Central Bank of Kenya

Twenty Seventh Bi-Annual Report of the Monetary Policy Committee

October 2021

LETTER OF TRANSMITTAL

In accordance with Section 4D 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 27th Monetary Policy Committee Report. The Report outlines the monetary policy formulation, developments in the key indicators of the economy, and other activities of the Committee in the six months to October 2021.

Patrick Njoroge

Dr. Patrick Njoroge

Governor

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EXECUTIVE SUMMARY

The twenty seventh bi-annual Report of the Monetary Policy Committee (MPC) reviews Kenya's monetary policy formulation and other developments that affected the economy in the six months to October 2021. Consistent with the price stability objective of the Central Bank of Kenya (CBK), the conduct of monetary policy during the period was aimed at maintaining inflation within the target range of 5± 2.5 percent.

Monetary policy was conducted in the context of the continuing recovery of the global economy supported by the deployment of vaccines, relaxation of COVID-19 containment measures, and strong policy measures. However, the pace of recovery of the global economy remained uneven across countries due to a resurgence of new COVID-19 variants. Inflation in some major economies and emerging markets rose sharply following increases in commodity prices particularly oil, the effect of fiscal stimulus, and supply chain bottlenecks.

The MPC published a White Paper on *Modernization of the Monetary Policy Framework and Operations* in July 2021, which outlines the reforms that would enhance the effectiveness of monetary policy and support anchoring of inflation expectations. These reforms entail: refining macroeconomic modelling and forecasting frameworks in line with changing structure of the economy, improving the functioning of the interbank market in order to strengthen monetary policy transmission and operations, and continued improvement of communication of monetary policy decisions.

The MPC held three meetings between May and October 2021, to review the outcome of its previous policy decisions and economic developments, and to put in place appropriate measures to maintain price stability. The Committee maintained an accommodative policy stance in the period. The MPC retained the Central Bank Rate (CBR) at 7.00 percent during the period, noting that inflation pressures had increased even as inflation expectations remained anchored within the target range in the medium term. The monetary policy stance together with CBK liquidity management ensured both price and market stability.

Overall inflation remained within the target range during the period. The inflation rate increased to 6.5 percent in October 2021 from 5.9 percent in May 2021, mainly driven by higher food and fuel prices, and the impact of tax measures. However, non-food-non-fuel (NFNF) inflation remained low and stable, indicating muted demand pressures in the economy. The NFNF inflation rate declined to 2.2 percent in October from 2.4 percent in May 2021. CBK continued to monitor the overall liquidity in the economy as well as any threats that could fuel demand driven inflationary pressures.

The economy rebounded strongly in the first half of 2021, following gradual normalization of economic activity, supported by easing of COVID-19 restrictions. Real GDP grew by 5.3 percent in the first half of 2021 compared with a contraction of 0.2 percent in a similar period in 2020. This performance was supported by recovery in the services sectors, including education, information and communication, wholesale and retail trade, transport and storage, and financial and insurance.

The foreign exchange market remained stable in the six months to October 2021, supported mainly by improvement in receipts from exports and strong remittances. The current account deficit widened to 5.6 percent of GDP in the 12 months to September compared to a deficit of 5.0 percent of GDP over a similar period in 2020. This mainly reflected an increase in imports particularly of oil and other intermediate goods which more than offset the increase in exports. Imports of oil increased following the rise in international oil prices with higher global demand as economies reopened amid supply disruptions. The CBK foreign exchange reserves which stood at USD 9,098 million (5.6 months of import cover) at the end of October, continued to provide adequate cover and buffer against short-term shocks in the foreign exchange market.

The banking sector remained stable and resilient. The average commercial banks' liquidity and capital adequacy ratios remained strong above the statutory requirements. The ratio of gross non-performing loans (NPLs) to gross loans stood at 13.6 percent in October, compared to 14.2 percent in April. Private sector credit growth remained resilient, supported by recovery in economic activities, the accommodative monetary policy stance and the implementation of the Credit Guarantee Scheme targeting Micro, Small and Medium sized Enterprises (MSMEs). The 12-month growth in private sector credit was 7.8 percent in October 2021, with strong growth recorded in credit to the manufacturing, transport and communication, finance and insurance, business services and consumer durables sectors.

The MPC held virtual meetings with CEOs of banks and members of the private sector after every meeting, to provide the background to its decisions and obtain feedback. The Governor's post-MPC media briefings provided the basis of policy decisions and updates on the economy. The meetings enhanced the public understanding of monetary policy formulation and implementation.

The Bank continued to monitor and remained vigilant to the risks posed by developments in the domestic and global environments, particularly the evolving COVID-19 pandemic, on the economy and the overall price stability objective.

1. DEVELOPMENTS IN THE GLOBAL ECONOMY

The global economic outlook improved in the six months to October 2021, mainly supported by the rollout of vaccines, reopening of economies and policy support. Major concerns around the world included increased uncertainties due to the emergence and spread of new COVID-19 variants, rising inflation, supply chain disruptions, unemployment rates, food insecurity, climate change, and rising global demand. According to the IMF World Economic Outlook (WEO) October 2021 update, global growth was projected at 5.9 percent in 2021 and 4.9 percent in 2022. This is marginally lower (0.1 percentage points) for 2021 compared to the July WEO Update. The revision was partly due to supply chain disruptions in advanced economies and slow pace of vaccine rollout in low income countries.

Growth in the advanced economies was expected to reach 5.2 percent in 2021 buttressed by vaccines roll out which is the effective mitigation measure for the pandemic. The projected growth in selected advanced economies in 2021 were: United States (6.0 percent), the United Kingdom (6.8 percent), Japan (2.4 percent), Spain (5.7 percent), France (6.3 percent), Italy (5.8 percent), and Germany (5.0 percent). Nonetheless, rising inflationary pressures in the U.S remained a major concern.

In the emerging markets, growth was expected to accelerate to 6.4 percent in 2021 supported by increasing vaccinations and effective COVID-19 containment measures. On the other hand, the growth forecast for China was 8.0 percent, a downgrade from the July WEO due to greater-than-anticipated reduction in public investment. Latin America's growth was projected to pick up to 6.3 percent, with growth for Brazil and Mexico projected at 5.2 percent and 6.2 percent, respectively. Growth in Sub-Saharan Africa (SSA) was expected at 3.7 percent in 2021, with Nigeria and South Africa growth rates projected to improve to 2.6 percent and 5.0 percent, respectively.

International oil prices continued to rise in the six months to October 2021, driven by increased demand as economies reopened, after the unprecedented decline in demand occasioned by the COVID-19 pandemic. Supply disruptions coupled with restrained production by OPEC and its partners (OPEC+) also contributed to rising global oil prices.

Looking ahead, the global economic outlook could be jeopardized by higher-than-expected inflation in the US and uncertainty about the duration of the pandemic. Additionally, vaccine unavailability and vaccine hesitancy which implies that there will be a large number of unvaccinated people for an extended period of time, could result in COVID-19 becoming endemic in the medium term. The existing US-China trade tensions could also pose a risk to global economic recovery.

2. DEVELOPMENTS IN THE KENYAN ECONOMY

2.1 Overall Economy

The Economic Survey 2021 with the rebased national accounts data indicates that the Kenyan economy contracted by 0.3 percent in 2020, reflecting the adverse effects of the COVID-19 pandemic. Following the containment measures imposed domestically and internationally to contain the spread of the disease, economic activity was disrupted, particularly in the services sectors. Key sectors affected include wholesale and retail trade, education, accommodation and restaurant, and transport and storage. However, the following sectors recorded positive growth rates: Agriculture (4.8 percent); Construction (11.8 percent); Health (6.7 percent); Real Estate (4.1 percent); Information and Communication (4.8 percent), and Financial and Insurance (5.6 percent).

The economy rebounded strongly in the first half of 2021, following gradual normalization of economic activity supported by the easing of COVID-19 restrictions. Real GDP grew by 5.3 percent in the first half of the year compared with a contraction of 0.2 percent in a similar period in 2020 **(Table 1)**. The second quarter recorded the strongest rebound, growing by 10.1 percent compared to a contraction of 4.7 percent in a similar quarter last year. The recovery in the economy was mainly supported by recovery in the services sectors, including education, information and communication, wholesale and retail trade, transport and storage, and financial and insurance. The strong recovery is expected to continue into the second half of the year.

The main upside risks to growth are the full reopening of the domestic economy following the lifting of the dusk to dawn curfew in October, as well as the continued vaccination drive which is expected to hasten the normalisation of economic activity. The domestic economy also continues to benefit from the ongoing Government COVID-19 economic recovery plan. In addition, the continued easing of travel restrictions in Europe and US is expected to boost tourism. However, the downside risks to growth remain significant, including protracted waves of infections leading to widespread and prolonged lockdowns both domestically and globally, uneven recovery within the global economy, and rising international oil prices.

Table 1: Real GDP growth (percent)

GROWTH RATES	2020				2020	2021		2020H1	2021H1
	Q1	Q2	Q3	Q4	Annual	Q1	Q2		
Agriculture	**4.3**	**4.9**	**4.2**	**5.8**	**4.8**	**-0.1**	**-0.9**	**4.6**	**-0.5**
2. Non-Agriculture (o/w)	**4.4**	**-7.2**	**-3.4**	**0.3**	**-0.7**	**1.0**	**13.3**	**-1.5**	**6.9**
2.1 Industry	**4.8**	**-0.3**	**3.5**	**7.8**	**4.0**	**4.4**	**8.5**	**2.3**	**6.4**
Mining & Quarrying	6.4	4.4	7.0	9.2	6.7	16.4	17.7	5.4	17.1
Manufacturing	2.2	-4.7	-1.7	3.8	-0.1	1.5	9.6	-1.2	5.4
Electricity & water supply	1.5	-4.7	0.2	3.5	0.1	2.0	5.2	-1.6	3.5
Construction	10.4	8.2	12.5	16.2	11.8	7.9	6.5	9.3	7.2
2.2 Services	**4.2**	**-7.1**	**-4.7**	**-0.9**	**-2.2**	**2.2**	**16.8**	**-1.5**	**9.2**
Wholesale & Retail Trade	4.9	-4.2	-5.0	2.6	-0.4	7.4	9.5	0.4	8.3
Accommodation & restaurant	-8.1	-56.8	-63.4	-62.2	-47.7	-48.8	9.1	-31.6	-31.1
Transport & Storage	2.2	-16.8	-10.1	-6.1	-7.8	-8.7	16.9	-7.4	2.9
Information & Communication	5.6	2.6	3.2	7.6	4.8	16.1	25.2	4.1	20.5
Financial & Insurance	7.5	4.4	3.0	7.4	5.6	9.4	9.9	5.9	9.7
Public administration	4.0	2.7	6.3	8.4	5.3	9.1	13.0	3.3	11.1
Professional, Administration & Support Services	0.3	-27.5	-19.7	-12.1	-15.0	-14.4	17.6	-14.1	-0.4
Real estate	5.4	4.6	3.7	2.7	4.1	4.5	4.9	5.0	4.7
Education	1.8	-22.4	-17.4	-5.3	-10.8	10.0	67.6	-10.2	34.6
Health	7.4	9.8	5.2	4.7	6.7	9.1	10.0	8.7	9.6
Other services	-1.5	-22.1	-12.9	-20.4	-14.2	-16.1	20.2	-11.8	-0.1
FISIM	-2.9	0.5	-2.3	-2.9	-2.0	0.3	-3.8	-1.2	-1.7
All Industries at basic prices	**4.3**	**-3.1**	**-1.5**	**2.0**	**0.4**	**2.1**	**10.9**	**0.6**	**6.4**
2.3 Taxes on products	**5.1**	**-20.8**	**-8.5**	**-6.4**	**-7.9**	**-14.5**	**0.5**	**-8.5**	**-7.7**
Real GDP Growth	**4.4**	**-4.7**	**-2.1**	**1.2**	**-0.3**	**0.7**	**10.1**	**-0.2**	**5.3**

Source: Kenya National Bureau of Statistics

2.2 Financial Market Developments

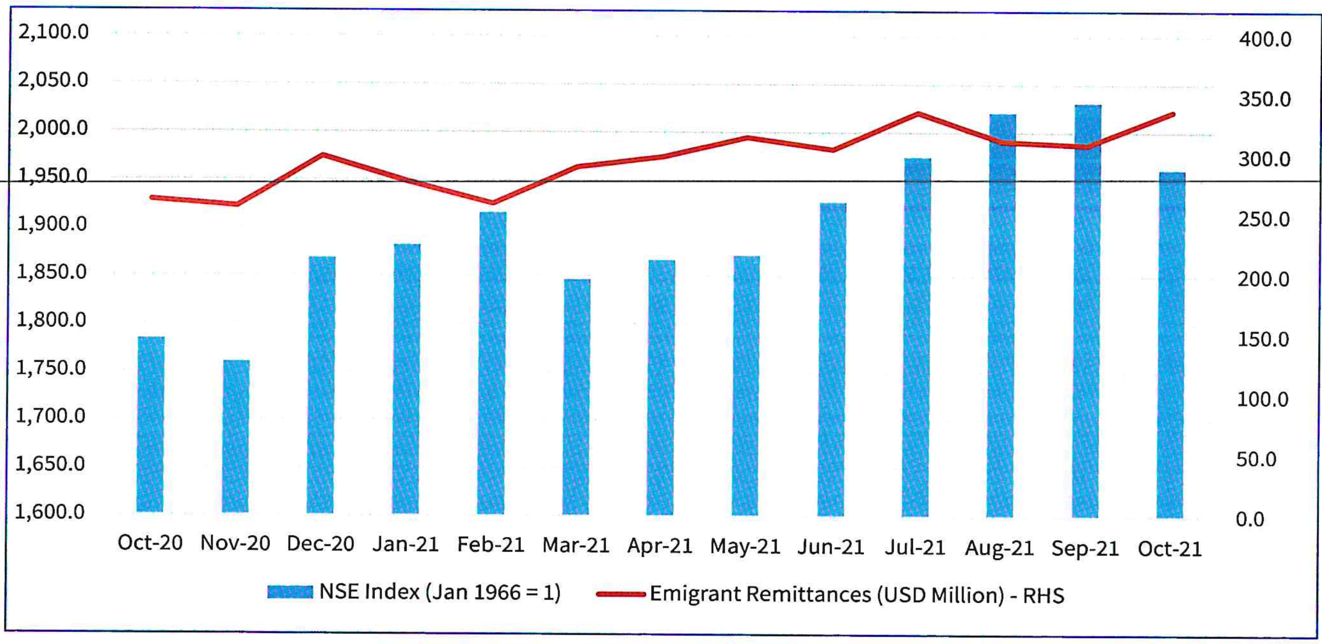
According to the IMF WEO October 2021, global economic recovery has continued despite a resurgence of the pandemic. The rapid spread of the Delta variant and the threat of new variants have increased uncertainty over how quickly the pandemic could be overcome. Policy choices in confronting multidimensional challenges (subdued employment growth, rising inflation, food insecurity, the setback to human capital accumulation, and climate change) have become more difficult with limited room to maneuver. Employment is generally expected to continue lagging recovery in output. In most cases, rising inflation reflects pandemic-related supply-demand mismatches and higher commodity prices compared to a year ago.

During the six months to October, the US dollar continued to appreciate, spurred by the June Federal Open Market Committee (FOMC) meeting when, against all expectations, the U.S. Federal Reserve turned more hawkish. Throughout the period, FOMC members continued to make the case for a tapering of asset purchases. The FOMC eventually announced tapering of asset purchases beginning November 2021. The Fed announced that it will reduce its buying of treasury and mortgage-backed securities each month by increments of USD10 billion and USD 5 billion, respectively.

The Euro continued to weaken throughout the period, trading at its lowest in mid-August, pressured mainly by the more hawkish tone adopted by the Federal Reserve during the June FOMC Meeting. The Sterling Pound appreciated during the period before correcting and reverting to its June levels. The Pound was bolstered temporarily at the beginning of August by heightened expectations that the Bank of England would raise the key policy rates in 2022, after a likely halt to asset purchases this year. The Sterling however had a sharp drop in October, with the Bank of England having opted to keep on hold the bank rate as well as its asset purchase programme.

In the domestic economy, diaspora remittances remained strong over the period **(Chart 1a)**. Similarly, activity at the Nairobi Securities Exchange (NSE) recovered with the pickup in economic activity as a result of the reopening of the economy. The NSE 20-Share index rose from 1,866.6 points in April 2021 to 2,031.2 and 1,961.3 points in September and October, respectively.

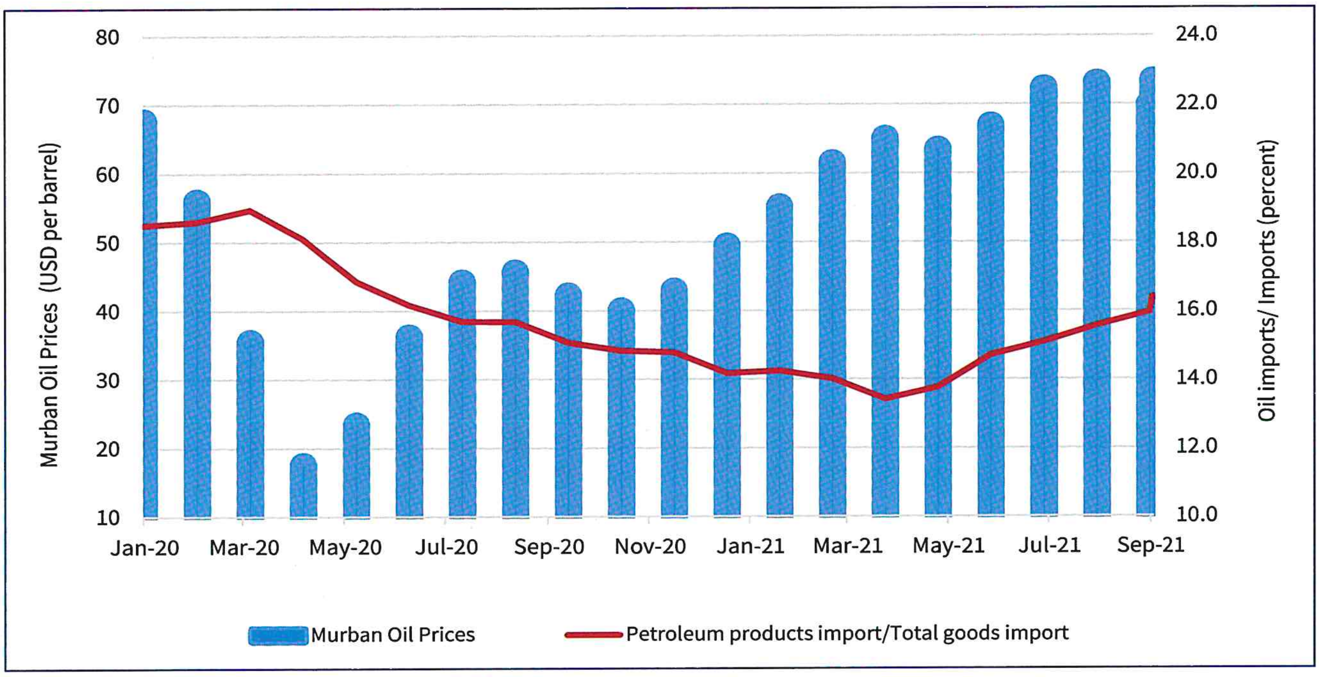
Chart 1a: Monthly Diaspora Remittances (USD Million) and NSE Index (Jan 1966=100)



Source: Central Bank of Kenya and Nairobi Securities Exchange

Developments in international oil prices have implications on the balance of payments position particularly when the proportion of imports of petroleum products in total imports is high. International oil prices rose in the six months to October 2021 driven by increased demand as economies reopened, after the unprecedented decline in demand occasioned by the COVID-19 pandemic. Supply disruptions coupled with restrained production by OPEC and its partners (OPEC+) also contributed to the rise in global oil prices **(Chart 1b)**.

Chart 1b: Murban Oil Prices and the ratio of 12-Month Cumulative Petroleum Product Imports to Total Imports of Goods (percent)



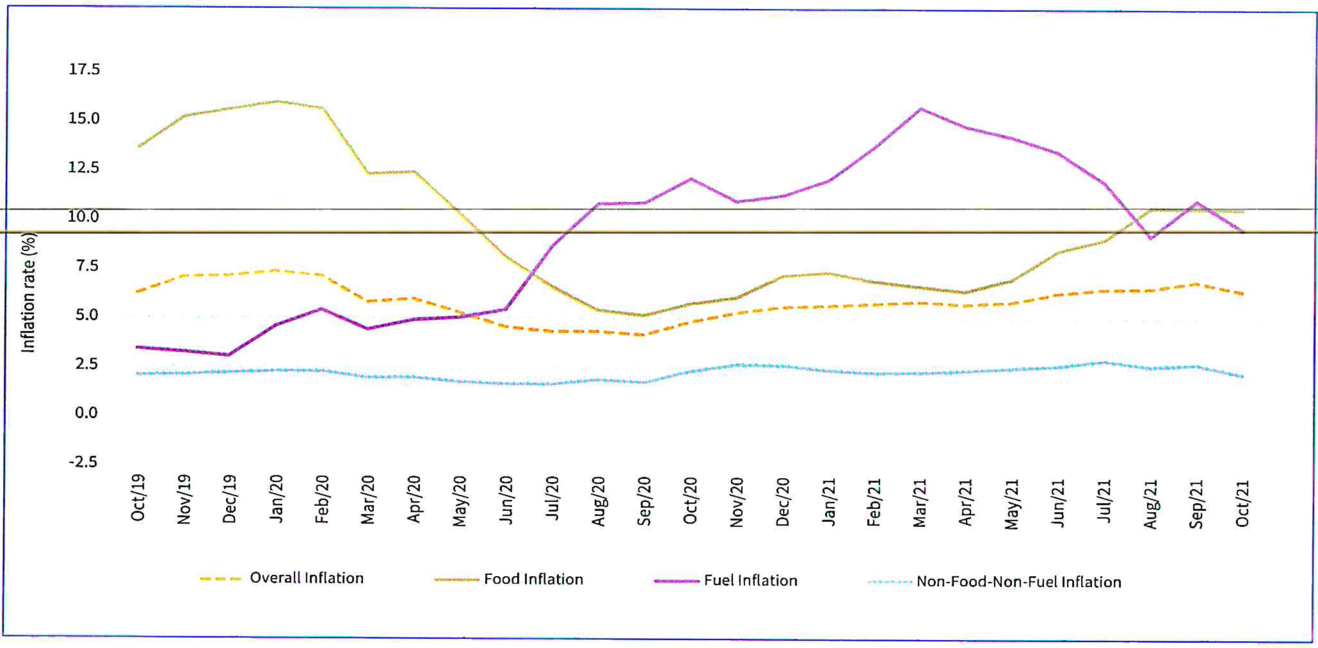
Source: Oil price.com and Kenya Revenue Authority

2.3 Developments in Key Economic Indicators

2.3.1 Inflation

Overall inflation remained within the target range during the six months to October 2021. The inflation rate increased to 6.5 percent in October 2021 from 5.9 percent in May 2021, mainly driven by higher food and fuel prices, and the impact of the recently implemented tax measures in the FY2021/22 Budget. Food inflation increased to 10.6 percent in October 2021 from 7.0 percent in May 2021. The increase was mainly on account of seasonal factors which affected supply of some vegetable food items, as well as international supply chain disruptions arising from the ongoing COVID-19 pandemic. However, fuel inflation declined to 9.6 percent in October from 14.4 percent in May, due to the downward adjustment of pump prices in October by the Energy and Petroleum Regulatory Authority (EPRA). Non-food-non-fuel inflation (NFNF)remained low and stable, reflective of muted demand pressures in the economy. The NFNF inflation rate declined to 2.2 percent in October from 2.4 percent in May **(Charts 2a)**.

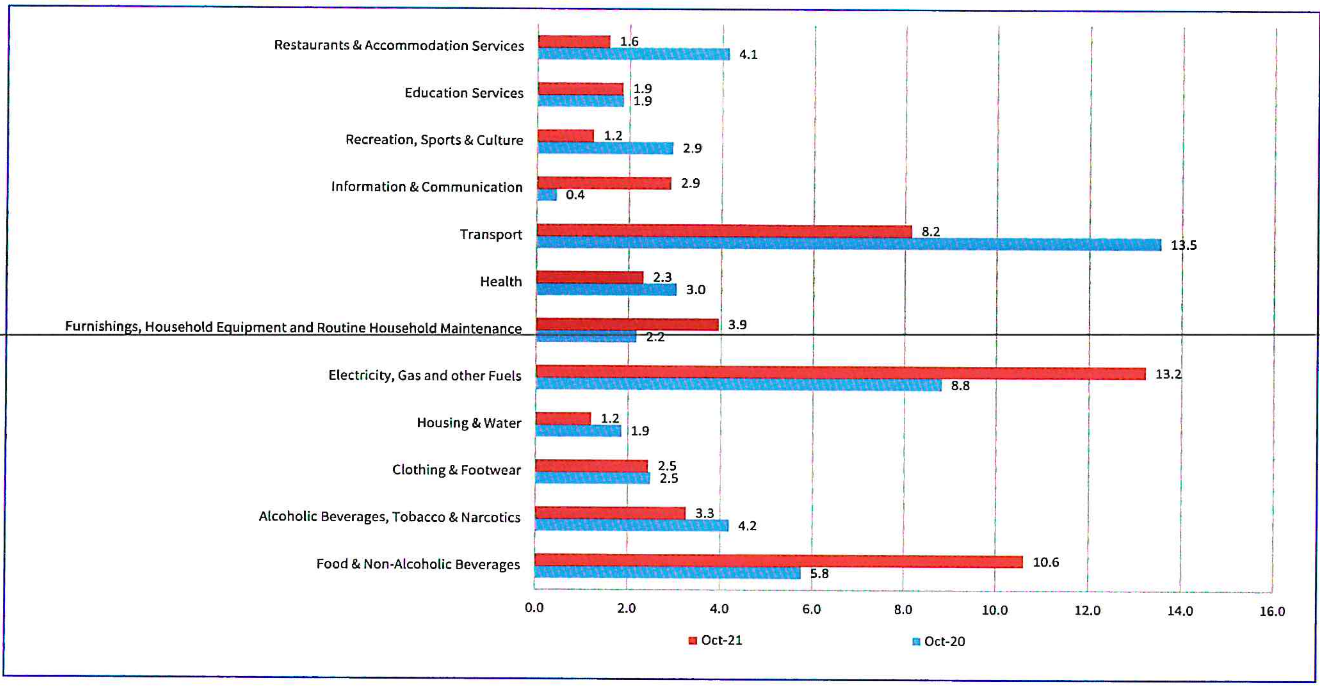
Chart 2a: Overall and Non-Food-Non-Fuel Inflation (percent)



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

Overall, the inflation of all broad categories in the CPI basket except Transport and Food and Non-alcoholic beverages were within the target range in October 2021 **(Chart 2b)**.

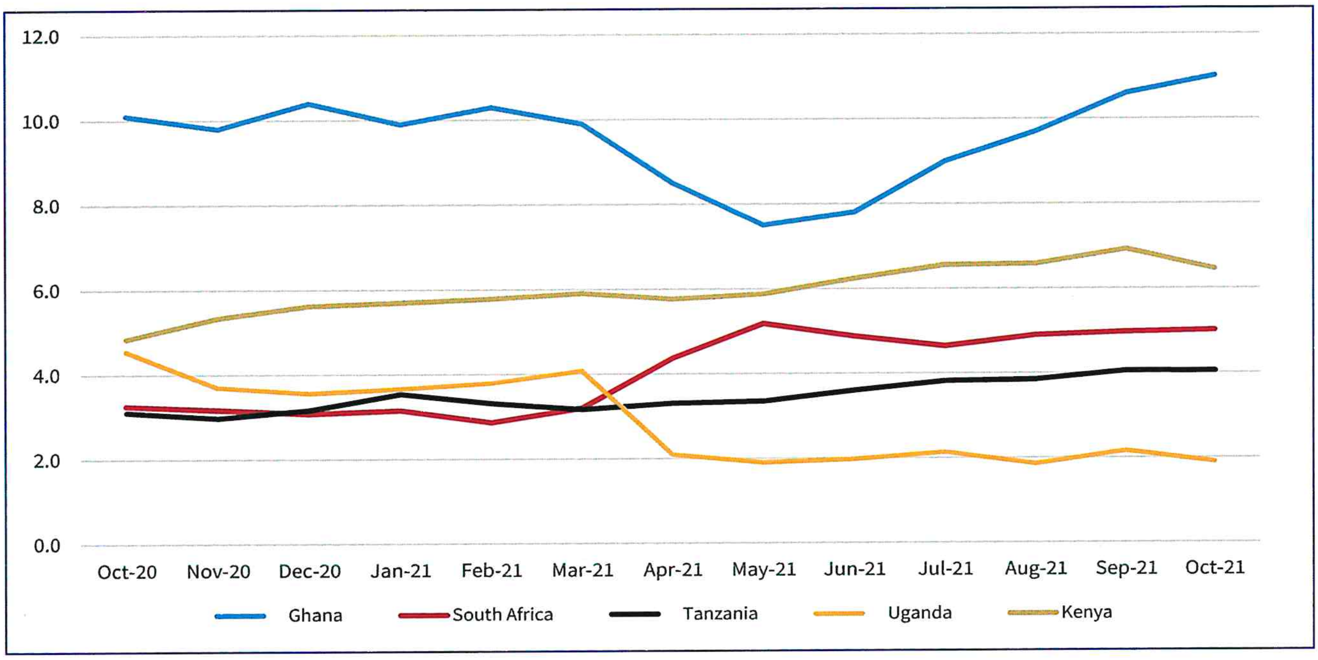
Chart 2b: 12-Month Inflation by Broad CPI Category (Percent)



Source: Central Bank of Kenya

The trend in the overall inflation rates in major East African Community (EAC) countries, as well as in Ghana and South Africa displayed similar patterns over the period **(Chart 2c)**. Food and energy prices were the main drivers of inflation in these countries.

Chart 2c: 12-Month Inflation in the Region (Percent)



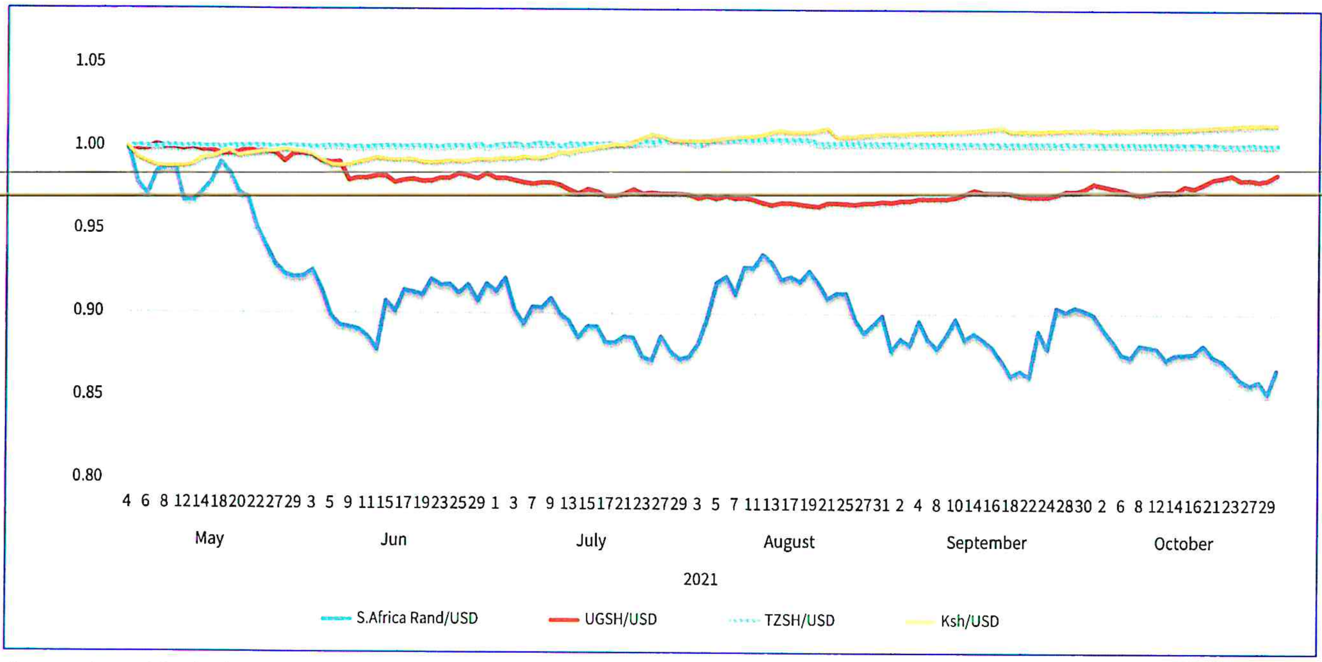
Source:Respective country central bank websites

2.3.2 Foreign Exchange Market Developments

The foreign exchange market remained relatively stable in the six months to October 2021, supported mainly by improvement in receipts from exports as well as resilient remittances. However, the rising import bill with regard to oil and other intermediate goods exerted moderate pressure. International oil prices rose sharply during the period with increased global oil demand. Diaspora remittances averaged USD 319.8 million per month in the six months to October 2021 compared to USD281.0 million per month in the six months to April 2021. The CBK foreign exchange reserves, which stood at USD 9,098 million (5.6 months of import cover) in October 2021, continued to provide adequate cover and a buffer against short-term volatility in the foreign exchange market.

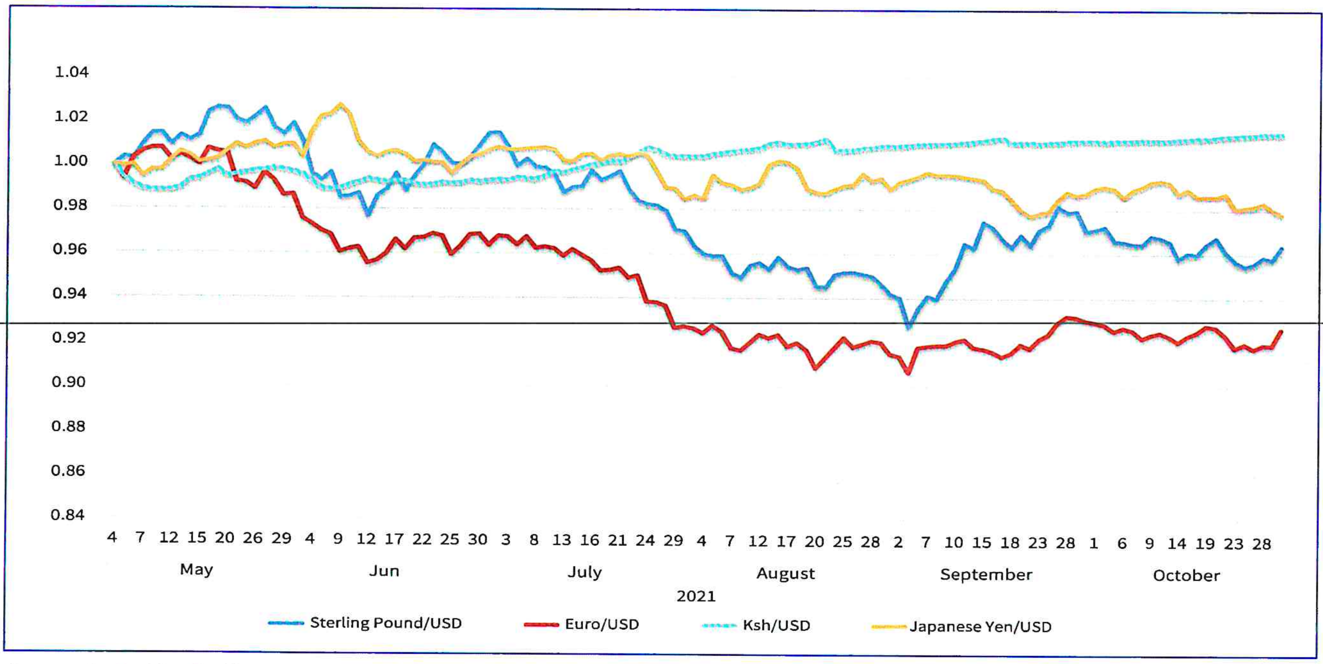
Global financial markets experienced volatility in July with the breakout of the Delta variant across countries posing a threat to continued global recovery. However, stability returned to the markets in subsequent months **(Charts 3a and 3b)**.

Chart 3a: Normalized Exchange Rates of the Kenya Shilling and Regional Currencies against the US Dollar (April 30, 2021 = 1)



Source: Central Bank of Kenya

Chart 3b: Normalized Exchange Rates of the Kenya Shilling and Major Currencies against the US Dollar (April 30, 2021 = 1)



Source: Central Bank of Kenya

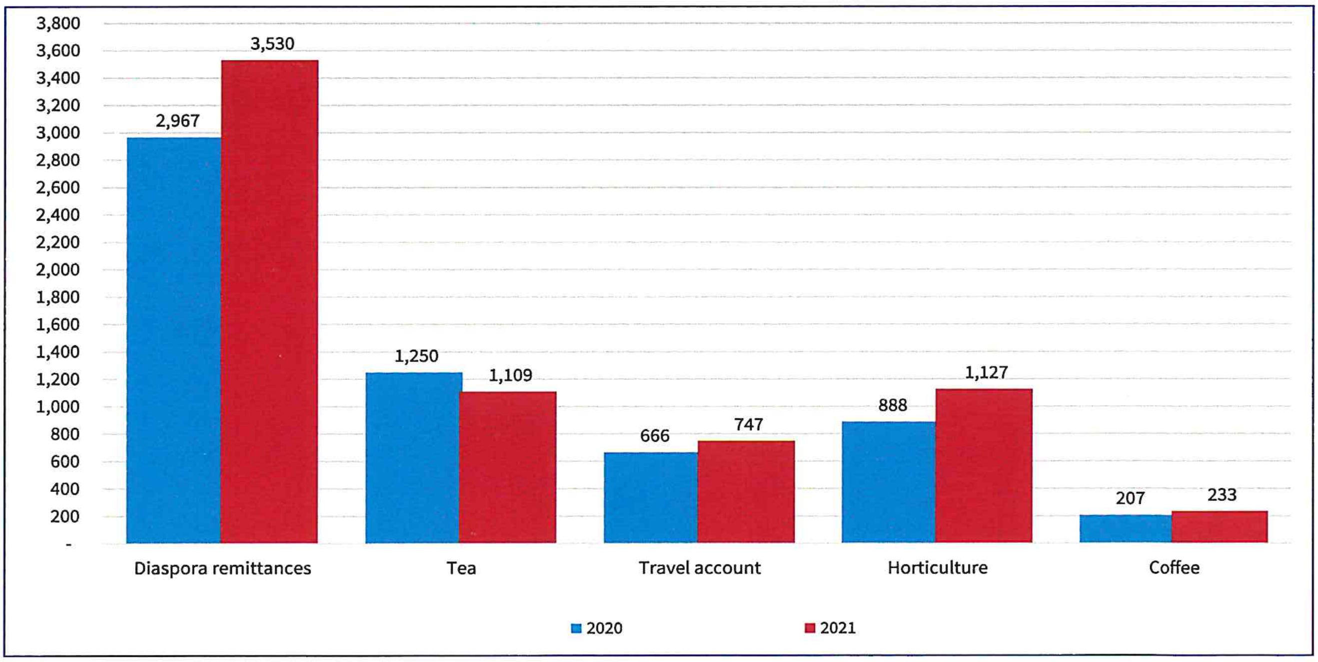
2.3.3 Balance of Payments Developments

The current account balance widened to a deficit of USD 5,989.3 million (5.6 percent of GDP) in the 12-months to September 2021 from a deficit of USD 4,938.2 million (5.0 percent of GDP) over a similar period in 2020. The wider deficit reflected a 14 percent increase in imports which more than offset the 8 percent increase in exports compared to a similar period in 2020. The increase in imports was attributed to higher international oil prices due to increase in global demand as economies reopen amid supply chain disruptions. Service exports particularly international travel continued to recover from the adverse impact of the COVID-19 pandemic with travel receipts increasing by 12 percent in the 12-months to September 2021. This reflected resumption of international travel as countries eased travel restrictions and reopened their borders. However, transport receipts declined by 13 percent over the same period.

The financial account recorded higher net inflows of USD 6,356.4 million in the 12-months to September compared to USD 3,907.7 million over a similar period in 2020. This reflected an increase in foreign direct investment (FDI) assets, a decline in FDI liabilities and an increase in portfolio investment liabilities. The capital account inflows increased to USD 438.2 million in the 12-months to September 2021 compared to USD 155.1 million in the 12-months to September 2020, primarily reflecting inflows from other capital transfers.

The value of merchandise exports increased to USD 6,503.0 million in the 12-months to September 2021 from USD 6,010.6 million in the 12-months to September 2020, largely reflecting increases in horticulture (21.2 percent), manufactured goods (28.3 percent), raw materials (20 percent), chemicals and related products (19 percent) and miscellaneous manufactured articles (14.1 percent) which more than offset the decline in tea and re-exports which declined by 7.3 and 23.2 percent, respectively. Earnings from tourism improved with the gradual reopening of international borders and the easing of the COVID-19 containment measures **(Chart 4a)**.

Chart 4a: Foreign Exchange Inflows from Major Export Categories in the 12-Months to September (USD Million)

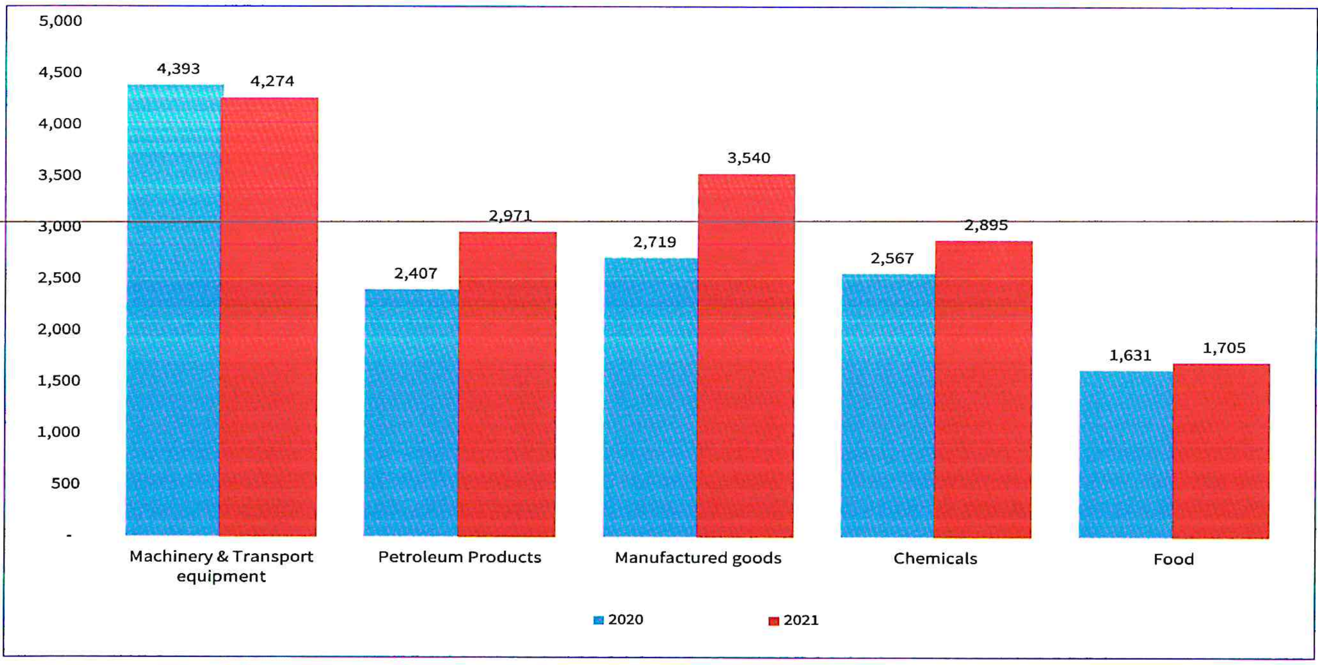


Source: Central Bank of Kenya

Merchandise imports increased to USD 16,962.4 million in the 12-months to September 2021 from USD 15,021.1 million over a similar period in 2020. The increase in imports was mainly driven by petroleum products, which rose by 21.5 percent, chemicals which increased by 13 percent and manufactured goods by 31 percent. The increase in oil products was attributed to higher oil prices due to increased global demand as economies reopened. However, imports of machinery and transport declined by 3 percent in the period under review **(Chart 4b)**.

During the period under review, the CBK continued to monitor global developments, particularly the effects of the COVID-19 pandemic, U.S. economic and trade policies, global trade and investment and inflationary concerns in major economies. The U.K. and U.S. accounted for 7.0 percent and 8.1 percent, respectively, of Kenya's total exports in the 12-months to September 2021. Exports to other trading blocs such as the EAC, COMESA and the EU accounted for 24.5 percent, 28.3 percent and 22.9 percent, respectively, of total exports over the period, compared to 24.4 percent, 25.3 percent and 22.6 percent of total exports in the 12-months to September 2020, respectively.

Chart 4b: Imports by Major Categories in the 12-Months to September (USD Million)



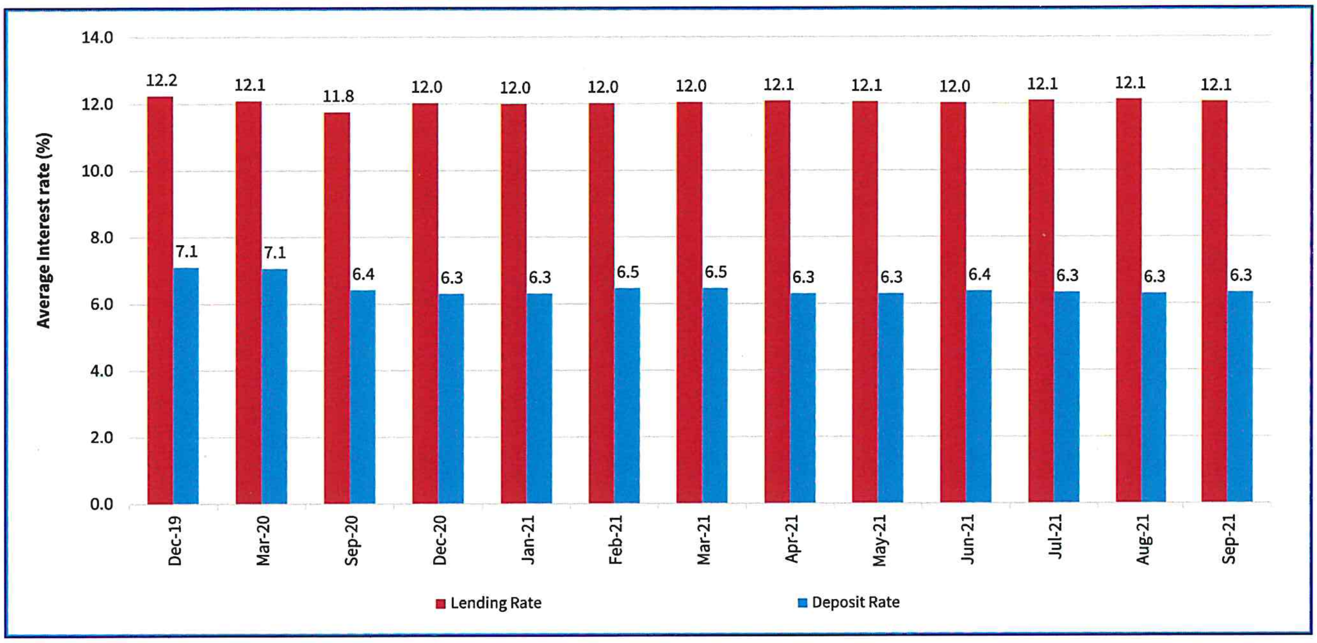
Source: Central Bank of Kenya

2.3.4 Banking Sector Developments

The banking sector remained stable and resilient in the period, with strong liquidity and capital adequacy ratios. The average commercial banks liquidity and capital adequacy ratios stood at 56.7 percent and 18.9 percent in October. The ratio of gross non-performing loans (NPLs) to gross loans stood at 13.6 percent in October 2021, an improvement from 14.2 percent in April 2021. This is reflected recovery in business activities as COVID-19 restrictions are eased and the rollout of COVID-19 vaccines.

Commercial banks' average lending rate remained relatively stable, at about 12.1 percent during the review period. Similarly, the average commercial banks' deposit rate was stable at about 6.3 percent, supported by ample liquidity conditions **(Chart 5)**.

Chart 5: Commercial Banks' Average Interest rates (Percent)



Source: Central Bank of Kenya

2.3.5 Developments in Private Sector Credit

Private sector credit growth remained resilient in the period, supported by recovery in economic activities, accommodative monetary policy stance and the implementation of the Credit Guarantee Scheme targeting Micro, Small and Medium sized Enterprises (MSMEs). The 12-month growth in private sector credit was 7.8 percent in October 2021 compared to 7.1 percent in May 2021, with strong growth recorded in credit to manufacturing, transport and communication, finance and insurance, business services and consumer durables **(Table 2)**. Growth of credit to the private sector is expected to remain strong on account of previous policy measures, including the MSMEs Credit Guarantee Scheme, and continued economic recovery.

Table 2: 12-Month Growth in Private Sector Credit (%)

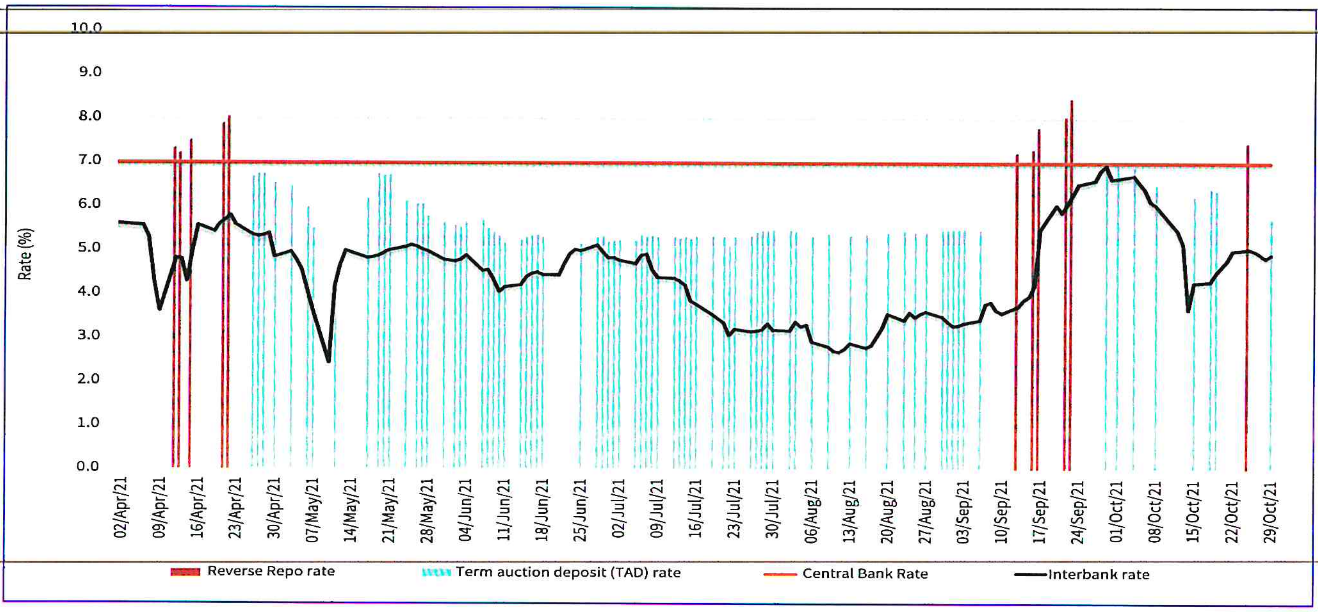
	Oct-20	Nov-20	Dec-20	Jan-21	Feb-21	Mar-21	Apr-21	May-21	Jun-21	Jul-21	Aug-21	Sep-21	Oct-21
Total Credit to Private Sector	**7.6**	**8.1**	**8.4**	**9.3**	**9.6**	**7.7**	**6.7**	**7.1**	**7.7**	**6.1**	**7.0**	**7.7**	**7.8**
Agriculture	17.0	19.3	15.3	15.6	13.4	12.3	10.0	4.3	3.7	2.8	1.4	3.3	2.7
Manufacturing	7.8	10.0	12.0	12.6	15.8	10.7	4.0	1.5	8.1	9.4	9.3	9.8	10.9
Trade	2.5	4.0	3.8	5.5	3.9	2.1	0.9	3.8	1.9	1.3	2.7	4.7	5.5
Building & construction	8.2	7.4	3.4	2.5	5.2	2.9	3.4	4.5	2.0	0.4	1.7	0.5	-0.5
Transport & communication	21.1	17.5	13.6	14.4	19.0	17.4	13.3	16.3	11.8	0.2	11.8	10.9	9.6
Finance and insurance	-2.2	0.2	7.1	14.0	9.0	7.5	7.6	6.7	11.5	8.9	7.7	11.7	8.9
Real estate	7.6	9.1	8.7	8.8	8.8	7.7	5.8	5.7	4.0	3.2	2.8	2.9	2.4
Mining & quarrying	-14.2	-15.4	-12.9	-6.1	21.6	-3.6	-8.8	-18.1	-13.0	-22.1	-23.1	-8.4	6.2
Private households	6.9	5.8	3.9	4.7	4.2	2.9	4.5	3.1	3.2	2.4	2.0	2.6	2.7
Consumer durables	15.7	18.8	18.1	18.7	20.3	17.6	19.3	22.0	23.4	21.7	20.1	17.6	16.5
Business services	5.9	2.7	4.0	6.5	5.0	5.7	7.2	6.9	5.2	4.9	5.8	7.6	8.2
Other activities	-10.4	-14.5	14.0	5.8	3.8	5.2	24.3	39.8	65.2	58.0	56.0	59.5	64.1

Source: Central Bank of Kenya

2.3.6 Interest rates

Short-term money market interest rates generally declined and remained below the CBR in the six months to October 2021, reflecting ample liquidity conditions in the market. This was supported by accommodative monetary policy stance as well as seasonal significant government payments towards the end of the fiscal year. The interbank rate however edged upwards between mid-August and September 2021 due to temporary tight liquidity conditions following higher government receipts relative to payments. The interbank rates declined in October as liquidity conditions normalized supported by government payments **(Chart 6a)**.

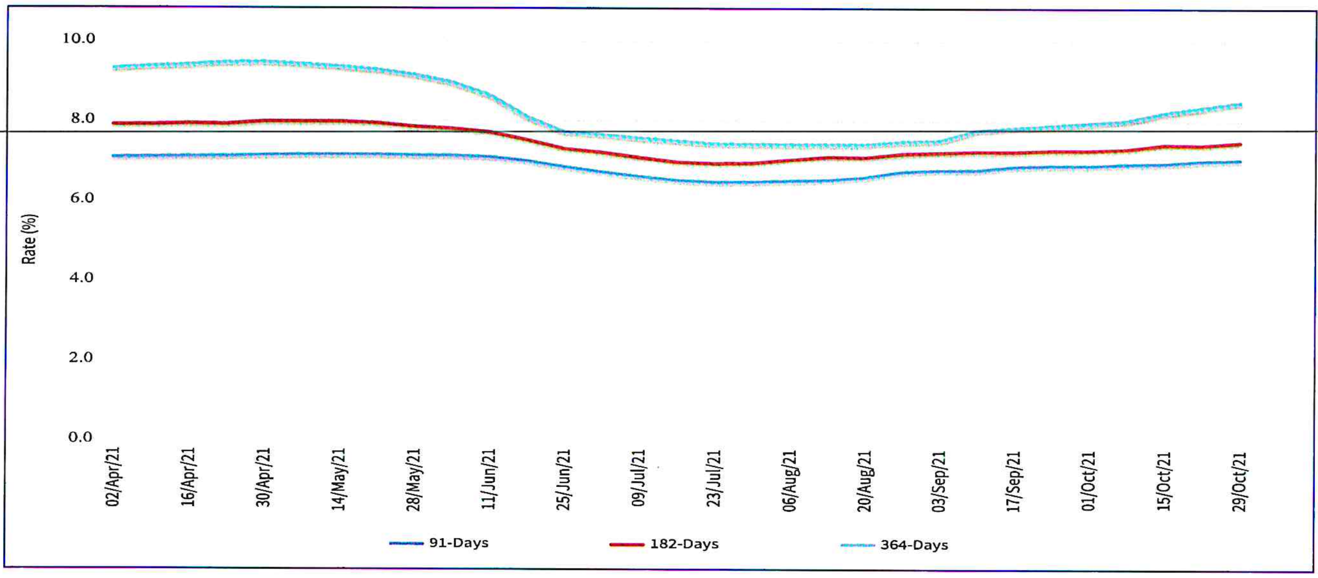
Chart 6a: Trends in Short Term Interest Rates (Percent)



Source: Central Bank of Kenya

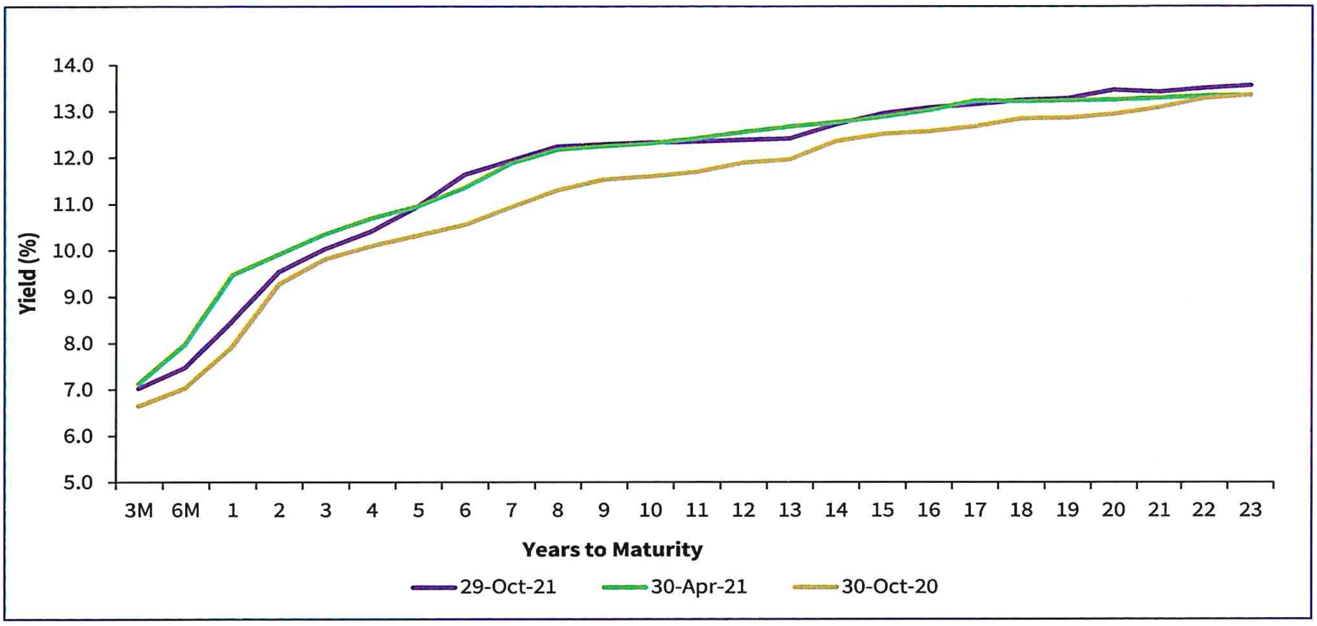
Similarly, interest rates on Government securities declined in the period April to August before marginal increases in september and October 2021. This reflected effective coordination of monetary and fiscal policies, particularly in the implementation of the Government domestic borrowing programme **(Chart 6b and 6c)**.

Chart 6b: Interest rates on Treasury Bills (Percent)



Source: Central Bank of Kenya

Chart 6c: Government Securities Yield Curve



Source: Central Bank of Kenya

3. MONETARY POLICY FORMULATION

3.1 Attainment of Monetary Policy Objectives and Targets

During the six months to October 2021, the MPC formulated monetary policy to achieve and maintain overall inflation within the target range as provided by the Cabinet Secretary for the National Treasury at the beginning of every fiscal year. The inflation target provided by the Cabinet Secretary for the National Treasury at the beginning of FY 2020/21 and FY2021/22 was 5± 2.5 percent.

The Central Bank Rate (CBR) remained the base for monetary policy operations and its adjustments both in direction and magnitude signaled the stance of monetary policy. The monetary policy stance was operationalised through various instruments including: Open Market Operations (OMO) and the CBK Standing Facility (Overnight Discount Window which is a lender of last resort facility). To achieve the desired level of money supply, OMO was conducted using Repurchase Agreements (Repos) and Term Auction Deposits (TAD). Monetary policy was conducted in the context of a flexible exchange rate regime.

The MPC published a White Paper on modernization of the *Monetary Policy Framework and Operations* in July 2021, which outlines the reforms that would enhance the effectiveness of monetary policy and support anchoring of inflation expectations. These reforms entail: refining macroeconomic modelling and forecasting frameworks in line with changing structure of the economy, improving the functioning of the interbank market in order to strengthen monetary policy transmission and operations, and continued improvement of communication of monetary policy decisions.

The annual growth in the broad money (M3) and private sector credit remained within their projected growth paths through the period under review. In particular, the 12-month growth in M3 was 8.7 percent in October 2021 compared to 9.3 percent in April 2021. The growth in M3 largely reflected the resilient growth in private sector credit during the period.

3.2 Monetary Policy Committee Meetings and Decisions

Over the six months to October 2021, the MPC held meetings on May 26, July 28 and September 28, 2021. These meetings were held against a backdrop of the continuing COVID-19 pandemic, and measures taken by authorities around the world to contain its spread. The meetings reviewed the impact of previous MPC measures to prevent the pandemic from becoming a severe economic and financial crisis.

In the May meeting, the MPC continued to assess the impact and the outcomes of its policy measures that were deployed since March 2020 to mitigate the adverse economic effects and financial disruptions due to the COVID-19 pandemic. The MPC noted that the global economic recovery continued to strengthen, largely supported by gradual reopening of economies, easing of COVID-19 restrictions particularly in the major economies, ongoing deployment of vaccines, and strong policy measures. Nevertheless, the outlook for global growth remained highly uncertain, due to the resurgence of infections, the reintroduction of containment measures and the uneven pace of vaccinations across the globe. Inflation expectations remained well anchored within the target range, supported by lower food prices and muted demand pressures, despite the increase in fuel prices. The MPC noted the resilient growth in the private sector credit and improved receipts from exports of horticulture and manufactured goods. The MPC concluded that the accommodative monetary policy stance remained appropriate, and therefore retained the CBR at 7.00 percent.

The July 2021 meeting was held against the backdrop of a rebound in the global economy, supported by the deployment of vaccines, relaxation of COVID-19 containment measures, and strong policy measures. However, the pace of recovery of the global economy remained uneven across countries particularly following a resurgence of new variants. Additionally, inflation in some major economies and emerging markets had risen sharply, mainly due to increases in commodity prices particularly oil, the effect of fiscal stimulus, and supply chain bottlenecks. Leading indicators for the Kenyan economy showed a relatively strong GDP recovery in the first half of 2021, mainly supported by strong performance of the construction, information and communication, education, and real estate sectors. The economy was expected to rebound in 2021, supported by the continued reopening of the services sectors including education, recovery in manufacturing, and stronger global demand. The MPC noted that inflation pressures were expected to remain elevated in the near term mainly on account of increases in food and fuel prices, and the impact of the recently implemented tax measures in FY2021/22. Nonetheless, inflation was expected to remain within the target range with muted demand pressures. The MPC concluded that the prevailing accommodative monetary policy stance remained appropriate, and would be supported by measures contained in the FY2021/22 budget, particularly the Economic Recovery Strategy which was expected to support domestic demand. The MPC therefore retained the CBR at 7.00 percent.

The September 2021 meeting was held in the backdrop of strengthening global economy, even as inflation in some major economies and emerging markets continued to rise sharply owing to increases in global oil prices, supply chain bottlenecks, and weather-related factors. The MPC noted that domestic inflationary pressures were expected to remain elevated in the near term, mainly driven by increases in fuel and food prices, and the impact of the implemented tax measures in FY2021/22. Nevertheless, inflation was expected to remain within the target range with muted demand pressures. The MPC also noted that the Economic Survey 2021 with the rebased national accounts data indicated that the Kenyan economy had contracted by 0.3 percent in 2020, owing to adverse effects of the COVID-19 pandemic, which disrupted activities mainly in the services sectors particularly wholesale and retail trade, education, accommodation and restaurant, and transport and storage. However, leading indicators for the economy continued to point to a strong GDP recovery in 2021, supported by the continued reopening of the services sectors, recovery in manufacturing, and stronger global demand. A survey of hotels by the CBK conducted in September indicated continuing recovery, with virtually all surveyed hotels being operational and reporting improved bed occupancy as well as increased restaurant and conference services. The MPC noted the progress in the implementation of the FY2021/22 Budget, in particular, the improved revenue performance with the continued pick up of economic activities. The roll out of the Economic Stimulus Programme and Economic Recovery Strategy were also noted, and were expected to boost domestic demand. The MPC concluded that the accommodative monetary policy stance remained appropriate, and retained the CBR at 7.00 percent.

4. IMPACT OF POLICY RESPONSES TO COVID-19 (CORONAVIRUS) PANDEMIC

During the six months to October 2021, the MPC continued to monitor the outcomes of the policy and emergency measures deployed at the onset of the COVID-19 pandemic in March 2020, to mitigate the anticipated adverse economic effects and financial disruptions from the pandemic. These measures were intended to provide liquidity to the banking sector, mitigate the adverse impact on bank borrowers and facilitate the use of mobile money. The assessment by the MPC showed that these measures protected the economy from substantial decline, and supported the most vulnerable citizens. In particular, the measures ensured continued provision of financial services and provided a buffer against a more adverse impact on the economy.

Interest rates remained low and stable supported by the accommodative monetary policy and improved liquidity conditions. Private sector credit growth continued to strengthen benefiting key sectors of the economy particularly manufacturing, transport and communications, agriculture, real estate and consumer durables. The operationalisation of the Credit Guarantee Scheme (CGS), in October 2020, was expected to de-risk commercial banks' lending and support additional credit uptake by the vulnerable Micro Small and Medium-sized Enterprises (MSMEs). As at end October 2021, all the seven approved banks were lending under the Scheme.

On the fiscal front, the Government continued to implement programmes to cushion citizens and businesses from the effects of the COVID-19 under the Economic Stimulus Programme. Revenues continued to improve following reopening of the economy, in particular, the lifting of the dusk to dawn curfew.

5. OTHER ACTIVITIES OF THE MONETARY POLICY COMMITTEE

The MPC Surveys conducted during the period as well as regular communication with the key stakeholders facilitated the MPC in its market information gathering process for effective conduct of forward-looking monetary policy. The MPC also continued to simplify its Press Releases to enhance the clarity of information communicated to the public, media, financial sector and other stakeholders.

The MPC's Private Sector Market Perceptions Survey, CEOs Survey, and the Survey of Hotels, revealed continuing optimism about economic growth prospects for 2021. Respondents attributed this optimism to continued business recovery in view of the easing of COVID-19 containment measures and increased vaccinations. Nonetheless, respondents remained concerned about continued uncertainties over the pandemic, the impact of increased taxes on business performance and intensified political activity.

Over the period, the MPC Chairman held virtual stakeholder meetings with the Chief Executives of commercial and microfinance banks after every MPC Meeting in order to apprise them on the background to its decisions and to obtain feedback. In addition, the Chairman of the MPC held virtual press conferences after each MPC meeting to brief the media on the background to MPC decisions and measures undertaken by the CBK to support macroeconomic stability as well as mitigate the impact of COVID-19 on the economy.

The Governor also held virtual meetings with various potential investors and representative from the private sector to brief them on economic developments and the outlook for the economy. The MPC continued to monitor the implementation of monetary policy decisions by the CBK. The Committee also continued interaction with other government agencies such as the National Treasury and Kenya National Bureau of Statistics (KNBS) on various data issues.

The Committee continued to closely monitor development in the economy through weekly meetings by the members of the MPC. The bi-monthly MPC meetings were preceded by analytical/technical meetings.

6. CONCLUSION

The monetary policy measures adopted by the MPC in the six months to October 2021 continued to support price stability, while also providing support to households and businesses in mitigating the adverse impact of COVID-19 pandemic. The stability of the exchange rate moderated any possible distortions that imported inflation would have had on the stability of domestic prices. The continued coordination of fiscal and monetary policies during the period also supported the achievement of price and market stability.

The CBK will continue to monitor developments in the domestic and global economy, the impact of the pandemic on the economy, the transmission of the monetary policy and other measures previously taken, and their effects on price stability. The MPC will also closely monitor the implementation of the reforms in the White Paper on *Modernization of the Monetary Policy Framework and Operations*, which will enhance the effectiveness of monetary policy and support anchoring of inflation expectations.

ANNEX

EVENTS OF PARTICULAR RELEVANCE TO MONETARY POLICY (MAY – OCTOBER, 2021)

Date	Event of Relevance to Monetary Policy
May	The MPC concluded that the current accommodative monetary policy stance remains appropriate, and therefore decided to retain the Central Bank Rate (CBR) at 7.00 percent
July	The MPC concluded that the current accommodative monetary policy stance remains appropriate, and therefore decided to retain the Central Bank Rate (CBR) at 7.00 percent.
	Lifting of the travel ban on movement into and out of five main COVID-19 hotspots, namely Nairobi, Kajiado, Kiambu, Machakos and Nakuru counties.
	Publication of a White Paper on the *Modernisation of the Monetary Policy Framework and Operations*. This followed the conclusion of a review by the Monetary Policy Committee (MPC) of the current monetary policy framework to determine the aspects that could be improved.
September	The MPC saw the need to closely monitor developments in inflation, standing ready to respond to any second-round effects. Nonetheless, the Committee concluded that the current accommodative monetary policy stance remains appropriate, and therefore decided to retain the Central Bank Rate (CBR) at 7.00 percent.
October	Release of the October 2021 World Economic Outlook (WEO) by the IMF revealing global economic growth projections of 5.9 percent in 2021 and 4.9 percent in 2022 (0.1 percentage point lower for 2021 than in the July 2021). The downward revision for 2021 reflected a downgrade for advanced economies—in part due to supply disruptions—and for low-income developing countries, largely due to worsening pandemic dynamics.
	Lifting of the country-wide dusk to dawn curfew.

GLOSSARY OF KEY TERMS

Overall Inflation: This is a measure of inflation in the economy measured by the year-on-year movement of indices of all consumer price items of goods and services sampled by the KNBS. It is affected by commodity components in the market that may experience sudden inflationary spikes such as food or energy.

Reserve Money: These are 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 held with 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 terms as follows: narrow money (M1); broad money (M2);
and extended broad money (M3). These aggregates are defined as follows:

- M1 Currency outside banking system + demand deposits
- M2 M1 + time and savings deposits + certificates of deposits + deposit Liabilities of Non-Bank Financial Institutions (NBFIs)
- M3 M2 + residents' foreign currency deposits

Central Bank Rate (CBR): This is the lowest rate of interest that the CBK charges on overnight loans to commercial banks. It is reviewed and announced by the Monetary Policy Committee at least every two months as part of its decisions. It is used by the commercial banks as a reference interest rate hence transmits to the financial sector and signals the CBK's monetary policy stance.

Cash Reserves Ratio(CRR): This is the ratio of deposits of commercial banks and non-bank financial institutions maintained with the CBK (as reserves) to commercial banks total deposit liabilities. The ratio is fixed by CBK as provided for by the law.

CBK Discount Window: The CBK Discount Window is a collateralized facility of last resort for banks. It has restrictive guidelines controlling access. The Discount Window plays a significant role in ensuring banking sector stability by offering overnight liquidity as a last resort. It is anchored on the CBR with a prescribed penalty.

Open Market Operations (OMO) : The act of buying or selling of government securities from or to commercial banks by the Central Bank in order to achieve a desired level of bank reserves. OMO is carried out in the context of an auction where commercial banks bid through the Reuters dealing system or by phone/fax.

Repurchase Agreement (Repo): Repos/reverse repos are agreements between the CBK and commercial banks to purchase/sell Government securities from/to commercial banks at agreed interest rates (REPO rate) for a specified period with an understanding that the commercial bank will repurchase/resell the security from/to the CBK at the end of the period. The period can be varied by the CBK.

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.

Horizontal Repo: This is an interbank Repo instrument which recognises Government securities as collateral for borrowing. The instrument has a variable tenor and allows commercial banks without credit lines with other banks to access credit from the interbank market.

Interbank Market: The interbank market is a critical channel for distributing liquidity that reduces the need for banks to access the CBK Overnight Discount Window. However, since not all banks have credit lines with each other, it is not a perfectly operating market and therefore banks may come to the Window as a last resort. The interest rates charged by banks reflect an individual bank's perception of the risk of the particular bank borrower and also the tightening liquidity in the market.

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