Central Bank of Kenya

Monetary Policy Statement

June 2018

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 42^{nd} Monetary Policy Statement of the Central Bank of Kenya. It reviews and assesses the implementation of monetary policy during the first half of 2018 and outlines the direction of monetary policy for the next twelve months.

Dr. Patrick Njoroge

Governor

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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. Financial stability, 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):** Repos entail the sale, through auction, of eligible securities by the CBK to reduce commercial banks' deposits held at CBK. Repos (also called *Vertical Repos*) have fixed tenors of 3 and 7 working days. *Reverse Repos* are purchases of securities from commercial banks and hence, they are an injection of liquidity by the CBK during periods of tighter than desired liquidity in the market. The current tenors for *Reverse Repos* are 7, 14, 21, and 28 days. The *Late Repo*, sold in the afternoon, has a 4-day tenor and is issued at an interest rate 100 basis points below the Repo on that day. When a weekend or public holiday coincide with the maturity date of the Repo, the tenor is extended to the next working day.

    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 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. Currently, the tenors for such deposits at CBK are 14, 21, or 28 day periods. At maturity, the proceeds revert to the respective commercial banks.

    iii. **Horizontal Repos:** Although Horizontal Repos are not strictly monetary policy instruments, they 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 5.25 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 FY 2018/19. It also reviews the outcome of the monetary policy stance adopted in the first half of 2018. During the period, CBK conducted monetary policy with the aim of keeping overall inflation within the Government target range of between 2.5 and 7.5 percent. Overall inflation remained well anchored within the target range during the period mainly due to lower food prices. The inflation rate declined from 4.5 percent in December 2017 to 4.3 percent in June 2018. Non-food-non-fuel (NFNF) inflation remained below 5 percent, an indication of muted demand pressures in the economy. During the period, the Monetary Policy Committee (MPC) reduced the Central Bank Rate (CBR) by 50 basis points to 9.5 percent in its March 2018 meeting in order to support economic activity. The liquidity management operations by the CBK ensured stability in the interbank market.

The foreign exchange market remained stable supported by the narrowing of the current account deficit to 6.7 percent of GDP in the 12 months to June 2018 compared to 6.8 percent in a similar period in 2017 supported by resilience in service and income accounts. This was despite continued uncertainties regarding the U.S. economic policies, the post Brexit trade arrangements, and pace of normalization of monetary policies in advanced economies. The CBK foreign exchange reserves which stood at USD 8,643.5 million (5.8 months of import cover) at the end of June 2018, continued to provide an adequate buffer against short term shocks in the foreign exchange market. The Precautionary Arrangements with the International Monetary Fund (IMF) provided an additional buffer against exogenous shocks.

The banking sector remained resilient and stable during the period. Growth in private sector credit continued to recover gradually to 4.3 percent in the 12 months to June 2018 from 2.5 percent in December 2017. Notable credit growth was recorded in the manufacturing, domestic trade, and building and construction sectors. Nevertheless, private sector credit growth remained subdued partly due to reduced credit demand attributed 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 monetary policy stance in FY 2018/19 will aim at maintaining overall inflation rate within the target range of between 2.5 and 7.5 percent. The foreign exchange market is expected to remain stable in 2018 supported by expected narrowing of the current account deficit to 5.4 percent of GDP due to continued growth in tea and horticulture exports, resilient diaspora remittances, and growth in tourism receipts. The CBK foreign exchange reserves will continue to provide a buffer against short-term shocks. Overall macroeconomic stability will be supported by continued coordination of monetary and fiscal policies. This will support the achievement of the Government's *Big 4* development priorities of food security and agricultural productivity, affordable housing, increased share of manufacturing, and universal health coverage.

Consistent with inflation and growth objectives stipulated in the Government Medium Budget Policy Statement for 2018, monetary policy will aim at containing annual growth in broad money (M3) at 11.0 percent by December 2018 and by 11.5 percent by June 2019. Growth in private sector credit is also expected to pick up gradually to 12.2 percent by June 2019. Monetary policy will aim at ensuring that movements in the short-term interest rates support the Bank's primary objective of price stability. The Bank will continue to review and enhance the effectiveness of its monetary policy instruments in order to maintain price stability.

The Bank continues to monitor the impact of interest rate caps on lending and monetary policy effectiveness. It will also continue to monitor the risks posed by developments in the domestic and global economies on the overall price stability objective. In particular, the Bank will closely monitor risks associated with the uncertainties on U.S. trade policies, Brexit resolution, pace of monetary policy normalisation in the advanced economies, and volatility in international oil prices.

1. INTRODUCTION

This Monetary Policy Statement (MPS) provides the direction of monetary policy in the FY 2018/19. It also presents the outcome of the monetary policy stance adopted in the first half of 2018.

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 Precautionary Arrangements with the International Monetary Fund (IMF) provide an additional buffer against exogenous shocks.

On the domestic scene, inflation remained well anchored within the Government medium term target range during the first half of 2018, supported by declining food prices. The exchange rate remained stable and continued to dampen any threat of imported inflation despite the rise in international oil prices. On the global scene, the recovery of the global economic activity strengthened in the third and fourth quarters of 2017 supported by increased growth of advanced economies and supportive financial conditions. Nevertheless, uncertainties remained with respect to the U.S. economic policies, the Brexit resolution, and the pace of normalization of monetary policy in advanced economies.

The rest of this Policy Statement is organized as follows. Section 2 reviews the outcome of the monetary policy stance implemented in the first half of 2018 while Section 3 describes the current economic environment and outlook for FY 2018/19. Section 4 concludes by outlining the specific monetary policy path for FY 2018/19.

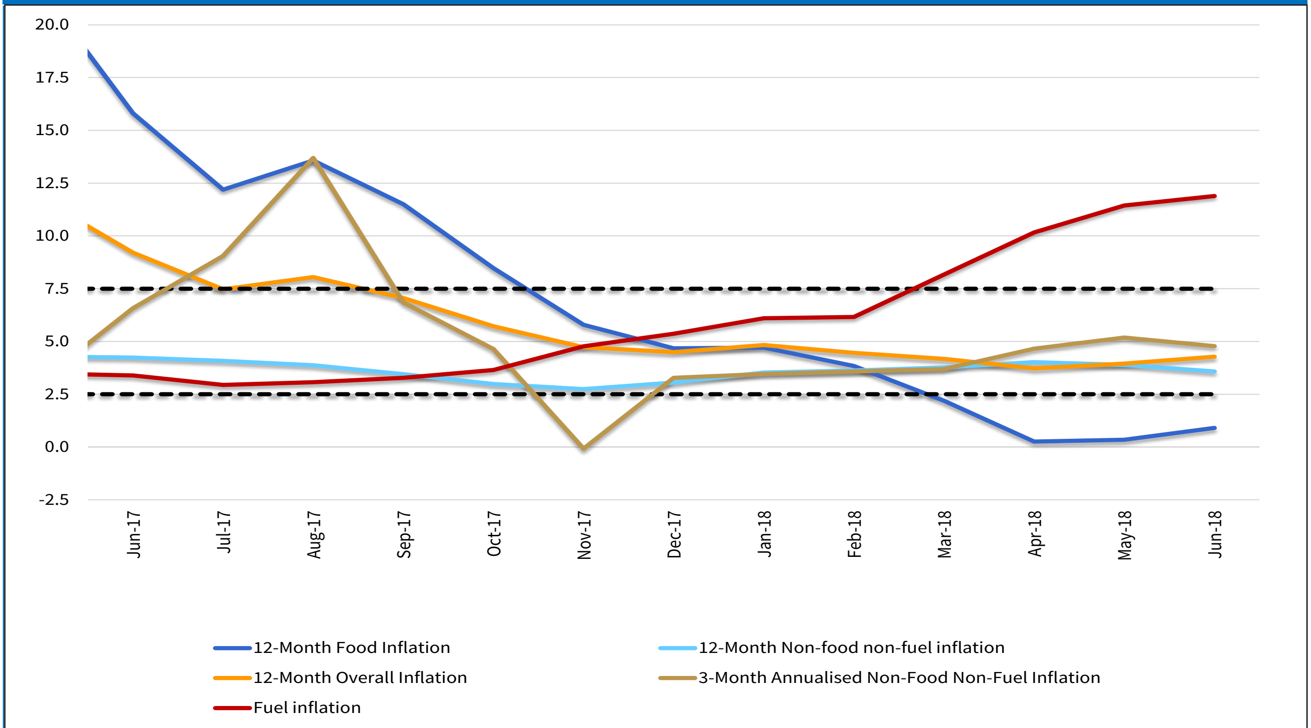
2. ACTIONS AND OUTCOMES OF THE POLICY STANCE IN THE FIRST HALF OF 2018

During the first half of 2018, 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 policy stance was also set to encourage growth and support stable interest rates. The Monetary Policy Committee (MPC) lowered the Central Bank Rate (CBR) to 9.50 percent in March from 10.00 percent in order to support economic activity. The MPC retained the CBR at 9.50 percent during its May meeting noting that the policy action of March was yet to be fully transmitted to the economy. The Committee continued to monitor the impact of the interest rate caps on the effective transmission of monetary policy. The following were the specific outcomes of the policy stance:

i. Inflation

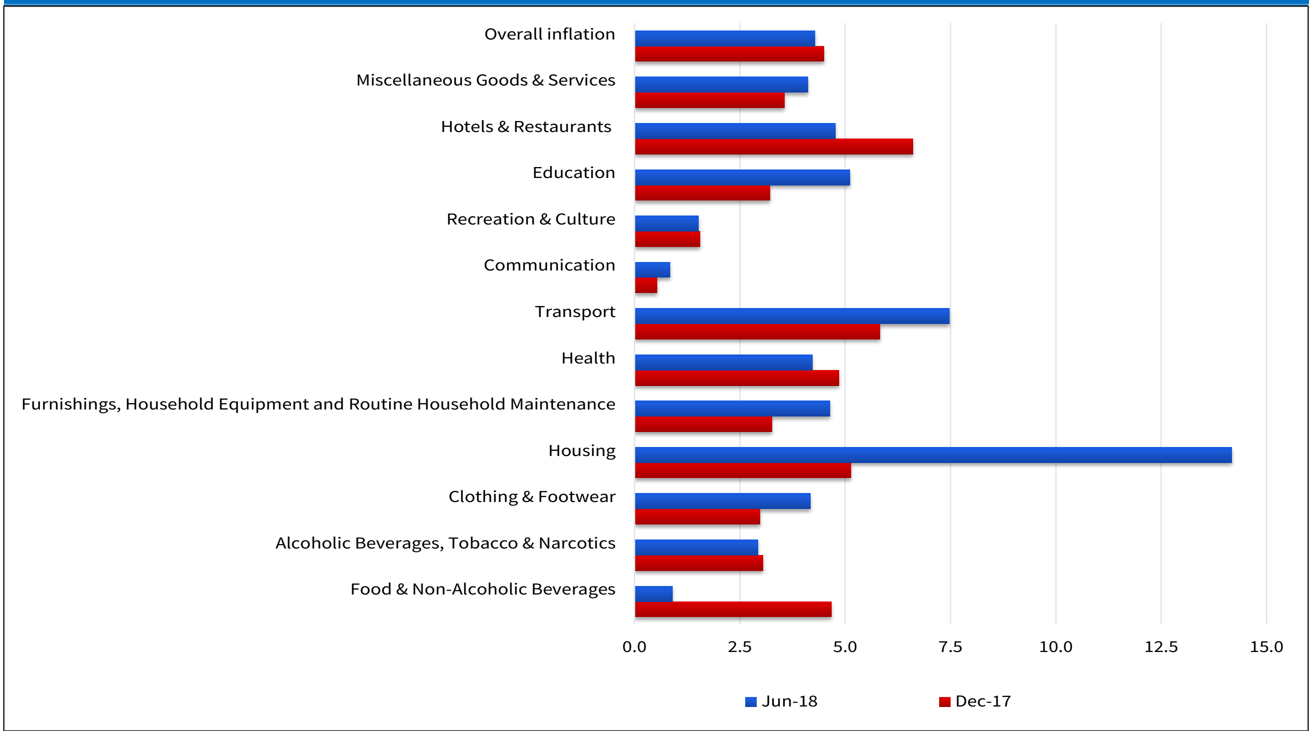
The overall inflation remained well anchored within the target range. It declined to 4.3 percent in June 2018 from 4.5 percent in December 2017, reflecting significant decreases in the prices of most food items **(chart 1a)**. Food prices fell due to improved weather conditions. The main food items with significant price decreases included cabbages, sugar, maize grain (loose), Irish potatoes and fresh packeted milk **(Chart 1c)**. However, inflation of most of the other broad CPI categories particularly Housing, Transport, Furnishings, household equipment and routine household maintenance, and Clothing and footwear increased **(chart 1b).**

Chart 1a: Inflation in Broad Measures (Percent)



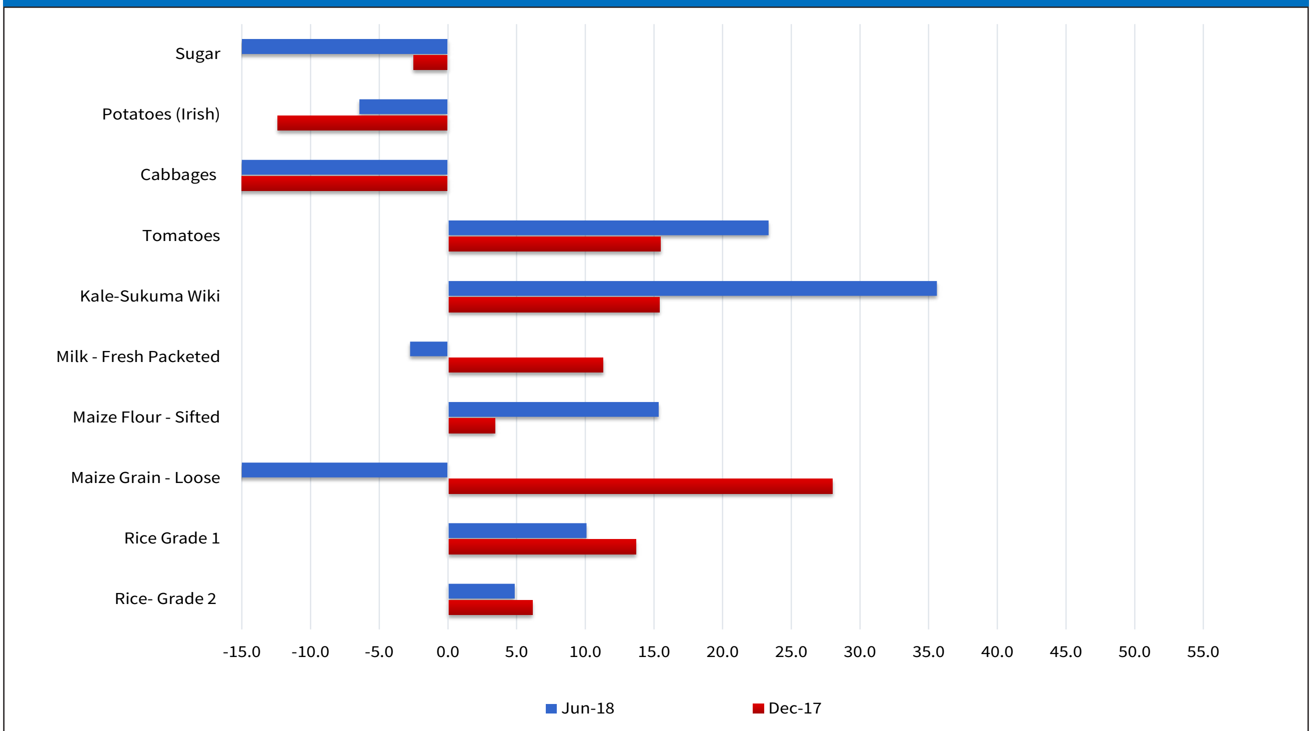
Source: Kenya National Bureau of Statistics and CBK

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



Source: Kenya National Bureau of Statistics

Chart 1c: 12-Month Change of Selected Food Commodity Price Indices (percent)



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

The 12-month non-food-non-fuel (NFNF) inflation remained below 5 percent in the first half of 2018 while the 3-month annualised NFNF inflation fell between April and June, an indication of muted demand pressures in the economy. The stability in the exchange rate continued to moderate the impact of import costs on consumer prices.

ii. Bank Credit to the Private Sector

The 12-month growth in credit to the private sector rose gradually to 4.3 percent in June 2018 from 2.5 percent in December 2017 **(Table 1)**. Notable credit growth was observed in Building and Construction (13.3 percent), Manufacturing (12.2 percent), Trade (8.5 percent), Consumer durables (7.8 percent), and Business services (6.7 percent).

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

Main Sectors	Dec-17	Jan-18	Feb-18	Mar-18	Apr-18	May-18	Jun-18
Agriculture	-7.5	-7.6	-12.9	-6.2	-4.4	-3.3	-4.7
Manufacturing	12.9	12.0	13.1	11.2	10.1	12.1	12.2
Trade	9.0	5.1	6.8	5.4	5.0	6.8	8.5
Building and construction	5.0	5.4	4.8	12.6	14.3	9.2	13.3
Transport and communication	-6.9	-10.9	-13.9	-18.4	-17.8	-14.9	-12.7
Finance and insurance	-4.2	-1.3	4.9	11.6	10.1	2.6	3.8
Real estate	8.7	8.2	8.4	4.5	3.6	3.7	3.8
Mining and quarrying	-5.0	-6.7	-6.7	-2.7	-4.4	-3.5	-9.1
Private households	-1.5	-1.4	-2.7	-0.7	2.6	3.8	2.9
Consumer durables	0.6	1.4	2.3	4.7	5.0	5.5	7.8
Business services	-8.4	0.0	-0.3	-0.5	2.8	11.0	6.7
Other activities	-5.6	-10.6	-2.2	-6.3	-2.2	-7.5	-7.9
Total private sector credit	**2.5**	**1.9**	**2.2**	**2.1**	**2.9**	**3.9**	**4.3**

Source: Central Bank of Kenya

iii. Developments in the other Monetary Aggregates

The 12-month growth of broad money, M3, rose to 10.4 percent in June 2018 from 8.8 percent in December 2017 supported by increased net domestic assets (NDA) and net foreign assets 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 **(Chart 2)**. Overall, monetary aggregates grew at a relatively slower pace compared to their respective targets **(Table 2)**.

iv. Interest Rates Developments

a. Central Bank Rate (CBR)

The Monetary Policy Committee (MPC) lowered the Central Bank Rate (CBR) to 9.50 percent in March from 10.00 percent in order to support economic activity. The MPC retained the CBR at 9.50 percent during its May meeting noting that the policy action of March was yet to be fully transmitted to the economy.

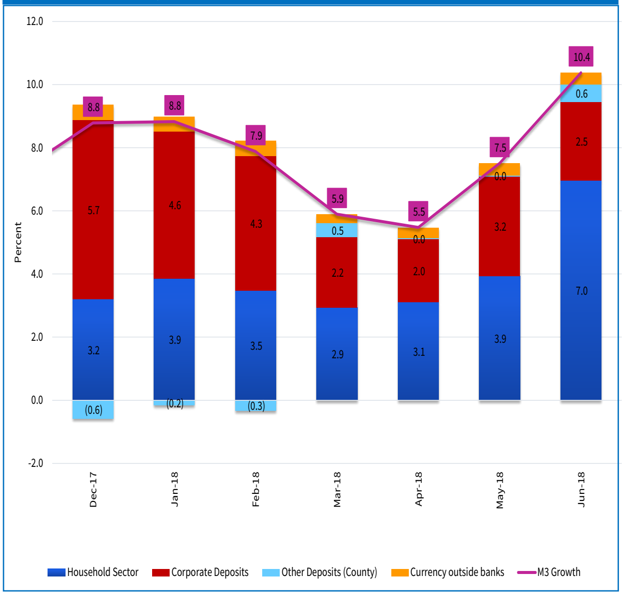
b. Short Term Rates

The interbank rate remained below the CBR during the first half of 2018 reflecting improved liquidity conditions in the market **(Table 3)**. However, the liquidity distribution remained uneven across the banks due to the segmentation in the interbank market. Liquidity management operations by the CBK remained active during the period to enhance liquidity distribution in the interbank market.

Interest rates on government securities declined marginally due to improved liquidity conditions in the market **(Table 3)**. The predictability in the government domestic borrowing programme continued to support market stability and a stable yield curve.

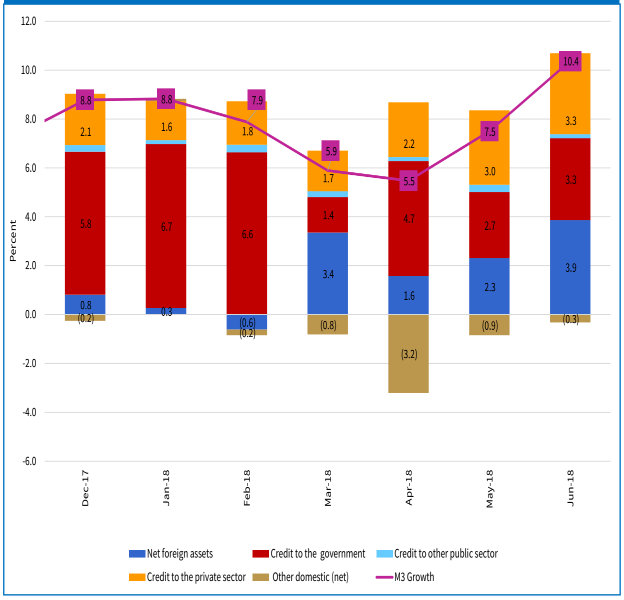
Chart 2: The 12-Month Growth in Broad Money Supply (M3) and its Sources (percent)

2a: Components of Money Growth (Percent)



Source: Central Bank of Kenya

2b: Sources of Money Growth (Percent)



Source: Central Bank of Kenya

Table 2: Actual and Targeted Growth in Key Monetary Aggregates

	Dec-17	Mar-18	Jun-18
Actual Broad Money,M3 (Ksh Billion)	3030.6	3035.4	3262.6
Target (Ksh Billion)	*3142.6*	*3121.5*	*3215.4*
Actual Reserve Money (Ksh Billion)	438.8	418.2	429.2
Target (Ksh Billion)	*460.5*	*441.8*	*444.0*
Actual Net Foreign Assets of CBK (Ksh Billion)	627.1	803.3	783.6
Target (Ksh Billion)	*667.1*	*612.6*	*752.8*
Actual Net Domestic Assets of CBK (Ksh Billion)	-188.4	-385.1	-354.4
Target (Ksh Billion)	*-206.6*	*-172.2*	*-317.3*
Actual Credit to private sector (Ksh Billion)	2364.5	2343.0	2380.4
Target (Ksh Billion)	*2300.9*	*2394.1*	*2447.3*
Memorandum Items			
12-month growth in actual Reserve Money (Percent)	*6.7*	*0.8*	*7.4*
12-month growth in actual Broad Money, M3 (Percent)	*8.8*	*5.9*	*10.4*

Source: Central Bank of Kenya

Table 3: Interest Rates (Percent)

	2017				2018					
	Mar	Jun	Sep	Dec	Jan	Feb	Mar	Apr	May	Jun
Central Bank Rate	10.00	10.00	10.00	10.00	10.00	10.00	9.50	9.50	9.50	9.50
Interbank	4.46	3.99	5.52	7.27	6.21	5.12	4.90	5.38	4.70	5.03
Repo	7.23	4.13	7.24	7.75	8.75	7.63	0.00	6.75	7.44	6.16
Reverse Repo	10.04	10.05	10.12	10.10	10.02	10.05	9.95	9.64	9.60	9.56
91-Tbill	8.69	8.42	8.13	8.01	8.04	8.03	8.02	8.00	7.96	7.87
182-Tbill	10.53	10.38	10.32	10.53	10.64	10.42	10.39	10.30	10.26	9.99
Average Lending Rate (1)	**13.61**	**13.66**	**13.69**	**13.64**	**13.65**	**13.68**	**13.49**	**13.24**	**13.25**	**13.22**
Overdraft/loan	13.29	13.38	13.65	13.54	13.61	13.75	13.40	13.29	13.30	13.23
1-5years	13.81	13.80	13.87	13.83	13.84	13.83	13.67	13.41	13.40	13.39
Over 5years	13.55	13.64	13.51	13.46	13.45	13.45	13.31	13.03	13.03	13.00
Average Deposit Rate (2)	**7.12**	**7.15**	**7.66**	**8.22**	**8.26**	**8.25**	**8.16**	**8.17**	**8.08**	**8.04**
Demand	1.24	1.21	1.15	1.14	1.32	1.20	1.25	1.10	1.09	1.08
0-3months	7.28	7.76	7.71	8.43	8.52	8.50	8.48	8.46	8.53	8.41
Over 3months	8.18	8.04	8.02	8.39	8.35	8.39	8.26	8.11	8.01	8.14
Savings	5.89	5.63	6.43	6.91	6.97	7.01	6.85	6.72	6.64	6.60
Spread (1-2)	**6.49**	**6.52**	**6.04**	**5.41**	**5.39**	**5.42**	**5.33**	**5.07**	**5.17**	**5.18**

Source: Central Bank of Kenya

c. Commercial Bank Rates

Commercial banks' lending rates declined from 13.64 percent in December 2017 to 13.22 percent in June 2018. The banks' average deposit rate also declined from 8.22 percent in December 2017 to 8.04 percent in June 2018 **(Table 3)**.

v. Banking Sector Developments

The banking sector remained stable and resilient in the first half of 2018. The average commercial banks' liquidity and capital adequacy ratios stood at 48.0 percent and 18.0 percent, respectively, in June 2018 compared to 43.7 percent and 18.5 percent, respectively, in December 2017. The distribution of liquidity in the sector also improved, although credit risk remained elevated as large corporates continued to restructure their borrowings. The ratio of gross non-performing loans (NPLs) to gross loans increased to 12.0 percent from 10.6 percent in December 2017, partly reflecting a slower growth of gross loans. The ratio of net non-performing loans to gross loans remained below 5 percent.

The CBK continued to strengthen the sector to ensure greater transparency, and to promote stronger governance, effective business models, and innovation leveraging on ICT.

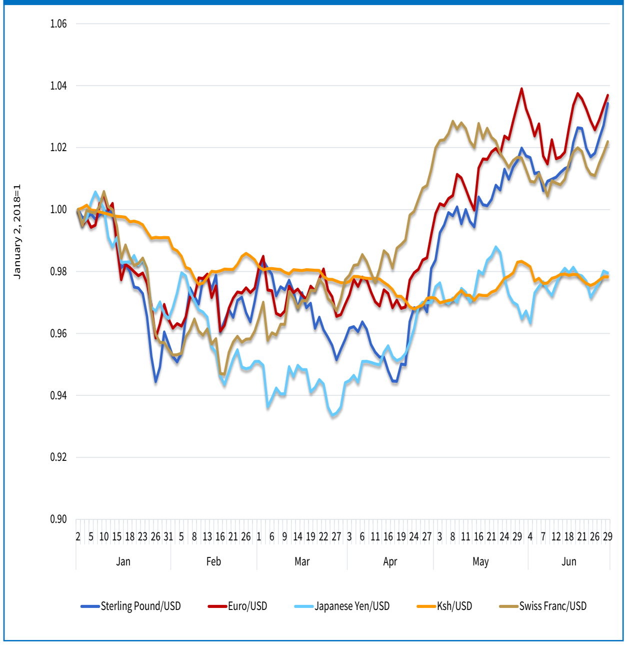
vi. Exchange Rates and Foreign Exchange Reserves

The foreign exchange market remained stable in the first half of 2018 due to the narrowing of the current account deficit supported by resilient tea and horticulture exports, and stronger diaspora remittances. This was despite continued uncertainties regarding the U.S. economic policies, the post Brexit trade arrangements, and the pace of normalization of monetary policies in advanced economies. The diversification of Kenya's exports in terms of both export products and external markets continued to cushion the economy against short-term shocks.

Most international currencies depreciated against the U.S. dollar between January and June 2018 **(Chart 3a)**. Regional currencies depicted mixed trends against the U.S. dollar during the period **(Chart 3b)**. The currencies in Kenya, Uganda, and Tanzania were relatively stable against the U.S. dollar, while the South African Rand was fairly volatile reflecting political developments and slower growth.

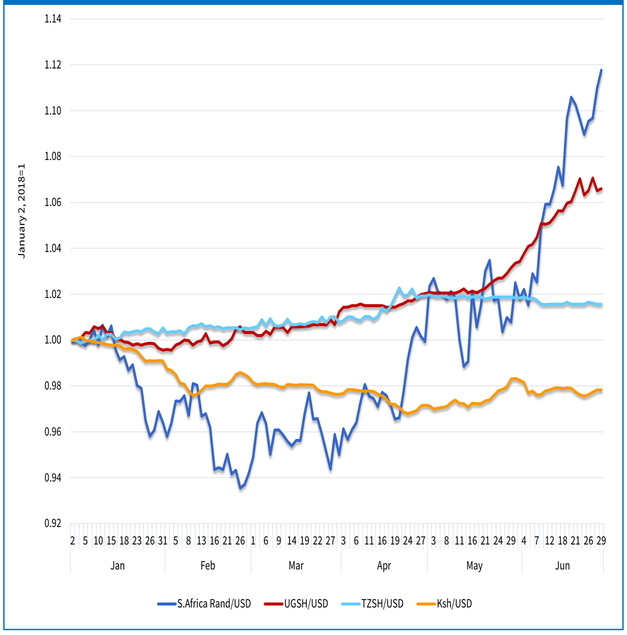
The CBK usable foreign exchange reserves rose to USD 9,146.1 million (equivalent to 6.1 months of import cover) at the end of April 2018 compared to USD 7,065.7 million (4.7 months of import cover) at

Chart 3a: Rate of Depreciation/ Appreciation of the Kenya Shilling and Major International Currencies against the U.S. Dollar



Source: Central Bank of Kenya

Chart 3b: Rate of Depreciation/ Appreciation of the Kenya Shilling and Regional Currencies against the U.S. Dollar



Source: Central Bank of Kenya

the end of December 2017 **(Chart 3c)**. The reserves declined marginally between April and June 2018 as a result of anticipated payments for government obligations. The reserves continued to provide an adequate buffer against short term shocks in the foreign exchange market. The Precautionary Arrangements with the IMF provided an additional buffer against exogenous shocks.

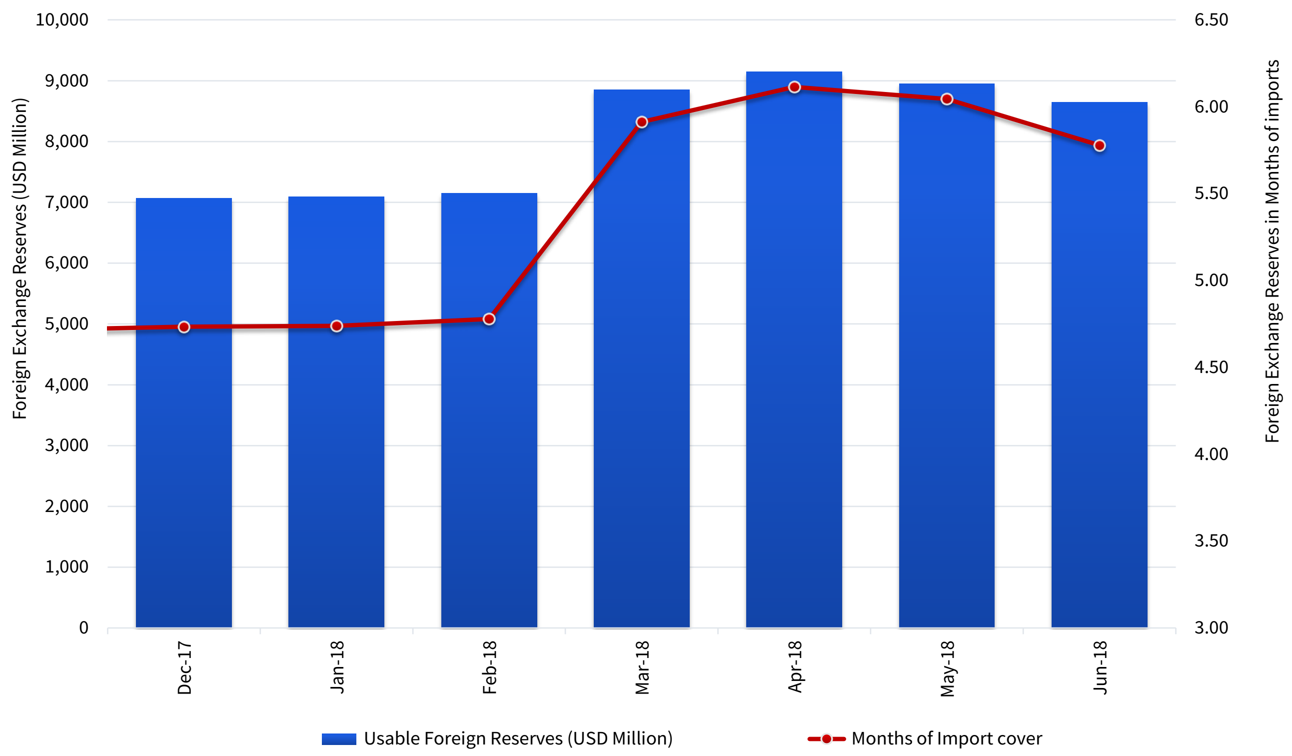
Other measures of foreign reserves adequacy remained robust and exceeded their respective indicative thresholds. The ratio of reserves to short-term debt averaged above 400 percent while that of reserves to broad money averaged 27.3 percent between January and June 2018. These were above their respective thresholds, that is the Greenspan-Guidotti rule of 100 percent cover for emerging markets and the prudent range of 20 percent for countries with large banking sector and open capital accounts, respectively.

vii. Balance of Payments Developments

The current account deficit narrowed marginally to 6.7 percent of GDP in the 12 months to June 2018 compared to 6.8 percent of GDP over a similar period in 2017 **(Chart 4 and Table 4)**. The narrowing in the current account deficit reflected an improvement in the secondary income account owing to strong remittance inflows. However, the trade balance worsened largely due to lower exports of merchandise goods especially re-exports. Imports of merchandise goods remained flat at 19.8 percent of GDP in the twelve months to June 2018 with the increases in the imports of petroleum products and other imports particularly food, as share of GDP, somewhat compensated by a decline in imports of machinery and transport equipment.

Exports of merchandise goods stood at 7.3 percent of GDP in the twelve months to June 2018 compared to 7.6 percent of GDP in a similar period in 2017 **(Table 4)**. Receipts from tea exports grew by 15.4 percent due to higher prices in the international market while horticulture exports rose by 14.8 percent. Travel and transport receipts and diaspora remittances grew by 12.1 percent, 12.8 percent and 38.3 percent, respectively, reflecting increased tourism promotion activities by the government, improved security, and continued recovery of the global economy.

Chart 3c: CBK Foreign Exchange Reserves

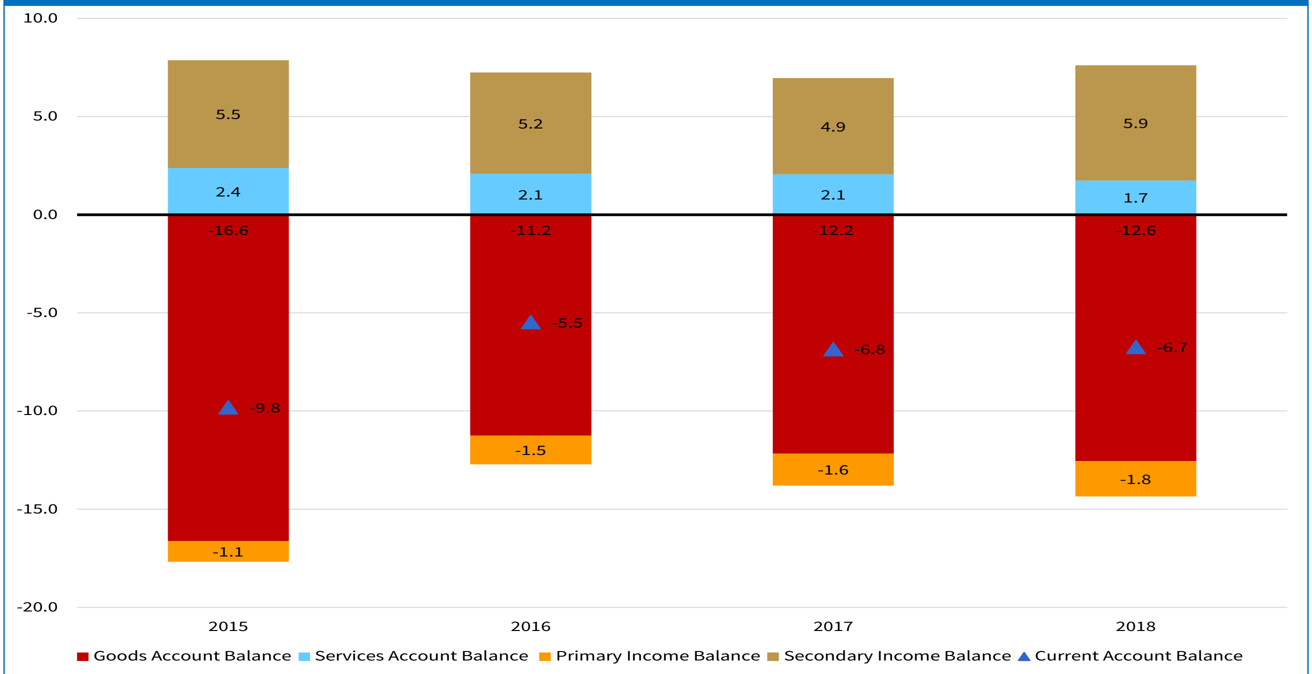


Note: Months of import cover computed based on the average imports over the previous 36 months

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.

Chart 4: Components of the Current Account Balance in the Year to June, (Percent of GDP)



Source: Central Bank of Kenya

Table 4: Balance of Payments in the Year to June (Percent of GDP)

	2015	2016	2017	2018
1. Current Account Balance	**-9.8**	**-5.5**	**-6.8**	**-6.7**
1.1 Goods Account Balance	**-16.6**	**-11.2**	**-12.2**	**-12.6**
Goods: Exports (fob)	9.0	9.0	7.6	7.3
o/w: Tea	1.8	2.0	1.7	1.8
Horticulture	1.3	1.3	1.1	1.1
Coffee	0.4	0.3	0.3	0.3
Other exports and re-exports	5.5	5.3	4.5	4.1
Goods: Imports (fob)	25.7	20.2	19.8	19.8
o/w: Oil	5.5	3.3	3.2	3.8
Machinery & transport equipment	10.2	7.6	6.3	5.4
Other imports	9.9	9.3	10.2	10.7
1.2 Services Account Balance	**2.4**	**2.1**	**2.1**	**1.7**
Credit	7.7	6.5	5.9	6.0
o/w: Transportation	3.3	2.5	2.1	2.1
Travel	1.2	1.2	1.2	1.2
Debit	5.3	4.4	3.9	4.3
1.3 Primary Income Balance	**-1.1**	**-1.5**	**-1.6**	**-1.8**
Credit	0.5	0.1	0.2	0.2
Debit	1.5	1.6	1.8	2.0
1.4 Secondary Income Balance	**5.5**	**5.2**	**4.9**	**5.9**
Credit	5.6	5.3	5.0	5.9
o/w: Remittances	2.3	2.5	2.4	2.9
Debit	0.1	0.1	0.1	0.1
2. Capital Account Balance	**0.4**	**0.3**	**0.3**	**0.3**
3. Financial Account Balance	**-8.4**	**-6.5**	**-8.3**	**-6.6**
3.1 Foreign direct investment,net	-1.3	-0.6	-0.9	-1.4
3.2 Portfolio investment, net	-1.8	0.3	0.9	-1.1
3.3 Other investment, net	-5.3	-6.2	-8.2	-4.1

Source: Central Bank of Kenya

Table 5: Kenya's Direction of Trade

IMPORTS	(in millions of USD) Year to June		Share of Imports (%) Year to June		EXPORTS	(in millions of USD) Year to June		Share of Exports (%) Year to June	
Region/Country	2017	2018	2017	2018	Region/Country	2017	2018	2017	2018
Africa	**1,632**	**2,136**	**11.0**	**14.4**	**Africa**	**2,199**	**2,169**	**38.5**	**35.8**
Of which					*Of which*				
South Africa	567	637	3.8	3.9	Uganda	611	601	10.7	9.9
Egypt	332	359	2.2	2.2	Tanzania	281	294	4.9	4.9
Others	732	1,140	4.9	6.9	Egypt	170	213	3.0	3.5
					Sudan	54	67	0.9	1.1
EAC	**417**	**743**	**2.8**	**4.5**	South Sudan	157	152	2.8	2.5
COMESA	**854**	**1,258**	**5.8**	**7.6**	Somalia	201	167	3.5	2.8
Rest of the World	**13,178**	**14,381**	**89.0**	**87.1**	DRC	197	167	3.4	2.8
Of which					Rwanda	167	176	2.9	2.9
India	1,826	1,627	12.3	9.9	Others	362	333	6.3	5.5
United Arab Emirates	1,029	1,029	6.9	6.2					
China	3,904	3,904	26.4	23.6	**EAC**	**1,135**	**1,129**	**19.9**	**18.7**
Japan	809	809	5.5	4.9	**COMESA**	**1,470**	**1,460**	**25.8**	**24.1**
USA	515	515	3.5	3.1	**Rest of the World**	**3,505**	**3,885**	**61.5**	**64.2**
United Kingdom	312	299	2.1	1.8	*Of which*				
Singapore	65	43	0.4	0.3	United Kingdom	357	397	6.3	6.6
Germany	385	460	2.6	2.8	Netherlands	418	447	7.3	7.4
Saudi Arabia	964	1,315	6.5	8.0	USA	463	446	8.1	7.4
Indonesia	506	481	3.4	2.9	Pakistan	516	644	9.0	10.6
Netherlands	163	219	1.1	1.3	United Arab Emirates	273	307	4.8	5.1
France	246	224	1.7	1.4	Germany	123	109	2.2	1.8
Bahrain	117	46	0.8	0.3	India	81	76	1.4	1.3
Italy	241	238	1.6	1.4	Afghanistan	36	29	0.6	0.5
Others	2,094	3,172	14.1	19.2	Others	1,238	1,428	21.7	23.6
Total	**14,810**	**16,517**	**100**	**100**	**Total**	**5,704**	**6,054**	**100**	**100**
EU	1,947	2,088	13.1	12.6	EU	1,184	1,183	20.8	19.5
China	3,904	3,904	26.4	23.6	China	122	75	2.1	1.2

Source: Central Bank of Kenya

viii. Economic Growth

The Kenyan economic performance was strong in the first half of 2018. Real GDP growth increased to 6.2 percent supported by recovery in agriculture and industry and resilience of the services sector **(Table 6 and Chart 5)**. The services sector remained the main driver of growth and contributed 2.9 percentage points to real GDP growth. This reflected strong performance of Wholesale and Retail trade, Information and Communication, Financial and Insurance, and Professional, Administration and Support Services. The agriculture sector rebounded following favourable weather conditions across the country. Growth of industrial output rose to 5.2 percent in the first half of 2018 from 4.2 percent in a similar period in 2017 reflecting resurgence of the manufacturing sector **(Table 6)**. A stable macroeconomic environment, continued government spending on infrastructure, and diversification of the economy were the major sources of resilience.

ix. Domestic Government Borrowing

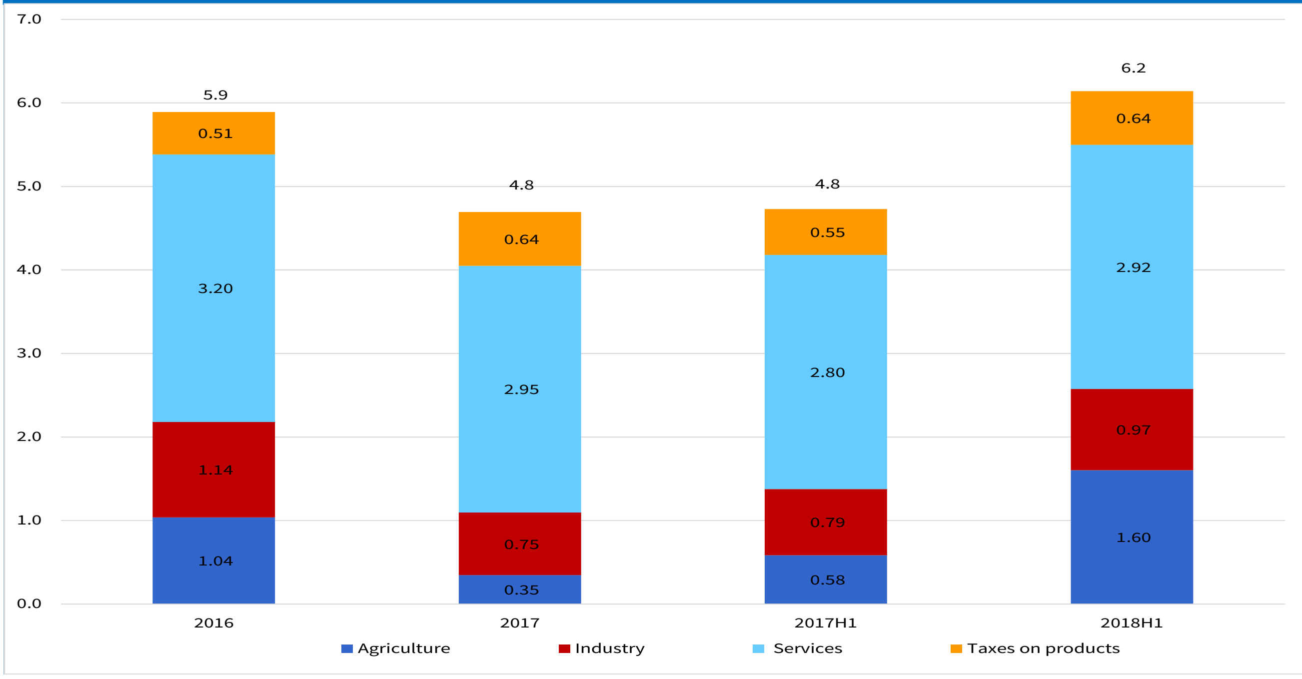
The coordination between monetary and fiscal policies continued to support macroeconomic stability. The Government's borrowing plan in the second half of the Fiscal Year 2017/18 ensured that the build-up in domestic debt was consistent with the thresholds set in the Medium-Term Debt Management Strategy. The Government continued to review its borrowing plan in line with market conditions and prudent budget management that focused on rationalisation of expenditures and strengthening of revenue collection measures.

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

Main Sectors	2016	2017	2017H1	2018H1
1. Agriculture	4.7	1.6	2.3	6.5
2. Non-Agriculture (o/w)	6.2	5.7	5.7	6.1
2.1 Industry	5.9	3.9	4.2	5.2
Manufacturing	3.1	0.7	1.0	4.3
Electricity & water supply	8.4	7.0	8.2	7.2
Construction	9.9	8.4	8.5	6.1
2.2 Services	6.4	5.9	5.9	6.1
2.3 Taxes on products	4.4	5.7	5.2	6.0
Real GDP	**5.9**	**4.8**	**4.8**	**6.2**

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

Chart 5: Contributions to Real GDP Growth (percent)



Source: Kenya National Bureau of Statistics

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

The MPC held forums with Chief Executive Officers of commercial banks after every meeting during the first half of 2018. The Committee also continued to improve and expand its 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 continuously reviewed to make them better focused to the public, media, financial sector and other stakeholders.

The Chairman of the MPC also held press conferences after each MPC meeting to brief the media on measures undertaken by the CBK to support macroeconomic and financial stability. As a result, the media and public understanding of monetary policy decisions and their expected impact on the economy continued to be enhanced. The Chairman and MPC members also held meetings with investors during the period in order to appraise them on recent economic developments in the country.

The CBK also held meetings with IMF Mission in April 2018 to discuss developments in the economy and to review Kenya's performance under the Precautionary Arrangements programme. Regular meetings were also held with the World Bank to discuss developments in the economy.

3. THE CURRENT ECONOMIC ENVIRONMENT AND OUTLOOK FOR THE FY 2018/19

a. International Economic Environment

Global output is estimated to have grown by 3.8 percent in 2017 up from 3.2 percent in 2016 **(Table 7)**. The stronger growth momentum witnessed in 2017 is expected to continue into 2018 and 2019, with global growth projected at 3.9 percent in both years. Growth would be supported by favourable global financial conditions and strong sentiment, that was expected to maintain the recent acceleration in demand. The temporal rise in U.S. growth owing to tax reforms and associated fiscal stimulus, was expected to have favourable demand spill overs for US trading partners.

According to the IMF, risks to the global growth forecast were broadly balanced in the near term, but skewed to the downside over the medium term. On the upside, the recovery could be stronger in the near term as the pickup in activity and easier financial conditions reinforce each other. On the downside, the possibility of a financial market correction associated with rich asset valuations and very compressed term premiums could dampen growth and confidence. Additionally, inward-looking policies, geopolitical tensions, and political uncertainty in some countries pose downside risks.

Inflation in advanced and emerging market economies is expected to pick up in 2018 and 2019 partly reflecting an increase in fuel prices and improved domestic demand. Inflation in advanced economies is expected to rise from 1.7 percent in 2017 to 2.0 percent in 2018 and 1.9 percent in 2019. In the emerging market and developing economies, inflation is projected to increase from 4.0 percent in 2017 to 4.6 percent in 2018 but decrease to 4.3 percent in 2019. Policy challenges are more diverse across advanced and emerging market economies in terms of supporting demand and structural reforms to stimulate medium term growth.

b. Domestic Economic Environment

i. Economic Growth

Real GDP growth is projected to pick up strongly to 6.2 percent in 2018 from 4.8 percent in 2017. The growth outlook will be supported by a stable macroeconomic environment, sustained investment in infrastructure, strong agricultural production due to favourable weather conditions, buoyant services sector, and increased investor and consumer confidence. The completion of the Mombasa-Nairobi SGR is expected to support industrialisation through

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

Region/Counry	2016 Act.	2017 Est.	2018 Proj.	2019 Proj.
World	3.2	3.8	3.9	3.9
Advanced Economies	1.7	2.3	2.5	2.2
United States	1.5	2.3	2.9	2.7
Japan	0.9	1.5	1.5	1.1
Euro Area	1.8	2.3	2.4	2.0
United Kingdom	1.9	1.8	1.6	1.5
Other Advanced economies	2.3	2.7	2.7	2.6
Emerging and developing economies	4.4	4.8	4.9	5.1
Sub-Saharan Africa	1.4	2.8	3.4	3.7
Emerging and Developing Asia	6.5	6.5	6.5	6.6
China	6.7	6.9	6.6	6.4
India	7.1	6.7	7.4	7.8
Middle East, North Africa, Afghanistan and Pakistan	4.9	2.6	3.4	3.7

Source: IMF, World Economic Outlook

lower transport costs and efficient movement of cargo. The Government's strategic focus on the Big 4 development priorities in food security and agricultural productivity, affordable housing, increased share of manufacturing, and universal health coverage in 2018 and the medium term is expected to provide an additional stimulus to growth.

ii. External Sector and Foreign Exchange Market

The Kenya Shilling is expected to be stable on account of a narrower current account deficit and resilient foreign exchange inflows. The current account deficit is expected to narrow from an estimated 6.7 percent of GDP in 2017 to 5.4 percent of GDP in 2018, largely due to lower imports of food and inputs for phase II of the SGR project, steady growth in tea and horticulture exports, strong diaspora remittances, and continued growth in tourism receipts. The 2018 growth outlook for Kenya's main trading partners in the region is strong, suggesting better prospects for exports performance. Export competitiveness will also be enhanced by the SGR through lower transportation costs and faster movement of goods to the port.

The main risks to the foreign exchange market in 2018 relate to continued uncertainties in the global financial markets with regard to the pace of normalization of monetary policy in advanced economies especially in the U.S. and the Brexit resolution. Nevertheless, the foreign exchange reserves will continue to provide an adequate buffer against short term shocks in the foreign exchange market. The Precautionary Facilities with the IMF provide an additional buffer against exogenous shocks.

iii. Inflation

Overall inflation is expected to remain within the Government medium term target range supported by lower food prices due to expected favorable weather conditions relative to 2017, and the monetary policy measures. Risks to the inflation outlook include the rise in international oil prices which has exerted upward pressure on domestic fuel prices, the likely impact of VAT on petroleum products which is expected to be introduced in September 2018, and the lifting of the Government's maize subsidy programme in June 2018. Prices of some items in the alcoholic beverages, tobacco and narcotics category could also increase slightly in 2018 if the Government implements the inflation based tax increases due after every two years as per the Excise Duty Act. However, these risks will be moderated by improved supply of maize following the imports in 2017 under the maize subsidy programme and the relatively good harvest in food basket regions. The continued exchange rate stability will dampen the threat of imported inflation.

iv. Fiscal Policy

Government borrowing continued to be anchored on the Medium-Term Debt Management Strategy which aims at maintaining public debt at sustainable levels. Consistent with Government's commitment to fiscal consolidation, the budget deficit is projected to decline from 7.4 percent of GDP in FY2017/18 to 5.7 percent of GDP in FY2018/19, and further to 3.0 percent in the medium term. The reduction in the deficit will be supported by reduced expenditures following the completion of general elections, improved weather conditions which will reduce the reliance on food imports, and the completion of major infrastructure projects. Net domestic financing is projected to increase from 3.4 percent of GDP in FY2017/18 to 3.8 percent in FY2018/19, before falling gradually to 1.5 percent of GDP in the medium term. The CBK will continue to work with the National Treasury to strengthen the coordination of monetary and fiscal policies.

4. DIRECTION OF MONETARY POLICY IN FY 2018/19

Monetary policy continues to be directed at achieving the Bank's principal objective of low and stable inflation. Thus, price stability will be the overriding objective of monetary policy in the FY 2018/19. In addition, monetary policy will support the Government's growth and employment creation objectives.

a) Monetary Policy Path and Foreign Exchange Reserves

The monetary targets for FY 2018/19 are consistent with the Medium-Term Government Budget Policy Statement for 2018 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) to 11.0 percent by December 2018 and 11.5 percent by June 2019. Growth in private sector credit is expected to pick up gradually from 4.3 percent in June 2018 to 7.3 percent by December 2018 and 12.2 percent by June 2019. These monetary targets are expected to enable the Bank maintain overall inflation within the current allowable margin of 2.5 percent on either side of the Government's medium-term target of 5 percent, and to anchor inflation expectations.

The CBK foreign exchange reserves will continue to provide a buffer against short-term shocks in the foreign exchange market. Precautionary Arrangements with the IMF will provide an additional buffer against exogenous shocks. Monetary policy will aim at ensuring that short-term interest rates are consistent with the CBK's price stability objective, while also ensuring the long-term sustainability of public debt. The coordination of monetary and fiscal policies will support macroeconomic stability. The CBK will continue to monitor the impact of the interest rate capping on lending and effectiveness of monetary policy transmission.

The Bank will continue to monitor developments in the Monetary Targets and make necessary reviews. The information will be reviewed to inform the MPC decision process. Monetary policy implementation will be based on the targets for Net Domestic Assets (NDA), and Net International reserves (NIR) of the Central Bank to be achieved through Open Market Operations (OMO). The Repurchase agreements (Repos) and Term Auction Deposits instruments will be used to withdraw any excess liquidity in the banking system and, where necessary, Reverse Repos will be used to inject liquidity.

The achievement of the targets set will depend on stability in the international prices of oil and global markets, favourable weather conditions, and continued commitment by the Government to operate within the domestic borrowing target in the FY2018/19. The success of the monetary policy measures will also depend on the effectiveness of the institutions charged with the responsibility of managing the supply side of the economy that would have a direct impact on food and fuel prices.

Table 8: Monetary Targets for the FY 2018/19

.	Sep-18	Dec-18	Mar-19	Jun-19
Broad Money, M3 (Ksh Billion)	3,293.1	3,343.3	3,479.7	3,616.7
Reserve Money, RM (Ksh Billion)	455.5	473.6	483.9	487.5
Credit to Private Sector (Ksh Billion)	2,304.5	2,374.1	2,431.6	2,531.9
NFA of CBK (Ksh Billion)	781.8	740.5	737.8	874.3
NDA of CBK (Ksh Billion)	-326.4	-266.9	-253.9	-386.8
12-month growth in RM (Percent)	7.3	7.9	15.7	13.6
12-month growth in M3 (Percent)	10.3	11.0	15.4	11.5
12-month growth in Credit to Private Sector (Percent)	6.0	7.3	9.5	12.2
Medium-Term 12-month overall Inflation (Percent)	5.0	5.0	5.0	5.0

Source: IMF, World Economic Outlook

ANNEX

EVENTS OF PARTICULAR RELEVANCE TO MONETARY POLICY (JANUARY – JUNE, 2018)

January	The MPC retained the CPR at 10.0 percent in order to anchor inflation expectations.
March	The MPC reduced the CBR from 10.0 percent to 9.5 percent.
May	The MPC retained the CBR at 9.5 percent.

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

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