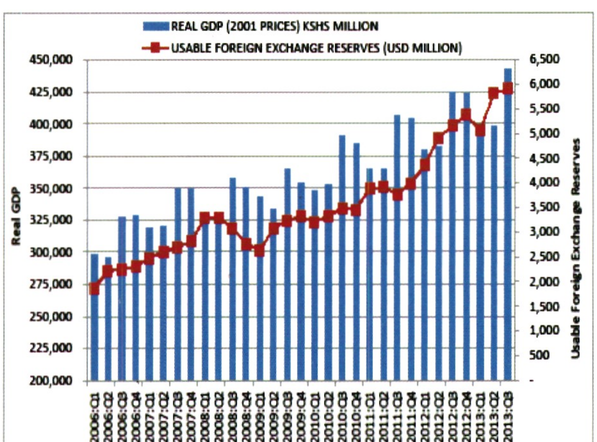

CENTRAL BANK OF KENYA

Monetary Policy Statement

Issued under the Central Bank of Kenya Act, Cap 491

DECEMBER 2013

Letter of Transmittal to the Cabinet Secretary for the National Treasury

Dear Honourable Cabinet Secretary,

I have the pleasure of forwarding to you the 33rd 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 period July to December 2013, then describes the current economic environment and outlook and finally, outlines the monetary policy path for January to June 2014.

Prof. Njuguna Ndung'u, CBS
Governor

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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 of 2.5 percent on either side of the target (currently 5 percent) 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 desired growth in the production of goods and services and employment creation through achieving and maintaining a low and stable inflation.

Instruments 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:

    - o **Repurchase Agreements (Repos):** Repos entail the sale of eligible securities by the CBK to remove excess liqudity from the market. Currently, Repos (often called *Vertical Repos*) have a fixed tenor of 7 working days. *Reverse Repos* are purchases of securities from commercial banks by the CBK thereby injecting liquidity into 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.
    - o **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.

- **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 affect 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. Short-term international flows of capital are affected by short-term interest rates in the country. These are, in turn, affected by movements in the CBR and hence indirectly, the exchange rate could also be affected.

- **The 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 15^{th} of the previous month to the 14^{th} 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 reserve cover equivalent to a three year average of four months' import. 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.

- **Horizontal Repos:** The CBK monitors but does not intervene in the Horizontal Repos market. These are not strictly monetary policy instruments but modes of improving liquidity distribution 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 help banks to overcome the problem of limits to lines of credit, thus promoting efficient management of interbank liquidity.

- **Standing Facilities**: The CBK acts the lender of last resort, providing 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.

- **Licensing and Supervision of Financial Institutions**: The Bank 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.

- **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.

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 the law under subsection (1) - 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 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 period July to December 2013. It also provides the policy path for the period January to June 2014.

The monetary policy stance adopted by the Monetary Policy Committee (MPC) in the first half of the Fiscal Year 2013/14 sustained inflation rate within the target bounds set by the Government except in September and October 2013. A notable rise in food prices in September 2013 due to seasonal factors as well as some traders imposing Value Added Tax (VAT) on non VAT-able food items drove overall inflation to 8.39 percent, which was above the upper target bound. However, overall inflation declined gradually to within the target bounds to 7.15 percent in December 2013. This reflected the impact of monetary policy measures adopted as well as the move by the Government to ensure the correct application of the new VAT law. The 12-month non-food-non-fuel inflation, which measures the impact of monetary policy, remained stable within the target bounds during the period indicating that there was a relatively low consumer demand pressure in the economy.

The exchange rate stability was sustained during the first half of the Fiscal Year 2013/14. This was supported by resilient inflows of diaspora remittances, liquidity management, increased foreign investor participation in equities at the Nairobi Securities Exchange, and confidence in the market following a build-up of the Central Bank of Kenya (CBK) official foreign exchange reserves. Exchange rate stability during the period moderated the threat of imported inflation. The CBK foreign exchange reserves remained above the statutory requirement of an equivalent of 4 months of import cover thereby providing a cushion to the foreign exchange market against external shocks during the period. The improvement in the 12-month cumulative current account deficit (as a percentage of GDP) from 10.45 percent in 2012 to an estimated level of 8.2 percent in 2013 also supported stability of the exchange rate. The planned augmentation of foreign exchange reserves towards meeting the East African Community Convergence Criteria will further bolster the country's foreign exchange reserves and support exchange rate stability. The movements in short-term rates were generally aligned to the Central Bank Rate (CBR) while Open Market Operations were sustained to support liquidity management during the period. Looking forward, the visit by the Managing Director of the International Monetary Fund (IMF) in January 2014 endorsed the country's track record of prudent macroeconomic policy and management and provided a positive signal to potential investors.

The monetary policy stance adopted by the MPC during the period anchored inflationary expectations and sustained the desired objective of price stability. The CBR was retained at 8.50 percent through-out the period so as to provide time for the full impact of the monetary policy path to be felt throughout the economy while at the same time supporting economic activity through non-inflationary credit growth. The policy stance in the second half of the Fiscal Year 2013/14 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 monetary policy objective and prudent management policies. The coordination between monetary and fiscal policies has continued to support the sustainability of the country's public debt.

During the second half of the Fiscal Year 2013/14, monetary policy will seek to constrain the annual growth in broad money supply, M3, to 15.7 percent by March 2014 and 16.1 percent by June 2014. The Net Domestic Assets (NDA) of the Bank is projected at Ksh -81.5 billion in March 2014 and Ksh-128.0 billion in June 2014. However, the annual growth in credit to the private sector is projected at 17.3 percent in March 2014 and 19.3 percent in June 2014. The Net International Reserves (NIR) targets of the CBK are projected at USD 5,018 million in March 2014 and USD 5,682 million in June 2014. 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 remains vigilant to risks posed by developments in the global and domestic economies and will take appropriate actions to maintain price stability. In this regard, the growth of the global economy was projected to pick up in 2014 but the recovery was expected to be modest and uneven. In addition, the normalisation of financial conditions in advanced countries particularly through the gradual reduction of the United States liquidity injections could also create some volatility in the financial markets in emerging market economies (as relative inflation and interest rates reach new levels) which are more integrated with the global economy. These developments, coupled with the instability in the Middle East and North Africa (MENA) and the likely impact of the emerging drought conditions in some parts of the country that could exert pressure on food prices, remain the main risks to macroeconomic outlook.

The Bank will also 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. This is expected to enhance the transmission of monetary policy signals to the real sector as well as to coordinate market expectations.

1. Introduction

This Monetary Policy Statement (MPS) presents the policy guidelines and broad targets for the CBK over the period January to June 2014. It also presents the policy outcomes in the period July to December 2013.

During the first half of the Fiscal Year 2013/14, the monetary policy stance adopted by the MPC contributed to the stable inflation and stability in the exchange rate. Notably, the new VAT measures implemented by the Government in September 2013 had a one-off impact on the price level while inflationary expectations did not change relative to the pre-VAT Act period. The exchange rate stability continued to anchor inflationary expectations as it dampened the threat of imported inflation. Resilient inflows of diaspora remittances, the Central Bank liquidity management, and increased foreign investor participation in equities at the Nairobi Securities Exchange have enhanced confidence in the market. In addition, the improvement in the 12-month cumulative current account deficit (as a percentage of GDP) supported confidence in the exchange rate.

The gradual easing of the monetary policy stance during the first half of the Fiscal Year 2013/14 and improved investor confidence in the economy after the March 2013 elections resulted in the pick-up in growth of credit to the private sector channeled to the main sectors of the economy. However, although the growth of the global economy was projected to recover in 2014, this recovery was projected to be modest and uneven. The expected normalisation of financial conditions in advanced countries particularly through the gradual reduction of the United States liquidity injections could also create some volatility in the financial markets in emerging market economies (as relative inflation and interest rates reach new levels) that are more integrated with the global economy. The likely impact of the projected dry spell in the country on food prices and continued instability in the MENA also pose risks to macroeconomic outlook.

Monetary policy formulation and implementation continues to be guided by the Government's Budget Policy Statements while 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 Bank's participation in the foreign exchange market will continue to be guided by the need to accumulate and maintain foreign exchange reserves at /or above the level of four 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 2013 MPS while Section 3 outlines the current economic environment and outlook for the period January to June 2014. Section 4 concludes by outlining the specific monetary policy stance for the period January to June 2014.

2. Actions and Outcomes of Policy Proposals in the June 2013 Monetary Policy Statement

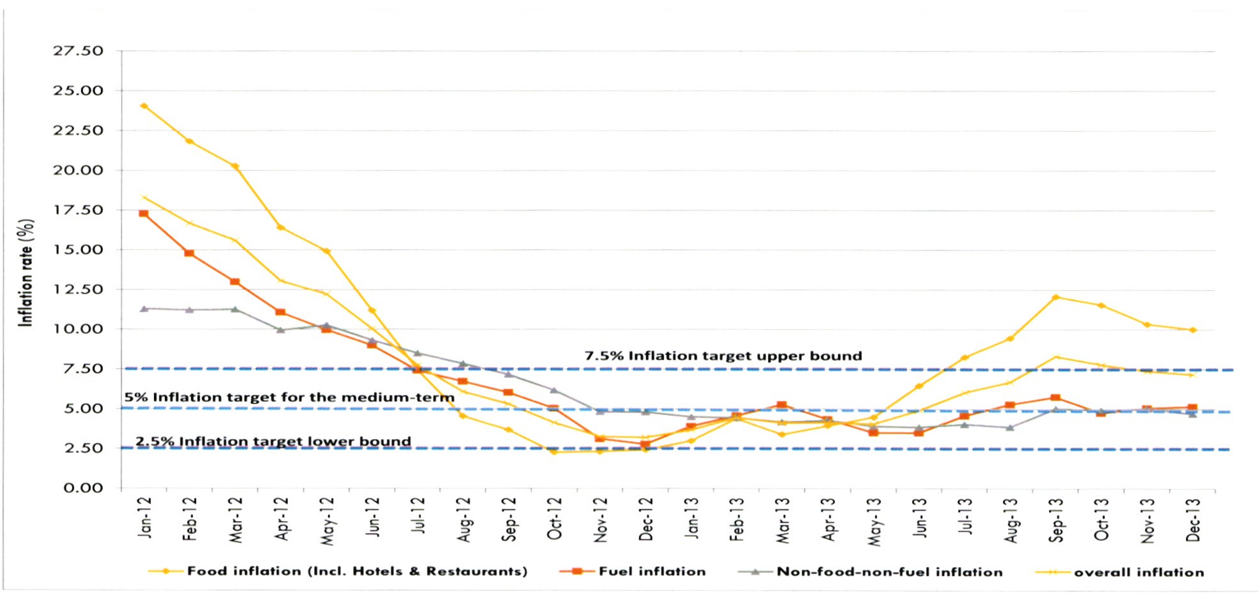
The overall aim of the Monetary Policy Statement for June 2013 (32nd MPS) was to set monetary policy targets that would ensure low and stable inflation, encourage growth, support long-term sustainability of public debt through stable interest rates and, by enhancing financial access within the economy, contribute to lowering the cost of doing business in Kenya. The MPC meetings were held on a bi-monthly basis during the first half of the Fiscal Year 2013/14 during which macroeconomic stability was sustained. The following are the specific outcomes of the policy proposals in the 32nd MPS:

a. Inflation

Price stability remained the primary objective of monetary policy formulation and implementation. During the first half of the Fiscal Year 2013/14, the 12-month overall inflation was sustained within the allowable margin of 2.5 percent on either side of the Government's medium-term target of 5 percent except in September and October 2013 (Chart 1). This was attributed to a notable rise in food prices arising from seasonal factors as well as some traders imposing VAT on non VAT-able food items. These drove overall inflation to 8.39 percent, which was above the upper target bound. However, overall inflation declined gradually to lie within the target bounds at 7.15 percent in December 2013 as the Government moved to ensure the correct application of the new VAT law.

The 12-month non-food-non-fuel inflation, which measures the impact of monetary policy, stabilised around 5 percent inflation target during the period indicating relatively low consumer demand pressures in the economy.

Chart 1: Trends in Inflation (CPI base February 2009=100)

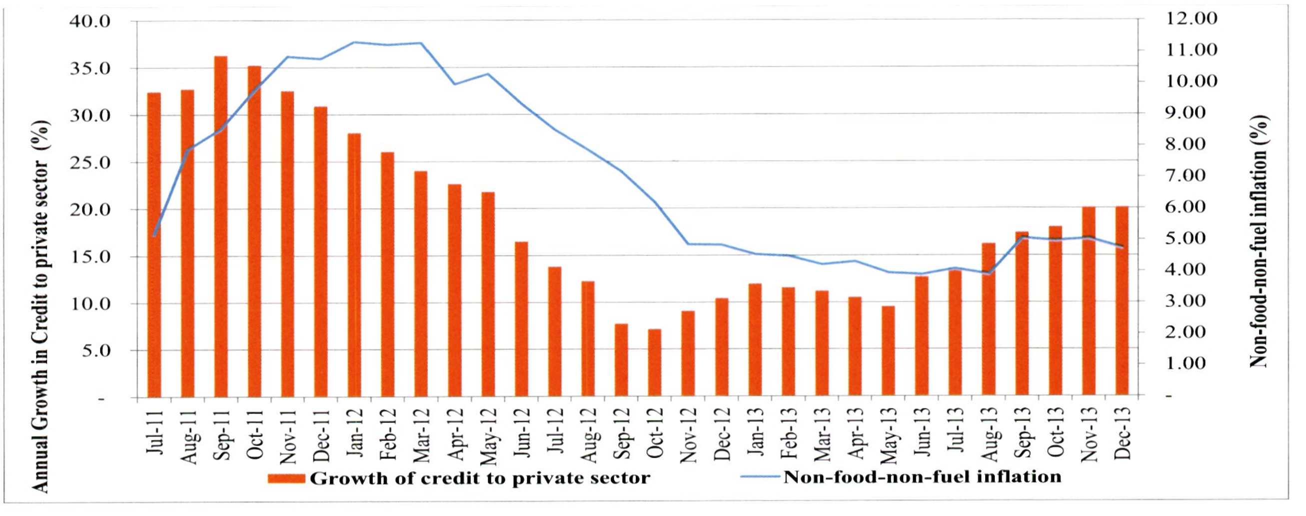


Source: Kenya National Bureau of Statistics and Central Bank of Kenya

i. Credit to Private Sector

Private sector credit growth picked-up during the first half of the Fiscal Year 2013/14 in response to the gradual easing of the monetary policy stance, pick-up in economic activity and, improved investor confidence in the economy after the March 2013 elections (Chart 2). The MPC reduced the Central Bank Rate (CBR) from 9.50 percent to 8.50 percent in May 2013 and retained it at this level in the rest of 2013. Consequently, the annual growth in the overall private sector credit rose from 12.69 percent in June 2013 to 20.08 percent in December 2013 which was largely consistent with the projected growth path. This expansion in private sector credit was non-inflationary as the 12-month non-food-non-fuel inflation stabilised at around 5 percent inflation target during the period.

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



Source: Central Bank of Kenya

ii. Monetary Programme

The CBK met the monetary programme targets during the first half of the Fiscal Year 2013/14 (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 targets pursued under the framework were consistent with those for the ceiling on the NDA and the floor on the NIR in the ECF programme, which was successfully concluded in December 2013.

Table 1: Actual and Targeted Growth in Key Monetary Aggregates

	Jun-13	Jul-13	Aug-13	Sep-13	Oct-13	Nov-13	Dec-13
Actual Broad Money,M3 (Ksh Billion)	1,820.9	1,835.8	1,850.0	1,862.0	1,879.1	1,919.5	1,957.5
Target Broad Money,M3 (Ksh Billion)	1,846.1	1,866.6	1,887.0	1,907.4	1,927.8	1,948.2	1,968.8
Actual Reserve Money (Ksh Billion)	287.4	284.0	309.8	290.3	307.2	316.8	320.8
Target Reserve Money (Ksh Billion)	282.6	286.0	286.8	288.5	294.0	297.5	304.3
Actual Net Foreign Assets of CBK (Ksh Billion)	402.1	411.0	408.7	417.3	403.7	421.2	432.0
Targets for Net Foreign Assets of CBK (Ksh Billion)	338.1	343.6	348.4	353.3	358.8	364.1	369.3
Actual Net Domestic Assets of CBK (Ksh Billion)	-114.7	-127.0	-98.9	-126.9	-96.5	-104.4	-111.2
Target Net Domestic Assets of CBK (Ksh Billion)	-55.5	-57.5	-61.6	-64.8	-64.8	-66.6	-65.0
Actual Credit to private sector (Ksh Billion)	1,367.2	1,389.5	1,427.8	1,452.6	1,480.5	1,519.3	1,541.7
Target Credit to private sector (Ksh Billion)	1,400.8	1,426.1	1,442.5	1,443.8	1,461.0	1,473.0	1,488.6
Memorandum Items							
12-month growth in actual RM (Percent)	11.7	10.3	23.8	12.1	22.7	13.3	9.2
12-month growth in actual M3 (Percent)	14.2	13.8	12.9	11.4	10.3	10.3	13.3
12-month growth in actual credit to private sector (Percent)	12.7	13.5	16.2	17.4	18.0	20.0	20.1

Source: Central Bank of Kenya

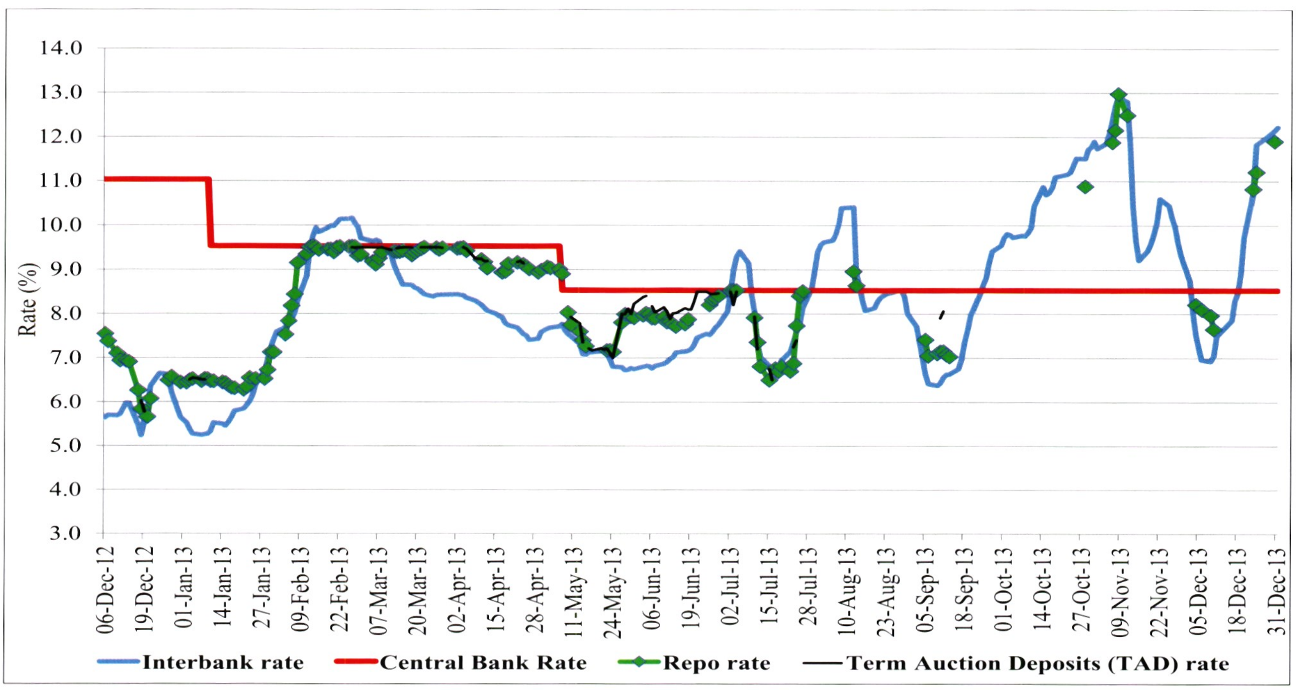
During the first half of the Fiscal Year 2013/14, the velocity of money remained fairly stable at about 2.0. However, the money multiplier remained unstable and fluctuated between 6.0 and 6.5 during the period which reflected changes in excess reserve holdings and cash in till of banks. The predictability 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. Notably, financial innovations which have affected the velocity of money and money multiplier have changed 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. This is borne out by the 2013 Financial Access Survey which shows that access to financial services in Kenya has increased and now stands amongst the highest in Africa. Specifically, the proportion of the adult population using formal financial services increased from 41.3 percent in 2009 to 66.7 percent in 2013. The commercial banks' branch network increased from 1,280 in March 2013 to 1,313 in September 2013 while the number of ATMs increased from 2,439 in June 2013 to 2,487 in December 2013. The increase in the number of ATMs was distributed across all the counties in the country. Similarly, the Agency Banking model continued to expand with the number of Agents standing at 23,477 by December 2013 while the number of transactions was 81.3 million valued at Ksh 431.9 billion which is a notable increase from June 2013 when the number of Agents stood at 19,649 while the value of transactions stood at Ksh 310.5 billion. In addition, a total of 13 commercial banks had been licensed by the CBK to undertake Agency transactions by December 2013.

iii. Interest Rates and Liquidity

The movements in short-term rates were generally aligned to the CBR during the first half of the Fiscal Year 2013/14 while Open Market Operations (OMO) were sustained to support liquidity management (Chart 3). The targeted OMO interventions were also successful in reversing adverse trends in the interbank rate. The CBR was retained at 8.50 percent during the period sustaining the impact of the previous monetary policy actions throughout the economy. However, liquidity conditions in the money market were relatively tight during the period. In July 2013, liquidity tightened owing to accumulation of Government deposits at the CBK as the payments structures for the newly constituted Government including Counties was being set up. The resultant pressure on interbank rates were moderated by the CBK redeeming outstanding Repo securities held by commercial banks and providing Reverse Repos to reverse the trend in mid-August 2013. In addition, the challenges of absorption of devolved funds since September 2013 and redistribution of liquidity across banks exerted upward pressures on the interbank rate. The engagement of stakeholders in the banking sector has continued in an effort to enhance the use of Horizontal Repos for redistributing liquidity.

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

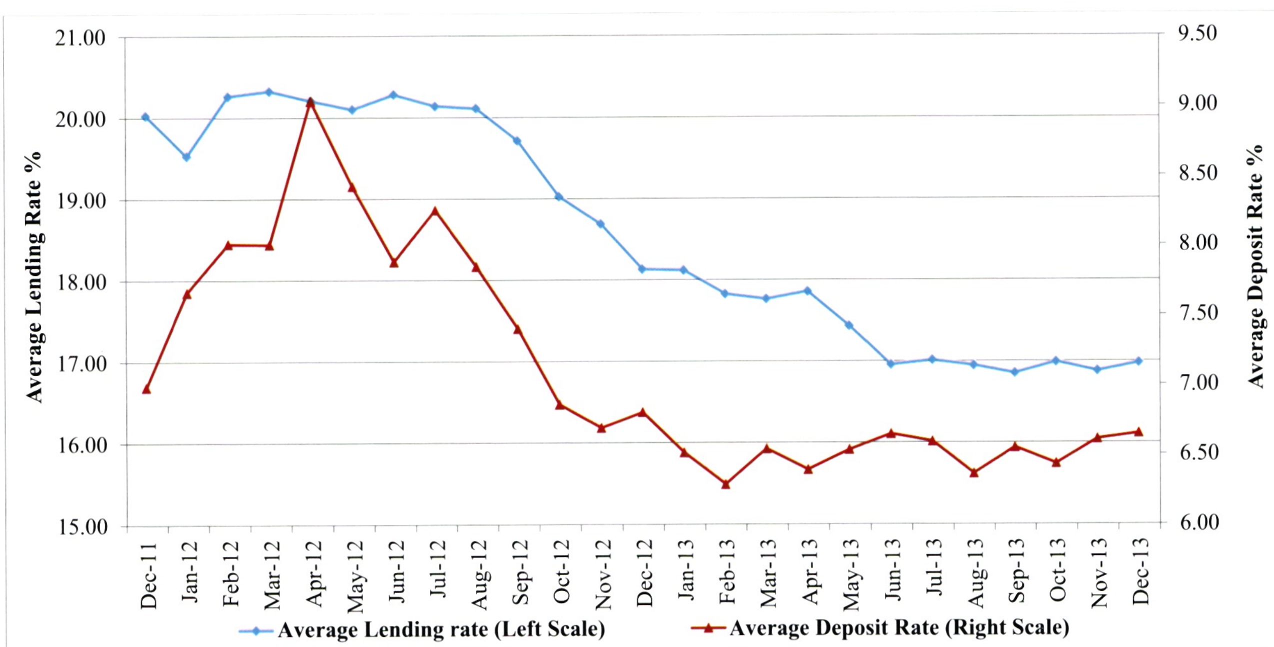


Source: Central Bank of Kenya

Consistent with the monetary policy stance adopted during the period, average ex-ante commercial banks' lending rate declined from 17.67 percent in the first half of 2013 to 16.95 percent in the second half of 2013 (Chart 4). However, the average ex-ante deposit rate increased from 6.48 percent to 6.53 percent during the period. Consequently, the average ex-ante interest rate spread declined slightly from 11.19 percent to 10.42 percent in the period. The CBK continues to work with the Kenya Bankers Association (KBA) to implement initiatives aimed at reducing the cost of doing business in the banking sector. In this regard, commercial banks have been allowed to use mobile phone financial platforms that leverage on technology development to reduce transaction costs. The cheque truncation to T+1 has ensured that cheques are cleared within one day of delivery of the cheque to the bank. On the other hand, the adoption of the Agency Banking framework, and operationalisation of Credit Reference Bureaus which have reduced the costs of information search and risk profiling process. The second phase of the Kenya Credit Information Sharing Initiative (CIS) is underway and is aimed at achieving full file information sharing in Kenya's banking sector by 2015. The scope of the CIS mechanism is also gradually being widened to allow non-bank institutions to participate in the CIS mechanism. In addition, revised regulations allowing for sharing of positive and negative credit information by banks and deposit taking microfinance institutions were gazetted in January 2014. Lastly, the opening of Currency Centres across the country has reduced costs associated with transporting cash.

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 based on a dialogue initiated through the MPC's Market Perception Survey.

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

The foreign exchange market remained generally stable during the first half of the Fiscal Year 2013/14 reflecting the impact of monetary policy measures in place (Chart 5a). Exchange rate stability during the period was supported by resilient inflows of diaspora remittances that averaged USD 111.1 million per month, disbursement of the last tranche of USD 110.2 million under the ECF programme in December 2013, and increased purchases of equity by foreigners at the Nairobi Securities Exchange. In addition, the Central Bank liquidity management and confidence by the market following a build-up in CBK foreign exchange reserves also supported the Kenya Shilling during the period. Commercial banks also sold foreign exchange to CBK in the first half of the Fiscal Year 2013/14 which fully compensated for the policy related foreign exchange sales in the period.

An analysis of exchange rates in the region showed that the Kenya Shilling remained generally stable against the currencies of the major East African Community countries but continued to strengthen against the South African Rand during the period (Chart 5b). The Rand continued to weaken against the US Dollar reflecting the strong trade links between South Africa and the turbulent Eurozone as well as the impact of capital outflows with the gradual recovery of the US economy boosting speculation for a cutback of the quantitative easing programme.

Chart 5a: Trends in the Kenya Shilling Exchange Rate against Major Currencies

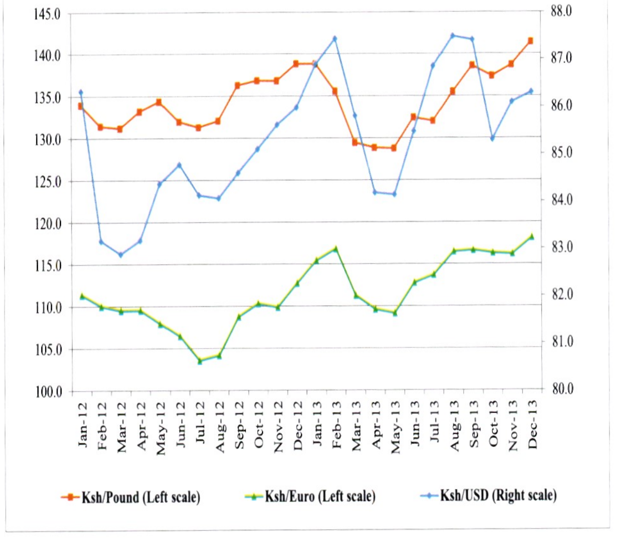
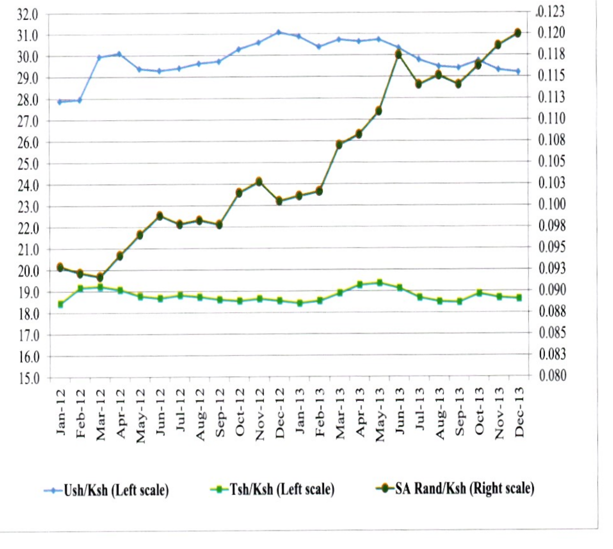


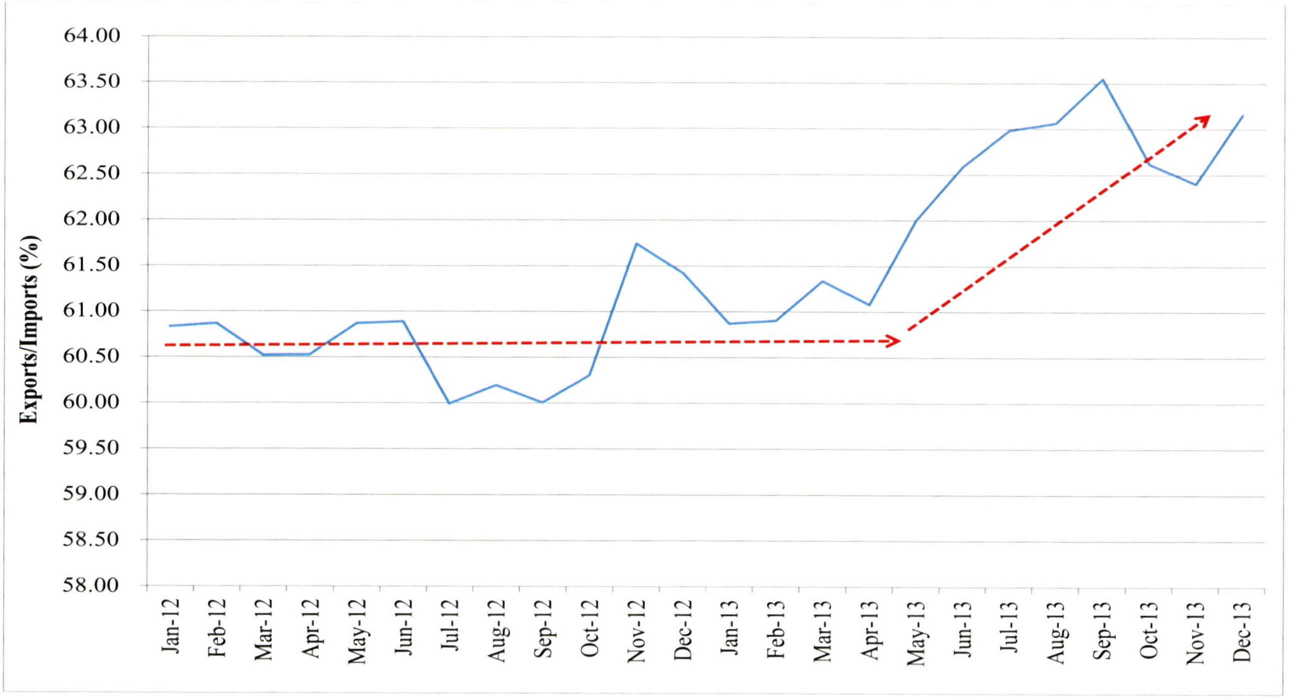
Chart 5b: Trends in the Kenya Shilling Exchange Rate against Regional Currencies



Source: Central Bank of Kenya

The improvement in the 12-month cumulative current account deficit (as a percentage of GDP) from 10.45 percent in 2012 to an estimated level of 8.2 percent in 2013 also supported stability of the exchange rate. The CBK is working with the Kenya National Bureau of Statistics to enhance the quality of the balance of payments data. This will capture some sectors which are currently under-reported or omitted. Nevertheless, the improvement in current account is attributed to normalisation of the import bill after the large amount of imports of equipement for infrastructure development and improvement in net receipts from services. As a result, the proportion of imports of goods and services financed by exports of goods and services increased slightly to an estimated 63.1 percent in 2013 from 61.4 percent in 2012 (Chart 5c). Nonetheless, imports of machinery and other equipment continued to account for a higher proportion of the import bill at about 26.5 percent in 2013. These are essential for enhancing future productive capacity of the economy.

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

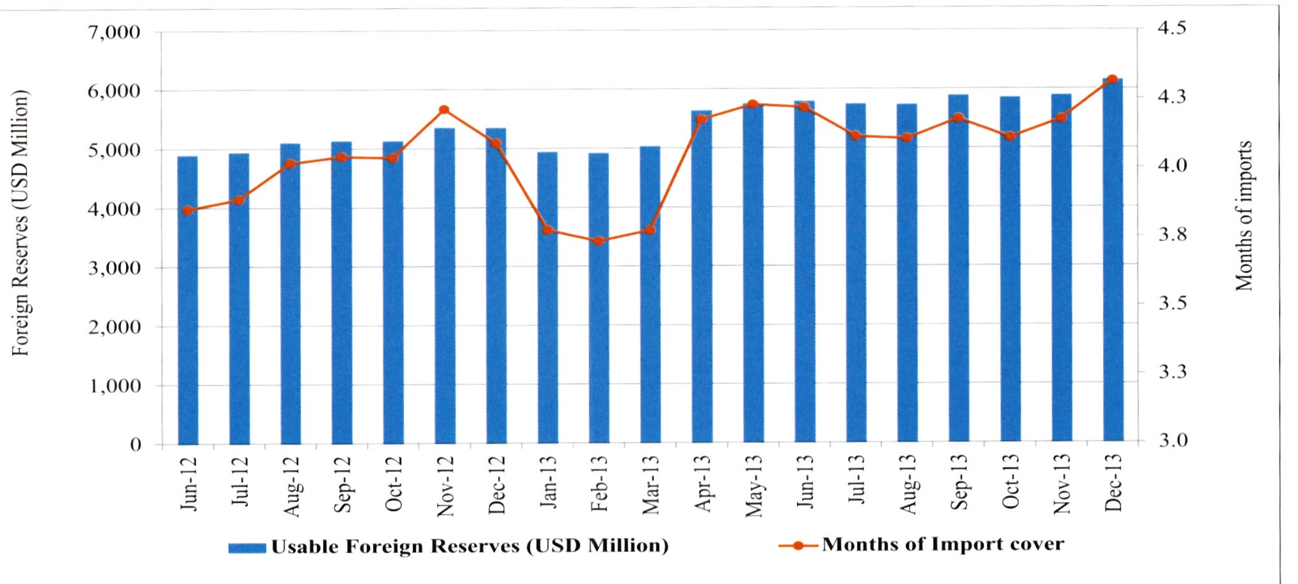


Source: Central Bank of Kenya and Kenya National Bureau of Statistics

ii) Foreign Exchange Reserves

The CBK increased its level of usable foreign exchange reserves from USD 5,810.59 million (equivalent to 4.22 months of import cover) at the end of June 2013 to USD 6,164.94 million (equivalent to 4.32 months of import cover) at the end of December 2013 (Chart 6). This is a significant improvement from the first three months of 2013 where reserves were below the 4 months of import cover. The build-up in foreign exchange reserves during the period was largely attributed to the disbursement of USD110.2 million by the International Monetary Fund (IMF) in December 2013 following the successful completion of the Extended Credit Facility (ECF) Program, and commercial banks selling foreign exchange to the CBK. This level of foreign exchange reserves is above the minimum requirement of four months of import cover. The CBK purchased foreign exchange totalling USD 430.0 million against sales of USD 63.0 million in the first half of the Fiscal Year 2013/14. The build-up in reserves provided a cushion to the foreign exchange market against external shocks experienced during the period .

Chart 6: CBK Usable Foreign Exchange Reserves



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

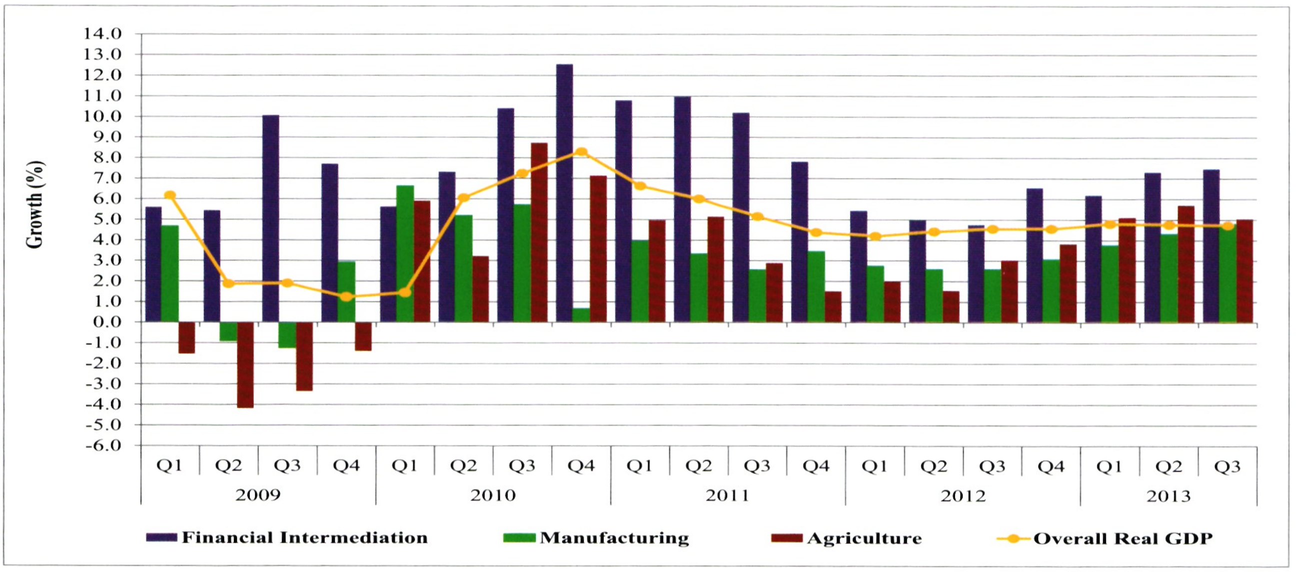
***Note**: The CBK usable foreign exchange reserves refer to reserves available for use without any restrictions held by the Central Bank. They exclude reserves held by CBK on behalf of the Government or commercial banks.*

Source: Central Bank of Kenya

c. Economic Growth

Data from the Kenya National Bureau of Statistics shows that the economy registered a growth rate of 4.4 percent in the third quarter of 2013 compared with 4.5 percent in a similar period in 2012 (Chart 7). The performance of the economy in the third quarter was supported by a stable macroeconomic environment characterised by stability in inflation and the exchange rate. It was driven significantly by a strong performance of the financial intermediation sector which grew by 7.2 percent on a quarter to quarter basis. Financial sector growth has consistently outpaced the overall 12 month real GDP growth since 2009. It was also driven by the manufacturing sector which grew at 4.6 percent, construction which grew at 13.3 percent and transport and communication sector which grew at 5.3 percent. Agricultural sector growth slowed down to 3.4 percent. Growth in the 2013 was affected by a sluggish recovery of the global economy.

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 2013/14 were consistent with the monetary policy objectives. The Government domestic borrowing plan ensured that Government borrowing did not crowd-out private sector credit growth through an increase in interest rates on Government securities. 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

During the first half of the Fiscal Year 2013/14, the MPC continued to hold bi-monthly stakeholder forums with Chief Executive Officers of commercial banks through the KBA Governing Council to obtain feedback. The MPC also continued to improve on the information gathering processes through the bi-monthly market Perception Surveys and communication with key stakeholders. The Committee worked with CBK staff to complete various research studies during the period which are being reviewed before they are considered for uploading on the CBK Website. It also initiated research papers that were targeted at providing insights in topical areas relevant for the formulation and implementation of monetary policy.

The MPC has also been working with the CBK to develop articles on topical issues which were uploaded on the CBK website. It also continued to improve on its Press Releases by enhancing their clarity and making them better focused to the public, media, financial sector and other stakeholders. MPC members participated in various conferences locally during the period as part of enhancing its capacity. The conferences enabled 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. They also held regular meetings with visiting potential investors.

3. The Current Economic Environment and Outlook for January to June 2014

a. International Economic Environment

The global economy is projected to improve from an estimated growth of 3.0 percent in 2013 to 3.7 percent in 2014 largely on account of recovery in the advanced economies (Table 2). The Eurozone is projected to recover from recession and at 1 percent in 2014 although the growth is expected to be uneven. The United States is expected to grow by 2.8 percent in 2014 up from an estimated 1.9 percent in 2013. The recovery in Europe and the United States is expected to boost tourism and horticultural exports in Kenya. The Sub-Saharan Africa and East African Countries (excluding Kenya) are projected to grow at 6.1 percent and 6.5 percent, respectively, in 2014. Given that over 40 percent of Kenya's exports are to the East African region, the strong growth projection for the region is expected to continue to benefit Kenya's export sector.

Although the growth of the global economy is projected to pick-up in 2014, the recovery is expected to be modest and uneven. Similarly, the projected slowdown in the growth of some emerging market economies, such as China, that are more integrated with the global economy, coupled with normalisation of financial conditions in advanced countries could create some volatility in the financial markets. The instability in the MENA region also continues to pose risks to macroeconomic outlook.

Global inflation is projected to stabilise at 3.8 percent in 2014 as the output is generally below potential especially in some of the advanced countries. 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 (%)		
	2012 Act.	2013 Est.	2014 Proj.	2012 Act.	2013 Est.	2014 Proj.
World	3.1	3.0	3.7	4.0	3.8	3.8
Advanced Economies	1.4	1.3	2.2	2.0	1.4	1.7
United States	2.8	1.9	2.8	2.1	1.4	1.5
Japan	1.4	1.7	1.7	0.0	0.0	2.9
Euro Area	-0.7	-0.4	1.0	2.5	1.5	1.5
United Kingdom	0.3	1.7	2.4	2.8	2.7	2.3
Other Advanced economies	1.9	2.2	3.0	2.0	1.5	2.1
Emerging and developing economies	4.9	4.7	5.1	6.0	6.1	5.6
Sub-Sahara Africa	4.8	5.1	6.1	9.0	6.9	6.3
East African Community (Excl.Kenya)	5.4	6.1	6.5	12.0	7.3	5.8
Developing Asia	6.4	6.5	6.7	4.7	5.0	4.7
China	7.7	7.7	7.5	2.7	2.7	3.0
India	3.2	4.4	5.4	10.4	10.9	8.9
Middle East and North Africa	4.1	2.4	3.3	10.7	11.7	10.0

Source: IMF World Economic Outlook (January 2014 and October 2013)

b. Domestic Economic Environment

i. Economic Growth

The Medium-Term Government Budget Policy Statement for 2014 projects real GDP to grow by 5.8 percent in 2014 up from an estimated growth of about 5.0 percent in 2013. The growth outlook is expected to be supported by: agriculture reforms, irrigation and value addition in agriculture; continued investment in infrastructure especially roads, energy, ports and construction of a Standard Gauge Railway; structural reforms, improving investment climate including security; continued investment in the social sectors of education, health and social protection; maintaining a stable macroeconomic environment; other initiatives geared towards export promotion including expansion of regional markets, Special Export Zones and commodity exchanges.

The MPC Market Perceptions Survey conducted in December 2013 showed increased optimism by private sector firms (including banks) for a strong growth in 2014 attributed to: increased Government of Kenya investment in infrastructure and agriculture; increase in business confidence and optimism for the economy; expected increase in foreign direct investment in infrastructure and energy sectors; political stability; the stable macroeconomic environment; pick-up in economic activity; pickup in the global economy; increase in private sector credit growth; increased regional trade; discovery of natural resources such as oil; operational structures of the devolved Government will be firmed up and this will spur growth in the counties. However, insecurity and slow recovery of the global economy were cited as the main risks to the growth outlook.

ii. Foreign Exchange Market

The exchange rate is expected to remain stable in the remainder of the Fiscal Year 2013/14. Central Bank liquidity management coupled with the resilient diaspora remittance inflows, expectations for increased foreign direct investment in infrastructure and improved investor confidence in the economy support a stable outlook for the exchange rate. In addition, the projected robust growth of Sub-Saharan Africa economies in 2014 which is expected to increase foreign exchange inflows from regional trade coupled with the commitment to the East African Community Convergence Criteria will bolster the country's foreign exchange reserves and support exchange rate stability. The MPC Market Survey for December 2013 corroborated this evidence of an expected stability in the exchange rate in the second half of the Fiscal Year 2013/14. However, the expected normalisation of financial conditions in advanced countries in particular the gradual reduction of the United States liquidity injections could create some volatility in the financial markets in emerging market economies (as relative inflation and interest rates reach new levels) which are more integrated with the global economy.

iii. Inflation

Overall inflation is expected to remain stable in the remainder of the Fiscal Year 2013/14 on account of the monetary policy measures that have been put in place by the CBK, general stability in the exchange rate, implementation of food security measures as proposed in the Fiscal Year 2013/14 Government Budget and lower energy prices. This inflation outlook is corroborated by the results of the December 2013 MPC Survey. However, the main risks to the inflation outlook include: the emerging drought conditions in some parts of the country which could exert pressure on food prices, likely increase in demand pressure in the economy with pick-up in economic activity, and volatile world oil prices.

iv. Interest Rates

Interest rates are expected to remain stable in the second half of the Fiscal Year 2013/14 on account of the monetary policy measures in place, the decline in demand pressure since the Government borrowing programme is on target, and the expected improvement in liquidity conditions in the market as challenges of redistribution of liquidity across banks and absorption of devolved funds are resolved. Sustained OMO by the CBK will also ensure stability of the interbank market interest rates around the CBR. The MPC Market Perceptions Survey for December 2013 showed that lending rates were expected to decline gradually following the decline in inflation and inflation expectations 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 2013/14 are consistent with monetary policy objectives. The realisation of Government's domestic borrowing target of Ksh.106.7 billion for the Fiscal Year 2013/14 is on schedule and should ensure that domestic borrowing in the Fiscal Year does not exert pressure on interest rates of Government securities while allowing for lengthening of the maturity of Government domestic debt. In addition, the borrowing plan should ensure that domestic debt remains within the thresholds set in the Medium Term Debt Management Strategy.

vi. Confidence in the Economy

Various indicators show that confidence in the economy remains strong (Table 3). In addition, the NSE-20 index remained buoyant in the first half of the Fiscal Year 2013/14 with increased foreign participation on average. Furthermore, the NSE was ranked among the top performing stock markets in Africa in 2013. Diaspora remittances have remained resilient, averaging USD 111.1 million per month between July and December 2013. The ratio of non-performing loans (NPLs) to total loans, which measures credit risk, declined from 5.3 percent to 5.0 percent during the period. However, the CBK has continued to monitor the level of NPLs. In addition, the MPC Market Survey undertaken in December 2013 showed increased confidence in the economy with expectations for enhanced foreign direct investment in the country.

Table 3: Indicators of Declining Risk and Confidence in the Economy

	Jun-13	Jul-13	Aug-13	Sep-13	Oct-13	Nov-13	Dec-13
Monthly Emigrant Remittances (USD Million)	99.81	112.83	107.05	106.96	112.91	113.42	113.22
NSE Index (Jan 1966 = 100)	4598.16	4787.56	4697.75	4793.20	4992.88	5100.88	4926.97
Net foreign purchases of equity at the NSE (Ksh Million)	2602.00	1625.00	9838.39	2063.00	2723.00	884.00	-690.00
Non-performing loans/Gross loans (%)	5.31	5.36	5.30	5.24	5.34	5.12	5.02

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

4. Future Direction of Monetary Policy (January – June 2014)

Monetary policy in the second half of the Fiscal Year 2013/14 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 second half of the Fiscal Year 2013/14 are based on the indicators in the Medium-Term Government Budget Policy Statement for 2013/14 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 15.7 percent by March 2014 and 16.1 percent by June 2014. The NDA of the Bank is projected at Ksh -81.5 billion in March 2014 and Ksh-128.0 billion in June 2014. The NDA targets are below a ceiling which could threaten stability and is the same indicator which was monitored under the ECF supported monetary programme that ended in December 2013. However, the annual growth in credit to the private sector is projected at 17.3 percent in March 2014, and 19.3 percent in June 2014. The NIR targets of the CBK are USD 5,018 million in March 2014 and USD 5,682 million in June 2014. 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. The projected path on NDA and NIR targets through June 2014 incorporates the accumulation of foreign reserves foreseen by the attainment of the East African Community Convergence Criteria remainder of the Fiscal Year 2013/14 and the liquidity management to ensure stability of the interbank market.

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 in order to enhance the country's capacity to absorb shocks that impact the foreign exchange market. 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 of its monetary policy instruments with regard to speed and magnitude of impact.

Table 4: Monetary Targets for January to June 2014

	Jan-14	Feb-14	Mar-14	Apr-14	May-14	Jun-14
Broad Money, M3 (Ksh Billion)	1,975.4	2,002.9	2,030.5	2,058.7	2,086.2	2,114.1
Reserve Money, RM (Ksh Billion)	322.2	321.8	323.0	334.2	329.8	331.5
Credit to Private Sector (Ksh Billion)	1,499.1	1,506.9	1,544.0	1,589.2	1,599.7	1,631.7
NFA of CBK (Ksh Billion)	412.6	408.6	404.5	467.2	463.6	459.5
NDA of CBK (Ksh Billion)	-90.5	-86.7	-81.5	-132.9	-133.8	-128.0
12-month growth in RM (Percent)	17.6	12.1	12.3	24.8	17.0	15.3
12-month growth in M3 (Percent)	14.2	14.6	15.7	14.2	14.4	16.1
12-month growth in Credit to Private Sector (Percent)	15.5	15.3	17.3	19.7	19.5	19.3
12-month growth in Real GDP (Percent)						5.9
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 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 remainder of the Fiscal Year 2013/14. 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

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 aimed at ensuring that such innovations are regulated accordingly 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 also 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.

The CBK will continue to work with stakeholders to identify and implement measures to enhance redistribution of liquidity in the interbank market. It will continue to work with the KBA to identify and implement measures to enhance the uptake of Horizontal Repos among banks. 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 with its transparency through the timely dissemination of all the requisite data through its website.

ANNEX 1: MAIN MACROECONOMIC INDICATORS (2012/13-2015/16)

	2012/13		2013/14			2014/15			2015/16		
	BPS'13	*Prov*	*BPS'13*	*BROP'13*	*BPS'14*	*BPS'13*	*BROP'13*	*BPS'14*	*BPS'13*	*BROP'13*	*BPS'14*
Annual percentage change, unless otherwise indicated											
National account and prices											
Real GDP	5.1	4.9	5.9	5.9	5.5	6.3	6.3	6.1	6.6	6.6	6.6
GDP deflator	7.4	6.6	7.4	7.4	6.5	7.9	7.9	7.2	7.7	7.7	6.8
CPI Index (eop)	6.3	6.0	6.4	6.4	5.8	6.0	6.0	5.3	5.5	5.5	5.0
CPI Index (avg)	5.9	5.9	6.7	6.7	6.0	6.2	6.2	5.7	5.8	5.8	5.0
Terms of trade (-deterioration)	5.7	-1.0	1.0	1.0	-0.3	4.3	4.3	4.2	5.4	5.4	5.6
In percentage of GDP, unless otherwise indicated											
Investment and saving											
Investment	21.9	20.9	23.9	23.9	22.5	24.9	24.9	24.1	25.4	25.4	25.2
Gross National Saving	10.9	10.4	13.5	13.5	12.8	15.6	15.6	15.6	17.7	17.7	18.1
Central government budget											
Total revenue	23.7	23.9	24.9	24.9	25.4	25.0	25.0	25.4	25.1	25.1	25.5
Total expenditure and net lending	32.6	32.9	35.4	35.4	36.2	30.6	30.6	31.1	30.5	30.5	30.9
Overall balance (commitment basis) excl. grants	-8.9	-9.0	-10.5	-10.5	-10.8	-5.6	-5.6	-5.7	-5.4	-5.4	-5.5
Overall balance (commitment basis) incl. grants	-6.8	-6.9	-8.7	-8.7	-8.9	-4.0	-4.0	-4.1	-3.8	-3.8	-3.9
External sector											
Exports value, goods and services	27.0	25.6	27.1	27.1	24.9	27.8	27.8	25.4	28.7	28.7	26.2
Imports value, goods and services	43.9	42.0	43.1	43.1	40.2	42.0	42.0	39.0	41.0	41.0	38.0
Current external balance, including official transfers	-11.0	-10.5	-10.5	-10.5	-9.6	-9.2	-9.2	-8.5	-7.7	-7.7	-7.1
Public debt											
Nominal central government debt (eop), gross	52.3	52.2	53.0	53.0	55.8	50.6	50.6	53.3	47.8	47.8	50.4
Nominal central government debt (eop), net of deposits	47.9	47.8	49.1	49.1	51.8	49.0	49.0	51.6	47.6	47.6	50.2
Domestic (net)	24.3	24.5	23.9	23.9	25.1	24.6	24.6	25.8	24.2	24.2	25.7
External	23.6	23.3	25.2	25.2	26.7	24.4	24.4	25.8	23.3	23.3	24.6
Memorandum items:											
Nominal GDP (in Ksh billions)	3,663	3,627	4,165	4,165	4,075	4,775	4,775	4,637	5,480	5,480	5,277
Nominal GDP (in US$ millions)	42,728	42,522	47,379	47,379	46,801	53,227	53,227	52,420	60,078	60,078	59,089

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 2013)

Date	Events
July 2013	a) The CBK sold a net of USD 63 million in line with the CBK's exchange rate policy.
	b) The CBK purchased USD 15 million offered by the market to build its foreign exchange reserves following stability in exchange rate market.
	c) The National Government started allocating funds to the County governments
August 2013	a) The CBK purchased USD 35 million offered by the market to build its foreign exchange reserves following stability in exchange rate market.
	b) Introduction of T+1 cheque clearing system allowing cheques to be cleared and the money accessed within one day.
September 2013	a) The CBK purchased USD 112 million offered by the market to build its foreign exchange reserves following stability in exchange rate market.
	b) The New VAT Act was operationalised
October 2013	The CBK purchased USD 5 million offered by the market to build its foreign exchange reserves following stability in exchange rate market.
November 2013	The CBK purchased USD 70 million offered by the market to build its foreign exchange reserves following stability in exchange rate market.
December 2013	a) The CBK purchased USD 193 million offered by the market to build its foreign exchange reserves following stability in exchange rate market.
	b) The CBK successfully completed the Extended Credit Facility programme with the International Monetary Fund
	c) Introduction by CBK of a requirement that commercial banks start reporting on the participation by foreign investors in the Government securities market

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 paid by consumers of goods and services 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:

M1 Currency outside banking system + demand deposits

M2 M1 + time and savings deposits + certificates of deposits + deposit Liabilities of NBFIs

M3 M2 + residents' foreign currency deposits