KENYA BANKERS ECONOMIC BULLETIN

QUARTER TWO OF 2018

VOLUME 24

A report prepared by:

The Centre for Research on Financial Markets and Policy®

KENYA BANKERS
ASSOCIATION

CENTRE FOR RESEARCH ON
FINANCIAL MARKETS AND POLICY®

About this Report

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

About the Centre for Research on Financial Markets and Policy®

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

CENTRE FOR RESEARCH ON
FINANCIAL MARKETS AND POLICY®

KENYA BANKERS ECONOMIC BULLETIN

Publisher	KBA Centre for Research on Financial Markets and Policy®
KBA CEO	Dr. Habil Olaka
Chief Editor	Jared Osoro
Contributors	Josea Kiplang'at
Design & Layout	Conrad Karume
Contacts	KBA Headquarters, International Life House, 13th Floor Mama Ngina Street, Nairobi
Mailing Address	P.O. Box 73100 00200 - Nairobi
Phone	+254-20-2221704, +254-20-2217757, +254-20-2224014
E-mail	research@kba.co.ke
Web	www.kba.co.ke.
Distributed by	Kenya Bankers Association

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In this Issue

FOREWORD

From the CEO's Desk

It is my pleasure to present to you the 24th issue of the *Kenya Bankers Economic Bulletin*. In this issue, we discuss the state of the Kenyan economy first half of the year. The Bulletin reviews the strides that the economy has made since the beginning of the year, with an emphasis on the opportunities and constraints that continue to shape the economy's gradual recovery.

Much of the discussions during the period largely reflects on the outcomes of the various sectors of the economy and how they have been influenced by the broader risks that the economy has faced, both at the local and international front. The usual focus of the *Bulletin* is on how the risks and policy responses play into influencing investor attitudes thus 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 how both legislation and the broader economic policy thrust will shape the economy going forward.

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

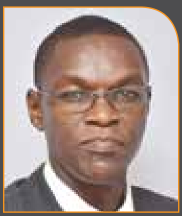
We welcome feedback on the content of this *Bulletin* as we continually seek to improve its relevance to you.

Dr. Habil Olaka
Chief Executive Officer,
Kenya Bankers Association

COMMENTARY

2018

Economic Outlook: A case for Trading Exuberance for Caution



By Jared Osoro

So, 2018 is meant to be a fabulous year from an economic standpoint, right? It depends on whom you ask. The headline macroeconomic numbers for the Kenyan economy seem to suggest in the affirmative. The whole macroeconomic picture can be painted as follows: the gross domestic product (GDP) is set to be on a recovery trajectory after its growth rate declined in 2017; inflation is under control, being within the target range; the external economy as would be inferred from the balance of payment (BOP) numbers seems to be in the right direction; and the supporting macroeconomic policy is structured to support the sustenance of the positive picture.

The positivity about the economy is encapsulated in the World Bank's October 2018 edition of its *Kenya Economic Update*[1]. The report described the projected growth of 5.7 percent in 2018 from 2017's 4.9 real growth as a rebound, its core argument being that harvest in agriculture is looking up, industrial activity is up, and services sector is robust. Some are even more upbeat, even on the back of subdued growth in private sector credit, and an element of probability of recurrence of adverse drought shocks, and fiscal slippages leading to macroeconomic instability could dampen growth prospects.

And there is the external front. The direction of the oil prices is not confirmed, with a reversal following a recent spike thus providing some respite but it's not clear how long it will last. There is uncertainty around the rising trade tensions. The tightening of global financial market conditions due to ongoing normalization of monetary policy in advanced economies may result in reversal of capital flows from emerging and frontier markets, Kenya included.

1. See http://documents.worldbank.org/curated/en/766271538749794576/pdf/Kenya-Economic-Update-18-FINAL.pdf

Trade-offs

So where does the trade-off between exuberance and caution lean towards? The answer depends of the magnitude of the probability that the down side risks alluded above will materialise, for if its high then the outlook will obviously be dimmer. Let's start with credit to the private sector.

If real output growth is to truly rebound in 2018, then growth of credit to the private sector must of necessity turn the corner. Admittedly, it will take a rejuvenation of market demand conditions for the supply of credit to appropriately respond. With the benefit of over two years of a capped interest rates regime, it's evident that it will take more than price incentive – in other words lower interest rates – for credit to start optimally flowing to the private sector.

While the concern regarding the slowdown in credit to the private has been there since the downward trend commenced in later 2015, attempts to stall the rolldown have at best led to a halt at the 2.5 percent – 4 percent average annual growth range. The outlook of the credit growth appreciably turning the corner is not clear. And it cannot be for lack of trying, for there has been a policy desire 'to do something'.

In the frontline has been the money policy whose accommodative stance since late 2016 has been assessed as appropriate[2]. To the extent that inflation is under control, the exchange rate market is generally stable, and the output gap remains negative, there is scope for private sector credit to expand at no risk to macroeconomic stability.

And so it started with an experiment 20th September 2016 with the easing of monetary policy with the explicit intention of igniting credit demand. With the policy experiment not yielding the expected results, the concern shifted. By 27th March 2017, the concern realistically shifted to the then prevailing uncertainties, including the impact of the interest rate caps on the effectiveness of monetary policy.

As we close the year, inflation is within the target rage, the exchange rate is stable amidst a healthy debate on whether its nominal rate needs to adjust, and the global economic situation is characterised by largely the same set of downside risks as was the case two years ago. Further, interest rate caps are not any less binding on money policy effectiveness now than they were a year ago.

There are two other noteworthy elements that one needs to inculcate in any expectations of the credit market outlook. One is that the banking

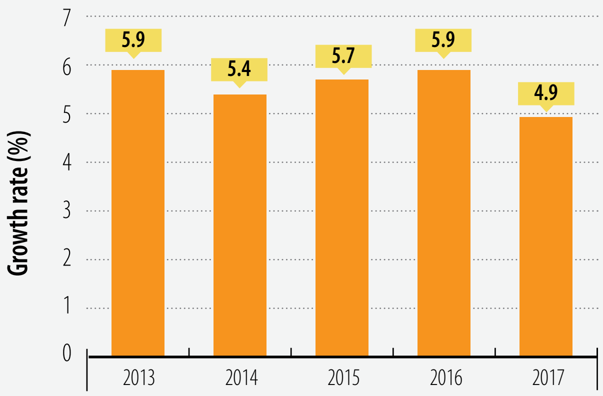
2. See IMF (2018) - https://www.imf.org/en/Publications/CR/Issues/2018/10/23/Kenya-Staff-Report-for-the-2018-Article-IV-Consultation-and-Establishment-of-Performance-46301

industry has commenced on a new asset classification regime (IFRS9) that requires more aggressive recognition of potential loan losses. The other is that the ratio of gross non-performing loans (NPLs) to gross loans is now perching at the double-digit level.

Unveiling

Against the above background, the reversal of the growth trend shown in **Figure 1**, following the 2017 rate dip, may require a deeper look beyond the macro numbers – for Aaron Levenstein may have been right in quipping thus: "Statistics are like bikinis. What they reveal is suggestive, but what they conceal is vital".

Figure 1: Quarterly Growth in GDP



Source: CBK

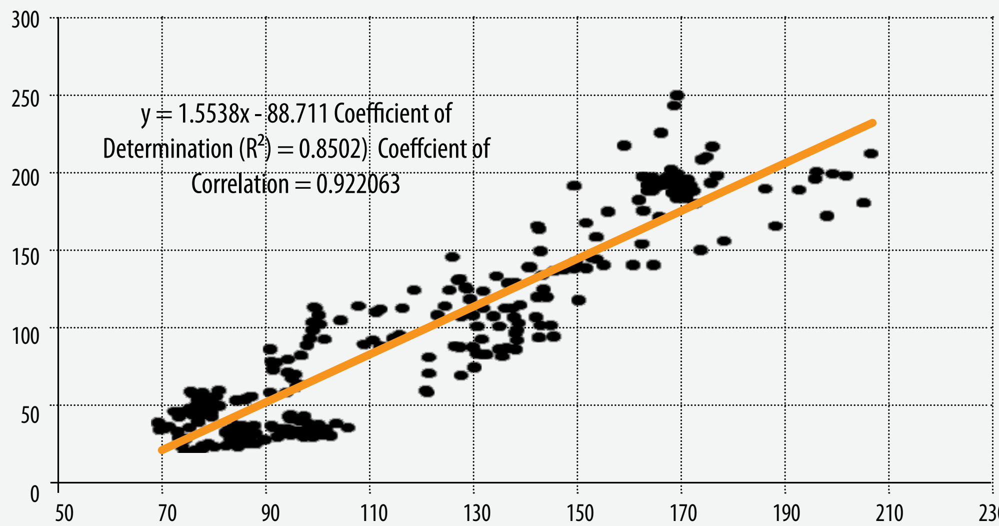
An attempted unveiling of the matters concealed entails looking in at least four areas. The first one is whether the output numbers mean much to households and firms. It is easy to make the argument that so long as the output gap (the difference between actual output and potential output) remaining negative, there is scope for non-inflationary growth. But there is a disconnect between growth as measured by output and as could be inferred from expenditure– for instance, a bumper maize harvest that feeds into high output lowering inflation, but the maize farmer is subjected to delayed payments.

The second one is the consideration that our external sector could be in the mend, but if that is happening on the back of a lower import bill as opposed to higher exports, then we are settling for a lower multiplier effects out of the closure of the economy's current account. A deeper reflection on the economic implications of the diaspora remittances being on a steady rise while tea, coffee, tourism and horticulture are experiencing lacklustre growth is necessary.

Punditry is upbeat as it argues that the rise in oil prices has reached its pick, and they can only go down. If the decline moment is maintained – of course with the caution that the trend may be frustrated by geopolitical developments. In any case, the respite from the easing of international oil prices, must be seen in the correct perspective.

Alongside the easing of oil prices has been the easing of prices of other commodities, notably some of Kenya's exports – coffee and tea. Thus, while the reduction in oil prices as observed is beneficial in terms of its easing the economy's import bill, such reduction need to more than

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



Source: IMF

compensate for the reduction in export revenue given the strong co-movement of commodity prices (**Figure 2**).

Furthermore, the projected narrowing of the economy's current account needs to be seen on the back of the global economic circumstances are far from rosy. The *IMF's World Economic Outlook* for October 2018 is optimistic but very cautious about the state of the global economy. This is on the back of the ongoing trade wars and geopolitical developments and the implication of the developments around Brexit. All these influence global demand and supply conditions.

The third one is that the profit warnings that companies listed on the Nairobi Securities Exchange (NSE) is an obvious indication that all is not rosy as the broader high-level numbers may suggest.

The fourth one is a candid recognition that the fiscal policy may have a bearing in weighing down growth. There is the public debt story that is new very topical. But we have to factor in the possibility that fiscal consolidation picking momentum is an assumption which, if realistic, will obviate the dominance government budgetary resource requirement. But if consolidation leans more towards increase revenue, some of which entailing tax measures with inflationary implication. In any case, Revenue shortfalls that persisted during 2017/18 fiscal year, put the consolidation plans somewhat at risk.

The growth outlook for 2018 and the near term must of necessity therefore temper its exuberance to avoid being seen more as a "peddling of prosperity" – in the words of economics Nobel Laurate Paul Krugman's 1995 classic[3] – and more as a cautious optimism that fully embeds the downside risks.

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

3. http://books.wwnorton.com/books/Peddling-Prosperity/

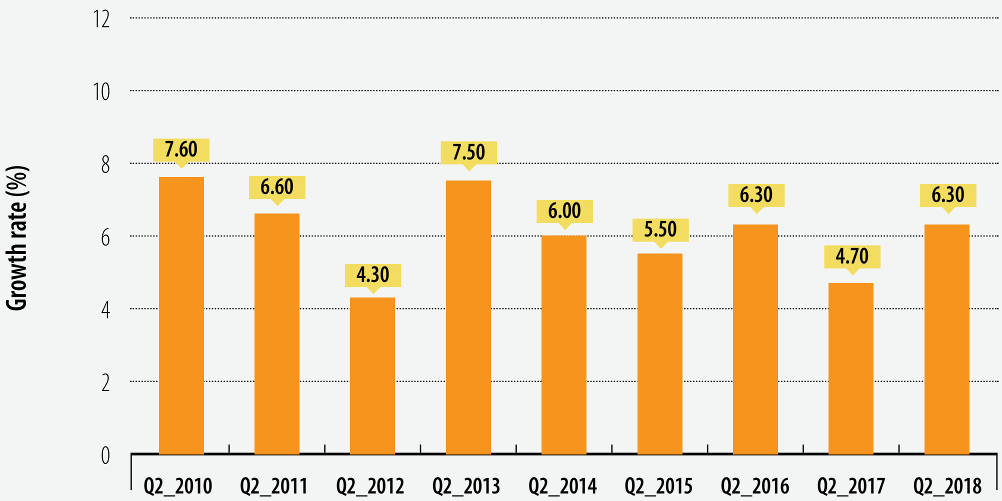
State of the Economy

Kenya's economy maintained its wide-based, strong growth in quarter two of 2018. GDP growth accelerated from 4.70% in quarter one to 6.30% in quarter two (**Figure 3**), positioning the country among the fastest growing economies in the East African region. The positive outlook was supported by stable macroeconomic environment and favourable weather conditions supporting growth in agriculture, and electricity and water supply.

Growth in accommodation and food service and information and communication sectors also helped bolster the observed growth during the quarter. Nonetheless, the upward growth trajectory at best remains lower than growth observed in similar previous period partly because the bolstering role of the financial sector in promoting growth has been thwarted by the recent introduction of Banking Amendment Act of 2016.

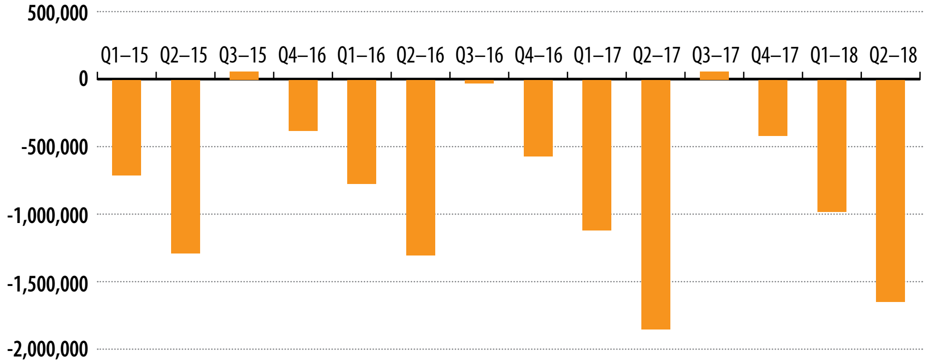
The balance of payments continued to register a deficit though it continues to narrow because of an improving capital and current account. However, the capital inflows are insufficient to cover the ever-growing shortfall in the trade balance. In addition to aggregate trade activity witnessing decrease in terms of value in quarter two of 2018, the growth in imports surpassed that of exports, driving this expansion and putting a constraint on the performance of the sector.

Figure 3: Quarterly Growth in GDP



Source: KNBS

Figure 4: Fiscal Deficit



Source: CBK

The fiscal sector, in the second quarter of 2018 relative to the same period in 2017 improved as the fiscal deficit shrank by 11.15 percent. Despite the slight improvement in the fiscal deficit, it has continued to weaken since the start of Q4 2017 to hit USD 1,662 Billion as of Q2 2018 (**Figure 4**). Due to the fall in total revenues and the continued exponential growth in expenditures.

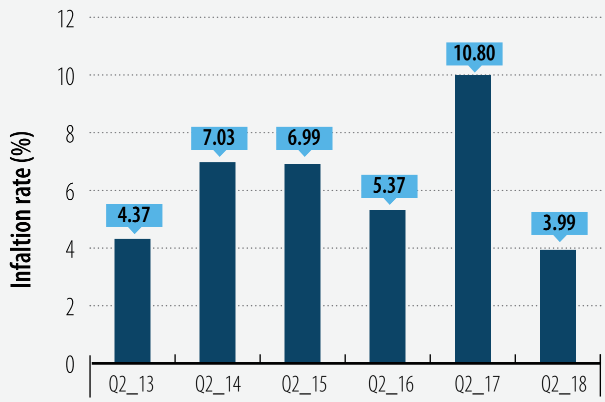
The banking and financial sectors continued to post positive results in its growth performance in Q2 2018. Assets, liquidity and deposits continue to grow albeit at a slower rate. Despite, the positive outlook, the industry continued to register deterioration in asset quality as credit supply continues to expand. In addition, private sector credit in quarter two of 2018 continued to be marked by up and downswings though remains higher that the credit observed allocation in a similar period in 2017.

The performance of the Nairobi Stock Exchange (NSE) at least by the yardstick of at its market capitalization was one of a dismal performance declining from 2,817.36 Billion in March to close at 2,549.0 Billion in May 2018, partially due to foreign investors off-loading their portfolio positions in profit in well-established blue-chip companies by investors.

The foreign exchange rate outlook was rather mixed but in the favor of the shilling strengthening against major global currencies. The appreciation of the Kenyan shilling can be seen in the context of increased portfolio capital inflows from investors abroad, banks cutting on their dollar positions and dwindling importer demand during the period. In addition, it has also been supported by diaspora remittance more inflows, tourism and horticulture exports earnings with the net effect being the cushioning of a rising import bill.

Further, the cost of living in the second quarter of 2018 remained below the upper bound of the Central Bank target with the year-on-year inflation outlook being stable. Compared to the second quarter of 2017, the average quarterly inflation rate declined threefold from 10.8 percent in Q2 2017 to 3.99 percent (**Figure 5**).

Figure 5: Average Quarterly Inflation Rates

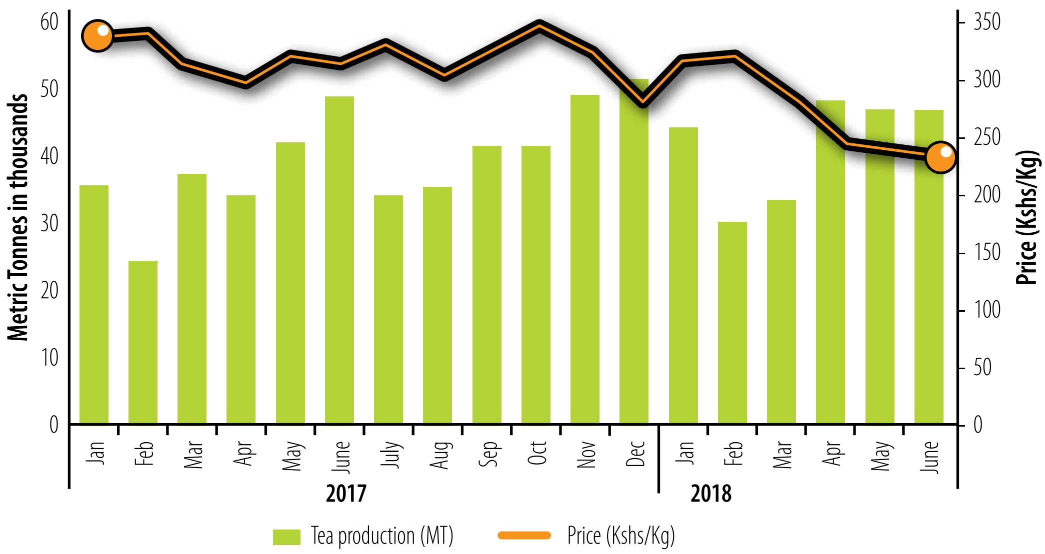


Sectoral performance

Agriculture

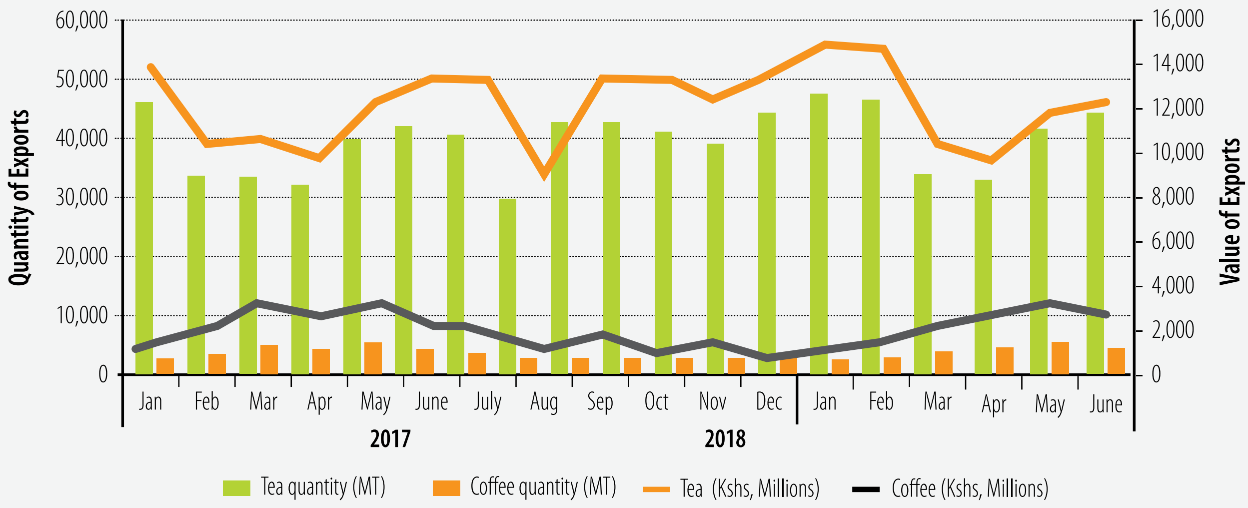
Kenya's agricultural sector continues to play a critical role, however its huge dependence on rain makes it more vulnerable to weather shocks. Despite its vulnerability to weather shocks the quarter was characterised by favourable weather conditions which as a result boosted agricultural production in Quarter growing by 5.6 percent compared to a 0.8 percent grow in a similar period in 2017. Whereas the sector's role in the economy is important, the sector is less-diversified, and activity remains concentrated in few crops such as maize, tea, coffee and horticulture. On this front, whereas tea production dominates, the quantity of produced tea decreased from 43,355.79 MT in May 2018 to 43,299.06 MT in June 2018. The price of processed tea dropped from KSh 262.95 to KSh 257.40 per kilogram over the same period (**Figure 6**).

Figure 6: Tea Production and Auction Prices



Source: KNBS

Figure 7: Quantity and Value of Tea and Coffee Exports



Source: KNBS

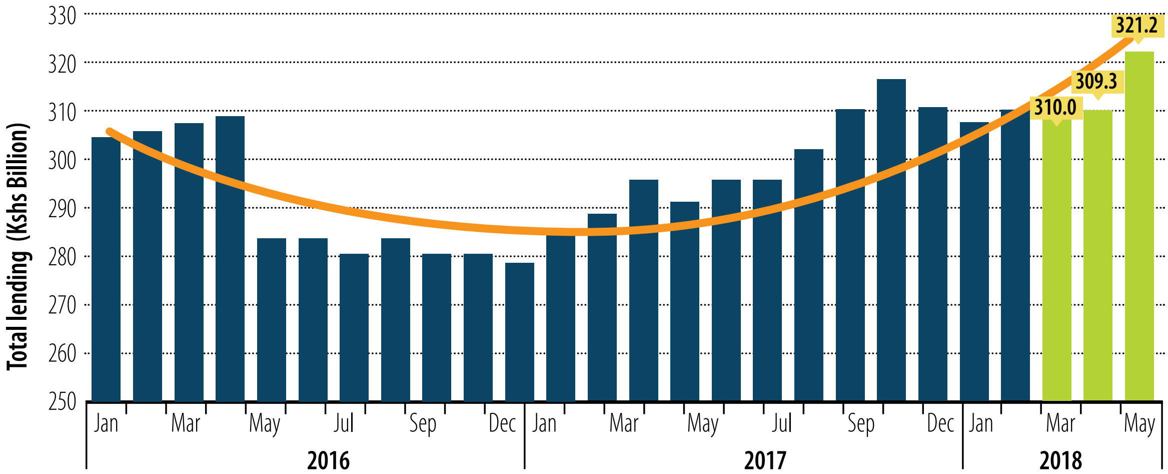
Turning on to exports, tea maintained its dominant position relative to coffee, albeit with prices being lower compared to a similar period in 2017. The quantity and value of tea exported increased from 42,532.98 MT in May 2018 to 45,182.21 MT in June 2018, while its value marginally increased from KSh 11,703.03 million to KSh 12,463.24 million over the same period. On the other hand, the quantity and value of exported coffee as well as its auction prices dipped. The quantity of coffee exported decreased from 5,572.91 MT in May 2018 to 4,649.03 MT in June 2018, its value dropped from KSh 3,209.36 million to KSh 2,664.46 million over the same period (**Figure 7**).

Manufacturing

During the quarter, the manufacturing sector outlook's was positive, recovering from a 0.2 per cent contraction recorded in a similar period in 2017 to expand by 3.1 percent in the quarter two of 2018. This improvement in the sector was partly attributable to agro-processing activities that benefitted substantially from increased agricultural production.

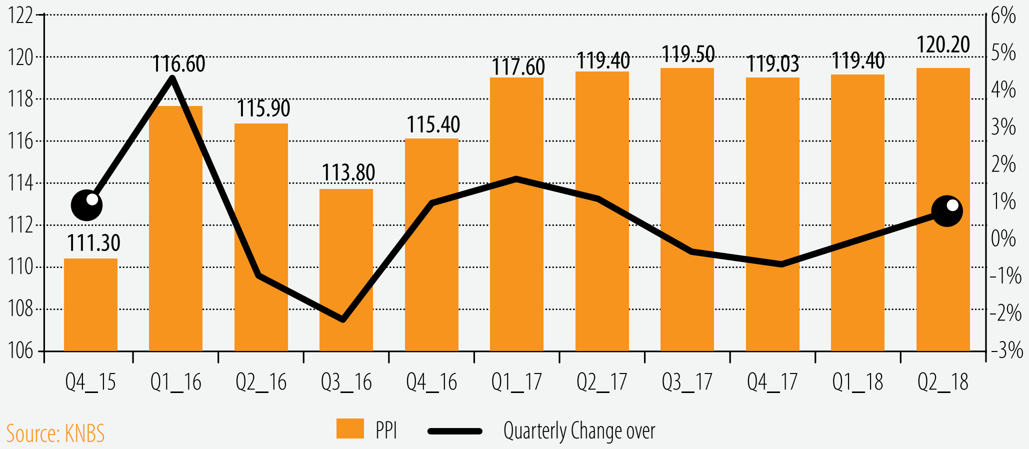
In contrast to the recent moderation in financial sector expansion, credit to the manufacturing sector accelerated further during the second quarter of 2018 compared to a similar period in 2017. The credit to the manufacturing sector standing at 321.2 Billion in May 2018 up from 309.3 Billion that was extended in April 2018 (**Figure 8**), indicating a continued appetite for manufacturing sector investment as it is deemed less risky than other sectors such as agriculture continues to attract less credit over the past years.

Figure 8: Credit to manufacturing Sector (Ksh Million)



Source: CBK

Figure 9: Producer Price Index



Source: KNBS

Producer Price Index

The producer price index marginally rose by 0.8 percent to stand at 120.2 percent in June 2018 which is also higher than the PPI in a similar period in 2017 (**Figure 9**). The rise in PPI during this period is attributed to rise in the prices of wood and of products of wood which rose by 23 percent and manufacture of rubber and plastic products which increased by 4.3 per cent. The latest developments reveal that there has been an uptick in PPI since quarter four of 2017 an indication of the pipeline pressures on prices for intermediate goods industries though they may not imply that the final consumer price inflation is likely to rise but may be an indicator of a potential rise. Similarly, the 'year on year' producer inflation rate declined from 6.39 per cent recorded in June 2017 to 0.65 per cent in June 2018. The decline in the index was mainly due to lower costs in the prices of maize flour, wheat flour and sugar.

Energy

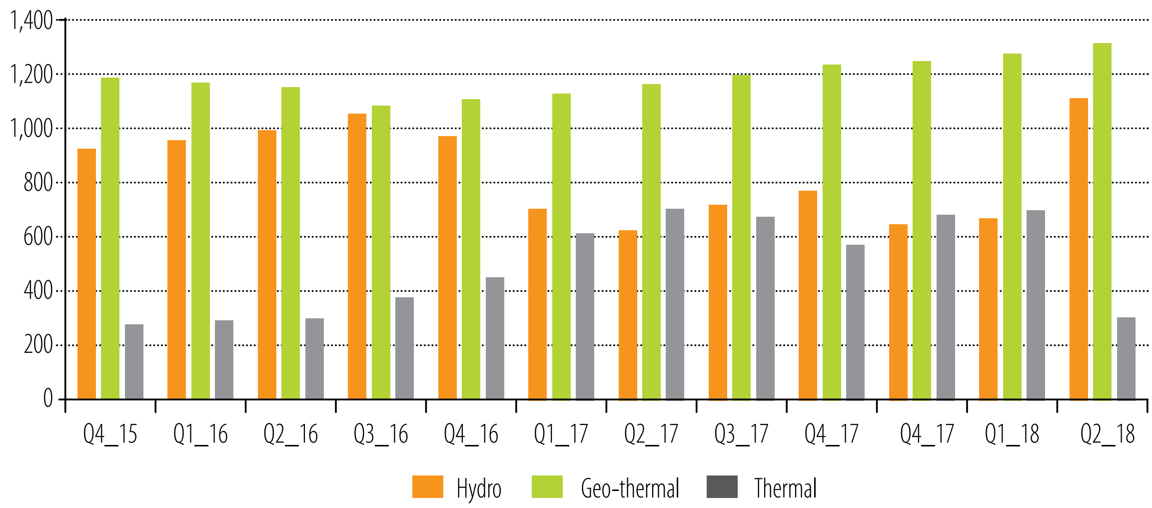
The cost of energy remains crucial in determining the cost of production in the country as well as an important factor in defining the cost of living. The sector is estimated to have expanded by 8.6 per cent in quarter two of 2018 compared to 6.0 per cent in a similar period in 2017. During the quarter, the sector's growth was driven by the substitution of input intensive energy sources with renewable energy sources that are relatively cheaper to produce. This was mainly supported by heavy rainfall that was experienced during the review period that led to a substantial increase of 77.9 per cent in hydro generated electricity compared to a decline of 37.1 per cent recorded in the same quarter of 2017 (**Figure 10**).

Electricity derived from geothermal sources increased by 13.3 per cent after growing by a paltry 1.0 per cent in the same quarter of 2017.

300MW wind farm at Lake Turkana ./File/LWTP

Generation of electricity from thermal sources that entails the use diesel-powered generators declined substantially by 57.8 per cent during the period under review compared to a growth of 134.4 per cent in the second quarter of 2017 (**Figure 10**). Consequently, the cost of electricity generation went down considerably during the quarter in review, thereby enhancing the growth of value added in the sub-sector.

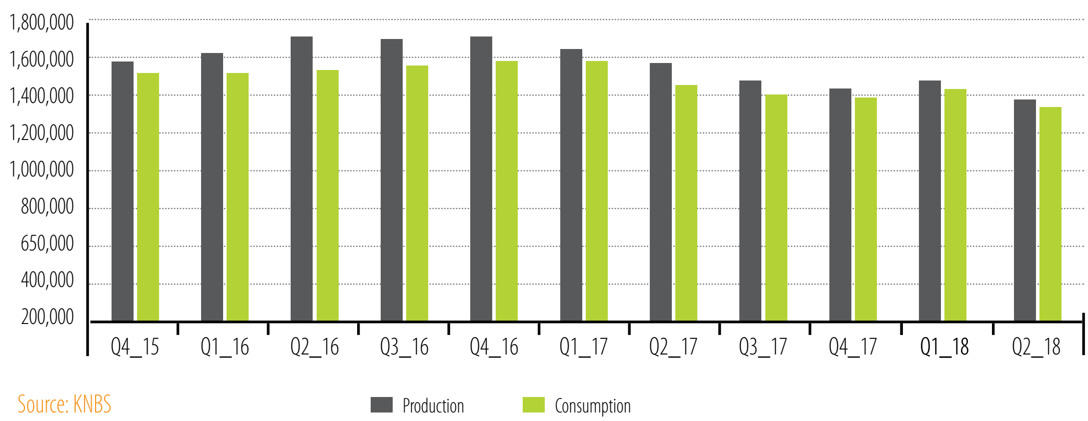
Figure 10: Electricity Generation by Source (Million KWh)



Building and Construction

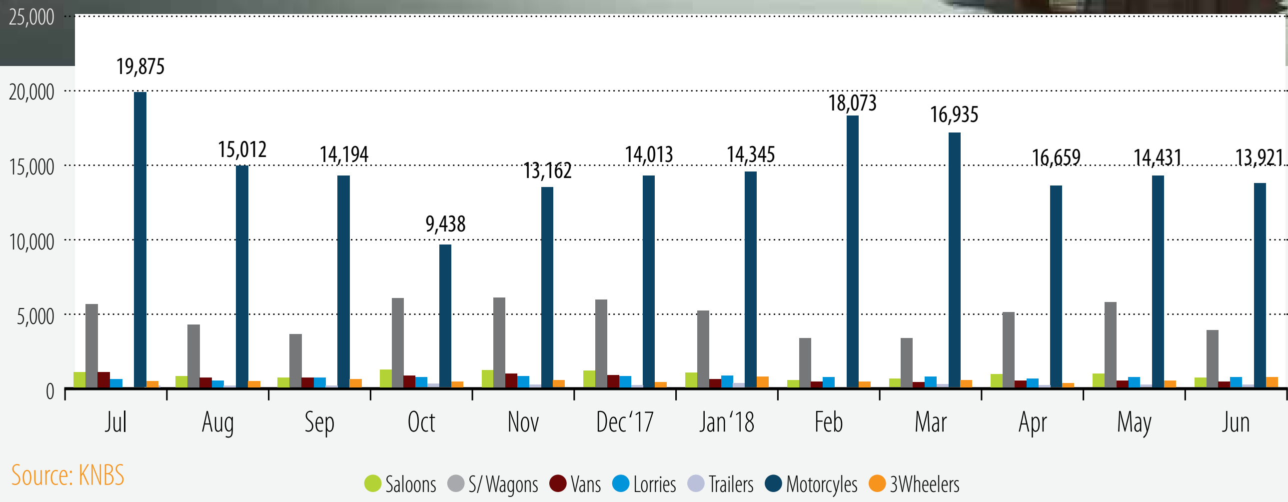
In the second quarter of 2018, the building and construction sector registered a slowdown to grow at 6.1 percent relative to a 9.1 percent growth in similar period in 2017. Despite a lower performance, the growth registered in the quarter was mainly supported by the construction of the second phase of the Standard Gauge Railway (SGR). Overall, import of construction related materials increased by 39.3 per cent in the second quarter of 2018. The consumption of cement, supply indicator of building activity declined by 6.8 per cent in the quarter under review, an indication of slowed activity in the sector. Credit to the construction industry grew by 12.4 per cent in the review quarter (**Figure 11**), a further reflection that the sector was vibrant during the quarter in review despite being comparably slower than similar period in 2017.

Figure 11: Cement Production and Consumption (MTs)



Source: KNBS

Figure 12: Registration of New Vehicles



Source: KNBS

Transport and Communication

In quarter two of 2018 the According to the KNBS, the transport and communication sector's performance was less robust compared to the corresponding quarter of 2017 but remained a key driver of the overall GDP. During the period under consideration the sector grew by 7.8 per cent mainly attributable to transportation of freight by both rail and road.

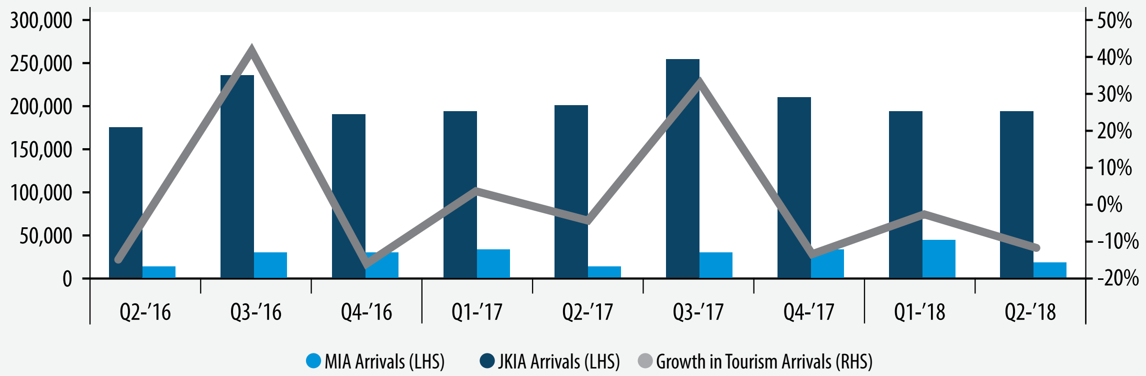
The number of newly registered station wagons rose by 18.75 percent between March and June 2018, while the newly registered saloon cars rose by 14.67 percent. The growth in newly registered 3 wheelers was 39.87 percent being the highest growth recorded across the different transport equipment's while newly registered lorries, trailers, motors cycles recorded a decline in quarter two of 2018 (**Figure 12**).

Tourism

Transport of passengers, another indicator of airport traffic and tourism, was on a decline in quarter two of 2018 compared to quarter one of 2018 though its performance is slightly higher than that of a similar period in 2018 (**Figure 13**).

On the positive front, the total number of visitors arriving through Jomo Kenyatta (JKIA) and Moi International Airports (MIA) increased to 76,608 in June 2018 up from 75,028 persons in May 2018. The number of passengers who landed at Jomo Kenyatta International Airport (JKIA) increased from 240,399 in May 2018 to 265,055 in June 2018, while passengers who embarked increased from 141,068 persons to 152,090 persons during the same period.

Figure 13: Trends in Visitor Arrivals (Thousand)



Source: KNBS

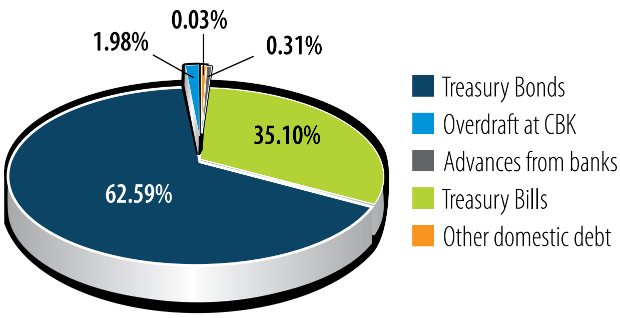
Financing of Government

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.

General government debt has been on an upward trajectory for a couple of years now with the government securities accounting for over 90 percent of the total domestic debt (**Figure 14**). The composition of debt in quarter two of 2018 remained stabled in terms of the pattern of distribution compared with previous quarters with the debt domestic debt more skewed towards treasury bonds, accounting for 62.59% of the total domestic debt advanced. Treasury bills accounted for 35.10% of the total domestic composition, overdrafts at the central bank accounting for 1.98% while advances from commercial banks and other domestic debt accounting for 0.31% and 0.03% respectively.

Figure 14: Composition of Domestic Debt



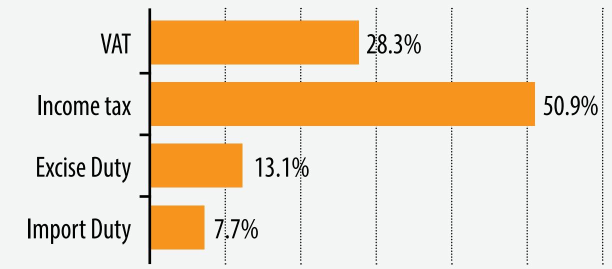
Source: CBK

Tax Revenue

During quarter two of 2017, the total tax revenue accounted for 85 percent of the total quarterly revenue with the non – tax revenue accounting for 15 percent. On the revenues side, income tax accounted for 50.9 percent of the total tax revenues while value added tax at 28.3 percent with excise duty coming third at 13.1% and import duty coming fourth at 7.7 percent

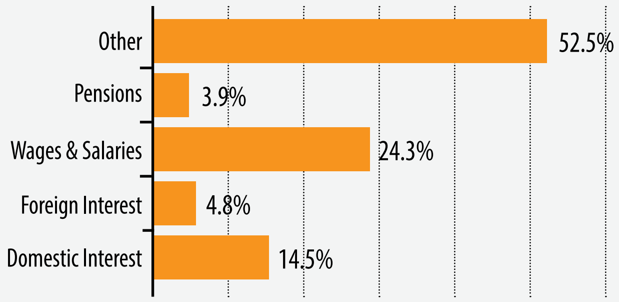
(**Figure 15**). From the previous analysis the government tax base seems to have remained constant with the contribution of each revenue stream changing marginally. This is an indication of the government's constraint in terms of widening the revenue base and coming up with new revenue sources despite of the government's expenditure continuing to rise with the onset of devolution government.

Figure 15: Tax revenue



Source: CBK

Figure 16: Recurrent Expenditure breakdown



Source: CBK

The total government expenditure on commitment basis for quarter two of 2018, reveal that recurrent expenditure accounted for 78.03 percent with the development expenditure accounting for 21.97 percent of the total government expenditure.

Breakdown of the recurrent expenditure in quarter two evidence that, Salaries and wages accounted for 24.3 percent with domestic interest payment accounting for 14.5 percent. Foreign interest repayments and pension payments accounted for 4.8 and 3.9 percent of the total recurrent expenditure respectively (**Figure 16**).

Inflation

The cost of living for the second quarter of 2018 remained below the upper bound of the Central Bank target (**Figure 17**). A look at the inflation outlook for quarter two of 2018 shows that year-on-year inflation has a stable outlook while the fuel inflation and the non-food non-fuel inflation has an upward outlook while food inflation is on a downward trajectory.

The food inflation declined continuously from 2.58 percent in March to 0.74 percent in May 2018 in part due to increased food supply because of improved weather conditions in the country that led to a decline in the prices of some foodstuff. Fuel inflation remained high, closing at 11.44 percent in May from 8.17 percent in March 2018. The rate of inflation measured by the annual change in consumer price index decelerated to 5.61 percent in May from 6.89 percent in March. A review of month – on – month inflation rates in quarter two of 2018 with the monetary policy's decision to retain the bank rate at 9 percent, inflation rate inflation remains at least anchored in quarter two of 2018.

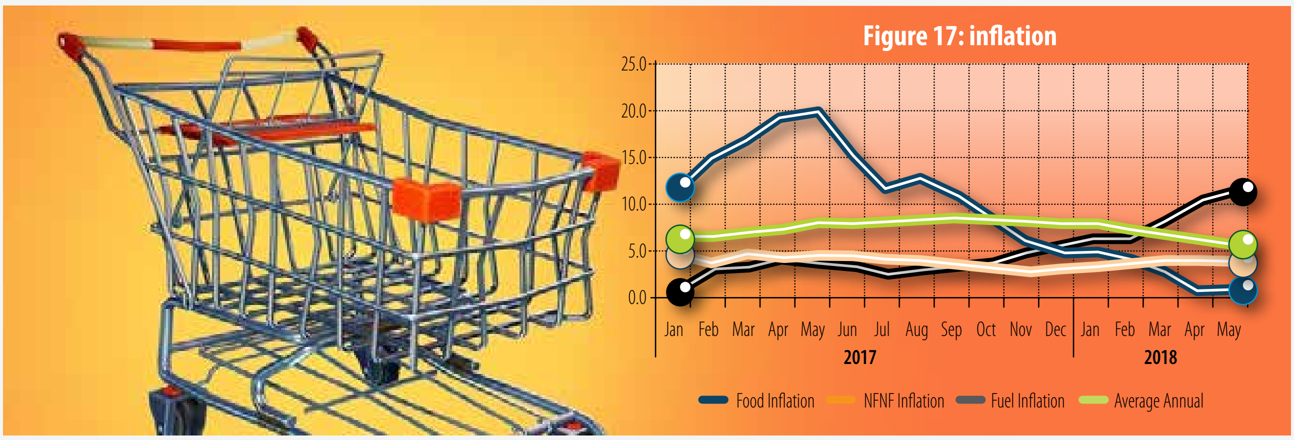


Figure 17: inflation

Interest Rates

Two notable periods, first, the weighted average lending rate pre-interest rate capping was on an upward trajectory partly reflecting the high cost of funding and risk associated with lending. In addition, the interbank rate has been oscillatory with the rate closely co-evolving with the deposit rate and slightly lower than the weighted average lending rate (**Figure 18**).

The fact that the interbank rate, the rate at liquidity constrained institutions seeks funds from and the fact that the deposit rates are high leaves financial institutions with less margin to price the credit risk of the borrowers and the cost-of-funds in the form of interbank borrowing and use of liabilities dries up the margin and leaves credit risk not being priced appropriately.

Both the weighted average deposit and lending rate seems to converge declining to 8.04 percent in June 2018, down from 8.17 percent in April 2018 and 13.22 percent in June 2018, down from 13.24 percent in April 2018 respectively. This is due to the recently introduced interest rate cap regulation that placed a ceiling on lending rates and a floor on deposit rates. However, the amendment of the floor on deposit rate is likely to affect the evolution of deposit rates going forward.

The interbank rate during the second quarter of 2018 averaged 7.98 percent (**Figure 19**) slightly lower than the rate observed in the first quarter of 2018 implying that there was an improved liquidity position in the market and hence a lower interbank rate. On the other hand, yields on short-tenored government securities (i.e. 91-day TB) continued to decline, albeit at a slower pace. In Quarter two of 2018 the short-tenored securities yields were 5.04 percent.

Figure 18: Evolution of Lending, Deposit and Interbank Rates

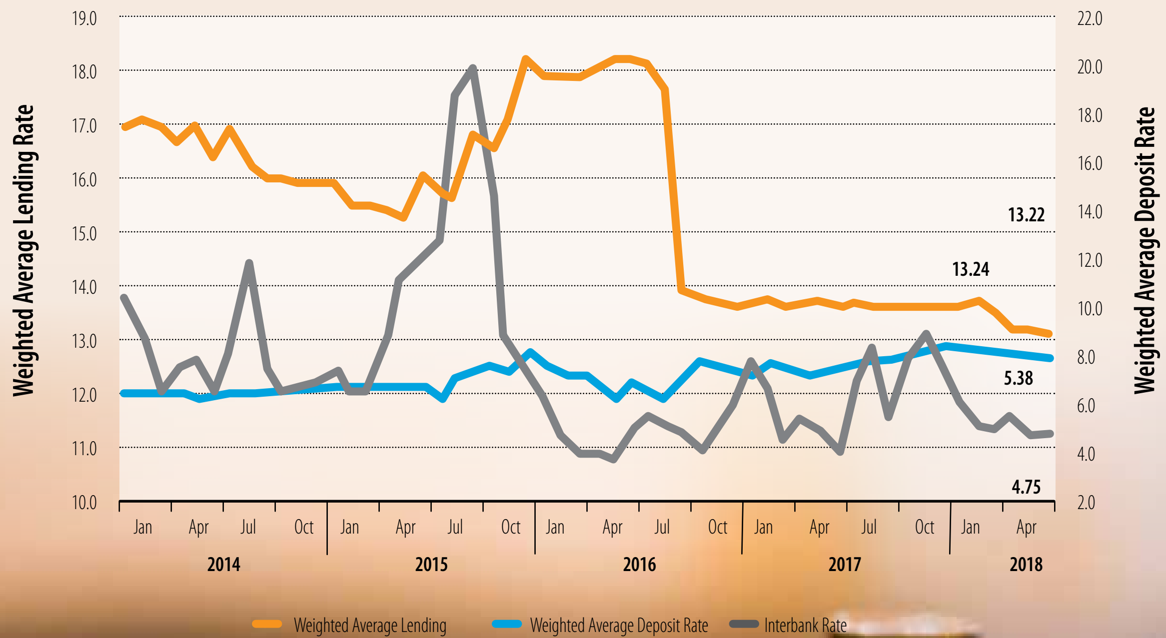
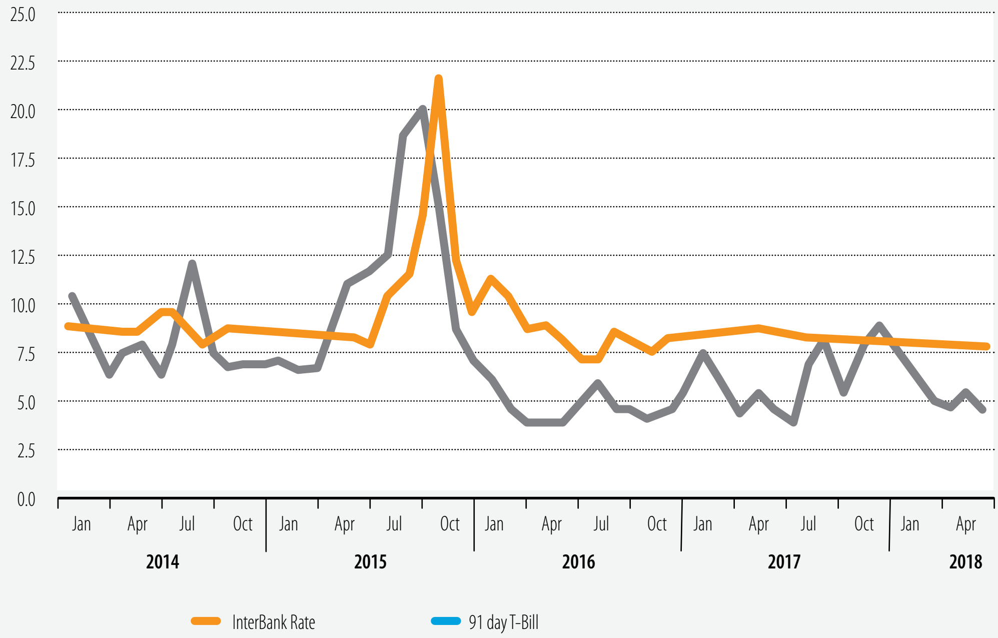


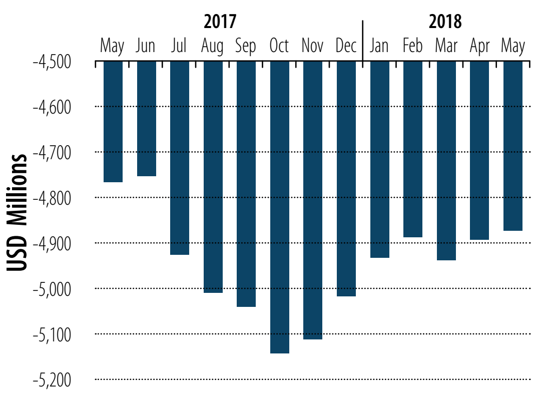
Figure 19: Interbank rates and 91-Day Treasury Bill Rates



Balance of Payments

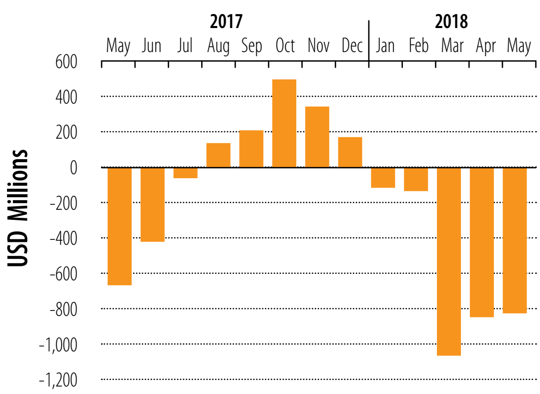
Kenya has consistently run a current account deficit (**Figure 20**), largely driven by a deficit on merchandise trade. However, since beginning of 2018 the current account deficit has been narrowing supported by a growing export momentum supported by the rising exports both in terms of value and volumes. As of May 2018, the current account deficit stood at USD 4873.6 million. On examining the overall balance of payment position, Kenya has had a BoP deficit (**Figure 21**) though since the beginning of the year the BoP position has improved from USD 1,054.30 million to USD 811.3 million in May 2018. Though the Current account and BoP's outlook is positive, the deficit remains.

Figure 20: Current account deficit improves



Source: CBK

Figure 21: Balance of payment position improves



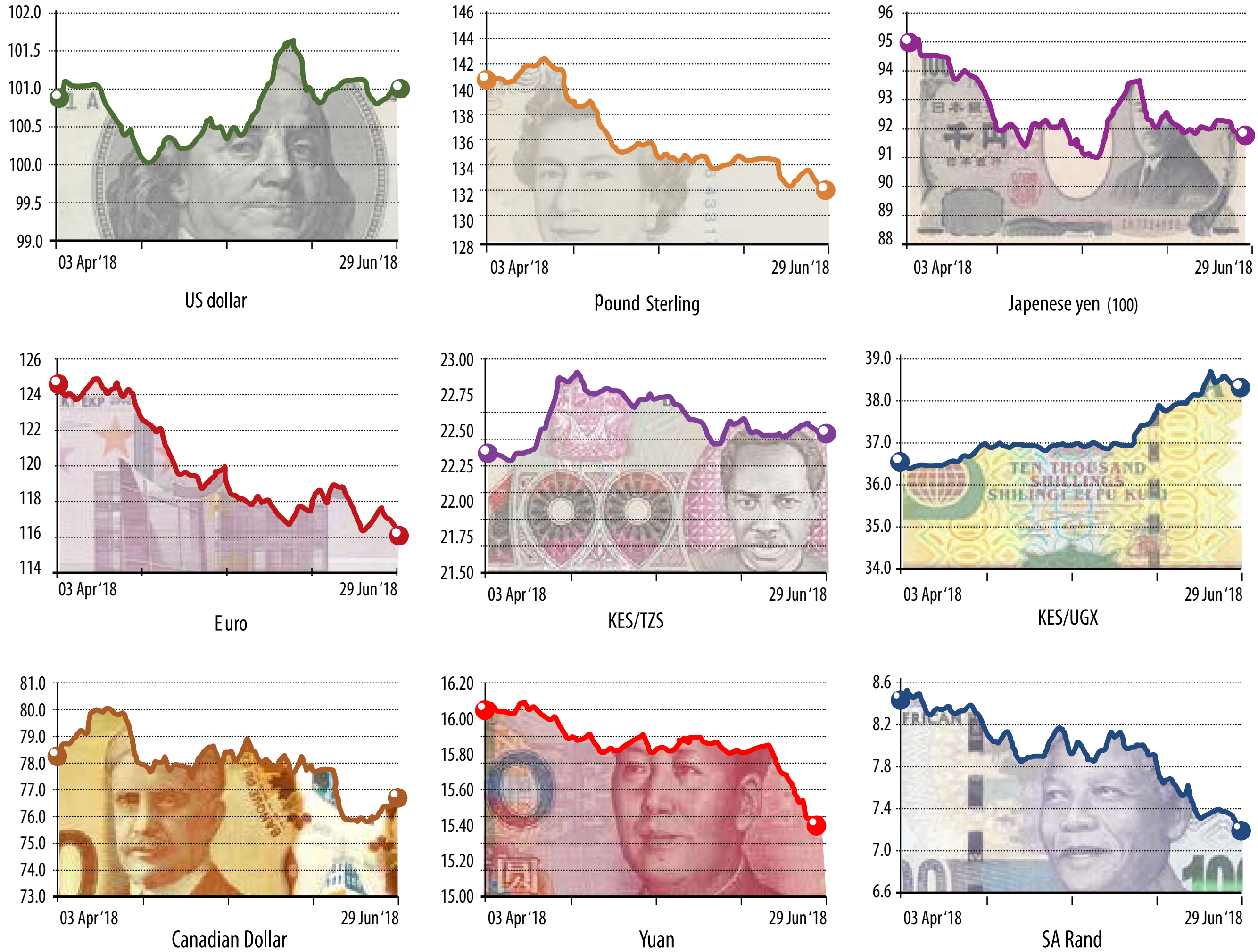
Source: CBK

Exchange Rate

In Q2 of 2018, the foreign exchange rate outlook was mixed but in the favor of the shilling strengthening against major global currencies (**Figure 22**). The Kenyan shilling appreciated against major global currencies during this period. The appreciation of the Kenyan shilling can be seen in the context of increased portfolio capital inflows from investors abroad, banks cutting on their dollar positions and dwindling importer demand during the period.

In addition, the strengthening of the Kenyan shilling has also been supported by more inflows from the diaspora in the form of remittances, tourism and horticulture exports earnings and thus cushioning the effect of a higher import bill due to rising price of oil.

Figure 22: Kenyan Shilling strengthens against major global currencies



Taking a keen look at the major global currencies, the US dollar showed some mixed performance with a depreciation in the month of April but later in May and June it appreciated against the shilling to close at 101.50. Against the Sterling Pound, the Kenyan shilling in Q2 of 2018 strengthened to close at 132.10 in June 2018 compared to the 141.84 at the beginning of April 2018.

Against the Euro, the shilling equally strengthened declining from its opening 124.5 position of to close at 116.86 in June 2018. The Chinese Renminbi depreciated against the shilling and closed the quarter at 15.30. On the flipside, the Ugandan shilling strengthened compared to the Kenyan Shilling in Quarter two of 2018 to close at 38.34 while the Japanese Yen showed a similar trajectory as the sterling Pound, the South African Rand and the Tanzanian shilling which all closed at a lower position.

Nairobi Securities Exchange

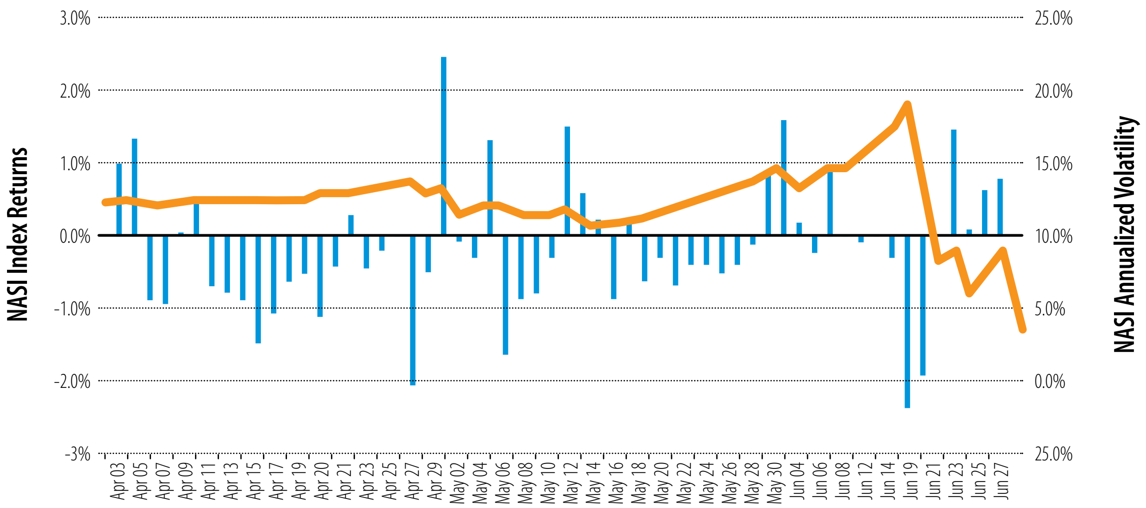
The performance of the Nairobi Stock Exchange (BSE) looking at its market capitalization, a measure of the value of the entity by accounting for the value and volume of the stocks listed was one of a dismal performance. This measures the dollar value of this entity by accounting for the value and volume of the stocks listed. The market capitalization declined from 2,817.36 Billion in March to close at 2,549.0 Billion in May 2018,

Table 2: Nairobi Securities Exchange

	2017						2018				
	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May
NASI	156	169	162	162	173	171	181	182	189	180	173
NSE 25	4,271	4,485	4,272	4,202	4,402	4,283	4,513	4,563	4,944	4703	4470
NSE 20 Share Index	3,700	4,027	3,751	3,730	3,816	3,711	3,737	3,751	3,854	449	677
Equities Turnover (Kshs Million)	21,304	16,024	16,248	9,390	14,760	11,867	20,340	17,920	22,890	15,076	18,377
Market Capitalization (Kshs Billion)	2358	2478	2377	2373	2562	2521	2660	2678	2,790	2,645	2,549

Source: Nairobi Securities Exchange

Figure 23: Stock Market Returns and Annualized Volatility



Source: NSE

partially due to profit offload in well-established blue-chip companies by investors. On the yardstick of the Nairobi All Share Index (NASI), the stock market registered a significant drop from a high of 191.23 points in March to 173.00 points in May 2018. Turning on to the NSE-25 Index metric, the stock market shed 495.69 points between March and May 2018.

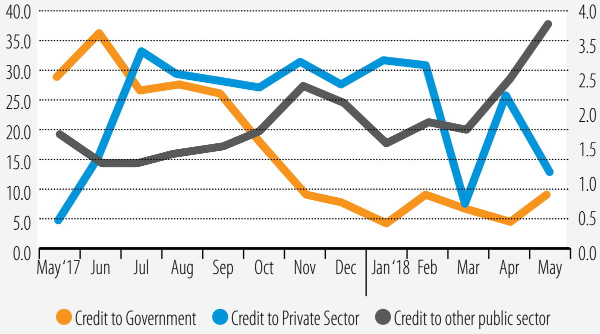
The equity turnover also drastically fall from 22,890 Billion in March 2018 to 18,377 Billion in May 2018 though is a slight recovery from the turnover registered in April 2018. The decline in the equity moved during the quarter reflects the decline in investor participation at the bourse. Despite a rise in the number of shares traded in Q2, it is still lower than the shares traded in Q1 of 2018. Both the NASI and NSE 25 index also dipped in Q2 of 2018. The asset market returns -captured by the NASI index returns in **Figure 23**– a measure of the stock market performance reveal that during quarter two of 2018 experienced sharp fluctuations with most days recording negative returns. However, towards the last period of the quarter the stock market returns were positive with a sharp dip in the annualized volatility. This is in line with the expectation that stock market rises – i.e. a rise in stock market index and consequently a rise in returns, the volatility declines. During this quarter it can thus be inferred that investment stock prices were relatively tight in the initial period of the quarter and the risk were relatively muted by during the month of May the build-up of risk were evidenced which later subsided in the month of June.

Banking Industry Performance

Recent developments in the banking sector are characterized by rising assets growth, moderate credit expansion and a continued deterioration in asset quality. The assets growth of the banking industry remains steadfast and has been of an upward trajectory since the beginning of the year. However, the industry also continues to register marked deterioration in asset quality as credit supply continues to expand. Quarter two of 2018 has remained another challenging period for the banking industry, with subdued pace of credit growth and continued stress on asset quality.

In Quarter two of 2018, Credit growth to the government declined by 12 percent from 25.4 percent in April 2018 to 13.4 percent in May 2018. Generally, credit to the private sector has been on a downward trajectory which kicked in September 2017 however, though credit growth is still low, it registered a slight growth in Q2 by 3.9 percent to stand at 8.3 percent in May 2018. Equally, credit growth to the other public sector other than the government increased by 1 percent to stand at 3.8 percent in May 2018 (**Figure 24**).

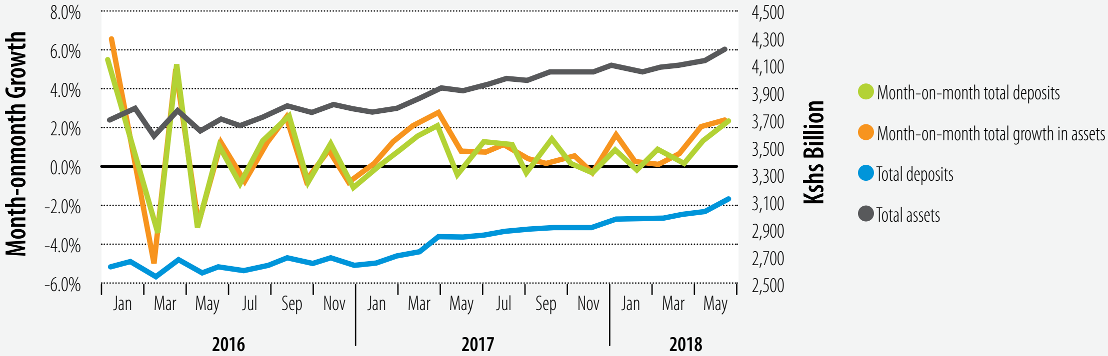
Figure 24: Credit to the private sector dampens as momentum in public sector credit rises



Source: CBK

The banking industry's deposits continued to grow reaching an all-time high of Kshs 3,106.60 Billion in May 2018 representing a 2.3 percent growth on a month-on-month basis. However, the growth in deposits has grown at a slow pace since the Q2 of 2017. More importantly, the total assets held by the banking industry has constantly grown though at a slower pace and as of May 2018 the total asset base was Kshs. 4,225.40 and the asset and deposit base growth have co-evolved over time (**Figure 25**).

Figure 25: Banking system asset and deposit base continues to grow albeit at a slower pace

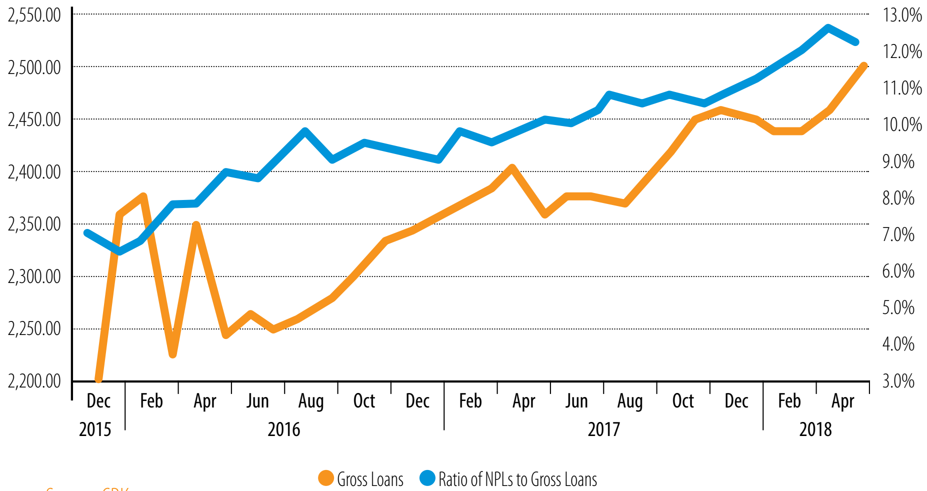


Source: CBK

The ratio of Non-Performing Loans (NPLs) to total loans during Quarter two maintained its upward trend and reached 12.13% by May 2018 indicating the continued deterioration of the industry's asset quality (**Figure 26**). On a related subject, the liquidity within the banking system has been increasing though at a slower pace as reflected by the 0.4 percentage increased observed from April through May of 2018 indicating that the banking industry has become more resilient to short-term liquidity constraints (**Figure 27**).

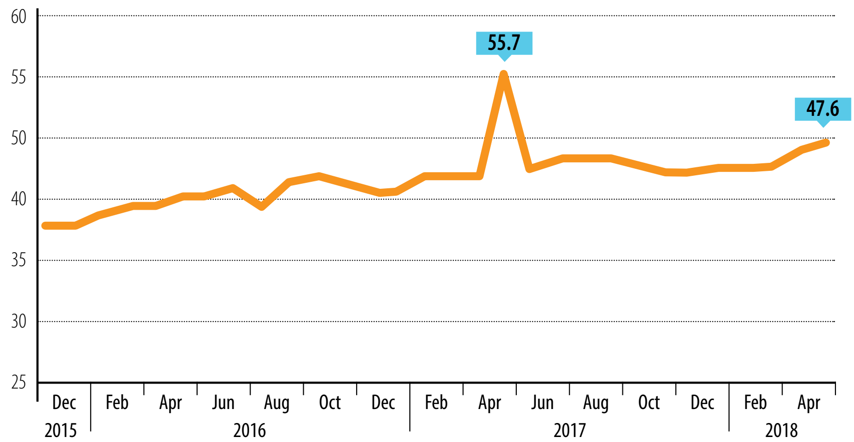
Short-term liquidity constraints ease, as asset quality continues to deteriorate

Figure 26: Asset Quality Changes



Source: CBK

Figure 27: Banking Industry's Liquidity ratio



Source: CBK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Kenya 2016
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KENYA BANKERS
ASSOCIATION
One Industry. Transforming Kenya.

Kenya Bankers Association
13th Floor, International House, Mama Ngina Street
P.O. Box 73100– 00200 NAIROBI
Telephone: 254 20 2221704/2217757/2224014/5
Cell: 0733 812770/0711 562910
Fax: 254 20 2221792
Email: research@kba.co.ke
Website: www.kba.co.ke