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PRESS RELEASE

MONETARY POLICY COMMITTEE MEETING OF 31ST MAY, 2011

"Taming Inflation and Inflationary Expectations"

I. Introduction

The Monetary Policy Committee met on 31st May 2011 to evaluate the impact of both its previous monetary policy decisions and the continuation of the supply constraints and price shocks which the economy had encountered in the last few months. It reviewed the performance of the economy in light of the information available. The Committee examined the results of its May 2011 Market Perception Survey (Market Survey) which showed that both the bank and the non-bank private sector had sustained their confidence in the economy despite the prevailing inflationary pressures. The Committee noted that following its previous decision, the Central Bank Rate (CBR) had effectively coordinated changes in expectations in the various markets: the rate of increase in inflation had slow down; the exchange rate was responsive to the policy; and short term interest rates had reverted to stable levels following temporary volatility. However, the Committee endorsed a continuation of its tight monetary policy stance to tame inflation and inflationary expectations and enhance exchange rate stability. To achieve these objectives the Committee raised both the Cash Reserve Ratio (CRR) and the CBR by 25 basis points to 4.75 percent and 6.25 percent, respectively. The Committee will also review the use of other tools for liquidity management to further enhance the effectiveness of monetary policy.

A. Information carried forward

- Continuation of supply side inflationary pressures;
- Continuation of the political crisis in the Middle East and North Africa (MENA) region;
- Sustained confidence in the economy;
- Strong performance of the banking sector; and
- Credit risk in the banking sector continues to decline.

B. New information

- Release of the Economic Survey for 2011 (Economic Survey) by the Kenya National Bureau of Statistics (KNBS);
- Release of the April 2011 World Economic Outlook (WEO) by the International Monetary Fund (IMF);
- Results of the MPC Market Survey for May 2011;
- World crude oil prices declining; and
- Excess volatility reflecting uncertainty in the global financial and foreign exchange markets.

C. Overall macroeconomic context

- Growth expectations from the Market Survey and other economic indicators show sustained confidence in the economy despite inflationary pressures;
- Continued volatility of the exchange rate creating uncertainty;
- IMF growth forecasts for both Kenya and neighbouring countries suggest that growth in 2011 will be strong. This is expected to increase demand for Kenya's exports;
- Financial developments and innovations based on mobile phone technology continue to enhance financial inclusion with a strong impact on the monetary policy transmission process;
- Balance of payment pressure was more than anticipated by CBK and Ministry of Finance.

II. Economic Outlook

a. Global Economic Outlook

The WEO indicates resilience of the global economy, amid shocks, with a projected growth of 4.4 percent in 2011 and 4.5 percent in 2012. In addition, strong growth is projected for Sub-Saharan Africa and in particular, the East African Community countries. Uganda is forecast to grow at 6.0 percent in 2011 and 6.5 percent in 2012 while Tanzania is forecast to grow at 6.4 percent and 6.6 percent, respectively, during the same period. These projected growth rates for the regional economies are expected to support an expansion in Kenya's manufactured exports thereby improving the balance of payments position.

However, the Committee noted that the global economic recovery was still fragile and dependent both on fiscal stimulus leading to fiscal consolidation as well as a decline in international food and oil prices. These policies that are being implemented in the developed economies are particularly important and should have a stabilising effect on exchange rates and demand for Kenyan exports. The recovery of Japan was noted to be faster than anticipated after the earthquake and tsunami. However, the European sovereign debt problems remain a threat to Kenya's horticulture exports and tourism, while the pass-though effect from import prices from the Eurozone threaten cost-push inflation.

b. Domestic Economic Developments

Economic Growth

The Committee noted that the coverage of the Market Survey had been expanded to include private sector firms in other regions of the country which had hitherto not been represented thereby improving the quality of the results. Both banks and the non-bank private sector firms revised their growth expectations slightly downwards, but nevertheless saw the economy as buoyant and thereby indicating confidence that temporary downturns due to shocks were not becoming systemic. These expectations were borne out by other information available to the Committee which showed that the performance of tourism in the first quarter of 2011 had improved. Specifically, the growth in tourist arrivals in January 2011 was 23.2 percent above that of January 2010; that of February 2011 was 9.2 percent above that of February 2010; and, that of March 2011 was 12.8 percent above that of March 2010. The 12-month cement production was noted to have slowed down but, nevertheless, was 9.4 percent above that in the 12-months to March 2010. In addition, the value of tea and coffee exports continued to benefit from improved prices which had compensated for lower production levels.

It was noted that the KNBS had released the Economic Survey for 2011 which provided information on economic performance for the year 2010 and – separately - the fourth quarter of that year. The strong performance of the agricultural sector – with a growth of 6.3 percent – had contributed significantly to the overall economic growth of 5.6 percent in 2010. The Financial Intermediation sector grew at 8.80 percent which was the highest ever recorded by the sector. The overall growth of the economy in the fourth quarter of 2010, at 6.9 percent, revealed that the economy was on a high growth trajectory prior to the adverse international economic environment and domestic weather patterns. The growth was broad based across most of the sectors of the economy. The strong growth numbers in 2010 and diverse distribution through the productive sectors within the economy is a testimony of the quality of macroeconomic policies adopted during the year.

On the basis of the growth data and the information underlying the macroeconomic strategies of Government in the upcoming Budget, the Committee upheld the need to support appropriate growth of private sector credit. Hence, it reiterated the need to nurture financial market stability to support the growth process.

Inflation

Since the last MPC meeting in March 2011, the KNBS had released data showing that the inflation rate had increased from 9.19 percent in March 2011 to 12.05 percent in April 2011 and further to 12.95 percent in May 2011. However, the Committee noted that although the inflation rate had accelerated between February and April 2011, the market was responding to policies announced at the March 2011 MPC meeting. Furthermore, the long rains had improved the availability of quick maturing vegetables. Consequently, the rate at which inflation had been rising slowed down. An analysis of the data showed that if the pace at which inflation decelerated in May 2011 were sustained for the next 12-months, inflation would fall to roughly 7.5 percent from its current level of 12.95 percent.

However, given that the rains are not uniformly distributed in the country, the Committee noted that there is uncertainty on the continued moderation and decline of food prices. Similarly, predictions regarding the timeframe for the restoration of stability in the MENA region which should result in a significant drop in oil prices meant that current inflation pressures, which were short term in nature, could easily be ratified if liquidity levels were to remain high. It was therefore important to address supply side inflationary pressures to ensure that they do not become endorsed through a cost structure that would threaten an inflationary spiral. In addition, the Market Survey showed that both banks and non-bank private sector firms expected inflation to rise but by moderate increments.

An analysis of the inflation data showed that 87.9 percent of the overall inflation in May 2011 arose from increases in the prices of food, transport, and housing. Housing includes a wide range of fuel related costs such as cooking gas, kerosene and electricity. As in the previous meeting, the Committee observed that transport costs relating to food and fuels such as charcoal was being affected by pump prices of petrol and diesel. Although exchange rates were still volatile, the strong upward trend had reversed thereby easing the upward pressure on the Kenya shilling costs of imported inputs since the last MPC meeting in March 2011.

In view of the prevailing inflation level, the Committee concluded that its previous actions on managing inflationary pressures were proving to be effective and should therefore be sustained.

III. Fiscal and Financial Sector Performance

Fiscal Performance

The Committee noted that as the fiscal year 2010/11 was coming to an end, a new Government borrowing programme for the fiscal year 2011/12 would be released in July 2011. The Government Budget for the fiscal year 2011/12 was therefore considered to be a critical input in the next MPC meeting. The Committee reviewed all available data provided to them on the fiscal position and did not foresee reasons for pressure on the financial markets as the fiscal year 2010/11 closes.

Interest Rates

The decision by the MPC to raise the CBR in March 2011 tightened the monetary policy stance. Consequently, short term interest rates increased immediately, with the interbank rate rising almost to the level of the CBR. The rise in short term interest rates, as was expected, also resulted in an overall upward shift in the yield curve. The Committee considered that it would require some time for the longer term interest rates to fully realign.

Average commercial banks lending rates remained virtually unchanged at 13.92 percent between March and April 2011. Similarly, the average deposit rate for banks remained virtually unchanged at 3.47 percent during the period. The Market Survey showed that commercial banks expected their lending rates to rise slightly. However, it was noted that small and medium sized banks had actually lowered their lending rates since the March 2011 meeting.

The Committee noted that the interest rate spread of the large and medium sized banks had remained very high while small sized banks had a narrower spread. It was also noted that country risk as a determinant of the interest rate spread was more significant in foreign owned banks. Available data showed that lending rates in Kenya were in line with those on the continent. However, deposit rates appeared to be much lower, resulting in a much wider spread potentially discouraging savings. The Committee therefore concluded that it was necessary to continue exploring ways to reduce the wide spreads by rewarding savers since this would spur investment and growth.

Banking Sector Developments

The Committee observed that stability in the banking sector had resulted in a strong performance of the sector. In particular, gross loans increased by Ksh.45.8 billion from Ksh.969.9 billion in February 2011 to Ksh.1,015.7 billion in April 2011 while the proportion of net non-performing loans to total loans declined from 1.44 percent to 1.36 percent in the period. Similarly, the number of loan accounts increased from 1,855,020 in February 2011 to 2,005,878 in April 2011 while that of deposit accounts increased from 13,160,029 in January 2011 to 13,478,376 in March 2011. Micro-finance deposit accounts continued to dominate the expansion in the number of deposit accounts. The Committee noted that commercial banks' lending was being channelled to the productive sectors of the economy. For example, loans to the manufacturing sector increased by 6.5 percent between February and April 2011. The Committee analysed the activities of the real estate sector following perceptions that the substantial increase in credit to the sector was fuelling an unsustainable building and construction boom. An analysis of non-performing loans in the real estate sector allayed this concern since these contracted by 6.9 percent between February and April 2011. Stress tests under extreme conditions showed that banks of all categories remained strong.

The Committee examined the liquidity ratio of banks which currently has a statutory minimum of 20 percent. Since banks have an average liquidity in excess of 40 percent, this tool was deemed to be ineffective. Consequently, the Committee undertook to explore ways of making it more effective as a liquidity management tool especially in periods of inflationary pressure.

The Committee therefore concluded that stability and improved performance in the banking system should continue to enable the private sector to access affordable credit in order to support growth.

Foreign Exchange Market and Reserves

The Committee noted that the major shock on the exchange rate witnessed prior to the MPC meeting in March 2011 had responded to the Committee's decision with a stabilisation of the exchange rate immediately after. However, international events continued to shift the values of the currencies of Kenya's major trading partners. When policy actions are taken, these currencies tended to react in a coordinated manner before returning to reflect the trends in the international financial markets.

The need for a steady supply of foreign exchange to support the Government's import and debt service requirements necessitated the Central Bank to continue the acquisition of foreign exchange in the domestic market. In these times of instability in these markets the Central Bank activities appear to have had an exaggerated impact.

Market Liquidity

The Committee analysed the daily performance of the interbank market and noted that the sharp rise in interest rates following the March 2011 meeting was not matched by an equivalent large movement in transacted volumes but did reflect an uneven distribution of liquidity rather than a shortage. By mid-April 2011, a picture was emerging that liquidity was fairly well distributed although some banks were still resorting to the use of horizontal repos and even the Central Bank window. The Committee decided that the late repo which had been in operation some time back should be revived but with a 4-day tenor. With this information, the Committee supported the operationalising of the repo so as to tighten the liquidity further to avoid endorsing inflationary pressures. The monetary targets set by the Committee at its meeting in March 2011 were satisfactorily achieved. The Committee has set the targets for broad money supply, M3, at Ksh.1,400.2 billion for June 2011 and Ksh.1,423.3 billion for July 2011.

IV. Key Considerations during the Monetary Policy Committee Meeting

The Committee concluded that economic growth is expected to remain strong in 2011. However, threats from potential food shortages were likely to impact negatively on the balance of payments position and inflation later in the year. The Committee further noted that the share of imports continued to weigh heavily in favour of capital and intermediate goods, which are supportive to growth. The fiscal position for the rest of the financial year is stable and is therefore not expected to create market pressures. Banking sector credit supply remains strong and on target, and was largely directed towards productive sectors. It was noted that the number of deposit and loan accounts across sectors had increased, endorsing confidence in the economy and revealing success of financial inclusion and access initiatives.

V. Monetary Policy Decision

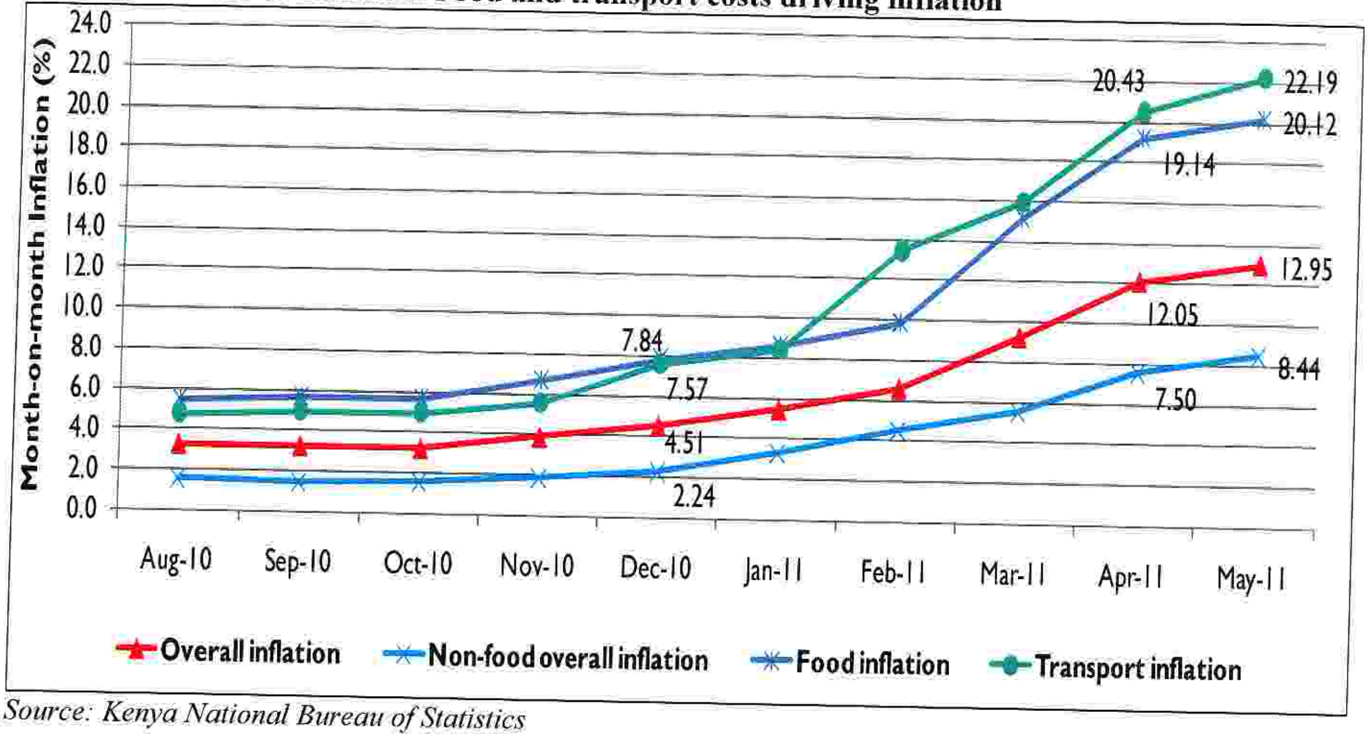
The Committee decided to continue with a tight monetary policy stance so that inflation and inflationary expectations are tamed and exchange rate stability enhanced. In this regard, the Committee raised both the CRR and CBR by 25 basis points to 4.75 percent and 6.25 percent, respectively. The Committee will also review the use of other tools to further enhance the effectiveness of monetary policy and liquidity management.

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

June 6, 2011

ANNEXE

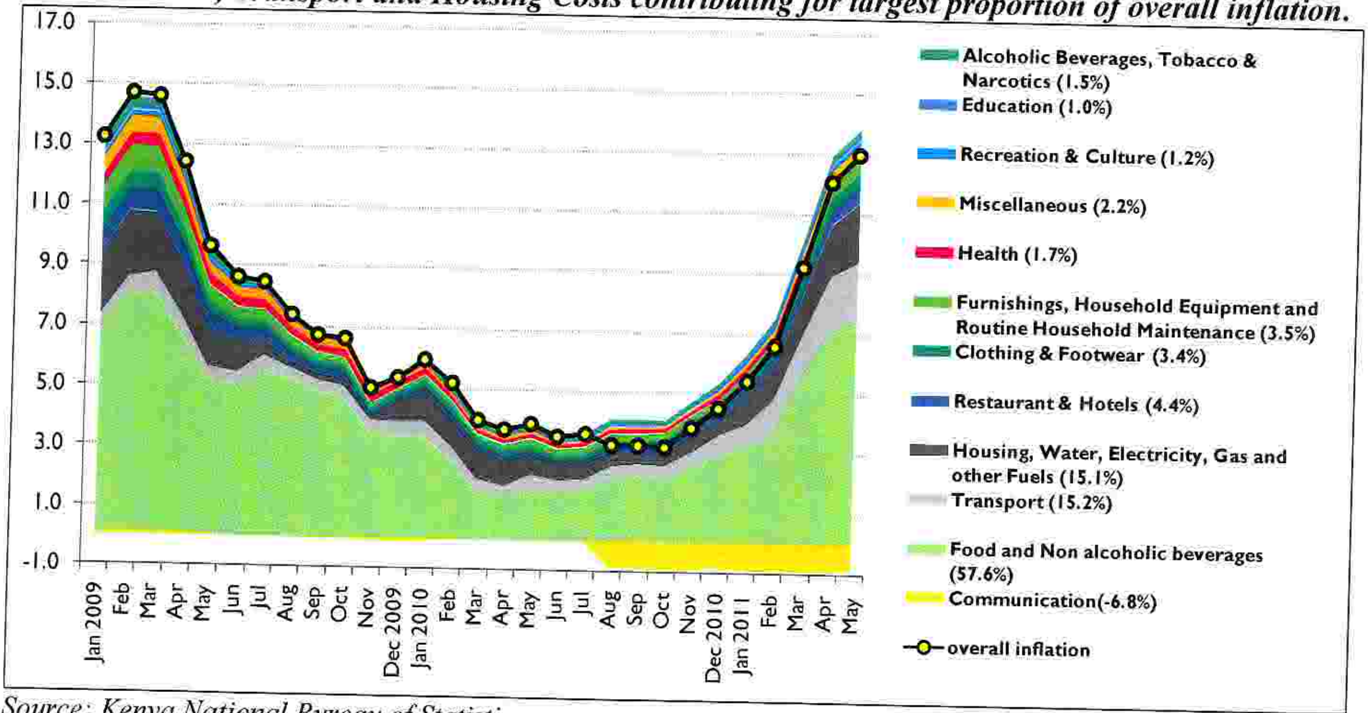
Chart 1: Drivers of Inflation: Food and transport costs driving inflation



Source: Kenya National Bureau of Statistics

- *Inflation decelerated in May 2011 but is still being pushed by the costs of food, fuel and transport.*

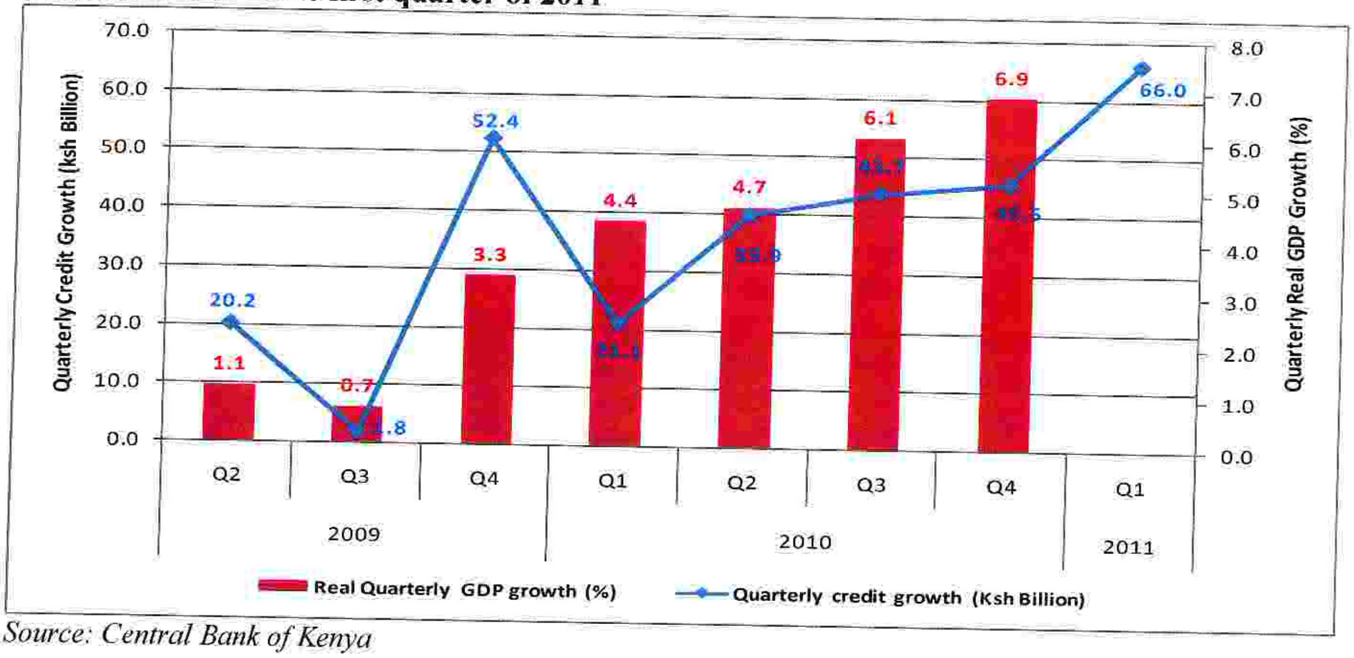
Chart 2: *Food, Transport and Housing Costs contributing for largest proportion of overall inflation.*



Source: Kenya National Bureau of Statistics

- *For May 2011, the main categories in the CPI basket contributed 87.9 percent of the inflation (i.e. 11.38 percent of the 12.95 percent)*

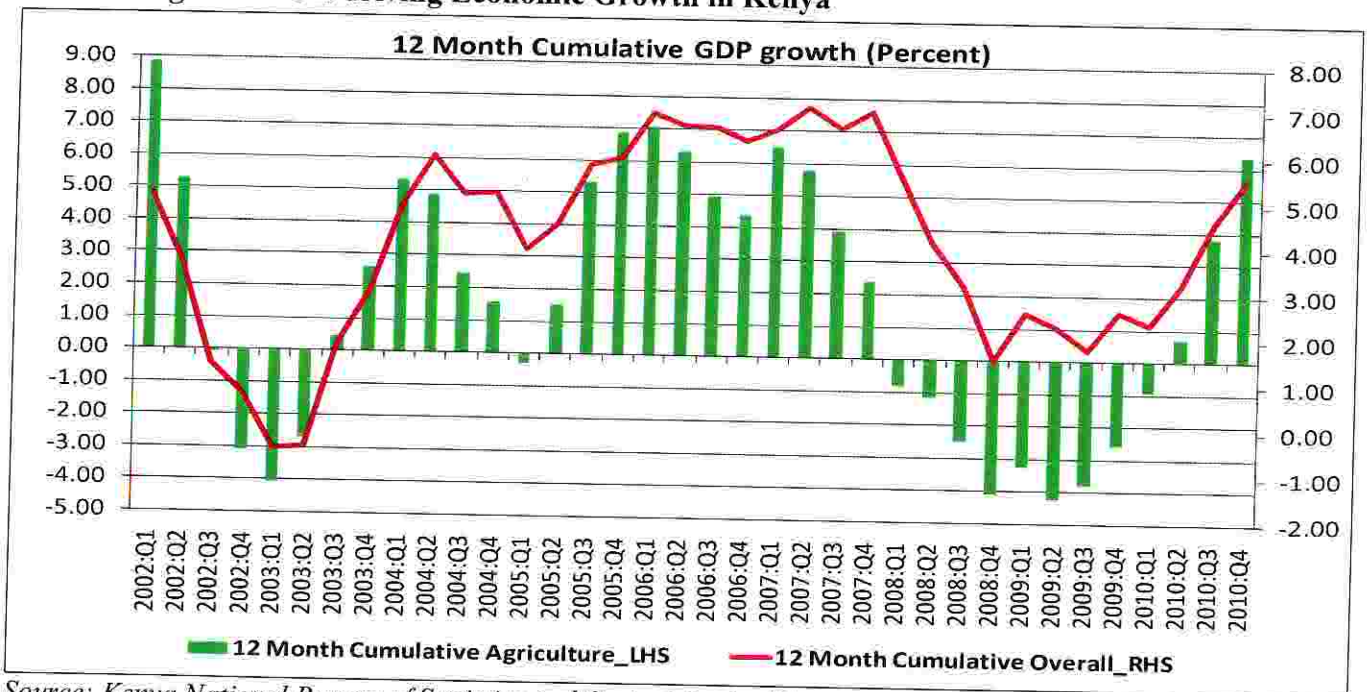
Chart 3: Credit expansion to the private sector financing economic activity: Credit expanded by Ksh.66.0 billion in the first quarter of 2011



Source: Central Bank of Kenya

- *The monetary policy stance has gradually tightened in order to ensure that lending rates do not rise to affect credit expansion that has been supporting economic growth. Credit growth was Ksh.25 billion in April 2011.*

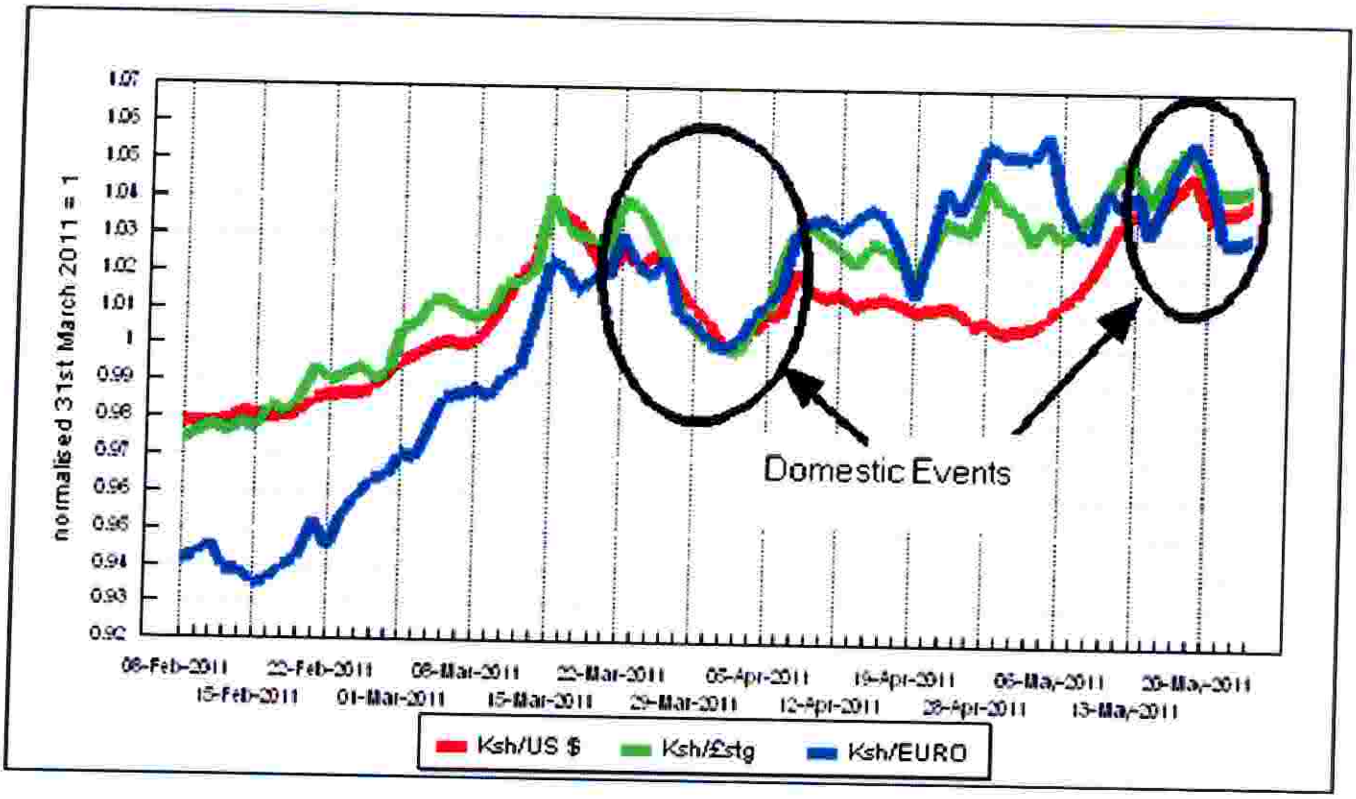
Chart 4: Agriculture is driving Economic Growth in Kenya



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

- *Agricultural production strongly correlated to overall economic growth in Kenya.*

Chart 5: Movements in the exchange rate of the Kenya shilling against major currencies mirror both domestic and international events



- *International events continue to shift the relative strengths and weaknesses of Kenya's major trading currencies so that when policy actions are taken, these currencies tend to react in a coordinated manner before returning to reflect the trends in the international financial markets.*