

KENYA BANKERS ECONOMIC BULLETIN

QUARTER THREE OF 2016



VOLUME **17**

A report prepared by:

**The Centre for Research on
Financial Markets and Policy®**



KENYA BANKERS
ASSOCIATION



About this Report

This *Bulletin* reviews the performance of the Kenyan economy for the 3rd quarter of 2016, 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 industry 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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Distributed by Kenya Bankers Association

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FOREWORD



From the CEO's Desk

It is my singular pleasure to present to you the 17th volume of the *Kenya Bankers Economic Bulletin*. In this issue, we discuss the state of the Kenyan economy during the third quarter of 2016. 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. There is recognition that the economy has been performing well relative to its peers in the continent. That is far from indicating that there are no challenges that could undermine such performance.

As the *Bulletin* notes, the challenges to the economy are both at the local and international front. The global economy's growth remains weak. The geopolitics, especially the ramification of the outcome of the US elections on the global economy brings on board a new sense of uncertainty.

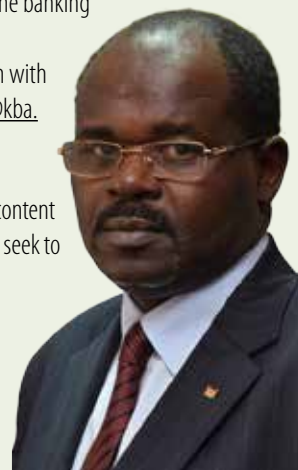
On the local scene, the focus has remained on how the *Banking (Amendment) Act 2016* will affect the credit market.

This is likely to influence the economy's growth trajectory in the near and medium term. It is probable that adverse weather developments could affect the agriculture sector. It is equally possible that uncertainties associated with the run-up to 2017 elections could lead to a wait-and-see attitude by investors. These considerations have a bearing on the economy's outlook.

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

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

Habil Olaka
Chief Executive Officer,
Kenya Bankers Association



COMMENTARY



“Kenya is one of the bright spots in Sub-Saharan Africa. With economic growth rates sustained at above 5 percent, Kenya has outperformed the regional average”
– World Bank

So all is well with the economy? Really?



By Jared Osoro

Introduction

The popular official view as 2016 comes to a close is that the economy is doing just fine. The second quarter real GDP growth numbers buttress such viewpoint. According to the Kenya National Bureau of Statistics, the Kenyan economy expanded by 6.2 percent in real terms during the second quarter compared to the first quarter’s 5.9 percent. When you compare this performance to the 5.0 percent and 5.9 percent real growth during the corresponding quarters in 2015, it is easy to jump into a quick conclusion that the economy is on course to doing better than the 2015 real growth of 5.6 percent.

The chorus is loud enough from international agencies that all is well. The World Bank, in its October 2016 *Kenya Economic Update*¹ is very colourful in its optimism: “Kenya is one of the bright spots in Sub-Saharan Africa. With economic growth rates sustained at above 5 percent, Kenya has outperformed the regional average, for 8 consecutive years. Robust domestic demand emanating from private consumption and government

investment are the key drivers of growth, underpinned by a stable macroeconomic environment, lower oil prices, diversification, improved security perceptions, and ongoing structural reforms”.

So the World Bank projects a real growth of 5.9 percent for Kenya in 2016, rising to 6.0 percent in 2017 and 6.1 percent in 2018. Predictably, its Bretton Woods sister – the International Monetary Fund (IMF) – is more optimistic than its past record of stellar projections that end up being mere messages of hope could justify. The IMF in its *World Economic Outlook* of October 2016 projects that the economy will hit 6.0 percent real growth in 2016, rising 6.1 percent in 2017 and hitting 6.5 percent by 2018.

The IMF’s *Regional Economic Outlook: Sub-Saharan Africa*² is equally colourful. It describes the continent’s growth as “multispeed”. There are slow movers, comprised of resource intensive economies that are simply crawling because they have been hit by low international commodity prices and the non-resource-intensive economies continuing perform well. Kenya is classified in the latter category of this dichotomy and countries in this cohort are anticipated to grow at a 6 percent – 8 percent range in the next couple of years.

The IMF however makes a very assertive commentary that “this high growth is unlikely to have positive spillovers on the hardest-hit countries,

¹ World Bank (2016), Kenya Economic Update, Edition No. 14, October (<http://documents.worldbank.org/curated/en/882161477667623804/pdf/109575-REVISED.pdf>)

² IMF (2016)–A, Regional Economic Outlook: Sub-Saharan Africa, October (http://www.imf.org/external/pubs/ft/rego/2016/afr/eng/pdf/chapter1_1016.pdf)

as intra-regional economic and financial linkages tend to remain limited". I can make two related deductions from the assertion. One is that the so-categorised star performers have little influence in the continent's fortunes. Yet, when the continent is bedevilled by bad fortunes, the star performers will hurt. Two, if the direction of influence is one way then the contagion from the continent's performance cannot simply be wished away in any respectable growth forecast. In other words, assuming an island of prosperity in a sea of turmoil amounts to a Robinson Crusoe economy assumption where it is largely the domestic circumstances that carries the day on matters growth and stability.

The Robinson Crusoe Adventure

How plausible is the Robinson Crusoe assumption? It is clear that Kenya's growth has a strong association with that of Sub-Saharan Africa than to the rest of the work (**Figure 1**). Our growth context should therefore be seen against the IMF's observation that on the backdrop of "lower commodity prices and a less-supportive global environment, economic activity in sub-Saharan Africa has decelerated sharply. The region's output is only expected to expand by 1.4 percent in 2016, the worst growth performance in more than 20 years, and the loss in momentum over the last two years has been on par with the deep slowdowns of previous decades."

Figure 1: Real Output Growth Association (1991 – 2015)



Where then do we look towards if the projected growth is to be realised? The World Bank tells us that “robust domestic demand emanating from private consumption and government investment are the key drivers of growth, underpinned by a stable macroeconomic environment, lower oil prices, diversification, improved security perceptions, and ongoing structural reforms”. In other words we have to look at three things simultaneously.

The first one is the possibility of the households consuming its way towards assuring sustained growth. If the logic is that consumption is linked to production, then the relatively good performance of agriculture is a positive signal – even though good agricultural produce is linked more to good weather than the incentive of increased consumption. But the performance of the manufacturing has not been strong, pointing to the fact that strong private consumption is linked with strong manufactured imports.

Therefore, part of the bridge between the local economy and the external economy is through the imports of consumables. The other part is the importation of plant and machinery, which often tilt the scale of

overall imports. Importation of plant and machinery – which is core to increasing the economy’s production capacity – has been weak at best³.

Then there is the export part of the bridge between the local economy and the external economy. There is no denying that exports have been weak such that when it comes to foreign exchange earnings, we often look to diaspora remittances with glee. A compelling technical chapter⁴ in the IMF’s *World Economic Outlook of October 2016* explains why global trade is subdued – and much of it has to do with the softness of the global economy, more so the emerging markets that have been dragging the world along even when the developed economies were down.

The above import-export picture tells us one thing: we have fallen into the temptation of celebrating a window dress – the fast narrowing of the current account deficit from a high of 9.8 percent equivalent of GDP

³ See Central Bank of Kenya’s Monetary Policy Committee (MPC) observation of November 28, 2016 ([https://www.centralbank.go.ke/uploads/mpc_press_release/1127537557_MPC%20Press%20Release%20-%20Meeting%20of%20November%202016%20\(4\).pdf](https://www.centralbank.go.ke/uploads/mpc_press_release/1127537557_MPC%20Press%20Release%20-%20Meeting%20of%20November%202016%20(4).pdf))

⁴ IMF (2016)-B, *World Economic Outlook*, October. (<http://www.imf.org/external/pubs/ft/weo/2016/02/pdf/c2.pdf>)

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in 2014 to 4.9 percent by June 2016. No wonder the narrowing of the current account has been the core explanation of the Monetary Policy Committee (MPC) of the Central Bank of Kenya (CBK) for the stability in the foreign exchange market.

As we have argued in the past⁵, the narrowing of the current account deficit needs to be seen in the context of the asymmetric nature of the contribution of the lower imports and higher exports to that narrowing. We contend that the foreign exchange stability cannot be entirely attributed to the narrowing of the current account. The CBK's presence in the foreign exchange market partly plays a role. That presence, even on the back of an IMF standby facility, cannot be perpetual; its limits are known.⁶

On the board macroeconomic stability, it is easy to agree that the official targets have been made. What is instructive though is that, faced with the new law on interest rate capping, the assurance of a stable and strong growth is a rarity. Not even the CBK's MPC, at least not publicly, can exude that confidence. My evidence is in the monetary policy decisions of September 2016 and November 2016.

⁵ KBA Research Centre (2016), Research Note No. 27, November; (<http://www.kba.co.ke/images/stories/RN%20No%206%202016.pdf>)

⁶ See Chutasripanich, N. and Yetman, J. (2015), Foreign Exchange Intervention: Strategies and effectiveness, BIS Working Papers No. 499, March (<http://www.bis.org/publ/work499.pdf>)

In September 2016 the MPC's concern was the slowdown in the rate of credit expansion to the private sector from double digit levels to single digit levels that in its view posed "a risk to economic growth". On that basis, the MPC decided to lower the CBR by 50 basis points even when the rates had been brought down by two weeks earlier by over 400 basis points through legislation.

By November 2016 the story was different – the MPC observed that "the slower credit growth witnessed over the last several months was found to be largely an outcome of structural factors in the banking sector rather than monetary policy. However, there is no evidence that this is having a negative effect on economic growth". In other words while two months is the short-run, it is enough for a quick transition from the clear evidence of the risk of slow credit growth to growth that prompted a policy move to an evidence searching escapade!

Just like we observe that the foreign exchange interventions have a constraint, the extent to which fiscal policy will continue to drive growth has its limits. Even as the ardent supporters of this policy such as the World Bank that see the "crowding-in" effects from the capacity enhancement angle, a blind eye shouldn't be turned on the possible "crowding out" from the quantity channel – and we are seeing evidence of this given that lenders are keen to invest in government securities than in the private sector, partly accounting for the slowdown in credit to the private sector that we are presently witnessing.

Even the optimists are aware of the downside risks that the economy is facing, both from the external and domestic fronts. On the external front, as I have alluded, we have a weaker than expected growth in the global economy. There is also volatility in global financial markets and a spike in oil prices now that the possibility of output cuts by OPEC is increasingly looking real. On the domestic front, there is a possibility of a delayed to fiscal consolidation; adverse weather developments could ruin the party in the agriculture sector; potential uncertainties associated with the run-up to 2017 elections could lead to a wait-and-see attitude by investors.

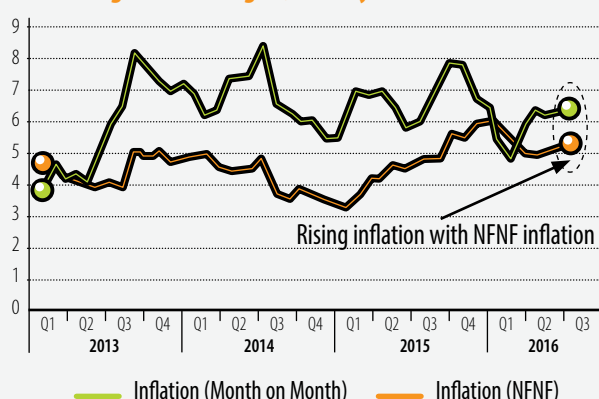
Given the all-happy attitude manifested in the rosy projections, it is evident that the downside risks with the potential to dampen short-term growth prospects have been generously discounted. I have elected to err on the side of caution and see the 2015 growth outlook the best case, not the base case. I hope I am wrong!

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

State of the Economy

During the third quarter of 2016, the economy's prospects for growth remained positive though challenging macroeconomic environment set in towards the end of the quarter. The Leading Economic Indicators mainly Consumer Price Indices (CPI) and inflation, interest rates, exchange rates, international trade, agriculture, energy, manufacturing, building and construction, tourism and transport among others all remained supportive of the economy's growth agenda in quarter three. During the quarter, the cost of living (inflation rate) as indicated by the month-on-month inflation remained within the government target range though on the upper target bound. The average quarterly inflation rate for quarter three was 6.33% compared to 5.37% during quarter two. This showed the reversal in the gains of the previous monetary policy stances that managed to anchor inflation within the lower target bound. The non-food-non-fuel inflation increased mildly signaling an element of mild demand pressure in the economy. The annualized inflation rate as at September 2016 was 6.52% higher than 6.28% as at September 2015.

Figure 2: Average Quarterly Inflation Rates

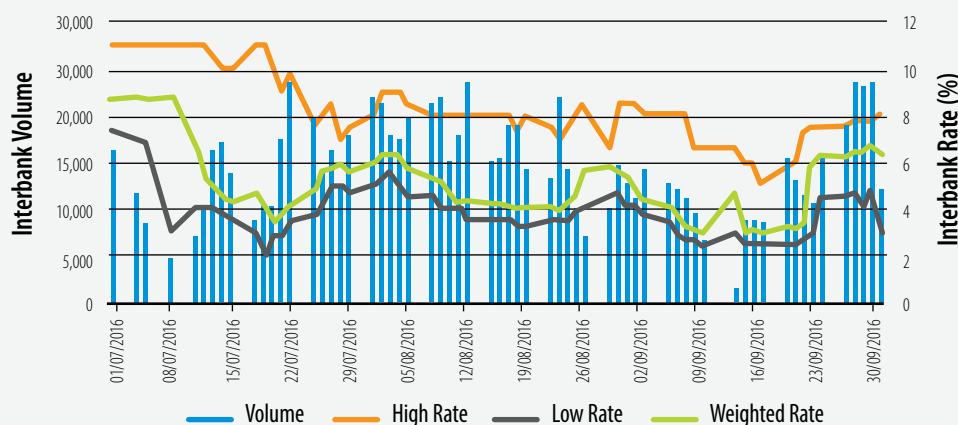


Source: Central Bank of Kenya

The 91 Treasury bill rates averaged at 7.57% in quarter three compared to an average rate of 8.11% in quarter two. The 91 Treasury bill rates have remained a single digit figure for a while since February 2016. This could be partly explained by two possible reasons. One is the likelihood of oversubscriptions in the short term government securities which in turn lead to the downward movement in the transaction rates. Secondly could be the government intention to keep the domestic borrowing rates low for two main things, first is to avoid the crowding out of the private sector through the price channel. The second reason for the government maintaining single digit rate on 91 treasury bills is the intention towards driving the overall lending rates in the economy low given that the 91 Treasury bill rate enters into computation of KBRR prior to the introduction of interest rates capping law.

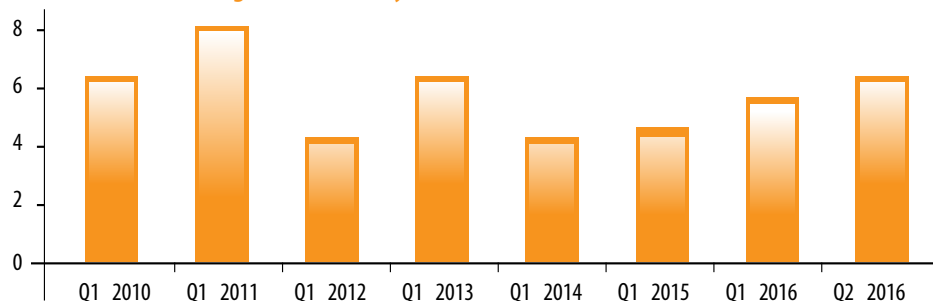
The interbank market remained suppressed for the entire of the quarter with both the volumes and the rates remaining low. However, looking at the daily rates, an upward surge can be evidenced in the beginning of the quarter in July and towards the end of September with the daily rate going beyond a 6% mark from a low of 3% mark as depicted by the weighted average rate. As such from the daily data, high levels of volatility can be evidenced in the interbank market thorough out quarter three of 2016. A unique scenario is evidenced in the interbank market during quarter three. Upon the signing of the interest rate capping law on 24th August 2016, the interbank rates immediately shoots up for a while. However, the rates comes down after a while when the two weeks given for the interpretation of the law nears the end and afterwards the rate shoots up. This is an evidence of how news and events drive the performance in the overnight lending market.

Figure 3: Daily Interbank Volumes and Rate for July 2016 – September 2016



Source: Central bank of Kenya

Figure 4: Quarterly Growth in GDP – 2009 Base Year



Source: KNBS

Quarterly Growth Rate

Sectoral performance

Agriculture

Agriculture remained to be a key sector driving economic growth in the quarter three of 2016. This is evidenced by the fact that the main exports for the country were majorly from the agricultural sector and accounted for the largest portion of the total exports. In addition the sector still remained to be the highest employer given its forward and backward linkages with the other sectors of the economy. The performance of the agricultural sector declined given the dry spell experienced between July and September prior to onset of short rains in October.

From the production point of view, tea production declined significantly during quarter three falling from 35,604 MT in June 2016 to 29,285 MT in July and August respectively. The decline in production are partly due to the dry spell witnessed in July – September period, a period in



Figure 5: Tea production in Metric Tonnes and Prices per Kilograms

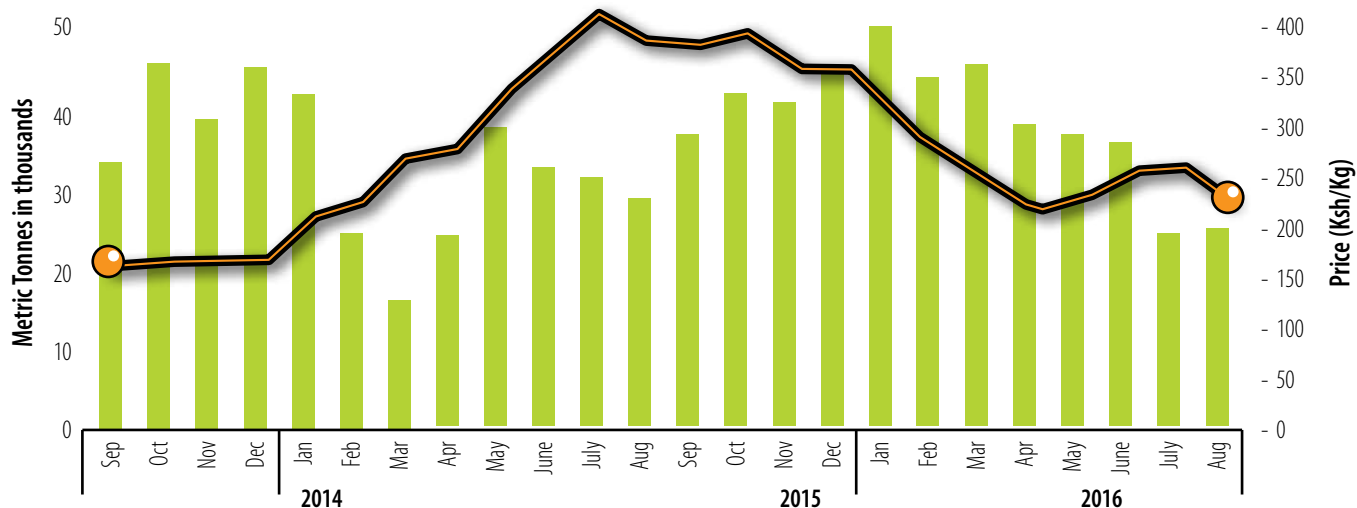
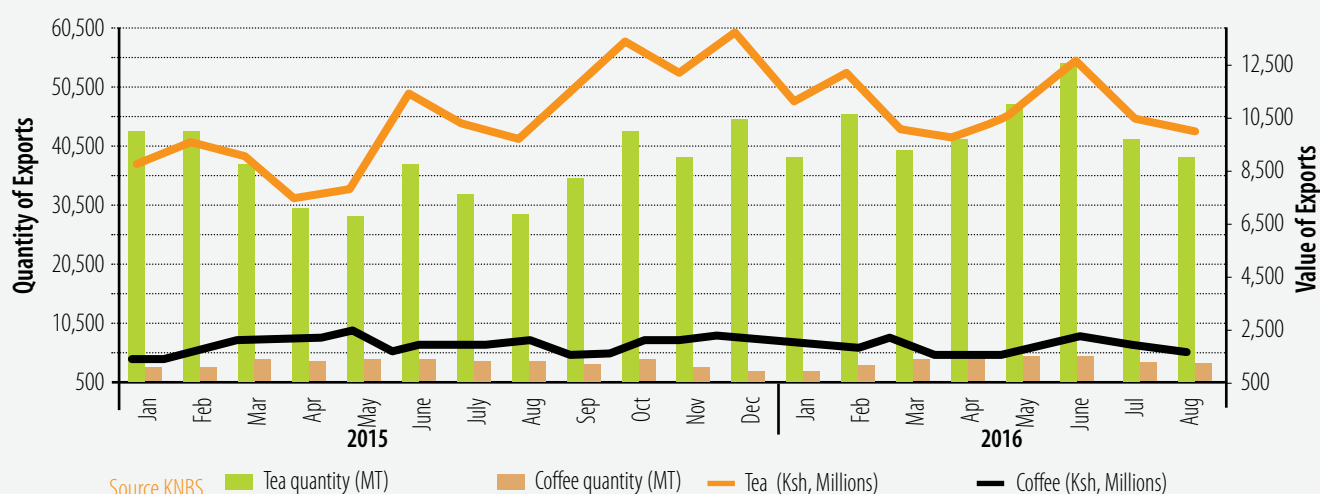


Figure 6: Value of Tea and Coffee Exports, Jan 2015 – Aug 2016



between the long rains and the short rains. In terms of prices, the average price per kilogramme rose marginally to Ksh. 246.44 per kilogramme in July from Ksh. 242.5 per kilogram in June. The prices later dipped to Ksh. 234.27 per kilogramme in August.

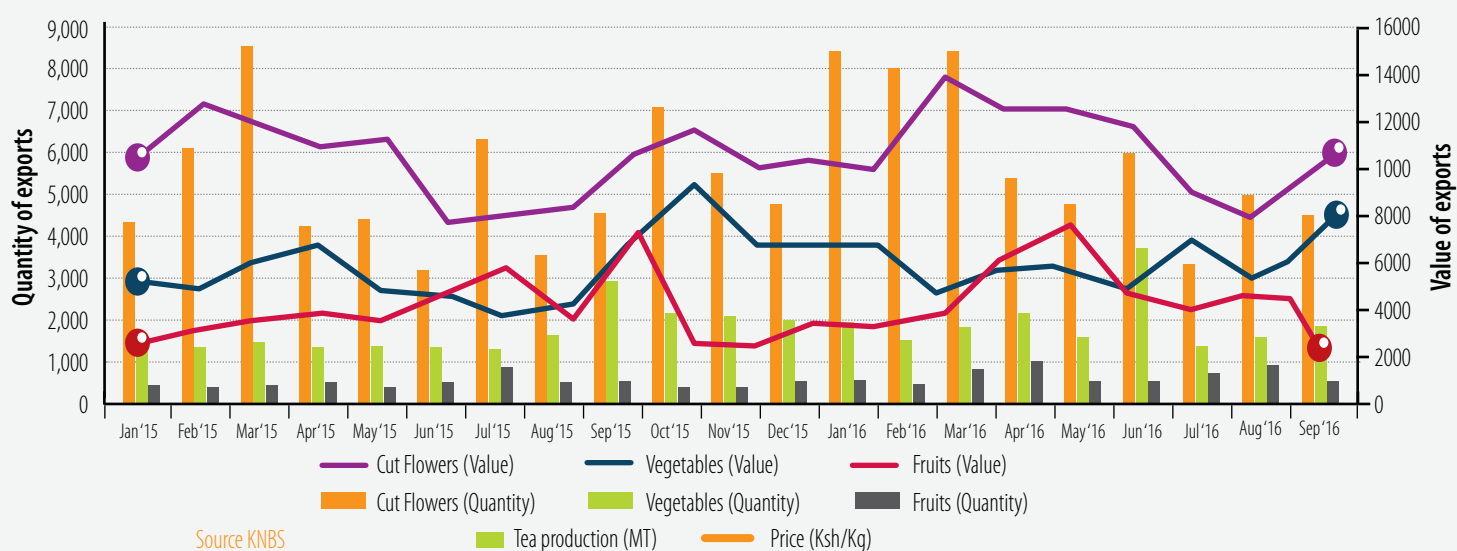
Milk deliveries to formal processors increased from 48.10 million litres in June to 58.5 million litres in July but decreased to 56.1 million litres as at the end August. The slight decline production was as a result of reduced milk delivery to the formal production plants following dry spell between July and September that saw decrease in animal feeds production.

Agriculture cash crop exports continue to command a good share of the total economy's main export, with tea topping in foreign exchange earning followed by coffee. As revealed in (Figure 8) the quantity of tea exported in July and August was 82,425.80 MT compared to 7,705.60 MT of coffee exported during the similar time period. The total value of tea exported

during the July – August was Ksh. 20,672.67 with that of coffee being Ksh. 3,434.53 million.

On horticultural exports (**Figure 7**), in terms of quantity exported in quarter three of 2016, cut flowers dominate this subsector contributing 47.51 percent of total quantity of horticultural, followed by vegetables at 34.17 percent with fruits exports recording the lowest contribution of 18.23 percent. Looking at the foreign exchange earned from horticultural exports for the entire quarter, cut flowers dominated this subsector accounting for 65.13 percent of total horticultural exports value, followed by vegetables at 25.53 percent with fruits exports recording the lowest contribution of 9.35 percent. However, in absolute terms, the quantity of cut flowers exported declined in quarter three by 15.38 percent compared to the amount exported in quarter two. Similarly is the quantity of fruits the fell by 36.71 percent. However, the quantity of vegetables exported in quarter three rose by 13.83 percent. On the value side, all registered a drop in the value of the exports within the quarter.

Figure 7: Horticultural Exports Jan 2015 – Sept 2016





Manufacturing

The manufacturing sector in Kenya is poised as one of the foundations in achieving vision 2030; transiting the economy from traditional agriculture to modern manufacturing economy.

A key component of the manufacturing sector is its output that targets the construction industry. Cement production was on rise during the quarter rising from 536,471 MT in June to 540,192 MT in July 2016 and further to 552,559 MT as at the end of August 2016. The increase in production may have been accessioned increased activity in the building and construction industry as signified also by the increased demand for cement as well and

the improvement in the building and construction sector as well. In addition, the large infrastructural projects by the government have occasioned the rise in cement production following the negotiations for local procurement of raw material by the government with regard to major infrastructural projects.

Production of soft drinks remained fairly stable within quarter three in comparison to quarter two. Production fell from 38,801 thousand litres in June to 35,769 thousand litres in July but later surged up to 39,316 as at the end of August 2016. For vehicle production, the newly assembled vehicles, production remained largely stable increasing from 491 units in July 2016 to 605 units in August 2016.

Figure 8: Production and Consumption of Manufacturing



Source KNBS



Energy

There has been continues concerted efforts to boosts energy production so as to meet the growing demand for energy by the growing economy. More so, there is continues shift from the conventional sources of energy to concentrate on cheaper and more reliable, clean and renewable sources of energy. This shift is observable, seeing that geo - thermal production as well as wind power generation combined have continued to lead the way in adding to the total energy production and hydro production, though significant, continues to relatively drop. In addition the demand for energy has been on the rise given the government's efforts to connect more households with power especially in the rural areas through the last mile power project.

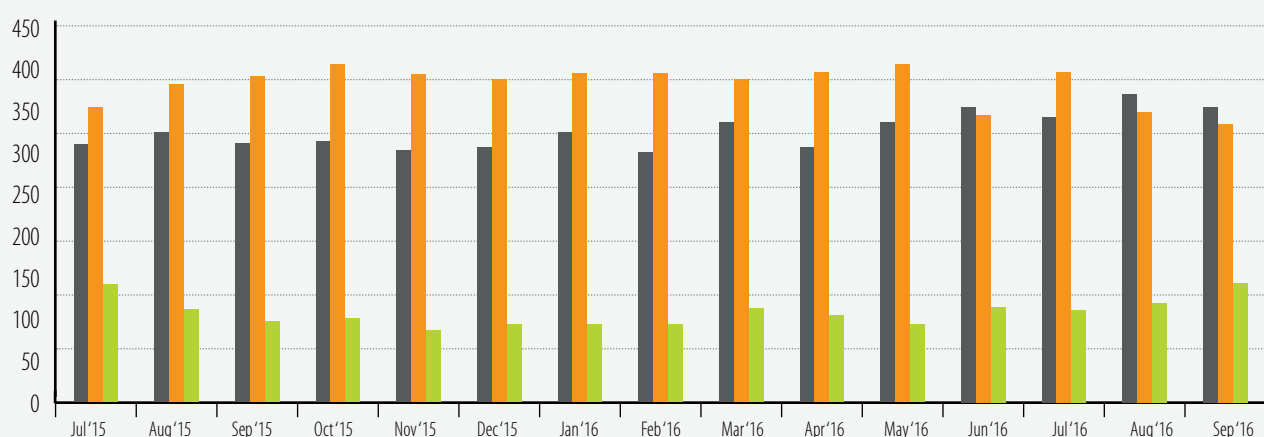
A review of the power generation for in the third quarter of 2016 reveals that the total energy production that was injected into the national grid declined from 2,433.25 million KWh in the second quarter to 2,506.54 million KWh in the third quarter of 2016. During the quarter, thermal production posted the highest rise in production compared to hydro and geothermal production. This is perhaps occasioned by the low levels of water for hydro production following the dry spell experienced between July and September 2016.

However, in overall, the geothermal production took the lead accounting for 42.82 percent of the total production followed closely by hydro production at 41.86 percent with thermal production being third at 15.32 percent of the total production.

However, despite the power demand outstripping power supply power losses still continued to persist. Within quarter three the total power losses stood at 416.08 million KWh compared to 268.66 million KWh in quarter two of 2016. It's also notable that within the quarter, the overall energy consumption remained below the overall production citing deficiency in consumption in relation to production.

On the oil prices, the global crude oil prices assumed an upward trend for the entire quarter. The monthly average crude oil prices for July stood at \$44.60 per barrel marginally rising further to \$45.75 per barrel in August and \$ 45.64 per barrel as at the end of September 2016. This has been attributed to reduced production as well as reduced supply in the oil market by the oil

Figure 9: Electricity Generation by source (Million KWh), Jul 2015 – Sept 2016



Source KNBS

Table 1: Average Monthly Crude Oil and Retail Fuel Prices

	Jun- 16	Apr - 16	May -16	Jun- 16	Jul- 16	Aug - 16	Sept - 16
Murban crude oil (US\$/Barrel)	38.20	42.00	47.35	49.05	44.60	45.75	45.64
Super petrol (KES/Litre)	86.46	81.61	85.14	87.07	93.81	96.01	92.28
Diesel (KES/Litre)	66.68	67.21	71.34	74.69	84.20	85.47	83.42
Kerosene (KES/Litre)	43.13	44.94	47.96	59.10	62.42	63.45	60.08
LPG (13Kgs)	2,277.48	2,268.37	2,252.86	2,231.38	2,097.51	2,078.76	2,029.12

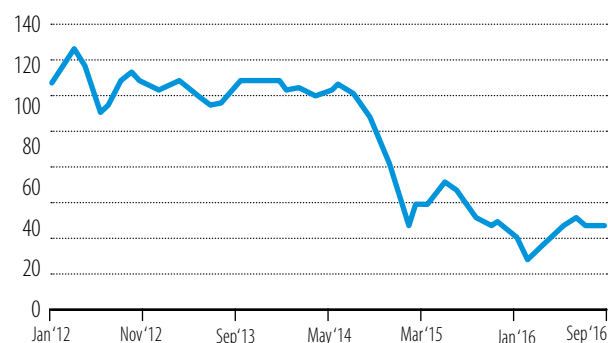
Source: ERC

producers on the realization the glut has had consequences especially on their budget financing. However, the situation in the oil market still remains fluid with no certainty on the next move given that the world oil prices assume a random walk. In addition, the Euro zone crisis following the Brexit continue to pose deflation challenges hence hampering growth and certainly demand for oil. As such even though the prices were on the rise, the increase remained minimal than expected to warrant any hope for recovery especially for the economies facing deflation pressures

A look at the monthly prices presents a more volatile state in the global oil market. However, the international prices have crossed the \$40 mark per barrel in the entire of quarter three. It remains optimistic that the upward trend in the international oil prices will be maintained by the OPEC members agreeing to cut down on the production in their meeting during the last quarter of 2016. However, the consensus towards agreeing to cut down production remains a wait and see scenario given the geopolitical crisis which still remains fluid. In addition, the Eurozone crisis coupled with the constrained demand in the

world demand for commodity are likely to continue contributing to the low oil prices in the world market.

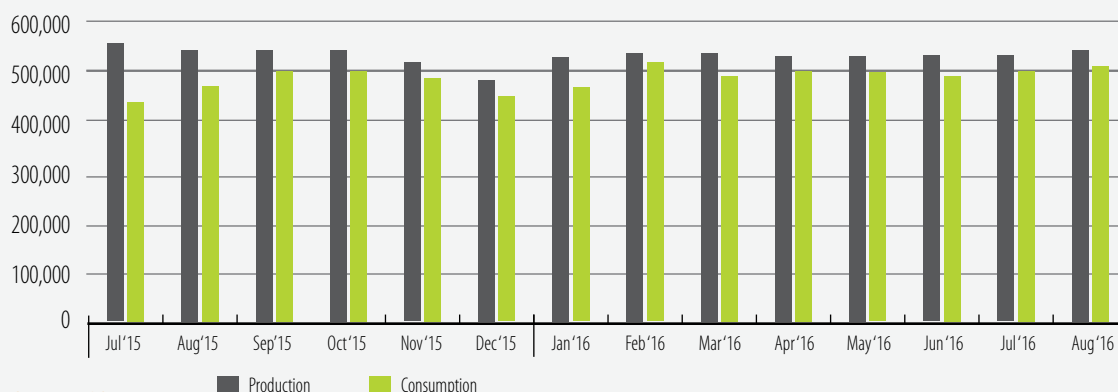
Figure 10: Mean Monthly Murban ADNOC Crude Oil Prices (USD/BBL)



Source: US. Energy Information Administration



Figure 11: Cement Production and Consumption (MTs)



Source: KNBS

Building and Construction

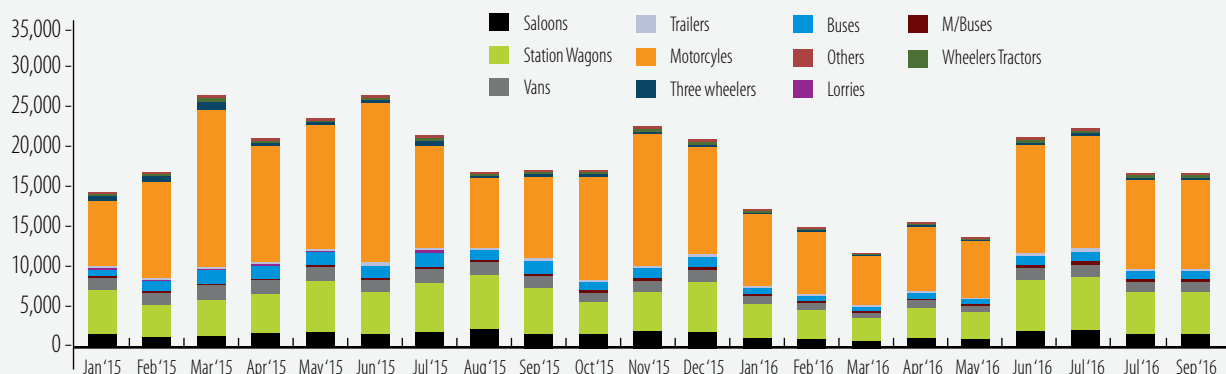
Building and construction sector continues to thrive well rising to be one of the core sector upon which the growth is anchored. The quantity of cement produced increased from 536,471 MT in June to 540,192 MT in July 2016 and further to 552,559 MT as at the end of August 2016. Similar trend was replicated for consumption with the July recording consumption level of 509,895 MT up from 474,300 MT in June. The month of August saw the consumption levels rise to 520,713 MT

Transport and Communication

The total number of registered vehicles as at quarter one significantly declined from 64,257 units in quarter four of 2015 to 37,741 units in quarter one of 2016. This substantial decline is attributed to the introduction of the new import charges on the imported second hand vehicles in December 2015. The month – on – month statistics reveal that the number of newly registered vehicles declined from 22,308 units in December 2015 to 14,690 units in January falling further to 12,771 units and 10,280 units in February and March respectively. Motor cycles continued to account for the big share of the total motor vehicles registered in the quarter.



FIGURE 12: Registration of New Vehicles Jan 2013 to Sept 2016



Source: KNBS



The dominance of mobile telephony in the communications industry has remained to be the case throughout. 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 of banking the unbanked population countrywide.

Tourism

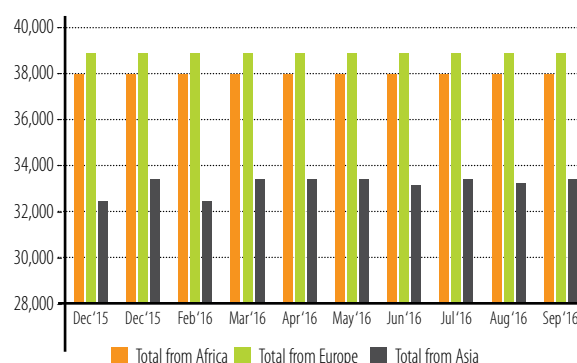
During quarter three, tourism continued to post good performance. Looking

at the number of visitors arrivals via the JKIA and Moi international airport, the JKIA arrivals significantly increased from a total of 175,056 visitors in quarter two of 2016 to 236,119 visitors in quarter three of 2016; a 34.88 percent rise.

For the arrival through the Moi International airport the quarterly total arrivals significantly improved from 11,629 visitors in the second quarter to 26,030 visitors as at the end of quarter three in 2016. In overall all the number of visitors reported in quarter three was 262,149 visitors compared to 186,685 visitors in quarter two. An insight into the quarter three reveals the July and August recorded the highest number of visitors via JKIA and MIA with August recording a significant drop. A review of the source of the visitors by origin during quarter three reveals that

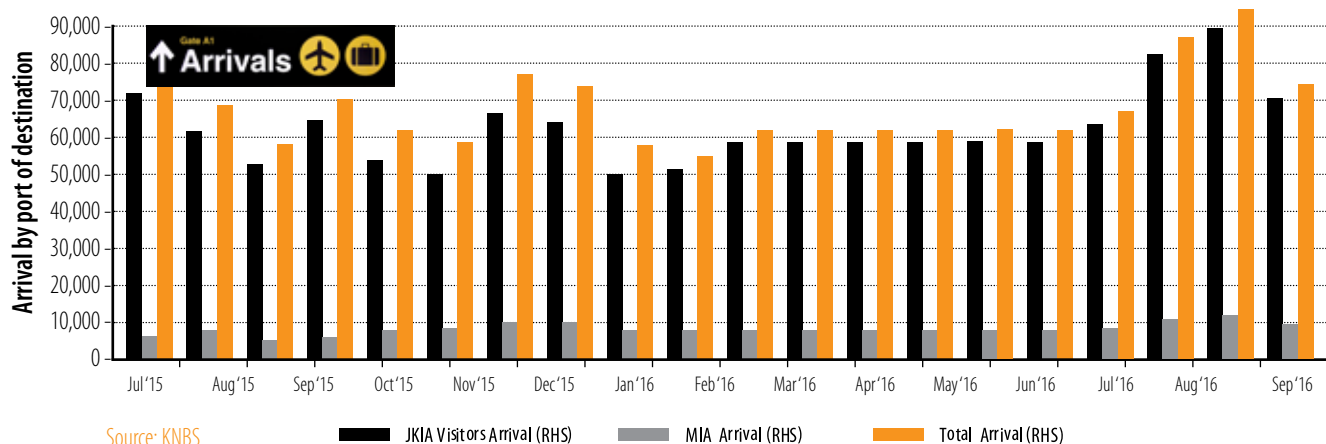
Looking at visitors' arrivals by their origin in quarter three of 2016, it's evident that Europe registered the highest number of arrivals via JKIA at 116,430 visitors followed closely by Africa at 113,806 visitors with Asia coming third at 99,776 visitors.

Figure 14: Origin of visitors for Dec 2015 – Sept 2016



Source: KNBS

Figure 13: Trends in Visitor Arrivals for Jul 2015 – Sept 2016



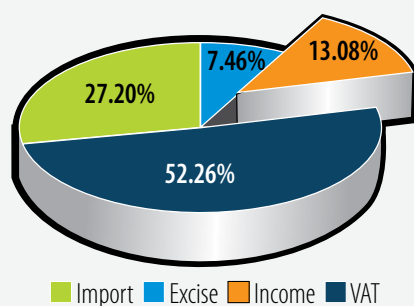
Source: KNBS



Financing of Government Expenditure

On the government revenues, the total revenue for quarter two of 2016 stood at Ksh 3,280,143 million. Of this, the total tax revenue accounted for 87.89 percent of the total quarterly revenue with the non – tax revenue accounting for 12.11 percent. For the tax revenue, income tax topped the list at 52.26 percent followed by value added tax at 27.20 percent with excise duty and import duty coming third and fourth at 13.08 percent and 7.46 percent respectively. From the previous analysis the government tax base seems to have remained constant with the contribution of each revenue stream changing marginally. This is an indication of the government's constraint in terms of widening the revenue base and coming up with new revenue sources despite of the government's expenditure continuing to rise with the onset of devolution government.

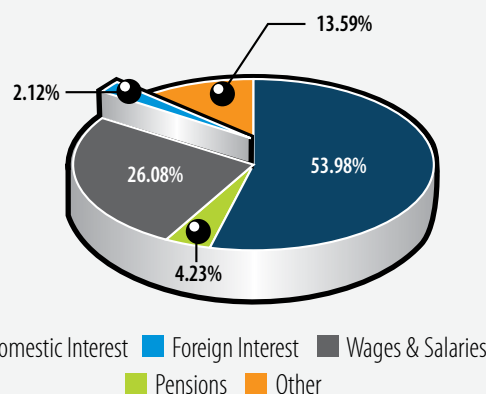
Figure 15: Tax revenue (Ksh Million)



The total government expenditure for quarter two of 2016 stood at Ksh 4,595,863 million. The total recurrent expenditure accounted for 74.35 percent with the development expenditure accounting for 25.65 percent of the total government expenditure in the quarter. On the recurrent

expenditure, domestic interest payment accounted for the largest proportion at 53.98 percent followed by wages and salaries at 26.08 percent.

Figure 16: Public Expenditure (Ksh Million)



Source: CBK

Public Debt

During the second quarter of 2016, the total quarterly public debt was Kshs.10.42 billion 9.741 billion compared to 9.741 billion in quarter one. An analysis on the breakdown of the public debt into domestic and external debt reveals that the government through the National Treasury tried to maintain an equal balance between the two debts to stand at 50.41 percent in favour of domestic as opposed to 49.59 percent in favour of external for the entire quarter.

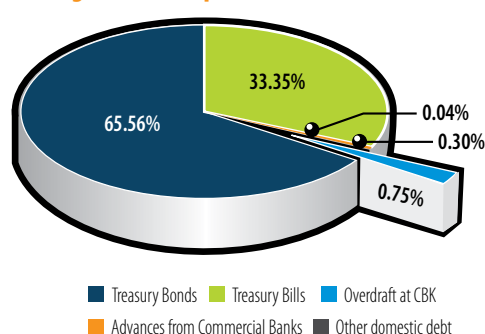


This reflects a tight trade – off and balancing act in the choice between the two types of borrowing hence limited flexibility of the National Treasury to prefer one at the expense of the other. Given the stability in the Kenya shilling in the quarter, more preference for external borrowing can be seen in quarter two of 2016 in addition to trying to avert crowding out – effects in the domestic market. As such a tight balancing between the two types of borrowing mean the balancing between crowding out effect and increased debt burden for foreign currency denominated debt.

On the financing of the government's public debt, open market operations take an upper hand with the preference on government treasury bonds including the government frozen debt remained being evidenced. In July – August 2016, the government's treasury bonds were the key money market

instruments intensively utilized by the government in domestic borrowing accounting for 65.56 percent with the Treasury bills, accounting for 33.35 percent. Overdrafts and advances accounted for 0.75 and 0.30 percent of total government debt respectively during July – August period.

Figure 17: Composition of Domestic Debt

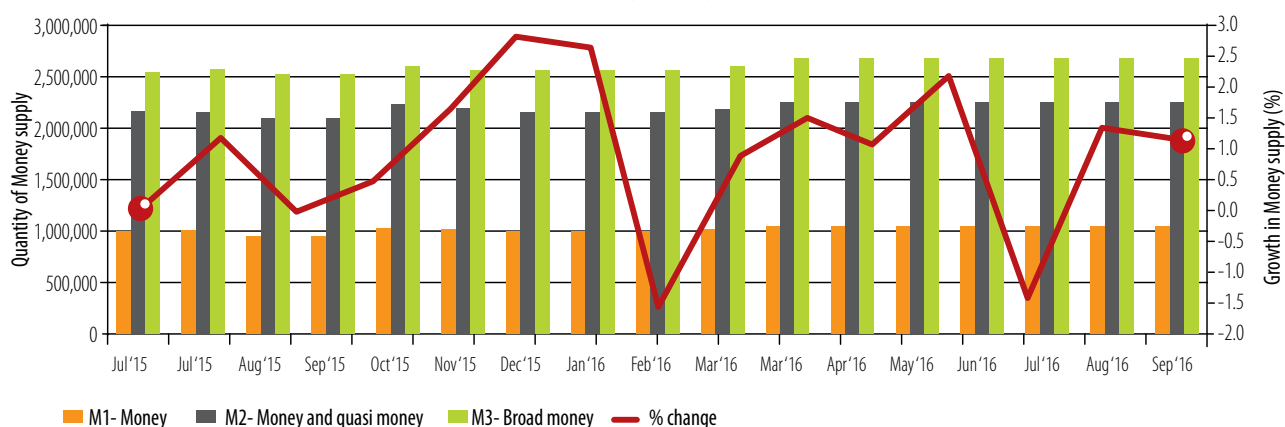


Source: CBK

Money and Credit

During the third quarter of 2016, the quarterly growth in money supply averaged at 0.1% compared to 1.13% in quarter two. This was a reflection of a fairly stable quarterly growth in the money supply thus ruling out any possibilities of demand pressures that would culminate into inflationary pressures. Its however noteworthy that a review into the quarter reveal that the growth in the money supply shrunk in July posting a negative growth of -1.46%. For the month of August and September growth in money supply was positive though below 1%.

Figure 18: Money Supply (KES Million)

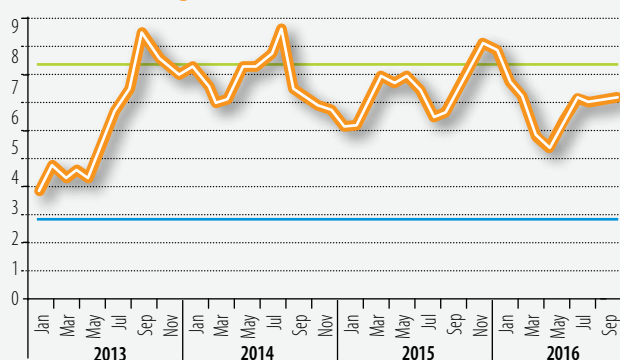


Source: KNBS and CBK

Inflation

Inflation rate during quarter three remained on the upper bound of government target averaging at 6.33 percent during the quarter. The month-on-month inflation for July was 6.47% falling to 6.36% August and later rising mildly to 6.34% in September. The rise in inflation rate within the quarter is attributable to a number of the reasons. One of the main reason underpinning the inflationary pressures experienced during the quarter has been the rise of food prices which ended up eroding all the gains from the low oil prices. This has culminated from the dry spell experienced in majority of the areas in the country during the third quarter. As such the gains by them previous monetary policy stance in quarter two of 2016 were eroded. The non-food-non-fuel inflation was also on the rise during the third quarter signalling some element of mild demand pressures in the economy. The effects of the raise of excise duty towards the end of 2015 could therefore be seen to having a continued effect in the economy three quarters later upon its implementation. As the end of October 2016, the NFNF inflation component was at 5.1% up from 5.0% in September mainly reflecting a rise in prices of some items such as clothing and footwear. The rise in inflation rates can also be confirmed by the year-to-year basis reveals that the annualized inflation rates which as at was 6.52% in September 2016 compared to 6.28% in September 2015

Figure 19: Inflation rate (%)



Source: CBK

The non – food – non – fuel inflation (NFNF) declined in quarter three from a quarterly average of 5.5 percent in quarter two to a quarterly average of 5.0 percent in quarter three of 2016. This decline in the NFNF inflation was largely due to reduction in the prices of food items and fuel. However, the month-on-month non-food-non-fuel (NFNF) inflation mildly rose to 5.0 percent in August from 4.90 percent in July and further rising to 5.1% in September. This is attributed to the rise in the prices of footwear and clothing component of the CPI as well as the introduction of the excises tax in December 2015.



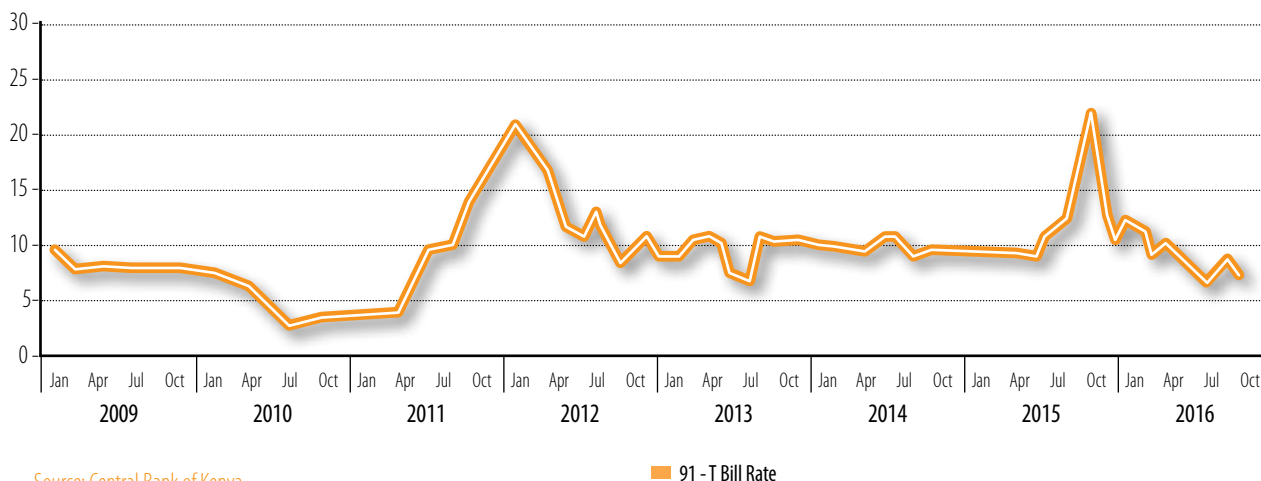
Therefore on the Month – on – month inflation analysis we can see some mild element of demand pressures building up within quarter three.

Interest Rates

Interest rates remained fairly stable during the first two month of third quarter of 2016 before the capping in September 2016. The 91 Treasury bill rates averaged at 7.57% in quarter three compared to an average rate of 8.11% in quarter two. The 91 Treasury bill rates have remained a single digit figure for a while since February 2016. This could be partly explained by two possible reasons. One is the likelihood of oversubscriptions in the short term government securities which in turn lead to the downward movement in the transaction rates. Secondly could be the government intention to keep the domestic borrowing rates low for two main things, first is to avoid the crowding out of the private sector through the price channel. The second reason for the government maintaining single digit rate on 91 treasury bills is the intention towards driving the overall lending rates in the economy low given that the 91 treasury bill rate enters into computation of KBRR prior to the introduction of interest rates capping law.

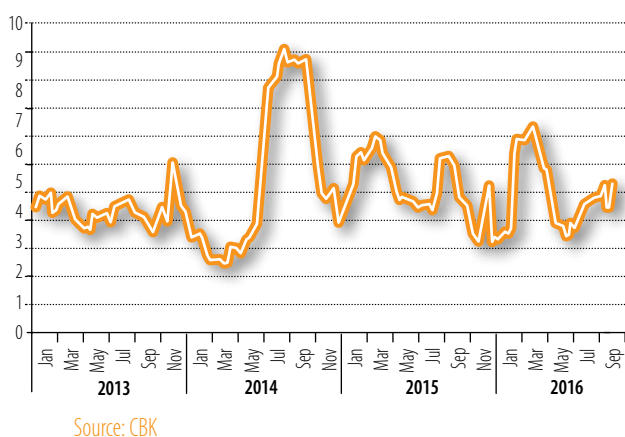
The interbank market remained suppressed for the entire of the quarter with both the volumes and the rates remaining low. However, looking at the daily rates, an upward surge can be evidenced in the beginning of the quarter in July and towards the end of September with the daily rate going beyond a 6% mark from a low of 3% mark. As such from the daily data, high levels of volatility can be evidenced in the interbank market thorough out quarter three of 2016. A unique scenario is evidenced in the interbank market

Figure 20: Monthly Average 91 – Day Treasury Bill rates



during quarter three. Upon the signing of the interest rate capping law on 24th August 2016, the interbank rates immediately shoots up for a while. However, the rates come down after a while when the two weeks given for the interpretation of the law nears to the end and afterwards the rate shoots up. This is an evidence of how news and events drive the performance in the overnight market.

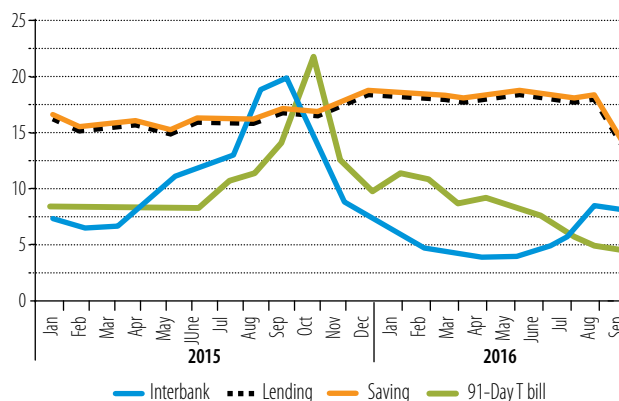
Figure 21: Daily Interbank market rates (%)



The key interest rates in the market reveal some element of commonality in some rates as depicted in figure 21. From the figure, there exists a one – on – one map between the average lending rates and the overdraft rates. On the other hand, the 91 Treasury bill rates seems to respond to the interbank rates but with a lag. This is because lending to the government via a purchase of government securities is an alternative to lending to other market players through the interbank market. A rise in the interbank market is a signal of tightening credit market. This therefore implies that is then government is to borrow in the domestic market using the short term instruments, then it must do so by offering a premium in order to attract lenders. This

premium would therefore come in form of high rates on the 91 – Treasury bill. This is perhaps the reason why the 91 – Treasury bill rate respond to a rise in the interbank rate with a lag and the response rate is higher compared to interbank rates.

Figure 22: Interest rates (%)



Balance of Payments

During quarter three, the volume of trade contracted from Ksh 180.0 billion in August 2016 to Ksh 170.6 billion in September 2016. The total value of exports fell to Ksh 46.20 billion while the value of imports decreased from Ksh 133.0 billion in August 2016 to Ksh 124.4 billion in September 2016. The fall in the imports came from the reduced propensity to import at the point where the exports volumes remained low given the loss of competitiveness of Kenya's exports in the external market. Domestic exports by Broad Economic Category (BEC) reveal that food and beverages was the main export category in August 2016 accounting for 41.4 per cent of exports, while the value of non-food industrial supplies and consumer goods not elsewhere

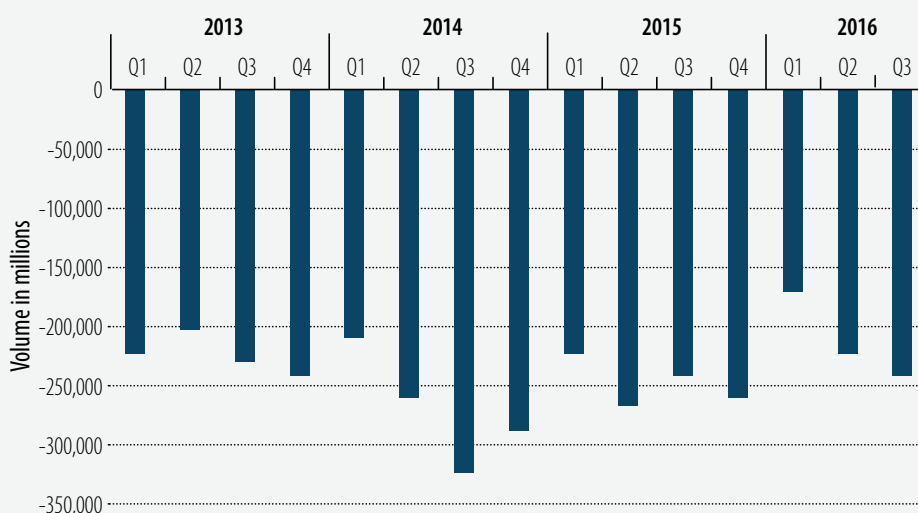


specified registered 25.5 and 26.9 per cent shares, respectively. BEC imports indicate that non-food industrial supplies was the main import category in August 2016 with a share of 36.0 per cent, while the values of machinery & other capital equipment, fuel and lubricants and transport registered shares of 21.7, 15.3 and 9.8 per cent, respectively. Food and beverage recorded a share of 8.1 per cent while consumer goods not elsewhere specified recorded a share of 9.0 per cent (KNBS, Report)

Despite the decline in the imports within the quarter, the overall monthly trade balance worsened from Ksh 223,773 million in quarter two to Ksh 233,470 in quarter three of 2016. This could be mainly attributed to the massive importation of

machinery and transport facilities in wake of continuing major physical infrastructural projects contributed to the worsening of the trade balance. Moreover the failure of the exports to fetch enough export earnings despite the depreciating shilling mainly due to the nature of the Kenya exports led to the trade balance deficit. Thus despite the decline in the import within the quarter, the trade balance remains high given that the decline is not matched with any increase in the exports earnings from the exportables. However on an annual comparison, the trade balance of the third quarter in 2016 is lower compared to the trade balance of same quarter in 2015 which stood at Ksh. 244,172 million.

Figure 23: Overall quarterly trade balance



Source: CBK



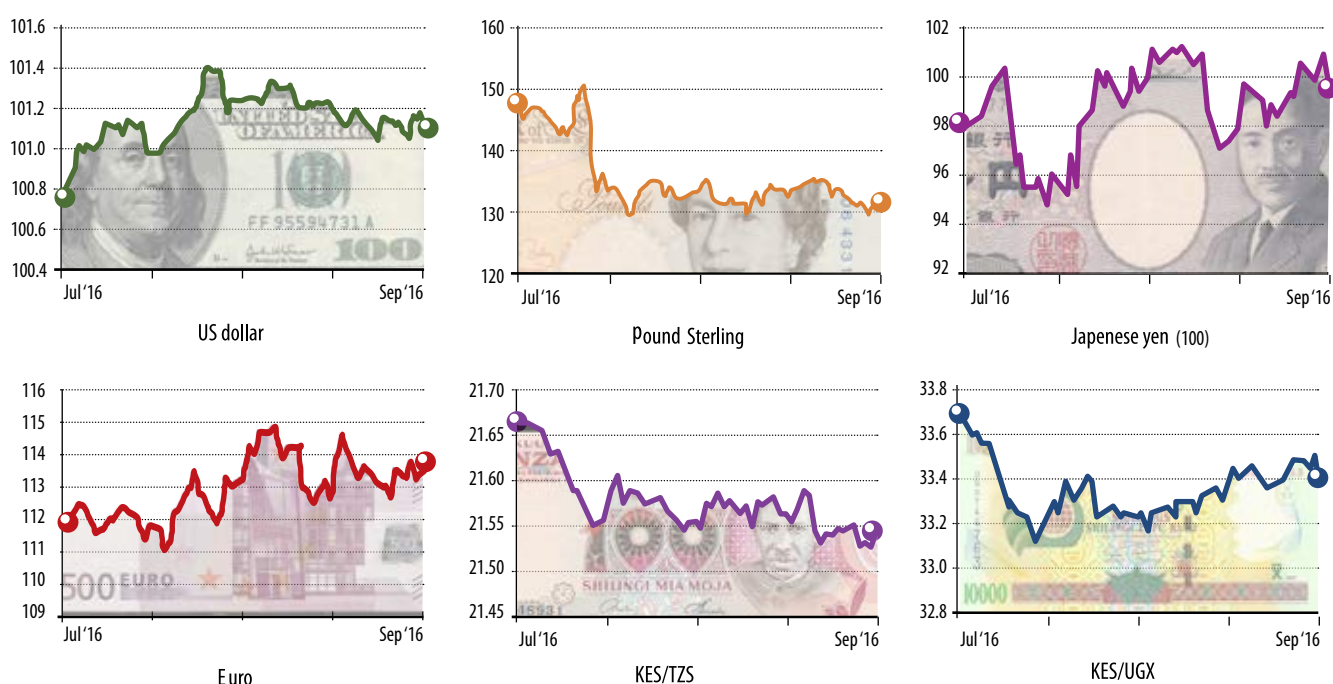
Exchange Rate

During the third quarter of 2016, the shilling portrayed resilience against other currencies both at the international and at the regional level. With regard to dollar, the shilling traded at a mean monthly rate of 101.33 in July but slightly weakening in August to trade at 101.41 mark and later improving to 101.27 in September. This stability could be attributed to the increase in the foreign reserves at the central bank of Kenya following precautionary loan facility from IMF amounting to \$1.5 million aided cushion against the short term shock in the value of shilling. However, much of this stability in the shilling against the dollar can be mainly seen to be arising from the

central bank's intervention in the forex market to cushion the shilling from weakening bias that would adversely infer into current account position.

Against the Sterling, the shilling appreciated considerably in the entire of quarter three. This is evidenced by the successive appreciation in the shilling against the pound from a mean monthly rate of 1464.32 mark in June 2016 to 133.15 as at September 2016. This could be attributed to the reduced competitive of the British economy which is still unfolding within the entire Europe market mainly within the Euro zone following Brexit from the Euro zone. For the East African scene the shilling was more stable as evidenced in its performance against the Ugandan shilling and Tanzanian shilling.

Figure 24: Nominal Exchange Rate





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Nairobi Securities Exchange

A bear run is now a reality in the Nairobi Securities Exchange as reflected in the third quarter of 2016. During the second quarter of 2016 the stock market continued to post poor performance as evidenced in the successive months indices during the quarter. Performance based on the NSE -20 Share index reveals a rebound in the market in April 2016 recording a high of 4009 points from 3982 points as at the end of March 2016. However, May and June saw the market performance dip significantly down to 3868 points and 3641 points in May and June respectively. On the other hand, performance based on all share index reveal that the index was fairly stable being 147 points in May and dipping afterwards to 146 points and 141 points in May and June 2016. Poor performance on monthly basis recorded in the previous quarters in 2016 was sustained for quarter three.

The dismal performance in the capital market in quarter two of 2016 is attributed to bearish behaviour in the market, driven majorly by the foreign investors given their increased market participation mainly as net

sellers rather than net buyers in the wake of reduced dividends following the profit warnings by a number of firms. This is evidenced by the dipping in the market performance in June where the participation of the foreign investors significantly fell from 67 percent to 56 percent. The overall market capitalization remained fairly stable in April and May before declining in June to a low of Ksh. 1,998 billion. A review of the market performance indicators for quarter two evidence that total shares traded, the number of equity transactions and equity turnover portray similar trends with all registering a sharp decline in May from April's performance but significantly improving in June towards the end of the quarter.

On the fixed income segment, mixed performance is evidenced with the bond market registering significant decline in the trading volumes from Ksh 67 billion turnover in March to a low of Ksh. 38 billion in April 2016. However, May and June bond turnover remained stagnant at Ksh. 55 billion.

Table 2: Nairobi Securities Exchange Market Indicators

Date	Jan-16	Feb-16	Mar-16	Apr-16	May-16	Jun-16
NSE 20 Share Index 100 = 1966	3773	3871	3982	4009	3868	3641
NSE All Share Index (NASI)	136	141	147	147	146	141
Market Capitalization (KES. Bn)	1926	1988	2078	2079	2051	1998
Total Shares Traded (Million)	422	341	536	426	384	601
No. of Equity Transactions	26857	25727	30789	25012	24212	26442
Equity Turnover (ET) KES. (Mill)	12999	10161	13449	10066	9741	17247
Bonds Turnover (KES. Bn)	21	24	67	38	55	55
Percent of Foreign Participation to ET	61	43	65	66	67	56

Source: NSE, Monthly Trading Report



Banking Industry Performance

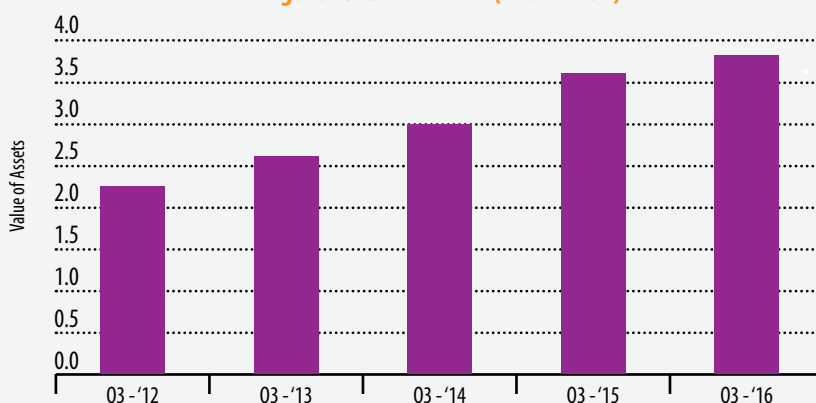
Assets and Loans

The industry's assets base registered a mild positive growth in quarter three with the total assets for the industry increasing marginally from Ksh 3.65 trillion as at the end of quarter two to Ksh 3.78 trillion as at the end of quarter three. This minimal growth in the industry can perhaps be attributed to the difficult situation the industry has gone through since last year upon placement of three commercial banks under receivership. This growth in the total industry's total assets base accounted for 2.99% compared to the total assets for second quarter in 2016. Looking at the annual increase in the asset base, the total assets grew by 3.56% compared to quarter three of 2015.

Similarly, the total loans by commercial banks during quarter three registered a dismal growth of 0.44% as compared to quarter two of 2016. However, an annual comparison in total loans advanced reveals that loans advanced recorded a negative growth of -1.72% in quarter three of 2016 as compared to quarter three of 2015 (figure 24). As a fact, the ratio of gross non-performing loans to gross loans rose to 9.1% in quarter two compared to 7.8% in quarter two thus adversely affecting the quality of assets.

The reduction in the total lending is attributable to a number of factors. First, is the rise in the non – performing loans within the industry following the challenges in the business environment that has effected business performance adversely hence influencing their ability to repay loans. Secondly,

Figure 25: Bank Assets (KES Trillion)



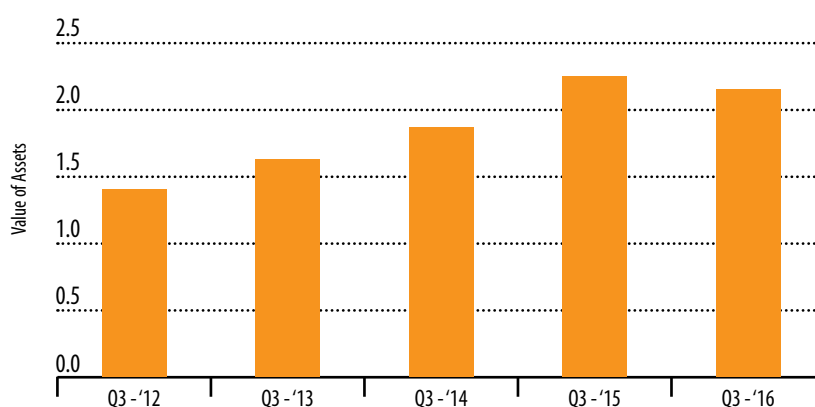
Source: CBK

the dip in the total loans advanced in quarter through can be deemed to arise from the capping of interest rates at 4% following the signing of the interest rates capping bill during the quarter. As such commercial banks have scaled down lending in response to the new operating environment. Interest rate capping and accompanying effect on the cost of funds and balance sheet constraints have forced the banks to tighten their credit standards hence the dip in the total loans by banks. The tightening of the credit standard by commercial banks in the wake of interest rates capping would imply locking out of vast of borrowers out of the credit market thus impacting adversely on the credit access. The decline in the loans advances remains to be experienced in the future given the uncertainty surrounding the direction upon which the

central bank rate takes whenever the Central Bank Monetary Policy Committee meets. Much as the capping of interest rates was meant to promote access to loans by the public, it now appears that the law has begun posting counter – productive results with credit to private sector shrinking substantially for the short period the law has been in existence.

Then credit recovery efforts have also been beefed up to cut down on the possibilities of rising bad debts. The new regulation on the interest rates has also seen banks re – align their lending based on sectoral view with the credit shifting from some sectors to other sectors that banks perceive to be less risky.

Figure 26: Banking Total Loans (Ksh. Trillion)



Source: CBK





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