NINTH
BI-ANNUAL REPORT OF THE MONETARY POLICY COMMITTEE

BANKI KUU YA KENYA

Central Bank of Kenya

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Enquiries concerning the Report should be addressed to:
Monetary Policy Committee Secretariat,
Central Bank of Kenya,
P.O. Box 60000-00200 Nairobi, KENYA**

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LETTER OF TRANSMITTAL TO THE MINISTER FOR FINANCE

Honourable Minister,

I have the pleasure of forwarding to you the ninth bi-annual Monetary Policy Committee (MPC) Report in accordance with section 4D (6) of the Central Bank of Kenya Act. The Report outlines the monetary policy formulation; developments in key interest rates, exchange rates and inflation and other activities of the Committee in the six months to October 2012. Copies of MPC Press Statements and the Minutes of all the Meetings of the MPC between May and October 2012 are attached to the Report for your information.

Prof. Njuguna Ndung'u, CBS
Governor, Central Bank of Kenya

TABLE OF CONTENTS

MEMBERS OF THE MONETARY POLICY COMMITTEE

Prof. Njuguna Ndung'u (CBS)
Governor, Chairman

Dr. Haron Sirima (OGW)
Deputy Governor, Vice-Chairman

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PS, Treasury
Treasury Representative

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Member

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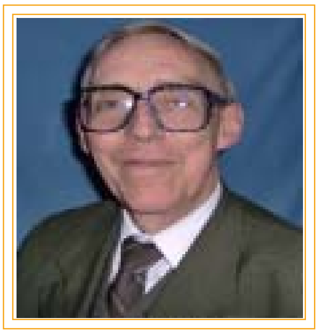
Member

Prof. Francis Mwega
Member



Prof. Terry C. I. Ryan
Member

Mrs. Farida Abdul
Member

Mr. John Birech
Member

EXECUTIVE SUMMARY

The ninth bi-annual Report of the Monetary Policy Committee (MPC) reviews Kenya's monetary policy formulation and economic developments during the six months to October 2012. Monetary policy operations in the six months to October 2012 were aimed at bringing down inflation to the Government's medium-term target of 5 percent in the fiscal year 2012/13. This is consistent with the price stability objective of monetary policy formulation and implementation.

The Report reviews the impact of the measures adopted by the MPC to address the instability in the foreign exchange market and inflationary pressure witnessed in the second half of 2011. During the six months to October 2012, inflation continued to decline while the exchange rate and short-term interest rates remained stable following the implementation of the monetary policy measures formulated by the MPC. In view of the declining risks to the inflation outlook and sustained exchange rate stability, the MPC embarked on a gradual easing of the monetary policy stance in July 2012 and also reverted to its bi-monthly meetings from the monthly meetings held since September 2011.

The MPC reduced the Central Bank Rate from 18 percent in December 2011 to 16.5 percent in July 2012, and further to 13.0 percent in September 2012. The tight monetary policy stance adopted in the second half of 2011 had contributed to the decline in the overall inflation to 4.14 percent in October 2012, that was within the 5 percent target set by the Government for the fiscal year 2012/13. The decline in inflation during the period was supported by falling food prices and easing demand pressures in the economy, and was reflected across all the measures of inflation as well as experienced by all income groups. Exchange rate stability during the period was supported by improved foreign exchange reserves following receipt of USD 600 million under the syndicated loan, as well as resilient inflows of diaspora remittances and improved participation by foreign investors at the Nairobi Securities Exchange. In addition, the successful implementation of the Extended Credit Facility programme by the CBK during the period provided further support to the exchange rate through expectations for future disbursements of foreign exchange.

In order to enhance the effectiveness and transparency of monetary policy formulation and implementation, the MPC continued with its regular interactions with stakeholders in the financial sector and timely release of relevant data during the period.

Despite these positive developments in the economy during the period, the continued slowdown in the global economy due to the persistent instability in the eurozone, volatile international oil prices and a high current account deficit remain the main risks to maintaining a low and stable inflation rate, and exchange rate stability. The MPC therefore, remains vigilant to these risks and continues to monitor developments in the domestic and global economy and to work with other Departments of the Central Bank of Kenya (CBK) to take appropriate measures when necessary.

1. INTRODUCTION

The ninth bi-annual Report of the MPC covers the period May 2012 and October 2012. During the period, the monetary policy and regulatory measures adopted by the CBK continued to support a decline in inflation and exchange rate stability.

A favourable domestic macroeconomic environment and improved weather conditions provided the base for the continued decline in inflation and stability in the exchange rate witnessed in the six months to October 2012. On the domestic scene, the onset of the long rains in the first half of 2012 more than offset the impact of volatile international oil prices on food and energy prices. A stable exchange rate during the period also moderated the impact of rising crude oil prices on the domestic energy prices as well as dampening any threat of imported inflation. However, the high current account deficit due to the increasing import bill and the decline in foreign exchange earnings from Kenya's major exports continues to exert pressure on the exchange rate. The estimated current account deficit as a proportion of GDP increased from 9.2 percent in May 2012 to 10.4 percent in October 2012. These developements show that exports of goods and services have continued to finance a smaller proportion of imports, thereby exerting pressure on the exchange rate and foreign exchange reserves. nevertheles, the main expansion of imports has been in machinery and equipment and hence should enhance future productivity.

On the international scene, the global foreign exchange markets were turbulent throughout the period but particularly in May 2012 following the instability in the eurozone. Consequently, the US Dollar strengthened globally as investors shifted from Euro to US Dollar-denominated assets. Several emerging market currencies and those in the region, including the Kenya Shilling, weakened against the US Dollar as a result of these developments. However, the monetary policy and regulatory measures adopted by the CBK sustained exchange rate stability during the period.

The remainder of this Report is structured as follows. Section 2 provides highlights of the monetary policy formulation in response to threats during the period while Section 3 provides a discussion of outcomes on key economic indicators. Other activities of the MPC with relevance to monetary policy formulation and implementation are discussed in Section 4 while Section 5 concludes.

2. MONETARY POLICY FORMULATION

2.1 Attainment of Monetary Policy Objectives and Targets

The main objective of the CBK is to formulate and implement monetary policy to achieve and sustain price stability in the economy. Price stability is necessary in the economy as it enhances investment and supports economic growth and employment creation. The CBK therefore formulates monetary policy to achieve the inflation target set by the Minister for Finance. The Government medium-term inflation target is 5 percent for the fiscal year 2012/13. The current monetary policy framework targets monetary aggregates which are consistent with the inflation target.

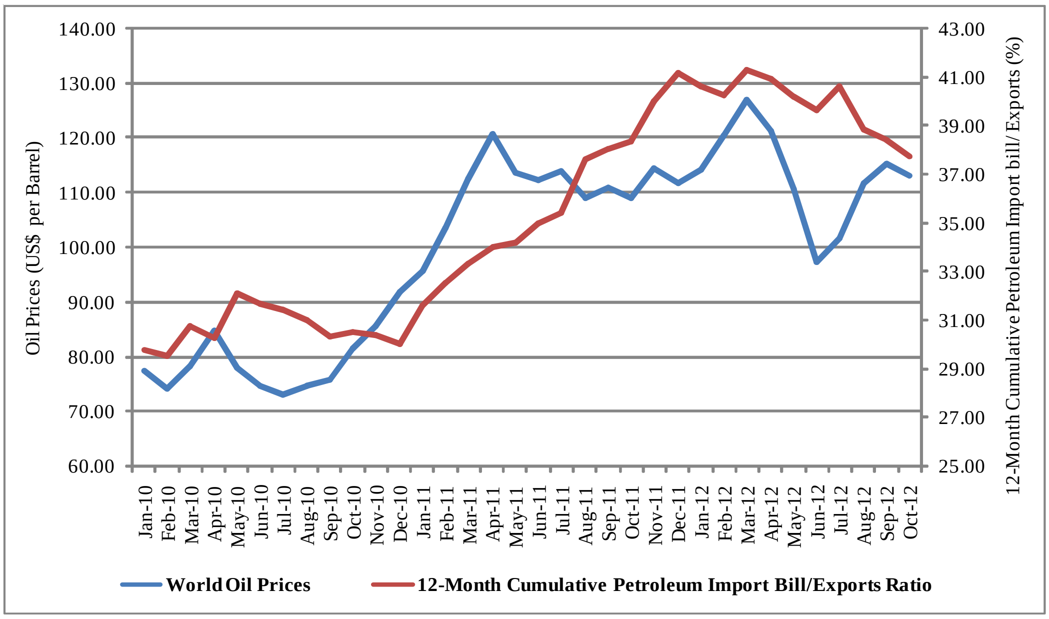
The CBR remained the base for all monetary policy operations during the period covered by this Report. Movements in the CBR, both in direction and magnitude, signals the monetary policy stance that are therefore reflected in changes in short-term interest rates. The MPC continued to pursue the monetary programme that was consistent with targets outlined in the Extended Credit Facility (ECF). The Net International Reserves (NIR) and Net Domestic Assets (NDA) are the quantitative performance criteria measures. The CBK met the NDA and NIR targets for June and September 2012 while the targets for broad money supply (M3) growth and private sector credit growth were met in October 2012.

2.2 Economic Environment

During the six months to October 2012, the economic environment was characterised by declining food prices due to improved weather conditions. The food price index fell from 149.07 in April 2012 to 142.40 in October 2012. There was also declining demand pressures in the economy due to the monetary policy measures in place, and a stable exchange rate. Liquidity conditions in the market also improved following adoption of a gradual easing of monetary policy by the MPC in July 2012. However, volatile international crude oil prices, high current account deficits, and persistent instability in the eurozone continued to pose risks to macroeconomic stability. These factors continued to exert pressure on foreign exchange reserves and the exchange rate during the period. Murban crude oil prices declined from USD 121.2 per barrel in April 2012 to USD 97.4 per barrel in June 2012 before rising slightly to USD 113.2 per barrel in October 2012.

The proportion of export earnings spent on petroleum product imports stabilized at about 40 percent in November 2011. Since May 2012, there has been a slow decline in the proportion. Furthermore, the rise of the international oil price from April 2012 had a moderate effect on inflation since improved rains across the country facilitated production of hydro-electric power (Chart 1).

Chart 1: Murban Oil Prices and Ratio of 12-Month Cumulative Petroleum Import Bill/Total Exports (%)



***Source**: Central Bank of Kenya*

2.3 Monetary Policy Committee Decisions

Following a decline in the risks to macroeconomic stability, a gradual easing of monetary policy was adopted by the MPC in July 2012. The frequency of MPC meetings was also reviewed from monthly to bi-monthly. On 5th June, 2012, the MPC introduced longer tenor (14-day, 21-day and 28-day) Term Auction Deposits as an additional instrument for liquidity management. On 5th July 2012, the CBR was reduced by 150 basis points to 16.5 percent. It was then reduced further by 350 basis points to 13.0 percent on 5th September 2012. The CBK also changed its policy to maintain a daily presence in the market through Open Market Operations (OMO) thereby reducing volatility in the interbank rate and ensure that it was aligned to the CBR.

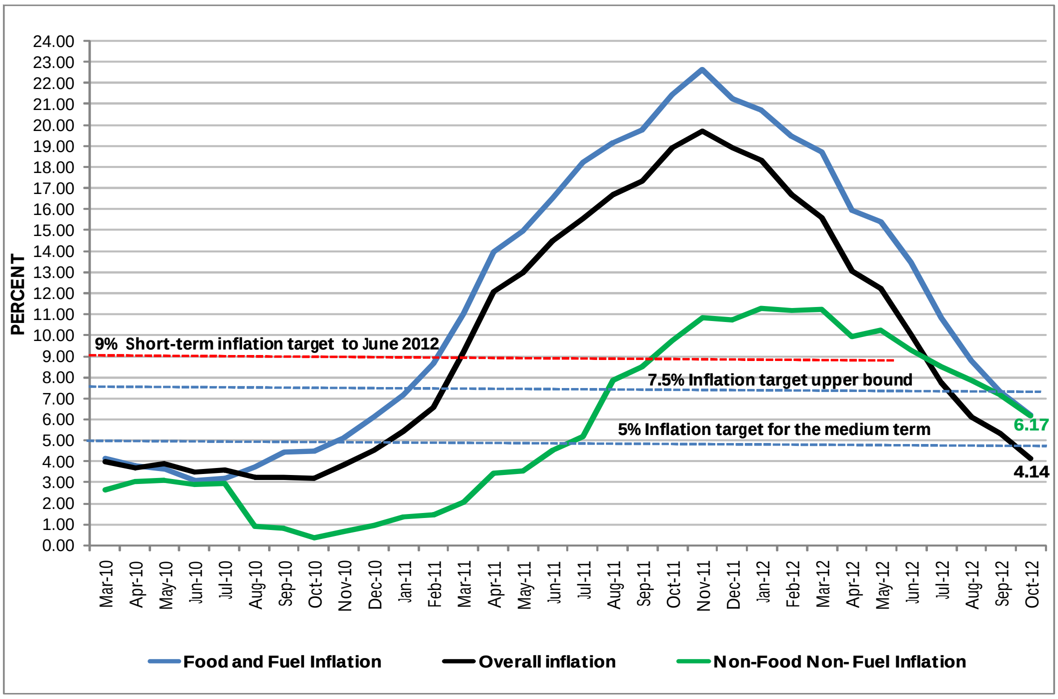
The Government successfully met conditions for disbursement of the USD 600 million syndicated loan in June 2012. This followed the Government's decision to externalise part of its domestic borrowing during the 2011/12 fiscal year. The disbursement of the loan improved the CBK's foreign exchange reserves which enhanced the Bank's capacity to respond to external shocks in the market. Consequently, interventions through foreign exchange sales by CBK complemented other measures in stabilising the exchange rate and by managing expectations. Nevertheless, the liquidity injection by the CBK in giving the Government the equivalent in Kenya Shillings for the USD 600 million has meant that the CBK has had to be active in the market reducing any consequent potential inflationary impact.

3. OUTCOMES ON KEY ECONOMIC INDICATORS

3.1 Inflation

Overall inflation continued to decline during the six months to October 2012, and was within the 5 percent target set by the Government for the fiscal year 2012/13 (Chart 2). Despite volatility in fuel prices, declining food prices coupled with easing demand pressures in the economy supported the decline in inflation. The 12-month overall inflation declined from 12.22 percent in May 2012 to 4.14 percent in October 2012. The decline in inflation in the period was reflected across all the measures of inflation and was experienced by all income groups. Non-food-non-fuel inflation declined from 10.27 percent in May 2012 to 6.17 percent in October 2012, and was within the 7.5 percent upper bound of the target set by the Government for overall inflation. Although these developments support a low and stable outlook for inflation, the MPC identified the volatility in oil prices, high world food prices, widening current account deficit, and instability in the eurozone which could affect the exchange rate to be the main risks to the inflation outlook.

Chart 2: 12-Month Inflation in Broad Categories (%)



***Source**: Kenya National Bureau of Statistics*

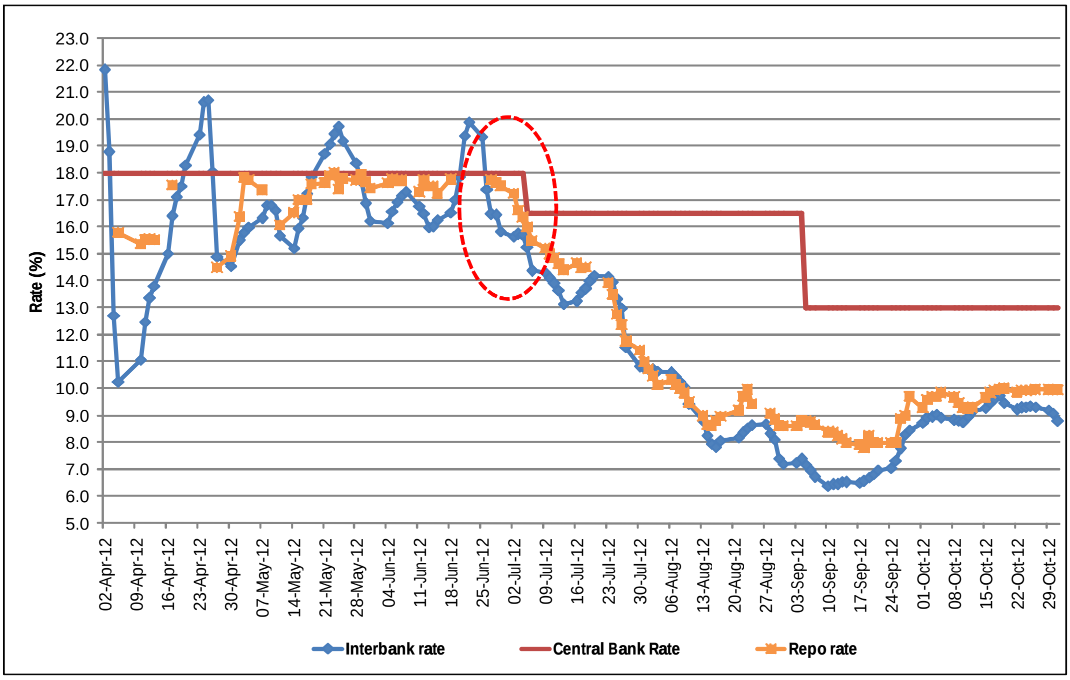
3.2 Interest Rates

3.2.1 Short Term Interest Rates

Short-term interest rates declined following improved liquidity conditions in the money market between May 2012 and October 2012 (Chart 3). The decision by the MPC to start easing the monetary policy stance in July 2012 through reductions in the CBR, a slowdown in private sector credit expansion (via higher lending rates) and regular purchases of foreign exchange by the CBK to boost its reserves. Furthermore, higher volumes of redemptions in the Government securities relative to new issues is the main factor which has contributed to the higher liquidity conditions during the period.

The movements in the short-term interest rates during the period were coordinated by the CBR. Improved liquidity conditions coupled with a high penal rate above the CBR on the CBK Discount Window rate ensured that few banks utilised the facility as a last resort. Banks only accessed funds totalling Ksh 6.8 billion from the CBK Discount Window between May 2012 and October 2012 compared with Ksh 23.4 billion from October 2011 to April 2012 when a tight monetary policy stance had been adopted by the CBK.

Chart 3: Trends in Daily Short Term Interest Rates (%)



***Source**: Central Bank of Kenya*

3.2.2 Commercial Banks Interest Rates and Spreads

Commercial banks interest rates declined slightly between April 2012 and October 2012 following improved liquidity conditions in the market and decline in short-term interest rates (Table 1). The average commercial banks lending rates declined from 20.22 percent in April 2012 to 19.04 percent in October 2012 while average deposit rates declined from 9.04 percent to 6.85 percent in the period. However, following a faster decline in deposit rates in the period, average interest rates spreads increased slightly from 11.18 percent in April 2012 to 12.19 percent in October 2012. Medium and Small banks maintained competitive deposit rates and therefore had lower spreads.

The high interest rate spreads indicate that the various initiatives formulated by the CBK and Kenya Bankers Association (KBA) to reduce the cost of doing business in banks are yet to be fully transferred to bank customers. The CBK has also provided avenues that reduce the cost of doing business for banks. These include integration with mobile phone financial platforms to lower transaction costs as well as adoption of the agency banking network. Credit Reference Bureaus have also reduced the costs of information search and risk. The CBK has continued to engage the Chief Executive Officers of commercial banks and KBA on this issue through bi-monthly forums.

Table 1: Average Commercial Banks Interest Rates and Spreads (%)

	Average Lending rates				Average Deposit rates				Average Interest rates Spreads			
	All banks	Small banks	Medium banks	Large Banks	All banks	Small banks	Medium banks	Large Banks	All banks	Small banks	Medium banks	Large Banks
Oct-11	15.21	15.17	15.52	15.95	4.83	5.14	5.29	3.04	10.39	10.03	10.24	12.91
Nov-11	18.48	17.57	19.37	18.82	5.75	6.66	6.41	2.99	12.73	10.90	12.96	15.83
Dec-11	20.04	19.12	20.59	20.95	6.99	7.24	7.54	3.63	13.05	11.88	13.05	17.32
Jan-12	19.54	19.60	20.32	19.70	7.66	7.65	8.49	4.15	11.88	11.95	11.83	15.55
Feb-12	20.28	19.93	21.20	20.52	8.01	8.26	8.61	5.18	12.27	11.67	12.59	15.35
Mar-12	20.34	19.08	21.04	21.09	8.01	8.06	8.93	5.01	12.33	11.01	12.12	16.09
Apr-12	20.22	19.65	21.38	20.97	9.04	8.35	10.19	6.61	11.18	11.30	11.19	14.36
May-12	20.12	20.00	20.68	21.00	8.42	8.38	9.50	5.09	11.70	11.62	11.18	15.91
Jun-12	20.30	20.97	21.44	20.86	7.88	8.52	9.38	5.07	12.42	12.45	12.06	15.79
Jul-12	20.15	20.31	21.16	20.77	8.25	8.26	9.34	5.02	11.90	12.05	11.82	15.75
Aug-12	20.13	19.68	20.85	21.51	7.85	8.46	8.83	5.07	12.28	11.22	12.02	16.44
Sep-12	19.73	19.60	20.62	21.09	7.40	8.29	7.96	4.36	12.32	11.31	12.66	16.72
Oct-12	19.04	18.68	19.82	20.57	6.85	7.75	7.74	4.17	12.19	10.92	12.09	16.40

***Source**: Central Bank of Kenya*

3.3 Exchange Rates

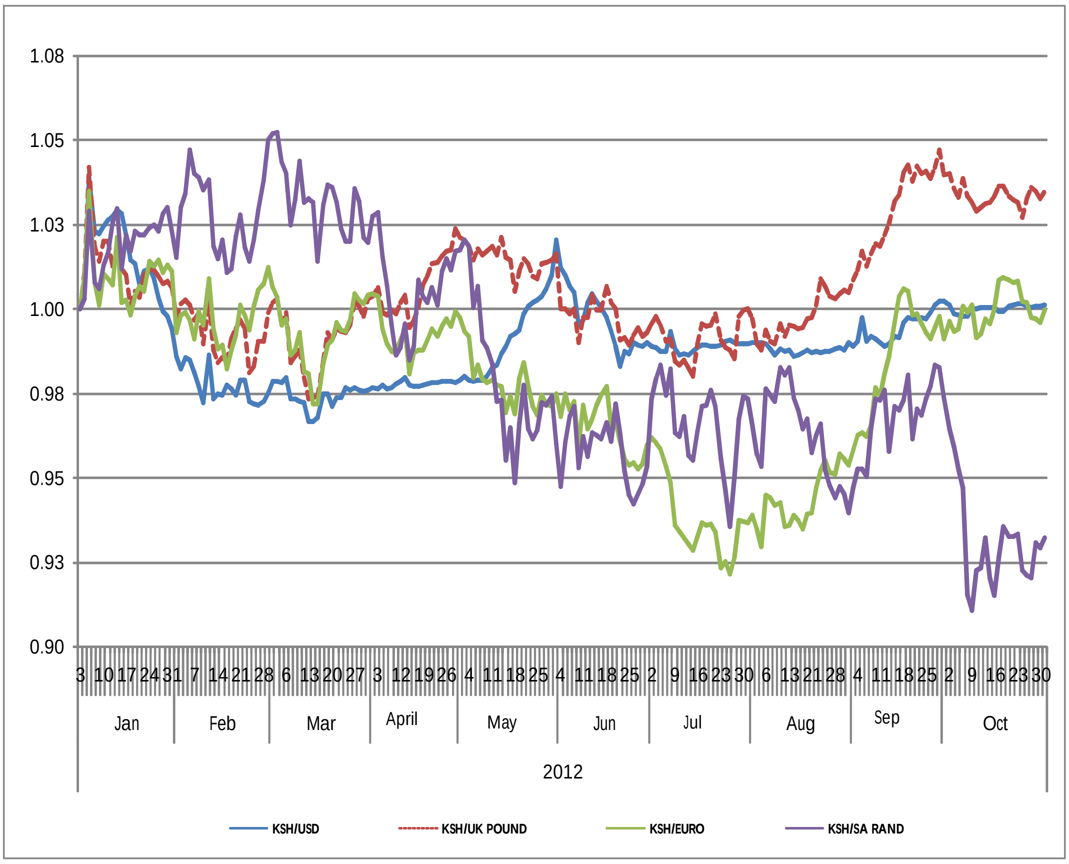
The foreign exchange market remained stable in the six months to October 2012 reflecting the impact of monetary policy and regulatory measures in place (Chart 4). The exchange rate of the Kenya Shilling against the US Dollar fluctuated within the narrow range of Ksh 84.91 and Ksh 85.28 in October 2012 compared with a range of Ksh 83.27 and Ksh 86.83 in May 2012. Exchange rate stability during the period was supported by steady inflows of diaspora remittances that averaged above USD 90.0 million per month during the period, disbursement of the USD 600 million under the syndicated external loan in June 2012, short-term capital inflows following higher yields on Government securities, and increased purchases of equity by foreigners at the Nairobi Securities Exchange.

The Kenya Shilling strengthened significantly against the South African Rand during the period. This reflected the strong trade links between South Africa and the turbulent eurozone, and the impact of the labour crisis in the mining sector.

The disbursements from the syndicated loan, coupled with interbank purchases of foreign exchange amounting to USD 495 million from May to October 2012, supported the exchange rate. The CBK's foreign exchange reserves position increased to USD 5,477.6 million (4.23 months of import cover) at the end of October 2012 compared with USD 4,980.2 million (4.15 months of imports) in April 2012.

The resilient diaspora remittance inflows are also expected to continue supporting the exchange rate. However, as indicated earlier, the main risks to exchange rate stability and foreign exchange reserves remain the high international crude oil prices, high current account deficits and the persistent instability in the eurozone.

Chart 4: Normalised Exchange Rates of the Kenya Shilling Against Major Currencies (3rd January, 2012 = 1)

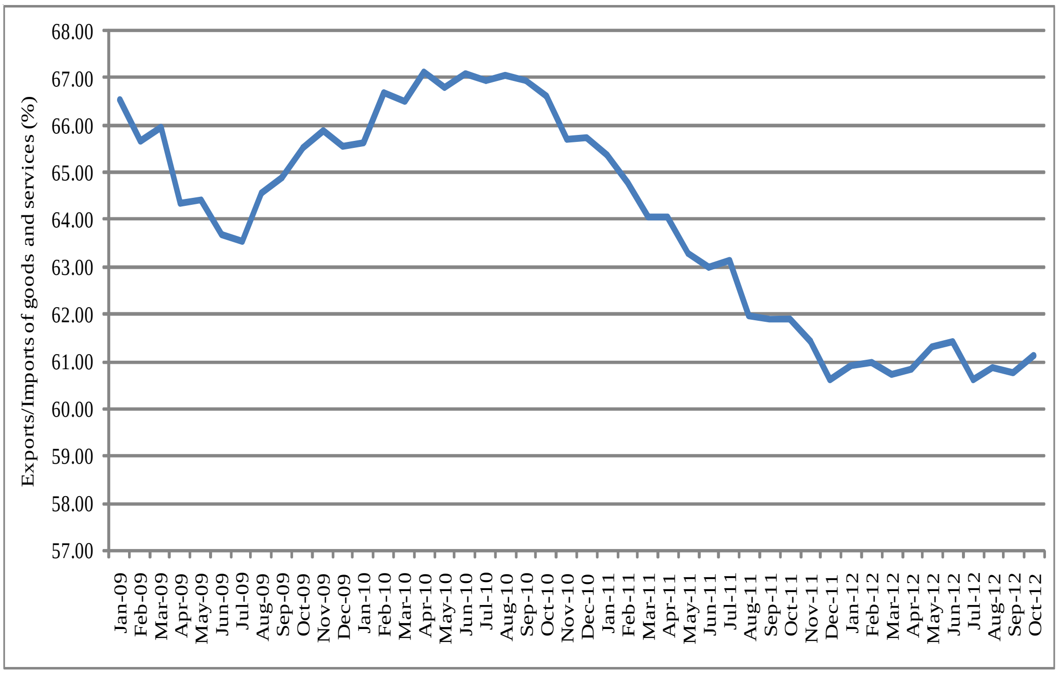


***Source**: Central Bank of Kenya*

The proportion of the 12-month cumulative imports of goods and services financed by cumulative exports of goods and services over a similar period stabilised at about 61 percent in the six months to October 2012 reflecting the impact of the tight monetary policy adopted by the MPC on import financing (Chart 5).

Despite the slowdown in trade credit, imports of machinery and other equipment continue to account for an increasing proportion of the import bill. On average, they account for between 14 and 18 percent of imports whereas during the period covered by this Report, they accounted for between 20 and 25 percent. Nevertheles, exports are still growing at a lower rate compared with imports thereby exerting pressure on the exchange rate.

Chart 5: Stabilisation of the Trend in the 12-Month Cumulative Exports/ Imports of Goods and Services (%)



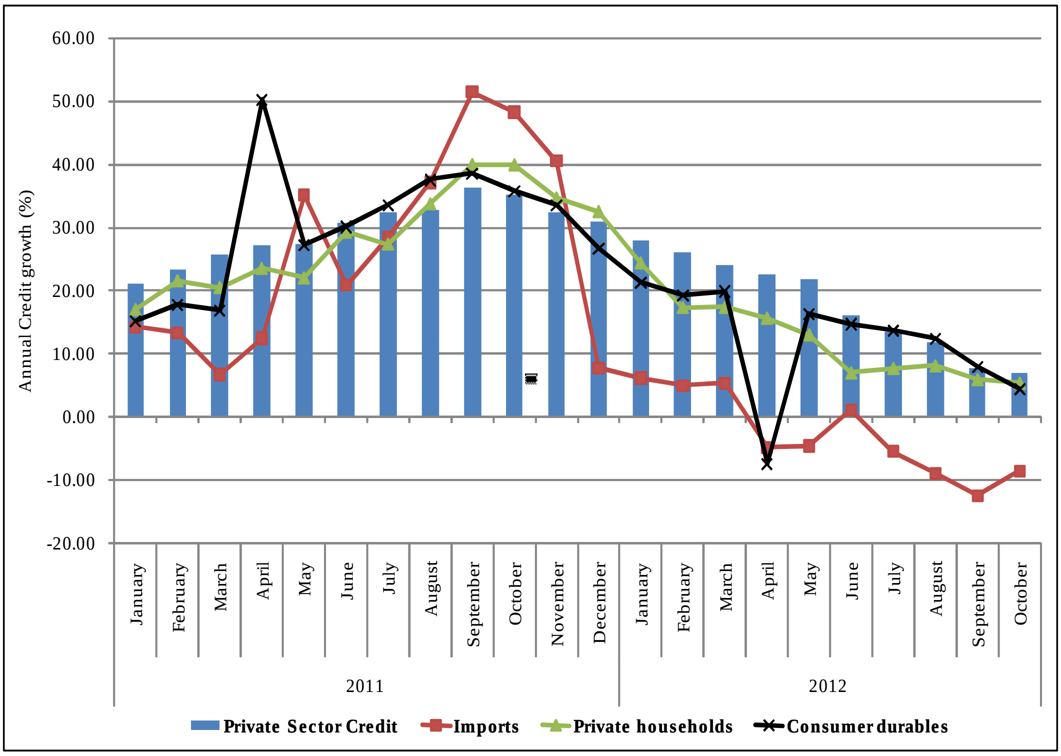
***Source**: Central Bank of Kenya*

3.4 Credit to Private Sector

Private sector credit growth maintained a gradual slowdown during the six months to October, 2012 reflecting the impact of the tight monetary policy stance adopted by the MPC in the second half of 2011 (Chart 6). Annual growth in overall private sector credit slowed down from 21.76 percent in May 2012 to 7.12 percent in October 2012. Similarly, annual credit growth to private households and financing consumer durables slowed down from 13.04 percent and 16.29 percent, to 5.40 percent and 4.52 percent, respectively, during the period. Furthermore, annual credit growth to finance imports slowed down from -4.55 percent to -8.57 percent during the period. The slowdown in the annual credit growth in the above sectors supported the decline in non-food-non-fuel inflation in the period covered by this Report. In addition, the slowdown in credit to finance imports during the period moderated the pressure on the exchange rate.

The gradual easing in the monetary policy stance adopted by the MPC in July 2012 is expected to support a non-inflationary credit expansion to the key sectors of the economy in the remainder of 2012 in order to stimulate economic activity.

Chart 6: Annual Growth in Private Sector Credit (%)



***Source**: Central Bank of Kenya*

4. OTHER ACTIVITIES OF THE MONETARY POLICY COMMITTEE

The MPC continued to hold stakeholder forums with Chief Executive Officers of commercial banks through the KBA Governing Council during the period covered by this Report. The Committee continued to improve on the information gathering processes through the bi-monthly Market Perception Surveys and communication with key stakeholders on the MPC decisions to obtain feedback. The set of indicators analysed was also expanded to cover other indicators such as global food price indices. MPC Press Releases were simplified with bullet points to make them more understandable and more focused to the public, media, financial sector and other stakeholders. The MPC press releases were also published in the widely circulating local dailies. Regular consultations were held regularly with the IMF to enhance the effectiveness of implementation of monetary policy decisions.

As part of enhancing its capacity, MPC Members participated in the international conference on Monetary Policy Frameworks in Developing Countries held in Kigali, Rwanda in July 2012. The conference was organised by the National Bank of Rwanda in collaboration with the IMF, World Bank and International Growth Center. It discussed the critical challenges underlying monetary policy effectiveness in developing countries under different monetary policy frameworks. It also provided a forum for countries in the region to share experiences on how respective central banks responded to periods of extreme shocks and structural changes in the financial sector in particular and economy in general.

5. CONCLUSION

The monetary policy responses and regulatory measures adopted by the CBK during the six months to October 2012 have yielded the desired results of easing inflationary pressures and maintaining exchange rate stability. The MPC will continue to monitor developments in the domestic and global economy that could have either direct or indirect impact on the economy, while recommending, where necessary, the appropriate monetary policy measures to be taken. However, there is need for the Government to address the structural problem in the economy where export earnings have been financing less imports, through the development of a long-term policy to support the export sector.

APPENDIX: EVENTS OF PARTICULAR RELEVANCE TO MONETARY POLICY FROM MAY TO OCTOBER 2012

	Date	Banking Circular/ Foreign Exchange Transactions	Objective
1.	4th May 2012	Banking Circular No. 2 of 2012 that announced the MPC decision.	• CBR maintained at 18.00 percent in order to ensure that inflation continued to decline towards the target of 9 percent for FY 2011/2012 and the exchange rate stability was sustained.
2.	6th May 2012	Banking Circular No. 3 of 2012 that announced multiple tenors on Term Auction Deposit (TAD) Facility.	• Reviewed the TAD instrument in line with changing liquidity environment in the market by introducing the 14, 21 and 28 days tenors with effect from *6th June 2012*. • The multiple tenors on the TAD instrument would provide flexibility to commercial banks on the choice of tenor and also serve as an investment instrument. • The price ceiling for the instrument was set at the CBR (then *at 18%)*
3.	6th June 2012	Issued a press release that announced the MPC decision.	• CBR maintained at 18.00 percent in order to ensure that inflation continued to decline towards the target of 9 percent for FY 2011/2012 and the exchange rate stability was sustained.
4.	6th July 2012	Banking Circular No. 4 of 2012 that announced the MPC decision.	• CBR adjusted downwards by 150 basis points from 18.0 percent to 16.50 percent with immediate effect. • MPC announced return to bi-monthly MPC meetings
5.	6th September 2012	Banking Circular No. 6 of 2012 that announced the MPC decision.	• CBR adjusted downwards by 350 basis points from 16.50 percent to 13.00 percent.
CBK Foreign Exchange Transactions			
	May 2012	• Sold USD 164 million Foreign Exchange • Purchased USD 10 million	To dampen volatility in the exchange rate following a resurgence of instability in the eurozone. Purchases were made after stability returned to the market.
	June 2012	• Sold USD 76 million Foreign Exchange • Purchased USD 10 million	To dampen volatility in the exchange rate. Purchases were made after stability returned to the market.
	July 2012	• Purchased USD 90 million	Purchase of foreign exchange offered by the market following stability in the exchange rate market.
	August 2012	• Purchased USD 218 million	
	September 2012	• Purchased USD 52 million	
	October 2012	• Purchased USD 115 million	

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 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.

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. It is used by the commercial banks as a reference interest rate hence transmits to the financial sector and signals the CBK's monetary policy stance.

Cash Ratio Requirement (CRR): This is the minimum ratio of cash balances (including deposits at CBK) of the total deposit liabilities of commercial banks and non-bank financial institutions maintained with the CBK as reserves. The ratio is fixed by CBK as provided for by the law.

CBK Discount Window: The CBK Discount Window is a collateralised facility of last resort for banks. It has restrictive guidelines controlling access. The Discount Window plays a significant role in ensuring banking sector stability by offering overnight liquidity as a last resort.

Open Market Operations (OMO) : The act of buying or selling of government securities from or to commercial banks by the Central Bank in order to achieve a desired level of bank reserves. OMO is carried out in the context of an auction where commercial banks bid through the Reuters dealing system or by phone/ fax.

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 has a variable tenor and allows commercial banks without credit lines with other banks to access credit from the interbank market.

Interbank Market: The interbank market is a critical channel for distributing liquidity that reduces the need for banks to access the CBK Overnight Discount Window. However, since not all banks have credit lines with each other, it is not a perfectly operating market and therefore banks come to the Window as a last resort. The interest rates charged by banks reflect an individual bank's perception of the risk of the particular bank borrower and also the tightening liquidity in the 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).