Remarks by

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Residence of the CEO, Stanbic Bank

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Let me begin by thanking you all for coming to this informal dinner. As always on these occasions I am delighted to see you all here. I want to make a few brief remarks about the current state of the economy and the prospects for the near and medium term.

When we open our newspapers in the morning we often read articles about how the economy is performing badly. But much of what is written is either exaggerated or misconstrued.

It is true that real growth in the current fiscal year will be lower than was initially projected, but that does not mean that the economy is in recession – which entails a contraction of output. There is a slowdown in economic growth but this should prove to be only temporary.

As we discussed at the last UBA meeting in April, real economic growth in the current fiscal year has been pulled down by the supply side shock to agriculture, caused by the drought.

The quarterly GDP data from UBOS indicate that real output was about 1.5 percent below its trend – which is a proxy for the equilibrium level of output - in the first half of 2016/17, with most of the shortfall due to lower than trend agricultural output.

We do not yet have the quarterly GDP data for the third quarter of 2016/17, but the BOU's composite indicator of economic activity – which is a high frequency indicator – shows that there was a rebound in economic activity in that quarter, with an acceleration of growth in both the industrial and services sectors.

Given the trends in the third quarter of the fiscal year and the fact that we are now enjoying better weather for agriculture, I expect that in the second half of the fiscal year, the economy should claw back some of the output losses which it suffered in the first half.

However, we are forecasting that real growth for the full fiscal year will be only about 4 percent, which is one percentage point below potential.

Nevertheless, the supply side shock to agriculture should be reversed in the next fiscal year, which will enable real output to revert to its medium term trend. This means that we should experience growth of more than 5 percent in 2017/18.

I also want to refute the claim that the economy is suffering from a lack of demand. Of course,

some individual industries may not have sufficient demand to sell all of their output – that will always be the case in any economy - but at the aggregate level there is little evidence to indicate that a lack of demand has depressed real economic growth. If that were the case, we would expect to see that the sectors most badly affected would be the non-traded goods sectors of the economy, because these sectors are dependent fully on domestic demand.

In fact the very opposite is the case. The services sector, which consists predominantly of non-traded goods industries, did much better than both industry and agriculture in the first half of the fiscal year, while our composite indicator of economic activity indicates that services also grew faster than the other sectors in the third quarter. That suggests that a shortage of aggregate demand is not the cause of the slowdown in growth in 2016/17.

A sustained deficiency of aggregate demand would also lead to disinflation (i.e. falling inflation). But there is no evidence of this occurring. Core inflation has been quite stable, at around 5 percent, for the last 9 months, which suggests that the level of aggregate demand is about right, given the economy's capacity to supply goods and services, which as I noted earlier, has been temporarily depressed by the supply side shock to agriculture.

On the subject of inflation, our forecasts indicate that core inflation should be in line with our 5 percent policy target in 12 months' time, which is the time horizon for our monetary policy decisions. Our 12 month forecast for inflation has remained largely unchanged since the end of last year. However, some of the upside risks to core inflation, which we had identified six months ago, notably the rising food and fuel prices, and the risk of further exchange rate depreciation, have abated somewhat.

Food crop prices have risen steeply – annual food crop inflation was nearly 22 percent in April – but the pass-through to core inflation has been muted. The exchange rate has also been relatively stable in the first half of 2017. The nominal effective exchange rate, which takes into account exchange rate movements of the Shilling against all our trading partners, has only depreciated by 1.6 percent since the end of 2016.

We also expect that the current food price shock should have started to ease by the third quarter of this calendar year, as the better weather that we are now experiencing boosts harvests, and that will help to lower headline inflation.

At the last informal UBA dinner I said that, provided that the outlook for inflation did not deteriorate, the BOU hoped to further lower the policy interest rate gradually during the course of 2017.

Accordingly we reduced the Central Bank Rate by 50 basis points at our Monetary Policy Committee meeting last month. Given the relatively benign outlook for core inflation, I believe that we should have scope to implement further modest reductions in the CBR in the near term, although again I want to stress the caveat that any further reductions are contingent on there being no worsening of the core inflation forecast.

Finally, I would like to re-emphasise my desire to see the reductions that we are effecting to the policy interest rate being passed through to bank borrowers.

The data on Shilling lending rates for March indicate that the average lending rate was still 22.5 percent, which means that the average lending rate had fallen by less than 3 percentage points from its most recent peak in February of last year.

I hope that we will be able to achieve more substantial reductions in bank lending rates in the next few months.

Thank you for listening.