bank of Kenya

Most of the decline in interest rates occurred during the second half of the twelve months. The interest rates in the past half of the period were however upward with the interest rate on the 91-day Treasury bill reaching 20.0% in December 1999 compared with 13% in December 1998. Meanwhile, the lending interest rate as represented by the overdraft interest rate, fell from about 26% in December 1999 to 24.2% in June 2000. The level of the three-months deposit interest rates followed that of the 91-day Treasury bill, falling throughout the twelve months from about 12% in December 1999 to 8.7% in June 2000. At the short-end of money market, the interbank rate fell to 7.9% at the end of June from about 13% in December 1999. The interest rate trend reflected the adjustment of the stance of monetary policy during the twelve months.

7. MONETARY POLICY IN THE TWELVE MONTHS TO JUNE 2001

(a) The Target on Money Supply

Monetary policy in the coming twelve months to June 2001 will be designed and implemented with the objective of reducing inflation to below 5% taking into account the performance of the real sector during the period. The supply of money will be managed to increase by no more than 8% which will be in line with the inflation target and the expected economic performance during the period. As in the past six months, the cash ratio, Open Market Operations and discount and overnight lending by the Central Bank as lender of last resort will be applied to keep the money suply on the desired growth path.

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)

	1999	2000		2001	Annual
	Jun. (Act.)	Jun. (Proj.)	Dec. (Proj.)	Jun. (Proj.)	Change (%)
1. Money Supply (M3) = (2+3)	309.8	320.2	335.1	345.0	7.8
2. Net Foreign Assets	48.5	59.5	65.3	74.5	25.2
3. Net Domestic Assets	261.3	260.7	269.8	270.5	3.7
Government borrowing from:	94.9	93.0	86.7	81.6	-12.2
Commercial Banks	65.2	66.5	60.6	62.0	-6.8
Central Bank	29.7	26.5	26.1	19.6	-26.0
Private and other public sector borrowing	277.7	295.9	311.1	332.5	12.4
Other items net	-111.3	-128.2	-128.0	-143.6	12.0

Source: Central Bank of Kenya

Adjustments to the target increase in money supply will be made in the course of the twelve months to reflect anticipated changes in performance of the real sector. The target will be revised downwards should economic activity turn out to be worse than the expected 2.6% growth.

- Balance of payments is expected to improve during the coming twelve months with foreign exchange projected to increase by shs 15bn during the period.

- Lending by the banking system as reflected by the net domestic assets, is expected to increase by shs 9.8bn during the twelve months.

  – The increase in the net domestic credit of the banking system will be wholly reflected in the increase of 12.4% in credit to the private and other public sectors, as Government borrowing from the Central

Bank and from the commercial banks is expected to fall by 12.2% during the twelve months.

(b) Strengthening of the Banking and Financial Systems

To further stabilise the banking system, the Central Bank, in consultation with the Ministry of Finance and Planning, will take the following actions during the year to June 2001.

(i) Further strengthen Bank Supervision Department through training and application of the latest information technology systems and equipment;

(ii) Ensure that banking institutions comply with the revised banking laws and regulations by levying monetary penalties where applicable;

(iii) Encourage the Government to fully divest itself from the banking sector;

(iv) Enforce the provisions of the amended Building Societies Act in order to harmonise the operations of building societies with banking institutions;

(v) Put in place appropriate legislation to prosecute drawers of bouncing cheques;

(vi) Propose enactment of legislation that will facilitate sharing of information on loan defaulters with credit reference bureaus, in order to encourage banking institutions to use credit reference agencies;

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

(viii) Take necessary measures to ensure implementation of the remaining requirements of the Basle Committee's core principles for effective banking supervision;

(ix) To work closely with the three East African central banks to harmonise banking legislation and supervisory practices within the region. These areas include joint supervision, cross-border and consolidated supervision, and improvement in corporate governance, information sharing on payment systems, foreign exchange management and the development of the micro-finance sector;

(x) Vet new shareholders in banking institutions by ensuring CBKs prior approval is granted for transfer of 5% or above of any institution's shareholding;

(xi) Encourage merger of small and medium sized banks by facilitating smooth merger through appropriate legal and other enabling procedures; and

(xii) Speeding up the judicial process in determination of court cases through expansion of the commercial courts.