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OBJECTIVES OF THE CENTRAL BANK OF KENYA

The Central Bank of Kenya's 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

CENTRAL BANK OF KENYA
MONETARY POLICY STATEMENT - DECEMBER, 1998

1. INSTRUMENTS OF MONETARY POLICY

The Bank will, in the next twelve months, implement a monetary policy geared towards realising its first principal objective of achieving and maintaining stability in the general level of prices. The policy will aim at reducing and maintaining the underlying inflation, that is, the inflation that can be controlled through the use of monetary and fiscal policies, at below 5%. The policy is expected to limit expansion in money supply growth to rates that would assist further reduction in interest rates and ensure a relatively stable shilling exchange rate both of which are important for the desired revival of economic activity.

To successfully implement the monetary policy, the Bank will ensure that the banking system remains efficient, liquid and solvent. The success of the monetary policy will also, to a large extent, depend on a tight fiscal policy being pursued by the Government. In pursuing this monetary policy, the Bank has the following policy instruments at its disposal:

- Cash ratio requirement for limiting the money supply available to the banks for lending in order to regulate money supply expansion.

- Open Market Operations for regulating banks' reserves.

- Prudent discounting and secured over-night lending of last resort to commercial banks to bridge short-term liquidity shortfalls while at the same time restraining undue monetary expansion.

2. MONETARY POLICY PROGRESS IN THE LAST SIX MONTHS

As set out in the previous monetary policy statement, the Bank pursued a tight monetary stance. It set out to reduce and confine underlying inflation to within single digits, specifically to below 5%. Consistent with the targeted level of inflation, money supply (M3) was to be limited to expand by no more than 10%. To generate the required growth in money supply, the following was to be ensured:

- The increase in lending by the banking system was set to grow by no more than 9.3% in the year to June 1999. However, during the period, the annual lending by the banking system increased from 9.9% in July 1998 to 11.3% in October which was well above the targeted 9.3%.

- Commercial banks were expected to increase their lending to the private sector by at least 17.8% in the year to June 1999. As at end of October 1998, lending to private sector had grown by only 10.1%.

- The Government, in line with continued tight fiscal policy, was required to reduce its borrowing by at least 5%. However, between July and October 1998, Government increased its borrowing from the banking system by 17%.

- An increase in the banking system's foreign exchange holdings out of which the Central Bank was to increase its holdings to US$ 870m equivalent to about 3.2 months of imports cover. Total foreign exchange reserves declined from US$ 1,311.7m in July 1998 to US$ 1,308.6m in October. However, the Bank increased its holdings from US$ 826.8m in July to US$ 842.1m in October equivalent to 3.3 months of imports cover.

In keeping with the tight monetary policy stance in the last six months, the expansion of money supply (M3) was successfully contained at less than 10% as set in the previous policy statement mainly through a decline in the total foreign exchange reserves which compensated for over performance in the lending by the banking system beyond the targeted level of 9.3%.

As a result of the sustained tight monetary policy, inflation remained low, interest rates especially treasury bill rate fell and the exchange rate remained stable.

3. INFLATION

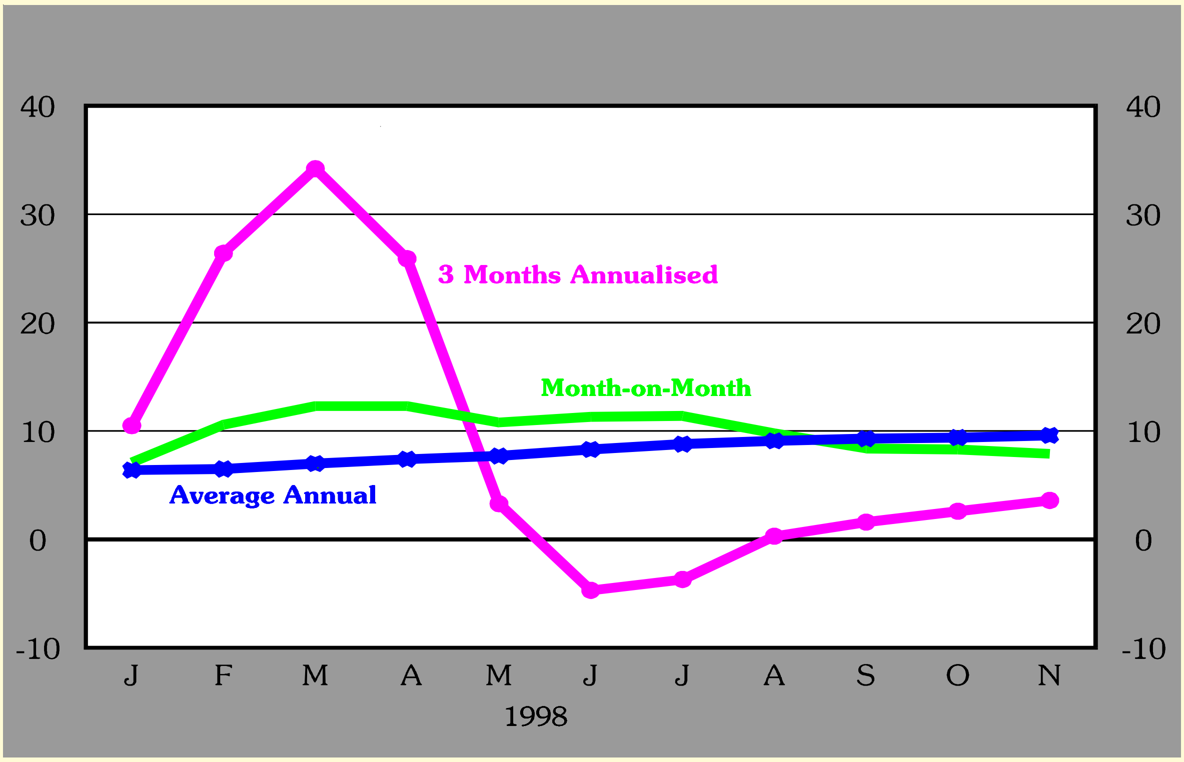
Inflationary pressures eased substantially during the period under review for instance, the **underlying month-on-month inflation** declined from 11.4% in July, 1998 to 7.9% in November, 1998 (Table 1 and Chart 1).

UNDERLYING INFLATION (%)

TABLE 1

1998	Jul	Aug	Sep	Oct	Nov
Month-on-month	11.4	9.8	8.4	8.3	7.9
Average Annual	8.8	9.2	9.3	9.4	9.6
3-months Annualised	-3.7	0.3	1.6	2.7	3.6

CHART 1



Source: Central Bank of Kenya

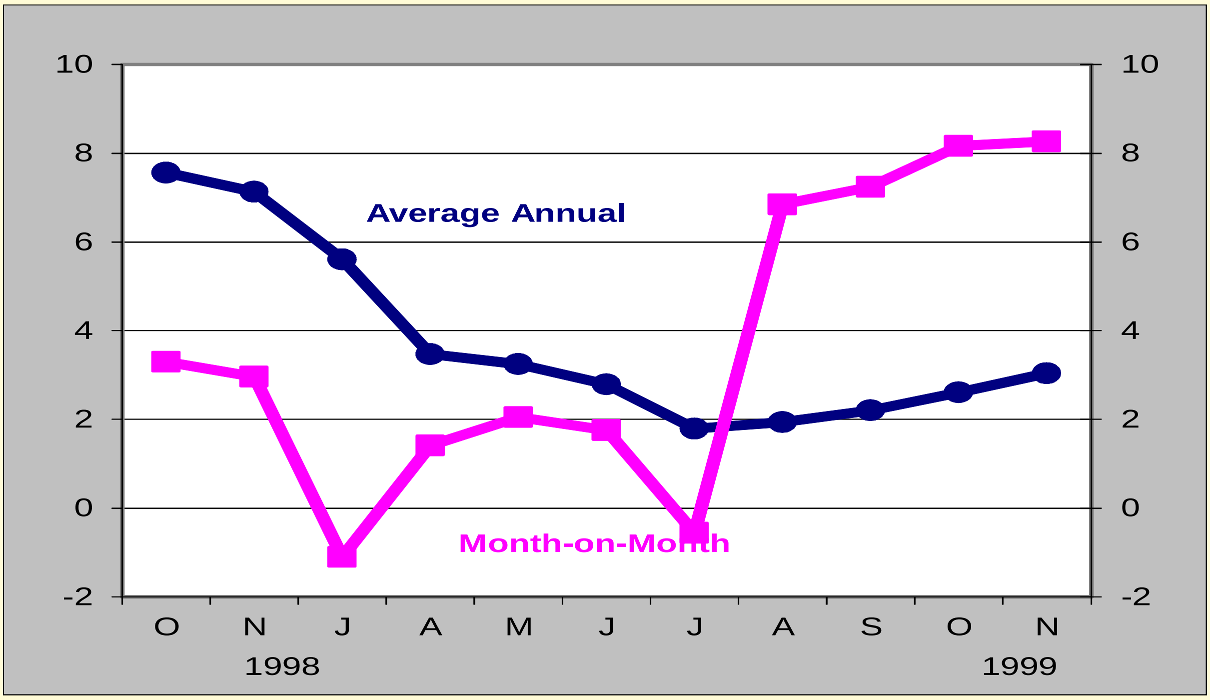
In response to favourable weather conditions and subsequent ample harvest of food crops early in the year, the **overall month-on-month inflation** fell substantially from 11.7% in July 1998 to 3.0% in November (Table 2 and Chart 2).

OVERALL INFLATION (%)

TABLE 2

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

CHART 2



Source: Central Bureau of Statistics and Central Bank of Kenya

4. FINANCIAL SYSTEM

The second principal objective of the Central Bank is to maintain the soundness and stability of Kenya's financial system. During the last twelve months, Kenya's banking system underwent serious turbulences which culminated into placement of five banks under Central Bank statutory management. The reasons for the bank failures were mainly:

(a) High level of non-performing loans caused by poor lending practices which were compounded by mismanagement and outright frauds.

(b) Conflict of interest in those cases where shareholders participate in the day-to-day management of their banks.

(c) Difficulties faced by banks in the recovery of non-performing loans through the judiciary.

(d) Some loans to non-viable projects appear to have been advanced on official influence.

(e) Insider lending to directors and their associates for non-viable investments.

(f) Under-capitalisation for most banking institutions.

(g) Over investment in the speculative property market which is currently experiencing dramatic drop in prices.

The Bank, in consultation with the Minister for Finance, is taking several actions to stabilise the banking system which include:

(a) Increased capitalisation by raising the minimum paid-up capital requirements for banks.

(b) Recommendations being made to the Government to progressively divest from the banking system.

(c) Efforts are also being undertaken by the Government to improve the judiciary by providing adequate Court facilities, computerisation, appointment of additional judges and other necessary improvements in order to uplift the efficiency of the court process.

(d) Encouraging small banks to merge so as to ensure adequate capitalisation.

(e) Banking regulations will be tightened. In particular the following conditions will apply for the re-opening of any institution that is now under statutory management:

1. No previous director shall be permitted to sit on the Board of the re-opened bank.

2. The previous Chief Executive and the majority of the senior managers will not be employed in the re-opened bank since they were responsible for the collapse of the bank.

3. No shareholder shall be permitted to participate in the management of the re-opened bank except as a non-executive director.

4. New directors shall not be allowed to borrow from the institution.

The Bank, through the Kenya School of Monetary Studies, will intensify the number and quality of the various seminars and workshops designed to improve the professionalism of the various categories of staff in Kenya's financial sector.

5. EXCHANGE RATES

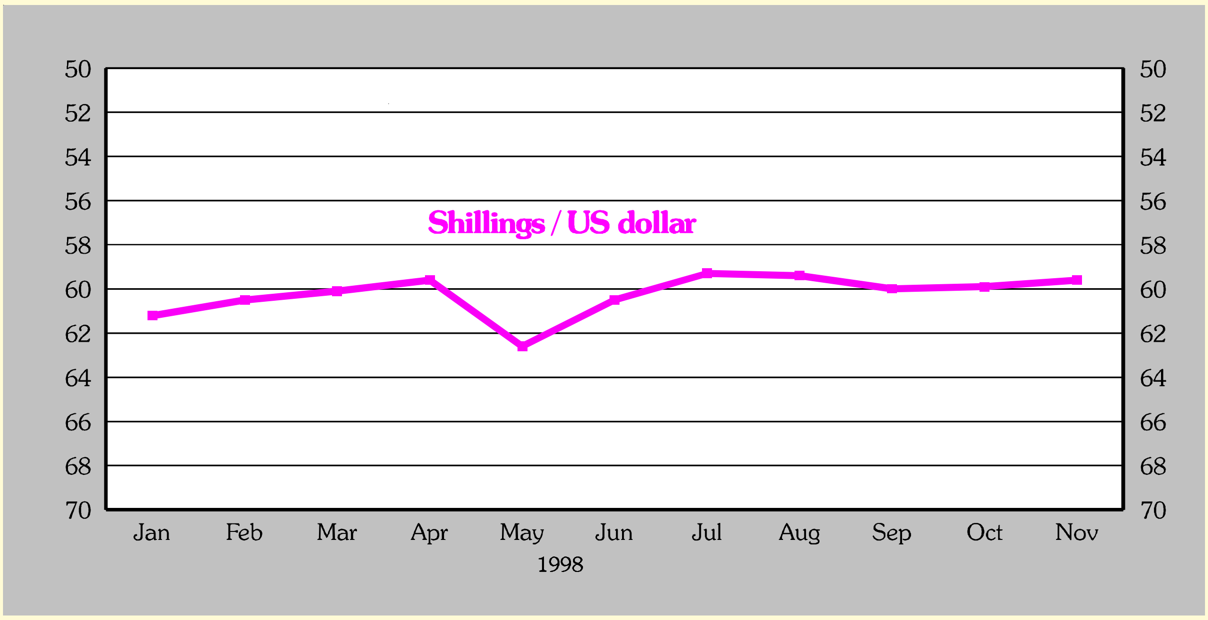
The shilling remained stable. It exchanged on average at between shs 59.34 and shs 59.66 to the dollar between July and November, 1998 (Table 3 and Chart 3).

SHILLING TO THE US DOLLAR EXCHANGE RATE

TABLE 3

1998	Jul	Aug	Sep	Oct	Nov
Shs/US $	59.34	59.37	60.01	59.87	59.66

CHART 3



Source: Central Bank of Kenya

6. INTEREST RATES

Interest rates on the 91-day Treasury bill, the benchmark on which other interest rates are based, fell from 24.7% in July 1998 to 14.4% in December. The average overnight interbank borrowing rate fell from 17.3% in July to 11.8% in November. The fall was driven mainly by the declining pressure from Government for funds and the increased liquidity in the banking system.

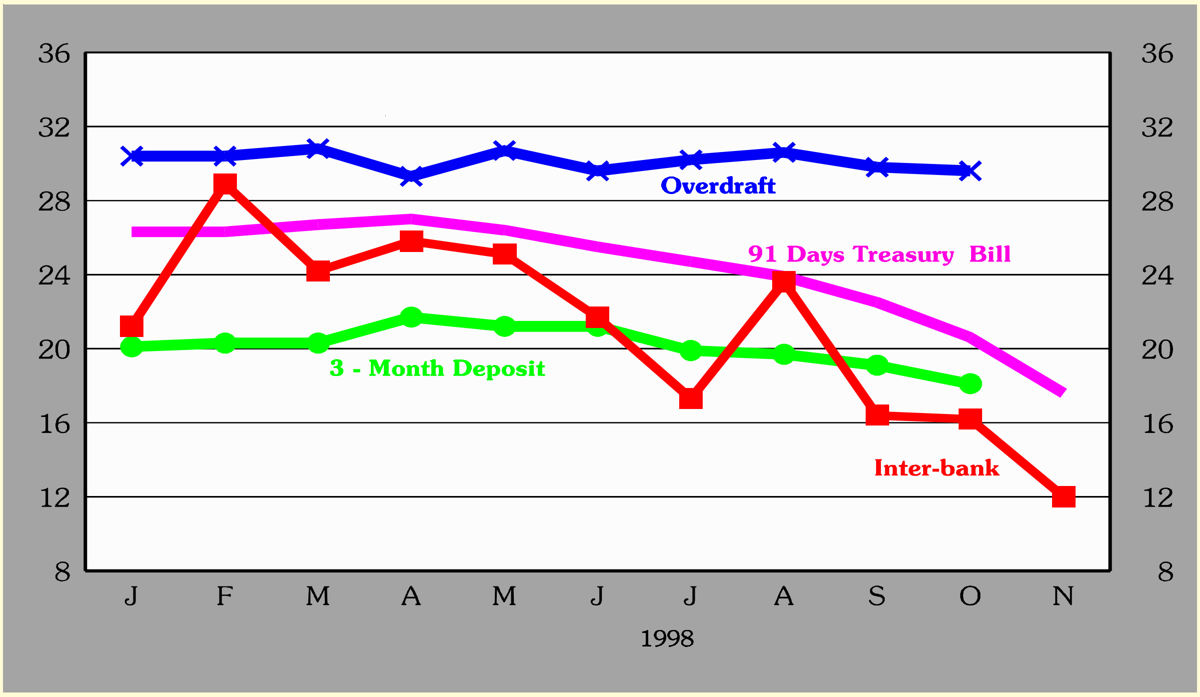
However, commercial banks' overdraft rates are yet to respond significantly to these money market developments. During this period, the overdraft rate fell by only 1.1 percentage points to 29.6% in November (Table 4 and Chart 4). Despite the general decline, the level of interest rates remain high to trigger the desired economic activity. Interest rates, especially commercial banks' lending rates, therefore, remain a major concern for the Central Bank.

INTEREST RATES (%)

TABLE 4

1998	Jul	Aug	Sep	Oct	Nov
91-day Treasury Bill	24.7	23.7	22.5	20.6	17.7
Overdraft	30.7	30.6	29.8	29.6	29.7
3-month Deposit	20.0	19.7	19.1	18.1	18.2
Interbank Borrowing	17.3	23.6	19.0	16.4	10.9

CHART 4



Source: Central Bank of Kenya

7. MONETARY POLICY IN THE TWELVE MONTHS TO DECEMBER 1999

Monetary policy in the coming twelve months will continue to focus first and foremost, on achieving the primary objective of the Bank of ensuring stability in the general level of prices. To achieve this, the Bank will continue to pursue a tight monetary policy it has been following in the last six months. This policy should create a monetary environment conducive to the revival of the economy.

The policy will seek to confine inflation within single digits, specifically to below 5%. Achievement of this relatively low inflation target is expected to increase investors' 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.

To achieve the required level of inflation, the Bank will ensure the following:

(a) Money supply (M3) will be managed to expand by no more than 10% in twelve months to December 1999 (Table 5);

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

	1997	1998		1999	Annual
	Dec. (Act.)	June (Act.)	Dec. (Est.)	Dec. (Proj.)	Change (%)
1. Money Supply (M3)(2+3)	282.0	291.2	302.2	332.4	10.0
2. Net Foreign Assets	57.8	55.1	53.0	60.4	14.0
3. Net Domestic Assets	224.2	236.1	249.2	274.4	9.3
Government borrowing from:	74.6	74.4	86.2	81.9	-5.0
Commercial Bank	54.8	43.1	69.6	66.1	-5.0
Central Bank	20.3	31.3	21.6	20.5	-4.9
Private sector borrowing	212.0	249.0	248.2	292.4	17.8
Other items net	-62.3	-87.3	-85.1	-45.0	-47.1

Source: Central Bank of Kenya

(b) Loans and advances extended by the banking system to private, Government 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:

(i) Commercial banks are expected to increase their lending to the private sector by at least 17.8% in the year to December 1999.

(ii) Government borrowing from the banking sector is expected to fall by at least 5.0% in the year to December 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.

(c) 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 December 1999 from US$ 536m in June 1998.

GLOSSARY

Banking System	The banking system comprise the Central Bank, commercial banks and non-bank financial institutions that operate under the Banking Act.
Cash Ratio	This is the ratio of the cash commercial banks and non-bank financial institutions are required to hold with the Central Bank relative to the deposits the public hold with these institutions. The Central Bank has statutory powers to vary the ratio in order to achieve desired level of money supply.
Money Market	Wholesale market for buying and selling money hereby used in a broad sense to include Treasury paper, certificate of deposits etc.
Financial System	Banking system and all other institutions that provide financial services.
Fiscal Policy	This is a statement which elaborates the course of action adopted by the Government as regards: • Tax and other revenue sources; • Government expenditure; and • Government borrowing.
Government Borrowing	This refers to all borrowing that the Government has made through Treasury bills, Treasury bonds and in form of overdrafts from Central Bank, commercial banks and non-bank financial institutions.

Inflation	This is the general change in prices of goods and services in the economy, normally expressed on a one year basis as a percent of the previous year's price level. For instance, the month-on-month inflation is a measure of the change in prices for a month relative to the level of prices in a similar month a year ago. The three-months annualised, however, is a month-on-month inflation for three months annualised to estimate expected inflation in a year's time.
Liquidity	This refers to the means such as currency, money in a deposit account used for instant payment for goods and services.
Monetary Policy	Management of money in an economy to achieve a desired level of, for example, prices.
Money Supply	Currency, that is notes and coins, with the public plus all the deposits the public hold with the deposit taking institutions.
Open Market Operations (OMO)	An arrangement through which the Central Bank buys and sells Government and other eligible securities in the money market for the purpose of managing the money supply.
Other Public Sector	Local Government and parastatal entities.
Price Stability	A condition in which the general price level remains relatively unchanged.

Private Sector	All the sectors of the economy excluding Central Government and other public entities.
Treasury Bill	A short term borrowing instrument issued by the Treasury through the Central Bank as a fiscal agent of the Government.
Treasury Bonds	A medium term borrowing instrument issued by the Treasury through the Central Bank as a fiscal agent of Government.