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PRESS RELEASE

MONETARY POLICY COMMITTEE MEETING OF 30TH JANUARY 2009

DEEPENING THE FINANCIAL MARKET FOR EFFECTIVE MONETARY POLICY TRANSMISSION

I. Introduction

The Monetary Policy Committee met on 30th January 2009. It carefully examined how the market had responded to its decisions of 1st December 2008. The decisions initiated had the desired effect of increasing market liquidity and moving to a low interest rate regime. The full impact of the measures has yet to be absorbed by the economy. Nevertheless, they provided the appropriate signals to stimulate and support the private sector. The MPC deliberations considered:

A. Existing Information Carried Forward:

- Global economic downturn and its expected implications on the domestic market.
- Money market performance and the overall liquidity situation.

B. New Information

- The slowing down of the domestic economic recovery.
- The shift from the financial crisis to global economic downturn
- Easing of domestic inflationary pressure.
- Declining interest rates in the money market.
- Formal declaration of famine as a national disaster in Kenya and its fiscal consequences.
- Lowering of the Treasury bill bid threshold.

C. The overall macroeconomic context was observed to have two key outcomes

- Impact of the second wave of the global financial crisis and economic downturn and risks posed.
- Liquidity constraints have eased but the full effects of the decisions are yet to permeate throughout the financial system.

II. International Context

The MPC, in its continued tracking of the international economic instability noted that what started as a global financial crisis has now evolved into a global economic downturn. The world economy appears to be undergoing an unusually sharp and synchronized downturn driving several countries into what looks like a prolonged recession. The USA and UK economies shrunk by 3.8 percent and 1.8 percent respectively in the fourth quarter of 2008. The story is no different for the Asian tigers. Singapore and South Korea saw their economies shrink by 3.7 percent and 3.4 percent respectively in the fourth quarter 2008. For Africa, real GDP growth rate is expected to decline from 6.2 percent to 4.6 percent in 2009, while the East Africa growth rates are projected to fall from 8.4 percent in 2007 to 6 percent in 2009.

As a small open economy, Kenya is not immune to the impact of the global economic downturn. However, the magnitude depends on the structure of the economy. As noted in the previous MPC press release, Kenya is primarily a rural agro-based economy with only a small minority of the population directly interfacing with the developed world. The main sectors likely to feel any significant impact include tourism and commercially oriented agriculture such as horticulture, tea and coffee. Other effects might be felt through foreign exchange volatility, inputs (cost and availability) and also the credit and trade restrictions. Strategies by the world economies affecting relative interest rates will affect the flow of short term capital (hot money) internationally.

The Committee noted with satisfaction that Kenya's country rating has been upgraded. The latest FitchRating upgraded Kenya to B stable from B negative, this supported the November 2008 Standard & Poors upgrading of Kenya. These signal an improved environment and restore confidence in the economy.

III. Review of Domestic Economic Developments

Since the December meeting, data have come available for the third quarter of 2008. These data, while showing a recovery from the post election disrupted first quarter give a significantly lower rate than was generally programmed. A number of indicators continue to show that business is still improving relative to 2007. Tea and cement, which are significant indicators of economic activity, show positive growth. But poor weather and the international downturn combined to undermine the rebound which had been anticipated in December 2008. The level of imports still show confidence in the economy and so long as foreign financiers do not undermine Kenya's capacity for growth momentum, the Committee believes there is good reason to see adequate growth to June 2009 and, depending on the March-May rains, recovery by the end of the year.

Inflation

The January inflation data were not yet available at the time of the MPC meeting, but have since been released. Inflation has dramatically fallen to 21.9 percent in January 2009, despite the previously discussed computational problems. Even this rate is driven by the upward biased effect of the untypical Low Income Nairobi seasonal food prices. The rest of the economy showed moderate increases.

Backed by research conducted in the Central Bank, the MPC concluded that the liquidity injection had not had any inflationary impact, furthermore, the pass-through effects of the oil price decline and the exchange rate instability were not transmitting adverse supply side signals into the Kenya market place. This reconfirms that economic activity has increased and supply constraints indeed are being resolved.

Interest Rates

In making its decisions in December 2008 the MPC proposed changes that were intended to increase the liquidity of the financial sector. The increased liquidity was intended to provide a competitive interest rate so that the institutions of the sector would offer credit to the economy at lower cost. In fulfillment of both of these intentions, the Committee was successful since this reaction did occur in the financial markets: interbank rates have come down, repo rates have declined and liquidity in the interbank has increased. In two Treasury bill auctions, Central Bank took some bids in excess of the offer thereby dampening the decline in yield rates which enabled the Treasury recover shortfalls from previous under-subscriptions.

Following the review of all these markets the Committee concluded that the liquidity expansion consequent on the December 2008 decisions was still in a dynamic phase utilising short term assets while the adjustment of longer term rates on less liquid assets were still under review.

Exchange Rates and Foreign Interest Rates

The Committee reviewed research on the time paths of exchange rates between the major currencies. It was observed that the global financial crisis was causing the monetary authorities in the United States, the United Kingdom and the Eurozone to take measures to stimulate their individual macroeconomies. This led to high exchange rate volatility as misaligned currencies responded to relative interest rates movements. This depreciated the Kenya shilling as the dollar strengthened globally. The Kenya shilling movements reflected the realignment of foreign currencies in the international market.

Monetary Developments

The Central Bank has continued meeting its monetary aggregate targets. The actual growth in reserve money was 4.6 percent in December, 2008 compared with the target growth of 9.7 percent. Broad money grew by 15.9 percent as compared to a target of 17.0 percent over the same period. The significant gap between the actual and target monetary aggregates growth rates implied that the recently observed economic performance was not aligned with the monetary program being implemented. It is for this reason that the MPC called for the review of the monetary framework to take into consideration the current economic growth. This would facilitate a proper tracking of the impact of the actions taken by the MPC in its previous meeting with respect to efficiency of the markets and how the economy responded.

The Central Bank reduced the Treasury bill bid threshold to Ksh100,000 effective from 1st January 2009. The main objective was to enable the small savers diversify their financial asset basket with a risk free asset that they were previously not able to access easily and increase returns to their savings. Results show that progress has been made with a rising number of investors who have less than Ksh1 million accessing the Treasury bill market directly. However, challenges to accessing the market remain. The Committee recommended the exploration of alternative channels to enhance access to the Treasury bill market at minimal transaction costs.

Developments in the Financial Sector

The MPC was satisfied that the financial sector in Kenya is by and large sound. In 2008, the total assets for the industry grew by 34 percent and deposits have now surpassed a trillion shillings. Average liquidity stood at 37 percent compared to the statutory minimum of 20 percent. The Total Capital to Total Risk Weighted Assets Ratio for the sector stood at 18.9 percent, above the statutory minimum of 12 percent. The percentage of the Gross Non Performing Loans to Gross Loans stood at 8.4 percent as at 31st December 2008, a decline of 2.5 percent from the 14.68 percent in January 2007. The recent finalization of the regulatory framework and licensing of Micro-Finance Institutions (MFIs) is a commendable step in improving access to financial services, particularly to the lower end of the market. This will enhance the financial reach of the sector while deepening the products available to the wider community.

It was considered that these services should be viewed as complements and not competition for the banking sector. The new environment poses a major challenge for the banking sector to improve its intermediation efficiently. The improved efficiency will lower the comparatively high transactions costs associated with the full range of financial products offered including credit, savings and money transfers. The Committee noted the on-going institutional reforms and considered that these would make a significant improvement to operational efficiency in the financial sector.

MPC observed that although the interbank market remains very vibrant, the recently introduced horizontal repo has yet to become a major instrument of the interbank market. The horizontal repo is supposed to enable banks without credit lines to access credit from other banks through the interbank market. This will deepen money market through enhanced efficiency in the interbank market. The Committee noted that this has not been fully operationalised for reasons that seem largely administrative.

IV. Key Considerations during the Monetary Policy Meeting

The Committee was satisfied that intended liquidity expansion occurred rapidly in the financial sector but it was concerned that the interest rate structure was still not responding adequately. Specifically, the gap between money market rates was too wide indicating inefficiencies. It was therefore necessary to allow time to see how the market would evolve.

Time was also necessary to establish how second round effects of the global economic downturn would impact the economy. It was clear to the Committee that these would be more adverse than the first round effects. Amongst the consequences expected were risks relating to a decline in the demand for Kenyan exports which would cause a slowing down of the economic recovery process.

Nevertheless, even with some downward revision to expected economic growth, it was noted that tax revenues continued on target. The only noteworthy new variables to be incorporated in forecasting demands by the Treasury were: firstly, the potential food imports and secondly, some infrastructure bond related shifts in demand for long dated securities.

V. Monetary Policy Decisions

Considering the various international and domestic developments highlighted above and given that inflation risks were on the downside, the Committee agreed to retain the CBR at its current level of 8.5 percent to allow for the impact of its previous decisions to be fully absorbed by the economy. In addition the Committee will provide better mechanisms to overcome the intermediation inefficiencies in the financial sector which have constrained the full benefits from being realized more rapidly and effectively.

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CHAIRMAN, MONETARY POLICY COMMITTEE

February 3, 2009