Central Bank of Kenya

Monetary Policy Statement

December 2019

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 45th Monetary Policy Statement of the Central Bank of Kenya. It reviews and assesses the implementation of monetary policy during the second half of 2019, and outlines the direction of monetary policy for the next twelve months.

Dr. Patrick Njoroge

Governor

CONTENTS

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, 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 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 for 2020. It also reviews the outcome of the monetary policy stance adopted in the second half of 2019, against a backdrop of domestic macroeconomic stability, sustained optimism on the economic growth prospects, and increased uncertainties in the global financial markets. The global economic outlook remained highly uncertain in 2019, largely due to escalation of trade tensions between the U.S. and China, concerns with Brexit resolution, and other geo-political tensions.

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. The MPC retained CBR at 9.00 percent in July and September 2019, as inflation remained well anchored within the target range, and ensured that the interbank market remained liquid and continued to function smoothly. In November, the MPC lowered the CBR to 8.50 percent, noting that the economy was operating below its potential level, and the tightening of fiscal policy provided room for accommodative monetary policy to support economic activity. The repeal of interest rate caps in November 2019 restored the clarity of monetary policy decisions and was expected to strengthen the transmission of monetary policy. The gradual demonetisation (withdrawal of the older KSh 1,000 notes) and the close monitoring by CBK ensured that the process was not disruptive to the economy.

Overall inflation remained within the target range in the second half of 2019, supported by lower fuel prices, muted demand pressures and despite of spillover effects of food prices as well as the excise tax indexation in July. The inflation rate stood at 5.8 percent in December compared to 5.7 percent in June. Non-food-non-fuel (NFNF) inflation remained below 5 percent, indicating muted demand pressures.

The foreign exchange market remained relatively stable, despite continued uncertainties in the global financial markets due to trade tensions and global strengthening of the US Dollar. This stability was supported by a narrowing in the current account deficit and an adequate reserves buffer. The current account deficit stood at 5.8 percent of GDP in 2019, the same level in 2018, compared to 7.2 percent of GDP in 2017, supported by lower oil and SGR-related imports, resilient remittances and improved transport service receipts. The CBK foreign exchange reserves, which stood at USD 9,116 million (5.5 months of import cover) at the end of December 2019, 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 implement measures aimed at strengthening the sector to ensure greater transparency and stronger governance, and to promote effective business models and innovation. Banks have adopted the Banking Sector Charter, which defines a commitment to entrench a responsible and disciplined banking sector which is cognizant of, and responsive to, the needs of their customers. Private sector credit growth improved to 7.1 percent in the 12 months to December, compared to 5.2 percent in June. Strong credit growth was recorded in the manufacturing, consumer durables, transport and communication, and trade sectors.

In 2020, the monetary policy stance will aim at maintaining overall inflation rate within the target range and supporting economic activity. 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 stable at 5.8 percent of GDP in 2020. The continued coordination of monetary and fiscal policies is expected to sustain macroeconomic stability and support the economy. Consistent with inflation and growth objectives, monetary policy will aim at supporting growth in broad money (M3) and credit to the private sector by about 12.3 percent and 11.8 percent, respectively, by December 2020. Recovery in private sector credit is expected to be sustained, supported by the repeal of interest rate caps, renewed focus by the Government on MSMEs and banks initiated-innovative credit products targeting this sector.

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 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 2020. It also presents the outcome of the monetary policy stance adopted in the second half of 2019.

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 2019 weakened due to heightened uncertainties relating to U.S. and China trade tensions, Brexit resolution and other geo-politics. It was expected to improve modestly in 2020, partly supported by continued implementation of more accommodative monetary policy by Central banks in major advanced and emerging market economies.

On the domestic scene, macroeconomic stability was sustained in the second half of 2019. Inflation was well anchored within the target range, the foreign exchange market remained stable dampening the threat of imported inflation, modest recovery in private sector credit growth, while economic growth remained resilient, despite delayed and below average rainfall experienced during the first half of 2019.

The repeal of interest rate caps on commercial loans in November restored the clarity of monetary policy decisions and strengthened the transmission of monetary policy. However, uncertainties on the impact of the interest rates caps on monetary policy largely remained in the second half of 2019 CBK continued to monitor the impact of interest rate capping on the effectiveness of monetary policy transmission. The gradual demonetisation (withdrawal) of the older KSh 1,000 notes and the close monitoring by CBK ensured that the process was not disruptive to the economy.

The banking sector remained stable and resilient, and the rollout of innovative, bank-initiated credit products mainly targeting MSMEs was expected to support growth in private sector credit. The CBK also continued to implement measures aimed at strengthening the sector to ensure greater transparency and stronger governance, and to promote effective business models and innovation. Banks have adopted the Banking Sector Charter, which defines a commitment to entrench a responsible and disciplined banking sector which is cognizant of, and responsive to, the needs of their customers.

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 2019 while Section 3 describes the current economic environment and outlook for the 2020. Section 4 concludes by outlining the direction of the monetary policy in 2020.

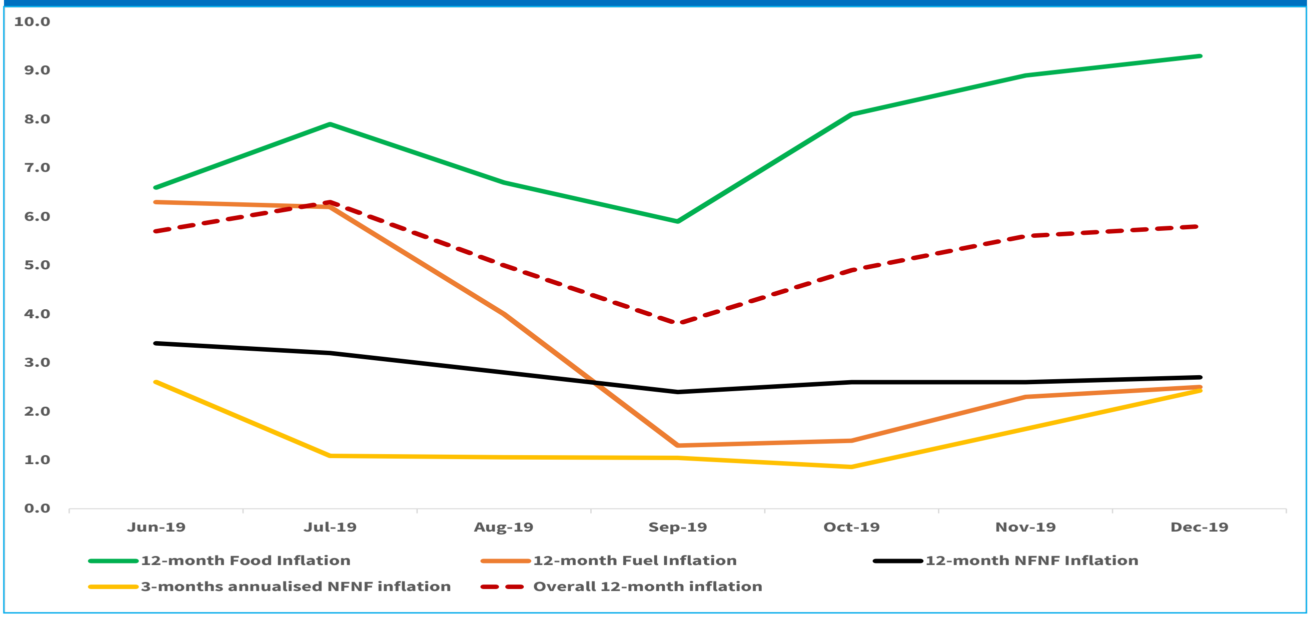
2. ACTIONS AND OUTCOMES OF THE POLICY STANCE IN THE SECOND HALF OF 2019

During the second half of 2019, 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 monetary policy decisions were made against a backdrop of domestic macroeconomic stability, sustained optimism on the economic growth prospects, and increased uncertainties in the global financial markets. During the Monetary Policy Committee (MPC) meetings in July and September 2019, the Committee retained the Central Bank Rate (CBR) at 9.00 percent, observing that inflation remained well anchored within the target range. In November 2019 meeting, the MPC decided to lower the CBR to 8.50 percent, noting that the economy was operating below its potential level, and the ongoing tightening of fiscal policy provided room for accommodative monetary policy to support economic activity. The following are the specific outcomes of the policy stance:

i. Inflation

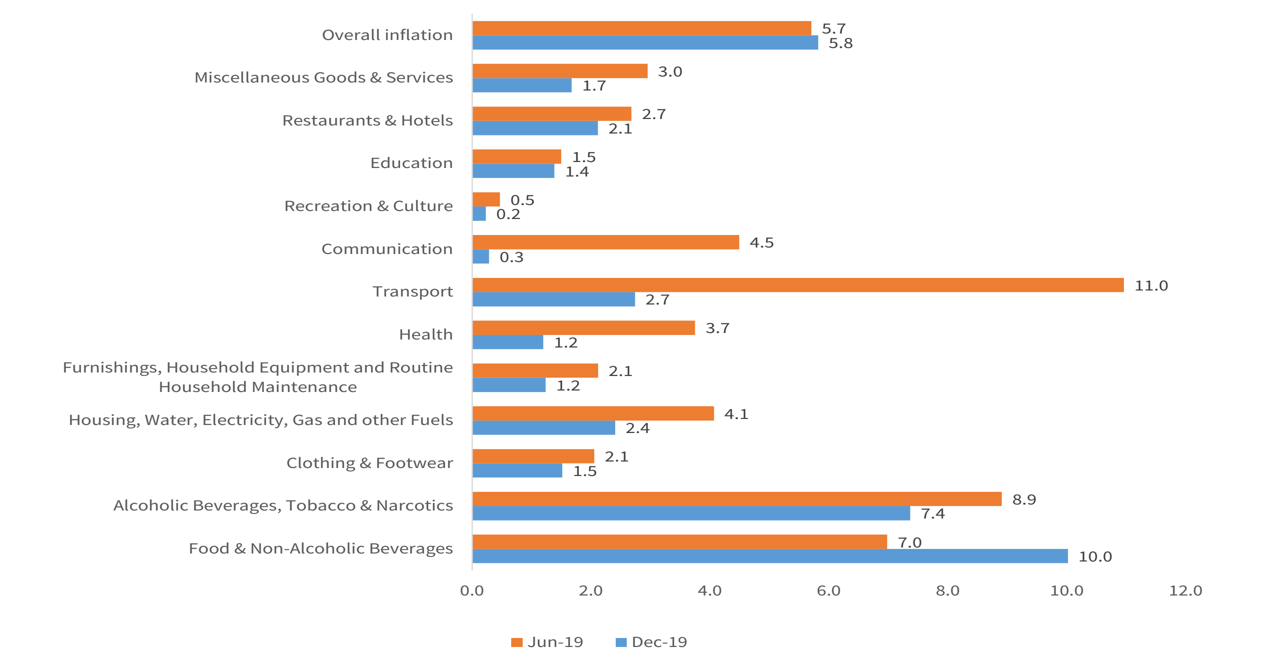
Overall inflation remained well anchored within the medium term target range in the second half of 2019 **(Chart 1a)**. The inflation rate remained stable at 5.8 percent in December 2019 compared to 5.7 percent in June 2019, supported by lower fuel prices, muted demand pressures despite spillover effects of food prices as well as the excise tax indexation in July. Fuel inflation declined to 2.5 percent in December from 6.3 percent in June in line with trends of domestic and international energy prices. However, food inflation increased to 9.3 percent from 6.6 percent in the period, largely reflecting increases in prices of selected cereals and vegetables, including maize products and tomatoes. Inflation rates for all the broad CPI categories except transport and food and beverages, were within the target range in December **(Chart 1b)**. Non-Food-Non-Fuel (NFNF) inflation remained low and stable below 5 percent, indicating 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 CPI Category (Percent)



Source: Kenya National Bureau of Statistics

ii. Bank Credit to the Private Sector

Recovery in private sector credit was sustained in the second half of 2019, growing by 7.1 percent in the 12 months to December 2019, compared to 5.2 percent in June **(Table 1)**. This was supported by recovery in demand with the improved economic activity, and accommodative monetary policy. Strong growth in credit was observed in the manufacturing, consumer durables, transport and communication, and trade sectors.

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

Main sectors	Jun-19	Jul-19	Aug-19	Sep-19	Oct-19	Nov-19	Dec-19
Agriculture	3.9	7.6	6.6	5.5	-5.2	-6.1	-2.4
Manufacturing	11.4	10.3	7.5	7.5	6.4	7.5	9.2
Trade	5.5	8.0	8.4	7.6	10.2	8.8	8.9
Building and construction	-6.3	-5.4	-6.0	-5.3	-5.5	-6.1	1.6
Transport and communication	5.8	6.4	5.8	5.0	4.8	9.8	8.1
Finance and insurance	4.7	5.3	8.2	14.5	15.1	15.8	0.4
Real estate	1.0	0.5	2.4	2.2	0.4	1.9	1.5
Mining and quarrying	-4.3	-13.5	-10.8	-5.1	0.1	-3.2	-5.8
Private households	7.6	7.1	8.6	8.8	5.3	6.1	5.6
Consumer durables	21.3	23.6	23.0	28.4	28.6	25.9	26.0
Business services	-3.2	1.6	-0.1	3.2	-0.4	-0.3	2.4
Other activities	-22.6	-17.2	-14.4	-13.6	12.7	30.9	16.0
Total private sector credit	**5.2**	**6.1**	**6.3**	**7.0**	**6.6**	**7.3**	**7.1**

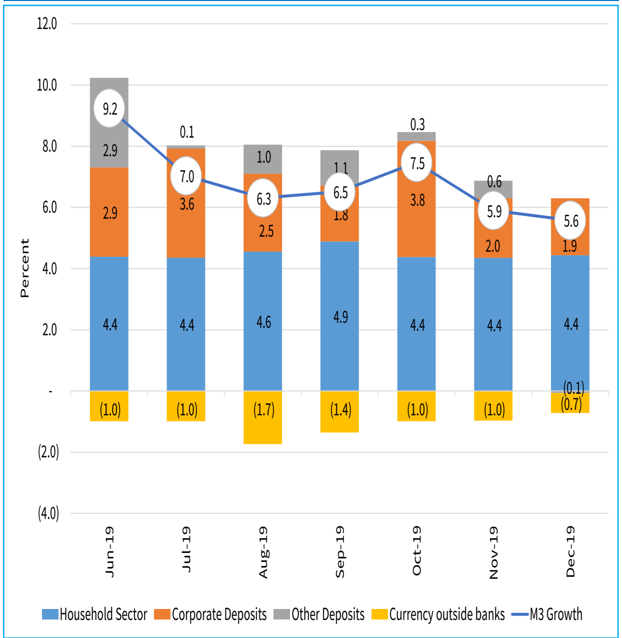
Source: Central Bank of Kenya

iii. Developments in the other Monetary Aggregates

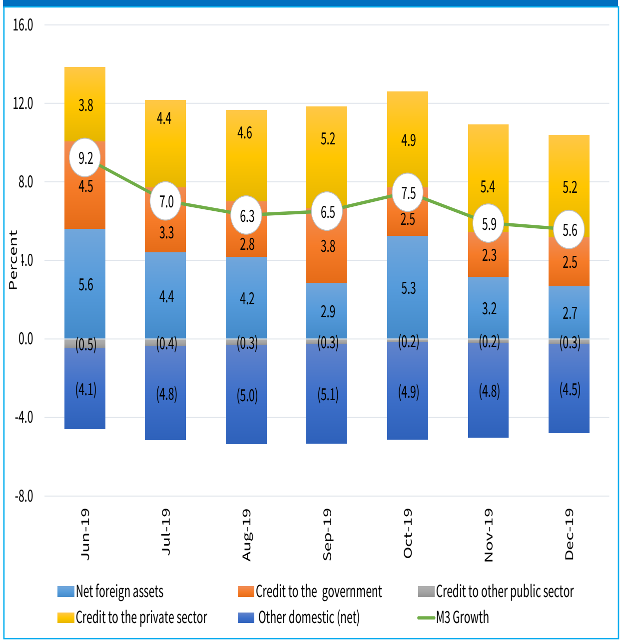
The 12-month growth of broad money, M3, decreased to 5.6 percent in December from 9.2 percent in June 2019, mainly due to decrease in net lending to government and net foreign assets of the banking system. Recovery in private sector credit growth supported growth in M3 during the period. On the liabilities side, the decline in money supply was mainly reflected in 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)**.

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

2a:Components of Money Growth (Percent)



2b: Sources of Money Growth (Percent)



Source: Central Bank of Kenya

Table 2: Actual and Targeted Growth in Key Monetary Aggregates

	Jun-19	Jul-19	Aug-19	Sep-19	Oct-19	Nov-19	Dec-19
Actual Broad Money,M3 (Ksh Billion)	3,564	3,509	3,465	3,473	3,518	3,462	3,524
Target (Ksh Billion)	3,512	3,532	3,576	3,545	3,538	3,602	3,666
Actual Reserve Money (Ksh Billion)	440	423	421	408	413	427	461
Target (Ksh Billion)	456	439	451	421	432	444	472
Actual Net Foreign Assets of CBK (Ksh Billion)	941	925	892	872	861	839	833
Target (Ksh Billion)	864	883	870	856	838	839	833
Actual Net Domestic Assets of CBK (Ksh Billion)	-501	-502	-471	-464	-448	-412	-372
Target (Ksh Billion)	-409	-444	-420	-435	-406	-395	-361
Actual Credit to private sector (Ksh Billion)	2,503	2,529	2,541	2,572	2,582	2,601	2,595
Target (Ksh Billion)	2,507	2,517	2,528	2,557	2,596	2,612	2,637
Memorandum Items							
12-month growth in actual Reserve Money (Percent)	2.5	-1.2	-6.5	-9.4	-7.8	-6.1	-6.3
12-month growth in actual Broad Money, M3 (Percent)	9.2	7.0	6.3	6.5	7.5	5.9	5.6

Source: Central Bank of Kenya

The demonetisation of the old KSh 1,000 notes (equivalent to 80.3 percent of total currency in circulation) from June to September 2019 had a minimal impact on broad money supply, M3. At the end of the exercise, KSh 7.4 billion (equivalent to 0.2 percent of M3 and 3.6 percent of total currency in circulation at the end of September 2019) were not exchanged due to the robust AML/CFT checks in place. However, the demonetisation resulted in a portfolio shift in the composition of M3 during the period towards deposits. The exercise resulted in a contraction in currency outside banks from KSh 222 billion at the end of May 2019 to KSh 158 billion at the end of September 2019, mainly due to reduced demand for physical cash by businesses and people as they exchanged the old 1,000 Shilling notes with new ones. The reduced demand for cash was partly mirrored in increased commercial banks deposits, which grew from KSh 3,174 billion to KSh 3,285 billion over the same period. In addition, increased usage of cashless payment platforms, such as mobile payments, partly reduced the demand for cash for transaction. Cash outside banks started to normalise immediately after the conclusion of the demonetisation exercise, rising from KSh 158 billion in September to KSh 177 billion in October.

iv. Interest Rates Developments

a. Central Bank Rate (CBR)

The MPC lowered the CBR to 8.50 percent in November 2019, after it had been retained at 9.00 percent during the July and September meetings. The MPC noted that the economy was operating below its potential level, and the tightening of fiscal policy provided room for accommodative monetary policy to support economic activity. Additionally, the CBK ensured that the interbank market remained liquid and continued to function smoothly, and continued to monitor any perverse response to its previous decisions.

b. Short Term Rates

Short-term interest rates were generally low in the second half of 2019, supported by accommodative monetary policy stance and improved market liquidity **(Table 3)**. The Government spending, including payments of pending bills also supported liquidity in the market. However, interest rates moderately increased towards the end of the year, partly reflecting seasonal demand for cash during the end year festivities. The average interbank interest rate that remained relatively low in the period, rose to 6.03 percent in December. Interest rates on government securities increased slightly, partly reflecting competitive biddings by banks. The average 91-day Treasury bill rate stood at 7.17 percent in December compared to 6.94 percent in June, while the average 182-day Treasury bill rate was 8.16 percent compared to 7.71 percent.

Table 3: Interest Rates (Percent)

	2018	2019							
	Dec	Mar	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Central Bank Rate	9.00	9.00	9.00	9.00	9.00	9.00	9.00	8.50	8.50
Interbank	8.15	3.72	2.98	2.28	3.70	6.59	6.86	4.24	6.03
Repo	7.72	3.49	4.23	4.55	7.37	8.69	7.83	6.52	7.45
91-Tbill	7.36	7.13	6.94	6.81	6.44	6.35	6.38	6.65	7.17
182-Tbill	8.45	8.32	7.71	7.57	7.12	7.10	7.23	7.61	8.16
Average Lending Rate (1)	**12.51**	**12.51**	**12.47**	**12.39**	**12.46**	**12.47**	**12.43**	**12.38**	**12.24**
Overdraft/loan	12.17	12.13	12.12	11.89	11.97	11.99	11.88	11.63	11.67
1-5years	12.70	12.70	12.64	12.58	12.67	12.67	12.62	12.68	12.50
Over 5years	12.47	12.49	12.46	12.42	12.48	12.46	12.47	12.43	12.29
Average Deposit Rate (2)	**7.41**	**7.22**	**7.19**	**6.97**	**6.91**	**6.98**	**6.96**	**6.56**	**7.11**
Demand	1.61	1.58	1.43	2.32	1.46	1.43	1.51	1.50	1.52
0-3months	7.83	7.62	7.55	7.26	7.28	7.42	7.40	7.37	7.60
Over 3months	7.67	7.43	7.53	7.34	7.21	7.23	7.21	6.27	7.50
Savings	5.13	5.05	4.77	4.77	4.54	4.58	4.44	4.47	4.02
Spread (1-2)	**5.09**	**5.29**	**5.28**	**5.42**	**5.56**	**5.48**	**5.47**	**5.82**	**5.14**

Source: Central Bank of Kenya

c. Commercial Bank Rates

Commercial banks' average interest rates declined in line with the reduction in the policy rate and improved liquidity conditions. The lending interest rate cap was repealed in November 2019. The weighted average lending rate declined to 12.24 percent in December 2019 from 12.47 percent in June 2019, while the weighted average deposit rate declined to 7.11 percent from 7.19 percent. As a result, the spread declined to an average of 5.14 percent from 5.28 percent.

v. Banking Sector Developments

The banking sector remained stable and resilient in the second half of 2029, with strong liquidity and capital adequacy ratios. Average commercial banks' liquidity and capital adequacy ratios stood at 49.7 percent and 18.8 percent, respectively, in December 2019, compared to 50.6 percent and 18.2 percent in June. The ratio of gross non-performing loans (NPLs) to gross loans declined to 12.0 percent in December from 12.7 percent in June 2019, mainly due to decreases in NPLs in the trade, real estate, financial services, manufacturing and personal/household sectors, reflecting repayments due to enhanced recovery efforts by banks, as well as write-offs.

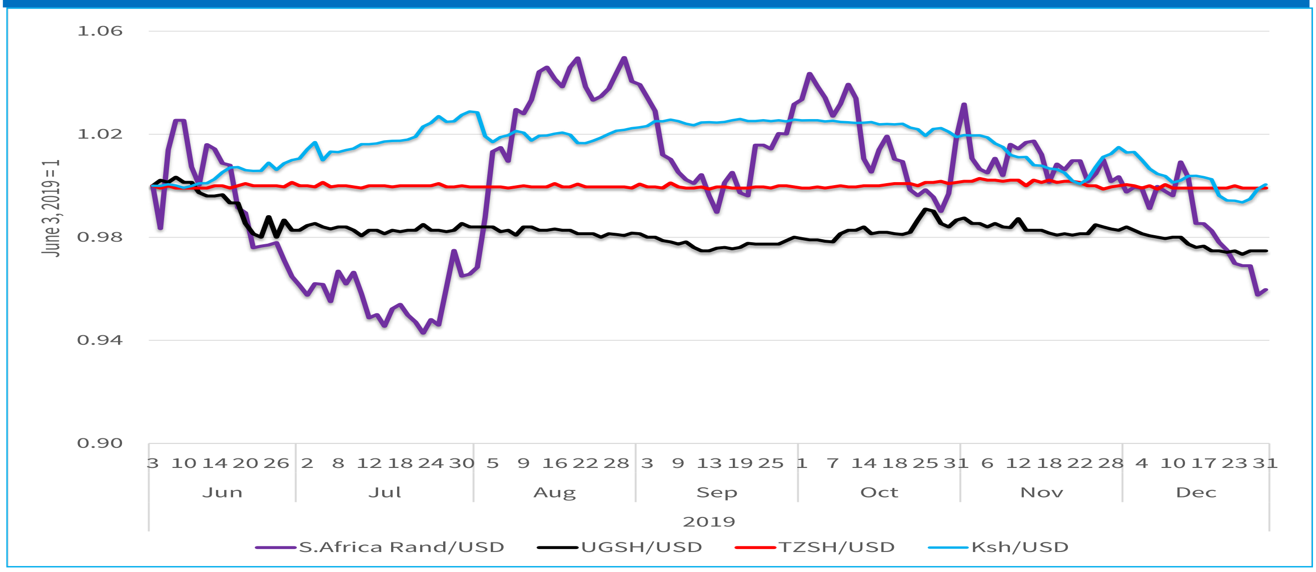
The CBK also continued to implement measures aimed at strengthening the sector to ensure greater transparency and stronger governance, and to promote effective business models and innovation. Banks have adopted the Banking Sector Charter, which defines a commitment to entrench a responsible and disciplined banking sector which is cognizant of, and responsive to, the needs of their customers.

vi. Exchange Rates and Foreign Exchange Reserves

The foreign exchange market remained relatively stable in the second half of 2019, supported mainly by narrowing current account deficit. Most major international and some regional currencies were volatile against the U.S. dollar largely due to heightened global uncertainties and volatility in international markets, and the strengthening of the US dollar **(Charts 3a and 3b)**. Resilience of Kenya's external sector supported the relative stability of the Kenya Shilling.

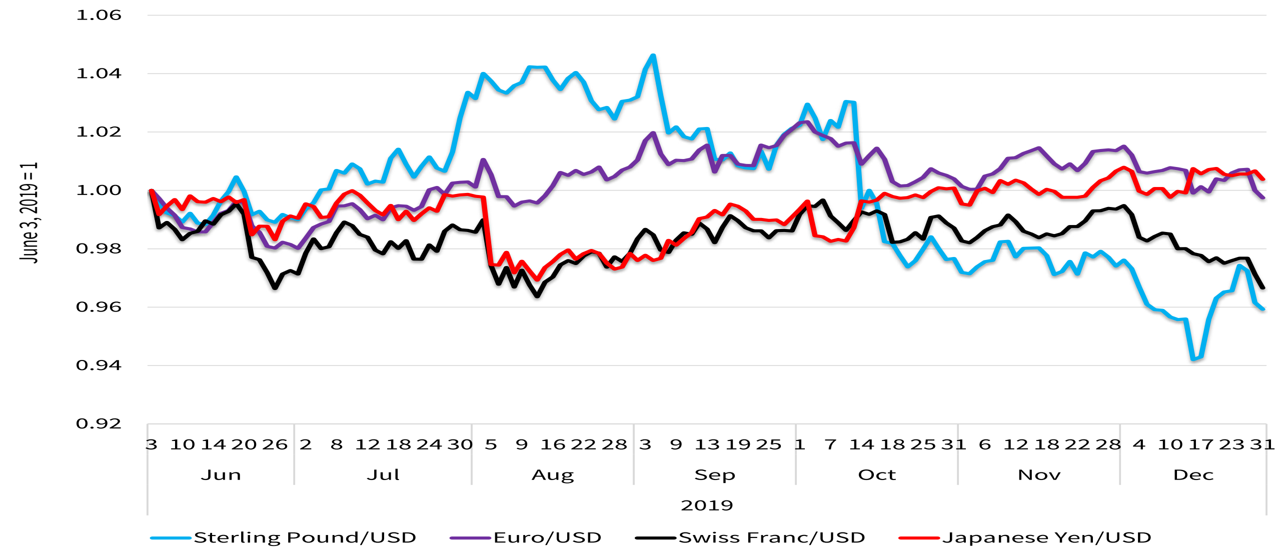
The CBK foreign exchange reserves, which stood at USD 9,116 million (5.5 months of import cover) in December 2019, continued to provide adequate cover and a buffer against short-term shocks in the foreign exchange market **(Chart 3c)**.

Chart 3a: Exchange rates of currencies in the region against the U.S. Dollar (June 3, 2019=1)



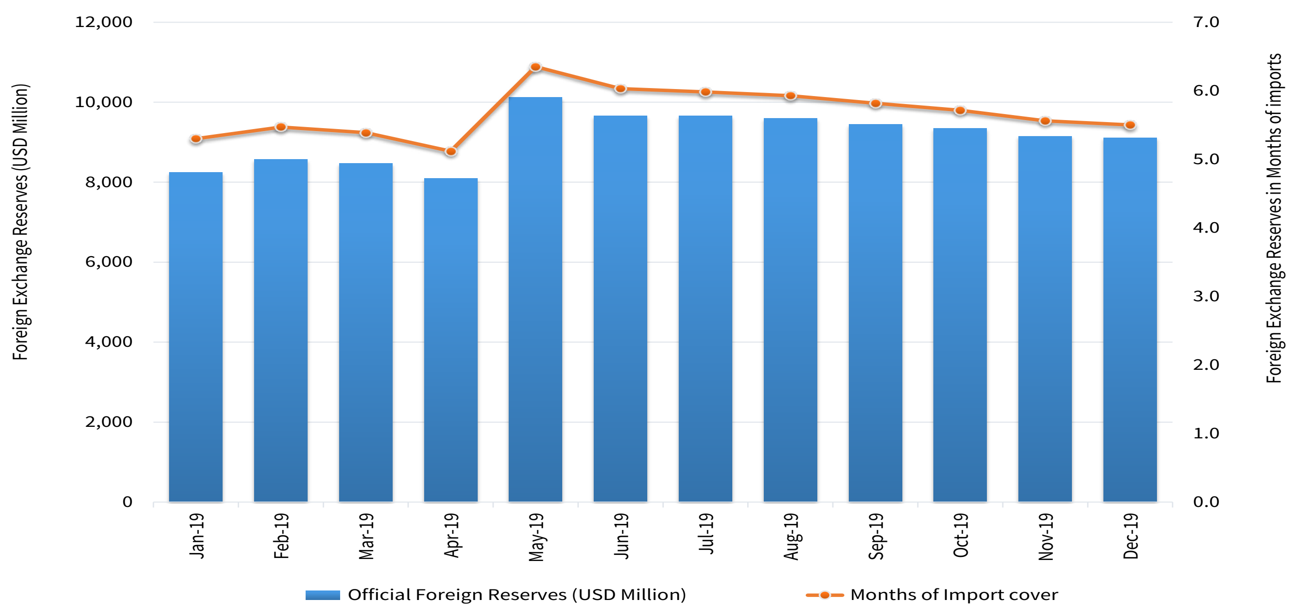
Source: Central Bank of Kenya

Chart 3b: Exchange rates of major international currencies against the U.S. Dollar (June 3, 2019=1)



Source: Central Bank of Kenya

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

vii. Balance of Payments Developments

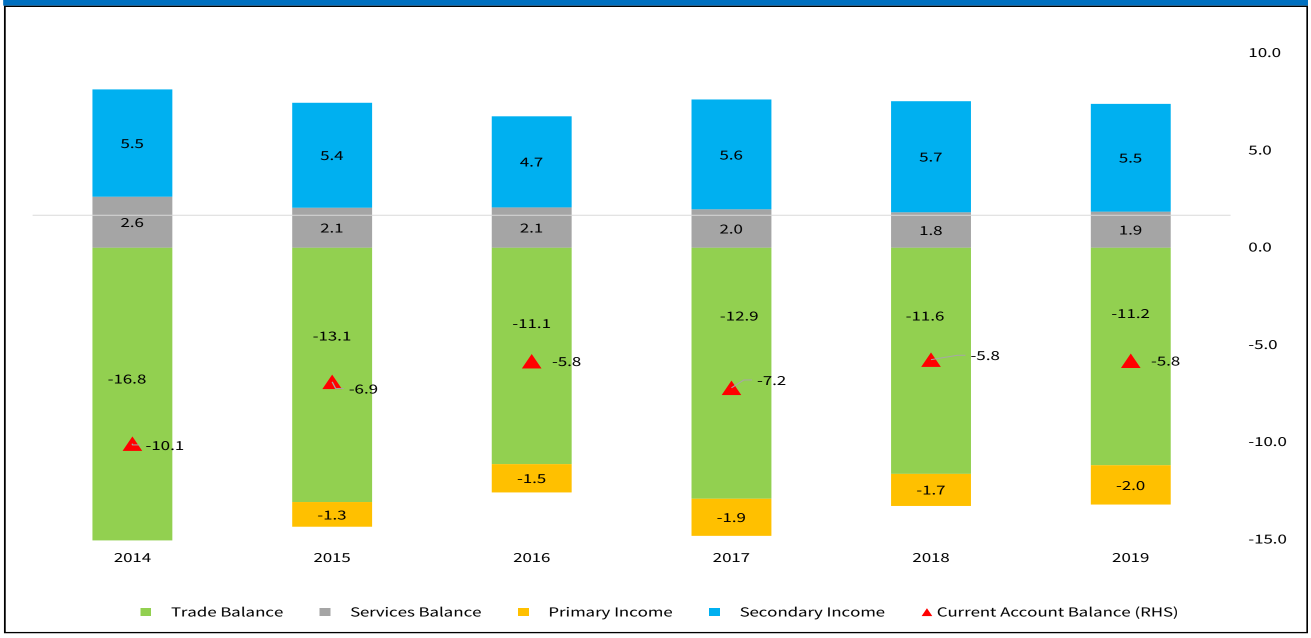
The current account deficit was stable at 5.8 percent of GDP in 2019, same level as in 2018, and a decline compared to 7.2 percent of GDP in 2017. The improvement was largely supported by the goods accounts **(Chart 4 and Table 4)**.

In particular, the balance in the goods account improved to a deficit of 11.2 percent of GDP in 2019 compared to a deficit of 11.6 percent in 2018, reflecting lower growth in merchandise imports attributed to lower oil imports on account of decline in international oil prices, and SGR-related imports with the completion of Phase 1 and Phase 2B of the SGR project. Exports of goods declined by 3.5 percent in 2019, largely reflecting reduced earnings from tea exports by 18.6 percent, due to decreased domestic production attributed to delayed and below average rainfall at the beginning of the year. Horticulture exports also declined by 6.0 percent during the period.

Exports to Africa accounted for 37.3 percent most of it going to COMESA and EAC region, which accounted for 25.1 percent and 23.3 percent, respectively. China and the European Union were the major sources of imports and accounted for 21.9 percent and 13.4 percent of the total exports, respectively **(Table 5)**.

The balance on the secondary income remained resilient mainly supported by remittances inflows, which accounted for 3.0 percent of GDP in 2019. The cumulative inflows in 2019 rose by 4.3 percent to USD 2,839 million. The balance on the services account remained relatively stable at 1.9 percent of GDP, supported by transport and tourism receipts. The deficit on the primary balance also remained relatively stable, partly reflected in reinvestment related outflows.

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



Source: Central Bank of Kenya

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

	2016 Act	2017 Act	2018 Act	2019 Act
Current account	**-5.8**	**-7.2**	**-5.8**	**-5.8**
1.1 Goods balance	**-11.1**	**-12.9**	**-11.6**	**-11.2**
Goods: exports, f.o.b.	8.3	7.3	6.9	6.1
o/w Tea	1.8	1.8	1.6	1.2
Horticulture	1.2	1.0	1.2	1.0
Manufactured Goods	0.6	0.5	0.4	0.4
Other	4.7	4.0	3.7	3.5
Goods: imports, f.o.b.	19.4	20.2	18.6	17.3
o/w Oil products	3.0	3.5	3.9	3.5
Other	10.1	10.9	9.5	10.1
Machinery & Transport equipment	6.3	5.9	5.2	3.7
1.2 Services balance	**2.1**	**2.0**	**1.8**	**1.9**
Services, Credit	6.0	5.9	6.2	5.9
Transportation	2.2	2.1	2.2	2.3
Travel	1.2	1.2	1.2	1.1
Services, Debit	3.9	3.9	4.4	4.0
1.3 Primary income, balance	**-1.5**	**-1.9**	**-1.7**	**-2.0**
Credit	0.1	0.2	0.2	0.2
Debit	1.6	2.1	1.9	2.2
1.4 Secondary income, balance	**4.7**	**5.6**	**5.7**	**5.5**
Credit	4.7	5.7	5.8	5.6
o/w Remittances	2.5	2.5	3.1	3.0
Debit	0.1	0.1	0.1	0.1
Capital account	**0.3**	**0.2**	**0.3**	**0.2**
Financial Account	**-7.5**	**-7.0**	**-7.5**	**-6.5**
Foreign Direct Investment balance	-0.8	-1.3	-1.7	-1.2
Portfolio Investment balance	0.5	1.0	-0.7	-1.4
Other Investment balance	-7.2	-6.8	-5.1	-4.0

Source: Central Bank of Kenya

Table 5: Kenya's Direction Trade

IMPORTS (in millions of US dollars)						
Country	**2017**	**2018**	**2019**	**2017**	**2018**	**2019**
Africa	1,939	2,033	2,196	12.1	12.5	13.3
Of which						
South Africa	598	639	691	3.7	3.9	4.2
Egypt	342	359	416	2.1	2.2	2.5
Others	999	1,035	1,088	6.2	6.4	6.6
EAC	**590**	**676**	**619**	**3.7**	**4.2**	**3.7**
COMESA	**1,115**	**1,139**	**1,180**	**7.0**	**7.0**	**7.1**
Rest of the World	**14,048**	**14,256**	**14,356**	**87.9**	**87.5**	**86.7**
Of which						
India	1,648	1,829	1,709	10.3	11.2	10.3
United Arab Emirates	1,338	1,457	1,636	8.4	8.9	9.9
China	3,777	3,663	3,624	23.6	22.5	21.9
Japan	790	985	948	4.9	6.0	5.7
USA	555	525	583	3.5	3.2	3.5
United Kingdom	291	311	330	1.8	1.9	2.0
Germany	416	460	438	2.6	2.8	2.6
Saudi Arabia	1,108	1,705	1,248	6.9	10.5	7.5
Indonesia	550	455	483	3.4	2.8	2.9
Netherlands	189	191	311	1.2	1.2	1.9
Italy	216	254	201	1.4	1.6	1.2
Others	3,170	2,420	2,844	19.8	14.9	17.2
Total	**15,987**	**16,289**	**16,551**	**100.0**	**100.0**	**100.0**
EU	1,986	2,151	2,222	12.4	13.2	13.4
China	3,777	3,663	3,624	23.6	22.5	21.9

EXPORTS (in millions of US dollars)						
Country	**2017**	**2018**	**2019**	**2017**	**2018**	**2019**
Africa	2,165	2,135	2,190	37.3	35.1	37.3
Of which						
Uganda	598	611	624	10.3	10.0	10.6
Tanzania	276	294	329	4.8	4.8	5.6
Sudan	67	61	57	1.2	1.0	1.0
South Sudan	162	128	123	2.8	2.1	2.1
DRC	183	150	132	3.1	2.5	2.2
Rwanda	166	176	227	2.9	2.9	3.9
Others	340	368	395	5.9	6.0	6.7
				0.0	*0.0*	*0.0*
EAC	**1,273**	**1,274**	**1,369**	**21.9**	**20.9**	**23.3**
COMESA	**1,448**	**1,452**	**1,477**	**25.0**	**23.9**	**25.1**
Rest of the World	**3,636**	**3,953**	**3,682**	**62.7**	**64.9**	**62.7**
Of which				0.0	0.0	0.0
United Kingdom	373	396	391	6.4	6.5	6.7
Netherlands	425	457	471	7.3	7.5	8.0
USA	457	467	509	7.9	7.7	8.7
Pakistan	619	586	444	10.7	9.6	7.6
United Arab Emirates	255	346	379	4.4	5.7	6.5
Germany	114	110	111	2.0	1.8	1.9
India	58	90	53	1.0	1.5	0.9
Others	1,306	1,462	1,289	22.5	24.0	21.9
Total	**5,801**	**6,088**	**5,872**	**100.0**	**100.0**	**100.0**
EU	1,209	1,290	1,305	20.8	21.2	22.2
China	97	110	148	1.7	1.8	2.5

Source: Kenya Revenue Authority and Central Bank of Kenya

viii. Economic Growth

The economy remained strong in the second half of 2019, supported by the non-agriculture sector particularly resilient services. The economy grew by an average of 5.4 percent, a similar level with the first half of 2019. The services sector grew by 6.8 percent compared to 6.6 percent in the first half of 2019, reflecting strong performance in information and communication, accommodation and restaurant, transport and storage, finance and insurance, real estate and wholesale and retail trade.

Agriculture sector growth remained slow at 3.2 percent in the second half of 2019 compared to 3.8 percent in the first half and 5.3 percent in the second half of 2018, reflecting impact of delayed onset and below average rainfall on agricultural production.

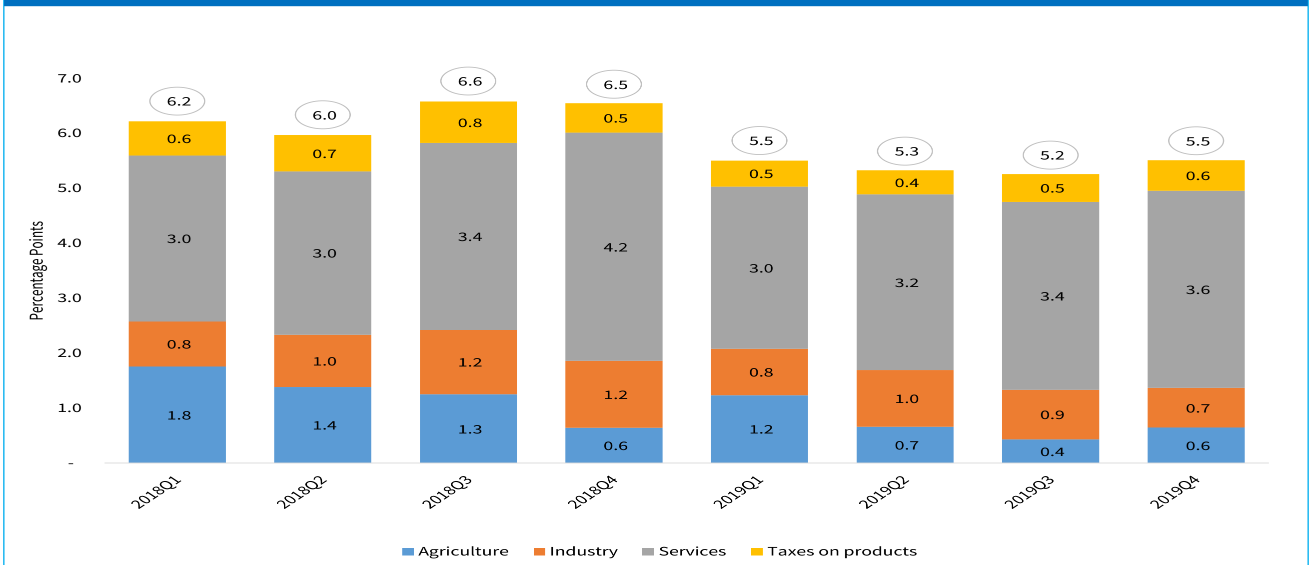
Industrial activity growth was subdued, largely driven by contraction in manufacturing sector due to the slow performance of agro-processing. It grew by 4.3 percent compared to 5.0 percent in the first half of 2019 and 6.2 percent in the second half of 2018. The construction sector, however, recorded strong performance during the period supported by increased construction of affordable housing under the Big 4 agenda, and high-quality Government investment in infrastructure across the country **(Table 6 and Chart 5)**.

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

Main Sectors	2018Q1	2018Q2	2018Q3	2018Q4	2019Q1	2019Q2	2019Q3	2019Q4	2018H2	2019H1	2019H2
1. Agriculture	6.7	5.9	6.8	3.9	4.7	2.9	2.4	4.0	5.3	3.8	3.2
2. Non-Agriculture (o/w)	6.0	6.0	6.5	7.1	5.8	6.0	5.9	5.8	6.8	5.9	5.8
2.1 Industry	4.5	5.0	6.0	6.4	4.7	5.4	4.7	3.8	6.2	5.0	4.3
2.2 Services	6.7	6.4	6.8	8.0	6.5	6.8	6.7	6.8	7.4	6.6	6.8
2.3 Taxes on products	6.1	6.0	6.2	4.3	4.7	4.0	4.2	4.5	5.3	4.3	4.4
Real GDP Growth	6.2	6.0	6.6	6.5	5.5	5.3	5.2	5.5	6.6	5.4	5.4

Source: Kenya National Bureau of Statistics

Chart 5: Contributions to Real GDP Growth (percent)



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 of the FY2019/20 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 Government's net domestic borrowing target. As at end-December, net cumulative borrowing stood at KSh 215 billion (71.5 percent) of annual target of KSh 300.3 billion. In line with the Medium-Term Debt Strategy (MTDS), the Average Time to Maturity for Treasury bonds rose to 7.9 years as at end December from 7.3 years in June. Treasury bills to bonds ratio stood at 31:69 by end of December compared to 36:64 in June 2019.

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

The MPC members held 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 held 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. In addition, MPC Members held 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 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 issues.

3. THE CURRENT ECONOMIC ENVIRONMENT AND OUTLOOK FOR 2020

a. International Economic Environment

The October 2019 IMF World Economic Outlook (WEO) projected global output to remained subdued due to heightened uncertainties with regard to escalation of trade tensions between the U.S. and China and Brexit resolution. Global growth was projected at 3.4 percent in 2020, which was 0.2 percentage point lower than in the April WEO projections, and a modest growth compared to projected growth of 3.0 percent in 2019. The weakening global trade was a key factor expected to continue undermining global output as the growth in the World trade volume was projected to decline to 1.1 percent in 2019 and 3.2 percent in 2021 compared to 3.6 percent in 2018.

Growth in advanced economies was projected at 1.7 percent in 2020, similar level in 2019 that was 0.2 percentage points lower than the April WEO. Trade related uncertainty negatively affected investment and growth in U.S., while Brexit-related uncertainty weakened growth in the United Kingdom and Euro area. In emerging and developing economies, growth was projected to increase modestly to 4.6 from 3.9 percent in 2019, and were lower than earlier projected, with the effects of trade tensions and weakening external demand dampening growth to varying extents across countries. Economic activity in sub-Saharan Africa (SSA) was expected to remain relatively resilient at 3.6 percent compared to 3.2 percent in 2019, partly supported by oil exporting countries like Angola and Nigeria **(Table 7)**.

Central banks in major advanced economies continued to implement more accommodative monetary policy to support growth and financial stability. However, the risk of increased volatility in the global financial markets and downside risks to global activity intensified. The escalation of trade disputes among major economies and a further escalation of geopolitical tensions could lead to increase in trade barriers and may pose risks to global trade and increase the probability of a marked global downturn.

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

Region/Country	2016 Act.	2017 Act.	2018 Act.	2019 Proj.	2020 Proj.
World Output	**3.3**	**3.7**	**3.6**	**3.0**	**3.4**
Advanced Economies	**1.7**	**2.3**	**2.3**	**1.7**	**1.7**
United States	1.6	2.2	2.9	2.4	2.1
Euro Area	1.9	2.4	1.9	1.2	1.4
Japan	1.0	1.7	0.8	0.9	0.5
United Kingdom	1.8	1.7	1.4	1.2	1.4
Emerging Market and Developing Economies	**4.4**	**4.7**	**4.5**	**3.9**	**4.6**
China	6.7	6.9	6.6	6.1	5.8
India	7.1	6.7	6.8	6.1	7.0
Brazil	-3.5	1.0	1.1	0.9	2.0
Russia	-0.2	1.5	2.3	1.1	1.9
Sub Sahara Africa	**1.4**	**2.7**	**3.2**	**3.2**	**3.6**
Nigeria	-1.6	0.8	1.9	2.3	2.5
South Africa	0.6	1.3	0.8	0.7	1.1

Source: IMF, World Economic Outlook

b. Domestic Economic Environment

The economy remained resilient in the second half of 2019, supported by macroeconomic stability, growth of MSMEs, and a robust services sector particularly accommodation and restaurant, information and communications technology, and transport and storage.

Stronger growth is expected in 2020 supported by, among others, continued implementation of the *Big 4* agenda, a stable macroeconomic environment, the recovery of the agricultural sector due to the interventions by the Government and stronger growth of MSMEs. The payment of pending bills to the various sectors particularly the MSMEs is expected to boost economic activity. The MPC Private Sector Market Perception Survey conducted in November 2019 indicated that respondents remained optimistic on economic prospects due to, among other factors, payments of pending bills by the government, improving weather conditions, implementation of the *Big 4* agenda projects, improved lending to the private sector following the repeal of interest rate caps, renewed focus by the Government on agriculture and MSMEs, and a stable macroeconomic environment. As a result, growth is projected at about 6.2 percent in 2020 from 5.4 percent in 2019.

The macroeconomic environment is expected to remain stable, with overall inflation remaining within the medium-term 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 current account deficit is expected to remain stable at 5.8 percent of GDP in 2020, supported by resilient remittances and strong receipts from agricultural exports and transport services, and lower imports of SGR-related equipment.

The FY 2019/20 Budget aims at fiscal consolidation with the fiscal deficit projected to decline to 6.3 percent of GDP from 7.7 percent of GDP in FY 2018/19. The Government objective to maintain fiscal consolidation over the medium term will stabilize growth in public debt.

4. DIRECTION OF MONETARY POLICY IN 2020

Price stability will be the overriding objective of monetary policy in 2020. Monetary policy will also support economic growth. The monetary targets for 2020 are therefore consistent with Government policy objectives articulated in the Medium-Term Government Budget Policy Statement and Budget Review and Outlook Paper for 2019 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 11 percent in June to December 2020, an increase from 6.3 percent in March. Growth in private sector credit is expected to pick up from 7.1 percent in December 2019 to 9.6 percent by June 2020 and 11.8 percent by December. Growth in reserve money is projected to increase to 7.0 percent by December 2020 from a decline of 6.3 percent in December 2019. The repeal of interest rate caps on commercial loans, the renewed focus by the Government on agriculture and MSMEs, and the banks initiated-innovative credit products targeting this sector, are expected to support lending to the private sector.

The CBK foreign exchange reserves are projected at US$ 9,324 million (about 5.4 months of import cover) by December 2020, 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. Domestic output growth is susceptible to occurrence of adverse weather conditions, and public expenditure pressures may result in the Government operating outside the domestic borrowing target, while the predictability of money demand continues to be affected by continued innovation in the financial sector. On the external front, the key downside risks include: weakening global economy with increased global uncertainties and volatility in international markets due to protracted U.S. and China trade tensions, Brexit resolutions and other geo-political tensions.

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 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 2020

	Mar-20	Jun-20	Sep-20	Dec-20
Broad Money, M3 (Ksh Billion)	3,631.8	3,919.1	3,846.9	3,957.3
Reserve Money, RM (Ksh Billion)	441.6	459.8	456.1	493.5
Credit to Private Sector (Ksh Billion)	2,652.9	2,743.7	2,831.4	2,899.7
NFA of CBK (Ksh Billion)	784.9	950.0	912.5	861.7
NDA of CBK (Ksh Billion)	-343.3	-490.2	-456.4	-368.1
12-month growth in RM (Percent)	-3.3	4.6	11.9	7.0
12-month growth in M3 (Percent)	6.3	10.0	10.8	12.3
12-month growth in Credit to Private Sector (Percent)	8.5	9.6	10.1	11.8
Medium-Term 12-month overall Inflation (Percent)	5.0	5.0	5.0	5.0

Source: Central Bank of Kenya

ANNEX

EVENTS OF PARTICULAR RELEVANCE TO MONETARY POLICY (JULY – DECEMBER 2019)

July	The MPC retained the CBR at 9.00 percent. The MPC noted that inflation expectations remained well anchored within the target range.
September	The MPC retained the CBR at 9.00 percent. The MPC noted that inflation expectations remained well anchored within the target range, and the prospective tightening of fiscal policy would provide scope for accommodative monetary policy in the near term.
	CBK announced successful completion of demonetisation of the old 1,000 Kenya Shillings notes, and the process was not disruptive to the economy.
October	Release of October 2019 WEO report showing global economy outlook momentum slowed down to 3.0 percent in 2019, due to heightened trade tension, geopolitics and policy uncertainties.
November	The MPC lowered the CBR to 8.50 percent from 9.00 percent. The MPC noted that inflation expectations remained well anchored within the target range, assessed that the economy was operating below its potential level, and the tightening of fiscal policy provided room for accommodative monetary policy to support economic activity.
	Repeal of interest rate caps on commercial loans.

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.

BANKI KUU YA KENYA

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