Central Bank of Kenya

MONETARY POLICY STATEMENT

Issued pursuant to Section 4B of the Central Bank of Kenya Act, Cap 491

June 2017

LETTER OF TRANSMITTAL TO THE CABINET SECRETARY FOR THE NATIONAL TREASURY

Dear Honourable Cabinet Secretary,

I have the pleasure of forwarding to you the 40th Monetary Policy Statement (MPS) of Central Bank of Kenya (CBK), pursuant to Section 4B of the Central Bank of Kenya Act. It reviews the outcome of the monetary policy stance during the first half of 2017, describes the current economic environment and outlook, and concludes with an outline of the direction of monetary policy for the FY 2017/18.

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 Article 231 of Kenya's Constitution. The principal objectives of the CBK as established in the Central Bank Kenya Act, Cap 491, are:

(1). to formulate and implement monetary policy directed to achieving and maintaining stability in the general level of prices;

(2). to foster the liquidity, solvency and proper functioning of a stable, market-based, financial system; and

(3). subject to (1) and (2) above, to support the economic policy of the Government, including its objectives for growth and employment.

Without prejudice to the generality of the above, the Bank shall:

- formulate and implement foreign exchange policy;
- hold and manage Government foreign exchange reserves;
- license and supervise authorised foreign exchange dealers;
- formulate and implement such policies as best promote the establishment, regulation and supervision of efficient and effective payment, clearing and settlement systems;
- act as banker and adviser to, and fiscal agent of, the Government; and
- issue currency notes and coins.

The CBK formulates and conducts monetary policy with the aim of keeping overall inflation within the allowable margin (currently 2.5 percent) on either side of the target prescribed by the National Treasury after the annual Budget Policy Statement. The achievement and maintenance of a low and stable inflation rate coupled with ensuring adequate liquidity in the market facilitates higher levels of domestic savings and private investment which leads to improved economic growth, higher real incomes and increased employment opportunities.

The CBK's monetary policy is therefore designed to support the Government's desired growth in the production of goods and services and employment creation through achieving and maintaining a low and stable rate of inflation.

INSTRUMENTS 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 by 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, but does not intervene, in the overnight interbank money market which is conducted by the banking industry. 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.

The CBR is also currently the base rate for commercial banks' lending interest rates and deposit rates on interest earning accounts under the Banking (Amendment) Act, 2016, which came in force on September 14, 2016.

- **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.

- **Foreign Exchange Market Operations:** The CBK can also inject or withdraw liquidity from the banking system by engaging in foreign exchange transactions. A sale of foreign exchange to banks withdraws liquidity from the system while the purchase of foreign exchange injects liquidity into the system. Participation by the CBK in the foreign exchange market is usually motivated by the need to acquire foreign exchange to service official debt, and to build-up its foreign exchange reserves in line with the statutory requirement.

  The CBK uses its best endeavours to maintain foreign reserves equivalent to four months' imports as recorded and averaged for the last three preceding years. The CBK does not participate in the foreign exchange market to defend a particular value of the Kenya shilling but may intervene in the exchange market to stabilise the market in the event of excess volatility.

  The following regulatory measures have been introduced, through Prudential Guidelines of banks, to support stability of the exchange rate:

  i. Limiting the tenor of swaps and Kenya Shilling borrowing where offshore banks are involved to a tenor of not less than one year;
  ii. Limiting the tenor of swaps between residents to not less than seven days;
  iii. Reduction of the foreign exchange exposure ratio of core capital from 20 percent to 10 percent. Furthermore, the foreign exchange limits should not exceed the 10 percent overall limit at any time during any day; and
  iv. Requiring that local banks obtain supporting documents for all transactions in the Nostro accounts of offshore banks.

- **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 both with respect to qualifications and character.

- **The National Payments System:** The modernisation of the National Payments System has continued to lower transaction costs, and improve the effectiveness of monetary policy instruments. The CBK ensures that the payment systems operate without major disruptions;

offers efficient, reliable and safe services to customers; and operate in line with the specified regulatory legal framework.

- **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 also enhance 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.

LEGAL STATUS OF THE MONETARY POLICY STATEMENT

1. Section 4B (1) of the CBK Act requires the Bank to submit to the Cabinet Secretary for The National Treasury, at intervals of not more than six months, a Monetary Policy Statement for the next twelve months which shall:
   i. Specify policies and the means by which the Bank intends to achieve its policy targets;
   ii. State reasons for adopting such monetary policies and means; and
   iii. Contain a review and assessment of the progress made in the implementation of monetary policy by the Bank during the period to which the preceding Monetary Policy Statement relates.

2. The Cabinet Secretary shall – by law – lay every Statement submitted under subsection (1) before the appropriate committee of the National Assembly not later than the end of the subsequent session of Parliament after the Statement is so submitted.

3a. The Bank shall – by law – publish in the Kenya Gazette:
   i) Its Monetary Policy Statement; and
   ii Its Monthly Balance Sheet.

3b. The Bank is further required to disseminate key financial data and information on monetary policy to the public.

4. In subsection (2) of section 4B, the expression "appropriate committee" means the committee of the National Assembly appointed to investigate and inquire into matters relating to monetary policy.

EXECUTIVE SUMMARY

This Monetary Policy Statement provides the direction of monetary policy in 2017/18. It also reviews the outcome of the monetary policy stance adopted in the first half of 2017.

During the first half of 2017, the CBK conducted monetary policy with the aim of keeping overall inflation within the Government target range. Month-on-month overall inflation was within the Government target range in January 2017, but exceeded the target range from February to June due to a sharp drought related increase in food prices. Food inflation rose sharply in February 2017 reflecting the adverse impact of the prolonged dry weather conditions in the first quarter of 2017 on the prices of key food items. As a result, overall inflation rose from 6.3 percent in December 2016 to 11.7 percent in May 2017. The Government initiated measures to mitigate the impact of the drought on key food items, including zero-rating of taxes on maize and bread, and duty free imports of maize and sugar. Reflecting the positive impact of these measures and improved supply of short maturing food stuff following the recent rains, inflation eased to 9.2 percent in June 2017. Average inflation for all CPI categories, excluding food and non-alcoholic beverages, remained below 5 percent throughout the period. Additionally, the 12-month non-food-non-fuel (NFNF) inflation and the 3-month annualized NFNF inflation remained within the 5 percent range; suggesting that demand pressures in the economy were muted.

The foreign exchange market remained stable during the first half of 2017 supported by resilient earnings from tea and horticulture exports, strong diaspora remittances, and continued recovery in tourism. The stability was also supported by closer monitoring of the market following increased uncertainties in the global financial markets following Brexit and the U.S. elections. The CBK foreign exchange reserves rose to the highest levels in the period; the reserves stood at USD7,979.3 million or 5.3 months of import cover at the end of June 2016. The CBK's foreign exchange reserves together with the Precautionary Arrangements with the International Monetary Fund (IMF) provided a buffer against short-term shocks.

The Monetary Policy Committee (MPC) retained the Central Bank Rate (CBR) at 10.0 percent in its January, March and May 2017 meetings in order to continue to anchor inflation expectations. The liquidity management operations by the CBK ensured stability in the interbank market in the period. The Central Bank relied on Open Market Operations (Repo, Term Auction Deposits and Reverse Repos) as the main instrument to support liquidity distribution in the interbank market.

The monetary policy stance in FY 2017/18 will aim at bringing down and maintaining overall month-on-month inflation rate within the Government's target range of 2.5 percent on either side of the 5 percent target. The price stability objective aims at supporting a strong and sustainable growth in the medium-term. The level of foreign exchange reserves together with the Precautionary Arrangements with the IMF will continue to provide an adequate buffer against short-term shocks. Overall macroeconomic stability and sustainability of public debt will be supported by continued coordination of monetary and fiscal policies.

The banking sector remained resilient during the period. However, growth in private sector credit maintained a downward trend partly due to tighter credit standards adopted by banks, weak performance in some sectors such as manufacturing and increased use of alternative funding sources such as international development finance institutions and alternative funding modalities. The CBK continued to monitor the impact of the capping of interest rates on lending and monetary policy effectiveness. Although banks are still adjusting their business models to ensure that they remain competitive in the new environment, preliminary data showed that there was reduced lending to sectors perceived to be risky, particularly the Micro, Small and Medium Enterprises (MSMEs).

Consistent with inflation and growth objectives in the Government Medium Budget Policy Statement for 2017, monetary policy will aim at containing annual growth in broad money (M3) at 13.7 percent by December 2017 and by 14.6 percent by June 2018. Monetary policy will also 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 and efficiency of its monetary policy instruments in order to maintain price stability while ensuring financial sector stability.

The CBK will continue to strengthen the banking sector to ensure greater transparency and stronger governance, and to promote effective business models and innovation. The Bank has continued to implement additional measures to lower the cost of credit on a sustainable basis including promoting innovation in the banking sector leveraging on ICT, and strengthening the Credit Reference Bureaus to provide for a credit scoring framework. The Bank will continue to collaborate with other stakeholders in the financial and real sectors to obtain regular feedback, and ensure the timely release of relevant monetary and financial data.

The Bank will continue to monitor risks posed by developments in the domestic and global economies on its overall price stability objective. It will also continue to monitor the impact of interest rate capping on monetary policy transmission, and the overall economy.

1. INTRODUCTION

This Monetary Policy Statement (MPS) provides the direction of monetary policy for the Fiscal Year 2017/18. It also presents the outcome of the monetary policy stance adopted in the first half of 2017.

Price stability remains the primary objective of monetary policy formulation and implementation. The CBK targets for Net Domestic Assets (NDA) and Net International Reserves (NIR) are the operational parameters. The Bank also monitors targets for key monetary aggregates such as broad money (M3) and credit to the private sector. The Central Bank Rate (CBR) signals the monetary policy stance, and is the base for all monetary policy operations. 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 and the Precautionary Arrangements with the International Monetary Fund (IMF) provide an adequate buffer against short-term shocks.

On the domestic scene, a sharp increase in food prices exerted upward pressure on consumer prices in the first half of 2017. The stability in the exchange rate is expected to dampen any threat of imported inflation in spite of volatility in international oil prices. On the global scene, uncertainties have increased relating to policy developments in the U.S., the pace of normalization of monetary policy in advanced economies and the outcome of Brexit.

The rest of this Policy Statement is organized as follows. Section 2 reviews the outcome of the monetary policy stance proposed in the December 2016 MPS while Section 3 describes the current economic environment and outlook for the Fiscal Year 2017/18. Section 4 concludes by outlining the specific monetary policy path for the Fiscal Year 2017/18.

2. ACTIONS AND OUTCOMES OF POLICY PROPOSALS IN THE DECEMBER 2016 MONETARY POLICY STATEMENT

The overall aim of the Monetary Policy Statement for December 2016 (39th MPS) was to set monetary policy targets that would ensure low and stable inflation, encourage growth, support long-term sustainability of public debt through stable interest rates and, by enhancing financial access within the economy, contribute to lowering the cost of doing business in Kenya. The following are the specific outcomes of the policy proposals in the 39th MPS.

a. Inflation

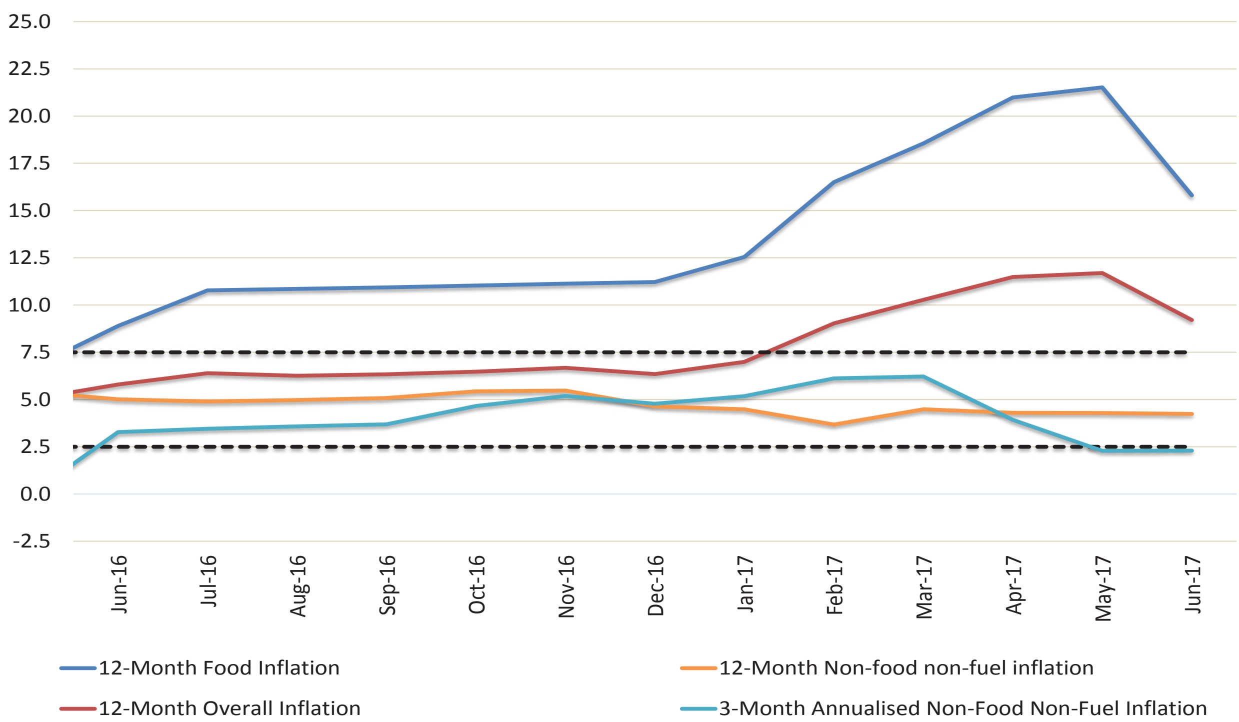
The monetary policy measures pursued by the Monetary Policy Committee (MPC) anchored inflation expectations and ensured market stability during the first half of 2017. The CBR was retained at 10.0 percent during the period in order to anchor inflation expectations. Overall month-on-month inflation exceeded the upper bound of the Government target range from February 2017 following a sharp increase in food prices reflecting the adverse effect of the drought in the first quarter of 2017 on food production (Chart 1).

The National Drought Early Warning Bulletin, published by the Ministry of Devolution and Planning in January 2017, showed that the food security situation was expected to worsen in the first quarter of 2017. This reflected the depressed rainfall over most parts of the country during the short rains season from October to December 2016. The rains were therefore inadequate to support any surplus food production from critical parts of the country.

Month-on-month overall inflation rose from 6.3 percent in December 2016 to 11.7 percent in May 2017 due to the elevated food prices. Food inflation rose from 11.2 percent in December 2016 to 21.5 percent in May 2017 due to sharp increases in the prices of key food items with significant weights in the CPI. The main food items with significant price increases include Irish potatoes, kale-sukuma wiki, cabbages, sifted maize flour, maize grain (loose), fresh packeted milk, and sugar (Chart 1b). Overall inflation fell to 9.2 percent in June 2017 due to increased supply of the quick maturing food items during the long rains season, and the impact of Government interventions including zero-rating of taxes on maize and bread, and duty free imports of maize (Chart 1c).

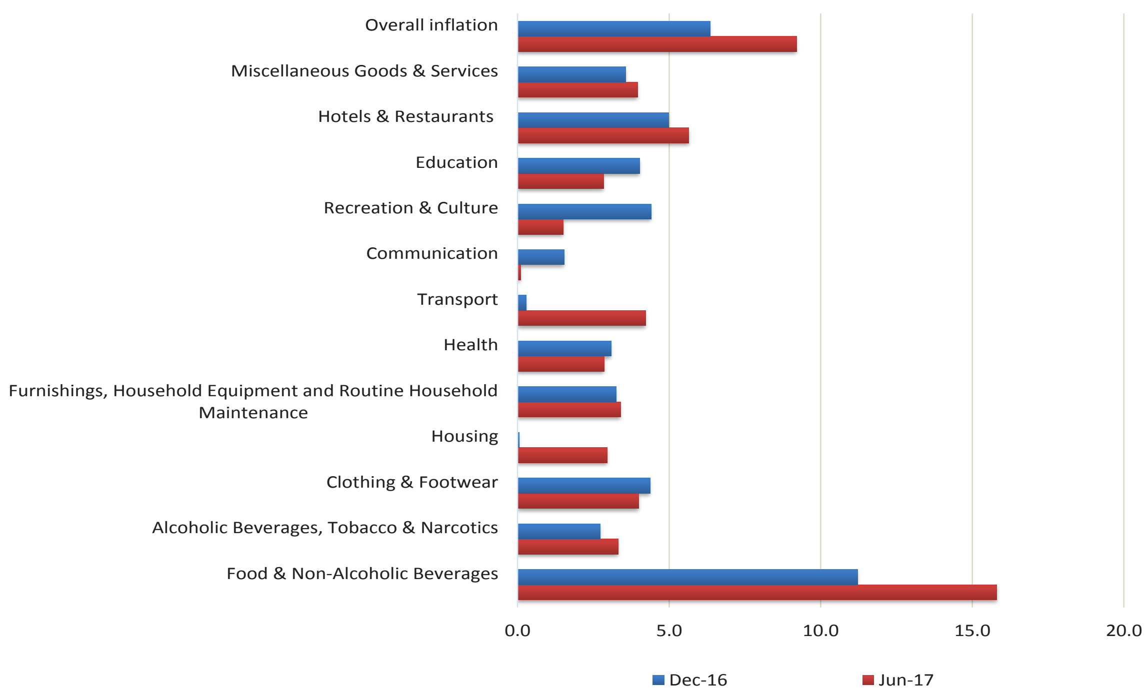
Nevertheless, the 12-month non-food-non-fuel (NFNF) inflation and the 3-month annualized NFNF inflation remained within the 5 percent range; suggesting that demand pressures in the economy was muted. Moreover, the average inflation for all categories, excluding food and non-alcoholic beverages, remained below 5 percent in the first half of 2017.

Chart 1: Overall and Non-Food-Non-Fuel Inflation Measures (%)



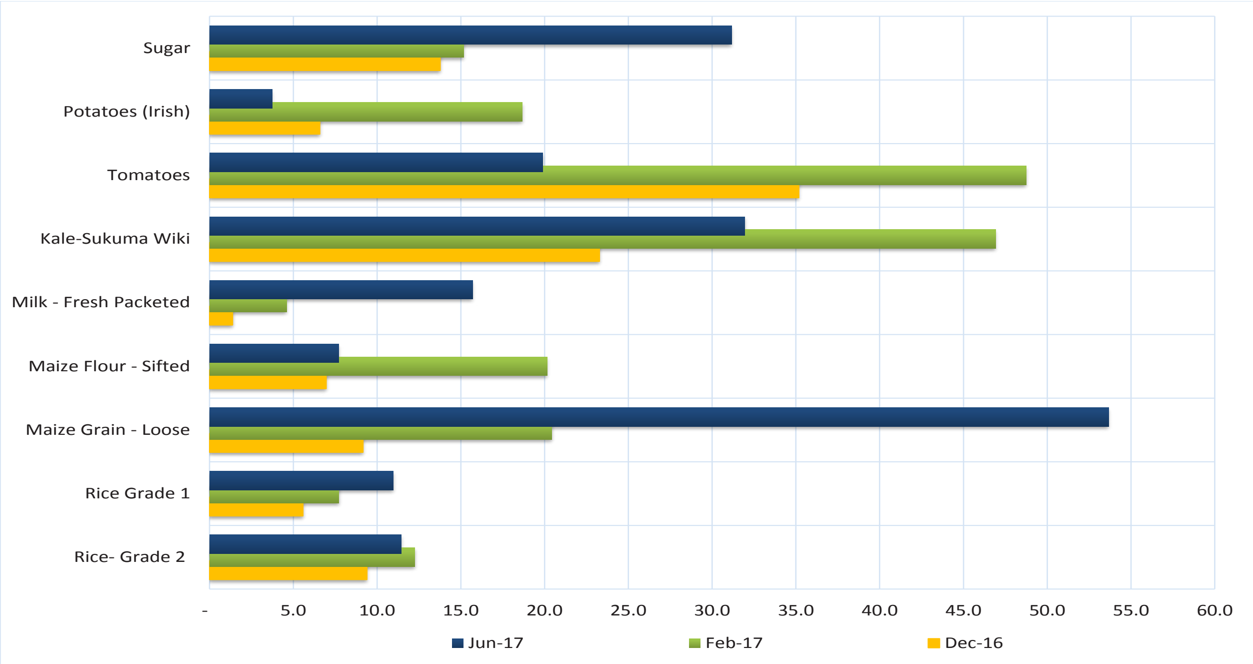
Source: Kenya National Bureau of Statistics and Central Bank of Kenya

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



Source: Kenya National Bureau of Statistics

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



Source: Kenya National Bureau of Statistics

i. Bank Credit to the Private Sector

The 12-month growth in credit to the private sector decelerated from 4.1 percent in December 2016 to 1.5 percent in June 2017 (Table 1). The slowdown in private sector credit growth was largely due to factors in trade, manufacturing, real estate, and private households' sectors.

Preliminary analyses showed that the slowdown in credit growth was due in part to tighter credit standards adopted by banks, weak performance of some key sectors such as manufacturing and increased use of alternative funding sources such as international development finance institutions and alternative funding modalities. Additionally, preliminary data on the implications of interest rate capping showed that there was reduced lending by commercial banks to sectors perceived to be risky, particularly the Micro, Small and Medium Enterprises (MSMEs).

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

	Dec-16	Jan-17	Feb-17	Mar-17	Apr-17	May-17	Jun-17
Agriculture	*0.9*	*-2.6*	*1.4*	*-7.7*	*-8.8*	*-12.6*	*-12.3*
Manufacturing	-2.4	-6.8	-8.6	-7.8	-6.8	-5.2	-7.1
Trade	*15.9*	*13.4*	*10.1*	*11.6*	*8.0*	*8.8*	*10.7*
Building & construction	-2.8	-0.8	8.3	0.6	-2.3	2.5	-0.7
Transport & communication	*14.9*	*10.2*	*8.0*	*9.6*	*7.6*	*5.6*	*3.2*
Finance and insurance	16.7	-0.6	-4.6	-9.2	-11.9	-2.8	-4.4
Real estate	*11.0*	*10.3*	*9.7*	*12.4*	*13.2*	*11.8*	*10.1*
Mining & quarrying	-19.1	-17.5	-25.5	-34.0	-34.2	-39.5	-37.8
Private households	*19.7*	*14.7*	*15.6*	*13.3*	*10.4*	*9.8*	*10.9*
Consumer durables	11.3	11.1	11.1	10.1	11.9	11.3	7.5
Business services	*-34.8*	*-13.0*	*-13.7*	*-15.5*	*-15.1*	*-21.8*	*-15.8*
Other activities	-27.0	-30.7	-28.5	-22.7	-19.0	-19.2	-25.0
Total private sector credit	***4.1***	***3.9***	***3.5***	***3.0***	***2.3***	***1.9***	***1.5***

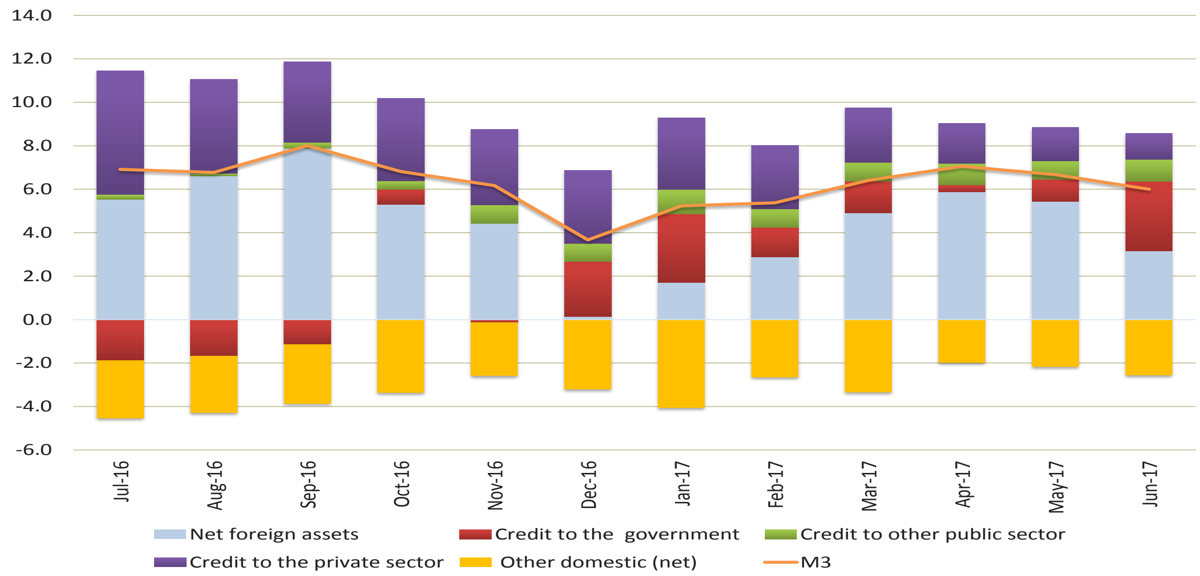
Source: Central Bank of Kenya

ii. Developments in the other Monetary Aggregates

The 12-month growth of broad money, M3, rose to 6.0 percent in June 2017 from 3.7 percent in December 2016. The main sources of M3 growth were net foreign assets, credit to government, and credit to other public sector. The contribution of credit to the private sector to the growth of M3 declined from 3.3 percentage points to 1.2 percentage points in the period. Other domestic assets (net) were also a drag to the growth of M3 (Chart 2). Both broad money and its main component, private sector credit, remained below target their respective targets in the first half of 2017 (Table 2).

The CBK met its Net International Reserves (NIR) and Net Domestic Assets (NDA) targets for March and June 2017 under the Precautionary Arrangements with the International Monetary Fund (IMF) aimed at safeguarding the economy against exogenous shocks. However, following sharp increases in food prices due to the drought in the first quarter of 2017, the average 12-month overall inflation exceeded the upper bound of the Government target range in the quarters ending March and June 2017.

Chart 2: Contribution of the M3 counterparts to the 12-Month growth in M3 (%)



Source: Central Bank of Kenya

Table 2: Trends in the Key Monetary Aggregates

	Dec-16	Mar-17	Jun-17
Actual Broad Money,M3 (Ksh Billion)	*2,764.5*	*2,764.5*	*2,764.5*
Target (Ksh Billion)	2,967.4	2,856.5	3,045.3
Actual Reserve Money (Ksh Billion)	*411.1*	*414.9*	*401.2*
Target (Ksh Billion)	421.5	430.0	432.3
Actual Net Foreign Assets of CBK (Ksh Billion)	*621.6*	*697.8*	*745.0*
Target (Ksh Billion)	676.8	727.0	832.0
Actual Net Domestic Assets of CBK (Ksh Billion)	*-210.4*	*-282.9*	*-343.8*
Target (Ksh Billion)	-255.3	-296.0	-399.0
Actual Credit to private sector (Ksh Billion)	*2,275.7*	*2,263.8*	*2,249.1*
Target (Ksh Billion)	2,374.1	2,329.1	2,378.3
Memorandum Items			
12-month growth in actual Reserve Money (Percent)	4.8	3.2	2.8
12-month growth in Broad Money, M3 (Percent)	*3.7*	*6.4*	*6.0*

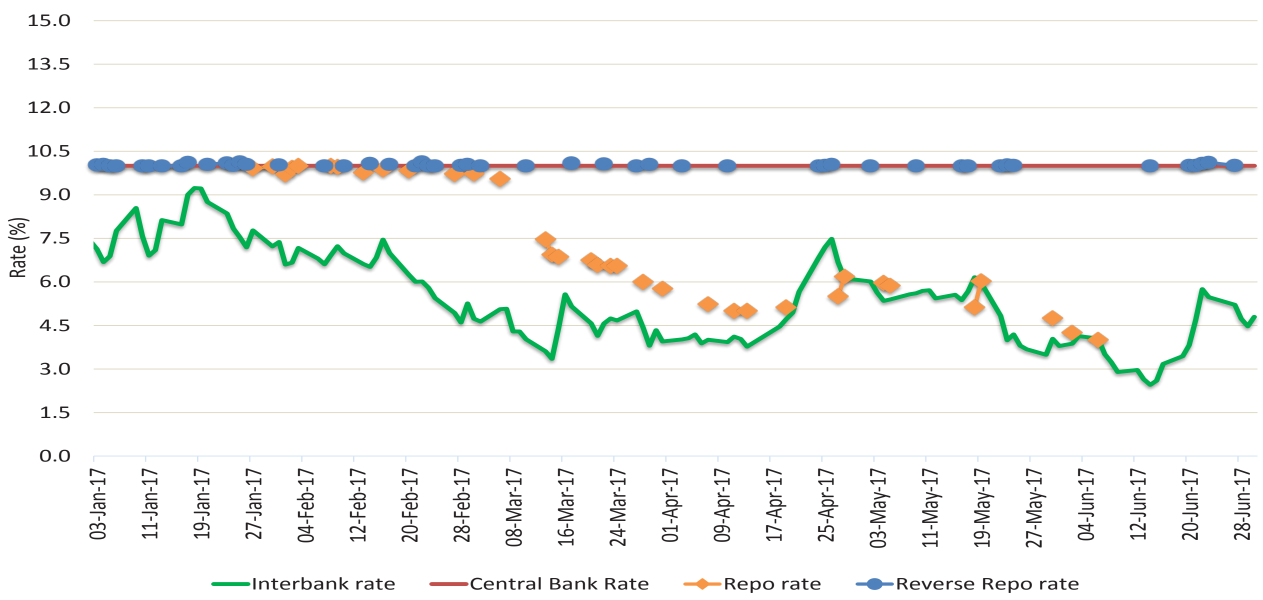
Source: Central Bank of Kenya

iii. Interest Rates and Liquidity

The interbank rate remained below the CBR during the six months to June 2017 reflecting improved liquidity conditions in the market. However, the liquidity distribution remained uneven across the banks due to the segmentation in the interbank market. Liquidity management operations by the CBK in the period were aimed at supporting stability in the interbank market. The CBK used Reverse Repos to supply liquidity to segments of the market facing temporary shortages, and Repos and Term Auction Deposits to withdraw liquidity from segments of the market with surpluses (Chart 3a).

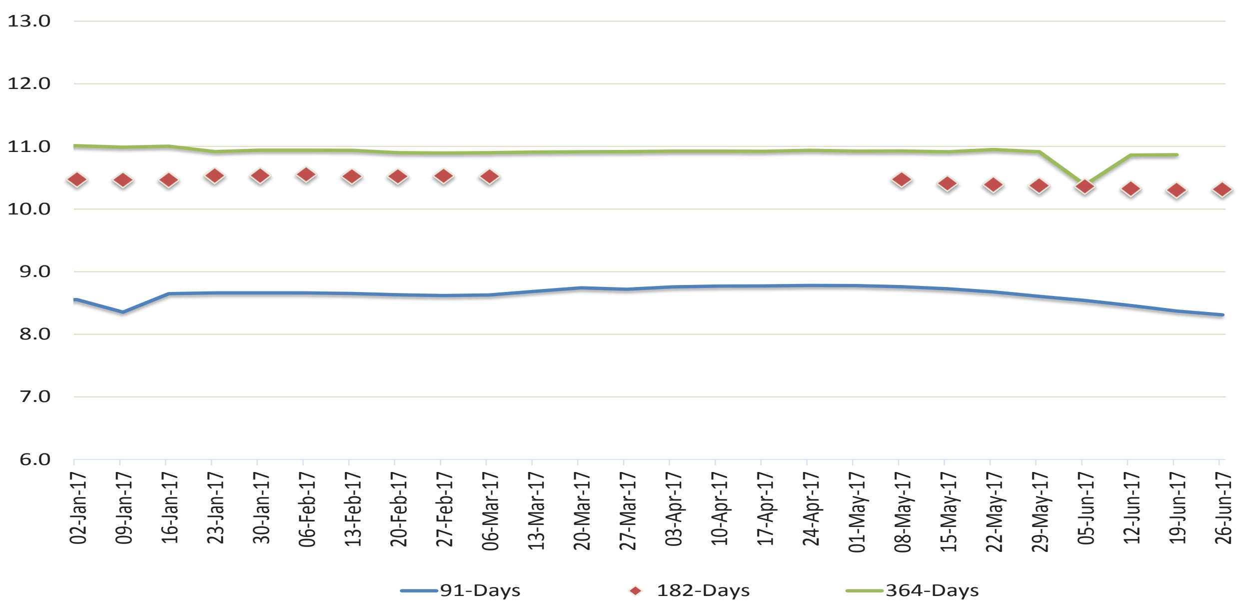
The implementation of the government domestic borrowing programme continued to support market stability. Interest rates on government securities were relatively stable during the first half 2017 (Chart 3b). Additionally, the stability of the yield curve in the period continued to enhance predictability in the government securities market.

Chart 3a: Trends in Short Term Interest Rates (%)



Source: Central Bank of Kenya

Chart 3b: Interest rates on Treasury Bills (%)



Source: Central Bank of Kenya

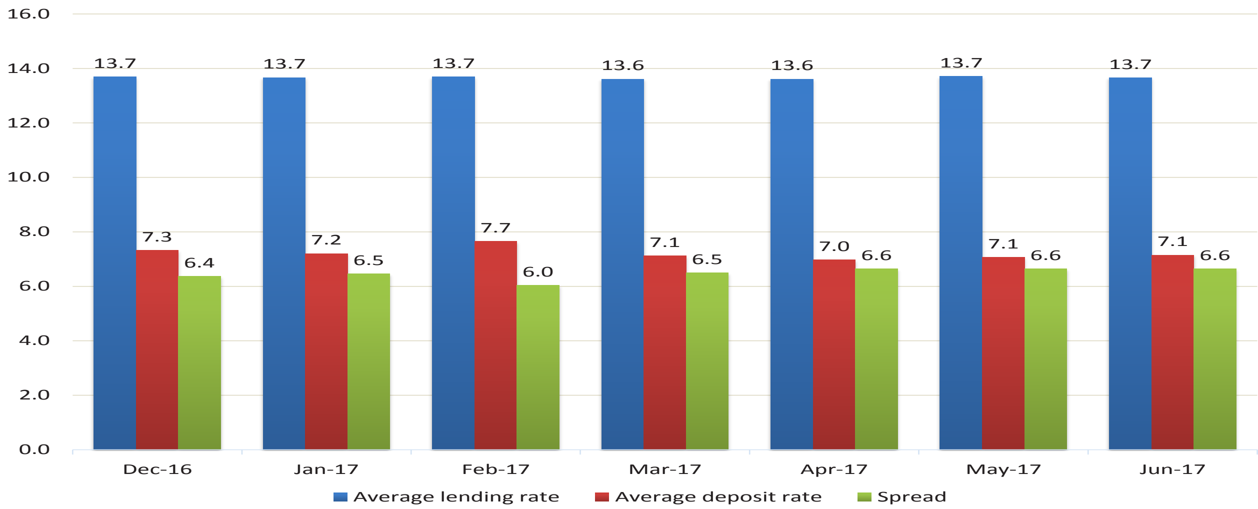
iv. Other Banking Sector Developments

The banking sector remained resilient with improved performance indicators in the first half of 2017. The average commercial banks liquidity rose from 41.4 percent in December 2016 to 44.7 percent in June 2017. The capital adequacy ratio stood at 19.6 percent in June 2017 compared with 18.7 percent in December 2016. 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 9.9 percent in June 2017 compared to 9.1 percent in December 2016, partly reflecting a decline in the growth of gross loans. However, the ratio of net non-performing loans to gross loans remained below 5 percent. Commercial banks' lending rates flattened out within the interest rate caps, while banks' funding costs, deposit rates, increased particularly from February 2017 (Chart 3c).

The CBK continued to monitor the impact of capping interest rates on lending and monetary policy. Preliminary data showed that the number of loan applications increased by 16.2 percent between August 2016 and June 2017, but the value of loan applications decreased by 18.9 percent, suggesting smaller size of loan applications. The number of loan approvals increased by 27.4 percent while their value decreased by 19.5 percent. Moreover, commercial banks' lending to Micro, Small and Medium Enterprises (MSMEs) fell by an estimated 4.6 percent between August 2016 and June 2017.

The CBK also continued to implement measures to promote transparency and competition in the sector, and to sustainably reduce the cost of credit. Toward this end, the CBK in collaboration with the Kenya Bankers Association (KBA) launched the Cost of Credit website in June 2017. The website provides information on fees and charges relating to loan products offered by commercial banks and microfinance banks. Full disclosure of credit information should facilitate customers to make informed credit decisions. This initiative will go a long way in promoting greater transparency in the pricing of loan products and enhance competition in the banking sector.

Chart 3c: Commercial Banks' Interest Rates and Spreads (%)



Source: Central Bank of Kenya

b. Foreign Exchange Market and Reserves Developments

The foreign exchange market remained stable, supported by resilient receipts from tea and horticulture exports, and strong receipts from tourism, coffee exports and diaspora remittances. (Charts 4a and 4b). Despite lower export volumes due to adverse weather conditions in the first quarter of 2017, receipts from tea and horticulture exports remained resilient..The resilience is supported by diversification of Kenya's exports in terms of both export products and external markets, relative to its peers, which has continued to cushion the econony against short-term shocks.

Most international currencies were volatile against the U.S. dollar between January and June 2017 largely due to uncertainties in the global financial markets such as the economic policies of the U.S., the pace of normalisation of monetary policy in advance economies, and the Brexit resolution. Sub-Saharan African (SSA) currencies depicted mixed trends against the U.S. dollar during the period (Chart 4b). Domestic currencies in Kenya, Uganda, and Tanzania were relatively stable against the U.S. dollar, while the South African Rand was more volatile reflecting political developments and slower growth.

Chart 4a: Rate of Depreciation of the Kenya Shilling and Major International Currencies against the U.S. Dollar (January 3, 2017=1)

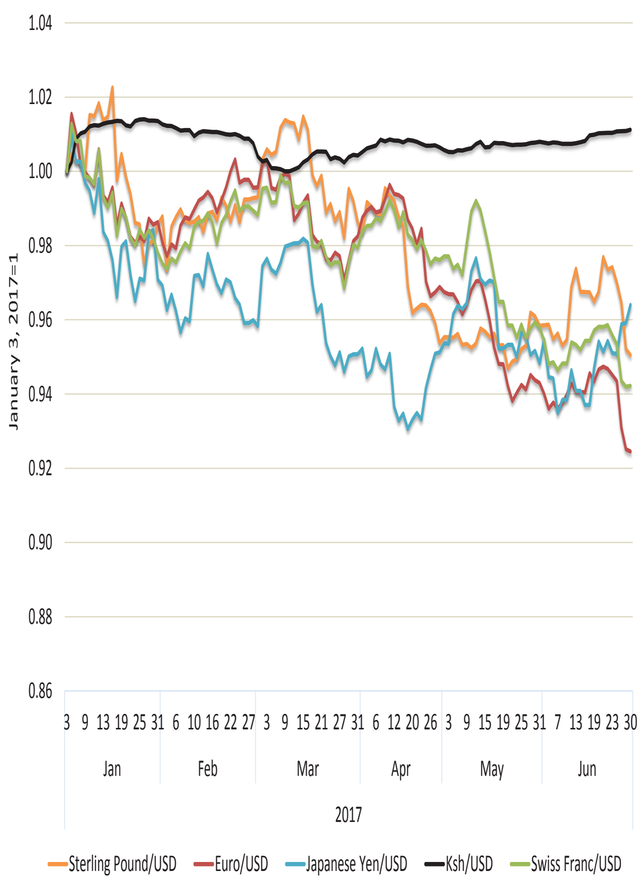
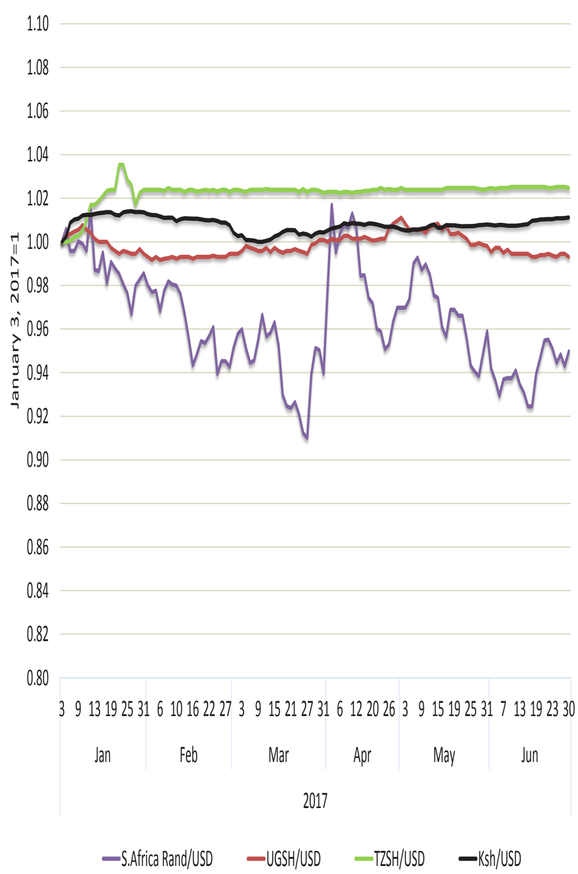


Chart 4b: Rate of Depreciation of the Kenya Shilling and Regional Currencies against the U.S. Dollar (January 3, 2017=1)

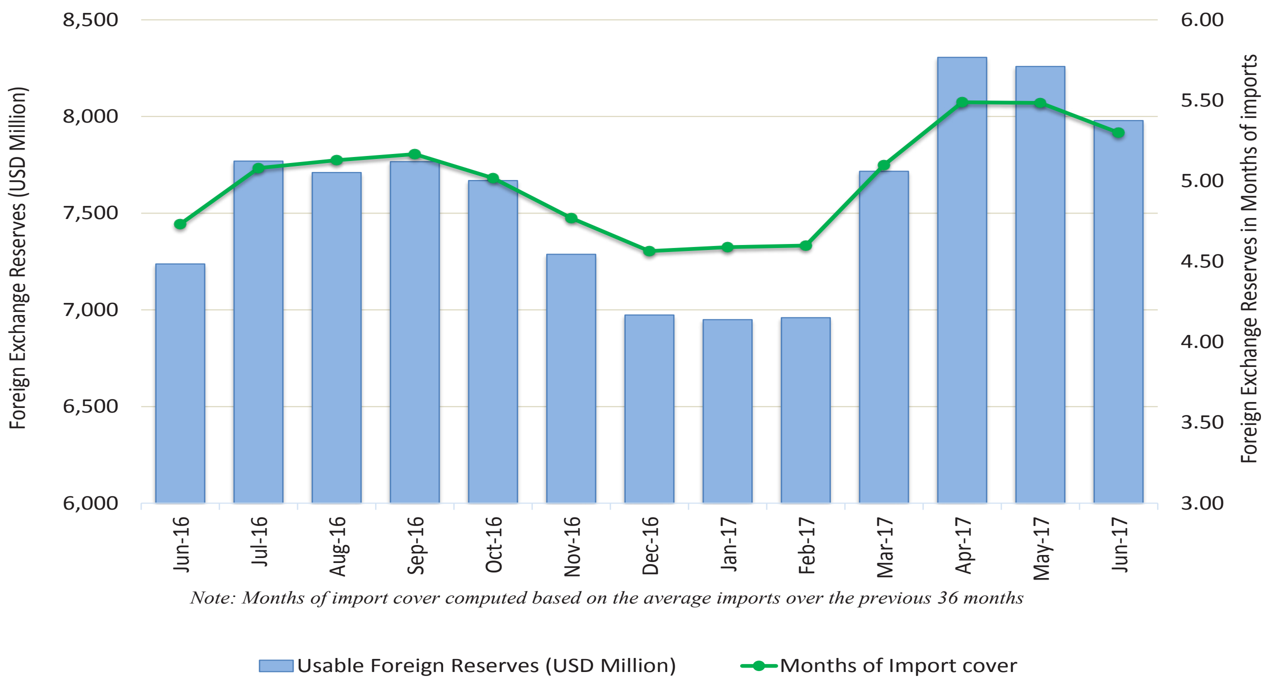


Source: Central Bank of Kenya

The CBK level of usable foreign exchange reserves stood at USD8.0 billion (equivalent to 5.3 months of import cover) at the end of June 2017 compared to USD7.0 billion (4.6 months of import cover) at the end of December 2016 (Chart 4c). The slight decline in the reserves observed between April and June 2017 was almost entirely as a result of anticipated payments for government obligations of USD560.7 million. These reserves continue to provide a buffer against short-term shocks, together with the Precautionary Arrangements with the International Monetary Fund (IMF), equivalent to USD1.5 billion.

Other measures of reserves adequacy remained robust and exceeded their respective indicative thresholds. The ratio of reserves to short-term debt averaged above 400 percent between January and June 2017 compared to the Greenspan-Guidotti rule of 100 percent cover for emerging markets. Over the same period, the ratio of reserves to broad money averaged 27.6 percent compared to prudent range 20 percent for countries with large banking sector and open capital accounts.

Chart 4c: CBK Usable Foreign Exchange Reserves



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.

Source: Central Bank of Kenya

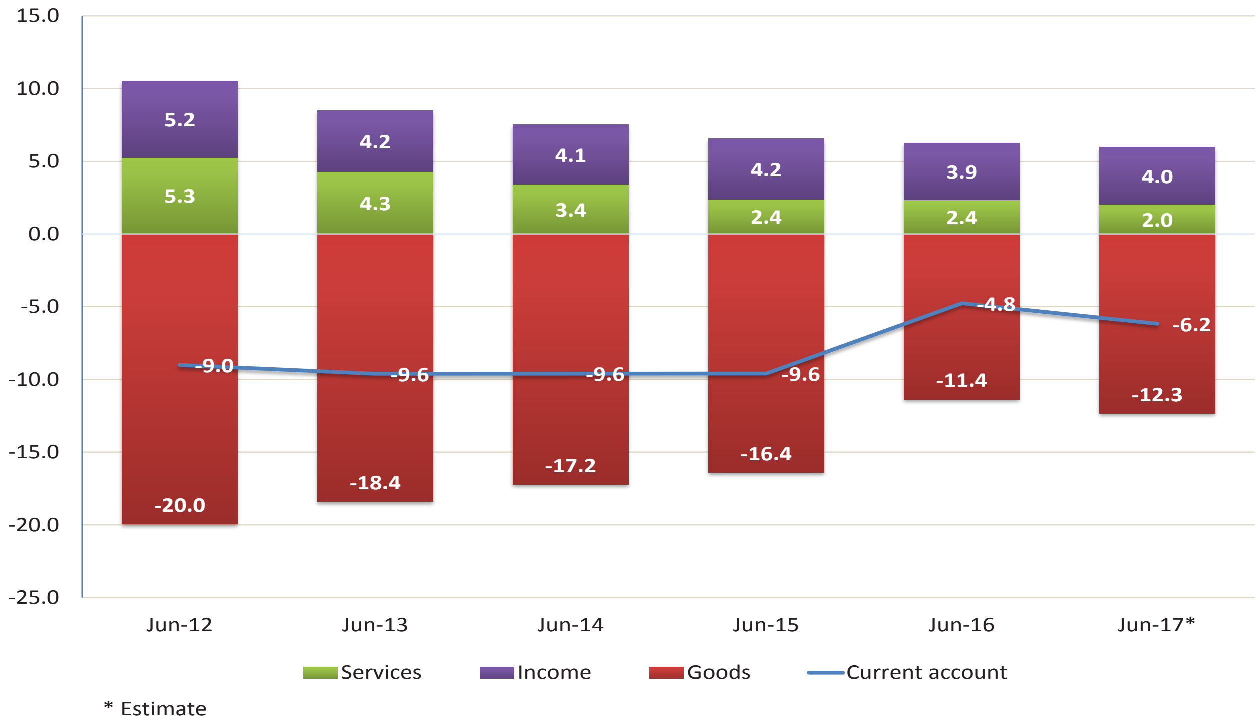
c. Balance of Payments Developments

The current account deficit widened to USD4,773.7 million (6.2 percent of GDP) in the twelve months to June 2017 from USD3,122.1 million (4.8 percent of GDP) in the year to June 2016 largely due to short-term import demand for cereals, sugar, and Standard Gauge Railway (SGR) related transport equipment (Chart 5a).

The value of merchandise imports increased from USD13,543.3 million in the year to June 2016 to USD15,031.3 million in the year to June 2017 and was mainly reflected in the value of imports of oil. The value of imports of chemicals and manufactured goods increased marginally in the year to June 2017 while imports of machinery and transport equipment declined further reflecting completion of the first phase of the SGR (Chart 5b). The petroleum products import bill rose slightly in the year to June 2017 reflecting increased imports of diesel for use in thermal power generation following the drought experienced in the first quarter of 2017. Over the same period, the value of merchandise exports declined to USD5,745.7 million from USD6,090.0 million largely due to a fall in re-exports. As indicated above, receipts from tea and horticulture remained resilient. Receipts from tourism, raw materials and coffee exports and diaspora remittances remained strong (Chart 5c).

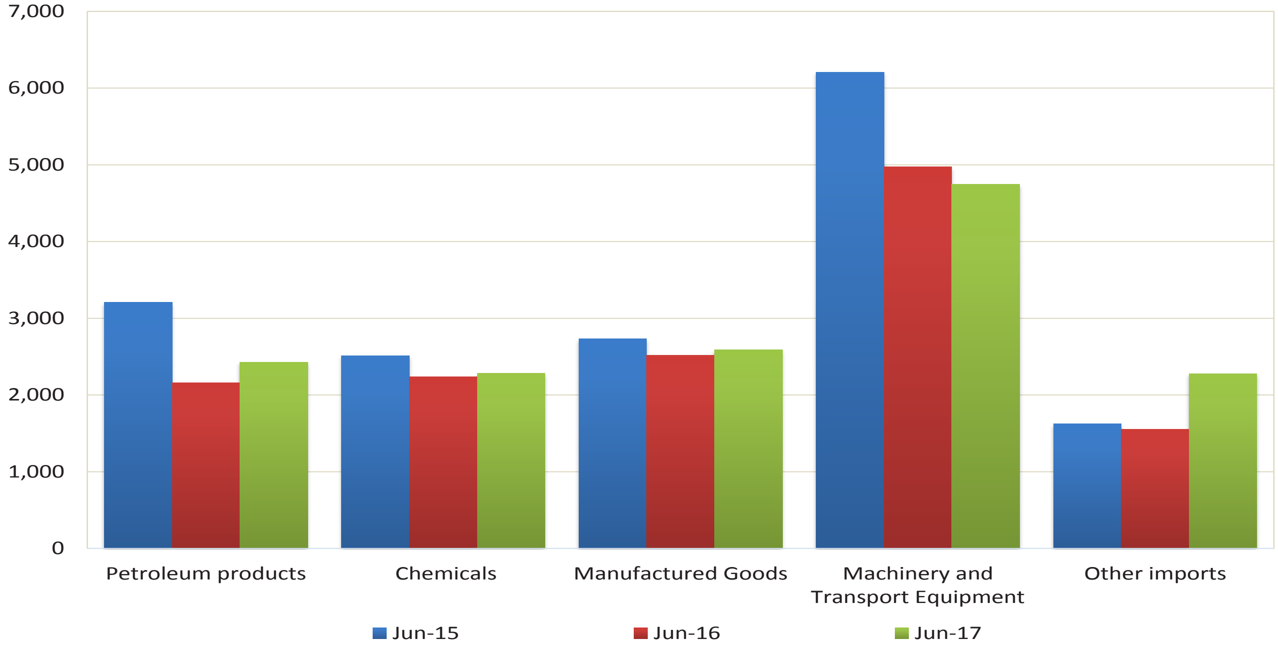
The CBK continued to monitor developments in the U.S. economic and trade policies as well as the impact of Brexit since these developments have implications on trade and foreign direct investment. The U.K. and U.S. accounted for 6.2 percent and 8.2 percent, respectively, of Kenya's exports at the end of June 2017. Kenya's exports to the U.S. are mainly through the African Growth and Opportunity Act (AGOA) framework.

Chart 5a: Current Account Particulars in the 12-Months to June (% of GDP)



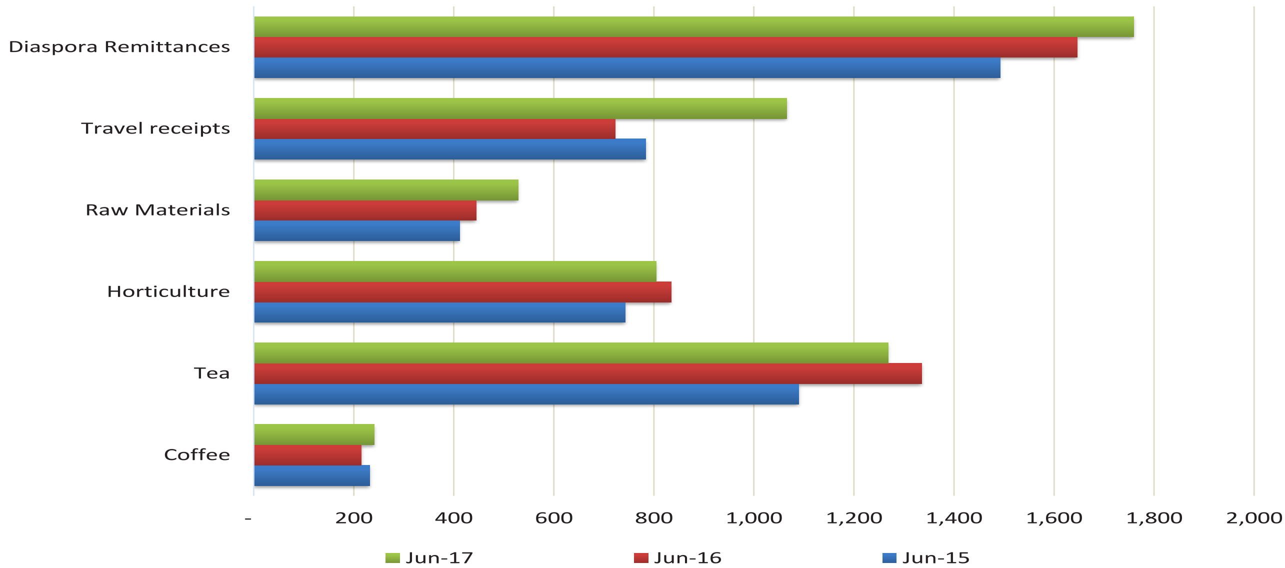
Source: Kenya National Bureau of Statistics and Central Bank of Kenya

Chart 5b: Imports of Merchandise Goods in the Year to June (USD Million)



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

Chart 5c: Foreign Exchange Inflows from Major Export Categories, Travel Receipts and Remittances in the Year to June (USD Million)



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

c. Economic Growth

The Kenyan economy remained resilient in 2016 having recorded an average growth of 5.8 percent compared to 5.7 percent in 2015. Growth was supported mainly by a stable macroeconomic environment, continued public investment in infrastructure which benefited the construction sector, low energy prices which supported the energy driven sectors of the economy, and the recovery of the tourism sector.

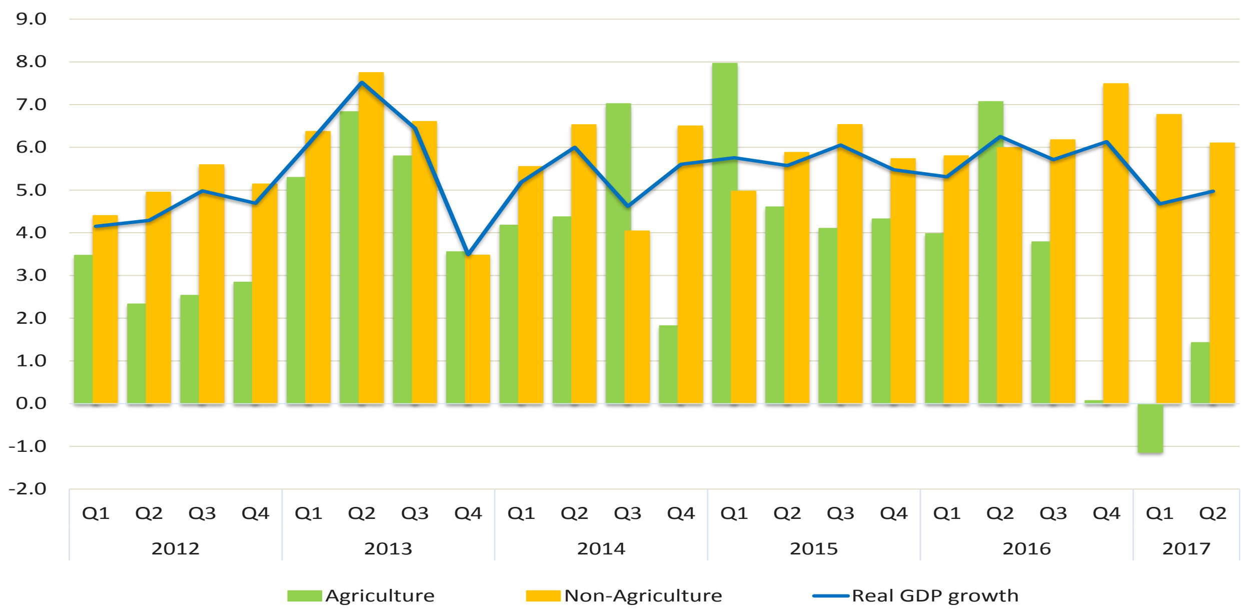
Growth slowed down in the first half of 2017 relative to a similar period in 2016 largely due to subdued performance of the agriculture sector following adverse weather conditions (Table 3). Growth stood at 5.0 percent in the second quarter of 2017 compared to 4.7 percent in the first quarter. However, non-agriculture sector remained strong growing by 6.1 percent in the second quarter of 2017 driven largely by the services sector. The services sector grew by 6.8 percent, supported by wholesale and retail trade, transport and storage, accommodation and restaurants, and real estate. (Chart 6).

Table 3: Real GDP Growth by Sector (%)

	Annual Growth		Quarterly Growth					
	2015	2016	2016				2017	
Sectors			Q1	Q2	Q3	Q4	Q1	Q2
Agriculture	5.5	4.0	4.0	7.1	3.8	0.1	-1.1	1.4
Mining and Quarrying	12.4	9.5	6.7	10.6	9.8	11.2	9.7	5.7
Manufacturing	3.6	3.5	1.7	5.3	4.4	2.5	2.9	2.3
Electricity and water supply	8.5	7.1	8.6	9.6	5.4	4.7	5.1	6.1
Construction	13.9	9.2	10.2	7.6	7.8	11.5	8.4	7.5
Wholesale and Retail Trade	5.9	3.8	3.6	2.3	4.3	5.0	6.1	2.8
Accommodation and restaurant	-1.3	13.3	10.4	15.8	13.5	14.2	15.8	13.4
Transport and Storage	8.0	8.4	8.9	7.1	7.1	10.4	9.9	8.2
Information and Communication	7.4	9.7	10.9	9.1	8.8	9.8	11.4	9.2
Financial and Insurance	9.4	6.9	8.2	8.1	7.1	4.1	5.3	4.3
Public administration	5.5	5.3	5.7	6.6	5.1	3.6	5.4	6.3
Professional, Administration and Support Services	2.5	4.3	3.3	5.4	3.8	4.7	4.8	6.4
Real estate	7.2	8.8	8.8	8.2	8.5	9.5	9.3	9.7
Education	4.5	6.3	6.2	6.0	6.9	6.3	5.9	5.6
Health	6.1	5.8	5.1	6.6	7.1	4.5	4.5	5.4
Other services	3.9	4.2	5.0	4.6	4.3	2.8	3.5	1.2
GDP at market prices	**5.7**	**5.8**	**5.3**	**6.3**	**5.7**	**6.1**	**4.7**	**5.0**

Source: Kenya National Bureau of Statistics

Chart 6: Disaggregated and Overall Quarter-to-Quarter Real GDP Growth (%)



Source: Kenya National Bureau of Statistics

d. Fiscal Developments and Debt

The Government's borrowing plan in the second half of the FY 2016/17 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. The coordination between monetary and fiscal policies continued to support macroeconomic stability.

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

The MPC held forums with Chief Executive Officers of commercial banks after every meeting during the first half of 2017. 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 a press conference after every 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 potential investors during the period in order to appraise them on recent economic developments in the country.

3. THE CURRENT ECONOMIC ENVIRONMENT AND OUTLOOK FOR FY 2017/18

a. International Economic Environment

Global growth is projected to pick up modestly to 3.6 percent in 2017 and 3.7 percent in 2018 from 3.2 percent in 2016 (Table 4). Economic activity is expected to pick pace in both advance and emerging market and developing economies. However, uncertainties in the global economy have increased due to risks posed by, among other factors, policy developments in the U.S., the Brexit resolutions, and pace of normalisation of monetary policy in advance economies. The growth outlook for Kenya's main trading partners in the region remains strong, suggesting better prospects for exports performance.

The inflation outlook in advanced and emerging market economies remain low in 2017 and 2018 reflecting lower commodity prices and weak domestic demand. Inflation in advanced economies is expected to rise from 0.8 percent in 2016 to 1.7 percent in 2017 and 2018, respectively. In the emerging market and developing economies, inflation is projected to fall from 4.3 percent in 2016 to 4.2 percent in 2017 and rise slightly to 4.4 percent in 2018. Policy challenges are more diverse across advanced and emerging market economies in terms of supporting demand and structural reforms to stimulate medium term growth.

Table 4: Performance and Outlook for the Global Economy

	2015 Act.	2016 Act.	2017 Proj.	2018 Proj.
World	3.4	3.2	3.6	3.7
Advanced Economies	2.1	1.7	2.2	2.0
United States	2.6	1.5	2.2	2.3
Japan	1.1	1.0	1.5	0.7
Euro Area	2.0	1.8	2.1	1.9
United Kingdom	2.2	1.8	1.7	1.5
Other Advanced economies	2.0	2.2	2.6	2.5
Emerging and developing economies	4.3	4.3	4.6	4.9
Sub-Saharan Africa	3.4	1.4	2.6	3.4
Emerging and Developing Asia	6.8	6.4	6.5	6.5
China	6.9	6.7	6.8	6.5
India	8.0	7.1	6.7	7.4
Middle East, North Africa, Afghanistan and Pakistan	2.7	5.0	2.6	3.5

Source: IMF World Economic Outlook

b. Domestic Economic Environment

i. Economic Growth

The CBK's price stability aims at supporting sound and sustained economic growth. The Government projects real GDP growth to pick up from a revised estimate of 5.5 percent in 2017 to 6.2 percent in 2018. The growth outlook is supported by a stable macroeconomic environment, sustained investment in infrastructure, and improvement in the performance of the service sectors. Particularly, the continued recovery in tourism is expected to provide an impetus to growth in the medium term. Additionally, the proposals in FY 2017/18 Budget targeting the manufacturing and agricultural sectors will support growth and export earnings.

The MPC Private Sector Market Perceptions Surveys conducted in January, March and May 2017 showed mixed growth expectations across commercial banks, microfinance banks, and non-bank private sector firms. The non-bank private sector firms expected the ongoing public infrastructure development to continue to support growth in 2017 and 2018. However, commercial banks expected the drought in the first quarter of 2017, the slowdown in private sector credit growth, interest rate capping, and concerns of a possible wait-and-see attitude by investors in the run up to the general election in 2017 to weigh down on growth in 2017.

ii. External Sector and Foreign Exchange Market

The Shilling is expected to be stable in 2017 and 2018 on account of a narrower current account deficit attributed to lower petroleum products import bill reflecting lower international oil prices and improved performance of tea and horticulture exports; strong diaspora remittances; continued recovery in tourism, and increased foreign direct investment in infrastructure. The current account deficit is projected at 5.8 percent of GDP in 2017. The growth outlook for Kenya's main trading partners in the region remains strong, suggesting better prospects for exports performance. The proposals in FY 2017/18 Budget to revamp the tourism sector will support foreign exchange market stability. These include continued improvement of security, and exemption from VAT of locally assembled tourist vehicles.

The Shilling exchange rate will also be supported by the adequate buffer of foreign exchange reserves and the Precautionary Facilities with the IMF. The main risks to the foreign exchange market in 2017 relate to continued uncertainties in the global financial markets with regard to U.S economic policies, pace of normalization of monetary policy in advanced economies, and the Brexit resolution.

iii. Inflation

Overall inflation is expected to return to the Government's target range in 2017 supported by the monetary policy measures, declining food prices, relatively lower international oil prices, and a stable Shilling which are expected to dampen any risks of imported inflation. The expected short rains during October to December 2017 together with the Government measures in place will continue to support lower food prices and further declines in overall inflation in the near term. The maize subsidy programme will partly offset the impact of any delays/shortfalls of the expected maize harvest in October 2017.

There are some risks to the inflation outlook in FY 2017/18. The maize output in the country is forecast at about 18 percent below average in 2017 due to erratic rainfall and pest infestation (Armyworm). The shortfall in maize production could exert upward pressure on food prices in early 2018. Additionally, international oil prices have been creeping up due to rising demand and reduced production by the OPEC countries, thereby exerting upward pressure on fuel prices in Kenya. Any inflation adjustment related to the Excise Act implemented in December 2015 will also exert some upward pressure on inflation in FY 2017/18.

iv. Fiscal Policy

Government borrowing in the FY 2017/18 is anchored in the Medium-Term Debt Management Strategy which aims at maintaining public debt at sustainable levels. The budget deficit is projected to decline from an estimated 9.0 percent of GDP in FY 2016/17 to 6.0 percent of GDP in FY 2017/18, and 4.0 in the medium term. The sharp reduction of the deficit reflects reduced expenditures owing to the one off expenditures mainly those related to the general elections, and the drought. Net domestic borrowing is projected to remain relatively stable at about 3.1 percent in FY 2017/18. The CBK will continue to work with the National Treasury to strengthen the coordination between monetary and fiscal policies.

v. Confidence in the Economy

Macroeconomic stability, improved security, and infrastructure development have created a conducive and predictable environment for investment, and economic activity. A favourable credit rating by the Standards and Poor's of B+ with a stable outlook, continued tourism recovery, and stability in the yield curve of Government securities indicates investor confidence in the economy. According to the World Bank 2017 Doing Business Report, Kenya climbed 16 ranks to position 92 from 108 in 2016 and is the World's third most reformed country.

4. DIRECTION OF MONETARY POLICY IN THE FY 2017/18

Monetary policy in the FY 2017/18 will focus on: setting monetary targets which are consistent with the objective of achieving and maintaining a low and stable inflation, encouraging growth, and supporting the long-term sustainability of public debt; and, enhancing financial inclusion.

a) Monetary Policy Path and Foreign Exchange Reserves

The monetary targets for FY 2017/18 are consistent with the Medium-Term Government Budget Policy Statement for 2017 published by the National Treasury. The monetary targets for the period are presented in Table 5. Monetary policy will aim at containing the annual growth in broad money (M3) to 13.7 percent by December 2017 and 14.6 percent by June 2018. Growth in private sector credit is expected to pick up gradually from 1.5 percent in June 2017 to 5.8 percent by June 2018. Monetary policy will aim at ensuring that movements in the short-term interest rates are consistent with the Bank's primary objective of price stability. The Bank will also continue to review and enhance the effectiveness and efficiency of its monetary policy instruments in order to maintain price stability while ensuring financial sector stability.

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 and the Precautionary Facility with the IMF will continue to provide a buffer against short-term shocks in the foreign exchange market. The monetary policy stance 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 also support macroeconomic stability. The CBK will continue to monitor the impact of the interest rate capping on lending and monetary policy transmission.

Table 5: Monetary Targets for 2017

	Sep-17	Dec-17	Mar-18	Jun-18
Broad Money, M3 (Ksh Billion)	3032.0	3142.6	3252.9	3363.8
Reserve Money, RM (Ksh Billion)	428.0	460.5	432.7	450.2
Credit to Private Sector (Ksh Billion)	2268.4	2300.9	2337.0	2379.4
NFA of CBK (Ksh Billion)	664.0	667.1	670.7	752.4
NDA of CBK (Ksh Billion)	-236.0	-206.6	-238.0	-302.3
12-month growth in RM (Percent)	9.0	12.0	4.3	12.2
12-month growth in M3 (Percent)	9.4	13.7	14.3	14.6
12-month growth in Credit to Private Sector (Percent)	1.1	1.1	3.2	5.8
12-month growth in Real GDP (Percent)		5.5		5.9
Medium-Term 12-month overall Inflation (Percent) Target		5.0		5.0

Source: Central Bank of Kenya and the National Treasury

The Bank will continue to monitor developments in the Monetary Targets and make necessary reviews. The information will be reviewed and incorporated in the data so as to inform the MPC decision process accordingly. Monetary policy implementation will be based on the targets for NDA, NIR, RM and broad money (M3) 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 on a timely basis 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, favourable weather conditions, and continued commitment by the Government to operate within the domestic borrowing target in the FY 2017/18. 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 economy that would have a direct impact on food and fuel prices.

b) Measures to Enhance Market Efficiency and Monetary Policy Transmission

The CBK will continue to support development of new products and innovations towards enhancing financial access in order to encourage economic growth. Appropriate legislation and regulations will be proposed to ensure that such innovations are operationalized accordingly so as to enhance market confidence. The Bank will monitor any new financial derivatives and /or innovations in the market that could have adverse effects on market stability. The CBK will work closely with the other stakeholders to promote transparency in credit pricing including strengthening the Credit Reference Bureaus to provide for a credit scoring framework.

The CBK will continue to work with stakeholders to identify and implement measures to enhance redistribution of liquidity in the interbank market. Forums with Chief Executive Officers will continue to be held both to obtain feedback and to explain the background to MPC decisions. These initiatives will support improvements in the financial sector that contribute to the lowering of the cost of doing business. The CBK will also continue with its transparency policy through the timely dissemination of all the requisite data and other relevant information through its website.

ANNEX: CHRONOLOGY OF EVENTS OF PARTICULAR RELEVANCE TO MONETARY POLICY

January 2017	The CBR was retained at 10.0 percent in order to anchor inflation expectations.
	The CBK suspended the Kenya Banks Reference Rate (KBRR) framework.
February 2017	Acquisition of Giro Bank by Investment and Mortgages Bank.
March 2017	The CBR was retained at 10.0 percent
	Introduction of M-Akiba.
	Diamond Trust Bank Announces plans to acquire Habib Bank Ltd.
	Invitation of investors to present an initial Expression of Interest (“EOI”) to take an equity interest in Chase Bank (Kenya) Limited (In Receivership).
April 2017	Licensing of DIB Bank Kenya Limited (DIB) which extensively offers Shariah compliant products.
May 2017	The CBR was retained at 10.0 percent.
	Completion of the acquisition of a majority stake in Fidelity Commercial Bank Limited (FCB) by SBM Africa Holdings Limited (SBM Africa)
June 2017	Launch of Cost of Credit website by Kenya Bankers Association and the CBK.
	Mayfair Bank Limited granted a license to conduct banking business in Kenya

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.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