



Central Bank of Kenya



MONETARY POLICY STATEMENT

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

December 2016

LETTER OF TRANSMITTAL TO THE CABINET SECRETARY FOR THE NATIONAL TREASURY

Dear Honourable Cabinet Secretary,

I have the pleasure of forwarding to you the 39th 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 second half of 2016, describes the current economic environment and outlook, and concludes with an outline of the direction of monetary policy for 2017.



Dr. Patrick Njoroge
Governor

CONTENTS

| | |
|---|------|
| LETTER OF TRANSMITTAL TO THE CABINET SECRETARY FOR THE NATIONAL TREASURY..... | i |
| THE PRINCIPAL OBJECTIVES OF THE CENTRAL BANK OF KENYA..... | iii |
| INSTRUMENTS OF MONETARY POLICY..... | iv |
| LEGAL STATUS OF THE MONETARY POLICY STATEMENT..... | viii |
| EXECUTIVE SUMMARY..... | ix |
| 1. INTRODUCTION..... | 1 |
| 2. ACTIONS AND OUTCOMES OF POLICY PROPOSALS IN THE JUNE 2016 MONETARY POLICY STATEMENT..... | 2 |
| 3. THE CURRENT ECONOMIC ENVIRONMENT AND OUTLOOK FOR 2017..... | 14 |
| 4. DIRECTION OF MONETARY POLICY IN 2017..... | 17 |
| ANNEX: CHRONOLOGY OF EVENTS OF PARTICULAR RELEVANCE TO MONETARY POLICY..... | 19 |
| GLOSSARY OF KEY TERMS..... | 20 |

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. 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. The CBK also participates in the regional and National Agricultural Society of Kenya Shows in order to sensitise the public on its functions.

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. It also reviews the outcome of the monetary policy stance adopted in the second half of 2016. A significant development during the period was the coming into force of the Banking (Amendment) Act, 2016 in September 2016.

Overall month-on-month inflation remained within the Government's target range during the second half of 2016 despite increases in food prices. It rose gradually from 5.8 percent in June 2016 to 6.3 percent in December largely due to increases in the prices of some food items. Food and non-alcoholic beverages inflation rose to 11.2 percent in December from 8.9 percent in June 2016 reflecting the impact of depressed rains in the second half of 2016. Nevertheless, month-on-month non-food-non-fuel (NFNF) inflation fell to 4.6 percent in December 2016 from 5.0 percent in June 2015, reflecting the dissipation of the impact of the excise tax implemented in December 2015. The relatively lower prices of petroleum products coupled with the stability of the Shilling moderated the risks of imported inflation. Demand pressures on inflation remained moderate.

The foreign exchange market remained stable in the second half of 2016. This was supported by a narrowing of the current account deficit largely due to lower imports of petroleum products, machinery and transport equipment. In addition, improved horticulture and tea production, higher tourism receipts, and resilient diaspora remittances benefitted foreign exchange inflows. The CBK's foreign exchange reserves which stood at USD6,973.4 million (4.6 months of import cover) at the end of December, together with the Precautionary Arrangements with the International Monetary Fund (IMF) continued to provide an adequate buffer against short-term shocks. In addition, closer monitoring of the market following the U.K. vote to leave the European Union (Brexit), and the U.S. elections supported the stability in the market.

The Monetary Policy Committee (MPC) reduced the Central Bank Rate (CBR) from the June 2016 level of 10.5 percent to 10.0 percent in September following the persistent slowdown in private sector credit growth in 2016. The slowdown in private sector credit growth in the period largely reflected developments in the trade, manufacturing, real estate, and private households' sectors, which account for 60 percent of total credit to the private sector. The contribution of these sectors to total credit growth declined gradually partly due to a slowdown in the manufacturing sector, and availability of alternative external financing for key private sector projects. Liquidity management operations by the CBK were used to support stability in the interbank market. Reverse Repos were used to address temporary liquidity shortages in segments of the market.

The monetary policy stance in 2017 will aim at 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.

Consistent with the inflation and growth objectives in the Medium-Term Budget Statement for 2016, monetary policy will aim at containing annual growth in broad money (M3) at 10.5 percent by June 2017, and 12.3 percent by December. 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 predictability in government domestic borrowing is expected to continue supporting a stable yield curve. 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.

The stability of the banking sector facilitates effectiveness of monetary policy transmission. The CBK will continue to strengthen banks through increased transparency, building stronger governance models, and, encouraging effective business models aimed at strengthening the resilience of banks, reducing costs, and supporting innovation. The guidance provided by the CBK to banks in November 2016 on the preparation of Internal Capital Adequacy Assessment Process (ICAAP) will ensure that banks have adequate capital that is aligned to the risk profile and business opportunities. The Bank will also continue its regular interactions with stakeholders in the financial and real sectors as well as the media to obtain feedback, and ensure the timely release of relevant monetary and financial data. The CBK will continue to work with stakeholders to identify and implement measures to enhance the distribution of liquidity in the interbank market. The Bank will continue to monitor the impact of the capping of interest rates on the effectiveness of monetary policy, and the overall economy. Risks of capping banks' interest rates include possible perverse responses of credit growth to monetary policy in the case of credit rationing by banks, and diversion of loanable funds by banks to alternative assets such as government securities.

The CBK will continue to closely monitor risks posed by developments in the domestic and global economies on its price stability objective. The main risks to inflation relate to the prevailing drought conditions which have resulted in a sharp increase in food prices and reduced hydro electricity generation, likely pickup in international oil prices following the decision by the Organization of Petroleum Exporting Countries (OPEC) to cut oil production, and rising global prices of food. Uncertainties in the global financial markets have also increased due to uneven pace of growth of the global growth, the Brexit outcome, and the future policies of the new U.S. administration.

1. INTRODUCTION

This Monetary Policy Statement (MPS) provides the direction of monetary policy in 2017. It also presents the outcome of the monetary policy stance adopted in the second half of 2016.

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 of the value of the Shilling. 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, rising food prices continued to influence movement in consumer prices in the second half of 2016. The stability in the exchange rate is expected to dampen the threat of imported inflation particularly with recent increase in international oil prices. On the global scene, uncertainties have increased relating to the future policy of the new U.S. administration, and the outcome of the Brexit negotiations.

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

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

The overall aim of the Monetary Policy Statement for June 2016 (38th 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 specific outcomes of the policy proposals in the 38th MPS, including on inflation, monetary aggregates, and the foreign exchange market, are outlined below.

a. Inflation

The monetary policy measures pursued by the Monetary Policy Committee (MPC) anchored inflation expectations and ensured market stability during the second half of 2016. The MPC lowered the CBR to 10.0 percent in September from 10.5 percent in June 2016 in order to support private sector credit growth while continuing to anchor inflation expectations.

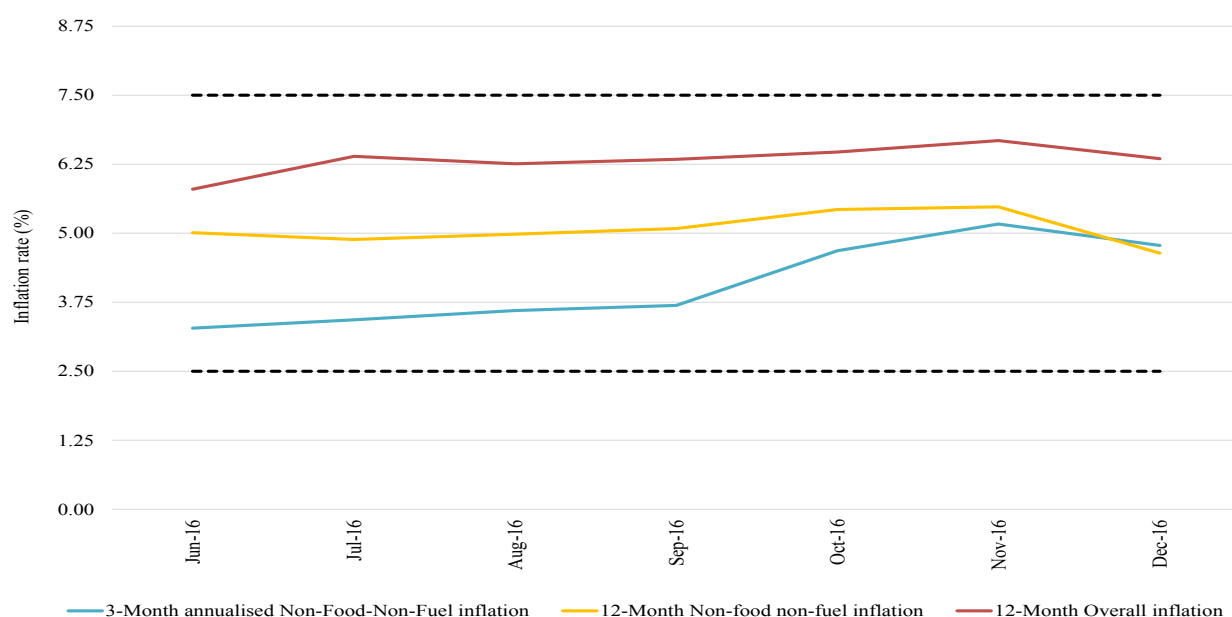
Despite increases in food prices, overall month-on-month inflation remained within the Government's target range (Chart 1a). The inflation rose gradually from 5.8 percent in June 2016 to 6.7 percent in November largely reflecting increases in the prices of some food items. Food and non-alcoholic beverages inflation rose to 11.2 percent in December from 8.9 percent in June 2016 reflecting the impact of depressed rains in the second half of 2016 (Chart 1b). Tomatoes, oranges, sugar, cabbages and kales contributed 1.5 percentage points to overall inflation in December. These food items contributed 4.1 percentage points to food inflation. Overall inflation decreased to 6.4 percent in December largely due to the dissipation of the impact of the excise tax introduced in December 2015.

The alcoholic beverages, tobacco and narcotics inflation fell sharply between June and December. The transport inflation decreased in the period reflecting the relatively lower international oil prices. Inflation rates for all categories except Food and non-alcoholic beverages and restaurants and hotels were below 5 percent in December 2016 (Chart 1b).

The month-on-month non-food-non-fuel (NFNF) inflation decreased to 4.6 percent in December 2016 from 5.0 percent in June 2015, reflecting the dissipation of the impact of the excise tax implemented in December 2015 on alcoholic beverages and tobacco products. The 3-month annualized NFNF inflation remained relatively stable below 5 percent, an indication of mild demand pressures in the economy. It stood at 4.8 percent in December compared with 3.3 percent in June 2016.

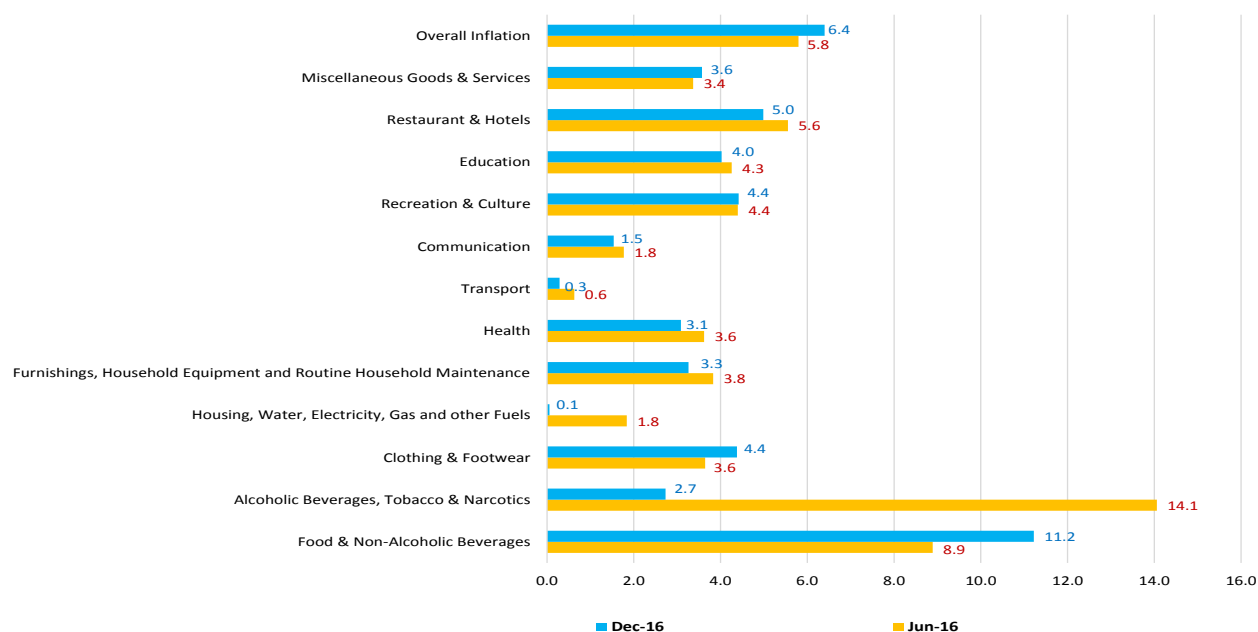
The main risks to inflation in the short term relates to the drought conditions which could impact on food production and hydro electricity generation, rising global prices of food particularly sugar and a likely pickup in international oil prices following the decision by major oil exporters to trim production.

Chart 1: Overall and Non-Food-Non-Fuel 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

i. Credit to Private Sector

The 12-month growth in credit to the private sector decelerated from 9.0 percent in June 2016 to 4.3 percent by December 2016 (Table 1). Credit growth slowed down in most sectors during the period. Nevertheless, there was a rebound in the credit growth to the trade, private households and consumer durables sectors in the last quarter of 2016.

The slowdown in private sector credit growth in the period largely reflected developments in the trade, manufacturing, real estate, and private households' sectors, which account for 60 percent of total credit to the private sector. The contribution of these sectors to total credit growth declined gradually to 5.1 percentage points in December 2017 from 13.6 percentage points in July 2015. This was partly due to a slowdown in the manufacturing sector, delays in registration of land titles and building approvals, and availability of alternative external financing for key private sector projects. Additionally, slower growth of deposits for some banks reduced the pool of loanable funds. Deposits are the main source of loanable funds in banks, accounting for about 70 percent of total liabilities for banks.

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

| | Jun-16 | Jul-16 | Aug-16 | Sep-16 | Oct-16 | Nov-16 | Dec-16 |
|----------------------------------|--------|--------|--------|--------|--------|--------|--------|
| Overall Credit to Private Sector | 9.0 | 7.1 | 5.5 | 4.7 | 4.7 | 4.6 | 4.3 |
| Agriculture | 18.1 | 9.7 | 5.4 | 3.1 | 4.1 | 7.5 | 5.0 |
| Manufacturing | 13.3 | 12.5 | -0.3 | -2.0 | -4.3 | -4.0 | -2.4 |
| Trade | 13.0 | 14.5 | 17.2 | 16.2 | 13.7 | 16.7 | 17.1 |
| Building and construction | 13.3 | 9.2 | 8.4 | 1.4 | -4.8 | -5.3 | -2.8 |
| Transport and communication | 13.5 | 11.9 | 16.3 | 13.4 | 14.3 | 15.8 | 14.6 |
| Finance and insurance | 3.3 | 7.7 | -7.9 | -2.7 | -4.7 | -5.7 | 9.3 |
| Real estate | 11.9 | 8.8 | 9.5 | 9.2 | 9.4 | 8.9 | 11.2 |
| Mining and quarrying | -1.6 | -4.5 | -32.8 | -33.7 | -36.4 | -21.3 | -19.1 |
| Private households | 5.8 | 3.2 | 7.3 | 10.6 | 9.9 | 10.5 | 19.5 |
| Consumer durables | 2.6 | 4.5 | 9.7 | 6.8 | 10.8 | 14.1 | 11.8 |
| Business services | 5.1 | -4.4 | -11.1 | -10.1 | -2.0 | -11.6 | -34.8 |
| Other activities | -7.7 | -8.7 | -12.4 | -18.7 | -15.5 | -24.2 | -21.2 |

Source: Central Bank of Kenya

ii. Developments in the other Monetary Aggregates

Broad money (M3) and its main component, credit to private sector, were below their respective targets in the second half of 2016 (Table 2). Monetary policy implementation was guided by CBK targets on the Net International Reserves (NIR) and Net Domestic Assets (NDA) as the operational parameters. These targets were consistent with the performance measures aimed at safeguarding the economy against exogenous shocks that might lead to balance of payments needs. The CBK met its NDA and NIR targets for September and December 2016. In addition, inflation remained within the Government target range.

The predictability of money demand continued to be affected by an unstable money multiplier and the long-term decline in the velocity of money in circulation. The money multiplier remained unstable in the period, fluctuating between 6.7 and 7.1 while the velocity of money ranged between 2.4 and 2.5. These outcomes on velocity of money and money multiplier are associated largely with financial innovations such as the mobile phone platforms which have continued to affect the design and conduct of monetary policy.

Table 2: Trends in the Key Monetary Aggregates

| | Jun-16 | Jul-16 | Aug-16 | Sep-16 | Oct-16 | Nov-16 | Dec-16 |
|---|---------|---------|---------|---------|---------|---------|---------|
| Actual Broad Money, M3 (Ksh Billion) | 2,755.9 | 2,713.0 | 2,739.0 | 2,761.8 | 2,750.4 | 2,767.1 | 2,753.5 |
| Target (Ksh Billion) | 2,925.0 | 2,789.2 | 2,824.9 | 2,860.6 | 2,896.3 | 2,931.8 | 2,967.4 |
| Actual Reserve Money (Ksh Billion) | 390.2 | 383.7 | 392.6 | 392.8 | 401.8 | 393.1 | 411.1 |
| Target (Ksh Billion) | 421.0 | 384.6 | 394.0 | 396.1 | 405.7 | 414.3 | 421.5 |
| Actual Net Foreign Assets of CBK (Ksh Billion) | 694.6 | 683.2 | 681.5 | 687.2 | 678.3 | 645.0 | 621.6 |
| Target (Ksh Billion) | 671.0 | 638.7 | 632.7 | 619.5 | 604.8 | 590.0 | 676.8 |
| Actual Net Domestic Assets of CBK (Ksh Billion) | -304.4 | -299.6 | -288.9 | -294.4 | -276.5 | -251.9 | -210.4 |
| Target (Ksh Billion) | -251.0 | -254.1 | -238.6 | -223.5 | -199.1 | -175.6 | -255.3 |
| Actual Credit to private sector (Ksh Billion) | 2,239.4 | 2,245.3 | 2,246.4 | 2,266.9 | 2,265.2 | 2,281.9 | 2,299.7 |
| Target (Ksh Billion) | 2,388.0 | 2,272.5 | 2,287.3 | 2,304.5 | 2,325.5 | 2,348.7 | 2,374.1 |
| Memorandum Items | | | | | | | |
| 12-month growth in actual Reserve Money (Percent) | 4.9 | 0.1 | 6.8 | 4.3 | -7.4 | 0.5 | 4.8 |
| 12-month growth in Broad Money, M3 (Percent) | 7.9 | 6.4 | 6.6 | 8.1 | 6.9 | 6.3 | 3.6 |

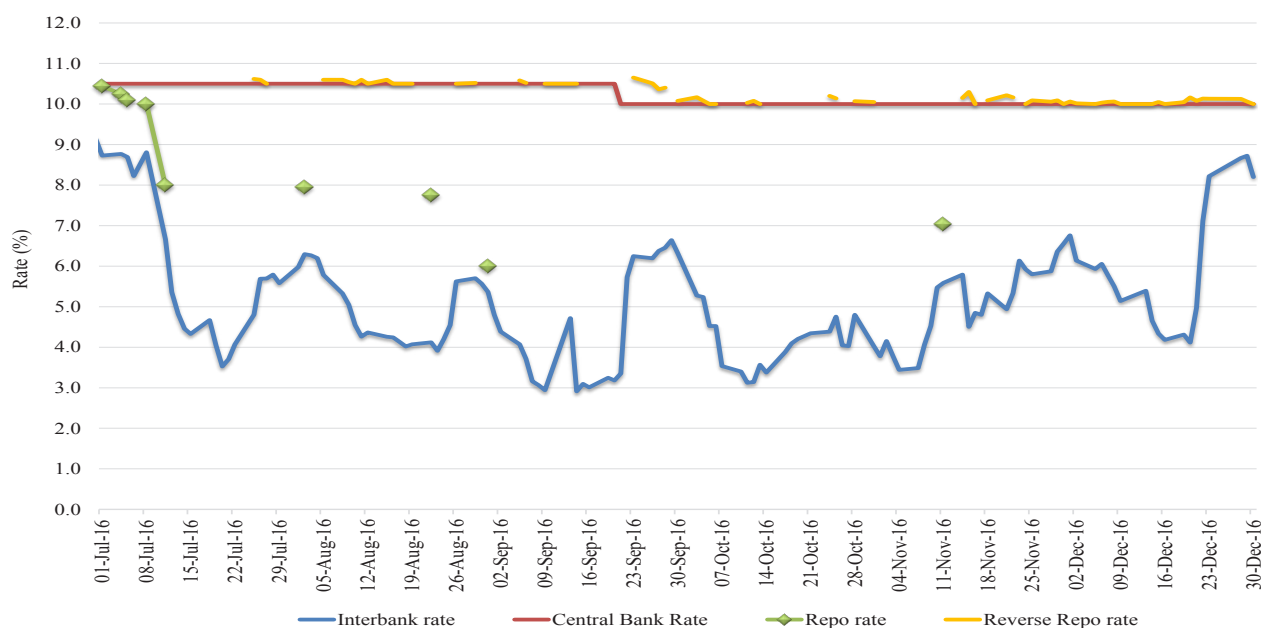
Source: Central Bank of Kenya

iii. Interest Rates and Liquidity

The interbank rate remained below the CBR during the six months to December 2016 reflecting improved liquidity conditions in the market. However, the liquidity distribution remained uneven across the bank tiers due to the segmentation in the interbank market. Liquidity management operations by the CBK in the second half of 2017 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 2a).

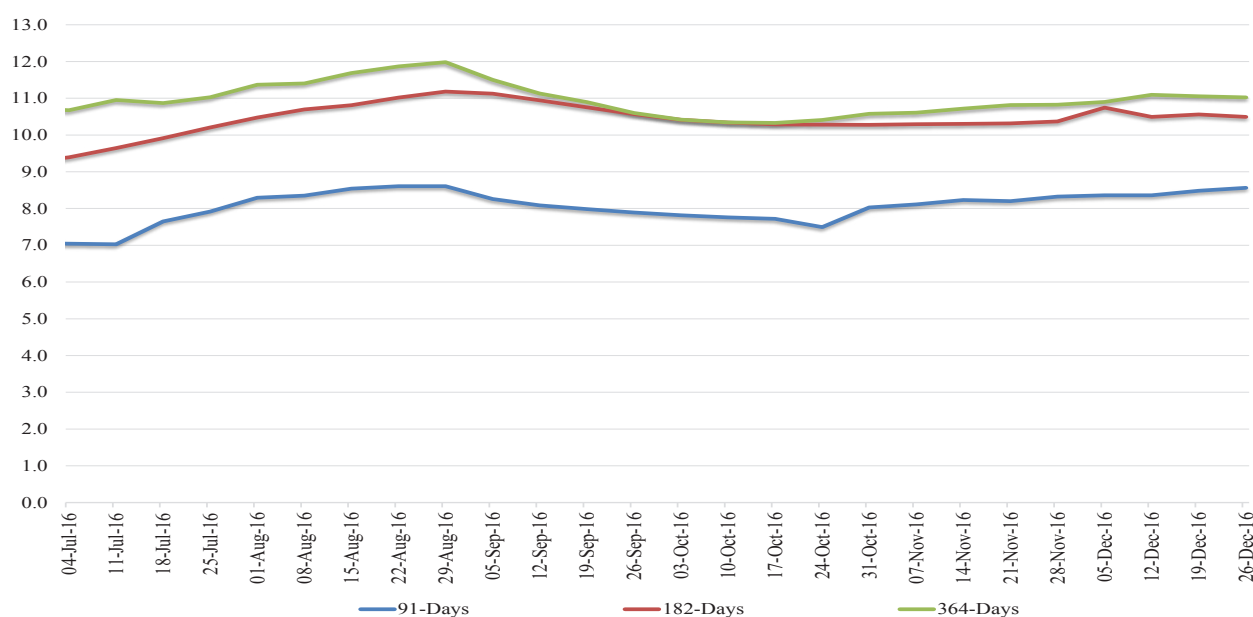
The implementation of the government domestic borrowing programme continued to support market stability. Interest rates on government securities were relatively stable during the second half 2016 (Chart 2b). additionally, the stability of the yield curve in the period enhanced predictability in the government securities market.

Chart 2a: Trends in Short Term Interest Rates (%)



Source: Central Bank of Kenya

Chart 2b: Interest rates on Treasury Bills (%)



Source: Central Bank of Kenya

iv. Banking Sector Developments - Banking (Amendment) Act, 2016

The Banking (Amendment) Act, 2016 came into force on September 14, 2016. The Act set the maximum interest rate chargeable for a credit facility in Kenya at no more than 4 percent above the base rate set and published by the CBK. It also set the minimum interest rate granted on a deposit held in an interest earning account in Kenya to at least 70 percent of the base rate. The CBR was determined to be the base rate in the determination of the maximum lending rates and minimum deposit rates when

implementing this law. The CBK is closely monitoring the impact of the law on monetary policy and the overall economy. Prior to the capping of banks' lending rates, the Kenya Banks' Reference Rate (KBRR) was the base rate for all commercial and microfinance banks' lending.

The capping of interest rates was largely due to the non-responsiveness of commercial banks' lending and deposit rates to monetary policy signals over the years with consequent high interest rate spreads and comparably high returns on equity in the sector relative to other investments in the economy. The risks of capping banks' interest rates were noted to include possible perverse responses of credit growth to monetary policy in the case of credit rationing by banks. Caps could also distort the market with a risk of stifling financial inclusion. In the event of a decrease in credit to the private sector, investment by banks in alternative assets such as government securities could increase.

v. Other Banking Sector Developments

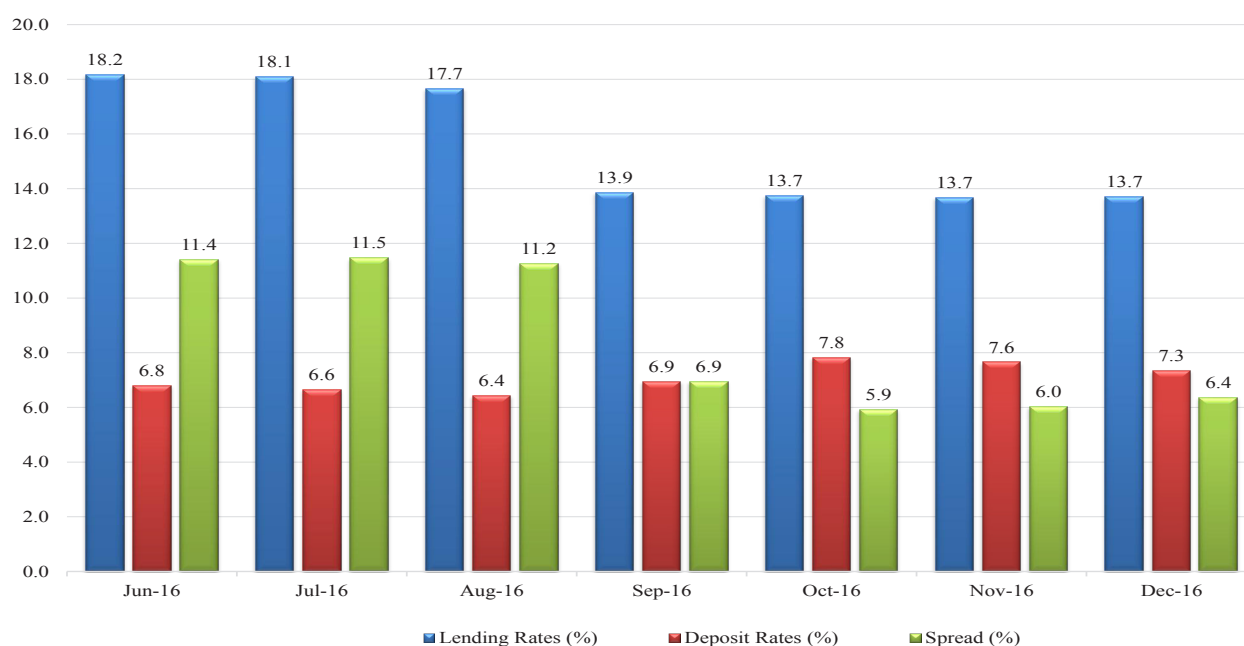
The banking sector remained resilient in the second half 2016. The average commercial banks liquidity stabilized at 41.4 percent in December compared to 41.6 percent in June 2016, while the capital adequacy ratio stabilized at 18.7 percent compared to 18.9 percent in June. The guidance provided by the CBK to banks in November 2016 on the preparation of Internal Capital Adequacy Assessment Process (ICAAP) will ensure that banks have adequate capital that is aligned to the risk profile and business opportunities.

The CBK's enforcement of existing regulation, especially with respect to the classification of loans, continued to strengthen and ensure transparency in the sector. The ratio of gross non-performing loans (NPLs) to gross loans stood at 9.1 percent in December compared to 8.4 percent in June 2016, partly reflecting tighter credit standards in line with the required reporting standards, and slowdown in private sector credit growth. The CBK continued to closely monitor liquidity and credit risks in the sector.

The average commercial banks' lending rates declined from 18.2 percent in June to 13.7 percent in December 2016 reflecting the impact of the implementation of the Banking (Amendment) Act, 2016, and lowering of the CBR in September (Table 4). The average commercial banks' deposit interest rates rose from 6.8 percent to 7.3 percent in the period. The rise in the deposit interest rates in the period was mainly in the large and medium tier banks. Small banks were already paying higher interest rates on deposits prior to the introduction of interest rate caps.

The CBK is working with the Kenya Bankers Association (KBA) to implement measures to sustainably reduce the cost of credit. These measures include promoting innovation in the banking sector leveraging on information and communications technology (ICT), and strengthening the Credit Reference Bureaus to provide for a credit scoring framework.

Chart 2c: Commercial Banks' Interest Rates and Spreads (%)



Source: Central Bank of Kenya

b. Foreign Exchange Market and Reserves Developments

Despite volatility in the global financial markets, the foreign exchange market remained relatively stable in the second half of 2016 (Charts 3a and 3b). This reflected a narrowing of the current account deficit largely due to lower imports of petroleum products, machinery and transport equipment. Additionally earnings from tea, coffee, and horticulture exports improved, while diaspora remittances remained resilient. Earnings from tourism improved in the period reflecting improved security and business environment. The stability of the foreign exchange market in Kenya also reflected the resilience and diversified nature of the economy relative to its peers. The economy is diversified in terms of both export products and external markets. About 40.6 percent of Kenya's exports in 2016 were to Africa, with the EAC accounting for slightly over 50 percent of the total exports to Africa.

Most international currencies weakened against the U.S. dollar between June and December 2016 largely due to volatility in the global financial markets. Global financial markets were volatile reflecting increased risks posed by slowdown in the global growth, uncertainties with respect to Brexit and future U.S. policies under the new administration, and the divergent monetary policies in the advanced economies. Other factors affecting the global markets included concerns about China and uncertainty with respect to the resumption of the tightening of U.S. monetary policy. As a result, the currencies of most emerging and frontier market economies weakened against the U.S. dollar due to increased capital outflows.

The major international and Sub-Saharan African (SSA) currencies depicted mixed trends against the U.S. dollar during the period (Chart 3a and 3b). Domestic currencies in Kenya, Uganda, and Tanzania

were relatively stable against the U.S. dollar, while the South African Rand was more volatile reflecting the slump in commodity prices, and widening trade deficit attributed to weak growth in its main trading partners including Europe. The national currencies in other commodity dependent economies such as Nigeria, Zambia, and Ghana witnessed significant depreciations against the U.S. dollar in the period. The Sterling Pound depreciated against most currencies in June 2016 following Brexit.

Chart 3a: Movements of Exchange Rates of the Kenya Shilling and Major International Currencies against the U.S. dollar (4th Jan 2016 = 1)

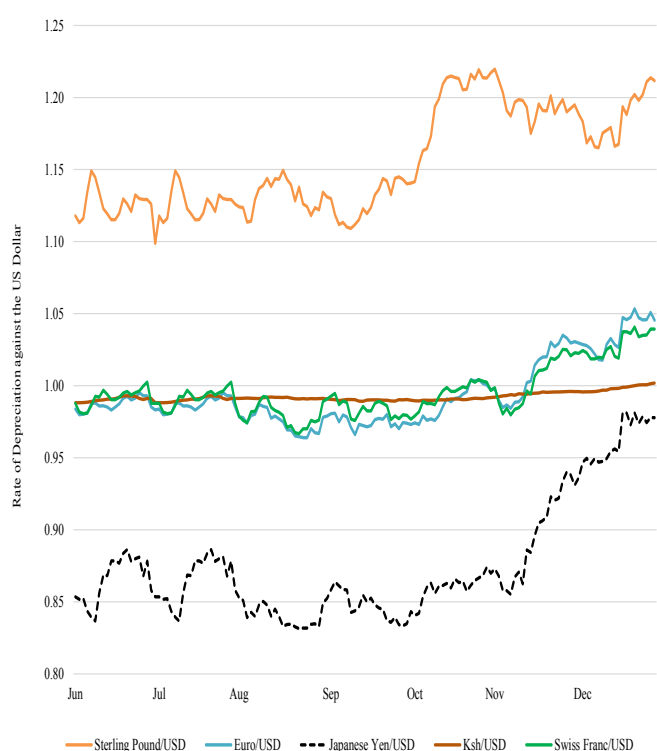


Chart 3b: Movements of Exchange Rates of the Kenya Shilling and Regional Currencies against the U.S. dollar (4th Jan 2016 = 1)

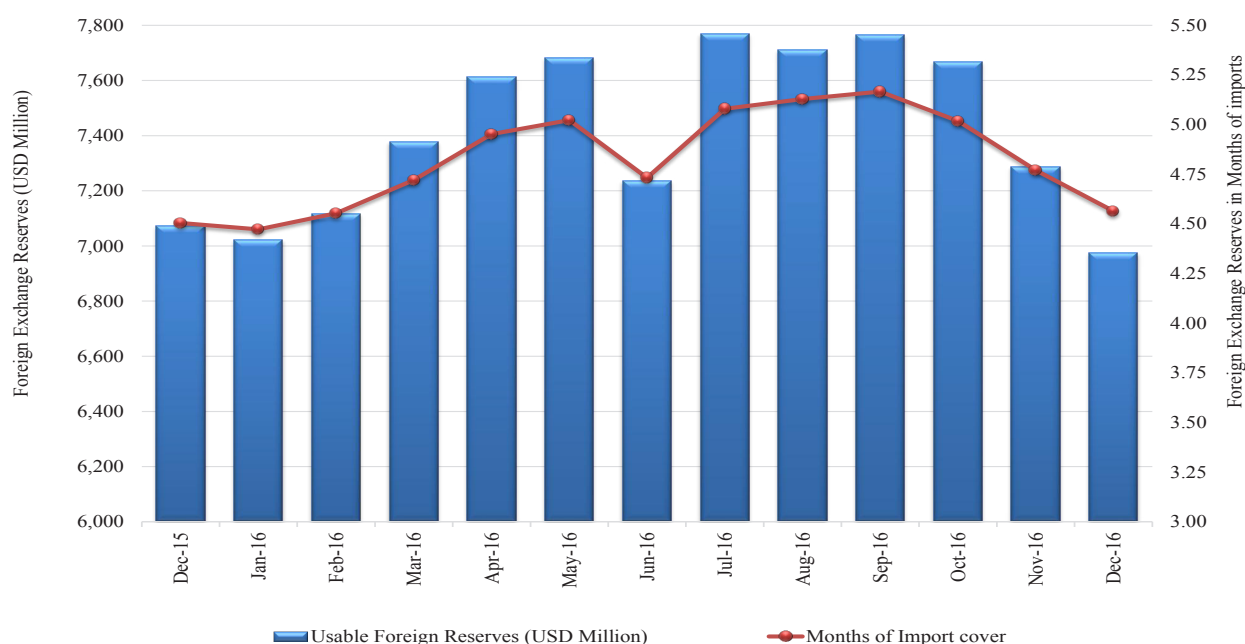


Source: Central Bank of Kenya

The CBK level of usable foreign exchange reserves stood at USD7.0 billion (4.6 months of import cover) at the end of December 2016 compared to USD7.2 billion (equivalent to 4.7 months of import cover) at the end of June 2016 (Chart 3c). During the period, the reserves remained above the statutory requirement of 4 months of average imports. These reserves, together with the Precautionary Arrangements with the IMF (equivalent to USD1.5 billion) continued to provides an adequate buffer against short term shocks.

The adequacy of reserves was corroborated by other alternative measures. The ratios of reserves to short-term debt and reserves to broad money exceeded the indicative thresholds. These ratios averaged above 400 percent and 27.9 percent, respectively, between July and December 2016. The ratio of reserves to short-term debt (Greenspan-Guidotti rule of 100 percent cover of short-term debt) is the most widely-used standard of reserves adequacy for emerging markets. For countries with large banking sector and open capital accounts, the prudent range for the ratio of reserves to broad money is 20 percent.

Chart 3c: CBK Usable Foreign Exchange Reserves



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

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 narrowed to USD3,653.1 million (5.2 percent of GDP) in 2016 from a revised USD4,288.9 million (6.7 percent of GDP) in 2015 largely due to an improvement in the value of the merchandise account (Chart 4). The value of imports of petroleum products, and machinery and transport equipment decreased from USD2,500.2 million and USD5,431.5 million, respectively, in 2015 to USD2,087.1 million and USD4,365.2 million, respectively, in 2016. In addition, export earnings from tea, coffee and horticulture grew by 1.2 percent, 3.8 percent, and 9.3 percent, respectively, between 2015 and 2016.

The overall balance of payments position recorded a deficit of USD129.0 million (0.2 percent of GDP) in 2016 from a surplus of USD253.7 million (0.4 percent of GDP) in 2015. The change in the overall balance of payments in the period reflected the deficit in the financial account, and a lower surplus in the capital account.

The demand for foreign exchange to finance imports of petroleum products, and machinery and transport equipment eased in the second half 2016. The 12-month cumulative proportion of imports of goods and services financed by exports of goods and services improved to 40.4 percent from 36.8 percent in 2015. The import bill of petroleum products continued to reduce due to lower international oil prices, which remained below their historical averages. Similarly, the value of imports of machinery

and transport equipment decreased in part due to completion of construction of the first phase of the Standard Gauge Railway (SGR). The shares of the values of imports of petroleum products, and machinery and transport equipment in total imports decreased from 18.9 percent and 35.1 percent, respectively, in 2015, to 15.2 percent and 34.3 percent, respectively, in 2016.

Although Kenya's current account balance improved during the period, the CBK continued to monitor the impact of Brexit since Kenya has significant trade and investment links with Europe. The Kenya National Bureau of Statistics's Foreign Investment Survey for 2015 showed that the stock of inward foreign direct investment from Europe to Kenya stood at 45 percent of total foreign direct investment, with the UK accounting for 23 percent. Additionally, a significant proportion of tea and horticulture exports are largely to the EU. The main risks relate to the uncertainty surrounding future trading relationships, as well as uncertainty over the signing and subsequent ratification of the EU-EAC economic partnership agreement.

Chart 4: Current Account Particulars (% of GDP)



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

c. Economic Growth

The Kenyan economy remained resilient in 2016 having recorded a growth of 5.8 percent (Table 3). 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. The ongoing public infrastructure projects continued to crowd-in private investments through reduced transportation and energy costs. According to the World Bank 2017 Doing Business Report, Kenya climbed 16 ranks to position 92

Monetary Policy Statement, December 2016

from 108 in 2016, and is the World's third most reformed country.

However, growth slowed down to 5.7 percent in the third quarter of 2016 compared to an average of 6.0 percent in the first two quarters of 2016 largely due to subdued performance of the agriculture sector. The slowdown in the agricultural sector performance was attributed to the below average rainfall witnessed in the second half of 2016, which escalated to the drought conditions in the last quarter of 2016.

Table 3: Kenya's Real GDP Growth by Sector (%)

| | Annual Growth | | | 2016 Quarterly Growth | | | |
|--|---------------|------------|------------|-----------------------|------------|------------|------------|
| | 2014 | 2015 | 2016 | Q1 | Q2 | Q3 | Q4 |
| Agriculture | 4.3 | 5.5 | 4.0 | 5.5 | 4.3 | 3.3 | 2.0 |
| Mining and Quarrying | 14.9 | 12.4 | 9.5 | 6.7 | 10.6 | 9.8 | 11.2 |
| Manufacturing | 2.5 | 3.6 | 3.5 | 1.7 | 5.3 | 4.4 | 2.5 |
| Electricity and water supply | 6.1 | 8.5 | 7.1 | 8.6 | 9.6 | 5.4 | 4.7 |
| Construction | 13.1 | 13.9 | 9.2 | 10.2 | 7.6 | 7.8 | 11.5 |
| Wholesale and Retail Trade | 6.9 | 5.9 | 3.8 | 3.6 | 2.3 | 4.3 | 5.0 |
| Accommodation and restaurant | -16.7 | -1.3 | 13.3 | 10.4 | 15.8 | 13.5 | 14.2 |
| Transport and Storage | 5.5 | 8.0 | 8.4 | 10.2 | 8.8 | 8.9 | 6.1 |
| Information and Communication | 14.5 | 7.4 | 9.7 | 10.9 | 9.1 | 8.8 | 9.8 |
| Financial and Insurance | 8.3 | 9.4 | 6.9 | 8.2 | 8.1 | 7.1 | 4.1 |
| Public administration | 5.6 | 5.5 | 5.3 | 5.7 | 6.6 | 5.1 | 3.6 |
| Professional, Administration and Support Services | 3.2 | 2.5 | 4.3 | 3.3 | 5.4 | 3.8 | 4.7 |
| Real estate | 5.6 | 7.2 | 8.8 | 10.1 | 9.5 | 8.5 | 7.0 |
| Education | 7.8 | 4.5 | 6.3 | 6.2 | 6.0 | 6.9 | 6.3 |
| Health | 8.1 | 6.1 | 5.8 | 5.1 | 6.6 | 7.1 | 4.5 |
| Other services | 4.2 | 3.9 | 4.2 | 5.0 | 4.6 | 4.3 | 2.8 |
| Financial intermediation services indirectly measured (FSIM) | 11.3 | 13.5 | 3.0 | 8.4 | 5.2 | 1.7 | -2.7 |
| All Industries at basic prices | 5.6 | 6.1 | 6.0 | 6.3 | 6.3 | 6.0 | 5.4 |
| Taxes on products | 3.4 | 2.8 | 4.5 | 3.5 | 2.6 | 3.1 | 8.6 |
| GDP at market prices | 5.4 | 5.7 | 5.8 | 6.0 | 5.9 | 5.7 | 5.8 |

Source: Kenya National Bureau of Statistics

d. Fiscal Developments and Debt

The Government's borrowing plan in the second half of the Fiscal Year 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 rationalization 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 regular stakeholder forums in the second half of 2016 in order to enhance the understanding of the background and impact its decisions. Bi-monthly meetings were held with Chief Executive Officers of banks. The Committee also continued to improve on the information gathering processes through the Market Perception Surveys and communication with key stakeholders on the MPC decisions to obtain feedback. The MPC Press Releases were simplified to enhance their clarity to the public, media, financial sector and other stakeholders.

The Governor held press conferences after MPC Meetings to brief the media on measures undertaken by the CBK to ensure macroeconomic and financial stability. The media and public understanding of monetary policy decisions and their expected impact on the economy continued to improve as can be noted by increased analysis and coverage in the press. MPC members participated in the preparatory activities leading to the epic celebrations of the 50th Anniversary of the CBK on September 14, 2016. Particularly, MPC members were involved in the drafting of the book on the *History and Development of Money in Kenya*.

The Governor held meetings with potential investors and International Rating Agencies in order to appraise them on recent economic developments and the outlook for the economy. He also held consultative meetings with the relevant Committees of Parliament to discuss economic and banking sector developments.

MPC members participated in local and international conferences as part of enhancing their responsibility, and to share experiences. The MPC Members held meetings with potential investors, and also participated in the World Bank and IMF Annual Meetings as well as other forums organized by these institutions to launch country and regional economic reports.

3. THE CURRENT ECONOMIC ENVIRONMENT AND OUTLOOK FOR 2017

a. International Economic Environment

Global economic activity is projected to pick up in 2017 particularly in emerging market and developing economies (Table 4). The outlook for advanced economies has also improved, reflecting stronger activity in the second half of 2016, projected fiscal stimulus in the U.S., and pick up in commodity prices. However, uncertainties with regard to the future policies of the new U.S. administration and Brexit. 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 2016 and 2017 reflecting lower commodity prices and weak domestic demand. Inflation in advanced economies is expected to rise to 0.7 percent in 2016, and 1.6 percent in 2017. In the emerging market and developing economies, inflation is projected to decline from 4.6 percent to 4.4 percent in the period. This indicates that the policy challenges are 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 Est. | 2017 Proj. | 2018 Proj. |
|--|--------------|--------------|---------------|---------------|
| World | 3.2 | 3.1 | 3.4 | 3.6 |
| Advanced Economies | 2.1 | 1.6 | 1.9 | 2.0 |
| United States | 2.6 | 1.6 | 2.3 | 2.5 |
| Japan | 1.2 | 0.9 | 0.8 | 0.5 |
| Euro Area | 2.0 | 1.7 | 1.6 | 1.6 |
| United Kingdom | 2.2 | 2.0 | 1.5 | 1.4 |
| Other Advanced economies | 2.0 | 1.9 | 2.2 | 2.4 |
| Emerging and developing economies | 4.1 | 4.1 | 4.5 | 4.8 |
| Sub-Saharan Africa | 3.4 | 1.6 | 2.8 | 3.7 |
| Developing Asia | 6.7 | 6.3 | 6.4 | 6.3 |
| China | 6.9 | 6.7 | 6.5 | 6.0 |
| India | 7.6 | 6.6 | 7.2 | 7.7 |
| Middle East and North Africa | 2.5 | 3.8 | 3.1 | 3.5 |

Source: IMF World Economic Outlook

b. Domestic Economic Environment

i. Economic Growth

The CBK's price stability objective aims at supporting a strong sustainable economic growth in the medium term. The Government expects real GDP growth to be 5.9 percent in 2017 supported by sustained investment in infrastructure, strong agricultural production, recovery in tourism, increased investor and consumer confidence, buoyant services sector, and macroeconomic stability. The proposed measures by the Government to enhance security, and improve governance will also support the business environment and growth.

The increased Budget allocation for tourism promotion activities is expected to foster confidence in the tourism sector. The FY2017/18 has also prioritized completion of ongoing projects and high priority infrastructure. This, together with proposals to revamp agriculture and manufacturing sectors will support growth in the medium term. The increased budgetary allocations for youth and women empowerment programmes will enhance the potential of youth and women in supporting inclusive growth.

The MPC Market Perceptions Surveys conducted in the second half of 2016 showed that private sector firms expected growth to be resilient 2017 on account of continued investment in infrastructure, the recovery of tourism and macroeconomic stability macroeconomic stability, robust agricultural performance, public investment in infrastructure, low energy prices, and the recovery of the tourism sector.

The risks to growth relate to the drought conditions which could slowdown agricultural production, uncertainties on the pace of global growth which has implications on Kenya's exports, and implications of the interest rates caps on private sector credit growth. Any significant increases in the prices of international crude oil prices could lead to higher production costs especially in the manufacturing sector.

ii. External Sector and Foreign Exchange Market

The Shilling is expected to be stable in 2017 on account of a narrowing 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; recovery in tourism, and increased foreign direct investment in infrastructure. The current account deficit is projected at 5.8 percent of GDP in 2017 compared with 5.2 percent in 2016.

The growth outlook for Kenya's main trading partners in the region remains strong, suggesting better prospects for exports performance. The Shilling will also be supported by the adequate buffer of foreign exchange reserves and the Precautionary Facilities with the IMF. The FY2017/18 Budget proposals to revamp the tourism sector will support foreign exchange market stability. These include continued

Monetary Policy Statement, December 2016

improvement of security and increased budgetary allocations for tourism promotional activities.

The main risks to the foreign exchange market in 2017 relate to possible volatility in the global financial markets due to increased uncertainties related to the outcome of Brexit and policy developments in the U.S.

iii. Inflation

Although food prices are expected to be high in the first quarter of 2017 due to the drought, demand pressures on inflation are expected to be muted. Overall inflation is expected to decline to within the Government's target range in 2017 with the onset of the long rains. This will also be supported by the monetary policy measures, relatively lower international oil prices, and a stable Shilling which is expected to dampen any risks of imported inflation.

The main risks to inflation include the drought conditions which could result in further increases in food and electricity prices in the first quarter of 2017, a likely increase in fuel prices following the decision by the major oil producing countries to reduce oil production, and the increase in global prices of food particularly sugar which could make importation of food expensive.

iv. Fiscal Policy

Government borrowing in the FY2016/17 and FY2017/18 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 FY2016/17 to 6.0 percent in FY2017/18, and 4.0 percent in the medium-term. Net domestic borrowing is projected to increase marginally from 3.0 percent of GDP to 3.0 percent and 3.1 percent in the period. It is therefore not expected to exert pressure on interest rates. The CBK will continue to work with the National Treasury to strengthen the coordination between monetary and fiscal policies.

v. Confidence in the Economy

Confidence in the economy is expected to remain strong in 2017 due to macroeconomic stability, improved security, and higher country profile. Kenya overall ranking in the World Bank's Ease of Doing Business Report improved in 2016. Additionally, the MPC Market Perception Surveys in the second half of 2016 showed private sector firms expected the business environment to be stable in 2017 supported by macroeconomic stability, infrastructure investments benefits, improved security and confidence in the economy, and tourism recovery.

4. DIRECTION OF MONETARY POLICY IN 2017

Monetary policy in 2017 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 2017 are consistent with the inflation and growth targets in the Medium-Term Budget Policy Statement for 2016. 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 10.5 percent by June 2017 and 12.3 percent by December. Growth in private sector credit is expected to pick up gradually to 6.2 percent by June 2017, and 7.1 percent by December. 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 to achieve and 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 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 and sustainable public debt.

Table 5: Monetary Targets for 2017

| | Mar-17 | Jun-17 | Sep-17 | Dec-17 |
|---|---------|---------|---------|---------|
| Broad Money, M3 (Ksh Billion) | 2,856.5 | 3,045.3 | 3,032.5 | 3,092.2 |
| Reserve Money, RM (Ksh Billion) | 430.0 | 432.3 | 454.9 | 465.0 |
| Credit to Private Sector (Ksh Billion) | 2,329.1 | 2,378.3 | 2,366.6 | 2,463.0 |
| NFA of CBK (Ksh Billion) | 727.0 | 832.0 | 736.0 | 747.0 |
| NDA of CBK (Ksh Billion) | -296.0 | -399.0 | -281.0 | -282.0 |
| 12-month growth in RM (Percent) | 7.0 | 10.8 | 15.8 | 13.1 |
| 12-month growth in M3 (Percent) | 7.3 | 10.5 | 9.8 | 12.3 |
| 12-month growth in Credit to Private Sector (Percent) | 5.1 | 6.2 | 4.4 | 7.1 |

Source: Central Bank of Kenya and the National Treasury

The Bank will continue to monitor developments in the Monetary Targets and make any 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 CBK will continue to monitor the impact of the interest rate caps on private sector credit growth.

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 FY2016/17 and FY2017/18. 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 work with stakeholders to identify and implement measures to enhance the distribution of liquidity in the interbank market. The Bank is exploring the use of pooled securities under the control of a central counterparty as collateral for interbank money market transactions. This is expected to address the problem of market segmentation and eliminate the credit risk premiums that small banks pay whenever they borrow from 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 through its website.

The CBK will also 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 improve the monetary policy transmission to lending rates, and promote transparency in credit pricing.

ANNEX: CHRONOLOGY OF EVENTS OF PARTICULAR RELEVANCE TO MONETARY POLICY

| Date | Events |
|-----------------------|--|
| July 2016 | The CBR was retained at 10.5 percent in order to anchor inflation expectations, and to maintain market stability. |
| September 2016 | Banking (Amendment) Act, 2016 came into force on September 14, 2016. The law caps banks' lending rates, and also sets the minimum interest rates on deposits in interest earning accounts. |
| | The CBR was reduced by 50 basis points to 10.0 percent. |
| November 2016 | a) The CBR was retained at 10.0 percent. b) Increased uncertainties in the global markets due to the outcome of the U.S. elections. |
| December 2016 | Resumption of tightening of U.S. monetary policy. |

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.

