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PRESS RELEASE

MONETARY POLICY COMMITTEE MEETING OF MARCH 23RD, 2010

"Expansion of Affordable Credit"

I. Introduction

The Monetary Policy Committee (MPC) met on 23rd March, 2010 to review the market's reaction to its previous decisions as well as the general economic performance. The Committee decided to lower the CBR by 25 basis points to 6.75 percent to stimulate an increase in private sector credit which is still necessary to sustain the current growth momentum. This decision was particularly informed by the MPC's market survey and widespread analytical work that supported these conclusions.

A. Information carried forward

- The fiscal stimulus package factored in the 2009/10 Government budget;
- Private sector credit growth;
- The up-take of horizontal repos between commercial banks;
- Declining credit risk;
- Improved current account balance and the foreign exchange reserves position.

B. New information

- MPC market survey - March 2010;
- Government's target to enhance its fiscal stimulus package by further domestic borrowing;
- Consensus on economic growth forecast for 2010;
- Licensing of the first credit reference bureau;
- Currency centres to lower transaction costs
- Year end results of the banking sector;
- Release of the new CPI series and inflation profile.

C. Overall macroeconomic context

- The international economic performance is improving and is expected to result in an increase in the demand for Kenya's exports and tourism earnings;
- Continued recovery of the economy as evidenced by substantial growth in credit to the private sector. However, the cost of credit remained high while the economic recovery is still fragile;
- In the banking sector, net non-performing loans as a proportion of outstanding loans declined indicating a decline in credit risk;
- Inflationary pressure eased and foreign exchange rate stabilised.

II. Economic Outlook

a. Global Economic Outlook

The Committee noted that since its last meeting, the Greek debt crisis had arisen. Similar pressures in Spain, Portugal and Ireland had presented a threat to the Euro zone. This was reflected by a sharp depreciation of the Euro with respect to major international currencies which quickly stabilised as the governments of the Euro zone were prepared to act to minimise this pressure.

The only new growth data noted by the Committee were: the massive USA economic expansion of 5.7 percent in the fourth quarter of 2009, and; the third and fourth quarter growth in China of 7.9 percent and 9.1 percent respectively. Growth forecasts for 2010 for Kenya's major trading partners remain unchanged. Of particular significance from Kenya's exports standpoint, Uganda and Tanzania are both projected to grow by over 5.0 percent in 2010.

b. Domestic Economic Developments

Economic Growth

While no new Kenya GDP growth data was released. Intermediate indicators were assessed to inform decisions on the economic growth path. The improved rainfall has contributed to increased milk and tea production with coffee production also showing a significant upturn. In particular, the monthly tea and coffee production grew by 48.0 percent and 31.4 percent in January 2010 from -4.8 percent and 1.1 percent in December 2009, respectively. Similarly, the monthly milk deliveries grew in February 2010 by 56.8 percent from February 2009, 37.6 percent in January 2010. Food production which affects the entire population has been forecast to grow significantly.

A review of other sectors of the economy indicated that there are signs of continued confidence in the economy as reflected by increased imports of capital equipment and tourist arrivals in Nairobi. Increased cement production suggests that the construction sector is growing. On the basis of these observations the Committee concluded that the assumptions with respect to economic growth which underlie the monetary programme remain valid.

Inflation

The Kenya National Bureau of Statistics (KNBS) released the first inflation data derived from the 2005/6 Integrated Household Budget Survey. The index showed a month on month inflation for February 2010 of 5.18 percent.

Other considerations with respect to inflation that were brought to the Committee's attention were the MPC market survey which showed that neither banks nor private sector firms anticipated a rise in inflation in the near future. In addition, the only upside risks noted by the Committee related to oil price forecasts and the resulting exchange rate instabilities, neither of which ware seen to pose a significant threat.

III. Fiscal and Financial Sector Performance

Fiscal Performance

The Committee was briefed on the performance of the Economic Stimulus Package (ESP) which is an important component in stimulating growth. With an appropriate implementation framework now in place, it was noted that the ESP had now gained momentum with increased absorption of funds.

The Committee was also informed of the upward revision in the domestic borrowing programme by Ksh.15.0 billion in the fiscal year 2009/10. However, it was seen not to exert pressure on interest rates. The Committee was therefore confident that this would provide additional support to the growth momentum.

Interest Rates

The Committee was satisfied that the transmission of monetary policy in the short end of the market had been successful with the money market rates stabilising at lower levels. Although horizontal repo rates were noted to track the interbank rates with some lag, this facility is yet to attain its full potential in redistributing liquidity among banks.

Interest rate spreads (the difference between lending rates and deposit rates) remain high. From the MPC market survey, cost of funds, credit risk and Treasury bill rates were identified as the key determinants of the spread. Available data indicated that these factors have been on the decline. However, this has not translated to lowering the interest rate spread. Importantly, the current responses have dropped inflation as one of the big determinants of the spread as seen in previous surveys.

The Committee observed that the policies adopted on lengthening the maturity of debt and removing discontinuities in the yield curve were successful. In addition the yields across all maturities declined, reflecting a revision of inflationary expectations. There was no longer a steepness in the yield curve showing uncertainty in the short rates nor were long tenor bonds demanding untypically high yields. Furthermore plans are underway to introduce a 25-year Government bond into the market.

Banking Sector Stability

The Committee reiterated the importance of providing adequate and appropriate finance to support the growth process. Information available indicates that gross loans increased from Ksh.771.7 billion in December 2009 to Ksh.783.8 billion in February 2010 while the number of loan accounts increased from 1,672,964 to 1,832,085 during the same period. However, the proportion of long term credit to total credit remains low and was of concern to the Committee. Further, the growth in loans during the period falls short of the perceived private sector demand. From the same survey, cost of funds and credit risk were identified as major constraints to credit supply. However, these constraints had been easing over time. The expansion of currency centres should also lower banks' transaction costs.

The latest stress tests indicated that the banking sector is stable. Net non-performing loans as a proportion of total loans fell from 2.93 percent in January 2010 to 2.67 percent in February 2010 an indication of reduced credit risk. This is expected to reduce further with the operations of the first credit reference bureau licensed in February 2010.

Foreign Exchange Market and Reserves

Currently, foreign exchange reserves amount to an equivalent of 4.0 months of import cover which is the statutory minimum. The Committee, though, saw the need to provide an additional cushion through a gradual build-up of the reserves to 4.5 months of import cover. This is in line with the EAC regional initiative of attaining a 6 month import cover. The Committee observed that this can be achieved without exerting significant pressure on the exchange rate and will further boost market confidence and stability.

Market Liquidity

The February 2010 data showed that the targets for growth in the monetary aggregates were generally met. The Committee set the target for reserve money and broad money grow: Reserve Money - Ksh.177.7 billion in April, Ksh.179.6 billion in May, and a provisional Ksh.181.4 billion in June 2010; Broad money supply (M3) - Ksh.1,083.0 billion in April, Ksh.1,094.7 billion in May and a provisional Ksh.1,106.6 billion in June 2010. During the period March to June 2010, growth in private sector credit is expected to expand by a minimum of 5.0 percent.

IV. Key Considerations during the Monetary Policy Committee Meeting

The above information shows that economic recovery is gaining momentum but there were downside risks that call for supportive measures. These include an enhanced supply of credit and monetary policy support in addition to the ongoing Economic Stimulus Package.

While private sector credit had grown both in volume and the number of loan accounts, the Committee observed that the cost of credit was still constraining adequate expansion of private sector loans. The Committee views credit expansion to key sectors of the economy as closely linked to their growth and that the economy's growth path would be best served by a lower cost of credit.

Since the economy is functioning below its full potential, the Committee noted that there was no significant upside risk to inflation, a fact supported by the MPC market survey which indicated that inflation was no longer a significant determinant of the interest rate structure. Furthermore, cost of loanable funds and credit risk which had been identified as major constraints to the supply of credit were easing. This provides space for lowering interest rates.

Finally, the yield curve for Government securities has levelled out thereby providing a good benchmark for pricing long term debt and loan products. Further the yields on the various maturities have taken a downward trend. This created an environment for banks to innovate with long term products that diversify the source for appropriate and adequate growth finance.

V. Monetary Policy Decisions

The direction and magnitude of movements of the CBR send signal to the market. The Committee decided to lower CBR by 25 basis points to 6.75 percent based on information and analysis. In particular the decline of any inflation threat meant that this policy stance should stimulate the supply of credit, anchor inflation expectations while supporting economic growth.

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March 25, 2010