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PRESS RELEASE

MONETARY POLICY COMMITTEE MEETING OF 22ND MARCH, 2011

"Sustaining the Growth Momentum: Coping with Supply Shocks"

I. Introduction

The Monetary Policy Committee (MPC) met on 22nd March, 2011 to assess and evaluate the performance of the economy since its last meeting and to review its monetary policy stance and to formulate policies for the next two months. The meeting analysed implications of domestic and external shocks on the economy. On the domestic scene, the Committee noted the onset of the rains but acknowledged the impact of dry weather conditions. It considered implications of the forecast of adequate but poorly distributed rainfall during the year. Externally, the instability in the Middle East and North Africa (MENA) had raised risks and pushed up oil prices. In addition, Japan, a major development partner which had been on a recovery path, suffered a severe setback following an earthquake and tsunami. In view of these events, and the need to contain inflationary pressures and stabilise the exchange rate, the Committee decided to tighten its monetary policy stance by raising the Central Bank Rate (CBR) to 6 percent.

A. Information carried forward

- Credit risk in the banking sector continues to decline;
- Sustained confidence in the economy;
- Need for more credit growth with longer tenor and lower interest rates to support domestic investments;
- Strong performance of the banking sector;
- Approval of the Extended Credit Facility (ECF) by the IMF Board in January 2011;
- Implementation of a new monetary programme against the backdrop of structural transformation of the financial sector.

B. New information

- Political crisis in the MENA region;
- A surge in world oil prices;
- Earthquake and tsunami in Japan;
- Results of the MPC Market Survey for March 2011 (Market Survey);
- Expected gradual unwinding of the Economic Stimulus Package by the Government.

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;
- Build-up of inflationary pressures;
- Volatility of the exchange rate creating uncertainty;
- Japan, a major development partner, suffered a severe earthquake and tsunami triggering a temporary close-down of some of their key manufacturing firms;
- IMF upward revisions of growth forecasts for both Kenya and neighbouring countries suggest that growth in 2011 is expected to be strong which is expected to increase demand for Kenya's exports;
- Financial developments and innovations based on mobile phone technology continue to enhance financial inclusion. This has strong effects on the monetary policy framework and the transmission process of monetary policy.

II. Economic Outlook

a. Global Economic Outlook

The IMF World Economic Outlook (WEO) update for January 2011 shows continued growth of the global economy in 2011. However, India and China have increased their policy rates to contain incipient inflationary pressures. Growth forecasts had been revised slightly, but overall, the global economy seemed set to grow. This revision was, however, made in mid-February 2011 before the escalating political turmoil throughout North Africa which was followed by a rapid increase in oil prices and a rise in freight insurance through the Suez Canal. Moreover, Kenya is dependent on Egypt as an important export market and the MENA region as a source of oil. These developments destabilised the exchange rate giving rise to speculation. In addition, the earthquake and tsunami in Japan are likely to have an adverse effect not just on Japan's economic recovery, but also its role as an important development partner.

In contrast, the East African economies are forecast to grow strongly in 2011 with Ethiopia leading with 8.5 percent followed by Tanzania at 7.2 percent and Uganda at 6.1 percent. Since these countries account for about 47 percent of Kenya's exports, this indicates a positive picture for Kenya's export sector during the year. Inflation in the major East African economies has been rising on account of higher food prices. In particular, overall inflation in Uganda increased from 5.0 percent in January 2011 to 6.0 percent in February, 2011 while in Tanzania it increased from 6.4 percent to 7.5 percent. The rise in inflation in these countries has seen increases in domestic interest rates. The Treasury bill rate in Uganda rose from 7.03 percent to 8.84 percent between December 2010 and January 2011 while that in Tanzania increased from 5.24 percent to 6.37 percent. In view of the importance of the East African market, the Committee conducted a detailed examination of the exchange rates in the neighbouring countries. It noted that their currencies had depreciated more significantly than the Kenya Shilling. The relative position of Kenya's exchange rate to the US Dollar was of importance where bilateral trade balance was in Kenya's favour.

The Committee therefore concluded that despite the recent shocks, the global economic outlook for Kenya is positive and that with the successful negotiation of the ECF there are no meaningful threats to the balance of payments.

b. Domestic Economic Developments

Economic Growth

The Market Survey showed that both banks and non-bank private sector firms continued to anticipate a strong economic growth in 2011. A majority of the respondents expected growth of 5.7 percent and above as had been the situation in the January 2011 Market Survey. On the basis of a variety of indicators, the Committee was confident that there was a strong base for economic growth projections. For example, electricity and cement consumption went up by 10.6 percent and 14.4 percent, respectively, while tourist arrivals increased by 23.6 percent in 2010. The Committee then considered the pressures that the economy was encountering which might jeopardise the targeted growth for 2011. It noted that the projected depressed rainfall in the country might slow down agricultural production. However, improved export prices in the international market will compensate for shortfalls. Investment goods continued to be imported showing confidence in the economy, while manufacturing output was expected to benefit from robust growth in neighbouring countries.

The Committee noted that the KNBS will be releasing the 2011 Annual Economic Survey in the near future which will provide the appropriate data for updating the economic models for forecasting. The Committee observed that the creeping inflation was a risk to growth and this trend was exacerbated by oil price movements and speculators taking financial gains without any related increase in real output. Action was necessary to steer inflation back towards the 5 percent target.

The Committee noted the decline in the Nairobi Stock Exchange Index and will continue to monitor both this trend and the identification of active participants.

Inflation

Data from KNBS showed that overall inflation increased from 4.51 percent in January 2011 to 6.54 percent in February 2011 which signalled a significant move away from the low inflation rates of 2010. It was clear from internal analysis that the dominant picture of the inflationary pressure was being initiated on the supply side through food shortfalls and high oil prices. In addition, oil price rises were also increasing transport costs while imported intermediate inputs were being affected by the instability in the foreign exchange market. In view of these factors, the Committee considered that the temporary supply shocks were starting to appear as persistent and hence required remedial action. The time lag for food to come on to the market owing to the onset of the rains means that for at least a couple of months, food prices would continue to exert pressure on consumer prices. However, the Committee noted that domestic grain prices were below those currently prevailing internationally.

In urban centres, the transport of food becomes a major consideration. The Committee observed that the drought effects were being augmented by the increased cost of oil. Other items being imported or exported were similarly going to be affected. The Committee continues to work with the KNBS on a non-tradable goods index which will disentangle the implications of monetary effects and hence the effects of monetary policy.

In view of the building inflationary pressures, the Committee concluded that action was now necessary. It was aware of the wider implications of these pressures on other financial markets where measures reducing inflation would also stabilise the exchange rate and return it to its long-run trend.

III. Fiscal and Financial Sector Performance

Fiscal Performance

The Committee was informed that the Government intends to gradually unwind the Economic Stimulus programme which has been in place for the last two years. The MPC observed that Government borrowing as a proportion of total domestic credit had remained at about 24 percent. This coupled with improved liquidity in the market will ensure that the Government domestic borrowing requirement would not exert significant pressure on short term interest rates as the monetary policy stance is tightened. The borrowing programme will continue to increase the maturity profile of domestic debt, hence reducing the concern on interest rate risk and domestic debt sustainability.

Interest Rates

Trends in the interbank rates continued to show that commercial banks were liquid. In addition, the distribution of liquidity was largely being handled without any need for periodic interventions by the Central Bank. The Committee noted that commercial banks were dominant players in the market for Treasury securities. The yield curve had risen slightly while at the same time becoming smoother. The Committee considered that the presence of a secondary market for Treasury bonds was responsible for the smoother transmission of signals in the various Treasury bonds tenors.

It was again noted that medium sized banks were lending at the lowest interest rate in February 2011 and appeared more responsive to MPC signals. In particular average lending rates for small, medium and large banks stood at 14.82 percent, 13.85 percent, and 14.66 percent, respectively, in February 2011. Large banks which should have been benefiting from economies of scale appeared to be trading on their significant market power offering the lowest deposit rate and maintaining the highest spread of 12.59 percent in February 2011. The Market Survey continued to show expectations that interest rates would largely remain the same or fall.

Banking Sector Developments

The banking sector was noted to be strong with initial figures showing that the performance of the sector was expected to improve in 2011. The momentum of lending to the private sector continued with Ksh.41.3 billion being lent to the private sector in the first two months of this year which was close to the borrowing in the last quarter of 2010. This expansion in credit is consistent with the outcome of the Market Survey where commercial banks expect to increase credit to the private sector by up to 20 percent in the remainder of 2011 with demand for credit by non-bank private sector firms also set to increase.

An analysis of the performance of banks by categories of banks (large, medium and small) was undertaken and these were also found to be strong. Net non-performing loans (NPLs) as a proportion of total loans declined further between January and February 2011 showing that economic growth had improved the credit worthiness of borrowers. In particular, the net NPLs as a percent of total loans declined from 1.51 percent in January 2011 to 1.44 percent in February 2011. The number of loan accounts increased by 61,356 (3.4 percent) between December 2010 and February 2011 to stand at 1,855,020. The increase in the number of loan accounts was in virtually all the sectors of the economy.

The Committee was informed that the categorisation of banks had been revised to reflect international best practise. Consequently, the number of large banks is now 6 compared with 22 in the previous classification; the number of medium banks remains at 15; while small banks have increased from 7 to 23. It was noted that medium banks have been performing better with respect to their loan portfolio and also their interest rate spread.

The Committee therefore concluded that stability and improved performance in the banking system should continue to enable the private sector to access affordable credit to finance flagship projects identified in the *Vision 2030*.

Foreign Exchange Market and Reserves

In view of the turbulence in the foreign exchange market in the recent past, the Committee examined the balance of payments in detail. It felt that there was need to stabilise expectations in the foreign exchange market. Consumption goods comprised a minor portion of the basket of imports while exports of tea were affected primarily by production shortfalls due to unfavourable weather and also the temporary disruption of the Egyptian tea market. The services sector continued to perform well with tourism earnings increasing and remittances from Kenyans abroad averaging USD65 million in December 2010 and January 2011.

The Committee noted that the ECF had been approved by the IMF Board and hence Kenya's monetary programme would now be a major indicator to be monitored. The first tranche of USD100

million has been disbursed. The MPC also noted that early this month, the Central Bank had to inform the media on several occasions that foreign exchange reserves are adequate not just to meet the oil import bill, but also to cover the cost of imports and foreign exchange financial liabilities. With this information, it considered that the foreign exchange reserves position would be kept under continual review, and would ensure that speculators would not attempt to destabilise the foreign exchange markets.

Market Liquidity

The Committee reviewed performance in the interbank market and noted that besides the stability of the rate which was responding to periodic reverse repos, the volumes normally transacted were indicative of a liquid banking system.

The monetary targets set by the Committee at its previous meeting for broad money supply (M3) for January 2011 were met satisfactorily. In particular, M3 stood at Ksh.1,290.5 billion in January 2011 against a target of Ksh.1,300.3 billion. Under the ECF programme, the target for M3 was Ksh.1,337.1 billion in February 2011. This was satisfactorily met. The Committee followed the ECF targets of Ksh.1,355.6 billion in March 2011, Ksh.1,374.5 billion in April 2011, and Ksh.1,393.0 billion in May 2011.

IV. Key Considerations during the Monetary Policy Committee Meeting

The Committee concluded that the changed international environment warranted a revision of the policy stance. Inflation could no longer be regarded as solely an outcome of supply-side shocks rather, it was beginning to be persistent and hence would acquire some permanent effects on domestic prices. This outcome therefore required monetary policy action. Furthermore, the instability of the exchange rate raised questions which had to be addressed by appropriate monetary policy action given that Kenya has an open capital account. This means that the flexible exchange rate will adjust balance of payments' temporary imbalances as the interest rate affects international capital movements and the price of domestic exports. The newly structured monetary programme was examined by the Committee. This informed its decisions to change the monetary policy stance by raising the CBR. The Committee will closely monitor the impact of this change on the supply of liquidity in the course of the next two months.

V. Monetary Policy Decision

In view of the above, the MPC decided to tighten the monetary policy stance by raising the CBR to 6 percent. The Committee's decision to raise the CBR reflects a shift in the monetary policy stance in order to send the signal that temporary shocks such as exchange rate volatility and seasonal food shortages should not be allowed to persist and be factored into pricing structures. This tightening will provide a solution to inflationary pressure and stabilise the exchange rate while still protecting economic activity. This monetary policy stance is also in line with the expected unwinding of the Economic Stimulus package by the Government.

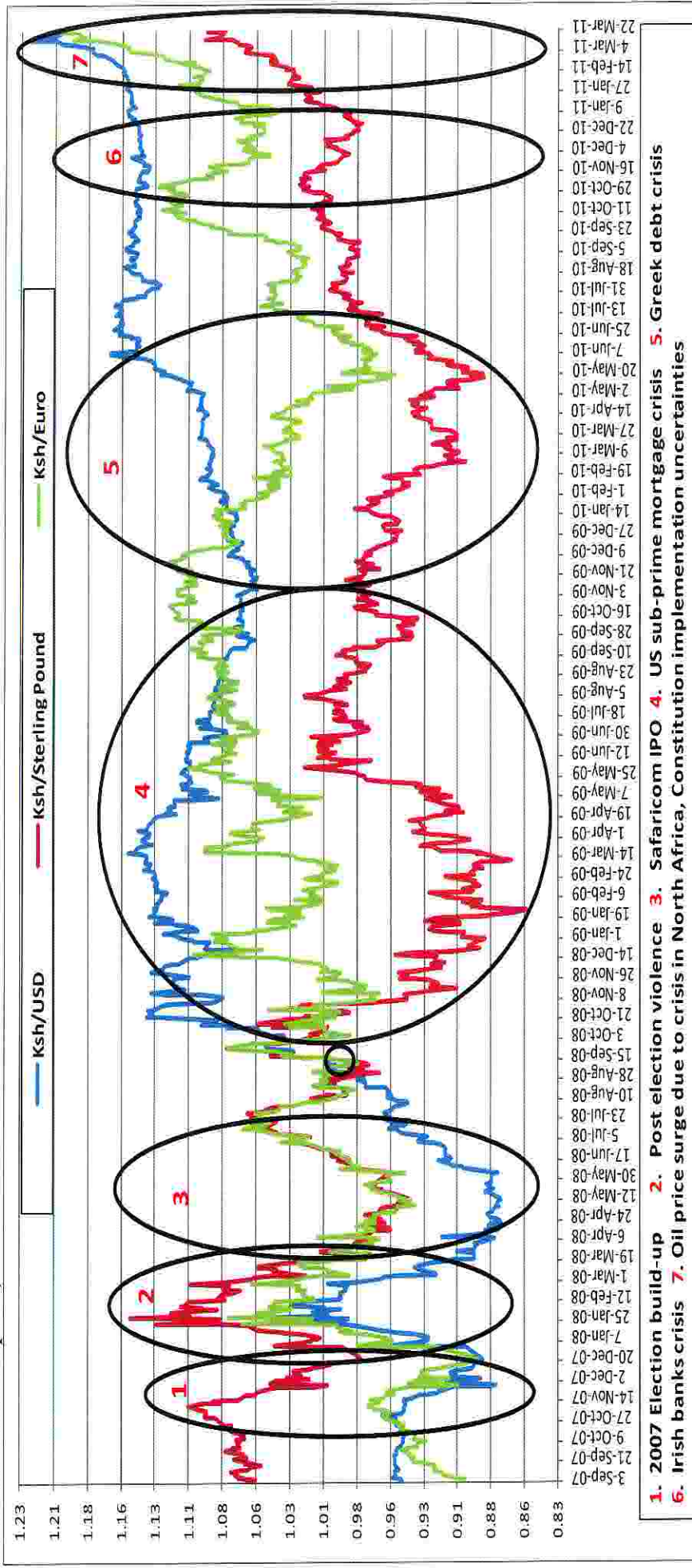


PROF. NJUGUNA NDUNG'U, CBS
CHAIRMAN, MONETARY POLICY COMMITTEE

March 25, 2011

ANNEXE

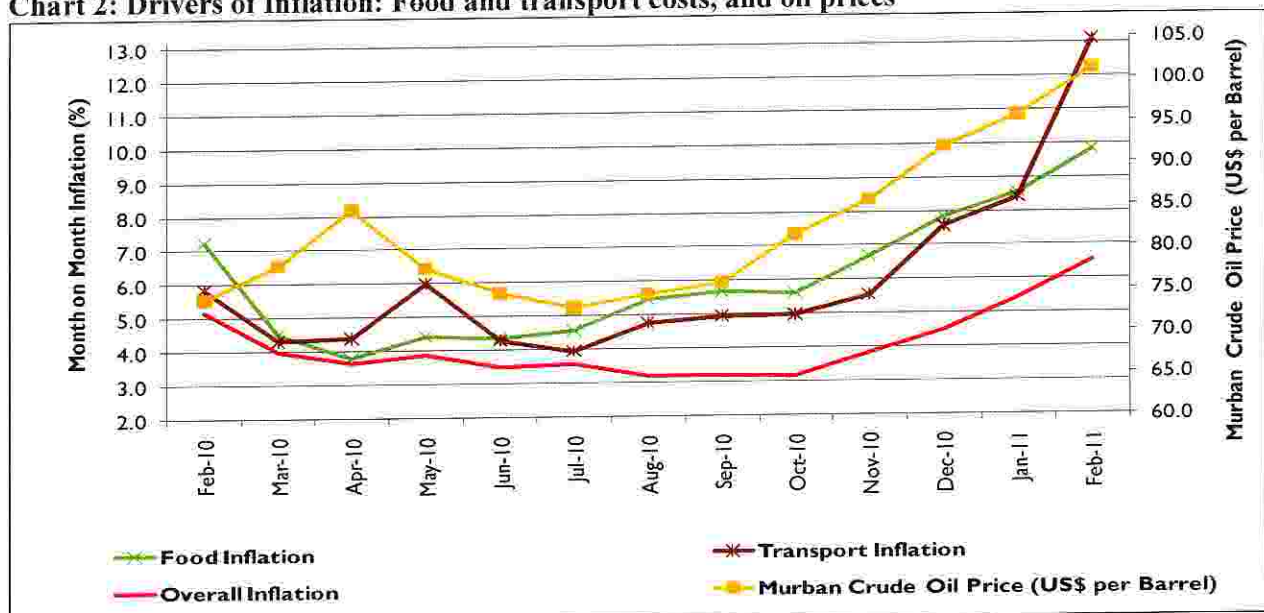
Chart 1: Normalised daily average exchange rates: there have been several episodes of exchange rate volatility in the recent past (15th September 2008 rates normalised to equal 1)



Source: Central Bank of Kenya

- The exchange rate is an automatic stabiliser – shocks are absorbed and adjustments made through it. This provides the economy with an appropriate adjustment tool.
- Since late 2007, we identify seven shocks of differing magnitudes which are explained by different events, but we also see the ability of the exchange rate to return to its long-run mean.

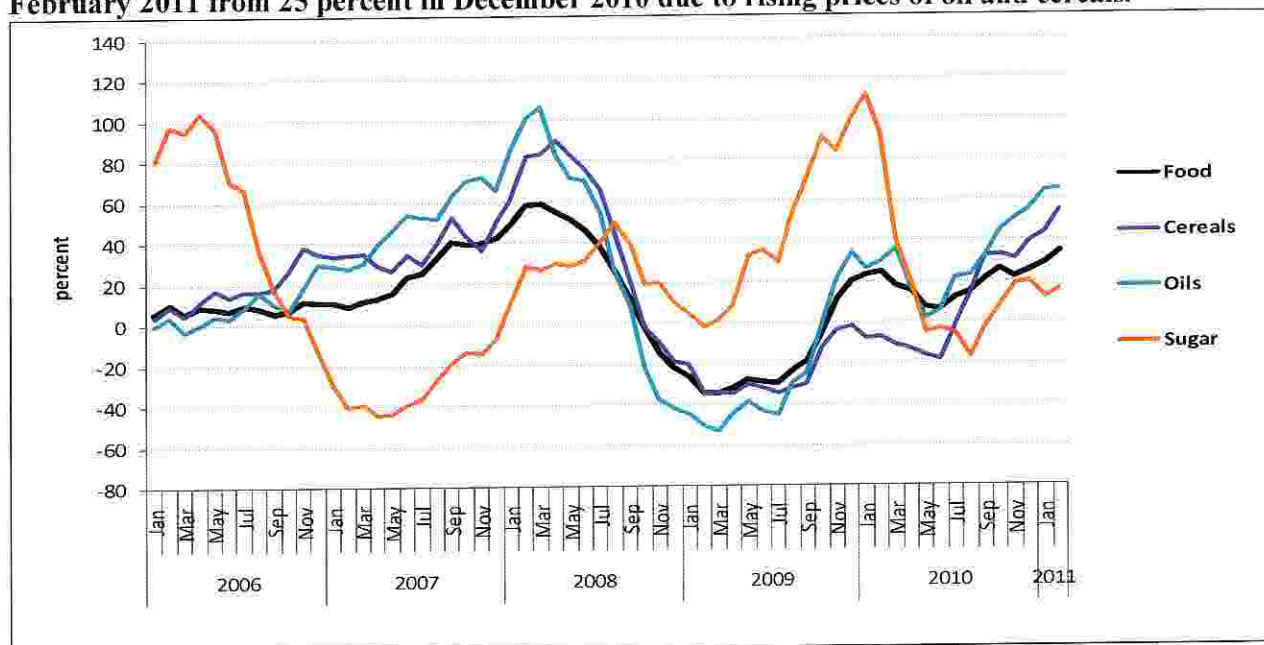
Chart 2: Drivers of Inflation: Food and transport costs, and oil prices



Source: Kenya National Bureau of Statistics

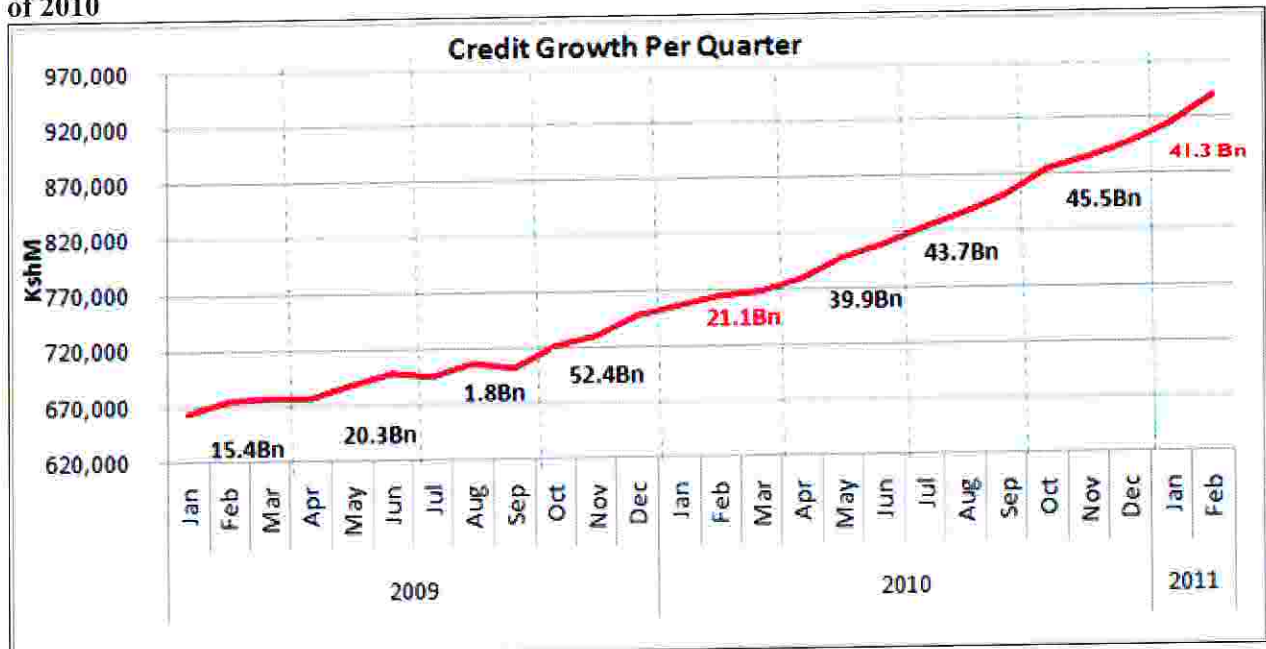
- Inflation is being pushed by the costs of food, fuel and transport. We anticipate some of these pressures to be shed off in the coming months.

Chart 3: High food prices a global phenomenon: world food inflation accelerated to 34 percent in February 2011 from 25 percent in December 2010 due to rising prices of oil and cereals.



Source: Food and Agriculture Organisation (FAO)

Chart 4: Credit expansion to the private sector financing economic activity: Credit expanded by Ksh.41.3 billion in the first two months of 2011 which is close to the total credit in the last quarter of 2010



Source: Central Bank of Kenya

- Credit grew in January and February 2011 by Ksh.41.3 billion even when the dry spell was prevailing. This is consistent with the stance taken then and the commensurate demand for credit from the private sector.