Governor

BANKI KUU YA KENYA

CENTRAL BANK OF KENYA

Haile Selassie Avenue
P.O. Box 60000-00200 Nairobi, Kenya
Telephone: 2861003/24 Fax: 2716556

PRESS RELEASE

MONETARY POLICY COMMITTEE MEETING OF JULY 28TH, 2010

"Signalling Market Confidence"

I. Introduction

The Monetary Policy Committee (MPC) met on 28th July, 2010 to review the market's reaction to its previous decisions as well as the general performance and direction of the economy. The Committee lowered the CBR by 75 basis points to 6.00 percent to signal the need for the banking sector to continue providing adequate and affordable credit. This will enable the private sector to take advantage of the growing opportunities that will enhance economic recovery. The Committee's decision was informed by the optimistic outlook expressed in the July 2010 MPC Market Survey, the latest IMF World Economic Outlook, the latest key economic indicators, and the 2010/11 national budget policies and expenditure proposals.

A. Information carried forward

- Need for private sector credit growth;
- Declining credit risk in the banking sector;
- Levelling out of the Government securities yield curve;
- Low and stable inflation.

B. New information

- Results of the MPC Market Survey for July 2010 and feedback from the media;
- Commencement of the East African Community (EAC) Common Market Protocol;
- Fiscal year 2010/11 national budget and first quarter 2010 GDP growth data released by the Kenya National Bureau of Statistics (KNBS);
- Easing of international oil prices;
- Containment of the Euro sovereign debt crisis;
- Performance of the banking sector in the first half of 2010;
- Strong economic outlook for Brazil, Russia, India and China (BRICs) to lead global growth.

C. Overall macroeconomic context

- The IMF World Economic Outlook revised upwards its growth forecasts reflecting the effectiveness of the rescue packages in Europe and buoyancy in BRICs economies. In Africa, the growth forecasts were also revised upwards.
- On the domestic scene, the recent data from KNBS showed that the first quarter economic growth was 4.4 percent which was strongly supported by agriculture, manufacturing, wholesale and retail, and transport and communications sectors. Recovery in the agricultural sector followed the good rains while the fiscal stimulus package and ongoing public investment in infrastructure have broadened the base for economic activity and built a strong capacity for future growth.
- Sustained growth of, and stability in the banking sector with increasing profitability and continuing decline in non-performing loans.
- Increased rains coupled with declining international oil prices led to cheaper hydro electricity, lower fuel costs and lower food prices.

II. Economic Outlook

a. Global Economic Outlook

A variety of sources pointed to continued improvement in world economic growth prospects. The July 2010 *World Economic Outlook* (WEO) Update revised its projection of the global economy. It forecast a growth of 4.6 percent in 2010 against a previous forecast of 4.2 percent. Likewise, Sub-Saharan Africa growth forecast was revised upwards to 5.0 percent from 4.7 percent.

The Euro Zone sovereign debt crisis appears to have been contained, thereby restoring confidence in the Euro. The WEO revision of economic growth for both the Euro Zone and UK were lower and this together with austerity measures being implemented might dampen demand for Kenya's exports. The outlook for the US economy shows a moderate improvement which will assist in global recovery. In addition, there are expectations that the global economic recovery is predicated on continued high growth in the BRICs economies. This is expected to increase the demand for Kenya's exports.

The Committee observed that the commencement of the EAC Common Market Protocol - together with the expected economic growth of the member states – will open new opportunities for Kenya. In the short term, this should expand the market for Kenya's manufactured exports while in the medium to long term it should give rise to mobility of capital and labour.

b. Domestic Economic Developments

Economic Growth

The first quarter of 2010 showed an improved growth of 4.4 percent. This was mainly driven by agriculture and manufacturing sectors. Agriculture recorded its first positive growth since 2007 while growth in manufacturing was the highest first quarter growth in 10 years. This was a shift from a dependence on the construction sector which had supported economic growth through the difficult times of 2008 and 2009. Furthermore, tourism is above the 2007 levels with Nairobi showing a greater growth.

The fiscal year 2009/10 tax revenue data shows that consumption taxes grew well ahead of inflation supporting an argument that growth in the second quarter of the year 2010 should be much the same as the first quarter. Other indicators such as cement consumption, power consumption and oil sales all endorse this forecast. This growth signals confidence in the recovery process and the likely capacity of Treasury to meet its revenue requirements in the first half of the fiscal year 2010/11. The growth of credit to the private sector, though, was noted to be below what is desirable for a high growth trajectory.

Market sentiment corroborates the strong growth expectations. The July 2010 Market Survey, the sixth in a series, showed that the private sector had revised upwards their growth expectations where in May 2010, 9 percent expected growth above 5 percent, by July 2010, 17 percent did. In September 2009, 68 percent of banks expected growth below 3 percent, by January 2010, 59 percent expected growth above 4.5 percent and in July 2010, this had risen to 83 percent.

Inflation

The July 2010 price data from KNBS showed inflation to be 3.6 percent relative to 3.5 percent and 3.9 percent in June and May 2010, respectively. An analysis of the sources of price changes showed an expected deterioration of rain dependent food prices and a negligible movement of fuel prices. The one-off tax effect on alcohol was picked up over June and July 2010 as was the effect of increased competition in the communications sector. Exchange rates, while showing a weakening of the Kenya shilling were not converting to higher domestic prices partly due to the low price regime abroad and hence a weak pass-through effect, but also, as the Committee noted, the correction of the exchange rate after the Greek crisis was slowly taking place.

The market surveys were conducted separately for private sector firms and for banks. While all banks were surveyed throughout, the sample of private sector firms has been increasing. Therefore, trend analysis is possible on the banks' perceptions but is not yet feasible for private sector responses; nevertheless in May 2010, 18 percent of private sector respondents considered inflation would remain unchanged and 37 percent thought it could decline. By July 2010, some 28 percent expected inflation to remain unchanged while 44 percent thought it could decline. On the other hand, 30 percent of banks expected unchanged inflation in November 2009 and 37 percent expected it to decline. By July 2010, 64 percent expected stable inflation with 14 percent expecting a further decline. Thus there is conclusive evidence from the surveys that inflation will be stable with a declining bias.

Looking forward, the Committee noted that international oil prices had declined (and were expected to decline further) while the shift from thermal generated electricity to hydro generation could ease production costs substantially.

III. Fiscal and Financial Sector Performance

Fiscal Performance

The Committee reviewed the 2010/11 Budget proposals presented to Parliament, and noted that a significant share of the budget had been allocated to development related programmes which are expected to enhance growth. The budget allocated 11 percent of the total budget to public investment to consolidate the gains made by the fiscal stimulus package. The borrowing programme was reviewed extensively and found to be compatible with non-inflationary injections of liquidity. In addition, the proposed domestic borrowing is lower than in the 2009/10 fiscal year which signals less pressure on interest rates. From the debt sustainability analysis, the current domestic debt ratios are within the thresholds established in the Medium Term Expenditure Framework.

Interest Rates

The Committee noted that short term interest rates had continued to decline in response to monetary policy signals. In particular, the interbank rate, after an initial rapid decline stabilised at around 1.5 percent. It was noted that the market liquidity was being enhanced partly by commercial banks shifting their portfolio out of Treasury bills. The yield curve for Government securities had shifted downwards and flattened somewhat. This was particularly interesting in view of the marketing and re-opening of the 25-year Treasury bond. These facts all suggest strong confidence in the long term stability of the economy.

The repo market reflected improved efficiency in the management of liquidity in the banking sector. The increased use of Horizontal Repos is a clear testimony to this fact. At the short end of the yield curve, the average 364-day Treasury bill rate declined from 6.009 percent to 4.138 percent while that for 182-day Treasury bill declined from 3.971 percent to 1.742 percent over the period between May and July 2010. The average 91-day Treasury bill rate declined from 3.343 percent to 1.462 percent during the June-July 2010 auctions.

Twenty three commercial banks lowered their base lending rates between March and June 2010. However, the average lending rate only declined marginally from 14.58 percent in April to 14.39 percent in June 2010 while the deposit rates declined by a larger margin thereby increasing the interest rate spread. This, for market development and efficiency is a perverse outcome.

The MPC Market Surveys have allowed the Committee to analyse expectations of commercial banks lending rates since September 2009. Generally, the banking sector and non-banking private sector have maintained expectations for decline in interest rates by 1-2 percent. However, the average rate has decreased by less than one percent over the period.

Banking Sector Developments

The banking sector continued to record improved performance. Loan accounts grew by 196,577 between April and June 2010. In addition, 88,000 micro accounts were opened in the last two months largely due to agency banking facilitation. This is a strong pointer towards increasing financial inclusion. Gross loans grew by Kshs.30 billion between April and June 2010 to stand at Kshs.828.9 billion; 26.7 percent of this went to the manufacturing sector and 13.4 percent went to energy and water. The Committee noted that this distribution of loans showed that sectors with economic potential were being supported by the banking sector. Non-performing loans declined with noteworthy improvements in trade, manufacturing, agriculture, financial services and households. Stress tests affirmed the soundness of the banking sector.

Both the banks and non-bank private sector firms expected credit growth in the remainder of the year. In particular, 41 percent of banks expected credit to grow by more than 10 percent while 53 percent of private firms expected to increase their demand for loans by over 10 percent.

Foreign Exchange Market and Reserves

The Committee observed that the Central Bank should continue to trade in all the three main currencies in maintaining and building its reserves. 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. The Committee noted that the foreign exchange reserves position was still in the range of 4 months of imports cover.

Market Liquidity

The monetary targets set by the MPC at its meeting in May 2010 were surpassed partly due to Government fiscal activities towards the end of the fiscal year 2009/10 and also increased economic activity. However, this did not pose a threat to inflation. The Committee confirmed the July 2010 targets for both reserve money and broad money supply (M3) as Kshs.187.2 billion and Kshs.1,213.3 billion respectively. The Committee then set targets for August and September 2010 as Kshs.182.9 billion and Kshs.186.4 billion respectively for reserve money, and Kshs.1,226.9 billion and Kshs.1,240.6 billion respectively for M3. The targets for CBK net foreign assets were established as Kshs.245.5 billion, Kshs.248.8 billion and Kshs.252.0 billion for July, August and September 2010 respectively.

IV. Key Considerations during the Monetary Policy Committee Meeting

The information analysed indicates that economic recovery is on course with increased optimism for enhanced growth in 2010. It also indicates that there are increasing opportunities both internationally and domestically to be taken advantage of. However, this can only be achieved by strengthening the capacity for growth of the private sector. To keep the momentum, the Committee is of the strong view that the economy still requires supportive and appropriate fiscal and monetary policies.

The commercial banks continued revising their base and lending rates downwards. New products and institutions have emerged including the Credit Reference Bureaus and budget lines for SMEs lending by the Ministry of Finance. Agency banking has taken off and therefore accessibility to financial services has been enhanced. All these considerations together with the growth optimism build a strong case for continued facilitation and provision of adequate and affordable credit.

The Committee was confident that the upside risks to inflation remain low with minimal pressure from international oil prices and the efforts to maintain adequate food supply through the Economic Stimulus Package.

Finally, the prevailing confidence in the economy provides a firm foundation for growth in economic activities. This is demonstrated by the downward shift and levelling out of the Government securities yield curve and the recovery of the stock market. The successful introduction of the 25-year Treasury bond provided another beacon to guide the financial sector to lengthen the tenors of its credit and debt instruments.

V. Monetary Policy Decision

Given the low inflation risk, the strengthening growth profile and growing confidence in the economy, the Committee was of the view that commercial banks and the private sector needed a strong signal in order to provide them with information that overall downside risks were declining and that other factors such as the EAC Common Market Protocol offer significant opportunities. The Committee therefore lowered the CBR by 75 basis points to 6.00 percent.

PROF. NJUGUNA NDUNG'U
CHAIRMAN, MONETARY POLICY COMMITTEE

August 2, 2010