

# KENYA BANKERS ECONOMIC BULLETIN

QUARTER FOUR OF 2017



VOLUME 22

A report prepared by:

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



**KENYA BANKERS  
ASSOCIATION**



CENTRE FOR RESEARCH ON  
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**About this Report**

This *Bulletin* reviews the performance of the Kenyan economy for the Fourth 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.

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## FOREWORD

### From the CEO's Desk



**Dr. Habil Olaka**  
Chief Executive Officer,  
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It is my pleasure to present to you the 22<sup>nd</sup> Issue of the *Kenya Bankers Economic Bulletin*. In this issue, we discuss the state of the Kenyan economy Fourth Quarter of 2017. The *Bulletin* reviews the strides that the economy has made during 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 year were largely reflections on the extended electioneering and its implications on the economy. In the past, elections have been disruptive. The usual focus on how that plays into influencing investor attitudes helps shape the views on the economy in the near term

Therefore the outturn 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. Even as we see the economy emerging from the election period and confidence getting back, cautions optimism should guide the outlook for 2018

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](mailto:research@kba.co.ke).

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



CENTRE FOR RESEARCH ON  
FINANCIAL MARKETS AND POLICY®

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## COMMENTARY

# Riding on Confidence – How Far Can It Take Us?



By Jared Osoro

The beginning of 2018 has been characterised by a sense of optimism, at least in the economic sense. The extent of optimism is varied, swinging from a modest recovery to a drastic swing from the slow down seen in 2017. If one was to take the Central Bank of Kenya's 6.2 percent real growth for 2018 as the exemplar of optimism on the state of the economy, then the question one needs to ask oneself is: what will it take for that stellar growth to be realised?

The answer, I could argue, lies in looking at how far the economy's performance is from its potential – the so-called output gap. Unfortunately not many analysts, even economists, look for answers on economic growth or stability in this direction. Instead the preoccupation is on how the economy is doing better than the global or continental average – which is interesting but not very helpful.

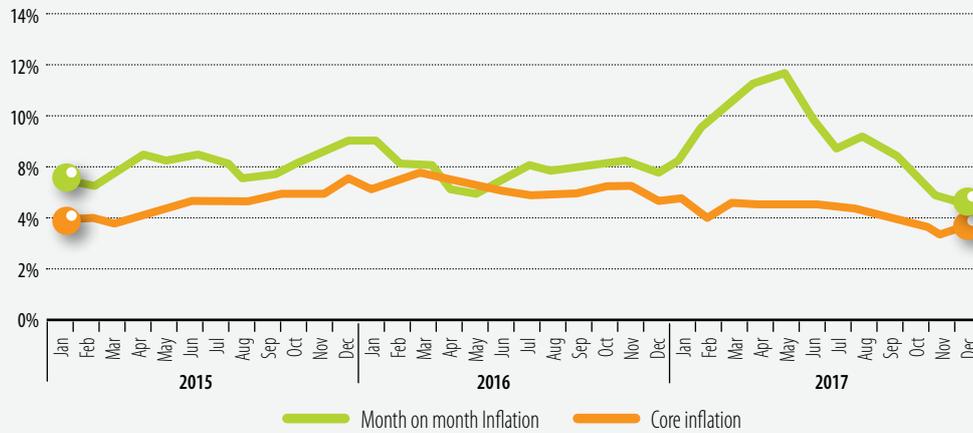
There are a few critical things to appreciate about potential output, which is also referred to as the production capacity of the economy. One is that, just like GDP can rise and fall, the deviation of an economy's output from potential output can be bi directional – it can be positive (meaning that actual output is more than full-capacity output) or negative (meaning that actual output is less than what an economy could produce at full capacity).

Either way, an output gap is a pointer that the economy is running inefficiently – either under stretching or over stretching its resources. While potential output is unobservable, therefore can only be an estimate, there can be telltale signs on whether we are on the negative side or the positive side.

All indications are that we are on the negative side, meaning that there is spare capacity or slack in the economy due to weak demand. This is a picture that you get by looking at the inflation trend over the recent past years (**Figure 1**). The core inflation (also known as the underlying inflation), which excludes food and fuel and therefore signals demand pressure, has been subdued.



**Figure 1: Inflation (%)**



Source: Kenya National Bureau of Statistics

It can only be assumed that our policy makers use potential output to gauge inflation and typically define it as the level of output consistent with no pressure for prices to rise or fall. In that case the output gap is a summary indicator of the relative demand and supply components of economic activity. Accordingly, the output gap measures the degree of inflation pressure in the economy and is an important link between the real side of the economy – which produces goods and services – and inflation.

Ceteris Paribus, if actual output falls below potential output over time, prices will begin to fall to reflect weak demand. But as **Figure 1** shows, the headline inflation has not been consistently low; in instances it has breached the official target and hit double digit levels, largely on account of the challenges on the real side of the economy. It is from here that the second critical issue about output gap – the unemployment gap – stems.

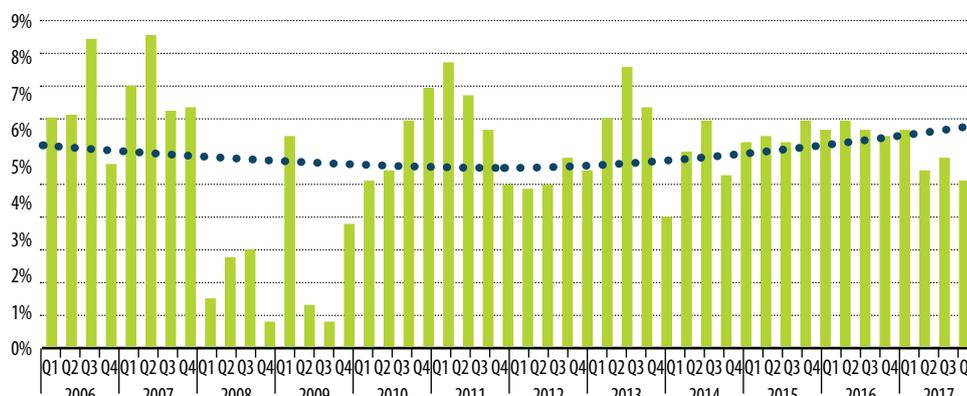
The unemployment gap is a concept that tightly links with the output gap, for both are central to the conduct of monetary and fiscal policies. In order to appreciate this link, one must have an understanding of a situation that economists call the nonaccelerating inflation rate of unemployment (NAIRU). This is the unemployment rate consistent with a constant rate of inflation.

When there are deviations of the unemployment rate from the NAIRU, they point to deviations of output from its potential level. If, for argument sake, policymakers get the actual unemployment rate to equal the NAIRU, the economy will produce at its maximum level of output without straining resources. That will be an economic nirvana – for there will be no output gap and no inflation pressure!





Figure 2: Real GDP Growth



Source: Kenya National Bureau of Statistics

## The Reality Check

But the nirvana in our case can only be imagined but not real. With the slowdown that the economy experienced in 2017 that has led to the estimated rate of output growth dipping to below 5.0 percent, it will take a drastic turn of events for the economy to quickly pick the growth slack and grow above its medium term trend (Figure 1). In the best of circumstances, any anticipated real GDP growth bounce back must of necessity be on the back of four factors.

First, increase private sector investments needs to be on a positive trajectory. When the economy is operating at a negative output gap it implies that firms are generally operating at excess capacity (meaning that their levels of operations are well below installed capacity). Intuitively, the priority of businesses is therefore to beef up capacity utilisation before additional capacity (i.e. investment) becomes a priority.

Second, while the dynamics on the investment side represent the supply side of the equation, there has to be a corresponding demand side response. It is often assumed that a low and stable inflation promotes not just a predictable environment for planning and investment, but enabled households continued consumption that then feeds into investment requirements.

It is important to acknowledge that it is the headline inflation and not the core inflation that is binding on consumers. It is indisputable that the decline in headline inflation from a high of 11.7 percent in May 2017 to the target range, associated largely with food prices, has nothing with

the monetary policy stance. It is purely a supply-side phenomenon, thus monetary policy lacks the appropriate tools for its redress.

The core inflation (which excludes foods and fuel) – and which is not the target given to the CBK – has largely remain low. This signals subdued demand. Does this signal monetary policy success? Not necessarily, especially when you consider that there have been instance (as will be discussed later) when the MPC has attempted to stimulate demand in vain. The economy now finds itself at a corner where demand is subdued and, according to a recent survey, consumer confidence sagging.<sup>1</sup>

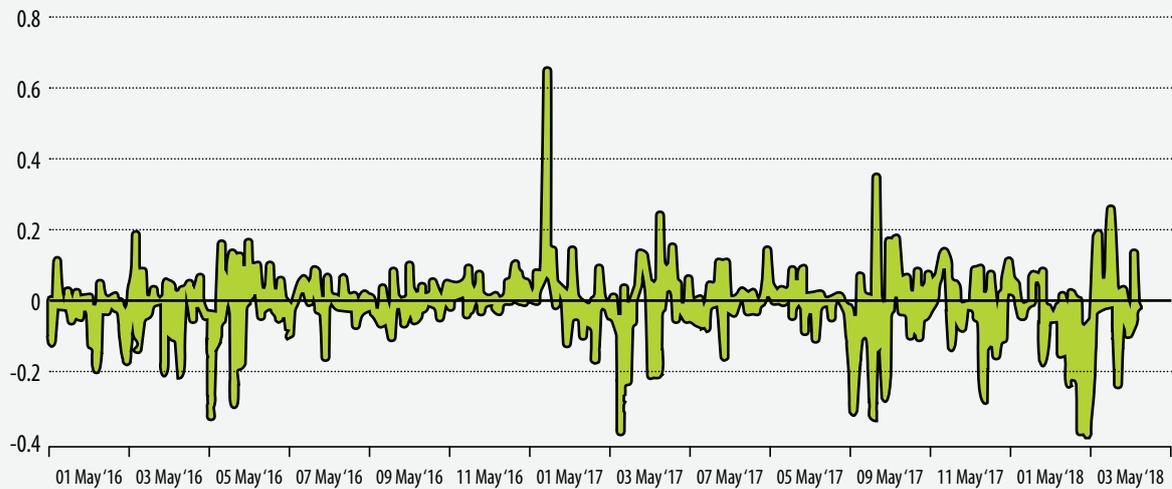
It may therefore amount to a hasty verdict, if one is to conclude that inflation expectations are now well anchored as to justify the though is there being scope for an accommodative monetary policy stance. As we have learned from recent studies<sup>2</sup>, the outlined inflationary story and monetary policy attitude easily portrays diversity of expectations. The anticipation may be that inflation expectations are “CBK- following” – where the outcome is as guided by the MPC pronouncements. The reality however could be that inflation expectations could be taking a “random walk” – as Figure 1 seems to suggest.

Third, there is a real possibility that the largely public expenditure led growth arrangement, which has arguably prevailed for well over two years, has run its full cycle. The typically large fiscal deficit, in instances over an equivalent of 8.0 percent of GDP has been associated with a rapid accumulation of public debt that is now in focus, having more than doubled over the past five years.

1. See <https://africabusinesscommunities.com/africadata/kenyas-latest-nielsen-consumer-confidence-report-indicates-decline/>

2. e.g. Hachem K., and Wu J. K. (2017), “Inflation and Social Dynamics”, *Journal of Money, Credit and Banking*, Vol. 48, No. 8, pp. 1673 – 1714. December.

**Figure 3: Changes in Nominal Exchange Rate( KES/US\$)**



Source: Central Bank of Kenya

That public debt is a matter of concern is in no doubt given that fiscal consolidation is now a compelling policy proposition. Little comfort can, for instance, be taken from the IMF–World Bank Debt Sustainability Analysis (DSA) observation that “Kenya’s risk of external debt distress remains low, while overall public sector debt dynamics continue to be sustainable”<sup>3</sup> while (a) the same institutions are expressing concern on the economy’s debt situation, and (b) the rating agencies are equally expressing concern<sup>4</sup>.

Fourth, the external position is anything but bubbling in health. The closure of the economy’s current account from its double digit deficit levels of GDP equivalent seen five years back to below 6.0 percent by end of 2017 is attributable more to the lower rate of growth of imports value than a vibrancy of exports. It is hardly surprising that the stand-by arrangement with the IMF remains critical<sup>5</sup>. Granted, the local currency has remained largely stable (**Figure 3**) even as on the back of unclearly about the direction the current account will take in 2018.

It will be interesting to see how the current account position of the economy plays out on the back of the rising oil prices in the international markets. While the recovery of the global economy has started gaining traction, the downside risks to the global economy of policy unpredictability – and especially the consequences of the US’ imposition

of new tariffs of 25 percent on steel and 10 percent on aluminium on all trading partners<sup>6</sup> – are worthy taking into account in any viewpoint on the state of the global economy.

### Confidence In Vain

On the back of the arguments above is the notion that confidence on the state of the economy is rising, especially given that the political events of 2018 are behind us. It is noteworthy though that confidence alone will not suffice a rebound is to be realised. Private sector credit must recover from the current level where its growth is a mere crawl.

Confidence cannot be nudged. It must spring from the real incomes of households getting a boost. Hardly is labour cost pass-through effect on inflation part of common conversation, meaning wages are largely subdued. Equally, we seem to be keen to celebrate the output growth numbers without the subject of unemployment being part of the discourse, for inclusive growth could well be merely a buzzword. Unless and until the discussion moves from how well we are doing than peer economies to how we can close the output gap, confidence will be in vain.

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

1. See <https://www.imf.org/external/pubs/ft/dsa/pdf/2017/dsacr1725.pdf>. e.g. Hachem K., and Wu J. K. (2017), “Inflation and Social Dynamics”, Journal of Money, Credit and Banking, Vol. 48, No. 8, pp. 1673 – 1714. December.  
 1. See [https://www.moodys.com/research/Moodys-downgrades-Government-of-Kenya-issuer-rating-to-B2-and-PR\\_379217](https://www.moodys.com/research/Moodys-downgrades-Government-of-Kenya-issuer-rating-to-B2-and-PR_379217)  
 1. See <http://www.imf.org/en/News/Articles/2018/03/13/pr1885-imf-executive-board-approves-6-month-extension-of-the-stand-by-arrangement-with-kenya>  
 1. See <https://piiie.com/blogs/trade-investment-policy-watch/trumps-steel-and-aluminum-tariffs-are-counterproductive-here-are>



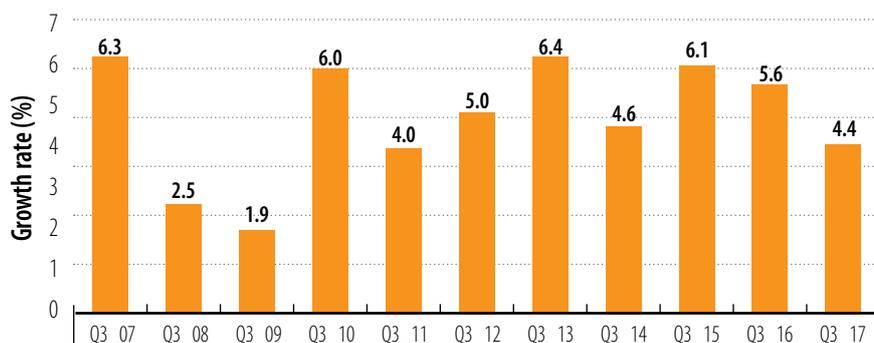
## State of the Economy

During the third quarter of 2017, the economy grew by 4.4 percent a slowdown compared to the growth of 5.6 percent in the same quarter in year 2016. The slowdown in the economic growth in the quarter was to a greater extent attributed to the poor performance in the agricultural sector following the poor performance in the rains. It is noteworthy that the growth of 4.4 percent for quarter three of 2017 was perhaps the lowest recorded growth since the last quarter of 2013. In addition to the poor performance in the agricultural sector other key sectors of the economy remained depressed in their performance. More specifically is the financial services sector the recorded the highest slump to 2.4 percent from a high of 7.1 percent in quarter three of 2016. Slowed growth was also recorded in the manufacturing, health accommodation and food

services, mining and quarrying and education

As such, the economy entered the fourth quarter of 2017 on a weak note with all the key macroeconomic factors essential for growth being weak at best though stable. The financial services sector remained weak on the backdrop of the interest rate capping bill that has seen the financial intermediation role of financial institutions adversely affected. Further, the headwinds from the weakening credit growth due to the introduction of the banking amendment act (2016) and more importantly the spillover effects of increased political uncertainty associated with the annulment of the august general elections continued to significantly weigh down on growth in the economy.

**Figure 4: Quarterly Growth in GDP – 2009 Base Year**



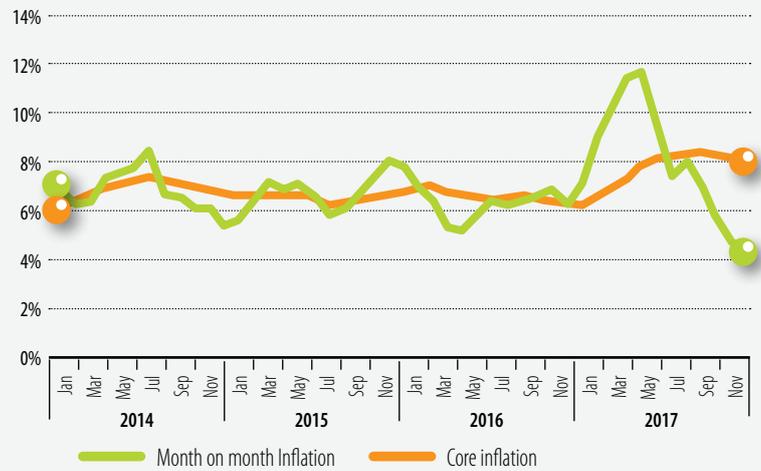
Source: KNBS

A review of the macroeconomic environment on the last quarter of 2017 posit that even though the macroeconomic fundamentals that support growth were fairly stable, they however largely remained weak during the entire quarter. To start with, the cost of living as measured by the inflation rate, we note that the month – on – month inflation rate remained on the lower bound of the Central Bank’s target of 5 percent  $\pm$  2.50 basis points ranging from 5.72 percent in October to 4.73 percent in November and to a lower rate of

Policy reforms to address the slowed credit growth and the existing slack in the economy as indicated by the negative output gap (i.e the difference in the medium-term growth prospect and the recorded level of economic growth), all point to a positive growth outlook over the medium term.

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 four of 2017 on a weak note. The spillover effect of the

Figure 5: Inflation (%)



Source: Kenya National Bureau of Statistics

continued weakening of the economy was also evident in the fourth quarter of 2017. The month-on-month inflation for the fourth quarter also reveals that it inflation rate was relatively stable and within the CBK’s targets rates clearly indicating that at least the CBK’s aim of anchoring inflation expectations in the fourth quarter achieved.



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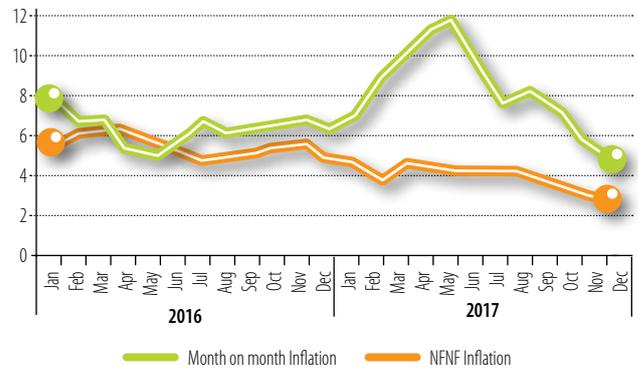
On the credit front, the financial sector recorded a modest growth in the fourth quarter of 2017. In addition, the fourth quarter also recorded a modest growth of 1.13 percent in credit, though compared to total assets this growth remain very mild. On the other hand, the total gross non – performing loans appear to portray mixed trend looking at the month – on – month growth

The forex market, 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 fourth quarter some rebound in the Tanzanian and Ugandan shilling was evident.

The current account similarly has been narrowing down during the year. Looking at the balance of payment in quarter four of 2017 indicates that the current account had narrowed compared to that of quarter four of 2016. 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 led to reduction in the economy's productive capacity and hence reversing the gains recorded in the current account position.

In the fourth 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 other quarters in 2017. The month – on – month headline inflation in the fourth quarter continued to decline. In September 2017, the month-on-month inflation stood at 7.06 percent and stood at 4.5 percent in December 2017. On the other hand the core inflation continued to be relatively stable but with some evidence of reduction during the fourth 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**

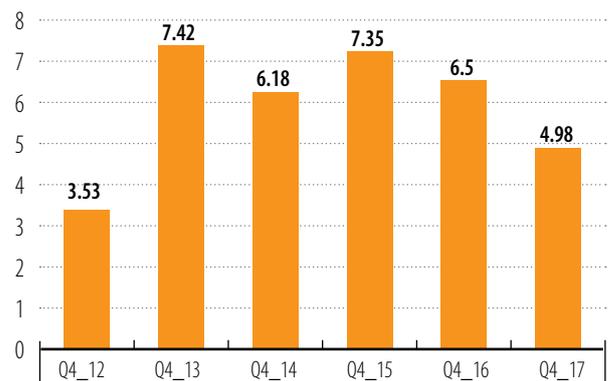


Source: KNBS

Since quarter three of 2017 through quarter four of 2017 the month-on-month inflation and the non-food non-fuel inflation has been on a trend decline an indication that monetary policy's role of anchoring inflation remained on target. The month-on-month inflation during this quarter was within the targets of the Central bank's rate of between 2.5 percent and 7.5 percent threshold.

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 3.8 percent in November and 2.9 percent in December which was the lowest inflation rate ever recorded since 2012.

**Figure 7: Average Quarterly Inflation Rates**



Source: KNBS

## Sectoral performance



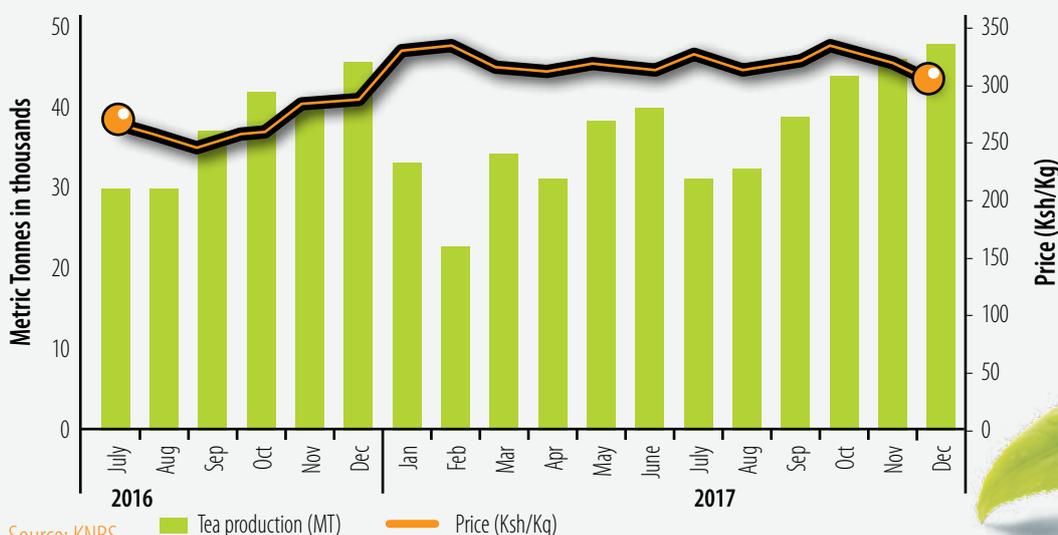
### Agriculture

The agricultural sector over time has remained to be the key driver of economic growth. Despite, the sector being key driver, the performance of the sector in quarter four of 2017 was evidently weak on the back drop of insufficient rains which substantially constrained the supply of the 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 45,374 metric tonnes

in November 2017 to 47,507 metric tonnes in December 2017 thereby reducing the effect of underperformances of the other sub-sectors on the overall growth of the sector. Despite, the increased production of tea the auction prices dropped from Kshs 316.27 in November 2017 to Kshs 308.62 per kilogram in December 2017.

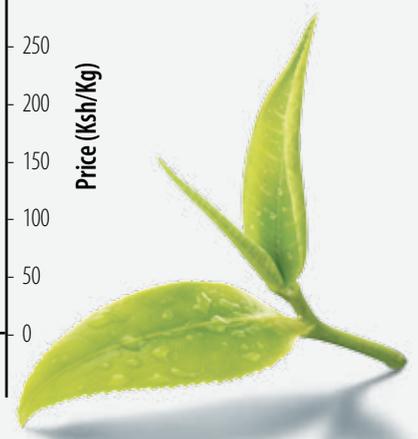
It is notable that the structure of the economy in terms of reliance on the primary agricultural products still remains. In addition, the agricultural cash crop exports of tea and coffee continue to be vibrant, commanding

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



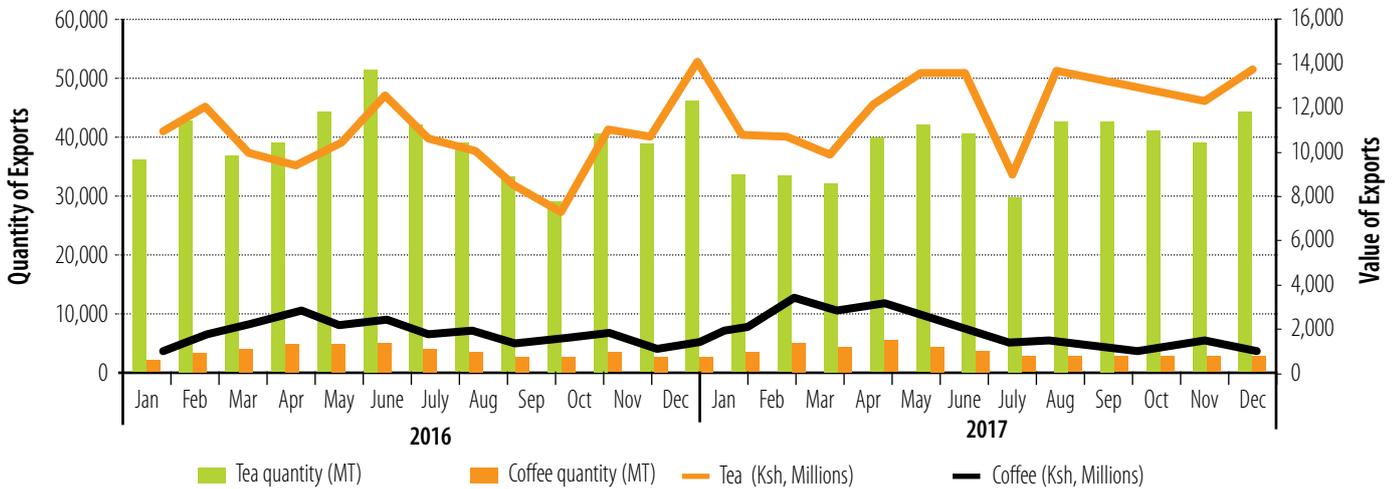
Source: KNBS

■ Tea production (MT)    — Price (Ksh/Kg)





**Figure 9: Value of Tea and Coffee Exports**



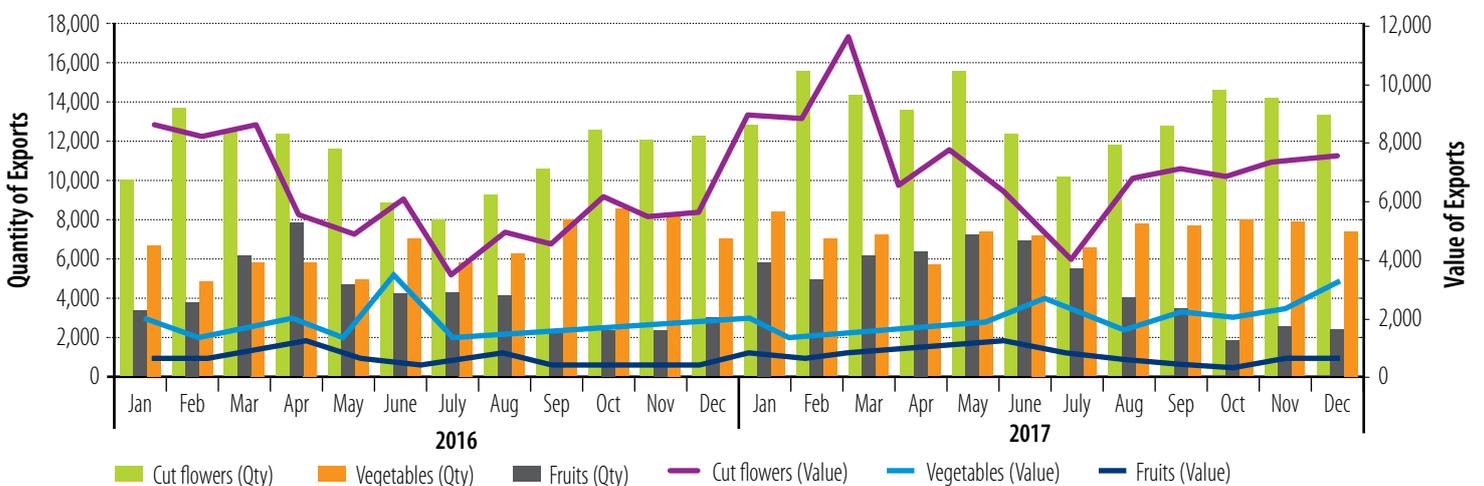
Source: KNBS

a big proportion of the economy's export structure. The dominance of tea and coffee in exports seems to be a phenomenon that is likely to exist for time given the reliance of the economy on agricultural primary products. The exports of coffee since quarter two of 2017 has been on a decline with exports of tea recording mixed performance but the fourth quarter of 2017 show signs of recovery. The quantity of tea decline from 41,173 Metric Tonnes in October 2017 to 39,128 metric tonnes in November but rose to 44,413 metric tonnes in December 2017 a pattern that seems consistent with the observed pattern in quarter four of 2016. The increased tea exports are attributed to the widening of market destinations of Kenyan

tea as indicated by the increased export volume of tea.

In the fourth quarter of 2017 horticultural exports showed signs of recovery compared to the pattern observed in quarter three of 2017. The exports of cut-flowers continued to dominate this sub-sector, a trend that has been persistent over time. The cut-flowers export in the fourth quarter of 2017 contributed to 59.7% of total production in October and 57.7% in November. It was followed by vegetables at 32.1% and lastly exports of fruits at 10.3%.

**Figure 10: Horticultural Exports**



Source: KNBS



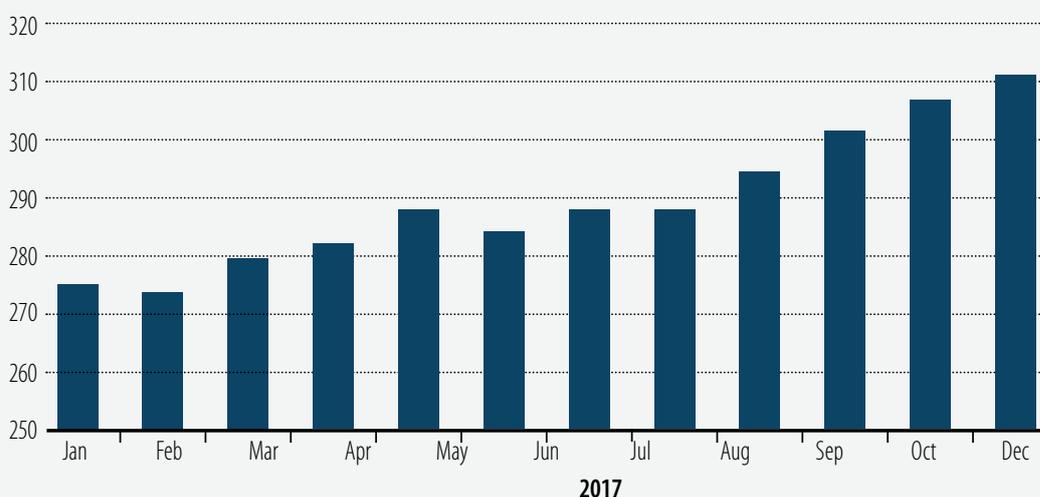
## Manufacturing

During the second 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 four contrary to what was recorded in quarter three 2017 showed slight improvements and this was mainly due to slight increase in credit to the 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

**Figure 11: Bank lending to manufacturing sector**





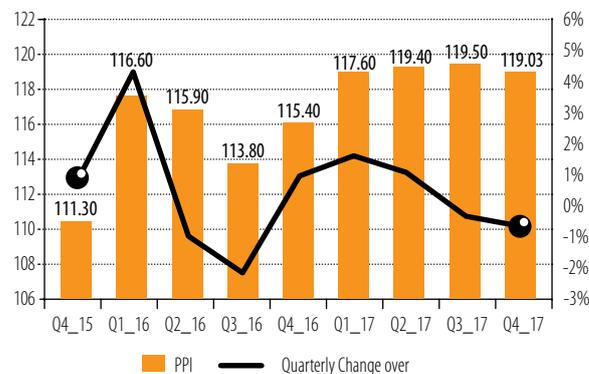
start of the rising in the credit advanced to the sector could be explained as a result of credit portfolio allocation with the manufacturing sector being a beneficiary at the expense of other sectors considered as more risky. As such, the manufacturing sector enters into a cohort of sectors that command 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 economy.

## Producer Price Index

The producer price index rose by decreased by 0.41 per cent from 119.52 points in the third quarter to 119.03 in the fourth quarter of 2017. From **Figure 13** it is noticeable that the index and the change has been on a downward path between the third quarter for 2017 and the fourth quarter. According to Kenya National Bureau of Statistics, during the fourth quarter of 2017, the decline in the producer price index was mainly driven by the decline in producer prices of food products, electricity and manufacture of other non-metallic mineral products declined during the period. However, the producer prices of furniture, fabricated metal products increased.

In quarter four of 2017 sugar production recorded tremendous growth. Its production increased from 32,296 Metric tonnes in October 2017 to

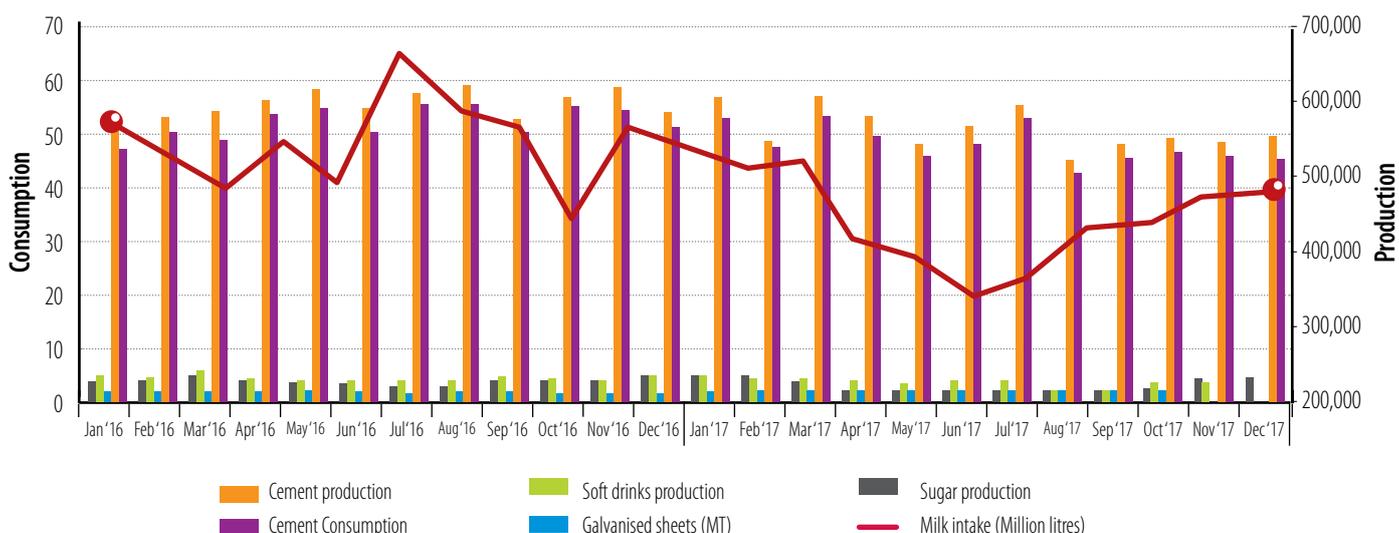
Figure 13: Producer Price Index



Source: KNBS

49,240 Metric tonnes in December 2017 representing a 52.5% growth compared to 21.1% growth between July and September of 2017. This increase in sugar production is attributed to increase cane deliveries from 452,810 metric tonnes in October to 521,650 metric tonnes in December 2017. Unlike in the quarter three of 2017 where sugar production showed slight improvements, sugar production in quarter four of 2017 continue to show a trend increase. Milk consumption in quarter four of 2017 continued to increase, milk intake in the formal sector rose from rose from 47.49 million litres in October 2017 to 47.79 million litres in December 2017.

Figure 12: Production and Consumption of Manufacturing



Source: KNBS

## Energy

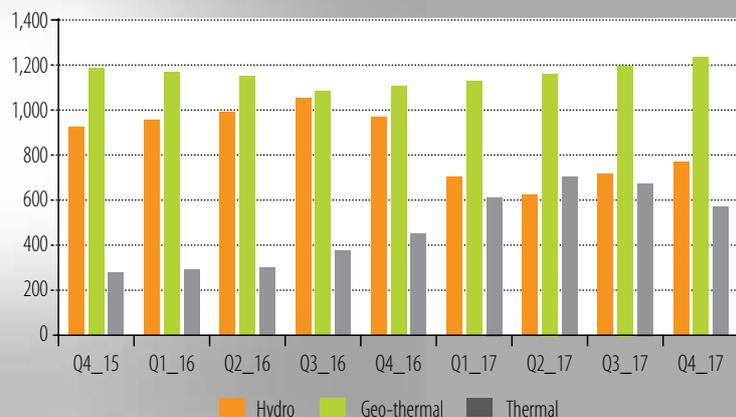
With the cost of energy remaining critical in the determination of the cost of production and living, there have been concerted efforts by the government towards production of cheap and clean energy overtime. Despite the significant progress in energy production, this has not been short of challenges as the sunk costs of setting up green energy are substantial. In addition is the wind energy production which is the new form of energy production that the government has ventured in. Despite the huge sunk investment costs of energy production, 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. Since quarter four of 2016 there has a rebound in geothermal production rising from 1,219.3 megawatts in quarter three to 1263.7 million megawatts in quarter four of 2017 topping in the energy production matrix. Similarly, the production of hydro as a share of the total energy production also increased to 772.56 megawatts in quarter four as compared to 683.33 megawatts in quarter three. On the other hand, thermal energy production remained subdued since quarter two of 2017 declining from 644.12 megawatts in quarter three to 562.17 megawatts in quarter four of 2017. 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 two 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 oil prices continued to decline reaching US Dollars 62.06 in December 2017, the lowest during Quarter four. The price of Murban crude oil decreased from an average of US Dollars 63.83 per barrel in October 2017 to US Dollars 62.06 per barrel in December, 2017. On the domestic front, the pump prices continued to gain an upward momentum, which is an indication of the high correlation between the international and domestic oil prices. The domestic retail oil prices of Super petrol rose from Kshs 101.09 per litre in October 2017 to Kshs



**Figure 14: Electricity Generation by Source (Million KWh)**



**Table 1: Average Monthly Crude Oil and Retail Fuel Prices**

	Mar-17	Apr-17	May-17	Jun-17	Jul-17	Aug-17	Sep-17	Oct-17	Nov-17	Dec-17
<b>Murban crude oil (US\$/Barrel)</b>	52.60	53.40	51.45	47.30	48.60	48.85	55.70	63.83	63.65	62.06
<b>Super petrol (Kshs/Litres)</b>	101.91	99.01	100.48	99.68	98.00	96.98	98.62	101.09	103.58	105.04
<b>Diesel (Kshs/litres)</b>	91.39	89.70	89.02	87.95	85.45	86.84	87.40	88.43	93.37	93.41
<b>Kerosene (Kshs/litres)</b>	68.93	65.44	66.26	66.04	63.55	64.41	65.33	67.12	72.20	72.39
<b>LPG (13Kgs)</b>	1,998.70	2,063.95	2,104.29	2,112.19	2,073.62	2,080.10	2,094.22	2,140.47	2128.59	2,141.46

Source: KNBS



105.04 per litre in December 2017. The price of diesel oil increased to retail at Kshs 93.37 in November 2017 up from Kshs 93.41 in December 2017. The average price for Kerosene rose to retail at Kshs 72.39 in December 2017 up from 72.20 in November 2017. The price of a 13-Kg cylinder of gas averaged Kshs 2,141.46 in December 2017.

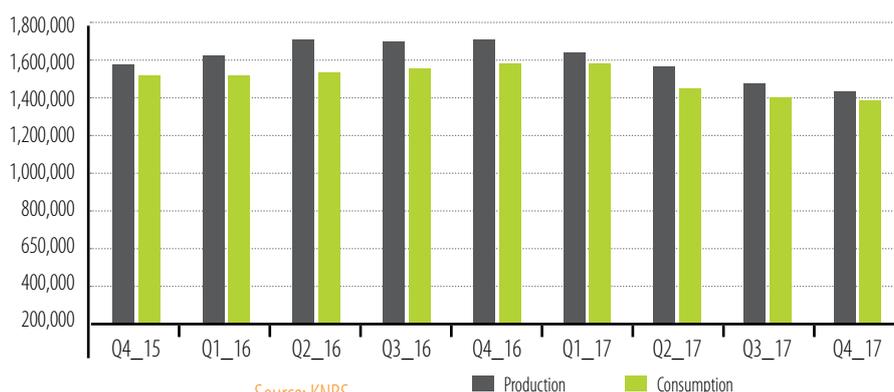
## Building and Construction

In the fourth quarter of 2017, the construction sector continued to be robust though with slight dip in the performance compared to the third quarter. Nonetheless, it remains to play a pivotal role in supporting economic growth and development. More importantly the sector will continue to be key in driving the economy given that the big four agenda being pursued by the government bangs on the delivery of affordable housing. The ongoing infrastructural projects will also play out a big role in enhancing the sector's contribution to economic growth.

The indicators of growth in this building and construction sector mainly cement production and consumption reveals that during the fourth quarter of 2017, both the cement production and consumption recorded a decline as was also the case in quarter four of 2017. The sector's dismal 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 a decline in cement production from 498,374 MT in October 2017 to 494,518 MT in November, 2017 as well as the consumption of cement from 477,047 MT to 459,868 MT during the same period.

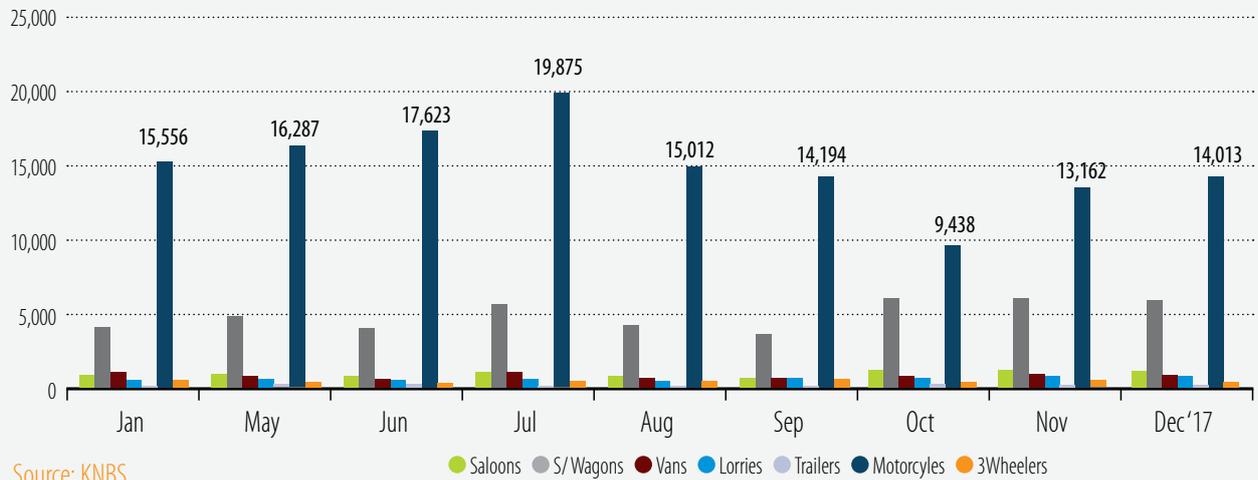
Credit to building and construction activities declined by 1.2 per cent, a further reflection of relatively less activity in the sector.

**Figure 15: Cement Production and Consumption (MTs)**



Source: KNBS

**Figure 16: Registration of New Vehicles**



## Transport and Communication

The total number of vehicles registered increased to 23,264 in December 2017 from 22,954 in November 2017. Motorcycles and station wagons dominated the share of the types of motor vehicles registered. With 14,013 motorcycles and 5,800 station wagons were registered during the month of December 2017.

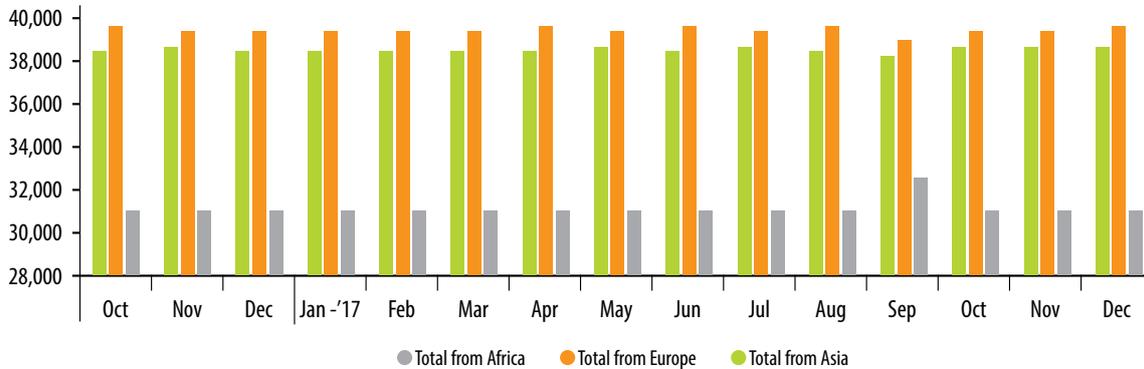
## Tourism

The tourism sector in quarter four of 2017 recorded a dip in performance relative to the quarter three of 2017 though a month-on-month statistics revealed an increase in the number of tourist arrivals. According to the KNBS, the total number of visitors arriving through Jomo Kenyatta (JKIA) and Moi International Airports (MIA) increased to 105,862 in December





**Figure 17: Trends in Visitor Arrivals (Thousand)**



Source: KNBS

from 72,573 in November 2017. Similarly, the number of passengers who landed at Jomo Kenyatta International Airport (JKIA) increased from 227,465 in November to 273,558 in December 2017, while passengers who embarked also increased from 132,116 persons to 152,691 persons in the same period.

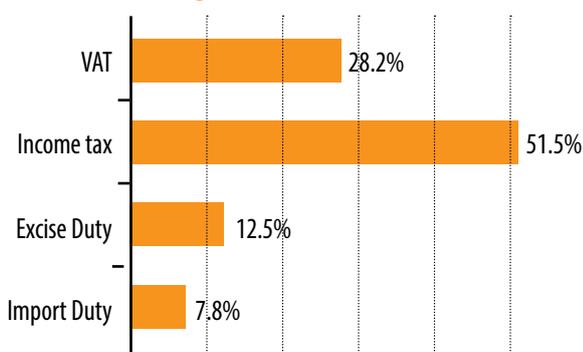
Arrival of the visitors into the country by port of origin seems to consistent overtime. Arrivals from Europe in December 2017 stood at 36% while arrivals from Africa were second at 35% and arrivals from Asia stood at 28%. The numbers of tourist arrivals in December were however low compared to arrivals November as a result of a marginal reduction in the number of tourist arrival from Europe and Asia.

## Financing of Government

During quarter four of 2017, the total tax revenue as a share of the total revenue dominated standing at 87.2% while non-tax revenue stood at 12.8%. On the sources of tax revenue, income tax topping the list of tax revenue at 51.5 percent followed by value added tax at 28.2 percent with excise duty and import duty coming third and fourth at 12.5 percent and 7.8 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.

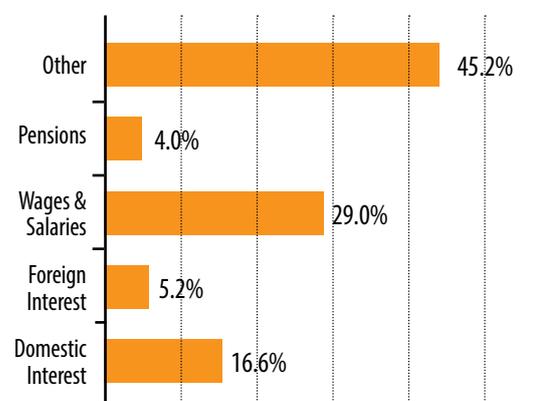
In quarter four of 2017, the total government expenditure on commitment basis shows that the recurrent expenditure stood at 77.7% which is a decline compared to 89.3% in quarter three of 2017. On the other hand, development expenditure rose marginally to stand at 22.3%. Breakdown of the recurrent expenditure indicates that Salaries and wages accounted for 29.0 percent, domestic interest payment accounting for 16.6 percent while foreign interest repayments and pension payments accounted for 5.2 and 4.0 percent of the total recurrent expenditure respectively.

**Figure 18: Tax revenue**



Source: CBK

**Figure 19: Recurrent Expenditure breakdown**



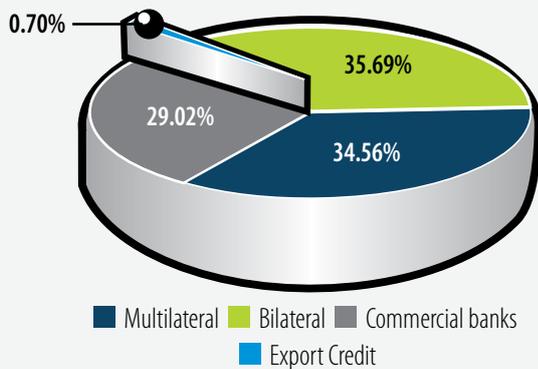
Source: CBK

## 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.

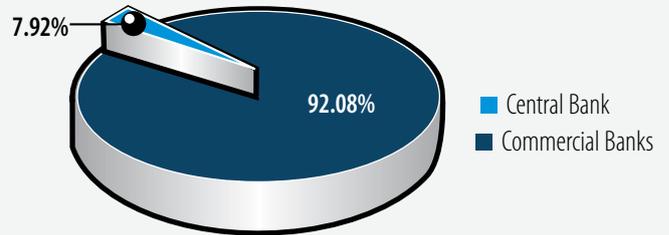
Of the external debts, multilateral debts accounted for 35.69 percent of the total external debts in quarter four of 2017 followed by bilateral debts at 34.56 percent. Commercial banks accounted for 29.02 percent with export credit accounting for a mere share of 0.70 percent. On the composition of domestic debt stock by held by banks, commercial banks accounted for 92.08 percent of the total domestic debt with central bank accounting for 7.92 percent of the total debt held by banks. The proportion of the domestic debt held by non – banks, pensions fund accounted for 62.81 percent with insurance companies and other non – bank holders accounting for 14.66 and 22.53 percent respectively.

**Figure 20: Decomposition of external debts**



Source: CBK

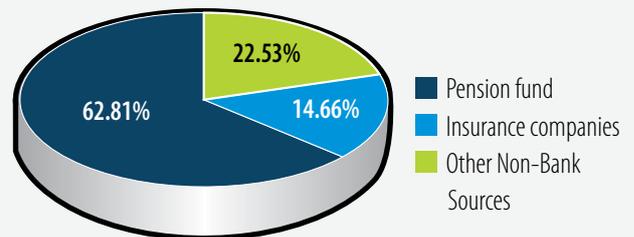
**Figure 21: Composition of Domestic debts by bank holder**



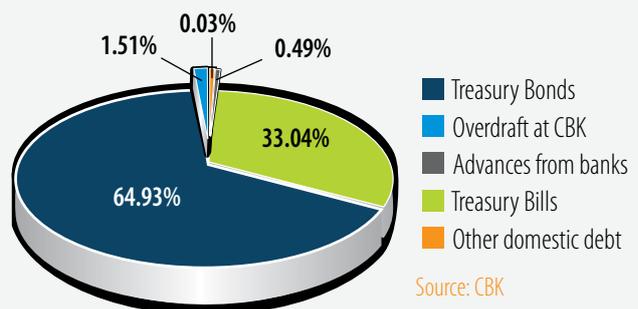
Source: CBK

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 four 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 22: Composition of Domestic debts by non – bank holder**



**Figure 23: Composition of Domestic Debt**

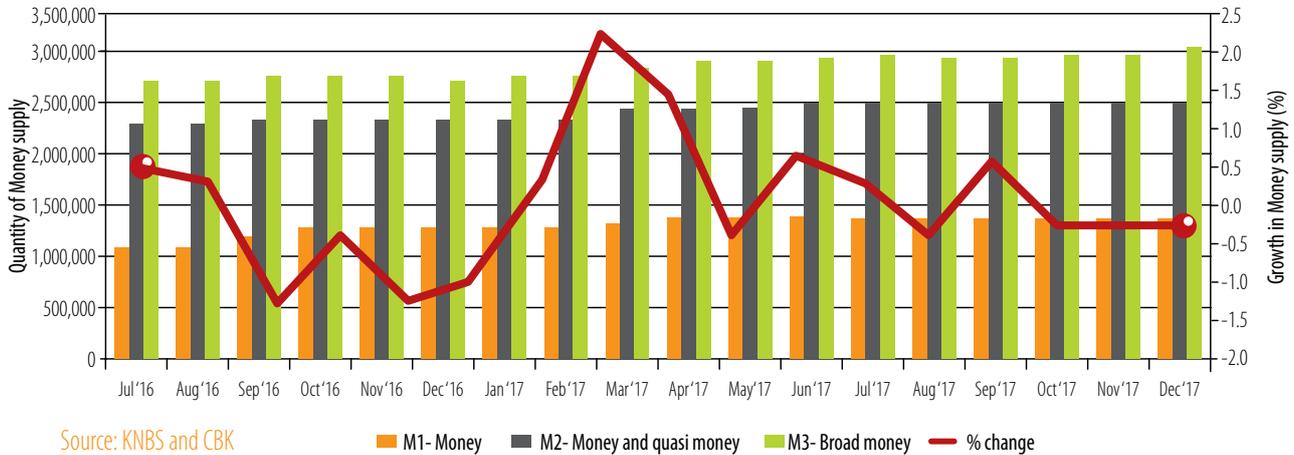


Source: CBK





**Figure 24: Money Supply (KES Million)**



Source: KNBS and CBK

■ M1- Money ■ M2- Money and quasi money ■ M3- Broad money — % change

## Money and Credit

During the fourth quarter of 2017, the monthly total money supply (broad money), a key indicator for monetary policy formulation, recorded a modest positive growth and has been relatively stable for the most part of the year increasing from KSh 2,987.90 billion in October 2017 to KSh 3,028.10 billion in December 2017.

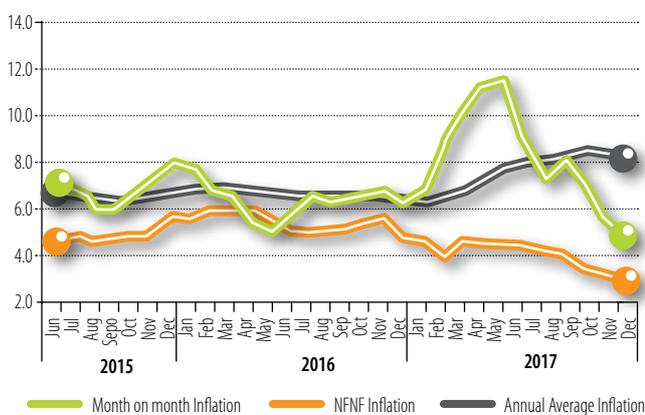
## Inflation

The cost of living for the fourth quarter of 2017 remained within the targets of the Central Bank.

A review of month – on – month inflation rates in quarter four 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. Looking at the year – to – year basis, inflation rates is rather on a downward trend and stood at reveals that the annualized inflation rates rose significantly as at 7.98 percent in December compared to annualized inflation rate of 8.33 percent as at the end of October 2017.

The non – food – non – fuel inflation (NFNF) remained relatively stable in quarter four of 2017 being on a fairly downward trend.

**Figure 25: Inflation rate (%)**

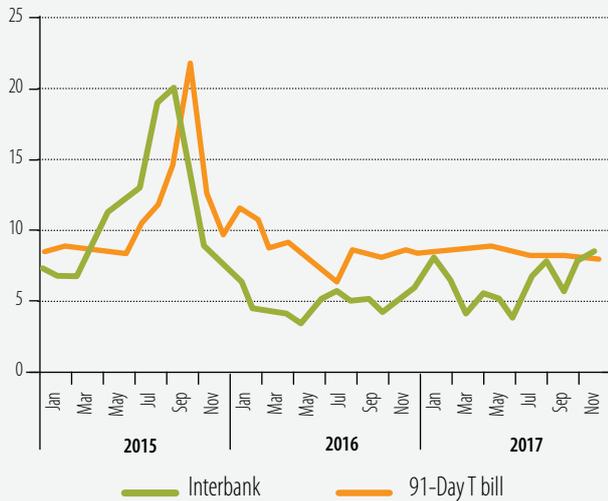


Source: Central Bank of Kenya

## Interest Rates

During the fourth quarter of 2017 interest rates continued to be fairly stable. The average yield rate for the 91-day Treasury bills, which is a benchmark for the general trend of interest rates, was constant at 8.01 percent in November and December 2017 while the inter-bank rate dropped from 8.86 per cent in November 2017 to 7.27 per cent in December 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. The average interbank rate in the fourth quarter stood at 8.13 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 8.03 percent in the fourth quarter compared to 8.636 percent and 8.64 percent in the first and second quarter of 2017 respectively.

**Figure 26: Interbank rates and 91 Treasury bill rates**



Source: Central Bank of Kenya

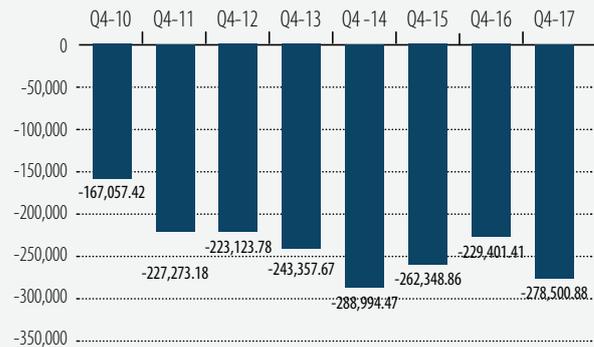
## Balance of Payments

According to the KNBS, in the fourth quarter of 2017, the volume of trade rose from Ksh 189.03 billion in November 2017 to Ksh 191.12 billion in December 2017. Specifically, the value of total exports decreased to Ksh 49.31 billion in December 2017 with food and beverages being the main export category accounting for 48.40 per cent of exports, while non-food industrial supplies and consumer goods not elsewhere specified accounting for 24.21 per cent and 24.65 per cent of the value of total domestic exports respectively. On the contrary, the value of imports rose from Ksh 138.15 billion in November 2017 to Ksh 141.81 billion in December 2017. A decomposition of the imports in the last quarter of 2018 indicates that Machinery & other capital equipment; fuel and lubricants; and transport equipment constituted 16.40, 18.44 and 9.64 per cent, of the total value of imports, respectively. Imports of food and beverage recorded a share of 14.87 per cent of the total imports while consumer goods not elsewhere specified recorded a share of 8.42 per cent

The overall quarterly trade balance worsened in the last quarter of 2017 to exceed the trade deficit of the last quarter of 2015 and 2016. A year – on – year analysis indicates that the trade deficit increased by 21.40 percent between the fourth quarter of 2016 and the fourth quarter on 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. In addition the disruption in production following the unfavorable political environment in 2017 could

have contributed to more import to bridge the gap in reduced domestic production in 2017.

**Figure 27: Trade balance (Ksh, Mill)**



Source: CBK

## Exchange Rate

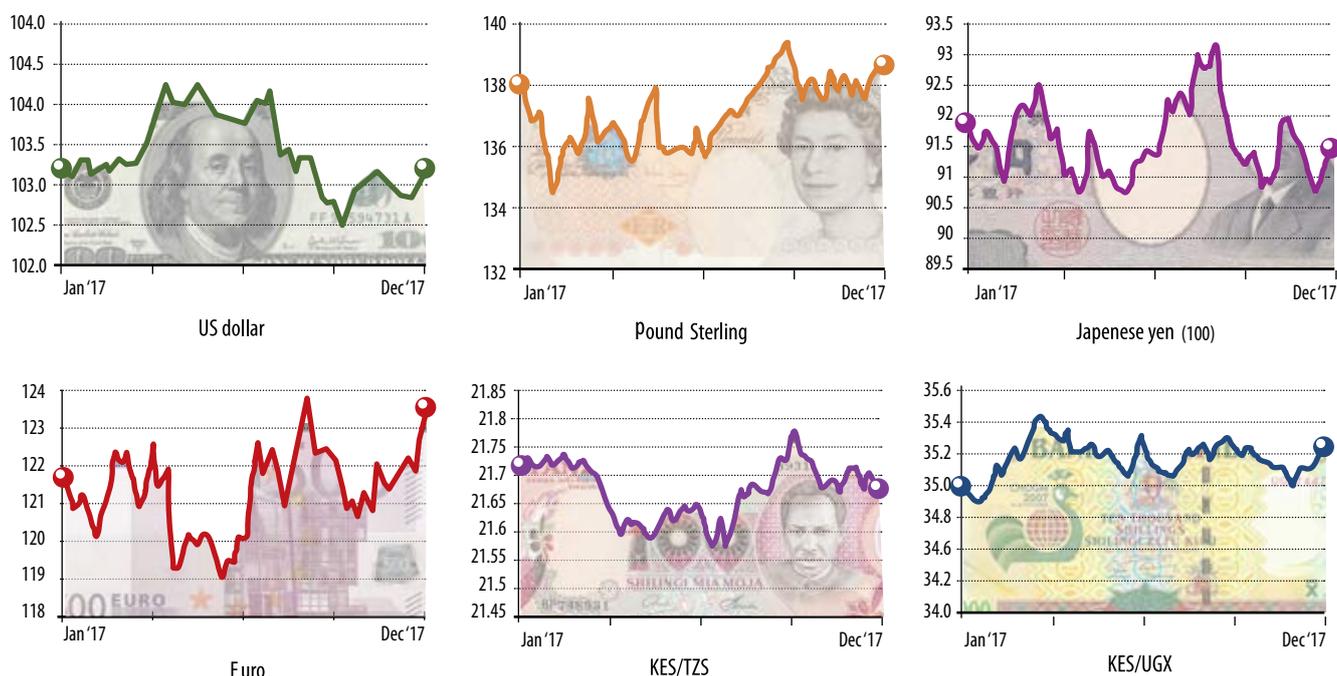
Exchange rates showed mixed performance in quarter four of 2017. The USD/Kshs. showed mixed performance in this quarter depreciating in the month of October, stabilizing in November and generally appreciating in December. This is due to the reduced investor confidence in the country following the uncertain political environment. Nonetheless, the dollar weakened towards the end of the quarter following a dissipation of the high political temperatures in the economy which eventually saw more inflows of investments.

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





**Figure 28: Nominal Exchange Rate**



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

Unlike the third quarter of 2017, the stock market performance in the fourth quarter recorded improved performance as evidenced by different measures of stock market. The NSE 20 share index and the all share index recorded an improvement between October and December 2017 as evidenced in Table 2.0. Similar, the all share index improved from 162 points to close at a monthly average of 171 points as at the end of December 2017. In terms of market participation between foreign and external traders, the market performance indicate that the percentage average foreign participation to equity turnover is in favour of the foreign traders who command more than half of trading in the entire of quarter four of 2017. Therefore compared to quarter three of 2017, a bullish behavior was evidenced in the stock market in quarter four of 2017 as opposed to the bearish behaviour which existed in quarter three of 2017.

**Table 2: Nairobi Securities Exchange**

	2017											
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
NSE 20 Share Index	2,794	2,995	3,113	3,158	3,441	3,607	3,700	4027	3717	3,730	3,816	3,711
NASI	122	125	131	133	148	153	156	169	163	162	173	171
Equity Turnover (Ksh. Mill)	12,054	12,579	12,461	11,409	16,348	17,144	21,304	16,024	16,248	9,390	14,760	11,867
FTSE NSE Kenya 25	79.81	73.37	76.85	72.41	63.40	57.94	49.14	57.05	55.69	72.41	56.69	64.75
Market Capitalization	1,770	1,812	1,894	1,935	2,151	2,224	2,358	2,479	2,394	2,373	2,562	
(Ksh Billion)	1,770	1,812	1,894	1,935	2,151	2,224	2,358	2,479	2,394	2,373	2,562	2,521

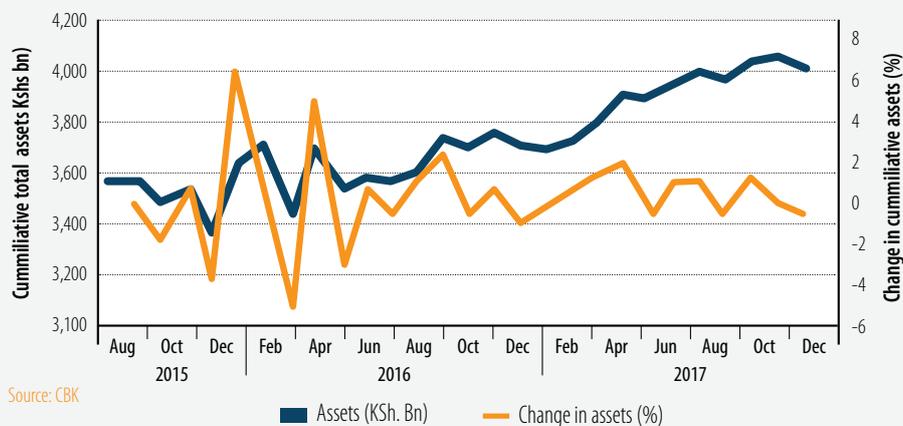
Source: Central Bank of Kenya

## Banking Industry Performance

During quarter four of 2017, the performance of the banking industry remained depressed: - a similar performance experienced in quarter three of 2017. This is evidenced by the key performance indicators of the industry namely: the total assets, total gross loans and advances, gross non – performing loan and gross deposits. The depressed performance in the industry is certainly attributed to the enactment of the interest rates capping law that has hampered the financial intermediation role of the

banking industry and consequently straining the banks in conversion of their liabilities into assets. It can be noted that from the **Figure 29**, the trend in the changes in assets perfectly mimics the trend in the changes in the gross loans thus speaking to the relationship between banks' assets and liabilities that is hinged on the banks' conversion of the bulk of liabilities (deposits) into bulk of assets (Loans and advances).

**Figure 29: Banks' Total Assets**



Source: CBK

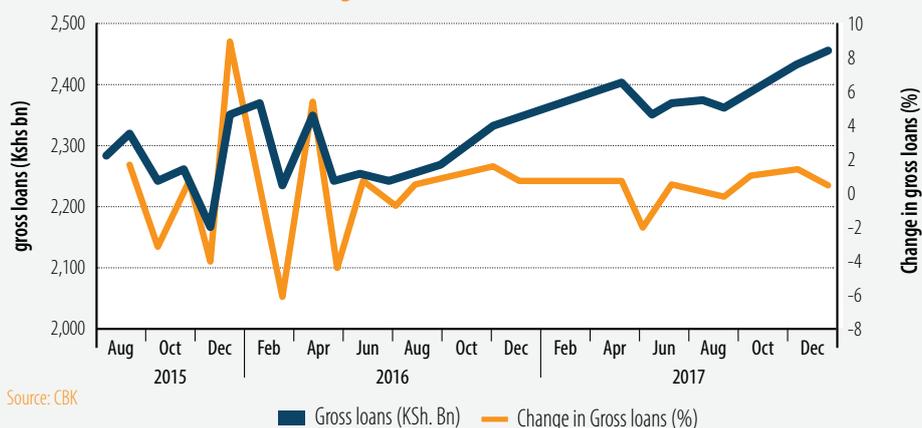
### Total Assets of banking industry

During quarter four of 2017, the performance of the banking total assets marginally increased compared to quarter three of 2017. From **Figure 29** We note that a major decline in the total industry's assets was recorded on December 2015 and May 2016. This could be attributed to the placement of Dubai, Imperial and Chase bank under receivership. A month – on – month comparison reveals that in the month of November 2017, the total industry's assets fell by 0.39 percent compared to October 2017. This implies that the total assets stood at Ksh. 4,020.70 billion in November

compared to 4,036.40 in October 2017. This reveals the depressed conversion of banks' liability into assets as well as the slowdown in the credit creation process as evidenced by the slow growth in the private sector credit by banks in the wake on interest capping. A mild recovery is reported in December 2017 with the total assets rising to Ksh. 4,051.80 billion.

On the total gross loans and advances, the results indicate that similar trend is observed as for the case of total assets especially on the largest downswings appearing between December 2015 and May 2016 upon the placement of Dubai, Imperial and Chase bank into receivership.

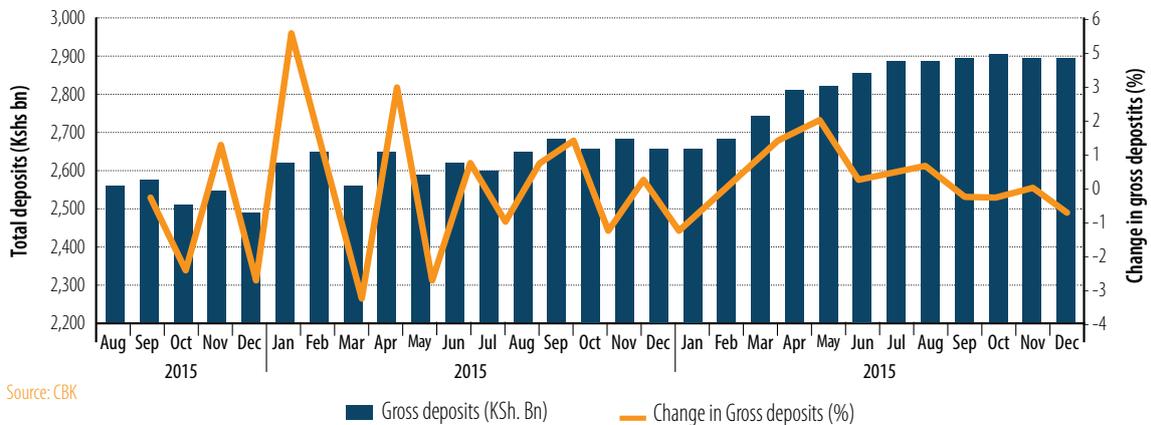
**Figure 30: Banks' Total Assets**



Source: CBK



**Figure 31: Bank Deposits (Ksh. Bn)**



Source: CBK

However, we note that on month – on month basis, an upward surge in total gross loans though mild is recorded from the month of September a trend that seems sustained till December 2017. Between October 2017 and December 2017, total gross loans grew by 1.62 percent. However, comparing this to total assets we note that this growth remain very mild in translating into a significant growth in the industry’s total assets base.

## Bank Deposits

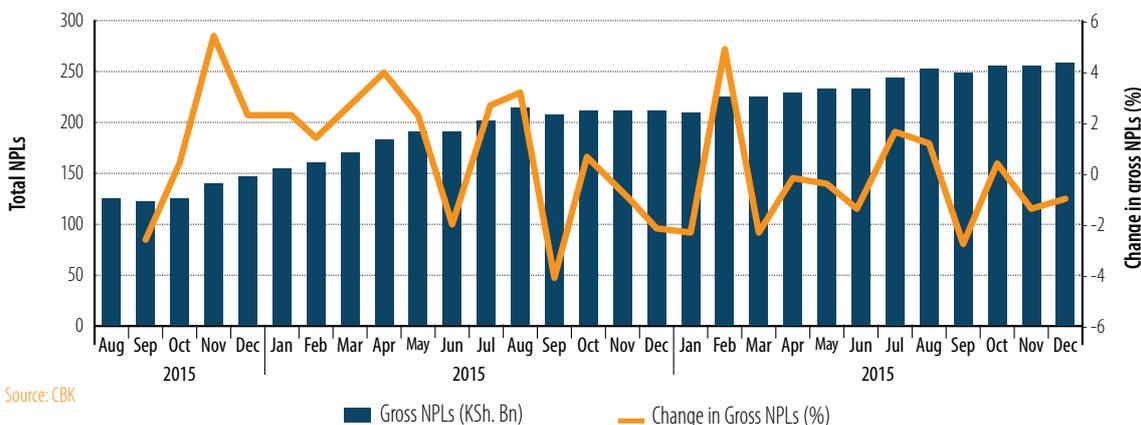
Since the beginning of quarter four of 2016 the banking industry’s deposit base has registered positive growth of 1.28 percent between October and December. Month – on Month data reveal that the industry’s total deposits has been on decline since April 2017 through with mild recoveries in July and October 2017 as portrayed in **Figure 31** This trend speak to the banks’ appetite towards deposit mobilization. The most certain explanation to this trend perhaps lies in the introduction of interest floor on deposits that came into effect upon the implementation of interest capping. The simple explanation of this scenario is that with the

reduced lending by the commercial banks that arises from their inability to price risk objectively in the wake of interest capping, the banks are most probably reluctant in mobilizing deposits that have cost on their end given that they are required to pay an inters of 7 percent per annum on such deposits.

## Gross Non-Performing Loans

The total gross non – performing loans appear to portray mixed trend looking at the month – on – month data in **Figure 32** however, trying to relate the levels of non – performing and the gross lending elicit an exciting finding that the rise in the total lending does not necessarily imply the rise in the bad loans/defaults. Bad loans recoded in the current month may actually be spill over of loans advance in previous quarters that exceed one month within which the loan was advanced. This founding therefore rules out the possibilities of one – on one match between current month NPL and the previous month’s lending assuming that the loans behind to be repayable in the immediate successive month.

**Figure 32: Gross Non-Performing Loans**



Source: CBK



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