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PRESS RELEASE

MONETARY POLICY COMMITTEE MEETING OF JANUARY, 26TH, 2010

"Enhancing the Transmission Mechanisms for Monetary Policy"

I. Introduction

The Monetary Policy Committee (MPC) met on 26th January 2010 to review the market's reaction to its previous decisions as well as the general performance of the economy. On the basis of available evidence, the Committee concluded that its previous decisions to reduce the CBR had successfully signalled a reduction in the short term interest rates and an expansion of private sector credit. The Committee therefore considered the current CBR level of 7.00 percent to be appropriate to consolidate its current direction of monetary policy. However, the transmission from short term interest rates to commercial bank lending rates was weak and hence failed to yield the benefits expected in sustaining the momentum of economic recovery. The structure of the commercial banks' credit market was a major hindrance to the transmission mechanism of monetary policy signals. Thus, the Committee recommended to the Central Bank to explore measures that would enhance the effectiveness and efficiency of the credit market bearing in mind that adequate and appropriate finance is critical to the economic growth process.

A. Information carried forward

- The fiscal stimulus package factored in the 2009/10 Government Budget;
- The operationalisation of horizontal repos between commercial banks;
- Growth of private sector credit;
- Declining credit risk in commercial banks;
- New inflation series released by the Kenya National Bureau of Statistics (KNBS);
- Improved current account position and build up in foreign exchange reserves.

B. New information

- January 2010 survey of commercial banks and private sector firms' perceptions and expectations on key financial and economic indicators;
- Poor economic growth outcome in the third quarter of 2009, indications of economic recovery in the fourth quarter, and prospects for improved economic growth in 2010. Significant progress in the implementation of the Treasury's Fiscal Stimulus Package is expected to provide strong impetus for economic recovery;
- Easing of food supply constraints following adequate rainfall throughout the country during the last quarter of 2009;
- Stability of the banking sector based on results of stress testing;
- Public debt sustainability with no threat of pressure on domestic interest rates;
- Declining commercial banks interest rates, but widening interest rate spreads due to comparably higher decline in deposit rates.

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;
- Good recovery of the economy in the fourth quarter of 2009 as evidenced by substantial growth in credit to private sector in the period as well as other economic indicators. The amount of credit to the private sector continued with an upward trend during the period under review, but lending rates remained high;
- In the banking sector, non-performing loans as a proportion of outstanding loans declined indicating a further decline in credit risk;
- Easing inflationary pressure and stability of the foreign exchange rate.

II. Economic Outlook

a. Global Economic Outlook

Major international financial institutions have provided recent evaluations of global economic recovery. The IMF, in its January 2010 World Economic Outlook (WEO), commented that "the global recovery is off to a stronger start than anticipated earlier... this represents an upward revision of ¾ percentage points from the October 2009 WEO". The overall picture seen by these institutions is: global growth recovering strongly to around 4.8 percent in the newly industrialised Asian economies and 6 percent in the emerging developing economies. Specifically, Sub-Saharan Africa is forecast to grow at 4.3 percent in 2010. Furthermore, progress towards the adoption of the East African Community Common Market Protocol is expected to boost trade. This development will have major implications in enhancing manufacturing activities, expansion of Kenyan banks to the region and employment.

The Committee noted that Kenya's 12 month overall inflation rate of 5.3 percent in December 2009 is comparable with that of its trading partners. For instance, South Africa's overall inflation was slightly below 6 percent in October and November 2009. Uganda's overall inflation rate of 13 percent in October 2009 was much higher. The 91-day Treasury bill rate in Uganda and South Africa were 6.12 percent and 7.01 percent, respectively, in November 2009. These rates compare well with Kenya's average 91-day Treasury bill rate of 6.82 percent.

b. Domestic Economic Developments

Economic Growth

Since the November 2009 meeting of the MPC, the Kenya National Bureau of Statistics (KNBS) has released growth data for the third quarter of 2009. While some sectors continued with positive performance, the agricultural sector, once again, showed a negative rate of growth which was attributed to the extent and intensity of the drought. The construction sector, which had been largely responsible for the successful performance in the first half of 2009, despite various shocks, witnessed a significant downturn. The performance of the fourth quarter as indicated by a variety of available indicators, including credit to various sectors, was considerably better. This implies that growth in productive activities is responsive to the availability of private sector credit. The rains witnessed in the last quarter of 2009 are expected to boost agricultural production in the first half of 2010. Consequently, the prices of key foodstuffs have moderated.

The results of the Committee's Survey on Perceptions on the Performance of the Economy indicate a resurgence of confidence in the attainment of the Government's economic growth target of between 4–5 percent in 2010, with increased growth in credit to private sector. In addition, imports of capital equipment and emigrant remittances together with the upturn in activity at the Nairobi Stock Exchange all portend a positive growth scenario.

Inflation

Based on the December 2009 inflation data, the Committee concluded that overall inflation continued to be low and stable. In addition, the Committee is aware that the KNBS will be producing the new Consumer Price Index (CPI) embodying the new consumer basket at the end of February 2010. This more relevant CPI basket will de-emphasize the vulnerability to fluctuations in food prices. Furthermore, given the higher growth prospects for emerging economies in 2010, coupled with the convergence of Kenya's inflation to that of its trading partners, the Committee felt that there are no upside risks to domestic inflation in the near future.

However, the Committee noted that international oil prices were rising, but that despite the extreme temperatures experienced in the European and American winter seasons, the price of oil has not returned to the USD147 per barrel observed in July 2008. In addition, the survey on perceptions on economic performance revealed that the business community and financial sector were not anticipating significant inflation.

III. Fiscal and Financial Sector Performance

Fiscal Performance

The Committee, in its September 2009 meeting, had noted that the Economic Stimulus Package was critical to economic growth. In November 2009, the Committee further noted that, while progress had been made, it was much slower than expected. Evidence provided during the January 2010 meeting showed that about 15,000 acres had been planted with food crops that are due for harvest in early 2010. It was also noted that infrastructure development was expanding countrywide with proposal requests for more than 50 irrigation projects expected to bring more than 300,000 hectares into agricultural production. Other expenditures on infrastructural development projects in the constituencies which have recorded significant progress include schools, maternity and children wards, and fresh produce markets. All of these should enhance employment and consumer expenditure to stimulate economic growth. In addition, an examination of Kenya Revenue Authority tax collection data showed that consumption and income taxes were performing well suggesting that earlier slippages in economic activity were now being rectified. Further, the Committee noted that the current deficit financing process is not a major threat to interest rates and debt sustainability.

Interest Rates

The CBR signals the short term end of the market. The recent signals to keep interest rates low has borne fruit with the short term interest rates declining significantly between May and December 2009. The repo market rate declined from 6.4 percent in May to 3.6 percent in December 2009. Similarly, the interbank and 91-day Treasury bill rates declined from 5.6 percent and 7.5 percent to 3.0 percent and 6.8 percent, respectively, during the period. Furthermore, yields on short term Government bonds declined during the period. The average commercial banks deposit rate declined from 5.0 percent to 4.8 percent while the average lending rate fell from 14.9 percent to 14.8 percent during the period. However, the interest rate spread (the difference between lending and deposit rates) increased slightly to 10.0 percent during the period following a faster decline in the deposit rate.

Banking Sector Stability

As reported in previous comprehensive Press Releases, the Committee's examination of banking sector behaviour was informed by the outcome of stress tests on individual banks and information on lending and non-performing loans. The stress tests which follow the international best practise indicated that the banking sector is stable. An examination of total loans and non-performing loans gave a positive picture that the banking sector was now emerging from the depressed economic environment of the third quarter during which credit to the private sector grew by only Ksh.4.1 billion whereas in the fourth quarter it grew significantly by Ksh.55.7 billion. The fourth quarter showed improvements in provisioning and the ratio of non-performing loans to total loans declined, hence the financial sector base for growth remains healthy and strong.

Foreign Exchange Market and Reserves

The Committee noted that the exchange rate of the Kenya shilling against major currencies continued to be stable, and that the gross foreign exchange reserves position was above the statutory minimum of 4 months of import cover. In addition the current account position of the balance of payments improved between September and December 2009. Furthermore, there was an improvement in foreign exchange inflows which were largely from short term capital.

IV. Market Liquidity

The December 2009 data indicates that growth in monetary aggregates was generally in line with the set targets. In particular, the twelve month broad money supply (M3) grew by 16.0 percent against the target growth of 15.0 percent in December 2009. Given the overall health of the financial sector and improved growth prospects, the Committee proposed that reserve money (RM) should grow to Ksh.175.2 billion in February and Ksh.175.9 billion in March 2010. These reserve money targets would support a broad money supply (M3) target in February 2010 of Ksh.1,059.6 billion and Ksh.1,071.2 billion in March 2010.

V. Key Considerations during the Monetary Policy Committee Meeting

The Committee examined the evidence on how its target markets had responded to its previous decisions. The mode of transmitting information to the financial sector was through influence on short term interest rates (interbank rate, the repo rates and Treasury bill rates). All of these had appropriately picked up the signal that interest rates should decline, as depicted by the easing of horizontal repos and interbank interest rates. These signals, though, had been translated into lower bid rates on short term Government securities. However, the depth of products in the banking sector has not been effective in providing long term loan products. In addition, they have not been responding to the signals of lower interest rates provided by the market.

The MPC had been emphasising the need for institutional change to enhance the effectiveness of financial intermediation which would result in an efficient monetary policy transmission mechanism. In this regard, it saw improvements in the use of the horizontal repo. The lowering of the threshold for investment in Treasury bills has seen some positive response, and more is expected as the institutional structures evolve. The recent introduction of agent banking should also improve access to financial services and also lower the operational cost of financial infrastructure. Nevertheless, the Committee noted that the failure of the banking system to extend the maturity of their loan products appears to have been a consequence of the structure of their deposits. However, economic growth could be supported by institutional developments that support development banking products and lending to small scale enterprises. Furthermore, the availability of international funds which could be intermediated by domestic financial institutions as well as long term bonds could be utilised more extensively by such institutional developments.

Although commercial bank lending rates are determined by numerous factors outside the Central Bank's control, the Committee noted that structural changes in the deposit and credit markets, including introduction of development banking products, can play a significant role in influencing a downward trend in the commercial banks lending rates.

VI. Monetary Policy Decisions

In view of the positive response from the market on the use of CBR as a means of signalling movements in short term interest rates, the Committee considered its current level of 7.00 percent to be appropriate to consolidate its current direction of monetary policy. Although signals from the CBR to the short term interest rates have worked, their effects are not being transmitted to the real sector through a response in lending rates. In this regard, the Committee asked the Central Bank to explore how development banking products can be introduced into the market; this would enhance the monetary policy transmission mechanism and lengthen the maturity profile of commercial bank term loans.

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January 28, 2010