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## **PRESS RELEASE**

### **CONSOLIDATING ECONOMIC GROWTH AFTER A SEVERE SHOCK AND TURBULENT INTERNATIONAL MARKETS**

#### **I. Introduction**

The Monetary Policy Committee (MPC) in its meeting on Monday 29<sup>th</sup> September 2008 reviewed the economic and financial developments since its last meeting on 6<sup>th</sup> August 2008. It noted with satisfaction, that the economy and the markets had responded to its previous policy actions.

A. Carried forward from its previous considerations were the significance of:

- The need for a more detailed understanding of the whole process and consequences of the Safaricom IPO;
- The emerging concern with respect to international economic events;
- The modality of inflation measurement and its interpretation.

B. New information that has become available to assist analysis and decisions with respect to Monetary Policy relates to:

- The Safaricom Analysis Report which has been finalised;
- The international financial crisis has deepened with financial institutions closing and international equity markets collapsing;
- Foreign governments have taken major measures to try and contain the damage including raising interest rates and taking over financial institutions;
- Domestic growth has rebounded satisfactorily and should not be very vulnerable to international events although some indirect impact can be expected;
- Inflation continues to be worrisome but it is all related to supply side food problems rather than to any monetary overhang effects.

C. Overall macroeconomic context was observed with two key outcomes:

- The economic growth has rebounded;
- The quest for a new inflation measure.

## **II. Review of Domestic Economic Developments**

### **Economic Growth**

The much talked about economic recession arising from the election-related crisis earlier in the year has not materialised. Instead the Bank's sentiments expressed in February have turned out to be correct. *Economic recession occurs when real GDP growth is negative for two or more consecutive quarters.* According to data released by Kenya National Bureau of Statistics (KNBS), the economy grew by 3.2 percent during the second quarter of 2008 (comparing second quarter of 2008 over the quarter of 2007). The first quarter growth numbers have been revised upwards from negative 1.3 percent to negative one percent after more data became available. Even though the 3.2 percent growth during the second quarter is lower when compared to the 8.9 percent in the same quarter of 2007, this is a remarkable achievement noting that the second quarter relative to the first quarter improvement this year has only been exceeded once since KNBS started calculating quarterly data from 2000.

The analysis of this recovery provides some useful insights. Manufacturing, Electricity and Water, Wholesale and Retail Trade, and Fishing performed better than in the first quarter of 2008, signalling the second quarter recovery. Construction, Mining and Quarrying and Public Administration posted improved growth compared to the same period in 2007. Agriculture Sector grew by 2.8 percent in the second quarter compared to 2.3 percent over the same quarter in 2007. However, while the performance of Manufacturing Sector of 2.8 percent growth in the second quarter is positive compared to the decline in the first quarter, it was much less than the 7.7 percent growth of last year.

The Committee is optimistic that the worst of the economic crisis is over and the economy is on the rebound as has been articulated by previous Bank statements. However, it is noted that the economy is not yet operating to its full potential.

### **Inflation**

The Consumer Price Index, a measure of retail goods and services in Nairobi and selected Kenyan urban centers, increased by 1.6 percent in September from the previous month, after a 0.5 percent monthly increase in August. Month on Month inflation was up 28.2 percent, just above the August rate of 27.6 percent. Information available to the Committee points to the fact that the increase in inflation numbers was driven by price changes in food, housing and medical costs. Other categories of goods remained relatively unchanged from the August numbers. The Committee showed

interest in the announcement that KNBS will be using the Kenya Integrated Household Budget Survey (KIHBS) of 2005/6 as the basis for its new Consumer Price Index (CPI). This signals a major change in the consumption pattern that might point to important changes in significant sectors of the consumption basket as indicated in the 2008 Economic Survey. In addition, the Committee noted the development that the KNBS was in agreement with the recent assertion by the IMF Staff Report that the methodology it currently uses to calculate inflation numbers had an upward bias which could be rectified by using an internationally acceptable mode of computation. Given these developments, the Committee observed that the current index had sufficient shortfalls that undermined deep analysis for monetary policy decision making. As such, members also expressed a need for an inflation index which would be responsive to demand side pressures that are within the compass of Central Bank policy decision.

### **Interest Rates**

Information available to the Committee showed that since its last meeting in August, 2008 the interest rates on the short end of the market, repo and interbank rates, declined significantly while those of short term government bills remained relatively stable. Specifically, the repo and the interbank rates fell from an average of 7.41 and 8.06 percent in July to 6.02 and 6.68 percent respectively in September. At the same time the 91 and 182 day Treasury Bills had fallen from an average of 8.03 and 9.09 percent in July to 7.66 and 8.05 respectively in September, 2008. The Committee expressed satisfaction that the fall on these two short end interest rates was as a result of the dissipation of skewed liquidity in the financial system. It cautioned against the market extracting the wrong signals from the repo rate movements that the Bank had relaxed its monetary operations. The fall in the repo rates is linked to the redistribution of Safaricom IPO related skewed liquidity which clogged the system but which had now been corrected.

### **Exchange Rates**

Since its last meeting, the Committee noted the turbulence in the foreign exchange market. The Kenya shilling had experienced excess volatility especially in the month of September. A number of reasons seem to have contributed to this excess volatility. Among them is the misperception within some segments of the market that the Central Bank had taken a cavalier attitude towards fighting inflationary pressures by not tightening monetary policy. The other is the "flight to safety" fear that occurs in times of financial crises like the one currently being experienced in the US, Europe and

other parts of the world. During such times the confidence of markets in emerging economies is shaken and investors tend to dump the local currencies for precious metals or “safe” currencies like the EURO and others. Lastly, these two factors have generated a high demand for foreign currencies among worried investors and speculators taking advantage of the situation. As these developments evolve the Central Bank has noticed speculative behaviour among foreign exchange dealers engaged in price gorging. The Central Bank’s initial reaction was to stabilise the market without determining the direction of the shilling by auctioning foreign currency into the market. This might have sent the wrong signal that the Bank was intervening. The position of the Bank was, and still is, that the exchange rate fundamentals do not justify the volatility being experienced in the market.

### **Monetary Developments**

With the skewed liquidity in the banking system dissipated, the Bank is now on its reserve money path. The actual growth in reserve money was 14.7 percent compared to the target growth of 16.0 percent in August 2008. Actual growth in broad money supply was expanding at 17.1 percent compared to the target rate of 17.3 percent during the same period. This is the first time in over five years that this milestone has been achieved. However, it is important to note that actual reserve money was still above target. Given these facts, the market needs to pick the signal that there is no monetary overhang in the economy that is putting pressure on domestic prices. In other words, the inflationary pressure being experienced is not as a result of a monetary phenomenon.

### **Lessons Learnt from the Safaricom IPO**

The background of the August 2008 meeting was dominated by the residual liquidity problems associated with the Safaricom IPO. This had impacted both on individual banks borrowings and interest rate movements. By the time of this meeting the Safaricom IPO message was now one of a careful understanding of what could have been done better to ease the process. In this, it was noted that there was significant asymmetry in bank behaviour in the lead up to the IPO and thereafter. Several banks had failed in their commitment to assist in the stable restoration of system-wide liquidity. In addition, some banks on-lending and adverse selection behaviour prevented a faster adjustment process. It is apparent that the regulator and other capital market actors failed to deliver to the economy the boost that an IPO of this magnitude should have delivered. They seemed to have focussed more on institutions to the detriment of the smaller investors.

### **III. The International Context**

Unlike the previous meeting where domestic macroeconomic issues were of first concern, the Committee agreed that domestic response to the serious downturn in international economic activity was of critical importance. Its view is that the domestic recovery was on track. However, possible risks exist that could see adverse international events stifling the beneficial domestic economic resurgence. In this it considered the transmission mechanisms of economic shocks into the domestic economy but saw no reason to be pessimistic about the 3<sup>rd</sup> and 4<sup>th</sup> quarter performance of 2008.

### **IV. Key Considerations in the Monetary Policy Meeting**

While considering what action to take to chart Monetary Policy to meet the Bank's objectives for the near future, the Committee took note of the developments in the domestic and international markets as discussed above. They took comfort in the fact that there was no liquidity overhang in the system as the Bank was on its reserve money path. There was no longer a need for reverse repos to stabilise the financial system. Despite these remarkable achievements, the Committee is still of the view that the levels of inflation are still unacceptably high albeit driven by factors beyond its control. In addition there is inflationary pressure in the economies of Kenya's trading partners which together with the instability in the financial system in the US, Europe and elsewhere means that, there is both a need for analysis of the mode in which international events transmit to Kenya's economy as well as a sensitive early warning system to allow timely decision.

Despite the positive news on economic performance from the second quarter data, the Committee noted that while the downside risks to growth remained the upside risks to inflation were of significant concern. The Committee will continue to monitor economic and financial developments and will act as needed to promote sustainable economic growth and price stability. Going forward, the Committee evaluated and was satisfied with the availability of scope and instruments the Bank had to ease inflationary pressures. Using the open market operations, the Bank could still tighten monetary policy. By doing that, domestic assets could become more attractive to wary foreign investors. A tightened monetary policy environment will also help dampen depreciation fears and stabilize the exchange rates movements.

## **V. Monetary Policy Decisions**

Considering the balance of prospects and risks the committee decided to retain the CBR at 9 percent. At this rate the Central Bank will deepen its open market operations to effectively manage market liquidity. It will also continue to vigilantly monitor the international developments and their possible impacts on the domestic market.



**PROF. NJUGUNA NDUNG'U**

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