# Njuguna Ndung'u: Economic and financial developments in Kenya

Speech by Prof Njuguna Ndung'u, Governor of the Central Bank of Kenya, at the Luncheon with members of the Eastern Africa Association, Nairobi, 21 January 2009.

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The Chairman Eastern Africa Association,
Members,
Distinguished Guests,
Ladies and Gentlemen;

Let me first thank the Chairman of the Association for this opportunity to share my experiences with economic performance, the conduct of monetary policy in 2008, and the perspective for 2009.

The experiences of the Central Bank have been vast but I will deal with economic performance and policy directions in three topical areas:

- The Conduct of Monetary Policy and Monetary policy decisions
- Economic growth outlook
- The Global Financial crisis and Kenya's economic performance

## A. The conduct of monetary policy in 2008

The past year has been a difficult one both from a local and global perspective. For monetary policy at the Central Bank of Kenya (CBK), three challenges emerged;

- liquidity management in the economy;
- inflation upsurge; and
- exchange rate volatility

These challenges tended to take monetary policy management to unfamiliar territory. In order to ensure price stability or fight inflation, the CBK relies on indirect instruments that affect liquidity in the economy and so the stock of money, which in turn affects interest rates and prices in the desired direction. The debate on what are the targets and what instruments to achieve the targets is relevant. Money supply growth was maintained within the target range for most of the months in 2008.

### *(i) Liquidity management in the economy*

The role of a modern central bank is in general price stability, that is to fight inflation. However, for the Central Bank of Kenya, stability of the financial system is equally important, so is the national payments and settlement system. The Bank implemented the first two objectives with varying degrees of success. While inflation was high we also faced downside risks to financial stability from the Safaricom IPO. The size and nature of the IPO led to large shifts in **liquidity**, and the unwinding process would no doubt have had longer term impacts on economic and financial variables if not properly managed. The offer attracted Ksh231 billion.

Liquidity was skewed in favour of a consortium of banks despite the mitigation mechanisms put in place by the banking system. The Bank's approach to this therefore was to mop up excess liquidity from the banking sector using the Term Auction Deposit and repos and inject liquidity to accommodate the liquidity shortfalls for banks outside the consortium, through reverse repos. This intermediation function helped to moderate effects on interest rates, and thereby ensured financial sector stability.

The Term Auction Deposit is a new instrument we introduced in May 2008 to support liquidity management. Foreign exchange spot sales or purchases were also another indirect instrument used.

### *(ii) Inflation upsurge*

The post-election disturbances early in 2008 put enormous pressure on supply networks for food in most parts of the country. Delayed land preparation and transportation constraints, coupled with high cost of fertilizer pushed overall inflation rapidly from 12.0 percent in December 2007 to 31.5 percent in May 2008. Similarly, underlying inflation rose from 5.1 percent in January 2008 to 7.2 percent in May 2008. From the outset, it did seem that inflation was going out of hand.

The January 2008 effect has taken longer than we had expected to dissipate with inflation in December 2008 at 27.7 percent. International crude oil prices which had peaked in July 2008 also sustained high inflation but their transmission downward takes a longer period.

A number of factors are also now coming to the fore; weaknesses in the distribution mechanisms of food in many parts of the country, high world food and oil prices were passing through to domestic food prices. The process to address these issues has started. But from the monetary policy side, we derived some measure of comfort in choosing to manage liquidity in the short term from the fact that inflation was coming from supply constraints in the economy, specifically supply and distribution factors associated with the post-election violence effects which caused food prices to increase. Monetary policy decisions are geared towards controlling the component of inflation that is linked to money supply and preventing rapid money supply growth – which would ratify high prices from the supply constraints.

In addition, there are changes to inflation computation relating to the basket of goods and weights used in major categories of the consumption basket that makes inflation computation closer to international standards.

### *(iii) Exchange rate volatility*

The foreign exchange market was turbulent particularly from the second half of 2008 onwards. The question we asked ourselves is what a small open economy can do in the face of portfolio capital flows. My works in the past have produced conclusions which are important even in the practical work at Central Bank. Stock adjustment, changing risk profile in the country and arbitrage process all work to warn us to do nothing when portfolio flows drive either securities markets or the economy. The shilling appreciated following increased capital inflows for the Safaricom IPO and depreciated as investors took profits and exited the stock market – a management failure in the IPO process. We have detailed this in the press release of the Monetary Policy Committee (MPC) of November 2008. We provide Monetary Policy Committee press releases to share information and even show how to process the information.

## B. Monetary policy decisions

**Inflation** continues to be a challenge but expectations are that it will come down to its target level in 2009 of 5 percent. It seems likely that there will be some disinflation in the upcoming months. The CPI computation has been revised, so is the basket of goods using the 2005/06 household budget survey. The Government is taking adequate steps to address the supply constraints.

There were indications of a liquidity crunch towards the end of 2008 with short term interest rates moving upwards. Money demand rises in the festive season and so we used our liquidity management tools to increase liquidity in order to stabilize the interest rates in the short term and also hope to sustain a low interest rate regime that would support investment and growth revival to the pre-crises period. You are aware the MPC reduced the statutory cash ratio from 6 percent to 5 percent at the beginning of December. To support this, it also lowered the Central Bank Rate from 9 percent to 8.5 percent to enhance liquidity in the banking system and to nurture the economic recovery process. So far Repo and interbank interest rates have declined to 4.8 percent and 5.8 percent respectively. CBK desires to have a low, stable interest rate environment that encourages private investment. This will support faster economic recovery from the 2008 shocks.

The **Kenya Shilling** was volatile and followed global developments; appreciating against the US dollar and the Sterling Pound but depreciating against the Euro and the Japanese Yen. Against the US dollar, the shilling has lately been oscillating around Ksh78 to the dollar. But most spectacular were the effects the dollar had on the Pound and Euro. Between September 2, 2008 and January 12, 2009, the US dollar has appreciated by 7.7 percent and 16.5 percent against the Euro and Pound respectively.

There were also “flight-to-safety” concerns in the wake of the global financial crisis as banks dumped asset backed securities and preferred US Bills and Bonds. The global liquidity is increasingly being measured in US dollars and so scarcity of the dollar when global banks were not lending to each other led to this depreciation and continues to sustain it even today. The road CBK took was a bit bumpy in that it accepted to live with some exchange rate volatility in the hope that they would soon soften once global banks started trading with each other.

The current trend in imports and exports is expected to be sustained in 2009 with the current account deficit expected to widen. This deficit will be financed by capital and financial inflows as has been the case in the last few years. We are taking a cautious view on private capital flows. We will monitor the current account and the deficit to ensure its sustainability. But so far, most imports have been inputs and machinery equipment – so signalling firm growth and expansion in the future.

## C. Economic growth

The economy was buffeted by internal and external shocks in 2008, thus performing below potential throughout the year. During the third quarter of 2008, the Kenya National Bureau of Statistics estimates the economy to have expanded by 2.1 percent compared to 6.3 percent in the corresponding quarter in 2007. The recovery from the post-election violence has been fast although agricultural performance lags behind. The shortfall in tourism receipts from January 2008 has also narrowed down and a catch up is expected during the next prime season.

### *Fiscal side*

The shocks that have taken place in 2008 and continuing food supply constraints have put a strain on the budget and a risk of overshooting the **fiscal targets**. The Government intended to borrow Ksh54 billion from the domestic market in the current fiscal year. This, so far has not changed. The Government delayed issuance of the sovereign bond of about Ksh34 billion, to await stability in international financial markets. But the Government in the coming weeks will float an infrastructural bond for Ksh18.5 billion to finance major infrastructure projects. I am encouraging corporates like yours to commit funds for this important bond.

## D. The global financial crisis

Starting as a global financial crisis it is now an economic crisis. For those countries that are less integrated in global financial markets, there is need to look at some of the risk factors.

- Capital flows: Short term capital inflows which had increased substantially in 2007 flattened out in 2008 above US dollars1.1 billion. Short term capital outflows which have been far less substantial have increased, and we know the dangers and destabilizing effects of these flows.
- Fiscal risks: Expenditures have been below target due to delays in implementing some projects. There may also be some diversion of expenditure to cater for famine relief and other recurrent expenditures. However, with respect to revenue, the Government is on target despite the fact that the benchmark was on the basis of a more optimistic growth path. Current figures from the Kenya Revenue Authority (KRA) on the last quarter show tax revenues overshooting their target.
- Export risks: Global growth is expected to decline from 2.5 percent in 2008 to 1 percent in 2009. Although demand for some of Kenya's exports is expected to remain robust, recent trade statistics indicate a slowdown in export volume growth. International commodity prices are also expected to decline. However, the impact of the global crisis on Kenya's exports may come from reduced aid flows to regional trading partners.
- Remittances: Remittance receipts through formal channels increased from US dollars574 million in 2007 to US dollars630 million in 2008 despite reductions beginning May 2008. The decline could persist with reduction in incomes in source countries. Remittances are predominantly used for smoothing consumption and for investment in real estate. But they are also pro-cyclical and tend to follow events in the economy. So their trend may not reveal much.
- Liquidity risks: While global banks are not lending to each other, local banks are. However, Government access to global financial markets may be constrained by weakening of these markets. The postponement of the sovereign bond is a pointer to this. The latest upgrade by Fitch rating agency for Kenya is improving the country ratings and once global financial markets are stable, Kenya's entry will be significant. But more significant will be the target enabling projects targeted to be financed by this bond issue.
- On the domestic banking sector, the expectation was that due to the global crisis and the political crisis in 2008, the banking system's net non-performing loans (NPLs) would rise. However, net NPLs as a share of total loans have come down from 2.9 in March 2008 to 2.2 in November 2009. This is due to improved provisioning and a decline in net NPLs portfolio.

The CBK is tracking these risks to assess their likely impact on macroeconomic stability. Nevertheless, the economy is expected to weather first round effects of the global crisis. This will be supported by productivity growth from improved business climate and improved policy frameworks. In 2009, we expect a modest recovery and a rebound to the growth trajectory in the medium term in line with the country's long term development strategy.

Our efforts to sustain macroeconomic stability will bear fruit.

Ladies and Gentlemen, let me thank you for your attention, and invitation to this auspicious occasion.

Thank you.