Central Bank of Kenya

MONETARY POLICY STATEMENT

Issued pursuant to Section 4B of the Central Bank of Kenya Act, Cap 491

December 2017

LETTER OF TRANSMITTAL TO THE CABINET SECRETARY FOR THE NATIONAL TREASURY

Dear Honourable Cabinet Secretary,

I have the pleasure of forwarding to you the 41st Monetary Policy Statement (MPS) of Central Bank of Kenya (CBK), pursuant to Section 4B of the Central Bank of Kenya Act. It reviews the outcome of the monetary policy stance during the second half of 2017, describes the current economic environment and outlook, and concludes with an outline of the direction of monetary policy for 2018.

Patrick Njoroge

Dr. Patrick Njoroge
Governor

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THE PRINCIPAL OBJECTIVES OF THE CENTRAL BANK OF KENYA

The role of the Central Bank of Kenya (CBK) is anchored in Section 231 of Kenya's Constitution and in the CBK Act. The CBK is responsible for formulating monetary policy to achieve and maintain price stability, and issuing currency. It promotes financial stability through regulation, supervision and licensing of financial institutions under its mandate. The Bank also provides oversight of the payments, clearing and settlement systems.

Financial stability, together with an effective and efficient payments and clearing system foster the liquidity, solvency and proper functioning of the financial system. The CBK also formulates and implements the foreign exchange policy, manages foreign exchange reserves, and is also the banker for, adviser to, and fiscal agent of the Government.

The CBK formulates and conducts monetary policy with the aim of keeping overall inflation within the target prescribed by the National Treasury at the beginning of the financial year. Currently, this target is 5.0 percent with a margin of 2.5 percent on either side. The target is consistent with the macroeconomic targets underlying the FY2017/18 Government Budget and the Medium Term Expenditure Framework (MTEF). The CBK's monetary policy therefore supports the Government's objectives with respect to growth.

The achievement and maintenance of a low and stable inflation rate coupled with adequate liquidity in the market, facilitates higher levels of domestic savings and private investment. This leads to improved economic growth, higher real incomes and increased employment opportunities.

INSTRUMENTS OF MONETARY POLICY

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

- **Open Market Operations (OMO):** This refers to actions by the CBK involving purchases and sales of eligible securities to regulate the money supply and the credit conditions in the economy. 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 hence increase the money supply. To achieve the desired level of money supply, OMO is conducted by using:
  - **i. Repurchase Agreements (Repos):** Repos entail the sale, through auction, of eligible securities by the CBK to reduce commercial banks' deposits held at CBK. Repos (also called Vertical Repos) have fixed tenors of 3 and 7 working days. Reverse Repos are purchases of securities from commercial banks and hence, they are an injection of liquidity by the CBK during periods of tighter than desired liquidity in the market. The current tenors for Reverse Repos are 7, 14, 21, and 28 days. The Late Repo, sold in the afternoon, has a 4-day tenor and is issued at an interest rate 100 basis points below the Repo on that day. When a weekend or public holiday coincide with the maturity date of the Repo, the tenor is extended to the next working day.
  - **ii. Term Auction Deposit (TAD):** The TAD is used when the securities held by the CBK for Repo purposes are exhausted or when CBK considers it desirable to offer longer than 7 day tenor options. The CBK seeks to acquire deposits through a transfer agreement from commercial banks at an auction price but with no exchange of security guarantee. Currently, the tenors for such deposits at CBK are 14, 21, or 28 day periods. At maturity, the proceeds revert to the respective commercial banks.
  - **iii. Horizontal Repos:** Although Horizontal Repos are not strictly monetary policy instruments, they are modes of improving liquidity distribution between commercial banks, and are conducted under CBK supervision. They are transacted between commercial banks on the basis of signed agreements using government securities as collateral, and have negotiated tenors and yields. Commercial banks, short of deposits at the CBK, borrow from banks with excess deposits on the security of an appropriate asset, normally a government security. Horizontal Repos also help banks overcome the problem of limits to lines of credit, thus promoting more efficient management of interbank liquidity.

- **Central Bank Rate (CBR):** The CBR is reviewed and announced by the Monetary Policy Committee (MPC) at least every two months. Movements in the CBR, both in direction and magnitude, signal changes in the monetary policy stance. In order to enhance clarity and certainty in monetary policy implementation, the CBR is the base for all monetary policy operations. Whenever the Central Bank is injecting liquidity through a Reverse Repo, the CBR is the lowest acceptable rate by law. Likewise, whenever the Bank wishes to withdraw liquidity through a Vertical Repo, the CBR is the highest rate that the CBK will pay on any bid received. However, to ensure flexibility and effectiveness of monetary policy operations in periods of volatility in the market, the CBK can raise the maximum acceptable interest rates on TAD to above the CBR. Movements in the CBR are transmitted to 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 move downwards. Lower interest rates encourage economic activity and thus growth. When interest rates decline, the quantity of credit demanded should increase.

The efficiency in the Repo and interbank markets is crucial for the transmission of monetary policy decisions. The CBK monitors, but does not intervene, in the overnight interbank money market which is conducted by the banking industry. It responds to the tightness or slackness in the interbank market liquidity through OMO. Short-term international flows of capital are affected by short-term interest rates in the country. These are, in turn, affected by movements in the CBR and hence indirectly, the exchange rate could also be affected.

The CBR is also currently the base rate for the determination of lending and deposit interest rates under the Banking (Amendment) Act, 2016. The Act sets the maximum interest rate chargeable for a credit facility in Kenya at no more than four percent above the base rate, and the minimum interest rate granted on a deposit held in an interest earning account in Kenya to at least seventy percent of the base rate.

- **Standing Facilities:** The CBK does not have automatic standing facilities with respect to overnight lending. The CBK, as lender of last resort, provides secured loans to commercial banks on an overnight basis at a penal rate that is over the CBR. This facility is referred to as the Discount Window. Access to the Window is governed by rules and guidelines which are reviewed from time to time by the CBK. Banks making use of this facility more than twice in a week are scrutinised closely, and supervisory action taken.

- **The Cash Reserves Ratio (CRR):** In accordance with the law, the CRR is the proportion of a commercial bank's total deposit liabilities which must be held as deposits at CBK. These deposits are held in the CRR Account at no interest. It is currently 5.25 percent of the total of a bank's domestic and foreign currency deposit liabilities. To facilitate commercial banks' liquidity management, commercial banks are currently required to maintain their CRR based on a daily average level from the 15th of the previous month to the 14th of the current month and not to fall below a CRR of 3 percent on any day.

- **Foreign Exchange Market Operations:** The CBK can also inject or withdraw liquidity from the banking system by engaging in foreign exchange transactions. A sale of foreign exchange to banks withdraws liquidity from the system while the purchase of foreign exchange injects liquidity into the system. Participation by the CBK in the foreign exchange market is usually motivated by the need to build-up its foreign exchange reserves in line with the statutory requirement. The CBK uses its best endeavours to maintain foreign reserves equivalent to four months' imports as recorded and averaged for the last three preceding years. The CBK does not participate in the foreign exchange market to defend a particular value of the Kenya Shilling, but may intervene in the market to stabilise the market in the event of excess volatility.

  The following regulatory measures have been introduced, through Prudential Guidelines of banks, to support stability of the exchange rate:

  i. Limiting the tenor of swaps and Kenya Shilling borrowing where offshore banks are involved to a tenor of not less than one year;
  ii. Limiting the tenor of swaps between residents to not less than seven days;
  iii. Reduction of the foreign exchange exposure from 20 percent to 10 percent. Furthermore, the foreign exchange exposure should not exceed the 10 percent overall limit at any time during any day; and
  iv. Requiring that local banks obtain supporting documents for all transactions in the Nostro accounts of offshore banks.

- **Licensing and Supervision of Financial Institutions:** The CBK uses the licensing and supervision tools to ensure stability and efficiency of the banking system; this includes vetting potential managers for suitability.

- **The National Payments System:** The modernisation of the National Payments System has continued to lower transaction costs and enhanced the efficiency of the payments systems. This has ensured the effectiveness of monetary policy instruments.

- **Communication:** The increasing use of communication media ensures a wider dissemination of monetary policy decisions and background data thereby increasing the efficiency of information transmission and managing expectations. The regular interaction between the MPC and the Chief Executive Officers of banks has ensured that monetary policy decisions are transmitted to the banking sector. The regular Governor's Press Conferences also enhance the media understanding of monetary policy decisions. The CBK website is an important source of up-to-date data on all aspects of the financial market including interest rates, exchange rates, results of auctions of government securities, and the MPC releases.

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 (Cabinet Secretary for The National Treasury), 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 Cabinet Secretary shall – by law – lay every Statement submitted under subsection (1) of Section 4B before the appropriate committee of the National Assembly not later than the end of the subsequent session of Parliament after the Statement is so submitted.

3a. The Bank shall – by law – publish in the Kenya Gazette:

i) Its Monetary Policy Statement; and

ii Its Monthly Balance Sheet.

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

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

EXECUTIVE SUMMARY

This Monetary Policy Statement provides the direction of monetary policy in 2018. It also reviews the outcome of the monetary policy stance adopted in the second half of 2017. The second half of 2017 was characterised by general macroeconomic stability, a decline in food prices, and uncertainties with regard to the prolonged election period. The CBK conducted monetary policy with the aim of keeping overall inflation within the Government target range of between 2.5 and 7.5 percent. Month-on-month overall inflation remained within the target range except in August, when it rose to 8.0 percent due to depressed supply of some key food items particularly in the second week which coincided with the general elections. Food prices, particularly in towns other than Nairobi, fell significantly due to improved weather conditions, the onset of the harvest season for maize in the food basket regions, normalization of food supply following the general elections in August, and the impact of Government measures instituted to mitigate the adverse effects of the drought. Overall inflation declined from 9.2 percent in June to 4.5 percent in December 2017. Non-food-non-fuel (NFNF) inflation remained below 5 percent, indicating that demand pressures in the economy were muted.

The foreign exchange market remained stable despite a widening of the current account deficit due to higher food and petroleum products import bills, and uncertainties with regard to a prolonged election period in the country. There were also uncertainties in the global financial markets particularly with regard to U.S. economic policies, Brexit resolution and pace of normalisation of monetary policy in the advanced economies. The stability in the foreign exchange market was largely due to resilient tea and horticulture exports, stronger diaspora remittances, and continued recovery in tourism. The CBK foreign exchange reserves which stood at USD7,065.7 million or 4.7 months of import cover at the end of December 2017, continued to provide an adequate buffer against short term shocks in the foreign exchange market. The Precautionary Arrangements with the International Monetary Fund (IMF) provided an additional buffer against exogenous shocks.

The Monetary Policy Committee (MPC) retained the Central Bank Rate (CBR) at 10.0 percent in its July, September and December 2017 meetings in order to anchor inflation expectations. The liquidity management operations by the CBK ensured stability in the interbank market in the period. Open Market Operations were undertaken to support liquidity distribution in the interbank market. The CBK continued to monitor the impact of the capping of interest rates on lending and monetary policy effectiveness.

The banking sector remained resilient and stable during the period. Growth in private sector credit picked up slightly from August 2017, with notable credit growth recorded in the manufacturing, domestic trade, and real estate sectors. Nevertheless, private sector credit growth remained subdued due in part to reduced credit demand attributed to weak performance of some sectors of the economy and opening of subsidiaries by Kenyan firms in the region, tightening of banking sector's credit standards, and increased usage of alternative funding sources such as joint ventures in real estate. Analyses by the CBK on the impact of interest rate capping on lending by banks showed a continued slowdown in private sector credit growth particularly to sectors such as the Micro Small and Medium Enterprises (MSMEs), which are perceived to be risky.

The monetary policy stance in 2018 will aim at maintaining overall month-on-month inflation rate within the Government's target range. The foreign exchange market is expected to remain stable in 2018 supported by an expected narrowing of the current account deficit to 5.4 percent of GDP due to continued growth in tea and horticulture exports, resilient diaspora remittances, and growth in tourism receipts. The CBK foreign exchange reserves will continue to provide a buffer against short-term shocks. Overall macroeconomic stability will be supported by continued coordination of monetary and fiscal policies. This will support the achievement of the Government's Big 4 priorities of food security and agricultural productivity, affordable housing, an increased share of manufacturing, and universal health coverage. Consistent with inflation and growth objectives stipulated in the Government Medium Budget Policy Statement for 2018, monetary policy will aim at containing annual growth in broad money (M3) at 9.5 percent by June 2018 and by 12.4 percent by December 2018. Growth in private sector credit is also expected to pick up gradually in the period. Monetary policy will aim at ensuring that movements in the short-term interest rates support the Bank's primary objective of price stability. The Bank will continue to review and enhance the effectiveness of its monetary policy instruments in order to maintain price stability.

The CBK will continue to strengthen the banking sector to ensure greater transparency, and to promote stronger governance, effective business models, and innovation leveraging on information technology. To address new risks associated with the increased use of emerging technologies and connectivity of customer channels, such as cyber security risk, the CBK issued a Guidance Note on Cyber security in August 2017. These measures will provide effective cyber security governance and risk management frameworks. Other reforms are being undertaken in the banking sector to enhance financial inclusion, and to strengthen the Credit Reference Bureaus to provide for a credit scoring framework.

The Bank continues to monitor the impact of interest rate caps on transmission of monetary policy signals in the financial sector. It will also continue to monitor the risks posed by developments in the domestic and global economies on the overall price stability objective. The Bank will closely monitor risks associated with the uncertainties on U.S. trade policies, Brexit resolution, pace of monetary policy normalisation in the advanced economies, and rise in international oil prices.

1. INTRODUCTION

This Monetary Policy Statement (MPS) provides the direction of monetary policy for 2018. It also presents the outcome of the monetary policy stance adopted in the second half of 2017. The second half of 2017 was characterised by general macroeconomic stability, a decline in food prices, and uncertainties with regard to a prolonged election period.

Price stability remains the primary objective of monetary policy formulation and implementation. The CBK targets for Net Domestic Assets (NDA) and Net International Reserves (NIR) are the operational parameters. The Bank also monitors targets for key monetary aggregates such as broad money (M3) and credit to the private sector. Movements in the Central Bank Rate (CBR) signal the monetary policy stance. It is the reference for all monetary policy operations. The Bank's participation in the foreign exchange market is guided by the need to maintain adequate level of foreign exchange reserves, meeting the Government's external obligations, and ensuring the stability in the foreign exchange market. The CBK foreign exchange reserves provide a buffer against short-term shocks. The Precautionary Arrangements with the International Monetary Fund (IMF) provide an additional buffer against exogenous shocks.

On the domestic scene, inflation has remained well anchored within the Government medium term target range during the second half of 2017, supported by declining food prices. The stability in the exchange rate continued to dampen any threat of imported inflation despite the rise in international oil prices. On the global scene, global economic activity strengthened in the third and fourth quarters of 2017 supported by increased growth of advanced economies and supportive financial conditions. Nevertheless, uncertainties remained with respect to the U.S. economic policies, the Brexit resolution, and the pace of normalization of monetary policy in advanced economies.

The rest of this Policy Statement is organized as follows. Section 2 reviews the outcome of the monetary policy stance proposed in the June 2017 MPS while Section 3 describes the current economic environment and outlook for 2018. Section 4 concludes by outlining the specific monetary policy path for 2018.

2. ACTIONS AND OUTCOMES OF POLICY PROPOSALS IN THE JUNE 2017 MONETARY POLICY STATEMENT

The overall aim of the Monetary Policy Statement for June 2017 was to set monetary policy targets that would ensure low and stable inflation, encourage growth, support long-term sustainability of public debt through stable interest rates and, by enhancing financial access within the economy, contribute to lowering the cost of doing business in Kenya. The following are the specific outcomes of the policy proposals in the June 2017 MPS:

a. Inflation

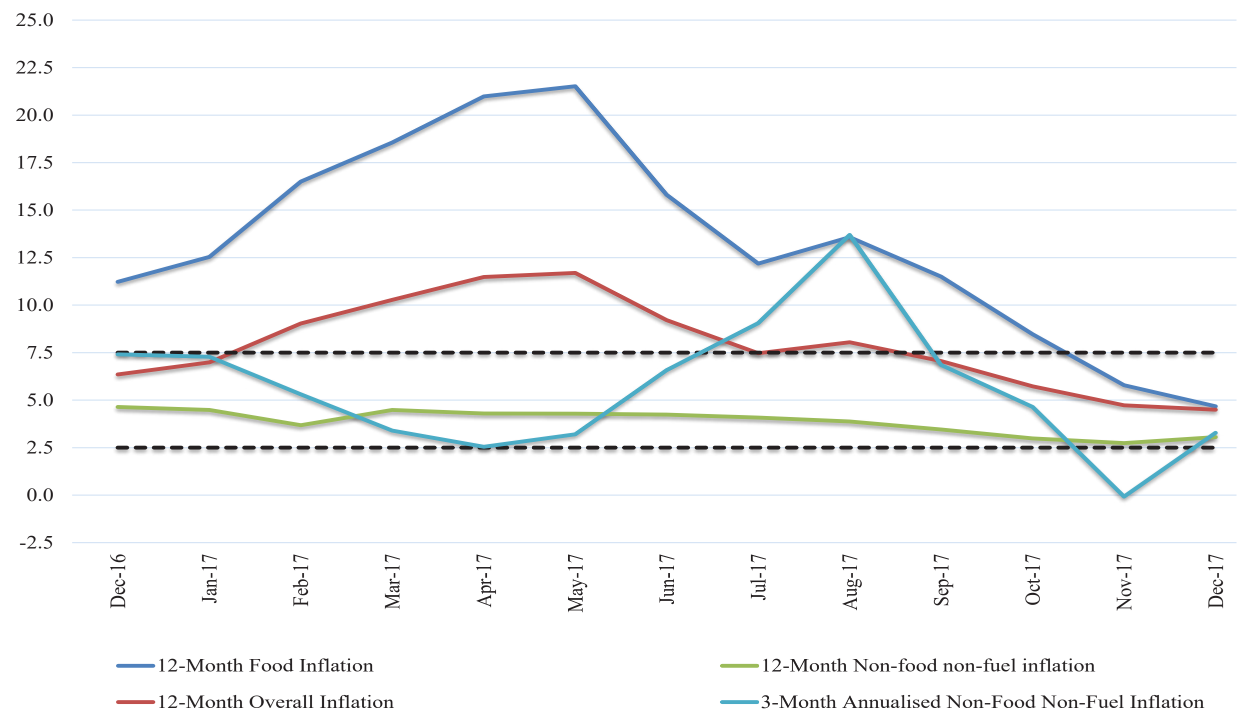
The monetary policy measures pursued by the Monetary Policy Committee (MPC) anchored inflation expectations, and ensured market stability during the second half of 2017. The MPC retained the CBR at 10.0 percent in order to anchor inflation expectations. Inflation declined in the period, and was broadly within the Government target range except in August 2017 (Chart 1a and 1b). The average inflation for all categories, excluding food and non-alcoholic beverages, remained below 5 percent in the second half of 2017.

Month-on-month overall inflation fell to 4.5 percent in December 2017 from a peak of 11.7 percent in May reflecting significant decreases in the prices of most food items. Food prices, particularly in towns other than Nairobi, fell significantly due to improved weather conditions, the onset of the harvest season for maize in the food basket regions, normalization of food supply following the general elections in August, and the impact of Government measures instituted to mitigate adverse effects of the drought. The main food items with significant price decreases include cabbages, sugar, maize grain (loose), kale-sukuma wiki, Irish potatoes, sifted maize flour, and fresh packeted milk (Chart 1c).

Nevertheless, overall inflation exceeded the upper bound of the target range in August 2017 reflecting limited supply of some food items, particularly tomatoes, following transport difficulties in the immediate period after the general elections. The 12-month overall inflation rose to 8.0 percent in August from 7.5 percent in July 2017. Food inflation rose to 13.6 percent in August from 12.2 percent in July 2017 reflecting increases in the prices of tomatoes, spinach, carrots, Irish potatoes, wheat flour, and rice. Housing, water, electricity, gas and other fuels inflation also rose in August due to increases in the prices of electricity and kerosene.

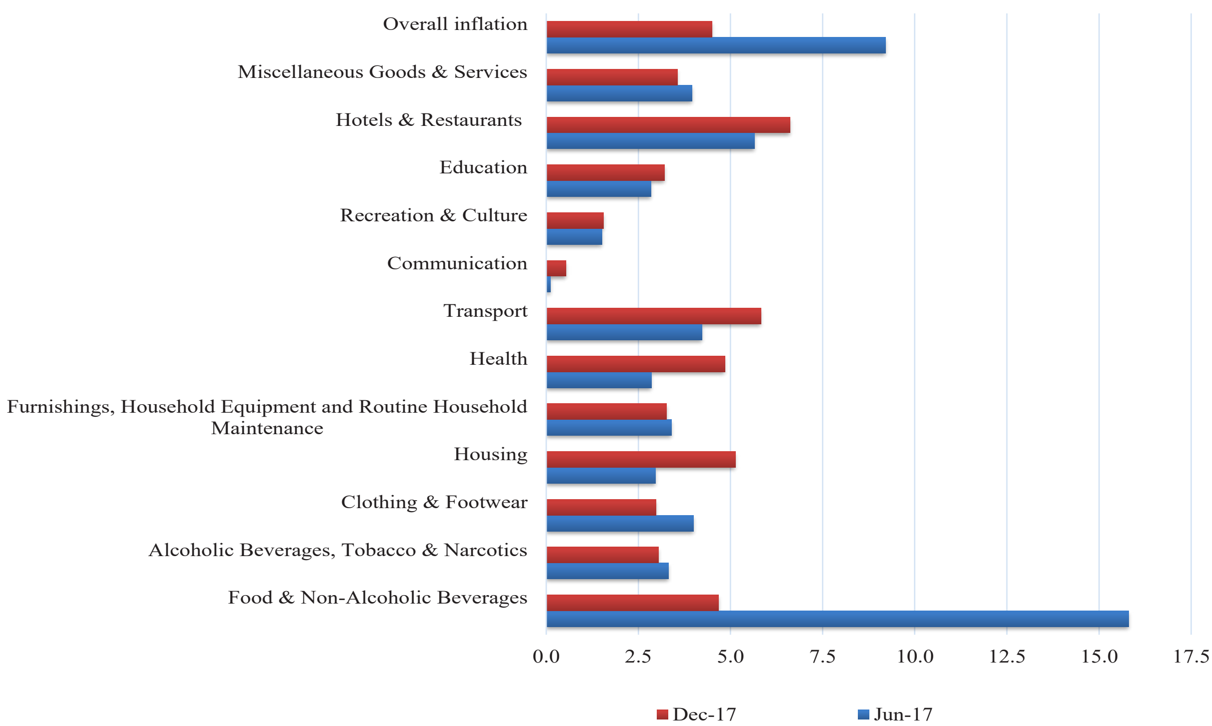
The 12-month non-food-non-fuel (NFNF) inflation remained below 5 percent in the second half of 2017 while the 3-month annualised NFNF inflation fell in the period, demonstrating that demand pressures in the economy were muted. The stability in the exchange rate continued to moderate the impact of import costs on consumer prices.

Chart 1: Overall and Non-Food-Non-Fuel Inflation Measures (%)



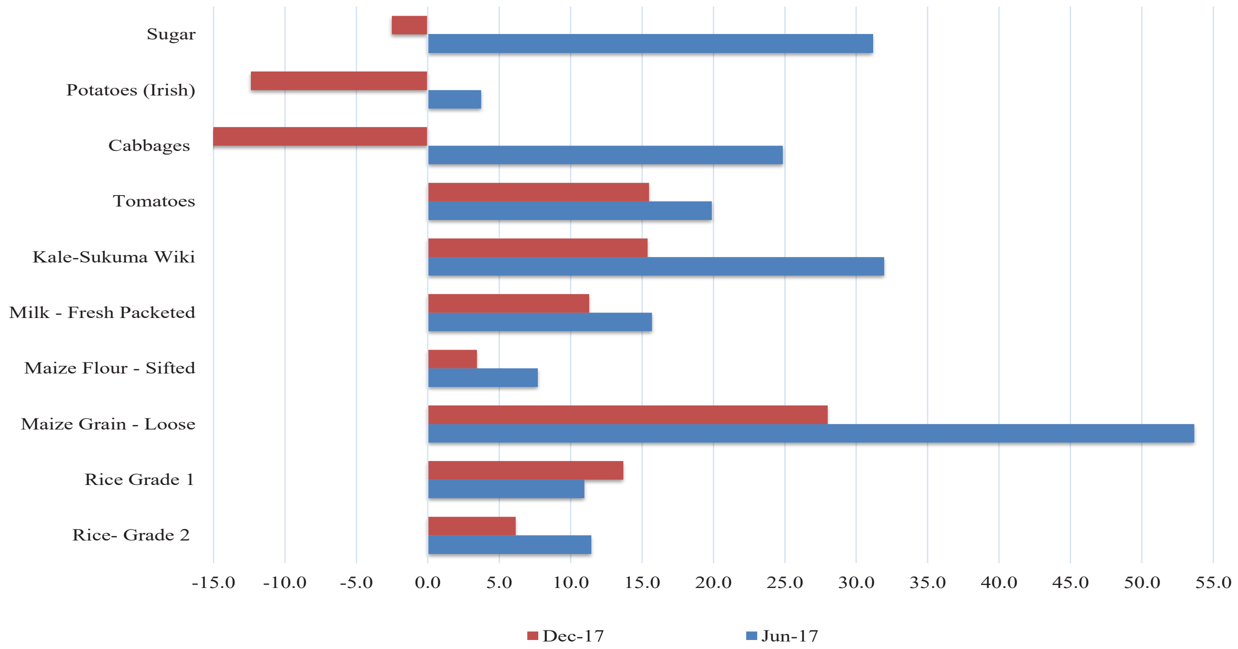
Source: Kenya National Bureau of Statistics and Central Bank of Kenya

Chart 1b: 12-Month Inflation by Broad CPI Categories (%)



Source: Kenya National Bureau of Statistics

Chart 1c: 12-Month Change of Selected Food Commodity Price Indices (%)



Source: Kenya National Bureau of Statistics

i. Bank Credit to the Private Sector

The 12-month growth in credit to the private sector rose gradually to 2.4 percent in December 2017 from 1.4 percent in July 2017, reversing the downward trend since August 2015 (Table 1). Manufacturing, Trade, Real estate, and Building and construction recorded the largest increases in credit of 13.0 percent, 9.0 percent, 8.6 percent and 4.8 percent, respectively.

Nevertheless, private sector credit growth remained low due in part to reduced credit demand attributed to weak performance of some sectors of the economy and opening of subsidiaries by Kenyan firms in the region, tightening of banking sector's credit standards, and increased usage of alternative funding sources such as joint ventures in real estate. Analyses by the CBK on the impact of interest rate capping on lending by banks showed a slowdown in private sector credit growth particularly to sectors such as Micro Small and Medium Enterprises (MSMEs), which are perceived to be risky.

Table 1: 12-Month Growth in Private Sector Credit across Sectors (%)

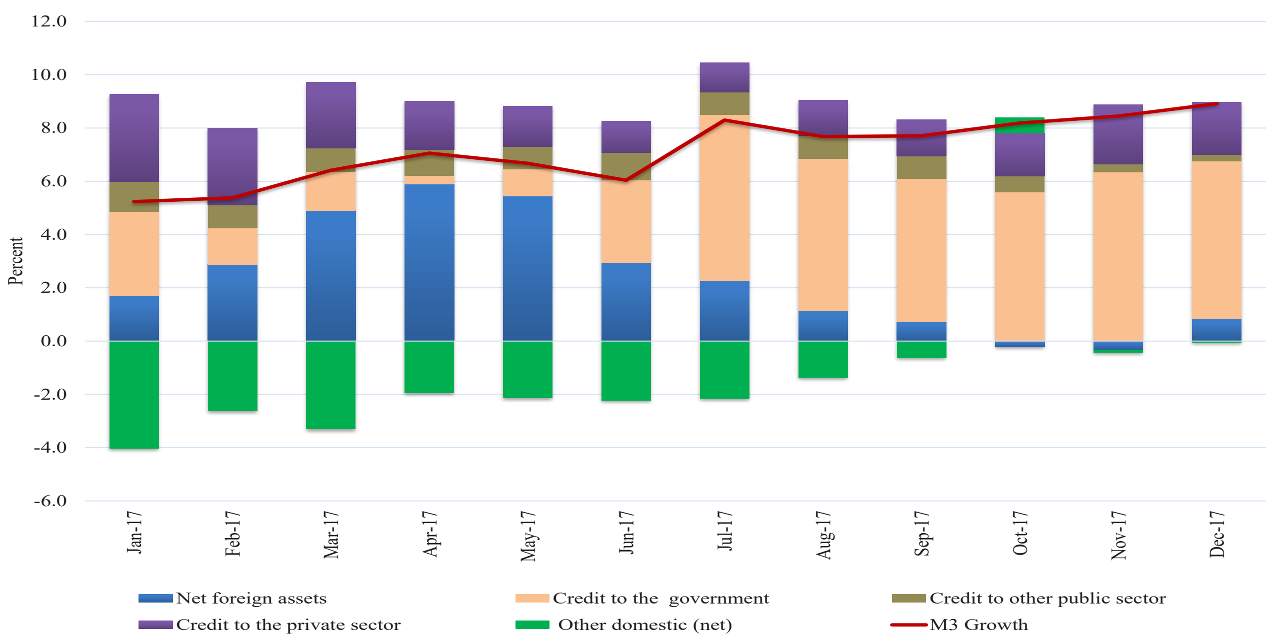
	Jun-17	Jul-17	Aug-17	Sep-17	Oct-17	Nov-17	Dec-17
Agriculture	-12.3	-11.6	-7.6	-2.0	-1.1	-7.7	-7.9
Manufacturing	-7.1	-6.6	3.3	6.1	10.2	10.6	13.0
Trade	10.7	9.0	4.3	6.9	11.5	10.0	9.0
Building and construction	-0.7	0.5	-1.5	1.8	4.0	3.1	4.8
Transport and communication	3.2	0.6	-2.3	-4.9	-8.2	-8.0	-7.2
Finance and insurance	-4.4	-8.5	5.4	-1.4	-1.3	1.5	-4.3
Real estate	10.1	11.8	9.7	8.9	10.0	9.3	8.6
Mining and quarrying	-37.8	-41.0	-7.6	-0.8	9.2	-3.2	-5.5
Private households	10.9	12.1	6.2	1.9	2.9	2.7	-1.5
Consumer durables	7.5	3.3	-1.6	-0.5	0.1	-0.4	-1.6
Business services	-15.8	-10.8	-6.5	-6.4	-19.2	-7.6	-6.4
Other activities	-25.0	-28.1	-27.4	-28.6	-35.0	-23.1	-7.5
Total private sector credit	**1.5**	**1.4**	**1.6**	**1.7**	**2.0**	**2.7**	**2.4**

Source: Central Bank of Kenya

ii. Developments in the other Monetary Aggregates

The 12-month growth of broad money, M3, rose to 8.9 percent in December 2017 from 6.0 percent in June reflecting increased growth of domestic credit. As shown in Chart 2, the main sources of monetary expansion during the second half of 2017 were credit to government, and credit to the private sector. Both broad money supply (M3) and reserve money, remained below their respective targets in the first half of 2017 (Table 2).

Chart 2: Contribution of the Broad Money Supply (M3) counterparts to the 12-Month growth in M3 (%)



Source: Central Bank of Kenya

Table 2: Actual and Targeted Growth in the Key Monetary Aggregates

	Jun-17	Sep-17	Dec-17
Actual Broad Money,M3 (Ksh Billion)	2,936.1	2,986.4	3,010.9
Target (Ksh Billion)	2,764.5	3,032.0	3,142.6
Actual Reserve Money (Ksh Billion)	399.6	424.5	438.8
Target (Ksh Billion)	401.2	428.0	460.5
Actual Net Foreign Assets of CBK (Ksh Billion)	738.3	694.6	627.1
Target (Ksh Billion)	745.0	664.0	667.1
Actual Net Domestic Assets of CBK (Ksh Billion)	-338.7	-270.1	-188.4
Target (Ksh Billion)	-343.8	-236.0	-206.6
Actual Credit to private sector (Ksh Billion)	2,249.1	2,281.6	2,330.2
Target (Ksh Billion)	2,249.1	2,268.4	2,300.9
Memorandum Items			
12-month growth in actual Reserve Money (Percent)	2.4	8.1	6.7
12-month growth in actual Broad Money, M3 (Percent)	6.0	7.7	8.9

Source: Central Bank of Kenya

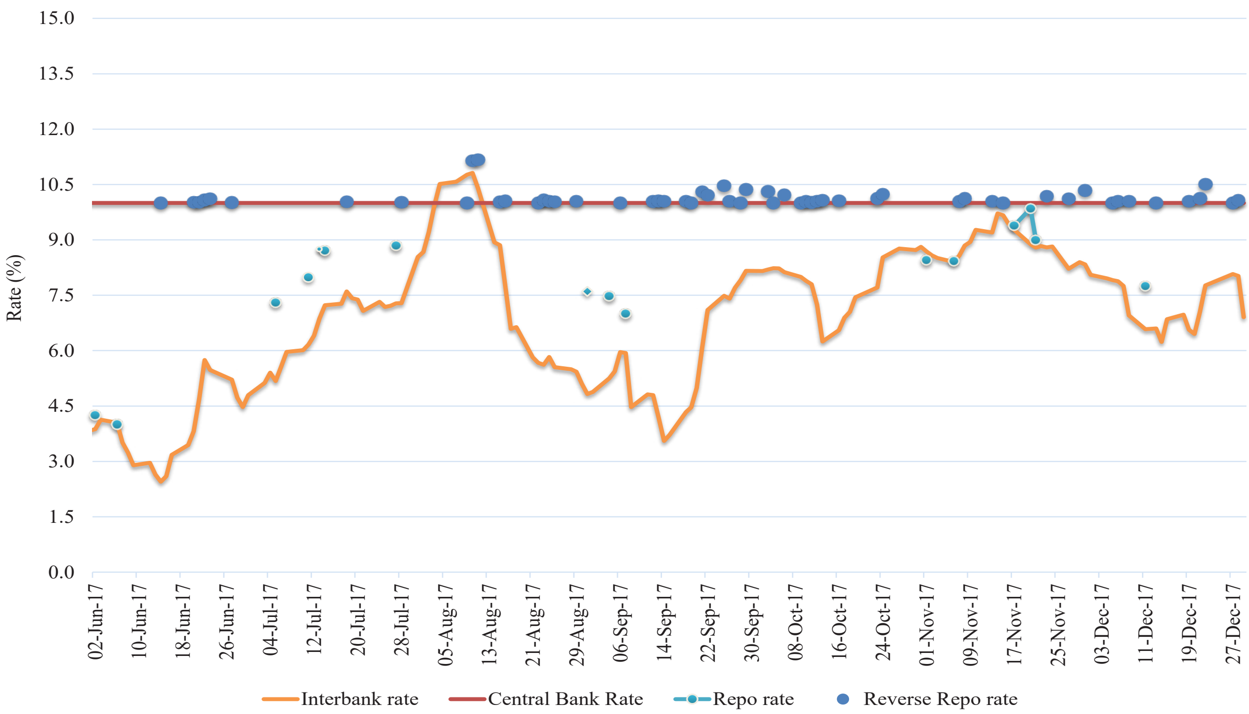
iii. Interest Rates and Liquidity

The interbank rate remained below the CBR during the second half of 2017 reflecting improved liquidity conditions in the market (Chart 3a). However, the liquidity distribution remained uneven across the banks largely due to asymmetric lines of credit across banks.

Liquidity management operations by the CBK in the period were aimed at supporting stability in the interbank market. The CBK used Reverse Repos to supply liquidity to segments of the market facing temporary shortages, and Repos and Term Auction Deposits to withdraw liquidity from segments of the market with surpluses. The proportion of currency outside banks in broad money supply (M3) rose from 7.0 percent in June to 7.5 percent in December 2017 largely due to the prolonged election period and end of year festivities.

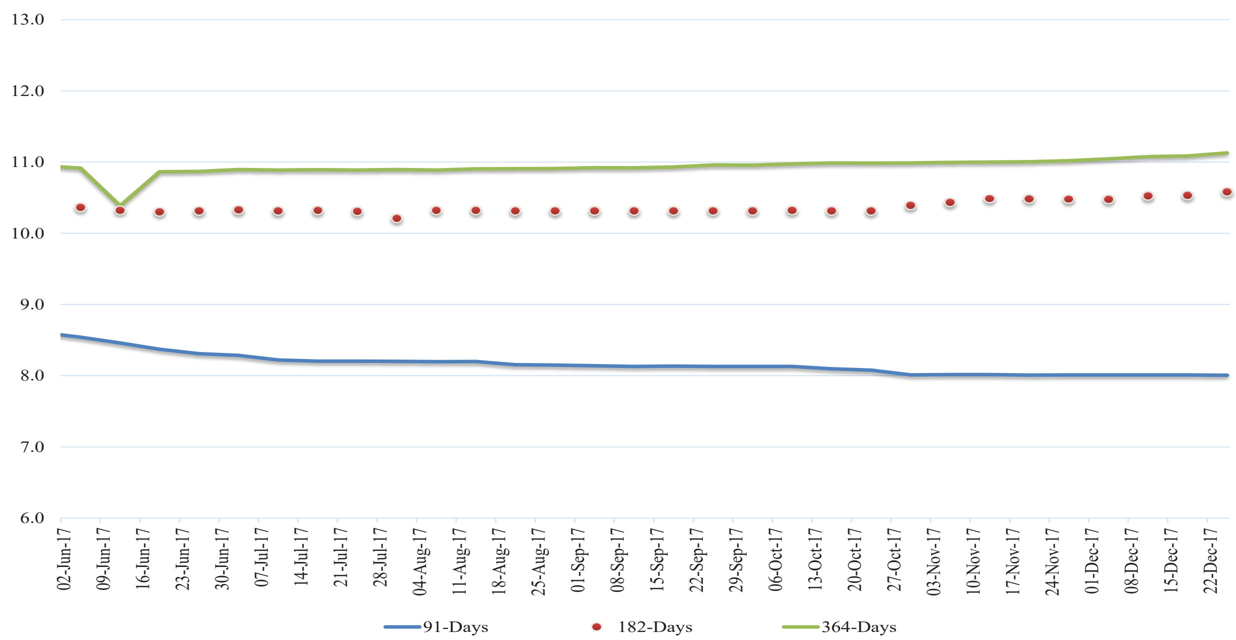
The predictability in the government domestic borrowing programme continued to support market stability and a stable yield curve. Interest rates on government securities remained stable during the first half 2017 (Chart 3b).

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



Source: Central Bank of Kenya

Chart 3b: Interest rates on Treasury Bills (%)



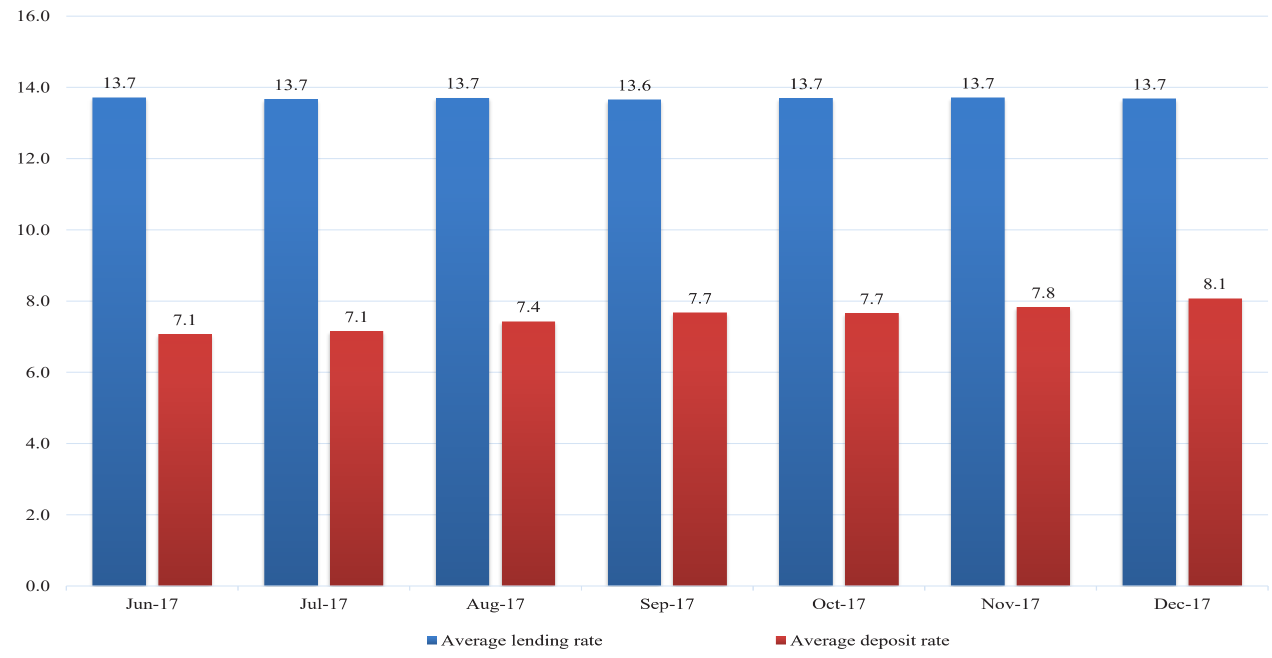
Source: Central Bank of Kenya

iv. Banking Sector Developments

The banking sector remained stable and resilient in the second half of 2017. The average commercial banks liquidity and capital adequacy ratios stood at 43.7 percent and 18.5 percent, respectively, in December 2017 compared to 44.7 percent and 19.6 percent, respectively in June 2017. The distribution of liquidity in the sector also improved, although credit risk remained elevated as large corporates continued to restructure their borrowings. The ratio of gross non-performing loans (NPLs) to gross loans increased to 10.6 percent from 9.9 percent in June 2017, partly reflecting a slower growth of gross loans. The ratio of net non-performing loans to gross loans remained below 5 percent. Commercial banks' lending rates flattened out within the interest rate caps, while banks' average deposit rates remained above the floor (Chart 3c). The Banking (Amendment) Act, 2016 Act sets the maximum interest rate chargeable for a credit facility in Kenya at no more than four percent above the base rate, and the minimum interest rate granted on a deposit held in an interest earning account in Kenya to at least seventy percent of the base rate.

The CBK continued to strengthen the sector to ensure greater transparency, and to promote stronger governance, effective business models, and innovation leveraging on ICT. To address new risks associated with the increased use of emerging technologies and connectivity of customer channels, such as cyber risk, the CBK issued a Guidance Note on Cybersecurity in August 2017. The Guidance Note outlines the minimum standards that institutions should adopt to develop effective cybersecurity governance and risk management frameworks. Other reforms being undertaken were aimed at enhancing financial inclusion, and strengthening the Credit Reference Bureaus to provide for a credit scoring framework.

Chart 3c: Commercial Banks' Average Interest Rates (%)



Source: Central Bank of Kenya

b. Foreign Exchange Market and Reserves Developments

The foreign exchange market remained stable in the second half of 2017 despite a widening of the current account deficit due to a higher food and the petroleum products import bill arising from the drought and rise in international oil prices. The period was also characterised by uncertainties with regard to developments in the global financial markets, and a prolonged election period in the country (Charts 4a and 4b). The stability in the foreign exchange market was supported by resilient tea and horticulture exports, stronger diaspora remittances, and continued recovery in tourism. Additionally, the diversification of Kenya's exports in terms of both export products and external markets continued to cushion the economy against short-term shocks.

Most international currencies depicted low volatility against the U.S. dollar between July and December 2017 due to stabilising financial conditions in the global economy. However, uncertainties remained with regard to the economic policies of the U.S., the pace of normalisation of monetary policy in advance economies, and the Brexit resolution. Regional currencies depicted mixed trends against the U.S. dollar during the period (Chart 4b). Domestic currencies in Kenya, Uganda, and Tanzania were relatively stable against the U.S. dollar, while the South African Rand was fairly volatile reflecting political developments and slower growth.

The CBK level of usable foreign exchange reserves stood at USD7,065.7 billion (equivalent to 4.7 months of import cover) at the end of December 2017 compared to USD7,979.3 billion (5.3 months of import cover) at the end of June 2017 (Chart 4c). The decline in the reserves observed between June and December 2017 was as a result of payments on anticipated government obligations. The reserves continued to provide an adequate buffer against short term shocks in the foreign exchange market. The Precautionary Arrangements with the IMF provided an additional buffer against exogenous shocks.

Other measures of foreign reserves adequacy remained robust and exceeded their respective indicative thresholds. The ratio of reserves to short-term debt averaged above 400 percent while that of reserves to broad money averaged 25.3 percent between July and December 2017. These were above their respective thresholds, that is the Greenspan-Guidotti rule of 100 percent cover for emerging markets and the prudent range of 20 percent for countries with large banking sector and open capital accounts, respectively.

Chart 4a: Rate of Depreciation of the Kenya Shilling and Major International Currencies against the U.S. Dollar (January 3, 2017=1)

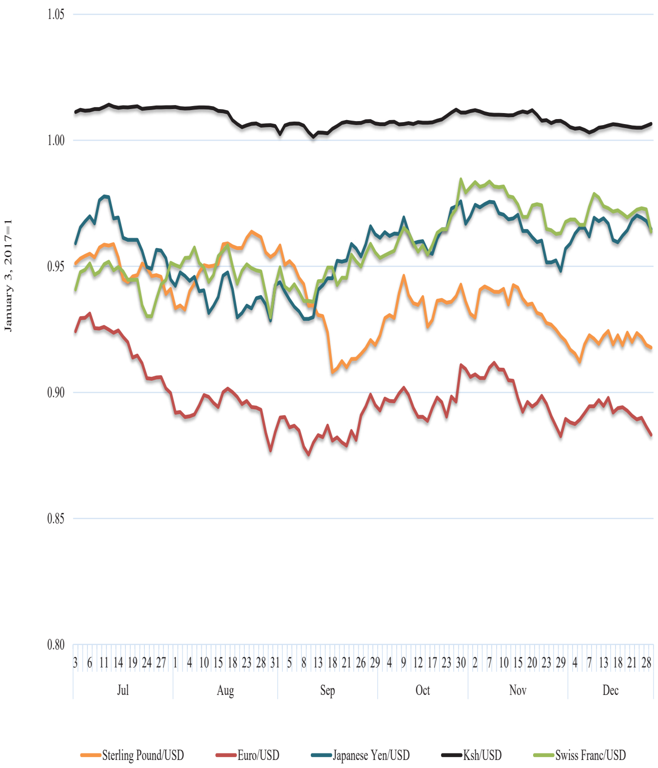
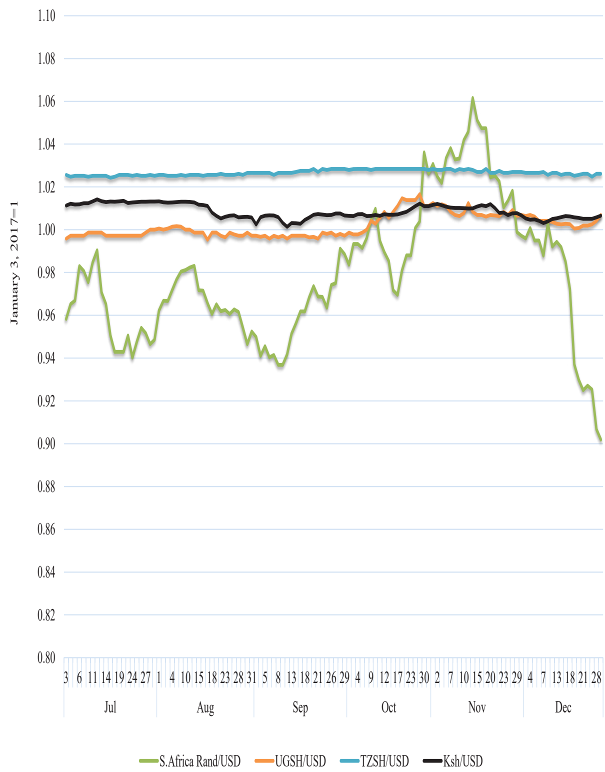
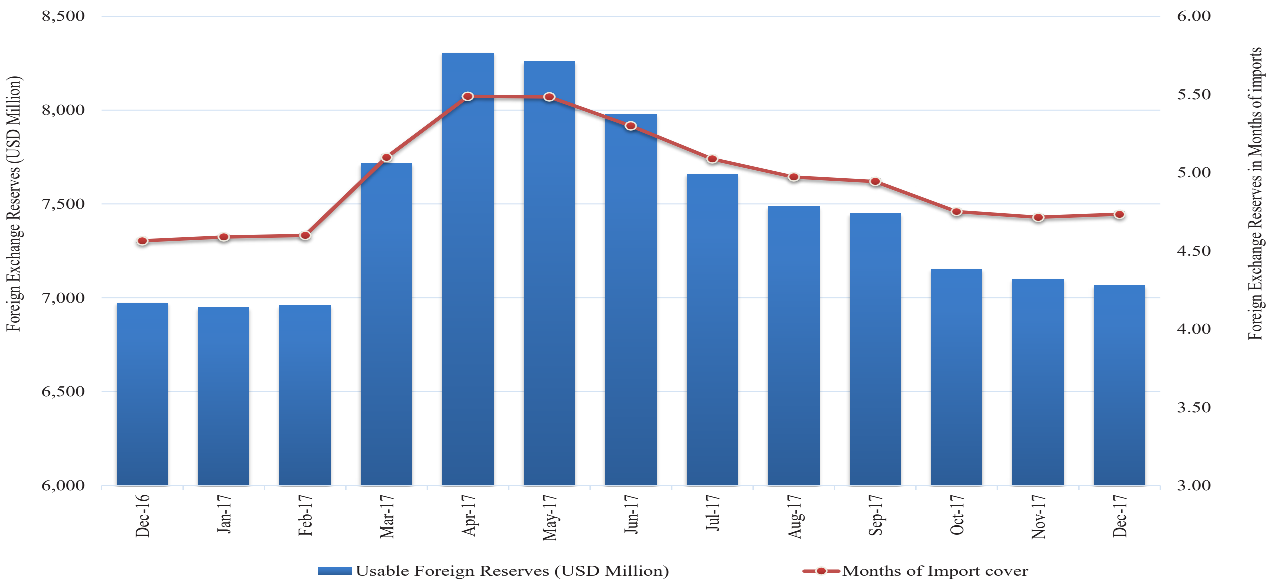


Chart 4b: Rate of Depreciation of the Kenya Shilling and Regional Currencies against the U.S. Dollar (January 3, 2017=1)



Source: Central Bank of Kenya

Chart 4c: CBK Usable Foreign Exchange Reserves



Note: Months of import cover computed based on the average imports over the previous 36 months

Note: The CBK usable foreign exchange reserves refer to reserves available for use without any restrictions. They exclude reserves held by CBK on behalf of the Government or commercial banks.

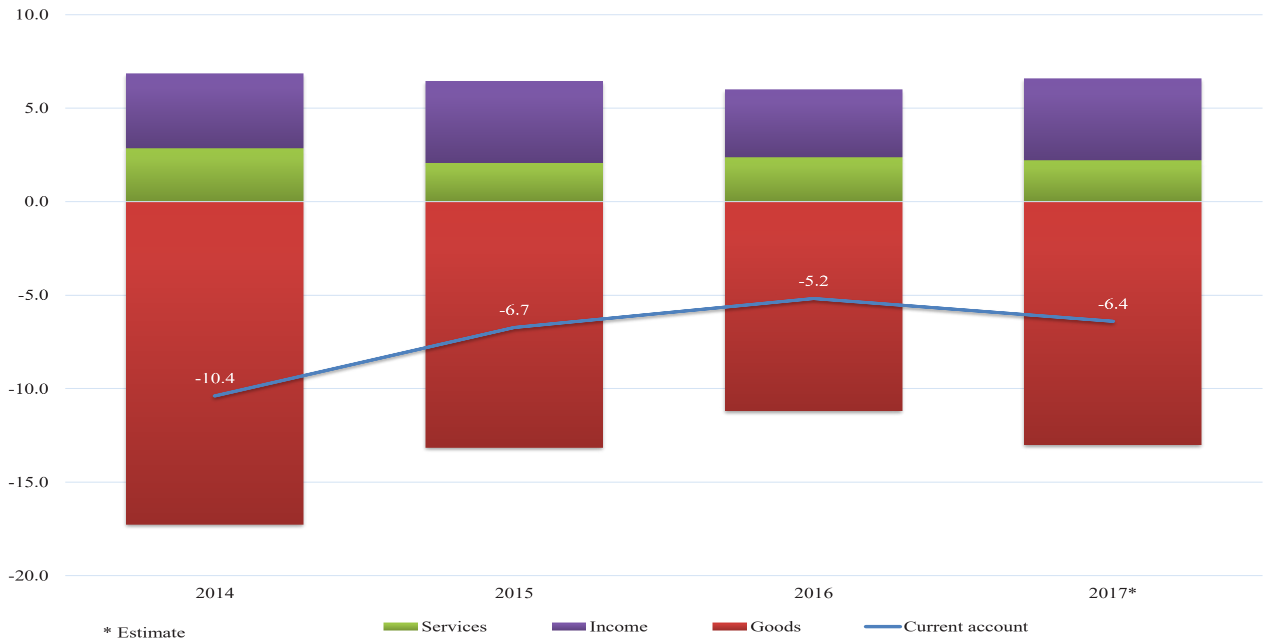
Source: Central Bank of Kenya

c. Balance of Payments Developments

The current account deficit was estimated at 6.4 percent of GDP in 2017 compared with 5.2 percent of GDP in 2016 (Chart 5a and Table 3). The widening in the current account deficit reflected a higher import bill with respect to food and petroleum products. Imports of goods and services rose to 24.6 percent of GDP in 2017 from 23.3 percent in 2016. Merchandise imports increased by 18.2 percent largely due to increases of 30.7 percent in the petroleum products import bill reflecting higher international oil prices, a 115.8 percent increase rise in the food import bill to mitigate the adverse effects of the drought in the first half of 2017, and 7.2 percent in the value of machinery and transport equipment imports. The moderate growth in imports of machinery and transport equipment reflected the completion of the first phase of the SGR project.

Exports of goods and services stood at 13.5 percent of GDP in 2017 compared to 14.6 percent of GDP in 2016 (Table 3). The value of merchandise and services exports grew by 0.9 percent and 13.4 percent, respectively, in 2017. Receipts from tea exports grew by 16.1 percent in 2017 due to higher prices in the international market. A modest growth of 1.5 percent was recorded from horticulture exports. Receipts from exports of manufactured goods fell by 8.5 percent largely due to increased competition from imported goods in the destination markets. Both travel receipts and diaspora remittances grew by 12.4 percent reflecting increased tourism promotion activities by the government, improved security, and continued recovery of the global economy.

Chart 5a: Components of the Current Account Balance (% of GDP)



Source: Kenya National Bureau of Statistics and Central Bank of Kenya

Table 3: Annual Balance of Payments (Percent of GDP)

	2015 Act.	2016 Act.	2017 Prov.
Current account balance	-6.7	-5.2	-6.4
Exports (fob)	9.4	8.1	7.3
of which: Tea	2.1	1.7	1.8
Horticulture	1.2	1.2	1.0
Manufactured Goods	0.8	0.6	0.5
Imports (fob)	-22.5	-19.3	-20.3
of which: Oil	-3.9	-3.0	-3.4
Machinery & Transport Equipment	-8.5	-6.2	-5.9
Food	-1.9	-1.6	-3.0
Services (net)	2.1	2.4	2.2
credit	7.3	6.4	6.5
of which : transportation	3.1	2.5	2.5
travel	1.1	1.2	1.2
debit	-5.2	-4.0	-4.3
Balance on goods and services	-11.1	-8.8	-10.8
Income (net)	-1.1	-1.0	-1.1
credit	0.8	0.6	0.6
debit	-1.8	-1.6	-1.7
of which official interest payments	-0.7	-0.7	-0.9
Current Transfers (net)	5.4	4.6	5.5
Official (net)	0.1	0.0	0.0
Private (net)	5.3	4.6	5.4
of which: remittances	2.5	2.4	2.4
Capital and Financial Account	-5.7	-5.6	-5.9
Financial Account	-6.1	-5.9	-6.3

Source: Kenya National Bureau of Statistics and Central Bank of Kenya

c. Economic Growth

Despite the adverse weather conditions that affected agriculture production, slowdown in private sector credit growth, and uncertainties with regard to a prolonged election period, the economy grew by 4.9 percent in 2017 compared to 5.9 percent in 2016 (Table 4). The resilience of the economy was supported by a stable macroeconomic environment, continued government spending on infrastructure, and strong performance of the service sectors such as information and communication, accommodation and restaurant, wholesale and retail trade, transport and storage, and real estate.

The diversification of the economy was a major source of resilience, with non-agriculture GDP providing impetus (Chart 6). The non-agriculture GDP grew by 5.8 percent compared to 6.2 percent in 2016. The agriculture sector grew by 1.6 percent compared to a growth of 5.1 percent in 2016 reflecting the adverse effects of the drought that affected production of key crops and animal rearing.

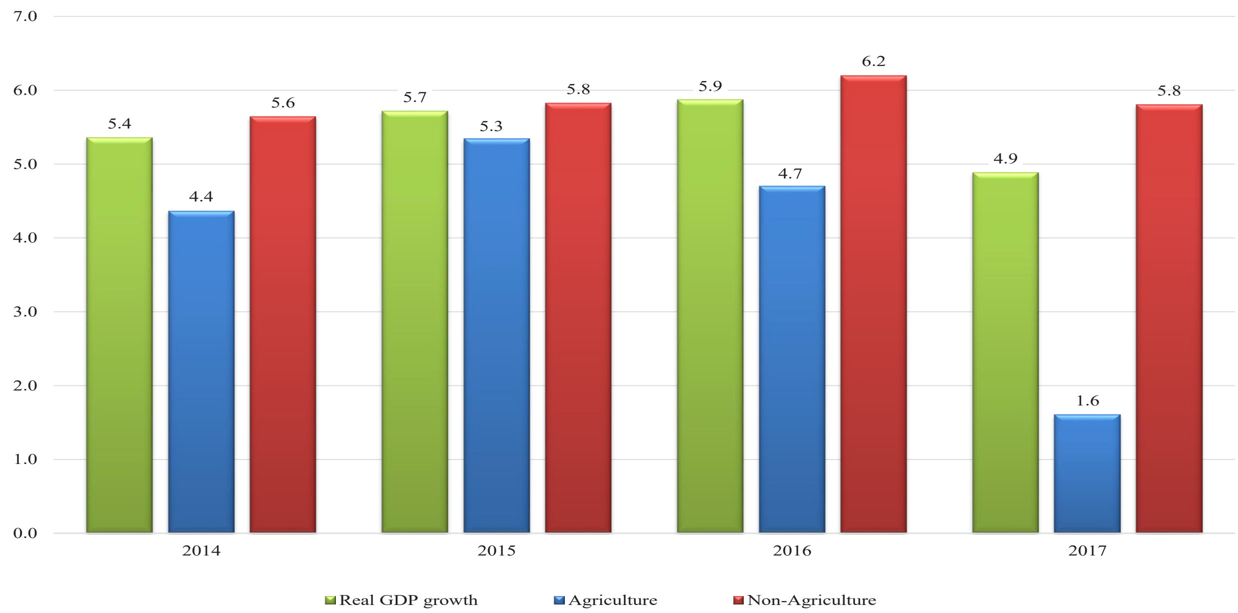
The manufacturing sector grew by 0.2 percent in 2017 compared to a revised growth of 2.7 percent in 2016 largely due to uncertainties with respect to the prolonged elections, and competition from imported goods.

Table 4: Kenya's Real GDP Growth across the Main Sectors (%)

	Annual Growth (%)			
Sectors	2014	2015	2016	2017
Agriculture	4.4	5.3	4.7	1.6
Mining and Quarrying	14.9	12.3	9.5	6.1
Manufacturing	2.5	3.6	2.7	0.2
Electricity and water supply	7.3	11.5	9.5	6.9
Water supply, sewerage, waste management	3.9	2.7	5.7	2.6
Construction	13.1	13.8	9.8	8.6
Wholesale and Retail Trade	6.9	5.9	3.4	5.7
Accommodation and restaurant	-16.7	-1.3	13.3	14.7
Transport and Storage	5.5	8.0	7.8	7.3
Information and Communication	14.5	7.4	9.7	11.0
Financial and Insurance	8.3	9.4	6.7	3.1
Public administration and defence	5.6	5.5	4.8	5.3
Professional, scientific and technical activitiues	4.1	3.6	6.2	4.3
Real estate	5.6	7.2	8.8	6.1
Education	7.8	4.9	5.4	6.1
Health	8.1	5.8	4.8	6.0
GDP at market prices	5.4	5.7	5.9	4.9

Source: Kenya National Bureau of Statistics

Chart 6: Non-Agriculture and Agriculture Real GDP Growth (%)



Source: Kenya National Bureau of Statistics

d. Fiscal Developments and Debt

The coordination between monetary and fiscal policies continued to support macroeconomic stability. The Government's borrowing plan in the first half of the Fiscal Year 2017/18 ensured that the build-up in domestic debt was consistent with the thresholds set in the Medium-Term Debt Management Strategy. The period was characterised by budgetary pressures to finance the repeat presidential elections in October 2017, and imports under the maize subsidy programme to mitigate the adverse effects of the drought in the first half of 2017. The Government continued to review its borrowing plan in line with market conditions and prudent budget management that focused on rationalisation of expenditures and strengthening of revenue collection measures.

e. Stakeholder Forums, MPC Market Perception Surveys, and Communication

The CBK held forums with Chief Executive Officers of commercial banks after every meeting during the second half of 2017. The Committee also continued to improve and expand its information gathering processes through the Market Perception Surveys and communication with key stakeholders on the MPC decisions to obtain feedback. The MPC Press Releases were continuously reviewed to make them better focused to the public, media, financial sector and other stakeholders.

The Governor also held a press conference after each MPC meeting to brief the media on measures undertaken by the CBK to support macroeconomic and financial stability. As a result, the media and public understanding of monetary policy decisions and their expected impact on the economy continued to be enhanced. The CBK and MPC members also held meetings with potential investors during the period in order to appraise them on recent economic developments in the country.

The CBK held meetings with IMF Mission in December 2017 to discuss developments in the economy and also to review the performance under the Precautionary Arrangements programme. Regular meetings were also held with the World Bank to discuss developments in the economy as well as ongoing research studies by the two institutions on the impact of the interest rate capping law.

3. THE CURRENT ECONOMIC ENVIRONMENT AND OUTLOOK FOR 2018

a. International Economic Environment

Global output is estimated to have grown by 3.8 percent in 2017 up from 3.2 percent in 2016 (Table 5). The stronger growth momentum witnessed in 2017 is expected to continue into 2018 and 2019, with global growth projected at 3.9 percent in both years. Growth would be supported by favourable global financial conditions and strong sentiment, that is expected to maintain the recent acceleration in demand. The temporal rise in U.S. growth owing to tax reforms and associated fiscal stimulus, is expected to have favourable demand spill overs for US trading partners.

According to the IMF, risks to the global growth forecast are broadly balanced in the near term, but skewed to the downside over the medium term. On the upside, the recovery could be stronger in the near term as the pick up in activity and easier financial conditions reinforce each other. On the downside, inward-looking policies, geopolitical tensions, and political uncertainty in some countries pose downside risks.

The inflation in advanced and emerging market economies is expected to pick up in 2018 and 2019 partly reflecting an increase in fuel prices and improved domestic demand. Inflation in advanced economies is expected to rise from 1.7 percent in 2017 to 2.0 percent in 2018 and drop to 1.9 percent in 2019. In the emerging market and developing economies, inflation is projected to increase from 4.0 percent in 2017 to 4.6 percent in 2017 but to decrease to 4.3 percent in 2019. Policy challenges are more diverse across advanced and emerging market economies in terms of supporting demand and structural reforms to stimulate medium term growth.

Table 5: Performance and Outlook for the Global Economy (%)

	2016 Act.	2017 Est.	2018 Proj.	2019 Proj.
World	3.2	3.8	3.9	3.9
Advanced Economies	1.7	2.3	2.5	2.2
United States	1.5	2.3	2.9	2.7
Japan	0.9	1.5	1.5	1.1
Euro Area	1.8	2.3	2.4	2.0
United Kingdom	1.9	1.8	1.6	1.5
Other Advanced economies	2.3	2.7	2.7	2.6
Emerging and developing economies	4.4	4.8	4.9	5.1
Sub-Saharan Africa	1.4	2.8	3.4	3.7
Emerging and Developing Asia	6.5	6.5	6.5	6.6
China	6.7	6.9	6.6	6.4
India	7.1	6.7	7.4	7.8
Middle East, North Africa, Afghanistan and Pakistan	4.9	2.6	3.4	3.7

Source: IMF World Economic Outlook

b. Domestic Economic Environment

i. Economic Growth

The Government expects real GDP growth to pick up strongly to 5.8 percent in 2018 from 4.9 percent in 2017. The growth outlook will be supported by a stable macroeconomic environment, sustained investment in infrastructure, strong agricultural production due to favourable weather conditions, buoyant services sector, and increased investor and consumer confidence. The completion of the Mombasa-Nairobi SGR is expected to support industrialisation through lower transport costs and efficient movement of cargo. The Government's strategic focus on the Big 4 development priorities in food security and agricultural productivity, affordable housing, increased share of manufacturing, and universal health coverage in 2018 and the medium term is expected to provide an additional stimulus to growth.

The outlook for the domestic economy is corroborated by the MPC Private Sector Market Perceptions Surveys which showed increased optimism by the private sector on economic prospects for 2018. More than 90 percent of banks and nonbank private sector firms were optimistic about the economic prospects and improvements in the business environment in 2018, with the conclusion of the elections, improved weather conditions, and continued public investment in infrastructure. The main risks to the growth outlook in 2018 are the weak private sector credit growth.

ii. External Sector and Foreign Exchange Market

The Shilling is expected to be stable in 2018 on account of a narrower current account deficit and resilient foreign exchange inflows. The current account deficit is expected to narrow from an estimated 6.4 percent of GDP in 2017 to 5.4 percent of GDP in 2018 largely due to lower imports of food and inputs for phase II of the SGR project, steady growth in tea and horticulture exports, strong diaspora remittances, and continued growth in tourism receipts riding on the expected direct flights to the U.S. and Visa on arrival policy for visitors from African countries. The 2018 growth outlook for Kenya's main trading partners in the region is strong, suggesting better prospects for exports performance. Exports competitiveness will be enhanced by the SGR through lower transportation costs and faster movement of goods to the port.

The main risks to the foreign exchange market in 2018 relate to continued uncertainties in the global financial markets with regard to the pace of normalization of monetary policy in advanced economies especially in the U.S. and the Brexit resolution. Nevertheless, the foreign exchange reserves will continue to provide an adequate buffer against short term shocks in the foreign exchange market. The Precautionary Facilities with the IMF provide an additional buffer against exogenous shocks.

iii. Inflation

Overall inflation is expected to remain within the Government medium term target range in 2018 supported by lower food prices due to expected favorable weather conditions relative to 2017, and the monetary policy measures. Risks to the inflation outlook include the rise in international oil prices which has exerted upward pressure on domestic fuel prices, the likely impact of VAT on petroleum products which is expected to be introduced in September 2018, and the lifting of the Government's maize subsidy programme in December 2017. Prices of some items in the alcoholic beverages, tobacco and narcotics category could also increase slightly in 2018 if the Government implements the inflation based tax increases due after every two years as per the Excise Act. However, these risks will be moderated by improved supply of maize following the imports in 2017 under the maize subsidy programme and the relatively good harvest in food basket regions. The continued exchange rate stability will dampen the threat of imported inflation.

iv. Fiscal Policy

Government borrowing in the FY2017/18 and FY 2018/19 is anchored in the Medium-Term Debt Management Strategy which aims at maintaining public debt at sustainable levels. The budget deficit is projected to decline from 9.1 percent of GDP in FY2016/17 to 7.2 percent of GDP in FY2017/18, and further to 3.0 percent in the medium term. The reduction of the deficit will be supported by reduced expenditures following the completion of general elections, improved weather conditions which will reduce the reliance on food imports, and the completion of major infrastructure projects. Net domestic borrowing is projected to increase from 3.4 percent and 3.8 percent of GDP in FY2017/18 to 3.8 percent in FY2018/19, before falling gradually to 1.5 percent of GDP in the medium term. The CBK will continue to work with the National Treasury to strengthen the coordination between monetary and fiscal policies.

v. Confidence in the Economy

Macroeconomic stability, improved security, and infrastructure development have created a conducive and predictable environment for investment, and economic activity. A favourable credit rating by the Standards and Poor's of B+ with a stable outlook, continued tourism recovery, and stability in the yield curve of Government securities indicates investor confidence in the economy. According to the World Bank 2017 Doing Business Report, Kenya climbed 16 ranks to position 92 from 108 in 2016 and is the World's third most reformed country.

4. DIRECTION OF MONETARY POLICY IN 2018

Monetary policy will continue to be directed at achieving the Bank's principal objective of low and stable inflation. Thus, price stability will be the overriding objective of monetary policy in 2018. In addition, monetary policy will support the Government's growth and employment creation objectives.

a) Monetary Policy Path and Foreign Exchange Reserves

The monetary targets for 2018 are consistent with the Medium-Term Government Budget Policy Statement for 2018 published by the National Treasury. The monetary targets for the period are presented in Table 6. Monetary policy will aim at containing the annual growth in broad money (M3) to 9.5 percent by June 2018 and 12.4 percent by December 2018. Growth in private sector credit is projected to pick up gradually from 2.4 percent in December 2017 to 8.8 percent by June 2018 and 12.6 percent by December 2018. These monetary targets are expected to enable the Bank maintain overall inflation within the current allowable margin of 2.5 percent on either side of the Government's medium-term target of 5 percent, and to anchor inflation expectations.

The CBK foreign exchange reserves will continue to provide a buffer against short-term shocks in the foreign exchange market. Precautionary Arrangements with the IMF will provide an additional buffer against exogenous shocks. Monetary policy will aim at ensuring that short-term interest rates are consistent with the CBK's price stability objective, while also ensuring the long-term sustainability of public debt. The coordination of monetary and fiscal policies will support macroeconomic stability. The CBK will continue to monitor the impact of the interest rate capping on lending and effectiveness of monetary policy transmission.

Table 6: Monetary Targets for 2018

	Mar-18	Jun-18	Sep-18	Dec-18
Broad Money, M3 (Ksh Billion)	3,121.5	3,215.4	3,309.4	3,403.7
Reserve Money, RM (Ksh Billion)	441.8	444.0	457.0	478.5
Credit to Private Sector (Ksh Billion)	2,394.1	2,447.3	2,535.0	2,622.7
NFA of CBK (Ksh Billion)	612.6	752.8	656.1	670.0
NDA of CBK (Ksh Billion)	-172.2	-317.3	-205.2	-193.7
12-month growth in RM (Percent)	6.5	11.1	7.7	9.0
12-month growth in M3 (Percent)	9.7	9.5	10.7	12.4
12-month growth in Credit to Private Sector (Percent)	5.8	8.8	11.1	12.6
Medium-Term 12-month overall Inflation (Percent)		5.0		5.0

Source: Central Bank of Kenya and the National Treasury

The Bank will continue to monitor developments in the attainment of the Monetary Targets and make necessary reviews including target revisions when required. The information will be reviewed and incorporated in the data so as to inform the MPC decision process. Monetary policy implementation will be based on the targets for Net Domestic Assets (NDA), and Net International reserves (NIR) of the

Central Bank to be achieved through Open Market Operations (OMO). The Repurchase agreements (Repos) and Term Auction Deposits instruments will be used to withdraw any excess liquidity in the banking system and, where necessary, Reverse Repos will be used to inject liquidity.

The achievement of the targets set will depend on stability in the international prices of oil and global markets, favourable weather conditions, and continued commitment by the Government to operate within the domestic borrowing target in the FY2017/18 and FY 2018/19. The success of the monetary policy measures will also depend on the effectiveness of the institutions charged with the responsibility of managing the supply side of economy that would have a direct impact on food and fuel prices.

b) Measures to Enhance Market Efficiency

The CBK will continue to work with stakeholders to identify and implement measures to enhance redistribution of liquidity in the interbank market. Forums with Chief Executive Officers will continue to be held both to obtain feedback and to explain the background to MPC decisions. These initiatives will support improvements in the financial sector that contribute to the lowering of the cost of doing business. The CBK will also continue with its transparency policy through the timely dissemination of all the requisite data and other relevant information through its website.

The CBK will continue to support development of new products and innovations in the banking system towards enhancing financial access in order to encourage economic growth. Appropriate legislation and regulations will be proposed to ensure that such innovations are operationalized accordingly so as to enhance market confidence. The Bank will monitor any new financial derivatives and /or innovations in the market that could have adverse effects on market stability. The CBK will work closely with the other stakeholders to promote transparency in credit pricing including strengthening the Credit Reference Bureaus to provide for a credit scoring framework.

ANNEX: CHRONOLOGY OF EVENTS OF PARTICULAR RELEVANCE TO MONETARY POLICY

July 2017	• The CBR was retained at 10.0 percent in order to anchor inflation expectations. • Mayfair and Dubai Islamic Bank were licensed.
August 2017	• Diamond Trust Bank Kenya Limited (DTB) acquired 100 percent of Habib Bank Limited Kenya (HBLK). • General elections were held
September 2017	• The CBR was retained at 10.0 percent.
	• The Société Générale (SG) of France granted authority to open a Representative Office in Kenya, which serve as marketing and liaison offices for its parent banks and affiliates.
October 2017	Repeat Presidential Elections
November 2017	The CBR was retained at 10.0 percent.

GLOSSARY OF KEY TERMS

Overall Inflation

Overall inflation is a measure of price change in the economy calculated as the weighted year-on-year movement of the indices of the prices charged to consumers of the goods and services in a representative basket established in a base year. The indices are derived from data collected monthly by the Kenya National Bureau of Statistics.

Reserve Money

Reserve Money is computed as the 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 (NBFIs) held by the CBK. 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 computed as follows:

Narrow Money

M0: Currency outside the banking system

M1: M0 + demand deposits of banks (or depository corporations).

Broad Money

M2: M1 + quasi (long term) money deposits i.e. time and savings deposits of banks and non-bank financial institutions.

Extended Broad Money

M3: M2 + residents' foreign currency deposits.

Overall Liquidity

L: M3 + non-bank holdings of Government Paper. This however, is not a monetary aggregate.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