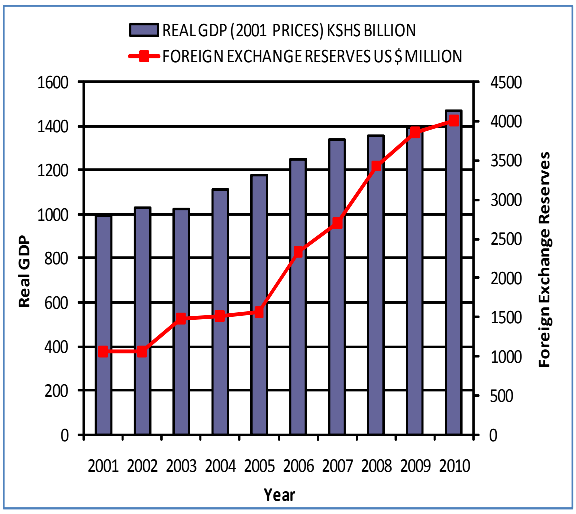

CENTRAL BANK OF KENYA

Monetary Policy Statement

Issued under the Central Bank of Kenya Act, Cap 491

DECEMBER, 2011

Letter of Transmittal to the Minister for Finance

Honourable Minister,

I have the pleasure of forwarding to you the 29th Monetary Policy Statement (MPS) of Central Bank of Kenya (CBK), pursuant to Section 4B of the Central Bank of Kenya Act. It reviews the outcome of the monetary policy stance in the period July to December 2011, describes the current economic environment and outlook, and outlines the monetary policy stance for January to June 2012.

Prof. Njuguna Ndung'u, CBS
Governor

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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 Government medium-term target of 5 percent. Achieving and maintaining a low and stable inflation rate together with adequate liquidity in the market facilitates higher levels of domestic savings and private investment and therefore leads to improved economic growth, higher real incomes and increased employment opportunities.

The Bank's monetary policy is therefore designed to support the Government's 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

The CBK pursues its monetary policy objectives through the following instruments:

- **Open Market Operations (OMO)**: Refers to actions by the CBK through purchases and sales of eligible securities to regulate the money supply and the credit conditions in the economy. OMO can also be used to stabilise short-term interest rates. When the Central Bank buys securities on the open market, it increases the reserves of commercial banks, making it possible for them to expand their loans which increase the money supply. To achieve the desired level of money supply, OMO is conducted using:

  - **Repurchase Agreements (Repos):** Repos entail the sale of eligible securities by the CBK to reduce commercial banks' deposits held in CBK. Currently, Repos (often called Vertical Repos) have a fixed tenor of 7 days. Reverse Repos are purchases of securities from commercial banks by the CBK during periods tighter than desired liquidity in the market. The late Repo, sold in the afternoon, has a 4-day tenor and is issued at an interest rate 100 basis points below the Repo on that day. Horizontal Repos are transacted between commercial banks on the basis of signed agreements using government securities as collateral, and have negotiated tenors and yields. Commercial banks, short of deposits at the CBK, borrow from banks with excess deposits on the security of an appropriate asset, normally Government securities. Horizontal repos help banks to overcome the problem of credit limits, thus promoting efficient management of interbank liquidity. They are not strictly monetary policy instruments but modes of improving liquidity distribution under CBK supervision.
  - **Term Auction Deposits:** In extreme market conditions when the securities held by the CBK for Repo purposes are exhausted, the CBK acquires deposits through a transfer agreement from commercial banks at a price but with no exchange of security guarantee. The deposits are transferred to the CBK for a 7 day period after which they revert back to the respective commercial banks' on maturity of the transfer agreement.

- **Central Bank Rate (CBR)**: The level of the CBR is reviewed and announced by the Monetary Policy Committee (MPC) at least every two months and its movements, both in direction and magnitude, signals the monetary policy stance. The CBR is the base for all monetary policy operations in order to enhance clarity and certainty in monetary policy implementation. Whenever the Central Bank is injecting liquidity through a Reverse Repo, the CBR is the lowest acceptable rate.

Likewise whenever the Bank wishes to withdraw liquidity through a Vertical Repo, the CBR is the highest rate that the CBK will pay on any bid received.

Movements in the CBR 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 should increase. 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. By fixing the tenor for bills sold in the repo market, the MPC aims to sharpen the signalling process. The CBK monitors but does not intervene in the overnight interbank money market which is conducted by the banking industry.

- **Standing Facilities**: The CBK, as lender of last resort, provides secured loans to commercial banks on an overnight basis at a penal rate that is over the CBR. The rules governing the operation of the CBK Discount Window are reviewed from time to time by the Bank. Currently, banks utilising the CBK Overnight Window are charged the CBR plus a high penalty. However, banks making use of this facility more than twice in a week are scrutinised to establish whether prompt corrective action is required.

- **The Cash Reserves Ratio (CRR)**: In accordance with the law, the CRR is the proportion of a commercial bank's deposit liability which must be deposited at CBK at no interest. These deposits are held in the CRR Account. The ratio is currently 5.25 percent of the total bank domestic and foreign currency deposit liabilities. To facilitate commercial banks' liquidity management, commercial banks are currently required to maintain their CRR based on an average from the 15th of the previous month to the 14th of the current month and a minimum CRR of 3 percent on a daily basis. A reduction in the CRR releases liquidity thus enhancing the capacity of commercial banks to expand credit. An increase in the CRR tightens liquidity and could also dampen demand-driven inflationary pressures.

- **Foreign Exchange Market Operations**: The CBK can also inject or withdraw liquidity in the banking system by engaging in foreign exchange transactions. A sale of foreign exchange to banks withdraws liquidity from the system while the purchase of foreign exchange injects liquidity into the system. Participation by the CBK in the foreign exchange market is usually motivated by the desire to prevent excessive volatility in the rate at which the Kenya shilling exchanges against various foreign currencies, or to acquire foreign exchange to service official debt and build its foreign exchange reserves where the statutory requirement is to use the Bank's best endevours to maintain a foreign reserves equivalent to a three year average of four months' import cover. The CBK does not participate in the foreign exchange market to defend a particular value of the Kenya shilling but may intervene to stabilise excess volatility in the exchange market. The following regulatory measures have been introduced to support stability of the exchange rate:

- Limiting the tenor of swaps and Kenya Shilling borrowing where offshore banks are involved to a tenor of not less than one year.
- Limiting the tenor of swaps between residents to not less than seven days.
- Reduction of the foreign exchange exposure ratio of core capital from 20 percent to 10 percent.
- Requirement that local banks obtain supporting documents for all transactions in the Nostro accounts of offshore banks.
- Suspension of the use of Electronic Brokerage System (EBS) by banks.

- **Licensing and Supervision of Financial Institutions**: The Bank uses the licensing and supervision tools to ensure the health and efficiency of the banking system, this includes vetting potential managers for suitability both with respect to qualifications and character.

- **Communications**: The increasing use of communications media ensures a wider dissemination of monetary policy decisions and background data thereby increasing the efficiency of information transmission. The regular interaction between the MPC and the Kenya Bankers Association (KBA) has ensured that monetary policy decisions and their underlying logic are transmitted to the banking sector. The CBK website is an important source of up-to-date data on all aspects of the financial market including interest rates, exchange rates and results of auctions of government securities.

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 provides the policy stance for the period between January and June 2012. The outcome of the monetary policy stance adopted between July and December 2011 is also analysed.

Inflationary pressure and exchange rate volatility escalated in 2011 as a result of a combination of domestic and international economic developments. Inflationary pressures peaked in response to increasing food and fuel prices due to persistently high international oil prices. Pressure on the exchange rate was attributed mainly to the build-up in the current account deficit due to the rising import bill for imports of machinery and transport equipment necessary for the economic recovery process as well as uncertainty in the global financial markets that was caused by the debt crisis in the eurozone. The adoption of new financial derivatives by banks exacerbated the pressure on the exchange rate.

An intensified tightening of monetary policy was adopted by the Bank in the second half of 2011 to dampen the persistent inflationary pressures and stabilise the exchange rate. Consequently, overall inflation peaked in November 2011 before easing in December 2011. The decline in inflation was supported by a fall in food and fuel prices and an appreciation of the exchange rate. In addition, private sector credit growth declined in November 2011 reflecting easing of demand driven inflationary pressures. The Bank also continued to review monetary policy operations in order to enhance liquidity management and the effectiveness of the monetary policy measures taken.

Despite the easing of inflation at the end of 2011, balance of payments pressures and their potential impact on the exchange rate are major risks. The continued turbulence in the global financial markets due to the debt crisis in the eurozone also presents a potential risk to the exchange rate. Although private sector credit growth has been slowing gradually, it is still growing faster than expected and should therefore slowdown further to stem demand related inflation pressures. The Bank will therefore maintain the tight monetary policy stance during the period January to June 2012 to work towards achieving and maintaining the overall inflation at the revised Government target of 9 percent by June

2012 and 5 percent in the medium term. This will also anchor inflation expectations. The Bank will also continue building its foreign exchange reserves towards achieving the statutory requirement. This will enhance the country's capacity to absorb shocks that impact the foreign exchange market.

Monetary policy during the period January to June 2012 will therefore seek to constrain the growth in broad money supply, M3, to 18.6 percent by March 2012 and 17.0 percent by June 2012. The Net Domestic Assets (NDA) of the Bank is planned to increase from Ksh. -51.6 billion in March 2012 to Ksh -46.3 billion in June 2012 which is consistent with the Extended Credit Facility (ECF) programme targets for the period. Consequently, annual growth in credit to the private sector is projected to slowdown from 22.7 percent in March 2012 to 18.2 percent in June 2012. The Net Foreign Assets (NFA) of the CBK is projected at Ksh 294.8 billion in March 2012 and Ksh 294.6 billion in June 2012. Similarly, the Net International Reserves (NIR) targets for the CBK are USD 3,183.2 million in March 2012 and USD 3,181.3 million in June 2012 which is consistent with the ECF programme targets for the period. The monetary policy stance will ensure that short term interest rates remain stable.

Lastly, in order to enhance the effectiveness and transparency of monetary policy formulation and implementation, the Bank will continue with its regular interactions with stakeholders in the financial and real sectors, including the Kenya Bankers Association, and timely release of relevant data. This will enhance the transmission of monetary policy signals and coordinate market expectations.

1. Introduction

This Monetary Policy Statement (MPS) presents the policy guidelines and broad targets for the CBK over the period January to June 2012. It also presents the policy outcomes in the period July to December 2011.

Inflationary pressures attributed to increases in food and fuel prices contributed to the substantial build-up in inflation in the second half of 2011, posing a risk to strong economic recovery. Increased demand pressures from significant private sector credit expansion exacerbated the inflation pressure. Exchange rate volatility in the period was largely attributable to the eurozone crises and the adoption of new financial derivatives. In addition, the persistence of balance of payments pressure from a rising import bill contributed to the pressure on the exchange rate. The Bank is implementing a tight monetary policy to rein in the inflationary pressures and dampen the pressure on the exchange rate.

The framework for monetary policy formulation and implementation continued to follow the Government's programme as reflected in the Extended Credit Facility (ECF) programme where targets for Net Domestic Assets (NDA) and Net International Reserves (NIR) are the operational parameters. The Bank also continues to monitor targets for key monetary aggregates such as broad money supply, M3. The Bank's participation in the foreign exchange market will continue to be guided by the need to accumulate and maintain foreign exchange reserves at or above the statutory level of four months of import cover as well as purchasing foreign exchange to meet the Government's external obligations, and ensuring stability of the value of the Kenya shilling.

The rest of this report is organised as follows. Section 2 reviews the outcome of the monetary policy stance stated in the June 2011 MPS while Section 3 outlines the current economic environment and outlook for the period January to June 2012. Section 4 concludes by outlining the monetary policy stance for the period January to June 2012.

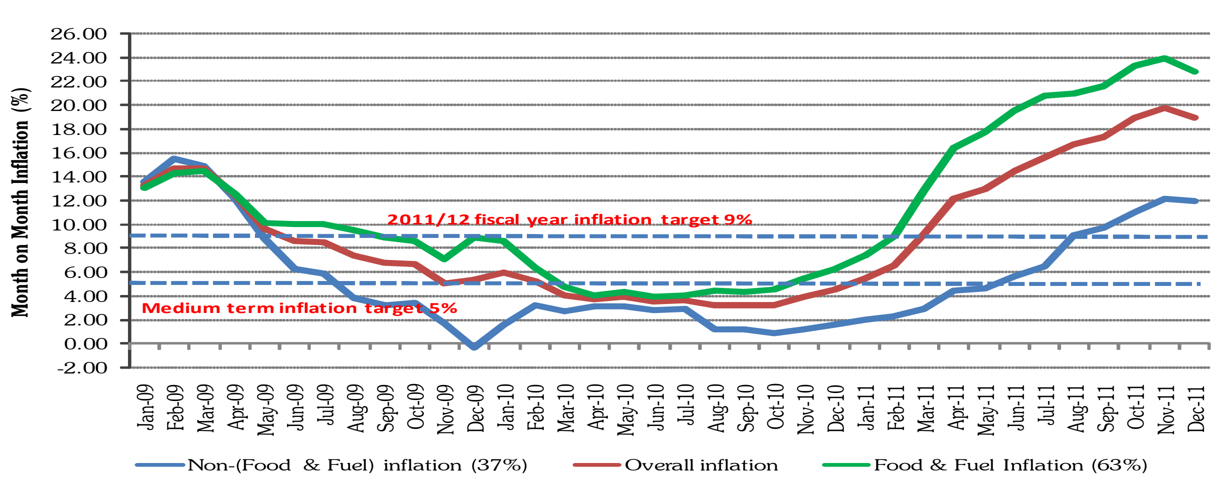
2. Actions and Outcomes of Policy Proposals in the 28th Monetary Policy Statement

The overall aim of the Monetary Policy Statement for June 2011 (28th MPS) was to set monetary policy targets that would ensure low and stable inflation, encourage growth and ensure long-term sustainability of public debt. It also aimed at enhancing financial access within the economy. The Monetary Policy Committee (MPC) shifted to from the bi-monthly to monthly meetings so as to ensure timely tracking of the changing economic environment. The following are therefore the outcomes of the policy proposals in the 28th Monetary Policy Statement:

(a). Inflation

The primary objective of monetary policy formulation and implementation is price stability. Overall inflation was above the revised target of 9 percent for the fiscal year 2011/12 by more than 2 percent between July and December 2011 (Chart 1). Consequently, overall inflation remained above the medium-term target of 5 percent throughout the period. Overall inflation rose from 14.48 percent in June 2011 to 19.72 percent in November 2011, but eased to 18.31 percent in December 2011. The high inflation was attributed to the persistence of high food and fuel prices and exchange rate volatility during most of the period. Demand driven inflationary pressures were also evident during the period as non-food and non-fuel inflation increased above target in the period.

Chart 1: Trends in Inflation (CPI base February 2009=100)



Note: Numbers in brackets represent respective weights in the CPI basket.

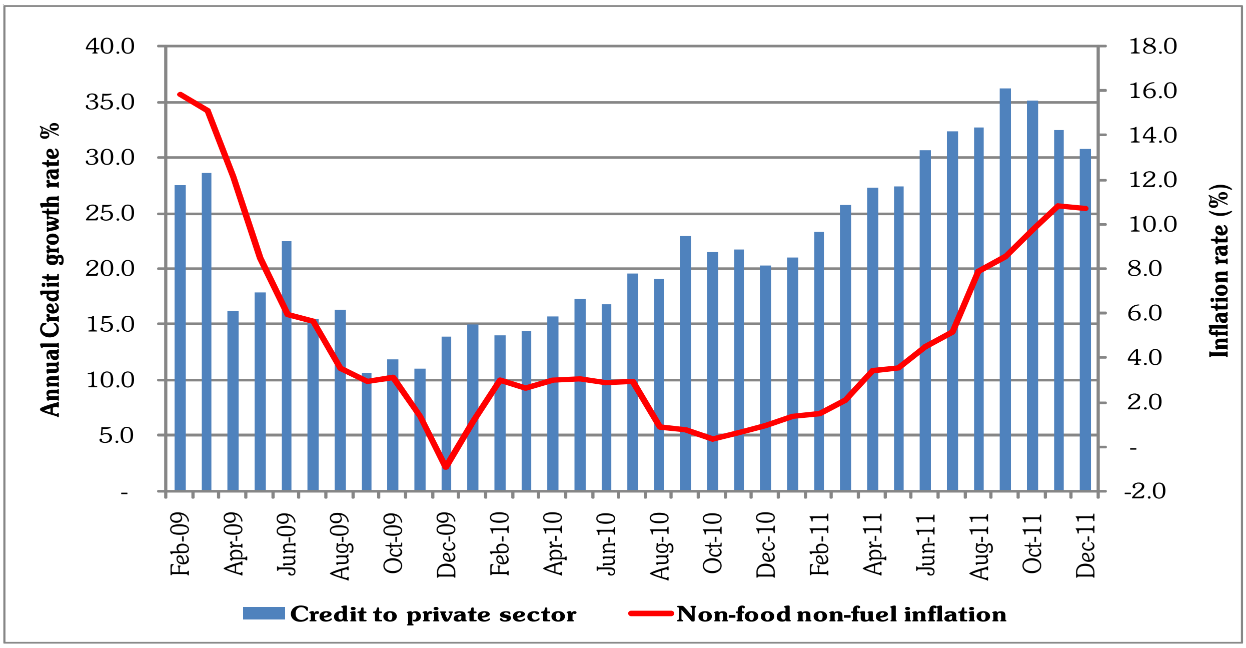
Source: Kenya National Bureau of Statistics

i. Credit to Private Sector

Increased private sector credit contributed significantly to the demand driven inflationary pressures in second half of 2011. As shown in Chart 2, private sector credit expansion

and non-food non-fuel inflation display a positive correlation. The MPC raised the CBR from 7.00 percent in July 2011 to 18.00 percent in December 2011. This slowed private sector credit expansion from Ksh 104.0 billion in the third quarter of 2011 to Ksh 14.1 billion in the fourth quarter. Consequently, non-food non fuel inflation stabilised in December 2011.

Chart 2: Annual Growth in Private Sector Credit and Inflation (%)



Source: Central Bank of Kenya

ii. Monetary Programme

The Bank continued to use the monetary aggregate targeting framework to work towards achieving its price target. These targets are consistent with those for NDA and NIR in the ECF programme. Table 1 show the performance against the monetary aggregate targets which were generally achieved.

Table 1: Actual and Targeted Growth in Key Monetary Aggregates

	Jun-11	Jul-11	Aug-11	Sep-11	Oct-11	Nov-11	Dec-11
Actual Broad Money,M3 (Ksh Billion)	1,380.7	1,412.7	1,436.9	1,484.2	1,513.7	1,489.8	1,514.2
Target Broad Money,M3 (Ksh Billion)	1,411.7	1,434.1	1,456.5	1,478.9	1,501.3	1,523.7	1,546.4
Actual Reserve Money,RM (Ksh Billion)	220.4	222.7	230.7	236.2	234.6	245.4	255.0
Target Reserve Money,RM (Ksh Billion)	221.3	225.4	226.3	223.1	224.9	230.3	229.6
Actual NFA of CBK (Ksh Billion)	282.8	281.9	291.8	292.0	289.5	261.4	258.7
Target NFA of CBK (Ksh Billion)	264.7	268.3	271.4	274.4	277.4	280.4	283.7
Actual Credit to private sector (Ksh Billion)	1,044.7	1,078.8	1,097.9	1,148.7	1,169.1	1,160.4	1,162.7
Target Credit to private sector (Ksh Billion)	1,002.5	1,020.7	1,030.7	1,037.5	1,064.7	1,080.0	1,094.9
Memorandum Items							
12-month growth in actual RM (Percent)	4.8	11.5	14.8	12.5	8.1	9.5	14.5
12-month growth in actual M3 (Percent)	15.2	16.4	18.1	19.3	20.7	18.3	19.1
12-month growth in actual credit to private sector (Percent)	30.7	32.4	32.7	36.3	35.2	32.5	30.9

Source: Central Bank of Kenya

The velocity of money and money multiplier should be stable in order to ensure that the traditional monetary programming framework is effective. The money multiplier was generally on a downward trend declining from 6.26 to 5.94 between June 2011 and December 2011. Similarly, the velocity of money remained fairly stable in the period but declined marginally from 2.00 to 1.96 in the period largely as a consequence of financial innovations.

iii. Interest Rates and Liquidity

Short term interest rates increased following the tight monetary policy adopted by the MPC in the second half of 2011 (Chart 3). Movements in the short term interest rates during the period were successfully coordinated by changes in the CBR. The average interbank rate was volatile during the period, rising from 6.36 percent in June 2011 to peak at 28.90 percent in November 2011, but easing thereafter to 21.75 percent in December 2011 due to improved liquidity management by banks. Introduction of new regulations enabling compliance to CRR to be based on averaging between the 15th of the previous month and the 14th of the current one coupled with the allowance that banks could draw their CRR account to a daily minimum of 3 percent of total deposits provided adequate flexibility in liquidity management by banks. In addition, banks offloaded some of their holdings of foreign exchange and Government securities in order to lessen the impact of the increased cost of funds.

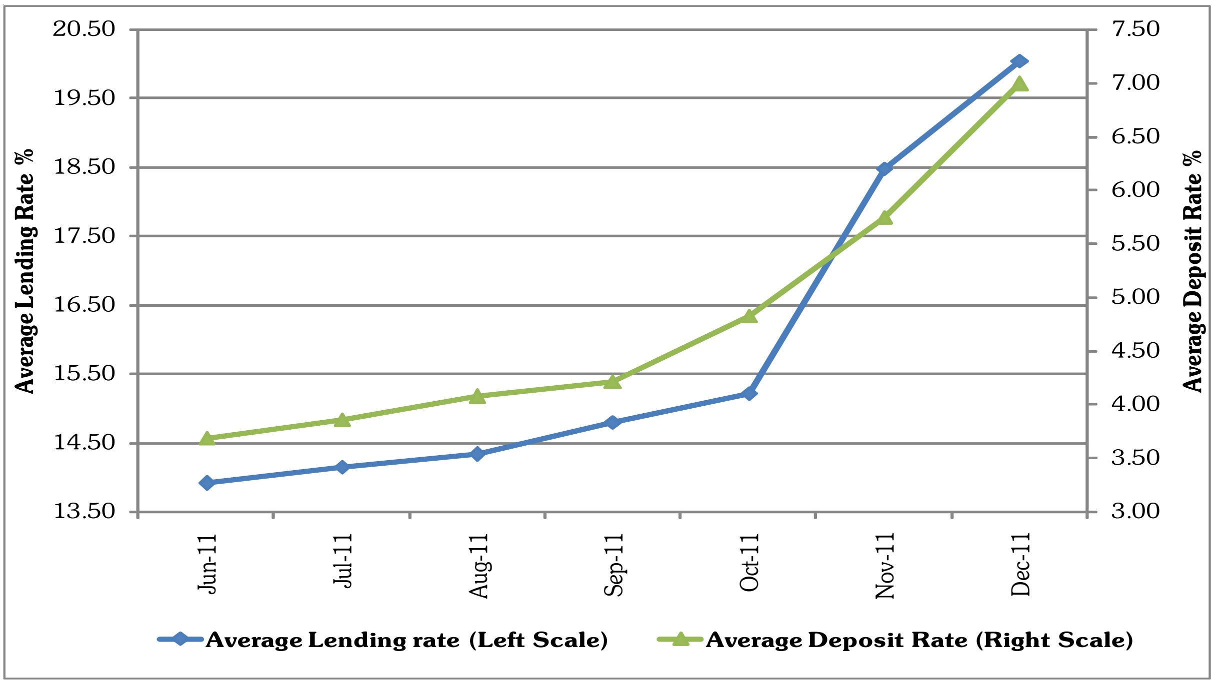
The CBK announced additional measures to improve liquidity management by banks and guide the operations of the CBK Discount Window during the period. These measures are summarised in Annex 3. The measures were also aimed at discouraging any potential adverse arbitrage of banks utilising funds borrowed from the CBK Window to invest in the interbank market or in the foreign exchange market.

Chart 3: Trends in Short Term Interest Rates (%)

Source: Central Bank of Kenya

Average commercial banks' lending and deposit interest rates increased sharply between June and December 2011 following tight liquidity in the market (Chart 4). Although the spread has risen over the period, there has been a noteworthy increase in deposit rates which is strong indicator of the impact of the tightening of the monetary policy stance. However, the CBK has been working with the Kenya Bankers Association (KBA) to address the high spreads. The operationalisation of Credit Reference Bureaus and establishment of currency centers around the country has reduced credit risk levels and the operation costs of banks. The CBK will continue to work with stakeholders to address the concerns and challenges around the collateral perfection process.

Chart 4: Trends in Commercial Bank Interest Rates (%)



Source: Central Bank of Kenya

(b). Exchange Rates and Foreign Exchange Reserves

The foreign exchange market experienced substantial volatility between June and July 2011 reflecting the turmoil in the global financial markets associated with both the European and US debt problems occurring at the same time. Independent of the volatility, there was also an increased demand for foreign exchange to finance the widening current account deficit. However, the tight monetary policy stance adopted by the MPC; the introduction of additional guidelines in the foreign exchange market (Annex 3) between June and December 2011, and the disbursements from the IMF through the ECF programme restored stability at the end of 2011 (Charts 5a and 5b).

In the region, the Kenya shilling strengthened against the South African Rand, and Uganda and Tanzanian shillings. The Rand weakened substantially due to the previously mentioned turmoil in the eurozone and higher oil prices. The Kenya shilling was also supported by increased foreign exchange inflows through immigrant remittances and tourism earnings.

Chart 5a: Trends in the Kenya Shilling Exchange Rate against Major Currencies

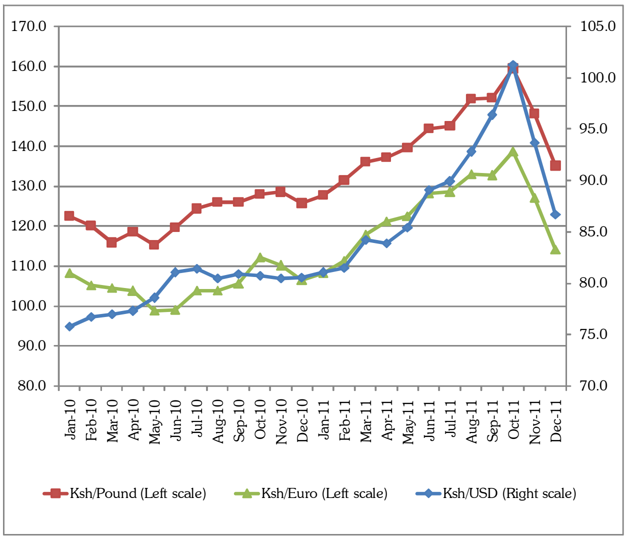


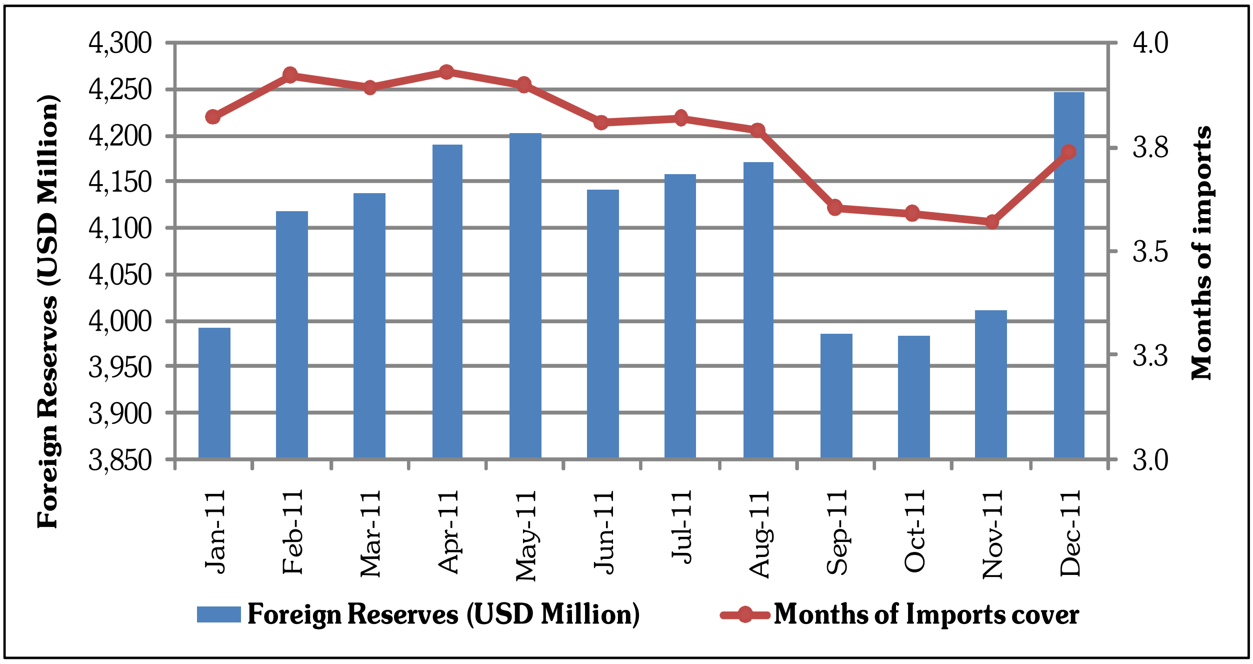
Chart 5b: Trends in the Kenya Shilling Exchange Rate against Regional Currencies

Source: Central Bank of Kenya

The level of official foreign exchange reserves held by the CBK increased Between June and December 2011 from USD 4,142 million in June 2011 to USD 4,248 million in December 2011 (Chart 6). However, following a rapid increase in the import bill, foreign exchange reserves averaged 3.70 months of import cover during the period. The build-up in official foreign exchange reserves in the second half of 2011 was through purchases of US Dollars amounting to USD 266.80 million. In addition, the Bank received USD 211.30 million from the IMF through the ECF programme. These foreign exchange receipts were however partly offset by sales of foreign exchange amounting to USD 118.25 million undertaken to stabilise the exchange rate during the period.

In October 2011, the foreign exchange guidelines were amended (see Annex 3) to curtail abuses associated with the use of foreign exchange unrelated to real economic activity.

Chart 6: Foreign Exchange Reserves

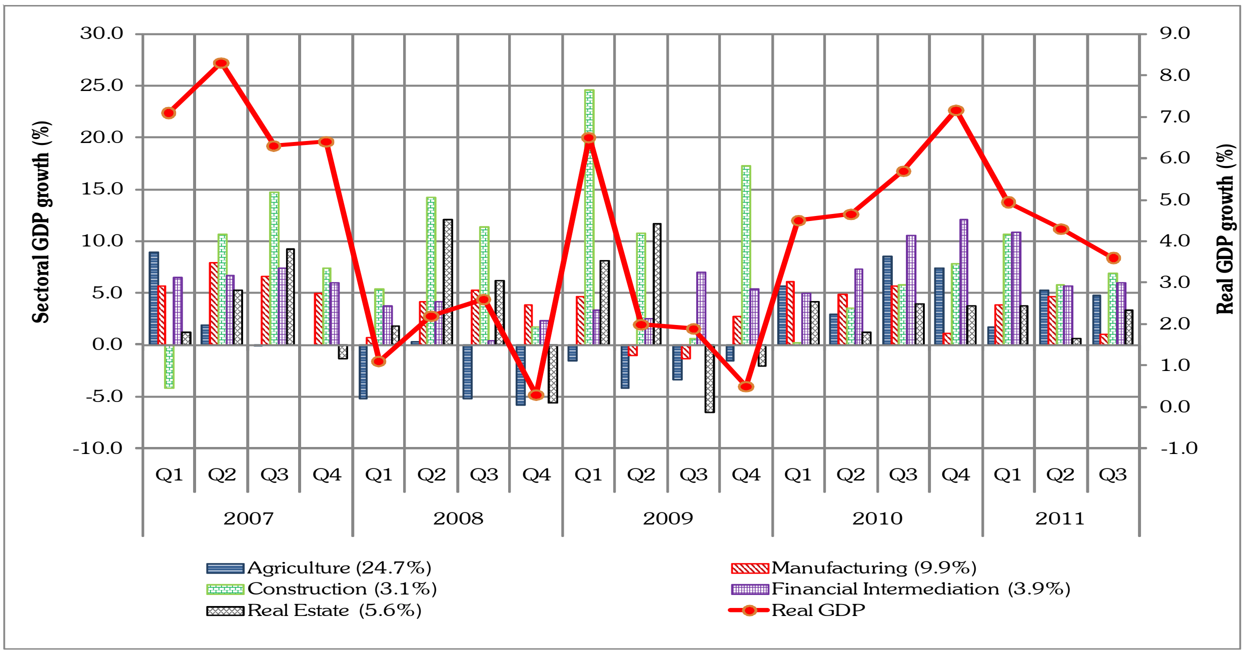


Source: Central Bank of Kenya

(c). Economic Growth

Data from the Kenyan National Bureau of Statistics (KNBS) shows that the economy grew by 3.6 percent in the third quarter of 2011 down from 5.7 percent in a similar period in 2010 (Chart 7). However, the economy remained resilient. Real GDP growth in the three quarters to September 2011 relative to the same period in 2010 was 4.3 percent which was slightly below the 5.0 percent for the same period in 2010. The decline in the performance of the economy in the third quarter of 2011 was attributed to the significant drop in the growth of the wholesale and retail sector allied to a major decline in the output of electricity associated following the earlier dry spell. However, agriculture and construction sectors grew by 4.8 percent and 6.9 percent, respectively, during the third quarter of 2011 on account of sustained credit supply to the sectors.

Chart 7: Selected Quarterly Sectoral GDP Growth Rates



Source: Kenya National Bureau of Statistics

Note: *Long term average contribution of the respective sectors to real GDP are given in brackets*

(d). Fiscal Developments and Debt

The Bank continued to work closely with the Ministry of Finance to ensure coordination between fiscal and monetary policies to support macroeconomic stability. The Government domestic borrowing programme did not exert pressure on interest rates between July and December 2011. The net domestic borrowing increased from Ksh 54.5 billion in the first half of the fiscal year 2010/11 to Ksh 62.5 billion in a similar period of the fiscal year 2011/12 but remained below the target of Ksh 81.5 billion for the period. Similarly, gross public debt decreased from 54.0 percent of GDP in June 2011 to 45.1 percent of GDP in December 2011. The public debt ratios were consistent with the thresholds set in the June 2011 Medium Term Debt Management Strategy.

(e). Banking Sector Developments

Monetary policy decisions during the second half of 2011 were cognisant of the implications of financial innovations on the monetary policy framework. The CBK continued to implement measures aimed at lowering transaction costs in the financial system as well as enhancing financial access during the year 2011. Increasing access to financial services in Kenya is evidenced by an increase in commercial banks' branch network from 1,030 in 2010 to 1,152 in 2011 while the number of commercial banks' ATMs increased by 5.5

percent during the period. The growth and health of the banking sector during the period can be assessed from the expansion of gross loans of banks rising by 30 percent to stand at Ksh 1.21 trillion at the end of 2011 while gross non-performing loans dropped from Ksh 58.3 billion in June 2011 to Ksh 23.1 billion in December 2011.

Other developments can be noted in Annex 3 where Banking Circulars affected foreign exchange exposure of banks and use of the CBK Discount Window. In particular, the use of the Electronic Brokerage System (EBS) was suspended. It had been observed that the system exposed the market to a range of external players and allowed for a much higher level of activity in the market, contributing to the rapid activity in foreign exchange trading and volatility of the exchange rate.

(f). MPC Market Surveys and Stakeholder Forums

In order to enhance the effectiveness and transparency of monetary policy formulation and implementation so as to coordinate market expectations, the Bank held regular interactions with stakeholders in the financial and real sectors. It also constantly updated its website with the release of timely, relevant data. Regular forums were held with the Kenya Bankers Association and Parliamentary Committees. The MPC also continued to improve on the information gathering processes through market perception surveys and communication with key stakeholders on the MPC decisions. Bi-monthly MPC Market Surveys were conducted to understand market perceptions on key indicators of the economy including inflation, interest rates, exchange rates and growth.

3. The Current Economic Environment and Outlook for January to June 2012

(a). International Economic Environment

Although the growth of the global economy is projected to slow down in 2012 due to expected international recession, sub-Saharan Africa and East African Countries (excluding Kenya) are forecast to grow at 5.5 percent in 2012 (Table 2). Given that a large proportion of Kenya's exports are to the region, this growth is expected to benefit Kenya's export sector and boost trade in the region. The expected recession in the global economy is as a result of the rise in bond yields, the impact of banks deleveraging on the real economy, and the impact of additional fiscal consolidation. Pressure on global inflation is expected to ease in 2012 reflecting the impact of tight monetary policy implemented by most countries to rein in inflationary pressures and dampen exchange rate volatility.

The main risks from the international economic environment are the uncertainties in the global financial markets due to the debt crisis in the eurozone. These have a likely impact on tourism and horticulture in particular. Furthermore, the geo-political risks associated with oil movement through the Strait of Hormuz could interrupt the crude oil supply and thus affect fuel prices globally. The consequence of these risks could be seen in Kenya through an increase in exchange rate volatility and potential weakening of the Kenya Shilling.

Table 2: Performance and Outlook for the Global Econony

	Real GDP Growth (%)			Inflation (%)		
	2010 Act.	2011 Est.	2012 Proj.	2010 Act.	2011 Est.	2012 Proj.
World	5.2	3.8	3.3	3.9	5.1	3.7
Advanced Economies	3.2	1.6	1.2	1.6	2.6	1.4
United States	3.0	1.8	1.8	1.6	3.0	1.2
Japan	4.4	-0.9	1.7	-0.7	-0.4	-0.5
Euro Area	1.9	1.6	-0.5	1.6	2.5	1.5
United Kingdom	2.1	0.9	0.6	3.3	4.5	2.4
Other Advanced economies	5.8	3.3	2.6	2.4	3.5	2.6
Emerging and developing economies	7.3	6.2	5.4	6.1	7.5	5.9
Sub-Sahara Africa	5.3	4.9	5.5	7.5	8.4	8.3
East African Community (Excl.Kenya)	5.8	5.9	6.2	7.2	6.2	11.4
Developing Asia	9.5	7.9	7.3	5.7	7.0	5.1
China	10.4	9.2	8.2	3.3	5.5	3.3
India	9.9	7.4	7.0	12.0	10.6	8.6
Middle East and North Africa	4.3	3.1	3.2	6.8	9.9	7.6

Source: World Economic Outlook (September 2011 and January 2012 Update)

(b). Domestic Economic Environment

i. Economic Growth

The economy is projected to remain resilient during the year 2012 and register positive growth per capita. In addition, the MPC Market Perceptions Survey conducted in December 2011 revealed sustained confidence in the economy. Specifically, continued public investment in infrastructure, improved tourist arrivals, and emigrant remittances are expected to continue to support this positive growth forecast. However, the continued slowdown in the growth of private sector credit due to the tight monetary policy and the subdued global economy suggest that a strong recovery is not likely in 2012.

ii. Foreign Exchange Market

Despite the continued pressure from the current account of the balance of payments, it is expected that the exchange rate of the Kenya shilling against major currencies will strengthen in first months of 2012 as a result of the tight monetary policy stance. Demand for credit to finance imports is expected to continue declining, and short term capital inflows to increase due to the higher interest rates. In addition, increased flows from tourism and less pressure from food imports due to expected improvement in the weather are expected to support the Kenya shilling. Pressure on the exchange rate will also ease following plans by the Government to externalise part of its domestic borrowing for the fiscal year 2011/12 amounting to USD 600 million. Foreign exchange reserves will be boosted accordingly. The MPC Market Survey for December 2011 corroborated this evidence of an expected stable exchange rate. However, risks on exchange rate stability in 2012 mainly revolve around the uncertainty in the resolution of the eurozone debt crisis.

iii. Interest Rates

Despite the tight monetary policy stance adopted by CBK, the Government's planned external commercial financing totaling USD 600 million as part of its borrowing requirement in the fiscal year 2011/12 is expected to dampen pressure on interest rates. In addition, the MPC Market Perceptions Survey for December 2011 showed that lending rates were expected to remain high in the short term but would decline with inflation coming down, with a strengthening exchange rate, and the ongoing moral suasion by KBA and CBK. Furthermore, most commercial banks are sensitive to the impact of any threat of an accumulation of non-performing loans. In order to diffuse any threat of loan defaults and cushion borrowers from the high interest rates, the CBK and KBA put in place several measures which were announced through a press release by KBA on 13th December 2011. These measures will ensure that the banking sector remains stable during the period of tight monetary policy. The main risk to the outlook on interest rates is to the international economic developments or supply side factors which could prompt additional measures by CBK to allay any adverse expectations with respect to inflation or exchange rate movements.

iv. Inflation

Inflation is expected to continue declining in the year 2012. The inflation outlook, which is corroborated by the MPC Market Survey results, is attributed to the CBK actions to tighten monetary policy which will ease the demand for credit. Lower energy costs and improved food supply due to better rainfall across the country together with the strengthening of Kenya Shilling to USD should also lower prices and hence inflation. However, uncertainty in the resolution of the eurozone debt crisis could result in exchange rate volatility with pass-through effects to domestic prices.

v. Fiscal Policy

The impact of the revised domestic borrowing programme for the fiscal year 2011/12 has been analysed and does not threaten either upward pressure on interest rates or debt sustainability. The planned commercial financing amounting to USD 600 million will contribute significantly to this outlook. In addition, enhanced expenditure on infrastructural projects in the country will continue to create employment and demand. Continued reorienting of expenditures to priority growth enhancing outlays and subsequent cuts on non-priority areas will enhance the country's growth potential while also dampening pressure on interest rates. The main risks to the fiscal outlook are the likely increase in expenditures to finance implementation of the New Constitution, preparations for the forthcoming elections, and the ongoing security operation in Somalia.

vi. Confidence in the Economy

Confidence in the Kenyan economy was sustained in the second half of 2011 despite the shocks on the economy. The re-affirming of Kenya's credit rating at *'B+ with stable outlook'* by the Standard and Poor's rating agency in December 2011 is a reflection of confidence in the country as an investment destination. Table 3 shows other indicators of sustained confidence in the economy. The cumulative diaspora remittances continued to grow, rising from USD 748.5 million in the 12-months to June 2011 to USD 891.4 million in the 12-months to December 2011. Similarly, the 12-month cumulative tourist arrivals remained well over 1,000,000 during the period. Other key signals to investors included the overall decline in credit risk and recovery of the stock market during the period. The MPC Market Surveys conducted in the period also pointed to sustained private sector confidence in the economy despite various shocks witnessed.

Table 3: Indicators of Declining Risk and Confidence in the Economy

	Jun-11	Jul-11	Aug-11	Sep-11	Oct-11	Nov-11	Dec-11
12-Month Emigrant Remittances (USD Million)	748.5	770.7	798.3	824.5	847.3	871.8	891.4
NSE Index (Jan 1966 = 100)	3,968.1	3,738.5	3,465.0	3,284.1	3,507.3	3,155.5	3,205.0
12-Month Number of Tourist Arrivals	1,161,467	1,188,264	1,223,640	1,230,773	1,239,498	1,257,861	1,264,926
Net NPLs/Total Loans ratio (%)	1.31	1.18	1.18	1.01	0.92	0.78	0.82

Source: Kenya National Bureau of Statistics and CBK

4. Future Direction of Monetary Policy (January – June 2012)

During the period January to June 2012, monetary policy will focus on: setting monetary targets which are consistent with the objective of maintaining a low and stable inflation, encouraging growth and ensuring the long term sustainability of public debt; and enhancing access to banking services.

(a) Monetary Programme and Foreign Exchange Reserves

The monetary targets for the period January to June 2012 are based on the assumptions in the June 2011/12 Budget Strategy Paper which are presented in Annexes 1 and 2, and the revised ECF programme targets. The monetary targets for the period are presented in Table 4. Specifically, broad money supply, M3, is set to grow by 20 percent in January 2012, 18.6 percent by March 2012, and 17.0 percent by June 2012. As a result, the NDA of the CBK is planned to increase from Ksh. -59.2 billion in January 2012, Ksh. -51.6 billion in March 2012 and to Ksh -46.3 billion in June 2012. The NDA targets for the period are consistent with the ECF programme targets of Ksh -40.0 billion in March 2012 and Ksh -35.0 billion in June 2012. Consequently, annual growth in credit to the private sector is projected to slowdown from 22.7 percent in March 2012 to 18.2 percent in June 2012. Similarly, the Net Foreign Assets (NFA) of CBK is projected at Ksh 294.8 billion in March 2012 and Ksh 294.6 billion in June 2012. The NIR targets are USD 3,183.2 million in March 2012 and USD 3,181.3 million in June 2012 which are consistent with the ECF programme targets of USD 3,125.0 million and USD 3,170 million, respectively, for the period.

This monetary targets are expected to enable the Bank achieve the policy objective of maintaining overall inflation at the revised target of 9 percent by June 2012 and 5 percent in the medium term in order to anchor inflation expectations. The planned build-up in foreign exchange reserves will enhance the country's capacity to absorb shocks that impact the foreign exchange market. The monetary policy stance will ensure that short-term interest rates remain stable which will encourage growth and ensure the long-term sustainability of public debt.

Table 4: Monetary Targets for January to June 2012

	Jan-12	Feb-12	Mar-12	Apr-12	May-12	Jun-12
Broad Money, M3 (Ksh Billion)	1,542.6	1,557.0	1,571.4	1,586.1	1,600.5	1,615.1
Reserve Money, RM (Ksh Billion)	236.8	241.9	243.1	246.5	241.2	248.2
NFA of CBK in Ksh Billion	296.0	295.0	294.8	294.5	294.3	294.6
NDA of CBK in Ksh Billion	-59.2	-53.1	-51.6	-48.1	-53.2	-46.3
12-month growth in RM (Percent)	13.7	15.3	16.1	15.7	15.2	12.6
12-month growth in M3 (Percent)	20.0	19.2	18.6	18.8	18.4	17.0
12-month growth in Credit to Private Sector (Percent)	28.1	24.5	22.7	20.8	19.0	18.2
12-month growth in Real GDP (Percent)						5.4
12-month overall Inflation (Percent)	9.0	9.0	9.0	9.0	9.0	9.0

Source: Central Bank of Kenya

The Bank will continue to monitor developments with respect to the Monetary Targets and make any necessary reviews. The achievement of the targets set will however depend on stability in the international prices of oil, normal weather conditions, stability of the exchange rate, and sustained commitment by the Government to operate within the domestic borrowing ceiling for fiscal year 2011/12. Monetary policy implementation will be based on monthly targets for NDA, RM and broad money supply, M3, 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. In addition, the success of CBK's monetary policy measures to fight inflation will depend on the effectiveness of the institutions charged with the responsibility of managing the supply side of prices that is ensuring an adequate food and fuel supply.

(b) Extending Access to 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 that have been shown to support economic growth. Appropriate legislation aimed at ensuring that such innovations are regulated accordingly to enhance market confidence will be recommended. The Bank will also continue to monitor any new financial derivatives in the market.

(c) Measures to Enhance Market Efficiency

The Bank will continue to work with stakeholders in the banking and real sectors in order to enhance the monetary policy transmission mechanism. The Bank will hold the second Monetary Policy Public Forum in June 2012 and will also continue with similar initiatives aimed at engaging stakeholders and obtaining feedback on the impact of MPC decisions. Measures to enhance the uptake of Horizontal Repos among banks will also be implemented, while stakeholder forums with Chief Executive Officers and Treasury Managers of banks will be held both to obtain feedback and to explain the background to MPC decisions. Furthermore, the MPC will continue to brief the market on its decisions with a view to coordinate market expectations.

ANNEX 1: MAIN MACROECONOMIC INDICATORS UNDERPINNING THE MEDIUM TERM FRAMEWORK, 2009/10-2013/14

	2009/10	2010/11		2011/12		2012/13		2013/14	
	Actual	*Budget*	*BPS'11**	*BOPA'11*	*BPS'11**	*BOPA'11*	*BPS'11**	*BOPA'11*	*BSP'11**
	Annual percentage change, unless otherwise indicated								
National account and prices									
Real GDP	4.1	5.1	5.4	6.1	5.7	6.7	6.3	6.8	6.5
Real GDP per capita	2.2	2.2	2.5	3.2	2.8	3.7	3.4	3.9	3.6
GDP deflator	5.7	6.4	6.4	6.8	9.1	5.6	6.0	4.9	5.0
CPI Index (eop)	3.5	5.0	13.0	5.1	7.8	5.0	5.7	5.0	5.0
CPI Index (avg)	5.5	5.0	7.4	5.2	9.3	5.0	6.4	5.0	5.0
Money and credit (end of period)									
Net domestic assets	34.6	13.8	17.1	15.4	16.2	10.5	14.1	13.0	16.2
Net domestic credit to the Government	59.7	16.9	29.3	10.9	18.3	5.0	5.2	5.0	4.7
Credit to the rest of the economy	16.8	20.0	23.3	18.3	17.6	15.0	17.8	15.7	17.5
Broad Money, M3 (percent change)	26.2	14.0	17.0	17.7	16.5	14.9	17.4	14.9	17.7
Reserve money (percent change)	31.5	11.7	1.8	14.8	13.6	14.9	17.4	14.9	17.7
	In percentage of GDP, unless otherwise indicated								
Investment and saving									
Investment	19.5	21.1	22.3	25.1	23.4	26.5	24.8	26.6	25.3
Central Government	10.3	10.2	9.8	10.6	12.5	11.8	11.0	11.2	10.5
Other	9.3	10.9	12.6	14.5	10.9	14.6	13.8	15.4	14.7
Gross National Saving	12.1	15.5	13.8	18.6	15.5	20.6	17.6	21.4	19.0
Central Government	2.0	6.4	2.7	4.4	3.9	6.2	5.5	6.4	6.1
Other	10.1	9.1	11.1	14.2	11.6	14.4	12.1	15.0	12.9
Central government budget									
Total revenue	23.9	24.9	24.9	25.3	24.7	25.3	24.9	25.5	25.2
Total expenditure and net lending	32.2	33.1	32.0	31.8	33.5	31.3	31.0	30.7	30.2
of which : wages and salaries	7.1	6.9	7.3	7.1	7.0	7.1	6.9	7.1	6.9
Interest payments	2.6	2.7	2.6	2.7	2.6	2.6	2.8	2.6	2.3
Development expenditures	10.4	11.7	9.9	10.7	12.6	11.9	11.1	11.3	10.6
Overall balance (commitment basis) excl. grants	-8.4	-8.2	-7.2	-6.6	-8.8	-6.0	-6.1	-5.2	-5.0
Overall balance (commitment basis) incl. grants	-7.1	-6.8	-5.9	-5.3	-7.4	-4.7	-4.7	-3.9	-3.7
Primary budget balance	-4.5	-4.1	-3.3	-2.7	-4.8	-2.0	-1.9	-1.3	-1.4
Net external borrowing	0.8	3.0	1.4	1.9	3.6	3.2	3.3	2.4	2.5
External sector									
Exports value, goods and services	25.4	24.5	28.3	24.6	28.2	24.3	27.2	24.4	26.8
Imports value, goods and services	38.8	35.2	42.5	36.5	41.4	35.5	39.3	34.7	37.7
Current external balance, including official transfers	-7.4	-5.6	-8.5	-6.4	-7.9	-5.9	-7.2	-5.3	-6.3
Current external balance, excluding official transfers	-7.4	-5.5	-8.5	-6.4	-7.9	-5.8	-7.1	-5.2	-6.2
Gross international reserve coverage in months of next year imports (end of period)	3.2	3.2	3.1	3.8	3.2	4.2	3.6	4.4	3.8
Public debt									
Nominal central government debt (eop), gross	49.9	50.3	52.3	51.6	52.3	50.7	51.2	49.4	49.7
Nominal central government debt (eop), net	45.0	46.0	48.0	47.7	48.6	47.2	47.9	46.3	46.7
Domestic (gross)	26.9	27.1	28.4	28.8	28.4	27.1	26.6	25.6	24.9
Domestic (net)	22.0	22.9	24.1	24.9	24.7	23.6	23.2	22.5	22.0
External	23.0	23.2	23.9	22.8	23.9	23.6	24.6	23.7	24.7
Memorandum items:									
Nominal GDP (in Ksh billions)	2,458	2,767	2,761	3,075	3,184	3,463	3,589	3,879	4,011
Per capita income (Ksh)	62,787	67,344	68,572	74,249	76,889	81,352	84,294	88,639	91,674

Source: Ministry of Finance

BOPA = Budget Outlook Paper

BSP = Budget Strategy Paper

BPS = Budget Policy Statement

eop - End of period

avg - period average

* Updated

ANNEX 2: MONETARY SURVEY 2009/10 – 2013/14 (END OF PERIOD, KSH (BILLION)

	2009/10	2010/11	2011/12	2012/13	2013/14
	Act.	Act.	Proj.	Proj.	Proj.
Central Bank of Kenya (CBK)					
Net Foreign Assets 1/	242.9	282.8	288.9	358.9	421.0
Net Domestic Assets	-32.6	-62.3	-45.7	-73.4	-85.1
Net credit extended	7.5	17.7	27.5	9.4	5.5
Net claims on Government	7.5	-7.1	19.7	22.1	24.5
Claims on banks	0.0	19.9	7.8	-12.7	-19.0
Other assets, net	-41.9	-80.0	-73.2	-82.8	-90.6
Reserve money (RM)	210.3	220.4	243.2	285.5	335.9
Monetary Survey					
Net Foreign Assets (NFA) 1/	280.3	283.8	384.2	492.7	600.5
Central Bank (CBK)	242.9	284.6	288.9	358.9	421.0
Banks	37.4	-0.8	95.3	133.9	179.5
Net Domestic Assets (NDA)	918.6	1,096.9	1,249.7	1,425.6	1,656.6
Domestic Credit	1,076.9	1,404.7	1,583.6	1,812.2	2,072.7
Claims on Government (net)	277.7	328.5	424.7	446.6	467.7
Central Bank	7.5	-9.0	19.7	22.1	24.5
Banks	270.2	337.5	405.0	424.5	443.3
Claims on Private Sector	799.2	1,054.5	1,158.9	1,365.6	1,605.0
Other items (net)	-167.1	307.8	-333.8	-386.7	-416.1
Broad Money (M3)	1,198.9	1,380.7	1,633.9	1,918.3	2,257.2
of which:					
Residents' foreign-currency deposits	165.2	196.0	225.2	264.4	311.1
Ratio of Foreign currency deposits/M3 (%)	13.8	14.3	13.8	13.8	13.8
Memorandum items:					
Reserve money annual percentage change	31.5	4.8	13.6	17.4	17.7
M3 Annual percentage change	26.2	19.2	16.5	17.4	17.7
Velocity (GDP/M3avg)	2.3	2.0	2.1	2.0	1.9
Multiplier (M3/RM)	5.7	6.3	6.7	6.7	6.7
Credit to private sector	16.8	30.7	17.6	17.8	17.5
Net Government borrowing	536.2	645.2	780.7	829.4	876.4
Banking sector	277.7	316.9	424.7	446.6	467.7
Non-banking sector	258.5	328.4	356.0	382.8	408.6

Source: Ministry of Finance and Central Bank of Kenya

1/ At current exchange rate

ANNEX 3: CHRONOLOGY OF EVENTS OF PARTICULAR RELEVANCE TO MONETARY POLICY AND INFLATION (JULY - DECEMBER 2011)

July 2011	a) The CBK reviewed the guidelines on the use of Discount Window. Banks lending in the interbank were barred from accessing Window funds on the same day. In a week (Monday-Friday) banks were restricted to borrow from the Window a maximum of their statutory cash reserves. The Window rate was reviewed downwards to 6.25 percent from 8.00 percent. Banks were signaled to consider liquidating their Treasury bills, bonds or foreign currency positions prior to resorting to CBK Window. b) The MPC maintained the CBR at 6.25 percent and introduced weekly averaging on cash reserves instead of the daily. Banks were also allowed to deviate from the 4.75 percent provided the five-day average of 4.75 percent was met.
August 2011	a) CBK provided further guidelines on the CBK Discount Window. Any bank accessing funds from the CBK window was not allowed to lend in the interbank market either on the same day or the following day. The Window rate was to be computed as CBR *plus* (Average interbank rate for the previous day-CBR) *plus* 3 percent penalty. Eligibility to access funds from the CBK Window would be determined by among other things, an individual bank's foreign exchange trading behaviour over the previous four trading days. Reverse repos were suspended until the stance on monetary policy was changed. b) CBK provided more guidelines on liquidity management and CRR. The formula for the Window rate was reviewed to reflect market conditions by introducing a weight on the gap between the average interbank rate and CBR and expanded the period for the average interbank rate component (*Averaging period was over 2 days).* The CBR was defined as the floor for the Window rate. Expanded averaging of cash reserves from weekly to monthly but limited the deviation to a minimum of 3 percent failure to which penalties would be effected.
September 2011	The MPC adjusted the CBR upwards from 6.25 percent to 7.00 percent during the special MPC meeting to rein in inflation and exchange rate instability.
October 2011	a) The MPC raised the CBR from 7.00 percent to 11.00 percent to tame inflationary pressure, stabilise exchange rate and re-establish a strong growth base. Introduction of monthly MPC meetings in the first week of the month until further notice. b) Extension of foreign exchange guidelines. Reverse-carry transactions that had been introduced into the market, and unrelated to economic activity, and which have not been utilised for domestic purposes were limited to a minimum tenor of one year. Foreign currency swaps involving Kenya shillings were limited to a minimum tenor of seven days. Foreign exchange exposure limits were reviewed downwards from 20 percent to 10 percent of core capital. c) Foreign currency swaps and forward transactions involving Kenya shillings for non-resident financial institutions limited to a minimum tenor of one year.
November 2011	The MPC raised the CBR from 11 percent to 16.5 percent to provide an enhanced monetary policy tightening stance. In addition, the CRR was adjusted upwards from 4.75 percent to 5.25 percent effective from 15th December, 2011.
December 2011	The MPC CBR raised the CBR from 16.5 percent to 18.0 percent to provide an enhanced monetary policy tightening stance.

GLOSSARY OF KEY TERMS

Overall Inflation

This is a measure of inflation in the economy measured by the year-on-year movement of indices of all consumer price items of goods and services sampled by the Kenya National Bureau of Statistics. 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.

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