
Letter of Transmittal to the Minister for Finance

Dear Honourable Minister,

I have the pleasure of presenting to you the 16th edition of the Monetary Policy Statement of the Central Bank of Kenya, in accordance with Section 4B (1) of the Central Bank of Kenya Act, 1996. The Statement reviews monetary policy implementation since the last *Statement* in December 2004, presents an overview of the current economic situation and outlines the appropriate monetary policy stance to be adopted over the next one year to June 2006.

Yours Sincerely,



Andrew K. Mullei

Governor

Central Bank of Kenya

MONETARY POLICY STATEMENT

JUNE 2005

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Glossary

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.

Objectives of the Central Bank of Kenya

The CBK (Amendment) Act of 1996 provides the following objectives and functions of the Central Bank of Kenya.

- **Primary objectives:**
 - ◇ To formulate and implement monetary policy directed at achieving and maintaining price stability.
 - ◇ To foster solvency and proper functioning of a stable market based financial system.
- **Secondary functions:**
 - ◇ To formulate and implement foreign exchange policy.
 - ◇ To manage official foreign exchange reserves.
 - ◇ To license and supervise dealers in the money market.
 - ◇ To promote efficient payment, clearing and settlement system.
 - ◇ To perform as banker, advisor and fiscal agent to the Government.
 - ◇ To issue currency notes and coins.

Importance of Maintaining Price Stability

A stable macroeconomic environment characterised by low and stable inflation is conducive for the economy to perform to its full potential. Such an environment provides certainty of expectations about prices not only of goods and services but also of salaries and wages, interest rates and exchange rates. With the stable prices, business people are facilitated to easily predict their costs of production in the light of the prices they expect from their outputs and thus plan effectively. Low inflation therefore allows producers and consumers to undertake predictable and consistent decisions that result in better economic performance.

In the medium to long term, low inflation facilitates a faster growth of the economy, and therefore higher employment creation and poverty reduction. Experience over the years and across countries attest to the fact that macroeconomic environments with low and stable rates of inflation provide for easy delivery of long term economic growth. Kenya's experience equally bears evidence of good economic performance in years of low and stable inflation as in the first decade of independence and poor economic growth performance in the lost decades of the 1980s and the 1990s when interest rates rose and the shilling exchange rate weakened in tandem with higher and uncertain future inflation.

Moreover, the benefits of price stability go beyond economic growth to equity and fairness in society. The public benefits from low and stable prices as the money they hold maintain value over time and ensure that it can enable them maintain a predictable level of consumption goods and services.

The Central Bank's strong commitment to low and stable inflation is therefore neither accidental nor whimsical. It is well founded on the fact that it is the only pursuit that the Bank can have with the capacity to make a lasting contribution towards improved economic growth performance. It is for this reason that the Central Bank continuously seeks price stability while keeping the growth of money supply in line with the highest sustainable economic growth.

What the Central Bank of Kenya Does to Ensure Price Stability

- The Central Bank of Kenya manages the growth of the money supply consistent with the highest possible economic growth. In particular, the Bank regulates the growth of broad money supply (M3X) to ensure that it does not create excess demand on goods and services, which could push up prices.
- To manage the growth of money supply, the Bank targets the reserve money. Reserve money, which forms the base on which commercial banks create credit in the economy, comprises Central Bank issued currency in circulation and commercial banks' deposits at the CBK.
- In deciding whether to expand or contract reserve money, the CBK takes into account many economic and financial developments. It also considers prospects of economic growth and whether inflation appears to be a problem.
- After reaching a decision on what monetary policy to pursue, the CBK executes the policy by employing a variety of instruments at its disposal. These instruments are outlined in the next section.

Instruments of Monetary Policy

- The Bank influences money supply in the banking system by using the following instruments of monetary policy:
 - ◇ **Open Market Operations** through which the Bank either buys or sells Government Treasury Bills to achieve a desired level of reserve money. The Bank injects money to the economy when it buys Treasury bills, and withdraws money when it sells them.
 - ◇ **Discount Window Operations** whereby the Bank, as lender of last resort, provides secured short-term loans to commercial banks on an overnight basis at a penalty rate known as discount rate, the rate is currently 3 percent above the 91 day Treasury bill rate. An increase/decrease in the discount rate discourages/encourages commercial banks from borrowing from the Central Bank window.
 - ◇ **Reserve Requirements** which the Central Bank is empowered by law to stipulate as a proportion of commercial banks' deposits be held as cash reserve requirement (CRR) at the Central Bank. An increase in CRR would reduce the capacity of commercial banks to extend credit. A reduction in the CRR enhances the capacity of commercial banks to expand credit. The CRR has remained at 6 percent of commercial bank deposits since July 2003.
 - ◇ **Foreign Exchange Market Operations** where the Bank effectively injects or withdraws liquidity by engaging in foreign exchange market transactions. Central Bank participation in the foreign exchange market in most cases is geared to arresting speculative tendencies rather than influencing domestic liquidity, although it has the scope to do so.

I INTRODUCTION

Since the publication of the 15th Monetary Policy Statement, there have been a number of developments of significance for monetary policy. Revised GDP numbers published in the 2005 Economic Survey indicated stronger economic performance with real GDP growth estimated to have grown by 4.3 percent in 2004, up from 2.8 percent in 2003. The stronger growth performance originated from favourable world economy that generated a higher demand for Kenyan exports. At the same time, robust growth in tourism (15.1 percent), manufacturing (4.1 percent) and transport and telecommunication (9.7 percent) generated expanded domestic demand.

Inflation also eased in response to the tight monetary policy stance adopted since December 2004. Much of the increased inflationary pressure continued to reflect shocks in oil and food price. At the same time, the Kenya shilling appreciated, partly due to strong export receipts from tea, horticulture and partly due to capital inflows occasioned by the relatively high domestic interest rates.

Looking ahead, the momentum of economic recovery should be sustained through 2005/06 with real GDP growth projected at 5 percent by June 2006, from 4.4 percent in 2004/05. Activity in the sectors that performed well in 2004/05, namely, tourism, manufacturing, and transport and communication is expected to increase further, coupled with a rebound in agriculture following favourable weather conditions. Furthermore, growth in the world economy is expected to continue, albeit at a moderate pace. As a result of this, Kenya's exports are expected to perform well.

Inflation is expected to continue to ease as food supplies improve and stability in the shilling exchange rate continues to check any imported inflation. The risk to this favourable inflation outlook, however, remains the upward bias of oil prices which could make the easing of inflation to 5 percent by June 2006 elusive. Monetary policy will continue to guard against any slippages that may worsen risks to inflation. The implication of this is that the monetary policy strategy to be pursued by the Central Bank will reflect an appropriately tight stance over the next one year to June 2006.

II PERFORMANCE OF MONETARY POLICY SINCE THE LAST STATEMENT IN DECEMBER 2004

Monetary policy objective

The 2004/05 monetary program aimed at keeping underlying inflation below 5 percent. The inflation objective was pursued by targeting reserve money, with broad money supply (M3X) as the intermediate target, and open market operations as the main instrument. The cash ratio requirement (CRR) was kept at the 6 percent level set in July 2003. Money supply and reserve money were targeted to grow by 7.5 percent and 3.8 percent in 2004/05, respectively. Credit to the private sector was expected to moderate, growing by 8.9 percent by end-June 2005.

Performance of the 04/05 monetary program

Monetary policy implementation was anchored on quarterly targets for broad money and reserve money. Under the monetary program, a floor on net foreign assets of the Central Bank (allowing for adjustment for any shortfall of programmed budgetary support) and a ceiling on reserve money were to be observed. The performance of the monetary program in 2004/05 is summarized in Table 1.

Table 1: Quantitative performance criteria and benchmark under the PRGF program

	Jun-04	December 2004*		March 2005**		June 2005*	
	Actual	Actual	Target	Actual	Target	Actual	Target
Average Reserve Money	90.3	97.7	93	94.2	93.3	93.9	93.7
NFA of the CBK***	81.5	82.9	74.4	77.3	73.2	89.9	78.7

* **Benchmark**

** **Performance criteria**

*** **Target adjusted for shortfall in nonproject budget support and external privatisation proceeds**

Source: Central Bank of Kenya

Reserve Money Program

While the reserve money target for December 2004 was missed by a substantial margin, the outturn for subsequent target in March and June 2005 quarters were broadly observed. In June 2005, the Bank achieved reserve money of Ksh 93.9 billion compared with the target of Ksh 93.7 billion. The excess was in currency outside banks, which are ordinarily difficult to immediately withdraw. This can only be achieved over a long time with the public reducing their currency holdings in favour of deposits.

Net foreign assets of the CBK

The target for the NFA of the Central Bank, adjusted for shortfalls in nonproject budget support and external privatisation proceeds, was achieved in all the quarters in 2004/05. NFA of CBK was above target by Ksh 8.6 billion in December 2004, Ksh 4.1 billion in March 2005 and Ksh 11.2 billion in June 2005.

Implementation of monetary policy was effected by the Bank through monitoring developments in reserve money on a daily basis. Cumulative deviations in reserve money relative to monthly targets were used to guide the daily open market operations (OMO). The OMO desk undertook the desired policy actions through REPOs when withdrawing liquidity or reverse REPOs when injecting liquidity. As shown in the Table 2, a total of Ksh 150 billion was posted for mop up in December 2004 but only Ksh 65 billion was realized, resulting in a shortfall of Ksh 87 billion. In March 2005, the Bank posted Ksh 114 billion but realised Ksh 73 billion with a shortfall of about Ksh 40 billion. Significant success was, however, achieved in June 2005 where Ksh 128 billion was realised against a posted amount of Ksh 151 billion, representing a shortfall of Ksh 23 billion.

**Table 2: Open Market Operation Dec 2004 - Jun 2005
(Ksh billion)**

	Amount posted	Amount realized	Shortfall
Dec-04	150	65	87
Mar-05	113.5	73.1	40.4
Jun-05	150.5	127.7	22.8

Source: Central Bank of Kenya

The Bank continued to face challenges in projecting daily liquidity due to difficulties in forecasting cash flow of Government operations. It is expected that liquidity forecasting will improve in the months ahead as the Government implements a more robust cash flow forecasting procedure.

III RECENT ECONOMIC DEVELOPMENTS

There have been a number of macroeconomic developments of significance for monetary policy since the publication of the last Monetary Policy Statement in December 2004.

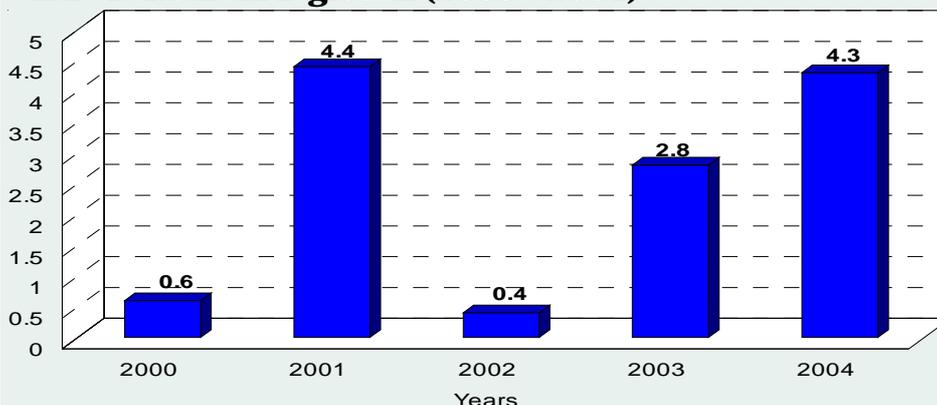
- New revised GDP numbers indicated stronger than envisaged economic performance with real GDP growth estimated at 4.6 percent in financial year 2004/05 compared with the projected 2.7 percent.
- Inflation remained high, despite the tight monetary policy stance maintained since December 2004. Much of the increase in

inflation continued to reflect oil and food price shocks that were not amenable to underlying monetary conditions.

- The Government made net repayment to the banking system as opposed to the programmed domestic borrowing of 2.5 percent of GDP.
- Gross official international reserves in terms of import cover remained more or less the same as the previous year's level of 3 months, despite the robust performance of the export sector and capital inflows occasioned by relatively high interest rates.

The Kenyan economy, on the basis of the new System of National Accounts (1993 SNA), expanded by 4.3 percent in 2004 compared with 2.8 percent in 2003 (Chart 1). The recovery in economic activity was mainly in tourism and transport and communications sectors, which grew by 15.1 percent and 9.7 percent, respectively. Manufacturing, trade, and building and construction, also performed well, expanding by 4.1 percent, 9.5 percent and 3.5 percent, respectively. Significant growth in the export sector activities came from horticulture (13.2 percent) and tea (10.5 percent). Economic growth was also supported by significant expansion of credit to productive sectors occasioned by affordable interest rates and growth in the world economy.

Chart 1: Real GDP growth (2000 - 2004)



Source: Central Bank of Kenya

Indications are that recovery in economic activity continued over the first five months of 2005. Tourist arrivals by air and sea remained robust, growing by 31 percent, while coffee production expanded by 31 percent compared with a decline of 6.6 percent in a corresponding period in 2004. Output of selected manufactures, namely beer and cigarettes grew by 23 percent and 25 percent, while soda ash and processed milk expanded by 5 percent and 10 percent, respectively.

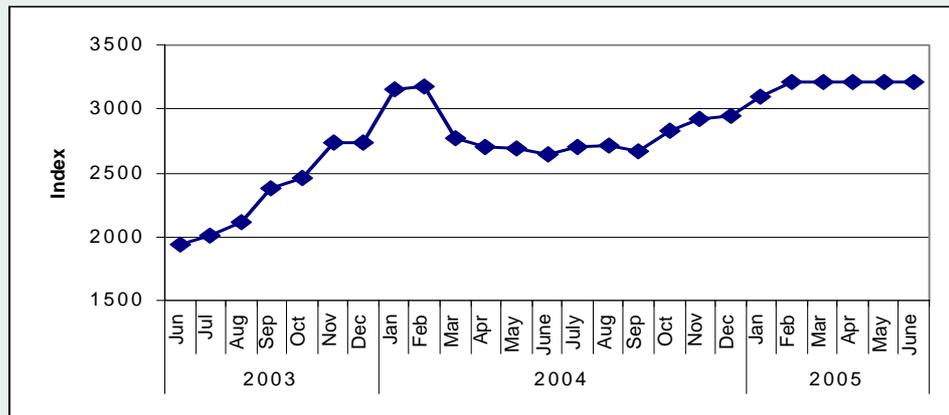
The strong economic performance was reflected in increased demand for utilities, particularly energy services. The consumption of electricity and fuel expanded by 7.4 percent and 18.1 percent, respectively, with large consumption coming from the manufacturing sectors. Meanwhile, imports of capital goods, namely crude materials, transport, machinery and chemical products grew by 32.7 percent, 13.2 percent and 36 percent, respectively.

In transport related services, cargo handled through the Port of Mombasa and fuel cargo transported by the Kenya Pipeline Company expanded by 11.2 percent and 14.7 percent, respectively, in the first five months of the year. In the communications sector, excise duty on airtime services increased to Ksh 1.3 billion in the first five months of 2005 from Ksh 1 billion in a corresponding period in 2004. There was also good performance in the construction sector, with cement consumption expanding by 9.3 percent compared with 7.9 percent in the corresponding period of 2004.

Credit to the private sector has also continued to support consumer demand and investment in the economy. Credit to the private sector expanded by 20.9 percent in the year to June 2005, up from 12.3 percent in the year to June 2004. Significant growth in credit to the productive sectors of the economy such as manufacturing (26.2 percent), transport and communication (38.7 percent) and building and construction (21.9 percent) was recorded in the year to June 2005. Businesses have generally been bullish about economic prospects, with optimism that constraints to public investment occasioned by slow pace of execution of the development budget will be addressed.

Performance in the stock market also responded and pointed to improved economic performance. The Nairobi Stock Exchange (NSE) activity improved in the 2004/2005 financial year with the NSE 20 Share Index increasing from 2640 in June 2004 to 3972 by June 2005 (Chart 2). Much of the increase was recorded in the last quarter of the financial year following the release of economic data indicating stronger than anticipated economic growth and a favourable outlook for 2005. Market turnover increased from Ksh 1.3 billion to Ksh 3.8 billion in June 2005. Increased volume of shares traded, coupled with increase in share price for most stocks, contributed to increased turnover and rise in the NSE 20 share index.

Chart 2: NSE Index (June 2003 - June 2005)



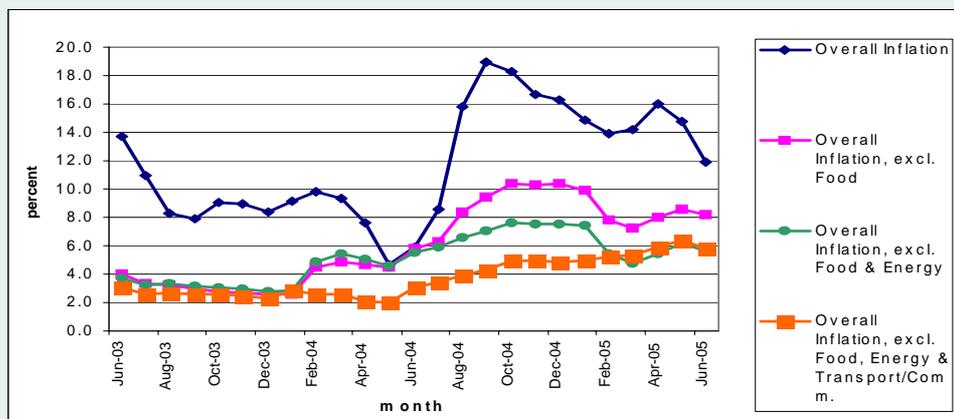
Source: Central Bank of Kenya

The positive impact of the favourable long rains, in contrast with the droughts experienced in the country over the last five years will lead to a recovery in agriculture and its related sectors of the economy. In turn these will drive the overall economic growth in the forecasted period.

Inflation

The 12-month overall inflation, which had eased to 5.9 percent in June 2004, rose to 19 percent in September 2004 before declining to 11.9 percent in June 2005 (Chart 3). Sharp pick up in overall inflation during the third quarter of 2004 reflected increased prices of basic foods following shortfalls in supply particularly vegetables occasioned by the adverse effects of drought. Similarly, high prices of crude oil in the international market exerted additional inflationary pressures. The onset of short rains in November 2004 and long rains in April 2005 helped improve supplies of basic food items, resulting in a gradual easing of overall inflation to 11.9 percent by June 2005.

Chart 3: 12-months inflation (Jun'03 - Jun'05)



Source: Central Bureau of Statistics

The 12-month underlying inflation, measured as overall inflation excluding food, energy and transport prices, rose steadily to reach 6.4 percent in May 2005 before easing to 5.8 percent in June. To some

Fiscal Development

extent the recent resurgence in underlying inflation is partly attributed to more than programmed expansion in money supply. Some of the shocks originating from food, oil and transportation prices influenced underlying inflation, as the method used to derive the measure does not completely isolate the temporary factors. Even then, the stability of the shilling exchange rate helped reduce inflationary pressures emanating from persistently rising international oil prices.

Government fiscal operations in the 2004/05 financial year resulted in a net domestic debt repayment to the banking sector of 0.3 percent of GDP instead of programmed domestic borrowing of 2.3 percent of GDP. The outcome reflected a tight fiscal policy stance in the face of delayed disbursement of donor budgetary support and difficulties, particularly in the first half of the financial year, in sourcing funds domestically to finance the budget.

The budget surplus, on a commitment basis, amounted to 0.3 percent of GDP compared with a target deficit of 2.6 percent of GDP, while on a cash basis, the deficit amounted to 0.1 percent of GDP compared with programmed deficit of 2.6 percent. The good performance reflected improved tax receipts and lower than budgeted expenditure. Tax revenues improved due to improved tax administration measures, increased corporate profits following recovery in economic activity, and positive response to tax amnesty offered to previous defaulters. The tax amnesty, for instance, netted revenues amounting to about 0.3 percent of GDP. Meanwhile, expenditures lagged behind due to delayed implementation of procurement measures and slow absorption of donor project disbursements.

Money and Credit

Broad money supply, M3X¹, expanded by 11.3 percent in the year to June 2005 compared with 12.9 percent in the year to June 2004 and 14.5 percent in the year to September 2004 (Table 3). While this expansion of M3X represented a deceleration, it was, however, above the 7.5 percent June 2005 target by some 4 percentage points.

Much of the increase in broad money continued to be supported by strong expansion in credit to the private sector, which grew by 20.9 percent in the year to June 2005 compared with 12.3 percent in a similar period in 2004.

Credit to the private sector increased from 12.3 percent in June 2004 to 25.7 percent in December, before easing to 20.9 percent in June

¹ M3X comprises currency outside banks, demand deposits and time and savings deposits (including foreign currency deposits of residents) with the financial system. Monetary policy has focused on the behaviour of the broader monetary aggregate rather than M3, mainly due to the stable relationship with nominal economic activity.

Table 3: Annual Growth Rates in Broad Monetary and Credit Aggregates (%)

	Reserve Money		M3X		Bank Credit	
	Actual	Target	Actual	Target	Private	Government
2004: Jun	5.5	-5.4	12.9	7.1	12.3	9.9
Sep	9.8	9.8	14.5	14.5	19.4	4.6
Dec	15.5	6.2	13.2	8.9	25.7	-2
2005: Jan	13.5	7.7	12.8	8.8	23.1	-5.9
Feb	11.5	7.7	13.3	8.8	24.4	-7.7
Mar	8.2	7.7	13.4	8.8	25.1	-6.1
Apr	7.1	3.8	12.2	7.5	24.4	-15.6
May	4.1	3.8	11.1	7.5	23.2	-12.6
Jun	4.8	3.8	11.3	7.5	20.9	-17.8

Source: Central Bank of Kenya

2005. Loans to private households expanded at a strong pace (60 percent) following the decline in interest rates and increased competition amongst commercial banks to lend to the private sector. Substantial credit to private sector was also evident in trade, transport and communication, and manufacturing — a reflection of improved economic activity in recent months.

Meanwhile, banking system credit to Government declined to 17.8 percent in June 2005 compared with 9.9 percent increase a year earlier. The decline reflected reduced domestic borrowing by the government with tight fiscal policy and difficulties from sourcing funds domestically.

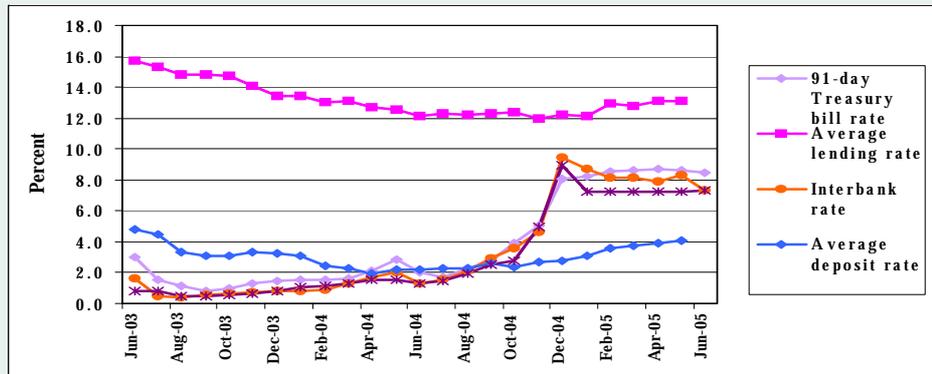
Interest Rate Developments

Interest rates continued to be market-determined. The 91-day Treasury bill rate, which had declined to below 1 percent in September 2003, rose to about 8 percent in December 2004 before stabilising at 8.5 percent through June 2005. The rapid increase in the 91-day Treasury bill rate in the last quarter of 2004 reflected speculative tendencies in the auction market occasioned by fears of the domestic borrowing required to finance the budget and pronouncements to the effect that interest rates were expected to move upwards to a particular level. Since the beginning of 2005, calm has been restored in the auction market for government securities enabling the Government to easily access domestic funds. At the same time, there was renewed interest in long-dated Government securities with the auction witnessing oversubscription for most of the floated bonds. Strong revenue performance also enabled the Government to smoothen out erratic movement in interest rates as the market discovered the new equilibrium.

On the shorter end of the money market, the REPO and interbank rates rose concomitantly with the 91-day Treasury bill rates mainly reflecting the tightening of liquidity in the banking system following the downward revision of the reserve money targets in December 2004. The tightening of monetary policy was occasioned by the rapid monetary expansion mainly in credit to private sector, which threatened to fuel inflationary expectations at the time when inflation had risen to double

digit level due to rising oil prices and adverse impact of drought on food prices.

Chart 4: Interest Rates (Jun'03 - Jun'05)

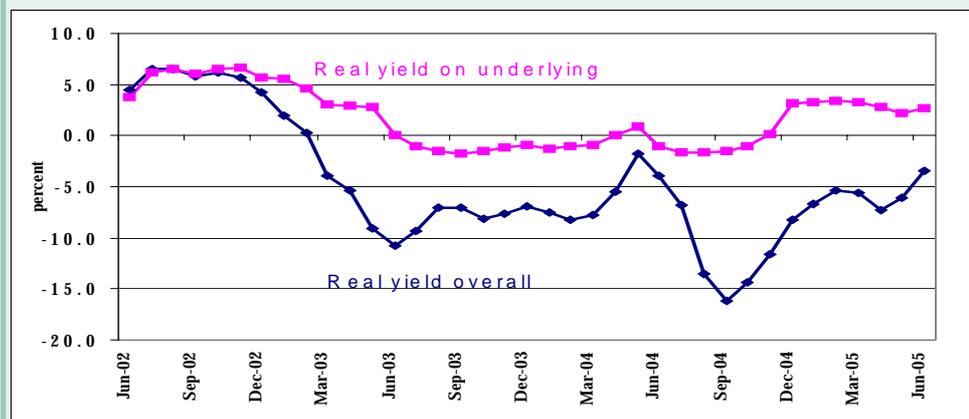


Source: Central Bank of Kenya

Commercial banks' lending rates, which had declined to about 12 percent rose marginally towards the end of 2004 in tandem with the increase in short-term money market interest rates. Deposit rates also adjusted upwards marginally, leaving lending-deposit margins more or less unchanged. There is evidence that commercial banks' interest rates are still influenced by structural inefficiencies in the banking system, in spite of the relative decline in the level of non-performing loans.

With overall inflation remaining high, interest rates were negative in real terms in 2004/05 (Chart 5). But compared with underlying inflation, the real rates have been positive since December 2004. The Bank continued to provide the necessary information on recent trends in economic and financial indicators to enable market participants make informed decisions. This was accomplished through the regular Weekly Bulletins, Monthly Economic Reviews, Statistical Bulletins and Annual Reports published by the Bank, as well as Governor's speeches and press statements.

Chart 5: Real yield on 91-day Treasury Bill Rate



Source: Central Bank of Kenya

The Bank maintained market-determined exchange rate. CBK participation in the market was limited to smoothing short-term excessive volatility, effecting external debt payments and maintaining the target for net international reserves.

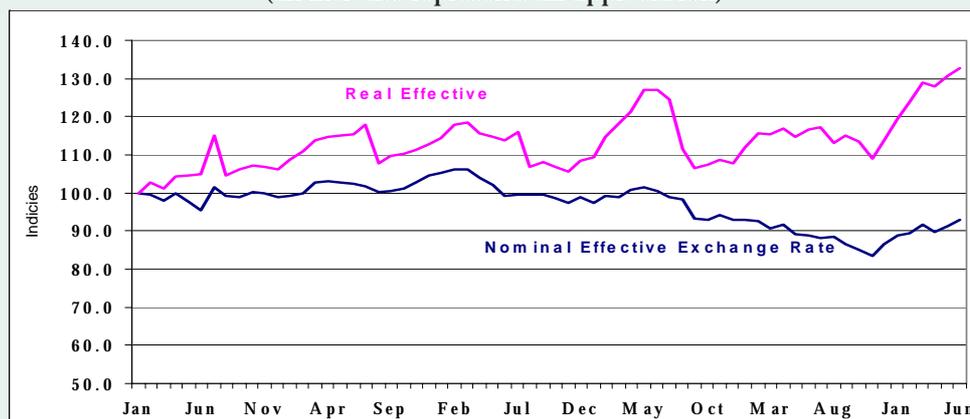
The shilling depreciated against the US dollar in August/September 2004 to a low of Ksh 82 per US dollar. This followed fears of increased demand for foreign currency to cover the rising import bill due to increased oil price and food imports to mitigate the supply shortage occasioned by drought. There was also the speculation that delayed donor inflows for budgetary support would put pressure on the exchange rate. The Bank intervened to mitigate the sharp drop in the shilling exchange rate as speculators cashed in on these factors to influence the market in their favour. The positive assessment of the economy by the IMF on the conclusion of PRGF Review in September 2004, strong foreign exchange receipts from key exports including tourism, tea and horticulture, and reversal of capital outflows following the increase in interest rates towards the end of 2004 helped the shilling to strengthen. By mid-March 2005, the shilling had strengthened to Ksh 73 to the US dollar. Thereafter, the shilling weakened to stabilize at Ksh 76 by June 2005 following moderate corporate demand for foreign exchange and strong purchases by the Central Bank.

Against the other major international currencies, notably, the Sterling pound, the Euro and the Japanese Yen, the shilling traded at Ksh 139.5, Ksh 93.2 and Ksh 70.6 in June 2005, respectively, compared with Ksh 144.8, 96.1 and 76.4 in June 2004. This represents 3.7 percent strengthening against the Sterling pound, 3.0 percent against the Euro and 2.5 percent against the Japanese yen compared with a weakening of 18.2 percent, 11.7 percent and 16.1 percent over the previous year to June 2004. The strengthening of the Kenya shilling against these currencies reflected the weakening of these currencies against the US dollar in the international currency market.

Reflecting these developments, the trade-weighted nominal effective exchange rate appreciated by 4.7 percent by June 2005 compared with a depreciation of 11.5 percent in June 2004 (Chart 6). In real effective terms, the exchange rate had appreciated by 13.6 percent in June 2005 compared with a depreciation of 8 percent in June 2004, reflecting the relatively high domestic inflation than that of Kenya's major trading partners.

The world economy grew by 4.7 percent in 2004/05, up from 3.5 percent in the previous year. Strong growth came from the United States and China, bolstered by rising productivity in the case of the

Chart 6: Norminal & Real Effective Exchange Rate (Jan'00 - Jun'05)
(January 2000 = 100)
(an increase represents an appreciation)



Source: Central Bank of Kenya

former and infrastructure investment in the case of the latter. The global recovery during the year was, however, subdued by the surge in oil prices.

Kenya's exports performed well in 2004/05 as export earnings grew by about 19.8 percent. Much of the increase came from tea and horticulture exports, which rose by 5 percent and 13.3 percent, respectively. Tourism earnings increased by 25 percent in 2004/05 following improved marketing and higher incomes in source countries, especially in Europe, Asia and America.

Imports increased by about 25 percent in the year to June 2005, due to rising oil prices and recovery in domestic economic activity. The value of oil imports rose by about 30 percent. Consequently, the current account deficit deteriorated to 4.7 percent of GDP in 2004/05 from 1.4 percent of GDP in 2003/04, reflecting the combined effect of increased domestic activity and the weakening of the terms of trade.

IV OUTLOOK FOR 2005/06

The macroeconomic framework underpinning the Government's economic recovery strategy aims at:

- Sustaining the economic growth momentum, particularly raising real GDP growth to 5 percent in 2005/06 from 4.6 percent in 2004/05) (Appendix Table 1);
- Bringing down inflation to the 5 percent range by end-June 2006;
- Keeping net domestic borrowing of the Government to no more than 1.8 percent of GDP in 2005/06; and

- Increasing official international reserves from 2.9 months of import cover in 2004/05 to 3.1 months of import cover in 2005/06, as a cushion against external shocks.

Economic recovery is expected to sustain its upward trend with real GDP projected to reach 5 percent by June 2006, up from 4.6 percent in 2004/05. Activity in the sectors that performed well in 2004/05, namely, tourism, manufacturing, transport and communication is expected to increase further coupled with a rebound in agriculture following favourable weather conditions. Procurement and fiscal reforms are also expected to increase growth by boosting public and private investment. There is already evidence that businesses are bullish in their growth prospects for 2005/06.

On the global scene, the world economy is expected to experience moderate growth after an impressive performance in 2004. World economy is forecast at 4.4 percent in 2005/06 compared with 4.7 percent in 2004/05. The moderate growth prospects for world economy continue to be threatened by rising oil prices. There are, however, better prospects in the regional scene. Resumption of peace in the horn of Africa and ongoing implementation of the Common External Tariff in the East Africa Community as well as the robust growth in Kenya's COMESA trading partners are expected to promote export led growth.

Inflation

Appropriate monetary policy stance, improved weather conditions and a stable shilling exchange rate have helped reduce inflationary pressures to 11.9 percent in June 2005 from a peak of 19 percent in September 2004. It is expected that food inflation will continue to ease in the months ahead with favourable weather conditions. This coupled with strong export receipts and the relatively high interest rates will keep the exchange rate stable and help reduce imported inflation, thereby favouring a continued decline in inflation.

The major risk to the inflation outlook, however, remains the persistent high oil prices, which could make the attainment of the 5 percent inflation by June 2006 elusive. It is therefore vital that monetary policy continues to guard against any slippages that may worsen these risks to inflation; otherwise expectations could become entrenched even if underlying inflation were to be below target. It is with this regard that the Central Bank has found it necessary to continue with a tight monetary policy stance over the next one year to June 2006.

The reserve money program outlined in Table 4 and Appendix Table 2 represents the stance that the Central Bank has adopted for the one year to June 2006 to ensure inflation is brought to target by June 2006.

Table 4: Growth targets for Monetary Aggregates for 2005/06

	Jun'05 <i>Act.</i>	Sep'05 <i>Proj.</i>	Dec'05 <i>Proj.</i>	Mar'06 <i>Proj.</i>	Jun'06 <i>Proj.</i>
Reserve money	94.6	96.3	101.6	97.8	99.3
NFA of CBK	95.7	94.5	95.1	98.6	102.9
<i>Memo items (Annual percentage change)</i>					
Real GDP	4.6				5
Inflation	11.9				5
M3X	11.3	9.8	8.4	6.8	7.8
Private sector credit	20.6	16.2	12.7	9.4	10.1
Reserve money	4.8	7.1	0.6	4.4	5.0

Source: Central Bank of Kenya

In implementing the program set out above, the principal monetary policy objective of the Bank will continue to aim at 5 percent inflation target to ensure macroeconomic stability, while supporting the broad macroeconomic objectives of the Government. The inflation objective will be pursued through reserve money targeting, with broad money (M3X) as the intermediate target and open market operations as the main instrument. M3X is targeted to grow by 7.8 percent in 2005/06, consistent with the forecast increase in economic activity and the appropriate tightening to bring inflation to target. By lowering inflation and thereby stable positive real interest rates during the period, bank credit to the private sector is expected to grow by about 10.1 percent to support increased economic activity.

Alongside open market operations, the Bank will continue to use the other instruments outlined earlier. It continued to use a broad set of indicators to monitor inflationary pressures and to gauge the appropriateness of the monetary policy stance. Under open market operations, the Bank will withdraw, on a timely basis, any excess liquidity. The Bank will continue to implement a market-driven exchange rate system, participating in the foreign exchange market only to meet its net foreign assets target and to smooth disruptive short-term fluctuations.

IV CONCLUSION

This Statement has reviewed the implementation of monetary policy since the last Statement in December 2004. Although the monetary program missed to achieve the desired reserve money in December, significant progress was made and subsequent March and June 2005 targets were broadly observed. Net foreign assets targets were achieved throughout the period.

As indicated in the review, the economy performed well in 2004/05, with real GDP growth estimated at 4.6 percent. The impressive performance followed a favourable world economy and recovery in domestic activity. The recovery is expected to gain momentum, with real GDP projected to grow by 5 percent in 2005/06, as sectors that performed well in 2004/05 are expected to improve further. Exports are expected to continue performing with strong growth in the world economy and increased regional market.

Inflationary pressures that emerged early in the financial year have started easing, with reduced food prices following improved food supplies. The strong export receipts and the relatively high interest rates continued to keep the exchange rate stable and have helped reduce imported inflation. The risk to inflation outlook remains the persistently high oil prices, which threaten to delay the lowering of inflation to the 5 percent target by June 2006. The persistence of high inflation, which partly reflects high oil prices and partly more than programmed expansion in credit to private sector, could be compounded by expectations being entrenched. In order to keep inflation under control, the CBK will continue with a tight monetary policy stance over the next one year to June 2006. The reserve money program outlined earlier provides the tightening to be effected over 2005/06 to bring inflation to target by June 2006.

In implementing the monetary program, monetary policy operations will be geared towards achieving the targets indicated for reserve money with open market operations (through sale and purchase of REPOs) as the main instrument. As was the case before, the Bank will continue to use a wide range of indicators to monitor inflationary pressures and to gauge the appropriateness of the monetary policy stance.

**Appendix Table 1: Medium-Term Macroeconomic framework,
2004/05- 2007/08**

	2004/05	2005/06	2006/07	2007/08
Real Sector				
Nominal GDP, KSh billion	1,362	1,536	1,713	1,901
Real GDP growth	4.3	4.9	5.2	5.4
CPI inflation (end of period)	15.3	7.6	4.2	3.5
Savings/GDP	14.2	14.1	14.8	16.6
Investment/GDP	18.9	20.1	20.6	20.9
External Sector				
Current Account (% of GDP)	-1.3	-4.7	-5.7	-6
Overall balance (US\$ million)	-119	-91	-17	64
Official reserves (US\$ million)	1,555	1,723	1,730	1,850
Months of import coverage	2.9	3.1	3.1	3.2
NPV of external debt ratio	21.3	20.4	19.3	18.4
Money and Credit (Annual % change)				
Net Domestic Assets	7.0	9.6	10.5	7.1
Net Credit to Government	-19.3	6.8	4.6	4
Credit to Private Sector	20.6	10.1	11.9	8.5
Broad Money (M3X)	11.3	7.8	8.4	8.4
Reserve Money	4.8	5.0	7.8	7.8
Fiscal Sector (% of GDP)				
Total Revenue	21.5	21.1	20.9	20.6
Total expenditure and net lending	22.1	26.7	25	23.9
Overall balance, excl. grants	-0.6	-5.6	-4.2	-3.3
Overall balance, incl. grants	0.4	-3.4	-2.7	-2.6
Net domestic borrowing	-0.3	2.5	1.6	1.3
Financing gap	0	0.4	0	0
Total donor support (grants & loans)	1.5	4.9	3.6	2.9

Source: Central Bank of Kenya

Appendix Table 2: Depository Corporations Survey June 2004 - June 2006 (in Ksh billions, unless otherwise indicated)

	Jun-04 <i>Act.</i>	2004/05				2005/06			
		Sep-04 <i>Act.</i>	Dec-04 <i>Act.</i>	Mar-05 <i>Act.</i>	Jun-05 <i>Act.</i>	Sep-05 <i>Proj.</i>	Dec-05 <i>Proj.</i>	Mar-06 <i>Proj.</i>	Jun-06 <i>Proj.</i>
Central Bank of Kenya									
Net foreign assets 1/	86.7	79.8	89.4	81.0	95.7	94.5	95.1	98.6	102.9
Net domestic assets	3.6	10.0	11.7	12.7	-1.1	1.8	6.5	-0.7	-3.6
Net domestic credit	11.2	14.3	18.0	18.0	-3.2	-0.4	4.4	-2.9	-5.8
Other items (net)	-7.7	-4.3	-6.3	-5.4	2.1	2.1	2.2	2.2	2.2
Reserve money (RM)	90.2	89.9	101.1	93.7	94.6	96.3	101.6	97.8	99.3
Currency outside banks	55.7	56.1	62.7	58.0	59.3	60.4	64.5	60.8	61.7
Bank reserves	34.6	33.8	38.4	35.7	35.2	35.9	37.1	37.0	37.5
Depository Corporations									
Net foreign assets 1/	33.1	37.2	37.0	64.1	52.8	51.9	52.4	51.0	50.4
Reserves	34.6	33.8	38.4	35.7	35.2	35.9	37.1	37.0	37.5
Credit to CBK	6.1	5.0	7.0	4.3	10.3	7.6	3.0	10.3	13.3
Net domestic assets	343.9	354.5	371.1	360.3	369.1	378.6	399.2	398.6	404.9
Domestic credit	412.6	428.5	450.3	454.8	459.2	469.9	494.3	494.0	502.0
Other items (net)	-68.7	-74.0	-79.2	-94.4	-90.1	-91.4	-95.1	-95.4	-97.1
Total deposits	417.8	430.4	450.5	464.5	467.5	473.9	491.7	497.0	506.1
Deposits in shillings	351.6	360.9	369.9	376.9	383.1	391.3	407.8	414.9	423.7
Deposits in foreign currency	66.1	69.5	80.6	87.5	84.4	82.6	83.9	82.1	82.4
Depository Corporations Survey									
Net foreign assets 1/	119.8	117.0	126.3	145.1	148.4	146.4	147.5	149.6	153.2
Net domestic assets	353.6	369.5	386.8	377.3	378.3	387.9	408.7	408.2	414.6
Domestic credit	430.0	447.8	472.3	477.1	466.3	477.1	501.6	501.4	509.5
Government (net)	136.6	136.0	131.0	127.2	112.3	114.9	116.9	118.6	119.9
Rest of the economy	293.4	311.8	341.3	350.0	354.0	362.2	384.7	382.8	389.6
Other items (net)	-76.3	-78.3	-85.5	-99.8	-87.9	-89.2	-92.9	-93.2	-94.9
M3X	473.4	486.5	513.2	522.5	526.8	534.3	556.2	557.7	567.8
<u>Memorandum items:</u>									
<i>(In Percent of Annual Change)</i>									
M3X	12.9	14.5	13.2	13.4	11.3	9.8	8.4	6.8	7.8
Reserve Money	5.5	9.8	15.5	8.2	4.8	7.1	0.6	4.4	5.0
Currency outside banks	12.0	13.4	13.0	5.6	6.6	7.7	2.9	4.8	4.1
Domestic credit	12.8	14.9	16.9	14.9	7.8	6.1	5.9	5.1	9.3
Government (net)	12.0	6.0	-1.0	-6.1	-19.3	-16.7	-11.6	-6.7	6.8
Rest of the economy	13.1	19.4	25.7	25.1	20.6	16.2	12.7	9.4	10.1
Multiplier (M3X/RM)	5.2	5.4	5.1	5.6	5.6	5.6	5.5	5.7	5.7
Reserve cover, in months of imports	3.0	2.5	2.9	2.8	3.0	2.9	3.0	3.0	3.1

1/ Constant Kenya shilling per US\$ exchange rate prevailing on September 30, 2001 (Ksh 78.95 per US \$)

Source: Central Bank of Kenya

Appendix 3: Chronology of events of particular relevance to monetary policy and inflation

2004/05

July 2004	The Central Bank of Kenya released its fourteenth Monetary Policy Statement, setting out the monetary program to be pursued in the financial year 2004/05 (July-June).
August/September 2004	An assessment of the impact of the drought indicated that the 2.7 percent real GDP growth estimate for 2004 might not be attained. Consequently, real GDP growth estimate was lowered to 2.4 percent
September 13-24, 2004	Following availability of firm monetary and fiscal data for June 2004 and the discussion with the IMF Mission on the First Review Under the PRGF program, the monetary program was tightened.
November/December 2004	With the monetary and inflation outcome for September 2004-quarter exceeding target, the monetary program was further tightened.
December 20, 2004	The IMF Executive Board approved the First Review under the Poverty Reduction and Growth Facility (PRGF) arrangement.
January/February 2005	The Central Bank of Kenya released its fifteenth Monetary Policy Statement.
March/April 2005	IMF initiates discussions on the Second Review of the PRGF Program
May 2005	The 2005 Economic Survey released. New GDP numbers indicate economic growth rate of 4.3 percent for 2004.
June 2005	The budget for 2005/06 financial year is read by the Minister for Finance. Discussions with the IMF on the Second Review of the PRGF program kick off. Pending the outcome of the June 2004 firm numbers, a tentative monetary program for 2005/06 was agreed upon.

GLOSSARY OF KEY TERMS

Overall Inflation

This is a measure of consumer price movement of all goods and services sampled by the Central Bureau of Statistics.

Underlying Inflation

This is a measure of price movements consumer goods and services other than food, energy and transport and communications. These items are excluded because they are susceptible to transient influences that are beyond the control of the CBK. Thus the underlying measure is used by the Central Bank to gauge the influence of monetary policy on inflation.

Reserve Money

These are CBK liabilities comprising currency in circulation (currency outside banks and till cash held by commercial banks) and deposits of both commercial banks and nonbank financial institutions held with the CBK.

Money Supply

The sum of currency outside banks and deposit liabilities of commercial banks. Deposit liabilities are defined as follows: narrow money (M1); and broad money M2, M3 and M3X. These aggregates are defined as follows:

M1	Currency in circulation plus demand deposits
M2	M1 plus quasi-money (time and savings deposits)
M3	M2 plus other deposits issued by nonbank financial institutions (savings and loan association, mortgage finance institutions etc.)
M3X	M3X plus residents' foreign currency deposits

Discount Rate

The rate of interest the Central Bank charges on loans it extends to commercial banks facing temporary liquidity shortfalls. The discount rate is currently set at 3 percentage points above the 91-day Treasury bill rate applicable to the last auction.

Open Market Operations (OMO)

The Central Bank's act of buying or selling Kenya Government treasury bills in the secondary market in order to achieve a desired level of bank reserves. OMO is done in the context of an action where commercial banks bid through the Reuters screen.

Repurchase Agreement (REPO)

This is an instrument used in OMO. REPOs are agreements by the CBK to purchase/sale government securities from/to commercial banks at agreed interest rate (REPO rate) for a specified period with an understanding that the commercial bank will repurchase/resell the security to the CBK at the end of the period.

Reserve Money Program

This is the desired expansion in 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

This is an amount of legally required balances of commercial bank and nonbank financial institutions held with the CBK. The Central Bank is empowered by the Act to demand a certain proportion of commercial banks' deposits to be held as reserves at the Central Bank. The ratio currently stands at 6 percent.