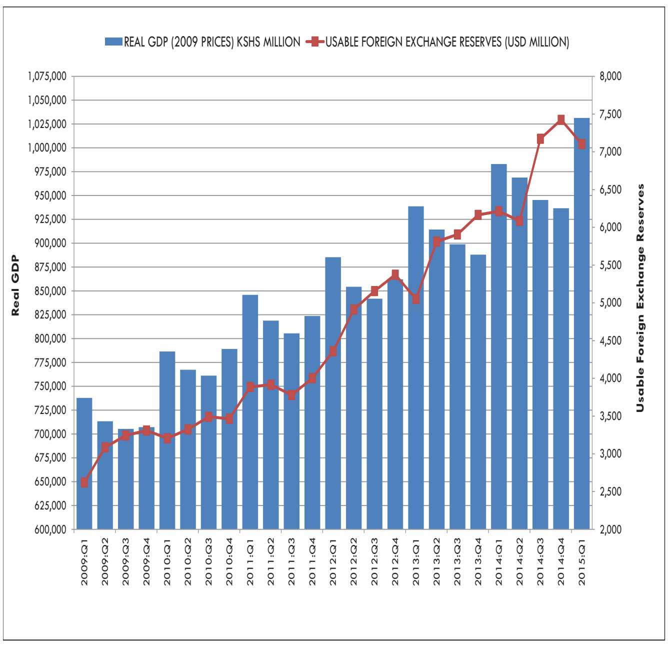

CENTRAL BANK OF KENYA

Monetary Policy Statement

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

JUNE 2015

Letter of Transmittal to the Cabinet Secretary for the National Treasury

Dear Honourable Cabinet Secretary,

I have the pleasure of forwarding to you the 36th 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 in the first half of 2015, describes the current economic environment and outlook, and concludes with an outline of the direction of monetary policy for the Fiscal Year 2015/16.

Patrick Njoroge

Dr. Patrick Njoroge
Governor

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The Principal Objectives of the Central Bank of Kenya

The principal objectives of the Central Bank of Kenya (CBK) as established in the CBK Act are:

1. To formulate and implement monetary policy directed to achieving and maintaining stability in the general level of prices;
2. To foster the liquidity, solvency and proper functioning of a stable, market-based, financial system;
3. Subject to (1) and (2) above, to support the economic policy of the Government, including its objectives for growth and employment.

Without prejudice to the generality of the above, the Bank shall:

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

The CBK therefore, formulates and conducts monetary policy with the aim of keeping overall inflation within the allowable margin (currently 2.5 percent) on either side of the target prescribed by the National Treasury after the annual Budget Policy Statement. The achievement and maintenance of a low and stable inflation rate together with ensuring adequate liquidity in the market facilitates higher levels of domestic savings and private investment, leading to improved economic growth, higher real incomes and increased employment opportunities.

In this regard, the Bank's monetary policy is designed to support the Government's desired growth in the production of goods and services and employment creation through achieving and maintaining a low and stable rate of inflation.

Instruments and Transmission of Monetary Policy

The CBK pursues its monetary policy objectives using 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 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 using:
    i. **Repurchase Agreements (Repos)**: Repos entail the sale of eligible securities by the CBK to reduce commercial banks' deposits held at CBK. Repos (often called *Vertical Repos*) have fixed tenors of 3 and 7 working days. *Reverse Repos* are purchases of securities from commercial banks and hence an injection of liquidity by the CBK during periods of tighter than desired liquidity in the market. 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 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:** While not being strictly monetary policy instruments, Horizontal Repos are modes of improving liquidity distribution between commercial banks 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 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 and its movements, both in direction and magnitude, signal 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.

- **Kenya Banks' Reference Rate (KBRR)**: The KBRR is the base rate for all commercial and microfinance banks' lending. The level of the KBRR is reviewed and announced by the Monetary Policy Committee at least every six months. The KBRR is computed as an average of the CBR and the weighted 2-month moving average of the 91-day Treasury bill rates.
- **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 Bank. Banks making use of this facility more than twice in a week are scrutinised 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 deposited at CBK. These deposits are held in the CRR Account at no interest. The ratio 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 a daily basis.
- **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 acquire foreign exchange to service official debt and to build-up its foreign exchange reserves in line with the statutory requirement of reserves equivalent to four months' import cover. The CBK does not participate in the foreign exchange market to defend a particular value of the Kenya shilling but may intervene in the exchange market to stabilise it 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 ratio of core capital from 20 percent to 10 percent. The foreign exchange limits should not exceed the 10 percent overall limit at any time during the day.
  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 the health and efficiency of the banking system; this includes vetting potential managers for suitability both with respect to qualifications and character.
- **The National Payments System**: The modernisation of the National Payments System has, and will continue to, reduce transaction costs and improve 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. The regular interaction between the MPC and the Chief Executive Officers of commercial banks through the Kenya Bankers Association (KBA) has ensured that monetary policy decisions are transmitted to the banking sector. 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. The CBK also participates in the regional and National Agricultural Society of Kenya Shows in order to sensitise the public on its functions.

Legal Status of the Monetary Policy Statement

1. Section 4B (1) of the CBK Act requires the Bank to submit to the 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) before the appropriate committee of the National Assembly not later than the end of the subsequent session of Parliament after the Statement is so submitted.

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

    i) Its Monetary Policy Statement; and
    ii) Its Monthly Balance Sheet.

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

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

Executive Summary

This Monetary Policy Statement provides the direction of monetary policy for the Fiscal Year 2015/16. It also reviews the outcome of the monetary policy stance adopted in the first half of 2015.

Overall month-on-month inflation remained within the Government target range in the first half of 2015. However, it rose towards the upper bound, from 5.5 percent in January 2015 to 7.1 percent in April 2015 mainly reflecting increases in prices of food, and pass-through effects of exchange rate depreciation. Overall inflation eased marginally thereafter to 7.0 percent in June 2015. Similarly, the 12-month non-food-non-fuel inflation (NFNF) rose to 4.6 percent in June 2015 from 3.5 percent in January 2015, indicating moderate demand pressure in the economy.

The Kenya Shilling exchange rate against the U.S. dollar weakened gradually during the first half of 2015. This largely reflected the global strengthening of the U.S. dollar which resulted in depreciation of most currencies against the U.S. dollar during the period. The strengthening of the U.S. dollar reflected in part, the uncertainty on the timing of the first U.S. interest rate increase since 2008 coupled with the debt crisis in Greece. In addition, domestic factors attributed mainly to a wide current account deficit on account of increased imports of capital goods and transport equipment, against lower than expected earnings from traditional exports, exacerbated the pressure on the Shilling exchange rate. However, diaspora remittances remained strong during the period. The Central Bank of Kenya (CBK) interventions through direct sales of foreign exchange to commercial banks dampened short-term volatility in exchange rate in the period.

The Monetary Policy Committee (MPC) augmented its tight policy stance by raising the Central Bank Rate (CBR) to 10.0 percent in June 2015 from 8.50 percent, which had prevailed since May 2013, in order to anchor inflationary expectations which were attributed to the depreciation of the Kenya Shilling and demand driven inflation threats. Consequently, movements in short-term interest rates were aligned to the Central Bank Rate (CBR) during the period. Consistent with the tight monetary policy stance adopted, liquidity management operations were aimed at maintaining the interbank rate above the CBR.

The monetary policy stance in the Fiscal Year 2015/16 will aim at maintaining overall month-on-month inflation rate within the Government's target range of 2.5 percent on either side of the 5 percent target. The price stability objective aims at supporting sound and sustained economic growth. The level of foreign exchange reserves and the precautionary facility with the International Monetary Fund (IMF) blending the non-concessionary Stand By Arrangement and the concessional Stand By Credit Facility will provide an adequate buffer against short-term shocks. The coordination between monetary and fiscal policies will be strengthened in order to support overall macroeconomic stability and to maintain the sustainability of public debt.

Consistent with the government growth and inflation targets in the Fiscal Year 2015/16, monetary policy will aim at constraining the annual growth in broad money, M3, to 17.3 percent by September 2015, 17.2 percent by December 2015, 17.5 percent by March 2016 and 13.8 percent by June 2016. The Net Domestic Assets (NDA) of the Bank is targeted at Ksh.-167.1 billion in September 2015, Ksh.-187.2 billion in December 2015, Ksh.-214.0 billion in March 2016 and Ksh.-203.7 billion in June 2016. However, the annual growth in credit to the private sector is projected at 19.1 percent in September 2015, 18.4 percent in December 2015, 18.3 percent in March 2016 and 15.5 percent in June 2016. The Net International Reserves (NIR) of the CBK are targeted at USD 5,308.2 million in September 2015, USD 5,986.6 million in December 2015, USD 6,005.0 million in March 2016 and USD 6,055.2 million in June 2016. The monetary policy stance will aim at ensuring that movements in the short-term interest rates support the Bank's primary objective of price stability. The Bank will also continue to enhance the effectiveness and efficiency of its monetary policy instruments.

The CBK will continue to monitor liquidity conditions in the market, and the risks posed by developments in the global and domestic economies and will take appropriate actions to maintain price stability. Global economic growth is projected to pick up gradually in the second half of 2015 through 2016. However, the uncertainty around the timing of the increase in U.S. interest rates, coupled with the debt crisis in Greece indicate possible instability in the financial markets.

The Bank will continue its regular interactions with stakeholders in the financial and real sectors to obtain feedback, and ensure the timely release of relevant monetary and financial data. Specifically, the Bank will continue to work with stakeholders to ensure effective implementation of the Kenya Banks' Reference Rate (KBRR) framework. This will enhance transparency in credit pricing and improve the transmission of monetary policy effects through commercial and microfinance banks' lending rates.

1. Introduction

This Monetary Policy Statement (MPS) provides the direction of monetary policy for the Fiscal Year 2015/16. It also reviews the outcome of the monetary policy stance adopted in the first half of 2015.

On the domestic scene, overall inflation remained within the Government target range in the first half of 2015 despite pressures from the pass-through effects of exchange rate depreciation and the supply side shocks. The rise in international oil prices coupled with depreciation of the Kenya Shilling increased the risks of imported inflation. The Kenya Shilling remained under pressure mainly reflecting the strengthening of the US dollar against most currencies, and the widening of the domestic current account deficit. On the global scene, the recovery of the global economy in 2015 has been gradual, driven mainly by the U.S. economy.

The precautionary arrangement with the International Monetary Fund (IMF) blending the non-concessionary Stand By Arrangement and the concessional Stand By Credit Facility (SBA/SCF) was approved in February 2015. The facility provides a cushion to the economy through access to SDR 488.52 million (about USD 688.3 million) of IMF resources in the event of exogenous shocks. This will support exchange rate stability. 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 continues to monitor targets for key monetary aggregates such as broad money (M3) and credit to the private sector. The Central Bank Rate (CBR) signals the monetary policy stance, and is the base for all monetary policy operations. The Bank's participation in the foreign exchange market will continue to be guided by the need to maintain adequate level of foreign exchange reserves, meeting the Government's external obligations, and ensuring stability of the value of the Kenya Shilling.

The rest of this Policy Statement is organized as follows. Section 2 reviews the outcome of the monetary policy stance proposed in the December 2014 MPS while Section 3 describes the current economic environment and outlook for the Fiscal Year 2015/16. Section 4 concludes by outlining the specific monetary policy path for the Fiscal Year 2015/16.

2. Actions and Outcomes of Policy Proposals in the December 2014 Monetary Policy Statement

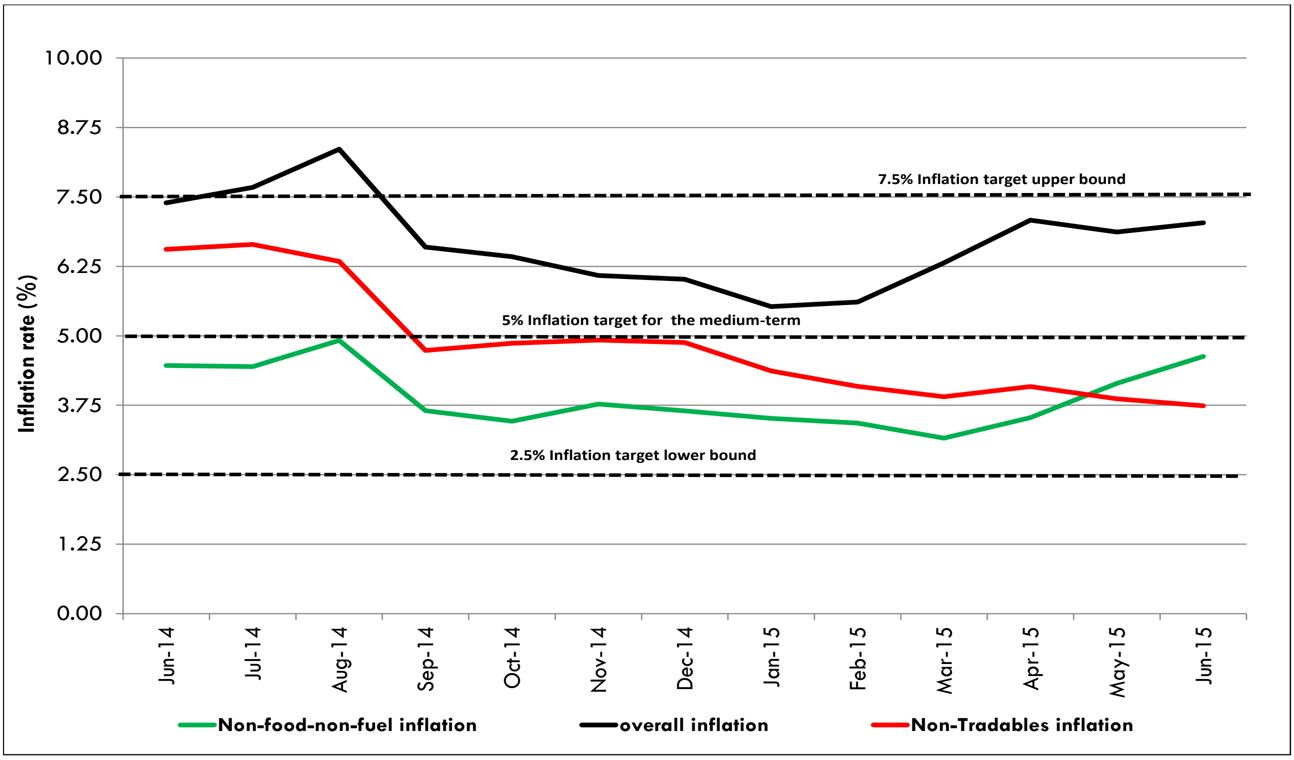
The overall aim of the Monetary Policy Statement for December 2014 (35th MPS) was to set monetary policy targets that would ensure low and stable inflation, encourage growth, support long-term sustainability of public debt through stable interest rates and, by enhancing financial access within the economy, contribute to lowering the cost of doing business in Kenya. The following are the specific outcomes of the policy proposals in the 35th MPS:

a. Inflation

Overall month-on-month inflation remained within the Government target range of 2.5 percent range on either side of the 5 percent target during the first half of 2015 (Chart 1a). It rose gradually from 5.5 percent in January 2015 to 7.1 percent in April 2015 largely reflecting increases in the prices of food, and tradable goods. The rise in tradable goods inflation mainly reflected pass-through effects of exchange rate depreciation on domestic prices (Chart 1b). Overall inflation eased marginally thereafter to 7.0 percent in June 2015 on account of a decrease in food prices.

The depreciation in the Kenya Shilling heightened the threat of imported inflation in the period. The 12-month non-food-non-fuel (NFNF) inflation rose to 4.6 percent in June 2015 from 3.5 percent in January 2015 indicating demand driven inflationary pressure in the economy.

Chart 1a: 12-Month Inflation in Broad Measures (%)



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

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

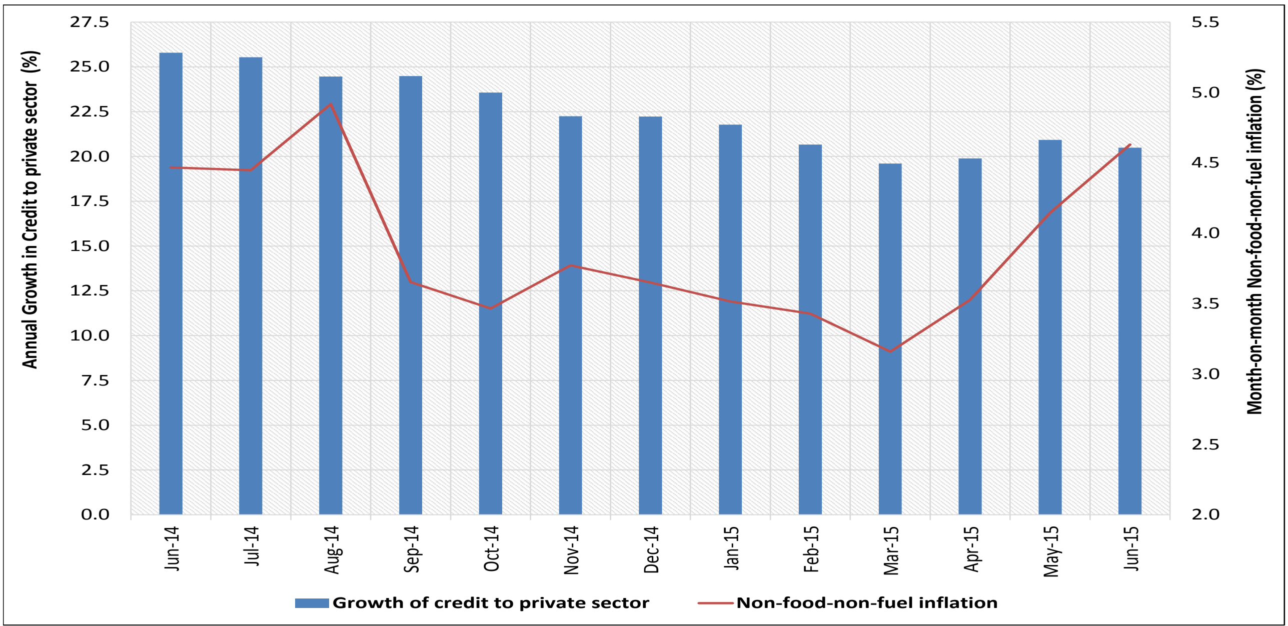
Source: Kenya National Bureau of Statistics and Central Bank of Kenya

i. Credit to Private Sector

The growth in credit to private sector remained strong in the first half of 2015 reflecting sustained demand with improved economic activity. Consistent with the projected growth path to deliver a stable inflation, the 12-month growth in credit declined gradually from 22.2 percent in December 2014 to 20.5 percent in June 2015. The trend in the growth of private sector credit was reflected in the 12-month NFNF during the period (Chart 2). The rise in NFNF inflation from March 2015 was partly explained by pass-through effects of the depreciation in the Kenya Shilling and moderate demand pressure in the economy.

However, the growth in private sector credit in the period was channelled largely towards key sectors of the economy. These sectors include agriculture, manufacturing, trade, transport and communication, finance and insurance, real estate, construction and business services.

Chart 2: Annual Growth in Private Sector Credit (%)



Source: Central Bank of Kenya

ii. Developments in the Monetary Aggregates and Impact of Financial Innovations

Broad money (M3) and credit to private sector were slightly above their targets in the first half of 2015 (Table 1). The conduct of monetary policy by CBK in order to achieve its price stability target was on the basis of the monetary aggregate targeting framework. The aggregates of NDA and NIR of the CBK have been the operational parameters. The CBR signalled the monetary policy stance and formed the base for all subsequent monetary policy operations. The NDA and NIR indicative targets for June 2015 were not met. The breach of the NIR target was attributed to drawdown of foreign exchange reserves through market interventions by the CBK in June 2015 to stem the excessive volatility in the exchange rate.

Table 1: Actual and Targeted Growth in Key Monetary Aggregates

	Dec-14	Jan-15	Feb-15	Mar-15	Apr-15	May-15	Jun-15
Actual Broad Money,M3 (Ksh Billion)	2,330.0	2,350.8	2,407.8	2,398.8	2,464.5	2,501.6	2,553.0
Target Broad Money,M3 (Ksh Billion)	2,320.5	2,343.3	2,366.0	2,388.7	2,411.6	2,434.3	2,457.2
Actual Reserve Money (Ksh Billion)	379.7	350.2	351.6	346.3	353.1	362.7	372.0
Target Reserve Money (Ksh Billion)	353.7	338.3	341.2	347.6	342.2	345.3	354.6
Actual Net Foreign Assets of CBK (Ksh Billion)	588.8	567.8	574.8	569.6	562.6	567.3	565.2
Targets for Net Foreign Assets of CBK (Ksh Billion)	601.4	597.1	592.9	589.4	587.0	585.1	575.0
Actual Net Domestic Assets of CBK (Ksh Billion)	-209.1	-217.6	-223.2	-223.3	-209.5	-204.6	-193.2
Target Net Domestic Assets of CBK (Ksh Billion)	-247.7	-258.8	-251.7	-241.9	-244.8	-239.8	-220.4
Actual Credit to private sector (Ksh Billion)	1,884.5	1,903.3	1,915.8	1,930.7	1,970.8	2,023.4	2,072.2
Target Credit to private sector (Ksh Billion)	1,873.8	1,893.1	1,912.7	1,938.2	1,958.8	1,984.3	2,028.1
Memorandum Items							
12-month growth in actual RM (Percent)	18.4	15.8	11.5	11.8	12.0	15.0	14.9
12-month growth in Broad Money, M3 (Percent)	16.7	16.0	18.6	16.4	17.3	16.5	18.6
12-month growth in actual credit to private sector (Percent)	22.2	21.8	20.7	19.6	19.9	20.9	20.5

Source: Central Bank of Kenya

The predictability of money demand continued to be affected by an unstable money multiplier and the long-term decline in the velocity of money in circulation. The money multiplier remained unstable in the period, fluctuating between 6.1 and 7.2 while the velocity of money declined from 2.3 in June 2014 to 2.2 in June 2015. These outcomes on velocity of money and money multiplier are associated largely with financial innovations such as the mobile phone platforms which have continued to affect the design and conduct of monetary policy.

The CBK continued to implement measures aimed at improving the efficiency of the banking sector as well as financial inclusion in order to enhance the monetary policy transmission mechanism. Notably, the commercial banks' branch network increased from 1,443 in December 2014 to 1,476 in June 2015; this increase was distributed across all the counties in the country. Similarly, the Agency Banking model continued to expand; a total of 17 commercial banks had been licensed by the CBK to undertake Agency banking by June 2015 compared with 16 banks in December 2014. The banks have contracted 36,080 active agents facilitating over 175.4 million transactions valued at Ksh. 930.1 billion by June 2015. This was a notable increase from December 2014 when the number of Agents stood at 35,789, and the number of transactions at 139.0 million valued at Ksh. 752.5 billion.

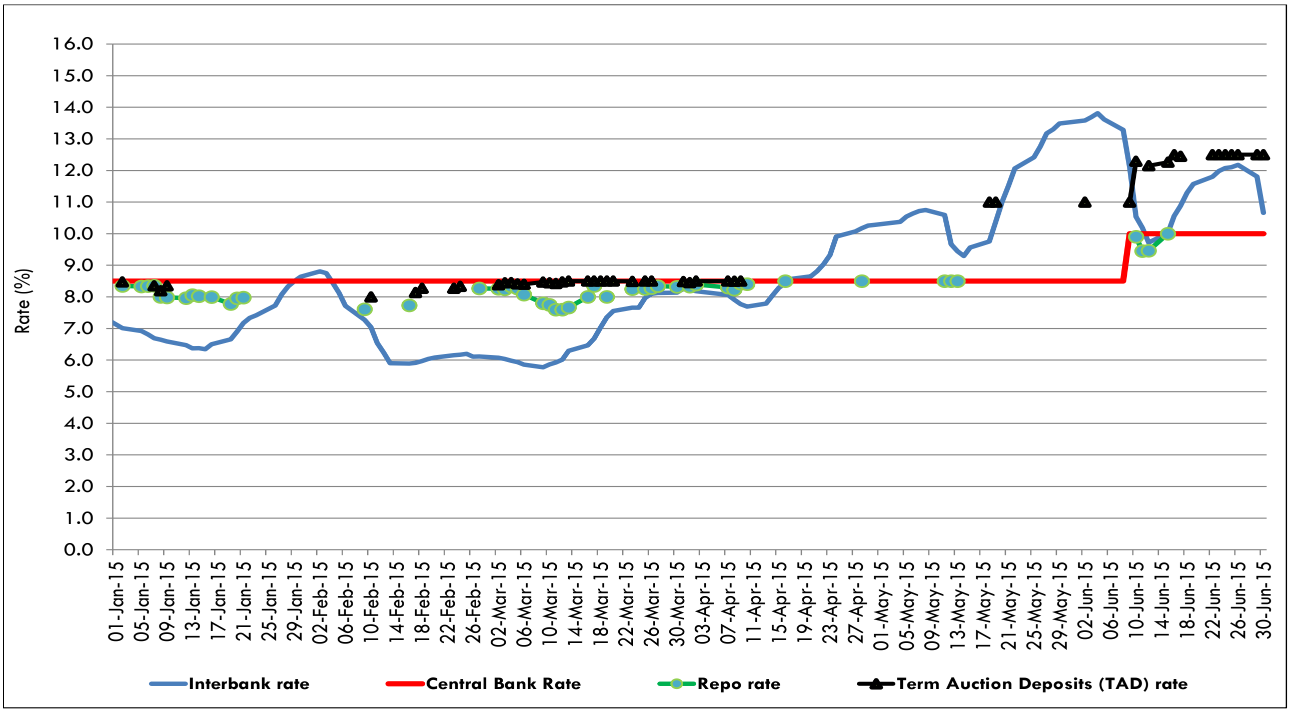
The mobile phone continued to be an important platform for financial services thereby reducing transaction costs. Mobile phone money transactions were estimated at Ksh. 7.6 billion per day in June 2015 compared with Ksh. 7.3 billion in December 2014. This points to the potential of technology-led delivery channels in increasing access to financial services.

iii. Interest Rates and Liquidity

Overall liquidity conditions were tight in the first half of 2015 with the interbank interest rate rising above the CBR from April 2015. Liquidity management by the CBK through Open Market Operations (OMO) ensured general stability in the interbank market in the period, and was consistent with the monetary policy tightening bias stance adopted by the MPC (Chart 3). The interbank rate was volatile between April and June 2015 reflecting changes in liquidity conditions as government deposits at the CBK declined towards the end of the Fiscal Year 2014/15.

The MPC raised the CBR to 10.0 percent in June 2015 from 8.50 percent in order to anchor inflationary expectations and curtail demand pressures in the economy. Consequently, the OMO activities were enhanced to withdraw excess liquidity through Repos and Term Auction Deposits (TAD) so as to move and sustain the interbank rate above the CBR. In particular, the effectiveness of the TAD instrument was enhanced by raising the maximum acceptable rate on the instrument to 250 basis points above the CBR from 150 basis points.

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



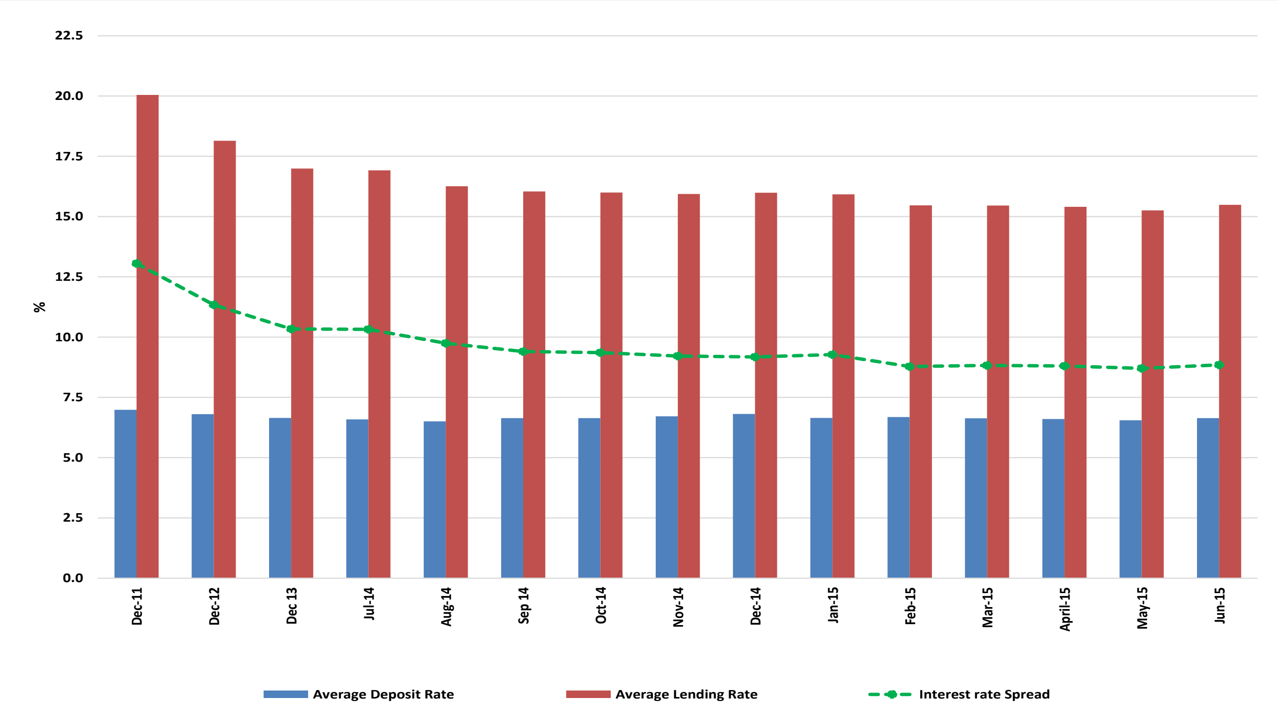
Source: Central Bank of Kenya

The CBK continued to work with the Kenya Bankers Association (KBA) to implement initiatives in the banking sector aimed at reducing the cost of doing business and promoting transparency in the banking sector. The use of mobile phone financial platforms that leverage on technology, roll-out of internet banking by CBK, adoption of the Agency Banking framework, and Credit Reference Bureaus have contributed to reduction of the cost of doing business in the banking sector. In addition, the Kenya Banks' Reference Rate (KBRR) and the Annual Percentage Rate (APR) frameworks introduced in July 2014 have improved transparency in credit pricing.

The CBK revised the KBRR from 9.13 percent to 8.54 percent in January 2015. Consequently, the commercial banks' average lending rate declined from 16.0 percent in December 2014 to 15.5 percent in June 2015 (Chart 4). The average deposit rate decreased from 6.8 percent to 6.6 percent during the period. The spread between average commercial banks' lending rate and deposit rate declined from 9.2 percent to 8.8 percent in the period. The full effect of KBRR will be assessed after all loans have been converted into the KBRR framework.

The MPC continued to engage the Chief Executive Officers of commercial banks through the KBA on various issues through regular forums after MPC meetings. This has facilitated a platform for moral suasion and provided a regular feedback mechanism.

Chart 4: Trends in Commercial Bank Interest Rates (%)



Source: Central Bank of Kenya

b. Exchange Rates and Foreign Exchange Reserve Developments

i) Exchange Rate Developments

The Kenya Shilling weakened gradually against the US Dollar in the first half of 2015 reflecting the stronger US Dollar in the global currency market, the widening of Kenya's current account deficit and high demand for foreign exchange witnessed in April and May 2015. However, sustained Open Market Operations (OMO) led to tight liquidity conditions in the interbank market in the period and helped curtail arbitrage activities between the interbank and foreign exchange markets. The tight liquidity conditions coupled with sales of foreign exchange by the CBK stemmed the volatility of the Kenya Shilling.

The uncertainty around the timing of the increase in U.S. interest rates, the removal of the Swiss Franc cap against the Euro, and the debt crisis in Greece contributed to increased instability in the financial markets in the first half of 2015. Most currencies remained volatile against the U.S. dollar during the period (Chart 5a and 5b). Consequently, the changing global risk perceptions saw net sales of equity by foreign investors in most emerging market economies, further exacerbating pressure on the exchange rate. However, the foreign exchange inflows through diaspora remittances remained strong during the period.

Chart 5a: Rate of Depreciation of the Kenya Shilling and Major International Currencies against the U.S. dollar (2nd January 2015 = 1)

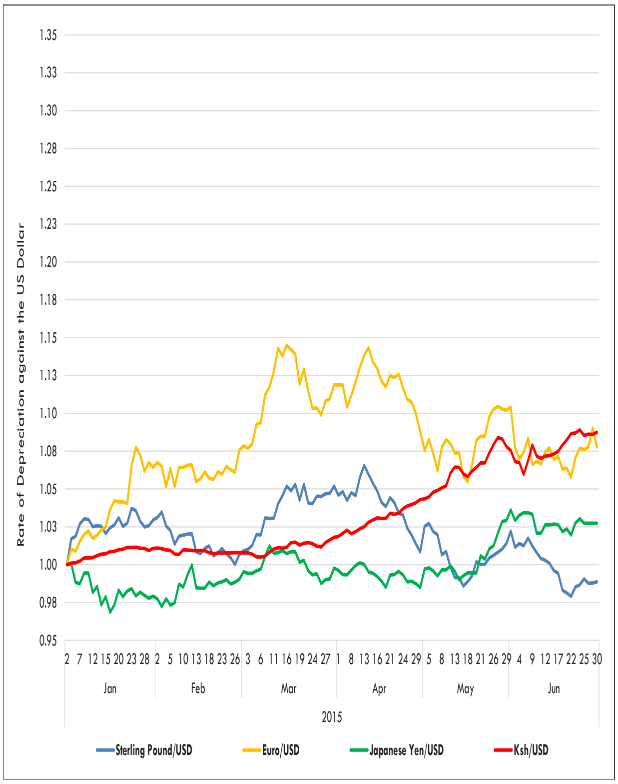
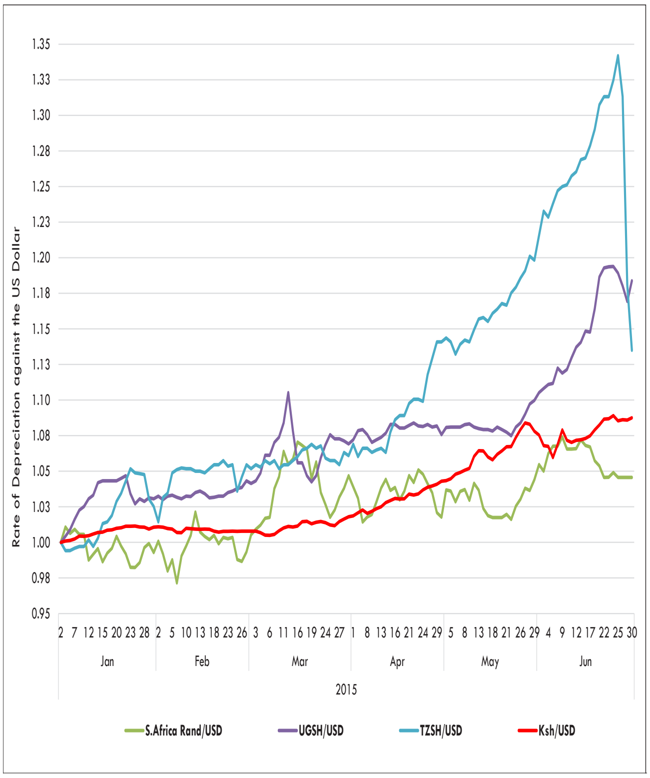


Chart 5b: Rate of Depreciation of the Kenya Shilling and Regional Currencies against the U.S. dollar (2nd January 2015 = 1)

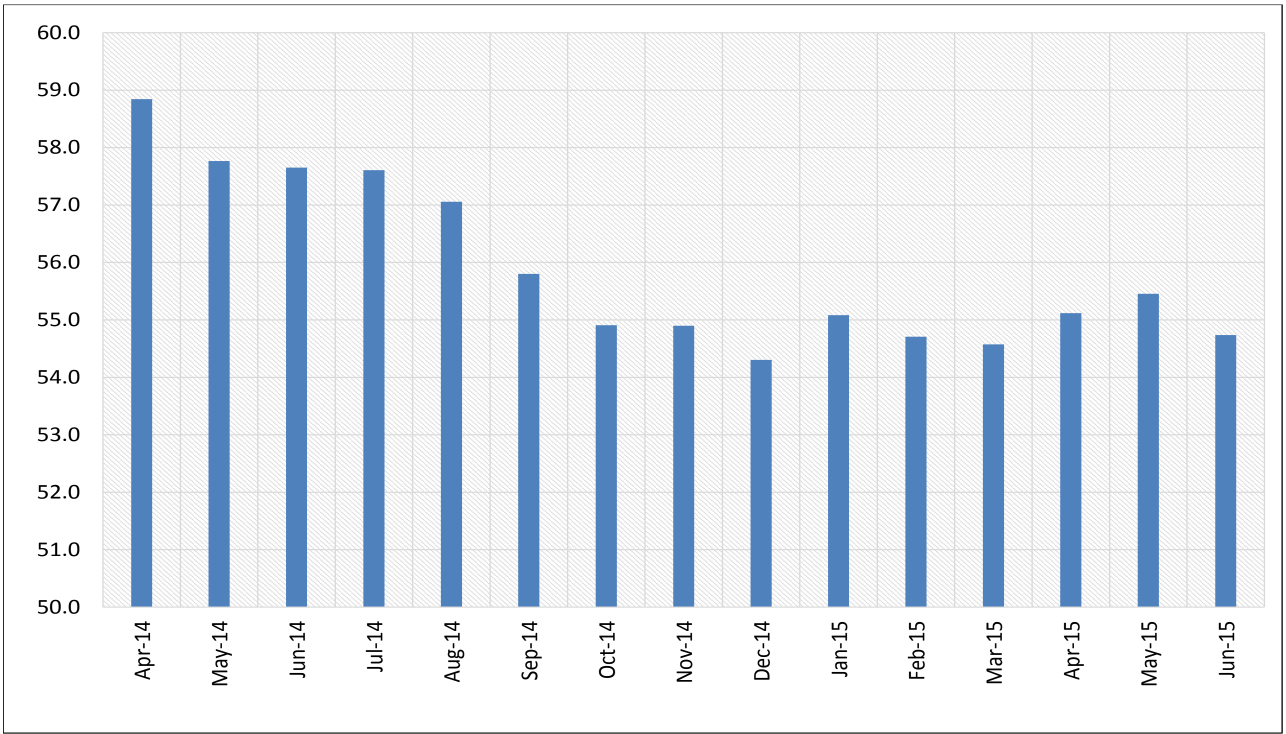


Source: Central Bank of Kenya

The movements in the exchange rate of the Kenya Shilling vis-à-vis the U.S. dollar in the first half of 2015 also reflected the higher demand for the U.S. dollar arising from increased imports coupled with lower than expected foreign exchange earnings from exports (Chart 5c). The 12-month cumulative proportion of imports of goods and services financed by exports of goods and services decreased from an average of 55.8 percent in the second half of 2014 to 54.9 percent in the first half of 2015.

Foreign exchange earnings from tea and tourism which are Kenya's main foreign exchange earners declined in the period mainly on account of the weak global demand and lower tea prices. The higher import bill in the period was as a result of enhanced demand to finance imports of machinery and equipment the bulk of which was towards infrastructure development and modernisation of the aircraft fleet at Kenya Airways. Imports of aircraft equipment increased by USD 1.03 billion to USD 1.42 billion in the 12-months to June 2015 from USD 381 million in the 12-months to June 2014. Imports of machinery and other equipment accounted for about 34.3 percent of total imports in the 12-months to June 2015. These imports are essential for enhancing the future productive capacity of the economy.

Chart 5c: 12-Month Cumulative Exports/12-Month Cumulative Imports (%)



Note: Exports and imports comprise goods and services

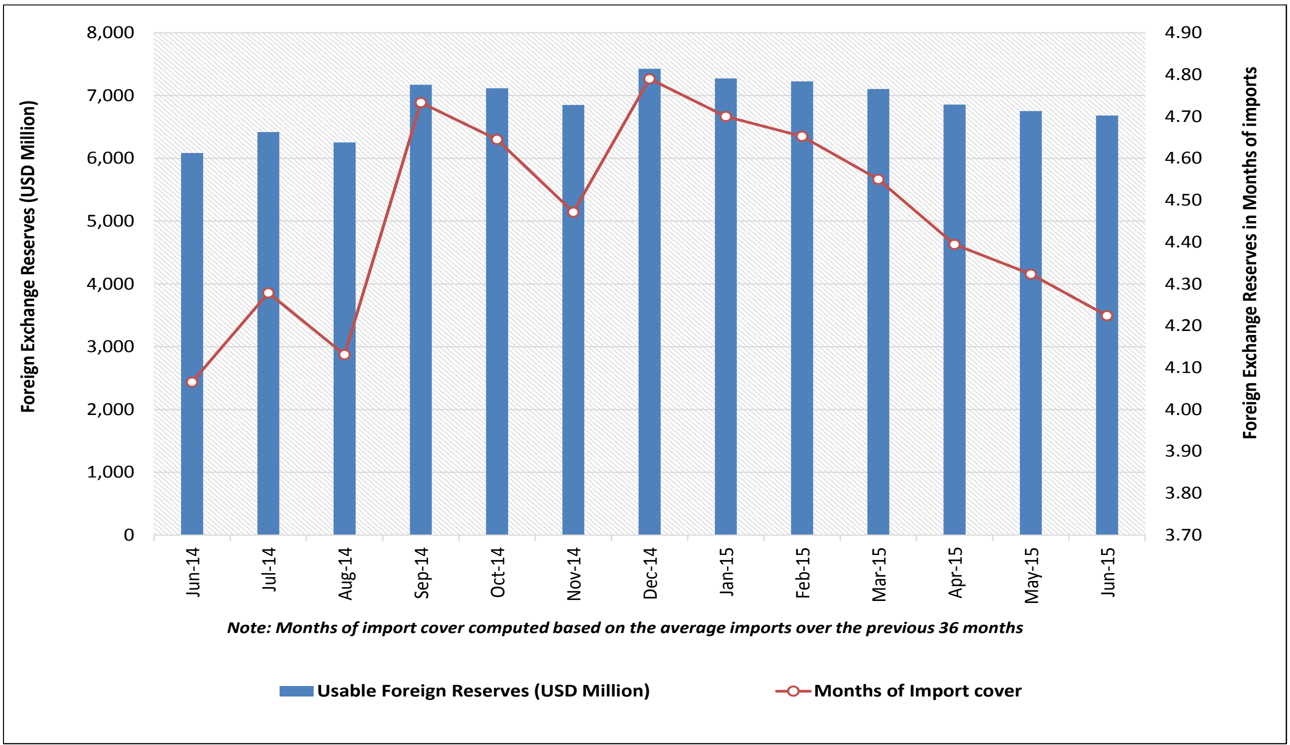
Source: Central Bank of Kenya and Kenya Revenue Authority

ii) Foreign Exchange Reserves

The CBK level of usable foreign exchange reserves decreased from USD 7,424.7 million (equivalent to 4.79 months of import cover) at the end of December 2014 to USD 6,682.5 million (equivalent to 4.22 months of import cover) at the end of June 2015 (Chart 6). The decline in foreign exchange reserves largely reflected CBK interventions to dampen short-term volatility in exchange rate, and payments of Government external obligations.

The current level of reserves together with the precautionary facility with the IMF provides an adequate buffer against short-term shocks.

Chart 6: CBK Usable Foreign Exchange Reserves



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

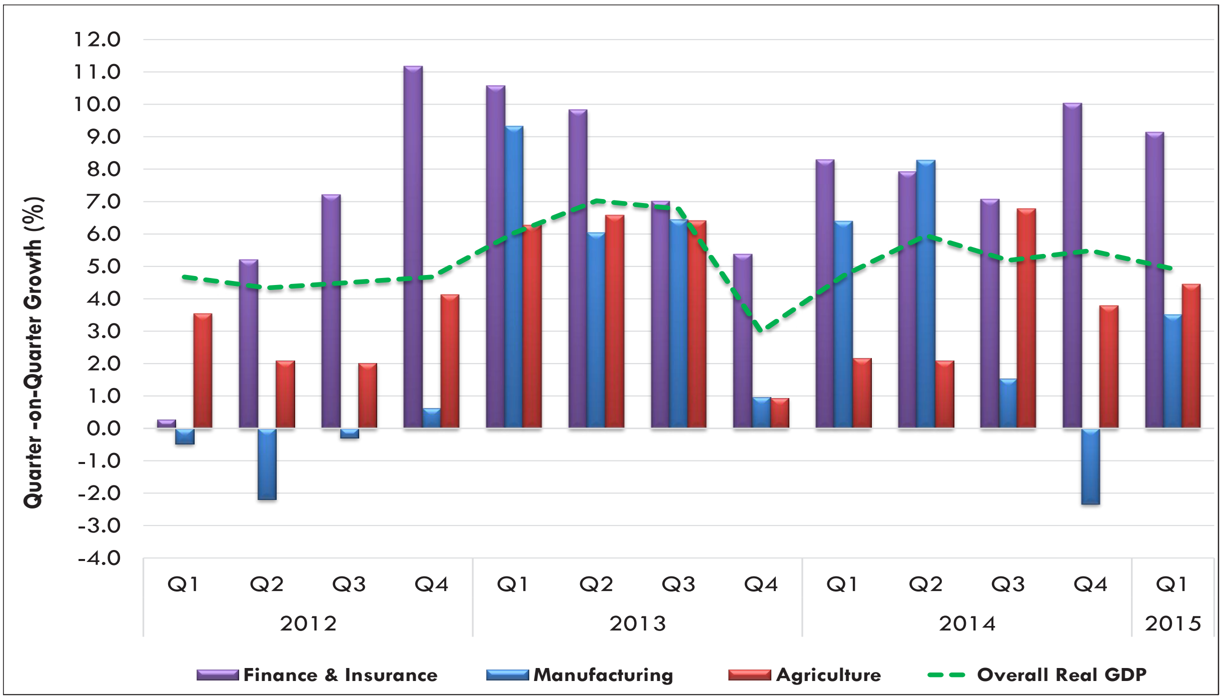
Source: Central Bank of Kenya

c. Economic Growth

The Kenya National Bureau of Statistics (KNBS) data for the first quarter of 2015 shows that the economy remains robust. It grew by 4.9 percent during the period compared with 4.7 percent in a similar period of 2014 (Chart 7). The finance and insurance sector which grew by 9.2 percent offered strong support to the growth performance.

In addition, the strong performance of the construction, information and communication, wholesale and retail trade, electricity and water supply, and agriculture and forestry sectors during the period was an indication of the continued recovery of the economy supported by macroeconomic stability.

Chart 7: 12-Month Sectoral and Overall Real GDP growth rates (%)



Source: Kenya National Bureau of Statistics

d. Fiscal Developments and Debt

The fiscal measures implemented by the Government in the second half of Fiscal Year 2014/15 were broadly consistent with the monetary policy objectives. The Government borrowing was anchored in the Medium-Term Debt Management Strategy which aims at maintaining public debt at sustainable levels.

e. Stakeholder Forums, MPC Market Perception Surveys and Communication

The MPC held regular stakeholder forums with Chief Executive Officers of commercial banks through the KBA Governing Council during the first half of 2015. The Committee also continued to improve on the information gathering processes through the bi-monthly Market Perception Surveys and communication with key stakeholders on the MPC decisions to obtain feedback. The Market Perceptions Surveys cover all commercial and microfinance banks, and a national sample of the non-bank private firms. The MPC Press Releases were continuously reviewed to make them better focused to the public, media, financial sector and other stakeholders. 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 also participated in the Agricultural Society of Kenya Shows in order to sensitise the public on its functions. MPC members also held meetings with various investors during the period in order to brief them on economic developments and the outlook for the economy.

3. The Current Economic Environment and Outlook for the Fiscal Year 2015/16

a. International Economic Environment

Global growth is projected to rise from 3.3 percent to 3.8 percent between 2015 and 2016 supported mainly by growth in both advanced and emerging market economies (Table 2). Growth in advanced economies is expected to be supported by the accommodative monetary policy and the relatively lower international oil prices. Notably, the growth recovery in the U.S. and Europe is expected to boost tourism and horticultural exports in Kenya. The growth outlook for the emerging market economies is weak with significant slowdown expected in China and some oil exporting economies. Growth in Sub-Saharan Africa (SSA) and East African Community (EAC) countries excluding Kenya is projected to remain strong. This is expected to boost Kenya's exports and support the exchange rate.

Although the growth momentum of the global economy is projected to pick-up between 2015 and 2016, there are near term risks including financial markets volatility attributed largely to the expected normalisation of U.S. monetary policy. The debt crisis in Greece and fall in equity prices in China also present risks to the global financial markets.

Global inflation is projected to remain low in 2015 and 2016 largely reflecting the slow global economic recovery. In addition, the relatively lower oil prices and declining international food prices are expected to dampen any upside risks on inflation. This will provide monetary policy space for the countries to support growth and employment.

Table 2: Performance and Outlook for the Global Economy

	Growth (%)			Inflation (%)		
	2014 Act.	2015 Proj.	2016 Proj.	2014 Act.	2015 Proj.	2016 Proj.
World	**3.3**	**3.3**	**3.8**	**3.5**	**3.2**	**3.3**
Advanced Economies	**1.8**	**2.1**	**2.4**	**1.4**	**0.4**	**1.4**
United States	2.4	2.5	3.0	1.6	0.1	1.5
Japan	-0.1	0.8	1.2	2.7	1.0	0.9
Euro Area	0.8	1.5	1.7	0.4	0.1	1.0
United Kingdom	2.9	2.4	2.2	1.5	0.1	1.7
Other Advanced economies	2.8	2.7	3.1	1.4	1.1	1.9
Emerging and developing economies	**4.6**	**4.2**	**4.7**	**5.1**	**5.4**	**4.8**
Sub-Sahara Africa	5.0	4.4	5.1	6.3	6.6	7.0
East African Community (Excl.Kenya)	6.0	6.1	6.2	4.3	4.3	4.7
Developing Asia	6.8	6.6	6.4	3.5	3.0	3.1
China	7.4	6.8	6.3	2.0	1.2	1.5
India	7.3	7.5	7.5	6.0	6.1	5.7
Middle East and North Africa	2.7	2.6	3.8	6.5	6.2	6.4

Source: IMF World Economic Outlook

b. Domestic Economic Environment

i. Economic Growth

The Bank's price stability objective aims at supporting sound and sustained economic growth. The Government Budget Policy Statement for 2015/16 projects growth at 6.9 percent in 2015 and 7.0 percent in 2016. The growth outlook is expected to be supported by activities generated in the construction of Standard Gauge Railway, increased production in agriculture following various agriculture reforms, irrigation and value addition, continued investment in infrastructure projects such as roads, energy and port, expansion of activities in other sectors of the economy such as building and construction, manufacturing, retail and wholesale and financial intermediation among others. The growth is also expected to benefit from increased investments and domestic demand following investor confidence and the ongoing initiatives to deepen regional integration.

The MPC Market Perceptions Survey of June 2015 showed optimism by private sector firms for a higher growth in 2015 relative to 2014 on account of: expected increase in foreign direct investment and public investment in infrastructure; increased investor confidence and enhanced security which is expected to support recovery of the tourism sector; strong growth in the construction, communications and financial sectors; positive effects of the long-rains on agriculture production; expected recovery of the global economy which will benefit exports; and, the impact of devolution which will spur growth in counties. However, there are downside risks to growth including: inflationary pressure attributed to depreciation of exchange rate, expected rise in fuel prices, sluggish recovery of the global economy, threats to security, and possible spill-over of risks in Greece to the Eurozone which could slowdown recovery of the Eurozone economy.

ii. Foreign Exchange Market

The Kenya Shilling is expected to be stable in the Fiscal Year 2015/16 on account of the monetary policy measures adopted by the CBK, the resilient diaspora remittance inflows, expectations for increased foreign direct investment in infrastructure, increased investor confidence in the economy, and the Government measures in the Fiscal Year 2015/16 Budget to bolster security and tourism. In addition, the projected resilient growth of SSA economies and that of Kenya's main trading partners is expected to boost regional trade. The Kenya Shilling will also be supported by the adequate buffer of foreign exchange reserves and the precautionary facility with the IMF.

However, the uncertainty around the timing of the increase in U.S. interest rates, the wide current account deficit, and possible instability in the Eurozone due to the Greek debt crisis remain the main risks to the Kenya Shilling.

iii. Inflation

Overall inflation is expected to remain within the Government's medium term target range in the Fiscal Year 2015/16 supported by the monetary policy measures in place, lower international oil prices, the declining international food prices which have dampened any upside risks to domestic food prices in the case of imports, and moderate electricity prices with increased output of geothermal power generation. However, the main risks to the inflation outlook include possibility of imported inflation attributed to depreciation in Kenya Shilling in case of a protracted global strengthening of the U.S. dollar. In addition, given the dominance of food in the consumer basket there remains a vulnerability to short-falls in the rains, and volatility in international oil prices.

iv. Interest Rates

Interest rates are expected to rise in the Fiscal Year 2015/16 in line with the tight monetary policy stance adopted by the MPC to contain inflationary expectations. Liquidity in the money market is expected to be supported by the normalization of absorption of devolved funds, and spending by the national government. In addition, the KBRR framework is expected to continue improving transparency in credit pricing. The promotion of full disclosure of bank charges through the Annual Percentage Rate (APR) for loans will also facilitate informed banking decisions by the public. The main risk to the outlook on interest rates is the international economic developments or supply side factors which could prompt additional measures by CBK to alleviate any adverse expectations with respect to inflation and /or exchange rate movements.

v. Fiscal Policy

The fiscal measures announced by the Government during the Budget Statement for the Fiscal Year 2015/16 remain consistent with the monetary policy objectives. The CBK will work with the National Treasury to strengthen the coordination between monetary and fiscal policies. Government borrowing is anchored in the Medium-Term Debt Management Strategy which aims at maintaining public debt at sustainable levels. The increased budgetary allocations towards bolstering security and facilitating the recovery of the tourism sector will support the long-term stability of the exchange rate.

vi. Confidence in the Economy

Confidence in the economy is expected to improve in the Fiscal Year 2015/16 due to improved security and Kenya's global positioning. Diaspora remittances are expected to remain strong on account of increased investment opportunities in Kenya and gradual pick-up in the growth of the global economy. Diaspora remittances recorded the highest ever inflow of USD 136.0 million in June 2015. Despite a net outflow of foreign investors in the NSE, there were noteworthy increases in foreign purchases in the first half of 2015.

The MPC Market Perception Survey conducted of June 2015 showed increased optimism by private sector firms for the business environment to improve in the remainder of 2015 on account of the expected decline in electricity prices which are expected to benefit the manufacturing sector, increased budget allocations to key sectors of the economy including security and tourism, high profile visits by international personalities indicating confidence, sustained public investment in infrastructure which is expected to lower the cost of doing business, government efforts to encourage investors and address governance, increased financial inclusion and access to credit, and improved spending in the counties

4. Direction of Monetary Policy in the Fiscal Year 2015/16

Monetary policy in the Fiscal Year 2015/16 will focus on: setting monetary targets which are consistent with the objective of achieving and maintaining a low and stable inflation, encouraging growth, and supporting the long-term sustainability of public debt; and, enhancing financial inclusion.

a) Monetary Programme and Foreign Exchange Reserves

The monetary targets for the Fiscal Year 2015/16 are consistent with the indicators in the Medium-Term Government Budget Policy Statement for 2015 summarised in Annex 1. The monetary targets for the period are presented in Table 3. Monetary policy will seek to constrain the annual growth in broad money (M3) to 17.3 percent by September 2015, 17.2 percent by December 2015, 17.5 percent by March 2016 and 13.8 percent by June 2016. NDA of the Bank is projected at Ksh.-167.1 billion in September 2015, Ksh.-187.2 billion in December 2015, Ksh.-214.0 billion in March 2016 and Ksh.-203.7 billion in June 2016. However, the annual growth in credit to the private sector is projected at 19.1 percent in September 2015, 18.4 percent in December 2015, 18.3 percent in March 2016 and 15.5 percent in June 2016. The NIR targets of the CBK are USD 5,308.2 million in September 2015, USD 5,986.6 million in December 2015, USD 6,005.0 million in March 2016 and USD 6,055.2 million in June 2016. The monetary policy stance will aim at ensuring that movements in the short-term interest rates are supportive to the Bank's primary objective of price stability.

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 in order to anchor inflation expectations. The CBK foreign exchange reserves and the precautionary facility with the IMF will provide a buffer against short-term shocks in the foreign exchange market. Appropriate regulatory measures will also be implemented to enhance the efficiency and integrity of the foreign exchange market. The programme targets are consistent with the performance criteria under the precautionary arrangement with the IMF blending the non-concessionary Stand-By Arrangement and the concessional Stand-By Credit Facility to cushion the economy by providing it with access to SDR 488.52 million (about USD 688.3 million) of IMF resources in the event of exogenous shocks.

The monetary policy stance will aim at ensuring that short-term interest rates remain stable which will support growth and ensure the long-term sustainability of public debt. The coordination of monetary and fiscal policies will be enhanced to maintain a sustainable public debt. The Bank will also continue to enhance the effectiveness and efficiency of its monetary policy instruments.

Table 4: Monetary Targets for the Fiscal Year 2015/16

	Jul-15	Aug-15	Sep-15	Oct-15	Nov-15	Dec-15
Broad Money, M3 (Ksh Billion)	2,582.5	2,611.9	2,641.5	2,671.0	2,700.5	2,730.1
Reserve Money, RM (Ksh Billion)	353.6	364.5	353.4	360.9	373.3	400.1
Credit to Private Sector (Ksh Billion)	2,096.5	2,123.3	2,150.1	2,173.2	2,198.3	2,227.1
NFA of CBK (Ksh Billion)	527.3	523.9	520.5	517.7	514.7	587.3
NDA of CBK (Ksh Billion)	-173.7	-159.4	-167.1	-156.7	-141.5	-187.2
12-month growth in RM (Percent)	16.1	2.1	9.5	3.5	14.3	5.4
12-month growth in M3 (Percent)	17.9	15.9	17.3	18.2	17.7	17.2
12-month growth in Credit to Private Sector (Percent)	20.4	19.7	19.1	19.0	18.6	18.4
12-month growth in Real GDP (Percent)						6.5
Medium-Term 12-month overall Inflation (Percent) Target	5.0	5.0	5.0	5.0	5.0	5.0

	Jan-16	Feb-16	Mar-16	Apr-16	May-16	Jun-16
Broad Money, M3 (Ksh Billion)	2,759.4	2,788.7	2,817.9	2,847.4	2,876.8	2,906.2
Reserve Money, RM (Ksh Billion)	368.5	379.2	375.1	370.4	382.7	390.2
Credit to Private Sector (Ksh Billion)	2,245.0	2,262.6	2,280.3	2,305.6	2,346.9	2,388.6
NFA of CBK (Ksh Billion)	587.9	588.5	589.1	590.2	591.3	593.9
NDA of CBK (Ksh Billion)	-219.4	-209.3	-214.0	-219.8	-208.7	-203.7
12-month growth in RM (Percent)	5.2	7.8	8.3	4.9	5.5	4.9
12-month growth in M3 (Percent)	17.4	15.8	17.5	15.5	15.0	13.8
12-month growth in Credit to Private Sector (Percent)	18.2	18.3	18.3	17.2	16.2	15.5
12-month growth in Real GDP (Percent)						6.8
Medium-Term 12-month overall Inflation (Percent) Target	5.0	5.0	5.0	5.0	5.0	5.0

Source: Central Bank of Kenya and the National Treasury

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 depend on stability in the international prices of oil, favourable weather conditions, and continued commitment by the Government to operate within the domestic borrowing target for the Fiscal Year

2015/16. The information will be reviewed and incorporated in the data so as to inform the MPC decision process accordingly.

Monetary policy implementation will be based on monthly targets for NDA, NIR, RM and broad money (M3) to be achieved through OMO. The Repurchase agreements (Repos) and Term Auction Deposits instruments 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. Specifically, OMO will be used to ensure that short-term interest rates continue to be aligned to the CBR. The success of CBK's monetary policy measures to fight inflation 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 Extend Access to Financial Services and Enhance Market Efficiency

The CBK will continue to support development of new products and innovations towards enhancing financial access in order to encourage economic growth. It will continue to propose suitable legislation and regulations aimed at ensuring that such innovations are operationalized accordingly so as to enhance market confidence. The Bank will also continue to monitor any new financial derivatives and /or innovations in the market that could have adverse effects on market stability. It will continue to work with stakeholders in the banking and real sectors in order to enhance the monetary policy transmission mechanism.

Initiatives aimed at engaging stakeholders and obtaining feedback on the impact of MPC decisions will be enhanced. In addition, the CBK will work closely with the institutions and other stakeholders to facilitate the effective implementation of the KBRR that facilitates a transparent credit pricing framework, and to ensure a wide dissemination of the framework to the public.

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 through the timely dissemination of all the requisite data through its website.

ANNEX 1: MAIN MACROECONOMIC INDICATORS (2014/15 – 2017/18)

	2014/15		2015/16	2016/17	2017/18
	Budget	*Rev. Proj.*	*Projections*		
Annual percentage change, unless otherwise indicated					
National account and prices					
Real GDP	6.1	6.1	7.0	7.1	7.0
GDP deflator	7.2	6.7	6.5	6.4	6.2
CPI Index (eop)	5.3	5.3	5.0	5.0	5.0
CPI Index (avg)	5.7	5.7	5.0	5.0	5.0
Terms of trade (-deterioration)	5.1	0.2	0.3	0.2	0.2
In percentage of GDP, unless otherwise indicated					
Investment and saving					
Investment	22.4	24.6	26.9	25.2	25.6
Gross National Saving	15.3	16.6	19.7	18.0	18.2
Central government budget					
Total revenue	21.0	20.4	20.7	21.5	21.8
Total expenditure and net lending	28.4	29.2	28.8	27.6	26.6
Overall balance (commitment basis) excl. grants	-7.4	-8.8	-8.2	-6.2	-4.8
Overall balance (commitment basis) incl. grants	-6.4	-8.0	-7.4	-5.4	-4.0
Nominal public debt, net	43.8	43.9	43.7	42.6	41.3
External sector					
Current external balance, including official transfers	-7.1	-8.0	-7.2	-7.2	-7.4

Source: Budget Policy Statement 2015, National Treasury

ANNEX 2: CHRONOLOGY OF EVENTS OF PARTICULAR RELEVANCE TO MONETARY POLICY (JANUARY – JUNE 2015)

Date	Events
January 2015	a) The CBK revised the KBRR from 9.13 percent to 8.54 percent. b) The European Central Bank announced that it would commence Quantitative Easing in the Eurozone. c) The Swiss Central Bank removed the cap of the Swiss Franc to the Euro.
February 2015	The precautionary facility amounting to SDR 488.52 million (about USD 688.3 million) under a blended Stand-By Arrangement and Standby Credit Facility was approved by the IMF.
April 2015	The Garissa terrorist attack on 2nd April, 2015 had implications on tourism performance.
May 2015	The effectiveness of the TAD instrument was enhanced by raising the maximum acceptable rate on the instrument to 250 basis points above the CBR.
June 2015	a) The CBR was raised from 8.5 percent to 10.0 percent to anchor inflation expectations. b) Appointment of the new CBK Governor.

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 goods and services in a representative basket in a base year. It is derived from data collected monthly by the Kenya National Bureau of Statistics. The inflation measure is affected by the commodities in the basket some of which may experience sudden price spikes such as food or energy. It may therefore present a distorted picture of the true state of the economy.

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:

- **M0**: Currency outside the banking system
- **M1:** M0 + demand deposits of banks (or depository corporations).
- **M2**: M1 + quasi (long term) money deposits i.e. time and savings deposits of banks and non-bank financial institutions.
- **M3**: M2 + resident foreign currency deposits.
- **L**: M3 + non-bank holdings of Government Paper. This however, is not a monetary aggregate.

Kenya Banks' Reference Rate (KBRR)

The KBRR is the base rate for all commercial and microfinance banks' lending. It is computed as an average of the CBR and the weighted 2-month moving average of the 91-day Treasury bill rates.