Central Bank of Kenya

Twentieth Bi-Annual Report of the Monetary Policy Committee

Issued under the Central Bank of Kenya Act, Cap 491

April 2018

The Bi-Annual Report is prepared by the
Members of the Monetary Policy Committee.

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LETTER OF TRANSMITTAL TO THE CABINET SECRETARY FOR THE NATIONAL TREASURY

Honourable Cabinet Secretary,

I have the pleasure of forwarding to you the twentieth bi-annual Monetary Policy Committee (MPC) Report in accordance with section 4D (6) of the Central Bank of Kenya Act. The Report outlines monetary policy formulation, developments in key interest rates, inflation, and exchange rates together with other activities of the Committee in the six months to April 2018. Copies of MPC Press Statements of the MPC between November 2017 and April 2018 are attached to the Report for your information.

Dr. Patrick Njoroge
Governor, Central Bank of Kenya

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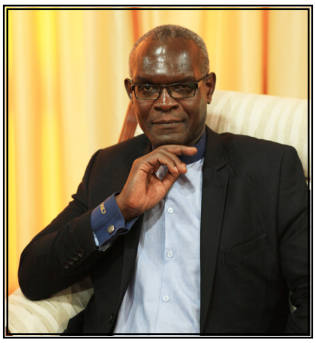
MEMBERS OF THE MONETARY POLICY COMMITTEE

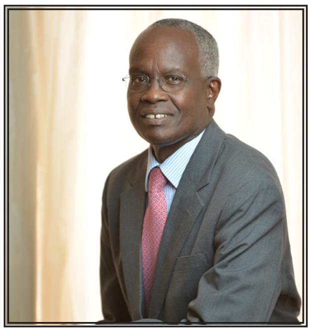
Dr. Patrick Njoroge
Governor, Chairman

Mrs. Sheila M'Mbijjewe
Deputy Governor, and Deputy Chairman

Dr. Kamau Thugge (CBS)
PS, National Treasury
Treasury Representative



Mr. Charles G. Koori
Member



Mr. John Birech
Member

LEGAL STATUS OF THE MONETARY POLICY COMMITTEE

(1) Section 4D of the Central Bank of Kenya Act states that there shall be a Committee of the Bank, to be known as the Monetary Policy Committee of the Central Bank of Kenya, which shall have the responsibility within the Bank for formulating monetary policy.

(2) The Committee shall consist of the following members:

- (a) the Governor, who shall be the chairman;
- (b) a Deputy Governor, who shall be the deputy chairman;
- (c) two members appointed by the Governor from among the staff;
- (d) four other members who have knowledge, experience and expertise in matters relating to finance, banking and fiscal and monetary policy, appointed by the Cabinet Secretary; and,
- (e) the Principal Secretary to the National Treasury, or his representative, who shall be a non-voting member.

(2A) Of the two members appointed under subsection (2) (c):

- (a) one shall be a person with executive responsibility within the Bank for monetary policy analysis; and
- (b) one shall be a person with responsibility within the Bank for monetary policy operations.

(3) At least two of the members appointed under subsection (2)(d) shall be women.

(4) Each member appointed under subsection (2)(d) shall hold office for a term of three years and shall be eligible to be appointed for one additional term.

(5) The chairman of the Committee shall convene a meeting of the Committee at least once every two months and shall convene additional meetings if requested by at least four members in writing.

(6) At least once every six months the Committee shall submit a report to the Cabinet Secretary with respect to its activities and the Cabinet Secretary shall lay a copy of each report before the National Assembly.

(7) The quorum of the Committee shall be five members, one of who must be the chairman or vice chairman.

(8) The Bank shall provide staff to assist the Committee.

EXECUTIVE SUMMARY

The twentieth bi-annual Report of the Monetary Policy Committee (MPC) reviews Kenya's monetary policy formulation and economic developments during the six months to April 2018. The period was characterised by macroeconomic stability and favourable weather conditions. Consistent with the price stability objective of the Central Bank of Kenya (CBK), the conduct of monetary policy during the period aimed at maintaining inflation within the target range of 5 percent with a flexible margin of 2.5 percent on either side. Monetary policy was conducted in an environment of interest rate caps which came into force in September 2016.

The MPC held three bi-monthly meetings during the period, to review the outcome of its previous policy decisions and economic developments, and to put in place measures to maintain price stability. The Committee retained the Central Bank Rate (CBR) at 10.0 percent in its November 2017 and January 2018 meetings, but lowered the CBR to 9.50 percent in March 2018 in order to support economic activity. While lowering the CBR in March, the MPC noted the risks of potential perverse reaction to its policy decision due to the interest rate caps.

Overall inflation remained within the target range during the six months to April 2018. The inflation rate fell to 3.7 percent in April from 5.7 percent in October 2017, mainly driven by declines in food prices following favourable weather conditions, and extension of the maize subsidy programme by the Government to December 2017. The contribution of food and non-alcoholic beverages to overall inflation declined to 0.1 percentage points in April 2018 from 3.8 percentage points in October 2017. However, fuel inflation rose steadily to 10.2 percent from 3.7 percent, reflecting the impact of the increase in international oil prices in the period. The increase in fuel prices was offset by the decline in food prices in the period. Non food non fuel (NFNF) remained below 5 percent during the period, an indication of muted demand pressures in the economy. The CBK continued to monitor the overall liquidity in the economy as well as any threats to exchange rate stability which could fuel demand driven inflationary pressures.

The foreign exchange market remained stable in the period, supported by strong foreign exchange inflows from diaspora remittances, resilient tea and horticultural exports, and the continued recovery in tourism. This stability also reflected the country's diversified exports products and destinations, which provided a cushion against the effects of external shocks. The CBK level of usable foreign exchange reserves stood at USD9.1 billion (6.1 months of import cover) at the end of April 2018. The reserves provided an adequate buffer against short term shocks in the foreign exchange market.

The banking sector remained stable and resilient in the period with strong liquidity and capital adequacy ratios. The CBK continued to monitor the impact of interest rate capping on the economy as well as on the effectiveness of monetary policy. Preliminary analyses showed that the interest rate caps had distorted the transmission of monetary policy signals to credit. Growth in private sector credit stood at 2.9 percent in the 12 months to April 2018, partly due to reduced lending to segments of the market perceived as highly costly and risky such as the Micro, Small and Medium Enterprises (MSMEs), lower credit demand by some sectors of the economy such as trade, and increased use of alternative funding sources.

The MPC held meetings with stakeholders in the banking sector after every meeting to discuss the basis for its decisions. The Governor held media briefings after every MPC meeting to discuss the basis of policy decisions and other market developments. These meetings provided a platform for obtaining feedback and continued to improve stakeholders' understanding on the formulation and conduct of monetary policy.

The Bank remained vigilant to the risks posed by developments in the domestic and global environments on its overall price stability objective. The main risks to inflation during the period related to the volatility in the global oil prices which had implications for domestic fuel prices. In the global scene, uncertainties with regard to the U.S. economic and trade policies, the post-Brexit resolution and the pace of normalisation of monetary policies in the advanced economies were the main risks to stability.

1. INTRODUCTION

The twentieth bi-annual Report of the MPC reviews outcomes of the monetary policy stance adopted by the Committee, as well as other economic developments in the period November 2017 to April 2018. During this period, there was sustained macroeconomic stability despite the prolonged elections period in 2017, improved weather conditions, and a positive outlook for the global economy.

The MPC formulated monetary policy to achieve and maintain overall inflation within the target range provided by the Cabinet Secretary for the National Treasury at the beginning of the fiscal year. The inflation target provided by the Cabinet Secretary for the National Treasury at the beginning of FY2017/18 was 5 percent with a flexible margin of 2.5 percent on either side. The Central Bank Rate (CBR) remained the base for monetary policy operations and its adjustments both in direction and magnitude signaled the stance of monetary policy. Overall inflation remained within the target range, supported by lower food prices, partly due to the extension of the Government's maize subsidy programme to December 2017. Fuel inflation, however, rose reflecting an increase in international oil prices over the period. Non-food-non-fuel (NFNF) inflation remained below 5 percent, suggesting that there were no demand pressures in the economy.

Economic growth remained resilient despite multiple shocks, including the effects of the drought in the first quarter of 2017 which had adverse effects on agricultural sector performance, a prolonged elections period and effects of interest rate caps on credit growth particularly to the Micro, Small and Medium Enterprises (MSMEs). The economy grew by 4.9 percent in 2017 compared with 5.9 percent in 2016, supported mainly by the services sector which grew by 6.2 percent in 2017, compared to 6.5 percent in 2016.

In the international scene, risks to the performance of the global economy and financial markets increased mainly due to uncertainties with regard to the U.S. economic and trade policies, the post-Brexit resolution and the pace of normalisation of monetary policies in the advanced economies.

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

2. MONETARY POLICY FORMULATION

2.1 Attainment of Monetary Policy Objectives and Targets

The MPC formulated monetary policy to achieve and maintain overall inflation within the target range provided by the Cabinet Secretary for the National Treasury at the beginning of every fiscal year. The target provided by the Cabinet Secretary for the National Treasury at the beginning of FY2017/18 was 5 percent with an allowable margin of 2.5 percent on either side.

The Central Bank Rate (CBR) remained as the base for monetary policy operations and its adjustments both in direction and magnitude continued to reflect the stance of monetary policy. The monetary policy stance is operationalized through various instruments including: Open Market Operations (OMO), changes in cash reserve requirements at CBK, and the CBK Standing Facility (Overnight Discount Window which is a lender of last resort facility). To achieve the desired level of money supply, OMO was conducted using Repurchase Agreements (Repos), Reverse Repos, and Term Auction Deposits (TAD). The CBK pursues a flexible exchange rate regime, allowing the exchange rate to move freely in the market, and intervening only to minimize volatility.

The 12 month growth in broad money supply, M3, and private sector credit were below their projected growth paths through out the period under review. The growth in M3 slowed down to 5.5 percent in April 2018 from 7.2 percent in October 2017, while growth in private sector credit rose to 2.9 percent from 2.4 percent in the period.

2.2 Domestic and Global Economic Environment

The domestic economic environment during the six months to April 2018 was characterized by macroeconomic stability, decline in the prices of key food items due to improved weather conditions, and slow growth of private sector credit. On the domestic scene, there were concerns on the impact of the interest rates caps on the effective transmission of monetary policy signals. Internationally, risks to the global economy persisted largely due to uncertainties on the impact of U.S. economic and trade policies, the post-Brexit resolution and the pace of normalisation of monetary policy in the advanced economies.

According to the IMF, global growth strengthened to 3.8 percent in 2017 from 3.2 percent in 2016, and was projected to rise to 3.9 percent in 2019. The recovery was supported by a strong rebound in global trade, investment recovery in advanced economies, continued strong growth in emerging Asia, a notable upswing in emerging Europe, and signs of recovery in several commodity-exporting countries. Global growth in 2018 is expected to be supported by favourable market sentiment, accommodative financial conditions, partial recovery in commodity prices, and the domestic and international repercussions of expansionary fiscal policy in the United States.

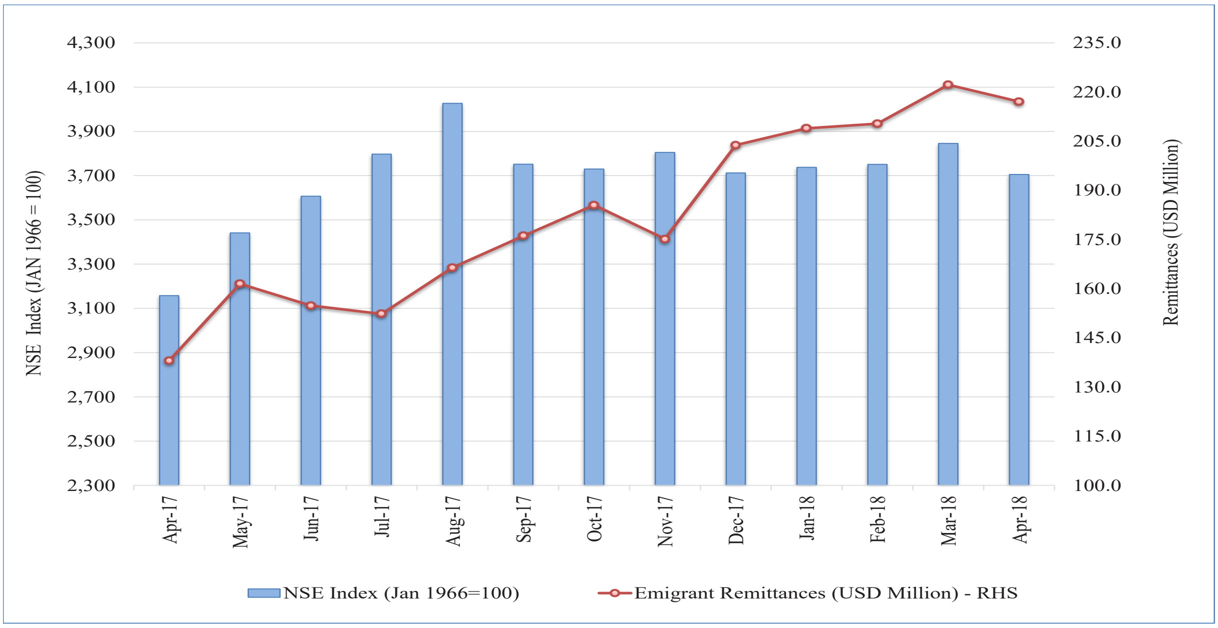
Risks to the global economy were broadly balanced but with a downside bias. These included the shift toward inward-looking policies and geopolitical tensions, and the pace of post-Brexit resolution. The support to growth that comes from pro-cyclical policies, including in the U.S., would eventually need to be reversed, but its pace may affect recovery in the emerging and developing economies. Growth in Sub-Saharan African (SSA) economies was 2.8 percent in 2017 compared to 1.4 percent in 2016 and was expected to rise to 3.4 percent in 2018, reflecting recovery of commodity prices, increased infrastructure spending, and a pickup in the global economy.

The domestic economic growth remained resilient, with real GDP growing by 4.9 percent in 2017 from 5.9 percent in 2016, supported mainly by strong performance of the services sector. The services sector, which comprises wholesale and retail trade, information and communication, accommodation and restaurants, public administration, education and health sectors, grew by 6.2 percent in 2017 and contributed 3.1 percentage points to real GDP growth in 2017, compared to a growth of 6.5 percent and contribution of 3.2 percentage points in 2016. Growth in agriculture decelerated to 1.6 percent in 2017 from 4.7 percent in 2016, reflecting the impact of unfavourable weather conditions coupled with widespread infestation of pests such as army worms, which adversely affected crop yields. The negative effects of interest rate caps on credit growth particularly to the Micro, Small and Medium Enterprises (MSMEs), coupled with uncertainties associated with the prolonged elections were the additional factors that contributed largely to the slower performance of the economy in 2017.

The foreign exchange market remained stable supported mainly by strong inflows of diaspora remittances, resilient agricultural exports of tea and horticulture, and continued recovery in tourism. Diaspora remittances averaged USD 206.3 million per month in the six months to April 2018, up from an average of USD166.0 million per month during the six months to October 2017 (Chart 1a). Activity at the Nairobi Securities Exchange (NSE) remained high in the period. The NSE-20 share index stood at 3,705.4 in April 2018 compared to 3,729.6 in October 2017.

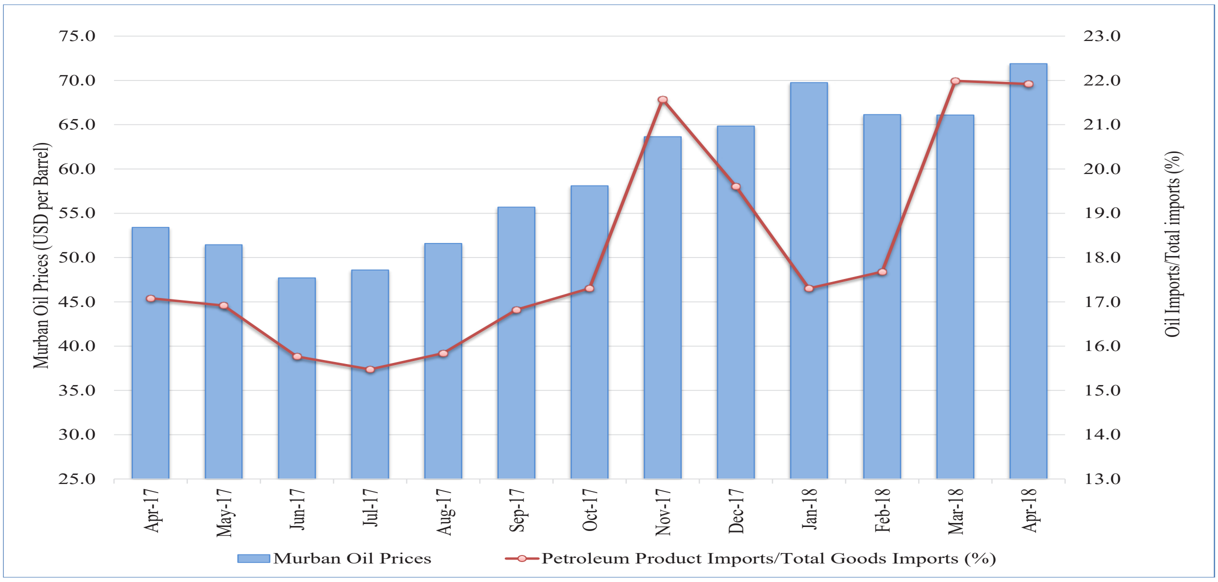
Changes in international oil prices particularly when the proportion of petroleum products imports in total imports is high has implications on the balance of payments position and the stability of the exchange rate. Murban crude oil prices rose to USD71.9 in April 2018 from USD58.1 per barrel in October 2017, and the proportion of imports of petroleum products in total imports of goods increased to 21.4 percent from 17.3 percent over the same period (Chart 1b). The rise in global oil prices was partly due to the decision by the major oil producing countries to reduce supply.

Chart 1a: Monthly Diaspora Remittances (USD Million) and NSE Index (Jan 1966=100)



Source: Central Bank of Kenya and Nairobi Securities Exchange

Chart 1b: Murban Oil Prices and the ratio of 12-Month Cumulative Petroleum Product Imports to Total Imports of Goods (%)



Source: Abu Dhabi National Oil Company and Kenya Revenue Authority

2.3 Monetary Policy Committee Meetings and Decisions

The MPC held its bi-monthly meetings on November 23, 2017, January 22, 2018 and March 19, 2018 to review market and economic developments as well as the outcome of its previous policy decisions. The November 2017 meeting was held against a backdrop of favourable weather conditions, sustained macroeconomic stability, the conclusion of a prolonged election period, and improved outlook for the global economy. Analysis of key indicators showed that inflationary pressures in the economy were muted, and that it was expected to continue to decline in the short term. The MPC, however, noted concerns of the possible perverse effects of the interest rate caps on the transmission of monetary policy. In this regard, the Committee decided to retain the Central Bank Rate (CBR) at 10.0 percent.

The January 2018 meeting was held at a time when there was sustained macroeconomic stability, increased optimism on the economic growth prospects, an improving business environment, and continued strengthening of the global economy. Inflation expectations were well-anchored within the Government target range. The Committee noted that while there existed some room for accommodative monetary policy in the near term, there was imminent risk of perverse outcomes due to the interest rate caps. In this regard, the Committee was of the view that there was need to further monitor and assess the impact of its policy actions, and therefore decided to retain the CBR at 10.0 percent.

The March 2018 meeting was held against the backdrop of a forward guidance provided in January 2018 on the stance of monetary policy in the near term. There was sustained macroeconomic stability, favorable weather conditions, increased optimism on the economic growth prospects, improvement in the business environment, and the continued strengthening of the global economy. While noting that inflation expectations and forecasts remained well anchored within the target range, and that there was increased optimism for growth prospects in the economy, the committee observed that the output gap was below its potential level. In order to support economic activity, and while noting the risk of perverse outcomes, the Committee decided to reduce the CBR to 9.50 percent from 10.00 percent to enhance growth in credit to the private sector.

During the six months to April 2018, the MPC analyzed the impact of its previous policy changes, monitored the impact of the interest rate caps on the effectiveness of monetary policy as well as other developments in the domestic and global economy, and stood ready to take additional measures as necessary. The CBK continued to work closely with the National Treasury to ensure effective coordination of monetary and fiscal policies for overall macroeconomic stability. The implementation of the Government domestic borrowing programme continued to support a stable yield curve and market stability.

The Bank also continued to closely monitor the foreign exchange market in view of the risks posed by increased uncertainties in the global financial markets. The CBK's foreign exchange reserves, together with the Precautionary Arrangements with the IMF, continued to provide adequate buffers against short term shocks.

3. IMPACT OF POLICY ON KEY ECONOMIC INDICATORS

3.1 Inflation

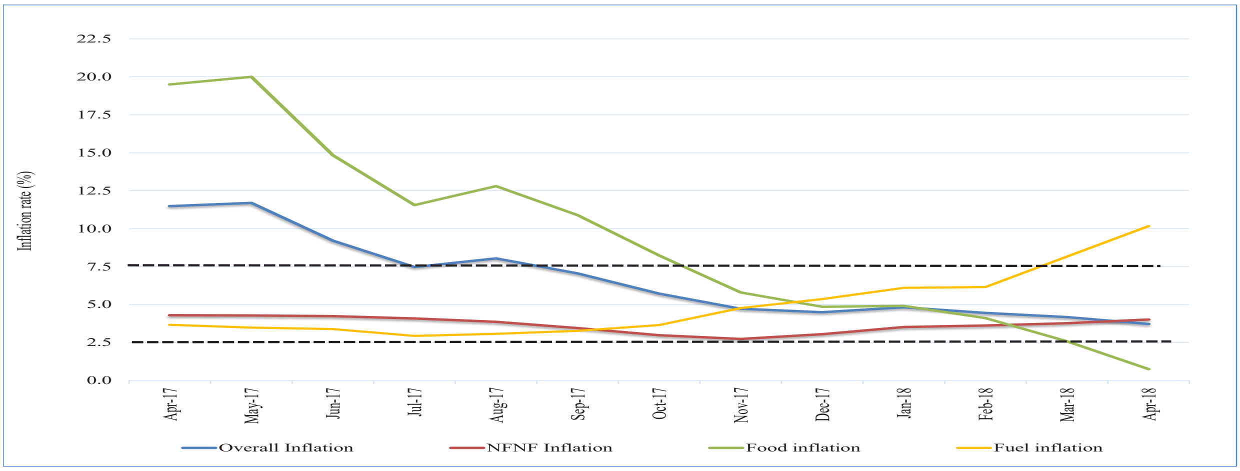
The 12-month overall inflation fell to 3.7 percent in April 2018 from 5.7 percent in October 2017 and 11.5 percent in April 2017 largely due to declines in food prices. In particular, overall inflation remained within the target range in the six months to April 2018 supported mainly by lower food prices (Charts 2a and 2b). The 12-month inflation for all the broad CPI categories, excluding the Housing, water, electricity, gas and other fuels category, also remained within the 2.5 to 7.5 percent target range during the period.

Food inflation declined to 0.3 percent in April 2018 from 21.0 percent in April 2017, largely reflecting increased supply of food crops attributed to favourable weather conditions in most parts of the country. Lower food prices were also supported by the Government's extension of the maize subsidy programme to December 2017, and increased supply of key food items particularly for cabbages and Irish potatoes due to improved weather conditions. Overall, the contribution of food and non-alcoholic beverages to overall inflation declined to 0.1 percentage points in April 2018 from 3.8 percentage points in October 2017.

Nevertheless, fuel inflation rose steadily to 10.2 percent in April 2018 from 3.7 percent in October 2017, reflecting the impact of the increase in international oil prices over the period. The increase in fuel inflation was offset by the decline in food prices during the period. Non-food-non-fuel (NFNF) inflation remained below 5 percent, suggesting that demand pressures in the economy were muted. The NFNF inflation rate stood at 4.0 percent in April 2018 from 3.0 percent in October 2017 (Chart 2a).

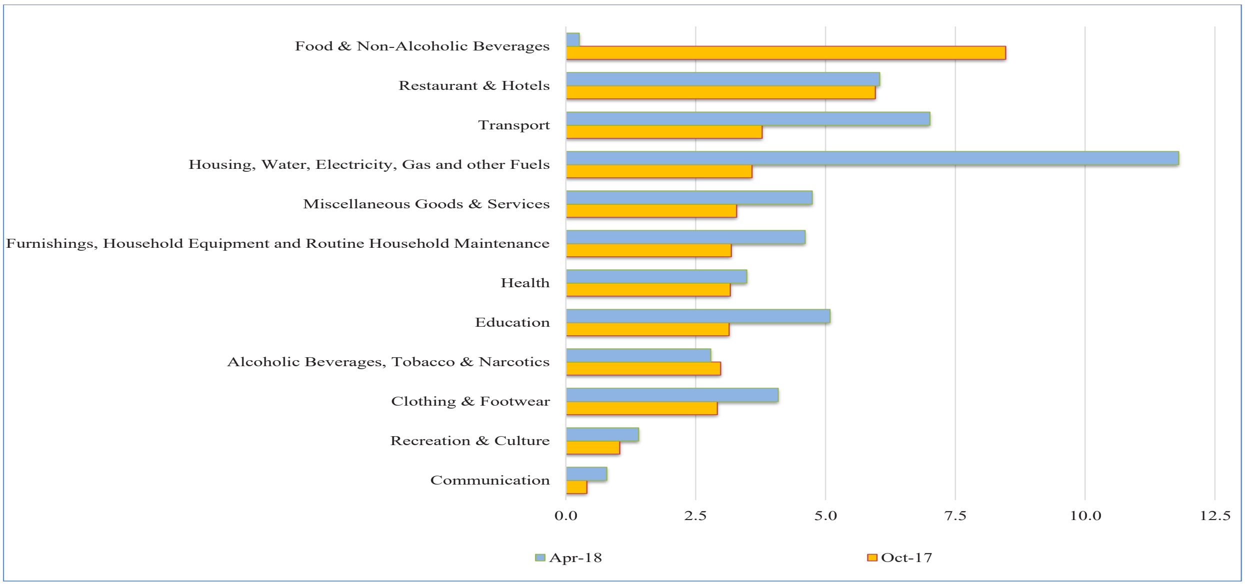
Overall inflation across East African Community (EAC) countries, with comparable composition of CPI baskets, displayed similar downward trends over the period (Chart 2c). The decline in inflation rates across the EAC countries mainly reflected lower food prices due to favorable weather conditions.

Chart 2a: Overall and Non-Food-Non-Fuel Inflation (%)



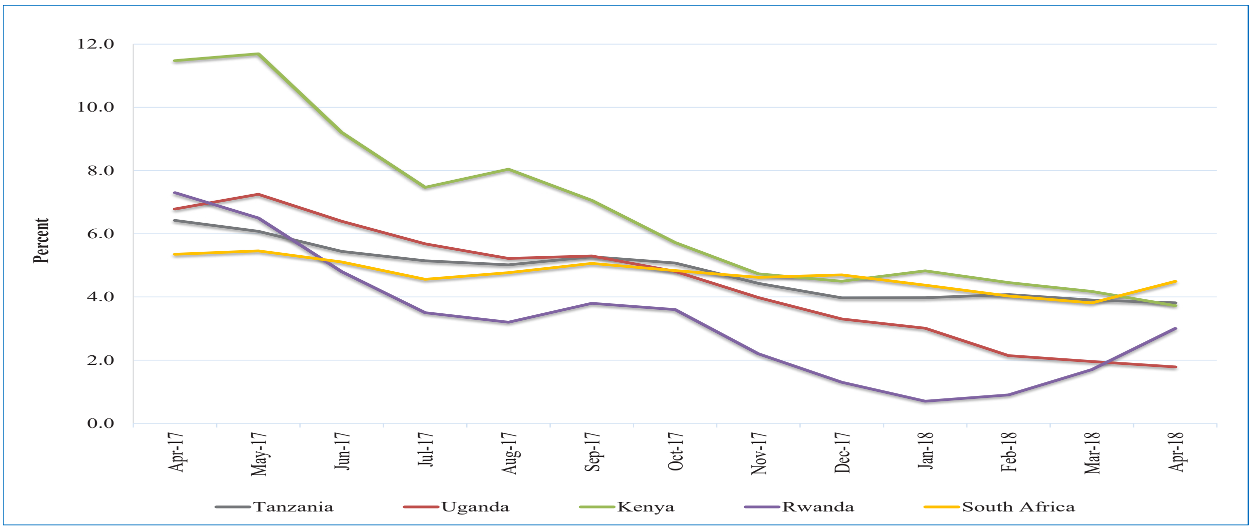
Source: Kenya National Bureau of Statistics and Central Bank of Kenya

Chart 2b: 12-Month Inflation by Broad CPI Category (%)



Source: Kenya National Bureau of Statistics

Chart 2c: 12-Month Inflation in the Region (%)



Source: Websites of respective Central Banks

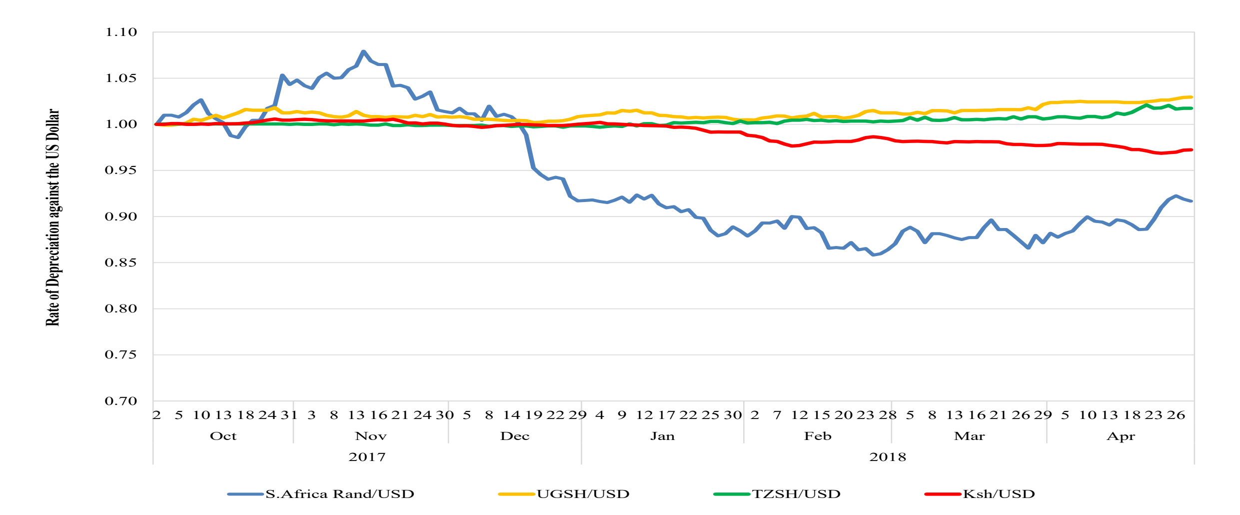
3.2 Foreign Exchange Market Developments

The foreign exchange market remained stable in the six months to April 2018, supported by strong foreign exchange inflows due to emigrant remittances, resilient tea and horticultural exports, and the continued recovery in tourism. The stability of the foreign exchange market also reflected Kenya's relatively more diversified exports and export destinations compared with those of its peers, which provide a cushion against adverse effects of external shocks. During the period, uncertainties in the global financial markets increased mainly due to developments in economic and trade policies of the U.S., the post-Brexit resolution, and the pace of normalisation of monetary policy in the advanced countries. The 12-month current account deficit narrowed to 6.2 percent of GDP in April 2018 from 6.9 percent in October 2017, largely due to slowdown in import of food following improved weather conditions, which offset the increase in the oil import bill attributed to the rise in international oil prices.

The CBK level of usable foreign exchange reserves stood at USD 9.1 billion (6.1 months of import cover) as at the end of April 2018, compared to USD 7.2 billion (4.8 months of import cover) at the end of October 2017. These reserves, together with the Precautionary Arrangements with the IMF, continued to provide an adequate buffer against short term shocks in the foreign exchange market.

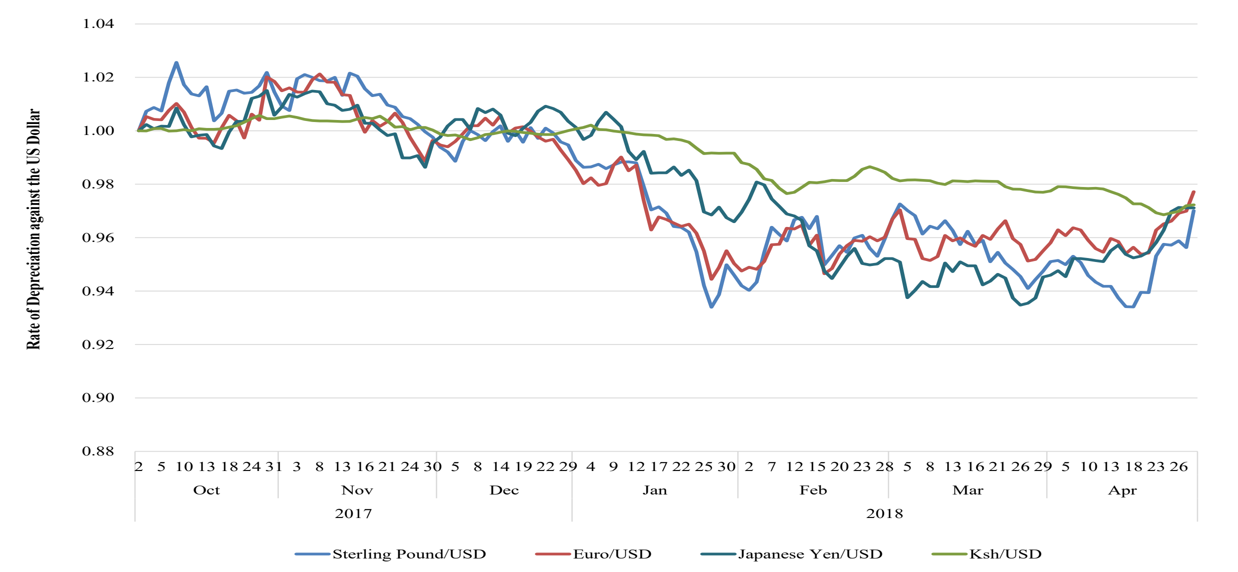
The major international and regional currencies' exchange rates against the US dollar in the six months to April 2018, were relatively volatile compared to the Kenya Shilling (Charts 3a and 3b). The stability of the Shilling reflected the narrowing in the current account deficit and balanced foreign exchange flows.

Chart 3a: Normalized Exchange Rates of the Kenya Shilling and Regional Currencies against the US Dollar (October 2, 2017=1)



Source: Central Bank of Kenya

Chart 3b: Rate of Depreciation of the Kenya Shilling and Major International Currencies against the US Dollar (October 2, 2017 = 1)



Source: Central Bank of Kenya

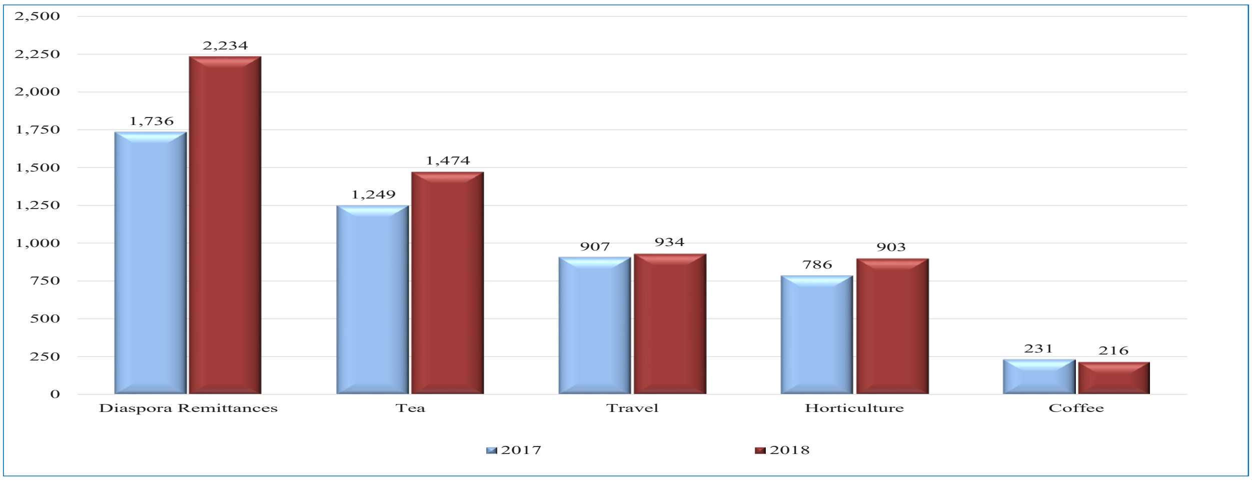
3.3 Balance of Payments Developments

The overall balance of payments position remained largely unchanged in the 12 months to April 2018 with a deficit of USD 837.2 million compared with a deficit of USD 838.7 million in the year to April 2017. The external current account deficit moderately widened to USD 4,730.8 million (6.2 of GDP) in the year to April 2018 from USD 4,619.1 million (6.3 percent of GDP) over a similar period in 2017, mainly due to the relatively higher international oil prices and increased imports of maize to mitigate the adverse effects of the drought during the period. Similarly, the financial account deficit widened to USD 6,015.3 million from USD 5,555.3 million over a similar period. This largely reflected a faster increase in foreign direct investment (FDI) liabilities than the increase in FDI assets, slowdown in other investment inflows and increase in government external borrowings. The capital account improved to USD 161.9 million in the 12 months to April 2018 from USD 158.8 million in the year to April 2017, primarily reflecting steady inflows of government grants.

The value of merchandise exports increased to USD 5,984.5 million in the year to April 2018 from USD 5,663.7 million in the year to April 2017, largely supported by tea and horticulture exports which grew by 18.0 percent and 14.9 percent over the same period, respectively. Earnings from tourism and coffee exports remained strong (Chart 4a). Merchandise imports however, grew faster than the exports to USD 16,438.5 million in the year to April 2018 from USD 14,370.6 million over a similar period to April 2017. Growth in imports was mainly driven by imports of petroleum products which increased to USD 2,965.6 million from USD 2,353.7 million (equivalent to a 26.0 percent growth). Imports of machinery and transport equipment decreased following the completion of phase 1 of the SGR project and comparably lower imports for phase 2 of the project (Chart 4b).

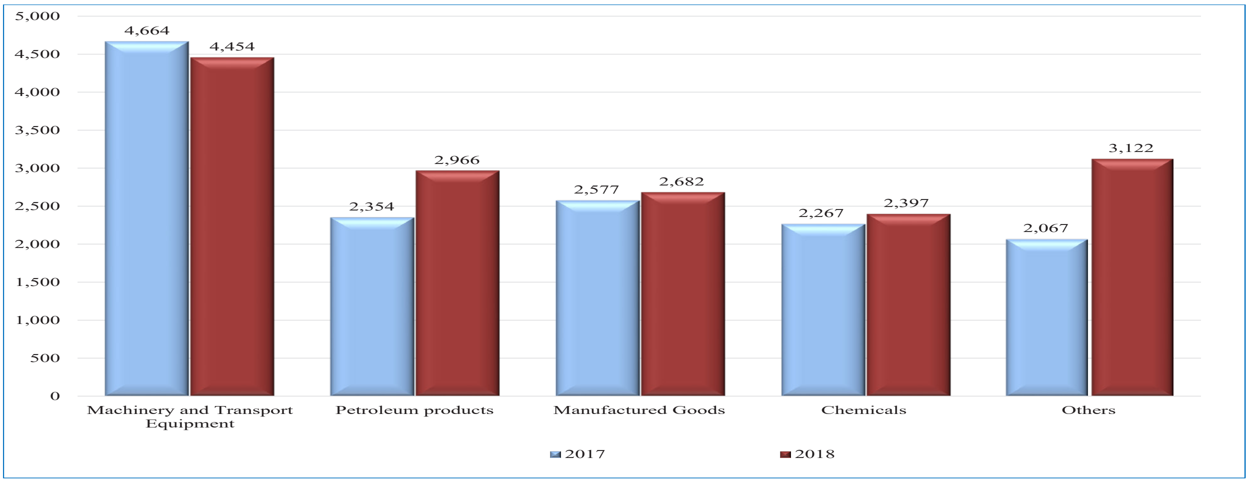
The CBK continued to monitor global developments, such as Brexit as well as the U.S. economic and trade policies, and their impact on trade and investment. The U.K. and U.S. accounted for an average of 6.4 percent and 8.0 percent, respectively, of Kenya's total exports over the six months to April 2018.

Chart 4a: Foreign Exchange Inflows from Major Export Categories in the Year to April (USD Million)



Source: Kenya National Bureau of Statistics, Kenya Revenue Authority and Central Bank of Kenya

Chart 4b: Imports by Major Categories in the Year to April (USD Million)



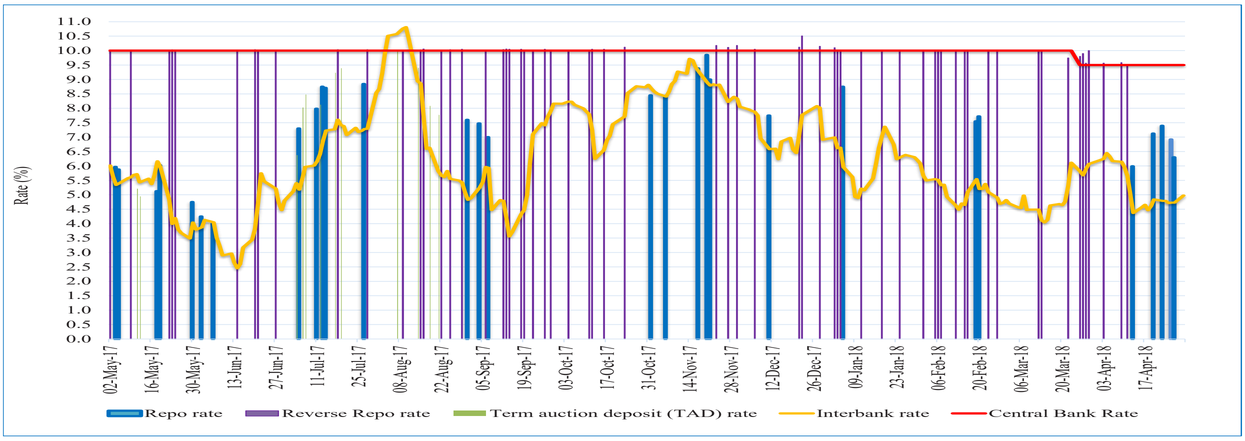
Source: *Kenya National Bureau of Statistics and Kenya Revenue Authority*

3.4 Interest Rates Developments

The short term interest rates remained below the CBR during the six months to April 2018, reflecting improved liquidity conditions in the market. In particular, the average interbank rate remained relatively stable at 6.3 percent in the six months to April 2018 compared to an average of 6.2 percent in a similar period to October 2017. Liquidity management operations by the CBK continued to ensure stability in the market. Open market operations remained active in the period. Reverse Repos were used to supply liquidity to segments of the market facing shortages, while Repos and Term Auction Deposits were used to withdraw liquidity from segments of the market with surpluses (Chart 5a).

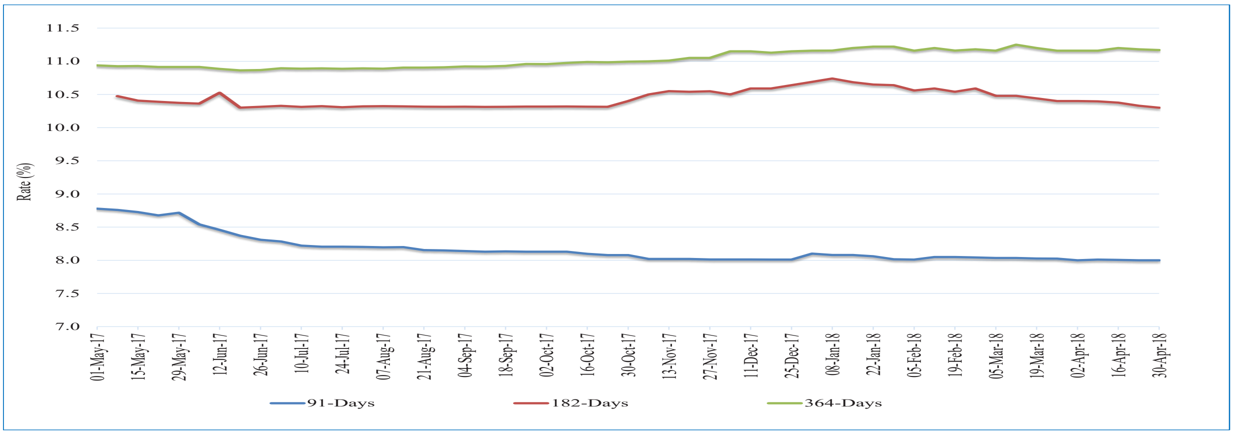
The interest rates on Government securities were largely stable during the six months to April 2018, which is an indication of effective coordination of monetary and fiscal policies. This was reflected in the stable yield curve of Government securities (Chart 5b and 5c). The stability in interest rates was largely achieved following the implementation by the Government domestic borrowing programme.

Chart 5a: Trends in Short Term Interest Rates (%)



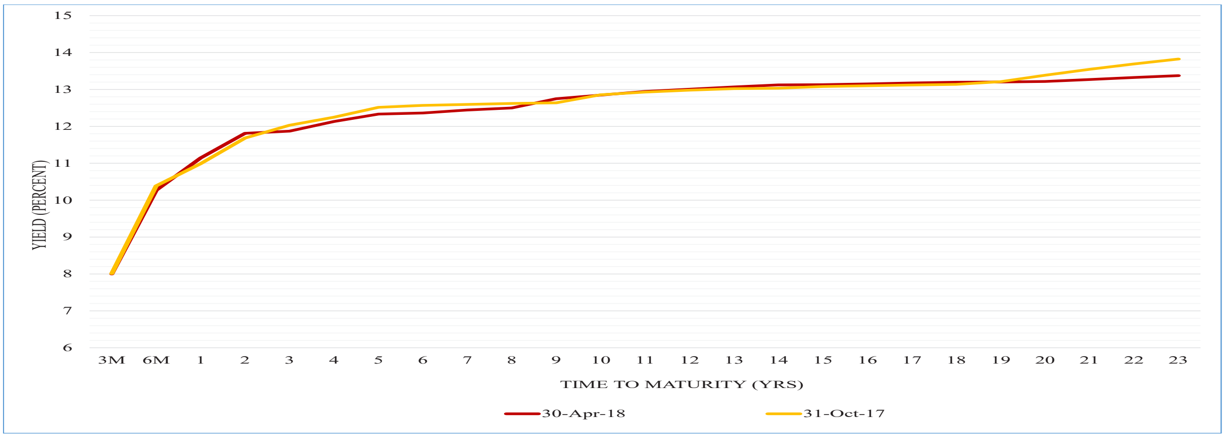
Source: Central Bank of Kenya

Chart 5b: Interest rates on Treasury Bills (%)



Source: Central Bank of Kenya

Chart 5c: Government Securities Yield Curve (%)



Source: Central Bank of Kenya

3.5 Banking Sector Developments

The banking sector remained stable and sound in the six months to April 2018. The average commercial banks liquidity ratio rose to 47.2 percent in April 2018 from 44.7 percent in October 2017. The capital adequacy ratio stood at 17.9 percent in April 2018 compared to 18.8 percent in October 2017. The ratio of gross non-performing loans (NPLs) to gross loans increased to 12.4 percent in April 2018 from 10.6 percent in October 2017, due in part to slower growth of credit ot the private sector. The average commercial banks' lending and deposit rates remained stable within the interest rate caps and floor, respectively, during the period (Chart 6). The CBK continued to monitor and analyze the impact of interest rate caps on the economy, as well as on the effectiveness of monetary policy.

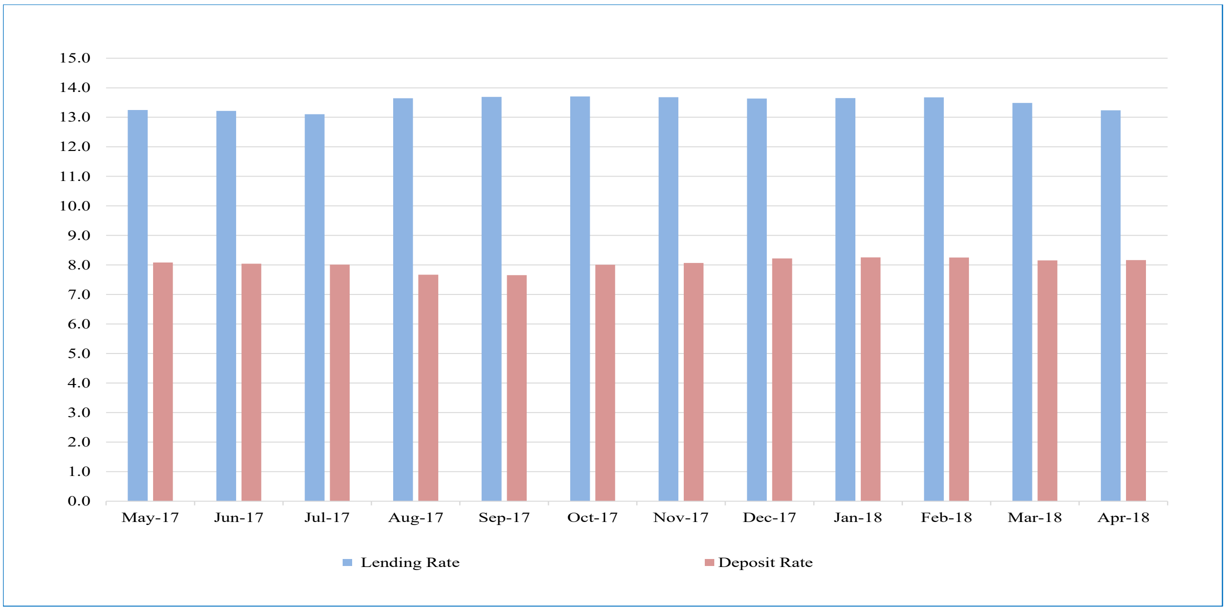
Preliminary analyses of a CBK study conducted in early 2018 to establish the impact of the interest rate capping law, established a number of findings. The effectiveness of monetary policy in influencing economic activity has been weakened through distortion of the transmission of monetary policy signals to credit expansion in the economy. A number of banks had withdrawn from specific segments of the market perceived as highly costly and risky, such as the small borrowers and MSMEs. The average loan size had increased pointing to reduced access to credit by small borrowers. There had been reduced competition in the banking sector and increased total cost of procuring a loan through additional non-interest charges charged by banks. There were indications that some borrowers had migrated to otherwise expensive alternatives.

The CBK continued to implement measures aimed at strengthening the sector to ensure greater transparency and stronger governance, and to promote effective business models and innovation. Pursuant to Section 33(4) of the Banking Act. The CBK issued guidance note in March 2018 to assist banks in Conducting Money Laundering/ Terrorism Financing (ML/TF) Risk Assessment by banks. The guidance note set the minimum standards that institutions should adopt to develop an effective ML/TF risk assessment framework. Additionally, the CBK in April 2018 issued a guidance note on implementation of International Financial Reporting Standard (IFRS) 9 on financial instruments, which came into effect from January 2018. The new standard replaced the International Accounting Standard (IAS) 39 with regard to making provisions for losses relating to financial instruments and assets.

The CBK continued to monitor the credibility of information provided through the cost of credit website, which was launched in June 2017. The website provided information on fees and charges relating to loan products offered by commercial banks and microfinance banks. While full disclosure of credit information by banks was expected to facilitate customers to make informed credit decisions, it was also envisaged to promote greater transparency in pricing loan products and enhance competition in the banking sector, ultimately further reducing the cost of credit.

The MPC continued to hold meetings with stakeholders in the banking sector during the six months to April 2018. Bi-monthly meetings were held with Chief Executive Officers of commercial banks and microfinance banks to discuss the basis for previous MPC decisions, and to provide a platform for the MPC to obtain feedback.

Chart 6: Commercial Banks' Average Interest rates and Spreads (%)



Source: Central Bank of Kenya

3.6 Developments in Private Sector Credit

The 12-month growth in credit to the private sector slowed down from 3.2 percent in November 2017 to 1.9 percent in January 2018 before picking up modestly to 2.9 percent in April 2018. The growth in credit to the private sector was mainly driven by building and construction, manufacturing, finance and insurance, and trade sectors, which grew by 14.3 percent, 10.1 percent, 10.1 percent and 5.0 percent, respectively in April 2018. These sectors jointly account for about 39.4 percent of total credit to the private sector. Trade credit growth was mainly dominated by export trade credit which grew by 26.9 percent in April 2018 compared to 1.9 percent in October 2017. Domestic trade credit growth decelerated to 3.9 percent from 12.6 percent over the same period (Table 1).

The slow growth in overall credit was attributed to a number of factors. These include reduced lending to segments perceived as risky particularly MSMEs due to the interest rate caps, slow growth in credit demand due to weak performance of some sectors of the economy, and increased use of alternative funding sources such as joint ventures in real estate development. Banking data showed that the value of loan applications and approvals declined to Ksh 114.3 billion and Ksh 94.0 billion, respectively, in April 2018 from Ksh 116.2 billion and Ksh 101.1 billion in October 2017. The decline, both in the value of loan applications and approvals, was mainly in the trade, agriculture, electricity and water, and transport and communication sectors. The larger decline in approved value of loans than the applications reflected a reduction in the average loan sizes over the six months to April 2018.

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

	Oct-17	Nov-17	Dec-17	Jan-18	Feb-18	Mar-18	Apr-18
Total Credit to Private Sector	**2.4**	**3.2**	**2.5**	**1.9**	**2.2**	**2.1**	**2.9**
Agriculture	-0.5	-7.0	-7.5	-7.6	-12.9	-6.2	-4.4
Manufacturing	10.5	10.9	12.9	12.0	13.1	11.2	10.1
Trade	11.6	10.2	9.0	5.1	6.8	5.4	5.0
Building and construction	4.6	3.6	5.0	5.4	4.8	12.6	14.3
Transport and communication	-7.5	-7.3	-6.9	-10.9	-13.9	-18.4	-17.8
Finance and insurance	-1.1	1.7	-4.2	-1.3	4.9	11.6	10.1
Real estate	10.3	9.7	8.7	8.2	8.4	4.5	3.6
Mining and quarrying	10.2	-2.1	-5.0	-6.7	-6.7	-2.7	-4.4
Private households	3.0	2.8	-1.5	-1.4	-2.7	-0.7	2.6
Consumer durables	0.1	-0.4	0.6	1.4	2.3	4.7	5.0
Business services	-17.7	-6.3	-8.4	0.0	-0.3	-0.5	2.8
Other activities	-29.9	-18.0	-5.6	-10.6	-2.2	-6.3	-2.2

Source: Central Bank of Kenya

4. OTHER ACTIVITIES OF THE MONETARY POLICY COMMITTEE

The MPC held regular stakeholder forums with Chief Executive Officers of banks in the six months to April 2018 aimed at enhancing understanding of the background and impact of the committee's previous policy decisions. The bi-monthly MPC Market Perceptions Surveys as well as regular communication with the key stakeholders facilitated the MPC in its market information gathering process for effective conduct of forward-looking monetary policy. The MPC also continued to simplify its Press Releases to enhance the clarity of information communicated to the public, media, financial sector and other stakeholders.

The MPC Chairman held press conferences after MPC Meetings to brief the media on the background information considered before each policy decision was reached, and the measures undertaken by the CBK to ensure macroeconomic and financial sector stability. The media and public understanding of monetary policy decisions and their expected impact on the economy continued to improve as was noted by increased coverage, commentaries and analyses by the press. The Chairman and MPC Members also held meetings with potential investors to discuss recent economic developments and the outlook for the economy.

5. WAY FORWARD

The monetary policy measures adopted by the MPC in the six months to April 2018 ensured that inflation was maintained within the target range. The stability of the exchange rate moderated the risks of imported inflation on the stability of domestic prices. Effective coordination of fiscal and monetary policies continued to support the achievement of price and market stability. Going forward, the MPC will continue to monitor the impact of interest rate caps on lending and the overall economy, as well as the implications of other developments in the domestic and global economy on price stability.

APPENDIX: CHRONOLOGY OF EVENTS OF PARTICULAR RELEVANCE TO MONETARY POLICY

Date	Events of Relevance to Monetary Policy
November 2017	The Central Bank Rate (CBR) was retained at 10.0 percent to anchor inflation expectations
January 2018	The CBR was retained at 10.0 percent to anchor inflation expectations
March 2018	The CBR was reduced to 9.50 percent from 10.0 percent in order to support economic activity

GLOSSARY OF KEY TERMS

Overall Inflation: This is a measure of inflation in the economy measured by the month-on-month movement of indices of all consumer price items of goods and services sampled by the KNBS. It is affected by commodity components in the market that may experience sudden inflationary spikes such as food or energy.

Reserve Money: These are CBK's monetary liabilities comprising currency in circulation (currency outside banks and cash held by commercial banks in their tills) and deposits of both commercial banks and non-bank financial institutions held with the CBK. 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 terms as follows: narrow money (M1); broad money (M2); and extended broad money (M3). These aggregates are defined as follows:

M1 Currency outside banking system + demand deposits
M2 M1 + time and savings deposits + certificates of deposits + deposit Liabilities of Non-Bank Financial Institutions (NBFIs)
M3 M2 + residents' foreign currency deposits

Central Bank Rate (CBR): This is the lowest rate of interest that the CBK charges on overnight loans to commercial banks. It is reviewed and announced by the Monetary Policy Committee at least every two months as part of its decisions. It is used by the commercial banks as a reference interest rate hence transmits to the financial sector and signals the CBK's monetary policy stance.

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

CBK Discount Window: The CBK Discount Window is a collateralized facility of last resort for banks. It has restrictive guidelines controlling access. The Discount Window plays a significant role in ensuring banking sector stability by offering overnight liquidity as a last resort. It is anchored on the CBR with a prescribed penalty.

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

Repurchase Agreement (Repo): Repos/reverse repos are agreements between the CBK and commercial banks to purchase/sell Government securities from/to commercial banks at agreed interest rates (REPO rate) for a specified period with an understanding that the commercial bank will repurchase/resell the security from/to the CBK at the end of the period. The period can be varied by the CBK.

Term Auction Deposits (TAD): The TAD is used in exceptional market conditions 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.

Horizontal Repo: This is an interbank Repo instrument which recognises Government securities as collateral for borrowing. The instrument has a variable tenor and allows commercial banks without credit lines with other banks to access credit from the interbank market.

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