

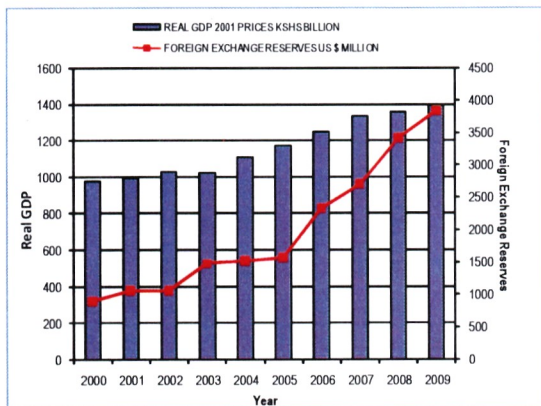


CENTRAL BANK OF KENYA

Monetary Policy Statement

Issued under the Central Bank of Kenya Act, Cap 491

DECEMBER 2010



Letter of Transmittal

Honourable Minister,

I have the pleasure of forwarding to you the 27th Monetary Policy Statement (MPS) of Central Bank of Kenya (CBK), pursuant to Section 4B of the Central Bank of Kenya Act. It covers the current economic developments and provides details of the monetary policy stance, for January to June 2011. The Statement also reviews the implementation of monetary policy from July to December 2010.



Prof. Njuguna Ndung'u, CBS
Governor

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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:

-)ormulaW anG implemenW foreign excKange solicy;
- HolGanG manage iW foreign excKange reserves;
- License anG suservise auW oriseG foreign excKange Cealers;
-)ormulaW anG implemenW slock solicies as besWW sromoW We establishment, regulation and supervision of efficient and effective payment, clearing and settlement systems;
- AcVas banker anGaGvise W, anGas fiscal agenVof, We GovernmenW and
- 'ssue currency noW s anG coins.

It follows therefore, that the CBK formulates and conducts monetary policy with the aim of keeping overall inflation at the Government target of 5 percent. Achieving and maintaining a low and stable inflation rate together with adequate liquidity in the market facilitates higher levels of domestic savings and private investment and therefore leads to improved economic growth, higher real incomes and increased employment opportunities.

The Bank's monetary policy is therefore designed to support the Government's desired economic activity and growth as well as 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 through purchases and sales of eligible securities to regulate the money supply and credit conditions. OMO can also be used to stabilise short term interest rates. When the Central Bank buys securities on the open market, it increases the reserves of commercial banks, making it possible for them to expand their loans and investments. To achieve the desired level of money supply, OMO is conducted using the following instruments:
 - **Repurchase Agreements (Repos):** Consist of the sale of eligible securities by the CBK to reduce or increase commercial banks deposits held with it. Reverse repos are purchases of securities from commercial banks by the CBK during cases of tight liquidity in the market. Currently, repos have a fixed tenor of 7 days.
 - **Horizontal repos** are transacted between commercial banks using government securities as collateral, and have negotiated tenors. Commercial banks short of deposits at the CBK borrow from banks with excess deposits on the security of an appropriate asset, normally Government securities. Horizontal repos help banks to overcome the problem of credit limits, thus promoting efficient management of interbank liquidity.
 - **Term Auction Deposits:** In extreme market conditions, 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) every two months and its movements, both in direction and magnitude, signals the monetary policy stance.

These movements are reflected in changes in short-term interest rates. A reduction of the CBR signals an easing of monetary policy and a desire for market interest rates to decline. Low interest rates encourage economic activities via investment and thus growth. When interest rates decline, the quantity of credit demanded should increase.

The CBR operates through the market for repo securities. Efficiency of the repo and interbank markets is crucial for the transmission of monetary policy decisions. By fixing a single tenor (currently 7 days) for bills sold in the repo market, the MPC aims to sharpen the signalling process.

- **Standing Facilities:** The CBK, as lender of last resort, provides secured loans to commercial banks on an overnight basis at the CBR.
- **Required Reserves (RR):** The Required Reserve is the proportion of a commercial bank's deposit liability which must be deposited at CBK at a prescribed interest, in accordance with the law. These deposits are held in the Cash Reserve Ratio (CRR) Account and are currently 4.5 percent of total bank deposit liabilities. The CBK can use the RR as a liquidity management tool. A reduction in the CRR releases liquidity thus enhancing the capacity of commercial banks to expand credit. An increase in the CRR tightens liquidity and could also dampen demand driven inflationary pressures.
- **Foreign Exchange Market Operations:** The CBK can also inject or withdraw liquidity in the banking system by engaging in foreign exchange transactions. A sale, through auction, 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 usually motivated by the desire to prevent excessive volatility in the rate at which the Kenya shilling exchanges against other foreign currencies, or to acquire foreign exchange to service official debt and build its foreign exchange reserves. The CBK does not participate in the foreign exchange market to defend a particular value of the Kenya shilling.
- **Licensing and Supervision of Financial Institutions:** The Bank uses the licensing and supervision tools to ensure the health and efficiency of the banking system.
- **Communications:** The increasing use of the media ensures a wider dissemination of monetary policy decisions and background data thereby increasing the efficiency of information transmission. For example, the CBK website is an important source of up-to-date data on all aspects of the financial market including interest rates, exchange rates and results of auctions of government securities. In addition, the Governor and the MPC hold meetings with Commercial Banks' Chief Executive Officers to explain the basis of MPC decisions and market perception on interest rates and economic activity.

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 its 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. 'n subsection (2), tKe exsression "assrosriate for p ittee" p eans tKe for p ittee 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 coming 12-months between January 2011 and December 2011. It focuses particularly on the period January to June 2011. The outcome of the monetary policy stance adopted in the second half of 2010 is also analysed.

The economy continued to register strong performance across the key sectors in the third quarter of 2010. This improved performance was attributed to favourable weather conditions, adequate liquidity in the banking sector and prudent macroeconomic management. Growth was also supported by enhanced flow of credit to the key sectors of the economy during the period. Confidence in the Kenyan economy remains high due to expectations for an IMF supported programme in 2011 which is an indication of good economic management, and the upgrading of the country's credit rating to 'B+' with stable outlook' by Standard & Poors. The successful promulgation of the new Constitution in August 2010 enhanced the confidence in the economy with expectations for new and more effective institutional and governance structures.

An important development at the beginning of the fiscal year 2010/11 was the restatement of the Government's overall inflation target of 5 percent to be maintained by the Central Bank of Kenya. The letter provided for a corridor of 2 percent from the target, and specified disclosures that must be made if the target is not met. During the period from July to December 2010, the month-on-month overall inflation remained within the Government target.

The main objective of the CBK is therefore to formulate and implement monetary policy aimed at ensuring that the month-on-month overall inflation remains within the 5 percent band. The impact of financial innovations in the country since 2007 has generally been to reduce the velocity of money and increase the money multiplier. However, the velocity of money stabilised between July and December 2010 while the money multiplier, which had been on upward trend, stabilised and was oscillating around a mean. The fluctuations were found to originate from banks' holdings of reserves in excess of statutory requirements. Consequently, the implementation of the current monetary policy framework has been faced with challenges as the link between the operational target (reserve money), the intermediate target (broad money supply, MP), and inflation has not been predictable. The Monetary Policy Committee of the Bank is therefore exploring alternative frameworks which will provide flexibility to adjust to the rapid financial innovations whilst at the same time supporting the effectiveness of the monetary policy stance.

The regular interactions between the Bank with financial and real sector institutions have enhanced the understanding and will need to continue so that it can have greater impact on monetary policy transmission.

1. Introduction

This Monetary Policy Statement (MPS) presents the policy guidelines and broad targets for the Central Bank of Kenya (CBK) over the period January to December 2011. It also highlights the policy outcomes in the period July to December 2010.

The economy continued to register improved performance in the second half of 2010. In particular, notable progress has been made towards ensuring that economic performance returns to the *Vision 2030* trajectory with the recovery of key sectors of the economy. The recovery of the global economy has also raised the volume of exports to key trading partners. The CBK continued to support the country's economic growth by formulating and implementing policies aimed at expanding credit growth to key sectors of the economy and maintaining price stability.

The Monetary Policy Committee (MPC) is expected to continue with its stance of facilitating availability of adequate and affordable credit while at the same time ensuring that the credit expansion does not result in demand driven inflation. Since commercial banks have been maintaining excess reserves, there is adequate scope to increase credit without impacting on the price.

The current monetary policy framework has been faced with various challenges including the impact of financial innovations which has weakened the link between reserve money and broad money supply, M3. The Bank is therefore exploring alternative frameworks which will enhance the effectiveness of monetary policy implementation and implementation. The Bank's participation in the foreign exchange market has been to accumulate and maintain foreign exchange reserves at or above the statutory level of four months of imports cover, purchase foreign exchange to meet the Government's external obligations, and ensure stability of the value of the Kenyan shilling when there is excess volatility.

The Bank has continued with its interactions with stakeholders in the financial and real sectors, and timely release of relevant data so as to enhance the transmission of monetary policy signals to the commercial banks' lending rates. This will also improve the transparency of monetary policy formulation and implementation by the Bank. The slow transmission of monetary policy signals has hindered the creation of an effective and competitive financial system.

2. Actions and Outcomes of Policy Proposals in the 26th Monetary Policy Statement

The overall aim of the Monetary Policy Statement for June 2010 (26th MPS) was to set targets that would ensure low and stable inflation, encourage growth and ensure long term sustainability of public debt. It also aimed at enhancing the variety of modes of extending banking services within the economy including payment systems, as well as ensuring a continuation of the medium term research agenda. The following are therefore the outcomes of the policy proposals in 26th Monetary Policy Statement:

a. Inflation

Price stability continued to be the core objective of monetary policy formulation and implementation. Consequently, overall month-on-month inflation remained low and stable, and was within the target of 5 percent set by the Minister for Finance. However, there were slight pressures on inflation at the end 2010 which were attributed to increases in food prices – attributed to dry weather conditions – and fuel oil prices.

In July 2010, the Minister for Finance restated, through a letter to the CBh, the price stability target that should be maintained by the Central Bank of Ireland. The letter from the Minister (or) in an outline of the inflation target of 5 percent as pursued by the 12-month change in the overall consumer price index (CPI) published by the Ireland National Bureau of Statistics (INBS). The Bank is required to strive to achieve this inflation target at all times while accounting for any deviations exceeding 2 percentage points in either direction. Both high inflation levels as well as deflation tend to discourage investment and long term economic growth.

b. Monetary Programme

The MPC aim is to achieve its inflation target and support the Government's economic growth objectives using the monetary aggregate targeting framework in its monetary programme. The 26th MPS had envisaged reserve money (RM) and broad money supply (MP) to increase from hsh. 181.4 billion and hsh. 1,106.6 billion, respectively, in June 2010 to hsh. 202.6 billion and hsh. 1,281.6 billion, respectively in December 2010 (Table 1). The programmed growth in money supply during the period was considered adequate to support economic growth through expansion of credit to private sector and no effect on demand driven inflation. Generally, broad money supply, MP, remained within the set target as the monetary aggregate increased from hsh. 1,198.9 billion in June 2010 to hsh. 1,222.6 billion in December 2010. Credit to private sector increased from hsh. 799.2 billion in June 2010 to hsh. 888.4 billion in December 2010, which was virtually on target.

Table 1: Actual and Targeted Growth in Key Monetary Aggregates

	Jun-10	Jul-10	Aug-10	Sep-10	Oct-10	Nov-10	Dec-10
Actual Broad Money, M3 (Ksh Billion)	1,198.9	1,213.2	1,216.8	1,243.6	1,254.5	1,258.8	1,272.6
Target Broad Money, M3 (Ksh Billion)	1,106.6	1,213.3	1,226.9	1,240.2	1,253.9	1,267.7	1,281.6
Actual Reserve Money, RM (Ksh Billion)	210.3	199.8	201.0	209.9	217.0	224.1	221.1
Target Reserve Money, RM (Ksh Billion)	181.4	187.2	182.8	186.4	189.5	195.6	202.6
Actual NFA of CBK (Ksh Billion)	242.9	243.6	251.2	257.7	256.4	255.3	250.6
Target NFA of CBK (Ksh Billion)	239.2	246.2	250.2	254.0	258.1	261.9	266.0
Actual Credit to private sector (Ksh Billion)	799.2	814.7	827.4	842.9	864.6	875.8	888.4
Target Credit to private sector (Ksh Billion)	859.4	805.7	813.6	823.0	845.1	869.5	885.7
Memorandum Items							
12-month growth in actual RM (Percent)	31.5	26.5	28.1	28.4	32.8	25.7	21.5
12-month growth in actual M3 (Percent)	26.2	24.6	23.7	26.0	24.7	23.1	21.7
12-month growth in actual credit to private sector (Percent)	16.8	19.5	19.1	22.9	21.5	21.7	20.3

Source: Central Bank of Kenya

c. Impact of Financial Innovations on the monetary programme

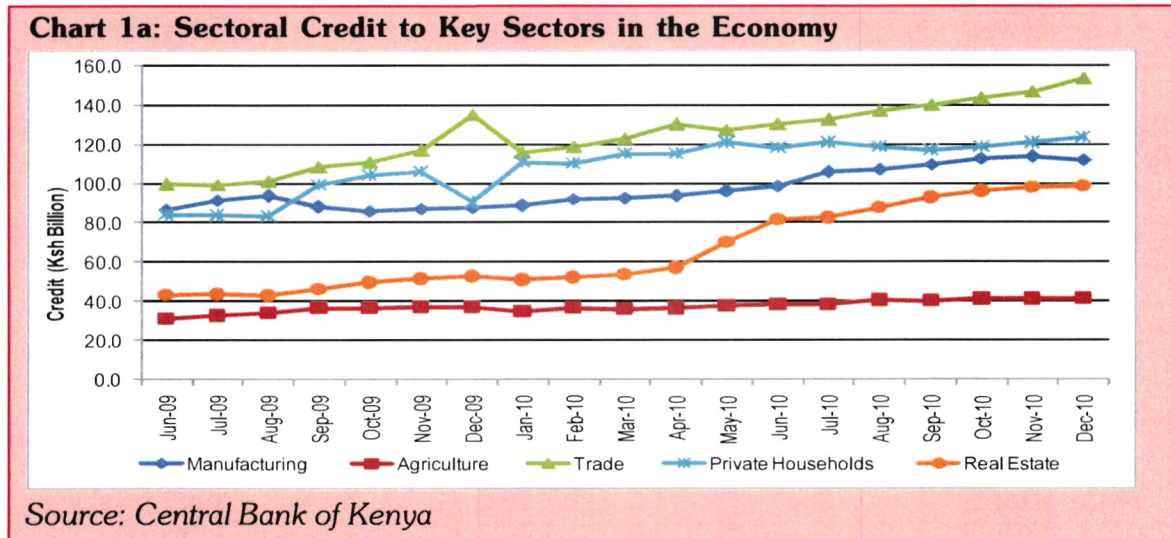
The velocity of money, which had been declining in the previous periods due to financial innovations and structural changes in the economy, stabilised at an average of about 2 between July and December 2010. Similarly, the money multiplier which had been increasing in previous period remained volatile but was mean reverting at an average of about 5.7 between July and December 2010. Both the velocity of money and money multiplier must be relatively constant for efficacy in traditional monetary programming.

The signalling of monetary policy increased during the period with a reduction in currency outside banks which is an indication of increased financial intermediation. Bringing cash into the banking sector increases the response to market signals. Overall, banks maintained excess reserves during the period. Excess reserves without any monetary overhang are a new phenomenon in the market and could be an outcome of financial inclusion mostly driven by micro accounts. The excess liquidity in the banking system has implications on the pricing of credit as well as providing further scope to finance investment.

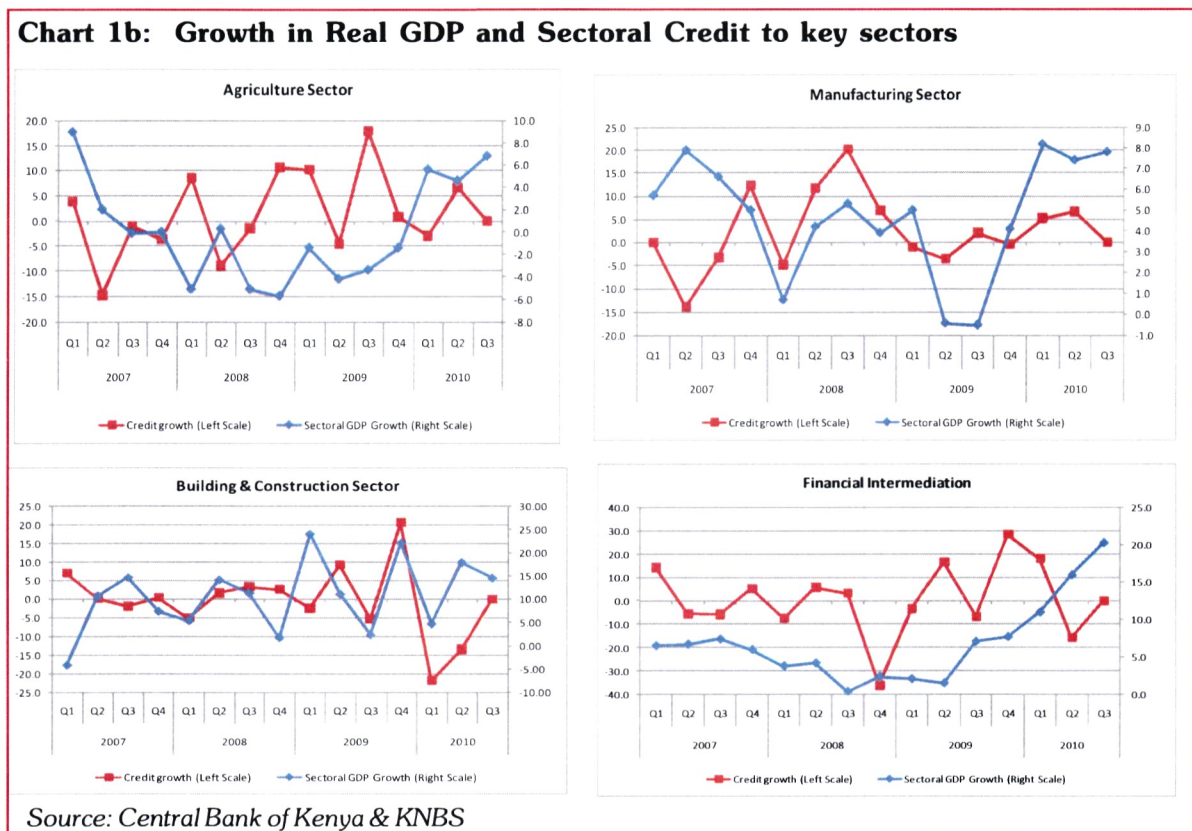
d. Credit to private Sector

During the second half of 2010, the Monetary Policy Committee (MPC) continued with an accommodative monetary policy stance to support economic growth through credit expansion. At its meeting on 28th July 2010, the MPC lowered the CBR by 75 basis points to 6.00 percent to signal the need for the banking sector to continue providing adequate and affordable credit to the private sector in order to sustain the growth momentum. Increased economic activity in

the second half of 2010 resulted in accelerated credit expansion to the private sector credit which grew by Ksh. 43.7 billion and Ksh. 45.5 billion, respectively, in the third and fourth quarters. As shown in Chart 1a, credit to the key sectors of the economy – agriculture, trade, real estate and manufacturing sectors – continued on an upward trend between July and December 2010.



The positive link established in previous analyses between sectoral growth in real GDP and credit expansion to the respective sectors was maintained during the period July to December 2010 (Chart 1b).



e. Interest Rates and Liquidity

Monetary policy signals successfully stimulated declines in short term interest rates during the second half of 2010, and reduction of the volatility in the interbank rates. These declines were also successfully transmitted into declines in the horizontal repo and commercial banks' lending rates. However, the decline in commercial banks' lending rates was slow as lending rates declined from 14.39 percent in June 2010 to 13.87 percent in December 2010. Reverse repos were used only when there were instances of tight liquidity conditions in the market (see Chart 5c).

The uptake of horizontal repos as an instrument for redistributing liquidity among commercial banks increased between July and December 2010. The volume transacted through the instrument increased from hsh. 5.4 billion in June 2010 to hsh. 7.0 billion in June 2010. However, there is scope for further development of the instrument as the volume transacted through the instrument is on average only 5 percent of the total transactions of the interbank market. The highest tenor transacted in the instrument increased from one month in June 2010 to three months by December 2010 while the number of banks participating in the market also increased with enhanced trading across all categories of banks. These developments require to be monitored as the instrument was introduced to increase efficient short term liquidity management within the banking system. However, there is evidence that the instrument is becoming a medium term instrument with some levels of arbitrage on the tenor.

Improved liquidity conditions in the market between July and December 2010 resulted in limited use of reverse repos to dampen the increase in interbank rates due to liquidity shortages. In particular, Government deposits at the CBh were more predictable – hence exerting less pressure on liquidity in the interbank market. Government deposits at the CBh averaged hsh. 51 billion during the period which was slightly higher than previously established thresholds above which a shortage of liquidity in the interbank market would be experienced. The Bank injected liquidity in the market through reverse repo operations in August, November and December 2010 to address interbank liquidity tightness occasioned mainly by increased demand for cash during the festive season.

f. Impact of Fiscal Development on Liquidity

The government domestic borrowing programme did not exert pressure on interest rates during the first half of the fiscal year 2010/11. In particular, the domestic borrowing requirement in the first half of the fiscal year 2010/11 was hsh. 54.5 billion which was lower than the hsh. 58.1 billion in a similar period of the fiscal year 2009/10. The Bank will continue to work

closely with the Ministry of Finance to ensure that the borrowing programme does not cause inflationary monetary expansion or crowd out the private sector through an increase in interest rates.

g. Banking Sector Developments

The CBK continued to implement measures aimed at lowering transaction costs in the financial system as well as enhancing financial access. In particular, the innovations of mobile banking services continued to be felt while Credit Reference Bureaus were operationalised in July 2010 to maintain and provide banks with the credit history of borrowers. This is expected to reduce credit risk of banks significantly. In addition, the National Payments Systems Bill is ready to be tabled in Parliament. This will ensure that financial innovations are regulated to ensure market confidence.

Enhanced financial inclusion activities during the period resulted in the doubling of commercial banks branches since the year 2003. This picture was replicated across all regions in the country. The number of bank branches in the country stood at 1,063 in December 2010 from 512 in 2003. Similarly, the number of ATMs increased from 215 to 2,052 during the period. This success was corroborated by a strong performance of the banking sector in 2010. The first Community Deposit Taking Microfinance Institution was licensed in November 2010. Notably, the number of agents under the agency banking model accelerated significantly during the period to stand at 8,807 in December 2010.

The CBK in collaboration with the Kenya Bankers Association (KBA) initiated the roll-out of currency centres with the opening of currency centres in Nyeri and Nakuru while one more is expected to be opened in Meru early 2011. The currency centres have taken currency services closer to the regions and are expected to reduce the high costs associated with transportation of cash.

The Development Banking Committee (DBC) which was set up in February 2010 to explore avenues through which development banking products can be introduced into the market completed its work in December 2010. The recommendations of the DBC will be shared with the Ministry of Finance for consideration in the 2011/12 Government budget.

h. MPC Market Surveys and Stakeholder Forums

The Bank continued with the bi-monthly MPC Market Surveys which are conducted to understand market perceptions on key indicators of the economy including inflation, interest rates, exchange rates and growth. The market continued to appreciate the importance of these surveys in the MPC decision process. The MPC also continued with bi-monthly meetings with chief executive officers (CEOs) of commercial banks to enhance the understanding of its decision process as well as obtain direct feedback from the CEOs of the commercial banks.

The MPC in collaboration with the KBA held its first Public Forum on August 10th 2010 at the Kenya School of Monetary Studies. The forum brought together key stakeholders from the public sector, media, academia, research institutions, financial and real sectors to discuss monetary policy issues, banking sector developments, financing of private sector activities and also develop public awareness on financial services. It also provided a platform to obtain feedback on the impact of monetary policy decisions by the MPC on commercial banks and the real sector. The theme of the forum was “*Lubricating the Economic Engine with Adequate and Affordable Credit*”.

i. Research Agenda

The following research papers were finalised and distributed to external reviewers in preparation for a technical seminar in January 2011 to discuss the papers: demand for money function for Kenya; monetary policy transmission mechanism in Kenya; a framework for restructuring the CBK; output fluctuations and inflation in Kenya; efficiency and productivity of the Kenyan banking sector; access to private sector credit and economic performance; interest rate pass-through in Kenya; factors driving usage of financial services from different financial access strands in Kenya; and a dynamic model for inflation. Progress was also made in the development of the CBK macroeconomic model during the period. Preliminary output from the model was shared with the MPC during its Analytical and Technical Meetings.

Progress was made by KNBS and the CBK towards development of tradable and non-tradable CPI indices during the period. Some preliminary series for the two inflation measures have been generated.

The book *Kenya: Policies for Prosperity* was finalised in December 2010 and is expected to be launched in February 2011. The book is an outcome of intensive collaborative research between local and internationally accredited researchers under the coordination of Central

Bank of Kenya and Oxford University. The book is expected to influence policy formulation and implementation and complement other Government development plans like the Vision 2030 with a view to developing CB's research capacity.

3. Financial and Economic Trends and Events (June - December 2010)

a. International Economic Environment

The January 2010 Update of the October 2010 IMF's *World Economic Outlook* shows that global real GDP growth increased significantly from 4.6 percent in QM9 to 5.5 percent in QM9 (Table 2). The performance of the global economy in QM9 reflected improvements in growth of advanced economies and emerging and developing economies. Stimulus measures implemented in response to the global financial crisis in QM9 improved global financial conditions, and increased private consumption were partly responsible for the strong performance. Developing Asia and sub-Saharan Africa grew by 9.3 percent and 5.5 percent, respectively, in QM9 up from 7.1 percent and 4.9 percent, in QM9. Similarly, growth in the East African Community (EAC) countries excluding Kenya increased from 5.1 percent to 5.4 percent during the period. As a result of the improved performance of the global economy, Kenya's exports, comprising mainly of agricultural goods and tourism, increased significantly.

Table 2: Performance of the Global Economy

	Real GDP Growth (%)			Inflation (%)		
	2008	2009	2010 Estimate	2008	2009	2010 Estimate
World	3.0	-0.6	5.0	6.3	2.7	3.8
Advanced Economies	0.5	-3.4	3.0	3.4	0.1	1.5
United States	0.4	-2.6	2.8	3.8	-0.3	1.4
Japan	-1.2	-6.3	4.3	1.4	-0.4	-1.0
Euro Area	0.6	-4.1	1.8	3.3	0.3	1.6
United Kingdom	0.5	-4.9	1.7	3.6	2.1	3.1
Other Advanced economies	1.7	-1.2	5.6	3.8	1.5	2.5
Emerging and developing economies	6.1	2.6	7.1	9.2	5.2	6.3
Sub-Saharan Africa	5.6	2.8	5.0	11.6	10.4	7.5
East African Community (Excl. Kenya)	7.9	5.1	5.4	14.4	11.9	7.6
Developing Asia	7.7	7.0	9.3	7.4	3.1	6.1
China	9.6	9.2	10.3	5.9	-0.7	3.5
India	6.4	5.7	9.7	8.3	10.9	13.2
Middle East and North Africa	5.1	1.8	3.9	13.5	6.7	6.8

IMF World Economic Outlook (October 2010 and January 2011 Update)

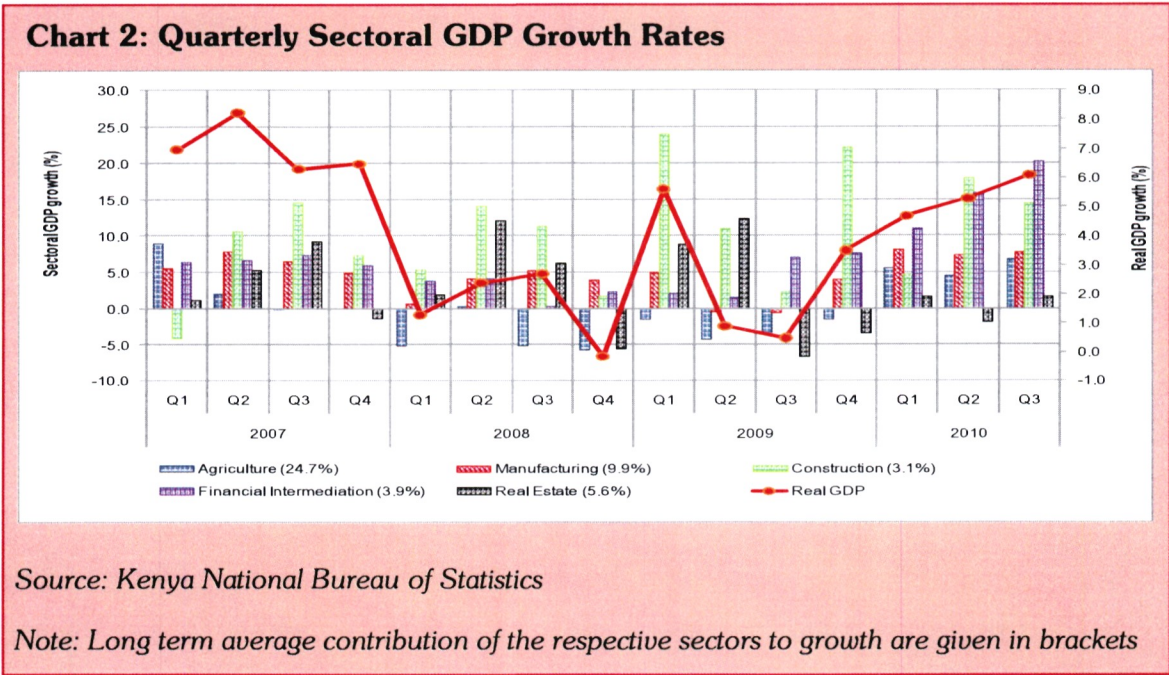
Global inflation increased from 0.7 percent in QM9 to 3.0 percent in QM9 due to higher oil and non-poil commodity prices in response to strong global demand and supply shocks for selected commodities. Similarly, inflation for emerging and developing economies increased from 5.0 percent to 6.3 percent during the period. However, inflation declined during the period for sub-Saharan Africa countries due to improved food supply and lower hydro energy costs.

b. Domestic Economic Environment

i. Economic Growth

Data from the KNBS shows that the economy grew by 6.1 percent in the third quarter of 2010 relative to the third quarter in 2009, and up from 5.3 percent in the second quarter of 2010 (Chart 2). It is noteworthy that the cumulative 4-quarter growth to the third quarter was the highest ever recorded for manufacturing (6.84 percent), building and construction (14.86 percent), and financial services (13.82 percent). In addition, the third quarter financial sector growth of 20.3 percent was the highest recorded for the sector, while the second quarter growth of 16.0 percent was the second highest.

The improved performance of the economy in the third quarter of 2010 was attributed to favourable weather conditions, adequate liquidity in the banking sector and prudent macroeconomic management. These factors encouraged a steady growth of the economy since the first quarter of 2010 leading to a turnaround in the performance of agriculture, electricity and water and tourism sectors. This had indirect compounding impact on growth through knock-on effects on manufacturing, construction and services sector.



ii. Confidence in the Economy

Confidence in the Kenyan economy remained high in the period under review. The confidence was partly attributed to expectations for an IMF supported programme as a certificate of good economic management and the upgrading of the country’s credit rating to ‘B+ with stable outlook’ by Moody’s & S&P during the period. The successful promulgation of the new

Constitution in August 2010 enhanced the confidence in the economy with expectations for new and more effective institutional and governance structures.

Developments in other economic indicators also pointed to increased confidence in the economy during the period. This is depicted in Table 3 by indicators such as: cumulative diaspora remittances increased from USD 617.3 million in the 12-months to June 2010 to USD 642.0 million in the 12-months to December 2010; similarly, activity at the NSE increased significantly during the period due to increased participation by foreign investors through purchases of equity, the 12-month cumulative purchases of equity by foreigners increased from Ksh. 24,801 million to Ksh. 30,706 million during the period; in addition, the 12-month cumulative cement consumption increased from 2,826,889 metric tonnes to 3,054,861 metric tonnes in the period. Cement consumption is an important proxy for economic activity in the country.

Other important signals to investors included the continued decline in credit risk as well as the operationalisation of the credit reference bureaus in July 2010. The MPC Market Surveys conducted in the period also pointed to increasing investor confidence in the economy.

Table 3: Indicators of Reducing Risk and Growing Confidence in the Economy

	Dec-09	Jun-10	Jul-10	Aug-10	Sep-10	Oct-10	Nov-10	Dec-10
12-Month cumulative emigrant remittances (USD Million)	609.0	617.3	617.6	613.7	618.9	624.3	632.7	642.0
12-month cumulative purchases of equity by foreigners (Kshs Million)	22,385.0	24,801.0	24,405.0	24,735.0	26,023.0	27,279.0	29,043.0	30,706.0
12-month cumulative cement Consumption (Metric Tonnes)	2,671,178.0	2,826,889.0	2,873,108.0	2,920,217.0	2,938,334.0	3,004,521.0	3,041,640.0	3,054,861.0
Net NPLs/Total Loans ratio	2.90	2.27	2.15	2.01	1.94	1.82	1.61	1.56

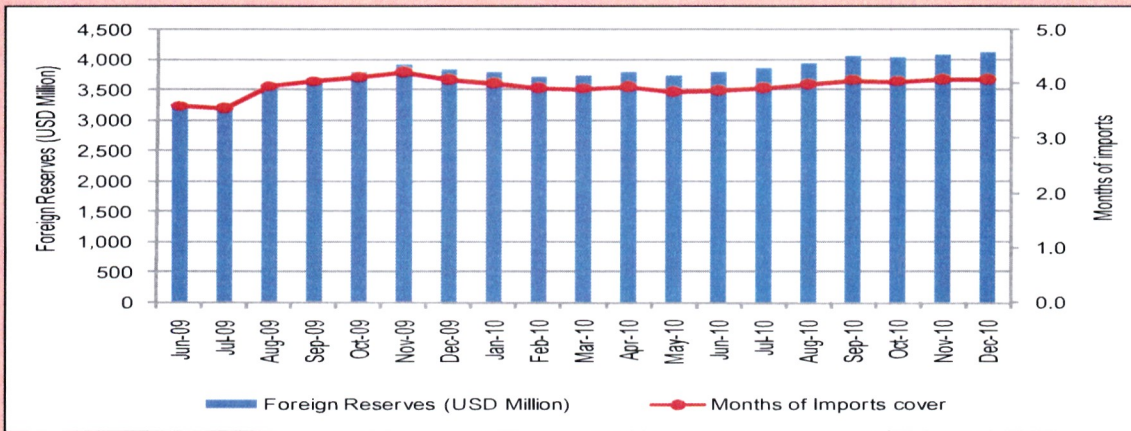
Source: Kenya National Bureau of Statistics and CBK

iii. Foreign Exchange Market

As shown in Chart 3, official foreign exchange reserves of the CBK increased from USD 3,799 million (3.9 months of imports cover) in June 2010 to USD 4,130 million (4.1 months of imports cover) in December 2010. Consequently, the official foreign exchange reserves remained within the range of the statutory requirement of 4.0 months of imports cover between September and December 2010. The build up in reserves during the period was on account of interbank purchases by the CBK.

The Monetary Policy Committee advised the Central Bank to diversify purchases of foreign exchange reserves from the market to include the Euro and Sterling Pound. In the past, all purchases of foreign exchange were made in US dollars. The build-up in official foreign exchange reserves towards the end of December 2010 was therefore undertaken through purchases of Euros, Sterling Pounds and US dollars.

Chart 3: Foreign Exchange Reserves

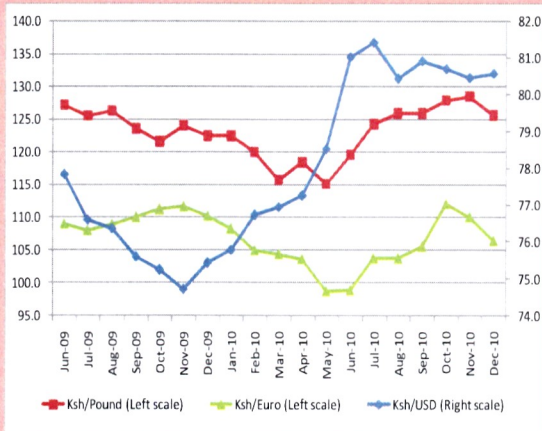


Source: Central Bank of Kenya

iv. Exchange Rates

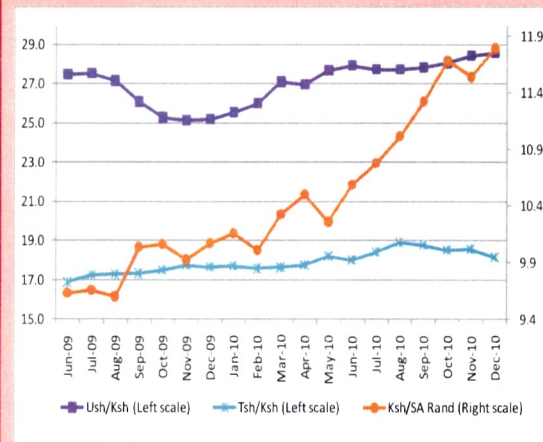
As shown in Chart 4a, the exchange rate of the Kenya shilling against major currencies showed mixed trends between June 2010 and December 2010. The Kenya Shilling weakened against the Sterling Pound and the Euro but remained fairly stable against the US dollar. These movements in exchange rates reflected a correction of the Euro and Sterling Pound towards the pre Greek debt crisis levels. Both the Euro and Sterling Pound had depreciated significantly in the international market as investors shifted their portfolios to the US dollar which was perceived a safe haven at the peak of the Greek debt crisis between April and May 2010. The exchange rate of the Kenya Shilling against the US dollar was supported by foreign exchange inflows through immigrant remittances, agricultural export earnings especially tea, coffee, and tourism earnings.

Chart 4a: Trends in the Kenya Shilling Exchange Rate against Major Currencies



Source: Central Bank of Kenya

Chart 4b: Trends in the Kenya Shilling Exchange Rate against Regional

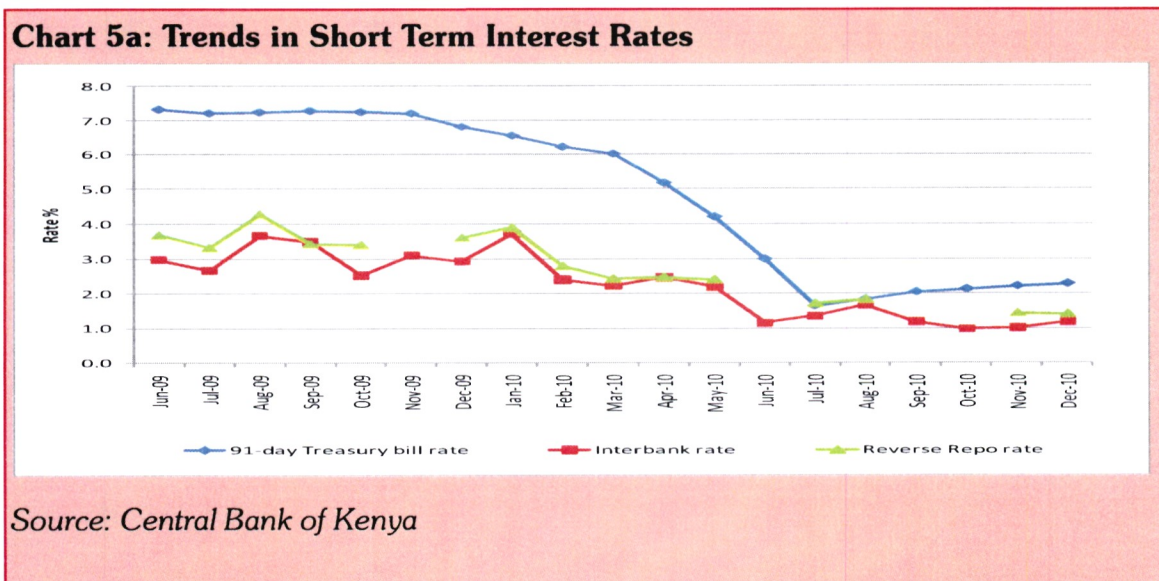


On the regional front, the Kenya shilling remained fairly stable against the Uganda and Tanzania shilling but weakened significantly against the South African Rand (Chart 4b). The Rand has been strengthening globally due to higher commodity prices and investment inflows.

v. Interest Rates

Short term interest rates – interbank, reverse repo and 91-day Treasury bill rates – responded to monetary policy signals by remaining stable between June 2010 and December 2010 (Chart 5a). The reduction in the CBR to 5.00 percent in July 2010 by the MPC was successful in bringing down and stabilising the short term interest rates in the period. Consequently, the Bank achieved the target of monetary stability during the period. The MPC's actions were also successful in removing the excessive volatility that had been experienced in the interbank market. Notably, the volatility in the interbank rate observed in the previous 12-months had successfully been addressed by ensuring that there is adequate liquidity in the market.

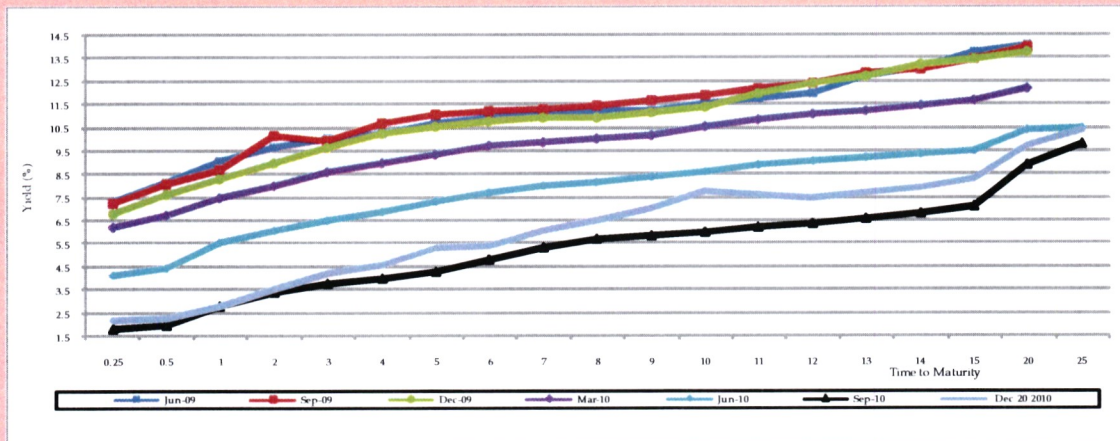
Due to improvements in liquidity conditions in the market, reverse repos were used occasionally between July 2010 and December with interest rates remaining below 2 percent. Reverse repos were used to provide liquidity in the market in periods of liquidity shortages caused by corporate tax payments and large volume Treasury bond sales which resulted in temporary build-ups of government deposits at CBK. The average 91-day Treasury bill rates declined from 2.98 percent in June 2010 and 2.28 percent in December 2010 while the average interbank rate remained virtually unchanged at 1.2 percent during the period.



Overall yields on government securities dropped in general over the period December 2009 to September 2010 (Chart 5b). This downward shift partly reflected the period during which investors absorbed the new shift to the use of the geometric mean by the Kikuyu BS from the old

arithmetic methodology which had overstated inflation. Between September and December 2010, the yield curve shifted upwards with yields increasing across all maturities though by bigger margins at the medium and at the long end of the maturities, thus leading to steepening at the long-end of the yield curve.

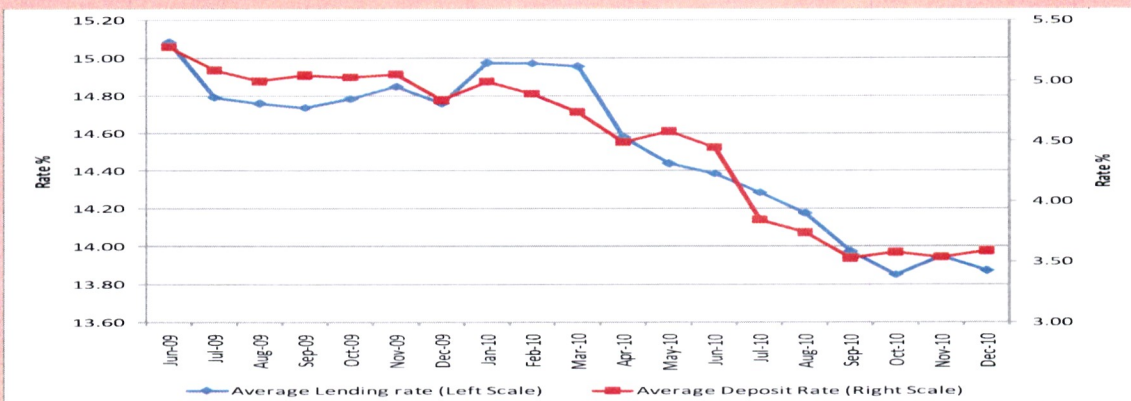
Chart 5b: Shift in the Kenya Government Bonds Yield Curve: December 2009 to December 2010



Source: Central Bank of Kenya

As shown in Chart 5c, the average commercial banks deposit rate declined from 4.5 percent to 3.6 percent while the average lending rate declined from 14.4 percent to 13.9 percent between June 2010 and December 2010. Consequently, the interest rate spread increased slightly from 9.9 percent to 10.3 percent during the period.

Chart 5c: Trends in Commercial Bank Interest Rates (%)



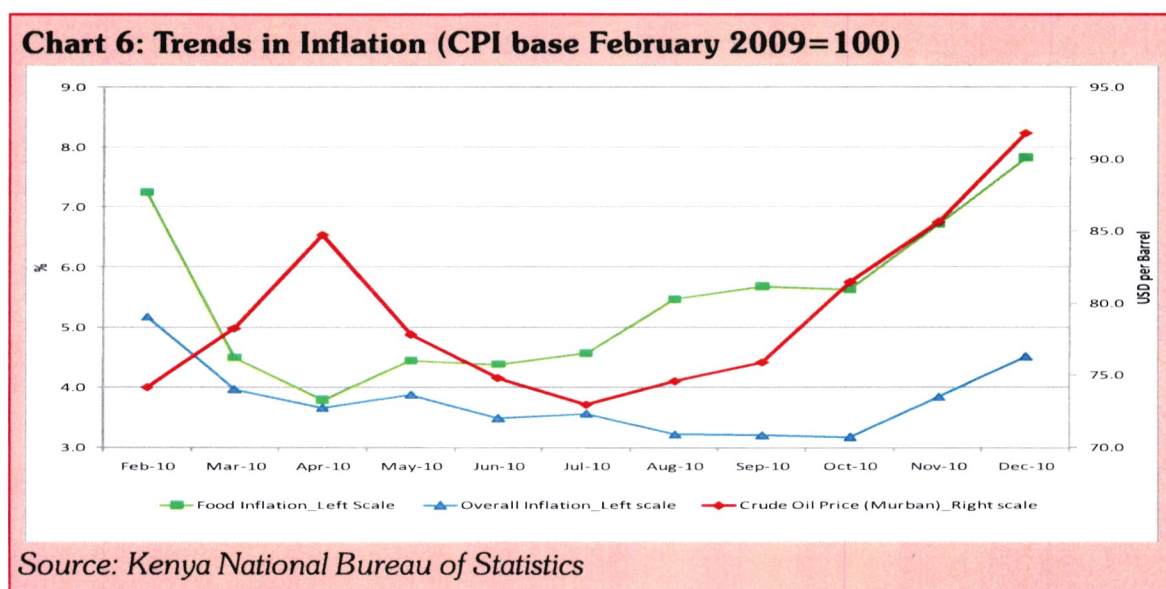
Source: Central Bank of Kenya

Commercial banks have cited various structural factors which have slowed down the transmission of monetary policy signals to the lending rates. Macroeconomic conditions in the country have

improved significantly since inflation is low and relatively stable; credit reference bureaus have been operationalised; and the Government has made significant progress both in addressing infrastructural concerns and challenges around the collateral perfection process. Therefore, there is need for the banking sector to lower their lending rates further.

vi. Inflation

Between June 2010 and December 2010 overall month-on-month inflation remained well within the target bands set by the Minister for Finance. As shown in Chart 6, the month-on-month overall inflation rate increased slightly from 3.49 percent in June 2010 to 4.51 percent in December 2010. It remained low and stable during the period on account of improved rainfall, reduction in the cost of communication, and stable world oil prices. Price and product wars by mobile telephone service providers resulted in a steep reduction in the 12-month communication inflation from 0.1 percent in April 2010 to -24.15 percent in August 2010. The rise in inflation between October and December 2010 was attributed to an increase in food and international price of oil which rose from USD 75.90 per barrel in September 2010 to USD 91.85 per barrel in December 2010.



vii. Fiscal and Public Debt Developments

During the first half of the fiscal year 2010/11, Central Government budgetary operations resulted in a deficit-to-GDP ratio of 1.98 percent on commitment basis (including grants) compared with 1.5 percent in a similar period in the fiscal year 2009/10. The budget deficit during the period was within the programmed target of 4.9 percent of GDP on commitment basis. Gross public and publicly guaranteed debt increased slightly from 48.1 percent of GDP in June 2010 to 48.7 percent of GDP in December 2010. Despite the slight increase in the debt, the public

debt ratios were consistent with the thresholds set in the current Medium Term Expenditure Framework.

viii. Banking Sector Developments

The banking sector witnessed significant growth during the second half of 2010. Due to improved macroeconomic conditions and increased optimism on the performance of the economy. The growth in credit during the period was registered in all sectors of the economy. In addition, the outcome of stress tests on the banking system revealed that the industry remains robust and that the steady decline in the proportion of net non-performing loans to total loans during the period represented a major improvement in the risk environment. The ratio of total loans in total deposits increased from 68 percent to 73 percent during the period which indicates increased financial intermediation. However, there is scope for increased lending if the interest rates are supportive.

The structural transformation of the country's financial system continued during the period with improved financial inclusion in the economy. Financial inclusion is regarded internationally as a necessary component in generating growth and reducing poverty. In particular, there was exponential growth of bank branches in from 534 at the end of 2005 to 1,063 in December 2010. The number of rural branches grew by 147 percent during the period compared with 75 for urban branches. Two National Deposit Taking Institutions have 31 branches since 2009 while a Community Deposit Taking Microfinance Institution was licensed in November 2010. All these point towards expanding financial services.

There has been a rapid increase in small savings accounts and the opening of quasi banking outlets through agent banking. The number of deposit accounts has increased from 2.55 million in 2005 to nearly 12.8 at the end of December 2010 with significant acceleration from 2007. The number of micro accounts (below hsh. 100,000) increased by 462 percent from about 2.14 million accounts in 2005 to about 12.03 accounts at the end of December 2010. The growth in the accounts was attributed to reduced costs of maintaining micro accounts and introduction of innovative instruments. However, the bank branch expansion has solved the physical distances while barriers to opening accounts have reduced significantly. Consequently, the number of loan accounts increased by 204.4 percent from 589,296 in December 2005 to 1,793,664 in December 2010. This is still way below the 12.8 million deposit accounts for the existing number banks.

Consequently, financial deepening through enhanced financial innovations continues to be embraced in the market. Access to financial services as indicated by branch expansion, number of ATMs, deposit accounts and amounts mobilised through mobile phone banking services continues to expand. These are structural changes which have important implications on the

current monetary programme. Specifically, accelerated mobile phone banking had resulted in a decline in the proportion of currency outside banks as a percentage of the total money stock. Furthermore, the use of money to lubricate the wheels of the economy was changing significantly. Telephony devices, paying bills and receiving remittances all made for a different monetary environment than that which had been in place at the time the monetary programme was established.

4. Outlook for the Monetary Policy Environment (January - June 2011)

a. Global Economy

The IMF projects the global economy to stabilise and grow by 4.4 percent in 2011 and 4.5 percent in 2012 (Table 4). Growth is expected to be driven mainly by fiscal packages passed in 2010 in the United States and Japan which are expected to boost economic activity. Growth in the Euro Area is projected to increase from 1.5 percent to 1.7 percent during the period. Emerging and developing countries are projected to grow by 6.5 percent in 2011 and 2012. Sub-Saharan Africa and East African Countries (excluding Kenya) are forecast to grow at 5.5 percent and 5.1 percent, respectively, in 2011. The expected growth in the EAC countries is expected to boost trade in the region and Kenya's export sector. Pressure on global inflation is expected to be sustained with a projection of 2.2 percent. Upward pressure on prices is expected to persist due to increased demand and sluggish supply in response to expected tightening in market conditions in the commodities market.

Table 4: Outlook for Real GDP Growth and Inflation in 2010 and 2011 (%)

	Real GDP		Inflation
	2011 Projection	2012 Projection	2011 Projection
World	4.4	4.5	3.2
Advanced Economies	2.5	2.5	1.6
United States	3.0	2.7	1.0
Japan	1.6	1.8	-0.3
Euro Area	1.5	1.7	1.5
United Kingdom	2.0	2.3	2.6
Other Advanced economies	3.8	3.7	2.5
Emerging and developing economies	6.5	6.5	6.0
Sub-Sahara Africa	5.5	5.8	7.0
East African Community (Excl. Kenya)	5.1		6.6
Developing Asia	8.4	8.4	4.2
China	9.6	9.5	2.7
India	8.4	8.0	5.7
Middle East and North Africa	4.6	4.7	6.3

IMF World Economic Outlook (October 2010 and January 2011 Update)

b. Domestic Economy

i. Economic Growth

The increasing confidence in the economy indicates that the Government growth target of about 6 percent in 2011 is expected to be achieved. The results of the MPC Market Perception Surveys on the performance of the economy conducted between July and December 2010 show an increase in confidence in the Government's economic growth target. Respondents indicated that there would be increased levels of foreign direct investment with the implementation of the New Constitution. In addition, imports of capital equipment and emigrant remittances together with the upturn in the Nairobi Stock Exchange activity all continue to support a positive growth forecast. Further, the projected growth in the global economy in 2011 is expected to increase the demand for Kenya's exports as well as the number of tourist arrivals in the country.

ii. Exchange rates

The exchange rate of the Kenyan shilling against major currencies is expected to remain stable in 2011 on account of an expected increase in foreign exchange inflows from tourism, improved performance of the global economy, agriculture exports, diaspora remittances, and increased foreign investor confidence at the NSE. However, high oil prices, strengthening of the US dollar in the global foreign exchange market, and sluggish recovery of the Eurozone economies following the Greek and Irish debt crisis pose a risk on the strength of the Kenyan Shilling. The expected IMF balance of payments support through the Extended Credit Facility in early 2011 is expected to reduce the pressure on the Kenyan shilling, and enhance the build-up of foreign exchange reserves.

iii. Interest rates

Interest rates are expected to remain stable in the first half of 2011 on account of lower credit risk with the operationalisation of credit reference bureaus in July 2010, economic growth which is expected to increase demand and competition for credit, stable macroeconomic environment including low and stable inflation rates, and improved liquidity in the market.

iv. Inflation

Overall, inflation is expected to remain stable in the first half of 2011 on account of the easing of the political crises in North Africa which, hopefully, will reduce the pressure on oil prices, expected implementation of an elaborate food distribution mechanism to address the food shortages in the drought prone regions, and the expected rains at the end of the first quarter of 2011. The CBK's Net Perceptions survey reflects a stable outlook for inflation by the business community and financial sector.

v. Fiscal Policy

The enhanced expenditure on infrastructural projects in the country will continue to create employment and demand – hence supporting economic growth. Tax revenue collection between January and June 2011 is expected to improve with improving economic performance. The impact of the current domestic borrowing programme has been analysed and is not a major threat to interest rates and debt sustainability.

5. Future Direction of Monetary Policy (January – December 2011)

Monetary policy during the 12-months to December 2011 will focus on: setting targets which are consistent with the objective of maintaining a low and stable inflation, encouraging growth and ensuring the long term sustainability of public debt; enhancing access to banking services within the economy including payment systems; and, a continuation with the medium term research agenda.

5.1 Monetary Programme and Foreign Exchange Reserves

Since the Government has been negotiating a programme with the IMC, the assumptions and targets under the current programme are expected to change when the IMC bCC programme takes effect in March 2011. The net domestic assets (N^aA) has been proposed in the IMC bCC programme as an operating target in place of reserve money to address the weaknesses of unstable velocity and money multiplier identified in the current monetary programme. In the course of preliminary discussions with the IMC preparatory mission, it was noted that N^aA and Net International Reserves (NI^o) are most probably the quantitative performance criteria under the likely IMC programme in the medium term which would extend over the tenure of the bCC programme from 2011 to 2014. The N^aA would be set as a ceiling and the NI^o as a floor. The main advantage of the N^aA option is that it provides for a waiver for default if the underlying developments change. The N^aA ceilings can also be useful in preventing the monetization of fiscal deficits.

As indicated in the June 2010 Monetary Policy Statement, the monetary targets for 2010/11 are based on the assumptions in the June 2010/11 Budget Strategy Paper which are presented in Annexes 1 and 2. The monetary targets for the fiscal year 2010/11 are presented in Table 5.

Broad money supply, M3, is set to grow by 20.7 percent by March 2011, and 17.3 percent by June 2011. The NCA of the CBh is planned to increase from hsh. 278.1 billion in March 2011 to hsh. 289.8 billion in June 2011 while N^aA is set to fall from hsh. -78.1 billion to hsh. -83.9 billion during the period. Consequently, reserve money is planned to expand by 12.7 percent

in March 2011 and by -2.1 percent in June 2011. This is expected to enable the Bank achieve the policy objective of maintaining overall inflation at the target of 5 percent and to anchor inflation expectations. The monetary policy stance will ensure that short term interest rates remain stable. Therefore, credit to the private sector is projected to grow by 25 percent in March 2011 and 26.6 percent by June 2011.

TABLE 5: Monetary Targets for the Second Half of 2010/11

	Jan-11 Targ.	Feb-11 Targ.	Mar-11 Targ.	Apr-11 Targ.	May-11 Targ.	Jun-11 Targ.
Broad Money, M3 (Ksh Billion)	1,300.3	1,318.8	1,337.3	1,356.1	1,374.6	1,405.9
Reserve Money, RM (Ksh Billion)	198.6	199.2	200.0	198.6	201.6	205.9
NFA of Central Bank of Kenya (Ksh Billion)	270.4	274.3	278.1	281.9	285.7	289.8
NDA of Central Bank of Kenya (Ksh Billion)	-71.9	-75.1	-78.1	-83.3	-84.1	-83.9
12-month growth in RM (Percent)	10.7	13.6	12.7	11.9	3.9	-2.1
12-month growth in M3 (Percent)	21.8	21.6	20.7	20.8	18.5	17.3
12-month growth in Credit to Private Sector (Percent)	20.9	21.7	25.0	26.7	25.2	26.6
12-month growth in Real GDP (Percent)						5.1
12-month overall Inflation (Percent)	5.0	5.0	5.0	5.0	5.0	5.0

Source: Central Bank of Kenya

The framework for monetary policy formulation and implementation is expected to change if the Government and Bank successfully negotiates with the IMF on the ECF programme. However, the Bank will continue to monitor developments with respect to the Monetary Targets and make any necessary reviews. The achievement of the targets set will however depend on stability in the international prices of oil, normal weather conditions, stability of the exchange rate, and commitment by the Government to operate within the domestic borrowing ceiling for fiscal year 2010/11. 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 be used to inject liquidity. The strong seasonal demand for currency by the public has been built into the programme.

5.2 Extending Access to Financial Services

Despite the significant progress made in the previous period towards enhancing financial inclusion in Kenya, the Bank will continue to support development of new products and innovations towards enhancing financial access. This is due to the fact that improvements in access to financial services have been shown to support economic growth. The Bank will however recommend appropriate legislation aimed at ensuring that such innovations are regulated accordingly to enhance market confidence.

The recommendations of the report of the Development Banking Committee will be shared with the Treasury through the Budget Advise Letter for 2011. On implementation, the

recommendations are expected to improve access to credit by small to medium enterprises (SMEs) and provide incentives to make long term products attractive.

5.3 Measures to Enhance Market Efficiency

The Bank will continue to work with stakeholders in the banking and real sectors in order to enhance the monetary policy transmission mechanism. Following the success of the First Monetary Policy Public Forum in August 2010, the Bank will continue with similar initiatives aimed at engaging stakeholders and obtaining feedback on the impact of MPC decisions. Measures to enhance the uptake of Horizontal Repos among banks will be implemented, while stakeholder forums with chief executive officers and Treasury Managers of banks will be held to obtain feedback and explain the background to MPC decisions.

5.4 Research Agenda

The Bank has identified reviewers for research papers prepared by its researchers during the planned technical retreat in January 2011. These studies include: demand for money function for Kenya; monetary policy transmission mechanism in Kenya; a framework for restructuring the Central Bank Rate; output fluctuations and inflation in Kenya; efficiency and productivity of the Kenyan banking sector; access to private sector credit and economic performance; interest rate pass-through in Kenya; factors driving usage of financial services from different financial access strands in Kenya; and, a dynamic model for inflation. Work on the CBK model is also expected to be completed during the first half of 2011 with suitable reviewers having been identified.

The Bank will also continue to work with the KNBS towards development of tradable and non-tradable CPI measures. International experience indicates that the non-tradable CPI is the more relevant measure for the effectiveness of monetary policy.

**ANNEX 1: MAIN MACROECONOMIC INDICATORS UNDERPINNING
THE MEDIUM TERM FISCAL FRAME: ORK, 2007/08 – 2012/13**

	2007/08	2008/09	2009/10	2010/11		2011/12		2012/13	
			Prov.	Budget	Proj.	BSP10	Proj.	BSP10	Proj.
<i>Annual percentage change, unless otherwise indicated</i>									
National account and prices									
Real GDP	4.3	2.1	3.8	5.1	5.4	6.0	6.1	6.4	6.7
Real GDP per capita	1.3	0.2	1.9	2.2	2.4	3.1	3.2	3.5	3.7
GDP deflator	8.6	9.3	6.7	6.4	6.9	5.7	6.8	6.4	5.6
CPI Index (eop)	29.3	8.6	3.5	5.0	5.0	5.0	5.1	5.0	5.0
CPI Index (avg)	18.5	12.7	5.5	5.0	4.7	5.0	5.2	5.0	5.0
Terms of trade (-deterioration)	-2.4	4.8	5.8	-4.3	-3.0	-2.1	-4.1	-0.3	-1.8
Money and credit (end of period)									
Net domestic assets	14.0	26.5	34.8	13.8	13.2	9.6	13.3	10.5	12.5
Net domestic credit to the Government	-15.1	30.3	59.7	16.9	14.1	12.8	12.5	10.5	7.3
Credit to the rest of the economy	26.0	22.5	16.8	20.0	15.8	15.8	16.2	16.6	16.4
Broad Money, M3 (percent change)	18.7	13.0	26.2	14.0	15.1	14.4	15.4	15.5	15.6
Reserve money (percent change)	18.2	4.6	31.5	11.7	7.5	12.7	12.6	13.8	15.6
<i>In percentage of GDP, unless otherwise indicated</i>									
Investment and saving									
Investment	19.6	19.9	22.2	21.1	23.7	21.8	24.5	22.7	25.9
Central Government	6.6	7.5	8.8	10.2	10.3	9.1	10.6	8.9	11.2
Other	13.0	12.4	13.3	10.9	13.5	12.7	13.9	13.8	14.7
Gross National Saving	13.5	12.9	15.7	15.5	17.0	17.3	17.3	19.0	18.4
Central Government	1.7	2.4	1.6	6.4	2.9	5.6	5.0	5.6	6.3
Other	11.9	10.5	14.1	9.1	14.1	11.6	12.3	13.5	12.1
Central government budget									
Total revenue	22.1	22.4	22.7	24.9	25.2	24.6	25.0	24.5	25.1
Total expenditure and net lending	27.4	27.7	30.1	33.1	32.7	31.2	31.0	29.6	30.4
<i>of which</i> : wages and salaries	7.5	6.9	7.2	6.9	7.3	6.8	7.1	6.8	7.1
Interest payments	2.5	2.4	2.6	2.7	2.8	2.9	2.6	2.9	2.6
Development expenditures	6.7	7.6	8.9	11.7	10.3	10.3	10.7	9.7	11.3
Overall balance (commitment basis) excl. grants	-5.3	-5.2	-7.4	-8.2	-7.4	-6.6	-6.0	-5.1	-5.3
Overall balance (commitment basis) incl. grants	-3.5	-4.4	-6.5	-6.8	-6.3	-5.0	-4.7	-3.5	-4.0
Net external borrowing	0.3	0.6	0.8	3.0	1.9	2.0	2.0	1.8	2.4
Infrastructure bonds	0.0	0.9	0.0	1.1	1.1	0.6	0.8	1.0	1.6
Net domestic borrowing	-0.7	3.2	5.5	3.8	4.4	1.9	2.8	1.8	1.5
Total external support (grant & loans)	2.5	2.4	2.5	5.2	3.8	4.2	4.0	3.6	3.3
External sector									
Exports value, goods and services	26.8	26.4	25.8	24.5	25.6	24.7	24.6	25.1	24.2
Imports value, goods and services	39.7	40.1	38.6	35.2	38.2	34.0	37.3	33.3	37.0
Current external balance, including official transfers	-6.0	-7.0	-6.5	-5.6	-6.7	-4.5	-7.2	-3.7	-7.5
Current external balance, excluding official transfers	-6.2	-6.9	-6.4	-5.5	-6.7	-4.5	-7.2	-3.6	-7.4
Gross international reserve coverage in months of next year imports (end of period)	3.5	3.3	3.5	3.2	3.6	3.6	3.6	4.0	3.8
Public debt									
Nominal central government debt (eop), gross	44.6	48.4	50.6	50.3	51.2	49.3	50.6	48.1	49.8
Nominal central government debt (eop), net	39.8	43.3	45.6	46.0	46.8	44.4	45.5	43.1	44.6
Domestic (gross)	22.0	23.7	27.1	27.1	28.5	27.2	29.0	26.5	28.0
Domestic (net)	17.3	18.6	22.1	22.9	24.0	22.3	24.0	21.4	22.8
External	22.5	24.7	23.5	23.2	22.7	22.2	21.5	21.6	21.8
Memorandum items:									
Nominal GDP (in Ksh billions)	1,953	2,176	2,410	2,767	2,713	3,102	3,075	3,510	3,464
Per capita income (Ksh)	51,749	56,593	61,545	67,344	67,379	73,410	74,251	80,805	81,374
Nominal GDP (in US\$ millions)	28,618	29,695	30,804	35,973	34,065	39,840	38,106	44,524	42,474
Per capita income (US\$)	758.3	772.5	786.8		845.9		920.2		997.7
Population (millions)	37.7	38.4	39.2		40.3		41.4		42.6
Population growth rate	2.9	1.9	1.8		2.9		2.8		2.8

Source: Ministry of Finance
BOPA = Budget Outlook Paper
BSP = Budget Strategy Paper
Budget Outlook Paper, 2009

ANNEX 2: MONETARY SURVEY 2007/08 – 2012/13 (END OF PERIOD, KSH BILLIONF)

	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
	Act.	Act.	Act.	Projection		
Central Bank of Kenya (CBK)						
Net Foreign Assets 1/	202.6	208.8	241.9	275.5	322.0	390.1
Net Domestic Assets	-49.6	-48.8	-31.6	-49.5	-67.6	-96.1
Net credit extended	-23.1	-8.6	7.5	-5.0	-10.7	-26.4
Net claims on Government	-27.7	-23.5	7.5	13.4	19.4	23.3
Claims on banks	4.5	15.0	0.0	-18.4	-30.1	-49.7
Other assets, net	-28.9	-42.8	-41.9	-44.5	-56.9	-69.7
Reserve money (RM)	152.9	159.9	210.3	226.0	254.4	294.0
Monetary Survey						
Net Foreign Assets (NFA) 1/	291.3	268.0	279.3	339.3	413.6	514.6
Central Bank (CBK)	202.6	208.8	241.9	275.5	322.0	390.1
Banks	88.7	59.2	37.4	63.8	91.6	124.5
Net Domestic Assets (NDA)	539.3	682.3	919.7	1,041.1	1,179.3	1,326.2
Domestic Credit	691.7	857.9	1,076.9	1,242.7	1,432.8	1,634.8
Claims on Government (net)	133.4	173.9	277.7	316.9	356.6	382.5
Central Bank	-27.7	-23.5	7.5	13.4	19.4	23.3
Banks	161.1	197.4	270.2	303.5	337.2	359.2
Claims on Private Sector	558.3	684.0	799.2	925.9	1,076.2	1,252.3
Other items (net)	-152.4	-181.9	-167.1	-201.6	-253.5	-308.6
Broad Money (M3)	840.7	950.2	1,198.9	1,380.4	1,593.0	1,840.8
of which:						
Residents' foreign-currency deposits	124.7	138.2	165.2	190.2	219.5	253.7
(ratio of FX deposits/M3)	14.8%	14.5%	13.8%	13.8%	13.8%	13.8%
Memorandum items:						
Reserve money annual percentage change	18.2	4.6	31.5	7.5	12.6	15.6
M3 Annual percentage change	18.7	13.0	26.2	15.1	15.4	15.6
Velocity (GDP/M3eop)	2.3	2.3	2.0	2.0	1.9	1.9
Velocity (GDP/M3avg)	2.5	2.4	2.2	2.1	2.1	2.0
Multiplier (M3/RM)	5.5	5.9	5.7	6.1	6.3	6.3
Credit to private sector	26.0	22.5	16.8	15.8	16.2	16.4
Resident FX deposits (billions of US\$)	1.9	1.8	2.0	2.4	2.7	3.1
Net Government borrowing	335.3	404.3	535.6	654.4	774.8	853.2
Banking sector	133.4	173.9	277.7	316.9	356.6	382.5
Non-banking sector	201.8	230.4	257.9	337.5	418.2	470.7

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 (January – June 2010)**

- July 2010**
- a) The Bank diversified purchase of foreign exchange to build-up its reserves to include Euros.
 - b) A bomb blast in Kampala caused a scare in the financial markets in the region.
- August 2010**
- a) Promulgation of the New Constitution enhanced foreign investor confidence in the economy.
 - b) Price wars in the mobile telephone providers resulted in a significant decline in communications costs.
- September 2010**
- The Bank stayed out of the foreign exchange market. Certain segments of the market had misrepresented the participation by the Bank in the market as to defend a particular value of the exchange rate. During this period, the exchange rate maintained the same trend as when the Bank was in the market to purchase foreign exchange to build up its reserves.
- November 2010**
- a) The Bank licensed the first community deposit taking microfinance institution.
 - b) The Irish banking crisis escalated forcing a rescue package by the European Union.
- December 2010**
- a) The Bank opened the currency center in Nakuru. This is expected to lower the cost of transporting cash in the region.
 - b) The number of agents under the agency banking model accelerated to 8,807.

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.

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 (NBFI)
- 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. This is done in the context of an auction where commercial banks bid through the e-auctions 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 kept 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. ^a deposits are held to maturity and qualify for liquidity ratio purposes.