Central Bank of Kenya

Nineteenth Bi-Annual Report of the Monetary Policy Committee

Issued under the Central Bank of Kenya Act, Cap 491

October 2017

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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 nineteenth bi-annual Monetary Policy Committee (MPC) Report in accordance with section 4D (6) of the Central Bank of Kenya (CBK) 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 2017.

Dr. Patrick Njoroge
Governor, Central Bank of Kenya

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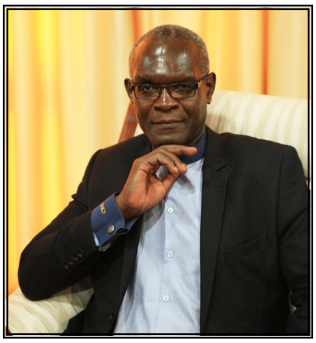
MEMBERS OF THE MONETARY POLICY COMMITTEE

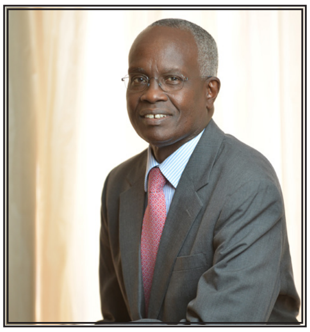
Dr. Patrick Njoroge
Governor, Chairman

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

Dr. Kamau Thugge (EBS)
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) 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 nineteenth bi-annual Report of the Monetary Policy Committee (MPC) reviews Kenya's monetary policy formulation and economic developments during the six months to October, 2017. The economic environment during the period was characterised by general macroeconomic stability, decline in food prices following favourable weather conditions, a prolonged election period, and continued uncertainties in the global economy.

The monetary policy stance of the Central Bank of Kenya (CBK) during the period aimed at maintaining inflation within the Government's target range of 2.5 percent on either side of the 5 percent medium-term target. The MPC held three bi-monthly meetings between May and October 2017 to review the outcome of its previous policy decisions and economic developments, and to put in place appropriate measures to maintain price stability. The MPC retained the Central Bank Rate (CBR) at 10.0 percent during the period to anchor inflation expectations. The monetary policy stance together with the CBK liquidity management ensured that there were no demand-driven inflationary pressures in the economy. The MPC continued to monitor the impact of interest rate capping on the effectiveness of monetary policy transmission.

Month-on-month overall inflation fell gradually to 5.7 percent in October 2017 from 11.5 percent in April 2017 reflecting decreases in food prices following improved weather conditions and the impact of Government measures. Prices of key food items fell significantly following the zero-rating of taxes on maize and bread and allowing of duty free imports of maize and sugar to address the adverse effects of the drought experienced in the first quarter of 2017 on food production. However, overall inflation was above the Government target range in May, June and August 2017 due to high food prices attributed to the spill over effects of the drought, and limited supply of key food items following transport difficulties in the immediate period after the general elections in August. Additionally, increased demand for some key food items in the immediate period before the elections exerted temporary upward pressure on inflation in August. As required in the notification on the price stability target, the CBK provided letters to the National Treasury explaining: why overall inflation remained above the target range in May 2017, and why it exceeded the target range in August 2017; the measures the MPC and CBK were taking to address the deviation from the target range; and, the expected time period for overall inflation to return to the target band. Month-on-month non-food-non-fuel (NFNF) inflation declined gradually to 3.0 percent in October 2017 from 4.3 percent in April 2017, indicating that there were no 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 during the period supported by strong diaspora remittances, resilient tea and horticultural exports, and the continued recovery in tourism. However, the expected current account deficit for 2017 was revised upwards to 6.2 percent of

GDP from the previous estimate of 5.8 percent reflecting continued import of food in the second half of the year to address the spillover effects of the drought witnessed in the first quarter of 2017, and an increase in the petroleum products import bill due to higher international oil prices. The stability of the exchange rate continued to moderate the risks of imported inflation. The CBK level of usable foreign exchange reserves stood at USD7.2 billion (4.8 months of import cover) at the end of October 2017. These reserves, together with the Precautionary Arrangements with the International Monetary Fund (IMF) continued to provide an adequate buffer against short term shocks in the foreign exchange market.

The banking sector remained resilient during the period. The average commercial banks' liquidity and capital adequacy ratios remained above the statutory levels. The CBK continued to implement measures to lower the cost of credit including promoting innovation in the banking sector leveraging on Information and Communications Technology (ICT), and strengthening the Credit Reference Bureaus to provide an effective credit scoring framework. The CBK in collaboration with the Kenya Bankers Association (KBA) launched the Cost of Credit website in June 2017 to provide customers with information on fees and charges relating to loan products offered by commercial banks and microfinance banks. Private sector credit growth stood at 2.0 percent in October 2017 compared to 2.2 percent in April 2017. The downward trend in credit growth witnessed since August 2015 reversed in August 2017, with strong growth in lending recorded in the domestic trade, manufacturing, and real estate sectors in October 2017. The MPC continued to monitor the impact of interest rate caps on lending, particularly to sectors such as Micro, Small and Medium Enterprises (MSMEs).

The Bank continued its regular interactions with stakeholders in the financial and real sectors as well as the media in order to obtain feedback and to enhance the understanding of monetary policy decisions. Bi-monthly meetings with Chief Executive Officers of commercial and microfinance banks were held to discuss the background informing the MPC's decisions. The Governor's media briefings after every MPC meeting informed the press on the background to the MPC decisions and developments in the banking sector. The CBK also held regular meetings with potential investors in order to brief them on economic developments and the outlook for the economy. The CBK continued to work closely with the National Treasury to ensure coordination of monetary and fiscal policies to maintain macroeconomic stability. Particularly, the execution of the Government domestic borrowing programme continued to support a stable yield curve and market stability.

The CBK continues to monitor developments in the domestic and global economies as well as any potential risks to the price stability objective. Unpredictable weather conditions and the rise in international oil prices remain the main risks to inflation. Although the global economy continues to stabilise, uncertainties remain with regard to the U.S. economic policies, the Brexit resolution, and the pace of normalisation of monetary policies in the advanced economies. Nevertheless, the monetary policy measures in place, exchange rate stability, government measures to increase the supply of key food items, and coordination between monetary and fiscal policies are expected to continue to support the CBK's price stability objective.

1. INTRODUCTION

The nineteenth 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 2017.The economic environment during the period was characterised by general macroeconomic stability, decline in food prices following favourable weather conditions, a prolonged election period, and continued uncertainties in the global economy.

On the domestic scene, food prices fell during the six months to October 2017 reflecting improved weather conditions, and the impact of Government interventions to increase the supply and lower the prices of key food items. However, overall inflation was above the Government target range in May, June and August 2017 due to high food prices attributed to the spill over effects of the drought, and limited supply of key food items following transport difficulties in the immediate period after the general elections in August. Fuel prices rose modestly during the period reflecting higher international oil prices. The monetary policy measures adopted by the MPC ensured that there were no demand driven inflation pressures. The economy remained resilient in the period despite the adverse effects of the drought witnessed in the first quarter of 2017 on agricultural sector performance, a prolonged election period which had implications on investment decisions, and the effects of interest rate capping on credit growth particularly to the Micro, Small and Medium Enterprises (MSMEs). The economy grew by 4.8 percent in the first half of 2017 compared to 5.8 percent in the first half of 2016. Growth was mainly supported by the services sector, particularly the MSMEs, which grew by 7.2 percent in the first half of 2017 compared to 6.8 percent in the first half of 2016. In order to facilitate private sector-led growth, the Government continued to implement measures aimed at improving the business environment, including infrastructure development. The World Bank 2018 Doing Business Report showed that Kenya climbed 12 ranks to position 80 from 92 in 2016 and position 3 in Africa behind Mauritius and Rwanda.

On the International scene, crude oil prices continued to rise gradually due to increased demand with the continued recovery of the global economy, and the decision by the OPEC economies to cut production. Uncertainties with regard to U.S. economic policies, the post-Brexit resolution, and the pace of normalisation of monetary policies in the advanced economies persisted during the period.

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.

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 provided 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) is the base for monetary policy operations. The change in both the direction and magnitude of the CBR signals the monetary policy stance. The monetary policy stance is operationalized 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 money supply, OMO is conducted using Repurchase Agreements (Repos), Reverse Repos, and Term Auction Deposits (TAD).

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 2017.

The annual growth rates of broad money supply (M3) and private sector credit were below their projected growth paths in the period. The 12-month growth in M3 slowed down from 7.1 percent in April 2017 to 6.0 percent in June and increased thereafter to 8.2 percent by October 2017. Growth in private sector credit declined from 2.2 percent in April 2017 to 1.4 percent in July, but reversed the trend in August to grow by 2.0 percent in October 2017. 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.

2.2 Domestic and Global Economic Environments

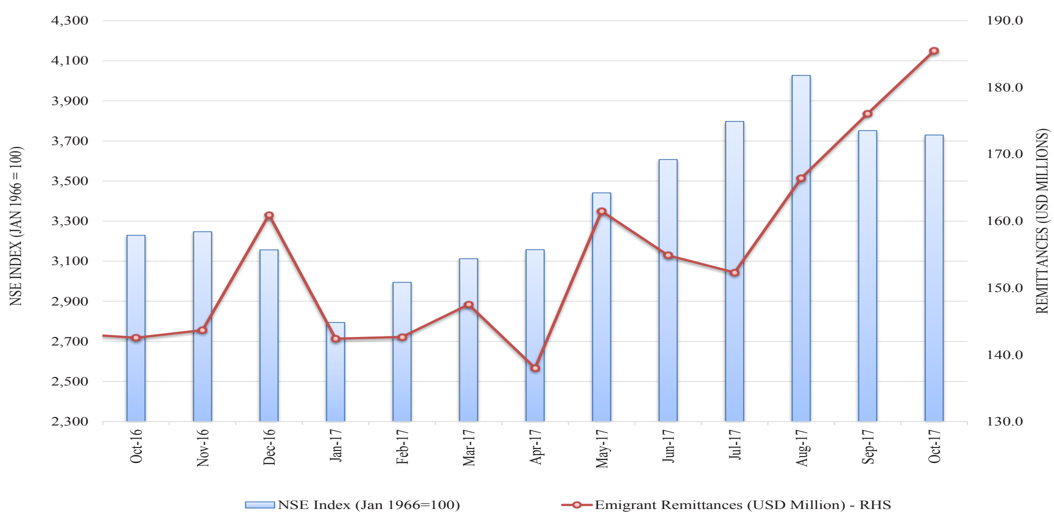
The domestic economic environment during the six months to October 2017 was characterised by general macroeconomic stability, decline in food prices following improved weather conditions, a modest recovery in private sector credit growth, and continued uncertainties on the impact of the interest rates caps on monetary policy.

Global growth was expected to pick up to 3.6 percent in 2017 and 3.7 in 2018 from 3.2 percent in 2016 supported by a recovery in advanced economies due to stronger growth in the Euro Area, Japan and Canada. However, the uncertainties with regard to Brexit resolution and economic policies in the U.S continued to dampen global growth. Growth in Sub-Saharan African (SSA) was expected to pick up to 2.6 percent in 2017 and 3.4 percent in 2018 from 1.4 percent in 2016 reflecting recovery of commodity prices, increased infrastructure spending, and a pickup in the global economy. Risks to global outlook relate to pressures for inward-looking policies in the advanced economies which may slowdown trade and investment, the Brexit resolution, and pace of normalisation of monetary policy in the advanced economies.

The foreign exchange market remained relatively stable supported by strong diaspora remittances, resilient tea and horticultural exports, and the continued recovery in tourism. Diaspora remittances increased to an average of USD166.0 per month during the six months to October 2017 compared to an average of USD146 million per month in the six months to April 2017 (Chart 1a). The Nairobi Securities Exchange (NSE) improved in the period, albeit a slight decline in September and October 2017, demonstrating resilience amidst uncertainty following the prolonged election period. The NSE 20-share index maintained an upward trend, rising from 3,157.6 in April 2017 to 4,027.1 in August, and thereafter stabilizing at 3,729.6 in October 2017.

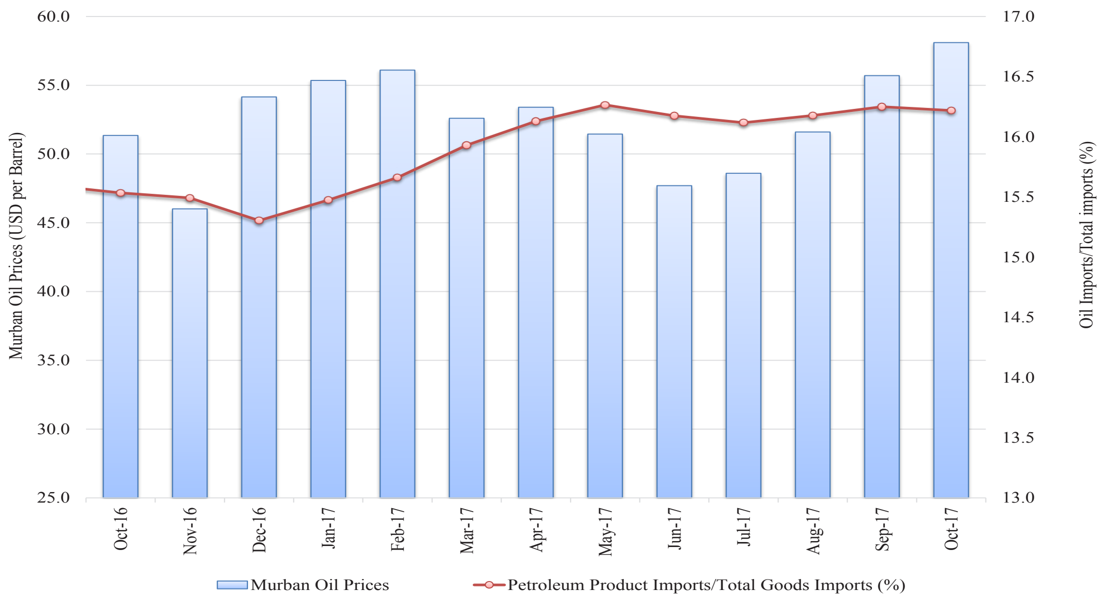
Murban crude oil prices rose gradually to USD58.1 per barrel in October 2017 from 53.4 in April 2017 due in part to the decision by the major oil producing countries to cut down production, amidst increased global demand with the pick up in the global economy (Chart 1b). The proportion of imports of petroleum products in total imports of goods increased to an average of 16.2 percent per month during the six months to October 2017 compared to an average of 15.7 percent per month in the six months to April 2017 (Chart 1b).

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**: Abu Dhabi National Oil Company website and Kenya Revenue Authority*

2.3 Monetary Policy Committee Meetings and Decisions

The MPC held its bi-monthly meetings on May 29, July 17, and September 18, 2017 to review the outcome of its policy decisions and recent economic developments, and to put in place appropriate measures to maintain price stability. The MPC retained the CBR at 10.0 percent during the period in order to continue anchoring inflation expectations. The MPC also continued to monitor the impact of interest rate caps on the effective transmission of monetary policy.

Overall inflation exceeded the Government target range in May, June and August 2017. The CBK wrote letters to the National Treasury during the period explaining: why overall inflation remained above the target range in May 2017, and why it exceeded the target range in August 2017; the measures the MPC and CBK were taking to address the deviation from the target range; and, the expected time period for overall inflation to return to the target band.

The Bank continued to closely monitor the foreign exchange market in view of the risks posed by the prolonged election period on capital flows, and uncertainties in the global financial markets. The CBK's foreign exchange reserves, together with the Precautionary Arrangements with the IMF, equivalent to USD1.5 billion, provided adequate buffers against short term shocks.

The CBK continued to work closely with the National Treasury to ensure coordination of monetary and fiscal policies to maintain macroeconomic stability. Particularly, the execution of the Government domestic borrowing programme continued to support a stable yield curve and market stability.

3. IMPACT OF POLICY ON KEY ECONOMIC INDICATORS

3.1 Inflation

The month-on-month overall inflation fell to 5.7 percent in October from 11.5 percent in April 2017 following significant decreases in food prices (Chart 2a). The decrease in food prices reflected improved weather conditions, and the extension of measures implemented by the Government during the first quarter of 2017 to mitigate the impact of the drought on key food items. These measures included the zero-rating of taxes on maize and bread, and allowing duty free imports of maize and sugar.

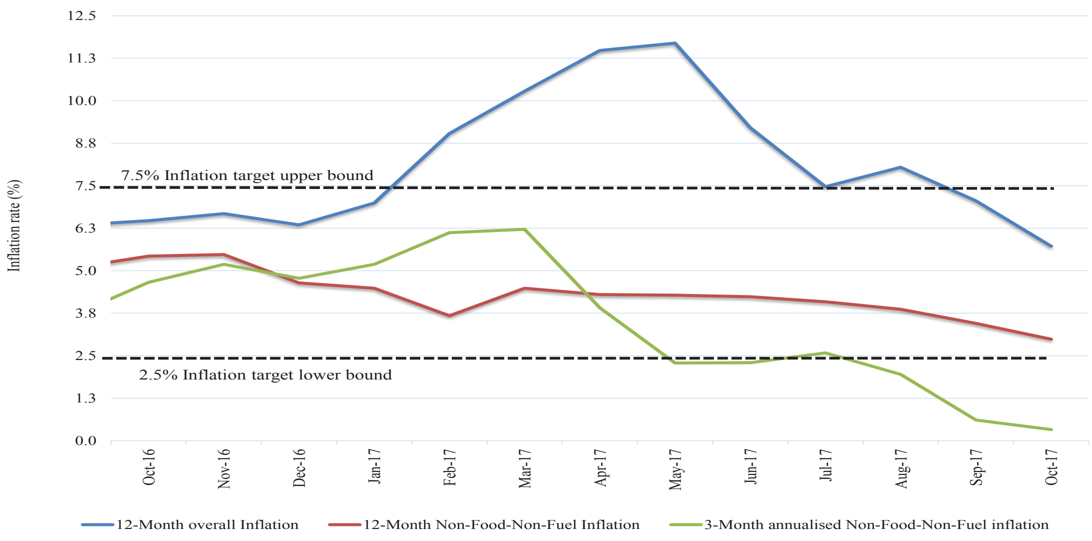
Food inflation fell to 8.5 percent in October 2017 compared with 21.0 percent in April 2017 driven by decreases in the prices of key food items, particularly of cabbages and Irish potatoes which have a combined weight of 1.5 percent in the CPI basket (Chart 2b). Prices of maize grain, maize flour and sugar also recorded significant decreases in the period due to the impact of Government interventions. As a result, the contribution of food and non-alcoholic beverages to overall inflation declined to 3.8 percentage points in October 2017 compared with 9.1 percentage points in April 2017.

Overall inflation rose temporarily in August 2017 reflecting limited supply of some food items, particularly tomatoes, following transport difficulties in the immediate period after the general elections. This, coupled with an unusual increase in demand for some food items such as wheat flour and rice in the period before the elections resulted in a temporary shortage, thereby exerting upward pressure on the prices. Additionally, the contribution of Housing, water, electricity, gas and other fuels in overall inflation rose slightly from 0.50 percentage points in April to 0.60 percentage points in October reflecting increases in the prices of electricity and kerosene. Fuel prices rose slightly in the period reflecting higher international oil prices. Overall inflation remained within the Government target range in September and October 2017.

Demand driven inflationary pressures remained muted between April and October 2017. Non-food-non-fuel (NFNF) inflation declined to 3.0 percent in October 2017 from 4.3 percent in April 2017. The 3-month annualised NFNF inflation also declined to 0.3 percent in October 2017 from 3.9 percent in April 2017, suggesting that there were minimal demand pressures in the economy in the short term (Chart 2a).

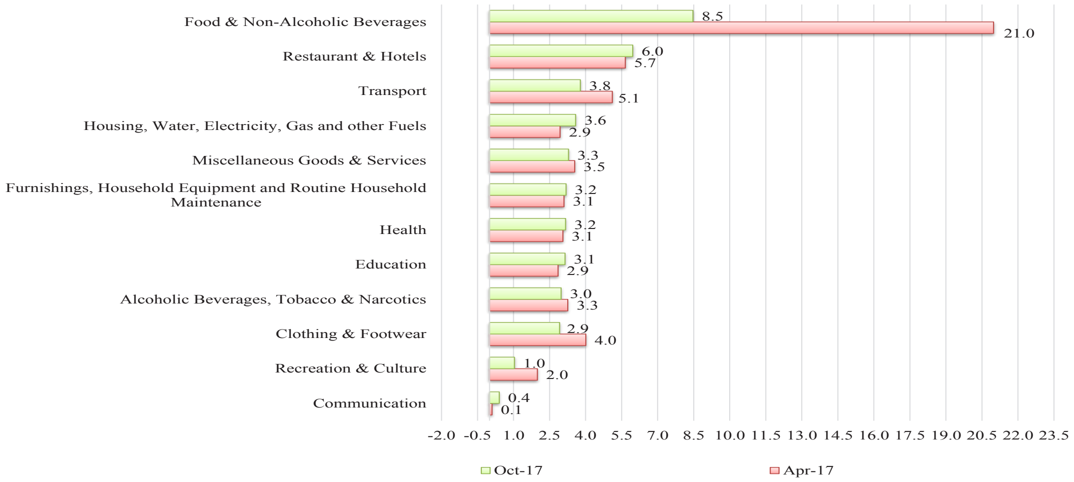
The East African Community (EAC) region, which has a fairly similar composition of the CPI basket, displayed similar trends in respective inflation rates in the period (Chart 2c). Inflation declined in Kenya, Rwanda, Uganda and Tanzania as well as in South Africa largely due to a decline in food prices due to improved weather conditions.

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



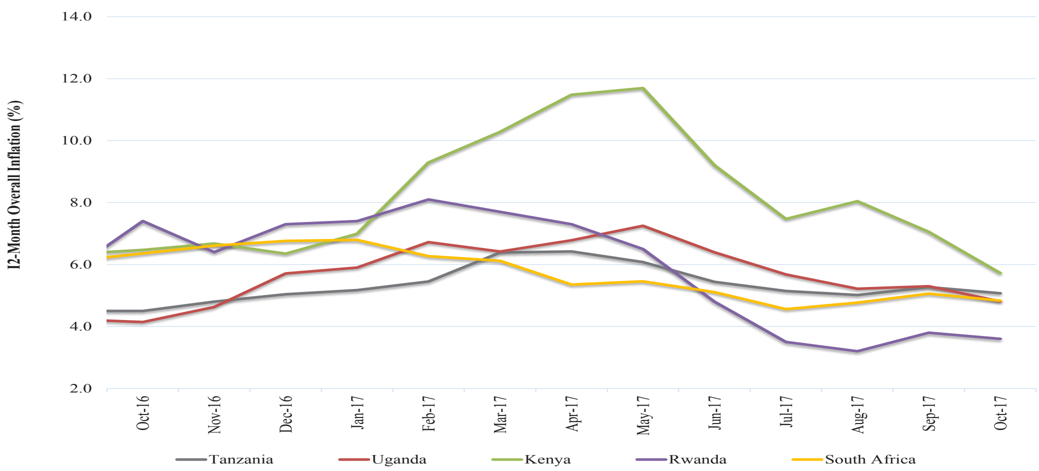
Source: *Kenya National Bureau of Statistics and Central Bank of Kenya*

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



Source: *Kenya National Bureau of Statistics*

Chart 2c: 12-Month Inflation in Selected Countries (%)



Source: *Websites of respective central banks*

3.2 Foreign Exchange Market Developments

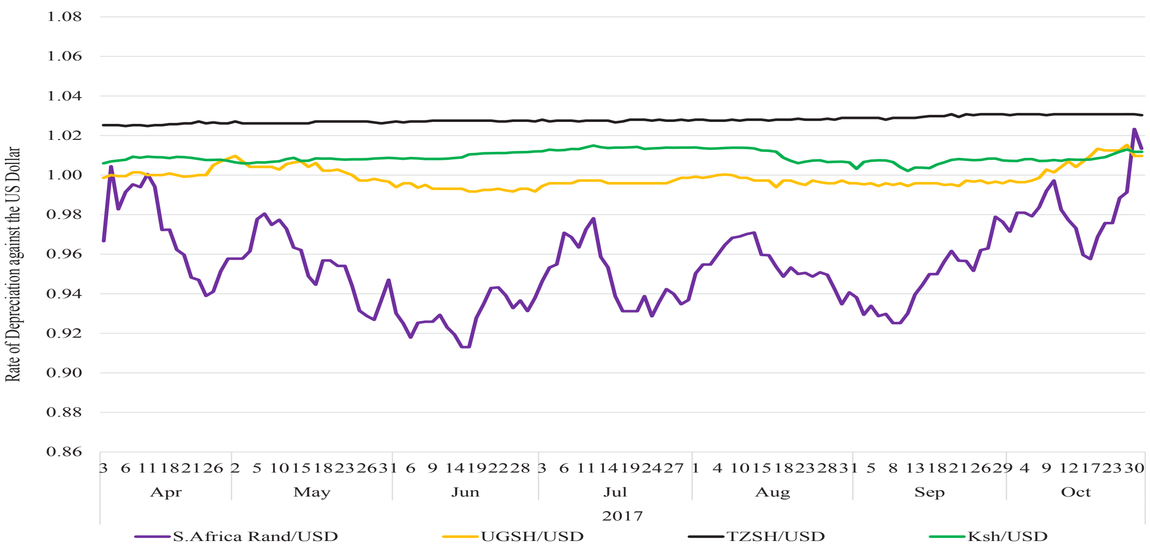
The foreign exchange market remained relatively stable in the six months to October 2017 despite uncertainties in the global financial markets and the prolonged election period in Kenya. The stability was supported by strong diaspora remittances, resilient tea and horticultural exports, and the continued recovery in tourism. However, the 12-month current account deficit widened to 6.5 percent of GDP in October 2017 from 5.9 percent of GDP in April 2017, largely due to higher food and petroleum products imports following the adverse effects of the drought witnessed in the first quarter of 2017, and a rise in international oil prices.

The stability of the foreign exchange market also reflected the resilience and diversified nature of the economy relative to its peers. The Kenyan economy is diversified in terms of export products and external markets, which is a major source of resilience against adverse effects of external shocks on exports. Kenya's exports to East Africa and Africa accounted for 25 percent and 40 percent, respectively, of total exports in the year to October 2017.

The CBK level of usable foreign exchange reserves stood at USD 7.2 billion (4.8 months of import cover) at the end of October 2017 compared with USD8.3 billion (5.5 months of import cover) at the end of April 2017. These reserves, together with the Precautionary Arrangements with the IMF, equivalent to USD1.5 billion, continued to provide an adequate buffer against short term shocks in the foreign exchange market.

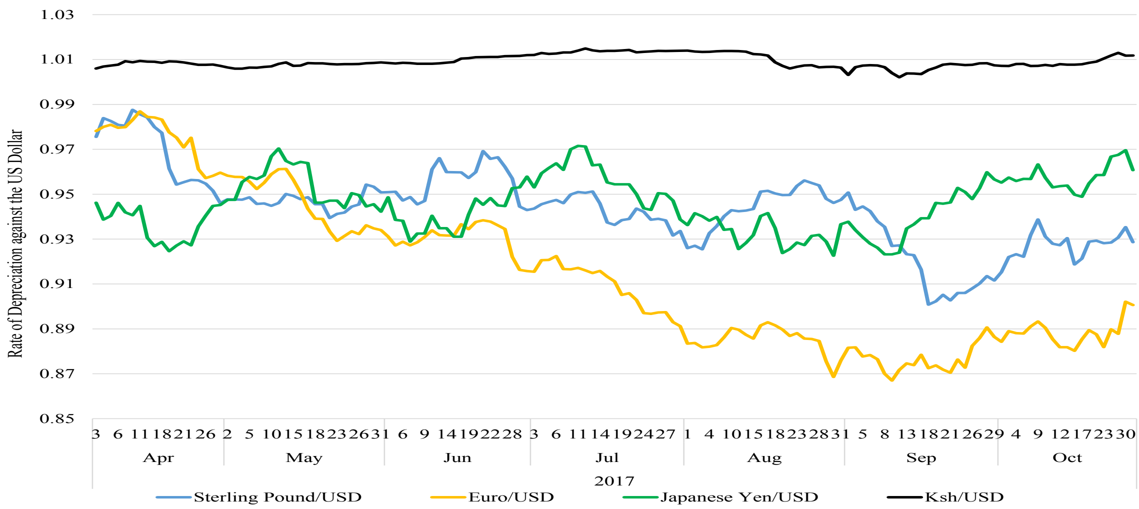
Most major international and some regional currencies were volatile against the U.S. dollar largely due to uncertainties in the global financial markets (Charts 3a and 3b). The uncertainties were particularly with regard to the U.S. economic policies, the post-Brexit resolution and the pace of normalisation of monetary policies in the advanced economies.

Chart 3a: Rate of Depreciation of the Kenya Shilling and Regional Currencies against the U.S. dollar (December 30, 2016 =1)



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

Chart 3b: Rate of Depreciation of the Major International Currencies against the U.S. dollar (December 30, 2016 =1)



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

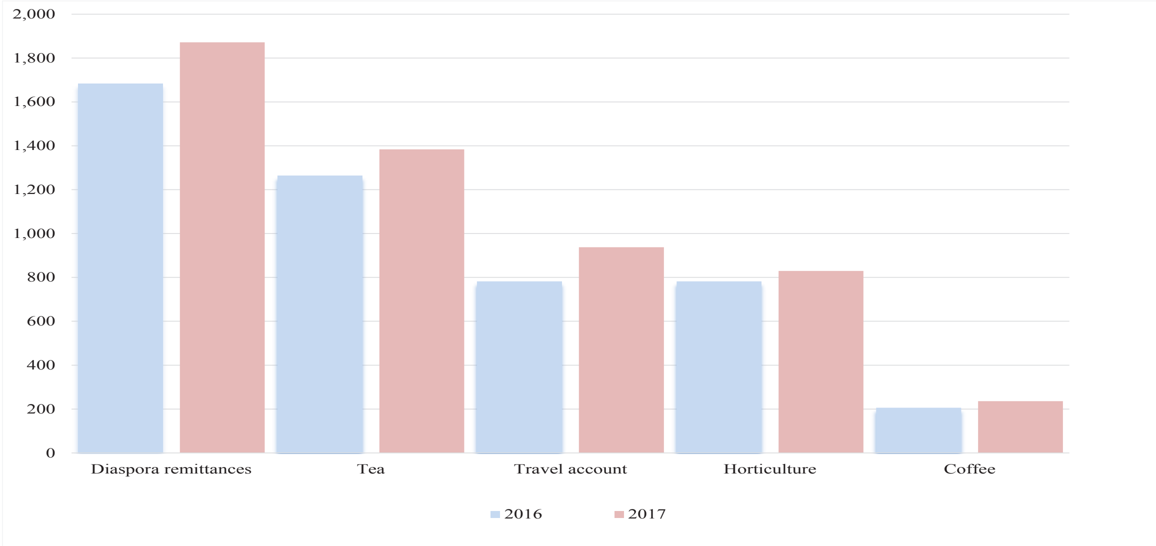
3.3 Balance of Payments Developments

The overall balance of payments position recorded a surplus of USD723 million (0.9 percent of GDP) in the year to October 2017 compared to a deficit of USD958 million (1.4 percent of GDP) in the year to October 2016. This was largely reflected in improvement of the financial account surpluses which more than offset the widening current account deficits. The current account deficit widened to USD5,193 million (6.5 percent of GDP) in the year to October 2017 from USD3,308 million (4.7 percent of GDP) in the year to October 2016 largely due to short-term import demand for food items such as cereals and sugar; petroleum products, and Standard Gauge Railway (SGR) related transport equipment. The financial account surplus improved to USD6,138 million (7.7 percent of GDP) in the year to October 2017 from USD2,802 (4.0 percent of GDP) million in the year to October 2016 largely reflected in foreign direct investments and other investment flows, including the government external borrowings.

The value of merchandise exports declined to USD5,766 million in the year to October 2017 from USD5,785 million in the year to October 2016 largely due to a fall in re-exports and manufactured goods. Receipts from tea, horticulture, coffee, tourism and diaspora remittances remained strong (Chart 4a).The value of merchandise imports increased to USD15,952 million from USD13,394 million in the period. Imports of machinery and transport equipment were higher in the year to October 2017 reflecting the SGR phase 2 related equipment. The petroleum products import bill was also higher in the period reflecting higher international oil prices (Chart 4b).

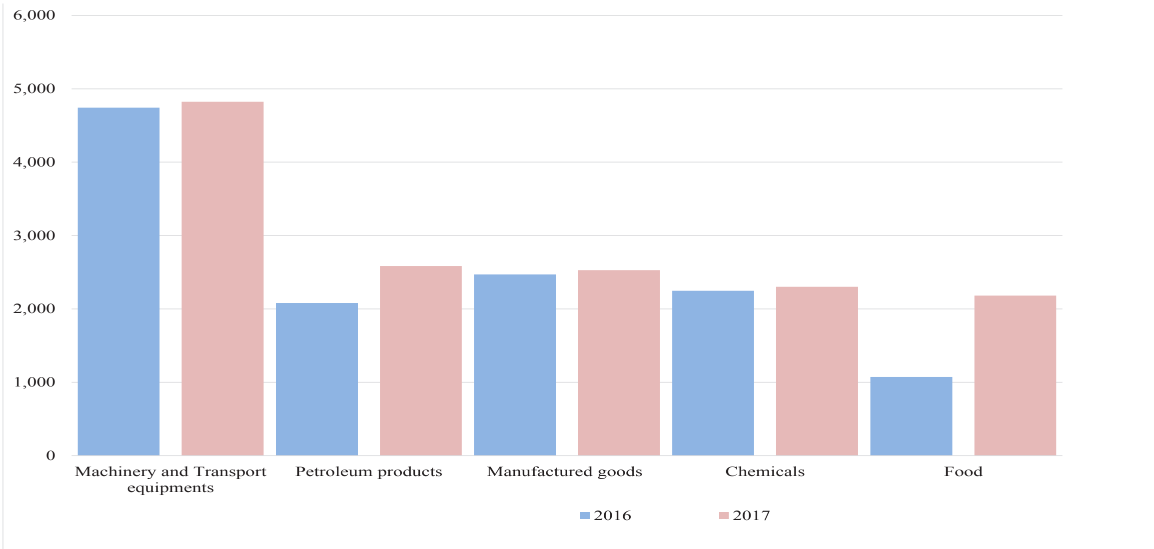
The expected current account deficit for 2017 was revised upwards to 6.2 percent of GDP from 5.8 percent reflecting continued import of food in the second half of 2017 to address the spillover effects of the drought witnessed in the first quarter of 2017, and an increase in the petroleum products import bill due to higher international oil prices. The CBK continued to monitor the impact of Brexit as well as the new U.S. economic policies since these developments have implications on trade and investment.

Chart 4a: Foreign Exchange Inflows from Major Export Categories and Diaspora Remittances in the Year to October (USD Million)



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

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

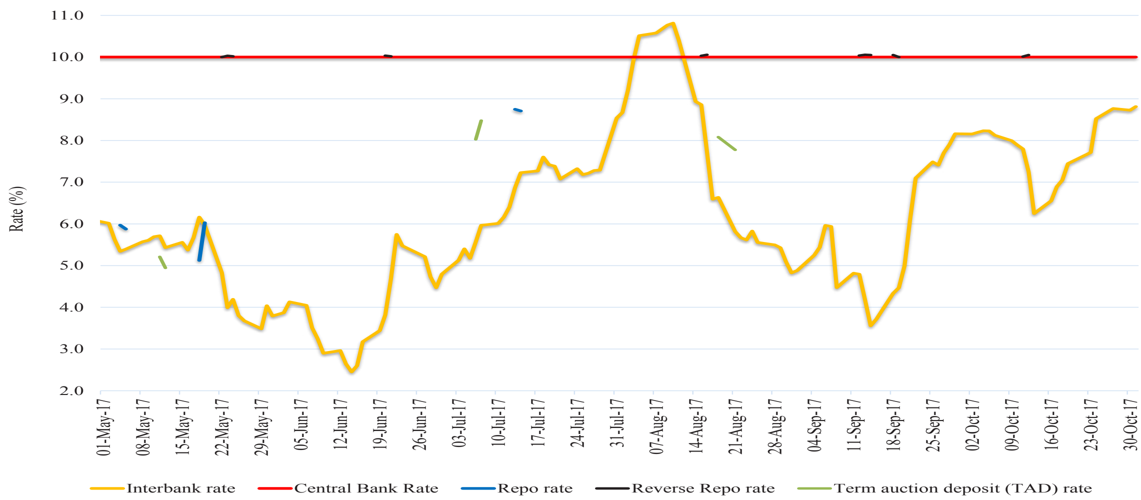


Source: *Kenya Revenue Authority*

3.4 Interest Rates Developments

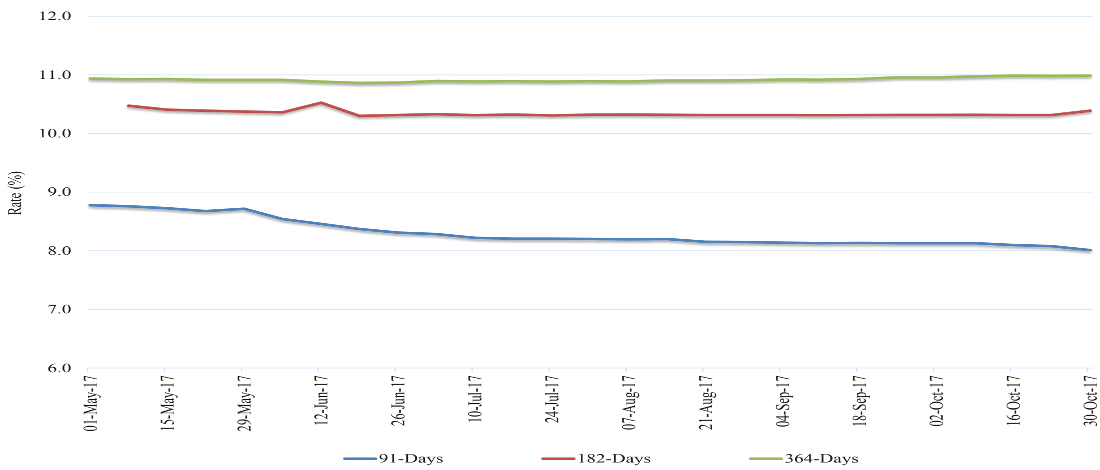
The interbank rate remained below the CBR during the six months to October 2017 reflecting improved liquidity conditions in the market, except around the general election in early August. However, the liquidity distribution remained uneven across the bank tiers due to the segmentation in the interbank 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 5a). The interest rates on Government securities were largely stable during the six months to October 2017, an indication of coordination of monetary and fiscal policies (Chart 5b). The implementation of the Government domestic borrowing programme continued to support market stability and a stable yield curve of Government securities.

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



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

Chart 5b: Average Interest Rates on Treasury Bills (%)



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

3.5 Banking Sector Developments

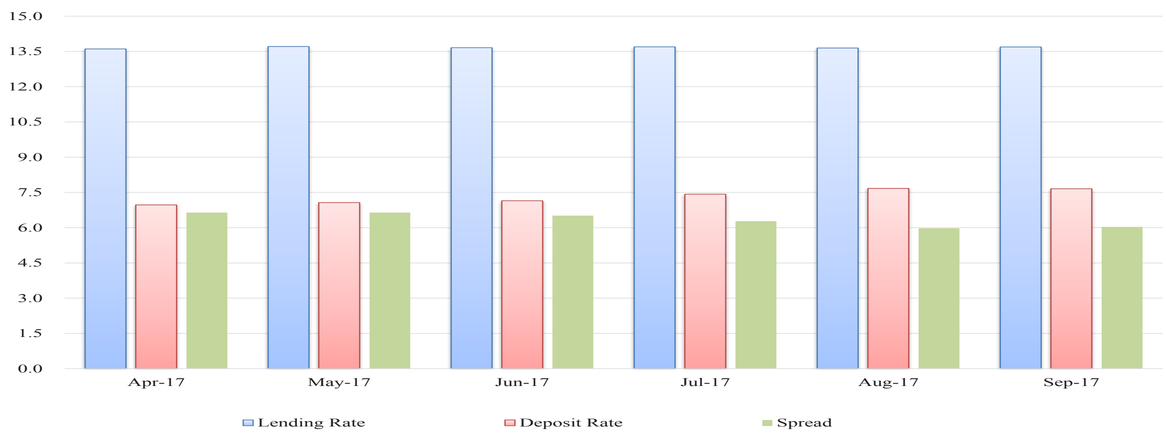
The banking sector was resilient in the six months to October 2017. The average commercial banks liquidity rose to 44.7 percent in October 2017 from 44.4 percent in April 2017. The capital adequacy ratio stood at 18.8 percent in October 2017, the same level as that in April 2017. The ratio of gross non-performing loans (NPLs) to gross loans increased slightly to 10.6 percent in October 2017 compared to 9.6 percent in April 2017 due in part to reclassification of loans in line with the required reporting standards and slower growth of credit. The CBK continued to closely monitor liquidity and credit risks in the sector. The average commercial banks' lending rates remained stable within the interest rate caps during the period (Chart 6). The average deposits rates rose slightly, and remained above the interest rate floor in the period.

The CBK continued to monitor the impact of interest rate capping on the economy as well as on monetary policy effectiveness. The MPC preliminary analyses showed that banks' profitability had declined, with return on assets (ROA) and return on equity (ROE) generally trending downwards from September 2016. Additionally, lending to the Micro, Small and Medium Enterprises (MSMEs), particularly by large and medium banks, slowed down in the period due to perceived risks with respect to lending to the sector. The structure of banks' deposits shifted, on average, towards demand deposits.

The CBK also continued to implement measures aimed at strengthening the sector to ensure greater transparency and stronger governance, and to promote effective business models and innovation. The Bank continued to implement measures to lower the cost of credit on a sustainable basis including promoting innovation in the banking sector leveraging on ICT and strengthening the Credit Reference Bureaus to provide for an effective credit scoring framework. The CBK in collaboration with the Kenya Bankers Association (KBA) launched the Cost of Credit website in June 2017. The website provides information on fees and charges relating to loan products offered by commercial banks and microfinance banks. Full disclosure of credit information facilitates customers to make informed credit decisions; promoting greater transparency in pricing loan products and competition in the banking sector.

The MPC continued to hold meetings with stakeholders in the banking sector during the six months to October 2017. Bi-monthly 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 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 from 2.2 percent in April 2017 to 1.4 percent in July, before reversing the trend to grow by 2.0 percent in October (Table 1). Strong recovery in credit has been recorded in the domestic trade, manufacturing, and real estate sectors, which grew by 12.6 percent, 10.2 percent, and 10.0 percent, respectively to October 2017. Some of the factors attributed to the slowdown in private sector credit growth since August 2015 included reduced credit demand due to weak performance of some sectors of the economy, tightening of banking sector's credit standards, and increased usage of alternative funding sources such as joint ventures in real estate.

The MPC preliminary analyses of the impact of interest rate capping on lending by banks showed a continued slowdown in private sector credit growth and increased lending to corporates. Available data showed that the number of loan applications increased by 17.6 percent between August 2016 and October 2017, but the value of the loan applications decreased by 24.1 percent. This indicates an increase in the number of small size loan applications in the period. Similarly, the number of loan approvals increased by 30.0 percent while their value decreased by 25.7 percent. The CBK continued to monitor the impact of interest rate capping on lending to sectors such as MSMEs, which are perceived to be risky.

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

	Apr-17	May-17	Jun-17	Jul-17	Aug-17	Sep-17	Oct-17
Total Credit to Private Sector	**2.2**	**1.9**	**1.5**	**1.4**	**1.6**	**1.7**	**2.0**
Agriculture	-8.8	-12.6	-12.3	-11.6	-7.6	-2.0	-1.1
Manufacturing	-6.8	-5.2	-7.1	-6.6	3.3	6.1	10.2
Trade	8.0	8.8	10.7	9.0	4.3	6.9	11.5
Building and construction	-2.3	2.5	-0.7	0.5	-1.5	1.8	4.0
Transport and communication	7.6	5.6	3.2	0.6	-2.3	-4.9	-8.2
Finance and insurance	-11.9	-2.8	-4.4	-8.5	5.4	-1.4	-1.3
Real estate	13.2	11.8	10.1	11.8	9.7	8.9	10.0
Mining and quarrying	-34.2	-39.5	-37.8	-41.0	-7.6	-0.8	9.2
Private households	10.4	9.8	10.9	12.1	6.2	1.9	2.9
Consumer durables	11.9	11.3	7.5	3.3	-1.6	-0.5	0.1
Business services	-15.1	-21.8	-15.8	-10.8	-6.5	-6.4	-19.2
Other activities	-19.8	-20.0	-25.0	-28.1	-27.4	-28.6	-35.0

Source*: Central Bank of Kenya*

4. OTHER ACTIVITIES OF THE MONETARY POLICY COMMITTEE

The MPC held regular stakeholder forums between May and October 2017 aimed at enhancing understanding the background and impact of 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 CBK commissioned studies on the impact of interest rate capping on the economy, and factors driving the slowdown in private sector credit growth since August 2015. Preliminary findings of the studies were presented to the MPC.

The Governor 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. The Governor and MPC Members also held meetings with potential investors in order to brief them on 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 October 2017 moderated demand-driven inflationary pressures, while stability of the exchange rate moderated any possible effects of imported inflation on the price level. The CBK will continue to monitor the transmission of the policy interventions and their impact on consumer prices.

Coordination of monetary and fiscal policies coupled with regular forum with stakeholders in the financial sector will continue to support market stability. The MPC will continue to monitor the impact of interest rate capping on lending and the overall economy, as well as the implications of other developments in the domestic and global economy to ensure price stability.

APPENDIX: CHRONOLOGY OF EVENTS OF PARTICULAR RELEVANCE TO MONETARY POLICY (MAY TO OCTOBER 2017)

May 2017	The Central Bank Rate (CBR) was retained at 10.0 percent in order to anchor inflation expectations.
June 2017	The Government of Kenya launched M-Akiba, a mobile based retail infrastructure bond that aims to enhance financial inclusion for economic development.
July 2017	The Central Bank Rate (CBR) was retained at 10.0 percent in order to continue anchoring inflation expectations.
August 2017	General elections in Kenya.
September 2017	The Central Bank Rate (CBR) was retained at 10.0 percent in order to continue anchoring inflation expectations.
October 2017	Repeat Presidential elections in Kenya following nullification of the August results by the Supreme Court

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 borrow from the Window as a measure of 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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