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PRESS RELEASE

MONETARY POLICY COMMITTEE MEETING OF MAY 20TH, 2010

"Consolidating Monetary Policy Gains"

I. Introduction

The Monetary Policy Committee (MPC) met on 20th May, 2010 to review the market's reaction to its previous decisions as well as the general performance of the economy. The Committee decided to retain the CBR at its current level of 6.75 percent to allow the financial sector continue absorbing the impact of the decline in short term interest rates: particularly, repo, interbank and Treasury bill rates. The Committee's decision was informed by the optimistic outlook expressed in the MPC Market Survey May 2010 (Market Survey) as well as positive international and domestic growth forecasts for 2010. The conclusions were informed by the following sets of information:

A. Information carried forward

- Growing private sector credit;
- Declining credit risk in the banking sector;
- Lengthening maturity profile of public debt.

B. New information

- Results of the MPC Market Survey for May 2010;
- Oversubscription of all public domestic debt issues;
- Data from the Economic Survey 2010;
- Decline and stabilisation of inflation;
- Rising oil prices globally;
- Developments in the Euro Zone due to the Greek crisis.

C. Overall macroeconomic context

- The fragile recovery of the Euro Zone coupled with potential debt crises in several member states. This has led to a weakening of the Euro internationally and widespread exchange rate instability. The flight to the dollar has weakened the shilling substantially.
- The domestic economy showed improved growth in 2009. Preliminary indicators show that the first quarter of 2010 will continue with this upturn conditional on appropriate supportive public policies and favourable weather conditions.
- Sustained growth and stability in the banking sector with continuing decline in non-performing loans.
- Improved rainfall enhancing agricultural production thereby easing basic food prices and reducing reliance on expensive oil generated power.

II. Economic Outlook

a. Global Economic Outlook

A variety of sources have indicated a major improvement in world economic growth prospects. For example, in its April 2010 World Economic Outlook (WEO), the IMF projects the global economy to grow by 4.5 percent in 2010 which represents a 1 percent upward revision from the October 2009 WEO. This improvement will not be evenly spread since the Greece debt crisis poses contagion effects. However, supportive measures are being undertaken to mitigate the potential risks.

Notwithstanding the challenges in the Euro Zone, the MPC saw improved prospects for growth worldwide as likely to benefit Kenya through increased demand for its exports. Importantly, growth forecasts in Uganda, Tanzania and Rwanda, where a large proportion of Kenya's manufactured exports are destined, continue to be robust.

b. Domestic Economic Developments

Economic Growth

The Economic Survey shows that the economy grew from 1.6 percent in 2008 to 2.6 percent in 2009. The new data for 2009, however, underscores the vulnerability of the Kenyan economy to weather effects both in agriculture and in hydro energy dependence. Notably, the Economic Survey forecasts strong growth of 4.0–5.0 percent for 2010. The Market Survey also shows that both banks and private sector firms are more optimistic about growth than they were in March 2010 and predict growth of between 4.2 and 5.0 percent in 2010.

The Committee's review of available performance indicators for the first quarter of 2010 shows that 12-month tax revenue collections had increased relative to 2009 and were well ahead of inflation. Specifically, income tax as an indicator of economic activity and VAT as an indicator of domestic consumption pointed towards a strong first quarter growth performance. This was supported by growth in power generation and consumption as well as recovery in tourism. In the latter, tourist arrivals are now back to levels before the post election crisis. In agriculture, tea and coffee are now fetching higher prices while tea and milk production have greatly improved.

Inflation

The latest data from KNBS shows that the inflationary pressure in the economy continued to ease with overall annual inflation declining from 4.0 percent in March 2010 to 3.7 percent in April 2010. The Committee analyzed the sources of inflation by broad commodity groups and noted that food and non-alcoholic beverages explained 39 percent of the April inflation while housing, water, electricity, gas and other fuel contributed 22 percent and transport contributed 11 percent. Inflation outlook for the next two months is favourable as the current rains indicate that food prices will continue to decline. Any inflationary pressure emanating from increases in oil will mainly affect the transport category which has a weight of 8.7 percent of the CPI basket. However this may be mitigated by a reduction in electricity prices and the second round effects on production costs.

To support this positive outlook is the Market Survey which indicates that 84 percent of banks and 56 percent of private sector firms expect no increase in inflation. This shows a downward revision in inflation expectations since March 2010.

III. Fiscal and Financial Sector Performance

Fiscal Performance

The Committee reviewed the 2009/10 budget performance and noted that both Government revenue and expenditure were below their respective targets as at end of April 2010. Additionally, it was noted that the Government had already met its domestic borrowing requirement for the fiscal year and as such there was minimal threat to monetary policy from the fiscal side.

The Committee also analysed the overall public debt position and was of the view that the current debt levels were satisfactory and did not pose significant risks to macroeconomic performance. Public debt ratios were observed to be consistent with the thresholds in the current Medium Term Expenditure Framework.

Interest Rates

The Committee noted that short term interest rates had declined in response to the CBR signal. However, there were some minor volatilities in the interbank market. The auctions of Government securities were oversubscribed indicating a liquid market. The introduction of Treasury bonds with market determined coupon rates has further endorsed the effectiveness of the CBR as banks continue to bid down the rates across the entire yield curve in response to the signals from the CBR.

The interbank rate continued to track the repo rate that operationalises the CBR signals. Specifically, since the previous MPC meeting, the daily weighted average rates in the interbank market ranged between 1.8 and 2.7 percent while in the repo market it ranged between 2.2 and 2.7 percent. The 91-day Treasury bills average yields declined from 5.7 percent at the end of March 2010 to 4.5 percent in the auction before the MPC meeting while the 182-day Treasury bill rates dropped from 6.2 to 4.5 percent during the same period. Over the same period, the issued Treasury bonds were significantly oversubscribed with resultant declining yields. For instance the 15-year Treasury bond sold at 9.98 percent compared with 13.7 percent in October 2009 while the 5-year bond declined from 10.8 percent in August 2009 to 6.8 percent in May 2010.

This is expected to continue in the next two months as indicated by the results from the Market Survey which shows that banks are absorbing the CBR signals with more than 75 percent of respondents expecting interest rates to decline significantly in the remainder of 2010. The overall picture thus corroborates the decline in inflation and optimistic economic activity in the future.

Banking Sector Stability

The latest stress tests show that the banking sector is healthy. Non-performing loans contracted by 1.9 percent between February and April 2010 with major improvements in agriculture, manufacturing, trade and real estate sectors. The Committee noted an increase in gross loans and the number of loan accounts with gross loans expanding by 2 percent from Kshs. 783.8 billion in February 2010 to Kshs. 799.5 billion in April 2010. The number of loan accounts increased from 1,832,085 to 1,843,342 in the same period. There was a noteworthy increase of 20 percent in loans to building and construction sector which has been a major force for growth in the recent past.

Going forward, these trends are expected to continue as the results of the Market Survey show that over 80 percent of banks expect to expand credit to the private sector in the remainder of the year mainly through introduction of new products. Corroborating this, the private sector indicated an expected increase in credit uptake to mainly finance investment.

Foreign Exchange Market and Reserves

Following the decision at the MPC's March 2010 meeting, the Central Bank has continued to build reserves to reach the statutory target and maintain stability in the foreign exchange market. In the long term, the 6-months of import cover foreign exchange reserves target for the East African Community (EAC) remains the goal. Meanwhile, the move towards 4.5 months of import cover without causing exchange rate instability remains the medium term objective.

Market Liquidity

The monetary targets set at the MPC meeting in March 2010 were achieved. Consequently, the targets for June 2010 are confirmed as Kshs. 181.4 billion for reserve money and Kshs 1,106.6 billion for broad money supply (M3). The CBK net foreign assets target is Kshs. 239.2 billion for June 2010.

IV. Key Considerations during the Monetary Policy Committee Meeting

The information available, and discussed above, shows that the economic recovery is on course with increased optimism for enhanced growth in 2010. To keep this momentum and to achieve the Vision 2030 growth trajectory the economy still requires supportive and appropriate fiscal and monetary policies.

The recent lowering of commercial banks base lending rates and the introduction of new loan products signals a positive response to the monetary policy stance. In addition, the continued decline in credit risk and improved macroeconomic stability provides further scope for banks to lower lending rates. It is expected that these actions will spur demand for credit by the private sector and further stimulate economic growth.

Current economic growth prospects show that the economy is functioning below its long run potential and trend which gives the Committee comfort that the upside risks to inflation remains low. This has been corroborated by the Market Survey which shows no expected increase in inflation by both banks and private sector firms. Furthermore, any inflationary pressures which may arise from higher oil prices will be mitigated by the declining electricity prices and subsequent lower production costs.

Finally, there is growing confidence in the market as the yield curve for Government securities continues to level-out and shift downwards. This gives commercial banks an appropriate benchmark for pricing their loan products. Further, it enhances the possibility of launching a 25-year Treasury bond in the near future that will lengthen the maturity profile of domestic debt.

V. Monetary Policy Decision

With inflation expectations anchored at a lower level and the upside risks to inflation low, the Committee was of the view that the market needed more time to consolidate its operations within the current monetary policy stance. The decision was therefore taken to maintain the CBR at 6.75 percent. The MPC will be reviewing the monetary programme in the new fiscal year.

PROF. NJUGUNA NDUNG'U
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CHAIRMAN, MONETARY POLICY COMMITTEE

May 24, 2010