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## PRESS RELEASE

### MONETARY POLICY COMMITTEE MEETING OF NOVEMBER 25<sup>TH</sup>, 2010

#### *“Endorsing Financial Innovations and Confidence in the Economy”*

#### I. Introduction

The Monetary Policy Committee (MPC) met on 25<sup>th</sup> November, 2010 to review the general direction and performance of the economy and the market’s reaction to its previous decisions. The Committee came to the conclusion that the Central Bank Rate (CBR) should be held at 6.00 percent since the review indicated that the growth momentum was accelerating and that increasing confidence in the economy required a stable macroeconomic environment. Credit to the key sectors of the economy continued to expand mainly benefiting small to medium size enterprises. Medium size banks that are leading the transformation have revised their lending rates downwards. The November 2010 MPC Market Survey and the latest economic indicators suggested that the outlook over the next two months would be one of strong growth with low and stable inflation. We provide the evidence supporting this decision:

#### A. Information carried forward

- Credit risk in the banking sector continues to decline;
- Low and stable inflation;
- Increasing confidence in the economy;
- Need for more credit growth with longer tenor and lower interest rates.

#### B. New information

- Growing impact of the role of medium sized banks and the deepening of the financial sector;
- Results of the MPC Market Survey for November 2010;
- Strong third quarter 2010 un-audited results of the banking sector;
- Continued support by the Euro zone in addressing the crises in Greece and Ireland;
- Standard and Poor’s upward revision of Kenya’s credit rating to B+ reinforcing the previous rating by Fitch Rating and the World Bank Country Policy and Institutional Assessment (CPIA);
- Dialogue with the IMF on the emerging Kenyan economy.

#### C. Overall macroeconomic context

- Growth expectations from the Market Survey and other economic indicators show no threat to the growth targets set in the 2010/11 Budget by the Minister for Finance;
- IMF revisions to growth forecasts for Kenya and neighbouring countries all suggest that growth in 2011 is expected to be strong which will boost Kenya’s export earnings;
- Although the Euro zone recovery encountered a recent shock from the Irish Banking Crisis, there is little evidence that this will be contagious, and will not pose threats of either real or nominal downturns in Kenya;
- Within the banking sector, an emergent role by medium sized banks should accelerate growth in the small to medium sized enterprises sector;
- Financial innovations based on mobile phone technology will continue to raise the level of financial inclusion, giving rise to the need for a new monetary policy framework to enhance the momentum as new borrowers and savers appear.

## **II. Economic Outlook**

### **a. Global Economic Outlook**

The Committee noted that there were positive revisions to the growth forecasts for the global economy in the IMF October 2010 World Economic Outlook (WEO) entitled “*Recovery, Risk and Re-balancing*”. These forecasts are supported by the Africa Monitor for the continental economies. The WEO shows that advanced economies are forecast to grow at 2.7 percent in 2010 up from a forecast of 2.6 percent in July 2010. Similarly, growth in the emerging and developing economies is projected at 7.1 percent up from a forecast of 6.8 percent in July 2010. The Euro zone is still dominated by the strength of the German economy while those countries which have witnessed economic crises are not important to Kenya’s trade patterns or development assistance. The growth of the global economy is mainly anchored on the strength and resilience shown in Brazil, Russia, India and China (BRICs). Within Africa, growth forecasts for 2010 with respect to Kenya’s main trading partners, Uganda and Tanzania are 5.8 percent and 6.5 percent, respectively. This suggests that growth in the regional markets will continue to support Kenya’s export sector.

It was observed that there are no indications of imported inflationary threats to Kenya. The only pressures likely to feed into the Kenyan economy would be through instability in exchange rates or oil price escalation. IMF forecasts of oil prices suggest that it would be unlikely that there would be a reversion to the high rates witnessed in mid 2008. The Kenyan shilling has shown a slow weakening against the South African Rand and stability with respect to the Ugandan and Tanzanian Shillings.

The Committee, therefore, concluded that there were no significant developments in the global economy that required revisions to the expectations in Kenya’s balance of payments or imported inflation.

### **b. Domestic Economic Developments**

#### **Economic Growth**

The Committee assessed the evidence on growth to establish whether any revisions of growth and policy drivers were required. These have been based on the 4.5-5.0 percent range of economic growth for 2010 announced by the Minister for Finance. There is evidence and expectation that the growth target for 2010 will be achieved. Indeed, indicators such as power consumption for the 12 months to September 2010, was 20 percent up, compared with that in a similar period in 2009 and preliminary indicators on cement consumption showed a 20 percent growth in a similar period. Tax collections on consumer goods and income tax have all expanded well above the inflation rate, hence in real terms, the economy appears to be well on target for recovery to the *Vision 2030* trajectory. In agriculture, tea output for the 12-months to September, 2010 was 5.3 percent above that in a similar period in 2009, while milk deliveries were 11 percent up. In value terms, tea was 44.1 percent up, due to improved prices. Power.

The Market Survey showed both banks and non-bank private sector firms to be increasingly optimistic on the growth outlook for 2010. 85 percent of the banks now expect a growth of 5 percent or above in contrast to 68 percent of them expecting a 2-3 percent growth in September 2009. This expectation is corroborated by the surveyed non-bank private sector firms where 81 percent of respondents expect a growth of 5 percent or above in 2010.

The Committee therefore concluded that when the Kenya National Bureau of Statistics (KNBS) releases the third quarter of 2010 data in December 2010, the Bank should re-evaluate its monetary programme since growth is accelerating.

## **Inflation**

The KNBS data for October 2010 showed a continuation of the declining trend on domestic prices. The October 2010 overall inflation of 3.1 percent was still heavily influenced by the strong competition in the communications sector which has seen a significant decline in communications charges. Food prices moved up marginally but adequate rains in the food producing areas suggested that steep rises are unlikely. The KNBS continued to work on a non-tradable goods price index and preliminary results suggest that the measure satisfactorily fulfils its function as a measure of price response to monetary policy while in future it will support further analysis to the movements in the real exchange rate.

Based on these developments and a review of the Market Survey responses from banks and non-bank private sector firms, the Committee concluded that the only meaningful threats to inflation would be through possible unanticipated oil price rises and any food deficiencies which might emerge before the onset of the long rains in 2011.

## **III. Fiscal and Financial Sector Performance**

### **Fiscal Performance**

The Committee reviewed data on revenue collection and borrowing, as well as foreign currency denominated expenditure activities. It noted that the Government had conducted discussions with the IMF on the possibility of a programme which would enable the Government to undertake growth enhancing development activities. In addition, the recent reinforcement of Kenya's credit rating by the Standard and Poors to a B+ provides an opportunity for both the Government and private sector to access international financial markets.

The Committee also noted that non-competitive tendencies of commercial banks were beginning to appear in the Treasury bill auctions where policy had successfully lowered the cost of Government debt. The agreed Government borrowing programme is broadly on track and therefore from the demand side, is not exerting upward pressure on interest rates. The Committee concluded that the close coordination with the Treasury had kept the cost of borrowing down – it was necessary to send strong messages that the auction for Treasury bills and bonds should be competitive.

### **Interest Rates**

The Committee noted that short term interest rates had risen slightly in the last one month. However, the interbank rate was still low and stable showing that loanable funds for the short term are easily available. It was however observed that the use of horizontal repos continued to expand but is not yet adequately widespread to effect a major change in liquidity distribution. The Committee observed heavy over-subscription on Treasury bond issues while Treasury bills seemed less attractive. This is consistent with the policy of lengthening the maturity of Government debt in order to minimise market risk. Analysis of Treasury bonds trading in the secondary market showed that returns reflected portfolio choices and the ease of disposing of Treasury bonds makes them more flexible than Treasury bills.

The Committee observed that in October 2010, lending rates for all categories of banks declined relative to those in May 2010. More particularly, medium size banks, which had the highest average lending rate of 15.02 percent in May 2010, had successively reduced the rates to 13.17 percent in October, 2010, making them the lenders with the lowest rate. This observation led to the need for a more detailed analysis where the Market Survey provided additional insights. First, the medium size banks have confidence in the vibrancy of the economy in that 60 percent of them expect the economy to grow by above 5.1 percent, in contrast with 44 percent of large banks and 28 percent of small banks. Most small banks expect growth at 5 percent. Second, it was also noted that, in September 2010, 73 percent of medium size banks expected to decrease their lending rates in contrast with 57 percent of large banks and 67 percent of small banks. In fact, the prediction by the medium size banks was fulfilled. Third, the medium banks revised their determinants of interest rates spread in such a way that administrative costs became less significant. Further examination of their portfolio showed that they had been reducing their rates on 1-5 year loans more significantly, giving

market players longer maturity loan options. The Committee therefore observed that medium size banks appeared to be taking a leading role. Small banks had cut their rates by over 3 percent on over 5 year loans where businesses were largely the beneficiaries. In contrast, large banks had made minor cuts in lending rates to all market segments, but appeared not to have moved aggressively as a consequence of declining risk. Finally, the outcome of the spread for the medium banks was much lower and their focus on SME lending very encouraging.

### **Banking Sector Developments**

The Committee reviewed the developments leading to improved financial inclusion in the economy. It noted that international experience had established that financial inclusion was a necessary component in generating growth and reducing poverty. Specifically, the Committee noted that there has been a rapid increase in small savings accounts and the opening of quasi-banking outlets through agent banking. While this had been commented on in previous Press Releases, the Committee felt that the sheer acceleration of this process warranted a better understanding of the dynamics of structural change taking place in the financial sector.

As a consequence, these structural changes were noted to have important implications on the current monetary programme. Specifically, accelerated mobile phone banking had resulted in a decline in the proportion of currency outside banks as a percentage of the total money stock. Furthermore, the use of money to lubricate the wheels of the economy was changing significantly while the financial markets continued to deepen. Telephony devices for paying bills and receiving remittances have changed the landscape of monetary and financial policy in Kenya.

The Committee noted that gross loans grew by 4.0 percent, or Ksh.34.8 billion between August and October 2010. Furthermore, the outcome of stress tests on the banking system revealed that the industry remains healthy and that the steady decline in the proportion of net non-performing loans to total loans from 2.93 percent in January 2010 to 1.82 percent in October 2010 represented a major improvement in the risk environment. The Committee also noted that total loans represented about 70 percent of total deposits as at end of October 2010. Hence, by and large, it was considered that developments in this area would need to be examined in more detail so as to ensure that the financial sector growth was not curtailed by inappropriate strategies supporting excessively conservative banking behaviour.

### **Foreign Exchange Market and Reserves**

The Committee noted that the media had been carrying numerous articles suggesting that the Central Bank had been protecting a particular value of the Kenya Shilling. This view came from its frequent purchases of foreign exchange from the market to build forex reserves. Despite pronouncements that Kenya is a small open economy and therefore a very minor player in the global financial markets, this perception persisted. The Central Bank stayed out of the foreign exchange market for several weeks between September and October 2010 and was able to demonstrate that its purchases of foreign exchange were irrelevant to any observed volatility in the exchange rate. The Committee reviewed this evidence and concluded that there was no correlation between exchange rate movements and Central Bank activity and therefore the Bank should continue to build up foreign reserves as required by previous MPC decisions. It was noted that foreign exchange reserves remained around 4 months of import cover.

### **Market Liquidity**

The monetary targets set by the Monetary Policy Committee in September 2010 of Ksh.1,243.6 billion for broad money supply (M3) was satisfactorily achieved with Ksh.1,240.2 billion. This was despite a significant overshooting of the reserve money target. However, the Committee noted that inflation targets were being met. This observation was not surprising in view of the fact previously alluded to that financial innovations associated with the expanding footprint of the broadly defined banking industry caused major revisions in the way in which people handled money. These developments have changed the behaviour of the money multiplier as well as the velocity of circulation of money. This reflects deepening and presence of innovation in our financial market.

The Committee established money supply (M3) targets for December 2010 and January 2011 of Ksh.1,281.6 billion and Ksh.1,300.3 billion, respectively. Reserve money targets were set at Ksh.202.6 billion and Ksh.198.6 billion for December 2009 and January 2011 respectively. The Central Bank net foreign assets for the same months were set at Ksh.266.0 billion and Ksh.270.4 billion, respectively. The money supply growth proposals built in a continued expansion of private sector credit growing at over 20 percent. The Committee noted that credit to the private sector over the previous two months has been satisfactory. In the third quarter of 2010, credit to agriculture grew by 9.8 percent, manufacturing by 24.4 percent, trade by 29.0 percent and finance and insurance sector by 14.8 percent. The Committee therefore concluded that banks credit to the private sector was going to productive sectors thereby supporting the growth forecasts.

#### **IV. Key Considerations during the Monetary Policy Committee Meeting**

The new dimensions and structural transformation appearing in the financial sector dominated much of the discussion. These were further supported by numerous indicators that showed increasing confidence hence lower risks. The Committee noted that medium sized banks were behaving somewhat differently from their competitors and hence might have been benefiting from improved financial inclusion. It does point to a conscious and deliberate policy to support the direction they have taken in order to reduce lending rates to levels that can support domestic investments and also follow the inflation decline. This is important in order to support sustained economic recovery and enhanced growth. Furthermore, financial deepening was seen as a way of enhancing competition in the financial sector where many institutions continued to operate in an environment of returns not commensurate with the risk.

Since growth expectations were high and inflation risks low, the Committee considered ways of ensuring that money supply would continue to be adequate to support these critical parameters.

#### **V. Monetary Policy Decisions**

The Committee concluded that there were numerous signs of increasing confidence in the economy. For example, the country's credit rating has been revised upwards to B+ which enhances the strong economic recovery being experienced, against the backdrop of improvements in CPIA – a measure of policy and institution quality. This confidence could best be endorsed by further consolidating the gains and maintaining stability. The Committee therefore considered the present level of CBR at 6 percent to be appropriate. The Committee sought to expand the lessons learnt in the course of recent structural transformations of the financial sector so as to increase competition among the market players and thus improve on its pricing structure and risk management.



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*November 30, 2010*