KENYA BANKERS ECONOMIC BULLETIN

VOLUME 26 | DECEMBER 2019

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, 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®

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TAWASSAL

FOREWORD

From the CEO's Desk

It is my pleasure to present to you the 26th issue of the *Kenya Bankers Economic Bulletin*. This is the final issue for 2019. 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 are largely a reflection of 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 *Bulletin* offers insights meant to support readers' near-term outlook.

Noteworthy is the observation that much as the Kenyan economy is on a strong growth footing, the external risks are weighing in on the ability to consolidate the economy's external position at a time when the domestic balance - the need for the Government to undertake fiscal consolidation - is under focus. The *Bulletin* proffers some thoughts on how the credit market could respond to the welcome decision of the repeal of the Banking Act to remove controls on lending rates.

It is my hope that you will find this issue of the *Kenya Bankers Economic Bulletin* interesting and useful. We welcome feedback on the content of this *Bulletin* as we continually seek to improve its relevance to you. You can send your feedback to Bulletin's Editor at ***research@kba.co.ke***

Dr. Habil Olaka
Chief Executive Officer,
Kenya Bankers Association

COMMENTARY

Avoiding the superficial temptation of unqualified, but unjustified, optimism

By Jared Osoro

In our last *Economic Bulletin* for 2019, we look at the interaction between two extreme positions that potentially shape expectations for 2020. First, the global economy is assessed to be at a bad corner. The International Monetary Fund's World Economic Outlook (October 2019)[1] observes that the global growth forecast of 3.0 percent for 2019 is the lowest level since 2008–09.

The report notes that "with uncertainty about prospects for several of these countries, a projected slowdown in China and the United States, and prominent downside risks, a much more subdued pace of global activity could well materialize".

Second, the domestic economy has been registering impressive top-line output growth numbers, albeit with clear evidence that households and enterprises are barely 'feeling' the growth. The October 2019 repeal of the Banking Act to remove interest rates capping that had been in place for three years has injected a sense of optimism. The optimism being anchored on the expectation that financial resource allocation that has been skewed towards government will soon see the commencement of a gradual shift towards households and businesses.

We ask two questions: Is the global picture ominous? Is the domestic picture sufficiently comforting? To be sure, we need to appreciate that the interplay between the global and local developments have been in focus over the past decade, with instances of policy responses to address economic weaknesses in the developed economies influencing financial resource flows to emerging and developing economies. Whether such influence is positive in the overall is a function of the nature of 'push-pull' circumstances.

A recent study[2] published in the Journal of Money, Credit and Banking – an academic journal – provides interesting insights on the 'push-pull' hypothesis that is relevant to our perspectives regarding the influence of global economic developments on the local economy. One, when global

1. See IMF (2019), October – [https://www.imf.org/en/Publications/WEO/Issues/2019/10/01/world-economic-outlook-october-2019]

2. Mandalinci, Z and Mumtaz, H. (2019), "Global Economic Divergence and Portfolio Capital Flows to Emerging Markets", Journal of Money, Credit and Banking, Vol 51. No. 6. pp.1713 – 1730, September.

Although the banking system has been generally stable, with adequate capital and liquidity buffers, non-performing loan ratios remain elevated

economic activity is adverse and American monetary policy is contractionary (implying either adjusting from non-conventional to conventional), there is a significant fall in portfolio capital flows. Two, even under uncertainty shocks and positive regional growth shocks, portfolio capital flows will experience significant falls.

The biggest insight in these two inferences is that portfolio capital flows are procyclical to global economic activity but countercyclical to regional economic activity. The two-level assessment with opposite forces – pro and counter cyclicality – obviously flies in the face of the popular logic that the advanced economies' dallying with near-zero or negative interest rate on the face of economic slowdown has an obvious consequence of increased portfolio capital flows to emerging and frontier markets.

Now that the IMF's October 2019 World Economic Outlook is espousing the notion that the global economy is in a "synchronized slowdown" – meaning that even the emerging markets that were dragging global output up at the time when advanced economies were in trouble are also experiencing softening growth – its neither obvious nor granted that portfolio capital flows will be merely following interest rates differentials.

Beyond financial flows, the bigger implication of a weaker global economy is the extent to which it will have a bearing on the local economy's external position. The generally stable foreign exchange market that is reported in this Economic Bulletin, and as would be represented in **Figure 1**, could be mapped to the state of Kenya's current account position as shown in **Figure 2**. The broad stability in the foreign exchange market has had a contributory effect on inflation in the form of at worst low pass-through effect. The observed stability and its outlook need to be taken in the context of the extent to which it is buttressed by the state of the economy's external position and the policy instruments available to the Central Bank of Kenya (CBK) to sustain it.

It is worth noting that the economy's current deficit continues to close. Whereas domestic demand conditions will have an influence on imports demand, a weak global economy will likely have a toll on exports. Elevated uncertainty surrounding trade and geopolitics as the IMF notes in the October 2019 World Economic Outlook may put a strain on global demand.

Doing the Bidding of Fiscal Profligacy?

The current account balance as presented above tells a bigger story than its nexus with the foreign exchange market. The bigger story stems from the fact that the current account hides as much as it reveals about the interplay between the domestic and external economy, for it is equivalent to the

economy's savings and investment gap. As we learn from a recent World Bank Research and Policy Brief (Devadas and Loayza, 2018)[3]:

> *"A current account deficit is sustainable when its underlying drivers support a smooth correction in the future. It is unsustainable when symptomatic of macroeconomic imbalances that would eventually trigger disruptive adjustments. Although a current account deficit in itself is neither good nor bad, it is likely to be unsustainable and lead to harmful consequences when it is persistently large, fuels consumption rather than investment occurs alongside excessive domestic credit growth, follows an overvalued exchange rate, or accompanies unrestrained fiscal deficits. Even though a current account deficit is often paralleled by deteriorating net foreign assets, it may not be as informative about immediate-term financial vulnerabilities as the size, maturity, and currency composition of gross financial stocks".*

As can be noted from **Figure 2**, Kenya's fiscal deficit has not been persistently large; if anything, it has been closing fast – and that potentially has its own negative ramifications. Although over the recent past years, public investments have contributed to the state of the current account, a fair share is attributable to private consumption. This has been on the back of the rate of growth private sector credit almost grinding to a halt as evidence of crowding out of the private sector is crystal clear.

While there is a healthy debate as to whether the Kenya shilling (KES) exchange rate is overvalued (a view held by the IMF[4]) or

Figure 1: Nominal Exchange Rate - KES/US$

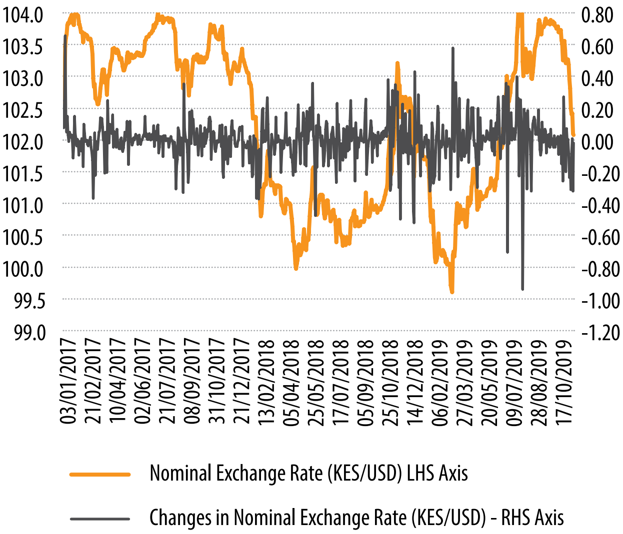
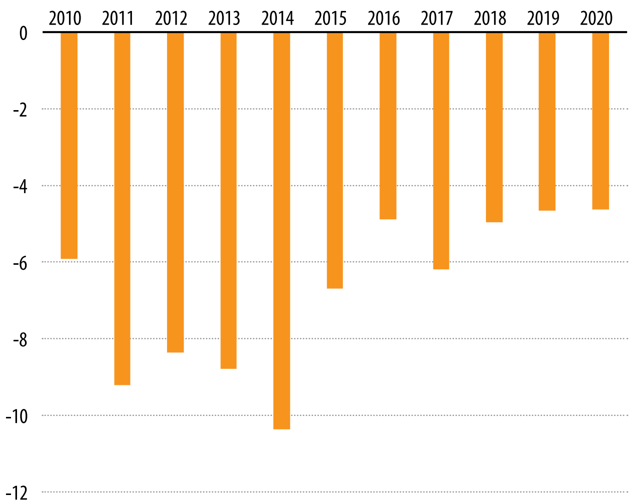


Figure 2: Kenya's Current Account Balance (% of GDP)



3. Devadas, S. and Loayza, N. (2018), "When Is a Current Account Deficit Bad?", Research & Policy Briefs, No 17. World Bank, October. [http://documents.worldbank.org/curated/en/507731538487989157/pdf/130415-BRI-PUBLIC-ADD-SERIES-When-is-a-current-account-deficit-bad.pdf]

undervalued (a view held by the CBK[5]), it is not debatable that the economy's fiscal deficit has remained unrestrained; it is no wonder fiscal consolidation is an important policy stance that the government has committed to.

The current account position cannot reveal any immediate-term financial vulnerabilities regarding size, maturity, and currency composition of gross financial stocks. An examination of the current debt stock and its profile – currency and tenor – reveals the fact that even as the economy embarks on the fiscal consolidation path, the past unrestrained fiscal deficit is a binding constraint. The fifty-fifty split between domestic debt and foreign debt that is characterized by a gradual tenor decline point to a stable currency – even on the Wisdom of immediate former president of the European Central Bank Mario Draghi in the form of 'whatever it takes' – being a key support to the economy's debt sustainability.

It is tempting to take the comfort of the foreign exchange reserves adequacy which currently estimated at an equivalent of about 6 months of import cover. It should be acknowledged though that the quantum of foreign exchange reserves is important but so is the source, for different sources have different multiplier effects on the domestic economy. It is evident that the build-up of the reserves is from diaspora remittances as the export earnings have not been that strong. Even as oil prices keep a declining trend (**Figure 3**) and therefore supporting savings of import costs and the observed low inflation though minimal oil prices pass-through effect, Kenya's commodity export earnings are likely to be subdued given the strong association between fuel and non-fuel commodity prices (**Figure 4**).

While a stable nominal exchange rate offers some critical, albeit not total, relief on foreign debt obligations, unwinding domestic debt situation and therefore addressing the crowding-out effect remains a challenge. There is an untested

Figure 3: Commodity Price Indices, 2016=100

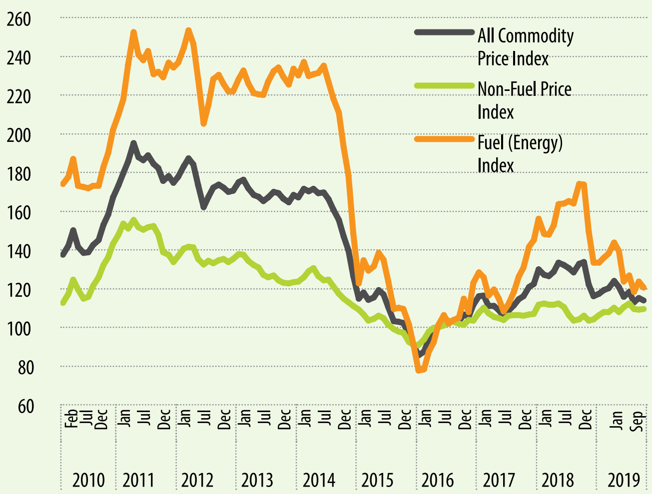
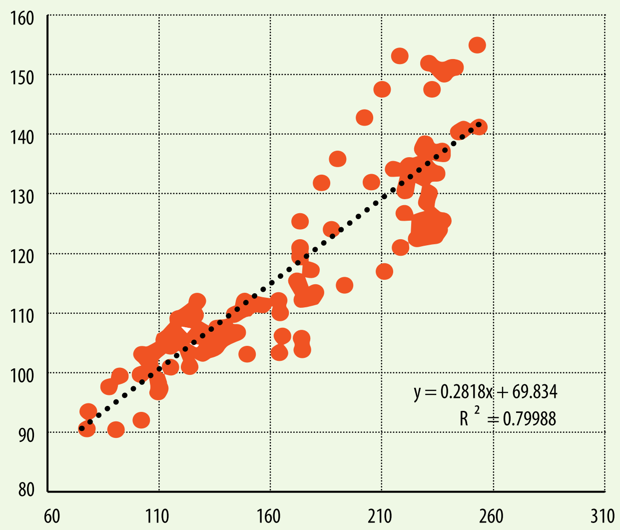


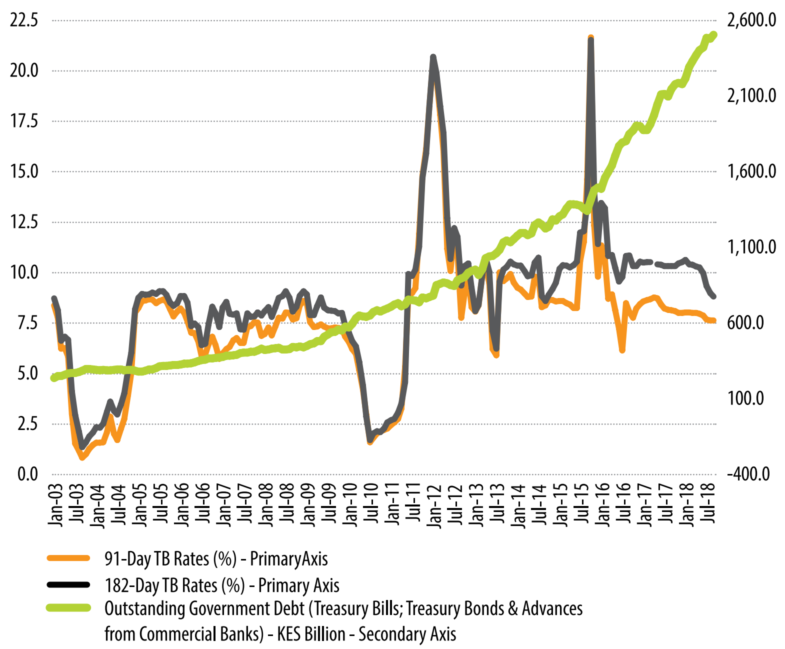
Figure 4: Fuel: Non-Fuel Price Index Correlation



4. See IMF (2018), "Kenya: Staff Report on 2018 Article IV Consultation and Establishment of Performance Criteria for the Second Review under the Stand–By Arrangement" October. [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]

5. See Central Bank of Kenya (2019), "An Assessment of Exchange Rate Misalignment in Kenya", October. [https://www.centralbank.go.ke/uploads/working_papers/668977093_Kenya%20Exchange%20Rate%20Misalignment%20Version%20final%20-%20December%202019.pdf]

Figure 5: Domestic Debt



– and data disproved – argument that the 2016 capping of interest rates was partly motivated by the desire to make borrowing cheap for the government. At the core of this assertion was the premise that if banks are not lending to the private sector due to the caps, then they will under-bid each other as they provide funding to the government.

Was there a race to the bottom when it came to the cost of debt to the government? There is evidence to the contrary. As **Figure 5** shows, the period 2003 – 2018 has been characterized by two pricing regimes for domestic debt to the government. The first one is the 2003 – 2011 when the rates largely remained within single-digit level, and the subsequent period when they were elevated. The low-interest rates were accompanied by low domestic borrowing, picking as the level of debt to government increased.

Essentially, the fiscal position of the government is at substantial welfare costs. The insights of Blanchard, (2019)[6] is helpful in making us appreciate such loss. The core argument is that when interest rates are low, there is at the worst low fiscal cost. But even in the absence of fiscal costs, public debt reduces capital accumulation and hence has welfare costs.

Under low-interest rates, such costs are lower than often assumed because the safe rate is the risk-adjusted rate of return to capital. If it is lower than the growth rate, it indicates that the risk-adjusted rate of return to capital is in fact low. In the Kenyan case, the opposite of this picture prevails, hence our observation that the current fiscal position is costly from a welfare standpoint.

How about a monetary policy 'raft' for the rescue?

Now that the pricing of credit has gone back to the market-determined regime, monetary policy potency has theoretically been restored. The question is: is there an avenue for it to have quick traction in supporting growth? The CBK's Monetary Policy Committee evidently believes so. With a

6. See IMF (2019), October – [https://www.imf.org/en/Publications/WEO/Issues/2019/10/01/world-economic-outlook-october-2019]

stable macroeconomic environment that we report in this *Economic Bulletin*, it could be argued that there is scope to deploy monetary policy to support growth. But that has to be accompanied by realism on how quick an accommodative stance will reveal potency insofar as output growth is concerned.

While as we noted earlier the economy is growing at a rate that could be characterised as strong (see also **Figure 6**), two things are clear: One, the scope for fiscal programmes to continue being a growth driver is limited as fiscal consolidation becomes a priority; two, enterprises are operating at excess capacity (limited or no demand for additional investments) and households' expenditure ability is constrained (our earlier observation of subdued core inflation). These two factors point to an economy with a negative output gap that superficially means an accommodative monetary policy will not compromise macroeconomic stability.

The key question to ask is: will monetary policy do the trick of taking the economy on the path of closing the output gap, especially post the repeal of the Banking Act to remove interest rate caps? To be sure, one must take into account that the credit market being trapped in a low equilibrium position (**Figure 7**) has a demand angle and supply angle. The alluded excess capacity and weak household demand point

Figure 6. Real Output Growth (%)

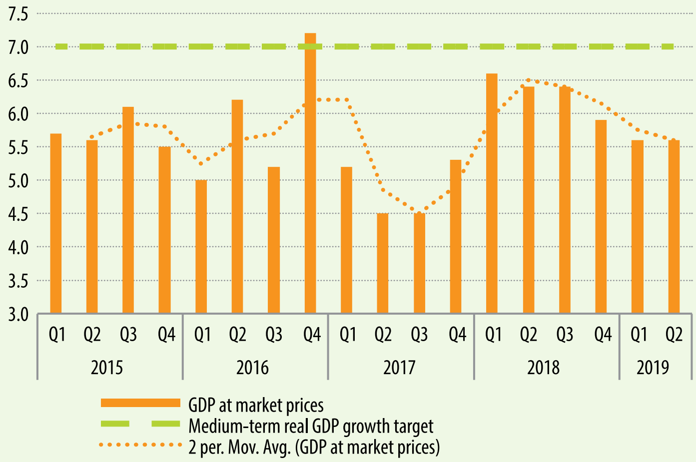
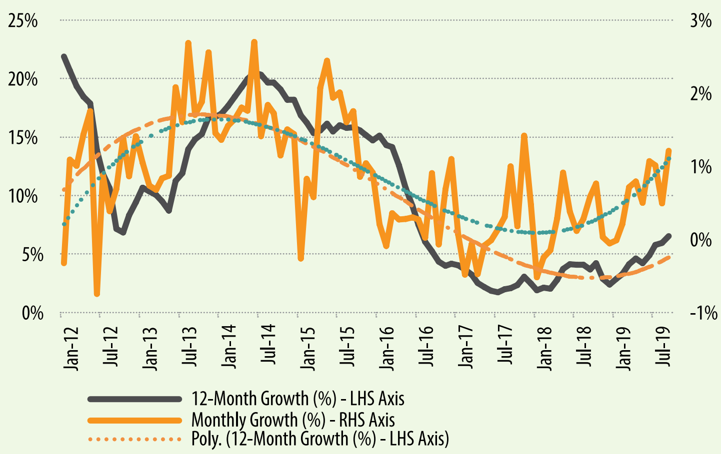


Figure 7: Claims on Private Sector (%)



to the possibility of limited effective credit demand even in the back of banks willing to avail funding in a non-controlled credit pricing regime.

We can argue that the credit market to be at an inflection phase and the policy choices – fiscal and monetary – will likely influence the path of the market in the near term. Amidst the already noted obvious fiscal challenges even as the government is committing to fiscal consolidation, it is tempting to assume that monetary policy will pick up the slack in supporting growth through stimulating credit. The plausibility of the assumption that the credit market will respond to an accommodative policy stance is predicated on the argument that the removal of the interest rate caps comes with an element of immediacy regarding the flexibility of the pricing of credit.

Taken together, these two arguments need to take in board the reality of the popular expectations of the rigidity of interest rates even without caps. With that, it's possible that the counterintuitive nature of the credit market not responding to the policy signal may still be binding in the immediate term.

Ultimately…

The interaction between external and domestic conditions point to a scenario where any rosy expectations for 2020 need to be tempered. The policy and market dynamics may superficially tempt unqualified, but unjustified, optimism.

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

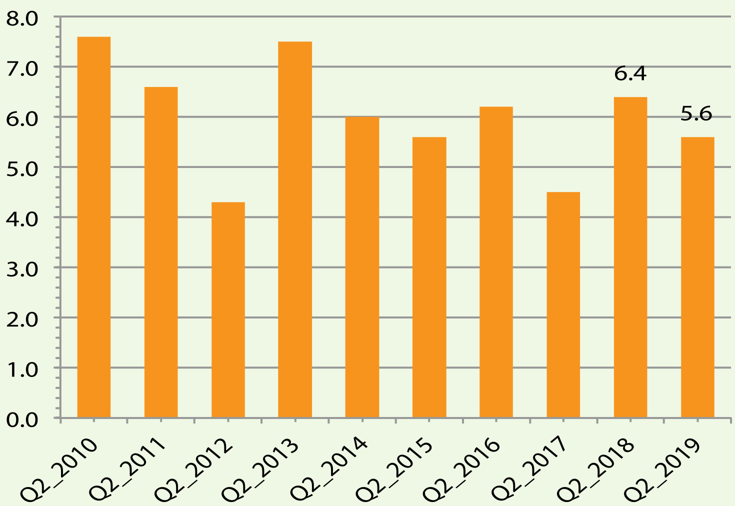
State of the Economy

In the first half of 2019, economic activity was subdued in comparison with a similar period in 2018. In particular, the economy expanded by 5.6 percent in the second quarter of 2019 compared to a 6.4 percent in a similar period in 2018 (Figure 8).

The contraction was driven by a confluence of factors. First, the performance in some sectors particularly, agriculture, manufacturing and transportation contracted. Nonetheless, the growth registered was supported by impressive performance in the accommodation and food services; information and communication; wholesale and retail trade; and construction industries thus supporting the overall GDP growth. This growth was also supported by a conducive macroeconomic environment and thus the economy's growth momentum remains positive, albeit weakening demand. The sustenance of the growth momentum will ultimately result in the narrowing of the output gap – the difference between the economy's actual real growth level and its potential level.

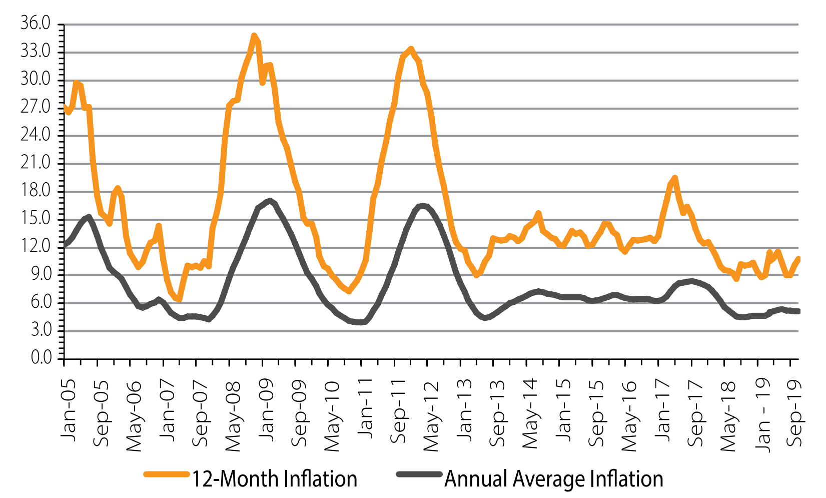
The inflation rate remained within the target range and well anchored. The overall 12-month inflation declined to 3.8 percent in September 2019 from 5.73 percent in June 2019

Figure 8: Quarterly Growth in GDP – 2009 Base Year

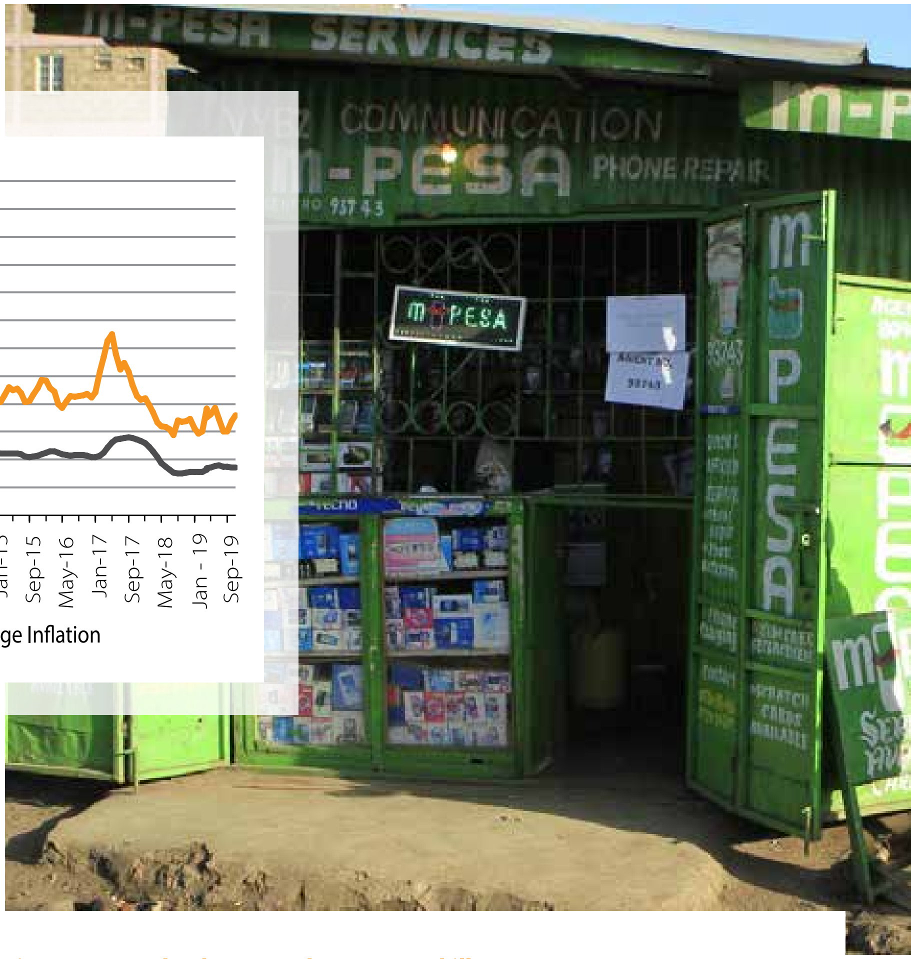


Source: KNBS

Figure 9: Monthly Inflation Rates



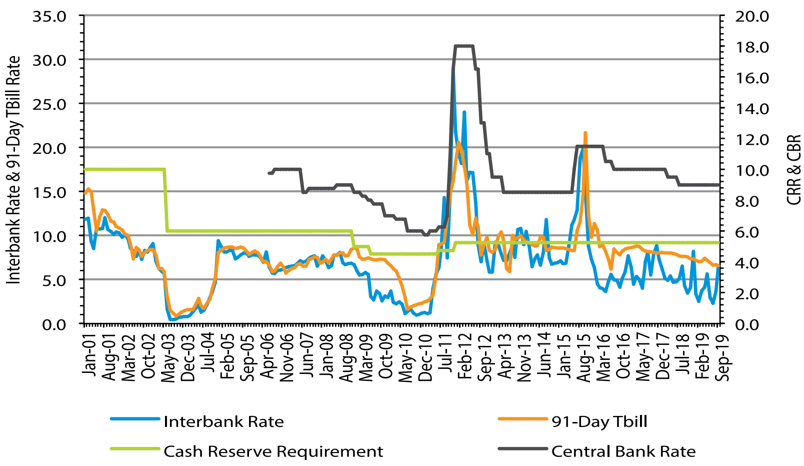
Source: KNBS



largely reflecting a decrease in the prices of both vegetable and non-vegetable food crops due to improved supply which led to a 203 basis points decline in food inflation from 7.94 percent in July 2019 to 5.91 percent in September 2019 following improved weather conditions.

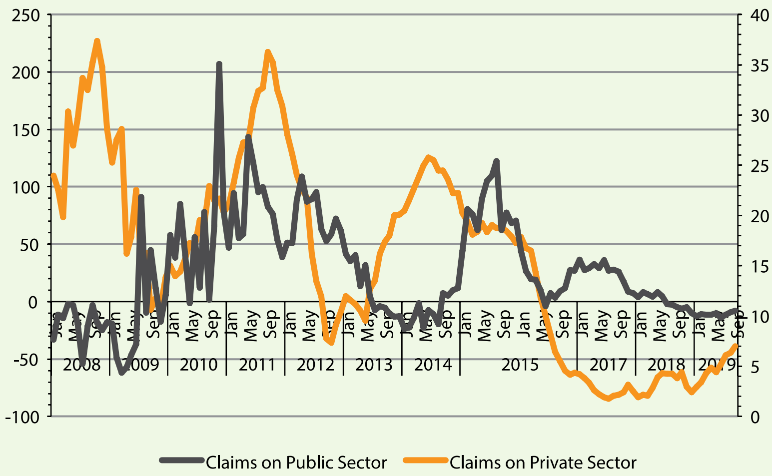
The interest rates during the third quarter of 2019 continued to be characterised by broad stability (**Figure 10**). During the third quarter, the Central Bank Rate (CBR) was retained at 9.0 percent during the July and September 2019 MPC meetings which were deemed appropriate as inflation expectations were well anchored and inflation rates were within the target range. On the other hand, the interbank rate was on an upward trend rising from 2.28 percent in July to 6.59 percent in September 2019 suggesting tight liquidity position in the market. Nonetheless, the average interbank rate for this period was lower than the rate registered in quarter two. The 91-day Treasury bill rate during the third quarter declined marginally from 6.62 percent in July 2019 to 6.56 percent in September 2019 and mirrors the downward trend that kicked in in April 2019.

Figure 10: Interbank rates and 91 Treasury bill rates



Source: CBK

Figure 11. Claims on Private Sector and Public Sector



Source: CBK

Private sector credit growth was characterized by growth albeit with a decline in the credit to the private sector (**Figure 11)**. The credit to the private sector grew by 7.01 percent in September 2019 compared to 6.1 percent in July 2019. Conversely, the growth of credit to the public sector, particularly parastatals and local government declined to 16.1 percent in September from 19.6 percent in July 2019. Whereas lending to the public sector still exceeds credit to the private sector, the decline in credit to the public sector reflects the reduction in commercial bank's subscription of government securities. Credit to the private sector as a proportion of the total domestic credit in September 2019 was mainly to trade with 17.08 percent compared to 17.22 percent in July 2019; credit to the private households rose to 16.49 percent in September 2019 from 16.26 percent in July 2019. On the other hand, credit to the manufacturing and real estate stood at 13.47 percent and 14.11 percent in September 2019 respectively. In July 2019, credit to the manufacturing and real estate sector stood at 13.59 percent and 14.42 percent in September 2019.

The overall balance of payments position deteriorated to a deficit of USD 1,061.7 million in the year to September 2019 from a deficit of USD 728.6 million in July 2019. This decrease reflects a reduction in the financial account but supported by a narrowing current account and improvement in the capital account. The current account narrowed by USD 132. 30 million translating to a 3.52 percent closure in the current account deficit and was driven by a significantly lower import bill, stronger diaspora remittance inflows and strong receipts from tourism. Similarly, the capital account increased by USD 8.30 million representing a 3.9 percent growth though lower than the position posted in the first half of 2019. The strong capital account position continued to be supported by the increasing official foreign reserves position.

“ The banking sector remains stable and resilient despite the tough regulatory and business environment.

The shilling has remained generally stable and strengthened against the majority of the EAC region currencies while being marked by mixed performance against the major international currencies during the third quarter of 2019 reflecting the developments on both the international and currency markets. Against the major international currencies, the shilling depreciated by 0.7 percent against the US Dollar, while appreciating by 0.2 percent and 0.1 percent against the Pound Sterling and the Euro respectively. Similarly, against the Chinese Yuan, the shilling was characterised by appreciation. Against the South African Rand, the Kenya shilling was stable with no changes being evident.

The performance of the Nairobi Securities Exchange continued to tumble in nearly all indicators suggesting a decline in trading activity at the bourse. More importantly, foreign investor participation continued to decline with the average foreign investor participation for the months of July and August 2019 averaging 66.9 percent and 62.3 percent respectively representing a 4.6 percent decline. On the other hand, foreign purchases and sales have also been dwindling.

The banking sector remains stable and resilient despite the tough regulatory and business environment with the asset base growing by 1.04 percent in the third quarter of 2019 and a reversal of the downtrend experienced in May 2019. Similarly, the shareholders' funds grew 1.7 percent. Further, the loans and deposits both registered modest growth with credit to the private sector grew by a 2.15 percent while deposits grew by 0.45 percent in the same period. Consequently, the asset quality albeit declining by 1.75 percent remains elevated but supported by the decreases in NPLs in the real estate, transport and communication, and building and construction sectors reflecting increasing repayments and the enhanced recovery efforts by banks.

Sectoral Performance

Agriculture

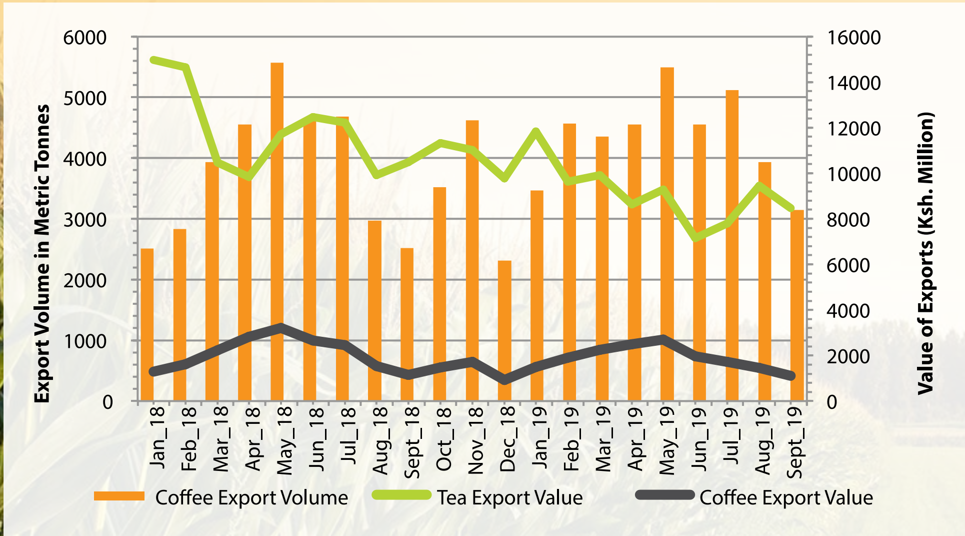
Over the years, agriculture remains to be a key contributor to the country's GDP. In quarter two of 2019, the sector's growth stood at 4.1 percent compared to 6.5 percent in a similar period in 2018.

The contraction under the period was mainly related to delayed long rains that adversely affected agricultural production. Nonetheless, this growth was bolstered a 17.6 percent growth in the production of cut flowers, 7.8 percent increase in the quantity of cane deliveries and 29.5 percent increase in the volume of coffee sales at the Nairobi Coffee Exchange (**Figure 12**).

On the downside, the contraction was driven by the reduction in tea production, which has since rebounded in the third quarter of 2019.

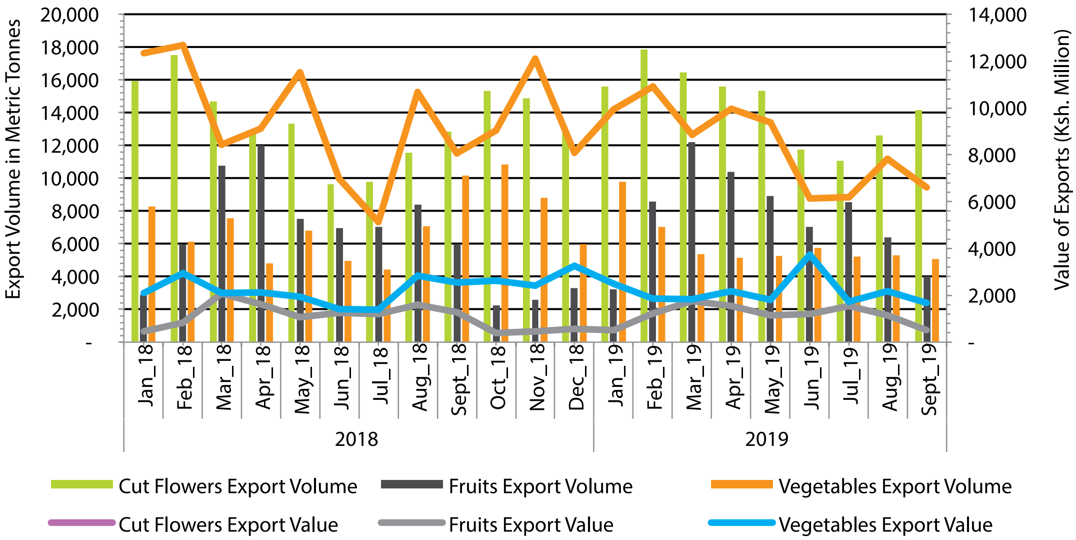
Further, the contraction of horticultural output also weighed down on the sector during the second quarter, but the third quarter had a slight improvement.

Figure 12: Tea and coffee production in MT and Prices per Kilograms



Source: KNBS

Figure 13: Majority of export of horticultural crops taper off ends except for fruits and vegetables



The performance of tea and coffee exports during the third quarter of 2019 was depressed albeit with modest improvement in tea performance.

The quantity of tea exports increased from 31,458 MT in July 2019 to 33,533 MT in September 2019 while the value of the exports increased from Kshs. 7,788.40 million to Kshs. 8,462.91 million over the same period.

On the flip side, both the quantity and value of coffee exports declined. The quantity of coffee exports declined from 5,115.45 MT in July to 3,144.73 MT in September 2019 while its value dropped from Kshs. 1,713.18 million to Kshs. 1,112.65 million over the same period.

The decline in the value of coffee exports was on account of the decline in the quantity exported given that the export prices increased during the period whereas the positive growth in tea exports was on account of increased prices and quantities exported.

During quarter three of 2019, the performance of exports of horticulture was depressed (**Figure 13**). First, the export quantity of cut-flower increased from 11,074 MT in July 2019 to 14,157 MT in September 2019 with its export value rising from Kshs. 6,188 million in July to Kshs. 6,612 million in September 2019.

Conversely, the exports of fruits and vegetables contracted with the volume of vegetable exports decreasing from 5,219 MT in July 2019 to 5,061 MT in September 2019.

The value of vegetable exports decreased from Kshs. 1,737

million to Kshs. 1,680 million during the same period. The volume of fruits exports also contracted from 8,546 MT in July 2019 to 4,035 MT in September 2019 with the export value dropping from Kshs. 1,556 million to Kshs. 522 million over the same period.

Manufacturing

Growth in the manufacturing sector, a key pillar in the government's Big 4 agenda and in jobs creation, remains positive but below desired levels.

In the second quarter of 2019, the manufacturing sector recorded subdued growth of 4.2 percent compared to a 4.7 percent growth it registered in the same period in 2018. This subdued growth was as a result of the reduction in the growth in the manufacture of food products especially the manufacture of tobacco products and processing and preservation of fish.

Nonetheless, the growth was bolstered by the growth in the manufacture of food sub-sector particularly, the production of sugar, manufacture of dairy products, processing of milk and manufacture of edible fats and margarine and manufacture of galvanized sheet, manufacture of cement and assembly of motor vehicles (**Figure 14**).

More importantly, the quantity of cement produced declined from 499,945 MT in July 2019 to 495,099 MT in August 2019 while the cement consumption also declined from 500,601 MT in July 2019 to 492,695 MT in August 2019. On the other hand, the production of sugar grew from 25,097 Metric tonnes in July 2019 to 32,705 Metric tonnes in August 2019. However, the uptake of milk in the formal sector dropped from 63.54 million litres in July 2019 to 60.46 million litres in August 2019.

Figure 14: Manufacturing Sector Leading Indicators

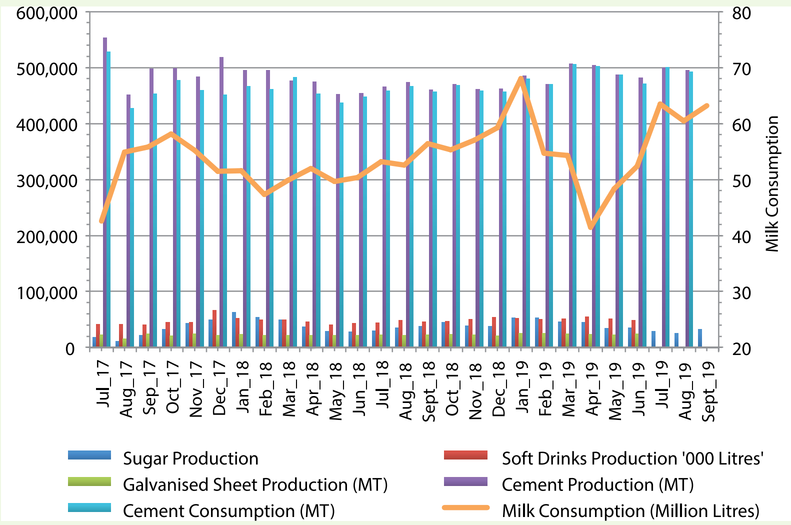
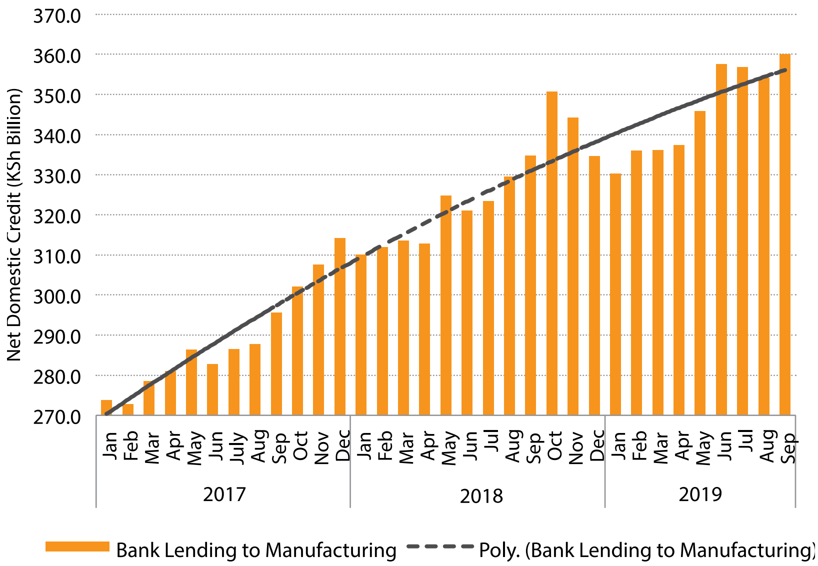


Figure 15: Bank lending to manufacturing sector



From the monthly lending, it is evident that the credit advanced to the sector has been increasing (**Figure 15**). In July 2019, credit to the manufacturing and real estate sector stood at 13.59 percent (or Kshs. 356,829.6 Billion) and 14.42 percent (or Kshs. 378,595.0 Billion) in September 2019.

Producer Price Index

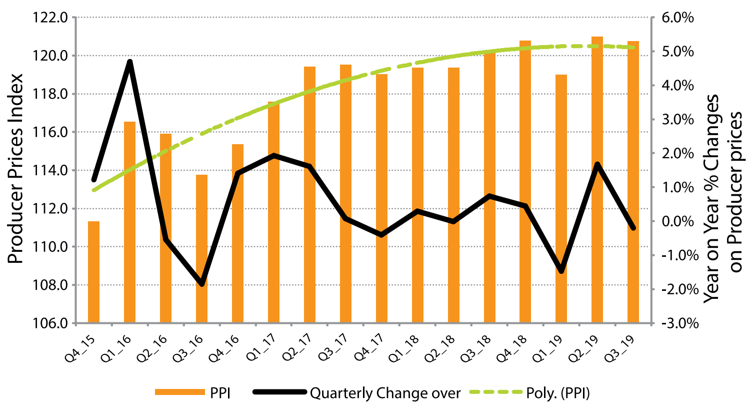
The producer price index (PPI) decreased by 0.2 per cent from 120.99 in June 2019 to 120.75 in September 2019 (**Figure 16**). However, the PPI has generally been characterised by an upward trend albeit modest trajectory.

According to the Kenya National Bureau of Statistics (KNBS), the decline in the PPI was mainly due to decreases in prices of sugar and tea.

Similarly, the decline was supported by the highest decline in the manufacture of food products by 1.89 percent from June 2019 to September 2019.

Further, the KNBS notes that over the last one year, producer price increases have been highest for electricity, manufacture of basic metals and mining and quarrying which rose by 5.46, 4.43 and 4.40 per cent, respectively. However, during the same period manufacture of food products and manufacture of wood and products of wood and cork except furniture declined by 1.51 per cent and 3.26 per cent, respectively.

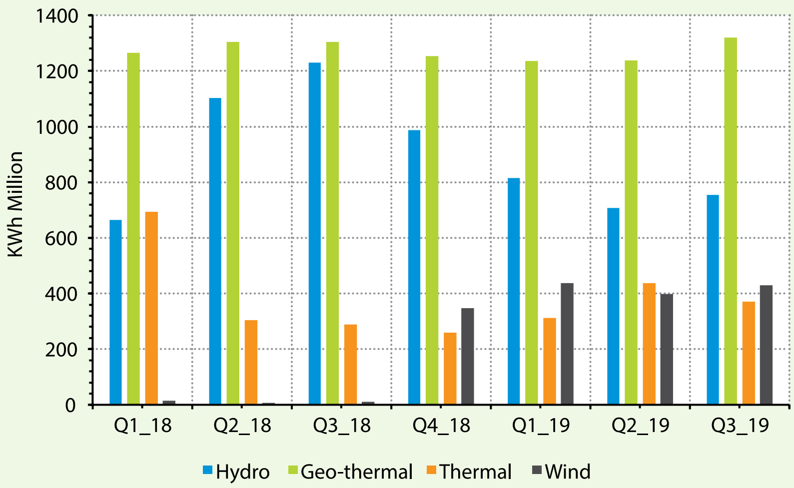
Figure 16: Producer Price Index and Percentage Changes on Producer Prices



Energy

Energy is a critical component not only for households but also for enterprises and it feeds into the cost of production among enterprises. During the second quarter of 2019, the sector expanded by 5.6 percent compared to 8.4 percent growth it registered in a similar quarter in 2018. In the third quarter of 2019, the generation of electricity from geothermal dominated contributing to 54.0 percent of the total energy mix compared to 46.2 percent in the same quarter in 2018 (**Figure 17**).

Figure 17: Electricity Generation by Source (Million KWh)



Source: KNBS

Production of electricity from hydro-power came in second at 30.9 percent in the third quarter of 2019 though a 12.7 percent decline from 43.6 percent in quarter three of 2018. The contraction experienced in the third quarter was negatively impacted by insufficient long rains during the first quarter as well as during the first two months of the second quarter which resulted resulting in a contraction in the generation of hydro-electric power.

On the international front, the price of Murban crude oil decreased from an average of US Dollars 62.75 per barrel in July 2019 to US Dollars 60.16 per barrel in September 2019. On the domestic front, the national average domestic retail oil prices of motor gasoline premium dropped from Kshs. 116.14 in July 2019 to Kshs. 113.57 per litre in September 2019. The price of light diesel oil dropped from Kshs. 105.57 in July 2019 to Kshs. 103.90 in September 2019. On the other hand, the average price for Kerosene also dropped from Kshs. 105.11 in July 2019 to retail at Kshs. 101.44 in September 2019. The price of a 13-Kg cylinder of gas averaged Kshs. 2,141.31 in September 2019 from Kshs. 2,171.47 in July 2019

Table 1: Average Monthly Crude Oil and Retail Fuel Prices

	Jan-19	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
Murban crude oil (US$/Barrel)	61	61	66	67	73	70	63	65	60
Super petrol (KES/Litre)	105	101	102	108	113	116	116	112	114
Diesel (KES/Litre)	103	97	98	103	105	106	105	105	104
Kerosene (KES/Litre)	103	103	98	100	102	105	105	101	101
LPG (13Kgs)	2,193	2,190	2,192	2,185	2,193	2,192	2,171	2,150	2,141

Source: KNBS

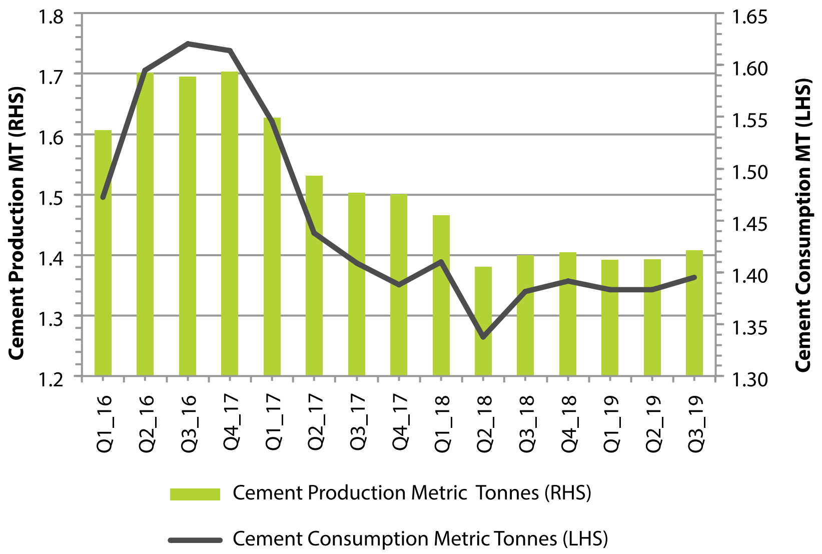
Building and Construction

The performance of the building and construction sector registered improved performance in the second quarter of 2019 registering a 7.2 percent growth compared to a 5.4 percent growth in the same quarter of 2018.

This impressive growth was largely supported by the ongoing infrastructural projects especially construction of roads and phase two of the Standard Gauge Railway. The leading indicators in the second and third quarter of 2019 similarly registered moderate growth (**Figure 17**).

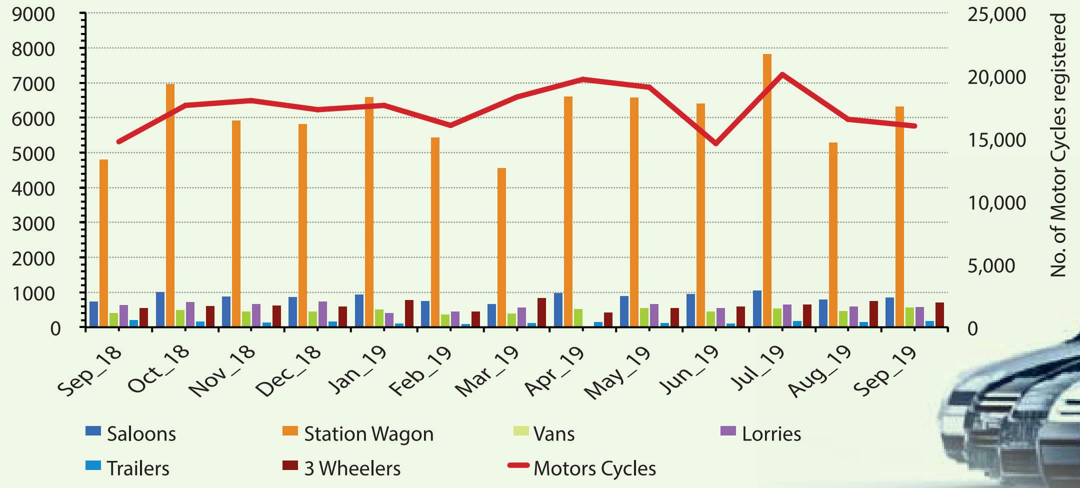
Cement consumption, which is a key input in the industry, increased by 3.6 per cent in the second quarter of 2019 compared to a contraction of 1.8 per cent the same period in 2018. On the other side, the quantity of cement produced decreased from 499,945 MT in July 2019 to 495,099 MT in August 2019 while the consumption of cement also dropped from 500,601 MT in July 2019 to 492,695 MT in August 2019.

Figure 17: Cement Production and Consumption (MTs in millions)

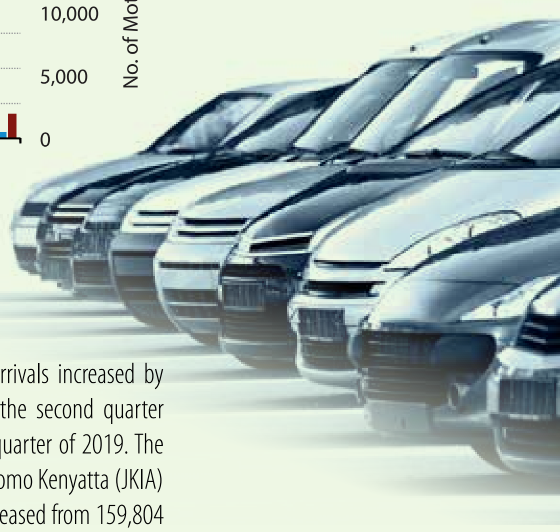


Source: KNBS

Figure 18: Registration of New Vehicles



Source: KNBS



Transport and Communication

In quarter two of 2019, the transport and storage sector performance contracted to 7.2 percent compared to 8.4 percent growth registered in the same quarter in 2018. On the other hand, the information and communication registered improved performance growing by 11.6 percent during quarter two of 2019 compared to 11.0 percent growth it registered during the same quarter in 2018.

Production of assembled vehicles increased from 558 units in June 2019 to 689 units in July 2019. On the other hand, the total number of vehicles registered in September 2019 stood at 26,281 out of which 6,322 were Station Wagons (**Figure 18**).

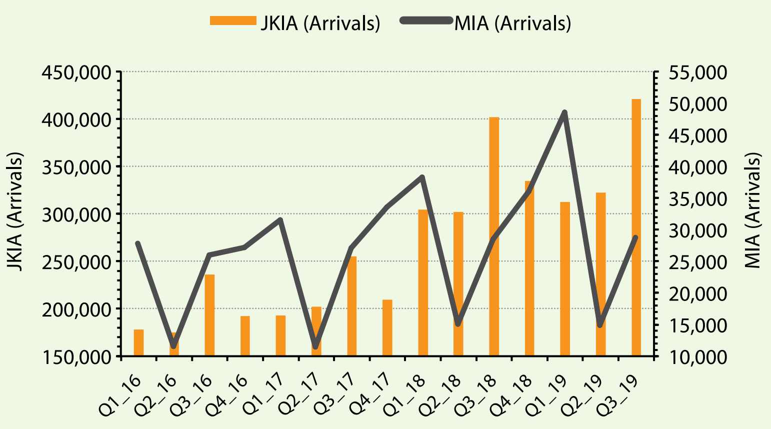
Tourism

In the third quarter of 2019, the performance of tourism sector rebounded compared to the performance in a similar period in 2018 and also during the second quarter of 2019 (**Figure 18**).

During the third quarter, the total tourist arrivals through the various points of entry increased by 4.55 percent from 430,063 visitors in the third quarter of 2018 to 449,620 visitors in the third quarter of 2019.

On a quarter-on-quarter basis, tourist arrivals increased by 24.94 percent from 337,477 visitors in the second quarter of 2019 to 449,620 visitors in the third quarter of 2019. The total number of visitors arriving through Jomo Kenyatta (JKIA) and Moi International Airports (MIA) decreased from 159,804 persons in August 2019 to 130,867 persons in September 2019. The number of passengers who landed at Jomo Kenyatta International Airport (JKIA) increased from 306,911 persons in July 2019 to 321,176 persons in August 2019, and passengers who embarked also increased from 172,599 persons in July 2019 to 208,197 persons in August 2019.

Figure 19: Trends in Visitor Arrivals

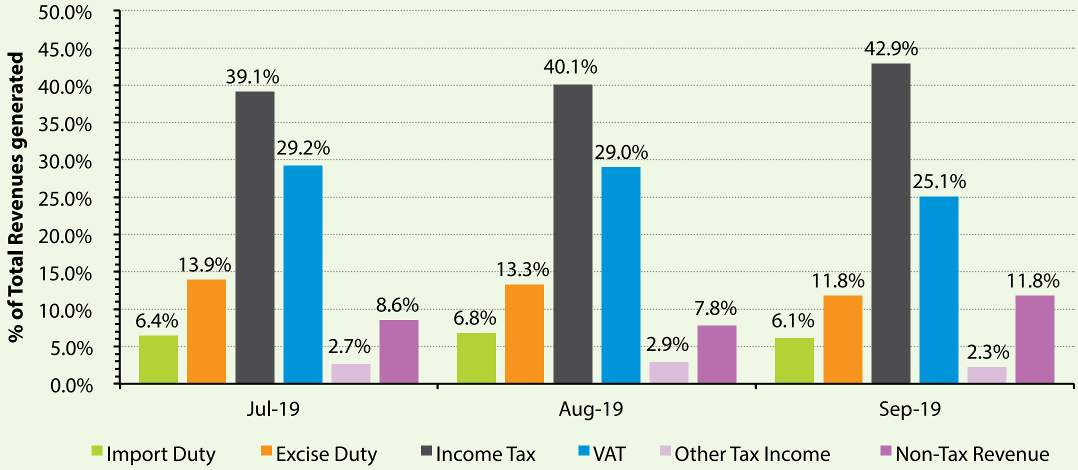


Financing the Government

During quarter three of 2019, the total tax revenues accounted for 90.6 percent of the government's total revenue, while non-tax revenue account 9.4 percent suggesting that the performance in tax revenue is expected to have a strong correlation with performance in economic activity.

Disaggregated by source, income tax accounted for 40.7 percent of the total revenues, underscoring its importance in revenue efforts to fund government expenditures and has been the most dominant source of government revenue. This is an indication of the government's constraint in terms of widening the revenue base and coming up with new revenue sources despite of the government's expenditure continuing to rise with the onset of devolution government. The Value added tax (VAT) accounted for 27.8 percent, excise duty accounted for 13.0 percent, import duty accounted for 6.5 percent while other tax incomes and non-tax revenues accounted for 2.6 percent and 9.4 percent respectively (**Figure 20**).

Figure 20: Sources of Government's Revenue



Source: CBK

In the third quarter of 2019, 89.8 percent of the total expenditure was on recurrent expenditure while development expenditure accounted for 10.2 percent (**Figure 20**). Disaggregated by expenditure component, the domestic interest accounted for 22.4 percent of the total recurrent expenditure, foreign interest payments accounted for 11.1 percent, pensions accounted for 4.1 percent while dominated by wages and salaries at 31.9 percent (**Figure 21**).

Public Debt

Kenya's debts over the five years have been rapidly growing driven by the expansionary fiscal policy. As of September 2019, the total debt stock stood at Kshs. 5.968 trillion up from Kshs. 5.809 trillion in June 2019. An analytical breakdown of the public debt analysis into domestic and external debt reveals that the government through the National Treasury

Figure 21: Composition of Expenditures

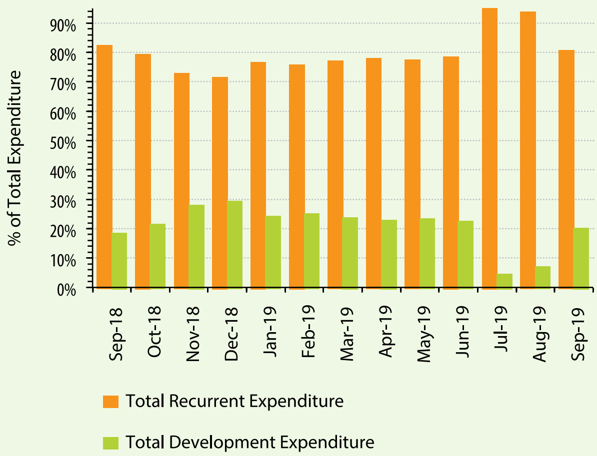
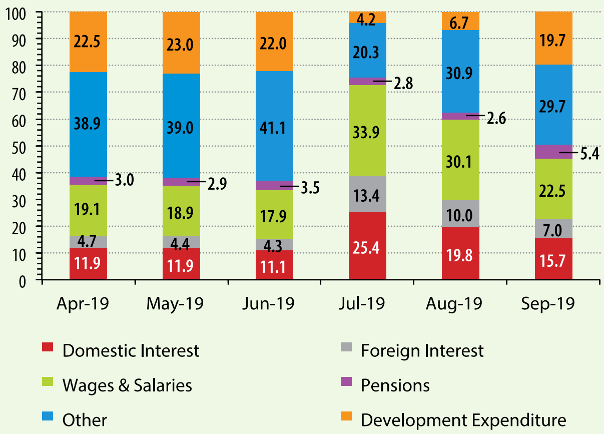
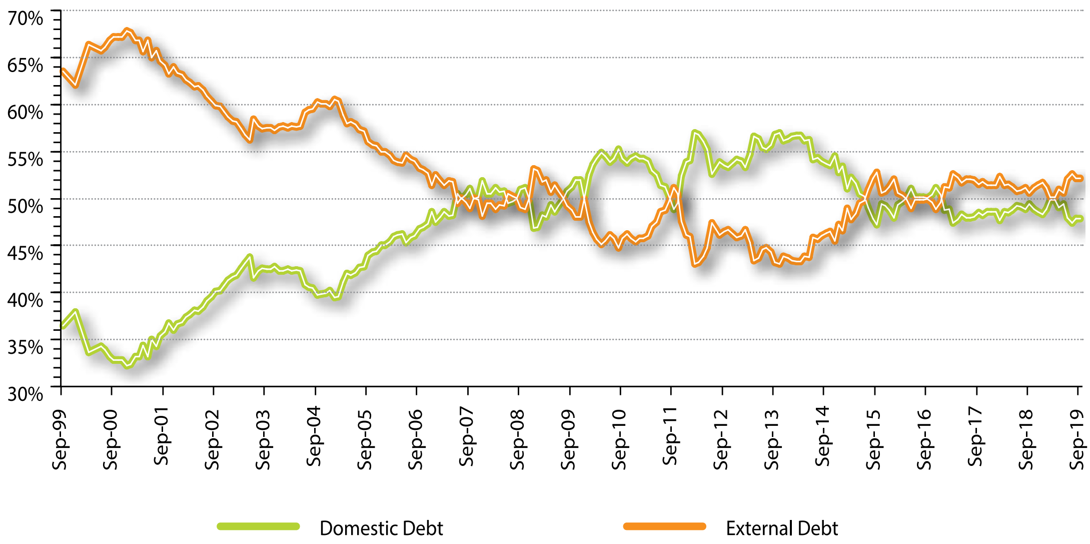


Figure 22: Expenditures by classification



Source: CBK

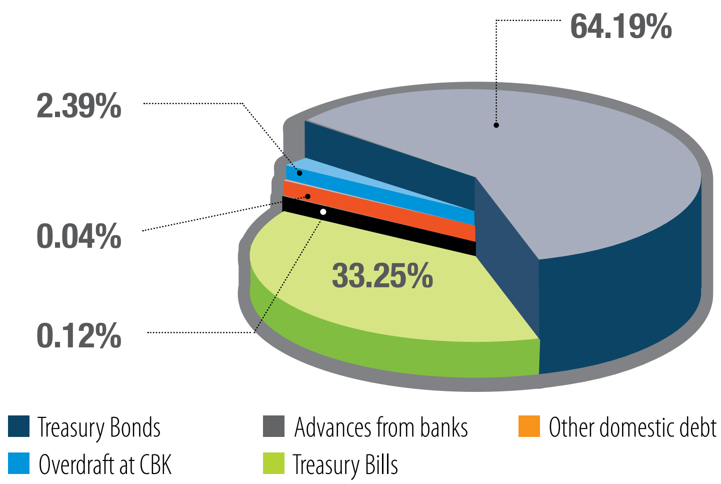
Figure 23: Evolution of Kenya's domestic and external debt profile



Source: CBK

has had a tight balance between domestic and external debt. More importantly, in September 2019, domestic debts accounted for 47.85 percent of the total debt while external debt accounted for 52.14 percent.

Figure 24: Composition of Domestic Debt

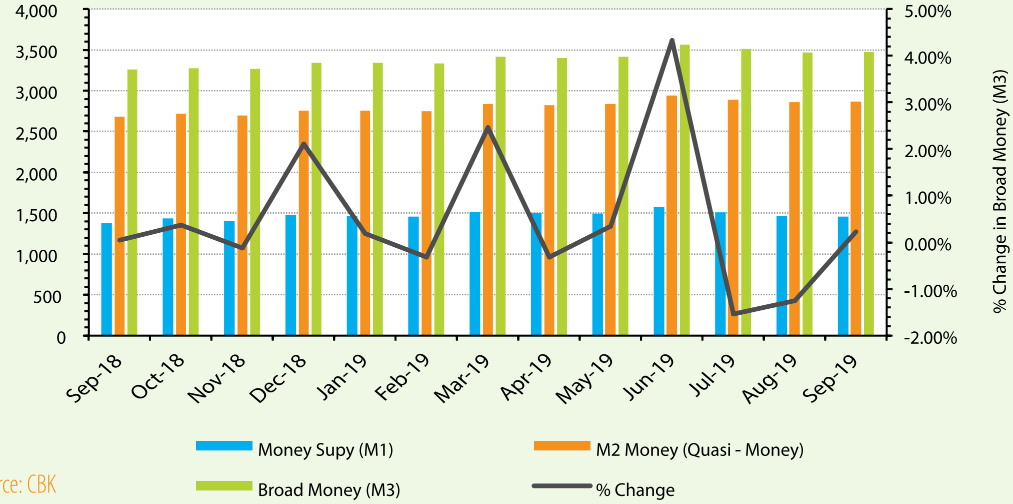


Evidently, the proportion of external debt to the total debt has generally been on a decline, albeit in the recent months has been rising while the proportion of domestic debt has also been rising (**Figure 23**). The split between external and domestic debt in the total debt stock is about 50:50. However, reflecting higher domestic interest rates, debt servicing charges on the domestic debt stock are about three times higher than from the external debt stock. Kenya continues to access international markets to refinance its external debt.

For the period ending September 2019, the composition of domestic debts remained largely unchanged from that of the previous quarters (**Figure 24**).

Treasury bonds accounted for 64.19 percent of the total domestic debt while treasury bills accounted for 33.25 percent of the total domestic debt while overdrafts at the Central bank accounted for 2.39 percent of the total domestic debt. Similarly, advances from commercial banks and other domestic debt accounted for 0.12 percent and 0.04 percent of the total domestic debt respectively.

Figure 25: Money Supply (KES Million)



Source: CBK

Money Supply and Domestic Credit

In the third quarter of 2019, the monetary aggregates, especially narrow money (M1), quasi money (M2) and broad money (M3), a key indicator for monetary policy formulation, were on a modest decline (**Figure 24**). M1 declined from Kshs. 1,510.8 Billion in July 2019 to Kshs. 1,459.70 Billion in September 2019. Similarly, M2 declined from Kshs. 2,892.60 Billion in July 2019 to Kshs. 2,866.00 Billion in September 2019 while M3 also registered a decline Kshs. 3,509.40 in July to Kshs. 3,473.40 Billion in September 2019.

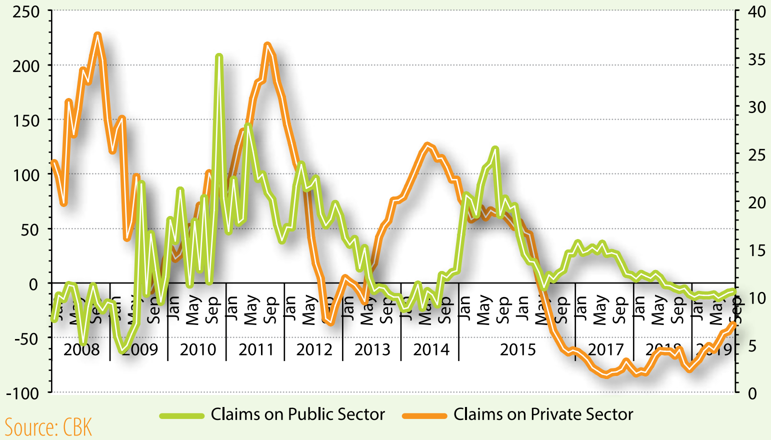
The slowdown in broad money (M3), on the asset side, was due to the decline in the Net Foreign Assets (NFA) which declined by Kshs. 65.30 Billion from Kshs. 900.7 Billion in July 2019 to Kshs. 835.4 Billion in September 2019. However, the reduction was partially offset by the growth in the Net Domestic assets (NDA) of the banking system which grew by Kshs. 29.10 Billion from Kshs. 2,608.80 Billion in July to Kshs. 2,637.90 Billion in September 2019.

During the third quarter, the credit to the private sector was characterized by growth whereas credit to the public sector was on a trend decline (**Figure 25**). The credit to the private sector grew by 7.01 percent in September 2019 compared to 6.1 percent in July 2019.

Conversely, the growth of credit to the public sector, particularly parastatals and local government declined to 16.1 percent in September from 19.6 percent in July 2019. Whereas lending to the public sector still exceeds credit to the private sector, the decline in credit to the public sector reflects the reduction in commercial bank's subscription of government securities.

Looking at the credit to the private sector as a proportion of the total domestic credit in September 2019 was mainly to trade with 17.08 percent (or Kshs. 456,525.3 Billion) compared to 17.22 percent (or Kshs. 451,965.7 Billion) in July 2019; credit to the private households rose to 16.49 percent (or Kshs.

Figure 26: Claims on Private Sector and Public Sector



Source: CBK

440,579.8 Billion) in September 2019 from 16.26 percent (or Kshs. 426,918.8 Billion) in July 2019.

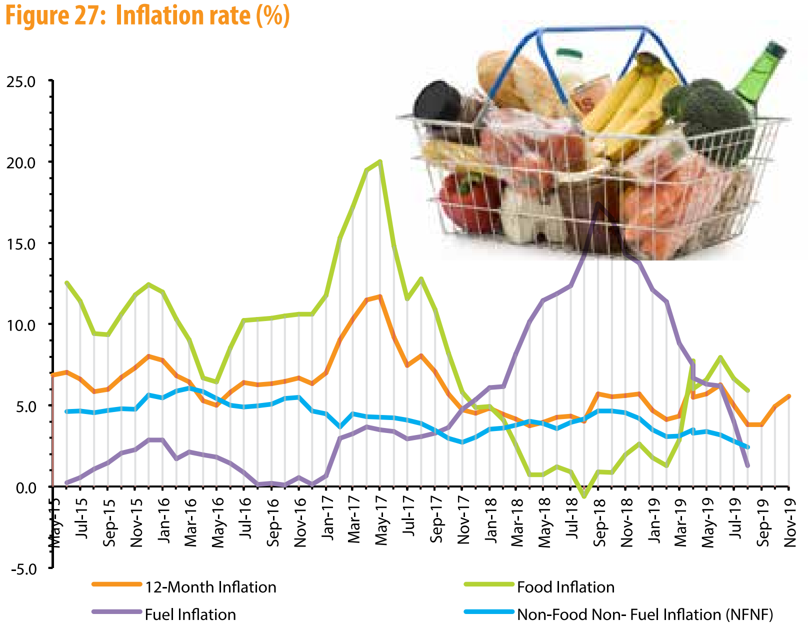
On the other hand, credit to the manufacturing and real estate stood at 13.47 percent (or Kshs. 359,967.4 Billion) and 14.11 percent (or Kshs. 377,089.0 Billion) in September 2019 respectively. In July 2019, credit to the manufacturing and real estate sector stood at 13.59 percent (or Kshs. 356,829.6 Billion) and 14.42 percent (or Kshs. 378,595.0 Billion) in September 2019

Inflation

In quarter three of 2019, the inflation rate remained within the target range and well-anchored (**Figure 27**). The overall 12-month inflation declined to 3.8 percent in September 2019 from 5.73 percent in June 2019 largely reflecting a decrease in the prices of both vegetable and non-vegetable food crops due to improved supply which led to a 203 basis points decline in food inflation from 7.94 percent in July 2019 to 5.91 percent in September 2019 following improved weather conditions.

The decline in inflation rate was further supported by a 490-basis point reduction in the fuel inflation from 6.2 percent in July 2019 to 1.3 percent in September 2019. Similarly, this reduction was further buttressed by a 76-basis points reduction in the non-food non-fuel inflation which declined from 3.19 percent in July 2019 to 2.43 percent in September 2019.

Figure 27: Inflation rate (%)



Non-food-non-fuel (NFNF) inflation remained below 5 percent, indicative of muted demand pressures and spillover effects of the excise tax indexation in July and the recent increase in fuel prices. The low inflationary pressure has also been supported by a stable local currency against the US dollar thereby serving as a nominal anchor to inflationary expectations.

However, the recent increase in international oil prices is expected to exert moderate upward pressure on fuel prices, but with limited pass-through effects on inflation. And more importantly, the November excise tax adjustments in the Finance Act 2019 are expected to only have a marginal impact on inflation.

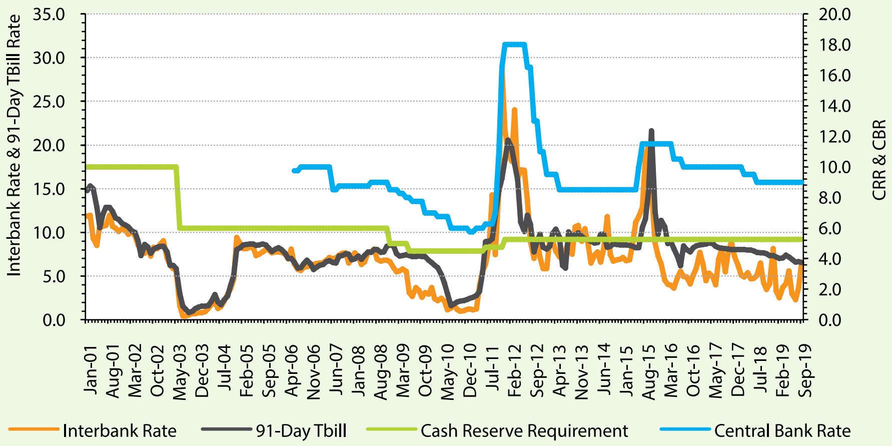
Interest Rates

The interest rates during the third quarter of 2019 continued to be characterised by broad stability (**Figure 28**). During the third quarter, the Monetary Policy Committee (MPC) meetings in July and September 2019 held against a backdrop of domestic macroeconomic stability, sustained optimism on economic growth prospects, heightened global uncertainties and volatility in international markets. The Central Bank Rate (CBR) was retained at 9.0 percent with the MPC noting that the stance was appropriate as inflation expectations remained well anchored within the target range and that the economy was operating close to potential.

In the third quarter, the interbank rate was on an upward trend rising from 2.28 percent in July to 6.59 percent in September 2019 suggesting tight liquidity position in the market. Nonetheless, the average interbank rate for this period was lower than the rate registered in quarter two. In particular, the average interbank rate in quarter two stood at 4.24 percent against 4.19 percent in the third quarter of 2019. Nonetheless, the uptick in the interbank rate led to a reduction in the volume of interbank loans as interbank borrowing is price sensitive given the existing interbank market segmentation.

The 91-day Treasury bill rate which largely reflects the government's borrowing profile declined marginally from 6.62 percent

Figure 28: Interbank rates and 91 Treasury bill rates



Source: CBK

in July 2019 to 6.56 percent in September 2019 and mirrors the downward trend that kicked in in April 2019. This decline in the Treasury bill may be attributed to decreased costs of borrowing in the interbank money market from June to August 2018.

Both the weighted average deposit and lending rate during quarter three of 2019 was rather stable. The weighted average lending rate declined marginally by 0.04 percent from 12.48 percent in quarter two of 2019 to 12.44 percent in the third quarter of 2019.

The stability of the weighted average lending is due to the stickiness of interest rates due to the capping of interest rates introduced by the Banking Amendment Act (2016) that set the interest rate chargeable on loans at no more than 400 basis points above the CBR.

Similarly, the weighted average deposit rate declined by 0.23 percent from 7.19 percent in quarter two to 6.95 percent in quarter three of 2019 and this movement has largely been driven by the market dynamics. Consequently, the interest rate spread increased by 0.19 percent between quarter two and three of 2019.

Balance of Payments

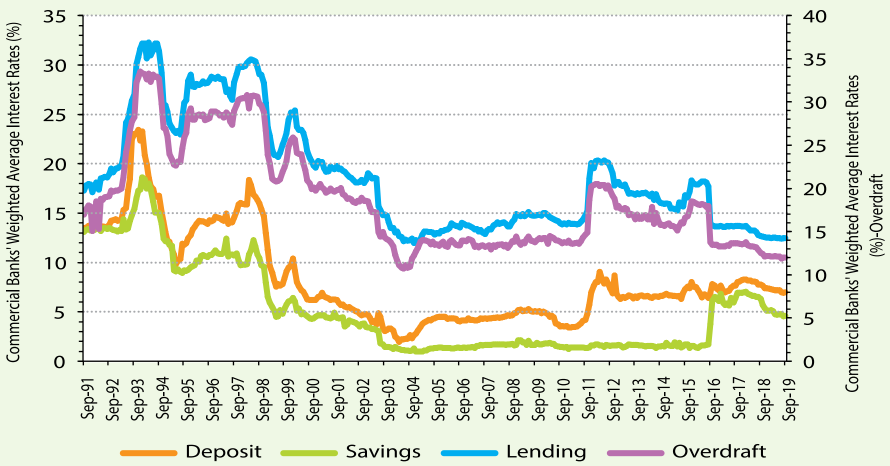
The overall balance of payments position deteriorated to a deficit of USD 1,061.7 million in the year to September 2019 from a deficit of USD 728.6 million in July 2019 (**Figure 29**). This decrease reflects a reduction in the financial account but supported by a narrowing current account and improvement in the capital account.

The current account narrowed by USD 132. 30 million translating to a 3.52 percent closure in the current account deficit from July and September of 2019 from USD 3,886.9 million in July to USD 3,754.6 million in September of 2019. This was driven by lower imports, stronger diaspora remittance inflows and strong receipts from tourism. The deficit was financed by official borrowing and private investment inflows.

On the other hand, the capital account increased by USD 8.30 million representing a 3.9 percent growth though lower than the position posted in the first half of 2019. The strong capital account position continued to be supported by the increasing official foreign reserves position which increased to USD 8,985 million (5.61 months of import cover) as at the end of September 2019 and continued to meet the CBK's statutory requirement to endeavour to maintain at least 4 months of import cover, and the EAC region's convergence criteria of 4.5 months of import cover.

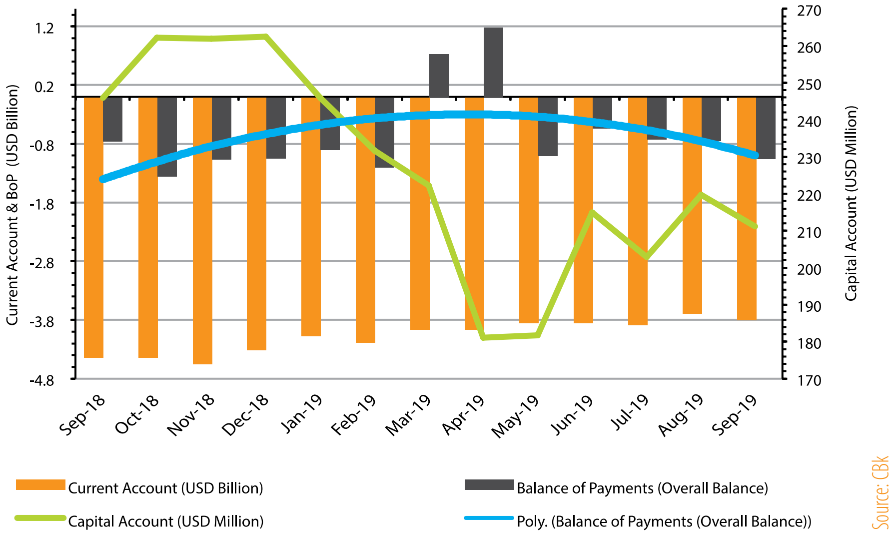
Looking at the trade balance position, the amount of imports declined in the third quarter of 2019 driven

Figure 29: Commercial Banks' Weighted Average Interest Rates (%)



Source: CBK

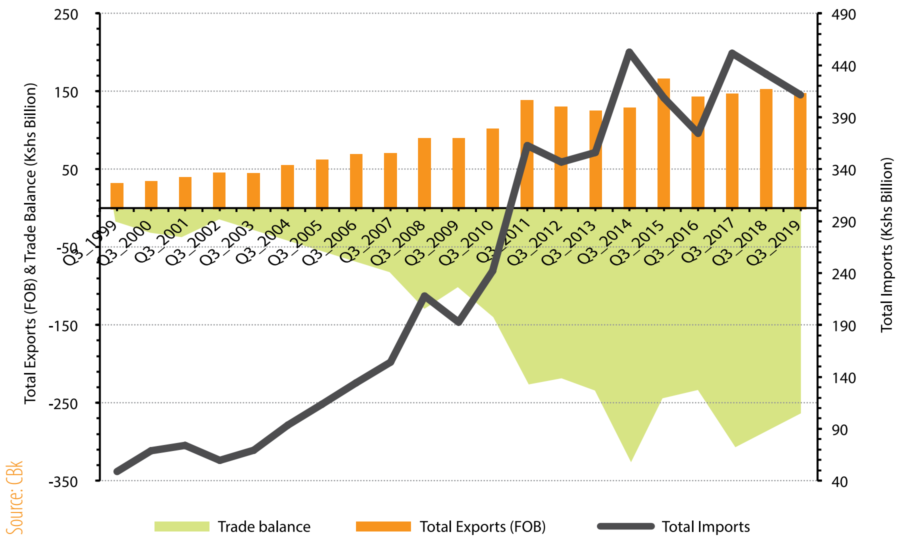
Figure 30: Balance of Payments Position



by low food and SGR related imports. On the other hand, the exports registered modest growth. This was supported by the country's exports of the first crude oil in August of 2019 which account for 0.2 percent of the total merchandise exports.

However, the EAC and other regional manufacturing exports markets have contracted by 4.8 percent in the first half of 2019. Despite, the contraction in the export position, there was still modest growth and together with the contraction of the import outlook, the current account deficit narrowed during the third quarter of 2019 (**Figure 30**).

Figure 30: Balance of Payments Position



Exchange Rates Developments

The Kenya shilling strengthened against the majority of the EAC region currencies while being marked by mixed performance against the major international currencies during the third quarter of 2019 (**Figure 31**) and reflected the developments on both the international and currency markets.

Against the major international currencies, the shilling depreciated by 0.7 percent against the US Dollar, while appreciating by 0.2 percent and 0.1 percent against the Pound Sterling and the Euro respectively. Similarly, against the Chinese Yuan, the shilling was characterised by appreciation. Against the South African Rand, the Kenya shilling was stable with no changes being evident.

On the EAC currencies front, the shilling appreciated by 1.2 percent against the Ugandan shilling, 0.7 percent against the Tanzanian shilling, 0.3 percent against the Rwandan Franc, and 0.5 percent against the Burundian Franc during the third quarter of 2019.

The foreign exchange market stable outlook continued to be supported by the narrowing of the current account deficit reflecting the resilience of the export performance - and more importantly that of horticultural and manufactured goods, higher receipts from tourism and transport services and lower imports of food and SGR-related equipment. The appreciation of the Kenya shilling against other currencies going forward will, however, have implications on the country's export competitiveness especially in its main export markets especially the intra-EAC and Inter-EAC trade.

Figure 31: Figure xx: Nominal Exchange Rates

Table 2: Nairobi Securities Exchange 2019

	Jan-19	Feb-19	Mar-19	Apr-19	May-19	Jun-19	Jul-19	Aug-19	Sep-19
NASI (2008=100)	154.5	152.9	157.7	157.3	149.9	149.6	148.3	147.6	145.5
NSE 25 Share Index	3873.1	3814.1	3976.3	3908.7	3616.4	3586.6	3583.1	3521.8	3475.0
NSE 20 Share Index (1966=100)	2982.7	2916.2	2846.4	2796.8	2676.9	2633.3	2627.8	2467.7	2432.0
Number of Shares Traded (Million)	557.0	425.0	446.0	295.0	452.4	334.0	374.2	322.0	367.6
Equities Turnover (KSh Billion)	16.2	14.2	15.9	9.9	12.5	10.5	11.5	8.7	10.6
Market Capitalization (KSh Billion)	2248.0	2284.0	2360.5	2354.0	2268.3	2278.9	2258.0	2222.0	2172.0

Source: CBK

Nairobi Securities Exchange

During the third quarter of 2019, the performance of the Nairobi Securities Exchange continued to tumble in nearly all indicators suggesting a decline in trading activity at the bourse during the third quarter of 2019. This is clear evidence of the dominance of the bearish behaviour that has characterized the market in recent months.

The NASI index shed 2.79 points from 148.25 points in July 2019 to 145.46 points in September 2019. Similarly, the NSE-25 index shed 108.12 points from a high of 3583.09 points in July 2019 to 3474.97 points in September 2019. In addition, the NSE-20 index, on the other hand, declined by 195.84 points from 2627.81 points in July 2019 to 2431.97 points in September 2019.

Further, in July 2019, the number of shares traded was 374.21 million which declined to 367.61 million in September 2019 representing a 6.6 million reduction in shares traded and translates to a 1.8 percent decline in trading activity.

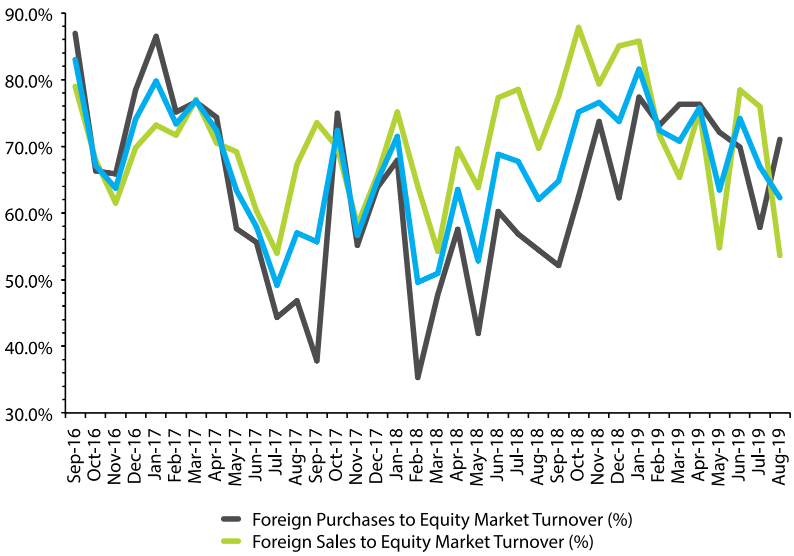
Equally, the equities turnover also lost ground shedding Kshs. 0.89 Billion between July and September 2019 representing an 8.43 percent decline. Correspondingly, the market capitalization declined by 3.96 percent declining from Kshs. 2258.0 Billion in July to 2172.0 Billion in September 2019 (**Table 2**).

On the other hand, foreign investor participation has been on a decline (**Figure 32**). The average foreign investor participation for the months of July and August 2019 averaging 66.9 percent and 62.3 percent respectively representing a 4.6 percent decline.

On the other hand, foreign purchases and sales have also been dwindling. For instance, in July the foreign purchases of equities stood at Kshs. 6,625 Million in July and declined to Kshs. 6,146 Million in August 2019 representing a 7.8 percent decline on a month-on-month basis.

Similarly, foreign sales decline from Kshs. 8,698 million in July 2019 to Kshs. 4,637 million in August 2019. More importantly, the foreign purchases on average exceed foreign sales in the third quarter of 2019.

Figure 32: Securities Exchange Foreign Investors Participation



Source: CBK

Banking Industry Performance

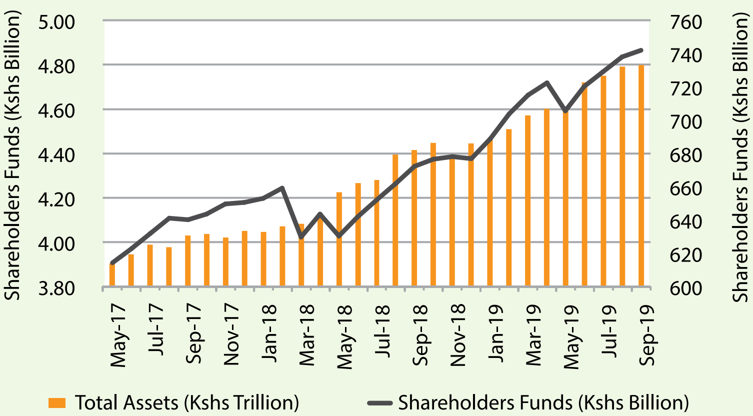
Banking sector plays one of the most important roles in the economic life of a country by facilitating, the production, distribution, exchange and consumption processes in the economic system, thus being an essential part of country's sustainable development.

This section reviews the trends and performance of the banking industry up to the third quarter of 2019. Overall, the banking sector remains stable and resilient despite the tough regulatory and business environment.

Assets and Equity

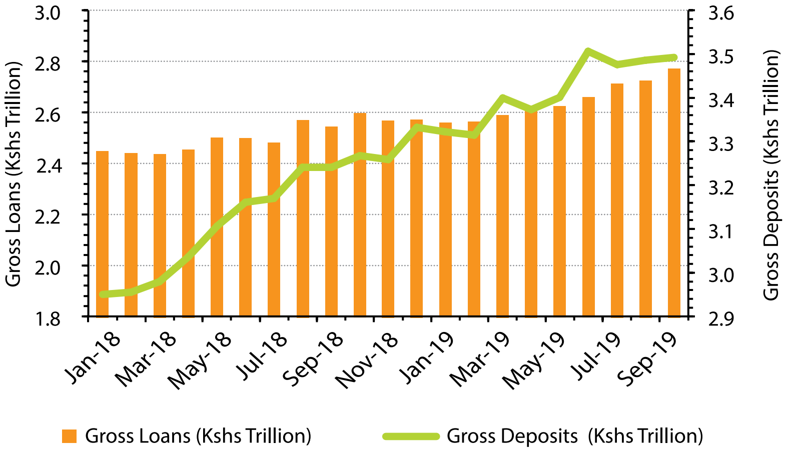
The asset base of the banking industry grew by 1.04 percent in the third quarter of 2019 and a reversal of the downtrend experienced in May 2019. The total assets stood at Kshs. 4.80 Trillion in September 2019 compared to Kshs. 4.75 Trillion in July 2019. The shareholders' funds grew 1.7 percent in the third quarter of 2019 from Kshs. 729.3 Billion in July 2019 to Kshs. 741.9 Billion in September 2019 (**Figure 33**).

Figure 33: Banking Industry Assets and Shareholders Funds



Source: CBK

Figure 34: Gross Loans and Deposits



Source: CBK

Loans and Deposits

Like the growth pattern of assets and shareholder's funds, both loans and deposits both registered modest growth during the third quarter of 2019. Credit to the private sector registered a 2.15 percent growth from Kshs. 2.71 Trillion in July 2019 to Kshs. 2.77 Trillion in September 2019.

Total deposits registered a modest growth of 0.45 percent in the third quarter of 2019 growing from Kshs. 3.47 Trillion in July 2019 to Kshs. 3.49 Trillion in September 2019 (**Figure 34**).

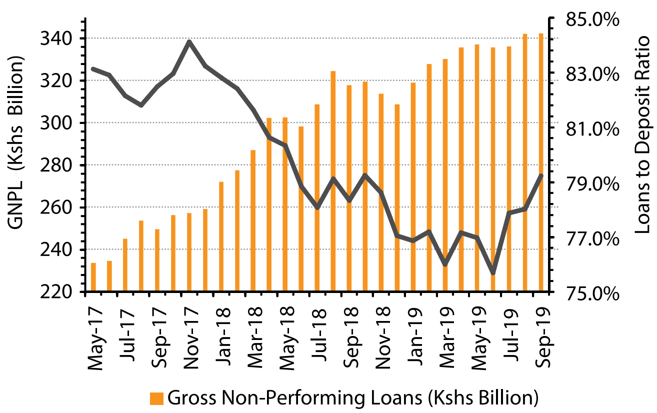
Turning on to the loan-to-deposit ratio, in the first half of 2019, the LDR declined and ranged between 74-77 percent but increased in July to 77.9 percent and further to 79.0 percent in September 2019. Similarly, the asset quality continued to deteriorate during the third quarter of 2019, rising from Kshs. 336.4 Billion in July 2019 to Kshs. 342.4 Billion in September 2019 representing a 1.75 percent increase in non-performing loans (**Figure 35**). This continued deterioration in the asset quality could be attributed to the challenges in the business environment that led to cash flow constraints among borrowers as a result of the delayed payments by national and country governments to service providers.

Nonetheless, the marginal decline in the ratio of gross non-performing loans (NPLs) to gross loans from 12.42 percent in July to 12.38 percent in September was driven by decreases in NPLs in the real estate, transport and communication, and building and construction sectors reflecting increasing repayments and the enhanced recovery efforts by banks

Profit Before Tax & Liquidity Ratio

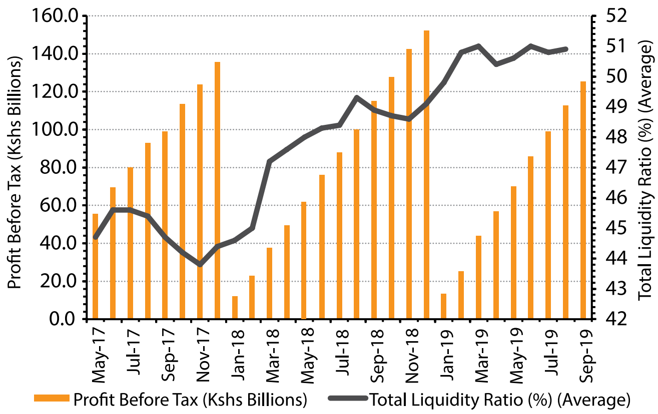
Similarly, the liquidity ratio though it declined by 0.9 percent between July and September 2019, it remains high compared to the liquidity levels recorded in the first half of 2019. The liquidity ratio remained above the minimum stipulated limit of 20 percent. On the other hand, the profit before tax rose by 20.9 percent from Kshs. 99.1 Billion in July 2019 to Kshs. 125.3 Billion in September 2019.

Figure 35: Gross Non-Performing Loans and Loans-to-Deposit Ratio



Source: CBK

Figure 36: Profit Before Tax and Liquidity Ratio



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