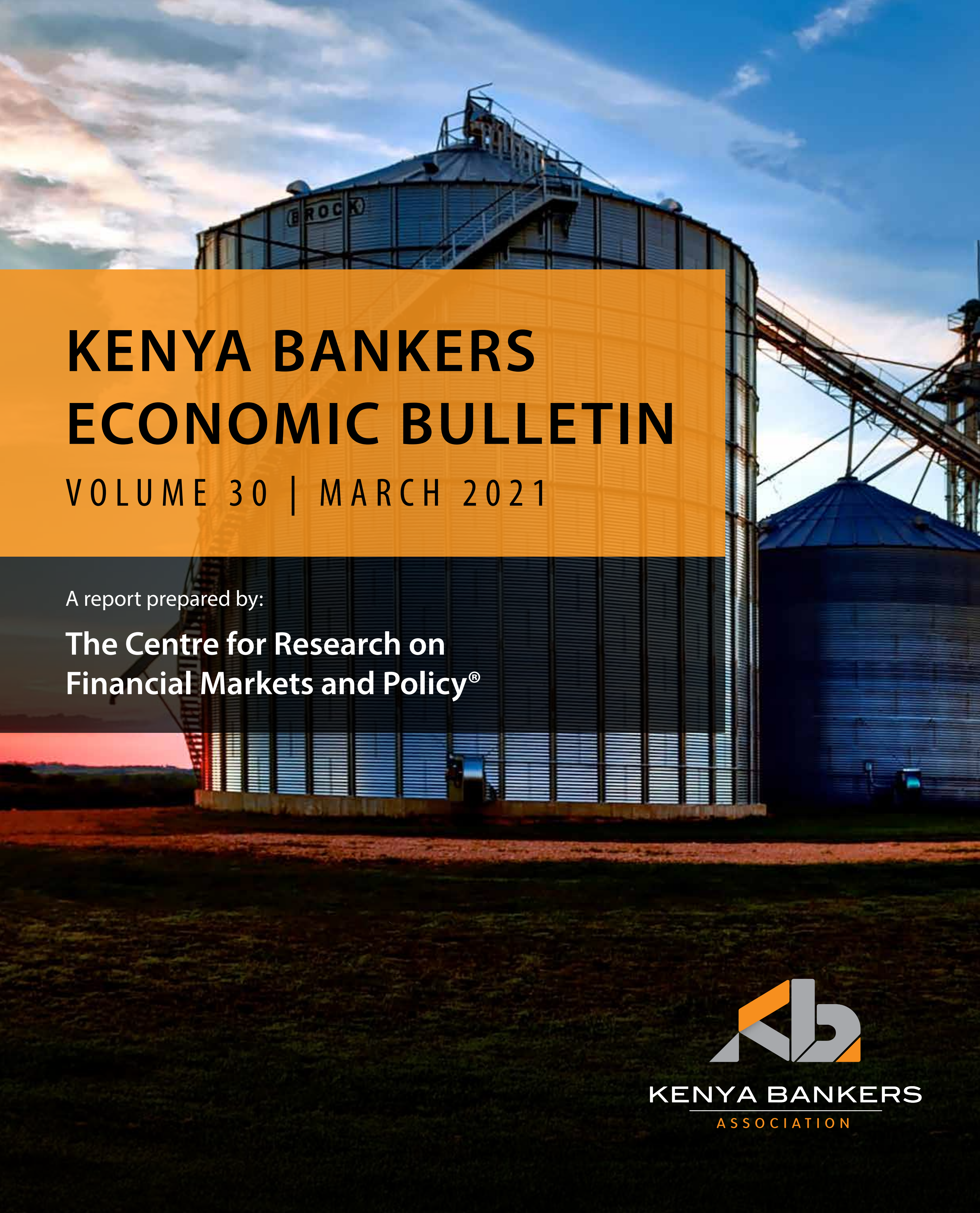

KENYA BANKERS ECONOMIC BULLETIN

VOLUME 30 | MARCH 2021

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 Kenya's economic performance, drawing on 2020's performance, and more specifically, the fourth-quarter performance and developments to provide perspectives on the year's outlook. The *Bulletin* covers trends in the real economy, government fiscal operations, public debt, inflation and interest rates, the balance of payments and exchange rate, 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®

Publisher KBA Centre for Research on Financial Markets and Policy®

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Distributed by Kenya Bankers Association

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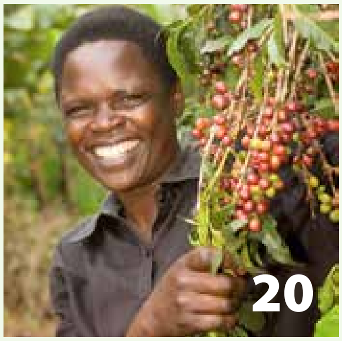
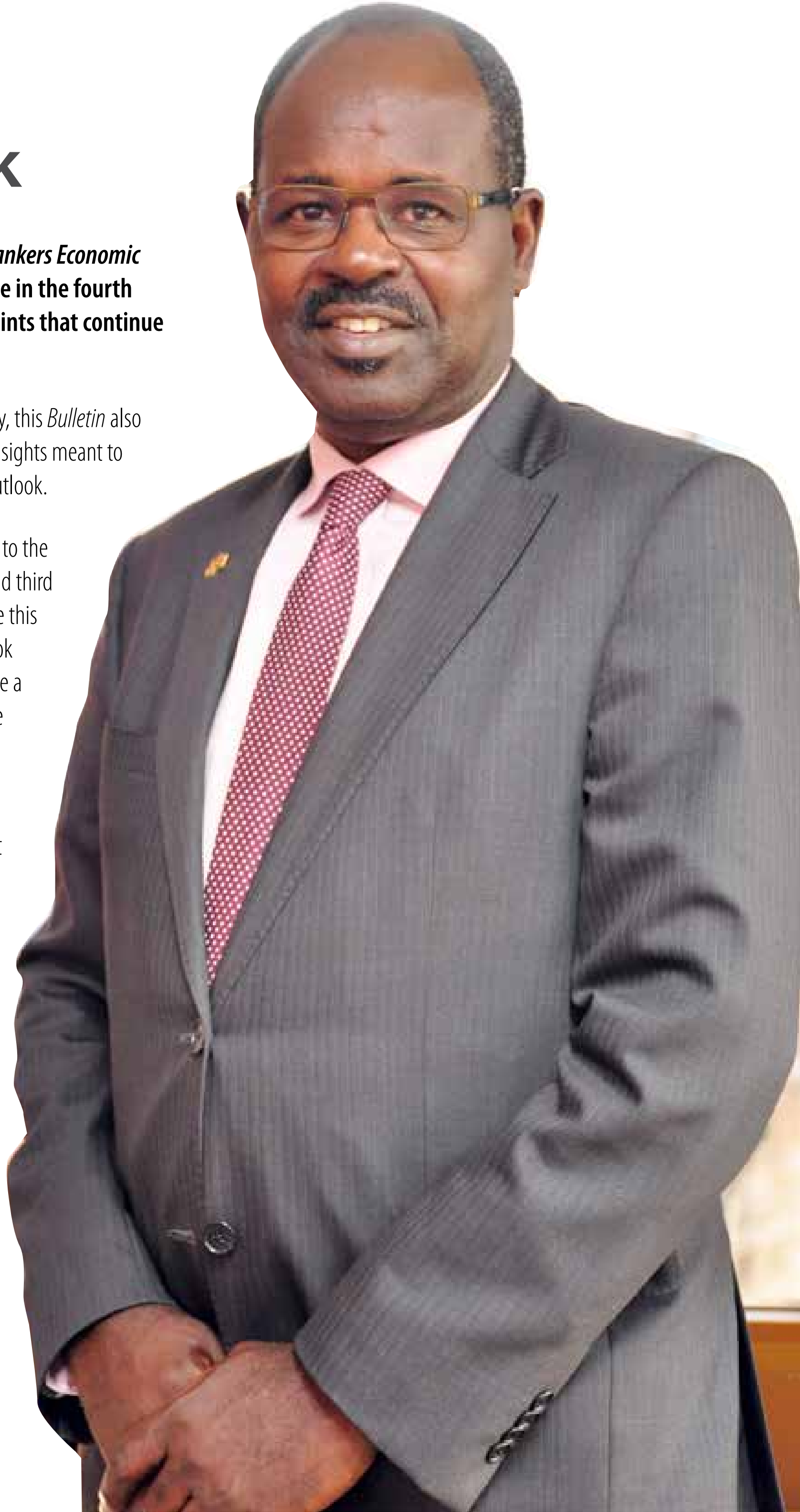


PEXELS/PIXABAY

FOREWORD

From the CEO's Desk



It is my pleasure to present to you the 30th issue of the *Kenya Bankers Economic Bulletin*. The *Bulletin* reviews the strides that the economy made in the fourth quarter of 2020, emphasizing on the opportunities and constraints that continue to shape its gradual recovery from the effects of the pandemic.

While focusing more on the effects of the pandemic on the domestic economy, this *Bulletin* also reviews some developments in the international economic front. It provides insights meant to support readers' understanding of the outcomes and shape their near-term outlook.

Noteworthy is the observation that the pandemic presented an adverse shock to the economy leading to a double dip in overall economic growth in the second and third quarters and continued to depress activity in the fourth quarter of 2020. While this *Bulletin* reports on the developments in the fourth quarter of 2020, any outlook formed based on the data and analyses presented herein should accommodate a high degree of uncertainty underpinned by the effects of the pandemic on the economy.

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

Dr. Habil Olaka
Chief Executive Officer,
Kenya Bankers Association

COMMENTARY

Economy on a Delicate Recovery Path; Which Levers will Provide a Stronger Anchor?

By Dr. Samuel Tiriongo

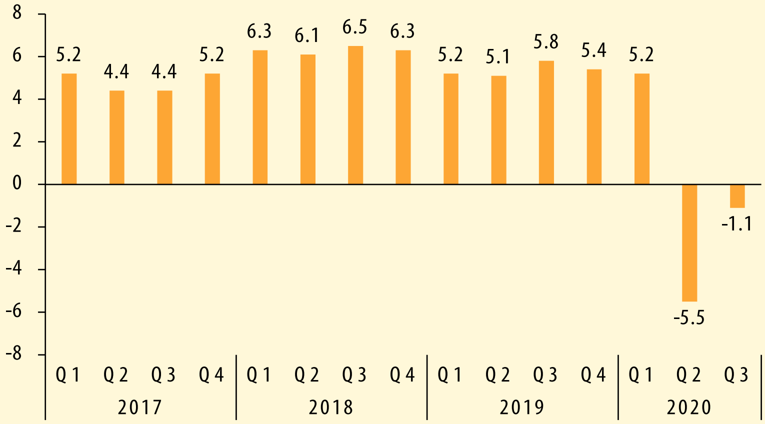
WHO/FRANCIS KOKOROKO

At the beginning of the pandemic, it would be wrong to imagine that its effects on the economies across the globe would reach levels reported currently. Even as the world comes to terms with its unprecedented effects that have differed from one country to another, and within each country, one sector to another, Kenya's experience is not any different.

As policymakers and analysts remain uncertain on the extend of disruptions that the pandemic continues to cause, the most critical question is, which policy levers will sustain some level of economic activity, and thereafter lift the hope of a stronger and sustainable recovery. Here, we discuss the economic outcomes of 2020 and explore the potency of both fiscal and monetary policy to anchor a stronger recovery of the Kenyan economy.

In 2020, despite the decisive and strong supportive fiscal, monetary policy and other banking sector measures deployed in March 2020, we observed a precarious economic situation characterized by double dips in the second and third quarters. Right on the heels of a strong growth outcome of 5.2 percent in the first quarter of 2020, the economy contracted by 5.5 percent in Q2 and by 1.1 percent in Q3 (**Figure 1**). With evident deceleration in the dips, Q4 performance will lift or tilt the scales for the annual growth outcome. Assuming no revisions in the previous data published by KNBS, to deliver the estimated 0.6 percent growth for the full year (IMF, 2021), will require Q4 to register a 3.7 percent growth. The feasibility of this outcome, in our view, remains far-fetched and unrealistic, given that the economy continued to face the challenges meted out by the pandemic.

Figure 1:
Quarterly Economic Growth



Source: KNBS

LEILA NAVIDI

Stronger Growth

A notable outcome in the economy was the improvement in GDP growth in Q3 (given its smaller contraction compared to Q2), supported by a stronger growth in agriculture and construction sectors, even as the services sector remained depressed. Agriculture, backed by more favourable weather conditions across the country, grew by 6.3 percent in Q3 compared with a 5.3 percent growth over a similar period in 2019. The construction sector expanded by 16.2 percent compared with a growth of 6.6 percent in Q3 of 2019. The services sector contracted by 5.5 percent in Q3, mainly reflecting a 57.9 percent contraction in accommodation and restaurant services which was attributed to the effects of COVID-19 containment measures that saw complete /partial closures of enterprises. Other services such as transport and storage, registered some recovery, to grow by 2.9 percent in Q3, compared with a contraction of 11.9 percent in Q2 as containment measures of movement across the regions of the country were eased.

Table 1:
Real GDP Growth by Broad Categories

	2019				2020		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Overall	5.2	5.1	5.8	5.4	5.2	-5.5	-1.1
Agriculture	4.0	2.0	5.0	3.6	5.8	7.3	6.3
Non-Agriculture	5.6	6.0	6.0	5.8	4.9	-9.2	-2.7
Services	*6.4*	*6.7*	*6.7*	*6.8*	*5.5*	*-11.6*	*-5.3*
• *o/w Food & Accommodation*	*11.0*	*12.1*	*9.9*	*9.0*	*-9.3*	*-83.2*	*-57.9*
• *Transport & Storage*	*6.4*	*7.6*	*7.6*	*9.2*	*6.1*	*-11.4*	*2.9*
Industry	*4.1*	*5.5*	*5.0*	*4.0*	*4.4*	*-0.5*	*4.9*
• *o/w Construction*	*6.1*	*7.2*	*6.6*	*5.7*	*5.3*	*3.9*	*16.2*

Source: KNBS & CBK

PEXELS/ JUHAS IMRE

The economy appears to have retreated to dependence on agriculture, reversing the gains that had been made towards dependence on services and industry.

In our assessment, the economy appears to have retreated to dependence on agriculture, reversing the gains that had been made towards dependence on services and industry. While the reprieve provided by agriculture is commendable on grounds on economic diversification, the attendant risks in agriculture – with the sector being predominantly rain-fed - therefore abound. Further, the sector absorbs less than 5 percent of credit to the private sector, implying that the sector's growth is largely a temporary reprieve. In this regard, to anchor the country's medium-term growth on the recovery of services and industry is paramount.

Other developments of relevance to signal economic growth outcomes in 2020 show that growth in commercial banks' private sector lending tapered off at below double-digit levels after August 2020. Such credit outcomes are sub-optimal given the credit requirements needed to support a strong and sustainable economic recovery going forward. The question then is, *what policy options must be considered to steer the economy out of the depression, and anchor stronger growth going forward?*

From the foregoing, we review the policy levers within the purviews of fiscal and monetary policies. Based on our view, the policy measures that need to be taken to place the economy on its strong footing in 2021 should lean more on monetary and its supportive measures than on fiscal policy. The latter's room for manoeuvre has narrowed and remains constrained as debt build-up and its sustainability concerns emerge. The announced fiscal consolidation policy over the medium term that appears to lean more on domestic revenue mobilisation may not be realized, given the delayed recovery of the economy on account of the protracted uncertainty with regard to the containment of the pandemic. In this regard, there is some potency in monetary policy especially if it is targeted at addressing some existing structural impediments that continue to affect the credit market.

Conventional monetary policy would call for a further cut in the interest rates, but concerns emerge on rising inflation, the impact of this move on the foreign exchange market, and capital flows on the back of any potential adverse interest rate differential. Furthermore, additional liquidity to the system, that is already liquid, may not have any desirable impact on the economy given that its marginal effects continue to approach zero (if not breaking towards the negative territory). In this regard, monetary policy must be augmented by some targeted structural prudential measures.

Removing Hinderances

In essence, the liquidity in the system needs to be *'pushed through the pipeline'.* To do this, the only feasible measure is to increase the 'pressure in the pipeline to either pull or push the liquidity'. As at end 2020, there was effectively excess demand for liquidity, particularly by sectors adversely affected by the pandemic. With this, the onus is on facilitating the supply side to push the liquidity to the economy. This will require removing any hindrances to credit flows, akin to cleaning up the pipe to allow easy flow of liquidity. A strong hindrance to credit flow at the moment is its constraining price.

Universally, any mispricing can introduce deadweight losses, exhibited typically in inefficient allocation of resources, which eventually hurt the economy. Such undesirable market outcomes, as proponents of free-market economies would argue, can be corrected through putting in place an incentive structure for suppliers of credit which on-boards risk considerations on the price to trigger a reallocation of resources.

In the face of elevated credit risk, fast-tracking the adoption and implementation of risk-based pricing will definitely deliver stronger credit growth outcomes by accommodating segments deemed to be riskier, such as the Micro, Small and Medium Enterprises.

"There is some potency in monetary policy especially if it is targeted at addressing some existing structural impediments that continue to affect the credit market.

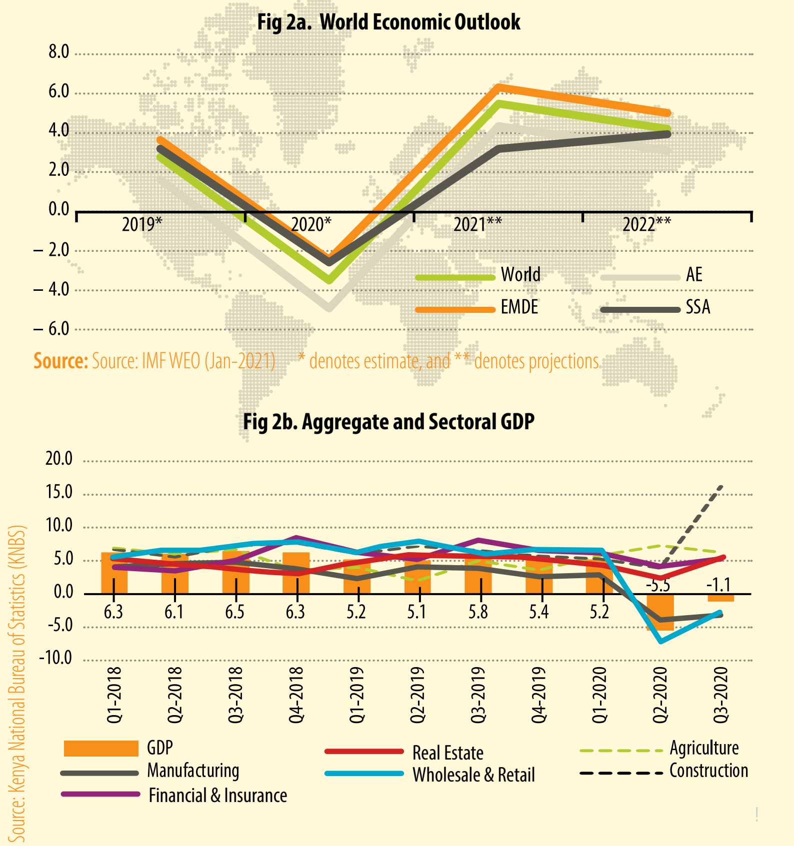
PEXELS/ TRACE HUDSON

***Dr. Samuel Tiriongo is the Director of the KBA Centre for Research on Financial Markets and Policy®**

State of the Economy

The global and domestic economic recovery is underway but remains partial and uneven, and its outlook extremely uncertain (Figure 2). According to IMF, in its *World Economic Outlook (2021)*, after the unprecedented sudden shock in the first half of 2020, some recovery was noted in the second half. The global economy is estimated to have contracted by 3.5 percent in 2020. The performance of the global economy has a direct bearing on the performance of the domestic economy. Following a strong economic performance in the first quarter, the domestic economy recorded a double dip in activity in the second and third quarters contracting by 5.5 percent and 1.1 percent, respectively. The lacklustre performance of the economy in the first three quarters of 2020 continued to cloud its full-year performance. The IMF (2021), based on the existing leading indicators, estimates that the economy contracted by 0.1 percent in 2020, reflecting a substantial output gap.

Figure 2.
Trends in Aggregate and Selected Sectoral Growth



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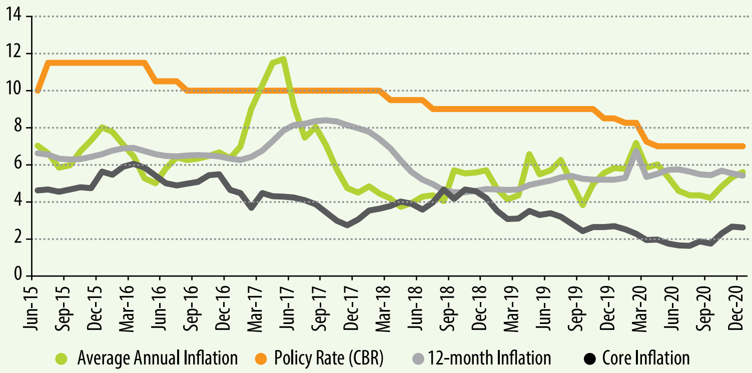
The impact of the pandemic across the key sectors of the economy was heterogeneous. In particular, contactless sectors, such as the agriculture sector, depicted more resilience than contact-intensive services sectors, with the latter heavily depressed by the pandemic's containment measures. The reopening of businesses and relaxation of COVID-19 containment measures in the second half of 2020 was accompanied by a recovery of activity, particularly in the third quarter. However, a continued high COVID-19 caseload constrained the normalization of economic activity in the fourth quarter.

On the back of reduced COVID-19 containment measures and the expected mass reopening of learning institutions in early 2021, the economy was projected to recover by 7.6 percent in 2021 (IMF, 2021). This recovery was, however, anchored on the pace of vaccine rollout of across the globe.

"The impact of the pandemic across the key sectors of the economy was heterogeneous. In particular, contactless sectors, such as the agriculture sector, depicted more resilience than contact-intensive services sectors.

Figure 3.
Central Bank Rate and Inflation Trends



Source: CBK

Given limited fiscal space, monetary policy remains a key policy lever to watch. Monetary policy conditions since the onset of the pandemic have been accommodative supported by low and stable inflation within the 5±2.5 percent target range (**Figure 3**). This resulted in a decline in interest rates during the period. Despite annual inflation being within the target range, it rose to 5.6 percent in December from 5.3 percent in November 2020, reflecting the impact of food and fuel price increases during the period. In particular, food and fuel inflation rates rose to 7.2 percent and 11.30 percent in December from 6.1 percent and 11.0 percent in November, respectively. The core inflation, that reflects the demand conditions in the economy, however, remained somewhat flat at about 2.6 percent over the period. The threat of inflation rising further remained real as global prices edged upwards with rising demand for oil following the reopening of major economies.

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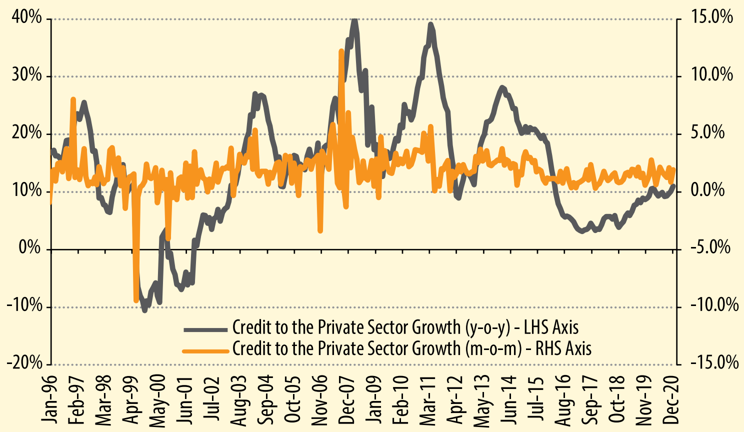
Bank lending has expanded, but its speed continues to taper off, despite the sustained accommodative monetary policy stance (Figure 4). The reduction in the Central Bank rate (CBR) from 8.25 percent to 7.00 percent in early 2020 yielded some moderate response in money market and loan rates and supported private credit growth during the year. Overall, private sector credit growth rose from 7.6 percent in September to 8.42 percent in December, largely supported by growth in credit to consumer durables (grew by 18.1 percent); agriculture (15.3 percent); transport and communication (13.6 percent); manufacturing (12.0 percent); and real estate (8.7 percent). This reflected a Ksh 33 billion growth in credit volume between October and December, which, if compared with an increase of about Ksh 40 billion between July and September 2020, meant a deceleration in the pace of loan expansion in the fourth quarter of 2020.

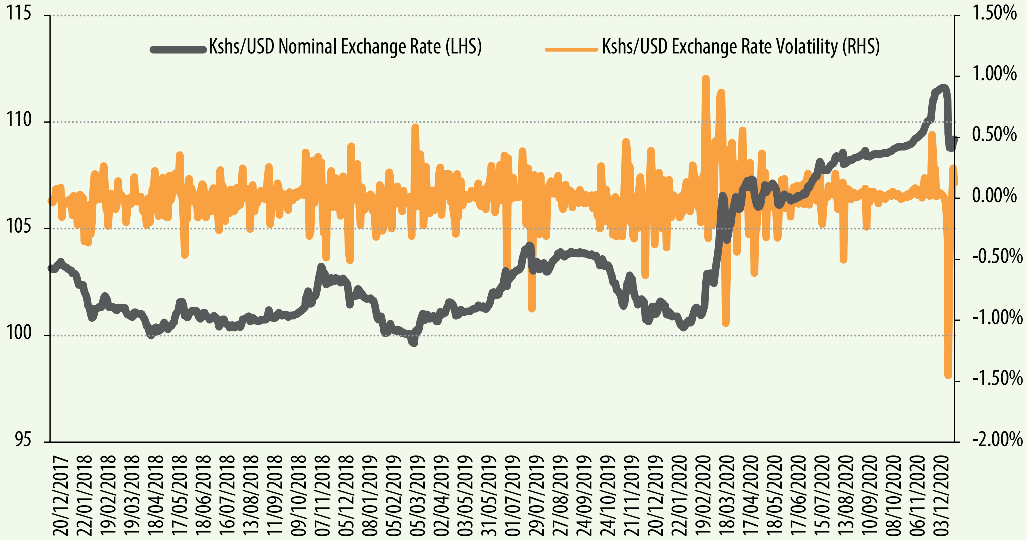
Figure 4.
Private Sector Credit and Growth Dynamics



Source: CBK

The domestic currency has relatively stabilized but continues to face headwinds. On the regional front, the shilling appreciated against several regional currencies in the fourth quarter of 2020. Since the start of 2020, the shilling was on a depreciating trend, amplified by uncertainty caused by the COVID-19 pandemic. As **Figure 5** shows, the shilling, while depreciating against the US dollar in the fourth quarter, did not depict high volatility. The exchange rate volatility was moderated by an adequate stock of foreign exchange reserves at 4.8 months of imports cover by the end of December 2020

Figure 5.
Kenya Shilling -US Dollar Exchange Rate Dynamics



Source: CBK

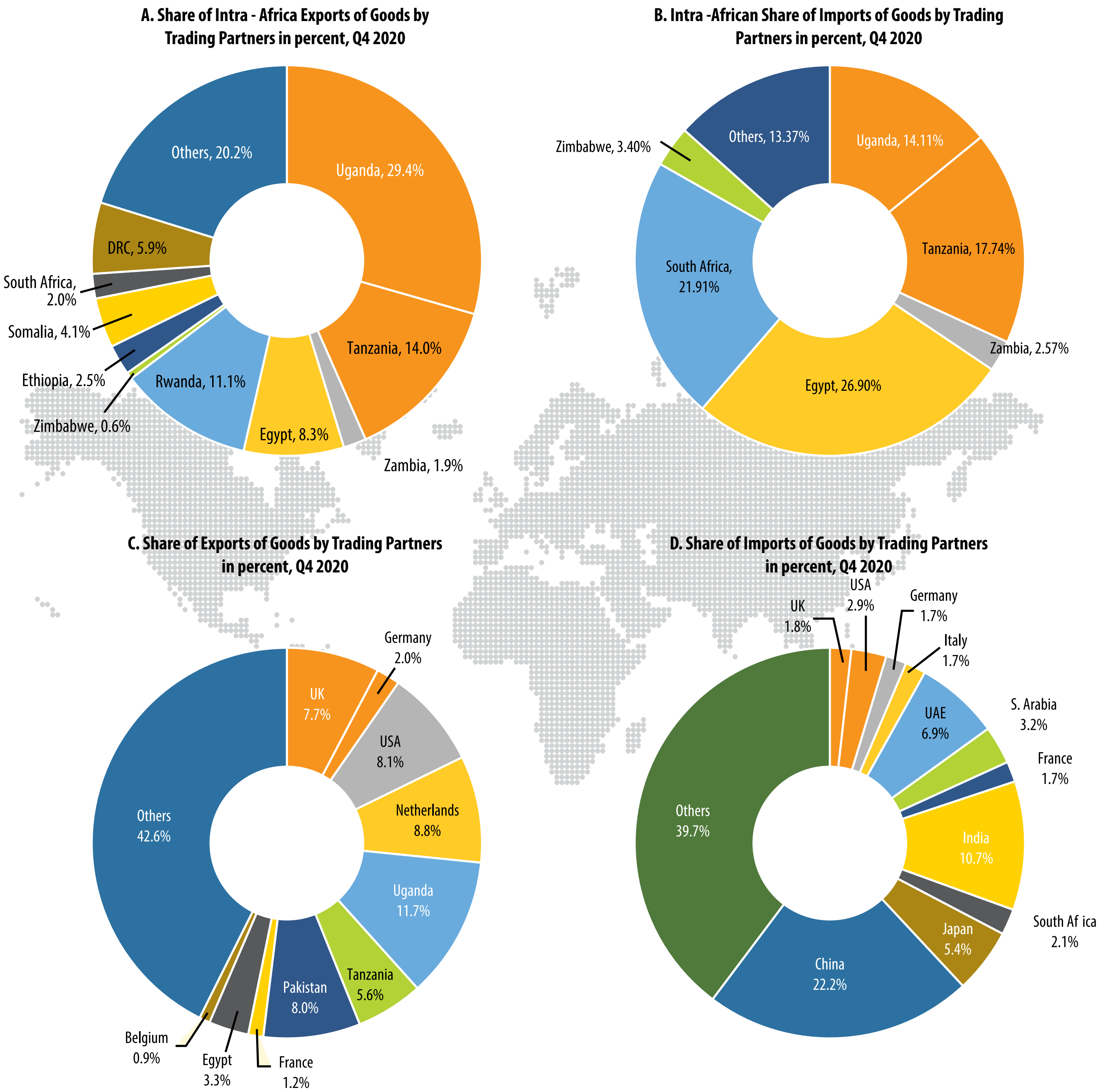
(compared to the statutory minimum of 4 months) and resilient inflows of diaspora remittances.

The outlook for trade remains positive, reflecting a recovery in exports as imports are subdued. The current account deficit was estimated at 4.8 percent of GDP in 2020, compared to 5.8 percent in 2019, mainly supported by a smaller oil import bill due to lower global prices, ongoing recovery in exports, especially of agricultural products with a pickup in demand in global markets, and continued resilience of remittances. On the one hand, exports edged up 34.45 percent in December 2020 compared to a similar period in 2019. On the other hand, imports also rose but by a smaller margin of 3.99 percent over a similar period, leading to a narrowing of the merchandise trade deficit.

While reflecting a reversal from the low activity due to the effects of the pandemic, the pickup in export trade activity remains concentrated in few markets. As **Figure 6** shows, in quarter four of 2020, intra-African trade, especially exports to Uganda, continued to dominate at 29.1 percent, followed by Tanzania and Rwanda at 14.0 percent and 11.1 percent, respectively. The level and structure of imports remained largely unchanged during the period. Intra-African imports were also dominated by Egyptian imports, accounting for 26.9 percent of total imports, while South Africa's imports accounted for 26.9 percent. Other significant sources of imports included Tanzania and Uganda, which accounted for 17.7 percent and 14.1 percent, respectively, during the period. On the global front, exports to the U.S.A, Pakistan and the Netherlands dominated, respectively, accounted for 8.60 percent, 8.0 percent and 8.8 percent during the period. China remained the primary single country import source for Kenya, accounting for 22.2 percent of total imports.

> **"Supported by a smaller oil import bill due to lower global prices, ongoing recovery in exports, especially of agricultural products with a pickup in demand in global markets, and continued resilience of remittances.**

Figure 6. Intra-African and Global Trade Developments



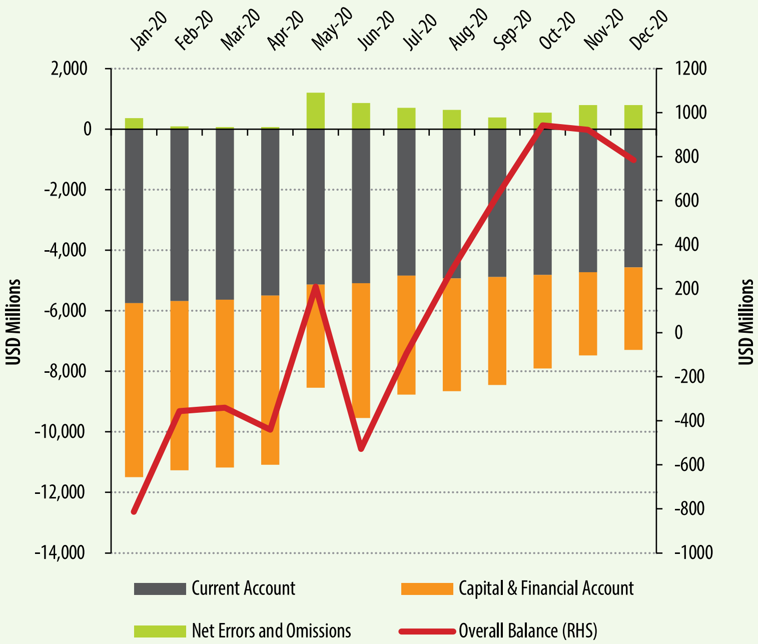
Source: CBK

Kenya's external position continues to weaken (Figure 7). On the one hand, the current account balance deficit registered some improvement in the second quarter to a deficit of KSh 82.2 billion was supported by the narrowing of the merchandise trade deficit by 32.5 percent. On the other hand, the balance of payments deficit widened with its outturn driven by the deterioration in the net inflow position that declined by 84.8 percent, thus outpacing the improvement in the current account balance.

Despite the turbulence occasioned by COVID-19, the banking sector remained stable and resilient in quarter four, underpinned by adequate capital and liquidity buffers. Capital adequacy ratios stood at (19.15 percent compared with a statutory minimum of 14.5 percent) and liquidity positions at 54.55 percent (well above the statutory minimum of 20 percent) in December 2020. The industry's total asset base continued to grow, albeit modestly, by 12.7 percent in 2020, largely driven by a 32.2 percent increase in investment in government securities and 11.5 percent growth of the loan book. Banking industry asset quality gains made in 2019 were partly eroded as the business environment remained subdued due to the effects of the pandemic. In December, the ratio of gross NPLs to gross loans deteriorated to 14.14 percent from 13.55 percent in October. Growth in NPLs was mainly noted in a number of sectors, mainly transport and communication, trade, real estate and agriculture.

Moreover, loans amounting to Ksh 1.63 trillion (or 54.2 percent of the total banking sector loan book of Ksh 3.0 trillion) had been restructured as of December 2020, reflecting adjustments in both tenures and interest payments. The banking sector remained profitable during the period, but the level of profitability declined. The industry's profit before tax fell by 29.1 percent to Ksh.112.8 billion in 2020 from Ksh.159.9 billion in 2019, with the decline attributed to faster growth in expenses (24.1 percent) than the growth in income (7.9 percent). With this, both the return on assets (ROA) and return on equity (ROE) during the period declined to 1.6 percent and 13.8 percent in 2020 from 3.3 percent and 21.8 percent in 2019, respectively.

Figure 7. Balance of the Payments Development

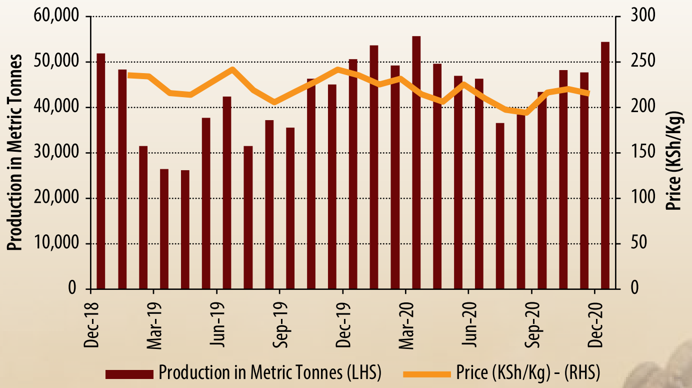


Sector Performance

Agriculture

Agricultural production continues to recover, with the sector's leading indicators registering impressive growth over the period. Tea production edged upwards (**Figure 8**), rising 5.85 percent on a year-on-year basis to 150,357 metric Tonnes in the fourth quarter of 2020 from 142,053 metric Tonnes in a similar period in 2019. Compared to quarter three's production of 118,492 metric Tonnes, tea production in quarter four rose 26.89 percent. Available data, however, show a decline in tea prices to Kshs. 214.85 per kilogram in October from Kshs. 220.18 per kilogram in September 2020; remaining comparatively lower than the prices reported over a similar period in 2019.

Figure 8:
Tea production and Prices



Source: KNBS

Tea and coffee exports depicted mixed performance during the fourth quarter of 2020 (**Figure 9**). On one hand, the volume of tea exports declined by 1.8 percent to 136,175 metric tonnes in quarter four from 138,610 metric tonnes in quarter three but increased by 5.9 percent from 128,624 metric tonnes in quarter four of 2019. In terms of value, tea exports contracted by 1.5 percent to Ksh. 30.849 billion in quarter four from Ksh. 31.33 billion in quarter four of 2019 but rose by 1.2 percent when compared to tea exports in the third quarter of 2020.

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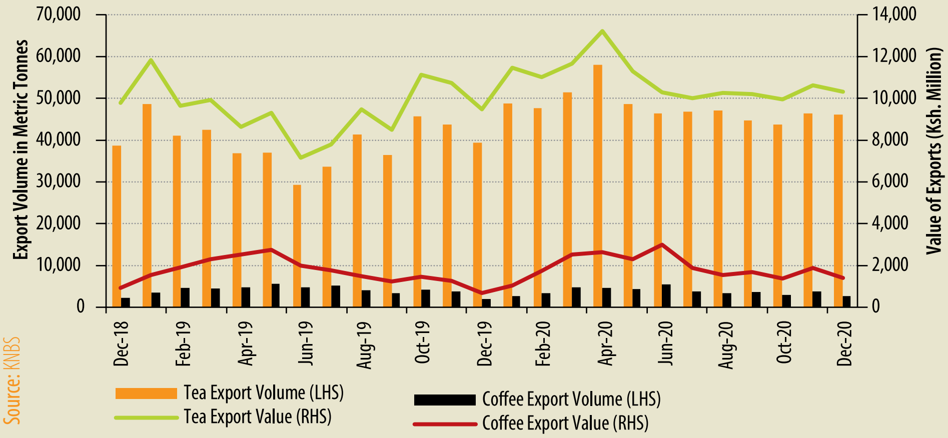
"Coffee exports contracted by 7.4 percent to 9,310 metric tonnes in quarter four of 2020 from 10,051 metric tonnes in quarter four of 2019.

Figure 9: Value of Tea and Coffee Exports

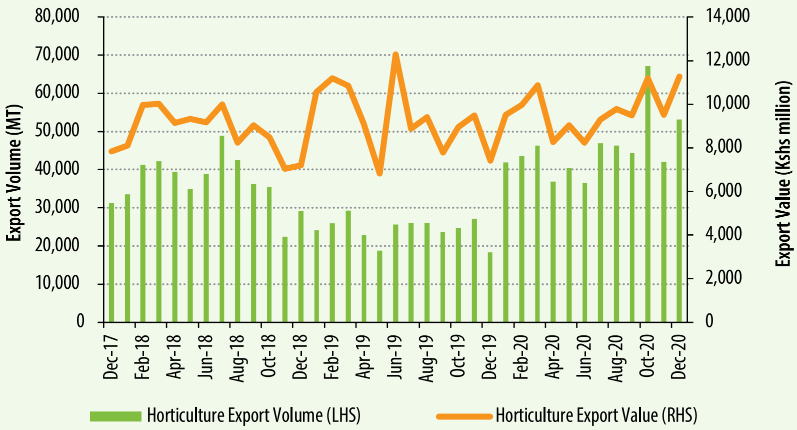


Source: KNBS

On the other hand, the volume of coffee exports contracted by 7.4 percent to 9,310 metric tonnes in quarter four of 2020 from 10,051 metric tonnes in quarter four of 2019. The coffee exports were also 12.5 percent lower in quarter four when compared to those reported in quarter three of 2020. In terms of value, however, coffee exports rose 37.0 percent from Ksh. 3.405 billion in quarter four 2019 to Ksh. 4.67 billion in quarter four of 2020, which reflected more favourable prices in 2020 compared to 2019. Despite this, the value of coffee exports in the third quarter was 8.6 percent higher than the value of exports in the last quarter of 2020.

Horticultural exports recorded a strong rebound in the fourth quarter (**Figure 10**). The volume of horticultural exports rose to 162,263.76 metric tonnes in quarter four 2020 from 137,628.57 metric tonnes in quarter three of 2020, representing a 17.90 percent rise. The fourth-quarter performance was 131.1 percent higher than that recorded over a similar period in 2019. In terms of value, horticultural exports rose by 23.7 percent to Ksh.31.98 billion during the last quarter of 2020 compared to a similar period in 2019. The fourth-quarter performance in value was 11.94 percent higher than of the third quarter of 2020.

Figure 10: Horticultural Exports



Source: KNBS

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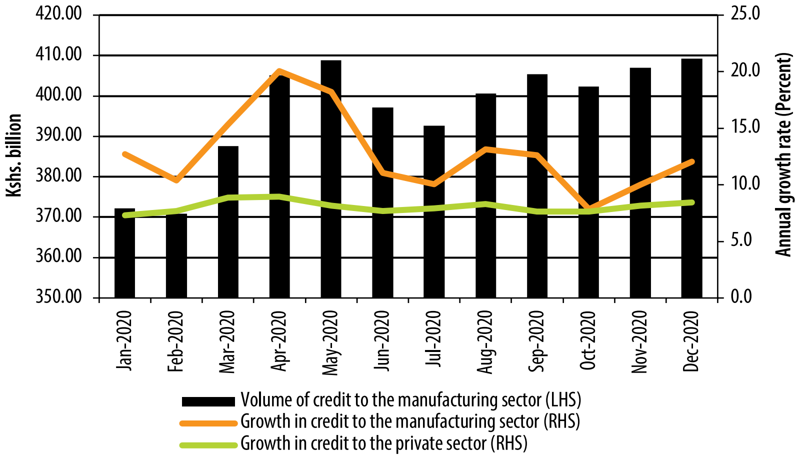
Manufacturing

Growth in the manufacturing sector remained positive. Since 2018, the sector's output has been softening. During quarter three of 2020, the sector's output contracted by 3.2 percent compared to 3.9 percent growth in a similar period in 2019. The contraction during the quarter was due, in part, to the contraction of activity in the food subsectors, particularly the manufacture of meat and meat products, liquid milk, wheat flour, beverages and other grain mill products. However, some improvement in the manufacture of edible fats and oils and cigarettes expanded in the review period. Manufacturing activity in the fourth quarter was also driven by growth in credit to the sector, which stood at 12.03 percent in December 2020; that was above the overall private sector credit growth of 8.42 percent over the same period (**Figure 11**).

Figure 11: **Credit to the Manufacturing Sector**



Source: CBK

Producer Price Index

The producer price index (PPI) was on an upward but modest trajectory, with the producer price inflation rate edging downwards. In September 2020, the Producer Price Index declined by 0.19 percent compared to a growth of 1.4 percent over the same period in 2019 (**Figure 12**). However, compared to June 2020, the producer price index increased by 0.48 percent in September 2020. The rise in the producer price index was on account of the increase in the cost of producing pharmaceuticals, medicinal chemical and botanical products, manufacture of motor vehicles, and manufacture of wood and wood and cork products except for furniture. However, the decline in the prices of manufactured motor vehicles and wearing apparel offered some respite.

Energy

Analyses of energy sector performance show a contraction in the total energy generation in the fourth quarter, even as the different energy sources posted mixed performances during the period (Figure 13). The composition of energy generation shows that during the fourth quarter of 2020, geothermal, hydro and wind energy accounted for 40.8 percent, 38.5 percent and 13.4 percent of total energy (3,010 KWH) during the period. Thermal energy accounted for 7.2 percent of total energy in the fourth quarter. While geothermal energy continued to dominate production, Hydro-electric power generation as a share of the total energy generated rose to 1,159 KWH; steadily increasing its share in total energy generated to 38.5 percent from 37.0 percent (1,071KWH) in the third quarter of 2020 and 32.5 percent (928KWH) in a similar period in 2019. However, geothermal energy production contracted by 1.9 percent in the last quarter of 2020 from its third-quarter levels when its share in total energy stood at 42.7 percent, and further from its quarter-four 2019 levels when its share stood at 50.3 percent. The wind energy generation's share reflected some improvement in the fourth quarter, from 12.7 percent in the third quarter of 2020 and 10.4 percent in the fourth quarter of 2019. Further, thermal energy generation contracted by 0.4 percent during the last quarter of 2020, with its share in total energy production at 7.2 percent compared to 7.6 percent in the third quarter. This was, however, higher than 6.8 percent share reported for quarter four of 2019.

Global crude oil prices rose, with evident pass-through effects to domestic pump prices during the period (Table 2). The Murban crude oil prices rose from US$ 40 in October to US$ 49 per barrel in December 2020, representing a 22.5 percent rise over the period, largely occasioned by the recovery in global demand as economic activity improved. On the domestic front, the average fuel pump prices, especially super petrol and kerosene, largely remained unchanged between November and December 2020. In contrast, the prices of diesel declined from Kshs. 94 per litre in October to Ksh 92 in November but edged up slightly to Kshs. 93 per litre in December 2020. The price of 13-kg Liquified Petroleum Gas (LPG), however, declined by 2.03 percent from Kshs. 2,018 in October to Kshs. 1,977 in December 2020; indicating that LPG prices do not mimic the movements in global oil prices.

Figure 12: Producer Price Index

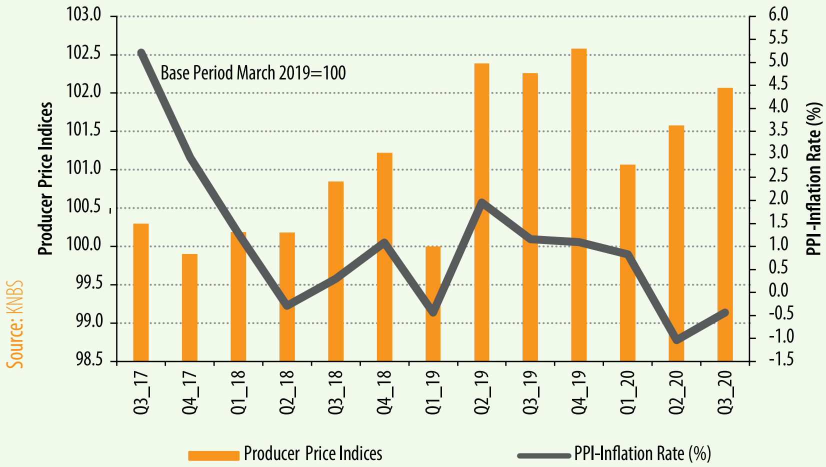


Figure 13. Monthly Electricity Generation by Source

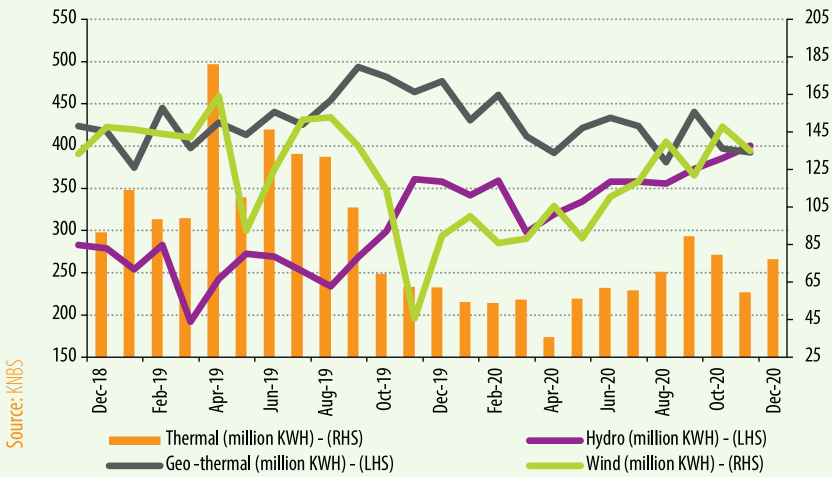


Table 2:
Average Monthly Crude Oil and Retail Fuel Prices

	Jan-20	Mar-20	Jun-20	Jul-20	Aug-20	Sep-20	Oct-20	Nov-20	Dec-20
Murban crude oil (US$/Barrel)	66.1	33.9	37.1	43.4	45.2	41.5	40.0	43.0	49.0
Super petrol (KES/Litre)	110.6	112.1	90.3	101.4	104.8	106.3	108.0	107.0	108.0
Diesel (KES/Litre)	102.8	102.9	75.9	92.8	95.6	95.5	94.0	92.0	93.0
Kerosene (KES/Litre)	104.5	96.7	63.8	66.4	84.6	84.1	85.0	83.0	85.0
LPG (13Kgs)	2144.8	2066.0	2078.5	2075.0	2060.2	2033.6	2018.0	2020.0	1977.0

Source: ADNOC oil prices and KNBS

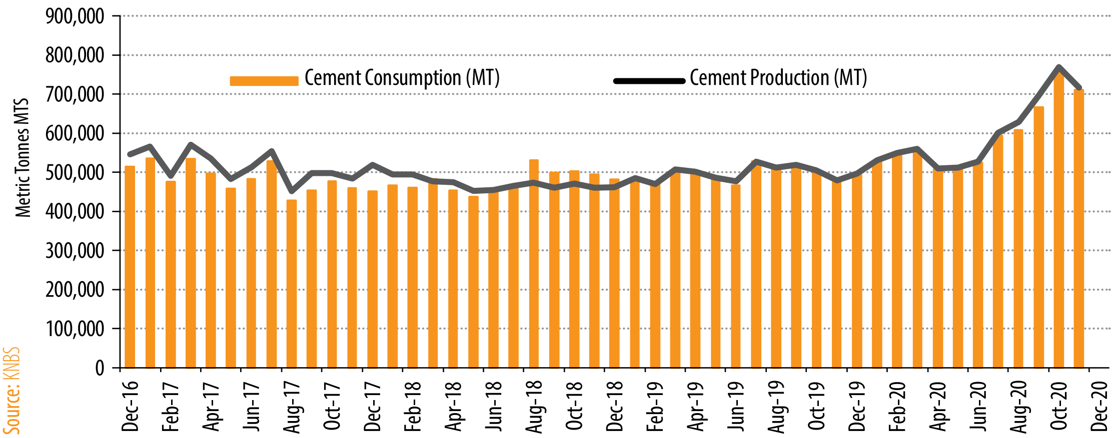
Building and Construction

Building and Construction sector activity rebounded in the fourth quarter, supported by growth in cement production and consumption. The construction sector recorded stellar performance in the third quarter of 2020 to grow by 16.2 percent compared to 6.6 per cent in the third quarter of 2019, supported by the growth in the volume of cement consumed. Cement consumption sustained an upward trend over the same period, although marginally declining in November 2020. The latest available data, covering the first two months of the last quarter of 2020, shows that cement production stood at 1,485,481 MTs and consumption at 1,471,454 MTs, compared with 983,700 MTs production and 973,430 MTs consumption over a similar period in 2019 (**Figure 14**).

Transport and Storage

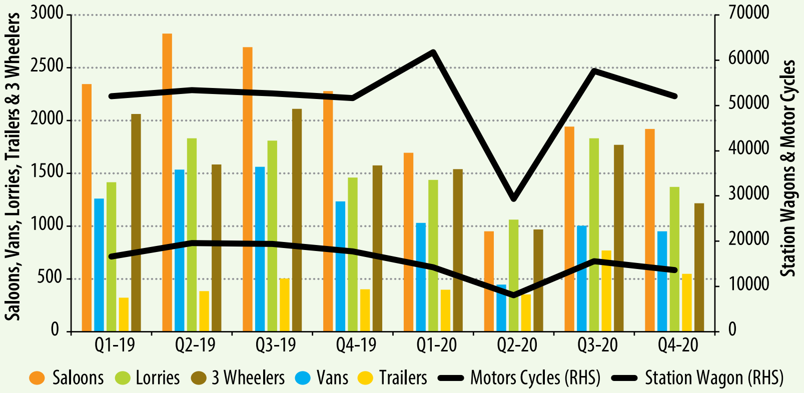
Despite the gradual easing of COVID-19 containment measures in the second half of 2020, the transport and storage sector recorded a sluggish recovery over the period. The sector grew by 2.9 percent in quarter three of 2020 compared to a 7.6 percent growth in a similar period in 2019 on account of a contraction in air transport and rail passenger transport services. Motor vehicles registration showed signs of recovery in the first two months of the fourth quarter. The number of saloons registered stood at 1,921 in October and November of 2020 compared to 1,941 saloons in the entire third quarter. The increase in motor vehicles registration was noted across all the categories, as station wagons registration during the two months rose to 952, vans at 952, lorries at 1,373, trailers at 550, and motorcycles and 3-wheelers at 52,060, and 1,215, respectively (**Figure 15**).

Figure 14:
Cement Production and Consumption



Source: KNBS

Figure 15:
Quarterly Motor Vehicles Registration

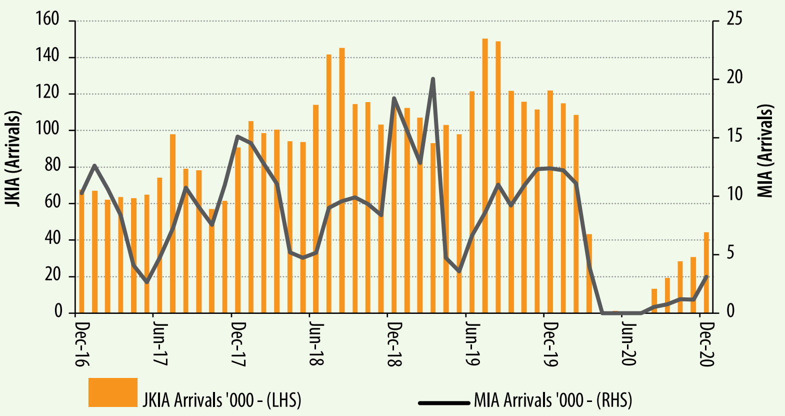


Source: KNBS

Tourism

Tourism, which had been depressed following the disruption of travel by COVID-19 containment measures, showed signs of recovery. Inbound tourist arrivals improved in the fourth quarter, following the relaxation of the pandemic containment measures- specifically the withdrawal of movement restrictions in and out of Nairobi and Mombasa counties and resumption of international flights from August 2020. In quarter four, total inbound tourist arrivals stood at 108,916, a three-fold increase from 34,701 arrivals in quarter three of 2020. Moreover, the inbound arrivals through JKIA stood at 103,449 in quarter four compared to 33,391 in quarter three and 249,288 arrivals in a similar period in 2019. Arrivals through Mombasa international airport (MIA) stood at 5,467 in quarter four (**Figure 16**). Despite the noted improvement, the tourist arrival numbers remained substantially below the pre-pandemic levels mainly attributed to the high prevalence of the pandemic in the country.

Figure 16:
Monthly Inbound Tourist Arrivals



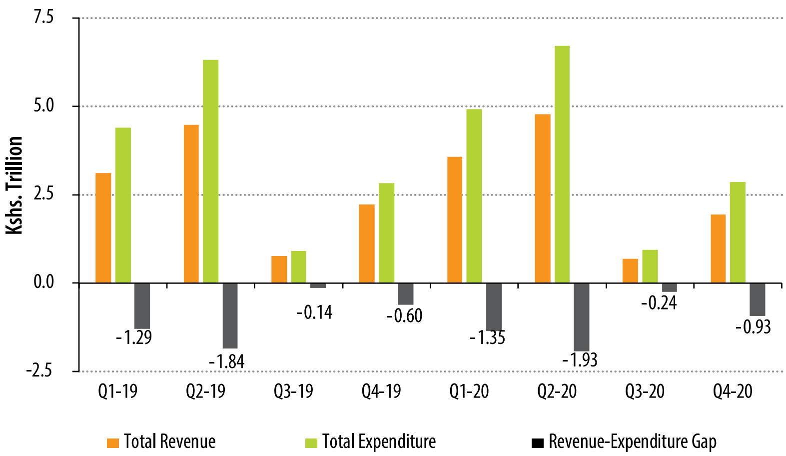
Source: KNBS

Financing of Government

Kenya's fiscal policy space during the third quarter remained narrow as the revenue-expenditure gap widened. While the government remains focused on maintaining fiscal sustainability and reducing debt-to-GDP to about 50 percent in the medium term, the COVID-19 shock adds to the government's fiscal pressures. With the pandemic adversely affecting nearly all economic activities and depressing government revenues, interventions adopted to mitigate the impact continued to widen the fiscal deficit. The actual fiscal deficit rose to 8.6% of GDP in the fiscal year 2019/20 from 7.8% of GDP in the 2018/19 fiscal year.

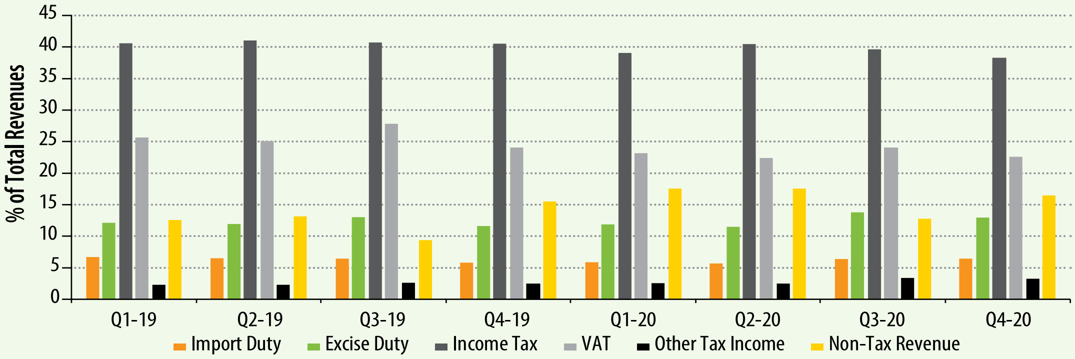
Following the outbreak of COVID-19 in the country, the revenue-expenditure gap widened in the second quarter of 2020, narrowed in the third quarter, but deteriorated in the fourth quarter, as shown in **Figure 17**. In particular, the deficit in the first quarter stood at Kshs. 1.35 trillion, widening to Kshs. 1.93 trillion in the second quarter. It, however, narrowed to Ksh 0.24 trillion in the third quarter as expenditure declined, before expanding to Kshs. 0.93 trillion in the fourth quarter, as the government spendiing increased.

Figure 17:
Quarterly Revenue-Expenditure Gap



Source: National Treasury

Figure 18:
Quarterly Revenue Structure

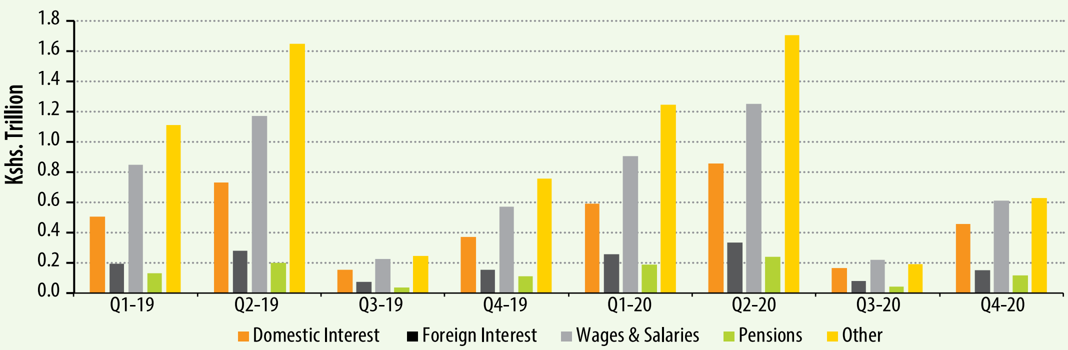


Source: National Treasury

The revenue mix reveals a static structure, with income tax and value-added tax (VAT) remaining the predominant revenue sources. Notably, the government's effort to widen the revenue base remains constrained, amid growing expenditure needs. Income tax remains the largest single source of government revenue, accounting for 38.3 percent of total revenue in quarter four of 2020. Compared with its share of 39.6 percent in the third quarter and 40.7 percent in the fourth quarter of 2019, this represents a marginal decline. Value-added tax (VAT) account for about one-fifth (22.6 percent) of government revenue, while excise duty and import duty accounted for 12.9 percent and 6.4 percent, respectively. During the same period, non-tax revenues accounted for 16.5 percent (**Figure 18)**.

Similarly, the expenditure structure remained largely unchanged, with wages and salaries, and foreign interest payments dominating. As **Figure 19** shows, wages and salaries stood at Kshs. 0.6 trillion accounting for 31.1 percent of the total expenditures in quarter four of 2020 compared to 37.7 percent in quarter three. Foreign and domestic interest expenses during the period were Kshs. 0.15 trillion and Kshs. 0.45 trillion, respectively, accounting for 31.1 percent in the fourth quarter of 2020, compared to 35.0 percent in the third quarter and 26.7 percent in a similar period in 2019. Expenditure on pensions grew three-fold over the period to Kshs. 0.11 trillion compared to Kshs. 0.04 trillion in quarter three, to account for 5.9 percent of the total expenditures in quarter four.

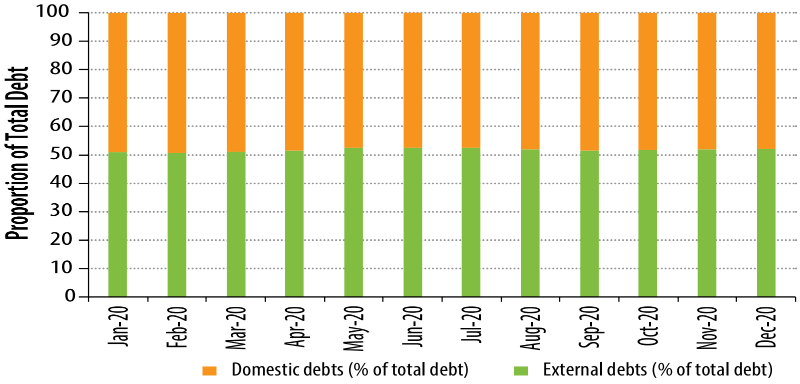
Figure 19:
Quarterly Expenditure Structure



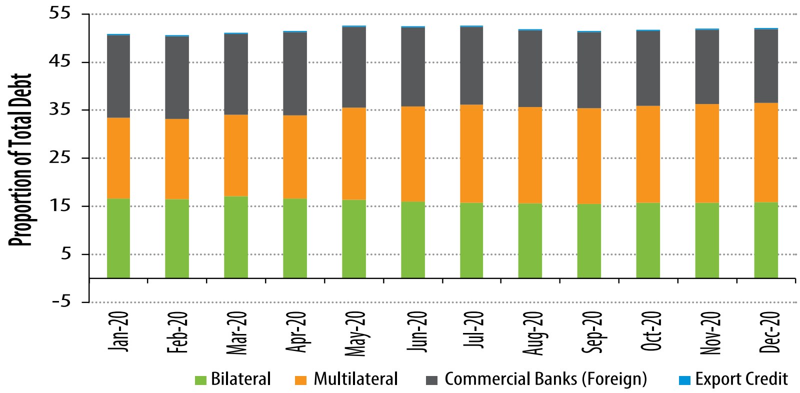
Source: National Treasury

Figure 20:
External and Domestic Debt and its Composition

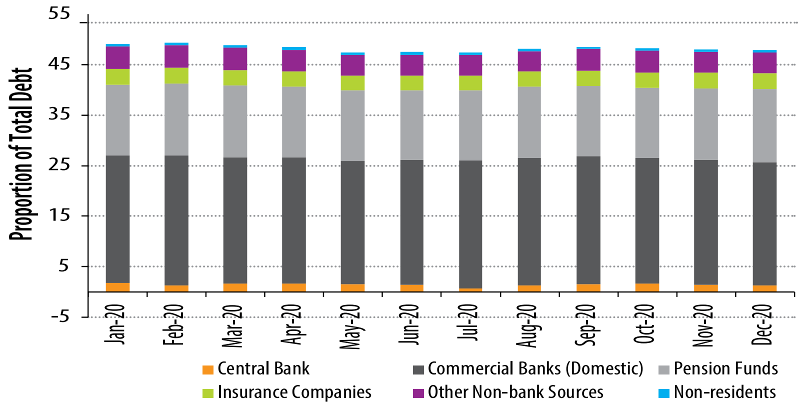
A. External and Domestic Debt Composition



B. Composition of External Debt



C. Composition of Domestic Debt



Public Debt

The distribution of outstanding government debt between domestic and foreign sources reveals a sustained balance. Kenya's stock of debt stood at Kshs. 7.2 trillion in December 2020. An analytical breakdown of the public debt analysis reveals that domestic and external debt account for 47.91 percent and 52.09 percent, respectively (**Figure 20A**). From the expenditure analysis in **Figure 19**, debt servicing charges on the domestic debt stock were about three times higher than on the external debt stock. Further disaggregation of the external debt by lender reveals that multilateral debt accounted for 20.58 percent, while bilateral and commercial banks external debts accounted for 15.89 percent and 15.37 percent in total debt, respectively. Export credit accounted for 0.25 percent of the total debt (**Figure 20B**).

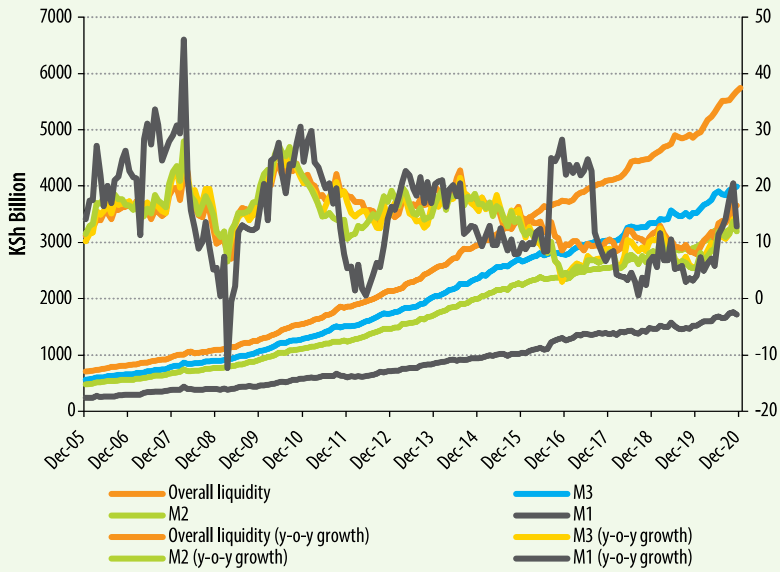
Analyses by domestic debt by lender shows that the Central Bank debt accounted for 1.36 percent, domestic commercial banks debt accounted for 24.30 percent, as pension funds, insurance companies and other entities represented for 14.53 percent, 3.08 percent, and 4.18 percent, respectively (**Figure 20C**). A faster growth in debt has several implications; it erodes investor confidence, especially on concerns of its sustainability and may result in the government paying a higher risk premium on its debt and limits the fiscal space for a manoeuvre to support the economy.

> **The distribution of outstanding government debt between domestic and foreign levels reveals a sustained balance**

Money Supply

Monetary aggregates growth in the fourth quarter of 2020 remained robust. As **Figure 21** shows, overall liquidity continued to improve, rising by 16.55 percent year-on-year basis in December 2020 to Kshs. 5,742.70 billion compared to Kshs. 5,519.78 billion in September and Kshs. 4,927.14 billion in a similar period in 2019. Similarly, broad money (M3) edged upwards by 13.25 percent on a year-on-year basis to Ksh 3,990.90 billion in December 2020 from Kshs. 3,843.50 billion in September 2020 and Kshs. 3,524.03 billion in December 2019. Moreover, quasi-money (M2) also increased to Kshs. 3,250.22 billion in December 2020 from Kshs. 2,904.35 in December 2019, representing 11.91 percent annual growth. Narrow money (M1) also registered a significant increase to Kshs. 1,720.34 billion in December 2020, from Kshs. 1,665.78 billion in September of 2020, and Kshs. 1,525.24 billion in December 2019.

Figure 21:
Trends in Monetary Aggregates

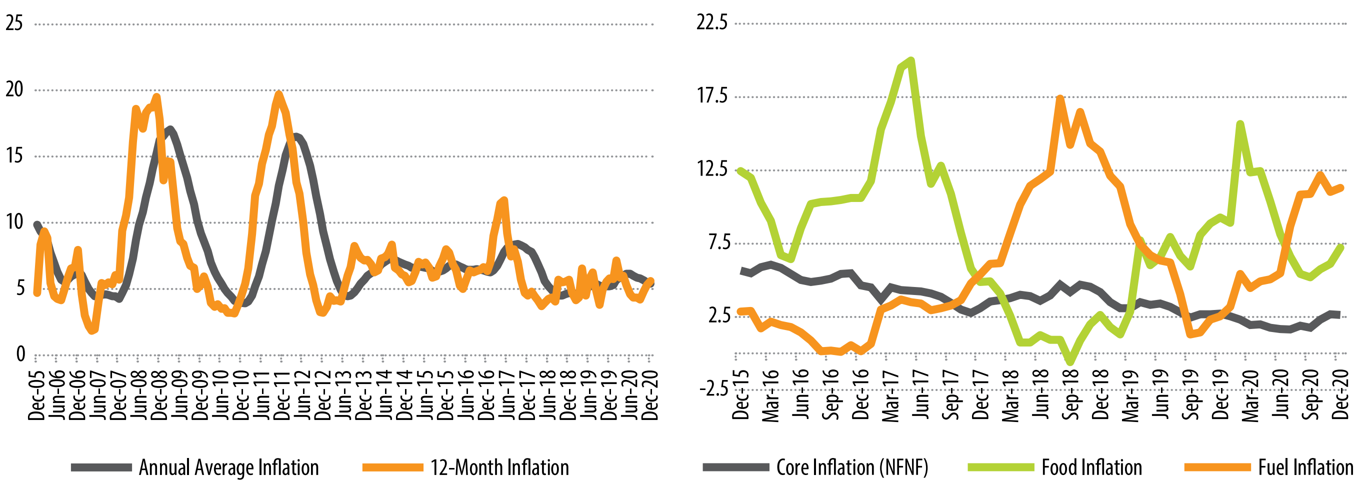


Inflation

Some signs of inflationary pressures are beginning to emerge, mainly driven by food and fuel price increases. During the fourth quarter of 2020, inflation remained around the midpoint of its target range, given as 5±2.5 percent. The 12-month (annual) inflation rate, as **Figure 22** shows, rose to 5.6 percent in December 2020 from 5.3 percent in November 2020, in part due to a surge in global oil prices, food inflation and a relatively weaker currency. In particular, food and fuel inflation rose to 7.2 percent and 11.30 percent in December compared to 6.1 percent and 11.0 percent in November. Core inflation (excludes food and fuel inflation), which reflects demand conditions in the economy, remained somewhat flat at 2.6 percent over the period. Underlying price pressures generally remained mild, as the pandemic constrained demand in the economy. Nonetheless, one-off factors, such as reopening in sectors previously subject to containment measures and indirect tax changes, continued to exert upward pressure on inflation.

Figure 22.
Inflation Dynamics

A. Inflation Dynamics **B. Inflation by Broad Categories**

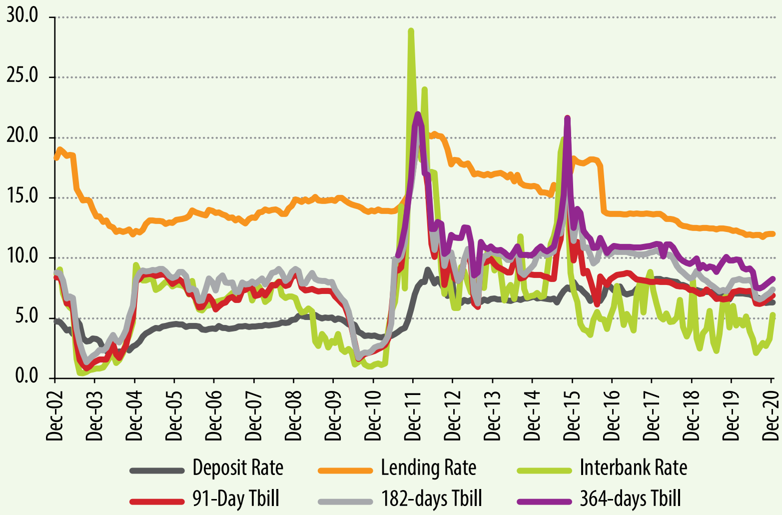


Source: CBK

Interest Rates

Monetary conditions since the onset of the pandemic have been accommodative, resulting in declines in the market interest rates. Following the easing of the monetary policy stance, which saw the CBR reduced from 8.25 percent to 7.0 percent in early 2020, there was a moderate decline in the market interest rates. However, in quarter four of 2020, money market rates and lending rates edged up slightly (**Figure 23**). The interbank market rate rose by 234 basis points to 5.29 percent in December from 2.95 percent in September 2020, reflecting a tightening of liquidity conditions. Similarly, the average yield rate for short-term government securities was also on the rise. The 91-day Treasury bill rate rose 61 basis points from 6.29 percent in September to 6.90 percent in December, while the 182-day Treasury bill rate rose by 68 basis points from 6.70 percent to 7.38 percent over the same period. The rise in both the interbank market and short-term government securities rates, which primarily reflect the interbank market liquidity and government borrowing requirements, suggest a tightening of the markets' liquidity position. Consequently, the average lending rate increased by 27 basis points, as the average deposit rates edged further downwards by 11 basis points, thus widening the interest rate spread by 38 basis points.

Figure 23:
Interest Rates Dynamics



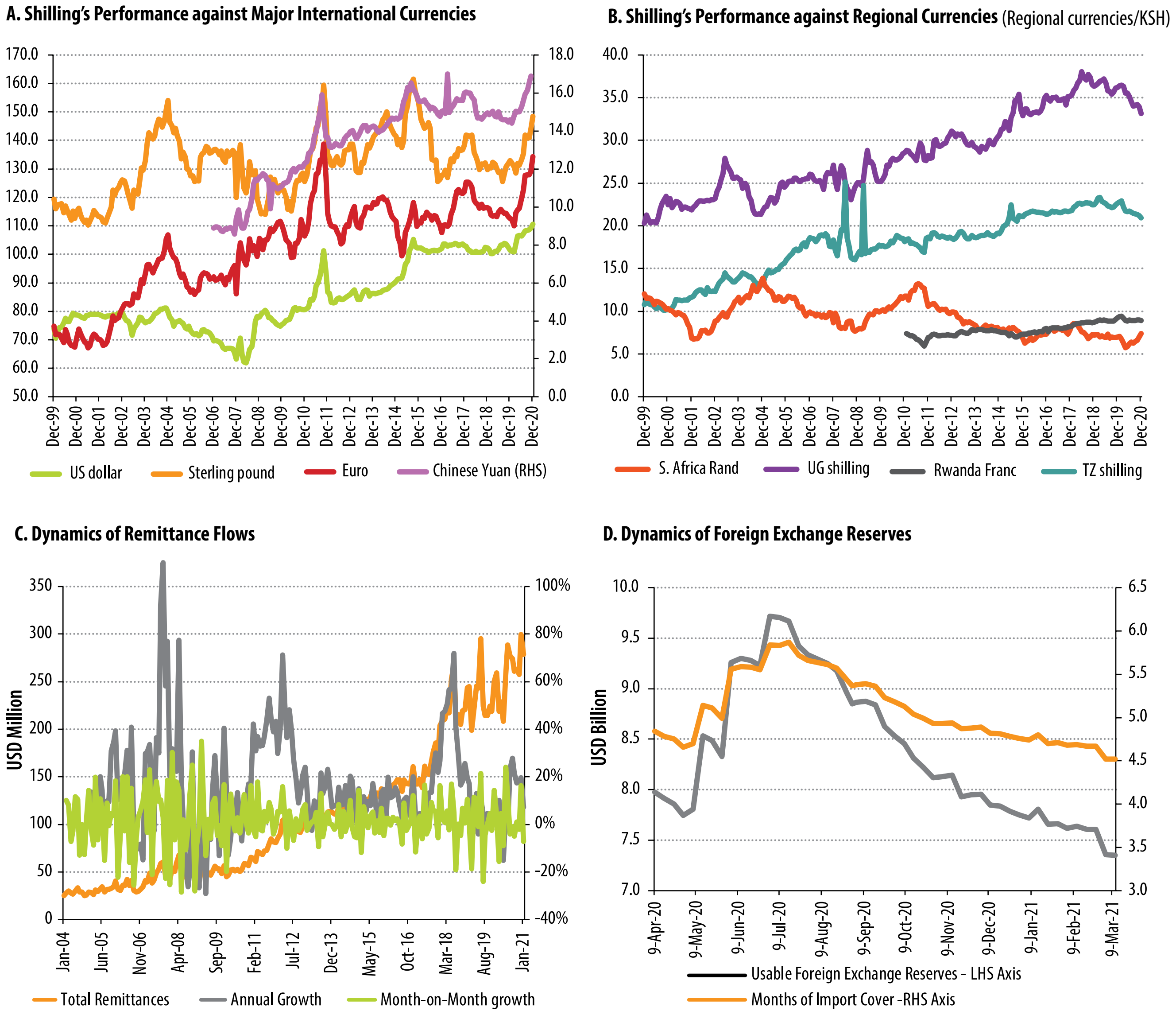
Source: CBK

Exchange Rates

Exchange rates continued to come under pressure even as signs of its stability emerged (Figure 24). On the regional front, the shilling remained strong against several regional currencies in quarter four of 2020. Since the start of 2020, the shilling has been on a depreciating trend, amplified by uncertainty due to the global pandemic. The shilling during the period buoyed by adequate (though on a declining trend) volumes of official foreign exchange reserves equivalent to 4.8 months of imports cover by the end of December 2020 (compared to the statutory minimum of 4 months) and resilient inflows of diaspora remittances. These coupled with a narrowing current account deficit, eased pressure on the exchange rate even as the Central Bank sustained its accommodative monetary policy stance.

"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.

Figure 24:
Exchange Rate Developments



Source: CBK

Balance of Payments

The balance of payments position showed significant improvements in December relative to its position in September 2020. As **Figure 25** shows, the overall balance reflected a surplus of USD 784.3 million compared to USD 622.1 million in September. This improvement was supported by an improvement in the current account balance, whose deficit narrowed from USD 4,882.7 million in September to USD 4,564.0 million in December 2020 on account of a lower import bill and more robust diaspora remittance inflows. The financial account also posted a narrower deficit of USD 2,850.5 million in December 2020 compared with USD 3,726.2 million in September. However, the improvement in the overall balance of payments position was tempered by a deterioration in the capital account balance to USD 130.4 million in December from USD 155.1 million in September 2020.

Figure 25:
Balance of Payments

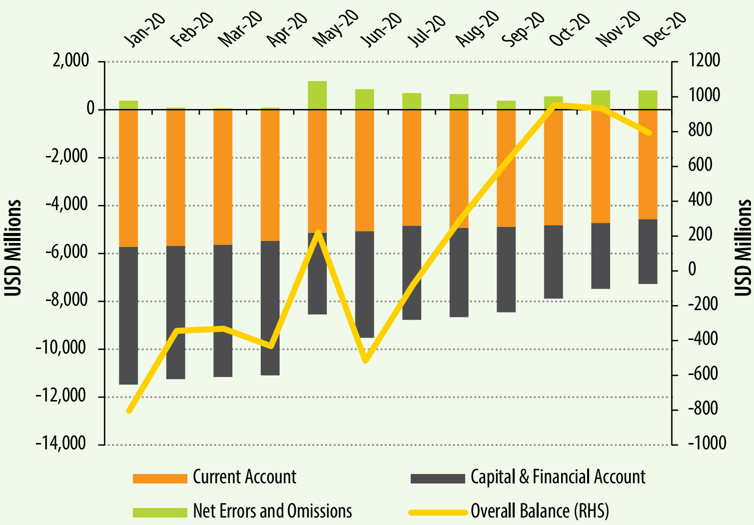


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Table 3: Nairobi Securities Exchange Leading Indicators

	Apr-20	May-20	Jun-20	Jul-20	Aug-20	Sep-20	Oct-20	Nov-20	Dec-20
NASI (2008=100) Points	139.69	137.13	137.68	133.23	139.68	139.89	140.04	145.20	152.11
NSE 25 Share Index	3292.64	3203.94	3217.11	3059.56	3223.79	3258.78	3170.87	3264.15	3415.24
NSE 20 Share Index (1966=100) Points	1958.07	1948.08	1942.12	1804.10	1794.85	1852.29	1783.68	1759.93	1868.39
Number of Shares Traded (Million)	439.03	430.26	552.55	517.07	470.56	524.53	219.42	381.00	369.13
Equities Turnover (KSh Million)	12659.61	14573.20	12301.61	13469.60	10543.37	13923.59	5880.91	11393.00	10236.93
Market Capitalization (KSh Billion)	2135.01	2095.92	2105.36	2036.04	2144.43	2147.74	2150.06	2229.00	2336.70

Source: NSE

Capital Markets

Activity at the Nairobi Securities Exchange remained bearish in the fourth quarter, even as volatility eased. However, the leading indices showed less volatility in quarter four than the other periods in the year. As shown in **Table 3**, the performance of the securities exchange reflected in movements in the NASI, NSE-25 and NSE-20 indices, showed some vibrancy of the capital market at its highest in December 2020. This followed depressed activity since the onset of the pandemic in the country, which peaked in April 2020. The NASI index improved from 139.89 points in September to 152.11 points in December. The NASI index's volatility in the fourth quarter of 2020 declined to 0.52 percent, measured by 3-month intra-month standard deviations of the index, compared to 0.63 percent in quarter three of 2020.

A similar trend was evident for both the NSE-25 and NSE-20 index, which rose to 3,415.24 points and 1,868.39 points in December from 3,258.78 points and 1,852.29 points in September, respectively. The average NSE-20 Share volatility Index stabilized in quarter four of 2020, having declined from 0.59 percent in quarter three to 0.35 percent in quarter four of 2020. However, the number of shares traded declined to 369.13 million in December 2020 from 524.53 million in September. Equities turnover followed a similar pattern, declining to Kshs. 10,236.93 million from Kshs. 13,923.59 million in September 2020. The Equity market capitalization, however, rebounded to Kshs. 2,336.70 billion in December 2020 from Kshs. 2,147.74 million in September.

NSE

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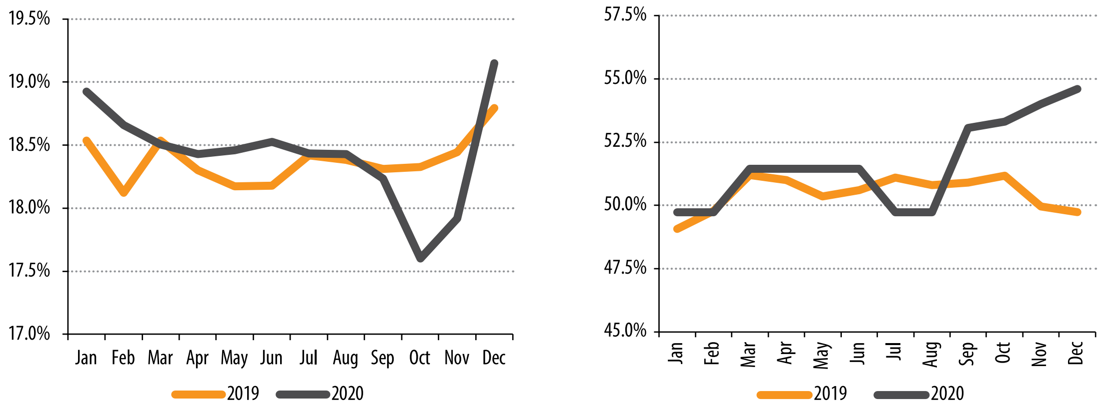
Banking Sector

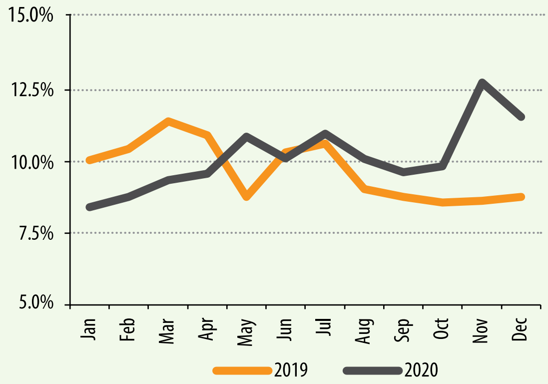
Despite the turbulence occasioned by the Covid-19, the banking sector remains stable and resilient in quarter four, underpinned by adequate capital and liquidity buffers (Figure 26). The banking industry total capital adequacy and core capital adequacy ratios respectively stood at 19.15 percent and 14.5 percent (above respective statutory minimums of 14.5% and 10.5%) in December 2020. In addition, the average liquidity ratio of the banking sector was 54.55 percent as at the end of December 2020, well above the statutory minimum of 20 percent. These buffers provided banks with adequate headroom to absorb more risk and accommodate borrowers with loan extensions and additional loans during the pandemic period as the effects of the pandemic persisted. Nonetheless, the banking sector asset quality continued to deteriorate, reflecting the adverse impact of the pandemic on the ability of borrowers to service their loans.

Figure 26:
Banking Sector Developments and Dynamics

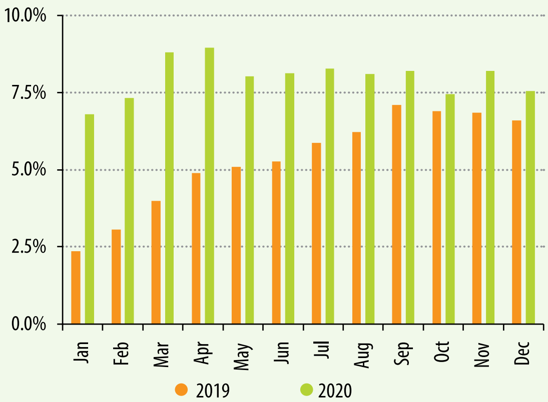
A. Capital Adequacy Ratios **B. Liquidity Ratios**



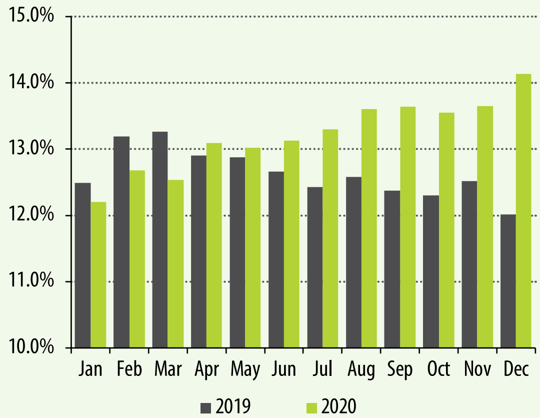
C. Growth in the Asset Base



D. Growth in Credit to the Private Sector



E. Asset Quality



Despite a deteriorating quality of assets, the industry's total asset base continued to grow, reflecting growth in both investments in government securities and the loan book. The total assets grew by 12.2 percent in December 2020, driven by a 32.2 percent increase in investment in government securities and 11.5 percent growth of the loan book (**Figure 26C**). Investment in government securities grew from Ksh.1.2 trillion in 2019 to Ksh.1.6 trillion in 2020, as loans and advances increased from Ksh.2,690.6 billion in 2019 to Ksh.2,999.5 billion in 2020. Between October and December 2020, the stock of credit to the private sector increased by about Ksh 33 billion on a net basis, compared with a growth of about Ksh 40 billion between July and September 2020, reflecting the deceleration in the pace of loan expansion in the fourth quarter.

Private sector credit growth rose from 7.6 percent in September to 8.42 percent in December, largely supported by growth in credit to consumer durables (grew by 18.1 percent); agriculture (15.3 percent); transport and communication (13.6 percent); manufacturing (12.0 percent); and real estate (8.7 percent).

Asset quality, however, continued to deteriorate with the ratio of gross NPLs to gross loans rising to 14.14 percent in December from 13.55 percent in October, a reversal of the gains made in 2019 in banks' asset quality that arose from a subdued business environment. Gross NPLs increased from Ksh. 336.6 billion in 2019 to Ksh.424.1 billion in 2020, concentrated in the transport and communication sector, trade, real estate and agricultural sector.

As of the end of December 2020, loans amounting to Ksh 1.63 trillion (or 54.2 percent of the total banking sector loan book of Ksh 3.0 trillion) had been restructured, largely reflecting adjustments in both principle and interest payments.

Table 4 below shows the top five sectors that accounted for the highest proportions of loan restructuring during the period. These sectors also accounted for over two-thirds (68.9 percent) of the total loan volumes issued between April and December 2020, indicating their sustained prominence in the banking sector loan book. The credit outlook will predominantly reflect the developments in the asset quality going forward and commercial banks response, and any further accommodations offered to customers on their loan restructuring requests.

While on a decline, banks remain profitable. Profit before tax declined by 29.1 percent to Ksh.112.8 billion in 2020 from Ksh.159.9 billion in 2019 on account of a 24.1 percent rise in expenses that outweighed a 7.9 percent growth in income. The increase in expenses in part is attributable to loan loss provisions and write-offs, which increased from Ksh.30.5 billion in 2019 to Ksh.98.9 billion in 2020. The banking industry's overall performance shows that the average return on assets (ROA) and return on equity (ROE) declined to 1.6 percent and 13.8 percent in 2020 from 3.3 percent and 21.8 percent in 2019.

> "As of the end of December 2020, loans amounting to Ksh 1.63 trillion (or 54.2 percent of the total banking sector loan book of Ksh 3.0 trillion) had been restructured

Table 4:
Sectoral Performance of Loan Volumes and Loan Restructuring

	Sector	Share (% based on volumes) of credit in Dec-2020)	% Share in volumes of total loans issued between April and Dec-2020	% Share in total loans restructured (as at end Dec-20)
1	Agriculture	3.3	5.2	9.8
2	Manufacturing	14.6	3.3	16.1
3	Real estate	14.5	15.8	12.2
4	Personal & Households	26.6	44.6	20.4
5	Trade	17.2	-1.6	16.9
6	Other sectors	23.8	32.7	24.6
	Total	**100.0**	**100.0**	**100.0**

Source: CBK

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KENYA BANKERS
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