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## PRESS RELEASE

### MONETARY POLICY COMMITTEE MEETING OF NOVEMBER 24<sup>TH</sup>, 2009

#### *“Boosting Credit Growth for Economic Recovery”*

#### I. Introduction

The Monetary Policy Committee (MPC) at its meeting on 24<sup>th</sup> November 2009 reviewed the CBR downwards by 75 basis points to 7.00 percent. Analysis before the Committee indicated that the banking sector was stable and credit risk was declining; the onset of the economic recovery was being signalled by a wide range of indicators; and finally, there was no evidence of emerging inflationary pressure. The economic environment in which the meeting of the MPC was held was much stronger than that which was described at the time of its September 2009 meeting. There was also a better understanding of how banks and non-bank public perceived the performance of the economy and interpreted the Committee's previous decisions.

#### 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.

#### B. New information

- Survey of the banking and private sectors' perceptions and expectations on the economy;
- Declining credit risk in commercial banks;
- Analyses of second and third quarter economic indicators that signal domestic economy is riding over the global economic crisis to a recovery path;
- Easing of food supply constraints especially short-run foods following adequate rainfall throughout the country during October and November 2009 and significant progress in implementation of the Treasury's fiscal stimulus package provide a good basis for continued recovery in the last quarter of 2009;
- Stability of the banking sector based on results of stress testing;
- New inflation series released by the Kenya National Bureau of Statistics (KNBS).

#### C. Overall macroeconomic context

- The international economic performance continues to depress demand for Kenya's exports of some goods and services but the current account position has improved;
- The economy is expected to record low but positive growth in the third and fourth quarters of the year despite numerous challenges;
- In the banking sector, net non-performing loans as a proportion of outstanding loans has been declining while the amount of credit to private sector rose strongly in the period under review;
- Easing inflationary pressure and stability in the exchange rate;
- Government revenue collection and domestic borrowing within target levels.

## **II. Economic Outlook**

### **a. Global Economic Outlook**

The Committee reviewed the latest data from the IMF's World Economic Outlook for October 2009 with respect to growth forecast and noted that the best estimates show that the US and UK were projected to grow at -2.7 percent and -4.4 percent respectively in 2009. However, the outlook for real GDP growth for advanced economies has been revised from -3.8 percent in April 2009 to -3.4 percent in October 2009. On the other hand, India and China, which suffered some setback in the course of the global economic crisis, were forecast to grow by 8.5 percent and 5.4 percent respectively in 2009.

The Committee examined data for Kenya's trading partners in the region which revealed that exchange rates with respect to Uganda, Tanzania and South Africa showed minor volatility. Real GDP growth in 2009 is projected at 7.0 percent, 5.0 percent and -2.2 percent for Uganda, Tanzania and South Africa, respectively. However, inflation rates using the same methodology as that now being used in Kenya showed that Uganda and Tanzania are still in double digit inflation, while South Africa, like Kenya, had inflation on a downward trend, dropping from 9.43 percent in March 2009 to 6.1 percent in September 2009. The South African 91-day Treasury bill rate had followed the same trend falling from 8.62 percent in March 2009 to 6.14 percent in September 2009. The 91-day Treasury bill rates in Uganda over the six months from April to September 2009 showed no clear trend but ranged between 5.93 percent and 7.10 percent. On the other hand the Tanzanian 91-day Treasury bill rates had been falling rapidly from 10.55 percent in April to 3.22 percent in September 2009.

The Committee therefore concluded that the international outlook presented opportunities rather than threats for Kenya's recovery process.

### **b. Domestic Economic Developments**

#### **Economic Growth**

Since the last meeting of the MPC, the second quarter growth data (2.05 percent) has been released. The KNBS data showed that many sectors were recording positive growth, while other sectors particularly those susceptible to drought and international economic downturn were more constrained. Third quarter preliminary data for 2009 continue to provide a positive story. Tourism data pointed towards a recovery in the sector. The highest tourist arrivals in Nairobi had been recorded in August 2007 at 82,487; by July 2009 tourist arrivals in Nairobi had reached a record level of 83,972. Mombasa tourist arrivals over the 12 months to September 2009 compared with a similar period in 2008 showed that an increase of 26.7 percent was recorded. In addition, tea production on a monthly basis increased by 29.2 percent, from 21,231 metric tonnes in August 2009 to 27,434 metric tonnes in September 2009.



The picture presented by the return of tourists is endorsed by an analysis where the Committee noted that the import of non-transport equipment and machinery was growing and that the expansion of exports relative to imports of goods and services in the balance of payments was improving. All of these indicators presaged a confident growth environment for the future. This was even further endorsed by the upturn in the Nairobi Stock Exchange Index together with increased foreign participation in the equity market. In addition, the growth of cement production suggests strong activity in the building and construction sector which had been the main driver of economic growth in the first two quarters of the year.

### **Inflation**

The Committee welcomed the release of the new inflation series by the KNBS. The new series confirmed the Committee's position which for long has been that there is a significant upward bias in the old series. The level of recorded inflation had in fact been seriously distorted by the previous computational methodology. For instance, September 2009 inflation under the old methodology was 17.9 percent whereas under the new methodology it was 6.71 percent. The Committee also noted that the new measure continued the downward trend perceived under the old methodology where inflation had dropped from 26.07 percent in April to 17.5 percent in October 2009.

Under the new methodology inflation dropped from 12.39 percent in April to 6.6 percent in October 2009. Clearly, the impact of foodstuffs returning to the market following the rains was lowering the cost of living to the public through declining prices.

## **III. Fiscal and Financial Sector Performance**

### **Fiscal Performance**

The Committee was informed that the various components of the Fiscal Stimulus Package were being disbursed and that the effect of these expenditures would be felt in the economy more in the first quarter of 2010 rather than the fourth quarter of 2009. It was noted that fiscal expenditures on infrastructure, are complementary to private sector investment and growth. This complementarity is expected to increase with Public Private Partnership projects.

An analysis of tax receipts data showed that the third quarter of 2009 collection associated with consumption (and therefore economic health) has been on an upward trend since the first quarter. Evidence such as this allayed any concerns about the crowding out of the private sector as banks responded to the Committee's efforts to expand credit. It also indicated that tax collection was generally on track with no threat of a domestic financing constraint.

### **Market Liquidity**

The Committee examined the performance of the economy against the targets of market liquidity it had established at its previous meeting. It was evident that the capacity of the economy to perceive the signals being transmitted by the MPC were improving since all targets were achieved within accepted limits. The Committee therefore established reserve

money (RM) targets for the next two months as Ksh.174.5 billion for December 2009 and Ksh.173.4 billion for January 2010. The targets for broad money supply M3 were set at Ksh.1,036.4 billion and Ksh.1,048.0 billion for December 2009 and January 2010 respectively.

### **Interest Rates and Interbank Market**

The Committee had requested detailed analyses on interest rates behaviour to be conducted so as to inform its understanding of the diversified market for liquidity. The outcome of the analyses provided significant insights on the differences in spread behaviour between large and small banks. At the same time, it allowed a better appreciation of how loanable funds were being generated and intermediated.

Following tradition, the Committee examined the relationship between interbank rates, horizontal repo rates and vertical repo rates. They were noted to be tracking each other closely, a clear indication of interactions in the money market. The decline and stability of these short term rates is an indication of the effect of monetary policy as required.

The Committee noted with satisfaction that efforts to activate the use of horizontal repos as a way of redistributing liquidity were beginning to bear fruit. The major cause of the uptake of the horizontal repo facility was the KENGEN Bond and build-up in Government deposits at the Central Bank which had temporarily affected liquidity distribution in the market. Since neither the horizontal repo nor the interbank markets are subject to direct Central Bank control, they provide a useful barometer on the status of liquidity in the banking sector.

### **Foreign Exchange Market and Reserves**

Following the targets established in the previous meeting of the MPC, the Central Bank had successfully increased its holding of foreign exchange reserves to 4.2 months of import cover. This build up in the reserves had no effect on the exchange rate beyond, perhaps, moderating the speed at which the international weakening of the US dollar had been drawn into the Kenyan economy. Furthermore, in the third quarter, exchange rates had tended to stabilise but with an appreciation bias relative to the volatility shown in the first six months of the year while the current account position has shown an improvement since July 2009. Emigrant remittances stabilised in the USD50–55 million range.

### **Banking Sector Stability**

The Central Bank has continued to perform stress tests on individual banks and was able to provide evidence that the banking sector is healthy and no banks are at risk. It showed over the last three months that there was a decrease in gross non-performing loans while the ratio of net non-performing loans to total loans declined. Evidence that the banking system was beginning to respond to the continuing message of the MPC's desired directions was to be seen in the exceptionally large expansion of loans to the private sector. The MPC conducted further analyses on those loans and noted that in general terms, they were supportive to economic growth.



#### **IV. Key Considerations during the Monetary Policy Meeting**

In the Committee's deliberations, analyses indicated that the global economy was showing signs of improvement but prospects remain highly uncertain. The recent quarterly growth outturns from KNBS confirmed the fragility of the domestic economic recovery. The current accommodative monetary policy which the Committee was pursuing had to continue, to stabilize expectations and strengthen both the effect of the fiscal and monetary support now being provided.

The Committee examined the status of inflation and economic activity. It welcomed the release of the new inflation series by KNBS that reflects an accurate measure of inflation. The release of the new inflation series implies that the Committee now has a better measure to address its statutory requirements of ensuring price stability. The Central Bank will work with KNBS on appropriate measures to indicate such things as core inflation or the inflation of non-tradable goods. These measures provide different ways of looking at market behaviour in an open economic environment.

In an environment where the upside risks to inflation were low, the Committee agreed that stimulating economic activity is critical in the short term. It confirmed that banks are holding adequate liquidity which will be re-absorbed by the private sector credit growth as the economy emerges from the slowdown and inflation kept in check.

The Committee observed from market perception survey that banks fearing credit default risk in a slow economic activity environment were still tightening credit, and were not likely to reduce lending rates for the rest of the year. However given the information before the Committee, such perceptions were far-fetched and unless revised to conform to reality, could affect not only the supply-side but also the demand-side. What is important for economic recovery and growth, was the rate at which consumers and firms can borrow to stimulate aggregate demand.

The cost of liquidity is easing as evidenced by the declining money market interest rates. Although the current market conditions indicate falling credit risk in the banking sector, lending rates seem not to have responded. As the economy moves towards a recovery path, financing of economic activities becomes critical. For this reason enhancing credit availability at lower cost becomes a key focus for this policy decision.

#### **V. Monetary Policy Decisions**

Given that the upside risk to inflation is low, and credit risk is declining the Committee considered that appropriate support to the nascent economic recovery could be provided by boosting credit availability. To achieve this objective and to provide guidance on the path of monetary policy over the next two months, the Committee reviewed the CBR downwards by 75 basis points to 7.00 percent.



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