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## **PRESS RELEASE**

### **THE INAUGURAL MEETING OF THE MONETARY POLICY COMMITTEE**

#### **I INTRODUCTION**

The MPC held its inaugural meeting on Thursday 5th June 2008. This meeting focused on recent turbulent events both internal and external to Kenya, and the markets' reactions to these events.

A. The Committee observed the following events that have implications on the financial services sector

- Inadequate November 2007 rains
- Post election disturbances
- A new political landscape
- The substantive Safaricom IPO
- International oil price escalation
- Commodity price shocks internationally
- Turbulence in the international capital markets

B. It was noted that the most immediate outcomes and concern to CBK were:

- a. Increasing inflationary pressures both underlying and overall
- b. The distorted liquidity position within the banking sector
- c. Likely portfolio flows taking advantage of interest rate differential and appreciating nominal exchange rate

C. The overall macro economic context was observed to be:

- a. Very strong economic growth and investment coming into the end of 2007
- b. Buoyant economic growth expectations for the later half of 2008
- c. Post election crisis affecting macro results that make the recovery more complex. Specifically the supply side, additional demands, and perceptions

## **II A BRIEF REVIEW OF ECONOMIC DEVELOPMENTS**

### **Interest rates**

The Committee noted that all three indicative wholesale short term rates were impacted by the Safaricom IPO. The market response was as predicted;

- It was expected that the Safaricom IPO would shift liquidity within the system. Through an informal agreement the inter bank rate was capped by a discount relative to the CBR. Except for a few errant cases, this cap was maintained.
- The Repo bills constraint to mop up excess liquidity was overcome by the introduction of a new instrument called the "Term Auction Deposit".
- Finally it was noted that in a high proportion of recent auctions the offer for the Treasury bill was not covered.

### **Exchange Rates**

The long term externally determined strengthening of the Kenya shilling against the dollar encountered a major shock with the declining confidence in the shilling as a result of the post election instability. These have now reverted to trend. We continue to monitor the interaction between the international oil price and the strength of the Kenya shilling. In addition, due to turbulence in the international capital markets, the CBK will continue to monitor portfolio flows into the economy.

### **Economic growth**

The momentum of the economy from a variety of indicators such as tourism, milk and tea production was noted to have declined, nonetheless there were other aspects of the economy indicating that some of this could merely be a "wait and see" and recovery is still promising. In the meantime the Kenya National Bureau of Statistics has committed itself to providing the results of the first quarter GDP by end of June 2008, by which time it will be possible to make a full quantitative assessment of the real sector requirements of support from the financial sector. In totality, it is expected that the worst case scenario of overall growth in the economy would be 4.5%.

### **Balance of Payments**

In considering the balance of payments it was noted that the structure of Kenya exports had moved significantly towards consumer goods, with the US emerging as a more favoured destination. In all probability these two observations are associated with the success of the export processing zones in providing consumer goods under AGOA.

On the import side it was noted that South Africa has become a significant source of Kenya imports. This may be associated with the strengthening of the Shilling against the Rand.

## **Inflation**

Inflation from January 2008 onwards shows both deterioration in the underlying inflation, from November 2007: 5.17% to May 2008: 6.58%. As well as the overall inflation November 2007: 11.83% to May 2008: 31.54%.

Food inflation at 44% is the driving factor as all other components are below 21%. In addition the total increase of 133 index points in food inflation is split unevenly, 117 of them coming in the last six months. This same result is observed in the inflation of the fuel and power sector which increased by 17.9%, an increase of 66 index points of which 55 were in the last six months.

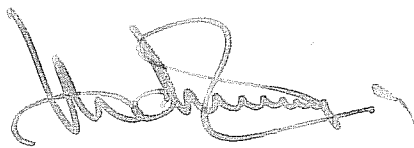
### **III KEY CONSIDERATIONS IN THE FORMULATION OF MONETARY POLICY**

Inflation is predominantly being driven by factors outside of monetary control, monetary policy is focusing on the implications on the one hand of the Safaricom IPO generated liquidity whilst on the other hand the need for the Government to take an active part in assisting the economic restoration. In watching the fiscal dynamics as the Government enters a new fiscal year with enlarged demands on its fiscal resources, the Central Bank will require space to allow it to tighten policy if need be at short notice so that the economy reverts to the growth trends of the previous five years.

The Central Bank in its responsibilities will be supporting the Government's efforts, to restore confidence to a level where the vision 2030 goals over the first five years can be realised.

#### **Monetary Policy Decisions**

After careful consideration of these economic, monetary and financial developments the Committee concluded that the Bank required some space in excess of that given by a CBR rate of 8.75%. It therefore raised the CBR to 9% with immediate effect, and set itself to monitor the distribution of the Safaricom IPO liquidity so as to assess its impact on both the real and nominal economy. In addition the exchange rate effects as well as the oil price changes whilst being outside its immediate capacity to influence would be carefully monitored since the balance of payments effects would have knock on affects into the money supply.



**PROF. NJUGUNA NDUNG'U**

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June 11, 2008