Central Bank of Kenya

Monetary Policy Statement

December 2018

LETTER OF TRANSMITTAL

In accordance with Section 4B of the Central Bank of Kenya Act, it is my pleasure to present to you, Honourable Cabinet Secretary of The National Treasury and Planning, the 43rd Monetary Policy Statement of the Central Bank of Kenya. It reviews and assesses the implementation of monetary policy during the second half of 2018 and outlines the direction of monetary policy for the next twelve months.

Dr. Patrick Njoroge

Governor

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THE PRINCIPAL OBJECTIVES OF THE CENTRAL BANK OF KENYA

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

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

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

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

INSTRUMENTS AND TRANSMISSION OF MONETARY POLICY

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

- **Open Market Operations (OMO):** This refers to actions by the CBK involving purchases and sales of eligible securities to regulate the money supply and the credit conditions in the economy. OMO can also be used to stabilise short-term interest rates. When the Central Bank buys securities on the open market, it increases the reserves of commercial banks, making it possible for them to expand their loans and hence increase the money supply. To achieve the desired level of money supply, OMO is conducted using:

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

  ii. **Term Auction Deposit (TAD):** The TAD is used when the securities held by the CBK for Repo purposes are exhausted or when CBK considers it desirable to offer longer tenor options. The CBK seeks to acquire deposits through a transfer agreement from commercial banks at an auction price but with no exchange of security guarantee. Currently, the tenors for such deposits at CBK are 14, 21, or 28 day periods. At maturity, the proceeds revert to the respective commercial banks.

  iii. **Horizontal Repos:** Although Horizontal Repos are not strictly monetary policy instruments, they are modes of improving liquidity distribution between commercial banks, and are conducted under CBK supervision. They are transacted between commercial banks on the basis of signed agreements using government securities as collateral, and have negotiated tenors and yields. Commercial banks, short of deposits at the CBK, borrow from banks with excess deposits on the security of an appropriate asset, normally a government security. Horizontal Repos also help banks overcome the problem of limits to lines of credit, thus promoting more efficient management of interbank liquidity.

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

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

- **Standing Facilities:** The CBK does not have automatic standing facilities with respect to overnight lending. The CBK, as lender of last resort, provides secured loans to commercial banks on an overnight basis at a penal rate that is over the CBR. This facility is referred to as the Discount Window. Access to the Window is governed by rules and guidelines which are reviewed from time to time by the CBK. Banks making use of this facility more than twice in a week are scrutinised closely, and supervisory action taken.

- **The Cash Reserves Ratio (CRR):** In accordance with the law, the CRR is the proportion of a commercial bank's total deposit liabilities which must be held as deposits at CBK. These deposits are held in the CRR Account at no interest. The ratio is currently 5.25 percent of the total of a bank's domestic and foreign currency deposit liabilities. To facilitate commercial banks' liquidity management, commercial banks are currently required to maintain their CRR based on a daily average level from the 15th of the previous month to the 14th of the current month and not to fall below a CRR of 3 percent on any day.

- **Licensing and Supervision of Financial Institutions:** The CBK uses the licensing and supervision tools to ensure stability and efficiency of the banking system; this includes vetting potential managers for suitability.

- **The National Payments System:** The modernisation of the National Payments System has continued to lower transaction costs and enhanced the efficiency of the payments systems. This has ensured the effectiveness of monetary policy instruments.

- **Communication:** The increasing use of communication media ensures a wider dissemination of monetary policy decisions and background data thereby increasing the efficiency of information transmission and managing expectations. The regular interaction between the MPC and the Chief Executive Officers of banks has ensured that monetary policy decisions are transmitted to the banking sector. The regular Governor's Press Conferences have also enhanced the media understanding of monetary policy decisions. The CBK website is an important source of up-to-date data on all aspects of the financial market including interest rates, exchange rates, results of auctions of government securities, and the MPC releases.

EXECUTIVE SUMMARY

This Monetary Policy Statement provides the direction of monetary policy for 2019. It also reviews the outcome of the monetary policy stance adopted in the second half of 2018. During the period, CBK conducted monetary policy with the aim of keeping overall inflation within the Government target range of between 2.5 and 7.5 percent. Overall inflation remained well anchored within the target range despite the impact of the imposition of Value Added Tax (VAT) of 8 percent in September 2018 on the pump prices of petrol, diesel and kerosene. The inflation rate stood at 5.7 percent in December compared to 4.3 percent in June 2018. Non-food-non-fuel (NFNF) inflation remained below 5 percent, an indication of muted demand pressures.

During the period, the Monetary Policy Committee (MPC) lowered the Central Bank Rate (CBR) in July 2018 to 9.00 percent from 9.50 percent in June, in order to support economic activity. The MPC noted that although inflation expectations were well anchored and economic growth prospects were improving, the economy was operating below its potential. The Committee retained the CBR at 9.00 percent during its meetings of September and November in order to anchor inflation expectations. The liquidity management operations by the CBK in the period supported stability of the interbank market. The CBK continued to monitor the impact of interest rate caps on lending to the private sector and monetary policy effectiveness. A preliminary assessment of the impact of the lowering of the CBR in March 2018, showed that the caps had weakened the effectiveness of monetary policy transmission, with evidence of perverse outcomes.

The foreign exchange market remained relatively stable supported by a narrowing in the current account deficit, balanced flows and adequate reserve buffer. The current account deficit narrowed to 5.7 percent of GDP in the 12 months to December 2018 compared to 7.2 percent in 2017, supported by strong export earnings particularly horticulture, resilient remittance inflows, and lower imports. This was against a backdrop of heightened uncertainties in the global financial markets, with regard to the pace of normalization of monetary policy in advanced economies especially in the United States, trade tensions between the United States and China, and the delayed Brexit resolution. The CBK foreign exchange reserves, which stood at USD 7,999.96 million (5.24 months of imports cover) by end December, continued to provide an adequate buffer against short-term shocks in the foreign exchange market. The diversification of Kenya's exports in terms of both export products and external markets continued to cushion the economy against exogenous shocks.

The banking sector remained resilient and stable during the period with strong liquidity and capital adequacy ratios. However, credit to the private sector remained subdued, growing by 2.4 percent in the 12 months to December 2018 compared to 4.3 percent in June, largely due to loan repayments and write-offs in manufacturing, building and construction, trade and real estate sectors. CBK continued to implement measures to strengthen the sector to enhance its competitiveness and resilience including through entry of strong foreign players.

The monetary policy stance in 2019 will aim at maintaining overall inflation within the target range of between 2.5 and 7.5 percent. The foreign exchange market is expected to remain stable supported by expected narrowing in the current account deficit with improved earnings from tea and horticulture exports, resilient diaspora remittances, and lower imports growth. The CBK foreign exchange reserves will continue to provide a buffer against short-term shocks. Overall, macroeconomic stability will be supported by continued coordination of monetary and fiscal policies. This will support the achievement of the Government's *Big 4* development priorities of food security and agricultural productivity, affordable housing, increased share of manufacturing, and universal health coverage.

Consistent with the inflation and growth objectives stipulated in the Government Medium Budget Policy Statement for 2018, monetary policy will aim at containing annual growth in broad money (M3) at 13.6 percent by December 2019, while the recovery in private sector credit growth is expected to gain momentum. 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 of its monetary policy instruments in order to maintain price stability.

The Bank will continue to monitor the impact of interest rate caps on lending and monetary policy effectiveness. It will also monitor the risks posed by developments in the domestic and global economies on the overall price stability objective. The Bank will closely monitor risks associated with weaker than anticipated global growth, escalation of trade tensions, concerns with regard to Brexit resolution, and volatility in international oil prices.

1. INTRODUCTION

This Monetary Policy Statement (MPS) provides the direction of monetary policy for 2019. It also presents the outcome of the monetary policy stance adopted in the second half of 2018.

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

In the second half of 2018, overall inflation remained well anchored within the target range despite the impact of the imposition of Value Added Tax (VAT) of 8 percent in September 2018 on the pump prices of petrol, diesel and kerosene. The inflation rate stood at 5.7 percent in December compared to 4.3 percent in June 2018. Non-food-non-fuel (NFNF) inflation remained below 5 percent, an indication of muted demand pressures. The stability in the exchange rate continued to dampen any threat of imported inflation, despite the rise in international oil prices.

On the global scene, the global economic activity softened on the back of negative effects of tariff increases imposed in the United States and China, and concerns about China's outlook.

The rest of this Policy Statement is organized as follows. Section 2 reviews the outcome of the monetary policy stance implemented in the second half of 2018 while Section 3 describes the current economic environment and outlook for 2019. Section 4 concludes by outlining the monetary policy path for 2019.

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

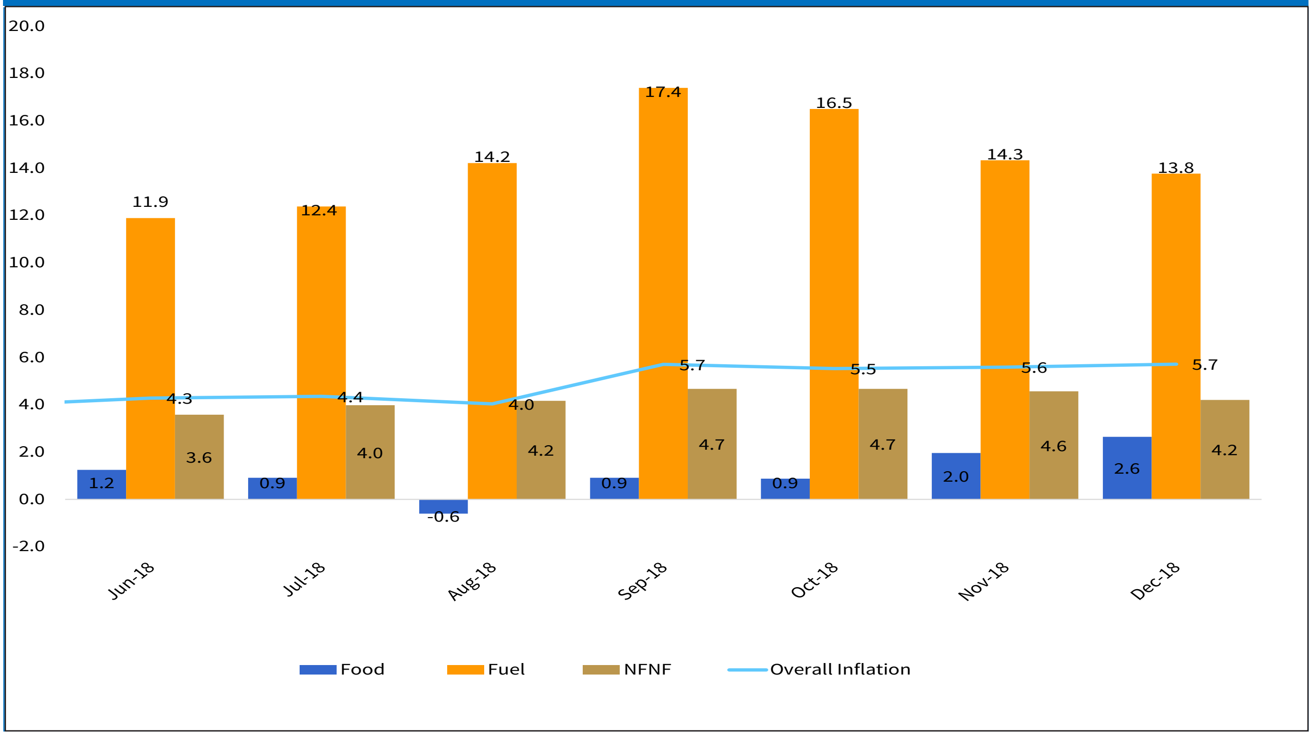
During the second half of 2018 the Monetary Policy Committee (MPC) lowered the Central Bank Rate (CBR) in July to 9.00 percent from 9.50 percent in June to support economic activity. The MPC noted that although inflation expectations were well anchored and economic growth prospects were improving, the economy was operating below its potential. The Committee retained the CBR at 9.00 percent during its meetings of September and November noting that inflation expectations remained well anchored but concluded that there was need to monitor any second-round inflationary effects arising from the VAT on petroleum products. The liquidity management operations by the CBK supported stability of the interbank market and redistributed liquidity from the surplus segments to segments facing liquidity shortfalls.

The Committee also continued to monitor the impact of the interest rate caps on the effective transmission of monetary policy. A preliminary assessment of the impact of lowering the CBR in March 2018 showed that this change, under the interest rate capping regime, had a smaller and slower impact on key macroeconomic variables such as credit and economic growth. The following are the specific outcomes of the policy stance:

i. Inflation

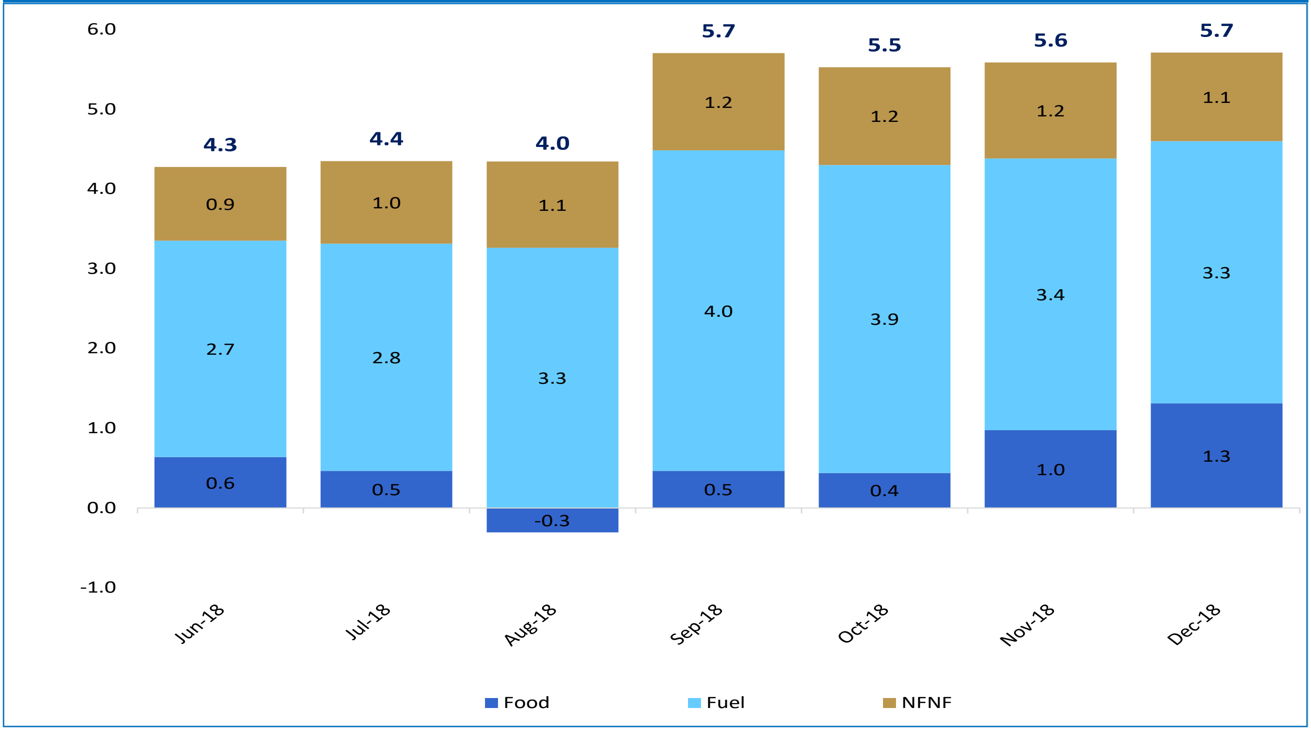
Overall inflation remained around the midpoint of the medium term target in the second half of 2018. It increased to 5.7 percent in December from 4.3 percent in the in June, mainly driven by higher energy prices **(Charts 1a and 1b)**.

Chart 1a: Trends of Broad Inflation Categories (percent)



Source: Kenya National Bureau of Statistics and CBK

Chart 1b: Contribution of Broad Inflation Categories to Overall Inflation (percentage points)



Source: Kenya National Bureau of Statistics

Fuel inflation increased to 13.8 percent from 11.9 percent in the review period, and contributed 3.3 percentage points to overall inflation, an increase from 2.7 percentage points in June. The elevated fuel inflation was driven by high charcoal prices following restrictions on charcoal trade and a ban on illegal logging that was imposed in March 2018. In addition, domestic pump prices continued to increase in line with rising international oil prices and the impact of the imposition of Value Added Tax (VAT) of 8 percent in September on the pump prices of petrol, diesel and kerosene. Electricity prices also picked up sharply during the period following an upward review of the fixed non-fuel tariff component of consumer bills by the Energy and Petroleum Regulation Authority in August 2018.

Food inflation remained low and stable supported by abundant food supply arising from favourable weather conditions experienced across the country. The food inflation rate stood at 2.6 percent in December compared to 1.2 percent in June and contributed 1.3 percentage points to overall inflation compared to 0.6 percentage points in June. The low food inflation was due to low prices of key vegetable items whose impact on this category of inflation is dominant.

Non-Food Non-Fuel (NFNF) inflation increased to 4.2 percent in December from 3.6 percent in June, on account of excise tax indexation and other tax revisions, mainly on alcoholic beverages such as beer, wines and spirits, and cigarettes in July. Despite the impact of these tax measures, NFNF inflation remained low reflecting muted demand pressures arising from appropriate monetary policy stance in place.

ii. Bank Credit to the Private Sector

Growth in credit to the private sector remained subdued in the second half of 2018, growing by 2.4 percent in the 12 months to December compared to 4.3 percent in June. All sectors with the exception of consumer durables, and finance and Insurance recorded declines in credit growth partly due to successful recovery efforts, loan repayments and write-offs mainly in manufacturing, building and construction, trade and real estate sectors **(Table 1)**.

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

Main Sectors	Jun-18	Jul-18	Aug-18	Sep-18	Oct-18	Nov-18	Dec-18
Agriculture	-4.7	-6.5	-4.3	-6.0	-5.6	-0.1	-2.0
Manufacturing	12.2	11.5	13.2	11.9	14.8	10.6	6.5
Trade	8.5	6.5	6.9	3.2	4.0	3.2	2.9
Building and construction	13.3	13.5	14.7	11.1	7.1	8.9	1.8
Transport and communication	-12.7	-10.7	-11.0	-9.1	-7.7	-10.7	-9.4
Finance and insurance	3.8	8.5	3.5	6.6	9.1	5.3	17.5
Real estate	3.8	4.3	0.9	1.7	1.2	-1.1	-0.5
Mining and quarrying	-9.1	0.2	-9.1	-15.5	-11.6	-10.6	-10.7
Private households	2.9	2.9	2.7	5.1	5.1	5.4	6.8
Consumer durables	7.8	9.1	11.5	7.8	7.6	8.9	11.0
Business services	6.7	3.3	6.5	4.3	12.1	9.5	8.0
Other activities	-7.9	-5.8	-4.6	2.7	-12.4	-23.4	-34.8
Total private sector credit	**4.3**	**4.3**	**4.3**	**3.8**	**4.4**	**3.0**	**2.4**

Source: Central Bank of Kenya

iii. Developments in the other Monetary Aggregates

The 12-month growth of broad money, M3, stabilised at 10.1 percent in December 2018 compared to 10.4 percent in June. The main sources of money growth were net claims to the Government and net foreign assets of the banking system. Following a slowdown in growth of private sector credit, its contribution to money supply growth declined from 3.3 percentage points in June to 1.9 percentage points in December. On the liabilities side, the growth of money supply was largely reflected in household and corporate sector deposits **(Chart 2)**. Overall, monetary aggregates grew at a relatively slower pace compared to their respective targets **(Table 2)**.

iv. Interest Rates Developments

a. Central Bank Rate (CBR)

The MPC reduced the Central Bank Rate (CBR) to 9.00 percent in July from 9.50 percent in June 2018 in order to support economic activity. The Committee retained the CBR at 9.00 percent during its subsequent meetings of September and November to continue anchoring inflation expectations.

b. Short Term Rates

The interbank rate remained below the CBR during the second half of 2018. Nonetheless, it increased from 5.03 percent in June to 8.15 percent in December, reflecting tight liquidity conditions in the market towards the end of the fourth quarter **(Table 3).** Liquidity distribution also remained uneven across the banks due to the segmentation in the interbank market. Liquidity management operations by the CBK remained active and supported redistribution of liquidity from the surplus segments to market segments facing liquidity shortfalls.

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

c. Commercial Bank Rates

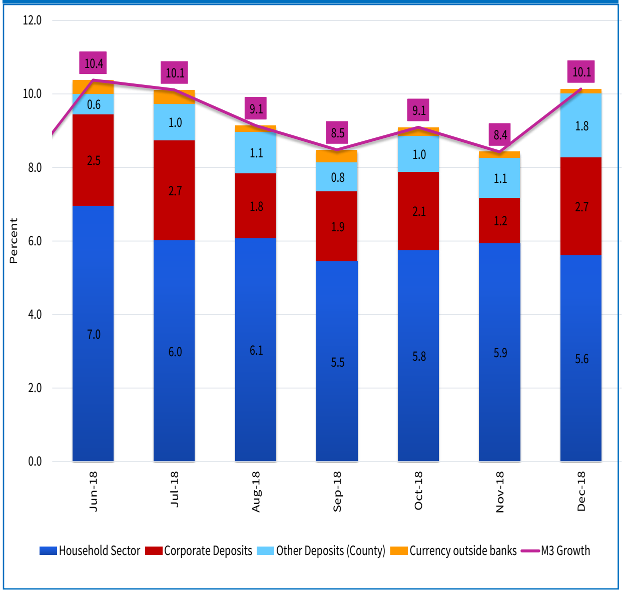
Commercial banks' interest rates remained within the interest rate in the second half of 2018. The average lending rate caps declined from 13.22 percent in June to 12.51 percent in the December while the average deposit rate declined from 8.04 percent to 7.41 percent. This in part reflected the reduction in CBR in July. The spread between the lending and deposit rates decreased marginally to 5.09 percent from 5.18 percent **(Table 3).**

v. Banking Sector Developments

The banking sector remained stable and resilient in the second half of 2018. The average commercial banks' liquidity and capital adequacy ratios stood at 48.6 percent and 18.7 percent, respectively, in December 2018 compared to 48.0 percent and 18.0 percent, respectively, in June. The distribution of liquidity in the sector also improved, although

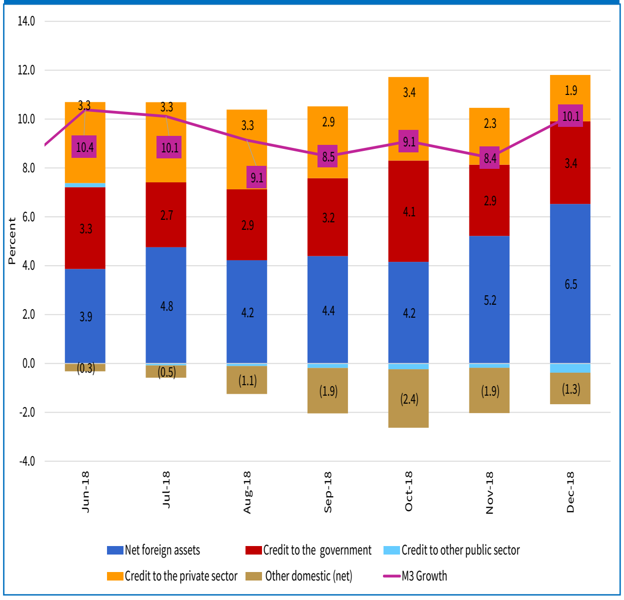
Chart 2: The 12-Month Growth in Broad Money Supply (M3) and its Sources (percent)

2a: Components of Money Growth (Percent)



Source: Central Bank of Kenya

2b: Sources of Money Growth (Percent)



Source: Central Bank of Kenya

Table 2: Actual and Targeted Growth in Key Monetary Aggregates

	Jun-18	Sep-18	Dec-18
Actual Broad Money,M3 (Ksh Billion)	3262.6	3261.1	3337.8
Target (Ksh Billion)	*3203.0*	*3290.8*	*3362.9*
Actual Reserve Money (Ksh Billion)	429.2	449.9	492.0
Target (Ksh Billion)	*440.4*	*448.0*	*466.3*
Actual Net Foreign Assets of CBK (Ksh Billion)	783.6	768.3	739.5
Target (Ksh Billion)	*752.8*	*656.1*	*670.0*
Actual Net Domestic Assets of CBK (Ksh Billion)	-354.4	-318.4	-247.5
Target (Ksh Billion)	*-312.4*	*-208.1*	*-203.7*
Actual Credit to private sector (Ksh Billion)	2380.4	2404.0	2422.0
Target (Ksh Billion)	*2451.4*	*2539.7*	*2638.2*
Memorandum Items			
12-month growth in actual Reserve Money (Percent)	*7.4*	*6.0*	*12.1*
12-month growth in actual Broad Money, M3 (Percent)	*10.4*	*8.5*	*10.1*

Source: Central Bank of Kenya

Table 3: Interest Rates (Percent)

	2017				2018							
	Mar	Jun	Sep	Dec	Mar	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Central Bank Rate	10.00	10.00	10.00	10.00	9.50	9.50	9.00	9.00	9.00	9.00	9.00	9.00
Interbank	4.46	3.99	5.52	7.27	4.90	5.03	4.82	6.52	4.28	3.48	4.09	8.15
Repo	7.23	4.13	7.24	7.75	...	6.16	6.56	8.01	4.77	4.70	7.10	7.72
Reverse Repo	10.04	10.05	10.12	10.10	9.95	9.56	9.46	9.02	9.03	9.06	...	11.34
91-Tbill	8.69	8.42	8.13	8.01	8.02	7.87	7.73	7.74	7.74	7.59	7.41	7.36
182-Tbill	10.53	10.38	10.32	10.53	10.39	9.99	9.40	9.09	8.86	8.56	8.36	8.45
Average Lending Rate (1)	**13.61**	**13.66**	**13.69**	**13.64**	**13.49**	**13.22**	**13.10**	**12.78**	**12.66**	**12.61**	**12.55**	**12.51**
Overdraft/loan	13.29	13.38	13.65	13.54	13.40	13.23	13.16	12.90	12.52	12.42	12.11	12.17
1-5years	13.81	13.80	13.87	13.83	13.67	13.39	13.26	12.94	12.85	12.82	12.79	12.70
Over 5years	13.55	13.64	13.51	13.46	13.31	13.00	12.88	12.53	12.51	12.46	12.50	12.47
Average Deposit Rate (2)	**7.12**	**7.15**	**7.66**	**8.22**	**8.16**	**8.04**	**8.01**	**7.78**	**7.76**	**7.63**	**7.41**	**7.41**
Demand	1.24	1.21	1.15	1.14	1.25	1.08	1.12	1.91	1.55	1.69	1.81	1.61
0-3months	7.28	7.76	7.71	8.43	8.48	8.41	8.41	8.28	8.22	8.03	7.85	7.83
Over 3months	8.18	8.04	8.02	8.39	8.26	8.14	8.04	7.53	7.64	7.76	7.56	7.67
Savings	5.89	5.63	6.43	6.91	6.85	6.60	6.53	6.52	6.33	5.70	5.38	5.13
Spread (1-2)	**6.49**	**6.52**	**6.04**	**5.41**	**5.33**	**5.18**	**5.09**	**5.00**	**4.91**	**4.98**	**5.14**	**5.09**

Source: Central Bank of Kenya

credit risk remained elevated as large corporates continued to restructure their borrowings. The ratio of gross non-performing loans (NPLs) to gross loans increased to 12.7 percent from 12.0 percent in June. The increase in NPLs was in part attributable to delayed payments by government agencies and the private sector, a challenging business environment and low uptake in the property market. .

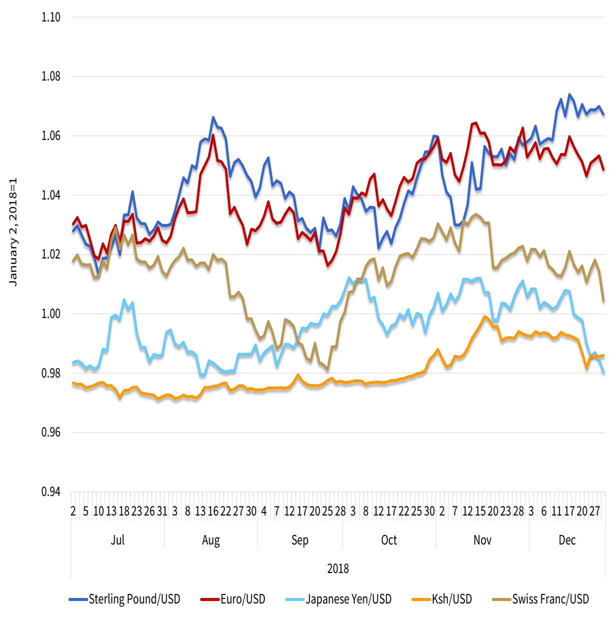
CBK continued to strengthen the sector to enhance its competitiveness and resilience including through entry of strong foreign players. The Bank also implemented several measures aimed at safeguarding public interest and maintaining the integrity of the financial sector. These included the adoption of a Risk-Based Supervisory Framework for Anti-Money Laundering and Combating Financing of Terrorism (AML/CFT).

vi. Exchange Rates and Foreign Exchange Reserves

The foreign exchange market remained relatively stable in the second half of 2018 supported by improvement in the current account balance, balanced flows and adequate reserve buffer. However, like most emerging market currencies, the Kenya Shilling weakened slightly against the US Dollar particularly in the fourth quarter of 2018. Most regional and international currencies were volatile, reflecting continued uncertainties in the global financial markets with regard to the pace of normalization of monetary policy in advanced economies especially in the United States, trade tensions especially between the United States and China, and Brexit resolution **(Chart 3a and 3b)**. The diversification of Kenya's exports in terms of both export products and external markets continued to cushion the economy against short-term shocks.

The official foreign exchange reserves remained well above the statutory requirement to endeavour to maintain at least 4.0 months of import cover and the EAC convergence criteria of 4.5 months of import cover. As at December 2018, official foreign exchange reserves stood at USD 7,999.96 million (5.24 months of imports cover) **(Chart 3c).** The decline in the reserves observed between June and December reflected payments for government obligations. The reserves continued to provide an adequate buffer against short-term shocks in the foreign exchange market.

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

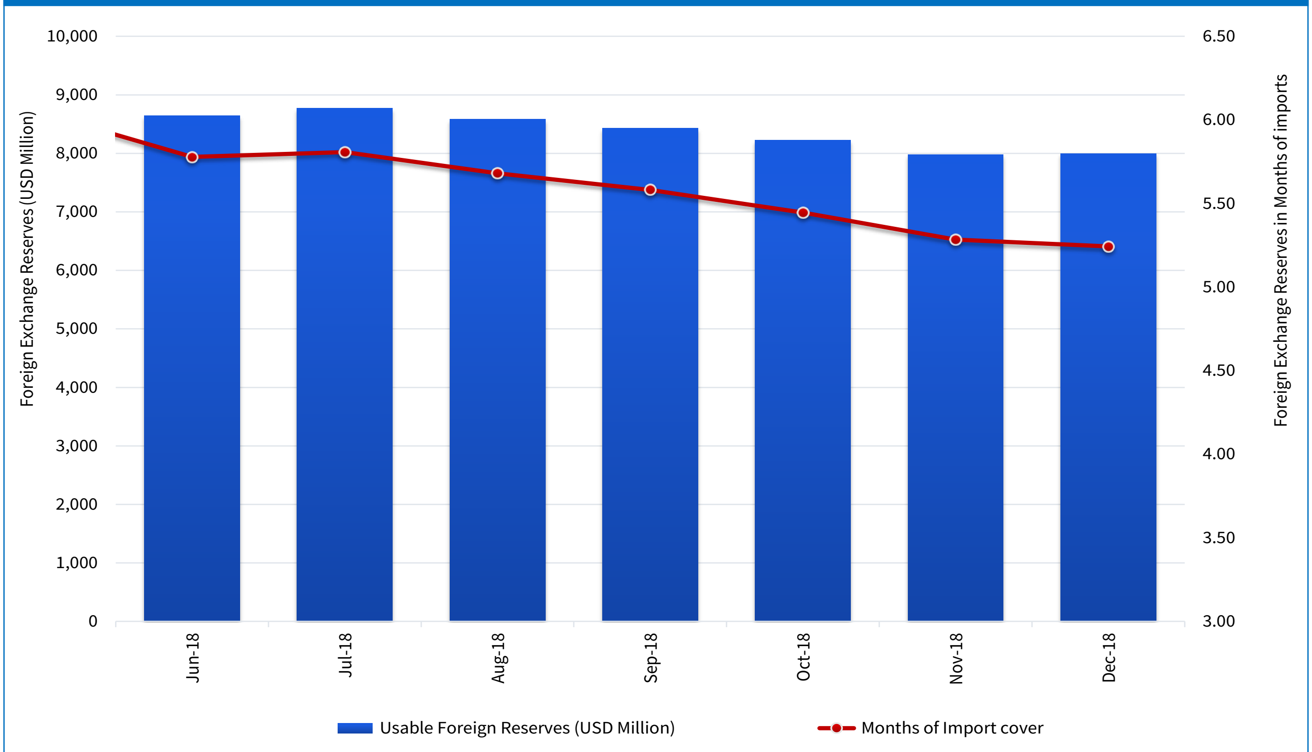


Source: Central Bank of Kenya

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

Source: Central Bank of Kenya

Chart 3c: CBK Foreign Exchange Reserves



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

Source: Central Bank of Kenya

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

vii. Balance of Payments Developments

The current account deficit narrowed to 5.7 percent of GDP in 2018 from 7.2 percent of GDP in 2017 **(Chart 4 and Table 4).** The narrowing in the current account deficit was attributable to improvement in the trade and secondary income balances. The trade balance improved largely due to lower imports of goods and resilient exports and services receipts. Imports of merchandise goods declined to 18.7 percent of GDP in 2018 on account of lower imports of food with favourable weather and machinery and transport equipment following completion of the first phase of the SGR project. However, the import bill of petroleum products increased due to higher international oil prices.

Exports of merchandise goods stood at 7.0 percent of GDP in the twelve months to December 2018 compared to 7.3 percent of GDP in 2017 **(Table 3).** Receipts from horticulture exports rose by 16.1 percent primarily due to increased earnings from cut flowers, while coffee export earnings increased by 1.1 percent. However, tea export receipts declined by 3.8 percent due to lower tea prices that prevailed in 2018 compared to 2017 following increased production attributed to high precipitation in tea growing areas.

The services account balance, as a percent of GDP, declined mainly on account of higher payments of other business services. This was despite improved earnings from tourism. The balance on secondary income improved to 5.8 percent of GDP supported resilient remittance inflows.

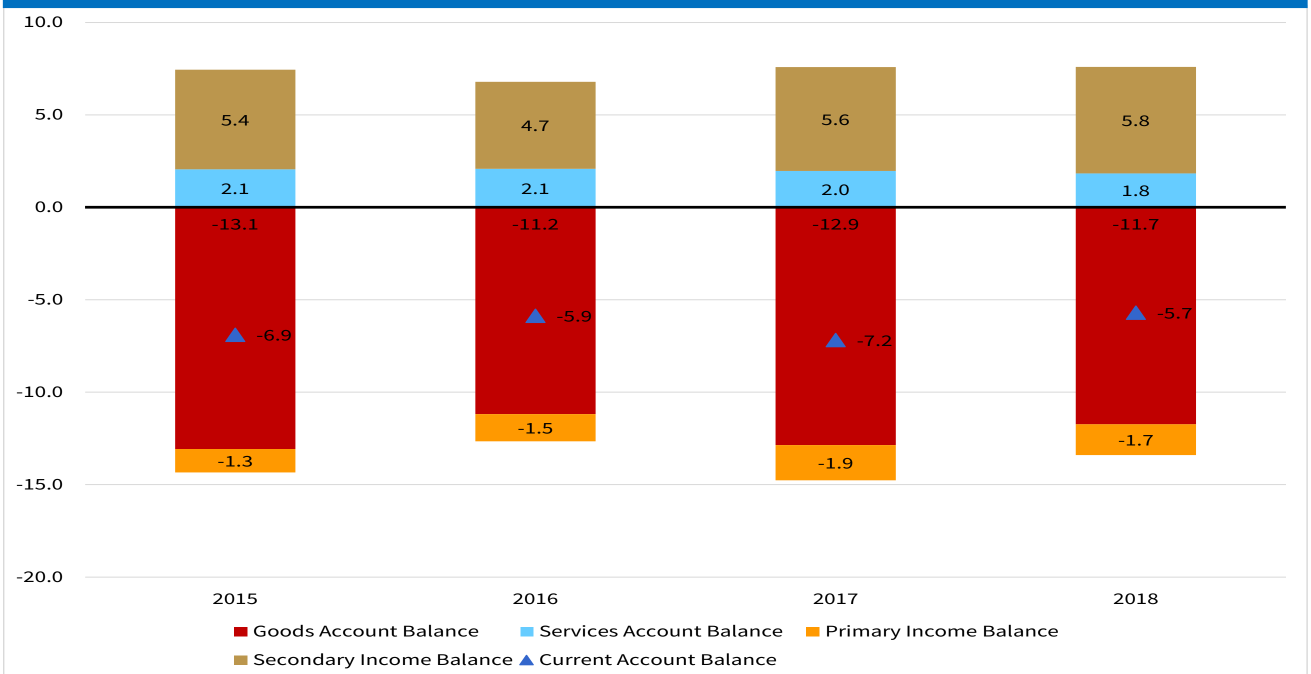
viii. Economic Growth

The Kenyan economy rebounded in 2018. Real GDP grew by 6.3 percent compared to 4.9 percent in 2017, mainly driven by favourable weather conditions, which supported agricultural activity, the resilience of the services and a resurgent manufacturing sector **(Table 5 and Chart 5).**

The Agriculture sector grew by 6.4 percent in 2018, a significant improvement compared to 1.9 percent in 2017 arising from favourable weather conditions, which supported increased production of crops and animal husbandry. As a result, its contribution to real GDP growth increased to 1.4 percentage points from 0.4 percentage points in 2017.

The Services sector grew by 6.9 percent compared to 6.5 percent in 2017 mainly supported by strong and resilient performance of Accommodation and Restaurants, Transport and Storage, Information and Communication, and Wholesale and Retail Trade sectors. Consequently, its contribution to Real GDP growth increased to 3.4 percentage points from 3.2 percentage points in 2017.

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



Source: Central Bank of Kenya

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

	2015	2016	2017	2018
1. Current Account Balance	**-6.9**	**-5.9**	**-7.2**	**-5.7**
1.1 Goods Account Balance	**-13.1**	**-11.2**	**-12.9**	**-11.7**
Goods: Exports (fob)	9.3	8.4	7.3	7.0
o/w: Tea	1.9	1.8	1.8	1.6
Horticulture	1.2	1.2	1.0	1.1
Coffee	0.3	0.3	0.3	0.3
Other exports and re-exports	5.9	5.1	4.2	4.1
Goods: Imports (fob)	22.4	19.5	20.2	18.7
o/w: Oil	3.9	3.0	3.4	3.9
Machinery & transport equipment	8.5	6.3	5.9	5.2
Other imports	10.0	10.2	10.8	9.6
1.2 Services Account Balance	**2.1**	**2.1**	**2.0**	**1.8**
Credit	7.2	6.1	5.9	6.3
o/w: Transportation	3.0	2.3	2.0	2.3
Travel	1.1	1.2	1.2	1.2
Debit	5.2	4.0	3.9	4.5
1.3 Primary Income Balance	**-1.3**	**-1.5**	**-1.9**	**-1.7**
Credit	0.1	0.1	0.2	0.2
Debit	1.4	1.6	2.1	1.9
1.4 Secondary Income Balance	**5.4**	**4.7**	**5.6**	**5.8**
Credit	5.5	4.8	5.7	5.8
o/w: Remittances	2.4	2.5	2.5	3.1
Debit	0.1	0.1	0.1	0.1
2. Capital Account Balance	**0.4**	**0.3**	**0.2**	**0.3**
3. Financial Account Balance	**-6.0**	**-7.5**	**-7.0**	**-7.5**
3.1 Foreign direct investment,net	-0.6	-0.8	-1.3	-1.7
3.2 Portfolio investment, net	0.2	0.5	1.0	-0.7
3.3 Other investment, net	-5.6	-7.3	-6.7	-5.1

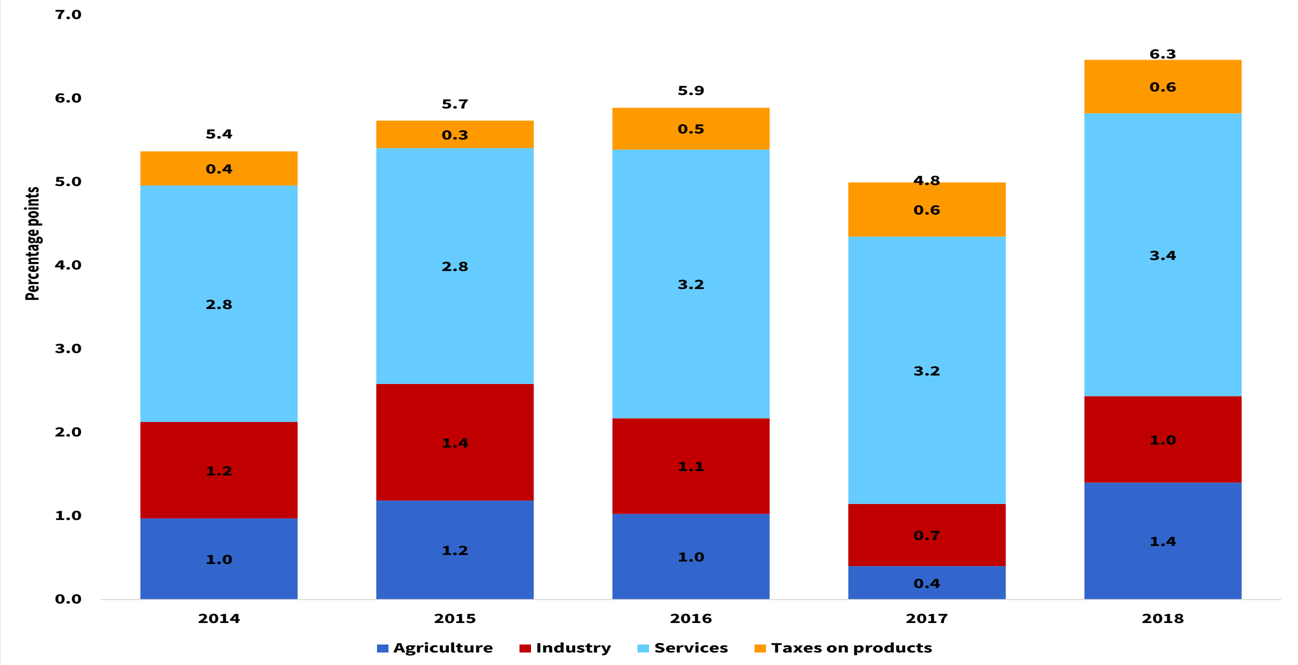
Source: Central Bank of Kenya

Table 4b: Kenya's Direction of Trade

IMPORTS	(in millions of US do		Share of Imports (%)		EXPORTS	(in millions of US dollars)		Share of Exports (%)	
Region/Country	2017	2018	2017	2018	Region/Country	2017	2018	2017	2018
Africa	**1,939**	**2,033**	**12.1**	**12.5**	**Africa**	**2,165**	**2,135**	**37.3**	**35.1**
Of which					*Of which*				
South Africa	598	639	3.7	3.9	Uganda	598	611	10.3	10.0
Egypt	342	359	2.1	2.2	Tanzania	276	294	4.8	4.8
Others	999	1,035	6.2	6.4	Sudan	67	61	1.2	1.0
					South Sudan	162	128	2.8	2.1
EAC	**590**	**676**	**3.7**	**4.2**	DRC	183	150	3.1	2.5
COMESA	**1,115**	**1,139**	**7.0**	**7.0**	Rwanda	166	176	2.9	2.9
Rest of the World	**14,048**	**14,256**	**87.9**	**87.5**	Others	340	368	5.9	6.0
Of which					**EAC**	**1,273**	**1,274**	**21.9**	**20.9**
India	1,648	1,829	10.3	11.2	**COMESA**	**1,448**	**1,452**	**25.0**	**23.9**
United Arab Emirates	1,338	1,457	8.4	8.9	**Rest of the World**	**3,636**	**3,953**	**62.7**	**64.9**
China	3,777	3,663	23.6	22.5	*Of which*				
Japan	790	985	4.9	6.0	United Kingdom	373	396	6.4	6.5
USA	555	525	3.5	3.2	Netherlands	425	457	7.3	7.5
United Kingdom	291	311	1.8	1.9	USA	457	467	7.9	7.7
Germany	416	460	2.6	2.8	Pakistan	619	586	10.7	9.6
Saudi Arabia	1,108	1,705	6.9	10.5	United Arab Emirates	255	346	4.4	5.7
Indonesia	550	455	3.4	2.8	Germany	114	110	2.0	1.8
Netherlands	189	191	1.2	1.2	India	58	90	1.0	1.5
Italy	216	254	1.4	1.6	Others	1,306	1,462	22.5	24.0
Others	3,170	2,420	19.8	14.9					
Total	**15,987**	**16,289**	**100**	**100**	**Total**	**5,801**	**6,088**	**100**	**100**
EU	1,986	2,151	12.4	13.2	EU	1,209	1,290	20.8	21.2
China	3,777	3,663	23.6	22.5	China	97	110	1.7	1.8

Source: Central Bank of Kenya

Chart 5: Contributions to Real GDP Growth (percent)



Source: Kenya National Bureau of Statistics

Table 5: Kenya's Real GDP Growth across the Main Sectors (Percent)

MAIN SECTORS	2014*	2015*	2016*	2017*	2018**
1. Agriculture	**4.4**	**5.3**	**4.7**	**1.9**	**6.4**
2. Non-Agriculture (o/w)	**5.6**	**5.8**	**6.2**	**5.7**	**6.3**
2.1 Industry	6.1	7.3	5.9	3.8	5.3
Mining & Quarrying	14.9	12.3	9.5	4.5	2.8
Manufacturing	2.5	3.6	3.1	0.5	4.2
Electricity & water supply	6.1	8.5	8.4	7.0	7.9
Construction	13.1	13.8	9.9	8.5	6.6
2.2 Services	6.0	6.0	6.8	6.5	6.9
2.3 Taxes on products	3.4	2.8	4.4	5.4	5.2
Real GDP Growth	**5.4**	**5.7**	**5.9**	**4.9**	**6.3**
**Revised*					
***Provisional*					

Source: Kenya National Bureau of Statistics and CBK

The growth of Industry rebounded to 5.3 percent in 2018 from 3.8 percent in 2017 reflecting good performance of manufacturing sector which grew by 4.2 percent compared to 0.5 percent, consistent with increased government and private sector activity to support the *Big 4* Agenda. Electricity and Water supply also remained strong as a result of favourable weather conditions which enhanced electricity generation and water supply. However, the contribution of Industry to overall GDP growth remained low at 1.0 percentage point.

ix. Domestic Government Borrowing

The coordination between monetary and fiscal policies continued to support macroeconomic stability. The Government's borrowing plan in the first half of the FY 2018/19 ensured that the build-up in domestic debt was consistent with the thresholds set in the Medium-Term Debt Management Strategy.

The Government continued to review its borrowing plan in line with market conditions and prudent budget management that focused on rationalisation of expenditures and strengthening of revenue collection measures.

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

The MPC held forums with Chief Executive Officers of commercial banks after every meeting. The Committee continued to improve and expand its information gathering processes through the Market Perception Surveys and communication with key stakeholders on the MPC decisions to obtain feedback. The MPC Press Releases were continuously reviewed to make them better focused to the public, media, financial sector and other stakeholders.

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

The CBK held meetings with IMF Mission in July and December 2018 to discuss developments in the economy under Article IV Consultations and to review the performance under the Precautionary Arrangements programme. The Committee also met the World Bank to discuss developments in the economy.

3. THE CURRENT ECONOMIC ENVIRONMENT AND OUTLOOK FOR 2019

a. International Economic Environment

Global economy weakened in 2018 with global growth estimated at 3.7 percent compared to 3.8 percent in 2017 **(Table 6).** The global economy is projected to grow by 3.5 percent in 2019. The softening reflects weakening financial market sentiment, negative effects of tariff increases enacted in the United States and China, and concerns about China's outlook. Weakness in the second half of 2018 is expected to spill over into the eraly months of 2019, including in Germany following the introduction of new automobile fuel emission standards and in Italy where concerns about sovereign and financial risks weighed on domestic demand. Growth in sub-Saharan Africa is projected to pick up from 2.9 percent in 2018 to 3.5 percent in 2019 despite the soft outlook for commodity prices that is expected to affect growth rates in Nigeria and Angola.

According to the IMF, risks to global growth are tilted to the downside. These include an escalation of trade tensions, further tightening of financial conditions, a "no-deal" withdrawal of the United Kingdom from the European Union and a greater-than-envisaged slowdown in China. Materialisation of any of these potential triggers could spark a further deterioration in risk sentiment. The outcomes of trade negotiations and the direction of financial conditions in coming months therefore remain key sources of risk to the global economic outlook.

Inflation is expected to decline to 1.6 percent in advanced economies in 2019, from 2.0 percent in 2018 reflecting softer outlook for commodity prices and the expected moderation in growth. Core inflation is projected to rise in the US, Euro area and Japan. In emerging market and developing economies excluding Venezuela, inflation is expected to firm to 4.9 percent from 4.8 percent in 2018, reflecting developments in a few economies. These include a temporary boost to consumer price inflation from a higher value-added tax rate in Russia and a gradual pickup in price pressure in India due to relatively strong demand conditions and a modest increase in food inflation.

Table 6: Growth Performance and Outlook for the Global Economy (Percent)

Region/Counry	2016 Act.	2017 Est.	2018 Est.	2019 Proj.
World	3.2	3.8	3.7	3.5
Advanced Economies	1.7	2.4	2.3	2.0
United States	2.2	2.2	2.9	2.5
Euro Area	1.8	2.4	1.8	1.6
Japan	1.0	1.9	0.9	1.1
United Kingdom	1.8	1.8	1.4	1.5
Emerging and developing economies	4.4	4.7	4.6	4.5
Sub-Saharan Africa	1.5	2.9	2.9	3.5
Emerging and Developing Asia	6.5	6.5	6.5	6.3
China	6.7	6.9	6.6	6.2
India	7.1	6.7	7.3	7.5
Middle East, North Africa, Afghanistan and Pakistan	5.0	2.2	2.4	2.4

Source: IMF, World Economic Outlook

b. Domestic Economic Environment

Economic growth is projected at 6.2 percent in 2019, supported by a confluence of favourable domestic and external factors. Domestic factors supportive of high growth prospects for 2019 include strong agricultural production due to favourable weather conditions, continued improvement in business environment, a stable macroeconomic environment and high priority by Government on the *Big-4* Agenda which will stimulate activity around manufacturing, construction and real estate, health, and agriculture sectors. The external environment remains favourable and is expected to be supportive of growth.

The macroeconomic environment is expected to remain stable, with overall inflation remaining within the target range of 5 percent with a margin of 2.5 percent on either side. The exchange rate is expected to be stable, reflecting further improvement in the current account and adequate foreign exchange reserves. The 12-month current account deficit is projected at 5.1 percent in 2019 from an estimated 5.4 percent of GDP in 2018, driven by good performance of agricultural exports, resilient remittances and lower imports.

Government borrowing will continue to be anchored the Medium-Term Debt Management Strategy, which aims at maintaining public debt at sustainable levels. Consistent with Government's commitment to fiscal consolidation, the budget deficit is projected to decline to 6.1 percent and 5.1 percent of GDP in FY 2018/19 and FY 2019/20, respectively, from 7.8 percent of GDP in FY 2017/18. Net domestic financing is projected to remain at 3.1 percent of GDP in FY 2017/18 and FY 2018/19 before declining to 2.4 percent of GDP in FY 2019/20. CBK will continue to work with the National Treasury to strengthen the coordination between monetary and fiscal policies.

4. DIRECTION OF MONETARY POLICY IN 2019

Price stability will be the overriding objective of monetary policy in 2019. Monetary policy will also support economic activity. The monetary targets for 2019 are therefore consistent with Government policy objectives articulated in the Medium-Term Government Budget Policy Statement and Budget Review and Outlook Paper for 2018 published by the National Treasury.

The monetary targets for the period are presented in **(Table 7).** Monetary policy will aim at containing the annual growth in broad money (M3) at about 13.6 percent by December 2019. Growth in private sector credit is expected to pick up from 2.4 percent in December 2018 to 8.7 percent by December. Growth in reserve money is projected to decrease from 12.1 percent in December 2018 to 3.0 percent in 2019.

The CBK foreign exchange reserves are projected at US$ 9,253 million (about 5.5 months of import cover) by December 2019, consistent with the positive outlook of the balance of payments. This level of foreign exchange reserves will continue to provide a buffer against short-term shocks in the foreign exchange market. The coordination of monetary and fiscal policies will support macroeconomic stability.

The monetary projections are subject to risks emanating from both the domestic and global fronts. The continued underperformance in revenue collections may undermine fiscal consolidation and result in Government temporarily operating outside the domestic borrowing target. Additionally, the predictability of money demand continues to be affected by continued innovation in the financial sector. On the external front, the key downside risks include continued uncertainties in the global financial markets with regard to the pace of normalization of monetary policy in advanced economies especially in the United States, trade tensions especially between the United States and China, and Brexit resolution.

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

Table 7: Monetary Targets for 2019

.	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19
		Actual			Projections		
Broad Money, M3 (Ksh Billion)	3,262.6	3,261.1	3,337.8	3,497.1	3,657.3	3,725.1	3,792.9
Reserve Money, RM (Ksh Billion)	429.2	449.9	492.0	470.1	474.0	483.3	506.8
Credit to Private Sector (Ksh Billion)	2,380.4	2,404.0	2,422.0	2,447.4	2,516.4	2,563.4	2,632.5
NFA of CBK (Ksh Billion)	783.6	768.3	739.5	732.3	879.7	856.4	852.8
NDA of CBK (Ksh Billion)	(354.4)	(318.4)	(247.5)	(262.2)	(405.7)	(373.2)	(346.0)
12-month growth in RM (Percent)	7.4	6.0	12.1	12.4	10.4	7.4	3.0
12-month growth in M3 (Percent)	10.4	8.5	10.1	15.2	12.1	14.2	13.6
12-month growth in Credit to Private Sector (Percent)	4.3	3.8	2.4	4.5	5.7	6.6	8.7
Medium-Term Overall Inflation Target (Percent)	5.0	5.0	5.0	5.0	5.0	5.0	5.0

Source: IMF, World Economic Outlook

EVENTS OF PARTICULAR RELEVANCE TO MONETARY POLICY (JULY – DECEMBER, 2018)

July	The MPC reduced the CBR to 9.00 percent from 9.50 percent in order to support economic activity.
August	Acquisition of certain assets and liabilities of Chase Bank (Kenya) Limited (In Receivership) by SBM Bank Kenya Limited. This would enhance competitiveness and the resilience of Kenya's banking sector through entry of strong foreign players who bring experience and expertise from other markets.
	New external MPC members were appointed.
September	The MPC retained the CBR at 9.00 percent to continue anchoring inflation expectations.
November	The MPC retained the CBR at 9.00 percent to continue anchoring inflation expectations.

GLOSSARY OF KEY TERMS

OVERALL INFLATION

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

RESERVE MONEY

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

MONEY SUPPLY

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

Narrow Money

M0: Currency outside the banking system
M1: M0 + demand deposits of banks (or depository corporations).

Broad Money

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

Extended Broad Money

M3: M2 + residents' foreign currency deposits.

Overall Liquidity

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

Central Bank of Kenya

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