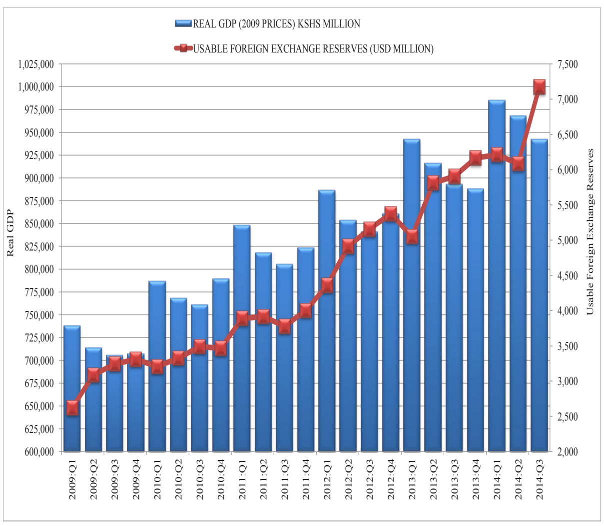


CENTRAL BANK OF KENYA

Monetary Policy Statement

Issued under the Central Bank of Kenya Act, Cap 491

DECEMBER 2014

Letter of Transmittal to the Cabinet Secretary for the National Treasury

Dear Honourable Cabinet Secretary,

I have the pleasure of forwarding to you the 35th 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 in the second half of 2014, then describes the current economic environment and outlook, and concludes with an outline of the monetary policy path for 2015.

Prof. Njuguna Ndung'u, CBS
Governor

TABLE OF CONTENTS

Letter of Transmittal to the Cabinet Secretary for the National Treasury........................ i

The Principal Objectives of the Central Bank of Kenya... iii

Instruments and Transmission of Monetary Policy iv

Legal Status of the Monetary Policy Statement... vii

Executive Summary viii

1. Introduction.. 1

2. Actions and Outcomes of Policy Proposals in the June 2014

Monetary Policy Statement... 2

3. The Current Economic Environment and Outlook for 2015...................................... 12

4. Direction of Monetary Policy in 2015 16

Annex 1: Main Macroeconomic Indicators (2013/14 – 2016/17) 19

Annex 2: Chronology of Events of Particular Relevance to Monetary Policy

(July – December 2014).. 20

Glossary of Key Terms 21

The Principal Objectives of the Central Bank of Kenya

The principal objectives of the Central Bank of Kenya (CBK) as established in the CBK Act 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;
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 as fiscal agent of, the Government; and
- Issue currency notes and coins.

The CBK therefore, 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 together with ensuring adequate liquidity in the market facilitates higher levels of domestic savings and private investment, and leading to improved economic growth, higher real incomes and increased employment opportunities.

The Bank's monetary policy is therefore designed to support the Government's (both National and County level) desired growth in the production of goods and services and employment creation through achieving and maintaining a low and stable inflation.

Instruments and Transmission of Monetary Policy

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

- **Open Market Operations (OMO)** refers to actions by the CBK through 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 which increase the money supply. To achieve the desired level of money supply, OMO is conducted using:
    - i. **Repurchase Agreements (Repos)**: Repos entail the sale of eligible securities by the CBK to reduce commercial banks' deposits held in CBK. Currently, Repos (often called Vertical Repos) have a fixed tenor of 7 working days. Reverse Repos are purchases of securities from commercial banks and hence an injection of liquidity by the CBK during periods of tighter than desired liquidity in the market. 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 coincides with the maturity date of the Repo, the tenor is extended to the next working day.
    - ii. **Term Auction Deposits (TAD)**: The TAD is used in exceptional market conditions 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 deposits are transferred to the CBK for a 14, 21, or 28 day periods after which they revert to the respective commercial banks on maturity of the transfer agreement.
    - iii. **Horizontal Repos** 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 help banks to overcome the problem of limits to lines of credit, thus promoting efficient management of interbank liquidity. They are not strictly monetary policy instruments but modes of improving liquidity distribution under CBK supervision.
- **Central Bank Rate (CBR)**: The CBR is the lowest rate of interest charged on loans to commercial banks by the CBK. The level of the CBR is reviewed and announced by the Monetary Policy Committee (MPC) at least every two months and its movements, 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. 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 activities and thus growth. When interest rates decline, the quantity of credit demanded should increase.

The efficiency of 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 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.

- **Kenya Banks' Reference Rate (KBRR)**: The KBRR is the base rate for all commercial and microfinance banks' lending. It is computed as an average of the CBR and the weighted 2-month moving average of the 91-day Treasury bill rates. Given that one of the components of the KBRR is the CBR, this framework enhances the transmission of monetary policy effects through commercial banks' lending rates.
- **Standing Facilities**: 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. The rules governing the operation of the CBK Discount Window are reviewed from time to time by the Bank. Currently, banks utilising the CBK Overnight Window are charged the CBR plus a high penalty. Moreover, banks making use of this facility more than twice in a week are scrutinised to establish whether prompt corrective action is required to address any weakness that is not merely temporary.
- **The Cash Reserves Ratio (CRR)**: In accordance with the law, the CRR is the proportion of a commercial bank's deposit liability which must be deposited at CBK. These deposits are held in the CRR Account at no interest. The ratio is currently 5.25 percent of the total of 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 an 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 a daily basis. A reduction in the CRR releases liquidity thus enhancing the capacity of commercial banks to expand credit. An increase in the CRR tightens liquidity and could also dampen demand-driven inflationary pressures.
- **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 build its foreign exchange reserves where the statutory requirement is to use the Bank's best endeavours to maintain foreign reserves equivalent to a three year average of four months' import cover. The CBK does not participate in the foreign exchange market to defend a particular value of the Kenya Shilling but may intervene to stabilise excess volatility in the exchange market. 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.
iv. Requiring that local banks obtain supporting documents for all transactions in the Nostro accounts of offshore banks.
v. Suspension of the use of any Electronic Brokerage System by banks.

- **Licensing and Supervision of Financial Institutions**: Monetary policy signals are transmitted to the real sector through banks. The Bank therefore uses the licensing and supervision tools to ensure the health and efficiency of the banking system; this includes vetting potential managers for suitability both with respect to qualifications and character. In addition, collaboration between the Bank and other financial sector regulators ensures stability of the sector.
- **The National Payments System**: The modernisation of the National Payments System (NPS) has reduced transaction costs and improved the effectiveness of monetary policy instruments. The NPS provides a critical positive externality to lower the cost of doing business by building confidence and reducing transaction time costs.
- **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. The regular interaction between the MPC and the Chief Executive Officers of commercial banks through the Kenya Bankers Association (KBA) has ensured that monetary policy decisions are transmitted to the banking sector. The CBK website is an important source of up-to-date data on all aspects of the financial market including interest rates, exchange rates and results of auctions of government securities. 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), 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 reviews the outcome of the monetary policy stance adopted in the second half of 2014. It also provides a detailed monetary policy path for the first half of 2015, and highlights for the second half of 2015.

Overall month-on-month inflation remained within the Government target bounds during the second half of 2014 except in July and August 2014. This reflected the success of the monetary policy stance adopted by the Monetary Policy Committee (MPC) in the period. Specifically, overall inflation rose from 7.39 percent in June 2014 to 8.36 percent in August 2014 mainly reflecting increases in the prices of energy and most foodstuffs. However, it declined gradually thereafter to 6.02 percent in December 2014 mainly reflecting the dissipation of the base effect attributed to the implementation of the VAT Act in September 2013 and decreases in prices of energy and some food items. The 12-month non-food-non-fuel inflation, which measures the impact of monetary policy, remained stable below the 5 percent target in the second half of 2014 indicating that there was no significant demand driven inflationary pressure or threat to the economy. The threat of imported inflation was dampened by the significant decline in international oil prices during the period.

Despite the temporary pressures on most international currencies reflecting the global strengthening of the US Dollar, the exchange rate of the Kenya Shilling against the US Dollar maintained its stable trend during the period. The Kenya Shilling strengthened, on average, against the other major international currencies and regional currencies. The strengthening of the US Dollar partly reflects the strong performance of the US economy and changing expectations on the timing of the first US interest rate increase coupled with weak growth in the Eurozone. The Kenya Shilling continued to be supported by the resilient foreign exchange inflows through diaspora remittances, increased net purchases of equity by foreign investors in the Nairobi Securities Exchange (NSE), and sustained confidence in the economy reflected in the massive over-subscription of the Sovereign Bond that was re-opened on tap in December 2014. Interventions by the Central Bank of Kenya (CBK) through direct sales of foreign exchange to commercial banks stopped short-term volatility in the period. The movements in short-term rates were generally aligned to the Central Bank Rate (CBR) while Open Market Operations continued to support liquidity management during the period. The MPC retained the CBR at 8.50 percent in the second half of 2014 to continue anchoring inflationary expectations and maintain the desired price stability objective.

The monetary policy stance in the first half of 2015, which is guided by the Medium-Term Government Budget Policy Statement, will be aimed at maintaining the overall month-on-month inflation rate within the current allowable margin of 2.5 percent on either side of the Government's medium-term target of 5 percent. The Bank will also continue building its foreign exchange reserves in line with the monetary policy objective and prudent management policies. The coordination between monetary and fiscal policies will continue to support the sustainability of the country's public debt and overall macroeconomic stability. The issuance of the Sovereign Bond in June 2014 and its subsequent re-opening in December 2014 has dampened pressure on both Government domestic borrowing and interest rates.

During the first half of 2015, monetary policy will seek to constrain the annual growth in broad money supply, M3, to 15.9 percent by March 2015 and 14.2 percent by June 2015. The Net Domestic Assets (NDA) of the Bank is projected at Ksh-241.9 billion in March 2015 and Ksh-220.4 billion in June 2015. However, the annual growth in credit to the private sector is projected at 20.3 percent in March 2015 and 18.2 percent in June 2015. The Net International Reserves (NIR) of the CBK is projected at USD 6,505.6 million in March 2015 and USD 6,531.3 million in June 2015. The Bank will also continue to enhance the effectiveness and efficiency of its monetary policy instruments. The monetary policy stance will aim at ensuring that movements in the short-term interest rates are supportive to the Bank's primary objective of price stability. The CBK will also continue to improve on its forecasting and policy analysis framework as an intermediate step towards adopting fully fledged inflation targeting. The monetary aggregates for the second half of 2015 will be derived from the assumptions in the Government Budget Statement for the Fiscal Year 2015/16. Overall inflation is expected to remain close to the medium-term target of 5 percent in the second half of 2015.

The CBK continues to monitor the risks posed by developments in the global and domestic economies and will take appropriate actions to maintain price stability. Global growth is projected to improve slightly in 2015 mainly driven by the US and UK economies. The lower international oil prices and introduction of Quantitative Easing (QE) in the Eurozone are expected to boost global growth in 2015. In addition, the commitment by the US Federal Reserve Bank to a balanced approach when it decides to begin to remove monetary policy accommodation is expected to support stability in the global currency and financial markets. The Government is negotiating for a precautionary facility blending the non-concessional Stand-By Arrangement and the concessional Stand-By Credit Facility which will provide Kenya with access to International Monetary Fund resources in the event of exogenous shocks. This will support exchange rate stability.

The Bank will continue its regular interactions with stakeholders in the financial and real sectors to obtain feedback, and ensure the timely release of relevant monetary and financial data. Specifically, the Bank will continue to work with stakeholders to support the implementation of the Kenya Banks' Reference Rate (KBRR) framework adopted in July 2014. This framework is facilitating transparency in credit pricing and is expected to improve the transmission of monetary policy effects through commercial and microfinance banks' lending rates. Lastly, collaboration between the CBK and other regional Central Banks will be sustained to ensure policy coordination on monetary policy formulation as well as implementation of banking sector initiatives to ensure stability.

1. Introduction

This Monetary Policy Statement (MPS) presents the policy guidelines and broad targets for the CBK in the first half of 2015, and highlights for the second half of 2015. It also presents the outcomes of its previous policy in the period July to December 2014.

On the domestic scene, the declining international oil prices dampened any threat of supply shocks on domestic prices during the second half of 2014. In addition, there was no significant demand driven inflationary pressure or threat to the economy in the period. The decline in international oil prices during the period dampened any threat of imported inflation. Despite short-term pressures on the exchange rate in the second half of 2014, the Kenya Shilling continued to be supported by the resilient foreign exchange inflows through diaspora remittances and strong confidence in the economy despite slowdowns in export earnings. The Kenya National Bureau of Statistics (KNBS) released new National Accounts Statistics in September 2014 which revised sector classifications and the base year to 2009. On the global scene, the growth of the global economy remained flat in 2014 mainly reflecting the weak Eurozone growth and slowdown in demand in China. However, growth in Sub-Saharan African countries remained strong.

Monetary policy formulation and implementation continues to be guided by price stability as the primary objective, and the economic growth objectives in the Government's Budget Policy Statements. The CBK targets for Net Domestic Assets (NDA) and Net International Reserves (NIR) are the operational parameters. The Bank also continues to monitor targets for key monetary aggregates such as broad money supply (M3) and credit to the private sector. The Central Bank Rate (CBR) signals the monetary policy stance and forms the base for all monetary policy operations. The Bank's participation in the foreign exchange market will continue to be guided by the need to accumulate and maintain foreign exchange reserves above the level of 4.5 months of import cover as well as purchasing foreign exchange to meet the Government's external obligations, and ensuring stability of the value of the Kenya Shilling.

The rest of this Policy Statement is organised as follows. Section 2 reviews the outcome of the monetary policy stance proposed in the June 2014 MPS while Section 3 describes the current economic environment and outlook for 2015. Section 4 concludes by outlining the monetary policy stance proposed for 2015.

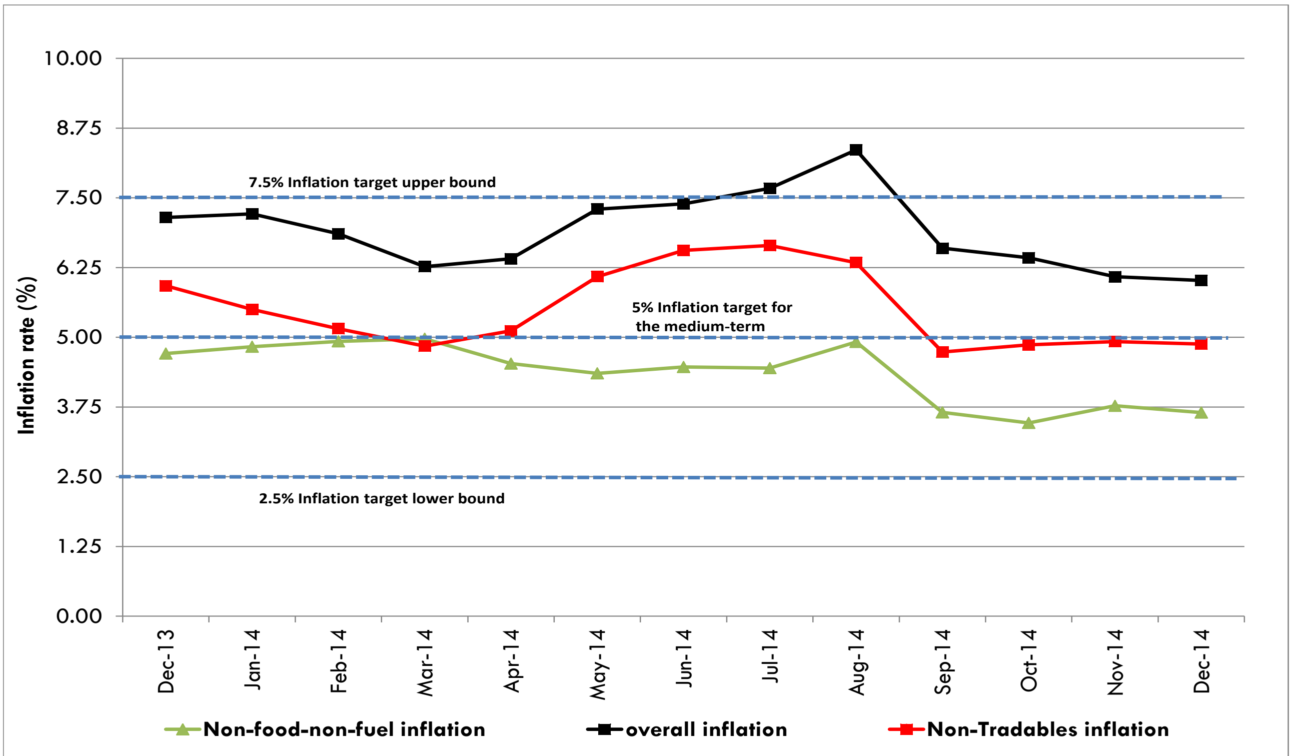
2. Actions and Outcomes of Policy Proposals in the June 2014 Monetary Policy Statement

The overall aim of the Monetary Policy Statement for June 2014 (34th MPS) was to set monetary policy targets that would ensure low and stable inflation, encourage growth, support long-term sustainability of public debt through stable interest rates and, by enhancing financial access within the economy, contribute to lowering the cost of doing business in Kenya. The following are the specific outcomes of the policy proposals in the 34th MPS:

a. Inflation

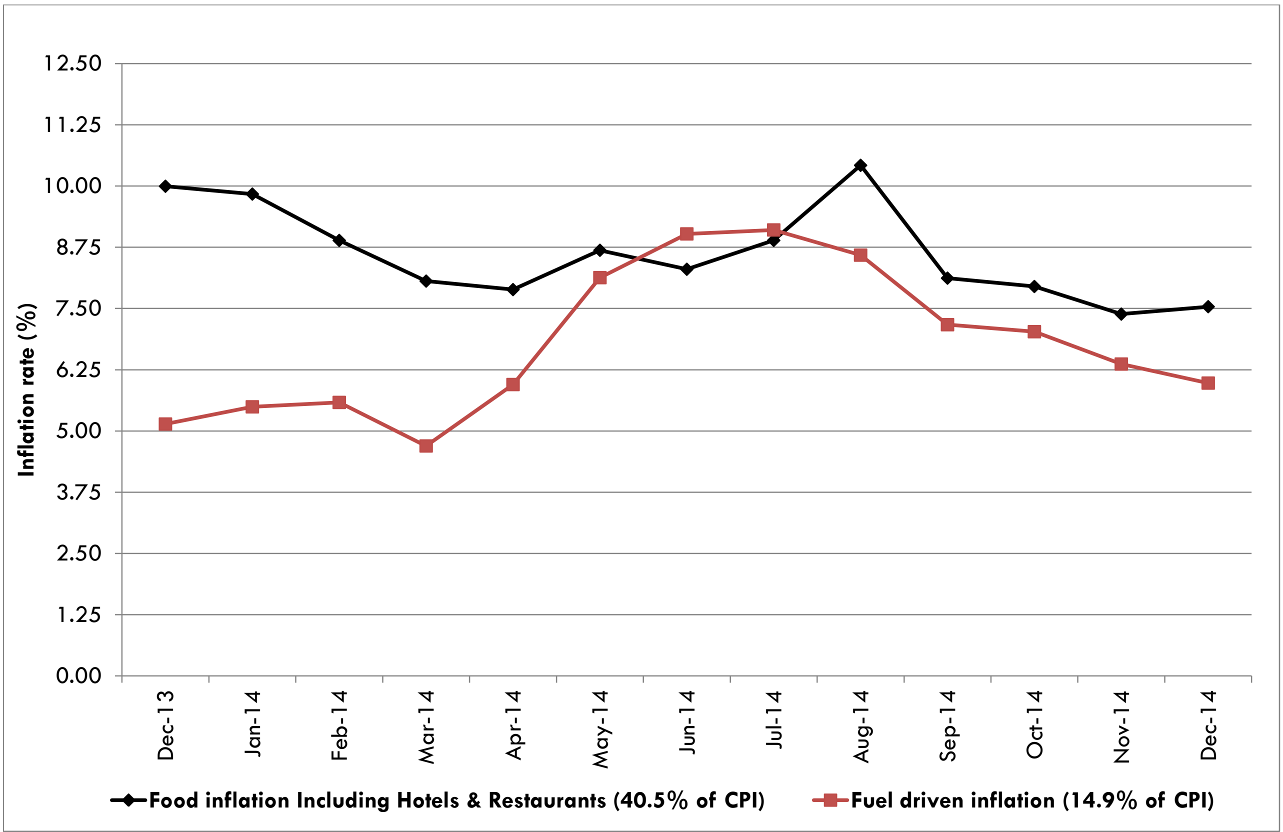
Overall month-on-month inflation remained within the allowable margin of 2.5 percent on either side of the Government's medium-term target of 5 percent during the second half of 2014, except in July and August 2014 (Chart 1a). It rose from 7.39 percent in June 2014 to 8.36 percent in August 2014 but declined gradually thereafter to 6.02 percent in December 2014. The decline in overall inflation was consistent with the monetary policy stance, decreases in the prices of fuel, electricity, and most foodstuffs as well as the dissipation of the base effect attributed to the implementation of the VAT Act in September 2013 (Chart 1b). The significant decline in international oil prices during the period minimised any threat of imported inflation that could have arisen due to exchange rate movements. The 12-month non-food-non-fuel inflation, which measures the impact of monetary policy, remained within the 5 percent inflation target. This indicates that there was no significant demand driven inflationary pressure or threat to the economy.

Chart 1a: 12-Month Inflation in Broad Measures (%)



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

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



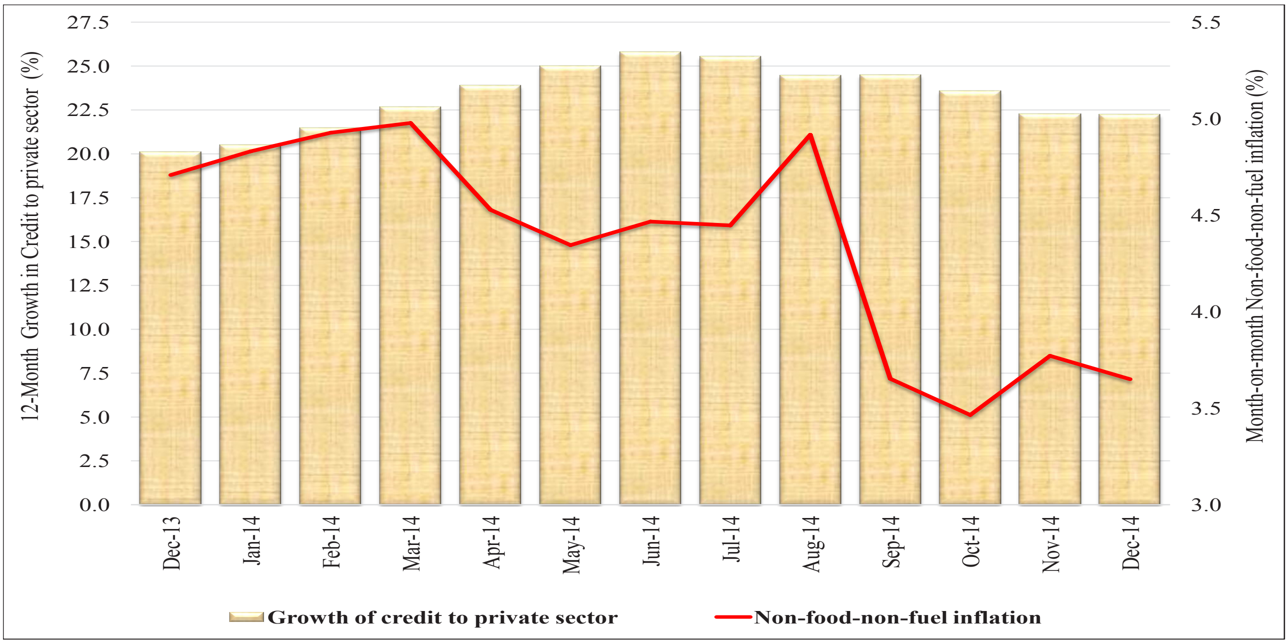
Source: Kenya National Bureau of Statistics and Central Bank of Kenya

i. Credit to Private Sector

The growth in private sector credit remained strong in the second half of 2014 reflecting sustained demand with improved economic activity. However, the 12-month growth in credit declined slightly from 25.8 percent in June 2014 to 22.2 percent in December 2014 which was consistent with the desired growth path to deliver a stable inflation. This level of expansion in private sector credit was non-inflationary as the 12-month non-food-non-fuel inflation declined during the period (Chart 2). The growth in private sector credit in the period was channelled towards key sectors of the economy. These sectors include agriculture, manufacturing, trade, transport and communication, finance and insurance, reals estate and construction.

Despite the strong growth in credit during the period, the ratio of gross non-performing loans to gross loans decreased from 5.7 percent in June to 5.4 percent in December 2014 indicating a decline in credit risk. However, the banking sector continued to build capital buffers to mitigate against any adverse business cycle effects.

Chart 2: Annual Growth in Private Sector Credit (%)



Source: Central Bank of Kenya

ii. Developments in the Monetary Programme

The monetary aggregates were generally within the projected path during the second half of 2014 (Table 1). This was consistent with the outcome on inflation. The CBK conducted monetary policy based on the monetary aggregate targeting framework in order to achieve its price stability target. The monetary policy framework has evolved from use of Reserve Money (RM) as the operating target to the current aggregates of NDA and NIR of the CBK reflecting the impact of financial innovations. The CBR signalled the monetary policy stance and formed the base for all subsequent monetary policy operations.

Table 1: Actual and Targeted Growth in Key Monetary Aggregates

	Jun-14	Jul-14	Aug-14	Sep-14	Oct-14	Nov-14	Dec-14
Actual Broad Money,M3 (Ksh Billion)	2,152.1	2,190.1	2,253.3	2,251.8	2,260.0	2,295.1	2,330.0
Target Broad Money,M3 (Ksh Billion)	2,093.8	2,342.3	2,355.6	2,368.9	2,274.7	2,297.6	2,320.5
Actual Reserve Money (Ksh Billion)	323.7	304.7	357.1	322.8	348.6	346.2	380.0
Target Reserve Money (Ksh Billion)	322.7	339.5	349.0	347.6	348.2	347.1	353.7
Actual Net Foreign Assets of CBK (Ksh Billion)	615.4	555.6	556.1	552.2	533.9	528.4	588.8
Targets for Net Foreign Assets of CBK (Ksh Billion) - Floor	472.2	543.6	546.1	548.7	536.3	545.7	601.4
Actual Net Domestic Assets of CBK (Ksh Billion)	-291.7	-250.9	-199.0	-229.5	-185.3	-182.2	-208.8
Target Net Domestic Assets of CBK (Ksh Billion) - Ceiling	-149.5	-204.1	-197.1	-201.1	-188.1	-198.6	-247.7
Actual Credit to private sector (Ksh Billion)	1,719.8	1,744.4	1,777.1	1,808.3	1,829.4	1,857.3	1,884.5
Target Credit to private sector (Ksh Billion)	1,615.5	1,742.3	1,776.2	1,800.8	1,826.3	1,849.9	1,873.8
Memorandum Items							
12-month growth in actual RM (Percent)	12.6	7.3	15.2	11.2	13.5	9.3	18.5
12-month growth in Broad Money, M3 (Percent)	18.2	19.3	21.8	19.4	18.9	17.5	16.7
12-month growth in actual credit to private sector (Percent)	25.8	25.5	24.5	24.5	23.6	22.2	22.2

Source: Central Bank of Kenya

The velocity of money computed using the rebased nominal GDP data declined gradually from 2.4 in December 2013 to 2.3 in December 2014. The money multiplier remained unstable, fluctuating between 6.1 and 7.2 during the period. The predictability of money demand has continued to be affected by an unstable money multiplier and the long-term decline in the velocity of money in circulation. 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.

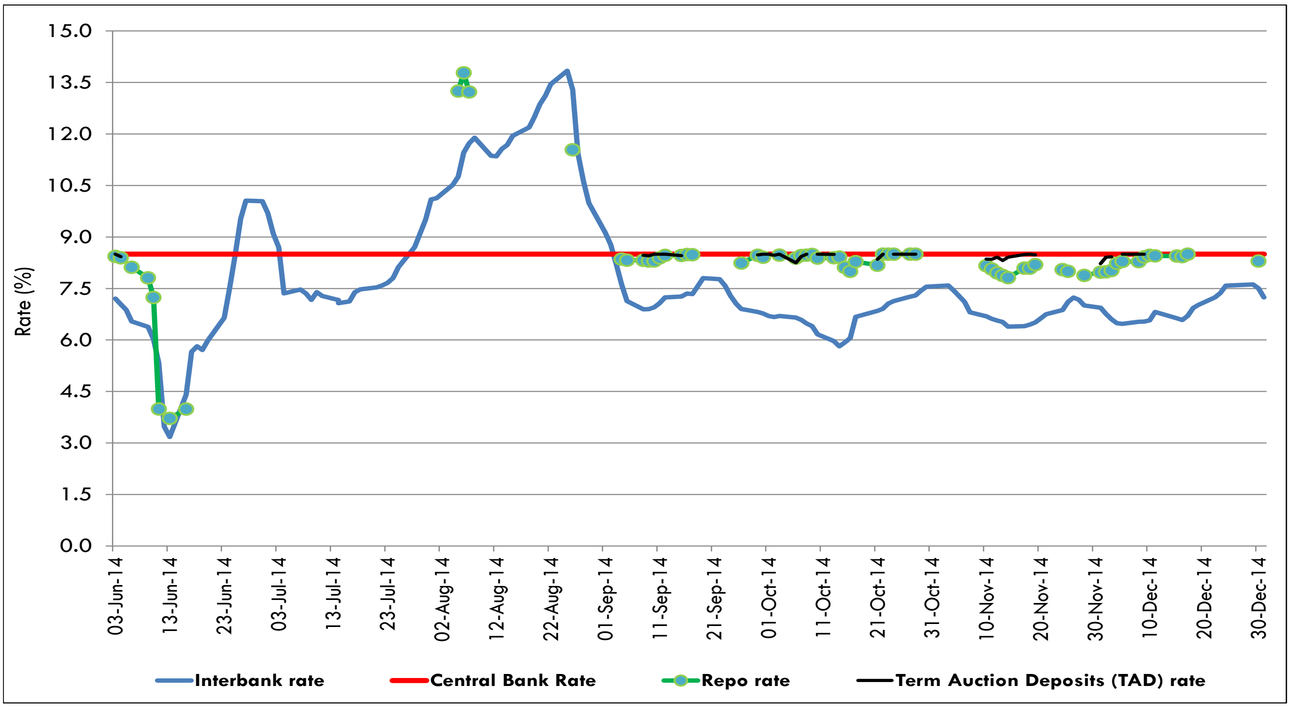
The CBK continued to implement measures aimed at improving the efficiency of the banking sector as well as financial inclusion in order to enhance the monetary policy transmission mechanism. The Kenya Banks' Reference Rate (KBRR) framework was introduced in July 2014 to enhance transparency in the pricing of credit as well as improving the transmission of monetary policy signals into changes in banks' lending rates. The KBRR will be reviewed and announced by the CBK after every six months (if market conditions do not change dramatically). It is computed as an average of the CBR and the 2-month weighted moving average of the 91-day Treasury bill rate.

The banking sector continued to grow in the second half of 2014. Specifically, the commercial banks' branch network increased from 1,363 in March 2014 to 1,413 in September 2014 and was distributed across all the counties in the country. Similarly, the Agency Banking model continued to expand; a total of 16 commercial banks had been licensed by the CBK to undertake Agency transactions by the end of December 2014 compared with 15 banks in June 2014. The banks had contracted 35,789 active agents facilitating over 139.0 million transactions valued at Ksh 752.5 billion by December 2014 which is a notable increase from June 2014 when the number of Agents stood at 26,750 while the number of transactions stood at 106.1 million valued at Ksh 571.5 billion. The mobile phone has also continued to be an important platform for financial services thereby reducing transaction costs. Mobile phone money transactions were valued at an estimated average of Ksh 7.3 billion per day in December 2014 compared with Ksh 6.3 billion per day in June 2014. This growth points to the potential of technology-led delivery channels in increasing access to financial services.

iii. Interest Rates and Liquidity

The sustained liquidity management by the CBK through Open Market Operations (OMO) ensured stability in the interbank market from mid 2014 (Chart 3). Consequently, the movements in short-term interest rates were closely aligned to the Central Bank Rate (CBR). The MPC retained the CBR at 8.50 percent during the period. The temporary accumulation of Government deposits at the CBK at the beginning of the Fiscal Year 2014/15 as Government ministries and departments firmed up their spending plans partly contributed to tight liquidity conditions in July and August 2014. To ease the pressure on interbank rates, the CBK injected liquidity through the reverse repo. Liquidity conditions improved thereafter supported by normalisation of Government payments, net redemptions of Government securities, and the CBK OMO activity which withdrew excess liquidity in order to stabilise the interbank rate.

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



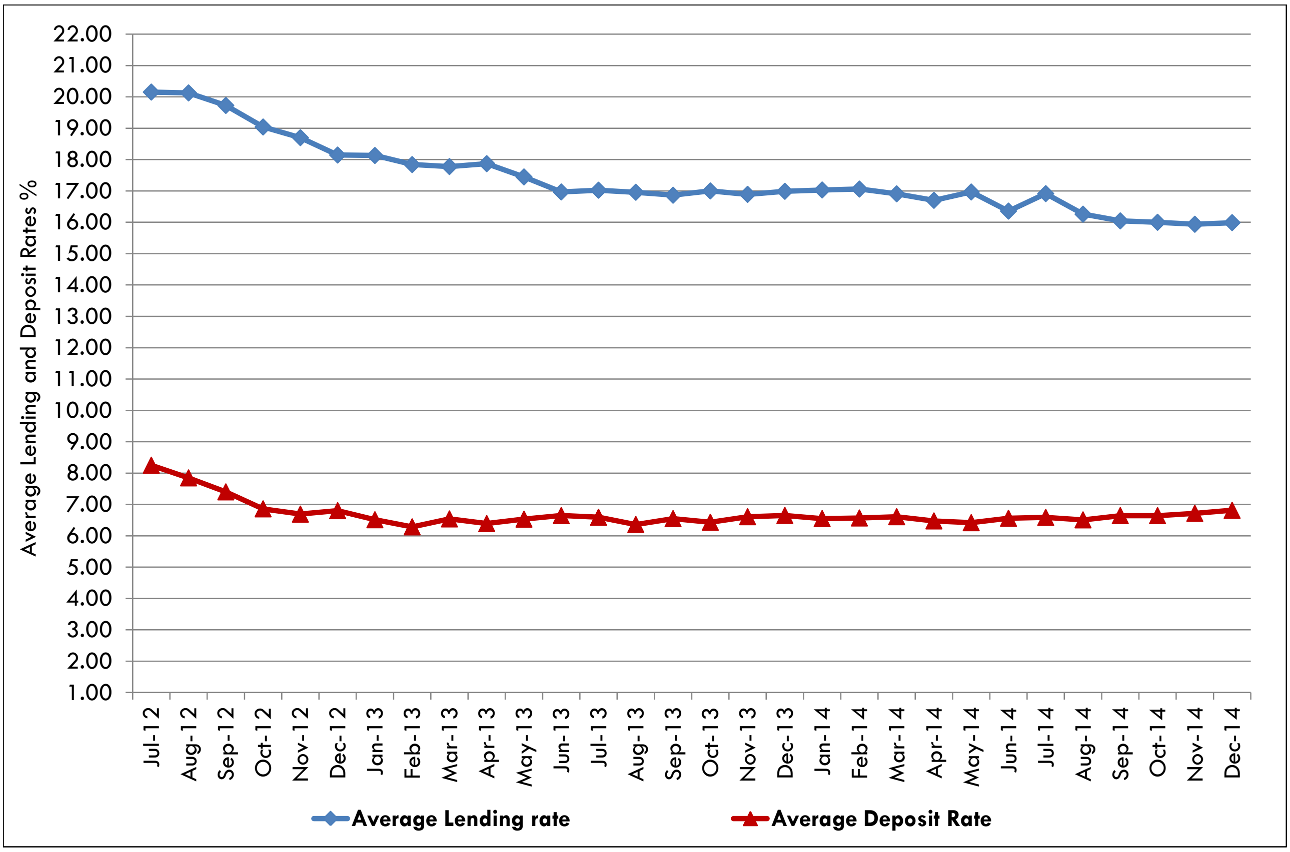
Source: Central Bank of Kenya

The CBK continues to work with stakeholders including the Kenya Bankers Association (KBA) to implement initiatives in the banking sector aimed at reducing the cost of doing business. It has undertaken reforms to promote consumer protection and enhance governance in the banking sector, and is currently working with various stakeholders to implement the recommendations aimed at increasing and enhancing private sector credit and mortgage finance supply in Kenya. Specifically: the use of mobile phone financial platforms that leverage on technology; cheque truncation that has reduced the clearing period to within one day of delivery of the cheque to the bank; the rollout of internet banking; the adoption of the Agency Banking framework; opening of currency centres in major towns; and operationalisation of Credit Reference Bureaus have contributed significantly to the reduction of the cost of doing business in the banking sector.

The introduction of the Kenya Banks' Reference Rate (KBRR) and Annual Percentage Rate (APR) frameworks in July 2014 was aimed at enhancing transparency in credit pricing and improving the transmission of monetary policy effects through commercial banks' lending rates. The KBRR and APR frameworks were developed as an outcome of discussions between the stakeholders, CBK and the National Treasury. The KBRR was developed as part of their recommendations to enhance the supply of private sector credit and mortgage finance in Kenya by facilitating a transparent credit pricing framework. It is the base rate for all commercial banks' lending. At its commencement on 8th July, 2014, the CBK computed and set the KBRR at 9.13 percent. Consequently, data from all commercial and microfinance banks showed that new and existing loans amounting to Ksh.732.2 billion had been converted to the KBRR framework by 28th December 2014. In addition, the commercial banks' average lending rate declined from 16.91 percent in July 2014 to 15.99 percent in December 2014 (Chart 4). The full effect of KBRR will be assessed after all loans have been converted into the KBRR framework. The average deposit rate increased slightly from 6.59 percent to 6.81 percent during the period reflecting increased banks' competition for deposits. Consequently, the spread between average commercial banks' lending rate and deposit rate declined from 10.33 percent to 9.18 percent in the period.

The MPC has also continued to engage the Chief Executive Officers of commercial banks through the KBA on various issues through the bi-monthly forums. This has facilitated moral suasion and provided a regular feedback mechanism through the MPC's Market Perception Surveys that formed the basis for the dialogue.

Chart 4: Trends in Commercial Bank Interest Rates (%)



Source: Central Bank of Kenya

b. Exchange Rates and Foreign Exchange Reserve Developments

i) Exchange Rate Developments

Despite the temporary pressures on most international currencies reflecting the global strengthening of the US Dollar, the exchange rate of the Kenya Shilling against the US Dollar maintained a stable trend during the second half of 2014 (Chart 5a and 5b). The Shilling strengthened, on average, against the Euro, the Sterling Pound and the Japanese Yen during the period. The strengthening of the US Dollar partly reflected the strong performance of the US economy and changing expectations on the timing of the first US interest rate increase following tapering of the QE coupled with the weak growth in the Eurozone. In the region, the shilling has strengthened, on average, against the South African Rand, Uganda and Tanzanian Shilling during the period. The major international and regional currencies have depreciated faster and depicted more volatility compared with the Kenya Shilling.

The Kenya Shilling exchange rate was supported by the resilient foreign exchange inflows through diaspora remittances, increased net purchases of equity by foreign investors in the Nairobi Securities Exchange (NSE), and sustained confidence in the economy reflected in the massive over-subscription of the Sovereign Bond that was re-opened in December 2014. In addition, interventions by the Central Bank of Kenya (CBK) through direct sales of foreign exchange to commercial banks stopped any short-term volatility which could have given rise to speculation.

Chart 5a: Rate of Depreciation of Exchange Rates of the Kenya Shilling and Major International Currencies against the US Dollar (1st July 2014 = 1)

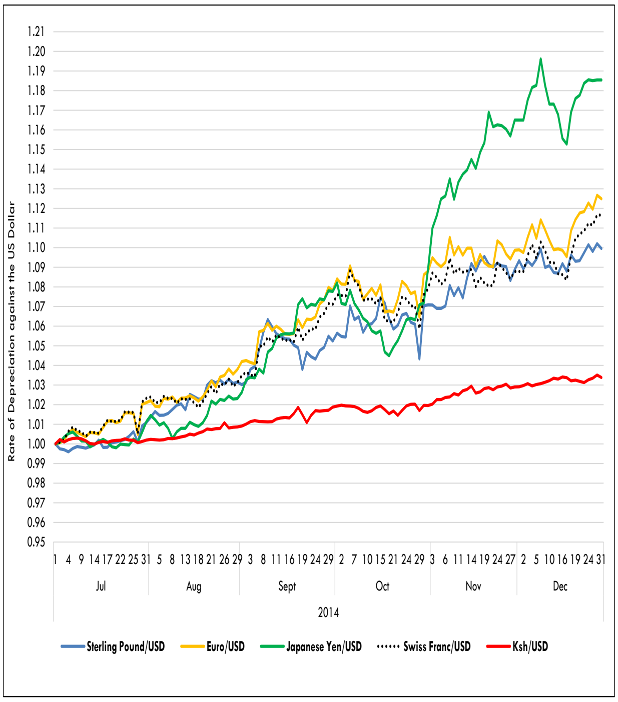
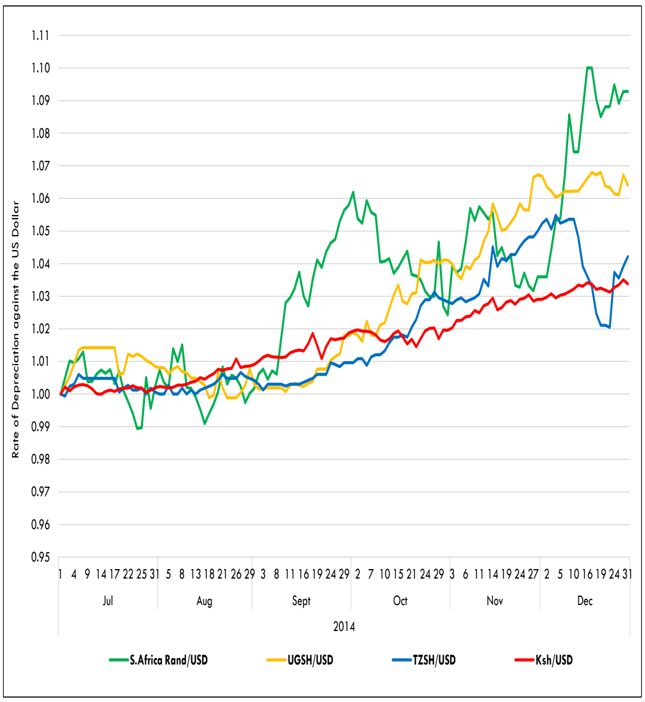


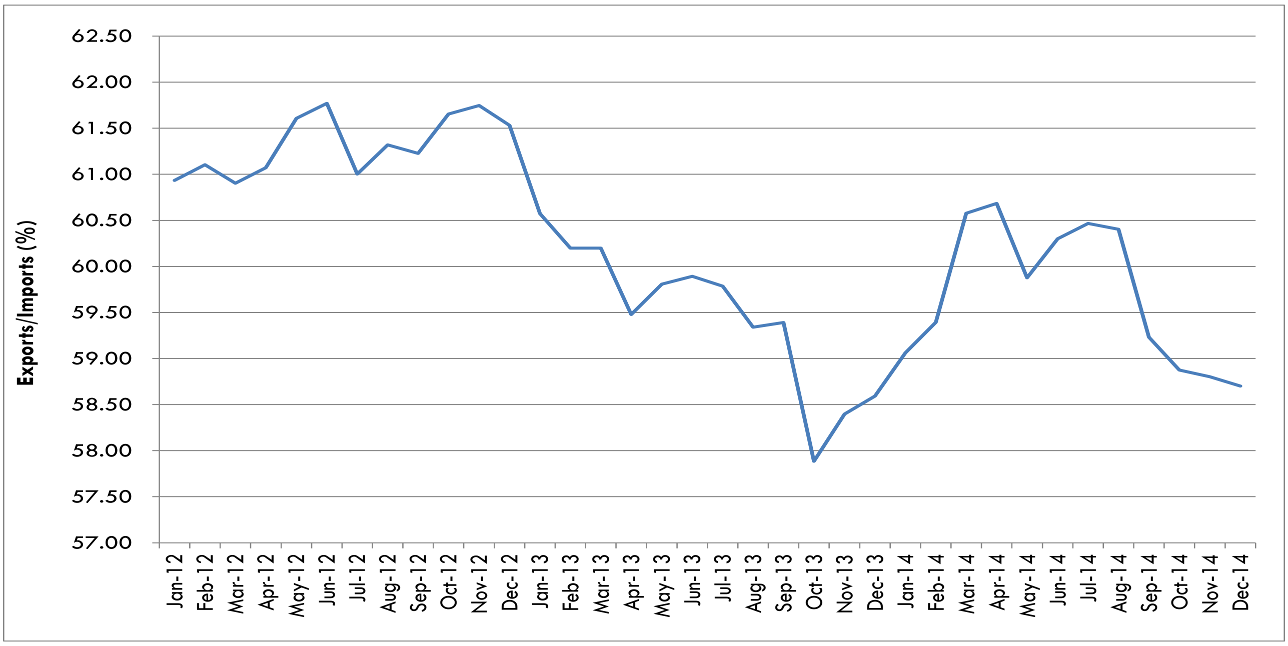
Chart 5b: Rate of Depreciation of Exchange Rates of the Kenya Shilling and Regional Currencies against the US Dollar (1st July 2014 = 1)



Source: Central Bank of Kenya

The movements in the exchange rate of the Kenya Shilling against the US Dollar in the second half of 2014 also reflected the higher demand for the US Dollar following increased economic activity and imports amid lower supply (Chart 5c). The 12-month cumulative proportion of imports of goods and services financed by exports of goods and services decreased from about 60.3 percent in June 2014 to 58.7 percent in December 2014. Foreign exchange earnings from tea and tourism which constitute a significant part of Kenya's foreign exchange earners have also slowed down mainly on account of the weak global demand and lower tea prices. There has also been an increase in imports of machinery and equipment, which was mainly towards infrastructure development as well as modernisation of the aircraft fleet at the Kenya Airways. Imports of machinery and other equipment accounted for about 31.1 percent of total imports. These are essential for enhancing the future productive capacity of the economy. However, the lower international oil prices provided some relief with respect to demand for foreign exchange to finance import of oil.

Chart 5c: 12-Month Cumulative Exports/12-Month Cumulative Imports (%)



Note: Exports and imports comprise goods and services

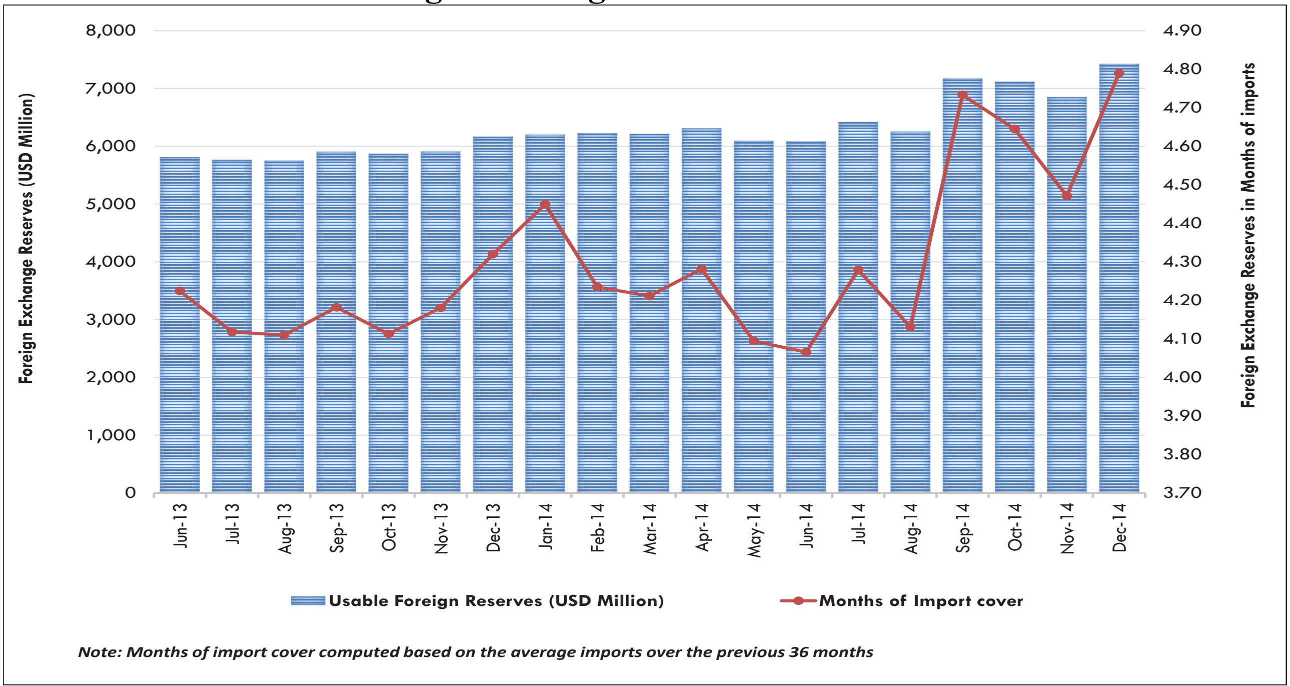
Source: Central Bank of Kenya and Kenya Revenue Authority

ii) Foreign Exchange Reserves

The CBK level of usable foreign exchange reserves increased from USD 6,084.6 million (equivalent to 4.07 months of import cover) at the end of June 2014 to USD 7,424.7 million (equivalent to 4.79 months of import cover) at the end of December 2014 (Chart 6). The build-up in foreign exchange reserves was mainly attributed to Government sale to CBK of the Sovereign Bond proceeds. The Government raised a total of USD 2.75 billion from the Sovereign Bond issued in June 2014 and its subsequent re-opening in December 2014 out of which USD 600 million was used to retire the syndicated loan in June 2014. The Government sold the balance of USD 2.15 billion to the CBK to acquire funds to finance government projects. In addition, the CBK purchased from the interbank market foreign exchange totaling USD 155.0 million against policy related sales of USD 407.5 million during the second half of 2014.

The CBK therefore has an adequate foreign exchange reserves buffer to intervene in the foreign exchange market to stem any excessive volatility in the exchange rate which might translate into inflationary pressure.

Chart 6: CBK Usable Foreign Exchange Reserves



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

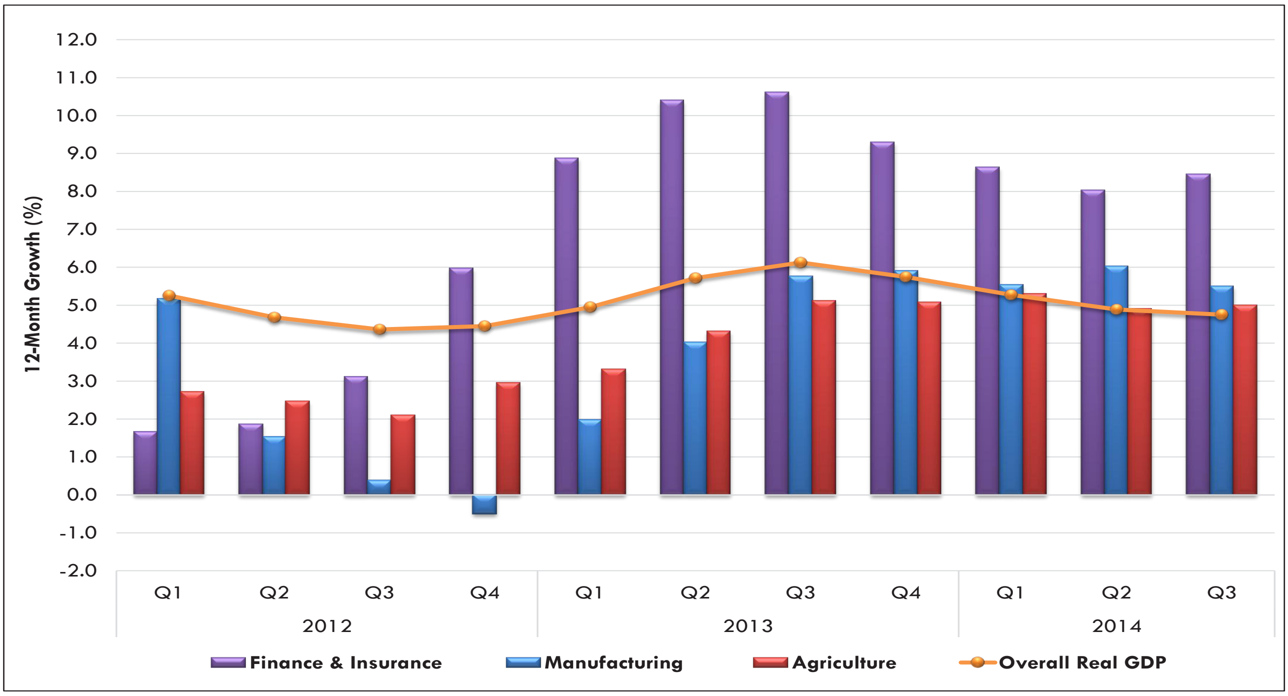
Source: Central Bank of Kenya

c. Economic Growth

The Kenya National Bureau of Statistics (KNBS) released new National Accounts Statistics in September 2014 which reflected revisions in sector classifications and the base year. The base year for the revised GDP is 2009 while the gap between the revised and previous GDP stood at 25 percent in 2013. The upward revision of the GDP was informed by use of better data, improved coverage and revised input-output production structures which were lower in a number of sectors compared to the revised estimates. Following this development, real GDP growth stood at 5.7 percent in 2013 while indicators such as the Debt/GDP, current account balance/GDP and fiscal deficit/GDP were lower.

The data for the third quarter of 2014 shows that the economy remained resilient; it grew by 4.8 percent, on a 12-month basis, compared with 4.9 percent in the second quarter of 2014 (Chart 7). The growth performance in the period was supported by a strong expansion of the finance and insurance sector that grew by 8.4 percent on a 12-month basis up from 8.0 percent in the second quarter. The performance of the finance and insurance sector continued to be driven by financial innovations and inclusion. The strong performance of the construction, wholesale and retail trade, information and communication, and agriculture and forestry sectors during the period was an indication of the continued recovery of the economy supported by macroeconomic stability.

Chart 7: 12-Month Sectoral and Overall Real GDP growth rates (%)



Source: Kenya National Bureau of Statistics

d. Fiscal Developments and Debt

The fiscal measures implemented by the Government in the first half of Fiscal Year 2014/15 were consistent with the monetary policy objectives. In addition, the issuance of the Sovereign Bond in June 2014 and its subsequent re-opening in December 2014 dampened pressure on both domestic borrowing and interest rates. The borrowing plan was also consistent with the thresholds set in the Medium-Term Debt Management Strategy for domestic debt.

e. Stakeholder Forums, MPC Market Perception Surveys and Communication

The MPC continued to hold bi-monthly stakeholder forums with Chief Executive Officers of commercial banks through the KBA Governing Council during the second half of 2014. The Committee also continued to improve on the information gathering processes through the bi-monthly market Perception Surveys and communication with key stakeholders on the MPC decisions to obtain feedback. The MPC Press Releases were constantly reworked to make them better focused to the public, media, financial sector and other stakeholders. Consequently, the media and public understanding of monetary policy decisions and their expected impact on the economy continued to be enhanced. The CBK also participated in the Agricultural Society of Kenya Shows in order to sensitise the public on its functions.

The MPC worked with CBK staff on various research activities during the period. Five technical papers commissioned by the MPC were completed and uploaded on the CBK website to solicit for comments from a wider readership. These papers are: Real Exchange Rate Misalignment and Implications for the Nominal Exchange Rate Level in Kenya in 2012; Monetary Policy Transmission Mechanism in Kenya; An Assessment of Kenya's Public Debt Dynamics and Sustainability; A Note on Term Structure and Inflation's Expectations in Kenya; and, Bank Rate and the Transmission Mechanism of Monetary Policy in Kenya.

As part of enhancing its capacity, MPC members participated in various conferences locally and internationally over the period covered by this Report. The conferences enable MPC members to share their experiences with other policy experts on critical challenges underlying monetary policy effectiveness in developing countries under different monetary policy frameworks and facing different macroeconomic shocks. MPC members also held meetings with various investors during the period in order to brief them on economic developments and the outlook for the economy.

3. The Current Economic Environment and Outlook for 2015

a. International Economic Environment

The global growth is projected at 3.5 percent in 2015 up from 3.3 percent in 2014 (Table 2). The lower international oil prices are expected to boost global growth in 2015 mainly through lower production costs and consumer prices for the net oil importing countries. However, the growth outlook for emerging market economies is mixed. Emerging Asian economies are expected to benefit from the US recovery while Russia and Brazil are expected to face growth challenges. In addition, the projected slowdown in growth in China and some oil exporting economies will slow the growth momentum of the global economy. However, growth in Sub-Saharan Africa is projected to remain resilient in 2015 while that in the East

African Community countries excluding Kenya is projected to rise from an estimated 6.0 percent in 2014 to 6.2 percent in 2015. This is expected to boost Kenya's exports and support exchange rate stability. In addition, the commitment by the US Federal Reserve Bank to a balanced approach when it decides to begin to remove monetary policy accommodation is expected to support stability in the global currency and financial markets.

Global inflation is projected to decline from an estimated 3.9 percent in 2014 to 3.8 percent in 2015 as the real output is generally below its potential especially in some of the advanced countries coupled with lower oil prices. The declining international food prices buoyed by abundant export supplies have also continued to dampen any upside risks to food prices. This provides monetary policy space for the countries to support growth and employment.

Table 2: Performance and Outlook for the Global Economy

	Real GDP Growth (%)			Inflation (%)		
	2013 Act.	2014 Est.	2015 Proj.	2013 Act.	2014 Act.	2015 Proj.
World	**3.3**	**3.3**	**3.5**	**4.2**	**3.9**	**3.8**
Advanced Economies	**1.3**	**1.8**	**2.4**	**2.0**	**1.4**	**1.6**
United States	2.2	2.4	3.6	1.5	2.0	2.1
Japan	1.6	0.1	0.6	0.4	2.7	2.0
Euro Area	-0.5	0.8	1.2	2.5	1.3	0.5
United Kingdom	1.7	2.6	2.7	2.6	1.6	1.8
Other Advanced economies	2.2	2.8	3.0	2.0	1.5	1.6
Emerging and developing economies	**4.7**	**4.4**	**4.3**	**6.1**	**5.9**	**5.5**
Sub-Sahara Africa	5.2	4.8	4.9	9.3	6.6	6.7
East African Community (Excl.Kenya)	5.5	6.0	6.2	6.5	5.2	5.3
Developing Asia	6.6	6.5	6.4	4.7	4.7	4.1
China	7.8	7.4	6.8	2.6	2.3	2.5
India	5.0	5.8	6.3	9.5	7.8	7.5
Middle East and North Africa	2.2	2.8	3.3	9.6	9.2	7.5

Source: World Economic Outlook October 2014 and January 2015 Update

b. Domestic Economic Environment

i. Economic Growth

The Medium-Term Government Budget Policy Statement for 2015 projects real GDP to grow by 6.9 percent in 2015 up from an estimated growth of about 5.3 percent in 2014. This translates to an average growth of 6.1 percent for the Fiscal Year 2014/2015. The growth outlook is expected to be supported by increased production in agriculture following the interventions through agriculture reforms, irrigation and value addition; continued investment in infrastructure projects such as roads, energy, port and construction of a Standard Gauge Railway; expansion of activities in other sectors of the economy such as building and construction, manufacturing, retail and wholesale and financial intermediation, among others. The growth is also expected to benefit from increased investments and domestic demand following investor confidence and the ongoing initiatives to deepen regional integration.

The MPC Market Perceptions Survey conducted in December 2014 showed increased optimism by private sector firms for a strong growth in 2015 attributed to increased public and foreign direct investment in infrastructure and energy sectors, declining crude oil and electricity prices which will reduce production costs and consumer prices, improved security which will spur recovery of the tourism sector, macroeconomic stability with lower inflation, recovery of the global and regional economies which will boost exports, declining lending rates which could spur credit growth, increased investor confidence, and, the expected impact of the devolved spending which is expected to spur growth in counties. However, the slowdown in the tourism sector, impact of Ebola on trade with West Africa, and expected weak recovery in the Eurozone pose a risk to the growth outlook.

ii. Foreign Exchange Market

The exchange rate is expected to remain on its stable trend in the first half of 2015 on account of: (a) the resilient diaspora remittance inflows and continued foreign investor participation at the NSE; (b) expectations for increased foreign direct investment in infrastructure; (c) improved foreign exchange reserves following the issuance of the Sovereign Bond in June 2014 and its subsequent re-opening in December 2014; (d) monetary policy measures in place; (e) and, expected less pressure on the oil import bill due to lower crude oil prices. In addition, the projected higher growth of Sub-Saharan Africa economies and that of Kenya's main trading partners in 2015 is expected to increase foreign exchange inflows from trade. In addition, the Government is negotiating with the International Monetary Fund for a precautionary Standby Arrangement/Standby Credit Facility that will enable the CBK to cushion the Shilling against any unforeseen shocks in the market. The MPC Market Perceptions Survey for December 2014 corroborated this evidence of an expected stability in the exchange rate.

iii. Inflation

Overall inflation is projected to decline gradually in the first half of 2015 supported by the monetary policy measures in place, the declining international oil prices which will dampen pressure on the prices of food and other key items in the consumer basket, the declining international food prices which have dampened any upside risks to domestic food prices in the case of imports, and, the increasing output of geothermal generated power which will continue to moderate electricity prices and support lower consumer prices towards a 5 percent overall inflation rate. This inflation outlook is corroborated by the results of the December 2014 MPC Market Perceptions Survey. However, the main risks to the inflation outlook include possibility of imported inflation with continued movements in the exchange rate in case of a protracted global strengthening of the US dollar against international currencies. In addition, given the dominance of food in the CPI consumer basket, there remains a vulnerability to short-falls in the rains.

iv. Interest Rates

Interest rates are expected to remain generally stable in the first half of 2015 on account of the expected lower and stable inflation rate and improved liquidity conditions with the normalisation of absorption of devolved funds. In addition, the expected conversion of all commercial and microfinance banks' loans to the KBRR framework will ensure that the institutions use the same base rate thereby enhancing transparency in credit pricing and improving the transmission of monetary policy effects to the lending rates. The promotion of full disclosure of bank charges through the Annual Percentage Rate (APR) for loans will also facilitate informed banking decisions by the public.

The MPC Market Perceptions Survey for December 2014 showed that lending rates are expected to decline gradually due to sustained macroeconomic stability with easing inflation pressure, increased competition in the loans market, expected decline in Government's domestic borrowing and yields on Treasury securities after the issuance of the Sovereign Bond, impact of adoption of a common base rate through KBRR, and the monetary policy measures in place. The main risk to the outlook on interest rates is the international economic developments or supply side factors which could prompt additional measures by CBK to alleviate any adverse expectations with respect to inflation and /or exchange rate movements.

v. Fiscal Policy

The fiscal measures announced by the Government during the Budget Statement for the Fiscal Year 2014/15 remain consistent with the monetary policy objectives. The revised Government's domestic borrowing target of Ksh 144.8 billion for the Fiscal Year 2014/15 is significantly below the Ksh 201.7 billion for the previous Fiscal Year. This borrowing, coupled with the proceeds from the re-opened Sovereign Bond should ensure that domestic borrowing does not exert pressure on interest rates of Government securities. In addition, the borrowing plan should ensure that domestic debt remains within the thresholds set in the Medium Term Debt Management Strategy. The fiscal measures for the second half of 2015 will be outlined in the Government Budget Statement for the Fiscal Year 2015/16.

vi. Confidence in the Economy

Various indicators show that confidence in the economy remained strong in the second half of 2014 (Table 3). Specifically, the Sovereign Bond that was re-opened in December

2014 in the international capital market was oversubscribed by 400 percent while the yields were lower by 100 basis points. This was further endorsed by the preference for the 10-year rather than the 5-year tenors for the Bond issues. Similarly, net purchases of equity at the NSE by foreign investors have remained resilient while the NSE-20 index improved to 5,112.7 in December 2014 compared with 4,885.0 in June 2014. Diaspora remittances remained resilient during the period, averaging USD 123.1 million per month during the second half of 2014. These remittances have maintained a strong upward trend since 2011 partly reflecting increased investment opportunities in Kenya, improved data capture by the commercial banks, and more recently, the pick-up in the growth of the US economy.

Furthermore, the MPC Market Perception Survey conducted in December 2014 showed that the private sector maintained their confidence in the economy with high optimism for the business environment to improve in 2015 on account of macroeconomic stability with the lower inflation, increased public investment in infrastructure which will lower the cost of doing business, declining energy prices which will lower manufacturing costs, political stability, and improving security.

Table 3: Indicators of Confidence in the Economy

	Jun-14	Jul-14	Aug-14	Sep-14	Oct-14	Nov-14	Dec-14
Monthly Emigrant Remittances (USD Million)	116.1	117.1	128.8	127.4	120.9	114.0	130.2
NSE Index (Jan 1966 = 100)	4,885.0	4,906.1	5,139.3	5,255.6	5,194.9	5,156.3	5,112.7
Net Foreign purchases of equity at the NSE (Ksh Million)	2,586.0	143.0	3,253.0	-850.0	-1,208.0	2,540.0	1,021.0

Source: Central Bank of Kenya and Nairobi Securities Exchange (NSE)

4. Direction of Monetary Policy in 2015

Monetary policy in 2015 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 access to banking services in order to improve the monetary policy transmission to the benefit of economic growth.

a) Monetary Programme and Foreign Exchange Reserves

The monetary targets for the first half of 2015 are based on the indicators in the Medium-Term Government Budget Policy Statement for 2015 summarised in Annex 1. The monetary targets for the period are presented in Table 4. Monetary policy will seek to constrain the annual growth in broad money supply, M3, to 15.9 percent by March 2015 and 14.2 percent by June 2015. The NDA of the Bank is projected at Ksh-241.9 billion in March 2015, and Ksh-220.4 billion in June 2015. The NDA targets are below a ceiling which would threaten stability. However, the annual growth in credit to the private sector is projected at

20.3 percent in March 2015 and 18.2 percent in June 2015. The NIR targets of the CBK are USD 6,505.6 million in March 2015 and USD 6,531.3 million in June 2015. The NIR targets are above a floor which would threaten stability. The monetary policy stance will aim at ensuring that movements in the short-term interest rates are supportive to the Bank's primary objective of price stability.

These monetary targets are expected to enable the Bank maintain overall inflation within the current allowable margin of 2.5 percent on either side of the Government's medium-term target of 5 percent in order to anchor inflation expectations. The CBK will also continue to build its foreign exchange reserves buffer in order to enhance the country's capacity to absorb shocks that impact the foreign exchange market. The Government is negotiating for a precautionary arrangement blending the non-concessionary Stand-By Arrangement and the concessional Stand-By Credit Facility (SBA/SCF) that will cushion the economy by providing it with access to IMF resources in the event of exogenous shocks. This will support exchange rate stability. The monetary policy stance will aim at ensuring that short-term interest rates remain stable which will support growth and ensure the long-term sustainability of public debt. The Bank will also continue to enhance the effectiveness and efficiency of its monetary policy instruments. The CBK will continue to improve on its forecasting and policy analysis framework as an intermediate step towards adopting fully fledged inflation targeting. The monetary aggregates for the second half of 2015 will be derived from the assumptions in the Government Budget Statement for the Fiscal Year 2015/16. Overall inflation is expected to remain close to the medium-term target of 5 percent in the second half of 2015.

Table 4: Monetary Targets for January to June 2015

	Jan-15	Feb-15	Mar-15	Apr-15	May-15	Jun-15
Broad Money, M3 (Ksh Billion)	2,343.3	2,366.0	2,388.7	2,411.6	2,434.3	2,457.2
Reserve Money, RM (Ksh Billion)	338.3	341.2	347.6	342.2	345.3	354.6
Credit to Private Sector (Ksh Billion)	1,893.1	1,912.7	1,938.1	1,958.8	1,984.3	2,028.1
NFA of CBK (Ksh Billion)	597.1	592.9	589.4	587.0	585.1	575.0
NDA of CBK (Ksh Billion)	-258.8	-251.7	-241.9	-244.8	-239.8	-220.4
12-month growth in RM (Percent)	11.9	8.1	12.2	8.5	9.5	9.5
12-month growth in M3 (Percent)	15.6	16.5	15.9	14.8	13.4	14.2
12-month growth in Credit to Private Sector (Percent)	21.4	20.8	20.3	19.4	18.9	18.2
12-month growth in Real GDP (Percent)						6.1
Medium-Term 12-month overall Inflation (Percent) Target	5.0	5.0	5.0	5.0	5.0	5.0

Source: Central Bank of Kenya and the National Treasury

The Bank will continue to monitor developments with respect to the monetary targets and make any necessary reviews. 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 for the first half of 2015. This 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 monthly targets for NDA, RM and broad money supply, M3, to be achieved through Open Market Operations. The Repos and Term Auction Deposits 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. Specifically, OMO will be used to ensure that short-term interest rates continue to be aligned to the CBR.

The success of CBK's monetary policy measures to fight inflation 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 Extend Access to Financial Services and Enhance Market Efficiency and Regional Integration Initiatives

The CBK will continue to support development of new products and innovations towards enhancing financial access in order to encourage economic growth. In this regard it will continue to propose suitable legislation and regulations aimed at ensuring that such innovations are operationalized accordingly so as to enhance market confidence. The Bank will also continue to monitor any new financial derivatives and /or innovations in the market that could have adverse effects on market stability. It will continue to work with stakeholders in the banking and real sectors in order to enhance the monetary policy transmission mechanism. Initiatives aimed at engaging stakeholders and obtaining feedback on the impact of MPC decisions will be enhanced. In addition, the CBK will work closely with the institutions and other stakeholders to facilitate a smooth and effective implementation of the KBRR that facilitates a transparent credit pricing framework, and to ensure a wide dissemination of the framework to the public.

The CBK will continue to work with stakeholders to identify and implement measures to enhance redistribution of liquidity in the interbank market. Forums with Chief Executive Officers will 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 to enhance its transparency through the timely dissemination of all the requisite data through its website.

Regional initiatives are fostering market integration thereby promoting trade and employment in the East African Community (EAC). Collaboration between the CBK and other regional Central Banks will be sustained to ensure policy coordination on monetary policy formulation as well as implementation of banking sector initiatives to ensure stability.

ANNEX 1: MAIN MACROECONOMIC INDICATORS (2013/14 – 2016/17)

	2013/14	2014/15			2015/16			2016/17		
	Prel	*Budget*	*BROP'14*	*Rev. Budget*	*BPS'13*	*BROP'14*	*BPS'15*	*BPS'14*	*BROP'14*	*BPS'15*
Annual percentage change, unless otherwise indicated										
National account and prices										
Real GDP	5.5	6.1	5.8	6.1	6.3	6.3	7.0	6.5	6.5	7.1
GDP deflator	6.2	7.2	5.4	6.7	6.8	6.4	6.5	6.3	6.2	6.4
CPI Index (eop)	5.8	5.3	5.3	5.3	5.0	5.0	5.0	5.0	5.0	5.0
CPI Index (avg)	6.0	5.7	5.7	5.7	5.0	5.0	5.0	5.0	5.0	5.0
Terms of trade (-deterioration)	1.5	5.1	5.0	0.2	6.6	6.5	0.3	3.5	3.4	0.2
In percentage of GDP, unless otherwise indicated										
Investment and saving										
Investment	21.1	22.4	27.5	24.6	22.7	26.5	26.9	23.0	27.1	25.2
Gross National Saving	12.7	15.3	18.4	16.6	16.9	18.4	19.7	17.8	19.5	18.0
Central government budget										
Total revenue	19.3	21.0	21.2	20.3	22.0	21.5	20.6	22.2	21.9	20.8
Total expenditure and net lending	25.7	28.4	32.0	30.0	28.4	28.6	28.8	28.2	27.9	26.9
Overall balance (commitment basis) excl. grants	-6.5	-7.4	-10.8	-9.7	-6.4	-7.1	-8.2	-6.0	-6.0	-6.1
Overall balance (commitment basis) incl. grants	-5.9	-6.4	-9.7	-8.7	-5.0	-6.1	-7.3	-4.6	-5.0	-5.4
External sector										
Exports value, goods and services	19.8	20.4	20.7	20.1	21.1	21.1	20.5	21.4	21.4	20.5
Imports value, goods and services	32.9	31.8	34.3	32.4	31.3	33.4	31.5	30.9	32.9	31.3
Current external balance, including official transfers	-8.5	-7.1	-9.1	-8.0	-5.8	-8.1	-7.2	-5.3	-7.6	-7.2
Public debt										
Nominal central government debt (eop), gross	48.0	45.8	47.9	47.6	46.5	47.5	46.9	54.3	47.1	45.2
Nominal central government debt (eop), net of deposits	44.1	43.8	44.4	44.3	43.4	44.4	43.9	51.6	44.3	42.6
Domestic (net)	21.6	21.2	21.5	21.6	21.1	21.2	21.8	20.0	21.0	21.1
External	22.5	22.6	22.9	22.6	22.4	23.2	22.1	21.9	23.3	21.5
Memorandum items:										
Nominal GDP (in Ksh billions)	5,052	5,633	5,559	5,719	6,294	6,290	6,521	7,104	7,113	7,430
Nominal GDP (in US$ millions)	58,046	63,756	62,852	64,728	70,559	70,440	73,096	78,876	78,895	82,501

Source: National Treasury

BPS = Budget Policy Statement

BROP = Budget Review & Outlook Paper

ANNEX 2: CHRONOLOGY OF EVENTS OF PARTICULAR RELEVANCE TO MONETARY POLICY (JULY – DECEMBER 2014)

Date	Events
July 2014	The Bank purchased USD 395 million from Government Sovereign Bond Proceeds.
	The rollout of Internet Banking by CBK to enhance the efficiency of banking services to the Government and commercial banks.
	Introduction of the Kenya Banks' Reference Rate and Annual Percentage Rate frameworks to enhance transparency in credit pricing and improve the transmission of monetary policy effects through commercial banks' lending rates.
August 2014	The CBK sold a net of USD 26.0 million in line with the CBK's exchange rate policy.
	Launch of the Integrated Financial Management System.
	Operationalization of the National Payment System Regulations.
September 2014	The CBK sold a net of USD 14.0 million in line with the CBK's exchange rate policy. The Bank also purchased USD 1.0 billion from the Government Sovereign Bond Proceeds.
	The Kenya National Bureau of Statistics released new National Accounts Statistics in September 2014 which revised sector classifications and the base year to 2009.
October 2014	Successful issuance of the 12-year Infrastructure Bond which was oversubscribed by 258.5 percent.
November 2014	The CBK sold a net of USD 127.5 million in line with the CBK's exchange rate policy.
December 2014	The CBK sold a net of USD 85.0 million in line with the CBK's exchange rate policy.
	The Bank also purchased USD 750 million from the Government proceeds of the re-opened Sovereign Bond.
	Significant drop in international oil prices mainly reflecting increased supply and weak global demand.
	Significant depreciation of the Russian Ruble on account of a strengthening US Dollar, falling oil prices, and a sluggish economy.

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 goods and services in a representative basket in a base year. It is derived from data collected monthly by the Kenya National Bureau of Statistics. The inflation measure is affected by the commodities in the basket some of which may experience sudden price spikes such as food or energy. It may therefore present a distorted picture of the true state of the economy.

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:

- **M0**: Currency outside the banking system
- **M1:** M0 + demand deposits of banks (or depository corporations).
- **M2**: M1 + quasi (long term) money deposits i.e. time and savings deposits of banks and non-bank financial institutions.
- **M3**: M2 + resident foreign currency deposits.
- **L**: M3 + non-bank holdings of Government Paper. This however, is not a monetary aggregate.

Kenya Banks' Reference Rate (KBRR)

The KBRR is the base rate for all commercial and microfinance banks' lending. It is computed as an average of the CBR and the weighted 2-month moving average of the 91-day Treasury bill rates.