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PRESS RELEASE

MONETARY POLICY COMMITTEE MEETING OF MARCH 20, 2009

MANAGING LIQUIDITY AND STABILITY WHILE STIMULATING GROWTH IN CHALLENGING TIMES.

I. Introduction

The Monetary Policy Committee met on 20th March 2009. It carefully examined how the market had responded to its decisions of 30th January 2009 and noted that the market continues to respond positively to the decisions made. However, it observed some distortions in the money markets and credit markets relating first to the perceived risk profile in the real sector due to the global financial crisis and second to intermediation inefficiency due to the segmented nature of the banking sector.

A. Information carried forward

- Global economic downturn and its expected implications on the domestic market.
- Money market performance and the overall liquidity situation.

B. New information

- Oversubscription of the first infrastructure bond.
- Continued global dollar liquidity effects on domestic foreign exchange reserves and the foreign exchange market.
- Fiscal targets and challenges.

C. Overall macroeconomic context

- Growth forecasts for 2008/09 and 2009/10 revised downwards with balance of payments and fiscal consequences.
- Profitability and performance of the banking system and access to credit.
- Competitiveness of the domestic market.

II. Overall Macroeconomic context

The Committee noted that despite several attempts to stimulate the economies of industrialised countries, the negative effects of the global financial and economic crises had yet to bottom out. According to the IMF assessment of the global economy, trade volumes have shrunk rapidly, while production and employment data suggest that global activity continues to contract in the first quarter of 2009. The latest GDP numbers for the fourth quarter 2008 showed USA, Japan, Britain and Euro Area economies had shrunk by 0.8, 4.3, 1.9 and 1.3 percent respectively. Kenya's trading partners in the East had performed better in the fourth quarter compared to those in the West. China, India, Pakistan and Egypt grew by 6.8, 5.3, 5.8 and 5.9 percent respectively in the fourth quarter.

Global activity is now projected by the IMF to contract by ½ to 1 percent in 2009 on an annual average basis—the first such fall in 60 years. According to the IMF report (March 2009) a modest recovery in growth is expected only in 2010 but even that is contingent on comprehensive policy steps to stabilise financial conditions, sizeable fiscal support, a gradual improvement in credit conditions, a bottoming out of the U.S. housing market crisis, and the cushioning effect from sharply lower oil and other major commodity prices.

In Africa, growth is expected to slow down particularly in commodity exporting countries. Several countries are experiencing reduced demand for their exports, lower remittances, and foreign direct investment, while aid flows are under threat. In Kenya, Treasury officials have revised the growth forecasts from 5.8 percent to between 3 and 3.5 percent for both 2008/09 and 2009/10.

In a move to preserve macroeconomic stability, the Ministry of Finance announced plans to cut Government expenditure to the tune of Kshs.25 billion to accommodate its decision not to float the international sovereign bond this fiscal year as the market conditions were unfavourable and because of delayed privatisation. By consolidating its fiscal position in the light of less than projected revenue, the Government signalled that it was committed to maintaining macroeconomic stability and focusing on the medium term path as outlined in Vision 2030. The Government has also indicated its intention to minimise interruption in the growth process during 2009 and 2010 by ensuring enhanced capacity for growth through exploiting Kenya's growth drivers by not cutting on key infrastructural projects.

In recognition of the fact that macroeconomic stability on its own was not sufficient, the Government initiated Kazi Kwa Vijana (KKV) programme to mitigate the rampant youth unemployment in March, 2009. KKV will generate employment opportunities for over 300,000 youth at a cost of Kshs.15 billion. Such programmes while giving our youth a chance to participate in gainful employment and building their self esteem and confidence, are also vital in boosting private consumption necessary to stimulate economic growth. In continuation of the strategy, the programme ought to be expanded to include amongst other projects, construction and rehabilitation of rural roads, laying of broadband cables, refurbishing schools and rural hospitals and dispensaries. These measures are expected to have the dual impact of injecting resources into the economy in terms of Government expenditure and at the same time creating employment and boosting savings and growth.

III. Domestic developments

Since the Committee's meeting in January, 2009, the Government has launched an infrastructure bond for investment and development. The appetite for this Kshs.18.5 billion bond was high as measured by the level of oversubscription which was 45 percent. The success of this type of bond, lays a foundation for further infrastructure bonds in the future to finance various planned projects, namely, railways, ports, airports, water and sanitation facilities and telecommunications. It will also serve to increase Government spending in the economy and create employment while acting as an economic stimulus to the economy. In addition, it is a vehicle that serves to stimulate savings and domestic investments.

On the real sector front, the poor November rains and the forecast of patchy March/April rains continue to make food considerations dominate domestic economic analysis and move them into the forefront for policymaking. The domestic food shortages are affecting the balance of payments and the national budget. The benefits from imported grain have yet to be felt in the domestic market where overall and food inflation has been driven by increased maize prices. Data for the fourth quarter GDP were not available, however, the Kenya National Bureau of Statistics (KNBS) Economic Survey should be available shortly giving the growth for 2008. This will provide a better basis for forecasts for 2008/2009. Nevertheless, the fourth quarter growth outcome data will be available soon and like the preceding quarter the building and financial sectors will continue to show good performance whilst rain-fed agriculture will be depressed. But in totality, the economy is healthy and the financial sector resilient.

Inflation

At the time of the meeting, inflation numbers for March, 2009 were not available. However, deeper analysis of inflation numbers gave an indication of the extent to which the February 2009 inflation outcomes were a consequence of the maize prices in Nairobi. Since the weight of food is high in the CPI basket, any increase in the food prices (which is dominated by maize) tends to spike inflation figures. The average price of a two kilogram packet of sifted maize flour increased by 18.5 percent from KShs.78.48 in January to KShs.92.99 in February 2009. As a result overall inflation increased from 21.9 in January to 25.1 percent in February while food inflation increased from 28.9 to 33.9 percent in the same period. However, underlying inflation, as measured by the KNBS and CBK, continued to decline. The KNBS month on month *underlying* inflation rate which *excludes food items* from the CPI basket decreased from a revised figure of 8.4 percent in January to 7.9 percent in February 2009 while the CBK underlying inflation declined marginally from 8.9 to 8.7 percent in the same period.

The Committee drew on six research projects covering different aspects of inflation being undertaken by the Research Department of the Central Bank. These *inter alia* covered imported inflation, market price formation and discriminate impact of price instability. These research projects will be important in informing policy formulation in future.

Interest rates

The Committee derived a mixed message after observing the developments in the money markets as regards interest rates. Interest rates in the interbank market in February 2009, contrary to the earlier period, were being driven by changes in demand rather than supply which had predominated since January 2009. The interbank market showed that a small set of borrowers were taking 75% of the overnight funds which would therefore, affect the monetary market liquidity situation.

Treasury bills were seen to be filling the gap caused by the shortfall in Government's requirement in its borrowing programme, while the over-bidding on the Treasury bond indicated liquidity was still available for risk free short tenor securities. As such, even though the Treasury had revised its domestic borrowing requirement by Kshs.20 billion to Kshs.74 billion from Kshs.54 billion, the Committee noted that the revision should not have an impact on Treasury bills and bonds interest rates.

The Committee however noted that a number of banks had either increased their lending rates and/or restricted lending to some particular sectors as a result of perceived risks emanating from the fallout of the global financial crisis. Disaggregate analysis showed average overdraft rates for corporate and businesses had fallen in both January and February while in the same two months private borrowing rates for 1 to 5 years rose. Overall however, the interest rate spread has declined noticeably from 9.98 percent in December to 9.59 percent in January to 9.44 percent, in February 2009. This is a good reflection that the financial sector is improving on its allocative efficiency.

Exchange rates, foreign exchange and international interest rates

Current account deficit for 2008 worsened by US$1.02 billion as it increased from US$1.10 billion in 2007 to US$2.12 billion in 2008. This was mainly attributed to the huge increase in the value of oil imports of US$1.12 billion. The oil bill increased from US$739 million in the second quarter to US$1,081 million in the third quarter but significantly declined to US$540 million in the fourth quarter as a result of the fall in the international oil price. The main destinations for Kenya's exports remain regional markets of EAC and COMESA. More of Kenya's goods are exported to the Middle East and Asia. These regions are expected to have positive growth in 2009/10. As such, the outlook for the current account remains stable even though exports of horticulture (especially flowers) are expected to be adversely affected by the economic down-turn.

The international cross rates between the dollar, Euro and sterling have continued to be reflected in real time in Kenya. This has meant significant volatility of the Kenya shilling vis-à-vis the major currencies. The shilling has depreciated by about 3 percent against the US dollar since the beginning of 2009 which is comparable to other currencies' performance. The UK sterling pound and the Euro have lost about 4 and 7 percent in the same period.

The Committee considered that the severity of the balance of payments problem would depend on the capital and financial account movement. In 2008, the capital account increased marginally by US$27million, while the financial account deteriorated by US$313 million. The deterioration in the financial account was mainly driven by the private medium and long term net outflows of US$523 million. Capital and financial inflows have increased from US$66.32 million in October to US$162.6 million in December 2008.

Monetary Developments

The Committee noted that the Bank had comfortably met the set monetary targets. In February, 2009, actual broad money, M3X, was Kshs.900.03 billion against a target of Kshs.939.84 billion while reserve money stood at Kshs.151.82 against a target of Kshs.164 billion. However, the Committee agreed on the need to review the monetary aggregate targets in the light of the new, revised GDP growth forecasts number and the 5 percent Cash Reserve ratio.

The Committee discussed at length the inefficiencies in the money and capital markets and the associated high transactions costs which continue to hinder financial intermediation. Among the options discussed was the Interbank Master Repurchase Agreement (Horizontal Repo) which was introduced in 2008 with the objective of deepening the capital and money market and enhancing the intermediation process. The Committee noted that the introduction of this facility was timely as it offered real time Delivery versus Payment for transactions and as such it was a tool that could help banks manage their liquidity. Since the Bank had also developed an electronic transaction system for the Repo programme, the Committee therefore urged the Bank to issue a circular to commercial banks requesting them to take advantage of the programme. To increase the attractiveness of the horizontal repo facility, the Bank was also urged to explore other administrative actions including reducing the flexibility of the REPO facility.

The handling of the foreign exchange reserves constituted a major area of analysis and policy considerations by the Committee which has, as part of its mandate to formulate and implement foreign exchange policy. It discussed the likely impact of the foreign reserves being below the statutory minimum of 4 months import cover. It concluded that at the moment, it was not necessary to build up reserves as the dollar effect was a distortion. The value of the dollar has been driven by "flight to safety" effect which happens during a crisis. A correction would be made once confidence is restored in world markets. Calculations by staff in the Central Bank indicate that foreign exchange reserve draw-downs were not drastic (less than 5%). However, CBK views the draw-down as part of its stabilisation programme. Had CBK attempted to replenish the draw-down during the crisis, the Kenya shilling exchange rates might have depreciated further which could have been inflationary. A deeper depreciation could have triggered higher interest rates. Most of the foreign reserves loss is attributed to revaluation losses which are merely book value in nature. The Bank analysis indicates that of the US$694.8 billion loss of reserves from July 1, 2008 to March 17, 2009, revaluation losses account for 76% while the net outflow of reserves account for 24%. The Committee considered that the relevant variable for import cover is a measure which captures how much imports can be purchased by foreign exchange reserves with a basket of currencies related to the pattern of trade. Thus the trade weighted months of import cover measure is the appropriate measure which CBK should adopt. This will require a change of law which the Central Bank will address in the near future via the budget letter.

IV. Key considerations during the Monetary Policy Meeting

The main challenge for the Committee was to pursue a monetary policy that kept in view the downside risk of slowing economic activity as external conditions deteriorate. It was necessary to ensure that the current high inflation does not become a permanent feature in the economy by balancing the concerns about inflation while providing an adequate flow of credit to the real sector. As such, ensuring an interest rates structure that supports economic growth without compromising the inflation goal is vital.

The second consideration arose from an expression of concern with respect to foreign exchange reserves and exchange rate instability. It was established that reserves when examined in their respective currencies relative to the requirement were adequate for trade and debt service. If anything the problem was one of a mis-match rather than an inadequacy. The need to dampen speculation did not arise. The Committee will continue monitoring the exchange rate movements of currencies of countries that compete with Kenya in its export markets.

Finally the Committee's decisions were guided by the examination of the overall market liquidity. To improve on this, it requested the Bank to introduce institutional modalities to free up liquidity currently used in less than optimal macroeconomic purposes and improve on the intermediation process in future.

V. Monetary Policy Decisions

The Committee considered that the most important aspect of enhanced access to liquidity would be through the operationalisation of the horizontal repo. It was agreed therefore to implement an immediate instrument to effect this. Backing this decision the Committee considered that a 25 basis points reduction of CBR would generate an appropriate signal to the banking sector that interest rates, both bid rates on securities and lending rates to customers should ease. Therefore, the CBR was revised downwards from its current level of 8.5 to 8.25 percent per annum. This rate would still yield a positive real return with respect to the underlying inflation rate.

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