KENYA BANKERS ECONOMIC BULLETIN

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

About the Centre for Research on Financial Markets and Policy

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

CENTRE FOR RESEARCH ON
FINANCIAL MARKETS AND POLICY

KENYA BANKERS ECONOMIC BULLETIN

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In this Issue

FOREWORD

From the CEO's Desk

It is my pleasure to present to you the 20th Issue of the *Kenya Bankers Economic Bulletin*. In this issue, we discuss the state of the Kenyan economy second Quarter of 2017. The *Bulletin* reviews the strides that the economy has made since the beginning of the year, with an emphasis on the opportunities and constraints that continue to shape the economy's gradual recovery.

Much of the discussions during the second quarter were largely reflections on the General Elections of August 2017 and their implications on the economy. In the past, elections have been disruptive. The experience of 2007/08 post-election violence is typically seen as the point of reference on how things can go wrong from the political front.

With hindsight though, we know that even with calm, the legislative agenda of parliament – itself a political process – can have adverse ramifications on the economy. This especially when realism is traded for populism as was the case in the 2016 when the National Assembly enacted the law that regulates interest rates to the detriment of the credit market. Evidence of how that affects the overall economic performance in a negative manner will most likely play out during the last two quarters of 2017.

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.

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.

Habil Olaka
Chief Executive Officer,
Kenya Bankers Association

COMMENTARY

Lion we May Be, But Are we Bouncing?

By Jared Osoro

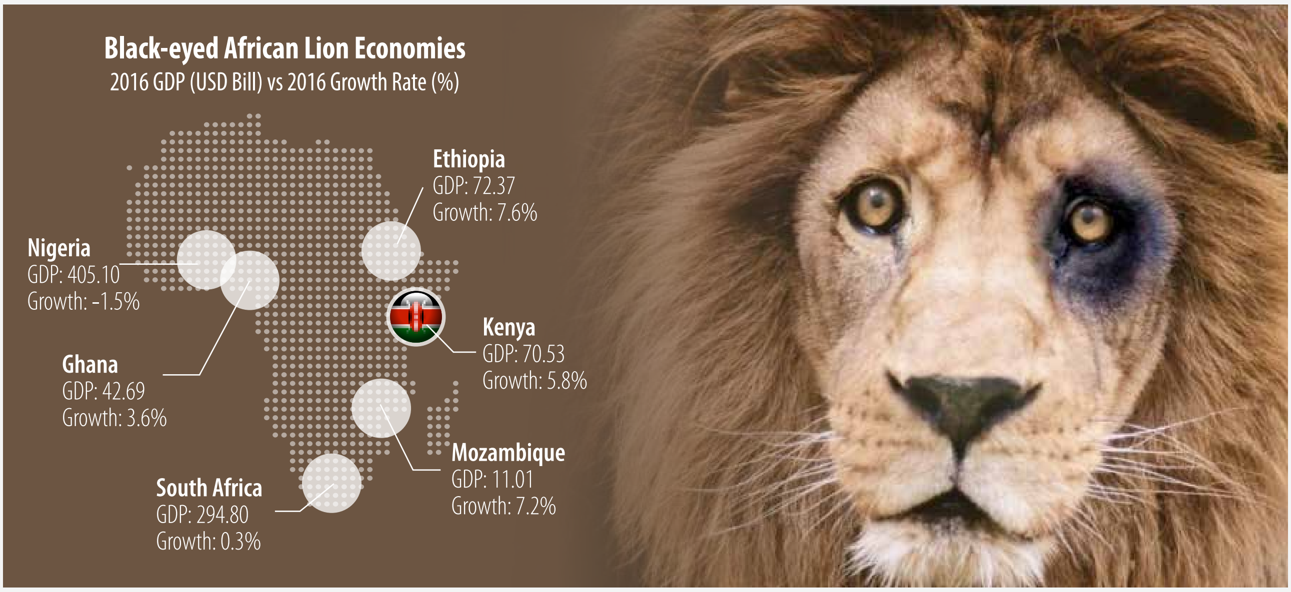
When an economy is likened to a lion, its custodians have every reason to beam with satisfaction. For good measure, it symbolises strength and dominance. That is precisely why a recent book - *Africa's Lions: Growth Traps and Opportunities for Six African Economies*[1] - is hinged on the experience of fast-growing and/or economically dominant African countries.

Kenya is among the six lions, the other five being Ethiopia, Ghana, Mozambique, Nigeria, and South Africa. The core of this analysis is the interplay between growth and employment outcomes. With a view that the growth of the global working-age population for the next two decades will be driven primarily by Africa, the relationship between economic growth and employment needs to be understood within the a country's anticipated demographic challenges and their implication for employment growth.

The analysis plays into the space of political economy and structural transformation, two linked subjects often crowded out by the fixation on a quarter-by-quarter economic growth as an end in itself. The relevance of these two areas in the context of Kenya, especially for this quarter's *Kenya Banker's Economic Bulletin*, draws from the fact that easy, not necessarily insightful, inferences are often drawn on the implications on the election calendar.

But the Kenyan chapter in The African Lions does dive into the subject. It makes a number of observations, notably the following. The peaceful transition in 2002 led to the focus on the economy underpinned by the economic and structural reforms under the Economic Recovery Strategy (ERS) and a favourable external environment. Good performance was inevitable.

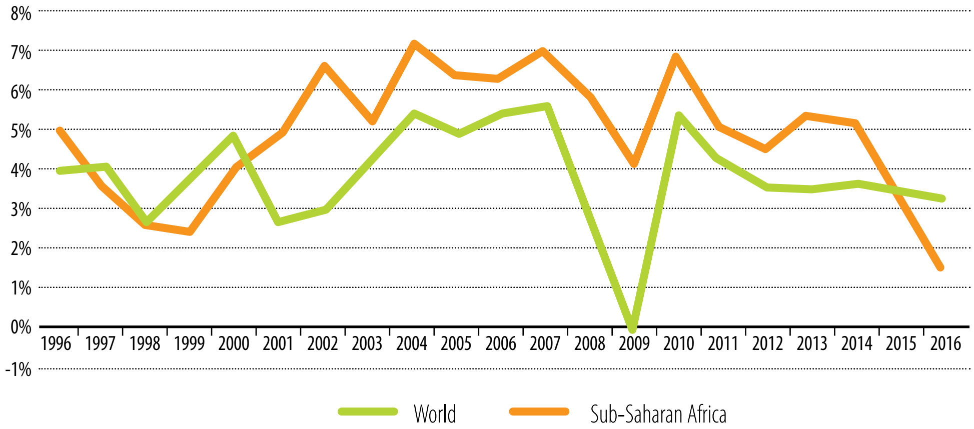
The good performance notwithstanding, the failure to develop an inclusive political agenda widened divisions in the country; thus the subsequent 2007 elections were followed by a serious outbreak of ethnic violence, significantly disrupting the economy. Even for the most optimistic, the Kenyan economy post the global financial crisis of 2008 has represented anything but a clear bounce-back. The sometimes feeble recovery has been underpinned by a not-so-clear pattern of quarterly real growth performance.



1. Bhorat H and Tarp F.,(eds) (2016), Africa's Lions Growth Traps and Opportunities for Six African Economies, Brookings Institution Press, November.

2. Kimenyi M.S., Mwega F.M and Ndung'u N.S (2016), African Lions: Kenya's Country Case Study, in Bhorat H and Tarp F., (eds) (2016), Africa's Lions Growth Traps and Opportunities for Six African

Figure 1: Real Output Growth Trend (%)



Source: IMF World Economic Outlook Database

Looking for the elusive bounce

So from where do we start the search for the elusive bounce? If indeed the six lions have dominance and resilience, then they "take the cake" in the 2016 Sub-Saharan Africa's dismal 1.4 percent real growth. It can be argued that growth in itself is not the problem – for most of the past two decades, the region has performed better than the global average (**Figure 1**).

This means therefore that the crux of the argument is on where growth emanates from. If one was to tap into the 1954 wisdom of economics Nobel Laureate Arthur Lewis, then our transformation would be underpinned by labour shifting from "traditional" sectors such as subsistence farming that could be perceived as unproductive to modern capitalistic ones.

How have the Lions fared on the Lewis test? On the one hand the answer is in seeking to understand whether labour productivity through adding capital or improving skills and technology. On the other hand it is in looking deeply into the evidence on structural changes that will incentivise workers to move between sectors.

If both of these sides were to be at play in one form or the other, then one should be able to see labour leaving small farms – mainly subsistence leaning – to factories. But that is not what we see. Instead what is all over our faces are movements from farms to being motorcycle taxi drivers (colloquially known as *boda boda* riders) hustling for customers or numerous small shops selling near-identical stuff.

No wonder informality in Africa is all over the place. In the estimate of the IMF, the informal economy is a key component of most economies in sub-Saharan Africa, contributing between 25 and 65 percent of GDP and accounting for between 30 and 90 percent of total non-agricultural employment[3]. This is a reflection of structural vulnerability to feed into the political economy.

On the Kenyan front, all may not be rosy even on the real output parameter, it is not all rosy. Even the very optimistic are tempering their expectations. The World Bank's April 2017 *Kenya Economic Update*[4], presents a downward revision of this year's growth outlook. This is a can only imply that if there is any chance for this year's real GDP growth to surpass last year's then remaining last two quarters of the year will have return stellar performance.

Evidence is scant to support such a position. Even a calm post-election period hardly provides such evidence. The legislative agenda of the new parliament – especially one with a direct leaning on the economy – is at the very least unclear, otherwise potentially destructive if it goes on a populist tangent.

More than many are willing to admit, last year's legislation that regulated interest rates, is now showing all the signs of adversely affecting the credit market and consequently the economy. With the evident denial of the negative effects, it is possible that the legislature could double down on more populist but damaging legislation.

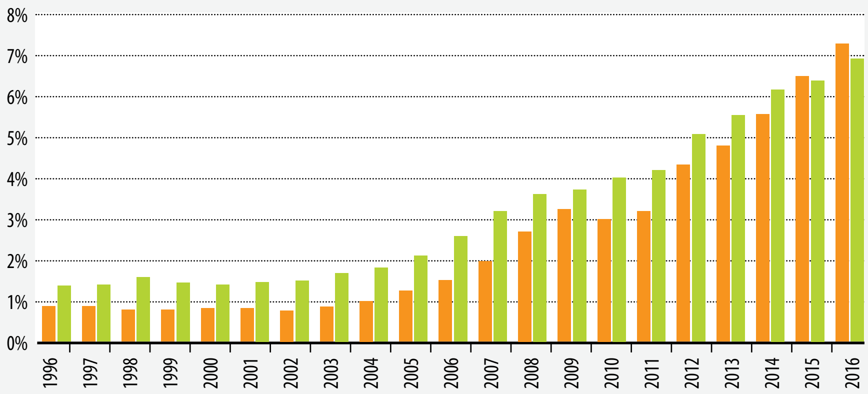
As I have argued in the past, there is a real possibility that the economy's "potential growth" has declined meaning that it is unrealistic to expect anything dramatic on the growth front. We may be seeing a "new normal" emerging where even a modest growth of 5 percent – 6 percent is celebrated as robust! The only check to the reduction in the economy's full employment level of income is the aggressive infrastructure expansion.

But even then, Kenya couldn't have lost the marathon to Ethiopia – the other so described lion – if its capacity was to be on an expansionary trajectory. As Figure 2 shows, Kenya's economy is now smaller than Ethiopia's – the latter was about 50 percent Kenya's size a decade ago.

3. See IMF (2017), Regional Economic Outlook: Sub-Saharan Africa Restarting the Growth Engine, April. (http://www.imf.org/en/Publications/REO/SSA/Issues/2017/05/03/sreo0517)

4. See https://openknowledge.worldbank.org/handle/10986/26392

Figure 2: Nominal Output Evolution (USD Billion)



Source: IMF World Economic Outlook Database

"Wo! I feel good"…The James Brown moment persisting

Without painting gloomy picture, I argue that the true state of affairs would be between "resilient" and "robust". But still the feel feel-good factor persists. This is particularly seen in the stock market. In the Nairobi Securities Exchange, it is positivity galore. This is hardly surprising. Positive sentiments are clearly critical in occasioning the short-run market outturn.

Typically, over the short-run investment horizon, investors tend to keep an eye on every business, economic or political news that could impact their portfolio; thus the market movements are significantly based on sentiments. Ordinarily, the trajectory of the stock market is often taken to mirror the posture of the real domestic. That is when the observed positive market outturn could be taken as a harbinger for the economy's sustained up-turn.

But as I that will be a hasty inference. A careful consideration of the international and domestic economic circumstance necessitates that the optimistic outlook on the economy's performance – while justifiable on account of the unrealism of its discounting based on political developments, now that the transaction has defied negative expectations – needs to factor in the hazy global environment and a fluid domestic market circumstances.

Kenya is increasingly looking at the Chinese economy as a principal trading partner. At 7 percent to 8 percent growth range, China's economy is maturing, and with maturity comes slow pace.

The Intentional Monetary Fund (IMF), in its April 2017 World Economic Outlook (WEO) illustrates how hazy the global environment is proving to be. Even though there is recognition that the global economic prospects have improved, recovery in the advanced economies is anticipated to remain constrained.

While the outlook presented above may be a justification for those keeping an eye on the Kenyan economy sighing with relief, there are issues that have not come out prominently but which need to be borne in mind. It may be too early to safely conclude that the challenges to the Eurozone have been adequately addressed and with finality. There is uncertainty on how Brexit – the decision by Britain to leave the European Union – will burn out.

Further, the economic consequences of North Korea's nuclear ambitions, heightened by the recent threats of missile launches need to be appreciated. If such threats culminate in armed conflict in the Korean Peninsula, it would most likely suck in much of Asia, the risk being a curtailment of the thriving Asia economy.

Kenya is now increasingly looking at the Asian economy, and in particular China, as a principal trading partner. The developments in North Korea, and in particular their potential adverse impact on the Asian economy comes at a time when China's economy – which for some time now has been the pillar for global growth – is experiencing slow growth.

The Chinese economy's growth in the 7 percent to 8 percent range is now normal. This is to be expected. China's economy is maturing, and with maturity comes slow pace. While this may have ramifications on economies that are not just seeing China as an opportunity for market diversification but as an alternative dominant market, it could be seen as a welcome development.

For one, consumption-led growth is now surpassing investment-led growth. Further, services are set to overtake industry as a contributor to the economy's output. Finally, as the economy matures, any attempt to flog faster growth may fuel inflation, for as some commentators have quipped, "growing faster is a poor alternative to growing up".

So lion we may be, but….

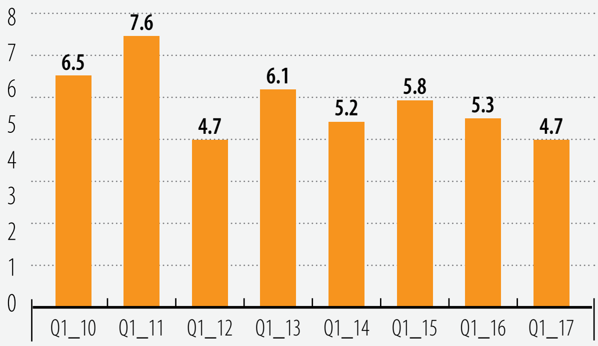
As growth is at everybody's mind, so should stability. So the policy thrust on stability, which is this Bulletin reported in a number of market outcomes shouldn't be overshadowed by the sanguine posture on the economy. This, we argue, does not imply that stability should be pursued as an end, but there has to be a continuous calibration in the strive for a sustainable balance between supporting economic recovery and entrenching stability.

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

State of the Economy

During the first quarter of 2017, the economy grew by 4.7 percent compared to 5.3 percent in the same quarter in 2016. This was perhaps the lowest ever posted quarterly growth since year 2013 if we compare the growth rates for first quarters for previous years. The slowdown in the quarterly growth during Q1 of 2017 can be seen to be an outcome of a number of factors and scenarios. First, from the sectoral analysis mainly of the sectors that significantly support the economy. Agricultural sectors posted slowed growth mainly arising from the poor performance in the short rains of October – December period. This culminated into drought in quarter one of 2017 and with the delay in the onset of the short rains for March June period, the situation worsened. This saw the cost of living rise mainly arising from the increase in the food prices hence negatively shocking the economy. This hurt the production of both the food as well as the cash crops thus while the domestic prices rose thus increasing the cost of living, adverse weather also shocked the exports through reduced production of agricultural cash crops.

Figure 3: Quarterly Growth in GDP – 2009 Base Year



Source: KNBS

From the macroeconomic front, the macroeconomic environment was not very conducive in favouring economic growth across all sector. First, the buildup of the inflationary pressures arising from the increase in the food prices could only be experienced at the expense of growth. Further the constrained credit to the private sector in the interest rates capping era also culminated into slowed growth in quarter one being barely a quarter upon the execution of the law in September 2017.

With this exposure of the snapshot on the performance of the economy in quarter one of 2017, and in particular the weakening of the macroeconomic fundamentals that support growth in quarter one of 2017, its evident that then economy entered the second quarter of 2017 on a weak note. The spillover effect of the weak macroeconomic environment in quarter one of 2017, were felt in the economy in the entire of the second quarter of 2017. More specifically, the cost of living as measured by the consumer price index was on an upward trajectory in the entire of quarter one. The month – on – month inflation rates surpassed the upper bound of the CBK's target creeping to double digit in the entire of Q2 of 2017. Surprisingly, the Central Bank held the monetary policy permanent despite the situation thus putting the practicability of the monetary policy in question with regard to anchoring inflation within the postulated range.

On the credit front, credit expansion was suppressed at best following the enactment of the Backing Act that capped interest rates. As a fact, during the quarter, the financial intermediation sector recorded a growth of 5.3 per cent during the first quarter 2017 compared to a growth of 8.2 per cent in the same quarter 2016. We note that despite the alleged reduction in the interest rates within the quarter, this has not translated into increased borrowing. This simply implies that lending or borrowing are not influenced by interest rates but rather, there are other factors at play.

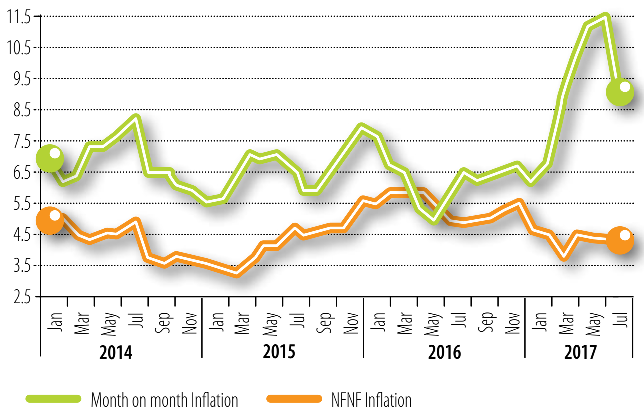
The forex market, the exchange rate though relatively stable, remained weak at best. The shilling oscillated around the 103 and 104 mark against the dollar. However, the shilling continued to weaken against the euro touching over the 120 mark though posted mixed performance against the sterling pound within the same time. However, at the local regional level the shilling posted fairly strong appreciation against the Ugandan and the Tanzanian shilling though some rebound in the Tanzanian and Ugandan shilling against the Kenya shilling can be evidenced towards the end of the quarter.

Further, we allude to our previous argument that the narrowing of the current account deficit in the previous few quarters did not simply imply that we are exporting more and importing less. Looking at the balance of payments in quarter one of 2017, the mere fact is that there the current account deficit more than doubled to Ksh 123.2 billion from Ksh 43.4 billion in the first quarter of 2017 is an evidence for a worsening current account balance based on the annual – to – annual analysis. From the quarter one of 2017 evidence, this poses a risk in that slowed importation of capital equipment imply reduced productive capacity of the economy in the future which may end up reversing the gains noted in the current account position.

Further we still hold that in quarter two of 2017, with the weakening of the shilling the stated gains in current account deficit may not be sustainable in the long run hence this gains cannot be boasted of as achievement. With the world crude oil prices assuming an upwards trend though the rise is slow and gradual and on the backdrop of weakening shilling, the obvious expectation is a rise in the oil import bill which will slowly offset the gains realized in the current account deficit. Further, with the poor performance in the short rains in the last quarter of 2016 and the first quarter of 2017, any pursuit in the importing food as the alternating to solve the looming food shortage could only mean widening current account deficit given that the countries agricultural exports have also been adversely affected by poor rains.

The month – on – month headline inflation sharply rose from 10.28 percent in March to 11.48 percent in April and further up to 11.70 percent in May. However a sharp decline is noted in the month of June where the rate feel to a single digit figure of 9.21 percent. The spike in the headline inflation can be mainly be attributed to the rise in the prices of the foods following the drought experienced on the backdrop of the poor performance in the rains during the last quarter of 2016 as well as the delayed on set of long rains in March 2017. However, on the other hand, the core inflation (non – food – non – fuel inflation) remained stable during the quarter thus ruling out the possibilities of demand driven inflation arising from the monetary policy stance. This can be largely supported by the fact that the monetary policy stance has been stable as well with the bank rate held at 10.0 percent since August 2016.

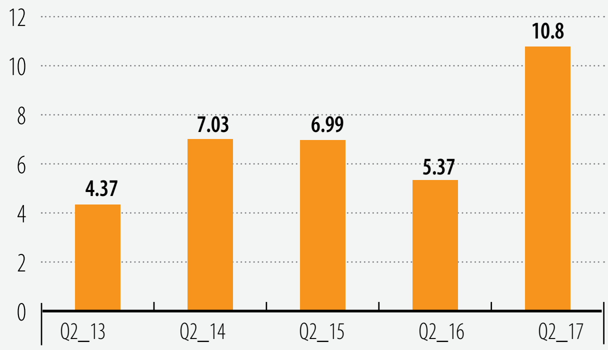
Figure 4: Monthly Inflation Rates



Source: KNBS

It is clear that as at quarter two, the Central Bank of Kenya was off the official inflation target if gauged by the trend of the month – on – month inflation for all the months within the quarter. The question therefore is "is the inflation targeting monetary policy plausible anymore and if so was the situation experienced in quarter tow of 2017 a total negation of the gains of the previous monetary policy stance in the previous quarters?" We argue that is as much that the central bank may be off the official inflation target range, the monetary policy is at test. In this case, it can be seen that the monetary policy space is at stake and if it does, its flexibility in anchoring inflation is questionable in the era of interest rates caps. With the interest rates capping, adopting an accommodative monetary policy in the high inflation rates environment still remained uncalled for in the entire of quarter two of 2017. On the other hand, adopting a contractionary monetary policy would be in contradiction with the government agenda of lowering the interest rates to a single digit. Moreover, a contractionary would imply more tightening in the credit market thus possibilities of worsening the scenario in the already constrained market. Therefore, with these two opposite scenarios, the flexibility of the monetary policy in anchoring inflation in the era of interest rates caps papers to be completely wiped out. In the entire quarter, the month – on – month inflation rates were above the upper bound of CBK target with April's inflation being 11.48 percent, 11.70 percent for May and 9.21 percent in June. Compared to the second quarter of 2016, the average quarterly inflation rate can be seen to have doubled in quarter two of 2017 from a quarterly average of 5.37 percent in 2016 to 10.8 percent in year 2017.

Figure 5: Average Quarterly Inflation Rates



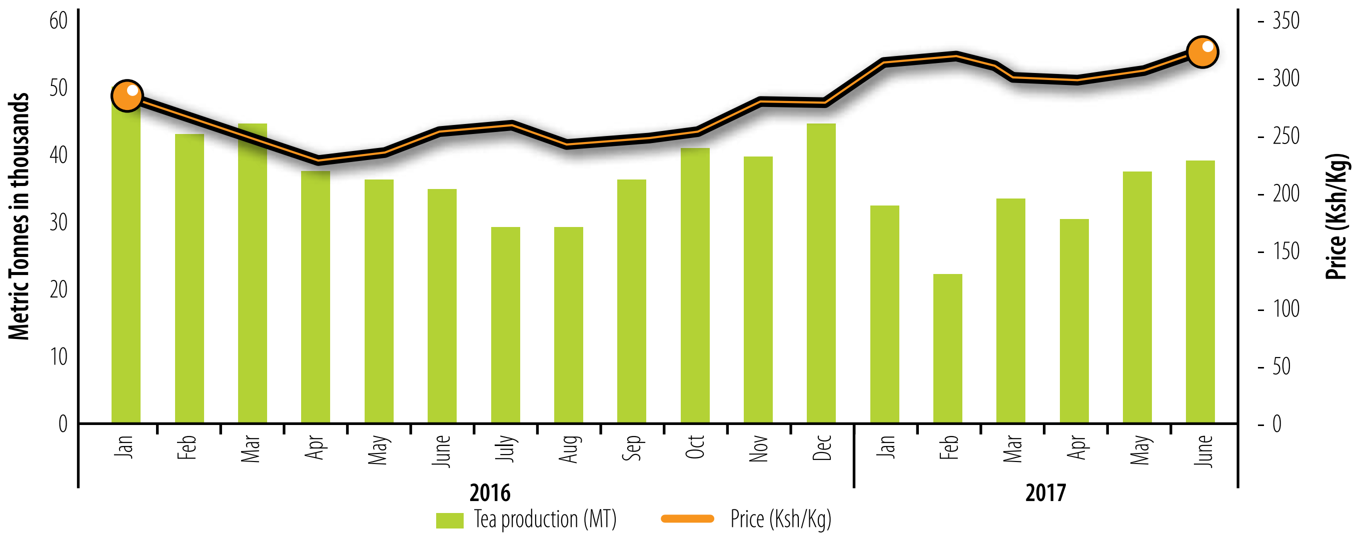
Source: Central Bank of Kenya

Sectoral performance

Agriculture

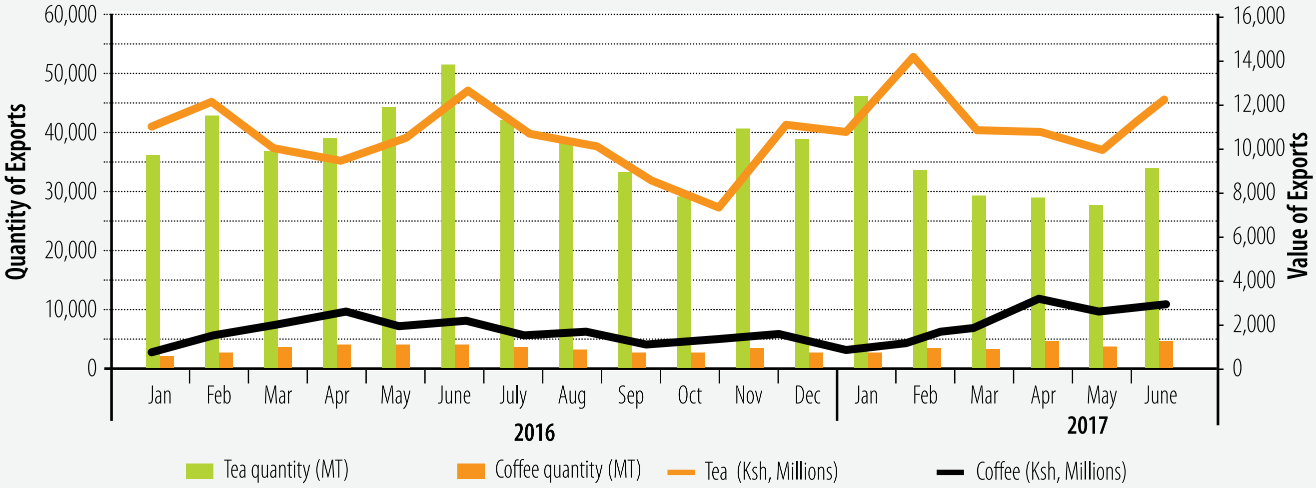
Agriculture remained to be one of the key sector driving economic growth in the quarter two of 2017 as evidenced in the previous quarters and years overtime. However, the performance of the sector was poor given the dry spell witnessed between January and March 2017 as well as the delay in the onset of short rains ion March 2017. From the major cash crop production point of view, tea production significantly increased on the backdrop of the March – June 2017 rainy season from 90,094 MT in quarter one of 2017 to 110,818 MT in quarter two of 2017. In addition the auction prices significantly improved also improved from a low of Ksh. 296.83 per kilogramme in April to Ksh 324.63 per kilogramme as at the end of June 2017. On monthly basis, tea production within the quarter improved from 31,458 MT in April to 40,538 MT in May and further to 40,538 MT in June.

Figure 6: Tea production in Metric Tonnes and Prices per Kilograms



Source: KNBS

Figure 7: Value of Tea and Coffee Exports

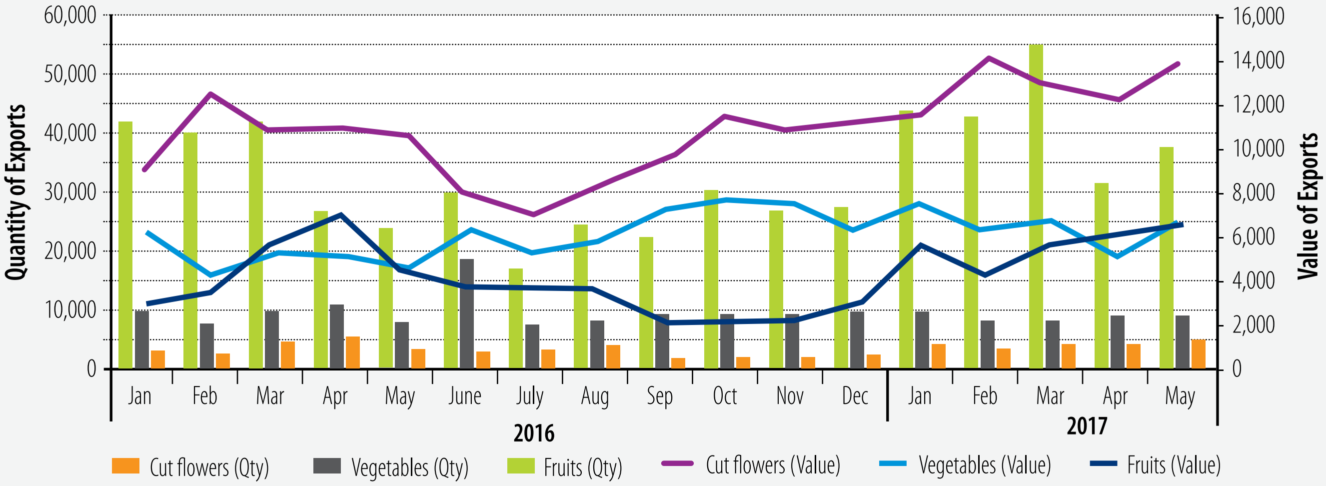


Source: KNBS

Milk deliveries to formal processors declined from 41,200 million litres as the end of March to 37,700 million litres in April and down further to 36,900 million litres in May 2017. The decline could be majorly attributed to the decline in milk production following the drought experienced within quarter one of 2017 thus implied a reduction in animal feeds. Even with the setting in of the long rains in March, the production could not rise but rather could only be realized i9n the third quarter of the year given the lag in production of feeds as well as milk production.

On the country's leading exports, agriculture cash crop continue to command a good share of the total economy's main export. The quantity of both the tea and coffee exports was in tandem with the quantity produced within the quarter as production responded to changes in the weather conditions. Quantity of tea exports declined in April but surged up in May as production surged as well following the rise in production upon the setting in of the long rains in March. Similar trends were noted for coffee exports within the quarter. The dominance of tea and coffee in exports seems to be phenomenon that is likely to exist for time given the reliance of the economy on agricultural primary products. In terms of value of exports, the value of both the tea and coffee exports declined in April following the decline in the respective quantities exports but later surged in May following a rise in their exports. It is notable that the structure of the economy in terms of reliance on the primary agricultural products still remains.

Figure 8: Horticultural Exports



Source: KNBS

On horticultural exports, in terms of quantity exported in the second quarter, cut flowers dominated this subsector contributing 52.35 percent of total production in April and May, followed by fruits at 24.32 percent and lastly vegetables at 23.33 percent. On the values of the horticultural exports, cut flowers majorly accounted for 71.90 percent of the total horticultural exports for April and May 2017. Vegetables and fruits came second and third at 18.83 and 9.28 percent respectively.

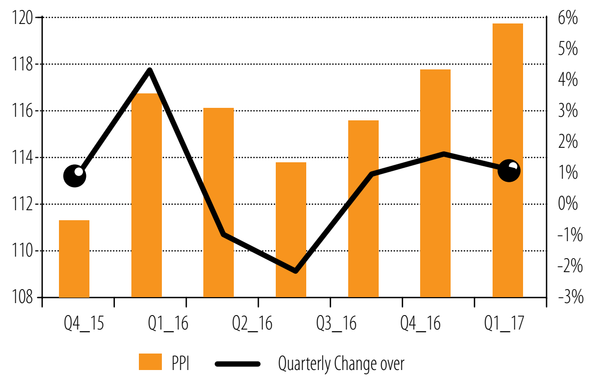
Manufacturing

During the first quarter, manufacturing sector grew by 2.9 percent compared to 1.7 per cent in a similar period of 2016. The growth in the sector was majorly supported by manufacture of soft drinks, bakery products, edible oils and wheat flour in the food subsector with production of steel bar and galvanized iron sheets driving growth in the non-food sub-sector. It is notable that the sector remain far behind in as much as the realization of its full potential is concerned. With the agro processing commanding a large share of the manufacturing sector, the depressed production in the agricultural sector following the drought spell experienced in quarter one of 2017 negatively shocked the growth momentum in the entire of the manufacturing sector. This shock was passed through and sustained in the entire of quarter two of 2017.

In addition to the depressed agro processing sub sector arising from depressed agricultural productio0n in the quarter, a number of factors can be deemed to have contributed into depressed growth in the sector. One is the cost of production mainly arising from the input side such as the cost of energy as well as the cost of other raw materials in different subsector. Secondly, is the reduction in the private sector credit to the sector in the era of interest rates capping.

From the monthly lending, it is evident that the credit advanced to the sector has dwindled from a high of Ksh 308.2 billion two months before the enactment of the interest rates capping bill to a low of Ksh. 282.2 billion as at April 2017. It can be evidenced that the monthly credit to the manufacturing sector began to surge up in March 2017 after being on a downward trend since November 2017 upon the implementation of the interest rates capping bill in the last quarter of 2016. The start of the rising in the credit advanced to the sector could be explained as a result of credit portfolio allocation with the manufacturing sector being a beneficiary at the expense of other sectors considered as more risky. As such, the manufacturing sector enters into a cohort of sectors that command more that 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.

Figure 9: Producer Price Index



Source: KNBS

Figure 10: Bank lending to manufacturing sector

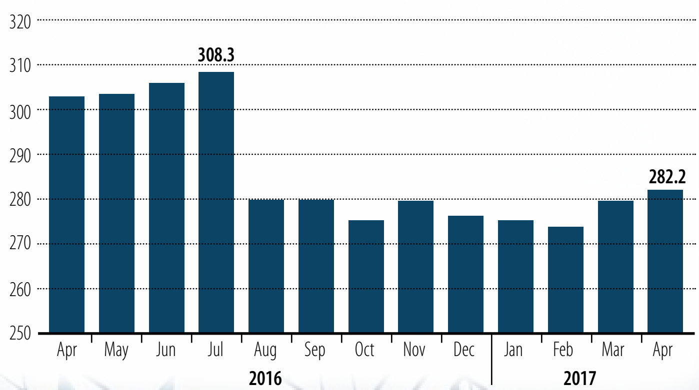
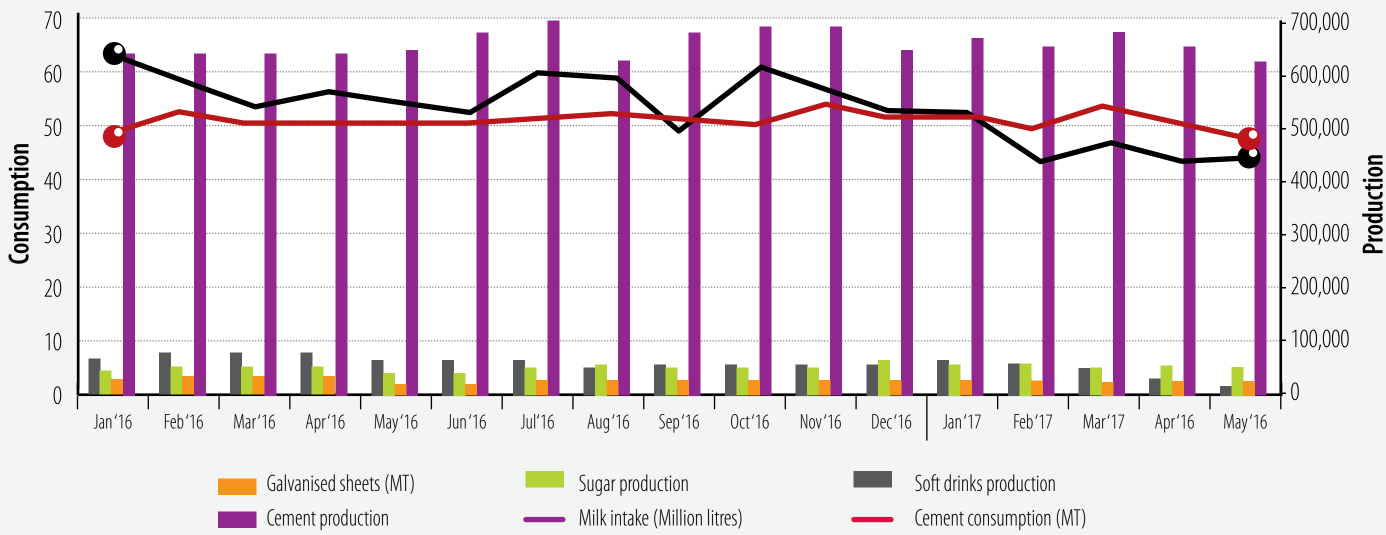


Figure11: Production and Consumption of Manufacturing



Source: KNBS

The producer price index rose by 1.61 percent in quarter two of 2017 to 119.47 points from 117.58 points in quarter one of 2017. From figure ...... it is noticeable that the index and the change was on a progress upwards trend since the third quarter for 2016. According to Kenya National Bureau of Statistics, during the second quarter of 2017, the increase in the producer price index was mainly driven by rise in the manufacture of food products and manufacture of chemicals and chemical products. However, during the same period producer prices of electricity, manufacture of other non-metallic mineral products and manufacture of basic metals declined. The producer price index of food products increased due to rise in prices of sugar, grain mill products especially maize flour, tea and processed milk compared with the first quarter of 2017.

However, domestic sugar production substantially declined from a high of 144,101 metric tonnes in quarter one of 2017 to a low of 57,620 metric tonnes as at end of quarter two of 2017. Reduced sugar production could be attributed mainly to reduced sugarcane delivery to the sugar processors. This is evidenced by the acute reduction in the sugar cane deliveries from a high of 581,600 metric tonnes in January 2017 to a low 231,970 metric tonnes as at May 2017. This reduction in the sugar cane deliveries to the processing plants could be deemed to arise from a number of reasons, one if the experienced drought in quarter one that could have hurt production. Second is the fact of delayed payments to sugarcane farmers by the processing plants that has demoralized farmers with some opting to quit from sugar cane farming to alternative crops such as maize farming. Milk processing also registered a decline in the terms of the volume formally processed declining falling from 41,200 million litres to a low of 36,900 million litres as at end of May 2017. The decline is largely due to the drought spell experienced in quarter one of 2017.

Energy

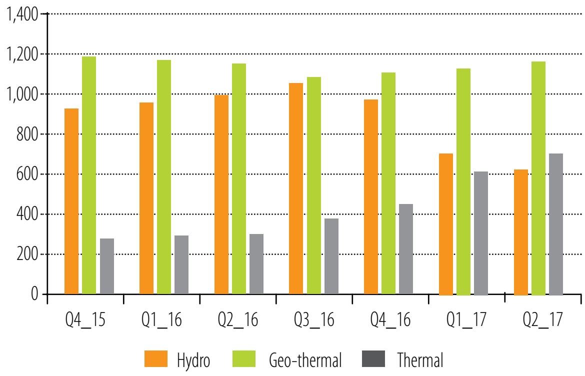
The cost of energy remains crucial in determining the cost of production in the country as well as an important factor in defining the cost of living. As such, this has seen concerted efforts by the government in pursuit of production of cheap and clean energy overtime. However achievement of this endeavor has not been free of challenges given the high initial cost in setting up green energy production plant. One of such production in Kenya has been geothermal production which is deemed to be clean and more reliable compared to the hydro production which is weather – reliant though

The share of hydro production declined from 28.81 percent to 24.98 percent between quarter one and two of 2017 with the thermal production conversely increasing from 25.04 percent to 28.88 percent in the same period.

high investment cost. In addition is the wind energy production which is the new form of energy production that the government has ventured in. Despite this, the country has made remarkable strides in increasing the share of the geothermal power production in the total energy production in the past few years.

A review of energy production in the second quarter of 2017 reveals that geothermal production topped accounting for 46.15 percent compared to a share of 46.15 percent of quarter one. This implies that the share of geothermal power production remained constant between quarter one and two of 2017.

Figure 12: Electricity Generation by Source (Million KWh)



Source: KNBS

However, looking at the hydro and thermal production, the share of hydro production declined from 28.81 percent to 24.98 percent between quarter one and two of 2017 with the thermal production conversely increasing from 25.04 percent to 28.88 percent in the same period. This clearly presents a scenario of perfect substitution between hydro and thermal production. As such, we can note that geothermal 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 reduction in the hydro production in quarter two of 2017 can be attributed to poor performance of long rains in March – June 2017 period. In overall, the total, quarterly energy production for quarter two was 2,495.26 million KWh a mild rise from a quarterly production of 2,431.80 million KWh as at quarter one of 2017.

On the international front, the prices of crude oil in the world market signified a sense of broad stability. However, the softening of the international crude oil prices can be evidenced during the quarter with the mean crude oil prices falling below the $50 mark to a low of $ 47.30 as at the end of June 2017. As such the resolution by the OPEC on cutting down on the daily crude oil production is still t stake given that it seems to be taking long for the desired results to be realized. This poses an element of non – compliance among the OPEC members with some members continuing to pump more in the world oil market.

A keen analysis of the crude oil market from the international market lens in quarter two of 2017 points out that the month-on-month oil futures on both sides of the Atlantic recovered, albeit the upward potential remained constrained by the resurgence of the US oil output. The bearish pressure in

Table 2: Average Monthly Crude Oil and Retail Fuel Prices

	Dec -16	Jan -17	Feb -17	Mar -17	Apr - 17	May -17	Jun - 17
Murban crude oil (US$/Barrel)	54.15	55.35	56.10	52.60	53.40	51.45	47.30
Super petrol (KES/Litre)	95.08	96.88	101.14	101.91	99.01	100.48	99.68
Diesel (KES/Litre)	88.18	85.20	90.22	91.39	89.70	89.02	87.95
Kerosene (KES/Litre)	64.52	64.41	68.15	68.93	65.44	66.26	66.04
LPG (13Kgs)	1,983.06	1,989.50	1,976.38	1,998.70	2,063.95	2,104.29	2,112.19

Source: ERC

the market continued to be evidenced arising from the unbalanced oil market conditions of the increasing US crude oil supplies and lower-than-expected inventory draws. During the second quarter of 2017, the global oil supply rose by 0.13 mb/d in May to average 95.74 mb/d, month – on month. We clearly argue that even though the non – OPEC supply decreased in the same period representing a contraction of 0.21 mb/d month – on – month, the OPEC crude oil production amounting to 0.34 mb/d not only offset the decline of non-OPEC supply but also increased overall global oil output in May. The share of OPEC crude oil in total global production therefore stood at 33.6% in May, an increase of 0.3% from April 2017. This speaks into decline in the mean monthly crude oil prices in the succeeding month of June 2017 to a low of $47.30 in June compared to $ 51.45 in May 2017.

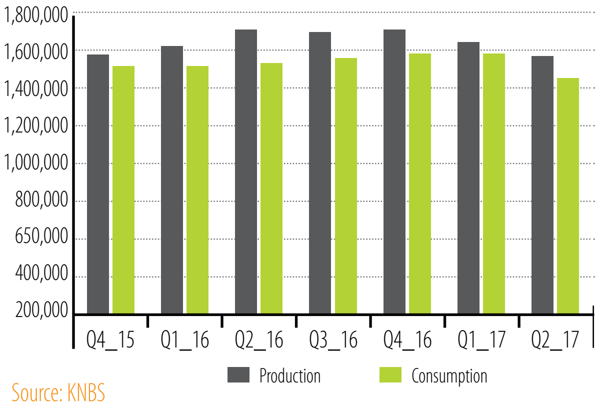
In the domestic market the pump prices took an upward trend as well given the high correlation between the world oil prices and the domestic market pump prices. This can be evidenced by the drop in the pump prices in June that is in concurrence the decline in the crude oil prices in June 2017.

Building and Construction

Building and construction sector continued to be one of the core sectors supporting economic growth. This is supported by the fact that the sector remained to be one of the four key sectors that toped in terms of private sector allocation within quarter one of 2017. Given the ongoing physical infrastructure construction, the sector has remain core in supporting the economy given the amount of the resources being channels to the sector. During quarter one of 2017, the sector registered a rise in demand for credit by 41 percent. However, the potentials of the sector remains untapped given the delayed payments by the government to the contractors with regard to the physical public infrastructural projects that has seen the tightening of the credit standards regarding the lending to this sector. However, in Q1 of 2017, KNBS records that the sector recorded a slowed growth of 8.4 per cent compared to 10.2 per cent growth in a similar quarter of 2016 mainly on the account of scaled-down activities of the SGR in the quarter under review as it neared completion.

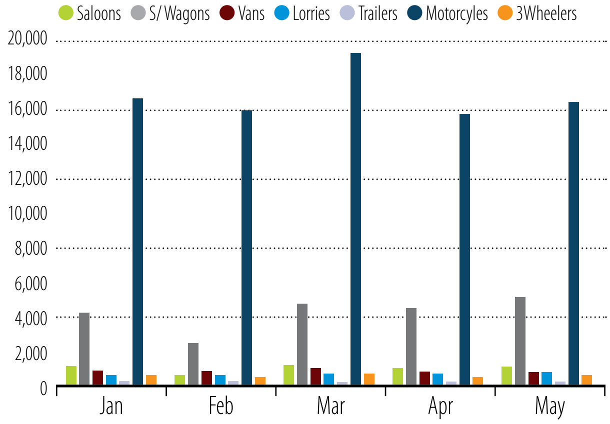
The indicators of growth in this building and construction sector mainly cement production and consumption reveal that during the second quarter of 2017, both the cement production and consumption recorded a decline with the cement production posting a decline of 5.41 percent in quarter two compared to quarter one of 2017 from 1,632,300 MT to 1,544,025 MT . Similarly, cement consumption recorded a decline of 9.58 percent in quarter two as compared to quarter one of 2017 from 1,562,696 MT to 1,412,961 MT. Apart from the slowdown in the construction of the major physical infrastructure by the government, the slowdown in the building and construction could also be viewed from the performance in the real estate sector which also offers market for cement, steel among other construction raw materials. First given the political environment in quarter two, real estate being a long term investment could have suffered from the adoption of the wait and see scenario especially for the developers in the building and construction sector who could be shying off from uptake and even implementation of new projects. This could partly explain the reduced cement production within the quarter.

Figure 13: Cement Production and Consumption (MTs)



Source: KNBS

Figure 14: Registration of New Vehicles



Source: KNBS

Transport and Communication

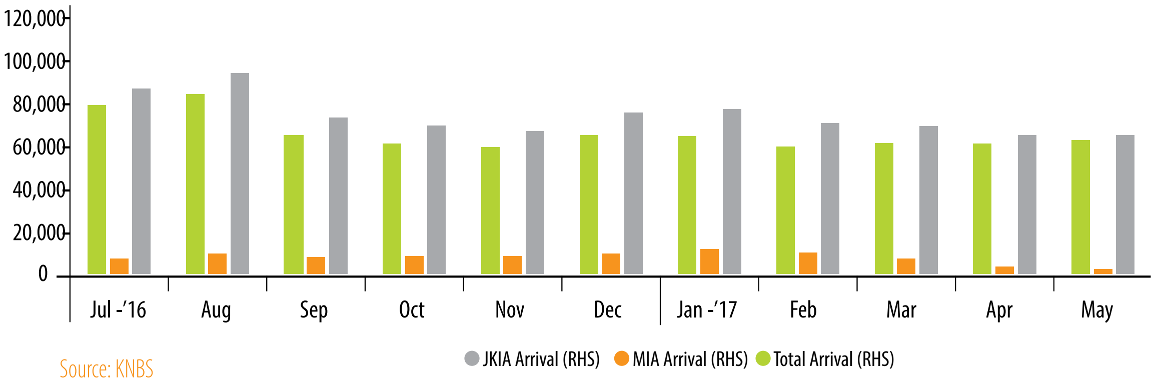
The total number of vehicles registered increased to 24,582 in May 2017 from 23,059 in April 2017. Motorcycles and station wagons dominated the share of the types of the motor vehicles accounting for 66.2 per cent and 20.3 per cent, of total motor vehicles registered in May 2017, respectively.

The dominance of mobile telephony in the communications industry continued to be evident. Mobile money transfer has been significant especially in rural areas where banks are not available, inaccessible, or where majority of the population do not hold bank accounts. At the same time this mode of money transfer has been characterized by ease of use and, despite recent revision of charges on transactions. This reflects the view that mobile transfer has the potential of raising living standards by offering employment with the entire value of mobile banking transactions. The facility has also been greatly adopted by commercial banks in offering mobile banking services in pursuit if banking the unbanked.

Tourism

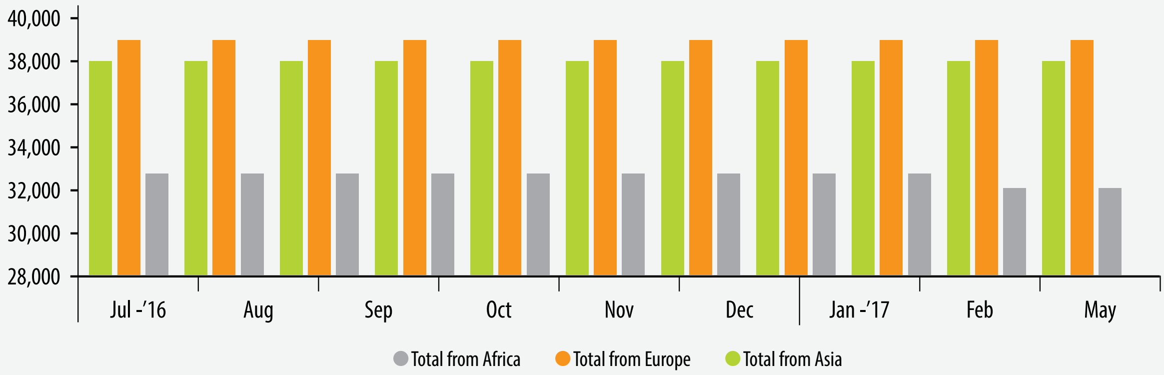
In quarter two of 2017, performance in the tourism sector remained relatively stable as the performance posted in quarter one of 2017. However, decline in the number of arrivals through the Jomo Kenyatta International Airport and Mombasa International airport declined in April and May 2017 falling from 71,950 visitors in total in March to 67,084 visitors in April but slightly improved to 67,531 visitors in May 2017. The decline in the number of visitors could be somewhat be explained by the political environment as the country waited to enter into the general election.

Figure 15: Trends in Visitor Arrivals (Thousand)



Source: KNBS

Figure 16: Trends in Visitor Arrivals (Thousand) by Port of Origin



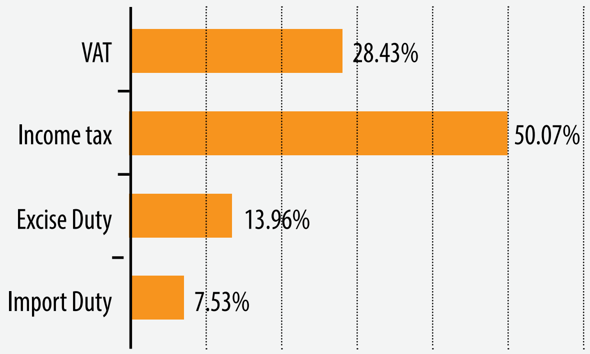
Source: KNBS

Arrival of the visitors into the country by port of origin seem to portly consistency overtime on quarterly basis. Arrivals from Europe and Africa seems to be relatively stable overtime since in April and May just as in the entire quarter of one of 2017 with European arrivals leading followed by arrivals from Africa accounting for 35.5 and 34.71 percent of the total visitors respectively. Arrivals for Asia comes third accounting for 29.79 percent of the total visitors in the month of April and May 2017.

Financing of Government

During quarter two of 2017, the total tax revenue accounted for 87.04 percent of the total quarterly revenue with the non – tax revenue accounting for 12.96percent. For the tax revenue, income tax topped the list at 50.66 percent followed by value added tax at 28.13 percent with excise duty and import duty coming third and fourth at 13.75 percent and 7.46 percent respectively. From the previous analysis the government tax base seems to have remained constant with the contribution of each revenue stream changing marginally. This is an indication of the government's constraint in terms of widening the revenue base and coming up with new revenue sources despite of the government's expenditure continuing to rise with the onset of devolution government.

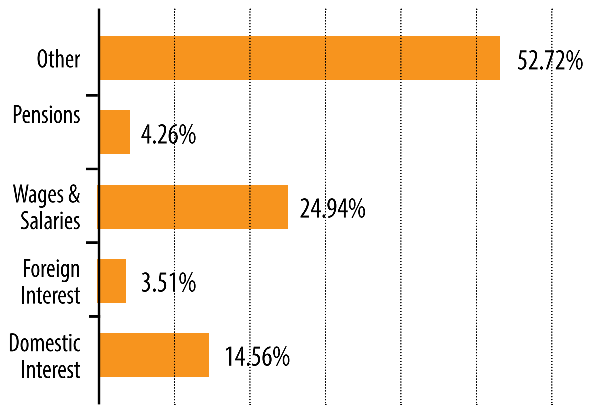
Figure 17: Tax revenue



Source: CBK

The total government expenditure on commitment basis for quarter two of 2017, reveal that recurrent expenditure accounted for 69.01 percent with the development expenditure accounting for 30.99 percent of the total government expenditure. Breakdown of the recurrent expenditure in quarter two evidence that, Salaries and wages accounted for 24.94 percent with domestic interest payment accounting for 14.56 percent. Foreign interest repayments and pension payments accounted for 3.51 and 4.26 percent of the total recurrent expenditure respectively.

Figure 18: Recurrent Expenditure breakdown



Source: CBK

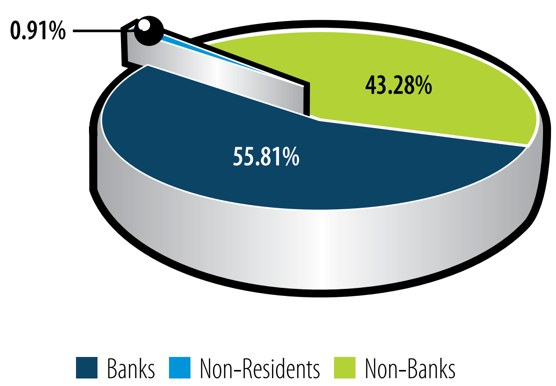
Public Debt

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.

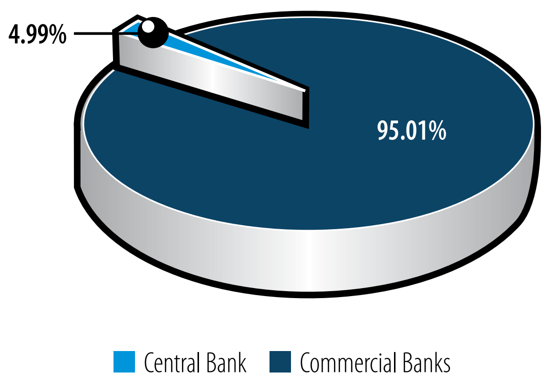
Of the external debts, multilateral debts accounted for 37.78 percent of the total external debts in quarter one of 2017 followed by bilateral debts at 32.38 percent. Commercial banks accounted for 29.12 percent with export credit accounting for a mere share of 0.72 percent. On the domestic debt stock, banks accounted for 55.81 percent of the total domestic debt with non – banks and non-residents accounting for 43.28 and 0.91 percent respectively. Within the banks contributions commercial banks account for 95.01 percent with central bank contributing a mere 4.99 percent. On the domestic debt contribution from the non – bank sources, pension fund top the list at 64.19 percent with insurance companies and other source accounting for 16.24 and 20.60 percent respectively.

Figure 19: Debt composition - Domestic debts

Decomposition of Overall Domestic Debt

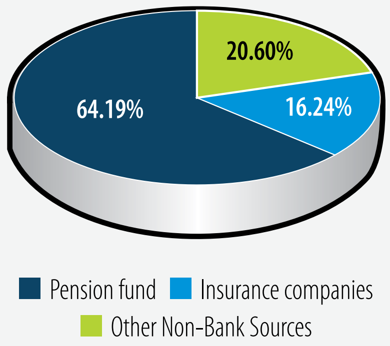


Decomposition of Banks Contribution to Domestic Debt



Source: CBK

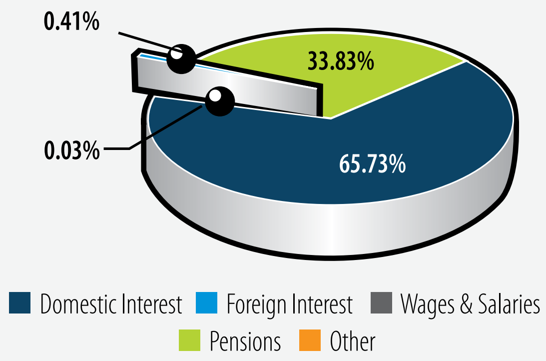
Figure 20: Debt composition - Domestic debts



Source: CBK

On the financing of the government's public debt, government treasury bonds including the government frozen debt remained accounted for 65.73 percent of the total government domestic debt in quarter two of 2017. Treasury bills, on the other hand accounted for 33.83 percent with advances from commercial banks and other domestic debts accounting for 0.41 percent and 0.03 percent respectively of total government debt during the quarter.

Figure 21: Composition of Domestic Debt

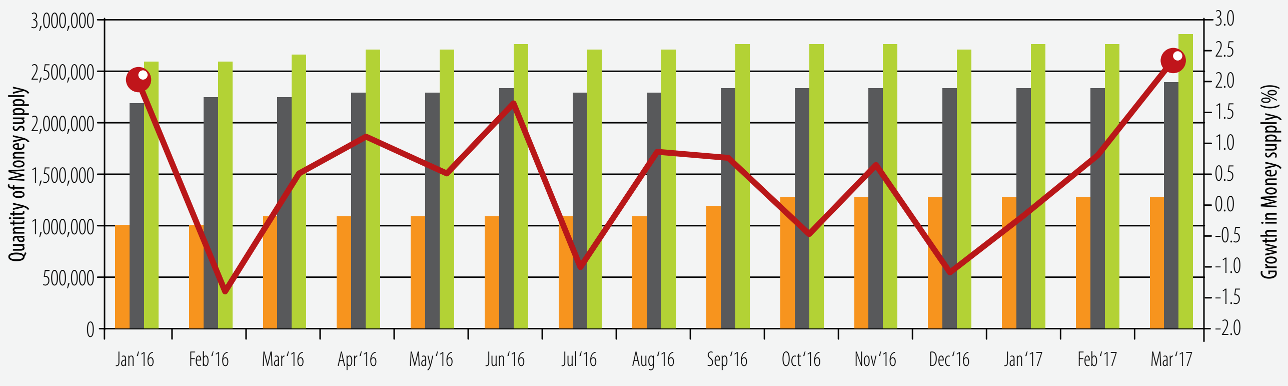


Source: CBK

Money and Credit

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

Figure 22: Money Supply (KES Million)



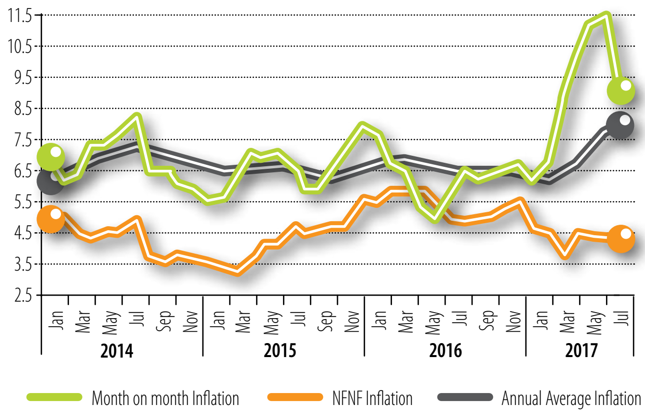
Source: KNBS and CBK

Inflation

The cost of living for the second quarter of 2017 remained high above the upper bound of the Central Bank target with the quarterly average inflation rate being 10.80 percent in quarter one of 2017 compared to 8.77 percent in quarter one of 2017. The rise in the inflation rates was mainly attributed to a number of factors. First is the rise in the food prices following the drought spell experienced in the first quarter of 2017. Further the delay in the setting in and poor performance in the long between March and June 2017 caused the food prices to remain though on the downward trend in the consecutive months within the sector.

A review of month – on – month inflation rates in quarter two of 2017 reveals that even though the monetary policy decision adopted to retain the bank rate at 10 percent inflation rate inflation remained on an upward trend above the target. This signifies the limited space for the monetary policy tools to be effective in anchoring inflation. A review on the year – to – year basis reveals that the annualized inflation rates rose significantly as at June 2017 standing at 8.10 percent compared to annualized inflation rate of 7.82 percent as at the end of May 2017.

Figure 23: Inflation rate (%)



Source: Central Bank of Kenya

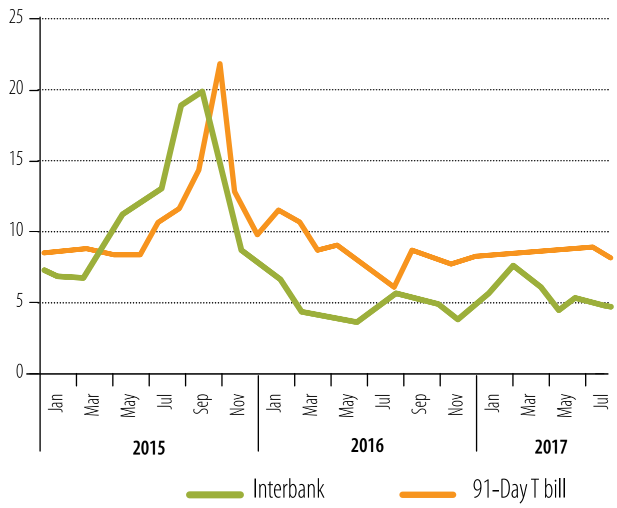
The non – food – non – fuel inflation (NFNF) remained relatively stable in quarter two of 2017 being on a fairly downward trend looking at the quarterly NFNF inflation between quarter one of 2017 and quarter two of 2017. As at quarter two of 2017, NFNF inflation averaged at 4.28 percent compared to 4.20 percent in quarter one of 2017. Further, looking into monthly NFNF inflation trends within the quarter, demand driven inflation seems muted at best given that the monthly NFNF shown a sense of broad stability in the entire quarter. Similar scenario is evidenced in the entire of quarter one of 2017.

Interest Rates

Interest rates remained fairly stable during the second quarter of 2017 following the coming into effect of the capping law. The short - term market interest rates as represented by the interbank market rates and the 91 – Treasury bill rates seems to mirror each other from May 2015 to December 2015 although with a one to two months lags. However, this trend reverses inn the entire of first two quarters of 2017 where the interbank rates take a downward trend with the 91 Treasury bill rates being fairly positive though stable since September 2016. During quarter two of 2017, 91 – Treasury bill rates remained relatively stable though high averaging at 8.62 percent compared to a quarterly average of 8.64 percent in quarter one of 2017m thus being fairly much stable.

On the other hand, the interbank market rate declined significantly to quarterly average of 5.01 percent during the quarter compared to of 6.12 percent in quarter one of 2017.

Figure 24: Interbank rates and 91 Treasury bill rates



Source: Central bank of Kenya

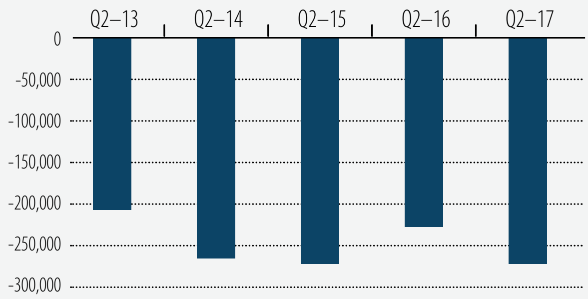
Turning to the average lending rates for the commercial banks, we find that the cumulative average weighted lending rates posted mixed trends within the quarter though quite stable. At first, the rates dropped to 13.52 in April rising marginally to 13.71 percent in May and later dropping marginally to 13.65 percent in June 2017. On quarterly basis, the average quarterly rate for quarter one of 2017 was 13.63 compared to 13.65 percent quarter one of 2016 thus evidencing broad stability in weighted average commercial banks' lending rates. In overall, the credit market still remained illiquid for the entire quarter two as evidenced by the relationship between the average lending rates and the CBR.

Balance of Payments

Volume of trade improved from Ksh 173.9 billion in April 2017 to Ksh 204.1 billion in May 2017. The value of total exports increased to Ksh 52.7 billion while the value of imports rose from Ksh 129.1 billion in April 2017 to Ksh 151.4 billion in May 2017. Domestic exports by Broad Economic Category (BEC) indicated that food and beverages was the main export category in May 2017 accounting for 49.5 per cent of exports, while non-food industrial supplies and consumer goods not elsewhere specified accounted for 22.0 per cent and 25.2 per cent of the value of total domestic exports, respectively. Imports by BEC indicate that non-food industrial supplies was the main import category in May 2017 with a share of 32.0 per cent. Machinery & other capital equipment; fuel and lubricants; and transport equipment constituted 18.0, 16.0 and 13.4 per cent, of the total value of imports, respectively. Imports of food and beverage recorded a share of 12.6 per cent of the total imports while consumer goods not elsewhere specified recorded a share of 7.8 per cent.

The overall quarterly trade balance slightly improved from Ksh 271,833 million in quarter one of 2017 to Ksh 270,842 in quarter two of 2017. This could be mainly attributed to the reduced massive importation of machinery and transport facilities for major physical infrastructural projects following the completion in the first phase of SGR. The narrowing of the trade balance does not in any case imply the improved exports but it's mainly from the reduction in the imports mainly related to the large government projects as the country neared election.

Figure 25: Trade balance (Ksh, Mill)



Source: CBK

Exchange Rate

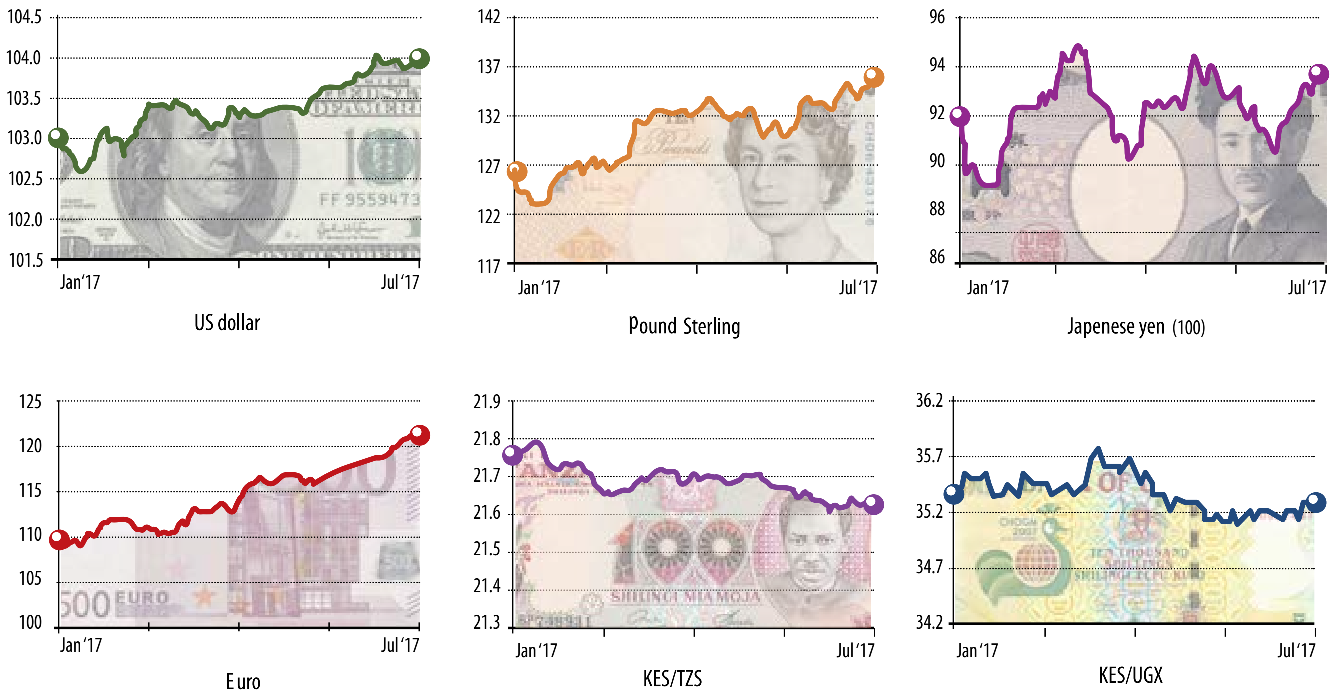
During the second quarter of 2017, the shilling suffered depreciation against the US dollar in June and July thus reversing the appreciation registered in the month of May. In June the shilling slided to a low of 103 and 104 mark on as indicated by the daily exchange rates. The weakening on the shilling against the dollar could be attributed to reduced exports in the event of drought

experienced during the quarter. In addition the political environment could be attributed to the weakening bias by reducing then inflow of foreign capital into the country.

Against the Sterling the shilling posted considerable mixed performance throughout the quarter. This is evidenced by the depreciation of the shilling against the pound in the beginning of the quarter before later appreciating in June but later depreciating in the last days of June. 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.

In the East African context, substantially weakened against the Ugandan and Tanzanian shilling.

Figure 26: Nominal Exchange Rate



Nairobi Securities Exchange

During the second quarter of 2017 the stock market posted improvement inn the performance as evidenced in the successive months' indices during the quarter thus evidencing the dominance of the bullish behaviour, a reverse of the bearish market behaviour that has characterised the market on the recent over six months now. The second quarter of 2017 saw the market performance surge up on the equity market segment in terms of the NSE 20 Share Index and the Nairobi All Share Index compared to the performance in the first quarter of 2016 based on the core market indicators. Similar performance is arrived at when analysing the fixed income segment in which both the FTSE NSE Kenya 15 and FTSE NSE Kenya 25 were both on an upward trend. The improvement in the performance could be partly explained by the market beginning to undergo correction upon taking into account the news of the enactment of the interest capping bill into law. Improvement in the performance of the banking industry stocks posted an improvement in the overall market capitalization as well.

Table 2: Nairobi Securities Exchange Market Indicators

	2016		2017					
	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
NSE 20 Share Index	3,247	3,186	2,794	2,995	3,113	3,158	3,141	3,596
NASI	137	133	122	125	131	133	148	152.4
FTSE NSE Kenya 25	170	164	148	149	161	170	185	196
FTSE NSE Kenya 15	166	159	142	146	164	165	181	190
Market Capitalization (Ksh Billion)	1,997	1,932	1,770	1,812	1,894	1,935	2,114	2,226

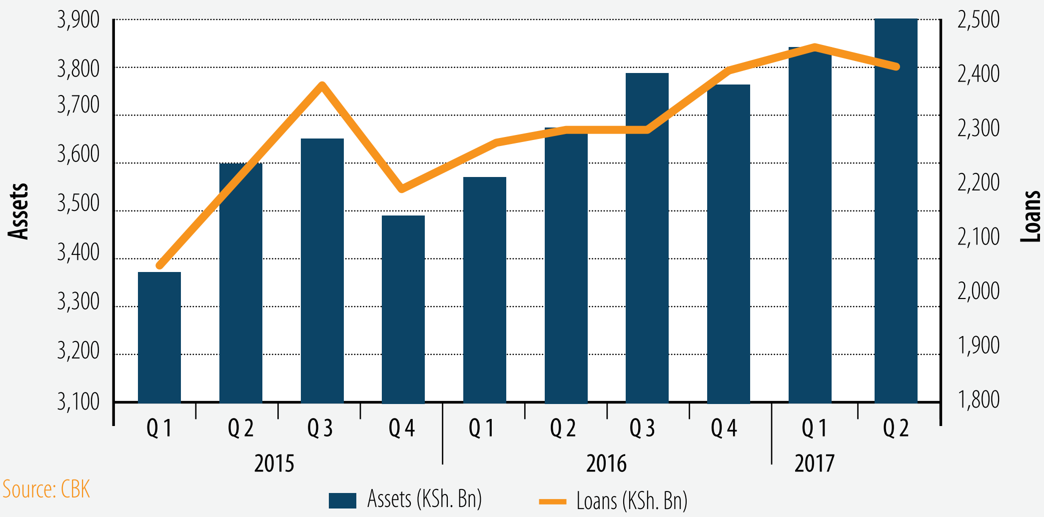
Source: NSE, Monthly Trading Report

Banking Industry Performance

Assets and Loans

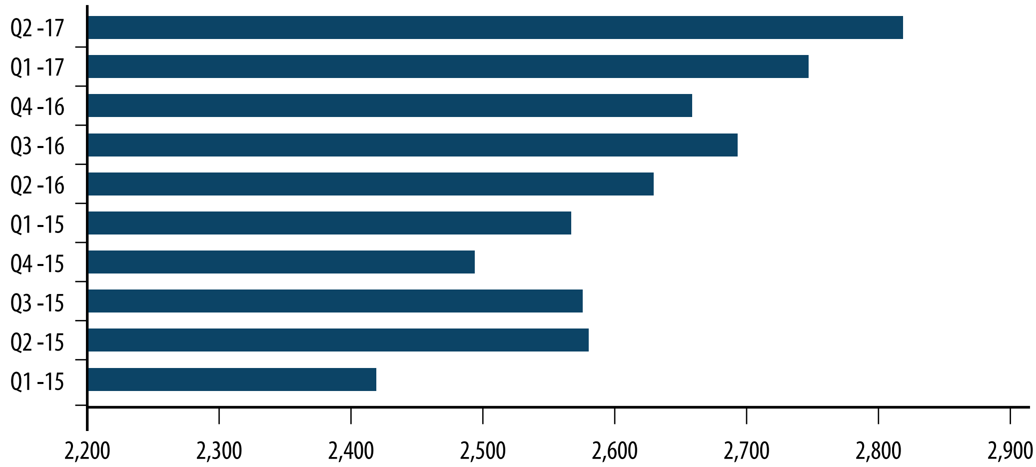
The industry's assets base registered a modest growth of 1.61 percent during the second quarter of 2017 from KES 3.84 trillion as at the end of March 2017 to KES 3.90 trillion as at the end of June 2017. The modest growth in asset base could be attributed to a number of factors. One of them, is the likely effect of the interest rate capping bill which came into effect in the last quarter of 2016 which could have affected banks' conversion of their liabilities (mainly deposits) into assets (mainly loans) arising from slowdown in lending. On the other hand, total industry's gross loans and advances recorded a negative growth of 1.14 percent in quarter two of 2017 from Ksh 2.38 trillion in quarter one of 2017 to Ksh 2.35 trillion in quarter two of 2017.

Figure 27: Bank Assets and Loans (Ksh Billion)



Source: CBK

Figure 28: Bank Deposits (Ksh. Bn)



Source: CBK

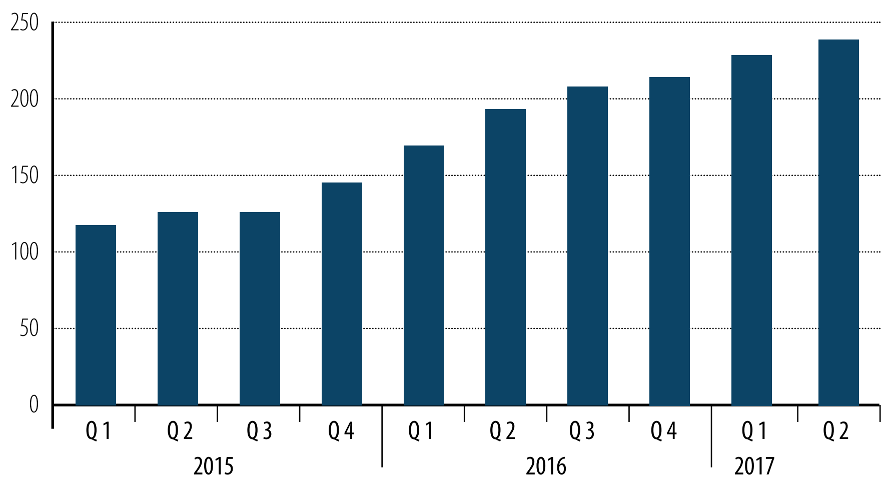
Bank Deposits

The total deposits in the second quarter of 2017 recorded a positive growth standing of 3.32 percent from Kshs 2.74 trillion in last quarter of 2016 to Kshs 2.83 trillion in quarter two of 2017. The trend in quarter two of 2017 with regard to deposit mobilization is negation of the trend experienced in last quarter of 2014 where the deposits were on downward trend. The rise in deposits could imply that the public in quarter one of 2017 preffered hold cash in bank deposits as opposed to cash balances at hand. This could be attributed to the rising cost of living in the quarter as evidenced by rising inflation rates in the entire of the quarter. On the other hand, it could imply the absence of viable investments to trade – off holding cash in bank deposits. Further with the political environment, general public appetite for investment would appear muted and as such preferring holding cash in bank deposits. The growth remains as the same with the growth between fourth quarter of 2016 and the first quarter of 2017.

Gross Non-Performing Loans

The ratio of gross non-performing loans to gross loans increased by 3.17 percent between quarter one of 2017 and the second quarter of 2017. This is down from the 6.43 percent rise between quarter four of 2016 and quarter one of 2017. The increase in gross non-performing loans was mainly attributable to challenges in the business environment that led to cash flow constraints for borrowers. The drought experienced in quarter one of 2017 affected the agribusiness afflicted enterprises thus the likelihood of such businesses being negatively affected.

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



Source: CBK


THE REPORT
Kenya 2016
ECONOMY
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BANKING
TRANSPORT
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