CENTRAL BANK OF KENYA

The Eighth Monetary Policy Statement

Issued under the Central Bank of Kenya Act

June 2001

The Eighth Monetary Policy Statement

CONTENTS

OBJECTIVES OF THE CENTRAL BANK OF KENYA

Principal Objectives

The objects of the Central Bank are laid down in the Central Bank of Kenya (Amendment) Act, 1996 as follows:

1. The first principal objective shall be to formulate and implement monetary policy directed to achieving and maintaining stability in the general level of prices.

2. The second principal objective shall be to foster the liquidity, solvency and proper functioning of a stable market based financial system.

Secondary Objectives

Without prejudice to the generality of the above two principal objectives, the Bank's secondary objectives shall be to:

1. Formulate and implement foreign exchange policy;

2. Hold and manage its foreign exchange reserves;

3. License and supervise authorised dealers in the money market;

4. Promote the smooth operation of payments, clearing and settlement system;

5. Act as a banker and adviser to, and as fiscal agent of the Government; and

6. Issue currency notes and coins.

LEGAL BASIS FOR THE PUBLICATION OF THE MONETARY POLICY STATEMENT

This statement is made pursuant to Section 4(B) of the Central Bank of Kenya Amendment Act 1996, which states that:

(1) The Bank shall at intervals of not more than six months, submit to the Minister a monetary policy statement for the next twelve months which shall -

(a) specify the policies and the means by which the Bank intends to achieve the policy targets;

(b) state the reasons for adopting such policies and means; and

(c) contain a review and assessment of the progress of the implementation by the Bank of monetary policy during the period to which the preceding policy statement relates.

(2) The Minister shall 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 shall -

(a) cause -

(i) every monetary policy statement submitted under subsection (1); and

(ii) its monthly balance sheet to be published in the Gazette; and

(b) 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.

1. IMPLEMENTATION OF MONETARY POLICY IN THE LAST TWELVE MONTHS TO JUNE 2001

Increased focus on achieving the inflation target

During the 12-month period to June 2001, the Central Bank intensified its monetary policy efforts towards maintaining price stability, specifically aimed at achieving an inflationary rate below 5%. To achieve this objective, the Bank had set the path of reserve money, that is, the anchor the Bank uses as its intermediate target, consistent with the expected rate of economic growth and the target inflation as shown in Table 1.

Table 1: Reserve Money Performance (shs m)

	ACTUAL (A)	TARGET (B)	PERFORMANCE C=(A-B)
Sep-00			
Reserve Money	74,305	76,271	-1,966
Net Foreign Assets	56,779	54,356	2,423
Net Domestic Assets	17,526	21,915	-4,389
Dec-00			
Reserve Money	74,816	74,284	532
Net Foreign Assets	56,638	56,470	168
Net Domestic Assets	18,178	17,814	364
Mar-01			
Reserve Money	73,612	73,624	-12
Net Foreign Assets	62,766	57,462	5,304
Net Domestic Assets	10,846	16,162	-5,316
Jun-01			
Reserve Money	71,659	71,382	277
Net Foreign Assets	66,130	64,512	1,618
Net Domestic Assets	5,529	6,870	-1,341

Tighter monetary policy stance pursued

In October 2000, the Bank revised the minimum cash ratio from 12% to 10% in line with its medium term policy to move away from the use of cash ratio to open market operations in the management of domestic liquidity. To ensure that the expansion in money supply was contained within the range compatible with the inflation target and the expected level of economic activity, the Bank revised the reserve money targets downwards in November 2000 and in May 2001.

The Bank successfully kept the reserve money within the programmed path in the year (Table 1) by stepping up its open market operations. As a result, the stock of repurchase agreements (REPOs) bills held by banks rose from shs 10.6bn by the end of June 2000 to shs 20.7bn by the end of March 2001 before declining to shs 16.6bn by end June 2001.

Expansion in monetary aggregates was on track

The trend of money supply during the period under review is shown in Table 2 below. The performance in monetary aggregates mirrored the stance of monetary policy adopted by the Central Bank and the slowdown in economic activity to a level below what had originally been envisaged. The increase in the money supply during this period mainly reflected: (i) credit expansion to the private and other public sectors of 4.0%; and, (ii) an accumulation of net foreign assets (NFA) by the banking system that partly benefited from inflows of programme finance in the first quarter of Fy 2000/01.

Table 2: Annual Change in Selected Monetary Aggregates (%)

	RM	M3	M3X	M3XT
Dec'99	5.3	2.8	3.7	6.4
Jun'00	4.0	0.2	1.4	5.8
Dec'00	-1.6	0.8	3.4	4.5
May '01	-2.9	-0.8	2.2	6.5

A notable development in the banking sector during the second half of the fiscal year was the increase in residents' deposits denominated in foreign currencies. This development was mainly attributed to an expectation of a substantial depreciation of the shilling exchange rate due to a heightened uncertainty surrounding the timing of resumption of budgetary support under the Poverty Reduction and Growth Facility (PRGF).

Credit to Government declined

Meanwhile, net credit to Government from the banking system declined by 1.0% in the year to June 2001 compared with a target of 4.6%. The decline was less rapid than programmed as the Government had to borrow more from the domestic market to finance expenditures that were originally envisaged to be financed with the external funds which were withheld in November 2000. Delays in the privatization of the Telkom Kenya Ltd. also affected the ability of the Government to reduce its net borrowing from the banking system.

The slowdown in monetary expansion helped to contain the inflationary pressures. The underlying month-on-month inflation declined from the double digit levels observed in the last quarter of 2000 to about 7% in June 2001.

2. SHILLING EXCHANGE RATE

After weakening in 2000, the shilling has stabilised

The shilling came under increasing pressure during the first ten months of 2000, weakening from shs 70.68 to the US dollar in January to shs 79.26 in October 2000. It recovered in November, and has since then been generally stable trading on average at about shs 78.30 per US dollar. This was against the backdrop of declining domestic interest rates and expectations of a further weakening of the shilling due to the suspension of PRGF-related budgetary support. The stabilisation of the shilling exchange rate between November 2000 and June 2001 reflected strong foreign exchange receipts from tea, horticulture and tourism, coupled with weak corporate demand for foreign exchange that helped mitigate the adverse effects of the delay in disbursements of external programme finance.

The exchange rate is expected to remain stable in the next financial year, reflecting the expected stability in Treasury bill rates and the expected resumption of programme budgetary support in September/October 2001.

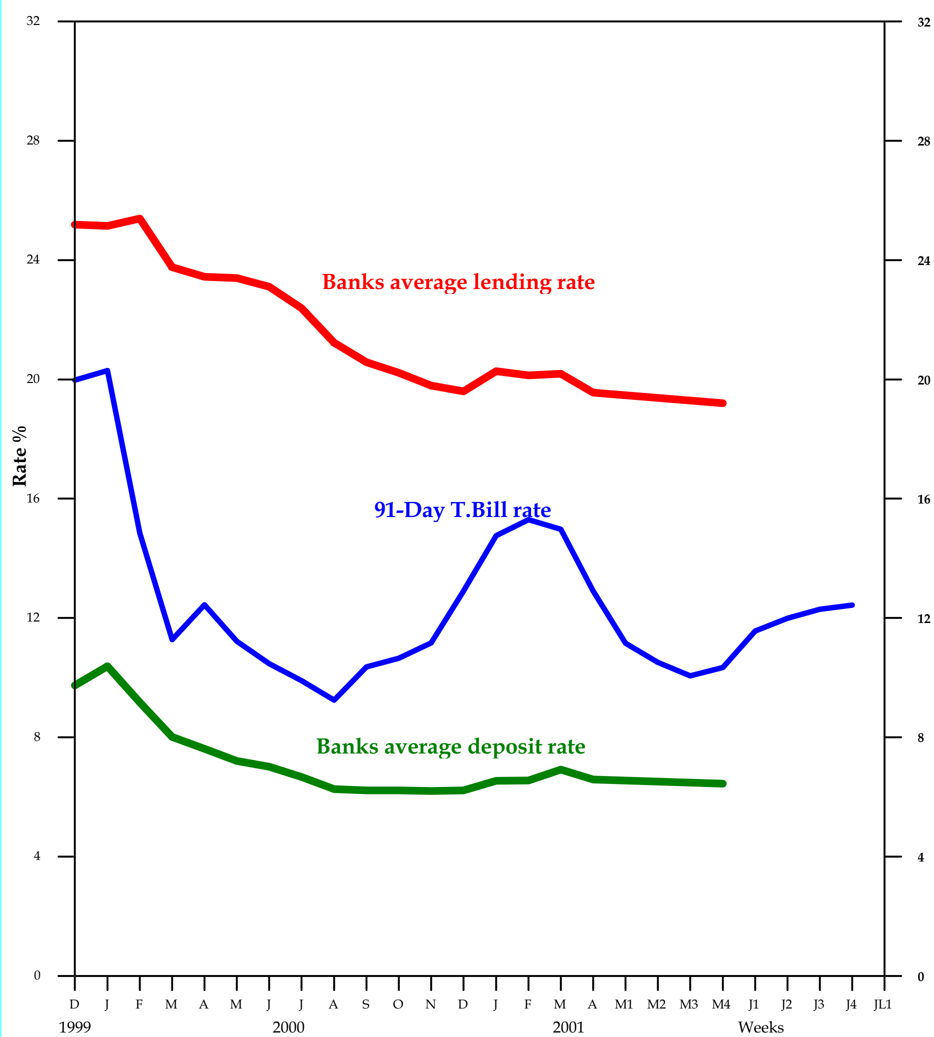
3. INTEREST RATES

3.1 Recent Developments

Interest on the 91-days Treasury bills fluctuated in the year

Interest rates in Kenya generally follow the trend of the interest rate for the 91-day Treasury bills. As shown in Chart 1, the 91-day Treasury bills rate declined for seven consecutive months from a high of 20.3% in January 2000 to a low of 9.2% in

CHART 1: TRENDS OF INTEREST RATES



Source: Central Bank of Kenya

Lack of alternative investment avenues led to increased focus on Treasury bills

August 2000. This reflected increased competition for the bills on offer by major investors in the absence of other profitable investment opportunities as economic activity continued to slow down. The consequent heavy demand for Treasury bills therefore pushed the rate below the originally expected levels. This meant that the liquidity in circulation was actually more than what was required to support productive economic activity. Recognising the danger that lay ahead, the Central Bank inevitably made effort to mop up the excess liquidity in order to forestall any resurgence in inflation.

The trend, however, reversed in September 2000 with the rate rising to 15% in March 2001. This reflected mainly additional domestic borrowing, which the Government had to undertake to cover the gap created by the delay in the disbursement of expected external budgetary support under the Poverty Reduction and Growth Facility. Since March, the rate has ebbed, save for a slight upward movement in May - June 2001.

Meanwhile, the deposit and lending rates have also been moving downward more or less in line with the trend of the Treasury bill rate.

3.2 Outlook for the next 12 months to June 2002

During the first half of Fy 2001/02, interest rates are expected to remain under intense pressure given the continued need for domestic financing of the budget deficit as not much external programme finance is envisaged to flow during this time. The pressure will, however, ease thereafter when external programme funds are expected to be disbursed.

4. DOMESTIC DEBT

Domestic Debt Structure

The level and maturity of structure of domestic debt has, and continues to be, a significant challenge to the Government. Securitised government domestic debt currently stands at shs 178bn, with the 91-day Treasury bills accounting for 74%. Moreover, on average, about 8.5 bn of the outstanding Treasury bills mature every week, thereby complicating the management of the cashflow of the Government. The Central Bank, as the fiscal agent of the Government, has therefore had to be in the market every week seeking to rollover the maturing bills. This trend has put excessive pressure on Treasury bill and other domestic interest rates.

CBK adopts a domestic debt restructuring programme

To address this problem, the Central Bank adopted a restructuring programme aimed mainly at: (i) reducing the share of the 91-day Treasury bills in the domestic debt; and (ii) developing a yield curve so that the structure of domestic interest rates reflects better the maturity profile of various debt instruments.

Result of restructuring programme are encouraging

As part of this programme, the Central Bank issued a 5- year floating rate Treasury bond for shs 5bn in May and a 3-year floating rate Treasury bond for shs 6bn in June 2001. The 5-year bond had a performance rate of 86% while the 3-year bond registered a performance rate of 140%. Part of the proceeds from the sale of Treasury bonds was used to finance redempitons of Treasury bills. As a result, Treasury bills which stood at 79% of the total domestic debt in April 2001 came down to 74% at the end of June 2001. This was a commendable achievement. More importantly, the willingness to invest in long-term government securities is significant as it reflects a major improvement in the future prospects of the Kenyan economy and an endorsement of the reform process the Government is implementing.

5. INFLATION

5.1 Recent Developments

Inflation pointed upwards reflecting supply-side shocks

Over the period between July and December 2000, both the overall and underlying inflation were on an upsurge (Table 3). **Overall month-on-month inflation** rose from an average of 6% in June to 7.5% in December 2000, while **underlying month-on-month inflation** increased more rapidly from 8.3% in June 2000 to 10.7% in December 2000. Paramount among the reasons for the acceleration in inflation were the rising cost of fuel and power associated with the steep rise in international prices of crude oil, the depreciation of the shilling, and the higher food prices following food supply shortages caused by the severe drought that afflicted the country during this period.

Table 3: Month-on-month Inflation (%)

	2000					2001					
	Jan	Mar	Jun	Sep	Dec	Jan	Feb	Mar	Apr	May	Jun
Underlying	8.2	8.4	8.3	11.6	10.7	10.1	10.5	7.1	7.8	7.3	7.2
Overall	8.7	3.4	6.0	7.1	7.5	6.0	5.2	3.9	3.7	2.1	0.2

Tighter monetary policy stance reduced inflationary pressures

On realising the threat of inflation surging even further, the Bank tightened monetary conditions between January and June 2001. The need to tighten monetary policy was intensified by weaker than expected prospects for economic recovery that became clear by the end of the January/March 2001 quarter. Following the tightening of monetary policy, coupled with improved food supply situation and the decline in international prices of crude oil, inflation decelerated. Overall month-on-month inflation declined to 2.1% in May and 0.2% in June 2001 from 7.5% in December 2000, while underlying month-on-month inflation, though still above the 5% target, eased to 7.3% in May and 7.2% in June 2001 from 10.7% in December 2000.

5.2 Outlook for the next 12 months to June 2002

Inflationary pressures expected to recede

As already noted, in view of the expected improved performance in agricultural production, food prices are expected to continue declining in the next twelve months. The shilling is also forecast to remain stable in the year, thus minimising inflationary pressures emanating from this source. Meanwhile, in the international scene, oil prices are expected to stabilise and inflation in developed countries is expected to be subdued. Taking all these factors into consideration, overall inflation is forecast to stabilise at around 4-5% in the next one year. However, as noted above, the underlying inflation currently exceeds the 5% target. It is therefore important that tight monetary policy, coupled with prudent fiscal policy, continue to be pursued in the period ahead.

6. MONETARY POLICY FOR THE PERIOD JULY 2001 TO JUNE 2002

6.1 Policy Objective

Increased focus to bring down and contain inflation within the 5% target

The Bank remains focused on achieving and maintaining the 5% inflation target in the next one year to June 2002. The pursuit of this objective will continue to be the Bank's principal contribution to sustained economic growth, employment generation and lasting reduction in poverty. As already noted, the rate of underlying inflation still remains ahead of the desired target. There is, therefore, no room for complacency and the firm monetary policy stance that was pursued through the first half of 2001 will be maintained.

6.2 Monetary Programme

Reserve money programmed to increase by 9.8%

During the next 12-month period to June 2002, the economy is expected to grow by 2.6%, propelled mainly by increased agricultural production and improved manufacturing output in the face of improved electric power supply. Taking this into account and the inflation target of 5%, reserve money is programmed to increase by around 9.8% (Table 4). Growth in broad money supply (M3X) will be limited to around 8% and credit to the private sector and other public sector is programmed to increase by about 10%, adequate to support the envisaged improved recovery. Meanwhile, in line with its commitment to reduce domestic debt, the Government is not expected, on a net basis, to borrow from the banking system.

Table 4: Reserve Money Programme, Jun'01 – Jun'02

	Jun'01 Est.	Dec'01 Proj.	Jun'02 Proj.
Reserve Money	71,659	78,632	78,650
Net Foreign Assets	66,130	72,933	76,127
Net Domestic Assets	5,529	5,700	2,524
Memo Item:			
Repo bills	16,060	16,679	14,675

6.3 Instruments of Monetary Policy

Monetary policy instruments to remain the same

To manage expansion in domestic credit and money supply in the economy in line with the stipulated monetary programme for the year, the Central Bank will continue to:

(i) Buy and sell Treasury bills or any other stipulated government paper, from time to time, in the open market with a view to influencing the level of bank reserves.

(ii) Require commercial banks to hold a specified minimum cash deposits at the Central Bank currently equivalent to 10% of their deposit liabilities.

(iii) Provide, as the lender of last resort, liquidity to commercial banks but in a manner that will not compromise the monetary policy stance for the year 2001/02.

7. STABILITY IN THE BANKING SECTOR

7.1 Overview

Noticeable improvement in banking sector profitability

The banking sector realised some appreciable improvement in year 2000. Published audited accounts of banks for the year 2000 showed a marked improvement in the financial performance over 1999. This was mainly as a result of the placing into liquidation institutions previously under statutory management whose poor performance were impacting negatively on the sector.

Several measures were undertaken by the Central Bank during the first half of 2001 to further strengthen the banking sector. The measures included the following:

(i) Issuing of a circular in January 2001 requiring all banking institutions to publish their audited accounts in the newspapers in the prescribed format by 31st March 2001. Enhanced disclosure requirements on non-performing loans, insider loans and provisions made for bad and doubtful loans ensured more transparency and accountability by the institutions. The circular called for the convening of tripartite meetings between the Central Bank, external auditors of institutions and their management where compliance with disclosure requirements on non-performing loans, insider loans and provisioning would be discussed prior to publication of financial results.

Recent prudential measures

(ii) The vetting of new directors of banking institutions was further tightened. A circular in this regard was issued in January 2001 requiring that the names of proposed new directors together with completed 'fit and proper' forms be forwarded to the Central Bank at least 14 days before the date of the Annual General Meeting where the directors are to be elected. This will allow adequate time for the vetting process and ensure that only eligible persons are voted in as directors of banking institutions.

The results of these measures, together with other measures the Central Bank has been implementing in the resent past, are encouraging. The banking sector is fairly stable with the number of collapsed institutions reducing significantly in the last five years. In addition, the financial position of the industry as a whole has been fairly strong with both core capital being around 8% of deposits and average liquidity at about 43% of deposits in May, 2001.

7.2 Further Measures to Strengthen Banking Stability

During the remaining part of year 2001, the Central Bank of Kenya will continue pursuing policies already in place to ensure that the sector remains stable. These include:

(i) Further strengthening of Bank Supervision Department through training of personnel and automation of work process.

(ii) Formulating legislation to facilitate operation of Credit Reference Bureaus. Proposals on legislation to allow banking institutions disclose debtor information were incorporated in the Banking (Amendment) Bill, 2001.

(iii) Developing a regulatory framework for micro-finance institutions. A draft micro finance bill is being discussed between the Association of Micro Finance Institutions and the Central Bank of Kenya before being presented to Parliament for enactment into law.

(iv) Working closely with the three East African Central Banks to harmonise banking legislation and supervisory practices within the region. The Bank is overseeing implementation of the recommendations adopted at the meeting of the Capital Markets, and Monetary and Fiscal Affairs Committees that was convened by the East African Community secretariat in May 2001.

8. OVERALL OUTLOOK

This monetary policy statement provides an assessment of economic and financial developments in the last twelve months, paying particular attention to monetary policy and regulation of the banking sector. The analysis indicates that inflation surged in the last half of 2000 but declined to within the single digit range in the first half of 2001 following the tightening of monetary policy by the Central Bank. The Bank was also successful in ensuring relative stability in the banking system.

The Bank is poised to continue to pursue a relatively cautious monetary policy stance in line with the envisaged economic growth during the next 12 months, while ensuring that we achieve the 5% inflation target. On banking stability, the Central Bank plans to take additional measures to further strengthen the sector, particularly measures to reduce the magnitude of non-performing loans.