Central Bank of Kenya

Seventeenth Bi-Annual Report of the Monetary Policy Committee

Issued under the Central Bank of Kenya Act, Cap 491

October 2016

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

Enquiries concerning the Report should be addressed to:
Monetary Policy Committee Secretariat,
Central Bank of Kenya,
P.O. Box 60000-00200 Nairobi, KENYA

also available on http://www.centralbank.go.ke

LETTER OF TRANSMITTAL TO THE CABINET SECRETARY FOR THE NATIONAL TREASURY

Honourable Cabinet Secretary,

I have the pleasure of forwarding to you the seventeenth 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 October 2016. Copies of MPC Press Statements and the Minutes of all the Meetings of the MPC between May and October 2016 are attached to the Report for your information.

Dr. Patrick Njoroge
Governor, Central Bank of Kenya

CONTENTS

MEMBERS OF THE MONETARY POLICY COMMITTEE

Dr. Patrick Njoroge
Governor, Chairman

Mrs. Sheila M'Mbijjewe
Deputy Governor

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 for the National Treasury; 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 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 for the National Treasury 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 seventeenth bi-annual Report of the Monetary Policy Committee (MPC) reviews Kenya's monetary policy formulation and economic developments during the six months to October, 2016. The monetary policy stance of the Central Bank of Kenya (CBK) during the period was aimed at maintaining inflation within the Government's target range of 2.5 percent on either side of the 5 percent medium-term target. This is consistent with the price stability objective of the CBK.

The MPC held three bi-monthly meetings between May 2016 and October 2016 to review the outcome of its previous policy decisions and examine the prevailing economic developments in order to put in place appropriate measures to maintain price stability. The MPC reduced the Central Bank Rate (CBR) by 150 basis points during the period in line with declining inflation expectations. This provided the space to ease the policy stance in order to support growth in private sector credit. Reverse Repos were used to address temporary liquidity shortages in segments of the market following the placement of Chase Bank Limited in receivership in April 2016.

Month-on-month overall inflation remained within the Government target range in the period. However, increases in the prices of some food items such as sugar and tomatoes kept inflation in the upper bound of the target range since June 2016. Overall inflation stood at 6.5 percent in October 2016 compared with 5.3 percent in April. Month-on-month non-food-non-fuel (NFNF) inflation declined from 5.8 percent to 5.4 percent in the period despite upward pressure from the excise tax introduced in December, 2015. The 3-month annualised NFNF inflation remained relatively stable in the period, an indication that there were no adverse demand pressures in the economy.

Despite volatility in global financial markets partly due to uncertainties with respect to Brexit, the foreign exchange market remained stable. The stability reflected a narrowing of the current account deficit due to improved earnings from tea and horticulture exports, a reduction in the petroleum products import bill due to lower prices, resilient diaspora remittances, and improved tourism performance. The current account deficit was estimated at 5.3 percent of GDP in the 12-months to October 2016 down from 6.8 percent of GDP in the year to December 2015. International oil prices remained below their historical averages in the period. This, coupled with the stability of the Shilling, continued to moderate risks of imported inflation.

The CBK level of usable foreign exchange reserves stood at USD7.7 billion (5.1 months of import cover) at the end of October 2016 compared to USD7.6 billion (equivalent to 5.0 months of import cover) at the end of April 2016. These reserves, together with the Precautionary Arrangements with the International Monetary Fund (IMF), continued to provide an adequate buffer against short term shocks.

Growth in credit to the private sector decelerated during the period largely due to structural factors including holding of high levels of excess reserves and diversification of asset portfolios by some banks, segmentation in the interbank market, and a slower growth of deposits. The slowdown in credit growth was also attributed to low utilization of overdraft facilities by some large corporate borrowers in the period.

Banking sector stability and efficiency enhances the transmission mechanism of monetary policy. The CBK continued to strengthen the sector to ensure greater transparency and stronger governance, and also to promote effective business models and innovation. The Banking (Amendment) Act, 2016, which caps commercial banks' interest rates came into force on September 14, 2016. The CBK is closely monitoring the impact of the law on the formulation of monetary policy and its transmission to the overall economy. The CBK is also implementing measures to promote innovation in the banking sector leveraging on ICT, and strengthening the Credit Reference Bureaus to provide for a credit scoring framework.

The CBK held regular meetings with various stakeholders during the period. Bi-monthly media briefings and meetings with Chief Executive Officers of commercial and microfinance banks were held to discuss the background information underpinning the MPC's decisions. The Chairman of the MPC also held consultative meetings with the relevant Committees of Parliament to discuss economic and banking sector developments. These forums continued to provide a regular feedback mechanism. MPC members participated in the preparatory activities leading to the epic celebrations of the 50th Anniversary of the CBK on September 14, 2016. The Chairman and MPC members also held meetings with potential investors and International Rating Agencies to appraise them on recent economic developments and the outlook for the economy.

The Bank remains vigilant in monitoring any risks posed by developments in the domestic and global economies on its overall price stability objective. The main risks to inflation relate to a likely pickup in international oil prices following the decision by the Organisation of Petroleum Exporting Countries (OPEC) to cut oil production, rising global prices of food particularly sugar, unfavourable weather conditions which could adversely impact food production and hydro electricity generation, and uncertainties in the global economy with respect to the impact of Brexit, political developments in the U.S., and possible resumption of a tightening of U.S. monetary policy. However, the attainment of the price stability objective will be supported by the monetary policy measures in place, exchange rate stability, the foreign exchange buffers and the continued coordination between monetary and fiscal policies.

1. INTRODUCTION

The seventeenth bi-annual Report of the MPC reviews outcomes of the monetary policy stance adopted by the Committee in pursuit of its price stability objective, as well as other economic developments in the period May to October 2016.

The monetary policy measures adopted by the MPC, a stable Shilling exchange rate, and moderate prices of fuel anchored inflation expectations during the six months to October 2016. Both the overall inflation and non-food-non-fuel inflation remained within the Government's target range. The foreign exchange market was fairly stable, reflecting the narrowing of the current account deficit. The performance of the economy in the second and third quarters of 2016 remained relatively strong, growing by 6.2 percent and 5.7 percent , respectively, compared to 5.9 percent and 6.0 percent in a similar periods of 2015. Growth of the agricultural sector slowed down in the third quarter. However, public investment in infrastructure, strong private consumption, and recovery of the tourism sector continued support growth.

On the international scene, global growth remained fragile and uncertain partly due to subdued growth in the advanced economies following Brexit, and weaker than expected growth of the U.S. economy. Uncertainties in the global financial markets increased due to risks posed by, among other factors, divergent monetary policies in the advanced economies, and political developments in the U.S. The growth outlook for Kenya's main trading partners in the region remained resilient, indicating better prospects for exports performance.

The remainder of this Report is structured as follows. Section 2 provides highlights of the monetary policy formulation during the period; and Section 3 provides an assessment 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.

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 government target range as provided by the Cabinet Secretary for the National Treasury at the beginning of every fiscal year. The Government overall inflation target for FY2016/17 was 5 percent with an allowable margin of 2.5 percent on either side.

The Central Bank Rate (CBR) is the base for signalling monetary policy operations. The change in both the direction and magnitude of the CBR signals the monetary policy stance. The monetary policy stance is operationalised through various instruments including Open Market Operations (OMO), changes in cash reserve requirements at CBK, foreign exchange market operations, and the CBK Standing Facility (Overnight Discount Window which is a lender of last resort facility). To achieve the desired level of bank reserves, OMO is conducted using Repurchase Agreements (Repos), Reverse Repos, and Term Auction Deposits (TAD).

The CBK conducted monetary policy in the context of a floating exchange rate, which allowed continued adjustment of the exchange rate to shifts in demand for and supply of foreign exchange, while ensuring that foreign exchange reserves were only used to smoothen short-term volatility in the exchange rate.

Banking sector stability ensured effective transmission of monetary policy. The CBK continued to monitor the banking sector to ensure compliance with statutory requirements including liquidity and capital adequacy ratios.

Monetary policy implementation was guided by CBK targets on the Net International Reserves (NIR) and Net Domestic Assets (NDA) as the operational parameters. These targets were consistent with the performance measures under the Precautionary Arrangements with the International Monetary Fund (IMF) aimed at safeguarding the economy against exogenous shocks that might lead to balance of payments needs. The CBK met its NDA and NIR targets for June and September 2016, and was on track with respect to the December 2016 targets.

The annual growth rates of broad money supply (M3) and private sector credit were below their projected growth paths. The 12-month growth in M3 slowed down from 9.2 percent in April 2016 to 6.9 percent in October, while private sector credit growth declined from 13.5 percent to 4.7 percent. The slower growth in credit to the private sector reflected structural factors including some banks holding high levels of excess reserves and diversified asset portfolios with a bias to low risk Government securities, segmentation in the interbank market and slower growth of deposits for some banks.

2.2 Domestic and Global Economic Environments

The economic environment during the six months to October 2016 was characterised by relative stability of key macroeconomic indicators. However, uncertainties in the global economy increased following the U.K. vote to leave the European Union (Brexit), which sparked global financial market volatility and a sharp depreciation of the Sterling Pound. Major central banks announced contingency measures to support confidence in the market including their readiness to provide liquidity and intervene to stabilise the financial markets.

Global growth for 2016 was revised downwards to 3.1 percent largely due to the subdued outlook for the advanced economies following Brexit, and a weaker-than expected growth of the U.S. economy. Sub-Saharan African (SSA) growth was also expected to slowdown to 1.4 percent in 2016 driven largely by lower commodity prices and a weak global economy. Most of the non-resource intensive SSA countries continued to perform well, benefitting from lower oil import prices, an improved business environment, and continuous strong infrastructure investment. Growth in the large commodity exporting SSA economies which include Angola, Nigeria, and South Africa remained subdued. These largely account for the slower expected growth in SSA. The global financial markets remained unsettled in part due to divergent monetary policies in advanced economies, the growth slowdown in China, the timing of the next US interest rate hike, political developments in the U.S. and the impact of Brexit.

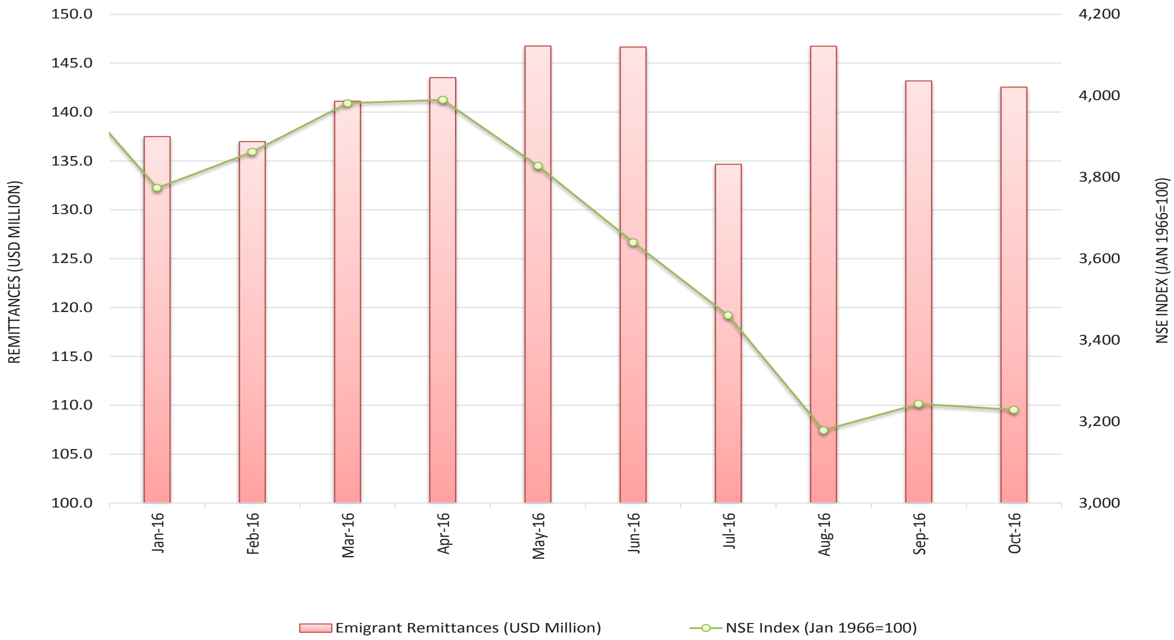
Inflation remained within the prescribed target range throughout the period despite persistent upward pressure on food prices. Unfavourable weather conditions affected food production, and could also exert pressure on energy prices through lower dam water levels in the hydro electricity generation areas. The foreign exchange market was relatively stable supported by the narrowing of the current account deficit due to improved earnings from tea and horticulture, a reduction in imports of petroleum products due to lower price, resilient diaspora remittances and improved tourism performance. Diaspora remittances increased to an average of USD143.4 per month during the six months to October 2016 compared to an average of USD137.3 million per month in the six months to April 2016 (Chart 1a).

The collapse in international crude oil prices seems to have bottomed out early in 2016 with prices of a barrel of Murban crude oil at USD30.0. Since then oil prices have risen to USD51.4 per barrel in October 2016 (Chart 1b). Despite the rise in oil prices, the proportion of the value of imports of petroleum products in total imports of goods declined to 15.0 percent in the 12-months to October from 15.5 percent in the 12-months to April 2016 (Chart 1b).

Uncertainties in the global economy coupled with capital outflows from emerging and frontier market economies weighed down on the equities market in the period. The NSE index fell from 3,990 in April to 3,229 by in October 2016 (Chart 1a). The prices of banking sector listed stocks registered significant declines after the enactment of the

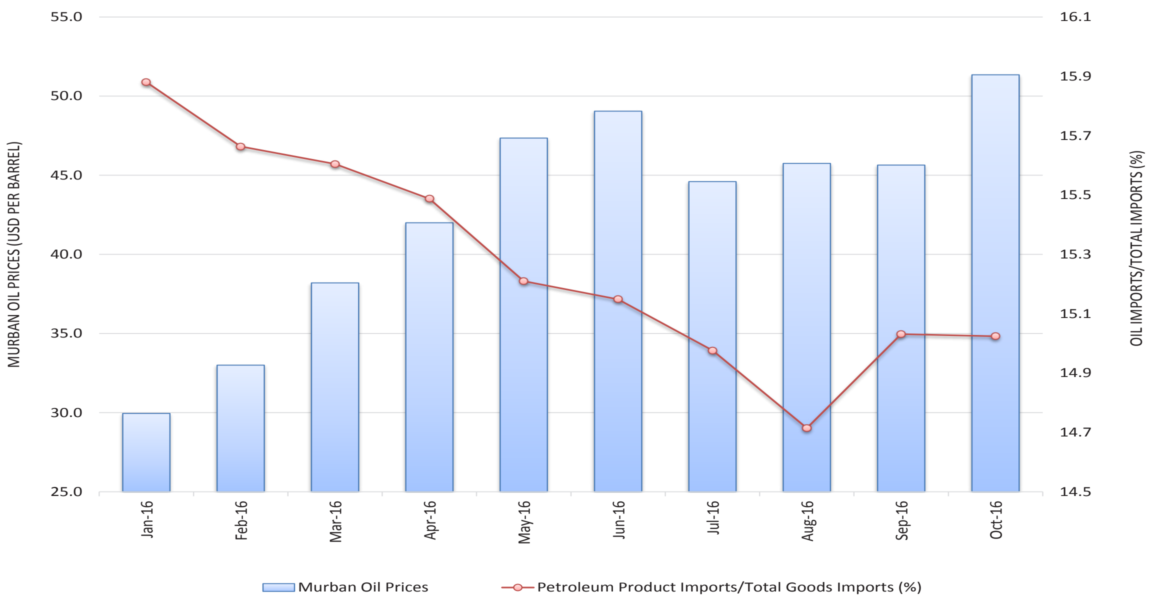
Banking (Amendment) Act, 2016 capping interest rates on lending and deposits. However, the downward trend in the prices of the stocks has since stabilised.

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 value of Petroleum Product Imports to Total value of Imports of Goods (%)



***Source**: Central Bank of Kenya and Kenya Revenue Authority*

2.3 Monetary Policy Committee Meetings and Decisions

The MPC held bi-monthly meetings on May 23rd, July 25th, and September 20th, 2016 to review developments in the domestic and international markets, and to take appropriate measures to maintain price stability. The MPC reduced the CBR by 100 basis points to 10.5 percent during its meeting on May 23rd, and retained it at that level on July 25th in order to anchor inflation expectations and ensure market stability. Given that inflation was expected to remain within the Government's target range, there was space to ease the monetary policy stance. The CBR was therefore reduced by a further 50 basis points on September 20th,2016.

The CBK continued to work closely with the National Treasury to ensure coordination of monetary and fiscal policies for overall macroeconomic stability. The execution of the Government domestic borrowing programme continued to support market stability.

The CBK continued to monitor closely the foreign exchange market in view of the risks posed by increased uncertainties in the global financial markets. Nevertheless, its foreign exchange reserves, which stood at USD7.7 billion (equivalent to 5.1 months of import cover) at the end of October 2016, together with the Precautionary Arrangements with the IMF (equivalent to USD1.5 billion) continued to provide an adequate buffer against short-term shocks.

3. IMPACT OF POLICY ON KEY ECONOMIC INDICATORS

3.1 Inflation

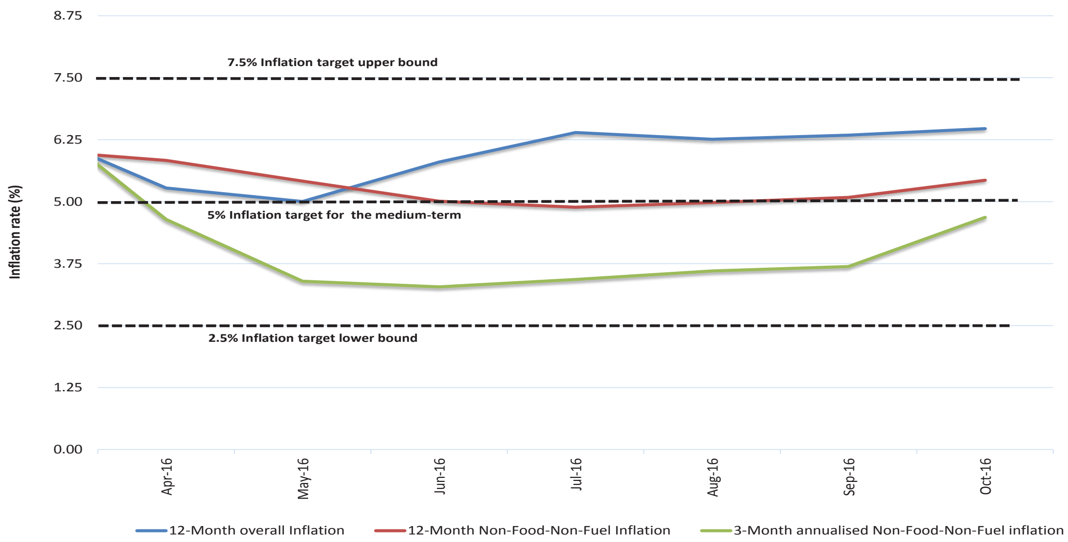
Month-on-Month overall inflation remained within the Government target range during the six months to October 2016 (Chart 2a). Overall inflation rose gradually to 6.5 percent in October from 5.3 percent in April 2016, and remained in the upper bound of the target range since June 2016 due to increases in prices of some food items such as sugar and tomatoes. The CPI category *food and non-alcoholic beverages* accounted for 4.7 percentage points of the month-month inflation in October compared to 2.8 percentage points in May 2016. The CPI category *Alcoholic beverages, tobacco and narcotics* also recorded a high inflation in the period reflecting the impact of the excise tax introduced in December 2015 (Chart 2b).

The month-on-month non-food-non-fuel (NFNF) inflation declined from 5.8 percent in April to 5.4 percent in October 2016. However, the NFNF rose gradually between July and October reflecting increases in the prices of items in the 'clothing and footwear' CPI category, and the impact of the excise tax introduced in December 2015. The 3-month annualised NFNF remained relatively stable below 5 percent between May and October 2016, suggesting that there were no adverse demand pressures in the economy (Chart 2a).

International oil prices remained below their historical averages in the period. This, together with the stability of the Shilling exchange rate, continued to moderate risks of imported inflation. However, international food prices inflation, based on the FAO food index, rose from -9.2 percent in April to 9.1 percent in October 2016 largely due to a significant increase in sugar price. International sugar price inflation rose from 16.0 percent to 59.8 percent in the period largely due to reduced production in Brazil and India. However, global inflation remained low in the six months to October 2016 reflecting lower commodity prices. A modest pick-up in global inflation was expected in 2016 with most advanced countries continuing to implement accommodative monetary policy to support growth.

The East African Community (EAC) region, which has a fairly similar composition of the CPI basket, displayed divergent trends in their inflation rates (Chart 2c). Inflation increased sharply in Rwanda, but remained relatively stable in Kenya and South Africa between July and October. However, comparably lower food prices contributed to a decline in inflation in Uganda and Tanzania. The trends in inflation in the respective countries reflected movements in food and energy prices due to their significant weight in the CPI baskets.

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

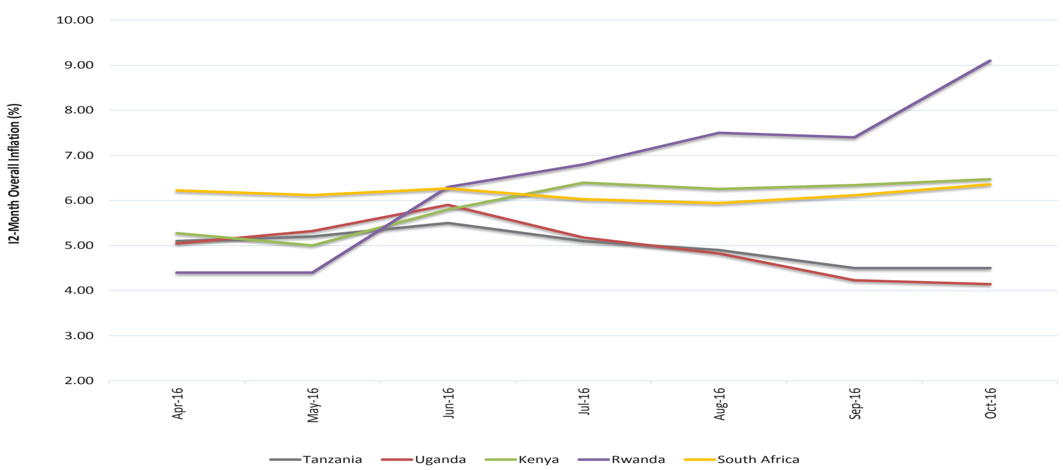


***Source**: Kenya National Bureau of Statistics and Central Bank of Kenya*

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

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

Chart 2c: 12-Month Inflation in Selected EAC Countries, and South Africa (%)



***Source**: Websites of respective central banks*

3.2 Foreign Exchange Market Developments

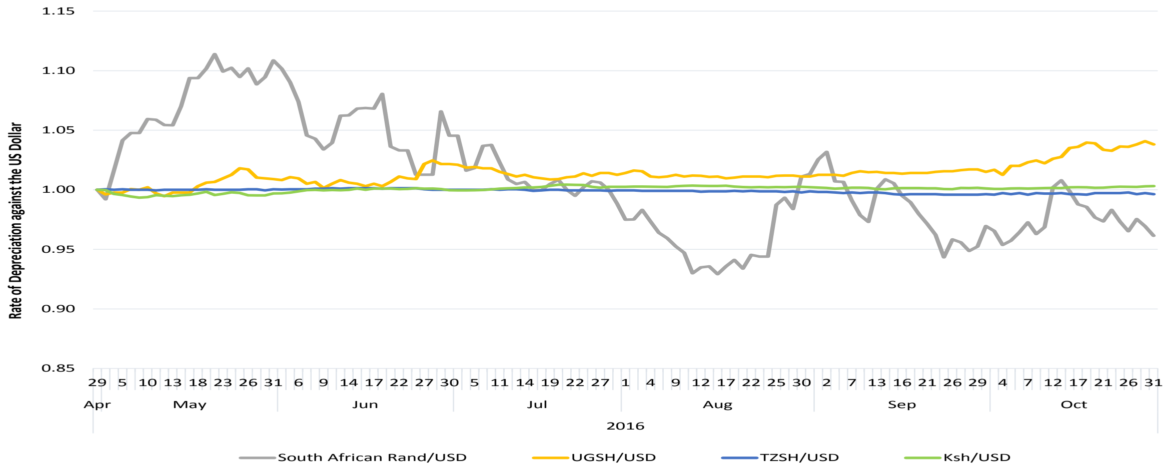
Despite volatility in the global financial markets attributed mainly to uncertainty with respect to Brexit, the foreign exchange market was relatively stable in the six months to October 2016. This was largely due to a narrowing of the current account deficit reflecting improved earnings from tea, coffee and horticulture exports, a lower petroleum products import bill due to lower oil prices, resilient diaspora remittances, and improved tourism performance. The stability of the foreign exchange market in Kenya also reflected improved market discipline, and the resilience and diversified nature of the economy relative to its peers. The economy is diversified in terms of both export products and external markets. This has been a major source of resilience against adverse effects of external shocks on exports. About 40 percent of Kenya's exports were to Africa in the year to October 2016. As a result, the spill over effects of global financial markets volatility on the foreign exchange market remained minimal.

The CBK level of usable foreign exchange reserves increased marginally to USD7.7 billion (5.1 months of import cover) at the end of October 2016 from USD7.6 billion (equivalent to 5.0 months of import cover) at the end of April 2016. These reserves, together with the Precautionary Arrangements with the IMF (equivalent to USD1.5 billion) continued to provides an adequate buffer against short term shocks.

Most international currencies weakened against the U.S. dollar between May and October 2016 largely due to volatility in the global financial markets. Global financial markets were volatile reflecting increased risks posed by slowdown in the global growth, the uncertainty with respect to the impact of Brexit, and the divergent monetary policies in the advanced economies. Other factors affecting the global markets included concerns about China and uncertainty with respect to the resumption of the tightening of U.S. monetary policy. As a result, the currencies of most emerging and frontier market economies weakened against the U.S. dollar due to increased capital outflows.

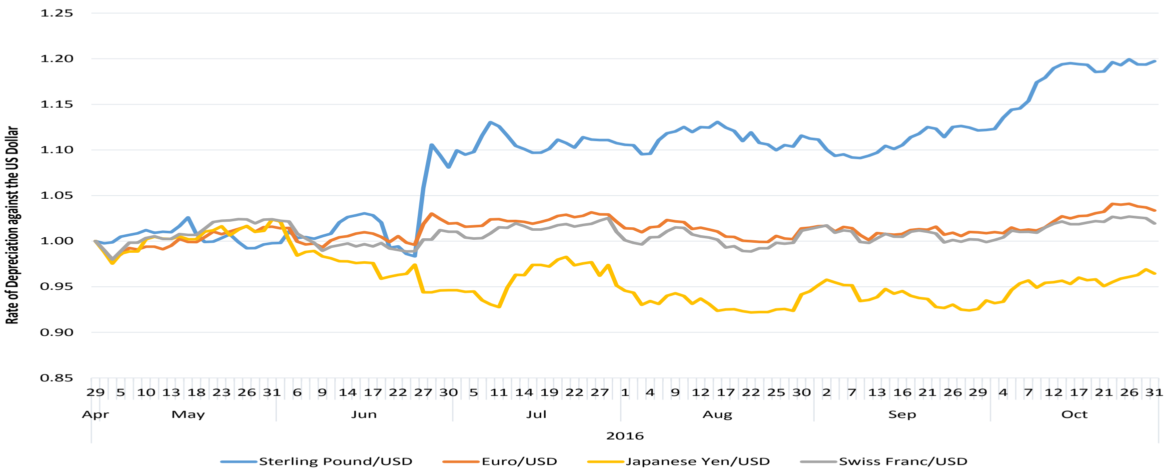
The major international and SSA currencies depicted mixed trends against the U.S. dollar during the period (Chart 3a and 3b). National currencies in Kenya, Uganda, and Tanzania were relatively stable against the U.S. dollar. The South African Rand was comparably more volatile in the region reflecting the slump in commodity prices, labour unrest in the mining sector, and widening trade deficit attributed to weak growth in its main trading partners including Europe. The national currencies in other commodity dependent economies such as Nigeria, Zambia, and Ghana witnessed significant depreciations against the U.S. dollar in the period (Chart 3c). Volatility in the global financial markets in June 2016 following Brexit resulted in a sharp depreciation of the Sterling Pound.

Chart 3a: Rate of Depreciation of the Kenya Shilling and Regional Currencies against the U.S. dollar (April 29, =1)



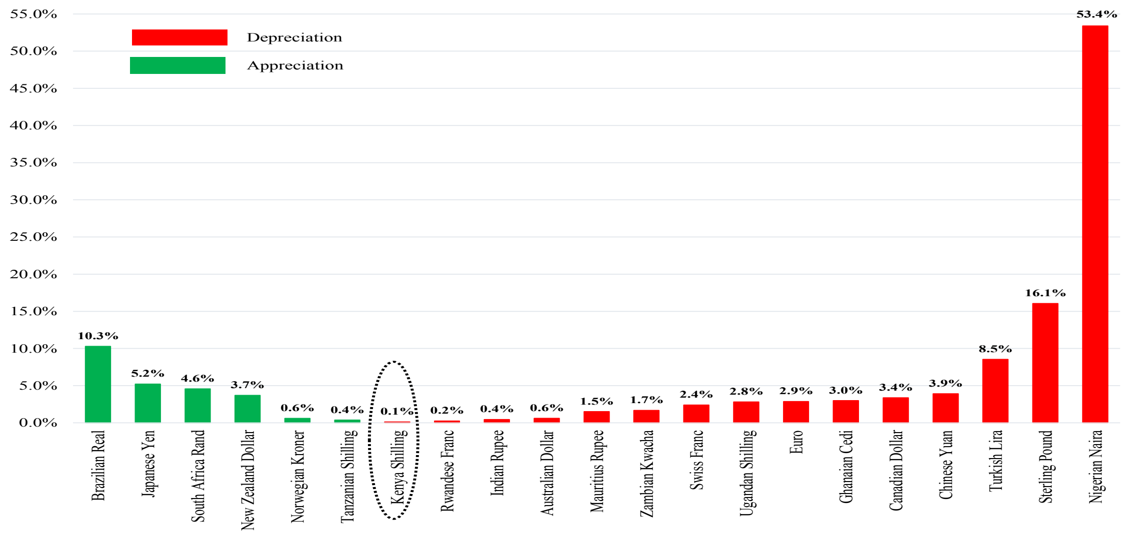
***Source**: Central Bank of Kenya*

Chart 3b: Rate of Depreciation of the Major International Currencies against the U.S. dollar (April 29, =1)



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

Chart 3c: Percentage Depreciation of Selected Currencies against the U.S. dollar between April and October 2016



***Source**: Computations based on data from Thompson Reuters*

3.3 Balance of Payments Developments

The overall balance of payments position recorded a deficit of USD957.8 million (1.5 percent of GDP) in the year to October 2016 from a surplus of USD458.2 million (0.7 percent of GDP) in the year to October 2015. The change in the overall balance of payments in the period reflected the widening of the deficit in the financial account, and a reduction in the surplus in the capital account.

The current account deficit narrowed during the period to USD3,864.1 million (5.3 percent of GDP) in the year to October 2016 from USD4,361.7 million (7.1 percent of GDP) in the year to October 2015 largely due to an improvement in the value of the merchandise account. The value of imports of petroleum products, and machinery and transport equipment decreased from USD2,676.1 million and USD5,176.5 million, respectively, in the year to October 2015 to USD2,080.5 million and USD4,742.4 million, respectively, in the year to October 2016. In addition, export earnings from tea and horticulture, and tourism receipts improved in the period.

The demand for foreign exchange to finance imports of petroleum products, and machinery and transport equipment eased in the six months to October 2016. The 12-month cumulative proportion of imports of goods and services financed by exports of goods and services improved to an average of 60.5 percent in the six months to October 2016 compared to an average of 60.0 percent in the six months to April 2016. The share of petroleum products import bill in total imports continued to reduce due to lower international oil prices, which remained below their historical averages. Similarly, the share of imports of machinery and transport equipment in total imports decreased in part due to completion of construction of the first phase of the Standard Gauge Railway (SGR). The shares of the values of imports of petroleum products, and machinery and transport equipment decreased from 15.5 percent and 35.3 percent, respectively, in the year to April 2016, to 14.9 percent and 34.0 percent, respectively, in the year to October 2016.

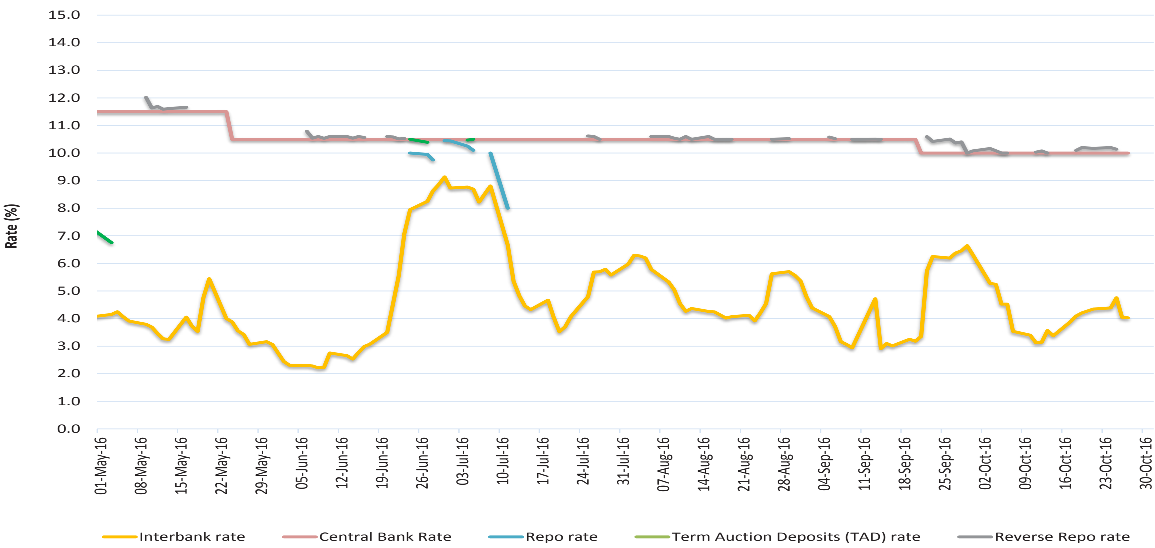
Although Kenya's current account balance improved during the period, the MPC continued to monitor the impact of Brexit since Kenya has significant trade and investment links with Europe. The Kenya National Bureau of Statistic's Foreign Investment Survey for 2015 showed that the stock of inward foreign direct investment from Europe to Kenya stood at 45 percent of total foreign direct investment, with the UK accounting for 23 percent. In addition, a significant proportion of tea and horticulture exports are largely to the EU. The main risks relate to the uncertainty surrounding future trading relationships, as well as uncertainty over the signing and subsequent ratification of the EU-EAC economic partnership agreement.

3.4 Interest Rates Developments

The interbank rate remained below the CBR during the six months to October 2016 reflecting improved liquidity conditions in the market. However, the liquidity distribution remained uneven across the bank tiers due to the segmentation in the interbank market. Liquidity management operations by the CBK continued to ensure stability in the market. The CBK used Reverse Repos to supply liquidity to segments of the market facing shortages, and Repos and Term Auction Deposits to withdraw liquidity from segments of the market with surpluses (Chart 4a). The Following the placement of Chase Bank Limited in receivership in April 2016, Reverse Repos were used to address temporary liquidity shortages in segments of the market.

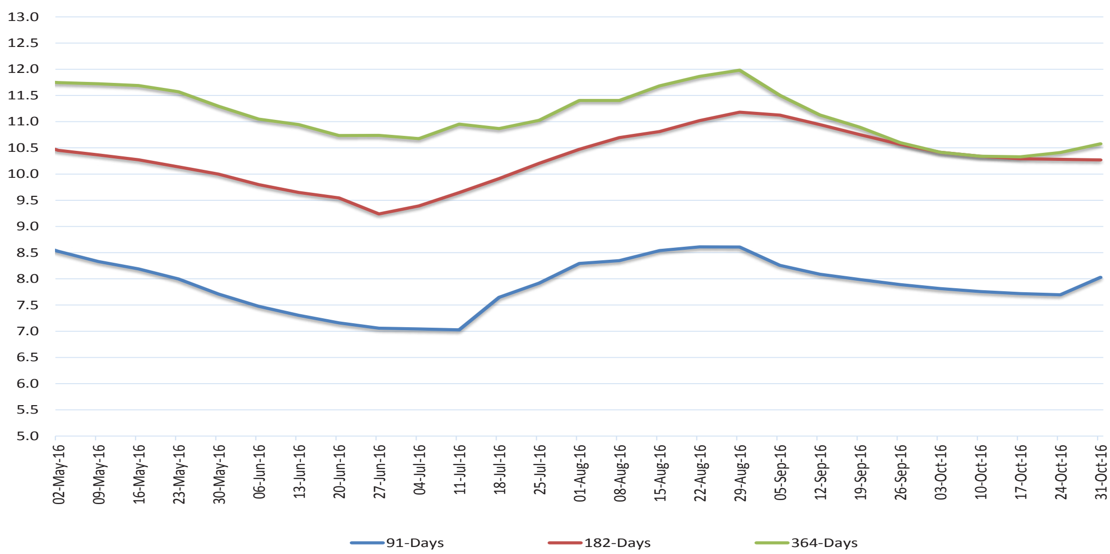
Interest rates on Government securities were relatively stable during the six months to October 2016, an indication of the coordination between monetary and fiscal policies (Chart 4b). In addition, the flattening and stabilisation of the yield curve in the period enhanced predictability in the Government securities market. The implementation of the Government domestic borrowing programme continued to support market stability.

Chart 4a: Trends in Short-Term Interest Rates (%)



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

Chart 4b: Average Interest Rates on Treasury Bills (%)



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

3.5 Introduction of Interest Rate Caps on Banks' Lending and Deposits

The Banking (Amendment) Act, 2016 came into force on September 14, 2016. The Act set the maximum interest rate chargeable for a credit facility in Kenya at no more than 4 percent above the base rate set and published by the CBK. It also set the minimum interest rate granted on a deposit held in an interest earning account in Kenya to at least 70 percent of the base rate. Following introduction of the law, the CBK clarified the base rate set and published by CBK to be the Central Bank Rate. The CBK is monitoring closely the impact of the new law on monetary policy and the overall economy.

The capping of interest rates was largely due to the non-responsiveness of commercial banks' lending and deposit rates to monetary policy signals over the years with consequent high interest rate spreads and comparably high returns on equity in the sector relative to other investments in the economy. The risks of capping banks' interest rates were noted to include possible perverse responses of credit growth to monetary policy in the case of credit rationing by banks. Caps could also distort the market with a risk of stifling financial inclusion. In the event of a decrease in credit to the private sector, investment by banks in alternative assets such as government securities could increase.

3.6 Banking Sector Developments

The banking sector was resilient in the six months to October 2016. The average commercial banks liquidity increased to 43.6 percent in October from 40.5 percent in April 2016, while the capital adequacy ratio rose to 19.1 percent from 18.8 percent. The quick and successful reopening of Chase Bank Ltd in April 2016 enhanced confidence in the sector.

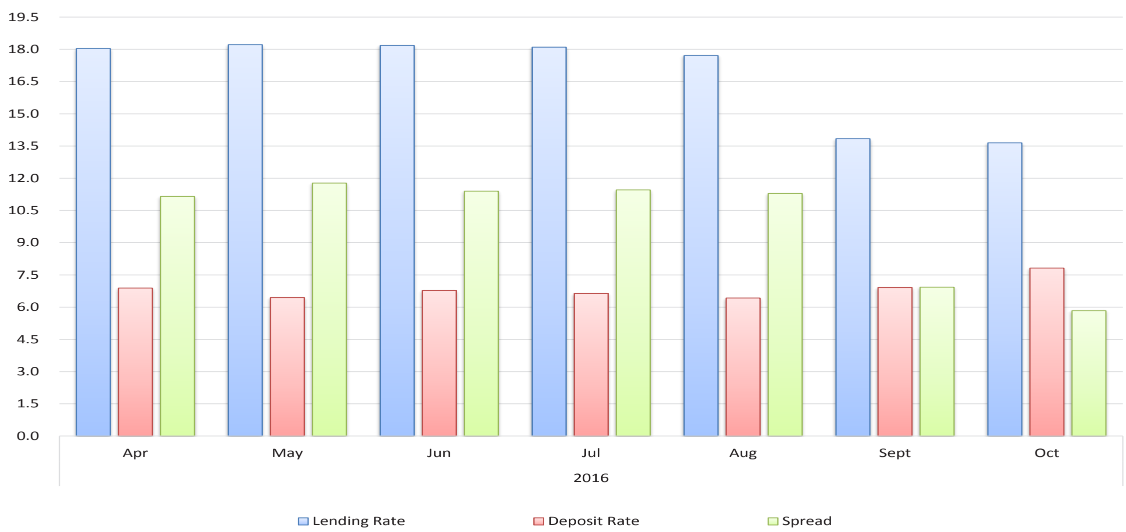
The CBK's enforcement of existing regulation, especially with respect to the classification of loans, continued to strengthen and ensure transparency in the sector. The ratio of gross non-performing loans (NPLs) to gross loans stood at 9.3 percent in October compared to 8.2 percent in April 2016, partly reflecting reclassification of loans in line with the required reporting standards. The CBK continued to closely monitor liquidity and credit risks in the sector.

The average commercial banks' lending rates declined from 18.0 percent in April to 13.6 percent in October 2016 partly reflecting the easing of monetary policy, and implementation of the Banking (Amendment) Act, 2016 in September 2016 (Chart 5). The average deposit interest rates for banks rose from 6.9 percent to 7.8 percent in the period. The rise in the deposit interest rates in the period was mainly in the large and medium tier banks. Small banks were already paying higher interest rates on deposits prior to the introduction of interest rate caps. The average interest rate spread between lending and deposit rate declined from 11.1 percent to 5.8 percent in the period.

The CBK continued to put in place measures to sustainably reduce the cost of credit including promoting innovation in the banking sector by leveraging on ICT, and strengthening the Credit Reference Bureaus to provide for a credit scoring framework. The CBK was also strengthenening bank supervision to ensure greater transparency and stronger governance, and also to promote effective business models and innovation.

The MPC continued to hold meetings with stakeholders in the banking sector during the six months to October 2016. Bi-monthly media briefings and meetings were held with Chief Executive Officers of commercial banks and microfinance banks to discuss the background to MPC decisions. The meetings also provided a regular feedback mechanism.

Chart 5: Commercial Banks' Average Interest Rates and Spreads (%)



Source: *Central Bank of Kenya*

3.7 Developments in Private Sector Credit

The 12-month growth in credit to the private sector decelerated from 13.5 percent in April 2016 to 4.7 percent by October 2016 (Table 1). Credit growth slowed down in most sectors during the period. Nevertheless, there was a rebound in credit growth in various sectors including trade, business services, and consumer durables.

The slowdown in private sector credit growth in the period largely reflected structural factors. First, some banks have persistently held high levels of excess reserves and diversified their asset portfolios with a bias towards government securities which are considered low risk. Second, the interbank market continued to be segmented with some banks holding excess liquidity while others having shortages. Third, slower growth of deposits for some banks has reduced the pool of loanable funds. Deposits are the main source of loanable funds in banks, accounting for about 68 percent of total liabilities for banks. Hence the slower growth in deposits constrained banks' capacity to lend. The slower credit growth in the period was also attributed to low utilization of overdraft facilities by some large corporate borrowers.

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

	Apr	May	Jun	Jul	Aug	Sep	Oct
Total Credit to Private Sector	**13.5**	**11.1**	**8.6**	**7.1**	**5.4**	**4.8**	**4.7**
Agriculture	23.5	28.3	20.9	12.2	5.8	1.2	1.5
Manufacturing	18.3	15.1	16.1	15.7	2.2	-2.0	-4.3
Trade	0.9	-2.1	-7.3	-7.4	-5.5	12.8	10.0
Building & construction	26.2	19.3	15.9	12.8	11.2	1.3	-4.9
Transport & communication	28.5	25.5	22.8	21.7	26.3	13.1	14.3
Finance & insurance	70.1	58.7	59.3	65.3	48.5	9.1	7.8
Real estate	23.5	17.7	20.2	17.0	18.3	8.7	9.2
Mining & quarrying	5.3	3.2	-1.6	-4.5	-32.8	-33.7	-36.4
Private households	7.3	5.1	2.6	0.1	4.0	5.9	5.6
Consumer durables	9.1	9.3	-0.1	0.0	6.4	35.2	37.5

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

4. OTHER ACTIVITIES OF THE MONETARY POLICY COMMITTEE

The MPC held regular stakeholder forums between April and October 2016 in order to enhance the understanding of the background and impact its decisions. In this regard, bi-monthly meetings were held with Chief Executive Officers of banks. The Committee also continued to improve on the information gathering processes through the Market Perception Surveys and communication with key stakeholders on the MPC decisions to obtain feedback. The MPC Press Releases were simplified to enhance their clarity to the public, media, financial sector and other stakeholders.

The MPC Chairman held press conferences after MPC Meetings to brief the media on measures undertaken by the CBK to ensure macroeconomic and financial stability. The media and public understanding of monetary policy decisions and their expected impact on the economy continued to improve as can be noted by increased analysis and coverage in the press. MPC members participated in the preparatory activities leading to the epic celebrations of the 50th Anniversary of the CBK on September 14, 2016. The Chairman of the MPC held meetings with potential investors and International Rating Agencies in order to appraise them on recent economic developments and the outlook for the economy. He also held consultative meetings with the relevant Committees of Parliament to discuss economic and banking sector developments.

During the period, MPC members participated in local and international conferences as part of enhancing their responsibility, and to share experiences. The MPC Members also participated in the World Bank and IMF Annual Meetings as well as other forums organised by these institutions to launch country and regional economic reports.

5. CONCLUSION

The monetary policy measures adopted by the MPC during the six months to October 2016 continued to anchor inflation expectations, and support stability in the foreign exchange market. Coordination of monetary and fiscal policies continued to support market stability. The MPC will closely monitor the impact of the interest rate caps on the formulation of monetary policy, and on the overall economy. The Committee will also continue to monitor developments in the domestic and global economy and take appropriate measures to maintain price stability.

APPENDIX: CHRONOLOGY OF EVENTS OF PARTICULAR RELEVANCE TO MONETARY POLICY (MAY 2016 - OCTOBER 2016)

Date	Events
May 2016	The CBR was lowered by 100 basis points to 10.50 percent in order to continue anchoring inflation expectations
June 2016	FY Budget Statement provided additional measures to address the high cost of credit.
	The U.K. voted to leave the European Union (Brexit).
July 2016	The CBR was retained at 10.5 percent in order to anchor inflation expectations, and to maintain market stability.
September 2016	Banking (Amendment) Act, 2016 came into force on September 14, 2016. The law caps banks' lending rates, and also sets the minimum interest rates on deposits.
	The CBR was reduced by 50 basis points to 10.0 percent.

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 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 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 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 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.


BANKI KUU YA KENYA