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PRESS RELEASE

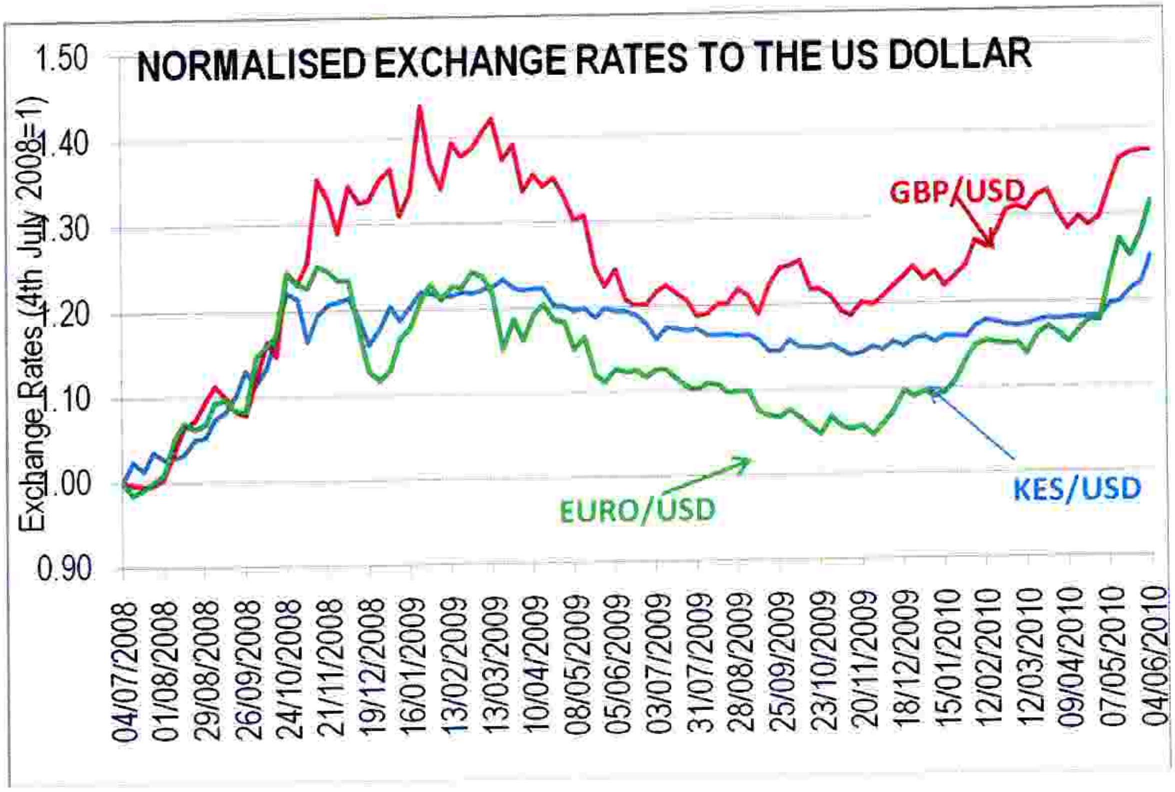
The Weakening of the Kenya Shilling

In recent weeks, the Kenya shilling has weakened against the US dollar but strengthened against the Euro. This movement of the local currency especially vis-à-vis US dollar has been picked up in the local media and might be a source of concern for some sections of the market and the general public. As such the Central Bank of Kenya would like to explain and to assure the market on these recent developments.

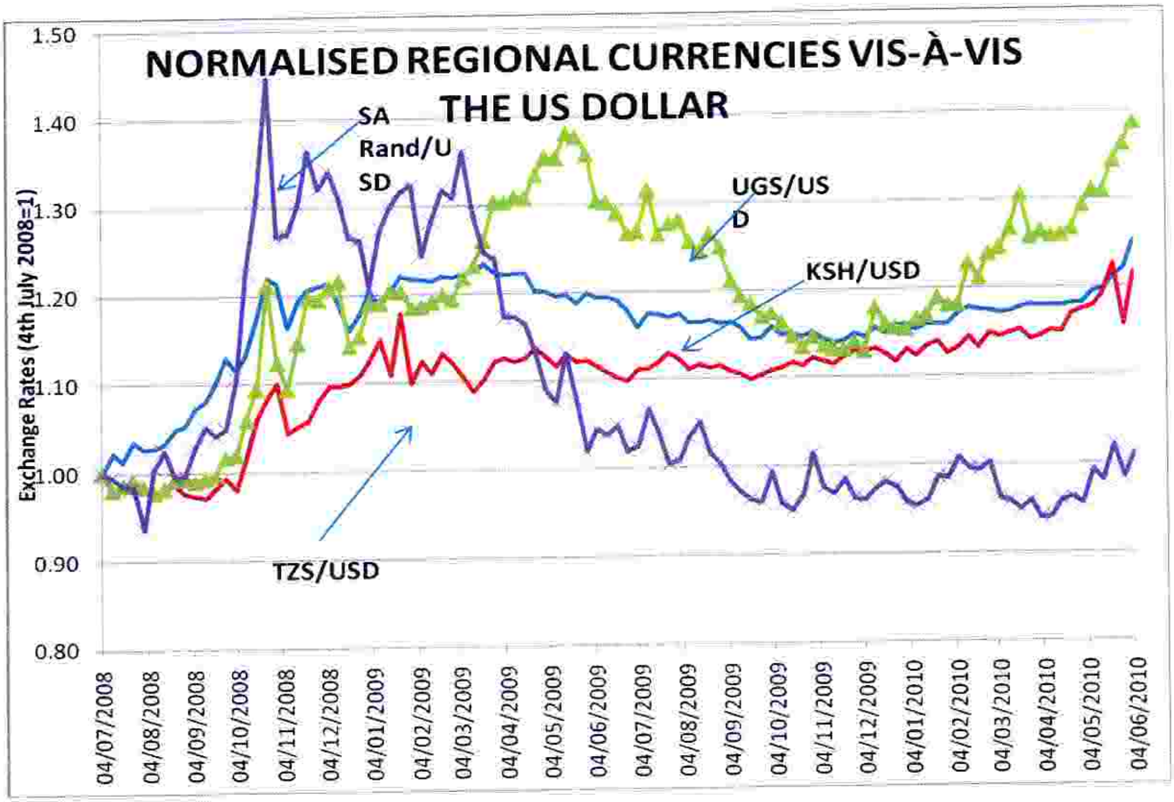
<u>The Crisis:</u> **The Greek Crisis has triggered a temporary "flight to safety" in the US dollar**

The recent turmoil in the international foreign exchange market was triggered by the economic events in Greece where it emerged that its economy had borrowed heavily in the past decade. As a result, the Greek economy could not recover from the global financial crisis with its budget deficit rising to 13.6 percent of GDP last year which is more than 4 times the limit under the euro zone rules. Given this level of debt, and without a credible restructuring plan, investors doubted Greece's ability to meets its obligations. Since the investors in the international market perceive that the problem might be pervasive in the euro zone and without a credible plan to restructure their budgets, the events in Greece have impacted on the common European currency the Euro. It is feared that the contagion effect of the Greek crisis may spread to other countries in the euro zone with similar fiscal constraints and debt burden.

As a result of the problems in the euro currency and the uncertainty in the euro zone market, investors are fleeing from currencies like the Euro and the Sterling pound to the US dollar perceived as a safe haven. The increased demand for the US dollar and US dollar denominated assets are thus driving up its price relative to other currencies. Investors are re-adjusting their portfolio by substituting Euro denominated for US dollar denominated assets. This has strengthened the dollar globally. This is similar to what happened during the global financial crisis, only that it is the dollar that was under attack.



These movements are captured by the chart above that shows that the movements of the Kenya shilling, the Sterling pounds and the Euro against the US dollar nominalised on July 2008. An increase will imply the dollar is strengthening and the other respective currencies are weakening. As can be observed at the start of the global financial crisis in October 2008, all the currencies weakened against the US dollar. The currencies recovered some of their values after the global financial crisis eased but started to lose against the US dollar in early 2010. The regional currencies are behaving the same way to the dollar, see the chart below



<u>The Market is Sound:</u> **The Kenya shilling fundamentals have improved and are sound**

The current movements in the shilling against other currencies are as a result of international market developments not related to Kenya. While the shilling is weakening against the US dollar, it is strengthening against the Euro locally. This reiterates that the fundamentals of Kenya exchange rate and the economy are sound:

<u>The Fundamentals:</u>

- Inflation has declined from 14.6 percent in February 2009 to 3.9 percent in May, 2010. This is against the Government's and CBK target of 5 percent. The upside risks to inflation remain low and from the Monetary Policy Committee's Market Survey, the inflation expectations are anchored to a lower level. The risk that might emerge from higher oil prices in the international market will be mitigated from lower food prices and lower hydro generated electricity prices.
- Kenya's current account even though high at about 6.5 percent of GDP still remains sustainable as most of the items in the current account are not for domestic consumption but for imports to expand capacity such as machinery and other intermediate goods. Tourism, a major foreign exchange earner has

recovered to pre-crisis levels. Remittances have recovered. The bumper harvest Kenya has had this year implies less foreign exchange will be needed for food imports. Exports are expected to recover in 2010 as increased demand emanates from the non-traditional destinations in the Far East and increase because of the greater access to EAC from July 2010.

- The Economy has recovered from the quadruple shocks (Political shocks, Drought, Commodity-Oil/Maize price shocks of 2008, and the Global Financial Crisis). Economic Growth increased from 1.6 percent in 2008 to 2.6 percent in 2009 and is forecasted to increase to between 4-5 percent in 2010.
- The foreign exchange reserve import cover is meeting the statutory minimum of 4 months of import cover. CBK gross forex reserves are over US$3.7 billion as at end May 2010 which is greater than reserves for any other country in the East African region.
- Kenya's fiscal position remains sound with Government fiscal deficit remaining in check, and debt to GDP ratio at 44 percent (Greece is at 115 percent). The confidence in the government fiscal position is supported by a continued reduction on yield of its securities. The 91 day Treasury bill has declined from over 7 percent last year to 3.49 percent this month.
- The Stock market is rebounding with foreign investment and interest in the bourse is at an all time high.

The Automatic stabilizer:

A flexible Exchange Rate Policy like ours is an automatic stabilizer meant to absorb the external shocks hitting the economy. To the Central Bank these shocks are temporary and the exchange rate movements are fulfilling their role. Once the volatility in the international market is stabilized and uncertainty in the euro zone is resolved, the shilling will rediscover its path consistent with the fundamentals outlined above.

In summary, the Central Bank's policy stance remains the same on the exchange rate. The Bank expects that the private sector and firms have their hedge instruments in place to mitigate the current volatility in the foreign exchange market as they are temporary.

PROF. NJUGUNA NDUNG'U
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