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KENYA BANKERS ASSOCIATION

CENTRE FOR RESEARCH ON

FINANCIAL MARKETS AND POLICY®

About this Report

This *Bulletin* reviews the performance of the Kenyan economy for the First Quarter of 2018, 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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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®

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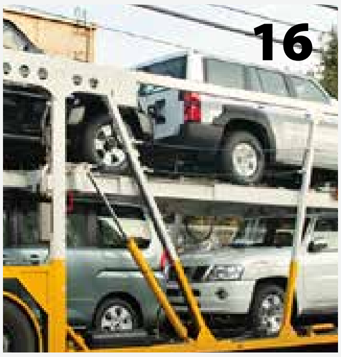


FOREWORD

From the CEO's Desk

Dr. Habil Olaka
Chief Executive Officer,
Kenya Bankers Association

It is my singular pleasure to present to you the twenty third volume of the *Kenya Bankers Economic Bulletin*. Like previous issues the *Bulletin* discusses the state of the Kenyan economy, 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.

It is noteworthy that the decline in the rate of real output growth of 2017 has largely been seen as a one-off jolt to an otherwise relatively good performance of the economy. It needs to be acknowledged, as the *Bulletin* does, both local and international circumstances need to be carefully considered to obviate any rosy 2018 outlook being merely aspirational.

It is my hope that you will find this issue of the *Kenya Bankers Economic Bulletin* interesting and useful. As always, we welcome feedback on the content of this Bulletin as we continually seek to improve its relevance to you.

Further, we are be happy to consider for publication incisive commentaries on topical issues of interest to the banking industry. For guidelines on submission requirements, please get in touch with the Bulletin's Editor at ***research@kba.co.ke***.

COMMENTARY

Positivity about Economy as Essential as Vigilance on the Downside Risks

By Jared Osoro

There is near unanimity that the performance of the economy in 2017 was the weakest we have seen in the recent past – at least over the past five years. The fact that the economy has been on a stable or positive growth trajectory hardly blinds us of the fact that the core driver has been public sector investments, mainly in infrastructure.

Unlike growth driven by private sector vibrancy, especially if it is characterised by investments, a public expenditure-led growth injects vulnerabilities to the economy if – even for no other reason – it yields debt accumulation. No wonder the recent public vigilance on public debt, as could be inferred from popular commentary, is signal pointing to a possible danger of distress.

It takes more than a cursory commentary to conclude that the space for pumping up more debt slack is getting thinner by the day. Instead, the private sector has more slack to pick up more debt; but credit is flowing in the opposite direction as two of our recent studies confirm[1].

That businesses are operating at excess capacity seems to be almost the norm. The sequencing of private credit recovery will start with working capital financing until optimal capacity utilisation is achieved that will usher demand for investments credit. How then will output growth break the slow pace of 2017 and pick to 5.5 in real terms in 2018?

The answer lies in the global, regional and domestic circumstances being attuned to a positive trajectory. Let us start with the global picture. The International Monetary Fund's World Economic Outlook (WEO) of April 2018 is the closes we can get of a Bobby McFerrin's *"Don't Worry, Be Happy"* posture. According to the WEO[2], the global economic upswing that commenced around mid – 2016 is now broader and stronger. Advanced economies, says the WEO, are expected to continue to expand above their

1. See and KBA Working Paper No. 17 (here: http://www.kba.co.ke/downloads/WPS%2018.pdf) and KBA Working Paper No. 19 (here: http://www.kba.co.ke/downloads/WPS%2019.pdf)
2. See IMF – WEO, April 2018 (here: http://www.imf.org/en/Publications/WEO/Issues/2018/03/20/world-economic-outlook-april-2018)

potential growth rate over the next two years. Emerging and developing economies on their part will realise increased growth before it levels off.

The report hastens to add though that can only make global growth more durable if policy makers are proactive, thus potentially obviating the next downturn. But as is the case in any good projection that must be buttressed by assumptions whose reasonableness has to be validated, the IMF's WEO didn't have to wait long before a revision was effected in July 2018. The message now while the global economy's growth is still strong, it is less even, more fragile, and under threat.

Economies in the euro zone, Japan, and the United Kingdom have experienced slow growth. Even in the US where output continues to grow faster than potential and job creation is still robust thanks in large part by recent tax cuts and increased government spending, the long cyclical recovery will run its course and the effects of temporary fiscal stimulus will wane. All these are not the critical pain points. Where then should there be vigilance?

The potential pain

One are of potential pain is the policy direction of the Federal Reserve, an institution that is critical in is global financial developments. Going by the strong US employment and firming inflation, the Fed is likely to sustain its interest rates hiking over the next two years; its monetary policy stance is likely to be tighter than that of other advanced economies.

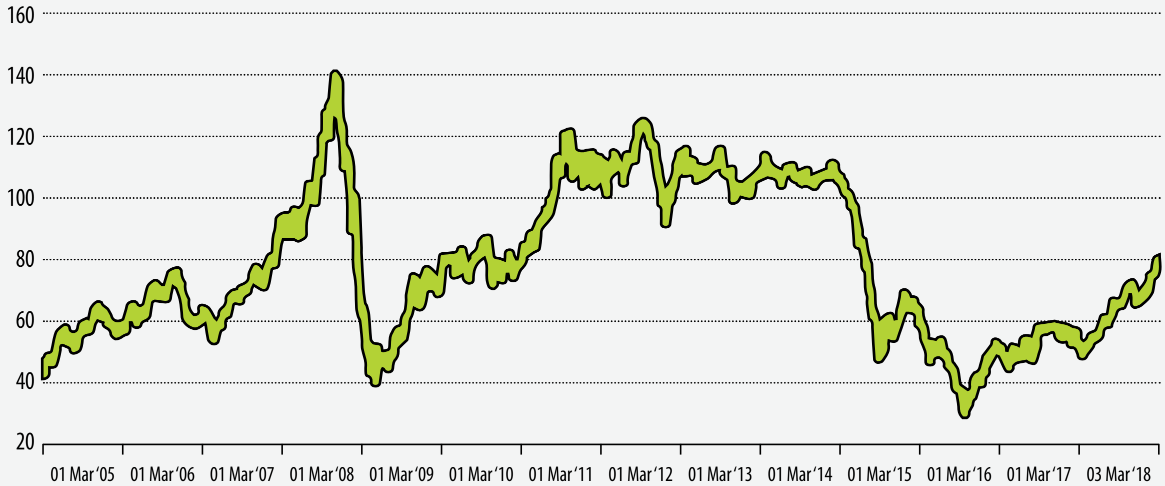
One effect of such policy move will be the strengthening the US dollar. The dollar has been on an appreciation trend since the commencement of the second quarter of 2018. More critically, the financial conditions facing emerging and frontier economies are increasingly becoming somewhat more restrictive. While some could argue that these financial conditions are relatively benign when taken in a historical context, if the Fed were to tighten faster than is currently expected, a broader range of countries could feel more intense pressures.

The bigger threat is likely to emerge from the current trade tensions. The United States has initiated trade actions affecting a broad group of countries, and now faces retaliation or retaliatory threats from China, the European Union, its North Atlantic Free Trade Area (NAFTA) partners, and Japan, among others. The likely effect of all these will likely be on the waning market confidence, with knock-on effect on asset prices, and investment with the attendant threat to global growth.

There are good reasons why this should be of concern for anybody projecting Kenya's growth, at least in the near term. To the extent that emerging markets literally dragged the global economy in a positive sense during the global economic meltdown such that as the US and the rest of the so-called G7 were at best crawling while some of the emerging market economies – especially China – registered robust performance implies that they are now systemically very important. It is worth noting that Kenya's ties to the Sub-Saharan Africa are strengthening, and arguably becoming stronger that those to the rest of the world. As a recent study

3. Oumar Diallo ; Sampawende J.-A. Tapsoba (2014), "Rising BRICs and Changes in Sub-Saharan Africa's Business Cycle Patterns", IMF Working Paper No 14/35.

Figure 1: OPEC Basket Price (USD/Barrel)



Source: OPEC

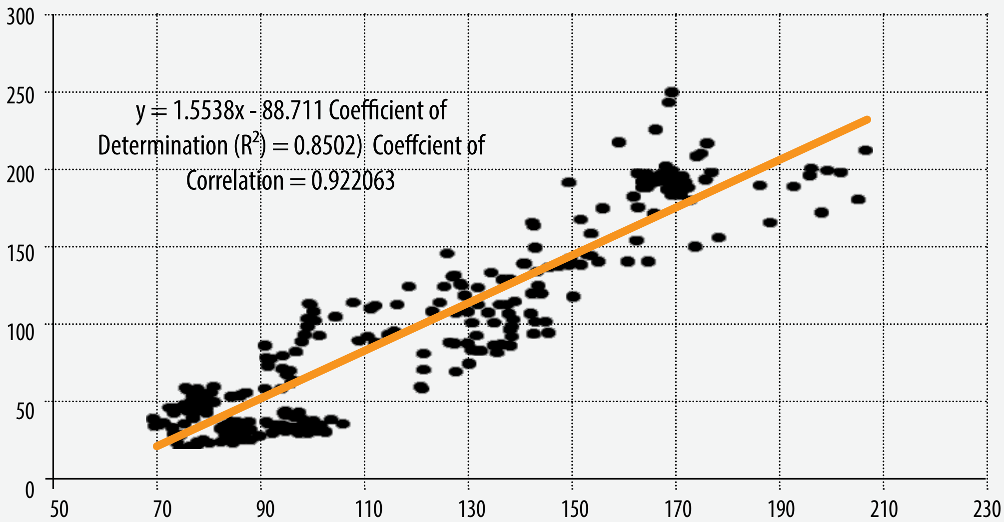
confirms , Sub-Saharan Africa's business cycle has not only moved in the same direction as that of the rest of the world, but has also gradually drifted away from the G7 in favour of the so called BRICs – Brazil, Russia, India and China. Trade with the BRICs turns out to be the strongest driver of this observed shift.

Therefore the challenges currently facing the emerging markets as outlined should be seen as having potential adverse effects that could be more than mild. Beyond trade, global developments are playing into the local economy. Supply disruptions and geopolitical tensions have helped raise oil prices (**Figure 1**), benefiting emerging oil exporters such as Russia and Middle Eastern suppliers but harming importers such as India, Kenya and other net importers.

It is possible that the rising oil prices will feed into the Kenya's import bill and jeopardise the projected further closing of the economy's current account. It is possible too that if the oil prices, augmented by the fiscal measures in form of taxes on consumables including oil products, filters into inflation, then the hand of the Central Bank of Kenya (CBK) will be moved towards monetary policy tightening.

Even then, it could be observed that the increase in oil process is not all gloom and doom. The fact that there is a very strong association between oil and non-oil prices (**Figure 2**) simply means that some of the Kenyan exports will benefit from rising prices. In essence, the two effects could offset each other.

Figure 2: Association between Fuel (Energy) Index and Non-Fuel Price Index (Jan 1992 - June 2018); 2005 = 100



Source: IMF

Our levers

If all the other parameters are exogenous, then the levers for growth influence are in the macro policy. Fiscal policy remains expansionary, even with the promise – now looking like a wish - of fiscal consolidation. Unless either expenditure gives (or we now have a presidential directive that ceases all new projects) or revenue mobilisation is enhanced (and we can argue that the difficulties for that are manifest in the tax measures that could be counterproductive and counterintuitive to economic growth), public debt will be the resort.

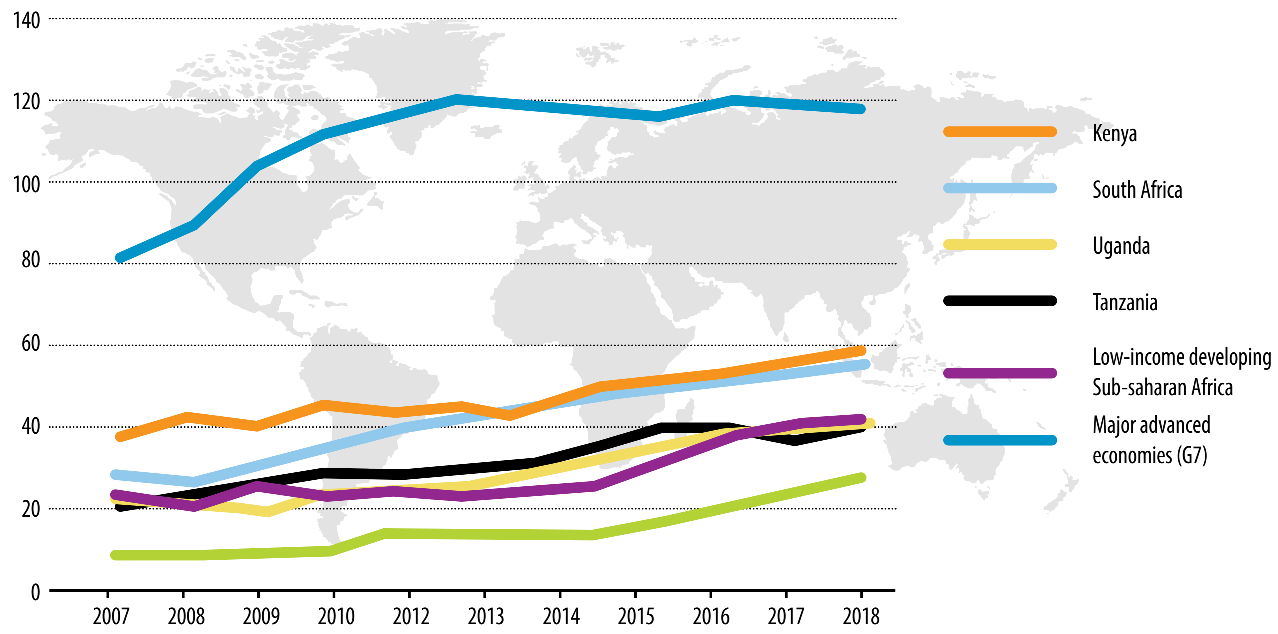
As alluded, the scope for increased public debt is evidently small. The economy's debt as a share of output, while substantially below that of advanced economies, is well above the regional partners and emerging markets such as South Africa (Figure 3).It is the characteristics of the debt, not the merely the absolute amount that is a source of worry. It is increasingly commercial, and the average tenor is decreasing. That means the amount of resource requirement for debt service is higher to the extent of eating into resources that could be channelled into social services.

For what it is worth, a distress should not be seen only in default but can be signalled by the opportunity cost in terms of what social priorities could be forgone as the economy meets its debt obligations. Does this then leave the task of boosting growth in the hands of the CBK through monetary policy conduct?

It is Apparent that the CBK is keen to ensure that market liquidity in the financial system, when not inflationary, is a boost to the sagging credit growth. The accommodative policy bias doesn't seem to have led to the private sector credit growth to pick. Taking all the above into account, it is highly probable that the economy's performance prospects could be good; but vigilance on the downside risks, both local and external, is critical.

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

Figure 3: Gross Debt (%of GDP)

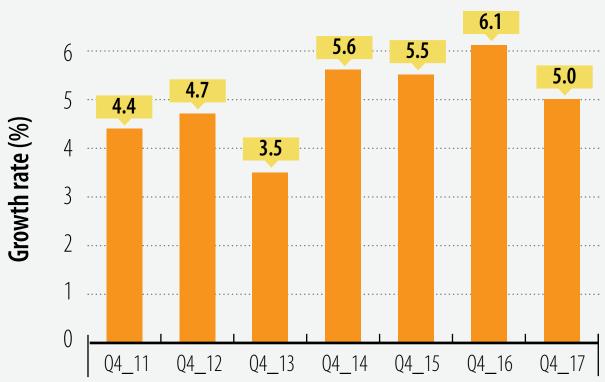


Source: IMF Fiscal Monitor

State of the Economy

The economy entered the first quarter on 2018 on a fairly weak macroeconomic environment though stable. A review of the macroeconomic environment evidence that the weak and unfavorable macroeconomic environment experienced in the last quarter of 2017 spilled over to the first quarter of 2018. To start with, the last quarter of 2017, registered a growth of 5 percent the lowest growth registered compared to growth rates of last quarters of previous years since year 2014. All the macroeconomic fundamentals in quarter one of 2018 were at best based on the weak growth in the last quarter of 2017.

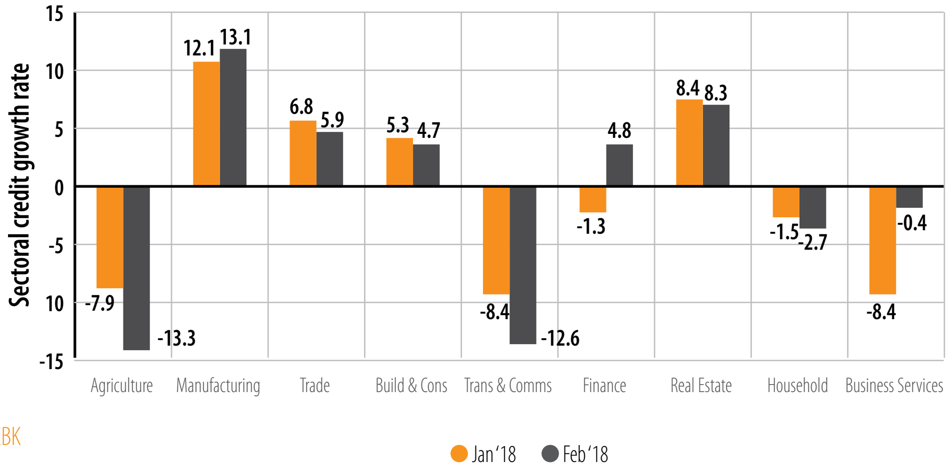
Figure 4: Quarterly Growth in GDP



Source: CBK

The Private sector claims / credit which is among the fundamentals supporting economic growth remained very low at best thus inhibiting full employment potentials of the economy by reduced household expenditure both as consumption and investment expenditure. The low private sector credit is attributed to the length of time taken by the commercial banks to realign their business model in line with the new era of rate capping so as to seize the possible opportunities. However, it is notable that the low private sector credit experienced in the first quarter of 2018 could also be emanating from the tightening of the credit standards by lenders following the rise in the Non – performing Loans arising from the low economic growth that has affected repayments. During the first quarter of 2018, majority of the sectors and mainly the key sectors that have anchored economic growth in the past registered a negative growth in credit allocation (**Figure 5**). Notably credit allocation to sectors such as agriculture, Household, transport and communication, business services, finance and insurance all decline considerably. This implies the increase in the risk profile of these sectors despite their crucial role in driving growth in the economy.

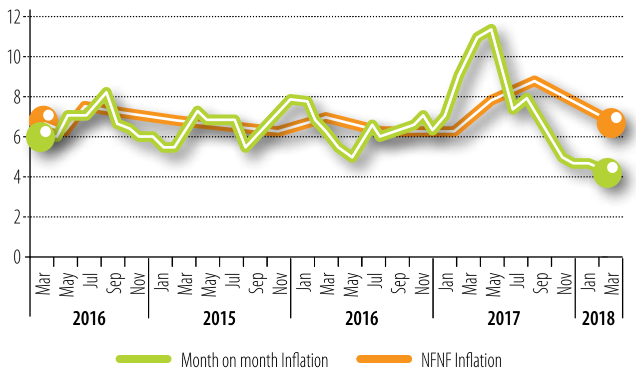
Figure 5 : Sectoral private sector credit allocation



Source: CBK

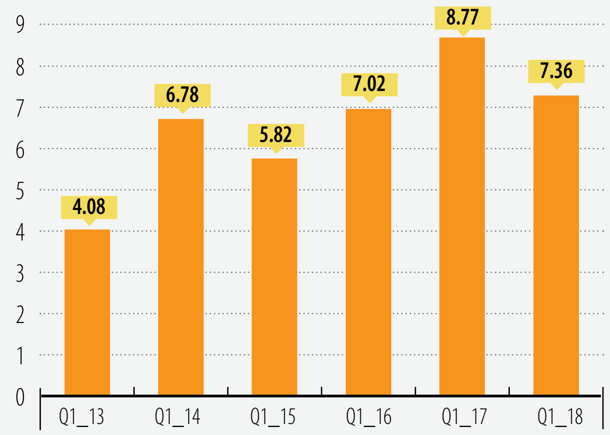
However, contrary to other macroeconomic variables, the cost of living as measured by the inflation rate indicates that the month – on – month inflation rate remained on the lower bound of the Central Bank's target of 5 percent ± 2.50 basis points ranging from 4.83 percent in January to 4.18 percent in March. However, the inflation rate might have eased off in quarter one of 2018 following the reduction in food prices as a results of the rains experienced in the last quarter of 2018 (**Figure 6**). Similar trends in the inflation rate as captured by month-on-month inflation are evidenced for the quarterly inflation whereby the quarterly average dropped from 8.77 percent in Q4 of 2017 to 7.36 percent in Q1 of 2018 (**Figure 7**). However, its notable that the non-food non-fuel inflation registered an upward trajectory though mild during the quarter increasing from 3.06 percent in December 2017 to 3.62 in February 2018 thus signifying some mild demand driven inflation.

Figure 6: Inflation Rates



non – food non – fuel inflation registered an upward trajectory though mild during the quarter increasing from 3.06 percent in December 2017 to 3.62 in February 2018.

Figure 7: Average Quarterly Inflation Rates



On government debts, the fact imply that the government fiscal space remained narrow with the total debt standing at approximately Kshs 4.9 trillion as at February 2018. The external borrowing remained high accounting for over 50 percent as a proportion of total debt. The government's borrowing space therefore continued to be limited with the call for fiscal consolidation being at the top of the agenda with an aim of ensuring debt sustainability. This continued to pile pressure on the government to come up with innovative yet sustainable way of raising the revenue to finance the budget for financial year 2018/ 2019 come July 2018.

The forex market, the exchange rate though relatively stable with significant appreciation being evidenced on the shilling against the dollar. Against the Sterling Pound, the Euro, and the Japanese Yen the shilling posted mixed performance throughout the quarter with depreciation taking an upper hand. However, at the local regional level the shilling posted fairly appreciation against the Ugandan and the Tanzanian shilling.

On the global front, we note that the situation remained fragile in Q1 of 2018. The American foreign policy on trade that stands to create trade wars is eminent. Further the geopolitical risks on matters concerning oil remained evident thus calling for the need to keep a close eye given the effects it has on the import bills and consequently the open account as well.

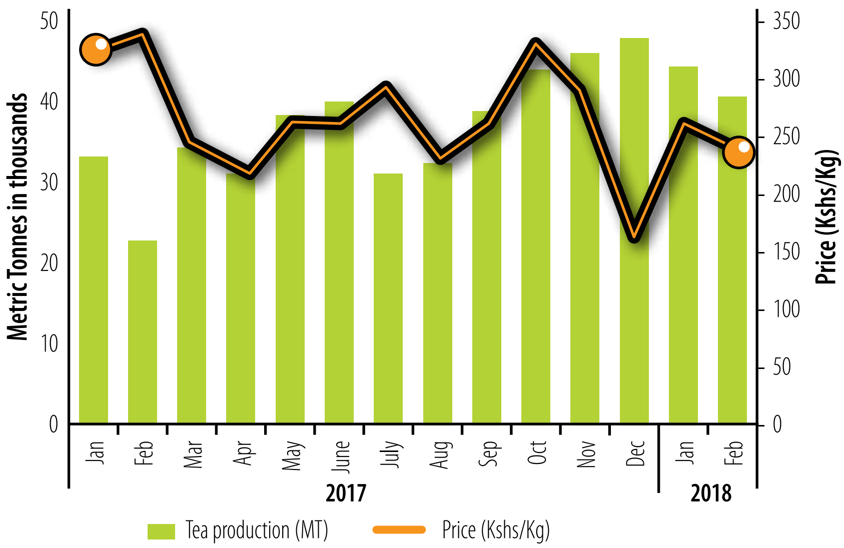
Sectoral performance

Agriculture

Despite the agricultural sector being a key driver of economic growth for Kenya, the growth of the sector significantly decelerated to 1.9% in Q4 of 2017, dampening the overall growth of the economy. The poor performance of the sector continued to be exacerbated in Q1 of 2018 as export of tea continued to nosedive compared to that of previous quarters. This poor performance is partly due to the adverse weather conditions.

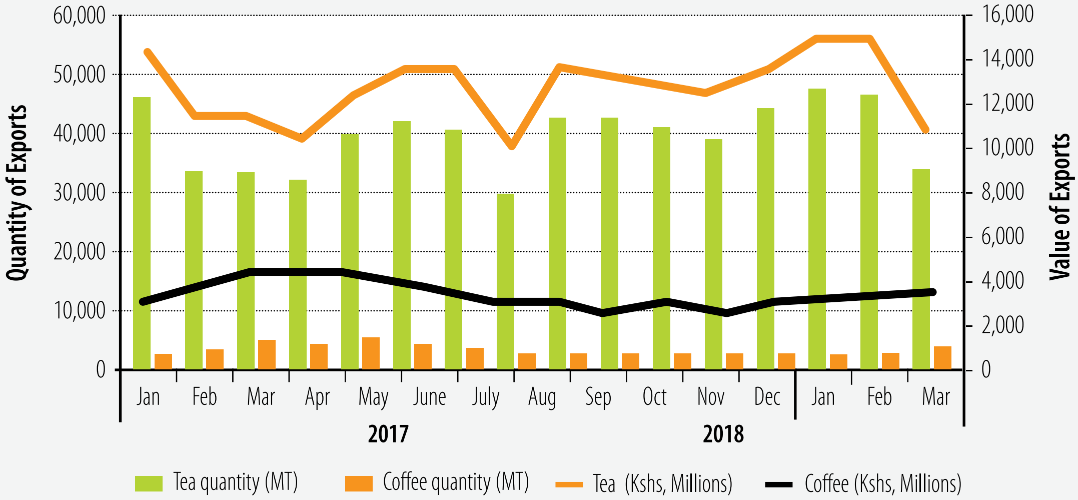
Over the past decade Kenya's reliance on primary agricultural production is noteworthy more so it's over reliance on export of tea and coffee. This phenomenon, going forward is likely to persist due to limited structural changes to the economy being undertaken that would otherwise shift it's over reliance on the sector. The quantity of tea exported drastically fell from 40,834.42 MT in January 2018 to 34,487.70 MT in March 2018 with the price marginally declining from Kshs 304.42 to Kshs 302.28 per kilogram over the same period. The reduced tea exports were attributed to clearance delays at the Mombasa auction. On the contrary, the export of coffee during the quarter increased from 2,509.26 MT in January 2018 to 3,936.10 MT in March 2018.

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



Source: KNBS

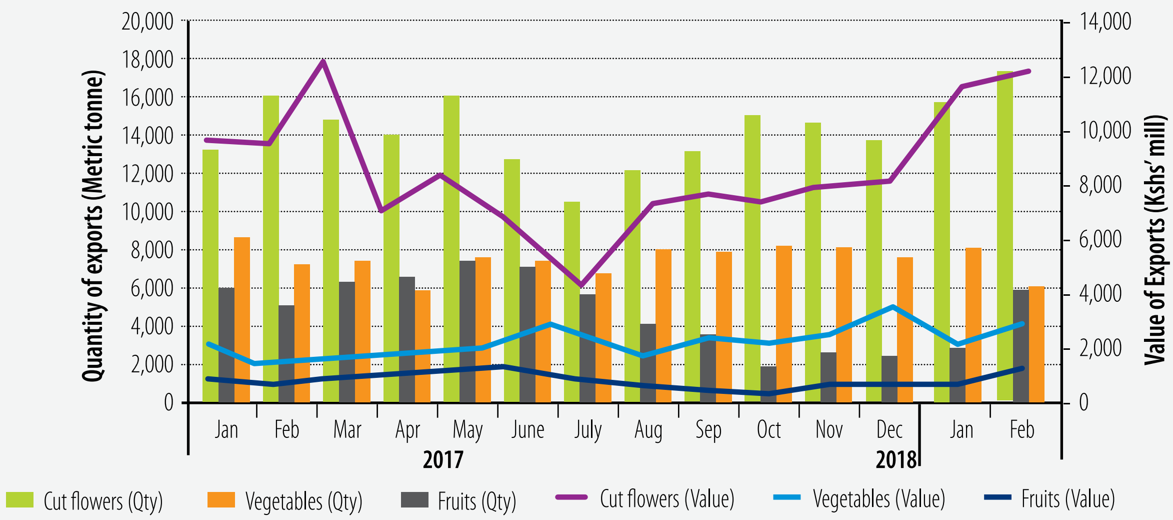
Figure 9: Value of Tea and Coffee Exports



Source: KNBS

Export of horticultural products showed signs of recovery during the first quarter of 2018 compared with the previous quarters with the export of cut-flowers maintaining its dominant position which have persisted for over time. During the first quarter, the quantity of cut flowers exported increased from 37.9% in January 2018 to 38.0% in February 2018 while fruits registered a 6.1% growth over the same period. Similarly, the quantity of vegetables exported over the same period declined by 6.4% but its value increased marginally by 1.4% as it fetched higher prices hence counteracting the registered decline in quantity exported.

Figure 10: Horticultural Exports

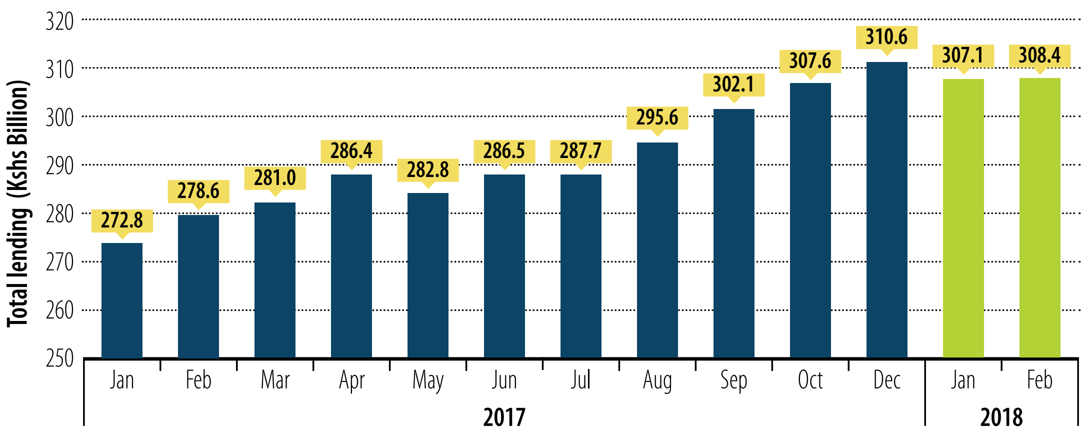


Manufacturing

From the monthly lending, it is evident that the credit advanced to the sector has increased marginally from Kshs 307.1 billion in January 2018 to Kshs 308.4 billion in February 2018 though still lower than credit allocation to the sector in December 2017. The growth in sectoral credit allocation between January and February of 2018 clearly indicates that more preference is given to the sector due to its non-risky nature compared to other sectors.

More importantly, it commands more that 60 % 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 center of revolutionizing the economy from being an agricultural based economy to an industrialized middle-income economy.

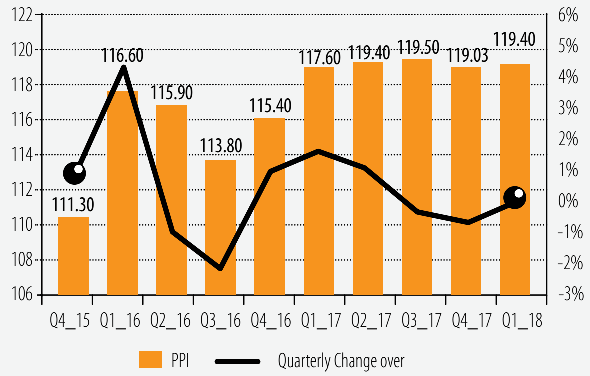
Figure 11: Bank lending to manufacturing sector



Producer Price Index

The producer price index rose by 0.29% quarter-on-quarter (q-o-q) basis and rose by 1.5% on a year-on-year (y-o-y) basis. The main contributors of the y-o-y increment in producer price index were the manufacture of wood and of products of wood (8.61%) manufacture of chemicals and chemical products (8.31%) but was countered by the reduction in the prices of manufacture of non-metallic products (11.89%) and manufacture of rubber (3.11%) and plastic products (2.11%).

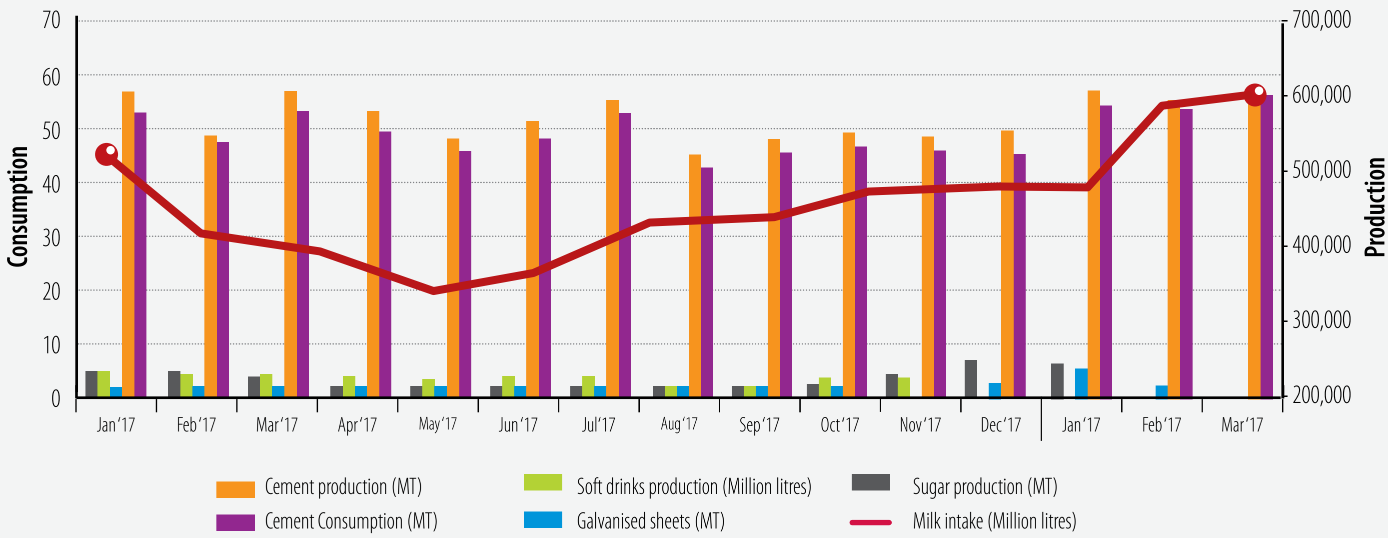
Figure 12: Producer Price Index



Source: KNBS

Milk uptake in the formal sector rose from 59.44 million litres in February 2018 to 60.29 million litres in March 2018.

Figure 13: Production and Consumption of Manufacturing



Source: KNBS

Energy

With the cost of energy being critical for firm's production and also in influencing the cost of living, the government of Kenya has pursued infrastructural projects in the energy sector with a view to lowering the cost and producing clean energy. Despite huge initial outlays - sunk costs – of undertaking these investments, tremendous progress has been made so far as evidenced by the ever increasing share of geothermal production to total energy production.

In particular, the energy landscape in the country has consistently been characterized by geothermal production with 1265.63 million KWh being produced in the first quarter of 2018 compared to 1122.18 million KWh produced in quarter one of 2017. Thermal production came second with its production also increasing however; the production of Hydro energy has declined from 695.79 million KWh in January to 664.77 million KWh in March 2018. The reduction in the hydro energy production in Q1 of 2018 can be water levels in hydro generation dams being low but is set for rebound with the onset of the long-rains of March to June 2018.

Unlike in previous quarters hydro energy generation in quarter one of 2018 was lower and fall short of thermal production which in the previous quarters has not exceed hydro energy generation. Whereas thermal production in Q1 of 2018 exceeded Hydro production, its supply is fairly inelastic and cannot be relied upon to bridge the production gap in the face of dwindling hydro production due to poor weather.

Figure 14: Electricity Generation by Source (Million KWh)

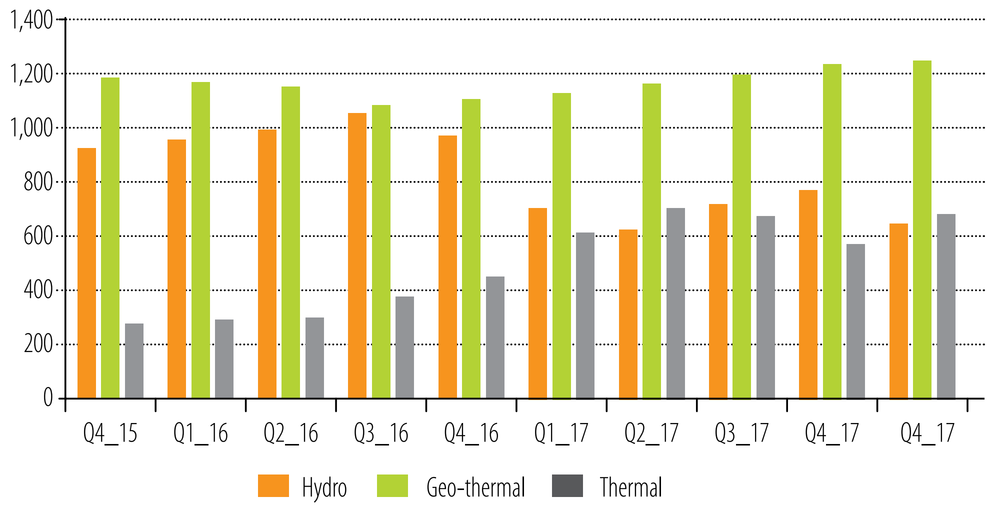


Table 1: Average Monthly Crude Oil and Retail Fuel Prices

	Sep-17	Oct-17	Nov-17	Dec-17	Jan-18	Feb-18	Mar-18
Murban crude oil (US$/Barrel)	55.70	63.83	63.65	62.06	66.28	65.98	66.31
Super petrol (KES/Litre)	99.20	102.55	103.58	105.04	107.17	108.79	108.33
Diesel (KES/Litre)	87.40	89.68	93.37	93.41	95.79	97.92	98.82
Kerosene (KES/Litre)	65.33	67.15	72.20	72.39	75.74	77.71	78.41
LPG (13Kgs)	2,094.22	2,140.47	2,128.59	2,141.46	2,140.37	2,150.20	2,169.19

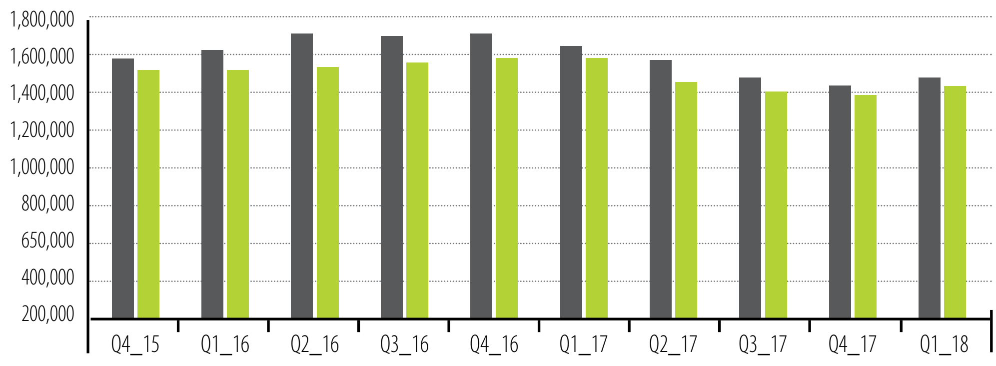
Source: KNBS

On the international front, the oil prices have spiraled upward reaching a high of $ 65 a barrel in March 2018. On the domestic front, fuel prices has mirrored the rising trend in global oil prices with the price of super petrol marginally rose from Kshs 107.17 per litre to Kshs 108.33 per litre in March 2018. Similarly, the price of diesel rose by Kshs 3.03 per litre from Kshs 95.79 in January 2018 to Kshs 98.82 per litre in March 2018. The price of kerosene and LPG gas also registered an increment from Kshs 75.74. Closely monitoring the developments in the global oil prices is therefore imperative as there is a correlation between international and domestic fuel prices and which has an implication on the cost of production and the overall level of inflation.

Building and Construction

On a quarter-on-quarter basis, cement production contracted in Q1 of 2018 by 10.2%, consumption contracted by 8.7% over the same period compared to a marginal 1.4% increment in production and a 4.9% increment in consumption during Q1 of 2017. Even cement consumption declined, consumption increased from 1,387,875 MT in Quarter 4 of 2017 to 1,410,169 MT in Quarter 1 of 2018. Nonetheless, the construction sector continues to exhibit robust performance and a key contributor to the economy's GDP. In addition, the sector will continue to be key in driving the economy given that the big four agenda being pursued by

Figure 15: Cement Production and Consumption (MTs)



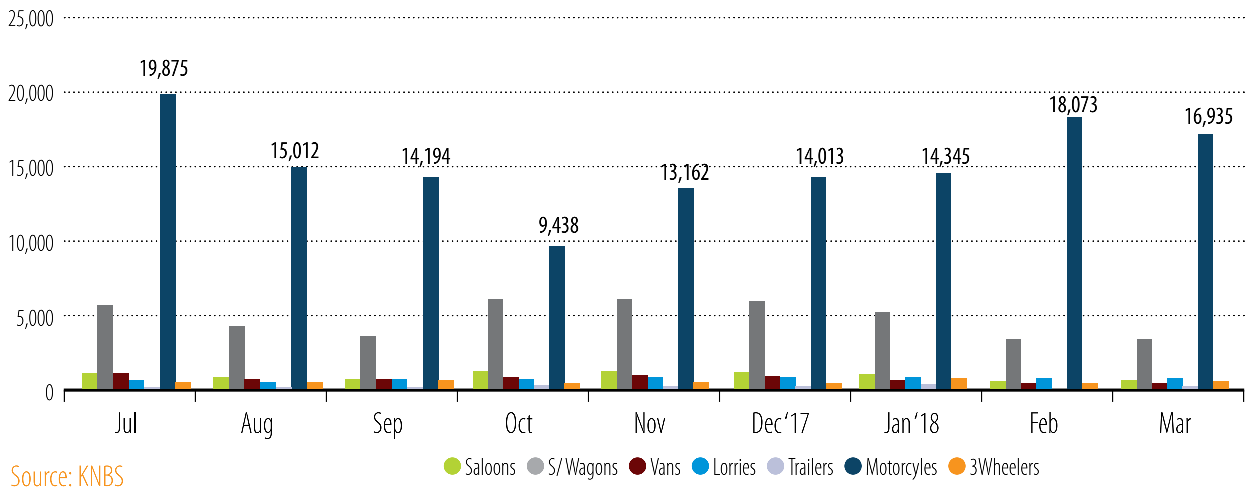
Source: KNBS

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 sector's dismal performance was mainly hampered by less activity during the period despite an increase in credit allocation to the sector.

Transport and Communication

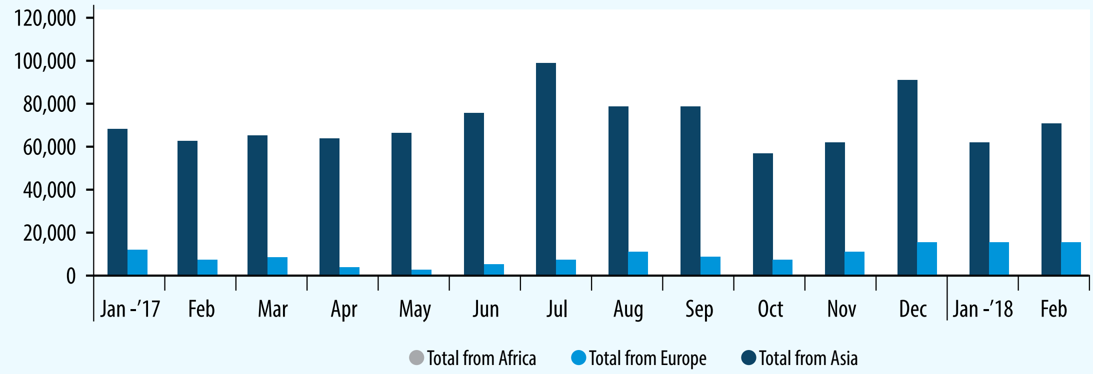
The registration of new vehicles in the country has over time been consistently rising with new motor vehicles registered in quarter 1 of 2018 increasing by 7.04% on q-o-q with registration of motor cycles leading (72%) followed by Lorries (17%), Saloon cars (2.9%), three wheelers (2.3%), vans (1.8%) and trailers (0.8%).

Figure 16: Registration of New Vehicles



Source: KNBS

Figure 17: Trends in Visitor Arrivals (Thousand)



Source: KNBS

Tourism

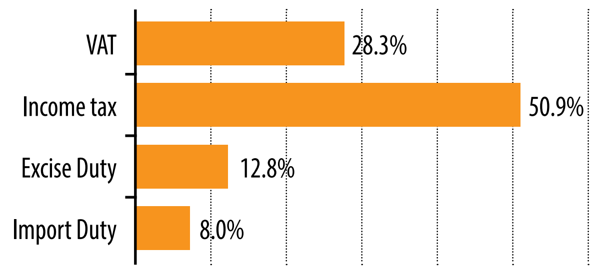
During quarter one of 2018, the tourism sector rebounded compared to the previous quarters with the total number of visitors arriving through Jomo Kenyatta (JKIA) and Moi International Airports (MIA) increasing to 83,651 in February 2018 from 76,649 in January 2018. Equally important to note is the increased number of passengers who landed at both JKIA and MIA with the passengers landing at JKIA significantly rising from 218,571 persons in February to 241,400 persons in March 2018, while the passengers who embarked through the airport also registered an increase from 120,852 persons to 148,177 persons over the same period.

The surge in the number of arrivals during the period to a large extent can be attributed to the calm political environment during this period and with it comes the multiplier effects through increased business activity within the sector and thus the increased demand of inputs from other sectors. Though the arrivals were on an upward trend but still less than arrivals in quarter 4 of 2017, it is evident that a quarter-on-quarter comparisons reveals that the first quarter is usually characterized with less tourism, a period that is usually a low season for the country.

Financing of Government

During quarter one of 2018, the total tax revenue as a share of the total revenue dominated standing at 86.8 % while non-tax revenue stood at 13.2%. On the sources of tax revenue, income tax topping the list of tax revenue at 50.0% followed by value added tax at 28.3% with excise duty and import duty coming third and fourth at 12.8% and 8.0% respectively. From the previous analysis the government tax base seems to have remained constant with the contribution of each revenue stream changing marginally. This is an indication of the government's constraint in terms of widening the revenue base and coming up with new revenue sources despite of the government's expenditure continuing to rise with the onset of devolution government.

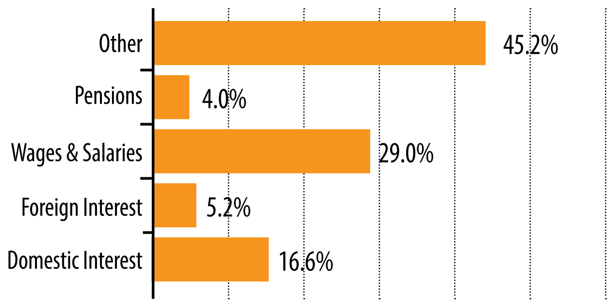
Figure 18: Tax revenue



Source: CBK

In quarter one of 2018, 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%. Looking at recurrent expenditure, an expenditure which does not result in the acquisition of fixed assets, wages and salaries constitute the biggest share (26.2%), domestic interest payment accounting for 14.4% while foreign interest repayments and pension payments accounted for 5.3% and 3.9% of the total recurrent expenditure respectively.

Figure 19: Recurrent Expenditure breakdown

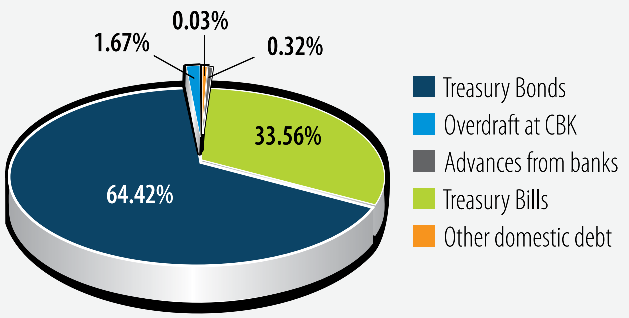


Source: CBK

Public Debt

The structure of Kenya's domestic debt reveals that it is highly skewed towards government securities. The Treasury bond (64.42%) constitute the main component of domestic debt in Kenya followed by Treasury Bills constituting 33.56%, overdraft at the central bank (1.67%), advances from commercial banks (0.32%) and other (0.03%) during quarter one of 2018.

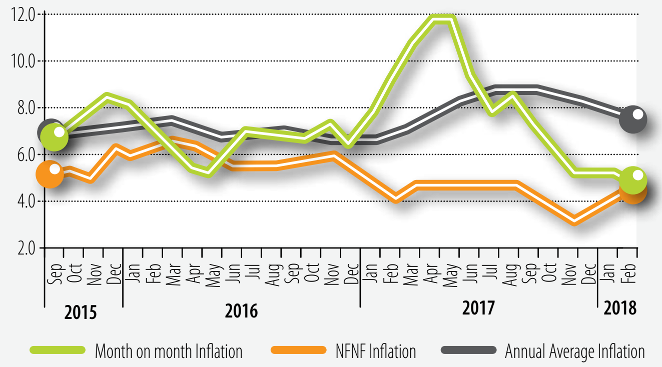
Figure 20: Composition of Domestic Debt



Source: CBK

Inflation

Figure 21: inflation

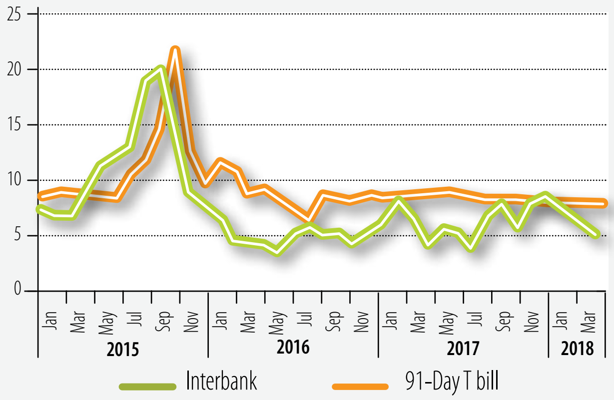


Source: Central Bank of Kenya

Interest Rates

The developments in interest rates on the money market - the interbank and the 91-day Treasury bill - for quarter one of 2018 continued its downward trend. The reduction in the interbank-bank is an indication of improved liquidity stance in the money market. The 91-day Treasury bill though declining has been moderately stable over time. Noteworthy is the co-evolution between the interbank rate and the 91-day Treasury bill.

Figure 22: Overall quarterly trade balance (Kshs, Mill)



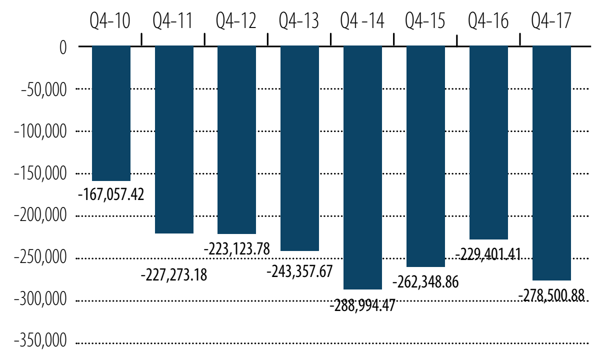
Source: Central Bank of Kenya

Balance of Payments

During the first quarter of 2018, the monthly trade balance posits a spike in the trade deficit in January of Kshs. 104,018.73 million though significantly reduced in February to Kshs. 71,628.04 million (**Figure 23**). We note that the spike in trade deficit in January 2018 could be traced in December 2017 where the deficit set up an upward trajectory trend. This could be emanating from reduced domestic exports flowing the disruption in production in the wake of prolonged electioneering period. In addition linking foreign exchange rate to imports trend could possibly offer an explanation to the spike in January's trade deficits.

Looking at the exchange rate between Kenya Shilling and the world's hard currencies for instance the dollar, it is evident that the shilling posted a significant appreciation against the dollar from a high of 103.5 mark as at beginning of January 2018 to a low 100.8 mark as at first week of February 2018. This appreciation in the shilling against the dollar in January 2018 would have triggered the spike in trade deficits in January 2018 via increased imports. However, this spike is short lived as the shilling stabilizes in February oscillating 101 mark against the dollar. Moreover, the reduced imports in February would signal the return to normalcy in the political environment that would have favored production of domestic exports.

Figure 23: Trade balance (Kshs, Mill)



Source: CBK

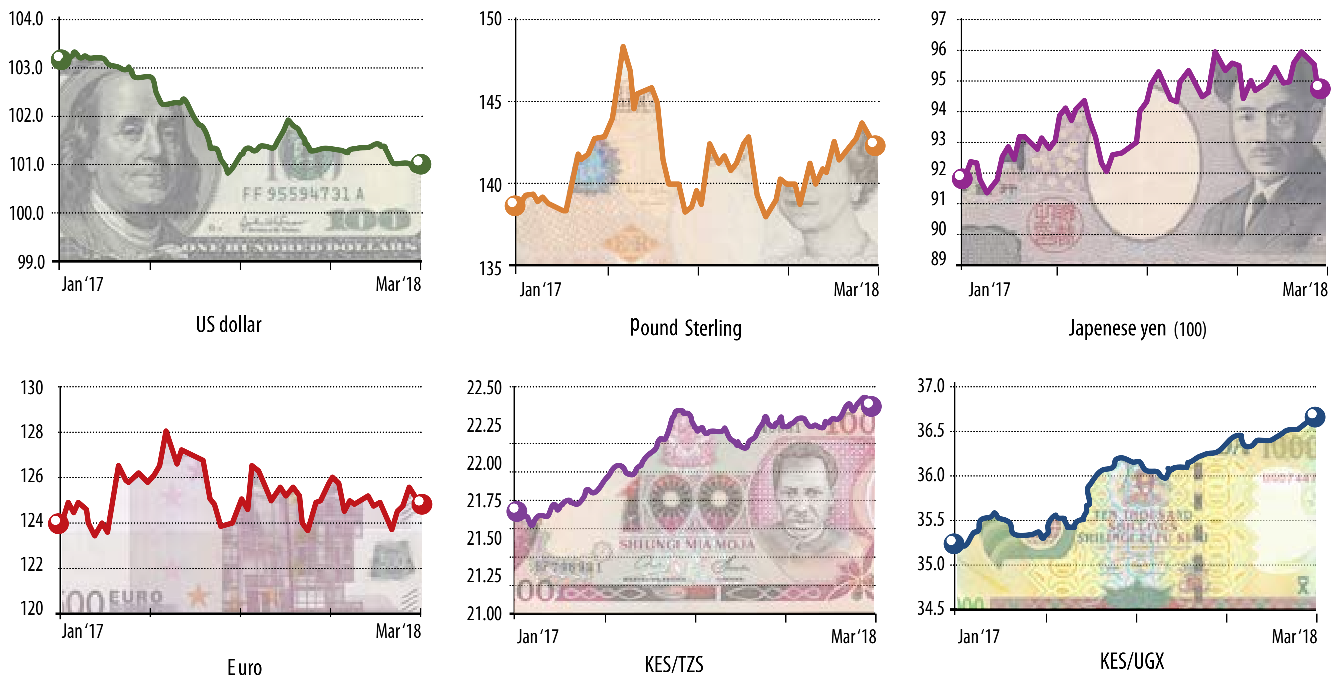
Exchange Rate

During Quarter one of 2018, the Kenyan shilling showed signs of depreciation with respect to the Japanese Yen. On the other hand, it showed mixed signs with respect to the Euro; depreciating in January but strengthening in the month of February and relatively stable in March. Against the US Dollar, the Kenyan shilling generally strengthen for the most part of the quarter save for early February when it weakened due to the escalating trade tensions with saw the US Dollar depreciate against major international currencies. The shilling's depreciation in January and March was mainly fueled by the signaling of the Federal Reserve to increase US interest rates which as a result led to capital outflows.

Against the Sterling Pound, the Kenyan shilling recorded mixed performance. In January, the shilling depreciated against the dollar strengthening in February before reverting to the trend performance experienced in January. On the regional front, the Kenyan shilling weakened against the Uganda shilling in Quarter one of 2018. A similar pattern is replicated against the Tanzania shilling where for a significant period of the quarter it generally weakened.

In Quarter one of 2018, the Kenya shilling generally depreciated with respect to major currencies be in international currencies or the domestic or rather regional currencies. The poor performance against major currencies during this period is attributed to a significant capital outflows arising from investors offloading their investments from the country's capital markets. Of notable consideration is the strengthening of the shilling against the Japanese Yen which is attributable to the shrinking of the Japanese economy that continues to grapple with negative interest rates

Figure 24: Nominal Exchange Rate



Nairobi Securities Exchange

Activities at the stock market remained strong with the NSE 20 Share Index improving to 3,854 points by end-March 2018 from 3,711 points in December 2017 while Market Capitalization improved to Kshs 2,790 billion in Q1 of 2018 from Kshs 2,521 billion in December 2017. The performance based on the NSE – 20 Share index indicate that the bourse was largely stable in the performance stagnating at approximately 3730 point on average compared to a 3,750 pints in Q4 of 2017. However, on the NASI yardstick, the market seems to have performed well rising from a 169 points on average in Q4 of 2017 compared to 184 points on average in Q1 of 2018. Moving away from the indices, the other securities markets' indicators such as equity turnover and market capitalization level indicate that the market in Q1 of 2018 performed well compared to Q4 of 2017.

Table 2: Nairobi Securities Exchange

	2017						2018		
	Jul	**Aug**	**Sep**	**Oct**	**Nov**	**Dec**	**Jan**	**Feb**	**Mar**
NASI	156	169	162	162	173	171	181	182	189
NSE 25	4,271	4,485	4,272	4,202	4,402	4,283	4,513	4,563	4,944
NSE 20 Share Index	3,700	4,027	3,751	3,730	3,816	3,711	3,737	3,751	3,854
Equities Turnover (Kshs Million)	21,304	16,024	16,248	9,390	14,760	11,867	20,340	17,920	22,890
Market Capitalization (Kshs Billion)	2358	2478	2377	2373	2562	2521	2660	2678	2,790

Source: Nairobi Securities Exchange

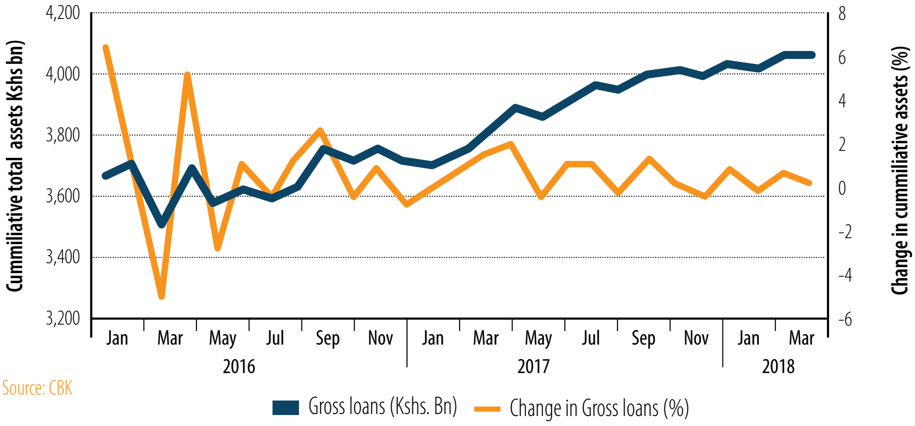
Banking Industry Performance

During the first quarter of 2018, the banking industry's performance registered a bit of depressed growth though mild. This performance could be attributed to the prolonged electioneering period in Q4 of 2017 that hurt favorable environment for economic growth. However, we note that looking at the absolute figures for all the variables regarding the industry they signify an increase in absolute terms for almost all the variables. However, computation of the month – on – month changes present a contrary view with majority of the variables recording negative change. Further, we note that the effect of the interest rate capping continued to be felt in the especially on the loans and advances which posted negative growth. In addition the non – performing loans were on the rise mainly attributable to the depressed growth in the economy that might have affected business and other economic activities adversely thus affecting borrower's ability to repay loans.

Total Assets of banking industry

During Quarter one of 2018, the performance of the banking total assets marginally increased compared to quarter four of 2017. The cumulative industry's total assets grew by 0.76 percent between Q4 of 2017 and Q1 of 2018. From **figure 25** We note that posits that even though the aggregated quarter growth was a positive growth, the month – on – month growth reveals a decline in the in January 2018 of 0.12 percent with February and March posting a positive growth of 0.63 and 0.23 percent respectively. Therefore, even though February and March posted a positive growth, it is clear that the growth in March was on a decline relative to February's growth. This reveals the depressed conversion of banks' liability into assets as well as the slowdown in the credit creation process as evidenced a scenario evidenced in the last quarter of 2017.

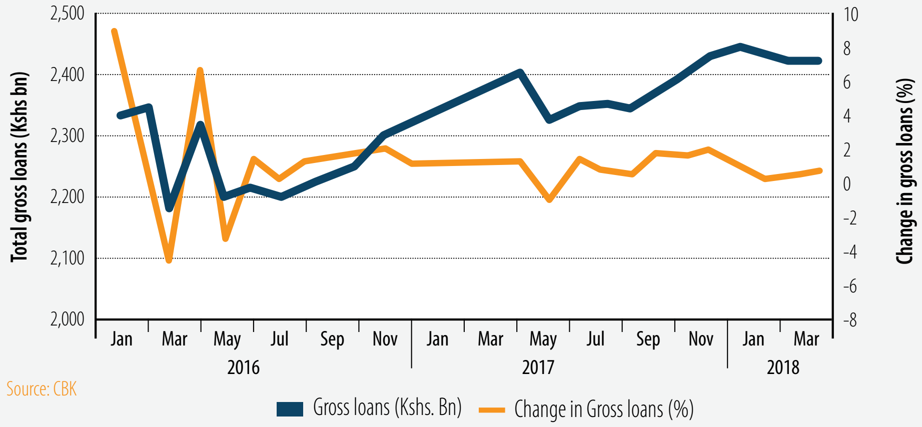
Figure 25: Banks' Total Assets



Source: CBK

On the total gross loans and advances, more pronounced negative growth was recorded on month-on-month basis. The aggregated quarterly growth there was a very minimal growth from Q4 of 2017 to Q1 of 2018 of 0.03 percent in the cumulative total industry's loans and advances. However, we note that on month-on-month basis, the growth was negative all through the three month in Q1 of 2018. In January, loans and advance grew by -0.41 percent with February and March posting a growth of – 32 and – 0.11 percent respectively. The decline in the lending could have been triggered by the rise in the bank's non – performing loans that might have contributor towards the tightening of their credit standards as well as recovery measures thus leading to reduced loans and advances.

Figure 26: Total Gross Loans

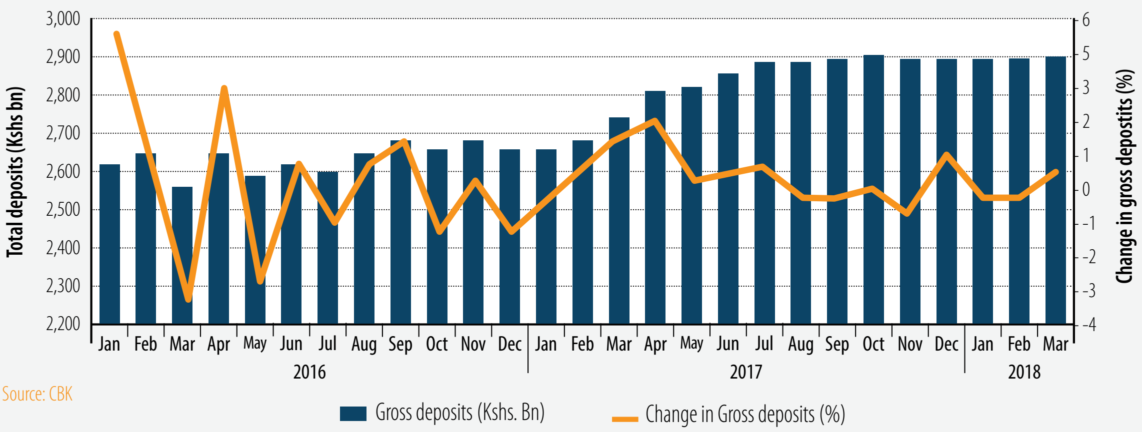


Source: CBK

Bank Deposits

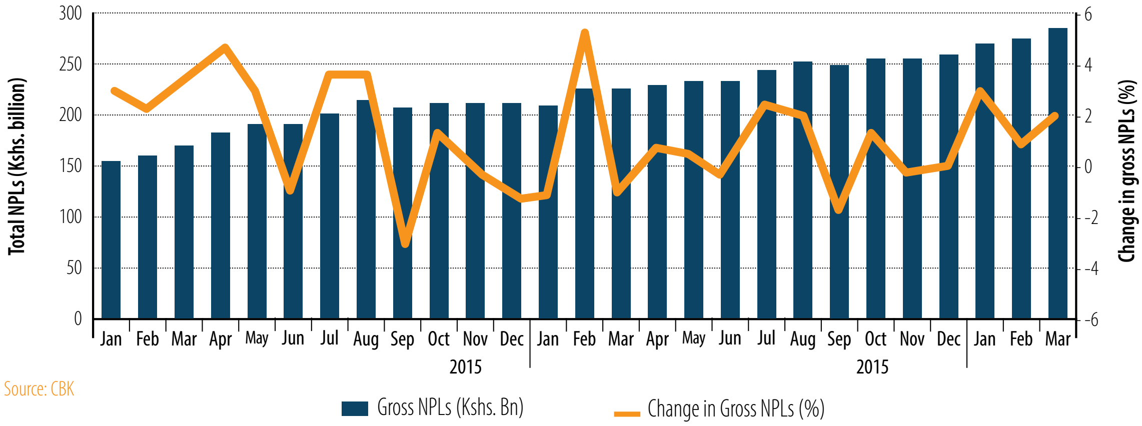
In quarter one of 2018 the banking industry's deposit base has registered positive growth. Month – on Month data reveal that the industry's total deposits has been on decline since December 2017 as portrayed in **figure 27** This trend speak to the banks' appetite towards deposit mobilization. The most 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. In addition in the event of the prolonged electioneering period in the last quarter of 2017 that spilled over to Q1 of 2017, the public may have opted to hold their cash balances in banks rather than invest with uncertainty. This could also speak into the positive results recorded in Q1 of 2018.

Figure 27: Bank Deposits (Kshs. Bn)



Source: CBK

Figure 28: Gross Non-Performing Loans



Source: CBK

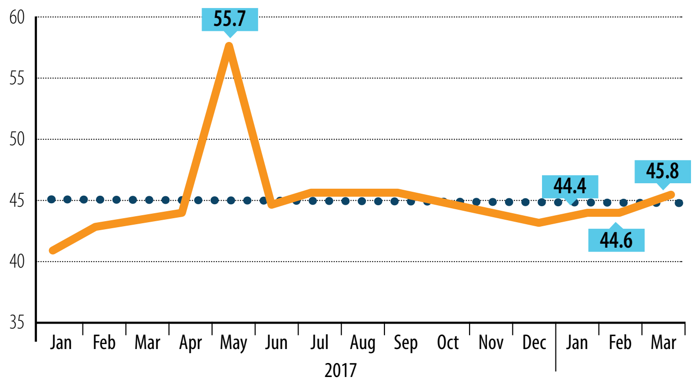
Gross Non-Performing Loans

The total gross Non-Performing Loans appear to portray mixed trend looking at the month-on-month data in **figure 28** The rise in the growth in the gross NPLs in Q1 of 2018 was substantial compared to Q4 of 2017. The month-on-month growth in Gross NPLs in Q1 of 2018 ranged from 5.02 percent in January to 2.02 and 3.42 percent in February and March respectively. The rise in the growth in the gross NPLs would speak much into the possible adverse effects in the economy arising from the prolonged electioneering period in the last quarter of 2017 that would have affected borrower's ability to repay loans.

Liquidity

The liquidity levels in the banking industry indicate that the liquidity level averaged between 44.4 percent in January 2018 and 44.4 and 45.8 percent in February and March 2018. As such the industry remained fairly liquid in the entire of Q1 of 2018. The results therefore indicate that the liquidity levels in the entire of Q1 of 2018 was above the statutory minimum requirement of 20 percent. However within the quarter, March recorded the highest liquidity levels imply that a higher growth in total liquid assets compared to the growth in total short-term liabilities compared to January.

Figure 29: Total Liquidity Ratio (%) (Average)



Source: CBK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