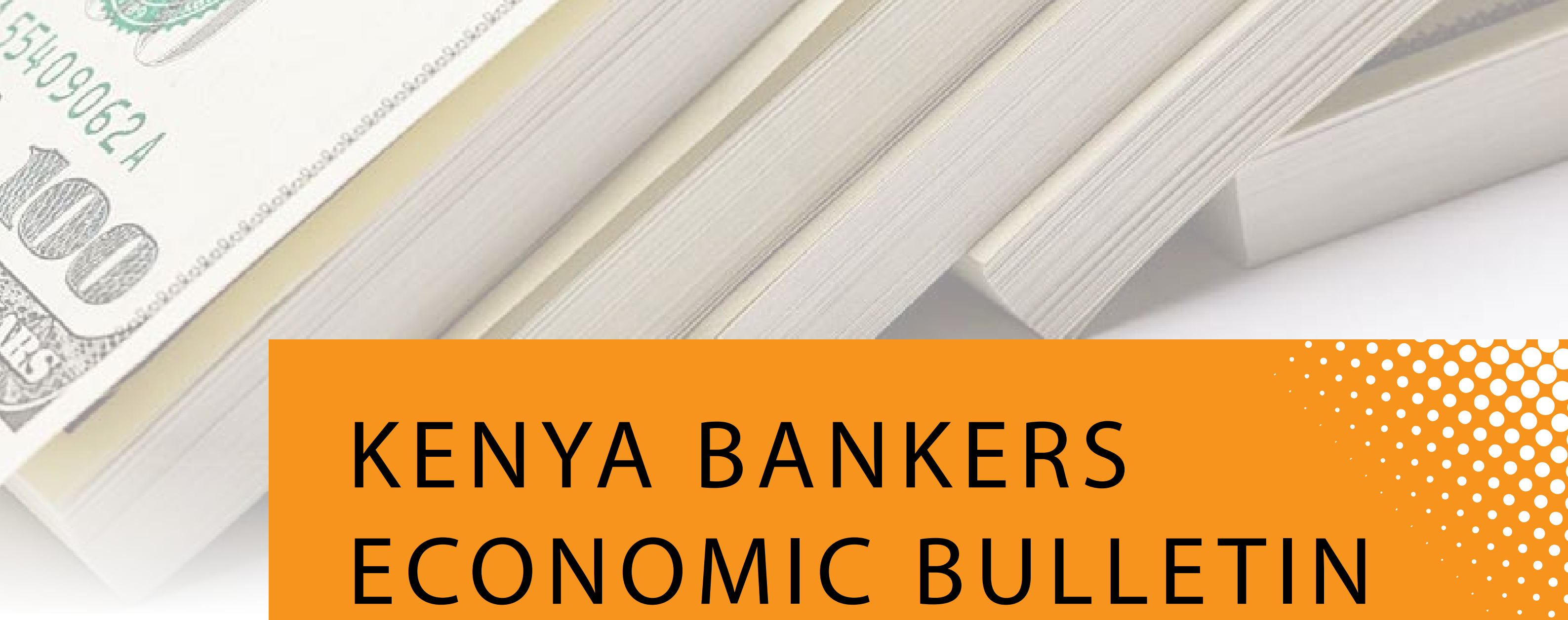

KENYA BANKERS ECONOMIC BULLETIN

QUARTER ONE OF 2017

VOLUME 19

A report prepared by:

The Centre for Research on Financial Markets and Policy®

KENYA BANKERS ASSOCIATION

CENTRE FOR RESEARCH ON

FINANCIAL MARKETS AND POLICY®

About this Report

This *Bulletin* reviews the performance of the Kenyan economy for the 1st Quarter of 2017, drawing on the performance of recent past months as well as current developments to provide perspectives on the outlook for 2017. The *Bulletin* covers trends in the real economy, government fiscal operations, public debt, inflation and interest rates, balance of payments and exchange rate, as well as activity at the Nairobi Securities Exchange and banking sector performance.

About the Centre for Research on Financial Markets and Policy

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

CENTRE FOR RESEARCH ON
FINANCIAL MARKETS AND POLICY

KENYA BANKERS ECONOMIC BULLETIN

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In this Issue

FOREWORD

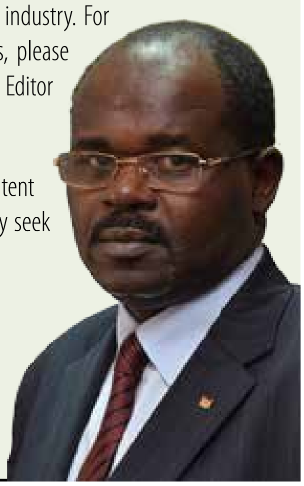
From the CEO's Desk

It is my pleasure to present to you the 19th volume of the *Kenya Bankers Economic Bulletin.* In this issue, we discuss the state of the Kenyan economy first Quarter of 2017. 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. On the international front, all eyes are trained on now how policy uncertainty is likely to affect the global economic prospects. This is on the back of the US's Federal Reserve Board resuming the conventional monetary policy after a long spell of Quantitative Easing and the rhetoric of inward orientation post Brexit and under the new US administration. As a consequence, there are signs fragility in the performance of the global economy even though there are signs of optimism.

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

The Misdemeanour or the Disguise: Which is Worse?

By Jared Osoro

Introduction

The latest issue of *Applied Economic Letters*, an academic journal, has an interesting essay about emerging economies. The essay, titled *"Economic growth in emerging economies: what, who, and why"*[1] tells us things that we often take for granted that we know but which we probably don't.

Let's start with the minor one: the 'emerging' nomenclature. We all often talk about emerging markets, which are those economies whose financial aspects that are deemed to attract interest of international investors. This is the understanding that global financial players have.

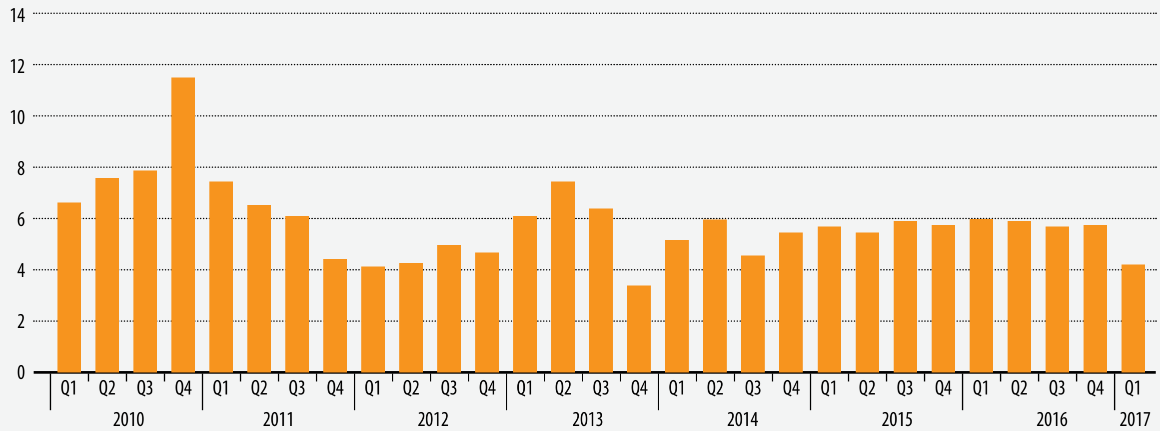
The same understanding lacks when it comes to the reference to emerging economies. Some assume that the characterisation of economies as 'emerging' is based on some high rate of economic growth. But is surely needs to be more than growth. It has to include additional parameters – demography, physical accumulation, human capital, trade, macroeconomic policy, exogenous circumstances, and institutional quality, all to the extent that they influence GDP per capita (not merely GDP) growth rate.

1 Saccone, Donatella, (2017), *"Economic growth in emerging economies: what, who, why",* Applied Economic Letters, July 2017, Vol. 24, No. 11, 800 - 803

From the essay, I learn three things. First, an economy can have a so-called "rebound effect" where sometimes high rate of growth could be following a spell of recession. Second, poorer countries tend to growth fast. Three, any claim to "emerging economy" status based on macroeconomic policy and trade only sits on the necessary thresholds that can only be sufficient if demography, physical capital accumulation and human capital are part of the equation.

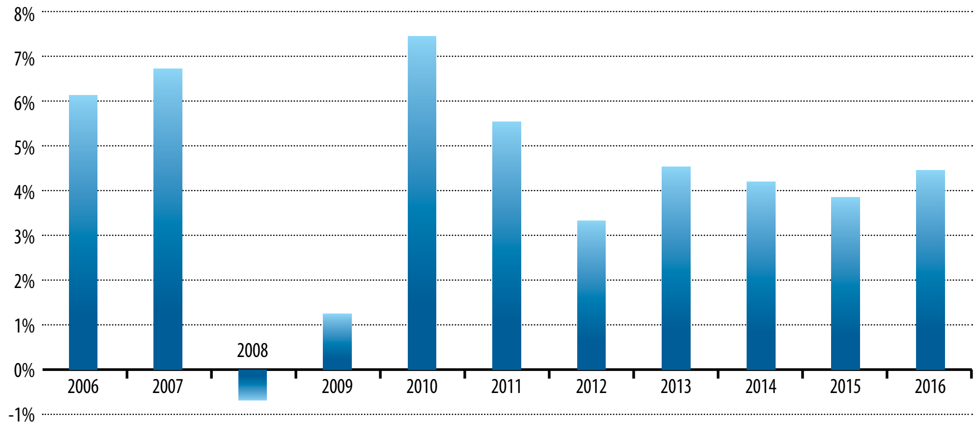
With Kenya's categorisation as a middle-income economy, albeit on the lower rang, one could assume that the "emerging" status is automatic. But there're lies the disguise: the prestige that comes with middle-income economy status is based on the rate of output growth, both real and nominal (see **Figure 1** for the recent evolution of the real economy status).

Figure 1: Real GDP Growth (%)



Source: KNBS

Figure 2: Per Capita GDP (on a PPP Basis)



Source: IMF World Economic Outlook Database

The growth evolution has been variedly described as strong, robust, resilient, and even buoyant depending on the year and the mode of the describer. The only characterisation that is not controversial is the inconsistency of the trend. On the back is the inconsistency, the rate of growth of per capita output – a better, not necessarily perfect, variable to gauge progress – is far from rosy; it equally shares the inconsistency moniker (**Figure 2**).

Eyes on the Macros

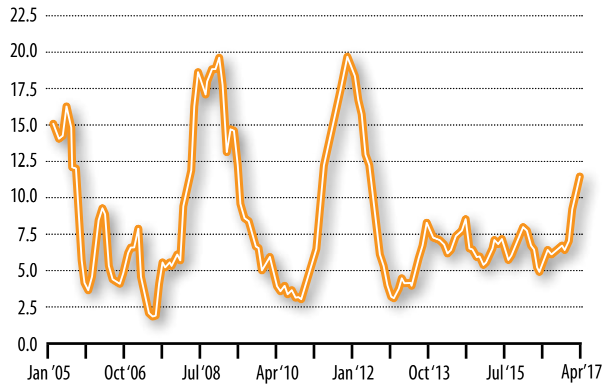
As we get deep into 2017, one thing is clear: the macroeconomic stability, at the very as measured by inflation is on focus. There is no denying that that inflation in Kenya is now well above the official target (**Figure 3**). The Central Bank of Kenya (CBK), whose mandate is to assure that stability forecasts that "overall inflation is expected to remain above the Government target range in the near term due to elevated prices of some food items".

But the CBK is emphatic that" the prevailing monetary policy stance has reduced the threat of demand driven inflation". In other words the CBK is telling us, and rightly so, that when it comes to inflation, we have a supply problem and not a demand problem.

I can argue though that the problem is bigger than that. I contend that there is the paradox of scarcity amidst growth that is not being confronted. If the economy's output growth is on an acceptable trajectory, why do we have food shortages that have necessitated fiscal interventions?

The answer is easily seen from the fact that the growth is largely underpinned by "the ongoing public infrastructure development". This is hardly surprising given the earlier observation about growth drivers in emerging markets. If this "will continue to spur growth", then we must accept to live with the assumption that the multiplier effect of such investments will spur production with a time lag, for infrastructure is not an output but an input into production.

Figure 3: Inflation (%)



Source: KNBS

The inflation story as depicted by **Figure 3** is by no means an uncharted territory. **Figures 1** and **2** tell an interesting story. In the recent past (January 2008 – August 2009), March 2011 – July 2012) we have had inflation spiralling out of target, only to revert back after some painful policy decisions. During these past inflationary incidences, economic growth has been mixed; not being strong (the post 2007/2008 politically inflicted economic damage), and being relatively better (2011/12) output performance that represented a rallying amidst global challenges post the global financial crisis.

Just as has been the assertion in advanced economies that inflation has been conquered (and the bigger threat has been deflation), we can say that the period August 2012 to January 2017 was characterised by the inflation target being met and the CBK seeking to entrench its inflation expectations' anchoring credentials.

If in the current circumstances we have projected growth amidst production and inflationary challenges, is this an in invitation to revisit the old inflation-economic growth nexus debate? Not necessarily because, when one takes a longer term perspective, high inflation is associated with low growth and the end of such a high inflation is associated with high growth[2].

It is tempting to re-open the debate on what is the appropriate level of the inflation target. There are those who have attempted to have the a discussion that seem to make the case for "moderate" inflation and how that relates to growth, conforming the challenge of determining what could be universally defined as "moderate" and ending up concluding that such pursuit could be misguided[3].

Even if we were to entertain a conceptually appealing argument that target differentials are necessary deepening on the level of development of an economy – and in effect the extent of monetary policy sophistication – any levels of inflation thresholds in the double digit levels are detrimental for growth; some studies have estimated such threshold to be 1 percent to 3 percent for developed economies and 7 percent to 12 percent for developing economies, above which inflation is detrimental for growth[4].

It is as much delusional therefore to imagine that as an economy we can tolerate double digit inflation as it is to imagine that time will sort things out; "for in the long run we are all dead", meaning that the policy dilemma and paradox already outlined need not only be acknowledged but confronted.

Throwing in the External Sector to give it a Balance

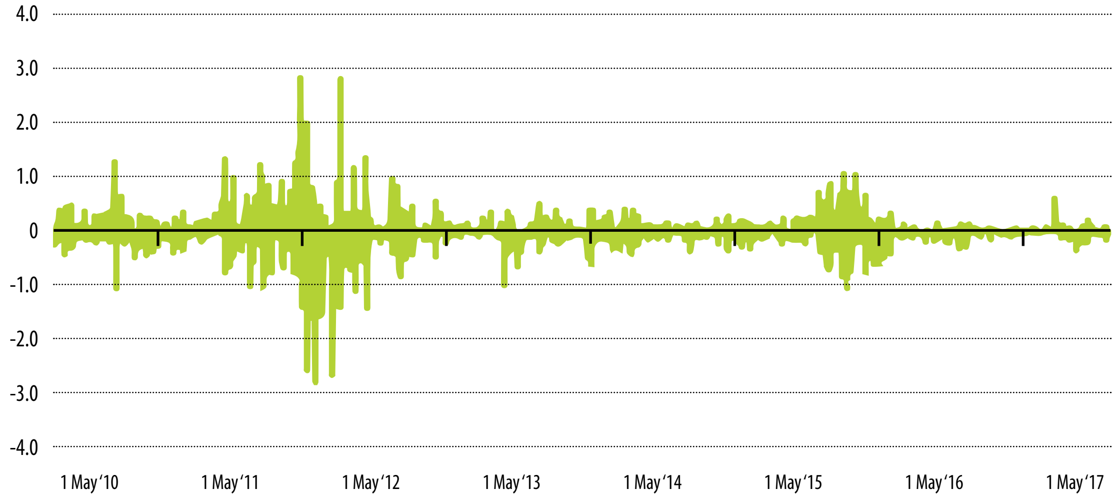
In order to have a balanced view regarding the overall stability we must take a look at the external front. The foreign exchange market has remained stable (**Figure 4**); it points put to both the adequacy of foreign reserves and the narrowing of the current account deficit. Even as this is the case, we need to acknowledge the external risks associated with policy uncertainties underpinned by global geopolitics. We would add

2 See for instance Bruno, M. and Easterly, W. (1998), "*Inflation crises and long-run growth*", Journal of Monetary Economics Vol 41, pp. 3 - 26; [https://williameasterly.files.wordpress.com/2010/08/18_easterly_bruno_inflationcrisesandlongrungrowth_prp.pdf]

3 Such thoughts are debunked by, for instance, Marty A.L. and Thornton, D. L. (1995), *"Is There a Case for "Moderate" Inflation?"*, Review, Federal Reserve Bank of St. Louis, July/ August.

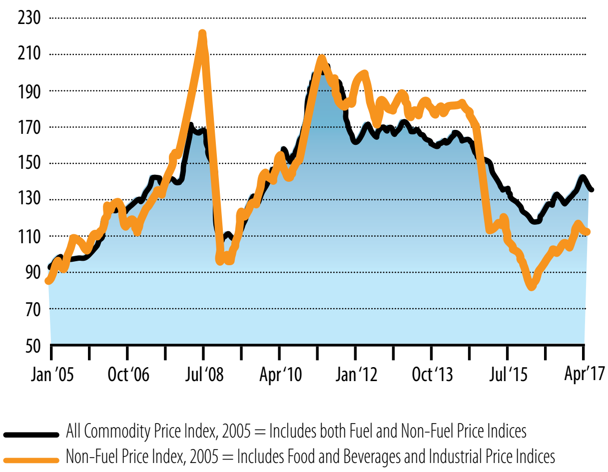
4 See Khan M. S. and Senhadjil. A. S. (2000), "Threshold Effects in the Relationship between Inflation and Growth", IMF Working Paper WP/00/110, June. [https://www.imf.org/external/pubs/ft/wp/2000/wp00110.pdf]

Figure 4: Nominal Exchange Rate (KES/US$) Movement



to this the fact that the recovery of the commodity prices will take a while before hitting the 2011 – 2014 levels (**Figure 5**).

Figure 5: Commodity Price Indices



Source: IMF

Just as the external balance and the attendant risks are of immediate policy concern, the domestic balance is as critical as it is the other side of the same coin[5]. The predictability of the government borrowing programme and the stability of the yield curve are necessarily but far from sufficient in assuring the external-domestic balance.

The distortionary effect of the interest rate capping on the yield curve – as the lower end of the curve is not in the negative real yield territory and the upper end of capped negates the advantages that come with the yield curve stability; stability is not synonymous to being static, for the latter is what the interest rate capping prescribes.

And credit to the private sector is not flowing optimally. Not even with the experiment of an accommodative policy stance in September 2016 didn't achieve the stated purpose of spurring credit to the private sector, coming after the capping of interest rates and at a time when growth of such credit had been on a steady down trend.

From close to 20 percent in January 2016, the growth of private sector credit has now "stabilized" at below 4.0 percent. The consequences on economic growth are obvious than many are willing to admit. According to a recent study , financial variables such as credit growth, stock prices and house prices have considerable predictive power for macroeconomic variables such as GDP. So credit trends are of no comfort even with a past attempted with a monetary policy support.

All said…

If the first quarter of 2017real GDP performance is guide, then the year ahead is far from rosy from an economic standpoint. The emerging economies as well as the middle income tags may well be mere emblems. The reality of how the economy is doing may be an outcome of either a misdemeanour or a disguise. Which is which is debatable; which is worse is equally debatable.

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

5 This argument is well developed in Stanley Fischer, S and Easterly, W. (1990), "The Economics of the Government Budget Constraint", The World Bank Research Observer vol. 5. No. 2, July pp. 127 – 142. [http://www1.worldbank.org/publicsector/pe/pfma06/easterly.pdf]

State of the Economy

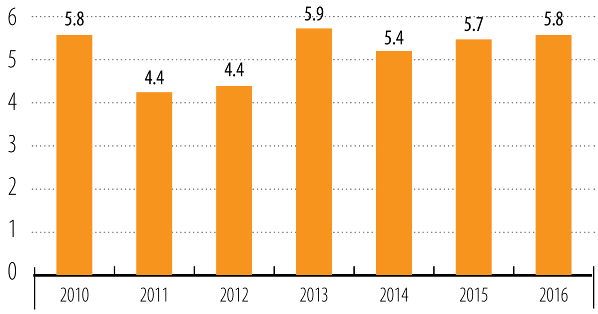
During 2016, the economy grew by 5.8 percent compared to a 5.7 percent growth in 2015. The economy posted good performance in the first three quarters of the year. However, the last quarter of 2016 saw the economy plug into a downward trend with the fundamental macroeconomic variables that underpinned growth being weak. The poor performance in the short rains in October – December 2016 shocked the food supply negatively leading to a rise in the food prices. This in turn resulted into an upward trajectory in the food inflation component of the overall inflation within the quarter. In addition the poor rains also fed into energy production with thermal production being resulted into as an alternative to bridge the gap in production. This could only imply the rise in the fuel component following the adjustment in oil levy component of the fuel inflation. The enactment of the banking Act in August 2016 capping the rates at 4 percent above the CBR also saw the decline in credit by four – fold with quarter four of 2016.

With this exposure of the general performance of the economy in 2016, and in particular the weakening of the macroeconomic fundamentals that support growth in quarter four of 2016, its evident that then economy entered the first quarter of 2017 on a weak note. The spillover effect of the weak macroeconomic environment in quarter four of 2016, were felt in the economy in the entire of the first quarter of 2017. More specifically, the cost of living as measured by the consumer price index was on an upward trajectory in the entire of quarter one. Similarly is the month – on – month inflation. Month – on – month inflation rates remained on an upward bound of the Central Bank of Kenya's target of 5 percent ± 2.50 basis point rising from a single digit of 6.99 percent in January to a double digit of 10.28 percent as at March 2017.

On the credit front, credit expansion was suppressed at best following the enactment of the Backing Act that capped interest rates. In overall lending to all sectors of the economy remained low within the sector. The forex market was no better in that despite the broad stability evidenced in the quarter, the weakening bias on the shilling against the major world currencies was sustained with the daily exchange rates against the dollar being above the 102 mark throughout the quarter. However, against the pound, the shilling posted resilience with significant appreciations in the shilling being evidenced. It is however notable that such appreciations could be largely attributed to the uncertainties facing Britain with regard to Brexit. The contemplations on the possible outcomes of the deliberations on Brexit for Britain posed uncertainties in the British economy and consequently feeding into the value of the pound against other currencies.

Further, we argue that the narrowing of the current account deficit in quarter three of 2016 does not imply that we are exporting more. The mere fact is that there has been slowed imports overtime. This further poses a risk in that slowed importation of capital equipment imply reduced productive capacity of the economy in the future which may end up reversing the gains noted in the current account position. In addition, with the weakening of the shilling the stated gains in current account deficit may not be sustainable in the long run hence this gains cannot be boasted of as achievement. With the world crude oil prices assuming an upwards trend, and on the backdrop of weakening shilling, the obvious expectation is a rise I the oil import bill which will slowly offset the gains realized in the current account deficit. Further, with the poor performance in the short rains in the last quarter of 2016, the pursuit of the importing food as the alternating to solve the looming food shortage could only mean widening current account deficit given that the countries agricultural exports have also been adversely affected by poor rains. As a matter of fact, the current account deficit rose from $ 3,709.2 million in September to $ 3,861.4 million in October 2016.

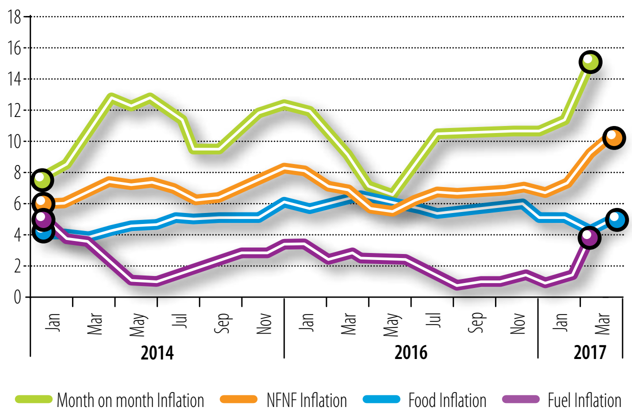
Figure 6: Quarterly Growth in GDP – 2009 Base Year



Source: KNBS

The month – on – month food inflation perfectly track the month – on – month overall inflation. As such the food inflation component largely determines the overall monthly inflation rates implying that any shock in the food production directly feeds into movements in the overall inflation rates. A sharp spike in the food inflation is evidenced in quarter one of 2017 largely contributed to the rise in the month – on – month inflation to double digit figure by the end of quarter one. The core inflation (non – food – non – fuel inflation), also mimicked the month – on month inflation in quarter one of 2017 especially from the second month of the quarter. This signifies an element of demand driven inflation in the economy mainly arising high demand for necessities mainly food on the backdrop of constrained supply following the poor performance in the long rains during the quarter. A sharp spike is evidenced in the NFNF inflation component in February 2017 which is sustained in the month of March as well. However we note that the NFNF inflation rise within the quarter is not as significant as the spike in the fuel inflation and the food inflation. Thus, comparing the three components of inflation in quarter one of 2017, the demand driven inflation as measured by the NFNF inflation appears muted relative to the food and fuel inflation components.

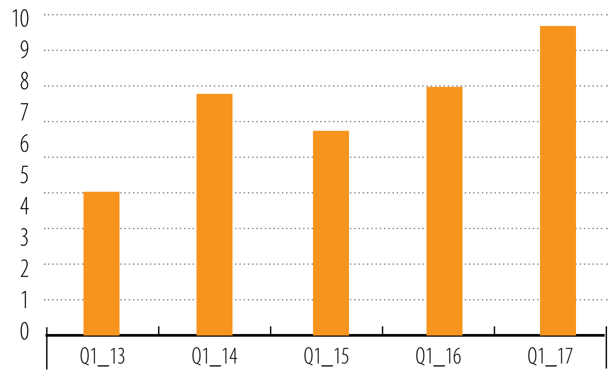
Figure 7: Monthly Inflation Rates



Source: KNBS

It is clear that as at quarter one, the Central Bank of Kenya was off the official inflation target if gauged by the trend of the month – on – month inflation within the consecutive months within the quarter. The question therefore is "is the inflation targeting monetary policy plausible anymore?" We argue that is as much that the central bank may be off the official inflation target range, the monetary policy is at test. In this case, it can be seen that the monetary policy space does not exist any longer and if it does, its flexibility in anchoring inflation is questionable in the era of interest rates caps. With the interest rates capping, adopting an accommodative monetary policy in the high inflation rates environment is uncalled for. On the other hand, adopting a contractionary monetary policy would be in contradiction with the government agenda of lowering the interest rates to a single digit. Therefore, with these two opposite scenarios, the space of the monetary policy in anchoring inflation in the era of interest rates caps papers to be completely wiped out. The argument for the high inflation rates have been attributed to high food prices following the prolonged dry spell. However, it is the mandate of the CBK to ensure price stability within the economy irrespective of the scenario existing at the moment. This calls for the application of the appropriate monetary policy tool to manage the prices. Therefore with or without the dry spell, it is within the mandate of CBK to ensure stability in general prices in the economy. But is appears that the operational space for implementation of such policies is limited mainly by the interest rates caps whereby the application of any monetary policy is no better but may complicate the situate further. As a result, the average quarterly inflation was at 8.77 percent in quarter one of 2017; - 1.27 percent above the upper bound of 7.50 percent target

Figure 8: Average Quarterly Inflation Rates



Source: CBK

Sectoral performance

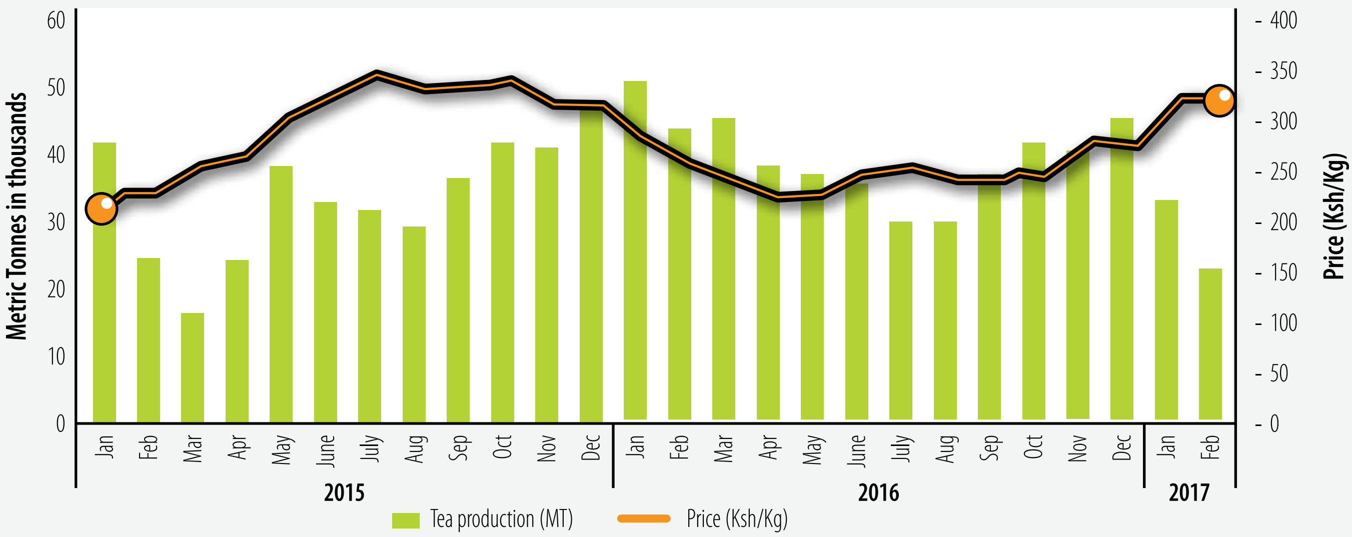
Agriculture

Agriculture remained to be one of the key sector driving economic growth in the quarter one of 2017 as evidenced in the previous quarters and years overtime. However, the performance of the sector was poor given the dry spell witnessed between January and March 2017 after the poor performance of the short rains for October – December 2016. The poor performance in the sector culminated into draught evidenced by very low crop production. The main cash crops for the economy were no spared either as the production of tea, coffee and horticultural crops drastically dwindled.

From the production point of view of the major cash crop, tea production significantly declined from 126,347 MT in quarter four of 2016 to 90,094 MT in quarter one of 2017. However, on the contrary the auction prices significantly improved following the shortage in supply relative to high demand. Monthly review of production within the quarter level the largest drop having been experienced in February hitting of 22,605 MT low the lowest monthly production since March 2017. However, following the onset of long rains in March production improved significantly. On the price front it notable that despite the improved prices on the backdrop of reduced production relative to high demand, this could not be leveraged on in the long run given the high price elasticity of supply. This can be evidenced in the last month of the quarter where the price start to decline as the production begins to improve.

WP content

Figure 9: Tea production in Metric Tonnes and Prices per Kilograms

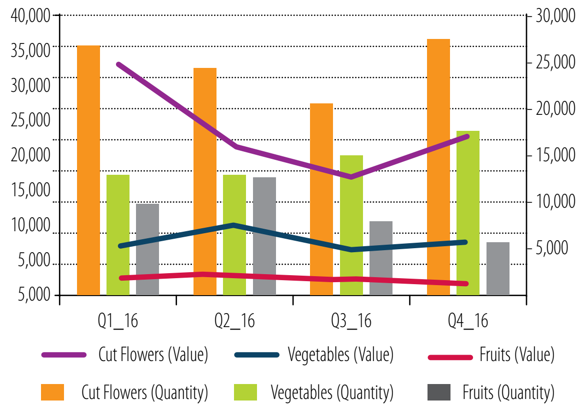


Source: KNBS

Milk deliveries to formal processors declined significantly to 125.2 million litres in quarter one of 2017 from 163.7 million litres in quarter four of 2016. The decline production in deliveries could be majorly accounted for by poor performance of short rains between October and December leading to prolonged drought that saw a decline in animal feeds production. Examination of the monthly data within the quarter, the actual milk deliveries for formal processors registered the largest dip in February when the dry spell had hardly hit the economy declining to a low of 39.8 million litres the lowest since April 2015. Some recoveries in terms of a rise in the formal deliveries seems to set in in March following the onset of the long rains

On the country's leading exports, agriculture cash crop continue to command a good share of the total economy's main export, with tea topping in foreign exchange earning followed by coffee. However, despite this leading the overall production was hurt by the dry spells experienced in the quarter which consequently implied low exports in terms of the volumes. Further, despite the decreased production and exports relative to demand, tea failed to attract a significant rise in the prices in February and March. Within the quarter, a total of 113.994 metric tonnes of tea were exported earning a total of Ksh. 6,878 million. On the contrary, the amount of coffee exported improved within the quarter rising to a quarterly total of 12,529 metric tonnes equivalent of total Ksh. 35,645 earnings. It is therefore evident that the price of coffee in the world market is higher compared to the price of tea given that even with low volumes of coffee exported compared to the volume of tea exported, earnings from coffee are way much high being approximately 5 times the quarterly earnings from tea.

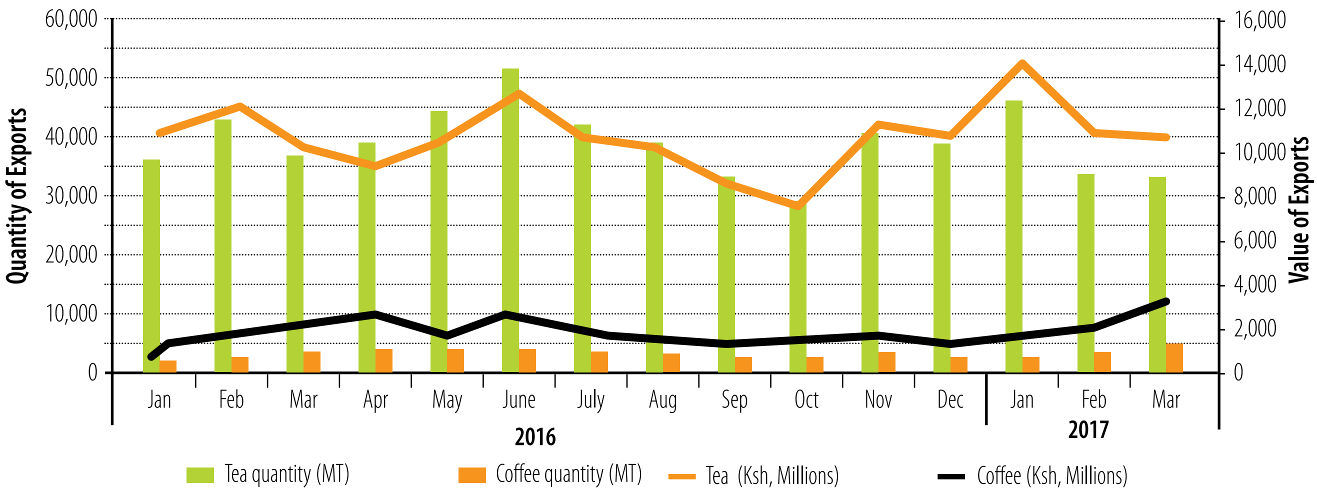
Figure 10: Horticultural Exports Oct 2015 – Dec 2016



Source: KNBS

On horticultural exports (**Figure 10**), in terms of quantity exported in quarter four of 2016, cut flowers dominate this subsector contributing 53.91 percent of total quantity of horticultural, followed by vegetables at 34.68 percent with fruits exports recording the lowest contribution of 11.41 percent. Turning to foreign exchange earned from horticultural exports for the entire quarter, cut flowers dominate horticultural subsector accounting for 71.03 percent of total horticultural exports value, followed by vegetables at 23.99 percent with fruits exports recording the lowest contribution of 4.98 percent.

Figure 11: Value of Tea and Coffee Exports, Jan 2015 – Aug 2016

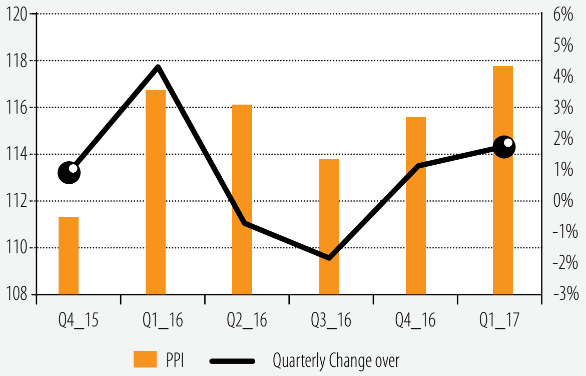


Source KNBS

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. During year 2016, the sector grew by 3.5 percent slightly below the 3.6 percent registered in 2015. A key component of the manufacturing sector is its output that targets the construction industry. Cement production slightly declined from 1,703,770 MT in quarter four of 2014 to 1,632,770 MT in quarter one of 2017. The decline cement production would be as a result of decline in the consumption given that production is likely to be derived from consumption. This may be as a result of slowdown in the building and construction sector with the developers taking a go slow in the awake of the election year.

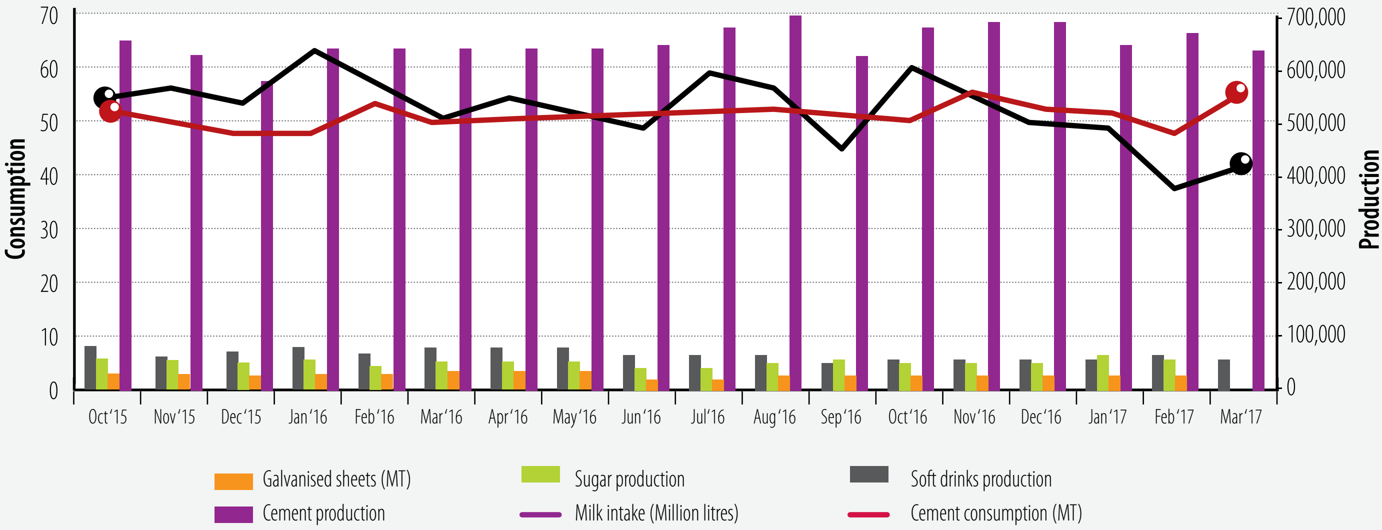
Figure 12: Producer Price Index



The producer price index rose by 1.92 percent in quarter one of 2017 to 117.58 points from 115.36 percent. From **figure 12** it is noticeable that the index and the change was on an upwards trend from the third quarter for 2016. During the first quarter of 2017, the rise in the production index was mainly driven by rise in the manufacture of food products, cost of electricity and water services. However, producer prices of manufacture of wood and products of wood and cork and manufacture of fabricated metal products declined over the same period.

However, domestic sugar production decline from 146,649 MT in quarter four of 2016 to 144,101 MT in quarter one of 2017. Milk processing also registered a decline in the terms of the volume formally processed declining from 163.7 million litres in quarter four of 2016 to 125.2 million litres in quarter one of 2017.

Figure 13: Production and Consumption of Manufacturing

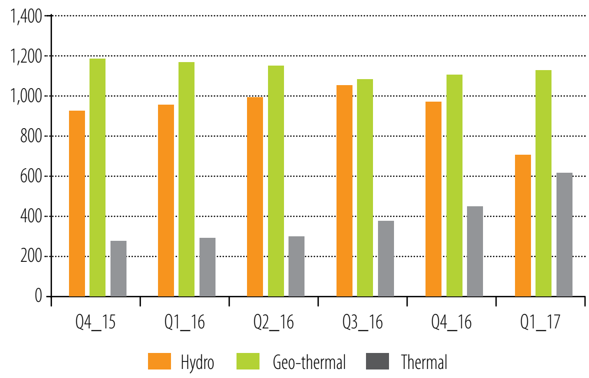


Source: KNBS

Energy

In the last few years, energy sector has received lot of government boost in effort to provide cheap and affordable energy that is core in transforming the economy into a manufacturing middle income economy. Generation of green energy has been at the fore front owing to the facts that is renewable, clean and thus sustainable. More specifically, geothermal power production has seen a significant growth compared to hydro and thermal production. However, the high initial cost has been an impediment to its development thus limiting the realization of its full potential overtime. A review of energy production in quarter one of 2017 reveals that geothermal production topped accounting for 46.15 percent of total quarterly production. Hydro production accounted for 28.81 percent of the total quarterly production with thermal production accounting for 25.40 percent. The drastic fall in the hydro power production contribution to total quarterly production from 38.44 percent in quarter four of 2016 to 28.81 percent in quarter one was mainly contributed for by the poor performance of the long rains in March 2017 that led to prolonged draught leading to drying up of the main water catchment areas. To bridge that short fall in the total production following the reduced hydro production, thermal production was increased accordingly. However, its noteworthy that the overall quarterly production in quarter one slightly declined from 2,525.95 million KWh in quarter four of 2016 to slightly a low of 2431.8 million KWh in quarter one of 2017..

Figure 14: Electricity Generation by Source (Million KWh)



Source: KNBS

On the international front, the prices of crude oil in the world market signified a sense of broad stability with the mean monthly crude oil prices being above the $50 mark. However, the expected upward surge in the crude oil prices after the OPEC resolution to cut down on the daily by 1.8 million barrels per day seems not coming into fruition soon though on the track if gauged with the performance in quarter one of 2017. The controversy here is that while some OPEC members have complied with the resolution to cut down on their daily production in the first six months since the day of the resolution, some members seem not to have complied. For the resolution to be effective in surging the world oil prices, the large contributors in the daily production

Table1: Average Monthly Crude Oil and Retail Fuel Prices

	Sep -16	Oct-16	Nov -16	Dec -16	Jan -17	Feb -17	Mar -17
Murban crude oil (US$/Barrel)	45.50	51.35	46.15	54.15	55.35	56.10	52.60
Super petrol (KES/Litre)	92.28	92.44	95.82	95.08	96.88	101.14	101.91
Diesel (KES/Litre)	83.42	83.08	83.14	88.18	85.20	90.22	91.39
Kerosene (KES/Litre)	60.08	59.68	63.13	64.52	64.41	68.15	68.93
LPG (13Kgs)	2,029.12	1,989.54	1,987.69	1,983.06	1,989.50	1,976.38	1,998.70

Source: ERC

such as Saudi Arabia are viewed to have to take more sacrifice and cut down further their production. Some producers such as Iraq, are deemed not to have fully complied with the resolution. The failure of the non – compliance by some members to cut down on their daily production therefore continue to pose a risk of the geopolitical stability.

In the domestic market the pump prices took an upward trend as well given the high correlation between the world oil prices and the domestic market pump prices with the diesel having the highest rise of price per litre of 6.19 shillings per litre. Throughout the quarter for the Energy Regulatory Commission reviewed the domestic pump oil prices upwards on the backdrop the rising in the prices of the barrel in the world oil market.

Building and Construction

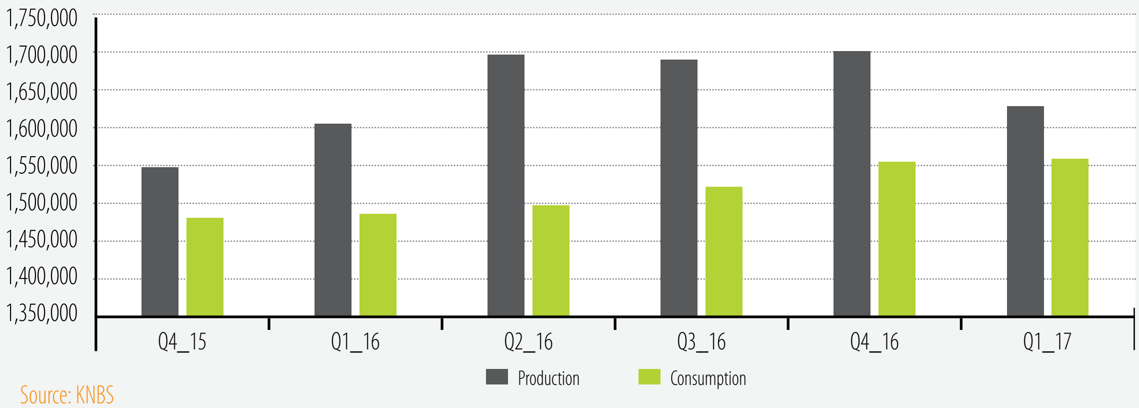
Building and construction sector continued to be one of the core sectors supporting economic growth. This is supported by the fact that the sector remained to be one of the four key sectors that toped in terms of private sector allocation. Given the ongoing physical infrastructure construction, the sector has remain core in supporting the economy given the amount of the resources being channels to the sector.

During quarter one of 2017, the sector registered a rise in demand for credit by 41 percent. However, the potentials of the sector remains untapped given the delayed payments by the government to the contractors with regard to the physical public infrastructural projects that has seen the tightening of the credit standards regarding the lending to this sector.

The indicators of growth in this building and construction sector mainly cement production and consumption reveal that during the first quarter of 2017, cement production declined from 1,703,770 MT in quarter four of 2016 to 1,632,300 MT in quarter one of 2017.

However, cement consumption rose marginally from 1,558,871 MT in quarter four of 2016 to 1,562,696 MT in quarter one of 2017 signifying low level of absorption. This could signify slow growth in the building and construction sector. This could be further explained by a number of issues. First is the slowdown in the implementation of the government infrastructural projects with the financial year coming into an end. Secondly, the political risk following the entering into the election period could imply a wait and see scenario especially for the developers in the building and construction sector who could be shying off from uptake and even implementation of new projects. Thirdly the effects of the interest rates capping in the last quarter of 2016 negatively impacted lending which would have had an effect on the financing of the developers in the building and construction sector hence the slowdown in the sector activities and consequently marginal rise in consumptions of raw material cement not being an exception. Given that production of cement is derived from consumption, the slowdown in the consumption could inform the cut down on the production.

Figure 15: Cement Production and Consumption (MTs)



Source: KNBS

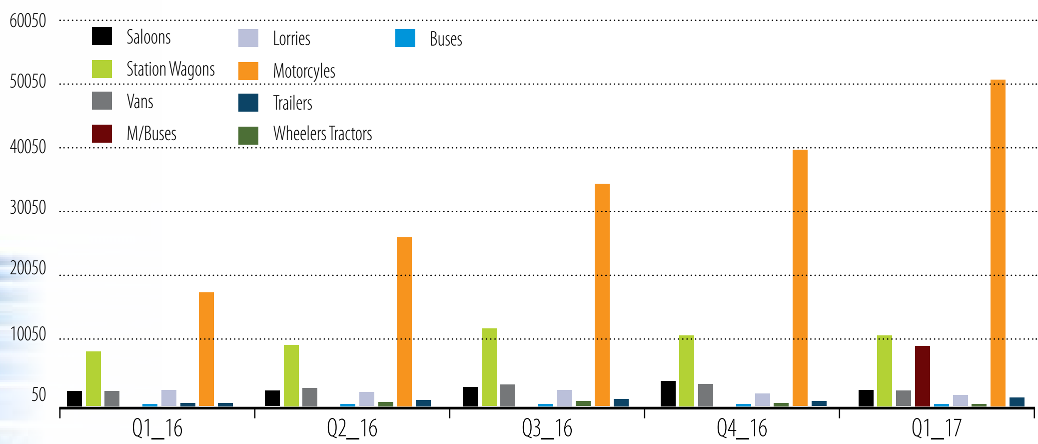
Made in Kenya: The Mobius II manufactured and sold for Africa's mass market.

Transport and Communication

The total number of newly registered vehicles in quarter four significantly increased from 60,257 units in quarter three to 67,735 units in quarter four. This is attributed to increase in the import of imported vehicles in the month of November and December 2016. This would imply that the market as at last quarter of 2016 had fully adjusted to introduction of new import charges on the second hand vehicles that were introduced in December 2015. Month – on – month statistics reveal that the number of newly registered vehicles rose from 11,018 units in October to 27,286 units in November and later marginally increasing to 27,431 as at end of December 2016.

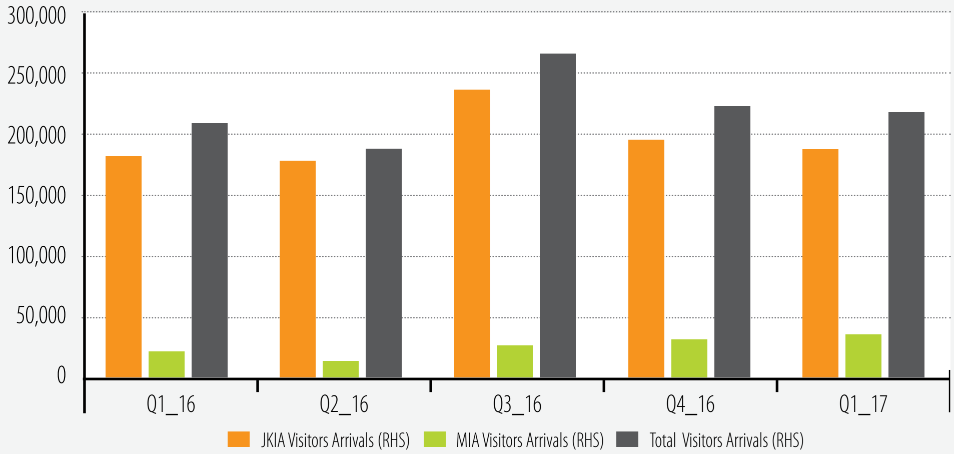
The dominance of mobile telephony in the communications industry continued to be evident. Mobile money transfer has been significant especially in rural areas where banks are not available, inaccessible, or where majority of the population do not hold bank accounts. At the same time this mode of money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

Figure 16: Registration of New Vehicles



Source: KNBS

Figure 17: Trends in Visitor Arrivals (Thousand)

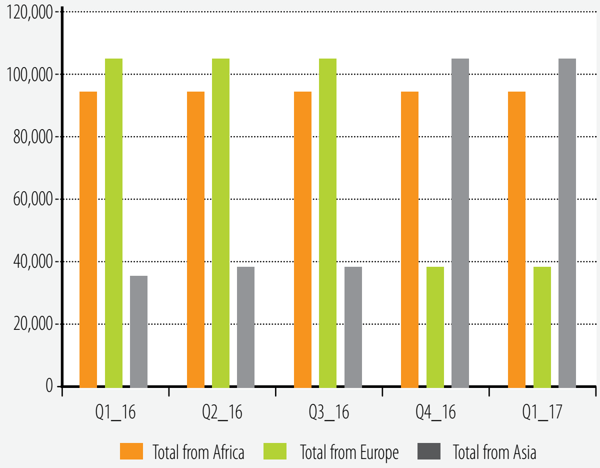


Source: KNBS

Tourism

In quarter four, tourism continued to post poor performance given the slump in the total quarterly number of visitors which dropped from 262,147 visitors in quarter three to 219,327 visitors in quarter four. Despite the last quarter being a festive season in December, the number of total visitors dwindled. This could be perhaps be attributed to unavailability of bookings for foreigners given that the bookings by the local tourist had rose substantially in the wake of the festive season in December. Within the quarter, it's evident that though the arrivals via Mombasa International airport remain relatively stable between quarter three and four, arrivals via Jomo Kenyatta International Airport declined substantially by 18.66 percent for the same period.

Figure 18: Trends in Visitor Arrivals (Thousand) by Port of Origin



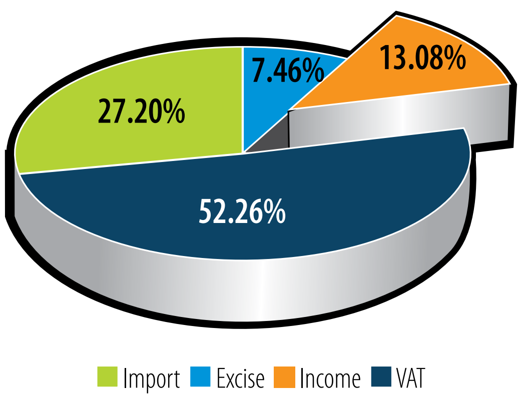
Source: KNBS

Arrival of the visitors into the country by port of origin seem to portly consistency overtime on quarterly basis. Arrivals from Europe and Africa seems to be relatively stable overtime since Q4_2015 with European arrivals leading followed by arrivals from Africa. However, arrivals from Asia seem reveals some element of volatility on quarterly basis rising from Q4_2015 but stable throughout Q1_2016 to Q4_2016 but falling in Q4_2016. This elucidates some element of cyclical patterns for Asian arrivals with a fall coming in the last quarter of the year.

Financing of Government

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 13.08percent 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.

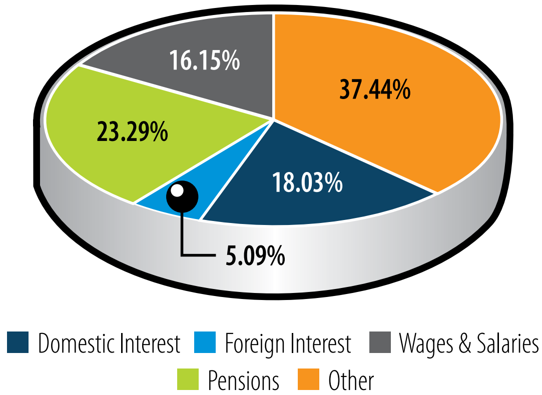
Figure 19: Tax revenue (Ksh Million



Source: CBK

The total government expenditure on commitment basis for quarter one of 2017, reveal that recurrent expenditure accounted for 56.34 percent with the development expenditure accounting for 30.57 percent of the total government expenditure while the country transfer accounted for 12.91 percent. Breakdown of the recurrent expenditure as at the end of March 2017, evidence that on the recurrent expenditure, domestic interest payment accounted for 18.06 percent with domestic interest payment accounting for 5.09 percent. Salaries and wages accounted for 23.29 percent while pension payment was 16.15 percent of the total recurrent expenditure

Figure 20: Recurrent Expenditure breakdown



Source: CBK

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Public Debt

An analytical breakdown of the public debt analysis into domestic and external debt reveals that the government through the National Treasury has had a tight balance between domestic and external debt.

This reflects a tight trade – off and balancing act in the choice between the two types of borrowing hence evidencing a broad limitation in the flexibility of the National Treasury to prefer one at the expense of the other which has existed for a while. 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 account of the strength of the domestic currency against other major currencies.

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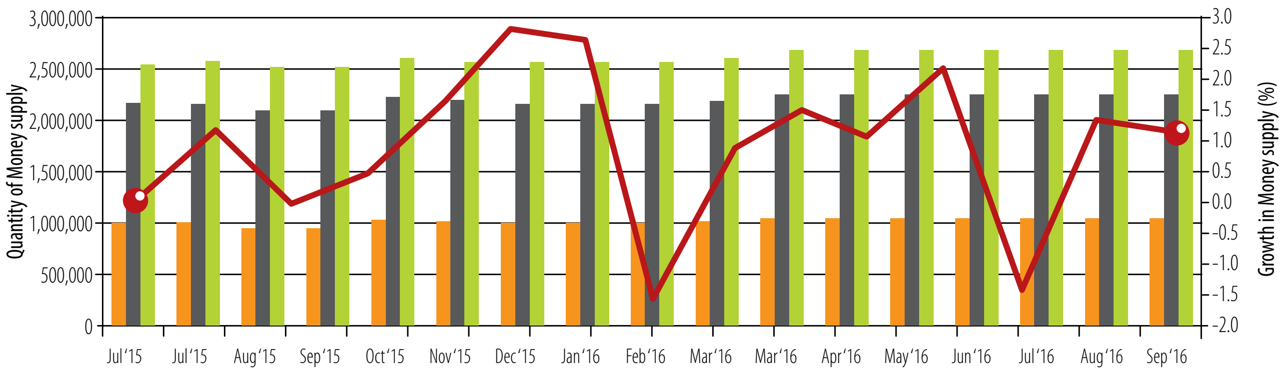
Money and Credit

During the first quarter of 2017, the monthly total money supply recorded a modest negative growth of -0.19 percent between in January followed by a positive growth of 0.72 and 2.34 percent registered in February and March respectively. This growth therefore did not warrant any demand pressures likely to cause inflationary trends within the quarter.

Inflation

The cost of living for the first quarter of 2017 remained high above the upper bound of the Central Bank target with the quarterly average inflation rate being 8.77 percent in quarter one of 2017 compared to 7.02 percent in quarter four of 2016. The rise in the inflation rates was mainly attributed to a number of factors. First, is the rise in the Food and Non-Alcoholic Drinks' Index which increased by 3.18 percent between February and March 2017. This was mainly attributed to increases in prices of several food items including, spinach, maize flour, milk, potatoes and maize grain. This increase in food prices was partly contributed by prevailing drought conditions.

Figure 21: Money Supply (KES Million)

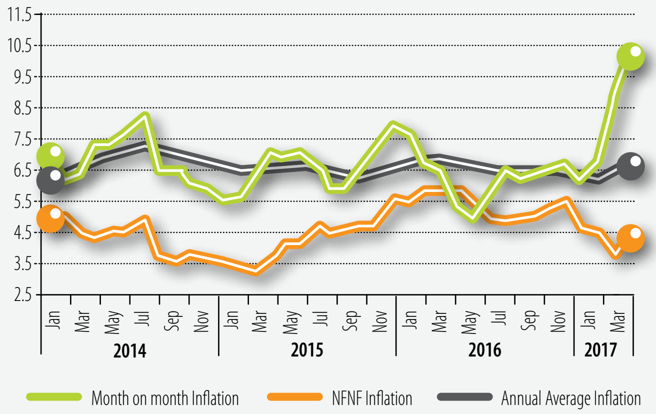


Source: KNBS and CBK

Secondly is the rise in the housing, water, electricity, gas and other fuels' index, increased by 0.69 percent. In addition, the transport index was on the rise as well rising by 0.27 percent in February - March 2017 mainly on account of increases in the pump prices of petrol and diesel. It is clear that in quarter one of 2017, almost all the components of the headline inflation were on an upward trajectory.

A review of month – on – month inflation rates in quarter one of 2017 reveals that even though the monetary policy decision adopted in the 30th January, 2017 and 27th March, 2017 to retain the bank rate at 10 percent inflation rate inflation remained on an upward trend above the target. This signifies the limited space for the monetary policy tools to be effective in anchoring inflation. A review on the year – to – year basis reveals that the annualized inflation rates rose significantly as at March 2017 stood at 10.28 percent compared to annualized inflation rate of 6.45 percent as at the end of March 2017.

Figure 22: Inflation rate (%)



Source: Central Bank of Kenya

The non – food – non – fuel inflation (NFNF) remained relatively stable in quarter one of 2017 being on a downward trend looking at the quarterly NFNF inflation between quarter four of 2016 and quarter one of 2017. As at quarter one of 2017, NFNF inflation averaged at 4.2 percent compared to 5.17 percent in quarter four of 2016. However looking into monthly NFNF inflation trends within the quarter, demand driven inflation seems to set in in the month of March with inflation significantly rising from 3.7 percent in February to 4.5 percent in March 2017. It is surprising that comparing the core inflation to headline inflation between February and March 2017, core inflation rose by 0.8 percent compared to a rise of 0.32 percent for headline inflation. This call for the need to focus on both the core and headline inflation and not only focus on the headline inflation as opposed to giving more emphasis on the headline inflation.

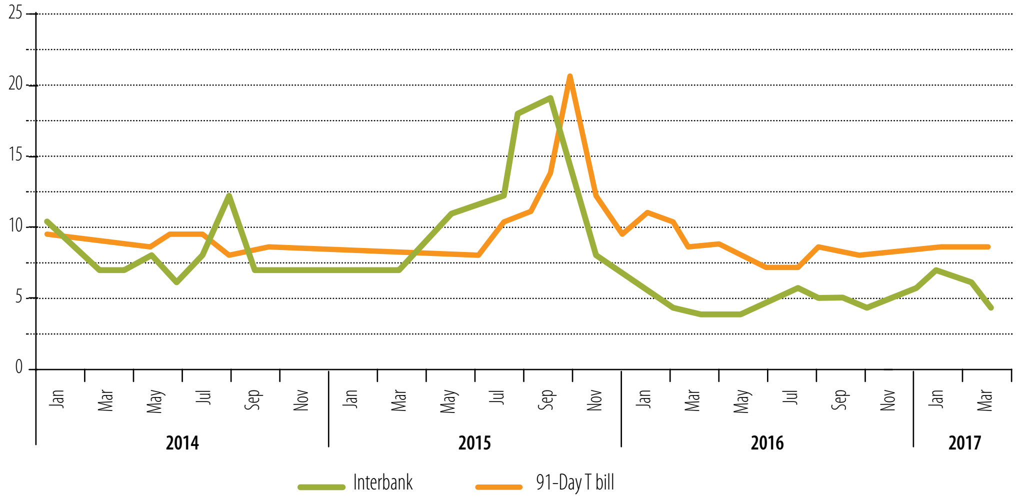
Interest Rates

Interest rates remained fairly stable during the first quarter of 2017 following the coming into effect of the capping law. The short - term market interest rates as represented by the interbank market rates and the 91 – Treasury bill rates seems to mirror each other from May 2015 to December 2015 although with a one to two months lags. However, this trend reverses inn the entire of quarter one of 2017 where the interbank rates take a downward trend with the 91 Treasury bill rates being fairly positive though stable since September 2016.

During quarter one of 2017, 91 – Treasury bill rates remained relatively stable though high averaging at 8.64 percent compared to a quarterly average of 8.14 percent in quarter four of 2016.

On the other hand, the interbank market rate surged up significantly to quarterly average of 6.12 percent from 4.81 percent in quarter four of 2016.

Figure 23: Interbank rates and 91 Treasury bill rates (%)



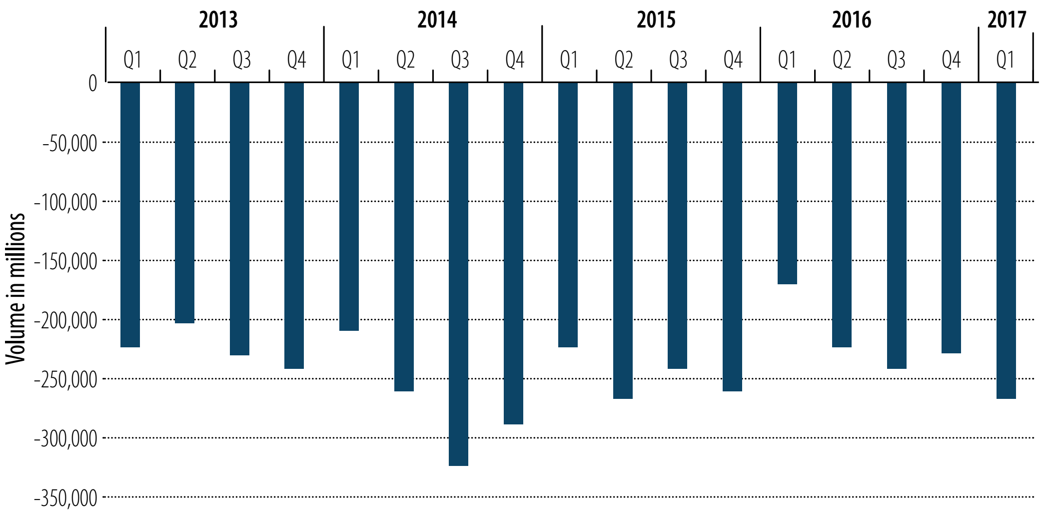
Source: CBK

Turning to the average lending rates for the commercial banks, we find that the cumulative average weighted lending rates posted mixed trends within the quarter though quite stable. At first, the rates dropped to 13.66 in January rising marginally to 13.69 percent in February and later dropping marginally to 13.61 percent in March 2017. On quarterly basis, the average quarterly rate for quarter one of 2017 was 13.65 percent compared to 13.88 percent the last quarter of 2016. In overall, the credit market still remained illiquid for the entire quarter two as evidenced by the relationship between the average lending rates and the CBR.

Balance of Payments

According Kenya National Bureau of Statistics, during quarter four, the volume of trade rose from Ksh 178.8 billion in February 2017 to Ksh 195.2 billion in March 2017. The value of total exports increased to Ksh 54.1 billion while the value of imports increased from Ksh 130.8 billion in February 2017 to Ksh 141.1 billion in March 2017. Domestic exports by Broad Economic Category (BEC) indicated that food and beverages was the main export category in March 2017 accounting for 42.8 per cent of exports, while non-food industrial supplies and consumer goods not elsewhere specified accounted for 26.5 per

Figure 24: Overall quarterly trade balance



Source: CBK

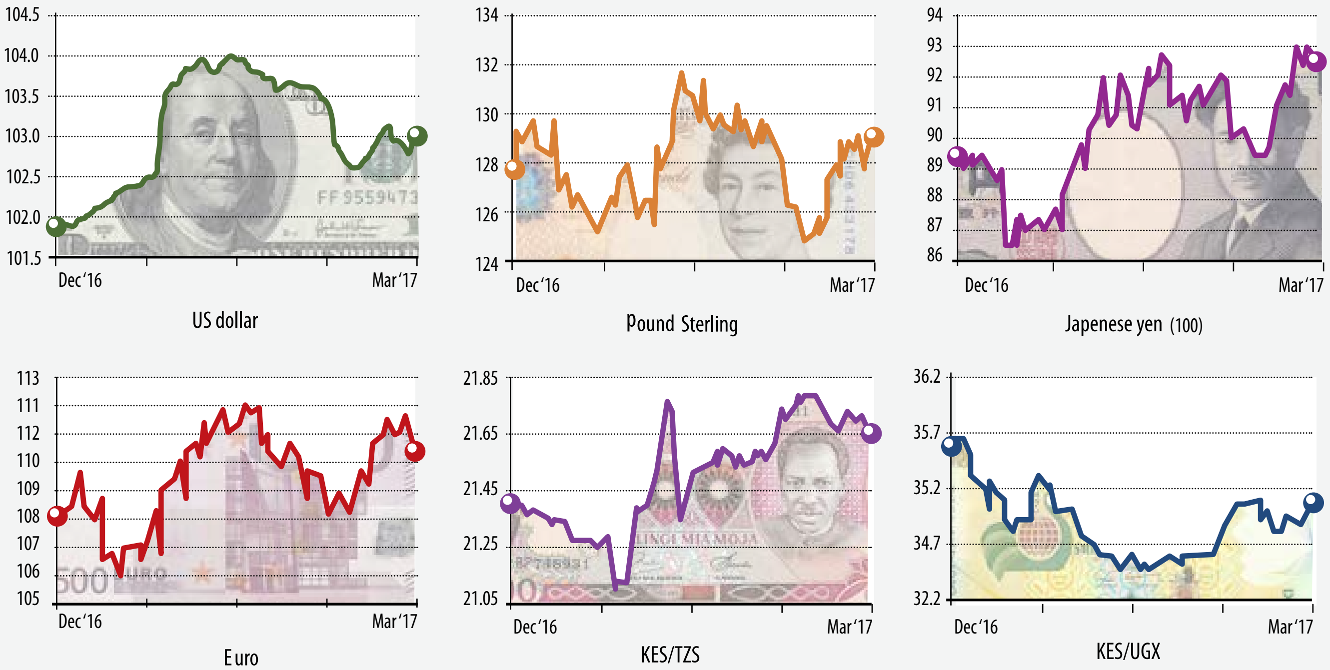
cent and 26.8 per cent of the value of total domestic exports, respectively. Imports by BEC indicate that non-food industrial supplies was the main import category in March 2017 with a share of 33.1 per cent. Machinery & other capital equipment; fuel and lubricants; and transport constituted 18.4, 16.0 and 15.6 per cent, of the total value of imports, respectively. Imports of food and beverage recorded a share of 9.5 per cent of the total imports while consumer goods not elsewhere specified recorded a share of 7.2 per cent.

The overall quarterly trade balance worsened from Ksh 229,369 million in quarter four of 2016 to Ksh 271,833 in quarter one of 2017. 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. Further the production of agricultural exports was also negatively affected by the poor performance in the rainfall in October – December 2016 season and the delay in the March 2017 short rain.

Exchange Rate

During the first quarter of 2017, the shilling suffered depreciation against the US dollar in January and February before posting some appreciation in value in the month of March. In January and February, the shilling slided to a low of 103 mark on as indicated by the daily exchange rates. The strengthening on the shilling against the dollar could be attributed to the reduced speculation

Figure 25: Nominal Exchange Rate



on the food importation following the setting in of the short rains in March. However, this would be subject to confirmation with time in quarter tow of 2017 given the state of food production.

Against the Sterling the Kenya Shilling posted considerable mixed performance throughout the quarter. This is evidenced by the appreciation of the shilling against the pound in the beginning of the quarter before later depreciating in the entire of February but later depreciating in the month of March. This could be attributed to the continued reduced competitive of the British economy within the entire Europe market mainly within the Euro zone which has seen Britain pursuing options for exit from the Euro zone. Struggles between Britain and the rest of European Union members on the modalities of exit seen to put Britain in a position of less bargaining power. As such although the domestic macroeconomic environment were not favorable for the resilience of the pound against the major world currencies, the lowering of competitive edge of Eurozone led to the shilling not depreciating much against the pound. Against the Euro, the shilling revealed mixed performance with the appreciations being more than the depreciations within the entire quarter.

Turning to the Japanese Yen the shilling posted significant appreciation in the entire of quarter four. This is attributed to the shrinking of the Japanese economy which is struggling with the negative interest rates within the year. In the East African context, substantially appreciated against the Ugandan Shilling but weakening against Tanzanian Shilling.

Nairobi Securities Exchange

During the first quarter of 2017 the stock market continued to post poor performance as evidenced in the successive months indices during the quarter thus evidencing the dominance of the bearing behaviour that has characterised the market on the recent over six months now. The first quarter of 2017 saw the market performance dip on the equity market segment in terms of the NSE 20 Share Index and the Nairobi All Share Index compared to the performance in the last quarter of 2016 based on the core market indicators. Similar performance is arrived at when analysing the fixed income segment in which both the FTSE NSE Kenya 15 and FTSE NSE Kenya 25 were both on the downward trend. Even though the performance in February posits some improvements compared to January's performance, both are on the lower side compared to Performance in quarter four of 2016.

A number of factors can be attributed to this performance in both the equity and the fixed income segments iof the market. First is the enactment of the interest capping bill into law that saw the market capitalization for the entire market fall significantly triggered by a fall in the market capitalization of the listed commercial banks. Secondly in the timings given the political risks that emanates from the factors arising from the fact that this is an election year. As such the investors are on the wait and see mode with majority of them being risk averse till elections are concluded.

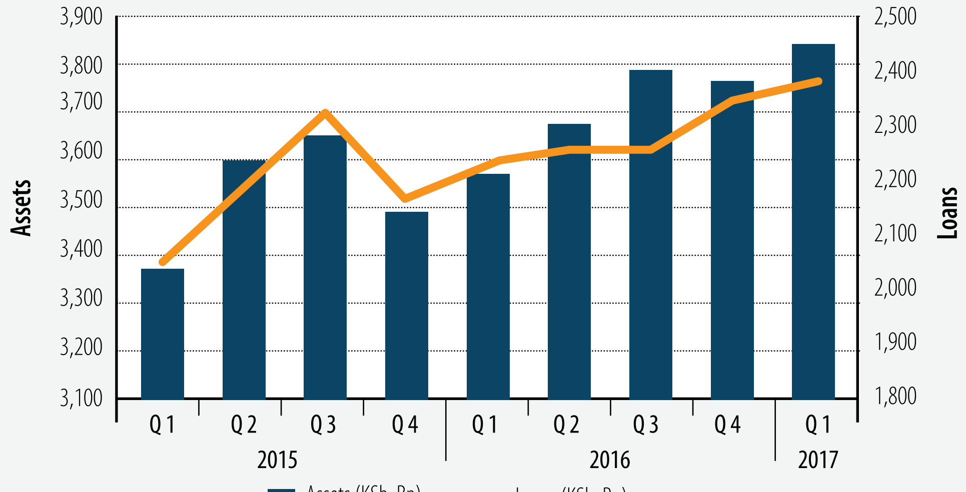
Table 2: Nairobi Securities Exchange Market Indicators

	2016					2017		
	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar
NSE 20 Share Index	3,179	3,243	3,229	3,247	3,186	2,794	2,995	3,113
NASI	135	137	137	137	133	122	125	131
FTSE NSE Kenya 25	163	167	171	170	164	148	149	161
FTSE NSE Kenya 15	156	161	165	166	159	142	146	164
Market Capitalization (Ksh Billion)	1,943	1,972	1,985	1,997	1,932	1,770	1,812	1,894

Source: NSE, Monthly Trading Report

Banking Industry Performance

Figure 26: Bank Assets and Loans (Ksh Billion)



Source: CBK

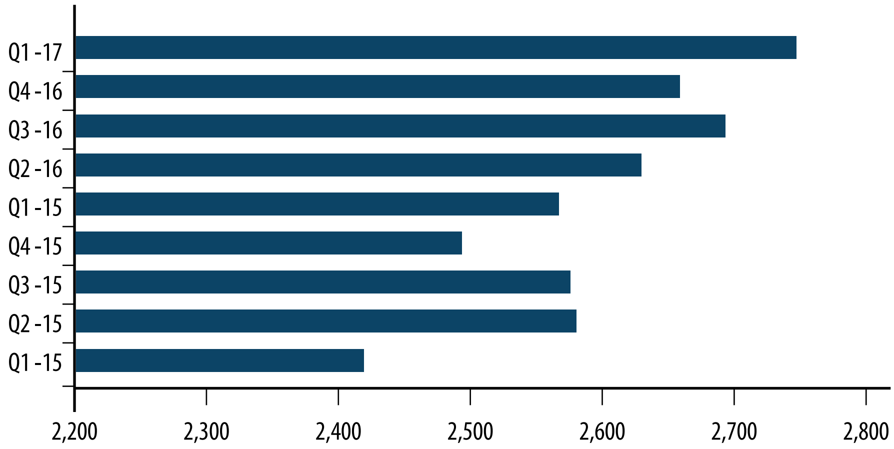
Assets and Loans

The industry's assets base registered a modest growth of 2.10 percent during the first quarter of 2017 from KES 3.76 trillion as at the end of December 2016 to KES 3.84 trillion as at the end of March 2017. The modest growth in asset base could be attributed to a number of factors. One of them, is the likely effect of the interest rate capping bill which came into effect in the fourth quarter of 2016 which could have affected banks' conversion of their liabilities (mainly deposits) into assets (mainly loans) arising from slowdown in lending. On the other hand, total industry's gross loans and advances recorded a growth of 1.76 percent in quarter one of 2017 from Ksh 2.34 trillion in quarter four of 2016 to Ksh 2.38 trillion in quarter one of 2017.

Bank Deposits

The total deposits in the first quarter of 2017 recorded a positive growth standing of 3.32 percent from Kshs 2.65 trillion in last quarter of 2016 to Kshs 2.74 trillion in quarter one of 2017. The trend in quarter one of 2017 with regard to deposit mobilization is negation of the trend experienced in last quarter of 2014 where the deposits were on downward trend. The rise in deposits could imply that the public in quarter one of 2017 preffered hold cash in bank deposits as opposed to cash balances at hand. This could be attributed to the rising cost of living in the quarter as evidenced by rising inflation rates in the entire of the quarter. On the other hand, it could imply the absence of viable investments to trade – off holding cash in bank

Figure 27: Bank Deposits (Ksh. Bn)



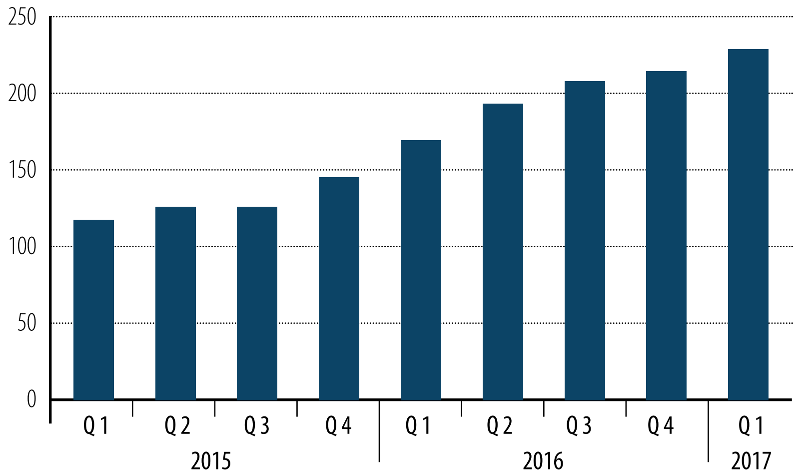
Source: CBK

deposits. Further with the political environment, general public appetite for investment would appear muted and as such preferring holding cash in bank deposits. All these could infer into the positive growth in total bank deposits in quarter one of 2017 by 3.32 percent up from a negative growth of 1.28 percent in quarter four of 2016.

Gross Non-Performing Loans

The ratio of gross non-performing loans to gross loans increased by 6.43 percent quarter one of 2017 as compared to 2.8 percent in quarter four of 2016. The increase in gross non-performing loans was mainly attributable to challenges in the business environment that led to cash flow constraints for borrowers.

Figure 28: Shareholders' Fund (Ksh. Bn)



Source: CBK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