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CENTRAL BANK OF KENYA
THE SECOND MONETARY POLICY STATEMENT – JULY, 1998

1. INTRODUCTION

This monetary policy statement is made in accordance with Section 4B of the Central Bank of Kenya Act that requires the Bank to submit to the Minister for Finance a monetary policy statement every six months. Accordingly, this statement:

(a) contains a review and assessment of the progress of implementation of monetary policy by the Bank during the twelve months to which the preceding policy statement relates;

(b) specifies the policies and the means by which the Bank intends to achieve the policy targets for next twelve months;

(c) gives reasons for adopting such policies and means.

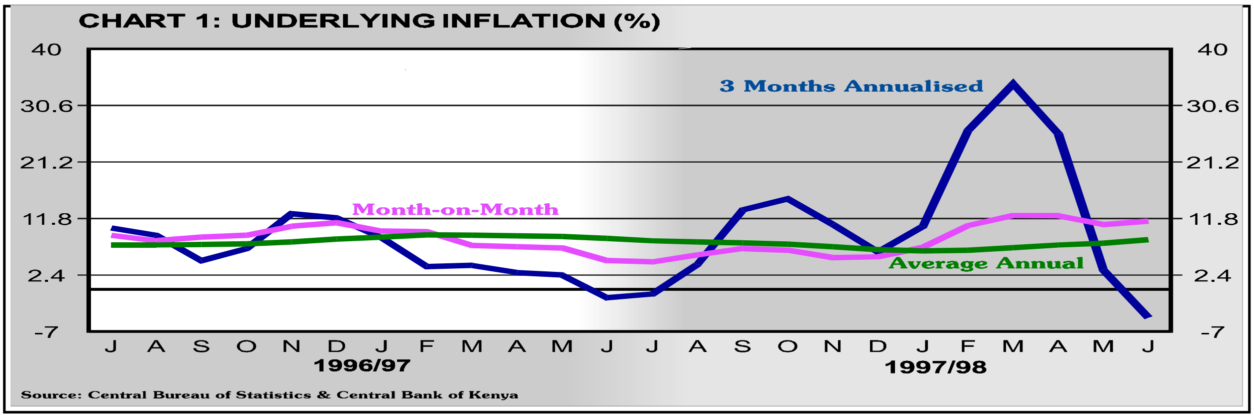
2. INFLATION IN THE YEAR TO JUNE, 1998

In spite of sustained reduction in the monetary expansion brought about by the pursuit of tight monetary policy, inflation remained generally higher than expected throughout the year to June 1998:

- Underlying inflation, that is the inflation that can be controlled through use of monetary policy, assumed a strong upward trend towards the end of the fiscal year. Measured on month-on-month basis, the underlying inflation increased to 11.3% in June 1998 from 4.8% in June 1997. It therefore remained well above the 5% target by the end of June 1998, having remained in the vicinity of the target most of the time in the year (Table 1 and Chart 1).

TABLE 1: UNDERLYING INFLATION (%)

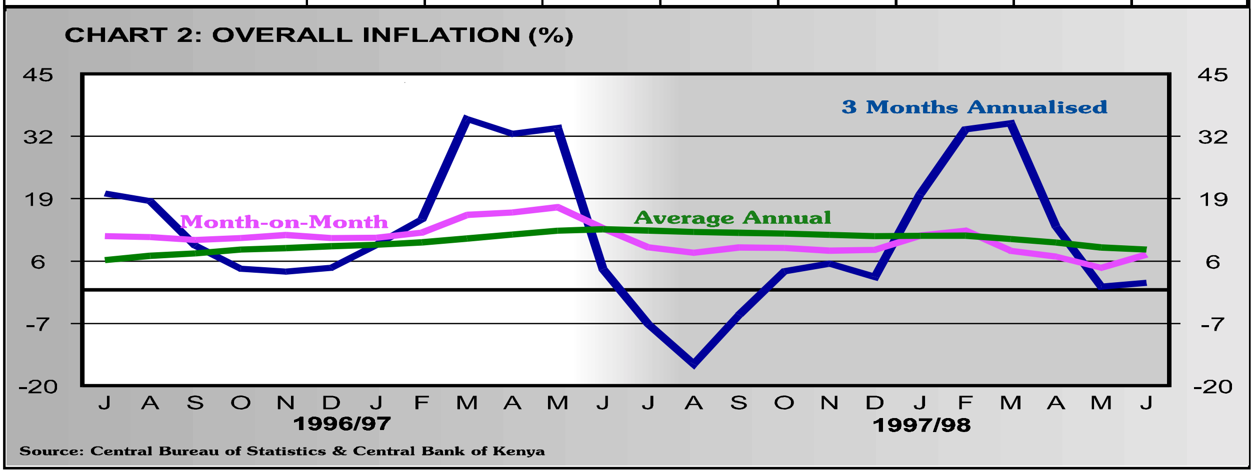
	1997					1998		
	Jan	Mar	Jun	Sep	Dec	Jan	Mar	Jun
Month-on-Month	9.7	7.3	4.8	6.8	5.4	7.0	12.3	11.3
Average Annual	8.7	9.0	8.5	7.7	6.6	6.4	7.0	8.3
3-months Annualised	8.6	4.2	-1.4	13.2	6.2	10.5	34.2	-4.7



- Overall month-on-month inflation however eased in the second half of the year to 7.4% by June 1998 from 12.8% in June 1997 (Table 2 and Chart 2).

TABLE 2: OVERALL INFLATION (%)

	1997					1998		
	Jan	Mar	Jun	Sep	Dec	Jan	Mar	Jun
Month-on-Month	10.8	15.7	12.8	8.8	8.3	11.3	8.1	7.4
Average Annual	9.4	10.7	12.6	11.9	11.2	11.2	10.6	8.4
3-months Annualised	9.4	35.7	4.3	-5.2	2.7	19.9	34.7	1.5



3. FACTORS BEHIND INFLATION IN THE YEAR TO JUNE 1998

Inflationary pressures in the year to June 1998 arose from various developments:

- There was less than expected supply of goods and services following poor economic performance in the year. Food prices in particular were adversely affected by widespread drought in late 1996 and early 1997 and the disruption of supplies by the "El-Nino" related rains. This more than offset the dampening effect of a sustained slow monetary expansion during the year;

- The upward adjustment of value added tax led to mark-up of prices during the year;

- Weakening of the shilling following the lapse of financial support from the multilateral financial institutions and other shortfalls in foreign exchange inflows also contributed to upward pressure on inflation.

4. MONETARY DEVELOPMENTS IN THE YEAR TO JUNE 1998

Continued tight monetary policy stance substantially reduced monetary expansion during the year to June 1998. Money supply, M3, increased by 5.2% in the year to June 1998 compared with 13.5% in the previous year. The expansion was well within the 8.3% target by the end of June 1998 and was satisfactory considering that the broader Money Supply, which incorporates foreign exchange and Treasury bills held by the private sector, increased by 11% in the year. The growth in money supply was wholly supported by an increase in banks' lending, namely net domestic assets (NDA) which was partially offset by the decline in foreign exchange holdings, that is, the net foreign assets (NFA). The net domestic assets of the banking system increased by 15.9% with loans and advances to the private sector rising by 18.8% in the year to June 1998. Net borrowing from the banking system by the Government increased by shs 6.1bn or by 7.9%:

- NDA increase contributed the whole growth in the money supply; while

- the fall in NFA partly offset the contribution of NDA to the expansion of money supply by 22%.

5. GOVERNMENT BORROWING FROM THE CENTRAL BANK

Government borrowing from Central Bank is shown in Table 3.

TABLE 3:
GOVERNMENT BORROWING FROM CENTRAL BANK (SHS BN)

	1997 JUNE	1998 JUNE	CHANGE IN THE YEAR
Securities	38.6	37.3	-1.3
Overdraft	0.0	5.4	5.4
Clearing Account	1.1	4.4	3.3
Deposits	-19.4	-7.4	12.0
Net Borrowing	**20.3**	**39.7**	**19.4**

Source: Central Bank of Kenya

Government borrowing from the Central Bank, outstanding at the end of June, 1998 was in accordance to Section 18(3) of the CBK Act. In line with the provision of the Act, the Government overdraft with the Central Bank was shs 5.4bn at the end of the fiscal year, well below the mandatory limit of shs 7bn.

6. FOREIGN EXCHANGE HOLDINGS

Foreign exchange reserves of the country decreased from US$ 1,552m at the end of June 1997 to US$ 1,289m at end June 1998. Of these, the Central Bank held US$ 754m, equivalent to 2.8 months of imports. This was mainly as a result of balance of payments deficit of US$ 199m in the twelve months to June 1998.

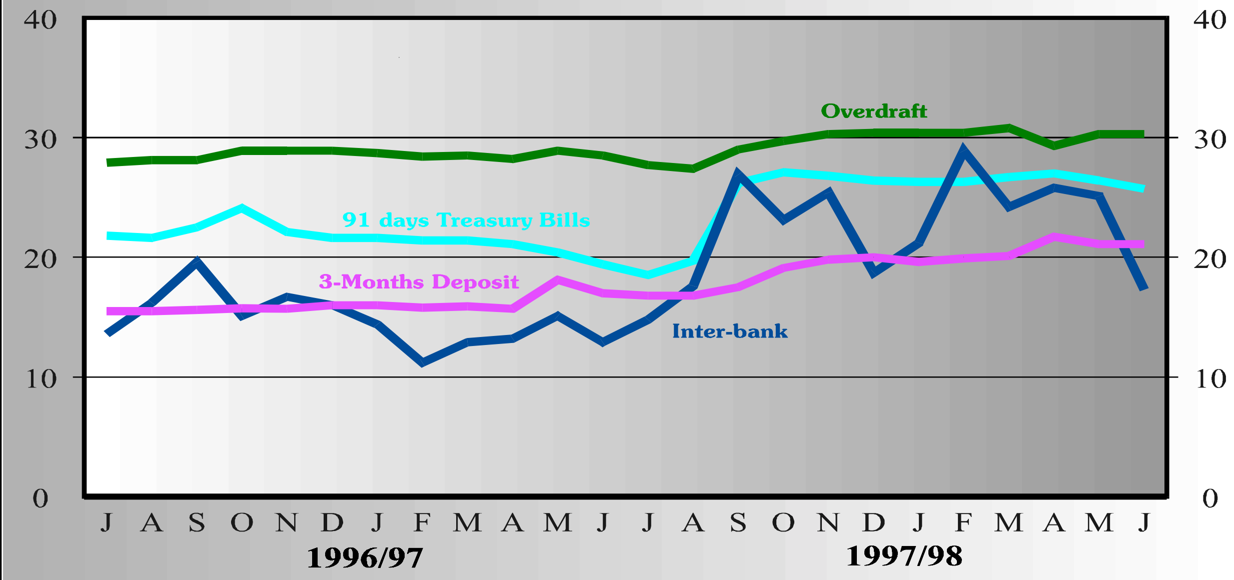
7. MONEY AND FOREIGN EXCHANGE MARKETS

The money and foreign exchange market was characterised particularly during the first half of the fiscal year by rising interest rates and a depreciating exchange rate:

- The interest rates as represented by the 91 days treasury bill increased from 19.4% in June 1997 to 27% in December, 1997. The rate however declined to 25.6% in June 1998.

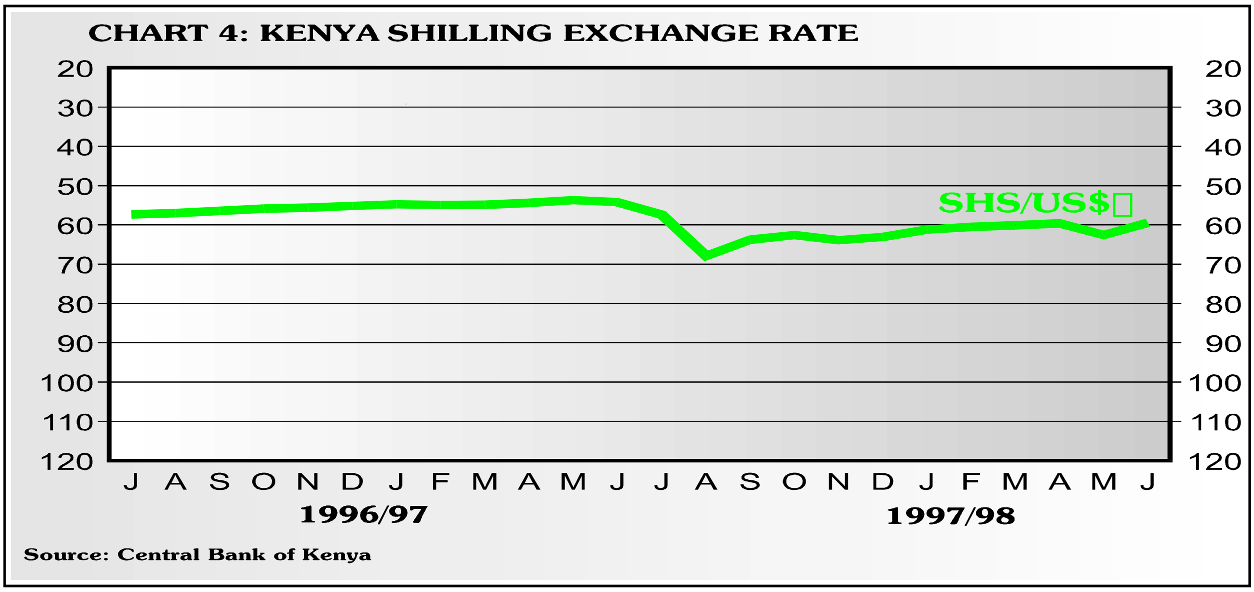
- Commercial banks' lending rates remained high at about 30% during most of the year (Chart 3).

CHART 3: INTEREST RATES (%)



Source: Central Bank of Kenya

• The exchange rate depreciated from shs 54 to the US dollar in June 1997 to shs 70 by August 1997. The exchange rate later appreciated to shs 60 by end of June 1998 (Chart 4).



8. MONETARY POLICY IN THE 12 MONTHS TO JUNE 1999

Monetary policy will be formulated and conducted according to the Central Bank of Kenya Act, with a view to achieving the primary objectives of maintaining price stability, that is low stable inflation and stability of the banking system. The policy in the next twelve months will therefore seek to confine inflation within single digits, specifically to below 5%. The inflation target is consistent with the Government's desire of revitalising the economy by increasing investor confidence in the country's macroeconomic conditions. The policy is expected to support a recovery in economic activity of at least 5% growth in output in the fiscal year. It is also expected to ensure that the country has adequate foreign exchange and that the financial sector, in particular the banking system, remains stable.

Broadly, monetary policy will be conducted along the following lines:

• Money supply (M3) and liquidity of the economy as a whole will be managed to expand by no more than 10% in twelve months to June 1999 (Table 4);

• Loans and advances extended by the banking system to both Government and private and other public sectors, measured as net domestic assets of the system, are expected to expand by no more than 9.3% in the next 12 months:

- Commercial banks are expected to increase their lending to the private sector by at least 17.8% in the year to June 1999.

- Government borrowing from the banking sector is expected to fall by at least 5.0% in the year to June 1999. The monetary targets have therefore been set on the basis that the Government will reduce its borrowing from the banking system, thereby freeing more resources for lending to the private sector for investment.

• The foreign exchange reserves of the Central Bank are projected to increase to US$ 870m, which will cover about 3.2 months of imports. The reserves, net of the Central Bank foreign exchange liabilities, are expected to increase to US$ 662m by end of June 1999 from US$ 536m in June 1998.

TABLE 4: MONEY SUPPLY AND ITS SOURCES (SHS BN)

	1997 JUNE (Act.)	1998 JUNE (Est.)	1999 JUNE (Proj.)	Annual Change %
1. Money Supply (M3) (2+3)	282.0	296.7	326.3	10.0
2. Net Foreign Assets	57.8	52.8	60.2	14.0
3. Net Domestic Assets	224.2	243.9	266.1	9.3
Government borrowing from:	74.6	80.6	76.5	-5.0
Commercial Banks	54.8	60.0	57.0	-5.0
Central Bank	20.3	20.3	19.3	-4.9
Private sector borrowing	212.0	161.6	190.4	17.8
Other items net	-62.3	1.7	-0.8	-47.1

Source: Central Bank of Kenya

9. HOW WILL CBK ACHIEVE THE TARGET INFLATION?

Both the anticipated reduction and stability in inflation during 1998/99 will be achieved by regulating and controlling money supply as follows:

• The Bank will undertake Open Market Operations to regulate commercial bank reserves to achieve the required change in the Money Supply and interest rates;

• Discounting and overnight lending to the commercial banks will continue to be provided by the Bank as a last resort facility to bridge short-term liquidity shortfalls. Conditions for access to these liquidity support facilities will continue to be tight enough to discourage misuse by commercial banks and to restrain undue monetary expansion;

- Banks and the markets as a whole will be informed of the trends in reserve money and liquidity in general;
- The Central Bank will stay out of the foreign exchange market and intervene only when it is absolutely necessary, otherwise the market will be determined by forces of supply and demand;
- The Bank will continue to use the cash ratio as one of the means to ensure that lending by the banking institutions does not undermine targets on money supply;
- Inspection of banking institutions will be intensified to ensure compliance with prudential and legal requirements.

10. OUTLOOK

Monetary policy in the next one year, starting July 1998 will be aimed at lowering inflation to at least 5%. The pursuit of this target will be made easier by the Governments success in achieving a balanced budget in the current financial year. With successful implementation of the monetary policy, the Central Bank will be contributing effectively to improving the economic performance of the country.

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 cash commercial banks and other deposit-taking institutions hold with the Central Bank as a percentage of deposits the public hold with the institutions. The institutions are required by the Bank to hold with the Bank on a fortnightly basis an average of 14% and at no time less than 11% of the deposit the public hold with them.
Domestic Money Market	The system through which money is borrowed and lent for a specified duration by 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 the 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 as the US dollar, the Pound Sterling, the Japanese yen and the Deutschemark are bought and sold among banks and between banks, forex bureau and the general public.
Government Borrowing	All borrowing from the Bank that the Government has made in form of overdraft, Treasury bills and Treasury bonds.

Inflation	General increase in prices of goods and services in the economy, normally expressed on a one year basis as a percent of the previous period's price level.
Liquidity	Means for instant payment for goods and services.
Monetary Policy	Manipulation of demand for and supply of money in the economy to attain stated objectives.
Money Supply	Currency, namely, notes and coins, held by the public outside the commercial banks and other deposit-taking institutions operating under the Banking Act, 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 buying and selling Government and other eligible securities 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, commonly referred to as PMG, is the main account at the Central Bank into which all Governments revenues are deposited and out of which all payments are made.
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 issues of financial instruments is made.
Private Sector	The whole economy excluding Central and Local Government activities.
Three-Months Annualised Inflation	The month-on-month inflation for three months annualised to estimate a whole year's inflation.
Treasury Bill	A short term borrowing instrument issued by the Treasury through the Central Bank as a fiscal agent of the Government.
Treasury Bond	A medium term borrowing instrument issued by the Treasury through the Central Bank as a fiscal agent of Government.
Underlying Inflation	The change in price levels that is mainly caused by policy factors particularly changes in the Money Supply and the exchange rate.