BANKI KUU YA KENYA

Central Bank of Kenya

Monetary Policy Statement

June 2020

LETTER OF TRANSMITTAL

In accordance with Section 4B of the Central Bank of Kenya Act, it is my pleasure to present to you, Honourable Cabinet Secretary of the National Treasury and Planning, the 46th Monetary Policy Statement of the Central Bank of Kenya. It reviews and assesses the implementation of monetary policy during the first half of 2020, and outlines the direction of monetary policy for the next twelve months.

Dr. Patrick Njoroge

Governor

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THE PRINCIPAL OBJECTIVES OF THE CENTRAL BANK OF KENYA

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

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

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

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

INSTRUMENTS AND TRANSMISSION OF MONETARY POLICY

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

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

    i. **Repurchase Agreements (Repos):** A repo is a collateralized loan involving a contractual arrangement between two parties, in which one party sells a security at a specified price with a commitment to buy the security back at a later date. Both parties therefore, meet their investment goals of secured funding and liquidity. CBK Repos are conducted through auctions with tenors of 3 and 7 days and are for mopping up liquidity from the market. The Late Repo, sold in the afternoon, has a 4-day tenor and is issued at 100 basis points below the repo rate of the day. Reverse Repos, on the other hand, are for liquidity injections and involve purchase of securities from commercial banks. The current tenors for Reverse Repos are 7, 14, 21, 28 and 91 days.

    ii. **Term Auction Deposit (TAD):** The TAD is used when the securities held by the CBK for Repo purposes are exhausted or when CBK considers it desirable to offer longer dated tenors. TAD is essentially not backed by collateral and it is conducted through an auction, similar to Repos. Currently, the tenors for such deposits at CBK are 14, 21, 28 or 91 days and upon maturity of TAD, the CBK credits the respective commercial bank with the deposit and interest.

    iii. **Horizontal Repos:** Horizontal Repos are modes of improving liquidity distribution between commercial banks, and are conducted under CBK supervision. They are transacted between commercial banks on the basis of signed agreements using government securities as collateral, and have negotiated tenors and yields. Commercial banks, short of deposits at the CBK, borrow from banks with excess deposits on the security of an appropriate asset, normally a government security. Horizontal Repos also help banks overcome the problem of limits to lines of credit, thus promoting more efficient management of interbank liquidity.

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

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

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

- **The Cash Reserves Ratio (CRR):** In accordance with the law, the CRR is the proportion of a commercial bank's total deposit liabilities which must be held as deposits at CBK. These deposits are held in the CRR Account at no interest. The ratio is currently 4.25 percent of the total of a bank's domestic and foreign currency deposit liabilities. To facilitate commercial banks' liquidity management, commercial banks are currently required to maintain their CRR based on a daily average level from the 15th of the previous month to the 14th of the current month and not to fall below a CRR of 3 percent on any day.

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

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

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

EXECUTIVE SUMMARY

This Monetary Policy Statement provides the direction of monetary policy for the financial year (FY) 2020/21. It also reviews the outcome of the monetary policy stance adopted in the first half of 2020, during which the global economy suffered a severe shock arising from the coronavirus (COVID-19) pandemic. The measures implemented across countries to contain the spread of the pandemic resulted in widespread business closures, severe disruptions to trade and supply chains, and collapse in global travel. The Government implemented measures to prevent the pandemic from becoming a health and economic crisis. Fiscal policy measures were put in place to cushion households and businesses from the adverse effects of the pandemic, while the CBK adopted accommodative monetary policy to support economic activity.

During the period, CBK conducted monetary policy with the aim of keeping overall inflation within the target range of 5±2.5 percent. Additionally, monetary policy was aimed at supporting economic activity through provision of liquidity to banks for on lending to the private sector following the onset of COVID-19 in March. The MPC lowered the CBR from 8.25 percent in January 2020 to 7.25 percent in March, and reduced the Cash Reserve Requirement (CRR) by 100 basis points to 4.25 percent in order to prevent the COVID-19 health crisis becoming a severe economic and financial crisis. The CBR was reduced further to 7.00 percent in April. CBK ensured that the interbank market and liquidity management across the sector continued to function smoothly. Month-on-month overall inflation remained within the target range due to improved food supply with favourable weather, lower international oil prices and muted demand pressures. Non-food-non-fuel (NFNF) inflation remained below 5 percent, indicating muted demand pressures in the economy.

The foreign exchange market remained relatively stable despite increased uncertainties due to the COVID-19 pandemic. This is supported by a narrowing current account deficit, balanced flows and an adequate reserve buffer. The current account deficit narrowed to 5.2 percent of GDP in the 12-months to June 2020 compared to 5.8 percent of GDP in 2019 reflecting a rebound in export earnings particularly horticulture and tea, resilient remittances, and a lower import bill particularly oil. Services receipts remain subdued due to weaknesses in international travel and transport. The CBK foreign exchange reserves, which stood at USD 9,740 million (5.9 months of import cover) at the end of June 2020, continued to provide an adequate buffer against short-term shocks in the foreign exchange market.

The CBK also announced emergency banking sector measures to mitigate the adverse impact of the pandemic on the sector and on businesses. Additional measures were agreed with the money transfer service operators and commercial banks to promote use of digital transactions instead of cash. Internally, protocols to protect staff were rolled out including alternative working arrangements. The sector remains stable and resilient, with strong liquidity and capital adequacy ratios. Private sector credit remained resilient, growing by 7.7 percent in the 12 months to June, compared to 7.1 percent in December 2019. Notable credit growth was recorded in the manufacturing, consumer durables, trade, transport and communication, real estate and private households sectors. CBK continued to strengthen the sector and instituted measures to ensure that the sector remained resilient despite the threats posed by the COVID-19 pandemic.

The monetary policy stance in the FY2020/21 will aim at maintaining overall inflation rate within the medium term target range of 5±2.5 percent. The foreign exchange market is expected to remain stable supported by expected narrowing of the current account deficit to 5.1 percent of GDP in 2020 and 5.2 percent in 2021. Overall, the continued coordination of monetary and fiscal policies is expected to sustain macroeconomic stability and revamp the economy during the post COVID-19 period. Consistent with inflation and growth objectives, monetary policy will aim at containing annual growth in broad money (M3) at about 11 percent by June 2021, while private sector credit growth is expected to gain momentum with the expected operationalisation of a Credit Guarantee Scheme for Micro Small and Medium sized Enterprises (MSMEs).

The Bank will continue to monitor the risks posed by developments in the domestic and global economies on the overall price stability objective. The Bank will also continue to closely monitor the economic impact of COVID-19 and the outcomes of policy measures in place as well as other developments in the domestic and global economies to safeguard price stability.

1. INTRODUCTION

This Monetary Policy Statement (MPS) provides the direction of monetary policy for the financial year 2020/21. It also presents the outcome of the monetary policy stance adopted in the first half of 2020.

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

The global economy suffered a severe shock during the period arising from the coronavirus (COVID-19) pandemic. The stringent measures implemented across countries to contain the spread of the pandemic resulted in widespread business closures, severe disruptions to trade and supply chains, and collapse in global travel. The Government moved quickly to implement measures to prevent the pandemic from becoming a health and economic crisis. Fiscal policy measures were put in place to cushion households and businesses from the adverse effects of the pandemic, while the CBK adopted accommodative monetary policy to support economic activity. The CBK also announced emergency banking sector measures to mitigate the adverse impact of the pandemic on the sector and on businesses. Additional measures were agreed with the money transfer service operators and commercial banks to promote use of digital transactions instead of cash. Internally, protocols to protect staff were rolled out including alternative working arrangements.

Overall inflation remained anchored within the term target range during the first half of 2020, supported by lower food prices, declining domestic energy prices and prudent monetary policy. Despite volatility in the global financial markets, the exchange rate was relatively stable and continued to dampen any threat of imported inflation.

The rest of this Policy Statement is organized as follows. Section 2 reviews the outcome of the monetary policy stance implemented in the first half of 2020 while Section 3 describes the external economic environment and outlook for the financial year (FY) 2020/21. Section 4 concludes by outlining the specific monetary policy path for FY 2020/21.

2. ACTIONS AND OUTCOMES OF THE POLICY STANCE IN THE FIRST HALF OF 2020

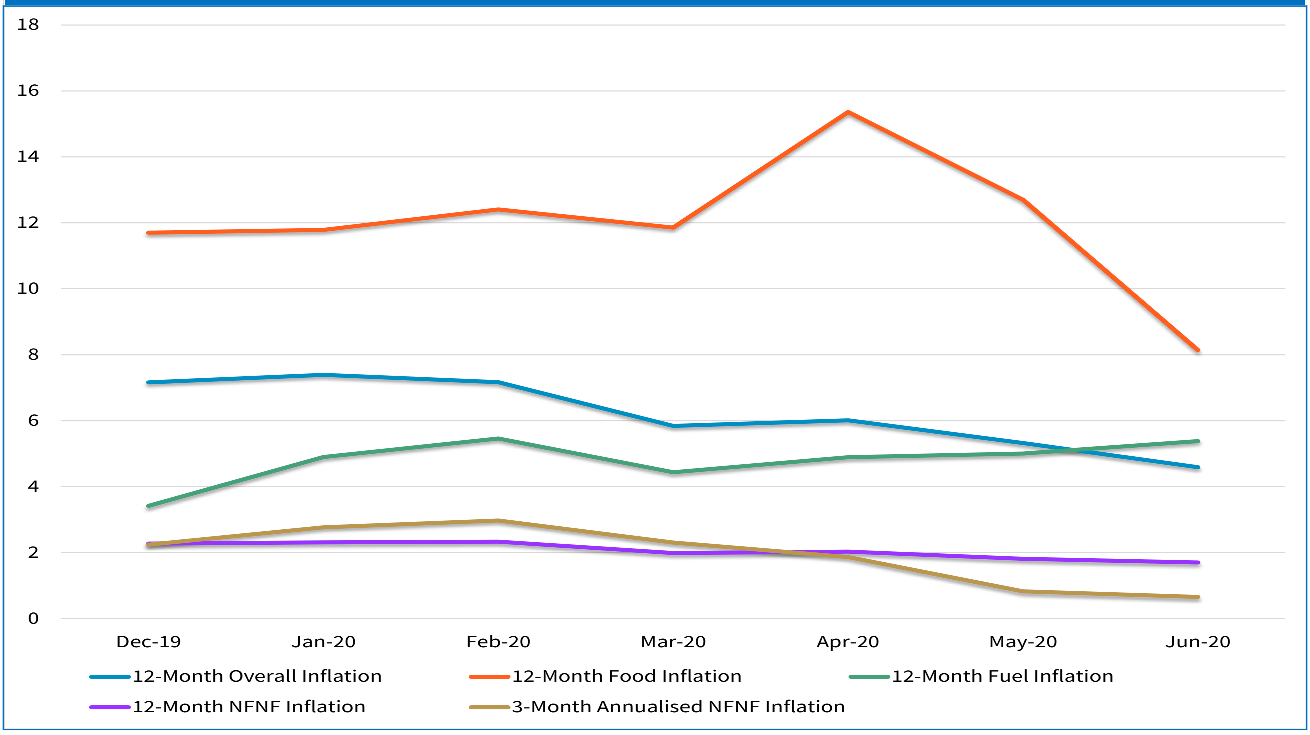
The main objective of the monetary policy stance in the first half of 2020 was to put in place measures to prevent the COVID-19 health crisis from becoming a severe economic and financial crisis. The policy stance was also to set monetary policy targets that would ensure low and stable inflation, encourage growth, support stable interest rates and, by enhancing financial access within the economy, contribute to lowering the cost of doing business in the country. The following are the specific outcomes of the policy stance:

i. Inflation

The monetary policy measures pursued by the MPC anchored inflation expectations, ensured market stability, and were supportive of economic activity. The MPC augmented its accommodative policy stance in March and April by reducing the CBR by 125 basis points cumulatively in order to mitigate the adverse economic effects and financial disruptions due to COVID-19 pandemic.

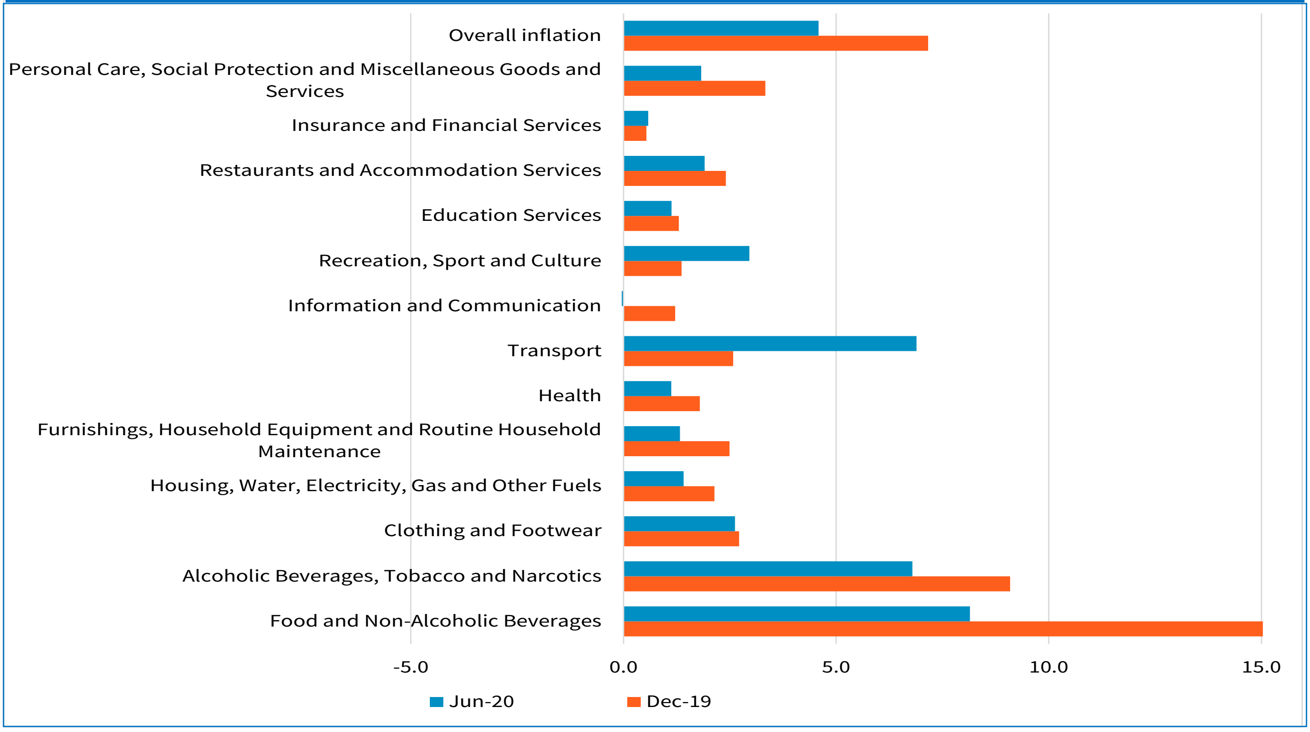
Overall inflation remained anchored within the target range in the first half of 2020. It declined to 4.6 percent in June 2020 compared to 5.8 percent in December 2019, driven mainly by declining food prices, relatively low international oil prices and muted demand pressures. Food inflation was elevated at 8.1 percent in June compared to 9.3 percent in December due to high prices of a few key food items such as tomatoes, onions, potatoes, maize products and kales, following crop destruction due to excess rainfall and supply disruptions occasioned by the COVID-19 pandemic. Fuel inflation remained relatively low, supported by low international oil prices **(Chart 1a and 1b).**

Chart 1a: Inflation in Broad Measures (Percent)



Source: Kenya National Bureau of Statistics and CBK

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



Source: Kenya National Bureau of Statistics

Over the same period, 12-month Non-Food-Non-Fuel (NFNF) inflation remained low and stable. It declined to 1.6 percent in June 2020 from 2.7 percent in December. Similarly, the three-months annualized NFNF was low reflecting muted demand pressures in the economy. The stability of the exchange rate continued to moderate the impact of import costs on consumer prices.

ii. Bank Credit to the Private Sector

Private sector credit remained resilient, growing by 7.7 percent in the 12 months to June, compared to 7.1 percent in December 2019 supported by accomodative monetary policy **(Table 1).** Strong growth in credit was observed in the following sectors: manufacturing (11.1 percent); consumer durables (15.2 percent); trade (9.4 percent), transport and communication (14.9 percent); real estate (4.9 percent) and private households (3.6 percent).

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

Main sectors	Dec-19	Jan-20	Feb-20	Mar-20	Apr-20	May-20	Jun-20
Agriculture	-2.4	-4.8	0.2	1.4	2.8	2.6	2.2
Manufacturing	9.2	12.7	10.4	15.3	20.1	18.2	11.1
Trade	8.9	6.0	9.5	9.4	10.3	8.0	9.4
Building and construction	1.6	4.0	-0.5	9.5	7.7	5.7	4.6
Transport and communicatior	8.1	9.9	7.4	7.1	9.1	5.7	14.9
Finance and insurance	0.4	-1.1	1.9	6.6	3.1	8.4	3.2
Real estate	1.5	3.5	3.4	2.2	4.8	4.4	4.9
Mining and quarrying	-5.8	-9.4	-14.6	3.9	11.0	5.8	10.0
Private households	5.6	5.6	5.9	3.4	2.2	3.2	3.6
Consumer durables	26.0	21.4	20.6	24.1	19.6	16.7	15.2
Business services	2.4	1.5	2.4	3.3	1.2	2.7	5.3
Other activities	16.0	24.4	33.4	36.8	14.3	16.9	-3.7
Total private sector credit	7.1	7.3	7.7	8.9	9.0	8.2	7.7

Source: Central Bank of Kenya

iii. Developments in the other Monetary Aggregates

The 12-month growth of broad money, M3, rose to 8.4 percent in June from 5.6 percent in December 2019 largely due to an increase in net domestic assets (NDA) of the banking system. The expansion in NDA of the banking system was attributed to growth in private sector credit and net lending to the government. On the liabilities side, the growth of money supply was reflected in households and corporate sectors' deposits and currency outside banks **(Chart 2)**. Overall, all the monetary aggregates grew at a slower pace compared to their respective targets **(Table 2).**

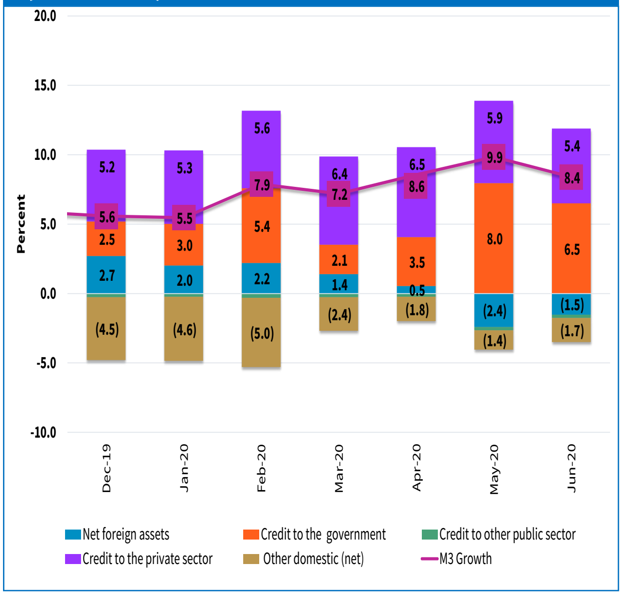
Table 2: Actual and Targeted Growth in Key Monetary Aggregates

	Dec-19	Jan-20	Feb-20	Mar-20	Apr-20	May-20	Jun-20
Actual Broad Money,M3 (Ksh Billion)	3524.0	3527.0	3596.0	3661.0	3696.0	3752.8	3863.6
Target (Ksh Billion)	3666.4	3527.0	3596.0	3628.2	3696.0	3752.8	3906.6
Actual Reserve Money (Ksh Billion)	461.1	441.3	449.7	445.5	435.8	432.1	426.9
Target (Ksh Billion)	472.2	441.3	449.7	442.5	435.8	432.1	442.9
Actual Net Foreign Assets of CBK (Ksh Billion)	833.3	800.8	792.2	800.6	794.6	862.1	918.1
Target (Ksh Billion)	833.0	800.8	792.2	763.4	794.6	862.1	834.4
Actual Net Domestic Assets of CBK (Ksh Billion)	-372.2	-359.4	-342.5	-355.1	-358.8	-430.0	-491.2
Target (Ksh Billion)	-360.8	-359.4	-342.5	-320.9	-358.8	-430.0	-391.5
Actual Credit to private sector (Ksh Billion)	2594.6	2598.7	2613.0	2661.2	2684.4	2678.8	2695.0
Target (Ksh Billion)	2636.5	2598.7	2613.0	2646.8	2684.4	2678.8	2707.0
Memorandum Items							
12-month growth in actual Reserve Money (Percent)	-6.3	-3.6	2.3	-2.4	-4.0	-11.0	-2.9
12-month growth in actual Broad Money, M3 (Percent)	5.6	5.5	7.9	7.2	8.6	9.9	8.4

Source: Central Bank of Kenya

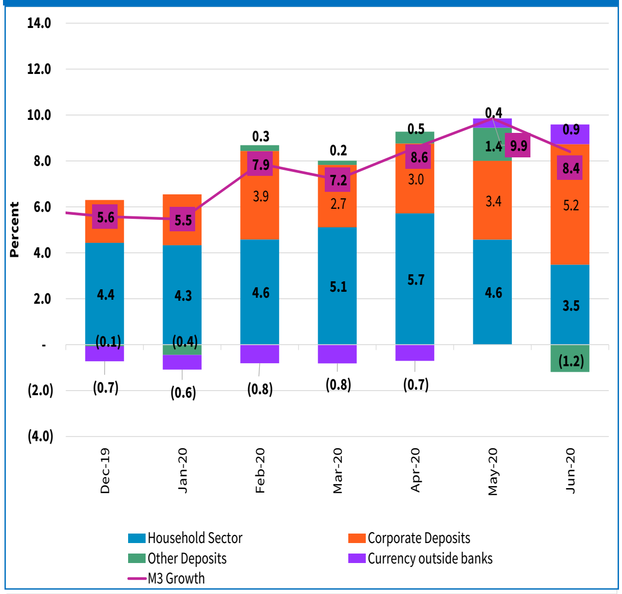
Chart 2: The 12-Month Growth in Broad Money Supply (M3) (Percent)

2a: Components of Money Growth (Percent)



Source: Central Bank of Kenya

2b: Sources of Money Growth (Percent)



Source: Central Bank of Kenya

iv. Interest Rates Developments

a. Central Bank Rate (CBR)

The MPC lowered the CBR from 8.50 percent in December 2019 to 7.00 percent in March, and lowered the Cash Reserve Requirement (CRR) by 100 basis points to 4.25 percent in order to prevent the COVID-19 health crisis becoming a severe economic and financial crisis. Additionally, the CBK ensured that the interbank market and liquidity management across the sector continued to function smoothly, as the MPC closely monitored the evolution of COVID-19.

b. Short Term Rates

Short-term interest rates declined during the first half of 2020 in line with the accommodative monetary policy stance adopted by the MPC, which resulted in improved market liquidity **(Table 3).** The increase in market liquidity was also attributable to increased government spending especially towards the end of its financial year. The average interbank interest rate fell to 3.27 percent in June from 6.03 percent in December. Similarly, the interest rates on government securities declined reflecting ample liquidity. The average 91-day Treasury bill rate declined to 7.14 percent from 7.17 percent, while the average 182-day Treasury bill rate decreased to 7.93 percent from 8.16 percent in December.

c. Commercial Bank Rates

Commercial banks' average interest rates declined in line with the monetary policy stance. The average commercial bank lending rate declined to 11.89 percent in June from 12.24 percent in December while the average deposit rate declined to 6.86 percent from 7.11 percent. Consequently, the interest spread decreased slightly from 5.14 percent to 5.02 percent.

v. Banking Sector Developments

The banking sector remains stable and resilient, with strong liquidity and capital adequacy ratios. The average commercial banks liquidity and capital adequacy ratios stood at 52.7 percent and 18.5 percent in June, respectively. However, the ratio of gross non-performing loans (NPLs) to gross loans increased from 12.0 percent in December to 13.1 percent in June. NPL increases were noted in the manufacturing, trade and personal sectors. The increase in NPLs could be attributable to delayed payments by the public and private sectors; low demand of developed housing and commercial units in the real estate sector; delays in cash inflows due to low business turnover; and low business activities as a result of COVID-19 pandemic, especially in the second quarter of 2020.

Table 3: Interest Rates (Percent)

	2019				2020					
	Mar	Jun	Sep	Dec	Jan	Feb	Mar	Apr	May	Jun
Central Bank Rate	9.00	9.00	9.00	8.50	8.25	8.25	7.25	7.00	7.00	7.00
Interbank	3.72	2.98	6.59	6.03	4.39	4.84	4.40	5.13	3.91	3.27
Repo	3.49	4.23	8.69	7.45	5.38	4.44	6.13	6.36	4.25	3.50
Reverse Repo									7.31	
91-Tbill	7.13	6.94	6.35	7.17	7.23	7.31	7.29	7.21	7.27	7.14
182-Tbill	8.32	7.71	7.10	8.16	8.17	8.25	8.14	8.14	8.18	7.93
Average Lending Rate (1)	**12.51**	**12.47**	**12.47**	**12.24**	**12.29**	**12.19**	**12.09**	**11.92**	**11.95**	**11.89**
Overdraft/loan	12.13	12.12	11.99	11.67	11.97	11.82	11.79	11.55	11.61	11.24
1-5years	12.70	12.64	12.67	12.50	12.44	12.35	12.20	12.06	12.09	12.07
Over 5years	12.49	12.46	12.46	12.29	12.28	12.16	12.11	11.96	11.95	11.98
Average Deposit Rate (2)	**7.22**	**7.19**	**6.98**	**7.11**	**7.07**	**7.06**	**7.07**	**7.01**	**6.96**	**6.86**
Demand	1.58	1.43	1.43	1.52	1.46	1.42	1.52	1.34	1.38	1.47
0-3months	7.62	7.55	7.42	7.60	7.39	7.40	7.42	7.33	7.20	7.11
Over 3months	7.43	7.53	7.23	7.50	7.52	7.53	7.56	7.53	7.57	7.40
Savings	5.05	4.77	4.58	4.02	4.25	4.20	4.15	4.21	4.18	4.15
Spread (1-2)	**5.29**	**5.28**	**5.48**	**5.14**	**5.22**	**5.13**	**5.02**	**4.92**	**4.99**	**5.02**

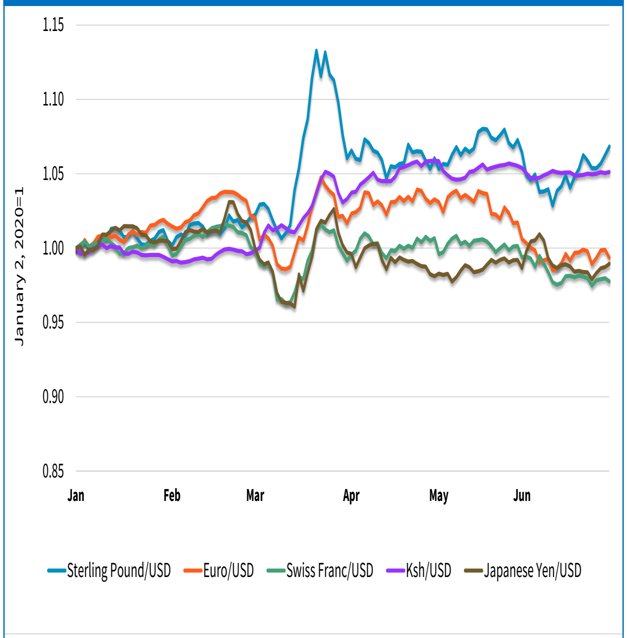
Source: Central Bank of Kenya

The CBK continued to strengthen the sector especially implementation of the Banking Sector Charter instituted in 2019 and strengthening of Credit Information Sharing System (CIS) to enhance consumer protection for borrowers, expand sources of information and ensure the sustainability of the CIS as a key tool to bridge the information gap about the borrower's creditworthiness. Additionally, the CBK instituted measures to ensure that the sector remained resilient despite the threats posed by the pandemic. To this end, the Bank deployed a series of emergency measures to mitigate the health and economic effects of the pandemic. These measures were intended to encourage the use of digital financial platforms and mitigate the COVID-19 transmission risk posed by use of bank notes and coins, cushion borrowers and especially MSMEs through flexibility in loan repayments, loan provisioning and classification and suspension of negative credit listing, support operations of the financial institutions by ensuring adequate liquidity for both banks and borrowers, and ensure that the sector continued to operate smoothly during the pandemic period .

vi. Exchange Rates and Foreign Exchange Reserves

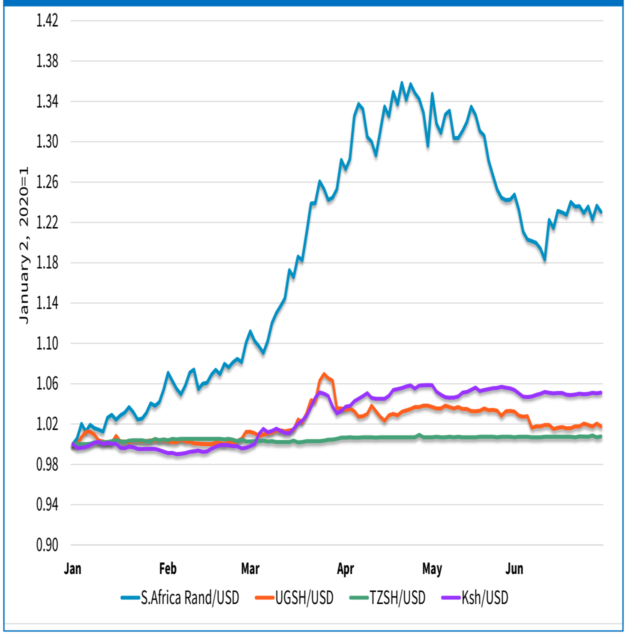
The Kenya foreign exchange market remained relatively stable supported by a narrowing current account deficit, balanced flows and an adequate reserve buffer. The Kenya shilling strengthened against the US dollar from an average of 102.52 per US dollar in the fourth quarter of 2019 to exchange at an average rate of 101.88 per US dollar in the first quarter 2020. However, with the onset of COVID-19, the US dollar strengthened leading to a weakening of currencies in emerging markets and developing economies. In tandem with this trend, the Kenya shilling gradually weakened before stabilizing by the end of the second quarter **(Charts 3a and 3b).**

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



Source: Central Bank of Kenya

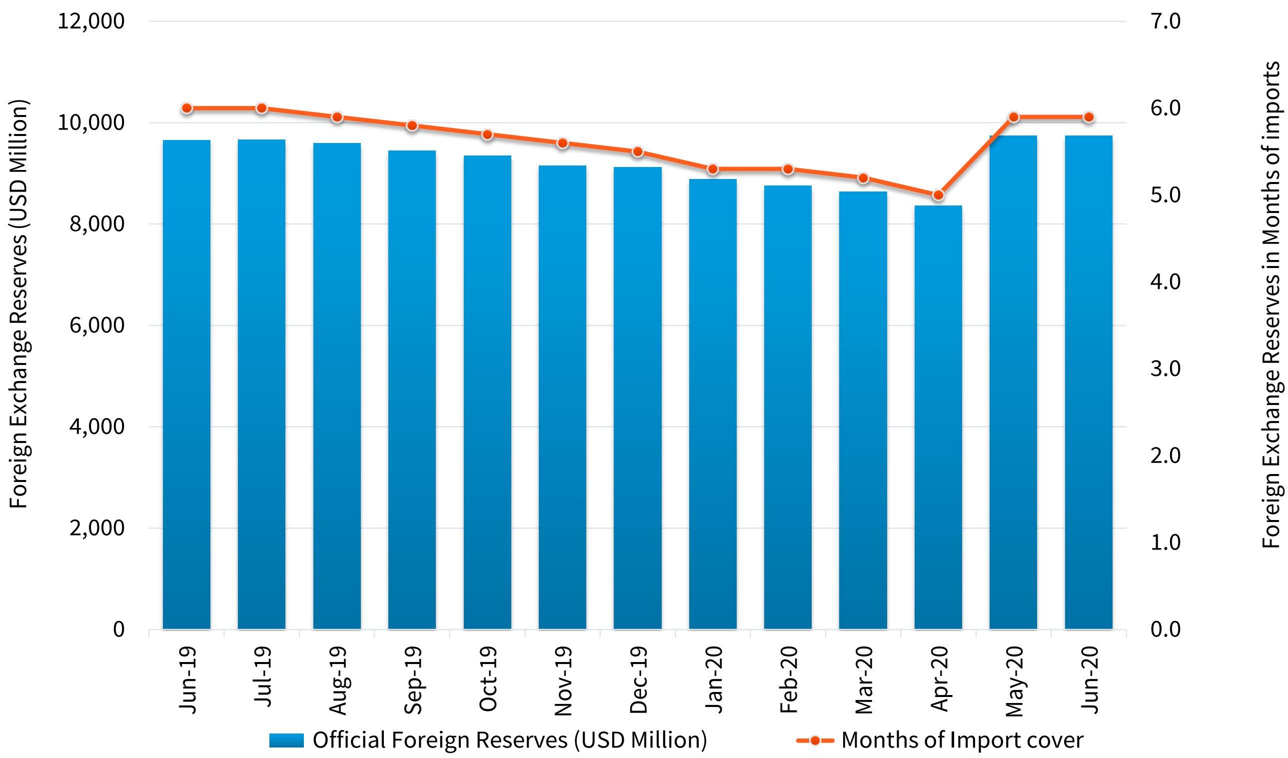
Chart 3b: Rate of Depreciation/ Appreciation of the Kenya Shilling and Regional Currencies against the U.S. Dollar



Source: Central Bank of Kenya

The official foreign exchange reserves remained significantly above the statutory requirement to endeavour to maintain at least 4.0 months of import cover and the EAC convergence criteria of 4.5 months of import cover. As at June 2020, official foreign exchange reserves stood at USD 9,740 million (5.9 months of import cover) compared to USD 9,116 million (5.5 months of import cover) in December 2019 **(Chart 3c).** These reserves continued to provide an adequate buffer against short-term shocks in the foreign exchange market.

Chart 3c: CBK Foreign Exchange Reserves



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

Source: Central Bank of Kenya

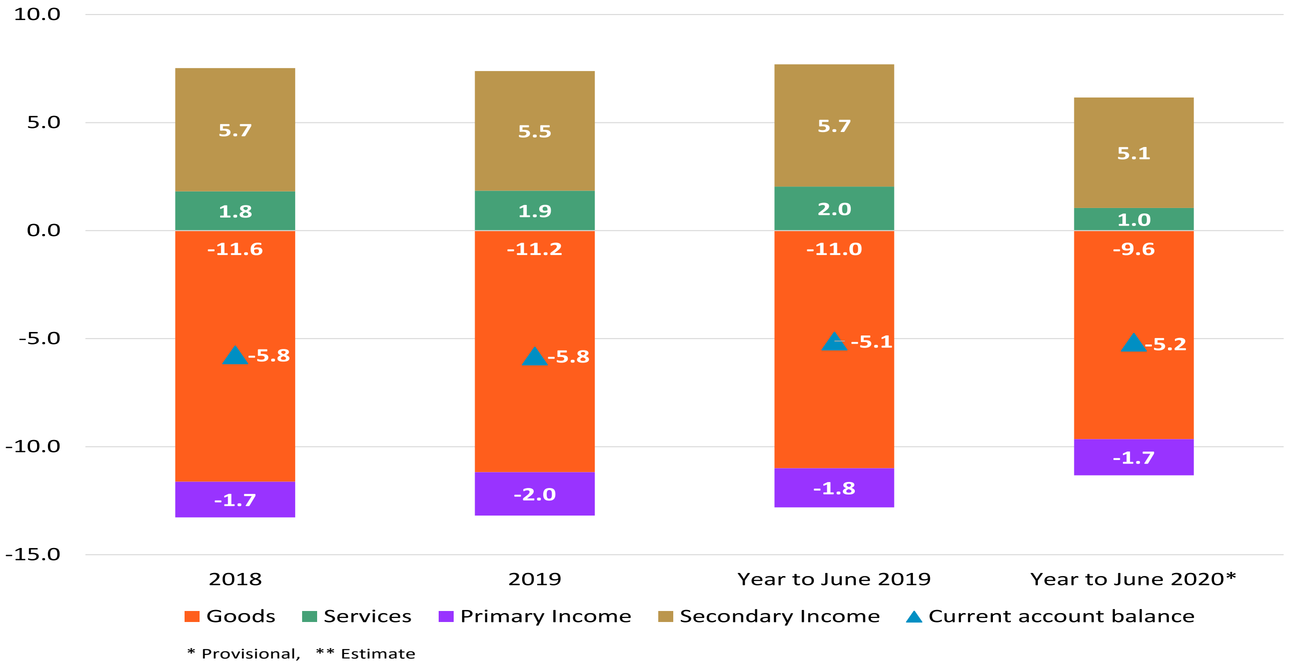
Note: The CBK usable foreign exchange reserves refer to reserves available for use without any restrictions. They exclude reserves held by CBK on behalf of the Government or commercial banks.

vii. Balance of Payments Developments

The current account deficit narrowed to 5.2 percent of GDP in the 12-months to June compared to 5.8 percent of GDP in December 2019. The improvement was recorded in the goods accounts **(Chart 4 and Table 4).**

The balance in the goods account improved to record a deficit of 9.6 percent of GDP, attributed to resilience in merchandise exports, especially tea and horticulture, and lower merchandise imports. Despite the impact of the pandemic, exports of goods have rebounded, growing by 1.7 percent in the first half of 2020 compared to a decline of 4.9 percent in a similar period in 2019. Receipts from tea exports over this period increased by 18.4 percent with increased production. Horticulture exports declined by 14.2 percent, largely reflecting the sharp contraction in flower exports in April. Since then, flower exports have recovered, reflecting increasing demand from key export markets with easing of restrictions and containment measures, and increased cargo space. Over the same period, imports declined by 14.0 percent largely due to decrease in oil and machinery and equipment. Analysis by direction of trade shows that Africa, especially the EAC and COMESA regions, and the EU were the main export markets. China and the EU were the main import sources **(Table 5).**

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



Source: Central Bank of Kenya

Table 4: Balance of Payments (Percent of GDP)

	2018 Act.	2019 Act.	Year to June 2019 Prov.	Year to June 2020 Prov.
1. Current account balance	**-5.8**	**-5.8**	**-5.1**	**-5.2**
1.1 Goods balance	**-11.6**	**-11.2**	**-11.0**	**-9.6**
Goods: Exports (fob)	6.9	6.1	6.4	6.0
o/w: Tea	1.6	1.2	1.3	1.2
Horticulture	1.1	1.0	1.1	0.9
Coffee	0.3	0.2	0.2	0.2
Other exports and re-exports	4.0	3.7	3.8	3.6
Goods: Imports (fob)	18.6	17.3	17.4	15.7
o/w: Oil	3.9	3.5	3.7	2.7
Machinery & transport equipment	5.2	4.9	4.8	4.4
Other imports	9.5	9.0	8.9	8.5
1.2 Services balance	**1.8**	**1.9**	**2.0**	**1.0**
Credit	6.2	5.9	6.2	4.9
o/w: Transportation	2.2	2.3	2.3	1.9
Travel	1.2	1.1	1.1	0.8
Debit	4.4	4.0	4.1	3.8
1.3 Primary Income, balance	**-1.7**	**-2.0**	**-1.8**	**-1.7**
Credit	0.2	0.2	0.2	0.2
Debit	1.9	2.2	2.1	1.9
1.4 Secondary Income, balance	**5.7**	**5.5**	**5.7**	**5.1**
Credit	5.8	5.6	5.7	5.2
o/w: Remittances	3.1	3.0	3.0	2.9
Debit	0.1	0.1	0.1	0.1
2. Capital Account balance	**0.3**	**0.2**	**0.2**	**0.1**
3. Financial Account balance	**-7.4**	**-6.5**	**-7.2**	**-4.7**
3.1 Foreign direct investment, balance	-1.3	-1.5	-1.5	-1.5
3.2 Portfolio investment, balance	1.4	-0.8	-0.8	-0.9
3.3 Other investment, balance	-5.2	-5.0	-5.4	-4.3

Source: Central Bank of Kenya

Table 5: Kenya's Direction of Trade

IMPORTS	(in millions of US dollars)		Share of Imports (%)		EXPORTS	(in millions of US dollars)		Share of Exports (%)	
	Year to June		Year to June			Year to June		Year to June	
Region/Country	2019	2020	2019	2020	Region/Country	2019	2020	2019	2020
Africa	**2,046**	**1,925**	**13.2**	**12.4**	**Africa**	**2,127**	**2,123**	**35.5**	**35.4**
Of which					*Of which*				
South Africa	679	547	3.9	3.2	Uganda	611	617	10.8	10.9
Egypt	369	419	2.1	2.4	Tanzania	298	292	5.0	4.9
Other Africa	998	959	5.8	5.6	Egypt	195	201	3.2	3.3
					South Sudan	118	116	2.0	1.9
EAC	**564**	**564**	**3.3**	**3.3**	Somalia	145	138	2.4	2.3
COMESA	**1,080**	**1,088**	**6.3**	**6.3**	DRC	150	148	2.5	2.5
Rest of the World	**15,154**	**14,149**	**88.1**	**82.3**	Rwanda	182	183	3.0	3.1
Of which					Other Africa	430	429	7.2	7.1
India	1,782	1,766	10.4	10.3					
United Arab Emirates	1,528	1,169	8.9	6.8	**EAC**	**1,284**	**1,282**	**21.4**	**21.4**
Japan	1,017	893	5.9	5.2	**COMESA**	**1,464**	**1,479**	**24.4**	**24.7**
USA	526	555	3.1	3.2	**Rest of the World**	**3,872**	**3,830**	**64.5**	**63.8**
United Kingdom	330	293	1.9	1.7	*Of which*				
Germany	449	407	2.6	2.4	United Kingdom	406	409	6.8	6.8
Saudi Arabia	1,587	915	9.2	5.3	Netherlands	469	453	7.8	7.6
Indonesia	508	580	3.0	3.4	USA	498	511	8.3	8.5
Netherlands	309	212	1.8	1.2	Pakistan	514	514	8.6	8.6
France	246	229	1.4	1.3	United Arab Emirates	356	339	5.9	5.7
Italy	218	203	1.3	1.2	Germany	113	111	1.9	1.9
Others	3,279	3,496	19.1	20.3	Others	1,384	1,348	23.1	22.5
Total	**17,201**	**16,073**	**100**	**100**	**Total**	**5,998**	**5,953**	**100**	**100**
EU	2,225	2,066	12.9	12.9	EU	1,312	1,292	21.9	21.7
China	3,373	3,430	19.6	21.3	China	131	144	2.2	2.4

Source: Central Bank of Kenya

The narrowing of the current account deficit was also supported by improvement in secondary income balance, particularly remittances. Remittances remained strong in the year to June and are estimated at 2.9 percent of GDP. They rose to USD 288.5 million from USD 258.2 million in May. Despite the effects of COVID-19, remittances were higher by 0.9 percent in the period January to June 2020 than in a similar period in 2019. However, services account balance declined from 2.0 percent of GDP to 1.0 percent of GDP. In the first half of 2020, services receipts declined by 20.0 percent reflecting the weakness in tourism and air transportation.

viii. Economic Growth

The Kenyan economy remained resilient in the first quarter of 2020. Real GDP grew by 4.9 percent, mainly supported by agricultural production. Leading economic indicators for the second quarter point to continued strong performance in agriculture, mainly due to favourable weather conditions and the lifting of restrictions in the key export markets. However, against a backdrop of severe disruptions from the COVID-19 containment measures, the services sector remained subdued, particularly hotels and restaurants, and the education sector **(Table 6 and Chart 5).**

ix. Domestic Government Borrowing

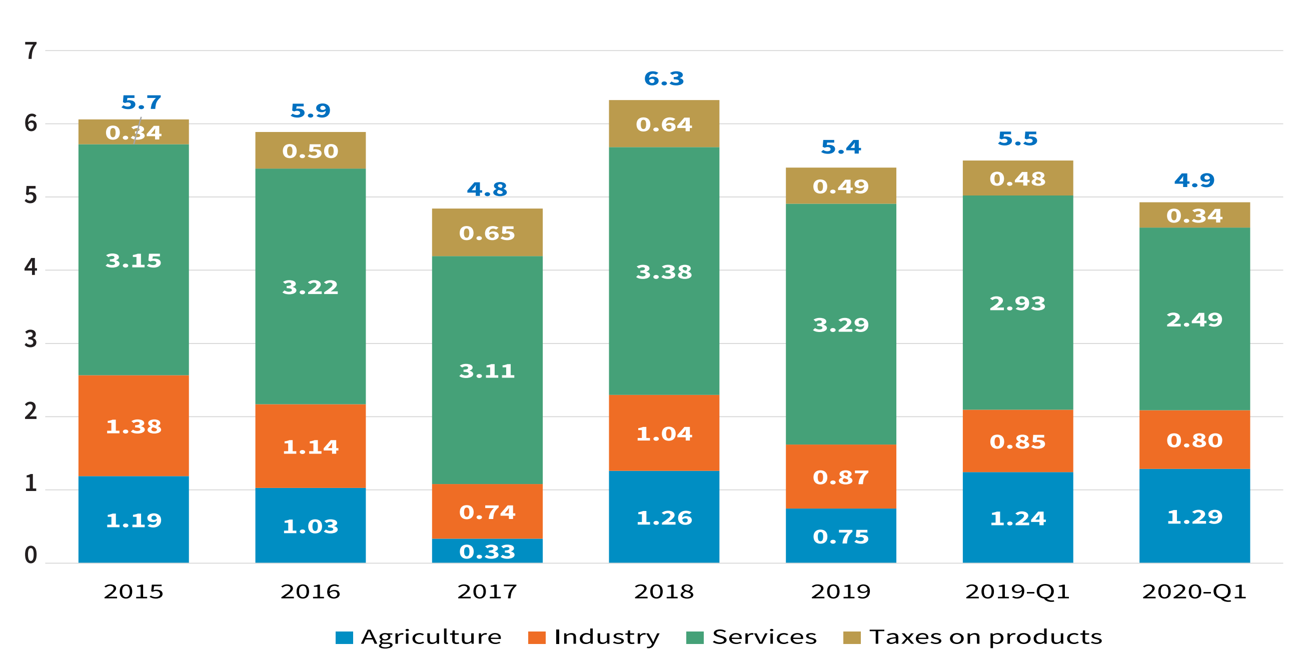
The coordination between monetary and fiscal policies continued to support macroeconomic stability. The Government's borrowing plan in the second half of the FY2019/20 ensured that the build-up in domestic debt was consistent with the thresholds set in the Medium-Term Debt Management Strategy. The Government continued to review its borrowing plan in line with market conditions and prudent budget management that focused on rationalisation of expenditures and strengthening of revenue collection measures.

Table 6: Kenya's Real GDP Growth across the Main Sectors (Percent)

Main Sectors	2015	2016	2017	2018	2019	2019 Q1	2020Q1
1. Agriculture	5.3	4.7	1.6	6.0	3.6	4.7	4.9
2. Non-Agriculture (o/w)	5.8	6.2	5.7	6.4	5.9	5.8	4.9
2.1 Industry	7.3	5.9	3.9	5.5	4.7	4.7	4.4
Manufacturing	3.6	3.1	0.7	4.3	3.3	3.5	2.9
Electricity & water supply	8.5	8.4	7.0	8.0	7.0	7.8	6.3
Construction	13.8	9.9	8.4	6.9	6.4	6.1	5.3
2.2 Services	6.0	6.8	6.5	7.0	6.7	6.5	5.5
2.3 Taxes on products	2.8	4.4	5.7	5.6	4.4	4.7	3.4
Real GDP	**5.7**	**5.9**	**4.8**	**6.3**	**5.4**	**5.5**	**4.9**

Source: Central Bank of Kenya

Chart 5: Contributions to Real GDP Growth (percent)



Source: Central Bank of Kenya

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

The MPC members held virtual stakeholder meetings with the Chief Executives of commercial and microfinance banks in order to apprise them on the background to its decisions. The MPC also continued to improve on the scope and information gathering processes through the Market Perception Surveys, and communication with key stakeholders to obtain feedback on its decisions.

In addition, the Chairman of the MPC held virtual press conferences after each MPC meeting to brief the media on measures undertaken by the CBK to support macroeconomic stability as well as mitigate the impact of COVID-19 on the economy. The MPC Chairman also held virtual meetings with various potential investors to brief them on economic developments and the outlook for the economy. The Committee monitored the implementation of the Committee's policy decisions by the Monetary Policy Management Committee of the Bank, and continued to interact with other government agencies such as the National Treasury and KNBS on various data issues.

3. POLICY RESPONSES TO COVID-19 (CORONAVIRUS) PANDEMIC

The first COVID-19 case in Kenya was confirmed on March 13, 2020 and the Central Bank of Kenya (CBK) immediately took a frontline position in ensuring that the Kenyan financial sector remained resilient despite the threats posed by the pandemic. CBK immediately instituted a series of emergency measures to mitigate the health and economic effects of the pandemic. These measures can be grouped into five categories as follows:

i. Measures to encourage use of digital finance:

The first series of emergency measures were announced on March 16, 2020 by CBK in conjunction with commercial banks and Payment Service Providers. These were intended to encourage the use of digital financial platforms and mitigate the COVID-19 transmission risk posed by use of bank notes and coins. The measures included elimination of charges for mobile money transactions under KSh 1,000, and transfers between banks accounts and mobile e-wallets. CBK also increased daily mobile money transaction limits from KSh 70,000 to KSh 150,000.

Implementation of the measures has resulted in a significant increase in the use of mobile money channels by individuals in both value and number of transactions. Most of the increase was in low-value transactions of KSh 1,000 or less—this band accounts for over 80 percent of mobile money transactions. The elimination of charges helped cushion the most vulnerable households. Moreover, more than 1.6 million additional customers are now using mobile money channels. These measures were timely and highly effective in facilitating official and personal transfers at a time of great need.

ii. Affordable credit

On March 23 and April 29 the MPC lowered the Central Bank Rate to signal the banking sector to lower lending and deposit rates. By end June, the average commercial banks' lending rates had fallen to 11.89 percent, a 16- year low, supporting provision of affordable credit to Kenyans.

iii. Banking sector measures

The emergency measures announced by CBK on March 18, 2020 on restructuring personal/household and other loans by banks were effective. As at June 30, the repayment period of personal/household loans amounting to KSh 240 billion or 30 percent of the banking sector personal/household gross loans had been extended. For other sectors, a total of KSh 604 billion had been restructured as at end June. The sectors that had recorded the highest levels of restructuring were Trade (23.5 Percent), Real Estate (20.5 percent), Transport and Communication (12.4 percent) and Manufacturing (11.4 percent). These are the sectors that bore the brunt of the slowdown occasioned by the pandemic. Total loans restructured of KSh 844 billion accounted for 29 percent of the total banking sector loan book of KSh 2.9 trillion.

iv. Measures to support operations of the financial institutions

The CBK also implemented measures to support operations of the financial institutions by ensuring adequate liquidity for both banks and borrowers. These included the lowering of the Cash Reserve Ratio (CRR) from 5.25 percent to 4.25 percent on March 23 which provided additional liquidity of KSh 35 billion to support the banks as they restructured performing loans adversely impacted by COVID-19. Additionally, the maximum tenor of Repurchase Agreements (REPOs) was extended from 28 to 91 days. This provided flexibility on liquidity management facilities provided to banks by CBK by enabling banks to access longer term liquidity secured on their holdings of government securities without having to discount them.

v. Measures to support business continuity and enhance resiliency of the financial sector

The banking sector activated business continuity measures, which included: creating two alternate teams; creating redundant teams for all critical functions and ensuring that the teams were facilitated to undertake requisite functions; ensuring that alternate recovery sites are ready; updating Business Continuity Plans (BCPs); and reporting to CBK when they invoke their BCPs and any incident relating to the pandemic affecting their staff members/premises. As a result, the banking sector continued to operate smoothly during the pandemic period serving customers both from branches and digital channels. While ensuring the health and safety of customers and staff, over 90 percent of the approximately 1,500 bank branches across the country remained open. The over 30,000 bank staff were in the frontline serving Kenyans even in areas locked down to contain the pandemic.

4. THE ECONOMIC ENVIRONMENT AND OUTLOOK FOR FY 2020/21

i. International Economic Environment

The COVID-19 pandemic has adversely affected the global economy. This has plunged the global economy into a severe recession akin to the great depression of 1930s. Consequently, the International Monetary Fund (IMF) has projected a contraction of global output by 4.9 percent in 2020 compared to a growth of 2.9 percent in 2019.

Advanced economies are expected to contract by 8.0 percent in 2020 from a growth of 1.7 percent in 2019. The US and the Euro area are projected to contract by 8.0 percent and 10.2 percent in 2020 from a growth of 2.3 percent and 1.3 percent, respectively. Similarly, emerging market and developing economies (EMDEs), which grew by 3.7 percent in 2019, are projected to contract by 3.0 percent in 2020. China is projected to grow by 1.0 percent in 2020 compared to 6.1 percent in 2019, while India would contract by 4.5 percent in 2020 after growing by 4.2 percent in 2019. Sub-Saharan African is projected to contract by 3.2 percent in 2020 compared to growth of 3.1 percent in 2019. Nigeria and South Africa, the main drivers of African growth, are projected to contract by 8.0 percent and 5.4 percent, respectively, in 2020 **(Table 7).**

Global trade is expected to decline by 11.9 percent in 2020. Furthermore, tighter external financial conditions triggered sudden capital outflows from EMDEs with sharp currency depreciations. The commodity and oil markets have also been negatively impacted, experiencing significant reduction in prices in the first half of 2020. However, prices have gained some recovery with the global oil prices stabilizing at about US dollar 40 per barrel in the second quarter of 2020. Global financial conditions are also expected to ease as economies continue to lift COVID-19 related restrictions.

The key downside risks to the global economy, which could worsen the outlook, include resurgence of new infections and re-imposition of containment measures, escalation of the US-China tensions

Table 7: Growth Performance and Outlook for the Global Economy (Percent)

Region/Country	2017 Act.	2018 Act.	2019 Act.	2020 Proj.	2021 Proj.
World Output	**3.7**	**3.6**	**2.9**	**-4.9**	**5.4**
Advanced Economies	**2.4**	**2.2**	**1.7**	**-8.0**	**4.8**
United States	2.3	2.9	2.3	-8.0	4.5
Euro Area	2.4	1.9	1.3	-10.2	6.0
Japan	1.7	0.3	0.7	-5.8	2.4
United Kingdom	**1.7**	**1.3**	**1.4**	**-10.2**	**6.3**
Emerging Market and Developing Economies	**4.7**	**4.5**	**3.7**	**-3.0**	**5.9**
China	6.9	6.7	6.1	1.0	8.2
India	6.7	6.1	4.2	-4.5	6.0
Brazil	1.0	1.3	1.1	-9.1	3.6
Russia	1.5	2.5	1.3	-6.6	4.1
Sub Sahara Africa	**2.8**	**3.2**	**3.1**	**-3.2**	**3.4**
South Africa	1.3	1.9	2.2	-5.4	2.6
Nigeria	0.8	0.8	0.2	-8.0	3.5

Source: IMF, World Economic Outlook

and disagreements among the OPEC+ countries. However, should a vaccine be found and recovery take a shorter time than anticipated, the global economy could rebound in the last quarter of 2020 and beyond.

ii. Domestic Economic Environment

Real GDP growth is expected to decline in 2020, following the COVID-19 pandemic. Economic activity was subdued during the first half of 2020 especially during the second quarter due to the impact of COVID-19 containment measures on service sectors. However, the economy is expected to recover during the second half with the easing of COVID-19 restrictions, normalisation of exports, and government interventions to mitigate the impact of the pandemic. Consequently, growth is projected to slow down from 5.5 percent in 2019 to 1.3 percent in 2020, and then rebound to 6.4 percent in 2021.

The macroeconomic environment is expected to remain stable, with overall inflation remaining within the medium term target range (5 percent with a margin of 2.5 percent on either side). The exchange rate is expected to be relatively stable, reflecting further improvement in the current account and adequate foreign reserves. The 12-month current account deficit is projected at 5.1 percent of GDP in 2020 and 2021 on the back of the rebound in export earnings (horticulture, tea), resilience in remittances, and a lower import bill particularly oil. Services receipts remain subdued due to weaknesses in international travel and transport.

5. DIRECTION OF MONETARY POLICY IN THE FY 2020/21

Price stability will be the overriding objective of monetary policy during the FY2020/21. Additionally, monetary policy will support economic recovery in the post COVID-19 period. The monetary targets for the FY2020/21 are therefore consistent with Government policy objectives articulated in the Medium-Term Government Budget Policy Statement for 2020 published by the National Treasury.

The monetary targets for the period are presented in (**Table 8).** Monetary policy will aim at containing the annual growth in broad money (M3) at about 11.4 percent between September 2020 and June 2021. Growth in private sector credit is expected to pick up from 7.7 percent in June to 9.8 percent by December and 11.4 percent by June 2021. Growth in reserve money is projected to decline by 4.0 percent by December, before rising to 10.2 percent by June 2021. The imminent operationalisation of the Credit Guarantee Scheme for the vulnerable Micro Small and Medium sized Enterprises (MSMEs), will de-risk lending by commercial banks, and is critical to increasing credit to this sector.

The CBK foreign exchange reserves are projected at US$ 9,514 million (about 5.7 months of import cover) by June 2021 compared to 9,740 million in June 2020, consistent with positive outlook of the Balance of Payments. This level of reserves will continue to provide a buffer against short-term shocks in the foreign exchange market. The coordination of monetary and fiscal policies will support macroeconomic stability. In this regard, the monetary outlook has taken into account net domestic financing amounting to Ksh 494.3 billion (4.4 percent of GDP) and external commercial borrowing of KSh 347 billion in line with the budget.

The monetary projections are subject to risks emanating from both the domestic and global fronts. Following subdued revenue collections and expenditure pressures due to impact of the pandemic that may result in government temporarily operating outside the domestic borrowing target while the predictability of money demand continues to be affected by continued innovations in the financial sector. On the external front, the key downside risks include: uncertainty about the evolution of COVID-19 and the possible reintroduction of containment efforts due to occurrence of a second wave, volatility in international oil prices, volatility in the global financial markets and resurgence of trade war between US and China. These have implications for emerging and developing economies.

Consequently, developments in the monetary targets will be closely monitored in light of these risks, in order to provide necessary reviews to inform the decision making process in the Bank. Additionally, the CBK will continue to monitor the economic impact of COVID-19 and the outcomes of policy measures in place as well as other developments in the domestic and global economies to safeguard price stability.

Table 8: Monetary Targets for the FY 2020/21

	Sep-20	Dec-20	Mar-21	Jun-21
Broad Money, M3 (Ksh Billion)	3,849.1	3,897.6	4,068.7	4,303.0
Reserve Money, RM (Ksh Billion)	447.9	479.4	474.7	470.5
Credit to Private Sector (Ksh Billion)	2,791.3	2,848.9	2,923.6	3,003.7
NFA of CBK (Ksh Billion)	812.2	752.9	661.9	869.4
NDA of CBK (Ksh Billion)	-364.4	-273.4	-187.1	-398.9
12-month growth in RM (Percent)	9.8	4.0	6.6	10.2
12-month growth in M3 (Percent)	10.8	10.6	11.1	11.4
12-month growth in Credit to Private Sector (Percent)	8.5	9.8	9.9	11.5
12-month overall Inflation (Percent)	5.0	5.0	5.0	5.0

Source: Central Bank of Kenya

EVENTS OF PARTICULAR RELEVANCE TO MONETARY POLICY (JANUARY - JUNE, 2020)

January	The MPC lowered the CBR to 8.25 percent from 8.50 percent to continue anchoring inflation expectations and support economic activity.
March	In order to prevent the COVID-19 health crisis becoming a severe economic and financial crisis, the MPC decided on the following policy actions: a) To lower the CBR to 7.25 percent from 8.25 percent. b) To reduce the Cash Reserve Ratio (CRR) to 4.25 percent from 5.25 percent, releasing K.35.2 billion as additional liquidity availed to banks to directly support borrowers that are distressed as a result of COVID-19.
	Extension of the maximum tenor of Repurchase Agreements (REPOs) was extended from 28 to 91 days. This provided flexibility on liquidity management facilities provided to banks by CBK by enabling banks access longer term liquidity secured on their holdings of government securities without having to discount them.
	The CBK announced emergency measures to enhance the usage of mobile money transactions, in particular to facilitate official and personal transfers to vulnerable households.
	CBK provided flexibility to banks with regard to requirements for loan classification and provisioning for loans that were performing on March 2, 2020 and whose repayment period was extended or were restructured due to the pandemic.
April	The MPC augmented its accommodative monetary policy stance by lowering the CBR to 7.00 percent from 7.25 percent.
May	The MPC decided that the accommodative monetary policy stance remained appropriate and retained the CBR at 7.00 percent.
June	The MPC retained the CBR at 7.00 percent.

GLOSSARY OF KEY TERMS

OVERALL INFLATION

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

RESERVE MONEY

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

MONEY SUPPLY

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

Narrow Money

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

Broad Money

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

Extended Broad Money

M3: M2 + residents' foreign currency deposits.

Overall Liquidity

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

Central Bank of Kenya

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