

KENYA BANKERS ECONOMIC BULLETIN

QUARTER TWO OF 2016



VOLUME **16**

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



**KENYA BANKERS
ASSOCIATION**



About this Report

This *Bulletin* reviews the performance of the Kenyan economy for the 2nd quarter of 2016, drawing on the performance of recent past months as well as current developments to provide perspectives on the outlook for the rest of 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

FROM THE CEO'S DESK	2
REAL ANY CHANGE WE CAN TALK THE ECONOMY UP? CLEARLY NOT!	3
STATE OF THE ECONOMY	
• GROWTH IN GDP	7
• AGRICULTURE	8
• MANUFACTURING	11
• ENERGY	11
• BUILDING AND CONSTRUCTION	13
• TRANSPORT AND COMMUNICATIONS	13
• TOURISM	14
• FINANCING OF GOVERNMENT	15
• PUBLIC DEBT	15
• MONEY AND CREDIT	17
• INFLATION	17
• INTEREST RATES	18
• BALANCE OF PAYMENTS	19
• EXCHANGE RATES	20
• NAIROBI SECURITIES EXCHANGE	21
• BANKING INDUSTRY PERFORMANCE	22



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FOREWORD

**President
Uhuru
Kenyatta
Signing the
Banking
(Amendment)
Act of 2016.**



From the CEO's Desk

It is my pleasure to present to you the 16th volume of the *Kenya Bankers Economic Bulletin*. In this issue, we discuss the state of the Kenyan economy during the second quarter of 2016. 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.

The performance of the Kenyan economy has over the years been shaped by both domestic as well as international dimensions. These circumstances have shaped the *Bulletin's* economic outlook. On the international front, all eyes are trained on now the softening of China's growth is likely to affect the global economic prospects. This is on the back of the US's Federal Reserve Board taking a pause after a clear signal of resumption of conventional monetary policy.

There is clearly fragility in the performance of the global economy on account of the weaknesses in the Emerging Market Economies and the Eurozone. While the low international oil prices are a boon to the domestic economy, other factors – notably money and foreign exchange markets – have tended to shape expectations on broad macroeconomic stability and

how that will shape economic outlook.

On the local scene, the focus is on how the *Banking (Amendment) Act 2016* will affect the credit market. This is likely to influence the economy's growth trajectory in the near and medium term.

I 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



GM East Africa Truck and Bus assembly: The economy grew by 6.2 percent in Q2 of 2016 compared to 5.9 percent in Q2 last year.

Any change we can talk the economy up? Clearly Not!



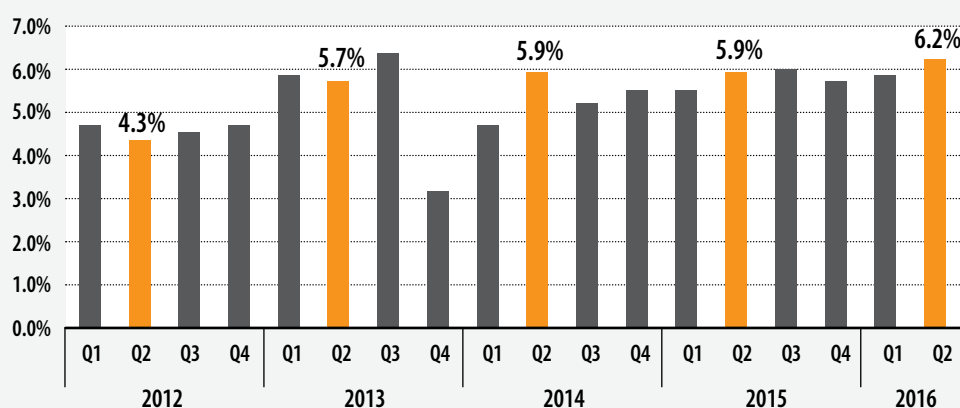
By Jared Osoro

The latest data from the Kenya National Bureau of Statistics indicates that the Kenyan economy grew by 6.2 percent in the second quarter of 2016 compared to 5.9 percent during last year's similar quarter (Figure 1). Evidently, over the last three years the second quarter of

each year has been a happy one; growth has been respectably above 5.0 percent. This performance has not been a reflection of the overall annual performance of the economy for over that period the highest real output growth has growth been 5.7 percent in 2013, which coincidentally was the same as the second quarter performance. During 2014 and 2015, the respective annual real growth rates of 5.4 percent and 5.6 percent have been below the second quarter performance.

It is the conviction of the Central Bank of Kenya (CBK) that this year will not be any different, projecting that the economy is on course towards a 6.0

Figure 1: Real GDP Growth (%)



Source: KNBS

Evidently, over the last three years the second quarter of each year has been a happy one; growth has been respectably above 5.0 percent.



percent annual real growth rate¹. This projection is shared by the often-optimistic International Monetary Fund (IMF) in its April 2016 World Economic Outlook. There is one big difference between the CBK projection and that of the IMF; the former is post the Banking (Amendment) Act 2016 that re-introduced interest rate capping and a floor for interest earning deposits.

It is highly probable that the IMF is reviewing its forecast on account of the new banking law, with the possibility of a downward revision. This makes the CBK projection the more interesting because its Monetary Policy Committee (MPC) is explicitly concerned about the effect of the new banking law on the already sagging private sector credit growth – according to the MPC, the decline in credit growth from 17.8 percent in December to 7.1 percent in July 2016 poses a risk to economic growth. In other words we have the CBK that is sanguine about the economy's growth prospects for 2016 and there is the CBK that is concerned about prospects of growth.

So which CBK carries the day?

Let's assume that the CBK that is alarmed by the plummeting credit growth has taken pre-emptive measures to reverse the trend. Those measures could include the MPC's September 20, 2016 decision to lower the Central Bank Rate (CBR) by 50 basis points from 10.5 percent to 10

percent. That on its own is an interesting policy move, for the declaration of the CBR as the pricing benchmark means that monetary policy is "easily" transmitted to the economy through the credit market. Superficially therefore, the worried CBK would give way to the sanguine CBK in the short three months before the end of year!

There is a small problem though: the CBK's reorientation of its monetary policy on the back of the new law towards a new "optimal" will not be that instantaneous. Typically the key channel for monetary policy transmission – the so-called credit channel – is such that the MPC will pursue the achievement of stabilisation mandate through influencing the interest rates, thus aligning the private sector incentives to stability through the price of credit.

As has been argued elsewhere², the CBK now finds itself at an interesting juncture where the other channel – the so-called expectations channel – is such that announcements or information disclosure on its views in economic fundamentals as a way of market expectations management has to depend on two things: one, the clarity and consistency of the explicitly stated information; and two the extent to which the implicit signal that accompanies the adjustment of the CBK's monetary instruments in line with the CBR changes is consistent with the broader stability mandate.

Will an accommodative monetary policy work the magic? The CBK's simple and clear answer is, well, yes. This hinges on the observation that inflation

¹ "Kenya economy on track for 6pc growth, says central bank" <http://www.nation.co.ke/business/Kenya-economy-on-track-for-6pc-growth--says-central-bank/996-3399310-bj3j5sz/index.html>

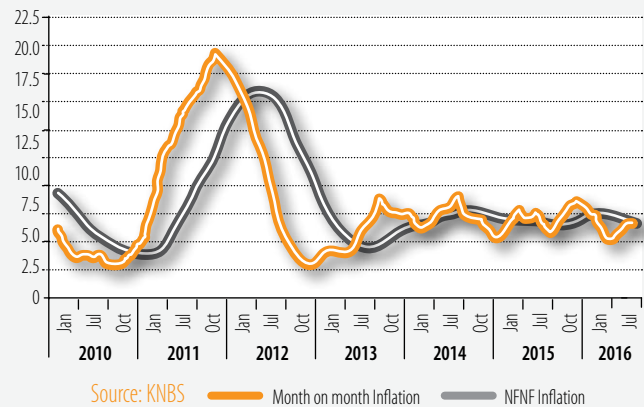
² Monetary Policy Stance – The Bobby McFerrin "Don't Worry, Be Happy" Signal. <http://www.kba.co.ke/images/stories/RN%20No%205%202016.pdf>

expectations are well anchored. It is clear that inflation has reverted to the target range, declining from a peak of 7.8 percent in January to 6.5 percent in August 2016 (**Figure 2**). Inflation however consistently remains on the upper bound of the target range. Part of the account for the decline is the reduction in food and fuel prices, and part of it is attributable to easing of the non-food-non-fuel components of the Consumer Price Index (CPI) – therefore signalling limited demand pressure.

There is no arguing that broadly the financial markets are stable as manifested in the key prices of exchange rate and interest rate. The domestic circumstances have undoubtedly supported the observed inflation outcome. Equally important though has been the eventual stabilisation of the foreign exchange market (**Figure 3**), stability that has been supported by the CBK's readiness to make a foray into the market to offer support. This has led to the substantial realisation of the benefits of low international oil prices, a situation hitherto compromised by foreign exchange instability on the back of a general depreciation.

It is safe to argue that the CBK is assuming normal market conditions. That is a limiting assumption. Recognising that the major risk confronting the

Figure 2: Inflation rate (%)



economy is the ever softening global economic performance while at the same time discounting its potential effect on the economy in the form of seeing better prospects for Kenya's exports buttresses the questioning of the validity of the assumption.

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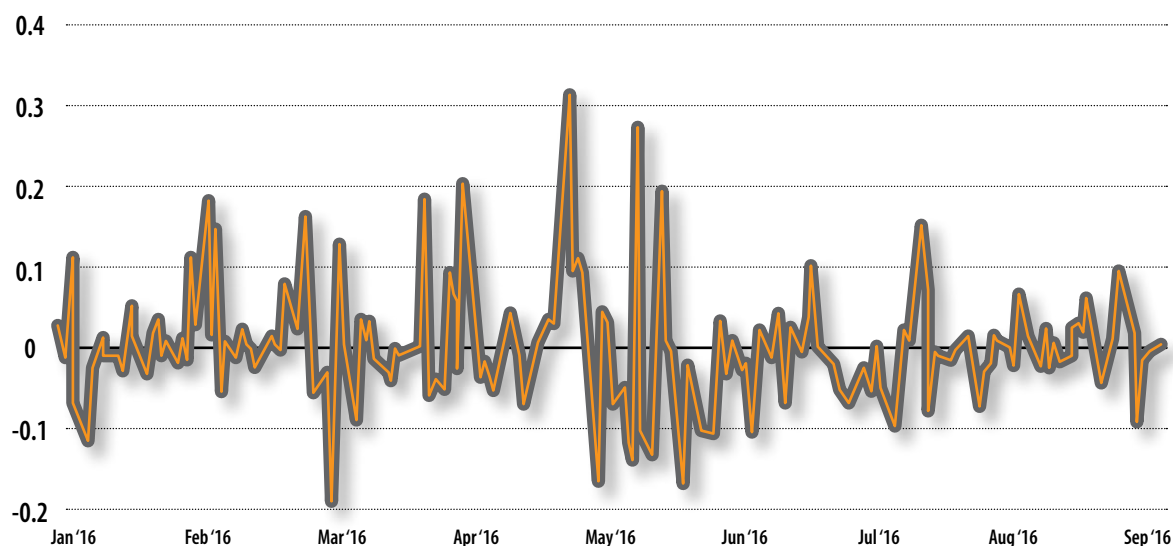
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Figure 3: KES/USD (-= Appreciation; +=Depreciation)



Source: Central Bank of Kenya

The new banking law has delivered a reduction in lending rates in a magnitude way higher than the CBR reduction that came only a week later. That the CBK was compelled to signal a further reduction can only mean that in its view the first round of reduction is not adequate to spur credit growth. This confirms the implicit belief that the credit demand function is very price sensitive even in circumstances of market anxiety. This is also a limiting assumption.

The limitation of this assumption arises from the consideration that the cause of the low rate of credit expansion is a supply side issue being "remedied" by a demand side prescription. There is a very high possibility that the new banking law will compound the problem of low credit expansion rate.

Experience in economies that have experimented with interest caps show that credit rationing is the immediate consequence. If such economies have an open capital account – and therefore a freely floating exchange rate – then the secondary effect will come from the foreign exchange market. It is therefore possible that the stability I observe above in the foreign exchange market is assured partly by the CBK's presence in the market – a presence that in itself is telling more than magnitude of market participation.

Ultimately, all factors taken into account, it may be a challenge to talk the economy up.

Jared Osoro is the Director, Kenya Bankers Association Centre for Research on Financial Markets and Policy

State of the Economy

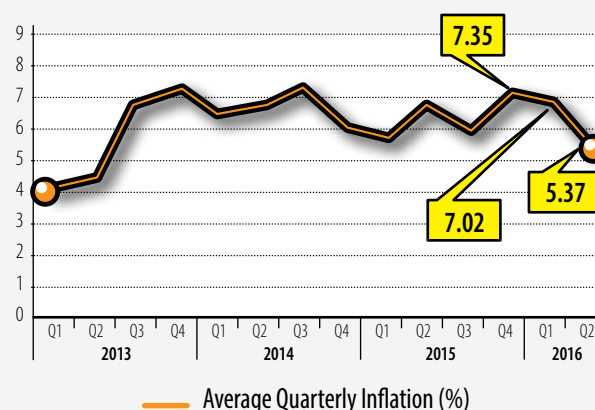


During the second quarter of 2016, the economy's prospects for growth remained positive. The overall key macroeconomic indicators remained positive and supportive of growth in the entire of quarter one. The Leading Economic Indicators mainly Consumer Price Indices (CPI) and inflation, interest rates, exchange rates, international trade, agriculture, energy, manufacturing, building and construction, tourism and transport among others all remained supportive of the economy's growth agenda in quarter two. On the general prices levels during quarter two, the cost of living for the second quarter of 2016 saw the reversal of the upward trend evidence in the first quarter. The month – on – month inflation declined to a low of 5.80 percent as at the end of quarter two of 2016 down from a high of 6.45 percent as at the end of quarter one. An insight into the inflation rates within the quarter reveals that the inflation rates fell to 5.30 percent in April 2016 from 6.45 percent in March 2016 and further down to 5.00 percent and 5.80 percent as at end of May 2016 and June 2016 respectively.

The decline in the inflation rates could be attributed to a number of first. First is the consistency in the monetary policy stance by the monetary policy committee over the previous quarter. The decision by the monetary policy committee to lower the bank rate at 10.50 percent in 23th May 2016 was a clear indication of consistency in the monetary policy and the urge to anchor inflation. The fall in the inflation rates is therefore a revelation of the realization in the outcome of the monetary policy decision adopted in the past MPC meetings thus evidencing an element of a lag between the policy adoption time and the time when the intended policy outcomes are realized. It is noteworthy that for the entire of quarter two, inflation rate remained on the lower bound of the CBK

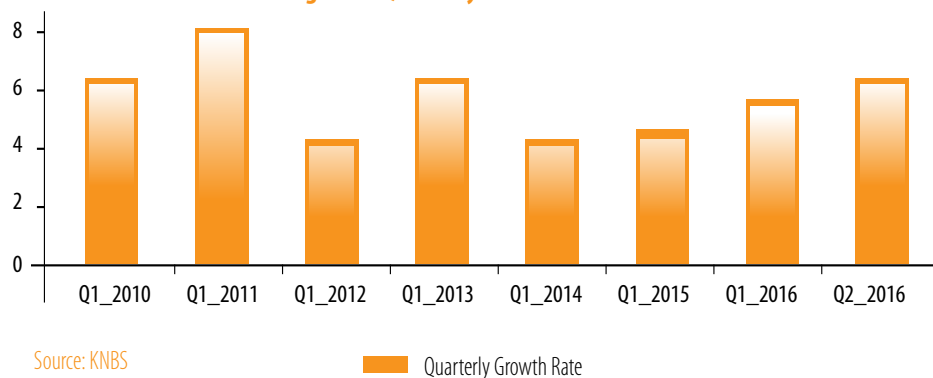
target with April recording inflation of 5.27 percent. Inflation rates for May and June were 5.00 percent and 5.80 percent respectively. In addition, the NFNF inflation was generally stable within the quarter. In overall, the month – on – month inflation rates remained within the lower bound of the Central Bank target range for the entire of quarter two. This is contrary to the scenario in quarter one of 2016 where inflation was on the upper bound of the Central Bank target range with the quarterly average inflation rate being 5.37 percent in quarter two compared to an average of 7.02 percent in quarter one. However, a review on the year – to – year basis reveals that the annualized inflation rates as at June 2016 stood at 5.22 percent compare to annualized inflation rate of 6.63 percent as at the end of June 2015 (**Figure 4**).

Figure 4: Average Quarterly Inflation Rates



Source: Central Bank of Kenya

Figure 5: Quarterly Real Growth Rate



Overall, the economy is estimated to have expanded by 6.2 per cent during the second quarter of 2016 compared to 5.9 per cent during the same quarter of 2015. This growth was mainly supported by better performances in the activities of; agriculture, forestry and fishing; transportation and storage; real estate; and wholesale and retail trade.

A review on the interest rates scenario for quarter two of 2016 present an interesting phenomenon. The average lending rates for commercial banks remained stable though high within the quarter averaging at 18.15 percent compared to 17.90 percent for quarter one of 2016. However during quarter two, the central bank rate was reviewed down to 10.50 from 11.50 in May 2016. On the short term interest the 91 – Treasury bill rates averaged at 8.10 percent in quarter two down from 11.00 percent during quarter one of 2016. However, a unique situation continued to be evidenced in the interbank market in quarter two of 2016 with the interbank market falling to average at 4.13 percent for the entire quarter. The interbank rate as at April 2016 was 4.01 percent falling further to

3.82 percent in April but rising to 4.56 percent as at end of June 2016. The scenario in the interbank market is attributed to the jitters facing the banking industry following the placement of Chase bank into the receivership by the central bank. The situation shocked the credit market negatively by making the market more illiquid. This is from the fact that the facilitation role of the interbank market in necessitating the credit availability is limited given the status the interbank market is in.

Sectoral performance

Agriculture

Agriculture remained to be a key sector driving economic growth in the quarter two of 2016. This is evidenced by the fact that the main exports for the country were majorly from the agricultural sector and accounted for the largest portion of the total exports. In addition the sector still remained to be the highest employer given its forward and backward





linkages with the other sector of the economy. The performance of the agricultural sector improved given the onset of the long rains in the beginning of the second quarter of 2016.

From the production point of view, tea production declined consecutively in all the three months in the second quarter falling from 45,330 MT in March to 37,571 MT in April and falling further to 36,573 MT and 35604 MT in May and June 2016 respectively. The decline in production are partly due to the dry spell witnessed experienced due to poor performance in the long rains. In terms of prices the average price per kilogramme significantly increased by Ksh. 28.61 per kilogramme between March 2016 and June 2016. This could be attributed to the reduced supply of tea in the market amid the declining production in quarter two of 2016 following the poor performance in the March– June long rains in 2016.

Milk deliveries to formal processors declined from 167.70 million litres in quarter one of 2016 to 152.4 million litres in quarter two of 2016. The slight decline production is as a result of reduced milk delivery to the formal production plants following poor performance of long rains that saw decrease in animal feeds production. However, looking into the monthly data within the quarter, the actual milk deliveries for formal processors increased in April to 54.2 million litres from 48.9 million litres in March on the onset of long rains. However, this declined to 50.1 million litres and 48.1 million litres in May and June respectively.

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

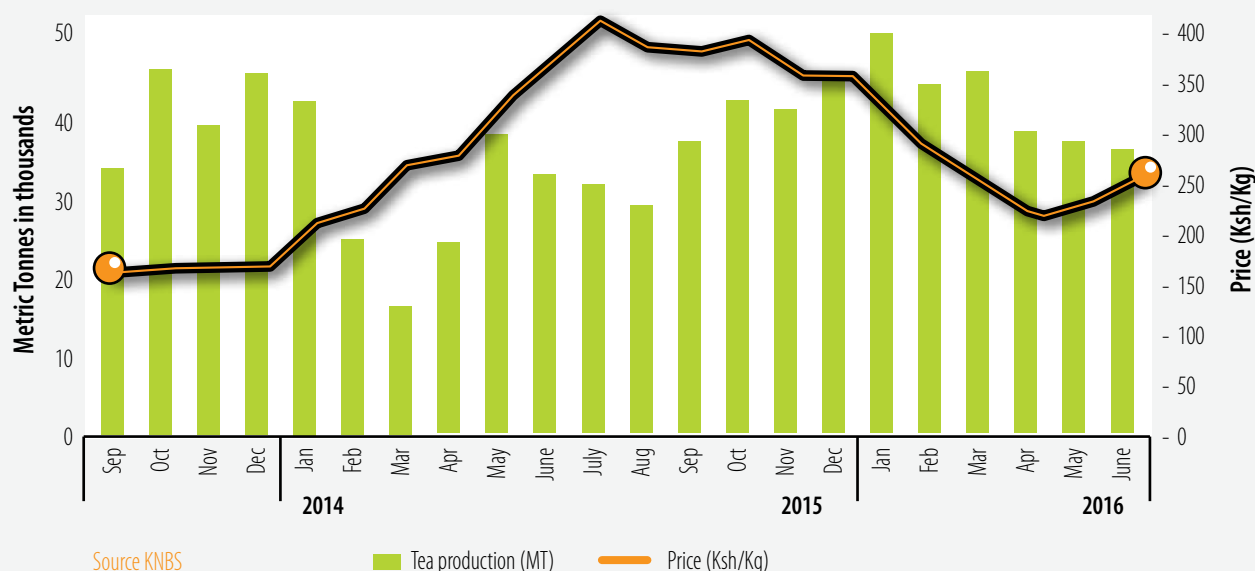
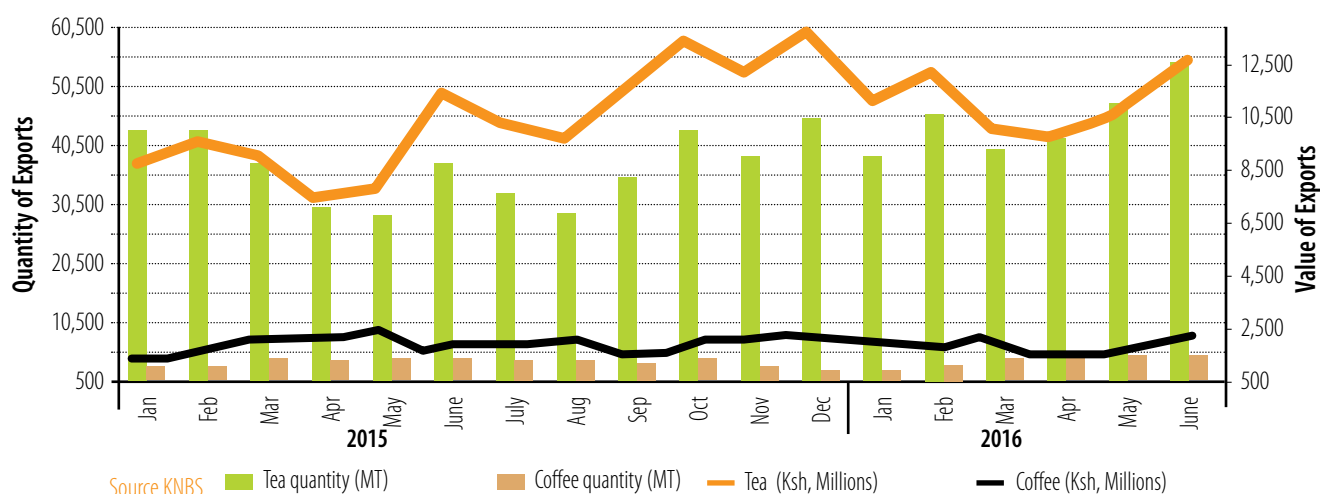


Figure 7: Value of Tea and Coffee Exports, Jan 2015 – June 2016



Agriculture cash crop exports continue to command a good share of the total economy's main export, with tea topping in foreign exchange earning followed by coffee. As revealed in (Figure 7) the quantity of tea exports having significantly increased from 117,432.70 MT in quarter one to 136,389.11 MT in quarter two. The rise in the quantity exported was as a result of increased production in May and June towards the end of long rains. Similarly, the quantity of coffee being exported significantly increased from 9,894.40 MT in quarter one to 14,600.56 MT in quarter two of 2016. The increase in the total coffee exports is attributed to the increased quarterly production as well increased auction prices for coffee in the international market.

Turning to the total value of exports, the total value from tea exports for the entire quarter two was Ksh. 32,787.70 Million against Ksh 33,098.40

Million in quarter one. On the other hand total value from coffee exports for quarter two stood at Ksh 7,079.95 against Ksh. 5,026.70 million in quarter four of 2015; a 40.85 percent increase.

On horticultural exports (Figure 8), in terms of quantity exported in quarter two of 2016, cut flowers dominate this subsector contributing 40.80 percent of total quantity of horticultural, followed by vegetables at 26.17 percent with fruits exports recording the lowest contribution of 25.03 percent. Looking at the foreign exchange earned from horticultural exports for the entire quarter, cut flowers dominate this subsector accounting for 62.36 percent of total horticultural exports value, followed by vegetables at 28.86 percent with fruits exports recording the lowest contribution of 8.78 percent.

Figure 8: Horticultural Exports Jan 2015 – July 2016

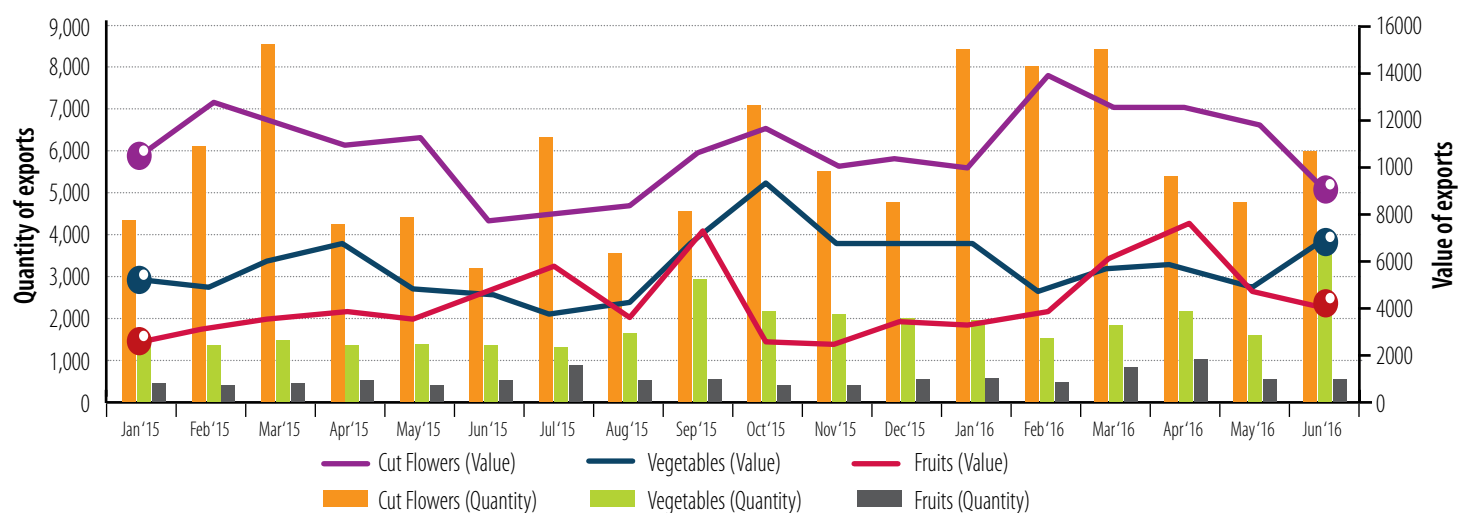
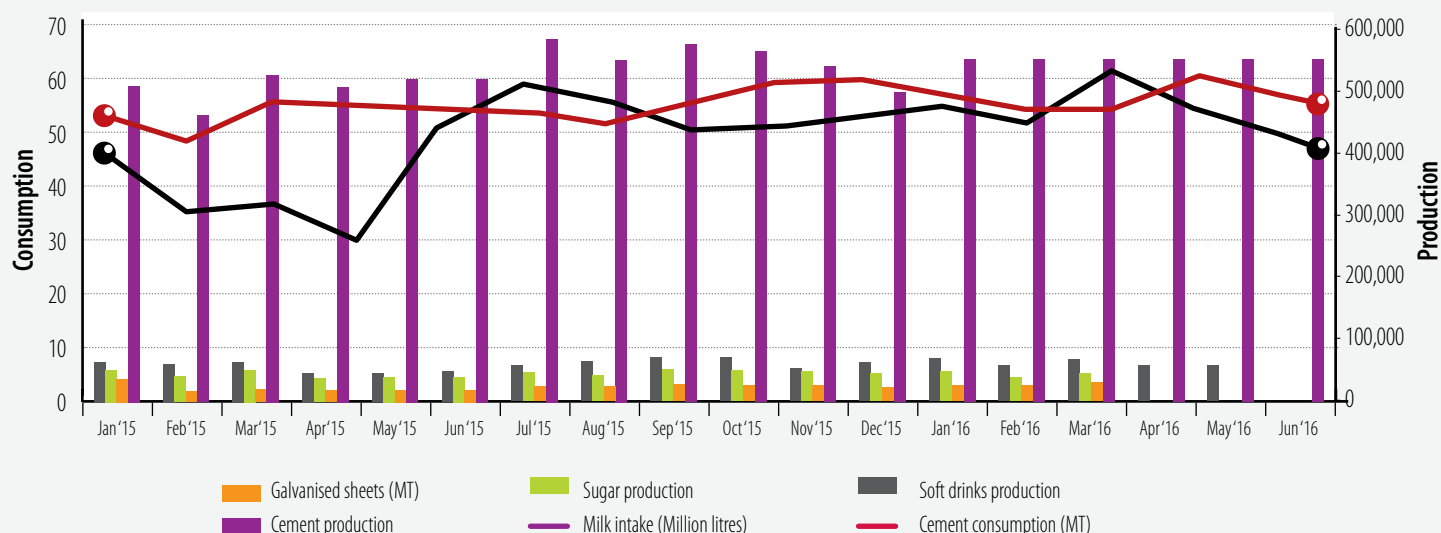


Figure 9: Production and Consumption of Manufacturing



Source KNBS

Manufacturing

The manufacturing sector in Kenya is poised as one of the foundations in achieving vision 2030; transiting the economy from traditional agriculture to modern manufacturing economy.

A key component of the manufacturing sector is its output that targets the construction industry. Cement production slightly rose from 1,607,294 MT in quarter one to 1,607,692 MT in quarter two of 2016. The increased cement production was in tandem with the cement consumption which registered an increased in the quarterly consumption from 1,489,101 MT in quarter one of 2016 to 1,500,958 MT in quarter two. The increase in production may have been accessioned increased activity in the building and construction industry as signified also by the increased demand for cement as well and the improvement in the building and construction sector as well.

In addition the domestic sugar production stood at 45,122 MT as at May 2016 a decline from 65,909 as at the end of quarter one. For the soft drinks domestic production increased from 37,670 thousand litres in January to 38,771 thousand litres in February and further rising to 43,454 thousand litres as at the end of March 2016. Looking at the production of assembled vehicles, the production remained largely stable with 650 units being assembled in May and 658 units assembled in April 2016

Energy

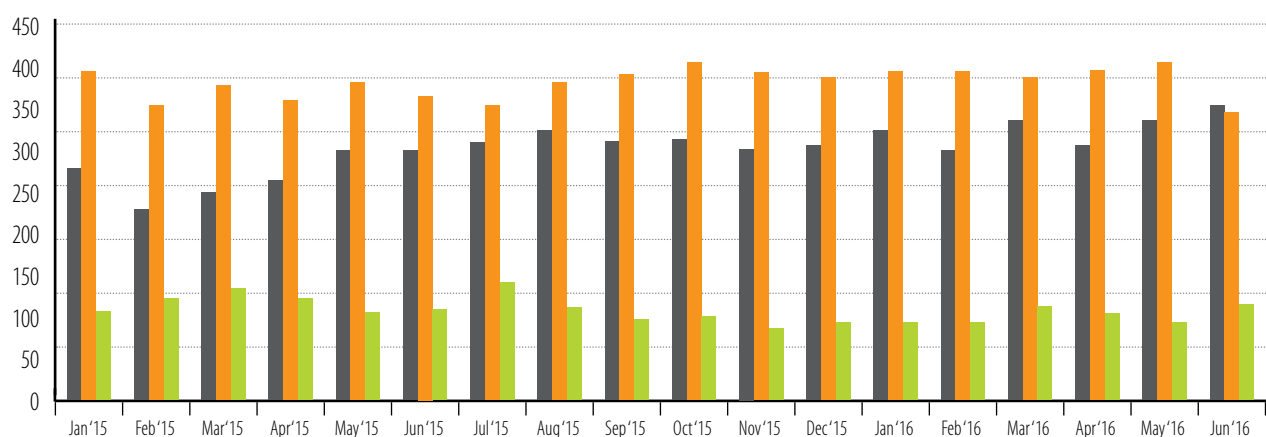
There has been continues concerted efforts to boosts energy production so as to meet the growing demand for energy by the growing economy. More so, there is continues shift from the conventional sources of energy



to concentrate on cheaper and more reliable, clean and renewable sources of energy. This shift is observable, seeing that geo - thermal production as well as wind power generation combined have continued to lead the way in adding to the total energy production and hydro production, though significant, continues to relatively drop.

A review of the power generation for in the second quarter of 2016 reveals that the total energy production that was injected into the national grid declined from 2421.19 million KWh in the fourth quarter to 2433.25 million KWh in the second quarter of 2016. During the quarter, hydro production posted a rise in production perhaps due to the increased water volumes following the successful long rains that were prolonged to the second quarter of 2016. However, in overall, the geothermal production took the lead accounting for 46.84 percent of the total production followed by hydro production at 40.52 percent with thermal production being third at 12.64 percent of the total production.

Figure 10: Electricity Generation by source (Million KWh), Jan 2015 – June 2016



However despite the power demand outstripping power supply power losses still continued to persist. Within quarter two the total power losses stood at 268.66 million KW a decline from a loss of 328.88 million KW in quarter one of 2016. It's also notable that within the quarter, the overall energy consumption remained below the overall production

On the oil prices, there was a world oil price in quarter two, the global crude oil prices have assumed an upward trend for the entire of the quarter. The monthly average crude oil prices for April stood at \$42.00 per barrel rising further to \$47.35 per barrel in May and \$ 49.05 per barrel as at the end of June 2016. This has been attributed to reduced production as well as reduced supply in the oil market by the oil producers on the realization the glut has had consequences especially on their budget financing. However, the situation in the oil market still remains fluid with no certainty on the next move given that the world oil prices assume a random walk. In addition, the Euro zone crisis following the Brexit continue to pose deflation challenges hence hampering growth and certainly demand for oil.

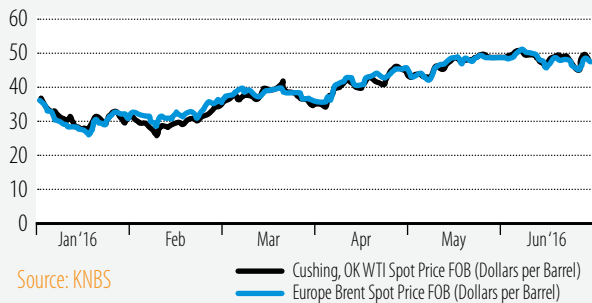
A look at the daily prices presents a more volatile state in the global oil market. The daily crude oil prices seem to have surpassed the \$40 mark in from April 2016 although a bit volatile. As such as long as the geopolitical crisis persist this phenomenon is likely to persist for a while. In addition the Eurozone crisis coupled with the constrained demand in the world demand for commodity are likely to continue contributing to the low oil prices in the world market.

Table 1: Average Monthly Crude Oil and Retail Fuel Prices

	Dec - 15	Jan - 16	Feb -16	Mar- 16	Apr - 16	May-16	Jun- 16
Murban crude oil (US\$/Barrel)	37.25	29.95	33.00	38.20	42.00	47.35	49.05
Super petrol (KES/Litre)	90.94	89.52	87.38	86.46	81.61	85.14	87.07
Diesel (KES/Litre)	79.47	77.66	68.85	66.68	67.21	71.34	74.69
Kerosene (KES/Litre)	54.23	47.11	40.60	43.13	44.94	47.96	59.10
LPG (13Kgs)	2,369.46	2,343.86	2,318.03	2,277.48	2,268.37	2,252.86	2,231.38

Source: US. Energy Information Administration

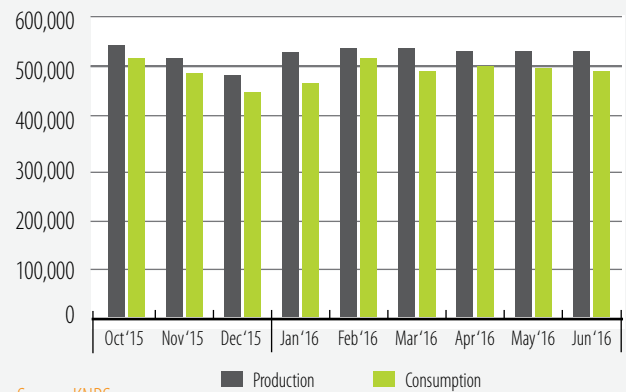
Figure 11: Oil Price Volatility



Source: KNBS

Source: West Texas Intermediate (WTI) - Cushing, Oklahoma, US. Energy Information Administration

Figure 12: Cement Production and Consumption (MTs)



Source: KNBS

Building and Construction

Building and construction sector continues to thrive well rising to be one of the core sector upon which the growth is anchored. The quantity of cement produced increased from 1,607,294 MT in quarter one to 1,607,692 MT in quarter two. Similarly cement consumption rose from 1,489,101MT in quarter one to 1,500,958 MT in quarter two.

Transport and Communication

The total number of registered vehicles as at quarter one significantly declined from 64,257 units in quarter four of 2015 to 37,741 units in quarter one of 2016. This substantial decline is attributed to the



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Front Office



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ATS

PLUGIN MODULES



Cheque



EFT



Case Management



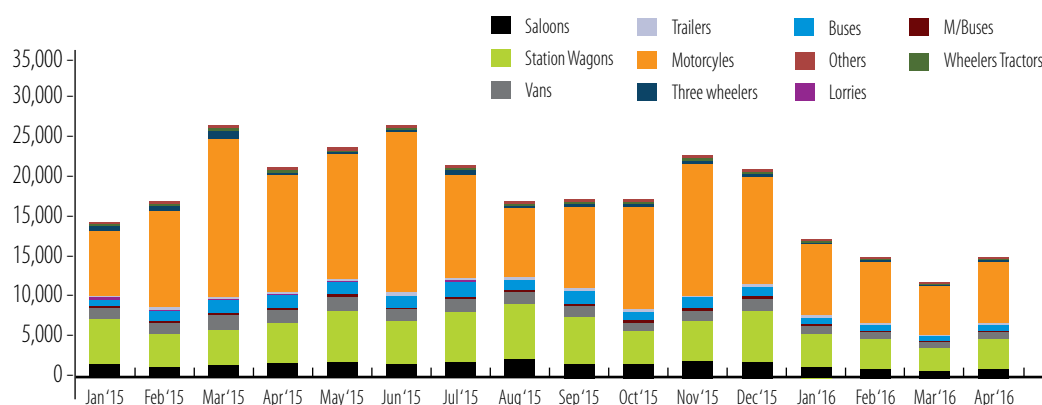
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Figure 13: Registration of New Vehicles Jan 2013 to March 2016



Source: KNBS



introduction of the new import charges on the imported second hand vehicles in December 2015. The month – on – month statistics reveal that the number of newly registered vehicles declined from 22,308 units in December 2015 to 14,690 units in January falling further to 12,771 units and 10,280 units in February and March respectively. Motor cycles continued to account for the big share of the total motor vehicles registered in the quarter.

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 of banking the unbanked.

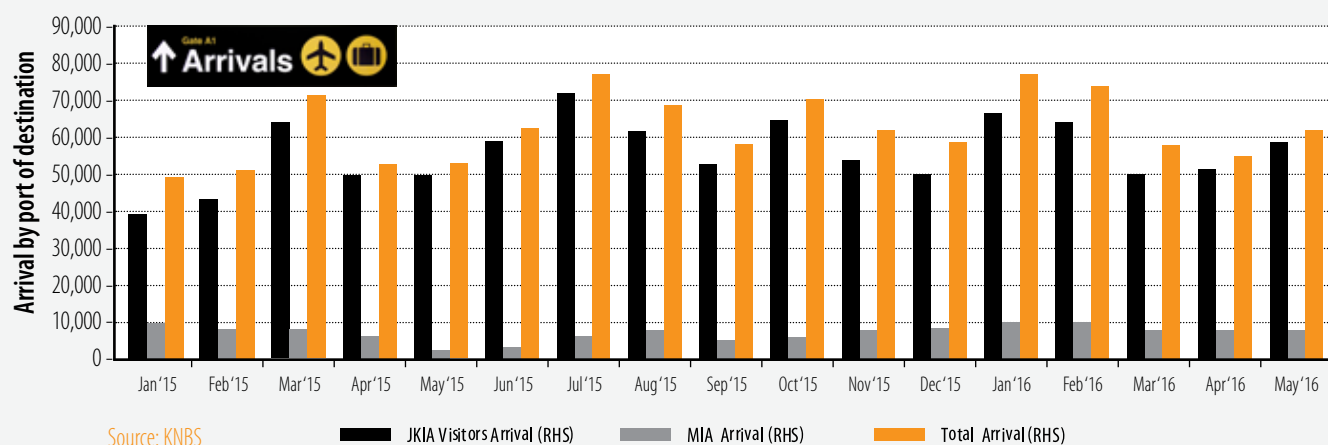
Tourism

During quarter two, tourism continued to post good performance. Looking at the number of visitors arrivals via the JKIA and Moi International Airport, the JKIA arrivals significantly increased from a total of 170,078 visitors in quarter four of 2015 to 179,037 visitors in quarter one of 2016; a 5.27 percent rise.

For the arrival through the Moi International Airport the quarterly total arrivals mildly improved from 22,837 visitors in the fourth quarter in 2015 to 27,941 visitors as at the end of quarter one in 2016. The insight into the quarter however reveals some upward and downward trends in the visitors' arrivals in both the JKIA and the Moi International Airport. Despite the rise in the total number of visitors during the quarter, the number of visitors within the months was on decline for both the airports with the numbers for JKIA falling from 66,185 visitors in January to 62,856 and 49,996 in February and March respectively. Similarly for the MIA, the monthly figures rose from 9,407 visitors in January to 9,983 in February but fell later to 8,551 in March. It's therefore likely that within the looming political tension in the country, the sector is set for a decline in the number of visitors in the near future as the trend in quarter one depict.

Looking at visitors' arrivals by their origin, it's evident that Europe registered the highest number of arrivals via JKIA at 116,370 visitors followed closely by Africa at 113,814 visitors with Asia coming third at 98,998 visitors

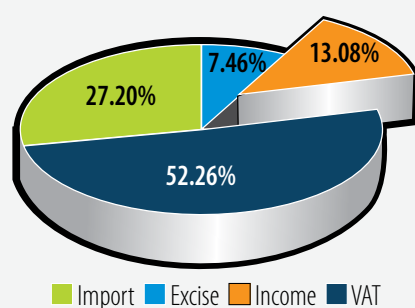
Figure 14: Trends in Visitor Arrivals (Thousand) for Jul 2015 – May 2016



Financing of Government Expenditure

On the government revenues, the total revenue for quarter two of 2016 stood at Ksh 3,280,143 million. Of this, the total tax revenue accounted for 87.89 percent of the total quarterly revenue with the non – tax revenue accounting for 12.11 percent. For the tax revenue, income tax topped the list at 52.26 percent followed by value added tax at 27.20 percent with excise duty and import duty coming third and fourth at 13.08 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.

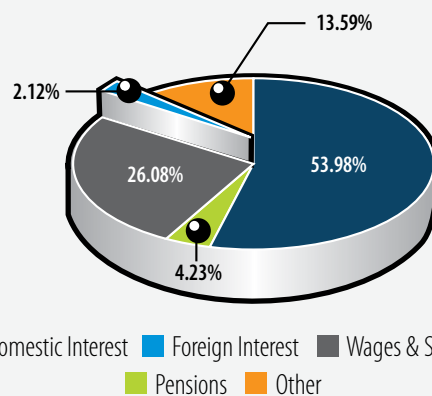
Figure 15: Tax revenue (Ksh Million)



The total government expenditure for quarter two of 2016 stood at Ksh 4,595,863 million. The total recurrent expenditure accounted for 74.35 percent with the development expenditure accounting for 25.65 percent of the total government expenditure in the quarter. On the recurrent

expenditure, domestic interest payment accounted for the largest proportion at 53.98 percent followed by wages and salaries at 26.08 percent.

Figure 16: Public Expenditure (Ksh Million)



Source: CBK

Public Debt

During the second quarter of 2016, the total quarterly public debt was Kshs.10.42 billion 9.741 billion compared to 9.741 billion in quarter one. An analysis on the breakdown of the public debt into domestic and external debt reveals that the government through the National Treasury tried to maintain an equal balance between the two debts to stand at 50.41 percent in favour of domestic as opposed to 49.59 percent in favour of external for the entire quarter.

Construction of the Standard Gauge Railway: On the financing of the government's public debt, open market operations take an upper hand.

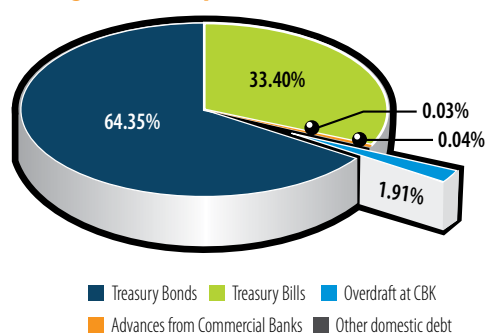


This reflects a tight trade – off and balancing act in the choice between the two types of borrowing hence limited flexibility of the National Treasury to prefer one at the expense of the other. Given the stability in the Kenya shilling in the quarter, more preference for external borrowing can be seen in quarter two of 2016 in addition to trying to avert crowding out – effects in the domestic market. As such 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 financing of the government's public debt, open market operations take an upper hand with the preference on government treasury bonds including the government frozen debt remained being evidenced. In quarter two of 2016, the government's treasury bonds were the key money market instruments intensively utilized by the government in domestic borrowing accounting for 64.35 percent though slightly lower than 65.29 percent in quarter one of 2016. Treasury bills, On the other hand accounted for 33.40m percent up from 31.68 percent in quarter

one. Overdrafts and advances accounted for 1.91percent and 0.03 percent respectively of total government debt for the entire of two of 2016.

Figure 17: Composition of Domestic Debt

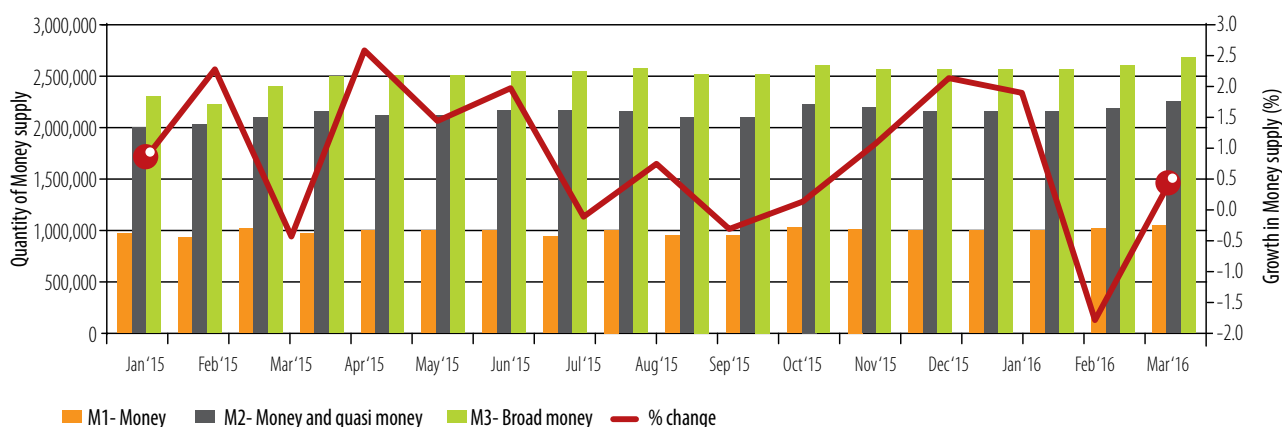


Money and Credit

During the second quarter of 2016, the monthly total money supply

Source: CBK

Figure 18: Money Supply (KES Million)



Source: KNBS and CBK

recorded a positive growth of 1 percent between March 2016 and April 2016 before declining by 0.63 in May. As at June 2016 the actual money supply grew by 1.67 percent. This growth was fairly stable signaling no demand pressures likely to cause inflationary trends.

Inflation

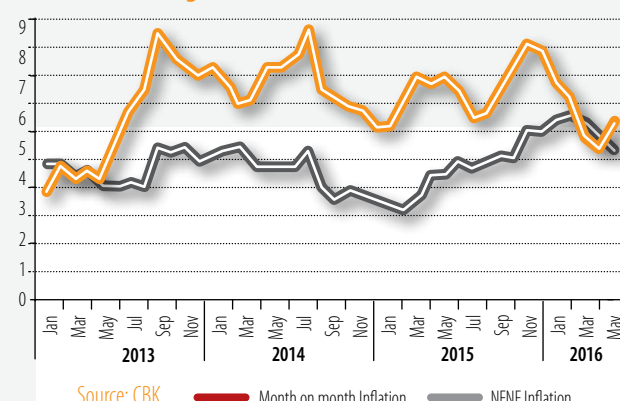
The cost of living for the second quarter of 2016 saw the reversal of the upward trend evidence in the first quarter. The month – on – month inflation declined to a low of 5.80 percent as at the end of quarter two of 2016 down from a high of 6.45 percent as at the end of quarter one. An insight into the inflation rates within the quarter reveals that the inflation rates fell to 5.30 percent in April 2016 from 6.45 percent in March 2016 and further down to 5.00 percent and 5.80 percent as at end of May 2016 and June 2016 respectively.

The decline in the inflation rates could be attributed to a number of first. First is the consistency in the monetary policy stance by the monetary policy committee over the quarter. The decision by the monetary policy committee to lower the bank rate at 10.50 percent in 23th May 2016 was a clear indication of consistency in the monetary policy and the urge to anchor inflation. The fall in the inflation rates is therefore a revelation of the realization in the outcome of the monetary policy decision adopted in the past MPC meetings thus evidencing an element of a lag between the policy adoption time and the time when the intended policy outcomes are realized. It is noteworthy that for the entire of quarter two, inflation rate remained on the lower bound of the CBK target with April recording inflation of 5.27 percent. Inflation rates for May and June were 5.00 percent and 5.80 percent respectively. In addition, the NFNF inflation was generally stable within the quarter. In overall, the month – on – month inflation rates remained within the lower bound of the Central Bank target range for the entire of quarter two. However, a review on the year – to – year basis reveals that the annualized inflation rates as at June 2016 stood



at 5.22 percent compare to annualized inflation rate of 6.63 percent as at the end of June 2015.

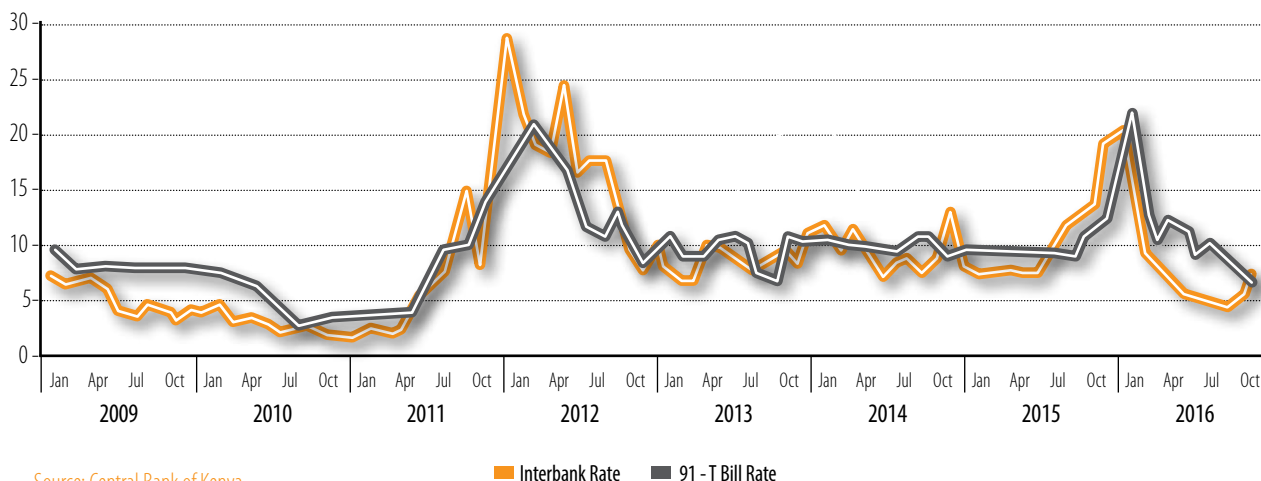
Figure 19: Inflation rate (%)



The non – food – non – fuel inflation (NFNF) declined in quarter two from a quarterly average of 5.80 percent in quarter one to a quarterly average of 5.4 percent in quarter two of 2016. This decline in the NFNF



Figure 20: 91 Treasury Bill Rate vs Inter Bank Rate



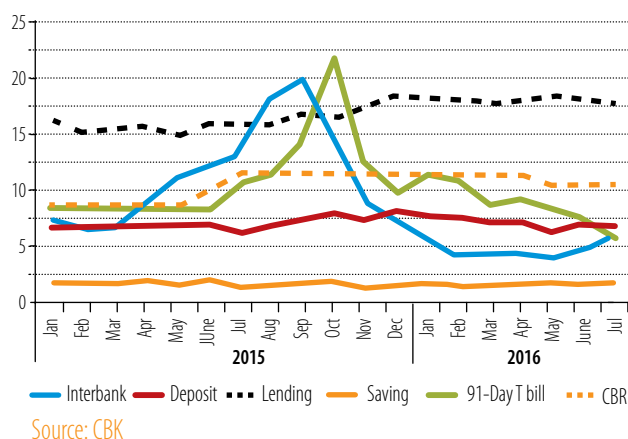
inflation was largely due to reduction in the prices of food items and fuel. Month-on-month non-food-non-fuel (NFnF) inflation also declined to 5.8 percent in April from 6.0 percent in March. The CPI category alcoholic beverages, tobacco and narcotics contributed 1.1 percentage points to NFnF inflation in April, reflecting the revised excise tax introduced in December 2015. Significantly, the 3-month annualised NFnF inflation fell from 6.8 percent in March to 4.6 percent in April, indicating that there were no significant demand pressures in the economy

Interest Rates

Interest rates remained fairly stable during the second quarter of 2016. This was attributed to a number of factors. First, the jitters in the exchange rate have eased with the shilling stabilizing and being resilient against the major world's currencies. This follows a number of measures being taken including but not limited the acquisition of cautionary fund from IMF to cushion against any short term shocks in the currency. In addition, the monetary policy stances adopted in 2nd July 2015 remained unchanged as at the end of quarter one. This stability could have facilitated the stability in the interest rates markets given that policies have a time – lag period before realizing their intended targets. Thirdly, is the downward revision in the Central Bank Rate in May by the monetary policy committee that has seen the downward revision in other rates in the market.

With regard to the short term interest rates, the 91 – Treasury bill rate for quarter two averaged at 7.19 percent compared to 9.42 percent in quarter one of 2016. This scenario shows a calm in the high volatility in the 91 TB rate experienced in the fourth quarter of 2015 given that the quarterly average stood at a single digit figure as at quarter two.

Figure 21: Interest rates (%)



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 rose to 18.04 in April and later 18.22 percent in May. As at the end of June, the average lending rate was 18.18 percent. On quarterly basis, the average quarterly rate for quarter two was 18.15 percent compared to 17.93 percent for quarter one. The movements in the 91 – day Treasury bill mimics the movement in the average lending rates given that the 91 – day Treasury bill enters into the computation of KBRR which in turn influences the 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. The savings rate remained general low and seems to stagnate around 1.6 percent mark for the entire quarter.

The interbank market has been crucial given that it facilitate overnight lending and borrowing among the banks hence helping banks meet short term cash challenges. A vibrant interbank market core in facilitating banking system deal with liquidity challenges by availing resources from the banks with excess liquidity to the banks with liquidity challenges. Even though the interbank market is generally volatility given that its market determined and driven, the revelations in quarter one of 2016 which continued to be experienced in quarter tow is worrying hence calling for a need to reflect on it with keen. In the first quarter the interbank market almost came to a standstill to a point of completely crashing given the new developments in the banking sector upon the placement of Chase bank into receivership some months after the collapse of Imperial bank. The interbank market volumes of transaction continued with the drastically decline in quarter two a scenario evidenced in quarter one as well. This is likely to impact on the efficiency of the interbank market with regard to liquidity allocation. As at the end of quarter two, the situation of the interbank market remained fluid. As such this calls for the need to have a vibrant repo market to address the challenges of liquidity in the interbank market whenever the interbank market is faced with challenges of effective allocation of liquidity among the banks.

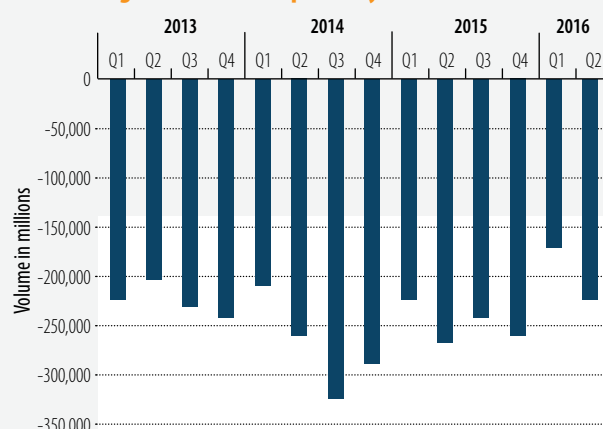
Balance of Payments

During quarter two, the volume of trade expanded from KSh 166.0 billion in May 2016 to KSh 175.5 billion in June 2016. The total value of exports fell to KSh 48.21 billion while the value of imports increased from KSh 116.2 billion in May 2016 to KSh 127.3 billion in June 2016. Domestic exports by Broad Economic Category (BEC) indicated that food and beverages was the main export category in June 2016 accounting for 50.5 per cent of exports, while the value of non-food industrial supplies and consumer goods not elsewhere specified registered 22.4 and 24.0 per cent shares, respectively. BEC imports indicate that industrial supplies not elsewhere specified was the main import category in June 2016 with a share of 32.4 per cent, while the values of machinery & other capital equipment, fuel and lubricants and transport registered shares of 23.6, 15.7 and 11.3 per cent, respectively. Food and beverage recorded a share of 7.6 per cent while consumer goods not elsewhere specified recorded a share of 7.4 per cent. The value of the total exports; – both the domestic exports and the re – exports the declined a clear indication that, despite the depreciation in shilling, the Kenyan exports have not leveraged on this opportunity that would arise from the exports being cheaper abroad. Regarding the major destination for the Kenyan exports globally, as at the end of quarter one of 2016, Uganda topped as a major destination followed by Netherlands with Kingdom coming third.



The overall monthly trade balance worsened from Ksh 174,520 million in quarter one to Ksh 223.733 in quarter four of 2015. This could be mainly attributed to the massive importation of machinery and transport facilities in wake of continuing major physical infrastructural projects contributed to the worsening of the trade balance. Moreover the failure of the exports to fetch enough export earnings despite the depreciating shilling mainly due to the nature of the Kenya exports led to the trade balance deficit

Figure 22: Overall quarterly trade balance



Source: CBK

Exchange Rate



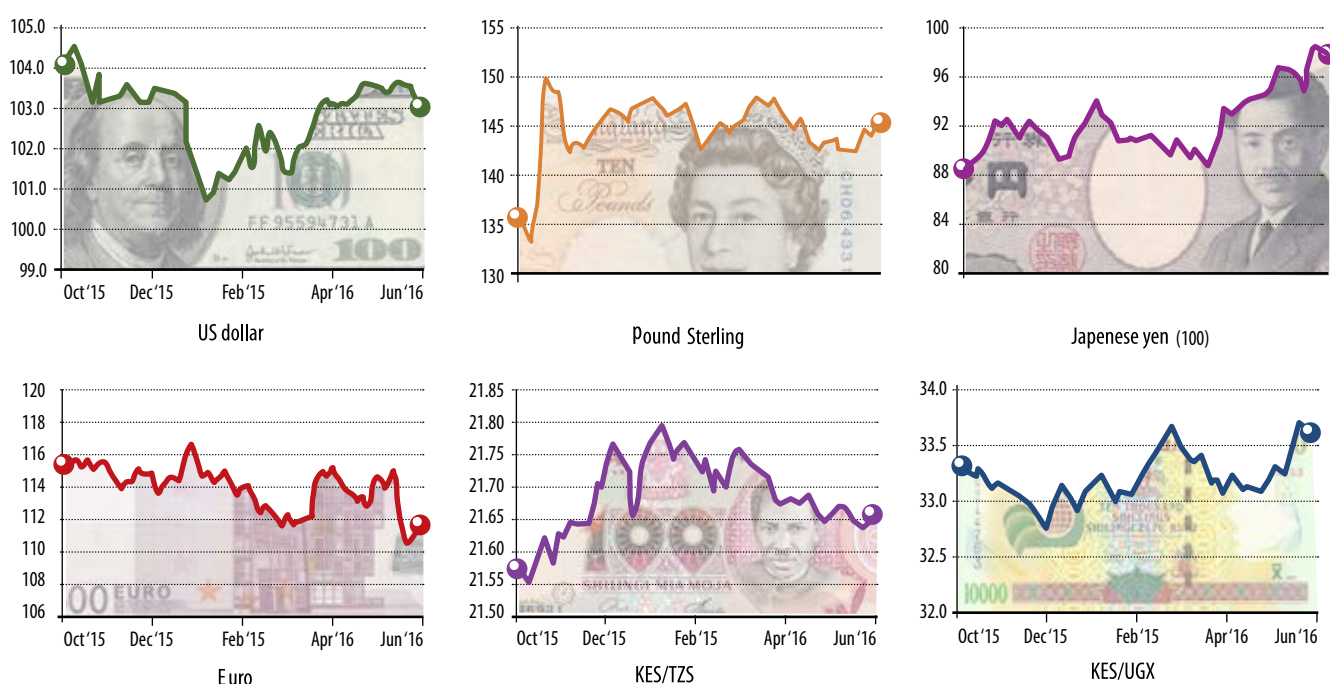
During the second quarter of 2016, the shilling portrayed resilience against other currencies both at the international and at the regional level. As for the dollar the shilling posted good performance maintaining stability against the dollar for the entire of the quarter. For the month of April the shilling traded at a mean monthly rate of 101.23 against the dollar improving to 100.73 mark in May but weakening to 101.14 mark in June. This could be attributed to the continued falling in the oil prices that reduced the demand for the dollars to finance the oil importation. Secondly the increase in the foreign reserves at the central bank of Kenya hitting a high of USD7, 688.3 million (equivalent to 5.0 months of import cover) as at May 2016. In addition the precautionary loan facility from IMF amounting to \$1.5 million in the past period aided cushion against the short term shock in the value of shilling.

Against the Sterling the shilling posted considerable mixed performance.

This is evidenced by the depreciating of the shilling against the pound from a mean monthly rate of 144.79 mark in April 2016 to 146.27 mark in May and eventually appreciating to 144.32 mark in June. This could be attributed to the 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. The Euro zone is still struggling with deflationary pressures with Greece being worst hit again thus reducing its competitiveness in the global market hence the strength in the shilling against the pound and the euro at large. In overall news on Brexit seem to have significantly affected the daily nominal exchange rate at which shilling exchanged for the pound with the shilling significantly appreciating against the pound as evidenced by the daily rate.

For the East African scene the shilling was more stable as evidenced in its performance against the Ugandan shilling and Tanzanian shilling.

Figure 23: Nominal Exchange Rate





Nairobi Securities Exchange

During the second quarter of 2016 the stock market continued to post poor performance as evidenced in the successive months indices during the quarter. Performance based on the NSE -20 Share index reveals a rebound in the market in April 2016 recording a high of 4009 points from 3982 points as at the end of March 2016. However, May and June saw the market performance dip significantly down to 3868 points and 3641 points in May and June respectively. On the other hand, performance based on all share index reveal that the index was fairly stable being 147 points in May and dipping afterwards to 146 points and 141 points in May and June 2016.

The dismal performance in the capital market in quarter two of 2016 is attributed to bearish behaviour in the market, driven majorly by the foreign investors given their increased market participation mainly as net sellers rather than net buyers in the wake of reduced dividends following

the profit warnings by a number of firms. This is evidenced by the dipping in the market performance in June where the participation of the foreign investors significantly fell from 67 percent to 56 percent. The overall market capitalization remained fairly stable in April and May before declining in June to a low of Ksh. 1,998 billion. A review of the market performance indicators for quarter two evidence that total shares traded, the number of equity transactions and equity turnover portray similar trends with all registering a sharp decline in May from April's performance but significantly improving in June towards the end of the quarter.

On the fixed income segment, mix performance is evidenced with the bond market registering significant decline in the trading volumes from Ksh 67 billion turnover in March to a low of Ksh. 38 billion in April 2016. However, May and June bond turnover remained stagnant at Ksh. 55 billion.

Table 2: Nairobi Securities Exchange Market Indicators

Date	Jan-16	Feb -16	Mar-16	Apr-16	May-16	Jun-16
NSE 20 Share Index 100 =1966	3773	3871	3982	4009	3868	3641
NSE All Share Index (NASI)	136	141	147	147	146	141
Market Capitalization (KES. Bn)	1926	1988	2078	2079	2051	1998
Total Shares Traded (Million)	422	341	536	426	384	601
No. of Equity Transactions	26857	25727	30789	25012	24212	26442
Equity Turnover (ET) KES. (Mill)	12999	10161	13449	10066	9741	17247
Bonds Turnover (KES. Bn)	21	24	67	38	55	55
Percent of Foreign Participation to ET	61	43	65	66	67	56

Source: NSE, Monthly Trading Report



Banking Industry Performance

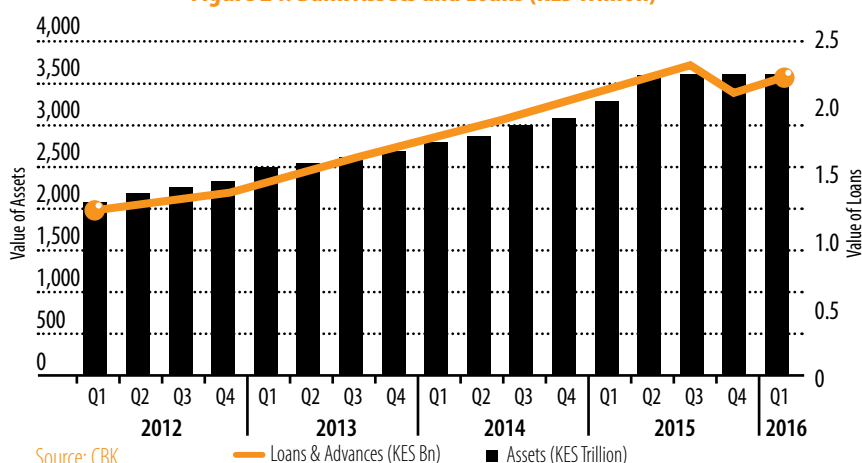
Assets and Loans

The industry's assets base registered a mild positive growth of 1.37 percent during the fourth quarter of 2015 to stand at KES 3.70 trillion as at the end of December 2015 compared to KES 3.65 trillion in September 2015. On the other hand, total industry's gross loans and advances recorded a growth of 2.58 percent from Ksh 2.17 trillion in December 2015 to Ksh 2.22 trillion in March 2016. The increase in the loan book was contributed by four economic sectors; real estate, trade, building and construction and

agriculture. Trade and real estate sectors recorded the highest increase in demand for credit with increases of Ksh 25.6 million or 42 percent and Ksh 21.3 million or 22 percent, respectively.

The growth in assets can be attributed to the banks' increased investments in government securities and demand for loans and advances, which increased by 13.6 percent and 2.58 percent respectively. Loans and advances remained the main component of assets accounting for 66.46 percent in March 2016, which was an increase from 64.94 percent in December 2015.

Figure 24: Bank Assets and Loans (KES Trillion)

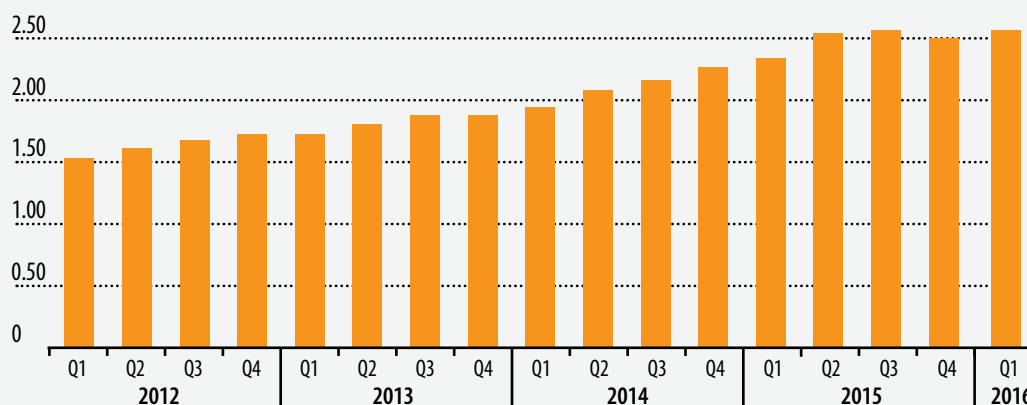


Source: CBK

Loans & Advances (KES Bn)

Assets (KES Trillion)

Figure 25: Deposits (KES Trillions)



Source: CBK

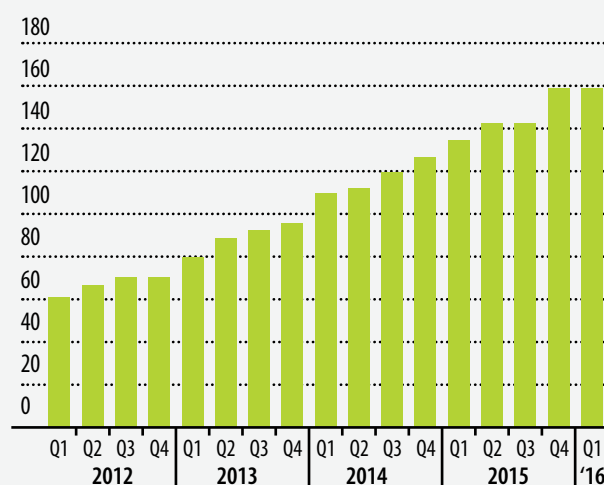
Deposits

The total deposits in quarter one of 2016 recorded a positive growth standing Ksh 2.56 trillion compared to Ksh 2.49 trillion in quarter four of 2015. Demand deposits continued to account for major source of total banking industry funding liabilities. It is however evident that, the spillover effects of placement of Dubai Bank in liquidation and Imperial Bank in receivership were short lived as far as mobilization of deposits by commercial bank from the general public is concerned.

Gross Non-Performing Loans

The gross Non-Performing Loans rose by 15.8 percent from Ksh 147.3 billion in December 2015 to Ksh 170.6 billion in March 2016. Real estate sector recorded the highest increase in NPLs over the quarter by Ksh 5.9 billion or 42.3 percent. This is attributable to slow uptake of housing units.

Figure 26: Bank Gross Non - Performing Loans (KES Billion)



Source: CBK





Personal/household sector registered NPLs increase of Ksh 5.77 billion or 21.5 percent between December 2015 and March 2016 as a result of negative macroeconomic drivers such as job losses and delayed salaries. The manufacturing sector had an increase in NPLs of Ksh 2.7 billion or 15.5 percent between December 2015 and March 2016 due to slow down in business leading to failure to generate enough cash flows to meet all financial obligations.

Transport and communication, agriculture and mining and quarrying economic sectors registered decreases in NPLs between December 2015

and March 2016. NPLs in transport and communication sector decreased by Ksh 5.6 billion or 31.1 percent. This was occasioned by enhancement of road safety rules, which has ensured continued business by transporters hence continued repayment of loans. The transport infrastructure has also been improved to the benefit of transporters. Agriculture sector recorded a decrease of Ksh 0.9 billion or 10.7 percent in NPLs between December 2015 and March 2016 – attributed to improved weather conditions.



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