THIRTEENTH BI-ANNUAL REPORT OF THE MONETARY POLICY COMMITTEE

Central Bank of Kenya

Issued under the Central Bank of Kenya Act, Cap 491

OCTOBER 2014

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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 thirteenth 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, exchange rates and inflation and other activities of the Committee in the six months to October 2014. Copies of MPC Press Statements and the Minutes of all the Meetings of the MPC between May and October 2014 are attached to the Report for your information.

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

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MEMBERS OF THE MONETARY POLICY COMMITTEE

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

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

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

Mr. Charles G. Koori
Member

Mrs. Farida Abdul
Member

Prof. Francis Mwega
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) the 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. Gazette Notice No. 6309 re-appointed the two eligible external members effective 1st May 2014; and,
(e) the Principal Secretary to the National Treasury, or his representative, who shall be 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 analyses; 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 an additional meeting 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 thirteenth bi-annual Report of the Monetary Policy Committee (MPC) reviews Kenya's monetary policy formulation and economic developments during the six months to October 2014. The monetary policy stance during the period was aimed at maintaining inflation within the allowable margin of 2.5 percent on either side of the Government's medium-term target of 5 percent. This is consistent with the price stability objective of the Central Bank of Kenya (CBK).

The monetary policy measures adopted by the MPC during the period contributed to the easing of inflationary pressure. The month-on-month overall inflation had increased from 6.41 percent in April 2014 to 8.36 percent in August 2014 mainly reflecting the base effect attributed to the implementation of the VAT Act in September 2013. However, it declined to 6.60 percent in September and further to 6.43 percent in October 2014 mainly reflecting significant declines in the prices of some foodstuffs and energy items as well as dissipation of the base effect carried from September 2013. The 12-month non-food-non-fuel (NFNF) inflation, which measures the impact of the monetary policy stance, remained below the 5 percent target during the period indicating that there were no adverse demand pressures in the economy. As a result, the MPC retained the Central Bank Rate (CBR) at 8.50 percent throughout the period in order to continue anchoring inflationary expectations and maintain price stability in the economy.

The exchange rate of the Kenya Shilling remained on a stable trend during the period despite short-term pressures arising from the global strengthening of the US Dollar. The exchange rate was supported by the resilient foreign exchange inflows through diaspora remittance, direct intervention through sale of foreign exchange by the CBK to commercial banks, and sustained foreign investor participation in the Nairobi Securities Exchange. In addition, the CBK usable foreign exchange reserves buffer increased from USD 6,339 million (equivalent to 4.37 months of import cover) at the end of April 2014 to USD 7,116.3 million (equivalent to 4.64 months of import cover) at the end of October 2014. The Government utilization of the Sovereign Bond proceeds contributed to this outcome. Confidence in the economy remained strong as corroborated by the latest Sovereign rating by Moody's conducted in May 2014 that placed Kenya at "B1 with stable outlook". In addition, the entry into the international capital markets through

issuance of a Sovereign Bond has boosted Kenya's rating. The Sovereign Bond was oversubscribed by 440 percent.

The effectiveness and transparency of monetary policy formulation and implementation by the CBK continued to be enhanced through its regular interaction with stakeholders in the financial and real sectors and timely release of relevant monetary and financial data. In addition, the introduction of the Kenya Banks' Reference Rate (KBRR) and Annual Percentage Rate (APR) frameworks in July 2014 should facilitate a transparent credit pricing framework and enhance the transmission of monetary policy signals through commercial banks' lending rates.

The CBK remains vigilant to risks posed by developments in the domestic and global economies to its overall price stability objective. The monetary policy measures in place, the declining international oil and food prices, reductions in domestic electricity tariffs due to the addition of a significant amount of geothermal power to the national grid, and the predicted favorable weather conditions support a stable outlook for inflation. However, the geo-political situation in the Middle East and North African region as well as in Ukraine remains a risk to the stability of international oil prices and the overall price stability objective that could come under pressure through the exchange rate.

1. INTRODUCTION

The thirteenth bi-annual Report of the MPC covers the period May to October 2014. The Report provides an update on the macroeconomic developments in response to the monetary policy stance adopted by the CBK in pursuit of its price stability objective during the period.

The monetary policy measures adopted coupled with a general decline in energy prices supported general stability in both inflation and exchange rate during the six months to October 2014. Following the dissipation of the base effect that can be attributed to the implementation of the VAT Act in September 2013, overall month-on-month inflation declined in September and October 2014 to within the target band. A number of goods previously VAT exempt became vatable in September 2013 resulting in an increase in the prices of some food and energy items. The threat of imported inflation was dampened by the signficant decline in international oil prices during the period. Despite short-term pressures on the exchange rate attributed to the global strengthening of the US Dollar, the resilient foreign exchange inflows through diaspora remittance, sustained foreign investor participation in the Nairobi Securities Exchange, direct interventions by the CBK through sale of foreign exchange to commercial banks, as well as enhanced confidence following successful issuance of a Sovereign Bond in June 2014 supported the exchange rate. However, the proportion of imports of goods and services financed by exports of goods and services decreased from 60.8 percent in April 2014 to 58.9 percent in October 2014. Despite the faster rise in imports relative to exports earnings, the fact that the composition of imports continued to be dominated by capital goods such as machinery and transport equipment and goods, and hence enhance the future productive capacity of the economy.

On the international scene, the geo-political uncertainties and a decline in energy prices contributed to a downward revision of the expected global growth in 2014. However, despite the weaknesses in the Eurozone and some emerging market economies, the US economy has been gaining momemtum and has partly contributed to global strengthening of the US Dollar. These developments, coupled with the monetary policy stance adopted by the CBK, the declining international oil and food prices, and falling domestic electricity prices indicate a stable outlook for inflation.

The remainder of this Report is structured as follows. Section 2 provides highlights of the monetary policy formulation in response to threats to price stability during the period while Section 3 provides a discussion of outcomes with respect to 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 the Report.

2. MONETARY POLICY FORMULATION

2.1 Attainment of Monetary Policy Objectives and Targets

During the six months to October 2014, the MPC formulated monetary policy to achieve and maintain overall inflation within the target bounds set by the Cabinet Secretary for the National Treasury. The Government medium-term overall inflation target is 5 percent for the Fiscal Year 2014/15 with an allowable margin of 2.5 percent on either side.

The CBR is the base for monetary policy operations and continued to coordinate movements in short-term interest rates in the period. The movement in the CBR, both in direction and magnitude, signals any change in the monetary policy stance. The monetary policy stance, as signalled by the movements in the CBR, is operationalised through various instruments. These include Open Market Operations (OMO), changes in cash reserve requirements at CBK, foreign exchange market transactions, and the CBK Standing Facility – the CBK Overnight Discount Window when it acts as lender of last resort.

Monetary policy implementation was guided by CBK targets on the Net International Reserves (NIR) and Net Domestic Assets (NDA) as the operational parameters. The CBK met its NDA and NIR targets for June and September 2014 and remained on course with respect to the December 2014 targets. The NDA averaged Ksh -195.1 billion by end October, 2014 compared to the target ceiling of Ksh -197.9 billion while the NIR averaged USD 6,202.9 million against a target floor of USD 6,252.3 million. The annual growth rates of broad money supply (M3) and private sector credit were largely consistent with the respective projected growth paths in the period. The 12-month growth in M3 increased from 16.5 percent in April 2014 to 19.4 percent in October 2014 – this was against a target of 17.8 percent for October 2014. The 12-month private sector credit growth decelerated slightly from 23.9 percent to 23.6 percent in the period – this was against a target of 25.3 percent for October 2014.

The Kenya National Bureau of Statistics released new National Accounts Statistics in September 2014 which reflect revisions in sector classifications and the base year. The base year for the revised GDP is 2009 while the gap between the revised and previous GDP stood at 25 percent in 2013. The upward revision of the GDP was informed by use of better data, improved coverage and revised input-output production structures which were lower in a number of sectors compared to the revised estimates. Following this development, real GDP growth stood at 5.7 percent in 2013 and 5.8 percent during the second quarter of 2014 while indicators such as the Debt/GDP, current account balance/GDP and fiscal deficit/GDP improved. The growth was supported by macroeconomic stability as well as strong performances of the construction, manufacturing, financial and insurance, information and communication, and trade sectors.

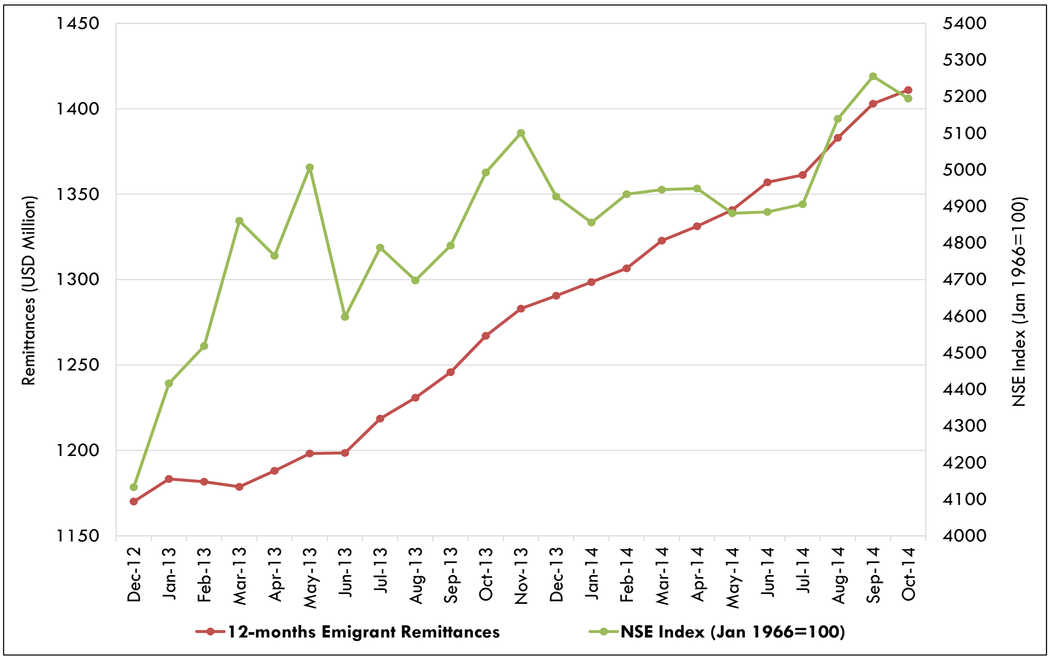
2.2 Economic Environment

The economic environment during the six months to October 2014 was characterised by stability of key macroeconomic indicators. This was supported by the prudent monetary policy stance reflected in a generally stable exchange rate and non-inflationary growth in private sector credit. The non-food-non-fuel (NFNF) inflation, which measures the impact of monetary policy stance, remained stable within the 5 percent target. Despite short-term inflationary pressure in July and August 2014, inflation declined to the prescribed target range in September and October 2014.

During the period, the exchange rate was supported by resilient foreign exchange inflows through diaspora remittance and sustained foreign investor participation in the Nairobi Securities Exchange (NSE) as well as enhanced confidence following successful issuance of a Sovereign Bond in June 2014. The NSE-20 index remained buoyant partly supported by foreign investor participation while the diaspora remittances increased significantly to an average of USD 121.66 million in the six months to October 2014 compared with an average of USD 113.5 million in the six months to April 2014 (Chart 1a). Cumulative net purchases of equity at the NSE by foreign investors rose to a net inflow of Ksh 1,346 million in the six months to October 2014 compared with a net outflow of Ksh 1,177 million in the six months to April 2014.

Market confidence in the economy was also boosted by the sovereign rating by Moody's conducted in May 2014 that placed Kenya at "B1 with stable outlook". The entry into the international capital markets through the issuance of a Sovereign Bond also boosted Kenya's rating. The Bond should help to benchmark the country's credit and facilitate access to international capital markets by corporate entities thereby enhancing investments. It was massively over-subscribed at 440 percent, while the realised yields were comparably lower relative to those on recent issues of similar bonds in the region.

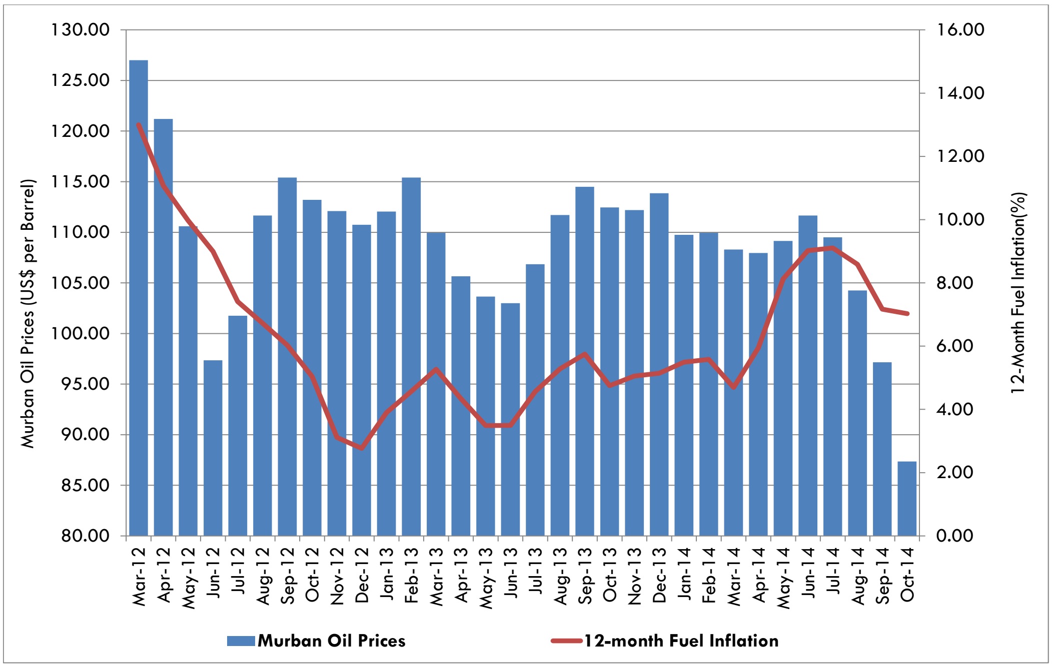
Chart 1a: 12-months Cumulative Diaspora Remittances (USD Million) and NSE Index (Jan 1966=100)



Source: *Central Bank of Kenya*

International crude oil prices declined during the period reflecting reduced demand attributed to the slowdown in the Chinese economy and some emerging market economies. In addition, the United States and Saudi Arabia increased their production of crude oil during the period. Consequently, Murban crude oil prices decreased from USD 109.2 per barrel in May 2014 to USD 87.4 per barrel in October 2014. This was largely mirrored in fuel inflation – where the index also includes electricity prices (Chart 1b).

Chart 1b: Murban Oil Prices and the 12-Month Fuel Inflation (%)



Source: *Central Bank of Kenya*

2.3 Monetary Policy Committee Decisions

The MPC continued to monitor developments in the domestic and international markets and took appropriate measures to maintain price stability. Liquidity management operations were sustained to ensure stability in the interbank market and that of short-term interest rates.

The monetary policy measures adopted during the six months to October 2014 supported a stable inflation and exchange rate. The MPC retained the CBR at 8.50 percent in its meetings held on 8th July and 3rd September, 2014 in order to continue anchoring inflationary expectations and maintain price stability. The last adjustment of the CBR was on 7th May 2013 when it was lowered by 100 basis points to the 8.50 percent. The monetary policy stance adopted by the MPC supported a non-inflationary growth in credit to the private sector. The growth in private sector credit is being monitored carefully by the CBK to ensure that it does not trigger any demand inflation pressure or adverse inflationary expectations.

The Government fiscal operations over the period covered by this Report span the transition to the fiscal year 2014/15 and were consistent with the monetary policy objectives. The close of the fiscal year 2013/14 was characterized by increased short-term domestic borrowing attributed to the delay in receipt of the proceeds of the Sovereign Bond in June 2014 which resulted in a temporary rise in Treasury bill rates. The Treasury bill rates returned to normal levels thereafter. In addition, the successful issuance of the Sovereign Bond is expected to dampen pressure on both Government domestic borrowing and interest rates. The borrowing plan was also consistent with the thresholds set in the Medium-Term Debt Management Strategy.

Interventions through net foreign exchange sales by CBK complemented other liquidity management measures in stabilising the exchange rate and managing expectations over the period covered by this Report. The official usable foreign exchange reserves build-up was sustained largely supported by the Government utilisation of proceeds of Sovereign Bond. This has boosted the Bank's capacity to respond to shocks in the market.

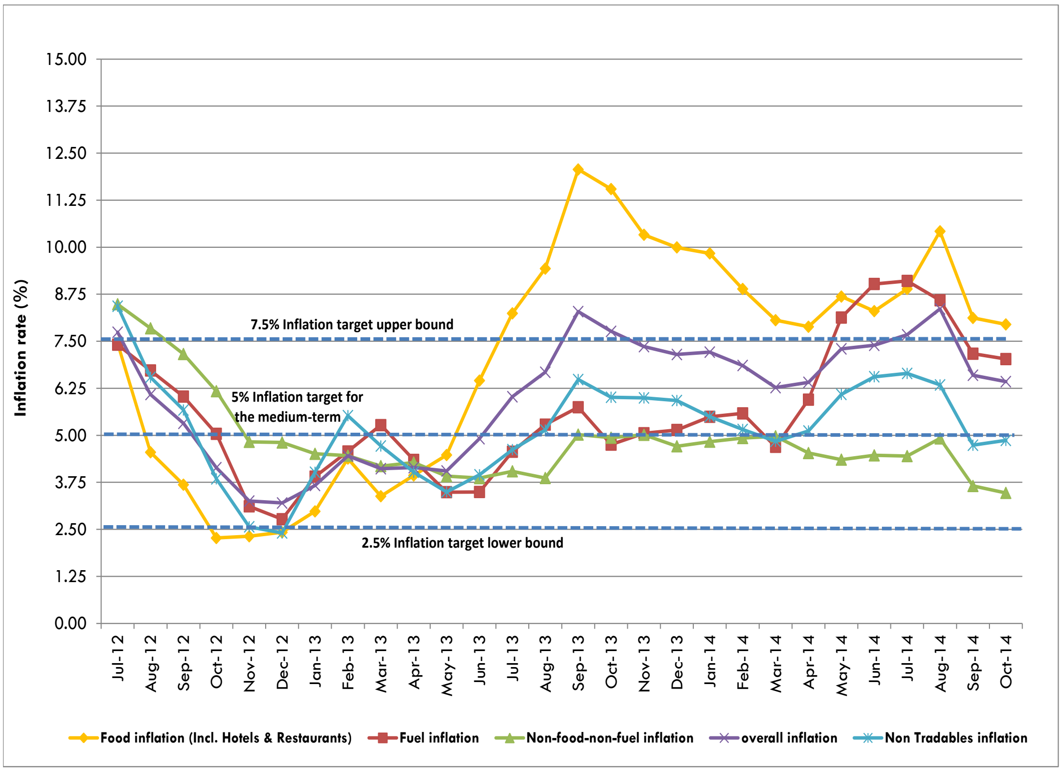
3. OUTCOMES WITH RESPECT TO KEY ECONOMIC INDICATORS

3.1 Inflation

The month-on-month overall inflation rate displayed mixed trends during the six months to October 2014. It had increased from 6.41 percent in April 2014 to 8.36 percent in August 2014 mainly reflecting the base effect attributed to the implementation of the VAT Act in September 2013 (Chart 2a). However, it declined to 6.60 percent in September and further to 6.43 percent in October 2014 mainly reflecting significant declines in the prices of some foodstuffs and energy items as well as dissipation of the base effect carried from September 2013. In addition, the 12-month non-food-non-fuel inflation, which measures the impact of monetary policy stance, remained below the 5 percent target during the period indicating that there were no adverse demand pressures in the economy in the period.

The monetary policy measures in place, the declining international oil and food prices, reductions in domestic electricity tariffs due to the addition of a significant amount of geothermal power to the national grid, and the predicted favorable weather conditions support a stable outlook for inflation. However, the geo-political situation in the Middle East and North African region as well as in Ukraine remains a risk to the stability of international oil prices and hence the overall domestic price stability objective.

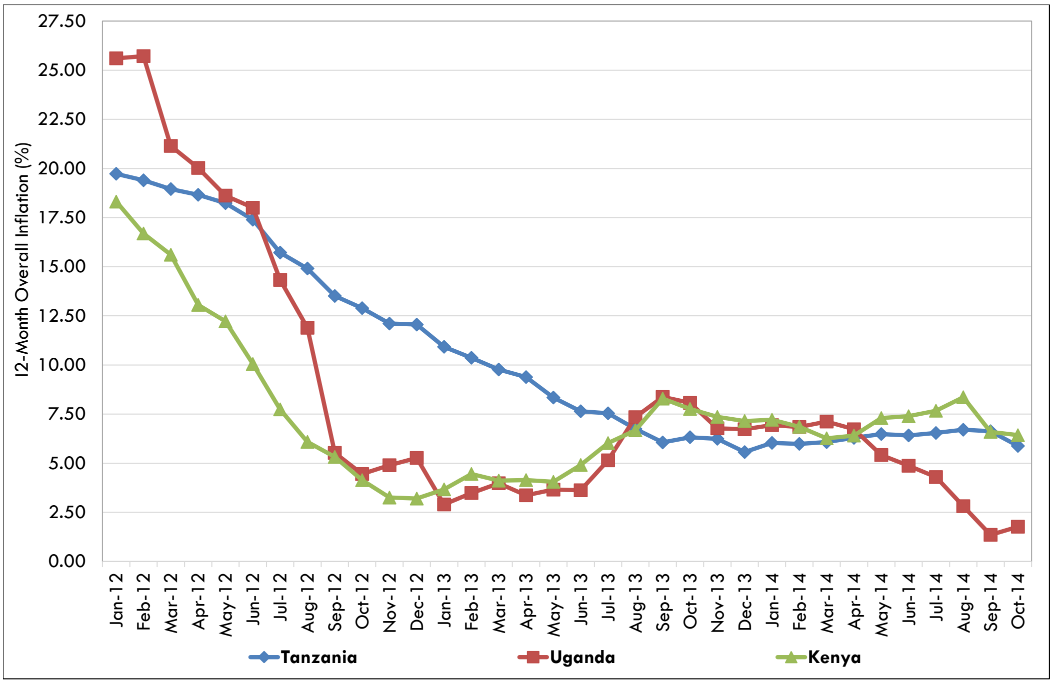
Chart 2a: 12-Month Inflation in Broad Categories (%)



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

The three large economies in the East African Community (EAC) region displayed similar trends in their inflation rates in the six months to October 2014 (Chart 2b). However, although the 12-month inflation rates in Kenya, Tanzania and Uganda declined between April and October 2014, it declined faster in Uganda mainly reflecting sensitivity to food prices. These trends largely reflect a common experience in the composition of the CPI basket in the region which is largely skewed towards food and energy items.

Chart 2b: 12-Month Inflation in the Selected EAC Countries (%)



***Source**: Websites of Respective Central Banks*

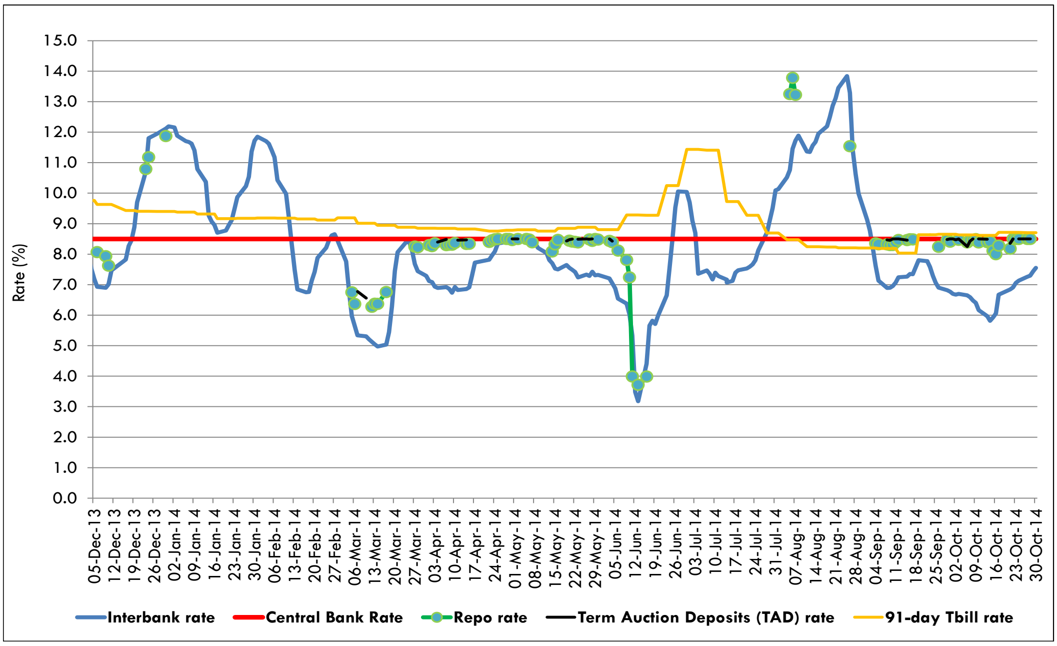
3.2 Interest Rates

3.2.1 Short-Term Interest Rates

The CBR continued to coordinate movements in short-term rates in the period between April and October 2014. However, interbank liquidity had tightened in June 2014 and exerted pressure on the interbank rate occasioned mainly by increased issuance of Government securities following a delay in receipt of proceeds of the Sovereign Bond (Chart 3a). The CBK intervened successfully through Open Market Operations (OMO) which stabilized the adverse trends in the interbank rate. The OMO withdrew excess liquidity arising mainly from large net redemptions of Government securities. Besides OMO, the temporary accumulation of Government deposits at the CBK at the beginning of the Fiscal Year 2014/15 as Government ministries and departments firmed up their spending plans also contributed to the tight liquidity conditions in July and August 2014. To ease the pressure on interbank rates, the CBK injected liquidity through the reverse repo. Liquidity conditions improved thereafter, supported by normalisation of Government payments and net redemptions of Government securities in September and October 2014.

The CBK has also continued to engage with stakeholders in the banking sector to explore strategies for enhancing the use of Horizontal Repos towards redistributing liquidity in the interbank market.

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



Source: *Central Bank of Kenya*

3.2.2 Commercial Banks' Interest Rates and Spreads

Commercial banks' average lending rate declined from 16.7 percent in April 2014 to 16.0 percent in October 2014. The decline in commercial banks average lending rate was consistent with the monetary policy stance adopted and reflected improved liquidity in the money market during the period (Chart 3b). The average deposit rate increased from 6.5 percent to 6.6 percent during the period reflecting increased banks' competition for deposits. As a result, the average commercial banks' interest rate spread declined from 10.2 percent to 9.4 percent in the period.

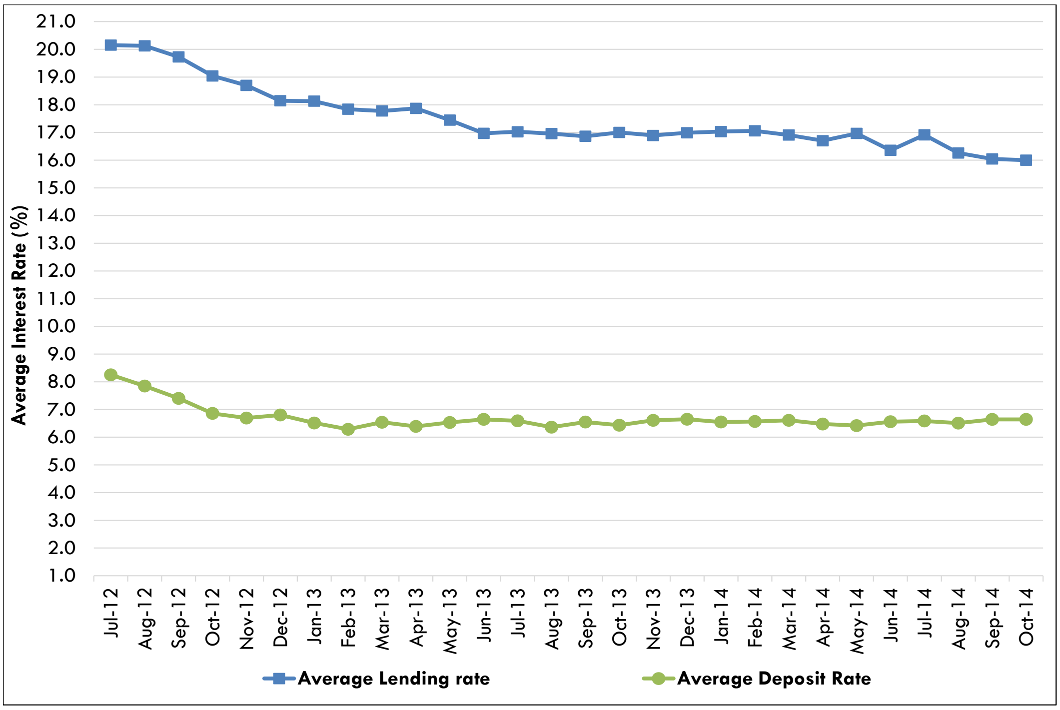
The CBK continues to work with stakeholders including the Kenya Bankers Association (KBA) to implement initiatives aimed at reducing the cost of doing business in the banking sector. It has undertaken reforms to promote consumer protection and enhance governance in the banking sector, and is currently working with various stakeholders to implement the recommendations aimed at increasing and enhancing private sector credit and mortgage finance supply in Kenya.

The introduction of the Kenya Banks' Reference Rate (KBRR) and Annual Percentage Rate (APR) frameworks in July 2014 will facilitate a transparent credit pricing framework and enhance the transmission of monetary policy signals through commercial banks' lending rates. The KBRR and APR frameworks were developed as an outcome of discussions between the stakeholders, CBK and the National Treasury as part of the recommendations to enhance the supply of private sector credit and mortgage finance in Kenya. The KBRR is the base rate for all commercial banks' lending. It will be computed as an average of the CBR and the weighted 2-month moving average of the 91-day Treasury bill rates. It is reviewed and announced by the CBK through MPC Press Releases after every six months (if conditions do not change drastically) from the effective date and operationalized through a Banking Circular. The KBRR was set at 9.13 percent on 8th July, 2014.

The cost of doing business in the banking sector has been addressed through various measures. Commercial banks have also been allowed to use mobile phone financial platforms that leverage on technology development to reduce transaction costs. The cheque truncation has reduced the clearing period to T+1 which has ensured that cheques are cleared within one day of delivery to the bank. The adoption of the Agency Banking framework has increased access to banking services while the operationalisation of Credit Reference Bureaus has reduced the costs of information search and risk profiling process. The commencement of full file credit information sharing in February 2014 and the inclusion of microfinance banks will increase demand for credit reports. Both commercial banks and microfinance banks are expected to offer their customers with good track record credit facilities on competitive terms.

The MPC has also continued to engage the Chief Executive Officers of commercial banks through the KBA on various issues through the bi-monthly forums. This has facilitated moral suasion and provided a regular feedback mechanism based on a dialogue initiated through the MPC's Market Perception Survey.

Chart 3b: Trends in Commercial Bank Interest Rates (%)



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

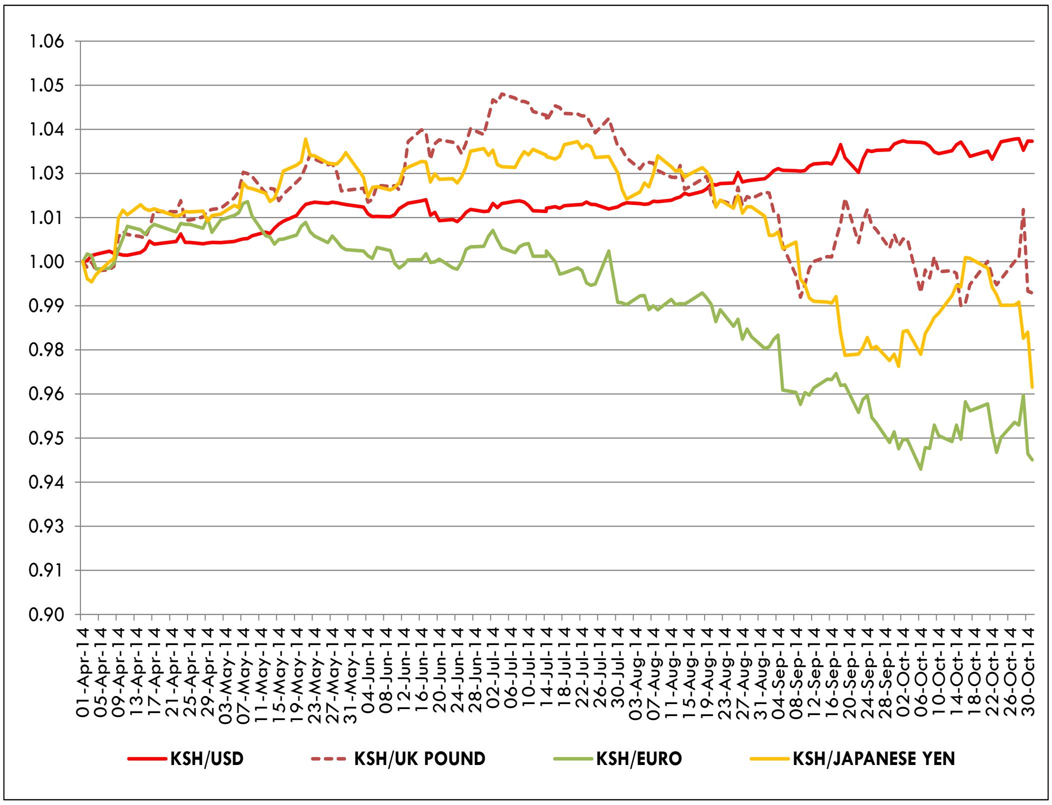
3.3 Exchange Rates

Despite short-term pressures arising from the global strengthening of the US Dollar, the exchange rate of the Kenya Shilling maintained a stable trend against the US Dollar but strengthened on average against the Euro, Sterling Pound and Japanese Yen in the six months to October 2014 (Chart 4a). The significant depreciation of the Euro and other major currencies largely reflects the recovery of the USA economy together with the stagnation of the Eurozone growth. The Kenya Shilling exchange rate was supported by the resilient foreign exchange inflows through diaspora remittance that averaged USD 121.66 million in the period, and the build-up of foreign exchange reserves which was boosted by utilisation of proceeds of the Sovereign Bond by the Government. The CBK usable foreign exchange reserves increased from USD 6,339 million (equivalent to 4.37 months of import cover) at the end of April 2014 to USD 7,116.3 million (equivalent to 4.64 months of import cover) at the end of October 2014. The exchange rate was also supported by the strong investor confidence in the economy as depicted by the massive oversubscription at 440 percent of the debut Sovereign Bond issued in June 2014. The realised yields on the Bond were comparably lower relative to those on recent issues of similar bonds in the region. Sustained foreign investor participation in equity at the NSE also reflected the confidence in the economy.

Following the global strengthening of the US Dollar, the regional currencies (South African Rand, Ugandan Shilling and Tanzanian Shilling) have depreciated faster and were more volatile compared with the Kenya Shilling (Chart 4b).

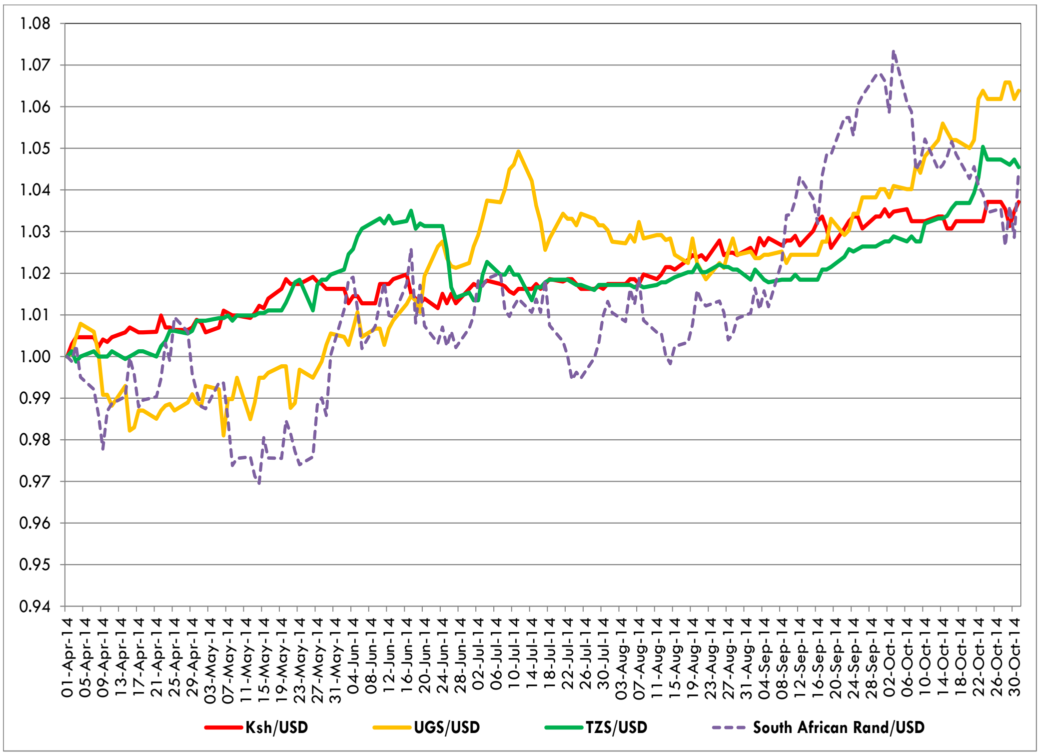
The exchange rate of the Kenya Shilling against major currencies was expected to remain stable reflecting resilient diaspora remittance inflows; expectations for increased foreign direct investment with sustained investor confidence in the economy; improved global economic recovery expected to increase demand for Kenya's exports, and the prudent monetary policy stance. However, the geopolitical risks associated with the tensions in Russia and Ukraine, the instability in the Middle East and North Africa (MENA), the slow recovery of the Eurozone economy, and the Ebola Outbreak in West Africa are the main risks to exchange rate stability through possible slowdown in tourism and exports as well as instability in international oil prices.

Chart 4a: Normalised Exchange Rates of the Kenya Shilling Against Major Currencies (1st April 2014 = 1)



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

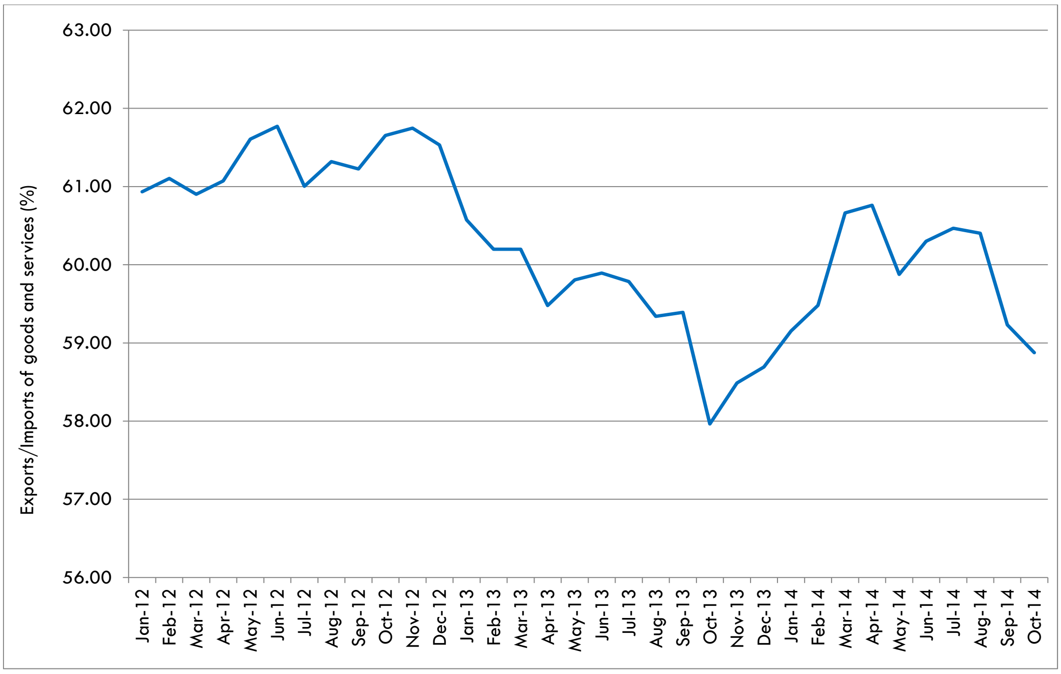
Chart 4b: Normalised Exchange Rates of Major Currencies in the Region against the US Dollar (1st April 2014 = 1)



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

The movements in the exchange rate of the Kenya Shilling against the US Dollar in the six months to October 2014 also reflected the higher demand for the US Dollar as a consequence of increased economic activity and imports, while there was a somewhat lower supply (Chart 5). The proportion of imports of goods and services financed by exports of goods and services decreased from 60.8 in April 2014 to 58.9 percent in October 2014. There has been a reduction in foreign exchange earnings from tea and tourism which constitute significant sectors of Kenya's foreign exchange earners. There has also been an increase in imports of machinery and equipment (which was mainly towards infrastructure) and petroleum products. Imports of machinery and other equipment accounted for about 34 percent of total imports during the review period and are essential for enhancing the future productive capacity of the economy. There is also the seasonal demand for the US dollar largely from importers from the energy and manufacturing sectors. However, the lower international oil prices provided some relief with respect to demand for foreign exchange.

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



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

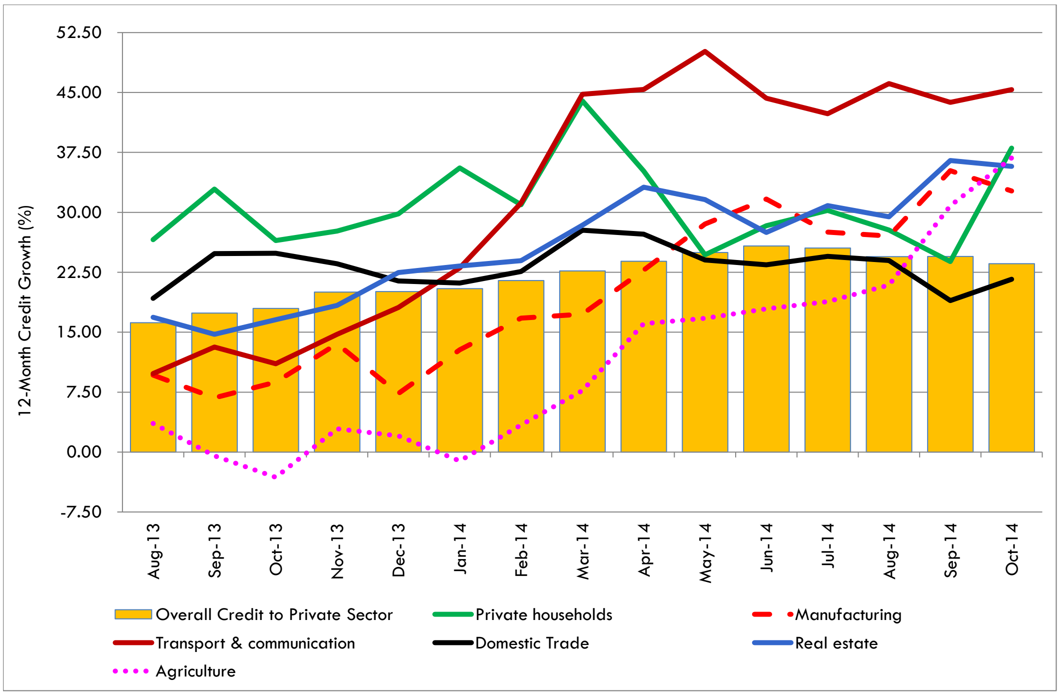
3.4 Credit to Private Sector

The overall private sector credit growth levelled out between April and October 2014 as demand was sustained with improved economic activity and continued investor confidence in the economy. As indicated, the 12-month annual growth in overall private sector credit rose marginally from 23.9 percent in April 2014 to peak at 25.8 percent in June 2014 before slowing down to 23.6 percent in October 2014

(Chart 6). The growth in credit during the period was consistent with the projected growth path. It was also distributed across the key sectors of the economy including financing demand from transport and communication, trade, finance and insurance, real estate, manufacturing and agriculture sectors. The ratio of gross non-performing loans to gross loans decreased from 5.7 percent in April to 5.4 percent in October 2014 indicating a lowering in credit risk.

The monetary policy stance adopted by the MPC during the period is expected to continue supporting a non-inflationary credit expansion to the key sectors of the economy in the remainder of financial year 2014/15.

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



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

4. OTHER ACTIVITIES OF THE MONETARY POLICY COMMITTEE

During the period May to October 2014, the MPC continued to hold bi-monthly stakeholder forums with Chief Executive Officers of commercial banks through the KBA Governing Council. The Committee continued to improve on the information gathering processes through the bi-monthly Market Perception Surveys and communication with key stakeholders on the MPC decisions to obtain feedback. The MPC also continued to improve on its Press Releases by simplifying them and making them better focused to the public, media, financial sector and other stakeholders. In particular, the MPC participated in the CBK Senior Business Editors sensitization workshop held in Naivasha on 2nd May, 2014 to sensitize senior business editors in the media on the functions of the CBK. The media was also sensitised on the CBK Monetary Policy Framework and the MPC Communications Strategy during the workshop. Consequently, the media and public understanding of monetary policy decisions and their expected impact on the economy has continued to be enhanced. The CBK also participated in the Agricultural Society of Kenya Shows in order to sensitise the public on its functions.

The MPC worked with CBK staff on various research activities during the period. Five technical papers commissioned by the MPC were completed and uploaded on the CBK website to solicit for comments from a wider readership. These papers are: Real Exchange Rate Misalignment and Implications for the Nominal Exchange Rate Level in Kenya in 2012; Monetary Policy Transmission Mechanism in Kenya; An Assessment of Kenya's Public Debt Dynamics and Sustainability; A Note on Term Structure and Inflation's Expectations in Kenya; and, Bank Rate and the Transmission Mechanism of Monetary Policy in Kenya.

As part of enhancing its capacity, MPC members participated in various conferences locally and internationally over the period covered by this Report. The conferences enable MPC members to share their experiences with other policy experts on critical challenges underlying monetary policy effectiveness in developing countries under different monetary policy frameworks and facing different macroeconomic shocks. 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.

5. CONCLUSION

The monetary policy measures adopted by the MPC in the six months to October 2014 contributed to the decline and stability in the inflation rate as well as general exchange rate stability. The MPC will continue to monitor developments in the domestic and global economy and take appropriate measures as and when required to sustain price stability.

APPENDIX: CHRONOLOGY OF EVENTS OF PARTICULAR RELEVANCE TO MONETARY POLICY (MAY - OCTOBER 2014)

Date	Events
May 2014	a) The CBK sold USD 165.5 million in line with the CBK's exchange rate policy.
	b) Introduction of a Kenya Banks' Reference Rate (KBRR) developed as an outcome of discussions between the stakeholders, CBK and lead by the National Treasury. This was part of recommendations to enhance the supply of private sector credit and mortgage finance in Kenya by facilitating a transparent credit pricing framework.
June 2014	a) The CBK sold USD 13.0 million in line with the CBK's exchange rate policy.
	b) Issue of the debut Sovereign Bond which was massively oversubscribed.
	c) Commencement of Over the Counter Trading in Treasury Bills using World Wide Interbank Financial Telecommunications.
July 2014	The CBK purchased USD 395 million as the Government utilised part of the Sovereign Bond proceeds.
August 2014	The CBK sold a net of USD 26.0 million in line with the CBK's exchange rate policy.
September 2014	a) The CBK sold a net of USD 14.0 million in line with the CBK's exchange rate policy.
	b) The CBK purchased USD 1.0 billion as the Government utilised the balance of the Sovereign Bond proceeds.

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.

Kenya Banks' Reference Rate (KBRR): This is the base rate for all commercial banks' lending. It is currently computed as an average of the CBR and the weighted 2-month moving average of the 91-day Treasury bill rates.

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

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

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

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

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