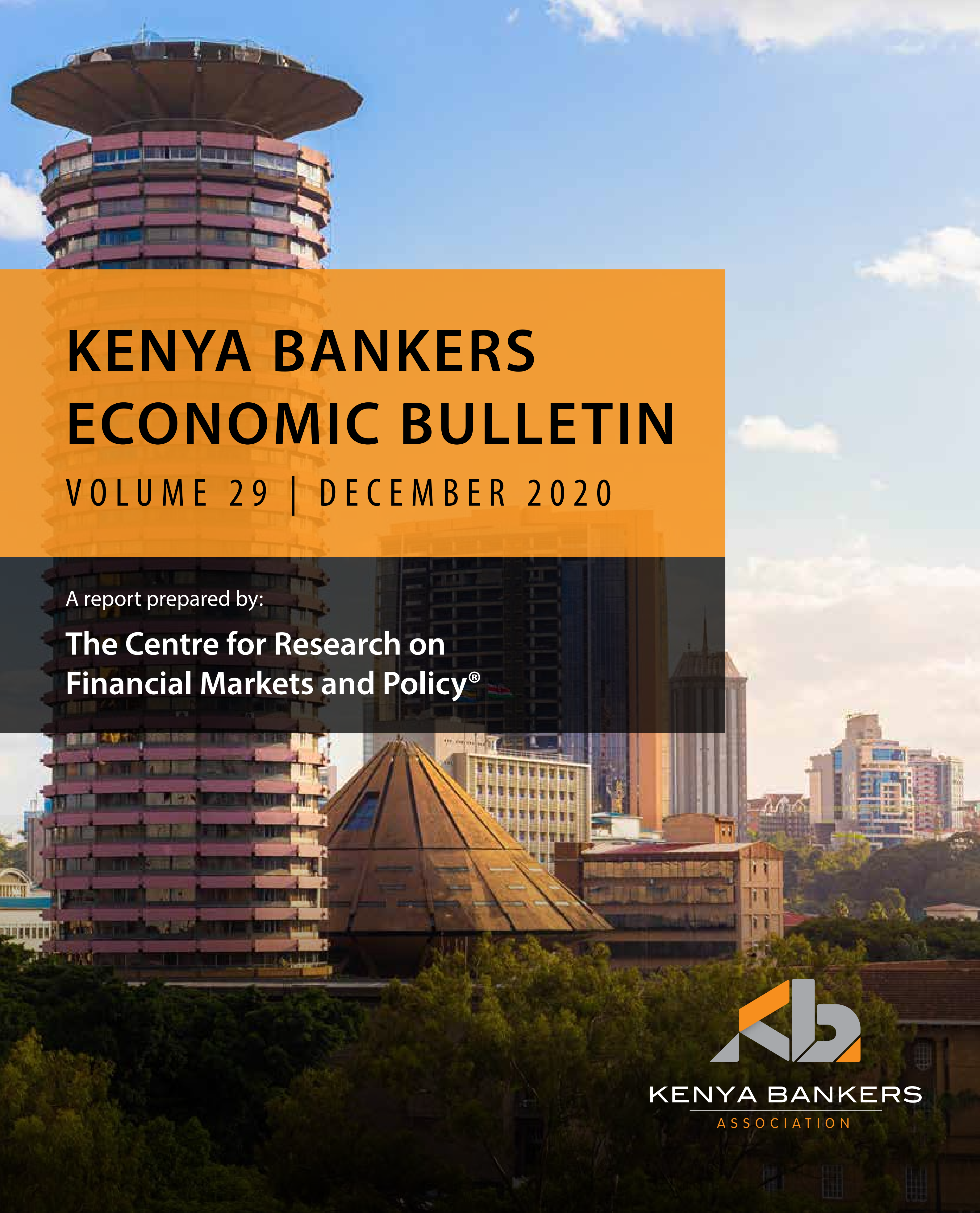

# KENYA BANKERS ECONOMIC BULLETIN

VOLUME 29 | DECEMBER 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 for the Third Quarter of 2020, 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, the 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.

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FINANCIAL MARKETS AND POLICY®

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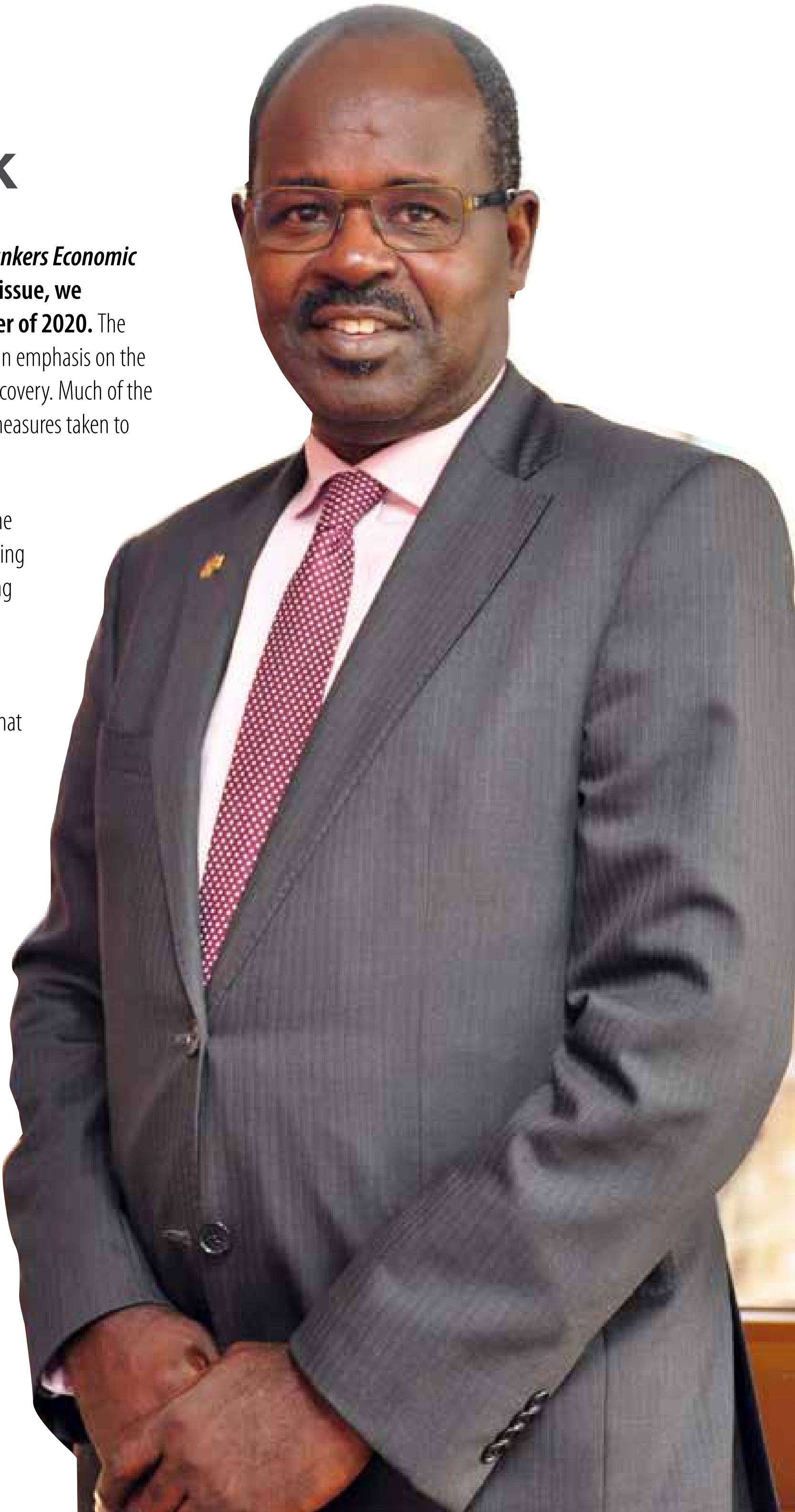
FOREWORD

# From the CEO's Desk



**It is my pleasure to present to you the 29th Issue of the *Kenya Bankers Economic Bulletin*. As the wild and turbulent year draws to a close, in this issue, we discuss the state of the Kenyan economy during the third quarter of 2020.** The *Bulletin* reviews the strides that the economy has made during the year, with an emphasis on the opportunities and constraints that continue to shape the economy's gradual recovery. Much of the discussions in this *Bulletin* is a reflection on the COVID-19 pandemic and the measures taken to contain it and its implications for the domestic economy.

As the *Bulletin* notes, the pandemic has sent the economy tumbling, and for the first time, the economy experienced an exceptionally depressed activity following a contraction by 5.7 percent in the second quarter of 2020. Even though leading economic indicators suggest that economic activity bottomed out in the third quarter; the outturn at the broader economic front and in various markets highlighted in this *Bulletin* should admittedly be seen with the lens of limited clarity especially at a time when there is a high degree of uncertainty about what lies ahead for the economy.

It is my hope that you will find this issue of the *Kenya Bankers Economic Bulletin* interesting and useful. We will be happy to consider for publications incisive commentaries on a topical issue of interest to the banking industry. For guidelines on such submissions, please get in touch with the Bulletin's Editor at research@kba.co.ke.

We welcome feedback on the content of this Bulletin as we continually seek to improve its relevance to you.

**Dr. Habil Olaka**
Chief Executive Officer,
Kenya Bankers Association

COMMENTARY

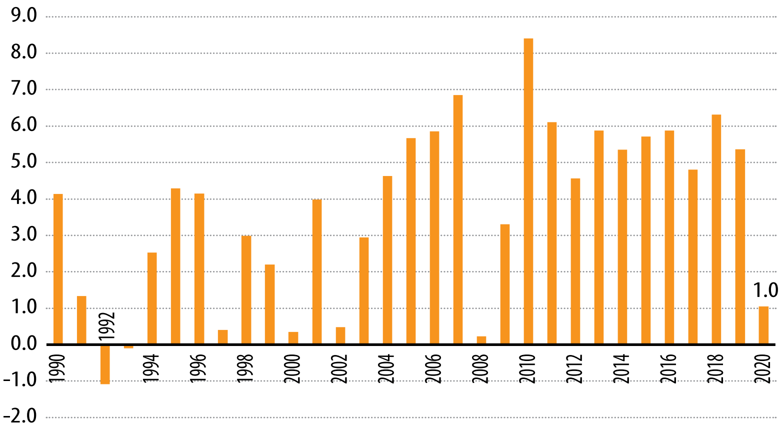
# The Coronavirus Economic Malaise – The Cause and Exacerbator?

**By Jared Osoro**

**The economic impact of Coronavirus continues to evolve. While we may exude optimism that the Kenyan economy will see the end of the carnage, it is imperative to reflect on whether the pandemic has been the cause or exacerbator.** That entails asking a simple question: were the initial conditions favourable for a quick recovery or they proved to be points of weakness?

First, the Kenyan economy had in the decade to 2019 registered strong performance (**Figure 1**). Over the period, government expenditure – especially heavy investment in physical infrastructure was a key growth driver. Attendant to the expenditure has been the astronomical rise in public debt, with the increased government expenditure occasioning a lingering fiscal deficit.

**Figure 1:**
**Real Output Growth (%)**




**Source:** Source: KNBS; IMF
**Note:** 2020 figures are projections based on IMF WEO (October 2020)


With the Coronavirus, the unprecedented but necessary restrictions have pushed economic activity in 2020 to an unimaginable low. After the initial shock, the fears of systemic meltdown have to a large degree been fulfilled, for the slowdown in growth in 2020 has been drastic. This is unimaginable by the standards of growth registered in 2019. We have had episodes of drastic slowdowns – 1991 through to 1993, 1997, 2000, 2002 and 2007. But recoveries to pre-slowdown levels of activity have been fairly fast.


**Will it be any different this time around?** Most probable yes; conceivably, the biggest surprise is that some anticipate positive – albeit mild – growth in 2020. That could be rising on sentiments. The partial restrictions have been eased. The positive developments in the discovery of a vaccine at the global level is as much good news for epidemiologists as it is to economists.

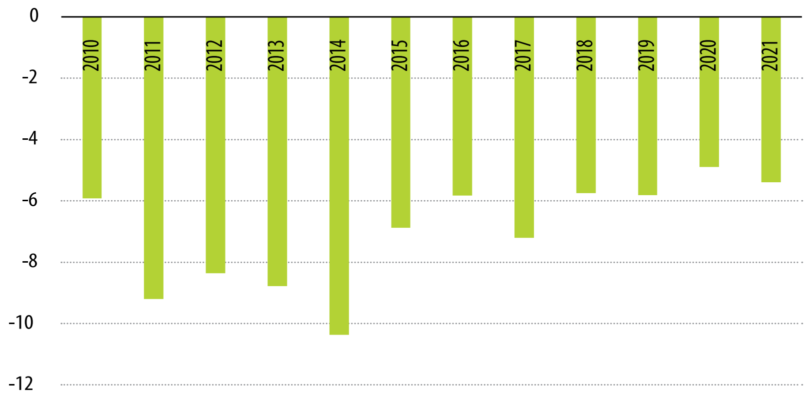
That hardly portents a precursor to quick recovery. The reason is in the second initial condition. The scope for fiscal policy to come to the rescue is extensively impaired. It is an open secret that the alluded fiscal challenges are a clear pointer to the possibility of debt distress. In there lies a dilemma. It is times such as now that fiscal policy is supposed to be countercyclical – meaning expansionary so that it can anchor recovery. The reality, though, is that even as the fiscal consolidation advocacy has more-or-less disappeared from popular discourse, the ogre of debt distress leaves hardly any room for fiscal manoeuvre.

It is not just the domestic imbalance that is an issue of concern; the external balance is an issue too – though it's important to point out that the two imbalances are twins even when there

**KQ cargo has played a vital role in delivering much-needed medical supplies including equipment and PPE. This has been done through dedicated KQ cargo freighters operations and the utilisation of cargo capacity in passenger aircraft.**
PICTURE:/KENYA-AIRCARGO

is a strong bond between them. The difference between the two is more than a nuance. While the domestic authorship of the domestic imbalance is the domestic policy posture, the external imbalances spring from the weaknesses at the global level that have affected economies across the board.

**Figure 2:**
**Current Account Balance (% of GDP)**




Source: KNBS; IMF
Note: 2020 and 2021 figures based on IMF WEO (October 2020)

It is a fact that we have seen worse times (2011 – 2014) when the external balance was an obvious feeble point (**Figure 2**). The closure in the subsequent years was welcome so long as it wasn't drastic. In all likelihood, a widening of the current account deficit is anticipated in 2021; the trend subsequently is not clear though but may well be a function of the interplay between commodity prices and the appetite for imports.

**The bridge between the domestic imbalance and the external imbalance is built on the fact that the latter is an equivalent of the difference between gross national savings and total investments.** The fact that the latter has consistently been higher than the former implies that we rely on external savings to finance local investments. In there lies the bond between the domestic imbalance that is now a source of worry and the external balance.

The accumulation of foreign resources in the domestic economy in the form of external borrowings shows up in the adjustments in the foreign exchange market. Kenya's

> 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.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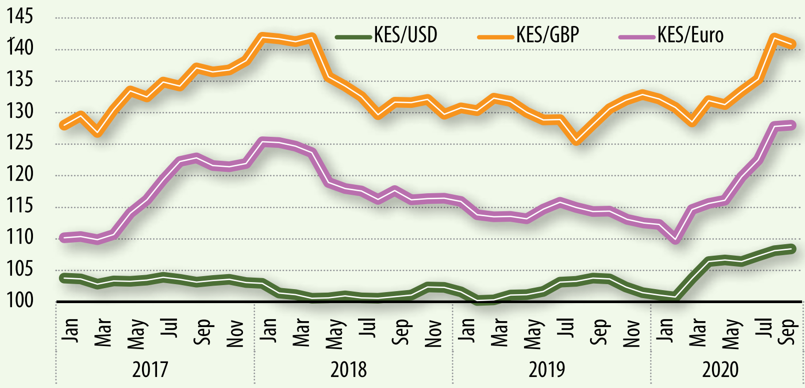
foreign exchange market responds to both fundamentals and sentiments. It is difficult to disentangle which of the two was occasioning the adjustment in the foreign exchange market as at end of September 2020. (**Figure 3**).

**The developments in the foreign exchange market reveals the third initial condition and the embedded dilemma.** Currency depreciation has the obvious implication of exacerbating the challenges of the economy's external debt position. The dilemma is in the incompatibility of an accommodative monetary policy and expectation of a strong currency.

The monetary policy stance of the Central Bank of Kenya (CBK) has been appropriately accommodative – with the reductions in interest rates already noted, any other stance will obviously not be tenable. Demand – whether households' or firms' – remains weak and it is yet to be seen whether monetary policy on its own can do the trick given the somewhat binding constraints that we have noted on the fiscal policy lever.

Arguably, the foreign exchange adjustment could be a necessary correction as an automatic stabilizer, the observed implication on the economy's public debt position – and even on the monetary policy stance going forward – notwithstanding. All these point to one thing: the initial conditions were feeble. The pandemic made them worse. It is therefore a toxic cocktail of cause and exacerbator.

**Figure 3:**
**Nominal Exchange Rate (KES/Foreign Currency)**




Source: CBK

> “Some sectors were resilient than others. Growth in the agriculture sector rebounded supporting some respite to the economic free-fall.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# State of the Economy

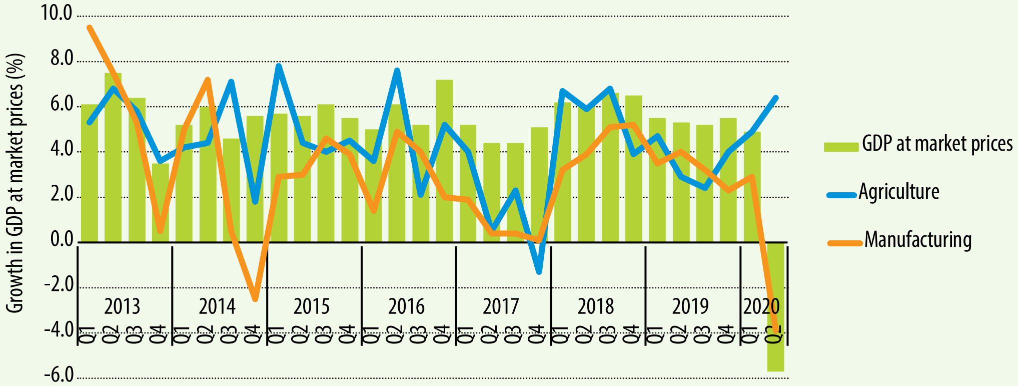
## Recent Macroeconomic Developments and Prospects

**GDP growth contracted by 5.7 perecent in the second quarter of the year, a drop from the 4.9 percent growth in the first quarter, with little hope of a significant turnaround in remaining quarters of the year.** This is partly on account of the softening of household spending, constrained private sector credit growth, and slowing export growth as a result of the measures taken both domestically and abroad to contain the pandemic.

The decline in economic activity was not just unprecedented but synchronised across several sectors; however, some sectors were resilient than others. Growth in the agriculture sector rebounded providing some respite to the economic free-fall (**Figure 4**).

With the rising second-wave of infections, the prospects for the economy are subject to extreme uncertainty in the rest of the year. The speed and magnitude of the economic recovery following the slump occasioned by the pandemic will depend crucially on the future course of the economic impairments caused by both the pandemic and the measures taken to contain it.

**Figure 4:**
**GDP Growth Battered by COVID-19 in 2020**




Source: KNBS

## So far, COVID-19 is having no significant impact on inflation

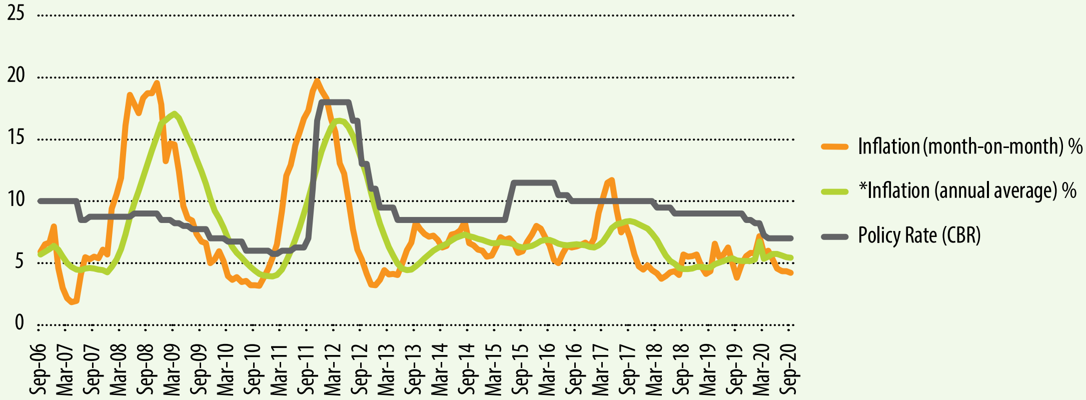
**With the Central Bank of Kenya's primary mandate being to maintain price stability, in the recent past inflation has remained within target range of 5±2.5 percent with no observable change in the general price trend.** Up to and including September, the pandemic and the containment measures continued to slighty moderate the consumer price inflation mainly through lower energy prices as demand remained subdued. Inflation stood at 4.4 percent in July and August and eased further to 4.2 percent in September 2020. A similar downward trend is observed on the annual average rate, which has eased from 5.6 percent in July to 5.5 percent in August and further to 5.4 percent in September 2020 (**Figure 5**). The low and stable inflation, and inflation expectations continued to support an accommodative monetary stance during the period.

## The Shilling remains under pressure to depreciate against all major trading currencies

**The currency albeit characterised as being stable, was under pressure between July and September 2020. It generally was depreciating particularly against the US dollar since the start of the year.** The weakening

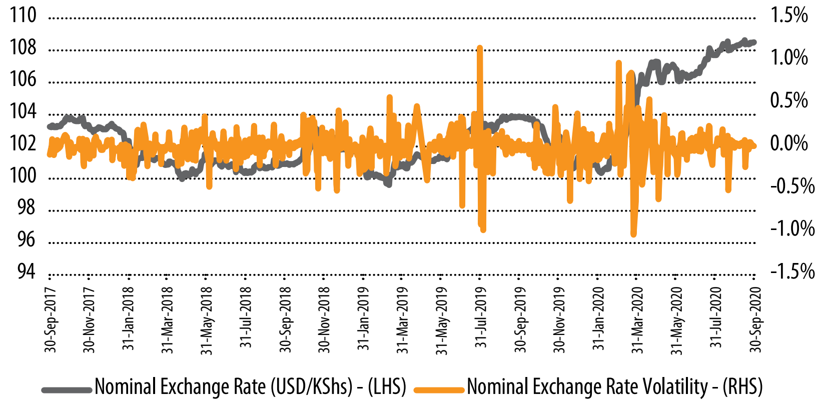
" So far, COVID-19 is having no significant impact on inflation

**Figure 5:**
**Inflation and Policy Rate Dynamics**



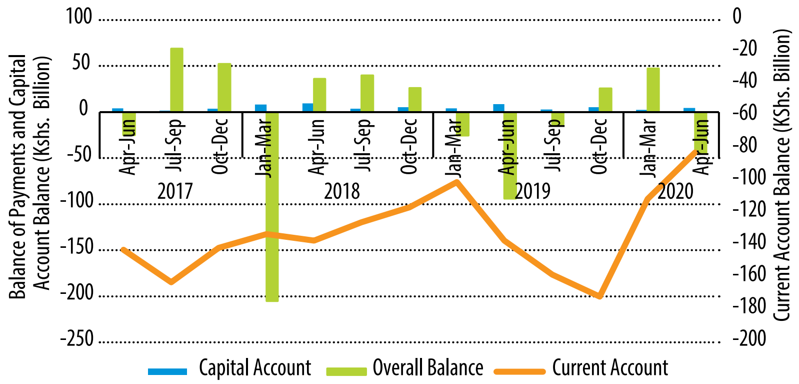

Source: CBK

**Figure 6:**
**US Dollar and the Shilling Exchange Rate Dynamics**




Source: CBK

**Figure 7:**
**Balance of the Payments Developments**




Source: KKNBS

was further significantly affected by the pandemic that triggered heightened risk aversion worldwide and led to increased demand for the US dollar, thus causing the latter to appreciate markedly against other currencies. As **Figure 6** shows, the shilling while depreciating against the US dollar, did not depict high volatility, buoyed by foreign exchange reserves stock that remains adequate – at USD 8,765.1 million (5.4 months of import cover) at the end of September 2020 – and thus continue to provide some buffer against short-term shocks in the foreign exchange market.

## External outlook weaknesses emerge

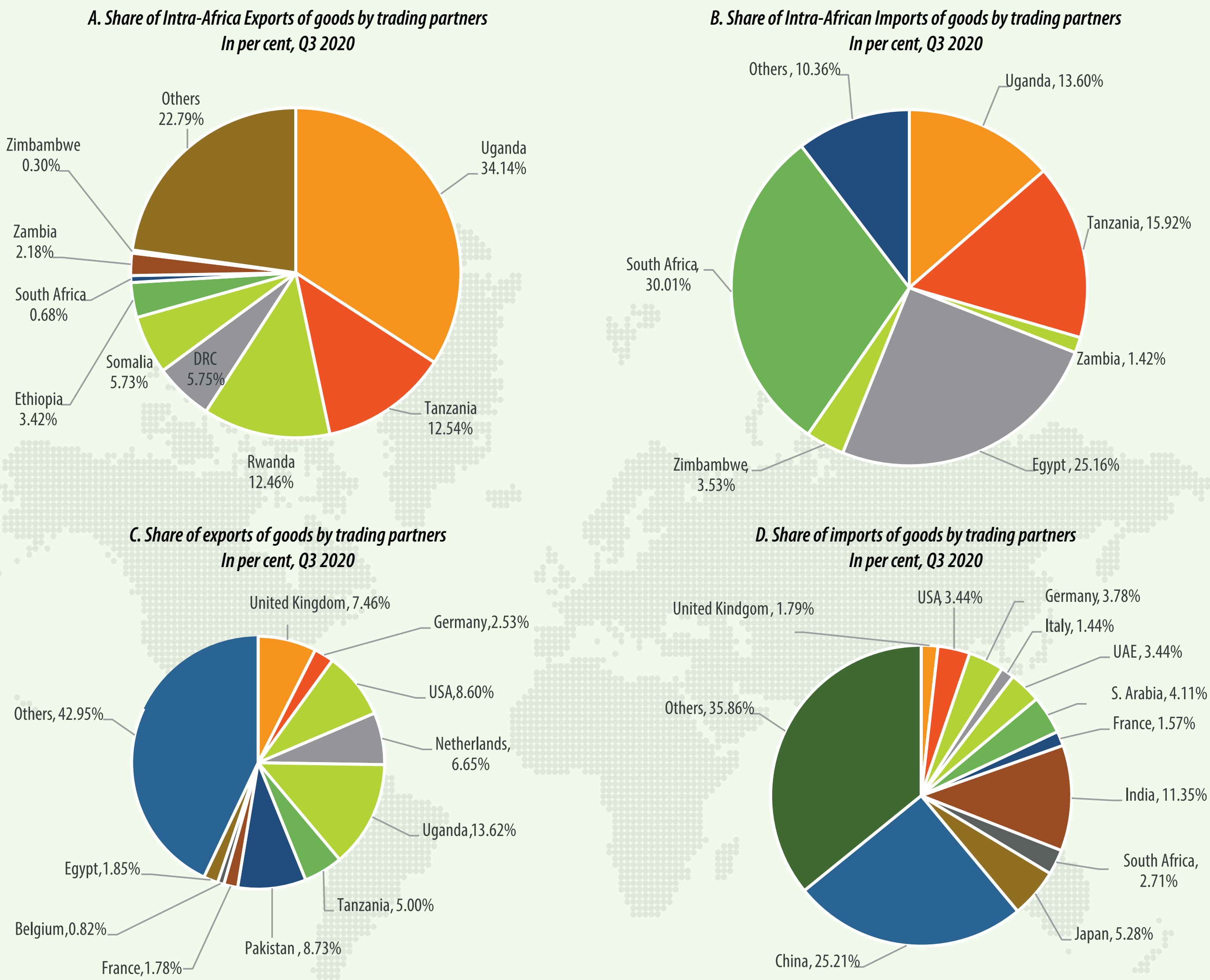
**Kenya's external position continues to weaken (Figure 7).** On the one hand, the current account balance deficit registered some improvement in the second quarter to a deficit of KSh 82.2 billion which was supported by the narrowing of the merchandise trade deficit by 32.5 percent. On the other hand,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

PICASSA

## Exports rebound though concentrated in few markets

**Export activity remains diversified, albeit concentrated in few markets and mainly agricultural products (Figure 8).** Intra-African trade exports, especially to Uganda continued to dominate in the third quarter at 34.1 percent, followed by Tanzania and Rwanda at 12.54 percent and 12.46 percent, respectively. Turning to intra-african imports, South-African imports accounted for the largest share at 30.01 percent of total imports, with imports from Egypt, Tanzania and Uganda accounting for 25.2 percent, 15.92 percent and 13.60 percent respectively. On the global front, exports to the USA of dominated, accounting for 8.60 percent, while exports to Pakistan and the United Kingdom accounted for 8.73 percent and 7.46 percent, respectively. Imports, on the other hand, as compared to the previous quarters, remained largely unchanged with China accounting for about a quarter of all the imports to the country.

**Figure 8:**
**Intra-African and Global Trade Developments**




Source: CBK

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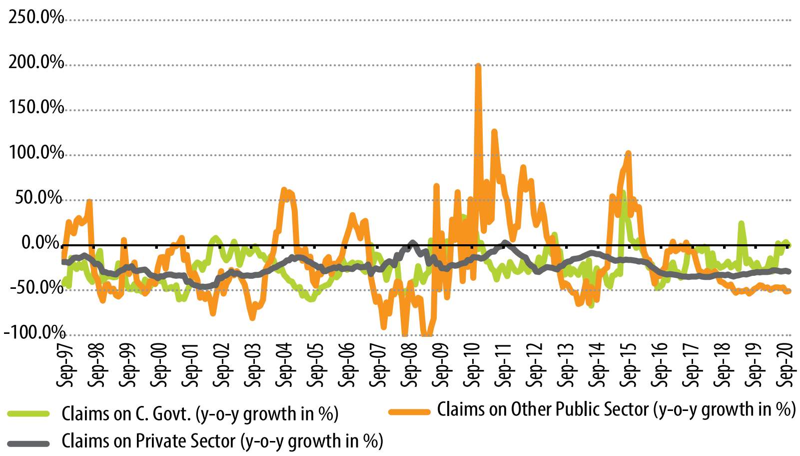
## Banking system remains sound and stable

**The COVID-19 pandemic has led to significant changes in banks' balance sheets and profit and loss positions, but the system remains sound and stable.** Gross loans have levelled-off with its month-on-month growth contracting as the asset quality deteriorated. Nonetheless, the banking system remained adequately capitalized, supporting its resilience.

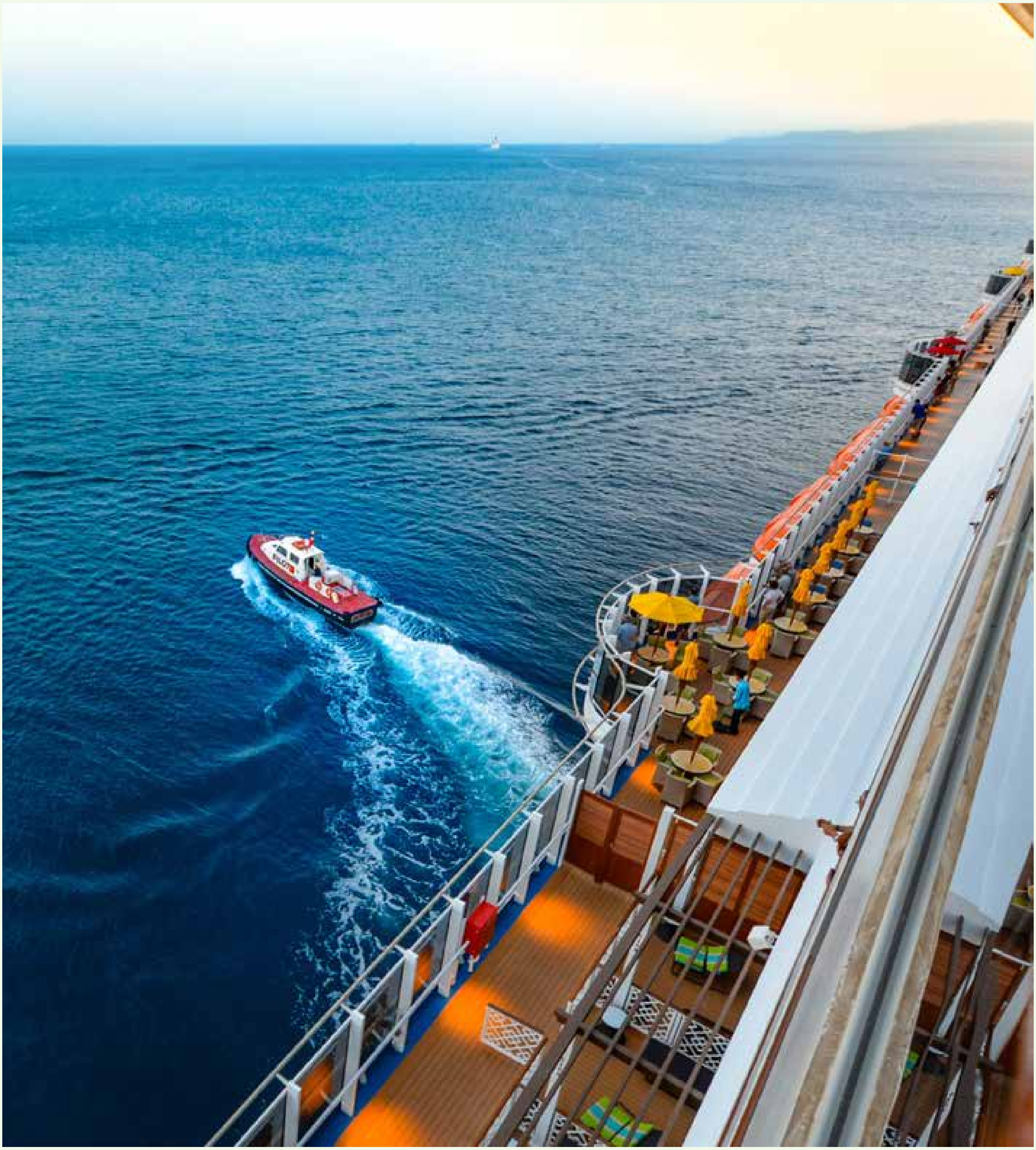
The resilience of the banking system as could be inferred from buffers above the minimum regulatory capital adequacy ratios signal the existence of sufficient loss-absorbing ability of the system to weather market shocks without triggering systemic instability. Liquidity remains sufficient and on the rise. Total assets are modestly growing. The total liabilities are edging upwards, but at a decelerating pace. The loan-to-deposit ratio is edging upwards after a decline in the first half of the year, as banks adjust their operating strategies in line with the prevailing business environment. Overall, the banking sector's intermediation priorities have been navigating the profitability – liquidity trade-offs.

**Figure 9:**
**Public and Private sector credit and growth dynamics**




Source: CBK

**Credit to the private sector remains resilient.** In the 12 months to September, growth in credit to the private sector stood at 7.7 percent (**Figure 9**), slightly lower than 8.07 percent and 8.39 percent in July and August 2020, but higher than 7.31 percent in September 2019. The relative recovery in the period was supported by continued recovery in demand from the COVID-19 related disruptions and the accommodative monetary policy. Strong growth in lending was observed in manufacturing (12.61 percent), transport and communications (20.59 percent), trade (6.56 percent), and consumer durables (15.61 percent) and, mining and quarring (8.19 percent).



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# Sectoral Performance


## Agriculture

**Despite the shocks occasioned by the Coronavirus pandemic on the domestic economy, agriculture remains a crucial driver of economic growth.** In the second quarter of 2020, the sector grew by 6.4 percent compared to a 4.9 percent growth during the first quarter.

**KSh 216.61**
Price/Kg Aug '20

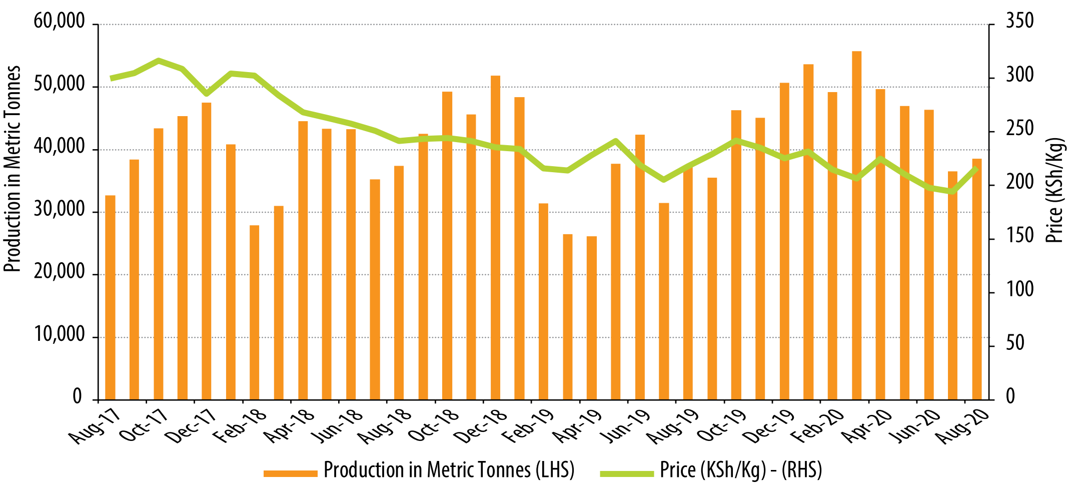
**KSh 197.62**
Price/Kg June '20

The robust growth recorded during the second quarter, according to the Kenya National Bureau of Statistics (KNBS), was on account of notable increases in tea production, cane deliveries, milk intake and fruit exports but weighed down by decline in production of horticultural exports and coffee sales.

Tea production declined to 38,525 MT in August 2020 from 46,378 MT in June, while its price edged up to KSh 216.61 per kilogram in August 2020 from from Ksh 197.62 per kilogram in June (**Figure 10**). Tea production between June and August 2020 was, however, higher than levels reported for a similar period in 2019, reflecting more favourable rainfall over the period. The improvement in tea prices was reflective of a seasonal pattern

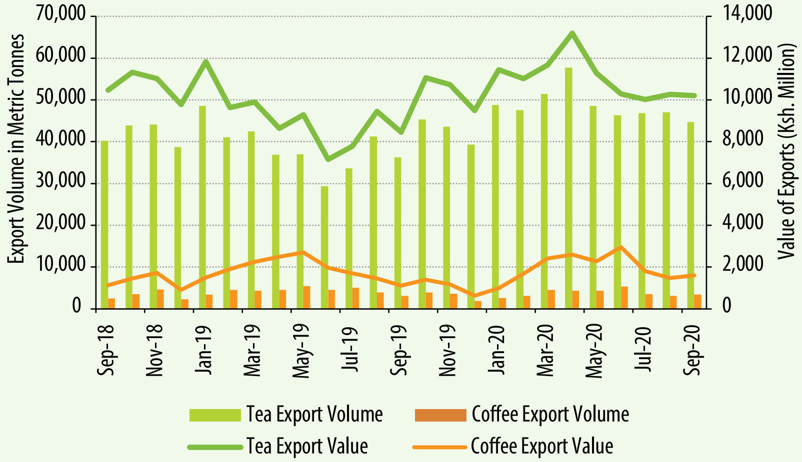
**Figure 10:**

**Tea production in Metric Tonnes and Prices per Kilogram**




Source: KNBS

**Figure 11:**
**Value of Tea and Coffee Exports**



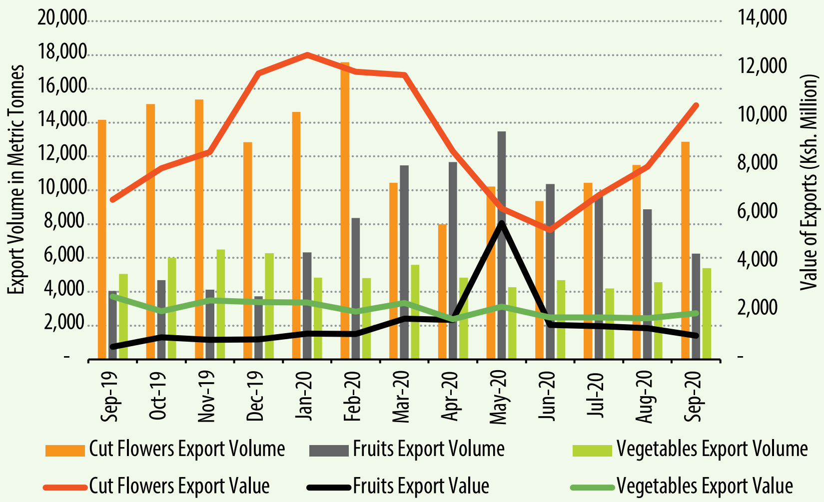

Source: KNBS

Exports of vegetables also increased from 4,561.09 MT in August 2020 to 5,405.00 MT in September 2020, while its value rose from from KSh 1,708.51 million to KSh 1,910.75 million during the same period. However, exports of fruits contracted during the period (**Figure 12**). The observed rise in horticultural products was on account of the pickup in global demand, and improvement in trade logistics particularly with the resumption in cargo flights.

There was a notable mixed performance in the exports of tea and coffee. On the one hand, tea exports increased from 46,850.57 MT in July 2020 to 47,034.93 MT in August 2020, and consequently, and its value rose from KSh 10,013.82 million to KSh 10,269.11 million over the same period. Conversely, coffee exports decreased from 3,546.25 MT in July 2020 to 3,181.82 MT in August 2020, with its value dropping from KSh 1,799.26 million to KSh 1,484.15 million over the same period (Figure 8).

Despite an overall reduction in exports of horticultural products, exports of cut flowers regained its dominance over other horticultural products. In July 2020, the volume of cut flower exports stood at 10,449.18 MT valued at KSh 6,792.95 million, an increase from 10,215.07 MT valued at KSh 6,254.05 million in May 2020.

**Figure 12:**
**Horticultural Exports**



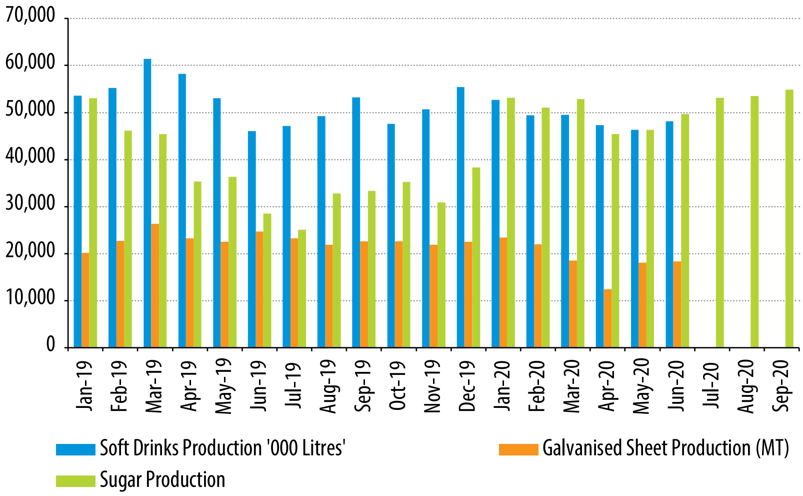

Source: KNBS

## Manufacturing

**Manufacturing sector perfomance has been erratic and its growth softening since 2018.** With the onset of COVID-19, the sector's softening growth was further exacerbated and its output contracted by 3.9 percent in the second quarter of 2020 compared to an expansion by 2.9 percent in the first quarter. This decline was attributable partly to subdued perfomance of some sub-sectors which traditionally support manufacturing, particularly in tea and sugar production, and fruits and vegetable exports, but continued to be supported by growth in activities such as production of cooking fat, dairy products, bread, meat and meat products, beverages as well as grain mill products.

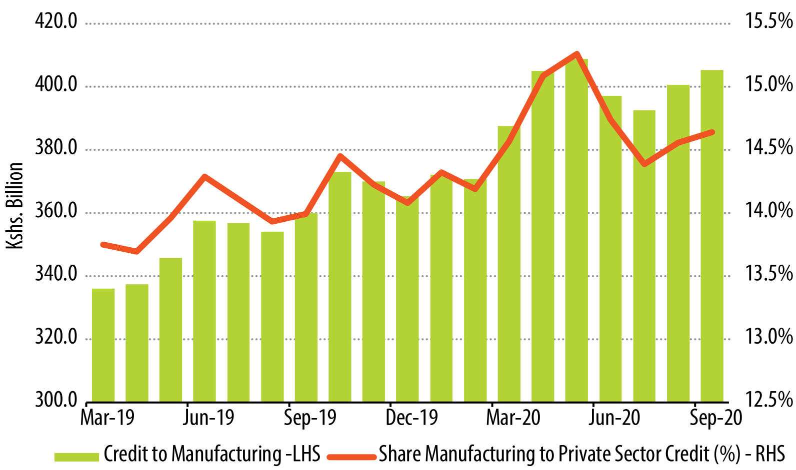
Selected leading indicators of the manufacturing sector during the third quarter showed improvements.Sugar production increased from 53,532 Metric tonnes in August 2020 to 54,873 Metric tonnes in September 2020, reflecting a growth of 64.5 percent over a similar period in 2019. Similarly, the quantity of cane deliveries increased from 572.37 thousand metric tonnes in June 2020 to 625.61 thousand metric tonnes in July 2020 (**Figure 13**). Additionally, bank lending to manufacturing sector on a year-on-year basis rose from 11.06 percent in June 2020 to 13.15 percent in August and 12.61 percent in September, indicating increasing activity in the sector (**Figure 14**)

**Figure 13:**
**Sugar, Soft Drinks and Galvanised Sheet Production**




Source: KNBS

**Figure 14:**
**Credit to Manufacturing Sector**




Source: KNBS

**The overall producer prices increased by 0.48 per cent in September 2020 from June 2020 on account of a rise in the manufacture of pharmaceuticals, medicinal chemical and botanical products; manufacture of motor vehicles and manufacture of wood and products of wood and cork except for furniture.**

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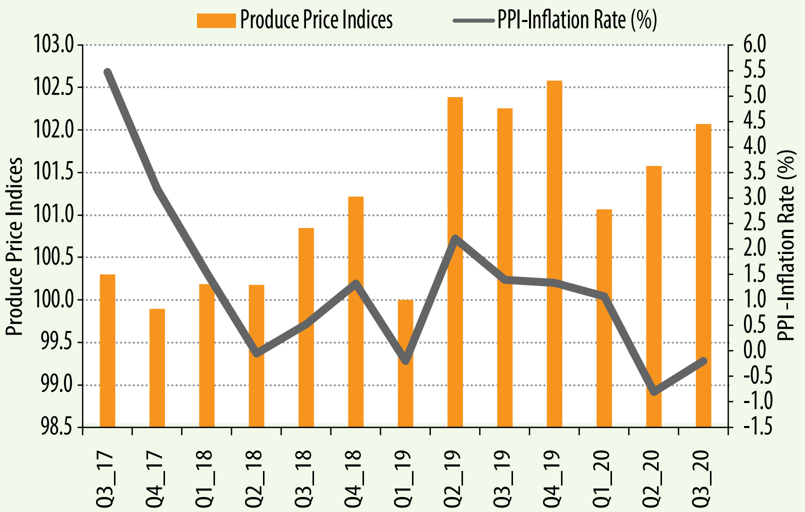
## Producer Price Index

**The Producer Price Index (PPI) rose further in the third quarter, while the annual Producer Price Index inflation contracted.** In September 2020, the Producer Price Index stood at negative 0.19 percent in September 2020 compared to 1.4 percent over the same period in 2019 (**Figure 15**). However, compared to in 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 rise in the manufacture of pharmaceuticals, medicinal chemical and botanical products; manufacture of motor vehicles and manufacture of wood and products of wood and cork except for furniture. However, the decline in the prices of manufactured motor vehicles and wearing apparel offered some respite.

**Figure 15:**
**Producer Price Index**




Source: KNBS

Base Period March 2019=100

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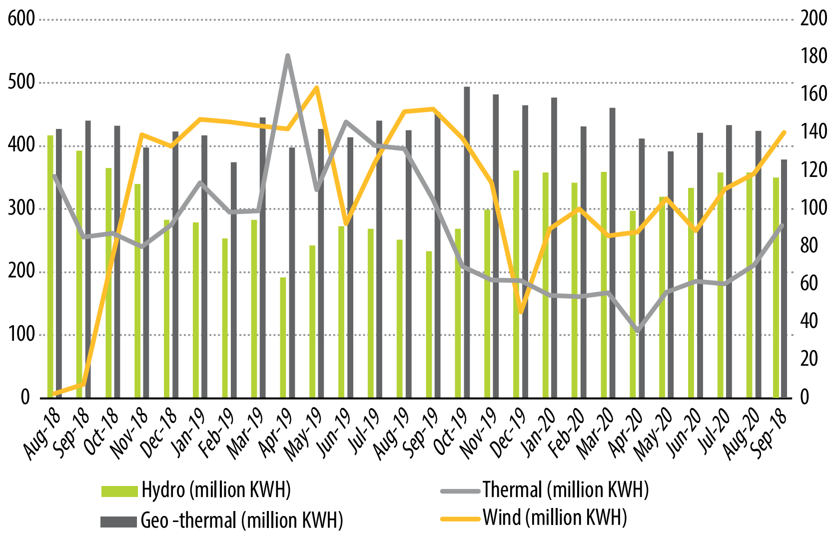
**Figure 16:**
**Electricity Generation by Source**




Source: KNBS

## Energy

**Activity in the energy sector eased in the third quarter of 2020.** In quarter two of 2020, the electricity and water supply sector conracted by 0.6 percent compared to expansions by 7.3 percent in the second quarter of 2019 and 6.3 percent in the first quarter of 2020. The contraction was notable in total electricity generated, which declined by 6.1 percent, largely on account of the decline in electricity generated from wind which contracted by 29.3 percent due to the low electricity demand. Conversely, activity in the sector was partly buoyed by an increase in hydroelectricity generation, which expanded by 34.5 per cent supported by sufficient rains received during the period.

In the third quarter of 2020, total electricity generated rose from 905.93 KWh in June to 962.35 KWh in July and 970.40 KWh in August, but eased to 965.73KWh in September. During the period between June and September, Geo-thermal electricity generation continued to dominate the total electricity generation accounting for an average of 43.66 percent, followed by hydro-electricity at 36.94 percent, then wind and thermal electricity at 11.98 percent and 7.41 percent, respectively (**Figure 16**).

**Table 1:**
**Average Monthly Crude Oil and Retail Fuel Prices**

| | Jan-20 | Feb-20 | Mar-20 | Apr-20 | May-20 | Jun-20 | Jul-20 | Aug-20 | Sep-20 |
|---|---|---|---|---|---|---|---|---|---|
| Murban crude oil (US$/Barrel) | 66.09 | 55.53 | 33.92 | 17.66 | 25.17 | 37.05 | 43.42 | 45.19 | 41.54 |
| Super petrol (KES/Litre) | 110.61 | 113.32 | 112.07 | 94.09 | 84.58 | 90.34 | 101.37 | 104.83 | 106.30 |
| Diesel (KES/Litre) | 102.81 | 105 | 102.93 | 98.84 | 79.67 | 75.88 | 92.81 | 95.57 | 95.45 |
| Kerosene (KES/Litre) | 104.46 | 103.29 | 96.72 | 78.59 | 81.08 | 63.79 | 66.41 | 84.6 | 84.09 |
| LPG (13Kgs) | 2,144.81 | 2,148.18 | 2,065.98 | 2,077.88 | 2,075.87 | 2,078.50 | 2,075.00 | 2,060.15 | 2,033.57 |

Source: KNBS

On the international front, crude oil demand despite depicting a marginal increase, remained low in the third quarter, and coupled with differences in strategy on supply by major oil producers have seen the oil prices drastically decline to the levels last seen in 2002, 2009 and 2016.

In line with the decline in the global oil prices, reflected by the Murban oil price movement from US$ 45.19 in August to US$ 41.54 per barrel in September 2020, the domestic pump prices also declined. In particular, the average price per litre of light diesel oil and Kerosene dropped from Ksh 95.57 and Ksh 84.60 in August to Ksh 106.30 and Ksh 95.45 in September, respectively. Similarly, the average price of a 13kg cylinder of cooking gas also declined in September. However, the price of gasoline premium rose from an average of Ksh 104.83 in August to Ksh 106.30 per litre in September, as shown in **Table 1**

## Building and Construction

**Building and Construction sector activity, despite depicting a slowdown in the second quarter, rebounded in the third quarter with cement production and consumption posting the highest levels in the last five years.** Leading indicators for the third quarter show a strong rebound in activity in the sector as reflected by an increase in cement production and consumption in July and August 2020. The quantity of cement produced increased from 600,571 metric tonnes in July 2020 to 628,496 metric tonnes in August 2020, while consumption rose from 594,028 metric tonnes to 607,383 metric tonnes over the same period (**Figure 17**). This recovery followed subdued activity reported in the latest published data by the KNBS showing that the building and construction sector recorded a slower growth of 3.9 percent in the second quarter of 2020, compared to 7.2 percent over a similar period in in 2019.

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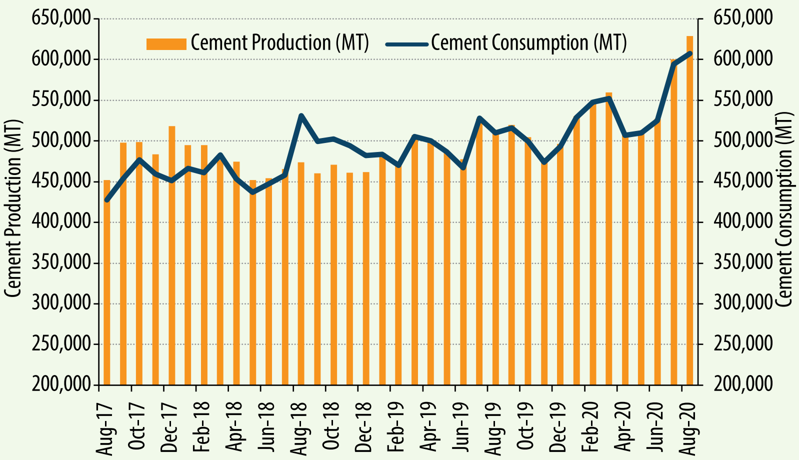
**Figure 17:**
**Cement Production and Consumption**

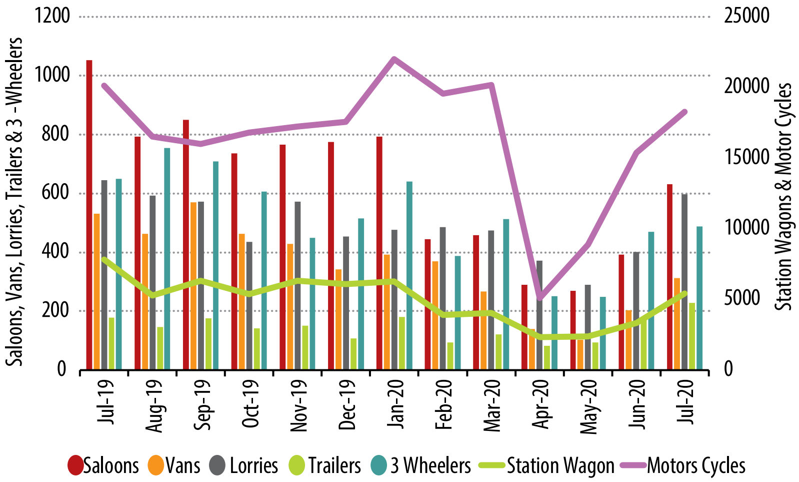



Source: KNBS

## Transport and Storage

**Activity in the transport and storage sector recorded a sluggish recovery in the third quarter following the easing of movement restrictions.** An indicator of activity in the sector; the total number of new registered motor vehicles, rose from 20,363 in June to 25,966 in July 2020 of which 5,444 were station wagons and 18,265 were motorcycles (**Figure 18**), trending towards the pre-COVID-19 levels. This indicated a recovery in activity in the transport sector. The KNBS published a contraction by 11.6 percent in activity in the transport sector in the second quarter, compared to a 7.6 percent growth in the corresponding quarter of 2019, largely reflecting the effects of movement restrictions imposed to curb the spread of COVID-19 infections that constrained travel and transport services. During the second quarter, the number of assembled vehicles declined from 659 units in May 2020 to 560 units in June 2020.

**Figure 18:**
**Registration of New Vehicles**

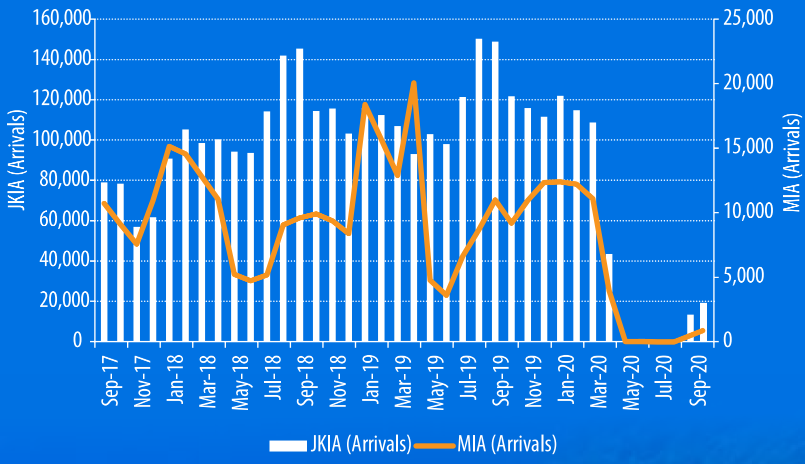



Source: KNBS

## Tourism

**Tourism, that had been depressed following the disruption of travel by COVID-19 containment measures, showed signs of recovery albeit marginally.** COVID-19 containment measures occasioned underutilisation of existing capacity and consequently leading to some enterprises within the sector either closing down temporarirly or permanently. In the second and third quarter, the number of tourist arrivals dipped significantly. Inbound passengers through the Jomo Kenyatta (JKIA) and Moi International Airports (MIA) increased from 13,919 persons in August 2020 to 20,164 persons in September 2020, but remained significantly lower than the pre-COVID-19 levels **(Figure 19).**

**Figure 19:**
**Tourist Arrivals**




**Source:** KNBS

PEXELS/ R SEAGAL


BUENA VISTA

# Financing of Government

**Kenya's fiscal policy space during the third quarter was limited as the revenue-expenditure gap widened. Before the outbreak of COVID-19, as shown in Figure 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 of GDP 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 largely on accommodation of some policy measures to mitigate the impact of the pandemic on taxpayers.

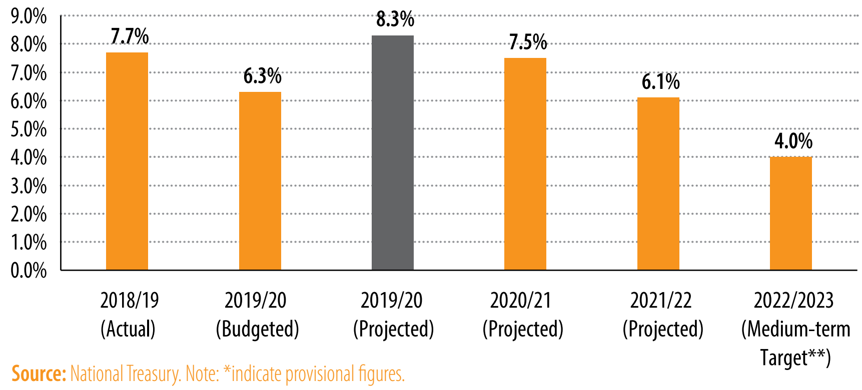
Before the pandemic, the National Treasury's fiscal framework, contained in its Budget Policy Statement (BPS), planned ambitious fiscal consolidation in 2019/20, with a deficit reduction of about 1.5 percent of GDP, to 6.3 percent of GDP and was predicated on the one-off transfer of 0.7 percent of GDP of dividends from State owned enterprises, spending cuts, and tight expenditure controls.

In the medium term, the deficit was envisaged to decrease to 4.9 percent of GDP in 2020/21, and further expected to decline to 3 percent of GDP by 2022/23. However, with the COVID-19 exogenous shock adversely affecting nearly all facets of the

domestic economy, interventions adopted will result in further widening of 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 2018/19 fiscal year largely on account of reduced economic activity that depressed revenues. It is envisaged that the fiscal gap will be financed through additional net domestic financing. In the short term, fiscal consolidation may not be a priority, and justifiably so with the increasing government expenditure demands amid low revenues with the ravaging effects of the pandemic on economic activity.

**Figure 20:**
**Kenya's Fiscal Deficit Dynamics**



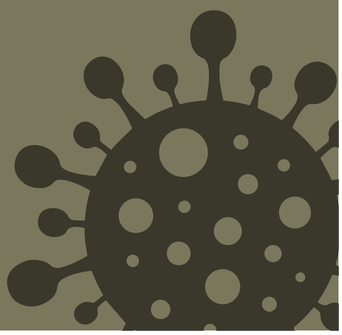

**Source:** National Treasury. Note: *indicate provisional figures.

## Box 1

### Fiscal Interventions to Cushion the economy from COVID-19 Pandemic

- COVID-19 spending interventions of KES 40 billion (0.4 percent of GDP) in 2019/20.
- Expediting the clearance of unpaid bills with suppliers (KES 13 billion set aside)
- Fast-tracking VAT refunds (KES 10 billion)
- Social protection programs especially cash transfers to the elderly, disabled, and low-income households (KES 10 billion)
- Tax relief measures including:
  - a) Reduction of PAYE from 30% to 25% with 100% tax relief for earning below Kshs. 24,000,
  - b) Reduction of corporation tax from 30% to 25%,
  - c) Reduction of turnover tax on small businesses from 4% to 1%,
  - d) Reduction of the VAT rate from 16% to 14%
  - e) Elimination in exemptions in the VAT and corporate tax.

The tax relief measures were estimated to cost 1.7 percent of GDP while the elimination of tax exemptions is expected to be revenue-neutral (i.e. not having a significant effect on additional revenue collections).



## Public Debt

**Government debt continues to be characterised by a tight balance between domestic and external debt.** The stock of external public and publicly guaranteed debt rose from Ksh. 3,023.1 billion as at the end of June 2019 to Ksh. 3,663.49 billion as at September 2020 (**Table 2**). Moreover, 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 its sustainability. The stock of multilateral debt rose to Ksh. 1,421.84 billion in September 2020, from Ksh. 1,321.6 billion in June 2020, accounting for 30.1 percent of the total outstanding external public and publicly guaranteed debt.

This trend reflects the tight balancing act insofar as ensuring that that there is limited crowding out effect of domestic borrowing and lower burden on foreign currency-denominated debt on the strength of the domestic currency against other major currencies.

The growing debt-to-GDP 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, as well limiting the fiscal space for a manoevre to support the economy.

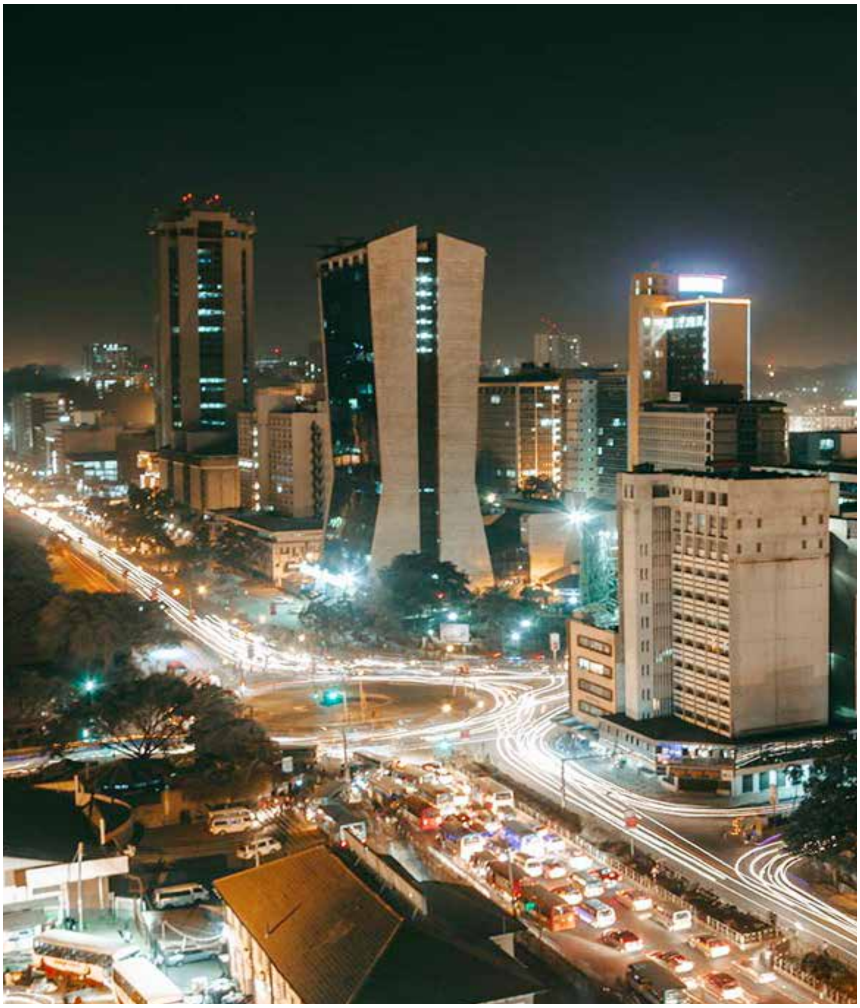


**Table 2:**
**Outstanding External Public and Publicly Guaranteed Debt, 2017/18 - 2019/20 (KSh Billion)**

| | Jan-20 | Feb-20 | Mar-20 | Apr-20 | May-20 | Jun-20 | Jul-20 | Aug-20 | Sep-20 |
|---|---|---|---|---|---|---|---|---|---|
| Bilateral | 1,016.5 | 1,015.8 | 1,075.9 | 1,070.1 | 1,090.2 | 1,074.3 | 1,086.4 | 1,101.8 | 1,102.9 |
| Multilateral | 1,027.24 | 1,028.26 | 1,060.61 | 1,114.36 | 1,272.40 | 1,321.63 | 1,410.66 | 1,423.20 | 1,421.84 |
| Commercial Banks | 1,052.48 | 1,056.25 | 1,058.80 | 1,115.13 | 1,116.09 | 1,102.29 | 1,123.61 | 1,123.39 | 1,120.80 |
| Export Credit | 16.65 | 16.71 | 17.33 | 17.76 | 17.70 | 17.63 | 17.83 | 17.91 | 17.96 |
| Sub-Total | 3,112.90 | 3,117.04 | 3,212.63 | 3,317.33 | 3,496.43 | 3,515.81 | 3,638.51 | 3,666.32 | 3,663.49 |
| (As a % of total debt) | 50.89 | 50.62 | 51.13 | 51.54 | 52.58 | 52.53 | 52.64 | 51.87 | 51.45 |

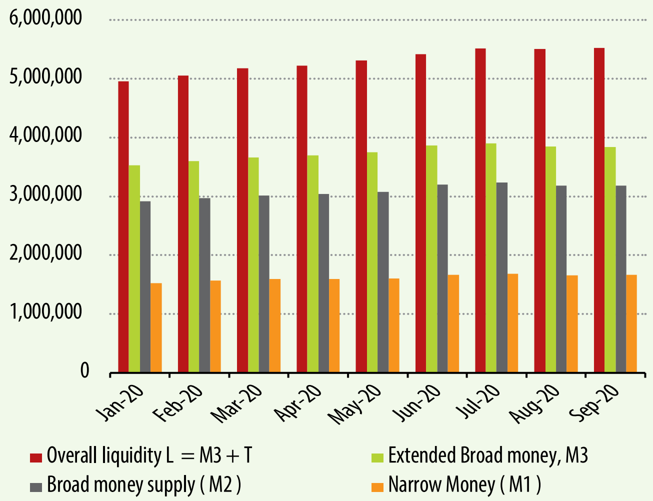
**Source:** CBK

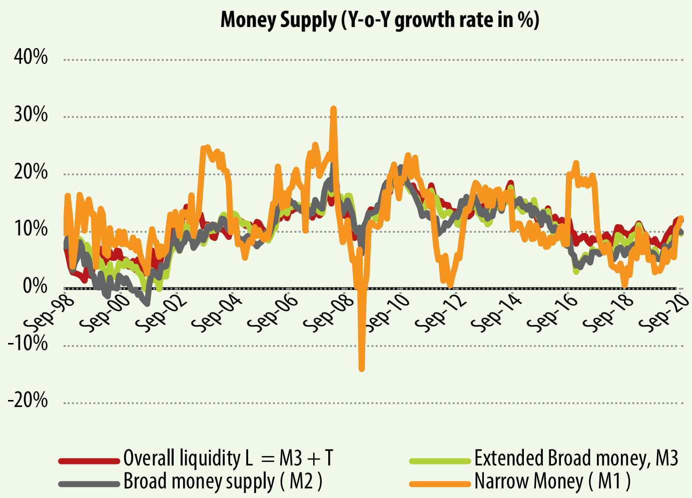
# Money Supply

**Monetary aggregates, despite depicting a slight decline in the third quarter, continued to rise on a year-on year basis.** The monetary aggregates during the third quarter maintained their growth trends. The broad money supply (M3), a key indicator for monetary and overall liquidity conditions, rose on a year-on year basis by an average of 9.90 percent in the quarter, to Ksh 3,843.50 billion in September 2020, compared with Ksh 3,473.39 billion in September 2019, but slightly lower than Ksh 3,863.63 billion in June 2020. (**Figure 21**). This marginal decline during the quarter was mainly attributed to a drop in deposits held in commercial banks and non-bank financial institutions.

Nonetheless, the year-on-year growth trends in narrower money supply indicators continued to edge upwards, with M2 and M1 rising, respectively, by an average of 10.25 percent and 11.30 percent in the third quarter of 2020 compared to levels recorded in a similar quarter in 2019. While the value of Gross Foreign Exchange Reserves decreased from KSh 1,463.57 billion in August 2020 to KSh 1,403.08 billion in September 2020, the value of Net Foreign Exchange Reserves dropped from KSh 804.94 billion to KSh 751.26 billion during the same period. This decline was mainly due to reduced remittances and a slowdown in earnings from exports of key products.

**Figure 21:**
**Money Supply**



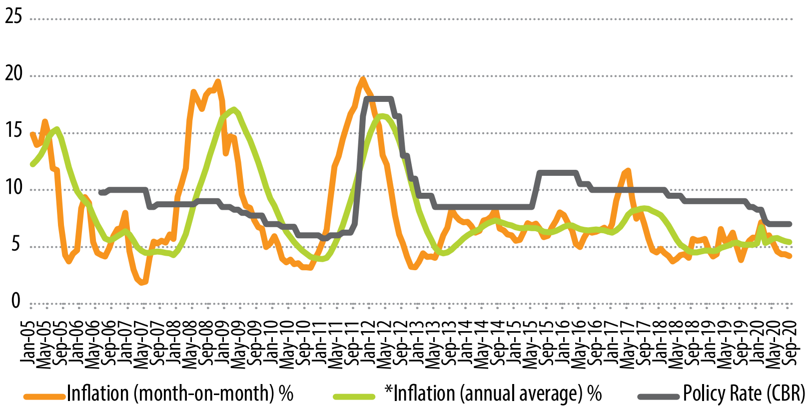

Source: CBK

"Inflation stood at 4.36 per cent in July and August and eased further to 4.2 percent in September 2020.

## Inflation

**During the third quarter of 2020, inflation rates remained stable and within the Government's target range of 5±2.5 percent.** Inflation stood at 4.4 per cent in July and August, and eased further to 4.2 percent in September 2020 (**Figure 22**). A similar downward trend was observed on the annual average inflation, which eased from 5.6 percent in July to 5.5 percent in August and further to 5.4 percent in September 2020 supported by relatively lower oil and food prices as well as muted demand pressures in the economy.

**Figure 22:**
**Inflation Dynamics**




Source: CBK

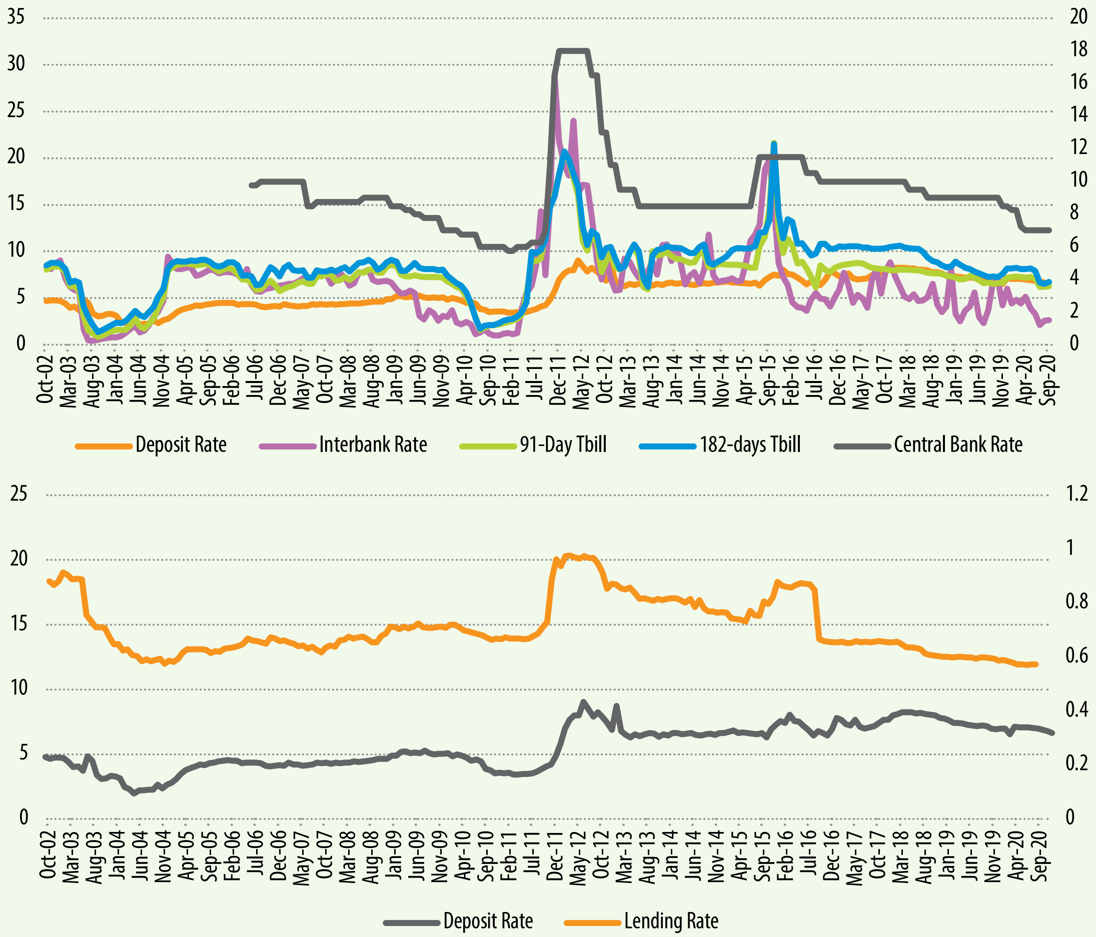
The stability in inflation partly supported a continuation of accommodative monetary policy.

## Interest Rates

**Interest rates declined in the third quarter, consistent with a continuation of an accommodative monetary stance adopted by the central bank.** The average interbank market and short-term government securities (91-day Treasury bill) rates declined from 3.3 percent and 7.1 percent in June to 2.6 percent and 6.3 percent in September 2020, respectively, largely attributed to enhanced liquidity conditions in the market (**Figure 23**).

The average yield rate for the 91-day Treasury bills, continued to be an active market benchmark for the general trend of interest rates during the period. The 182-day treasury bill rate depicted a similar trend, dropping from 7.9 percent in June to 6.7 percent in September. The central bank rate (CBR) was maintained at 7.0 percent during the quarter sustaining an accommodative monetary policy stance following its reduction by 125 basis points between March and April 2020 to mitigate the effects of COVID-19 pandemic on the economy. The accommodative stance was maintained partly based on an observation that inflation was stable and inflation expectations were well anchored.

**Figure 23:**
**Interest Rates Dynamics**




**Source:** CBK

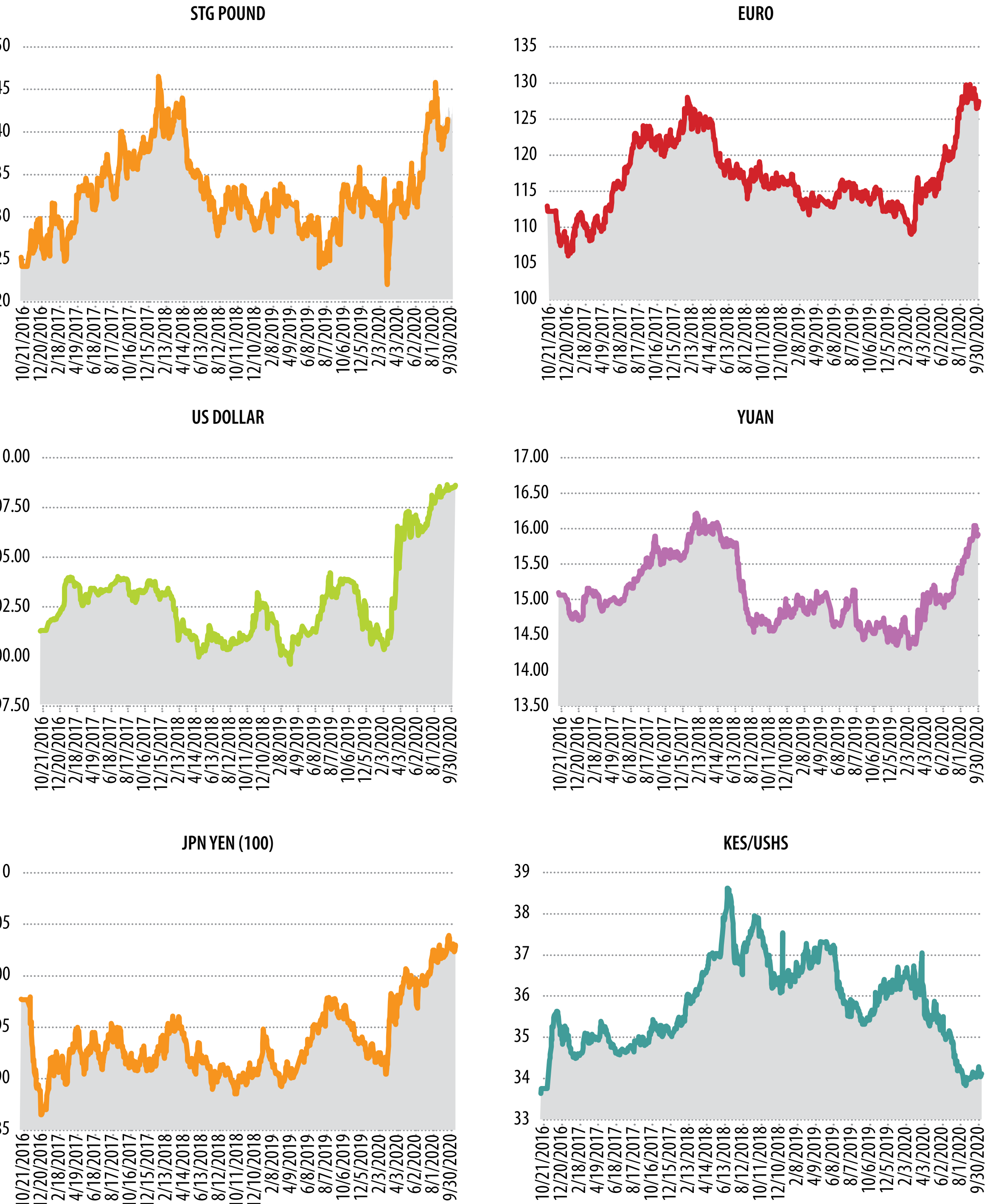
## Exchange Rates

**In the third quarter of 2020, the Shilling came under pressure from all major trading currencies, but appreciated against the regional currencies (Figure 24).** Generally, the shilling has been on a depreciating trend since the start of the year which was amplified by the uncertainty caused by the global spread of the COVID-19 pandemic.

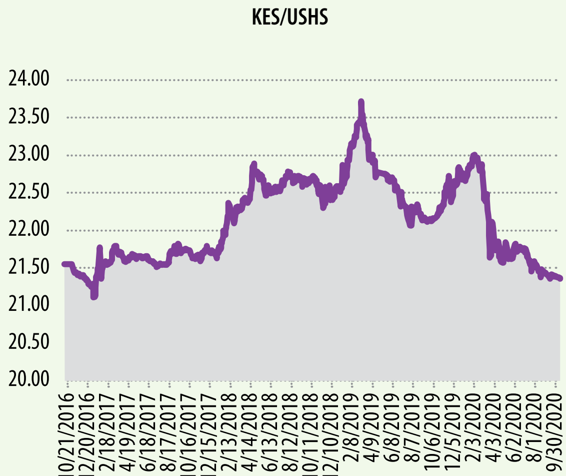
In the global foreign exchange markets, the pandemic triggered a significant rise in risk aversion, which led to increased demand for the US dollar, thus causing it to appreciate markedly against other currencies. On the regional front, the Shilling, however, depicted mixed performance; appreciated against the Ugandan and Tanzanian Shilling, but depreciated against the South African Rand.

Exchange rate volatility rose in the recent months, partly due to increased uncertainties on the impact of COVID-19 which resulted in capital outflows from emerging markets economies as investors held concerns around the safety of their asset portfolios.

**Figure 24:**
**Exchange Rate Developments**




Source: CBK



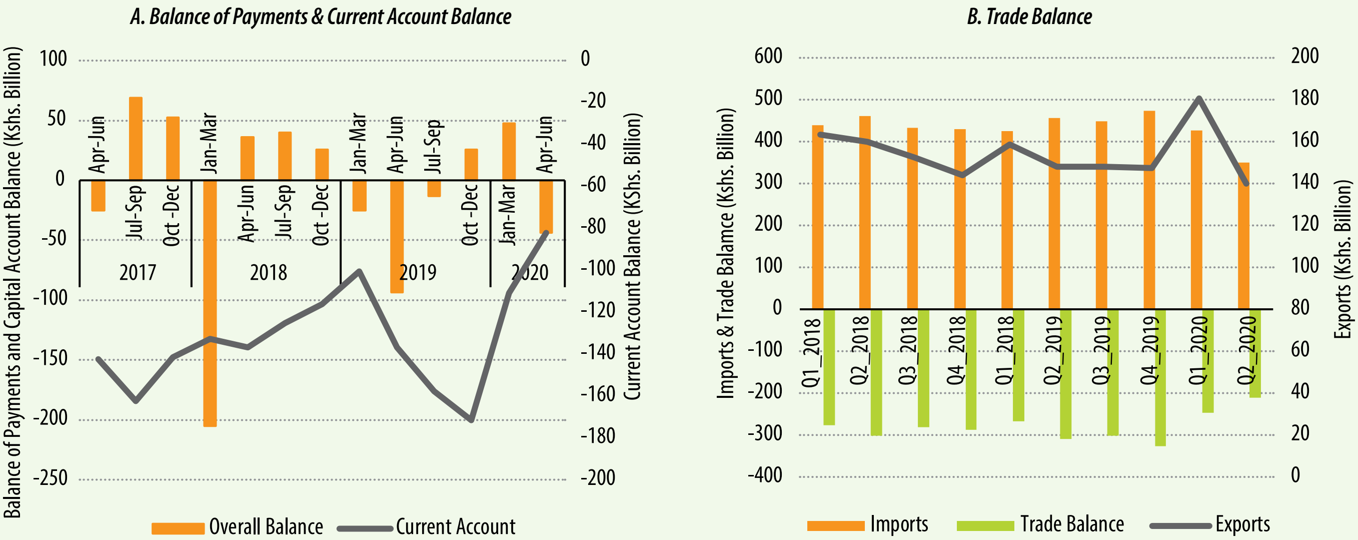

**Source:** CBK


**Source:** CBK

## Balance of Payments

**Kenya's overall external position has weakened, with the widening in the overall balance of payments deficit in the second quarter of 2020.** The widening in the overall deficit reflected a sharp decline in the position of the net inflow of foreign exchange by 84.8 percent that more-than-offset an improvement in the current account balance during the period. The current account deficit contracted to a deficit of KSh 82.2 billion in the second quarter of 2020 from Ksh 110.90 billion in the first quarter, largely supported by the narrowing of the merchandise trade deficit by 32.5 percent (**Figure 25**).

**Figure 25:**
**Balance of Payments**




**Source:** CBK

## Box 2

### Reforms Towards Kenya's Capital Market Deepening

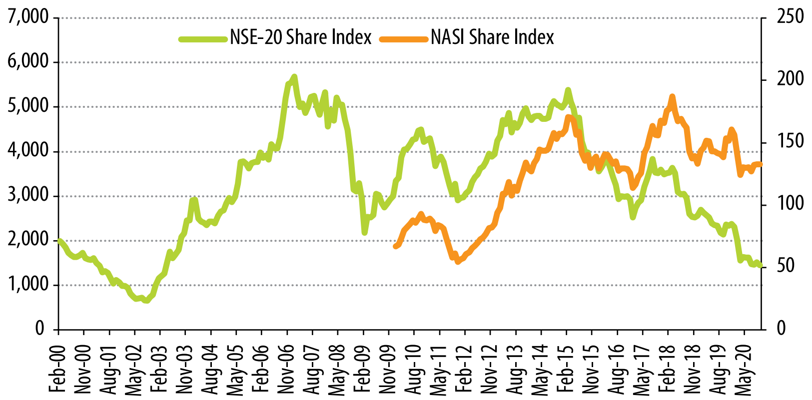
Over the years, Kenya's capital market has seen a significant amount of development, thus enabling it to play a role in financing the economy increasingly. An improving market infrastructure as well as policy and regulatory framework have continued to spur innovations in the market. Supporting that observed growth within the Kenyan capital markets have been a number of reform initiatives;

- Implementation of Risk-Based Supervision (RBS);
- Modernisation of market infrastructure with an Automated Trading and Settlement System (Equities since 2006 and debt since 2009) and a robust Central Securities Depository;
- Introduction of a listing platform for Small and Medium Enterprises (SME) and Venture Companies through the Growth and Enterprise Market Segment (GEMS);
- Introduction of Real Estate Investment Trust (REITs); and
- The Demutualisation of the Nairobi Securities Exchange (NSE).

Notwithstanding the reform initiatives the capital markets are still faced with multiple challenges;

- Low financial and investment literacy and savings levels;
- Limited innovation in the market;
- Inadequate supply of appropriate products and insufficiently responsive structures that satisfy potential demand in the market;
- Inadequate expertise for the structuring of complex capital market products;
- Weaknesses in the conduct of business by intermediaries which has contributed to investor apathy thus affecting liquidity in the market; and
- Concerns of inadequacy and competitiveness of critical systemic market infrastructure.

**Figure 26:**
**NSE-25 Share Price Indices**




Source: NSE

# Capital Markets

**Activity at the Nairobi Securities Exchange (NSE) continued to slowdown, but a slight recovery was seen in September.** The 20-share index declined from 1,942 points in June 2020 to 1,795 points in August, but recovered slightly to 1,852 points in September 2020. At the same time, the total number of shares traded also dipped from 553 million shares in June to 471 million shares in August and recovered to 525 million shares in September. The total value of the shares traded also depicted a similar pattern over the period (**Table 3**).

During the COVID-19 pandemic period, there has been heightened investor risk aversion. Nonetheless, while the NSE-20 share index partly recovered modestly in the third quarter, it remained below the pre-COVID-19 levels. This slight uptick in the index benefited from some surprisingly upbeat economic data, after the relaxation of the restrictive measures that had been put in place to mitigate the spread of the pandemic as well as the adoption of supportive fiscal and monetary policies.

**Table 3:**
**Nairobi Securities Exchange (January - August 2020)**

| | Jan-20 | Feb-20 | Mar-20 | Apr-20 | May-20 | Jun-20 | Jul-20 | Aug-20 | Sep-20 |
|---|---|---|---|---|---|---|---|---|---|
| NSE 20 Share Index (1966=100) Points | 2600 | 2337 | 1966 | 1,958 | 1,948 | 1,942 | 1,804 | 1,795 | 1,852 |
| Number of Shares Traded (Million) | 336 | 385 | 639 | 439 | 430 | 553 | 517 | 471 | 525 |
| Equities Turnover (KSh Billion) | 12.3 | 12.3 | 19.1 | 12.7 | 14.6 | 12.3 | 13.5 | 10.5 | 13.9 |

Source: NSE

# Banking Industry Performance

**The COVID-19 pandemic continued to cause significant changes in banks' balance sheets and profit and loss positions. Despite gross loans levelling off and its month-on-month growth decelerating, and the asset quality deteriorating, the banking sector remained well capitalised with adequate liquidity.**

The resilience of the banking system, as could be inferred from buffers above the minimum regulatory capital adequacy ratios, continued to signal the existence of sufficient loss-absorbing ability of the banking system to weather market shocks without triggering systemic instability.

The banking system remained adequately capitalised. Albeit on a decline, the ratio of total capital to the total risk-weighted assets stood at 18.24 percent in September compared to 18.52 percent in Junee, above the statutory mimumum of 14.5 percent.

Liquidity remained sufficient and on the rise. It stood at 53.1 percent in September 2020 up from 51.45 percent in June 2020, above the minimum stipulated limit of 20 percent.

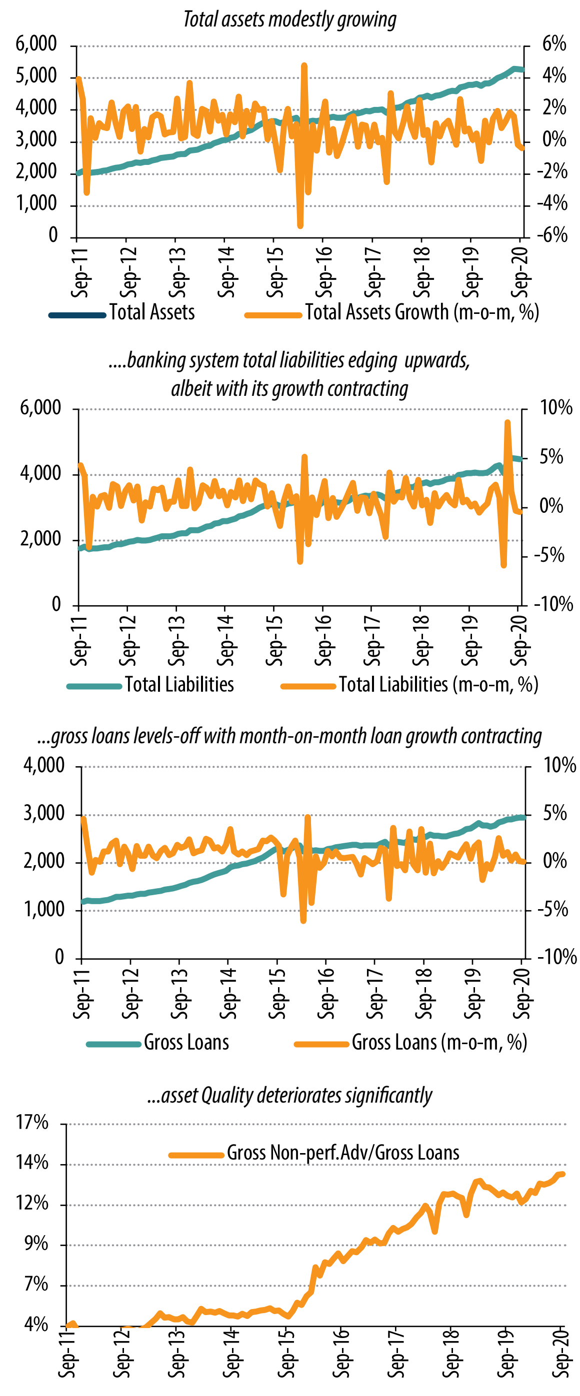
Total assets grew modestly to Kshs. 5,265 Billion in September 2020 from Kshs. 5,208 Billion in June 2020, as total liabilities also edged upwards during the period, albeit at a slower pace than the growth in assets.

The ratio of gross non-performing loans (NPLs) to gross loans stood at 13.64 percent in September, compared to 13.13 percent in June, largely due to the adverse effects of the pandemic on economic activity that weakened the capacity of borrowers to service their loans.

The loan-to-deposit ratio recovered after a decline in the first half of the year, as banks adjusted their operating strategies in line with the prevailing business environment. Banks' intermediation priorities have been navigating the profitability – liquidity trade-offs.

The shareholder's funds have been on a sustained uptrend; growing from Kshs. 769.52 Billion in June 2020 to Kshs. 789.53 Billion in September 2020 **(Figure 27).**

**Figure 27:**
**Banking Sector Developments and Dynamics**




**Source:** CBK

# Box 3

## Monetary Policy Response to the Coronavirus Pandemic

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;

a) Lowering of the policy rate, the CBR from 8.25 percent to 7.25 percent and 7 percent in March and April 2020, respectively;

b) Reduction of the Cash Reserve Ratio (CRR) from 5.25 percent to 4.25 percent, thus releasing KES 35.2 billion as additional liquidity to the banking sector to support borrowers under distress as a result of the COVID-19 pandemic.

- As of September 2020, KES 32.4 billion (92 percent) of KES 35.2 billion released as additional liquidity had been used to support lending, especially to the tourism, trade and transport and communication, real estate, and manufacturing sectors.

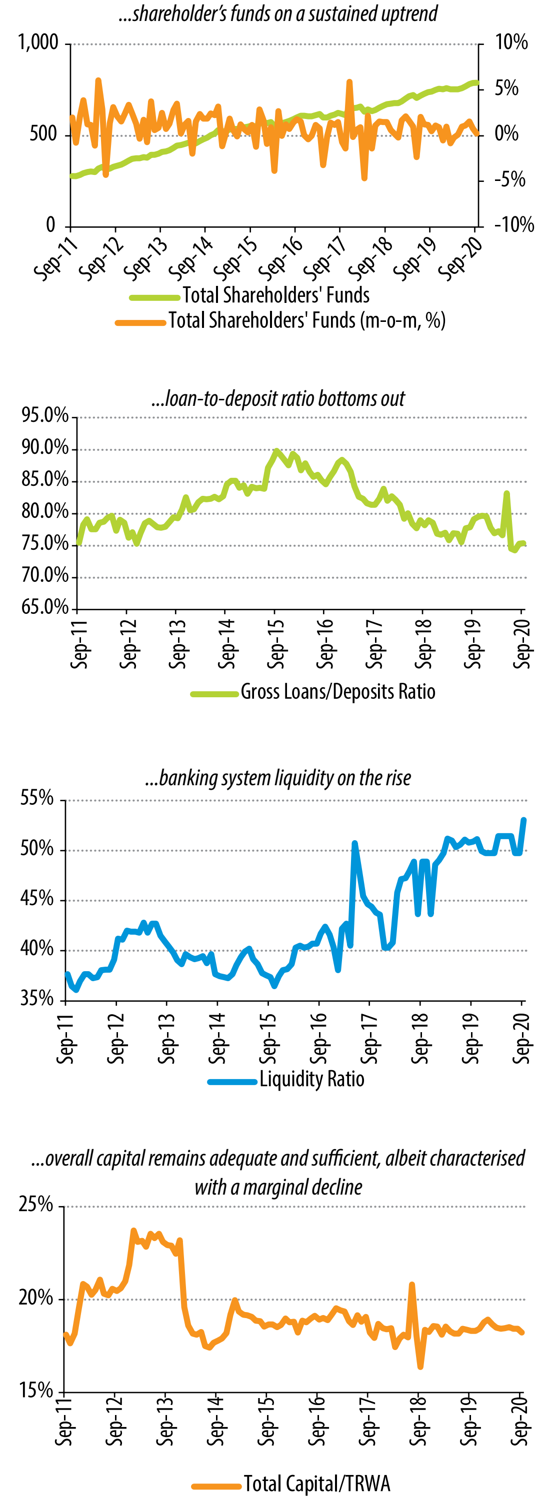
c) Loan restructuring for borrowers affected as a result of the pandemic while allowing for flexibility regarding loan classification and provisioning especially for facilities that were performing on March 2, 2020, and whose repayment period was extended or were restructured due to the pandemic;

- 38 percent of the total banking sector loan book of KES 2.9 trillion (equivalent to KES 1.12 trillion) have been restructured by the end of August of 2020. Of this, personal/household loans amounting to KES 271 billion (33 percent of the gross loans to this sector) have had their repayment period extended. For other sectors, a total of KES 849.9 billion had been restructured mainly to trade (20.7 percent), manufacturing (20.2 percent), real estate (18.3 percent) and agriculture (11.1 percent).

d) 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.

**Figure 27:**

**Banking Sector Developments and Dynamics**

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ASSOCIATION