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PRESS RELEASE

MONETARY POLICY COMMITTEE MEETING OF 27TH JANUARY, 2011

"Supporting Growth through Adequate and Affordable Credit"

I. Introduction

The Monetary Policy Committee (MPC) met on the 27th of January 2011 to assess and evaluate the performance of the economy since its last meeting and review its current monetary policy stance. The Committee used the Kenya National Bureau of Statistics (KNBS) third quarter growth data and reviewed available indicators for the fourth quarter of 2010 to establish the base for growth in 2011. The Committee concluded that the growth momentum was strong. Furthermore, it is evident that the increase in inflation in December 2010 and January 2011 was not a monetary phenomenon and that, other than supply driven concerns, inflation threats were negligible. The Committee noted that the banking system had the capacity to enhance credit to the private sector and that Government borrowing would not crowd out demand if it was stimulated by lower lending rates. Even though the banks had generally lowered their base lending rates, the Committee concluded that there is adequate scope to lower the rates further. Consequently, the Committee decided to lower the Central Bank Rate (CBR) by 25 basis points to 5.75 percent.

A. Information carried forward

- Credit risk in the banking sector continues to decline;
- Overall inflation lay within the 5 percent target band in December 2010;
- Increasing confidence in the economy;
- Need for more credit growth with longer tenor and lower interest rates;
- Strong third quarter 2010 un-audited results for the banking sector;
- Standard and Poor's upward revision of Kenya's credit rating to B+ with stable outlook, reinforcing the previous rating by Fitch.

B. New information

- Results of the MPC Market Survey for January 2011 (Market Survey);
- Release by the IMF of the January 2011 World Economic Outlook (WEO) Update;
- The Government proportion of total domestic credit has remained constant;
- Evidence that the monetary policy stance has been successful;
- The IMF Board has discussed and approved a programme with Kenya;
- The need for a new monetary policy programme with the new programme approved by IMF

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;
- IMF upward revisions of growth forecasts for both Kenya and neighbouring countries all suggest that growth in 2011 is expected to be strong which is expected to be backed by 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, posing threats of either real or nominal downturns in Kenya;
- Financial innovations based on mobile phone technology continue to increase the pace of financial inclusion. This will affect financial development and the monetary policy framework.

II. Economic Outlook

a. Global Economic Outlook

The IMF World Economic Outlook (WEO) update for January 2011 entitled "*Global Recovery Advances but Remains Uneven*" projects a strong growth for developing countries, particularly those in sub-Saharan Africa. However, uneven effects of debt-related crises in Europe will continue to affect Europe and, to a lesser extent, the United States. In particular, the Committee noted that the projected growth for countries which are Kenya's main export destinations is strong. In 2011, the advanced economies are expected to grow by 4.4 percent; emerging and developing economies by 6.5 percent, which is dominated by the BRICS economies; developing Asia by 8.4 percent; and sub-Saharan Africa by 5.5 percent.

The Kenya shilling has continued to move in tandem with the cross rates in the major financial markets. The Committee therefore noted that other than the possibility of oil import impact, there was no significant threat of imported inflation through the weakening of the Kenyan shilling. Nevertheless, the growth and exchange rate fluctuations in the region suggest that Kenya could benefit from growth not only in its current export industries, but also from expansions of its financial sector operations in those countries. In particular, the recent developments in Southern Sudan offer trade opportunities for the country. Since the last MPC meeting in November 2010, policy rate movements have been driven by country specific factors. For example, Uganda raised its policy rate from 11.97 percent to 12.54 percent while South Africa lowered its policy rate from 6 percent to 5.5 percent. China raised its policy rate from 5.56 percent to 5.81 percent in an effort to control the moderate inflationary pressure.

The Committee therefore concluded that the global economic outlook for Kenya is positive and that there are no specific threats in the balance of payments particularly since the Government has successfully negotiated an Extended Credit Facility (ECF) programme with the IMF.

b. Domestic Economic Developments

Economic Growth

The MPC Market Survey showed that both banks and non-bank private sector firms are anticipating a significant improvement in economic growth in 2011 with a majority expecting a growth of 5.7 percent and above. This was a noteworthy improvement in the expectations compared with that in November 2010 where a growth of 5–5.6 percent was expected for 2010. These results are reflected by the broad based growth momentum shown in the KNBS third quarter outcomes as evidenced in key sectors such as ICT, manufacturing, agriculture, financial services and transport. An analysis of the balance of payments over the recent past suggests improved confidence in the domestic economy. Imports of industrial supplies (intermediate inputs to industry) have increased by about 15 percent compared with that in late 2009 and early 2010. Furthermore, imports of machinery and other (non-transport) capital equipment increased to Ksh.100.7 billion between June and November 2010, in contrast with Ksh.70.2 billion in the preceding six months. In addition, disaggregated data on cement production and consumption continue to support the argument in previous press releases that the construction sector was strong. These factors provide confidence that the growth target announced by the Ministry of Finance of around 6 percent in 2011 will be achieved.

The dry weather conditions witnessed in some areas of the country could cause some downturn in agricultural output and food inflation but this is largely seasonal.

Inflation

The Committee noted that the December 2010 overall inflation was 4.51percent and it forecast the January rate at 5.4 percent (it actually came out at 5.42 percent) but that it was clear this was driven by food and transport costs for December. Furthermore, rent and school fees which also rose are always significant factors in January. Most of the enduring pressures are related to dry weather conditions and oil prices while some others are one-off price adjustments like in rent. In particular, food and transport inflation increased from 6.71 percent and 5.54 percent, respectively, in November 2010 to 7.84 percent and 7.57 percent, respectively, in December 2010. The food prices reflected not just temporary food shortages but also the transport cost from producing areas. The Committee noted that this has implications for the immediate future since the drought affected areas will require food from those areas currently marketing significant surpluses. The Committee was informed that the Government has put adequate measures in place to resolve the food distribution challenges. The Committee believes that any additional inflationary risk emanating from rising oil prices should be mitigated by economic growth.

The Committee noted that inflation lay comfortably within the target range around 5 percent and would stabilize once temporary weather related fluctuations were removed. Hence, monetary policy was successfully delivering on its mandate.

III. Fiscal and Financial Sector Performance

Fiscal Performance

The Committee analysed Government revenue collection and the Treasury's borrowing programme. It noted that the Government would require additional funds to support the implementation of the new Constitution and provide support during the dry season. The Committee was advised that the Government would continue to front-load its borrowing programme in an effort to implement development programmes promptly. This process of Government borrowing is planned and controlled by statutory limits. In addition, the Committee identified surplus liquid funds still held by banks. Finally, the Committee observed that Government borrowing as a proportion of total domestic credit had remained constant at about 24 percent. The Committee does not therefore expect that Government borrowing requirements will exert upward pressure on short term interest rates. The borrowing programme will continue to increase the maturity profile of domestic debt, hence reducing the concern on its sustainability. The Committee also concluded that interest rates on Government debt instruments are a poor predictor of the monetary policy stance and overall market interest rates.

Interest Rates

The Committee was satisfied that the monetary policy stance implemented had reduced the high volatility of the interbank rates which had been experienced in the period from May 2009 to May 2010. The current level of the interbank rate shows adequate liquidity and that the need to resort to the use of the reverse repo is now minimal. Besides the significant stabilisation of the interbank rate which reflects the liquidity of the banking system, Treasury bill rates have increased at a slow rate. This clearly shows the different characteristics of the two interest rates and the need to analyse them separately. This conclusion was brought out strongly by the fact that all lending rates declined in December 2010. The average lending rates on loans of over 5 years fell from 15.24 percent in March 2010 to 13.51 percent in December 2010 while the overdraft rate declined in the same period from 14.06 percent to 13.69 percent. The Market Survey continued the story from November 2010 with expectations that interest rates would remain the same or fall.

The Committee concluded that the impact of CBR signals continued to coordinate movements in the lending rates, with some lag, but that there was enough liquidity in the banking system to support further lending without exerting upward pressure on the rates.

Banking Sector Developments

The Committee reiterated that the financial inclusion considerations which were highlighted in the November 2010 Press Release were further enhanced by information that showed commercial bank branches had doubled since the year 2005, it also depicted a similar picture even when disaggregated by region. In particular, the number of bank branches over that period had virtually doubled from 534 in 2005 to 1,063 in 2010. Similarly, the number of ATMs increased from 555 in 2005 to 2,052 in November 2010. This success is further reflected in the improved results of the banking sector for the nine months to September 2010.

The Committee, in its analysis of how monetary policy had been implemented, noted that private sector credit growth had continued to expand with Ksh.45.5 billion being lent in the fourth quarter of 2010 and Ksh.43.7 billion in the third quarter. The Committee noted that credit had been provided to all sectors of the economy except for a minor downturn in loans to mining and quarrying. Strong support to sectors such as trade and manufacturing was expected to convert to growth in the near future. This assumption was backed by data on net non-performing loans which showed a decline of 5.6 percent in December 2010 with decreases in virtually all sectors. The Market Survey noted an increase in the expected growth of credit to the private sector between November 2010 and January 2011. Furthermore, the non-bank private sector was also predicting an expansion in demand for credit.

The Committee therefore concluded that stability and improved performance in the banking system should enable the private sector to access affordable credit to endorse growth targets towards the levels envisaged in the *Vision 2030*.

Foreign Exchange Market and Reserves

The Committee examined information on the international foreign exchange market and observed that Kenya is a small player in the global financial markets. Consequently, the evolution of exchange rates of the Kenya shilling against major international currencies reflected the pressures that the Euro had come under in the last two months. It was considered that the expected IMF ECF support would reduce pressure on the Kenyan shilling and enhance the build-up of foreign exchange reserves which stand at about 4 months of imports cover at present.

Market Liquidity

The monetary targets set by the Committee at its previous meeting for broad money supply (M3) for November and December 2010 were met satisfactorily. However, net foreign assets were short of target. The growth in private sector credit as indicated in the previous section demonstrated the successful working of monetary policy. The recommendations which the MPC has been giving have been based on a monetary programme that will be replaced by the new IMF programme. Hence, the Committee did not find it prudent to announce targets for February and March 2011. However, the January 2011 target of Ksh.1,300.3 billion for M3 is still in place.

Key to the Committee's considerations in arriving at its decision was an analysis of the liquidity situation in the banking system. Statutorily, banks are required to maintain a minimum liquidity ratio of 20 percent. The liquid assets of banks include holdings of all Government securities (Treasury bills and bonds). It was considered that an appropriate short term measure would be an analysis of those liquid assets which were immediately available since they would affect both the interbank rate and the capacity for commercial banks to extend credit. This modified liquidity ratio has declined from 13.3 percent in September 2010 to 11 percent in December 2010 thereby showing a further success of the monetary policy stimulus. Nevertheless, the Committee noted that with a required cash reserve ratio of 4.5 percent, there is still significant space for further lending.

IV. Key Considerations during the Monetary Policy Committee Meeting

The Committee concluded that the outcomes of low inflation, improving real GDP growth, growth in private sector credit, low volatility in the interbank market and declining interest rates were all satisfactory outcomes of the current monetary policy stance. Furthermore, the Committee noted that increasing confidence from the expanded footprint of financial intermediation and imports of intermediate inputs and capital goods all portend future growth for the economy. The potential for enhanced, affordable and non-inflationary expansion of credit to support growth was established. Even though banks had generally lowered their base lending rates, the Committee concluded that there is adequate scope to lower the rates further. The Committee considered that it would examine carefully the agreed programme that the Government will undertake with the IMF and provide appropriate direction for the Central Bank's monetary policy operations.

V. Monetary Policy Decisions

The Committee observed that its monetary policy stance had been successful as indicated by robust economic growth, a low and stable inflation regime and decreased volatility in the interbank rate. In addition, the CBR was effective in coordinating movement in short term interest rates. In order to provide the impetus to enhance further growth, the MPC was of the view that private sector investment should be supported with adequate and affordable credit. Even though the banks had generally lowered their base lending rates, the Committee concluded that there is adequate scope to lower the rates further. The Committee therefore decided to lower the CBR by 25 basis points to 5.75 percent.

PROF. NJUGUNA NDUNG'U
CHAIRMAN, MONETARY POLICY COMMITTEE

February 1, 2011

ANNEXE

Chart 1: Trends in Money Market Interest Rates: ***CBR has coordinated money market interest rates downwards and stabilized***

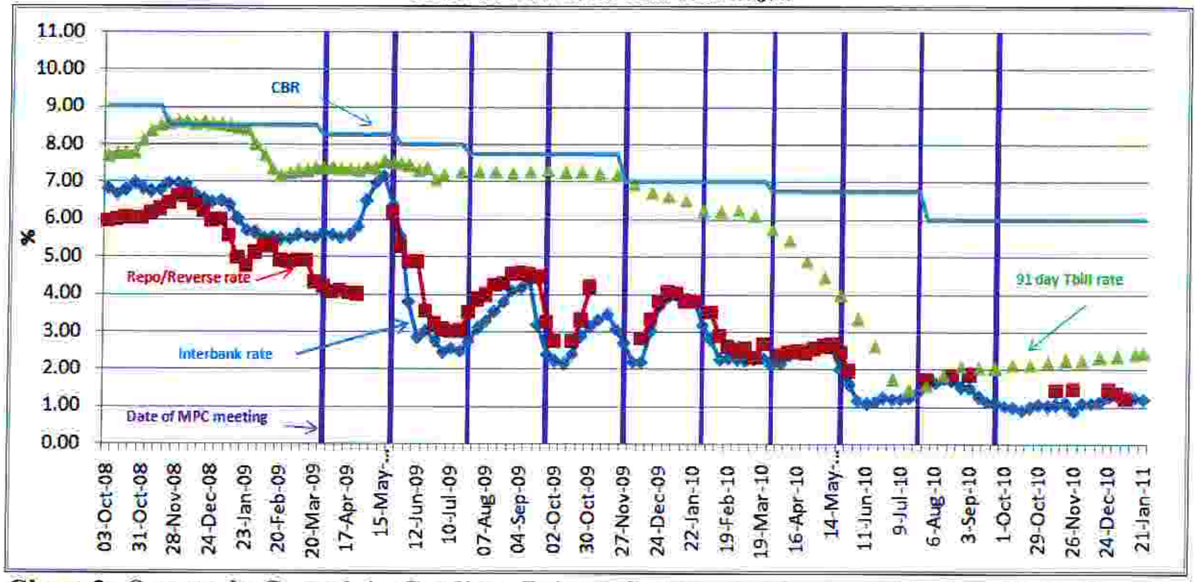

Chart 2: Quarterly Growth in Credit to Private Sector: ***Has increased by Ksh.45.5 billion the last quarter and Ksh.43.7 billion in quarter 3 of 2010***

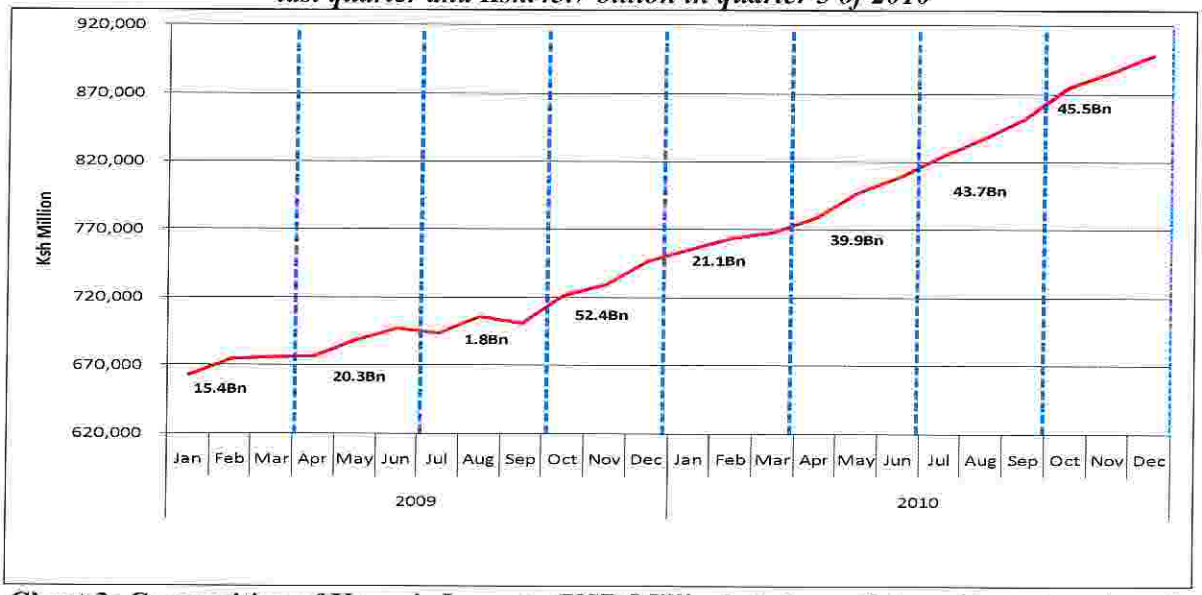

Chart 3: Composition of Kenya's Imports (USD Million): ***Intermediate and investment goods dominate the upward movement: capacity for future growth***