Governor

BANKI KUU YA KENYA

CENTRAL BANK OF KENYA

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PRESS RELEASE

MONETARY POLICY COMMITTEE MEETING OF 27TH JULY, 2011
"Enhancing the Effectiveness of Monetary Policy through Liquidity Management"

I. Introduction

The Monetary Policy Committee (MPC) met on 27th July, 2011 to assess developments in the economy since its last meeting and review the impact of its previous decision that tightened the monetary policy stance to rein in inflation and inflationary expectations. It examined a broad array of available information as well as the results of the July 2011 Market Perception Survey (Market Survey) that revealed strong economic growth. The Committee observed that at the moment, and for the next few weeks, further tightening of the monetary policy stance would not achieve the desired results if the supply side of food, fuel and energy were not signalling relief to the constraints fuelling inflationary expectations. In addition, the recently introduced power rationing targeting manufacturing firms will create a further drag on economic recovery and supply of goods and services. However, the growth of broad money supply was noted to have been below its target since September 2010. In addition, although private sector credit was still growing, it was more towards financing economic activities in the productive sectors. These effects therefore ruled out demand pull inflation or overheating in the economy. The Committee was of the view that monetary policy was tight enough and that any further tightening without a solution to supply side constraints in sight would be counter-productive and distort the market. Consequently, the Committee decided to retain the Central Bank Rate (CBR) at 6.25 percent but continue to monitor the situation further. Furthermore, in order to facilitate commercial banks liquidity management, the Committee decided that commercial banks will be required to maintain Cash Reserve Ratio (CRR) based on a weekly average instead of the current daily average.

A. Information carried forward

- Persistence of supply side inflationary pressures;
- Sustained confidence in the economy;
- Strong performance of the banking sector;
- Credit risk in the banking sector continues to decline;
- Release of the Economic Survey for 2011 (Economic Survey) by the Kenya National Bureau of Statistics (KNBS);
- Continued political unrest in the Middle East and North Africa (MENA) regions;
- World crude oil prices falling; and
- Continued volatility in the global financial and foreign exchange markets reflecting uncertainty.

B. New information

- Release of the June 2011 Update of the World Economic Outlook (WEO) by the International Monetary Fund (IMF) and African Economic Outlook 2011 (AEO) by the African Development Bank.
- Release of the 2011 first quarter economic performance data by KNBS;
- Results of the MPC Market Survey for July 2011;
- Independence of Southern Sudan in early July 2011; and
- Upsurge in Somali refugee crisis due to drought in the region.

C. Overall macroeconomic context

- Despite persistence of inflationary pressures, growth expectations from the Market Survey and other economic indicators show sustained confidence in the economy;
- Continued volatility of the exchange rate creating uncertainty;
- IMF and African Economic Outlook growth forecasts for both Kenya and neighbouring countries suggest that growth in 2011 will be strong. This is expected to increase demand for Kenya's exports;
- Financial developments and innovations based on mobile phone technology continue to enhance financial inclusion with a strong impact on the monetary policy transmission process.

II. Economic Outlook

a. Global Economic Outlook

The World Economic Outlook projects the global economy to slow down from a growth of 5.1 percent in 2010 to 4.3 percent in 2011. The projected growth in 2011 is slightly lower compared with the projection of 4.6 percent in April 2011 on account of slowdown of the quarter two growth in the US, Japan and some emerging economies. Emerging and developing countries are projected to grow at 6.6 percent in 2011 down from 7.4 percent in 2010 but at a slightly higher rate than the 6.5 percent projected in April 2011. Sub-Saharan Africa economies were expected to grow by 5.5 percent in 2011 up from 5.1 percent in 2010. Similarly, the African Economic Outlook projects a growth of 6.7 percent in 2011 and 2012 for the East African Community economies.

The downward revisions in the growth rates of the major world economies could have implications on Kenya if these downturns continue into the third and fourth quarters of 2011. Specifically, tourism and the high income products in the horticultural market could be affected. India and China, who are among Kenya's major trading partners, were noted to be implementing measures to curb inflation which could shift demand in these countries from domestically produced goods to cheaper imports. However, this was not considered to have a major impact on Kenya's exports to these countries. The advent of Southern Sudan into the arena as an independent nation was analysed. It was observed that Kenya would benefit significantly through enhanced trade opportunities. However, it was also observed that the newly introduced South Sudan Pound could provide moderate pressures on the Kenya Shilling which has previously been used to transact business in that economy.

A variety of the indicators for the global economy reviewed by the Committee were being affected by international events in both the Euro Zone and the United States. In particular, there were significant financial sector driven concerns in these countries which resulted in instability in the Euro and US Dollar, respectively. As had been previously observed, these instabilities reflected into Kenya in the course of the last two months and were exacerbated by distortions arising from positions being taken by some international banks in the foreign exchange market.

The Committee concluded that the continuing global and regional economic expansion is expected to benefit the Kenyan economy through increased capital inflows (especially diaspora remittances), and earnings from tourism and exports.

b. Domestic Economic Developments

Economic Growth

The Committee undertook further analysis of the data released in May 2011 by the KNBS on economic performance in 2010. It also noted that the 12-month economic growth to the end of March 2011 was 5.7 percent; hence the trend of recovery which had commenced in the first quarter of 2010 when the economy was growing at 2.3 percent had continued. A review of the data available for the second quarter showed that power and cement consumption, which are important indicators of economic activity, had both continued to increase in real terms which are an indication of sustained economic growth. The growth in the 12-month cumulative cement consumption increased from 17.5 percent in April 2011 to 18.3 percent in May 2011. Similarly, the growth in the 12-month cumulative power consumption increased from 7.4 percent to 7.5 percent in a similar period. In addition, increased economic activity was depicted in Government tax collections which showed that the last quarter of the fiscal year 2010/11 was buoyant. Specifically, the monthly growth in tax revenue increased from 18.3 percent in April 2011 to 31.6 percent in May 2011 and further to 32.3 percent in June 2011. However, the unevenly distributed rainfall in the first half of 2011 adversely affected agricultural production in country.

The Market Survey indicated that both banks and the non-bank private sector expect growth to slow down but within the Government target of 5.3 percent in 2011. These perceptions were supported by their expectations of continued growth in supply and demand for private sector credit. In addition, confidence in the economy was indicated by the continued growth in imports of non-transport capital goods and intermediate imports by the manufacturing sector. Furthermore, the banking sector which had provided a significant stimulus to the second quarter growth was showing improvements through continued decline in non-performing loans. The Committee concluded that confidence in the economy remained high while the data analysed revealed strong economic growth outlook.

Inflation

The data released by KNBS showed that the July 2011 overall inflation rate continued to rise but at a decelerated rate. Specifically, overall inflation increased from 14.49 percent in June 2011 to 15.53 percent in July 2011. The Committee noted that the prices of food and fuel, both of which are dependent on the level of supply, continued to account for the largest proportion of the rise in inflation during the period. Food inflation increased from 22.5 percent in June 2011 to 24.0 percent in July 2011 largely reflecting a rise in the price of dry maize and maize flour. Fuel prices have been adjusted upwards twice since the last MPC meeting.

An analysis of trends in inflation in the four months to July 2011 compared with that in a similar period in 2010 revealed that while there is an upward trend in the cost of non-food-non-fuel items in the CPI basket, the rate of inflation of this group remained within the 5 percent target range. Specifically, non-food-non-fuel inflation increased from 5.6 percent in June 2011 to 6.5 percent in July 2011. This category of goods accounts for 37 percent of the expenditure and 54 percent of the surveyed items of the CPI basket. The products included in the computation of the consumer price index in this category fall broadly under the possible control of monetary policy. The Committee also analysed the likely impact of the upsurge in Somali refugees in North Eastern Kenya. This may add to the current food supply constraints and increase pressure on food prices.

A disaggregated analysis of the overall CPI items showed that most of the 12 sectors which the KNBS surveyed have strong peaks and troughs rather than trends. The Committee therefore concluded that this cyclical behaviour could be expected to continue in the future moderating the current high inflation rates. In view of the lack of evidence of any strong demand pull pressures arising from monetary overhang, the Committee concluded that its current stance was adequately addressing the noticeable upturn in non-food-non-fuel prices.

III. Fiscal and Financial Sector Performance

Fiscal Performance

The Committee analysed the data on the outcome of the fiscal year 2010/11 Government budget as well as the budget estimates for the fiscal year 2011/12. On the former, it was noted that final figures were yet to become available in several sectors but that the Government's domestic revenue targets had been met. However, the actual expenditure data on development projects which will enhance the future growth potential were still being analysed. On the other hand, the fiscal year 2011/12 Government budget is based on sound macroeconomic fundamentals which will ensure that the private sector driven growth would not be threatened by either crowding out or foreign debt related risk through exchange rate volatility.

Interest Rates

An analysis of the evolution of interest rates over the last two months showed that the interbank rate had responded to monetary policy signals. However, the immediate response of the interbank rate to equal the CBR following the MPC meeting in May 2011 meant that borrowers in the interbank market were effectively being charged the penalty discount rate. The Committee was informed that mis-information around the availability of the CBK Discount Window resulted in rise in the interbank rate above the Discount Window rate on 28th June 2011. In particular, the interbank rate rose from 6.25 percent on 27th June, 2011 to 7.08 percent on 28th June 2011 and maintained this upward trend to peak at 10.67 percent on 15th July, 2011. This market reaction arguably demonstrates the degree to which mis-information can distort an otherwise stable system.

The Committee advised the Bank to invoke the CBK Act to restore order while it worked on policies which would provide longer term stability. In view of this instability in the interbank market, the Committee considered that its first objective in the interest rate regime was to restore the statutory purpose of the CBR and remove arbitrage opportunities. Consequently, the CBK announced new measures to guide the operations of the CBK Discount Window but also provided liquidity through reverse repos to stabilise the interbank market.
Consequently, the latest data made available to the Committee showed that the CBR was taking the role of an indicatory rate while the market was returning to a more stable order.

Banking Sector Developments

The Committee noted that the banking sector maintained stability resulting in improved performance. Specifically, gross deposits increased by 4.3 percent from Ksh.1,354.6 billion in April 2011 to Ksh 1,412.8 billion in June 2011. Similarly, gross loans increased by 6.6 percent during the period to stand at Ksh 1,083.1 billion in June 2011. The growth in credit during the period was distributed across all the key sectors of the economy. Based on stress test results and financial soundness indicators, the sector remained sound. In addition, non-performing loans (NPLs) decreased by Ksh 1.7 billion during the period resulting in an improvement in NPLs to gross loans ratio from 5.9 percent to 5.4 percent. Loans to private households had been a matter of concern over the last few months due to an increasing proportion falling into the non-performing loans category. This trend was reversed in June 2011. This same story of declining vulnerability is even more strongly shown in loans to trade where non-performing loans have been decreasing month by month since December 2010.

Based on the above developments, the Committee concluded that credit risk in the banking sector was declining. In particular, small banks showed the greatest improvement. In terms of loans, the Committee noted that productive sectors such as manufacturing, trade and transport and communications were all major beneficiaries of expanding credit in the banking sector while categories normally associated with inflationary pressure (i.e. loans to private households and consumer durables) decreased.

In view of this stability and improved performance of the banking system, the Committee concluded that the measures taken by the CBK in the last two months to ensure stability in the sector were effective.

Foreign Exchange Market and Reserves

The Committee observed that the level of foreign exchange reserves held by the CBK was adequate. However, the gross foreign exchange reserves remained virtually unchanged at USD 4.12 billion (3.87 months of import cover) between May and July 2011. The Bank received USD 69.5 million in July 2011 from the IMF through the Extended Credit Facility programme following successful attainment of the set targets. However, despite the pressure from servicing of Government external debt obligations, the CBK did not consider it appropriate to build-up foreign exchange reserves through purchases from the domestic foreign exchange market between May and July 2011 in view of turbulences generated internationally. The exchange rate effects on domestic prices and interest rates were found to be negligible while the foreign exchange holdings of commercial banks were significantly reduced in the course of speculation in taking forward positions with respect to the Shilling. The Committee looked at the policy implications of this speculation and provided appropriate advice to addressing its short term consequences. However, the Committee concluded that in future, CBK should explore alternative frameworks for building up its foreign exchange reserves.

Market Liquidity

One of the key concerns addressed by the Committee in the course of its meeting was the extremely rapid rise in the interbank rate beyond the CBR, and the increasing utilisation of the CBK Discount Window which is a facility whereby the Bank acts as a lender of last resort. In particular, the amount of funds borrowed by banks through the Overnight Window peaked at Ksh 30.7 billion on 21st June 2011. The Committee established that the interbank volatility was similar to that experienced during the Initial Public Offers (IPOs) in the past and hence was primarily due to the concentration of scarce liquidity in a few banks. However, it was noted that the liquidity was tight as a consequence of the Committee's tight monetary policy stance and therefore scarce liquidity would necessarily have put pressure on interest rates. However, the extent to which the overnight window was being utilised suggested that the rise in interbank rates was more of result of market distortions than the absolute absence of short term funding to the banking system.

The monetary targets set by the Committee at its meeting in May 2011 were effectively met for the broad money supply (M3) growth. However private sector credit had grown faster due to a slow down of Government borrowing. The Committee set targets for M3 at Ksh 1,417.1 billion in August 2011 and Ksh 1,435.4 billion in September 2011.

IV. Key Considerations during the Monetary Policy Committee Meeting

The Committee noted that exchange and interest rates volatility in the recent past had necessitated the need for policy revisions prior to the meeting in order to improve commercial banks' liquidity management. It also noted that the direction and volatility of the exchange rate in recent times was not supported by fundamentals. Foreign exchange reserves continued to lie within the target range while the fiscal deficit continued to support macroeconomic stability. The Committee concluded that further tightening of the monetary policy stance would not achieve the desired results if the supply side of food, fuel and energy was not signalling relief to the constraints since they have been guiding inflationary expectations. Given that the growth of broad money supply has been below its target since September 2010 and that there was no evidence of significant monetary overhang, the Committee concluded that monetary policy was tight enough and that any further tightening under the current economic conditions would be counter-productive.

V. Monetary Policy Decision

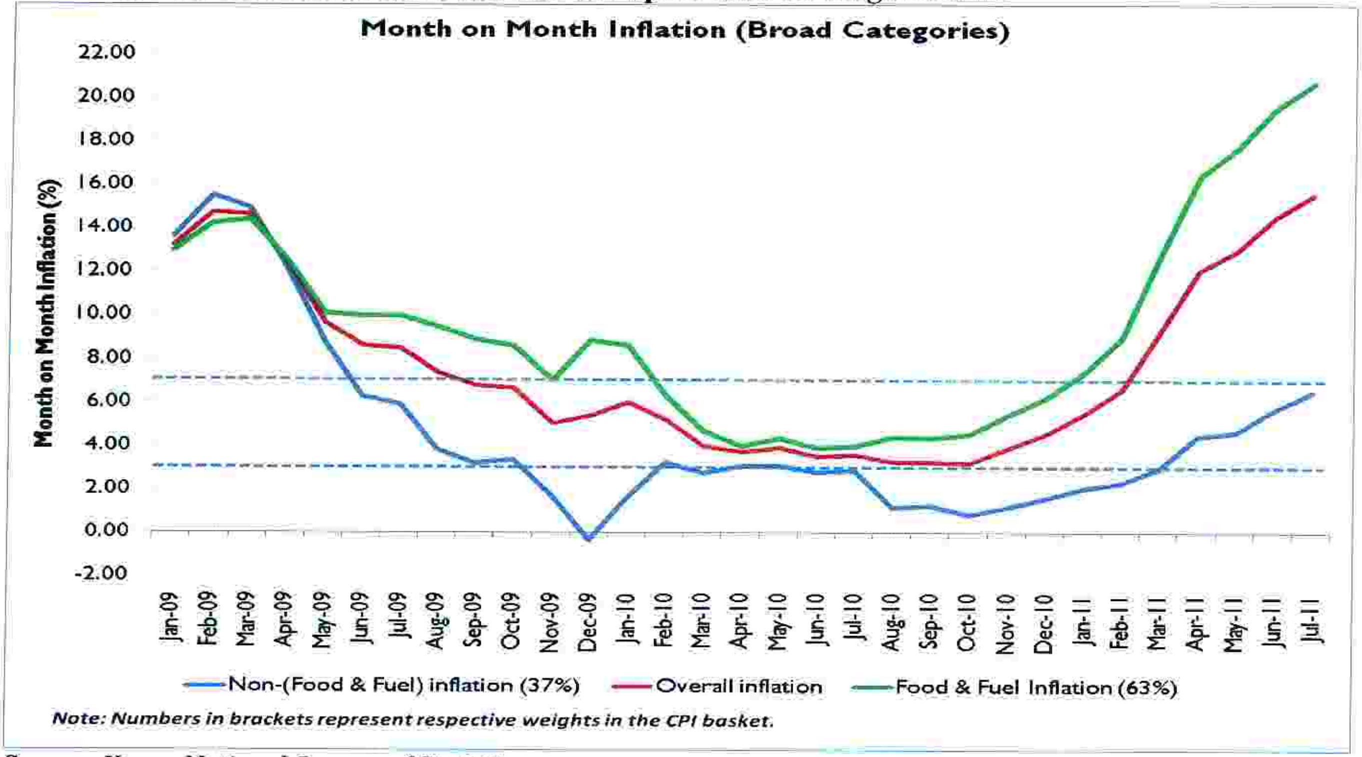
The Committee decided to retain the CBR at 6.25 percent. Furthermore, in order to facilitate commercial banks liquidity management, the Committee decided that commercial banks will be required to maintain their Cash Reserve Ratio (CRR) based on a weekly average instead of the current daily average.

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

August 1, 2011

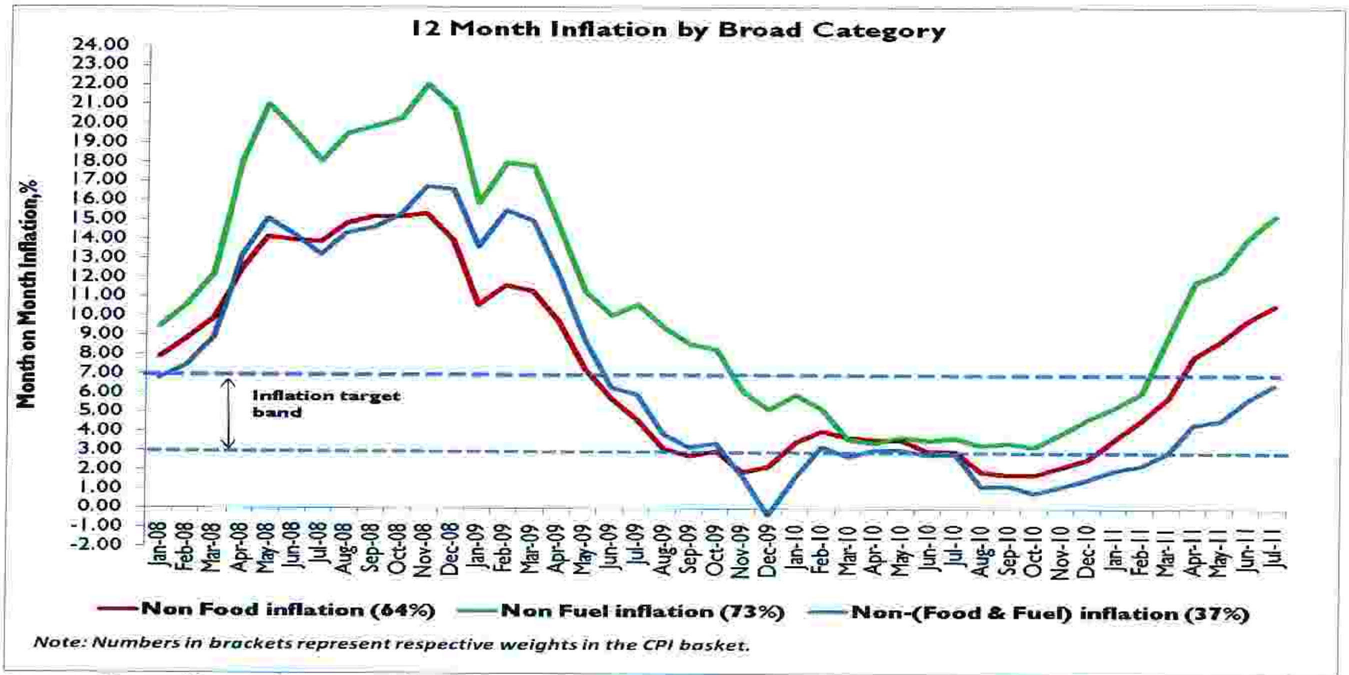
ANNEXE

Chart 1a: Drivers of Inflation: Food and transport costs driving inflation



Source: Kenya National Bureau of Statistics

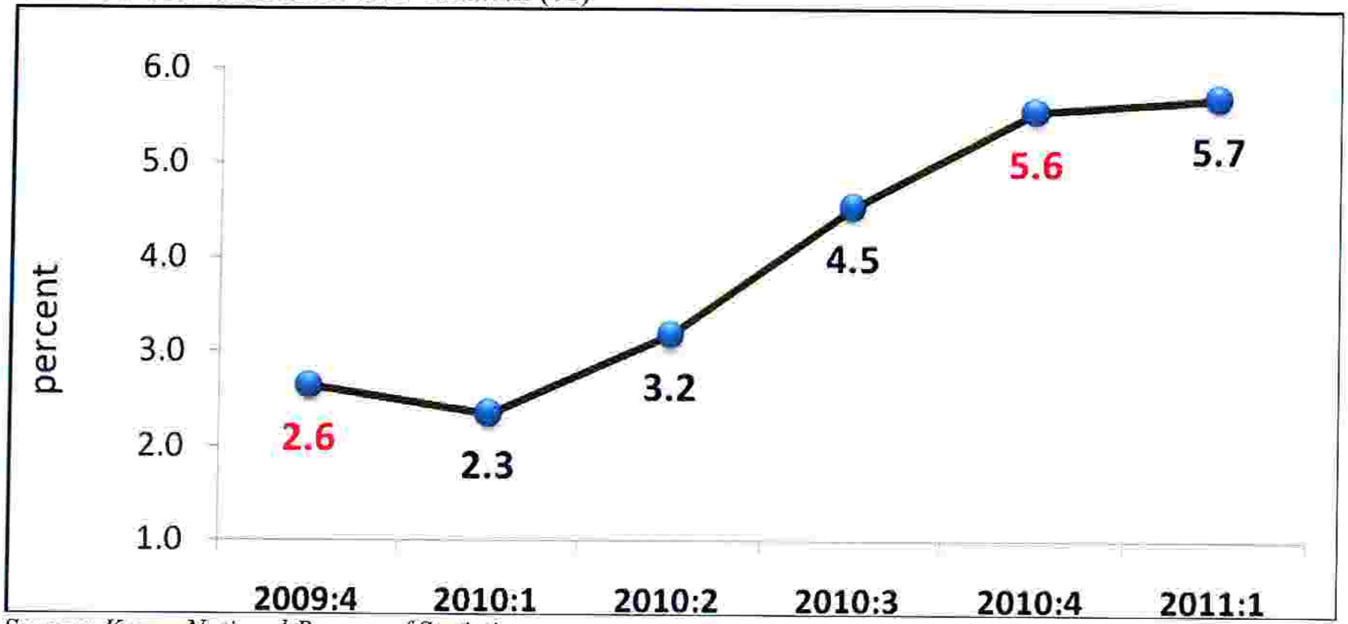
Chart 1b:



Source: Kenya National Bureau of Statistics

- *Food and Fuel inflation that were declining in the first six months of 2010 increased in a similar period in 2011 significantly driving the rise in overall inflation. In addition, there have been less inflationary pressures on the non- food and fuel items – seen below 7%*

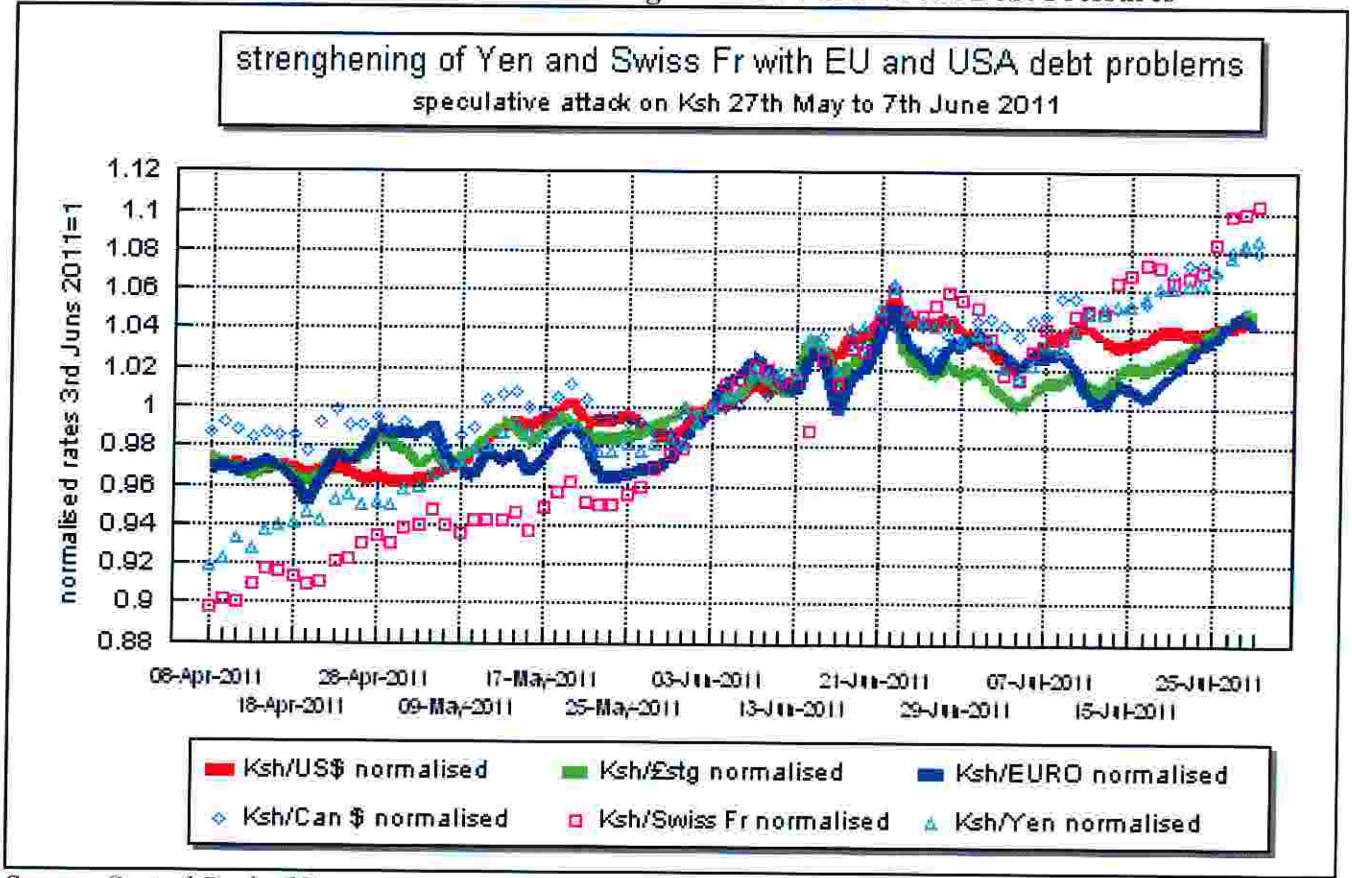
Chart 2: 12-Month Real GDP Growth (%)



Source: Kenya National Bureau of Statistics

- *Upward growth trajectory depicts optimism*
- *This growth surge will fight inflation, attract investment and raise absorption capacity in the economy.*

Chart 3: Other Reserve Currencies have emerged with US and Greek Debt Pressures



Source: Central Bank of Kenya

- *International events continue to shift the relative strengths and weaknesses of Kenya's major trading currencies.*
- *Swiss Franc, Japanese Yen and Canadian Dollar have been main gainers with international currency portfolio shifts.*