Monetary Policy Statement
December 2001

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OBJECTIVES OF THE CENTRAL BANK OF KENYA

Principal Objectives

The objects of the Central Bank are laid down in the Central Bank of Kenya (Amendment) Act, 1996 as follows:

(i) Formulate and implement monetary policy directed to achieving and maintaining stability in the general level of prices; and

(ii) 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 objects, the Bank's secondary objectives shall be to:

(i) Formulate and implement foreign exchange policy;

(ii) Hold and manage its foreign exchange reserves;

(iii) License and supervise authorised dealers in the money market;

(iv) Promote the smooth operation of payments, clearing and settlement system;

(v) Act as a banker and adviser to, and as fiscal agent of the Government; and

(vi) Issue currency notes and coins.

LEGAL BASIS FOR THE PUBLICATION OF THE MONETARY POLICY STATEMENT

This Statement is made pursuant to Section 4(b) of the Central Bank of Kenya (Amendment) Act, 1996, which states that:

(i) 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; and

  (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.

(ii) 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.

(iii) The Bank shall:

  (a) cause every monetary policy statement submitted under subsection (1) and its monthly balance sheet to be published in the Gazette; and

  (b) disseminate key financial data and information on monetary policy to the public.

(iv) In subsection (ii), the expression 'appropriate committee' means the committee of the National Assembly appointed to investigate and inquire into matters relating to monetary policy.

1. IMPLEMENTATION OF MONETARY POLICY FOR THE PERIOD JULY TO JUNE 2002

1.1 Key Elements of the Policy

Monetary policy in 2001/02 focused on achieving inflation target under good economic prospects

The monetary policy for the twelve months to June 2002 was formulated to further reduce inflation against a background of high expectation for a much more robust economy and good prospects for growth in all sectors. Overall, the economy was expected to grow by 2.0% over the calendar year 2001 and by 2.6% in the fiscal year to June 2002. Virtually all critical fundamentals then appeared to favour a remarkable improvement on the 0.3% decline in economic growth realized in 2000.

First, the drought conditions that prevailed in the first ten months of 2000 had ended with the onset of the short-rains in November 2000 and adequate rains had been experienced in the main grain and cash crop growing areas through June 2001. **Second**, the trend towards lower prices and interest rates as reflected by the decline in the 91-day Treasury bill rate from 15% in March 2001 to 12.1% in June 2001 was a positive development for the economy. **Third**, there was high optimism that the suspended external budgetary support under the IMF Poverty Reduction and Growth Facility (PRGF) would be reinstated early in the current financial year. **Fourth**, the continued stability of the Kenya shilling exchange rate was another positive development for the economy.

On the basis of the prospects for economic recovery and scope for further reduction of the underlying inflation, the Central Bank programmed money supply (M3X)[1] to grow by approximately 8% (Table 1). Reserve money[2], which forms the basis for the creation of money supply, was projected to grow by 9.8% over the year to June 2002 and was to be wholly built up through the accumulation of foreign exchange reserves of the Central Bank.

TABLE 1: ORIGINAL MONETARY PROGRAMME PROJECTIONS FOR JULY-JUNE 2002 (in Ksh m)

	2001						2002	
	Jul	Aug	Sept	Oct	Nov	Dec	Mar	Jun
1. Banking Survey								
Money supply (M3X)*	370,439	367,818	367,882	371,391	376,284	382,856	387,951	391,143
	(4.4)	(4.9)	(5.4)	(6.7)	(6.5)	(7.0)	(9.0)	(11.1)
Net foreign assets	89,659	92,962	93,451	93,940	94,894	95,606	95,584	98,799
Net domestic assets	280,780	274,857	274,431	277,451	281,390	287,250	292,367	292,344
2. Central Bank Balance Sheet								
Reserve money*	71,362	73,227	73,377	73,262	76,328	78,125	76,211	78,143
	(-2.9)	(-0.9)	(-2.0)	(5.2)	(6.2)	(4.4)	(3.5)	(9.1)
Net foreign assets	66,986	70,289	70,778	71,268	72,221	72,933	72,911	76,127
Net domestic assets	4,376	2,938	2,599	1,995	4,107	5,192	3,300	2,016

*Figures in brackets show annual percentage changes

Source: Central Bank of Kenya

Economic prospects weaken during the second half of 2001

On the external front, prospects for exports and in particular tourism, worsened following the September 11th terrorist attacks in the United States of America. In addition, prospects for the disbursement of the suspended budgetary support under the PRGF became bleak. On the domestic front, economic activity remained subdued necessitating the Bank to scale down its real GDP growth forecast for 2001 to 1% and that for 2002 to 1.4%. Resultant of these unfavourable external and domestic developments particularly during the period

[1] The Central Bank uses broad money supply, M3X, as the intermediate target for monetary policy. M3X is defined to include currency held by the non-bank public plus Kenya shilling and foreign currency denominated deposits of the non-bank private sector.

[2] Reserve money comprises currency in circulation and deposits of banking institutions at the Central Bank.

July - September 2001, the Central Bank revised its original monetary programme effective November 1, 2001. With the lower than expected economic growth rates, the continued implementation of the initial monetary programme would have undoubtedly created liquidity overhang that would only have resulted in higher inflation in the next six months or so.

Tighter monetary policy stance adopted

Taking cognizance of the revised real GDP growth rates for 2001 and 2002 whilst also retaining the 5% inflation target, the broad money supply (M3X) was programmed to grow by a much lower rate of 6% in the year to June 2002. To support this expansion in broad money supply, reserve money targets were concomitantly revised as shown in Table 2. As in the past, daily deviations of reserve money from the target were used to guide the Central Bank in managing the liquidity of the banking system.

TABLE 2: REVISED MONETARY PROGRAMME PROJECTIONS FOR JULY-JUNE 2002 (in Ksh m)

	2001						2002	
	Jul	**Aug**	**Sept**	**Oct**	**Nov**	**Dec**	**Mar**	**Jun**
1. Banking Survey								
Money supply (M3X)*	370,439	367,818	367,882	371,391	367,962	376,927	374,565	369,589
	(4.4)	(4.9)	(5.4)	(6.7)	(4.2)	(5.3)	(5.2)	(4.9)
Net foreign assets	89,185	89,659	92,962	93,451	90,140	90,155	92,778	93,512
Net domestic assets	280,780	274,857	274,431	277,451	277,823	286,771	281,787	276,077
2. Central Bank Balance Sheet								
Reserve money*	71,362	73,227	73,377	73,262	73,920	76,627	75,253	74,974
	(-2.9)	(-0.9)	(-2.0)	(5.2)	(6.2)	(4.4)	(2.2)	(4.7)
Net foreign assets	66,986	70,289	70,778	71,268	72,896	72,912	75,534	76,268
Net domestic assets	4,376	2,938	2,599	1,995	1,024	3,715	(281)	(1,295)

*Figures in brackets show annual percentage changes

Source: Central Bank of Kenya

1.2 Progress in Implementation of Monetary Policy, July to Dec 2001

Reserve money remained generally on track

During the six-month period to December 2001, the Central Bank on average achieved the reserve money targets except for July, November and December (Table 3). The attainment

TABLE 3: RESERVE MONEY PERFORMANCE[1] JUL-DEC 2001 (in Ksh m)

	ACTUAL	PROG. TARG.	PERFORMANCE	
	(A)	(B)	C=(A-B)	RESERVE MONEY DEVIATION
JUL				
Reserve Money	72,515	71,362		1,152
Net Foreign Assets	67,627	66,986	641	
Net Domestic Assets	4,888	4,376	511	
AUG				
Reserve Money	72,828	73,227		-399
Net Foreign Assets	68,752	70,289	-1,537	
Net Domestic Assets	4,076	2,938	1,138	
SEPT				
Reserve Money	72,503	73,377		-874
Net Foreign Assets	70,022	70,778	-756	
Net Domestic Assets	2,481	2,599	-118	
OCT				
Reserve Money	73,023	73,262		-239
Net Foreign Assets	70,953	71,268	-315	
Net Domestic Assets	2,070	1,994	76	
NOV				
Reserve Money	75,371	73,920		1,451
Net Foreign Assets	70,738	72,896	-2159	
Net Domestic Assets	4,633	1,024	3609	
DEC				
Reserve Money	78,143	76,627		1,517
Net Foreign Assets	73,968	72,912	1,056	
Net Domestic Assets	4,175	3,715	460	

[1] Monthly averages

Source: Central Bank of Kenya

of reserve money targets was due to a less than expected expansion in net foreign assets (NFA) that offset the more than programmed expansion in net domestic assets (NDA). The expansion of NDA in turn reflected a decline of repo holdings by commercial banks, from Ksh 19.3bn in July to Ksh 7.3bn in October 2001, whose impact on NDA was partly offset by a build up of government deposits at the Central Bank from Ksh 26.5bn to Ksh 37.7bn.

Expansion in virtually all monetary aggregates remained subdued

Despite the generally high level of reserve money in the period under review, the expansion in all the various measures of money remained well below expectation (Table 4). Analysis of the money multiplier of M3X during this period shows that it was fairly stable, averaging 4.3% and within the level forecast in the programme. This clearly shows that the lower growth in money supply reflected the sluggish growth in credit

TABLE 4: EVOLUTION OF SELECTED MONETARY AGGREGATES
Annual % Changes

		RM	M3	M3X	M3XT
Dec-00	Actual	-1.6	0.8	3.4	4.5
	Target	-10.9	4.3	5.6	8.4
Mar-01	Actual	-2.8	-0.2	3.5	4.6
	Target	2.2	4.3	5.6	8.1
Jun-01	Actual	-8.5	1.5	1.7	5.0
	Target	-5.7	1.8	5.1	5.5
Sep-01	Actual	0.2	0.7	1.7	6.4
	Target	5.4	4.2	5.5	11.0
Dec-01	Actual	1.8	2.5	2.3	6.1
	Target	-1.4	5.8	2.2	9.2

Source: Central Bank of Kenya

to the private sector occasioned by the slow pace of economic recovery. Throughout 2001, credit to the private sector hardly changed. Several factors, including low business confidence, impact of the persistent high lending interest rates, and restrained lending by banks largely due to the uncertainty sparked by the Central Bank of Kenya (Amendment) Act, 2000, contributed to the sluggish growth in bank credit to the private sector. The Act reintroduced controls on interest rates.

Inflationary pressures eased substantially

On the inflation front, good progress was made in the year to December 2001. Inflation slowed down substantially in 2001, particularly during the second half of the year (Table 5). The overall month-on-month inflation eased from 6.0% in January 2001 to 3.9% in March 2001, to 0.2% in July 2001 and further to negative rates through December. The overall average annual inflation also eased throughout the period reaching

TABLE 5: INFLATION (%)

	2000	2001												2002	
	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb
Overall															
Month-on-month	7.5	6.0	5.2	3.9	3.7	2.1	0.2	0.2	-0.3	-2.2	-2.4	-2.9	-3.1	-3.1	-2.3
Annual average	6.2	6.0	6.0	6.0	5.9	5.7	5.2	4.6	4.1	3.3	2.6	1.7	0.8	0.1	-0.6
Underlying															
Month-on-month	10.7	10.1	10.5	7.1	7.8	7.3	7.2	7.8	7.3	2.5	2.0	2.0	1.4	1.5	1.5
Annual average	9.2	9.4	9.6	9.5	9.4	9.3	9.2	9.2	9.2	8.4	7.6	6.8	6.1	5.4	4.7

Source: Central Bureau of Statistics

0.8% in December 2001, down from 6.0% in January 2001. The underlying month-on-month inflation declined to 1.4% in December 2001 from 10.1% in January 2001, while the underlying average annual inflation eased to 6.1% from 9.4% over the same period.

The easing of inflation during the year reflected the effect of the sustained implementation of an appropriate monetary policy, ample supply of food following favourable weather conditions that caused increased food-crop production, sharp drop in the international prices of crude oil, and relative stability in the shilling exchange rate.

2. MONETARY POLICY FOR THE TWELVE MONTHS TO DECEMBER 2002

2.1 Current Economic Situation

2.1.1 Inflation

As discussed above, the underlying inflation declined remarkably between July and December 2001. This was attributed to sustained implementation of an appropriate monetary policy, ample supply of food following increased food crop production, sharp drop in the international prices of crude oil and relative stability in the shilling exchange rate.

2.1.2 Domestic Output

Modest economic recovery expected in 2001

Available production data up to November 2001 for key economic sectors show that the economy registered a mild recovery in 2001, with real GDP estimated to have increased by 0.8% compared with a negative growth of 0.3% in 2000. The recovery was mainly driven by the following sectors:

- Agriculture, which, due to favourable weather conditions, expanded by an estimated 2.5% in twelve months to November 2001 compared with a decline of 2.4% in 2000. Recovery was still weak, however, as coffee and sugar sub-sectors continued to perform poorly.

- Trade, restaurants and hotels, which are estimated to have grown by 2.0% in the twelve months to November 2001 compared with a growth of 1.0% in 2000.

- Increased investment in the communications sub-sector following liberalization of the sector

2.1.3 Outlook

Recovery momentum anticipated to continue into 2002

The economy is expected to continue on the recovery path in 2002, growing by 1.4%. Whilst the expected restoration of the Poverty Reduction and Growth Facility (PRGF) programme in the second half of 2002 is expected to sustain the modest recovery, persistently weak commodity prices of major exports associated with poor growth prospects of the global economy, and persistent structural constraints in the economy are likely to slow down the pace of that recovery.

Government domestic borrowing on an upward trend

The Government is expected to continue borrowing significantly from domestic sources to cover the gap arising from suspension of quick disbursing external financing. Thus, the share of net domestic debt in GDP is projected to rise to 22.4% in 2002 from 20.8% in 2001. As such, net domestic debt is projected to rise by Ksh 13.4bn and Ksh 12bn, respectively, in June and December 2002. These resources will be raised largely from the non-bank sources to the tune of Ksh 14.7bn, while Ksh 9.5bn is expected to come from commercial banks.

Inflation projected to remain on target

The underlying inflation, which was successfully reduced to below the desired level of 5% in the second half of 2001, is forecast to remain within that range over the next twelve months to December 2002. The favourable inflation expectation is based on continued stability of the shilling exchange rate and implementation of an appropriate monetary policy.

2.2 Monetary Policy for 2002

2.2.1 Objectives

Monetary policy continues to focus on containing inflation within the 5% target

The Central Bank will anchor its monetary policy throughout year 2002 on a monetary programme designed to contain inflation at below 5% and to support the projected economic growth of 1.4%. The Bank also aims to build up the level of unencumbered foreign exchange reserves to US$

991m in June 2002 and to US$ 1,008m in December 2002, from US$ 938m in December 2001.

2.2.1.1 Monetary Programme

Broad money supply (M3X) programmed to increase by 6%

Consistent with the expected growth in 2002, target inflation, and the expected foreign exchange build-up, the broad money supply (M3X) is projected to increase by 6.1%, supported by 7.8% expansion in net foreign assets (NFA) of the banking system and 5.6% growth in net domestic assets (NDA) (Table 6). Credit to the private and other public sectors combined is programmed to increase by 9.0%. This is considered adequate to support the envisagedslight acceleration in economic activity. Government borrowing, largely because of the delayed external financial support, is expected to be around Ksh 32bn in the fiscal year 2001/02.

TABLE 6: MONETARY PROGRAMME, SEP 2001 - DEC 2002 (in Ksh m)

	Sep-01	Dec-01	Mar-02	Jun-02	Dec-02
NFA	93,451	90,155	92,788	93,512	97,184
NDA	274,431	286,771	281,787	276,077	302,837
RM*	73,377	76,627	75,233	74,974	82,287
	(-2.0)	(2.4)	(2.2)	(4.7)	(7.1)
M3XT*	468,009	477,787	475,700	472,154	514,755
	(10.9)	(10.3)	(8.5)	(6.3)	(7.7)
M3X*	367,882	376,927	374,565	369,589	400,020
	(5.4)	(5.3)	(5.2)	(4.9)	(6.1)
M3*	321,312	332,591	330,229	325,253	355,685
	(4.1)	(5.7)	(6.9)	(6.4)	(6.9)

*Figures in brackets show annual percentage changes

Source: Central Bank of Kenya

2.2.1.2 Monetary Policy Instruments

Monetary policy instruments to remain the same

The Central Bank will continue to use monetary targetting as the framework for implementing its monetary policy geared to maintaining low and stable inflation. To achieve the growth in reserve money and other monetary aggregates and hence the inflation target, the Bank will rely on the use of the traditional monetary policy instruments that are available to it. Thus, the Central Bank will during the year:

- Buy and sell Treasury bills or any other stipulated government paper, from time to time, in the open market through repurchase agreements with a view to influencing the level of bank reserves.
- Require commercial banks to hold a specified minimum cash deposit at the Central Bank, currently equivalent to 10% of their deposit liabilities.
- Provide, as a lender of last resort, liquidity to commercial banks but in a manner that will not compromise the monetary policy stance for the year.

3. CONCLUSION

Price stability needs to be complemented with structural reform measures

The Central Bank believes the best way it can contribute to the recovery of the economy is by attaining price and financial stability. But it is important to underscore that, unless other stakeholders equally play their part, the recovery of the economy will remain elussive. It is, therefore, critical that a concerted effort, under the Government's Poverty Reduction Strategy Paper (PRSP), is made to address the structural constraints that continue to keep the performance of the economy depressed.