**CBK on the spot as shilling falls to lowest level in two decades**

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WILL IT HIT SH90? Governor Njuguna Ndung’u says this is a temporary storm, but key influential watchers say he is underrating the risk of importing inflation as the economy is poised for a much awaited take off. Photo/FILE

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Posted Monday, March 14 2011 at 00:00

Never before has the Kenya shilling faced so much pressure.

As we went to press, the currency — the most liquid in sub-saharan Africa after the South African Rand — had extended its decline to the weakest level in nearly two decades.

Traders attributed the phenomenon to unprecedented demand for dollars from oil companies and unexpected strong demand from offshore banks.

Throughout the week, oil marketers and traders were piling up stocks,  responding to consistent and sharp rises in  international crude prices.

With the political instability in Libya — the World’s 12th largest exporter — showing no signs of ending soon, and market sentiment predicting further depreciation of the shilling — indications were that the pressure on the local currency  would continue  to mount.

**Dollar earnings fall**

Three other factors added to the pressure on the shilling. Dollar earnings from tea exports had plummeted, Kenya’s current account continued to be under pressure — the country’s international reserves having slipped just below the conventional four- month- import- cover threshold — and the inflation rate was rising.

On its part, the Central Bank of Kenya had decided to put a brave face, insisting that the depreciation of the shilling was but a temporary phenomenon and arguing that since Kenya practised a flexible exchange rate policy, the shilling was merely responding to supply and demand conditions.

Central Bank Governor Njuguna Ndungu said that since the economic fundamentals were still strong, the currency was bound to stabilise when normalcy returns to North Africa.

“You cannot use demands-side instruments like interest rates to contain or resolve supply side shocks”, he told *The EastAfrican*, in response to calls for higher interest rates.

He added: “Once the political crises in North Africa and the Middle East are resolved, the shilling will rediscover its path, consistent with the fundamentals”

Prof Ndungu said it did not make sense to change the monetary policy stance, which has delivered on low inflation and low interest rates, just because of short term movements in the value of the Kenya shilling.

Still, opinion remained divided over the appropriate response to the weakening shilling, with some members of the Monetary Policy Committee hinting that the circumstances may force slight and downward adjustments on the interest rate, if only to deflect some of the pressures the shilling is absorbing.

Clearly, the uncertainties in the market were compounded by the absence of a clear stance on the government’s macro-economic priorities: Whether seeking growth was a higher priority than was keeping inflation low.

“We have to choose between allowing the exchange rate to continue depreciating or an increase in interest rates. Something will have to give,” said an MPC member, speaking on condition of anonymity.

Clearly, the Central Bank had found itself in a dilemma: if it moved by influencing interest rates downwards in order to deflate the pressure on the shilling, it risked  undermining  the flow of credit to the private sector, thus jeopardising the fragile growth the economy was beginning to enjoy.

Prof Ndungu said high interest rates would hurt the economy, pointing out that such rates would only serve to increase inflationary expectations in the economy.

Political considerations were also a factor. With the outgoing administration of President Mwai Kibaki having put so much premium on leaving behind a legacy of low interest rates, and delivering an irreversible path of consistent growth — a decision by the  MPC to influence interest rates upwards would have major political ramifications.

Still, it was clear that the Central Bank had taken a risky gamble — assuming that the current pressures on the shilling are a temporary phenomenon.

This at a time when trends in international forward contracts for crude oil showed that crude prices were not about to stabilise in the next few months and that high oil prices might be with us for  a much extended period.

Indeed, going by the trends quoted on forward crude oil contracts, chances that international crude oil prices will return to the pre-crisis levels of $60 per barrel within, for instance, six months, look more and more remote.

“Isn’t it just prudent to assume that the high oil prices will last more than six months. Where is the evidence that this situation is temporary?” asked a Treasury-based economist.  
Just how temporary is the oil shock and when can we expect international prices to start stabilising?

What if the drought conditions drag for a longer period than the monetary authorities are anticipating?

Whichever way one looks at it, the MPC has been confronted with the most challenging circumstances since it was established more than four years ago

Indeed, a consistently weakening shilling will continue to alter the economic fundamentals in major ways

With oil imports constituting a third of Kenya’s current account, the high international crude prices have shifted the country’s terms of trade significantly, putting more pressures on a balance of payments position that was under pressure even before crude prices started rising.

In the past three years, foreign reserves coverage have remained flat, despite support last year by the International Monetary Fund, improved tourism receipts and remittances from the diaspora

Indeed, the country has only recently signed a new $500 million deal with the IMF under a programme premised on boosting the country’s international reserves buffer to four months of imports.

According to statistics from the Central Bank, the country’s reserves are still marginally below the four-month import cover threshold.

As at March 3, reserves totalled $3.64 billion, equivalent to 3.61 months of imports.

Even with $500 million from the IMF, it is clear that the country’s balance of payments position will remain under pressure if the oil import bill continues to mount.

Another key fundamental that has changed is the inflation rate.

The impact of high crude prices and the weakening shilling on inflation are already being felt, with the rate of inflation moving from a level of 3.18 per cent in October last year to 6.5 per cent last month.

With food and transportation accounting for 63 per cent of the consumer price index, the impact of  high oil prices will take a major toll on living standards.

“More than ever before, the MPC needs to strongly signal that it is fighting inflation. Inflationary expectations must not be allowed to get entrenched,” said a Central Bank official.

He added: “Monetary policy is about managing expectations,” adding that if the government persists in treating the current happenings as a temporary phenomenon and in dismissing the weakening shilling as the expected behaviour of “automatic stabiliser”, inflationary expectations will get entrenched.