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PRESS RELEASE

MONETARY POLICY COMMITTEE MEETING OF SEPTEMBER 23RD, 2010
"Consolidating Monetary Policy Gains"

I. Introduction

The Monetary Policy Committee (MPC) met on 23rd September, 2010 to review the general direction and performance of the economy and the market's reaction to its previous decisions. The Committee decided to hold the CBR at 6.00 percent to consolidate the gains of the current monetary policy stance which should ensure that the banking sector continues to provide adequate and affordable credit. Credit to key sectors of the economy has been expanding indicating economic growth beyond mere recovery. The Committee's decision was informed by the latest key economic indicators and the optimistic outlook expressed in the September 2010 MPC Market Survey (Market Survey).

A. Information carried forward

- Need for private sector credit growth;
- Declining credit risk in the banking sector;
- Low and stable inflation;
- Strong performance of the banking sector in the first half of 2010, and expanded financial services;
- Strong economic outlook for Brazil, Russia, India and China (BRICs) to lead global growth, and also relatively stronger growth for EAC economies.

B. New information

- Results of the MPC Market Survey for September 2010 and feedback from the media;
- Promulgation of the New Constitution has led to improved confidence in the economy;
- Improved growth in Germany and France as an anchor to recovery in Europe;
- Release of the June 2010 un-audited bank results.

C. Overall macroeconomic context

- Imports of investment goods are expected to increase. Identified growth in African and European economies should boost exports. There is no evidence of imported inflation or of any likelihood of a strong impact as a result of foreign recession;
- Growth expectations for 2010 converge in the 4.5–5 percent range. All, primary and tertiary, sectors of the economy are growing. Growth forecasts for the fourth quarter show expectations of non-inflationary growth backed by fiscal expenditures on infrastructure;

- Sustained growth of, and stability in, the banking sector with increasing profitability and continuing decline in non-performing loans all suggest a return to stronger growth;
- Projections for steady international oil prices in the near future.

II. Economic Outlook

(a) Global Economic Outlook

An analysis of the latest international economic growth forecasts provided a mixed signal with downward revisions for the second quarter in the USA and Brazil while the Euro Zone, UK and India showed minor upward revisions. China's second quarter growth was considerably lower than that in the first quarter but remained above 10 percent. Growth in Russia more than doubled to 5.2 percent in the second quarter.

The Committee also reviewed inflation and interest rate developments in Uganda, Tanzania and South Africa as these countries are key trading partners for Kenya. Inflation in these countries has been declining since June 2010 while interest rates, as measured by the 91-day Treasury bill rate, have increased except in South Africa. The exchange rate with respect to the Ugandan and Tanzanian shillings remained stable.

Following these developments, the Committee concluded that there were no new signals requiring it to change its outlook with respect to global trade.

(b) Domestic Economic Developments

Economic Growth

The Committee noted that different figures for economic growth prospects for 2010 had been reported in the media. Since the current monetary programme is based on the growth target of 4.5 percent presented by the Minister for Finance in his 2010/11 Budget Speech, it was found necessary to examine the alternative figures in detail. The Market Survey, which was the seventh in a series, showed that growth expectations by both banks and non-bank private sector were converging in the 4.5–5 percent range. It was noted that those who previously had conservative forecasts had revised their expectations upwards while those with more liberal forecasts on growth had revised them downwards into this band.

Second quarter of 2010 growth data from the Kenya National Bureau of Statistics (KNBS) is expected by the end of September 2010. However, all indicators support an argument that the growth momentum in the first quarter of 2010 was sustained into the second quarter. Data for the third quarter again show that the growth momentum has not been held back by either domestic or foreign events. For example, July 2010 tourist arrivals in the country were 19.6 percent above those in July 2009. This growth was observed in both Nairobi and Mombasa. Milk deliveries, benefiting from the improved rainfall were 13.6 percent above the July 2009 figure while power generation, an important indicator of economic activity, also showed significant growth relative to the earlier months of this year. Power generation recorded double digit growth at 11.0 percent in August 2010 which is the first double digit growth since November 2007. An analysis of August 2010 revenue collections showed that growths in all tax items were well above inflation relative to August 2009. Income tax, a strong indicator of economic activity, was 19.8 percent up while overall revenue collection increased by 21.4 percent. Hence, the Treasury growth target for 2010 continues to look achievable.

Inflation

The KNBS August 2010 inflation data showed a drop in overall inflation from 3.6 percent in July 2010 to 3.2 percent in August 2010. The driving component of this was the outcome of competition in the communication sector. This notwithstanding, there was no obvious sign of any major inflationary pressure coming from the domestic or global economies. The KNBS, following discussions with the Committee, is developing a non-tradable goods index which will enable the MPC to isolate the price components related more specifically to the domestic monetary environment. The Committee will continue to monitor weather conditions as they affect inflation and growth.

The Committee also reviewed the outcome of data collected in its Market Survey and noted that neither the banks nor the non-bank private sector anticipated any significant increase in prices. The Committee considered the implications of exchange rate movements given the returning stability in Europe and the temporary fuel price adjustments which were not associated with international oil prices. On the basis of these analyses, the Committee concluded that there was no immediate inflation threat requiring a review of its monetary policy targets.

III. Fiscal and Financial Sector Performance

Fiscal Performance

The Committee reviewed the achievement of the front-loading of the domestic borrowing programme enabling the Treasury to initiate projects early in the 2010/11 fiscal year rather than holding back until seasonal tax collections provided the necessary funding. In particular, the August 2010 Infrastructure Treasury Bond amounting to Kshs. 31.6 billion was oversubscribed by 7.8 percent while the 2-year Treasury Bond in September 2010 was also oversubscribed.

The Committee further noted that the Bank had continued to implement the agreed Government domestic borrowing programme to ensure that liquidity management avoids any stresses which might give rise to inflationary expectations or interest rate pressure.

Interest Rates

Since the last MPC meeting, there has been no general trend in interest rate movements. The decline in Treasury bill rates bottomed out while the interbank rate, arising from banks' own operations, showed minor movements. However, it was observed that interbank volumes and rates were both trending downwards in August and September 2010 which suggested that there was no shortage of liquidity in the market. Commercial banks continued to gradually reduce their interest rates. On average, between May and August 2010, banks reduced their base lending rates by 0.25 percent and their average lending rates by 0.26 percent. In particular, large banks reduced their lending rates to all segments of borrowers while small and medium banks were less consistent. However, the Committee considered this to be still short of what is required to stimulate further expansion in borrowing to support a greater stimulus to economic activity.

An analysis of secondary trading in Treasury bonds allowed the Committee to observe the dynamics of the Government securities yield curve. The yield curve had dropped steeply from June 2010 to July 2010, and flattened out significantly. In August and September 2010, the yield curve had risen slightly but there was no sign of any steepening at the short end which would suggest a change in expectations.

The Market Survey showed expectations that interest rates were unlikely to rise although the expectation of further decreases was varied. Large banks, which were previously noted to have reduced their lending rates, indicated that further decreases were only likely on the basis of expanded economic activity.

Banking Sector Developments

The Committee examined the dynamics of financial sector developments as it is convinced that improvements in access to financial services would be beneficial to economic growth. Furthermore, it noted that any improvement in access spreads overhead costs and should therefore reduce the cost of lending. To this end, it noted that there had been an increase of 24 bank branches between December 2009 and August 2010 and an increase of 166 ATMs over the same period. Agent banking, which was introduced in January 2010 has already taken root with 5,892 registered agents. This ensures that the physical distances travelled to access banking services have been significantly reduced. The innovation of M-Kesho, launched in May 2010, has already generated 201,838 new deposit accounts not taking into account the expansion of old accounts which benefited from this new facility. These new accounts had already mobilised Kshs. 177.8 million by mid September 2010 with the number of agents offering this service standing at approximately 4,000. Mobile banking services through the mobile phone companies have already shown improved growth with 9,961 new agents providing these services between December 2009 and July 2010. There was also an increase of 4.88 million transactions valued at Kshs. 9.31 billion over the same period.

Stress test results showed that the banking system continues to reflect consistent strength. Banks continued to expand credit to the private sector. Gross loans grew by 4.3 percent or Kshs. 17.7 billion between June and August 2010. Major beneficiaries of expanding loans, besides personal loans - which in many cases relate to SMEs - were trade, manufacturing and the agricultural sectors. As mentioned earlier, the strong developments in the tourism sector were reflected in a significant expansion of loans to industries supportive of the sector. Among the other noteworthy banking sector developments noted by the Committee to support its expectations with respect to growth and stability were the decline in non-performing loans (NPLs) in absolute terms. Similarly, net NPLs as a percentage of total loans continued on a downward trend dropping from 2.93 percent in January 2010 to 2.01 percent in August 2010.

The Committee noted that the uptake of Horizontal repos was now equivalent to over 5 percent of interbank transactions and that almost two thirds of commercial banks had participated at one time or another since the instrument was introduced. Since this facility was only introduced in April 2009, this indicates that this alternative to liquidity management is gradually being perceived as attractive. Confidence in the facility is further enhanced by the fact that banks are now borrowing in a wide range of tenors.

Foreign Exchange Market and Reserves

During the last two months, the Central Bank has continued to build up its foreign exchange reserves through either the US dollar or Euro purchases from the market. It was noted that the media had misrepresented participation by the Bank in the foreign exchange market by suggesting that this intervention was to support a particular value of the exchange rate of the shilling to the US dollar. In the period under review the Committee observed that the Central Bank had participated in the foreign exchange market to build up its foreign exchange reserves in line with the targets set by the MPC. It was noted that the foreign exchange reserves position was slightly over the statutory requirement of 4 months of imports cover and was in line with the targets set.

Market Liquidity

The monetary targets set at the MPC meeting in July 2010 were generally met. Consequently, there was no demand driven threat to inflation. The Committee then set targets for October and November 2010 as Kshs. 189.5 billion and Kshs. 195.6 billion respectively for reserve money, and Kshs. 1,253.9 billion and Kshs. 1,267.7 billion respectively for broad money supply (M3). Consequently, credit to the private sector should grow from Kshs. 827.4 billion in August 2010 to Kshs. 869.5 billion in November 2010. The targets for CBK net foreign assets were established as Kshs. 258.1 billion and Kshs. 261.9 billion in October and November 2010, respectively, compared to the August 2010 level of Kshs. 251.2 billion.

IV. Key Considerations during the Monetary Policy Committee Meeting

The Committee's analysis of data available and market feedback revealed that the perceptions of growth are positive while inflation and exchange rate remain stable. The Committee noted that, following its previous decision, credit growth responded and bank lending rates had slightly declined. However, there is still scope for further reduction in lending rates. Furthermore, credit expansion was in line with the set targets. In particular, private sector financial access improved and this was coupled with a noteworthy growth in lending.

The Committee also considered the measures that would be necessary to improve the efficiency of the financial sector which was necessary to support the growth of the economy. Among the factors that affect efficiency which would give rise to higher costs of capital, are the challenges of realizing on collateral and the sufficiency of information for pricing risk. Furthermore, the Committee noted that the models used by the banking sector to price risk do not seem to reflect a competitive market environment.

The presence of excess reserves in the banking system signals commercial banks' readiness to meet any surge in demand for liquidity. Hence, such an increase could be easily absorbed with no adverse impact on the interest rate structure. It was also observed that the factors influencing bank interest rate spreads have changed over time. These indicate a reduction in risk and therefore the capability for banks to reduce their spreads. The Committee was confident that access to financial services would continue to improve along the lines noted earlier.

V. Monetary Policy Decisions

In view of the fundamentals, the Committee decided to hold the CBR at its current level of 6 percent to consolidate the gains in this monetary policy stance. It would continue to explore ways of improving the transmission of the signal to other interest rates in the economy. This would include structural changes mentioned above aimed at enhancing financial sector efficiency and interest rate adjustments. Consequently, the Committee recommended that Central Bank of Kenya explores ways to address alternative dispute resolution models and by making data on cost of borrowing by individual banks more easily available. However, while these efforts are going on, the effects of which may take some time to be felt, banks have both the duty and scope to see how lending rates can be adjusted downwards, spreads reduced, and services expanded.

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September 28, 2010