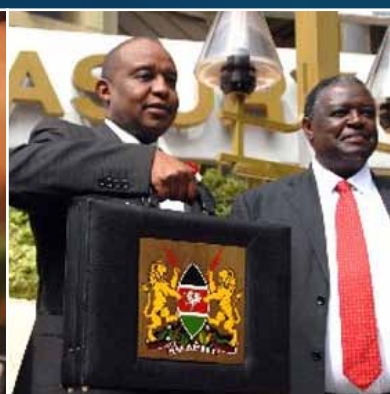


2013

KENYA BANKERS ECONOMIC BULLETIN

VOLUME SIX



A report prepared by:

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



KENYA BANKERS
ASSOCIATION

One Industry. Transforming Kenya.



CENTRE FOR RESEARCH ON
FINANCIAL MARKETS AND POLICY

About this Report

This *Bulletin* reviews the performance of the Kenyan economy for the first half of 2013, 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.

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



CENTRE FOR RESEARCH ON
FINANCIAL MARKETS AND POLICY

Kenya Bankers Economic Bulletin

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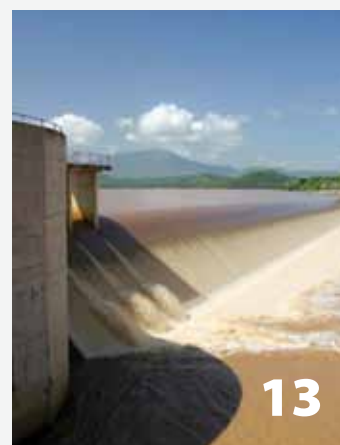
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From the CEO's Desk

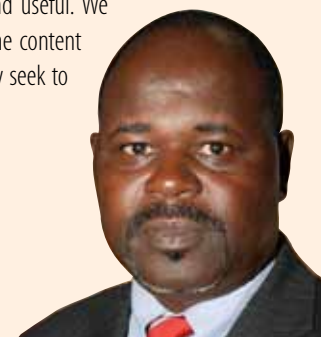
It is my pleasure to present to you the sixth volume of the *Kenya Bankers Economic Bulletin*. This issue discusses the state of the Kenyan economy during the first half of the year 2013. The *Bulletin* outlines the consolidation by all economic agents that has taken place in the period subsequent to the March 2013 general elections, cognisant of the anxiety and the lull that characterised the first quarter of the year.

With the entire Government executive team now in place, the new administration's ambitious economic agenda for the 2013/14 fiscal year is now out. In this issue of the *Bulletin*, we present an elaborate commentary that gives critical perspectives of the inaugural Budget of the new administration. Whereas the Budget is replete with good intentions, the *Bulletin* points out at the possible downside risks that can derail the realisation of its objectives.

Besides reviewing the economy and its outlook, this *Bulletin* publishes a special feature by Prof. Njuguna Ndung'u, the Governor of the Central Bank of Kenya, on Credit Information Sharing (CIS). In the essay, Prof. Ndung'u persuasively argues that CIS is absolutely critical in enhancing effectiveness and efficiency of the credit market, consequently fostering the safety, soundness and stability of the Kenyan financial sector and at the same time enhancing financial inclusion.

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

Habil Olaka
CEO, Kenya Bankers Association



A Robust Credit Information Sharing Framework – A key contributor to Safety and Soundness of the Financial System and Improved Financial Access



By Prof. Njuguna Ndung'u

Background

Credit Information Sharing (CIS) entails exchange of information on the borrowing history of individuals as a way of reducing information asymmetry between lenders and borrowers. This is what now is being described as information capital. One of the earliest knowledge base in the financial markets is the twin problem generated by information asymmetry, that is, a moral hazard on the borrower and an adverse selection on the lender. These problems can starve the market of credit and may not guarantee the quality or the appropriate quantity of credit in the market. In Kenya, the financial markets CIS framework is at a nascent stage. However, for the credit market to function efficiently and effectively, an information capital must be developed. Lenders can use this information and borrowers will be happy that they will be objectively assessed in their credit demands.

Efficient and effective credit provision, otherwise, relies a great deal on having sufficient information on potential and actual borrowers' ability,

reliability and willingness to repay. This is the information capital. Having this information greatly reduces borrowers' credit risks or the probability of default. Without sufficient information, therefore, lenders opt to charge high interest rates on loans and demand tangible collateral to cushion them against the high credit risk. This is counterproductive because; (i) of adverse selection where more creditworthy borrowers who shun high interest loans are rationed out, (ii) of moral hazard, where borrowers invest wrongly in riskier investments to enable them repay the expensive loans or may hide information to help get the loan and apply it differently, and (iii) it does not guarantee the quality of investments and raises the risk of default.

In 2010, the Central Bank of Kenya (CBK) in partnership with Kenya Bankers Association (KBA) undertook the search for credit data by rolling out the banking industry credit information sharing (CIS) framework. The initiative required establishing credit reference bureaus (CRBs) to which all institutions licensed under the Banking Act submit negative credit information. However, the institutions were not compelled to use credit reports when appraising loan applications; it was left out as a voluntary commercial decision by the banks. Over the three year period of the CIS mechanism in Kenya, the banking industry players, led by CBK and KBA, continued to drive reforms aimed at deriving maximum benefits from the CIS mechanism.



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Kenya has paid dearly in the past for lack of CIS following the collapse of more than ten banks in mid-1990's that was mainly attributed to poor loan assessment and collateral quality that led to non-performance of loans.

CIS as a key contributor to Safety, Soundness and Stability of the Financial System

Kenya has paid dearly in the past for lack of CIS following the collapse of more than ten banks in mid-1990's that was mainly attributed to poor loan assessment and collateral quality that led to non-performance of loans. The banks attributed the high non-performing loans to the then prevailing information asymmetry. The banks, it was noted, did not undertake comprehensive appraisal and screening of their borrowers as well as proper monitoring and follow up, which was considered expensive due to information search and cost problems.

The high non-performance loans ushered a regime of high lending rates, which further exacerbated the levels of default. As a result, the Kenyan banking industry experienced unprecedented instability. The rollout of the CIS mechanism in 2010, long overdue, was primarily aimed at eliminating information asymmetry. However, information symmetry can only be achieved if banks make optimum use of the CIS mechanism. Although currently it is not mandatory for banks to utilize credit reports when appraising credit applications, they stand to benefit a great deal by making it a norm rather than an exception. Inclusion of credit reports in the credit providers credit risk appraisal processes enriches the appraisal

and screening process, in particular because credit reports contain more information about the borrowers than what borrowers disclose to the credit providers. But the regulator, in cases of non-performance loans, may want to know what information was used to assess a loan application.

Credit providers who have fully embraced credit information sharing as part of their credit risk appraisal are expected to offer lower lending rates to customers with favourable credit histories. Consequently, adverse selection and moral hazard will be curtailed and non-performing loans will come down when all credit providers embrace credit information sharing. Since rolling the CIS mechanism, CBK has continued to emphasize to credit providers to appreciate the resultant risk management benefit and not to view it as a compliance requirement.

Some of the reasons cited as having propelled the US sub-prime mortgage crisis in 2007–2009 were the problems of analysing and pricing risks appropriately and tractability of who was holding the toxic assets and liabilities. With an effective CIS mechanism in place, chances of pricing borrowers' risks inappropriately and not being able to track their assets and liabilities are reduced so long as the record is regularly updated with full file information covering all credit providers in the economy that must be shared and used by all credit providers. The success of this initiative, however, depends on the frequency at which credit providers inculcate credit reports in their credit appraisal processes.



The envisaged full-file and comprehensive CIS mechanism should capture significant credit commitments of borrowers and histories. Besides, an effective CIS mechanism inculcates financial discipline on the part of borrowers, to “live within their means”. They will not access adequate and affordable credit when they over-borrow leading to adverse credit ratings, hence inappropriate pricing. The CIS mechanism manages the levels of non-performing loans and tames over-indebtedness of borrowers thereby contributing significantly to the stability and soundness of the financial sector.

CIS Role in contributing to Financial Inclusion

Prevailing information asymmetry in the Kenyan banking industry in the past, led to physical collateral based lending. The demand for collateral created a barrier to potential borrowers, especially at the lower end of the pyramid and micro, small and medium scale enterprises that lack required tangible collateral. The most affected groups are the poor and low-income households and the myriad Micro, Small and Medium Enterprises (MSMEs). This segment of borrowers however may possess useful credit histories. Initiatives to expand financial inclusion especially with respect to credit products would capitalize on these and the introduction of the CIS mechanism is important in contributing to the enhancement of financial inclusion as follows:

- **Offers an alternative security for loans to physical assets.** Borrowers' credit history provided in form of credit reports is very useful information capital that the borrowers can use as collateral for loans. Borrowers who could otherwise have been denied credit

due to lack of physical collateral, such as title deeds and log books, are able to use their credit history as a valuable “information capital” to secure credit. Prior to the introduction of CIS mechanism, potential borrowers would shun financial institutions with bureaucratic formalities. With a comprehensive CIS mechanism, some of the requirements are reduced and as a result, many borrowers are attracted to the formal banking system.

- **Lowens interest rates for borrowers with favourable credit scores.** Borrowers with positive credit reports are able to negotiate for better terms and conditions from lenders. The benefits include; lower interest rates, longer repayment periods or higher credit limits than the borrower could otherwise access.
- **Circumvents the lengthy contract enforcement with regard to collateral.** Even where borrowers offer tangible collateral, in many developing and emerging countries like Kenya, cultural constraints on land and court procedures of reclaiming the collateral are not well established and cumbersome. Difficulties in their enforcement are common. Credit providers become jittery where such weaknesses exist with law enforcement mechanism. They would rather avoid seeking legal recourse where legal frameworks tend to be unsupportive and time consuming. Relying more on CIS mechanisms will help credit providers by relying less on such legal frameworks.

Conclusion

The CIS mechanism is an important component of a financial system's infrastructure, especially its credit market development. It develops information capital, a missing link in financial system's screening and monitoring technology, not only for new and potential customers but also existing profiles of customers and other participants. This information capital facilitates access to credit, protects clients' over-indebtedness, and helps lending institutions to manage risk and decrease costs of lending and bad debts. However, establishing CIS mechanisms that support financial inclusion can be challenging for some reasons, for example, limited information on clients at the bottom of the pyramid and the need to support credit information reporting by credit providers serving the poor and low-income clients.

The challenges, nonetheless, have to be overcome to enable those at the bottom of the pyramid to fully unleash their potential. It is this realization that makes CBK continue to encourage credit providers to fully embrace credit information sharing. It is only when credit providers purposely include credit reports in their credit risk management at loan applications appraisal and screening stage that the desired benefits can be optimised. Once a full-file and comprehensive CIS mechanism is in place, the effectiveness and efficiency of the credit market is enhanced, thus fostering the safety, soundness and stability of the Kenyan financial sector and at the same time enhance financial inclusion.

Prof. Nguguna Ndung'u is the Governor of the Central Bank of Kenya

Commentary: The 2013/14 Budget and the "IMF" Perception



By Jared Osoro

Considerable attention on the Budget Statement by the Cabinet Secretary for the National Treasury to the Budget and Appropriation Committee of the National Assembly on the 13th June 2013 has been on its magnitude. The proposed expenditure amounting KES 1.6 trillion – equivalent to 39 per cent of GDP – the 2013/14 budget is unprecedented. And this matters because it has the potential to make a contribution to the economy's output growth crawling back to its pre-2008/09 level, which is the medium term target.

Further, it is a reflection of ambition on the part of the new executive administration. To unravel the ambition, one needs to look beyond the mere size of the budget and especially have a focus on the highlights of what the budget is expected to accomplish. Its thrust, "transformation for shared prosperity" embeds the notion that it's the public fiscal programme that is at the centre of the economy's transformation.

This is an attitude that is fairly mainstream nowadays, and a reminder of the popular but sarcastically quip that the IMF's acronym stood for

"It's Mostly Fiscal", as a reflection of the tendency of the International Monetary Fund to advocate for tighter fiscal policy regardless of the problem bedeviling a client economy¹. Only that this time around, the Fund has taken a more nuanced stance in so far as fiscal policy is concerned, and especially the issue of austerity in the face of slow growth or weak recovery.

So the deployment of the equivalent of nearly 40 per cent of GDP as indicated in the 2013/14 budget, together with administrative policy measures is meant to address a handful of objectives – some of which obviously commencing, but with the medium term as the time frame for realisation of the objectives. The overriding agenda is to support the acceleration of growth by targeting resources to improving productivity and competitiveness, and opening up the economy to investment and export opportunities.

To actualise the agenda, the budget highlights the key areas of focus. These include the following:

¹ In Zimbabwe during the late 1990s and early 2000s, as the economy was entrapped in a cycle of shrinking fortunes, the joke was that the IMF was at the centre of it, only that the acronym IMF in this case stood for *"It's Mugabe's Fault"*; In Asia, when the IMF actually prescribed tighter fiscal policies for the economies that were caught in financial distress, the ensuing retrenchments led to the acronym taking the meaning of *"IM Fired"*.



- A continuation of both public and private investment programmes, especially in infrastructure, that have the highest impact to growth, covering roads, railways, pipelines, ports, and energy;
- Ensuring that macroeconomic stability is maintained as could be manifested in inflation low and stable inflation, and or a stable and competitive exchange rate, while enhancing our capacity to respond to external shocks;
- Supporting small and medium enterprises through targeted financial support, skills development, and access to markets;
- Creating a business climate that encourages innovation, investment and growth;
- Improving the quality of education and training through leveraging on ICT, starting with the primary level;
- Investing in law enforcement and security through modernizing police force to effectively and efficiently respond to crime;
- Boosting food security by investing in agriculture including opening up new land through irrigation and other initiatives;
- Sealing leakages in our revenue collection system and extending the tax base, while ensuring efficiency in public expenditure; and
- Supporting devolution through capacity building to effectively

deliver public services and ensuring county governments receive adequate resources to fund their functions;

The logic in the outlined budget pillars that are meant to support the overriding goal of the budget of spurring growth is undoubtedly credible. Holding everything constant, a follow through on all these pillars – in essence a seamless budget implementation – will only mean that the multiplier effects of the public expenditure will optimally enhance growth. But in the real world, especially in our world where evidence of self-interest overriding common good is all too clear, things will never remain constant.

As we argue shortly, with the pieces of the puzzle appearing to me moving in different directions, the extent of the multiplier effect – the extent to which changes in fiscal policy have knock on effects on the rest of the economy – is likely to be sub-optimal; indeed it may not be simply the case of magnitude, but also a case of the direction.

Multiplier: How big? Which way?

On account of at least two factors, a positive multiplier effect of the proposed budgetary expenditure could *a priori* be expected. The first factor is that while the Kenyan economy is showing strong signs of entrenching recovery – having registered a real growth of 5.2 per cent



Photo / IMF

during the first quarter of 2013 and is projected to grow by 5.8 per cent for the year 2013 – it is still yet to attain its medium term of 7 per cent. Some of the downside risks that we will highlight later will only imply that the attainment of the desired growth target will neither be fast nor smooth. This is pointer in favour of the argument that any weaknesses that we see in the recovery signal more spare capacity in the economy, which reduced the risk of “crowding out” effects. In other words increasing government demands for funding will not have a large upward impact on interest rates—which in normal times would have slowed economic growth.

Some recent unorthodox thinking and empirical confirmation at the IMF gives the comfort that the fiscal multiplier may in some cases have been understated when the issue of spare capacity has been given little prominence². Even though this piece of research draws on the experience of the European economies – and revising the multiplier upwards significantly from 0.5 to over 1 (meaning for every USD1 unit of government injection to the economy the net benefits are revised upwards from an equivalent of USD 0.5 to more than USD 1) – it has traces of relevance to economies such as Kenya.

That link is via another recent study which looks at multiplier effects in from another angle³. It distinguishes the multiplier arising from government consumption from that arising from government investment, determining that former is estimated at 0.66 for developed economies and the latter is estimated at 1.5. For developing economies, the story gets worse. The multiplier on government spending is negative 0.63, meaning

every 1 USD on government consumption, there is a decline in GDP by 63 cents; government investment however results in a 1.6 multiplier effect in developing economies.

These studies give a succinct picture of what to expect of the Kenyan budget in respect of the possible multiplier. The amount budgeted for gross recurrent expenditure, at KES 955.5 billion, is more than double the gross development expenditure budget of KES 447.9 billion. Essentially, the loud agitation of higher salaries and wages for members of the legislature and the national county levels, and public service workers stands to tilt the multiplier in the wrong direction, given the structure of the proposed expenditure that we outline.

The second factor stems from the extent to which monetary policy is in tune with fiscal policy to the extent that fiscal dominance is ruled out and that an accommodative monetary policy stance will facilitate optimal multiplier realization, on the spare capacity in the economy. The CBK is sanguine that the fiscal stance presents no risk of dominance. Indeed its Monetary Policy Committee (MPC) decisions over the past half year – which have largely been accommodative – makes such inference explicit, indicating that it has scope to facilitate further credit expansion without provoking inflationary expectations.

For the National Treasury, the feeling seems to be mutual. Even on the back of an ambitious expenditure programme, much of which being consumption inclined, the National Treasury is of the view that inflation – having declined consistently over the past one year – would remain around the 5 to 7 per cent target, and that interest rates and the exchange rate that are fairly stable are expected to remain so going forward.

What about the Risks?

Whereas there is a lot to agree with when it comes to the CBK and National Treasury’s respective summation of the macroeconomic stability situation, we seek to contend that their outlook is ambitious than even the evidence already in could justify. We see risks emanating from three fronts namely: one, the CBK – in the true spirit of central banking – portraying a sense of ‘constructive ambiguity’ in its articulation of monetary policy decisions; two, the potential risks from the budget’s funding proposals being assumed away; and three, the softening of the global recovery that may contribute towards frustrating the realisation of the economy’s projected growth upon which revenue targets are based.

² Blanchard, O. J., and Leigh, D. (2013). “Growth forecast errors and fiscal multipliers” *IMF Working Paper (WP/13/1)*, January.

³ Iztetzki, E., Mendoza, E.G. and Végh, C.A. (2013) “How big (small?) are fiscal multipliers?”, *Journal of Monetary Economics*, Volume 60, Issue 2, Pages 239–254.

On the first issue, we contend that the CBK's signalling has not been crystal clear, perhaps indicating that there is some level of self-constraint in providing forward guidance in its monetary policy decisions. As we have argued in the recent past⁴, it is obvious that the CBK cannot commit to future policy – and we do not expect it to. All it can do is signal its character given the inherent difficulty in monetary policy conduct anywhere in the world to lock in a future policy stance. This is however no excuse for not setting the platform for the immediate future policy position. Forward guidance is not a give-away but a sign of a maturing monetary policy framework.

We observe that over the past half year, the CBK has to its credit maintained unequivocally that its core focus is price stability. However, its often optimistic posture that somewhat overshadows some critical domestic risks to a stable inflation outlook points to the possibility of a strive to balance between supporting economic growth and entrenching price stability, sometimes arguably leaning more towards the former. As noted earlier, pursuance of growth maximisation remains the explicit objective of the National Treasury. This could well be a motivation of a debate that is going on as to whether there should be a “bright line” between monetary policy and fiscal policy⁵.

On the second issue, the National Treasury is very categorical that “the fiscal framework for 2013/14 is fully financed”. As a forward looking conjecture, this is a true assertion. Nonetheless, it has to be subjected to be some reality checks. First, the fiscal challenges of 2012/13 that were characterised by shortfall in revenue and mounting expenditure pressures is still fresh in our minds. This necessitated rationalisation of expenditures, with the remaining residual gap being bridged through additional borrowing. With only a few new tax proposals in the Finance Bill 2013 – which include the controversial Value Added Tax (VAT) on basic consumer goods, railway development levy on all imported goods – the burden of realising the revenue targets seems to lie more on tax administration; this is the case even when some of the earlier taxes – e.g. excise duty on financial services – are characterised by compliance challenges.

It therefore remains to be seen whether, when it comes to the meeting of the revenue targets, 2013/14 will be different from 2012/13. Equally it remains to be seen whether the financing of the deficit of KES 329.7 billion (equivalent to 7 per cent of GDP) will be price neutral. While the proposal is that a bigger portion of the deficit (KES 223.0 billion) will

be financed through external borrowing, the influence of the domestic borrowing component amounting KES 106.7 billion remains a function of the market liquidity conditions. As reported in this *Bulletin*, interest rates on government securities that previously tracked the inter-bank rates, have started edging up albeit gradually but breaking away from the inter-bank rates, thereby signalling the tightening of market liquidity.

On the third issue, the softening of the global economic recovery seems to be taking a new dimension, with the challenge extending beyond the Euro zone to the emerging markets. The IMF, in its post-April 2013 growth forecast undertaken in July 2013, trimmed its global output growth projections from 3.3 per cent to 3.1 per cent on account of not just the recession-struck Europe but also because of the emerging markets woes; this is the fifth time the IMF has reviewed downwards its global growth projections, pointing to the fact that the recovery momentum still remains feeble.

To add insult to injury, the US's Federal Reserve appears to have miscommunicated its policy intention by hinting at “tempering” its Quantitative Easing programme, thereby precipitating a sharp reaction from markets both in the developed and emerging economies that saw an upsurge in interest rates; its subsequent clarification didn't seem to result in a correction. It didn't help either that there is a drive by, among others, the Bank for International Development, for a monetary policy shift into a tightening stance in some economies that have not realised full entrenchment of recovery; this position is almost the opposite of the IMF's considered position that is arguably pragmatic. The state of affairs in the global arena may be a binding constraint to the realisation of the projected growth, thereby frustrating the base upon which revenue collection is based.

Ultimately

The foregoing analysis leads to the observation that Kenya's fiscal policy as attested by the 2013/14 budget will without a doubt have an effect on the economy, but not in the manner that many may have thought. To the extent that an ambitious fiscal programme such as Kenya's is seen as a stimulant to the economy that is trying to restore its full employment level, its deployment must take cognisance of the implications that will ensue. In other words, “*It's Mostly Fiscal*” (“IMF”) is still relevant, only that it is not necessarily a zoo-in towards the attainment of the desired economic outcome.

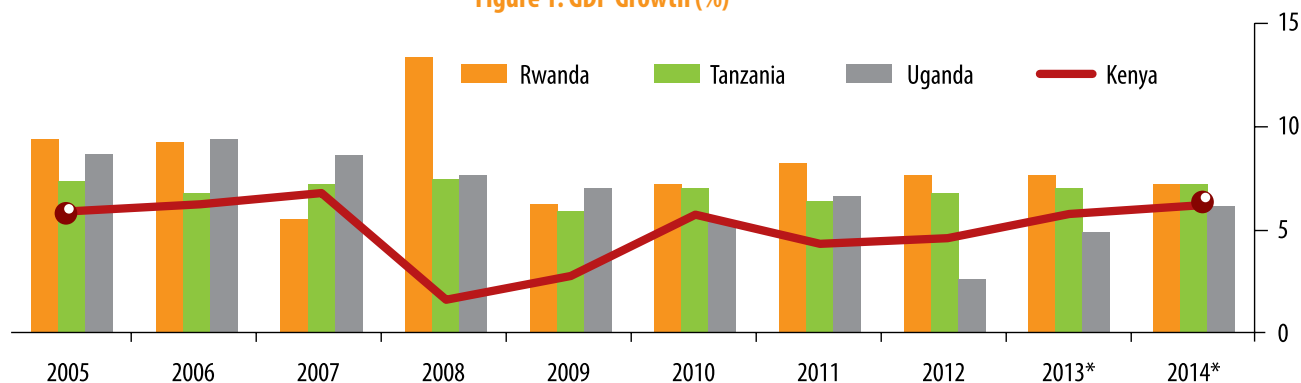
Jared Osoro is the Director, Research and Policy, Kenya Bankers Association and the Director of the KBA Centre for Research on Financial Markets and Policy

⁴ Kenya Bankers Association Centre for Research on Financial Markets and Policy, (2013), “Monetary Policy Stance: A sort-of Pause Before Correction?”, *Research Note No. 3.* – 2013 (RN/3/13), July.

⁵ Plosser, C.I., (2013), “Fiscal Policy and Monetary Policy: Restoring the Boundaries”, 2012 *Annual Report*, Federal Reserve Bank of Philadelphia.

State of the Economy

Figure 1: GDP Growth (%)



Source: KNBS; IMF World Economic Outlook Database (April 2013)

Growth in GDP

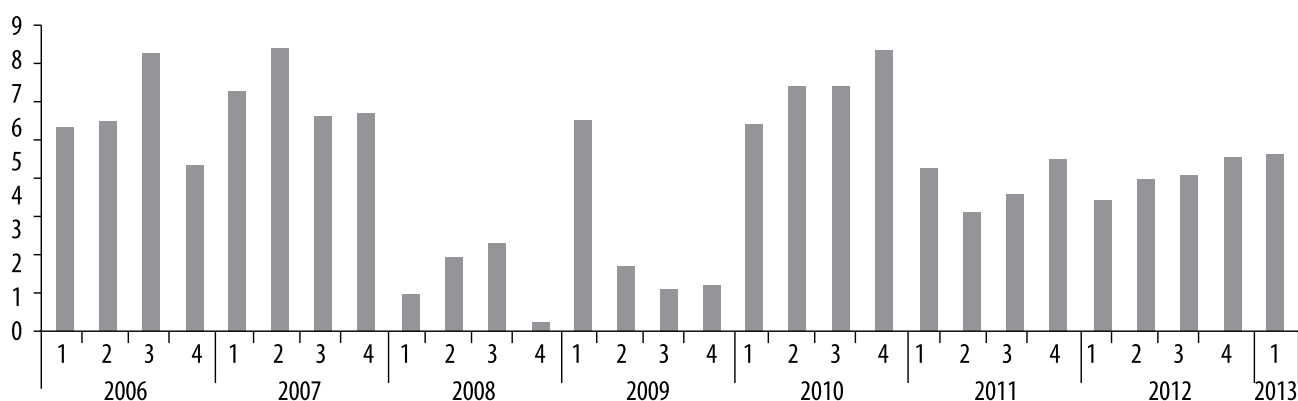
The *Economic Survey 2013* that the Kenya National Bureau of Statistics (KNBS) published in June 2013 confirmed that the economy sustained an upward real growth trajectory, albeit with feeble momentum. The real output growth for the year 2012 was 4.6 per cent compared to the previous year's 4.3 per cent. Cognisant that the economy's real GDP expanded by 5.8 per cent in 2010, its 2012 performance represented two consecutive years of improved growth following the growth slowdown experienced in 2011 (**Figure 1**). It is evident therefore that the economy has not fully recovered from the domestic as well as international shocks of the 2007 – 2009 period. However, the International Monetary Fund (IMF) forecasts that the economy will maintain the growth trend as it mildly moves towards the pre-global economic meltdown growth rate.

The projected real output expansion is underpinned by the quarterly growth trend that has in the recent past been positively consistent even

amidst a number of downside risks. After a mild dip during the first and second quarter of 2011 and the first quarter of 2012, the economy's quarterly growth rate has been on the rise (**Figure 2**). The growth momentum, especially during the last four quarters to March 2013, has been on the back of sustained monetary policy easing that followed the decline in inflation from the peak reached in November 2011, and mild reduction in global oil prices especially during the first quarter of 2013.

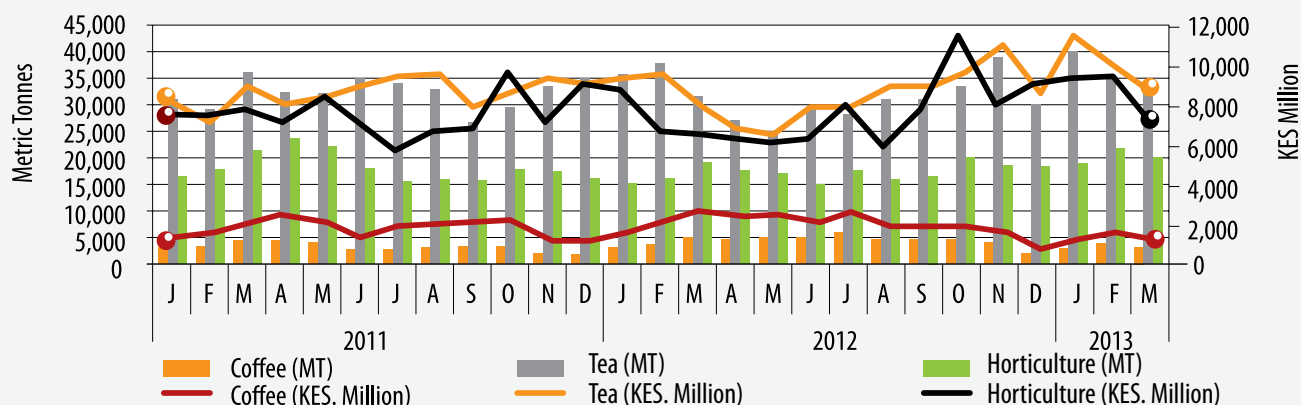
The economy entered the second quarter with a clear perception of waned political risks although the loud squabbling amongst the two chambers of parliament, early challenges of devolved government system – especially the turf wars on resources devolution, and the national assembly's clamour for higher pay seemed to take the limelight. These events if not checked might have a depressing effect on optimistic growth forecasts for the quarter and ultimately for the year that have been projected at an optimistic 5.8 per cent.

Figure 2: Quarterly GDP Growth (%)



Source: KNBS

Figure 3: Agricultural Exports - Volumes (MT) and Value (KES Million)



Source: KNBS

Agriculture

Agriculture remains the backbone of the economy, contributing directly to about one quarter of the economy's output and indirectly by a similar magnitude. Despite erratic weather manifested especially in delayed rainfall that affected tea and horticultural yields, agriculture continued to register positive performance that propelled the growth trend observed above. Over the past three years the share of key cash crops (excluding grains and horticulture) of tea, coffee and sugar cane has been 89.6 per cent, 9.2 per cent and 1.2 per cent respectively.

Both tea and coffee have been showing signs of production recovery into the second quarter of 2013, with tea having attained a peak of 45390 MT – the highest in three years. The recovery was attributed to favourable weather conditions, in particular well distributed rainfall experienced the major part of the second quarter of 2013. Production of these cash crops depends on incentives, particularly the prices they fetch from the international markets as reflected also in their exports. International prices of coffee in the past have been highly volatile unlike those of tea that have been quite stable. They have since then stabilised beginning June last year. The price trend of these two cash crops, together with the production levels, resulted in the fairly stable export values (**Figure 3**). It is noteworthy though that their supply responsiveness to price changes comes with a time lag that may span into years given the nature of the crop.

Agricultural exports alone account for over 50 per cent of the economy's total foreign exchange earnings. As Figure 3 illustrates, there is a clear dominance of tea and horticulture in agriculture export, with a clear rivalry that has seen the leadership of tea as the main export challenged. This is despite the fact that its total quantity exported falls far below that of tea. Over the past two years to the first quarter of this year, for example, the disparity in their export volumes was averagely 80 per cent while it was only about 15 per cent for their foreign exchange earnings over the same period.

Kenya's horticultural produce's high quality and freshness attract competitive prices from the international scene. On the volume and value horticultural exports, cut flowers lead the pack with fruits taking the least share. In the first four months of this year, the quantity of fruits exported rose a bolstering 211.5 percent to settle at 4780.72 MT in April. For fruits therefore, this became the first peak in the post August 2012 horizon where 4838.5 MT of fruits had been exported. In contrast, however, the quantities of cut flowers and vegetables exported declined by 8.8 and 13.8 per cent in their respective orders, over the same period. Similar trends indeed reflect for their respective values.

Despite this, the horticultural subsector as a whole faces a number of challenges including high production costs, contraction in demand of export destinations especially resulting from recent tumbling of European markets, problems in procurement, and erratic weather that makes production susceptible to pests and diseases consequently lowering both yield and quality of their exports. But recent emphasis of expanding

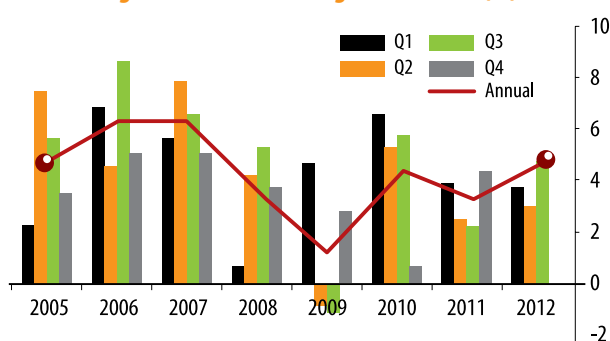


agribusiness credit and uptake of irrigation that saw a budget allocation of KES 8 billion to the irrigation board will augur down well not only into this subsector but on agriculture as a whole, in the long run.

Manufacturing

The manufacturing sector's growth rate has been erratic in the recent past years (Figure 4). The annual growth of this sector has been aligned to the performance of the second and third quarters. Manufactured output has been characterised by high variability as regards its various segments. In the food subset, between 2011 and quarter one of 2013, milk has had greater dominance averaging 43 million litres followed by soft drinks that averaged 31 million litres, and sugar at 41175 MT. However, while milk has remained fairly constant across trend, both production of soft drinks and sugar have posted a mild downward drifting output.

Figure 4: Manufacturing Growth Rate (%)



Source: KNBS

On the non-food segment, production of cement was well above that of galvanised sheets with disparity of about 94 per cent (Figure 5). While the trend in cement production (between 2011- March 2013) has been on the rise, the opposite has been observed for galvanised sheets. Cement

consumption that broadly underlies activity in building and construction has also observed an upward trend despite the decline that was observed in during the first quarter of 2013. This has been associated with faster activity in development in both urban and rural residential and non-residential premises including offices.

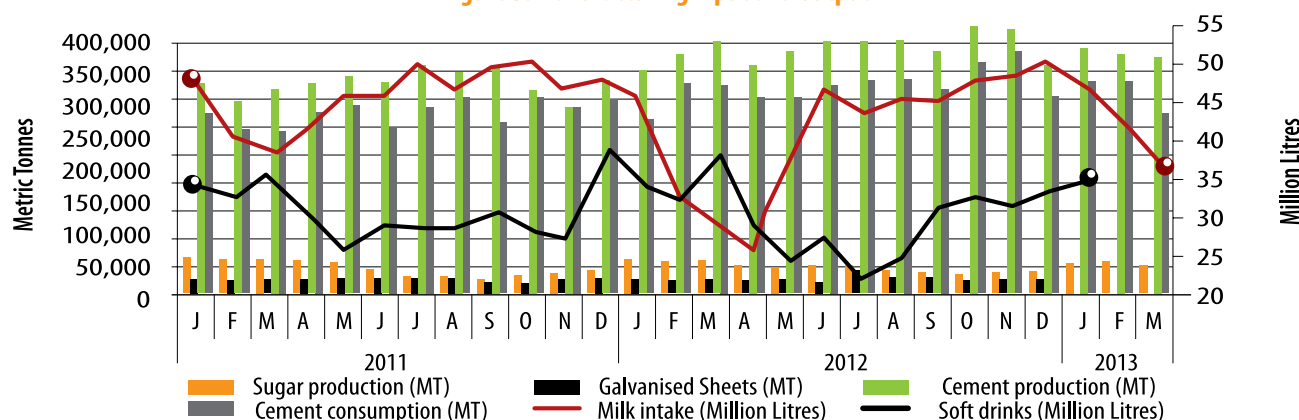
Energy

Hydroelectric, thermal and geothermal power sources continue to be the main contributors to the national electricity grid. In the period beginning 2011 to May 2013, their shares were 47.9 per cent, 28.1 per cent, and 19.5 per cent of the total electricity generation, respectively. Emergency power thermal generation has been as important, accounting for 4.0 per cent of the total electricity generation while import from Uganda accounted for 0.5 per cent.

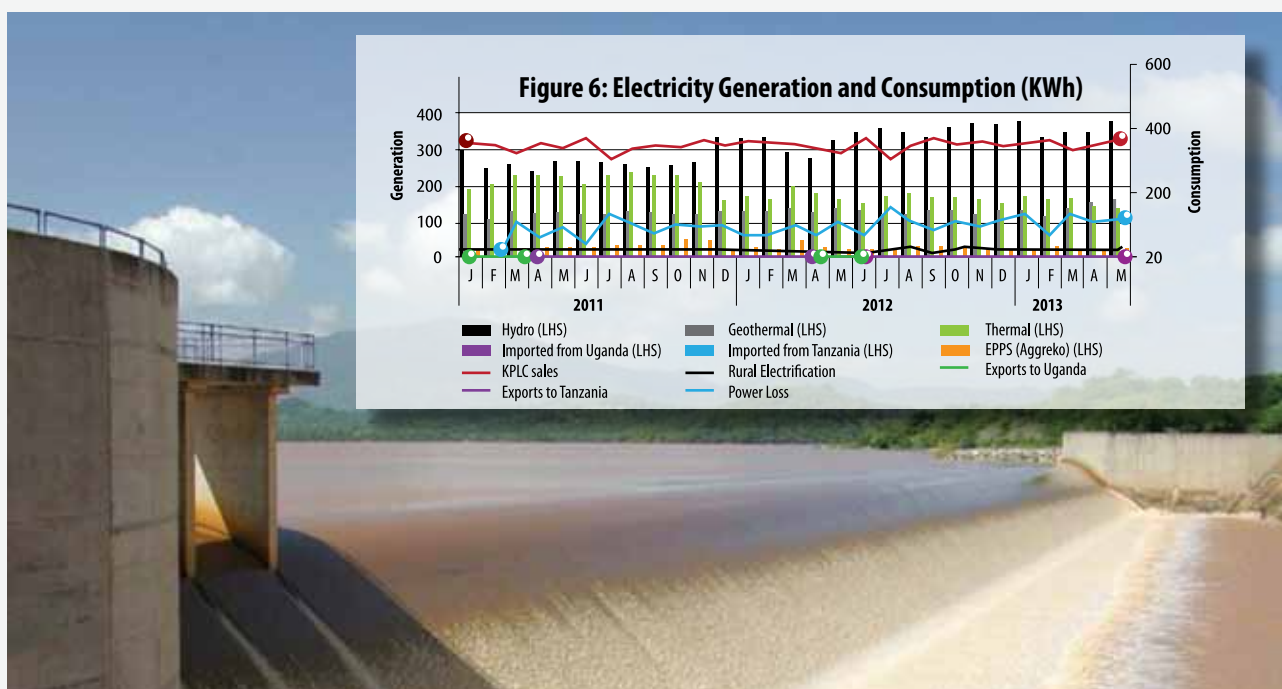
The economy's aspirations as detailed in the *Vision 2030* blueprint necessitate the increase in electricity supply at competitive pricing. This is expected to reduce the cost of doing business, which will in turn be reflected in competitive pricing of products and services benefit of consumers and the economy at large. Currently, energy costs are driven by exogenous factors such as the erratic oil prices. Unpredictable weather, especially prolonged drought, tends to affect hydroelectric power generation. At the same time, there is a dire need for increased investment to boost grid efficiency, cognisant that power losses made up 10.2 per cent of total electricity consumption – well above total consumption on rural electrification that stood at 2.6 per cent – for the period 2011 – April 2013 (Figure 6).

There are notable steps being taken to address the challenges in the energy sector. A USD 1 billion green energy strategy focussing on geothermal with a potential of about 280 megawatts has been under implementation since December of 2012 and is projected to be completed by 2014. Being

Figure 5: Manufacturing Input and Output



Source: KNBS



Source: KNBS. Photo/Kengen

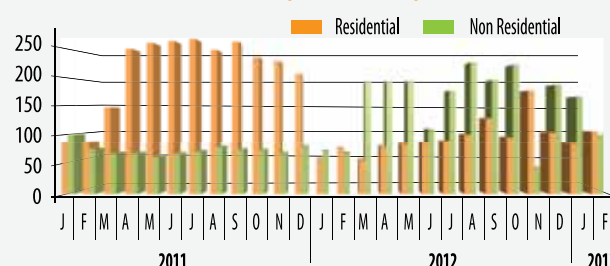
able to tap into other energy sources like solar, wind among others that have the potential to not only ensure power adequacy, but also lead to predictable and affordable power.

Fuel prices have generally remained high although they have somewhat declined from their peaks of November 2011. The first two quarters of 2013 saw prices of motor gasoline and light diesel oil assume an upward trend. This was despite reduction in international crude oil prices. This decline was however not sustained, as the downward trend hit the trough attained in February 2013, subsequently assuming an increasing trend. This quick reversal was largely associated with the crisis in most oil producing countries.

Building and Construction

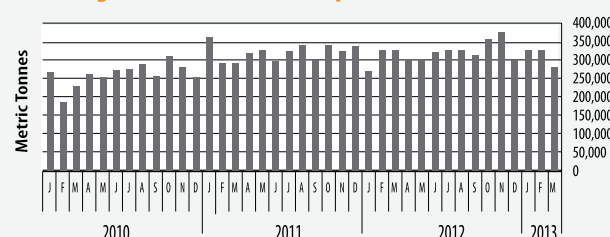
The number of investments in non-residential premises outgrew residential premises for the period February 2012 – January 2013, with growth in residential premises picking up in the first two months of the year (Figure 7). More recent data reveal that despite non-residential plans attaining a trough in November 2012 over the past two years, its trend has remained on the decline, falling by 3.8 per cent between December last year and February of this year. The trend in the building and construction sector was aligned to that of cement production and consumption (Figure 8).

Figure 7: Real Building plans Approved by Nairobi City Council (KES Millions)



Source: KNBS

Figure 8: Cement Consumption (Metric Tonnes)



Source: KNBS

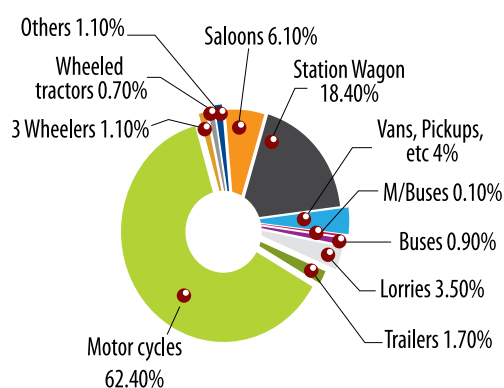




Transport and Communications

Activity in the transport sector as shown by motor vehicle registration has been characterised by high variability in the past. Recent data indicate that April 2013 registrations (at 20,203 units) are not only below their January 2013 levels (20,997 units) but also their sixteen months peak (22,557 units registered in July 2011). The shares of specific vehicle registrations over the past two years are shown in Figure 9. The observed dominance of motor cycles as a critical means of transport has carried with it an upside risk, especially accidents and crime.

Figure 9: Motor Vehicle Registration (2011- April 2013)



Source: KNBS

The railway subsector maintained upward momentum, recording positive freight traffic and associated revenue. The growth in revenue in this segment reflected higher tariffs on cargo in transit. On the passenger segment, after the decline in passenger journeys by about 62 per cent in 2010, the number of passenger journeys recovered, increasing by 18 per cent in 2012 from 6,004 thousand passenger journeys in 2011. The passenger journeys for 2012 were the highest since 2010, but overall, their 2009 levels are still the highest ever recorded. However, after successively increasing in the past four years, this segment's revenue declined by 23.5 per cent from their previous year level to KES 202 million in 2012.

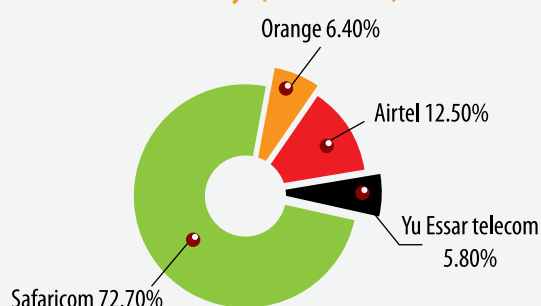
Activity in the air transport segment declined in 2012, reflecting contraction in the passenger, cargo and mail segments. This manifested slow recovery in the global economy specifically the Eurozone banking crisis, whose members combined form the largest user of the domestic air transport system. Along this line, the number of passengers handled by local airports declined by about 1.58 per cent, with notable increases in departures through Jomo Kenyatta International Airport (JKIA), Nairobi.

The communications subsector sustained its upward momentum. On several frontiers, this sector was characterised by distinctive domination of mobile telephony. Statistics from the Communication Commission of Kenya (CCK) show that mobile phone penetration, measured by the number of active users of mobile phones per 100 inhabitants, continued to rise. In the fourth quarter of 2012, mobile penetration edged up 0.8 percentage points to 78 active mobile phone users per 100 inhabitants in December. This, however, represented modest growth given the increase of 1.8 per cent, 1.4 per cent and 2.7 per cent in mobile penetration in the third, second and first quarters of the same year, respectively.

Similarly, the total mobile subscriptions by individual mobile operators reflected on the overall growth in mobile subscriptions. Safaricom with the largest market share (**Figure 10**) was characterised by growth in both the pre-paid and post-paid segments, similar to Essar Telecom and Airtel (although its post-paid subscriptions declined). In contrast, the total subscriptions into Telkom Orange declined by about 20 per cent together with its respective components, reflecting falling subscriber confidence especially owing to the operator's financial woes in the past; in particular, it's high indebtedness to the government and also banks and therefore the need for a bailout.



Figure 10: Per cent Market Shares for main Mobile Providers in Kenya (2008 – 2012)



Source: CCK

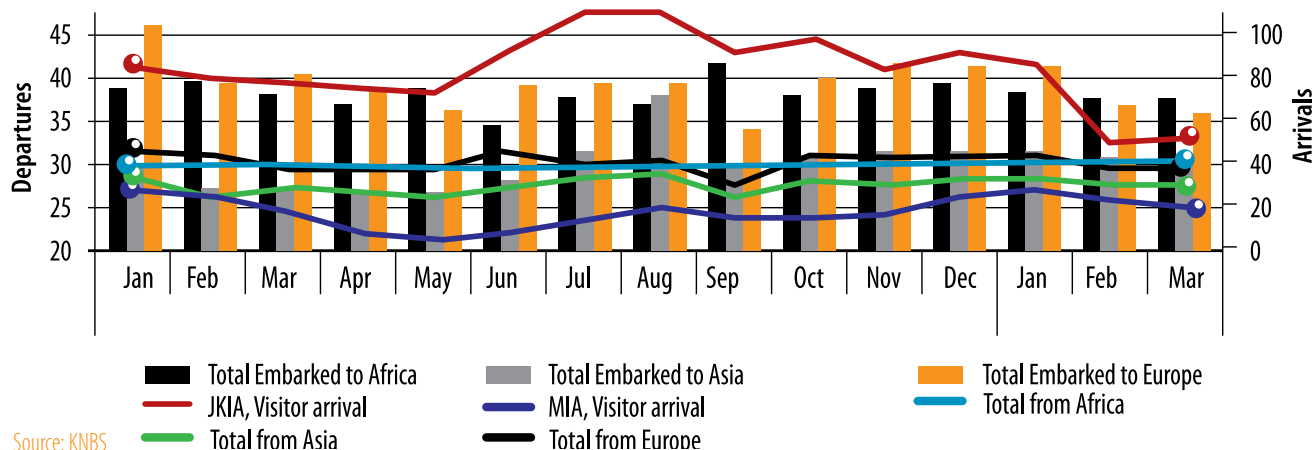
Mobile telephony money transfer has continued to gain immense attractiveness in terms of facilitating transactions. Mobile payment statistics indicate that the total number of agents, customers together with transactions (in millions) and ultimately their worth (value) in billion Kenyan shillings (KES) has over the past six years sharply increased. However, the value of mobile payments has been on the decline since the six year historic peak of KES 150.16 billion attained in December 2012, falling 10.5 per cent to the end of level attained by the end of March 2013. A modest recovery, however, was seen towards the second quarter of 2013 with the value of transactions at KES 142.61 billion in April 2013 being 6.1 per cent higher than their March 2013 levels.

Tourism

Tourism remains an important contributor to the country's foreign exchange earnings. Total foreign exchange earned by this sector declined by a margin of close to 2 percent over the past two years to stand at an equivalent of KES. 96 billion by the end of 2012. This was the first time over the past four years that this sector recorded a decline in its foreign exchange earnings. Global challenges, in particular the recession prevalent in European nations that are a leading tourist source, accounted to that state of affairs. Total visitors from Europe who have been on the decline since 2012 decelerated further in the first quarter of 2013 and fell below their counterparts from Africa by end of March 2013

Asia remained the lowest source of visitors, averaging 30 thousand since 2012. Despite JKIA being preferred by most visitors, its role has been on the decline while that of Moi International Airport (MIA), Mombasa, has been on the rise though. The total number of visitors to national parks and game reserves was on the decline for the second successive year since 2010. In 2012, the total number of visitors declined by 6.5 per cent from their 2011 levels to 2492.2 thousand visitors. This reflected further decline in the total visitors using these facilities compared to the decline of 3.6 per cent in 2011. In addition, compared to the periods 2008 – 2010 when visitors increased by about 16 per cent, this reflected performance that was below potential.

Figure 11: Visitor arrivals (Thousand)



Financing of Government

Recent times have seen public expenditure grow faster than growth revenue not only in Kenya but across many other economies. The budget deficit measured on commitment basis amounted to KES 150.1 billion in February this year, and 19.8 per cent higher than projected; this represented an increase of 16.4 per cent from the same month in 2012. Higher fiscal deficits have been partly associated with faster growth in expenditures and partly to falling revenue.

Despite growing development expenditures due to increasing investment into infrastructure, recurrent expenditures remain higher in comparison to the former and have been driving most public expenditures. The share of recurrent expenditure to total public expenditure was 74.9 per cent compared to 25.1 per cent for development expenditure in the first quarter of 2013. In addition, the share of recurrent expenditure to total public expenditure edged up, albeit modestly, with the converse being true for development expenditure as reflected by their percentage shares of 72.3 and 27.7 respectively the previous year.

Figure 12: Composition of Recurrent Expenditure (KES million)

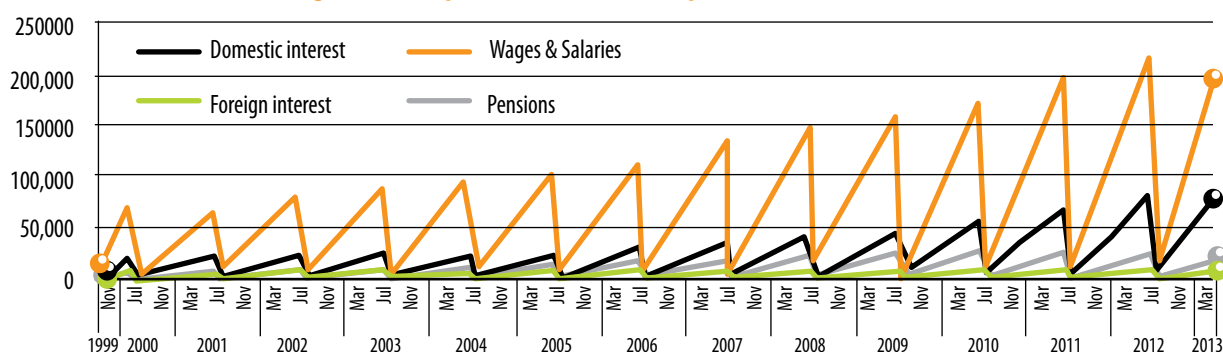
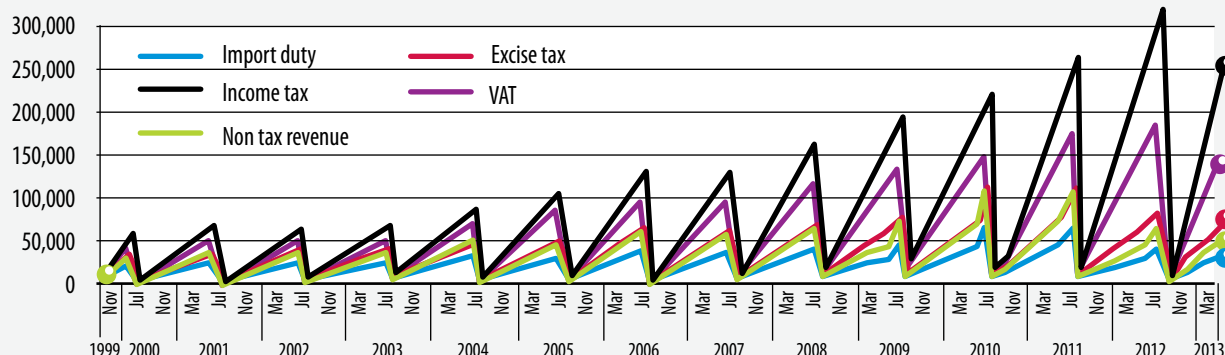


Figure 13: Composition of Revenue (KES million)



Source: The National Treasury

Salaries and wages and to an extent payments of domestic interest remain important drivers of total recurrent expenditure. In the first quarter of 2013, salaries and wages alone made up 34.9 per cent of total recurrent expenditure while interest payment on domestic debt was 13.8 per cent. Expenditures on pensions and foreign interest remained below salaries and wages as well as domestic interest payments. While lower foreign interest payments reflect debt restructuring policy, in particular to more long dated domestic debt instruments, lower expenditures on pensions indicate prevalent higher populations of the young than the old and also inadequately established/functioning social security systems for the aging, a trend common in many developing nations, thanks to modernisation of the NSSF.

On the revenue side, except between June 2005 and 2006 when there was a sudden jump – with total revenue rising in the range of 28.7 per cent – there has been a gradual growth. During the first quarter of 2013, total revenue stood at KES 474,818 million. This represented growth of about 15 per cent from the same period in 2012. The growth in total revenue reflects faster growth in the tax revenue segment with notable domination of income tax and Value Added Tax (VAT), but with import

duty falling further below these two categories. In spite of this, unlike in the past where revenues from excise tax and non-tax sources closely tracked each other, excise tax revenue has outgrown the non-tax revenues not only in this quarter but since July 2011, a trend evident also in the last half of 2009, the first quarter of 2006 and the fourth quarter of 2005.

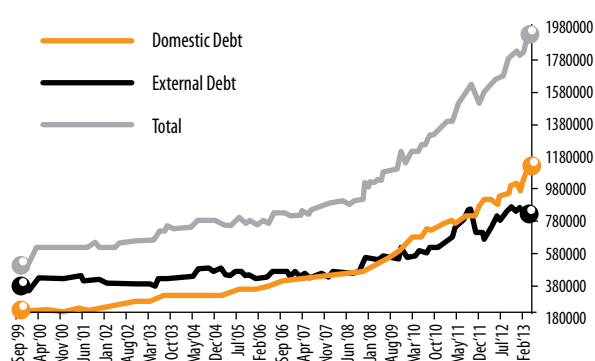
Public Debt

The level of public debt over the past one decade has been growing in response to the growth in government operations (**Figure 14**). The government however seems to have managed the rate of growth of the public debt, which was 23 per cent for the period November 2011 – to April 2013 compared to a high of 58% for the December 2008 – and September 2011 period. The observed reduction in the rate of public debt growth reflects the successful reduction in external component that eventually fell below domestic debt beginning December 2009 (with exceptions of September and October 2011). It is a further reflection of the government's commitment to more domestic financing of its expenditure, a strategy meant to reduce risks associated with external debt instruments. The composition of total public debt for 2012 was such



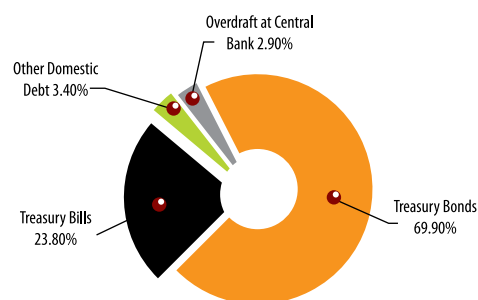
that domestic debt accounted for 54.4 per cent in while external debt accounted for 45.6 per cent in their respective orders. The composition of domestic debt as at the second quarter of 2013 is shown in Figure 15.

Figure 14: Public Debt (KES million)



Source: CBK and the National Treasury

Figure 15: Composition of Domestic debt in the second quarter 2013



Source: CBK

On the external debt front, there has been a dominance of multilateral creditors who accounted for 59.5 per cent of this debt component for the period January – April 2013. Over the same period, bilateral creditors accounted for 31.4 per cent while commercial banks and “other” creditors accounted for 7.1 per cent and 1.9 per cent of total external debt respectively. While there was notable domination of International Development Association (IDA) in the multilateral creditors segment, the bilateral segment saw increasing participation from China and Japan although the latter’s share has been declining over time. Energy and infrastructure development had highest allocations of external debt, receiving 37 per cent of the total external debt for the period January to April 2013.

Money and Credit

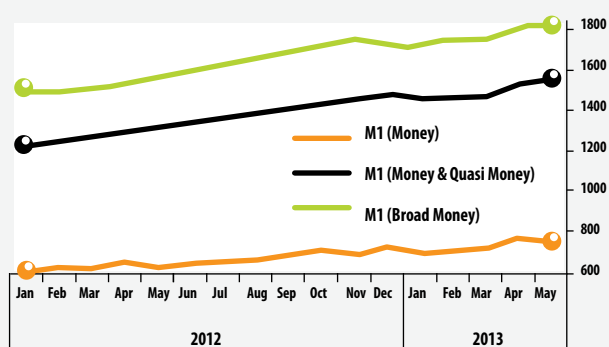
Even though all components of money supply and domestic credit have been on the rise, the trend has been gradual and stable. This has been the underlying factor for the limited inflationary pressure arising from the demand side as well as the fact that the credit expansion is a reflection of the fact that the economy’s sustained recovery is gaining traction on account of the credit demand for both capacity utilisation and expansion. Between November 2012 and March of this year, expansion in currency and demand deposits (M1) was about four times the expansion in each of the components of money and quasi money (M2) and broad money (M3). However, broad money (M3) was almost flat, growing at less than 1 per cent, as activity picked in the period subsequent to the March 2013 elections, signalling end of uncertainty in the domestic economy, all components of money supply grew at a relatively faster rate. In terms of the composition, during the first five months of 2013 there was evident





domination of broad money (M3) accounting for 44.3 per cent of total money supply with currency and demand deposits (M1) accounting for 18.2 per cent.

Figure 16: Money Supply (KES billion)



Source: CBK

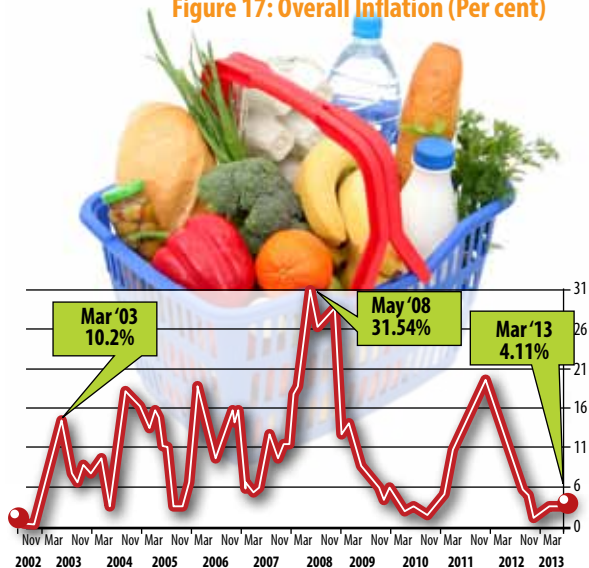
Inflation

The accommodative monetary policy stance that has been observed during the first half of the year is a reflection of the CBK's implicit argument that inflationary expectations have been contained within the target range. Such viewpoint could be driven by the fact that the economy's annual inflation has eased from its November 2011 peak, attained a trough in December 2012 and largely remaining with in the CBK's target range of 5 per cent [(+)(-) 2.5 percentage points] as seen in Figure 17. Even then, inflation seems to have assumed an upward trajectory especially during the second quarter of 2013. Even though the signalling of the CBK's Monetary Policy Committee in its decisions in regard to the Central Bank Rate (CBR) give the impressions that the upward trajectory is at the very worst mild, it certainly put to focus MPC Market Perception Survey of April 2013 that indicated that the macroeconomic environment remained stable hence the private sector expected lower inflation the rest



of the year. This is especially so given that by June 2013 there was an increase in inflation to a nine month peak. In addition, in June this year, inflation rose further attaining a nine months peak since October 2012.

Figure 17: Overall Inflation (Per cent)

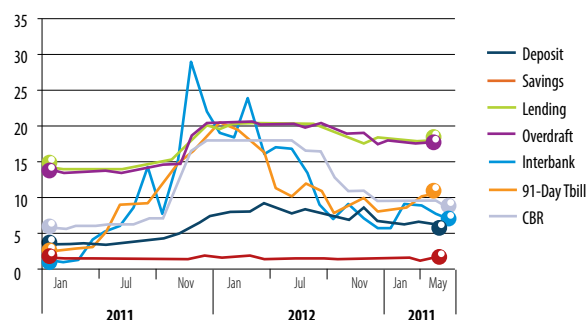


Source: KNBS

Interest Rates

While the CBR as a policy signalling rate was intended to signify the CBK's policy stance in view of the prevailing inflationary conditions and the inflation expectations, it was intended to be transmitted through the cost of credit. With the CBR signalling an accommodative monetary policy stance, a position that was confirmed by a further easing through a further reduction of 100 basis points in May 2013, the interest rate regime has generally been characterised by a general sense of stability, with a mildly declining stance (**Figure 18**). Although the 91-day Treasury Bill rates have edged up to surpass the CBR in the second quarter of 2013, the interbank rate has consistently been lower than the policy signalling rate for the entire half year; this reflects the liquidity adequacy in the money market but also signals that the market liquidity may be tightening.

Figure 18: Interest Rates (%)

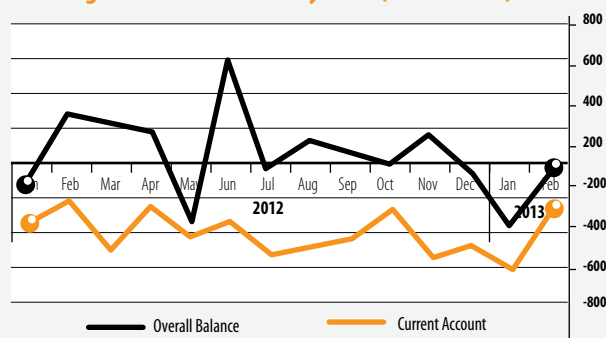


Source: CBK

Balance of Payments

The economy's balance of payment continued to be characterised by a weak current account position (**Figure 19**). This follows the weak export position on the back of the recession in the major export destinations as well as huge import demand, part of which necessitated by the investment requirements and part occasioned by the high prices of oil in the international market. While imports that go towards boosting the economy's productive capacity have positive medium term to long term effects, when combined with the imports meant for consumption, they tend to have the immediate effect of subjecting the local currency to depreciation pressure. The current account deficit as a proportion of GDP is currently estimated at over 10 percent.

Figure 19: Balance of Payment (USD million)



Source: CBK

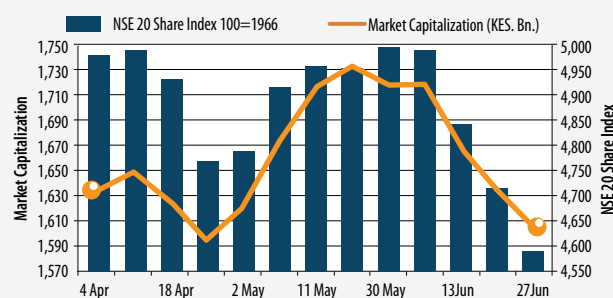
Exchange Rates

During the second quarter of 2013, the Kenyan shilling depreciated against major international currencies attaining the lowest points between the second and fourth weeks of June; the local unit however appreciated against the Ugandan shilling and Tanzanian shilling (Figure 20). The depreciation against the Japanese yen was however moderate compared to the rest of the currencies. Much of the depreciation was attributed to the weak current account position, with the extent of depreciation largely reflecting the demand and supply conditions for each respective currency.

Nairobi Securities Exchange

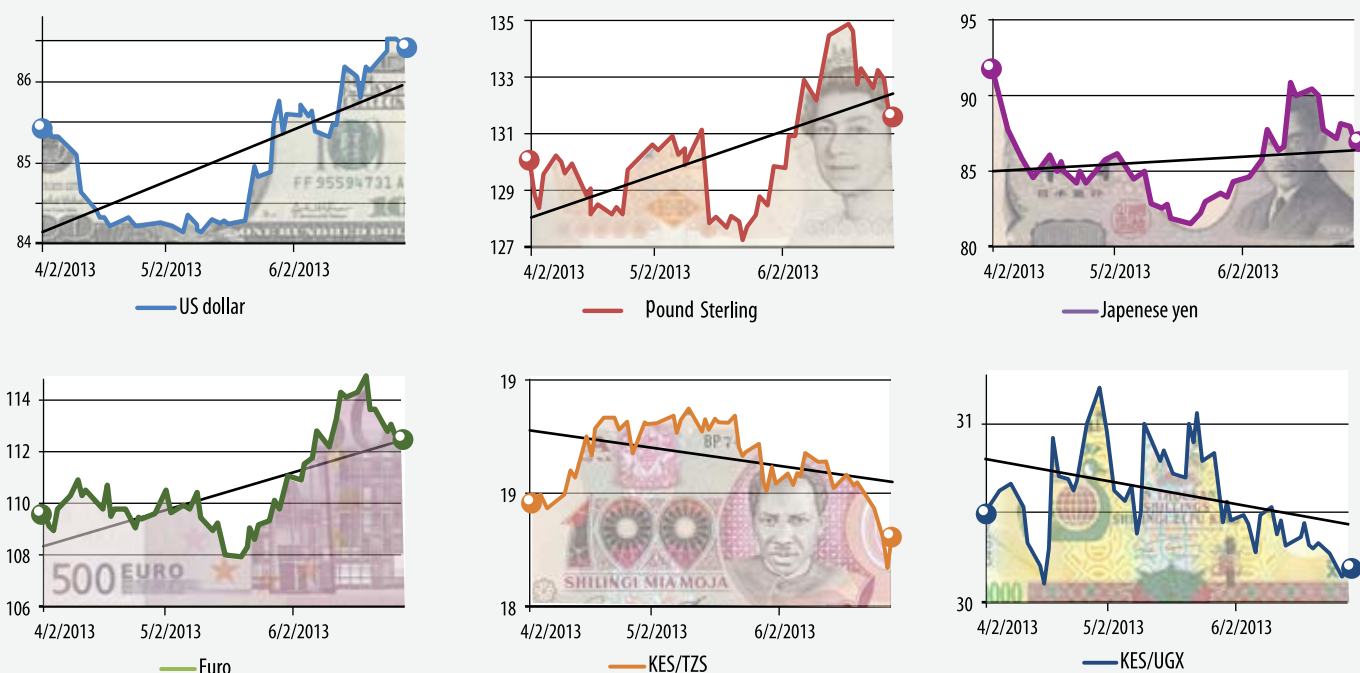
Activity at the Nairobi Securities Exchange (NSE) in the second quarter of 2013 was mixed (Figure 21), representing a departure from the first quarter when the bourse defied all odds and posted positive performance as the economy went through anxious times over the March 2013 general elections. Except for the first week of April, the decline in the NSE 20 share index was manifest in the remaining part of April and the whole of June. As the quarter came to an end, the NSE 20 share index ultimately hit a trough. The decline eroded the gains previously made in May 2013.

Figure 21: Nairobi Securities Exchange



Source: Central Bank of Kenya (CBK) weekly statistics

Figure 20: Exchange Rates



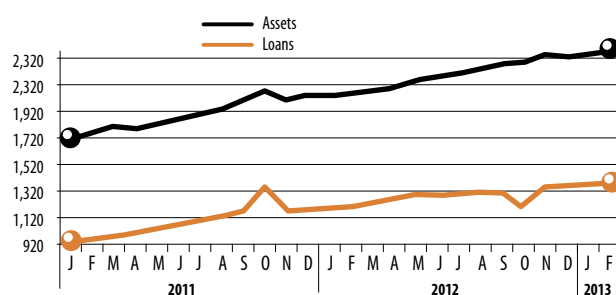


Banking Industry Performance

Performance of the banking sector has maintained an upward trajectory over the last two years to February this year. However, prior to December 2012 where growth was much fast with most rapid growth between January and October 2011, the rate of growth over the whole period continues to fall successively. As banks report their half year results, it is evident that the first quarter of 2013 was challenging, with lending being constrained by the uncertainties surrounding the general elections – especially regarding not just the outcome but also the post-election reaction to the outcome.

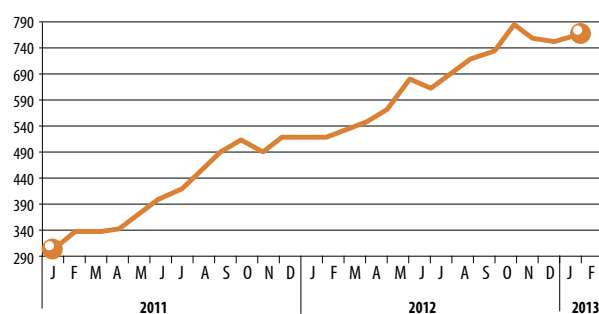
While much of the data available is for the first quarter of 2013, it is evident from the trickling-in results from a number of banks that the positive outcome of the elections and the bullish economic outlook that has been vindicated by a strong first quarter performance will bolster confidence in the industry to increase credit volumes. At the same time, the positive economic performance will help check the cost to the industry arising from the quality of the loan book given that the level of non-performing loans tend to rise when the economy is weak and the interest rate regime is unstable or on an upward trajectory. The trend of the key indicators of the banking industry's performance up to early 2013 is shown in Figures 22, 23, 24, 25 and 26.

Figure 22: Bank Assets and Loans (KES billion)



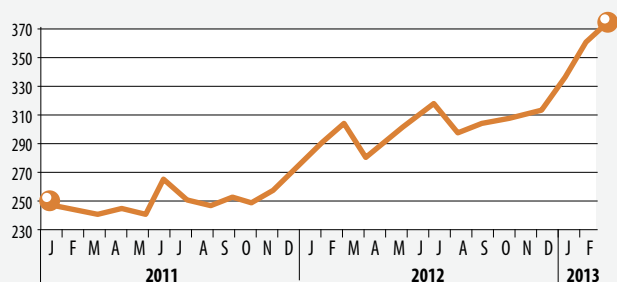
Source: CBK

Figure 23: Bank Deposits (KES billion)



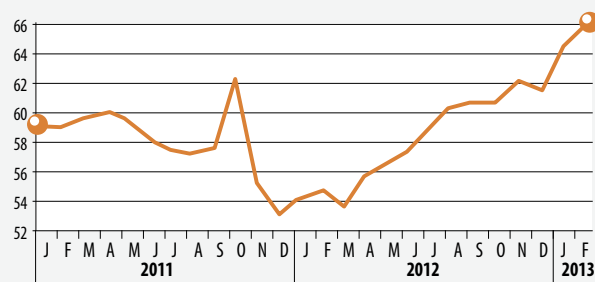
Source: CBK

Figure 24: Bank Capital (KES billion)



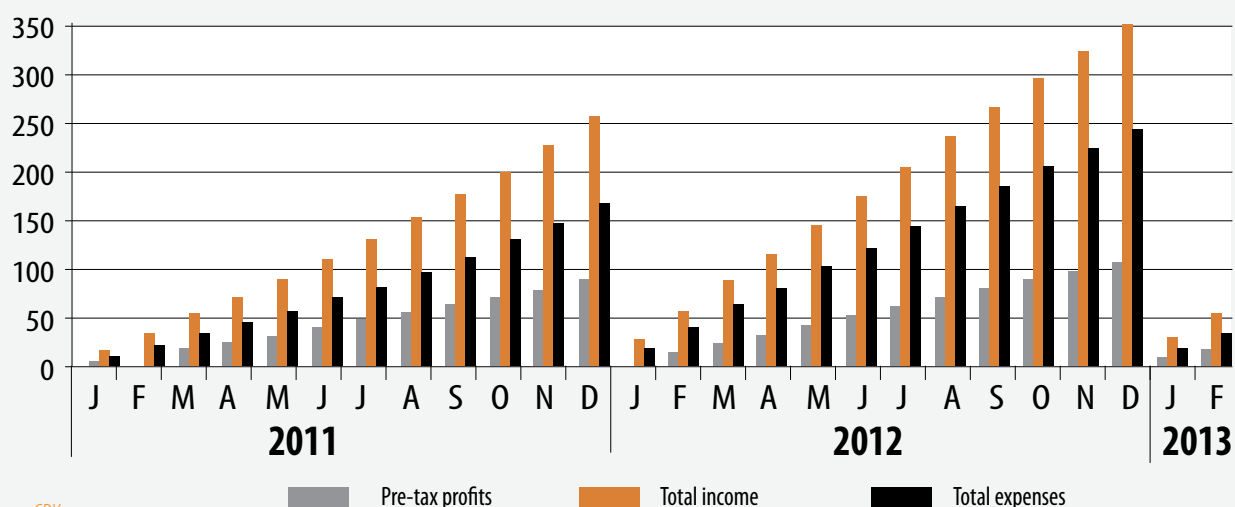
Source: CBK

Figure 25: Bank Gross Non-Performing Loans (KES billion)



Source: CBK

Figure 26: Bank Profitability (KES billion)



Source: CBK



Developing a pool of credible borrower information in order to

- » Increase access to affordable credit
- » Enhance credit risk management among lenders
- » Improve the loan repayment culture among borrowers



“last year my loan application was declined... learning my credit score helped me reorganise my finances. I now have an approval”

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Easier access to credit can enable individuals and businesses take advantage of opportunities. Customers with good credit histories (including those that make an effort to improve theirs) will benefit from a favorable credit report. They will use their good credit scores to negotiate for better credit terms such as lower interest rates, reduced collateral requirements, and flexible loan repayment periods. KCISI is working for the interests of customers who repay their credit on time.

For the Lender . . .

Lenders providing credit in Kenya need to remain sustainable in a very competitive environment. Having access to comprehensive information allows them to make informed credit risk assessments. KCISI upholds the sharing of full-file credit information (i.e., providing data on both a customer's timely payments and default/late payments) that enables credit providers to:

- Assess the true creditworthiness of potential and existing customers
- Control losses that come from bad debts
- Avoid lending to over indebted borrowers

For the Economy . . .

A financial system that functions well is good for the economy. A reduction in costs of obtaining information helps the financial system to mobilize savings and facilitates trade and allocation of capital. This helps to foster growth and innovation. KCISI promotes sharing of comprehensive credit information to improve financial intermediation in Kenya.

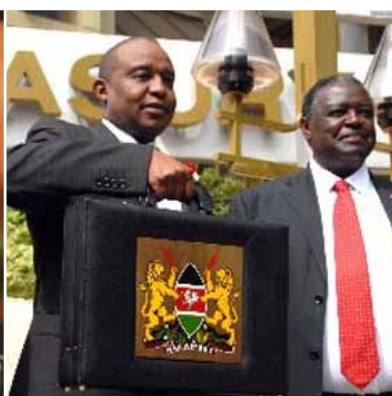
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