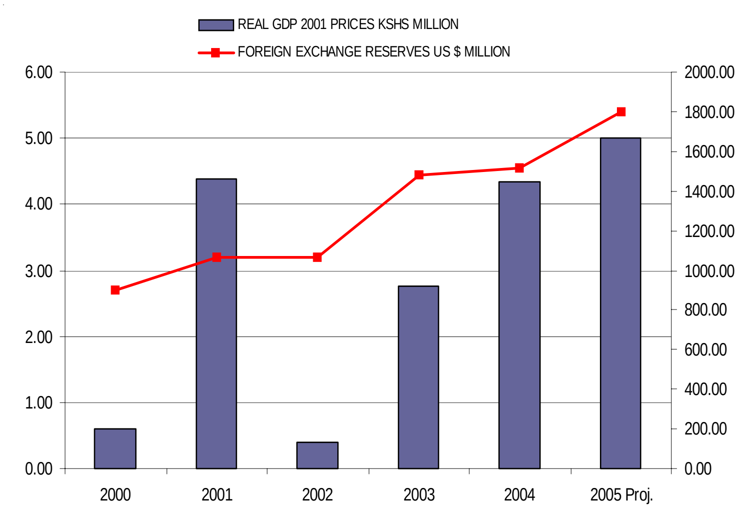
CENTRAL BANK OF KENYA

Monetary Policy Statement

Issued under the Central Bank of Kenya Act, Cap 491

December 2005



Letter of Transmittal to the Minister for Finance

Dear Honourable Minister,

I have the pleasure of forwarding to you the 17th edition of the Monetary Policy Statement of the Central Bank of Kenya. The Statement reviews monetary policy performance since the last *Statement* issued in June 2005. It also discusses the current economic situation as well as the monetary policy to be pursued over the next one year to December 2006.

Andrew K. Mullei
Governor

The Principal objects of the Central Bank of Kenya are:

1. To formulate and implement monetary policy directed to achieving and maintaining stability in the general level of prices.

2. To foster the liquidity, solvency and proper functioning of a stable market-based financial system.

Without prejudice to the generality of the above, the Bank is required to:

- Formulate and implement foreign exchange policy;

- Hold and manage its foreign exchange reserves;

- License and supervise authorized dealers;

- Formulate and implement such policies as best promote the establishment, regulation and supervision of efficient and effective payment, clearing and settlement systems;

- Act as banker and adviser to, and as fiscal agent of the Government; and

- Issue currency notes and coins.

Objectives of Monetary Policy

The CBK's monetary policy is aimed at achieving and maintaining price stability. The CBK, in consultation with the Government, defines price stability as the containment of inflation below 5 percent.

Price stability raises economic well being by reducing uncertainty about the future. Evidence indicates that countries with lower inflation rates tend to have higher long-term economic growth rates.

Instruments of Monetary Policy

The CBK's uses the following instruments in pursuit of its monetary policy objectives:

- **Open Market Operations** whereby the CBK either buys or sells Government Treasury bills and any other eligible securities to achieve a desired level of money. The CBK injects money to the economy when it buys Treasury bills, and withdraws money when it sells them.

- **Standing Facilities** whereby the CBK, 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. Similarly, commercial banks facing temporary liquidity needs may rediscount its holding of Treasury bills at the same penalty rate known as the discount rate.

- **Reserve Requirements** whereby the CBK is empowered by law to stipulate a proportion of commercial banks' deposits to be held as cash reserve requirement (CRR) at the CBK. An increase in CRR reduces 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** whereby the CBK effectively injects or withdraws liquidity by engaging in foreign exchange transactions. CBK 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.

Monetary Policy Statement

1. The CBK Act Section 4B requires the Bank to submit to the Minister for Finance, at intervals of not more than six months, a Monetary Policy Statement for the next twelve months.

2. The Minister is required by the law to lay every Statement submitted under subsection (1) before the appropriate committee of the National Assembly not later than the end of the subsequent session of Parliament after the Statement is so submitted.

3. The Bank is required by the law to publish in a Gazette:
   - i) Its monthly balance sheet; and
   - ii) Its Monetary Policy Statement.

4. The Bank is further required to disseminate key financial data and information on monetary policy to the public stating the following:
   - i) Policies and the means by which the Bank intends to achieve the monetary policy targets;
   - ii) Reasons for adopting such monetary policies and means; and
   - iii) Progress made in the implementation by the Bank of monetary policy during the period to which the preceding Monetary Policy Statement relates.

5. 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.

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EXECUTIVE SUMMARY

In October 2005, the Bank modified monetary policy to reflect the favourable outlook for inflation and economic growth. The Bank relaxed the target growth rate of key monetary aggregates compared with the tightening adopted in the context of the June 2005 Monetary Policy Statement. The stance of monetary policy pursued since June 2005 will be continued in 2006 with appropriate modifications to accommodate:

- Stronger-than-expected accumulation of foreign exchange reserves in the last quarter of 2005; and

- Expected leakages in liquidity due to additional domestic financing occasioned by drought relief operations.

INTRODUCTION

This 17th Monetary Policy Statement (MPS) is presented in three parts. Section one reviews monetary policy and modifications made to it since the release of the June 2005 MPS. The section also outlines the progress made in the implementation of monetary policy stance adopted in that Statement. Section two covers the recent economic developments in the second half of the 2005 and outlook for 2006. Section three provides the basis for the monetary policy stance adopted over the next one year to December 2006.

1 MONETARY POLICY SINCE THE LAST STATEMENT IN JUNE 2005

1.1 Review of Recent Monetary Policy Stance

Since late 2004, the CBK has pursued a tight monetary policy with expansion of reserve money confined to below 5 percent by June 2005 — well below the expansion in nominal GDP of over 10 percent. Partly as a result of this policy stance short-term interest rates increased from below 3 percent in September 2004 to about 8.5 percent by June 2005.

By the time the June 2005 Statement was published, inflation had eased from 19 percent in September 2004 to 11.9 percent in June 2005. Inflation outlook to June 2006 then looked favourable with improved food supplies. It was clear that the threat of rising oil prices and strong expansion in credit to private sector challenged the Bank in its pursuit of the 5 percent inflation objective. Consequently, the Bank considered it prudent to continue with a tight monetary policy by limiting the expansion of reserve money and the associated extended broad money (M3)[1] to 5 percent and 7.8 percent, respectively, by June 2006.

It became clear to the Bank by the end of September 2005 that the extent of tightening may have been exaggerated as key economic indicators proved stronger than anticipated. Growth prospects indicated that the real gross domestic product (GDP) growth could exceed 5 percent and strong external demand cushioned export earnings at a time when the shilling exchange rate was strengthening. Inflation continued to ease to below objective and the outlook looked even brighter with improved food supplies, easing oil prices and strengthening of the shilling exchange rate. By October 2005 inflation had eased to 3.7 percent.

As a result of these developments, the Bank modified its monetary policy stance in October 2005. It revised the M3 growth from 7.8 percent to 10 percent and reserve money growth to 6.3 percent from 5 percent indicated in the June 2005 Statement. With

[1] Effective January 2006, the CBK adopted a harmonized definition of monetary aggregate for the East Africa partner states. Consequently, M3X has now been renamed M3 denoting extended broad money (see glossary of key terms for new definitions of money supply).

these modifications, short-term interest rates — the repo, interbank and 91-day Treasury bill rates — eased to hover between 7-8 percent by December 2005.

The key elements of the revised 2005/06 monetary program are summarized in Table 1 below.

Table 1: Growth Targets for Key Aggregates for 2005/06 Monetary Programme

	Dec'05		Mar'06		Jun'06	
	June' 05 MPS	Revised	June' 05 MPS	Revised	June' 05 MPS	Revised
Reserve money (Ksh billion)	101.6	103.5	97.8	99.0	99.3	100.4
NFA of CBK (Ksh billion)	95.1	106.4	98.6	107.3	102.9	108.4
Memo (annual change in percent)						
Reserve money	0.6	2.5	4.4	5.7	5.0	6.3
M3*	8.4	10.5	6.8	9.0	7.8	10
Real GDP growth					5.0	5.0
Overall inflation					5.0	5.0

Source: Central Bank of Kenya

* Extended broad money, previously known as M3X. The redefinition follows the adoption of harmonized definition of monetary aggregate within the East Africa region, with effect from January 2006

The monetary policy objective for 2005/06 continued to be to achieve the 5 percent inflation by June 2006. The inflation objective was pursued by targeting reserve money expansion of no more than 6.3 percent by June 2006. This programmed reserve money growth was sufficient to support the 10 percent growth in broad money, which in turn was enough to support the 5 percent projected non-inflationary expansion in economic activities. Meanwhile, the balance of payments was expected to improve to allow net foreign assets of the CBK to increase to Ksh 108.4 billion by June 2006.

Implementation of the monetary program for the financial year 2005/06 was anchored on quarterly targets for reserve money. A ceiling on reserve money and a floor on net foreign assets of the CBK (allowing for adjustment for any shortfall of programmed budgetary support) were set for every quarter beginning December 2005. Monthly reserve money targets consistent with the quarterly targets were determined.

1.2 Performance of the Monetary Policy to December 2005

Using liquidity forecasting framework, the CBK implemented the reserve money program outlined in Table 1 with repurchase agreement (REPOs) in Government securities as the main instrument. Most monetary operations entailed withdrawing liquidity from the banking system through selling of Treasury bills. As a result, the stock of REPO Treasury bills held by commercial banks increased to Ksh 9.3 billion by December 2005 from Ksh 5.3 billion in June 2005.

Reserve Money

Reserve money broadly performed within target in the period July 2005 through October (Table 2). It, however, exceeded target in November and December 2005 following unexpected strong demand for currency to accommodate the run up to the November 21, 2005 referendum and subsequent holidays, including Christmas. By the end of December, reserve money averaged Ksh 105.2 billion or Ksh 1.7 billion above the target. Of the excess reserve money in December 2005, Ksh 1.5 billion was held in currency outside banks and only Ksh 0.2 billion was in bank reserves with the CBK.

Table 2: Reserve Money (RM) Performance and Targets for 2005/06 (Ksh billion)

	2005				2006					
	Sep'	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
RM (Target)	96.1	97.6	98.0	103.5	98.9	98.9	99	99.7	100	100.4
Average RM (Actual)	96.1	97.7	101.1	105.2						
Deviation	0.0	0.1	3.1	1.7						
Currency outside banks	-0.1	-0.5	3.0	1.5						
Excess bank reserves	0.1	0.6	0.1	0.2						

Source: Central Bank of Kenya

Ordinarily, excess currency holdings by the public are not easily amenable to open market operations. Sustained favourable deposit rates induce the public to substitute currency holdings with deposits. Only when the public deposit their currency with commercial banks can the CBK stand the chance of accessing the funds through open market operations.

Liquidity forecasting benefited from a monthly cash flow provided by the Government. The Government also implemented a single Treasury Funding Account (TFA) where all Government payments are released in one account. This eased daily monitoring of Government payments and helped improve liquidity forecasting. It is expected that as longer series of flows in the TFA become available, the Bank will be able to analyse their trend and improve on liquidity projections.

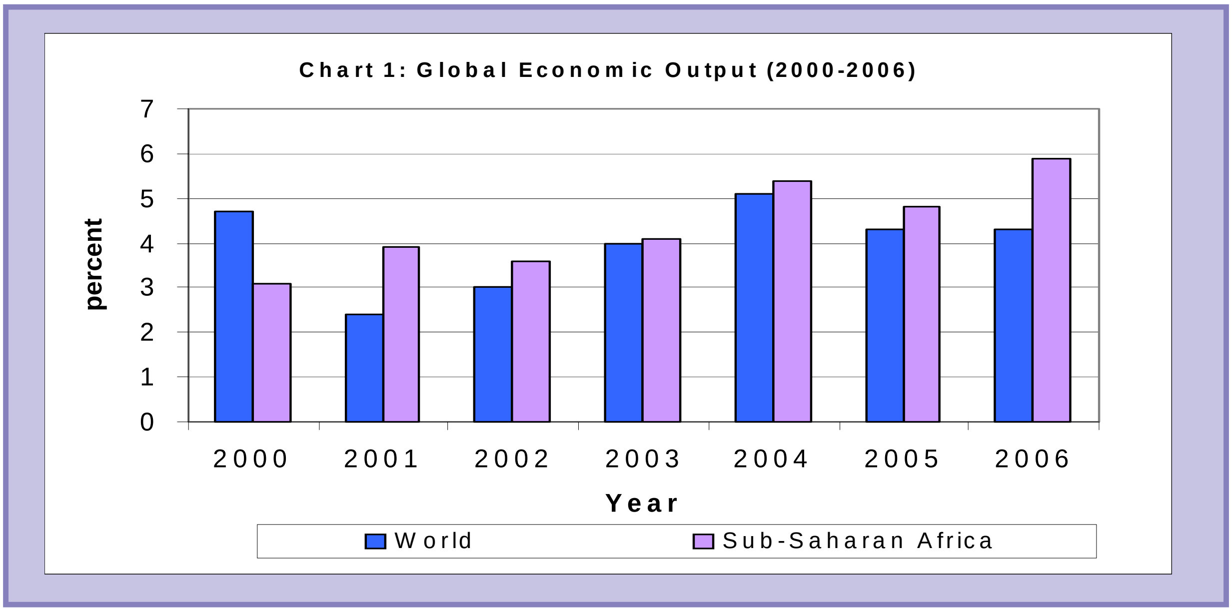
Net Foreign Assets of the CBK

The Bank met the target for net foreign assets of the CBK for all the months through December 2005, following foreign exchange purchases from the interbank market and budgetary donor funds from the African Development Bank in July 2005.

2 CURRENT ECONOMIC SITUATION AND OUTLOOK FOR 2006[2]

2.1 The World Economy

According to the International Monetary Fund's World Economic Outlook (WEO) for September 2005, the world economy is estimated to have grown by 4.3 percent in 2005, compared with 5.1 percent in 2004 (Chart 1). The lower growth reflected the negative effects of higher oil prices and catastrophic effects of Hurricane Katrina that spilled over on the rest of the world. Associated with this robust global growth, however, is the wide divergence across regions. Growth in the United States and China continued to be strong underpinned by increased productivity in the case of the former and infrastructural investment in the later. Growth in the Euro area and Japan was, meanwhile, undermined by falling exports and weak domestic demand.



GDP growth is estimated to have moderated in sub-Saharan Africa to 4.8 percent in 2005 following the 5.4 percent expansion in 2004. The slowdown reflects declining oil revenues in Nigeria where production grew less rapidly than in 2005 due to limited capacity. Oil importing countries in the region, however, showed resilience to high oil prices following price increases in nonfuel commodities, improved macroeconomic stability and ongoing structural reforms.

Outlook for 2006

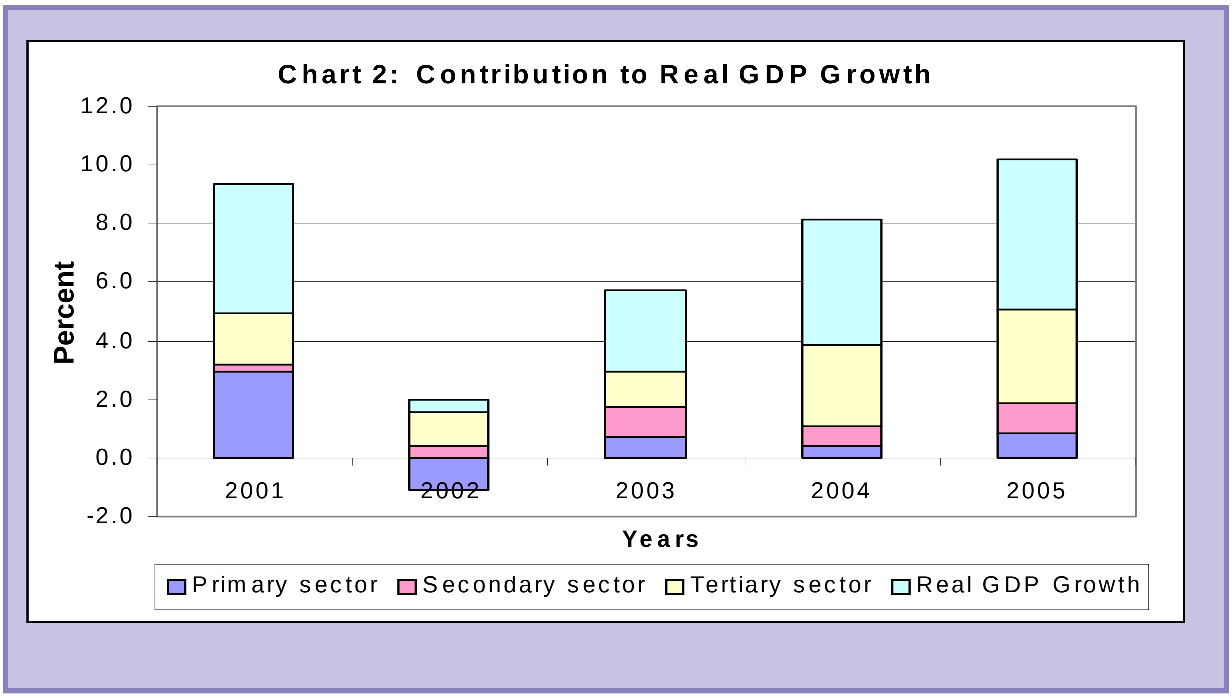
World output growth is expected to remain at 4.3 percent in 2006. The threat to global output of higher oil prices arising from stronger global demand and debilitating effects of the Hurricane Katrina in the U.S. Gulf Coast is expected to be offset by the strengthening of global manufacturing and trade as well as the falling oil consumption per unit of GDP due to the development of more energy-efficient technologies and expansion of the services sector.

[2] See Appendix 1 for the detailed Macroeconomic Framework

Growth in the sub-Saharan Africa is forecast to rebound to 5.9 percent in 2006, supported by increased production capacity in oil exporting countries. The growth prospects for the region will largely depend on the policy environment, weather patterns and the political situation.

2.2 The Domestic Economy

Leading economic indicators show that real GDP growth could exceed the 5 percent forecast for 2005, up from 4.3 percent in 2004 (Chart 2). The estimated growth is consistent with forecast from various investment analysts and East Africa Business Association.



The broad based growth realized in 2004 continued into 2005 and was mainly driven by strong domestic demand combined with increases in production of key exports. Agricultural sector benefited from favourable weather in the major grain growing areas that resulted in improved crop production, particularly maize, wheat and rice. Horticulture and coffee production rose due to improved prices and better credit facilities. Tourism earnings increased with increased tourist arrivals following improved marketing abroad and stepped up security in tourist resorts. Arrival of tourists was also boosted by diversion from Asian markets in the wake of Tsunami and bird flu. Manufacturing benefited from robust demand for exports from the regional markets, particularly sales of light manufactures in the East African Community and COMESA with increased economic integration. Growth in construction was associated with increased demand for residential housing following improved mortgage rates. The construction boom, as demonstrated by the 8 percent increase in cement consumption, was also associated with countrywide projects, particularly hospitals and schools mainly financed by the Constituency Development Funds (CDF).

Macroeconomic and regulatory environment improvements combined with strong corporate governance that enhanced stability and performance in the financial sector helped improve business confidence in private business and increased demand for credit. Consequently, consumption and investment expenditure increased, benefiting the key sectors of the economy including agriculture, manufacturing, construction, and mining and quarrying.

The developments in key sectors of the economy had spillover effects into the other sectors including transportation and communication, utilities and other services. Mobile telephony and air transport grew with liberalization in telecommunications and reforms by Kenya Airways. Consumption of electricity and petroleum fuel increased by 6.3 percent and 17.1 percent in the first ten months of 2005, compared with 8.1 percent and 8.7 percent respectively in the corresponding period in 2004.

Projections for 2006

While the recent recovery in economic activity has benefited from reforms in various fronts, the current macroeconomic stability provides a conducive environment for the Government to accelerate the remaining reforms necessary to sustain the growth momentum and reduce poverty, and attain the Millennium Development Goals (MDGs). Other growth supporting measures include upgrading of essential infrastructure in the transportation, telecommunications, and power sectors, and continuing efforts to rebuild key regulatory institutions. Already one of the key hurdles to privatization has been sorted out with the passage of the Privatization Law in late 2005. This has set the stage for privatization of Kenya Railways (KR) and Kenya Electricity Generation Company (KenGen) beginning March 2006. Rehabilitation of key road networks has also commenced with improved absorption capacity by the Government to utilize donor funds.

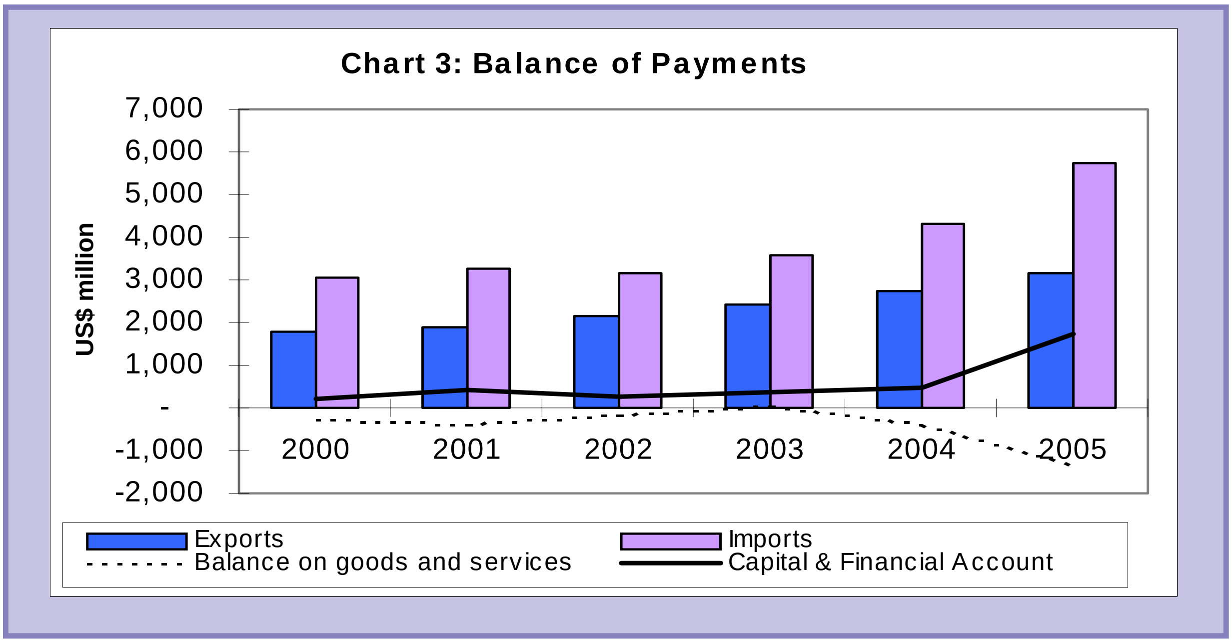
The outlook for growth in 2006 is therefore broadly positive, with real GDP growth expected to average at least 5 percent in 2006-2008. Economic expansion would be supported by the expected reforms including the privatization of the railways, energy, ports and telecommunications sectors. Tourism receipts are expected to increase further as countries in the Far East are yet to recover from the effects of Tsunami and bird flu. Tea, coffee and horticultural exports are expected to expand with increased world prices of these commodities. Exports of light manufactures will continue to benefit from increased demand from the subregion, especially with the reconstruction of the Southern Sudan, and as regional integration under the EAC takes a firm hold.

The downside risk to this favourable growth outlook is the ongoing drought in some parts of the country and high oil prices. If the poor weather persists into the first half of 2006, various sectors of the economy will be negatively impacted with shortfalls in production of food, water and hydroelectric power. Imports to cover these shortfalls and high oil prices are expected to result in a widening of the current account deficit. High oil prices will also increase the cost of domestic production and inhibit growth.

2.3 Balance of Payments

Overall balance of payments increased to a surplus of US$ 415 million in the year to October 2005 from a deficit of US$ 2 million in the corresponding period in 2004 (Chart 3). The improvement was in a strong surplus in the capital and financial account, which increased by US$ 1,527 million as a result of an increase in private capital inflows and reduced official capital outflows occasioned by debt rescheduling. This more than offset the US$ 1,109 million deterioration in the current account deficit due to higher trade deficit.

The trade deficit increased to US$ 2.6 billion in the year to October 2005 from US$ 1.5 billion in a similar period in 2004. The deficit reflected an increase by 46.1 percent in merchandise imports, which more than offset the 26.2 percent increase in exports. Merchandise imports rose to US$ 6 billion while exports rose to US$ 3.3 billion. Higher growth of imports was attributed to increased import of oil, chemicals and machinery and transport equipment while improvement in export earnings was attributed to tea, coffee, horticulture and oil products.



Net receipts in the export of services increased to US$ 1.3 billion in the year to October 2005 from US$ 1.2 billion in the year to October 2004, following increased receipts from transportation services and tourism. Tourism earnings increased to US$ 521 million from US$ 452 million in the year to October 2004.

As a result of developments in the trade in goods and services, the current account balance turned out a deficit of US$ 1.4 billion in the year to October 2005, up from a deficit of US$ 295 million in a similar period in 2004. The current account was more than financed by the surplus in the capital and financial account, which increased to US$ 1.8 billion from US$ 293 million, mainly as a result of strong private capital inflows. The overall balance of payments was therefore a surplus of US$ 415 million compared with a deficit of US$ 2 million in a corresponding period in 2004.

Gross official foreign exchange reserves increased to US$ 1.7 billion (equivalent to 3.1 months of imports cover) by the end of October 2005 from US$ 1.3 billion (equivalent to 3.3 months of import cover) at the end-October 2004. By end-December 2005, gross official foreign exchange reserves stood at US$ 1.8 billion, equivalent to 3.3 months of import cover.

Projections for 2006

The current account deficit is expected to widen reflecting continued robust demand for imports to support the projected economic growth. Oil, chemicals, manufactures and machinery and transport equipment imports, which have been rising since 2004, are expected to increase further in 2006 and in the medium term.

Earnings from exports of goods are expected to remain strong in 2006, buoyed by robust demand from the subregion and traditional markets abroad. This is expected to offset the decline from supply response emanating from lower international prices for commodity exports, according to commodity price projections in the latest IMF's WEO.

The deterioration of the current account deficit is expected to be offset by improvement in the capital and financial account following an increase in private and official capital inflows. As a result, the overall balance of payments is expected to record a surplus of about US$ 80 million in 2006.

Over the medium term the current account deficit would continue to widen, as the expansion in investment leads to an increase in imports that will not be matched by the expansion in exports. The deficit in the current account will be more than financed by strong capital inflows, hence a stable surplus in the overall balance of payments of around US$ 200 million over the medium term.

Following the improved balance of payments, the gross official foreign exchange reserves are projected to increase to US$ 2 billion in 2006 and to about US$ 2.5 billion in 2007, equivalent to 3.3 months of imports cover, up from 2.8 in 2005.

2.4 Fiscal Developments

Government fiscal operations resulted in a budget deficit (on commitment basis) of Ksh 9.6 billion, or 0.7 percent of GDP, in the first four months of the fiscal year 2005/06 compared with a surplus of Ksh 0.5 billion (0.04 percent of GDP) in a similar period in 2004/05 (Table 3). The deficit was well within the target of Ksh 22.5 billion (1.7 percent of GDP) for October 2005. On a cash basis, the deficit was 1.4 percent of GDP compared with the target for 1.2 percent of GDP for the same period.

Revenue and grants amounted to Ksh 94 billion (7 percent of GDP) compared with a target of Ksh 87.9 billion (6.6 percent of GDP). The increase in revenue was attributed to improvement in tax administration by Kenya Revenue Authority, which saw the rolling out of the new computerized system for clearing customs goods in July 2005.

Expenditure amounted to Ksh 103.5 billion (7.7 percent of GDP) and was below the Ksh 110.4 billion target for October 2005. The less than budgeted expenditure was occasioned by the slow execution of expenditure in the first quarter of the financial year following hitches in the implementation of a new custom clearing system and modalities for payment of petroleum duties.

Table 3: Central Government Fiscal Outturn (Ksh Billion)

	2003/04	2004/05	Jul-Oct'05		2005/06	2006/07
	Act.	Prov.	Prov.	Target	budget	Proj.
1. Total Revenue and Grants	270.9	304.7	94.0	87.9	354.1	379.7
2. Total Expenditure	282.2	303.7	103.5	110.4	410.9	434.8
3. Surplus/Deficit (commitment basis)	-11.3	1.0	-9.6	-22.5	-56.8	-55.1
% of GDP	-1.0	0.1	-0.7	-1.7	-4.0	-3.5
4. Adjustment to cash	11.4	6.3	-8.6	7.1	-2.0	0.0
5. Surplus/Deficit (cash basis)	0.1	7.3	-18.2	-15.4	-58.8	-55.1
% of GDP	0.0	0.6	-1.4	-1.2	-4.1	-3.5
6. Total Financing	-0.1	-7.3	18.2	15.4	58.8	55.1
a. Net External	-8.9	-0.6	1.1	-1.2	23.4	23.5
b. Net Domestic	8.8	-6.7	17.1	16.6	25.4	31.6
c. Others*	0.0	0.0	0.0	0.0	10.0	0.0

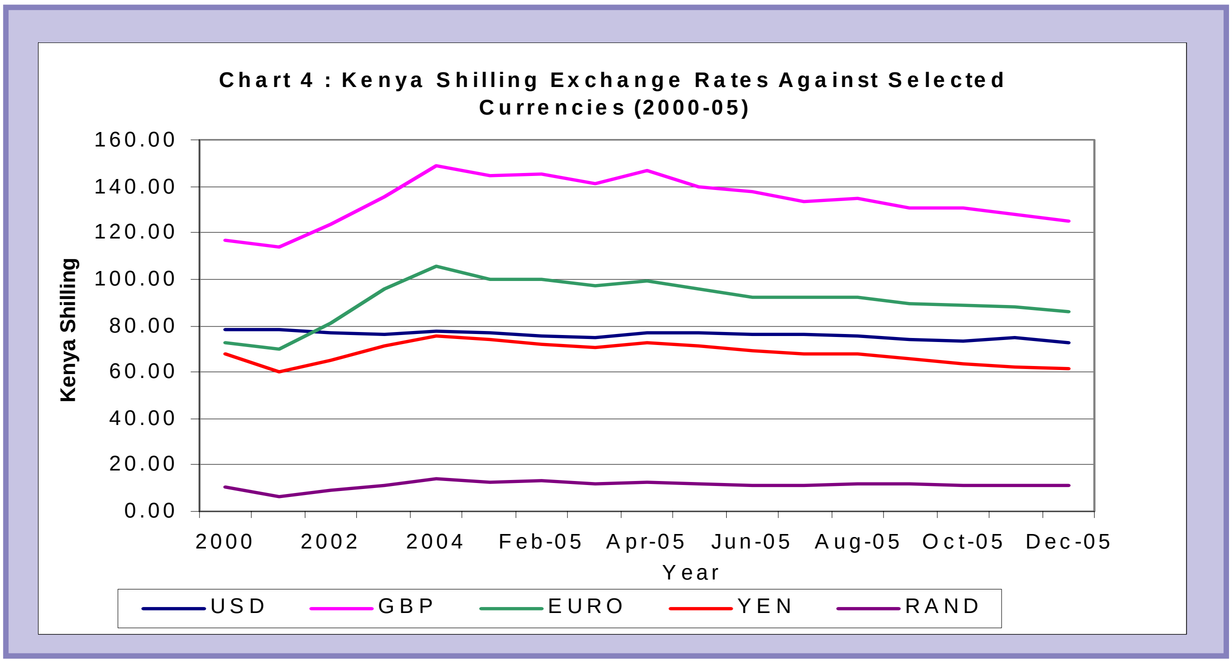
Source: Ministry of Finance and Central Bank of Kenya
* Includes privatization proceeds and securitization of domestic payments arrears.

During the period under review, Government fiscal operations resulted in a net borrowing of Ksh 17.1 billion compared with the target of Ksh 16.6 billion. Success in raising funds for the Government in the domestic market was attributed to stability in interest rates following improved availability of information on Government borrowing requirements.
For the financial year 2005/06, Government revenue and grants are projected at Ksh 354.1 billion, while expenditure is expected to amount to Ksh 410.9 billion. This implies a budget deficit on commitment basis of Ksh 56.8 billion, or 4.0 percent of GDP, which is expected to be financed by external borrowing amounting to Ksh 23.4 billion and by domestic borrowing amounting to Ksh 25.3 billion.

Projections for the financial year 2006/07 indicate that expenditures will exceed revenues by Ksh 55.1 billion (3.5 percent of GDP). The deficit is expected to be financed by domestic borrowing amounting to Ksh 31.6 billion and external borrowing amounting to Ksh 23.5 billion, more or less the same level as in 2005/06.

2.5 Exchange Rate

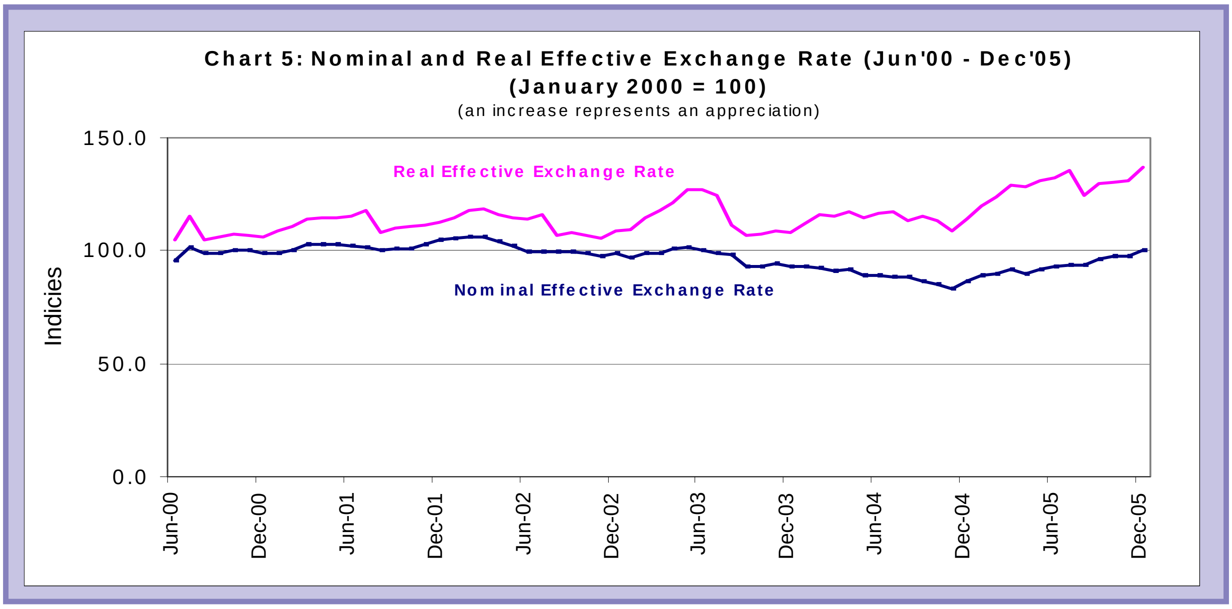
The Kenya shilling strengthened against all the major international currencies during the second half of 2005 (Chart 4). By the end of December 2005, the shilling was exchanging at Ksh 72.4 per US dollar compared with Ksh 76.2 at the end of June 2005. Against the sterling pound, the Euro and Japanese yen, the shilling appreciated by 9.3 percent, 7.6 percent and 10.7 percent over the similar period. The shilling also strengthened against the South Africa rand, Uganda shilling and the Tanzania shilling by 0.2 percent, 9.8 percent and 8.9 percent, respectively. Consequently, the trade weighted nominal effective exchange rate (NEER)[3] appreciated by 7.5 percent over the same period.



The strengthening of the shilling exchange rate against the US dollar reflected increased foreign exchange inflows from key exports, particularly horticulture, tea, coffee and tourism. The shilling was also bolstered by stable and attractive domestic interest rates that resulted in increased capital inflows. In addition, disbursement of budgetary support by the Africa Development Bank and improved investor confidence in the economy following continued engagement with the IMF under the PRGF supported arrangement also contributed to the strengthening of the shilling. Meanwhile, the strengthening of the Kenya shilling against the other major currencies reflected the weakening of these currencies against the US dollar in the international currency market.

In real term, as measured by the Real Effective Exchange Rate (REER), the shilling appreciated by 20.5 percent in 2005 compared with 5.5 percent in 2004. This reflected the combined effects of an appreciation of the NEER and relatively higher domestic inflation compared with Kenya's trading partners (Chart 5).

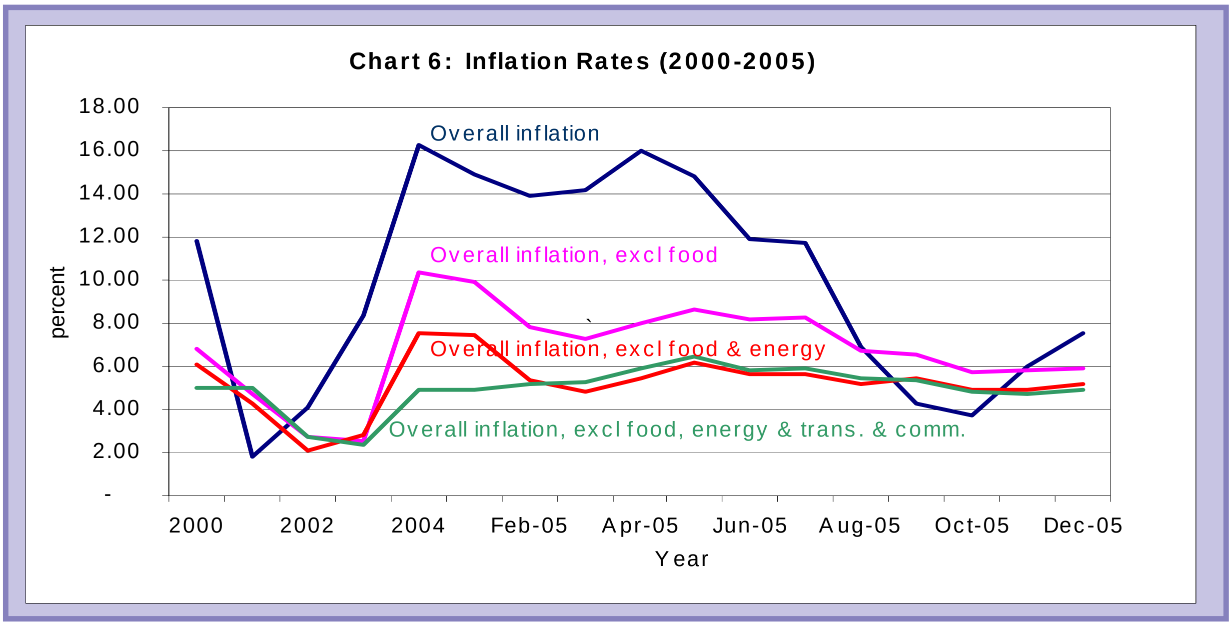
[3] The NEER and REER are constructed using geometric mean of trade weights of major trading partners with the base period of January 2000.



The CBK will continue to maintain a market determined exchange rate, limiting its participation in the foreign exchange market to intervention to smooth out short-term exchange rate fluctuations. The shilling is expected to remain stable in 2006 and in the medium term with the pursuit of prudent macroeconomic polices.

2.6 Inflation

The annual 12-months overall inflation declined to 3.7 percent in October 2005 from 11.9 percent in June 2005 and a peak of 19 percent in September 2004 (Chart 6). The decline in inflation was due to easing of prices of food following improved food supplies over the period. The strengthening of the shilling combined with stable oil prices also helped ease inflationary pressures. However, owing to inadequate short rains in October – December 2005 and drought in various parts of the country that reduced the supply of basic foodstuff, food inflation has intensified, causing overall inflation to rise to 6.1 percent in November 2005 and 7.6 percent by December.



Underlying annual inflation measures were fairly low in the last half of 2005, fluctuating around the 5 percent objective (Table 4). Inflation excluding food declined from 9.5 percent in September 2004 to 6 percent in December 2005, while that excluding food and energy declined from 7 percent to 5.2 percent. When transport and communication is further excluded to completely isolate transitory factors emanating from energy prices, underlying inflation was more or less stable around the target, reflecting the tight monetary policy pursued over the last one year.

Table 4: CPI (2004-2005)

	2004			2005							
	Jun	Sep	Dec	Mar	Jun	Jul	Aug	Sep	Oct	Nov	Dec
CPI	5.9	19.0	16.3	14.2	11.9	11.8	6.9	4.3	3.7	6.1	7.6
Food & Drink	6.1	26.9	21.0	19.6	14.7	14.4	7.0	2.6	2.3	6.2	8.8
Alcohol & Tobacco	1.7	2.9	1.9	3.6	9.7	9.7	9.7	8.9	8.6	8.6	9.2
Clothing & Footwear	3.9	5.2	5.3	5.7	4.3	4.0	7.0	3.7	3.3	3.3	3.1
Housing	2.3	4.2	5.4	5.9	6.4	6.9	5.5	6.0	4.6	4.5	5.5
Fuel &Power	7.9	30.1	34.1	28.1	28.7	29.2	17.7	14.6	11.0	12.4	11.2
Household Goods &Services	3.2	4.3	6.4	7.6	7.2	7.5	7.2	6.5	5.8	5.2	4.7
Medical Goods & Services	2.8	3.1	3.8	3.3	5.7	6.2	6.5	6.5	6.1	5.2	5.3
Transport & Communication	21.3	24.6	24.5	2.0	4.5	4.2	3.5	5.7	5.5	5.8	6.5
Recreation & Education	4.3	4.9	4.4	3.7	4.2	4.1	4.1	4.0	4.2	4.3	4.3
Personal Goods & Services	2.4	3.5	3.9	4.1	3.4	3.6	3.3	3.2	3.3	3.9	4.0
Underlying Inflation (various measures)											
CPI excluding food		9.5	10.4	7.3	8.2	8.3	6.7	6.6	5.7	5.8	6.0
CPI excluding food and energy		7.0	7.5	4.8	5.6	5.7	5.2	5.4	4.9	4.9	5.2
CPI excluding food, energy and transport & communication		4.3	4.9	5.3	5.8	6.0	5.5	5.4	4.8	4.7	4.9

Source: Central Bank of Kenya and Central Bureau of Statistics

Projection for 2006

Inflationary pressures are expected to persist in the coming months owing to the ongoing drought in various parts of the country that is expected to lead to increased food prices. The outlook could worsen if the expected long rains in March-May 2006 are delayed or turn out inadequate and if oil prices increase to higher levels. In the medium term, inflation outcome will depend on the movement of the shilling exchange rate, inflation levels in trading partner countries and the rate at which the productive capacity keeps pace with growth in domestic demand.

Prudent implementation of fiscal and monetary policies will be sustained to enhance stability in interest rates and the shilling exchange rate thereby containing inflation.

2.7 Monetary and Financial Developments

Money and Credit

Annual growth in extended broad money, M3, decelerated to 10.2 percent in the year to December 2005 from 13.2 percent a year earlier (Table 5). This compares favourably to the 10.5 percent target for December 2005. The deceleration in the growth in M3 reflected the tight monetary policy stance pursued over the last one year to bring down inflation to target. The contribution of net foreign assets to the M3 expansion was 7.4 percent, while that of net domestic credit was 2.8 percent. Reserve money grew by 5.1 percent over similar period compared with 15.5 percent in December 2004, following deceleration in the expansion of currency outside the banking system from 13 percent to 5.7 percent.

Table 5: Contribution to Growth in Broad Money, M3 (percent)

	Jun-04	Sep-04	Dec-04	Mar-05	Jun-05	Sep-05	Dec-05
Annual growth in M3	12.9	14.5	13.2	13.4	11.0	11.3	10.2
Net Foreign Assets	3.7	2.3	3.1	5.0	5.0	6.1	7.4
Net Domestic Assets	9.2	12.3	10.0	8.4	6.0	2.9	2.8
Domestic Credit	11.1	13.3	14.8	13.2	10.7	5.4	4.9
Government (net)	2.9	1.4	-0.6	-2.1	-2.1	-5.1	-2.0
Rest of the Economy	8.1	11.9	15.4	15.2	12.8	10.5	6.9
Other public sector	0.7	1.2	1.1	0.5	0.2	-0.1	0.2
Private sector	7.4	10.7	14.3	14.7	12.6	10.6	6.7
Other Items (net)	-1.9	-1.0	-4.8	-4.7	-4.7	-2.5	-2.1

Source: Central Bank of Kenya

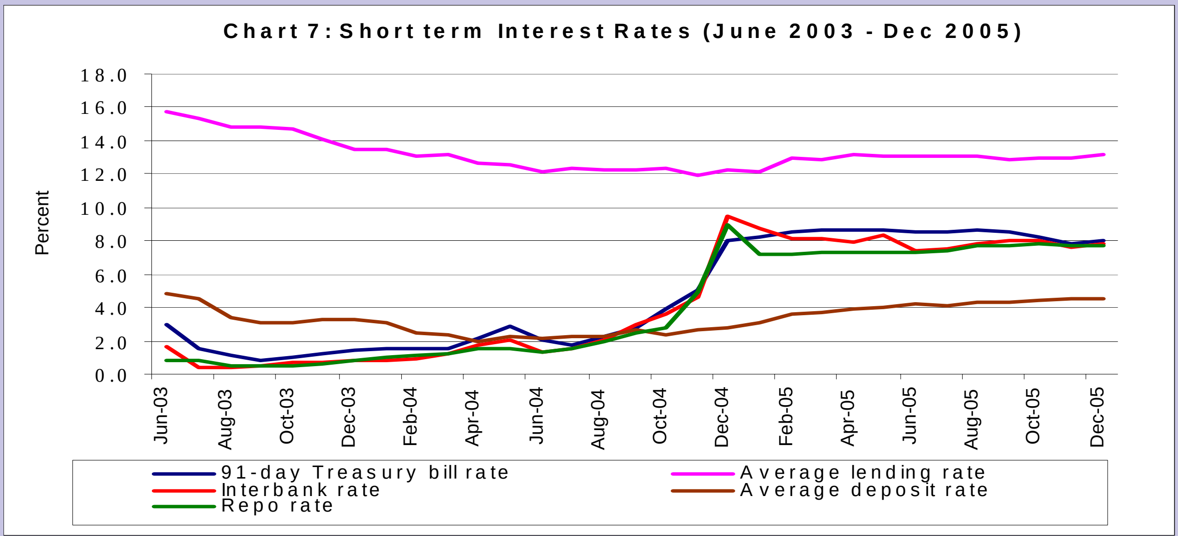
Growth in banking system extension of credit to the domestic economy eased to 5.3 percent in the twelve months to December 2005 from 16.9 percent in the corresponding period in 2004. Credit to Government declined by 7.7 percent following reduced borrowing occasioned by improved revenue performance. This was more than offset by increased credit to private sector, which grew by 10.4 percent by December 2005 compared with 24.4 percent in the same period in 2004. While credit to private sector represented a deceleration, the level of expansion remained appropriate with improved macroeconomic stability and investor confidence in the recent past. Most of the credit to the private sector was to consumer durables (58.0 percent), business services (38.3 percent), transport and communication (33.8 percent), mining and quarrying (23.9 percent), real estate (21.3 percent), finance and insurance (16.9 percent) and building and construction (16.0 percent).

Table 6: Credit to Private Sector						
	2004		2005		Annual	
	Dec Ksh bn	Share (%)	Dec Ksh bn	Share (%)	Change Ksh bn	percent
Credit to Private Sector	**330.3**	**69.7**	**364.5**	**73.1**	**34.2**	**10.4**
Agriculture	30.1	6.3	33.0	6.6	2.9	9.7
Manufacturing	63.3	13.4	63.3	12.7	0.0	0.0
Trade	47.9	10.1	51.6	10.4	3.7	7.7
Building and construction	20.1	4.2	23.3	4.7	3.2	16.0
Transport & communications	20.3	4.3	27.1	5.4	6.9	33.8
Finance & insurance	27.6	5.8	32.2	6.5	4.7	16.9
Real estate	20.2	4.3	24.6	4.9	4.4	21.7
Mining and quarrying	1.9	0.4	2.4	0.5	0.5	23.9
Private households	38.2	8.1	46.4	9.3	8.1	21.3
Consumer durables	5.9	1.3	9.4	1.9	3.5	58.0
Business services	25.0	5.3	34.6	6.9	9.6	38.3
Other activities	29.7	6.3	16.5	3.3	-13.2	-44.3

Source: Central Bank of Kenya

Interest Rates

Short term interest rates were stable in the second half of 2005 with Treasury bill rates and the interbank rate fluctuating in the range of 7 to 8 percent, after rising sharply in the last quarter of 2004 as shown in Chart 7.



The stable 91-day Treasury bill rates reflected the relatively stable domestic borrowing by the Government following improved revenue collection and slower execution of the budgeted expenditures. The interbank rate also stabilized with improved liquidity conditions.

Similarly, the lending rate ranged between 12 percent and 13 percent, while the deposit rate increased to 4.5 percent in December 2005 from 4.2 percent in June 2005. Consequently, the spread in interest rate declined to 8.4 percent from 8.9 percent in June 2005.

Overall, the stability in interest rates in part reflected prudent monetary policy stance and improved investor confidence in the economy. The introduction of risk based lending procedures for commercial banks is expected to have a dampening effect on commercial bank lending rates as the level of non-performing loans reduce.

3 MONETARY POLICY FOR 2006

As indicated in the previous Statements, prudent monetary policy sustained over a longer period would create a conducive environment for businesses, which in turn support faster economic activity and reduce poverty.

Sustained economic recovery, relatively low inflation - albeit the setback of the ongoing negative effects of drought on food prices - and strong fiscal position provides the basis for continuation of the current monetary policy stance in 2006. Appropriate modification of reserve money path has, however, been made to accommodate the strong accumulation of foreign exchange reserves in the last quarter of 2005 and the anticipated domestic financing of drought relief operations. The growth targets indicated in Table 7 and Appendix Table 2 represents the appropriate monetary policy stance to be pursued over the next one year to December 2006.

Table 7: Growth Target for Monetary Aggregates for 2006

	Dec'05	Mar'06	Jun'06	Sep'06	Dec'06
	Act.	Projection			
Reserve money (Ksh million)	106.4	101.4	101.6	103.5	110.5
NFA of CBK (Ksh million)	114.8	112.4	110.8	114.9	114.1
Memo:					
Annual change in reserve money	5.6	8.3	7.6	7.9	4.0
Annual change in extended broad money (M3)	10.7	9.9	10.0	9.5	10.4
Real GDP growth			5.0	5.1	5.1
Overall inflation			5.0	5.0	5.0

Source: Central Bank of Kenya

Extended broad money is expected to expand by about 10 percent, while reserve money will increase by an average of 7 percent in 2006. The expansion in broad money is considered non-inflationary. With stable interest rates, private sector credit is expected to grow by 12 percent in 2006.

Although detailed assessment of the impact of the drought on economic growth and inflation is yet to be completed, the Bank expects that a significant cost of drought relief operations will be financed through international assistance. This will enable the Government to maintain disciplined fiscal stance and help sustain stable domestic interest rates and encourage the private sector to continue investing to support economic growth. Moreover, with the expected sourcing of relief food from domestic sources and cross border trading, the Bank expects limited effect on the shilling exchange rate.

In this context, the Bank, while pursuing the appropriate monetary policy stance, will monitor the short-term monetary shocks emanating from the adverse effects of the drought with a view to appropriately responding to achieve price stability in 2006 and over the medium term. When and if domestic financing of drought relief operations become pressing beyond the accommodations in-built in the monetary policy stance for 2006, the Bank will consider other appropriate options of intervention, while keeping a keen eye on price stability.

As in the past, the inflation objective will be pursued through reserve money operating framework, with open market operations as the main instrument. Daily liquidity forecast will be used to determine the direction of intervention in the money market. Repos will be used to withdraw, on a timely basis, any excess liquidity in the banking system and vice versa when the need arises. The Bank's participation in the foreign exchange market will be limited to smoothing out any erratic movements in the exchange rate, meet foreign obligations of the Government and achieve the targeted foreign exchange level consistent with the developments in the balance of payments.

APPENDIX 3: CHRONOLOGY OF EVENTS OF PARTICULAR RELEVANCE TO MONETARY POLICY AND INFLATION (JUNE – DECEMBER 2005)

2005

July 2005	The Central Bank of Kenya released its sixteenth Monetary Policy Statement (June 2005), setting out the monetary program to be pursued in the financial year 2005/06 (July-June).
August 2005	The 2005/06 monetary program was rebased with actual June 2005 monetary data. While the growth rates for M3 and reserve money were retained as in the June 2005 Statement, the rebasing resulted in new target levels for these key variables.
October 2005	With growth forecast for 2005/06 financial year remaining robust and significant easing of inflation to 3.7 percent in October 2005, the June 2006 growth targets for M3 and reserve money were relaxed from 7.8 percent and 5 percent, to 10 percent and 6.3 percent, respectively. This was in the context of the second round of discussion with the IMF Mission on the Second Review under the PRGF program.
November/December 2005	More than envisaged demand for currency by the public, following the run up to referendum campaigns, puts upwards pressure on reserve money in November 2005. The pressure extended to December 2005 with seasonality associated with Christmas festivities leading to the reserve money benchmark being exceeded by Ksh 1.7 billion.
December 2005	The IMF Executive Board meeting scheduled for 5th December 2005 to approve Kenya' Second Review under the PRGF arrangement was postponed.

GLOSSARY OF KEY TERMS

Overall Inflation

A rise, over time, in the average level of prices. It is measured by the of movement of indices of all consumer price items of goods and services sampled by the Central Bureau of Statistics.

Underlying Inflation

This is overall inflation excluding price items that are affected by transitory factors. It is measured by excluding food, energy and transport and communications in the consumer price indices. These items are excluded because they are susceptible to transient effects that are in most cases beyond the control of the CBK. Thus the underlying inflation measure is used by the Central Bank to gauge the influence of monetary policy on inflation.

Reserve Money

These are CBK monetary 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

Money supply is the sum of currency outside banks and deposit liabilities of commercial banks. Deposit liabilities are defined in the narrower and broader sense as follows: narrow money (M1); broad money (M2); and extended broad money (M3). These aggregates are defined as follows:

M1	Currency outside banking system + demand deposits
M2	M1 + time and saving deposits + certificate of deposits + deposits Liabilities of Non-Bank Financial Institutions (NBFIs)
M3	M2 + resident's 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 Government treasury bills in the secondary market in order to achieve a desired level of currency in circulation and bank reserves. OMO is done in the context of an auction where commercial banks bid through the Reuters screen.

Repurchase Agreement (REPO)

This is an instrument used in OMO. REPOs are agreements between the CBK and commercial banks to purchase/sell 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 the reserve money operating target to achieve the money supply growth target (intermediate target) that is consistent with the inflation target (ultimate target).

Cash Reserve Requirement

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 that a certain proportion of commercial banks' deposits to be held as reserves at the Central Bank. The ratio currently stands at 6 percent.

Appendix Table 1: Medium-Term Macroeconomic Framework, 2003 - 2007

	2002	2003	2004	2005	2006
Real Sector					
Nominal GDP, KSh billion	1,058	1,104	1,449	1,610	1,757
Real GDP growth	0.4	2.8	4.3	5.0	5.1
CPI inflation (end of period)	9.8	11.6	10.3	4.3	3.5
Savings/GDP	17.4	15.0	13.8	15.2	15.7
Investment/GDP	17.4	18.4	19.8	21.2	22.0
External Sector					
Current Account (% of GDP)	0.5	-2.4	-6.2	-6.3	-6.6
Overall balance (US$ million)	413	61	-20	87	227
Official reserves (US$ million)	1,480	1,519	1,708	2,004	2,440
Months of import coverage	4.2	3.6	2.7	3.0	3.3
NPV of external debt ratio	25.1	22.5	20.05	19.9	20.8
Money and Credit					
(Annual % change)					
Net Credit to Government	23.1	-1.0	-6.8	6.5	3.9
Credit to Private Sector	6.9	24.4	10.3	11.7	13.0
Extended Broad Money (M3)	11.7	13.2	10.2	10.4	10.1
Reserve Money	-1.1	15.5	5.1	7.7	9.7
Fiscal Sector (% of GDP)					
Total Revenue	20.2	21.2	21.3	21.5	21.8
Total expenditure and net lending	23.6	22.9	25.2	27.7	28.6
Overall balance, excl. grants	-3.4	-1.65	-3.9	-6.2	-6.8
Overall balance, incl. grants	-2.1	-0.25	-2.0	-3.8	-4.7
Net domestic borrowing	2.3	0.1	0.6	1.6	1.3
Financing gap		0.3	0.3	0.5	0.9
Total donor support (grants & loans)	2.2	2.2	3.4	4.9	5.8
Domestic Debt/GDP	22.2	20.0	19.1	19.5	19.1

Source: Central Bank of Kenya and Ministry of Finance

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

	2004/05					2005/06				2006/07	
	Jun-04	Sep-04	Dec-04	Mar-05	Jun-05	Sep-05	Dec-05	Mar-06	Jun-06	Sep-06	Dec-06
	Act.	*Act.*	*Act.*	*Act.*	*Act.*	*Act.*	*Act.*	*Proj.*	*Proj.*	*Proj.*	*Proj.*
Central Bank of Kenya											
Net foreign assets 1/	86.7	79.8	89.4	81.0	95.7	106.1	114.8	112.3	110.7	114.9	114.1
Net domestic assets	3.6	10.0	11.7	12.7	-1.1	-10.2	-8.6	-10.9	-9.2	-11.3	-3.6
Net domestic credit	11.2	14.3	18.0	18.0	-3.2	3.3	0.5	-2.8	-0.3	-3.4	5.6
Other items (net)	-7.7	-4.3	-6.3	-5.4	2.1	-13.4	-9.1	-8.1	-8.9	-7.9	-9.1
Reserve money (RM)	90.2	89.9	101.1	93.7	94.6	95.9	106.2	101.4	101.6	103.5	110.5
Currency outside banks	55.7	56.1	62.7	58.0	59.3	59.3	66.3	62.1	62.3	63.1	66.6
Bank reserves	34.6	33.8	38.4	35.7	35.2	36.6	40.0	39.2	39.2	40.4	43.9
Other Depository Corporations											
Net foreign assets 1/	33.1	37.2	37.0	64.1	52.8	51.5	49.4	49.4	49.4	49.4	49.4
Reserves	34.6	33.8	38.4	35.7	35.2	36.6	40.0	39.2	39.2	40.4	43.9
Credit to CBK	6.1	5.0	7.0	4.3	5.3	5.1	5.3	8.6	6.2	9.5	0.7
Net domestic assets	343.9	354.5	371.1	360.3	369.1	391.3	404.6	415.0	422.2	433.0	463.9
Domestic credit	412.6	428.5	450.3	454.8	459.2	473.3	492.9	501.1	505.7	518.6	541.2
Other items (net)	-68.7	-74.0	-79.2	-94.4	-90.1	-82.0	-88.3	-86.1	-83.5	-85.5	-77.3
Total deposits	417.8	430.4	450.5	464.5	467.5	484.6	499.2	512.2	517.1	532.4	557.9
Deposits in shillings	351.6	360.9	369.9	376.9	383.1	394.4	408.2	434.1	439.7	455.8	482.0
Deposits in foreign currency	66.1	69.5	80.6	87.5	84.4	90.2	91.0	78.2	77.4	76.6	75.8
Depository Corporations Survey											
Net foreign assets 1/	119.8	117.0	126.3	145.1	148.4	157.6	164.2	161.7	160.1	164.3	163.5
Net domestic assets	353.6	369.5	386.8	377.3	378.3	386.4	401.3	412.7	419.3	431.2	461.0
Domestic credit	430.0	447.8	472.3	477.1	466.3	481.6	498.7	506.9	511.6	524.7	547.4
Government (net)	136.6	136.0	131.0	127.2	112.3	118.8	122.2	123.6	124.7	127.3	130.1
Rest of the economy	293.4	311.8	341.3	350.0	354.0	362.8	376.5	383.4	386.9	397.4	417.3
Other items (net)	-76.3	-78.3	-85.5	-99.8	-87.9	-95.2	-97.3	-94.3	-92.3	-93.5	-86.4
M3	473.4	486.5	513.2	522.5	526.8	543.9	565.5	574.3	579.4	595.5	624.5
Memorandum items:											
(In Percent of Annual Change)											
M3	12.9	14.5	13.2	13.4	11.3	11.8	10.2	9.9	10.0	9.5	10.4
Reserve Money	5.5	9.8	15.5	8.2	4.8	6.7	5.1	8.3	7.6	7.9	4.0
Currency outside banks	12.0	13.4	13.0	5.6	6.6	5.7	5.7	7.2	5.1	6.4	0.5
Domestic credit	12.1	14.5	16.6	14.9	8.4	7.1	5.6	6.3	9.7	9.0	9.8
Government (net)	9.9	4.6	-2.0	-6.1	-17.8	-13.8	-6.8	-2.8	11.0	7.2	6.5
Rest of the economy	13.1	19.4	25.7	25.1	20.6	16.4	10.3	9.5	9.3	9.5	10.8
Multiplier (M3X/RM)	5.2	5.4	5.1	5.6	5.6	5.7	5.3	5.7	5.7	5.8	5.6
Reserve cover, in months of imports	3.0	2.5	2.9	2.8	3.0	3.1	3.0	3.0	3.1	3.1	3.2

Source: Central Bank of Kenya

[1]/ Constant Kenya shilling per US dollar exchange rate prevailing on September 30, 2001 (Ksh 78.95 per US dollar)