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PRESS RELEASE

SPECIAL MONETARY POLICY COMMITTEE MEETING 14TH SEPTEMBER, 2011

I. INTRODUCTION

The Monetary Policy Committee (MPC) held a Special Meeting on 14th September, 2011 to assess developments in the economy since its last meeting and the volatility seen in the financial market. The meeting reviewed the outcomes of various measures that had been taken to stabilise the market as well as analyse the direction and results of various policies. The last MPC meeting was simply affected by the supply confusion in the economy. The Committee observed that inflation, exchange rate and money market volatility continued to pose a challenge to the economy. Specifically, the debt crisis in Europe continues to have a significant impact on the economy through the exchange rate volatility. Events in the USA and Europe are expected to continue affecting the exchange rate, inflation and the economic recovery. High food and fuel prices continue to drive inflation while balance of payments pressures are unduly impacting the exchange rate. However, the Committee noted with satisfaction that international oil prices were declining. Furthermore, the Meteorological Department had forecast adequate short rains throughout the country which will, in the end, relieve some of the price pressures from food. Furthermore, it was noted that unequal distribution of liquidity in the market had led to volatility in the money market. The Committee noted that the various measures adopted in the implementation of its current stance had started to stabilise the market.

II. MONETARY POLICY FRAMEWORK AND OBJECTIVES

The Committee identified four key areas that needed to be addressed arising from the current domestic and international situations.

1. **Market uncertainty:** The Euro Crisis that is a continuation of the global financial and economic crisis continues to have a significant impact on the Kenyan economy both on economic recovery efforts and on monetary indicators. The events in Europe (and in the US debt market together with the currency wars taking place are an external environment) will continue buffeting the Kenyan economy. These external events will continue affecting the exchange rate, inflation and the economic recovery.
2. **A high inflation episode is persisting**: The high overall inflation environment is mainly a consequence of high food prices and high fuel and energy prices. The latest foodstuff to give us a price shock, just when we thought we were coming to a solution with respect to food, has been sugar. Sugar has a significant weight in the CPI basket even when assessed against the weight on maize. Monetary policy in tackling these sources of inflation, has limited possibilities. But we also do know that they are seasonal in nature and they will disappear in time. Unfortunately, the return to normal prices has been slower than the experience in 2009. With respect to the non-food-non-fuel index inflation which accounts for just under one third of the items surveyed by the Kenya National Bureau of Statistics (KNBS), the Committee continued to observe the upward drift in inflation which now registers over 7 percent. These increases appear to be a consequence of the weakening of the Kenya Shilling and the cost push pressure due to fuel and energy costs.

3. **Market volatility**: The Committee noted that some of its earlier reactions to the crisis had failed to deliver stability and that they were even interpreted adversely. The market reactions were equally perverse. Specifically, the market had confused the role of the CBK Overnight Window rate as a signal of monetary policy. The CBK Overnight Window remains a facility to provide funds as a lender of last resort. It is therefore penal so as to encourage more effective and efficient liquidity management. Furthermore, banks commenced setting the interest rate in the interbank market with respect to the CBK Overnight Window rate. Since the Window rate is meant to be a penal rate, this action by banks frustrated the purpose. Initially the decision was made to ration access to the Window but this was seen to be controlling both price and quantity in the same market. The Committee noted that this inevitably created confusion and hence it was necessary to clarify that the Overnight Window rate was in fact an outcome of the Central Bank Rate (CBR), a penalty, and a measure of market tightness. This will be continued with more clarity now.

4. **Balance of payment current account under pressure:** The Committee noted that the external account posed significant challenges to monetary policy. It considered that there may well be a change in fundamentals since the increasingly negative 12-month current account has been pushing the exchange rate depreciation. An examination of the Real Effective Exchange Rate (REER) and Nominal Effective Exchange Rate (NEER) showed that the nominal depreciations have not been translated into benefits for exporters. So the nominal depreciations have not been supported by fundamentals and have not been translated into REER depreciations and so these nominal depreciations may reverse in future.

III. WAY FORWARD

In reviewing the market reactions to the domestic and international events, the Committee noted that there was a need for a strong, well coordinated statement of the framework in which actions would be taken. In this way, possible confusions in the market would be minimised and hence stability in the various markets will be ensured.

1. The Committee strongly reiterated its overriding objective to fight inflation and to bring it down to target levels in light of the growth target and the monetary policy framework in place. In this regard, the CBK will pursue the inflation objective through a continuation of the gradual tightening of monetary conditions. That tightening will be implemented by adhering to quarterly Net Domestic Assets (NDA) targets as agreed under the Extended Credit Facility (ECF) supported program. NDA together with Net Foreign Assets (NFA) add to the total money supply hence the program targets the domestic component through NDA and the foreign component through Net International Reserves (NIR). In short the message is that monetary policy will anchor inflation and rein in inflation expectations.

2. The interest rate policy will be designed to deliver an outcome that is purely based on the NDA target. The movement or adjustment in the CBR will always be consistent with the NDA target and for this period it is aimed at gradually tightening of monetary policy. So the CBR will move in line with the NDA targets. If NDA is above the target, the policy rate will be raised as a result, and vice versa.

3. The Committee will emphasize and communicate to the market the differences between the medium-term objective of monetary policy and short-term liquidity management. Liquidity injections to ease banks' liquidity constraints from time to time are, and should be, treated as temporary in nature and the attainment of the NDA target will not be undermined as a result.

4. The Committee will explicitly show the precise way in which the CBR is indeed the policy rate governing the levels of other rates. The CBR will be the pivot that will enable the policy stance to transmit to the other aspects of CBK operations. When the CBK intervenes with reverse repos or mops up with vertical repos as needed for liquidity management purposes, the rates that will be operated will be clearly defined with respect to the CBR.
5. The Committee noted that the balance of payments pressure on current account would be eased by further support to the balance of payments which would help to stabilize the exchange rate. This support would arise from additional financial support from the IMF as requested by the Minister for Finance. Discussions on additional support will take place in the context of the second review of the program which is scheduled to take place in October, and will be based on a clear agreement on the direction of monetary policy moving forward. Other foreign exchange inflows could be expected from the forthcoming infrastructure bond targeting Kenyans in the diaspora. In addition the Ministry of Finance is considering issuing a sovereign bond in the course of this fiscal year. This bond had been programmed for issuance in the next fiscal year.
6. The Central Bank stands ready to take appropriate action to ease pressure on exchange rate in the market due to importation of essential foods to alleviate supply constraints.
7. The Cash Reserve Ratio (CRR) averaging had created flexibility in liquidity management in the commercial banks. This was consistent with the expectation that liquidity shortages in a segment of banks were of a short term nature. The MPC will continue to monitor the effectiveness of the use of this tool.

IV. MONETARY POLICY DECISIONS

On the basis of the foregoing analysis and the need for gradual tightening of monetary policy, the Committee decided to raise the CBR to 7.00 percent from its current level of 6.25 percent. Furthermore, in order to continue to facilitate commercial banks' liquidity management, the Committee decided that the current requirement that banks maintain their Cash Reserve Ratio (CRR) based on a 30 day average with a floor of 3 percent should be continued. The Committee noted that other countries had successfully solved short term liquidity problems using this framework.

The MPC believes that with these measures and others which are ongoing in liquidity management, the economy will be cushioned from inflationary pressure and domestic prices stabilized while providing a flexible space for banks to manage their liquidity efficiently.

PROF. NJUGUNA NDUNG'U, CBS
CHAIRMAN, MONETARY POLICY COMMITTEE

14th September, 2011