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VOLUME TEN

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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 fourth quarter of 2014, drawing on the performance of recent past quarters as well as current developments in quarter 4 and the entire year at large. 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

Publisher	KBA Centre for Research on Financial Markets and Policy®
KBA CEO	Habil Olaka
Chief Editor	Jared Osoro
Contributors	David Muriithi
Design & Layout	Conrad Karume
Contacts	KBA Headquarters, International Life House, 13th Floor Mama Ngina Street, Nairobi
Mailing Address	P.O. Box 73100 00200 - Nairobi
Phone	+254-20-2221704, +254-20-2217757, +254-20-2224014
Email	research@kba.co.ke
Web	www.kba.co.ke.
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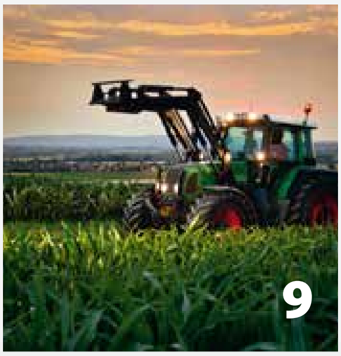
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FOREWORD

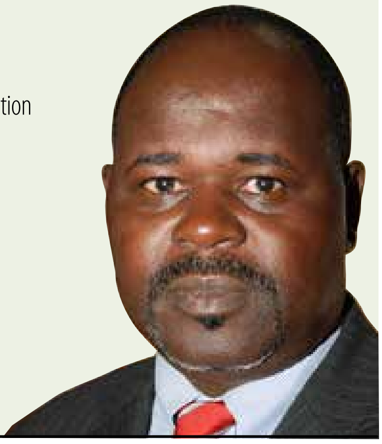
From the CEO's Desk

It is my pleasure to present to you the tenth volume of the *Kenya Bankers Economic Bulletin*. This issue discusses the state of the Kenyan economy during the fourth 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 recent dynamics in the international oil market; the focus is based on the fact that low oil prices have been the basis of ambitious growth projections that may not materialise if there were price reversals.

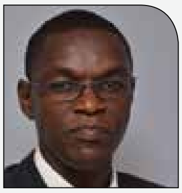
I hope that you will find this issue of the *Kenya Bankers Economic Bulletin* interesting and useful. We welcome feedback on the content of this *Bulletin* as we continually seek to improve its relevance to you. As always we will be happy to consider for publications incisive commentaries on a topical 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

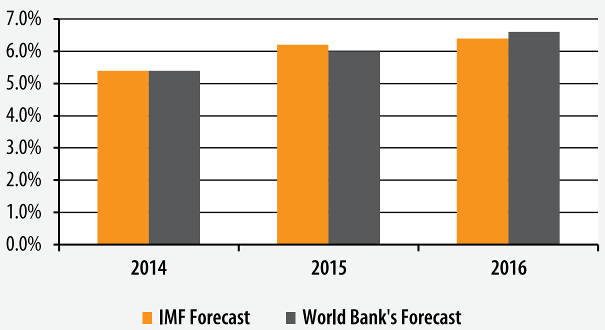
The Happy Season is Here - But the Exuberance Needs Tempering



By Jared Osoro

Optimist about the state of the Kenyan economy is clearly evident. There is some sort of convergence in the economy's outlook amongst the Bretton Woods duo – the IMF and the World Bank. Typically, the World Bank has been more conservative in its projection of the economy's performance. But as **Figure 1** shows, the projected growth from the Kenya National Bureau of Statistics' estimate of 5.4 percent for 2014 reflects the convergence in outcome of the World Bank's *Kenya Economic Update* (December 2014) and the *IMF's World Economic Outlook* (October 2014).

Figure 1: Kenya's Economic Outlook



This is an interesting outlook considering that the Kenya Economic Update hinges its projection on government's infrastructure investments and a fall in oil prices. The positive effects of the ongoing infrastructure projects are easy to see. It is the underpinning of the growth projection on the decline in oil prices that requires more security.

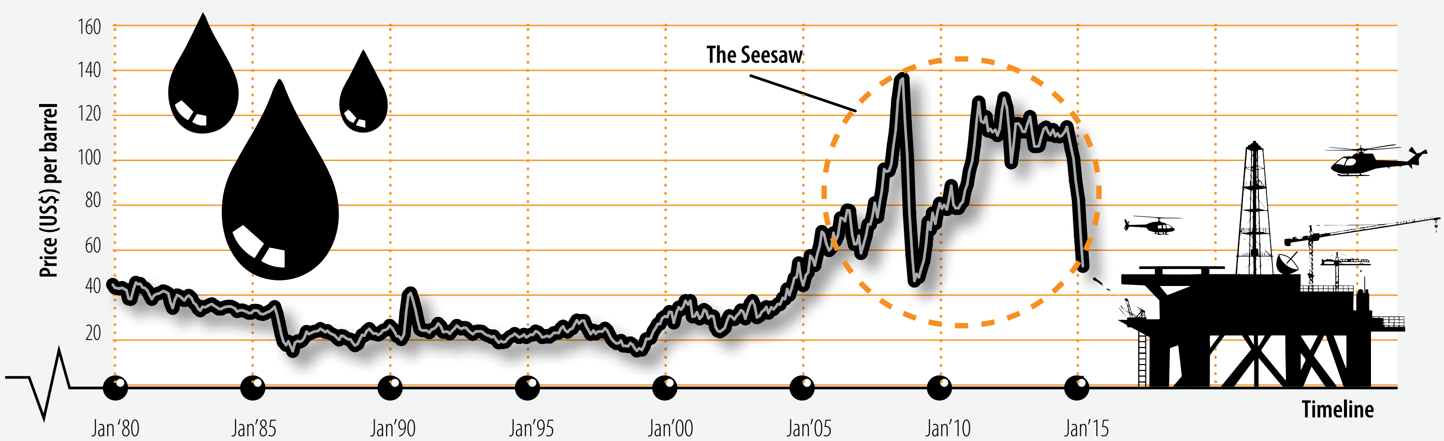
As I have argued elsewhere[1], we may have turned the corner insofar as the decline in oil prices is concerned. Granted, the recent spate of oil prices plunge has translated into a boost in households' real income boost, consequently increased consumption and growth. But then over the past decade any drastic fall in oil prices has been characterised by an equally drastic, the time span for both the decline and rise being within a year (**Figure 2**).

The tempting question to ask is: what makes the situation different so that the seesaw that has been witnessed in the past should not be envisaged now? The answer lies in a deep examination of the oil market dynamics and some sense of history.

A little while back – precisely in March 1999 - The Economist magazine proclaimed that we were "drowning in oil". At that point in time, the price of oil was in the US$ 40 – US$ 43 per barrel range. Characteristic of *The Economist's* sometimes sanguine posturing style, the core argument was that the "world is awash with the stuff, and it is likely to remain so".

1 See http://www.businessdailyafrica.com/Opinion-and-Analysis/What-leads-to-a-plunge-in-global-oil-prices/-/539548/2632996/-/i3j56gz/-/index.html

Figure 2: International Oil Prices US$per Barrel



Source: IMF Commodity Prices Database

Clearly, this popular commentary had throws caution out of the window. On the heels of *The Economist's* story was the *Newsweek* with a cover in one of its April 2009 editions that boldly, but carelessly, screamed: "Cheap Oil Forever".

Of course oil was never cheap forever. The drastic decline then from a high of about US$ 130 per barrel was a drastic as the one we have recently experienced. Interestingly, the climb was equally drastic. Within one year, the prices had climbed to over US$ 85 per barrel before surpassing the US$120 mark by April 2011. What is happening here? Is a repeat a likely scenario? The answer lies in three - not necessarily competing - hypotheses.

The first one is the so-called M. King Hubbert theory, also referred to as the "peak oil" account. This theory states that based on geological considerations the production of oil will be characterised by a three phase evolution – rapid rise, peak and terminal decline. Hubbert predicted in early 1970s that world oil production would peak mid 1980s and then decline to 35 million barrels by 2000. This simply means that the peak theory would engender expectations that the world was running out of oil.

Those sympathetic with Hubbert's science will therefore argue that the consistent climb in oil prices from a low of about US$10 per barrel in January 1999 to the record breaking price of US$147 in July 2008 is a vindication of his theory. But evidence has indicated that then Hubbert's projection is totally off the mark. Even a casual look at the historical data indicates that in 1980 the global oil production was at 59 million barrels per day, rising to its current levels of over 75 million barrels per day. So the data rejects the "peak oil" explanation for all the episodes of drastic price rise – the January 2008 to July 2008 and the one that followed the dip of July 2008 – December 2008 where prices rose from about US$ 40 per barrel to about US$120 per barrel by April 2011.

This leads to the second hypothesis, the so-called fundamentals theory. Those subscribing to this theory –call them market fundamentalists – argue that the rise and fall of oil prices even when drastic in either direction is primarily an outcome of demand and supply conditions.

The case of the market fundamentalists is credible, but not exhaustive. I argue so on the persuasion of a 2009 paper – *'Causes and Consequences of the Oil Price Shocks of 2007 – 2008'* – by economist James Hamilton, published by the Brookings papers on Economic Activity which argues that the price responsiveness of demand and supply of oil is very low. This simply means that a small change in demand requires large changes prices so as to equate supply with demand.

So when demand softens as it did with the onset of the global economic meltdown in 2008, large price swings could have been expected. The demand responsiveness arising from the global economic performance may have somewhat increased in the recent past. Indeed the extent to which oil prices respond to economic slowdowns has been progressively increasing from the 1970s going forward.

A number of studies indicate that such changes arise from at least three points. One, the powers of OPEC – the oil carrel – has been gradually withered by other players; the shale oil extraction that the US is deploying may be part of the equation that is working on OPEC's market power. Two, while in the 1970s major oil producers used to enter into contract pricing, the market has moved largely into spot selling in the 1990s; so price responsiveness was obviously slower in the earlier days than now. Three, futures markets for oil were either limited or underdeveloped in the 1970s than they are now. This means that opportunities to take speculative market positions on future oil prices were limited then that they are now. This can only mean that the market fundamentalists tell only part of the story.

The other part motivates the third hypothesis, namely speculation. If the global economy had not moved out of the recession in the period December 2008 to April 2011, what can explain the price increase over that period as earlier observed? Part of the answer lies with the fact that over the past decade there has been substantial financilisation of the oil market; and this has the obvious consequence of engendering speculative market behaviour.

I argue so drawing from on the wisdom from very unlikely quarters – a 1976 seminal paper by economist Rudiger Dornbusch titled *'Expectations and Exchange Rate Dynamics',* published by the *Journal of the political economy.* The intuition of this influential essay – popularity known among economists as the "overshooting" paper – is that while financial markets adjust instantaneously, goods markets adjust slowly.

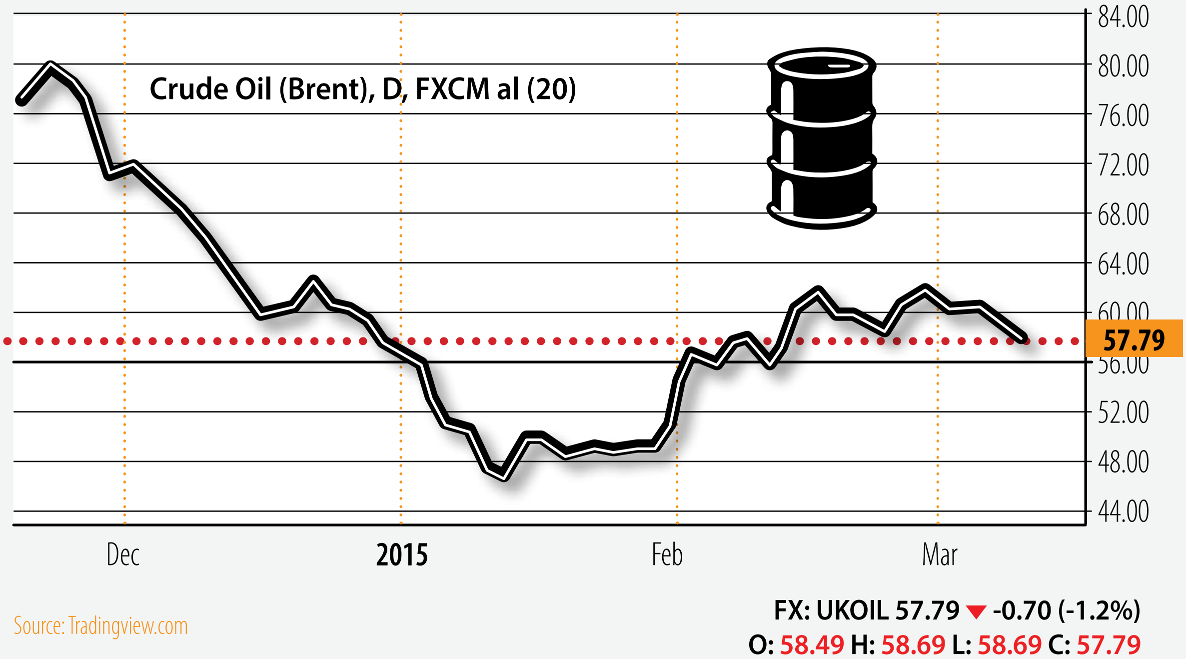
But not oil, I argue, given the level of financialisation as already observed. This can only mean that in the event of drastic market movements, prices of oil may undershoot or overshoot a given range that may be considered suitable for both consumers and without hurting producers. In the absence of a formal model to determine such equilibrium level, those who keenly watch the market and use indicators such as market valuation of major oil companies plus what some OPEC mandarins consider to be "fair" put that range at US$75 per barrel to US$90 per barrel.

If indeed the market undershot this time around, then the latest IMF commodity price forecast indicates that we are now turning the corner. We could have a debate on how fast the correction will happen. And the evidence I have seen (**Figure 3**) indicates that the correction is underway.

What then is in store on the external balance front?

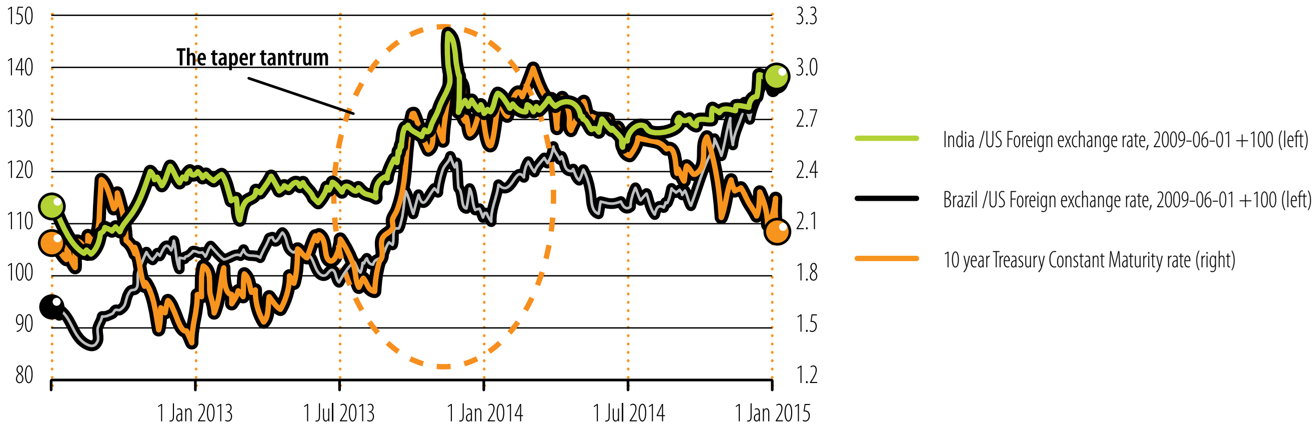
From the foregoing argument, it is clear that those who banked on continued decline in oil prices resulting in a noticeable reduction in the economy's current account balance have some rethinking to do. This is compounded by the fact that export growth is slow at a time when the global economy is recovery is hazy, the monetary policy regimes in major central banks is not synchronised – largely dictated by the local circumstances in each jurisdiction – with the US's Federal Reserve Board almost resuming a conventional monetary policy after an arguably successful quantitative easing (QE) programme at the time when the European Central Bank

Figure 3: The Oil Market "Price Correction"



Source: Tradingview.com

Figure 4: Emerging Markets Soft Underbelly



Data Source: Federal Reserve Bank of St. Louis

(ECB) getting into QE with the Eurozone now in a deflation.

Accompanying the policy shifts have been market tantrums that can be seen in two fronts. The first one is after the signal that the Fed will move towards the conventional monetary policy. The emerging markets went into what one could call 'the taper' tantrum – coinciding with the time when the then Chairman of the Fed, Ben Bernanke, talked of the tapering of the QE (**Figure 4**) – and exposing the emerging markets' soft underbelly.

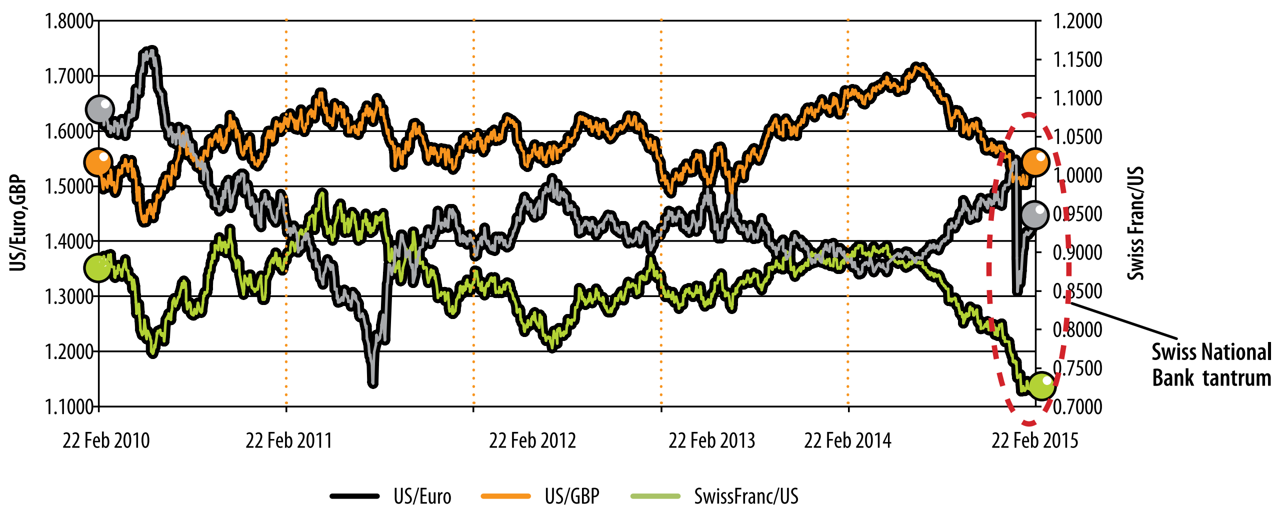
The second tantrum arose from the Swiss National Bank (the Central Bank) when it abandoned the Cap and Peg on Euro on 15th January 2014. This led to a drastic appreciation of the Swiss Franc against the Euro and US$ almost immediately, although there was some correction against the US$ commences soon afterwards. This was also a turning point insofar as US$ appreciation against the Pound Sterling (GBP) and Euro is concerned; the GBP commenced appreciating while the Euro seems to have paused and there is no evidence of appreciation commencement given the ECB monetary stance and the uncertainty and anxiety around the Greece bailout deal .

The global market dynamics have played into the local markets on the back of the continuous real appreciation of the Kenyan shilling over the past decade (implying loose of competitiveness of the economy) and a gradual but sustained nominal depreciation that is the inevitable correction. Therefore a quick reduction in the current account deficit as some have envisaged may clearly be ambitious.

Ultimately therefore, while the happy season may be here in terms of growth expectations it should translate into exuberance; for the 6 percent projected growth for 2015 that is presented as the baseline scenario may end up being the best case scenario and a less growth within the 5 percent range may well be the realistic outlook.

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

Figure 5: Nominal Exchange Rate



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Data Source: Federal Reserve Bank of St. Louis

State of the Economy

Growth in GDP for Quarter Four of 2014

Upon the revision of GDP in September 2014, following the debasing, the provisional estimates for the GDP posit that the country's economy expanded by 5.5 per cent during the third quarter of 2014 compared to 6.2 per cent recorded during a similar quarter of 2013. This growth was mainly supported by robust expansion in construction, finance and insurance; wholesale and retail trade; information and communication; agriculture and forestry. In addition, the declining world oil prices positively impacted on the quarterly growth in the third quarter as well as the fourth quarter in year 2014.

The macroeconomic stability witnessed in the previous quarters of 2014, continued to be experienced especially as witnessed by the declining inflation rates. With the declining world oil prices, the overall month – on – month inflation rates interest rates remained steady. However, the erratic rains in October – December 2014 curtailed the sufficient food production which resulted into an upward surge in the food prices. However, the rise in the food prices for quarter four of 2014 was mild hence a modest impact on the overall month – on – month inflation rates. Similarly, the liquid management via the open market operations by the central bank of Kenya helped stabilize the inter –bank rates and consequently, stabilization in the short – term interest rates.

Looking at the forex market, the Kenya shilling continued to experience a weakening bias against the dollar. This was mainly underpinned on the declining world oil prices which arose from resurgent of the US dollar worldwide and the depreciation of other currencies. However, despite the

weakening bias on the shilling, the foreign exchange reserves remained stable standing at 4.64 months import cover as at October 2014. From the world outlook, it's clear that it's not the shilling that experienced a weakening bias but other currencies such as the Japanese yen, Nigerian Naira and the Russian rupee among others.

The average yield rate for the 91- day Treasury bills, which is a benchmark for the general trend of interest rates, declined from an average of 8.82 per cent in quarter three to an average of 8.63 per cent in the fourth quarter of 2014 signaling some sense of stability in the credit market. The cost of credit declined mildly as evidenced by the mild decrease in the average quarterly lending rates from 16.40 per cent in quarter three to a quarterly average of 15.98 per cent in quarter four of 2014.

Figure 6: Quarterly Growth in GDP – 2009 Base Year

Source: KNBS

From the cash crops point of view, the quantity of processed tea decreased from 45,368 MT in October 2014 to 38,614 MT in November 2014 albeit average auction price rose negligibly from Ksh 180.48 per kilogram in November to Ksh 181.71 per kilogram in December 2014. The poor bonus pay to tea farmers with large disparities among various tea growing zones in the country could be a factor underpinning fluctuation in tea production in the fourth quarter of 2014. However, for milk production, milk deliveries to formal processors rose from 42.5 million litres in September 2014 to 44.5 million litres in December 2014 mainly due to the increased milk production arising from the October - December 2014 short rains.

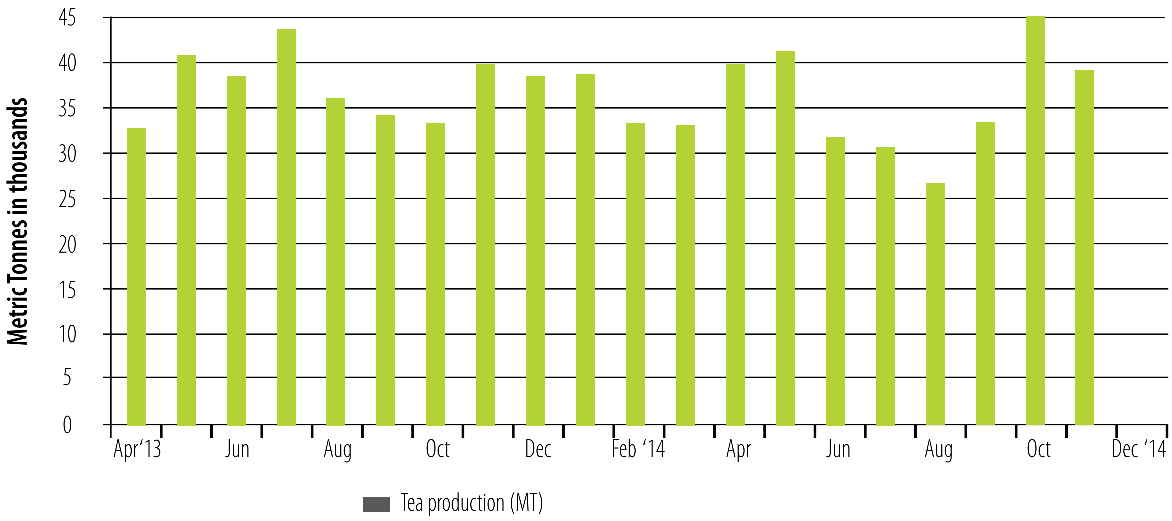
It's notable that while the prices of tea mildly rose from Ksh 180.48 per kilogram in November to Ksh 181.71 per kilogram in December 2014, auction prices of coffee at Nairobi coffee exchange fell from Ksh 422.76 in October to Ksh. 410.25 in November 2014.

The setting in of decline in the production of tea and 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 as compared to income from tea and 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 exports is to be guaranteed in addition to food security.

Agriculture

Despite agriculture being the major contributor to the overall GDP growth, its general performance remained far below its potentials in quarter four of 2014 just as in the previous quarters in 2014. According to the revised GDP estimates with the based year being 2009, the sector is estimated to have expanded by 6.2 per cent in quarter three of 2014 against 5.8 per cent in the similar quarter in 2013. This is attributable to the erratic rains in quarter two of 2014 which was replicated in quarter four of 2014

Figure 7: Tea production in Metric Tonnes



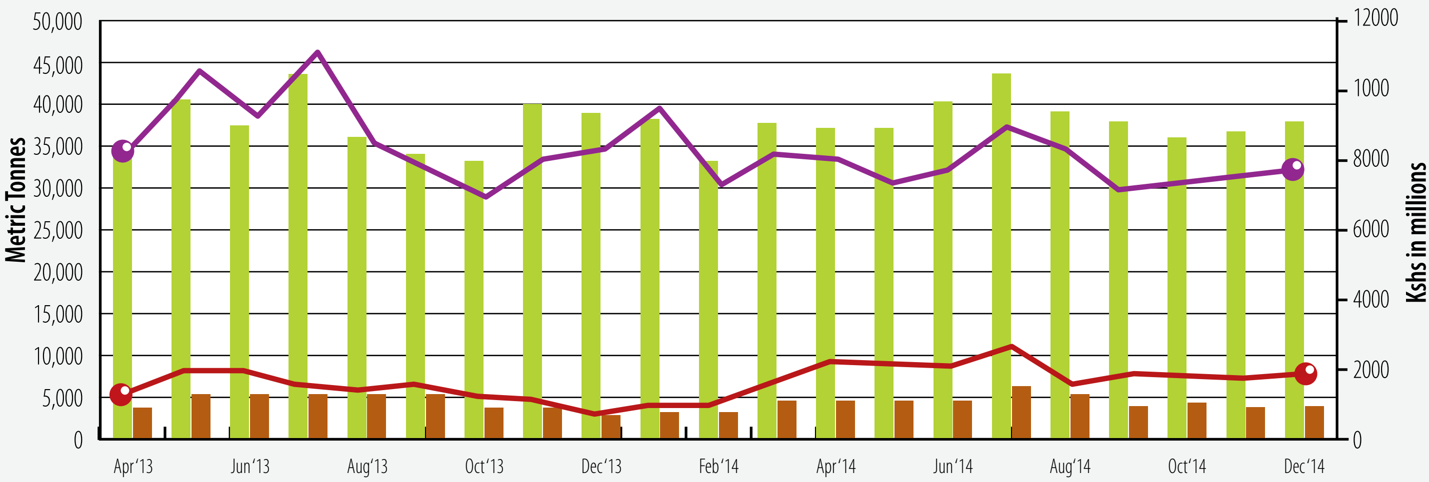
Source KNBS

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 8)** the quantity of tea exports improved from 35,960.60 metric tonnes in September 2014 to 38,275.20 metric tonnes in December 2014. However coffee exports declined from 3,944.10 metric tonnes in September 2014 to 37,717.90 metric tonnes in December 2014.

Turning on the value of cash crop exports the value of the tea exports increased from Ksh. 7,243.60 million in September 2014 to Ksh. 7,594.60 million in December 2014. Similarly value of the coffee exports increased from Ksh. 1,722 million in September 2014 to Ksh. 1,747 million in December 2014.

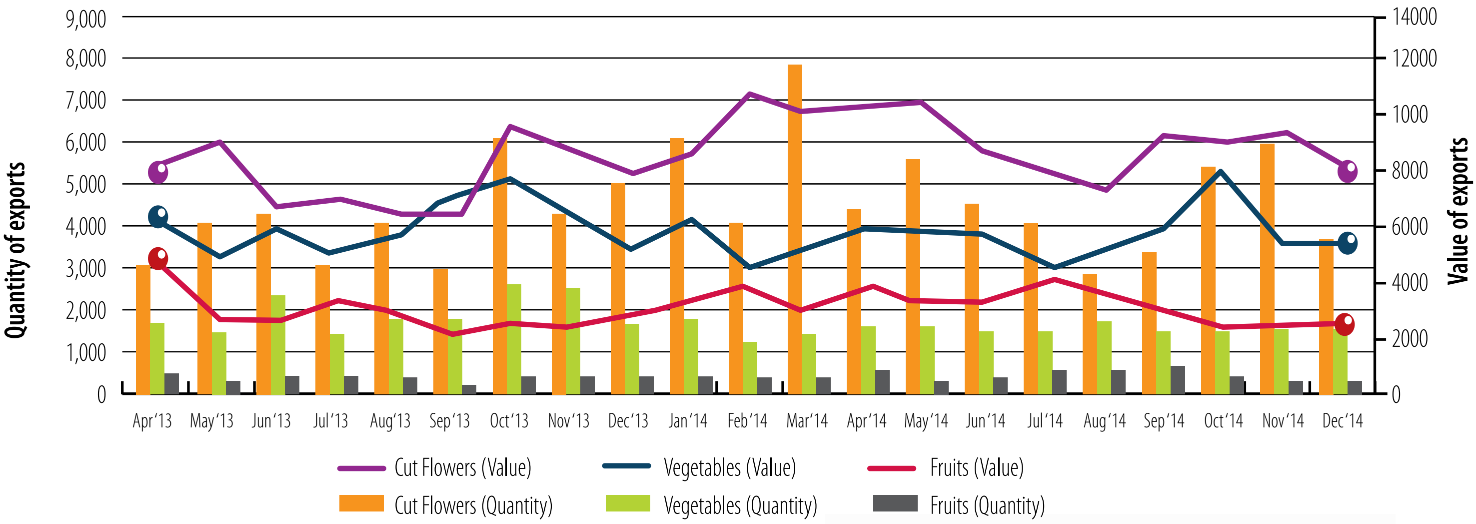
On horticultural exports **(Figure 9),** in terms of quantity exported, cut flowers dominate the horticultural subsector contributing on average 52.08 per cent of total horticultural exports for the entire of quarter four of 2014, followed by vegetables at 36.12 percent with fruits exports re-

Figure 8: Value of Tea and Coffee Exports, April 2013 – December 2014



Source KNBS

Figure 9: Horticultural Exports April 2013 – December 2014



Source KNBS

cording the lowest contribution of 11.79 per cent. Looking at the foreign exchange earned from horticultural exports, cut flowers dominate this subsector contributing on average 72.48 per cent of total horticultural exports for the entire of quarter four of 2014, followed by vegetables at 22.5 percent with fruits exports recording the lowest contribution of 5.02 per cent. However, the production and exports of cut flowers and fruits drastically declined in the fourth quarter of 2014 especially between November and December dropping from 9,615.63 tonnes to 8,312 tonnes for the cut flowers and 2,092.84 tonnes to 2,112.29 tonnes for fruits for the similar period. This may be attributable to the dead lock 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 continued 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

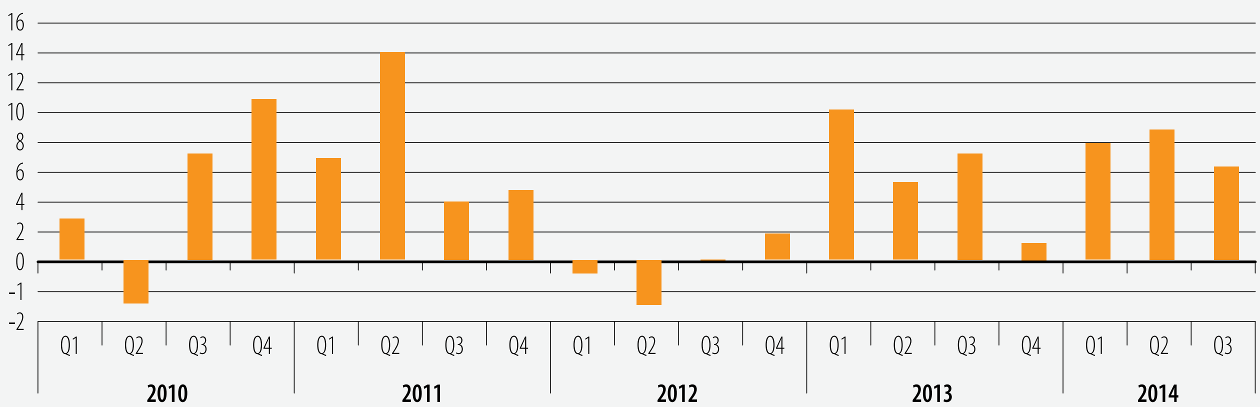
The manufacturing sector in Kenya is considered to be one of the pillars for the achievement of vision 2030 goals through transiting the economy from traditional agricultural dominated economy to modern manufacturing economy. As per the debased GDP estimates manufacturing sector grew by 4.5 per cent in quarter three of 2014 compared to 6.8 per cent in quarter three of 2013.

Locally manufactured charcoal wood stove popularly known as the 'jiko': The sector is set for a revolution following the 2014/2015 budget reading which is likely to benefit the sector from tax exemptions for locally manufacturing industries

Complete Knock Down (CKD kit) assembly plant at General Motors Kenya.
(Photo/ Courtesy GM)

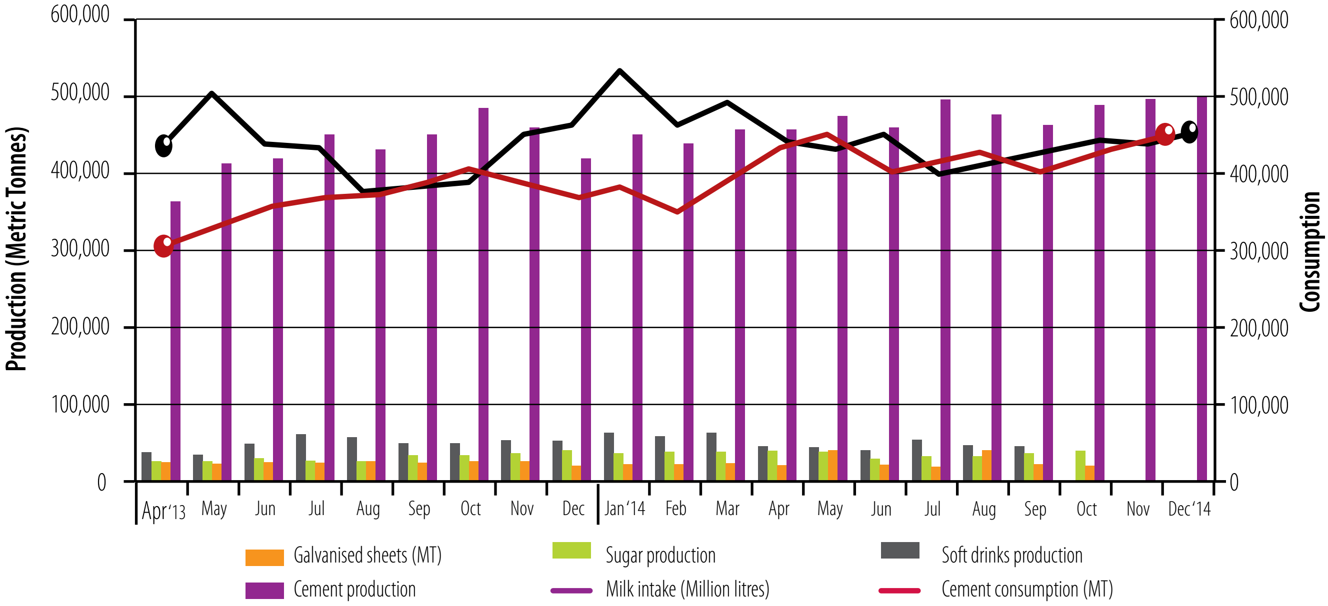
For the fourth quarter, assembled vehicles decreased from 887 units in October 2014 to 724 units in November 2014. However, cement production increased from 490,568 metric tonnes in September 2014 to 501,624 metric tonnes. The improvement in cement production and consumption arose from the rapid growth in the real estate sector. Similarly milk intake rose from 42.5 million litres to 444 million litres in December 2014. The sector is set for a revolution 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. Lots of keen on energy continue to be put across in attempts to lower the cost of energy which adversely affects production costs. Concerted efforts to boosts energy production especially the geo - thermal and reduce over reliance on hydro production continues to be a priority in the central government the results are being realised with energy from geothermal well starting to enter the national grid. 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.

Figure 10: Manufacturing Growth Rates (with 2009 as Base year)



Source CBK

Figure 11: Production and Consumption of Manufacturing



Source KNBS

A key component of the manufacturing sector is its output that targets the construction industry. The domestic production of cement production increased to hit a high of 501,624 metric tonnes the highest ever recorded monthly cement production. In terms of monthly cement consumption, November 2014 recorded a significant rise to 441, 433 metric tonnes from a low of 407,531 metric tonnes in September 2014.

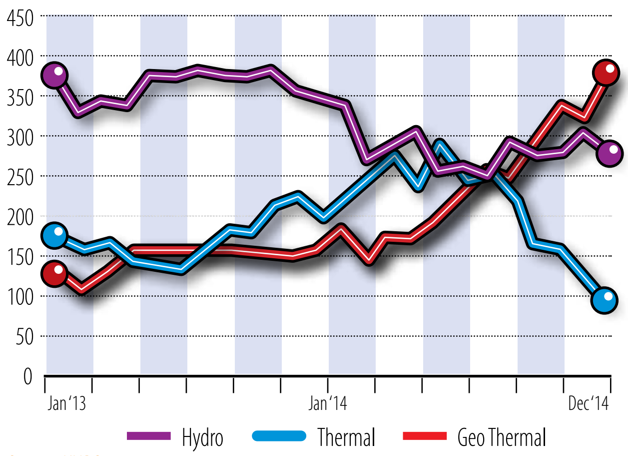
Turning to the number of assembled vehicles, the total number significantly declined in the in November to record a low of 2,032 vehicles from a high of 4,327 before surging up to 2,533 vehicles as at the end of December 2014. On the other hand, milk production improved with milk deliveries to formal processors rising from 42.5 million litres in October 2014 to 44.4 million litres in December 2014.

Energy

Electricity generation has continued to grow, albeit still outpaced by demand. In the fourth quarter of 2014, the thermal power generation dwindled drastically by 41.84 per cent from 639.61 million KWh in quarter three to 371.97 million KWh in quarter four. This is mainly attributed to government's effort to boost the power generation from geothermal sources which is more sustainable and environmentally friendly given the high power bills arising from massive generation of power from thermal source which wholly depends on diesel for power generation. On the other hand, the geothermal power generation recorded a tremendous increase from the third quarter to the fourth quarter of 2014 by 30.78 per cent growth. This is noted by the rise in production from 797.64 million KWh in quarter three to 1043.13 million KWh in quarter four of 2014. This resonates well with the government's agenda to boost geothermal generation which takes into consideration of the green economy. Hydro power generation increased marginally by 5.23 per cent from a total production of 825.36 million KWh in the third quarter to a total production of 868.52 million KWh in the fourth quarter of 2014.

Despite the power production lagging far much below the demand,

Figure 12: Electricity Generation by source (Million KWh)



Source: KNBS

power loses continue to be on the rise owing to inefficiency to close the loop holes. Power losses continued to be on rise standing at 105.01 million KWh in October, falling to a low of 95.20 million KWh in November and rising to 113.26 million KWh in December 2014.

Energy prices in Kenya for the entire of quarter four were on decline given the declining world oil prices. The average cost of products imported as well as locally refined products declined during the three months of quarter four (**Table 2**). The oil market performance in the fourth quarter of 2014 was a clear revelation that the economics of oil has really changed beyond being ruled by the forces of demand and supply. This is informed by the outcomes of the geo political crisis. At first there was a worldwide perception that the political tension in the geopolitical zone coupled with the Euro crisis could potentially drive the world oil prices up.

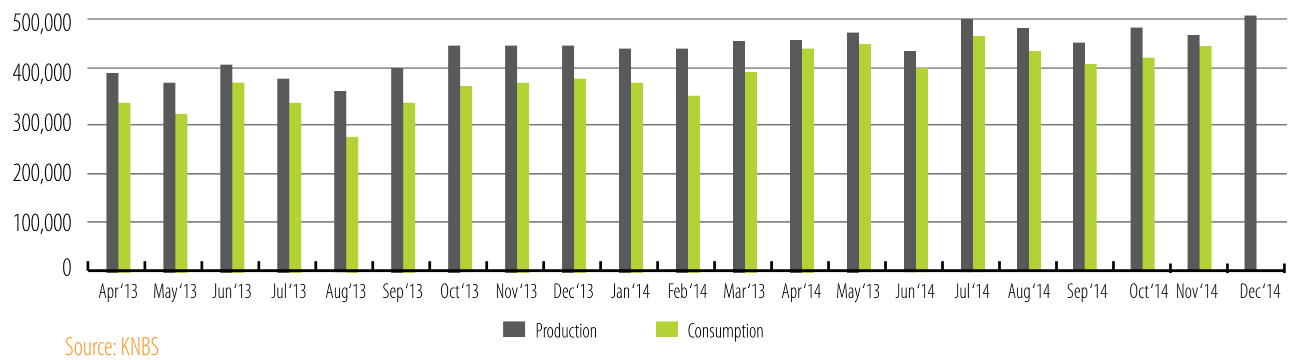
However, the opposite has come to pass in the fourth quarter of 2014 where by the world oil prices experienced a tremendous decline falling below the 60 dollar mark. As per the fourth quarter of 2014 the world oil supply outstripped the world oil demand leading into a market glut; - the underpinning factor behind the plunge in the world oil prices. In addition, the failure to agree among the OPEC member saw the failure of a unanimous decision to cut down on oil production come to fruition. This is driven by the major oil producers taking sides with regard to the Russia - Ukraine battle.

Table 2: Crude Oil and Fuel Import Prices

Product	Aug-14	Sep -14	Oct - 14	Nov -14	Dec - 14
Murban crude oil (US$/Barrel)	104.25	97.95	87.35	77	60.65
Super petrol (KES/Litre)	117.43	112.46	111.72	107.64	102.86
Diesel (KES/Litre)	103.90	103.28	101.59	95.45	91.79
Kerosene (KES/Litre)	83.97	82.55	81.81	77.24	72.30
LPG (13Kgs)	3,109.67	3,111.74	3,068.58	3,033.28	3,018.45

Source: ERC

Figure 13: Cement Production and Consumption, MTs



Source: KNBS

Its, however, noteworthy that despite the low oil prices being good news to less developed countries such as Kenya, it has on the other hand adversely affected the oil producers such as Venezuela, Nigeria, Saudi, Russia and Angola among other given that their budgets are substantially financed by oil revenue. Therefore the reverse of a commodity boom in the oil market is seen to have substantially affected the oil producers negatively.

Building and Construction

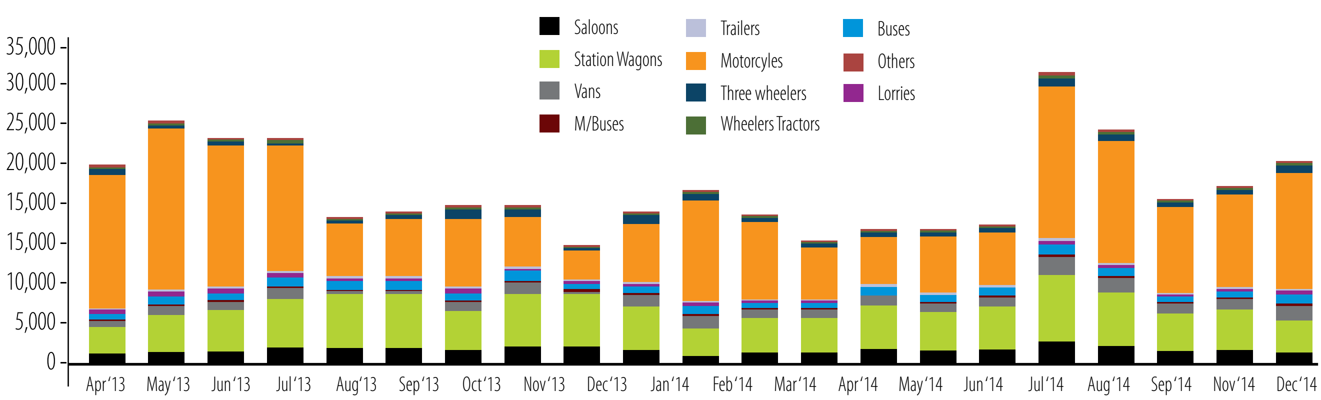
Building and construction posted an impressive performance of 11.0 per cent growth rate in the third quarter of 2014. The growth was mainly buoyed by the expansion in the real estate sector that increased demand for cement and other building materials. In addition, the demand from both the private sector as well as the public sector through the ongoing construction of the public physical infrastructure boosted the growth in the sector.

Looking at the production and consumption of cement as a proxy for measuring the growth in the building and construction sector, it's evident that cement consumption increased from 407,531 metric tonnes in September 2014 to 441,433 metric tonnes in November 2014; - a 8.32 per cent growth. An insight into cement production also reveals the growth in the building and construction sector. The production grew from 465,483 metric tonnes in September to 501,624 metric tonnes in December 2014; - a 7.64 per cent growth rate. Looking at the quarterly growth in cement production, the total quarterly production in the third quarter stood at 481,904 compared to 490,396 metric tonnes in December 2014; - an 8,492 metric tonnes growth. 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 Communication

The total number of registered vehicles in Kenya recorded an impressive performance in the fourth quarter of 2014 looking at the month – on – month growth. Between the month of November and December 2014 the total number of registered vehicles rose from 17, 226 to 20,608; - a

Figure 14: Registration of New Vehicles April 2013 to December 2014



Source: KNBS

19.63 per cent growth. This growth was tremendously contributed to by station wagons and motor vehicles. However, looking at the total quarterly number of vehicles, it's evident that quarter four of 2014 recorded a decline in the total number of registered vehicles compared to quarter three. In quarter three the total number of registered vehicles stood at 71,191 compared to a total of 55, 048 vehicles in the fourth quarter **(Figure 14)**.

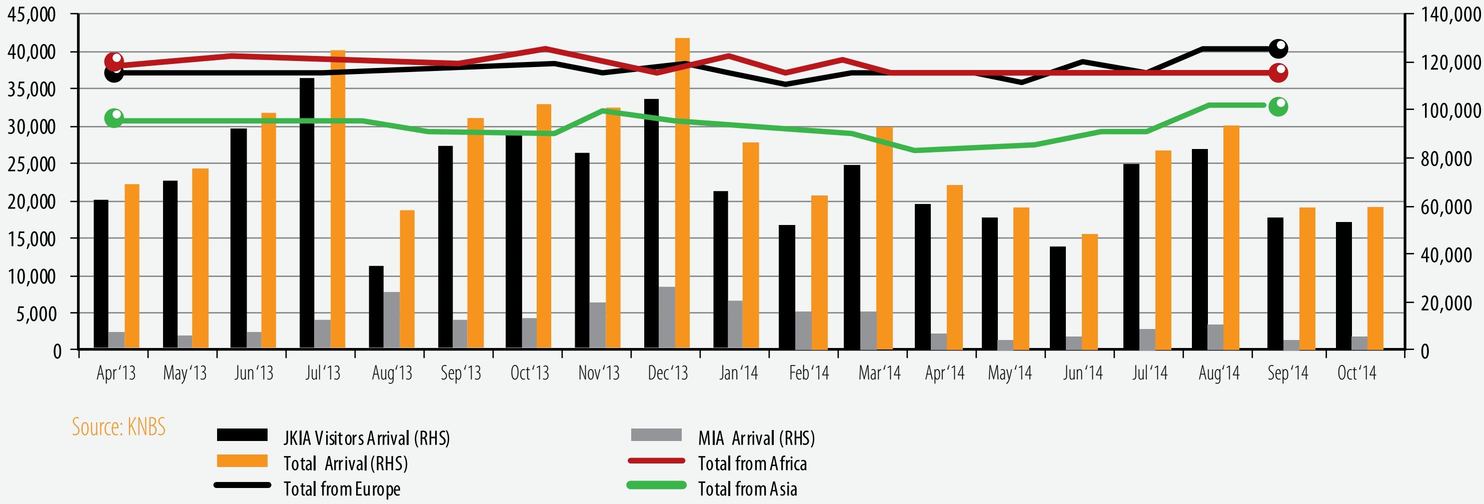
The dominance of mobile telephony in the communications industry continues to be evident. Mobile money transfer has been significant especially in rural areas where banks are not available, inaccessible, or where majority of the population do not hold bank accounts. At the same time this mode of money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

Tourism

For the entire of quarter four of 2014, tourism continued to post mixed results. On one hand, the adverse performance of the tourism sector for the fourth quarter of 2014 can be attributed to 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 in the past quarters of 2014. Looking at the number of tourists arrivals via the JKIA and Moi international airport reveal a decline from

60,521 in September to 58,929 tourists in October 2014. However a review of the tourists numbers by their origin show that the tourist's numbers from Asia, Europe and Africa were in gradual increase from September to November 2014. Tourists from Africa rose from 36,907 in September to 38,047 in November. Similarly from Europe the numbers mildly rose from 37,679 in September to 40, 235 tourists in December 2014 with Asian tourist increasing from 29,667 tourists to 33,342 tourists for the same period respectively. In addition to travel advisories being a hindrance to growth in tourism, poaching menace still continued to put tourism sector in jeopardy through reduction in the wildlife population.

Figure 15: Trends in Visitor Arrivals

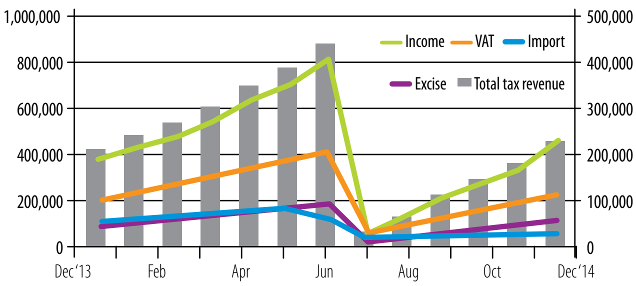


Source: KNBS

Financing of Government

Looking at the government revenues, the total quarterly revenue for the fourth quarter of 2014 stood at Ksh 1.25 billion compared to Ksh 455.96 million in quarter three. Of this, the total tax revenue accounted for 88.13 per cent of the total quarterly revenue in quarter four with the non – tax revenue accounting for 11.87 per cent. Of the tax revenue, income tax topped the list at 51. 72 per cent followed by value added tax at 27.67 per cent with excise duty and import duty coming third and fourth at 12.83 per cent and 7.78 per cent respectively.

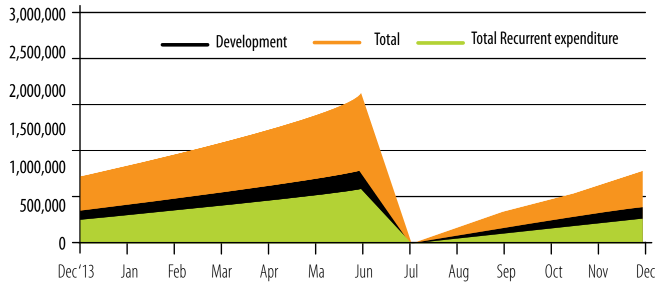
Figure 16: Tax revenue (Ksh. Million)



Source: CBK

Turning in to the government expenditure, the total quarterly expenditure for the fourth quarter of 2014 stood at Ksh 1.27 billion; - a 187.62 per cent growth from the third quarter total quarterly expenditure. Of this, the recurrent expenditure dominated the total expenditure accounting for 73.50 per cent while the development expenditure accounted for 26.50 per cent of the total quarterly expenditure in quarter four of 2014. The growth in the recurrent expenditure can be attributed to the increment of the civil servants salaries following the adoption of the previous collective bargaining and labour unrests. Between quarter three and quarter four of 2014, the total quarterly development expenditure grew by 610.33 per cent form a low of Ksh 47.5 million in quarter three to Ksh 337.5 million in quarter four. This is attributed to the rolling out of various development projects mainly the physical infrastructure in the road transport networks, the standard gauge railway and airport expansion among others.

Figure 17: Public Expenditure (Ksh. Million)

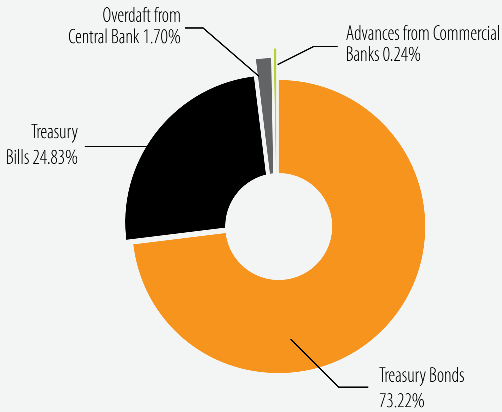


Source: CBK

Public Debt

The total public debt increased by a 5.53 per cent from Ksh 2.35 billion in September 2014 to Ksh 2.48 billion in December 2014. This was largely contributed by the external debt which grew from Ksh 1.09 billion to Ksh 1.17 billion in the same period compared to domestic debt which rose from Ksh. 1.26 billion to Ksh 1.31 billion in the same period . The growth in the external debt could be attributed to the government efforts to cut down on domestic borrowing to avoid crowding out effect as well as the need to keep the domestic interest rates as low as possible. In addition, the rising cost of international borrowing following the spillover effects of the US tapering could still be at play in explaining the rise in the external debts. Moreover, the weakening bias on the Kenya shilling arising from the falling world oil prices which has in turn led into the appreciation of the US dollar could be another underpinning factor behind the rise in the external debts for the entire of quarter four especially for the foreign currency denominated debts. Government treasury bonds remained the key money market instruments intensively utilized by the government in domestic borrowing accounting for 73.22 per cent of the total government debt as at the end of June 2014. Treasury bills, overdrafts and advances accounted for 24.83%, 1.70% and 0.24% percent of total government debt for the entire of quarter four of 2014 **(Figure 18)**.

Figure 18: Composition of Domestic Debt



Source: CBK

Money and Credit

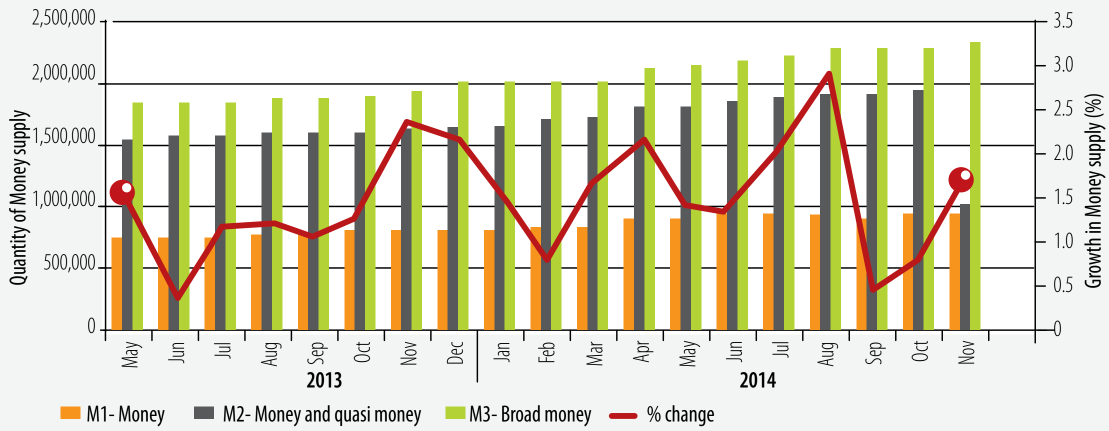
In the fourth quarter of 2014, the monthly total money supply grew substantially from -0.07 in September to 1.41 per cent in November **(Figure 19)**. It can be deduced that the total money supply posted a growth that was in tandem with the Central Bank's inflation rate target bound of 5 percent 2.50 basis points. Therefore expansion in money supply did not impose adverse inflationary pressures in the economy.

Inflation

The upward trajectory in the month –on - month inflation rates as experienced in the entire quarter two of year 2014 experienced a reversal in the subsequent fourth quarter **(Figure 20)**. For the entire quarter four, the month – on – month inflation rate was on a downward trend from 8.36 percent in August to 6.02 percent in December 2014. The drastic reduction in the inflation rate is majorly attributed to the declining international oil prices arising from a market glut in the world oil market, hence the low fuel and electricity inflation component of the entire inflation rate.

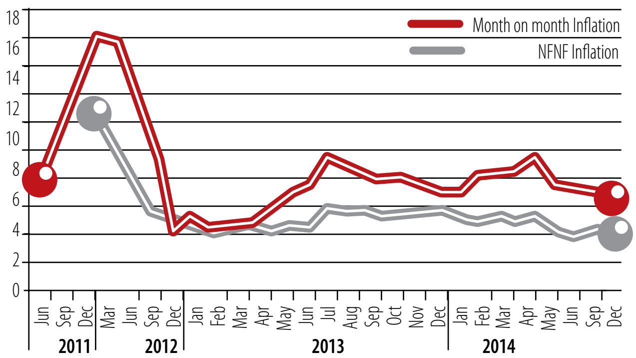
However, despite the reduction in the fuel inflation component, the food inflation was on rise following the looming food crisis amid of the inadequate short rains in October and December 2014. The month – on – month non-food non-uel inflation for the quarter four remained stable. More specifically in December 2014, the non-food non-fuel (NFNF) inflation stood at 3.65 percent compared to 3.77 percent in November signifying absence of any demand driven inflation pressures in the economy as at the end of quarter four of 2014. Since the non- food non-fuel (NFNF) inflation impact of monetary policy in the economy, therefore, it's evident that the monetary policy stance adopted by the Central Bank continued to support a stable inflation rate for entire of quarter four which is in tandem with the central bank's inflation targets of 5 percent +/- 2.50 basis points.

Figure 19: Money Supply (KES Million)



Source: KNBS and CBK

Figure 20: Inflation rate (%)



Source: KNBS

Interest Rates

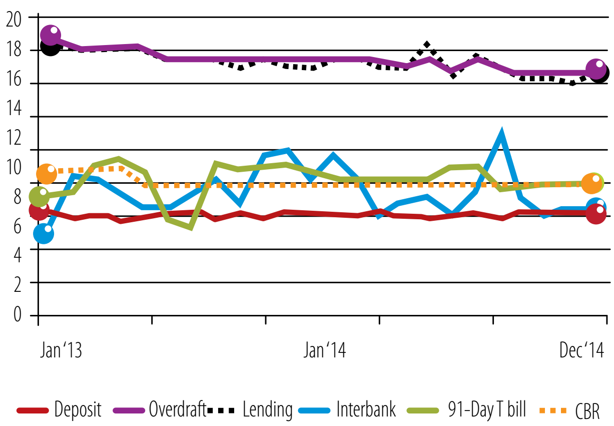
Interest rates have largely been stably during the fourth quarter of 2014 **(Figure 21)**. This was on the back of monetary policy being constant as evidenced by unchanging Central Bank Rate (CBR) as well as marginal change in interest rates on government securities. The CBR has continued being pegged at 8.5 percent throughout the fourth quarter following the MPC meeting on 4th November 2014 signaling central bank's commitment to anchor inflation rates ever since May 2013.

Treasury bill rate remained fairly stable though on decline. For the quarter four, the rate averaged at 8.63 percent; - 0.29 basis points down compared to a quarterly average of 8.82 percent in the third quarter. However, the rate for the 182 days T- bill and 364 days T-bill continued to be on the rise signifying the government appetite for longer term debts as opposed to very short term debt perhaps in attempt to avoid being locked in short term debts.

Cumulative average weighted lending rates mildly declined from 16.04 percent as at the end of the third quarter to stand at 15.94 percent as at the end of November 2014. 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 four of 2014 as evidenced by the relationship between the average lending rates and the CBR. This implies that the central government's effort to reduce the domestic borrowing in attempts to avoid crowding out effect and maintain low interest rates has not yielded much in lowering market interest rates.

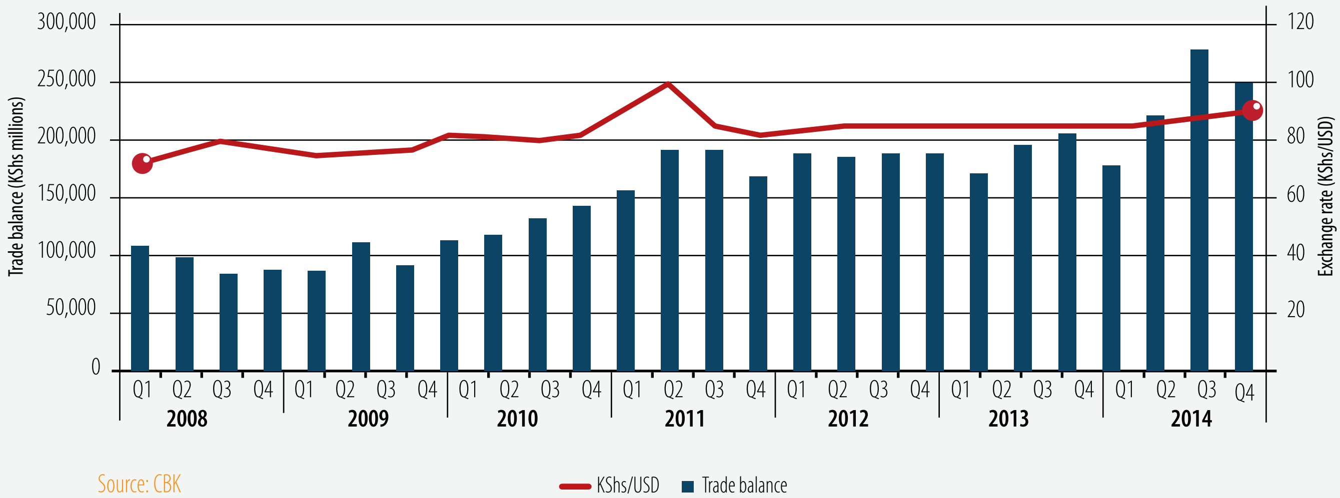
The interbank rates recorded a significant downward shift from 11.72 percent in August to 6.73 percent in October. However, the interbank rate started rising from November, following the central bank's intervention in the money market via repurchase of excess shilling and pumping of foreign exchange into the forex market in attempt to cushion the shilling which was under intense weakening bias for the entire of quarter four.

Figure 21: Interest rates (%)



Source: CBK

Figure 22: Overall trade balance and exchange rate



Source: CBK

Balance of Payments

In the fourth quarter of 2014, the volume of trade decreased from KSh 201.5 billion in October 2014 to KSh 164.5 billion in November 2014. For the same period, the total value of exports declined marginally by 2.08 per cent to stand at Ksh. 36.72 billion. Similarly the total value of import declined between October 2014 and November 2014 by 5.64 per cent to stand at Ksh. 121.6 billion in November 2014.

Domestic exports by Broad Economic Category (BEC) indicated that food and beverages was the main export category in November 2014 accounting for 41.1 per cent of exports, while the value of non-food industrial supplies and consumer goods not elsewhere specified registered 27.5 and 27.4 per cent shares, respectively. BEC imports indicate that industrial supplies (non-food) was the main import category in November 2014 with a share of 29.90 per cent, while the values of fuel and lubricants, machinery and other capital equipment and transport equipment registered shares of 19.92, 16.81 and 17.92 per cent respectively. Food and beverage recorded a share of 7.19 per cent while consumer goods not elsewhere specified recorded a share of 6.53 per cent.

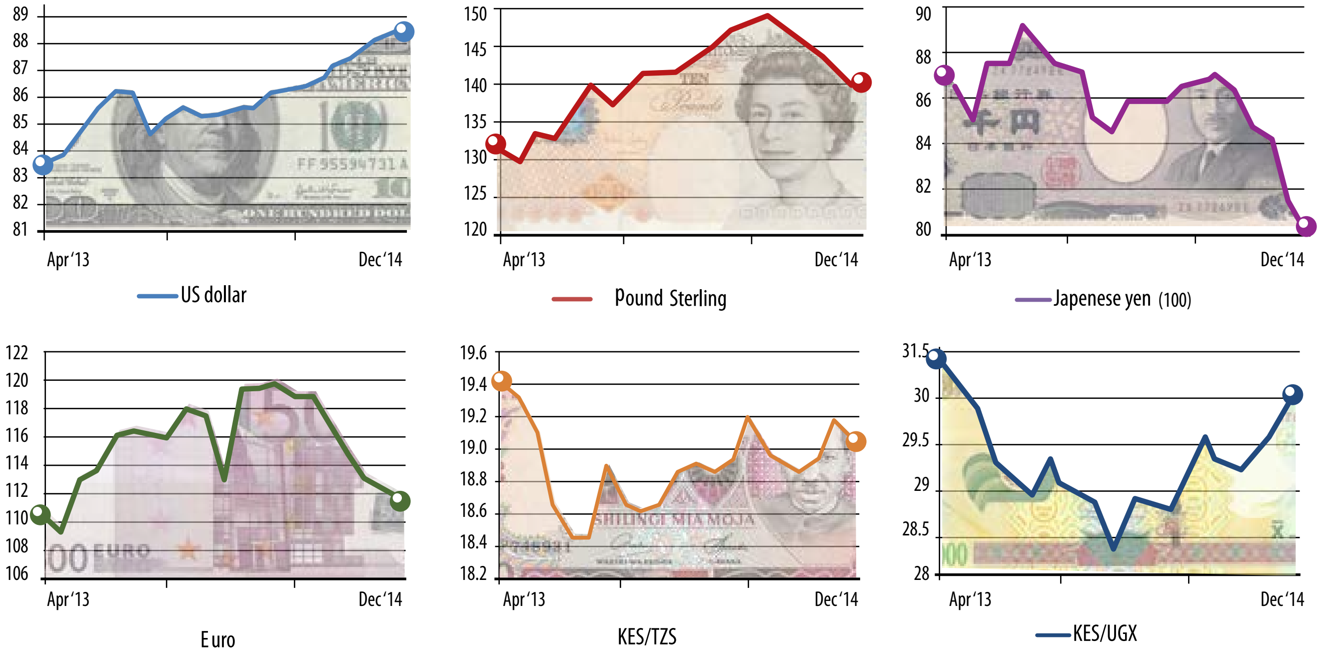
Focusing on the major exports;- tea, coffee and horticulture, tea exports topped the exports list to recording 19.99 per cent of the total value of exports for October and November 2014 combined followed closely by horticulture at 17.43 per cent with chemicals, coffee, cement, petroleum products and fish following in that order. For the intra African trade, Uganda topped as the most preferred export destination for domestic exports with a high of 24.31 per cent of Kenya's total exports for October and December combined followed by Tanzania at 14.30 per cent. Looking at the Kenya exports destinations outside Africa for October and November 2014 combined, Netherlands topped at 7.07 per cent followed closely by United Kingdom at 5.98 per cent, Pakistan and Egypt in that order.

Turning into the overall quarterly trade balance, it's evident that while the trades balance worsened by 23.92 per cent between the second quarter and the third quarter of 2014, quarter four recorded an improvement in the trade balance. During quarter four of 2014 the quarterly trade balance improved by 10.22 per cent. This may be attributed to the gains from increased exports owing to the depreciation in the Kenya shilling against other major currencies that made the Kenyan exports cheaper in the export markets.

Exchange Rate

During the fourth quarter of 2014, the shilling has posted poor performance against hard currencies in nominal terms with the weakening bias on it being prolonged for the entire of quarter four. The shilling fluctuated between 89.23 and 90.44 marks against the US dollar between October and December respectively. The weakening bias on the

Figure 23: Exchange Rates



Source: CBK

shilling was mainly attributed to the declining world oil prices following the oil market glut that saw the US dollar appreciate given that oil is traded in the dollars. Although the central bank tried to intervene in the forex market the weakening bias continued to exist though modest.

Looking at the sterling pound, the shilling gained to average at 141.45 marks in December up from 143.62 marks in October 2014. This can be attributed to the effects of Euro crisis on the British economy given its European Union membership. For the Euro and Japanese, the shilling appreciated with the major factors being the geopolitical oil price crises coupled with the slow recovery and then Euro crisis. With the Euro zone facing the deflation, the Euro has been under weakening pressure against other world currencies hence the depreciation (**Figure 23**).

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 30.62 in the month of December up from a monthly average of 30.02 in October while for the Tanzanian shilling the monthly average nominal exchange rate oscillated between 18.95 and 19.11 mark in October and December 2014 respectively.

Nairobi Securities Exchange

The Nairobi Securities Exchange (NSE) posted impressive performance in the entire of quarter four of 2014 as revealed by all the market indicators which appear to have been on an upward trend. The NSE – 20 share index was still resilient for the entire of quarter four of 2014 remain at above the 5,000 points mark. However, the inter – month analysis of the index points some decline from a high of 5,195 points in October 2014 to a low of 5,113 points as at the end of December 2014; - a mild decline of 1.58 basis points. The performance of above 5,000 basis points was mainly supported by increased participation

of the local investors as evidenced by the decline in the foreign investors' participation from 53.95 per cent in October to 32.37 per cent in December thus signalling a rise in the local investors' participation. This implies that foreign investors turned from being net sellers between November and December 2014.

Table 3: Nairobi Securities Exchange Market Indicators

Date	Oct 2014	Nov 2014	Dec 2014
NSE 20 Share Index 100=1966	5,195	5,156	5,113
NSE All Share Index (NASI) 100=2008	159	163	169
Total Shares Traded (Million)	506	666	900
Equity Turnover (ET) KES. million	19,287	14,341	31,583
Bonds Turnover (KES. million)	38	50	43
Percent of Foreign Participation to ET	53.95%	56.53%	32.37%

Source: NSE, Monthly Bulletin

The NSE All share index rose from 159 points in October to 169 points in December 2014; - a 6.29 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 growth entreprise market segment (GEMs) of the bourse remains challenged given the few listings and the poor performance of the companies listed in the segment.

The fixed income segment as represented by the bond market posted some remarkable performance in November as evidenced by the upward surge in the bond turn over from Ksh. 38 million in October to Ksh. 50 million in November. Notably, the bearish behaviour dominated the market especially towards the end of the year. This could be attributed to the information on the introduction of capital gain tax coming January 2015. This could also explain the significant reduction in the percentage of foreign participation to equity market turnover hence making the foreign investors more net sellers prior to the introduction of 5 percent capital gain in January 2015.

Banking Industry Performance

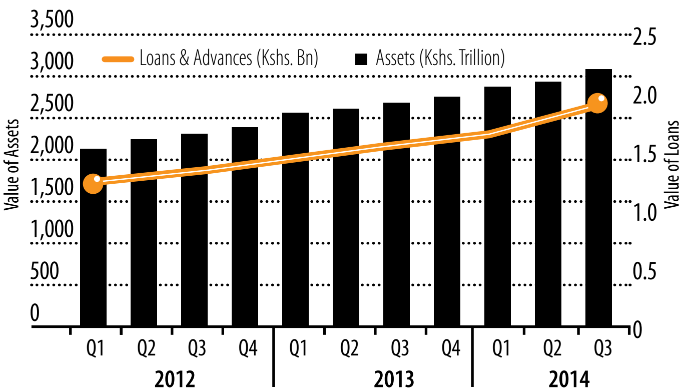
A highlight of the banking industry for quarter four of 2014 posits that demand for credit generally grew in a number of sectors namely: personal / household, trade, real estate, manufacturing, transport and communication, energy and water, building and construction, agriculture and financial services. However, tourism and hotels sector registered a decline in credit growth due to higher repayments than new loans granted for the entire of quarter four 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 four of 2014 was sustained with agency banking.

Assets and Loans

The industry's assets base registered positive growth of 5.84 percent as at December 2014 to stand at Ksh. 3.62 trillion compared to Ksh. 3.08 trillion in quarter three of 2014. Looking at the annual growth in the banking industry balance sheet growth, it's evident that as at December 2014, the industry balance sheet grew by 19. 36 per cent compared to December 2013.

Similarly, total industry's loans and advances marginally grew by 3.14 per cent from quarter three to quarter four of 2014. An annual analysis posit that as at the end December 2014, the total loans and advances for the industry posted a growth of 22.85 percent compared to December 2013. By December 2014, the total loans and advances stood at Ksh. 1.97 trillion compared to Ksh. Ksh.1.60 trillion in December 2013. Comparing the quarterly growth in loans and advances between quarter three and four of 2014 with the growth in the demand deposits, it's evident that Loans and advances, the difference between the two is dismal. This is because, the deposits grew by 3.56 percent in the same period while the total loans and advances grew by 3.14 percent hence signifying the banks' capability to convert their liabilities into assets. 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 24: Bank Assets and Loans (Kshs Billion)

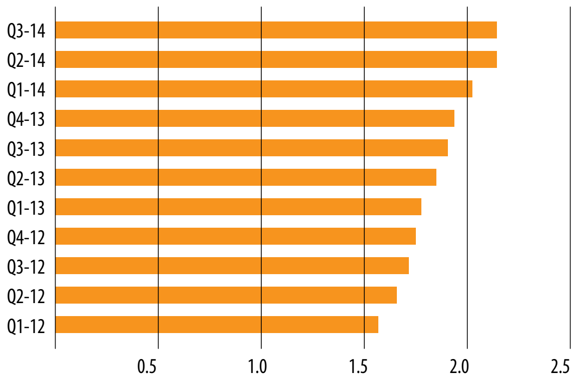


Source: CBK

Deposits

The total deposits in quarter four of 2014 recorded a mild growth of 3.6 percent compared to previous quarter three. Demand deposits accounted for major source 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 four the total industry's deposits stood at Kshs. 2.33 trillion compared to Kshs. 2.25 trillion in quarter three of 2014.

Figure 25: Bank Deposits (KES Trillions)

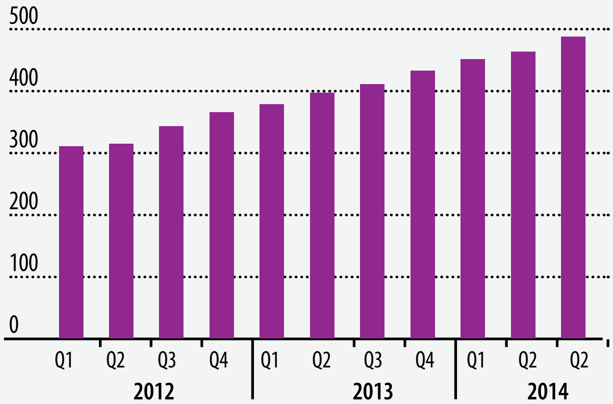


Source: CBK

Total Shareholder Funds

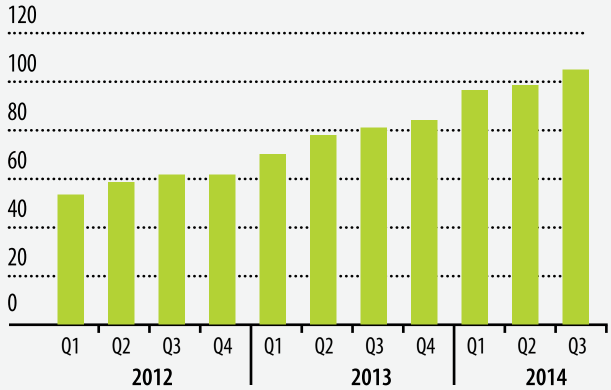
Total capital stock of the Kenya banking sector sustained its upward trajectory in the fourth quarter of 2014 thus signifying growth in the shareholders' wealth in the banking industry. The quarter recorded a growth in share holders' wealth of 8.47 percent from Ksh 488.7 billion as at the end of September 2014 to Ksh 530.09 billion as at December 2014. This increases confidence in the banking industry given that the increase in the shareholders' funds represents a trade - off of equity for debts financing.

Figure 26: Shareholder Funds (Kshs Billion)



Source: CBK

Figure 27: Bank Gross Non - Performing Loans (KES Billion)



Source: CBK

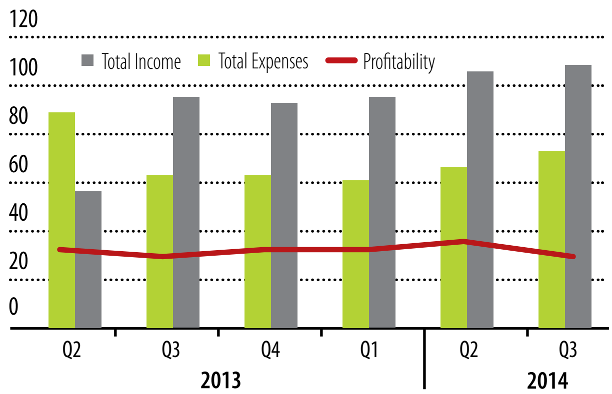
Gross Non-Performing Loans

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. 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

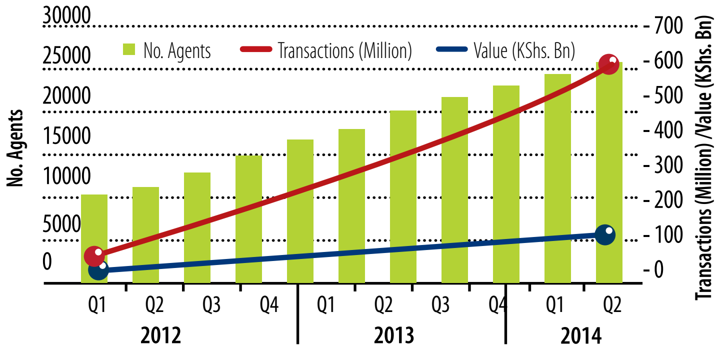
The banking sector recorded a decline in the profit before tax in quarter three of 2014, to stand at Ksh. 33.5 billion against Ksh 37.6 billion (**Figure 28**). This represents a 10.9 percent drop. Total income remained unchanged for quarter three stood at Ksh. 104.0 billion while total expenses increased 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 28: Bank Profitability (KES Billion)



Source: CBK

Figure 29: Cumulative Agency Banking (no. of agents, transactions volume and Value)



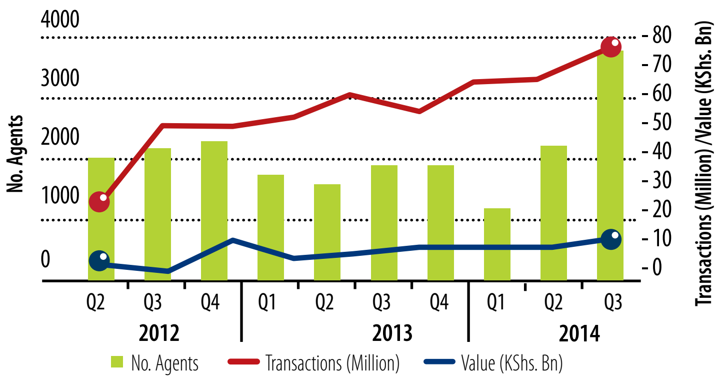
Source: CBK

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 30 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.

Figure 30: Quarterly Growth in Agency Banking (no. of agents, transactions volume and Value)



Source: CBK

KENYA BANKERS
ASSOCIATION

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Kenya Bankers Association
13th Floor, International House, Mama Ngina Street
P.O. Box 73100– 00200 NAIROBI
Telephone: 254 20 2221704/2217757/2224014/5
Cell: 0733 812770/0711 562910
Fax: 254 20 2221792
Email: research@kba.co.ke
Website: www.kba.co.ke