



Central Bank of Kenya

Monetary Policy Statement

December 2020





LETTER OF TRANSMITTAL

In accordance with Section 4B of the Central Bank of Kenya Act, it is my pleasure to present to you, Honourable Cabinet Secretary of the National Treasury and Planning, the 47th Monetary Policy Statement of the Central Bank of Kenya. It reviews and assesses the implementation of monetary policy during the second half of 2020, and outlines the direction of monetary policy for the next twelve months.

Dr. Patrick Njoroge

Governor

CONTENTS

LETTER OF TRANSMITTAL.....	I
THE PRINCIPAL OBJECTIVES OF THE CENTRAL BANK OF KENYA.....	III
INSTRUMENTS AND TRANSMISSION OF MONETARY POLICY.....	III
EXECUTIVE SUMMARY.....	V
1. INTRODUCTION.....	1
2. ACTIONS AND OUTCOMES OF THE POLICY STANCE IN THE SECOND HALF OF 2020.....	2
3. THE EXTERNAL ECONOMIC ENVIRONMENT AND OUTLOOK FOR 2021	11
4. DIRECTION OF MONETARY POLICY IN 2021.....	14
ANNEX: EVENTS OF PARTICULAR RELEVANCE TO MONETARY POLICY (JULY - DECEMBER 2020).....	15
GLOSSARY OF KEY TERMS.....	16

THE PRINCIPAL OBJECTIVES OF THE CENTRAL BANK OF KENYA

The role of the Central Bank of Kenya (CBK) is anchored in Section 231 of Kenya's Constitution and in the CBK Act. The CBK is responsible for formulating monetary policy to achieve and maintain price stability, and issuing currency.

The Bank also promotes financial stability through regulation, supervision and licensing of financial institutions under its mandate. It also provides oversight of the payments, clearing and settlement systems, and fosters liquidity, solvency and proper functioning of the financial system. The CBK formulates and implements the foreign exchange policy, and manages foreign exchange reserves. It is also the banker for, adviser to, and fiscal agent of the Government.

The CBK's monetary policy is designed to support the Government's objectives with respect to growth. The CBK formulates and conducts monetary policy with the aim of keeping overall inflation within the target prescribed by the National Treasury at the beginning of the financial year. Currently, this target is a range between 2.5 percent and 7.5 percent.

The achievement and maintenance of a low and stable inflation rate coupled with adequate liquidity in the market, facilitates higher levels of domestic savings and private investment. This leads to improved economic growth, higher real incomes and increased employment opportunities.

INSTRUMENTS AND TRANSMISSION OF MONETARY POLICY

The CBK pursues its monetary policy objectives using the following instruments:

- **Open Market Operations (OMO):** This refers to actions by the CBK involving purchases and sales of eligible securities to regulate the money supply and the credit conditions in the economy. OMO can also be used to stabilise short-term interest rates. When the Central Bank buys securities on the open market, it increases the reserves of commercial banks, making it possible for them to expand their loans and hence increase the money supply. To achieve the desired level of money supply, OMO is conducted using:
 - i. **Repurchase Agreements (Repos):** A repo is a collateralized loan involving a contractual arrangement between two parties, in which one party sells a security at a specified price with a commitment to buy the security back at a later date. Both parties therefore, meet their investment goals of secured funding and liquidity. CBK Repos are conducted through auctions with tenors of 3 and 7 days and are for mopping up liquidity from the market. The Late Repo, sold in the afternoon, has a 4-day tenor and is issued at 100 basis points below the repo rate of the day. Reverse Repos, on the other hand, are for liquidity injections and involve purchase of securities from commercial banks. The current tenors for Reverse Repos are 7, 14, 21, 28 and 91 days.
 - ii. **Term Auction Deposit (TAD):** The TAD is used when the securities held by the CBK for Repo purposes are exhausted or when CBK considers it desirable to offer longer dated tenors. TAD is essentially not backed by collateral and it is conducted through an auction, similar to Repos. Currently, the tenors for such deposits at CBK are 14, 21, 28 or 91 days and upon maturity of TAD, the CBK credits the respective commercial bank with the deposit and interest.
 - iii. **Horizontal Repos:** Horizontal Repos are modes of improving liquidity distribution between commercial banks, and are conducted under CBK supervision. They are transacted between commercial banks on the basis of signed agreements using government securities as collateral, and have negotiated tenors

and yields. Commercial banks, short of deposits at the CBK, borrow from banks with excess deposits on the security of an appropriate asset, normally a government security. Horizontal Repos also help banks overcome the problem of limits to lines of credit, thus promoting more efficient management of interbank liquidity.

- **Central Bank Rate (CBR):** The CBR is reviewed and announced by the Monetary Policy Committee (MPC) at least every two months. Movements in the CBR, both in direction and magnitude, signal the monetary policy stance. In order to enhance clarity and certainty in monetary policy implementation, the CBR is the base for all monetary policy operations. Whenever the Central Bank is injecting liquidity through a Reverse Repo, the CBR is the lowest acceptable rate by law. Likewise, whenever the Bank wishes to withdraw liquidity through a Vertical Repo, the CBR is the highest rate that the CBK will pay on any bid received. However, to ensure flexibility and effectiveness of monetary policy operations in periods of volatility in the market, the CBK can raise the maximum acceptable interest rates on TAD to above the CBR. Movements in the CBR are transmitted to changes in short-term interest rates. A reduction of the CBR signals an easing of monetary policy and a desire for market interest rates to move downwards. Lower interest rates encourage economic activity and thus growth. When interest rates decline, the quantity of credit demanded should increase.

The efficiency in the Repo and interbank markets is crucial for the transmission of monetary policy decisions. The CBK monitors the overnight interbank money market. It responds to the tightness or slackness in the interbank market liquidity through OMO. Short-term international flows of capital are affected by short-term interest rates in the country. These are, in turn, affected by movements in the CBR and hence indirectly, the exchange rate could also be affected.

- **Standing Facilities:** The CBK does not have automatic standing facilities with respect to overnight lending. The CBK, as lender of last resort, provides secured loans to commercial banks on an overnight basis at a penal rate that is over the CBR. This facility is referred to as the Discount Window. Access to the Window is governed by rules and guidelines which are reviewed from time to time by the CBK. Banks making use of this facility more than twice in a week are scrutinised closely, and supervisory action taken.
- **The Cash Reserves Ratio (CRR):** In accordance with the law, the CRR is the proportion of a commercial bank's total deposit liabilities which must be held as deposits at CBK. These deposits are held in the CRR Account at no interest. The ratio is currently 4.25 percent of the total of a bank's domestic and foreign currency deposit liabilities. To facilitate commercial banks' liquidity management, commercial banks are currently required to maintain their CRR based on a daily average level from the 15th of the previous month to the 14th of the current month and not to fall below a CRR of 3 percent on any day.
- **Licensing and Supervision of Financial Institutions:** The CBK uses the licensing and supervision tools to ensure stability and efficiency of the banking system; this includes vetting potential managers for suitability.
- **The National Payments System:** The modernisation of the National Payments System has continued to lower transaction costs and enhanced the efficiency of the payments systems. This has ensured the effectiveness of monetary policy instruments.
- **Communication:** The increasing use of communication media ensures a wider dissemination of monetary policy decisions and background data thereby increasing the efficiency of information transmission and managing expectations. The regular interaction between the MPC and the Chief Executive Officers of banks has ensured that monetary policy decisions are transmitted to the banking sector. The regular Governor's Press Conferences have also enhanced the media understanding of monetary policy decisions. The CBK website is an important source of up-to-date data on all aspects of the financial market including interest rates, exchange rates, results of auctions of government securities, and the MPC releases.

EXECUTIVE SUMMARY

This Monetary Policy Statement provides the direction of monetary policy in 2021. It also reviews the outcome of the monetary policy stance adopted in the second half of 2020, against a backdrop of the continuing global COVID-19 (coronavirus) pandemic, and measures taken by authorities around the world to contain its spread and impact. The global economic outlook remained highly uncertain in 2020, largely due to resurgence in COVID-19 infections in the advanced economies. The pace of recovery of the global economy in the second half of 2020 was dampened by the re-introduction of containment measures in some countries. However, global business sentiment improved especially in the last quarter, with announcements of COVID-19 vaccines, and the conclusion of the U.S. elections.

During the period, CBK conducted monetary policy with the aim of keeping overall inflation within the target range of 5 ± 2.5 percent. Monetary policy in the period was also aimed at supporting economic activity through accommodative policy to support banks' lending to the private sector to mitigate the adverse effects of COVID-19 on the economy. The MPC retained the CBR at 7.00 percent throughout the period, and ensured that the interbank market remained liquid and continued to function smoothly. Overall inflation remained within the target range, supported by lower food prices, the impact of the reduction of VAT and muted demand pressures. The inflation rate stood at 5.6 percent in December compared to 4.6 percent in June. Non-food-non-fuel (NFNF) inflation remained below 5 percent, indicating muted demand pressures in the economy.

The foreign exchange market remained relatively stable, despite continued uncertainties in the global financial markets due to the impact of COVID-19 pandemic. This stability was supported by a narrowing in the current account deficit and an adequate reserve buffer. The current account deficit narrowed to 4.7 percent of GDP in the 12-months to November 2020 from 5.4 percent of GDP in a similar period in 2019, reflecting lower merchandise imports attributed to lower oil imports, improved tea exports, a rebound of horticulture exports and resilient remittances. The CBK foreign exchange reserves, which stood at USD 7,750.5 million (4.76 months of import cover) at the end of December 2020, continued to provide an adequate buffer against short-term shocks in the foreign exchange market.

The banking sector remained stable and resilient during the period, with strong liquidity and capital adequacy ratios. The CBK continued to monitor the impact of the package of measures deployed since March to mitigate the adverse impact of the pandemic on the sector and on businesses. These measures have provided the intended relief to borrowers, facilitated increased usage of digital platforms and supported smooth operation of the sector during the crisis. As at end December, loans amounting to KSh 1.63 trillion had been restructured (54.3 percent of the total banking sector loan book) while KSh 32.6 billion (92.7 percent of the KSh 35.2 billion freed from the reduction in CRR) had been used to assist borrowers affected by COVID-19. A significant increase in mobile money usage was also noted, with the monthly volume of person-to-person transactions increasing by 87 percent between February and October 2020 while the volume of transactions below KSh 1,000 increased by 114 percent.

Credit to the private sector credit remained resilient during the period, growing by 8.4 percent in the 12 months to December, compared to 7.7 percent in June. Strong credit growth was recorded in the manufacturing, consumer durables, transport and communication, agriculture, real estate and private household sectors. Leading indicators for the Kenyan economy pointed to a recovery in the second half of 2020, from the disruptions witnessed in the second quarter. Real GDP is estimated to have contracted by 0.4 percent in the first half, reflecting the adverse impact of the COVID-19 pandemic in the second quarter on services sector, particularly education, transport and storage, and accommodation and restaurant services. The contraction was partly offset by strong growth recorded in agriculture, health, ICT, and the financial and insurance sectors. The resilience in the second half of 2020 was supported by agriculture, a recovery in manufacturing, exports, and services following the easing of COVID-19 restrictions as well as the impact of policy interventions.

In 2021, the monetary policy stance will aim at maintaining overall inflation rate within the target range of 5 ± 2.5 percent, and supporting post COVID-19 economic recovery. The foreign exchange market is expected to remain stable consistent with a favourable outlook for the external sector. The current account deficit is projected to remain relatively stable at 5.2 percent of GDP in 2021 and 5.3 percent in 2022 compared to 5.1 percent in 2020. Overall, the continued coordination of monetary and fiscal policies is expected to sustain macroeconomic stability and revamp the economy during the post COVID-19 period. Consistent with inflation and growth objectives, monetary policy will aim at supporting growth in broad money (M3) and credit to the private sector of about 12.1 percent and 11.3 percent respectively, by December 2021. Private sector credit growth is expected to gain momentum in 2021 following the operationalisation of a Credit Guarantee Scheme for Micro, Small and Medium sized Enterprises (MSMEs).

The Bank will continue to monitor the risks posed by developments in the domestic and global economies on the overall price stability objective. The Bank will also continue to closely monitor the economic impact of COVID-19 and the outcomes of policy measures in place as well as other developments in the domestic and global economies to safeguard price stability.

1. INTRODUCTION

This Monetary Policy Statement (MPS) provides the direction of monetary policy for the year 2021. It also presents the outcome of the monetary policy stance adopted in the second half of 2020.

Price stability remains the primary objective of monetary policy formulation and implementation. The Central Bank Rate (CBR) signals the monetary policy stance, and is the base for all monetary policy operations. The Bank monitors targets for key monetary aggregates such as broad money (M3) and credit to the private sector. The Bank maintains a flexible exchange rate regime. The Bank's participation in the foreign exchange market is guided by the need to maintain adequate level of foreign exchange reserves, meeting the Government's external obligations, and ensuring stability in the foreign exchange market. The CBK foreign exchange reserves provide a buffer against short-term shocks.

The global economic outlook for 2020 remained highly uncertain, largely due to the unpredictability of the COVID-19 pandemic. After the sharp contraction in the first half of 2020, a gradual recovery in global economic activity was recorded in the second half, reflecting the impact of the lifting of containment measures and effects of the fiscal and monetary policy interventions. However, the pace of recovery was dampened by the re-introduction of containment measures in some countries following a resurgence

in COVID-19 infections. Nonetheless, global business sentiment improved especially in the last quarter of the year with the announcements of COVID-19 vaccines, and the conclusion of the U.S. elections.

The CBK continued to monitor the impact of the policy measures deployed since March 2020 to mitigate the adverse economic effects and financial disruptions from the pandemic. During its meetings of September and November the MPC noted that the package of policy measures were having the intended effect on the economy, and would be augmented by the announced fiscal measures for FY 2020/21. In particular, the emergency measures implemented in the banking sector continued to provide the intended relief to borrowers, facilitated increased usage of digital platforms and supported smooth operation of the sector during the crisis. Private sector credit growth remained resilient, supported by accommodative monetary policy.

The rest of this Policy Statement is organized as follows. Section 2 reviews the outcome of the monetary policy stance implemented in the second half of 2020 while Section 3 describes the external economic environment and outlook for the 2021. Section 4 concludes by outlining the direction of the monetary policy in 2021.

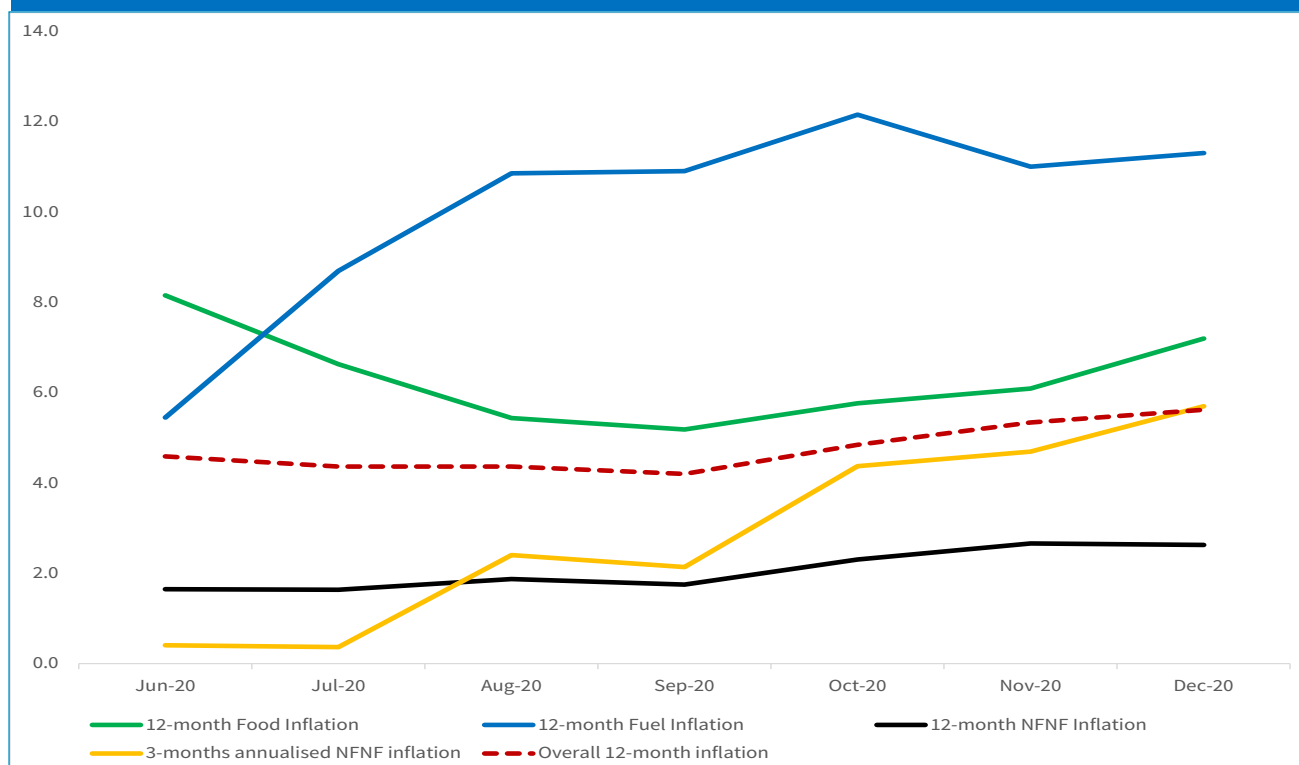
2. ACTIONS AND OUTCOMES OF THE POLICY STANCE IN THE SECOND HALF OF 2020

During the second half of 2020, monetary policy formulation and implementation was aimed at maintaining overall inflation at the target of 5.0 percent with a flexible margin of 2.5 percent on either side. The stance of monetary policy also aimed at mitigating the adverse economic effects and financial disruptions from the COVID-19 (coronavirus) pandemic. During the Monetary Policy Committee (MPC) meetings in July, September and November 2020, the Committee retained the Central Bank Rate (CBR) at 7.00 percent, observing that the package of policy measures adopted since March were having the intended effect on the economy, and that these measures would be augmented by the announced fiscal measures for FY 2020/21. The following are the specific outcomes of the policy stance:

i. Inflation

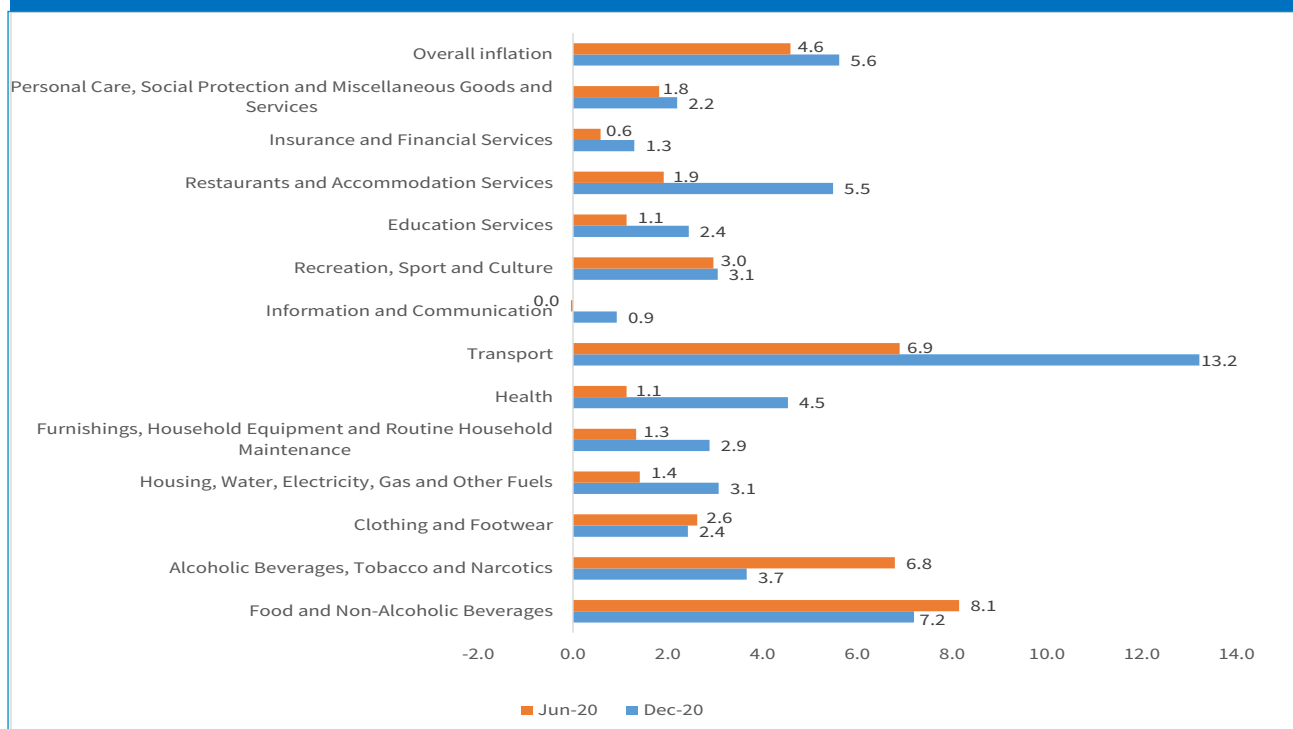
Overall inflation remained well anchored within the medium term target range in the second half of 2020 (**Chart 1a**). The inflation rate stood at 5.6 percent in December 2020 compared to 4.6 percent in June 2020, mainly driven by rising fuel inflation. Fuel inflation increased to 11.3 percent in December from 5.4 percent in June as the cost of transport increased due to the impact of measures introduced by the government to contain the spread of COVID-19. However, food inflation declined to 7.2 percent from 8.1 percent in the period, largely due to declines in prices of key food items due to favourable weather conditions. Inflation rates for all the broad CPI categories except transport, remained within the target range in December (**chart 1b**). Non-Food-Non-Fuel (NFnF) inflation remained low and stable below 5 percent, consistent with the muted demand pressures in the economy.

Chart 1a: Inflation in Broad Measures (Percent)



Source: Kenya National Bureau of Statistics and CBK

Chart 1b: 12-Month Inflation by Broad CPI Categories (Percent)



Source: Kenya National Bureau of Statistics

ii. Bank Credit to the Private Sector

Private sector credit remained resilient in the second half of 2020, growing by 8.4 percent in the 12 months to December 2020, compared to 7.7 percent in June (Table 1). This was supported by recovery in demand with the improved economic activity following the easing of COVID-19 containment measures, and accommodative monetary policy. Strong growth in credit was observed in the manufacturing, consumer

durables, transport and communication, real estate and finance and insurance sectors.

iii. Developments in the other Monetary Aggregates

The 12-month growth of broad money, M3, increased to 13.2 percent in December from 8.4 percent in June 2020, supported by increase in net domestic assets

Table 1: 12-Month Growth in Private Sector Credit across Sectors (Percent)

Main sectors	Jun-20	Jul-20	Aug-20	Sep-20	Oct-20	Nov-20	Dec-20
Agriculture	2.2	1.1	0.9	1.7	17.0	19.3	15.3
Manufacturing	11.1	10.0	13.1	12.6	7.8	10.0	12.0
Trade	9.4	9.1	8.1	6.6	2.5	4.0	3.8
Building and construction	4.6	5.5	5.2	4.1	8.2	7.4	3.4
Transport and communication	14.9	20.7	19.0	20.6	21.1	17.5	13.6
Finance and insurance	3.2	3.5	4.6	-3.3	-2.2	0.2	7.1
Real estate	4.9	5.0	6.8	6.6	7.6	9.1	8.7
Mining and quarrying	10.0	11.3	12.0	8.2	-14.2	-15.4	-12.9
Private households	3.6	5.4	5.1	3.5	7.3	6.2	4.3
Consumer durables	15.2	13.8	13.7	15.6	15.7	18.8	18.1
Business services	5.3	3.2	3.4	4.1	5.9	2.7	4.0
Other activities	-3.7	-6.7	-7.6	-5.8	-10.4	-14.5	14.0
Total private sector credit	7.7	7.9	8.3	7.6	7.7	8.1	8.4

Source: Central Bank of Kenya

(NDA) of the banking system. The expansion in NDA of the banking system was attributed to growth in private sector credit and net lending to the government. On the liabilities side, the growth of money supply was

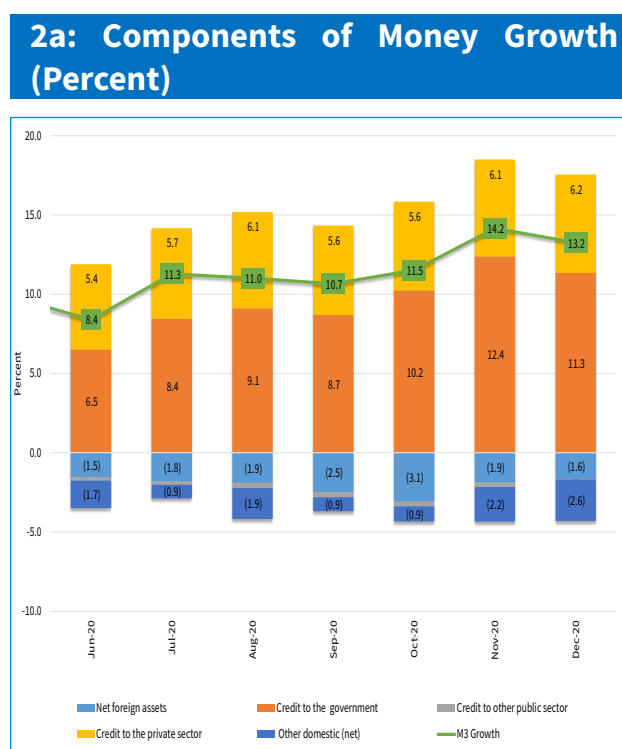
reflected in household and corporate sector deposits and currency outside banks (**Chart 2**). Overall, monetary aggregates grew at a relatively slower pace compared to their respective targets (**Table 2**).

Table 2: Actual and Targeted Growth in Key Monetary Aggregates

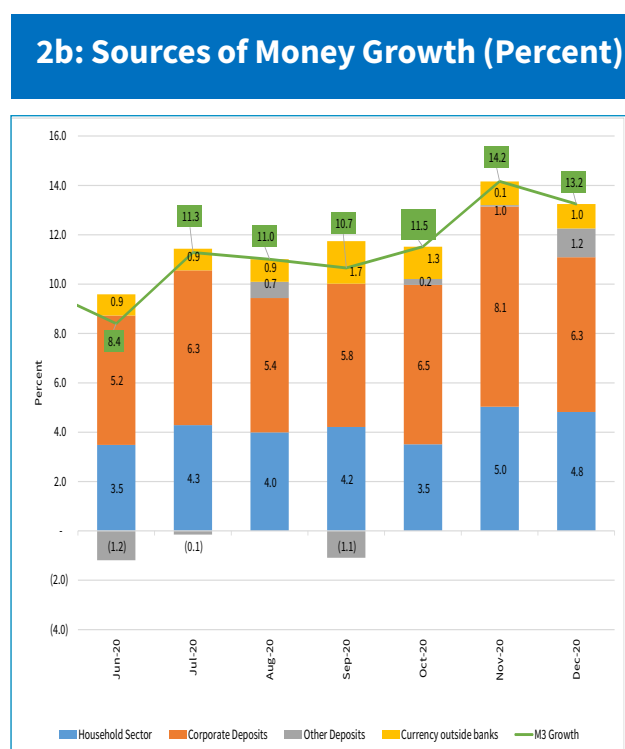
	Jun-20	Jul-20	Aug-20	Sep-20	Oct-20	Nov-20	Dec-20
Actual Broad Money, M3 (Ksh Billion)	3,863.6	3,905.4	3,847.0	3,843.5	3,922.7	3,952.3	3,990.9
Target (Ksh Billion)	3,906.6	3,834.0	3,794.3	3,825.4	3,873.8	3,842.2	3,897.3
Actual Reserve Money (Ksh Billion)	426.9	461.9	476.5	452.2	445.0	461.3	469.9
Target (Ksh Billion)	442.9	434.6	431.6	445.1	459.7	462.5	479.4
Actual Net Foreign Assets of CBK (Ksh Billion)	918.1	883.5	842.9	804.9	762.3	753.6	738.5
Target (Ksh Billion)	834.4	848.7	819.5	815.8	797.2	774.3	756.1
Actual Net Domestic Assets of CBK (Ksh Billion)	-491.2	-421.5	-366.4	-352.7	-317.3	-292.3	-268.6
Target (Ksh Billion)	-391.5	-414.0	-387.9	-370.6	-337.6	-311.8	-276.7
Actual Credit to private sector (Ksh Billion)	2,695.0	2,728.8	2,751.8	2,768.6	2,779.6	2,812.8	2,813.1
Target (Ksh Billion)	2,707.0	2,723.6	2,750.1	2,790.6	2,815.0	2,834.2	2,849.4
Memorandum Items							
12-month growth in actual Reserve Money (Percent)	-2.9	9.1	13.2	10.9	7.8	8.0	8.4
12-month growth in actual Broad Money, M3 (Percent)	8.4	11.3	11.0	10.7	11.5	14.2	13.2

Source: Central Bank of Kenya

Chart 2: The 12-Month Growth in Broad Money Supply (M3) (Percent)



Source: Central Bank of Kenya



Source: Central Bank of Kenya

iv. Interest Rates Developments

a. Central Bank Rate (CBR)

The MPC retained the CBR at 7.00 percent during the second half of 2020, noting that the package of policy measures adopted since March was having the intended effect on the economy, and that these measures were being augmented by the announced fiscal measures for FY 2020/21. Additionally, the CBK ensured that the interbank market remained liquid and continued to function smoothly, and closely monitored the evolution of COVID-19.

b. Short Term Rates

Short-term interest rates generally declined in the second half of 2020, supported by accommodative monetary policy stance and improved market liquidity (**Table 3**). The liquidity in the market was also attributable to increased government spending especially towards the end of the financial year, including payments of pending bills and COVID-19 related expenditures. Interest rates on government securities declined. The average 91-day Treasury bill rate declined to 6.90 percent in December from 7.14 percent in June, while the average 182-day Treasury bill rate decreased to 7.38 percent from 7.93 percent. The average interbank interest rate remained

relatively low in the period, but rose to 5.29 percent in December partly reflecting increased demand for cash during the end year festivities.

c. Commercial Bank Rates

Commercial banks' average interest rates declined in line with the monetary policy stance. The average commercial bank lending rate declined, to a historic low of 11.75 percent in September from 11.89 percent in June, and thereafter stabilized at 11.99 percent in November. The average deposit rate declined to 6.31 percent in November from 6.86 percent in June. The interest spread increased from 5.02 percent to 5.68 percent.

v. Banking Sector Developments

The banking sector remained stable and resilient in the second half of 2020, with strong liquidity and capital adequacy ratios. The average commercial banks liquidity and capital adequacy ratios stood at 54.6 percent and 19.2 percent in December compared to 52.7 percent and 18.5 percent in June, respectively. The ratio of gross non-performing loans (NPLs) to gross loans stood at 13.6 percent in December from 13.1 percent in June, with increases in NPLs recorded in the transport and communication, energy and water, tourism, restaurant and hotels, and real estate

Table 3: Interest Rates (Percent)

	Dec	Mar	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Central Bank Rate	8.50	7.25	7.00	7.00	7.00	7.00	7.00	7.00	7.00
Interbank	6.03	4.40	3.27	2.12	2.56	2.95	2.69	3.27	5.29
Repo	7.45	6.13	3.50	3.84	3.59	3.18	3.97	6.64	6.87
91-Tbill	7.17	7.29	7.14	6.24	6.20	6.29	6.49	6.69	6.90
182-Tbill	8.16	8.14	7.93	6.69	6.56	6.70	6.89	7.11	7.38
Average Lending Rate (1)	12.24	12.09	11.89	11.94	11.94	11.75	11.98	11.99	
Overdraft/loan	11.67	11.79	11.24	11.18	11.18	11.15	11.44	11.39	
1-5years	12.50	12.20	12.07	12.11	12.08	11.62	12.07	12.11	
Over 5years	12.29	12.11	11.98	12.10	12.12	12.12	12.12	12.11	
Average Deposit Rate (2)	7.11	7.07	6.86	6.78	6.63	6.41	6.26	6.31	
Demand	1.52	1.52	1.47	1.53	1.79	1.39	1.49	1.54	
0-3months	7.60	7.42	7.11	7.01	6.77	6.47	6.44	6.42	
Over 3months	7.50	7.56	7.40	7.31	7.20	7.07	6.79	6.93	
Savings	4.02	4.15	4.15	4.11	4.10	3.78	3.38	3.42	
Spread (1-2)	5.14	5.02	5.02	5.16	5.30	5.34	5.72	5.68	

Source: Central Bank of Kenya

sectors. The increase in NPLs was mainly attributed to disruptions in business activity due to the pandemic, delayed payments to contractors and low occupancy of housing and commercial units.

The CBK continued to monitor the impact of a series of emergency measures deployed since March to mitigate the health and economic effects of the pandemic. In Particular, these measures were intended to: encourage the use of digital financial platforms; cushion borrowers especially MSMEs through flexibility in loan repayments, loan provisioning, classification and suspension of negative credit listing; support operations of the financial institutions by ensuring adequate liquidity; and ensure that the sector continued to operate smoothly during the pandemic period.

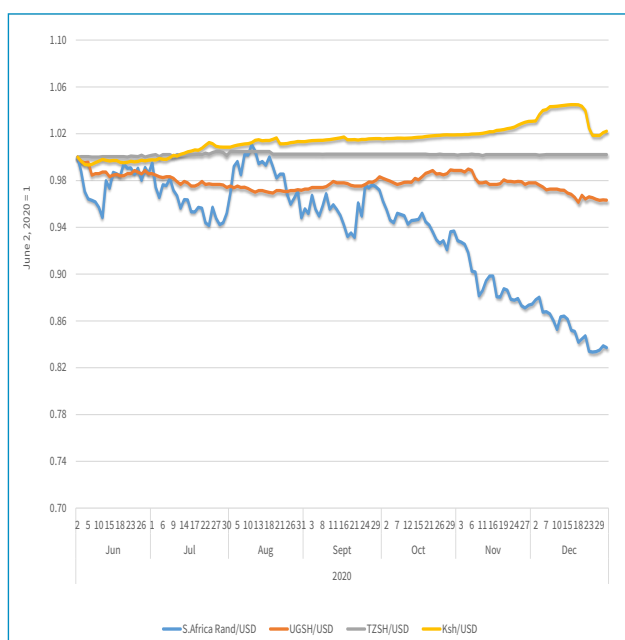
Available data shows that these measures were timely and effective. As at end December, loans amounting to KSh 1.63 trillion (54.3 percent of the total banking sector loan book) had been restructured, thereby providing the intended relief to

borrowers. Additionally, of the KSh 35.2 billion that was released by the lowering of the Cash Reserve Ratio (CRR) in March, KSh 32.6 billion (92.7 percent) had been used to support lending, especially to the tourism, trade and transport and communication, real estate, manufacturing and agriculture sectors. A significant increase of mobile money usage was also noted over the period. For instance, the monthly volume of person-to-person transactions increased by 87 percent between February and October 2020. Over this period the volume of transactions below KSh 1,000 increased by 114 percent, while 2.8 million additional customers are using mobile money.

vi. Exchange Rates and Foreign Exchange Reserves

The foreign exchange market remained relatively stable in the second half of 2020. However, like most emerging market currencies, the Kenya Shilling weakened slightly against the US Dollar. Most regional and international currencies were volatile, reflecting continued uncertainties in the global

Chart 3a: Exchange rates of currencies in the region against the U.S. Dollar (June 2, 2020=1)



Source: Central Bank of Kenya

Chart 3b: Exchange rates of major international currencies against the U.S. Dollar (June 2, 2020=1)

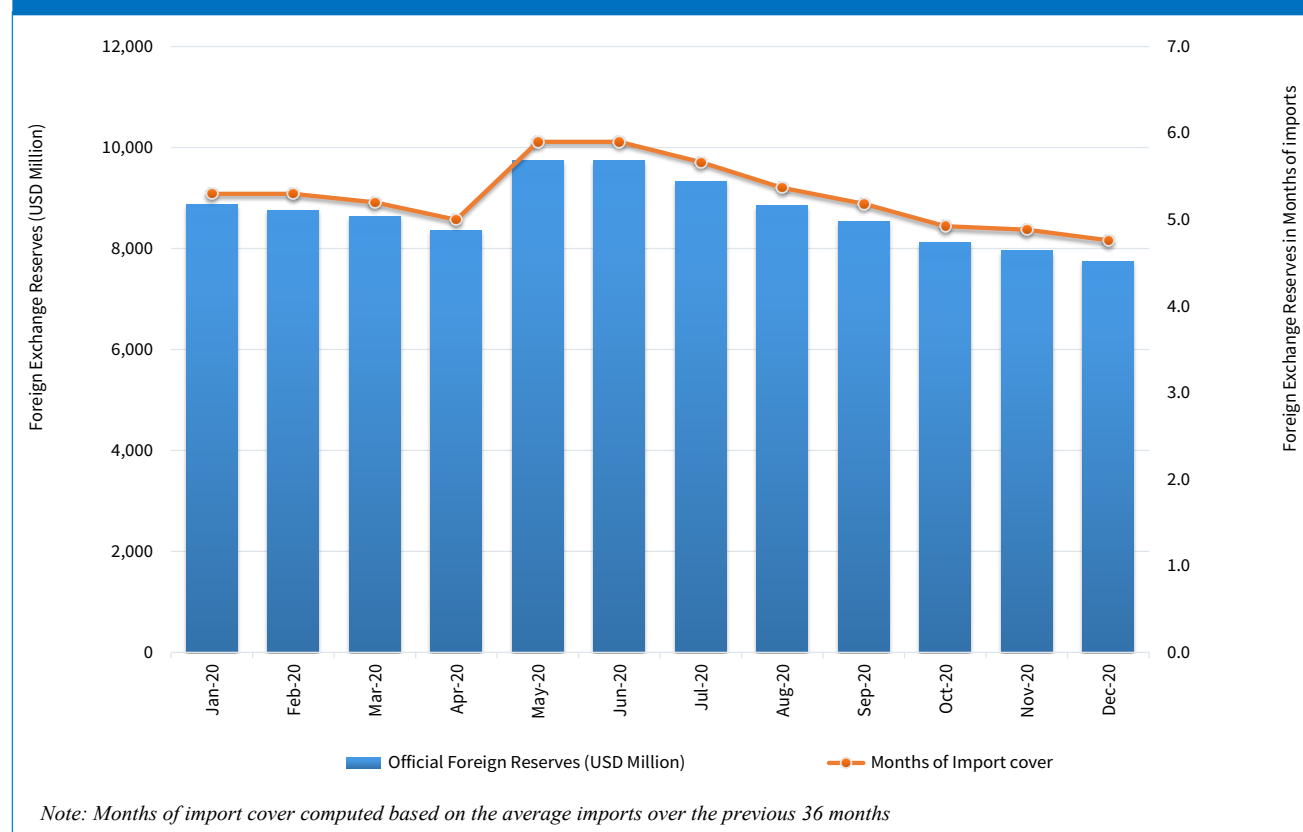


Source: Central Bank of Kenya

financial markets due to COVID-19, and a stronger US Dollar (**Charts 3a and 3b**). The reopening of the economy in the period and consequent pick up in demand for foreign exchange to finance imports also exerted some moderate pressure on the Kenyan Shilling.

The official foreign exchange reserves remained well above the statutory requirement to endeavor to maintain at least 4.0 months of import cover and the EAC convergence criteria of 4.5 months of import cover. As at December 2020, official foreign exchange

Chart 3c: CBK Foreign Exchange Reserves



Source: Central Bank of Kenya

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

reserves stood at USD 7,750 (4.76 months of imports cover) compared to USD 9,503 (5.71 months of imports cover) in June 2020. The reserves continued to provide adequate buffer against short term shocks in the foreign exchange market.

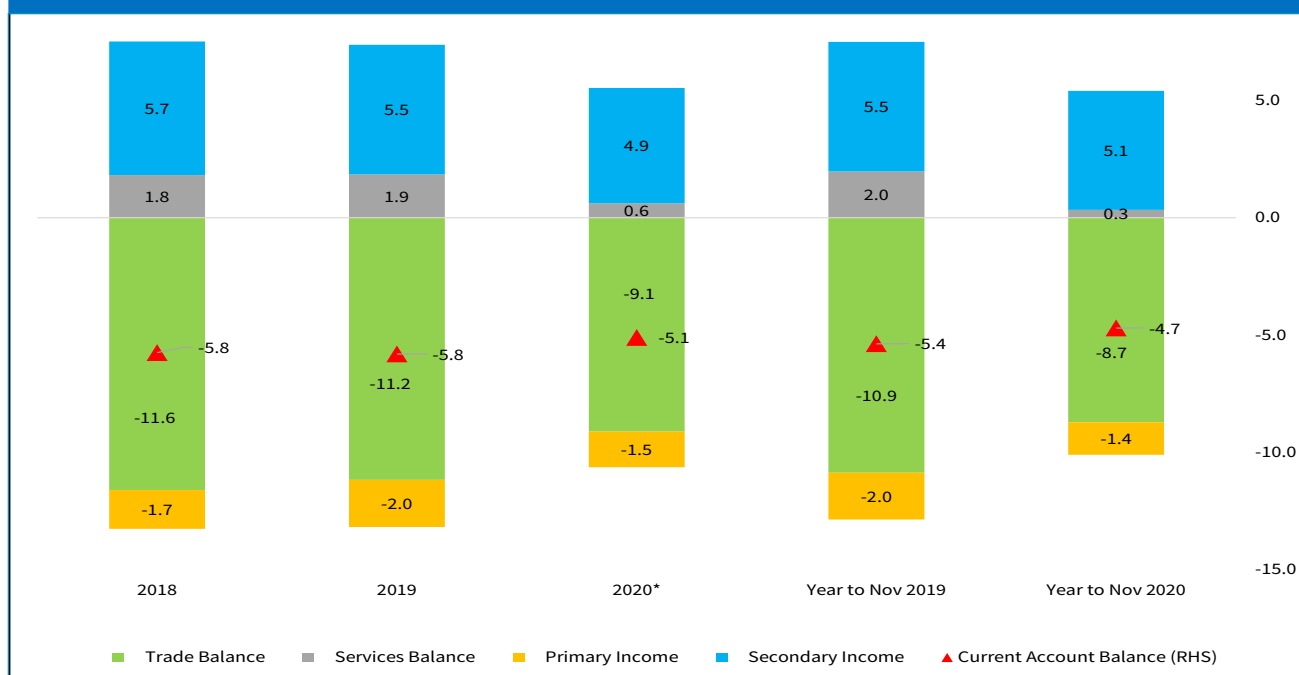
vii. Balance of Payments Developments

The current account deficit narrowed to 4.7 percent of GDP in the 12 months to November 2020 from 5.4 percent of GDP in the 12 months to November 2019. The improvement was recorded in the goods and primary income accounts (**Chart 4 and Table 4**).

In particular, the balance in the goods account improved to a deficit of 8.7 percent of GDP, reflecting lower merchandise imports attributed to lower oil

imports, improved tea exports as well as resilient horticulture exports. Exports of goods grew by 0.9 percent in the 12 months to November 2020 compared to a decline of 4.1 percent in similar period in 2019. Earnings from tea exports improved by 9.8 percent following increased domestic production and limited disruptions to the international supply chain. Cumulatively, tea production from January to September rose by 32.1 percent to 419.2 million kilograms from 316.8 million kilograms in a similar period of 2019. Horticulture exports, which had declined by 19.2 percent in the second quarter due to COVID-19 related disruptions, rebounded to grow by 5.4 percent in the third quarter. The improvement reflected gradual easing of restrictions in key export markets and increase of cargo space.

Chart 4: Components of the Current Account Balance (Percent of GDP)



Source: Kenya National Bureau of Statistics

Table 4: Annual Balance of Payments (Percent of GDP)

	2018	2019	Year to November 2019	Year to November 2020
	Act	Act	Act	Prov
Current account	-5.7	-5.8	-5.4	-4.7
1.1 Goods balance	-11.6	-11.2	-10.9	-8.7
Goods: exports, f.o.b.	6.9	6.1	6.2	6.0
o/w Tea	1.6	1.2	1.2	1.3
Horticulture	1.2	1.0	1.0	1.0
Manufactured Goods	0.4	0.4	0.4	0.4
Other	3.7	3.5	3.5	3.4
Goods: imports, f.o.b.	18.6	17.3	17.0	14.8
o/w Oil products	3.9	3.5	3.4	2.4
Other	9.5	10.1	9.9	8.3
Machinery & Transport equipment	5.2	3.7	3.7	4.1
1.2 Services balance	1.8	1.9	2.0	0.3
Services, Credit	6.2	5.9	5.9	4.0
Transportation	2.2	2.3	2.3	1.4
Travel	1.2	1.1	1.1	0.6
Services, Debit	4.4	4.0	4.0	3.7
1.3 Primary income, balance	-1.7	-2.0	-2.0	-1.4
Credit	0.2	0.2	0.2	0.3
Debit	1.9	2.2	2.2	1.6
1.4 Secondary income, balance	5.7	5.5	5.5	5.1
Credit	5.8	5.6	5.6	5.1
o/w Remittances	3.1	3.0	3.0	3.1
Debit	0.1	0.1	0.1	0.1
Capital account	0.3	0.2	0.2	0.1
Financial Account	-7.5	-6.5	-6.9	-2.9
Foreign Direct Investment balance	-1.7	-1.2	-1.2	-0.3
Portfolio Investment balance	-0.7	-1.4	-1.3	1.4
Other Investment balance	-5.1	-4.0	-4.4	-3.9

Source: Central Bank of Kenya

Exports to Africa accounted for 37.7 percent most of it going to COMESA and EAC region, which accounted for 25.7 percent and 24.3 percent respectively. China and European Union were the major source of imports and accounted for 23.8 percent and 14.8 percent of the total imports respectively (**Table 5**).

Imports declined by 10.9 percent over the same period largely due to a lower oil import bill reflecting relatively lower international oil prices in 2020.

The balance on the secondary income remained resilient mainly supported by remittance inflows, which accounted for 3.1 percent of GDP in the 12 months to November 2020. The cumulative inflows in the 12 months to November totaled USD 3,040.5 million compared to USD 2,792 million in the 12 months to November 2019. However, the balance on the services account declined from 2.0 percent of GDP to 0.3 percent due to weaknesses in international air transport and tourism. The deficit on the primary balance reduced largely on account of lower reinvestment related outflows.

Table 5: Kenya's Direction of Trade

IMPORTS (in millions of US dollars)				Share of Imports (%)				EXPORTS (in millions of US dollars)			Share of Exports (%)			
		Year to Nov					Year to Nov			Year to Nov				Year to Nov
Country	2019	2020	2016	2017	2018	2019	2020	Country	2019	2020	2017	2018	2019	2020
Africa	2,196	1,671	10.3	12.1	12.5	13.3	11.5	Africa	2,190	2,239	37.3	35.1	37.3	37.7
Of which								Of which						
South Africa	691	438	3.7	3.7	3.9	4.2	3.0	Uganda	624	664	10.3	10.0	10.6	11.2
Egypt	416	406	2.2	2.1	2.2	2.5	2.8	Tanzania	329	287	4.8	4.8	5.6	4.8
Others	1,088	826	4.4	6.2	6.4	6.6	5.7	Sudan	57	77	1.2	1.0	1.0	1.3
								South Sudan	123	202	2.8	2.1	2.1	3.4
EAC	619	484	2.4	3.7	4.2	3.7	3.3		132	135	3.1	2.5	2.2	2.3
COMESA	1,180	948	5.1	7.0	7.0	7.1	6.5	Rwanda	227	234	2.9	2.9	3.9	4.0
Rest of the World	14,356	12,822	89.7	87.9	87.5	86.7	88.5	Others	395	362	5.9	6.0	6.7	6.1
Of which											0.0	0.0	0.0	0.0
India	1,709	1,751	15.1	10.3	11.2	10.3	12.1	EAC	1,369	1,442	21.9	20.9	23.3	24.3
United Arab Emirates	1,636	930	6.7	8.4	8.9	9.9	6.4	COMESA	1,477	1,522	25.0	23.9	25.1	25.7
China	3,624	3,445	24.7	23.6	22.5	21.9	23.8	Rest of the World	3,682	3,694	62.7	64.9	62.7	62.3
Japan	948	832	6.0	4.9	6.0	5.7	5.7	Of which			0.0	0.0	0.0	0.0
USA	583	535	3.5	3.5	3.2	3.5	3.7	United Kingdom	391	459	6.4	6.5	6.7	7.7
United Kingdom	330	273	2.5	1.8	1.9	2.0	1.9	Netherlands	471	444	7.3	7.5	8.0	7.5
Germany	438	381	3.2	2.6	2.8	2.6	2.6	USA	509	464	7.9	7.7	8.7	7.8
Saudi Arabia	1,248	789	5.1	6.9	10.5	7.5	5.4	Pakistan	444	515	10.7	9.6	7.6	8.7
Indonesia	483	595	3.3	3.4	2.8	2.9	4.1	United Arab Emirates	379	323	4.4	5.7	6.5	5.4
Netherlands	311	342	1.2	1.2	1.2	1.9	2.4	Germany	111	134	2.0	1.8	1.9	2.3
Italy	201	219	1.7	1.4	1.6	1.2	1.5	India	53	63	1.0	1.5	0.9	1.1
Others	2,844	3,510	16.7	19.8	14.9	17.2	24.2	Others	1,289	1,269	22.5	24.0	21.9	21.4
Total	16,551	14,493	100.0	100.0	100.0	100.0	100.0	Total	5,872	5,933	100.0	100.0	100.0	100.0
EU	2,222	2,140	15.2	12.4	13.2	13.4	14.8	EU	1,305	1,362	21	21	22	23
China	3,624	3,445	24.7	23.6	22.5	21.9	23.8	China	148	146	2	2	3	2

Source: Kenya Revenue Authority and Central Bank of Kenya

viii. Economic Growth

The economy contracted by 0.4 percent in the first half of 2020 arising from the impact of COVID-19 in the second quarter. It contracted by 5.7 percent in the second quarter of 2020 compared to a growth of 4.9 percent in the first quarter, mainly due to the devastating impact of the COVID-19 pandemic on the services sectors. The various containment measures implemented domestically and internationally during the quarter to mitigate the spread of the disease had a significant adverse effect on economic activity in general and activity in service oriented sectors in particular.

Despite the impact of COVID-19, agriculture sector performance remained strong following favourable weather conditions across the country. The sector expanded by 5.6 percent in the first half of 2020 compared to 3.9 percent in a similar period of 2019, and 6.4 percent in 2020Q2 compared to 4.9 percent in 2020Q1. This performance was boosted by improved production of tea, cane deliveries, milk intake, and fruit exports. However, coffee sales and some horticultural exports contracted, reflecting the impact of international travel restrictions and subdued demand in export markets.

Services sector experienced the most significant impact of COVID-19 pandemic arising from domestic and international containment measures. It contracted by 3.2 percent in the first half of the year compared to a growth of 6.6 percent in a similar period of 2019, and a contraction of 11.7 percent in 2020Q2 compared to a growth of 5.5 percent in 2020Q1. This was mainly driven by contractions in accommodation and restaurant, education, professional, administration and support services, transport and storage and wholesale and retail trade. Positive growth rates were recorded in health, public administration, information and communication,

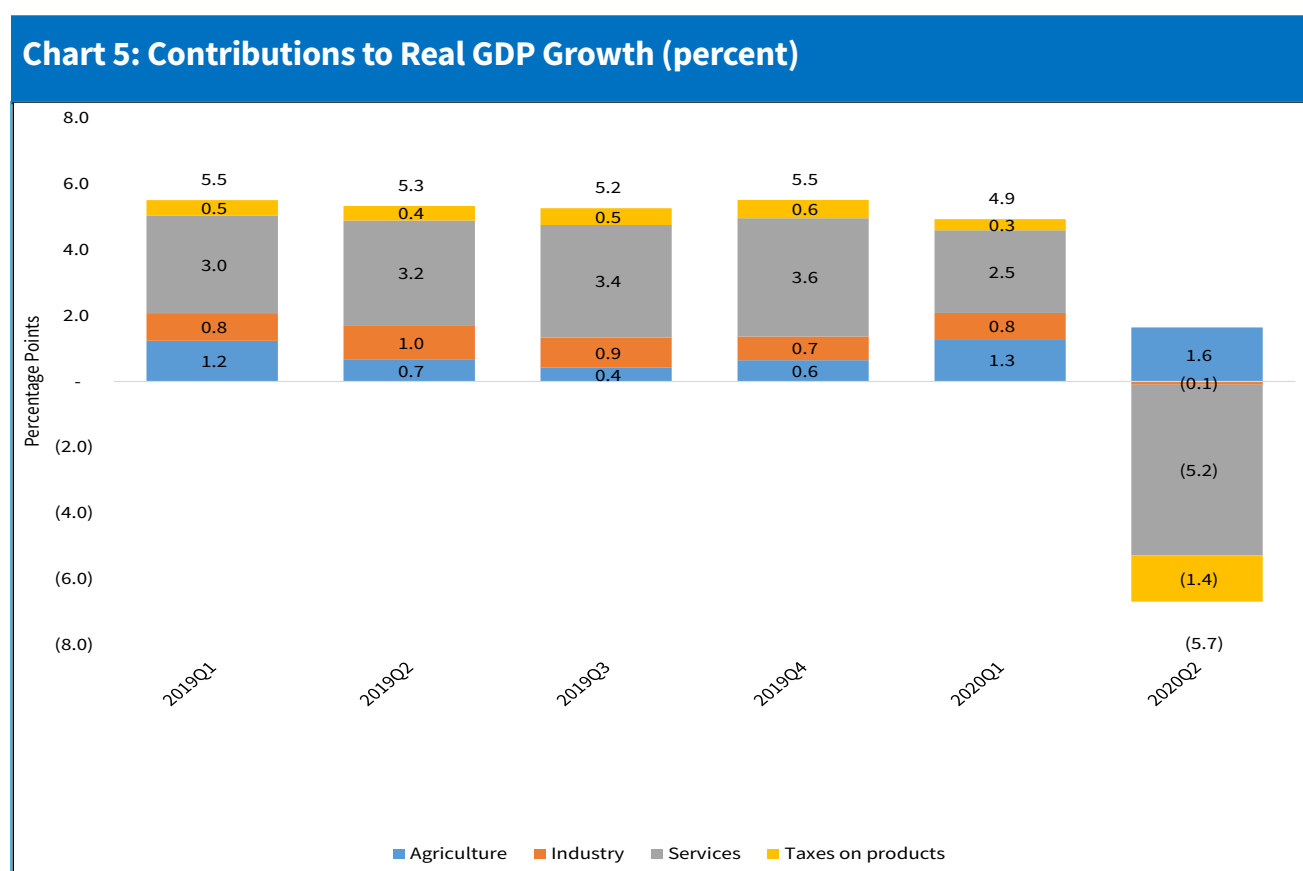
and financial and insurance sectors, which benefited from measures put in place to contain the spread of COVID-19.

Industrial activity growth was subdued, largely driven by contraction in manufacturing sector whose performance was adversely affected by COVID-19. It expanded by 1.9 percent in the first half of 2020 compared to 5.1 percent in a similar period in 2019, and contracted by 0.5 percent in 2020Q2 compared to a growth of 4.4 percent in 2020Q1 (**Table 6 and Chart 5**).

Table 6: Kenya's Real GDP Growth across the Main Sectors (Percent)

Main Sectors	2019Q1	2019Q2	2019Q3	2019Q4	2020Q1	2020Q2	2019H1	2020H1
1. Agriculture	4.7	2.9	2.4	4.0	4.9	6.4	3.9	5.6
2. Non-Agriculture (o/w)	5.8	6.0	5.9	5.8	4.9	-9.3	5.9	-2.3
2.1 Industry	4.7	5.4	4.7	3.8	4.4	-0.5	5.1	1.9
2.2 Services	6.5	6.8	6.7	6.8	5.5	-11.7	6.6	-3.2
2.3 Taxes on products	4.7	4.0	4.2	4.5	3.4	-14.2	4.3	-5.6
Real GDP Growth	5.5	5.3	5.2	5.5	4.9	-5.7	5.4	-0.4

Source: Kenya National Bureau of Statistics



Source: Kenya National Bureau of Statistics

ix. Domestic Government Borrowing

The coordination between monetary and fiscal policies continued to support macroeconomic stability. The domestic debt market performed well during the first half year of the FY2020/21 with sustained stability in the yield curve, lengthening of the maturity profile of domestic debt and increased bond market liquidity. The CBK was on course in achieving the Government's net domestic borrowing target. As at end December, net cumulative borrowing stood at KSh 319.5 billion (64.6 percent) of annual target of KSh 494.9 billion. In line with the Medium-Term Debt Strategy (MTDS), the Average Time to Maturity for Treasury bonds rose to 8.4 years as at end December 2020 from 7.69 years in June. Treasury bills to bonds ratio stood at 26:74 at the end of December 2020 compared to 29:71 in June.

x. Stakeholder Forums, MPC Market Perception Surveys, and Communications

The MPC members held virtual stakeholder meetings with the Chief Executives of commercial and

microfinance banks in order to apprise them on the background to its decisions and to obtain feedback. The Governor also held virtual press conferences after each MPC meeting to brief the media on the background to MPC decisions, and measures taken by the CBK to support macroeconomic stability as well as mitigate the impact of COVID-19 on the economy. In addition, MPC Members held virtual meetings with investors to brief them on economic developments and the outlook for the economy.

The MPC continued to improve on the scope and information gathering processes through the regular private sector market perceptions surveys. The Committee also introduced surveys of hotels and flower farms in order to facilitate monitoring of the recovery of the sectors from the adverse impact of the pandemic. The MPC continued to monitor the implementation of MPC decisions by the CBK, and interacted with other government agencies such as the National Treasury and KNBS on various policy and data issues.

3. THE EXTERNAL ECONOMIC ENVIRONMENT AND OUTLOOK FOR 2021

i. International Economic Environment

The October 2020 IMF World Economic Outlook (WEO) projected global output to contract by 4.4 percent in 2020, and to recover in 2021 to record a growth of 5.2 percent. The forecasts were an improvement compared to those in the June 2020 WEO update, reflecting better-than anticipated second quarter GDP outturns in advanced economies after easing of pandemic induced lockdowns in May and June. These projections were premised on the assumption of a more rapid recovery in the second half of 2020 alongside assumptions on social distancing spilling over into 2021 before fading as the vaccine coverage expands and therapies improve.

Output in the advanced economies was expected to contract by 5.8 percent in 2020 from a growth of 1.7 percent in 2019, before recovering to grow by 3.9 percent in 2021. This represented an improvement of 2.3 percentage points from the June 2020 WEO on account of the better than expected US and Euro area GDP outturns in the second quarter. In the emerging market and developing economies, output

was projected to contract by 3.3 percent in 2020, 0.2 percentage points lower relative to the projections in the June WEO update. It is expected to recover and pick up to 6.0 percent in 2021 driven mainly by China where economic activity normalized faster than expected. China reopened its economy in early April and registered a positive second quarter GDP growth, supported by strong policy support and resilient exports. Real GDP in Sub-Saharan Africa was projected to contract by 3.0 percent in 2020, and to recover to a growth of 3.1 percent in 2021 (**Table 7**).

Global trade was projected to contract by about 10 percent in 2020, due to lockdowns imposed across countries in the first quarter of the year. The global current account deficits and surpluses were projected to widen or shrink in 2020 to their lowest levels in the past two decades, and to remain broadly stable in 2021 for both creditor and debtor countries. Global financial conditions eased further supported by continued decline in interest rates and a rebound in equity markets.

Table 7: Growth Performance and Outlook for the Global Economy (Percent)

Region/Country	2017 Act.	2018 Act.	2019 Act.	2020 Proj.	2021 Proj.
World Output	3.7	3.6	2.9	-4.4	5.2
Advanced Economies	2.4	2.2	1.7	-5.8	3.9
United States	2.3	2.9	2.3	-4.3	3.1
Euro Area	2.4	1.9	1.3	-8.3	5.2
Japan	1.7	0.3	0.7	-5.3	2.3
United Kingdom	1.7	1.3	1.4	-9.8	5.9
Emerging Market and Developing Economies	4.7	4.5	3.7	-3.3	6.0
China	6.9	6.7	6.1	1.9	8.2
India	6.7	6.1	4.2	-10.3	8.8
Brazil	1.0	1.3	1.1	-5.8	2.8
Russia	1.5	2.5	1.3	-4.1	2.8
Sub Sahara Africa	2.8	3.2	3.1	-3.0	3.1
Nigeria	1.3	1.9	2.2	-4.3	1.7
South Africa	0.8	0.8	0.2	-8.0	3.0

Source: IMF, World Economic Outlook

The key downside risks to the global economy include COVID-19 outbreaks recurring; cross-border spillovers from weaker external demand, which could further magnify the impact of country or region specific shocks on global growth, premature withdrawal of policy support, or poor targeting of measures because of design and implementation challenges.

ii. Domestic Economic Environment

After a contraction of 0.4 percent in the first half due to the adverse impact of the COVID-19 pandemic in the second quarter particularly on the services sector, leading indicators point to a recovery in the second half of 2020. The resilience in the second half of 2020 was supported by higher agricultural output, a recovery in manufacturing, exports, and services, and normalization of domestic and global value chains following the easing of COVID-19 restrictions. The rebound in activity is expected to continue in 2021, on the back of solid growth in agriculture, continued recovery of the industry and services sectors, and the impact of policy interventions in place. A further easing of lockdown and reopening of economies and progress in the roll out of COVID-19 vaccines will provide additional impetus

to economic activity. As a result, growth is projected at about 7.6 percent in 2021 from an estimated 1.3 percent in 2020.

The macroeconomic environment is expected to remain stable, with overall inflation remaining within the target range (5 percent with a margin of 2.5 percent on either side). The exchange rate is expected to be stable, reflecting further improvement in the current account and adequate foreign reserves. The 12-month current account deficit is projected at 5.2 percent and 5.3 percent of GDP in 2021 and 2022, respectively driven by good performance of agricultural exports and resilient remittances. Imports are expected to pick up in the outer years while service exports take time to recover.

The FY2020/21 Budget is expected to be reviewed through a Supplementary Budget to incorporate expected tax reversals in January 2021 and the prolonged effects of COVID-19 on the economy. The fiscal deficit inclusive of grants is expected to increase in the FY2020/21 before declining in the medium term. This will result in fiscal consolidation over the medium term and stabilize growth in public debt.

4. DIRECTION OF MONETARY POLICY IN 2021

Price stability will be the overriding objective of monetary policy in 2021. Monetary policy will also support economic recovery in the post COVID-19 period. The monetary targets for 2021 are therefore consistent with Government policy objectives articulated in the Medium-Term Government Budget Policy Statement and Budget Review and Outlook Paper for 2020 published by the National Treasury.

The monetary targets for the period are presented in **Table 8**. Monetary policy will aim at containing the annual growth in broad money (M3) at about 12.1 percent by December 2021. Growth in private sector credit is expected to pick up from 8.4 percent in December 2020 to 10.5 percent by June 2021 and 11.3 percent by December. Growth in reserve money is projected to increase from 4.0 percent in December 2020 to 7.1 percent by December 2021. The operationalisation of the Credit Guarantee Scheme for the vulnerable Micro Small and Medium sized Enterprises (MSMEs), will de-risk lending by commercial banks, and is expected to support lending to this sector.

The CBK foreign exchange reserves are projected at US\$ 9,195 million (about 5.5 months of import cover) by December 2021, consistent with the positive outlook of the balance of payments. This level of foreign exchange reserves will continue to provide

a buffer against short-term shocks in the foreign exchange market. The coordination of monetary and fiscal policies will support macroeconomic stability.

The monetary projections are subject to risks emanating from both the domestic and global fronts. The subdued revenue collections and expenditure pressures due to impact of the pandemic may result in Government temporarily operating outside the domestic borrowing target while the predictability of money demand continues, will be affected by continued innovation in the financial sector. On the external front, the key downside risks include: uncertainty about the global outlook, largely due to resurgence in COVID-19 infections in the advanced economies and reintroduction of containment measures, and volatility in international oil prices and global financial markets. However, global business sentiment has improved with recent roll out of COVID-19 vaccines.

Consequently, developments in the monetary targets will be closely monitored in light of these risks, in order to provide necessary reviews to inform the decision-making process in the Bank. Additionally, the CBK will continue to monitor the economic impact of COVID-19 and the outcomes of policy measures in place as well as other developments in the domestic and global economies to safeguard price stability.

Table 8: Monetary Targets for 2021

	Mar-21	Jun-21	Sep-21	Dec-21
Broad Money, M3 (Ksh Billion)	4,081.3	4,314.9	4,316.2	4,475.2
Reserve Money RM (Ksh Billion)	464.4	467.7	484.1	503.4
Credit to Private Sector (Ksh Billion)	2,886.3	2,978.3	3,064.0	3,132.1
NFA of CBK (KSh Billion)	672.4	843.6	711.1	732.9
NDA of CBK (KSh Billion)	-207.9	-376.0	-227.0	-229.5
12-month growth in RM (Percent)	4.2	9.6	7.0	7.1
12-month growth in M3 (Percent)	11.5	11.7	12.3	12.1
12-Months Growth in Credit to Private Sector (Percent)	8.5	10.5	10.7	11.3
Medium-Term 12-Months overall Inflation (Percent)	5.0	5.0	5.0	5.0

Source: Central Bank of Kenya

EVENTS OF PARTICULAR RELEVANCE TO MONETARY POLICY (JULY – DECEMBER, 2020)

July	The MPC retained the CBR at 7.00 percent. The package of policy measures implemented since March were having the intended effect on the economy.
September	The CBR retained at 7.00 percent.
	Expiry of the suspension of the listing of negative credit information for borrowers
	Licensing of Kenya Mortgage Refinance Company whose principal objective is to provide long-term finance to primary mortgage lenders (commercial banks, mortgage finance companies, microfinance banks and SACCOs) to increase the availability and affordability of mortgage loans to the public.
October	Resurgence of the second wave of the COVID-19 infections in key export markets for Kenya especially for horticulture especially flowers.
	Release of October 2020 WEO report showing a less severe projected global contraction of 4.4 percent in 2020, compared to June 2020 projection due to better-than-expected second quarter growth.
	Establishment of a new Currency Centre in Kisii to serve seven counties in the region; Kisii, Nyamira, Migori, Bomet, Homa Bay, and parts of Narok and Kericho. The Centre offers a wide range of services, including currency services to the public and bank branches in the region, opportunities for investment in Government securities and general banking services to County Governments.
November	The MPC retained the CBR at 7.00 percent. The Committee noted that the package of policy measures implemented since March were having the intended effect on the economy, and would be augmented by the implementation of the measures in the FY2020/21 Budget.
December	Expiry of emergency measures to facilitate mobile money transactions
	Introduction of principles to guide pricing of mobile money transactions aimed at supporting the development of an efficient, safe and stable payments and mobile money ecosystem where the customer and public interests are adequately protected.

GLOSSARY OF KEY TERMS

OVERALL INFLATION

Overall inflation is a measure of price change in the economy calculated as the weighted year-on-year movement of the indices of the prices charged to consumers of the goods and services in a representative basket established in a base year. The indices are derived from data collected monthly by the Kenya National Bureau of Statistics.

RESERVE MONEY

Reserve Money is computed as the CBK's monetary liabilities comprising currency in circulation (currency outside banks and cash held by commercial banks in their tills) and deposits of both commercial banks and non-bank financial institutions (NBFIs) held by the CBK. It excludes Government deposits.

MONEY SUPPLY

Money supply is the sum of currency outside banks and deposit liabilities of commercial banks. Deposit liabilities are defined in narrower and broader senses as follows: narrow money (M1); broad money (M2); and extended broad money (M3). These aggregates are computed as follows:

Narrow Money

M0: Currency outside the banking system

M1: M0 + demand deposits of banks (or depository corporations).

Broad Money

M2: M1 + quasi (long term) money deposits i.e. time and savings deposits of banks and non-bank financial institutions.

Extended Broad Money

M3: M2 + residents' foreign currency deposits.

Overall Liquidity

L: M3 + non-bank holdings of Government Paper. This however, is not a monetary aggregate.



Central Bank of Kenya

Haile Selassie Avenue P.O. Box 60000 - 00200 Nairobi | Tel: (+254) 20 - 286 0000 / 286 1000 / 286 3000