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PRESS RELEASE

MONETARY POLICY COMMITTEE MEETING OF SEPTEMBER 23RD, 2009

“Support for Strong Economic Activity”

I. Introduction

The Monetary Policy Committee met on 23rd September 2009 at a time that the economy had been and continued to be buffeted by the impact of the failure of the long rains with the consequent effects on growth. In addition, the slow economic recovery from the global economic crisis by Kenya's trading partners was taken into consideration by the Committee in its decision to ensure that the Government's focus on growth is supported by the financial sector.

A. Information carried forward

- An assessment of the threat to economic recovery due to inadequate rainfall;
- The inflationary impact of the rise in oil prices and short term food shortages;
- The fiscal stimulus factored in the 2009/10 Government Budget;
- The operationalisation of horizontal repos between commercial banks and growth of private sector credit.

B. New information

- Surveys of the financial and private sectors – their perception of the economy and reactions to monetary policy decisions;
- Analyses of second and third quarter economic indicators;
- Appraisal of the effects of the drought on the 2009/10 Government Budget;
- A possible tea boom and the expected good rains.

C. Overall macroeconomic context

- The international economic performance continues to depress demand for Kenya's exports of some goods and services;
- The economy is expected to record a positive growth in the second quarter of the year despite numerous challenges;
- The third quarter data are very partial but they do reflect the deleterious effects of drought on the economy;
- The projected adequate rainfall throughout the country from October to December, combined with enhanced expenditure through the fiscal stimulus programme forms a good basis for a strong recovery in the last quarter of 2009;
- The Committee's July 2009 interest rate signals are yet to be transmitted to some market segments;
- In the banking sector, overall non-performing loans declined while credit to private sector rose in the period under review.

II. Economic Outlook

a. Global Economic Outlook

Data released in the IMF World Economic Outlook Update in July 2009 forecast global growth in 2009 to contract by 1.4 percent and grow by 2.5 percent in 2010, which is 0.6 percentage points higher than envisaged in April 2009. It states that the outlook still remains very uncertain and that the timing and pace of recovery depends critically on strong policy actions. The capacity to initiate further actions will become increasingly difficult as the easier options are exhausted. Spreads in funding markets have only narrowed gradually and credit still remains constrained. This uncertainty in the financial markets has spilled over into the real sector with low commodity prices and depressed consumer spending and trading. The restructuring of the financial sector which will result in resolving the uncertainty around losses and block the spin-off into the real sector is now important.

This assessment supported the Committee's own reports on the global financial crisis covering the period from September to December 2008, and another one covering the period from January to June 2009. There has been talk of the crisis bottoming out and that the worst is over as less dramatic news emerge supported by other signs of recovery that are evident particularly in China and America. However messages are still mixed and caution is evident.

Scenarios reflect a longer more drawn out recovery which is normal for financial crises and is exacerbated in this instance by its global structure. The growth prospects in 2010 will improve as output grows assuming more coordinated and sustained global policy actions to support a gradual normalisation of the financial markets. The effectiveness of interest rate cuts implemented by Central Banks around the world is likely to remain muted unless credit markets return to more normal activity levels.

b. Domestic Economic Developments

Economic Growth

The Kenyan National Bureau of Statistics (KNBS) data for the second quarter economic outcome is due at the end of this month. However, preliminary analyses of individual sectors shows that agriculture, the sector that accounts for about 24 percent of the country's GDP, was weak in the second quarter and declined further in the third quarter relative to the previous year. Cement consumption continues to indicate that the construction sector has been buoyant and, as it was in 2008 and the first quarter of 2009, it may well sustain the growth momentum of the economy. Revenue collection data suggests that consumption grew, but was slightly below target. However, tourist arrivals in Nairobi and Mombasa grew by 9 percent and 4 percent, respectively, in the 12-months to July 2009.

The Meteorological Department has predicted good rains throughout the country from October 2009 onwards. This is expected to result in an increase in food availability as well as tea production. The prices of tea and coffee have been improving and are expected to continue with the upward trend into the fourth quarter. If the fiscal stimulus package expenditure gets underway in early October 2009, it can be expected to generate significant consumer demand particularly in rural areas in the course of the fourth quarter. Therefore, fourth quarter growth should see a recovery. On the basis of this, the monetary programme assumptions related to growth are challenging but achievable.

Inflation

With the awareness that the KNBS will be releasing the new inflation measures next month, the Committee looked at the current trends rather than levels. The same rain-dependent food prices that have caused inflation to rise in the past will continue to affect the cost of living in the near future. The onset of the rains will result in quick-growing food stuff coming onto the market. This will not solve the maize question in the very short run, which is more dependent on the success of the irrigation programme and the availability of maize imports. The Committee noted that oil prices continue to rise gradually and expressed concern that this may be compounded by increased demand resulting from the northern hemisphere winter. Added to the fact that emergency electricity generation relies on oil, the effect on energy prices may be significant.

The Committee appreciated the analytical work on the methodologies for forecasting inflation being undertaken by the Bank. These studies will be a significant input when formulating monetary policy in future especially when the new data series becomes available.

The target of money supply consequential on the reserve money programme recommended in the July 2009 meeting was almost attained with a shortfall of 0.7 percent. On the basis of these analyses, the Committee concluded that liquidity in the market is not fuelling and is not likely to fuel inflation currently or in the near future.

III. Fiscal and Financial Sector Performance

Fiscal Performance and Interest Rates

The months under review are the first three months of the 2009/10 fiscal year. The Committee looked at the disaggregation of revenue performance, while noting that the Government has already had to reappraise its response as a result of the deteriorating food situation. The stimulus package, which is intended to drive private consumption and employment and facilitate economic growth, has become a matter of increasing urgency. The Bank is in agreement with the Ministry of Finance on the urgency and need to front-load the fiscal stimulus at the Constituency level.

The Committee has monitored the borrowing programme, and noted that the market has shown a preference for longer dated paper. Since July 2009, the 91-day Treasury bill has consistently been undersubscribed while the 182-day bill has been oversubscribed. The Treasury bill interest rates have shown no real trend but have remained generally stable over the last two months. In addition, the first 364-day Treasury bill was heavily oversubscribed. The new instrument was seen by the Committee as satisfactorily addressing Treasury's requirements for short term liquidity.

Market Liquidity

The Committee noted that the Bank had to undertake reverse repos on several occasions over the last two months when the market was short of liquidity. This shortage was occasioned by a build-up of Government deposits at the Bank. The build up of Government deposits first arose earlier in the year when there was delayed approval of Supplementary Budget Estimates by Parliament, and recently between July and September as a result of a slow uptake of ministerial budgetary allocations. The Bank's interventions on these occasions ensured that interest rates remained stable.

The Committee set as targets for reserve money for October and November 2009 of Kshs166.6 billion and Kshs168.5 billion respectively. This implies that the broad money supply will grow by 14.7 percent in October and 15.1 percent in November 2009. This latter figure will provide for the seasonal cash requirements which always appear at the end of the year.

Interbank Market

The Committee noted extensive activity in the interbank market during the last two months. Volumes of transactions ranged between Kshs9 billion and Kshs18 billion. The interbank interest rates rose steadily between August and mid-September 2009. This rate has fallen precipitously in the latter half of September 2009 as Government draw down of the previously mentioned deposits have provided banks with additional liquidity.

The activity in the horizontal repos market has continued to increase albeit slowly, and the Committee still considers this to be an effective device for redistributing liquidity among commercial banks and improving overall market liquidity.

Foreign Exchange Market and Reserves

The Committee reviewed the Balance of Payments and found it satisfactory. The interbank foreign exchange market has remained very liquid. The Bank, in its monetary policy operations in the last two months, purchased USD190.25 million from the market to build its foreign exchange reserves and inject liquidity into the market when needed. The Bank has continued to build its foreign exchange reserves and has exceeded the 3.6 months of import cover target indicated in the previous meeting. It is currently at 3.73 months of import cover. Despite the Bank's presence in the market, the Kenya shilling remained relatively stable against the US dollar, Euro and Sterling Pound.

Among the indicators that have been examined to assess the effect of the international economic downturn was the level of emigrant remittances. This was observed to have sustained the long term average of USD50 million per month. For the month of August 2009, remittances stood at USD55.95 million.

Financial Sector Stability

Analyses of the banking sector indicators showed that non-performing loans (NPLs) had declined while gross loans to most sectors had increased. Furthermore, the most recent stress testing on capital adequacy and risk showed that the banking system was robust. Overall, banks continue to be very liquid with an average liquidity ratio of 41 percent compared with the requirement of 20 percent. It was also noted that returns on assets continued to be strong.

IV. Key Considerations during the Monetary Policy Meeting

The impact of the drought on the performance of the economy dominated the Committee's discussions. It was noted that the drought had both fiscal and physical effects. The fiscal effects were seen in both the reallocation of funds to support those adversely affected by the drought, and a shortfall in revenue collection. On the physical side, the livestock mortality was seen to have a long term impact on growth while crops could be expected to recover more rapidly as a consequence of the onset of the October rains.

The Committee was of the view that the downside risks to economic growth had significantly increased for 2009 because of the combination of the impact of drought and the negative effects of the global economic crisis. However, twin factors will mitigate these downside risks. First the fiscal stimulus which is being front-loaded by the Government will spur spending and employment opportunities for communities across the nation in the next quarter. Second, the Meteorological Department's forecasts of good rains throughout the country will reduce the power and water rationing. In addition, the higher tea and coffee incomes might lead to increased consumption and economic activity.

The Committee's analysis indicated that inflation continued to be a supply side phenomenon with drought being a significant factor. Since the supply side factors to inflation were short term in nature, the Committee was of the view that the upside risks to inflation were low.

The survey of banks showed that relatively few institutions had lowered their lending rates as a consequence of the Committee's previous decisions which could have reduced the cost of credit. However it was noted that structural factors might have contributed to this rigidity. The Bank will work with the stakeholders to find ways to address these structural rigidities.

The Committee, in reviewing its previous decisions and analysing current data, was of the firm view that the financial system had sufficient liquidity to support growth. What remained was a discussion with the Banking sector to find ways on how to improve the intermediation process so that its signals could be transmitted to the various sectors of the economy. This implies having in place supportive modalities to ensure complementarity between the public sector's growth enhancing initiatives and commercial banks' willingness to increase access to credit to customers at affordable rates as the stimulus package starts to bear fruit.

V. Monetary Policy Decisions

Following these deliberations, the Committee agreed to continue with the current monetary policy stance. It therefore decided to retain the CBR at its existing level of 7.75 percent and the target growth rates of money supply, and will continue to monitor performance of the financial sector and overall economic activity.



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September 25, 2009