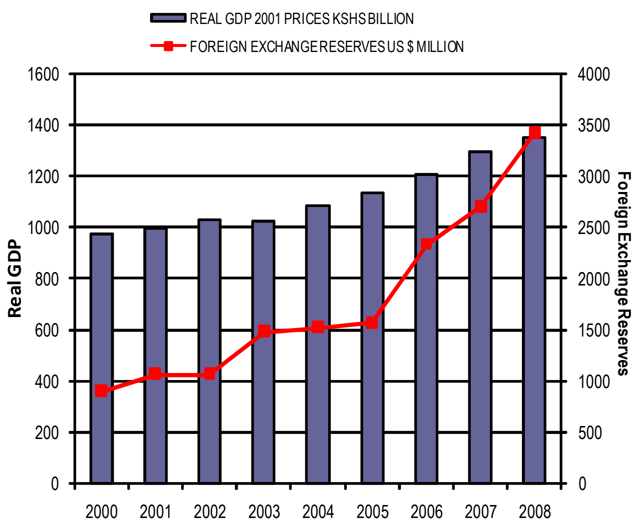

CENTRAL BANK OF KENYA

Monetary Policy Statement

Issued under the Central Bank of Kenya Act, Cap 491

DECEMBER 2009

Dear Honourable Minister,

I have the pleasure of forwarding to you the 25th Monetary Policy Statement (MPS) of Central Bank of Kenya (CBK), pursuant to Section 4B of the Central Bank of Kenya Act. The Statement reviews the implementation of monetary policy from July to December 2009. It also covers the current economic developments and outlines details of the monetary policy stance for the six months: January to June 2010, and policy trends to the end of 2010.

Prof. Njuguna Ndung'u
Governor

MONETARY POLICY STATEMENT
DECEMBER 2009

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The Principal objectives of the Central Bank of Kenya

The principal objectives of the Central Bank of Kenya (CBK) are:

1. To formulate and implement monetary policy directed to achieving and maintaining stability in the general level of prices;
2. To foster the liquidity, solvency and proper functioning of a stable, market-based, financial system;
3. Subject to (1) and (2) above, to support the economic policy of the Government, including its objectives for growth, and employment. Without prejudice to the generality of the above, the Bank shall:

- Formulate and implement foreign exchange policy;
- Hold and manage its foreign exchange reserves;
- License and supervise authorised foreign exchange dealers;
- Formulate and implement such policies as best to promote the establishment, regulation and supervision of efficient and effective payment, clearing and settlement systems;
- Act as banker and adviser to, and as fiscal agent of, the Government; and
- Issue currency notes and coins.

It follows therefore, that the CBK formulates and conducts monetary policy with the aim of keeping inflation low and stable. This policy facilitates higher levels of domestic savings and private investment and therefore leads to better economic outcomes including improved economic growth, higher real incomes and increased employment opportunities through a stable macroeconomic environment for sustainable economic growth.

The Bank's monetary policy is thus designed to support the desired growth in the production of goods and services and employment creation through achieving and maintaining a low and stable inflation.

Instruments of Monetary Policy

The CBK pursues its monetary policy objectives through the following instruments:

- **Open Market Operations (OMO):** Refers to actions by the CBK to vary the amount of commercial banks' deposits held with it in relation to the statutory requirement. Change in these deposits impact on the rate of interest at which credit is provided which in turn affects the growth of deposits held with commercial banks (which is the dominant component of money supply) and ultimately domestic prices. To achieve the desired level of money supply, OMO is conducted using the following instruments:
    - o **Repurchase Agreements (Repos)** – Which consist of the sale or purchase of eligible securities by the CBK to reduce or augment commercial banks excess deposits held with it. Reverse repos are purchases of securities from commercial banks by the CBK during periods of tight liquidity in the market. Horizontal Repos are transacted at the commercial banks level. Commercial banks short of deposits at the CBK borrow from banks with excess deposits on the security of appropriate assets, mostly government securities. The instrument helps banks overcome the problem of credit limits, thus promoting efficient management of interbank liquidity.
    - o **Term Auction Deposits** – The CBK acquires deposits from commercial banks at a price but with no exchange of security guarantee. The deposits are transferred to the CBK for a 7 days period after which they revert back to the respective commercial bank on maturity of the transfer agreement.
- **Central Bank Rate (CBR):** This is the rate of interest that the CBK charges on loans to commercial banks. It is reviewed and announced by the Monetary Policy Committee (MPC) at least every two months and its movements are a signal of the intended direction of change of money market interest rates.

  The direction and magnitude of movements of the CBR signals the monetary policy stance of the Bank. This signal is first operationalised through movements of the short term interest rates. A reduction of the CBR signals an easing of monetary policy and a desire for market interest rates to move downwards. Lower interest rates encourage economic activities and thus growth. When interest rates decline, the quantity of credit demanded increases.

The efficiency of the OMO and interbank markets are crucial for the transmission of monetary policy decisions. By fixing a single tenor for bills sold or bought in the repo market, the monetary authority aims to sharpen the signalling process. at present, there is a fixed 7 day tenor for bills used in the repo market.

- **Standing Facilities:** The CBK, as lender of last resort, provides secured loans to commercial banks on an overnight basis at the CBR.
- **Required Reserve (RR):** The Required Reserve stipulated under Section 38 of the CBK Act is the proportion of a commercial bank's deposit liability which is held at the CBK. These deposits are held in the Cash Reserve Ratio (CRR) Account. The CBK uses the RR as a direct instrument for monetary policy. If the CBR is lowered, part of the blocked deposits initially mobilised by commercial banks enhance their capacity to expand credit.
- **Foreign Exchange Market Operations:** The CBK can also inject liquidity into or withdraw it from the banking system by engaging in foreign exchange transactions. A sale of foreign exchange to banks withdraws liquidity from the system while the purchase of foreign exchange injects liquidity into the system. Participation by CBK in the foreign exchange market is commonly motivated by the desire to prevent excessive volatility in the rate at which the Kenya shilling exchanges against other foreign currencies, to acquire foreign exchange to service official debt and build its foreign exchange reserves or for liquidity withdrawal/injection. The credibility of the Kenya shilling as an internationally respected currency ensures that correspondent banks provide trade credit at convenient terms.

- **Licensing and Supervision of financial institutions:** The Bank uses the licensing and supervision tools to ensure the health and efficiency of the banking system.

- **Communication Strategy:** The increasing use of communications media ensures a wider dissemination of monetary policy decisions thereby increasing the efficiency of information transmission.

Legal Status of the Monetary Policy Statement

1. Section 4B (1) of the CBK Act requires the Bank to submit to the Minister for Finance, at intervals of not more than six months, a Monetary Policy Statement for the next twelve months which shall:
   i) Specify policies and the means by which the Bank intends to achieve the policy targets;
   ii) State reasons for adopting such monetary policies and means; and
   iii) Contain a review and assessment of the progress made in the implementation of monetary policy by the Bank during the period to which the preceding Monetary Policy Statement relates.
2. The Minister shall - by the law under subsection (1) lay every Statement submitted under subsection (1) before the appropriate committee of the National Assembly not later than the end of the subsequent session of Parliament after the Statement is so submitted.

3a. The Bank shall by law publish in the Kenya Gazette:
   i) Its Monetary Policy Statement; and
   ii) Its Monthly Balance Sheet.

3b. The Bank is further required to disseminate key financial data and information on monetary policy to the public.

4. In subsection (2), the expression "appropriate committee" means the committee of the National Assembly appointed to investigate and inquire into matters relating to monetary policy.

Executive Summary

This Monetary Policy Statement (MPS) provides the policy stance for the period January to June 2010 while sketching the policy stance in the last half of 2009. It tracks the performance of the domestic economy and developments in the global economy in the period from July to December 2009, and provides the outlook for the first six months of 2010.

The review of the performance of the economy in the second half of 2009, with respect to what was proposed in the June 2009 MPS, enabled an assessment of the status of the recovery of the economy from the financial crisis and drought conditions witnessed in the third quarter of 2009.

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

The Central Bank will intensify interactions with the institutions in the financial sector so as to improve the transmission of monetary policy decisions to the commercial banks' lending rates. This will stimulate the economy through lowering the cost of borrowing for investment in Kenya. The Central Bank will also work closely with Kenya National Bureau of Statistics as it moves towards the preparation and release of the new Consumer Price Index in February 2010. The new measure will be a necessary component for inflation analysis.

1. Introduction

This Monetary Policy Statement (MPS) presents the policy guidelines for the Central Bank of Kenya (CBK) over the period January to June 2010 while also providing an analysis of the policy outcomes in the last half of 2009.

The after effects of the global financial crisis and drought conditions witnessed in the third quarter of 2009 all posed a serious challenge to Kenya's recovery process from the December 2007 post election crisis. The CBK has therefore enhanced its responsibilities by moving to a more careful consideration of how it can best fulfill its mandate.

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

The Bank will continue with interactions with stakeholders in order to accelerate the reduction of the spread between borrowing and lending rates which has hindered the creation of a competitive financial system. This will come about by improving the transparency and consequential efficiency of the transmission mechanisms relating to the Monetary Policy Committee signals. An outcome of this should be to improve access to appropriate financial services both with respect to product diversity and to spatial availability. The Bank will continue to augment liquidity when the signals suggest there is inappropriate tightness in the market or mop up liquidity when it is excessive relative to reserve money targets.

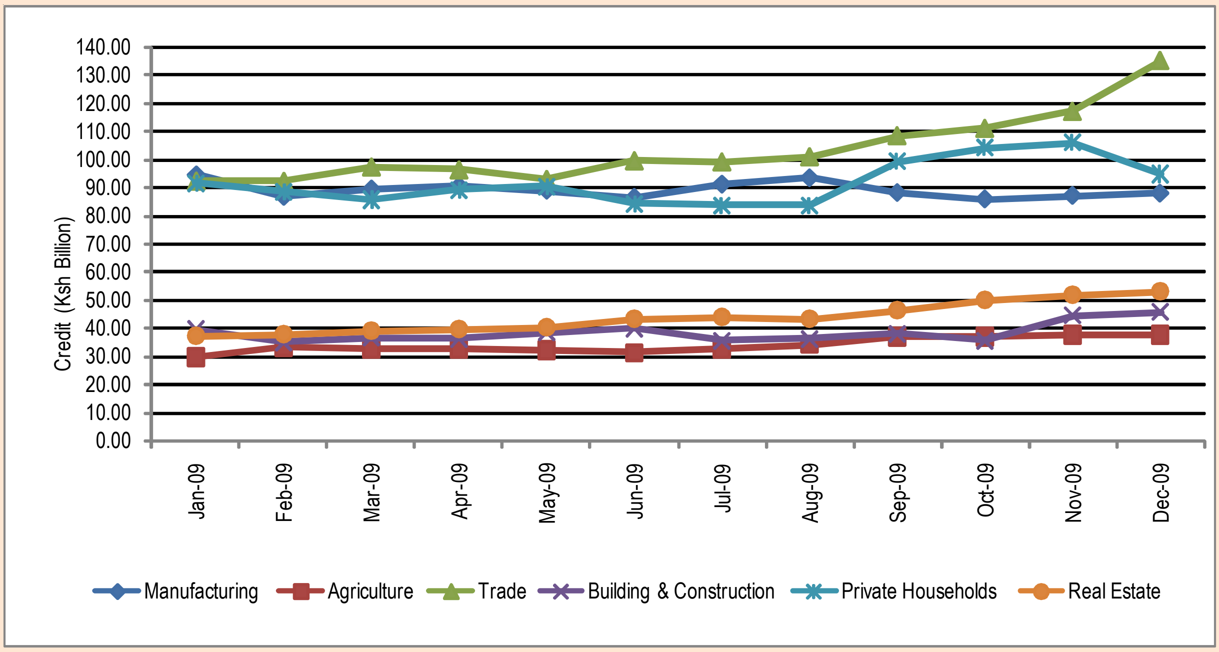
The Bank will work with the Kenya National Bureau of Statistics (KNBS) in the production of the new consumer price index which is a critical component for generating relevant data for inflation management, and also in generally conducting monetary policy.

2. Actions and Outcomes of Policy Proposals in the 24th Monetary Policy Statement

a. Credit to Private Sector

The identification of private sector credit as a necessary but not sufficient condition for economic growth meant that policies during the last half of 2009 were largely related to stimulating the financial sector to provide expanded credit. In their meeting on 22nd July 2009, the Monetary Policy Committee lowered the CBR by 25 basis points to 7.75 percent and reduced the required cash reserve ratio from 5.0 to 4.5 percent. This two pronged strategy was both to expand the loanable funds in banks and to make them cheaper to stimulate demand. Unfortunately, the impact of the poor weather conditions on agricultural production and energy costs continued depressing the overall economic activity in the third quarter of 2009 where private sector credit only grew by Kshs 4.1 billion, but improved weather sparked a strong recovery in the fourth quarter when Kshs 55.7 billion were loaned. As shown in Chart 1, credit to the trade, building and construction, real estate and manufacturing sectors maintained an upward trend between October and December 2009.

CHART 1: SECTORAL CREDIT TO KEY SECTORS IN THE ECONOMY



Source: Central Bank of Kenya

b. Interest Rates and Liquidity

In the 24th November, 2009 meeting, the MPC returned once again to this endeavour by cutting the CBR by a further 75 basis points. This change successfully transmitted to decreases in those interest rates directly associated with the Bank's policy i.e. the interbank and repo. The commercial banks absorbed this information, as can be seen through the decline in the interbank rate and the horizontal repos, and as pointed out credit, expanded satisfactorily. However, there was no significant change in the commercial banks lending rates. The Committee recommended extending the minimum tenor on repo bills purchased to 7 days from 5 days so as to separate this facility clearly from the commercial banks' interbank overnight market, and as step towards enhancing efficiency in the money market. Repo trading was also modified so that information on repos on offer would only come available after interbank operations had already been undertaken.

In previous Policy Statements, the efforts to expand the use of the Horizontal Repos as an appropriate way of distributing liquidity was discussed and advocated. In the course of these six months, the instrument has become more active both in terms of the variety of tenors at which they have traded as well as an increasing cross-section of banks participating. The Horizontal Repo proved to be a useful device in the course of the KenGen bond issue particularly when compared with previous experience in the earlier KenGen bond and Safaricom capital expansion.

In September 2009, the MPC introduced forums with Chief Executive Officers (CEOs) of commercial banks as an attempt to improve on the signalling process of its decisions. The meetings are held to provide a forum for the MPC to explain to the CEOs the background to its decisions as well as obtain feedback from the commercial banks.

c. Auctions of Government Securities

Efforts were made to improve efficiency in the Treasury bills auctions. These included separating the 91 and 182-day Treasury bills auctions into alternating weeks. Furthermore, a 364-day Treasury bill was introduced. It had many properties similar to the previously issued zero-rated one year Treasury bond. There was also increased participation in the Treasury bills market following the lowering of the threshold for investment in the securities from Kshs 1,000, 000 to Kshs 100,000.

d. National Payments System

A further effort at lowering transaction costs in the financial system was introduced through value capping of cheques and foreign exchange transfers valued at over Kshs 1.0 million such that they had to go through the Real Time Gross Settlement System (RTGS) of the KEPSS rather than through the electronic fund transfer (EFT). The Proceeds of Crime and Anti-Money Laundering Act was signed into law in December 2009 which should decrease the volatility of exchange rates associated with illegal fund flows.

e. Impact of Fiscal Developments on Liquidity

The Treasury's Fiscal Stimulus Package was being relied upon to spark growth recovery during the six months. Unfortunately, the requirements of carefully evaluating the proposals and project costs delayed the release of funds which were collected from taxation. These therefore, built up in Government deposits. This would have meant a short term constraint on liquidity had the CBK not moved in to pump in liquidity through reverse repos thereby dampening the increase in interbank rates which was signalling the liquidity shortage.

f. Inflation

Work with the KNBS was successfully completed on the launching of the new methodology being applied to the 1997 basket of goods in the CPI. The geometric mean used in this new index is the international best practice being recommended by the International Labour Organisation (ILO). The effect of the new measure has been to bring Kenya's inflation in line with its neighbours and trading partners like South Africa. Rather than being seen as a high inflation and therefore risky, destination for investment, Kenya therefore becomes an acceptable destination for foreign direct investment. The new measure reduced the vulnerability to volatile prices on some food products and so that, as the drought took its toll, the price instability was moderated.

g. Monetary Programme

The 24th MPS had envisaged reserve money (RM) and broad money supply (M3) to increase from Kshs 163.6 billion and Kshs 966.5 billion respectively in June 2009 to Kshs 174.5 billion and Kshs 1,036.4 billion respectively in December 2009 (Table 1). The achieved growth in money supply during the period supported growth in credit to private sector, and economic growth in general. Furthermore, monetary expansion did not affect inflation since the inflation process was generally influenced from the supply side. The monetary aggregates remained generally within the set targets as RM and M3 increased from Kshs 159.9 billion and Kshs 950.2 billion to Kshs 181.96 billion and Kshs 1,045.7 billion respectively during the period.

TABLE1: ACTUAL AND TARGETED GROWTH IN KEY MONETARY AGGREGATES

	Jun-09	Jul-09	Aug-09	Sep-09	Oct-09	Nov-09	Dec-09
Actual Broad Money,M3 (Ksh Billion)	950.24	973.62	982.85	986.90	1,006.01	1,022.42	1,045.66
Target Broad Money,M3 (Ksh Billion)	966.50	978.28	989.95	1,001.54	1,013.20	1,024.82	1,036.42
Actual Reserve Money,RM (Ksh Billion)	159.94	157.95	156.88	163.49	163.45	178.18	181.96
Target Reserve Money,RM (Ksh Billion)	163.58	161.04	162.89	164.74	166.61	168.50	174.50
Actual NFA of CBK (Ksh Billion)	208.78	206.39	208.69	210.18	217.35	224.77	222.89
Target NFA of CBK (Ksh Billion)	208.78	213.46	214.70	216.06	223.18	228.22	232.93
Memorandum Items							
Actual Annual Change in RM (Percent)	4.59	3.66	3.28	7.11	3.96	10.91	11.23
Actual Annual Change in M3 (Percent)	13.03	14.42	14.96	14.85	13.87	14.85	16.05
Actual Annual Change in credit to private sector (Percent)	20.71	16.30	15.91	10.54	10.97	10.81	15.55

Source: Central Bank of Kenya

Visits to other central banks MPCs continued during the period so as to establish best practice for the Kenyan environment in terms of the MPC operations and also monetary policy formulation and implementation.

3. Financial and Economic Trends and Events (July – December 2009)

a. International Economic Environment

The October 2009 and January 2010 data from the IMF's World Economic Outlook show that global real GDP growth fell from 3.0 percent to a projected -0.8 percent in 2009 (Table 2). The performance of the global economy mainly reflected contractions of advanced economies following the effects of the financial crisis in September and October 2008, and the after effects on emerging and developing economies that resulted in a slowdown in their growth. The contraction in demand for exports from the developed countries had major impact on some developing economies. However, developing Asia and Africa (excluding Zimbabwe) are estimated to have grown by 6.4 percent and 1.8 percent respectively in 2009.

Following a slowdown in demand and an increase in excess capacity in the advanced economies, inflation is estimated to have contracted from 3.4 percent in 2008 to 0.1 percent in 2009. Similarly, inflation for emerging and developing economies fell from 9.2 percent to 5.2 percent during the period. Consequently, world inflation is estimated to have decreased from 6.0 percent to 2.5 percent in the period.

TABLE 2: PERFORMANCE OF GLOBAL ECONOMY

	Real GDP Growth (%)			Inflation (%)		
	2007	2008	2009 (estimate)	2007	2008	2009 (estimate)
World	5.2	3.0	-0.8	4.3	6.0	2.5
Advanced Economies	2.7	0.5	-3.2	2.2	3.4	0.1
United States	2.1	0.4	-2.5	2.1	3.8	-0.4
Japan	2.3	-1.2	-5.3	0.0	1.4	-1.1
Euro Area	2.7	0.6	-3.9	2.1	3.3	0.3
United Kingdom	2.6	0.5	-4.8	2.3	3.6	1.9
Other Advanced economies	3.8	1.7	-1.3	2.1	3.8	1.3
Emerging and developing economies	8.3	6.0	2.0	6.4	9.2	5.2
Africa (Excl. Zimbabwe)	6.3	5.3	1.8	6.0	10.3	9.0
Sub-Sahara Africa	7.0	5.7	1.5	6.8	11.9	10.5
East African Community (Excl.Kenya)	6.8	8.0	5.1	7.8	14.4	12.3
Developing Asia	10.6	7.6	6.4	5.4	7.5	3.0
China	13.0	9.0	8.5	4.8	5.9	-0.1
India	9.4	7.3	5.6	6.4	8.3	8.7
Middle East	6.2	5.3	2.2	11.2	15.0	8.3

Source: World Economic Outlook (October 2009 and January 2010)

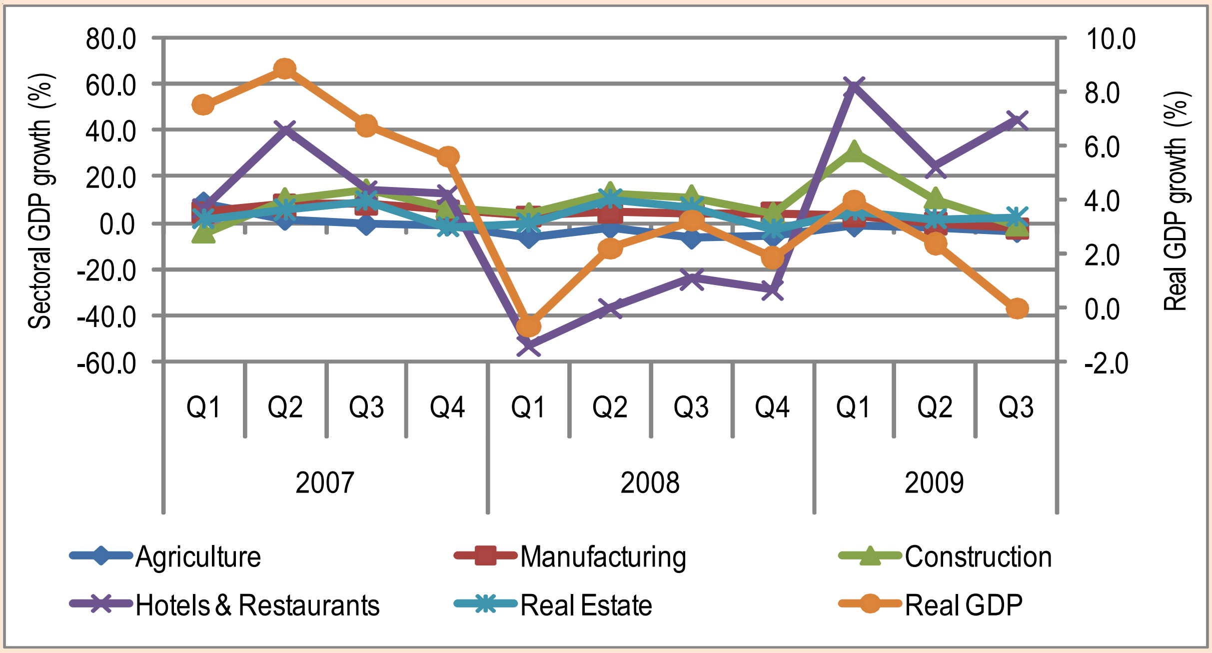
b. Domestic Economic Environment

i. Economic Growth

The economy stagnated in the third quarter of 2009, registering a growth of zero percent relative to the third quarter in 2008, down from 2.4 percent in the second quarter (Chart 2). The subdued performance of the economy in the third quarter of 2009 was attributed to persistence of drought conditions which impacted negatively on agricultural production, high energy prices and reduced external demand following the global financial crises. The poor performance in the third quarter was in Agriculture, manufacturing and construction which contracted by 3.5 percent, 2.4 percent and 1.1 percent, respectively. The contraction in electricity and water sectors was transmitted to the manufacturing sector.

However, hotels and restaurants achieved the highest growth of 44.4 percent following a continuation of the recovery in tourism. Similarly, the growth in real estate improved from 1.6 percent in the second quarter to 2.7 percent in the third quarter.

CHART 2: SECTORAL GDP GROWTH RATES



Source: Kenya National Bureau of Statistics

ii. Confidence in the Economy

Despite the stagnation of the economy in the third quarter of 2009, confidence in the Kenyan economy remained high in the period under review. This is depicted in Table 3 where diaspora remittances increased from USD 46.35 million in June 2009 to USD 56.33 million in December 2009 while the NSE index ranged between 3,083.6 indices and 3,294.6 indices in the period. Activity at the Nairobi Stock Exchange remained passive due to moderate participation of foreign investors. However, the number of tourist arrivals through Nairobi and Mombasa increased from 69,059 in June to 99,261 in December 2009 with a high of 100,314 in August 2009. The monthly cement production, which is an important proxy for economic activity in the country, was erratic suggesting unstable demand.

Confidence in the economy is also manifested in the results of the recent sovereign ratings. Standard & Poors review mission revised Kenya's sovereign rating in August 2008 from stable to positive but retained the rating of 'B' long-term foreign currency and local currency debts. This rating was retained in the July 2009 review mission. Fitch Ratings on the other hand conducted their annual review for the last time in November 2008 and retained the country's rating at B+ and BB- for long-term foreign currency and local currency debts, respectively, with stable outlook.

TABLE 3: INDICATORS OF CONFIDENCE IN THE ECONOMY

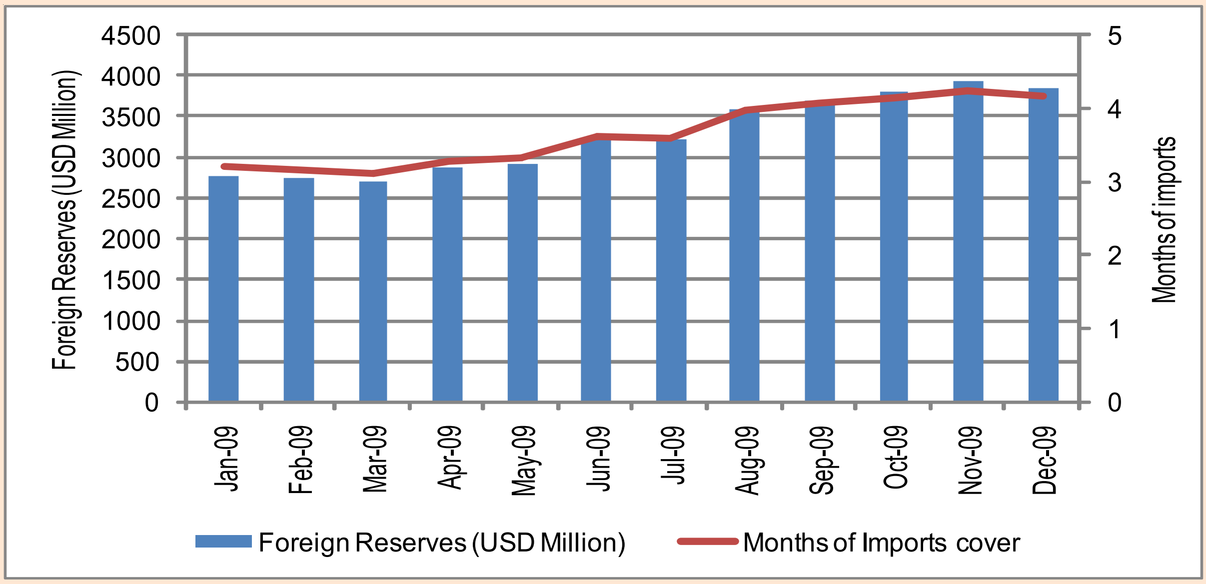
	Jun-09	Jul-09	Aug-09	Sep-09	Oct-09	Nov-09	Dec-09
Emigrant Remittances (USD Million)	46.35	50.37	55.95	53.35	53.04	48.23	56.33
NSE Index (Jan 1966 = 100)	3,294.56	3,273.10	3,102.68	3,005.41	3,083.63	3,189.55	3,247.44
Cement Production (Metric Tonnes)	258,534	248,340	243,162	206,870	247,811	251,792	242,251
Number of Tourist Arrivals	69,059	97,661	100,314	76,022	81,180	84,057	99,261

Source: Kenya National Bureau of Statistics

iii. Foreign Exchange Market

Official foreign exchange reserves of the Central Bank of Kenya increased significantly from USD 3,219 million (3.6 months of imports cover) in June 2009 to USD 3,847 million (4.1 months of imports cover) in December 2009 (Chart 3). The buildup in reserves during the period was on account of interbank purchases and additional special drawing rights allocation from the IMF in September 2009 to moderate the adverse effects of the global financial crisis. Consequently, the official foreign exchange reserves remained above the statutory requirement of 4.0 months of imports cover between September and December 2009.

CHART 3: FOREIGN EXCHANGE RATE

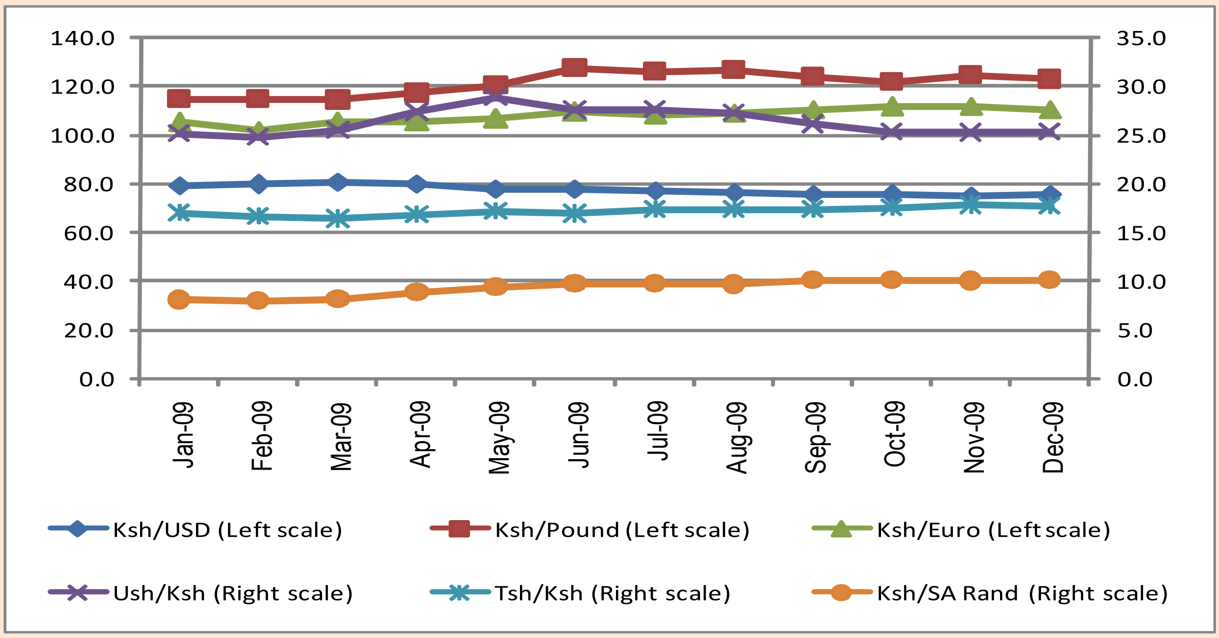


Source: Central Bank of Kenya

iv. Exchange Rates

As shown in Chart 4, the Kenya shilling strengthened against the US dollar, South African rand, Tanzanian Shilling and Sterling Pound between June and December 2009. However, the Shilling weakened against Euro and Ugandan Shilling during the period. The performance of the Kenya Shilling against the US dollar during the period was largely attributed to the weakening of the latter in the global market against the Euro and Japanese Yen. The general stability in the exchange rate of the Kenya Shilling against major currencies during the period was also attributed to significant increases in tourism earnings, diaspora remittances and earnings from tea exports.

CHART 4: TRENDS IN EXCHANGE RATE



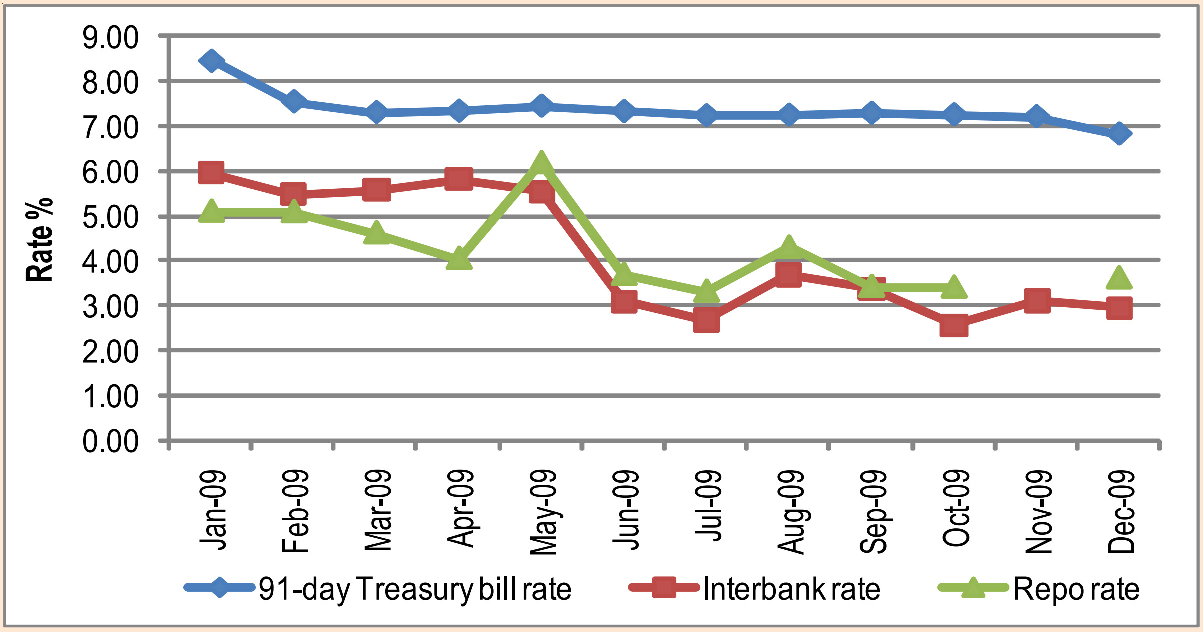
Source: Central Bank of Kenya

v. Interest Rates

The recent signals by the CBK to keep interest rates low, through reductions in the CBR and cash ratio rate, was successful in bringing down the short term interest rates significantly between May and December 2009 (Chart 5a). Reverse repos were used extensively during the six months ranging at rates between 3.3 percent and 3.7 percent in the period. Similarly, the interbank and 91-day Treasury bill rates declined from 5.6 percent and 7.5 percent to 3.0 percent and 6.8 percent, respectively, during the period.

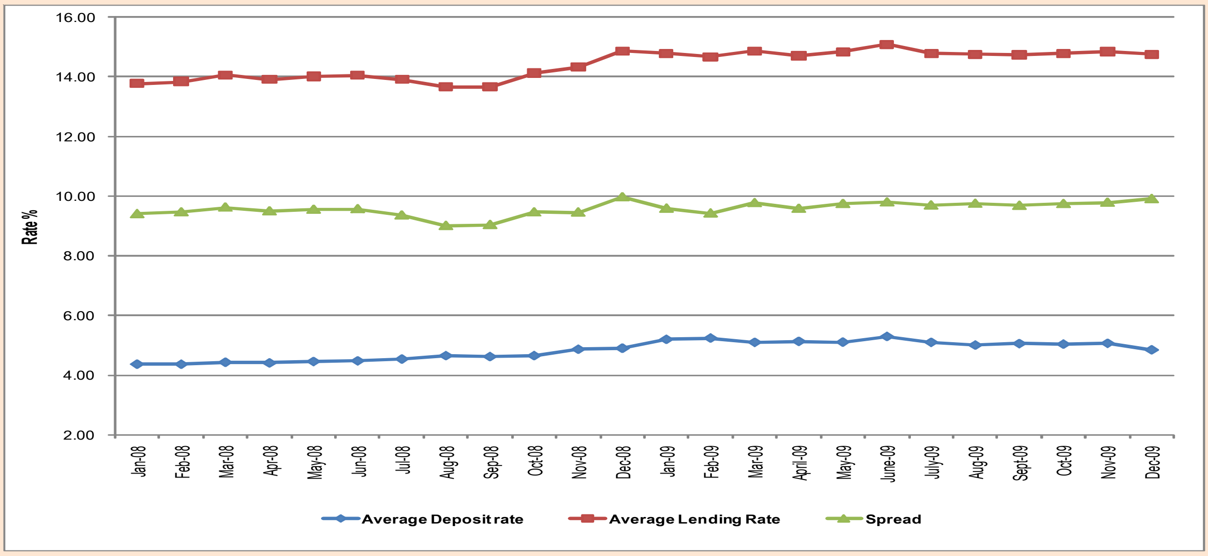
As depicted in Chart 5b, the average commercial banks deposit rate declined from 5.0 percent to 4.8 percent while the average lending rate fell from 14.9 percent to 14.8 percent between May and December 2009. However, the interest rate spread increased during the period following a faster decline in the deposit rate. Commercial banks lending rates have remained high due to structural rigidities in the intermediation process.

CHART 5A: TRENDS IN SHORT TERM INTEREST RATES



Source: Central Bank of Kenya

CHART 5B: TRENDS IN COMMERCIAL BANKS LENDING RATES



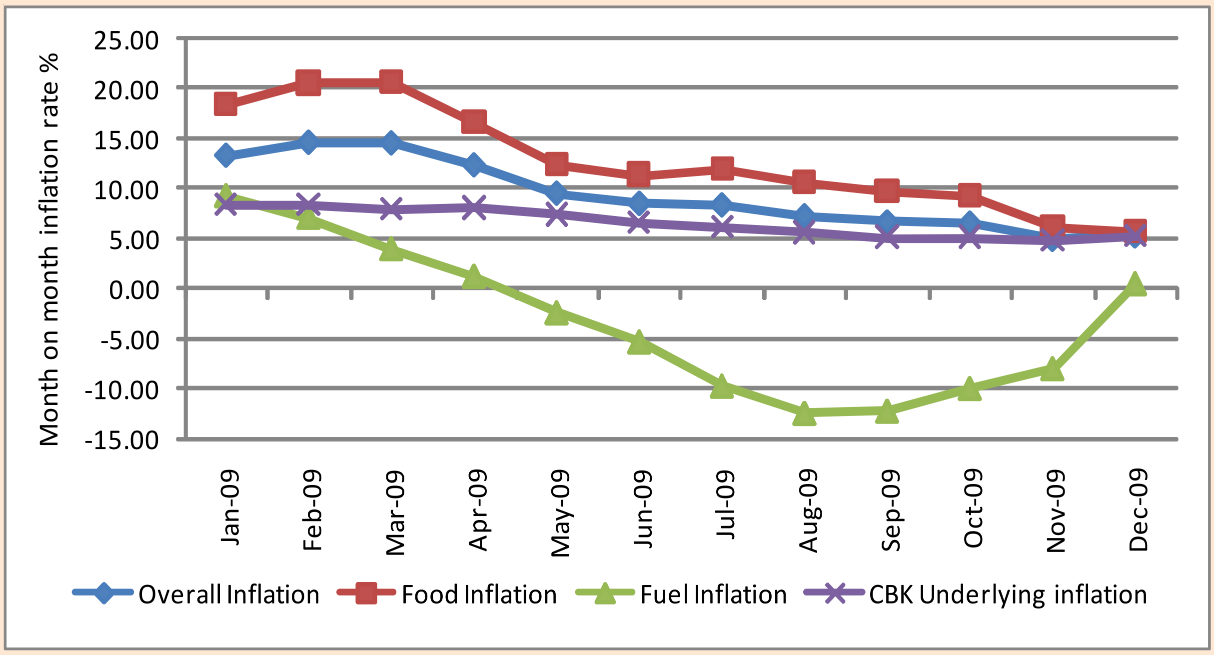
Source: Central Bank of Kenya

vi. Inflation

Both the overall and underlying inflation rates, based on the geometric mean methodology, have been falling since February 2009 (Chart 6). In particular, overall inflation fell from 8.57 percent in June to 5.34 percent in December while the CBK underlying inflation dropped from 6.70 percent to 5.20 percent during the period. The decline in the inflation levels was attributed to easing of food prices following a return of the rains as well as a fall in oil prices which resulted in lower fuel prices.

The KNBS released the new inflation series in October 2009 which resulted in a significant drop in reported inflation. The level of recorded inflation had been seriously distorted by the previous computational methodology. For instance, September 2009 inflation under the old methodology was 17.9 percent whereas under the new methodology it was 6.71 percent. The new measure continued the downward trend perceived under the old methodology where inflation had dropped from 26.07 percent in April to 17.5 percent in October 2009. Under the new methodology inflation dropped from 12.39 percent in April to 6.6 percent in October 2009.

CHART 6: TRENDS IN INFLATION (Geometric Mean CPI)



Source: Central Bank of Kenya

vii. Fiscal and Public Debt Developments

During the first half of the fiscal year 2009/10, Central Government budgetary operations resulted in a deficit-to-GDP ratio of 2.4 percent on commitment basis compared with 0.2 percent in a similar period of 2008/09. Despite the increase, the budget deficit during the period was within the programmed target of 3.9 percent of GDP on commitment basis. Similarly, Kenya's public and publicly guaranteed debt increased from 44.0 percent of GDP in June 2009 to 45.4 percent of GDP in December 2009. The external debt to GDP ratio decreased from 22.4 percent in June 2009 to 21.4 percent in December 2009, while the domestic debt to GDP ratio increased from 21.7 percent to 24.0 percent during the period.

4. Outlook for the Monetary Policy Environment (January – June 2010)

a. Global Economy

As shown in Table 4, the IMF projects the global economy to recover strongly to around 6.0 percent in the emerging and developing countries, and a modest 2.1 percent in the advanced countries. Specifically, sub-Saharan Africa and East African countries (excluding Kenya) are forecast to grow at 4.3 percent and 5.1 percent respectively in 2010. Progress towards the adoption of the East African Community Common Market Protocol is also expected to boost trade. The inflation level for the world economy is projected to fall to 3.0 percent in 2010 as the developed countries implement monetary policies to mop up the excess liquidity from the fiscal stimulus packages implemented in 2009 to mitigate the impact of the global financial crisis.

TABLE 4: OUTLOOK FOR REAL GDP GROWTH AND INFLATION IN 2010 (%)

	Real GDP	Inflation
World	3.9	3.0
Advanced Economies	2.1	1.3
United States	2.7	1.7
Japan	1.7	-0.8
Euro Area	1.0	0.8
United Kingdom	1.3	1.5
Other Advanced economies	3.3	1.6
Emerging and developing economies	6.0	5.4
Africa (Excl. Zimbabwe)	4.2	6.5
Sub-Sahara Africa	4.3	7.3
East African Community (Excl.Kenya)	5.1	7.6
Developing Asia	8.3	3.4
China	10.0	0.6
India	7.7	8.4
Middle East	4.5	6.6

Source: World Economic Outlook (October 2009 and January 2010)

b. Domestic Economy

i. Economic Growth

The recovery in the global economy in 2010 is expected to increase the demand for Kenya's exports as well as the number of tourist arrivals in the country. Results of the survey on perceptions on the performance of the economy conducted by the CBK indicate a resurgence of confidence in the attainment of the Government's economic growth target of between 4–5 percent in 2010, with increased growth in credit to private sector. In addition, imports of capital equipment and emigrant remittances together with the upturn in the Nairobi Stock Exchange activity all portend a positive growth scenario.

ii. Exchange rates

The exchange rate of the Kenya shilling against major currencies is expected to remain stable in the first half of 2010 on account of an expected increase in foreign exchange inflows from tourism (also includes the impact of the football world cup in South Africa in June 2010), recovery of the global economy, agriculture exports (horticulture, tea, and coffee), diaspora remittances, and increase in foreign investor confidence at the NSE. However, high oil prices and recovery of the US economy pose a risk on the strength of the Kenya Shilling.

iii. Interest rates

Interest rates are expected to remain stable in the first half of 2010 on account of economic recovery which is expected to increase demand and competition for credit, lower inflation rates, and the high liquidity in market which is expected to result in a decline in the short term interest rates and interest rates on Government securities.

iv. Inflation

The KNBS is expected to produce the new Consumer Price Index (CPI) embodying the new consumer basket at the end of February 2010. This more relevant CPI basket will de-emphasise the vulnerability to fluctuations in food prices. Consequently, the CBK will have a better measure to address its statutory requirements of ensuring price stability. The Central Bank will work with KNBS on appropriate measures for core inflation or the inflation on non-tradable goods. The CBK's perceptions survey revealed that the business community and financial sector were not anticipating significant changes in inflation in 2010.

v. Fiscal Policy

The ongoing expenditure under the Fiscal Stimulus Package and expenses under other infrastructural projects will enhance employment and consumer expenditure to stimulate economic growth. Tax revenue collection in the last half of 2009/10 fiscal year is also expected to improve with the anticipated domestic economic recovery. Consumption and income taxes have been performing well suggesting that earlier slippages in economic activity have now being rectified. Furthermore, the current deficit financing process is not a major threat to interest rates and debt sustainability.

5. Future Direction of Monetary Policy (January – June 2010)

The direction of monetary policy during the first six months of 2010 will be concentrated on three areas. The first will be setting targets which are compatible with the responsibilities of maintaining a low and stable inflation, encouraging growth and ensuring the long term sustainability of public debt. The second relates to a variety of modes of extending banking services within the economy, while the third establishes and continues with the medium term research agenda.

5.1 Monetary Programme and Foreign Exchange Reserves

The main assumptions for the monetary targets for 2009/10 are based on the June 2009/10 Budget Strategy Paper. These are presented in Annexes 1 and 2. The monetary targets for the last half of the fiscal year 2009/10 are presented in Table 5. Broad money supply, M3, is set to grow by 18.2 percent by March 2010, and 14.5 percent by June 2010. Reserve money is programmed to expand by 13.2 percent in March 2010 and by 10.9 percent in June 2010. This is expected to enable the Bank achieve the policy objective of bringing inflation to the target of 5 percent and to anchor inflation expectations. The Monetary Policy will stabilise short term interest rates and so credit to the private sector is projected to grow by between 16.9 percent and 18.2 percent in the period.

TABLE 5: MONETARY TARGETS FOR 2009/10

	Dec-09 Act.	Dec-09 Targ.	Jan-10 Targ.	Feb-10 Targ.	Mar-10 Targ.	Apr-10 Targ.	May-10 Targ.	Jun-10 Targ.
Broad Money, M3 (Ksh Billion)	1,045.50	1,036.42	1,048.02	1,059.56	1,071.25	1,083.03	1,094.70	1,106.61
Reserve Money, RM (Ksh Billion)	181.96	174.50	173.40	175.24	175.91	177.74	179.55	181.38
NFA of Central Bank of Kenya (Ksh Billion)	222.89	232.93	237.98	242.87	247.92	252.73	257.78	262.49
Annual Change in RM (Percent)	11.23	6.67	13.71	15.42	13.20	16.24	11.94	10.88
Annual Change in M3 (Percent)	16.05	15.00	17.05	17.73	18.23	16.60	17.89	14.50
Annual Change in Credit to Private Sector (Percent)	15.55	14.80	14.48	13.99	16.92	17.58	17.98	18.18
Real GDP Growth (Percent)		3.00						3.10
Overall Inflation (Percent)	5.30	5.00						5.00

Source: Central Bank of Kenya

The Bank will continue to monitor developments in the Monetary Targets and make any necessary reviews. The attainment of the targets set will however depend on stability in the international prices of oil, easing in the drought conditions, stability of the exchange rate, and commitment by the Government to operate within the domestic borrowing ceiling for fiscal year 2009/10. Monetary policy implementation will be based on monthly targets for reserve money to be achieved through open market operations. The repos will be used to withdraw any excess liquidity in the banking system on a timely basis and where necessary reverse repos will inject liquidity. The strong seasonal demand for currency by the public has been built into the programme.

5.2 Extending Access to Financial Services

There are many dimensions which have been identified where financial service delivery to the public and economy at large can be improved. Already, many banks have been bringing in Sharia-related products thereby expanding acceptable services to a significant portion of the community. Other portions of the economy are lagging behind and have largely been using mobile phone related services as a way of enhancing the purchasing power and easing time constraints in using existing financial services. Branchless banking must therefore move up in the policy agenda and such things as permitting agency banking and the creation of well targeted products must become part of the thrust during the coming six months. Specifically, small and medium enterprises and microfinance institutions need to be served better considering collateralization questions as well as regulation to ensure the best service to both depositors and borrowers. Besides the small scale sectors of the economy, the large investment projects required for economic growth have been identified as a segment of the economy that is ill-served by the present structures since it is impossible to match portfolios of short term deposits with long term lending.

5.3 Measures to Enhance Market Efficiency

The Bank will continue to implement various measures to enhance the transmission mechanism of monetary policy from the short term interest rates to the commercial banks lending rates. Credit reference bureaus to lower risks and identify serial defaulters will be developed while on the other hand the investing public will be assisted in accessing riskless Government paper through the development of convenient nationwide outlets. Measures to enhance the uptake of Horizontal Repos among banks will be implemented while stakeholder forums with CEOs and Treasury managers of banks will be held.

5.4 Research Agenda

In order to ensure that policy decisions are well informed, research will be conducted on the transmission mechanisms to establish both the length of the lag from the signal to outcome and the precise intermediate modalities which, in the course of their intervention between such signals and outcomes, may distort or dampen their significance. Specifically, the monetary programme mentioned earlier is dependent on the stability of the demand for money and therefore its predictability, the extent to which those instruments available to the Monetary Policy Committee can be used to fine tune the money supply and the foreign exchange reserves will be explored.

Since the prime objective of the Central Bank is to formulate and implement monetary policy to achieve and maintain stability in the general level of prices, it follows that the production by the Kenya National Bureau of Statistics (KNBS) of a new CPI index in the course of the next six months will require significant research to incorporate the new data into existing models while at the same time working with KNBS to produce a more fruitful vector of inflation indices. International best practice, in general, recommends the use of a tradable goods inflation index as a requirement for understanding how international events convert into domestic outcomes.

It is intended that visits to other countries to study their modalities of monetary policy formulation and implementation will continue during the six months.

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

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

BOPA = Budget Outlook Paper

BSP = Budget Strategy Paper

Source: Ministry of Finance

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

(end of period; in billions of KSh)

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

1/ At current exchange rate

Source: Ministry of Finance and Central Bank of Kenya

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

July 2009	a)	Commence alternate week auctions for 91-day and 182- day Treasury bill
	b)	Lengthen tenor of repo bills to 7 days.
	c)	CBR reduced from 8.00 to 7.75 percent and cash ratio rate from 5.0 to 4.5 percent.
August 2009	a)	Introduce 364 day Treasury bills to be auctioned bi-Monthly.
	b)	Shift the time when repo trading starts from 10.00 am to 11.30 am.
October 2009	a)	Value capping of cheques to be cleared through Electronic Fund Transfers. Cheques over Kshs 1.0 million to go through RTGS
	b)	Introduction of the geometric mean in computation of the Consumer Price Index (CPI) and the consequent inflation.
November 2009		CBR reduced to 7.00 percent.

GLOSSARY OF KEY TERMS

Overall Inflation

This is a measure of inflation in the economy measured by the month-on-month movement of indices of all consumer price items of goods and services sampled by the Kenya National Bureau of Statistics (KNBS). It is affected by commodity components in the market that may experience sudden inflationary spikes such as food or energy and may therefore not present an accurate picture of the current state of the economy.

Underlying Inflation

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

Reserve Money

These are CBK's monetary liabilities comprising currency in circulation (currency outside banks and cash held by commercial banks in their tills) and deposits of both commercial banks and non-bank financial institutions held with the CBK. However, it excludes Government deposits.

Money Supply

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

M1 Currency outside banking system + demand deposits
M2 M1 + time and savings deposits + certificates of deposits + deposit Liabilities of Non-Bank Financial Institutions (NBFIs)
M3 M2 + residents' foreign currency deposits

Central Bank Rate (CBR)

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

Open Market Operations (OMO)

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

Repurchase Agreement (REPO)

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

Horizontal REPO

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

Reserve Money Programme

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

Cash Reserve Requirement (CRR)

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

Term Auction Deposits

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