



KENYA BANKERS ECONOMIC BULLETIN

QUARTER THREE OF 2017



VOLUME **21**

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

About the Centre for Research on Financial Markets and Policy®

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



CENTRE FOR RESEARCH ON
FINANCIAL MARKETS AND POLICY®

KENYA BANKERS ECONOMIC BULLETIN

Publisher KBA Centre for Research on
Financial Markets and Policy®

KBA CEO Dr. Habil Olaka

Chief Editor Jared Osoro

Contributors David Muriithi,
Josea Kiplang'at

Design & Layout Conrad Karume

Contacts KBA Headquarters,
International Life House,
13th Floor Mama Ngina
Street, Nairobi

Mailing Address P.O. Box 73100
00200 - Nairobi

Phone +254-20-2221704,
+254-20-2217757,
+254-20-2224014

E-mail research@kba.co.ke

Web www.kba.co.ke.

Distributed by Kenya Bankers Association

Disclaimer

Views expressed in this publication do not necessarily express the views of the members of Kenya Bankers Association. The entire content of this publication is protected by copyright laws. Reproduction in part or whole requires express written consent from the publisher.

Pictures used herein have been sourced from the internet and other sources.



In this Issue

FROM THE CEO'S DESK	2
WHEN HOPE IS TAKEN AS A SUBSTITUTE FOR A FORECAST	3
STATE OF THE ECONOMY	
• GROWTH IN GDP	7
• AGRICULTURE	10
• MANUFACTURING	12
• ENERGY	13
• BUILDING AND CONSTRUCTION	15
• TRANSPORT AND COMMUNICATIONS	16
• TOURISM	16
FINANCING OF GOVERNMENT	
• PUBLIC DEBT	18
• MONEY AND CREDIT	19
INFLATION	20
INTEREST RATES	20
BALANCE OF PAYMENTS	21
EXCHANGE RATES	21
NAIROBI SECURITIES EXCHANGE	22
BANKING INDUSTRY PERFORMANCE	23



This bulletin can also be downloaded from: www.kba.co.ke

FOREWORD



Swahili Dhow docks for repairs at the Kilifi creek. Picture/ Sheikha Mkambe

From the CEO's Desk

It is my pleasure to present to you the 21st issue of the *Kenya Bankers Economic Bulletin*. In this issue, we discuss the state of the Kenyan economy third 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.

Much of the discussions during the quarter were largely reflections on the extended electioneering period and its implications on the economy. In the past, elections have been disruptive. The usual focus on how that plays into influencing investors' attitudes helps shape the views on the economy in the near term

Therefore the out turn at the broader economic front and in various markets highlighted in this *Bulletin* should admittedly be seen with the lens of limited clarity around how both

legislation and the broader economic policy thrust will be shaped by the election outcome.

It is my hope that you will find this issue of the *Kenya Bankers Economic Bulletin* interesting and useful. We will be happy to consider for publications incisive commentaries on a topical issue of interest to the banking industry.

For guidelines on such submissions, please get in touch with the *Bulletin's* Editor at research@kba.co.ke.

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

Dr. Habil Olaka
Chief Executive Officer,
Kenya Bankers Association



COMMENTARY

When Hope is taken as a Substitute for a Forecast



By Jared Osoro

Kenyans are a hopeful lot, at least in terms of how they think about the future of the economy. Even when underneath there are glaring weaknesses that should engender caution, optimism is galore. As we publish the last *Economic Bulletin* for the year, the popular basis for the economy's output projection is that confidence is returning subsequent to the prolonged electioneering period that put investors on a predictably cautious mood. Is the exuberance justifiable?

To be sure, let's take a step back. Kenya's output growth is evidently softening, although often described as resilient — a code for staying afloat amidst strong headwinds. Even habitual optimists such as the International Monetary Fund (IMF) have revised downwards the economy's growth forecasts.

In its October 2017 World Economic Outlook (WEO), the IMF for instance projects a real GDP growth of 5.0 percent for 2017 compared to 2016's 5.8 percent real GDP growth. This is a substantial revision from its October 2016 WEO's growth projection of 6.1 percent. The World Bank, in its latest *Kenya Economic Update*¹, projects a real GDP growth of 4.9 percent.

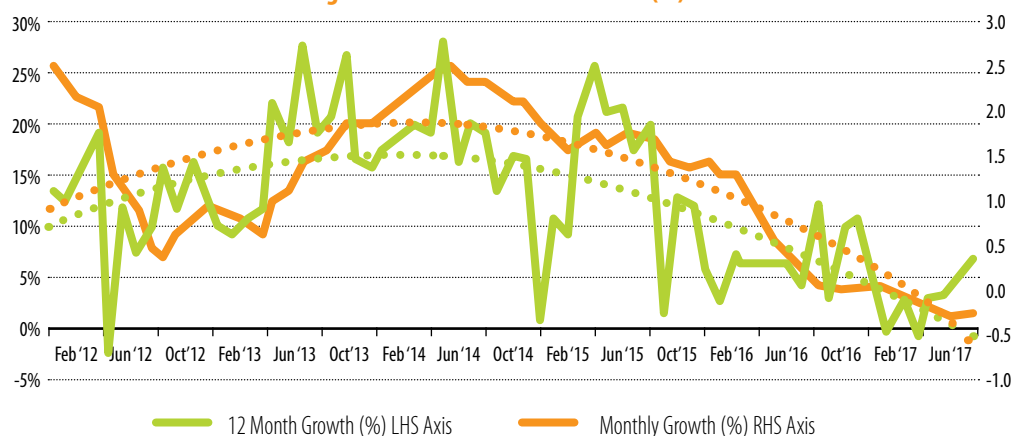
Given its small-open-economy status — therefore without systemic importance — Kenya's downward revision interestingly comes at a time when the global economy's prospects are looking up. The October 2017 WEO asserts that there will be a global upswing in economic activity, with global growth projected to rise to 3.6 percent in 2017 and 3.7 percent in 2018; this growth that has been characterised as broad-based with upward revisions in the euro area, Japan, emerging Asia, emerging Europe, and Russia would more than offset downward revisions for the United States and the United Kingdom.

The foregoing could be a strong pointer to the fact that Kenya's growth challenges are largely stemming from domestic conditions. One such condition is the state of the private sector credit — where it will take utter deniability to assume away the nexus between private sector and economic performance, even as there remains a healthy debate regarding



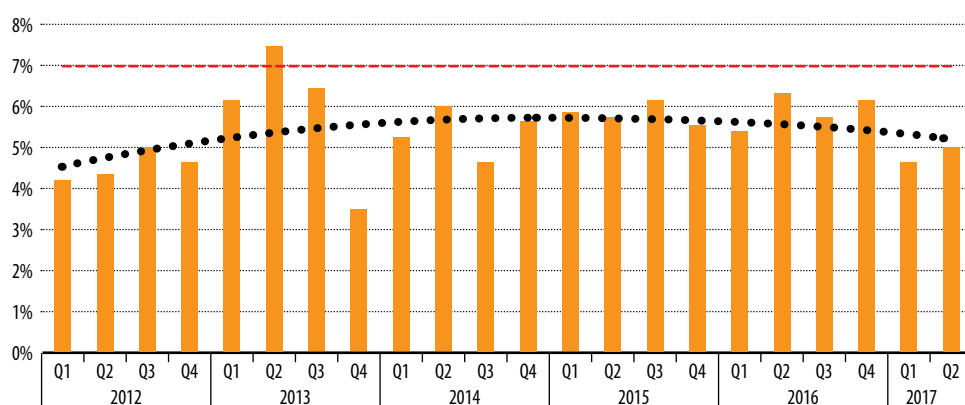
1. World Bank (2017), *Kenya Economic Update: Poised to Bounce Back? — Reviving Private Sector Credit and Boosting Revenue Mobilisation to Support Fiscal Consolidation*; December.

Figure 1: Claims on Private Sector (%)



Source: Central Bank of Kenya

Figure 2: Output Growth



Source: Kenya National Bureau of Statistics

the magnitude of elasticities (i.e. the extent of change in real output growth arising from a one percentage change in credit growth).

Based on **Figure 1** and **Figure 2**, I can make the argument that there is a fairly strong association between credit growth to the private sector and the economy's real output growth. If we assume that the economy's full employment level of real output growth – often taken as the medium term target – is in the 6.5 – 7 percent range, the economy would be operating at a negative output gap (difference between actual and potential real growth).

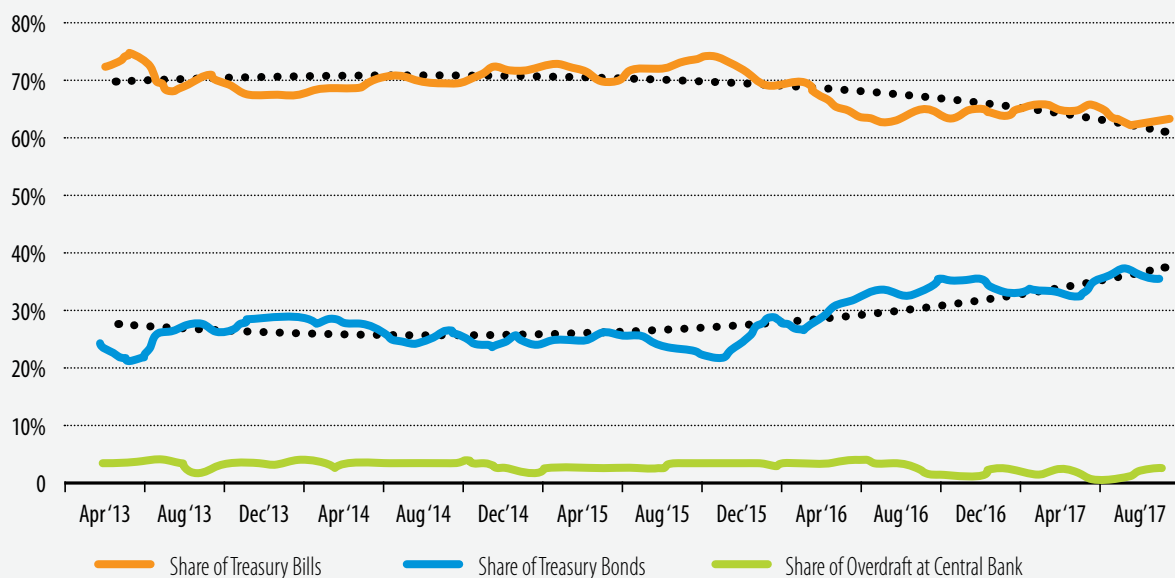
Under such circumstances, it is possible to increase credit without triggering demand driven inflation. But at the core of the snail speed of private sector credit expansion is the muted demand as confirmed in monetary policy pronouncements over the past one year. Subdued demand filters into supply such that firms operate at less than

installed capacity. The implication is therefore that demand for credit is more towards boosting existing capacity utilisation than towards capacity expansion.

The monetary policy toolkit is suited for addressing demand-side challenges and not supply-side challenges. That means therefore that any policy adjustment towards spurring credit expansion remains constrained, even more so cognisant that the Banking (Amendment) Act 2016 restricts free pricing of credit risk. The policy conundrum presented above has a contributory effect on the downward revision of the economy's growth near-term forecast.

The obviously limiting assumption that the economy will continue to grow regardless of the observed association between credit to private sector ignores the fact that if such growth is driven by fiscal policy then it is likely to hit a limit beyond which that very policy will become a growth drag.

Figure 3: Domestic Public Debt (Proportions)



Source: Central Bank of Kenya

If there is an expansionary fiscal policy as the economy is suffering from weak demand, then either the economy is set to realise the benefits of such policy with a longer time lag; it would be presupposed that the expansionary fiscal policy is investment leaning more than it is consumption inclined. But then there is a possibility – inferring from the reducing trend in the tenor of the domestic borrowing instruments (**Figure 3**) – that public expenditure could be consumption leaning.

The evolution of public debt over the past five years has now brought to the fore the concerns regarding the possibility economy approaching debt distress levels. The stock of debt has more than doubled over the period, hitting a historic level of over Kshsh 4 trillion equivalent. If this stock of debt has evolved with reduced tenors, then the challenge is not merely the stock itself (outstanding amounts) but also the flows (how the reduced tenors put a strain the repayment ability at any given time).

Furthermore, as external debt doubles, the current account balance is narrowing, meaning that the as the reliance on foreign resources to fill the domestic savings gap (the difference between investment requirements and domestic gross savings) reduces, public external borrowing is on the rise; this is a form of crowding out of international intermediation.

But that is half the story. The other half is that crowding out is even more evident at the domestic front; and it is happening through the quantity



channel (actual resource shift from private sector to public sector) as, for instance banks as willing to lend to government at negative real returns than through the price channel (where government borrowing severely influences the lending rates, hence credit to the private sector) given the current interest rate capping regime.



A Watchful Eye on the Shilling as Oil Prices Commence the Rise

If my reading on the CBK's policy reaction function is correct, then I would expect a sustenance of the effort of maintain foreign exchange market stability. That the CBK has adequate reserves is an indication that it has scope for market intervention where necessarily in the event of market volatility. The hawk-eyed stance on the currency stability that has seen the

local unit remaining largely stable could help ameliorate the challenges of ballooning external debt, albeit as a sub-optimal strategy.

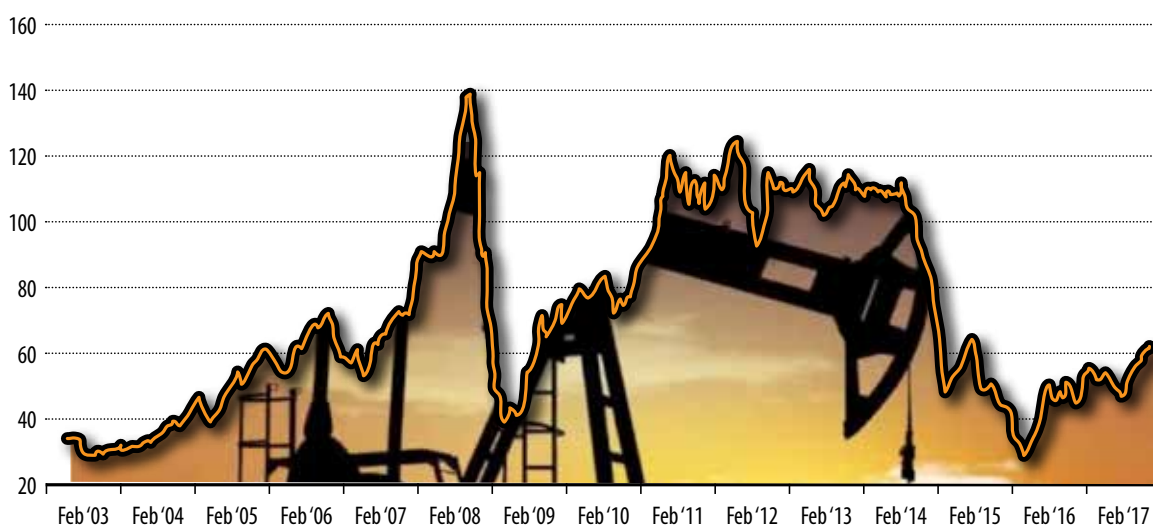
This is especially so given that it is difficult to assure debt sustainability largely through currency management. In any event the economy's balance of payment (BOP) position necessitates the support of the IMF in the form of the IMF's stand-by facility. If the foreign exchange market has to be stable almost at whatever cost, then such costs would of necessity need to have the compensatory effect of the rising oil prices (Figure 4).

The June 2014 – January 2016 plunge in oil prices substantially helped repair the economy's weak current account position. The effects price resurgence that has since emerged needs to be countered by a stable currency (at least not a weakening currency). How that stability is realised requires a combination of policy tools, and not a bias towards market interventions.

On the balance of the outlined circumstances, while the right to be hopeful on the basis of the resumption of confidence should be retained by many, it worthynoth that hope is a very poor substitute of a forecast.

Jared Osoro is the Director of the KBA Centre for Research on Financial Markets and Policy®

Figure 4: OPEC Basket Price – USD/Barrel



Source: OPEC

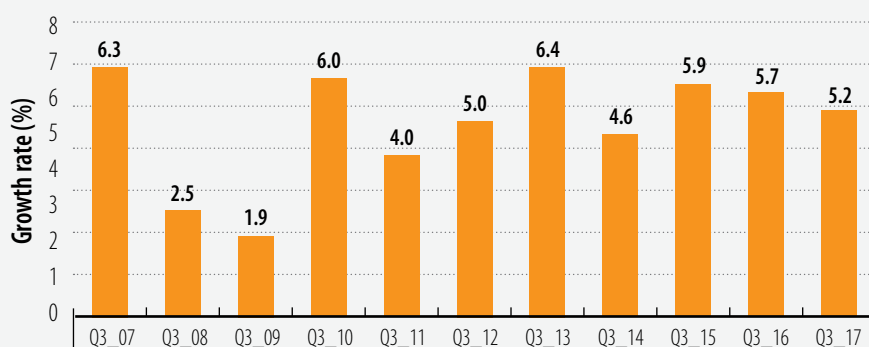


State of the Economy

During the third quarter of 2017, the economy grew by 5.2 percent compared to 5.7 percent in the same quarter in 2016. This was perhaps the lowest ever posted quarterly growth since the third quarter of 2015 comparing the growth rates recorded in the third quarters of for the previous years. The quarter in review was characterized by uncertain political environment, a notable rise in international oil prices. Equally, the slowdown in economic growth in this quarter compared to other quarters of the previous years could also be attributed to the slowdown in the growth of the sectors that support the economy. The political environment in the country hurt production in most sectors of the economy and as a such shocking the exports through reduced production of agricultural cash crops.

From the macroeconomic front, the macroeconomic environment was not very conducive in favoring economic growth across all sectors. Generally, since the beginning of the year 2017 the macroeconomic fundamentals have been weakening and the economy entered quarter three of 2017 on a weak note. The spillover effect of the continued weakening of the economy was also evident in the third quarter of 2017. The month-on-month inflation for the third quarter also reveals that the inflation rate was relatively stable and within the CBK's targets rates except for the month of September where it exceeded the upper bound of the target. This clearly, indicates that at least the CBK's aim of anchoring inflation expectations especially within this quarter.

Figure 5: Quarterly Growth in GDP – 2009 Base Year



Source: KNBS



On the credit market front, the financial sector recorded a growth of 4.3 per cent in the second quarter of 2017 compared to a growth of 8.1 per cent in the same quarter of 2016. In the third quarter credit expansion continued to suffer on the backdrop of the enactment of the Banking Act that capped interest rates at 14 percent. Nevertheless, the credit growth in the third quarter of 2017 was higher compared to other quarters since the introduction of the caps however, the gross non-performing loans also continued to grow thus, deterioration in the banking industry quality of asset though mild.

A review of the forex market over the quarter reveals that the exchange rate though relatively stable, remained weak at best. The shilling oscillated around the 102.70 and 104.02 mark against the dollar. Against the Sterling Pound, the Euro, and the Japanese Yen the shilling posted mixed performance throughout the quarter. However, at the local regional level the shilling posted fairly appreciation against the Ugandan and the Tanzanian shilling though towards the end of the third quarter some rebound in the Tanzanian and Ugandan shilling.

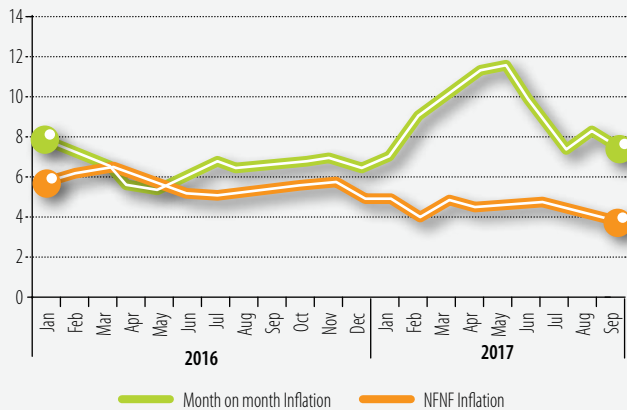
The open account of the economy during the quarter reveals that the current account has been narrowing down during the year. Looking at the balance of payment in quarter three of 2016 indicates that the current

account had a huge current account deficit compared to the third quarter of 2017. This however does not imply that the country has been exporting more and importing less rather there has been a decline in the import of commodities. The reduction in exports which has led to the reduction in the current account deficit has mainly been occasioned by the decline in the composition of exports from the country and mainly from the agricultural sector. The change in the country's import and export structure for most part of the year clearly indicates that there has been a reduction in the appetite for investment and this poses a serious problem to the economy in further as the slowed importation of capital equipment will eventually lead to reduction in the economy's productive capacity and hence reversing the gains recorded in the current account position.

In the third quarter of 2017, it is evident that the central bank was on target in anchoring inflation especially when gauged on the month-on-month inflation yardstick and continued to decline compared to the quarter one and quarter two of 2017. In July 2017, the month-on-month inflation stood at 7.47 percent, rising to 8.04 percent in August and then declining to 7.06 percent in September. The spike in the headline inflation in the month of August may be attributed to supply pressures due to the political environment in the country rather than demand pressures. On the other hand the core inflation continued to be relatively stable but

with some evidence of reduction during the third quarter of 2017 and this is attributed to the stable monetary policy trajectory since August 2016 which has been maintained at 10.0 percent.

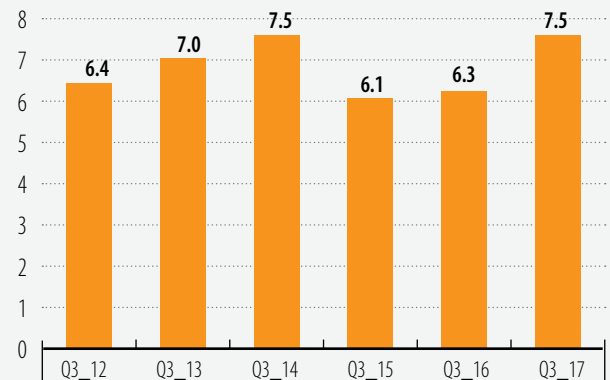
Figure 6: Monthly Inflation Rates



Source: KNBS

Turning to the quarterly inflation rates, the month-on-month inflation rates has been on a downward trend. In quarter three of 2017 the month-on-month inflation rate stood at 7.5 percent.

Figure 7: Average Quarterly Inflation Rates



Source: KNBS



#Twaweza

Oilibya Westlands is a Ready Business

Our desire to stand out as one of the best petrol stations in Kenya is fuelled by the partners who understand our vision and work with us to realise it. Safaricom Business is that partner and through Lipa na M-PESA, we are able to deliver value to our customers, especially in terms of convenience and secure cashless payments. This makes us a Ready Business.

Be a Ready Business today

Take the readiness test at
WWW.SAFARICOM.CO.KE/READYBUSINESS

Yusuf Ali
 Managing Director, Oilibya Westlands

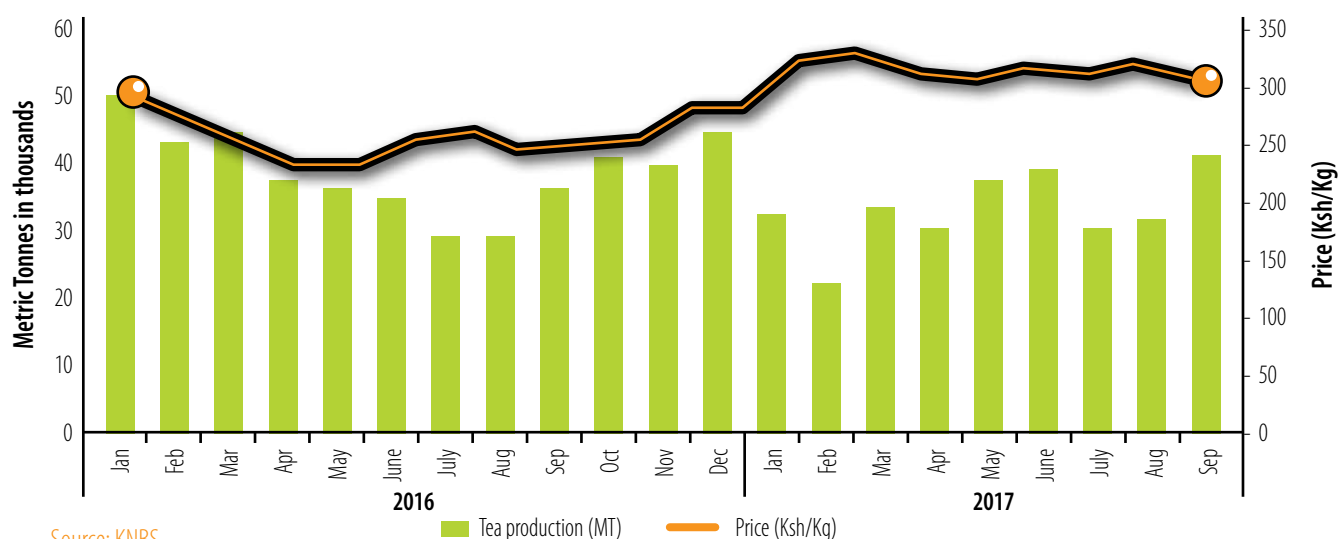


Agriculture

The agricultural sector remains to be one of the key sectors driving economic growth as evidenced in Quarter 3 of 2017 as well as over the past years. Nonetheless, the performance of the sector in the third quarter of 2017 still remains very low occasioned by insufficient long

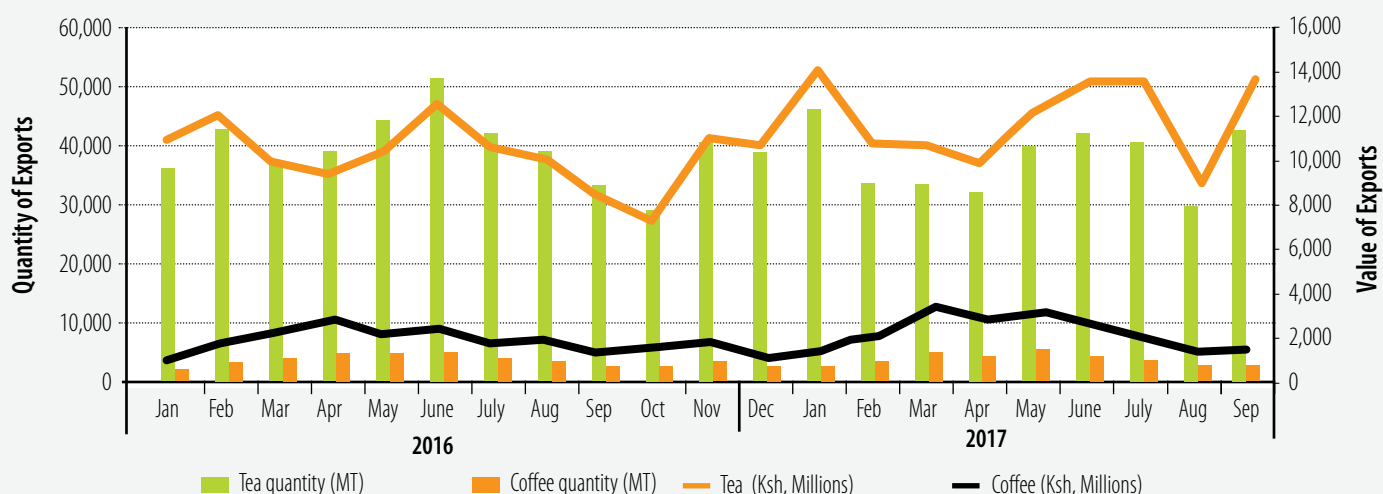
rains experienced during the period under review which affected most food crops. The substantial slowdown was constrained supply of main food crops. In spite of poor performances in some sub-sectors, the performance of the sector was supported by a slight improvement in production of tea which increased marginally from 31,565 metric tonnes in July 2017 to 32,693 metric tonnes in August 2017 thereby reducing the effect of underperformances of the other sub-sectors on the overall

Figure 8: Tea production in Metric Tonnes and Prices per Kilograms



Source: KNBS

Figure 9: Value of Tea and Coffee Exports



Source: KNBS

growth of the sector. Despite, the increased production of tea the auction prices dropped to a low of Kshs. 299.52 in August 2017 from Kshs. 309.97 in July 2017 however this decline in auction prices were counteracted by the increased production. A surge in prices seems to set in September rising to Kshs 304.52 with the production rising as well to MT 38,386.

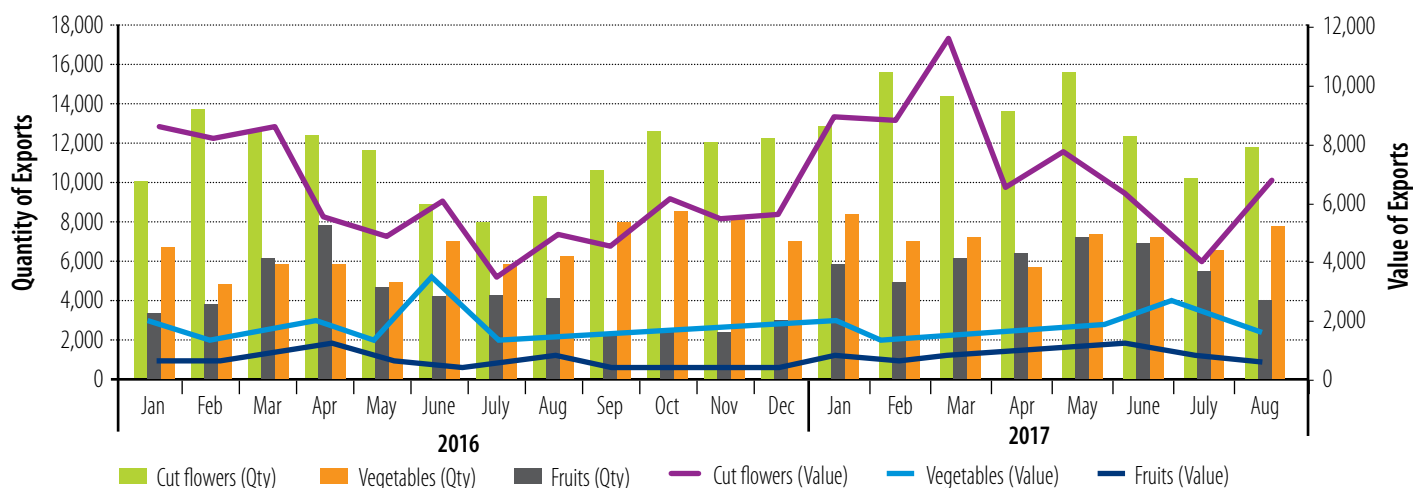
Milk deliveries to formal processors increased to 42.92 million litres as the end of August from 42.83 million litres in July 2017. The improvement in the milk production was due to the improvement in the weather conditions during the review period. On the country's leading exports, agriculture cash crop continue to command a good share of the total economy's main export. The quantity of both the tea and coffee exports was in tandem with the quantity produced within the quarter. Quantity of tea exports declined in August compared to that of July. Similar trends were noted for coffee exports within the quarter. The dominance of tea and coffee in exports seems to be phenomenon that is likely to exist for time given the reliance of the economy on agricultural primary products. In terms of value of exports, the value of tea increased in quarter three while that of coffee exports declined and the increase in the value of tea exports is due to the widening of market destinations of Kenyan tea as indicated by the increased export volume of tea. It is notable that the structure of the economy in terms of reliance on the primary agricultural products still remains.

Horticultural exports, in terms of quantity exported in the third quarter, cut flowers dominated this subsector contributing 52.35 percent of total production in August, followed by fruits at 24.32 percent and lastly



vegetables at 23.33 percent. On the values of the horticultural exports, cut flowers majorly accounted for 71.90 percent of the total horticultural exports for August 2017. Vegetables and fruits came second and third at 18.83 and 9.28 percent respectively.

Figure 10: Horticultural Exports



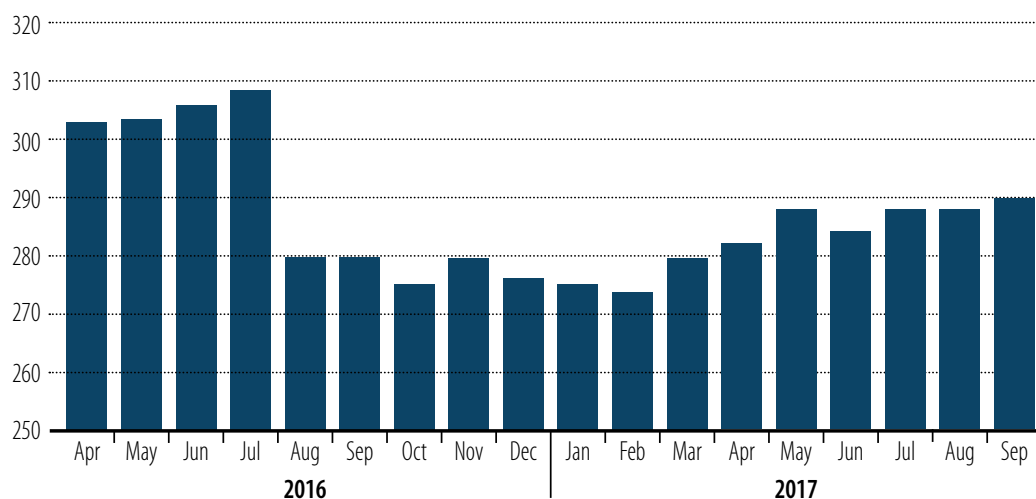
Source: KNBS

Manufacturing

During the third quarter, the sector grew by 2.3 per cent compared to a growth of 5.3 per cent in a similar period in 2016. The growth in the manufacturing sector was largely impeded by the subdued performance in the production of sugar, manufacture of edible fats and margarine and processing of milk. In spite of the subdued growth of the sector some

sectors of the manufacturing sector including processing of maize and wheat flour, manufacture of bakery products and production of soft drinks recorded positive growth. The decline in production in the indicated sectors is partly due to the increased cost of electricity and the slight reduction in credit to the sector during the second quarter in 2017. The manufacturing sector in quarter three contrary to what was recorded in quarter two 2017 showed slight improvements and this was mainly due to slight increase in credit to the sector.

Figure 11: Bank lending to manufacturing sector





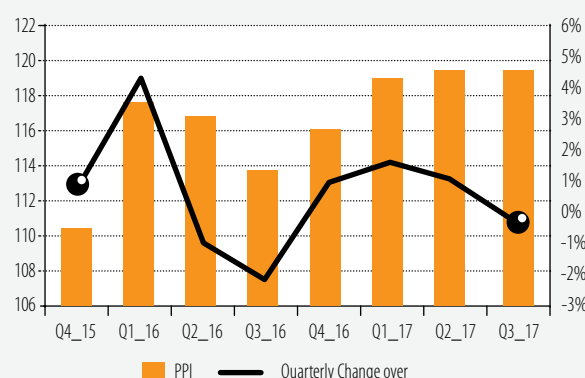
From the monthly lending, it is evident that the credit advanced to the sector has increased marginally from 286.5 billion in August 2017 to 287.7 billion in September 2017 a reversal of the trend that was seen after the coming into effect of the Banking Amendment Act of 2016. The start of the rising in the credit advanced to the sector could be explained as a result of credit portfolio allocation with the manufacturing sector being a beneficiary at the expense of other sectors considered as more risky. As such, the manufacturing sector enters into a cohort of sectors that command more than 60 percent of the total credit advanced by commercial banks. The sector can be seen as promising given that the concerted efforts and emphasis by the government put the sector at the centre of revolutionising the economy from being an agricultural based economy to an industrialized middle income by raising the sector's share of GDP to 15 percent by the year 2030.

Producer Price Index

The producer price index rose by 0.06 percent in quarter three of 2017 to 119.5 points from 119.5 points in quarter two of 2017. From figure 8 it is noticeable that the index and the change has been on an upward path between the third quarter for 2016 and the first quarter of 2017 but this seems to be reversing and declining especially between quarter two and quarter three of 2017. According to Kenya National Bureau of Statistics, during the third quarter of 2017, the decline in the producer price index was mainly driven by water, motor vehicles, wood products and manufacture of food. However, during the same period the producer prices of electricity increased mainly due to foreign exchange rate fluctuation adjustment. Similarly, the prices of basic metals and chemicals and chemical products also increased.

Domestic sugar production during quarter two of 2017 recorded some slight improvement compared to the quarter one of 2017. In July 2017 domestic sugar production stood at 16,144 metric tonnes compared to 15,246 metric tonnes in May 2017. The increase in sugar production during this period is attributed to the increased deliveries of cane from

Figure 12: Producer Price Index

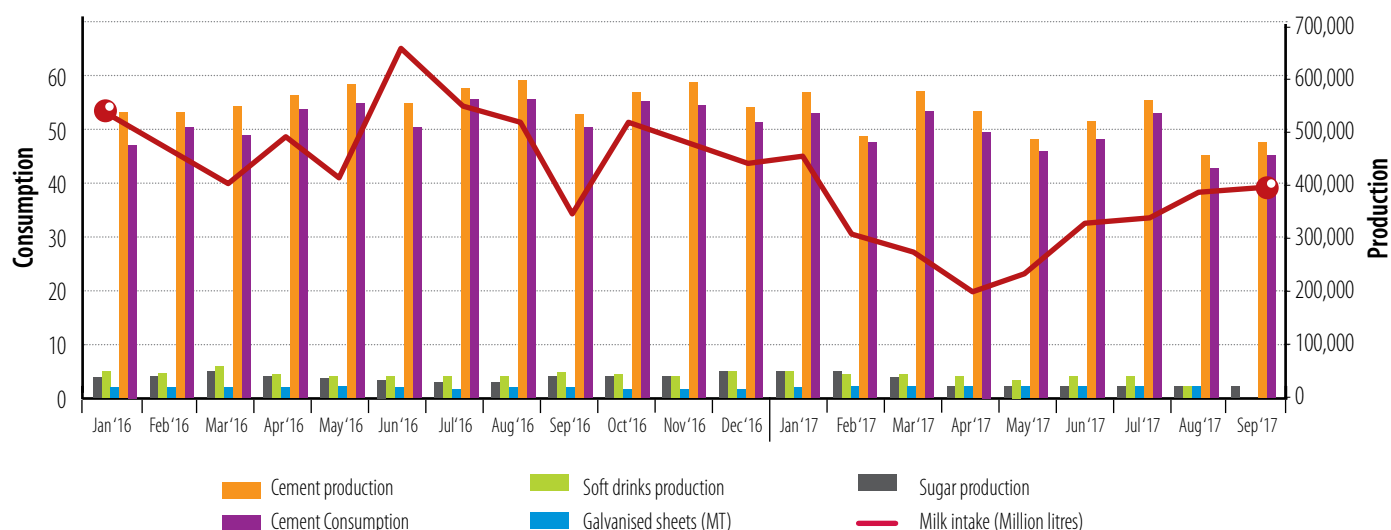


Source: KNBS

231,970 metric tonnes in May to 248,940 metric tonnes in June 2017. However, the increased production in June was thwarted in the third quarter of 2017 and this was mainly attributable to the reduction in cane deliveries from 244,690 metric tonnes in July 2017 to 173,260 metric tonnes in August 2017. This reduction in the sugar cane deliveries to the processing plants could be deemed to arise from a number of reasons, one if the experienced drought in quarter one that could have hurt production. Second is the fact of delayed payments to sugarcane farmers by the processing plants that has demoralized farmers with some opting to quit from sugar cane farming to alternative crops such as maize farming.

Similarly, milk processing registered an increase in the third quarter of 2017 compared to the second quarter. In terms of volume milk processing increased from 41.77 million litres in July 2017 to 46.16 million litres in August 2018 and further to 46.24 million litres in September 2017 and being the highest since February 2017. The increase in milk process is attributed to the rains that started in March.

Figure 13: Production and Consumption of Manufacturing



Source: KNBS



Energy

The cost of energy remains crucial in determining the cost of production in the country as well as an important factor in defining the cost of living. As such, this has seen concerted efforts by the government in pursuit of production of cheap and clean energy overtime. However achievement of this endeavor has not been free of challenges given the high initial cost in

setting up green energy production plant. One of such production in Kenya has been geothermal production which is deemed to be clean and more reliable compared to the hydro production which is weather – reliant though high investment cost. In addition is the wind energy production which is the new form of energy production that the government has ventured in. Despite this, the country has made remarkable strides in increasing the share of the geothermal power production in the total energy production in the past few years.

A review of energy production in the third quarter of 2017 reveals that geothermal production slight improved and continued to top in the energy production matrix and accounted for 48.3 percent compared 46.1 percent of quarter two. Similarly, the production of hydro as a share of the total energy production also increased to 26.2 percent in quarter three as compared to 25.04 percent in quarter two. However, the thermal production was subdued in quarter three with its share in the total energy production in this period being 25.5 percent compared to 28.88 percent during quarter two. As such, we can note that thermal production is fairly inelastic in supply and therefore cannot be relied on in bridging the production gap whenever the hydro production dwindles in the event of harsh weather conditions. The improvement in the hydro production in quarter three of 2017 can be attributed to increased water levels as a result of the rains received in August and September 2017.

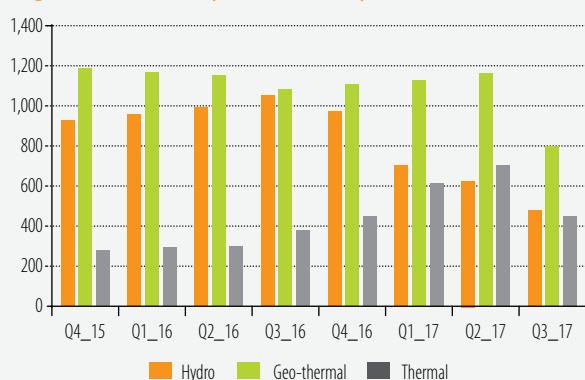
On the international front, the world market crude oil prices were volatile. According to KNBS, the fluctuations in the crude oil prices went above the \$50 mark to stand at \$55.70 in September 2017 up from \$48.85 in

Table 1: Average Monthly Crude Oil and Retail Fuel Prices

	Jan -17	Feb -17	Mar -17	Apr -17	May -17	Jun -17	Jul-17	Aug-17	Sep-17
Murban crude oil (US\$/Barrel)	55.35	56.10	52.60	53.40	51.45	47.30	48.60	48.85	55.70
Super petrol (Kshs/Litres)	96.88	101.14	101.91	99.01	100.48	99.68	98.00	96.98	98.62
Diesel (Kshs/litres)	85.20	90.22	91.39	89.70	89.02	87.95	85.45	86.84	87.40
Kerosene (Kshs/litres)	64.41	68.15	68.93	65.44	66.26	66.04	63.55	64.41	65.33
LPG (13Kgs)	1,989.50	1,976.38	1,998.70	2,063.95	2,104.29	2,112.19	2,073.62	2,080.10	2,094.22

Source: KNBS

Figure 14: Electricity Generation by Source (Million KWh)



Source: KNBS

August 2017. In the international market, the price of Murban crude oil increased from an average of US Dollars 48.85 per barrel in August 2017 to US Dollars 55.70 per barrel in September, 2017.

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. 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. This can be evidenced by the concurrent increase in the pump prices and crude oil prices in September 2017.

Building and Construction

Growth in the construction sector in the third quarter was robust despite being slower than that of the third quarter of 2016 and it continues to be one of the core sectors supporting economic growth. This supported by the fact that the sector remained to be one of the four key sectors that topped in terms of private sector allocation within quarter two of 2017. Given the ongoing physical infrastructure construction, the sector has remained core in supporting the economy given the amount of the resources being



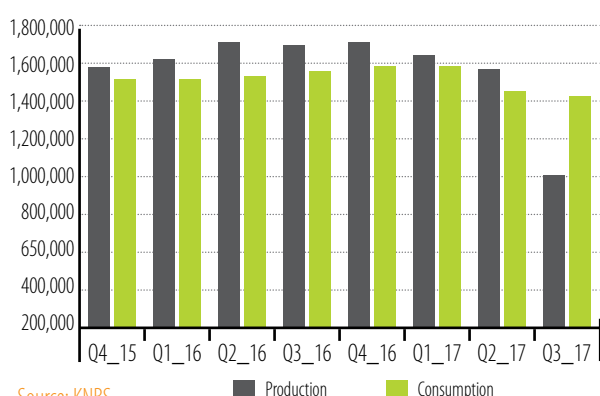
channels to the sector. Gross value added in the sector is estimated to have expanded by 7.5 per cent in the quarter three compared to 7.6 per cent recorded in a similar period of 2016. The sector's performance was mainly driven by the ongoing activities in property development as well as civil works being implemented by the Government. The slowed growth was evidenced by 6.3 per cent decline in cement consumption which is a key input in the sector. Credit to building and construction activities declined by 1.2 per cent, a further reflection of relatively less activity in the sector.

The indicators of growth in this building and construction sector mainly cement production and consumption reveals that during the third quarter of 2017, both the cement production and consumption recorded a decline. Apart from the slowdown in the construction of the major physical infrastructure by the government, the slowdown in the building and construction could also be viewed from the performance in the real estate sector which also offers market for cement, steel among other construction raw materials. First, given the political environment



in quarter three, real estate being a long term investment could have suffered from the adoption of the 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. This could partly explain the reduced cement production within the quarter.

Figure 15: Cement Production and Consumption (MTs)



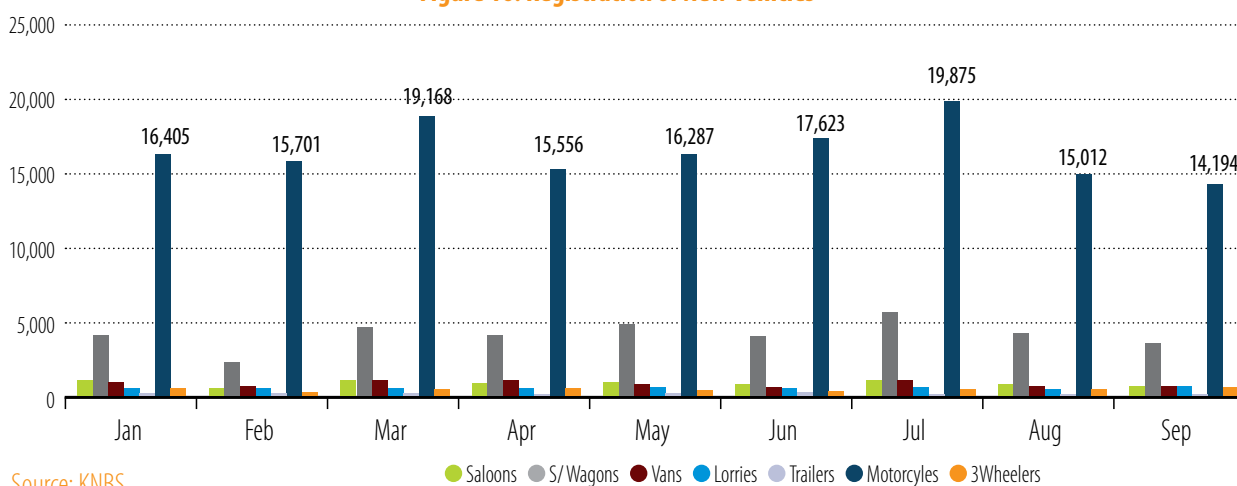
Source: KNBS

Transport and Communication

The total number of vehicles registered decreased to 21,137 in September 2017 from 22,422 in August 2017. Motorcycles and station wagons dominated the share of the types of motor vehicles registered accounting for 67.1 per cent and 17.0 per cent in September 2017, respectively.

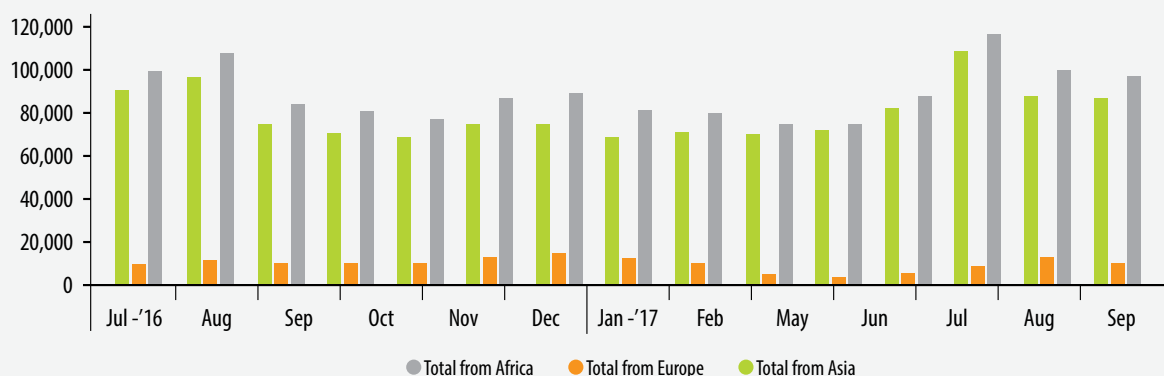


Figure 16: Registration of New Vehicles



Source: KNBS

Figure 17: Trends in Visitor Arrivals (Thousand)



Source: KNBS

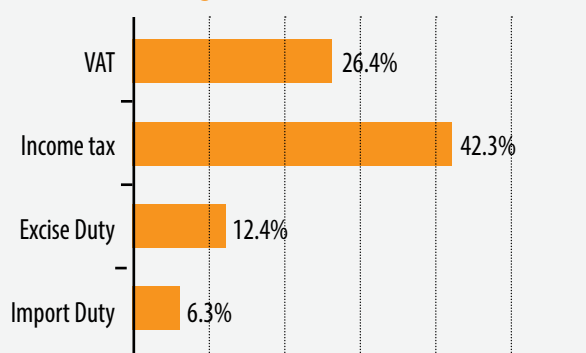
Tourism

In quarter three of 2017, the tourism sector recorded a dip in performance relative to the quarter two of 2017. According to the KNBS, The total number of visitors arriving through Jomo Kenyatta (JKIA) and Moi International Airports (MIA) decreased to 89,782 in August 2017 from 105,241 in July 2017. Similarly, the number of passengers who landed at Jomo Kenyatta International Airport (JKIA) decreased from 179,548 in July 2017 to 179,511 in August 2017, while passengers who embarked decreased from 180,452 persons to 180,400 persons in the same period. The decline in the number of visitors could be somewhat be explained by the political environment as the country waited to enter into the general election.

Arrival of the visitors into the country by port of origin seems to consistent overtime on a quarterly basis. Arrivals from Europe stood at 35.21 percent while arrivals from Africa were second at 36.1 percent and arrivals from Asia stood at 28.66% in August 2018. However compared to the number of arrivals in August was much low compared to arrivals July and this largely being as a result of the reduction in arrivals from Africa by 0.17 percent on a month-on-month basis. Contrary to the wide acclamation that visitors arrival around and during election periods are usually affected especially for visitors outside Africa, arrivals from Europe and Asia increased by 0.22 percent and 0.05 percent respectively.

Financing of Government Expenditure

Figure 16: Tax revenue



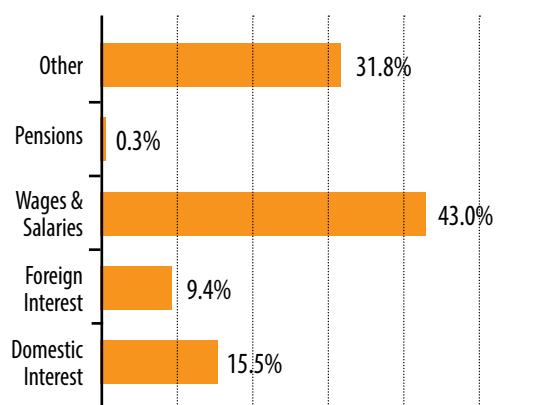
Source: CBK

During quarter three of 2017, the total tax revenue as a share of the total revenue dominated, accounting for 87.71 percent of the total quarterly revenue. For the tax revenue, income tax topped the list at 42.3 percent

followed by value added tax at 26.4 percent with excise duty and import duty coming third and fourth at 12.4 percent and 6.3 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.

The total government expenditure on commitment basis for quarter three of 2017, reveal that recurrent expenditure accounted for 89.3 percent with the development expenditure accounting for 6.4 percent of the total government expenditure. Breakdown of the recurrent expenditure in quarter three indicates that Salaries and wages accounted for 43 percent with domestic interest payment accounting for 15.5 percent. Foreign interest repayments and pension payments accounted for 9.4 and 0.3 percent of the total recurrent expenditure respectively.

Figure 18: Recurrent Expenditure breakdown



Source: CBK

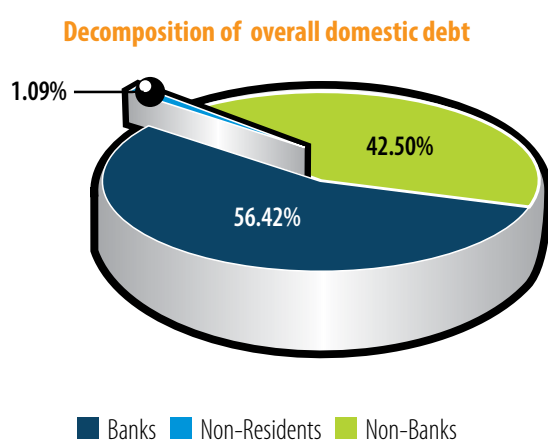
Public Debt

A 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.



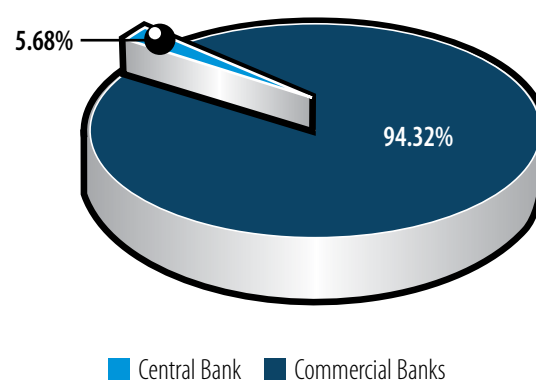
A decomposition of the external debts, multilateral debts accounted for 18.8 percent of the total external debts in July of 2017 followed by bilateral debts at 16.8 percent. Commercial banks accounted for 16.1% percent with export credit accounting for a mere share of 0.4 percent. On the domestic debt stock, banks accounted for 56.42 percent of the total domestic debt with non-banks and non-residents accounting for 42.50 and 1.09 percent respectively. Within the bank's contributions, commercial banks account for 94.32 percent with central bank contributing a mere 5.68 percent. On the domestic debt's contribution from the non-bank sources, pension fund top the list at 64.18 percent with insurance companies and other source accounting for 15 and 21 percent respectively.

Figure 19: Debt composition - Domestic debts



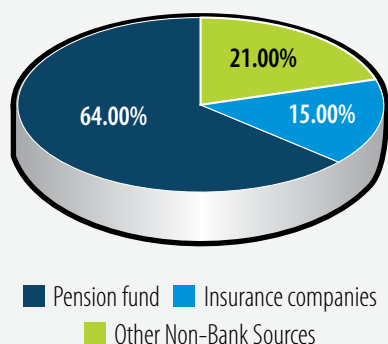
Source: CBK

Decomposition of Bank Contribution to domestic debt



Source: CBK

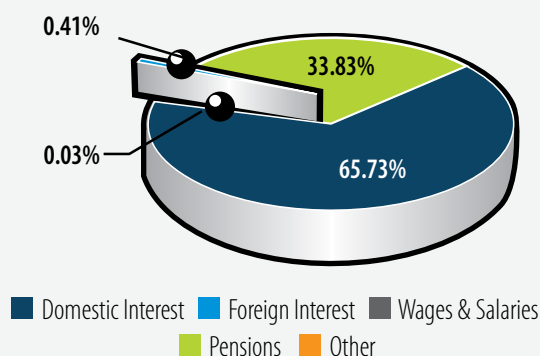
Figure 18: Decomposition of Non-bank Contribution to domestic debt



Source: CBK

On the financing of the government's public debt, government treasury bonds including the government frozen debt accounted for 63.88 percent of the total government domestic debt in quarter three of 2017. Treasury bills, on the other hand accounted for 35.51 percent with advances from commercial banks and other domestic debts accounting for 0.57 percent and 0.03 percent respectively of total government debt during the quarter.

Figure 20: Composition of Domestic Debt

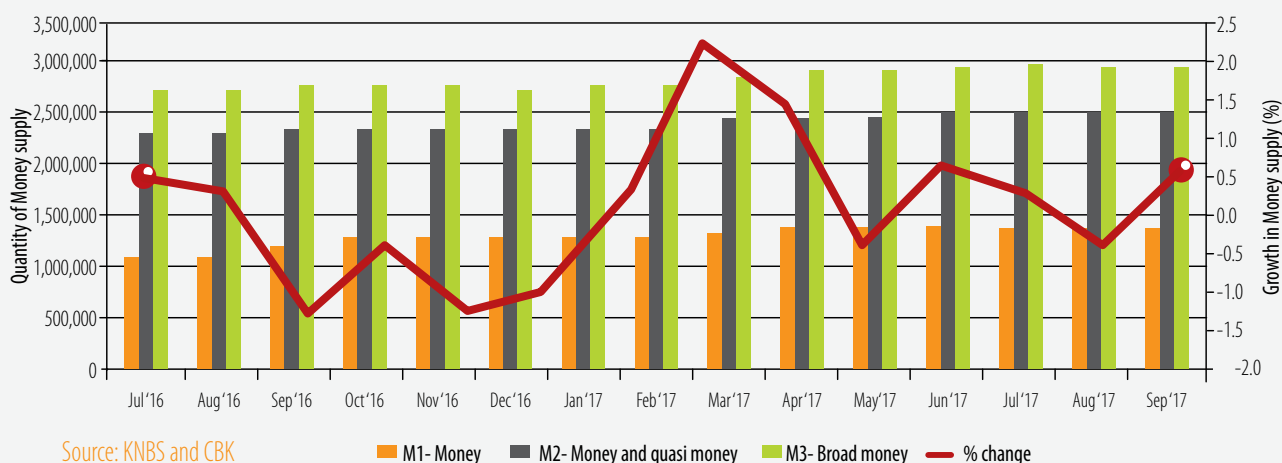


Source: CBK

Money and Credit

During the third quarter of 2017, the monthly total money supply (broad money), a key indicator for monetary policy formulation, recorded a modest positive growth and has relatively stable been relatively stable for the most part of the year. It increased from Kshs 2,957.94 billion in July 2017 to Kshs 2,988.64 billion in September 2017.

Figure 21: Money Supply (Kshs Million)



Source: KNBS and CBK

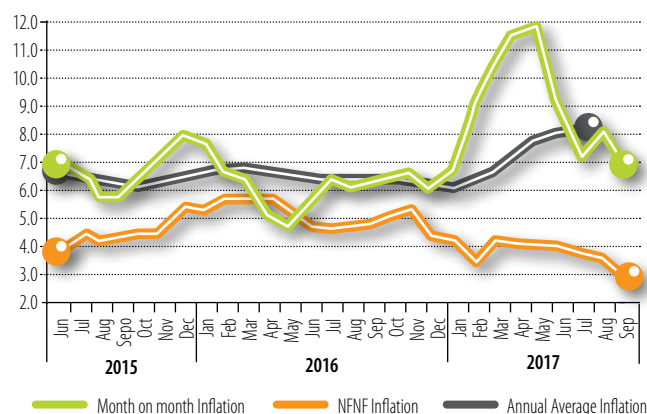


Inflation

The cost of living for the third quarter of 2017 remained slightly above the upper bound of the Central Bank target with the quarterly average inflation rate being 7.52 percent in quarter three of 2017. The high though modest inflation rates was mainly attributed to a number of factors. First is the rise in the food prices following the drought spell experienced in the first quarter of 2017. Further the delay in the setting in and poor performance in the long between March and June 2017 caused the food prices to remain though on the downward trend in the consecutive months within the sector. A review of month – on – month inflation rates in quarter three of 2017 reveals that in line with the monetary policy decision to retain the bank rate at 10 percent, inflation rate was on a decline during the quarter and signals some effectiveness of the monetary policy in anchoring inflation in the economy.

The non – food – non – fuel inflation (NFnF) remained relatively stable in quarter three of 2017 being on a fairly downward trend between quarter one of 2017 and quarter three of 2017. In quarter three of 2017, the average NFnF inflation was 3.83 percent compared to 4.27 percent in quarter two of 2017. Further, looking into monthly NFnF inflation trends within the quarter, demand driven inflation seems muted at best given that the monthly NFnF shown a sense of broad stability in the entire quarter as compared to quarter two of 2017.

Figure 22: Inflation rate (%)



Source: Central Bank of Kenya

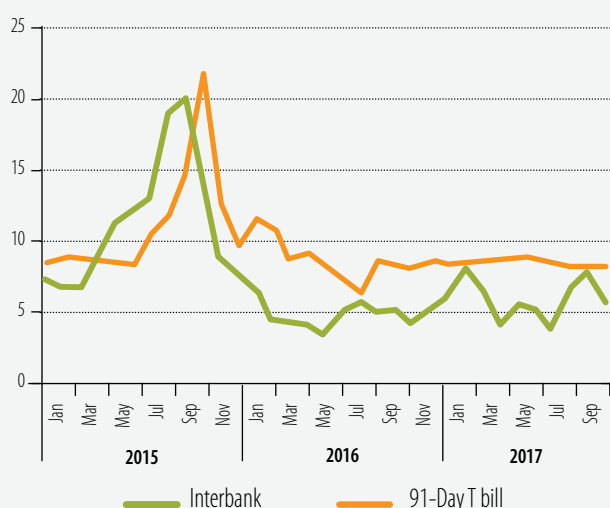
Interest Rates

During the third quarter of 2017 interest rates continued to be fairly stable as was also evident in the second quarter of 2017 mainly attributable. The average yield rate for the 91-day Treasury bills, which is a benchmark for the general trend of interest rates, decreased from 8.22 per cent in July 2017 to 8.19 per cent in August 2017 while the inter-bank rate rose



from 6.84 per cent in July 2017 to 8.12 per cent in August 2017. The short-term interest rates encapsulated by the interbank market rates and the 91-day TB tend to follow a similar path of evolution although with one or two months lag since 2015. However, the trend is reversed in the third quarter especially in the month of August and September where the interbank rates take on a downward trend to hit a low of 5.5 percent at the end of the third quarter. The average interbank rate in the third quarter stood at 6.86 percent being the highest since quarter one of 2017 where it stood at 6.19 percent and 4.75 percent in quarter two, an indication of liquidity constraints in the inter-bank market. On the other hand, the 91-day TB also hit a low of 8.17 percent in the third quarter compared to 8.636 percent and 8.64 percent in the first and second quarter of 2017 respectively.

Figure 23: Interbank rates and 91 Treasury bill rates



Source: Central Bank of Kenya

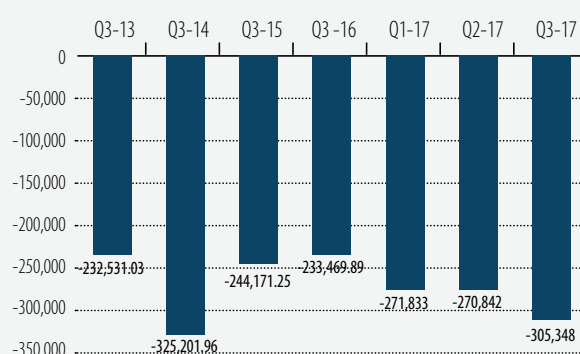
Balance of Payments

According to the KNBS, in the second quarter of 2017, the value of imports increased by 15.5 per cent to Kshs 410.9 billion from Kshs 355.9 billion in the second quarter of 2016, mainly on account of increased bill on imports of food and petroleum products. On the other hand, exports increased by 2.9 per cent to Kshs 150.2 billion in the same period resulting in a 24.2 percent widening of the merchandise trade deficit to 260.8 billion. Similarly, the value of domestic exports rose by 0.6 per cent to Kshs 132.4 billion in the second quarter of 2017 compared to Kshs 131.6 billion registered in a similar period in 2016. This was mainly on account of increased foreign earnings from tea, horticulture, unroasted coffee and titanium ores during the quarter two of 2017.



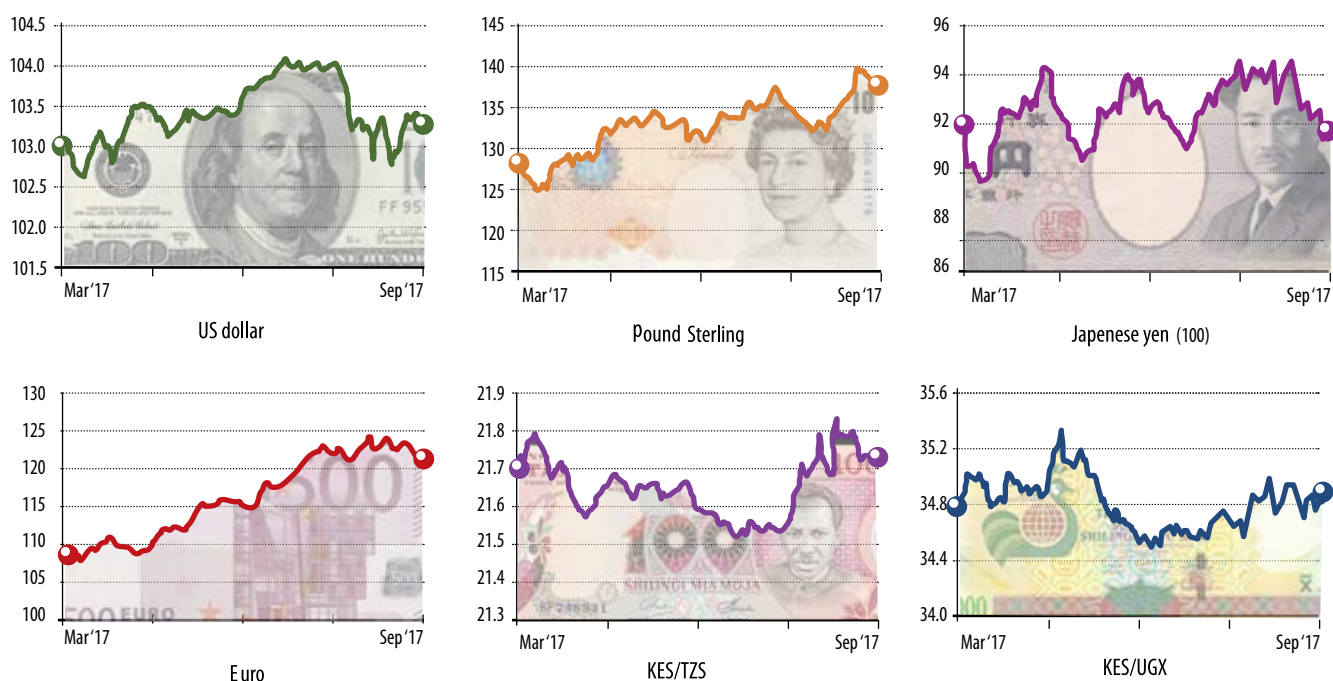
The overall quarterly trade balance has been worsening from Kshs 233,469 million in quarter three of 2016 to Kshs 270,842 in quarter two of 2017. This could be mainly attributed to the massive importation of machinery and transport facilities in wake of continuing major physical infrastructural projects 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. Equally, the trade deficit in August 2017 stood at 112,652 million but reduced to stand at 102,628 million in September 2017. This is could be mainly attributed to the prevailing political environment which saw a reduction in imports during the third quarter of 2017.

Figure 25: Trade balance (Ksh, Mill)



Source: CBK

Figure 26: Nominal Exchange Rate



Exchange Rate

During the third quarter of 2017, the shilling continued to suffer depreciation against the US dollar in July before posting some appreciation in value in the month of August and September though its magnitude of was very low. During the third quarter the shilling against the dollar hit a low of 102.70 and a high of 104.02 mark as indicated by the daily exchange rates. The strengthening on the shilling against

the dollar could be attributed to the reduced speculation on the food importation following the sustained short rains that began in March up until the third quarter of 2017.

Against the Sterling Pound, the shilling posted mixed performance throughout the quarter. This is evidenced by the depreciation of the shilling against the pound in the beginning of the third quarter before later appreciating in the entire of August but later depreciating in the month of September. 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. Equally, the Japanese Yen also posted mixed performance during the entire period of the third quarter. 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, the shilling substantially appreciated against the Ugandan and Tanzanian shilling.

Nairobi Securities Exchange

During the third quarter of 2017 the stock market despite showing improved performance as compared with the previous quarters it experienced mixed performance. The Nairobi Securities Exchange (NSE) 20 share index decreased from 4,027 points in August 2017 to 3,751 points in September 2017, while the total number of shares traded dropped from 640 million shares to 557 million shares during the same period. The total value of NSE shares traded increased from Kshs 16.0 billion in August 2017 to Kshs 16.2 billion in September 2017. Between July and

August the stock market was bullish but in September it was bearish and this is partly due to the political temperatures in the country following the annulment of the 8th August presidential election. Similarly, even though the performance in August was higher compared to that of other periods a number of factors could be attributed to the bearish performance experienced in September 2017. First, investors were afraid of the political events and what the outcome of the fresh elections in September would turn out to be and as such investors were on a wait and see mode with majority of them being risk averse during the month of September as they awaited the outcome of the repeat presidential election.

Table 2: Nairobi Securities Exchange

	2016			2017								
	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
NSE 20 Share Index	3,229	3,247	3,186	2,794	2,995	3,113	3,158	3,441	3,607	3,700	4027	3717
NASI	137	137	133	122	125	131	133	148	153	156	169	163
FTSE NSE Kenya 15	171	170	164	148	149	161	165	186	190	198	.	.
FTSE NSE Kenya 25	165	166	159	142	146	164	170	191	196	205	.	.
Market Capitalization (Kshs Billion)	1,985	1,997	1,932	1,770	1,812	1,894	1,935	2,151	2,224	2,358	2479	2394

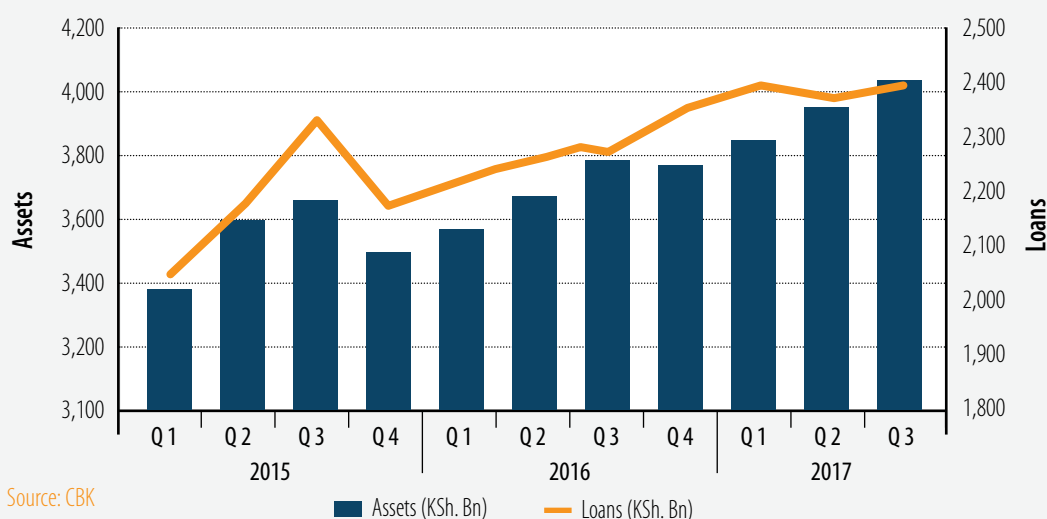
Source: Central Bank of Kenya

Banking Industry Performance

Assets and Loans

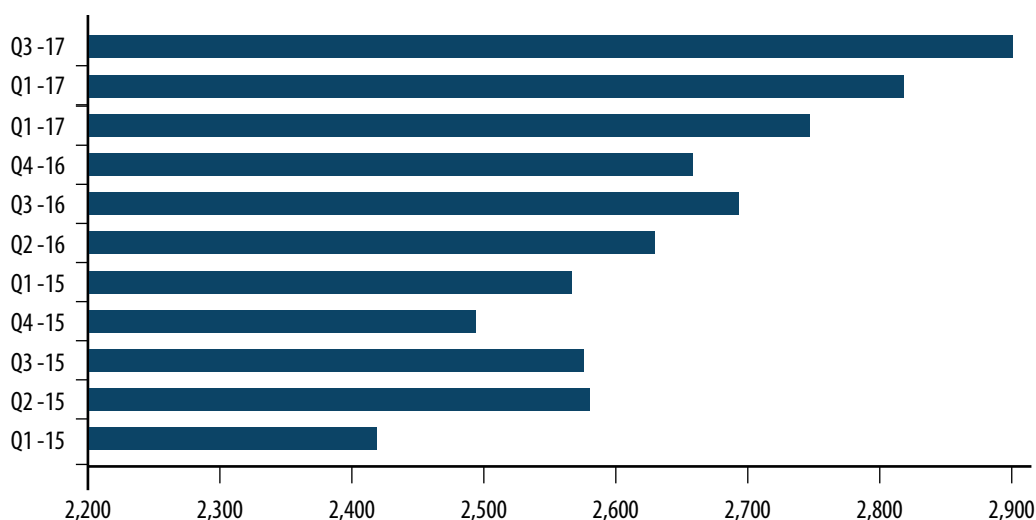
The banking industry's asset base registered a modest growth of 2.1% during the third quarter of 2017 compared to 1.61% growth between quarter one and quarter two of 2017. At the end of the third quarter the bank's asset stood at 4.03 trillion compared to 3.95 trillion as at the end

of June 2017. This modest growth can be as a result of bank's conversion of their liabilities into assets as a result of their come into force of the interest rate capping bill which led to shrinkage in bank lending activities. Similarly, there was a marginal (1.10%) increase in the industry's total gross loans and advances after a dip in the second quarter of 2017 with the loans and advances standing at 2.39 trillion in quarter three as opposed to 2.37 trillion in quarter two of 2017.



Source: CBK

Figure 28: Bank Deposits (Ksh. Bn)



Source: CBK

Bank Deposits

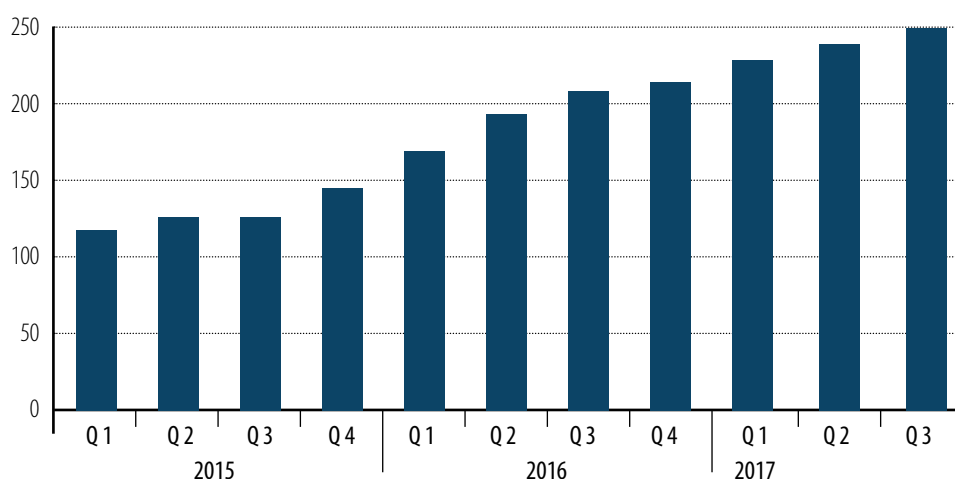
The total deposits in the third quarter of 2017 recorded a positive growth to stand at from Kshs 2.9 trillion in quarter three from 2.85 trillion in the second quarter of 2017. The trend in quarter two of 2017 with regard to deposit mobilization is negation of the trend experienced in quarter four of 2015 and the first quarter of 2016 where the deposits were on downward trend. The deposits in the third quarter of 2017 were the highest of all compared to other quarters since 2015. The increase in bank deposits in quarter three of 2017 can only imply that the preference of holding cash in a bank over holding it in cash at hand was high. This could be an indication that there was lack of better investment opportunities and therefore individuals traded-off for cash deposits at bank. Similarly, the lack of better investment opportunities could be as a result of the fears

that the election outcome may go sour and thus the public held back on investing and due to the uncertainty in the investment environment.

Gross Non-Performing Loans

The ratio of gross non-performing loans to gross loans increased by 6.0 percent between the second quarter of 2017 and third quarter of 2017, this is up from the 234.6 Billion in Quarter two to stand at 249.65 Billion in quarter three of 2017. The increase in gross non-performing loans was mainly attributable to challenges in the business environment that led to cash flow constraints for borrowers. The harsh business environment being as a result of the election jitters in the country related to the august election and the repeat presidential election of October 2017.

Figure 29: Gross Non-Performing Loans (Ksh. Bn)



Source: CBK



Oxford Business Group is a global economic research house and consultancy producing annual investment and economic reports in more than 35 markets.

“The most concise and authoritative guide to business and economics available on emerging markets.”
– ***Newsweek***



ANJARWALLA
& KHANNA



THE INSIDE EDGE
www.oxfordbusinessgroup.com
kenya@oxfordbusinessgroup.com



KENYA BANKERS ASSOCIATION

One Industry. Transforming Kenya.



Kenya Bankers Association

13th Floor, International House, Mama Ngina Street

P.O. Box 73100– 00200 NAIROBI

Telephone: 254 20 2221704/2217757/2224014/5

Cell: 0733 812770/0711 562910

Fax: 254 20 2221792

Email: research@kba.co.ke

Website: www.kba.co.ke