CENTRAL BANK OF KENYA

TALKING NOTES

by

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at the

AMERICAN CHAMBER OF COMMERCE OF KENYA MONTHLY LUNCHEON

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Distinguished Members of the American Chamber of Commerce and Invited Guests:

1. It is my pleasure to join you at this monthly luncheon and I thank you for inviting me.
2. This Luncheon has an important timing: First, it comes after the visit of the American Vice President to this country, an important visit for Kenya. Second, it comes soon after the Minister for Finance put forward the budget proposals and policies to achieve them. Finally, it comes at a time when Kenyans are debating and campaigning for a positive vote to a new constitution. I am very sure that since I am addressing an audience comprising mainly investors, entrepreneurs and business people who wish to live in an environment of high economic growth and low and stable prices, I am certain that the superior law is important. The Constitution protects and safeguards their interests. This is how markets work – that is how development of markets and institutions takes place.
    - The government economic agenda is guided by the strategic framework for faster development underpinned by a stable macroeconomic environment and structural reforms aimed at raising productivity and improving business climate. This is key to enhancing Kenya's competitiveness and accelerating private sector development.
    - Personally, I do believe that for growth to be achieved, it depends on investments. Investments in turn depend on incentive mechanisms and legal safeguards to protect them.
    - I believe also in strong institutions. Strong institutions define the appropriate incentives that encourage prudent behaviour.
    - This is what the superior law - the New Constitution will do to institutions and give confidence to markets.

3. The Kenyan economy has undergone a turbulent time from 2008 stemming from multiple shocks: the domestic political crisis; the

drought; high petroleum and food prices as well as the global financial crisis. However, we have started to see some recovery. From the steep decline to 1.6 percent growth in 2008 the economy recovered to post 2.6 per cent growth in 2009. This growth was mainly supported by a resurgence of activities in the tourism sector and resilience in the building and construction industry. We do hope the Greek crisis will not prolong the recession in Europe – that may produce further knock-on effects in the Kenyan economy.

4. Economic prospects for 2010 and medium term prospects are quite optimistic. Growth is forecast at 4-5 percent for 2010. This is a conservative forecast as various indicators point to a higher growth rate. Growth will be driven mainly by increased investment in key sectors including agriculture, services, infrastructure, health and education. After this recovery, Kenya will be in a good position to refocus its efforts towards achieving vision 2030 goals. The government has identified the binding constraints whose resolutions will lower the cost of doing business substantially and propel the growth forecast higher;

- Kenya's growth diagnostic studies have identified a lack of complementary factors: They include infrastructure gaps and poor private appropriability factors that prevent the private sector to reap full returns to their investment such as: crime, corruption and relics of political instability. The proposed constitution once adopted will herald institutional changes of unprecedented proportions for this great nation.
- To ease infrastructural constraints the 2010/11 national budget continues to allocate more funds for infrastructure. The infrastructure budget for FY 2010/11 is equivalent to 23.3 percent of total expenditure reflecting the critical role infrastructure is expected to play towards reducing cost of doing business to improve domestic production competitiveness.
- The Central Bank has developed an effective instrument for this; the Infrastructure Bonds – they have been very successful in the

market. They have a further dimension of enhancing a savings–investment platform for Kenyans and a strong stimulus to crowd-in rather than crowd out the private sector.

5. As a central banker, I want to reiterate the importance the Government attaches to macroeconomic stability. You might have heard some assertions in some sections of the media that Kenya's debt position might be a problem in the future. Given the developments in the Euro zone where investors have punished countries for their fiscal position (we call this debt overhang problem or risk – the private sector believes taxes will be increased in future to affect resource transfers from the private sector to the Government to pay for high debt). It is imperative that I parade the Kenyan case to this esteemed audience. As of May 2010, Kenya's debt level stood at 44 per cent of GDP, external debt to GDP is at 28 per cent – a level much lower than for most countries in this region (it has moved from 60 percent in 2003 to 40 percent in 2009 and to 44 percent as at May 2010). You will agree with me that this is commendable for a country which has not been a beneficiary of the HIPC initiative. The overriding fiscal thrust of the Government, is to contain the stock of debt to a sustainable level of 40 percent of GDP. Debt sustainability analysis carried out by the Ministry of Finance, the IMF and the World Bank have not found any significant risk posed by our debt levels. To demonstrate this commitment of reducing the domestic debt, the government will reduce its domestic borrowing from 5.1 percent of GDP in 2009/10 to 3.8% in 2010/11. This fiscal space, as was demonstrated during the drought and global financial crises is important for propelling growth even in times of crisis – the fiscal stimulus would not have been possible – Gives room for monetary policy to perform.

6. It is the Central Bank's belief that the fiscal and monetary policies currently in place will enhance investor confidence by increasing expectations of economic recovery or reducing tail risks associated with the exogenous shocks that have buffeted Kenya's economy in the

recent past. In particular the government expenditure programs and the current monetary policy stance are likely to have larger than normal positive impacts on demand and benefits that may persist for a significant period of time.

7. For us in the Central Bank, our pre-occupation is to align monetary policy with the growth and development goals while at the same time maintaining low and stable inflation – a target of 5%. In addition, a stable and market driven exchange rate, increased efficiency in the financial system, financial stability, and a reliable and efficient national payment system. To give you some indication:
   - Inflation was provisionally 3.2 percent for the month of June 2010. Inflation expectations as indicated in the MPC Market Surveys are anchored at a lower level. The current exchange rate movements of the Kenya shilling against other major currencies is largely a response to external developments especially the uncertainty in the Euro zone market. The exchange rate in this case works as an automatic stabilizer via relative price movements.
   - Interest rate structure that carries with it cost of investment as well as inflation expectations have declined drastically since the middle of 2009.

Distinguished Members, Ladies and Gentlemen

8. Let me note that the current economic environment in Kenya is based on policies that are market leaning and offer a level playing field for potential investors.
9. In the banking sector, our vision is to build a strong financial sector and be the financial hub of the East African Community. The strength and presence of Kenyan banks is now being felt in the region, specifically within the East African Community where some of our banks have opened branches.
10. One of the more recent reforms is the licensing of credit reference bureaus. The credit information sharing mechanism is now fully

operational and as a result we expect to subsequently see a reduction in costs as banks pass the resultant benefits to their customers.

12. As a Researcher, I would like at some point in future when doing my economic analyses on the Kenyan economy, to find a very significant “Obama Effect” on Kenya’s growth and development. That “Obama Effect” together with a renewed political leadership able to undertake political and social reforms supported by a Superior Law – the Constitution - will be noticed in our econometric studies in future. But this will only be realised if all of you in this room and elsewhere scale-up your investments in Kenya.

Finally, **Distinguished Guests, Ladies and Gentlemen**, I conclude by wishing you fruitful discussions.

Thank you