



CENTRAL BANK OF KENYA

The Fourteenth Monetary Policy Statement

Issued under the Central Bank of Kenya Act, Cap 491

June 2004

MONETARY POLICY STATEMENT

JUNE 2004

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I. INTRODUCTION

Programme Overview

This 14th Monetary Policy Statement, reviews progress in the implementation and performance of the monetary policy programme for the six months to June 2004, and proposes the monetary policy implementation path considered appropriate for the 12 months to June 2005. The programme is designed to facilitate the achievement of strong employment generating and poverty reducing economic growth while ensuring that effects of Kenya's macroeconomic vulnerabilities are well contained.

For calendar year 2004, the Central Bank of Kenya¹ set the monetary programme to achieve an underlying inflation at 3.5%, being the average rate achieved by Kenya's trading partners and to support recovery of real gross domestic product (GDP) from 1.3% growth in December 2003 to 2.6% in December 2004. To this end, the programme provided for broad money supply, M3X, to expand by 8.1% and reserve money to increase by 6.8% in 2004. The programme further envisaged gross foreign exchange reserves at U.S. dollar value equivalent of 3.0 months of imports of goods and non-factor services based on a projection of imports for the twelve months in 2005. Finally, the programme assumed a domestic deficit-financing requirement of Ksh 8.1 billion during 2004 resulting in net domestic indebtedness of Government increasing from Ksh 249.7 bn in December 2003 to Ksh 257.9 bn by December 2005.

Performance criteria and benchmarks under the monetary programme were a ceiling on monthly net domestic assets (NDA) and floor on the end month net foreign assets (NFA) of the Central Bank. Provisions were made for the programme targets to be adjusted to accommodate deviations from programmed levels in three areas namely, donor budgetary flows, non-bank holdings of Government securities and the foreign component of privatization proceeds. It was necessary to adjust for deviations from programmed donor support to underscore the critical role of donor resources in propelling the public investment programme. It was important to allow Government to bridge the resource gap from domestic sources and ensure that the programme does not stall in the face of delay in disbursements.

Legal Basis for the Publication of the Monetary Policy Statement

The Monetary Policy Statement is published in accordance with Part II Section 4B(1) of the Central Bank of Kenya Act, CAP 491. The law states that:

- 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:
 - *Specify the policies and the means by which the Central Bank intends to achieve the policy targets;*
 - *State reasons for adopting such policies and means;*
 - *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.*
- *The Minister shall lay every statement submitted under section (1) before the appropriate committee of the National Assembly not later than the end of the subsequent session of Parliament after the statement is submitted.*
- *The Bank shall:*
 - *Cause every monetary policy statement submitted under subsection (1) and its monthly balance sheet to be published in the Gazette; and*
 - *Disseminate key financial data and information on monetary policy to the public.*
- *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.*

To comply with the above provisions, the Central Bank produces a rolling monetary policy formulation and implementation framework every six months. By regularly communicating its monetary policy stance through these Statements, the Central Bank enables various agents to make informed economic decisions. Such shared knowledge about monetary policy enhances macroeconomic stability which underpins economic activity.

The remainder of this Monetary Policy Statement is organized into three sections. The section following this overview reviews the implementation status of the first half of the current monetary policy programme for January - December 2004 and the current and future economic prospects. Section 3 projects the monetary programme for the twelve months to June 2005 while Section 4 provides conclusions.

II. REVIEW OF MONETARY POLICY IN THE TWELVE MONTHS TO JUNE 2004

Jointly with the International Monetary Fund (IMF), the Government formulated a monetary programme for Kenya for the twelve months to June 2004 in May-June 2003. The programme not only covered the remaining six months to June 2004 but extended its scope through successive financial years to June 2008. The programme was finalized in the negotiations in September and October 2003.

As designed, the monetary programme provided the basis for strong economic growth that would generate employment growth and reduce poverty while avoiding the potential effects of Kenya's macroeconomic vulnerabilities. The Central Bank of Kenya adopted the 2003-04 monetary programme in December 2003, and used the medium term framework to formulate the monetary programme for calendar year 2004 shown in Table 1 below. It targeted money supply to increase by 8.1% and reserve money to expand by 6.8% in December 2004. The expansion in money supply was consistent with 2.6% real GDP growth, 3.5% underlying inflation² target, foreign exchange reserves³ build up equivalent of 2.8 months of next years imports and a budget deficit of Ksh 48bn with the domestic financing capped at Ksh 19.8bn in the twelve months to June 2004. In January - June 2004, a net reduction of net domestic credit to Government by Ksh 4.0 bn financed with external budgetary support was programmed.

Programme Performance Review

TABLE 1: MONETARY PROGRAMME FOR DECEMBER 2003 - DECEMBER 2004 IN KSH (M) 1/

	2002	2003					2004			
	Dec Act.	Mar Act.	Jun Act.	Sep Act.	Dec Act.	Dec Proj.	Mar (Proj)	Jun (Proj)	Sep (Proj)	Dec (Proj)
1. Monetary Survey										
Money supply (M3)	406,009	408,817	419,419	424,704	453,348	431,956	438,529	449,299	451,887	466,882
Annual % Change	10.2	11.7	10.9	9.6	11.7	6.4	7.3	7.1	6.4	8.1
Net Foreign Assets	102,150	104,537	104,352	107,434	112,067	105,516	111,608	117,613	123,445	130,043
Annual % Change	8.7	9.5	7.5	10.8	9.7	3.3	6.8	12.7	14.9	23.2
Net Domestic Assets	303,859	304,280	315,067	317,270	341,280	326,441	326,921	331,686	328,441	336,840
Annual % Change	10.7	12.4	12.0	9.3	11.2	7.4	7.4	5.3	3.5	3.2
2. Central Bank Balance Sheet										
Reserve money	88,453	84,113	85,494	81,849	87,512	83,574	80,696	80,854	83,990	89,226
Annual % Change	11.8	11.0	11.2	4.1	(1.1)	(5.5)	(4.1)	(5.4)	2.6	6.8
Net Foreign Assets	70,274	79,136	81,482	84,115	88,262	83,101	89,417	95,644	101,476	108,791
Annual % Change	(7.1)	1.9	4.7	10.4	25.6	18.3	13.0	17.4	20.6	30.9
Net Domestic Assets	18,179	4,977	4,012	(2,266)	(750)	473	(8,721)	(14,790)	(17,486)	(19,565)
Annual % Change	416.4	(364.1)	(521.7)	(193.5)	(104.1)	(97.4)	(275.2)	(468.6)	671.6	(4,232.8)

1/ Actuals end-months, and expected monthly averages for CBK balance sheet projections

Source: Central Bank of Kenya

Money Supply

Money supply measured by the three aggregates, namely, M3⁴, M3X⁵ and M3XT⁶ as shown in Table 2, overshoot their respective targets from December 2003 through May 2004. M3X, the intermediate target for monetary policy, increased by 13.5% thereby exceeding the 7.1% target growth over the twelve months to June 2004. In spite of the fairly rapid expansion of M3X, however, inflation was generally subdued as low domestic demand largely eased pressure off the underlying (monetary based) inflation.

Table 2: Annual Percentage Changes in Selected Monetary Aggregates, June 2003 to May 2004

	RM		M3		M3X		M3XT		DRM	DM3	DM3X	DM3XT
	Act.	Targ.	Act.	Targ.	Act.	Targ.	Act.	Targ.				
Jun,03	11.2	6.6	9.3	7	10.9	7	12.1	11.8	4.6	2.3	3.9	0.3
July	-2.9	-4.2	11.0	8.8	11.7	7.5	12.9	12.8	1.3	2.2	4.2	0.1
Aug	9.8	12.1	9.3	8.5	8.9	8.2	10.0	8.8	-2.3	0.8	0.7	1.2
Sep	4.1	10	10.3	9.5	9.6	9.1	9.6	8.8	-5.9	0.8	0.5	0.8
Oct	15.8	11.5	12.2	9.6	12.5	8.9	11.1	8.8	4.3	2.6	3.6	2.3
Nov	10.5	10.4	11.9	9.3	12.0	8.1	9.9	9.4	0.1	2.6	3.9	0.5
Dec.	-1.1	-5.5	12.7	7.3	11.7	6.4	9.3	8.7	4.4	5.4	5.3	0.6
Jan, 04	0.8	-4.1	12.4	8.7	11.4	7.3	8.9	8.7	4.9	3.7	4.1	0.2
Feb	3.5	-4.1	11.4	8.7	11.9	7.3	9.7	8.7	7.6	2.7	4.6	1.0
Mar	3.0	-4.1	11.9	8.7	12.7	7.3	10.0	8.7	7.1	3.2	5.4	1.3
Apr	7.5	-5.4	13.9	8.9	13.6	7.1	9.8	8.3	12.9	5.0	6.5	1.5
May	7.2	-5.4	13.8	8.9	13.5	7.1	9.2	8.3	12.6	4.9	6.4	0.9

Source: Central Bank of Kenya

Reserve Money

Reserve money performance is summarized in Table 3 below. It can be observed reserve money⁷, was on average, above the monetary programme targets for March and June 2004. The excess reserves represented clearing account balances of commercial banks. These

Table 3: Reserve Money Performance June 2003 to May 2004 1/ in Ksh M

	2003							2004				
	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May
1. Liabilities												
Reserve Money												
Actual	87637	81733	85528	85283	85770	88351	89512	85800	87248	86080	87093	89802
Target	81951	79593	86946	86471	86039	88042	83574	80697	80697	80697	80853	80853
Deviation	5686	2140	-1418	-1188	-268	-692	5938	5103	6551	5383	6240	8949
(%)	6.94	2.69	-1.63	-1.37	-0.31	-0.78	7.11	6.32	8.12	6.67	7.72	11.07
2. Assets												
Net Foreign Assets												
Actual	81259	80269	81156	84316	86143	85806	85882	87498	86396	85209	85568	84391
Target	81680	84021	76332	75964	78162	76337	89763	89417	89417	89417	95644	95644
Deviation	-430	-3752	4824	8353	7981	9469	-3881	-1919	-3021	-4208	-10076	-11253
Net Domestic Assets												
Actual	6377	1464	4371	967	-372	2545	3630	-1697	852	872	1525	5412
Target	261	-4428	10614	10507	7877	12705	-6189	-8720	-8720	-8720	-14791	-14791
Deviation	6116	5892	-6242	-9540	-8249	-10161	9819	7023	9572	9592	16316	20203

Monthly averages

Source: Central Bank of Kenya

reserves had not been anticipated in the pre-budget programme scenario with the new cash ratio regime.

After a six month learning period in the management of settlements risks, the average excess reserves holding of banks declined from Ksh 6.6bn in the six months to December 2003 to Ksh 2.2 bn in the five months to May 2004. Most of the reduction in excess reserves was attributed to increased liquidity mop up by the Central Bank's open market operations in the five months to May 2004, coupled with accelerated credit expansion to the private sector as interest rates stagnated at lower levels.

Credit to the private sector increased by 12.0% in the year to May 2004 compared with 4.8% target growth under the monetary programme and 5.0% growth in the year to May 2003. For the five months to May 2004, credit to the private sector expanded by 5.2% thereby exceeding the 3.1% target growth for the six months to June 2004. On a monthly basis and except for February 2004, credit to the private sector was on an upward trend since September 2003, with the expansion being attributed to increased demand following significant reduction in commercial banks average lending rates, aggressive marketing of loan facilities by commercial banks and positive sentiment on economic prospects. Most of the new lending was channelled largely to domestic trade, private households and manufacturing activities.

Table 4: Excess Reserves of commercial Banks and NBFIs at the Central Bank- June 2003 to May 2004 in Ksh M 1/

		Banks Deposits at Central Bank		
		Total	Required	Excess
2003	Jun	31652	28499	3153
	Jul	27346	20709	6637
	Aug	29226	21034	8193
	Sep	28764	21064	7699
	Oct	28610	21194	7416
	Nov	28407	21693	6714
2004	Dec	26284	22140	4144
	Jan	24811	22524	2287
	Feb	24535	22726	1810
	Mar	23737	22829	908
	Apr	24749	23202	1547
	May	27830	23471	4358

1/ Calendar month averages

The cash ratio and cash ratio administration were reviewed on 1st July 2003. The cash ratio was lowered from 10% monthly average subject to 8% daily minimum, to 6% daily minimum. The cash ratio balances were frozen and therefore no longer accessible to depository institutions. The deposit base was widened to include residents' foreign currency denominated deposits. Commercial banks opened clearing accounts for daily settlement of business in the clearing house.

Source: Central Bank of Kenya

**The PRGF
Programme**

Quantitative Financial Performance Criteria

Under the PRGF programme, monetary performance criteria and benchmarks were to be on the net domestic assets (NDA) and net foreign assets (NFA) of the Central Bank. The NDA was set at a maximum (ceiling) average of Ksh -1,237 million as a benchmark for September, 2003; Ksh 2,026 million as performance criteria for December 2003, Ksh -7,167m as a benchmark for March 2004 and Ksh -13,238m as performance criteria for June 2004. Similarly, the NFA was set at a minimum (floor) of Ksh 75,921m as benchmark for end September 2003, Ksh 77,562m as performance criteria for end December 2003, Ksh 83,878m as benchmark for end March 2004 and Ksh 90,105m as performance criteria for end June 2004.

The closely related net domestic financing (NDF) of the Central Government performance criterion, under the Treasury, was set with respective quarterly targets of Ksh 12.2 bn for end December 2003, Ksh 19.0bn for end March 2004 and Ksh 19.8bn for end June 2004.

**Programme
Adjusters**

Performance indicators were to be adjusted for deviations from programmed levels in three areas, namely, donor budgetary flows, non-bank holdings of Government securities and the foreign component of privatization proceeds.

**NDA
Performance**

The Central Bank achieved the Monetary Programme NDA targets for March 2004 and provisionally for June 2004 quarter as shown in the Table 5 below by conducting mop up of excess liquidity beginning November 2003 onwards. The Bank enhanced and diversified its Open Market Operations in January 2004 to include a one-year repurchase Treasury bill designed to raise Ksh 15 bn at 3.5% interest, that was a

Table 5: Summary of NDA Performance, Ksh M

	Sept 2003**	Dec 2003***	Mar 2004**	June 2004***
1 Program Target	-1,237	2,026	-7,167	-13238
2 Shortfall in non project budget support	2,789	5,378	12,442	19,506
3 Shortfall in non bank public holding government securities	5,176	15,170	15,299	19,755
4 Adjusted Program Target (1+2+3)	6,728	22,106*	20,574	6,268
5 Actual NDA	967	3,670	858	5,409
6 Deviation (4-3)	-5761	-18,436	-19,706	-859
Performance Criteria met	Yes	Yes	Yes	Yes

* Kshs.22,106m is the max. equivalent allowed adjuster of USD 280 million in the programme.

The actual of Kshs 22,574m is higher than Kshs.22,106m

** Benchmark dates

*** Test dates, June 2004 performance based on estimates in May 2004

Source: Central Bank of Kenya

NFA Performance

0.5% margin above the yield on one-year bond. This effort, coupled with the adjustments made to accommodate the shortfalls in donor budgetary support, resulted in the success of the programme. This success notwithstanding, the Bank experienced major difficulties in its open market operations.

The monetary programme was successful with respect to the NFA target for end March 2004 NFA and end June 2004 quarters by significant margins as shown in Table 6. The observed success in the NFA benefited from purchases of foreign exchange from commercial banks as well as from donor inflows for budget support.

Table 6: Summary of NFA Performance in Ksh M

		Sept 2003*	Dec 2003**	Mar 2004*	June 2004**
1	NFA Program Target	75,921	77,562	83,878	90,105
2	Shortfall in non project budget support	2,789	5,378	12,442	19,506
3	Adjusted Program Target (1+2)	73,132	72,184	71,436	70,599
4	NFA Actual (unencumbered)	78,784	82,452	80,707	79,229
5	Deviation (4-3)	5,652	10,268	9,271	8,630
6	Performance met	Yes	Yes	Yes	Yes

* Benchmark dates

** Test dates, June 2004 performance based on estimates in May 2004

Source: Central Bank of Kenya

Domestic Inflation

Except for a modest build up in January and February 2004, inflationary pressures eased during the twelve months to May 2004 as shown in Table 7. More specifically, the overall month-on-month inflation eased from 13.7% in June 2003 through 8.4% in December 2003 and 4.7% in May 2004. The rate of increase in the general price level was low and stable with the exclusion of the food component, while the price index displayed stability when both food and energy components are excluded. Overall 12-month inflation excluding food, varied from a low of 2.6% to a high of 4.87% during the period while the underlying inflation (excluding food and energy components) was more stable ranging from 2.0% to 2.9% for all the months but May 2004 when it declined to 1.95%.

The decline to 1.95% increase in underlying inflation in May 2004 was the result of sustained success in the implementation of prudent monetary policy by the Central Bank. Notwithstanding the reduction and stability of prices, increases in prices between June 2003 and May 2004 was attributed partly to the following factors:

- Depreciation of the Kenya shilling in the foreign exchange market. This made imported inputs denominated in hard currencies more expensive.
- Increases in oil prices that followed uncertainties in major oil producing countries, particularly Saudi Arabia, Iraq and the entire Middle East, in general.
- Inadequate rainfall in various parts of the country which contributed to shortage of basic food items, especially those consumed by the low-income group.

Table 7: Inflation in Kenya, June 2003 - May 2004

		Overall Inflation	Overall Inflation Excluding Food	Overall Inflation Excluding Food and Energy	Food
2003	Jun	13.70	4.00	2.80	22.20
	Jul	10.90	3.30	2.40	17.70
	Aug	8.30	3.30	2.50	12.80
	Sep	7.90	3.00	2.60	12.40
	Oct	9.10	2.80	2.60	14.70
	Nov	9.00	2.70	2.30	14.60
	Dec	8.40	2.60	2.33	13.50
2004	Jan	9.14	2.60	2.85	15.00
	Feb	9.85	4.48	2.58	14.60
	Mar	8.32	4.87	2.55	11.40
	Apr	7.58	4.63	2.08	8.40
	May	4.66	4.49	1.95	5.10

Source: Central Bank of Kenya

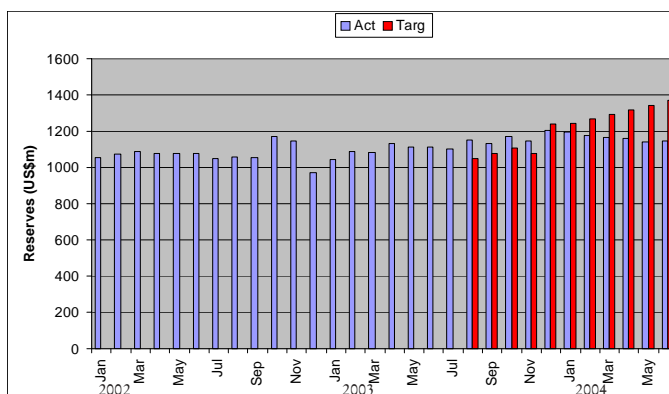
Foreign Exchange Reserves

The Central Bank continued to meet its statutory foreign exchange reserves, set at an average value of 4.0 months imports as recorded and averaged for the last three preceding years. Between July 2003 and June 2004, usable international reserves of the Central Bank increased from US \$1,102.9 million (equivalent to 3.6 months of imports cover) to US\$ 1,146.0 million (equivalent to 4.0 months of imports cover) respectively as shown in Table 8. On average, reserves accumulation for the twelve-month to June 2004 equalled 4.03 months of imports cover. The statutory reserves level was therefore generally met through the last twelve months. Actual reserves accumulation outperformed the Poverty Reduction and Growth Facility (PRGF) program target of 3.4 months of imports cover (the benchmark for December 2003). Growth in Bank's reserves was achieved through both inter-bank purchases and donor program financing between June 2003 and June 2004. The purchase of foreign exchange from commercial banks was facilitated by US\$84m surplus in the balance of payments accumulated over the twelve months to March 2004, down from US\$ 176m surplus for the twelve months to March 2003.

Usable reserves, however, fell below the PRGF targets in the six months to June 2004 as shown in Table 8 and Chart 2. This followed delays in disbursement of pledged budgetary support.

Table 8 and Chart 2: Usable Net Foreign Assets of the Central Bank in US \$ m

	Act	Targ
2002 Jan	1053.0	
Feb	1072.0	
Mar	1090.0	
Apr	1080.0	
May	1077.0	
Jun	1078.0	
Jul	1048.0	
Aug	1059.0	
Sep	1055.0	
Oct	1169.0	
Nov	1148.0	
Dec	972.0	
2003 Jan	1042.0	
Feb	1087.0	
Mar	1084.0	
Apr	1133.0	
May	1112.0	
Jun	1114.0	
Jul	1102.9	
Aug	1151.1	1051.0
Sep	1134.1	1079.0
Oct	1169.0	1107.0
Nov	1148.0	1077.0
Dec	1206.5	1237.4
2004 Jan	1194.3	1242.8
Feb	1175.5	1266.5
Mar	1167.7	1292.1
Apr	1159.8	1318.0
May	1143.3	1343.9
Jun	1145.9	1369.9



Source: Central Bank of Kenya

Macroeconomic Developments

The economic recovery in 2003 was attributed to the positive impact of improvements in political and economic governance underpinned by intensified fight against corruption; stable macroeconomic environment manifested in low inflation, falling interest rates, stable shilling exchange rate, and resumption of donor support. The recovery occurred largely in agriculture, and in the services sectors such as telecommunications and financial services.

Leading economic indicators over the first four months of 2004 show that economic recovery remained on track and the real GDP growth of 2.7% for 2004 envisaged is achievable. In agriculture, major cash crops, namely, tea, horticulture, sugar cane and pyrethrum recorded substantial increases in output due to the favorable weather conditions. Tea deliveries increased by 29.5% compared with a decline of 7.5% in a corresponding period of 2003 due to the timely and good distribution of the long rains over the tea growing districts in contrast with the unfavorable rain patterns experienced in the same period last year. Horticultural crop exports also increased by 24.1% to 62,810 tonnes following expansion to new export markets in the Middle East and South Africa. Sugarcane deliveries picked up to 37.7% in the first four months of 2004 compared with a decline of 26.3% in the first four months of 2003. Similarly, pyrethrum grew by 0.6% in the period.

Telecommunications services also grew significantly. Active mobile phone lines grew by 68.9% to 3,300,000 by the end of May 2004 from 1,954,034

Macroeconomic Performance

subscriptions in December 2003, and fixed line subscriptions picked up by 9.5% to 360,000 from 328,500 over the same period.

In the transport sub-sector, cargo handled through the Port of Mombasa increased by 2.3% to 4,106,433 tonnes from 4,013,664 tonnes in the period, while throughput by Kenya Pipeline Company rose by 5.3% in the period reflecting increased use of the two facilities.

In the energy sector, generation and consumption of electricity improved in the period under review. Local generation of electricity grew by 8.4% to 1,633 million Kilowatt Hours (KWH) from 1,506 million KWH in the corresponding period of 2003 while consumption, which is largely by industry, increased by 9.3% to 1,030 million KWH from 942 million KWH in the same period.

In the financial sector, commercial banks, non-bank financial institutions and building societies maintained stability during the first four months of 2004. During the period non-performing loans as a proportion of total loans fell to 24.8% from 29.2% in the first four months of 2003.

Given sustained implementation of the government investment programme underlying the monetary programme, economic growth as outlined in the 2004/05 Budget Speech and the Economic Recovery Strategy is expected to rise further to 3.3% in the year 2005. Enhanced resource flows is expected to be realized in the financial year 2004/05 and over the medium term. Economic recovery will also be enhanced by prudent fiscal and monetary policies. In particular, following reduction in government domestic borrowing and restructuring of debt in favor of long-dated instruments, private sector credit picked up from 5.0% annual growth in May, 2003 to 12% in May 2004 after a long period of stagnation. Credit to the private sector is further programmed to increase by 13.5% in the fiscal year 2004/05. In the foreign exchange market, the Kenya shilling is expected to remain competitive against major currencies, thus balancing the interests of both importers and exporters. Similarly, lending rates have become increasingly affordable with the weighted average lending rates falling by 5.97 percentage points to 12.5% in May 2004 from 18.52% in May 2003. Affordable interest rates are expected to persist as the government is committed to limit borrowing to Ksh 22bn during the fiscal year 2004/05.

Fiscal Performance

The Government budgetary operations recorded impressive results in the first three quarters of the fiscal year 2003/04. As at end March 2004, the budget deficit on a commitment basis was Ksh 7.2bn or 0.7% of GDP compared with Ksh 29.3bn or 2.7% of GDP target. On a cash basis, the deficit was Ksh 7.0bn against a target of Ksh 30.5bn. The impressive performance was due to lower expenditures than targeted during the period, increased tax revenue collection and good inflows of external grants. During the review period, the total Government expenditure amounted to Ksh 189.4bn while total revenue and grants amounted to 182.3bn.

While the Government expenditure and net lending fell short of the target by Ksh 29.2bn, the revenues, despite underperformance in non-tax revenue, reached the target. Tax revenue exceeded the end March target by 6.1% or Ksh 8.3bn. Two factors, namely, the delays in donor programme support which constrained development expenditure by Ksh 20.6bn from the targeted Ksh 40.6bn and the Government's suspension of awards of new contracts, suspension of payment of existing contracts as well as suspension of procurement of goods and services without prior Treasury approval from May 2003 to September 2003 explain the lower expenditures during the period.

Consequently, the budgetary operations from July 2003 to March 2004 led to domestic financing requirement of Ksh 15.5bn to finance net repayment of external debt totalling Ksh 6.1bn, repayment of debt due to non-bank institutions totalling Ksh 3.7bn and build up of Government deposits at the Central Bank by Ksh 3.9bn. Largely reflecting this Government deposits build up, the net indebtedness of Government to the Central Bank declined by Ksh 4.2bn in the first three quarters of the fiscal year 2003/04. The entire Ksh 15.5bn financing requirement was mobilised from commercial banks through the issuance of Treasury bills and bonds.

Financing remained well within the target as the net domestic financing (NDF) amounted to Ksh 7.7bn compared to a target of Kshs 19bn. With respect to securities, the domestic borrowing resulted in the stock of Treasury bonds increasing from Ksh 161.5bn in June 2003 to Ksh 187.5bn in March 2004. Proceeds from Treasury bond sales were used to finance the Government deficit, repay external debt, and redeem maturing Treasury bills in line with the domestic debt restructuring policy to lengthen the domestic debt maturity.

Exchange Rate Behaviour

Determined competitively under a flexible exchange rate regime, the Kenya shilling exchange rate continued to display mixed results through the last 6 months of 2004. During trading in the foreign exchange market, the shilling's behavioural path alternated between periods of appreciation and depreciation. In most of the cases, the extent of appreciation was more than outweighed by the subsequent depreciation so that the overall effect was that of a weakening shilling. While this was happening with respect to major hard currencies, the shilling continued to emerge stronger against other regional currencies, particularly against the Uganda shilling and the Tanzania shilling (See Table 9 below).

It is evident that in 2004, the shilling traded at a weaker position since the average for each month was higher than the annual average for 2003. For example, the shilling exchanged at an average of Ksh 79.24 per US dollar in May 2004, from an annual average of Ksh 75.94 in 2003. Likewise, the shilling traded at an average of Ksh 141.47 and Ksh 95.13

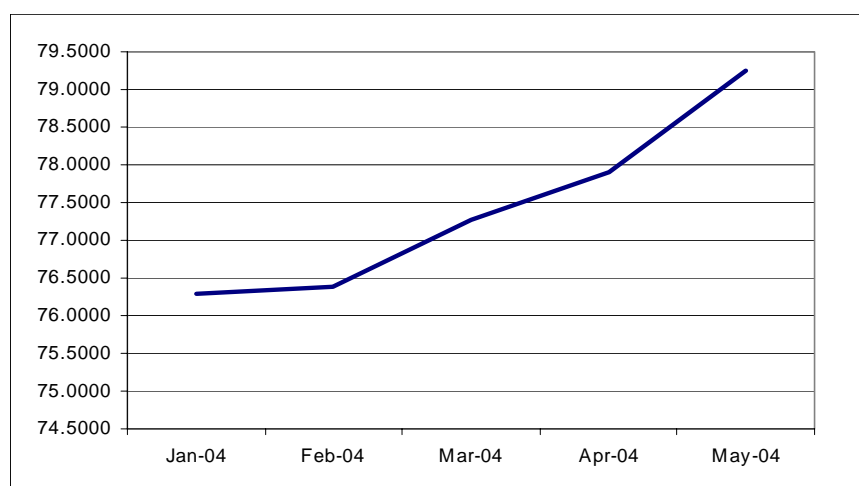
against the Pound Sterling and Euro, respectively, in May 2004, compared with an averaging trading of Ksh 124.13 and Ksh 85.87 for 2003.

Table 9: Kenya Shilling Exchange Rates

	K sh/\$	K sh/£	K sh/Yen	K sh/EUR	K sh/SDR
Jan-03	77.7175	125.6618	65.7833	82.6033	103.7975
Feb	76.8410	123.8360	64.3315	82.7773	105.3075
Mar	76.5826	121.1663	64.5394	82.6666	104.9227
Apr	75.6564	119.1798	63.1407	82.1815	102.1251
May	71.6074	116.1869	61.1661	82.8175	100.7329
Jun	73.7223	122.5313	62.3393	86.0762	104.3089
Jul	74.7473	121.4666	62.9864	85.0436	104.5206
Aug	75.9602	121.1184	63.9348	84.7004	105.1989
Sep	77.9042	125.4598	67.6909	87.4757	108.7944
Oct	77.7651	130.4129	70.9720	91.0154	111.3762
Nov	76.7375	129.6012	70.2667	89.7756	109.5698
Dec-03	76.0194	132.9265	70.4957	93.2828	111.5559
Annual Average	75.9384	124.1290	65.6372	85.8680	106.0175
Jan-04	76.2945	138.9512	71.6599	96.2205	113.7621
Feb-04	76.3897	142.5996	71.7163	96.5567	114.3152
Mar-04	77.2619	141.3215	71.1494	94.8482	113.8090
Apr-04	77.9099	140.5250	72.4310	93.4103	113.7510
May-04	79.2425	141.4661	70.5971	95.1255	114.4870
Average Jan-May 04	77.4197	140.9727	71.5107	95.2322	114.0249

Source: Central Bank of Kenya

Chart 2: Kenya Shilling - US\$ Exchange Rate January - May 2004



Source: Central Bank of Kenya

Interest Rate Trends

Interest rates had mixed trends over the first six months of 2004 compared with the last half of 2003. For example, while the average interest rate on 91-day T-bill was 3.0% in June 2003, it had declined to 0.83% by end of November 2003 and then followed a sustained increase, reaching an average of 2.9% by the end of May 2004, before easing to 2.00% in June 2004. A similar trend was observed for the 182-day T-bill whose average interest rate moved from 4.12% in June 2003, then followed a declining trend in the subsequent months through September 2003 with an average of 1.35%. Thereafter, a sustained increase ensued. By the end of May 2004, the average rate stood at 3.6% but eased to 3.1% in June 2004. Table 10 provides details on trends in the various interest rates between January 2003 and June 2004.

Table 10 below shows substantial changes in commercial banks interest rates between June 2003, December 2003 and May 2004. The average commercial banks' lending rate declined over the period, from 15.73% to 13.47% and further to 12.5% between June 2003, December 2003 and May 2004, respectively. During the same period, the average deposit rates declined from 4.84% to 3.27% and further to 2.22%. After easing to 0.43% in August 2003, the average inter-bank rate rose gradually to 2.0% in May 2004, but eased to 1.28% in the following month.

Short-term interest rates behaviour during the period reflected liquidity conditions in the money market as well as market expectations of players in the money market. However, at the longer end, interest rate trends on Treasury bonds were mixed as shown in Table 10.

TABLE 10: TRENDS IN KEY INTEREST RATES: JUNE 2003 - JUNE 2004 IN %

	2002		2003							2004					
	Dec	Mar	June	July	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	June
Treasury bill ¹ 91days	8.38	6.24	3.0	1.5	1.18	0.83	1.00	1.28	1.46	1.58	1.57	1.59	2.11	2.87	2.01
182 days	8.79	6.64	4.12	2.9	2.12	1.35	1.61	1.88	2.09	2.35	2.33	2.53	3.12	3.61	3.15
Average Lending Rate	18.34	18.49	15.73	15.30	14.81	14.82	14.75	14.07	13.47	13.48	13.01	13.12	12.67	12.55	
Overdraft	18.56	17.26	14.93	14.43	14.96	14.31	14.13	14.02	13.74	13.30	12.30	11.65	11.08	10.79	
Interbank rate	8.69	6.23	1.62	0.5	0.43	0.54	0.69	0.73	0.81	0.82	0.90	1.27	1.72	2.05	1.28
Average Deposit rate	4.75	3.99	4.84	4.49	3.37	3.07	3.13	3.32	3.27	3.12	2.47	2.32	1.96	2.22	
3-months deposits	5.42	4.44	4.69	3.96	3.23	2.50	2.54	3.17	2.97	2.86	2.17	2.15	2.02	2.22	
Savings	3.47	3.28	3.07	1.79	1.72	1.44	1.43	1.44	1.38	1.43	1.47	1.30	1.24	1.15	
Treasury bonds															
1 Year	-	-	8.37	11.75	-	-	-	10.45	3.85	-	-	7.32	-	-	-
1.5 Year	-	14.50	-	-	-	-	-	-	-	-	-	-	-	-	-
2 Years	13.11	7.24	12.99	8.37	12.19	-	13.45	6.18	7.91	1.54	12.19	13.01	13.00	1.13	6.82
3 Years	8.05	11.84	8.03	12.47	-	10.95	6.26	12.33	2.24	10.35	1.66	13.75	0.93	7.66	2.77
4 Years	-	-	13.25	9.16	-	12.50	14.00	-	10.07	13.75	-	12.50	8.54	10.07	10.07
5 Years	14.00	14.50	14.00	-	13.70	14.50	11.95	6.51	14.00	-	11.06	-	11.95	2.04	14.00
6 Years	-	14.25	-	14.00	-	14.25	4.73	11.50	-	14.00	-	14.25	2.14	10.19	-
7 Years	-	-	-	-	-	13.75	-	-	-	-	-	13.75	6.50	-	-
8 Years	-	-	-	-	-	-	12.50	-	-	-	-	7.00	12.50	-	-
9 Years	-	-	-	-	-	-	-	-	-	9.50	-	-	-	12.75	-
10 Years	-	-	-	-	-	-	-	-	13.25	-	8.50	-	-	-	13.25

Source: Central Bank of Kenya

III. MONETARY PROGRAMME OUTLOOK

Programme Objectives and Assumptions for 12 months to June 2005

This is the second of the annual monetary programmes to be formulated within the context of the PRGF-2003-2008 medium term framework. It reflects the essence of the common understanding reached on key issues between the Kenya Government and the IMF following the review of the twelve month programme for the year ending June 2004 that was undertaken during the IMF Article IV Consultations and PRGF review in May 2004. The monetary programme for the twelve months to June 2005, is underpinned by:

1. A careful review of the basis of the programme in view of the performance of the economy during 2003. Over 2003, the underlying month-on-month inflation remained within the 3.5% target, but the overall remained high, at 4.7% in May 2004. Due to uncertainty on the international price of oil given the recent increases, possible weather related seasonal increase in food prices and other adverse supply side shocks, the overall inflation is projected to decelerate gradually to a convergence with the underlying in 2006. Real GDP growth is revised upwards in line with the better outcome during 2003 where real GDP growth is estimated at 1.8% compared with the 1.3% target under the earlier programme and is poised to improve further following continued implementation of appropriate economic and social policies.
2. Successful implementation of the PRGF 2003/04 reserve money programme during the last six months to June 2004 where the Central Bank achieved all quantitative performance criteria and benchmarks and sustained pick up in credit to the private sector was realised. The trends are expected to continue. In particular, credit growth to the private sector in the range of 10% to 14%.
3. Internalising in full the implications of the 1st July 2003 review of the cash ratio regime on the reserve money projections for effective implementation, and transmission to the intermediate and ultimate targets of monetary policy. The reserve money programme for the year to June 2004 had failed to anticipate commercial banks holding of excess reserves following the separation of the cash ratio account from settlement accounts of commercial banks from 1st July 2003. Consequently, the reserve money programme was tighter than warranted as commercial bank deposits at the Central Bank were understated. Many were the instances when excess liquidity presented largely as clearing account balances held for a precautionary purpose

TABLE 11: MONETARY PROGRAMME FOR JULY 2004 TO JUNE 2005 IN KSH (M) 1/

	2003			2004				2005		
	Jun	Sep	Dec	Mar	Jun		Sep	Dec	Mar	Jun
	(Act)	(Act)	(Act)	(Act)	(Proj)	Revised Proj	(Proj)	(Proj)	(Proj)	(Proj)
1. Monetary Survey										
Money supply (M3X)	419,419	424,704	453,348	460,605	449,299	468,537	476,546	495,797	497,387	506,573
Annual % Change	10.9	9.6	11.7	12.7	7.1	11.7	12.2	9.4	8.0	8.1
Net Foreign Assets	104,352	107,434	112,067	122,104	117,613	124,170	127,717	129,203	132,752	134,009
Annual % Change	7.5	10.8	9.7	16.8	12.7	19.0	18.9	15.3	8.7	7.9
Net Domestic Assets	315,067	317,270	341,280	338,501	331,686	344,367	348,829	366,594	364,635	372,564
Annual % Change	12.0	9.3	12.3	11.2	5.3	9.3	9.9	7.4	7.7	8.2
2. Central Bank Balance Sheet										
Reserve money	85,494	81,849	87,512	86,618	80,853	88,584	90,092	95,168	93,138	93,132
Annual % Change	11.2	4.1	(1.1)	3.0	(5.4)	3.6	10.1	8.7	7.5	5.1
Net Foreign Assets	81,482	84,115	88,262	85,321	95,644	87,565	91,295	92,963	96,693	98,131
Annual % Change	4.7	10.4	25.6	7.8	17.4	7.5	8.5	5.3	13.3	12.1
Net Domestic Assets	4,012	(2,266)	(750)	1,297	(14,791)	1,019	(1,203)	2,205	(3,555)	(4,999)
Annual % Change	(521.7)	(193.5)	(104.1)	(73.9)	(468.7)	(74.6)	(46.9)	(394.1)	(374.2)	(590.6)

Source: Central Bank of Kenya

1/ Actuals end-months, and expected monthly averages for CBK balance sheet projections

by commercial banks. The current programme provides for excess reserves holding of Ksh 1.8bn throughout the period.

4. A stable money multiplier ranging from 5.2 to 5.4 and a mean and median of 5.3 during the programme period.
5. Build up of foreign exchange reserves at the Central Bank from 3.8 months in June 2004 to 4.1 months of imports cover by June. With this reserves, the net foreign assets of the Central Bank is projected to expand by 5.1% annually by June 2005 compared with 3.% growth in the twelve months to March 2004.
6. Domestic financing of Ksh 22bn. The large domestic financing relative to Ksh 9bn repayment under the previous programme is attributed to donor delays in disbursement of pledged resources.
7. Continued stability of banking system institutions through effective supervision

Broad Money Supply

Consistent with the above projections, money supply, M3X, is programmed to decelerate to 8.1% annual growth by June 2005 from 12.6% growth in the year to March 2004. The monetary expansion over the programme period will be supported by increases in net foreign assets and net domestic assets as shown in Table 11. The expansion in NDA is envisaged to slow down to 8.2% in the twelve months to June 2005 from 11.2% in the year to March 2004. The deceleration reflects lower recourse by Government to the banking system for domestic financing. Meanwhile, credit to the private sector is projected to increase by 13.5% in the year to June 2005

**Reserve Money
Growth**

compared with 9.5% increase over the same period by March 2004. The expansion, projected in commercial bank credit to the private sector is consistent with the emerging pick up in economic recovery and the observed shift in business focus by commercial banks towards private sector lending.

Reserve money growth will remain the operating target for implementing monetary policy. Under the monetary programme, reserve money growth is envisaged to accelerate to 5.1% by June 2005 from 3% growth in the year to March 2004. As an indicator of the consistency of the reserve money program with the expansion in broader domestic liquidity, the money multiplier will remain on a stable path, fluctuating within a range of 2% around a 5.3 mean value over the programme period.

**Monetary
Policy
Instruments**

The Central Bank shall continue to depend on the following monetary policy instruments which proved to be effective for implementing the Monetary Policy Programme in the year ending December 2004:

- Open Market Operations (OMO);
- Minimum Cash Ratio Requirement of 6% of banks' deposit liabilities; and
- Conditions of access to lender of last resort window.

**Monetary
Programme
Evaluation**

The IMF and the Central Bank of Kenya reviewed the performance criteria and benchmarks for the PRGF 2004-05 monetary programme from an average of domestic assets and an end floor on usable net foreign assets of the Central Bank to an average ceiling on the reserve money and an average floor on the net foreign assets of the Central Bank during the May 2004 Article IV consultation and PRGF programme evaluation. The adjusters on programme targets are confined to raising or lowering the NFA floor with the excess or shortfall in external budget support or external privatisation proceeds relative to programmed levels. The target on reserve money was however, maintained at the programme levels unlike under the previous programme which required to adjust the average NDA target upwards or downwards with the shortfall or excess in both the donor budgetary support and external privatisation proceeds. Under the current monetary programme, the reserve money path is upheld for consistency with basic programme assumptions. Like under the previous programme, the adjustments to the NFA for a given reserve money implies adjustment in the NDA and its components as previously. Consequently, the Central Bank will have to accommodate a shortfall in donor budgetary support by lowering the NFA floor, which under the balance sheet identity assumptions implies raising the NDA and thereby enabling the Government source the budgetary shortfall from Central Bank resources to ensure that budgetary programmes are not suspended for lack of financing. In the event that donor resources exceed the programme targets, then the Central Bank will raise the NFA

**Overall
Inflation
Outlook**

floor and thereby lower the NDA through mopping the excess liquidity injected following acquisition of the foreign exchange from Government.

Three main factors will determine the outlook for overall inflation over the next 12 months namely, : what happens in the international oil market; the external value of the shilling; and weather conditions. While substantial uncertainty prevails with respect to the first two factors, the rising oil prices could be checked with the pledge by Saudi Arabia and other OPEC producers to increase production beyond set quotas in order to lower the price.

On its part, the CBK has been keen in ensuring that money-based inflation as reflected in the underlying inflation concept is not only low but also stable and predictable.

**Prospects for
Fiscal Policy
Objectives**

The Government fiscal operations are expected to remain favourable as recorded in the first three quarters of the fiscal year. The Government expenditures will remain below the budget targets for end June 2004, while the tax revenue collection is projected to remain above the target until the end of the financial year. However, a shortfall in non-tax revenue target is projected mainly because of the failure to realise the expected license fees of the third mobile phone operator. Indications are that the Government will achieve its net domestic financing targets despite the expected shortfall in non-tax revenue.

IV. CONCLUSIONS

Lessons in Programme Implementation from previous period

- There were difficulties in mopping what appeared as excess liquidity under the PRGF monetary programme. A shortfall in programmed external budgetary support had to be covered by the Government accessing more than programmed domestic financing, thus making mopping difficult.
- In the course of implementing the monetary programme, interest rate, especially at the shorter end of the interest rate structure, declined in line with the fall in the 91 days Treasury bill rate. The decline in commercial bank lending rates was not as large as in the money market rates, but gave a modest boost to credit to the private sector. Credit to the private sector increased, accelerating from 4.8% in the year to December 2002 to 6.9% in the year to December 2003. The expansion which had remained below the overall inflation over the year to December 2003, surpassed the latter from March 2004.

- Credit to the private sector increased in real terms to meaningfully support the envisaged economic recovery. The decline in interest rates alone is not a sufficient condition for economic recovery. While interest rate volatility should be minimised to boost credit demand, other structural factors that continue to discourage private sector investment must be simultaneously addressed.

Challenges in implementing the proposed programme

- Central Bank monetary operations were complicated by the fact that the projected reserve money path did not fully accommodate the changes induced by the review of the cash ratio administration from 1st July 2003. The separation of the commercial bank's cash ratio account from clearing accounts necessitated the holding of excess balances for settlement purposes. By not factoring the latter, the PRGF reserve money targets underestimated the desired reserve money under the revised cash ratio regime. In implementing this programme, the Central Bank could not access the excess reserves implied by the programme because commercial banks needed the same for settlement purposes. Furthermore, as already indicated the shortfall in external budgetary support aggravated the situation as its use was accommodated by the allowance for increased domestic financing.
- Credible projection of GDP growth over the programme period remains a big challenge in programme formulation. A good projection is required of the growth path to ensure consistency of the money supply and reserve money under the programme with what the economy actually needs to support its activities without imparting undue pressure on inflation.
- During the recently concluded IMF Article Consultation and PRGF review, the need to contain domestic financing of the budget to Ksh 22bn for the twelve months to June 2005 was underscored. However, should the Government exceed the ceiling on domestic borrowing, due to delays in the disbursement of budgetary support funds pledged by donors, this may impact the economy adversely. The large borrowing will initially impact on Treasury bill rate thereby raising them more sharply to levels beyond the rates on Treasury bonds. This may have far reaching effects on the Government bond programme, as well as a substantial

increase in net domestic borrowing with the potential to trigger rediscounting of outstanding Treasury bonds especially those issued at low coupon rates as borrowing in Treasury bill increase. This would seriously undermine the gains so far made in extending the maturity profile of the domestic debt such as better management of risks and cost of debt. More significantly, shifting investment in Government securities away from Treasury bonds would severely undermine the Government and private sectors desire for a vibrant capital market, particularly the secondary market that is key to mobilizing long- term credit for Government. Last, but not least, any Treasury bonds rediscounted but not rolled over into Treasury bills will increase the magnitude of liquidity mop up by the Central Bank. This would create a second spiral of increase in interest rates as well as constrain the balance sheet of the Central Bank by eroding the Bank's profitability. An upward increase in the interest rate structure would reduce private sector borrowing relative to programme targets, with adverse effects on economic growth. These effects will compromise the implementation of the proposed monetary programme for the 12 months to June 2005.

After proper assessment and review of the basis of the PRGF programme, stable macroeconomic environment that is conducive to the realisation of the key objectives of the programme, the envisaged economic recovery is possible.

Endnotes

1. For brevity the Central Bank of Kenya is also simply referred to as “Bank”. This is consistent with the interpretation given in Part I of the Central bank of Kenya Act, CAP 491.
2. Underlying inflation concept is used in this case. Unlike the Overall Domestic Inflation Measure that incorporates the highly volatile prices of food and energy, the Underlying Inflation Measure excludes prices of the two items. In so doing, domestic price stability is defined in terms of a customer price index that is not subject to transitory demand and supply shocks.
3. The valuation of the foreign exchange reserves is to be done at Kshs 78.95 to the US\$, the exchange rate that prevailed as at end September 2001.
4. M3 denotes broad money, comprising currency outside banking institutions and all private and other public sector holdings of Demand Deposits, Savings and Time Deposits. It excludes Central and Local Government deposits with banking institutions.
5. M3X denotes broader money, comprising M3 and residents’ Foreign Currency Deposits with local banks.
6. M3XT denotes broader money comprising M3X and non-banking public holding Government securities.
7. Reserve money comprises banking institutions’ deposits with the Central Bank of Kenya and currency in circulation. As the basis for domestic credit creation in the banking industry, reserve money constitutes the monetary policy operations target.