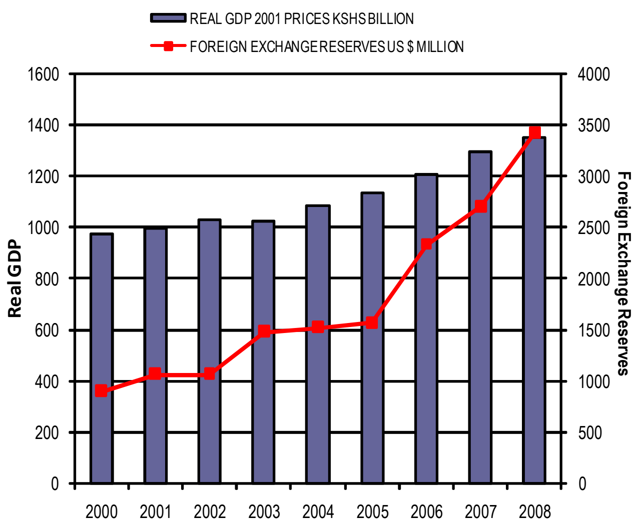


CENTRAL BANK OF KENYA

Monetary Policy Statement

Issued under the Central Bank of Kenya Act, Cap 491

JUNE 2009

Letter of Transmittal

Dear Honourable Minister,

I have the pleasure of forwarding to you the 24th Monetary Policy Statement (MPS) of Central Bank of Kenya (CBK), pursuant to Section 4B of the Central Bank of Kenya Act. The Statement reviews the implementation of monetary policy from January to June 2009. It also covers the current economic developments and outlines the monetary policy stance for the six months from July to December 2009, while covering the January to June 2010 period in more general terms.

Prof. Njuguna Ndung'u
Governor

MONETARY POLICY STATEMENT
JUNE 2009

TABLE OF CONTENTS

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 inflation low and stable. This policy facilitates higher levels of domestic savings and private investment and therefore leads to better economic outcomes including improved economic growth, higher real incomes and increased employment opportunities through a stable macroeconomic environment for sustainable economic growth.

The Bank's monetary policy is thus designed to support the 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 to vary the amount of commercial banks deposits held with it in relation to the statutory requirement. Change in these deposits impact on the rate of interest at which credit is provided which in turn affects the growth of deposits held with commercial banks (which is the dominant component of money supply) and ultimately domestic prices. To achieve the desired level of money supply, OMO is conducted using the following instruments:
    - o **Repurchase Agreements (Repos)** – Which consist of the sale or purchase of eligible securities by the CBK to reduce or augment commercial banks excess deposits held with it.
    - o **Horizontal repurchase agreements** – These are transacted at the commercial banks level. Commercial banks short on deposits at the CBK borrow from banks with excess deposits on the security of an appropriate asset, mostly Government securities. The instrument helps banks overcome the problem of credit limits, thus promoting efficient management of interbank liquidity.
    - o **Term Auction Deposits** – The CBK acquires deposits from commercial banks at a price but with no exchange of security guarantee. the deposits are transfered to the CBK for a 7 days period after which they revert back to the respective commercial bank on maturity of the transfer agreement.

- **Standing Facilities:** The CBK, as lender of last resort, provides secured loans to commercial banks on an overnight basis at a rate known as the Central Bank Rate (CBR). The value of the CBR is determined and announced by the Monetary Policy Committee (MPC) at least every two months.

- **Required Reserves (RR):** The Required Reserve is the proportion of a commercial bank's deposit liability which is held at the CBK in accordance with the law. These deposits are held in the Cash Reserve Ratio (CRR) Account. The CBK uses the RR as a direct instrument for monetary policy. By availing part of the blocked deposits initially mobilised by commercial banks, a reduction in the CRR enhances the capacity of commercial banks to expand credit.

- **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 CBK in the foreign exchange market is commonly motivated by the desire to prevent excessive volatility in the rate at which the Kenya shilling exchanges against other foreign currencies, to acquire foreign exchange to service official debt and build its foreign exchange reserves or for liquidity withdrawal/injection.

- **Central Bank Rate (CBR):** This is the rate of interest that the CBK charges on loans to commercial banks. It is reviewed and announced by the Monetary Policy Committee (MPC) every two months to signal the direction of money market interest rates.

  The direction and magnitude of movements of the CBR signals the monetary policy stance thus the Bank sends policy signals to the market. 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 increases.

  The CBR is operationalised through the market for repo securities. As such, efficiency of the repo and interbank market is crucial for the transmission of monetary policy decisions. By fixing a single tenor for bills sold in the repo market, the monetary authority aims to sharpen the signalling process, the CBK has a fixed single 7 day tenor for the repo market.

Licensing and Supervision of financial institutions: The Bank uses these tools to ensure the health and efficiency of the banking system. While an increasing use of communications media ensures the wider dissemination of monetary policy decisions thereby increasing the efficiency of information transmission.

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 the 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 (MPS) spans in some detail the six months from July to December 2009 inclusive while sketching the policy stance for the first six months of 2010. It tracks the performance of the domestic economy and developments in the global economy in the period from January to June 2009, and provides the outlook for the twelve months to June 2010.

The review of the performance of the economy in the first half of the year, with respect to what was proposed in the December 2008 MPS, enabled an assessment of the capacity of the economy to both withstand and absorb change.

The statutory policy requirement of the Central Bank of Kenya remained unchanged: Price stability remains the dominant objective and in consequence drives the proposal for actions which will affect the money supply so as to address any likelihood of demand driven inflation while at the same time proposing the use of monetary policy tools to address economic growth and consequently, any supply side inflation. Any risk of imported inflation through exchange rate volatility will be addressed through the re-establishment of Central Bank's accessible foreign exchange reserves.

From the institutional standpoint, the Central Bank will continue to work with the institutions of the financial sector, broadly defined, so as to lower the cost of doing business in Kenya. These actions will both attract foreign investment funds relieving balance of payments pressures while at the same time enhancing growth with consequential decreases in inflationary pressure.

The Central Bank will work closely with Kenya National Bureau of Statistics as it moves towards the preparation and release of the new Consumer Price Index which will be a necessary component for inflation analysis.

1. INTRODUCTION

This Monetary Policy Statement (MPS) represents the guidelines for the Central Bank of Kenya (CBK) over the period July to December 2009 while setting the framework for the subsequent six months.

The seriously disrupted 2008 Kenyan economy has meant that institutions have had to be strengthened and modifications made to the ways in which economic management is to be conducted. CBK has enhanced its responsibilities by moving to a more careful consideration of how it can best fulfil its mandate.

On the one hand, research has suggested that the current methodology for conducting CBK inflation control through reserve money management may be superseded by focusing on some other monetary aggregate or even moving to a more explicit inflation targeting. On the other hand, the Bank will continue its stance with respect to the value of the Kenya shilling while leaving the international cross rates to be determined in the world currency markets. Meanwhile, it will reappraise the quantity and quality of its foreign exchange reserves so as to best further support the Government's growth targets.

By working closely with the stakeholders, the Bank will also accelerate the reduction of the spread between borrowing and lending rates which has bedevilled the creation of a competitive financial system. This will come about by improving the transparency and consequential efficiency of the transmission mechanisms relating to the Monetary Policy Committee signals. An outcome of this should be to improve access to appropriate financial services both with respect to product diversity and to spatial availability. The Bank will continue to augment liquidity when the signals suggest there is tightness in the market.

The Bank will work with the Kenya National Bureau of Statistics (KNBS) in the production of the new consumer price index which is a critical component for generating relevant data for inflation management, but in general conducting monetary policy.

2. ACTIONS AND OUTCOMES OF POLICY PROPOSALS IN THE PREVIOUS MONETARY POLICY STATEMENT

2.1 POLICIES PROPOSED

The Monetary Policy Statement to December 2008 outlined policy proposals to:

a) **Maintain price stability**: To accomplish this, the Bank was to ensure that market liquidity was managed in such a manner as to minimise any demand-driven inflation while ensuring that there was adequate liquidity to support growth of economic activities and ease any supply constraints. The Bank was also to endeavour to support an interest rate regime that would nurture faster economic recovery towards the Vision 2030 growth path. The CBK was expected to ensure that there was a reduction in cost of funds that fed into the cost of doing business which had in the past caused high inflation. Lastly, the Bank was to take steps to moderate volatility in foreign exchange rates and reduce imported inflation so as to maintain confidence and promote productive activities, without necessarily defending the exchange rate level or direction, but building foreign exchange reserves to counter any shocks that would promote exchange rate instability and consequently destabilise domestic prices.

b) **Foster liquidity, solvency and proper functioning of a stable, market-based financial system**: In this regard, the Bank proposed to continue with the implementation of institutional reforms to enhance efficiency in the banking sector. The Bank was also to review the reserve money programme to take into consideration the slowing economic recovery process at the time, and also enable a proper tracking of the impact of policy actions with respect to efficiency of both the markets' and economy's responses. The Bank was also to operationalise the horizontal repo market in order to facilitate deepening of the interbank market.

c) **Support of economic policy on growth and unemployment**: The Bank was to monitor second round effects of the global recession and support growth and employment by pursuing an exchange rate policy that balanced the interest of both exporters and importers. Complementarity of policies was also to enhance efficiency and create employment. The Bank was also to ensure that the private sector had access to adequate financing while not being crowded out by fiscal obligations.

d) **Formulate and implement foreign exchange policy**: The Bank sought to continue pursuing open economy policies consistent with the move towards the implementation of the convergence criteria for the creation of an effective, prosperous East African Community (EAC). The Bank was also to strive to maintain adequate foreign reserves that would enable it to play its role in facilitating the payment of debt and other overseas financial obligations of Government, exchange rate management, liquidity management and preserve investor confidence.

e) **Promote the establishment, regulation and supervision of efficient and effective payment, clearing and settlement systems**: In this regard, the Bank sought to work towards lowering transaction costs by strengthening institutional frameworks.

2.2 ACTIONS TAKEN TO ACHIEVE THE POLICY OBJECTIVES

a) Liquidity Management

The Monetary Policy Committee (MPC) of the Bank operationalised the Horizontal Repo in March 2009 to enhance access as well as improve distribution of liquidity in the interbank market. This move was aimed at freeing up liquidity which was not being used optimally for macroeconomic activities, and improve the intermediation process. This action was backed by the reduction in the CBR from 8.50 percent to 8.25 percent to provide an appropriate signal to the banking sector that interest rates should fall. In its May 2009 meeting, the MPC reduced the CBR further to 8.00 percent in order to enhance the potential for economic growth. This action was backed by a review of the tenor for repo transactions to a single 5-day tenor in order to improve liquidity management in the interbank market.

b) Financial Sector Stability and Foreign Exchange Reserves

The MPC continued to monitor the impact of the global financial crisis on the Kenyan economy and produced a report on the crisis covering the period January to June 2009. The Bank also engaged in purchases and sales of foreign exchange to stabilise the exchange rate as well as build its foreign exchange reserves to the statutory level of four months of imports cover. In an effort to ensure that the financial sector was stable, the Bank temporarily suspended penalties on meeting reserve requirements to some of the banks which were exposed following the collapse of the Triton Oil Company.

c) Payments Systems Improvement

The MPC also undertook studies during the period to improve the efficiency of the payments system in Kenya. The studies revealed that interconnectivity of the existing commercial banks' Automatic Teller Machines (ATMs) would lower transactions costs significantly. The issue is being addressed through the Kenya

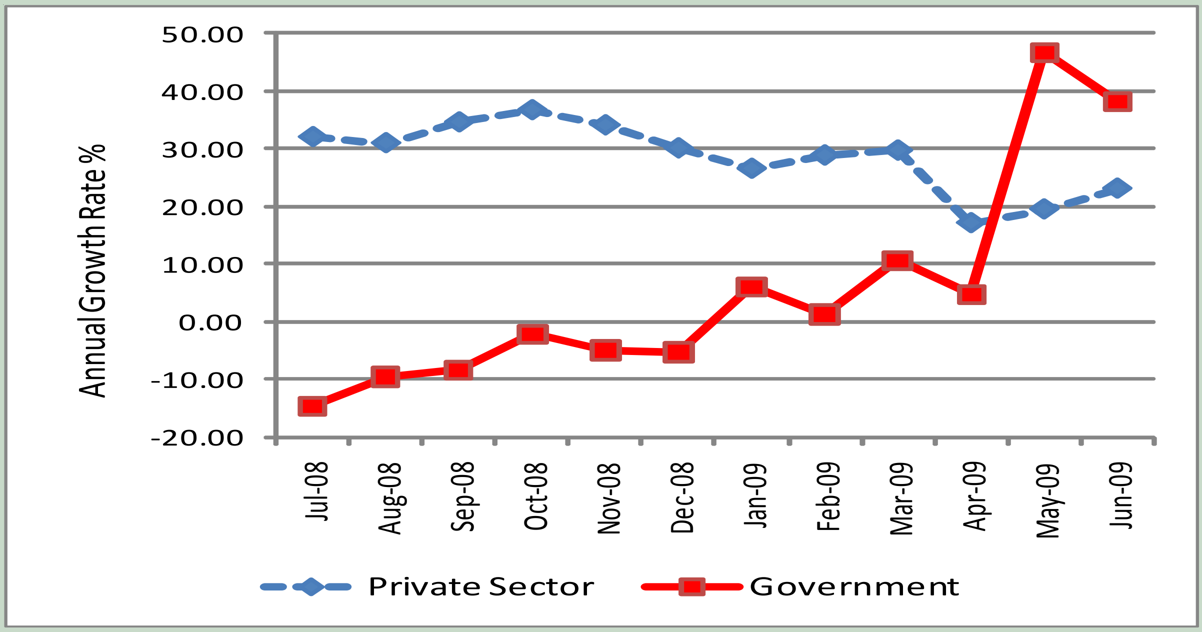
Bankers Association (KBA). The Bank also continued to monitor the mobile phone money transactions which include M-PESA in order to ensure that the facility was a safe mode of undertaking transactions and was not used for money laundering purposes.

2.3 POLICY OUTCOMES

a) Credit to Private Sector growth

Despite the efforts of the MPC to inject liquidity in the banking system, credit to private sector growth slowed down between January and April 2009, but picked up albeit slowly from May 2009 (Chart 1). However, growth in credit to Government picked up significantly on account of increased borrowing through Treasury bills and bonds mainly to finance infrastructure development in the country. The sluggish growth in private sector credit poses a challenge to financing of investment by private entities but reflects the slowdown in economic activity in general.

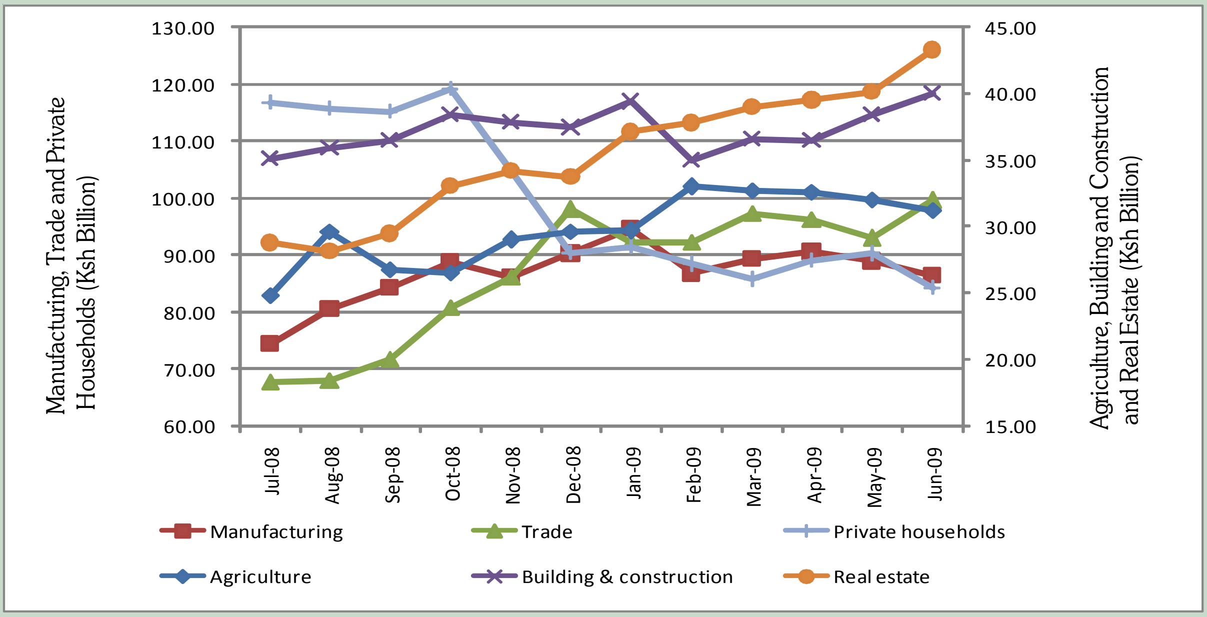
CHART 1: ANNUAL GROWTH IN CREDIT



Source: Central Bank of Kenya

As shown in Chart 2, the amount of credit to the trade, building and construction and real sectors increased between January and June 2009. However, agriculture, manufacturing and private household sectors recorded a decrease in the level of credit. The decline in credit to these sectors was attributed to perceived risks including drought, risk of default and slowdown in the demand for manufactured commodities.

CHART 2: CREDIT TO PRIVATE SECTOR (Ksh Billion)

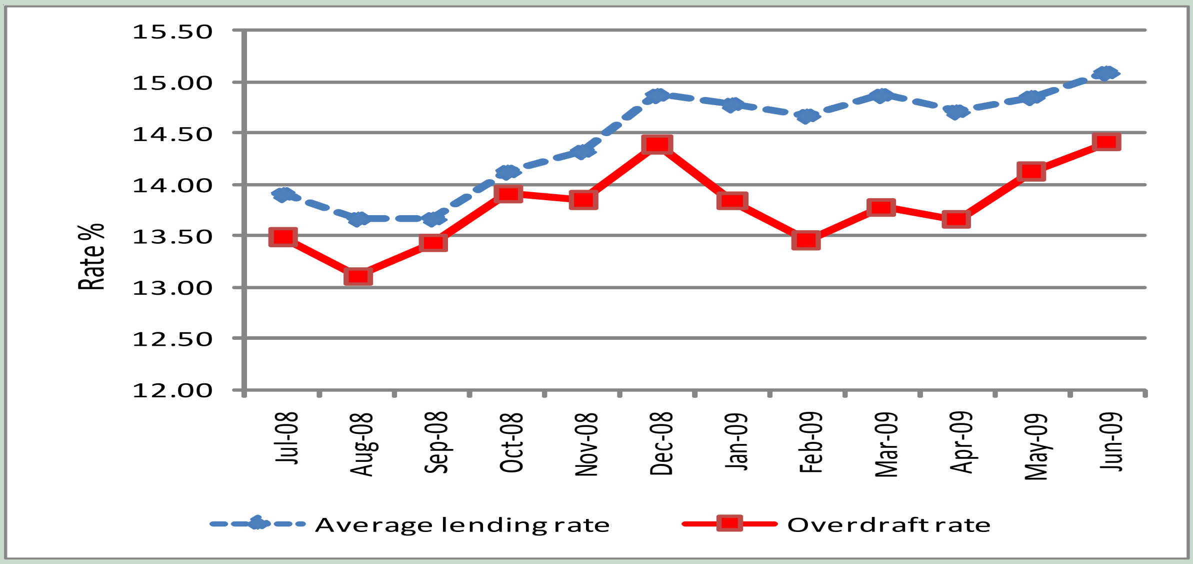


Source: Central Bank of Kenya

b) Interest Rates

Despite the actions taken by the Bank to increase liquidity in the banking system during the period, commercial banks' interest rates maintained an upward trend due to structural rigidities (Chart 3a). Most of these rigidities relate to the screening and monitoring processes in a period of perceived risks. However, as shown in Chart 3b, short term interest rates comprising of the 91-Treasury bill rate, interbank rate and repo rate declined during the period which was in line with the expectation of the actions of the MPC. It is also important to note that the repo was used only once in May 2009, and was not utilised at all in June 2009.

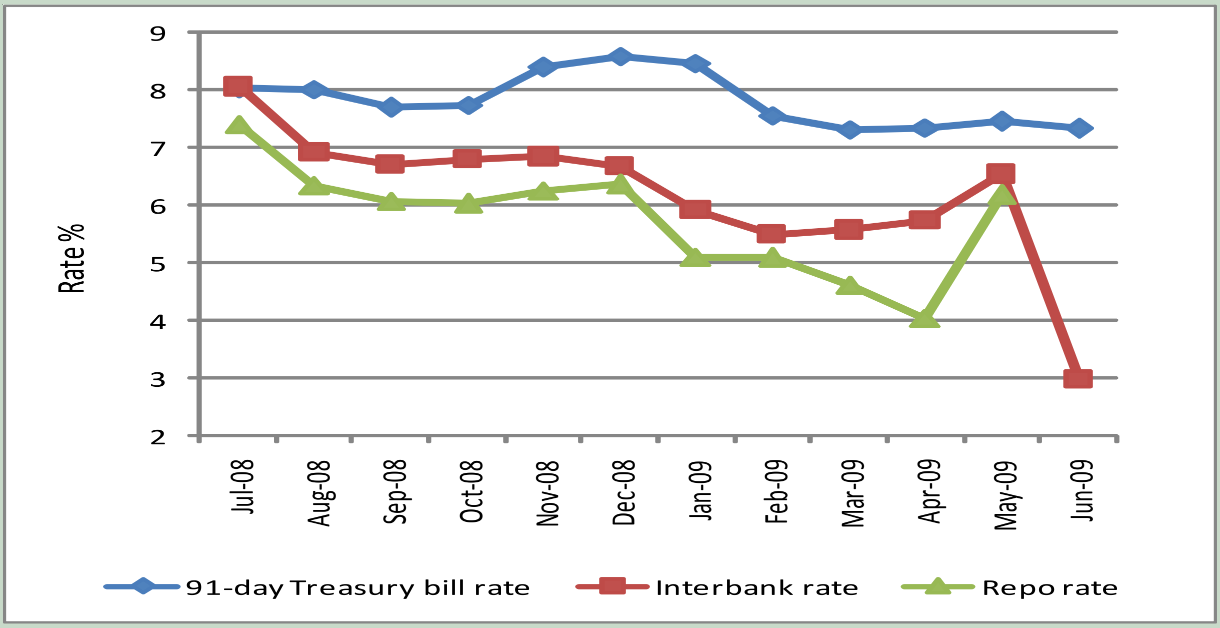
CHART 3A: TRENDS IN COMMERCIAL BANKS LENDING RATES



Source: Central Bank of Kenya

It is important though to point out that monetary policy affects short term money market interest rates. But the overall macro stability and short term rates can influence the real economy and investment decisions that are ingredients for credit demands.

CHART 3A: TRENDS IN SHORT TERM LENDING RATES



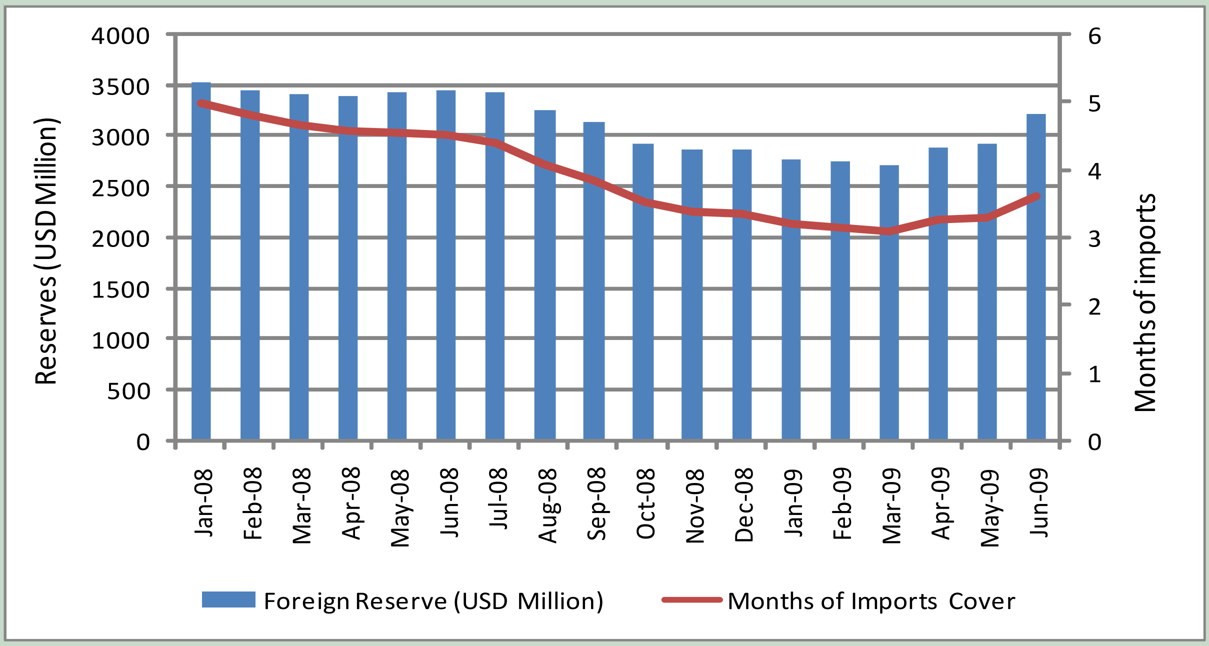
Source: Central Bank of Kenya

c) Foreign Exchange Reserves

As depicted in Chart 4, official foreign exchange reserves of the Central Bank of Kenya fell significantly from USD 3,522 million (4.98 months of imports cover) in January 2008 to USD 2,714 million (3.1 months of imports cover) in March 2009. The drawdown in reserves during the period was attributed to exchange rate revaluation losses and the impact of the global financial crisis. Thus, the country was faced with higher international food, fuel and fertiliser costs, and a slowdown in external demand. However, official Central Bank of Kenya foreign exchange reserves have been on an upward trend since March 2009, rising to USD 3,219 billion (3.6 months of import cover) at the end of June 2009.

The gross foreign exchange reserves of the Bank increased in June 2009 following disbursements of SDR 135.7 million (about US$209 million) in June 2009 under the Exogenous Shocks Facility (ESF).

CHART 4: OFFICIAL FOREIGN EXCHANGE RESERVES



Source: Central Bank of Kenya

d) Banking Sector Stability

The overall performance of the banking sector was rated strong by end of June 2009. As at the end of June 30, 2009, the banking sector maintained high capital adequacy ratios, adequate liquidity and low non-performing loans as a proportion of gross loans. The total shareholders' funds, deposits and assets expanded by 25.4 percent, 9.5 percent and 15.0 percent respectively. Liquidity was considered strong, with the ratio of liquid assets to total deposit liabilities at 40.9 percent, well above the statutory minimum requirement of 20 percent.

2.4 POLICY TARGETS IN THE PREVIOUS MONETARY POLICY STATEMENT

Broad money supply (M3) and reserve money (RM) which had been programmed to grow by 17.1 percent and 10.7 percent, respectively, in the year to June 2009, grew by 13.0 percent and 4.6 percent respectively. Broad money supply (M3) increased from Kshs 840.7 billion in June 2008 to Kshs 950.2 billion in June 2009 while reserve money (RM) increased from Kshs 152.9 billion to Kshs 159.9 billion during the period. The slower growth in M3 was attributed to the decline in the banking system's net foreign assets (NFA) which partly offset the growth in net domestic assets (NDA). The NFA declined from Kshs 291.3 billion to Kshs 278.2 billion while NDA increased from Kshs 549.4 billion to Kshs 672.1 billion during the period. The slowdown in the growth in reserve money reflected lower expansion in both commercial banks' reserves and cash outside banks which grew by 4.7 percent and 4.5 percent, respectively, in the year to June 2009. These declines are related to the slowing down of economic activity.

3. INTERNATIONAL ECONOMIC ENVIRONMENT

3.1 IMPACT OF THE GLOBAL FINANCIAL CRISIS

The Monetary Policy Committee (MPC) conducted various studies on the financial crises which indicated that the impact of the international economic crises on Kenya was moderate compared with that on both its African peers and the developed world on the financial sector, but had knock on effects on the real sector. The analyses showed that the global economy was stabilising on account of unprecedented macroeconomic and financial policy support. However, the recovery was projected to be sluggish. The analyses indicated that the second quarter of 2009 marked a return to modest growth compared with a disappointing first quarter.

According to IMF reports, the world economy was forecast to contract by 1.4 percent in 2009 but to expand by 2.5 percent in 2010. In particular, real output growth was projected to increase from a negative 3.8 percent in 2009 to 0.6 percent in 2010 in the developed countries but from 1.5 percent to 4.7 percent in the same period for emerging and developing countries. However, inflation had been forecast to fall from 3.4 percent in 2008 to 0.1 percent in 2009 in the developed countries and from 9.3 percent to 5.3 percent in the same period for emerging and developing economies.

3.2 FOREIGN ECONOMIC POLICIES

The policy actions taken by the major economies in the world from January to June 2009 were generally aimed at addressing the effects of the global financial crises. These policies comprised both fiscal and monetary policy actions and were generally aimed at improving the macroeconomic environment, promoting market stability, and restoring credibility to their financial systems. The main measures aimed at promoting market stability included provision of liquidity to particular segments of the economy as well as corporate entities in order to protect jobs and stimulate growth. Other measures taken included the reduction of policy interest rates in order to stimulate consumption and investment. In particular, policy rates were reduced gradually between January and June 2009 from 1.5 percent to 0.5 percent in the UK and from 8.00 percent to 7.50 percent in South Africa. However, the US policy rate remained unchanged at 0.25 percent in the period.

3.3 SOVEREIGN BOND ISSUANCE

The Government had planned to issue a sovereign bond worth USD 300 million in the first half of 2009 to finance infrastructure development as well as provide a benchmark for offshore borrowing by the private sector. Issuance of the bond was however postponed due to cost implications that would have been attributed to the high risk premiums following the global financial crisis. In addition there was significant volatility in the foreign exchange markets at the time. However, the country was given a “B” stable long and short sovereign rating in November 2008 by the Standard and Poors rating services. The country’s rating had been downgraded to negative following the post election crisis in early January 2008.

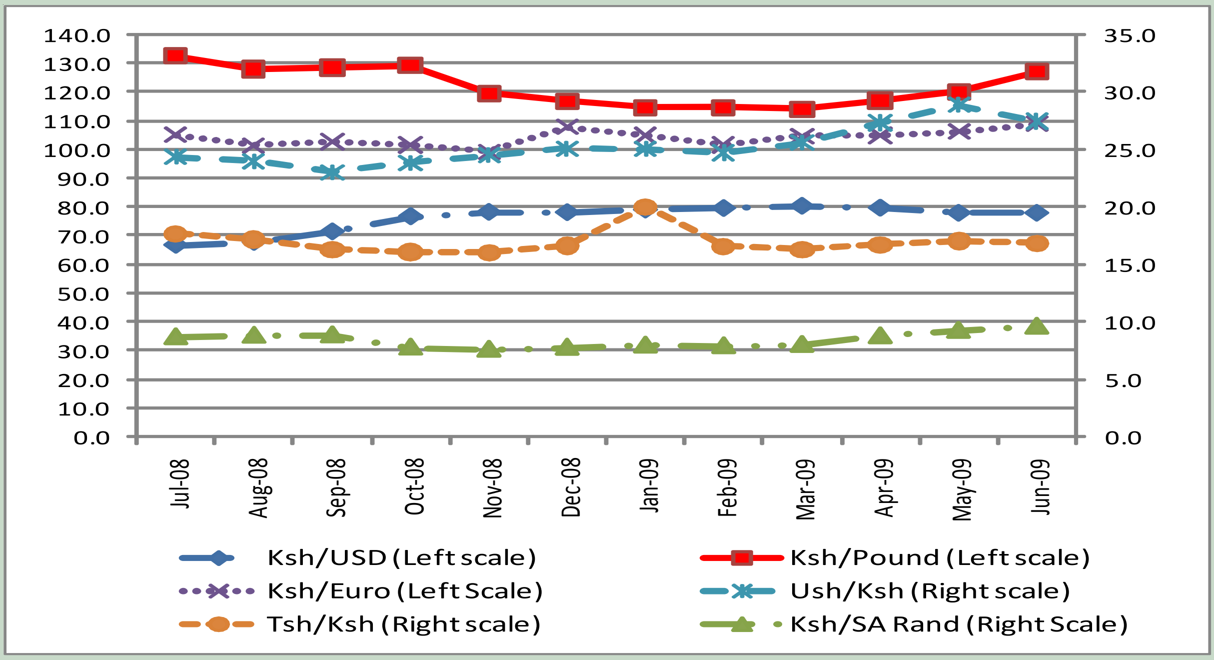
3.4 REGIONAL DEVELOPMENTS

The Bank organised and held a seminar on the “Choice of Monetary Policy Regime in the East African Community (EAC) Economies” in May 2009. The objective of the meeting was to provide insights into various aspects of current challenges facing the region in managing the challenges it faces in monetary policy making, formulation and execution. There was consensus that although the reserve money framework had generally served the region well, a number of challenges called for a modified reserve money framework which takes into consideration country differences, the regional integration process and the need to improve liquidity forecasting. The issue is being followed up through the Monetary Affairs Committee (MAC) of the EAC.

3.5 DEVELOPMENTS IN THE EXCHANGE RATE

The exchange rate of the Kenya shilling to US dollar, Tanzanian shilling, Uganda shilling and South African rand remained stable in the first half of 2009 (Chart 5). However, the Kenya shilling depreciated against the Sterling Pound and

CHART 5: TRENDS IN THE EXCHANGE RATES

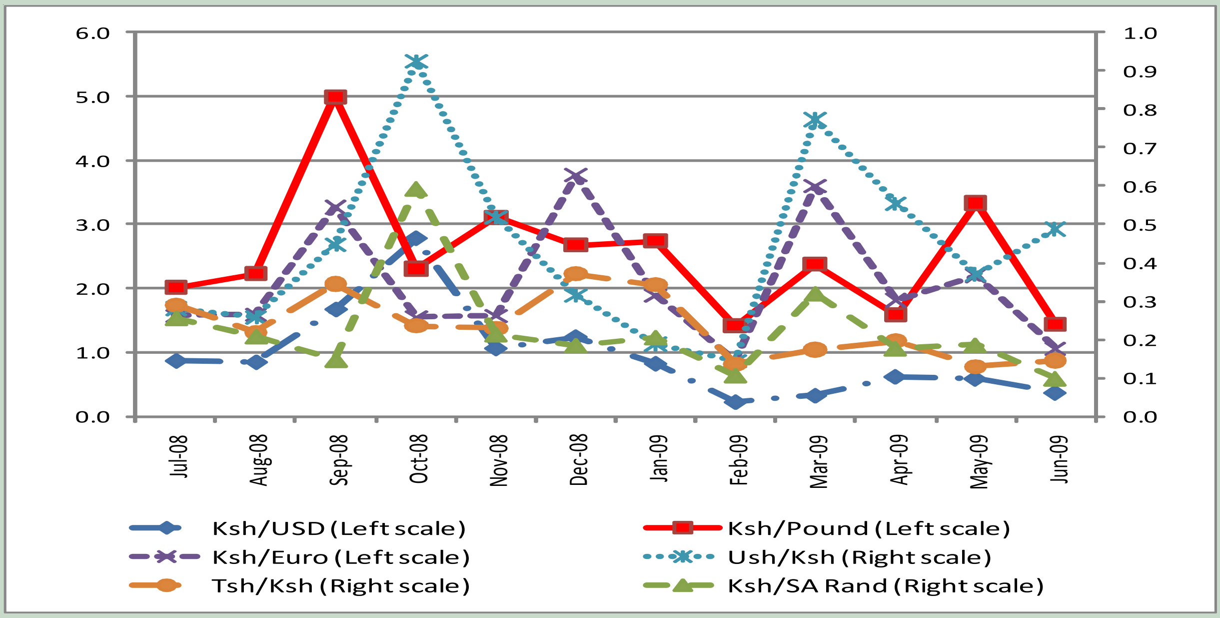


Source: Central Bank of Kenya

Euro during the same period as the two currencies strengthened against the US dollar in the global market.

On the other hand, as shown in Chart 6, the first half of 2009 saw relative stability in the exchange rate of the Kenya shilling against the US dollar. However, the exchange rates of the Kenya shilling against the Sterling pound, Uganda shilling and Euro depicted significant volatility (measured by the standard deviation). The volatility in the exchange rates dipped in February 2009 on account of increased foreign exchange inflows from diaspora remittances and tourism earnings.

CHART 6: VOLATILITY OF EXCHANGE RATES



Source: Central Bank of Kenya

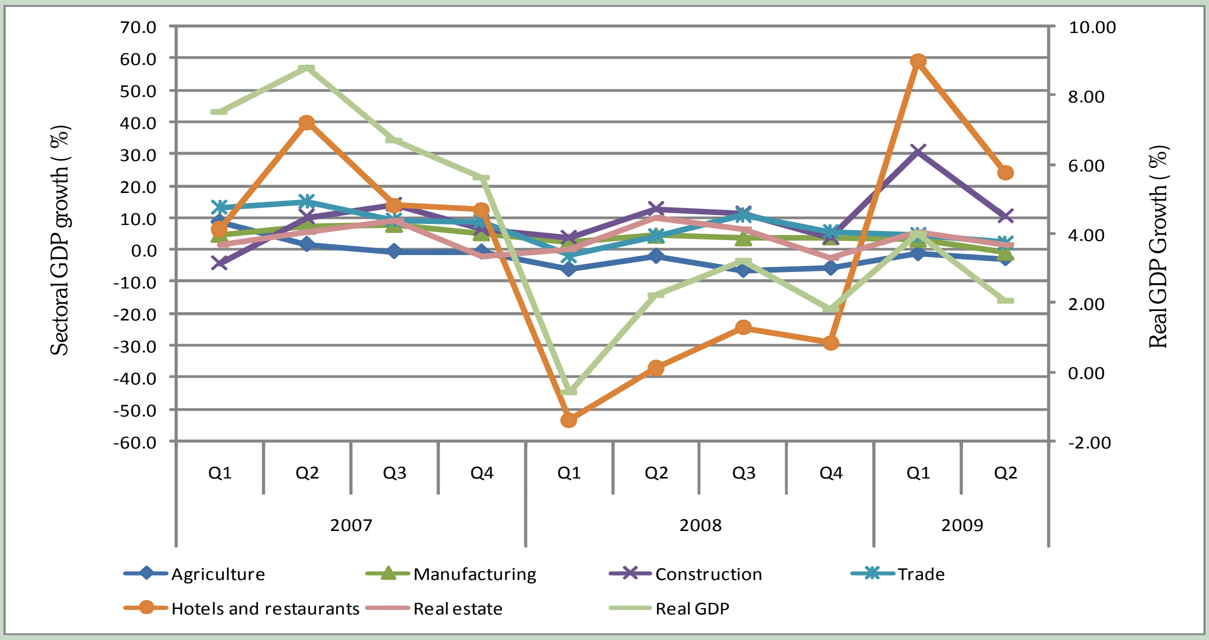
4. DOMESTIC ECONOMIC ENVIRONMENT

4.1 ECONOMIC GROWTH

As shown in Chart 7, the economy grew by 2.1 percent in the second quarter of 2009 relative to the second quarter in 2008, down from 4.0 percent in the first quarter. The first quarter of 2008 had been seriously affected by post election disruption. The slowdown in the performance of the economy in the second quarter of 2009 was attributed to drought conditions which impacted negatively on agricultural production, electricity and water, and the global economic slowdown which affected exports.

Notably, hotels and restaurants achieved the highest growth of 24.2 percent following a recovery in tourism, while agriculture contracted by 2.7 percent in the quarter. However, the highest contraction of 5.0 percent was recorded in electricity and water. The contraction in electricity and water sectors was also transmitted to the manufacturing sector, leading to a contraction of 0.7 percent.

CHART 7: SECTORAL GDP GROWTH RATES (%)

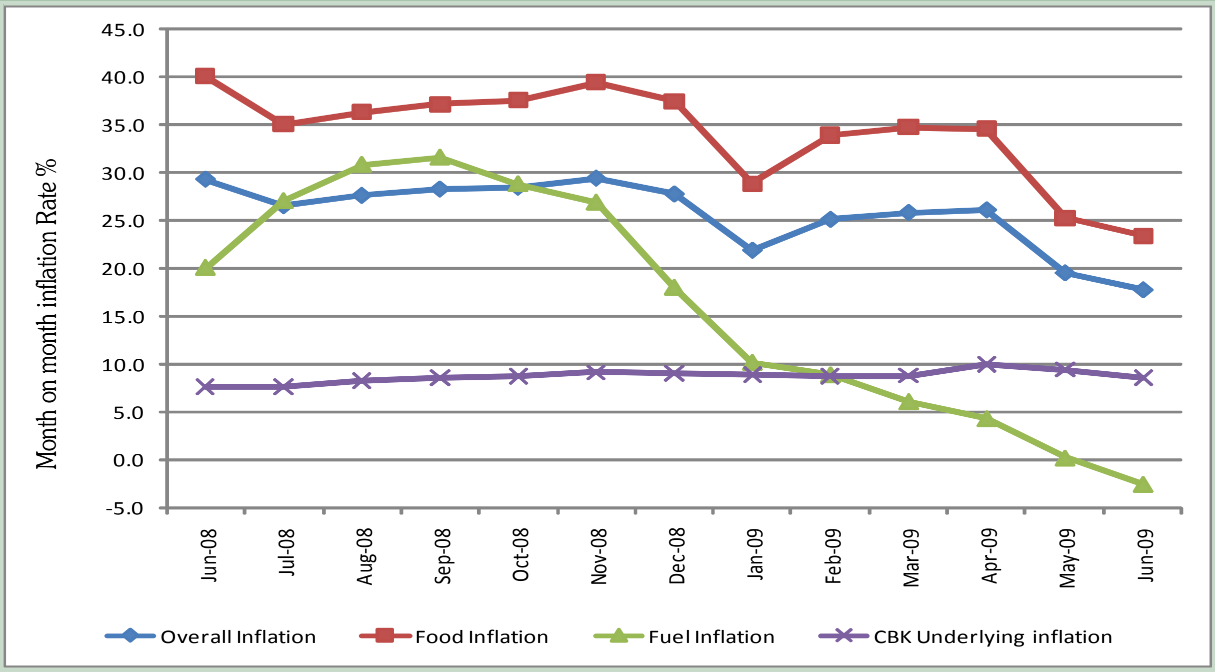


Source: Central Bank of Kenya

4.2 INFLATION

Despite the computational shortfalls and use of an outdated consumer basket of goods and services (1993/4) that characterise the current consumer price index (CPI), overall month on month inflation decreased from 21.87 percent in January to 17.76 percent in June 2009 on account of a significant decrease in fuel and food prices during the period (Chart 8). In particular, food inflation fell from 28.90 percent to 23.45 percent during the period following the short rains in March and April 2009 which increased the supply of the seasonal food crops such as vegetables. Similarly, fuel inflation fell from 10.17 percent to negative 2.56 percent during the period on account of a gradual decline in crude oil prices from USD 134.0 per barrel in June 2008 to USD 71.65 per barrel in June 2009. Notably oil prices had peaked at USD 147.3 per barrel on 11th July 2008. However, the downside risks on overall inflation were real as the unpredictable rains continued to pose a risk to production of maize and other crops with longer maturity periods. On the other hand, underlying inflation as computed by the Bank remained generally stable albeit falling from 8.89 percent to 8.51 percent during the period.

CHART 8: TRENDS IN MONTH-ON-MONTH INFLATION (%)



Source: Central Bank of Kenya

4.3 FISCAL AND PUBLIC DEBT DEVELOPMENTS

Government budgetary operations in the fiscal year 2008/09 resulted in a budget deficit of 4.6 percent of GDP compared with 4.5 percent of GDP in the fiscal year 2007/08. Despite the increase, the budget deficit in the fiscal year 2008/09 was within the revised budget target of 5.8 percent of GDP. Public and publicly guaranteed debt (both domestic and foreign) increased from 42.8 percent of GDP in June 2008 to 44.0 percent of GDP in June 2009 following a slower growth in GDP. Consistent with the Government debt management strategy of reducing the market risk on domestic debt by restructuring the debt to longer term instruments, the average maturity of domestic debt (by the period to maturity) increased from 3 years and 8 months in June 2008 to 3 years and 9 months in June 2009.

4.4 CONFIDENCE IN THE ECONOMY

Despite the slowdown in the economy in the first quarter of 2009 and the challenges posed by the global financial crisis, confidence in the Kenyan economy remains high. As shown in Table 1, diaspora remittances increased from USD 39.5 million in January 2009 to USD 46.4 million in June 2009 while the NSE index edged up from 3,198.9 to 3,294.6 indices in the period. Activity at the Nairobi Stock Exchange was however, generally low within the period due to moderate participation of foreign investors. Similarly, the 12-month cumulative foreign direct investment into and out of the country increased from USD 22.3 million to USD 48.9 million during the period. Twelve month cumulative cement production, which is an important proxy for economic activity in the country, was generally on an upward trend between January and June 2009.

TABLE 1: TRENDS IN INDICATORS OF CONFIDENCE IN THE ECONOMY

	Jan-09	Feb-09	Mar-09	Apr-09	May-09	Jun-09
Emigrant Remittances (USD Million)	39.5	53.4	55.4	48.1	49.2	46.4
NSE Index (Jan 1966=100)	3,198.9	2,474.8	2,805.0	2,800.1	2,852.6	3,294.6
Cement Production (Metric Tonnes)	247,984.0	246,746.0	269,971.0	256,132.0	275,323.0	258,534.0
12-Month Cumulative Foreign Direct Investment (USD Million)	22.3	46.1	31.8	46.3	42.5	48.9

Source: Central Bank of Kenya and Kenya National Bureau of Statistics

5. FUTURE DIRECTION OF MONETARY POLICY

5.1 MONETARY TARGETS FOR JULY TO DECEMBER 2009

During the fiscal year 2009/10, monetary policy will continue to be directed towards achieving and maintaining an inflation rate of 5 percent. The effort by the Bank to achieve this inflation target is expected to be complemented by the planned release of the new CPI by KNBS in February 2010. The KNBS has committed itself to releasing a new methodology computed index by end of October 2009. The new CPI, to be released next year, will incorporate an expanded basket taking into consideration new items consistent with current consumer patterns in the country, as well as the modern computation method using the geometric mean which is expected to reduce the upward bias embodied in the current technique based on the arithmetic mean. Overall, the inflation numbers to be reported are expected to improve the forecast and thus the conduct of monetary policy.

Favourable economic performance is expected in the last quarter of 2009 on account of a forecast of adequate rainfall by the Meteorological Department and the expected bottoming out of the impact of the global financial crisis. However, economic performance in the third quarter of 2009 is expected to be subdued due to the prevailing drought conditions. One of the main impediments to growth identified by the MPC in its previous meetings is the high cost of credit from commercial banks which has resulted in sluggish growth in private sector credit thereby curtailing investment financing. The cost of credit is an outcome of many factors, but economic recovery is expected to increase investment opportunities and thereby lower the cost of credit.

However, the Government has already completed construction and repair of most major roads under the ongoing infrastructure development programme. In the past, a dilapidated road network was cited by business as a major structural factor incorporated in the cost of doing business. The planned domestic borrowing amounting to Ksh 109.5 billion (4.3 percent of GDP) in the fiscal year 2009 is not expected to increase interest rates as most of the borrowing will be through long term bonds. In addition, the borrowing will be largely to finance infrastructural development and therefore have a direct positive impact on economic growth. It is envisaged that the fiscal stimulus package amounting to Ksh 22 billion which is factored in the fiscal year 2009/10 will also drive private consumption and create employment thereby facilitating an increase in economic activitiy.

The monetary policy stance for the fiscal year 2009/10 is underpinned by the need to maintain price stability in order to provide the necessary macroeconomic environment for stimulating economic growth. The main assumptions underpinning the monetary targets for 2009/10 are obtained from the June 2009/10 Budget Strategy Paper. These are presented in annexes 1 and 2.

As shown in Table 2, which sets out the monetary policy targets for 2009/10, broad money supply, M3, is set to grow by 16.5 percent by September 2009, 15.0 percent by December 2009, 18.2 percent by March 2010, and 14.5 percent by June 2010. To achieve the policy objective of bringing inflation to the target of 5 percent and to anchor inflation expectations, reserve money is programmed to expand by 10.9 percent in June 2010. The Monetary Policy will stabilise short term interest rates and so credit to the private sector is projected to expand by between 21.6 percent and 25.5 percent in the period.

TABLE 2: MONETARY TARGETS FOR 2009/10

	Jun-09 Act.	Jun-09 Targ.	Jul-09 Targ.	Aug-09 Targ.	Sept-09 Targ.	Oct-09 Targ.	Nov-09 Targ.	Dec-09 Targ.	Mar-10 Targ.	Jun-10 Targ.
Broad Money, M3 (Ksh Billion)	950.2	966.5	978.3	989.9	1,001.5	1,013.2	1,024.8	1,036.4	1,071.2	1,106.6
Reserve Money, RM (Ksh Billion)	159.9	163.6	161.0	162.9	164.7	166.6	168.5	174.5	175.9	181.4
NFA of Central Bank of Kenya (Ksh Billion)	208.8	208.8	213.5	215.0	216.4	217.9	219.3	220.8	225.2	229.5
Annual Change in RM (Percent)	4.6	7.0	5.7	7.2	7.9	6.0	4.9	6.7	13.2	10.9
Annual Change in M3 (Percent)	13.0	15.0	15.0	15.8	16.5	14.7	15.1	15.0	18.2	14.5
Annual Change in Credit to Private Sector (Percent)	20.7	27.0	16.2	16.4	22.7	10.7	11.1	25.4	25.5	21.6
Real GDP Growth (Percent)	2.8	3.0								3.1
Overall Inflation (Percent)	17.8	5.0								5.0

Source: Central Bank of Kenya

The Bank will continue to monitor developments in the Monetary Targets and make necessary reviews. The achievement of the milestones set in the Monetary Targets will however depend on stability in the international prices of oil, easing in the drought conditions, stability of the exchange rate, and commitment by the Government to live within the domestic borrowing ceiling for fiscal year 2009/10.

Monetary policy implementation will be based on monthly targets for reserve money to be achieved through open market operations. Based on the Bank's daily balance sheet and liquidity-forecasting framework, changes in the reserve money will be monitored on a daily basis. The repos will be used to withdraw any excess liquidity in the banking system on a timely basis and where necessary reverse repos will inject liquidity. The strong seasonal demand for currency by the public has been built into the programme.

5.2 FOREIGN EXCHANGE RESERVES

The Bank will limit its participation in the foreign exchange market to smoothening out any erratic movements in the exchange rate, meeting external obligations of the Government, and to maintaining the appropriate import cover for foreign exchange reserves. The monetary targets above also considers a gradual build up in foreign exchange reserves by the Bank from 3.6 months of import cover in June 2009 to the statutory level of 4 months by June 2010.

5.3 NATIONAL PAYMENTS SYSTEM

Apart from monetary and exchange rate policy, the Bank will also continue to work on various initiatives aimed at improving the efficiency and access of the National Payments System as well as lowering transaction costs in the banking sector. High transaction costs have been cited as major contributors to the wide interest rate spreads.

ANNEX 1: MAIN MACROECONOMIC INDICATORS UNDERPINNING THE MEDIUM TERM FISCAL FRAMEWORK, 2007/08 – 2011/12

					Medium-Term								
	2007/08	**2008/09**			**2009/10**			**2010/11**			**2011/12**		
	Prov.	Budget	BOPA'09	BSP'09	BSP'08	BOPA'09	BSP'09	BSP'08	BOPA'09	BSP'09	BSP'08	BOPA'09	BSP'09
Annual percentage change, unless otherwise indicated													
National account and prices													
Real GDP	4.0	5.8	3.6	2.5	6.9	4.6	3.1	6.8	5.2	5.2	6.8	6.0	6.4
Real GDP per capita	1.0	2.9	0.7	-0.4	4.0	1.7	0.2	3.9	2.3	2.2	4.0	3.1	3.4
GDP deflator	12.1	11.1	12.8	11.5	5.2	10.7	10.2	4.3	6.0	5.7	4.2	4.6	4.6
CPI Index (eop)	29.3	7.5	13.2	18.0	5.0	8.8	10.1	5.0	5.9	5.9	5.0	5.0	5.0
CPI Index (avg)	18.5	16.9	19.7	22.2	6.5	10.9	13.4	5.0	6.8	6.8	5.0	5.0	5.0
Terms of trade (-deterioration)	-4.5	-7.0	-0.9	0.2	-0.9	0.3	0.3	0.4	-1.2	-2.5	0.2	-0.5	-0.7
Money and credit (end of period)													
Net domestic assets	16.1	17.9	17.6	21.4	19.8	13.1	13.4	18.5	9.5	13.0	16.0	11.4	10.0
Net domestic credit to the Government	-15.1	14.8	11.8	20.4	12.1	8.5	22.5	10.8	11.6	12.1	11.5	11.4	10.3
Credit to the rest of the economy	28.2	16.3	15.1	21.6	16.7	14.1	18.6	16.2	13.3	20.5	16.2	13.7	17.1
Broad Money, M3 (percent change)	18.7	17.1	16.9	13.0	17.0	15.2	15.9	16.1	14.4	15.2	16.2	14.3	15.3
Reserve money (percent change)	18.2	16.2	15.2	6.9	16.5	14.6	14.1	16.1	14.4	15.2	16.2	14.3	15.3
In percentage of GDP, unless otherwise indicated													
Investment and saving													
Investment	19.1	22.3	17.8	18.1	23.8	20.2	19.2	24.8	21.5	22.1	23.5	22.7	23.3
Central Government	6.6	8.6	7.7	7.6	8.3	7.9	10.2	8.6	8.0	8.9	9.4	8.2	9.1
Other	12.5	13.7	10.2	10.5	15.6	12.3	9.1	16.2	13.5	13.2	14.2	14.5	14.2
Gross National Saving	13.5	15.3	9.1	11.9	17.5	13.4	14.1	18.9	15.7	17.3	18.0	18.2	19.0
Central Government	1.7	1.6	2.2	1.7	2.8	3.0	2.3	3.2	3.0	5.2	3.7	3.1	6.6
Other	11.8	13.7	6.9	10.1	14.6	10.3	11.8	15.7	12.7	12.1	14.2	15.1	12.5
Central government budget													
Total revenue	22.0	21.4	22.1	22.6	21.7	21.6	22.4	21.8	21.7	22.5	21.8	21.8	22.6
Total expenditure and net lending	27.2	28.3	27.6	28.5	27.2	26.6	30.3	27.3	26.8	28.4	27.6	27.0	28.3
of which : wages and salaries	7.4	6.8	7.0	7.1	6.6	6.5	6.8	6.4	6.5	6.7	6.4	6.5	6.7
Interest payments	2.4	2.4	2.5	2.4	2.3	2.4	2.5	2.4	2.5	2.8	2.4	2.4	2.7
Development expenditures	6.7	8.5	7.8	7.7	8.4	8.0	10.3	8.7	8.1	9.0	9.5	8.3	9.2
Overall balance (commitment basis) excl. grants	-5.2	-6.9	-5.5	-6.0	-5.5	-5.0	-8.0	-5.5	-5.1	-5.9	-5.7	-5.2	-5.7
Overall balance (commitment basis) incl. grants	-3.5	-5.4	-4.1	-4.9	-3.9	-3.5	-6.6	-3.6	-3.4	-4.5	-3.6	-3.4	-4.2
Net external borrowing	0.3	1.2	1.1	1.1	1.5	0.4	2.0	1.4	1.0	1.7	1.4	1.0	1.7
Infrastructure bonds	0.0	0.8	2.3	0.8	0.8	2.0	1.3	0.8	1.1	1.3	0.8	1.1	1.2
Net domestic borrowing	-0.7	1.5	2.4	3.7	1.1	1.4	4.3	0.9	1.9	2.5	1.0	1.9	2.2
Total external support (grant & loans)	2.4	3.6	3.5	2.9	3.8	3.0	4.1	4.0	3.6	3.4	4.3	3.8	3.5
Balance of payments													
Exports value, goods and services	25.9	23.1	26.0	27.2	23.7	26.3	26.4	24.2	27.7	26.3	24.8	28.7	26.6
Imports value, goods and services	38.1	36.0	40.8	39.8	35.7	38.7	37.2	35.6	38.7	36.4	35.8	38.1	35.9
Current external balance, including official transfers	-5.6	-7.0	-8.7	-6.2	-6.3	-6.9	-5.1	-5.9	-5.9	-4.8	-5.6	-4.5	-4.3
Current external balance, excluding official transfers	-5.7	-7.0	-8.7	-6.2	-6.3	-6.9	-5.1	-5.9	-5.9	-4.8	-5.6	-4.5	-4.2
Gross international reserve coverage in months of next year imports (end of period)	3.4	3.4	3.1	2.8	3.5	3.2	2.9	3.6	3.5	3.1	3.9	3.8	3.5
Public debt													
Nominal central government debt (eop), net	39.3	38.8	40.6	42.6	36.2	39.5	44.5	38.3	39.2	44.3	35.9	38.9	43.8
Domestic (net)	16.9	16.8	16.6	18.5	16.4	15.2	20.6	16.0	15.1	21.1	15.7	15.1	21.1
External	22.4	22.0	24.0	24.1	19.8	24.3	23.9	22.3	24.1	23.2	20.1	23.8	22.7
Memorandum items:													
Nominal GDP (in Ksh billions)	1,963	2,393	2,299	2,241	2,690	2,662	2,547	2,993	2,969	2,831	3,332	3,293	3,150
Nominal GDP (in US$ millions)	29,885	35,580	31,229	30,384	39,204	32,844	32,687	42,775	34,820	36,464	46,686	37,609	40,376
Per capita income (US$)	*792*	*916*	*804*	*782*	*981*	*822*	*818*	*1,041*	*847*	*887*	*1,105*	*890*	*956*

BOPA = Budget Outlook Paper

BSP = Budget Strategy Paper

Source: Ministry of Finance

ANNEX 2: MONETARY SURVEY 2007/08 – 2011/12 (END OF PERIOD, KSH BILLION)

Annex 2: Monetary Survey 2007/08 - 2011/12
(end of period; in billions of KSh)

	2007/08	2008/09	2009/10	2010/11	2011/12
	Act.	*Proj.*	*Medium term projection*		
Central Bank of Kenya (CBK)					
Net Foreign Assets 1/	202.6	173.4	211.9	254.3	332.1
Net Domestic Assets	-49.6	-10.0	-25.4	-39.4	-84.4
Net credit extended	-23.1	-82.4	60.3	62.2	36.9
Net claims on Government	-27.7	-17.5	-12.1	-8.5	-5.0
Claims on banks	4.5	-64.9	72.3	70.7	41.9
Other assets, net	-28.9	-66.9	-85.7	-101.6	-121.3
Reserve money (RM)	152.9	163.4	186.5	214.9	247.7
Monetary Survey					
Net Foreign Assets (NFA) 1/	291.3	283.2	344.7	413.9	522.5
Central Bank (CBK)	202.6	173.4	211.9	254.3	332.1
Banks	88.7	109.8	132.8	159.6	190.4
Net Domestic Assets (NDA)	549.4	666.8	755.8	854.1	939.4
Domestic Credit	701.8	851.6	1,016.3	1,207.8	1,399.6
Claims on Government (net)	133.4	160.6	196.8	220.6	243.3
Central Bank	-27.7	-17.5	-12.1	-8.5	-5.0
Banks	161.1	178.2	208.8	229.0	248.3
Claims on Private Sector	568.3	690.9	819.5	987.2	1,156.3
Other items (net)	-152.4	-184.8	-260.5	-353.7	-460.3
Broad Money (M3)	840.7	950.0	1,100.6	1,268.0	1,461.9
of which:					
Residents' foreign-currency deposits	124.7	152.0	176.1	202.9	233.9
(ratio of FX deposits/M3)	*14.8%*	*16.0%*	*16.0%*	*16.0%*	*16.0%*
Memorandum items:					
Reserve money annual percentage change	18.2	6.9	14.1	15.2	15.3
M3 Annual percentage change	18.7	13.0	15.9	15.2	15.3
Velocity (GDP/M3eop)	2.3	2.3	2.3	2.2	2.2
Velocity (GDP/M3avg)	2.5	2.5	2.5	2.4	2.3
Multiplier (M3/RM)	5.5	5.8	5.9	5.9	5.9
Credit to private sector	28.2	21.6	18.6	20.5	17.1
Resident FX deposits (billions of US$)	1.9	2.0	2.3	2.6	3.0
Net Government borrowing	335.3	417.7	527.2	599.4	668.2
Banking sector	133.4	160.6	196.8	220.6	243.3
Non-banking sector	201.8	257.1	330.4	378.8	424.9

1/ At current exchange rate

Source: Ministry of Finance and Central Bank of Kenya

ANNEX 3: CHRONOLOGY OF EVENTS OF PARTICULAR RELEVANCE TO MONETARY POLICY AND INFLATION (January – June 2009)

1. East Africa Community Central Bank Governors signed a memorandum of understanding on monetary cooperation in January 2009.
2. The Horizontal repos operationalised on 22nd March 2009
3. The MPC reduced the CBR from 8.50 percent to 8.25 percent on 20th March 2009.
4. The delay in approval of the Supplementary Estimates by Parliament caused a temporary build up in Government deposits at Central Bank of Kenya between April and May 2009.
5. The MPC reduced the CBR from 8.25 to 8.00 percent on 21st May 2009.
6. The Bank embarked on the reopening of benchmark bonds in April 2009 to reduce the fragmentation in the existing bonds as well as increase the liquidity around these bonds. The reopening was a resounding success.

GLOSSARY OF KEY TERMS

Overall Inflation

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

Underlying Inflation

This is the overall inflation measure that excludes volatile components that include food, energy, transport and communications which are beyond the control of the CBK. Thus, the underlying measure is used by the CBK to gauge the influence of monetary policy on inflation.

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

Central Bank Rate (CBR)

This is the lowest rate of interest that the CBK charges on loans to commercial banks. It is reviewed and announced by the Monetary Policy Committee at least every two months as part of its decisions.

Open Market Operations (OMO)

The act of buying or selling Treasury bills in the secondary market by the Central Bank in order to achieve a desired level of bank reserves. OMO is done in the context of an auction where commercial banks bid through the Reuters screen.

Repurchase Agreement (REPO)

REPOs/reverse repos are agreements between the CBK and commercial banks to purchase/sell Government securities from/to commercial banks at agreed interest rates (REPO rate) for a specified period with an understanding that the commercial bank will repurchase/resell the security from/to the CBK at the end of the period. The period can be limited by the CBK.

Horizontal REPO

This is an interbank REPO instrument which recognises Government securities as collateral for borrowing. The instrument allows commercial banks without credit lines with other banks to access credit from the interbank market.

Reserve Money Programme

This is the desired movement in the reserve money operating target to achieve the money supply growth target (intermediate target) that is consistent with the inflation target (ultimate target).

Cash Reserve Requirement (CRR)

This is the legally required position of commercial banks and non-bank financial institutions deposits held with the CBK. The CBK is empowered by the CBK Act to demand that a certain proportion of commercial banks' deposits be held as reserves at the CBK. The ratio currently stands at 4.5 percent.

Term Auction Deposits

A deposit product of the Central Bank of Kenya transacted with commercial banks under Open Market Operations through a competitive auction bidding system. Deposits are held to maturity and qualify for liquidity ratio purposes.