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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 2014, drawing on the performance of recent past months as well as current developments to provide perspectives on the outlook for the rest of the year. The *Bulletin* covers trends in the real economy, government fiscal operations, public debt, inflation and interest rates, balance of payments and exchange rate, as well as activity at the Nairobi Securities Exchange and banking sector performance.

About the Centre for Research on Financial Markets and Policy

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

CENTRE FOR RESEARCH ON
FINANCIAL MARKETS AND POLICY

KENYA BANKERS ECONOMIC BULLETIN

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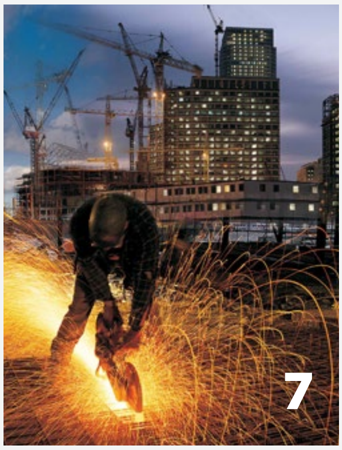
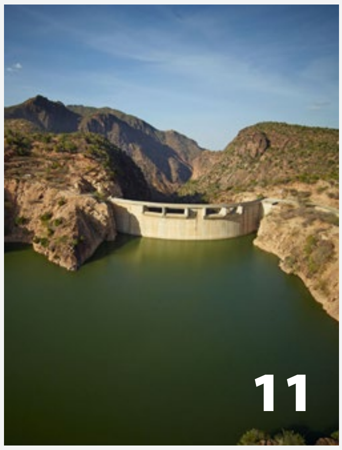




FOREWORD

From the CEO's Desk

It is my pleasure to present to you the ninth volume of the *Kenya Bankers Economic Bulletin*. This issue discusses the state of the Kenyan economy during the third quarter of 2014. The *Bulletin* reviews the strides that the economy has made since the beginning of the year, with an emphasis on the opportunities and constraints that continue to shape the economy's gradual recovery.

The performance of the Kenyan economy has over the years been shaped by both domestic as well as international dimensions. These circumstances have shaped the *Bulletin's* economic outlook. Further, the *Bulletin* provides insights regarding the meaning and implication of the rebasing of the economy that was undertaken in September 2014.

I hope that you will find this issue of the *Kenya Bankers Economic Bulletin* interesting and useful. We welcome feedback on the content of this Bulletin as we continually seek to improve its relevance to you. As always 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 .

Habil Olaka
CEO, Kenya Bankers Association

COMMENTARY

The Responsibility of 'Grown-Up' Economic Status

By Jared Osoro

Even those who least care about National Income Accounting, the term rebasing is now familiar – on occasion being thrown casually into conversation to confirm knowledgeability. To many, it is that statistical strategy that "transformed" the Nigerian economy early in the year. It also gave the Kenyan economy a 25 percent "boost" in September.

So rebasing the economy must be a good thing, only that the Nigerian or Kenyan population did not become richer than they were before the GDP figures were revised; the number of those living below the poverty line (USD 1.25 a day) remained more or less the same. But then, the Nigerian economy almost doubled in size such that by 2013 its GDP was revised to USD 510 billion, meaning that the economy leapfrogged South Africa to be Africa's largest economy, rising to the 24th largest world economy.

To those with jaundiced eyes – to whom everything always looking yellow – this may be one of those 'double-your-money' sort of scams stereotypically associated with Nigeria. Admittedly, that is unwarranted cynicism. Rebasing is unquestionably an essential exercise. For one to get the sense why it is, one needs to have an understanding of what it is.

An economy's output is typically measured by reference to the economic structure in a "base" year. Through sampling businesses in different segments of the economy, data is collected to determine how fast each of those segments is growing. The weight attached to each sector depends on its importance to the economy in the base year. As time passes and the structure of the economy changes, these figures' accuracy is obviously blunted.

Rebasing therefore comes in to update the numbers and provide the necessary accuracy. More recently collected data replaces an old base year with a new one to reflect the structural changes in the economy. It also provides an opportunity to add new or more comprehensive data, incorporate new or better statistical methods, and apply advancements in classification and compilation standards.

To its credit, the Kenya's government statistical agency – the Kenyan National Bureau of Statistics (KNBS) – has been updating its GDP numbers more frequently; the last "base year" was 2001, which now moves to 2009 with the rebasing. In the Nigerian case, the base has disappointingly been 1990 for all that long. Little wonder therefore that the change in the GDP size was not as massive for the case of Kenyan as it was for Nigeria.

Luthuli Avenue in downtown Nairobi: Kenyan population did not become richer than they were before the GDP figures were revised; the number of those living below the poverty line (USD 1.25 a day) remained more or less the same.

Implications and Misconceptions

But the 25 percent boost to Kenya's GDP comes with obvious implications and misconceptions. The implications first. Even from a pure arithmetic consideration, the increased in the level of the economy's GDP leads to two things. One, the debt-to-GDP ratio declines; two, fiscal deficit-to-GDP ratio declined too. That by no means provides a *carte blanche* for more borrowing or pursuance if a larger deficit.

It is easy to imagine why the economy's capacity to absorb additional debt is higher with a higher GDP base than previously. What is more, Kenya has never been a beneficiary of debt relief initiatives such Heavily Indebted Poor Countries (HIPC) programme of its enhanced version. Additionally, the debt sustainability analysis (DSA) either by the IMF or jointly the IMF and World Bank over the years have consistently returned a verdict of a debt sustainable position (both domestic and external).

Furthermore there seems to be some intellectual vindication for those who believe that there is even more scope to take more debt. One of the key conclusions of a recent study (Berg, et.al. 2014[1]) is that the so-called 'Worst Scenario Aggregator' (WSA) employed by the IMF-World Bank DSA is too conservative, meaning it predicts a crisis too soon. My interpretation here is that a sustainable debt verdict based on this methodology means that the economy could comfortably take more debt.

My view therefore is that it is not a simple '*Animal Farm*' like matter of Snowball's doctrine of two legs bad, four legs good: in other words more debt bad, low debt good. There has to be a nuance; and that nuance is that the ability to service those debts is a function of tax revenues and export receipts which have remained unchanged.

How about the fiscal deficit? We know that the economy has been struggling to attain a faster rate of growth that we last saw before the global economic meltdown of 2008-2009. Indeed, as **Figure 1** shows, the 2010 spike was just one episode that was subsequently followed by lackluster performance even with the rebase. If we have to use the fiscal policy as a growth stimulant, then we have to figure out which of the three competing arguments carries the day.

- If it is the new classical theory argument, then the faster growth in expenditure will be accompanied by the temptation to tax more; and taxes may have a distortionary effect that could dampen growth.

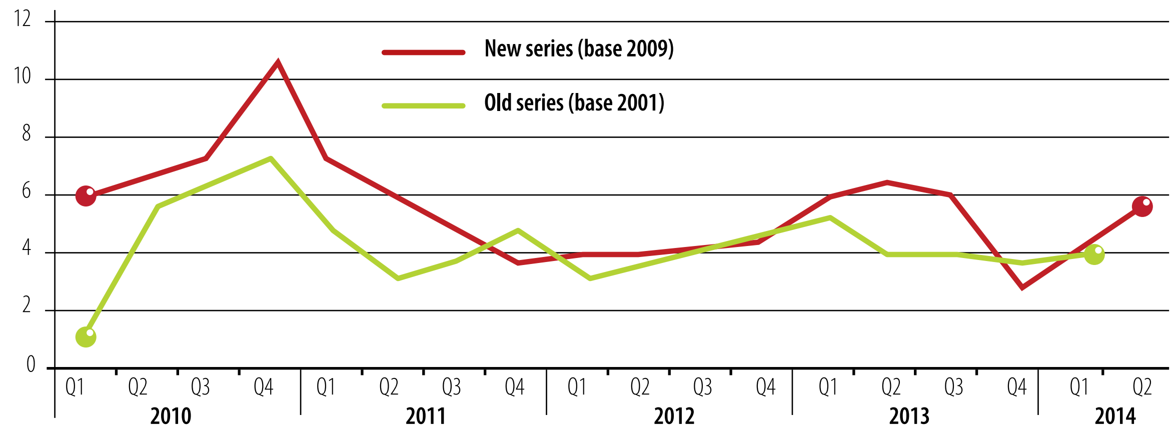
- If it is the Keynesian argument, then increased expenditure has a demand stimulating effect that could promote growth; in good times it is necessary sugar if aligned with monetary policy to avoid comprising stability and in bad times it is necessary antibiotic.

- If it is the Ricardian Equivalence argument, then the desire by the government to boost growth through debt-financed expenditure will have no significant effect on economic performance in the long-run because rational behaviour will occasion expectation of tax increase in future, thus the underlying demand behaviour will not change.

When it is convenient, we all become Keynesians; even Milton Friedman – a die-hard critic of John Maynard Keynes once proclaimed as much. But even here there has to be some nuance; and that nuance is that the implications any increased deficit as a result of stimulating expenditure have to be care-

1 Berg, A., Berkes, E, Catherine Pattillo, C., Presbitero, A.F, Yakhshilikov, Y., (2014). Assessing Bias and Accuracy in the World Bank- IMF's Debt Sustainability Framework for Low-Income Countries; IMF Working Paper WP/14/48, March.

Figure 1: Quarterly Real GDP Growth (%)



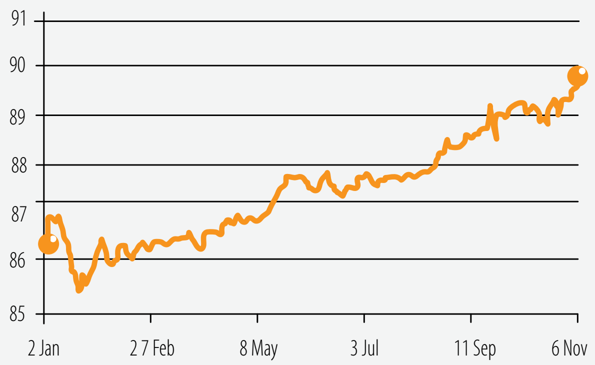
Source: KNBS

fully considered. As recently commentary, for instance by the World Bank, correctly puts it, depending on how they are financed, fiscal deficits can either add pressure on domestic interest rates if financed through local borrowing or add pressure on the exchange rate if borrowing is financed externally.

It is not secret that the economy's current account is clearly weak even on the back of the rebasing. So long as the current remains in its weak state, the local currency will maintain the depreciation bias (**Figure 2**). The recent depreciation episodes coinciding with foreign exchange demand on the back of weak inflows demonstrate how fragile the external position remains; it doesn't help that insecurity persists in the economy – even in non-tourism areas – and the blunt signal is that the country is not ideal for tourism in the current state; it doesn't help either that the outbreak of the Ebola pandemic in some parts of Africa has had effects that reverberates to Kenya thus affecting the economy's current account.

Against this backdrop the Central Bank of Kenya (CBK) has where necessary been in the market to correct for any volatility. It could well be a case of the CBK boldly signalling a commitment to assure foreign exchange market stability; nonetheless it points to the fact that any depreciation persistence will signal the need for market correction in the form of relative price increase and therefore a slow down on imports.

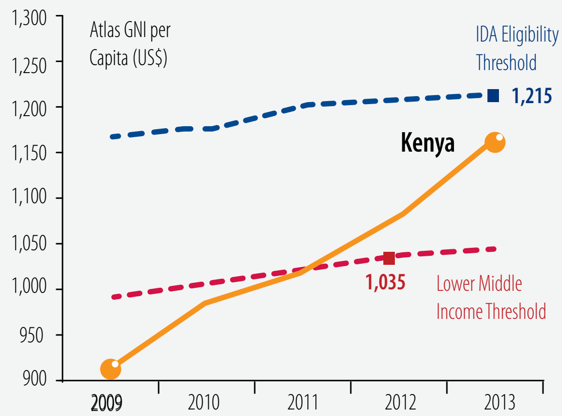
Figure 2:Nominal Exchange Rate (KES/USD)



Source: CBK

Then comes the misconception that Kenya's "grown-up" economic status will block it out of the concessional funds from the World Bank, a major funder of government programmes and projects. The common categorization of economic status based on income per capita is such that when it crosses USD 1,035 then the economy attains lower-middle income status. Kenya's 2013 income per capita of USD 1160 puts it above the lower-middle income threshold. But the IDA eligibility cut-off currently stands at a GNI per capita of. Nonetheless, the World Bank indicates that the cut of criteria for accessing its concessional window – the International Development Association (IDA) – is an income per capita of USD 1,215, thus confirming Kenyans continued eligibility – at least for now (**Figure 3**).

Figure 3: Kenya's Income Per Capita Status and Its IDA Eligibility



Source: World Bank (http://blogs.worldbank.org/opendata/kenya-s-re-based-national-accounts-myths-facts-and-consequences)

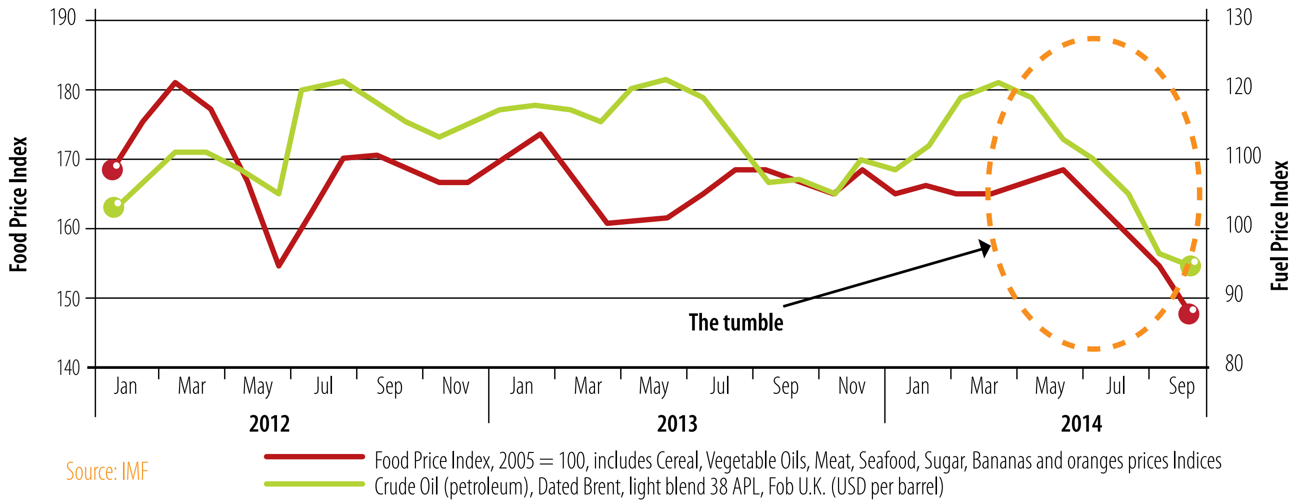
Some Help from Good Fortunes

As many reflect on what "fortunes" the rebasing of the economy brings, there comes a helping hand associated with the tailwinds emanating from declining food and oil prices (**Figure 4**). The picture presented by the oil prices in particular is interesting. Oil have taken the nose-dive on the back of ample supply and signals from key OPEC members, Saudi Arabia and Kuwait, that they can deal with lower prices thus a low likelihood of output reduction to counter price decline.

The current Brent crude price of about USD 87.74 a barrel is the lowest level since December 2010. The context of oil prices goes beyond the simple conjecture of whether high oil prices or low oil prices are good—it more about maintaining the proper balance. When oil prices fall below USD 100 a barrel, the OPEC members have a difficult time balancing their budgets, which are largely dependent on oil revenues.

What makes the oil market dynamics interesting is the fact that individual OPEC members may be looking at their own interest and the cartel may not be speaking in unison. Moreover, the era of the all-powerful OPEC may be coming up to a challenge from new entrants into to the space, notably the US. Market observers note some confusion even within the leading players – notably Saudi Arabia; the Saudi Prince has publicly

Figure 4: Food and Fuel Prices



Source: IMF

stated his disbelief that Saudi Arabia would allow oil prices to fall below USD 90 a barrel on the back of 90 percent of Saudi Arabia's budget is reliant on oil revenues and that a continued fall in prices would be catastrophic.

Meanwhile, another leading OPEC-member, Venezuela, has been on the other side of the output-cut divide, calling for an emergency meeting of the group to respond to falling prices. But Kuwait and Saudi Arabia seem not to budge. It is conceivable that Kuwait and Saudi Arabia can survive a few more months of low oil prices, hence their reluctance to cut output. Russia will find it more difficult.

Russia's economic growth is already feeble and a further drop in the oil price could be catastrophic given that oil and gas make up 70 percent of Russia's exports and half of the federal budget. The ample supply is largely due to surging production from Russia and the US. Notably, the US shale boom has been threatening to overtake Saudi Arabia's own output. With that in mind, Saudi Arabia has limited incentive to reduce output to boost prices.

The balancing effect I have alluded to will mean that oil prices are not in for a free fall. On account of the changes in the market dynamics as outlined, we are not likely to see a reversal of oil prices, similar to what was observed in March 2012 – June 2013 price drop. Instead I envisage prices to stabilise in the USD80 – USD 90 per barrel range into 2015. The fact that the global economic recovery is till feeble and the IMF World Economic Outlook (October 2014) has projected modest recovery in real output from 3.3 percent in 2014 to 3.8 percent in 2015 would mean that pressure on oil price increase occasioned by demand is at best limited. The fall in oil prices comes as a boon to the local economy in two respects.

One, it coincides with a time when the power supply landscape is changing in disfavour of thermal energy. The injection of 201 megawatts of geothermal energy in October 2014 lead to this power source overtaking hydroelectricity; by the end of October 2014 geothermal energy accounted for about 43 percent of the 794 million units of electricity consumed in the economy while hydroelectricity accounted for about 35 percent.

These developments will translate to cheaper energy given that geothermal source is cheaper than thermal, and a move away from the weather-linked hydroelectricity will obviate the frequent resort to thermal power whenever the weather is not favourable for hydrogenation.

Two, the inflation that filters from direct and indirect oil consumption will be ameliorated. While the fall in international food prices that we can observe from observe in **Figure 4** is an obvious a boon, it needs to be appreciated that it is not necessarily arise from abundant domestic production. Even then, any food import will obviously be at favourable prices.

Outlook

The good fortunes I outline, coming at a time when Kenya has undertaken the rebasing, have been associated with an interesting outcome: the economy has not just the growth from a higher base, but at a rate that is faster. The economy registered a real growth of 5.8 percent second quarter of 2014. There are nonetheless doubts – even in official circles - as to whether the year's ambitious growth projections of over 5.5 percent will be realised. In the circumstances therefore, a real growth of even 5 percent in 2015 will look good.

Jared Osoro is the Director of Kenya Bankers Association Centre for Research on Financial Markets and Policy®

State of the Economy

Real Output Growth

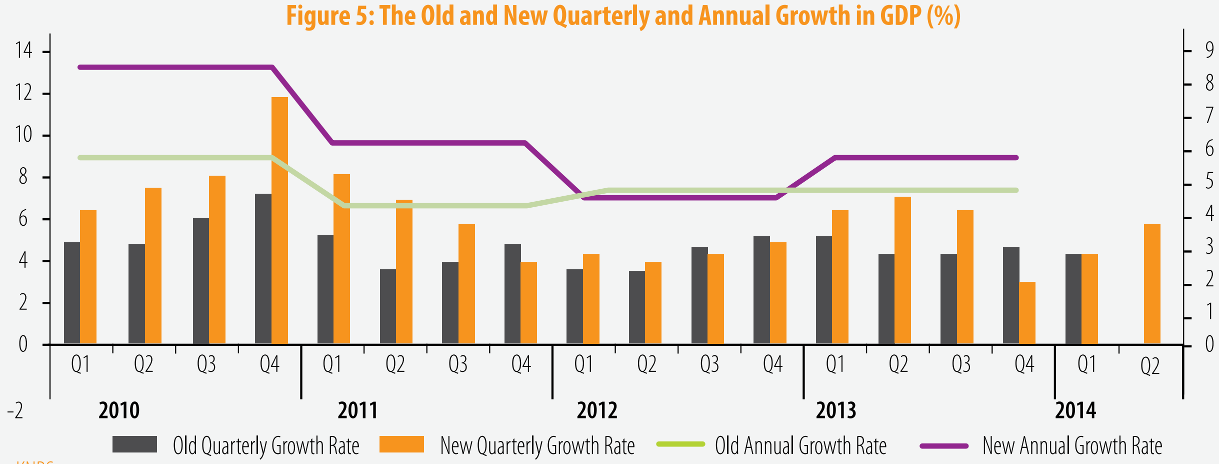
Upon the revision of the economy's output computation base from 2001 to 2009 that saw the economy's size expand by about 25 percent, provisional estimates posit a 5.8 percent growth during the second quarter of 2014 compared to 7.2 per cent recorded during a similar quarter of 2013. This growth was mainly supported by robust expansion in construction (18.9 percent), manufacturing (9.1 percent) financial services (8.3 percent); information and communication (6.4 percent); and wholesale and retail trade (6.8 percent). At the same time the rebasing of the GDP saw the economy shift to a middle income country form a GDP per capita of 994 USD to 1,246 USD.

Unlike the first two quarters of the year that were characterized by a largely stable macroeconomic environment, third quarter was relative shaky. This was evidenced in by the rise in the inflation rate for the entire quarter three as well as a clear weakening bias on the Kenya shilling. The erratic long rains adversely shocked the economy from the supply side of food stuffs thus fueling inflation upwards. The major foreign exchange earners continued to post poor performance, especially tea and coffee whose export volumes were affected by erratic rains. Increased incidences of insecurity reduced investors' confidence with the major foreign exchange earning sectors such as tourism registering poor performance. Nonetheless, interest rates remain fairly stable in quarter three with the yield on government treasury bills averaging at 8.29 percent for the 91 day Treasury Bills, the lowest monthly yield ever since August 2013.

The construction boom

Upon debasing, the quarterly GDP growth rose compared to the previous growth rates. However, for the entire 2012, the new annual GDP growth rate largely coincides with the old annual GDP growth rates; the same is observable for quarterly the quarterly GDP growth rates.

Figure 5: The Old and New Quarterly and Annual Growth in GDP (%)



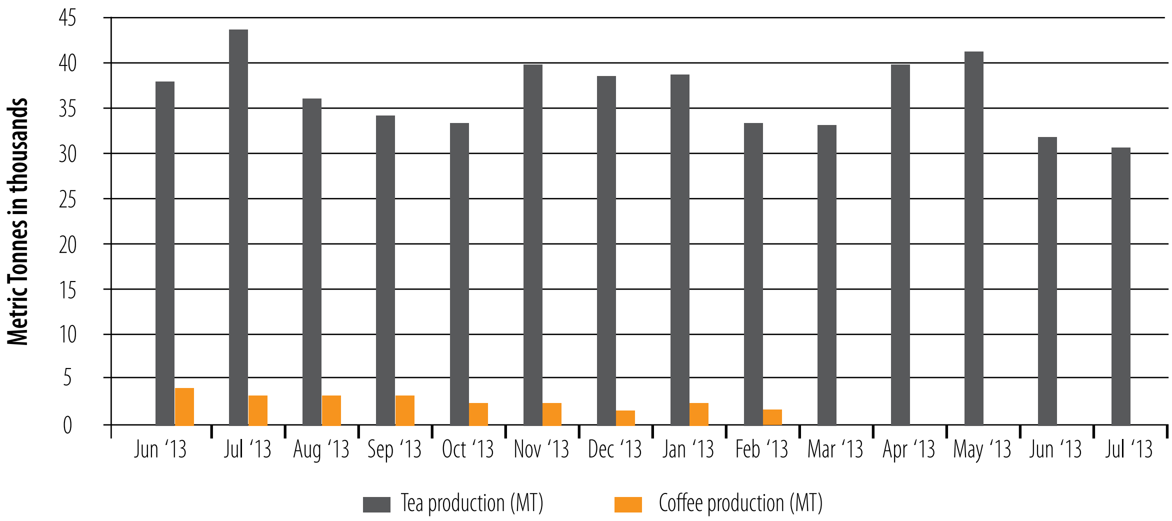
Source: KNBS

Agriculture

Despite agriculture being a contributor to the overall GDP growth, its general performance remained below its potentials. According to the revised GDP estimates the sector is estimated to have expanded by 5.5 percent in the second quarter of 2014 compared to 5.9 percent in second quarter. This is attributable to the erratic rains in quarter two of 2014. However, with the heavy short rains expected in the fourth quarter of the year, the status is expected to change and faster growth consequently realized.

The quantity of processed tea decreased from 31,945 MT in June 2014 to 30,790 MT in July 2014 although average auction price increased from KSh 177.90 to Ksh 199.85 per kilogram over the same period. Milk deliveries to formal processors rose from 40.2 million litres in June 2014 to 43.0 million litres in July 2014. Maize shock supply experienced in the second quarter of 2014 eased following the inflow of maize imports from Tanzania hence normalizing supply. The poor performance in Tea production continued to be felt for the entire part of the third quarter. This was evidenced by the poor'bonus'payment to tea

Figure 6: Tea and Coffee production in Metric Tonnes: June 2013 – July 2014

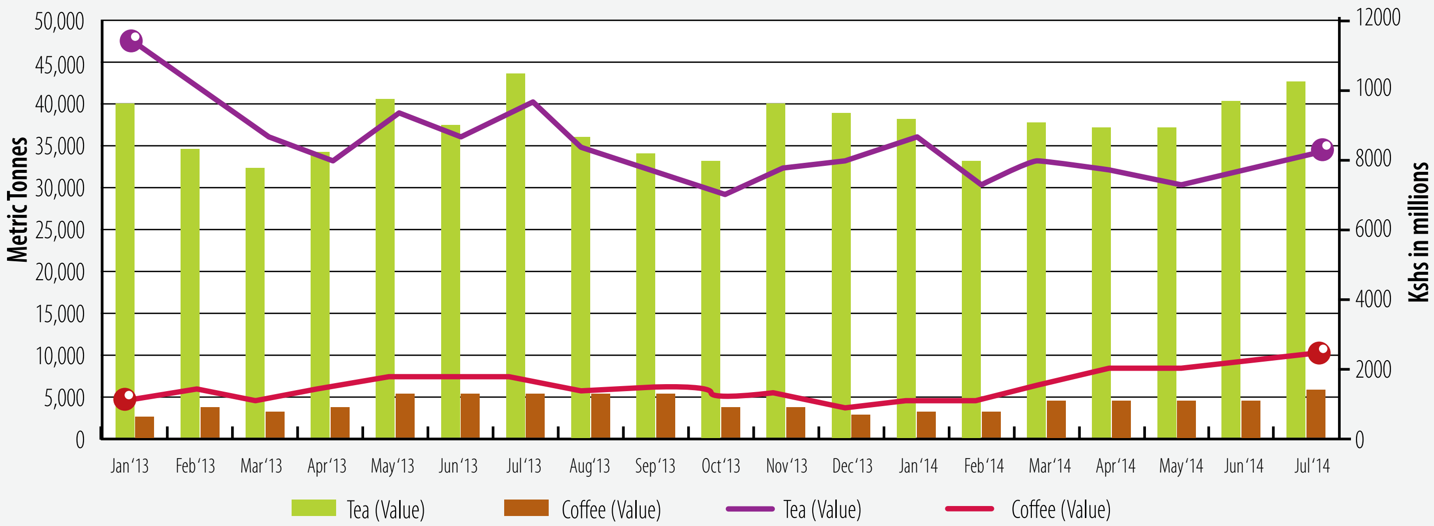


farmers with large disparities among various tea growing zones in the country. Notwithstanding the improvement in international prices to Ksh.199.85 per kilogram in July 2014 compared to a low of Ksh. 177.90 in June 2014, tea production continued to dwindle from a high of 41,186 metric tonnes in May 2014 to a low of 30,790 metric tonnes in July 2014.

A taster samples varieties of tea for quality at the Mombasa Tea Auction.

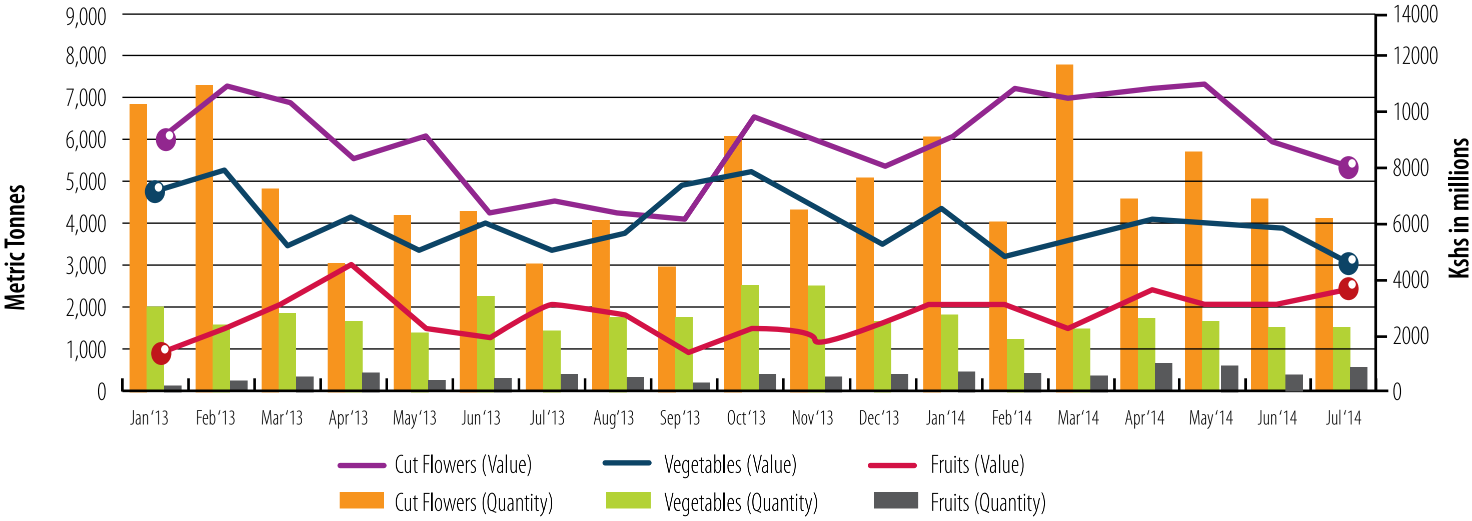
The setting in of decline in the production of coffee is not wholly caused by erratic rains but also the encroachment of coffee production zone for real estate development especially in central province since the rental income from real estate yield higher returns compared to income from coffee sale. There is therefore the need for government intervention to formulate policies that will delineate agricultural land from settlement lands if the future of major agricultural exports and good security is to be guaranteed. This notwithstanding, agriculture cash crop exports continue to command a good share of the total economy's main export, with tea leading the pack followed by coffee. However, as revealed in (**Figure 7)** the value of tea exports improved in July 2014 compared to June 2014 to hit a high of Ksh. 8,468.02 million compared to Ksh. 7,692.29 million in June 2014.

Figure 7: Quantity and Value of Tea and Coffee Exports, January 2013 – July 2014



Source KNBS

Figure 8: Horticultural Exports



Source KNBS

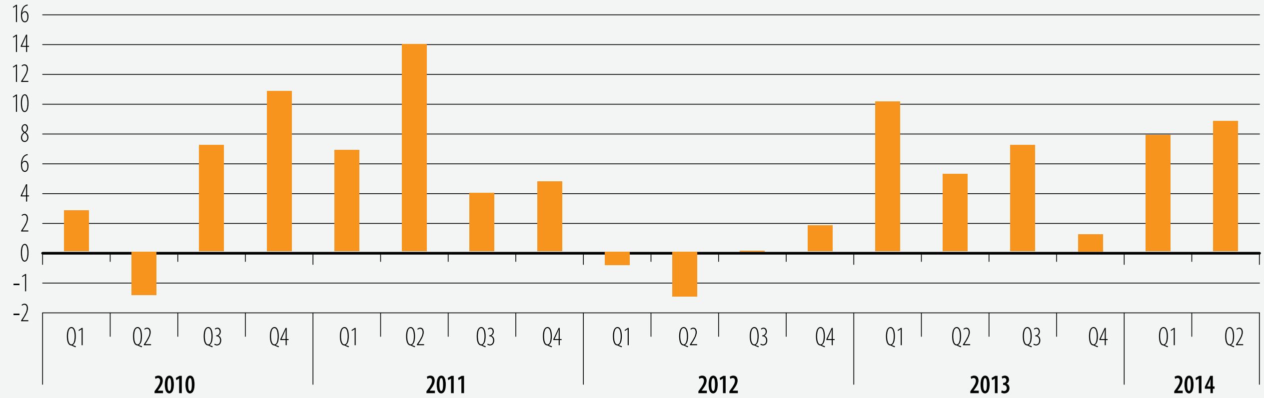
On horticultural exports **(Figure 8)**, cut flowers dominate in terms of both the quantity and foreign exchange earned, contributing on average 65.95 per cent of total horticultural exports for July 2014, followed by vegetables at 24.58 percent with fruits exports recording the lowest contribution of 9.47 per cent. However, the production and exports for cut flowers and vegetables drastically declined in the third quarter of 2014. This is attributable to the dead-lock in the negotiations with the European Union on the taxing of the Kenya exports entering the European market. It's expected that the exports of the horticultural products to the European union market will continue to face the down side risks for the better part of quarter four of 2014 with the introduction of the 30 per cent tax on Kenya's horticultural exports to the European market coming into effect.

Manufacturing

The manufacturing sector in Kenya is considered to be one of the pillars for the achievement of vision 2030 goals through transiting the economy from traditional agriculture to a modern economy. According to the debased GDP estimates, manufacturing sector grew by 9.1 per cent in quarter 2 of 2014 compared to 7.9 per cent in quarter 1 of 2014. The sector is set for a rebound following the 2014/2015 budget reading which is likely to benefit the sector from tax exemptions for locally manufacturing industries as well as tax imposition on the external manufactured goods to cushion local industry from unfair competition. However following the policy lag effect, the results of 2014/2015 budget on the manufacturing sector are yet to be realised for the rest of the year. For the third quarter, sugar production t rose up from 42,866 metric tonnes in June 2014 to 55,912 metric tonnes in July 2014 as well as Production of assembled vehicles that slightly increased from 844 units in July 2014 to 879 units in August 2014.

In order to support the manufacturing as well as the service sector, there evidently keen interest in the efforts towards lowering the cost of energy which adversely affects production costs. Concerted efforts to boosts energy production especially the geothermal and reduce over reliance on

Figure 9: Manufacturing Growth Rates (Quarterly)

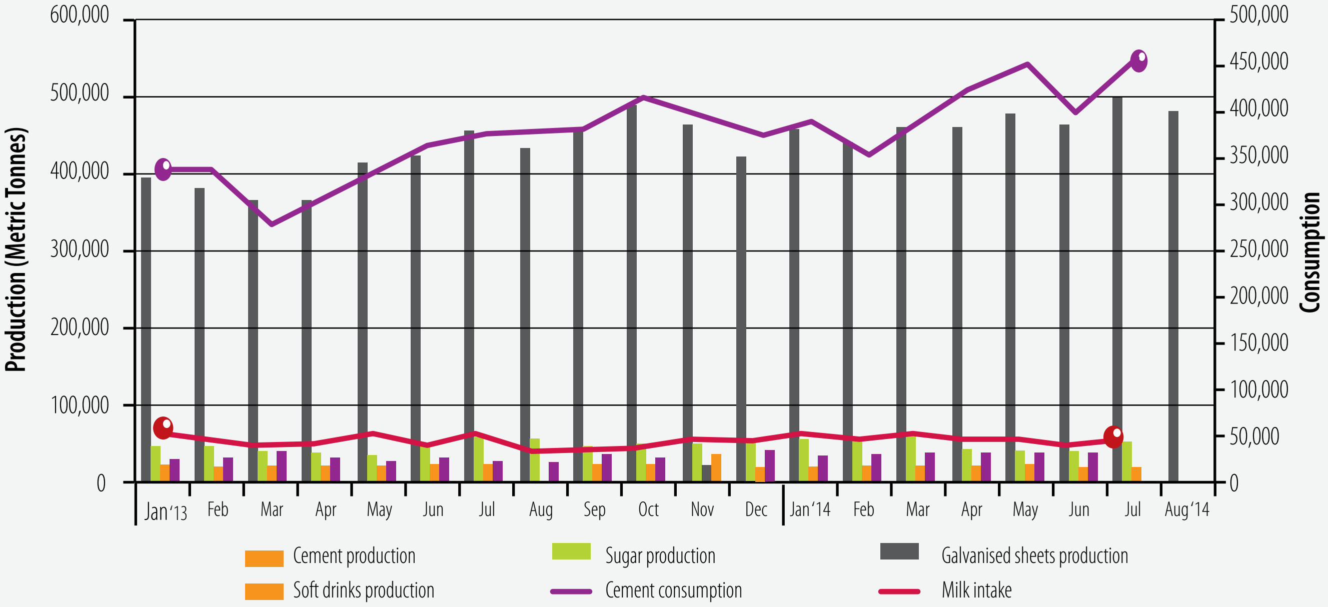


Source CBK

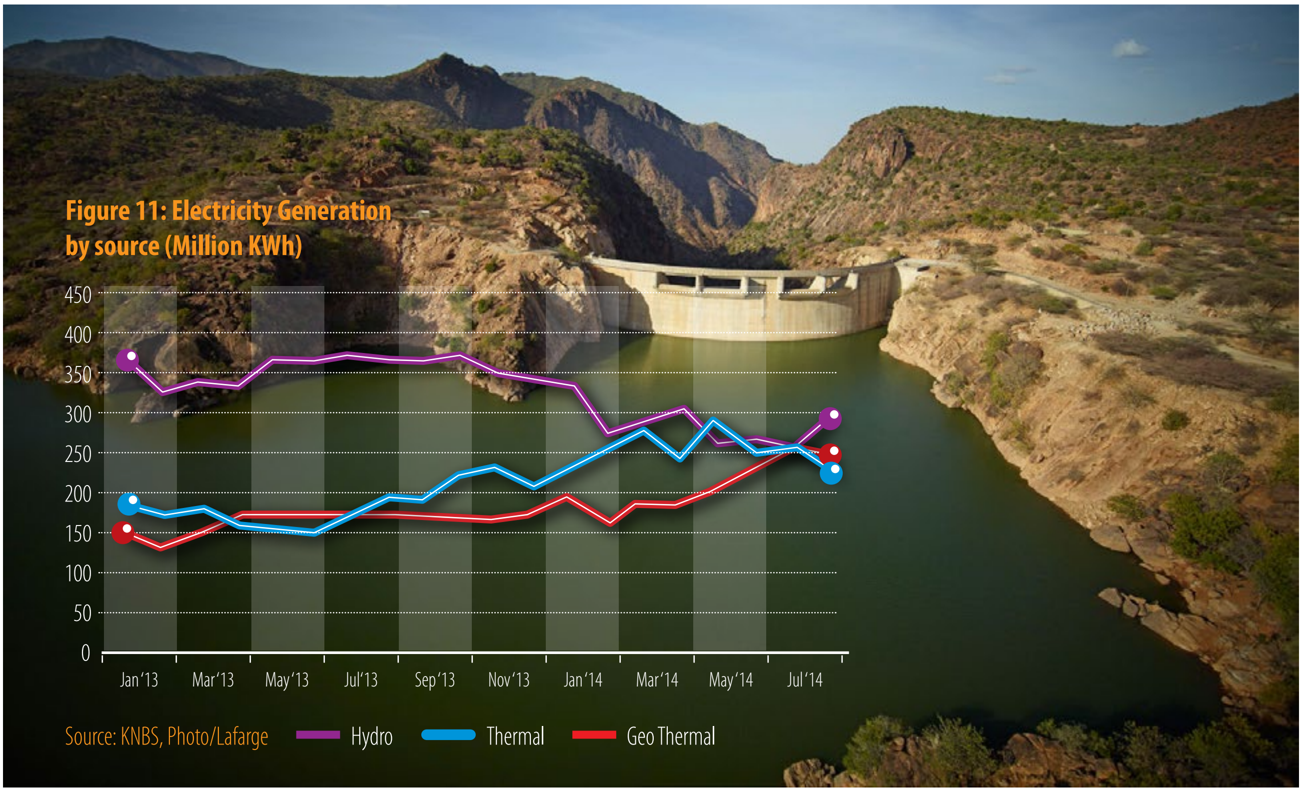
hydro production continues to be a priority in the central government. In addition new reflections on boosting green energy such as solar energy has come into the limelight especially for households use hence reducing demand pressures on the national grid line. This is evidenced by commissioning of an additional geothermal power plant adding 140 megawatts into the national grid hence lowering the cost of power by 30 per cent.

A key component of the manufacturing sector is its output that targets the construction industry. The domestic production of galvanized sheets slightly declined from 23,143 metric tonnes in June 2014 to 23,002 metric tonnes in July 2014. Cement production increased in the July to hit a high of 500,428 metric tonnes from 462,929 metric tonnes in June 2014. However August 2014 recorded a slight decline in cement production to post a low of 479,801 metric tonnes. In terms of monthly cement consumption, July 2014 recorded a significant rise to 459,881metric tonnes compared to 402,249 metric tonnes in June 2014.The number of assembled vehicles marginally decline in the onset of quarter three from 871 in June 2014 to 844 in July before slightly rising to 879 in August 2014. Milk production improved with milk deliveries to formal processors rising from 40.2 million litres in June 2014 to 43.0 million litres in July 2014.

Figure10: Production and Consumption of Manufacturing Exports



Source KNBS



Energy

Electricity generation has continued to grow, albeit still outpaced by demand. Both thermal and geo-thermal production increased tremendously in June and August with hydro production experiencing a drastic increase in production. Total electricity generation declined from 730.12 million KWh in June 2014 to 763.08 million KWh in July before mildly surging up to 764.74 million KWh in August 2014 mainly as a result of increased hydro production August. Domestic consumption of electricity rose from 648.30 million KWh in June 2014 to 672.56 million KWh in August 2014. This follows the increase in the new power connections mainly in the rural areas under the rural electrification programme.

The slight dominance of hydroelectric power generation is evident, with its contribution to total energy production for July and August combined accounting for 35.85 percent, closely followed by geothermal production at 33.01 percent with thermal production coming third at 31.14 percent. However the respective share by source signifies that none of the production source is dominant of the other two but rather all complement each other. As more geothermal capacity comes on broad, we are likely to see the hydro source being overtaken as depicted in the trend in **Figure 11**.

A decline in thermal and geo thermal production is evident between July and August 2014 with the production falling from 257.71 and 251.50million KWh for geo thermal and thermal production respectively in June to 246.67 and 224.20 million KWh in August 2014 geothermal and thermal production respectively. However, for the hydro power, production increased from 253.87 million KWh in July to 293.87 million KWh in August 2014.

Despite the power production lagging far much below the demand, power loses continue to be on the rise owing to inefficiency to close the loop holes. Power losses increased from 96.67 million KWh in June 2014 to 226.20 million KWh in July before declining marginally to 106.38 million KWh in August. This is mainly due to illegal power connections that are not recognized by the Kenya Power and Lighting Company.

Energy prices have remained high in Kenya. The average cost of products imported as well as locally refined products increased during the first two months of the third quarter (**Table 2**). The Energy Regulatory Commission (ERC) effected price increases in fuel effective 15th of every month. The rise in oil prices is partly on account of increasing refining costs arising from the inefficiency of the Kenya Petroleum Refinery as well as increase in world oil price. Partly though, the increase has been attributed to forward shifting of prices by oil marketers due to penalties they face from shippers on account of delays.

Table 2: Crude Oil and Fuel Import Prices

Product	June 2014	July 2014	Aug 2014
Murban crude oil (US$/Barrel)	111.65	109.50	105.18
Super petrol (KES/Litre)	115.43	116.67	117.43
Diesel (KES/Litre)	105.73	105.59	103.90
Kerosene (KES/Litre)	84.04	85.03	83.97

Source: ERC

In addition, imports of refined petroleum products remain significantly restricted in Kenya with the oil company winning the Open Tender System bid required to import more crude oil than refined products to sell to the other oil marketers. In addition the geo-political tensions in Russia and Ukraine have had an influence on oil prices. Further, the depreciation of Kenya shilling against the US dollar surged the oil prices up given the high oil import bill.

Building and Construction

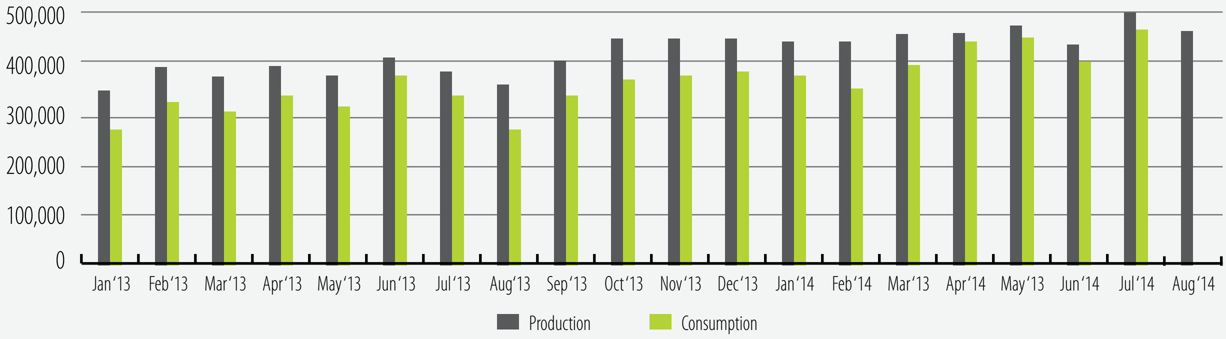
Building and construction recorded an impressive performance in the first month of quarter three as evidenced by increased production and consumption of cement for the period under review. Cement consumption, a proxy of activity in the construction industry increased by 57,632 metric tonnes between June and July 2014 far above the increased production of 37,499 metric tonnes in the same period. For cement production August saw the total monthly production declines by 20,627 metric tonnes from 500,428 metric tonnes in July to 479,801 metric tonnes in August 2014. The rise in the cement consumption arises from increased demand for construction mainly in real estate development among the expanding middle income and overall growth in population and its composition as well as increased government construction of the physical infrastructure.

Transport and Communications

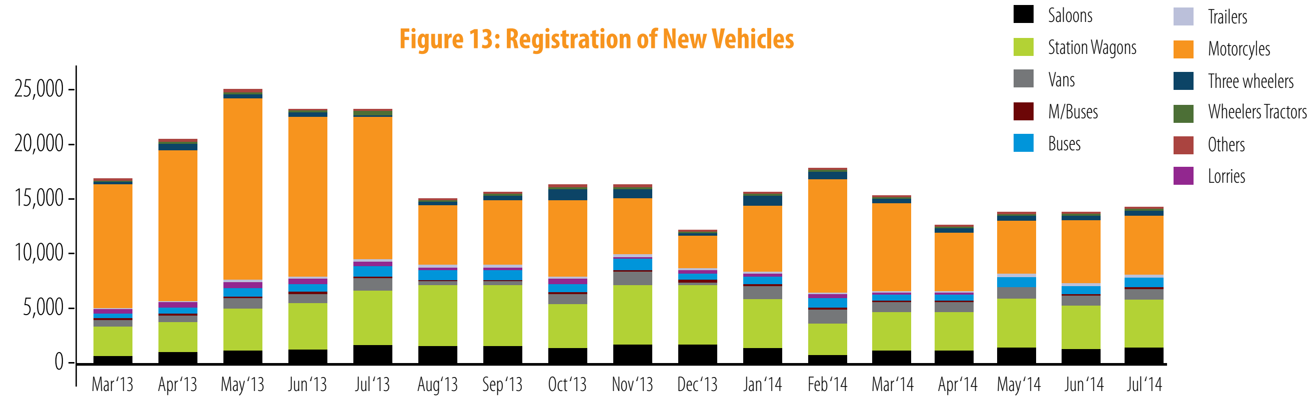
The total number of vehicles registered expanded from 14,011 in June 2014 to 14,399 in July 2014. Motor cycles accounted for 39.0 per cent of the total motor vehicles registered in July 2014. (**Figure 13**). Motor cycles still remain an important aspect of transport both in urban and rural areas. A modest rise was seen in July 2014 from the June 2014 levels in the registration of Lorries, saloons, buses, station wagons, vans, and trailers with motor cycles and three wheelers posting declines over the same period.

The dominance of mobile telephony in the communications industry continues to be evident. Mobile money transfer has been significant especially in rural areas where banks are not available, inaccessible, or where majority of the population do not hold bank accounts. At the same

Figure 12: Cement Consumption, MTs



Source: KNBS



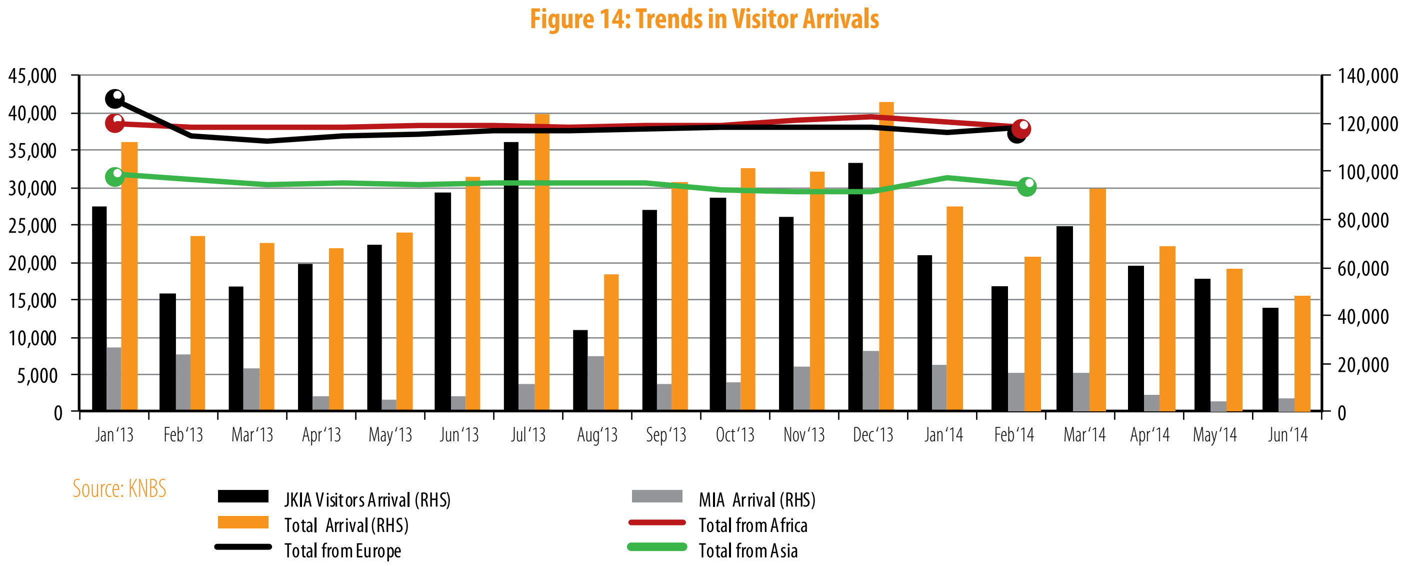
Source: KNBS

time this mode of money transfer has been characterized by ease of use and, despite recent revision of charges on transactions. This reflects the view that mobile transfer has the potential of raising living standards by offering employment with the entire value of mobile banking transactions. The facility has also been greatly adopted by commercial banks in offering mobile banking services in pursuit of banking the unbanked.

Tourism

The adverse performance of the tourism sector for the second quarter of 2014 continued being felt for the entire of the third quarter following the travel advisories issued by The United States, United Kingdom, France and Australia to their citizens following terror threats in the country especially in the coastal region. This is perhaps the sector that registered huge loss for quarter two as well as quarter three of 2014. However, compared to the second quarter, the onset of quarter three posted some improvements albeit the number of non – performing loans for the sector remained still high for in quarter three.

The poaching menace still continued to put tourism sector in jeopardy through reduction in the wildlife population. From the KNBS statistics, the number of arrivals from Europe slightly declined from 36,622 in June to 36,096 in August 2014. However, looking at the total arrival from Africa tourists' arrival to Kenya rose from 36,932 in June to 37,106 in July 2014. Similarly form Asia, tourists arrivals to Kenya marginally improved from 26,821 to 26,916 in June and July respectively. Given the reduced foreign tourism, the government has for the better part of quarter two and three embarked on measures promoting domestic tourism such as allowing all corporate and business entities to pay vacation trip expenses for their staff on annual leave in Kenya and deduct such expenditures in their taxes, subjecting all ticketing services supplied by travel agents to tax exemption to enhance our competitiveness in the region.



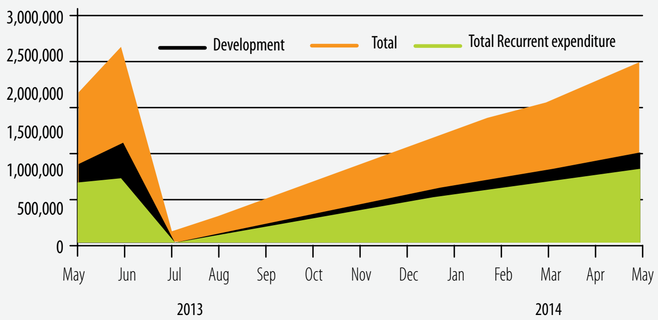
Source: KNBS

Financing of Government

The second quarter of 2014 witnessed the reading of the 2015 /2015 financial year budget estimates. In the budget, the government plans to finance it majorly through tax with tax revenues estimated to finance 83.6 percent of the total budget. The budget propose the intention to raise tax revenue collection by 15.5 percent to Kshs, 1,180.8 billion equivalent to 25.5 percent of the total GDP with only Kshs 94.1 billion coming through the Appropriations – In –Aid.

In quarter 2of 2014, the total tax revenue for April and May grew tremendously to stand at Kshs. 708,790 and Kshs. 783,107 respectively. However, the recurrent expenditure for April and May 2014 stood at 815,652 and 919,792 respectively while the development expenditure was 209,479 and 237,985 respectively. This therefore shows that the government still continued to struggle with budget deficit. In addition recurrent expenditure continues to take the large share of financial resources leaving a few for any meaningful development expenditure a trend that cannot guarantee sustainable growth and development of the economy. Similar trend is was replicated in the 2014/2015 budget estimates with the national government expenditure of Kshs. 654.1 billion and Kshs. 476.4 billion for recurrent and development respectively. However, it's noteworthy that the recurrent expenditures as a percentage of GDP would decline from 20.4 percent in FY 2013/2014 to 18.7 percent in FY 2014/2015. Although development expenditure seems to have increased as per the FY 2014/2015 budget estimates, only Kshs. 289.2 billion will be mobilised from the domestic resources with a chunk of Kshs.187.2 billion projected to be mobilised from external loans and grants.

Figure 15: Public Expenditure (Kshs Million)

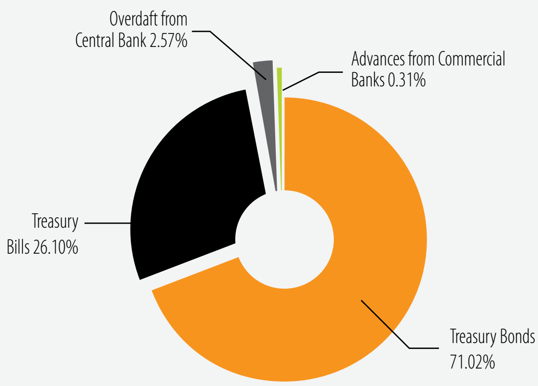


Source: CBK

Public Debt

The total public debt increased marginally with 0.69 percent in July 2014 from Ksh 2,370,255.82 million in June 2014 to Ksh 2,386,100.50 million in July 2014. This was largely contributed by the domestic debt. This could be attributed to the rising cost of international borrowing following the spillover effects of the US tapering coupled with the ballooning public wage bill and other recurrent expenditure as well as the duplication of expenditures in both the central and the county governments. Government treasury bonds remained the key money market instruments intensively utilized by the government in domestic borrowing accounting for 71.02 percent of the total government debt as at the end of June 2014. Treasury bills, overdrafts and advances accounted for 26.10, 2.57 and 0.31 percent of total government debt respectively for the months of July and August combined.

Figure 16: Composition of Domestic Debt

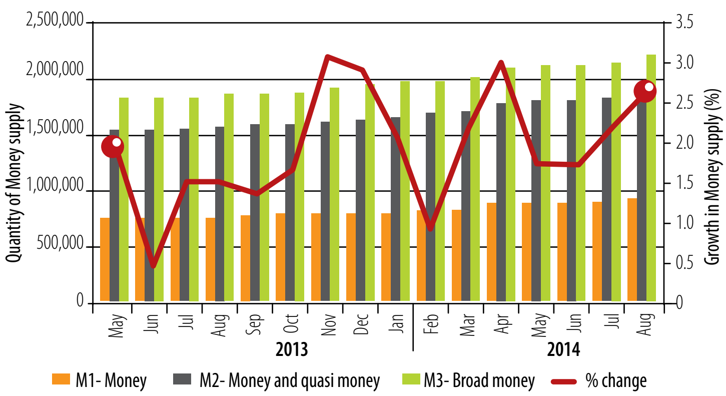


Source: CBK

Money and Credit

In the third quarter of 2014, total money supply grew marginally by 1.87 per cent as shown by the percentage change with June and August 2014 from 1.01 and 2.88 percent respectively (**Figure 17**). It can be deduced that the total money supply posted a growth that was in tandem with the Central Bank's inflation rate target bound of 5 percent ± 2.50 basis points. Therefore expansion in money supply did not impose adverse inflationary pressures in the economy.

Figure 17: Money Supply (KES Million)



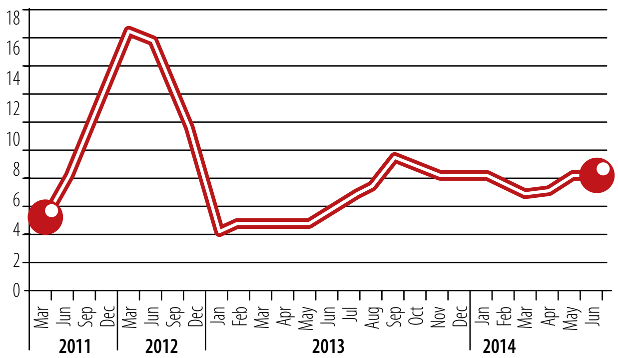
Source: KNBS and CBK

Inflation

The year 2014 began with low inflationary pressures touching a low of 6.27 percent in March 2014. This was on the expectations of adequate food supply and low cost of power generation which were thought could arise on the onset of long rains. However, a reversal trend set in April following the realization of erratic rains that were inadequate. Inflation rate took an upwards trajections for the entire quarter 2 hitting a high of 7.39 percent in June; 0.11 basis points marginally below the CBK upper bound limit of 7.5 basis points.

For the third quarter, the month – on – month inflation rates continued soaring high recording a high of 8.36 per cent in August 2014. This is attributable to the high cost of the food especially the dry cereals following the poor erratic long rains experienced in quarter two. The high cost of energy also contributed to the upward trend in the inflation rates. However, a significant decline in then inflation rates was evidenced in September following a decline from 8.36 per cent in August to 6.60 per cent in September 2014.

Figure 18: Inflation rate (%)



Source: KNBS

Interest Rates

Interest rates have largely been stably during the third quarter of 2014 (**Figure 19**). This was on the back of monetary policy being constant as evidenced by unchanging Central Bank Rate (CBR) as well as marginal change in interest rates on government securities. The CBR has continued being pegged at 8.5 percent throughout the third quarter signaling

central bank's commitment to anchor inflation rates ever since May 2013. Treasury bill rate remained fairly stable though on decline in July and August averaging at 9.78 percent in July against 8.29 per cent in August 2014. This follows the reduced government domestic borrowing and the move to borrow externally through the euro bond issued in June in attempt to surge up the domestic market liquidity.

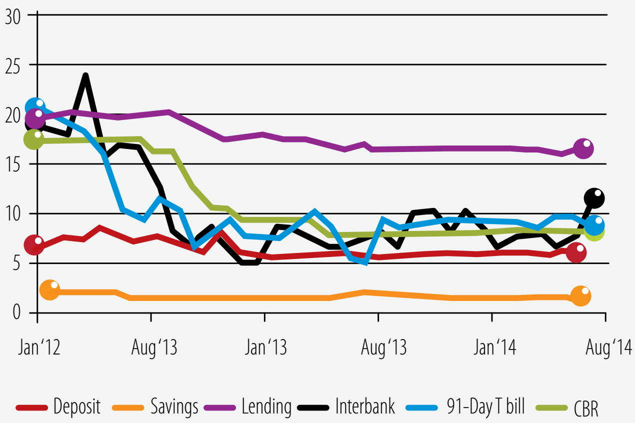
Cumulative average weighted lending rates rose mildly from 16.36 percent in June to 16.91 percent in July 2014 before falling marginally to 16.24 per cent in August. Therefore, there has been a fair transmission of monetary policy easing on credit offered to customers by banks as manifested by interest rates. However, banks still face high costs of operations as manifested by some banks recording declining profit margins and stark changes in their rates would impact their operations adversely. However, the financial market still remained illiquid for the entire quarter three of 2014 as evidenced by the relationship between the average lending rates and the CBR. This implies the insignificant effects of the DEBUT FROM THE June 2014 Euro bond in lowering market illiquidity. The interbank rates recorded a significant upward shift from 6.95 per cent in June to 8.05 percent in July and further to 11.72 percent in August 2014. This is due to the central bank's intervention in the money market via repurchase of excess shilling and pumping of foreign exchange into the forex market in attempt to cushion the shilling against adverse depreciation.

The effects of the newly launched KBRR in lowering the lending rates still remain to come into fruition given that this is a long term expectation. Hence the KBRR did not have any significant effect with respect to lowering the lending rates for the entire quarter four of 2014.

Balance of Payments

Volume of trade expanded from KSh 157.85 billion in June 2014 to KSh 191.74 billion in July 2014. The total value of exports declined marginally from KSh 44,160.29 million to 43,001.07 million during the same period. Value of imports however, rose to KSh 148,739.56 million in May 2014 from KSh 113,690.24 in June 2014. Domestic exports by Broad Economic Category (BEC) indicated that food and beverages was the main export category in July 2014 and accounted for 47.74 per cent of exports up from 41.14 by the end of quarter two of 2014, while the value of non-food industrial supplies and consumer goods not elsewhere specified registered 21.54 and 27.26 per cent shares, respectively. Imports by Broad Economic Category (BEC) indicate that industrial supplies (non-food) was

Figure 19: Interest rates (%)



Source: CBK

one of the main import category in July 2014 with a share of 26.26 per cent, while the values of fuel and lubricants, machinery & other capital equipment and transport equipment registered shares of 19.54, 14.92 and 25.37 per cent respectively. Food and beverage recorded a share of 5.38 per cent while Consumer goods not elsewhere specified recorded a share of 7.29 per cent in the month of July 2014.

Total exports declined in for July and August stood at KES 24,134 million against KES 22,854 million for the entire quarter two. Tea exports topped the exports list to account for 29.99 percent of the total value of exports for July and August combined followed closely by horticulture at 17.38 percent with chemicals, coffee, cement, petroleum products and fish following in that order. For the intra African trade, Tanzania topped as the most preferred export destination for domestic exports with a high of 20.85 percent of Kenya's total exports for July and August combined followed by Uganda at 14.27 percent. Looking at the Kenya exports destinations for July and August combined, Tanzania topped at 8.86 per cent followed closely by Unite States at 8.17 per cent. United Kingdom, Uganda, Netherlands and Pakistan followed in that order.

This trend in exports' destination is totally deviates from that of quarters 1 and two of 2014 and the entire 2013 reflecting some element of diversification in our export destinations. The depressed performance of the rains that affected the agriculture sector which is the single largest contributor to our GDP led to the decline in exports resulting to worsening of trade balance. The weakening shilling against the US dollar especially in August and September also contributed towards deteriorating trade balance which in so far directly influence the current account balance.

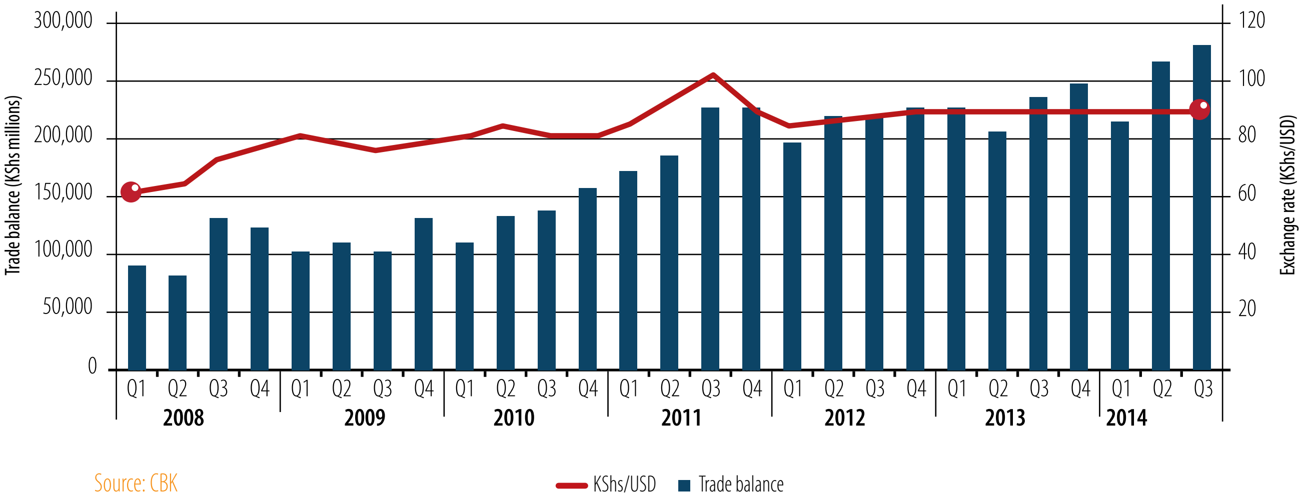
Turning into the overall quarterly trade balance, it's evident that the trade balance worsened by 4.89 per cent in the quarter three of 2014 from quarter two. In quarter three the overall trade balance was Kshs. 275,269 million compared to Ksh 262,431 million in quarter two. This was mainly contributed to by the weakening bias of the shilling against the major world currencies as well as the heavy governmental importation for the infrastructural investments. From **figure 20** the trade balance responds to the depreciation in the shilling with a lag thus the effects of the August/ September 2014 weakening bi8as in the Kenya shilling is likely to be experienced for the better part of the last quarter of 2014.

Exchange Rate

During the third quarter of 2014, the shilling has posted poor performance against hard currencies in nominal terms with the exchange rate fluctuating between 87.77 and 88.11 against the US dollar in July and August respectively.

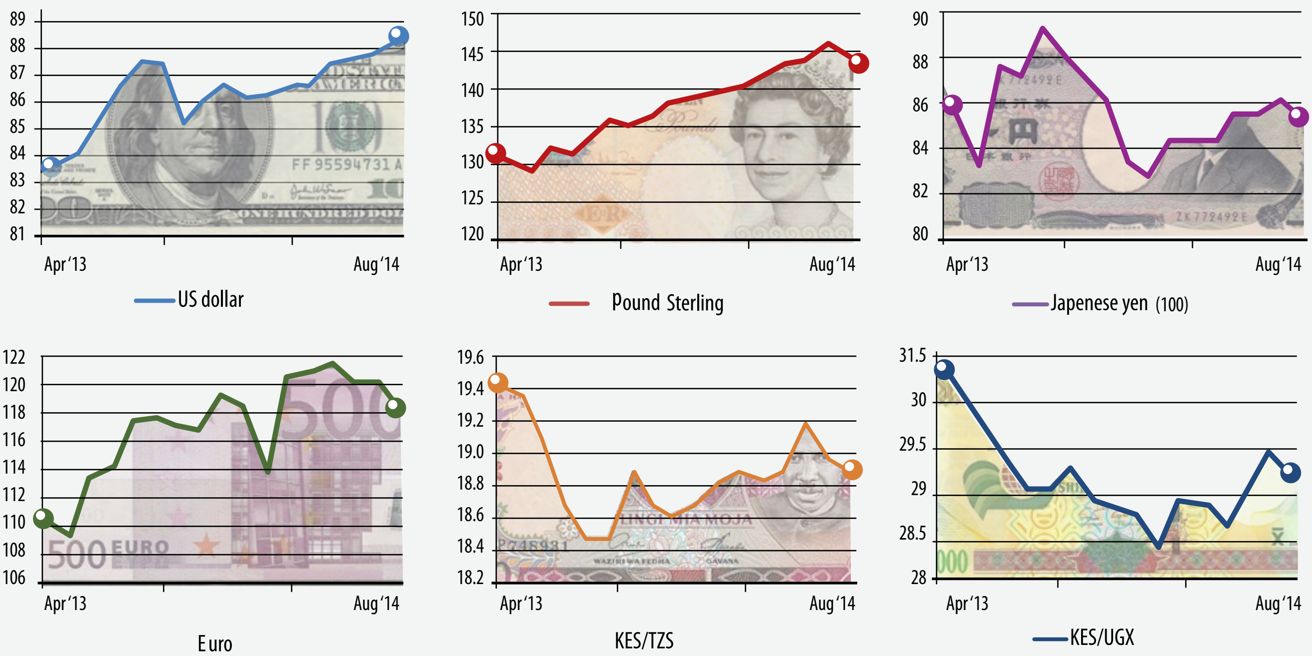
The shilling depreciated sharply against the dollar in August to post a low performance of an average of 88.11. The similar trend was replicated for the sterling pound where the shilling posted poor performance against

Figure 20: Overall trade balance and exchange rate



Source: CBK

Figure 21: Exchange Rates



Source: CBK

the pound between June and July before strengthening in August against the pound from 150.04 in July to 147.24 rate in August. For the Euro, the shilling performed fairly well with the exchange rate being fairly stable at 119.02 in July and 117.40 rate in Auigust2014 given the crisis at the Euro zone that have seen the monetary authority signal adoption of quantitative easing to spur growth given the down side risks experienced in the zone.

For the East African financial market the shilling continued to post resilient performance against the Ugandan and the Tanzanian shilling. For the Ugandan shilling the shilling exchanged at an average of 29.81 in both July and August while for the Tanzanian shilling the average rates for July and August were 18.97 and 18.89 respectively.

Nairobi Securities Exchange

All Nairobi Securities Exchange (NSE) indicators exhibited mixed performance marginally during the third quarter of 2014 (Table 3) compared to quarter 2 of 2014. However, some performance of the second quarter continued to be replicated in quarter three. Activity at the NSE increased as indicated by the NSE 20 share index that increased with the investors following the end of the dividend payout period. Both the equity and the bond market posted improved performance especially in the month of August. However, the total number of shares traded declined from 731 million in June to 625 million in July before marginally rising to 629 million shares in August.

Table 2: Nairobi Securities Exchange

Date	June 2014	July 2014	Aug 2014
NSE 20 Share Index 100=1966	4,885	4,906	5,139
NSE All Share Index (NASI) 100=2008	150	152	158
Market P/E Ratio	15	14.67	15
Total Shares Traded (Million)	731	625	629
Equity Turnover (ET) Kshs. million	18,190	15,043	15,513
Market Capitalization (Kshs. Bn.)	2,107	2,125	2,217
Bonds Turnover (Kshs. million)	29	50	55
Bond Deals	365	597	553
Percent of Foreign Participation to ET	56	56	45

Source: NSE

The Nairobi Securities Exchange posted impressive performance to record a high of 5,139 points in August touching a high of 5,300 points in September 2014. This was manly supported by increased participation of the local investors as evidenced by the decline in the foreign investors' participation from 56 per cent in July to 469 per cent in August and a rise in the local investors' participation. This implies that foreign investors turned from being net sellers in the month of June and July to net buyers in August 2014. This was replicated in the All share index as well which rose from 150 points in June to 158 points in August 2014; - a 5.33 percent rail. It is also notable that the issuance of the NSE IPO positively buoyed the market performance by instilling investors' confidence with the market.

The market's price – earnings ratio stabilized at around 14.89 for the entire quarter three for 2014. The high NSE -20 Share index for August could perhaps signal stability in the market upon the end of the dividend payout period of June and July hence a reduction in the market volatility. A high Equity turn over for the month of June signals the helm of massive trading in attempt to maximize returns for the dividend pay out period.

The fixed income segment as represented by the bond market posted some remarkable performance in July as evidenced by the upward surge in the bond turn over and deals from Ksh. 29 million and 365 deals to Ksh. 50 million and 365 deals respectively. The total market capitalization grew by 5.22 per cent from Ksh. 2,107 billion in June to Ksh. 2,217 billion in August. However, market volatility still remained quite high for the entire quarter three as signaled by a significant withdrawal of the foreign investors from the market. Notably, the bullish behaviour experienced in June continued to have a pass through effects in July and for the better part of August.

Banking Industry Performance

Financial intermediation sector recorded a slowed growth of 8.3 per cent in quarter three of 2014 compared to 8.6 per cent growth in the second quarter of 2014 as per the revised GDP values upon debasing . However, the banking industry in Kenya sustained positive and resilient growth in the third quarter of 2014 compared to quarter two though the quarterly industry pre - tax profits fell by 10.9 percent compared to quarter two of 2014. The industry continued to support economic growth by proving the bulk of private sector credit to the key sectors of the economy with credit to personal household topping the list. Looking at the banking industry's liquidity, as at the end of quarter three, the average liquid assets stood at Kshs 816.3 billion while the liquid liabilities were worth Ksh 2,180.9 billion hence yielding to 38.7 per cent average liquidity ration which is far above the minimum statutory limit of 20 per cent.

A highlight of the banking industry for quarter three of 2014 posits that Demand for credit generally grew in a number of sectors namely: personal / household, trade, real estate, manufacturing, transport and communication, energy and water, building and construction, agriculture and financial services. However, tourism and hotels sector registered a decline in credit growth due to higher repayments than new loans granted for the entire of quarter three as the banks embark on intensifying their credit recovery effort to mitigate on non – performing loans.

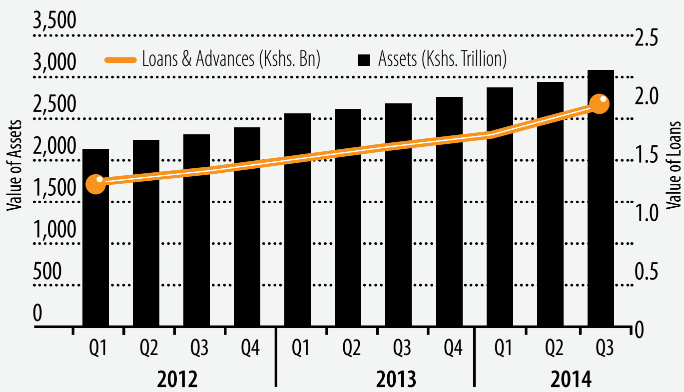
In addition, the upward momentum in the industry's growth in quarter three of 2014 was sustained with agency banking enhancing the growth given its excellent performance in quarter three posting a 14.5 per cent growth in the total number of transactions.

Assets and Loans

The industry's assets base and loan book registered positive growth of 3.7 percent both as at September 2014 a decline in quarter two's growth of 5.3 per cent. With reference to quarter 3 of 2013, industry's assets for second quarter of 2014 grew by approximately 17.56 percent in assets from Ksh 2.62 to 3.08 trillion.

Loans and advances, securities owned by government and placements comprised a major part of the sectors balance sheet. The growth in loans and advances was buoyed by increased demand for credit mainly in personal and household, trade and real estate. Tourism and hotels industry recorded the lowest uptake of credit given the security challenges that discouraged investment in these sectors.

Figure 22: Bank Assets and Loans (Kshs Billion)

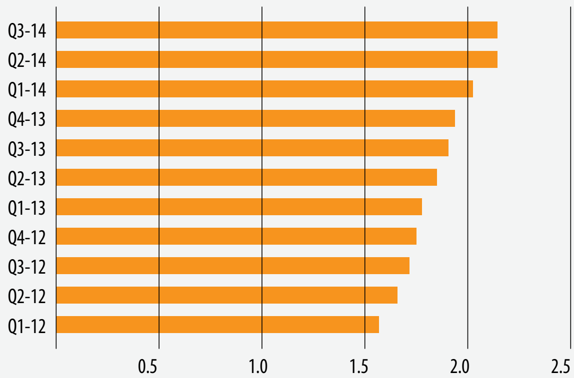


Source: CBK

Deposits

Quarter three of 2014 recorded a growth of 4.7 percent compared to previous quarter two. Demand deposits accounted for major source of funding of approximately 73.1 percent of total banking industry funding liabilities. The growth in deposits was majorly attributed to increased branch expansions as banks initially involved in corporate banking continue embracing retail banking to leverage on competition from other players, remittances and receipts from exports. In addition, the tremendous growth in agency banking contributed to the growth in the demand deposits base. For quarter three total deposits stood at Kshs. 2.25 trillion compared to Kshs. 2.15 trillion in quarter two of 2014.

Figure 23: Bank Deposits (KES Trillions)

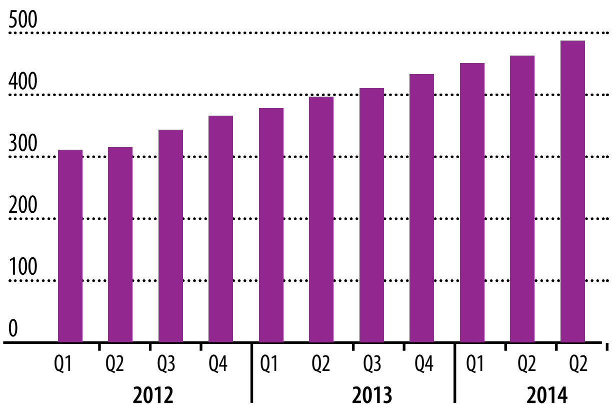


Source: CBK

Total Shareholder Funds

Total capital stock of the Kenya banking sector sustained its upward trajectory in the third quarter of 2014 thus signifying growth in the shareholders' wealth in the industry. Quarter three recorded a growth in share holders' wealth of 6.4 percent from Ksh 459.4 billion in June 2014 to Ksh 488.7 billion in September 2014.

Figure 24: Shareholder Funds (Kshs Billion)

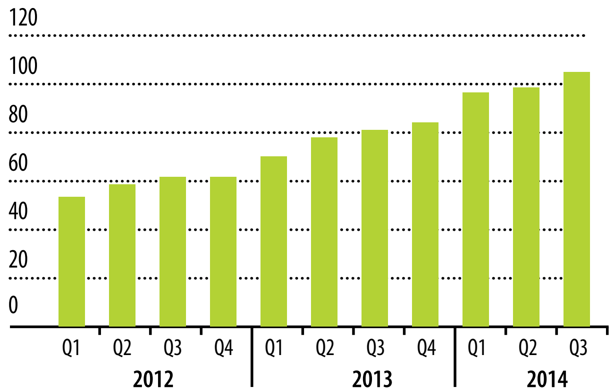


Source: CBK

Gross Non-Performing Loans

The gross non – performing loans increased marginally in quarter three of 2014 by 2.0 per cent to average at Kshs. 103.7 billion in quarter 3 compared to Kshs. 101.7 billion in quarter 2.

Figure 25: Bank Gross Non - Performing Loans (KES Billion)



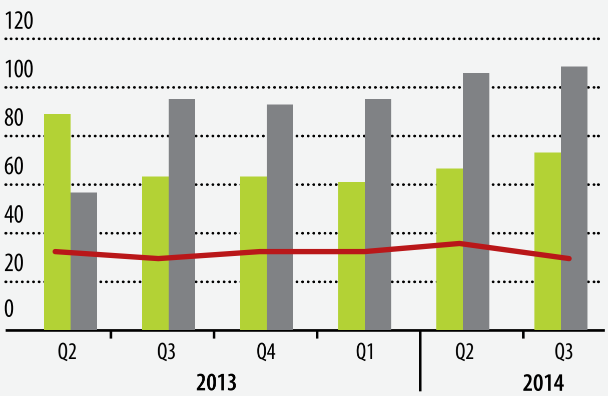
Source: CBK

During this quarter, Six out of eleven sectors analysed, recorded an increase in the non – performing loans with the underpinning factors mainly being the spill over effects of high lending rates and the challenges in the business environment. Personal and households topped the NPLs per sector at 26.5 percent followed by trade at 26.3 per cent while real estate came third at 12.6 per cent. Energy and water sector and mining and quarrying posted the least contribution to the total NPLs of 1.3 and 0.7 percent respectively.

Bank Profitability

The banking sector recorded a decline in the profit before tax in quarter three of 2014, to stand at Ksh. 33.5 billion against Ksh 37.6 billion (**Figure 25**). This represents a 10.9 percent drop. Total income remained unchanged for quarter three stood at Ksh. 104.0 billion while total expenses increased by 5.7 percent from Ksh. 66.6 billion in June 2014 quarter to Ksh. 70.4 billion in September 2014 quarter. Interest on loans and advances, fees and commissions and government securities were the major sources of income accounting for 59.2 percent, 18.7 percent and 15.1 percent of total income respectively. Contrary, interest on deposits, staff costs and other expenses were the main components of expenses, accounting for 32.7 percent, 28.2 percent and 24.1 percent of the total expenses respectively.

Figure 26: Bank Profitability (KES Billion)

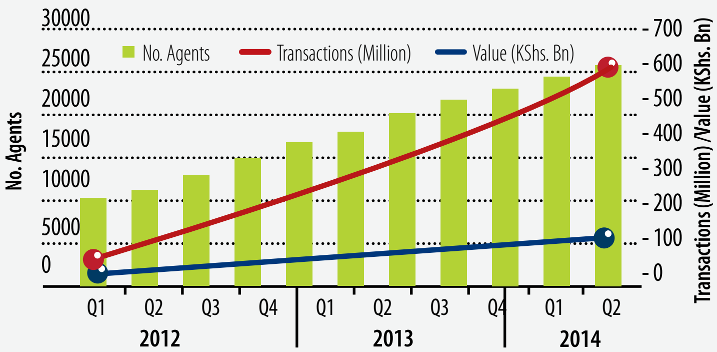


Source: CBK

Agency Banking

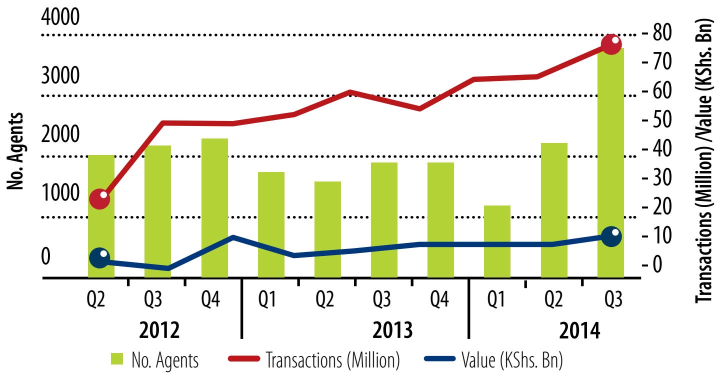
Agency banking model in Kenya has become a critical model of branchless expansion in the Kenya banking industry ever since its inception in May, 2010. It has seen tremendous growth as evidenced by the upward trajectory on the total cumulative in the number of active agents, transaction volumes and total value. As at third quarter of 2014 the cumulative number of active agents stood at 30,449 transacting approximately 120.6 million transactions valued at Kshs. 653.7 billion compared to 26,750 active agents transacting approximately 106.1 million transactions valued at Ksh 571.5 billion in the second quarter of 2014. This growth is underpinned on continued contracting of varied retail entities to offer basic banking services by commercial banks. These entities include among others;- security companies, courier services, pharmacies, supermarkets and post offices which act as third party agents providing cash- in -cash-out transactions and other services in compliance with the laid down guidelines by the central bank.

Figure 27: Cumulative Agency Banking (no. of agents, transactions volume and Value)



Source: CBK

Figure 28: Quarterly Growth in Agency Banking (no. of agents, transactions volume and Value)



Source: CBK

Figure 28 shows the actual quarterly growth in the agency banking. Quarter three of 2014 registered a positive growth of 3,699 in active agents as the banks try to diversify their products to bank the unbanked as well as reducing operating costs such as rental charges, additional staff and other administration costs that come with the opening of news branches.

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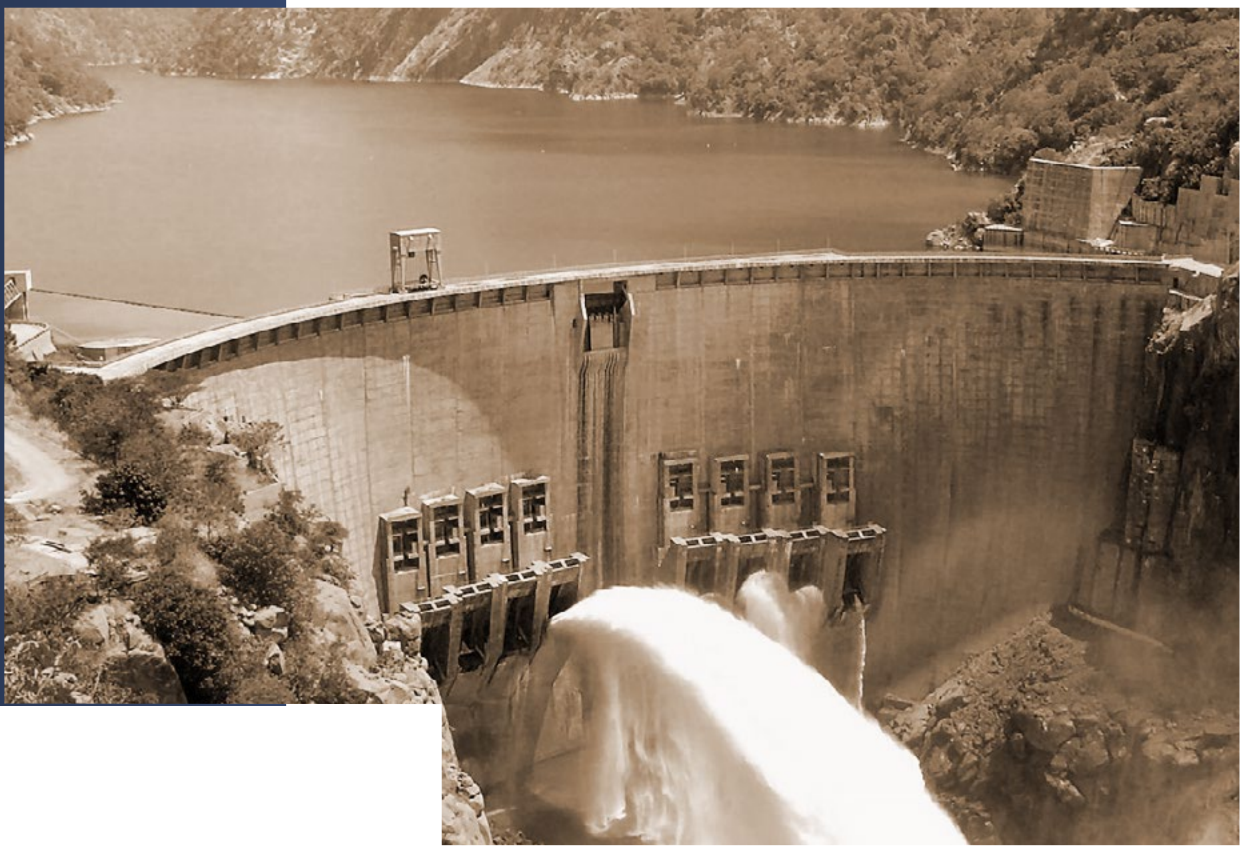

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