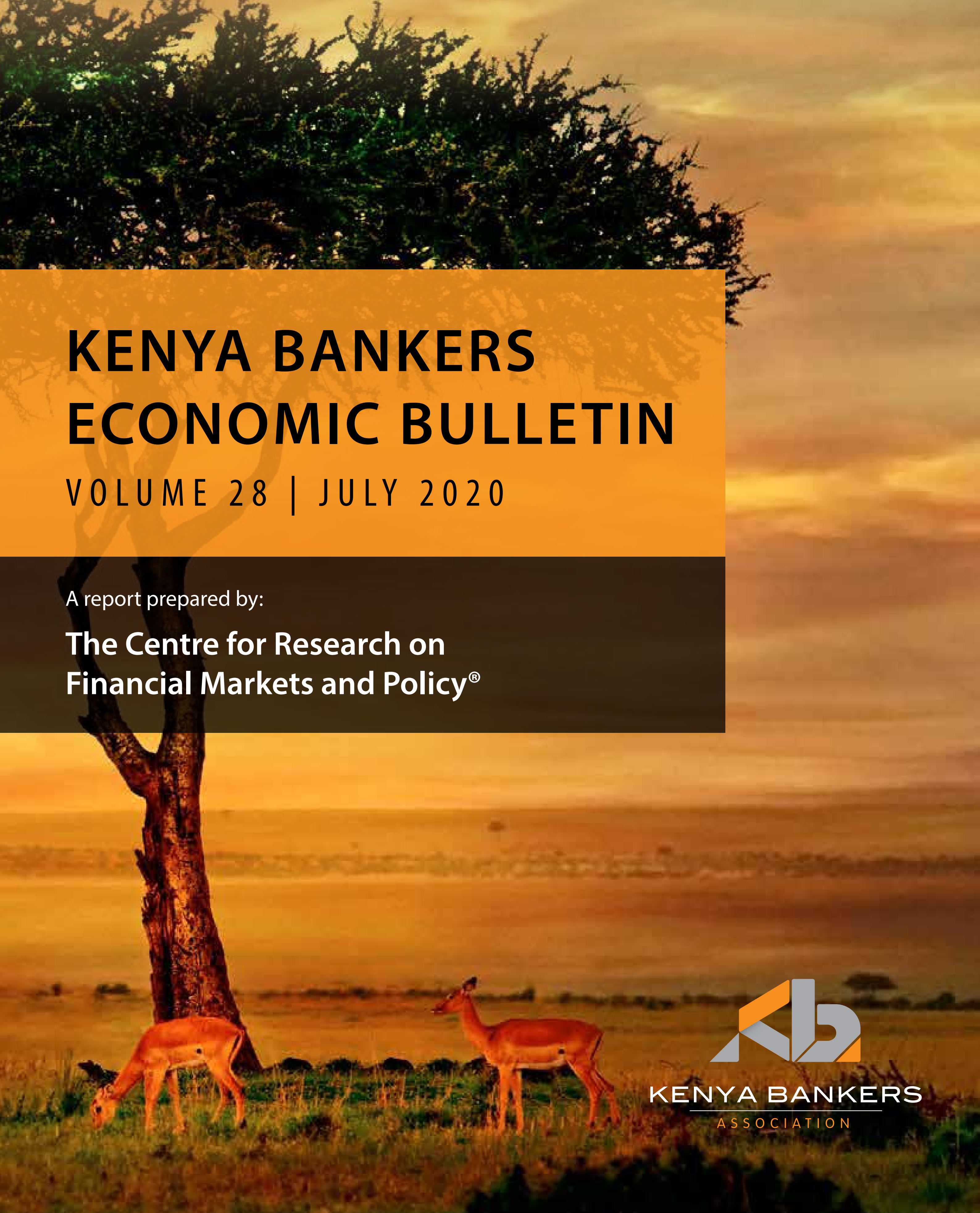

KENYA BANKERS ECONOMIC BULLETIN

VOLUME 28 | JULY 2020

A report prepared by:

The Centre for Research on Financial Markets and Policy®

KENYA BANKERS ASSOCIATION

CENTRE FOR RESEARCH ON
FINANCIAL MARKETS AND POLICY®

About this Report

This *Bulletin* reviews the performance of the Kenyan economy, drawing on the performance of recent past months as well as current developments to provide perspectives on the outlook for the year. The *Bulletin* covers trends in the real economy, government fiscal operations, public debt, inflation and interest rates, balance of payments and exchange rate, as well as activity at the Nairobi Securities Exchange and banking sector performance.

About the Centre for Research on Financial Markets and Policy®

The Centre for Research on Financial Markets and Policy® was established by the Kenya Bankers Association in 2012 to offer an array of research, commentary, and dialogue regarding critical policy matters that impact on financial markets in Kenya. The Centre sponsors original research, provides thoughtful commentary, and hosts dialogues and conferences involving scholars and practitioners on key financial market issues. Through these activities, the Centre acts as a platform for intellectual engagement and dialogue between financial market experts, the banking sector and the policy makers in Kenya. It therefore contributes to an informed discussion that influences critical financial market debates and policies.

CENTRE FOR RESEARCH ON
FINANCIAL MARKETS AND POLICY®

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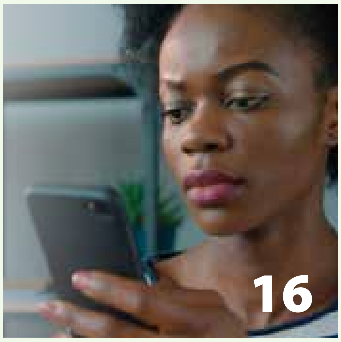


FOREWORD

From the CEO's Desk

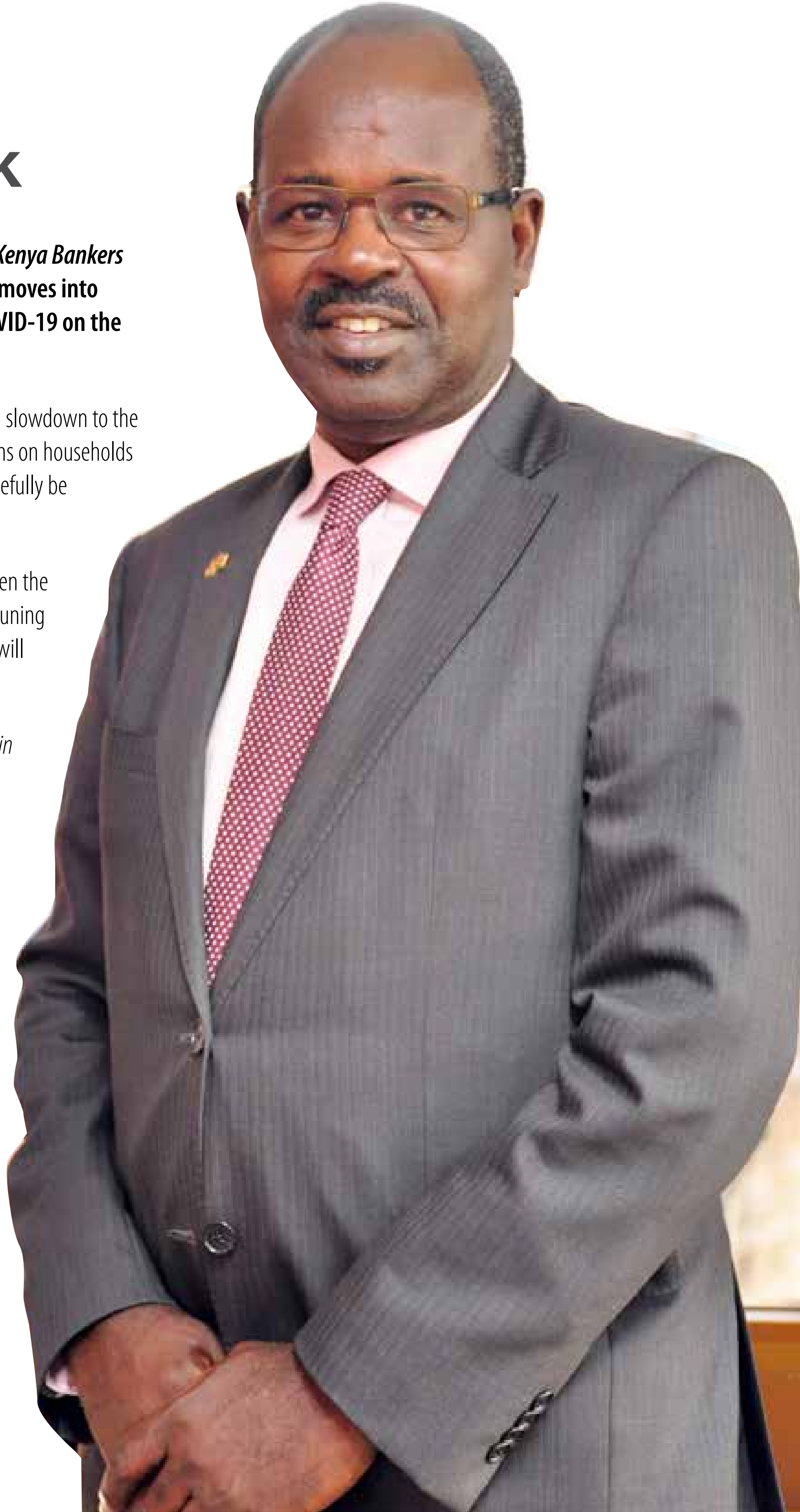
It is my singular pleasure to present to you the 28th issue of the *Kenya Bankers Economic Bulletin*. This is the second issue for 2020. As the year moves into its second half, the effects of the shocks associated with the COVID-19 on the economy are all too obvious.

Increasingly, we are slowly adjusting our expectations from the possibility of a slowdown to the reality that even a shrinkage may be in the offing. That has adverse implications on households and businesses. The Bulletin seeks to offer facts and perspectives that will hopefully be invaluable to readers as we all navigate these unprecedented times.

The narrative that the bulletin offers is a presentation of the interaction between the policy positions and the responses from individuals and businesses. The fine-tuning on both segments of the divide will inform the extent to which the economy will have a chance to turn the corner in the near to medium term.

It is my hope that you will find this issue of the *Kenya Bankers Economic Bulletin* useful. We welcome feedback on the content of this Bulletin as we continually seek to improve its relevance to you. You can send your feedback to Bulletin's Editor at ***research@kba.co.ke.***

Dr. Habil Olaka
Chief Executive Officer,
Kenya Bankers Association



COMMENTARY

Not out of the Woods Yet

By Jared Osoro*

The International Monetary Fund's June 2020 update of its Sub-Saharan Africa Regional Economic Outlook is stuff that is scary to read. In April 2020, the IMF projected that Sub-Saharan Africa's economy will contract by 1.6 percent during the year. By June 2020 the extent of contraction had been revised to 3.2 percent.

It is obvious from this and other forecasts that the contraction is linked to the necessary strict confinement measures that Governments across the continent – like elsewhere in the world – implemented to contain the COVID-19 outbreak. With people mainly staying at home and reducing movements with services and recreational facilities, both the formal and informal economy is hurting.

Under the current circumstances, it will take utmost optimism to project positive growth in any economy even when such outlook is barely above zero. Not only are the domestic conditions weak, but so are external conditions that are characteristically less favourable. Just like the Sub-Saharan Africa story, global growth has been deteriorating.

On the back of (a) global travel collapsing (b) tourism flows grinding to a halt (c) remittances dwindling (d) commodity prices stuck at low levels (d) tight external financing conditions even when the tone of macroeconomic policy among major economies is one of easing, the global output growth is on the

> **"Not only are the domestic conditions weak, but so are external conditions that are characteristically less favourable. Just like the Sub-Saharan Africa story, global growth has been deteriorating.**

1 IMF (2020), Regional Economic Outlook June 2020 Update https://www.imf.org/~/media/Files/Publications/REO/AFR/2020/Update/June/English/SREOENG202006.ashx?la=en

decline. Global growth for 2020 has since April 2020 been revised down by 1.9 percentage points to negative 4.9 percent.

Admittedly, a weak domestic economy manifests itself in challenged domestic balances. A weak external economy manifests itself in a weak external balance. When they occur simultaneously – a situation that doesn't necessarily make them twins – that is enough reason to trade hubris for caution.

Any economy that is projecting positive growth makes the cardinal assumption of operating as Robinson Crusoe – restricted interaction with other economies (if at all), and producing as much as is needed for own consumption. That is obviously a limiting assumption.

For one, an economy needs to trade with others in its neighbourhood of afar; but we observe weaknesses all over. Further, beyond trade has been the disruption of financial flows; a quick reversal of the portfolio flows had the obvious intertemporal effect on the balance of payment position of many economies.

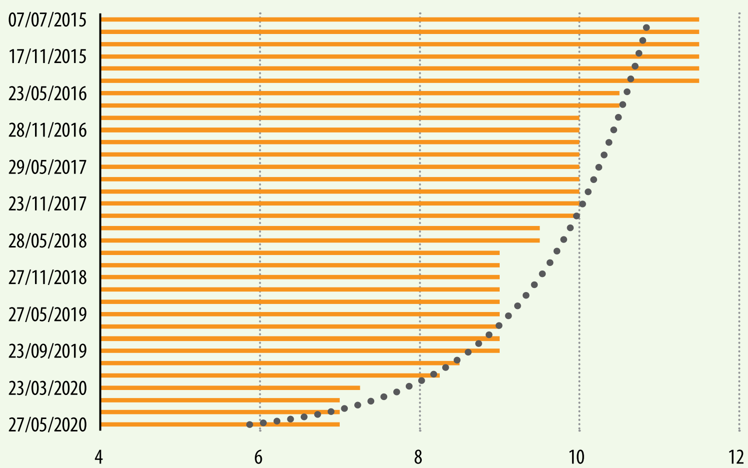
Now that it's stormy all around…

It is against the above background that the big economies in Africa find themselves in stormy waters. Nigeria and Angola are mostly oil-dependent. With plummeting oil prices, these two economies are paying the price of limited diversification. With strict restrictions, South Africa is headed for an 8 percent shrinkage.

This begs the question: will the Kenyan economy, one of the economies in the 'big' category remain in the positive territory? The official position is in the affirmative. Macroeconomic policy has been deployed toward that end. Whether or not it will succeed requires close examination.

Monetary policy has been accommodative (**Figure 1**), and justifiably so. Arguably, this stance ought to be seen as complementary to other government policy measures. The fiscal policy on its part – as signalled by the June 11, 2020,

Figure 1:
Central Bank Rate (%)



Source: CBK

Budget Statement – has remained expansionary in posture.

Even amidst constrained fiscal space occasioned by dwindling revenue prospects, the financial resource requirement to support the economy. With fiscal consolidation obviously, and rightly, taking a back seat as the fiscal deficit widens (**Figure 2**), it is critical to reflect on how – or whether - the two major macro policies are in rock-step.

The macroeconomic policies are obviously being deployed with a sense of urgency. Expectations are that they will provide the necessary stabilisation as a platform for future recovery. What is not clear though is whether more of the same ingredients of the policy will see the economy show signs of turning the corner. At the centre of that unclarity are at least three questions:

Will the further easing of financial conditions as reflected in the monetary policy stance necessarily translate to increased demand and therefore spurred economic activity? Considering the prevailing macroeconomic conditions, can the evidence of compete transmission of the previous monetary policy decisions discernible?

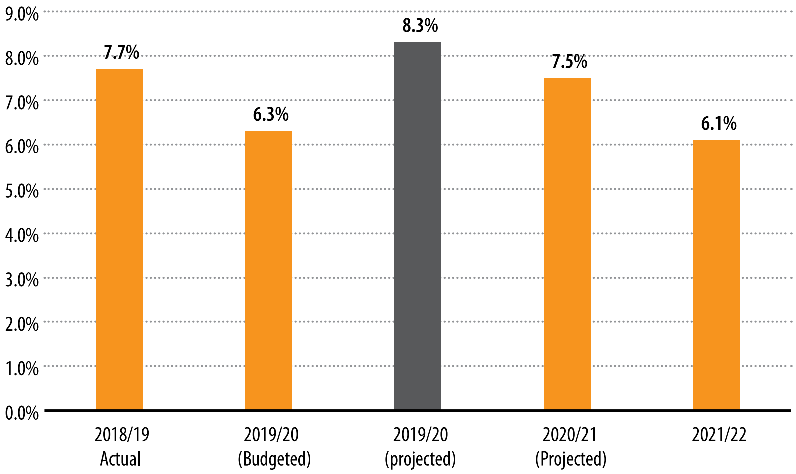
With the pandemic still evolving – and with limited clarity on how it will pan out – any answer to these questions will be tentative. It is nonetheless worth to proffers two sets of arguments.

- One, if the efficacy of monetary policy is seen in the context of attaining macroeconomic stability as could be inferred from inflation being within the target range, it is tempting to argue that monetary policy is meeting the primary objective. That implies that the risks to stability by a further accommodative stance are low. While such an argument has its merits, it needs the qualification that demand remains weak; thus, the accommodative stance has not necessarily triggered more credit uptake.

- Two, if credit demand remains weak on account of businesses operating at excess capacity and households are lacking effective demand, then resource allocation will likely follow the monetary policy – fiscal policy interplay. Banks will see opportunity in lending to the government in view of the wider fiscal deficit; this may push the economy into a vicious cycle that the crowding-out effect at the centre of such resource allocation may trigger.

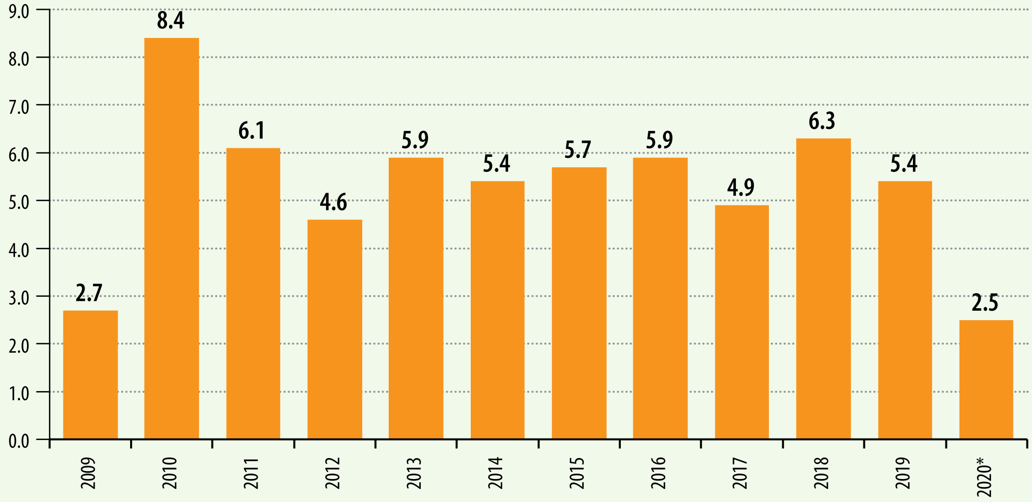
If these arguments are merited, it's critical to see how they play

Figure 2:
Fiscal Deficit (% of GDP)



Source: National Treasury

Figure 3:
Real Output Growth (%)



into the forward expectations of output performance. Kenya's output growth prior to the COVID 19 pandemic has been characterised as strong, even when it had started showing sights of a slowdown in 2019 compared to 2018 (**Figure 3**). It is now evident that the earlier projections of a GDP growth of 5.8 percent for 2020 are not attainable; indeed, even the 2.5 percent forecast may well be very optimistic in the circumstances. That points to the possibility of the economic slack widening over time is real.

The negative output gap is a pointer to the possibility of sustaining an accommodative monetary policy at limited risk of upsetting macroeconomic stability. While such an argument has its merits, it needs the qualification that demand remains weak; thus, the accommodative stance has not necessarily triggered more credit uptake.

As noted, credit demand is weak on account of businesses operating at excess capacity and households are lacking effective demand. We face the possibility of resource allocation likely following the monetary policy – fiscal policy interplay. Banks will see opportunity in lending to the government in view of the wider fiscal deficit; this may push the economy into a vicious cycle that the crowding-out effect at the centre of such resource allocation may trigger.

… but macroeconomic stability is evident

As a proven indirect growth strategy, macroeconomic stability will have to remain the focus. So far, there is an element of success in this front. The economy's inflation dynamics reflect an interesting interplay between demand and supply conditions of the economy. As this Bulletin reports, overall inflation – while remaining on the upper bound – is within the target range. Core inflation remains sticky and below the lower range.

On the one hand, the inflation picture reflects muted supply-side pressures. On the other hand, though, it suggests that no demand-side pressures exist as aggregate demand is depressed. The observed inflation trend is supported by two factors. One, the stability of the exchange rate albeit characterised by depreciating trend in the recent months; and two lower oil prices buttress the stable inflation outlook.

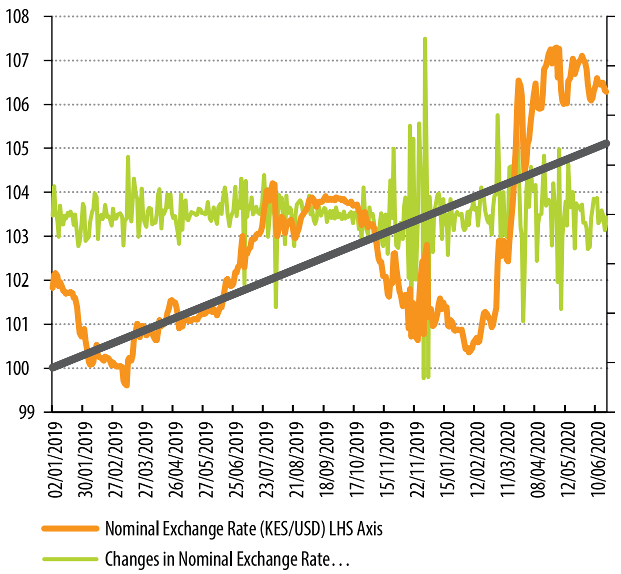
> **On the foreign exchange market, the shilling has exhibited broad stability, albeit with a general depreciating trend**

Amid the uncertainty associated with the outbreak of the COVID-19 pandemic, enterprises and household's decision-making inertia has been amplified and demand is muted, a clear suggestion that the economy may have simply run short of "marginal" consumers who can be encouraged to spend. In addition, financial distress among enterprises and households will cause the share of banks' non-performing loans (NPLs) to rise, weighing on bank capital and potentially clogging the bank lending channel of monetary policy.

On the foreign exchange market, the shilling has exhibited broad stability, albeit with a general depreciating trend (**Figure 4**). This on account of the economy's external position remaining weak on the back of a feeble global economy. The compensatory effect of reduced oil import bill as a result of lower prices provides a cushion.

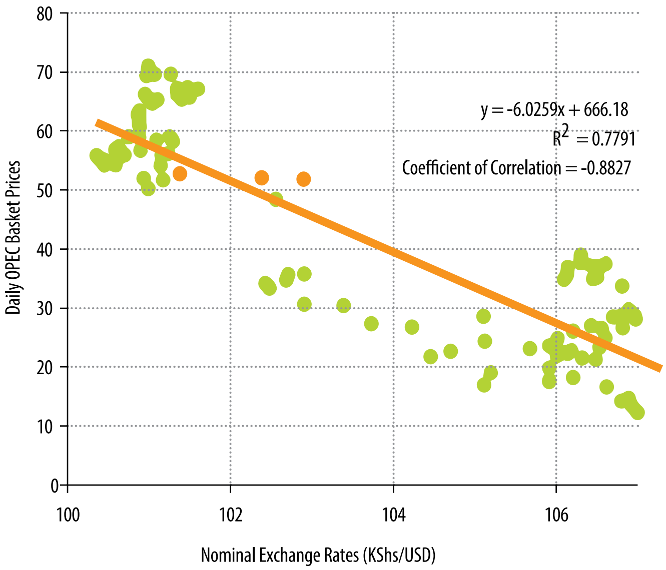
The slowdown of remittances, which have increasingly been accounting for a significant share of the economy's foreign exchange reserves, has had a contributory effect on the weak external position. Further, the strong association between

Figure 4:
Nominal Exchange Rate (KES/USD)



Source: CBK

Figure 5:
Correlation between Exchange rate and Oil Prices



Source: Computed based on CBK & OPEC Data

> **But since the economy is a net commodity exporter and commodity prices tend to depict strong co-movement, the current account deficit is projected to widen to about 5.8 percent by the end of 2020.**

international oil prices and the changes in the local currency's nominal exchange rate (**Figure 5**) plays an integral role in influencing the economy's current account deficit.

The attribute of international oil prices filtering into the local foreign exchange market points to the fact that the lower oil prices are likely to be associated with currency stability and hence maintenance of the current account deficit albeit temporarily as oil prices edge up.

But since the economy is a net commodity exporter and commodity prices tend to depict strong co-movement, the current account deficit is projected to widen to about 5.8 percent by the end of 2020.

All said

Ultimately, it is easy to see that there are so many moving parts whose direction has been influenced by the uncertainties associated with the COVID-19 pandemic. While positivity is a virtue, a sense of realism in what to expect on the economic front amidst the uncertainties is critical. That is why any temptation for hubris must give way for caution.

***Jared Osoro is the Director of the KBA Centre for Research on Financial Markets and Policy®**

State of the Economy

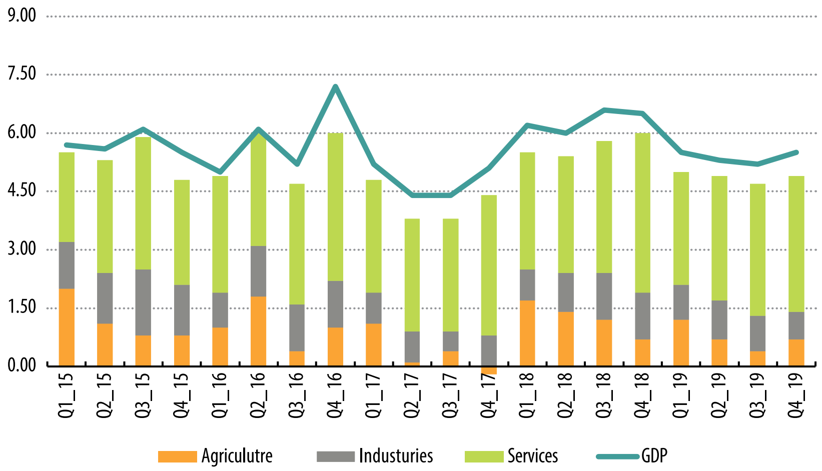
Recent macroeconomic developments and prospects

In 2019, real GDP in Kenya grew by an estimated 5.5 percent, slightly less than the 5.9 percent in 2018 (Figure 1), partly reflecting a softening of household spending, constrained private sector credit growth, and slowing export growth. And with the Economy entering 2020 with more considerable economic slack, the output gap is expected to widen significantly as real output growth is projected to be much lower than anticipated at the end of 2019.

Economic growth is projected to contract to about 2.3 percent from a baseline estimate of 6.2 percent in 2020 according to estimates of the Central Bank of Kenya (CBK), partly due to adverse direct and indirect impact of COVID-19 on the domestic Economy. On the supply side, economic growth is primarily driven by growth in the services sector, mainly wholesale and retail trade, transport and storage, information and communication, and accommodation and restaurants. On the demand side, consumption continues to underpin the observed growth trajectory.

Kenya's economic outlook has been subdued and on a downward growth trajectory (**Figure 5**). And while the domestic circumstances have played a part in the subdued outlook, the COVID-19 pandemic represents a significant downside risk for 2020. It has occasioned significant downward revisions of growth projections with the Economy expected to grow by 3.4 percent from a projected 6.2 percent growth[1]. These projections, while being modest, in the worst-case scenario, one may draw parallels to the 2007 shock that led to a slump in economic growth. However, the circumstances are different, and the outturn uncertain.

Figure 5:
The Economy Continues to Grow albeit Moderately



Source: Kenya National Bureau of Statistics (KNBS)

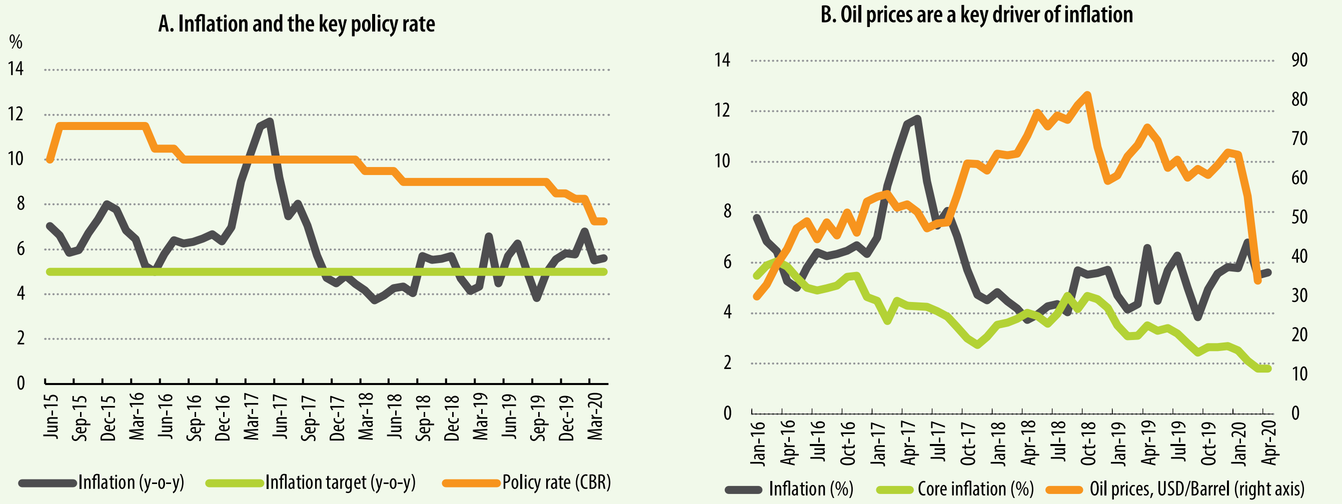
1 https://www.centralbank.go.ke/uploads/mpc_press_release/765216187_MPC%20Press%20Release%20-%20Meeting%20of%20March%2023,%202020.pdf

With the Central Bank of Kenya's mandate being to maintain price stability, in the recent past inflation has remained within the target range of 5±2.5 percent albeit with an upper bound bias. And with the stable inflation, the monetary policy stance over the past four years (2016-2020) has been appropriately accommodative as reflected in the movements of the central bank rate (CBR), the CBK's policy rate. For instance, in May 2016, it cut its policy rate by 100 basis points and since the beginning of 2020 to June its lowered it by 125 basis points from 8.25 percent in January to 7 percent in May 2020 in response to the COVID-19 pandemic (**Figure 6**, **Panel A**).

Overall inflation rate edged upwards by 0.10 percentage points to 5.60 percent in April from 5.50 percent in March, due increase in prices of food and non-alcoholic goods, electricity and cooking gas, and transport prices outweighing the decrease in the cost of Kerosene. Also, oil prices continue to be a key driver of inflation (**Figure 6**, **Panel B**), with the lower international oil prices supporting the stability of inflation rate. Even so, widening output gap as pointed out earlier, and the depreciation of the shilling against the dollar exerts upward pressures on inflation, but with a limited pass-through due to reduced imports but also the low international oil prices. Overall, with the inflation within the target, monetary policy has room for further easing as it seeks to support further an economy battered by both demand and supply-side shocks.

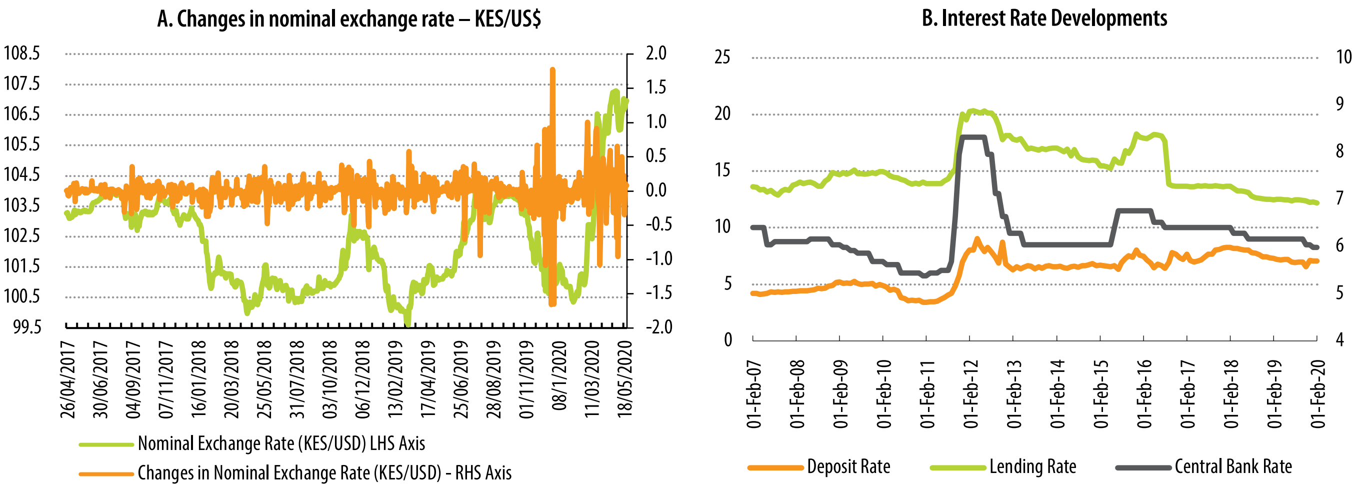
" Economic growth is projected to contract to about 2.3 percent from a baseline estimate of 6.2 percent in 2020 according to estimates of the Central Bank of Kenya (CBK).

Figure 6:
Monetary Policy is Contributing to Macroeconomic Stability



Source: Central Bank of Kenya (CBK)

Figure 7:
Monetary policy, Exchange Rate, and Interest Rate Dynamics

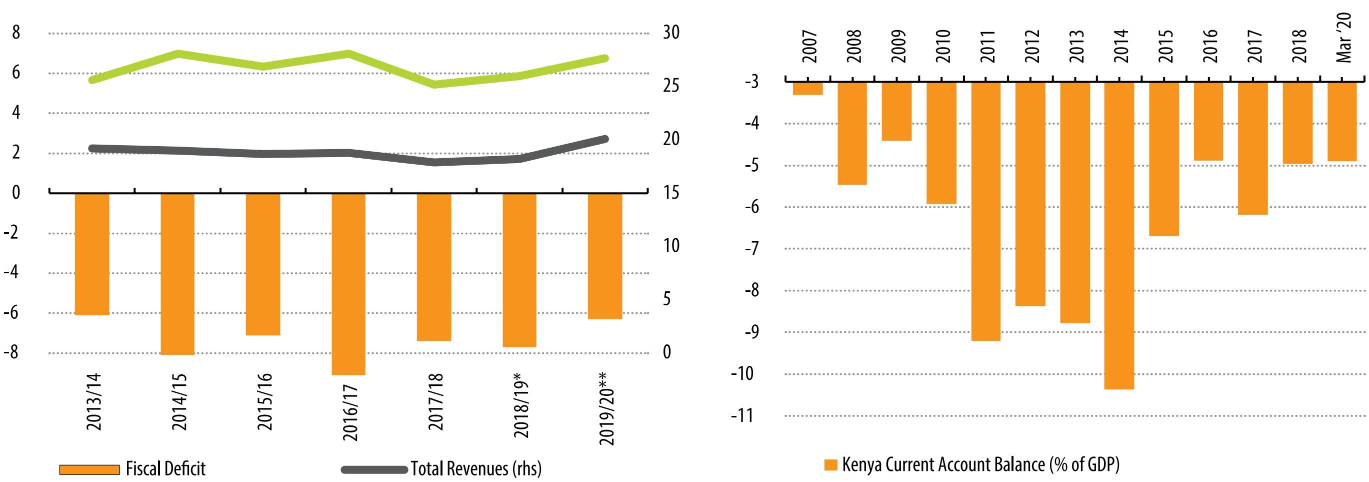


Source: Central Bank of Kenya (CBK)

Further, interest rates have tended to adjust only partially, and with a lag to the policy rate decline in the policy (**Figure 7, Panel A**). Even so, interest rate spreads overtime has been narrowing, reflecting the substantial developments and transformations within the financial system in spite of deteriorating asset quality and hence higher provisioning pushing up lending rates.

The currency has fluctuated (**Figure 7, Panel B**). In the first quarter of 2020, albeit the stability of the shilling, in recent months it has been volatile, depreciating against the US dollar, partly due to the due to uncertainties about the impact of COVID-19 which resulted in massive capital outflows from emerging markets economies as concerns around the safety of asset portfolio emerged. Even then, the central bank's foreign exchange reserves remain sufficiently adequate - as of June 2020 stood at USD 8,341.5 million (5.02 months of import cover) – even as diaspora remittances dry-up. The foreign exchange reserves at 5-months of import cover continue to provide adequate cover and a buffer against short-term shocks in the foreign exchange market.

Figure 8:
Fiscal and Current Account Balances

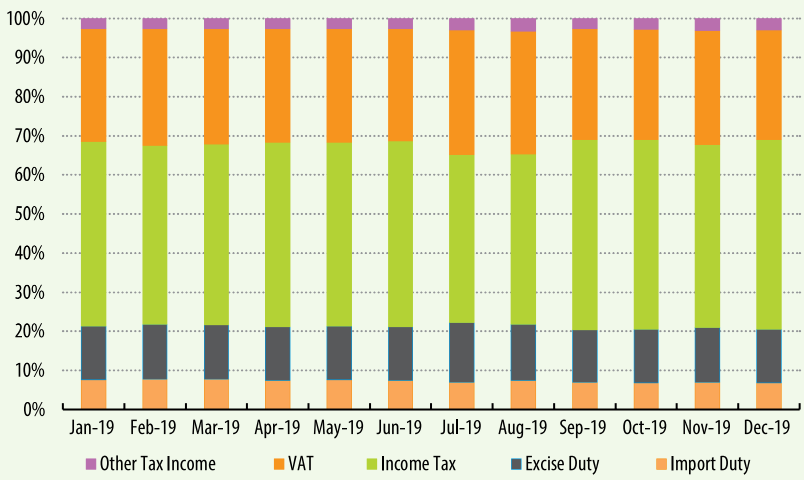


Source: Kenya National Bureau of Statistics

As **Figure 8** shows, Kenya's fiscal space is limited and constrained by low revenues and elevated spending. During the 2019/2020 fiscal year, the fiscal deficit is projected to be approximately 6.3 percent of GDP. With the much slower growth in revenues, the government has matched the deficit in expenditure needs with additional borrowing, which has eventually seen the public debt levels significantly rise. On the other side, the current account has consistently been negative with episodes of narrowing and widening being evident partly due to the disproportionate increase in imports over exports. In 2018 and 2019, the current account deficit stood at 5.8 percent of GDP and is projected to remain at the same level in 2020 with lower oil imports more than offsetting the projected reduction in remittances due to the impact of COVID-19

Over 85 percent of revenues are raised from taxes, with around half of the tax revenues raised from income (PAYE) taxes, 30 percent from value-added taxes (VAT), around 10 percent excise duty,7 percent import duty and other taxes accounting for 3 percent of the total tax revenues (**Figure 9**). In terms of expenditure, recurrent expenditure accounts for 80 percent while development expenditure accounts for 20 percent. Approximately 30 percent of the recurrent expenditures are on wages and salaries, with domestic and foreign interest payments jointly accounting for 30 percent of the total recurrent expenditure.

Figure 9:
Income Taxes are the Primary Source of Tax Revenues



Source: Central Bank of Kenya; Kenya National Bureau of Statistics

External positions are also likely to weaken as external demand moderates and will significantly affect the balance of payments position but more pronounced on the current account balance and importantly on the trade balance. Kenya's trade performance has been weakening with the ratio of exports to imports declining and stood at around 40 percent during the first quarter of 2020.

Exports, a key contributor to foreign exchange earnings and GDP, as **Figure 10** shows have grown sluggishly, is volatile and highly concentrated on a few export markets. Uganda remained Kenya's most significant export trading partner importing 15 percent of Kenya's goods followed by the United Kingdom and Pakistan, which accounted for 14 percent, respectively—cumulatively the three countries account for 43 percent of Kenya's total exports, a clear indication of the concentrated nature of her export destinations.

More importantly, intra-EAC trade is substantial with exports to the region, accounting for approximately 30 percent of exports. Imports, on the other hand, has been trending upwards on account of substantial infrastructural and related imports with imports 30 percent of the imports being from China, 22 percent from India, 10 percent from United Arab Emirates

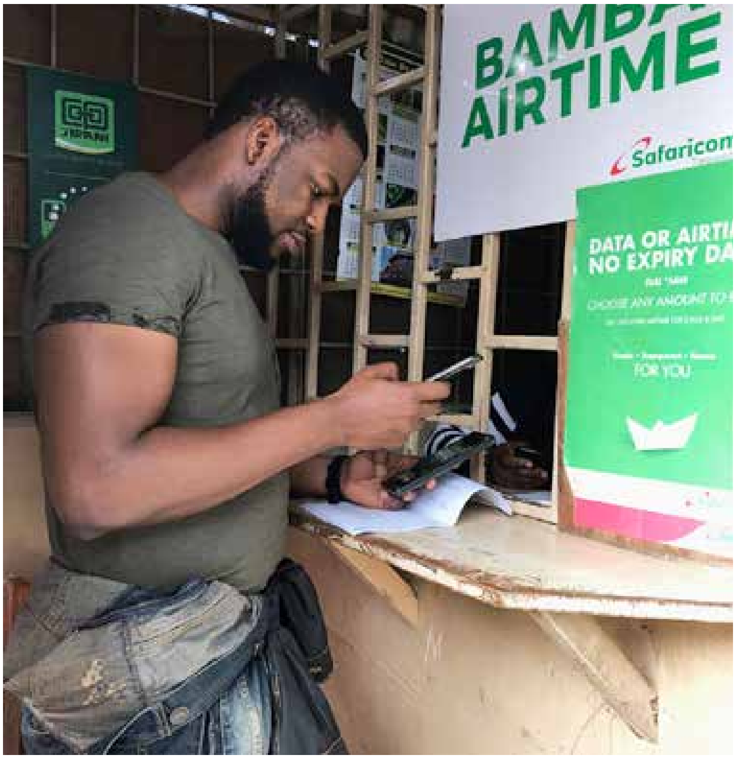
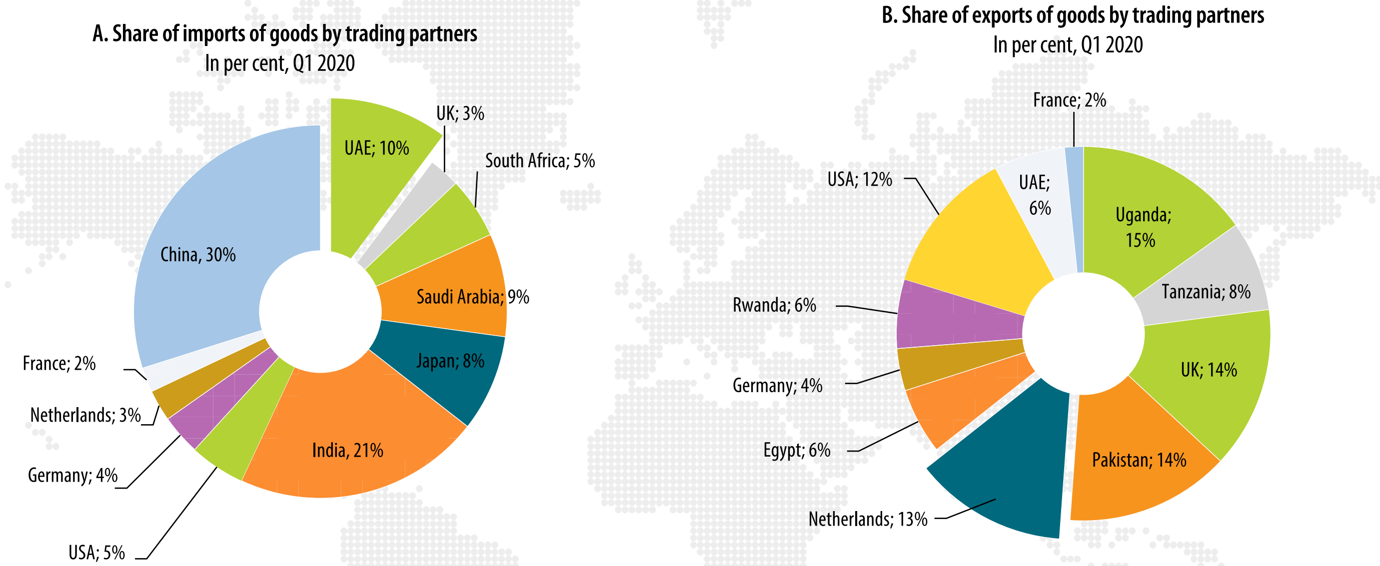


Figure 10:
Trade Developments



Source: Central Bank of Kenya (CBK)

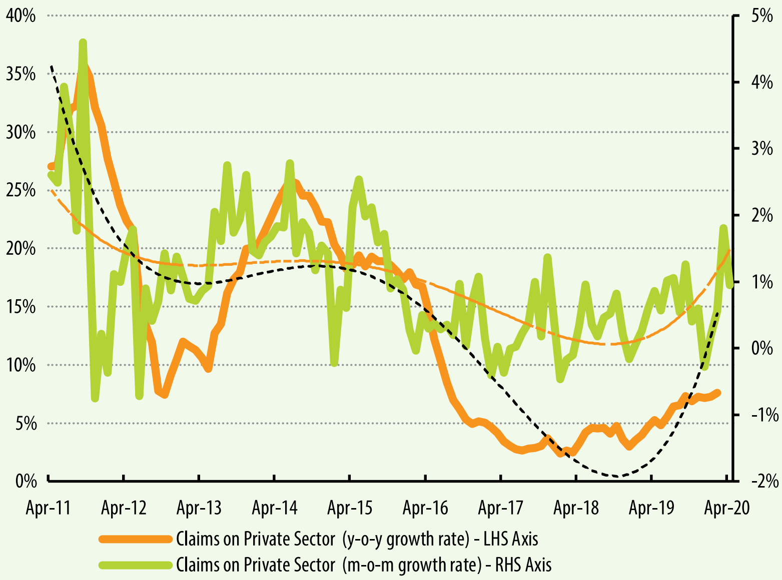
The banking system is sound and stable. Well capitalised and with sufficient buffers and thus enabling it to weather shocks associated with the pandemic without adverse implications on the system. It also has sufficient liquidity, albeit the modest deterioration in asset quality which is exerting downward pressure on profits and upward pressure on provisioning and thus likely to constrain private sector lending as the capital base is drawn. Since COVID-19 hit, the central bank has put in place a raft of policy measures to help alleviate its adverse effects. Among the measures adopted are;

- Lowering of the policy rate, the CBR from 8.25 percent to 7.25 percent and 7 percent in March and April 2020 respectively;
- Reduction of the Cash Reserve Ratio (CRR) to 4.25 percent, thus releasing KSh. 35.2 billion as additional liquidity to the banking sector to supported borrowers under distress as a result of the COVID-19 pandemic.
- Loan restructuring for borrowers affected as a result of the pandemic while allowing for flexibility regarding loan classification and provisioning especially for facilities that were performing on March 2, 2020, and whose repayment period was extended or were restructured due to the pandemic; and
- Extension of the maximum tenor of Repurchase Agreements (REPOs) from 28 to 91 days. This aimed at providing flexibility on liquidity management by allowing banks to access longer-term liquidity secured on their holdings of government securities without necessarily being discounted, among other measures.

As **Figure 11** shows, the trajectory of credit to the private sector at the beginning of 2020 was looking up. In 12 months to April 2020, it grew by 9.0 percent on account of the various policies put in place to support access to credit and loan repayments by customers affected by COVID-19. In particular, the observed credit growth was supported by credit extension to the manufacturing (20.1 percent), trade (10.3 percent), transport and communication (9.1 percent), building and construction (7.7 percent), and consumer durables (19.6

percent) sectors. With the prospective Credit Guarantee Scheme by the National Treasury materialising, credit uptake by Micro Small and Medium Enterprises (MSMEs) is expected to increase as the scheme aims to de-risk lending to this critical sector of the Economy.

Figure 11:
Private sector credit and growth dynamics



Source: Central Bank of Kenya (CBK)

Sectoral Performance

Agriculture

The agricultural sector remains a key driver of economic growth in Kenya, contributing over a third of the Economy's total value in 2019 in spite of the drought that hit in the Economy in the first half of the year. In the fourth quarter, the sector grew by 4 percent, compared to 2.4 percent in the third quarter of 2019 with the observed growth supported by a modest increase in the production of drought-resistant food crops. However, the sector is dominated by exports of coffee and tea, a trend that has been persistent for decades.

The quantity of tea produced decreased from 53,635.65 metric tonnes in January 2020 to 49,201.18 metric tonnes in February but rebounded in March to 55,732.73 metric tonnes. The price of tea at the Mombasa auction has been on a decline in recent months with the prices dropping to KSh 214.49 in February 2020 from KSh 231.50 per kilogram and further to KSh 206.53 in March (**Figure 12**), partly attributable to the overproduction amid a slowdown in global tea demand.

On the other hand, both the volume and value of exports of tea also declined with exports volumes in March standing at 47,569.72 metric tonnes compared to 48,770.49 metric tonnes at a value of 11,021.86 million and KSh 11,452.01

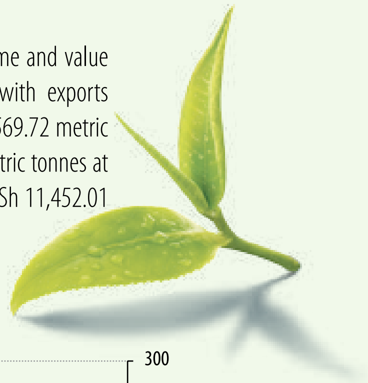
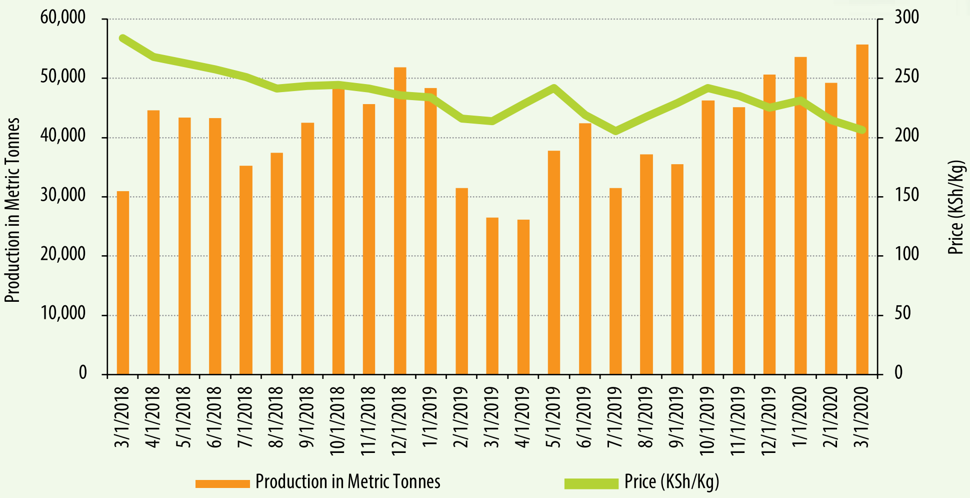
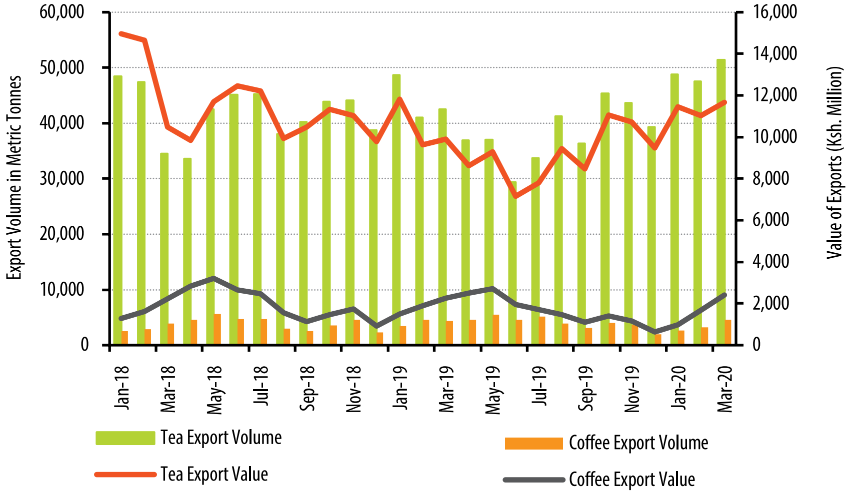


Figure 12:
Tea production in Metric Tonnes and Prices per Kilograms



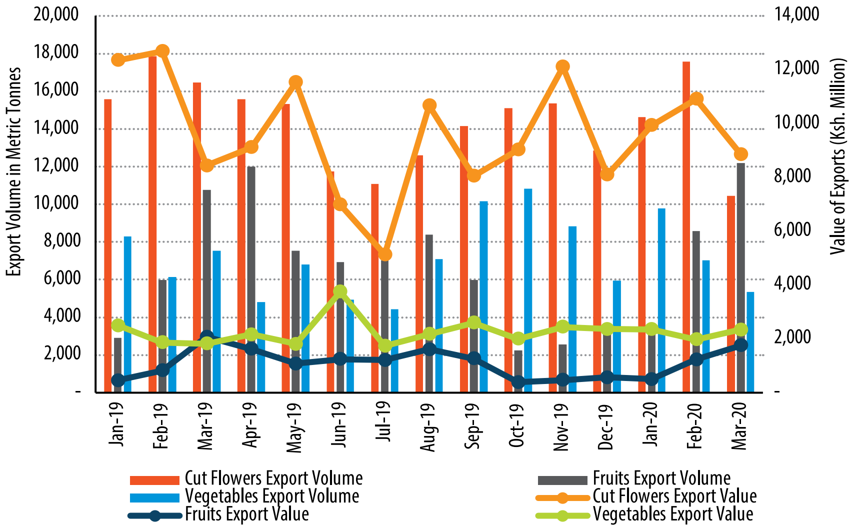
Source: Kenya National Bureau of Statistics

Figure 13:
Value of Tea and Coffee Exports



Source: Kenya National Bureau of Statistics

Figure 14:
Horticultural Exports



Source: Kenya National Bureau of Statistics

million, respectively. The decline in tea exports is attributed to the global slowdown amid tensions and thus reduced demand in some destinations of Kenyan tea. However, trends in coffee exports do not mirror the pattern observed in tea exports with the volume of coffee exports in January standing at 2,639.38 metric tonnes equivalent to KSh 985.32 million but rose to 4,604.42 metric tonnes in March, thus earning KSh 2,410.16 million (**Figure 13**).

Exports of cut flowers continue to dominate over other horticultural crops contributing to 77.6 percent of the total horticultural exports in the first quarter of 2020 compared to 8.1 percent and 14.3 percent contribution of fruits and vegetables respectively (**Figure 14**). The quantity of cut-flower exports in February 2020 was 17,599.99 metric tonnes while its value of exports was KSh 11,905.95 million.

However, in February, it decreased to 4,805.65 metric tonnes with its value declining to KSh 1,982.72 million but rebounded in March to 10,438.22 metric tonnes equivalent to KSh 11,767.55 million during the same period. On the other hand, the exports of vegetables were characterised by mixed trends, particularly declining in February before rebounding in March of 2020 with the exports decreasing from 4,831.56 metric tonnes in January to 4,805.65 metric tonnes in February before rebounding to 5,585.77 metric tonnes in March 2020. However, with the reduction in cargo flights due to COVID-19, the horticultural exports in April and May waned.

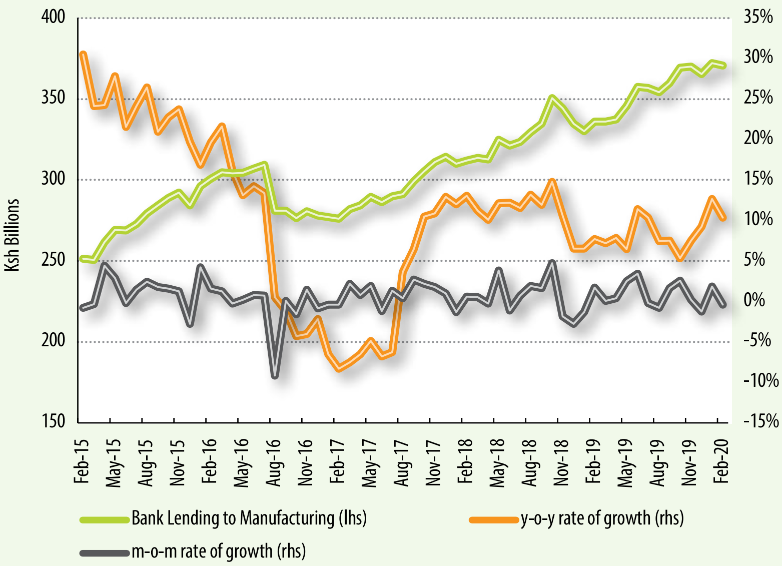
> The manufacturing sector continued to receive more credit with the sector receiving 372.20 billion and 370.80 billion in January and February, representing a 12.7 percent and 10.4 percent growth on a year-on-year basis respectively.

Manufacturing

The manufacturing sector's contribution to the Economy continues to be crucial, albeit characterised by slowdown in its growth having registered a 3.2 percent growth in 2019 compared to 4.3 percent in 2018. Partly due to a decline in certain sub-sectors among them tea production, sugar production, fruits and vegetable exports among others but continued to be supported by the growth of other segments including the manufacture of cooking fat, dairy products, bread, meat and meat products, beverages as well as grain mill products.

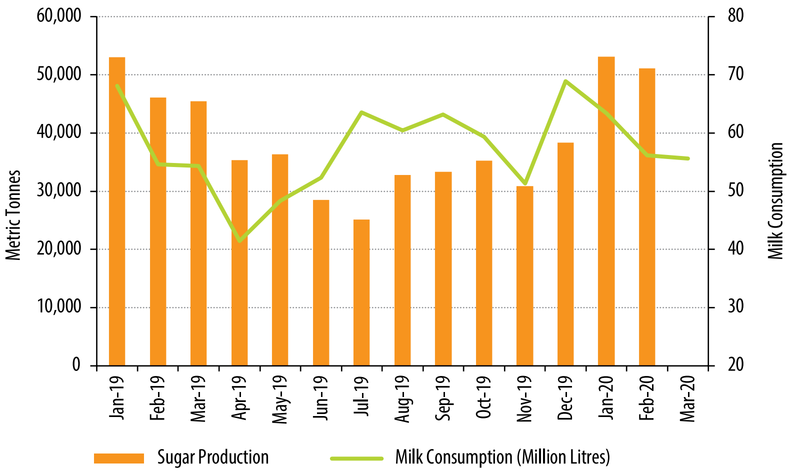
On the credit front, the sector's credit allocation rose by 9.3 percent to stand at KSh 366.9 billion in 2019, a further indication of increased activity in the sector. During the first quarter of 2020, it continued to receive more credit with the sector receiving 372.20 billion and 370.80 billion in January and February, representing a 12.7 percent and 10.4 percent growth on a year-on-year basis respectively (**Figure 15**).

Figure 15:
Bank Lending to the Manufacturing Sector



Source: Central Bank of Kenya

Figure 16:
Sugar and Milk Consumption



Source: Kenya National Bureau of Statistics

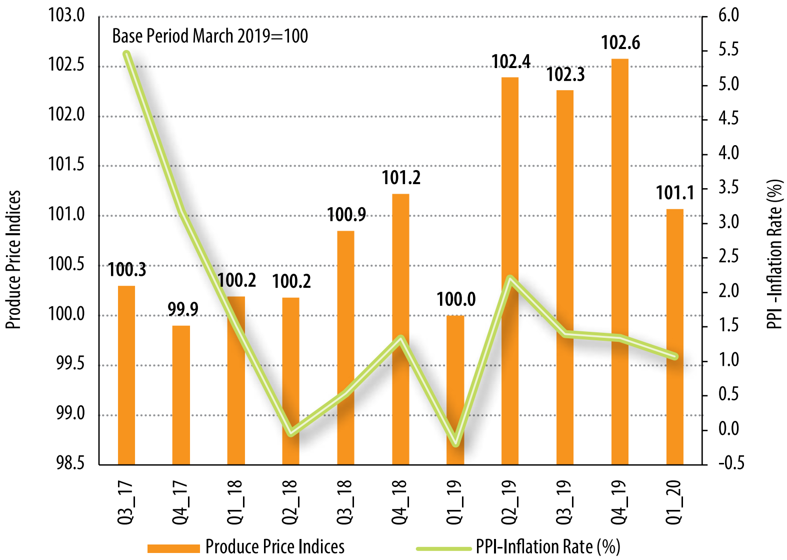
In the first quarter of 2020, sugar production declined from 53,155 metric tonnes in January to 51,083 metric tonnes in February representing a 3.90 percent decline compared to 13.4 percent decline over the same period in 2019, despite the increase in cane deliveries to 533.68 thousand tonnes in February from 522.87 thousand tonnes in January 2020. Milk consumption in January 2020 stood at 63.39 million litres but declined in both February and March to 56.17 million litres and 55.66 million litres, respectively (**Figure 16**).

Producer Price Index

As **Figure 17** Producer Price Index (PPI) during the first quarter of 2020 stood at 101.07, representing year-on-year overall producer inflation of 1.07 percent compared to 0.19 percent in the first quarter of 2020. On a quarter on quarter basis, the overall producer prices decreased by 1.47 per cent from December 2019 to March 2020 supported by a decline in the prices of manufacture of primary metals at negative 5.36 per cent. However, the observed producer inflation was driven by a 6.4 percent increase in the manufacture of wood and wood products and cork except for furniture.

Figure 17:

Producer Price Index

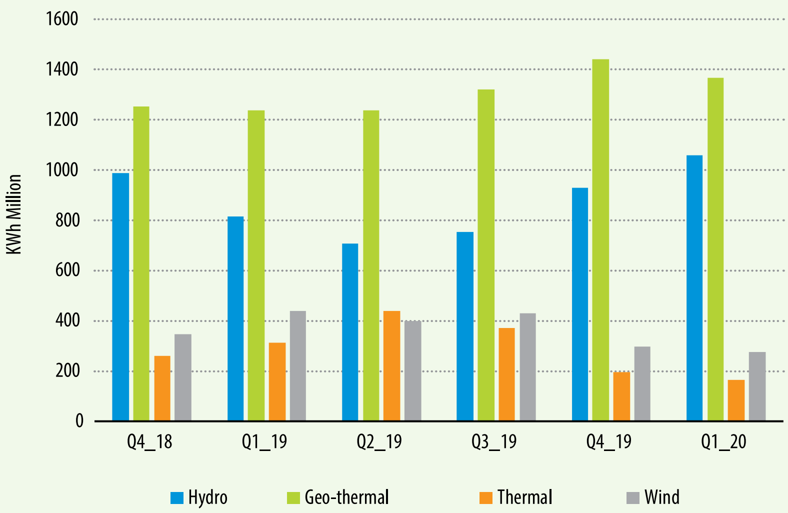


Source: Kenya National Bureau of Statistics

Energy

Energy remains a critical element in the production process of enterprises but also for households. A look at the energy mix in the first quarter reveals that geothermal production dominates over other sources (**Figure 18**). In January 2020, the total local electricity generation stood at 986.09 million KWh but declined to 933.61 million KWh in February but edged up to 968.71 million KWh in March but further decreased to 840.92 million KWh in April 2020.

Figure 18:
Electricity Generation by Source



Source: Kenya National Bureau of Statistics

These are unprecedented times for energy markets. On the international front, crude oil demand has crumbled as economic activity has been suspended around the world, and nearly 3 billion people stay at home to flatten the curve of contagion. As a result, prices have plummeted by about 50 percent not seen since the early 2000s.

However, the subsequent production cut agreement by OPEC+ at the start of April, complemented by further production cuts by oil-exporting G20 economies, could provide some support to oil prices, particularly if global demand increases. In the international market, the price of the OPEC crude oil basket decreased by 48.0 per cent to US Dollars 17.66 per barrel in April 2020.

On the domestic front, as **Table 1** shows the national average domestic retail oil prices of motor gasoline premium rose from KSh 110.61 per litre in January to KSh 113.32 in February and came down to KSh 112.07 in March 2020. The price of light diesel oil rose from KSh 102.81 in January to retail at KSh 105.00 in February and further down to retail at KSh 102.93 in March 2020.

On the other hand, the average price for Kerosene dropped from KSh 104.46 in January to retail at KSh 103.29 and KSh 102.93 in February and March 2020, respectively. Charcoal prices averaged KSh 154.70 per 4KG tin in February 2020 and averaged KSh 56.83 per Kg in March 2020 while the price of a 13-Kg cylinder of gas averaged KSh 2,148.18 in February and KSh 2,065.98 in March 2020. The price of a 13-Kg cylinder of gas averaged KSh 2,065.98 in March and KSh 2,075.87 in April 2020.

Global Crude Oil Prices USD/Barrel

Table 1:

Average Monthly Crude Oil and Retail Fuel Prices

	Aug	Sep	Oct	Nov	Dec-19	Jan-20	Feb-20	Mar-20
Murban crude oil (US$/Barrel)	64.86	60.16	60.88	63.48	66.66	66.09	55.53	33.92
Super petrol (KES/Litre)	111.7	113.57	108.83	110.99	109.91	110.61	113.32	112.07
Diesel (KES/Litre)	104.92	103.9	102.82	105.10	102.28	102.81	105	102.93
Kerosene (KES/Litre)	100.6	101.44	101.94	104.53	102.81	104.46	103.29	96.72
LPG (13Kgs)	2,150.27	2,141.31	2,124.79	2,100.88	2,101.16	2,144.81	2,148.18	2,065.98

Source: Kenya National Bureau of Statistics

Building and Construction

Construction activities continued to be an essential sector in the economy despite recording a slower growth for the fourth year running with the gross value of the sector estimated to have risen by 6.4 percent in 2019 compared to 6.9 percent in 2018.

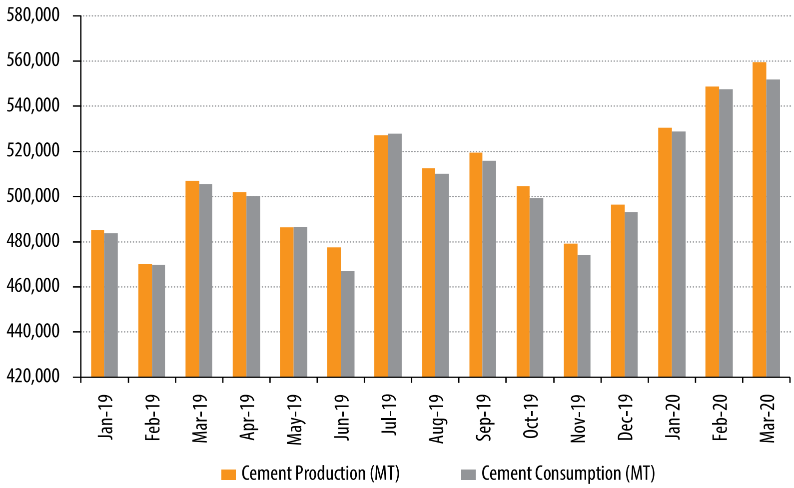
The contraction of the sector's output is attributable to the Construction activities continued to be an essential sector in the Economy despite recording a slower growth for the fourth year running with the gross value of the sector estimated to have risen by 6.4 percent in 2019 compared to 6.9 percent in 2018.

In addition, the slowdown is also reflected in the reduction in the consumption of cement in 2019, albeit the first quarter of 2020 is showing signs of a rebound in both consumption and production of cement (**Figure 19**). In particular, cement production rose to 530,404 metric tonnes in January 2020 from 496,517 metric tonnes in December 2019 while consumption rose from 497,872 metric tonnes to 528, 904 metric tonnes

Construction activities continued to be an essential sector in the economy despite recording a slower growth for the fourth year running

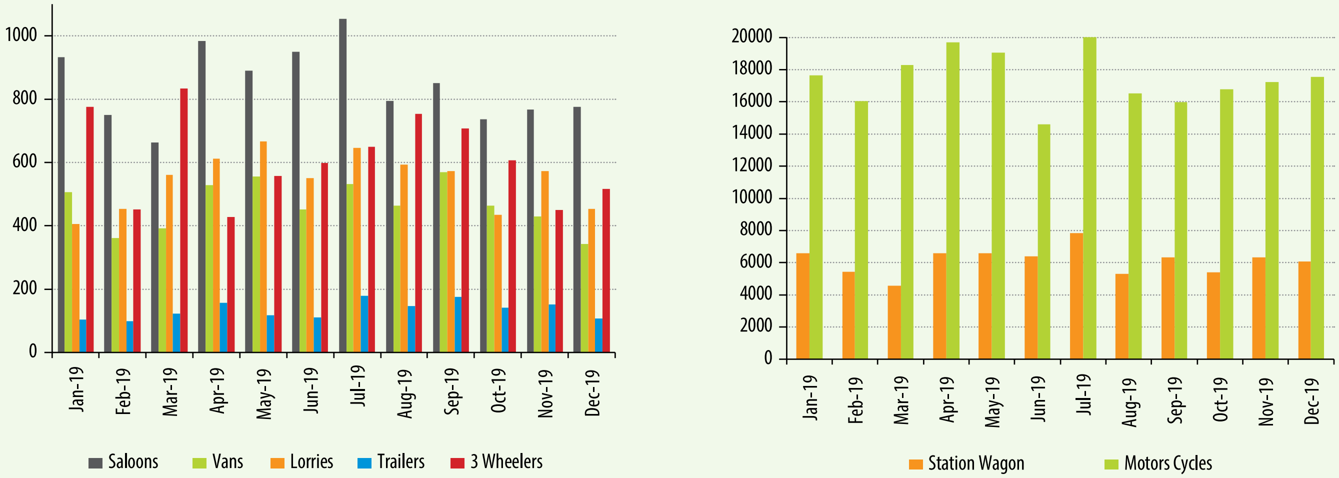
Figure 19:

Cement Production and Consumption



Source: Kenya National Bureau of Statistics

Figure 20:
Registration of New Vehicles



Source: Kenya National Bureau of Statistics

over the same period.

Transport and Communication

Transportation and Storage sector expanded by 7.8 per cent in 2019 compared to 8.5 per cent growth in 2018. The sector's performance benefitted from low international oil prices and the continued expansion of transportation infrastructures such as roads, railways, and ports.

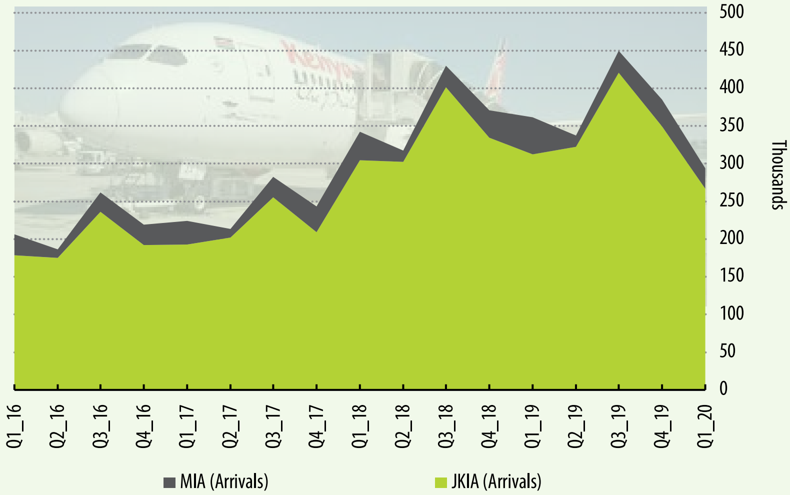
In terms of the production of assembled vehicles, it increased from 548 units in January 2020 to 742 units in February 2020 while the total number of vehicles registered in December 2019 stood at 26,753 out of which 6,070 were Station Wagons, and 17,563 were Motor Cycles (**Figure 20**)

Tourism

The total number of visitors arriving through Jomo Kenyatta (JKIA) and Moi International Airports (MIA) increased from 127,087 persons in January 2020 to 119,670 persons in February 2020. However, it decreased by 60 percent to 47,296 persons in March 2020. I

n terms of the point of entry, the number of passengers who landed at Jomo Kenyatta International Airport (JKIA) decreased from 269,918 persons in January 2020 to 242,621 persons in February 2020, while passengers who embarked decreased from 162,109 persons in January 2020 to 134,302 persons in February 2020. A similar trend is observed for arrivals through Moi International Airports (MIA) in Mombasa.

Figure 21:
Trends in Visitor Arrivals by Point of Arrival



Source: Kenya National Bureau of Statistics

Financing of Government

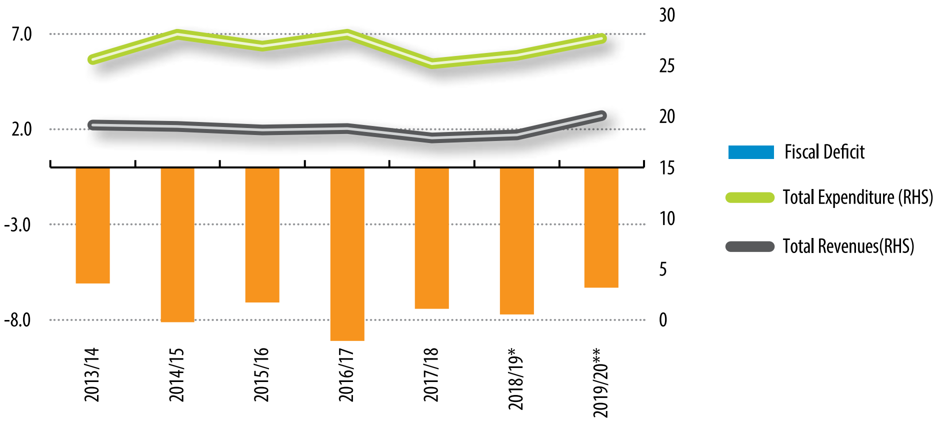
Kenya's fiscal policy space is limited as the revenue-expenditure gap widens hence the fiscal deficit (Figure 22). Before the outbreak of COVID-19, the fiscal deficit had expanded to 7.7 percent of GDP in FY2018/19 (from 7.4 percent in FY2017/18), and nominal public debt increased to 62.4 percent in December 2019.

While the government remains focused on maintaining fiscal sustainability and reducing debt-to-GDP to about 50 percent over the medium term, the exogenous COVID-19 shock adds to the fiscal pressures faced by the government amid dwindling revenues as some policy measures are adopted.

Among the fiscal policy measures adopted so far includes offering reliefs, VAT refunds, paying of bending domestic arrears, reduction in PAYE (income tax) and corporate tax, turnover tax, and sought to protect the vulnerable groups from the crisis through cash transfers to the elderly, orphans and other vulnerable members as well as voluntary pay cuts by the executive arm of government.

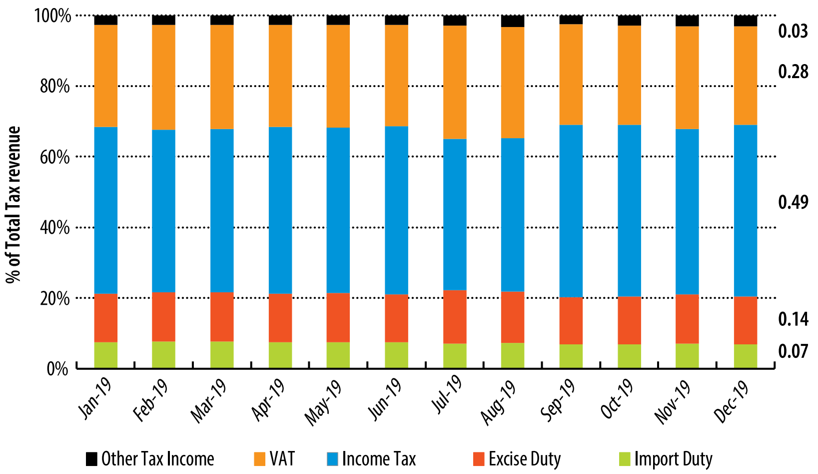
On the tax revenue side, and as **Figure 23** shows, income tax constitutes the primary source of revenue accounting for approximately 49 percent of the collected tax revenues, followed by value-added tax (VAT) at 28 percent, excise duty at 14 percent, import duty and other tax income at 7 percent and 3 percent respectively as at the end of December 2019.

Figure 22:
Kenya's Fiscal Position Continues to Deteriorate



Source: National Treasury. Note: *indicate provisional figures.

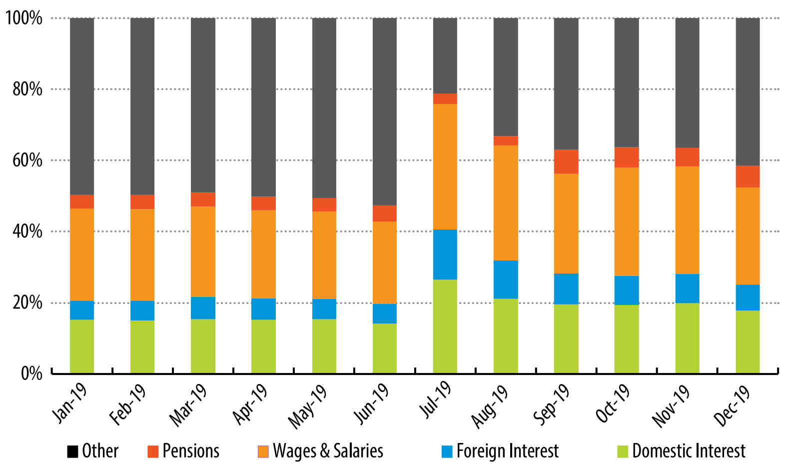
Figure 23:
Composition of Tax Revenue Sources



Source: Central Bank of Kenya

Public spending has been expanding, with a significant portion being on recurrent expenditure (66 percent in February 2020) rather than development expenditure (23 percent). An examination of the recurrent expenditure composition reveals that it contains higher spending on wages and salaries (27 percent), domestic and foreign interest payments at 18 percent and 7 percent, respectively. In comparison, pension payments account for 6 percent of the recurrent expenditure as at the end of February 2020 (**Figure 24)**.

Figure 24:
Composition of Recurrent Expenditures



Source: Central Bank of Kenya

Public Debt

An analytical breakdown of the public debt analysis into domestic and external debt reveals that the government, through the National Treasury, has had a tight balance between domestic and external debt. Domestic and external debt composition stood at 51:49 ratio as at the end of February 2020 (**Table 2**).

This trend reflects the tight balancing act insofar as ensuring that the limited crowding out effect of domestic borrowing and the increased debt burden for foreign currency-denominated debt on account of the strength of the domestic currency against other major currencies. Even so, the external debt has tended to rely on expensive commercial debt rather than concessional debt and is contracted from non-Paris Club creditors, notably China, raising concerns about debt transparency as well as debt collateralisation.

Of the external debts, multilateral and bilateral debts accounted for 33 percent of the total external debt in February respectively, while commercial banks accounted for 34 percent of the external debt and export credit standing at 0.5 percent. In terms of the domestic debt, bank's debts accounts for 54.7 percent, while non-bank and non-resident's debts account for 44.3 and 1 percent respectively as at the end of February 2020.

Table 2:
Stock of Kenya's Public and Publicly Guaranteed Debt (*KSh Billion*)

	Oct-19	Nov-19	Dec-19	Jan-20	Feb-20
External Debt					
Bilateral	1,020.6	1,018.2	1,023.8	1,016.5	1,015.8
Multilateral	1,033.8	1,036.3	1,037.5	1,027.2	1,028.3
Commercial Banks	1,056.2	1,043.4	1,028.7	1,052.5	1,056.3
Export Credit	17.1	17.0	16.8	16.7	16.7
Sub-Total	**3,127.6**	**3,115.0**	**3,106.8**	**3,112.9**	**3,117.0**
(As a % of total debt)	**51.9**	**51.6**	**51.4**	**50.9**	**50.6**
Domestic Debt Composition					
Banks	1,585.7	1,595.4	1,607.4	1,650.5	1,662.6
Central Bank	117.8	109.5	116.0	111.5	82.7
Commercial Banks	1,467.9	1,485.9	1,491.4	1,539.1	1,579.8
Non-banks	1,281.3	1,291.6	1,304.1	1,322.7	1,347.6
Pension Funds	818.6	823.3	841.3	857.1	877.5
Insurance Companies	185.1	187.5	189.0	192.3	191.3
Other Non-bank Sources	277.6	280.7	273.9	273.3	278.8
Non-residents	30.2	30.4	30.6	30.5	30.8
Sub-Total	**2,897.1**	**2,917.4**	**2,942.1**	**3,003.7**	**3,041.0**
(As a % of total debt)	**48.1**	**48.4**	**48.6**	**49.1**	**49.4**
GRAND TOTAL	**6,024.7**	**6,032.3**	**6,048.9**	**6,116.6**	**6,158.0**

Source: Central Bank of Kenya

A further disaggregation shows that commercial bank's debt to government stands at 52 percent, pension fund's debts stood at 28.9 percent while insurance companies and other non-bank sources at 6.3 and 9.2 percent over the same period, respectively.

The growing debt-to-GDP has several implications. First, it erodes investor confidence, especially if concerns on its sustainability emerge and as a result leading to the government paying a higher risk premium on its debt. Second, it reduces the effectiveness of the fiscal policy[2]. Specifically, high government debt can reduce the size of fiscal multipliers through the Ricardian channel[3] and investor sentiment channel[4]. Third, it slows growth and investment

2 See, for example Adam & Bevan (2005). "Fiscal deficits and growth in developing countries". Journal of public economics, 89(4), 571-597 and Debrun & Kinda, (2016). "That squeezing feeling: the interest burden and public debt stabilization". International Finance, 19(2), 147-178.

3 Under the Ricardian channel, a fiscal stimulus under a high debt scenario is likely to lead to a cut in consumption and higher saving (the "Ricardian" reaction to government dis-saving) as consumers expects taxes to increase than when debt is low.

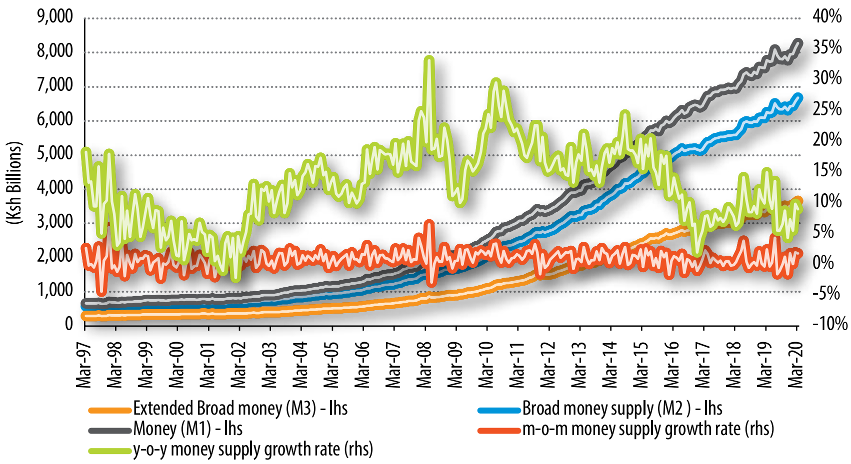
4 Equally, under the investor sentiment channel, economies with higher sovereign debt are more likely to have to pay a risk premium to borrow as it increases creditors' concerns about sovereign credit risk and thus raising sovereign bond yields and, consequently the borrowing costs for the economy.

Money Supply and Domestic Credit

In the first quarter of 2020, the monetary aggregates were broadly stable and slightly edged upwards (Figure 25). Extended broad money supply (M3), a key indicator for monetary policy formulation, increased from KSh 3,527.01 million in January 2020 to KSh 3,596.05 million in February 2020 and further to KSh 3,661.01 million in March 2020.

On the other hand, broad money (M2) rose from KSh 2,915.71 million in January 2020 to KSh 2,970.10 million in February 2020 and further to KSh 3,018.86 million in March 2020. Similarly, narrow money (M1), also registered growth, with the aggregate rising from KSh 1,524.03 million in January 2020 to KSh 1,568.05 million in February 2020 and further to KSh 1,595 million in March 2020.

Figure 25:
Money Supply



Source: Central Bank of Kenya

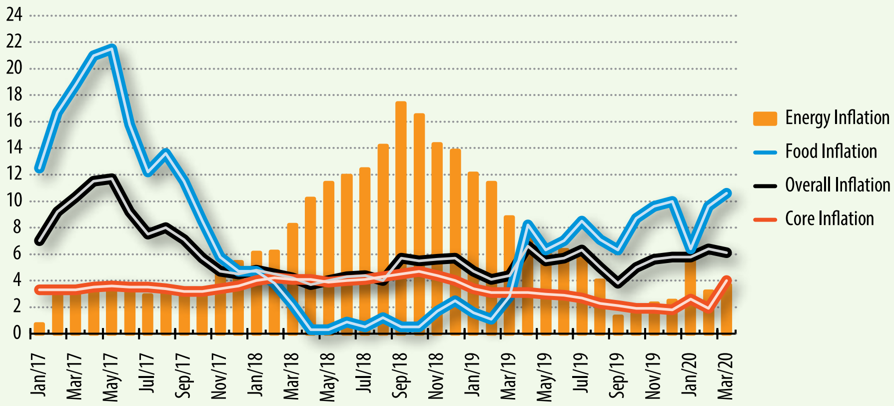
Inflation

The cost of living in the first quarter of 2020 remained within the targets of the Government target range of 5±2.5 percent, albeit with an upper bound as **Figure 26** shows. The 12-month inflation rose to 6.37 percent in February from 5.78 percent in January 2020.

The annual average inflation rose from 5.29 percent in January to 5.48 percent in February 2020 and edged further upwards to 5.50 percent in March and 5.60 percent in April mainly due to an increase in prices of food and non-alcoholic, electricity and cooking gas, which outweighed the decrease in the cost of Kerosene, and also an increase in the transport prices.

> **The cost of living in the first quarter of 2020 remained within the targets of the Government target range of 5±2.5 percent.**

Figure 26:
Inflation dynamics



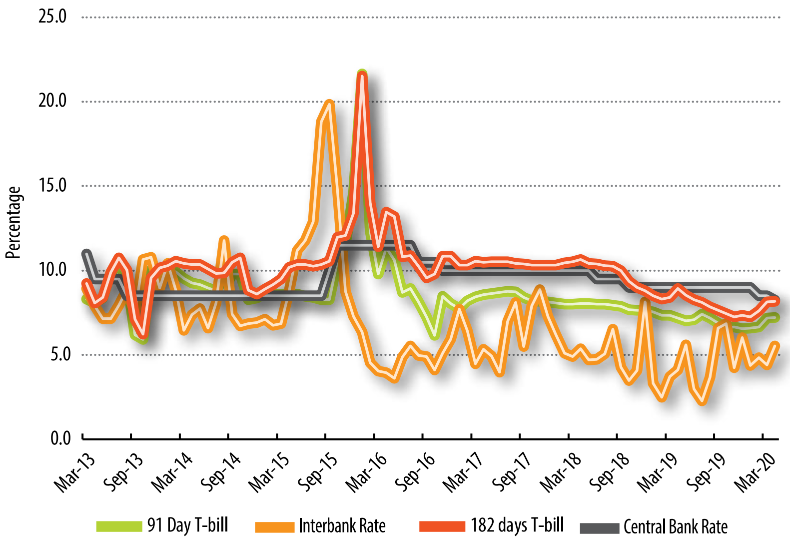
Source: Central Bank of Kenya

On the other hand, core inflation continues to exhibit stickiness to the downside. In April it stabilised at 1.8 percent recorded in March, sustaining a fourth consecutive month of a downward trend. With the core inflation – a measure of demand-side inflationary pressures – remaining low, monetary policy would be expected to remain sufficiently accommodative as a platform for spurring demand.

Interest Rates

In the first quarter of 2020, the money market rates have been characterised by broad stability (**Figure 27**) supported by accommodative monetary policy. The central bank rate (CBR), the CBK's policy

Figure 27:
Evolution of Short-Term Interest Rates and Monetary Stance



Source: Central Bank of Kenya

rate has been reduced by 125 basis points from 8.25 percent in January to 7 percent in May 2020 in response to the COVID-19 pandemic and also the observation that inflation is stable and inflation expectations are well anchored.

Both the interbank market and short-term government securities rates which primarily reflects the government's borrowing profile shows signs of upward movements. In particular, the average yield rate for the 91-day Treasury bills, which is a benchmark for the general trend of interest rates rose marginally from 7.23 per cent in January 2020 to 7.31 per cent in February 2020 but dropped marginally to 7.29 per cent in March 2020. The inter-bank rate, on the other hand, rose from 4.39 percent in January 2020 to 4.84 percent in February but dropped to 4.40 percent in March 2020.

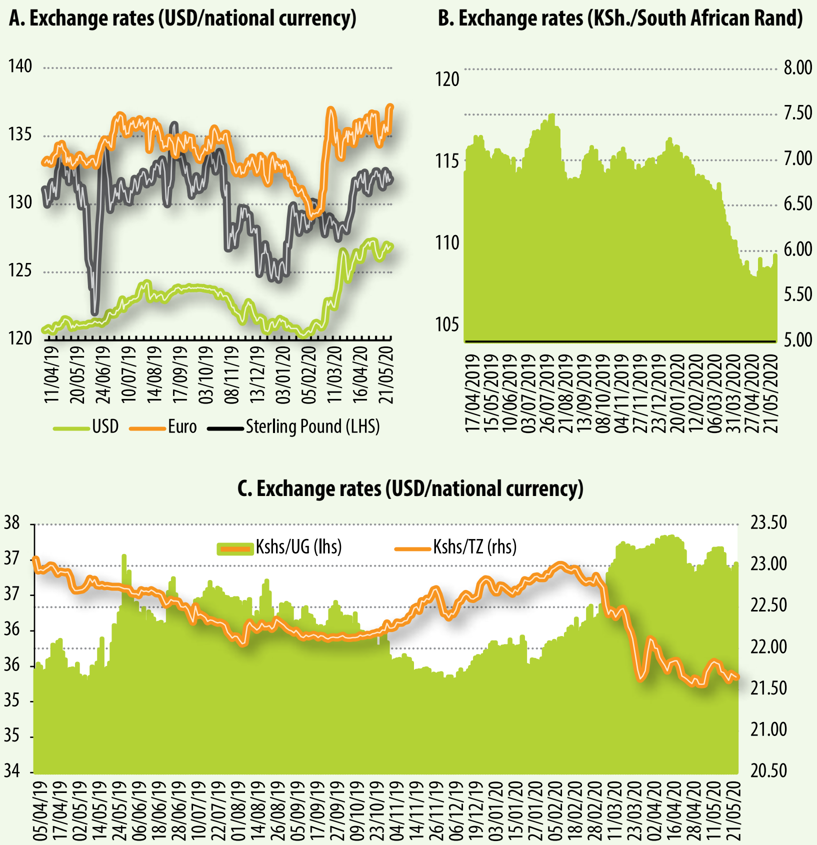
Exchange Rates Developments

The exchange rate developments during the first quarter of 2019 have been characterised by mixed patterns. For instance, the Kenyan Shilling appreciated against the major trading currencies in February 2020 but in March depreciated against the major trading currencies except the Sterling Pound and the SA Rand. It further depreciated against the major trading currencies except for the SA Rand, the Ugandan Shilling, and the Tanzanian Shilling in April 2020 (**Figure 28**).

The volatility in the recent months it has been partly due to the due to uncertainties about the impact of COVID-19 which resulted in massive capital outflows from emerging markets economies as concerns around the safety of asset portfolio emerged. Even then, the central bank's foreign exchange reserves remain sufficiently adequate - as of June 2020 stood at USD 8,341.5 million (5.02 months of import cover) – even as diaspora remittances dry-up. The foreign exchange reserves at 5-months of import cover continue to provide adequate cover and a buffer against short-term shocks in the foreign exchange market.

Although exchange rate fluctuations may play a shock-absorbing role, in some cases, they can exacerbate corporate vulnerabilities and discourage investment, especially when corporate foreign exchange liabilities are large and financial markets not well developed. Currency depreciations have

Figure 28:
Exchange Rates Developments



Source: Central Bank of Kenya

two opposing effects on the domestic Economy: they support activity by improving the competitiveness of exporters and import-competing industries, but they may depress activity by increasing the debt burden of firms with foreign exchange liabilities. Where such liabilities are significant and unhedged, the balance sheet effect can dominate, which appears to have been the case in several emerging market economies subject to extensive and volatile capital flow shocks.

Balance of Payments

According to the Kenya National Bureau of Statistics (KNBS) Economic Survey, the Balance of Payments (BOP) position improved in 2019, on account of a build-up in official reserves. However, the current account worsened by 10.9 per cent to KSh 567.0 billion from KSh 511.3 billion in 2018, which was occasioned by a 2.9 per cent decline in merchandise exports to KSh 598.8 billion, a 2.3 per cent increase in merchandise imports (f.o.b) to KSh 1,688.3 billion (**Figure 29**) and a 33.7 percent worsening on the primary income account to a deficit of KSh 196.3 billion.

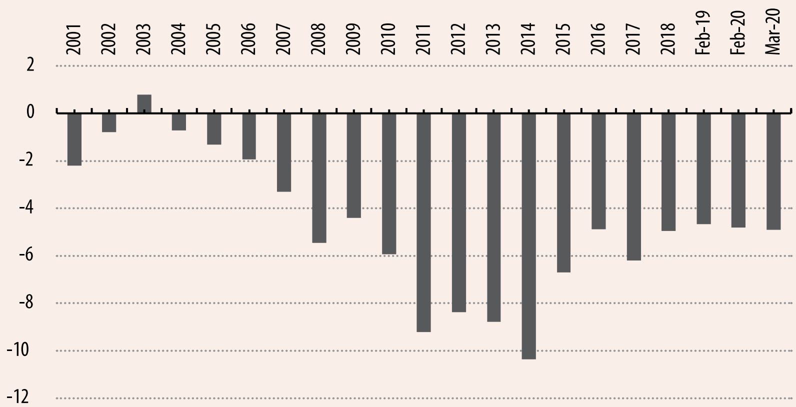
As **Figure 30**, shows the balance of international merchandise trade in the first two months of 2020 improved as exports grew by 15.03 percent and imports shrank by 13.76 percent on a month on month basis in February. The value of imports dropped from KSh. 155,302 million in January to KSh. 133, 938 million in February 2020, while exports rose from KSh. 53,126 million to KSh. 61,106 million over the same period and thus narrowing the trade balance deficit from KSh. 112.5 billion in January to KSh. 72.8 billion in February.

Even though the trade balance deficit is narrowing, Kenya's trade performance as a ratio of exports to imports has declining and stood at around 40 percent during the first quarter of 2020. The export destination markets remain highly concentrated with Uganda being the largest importer of Kenya's products importing 15 percent of Kenya's goods, followed by the United Kingdom and Pakistan, which accounted for 14 percent, respectively.

Cumulatively the three countries (Uganda, United Kingdom and Pakistan) account for 43 percent of Kenya's total exports, a clear indication of the concentrated nature of her export destinations. More importantly, intra-EAC trade is substantial with exports to the region, accounting for approximately 30 percent of exports. Imports, on the other hand, has been trending upwards on account of substantial infrastructural and related imports with imports 30 percent of the imports being from China, 22 percent from India, 10 percent from United Arab Emirates

Figure 29:

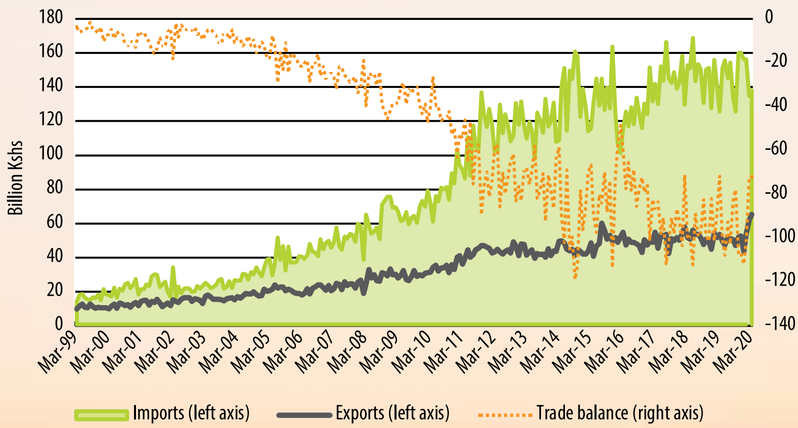
Kenya's Current Account Balance *(% of GDP)*



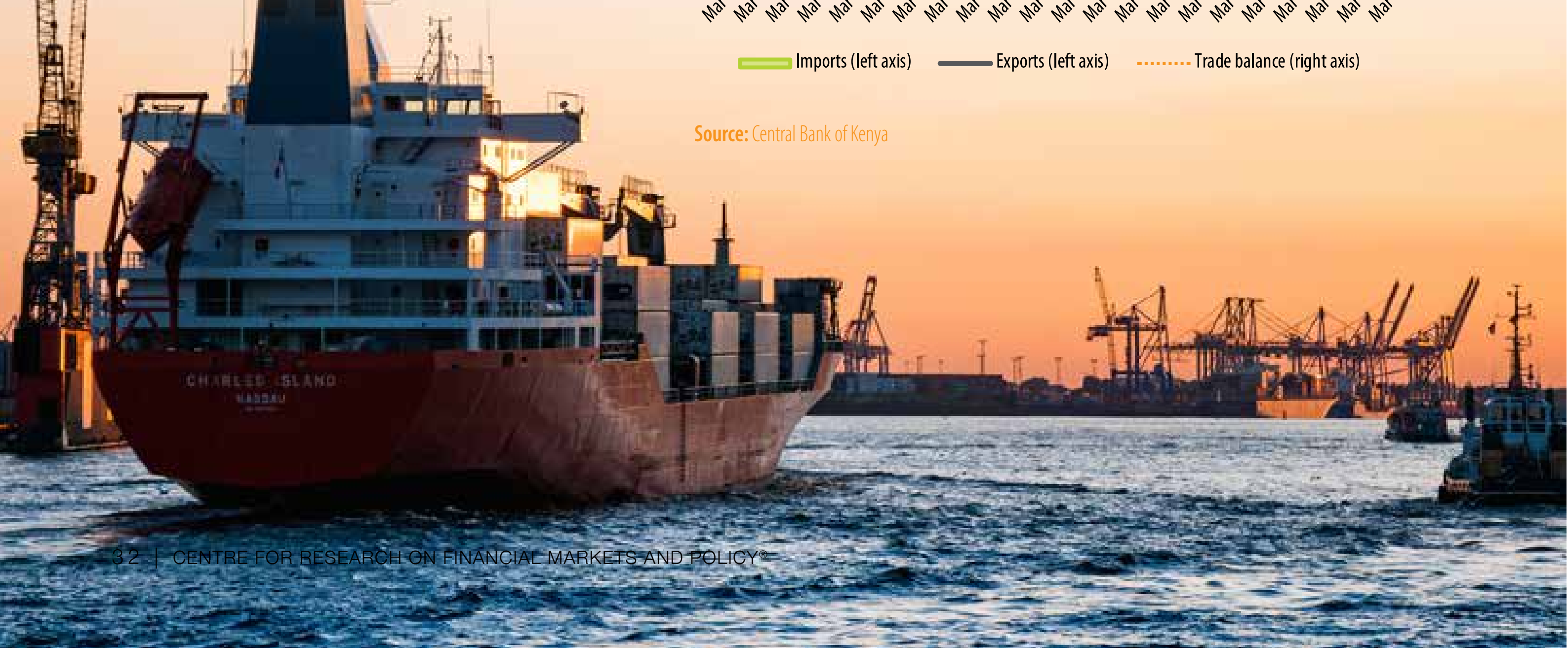
Source: Central Bank of Kenya

Figure 30:

Export and Import Growth and Trade Balance



Source: Central Bank of Kenya



Nairobi Securities Exchange

In the capital markets, the Nairobi Securities Exchange (NSE) 20-Share index dropped to 1,966 points as at March 2020 from 2,600 points in January and 2,337 points as at February 2020, while equities turnover increased to KSh 19.1 billion in March from KSh 12.3 billion in January 2020. Similarly, the number of shares traded rose from KSh 336.0 billion in January to KSh 639 billion in March 2020.

As a result of COVID-19, there has been heightened investor risk aversion, and as **Figure 31** reveals the securities market is gyrating downwards, with the speed of the selloff unparalleled to the extent of trading activity being halted on Friday 13, March 2020 after the share index declined by more than 5 percent[5].

It can be argued that even though the NSE-20 index sustained a downward pattern even before COVID-19, the decline partly reflected the short-term effects of the epidemic on the Economy. Whereas the short-term effect of the shock is permeating to the securities market, it would have long-latest implications if market expectations and confidence on the performance of the Economy deteriorates resulting in a reduction of investors propensity to consume and save.

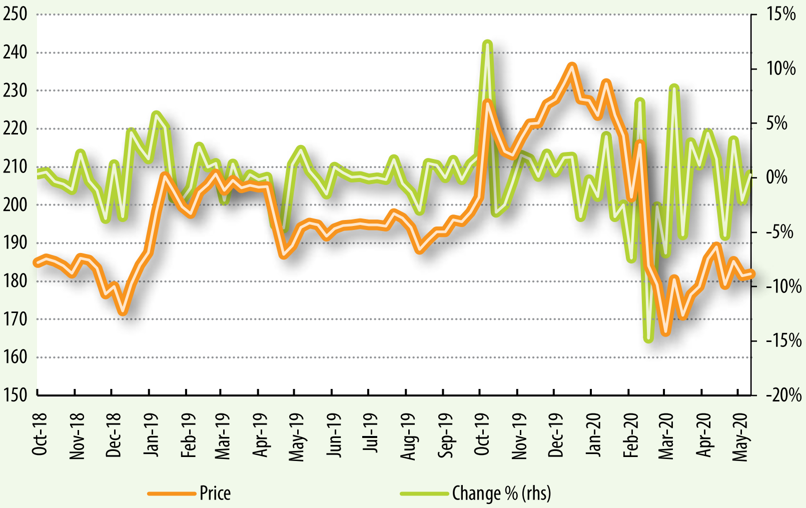
5 See https://www.nse.co.ke/media-center/press-release.html?download=12717%3Apublic-notice-market-halt

Table 3: Nairobi Securities Exchange Sep 2019 - Mar 2020

	Sep	Oct	Nov	Dec-20	Jan-20	Feb-20	Mar-20
NSE 20 Share Index (1966=100)	2432.0	2643.0	2619.0	2654.0	2600.0	2337.0	1966.0
Number of Shares Traded (Million)	367.6	451.0	482.0	357.0	336.0	385.0	639.0
Equities Turnover (KSh Billion)	10.6	16.0	17.0	12.0	12.3	12.3	19.1

Source: CBK

Figure 31:
NSE-25 Share Price Indices



Source: Nairobi Securities Exchange

The observed performance continues to be supported by local investors taking up more positions if by way of exuding confidence in the market[6] rather than the lack of alternate investment options as foreign investor participation wanes. Of course, it isn't impossible to think that the bottom has been reached; the fluidity of the situation has a long-term impact on confidence and consumption.

6 See https://www.nse.co.ke/media-center/press-release.html?download=12719%3Alocal-investors-boost-market-activity

Banking Industry Performance

The banking system is considered sound, well-capitalised, liquidity is sufficient, but non-performing loans are on an upward trend; further, the industry's asset position continues to trend upwards, albeit with mixed patterns in terms of asset growth. On the other hand, the gross loans and deposits over the recent years have been rising, albeit from a lower base (Figure 28).

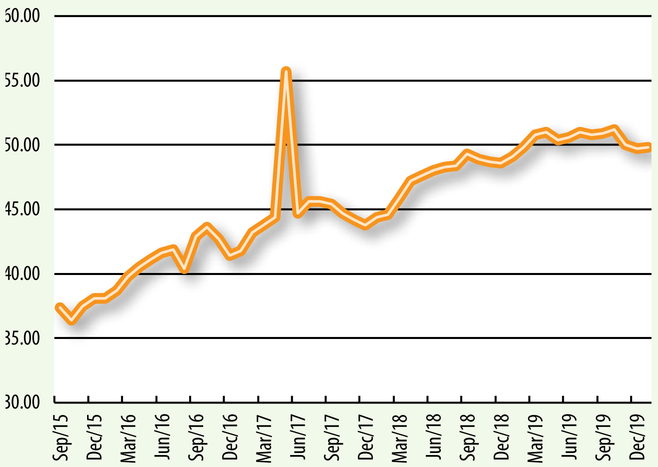
Average commercial banks' liquidity and capital adequacy ratios stood at 51.1 percent and 18.7 percent, respectively, in February (**Figure 32, Panel A**). On year on year basis, private sector credit grew by 8.9 percent in March, and 9.0 percent in April 2020 (**Figure 32, Panel B**). Supported by an increase in private sector lending to the manufacturing, trade, transport and communication, building and construction, and consumer durables following the enactment of the Finance Act, 2019 in November 2019 that saw 33B of the Banking Act, 2016 that provided for capping of interest rates amended to enhance access to credit by the private sector.

Further, Cognisant of the underlying risks to the Economy, a raft of policy measures both monetary and fiscal have been put in place to cushion the Economy from the shock and ensuring financial stability. On the monetary front, in its Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) meeting on March 23, 2020, the CBK continued with its monetary easing stance by reducing both the Central Bank Rate (CBR) and the Cash Reserve Ratio (CRR)[7], to mitigate the adverse impact of the Covid-19 on the financial sector and the Economy. It further put additional measures, including the extension of the tenor of Repurchase Agreements (REPOs),

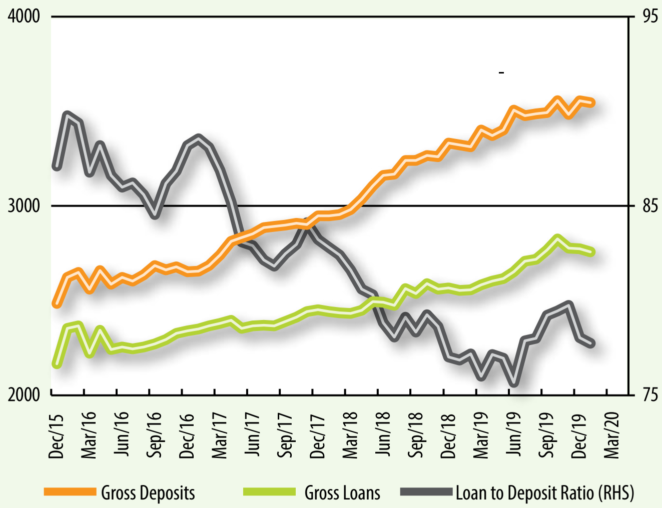
7 On March 23, 2020 it lowered by 100 basis point the Central Bank Rate (CBR) from 8.25 percent to 7.25 percent and the Cash Reserve Ratio (CRR) from 5.25 percent to 4.25 percent resulting to an additional liquidity of KES. 35 billion for lending (https://www.centralbank.go.ke/uploads/mpc_press_release/765216187_MPC%20Press%20Release%20-%20Meeting%20of%20March%2023,%202020.pdf)

Figure 32:
Banking Sector Developments and Dynamics

A. Liquidity ratio



B. Total Gross Loans, Deposits and Loan-to-deposit ratio



as well as allowing for flexibility in loan classification and provisioning[8].

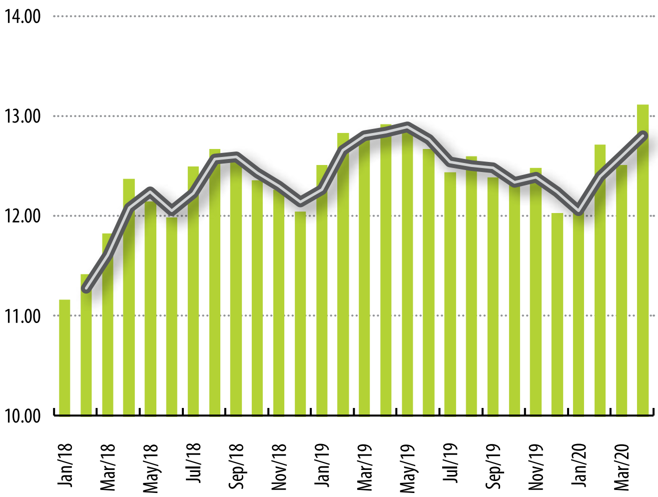
The ratio of gross non-performing loans (NPLs) to gross loans stood at 13.1 percent in April, 12.5 percent in March compared to 12.7 percent in February (**Figure 28, Panel C**). The decline in asset quality was as a result of the increase in increased NPLs in the real estate, trade and manufacturing sectors following a further slowdown in economic activity.

However, the effects on the pandemic will lead to a further deterioration in the NPLs as households and businesses capacity to service their debts weakens. Addressing the asset quality and credit uptake requires a sufficient capital base. The banking industry enters this period from a position of strength, and this enables most banks to weather the significant disruptions in the markets.

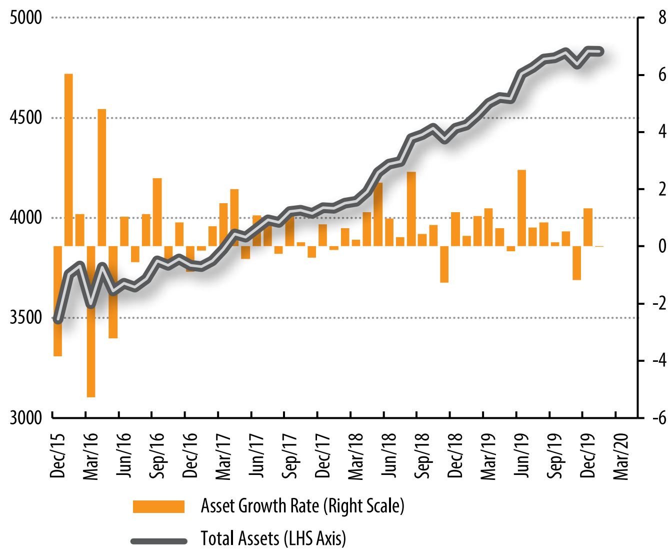
8 See https://www.centralbank.go.ke/uploads/press_releases/2088534699_Press%20Release%20-%20Banking%20Sector%20Additional%20Measures.pdf

Figure 32:
Banking Sector Developments and Dynamics

C. Nonperforming loans to total gross loans



D. Asset Evolution and growth dynamics



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