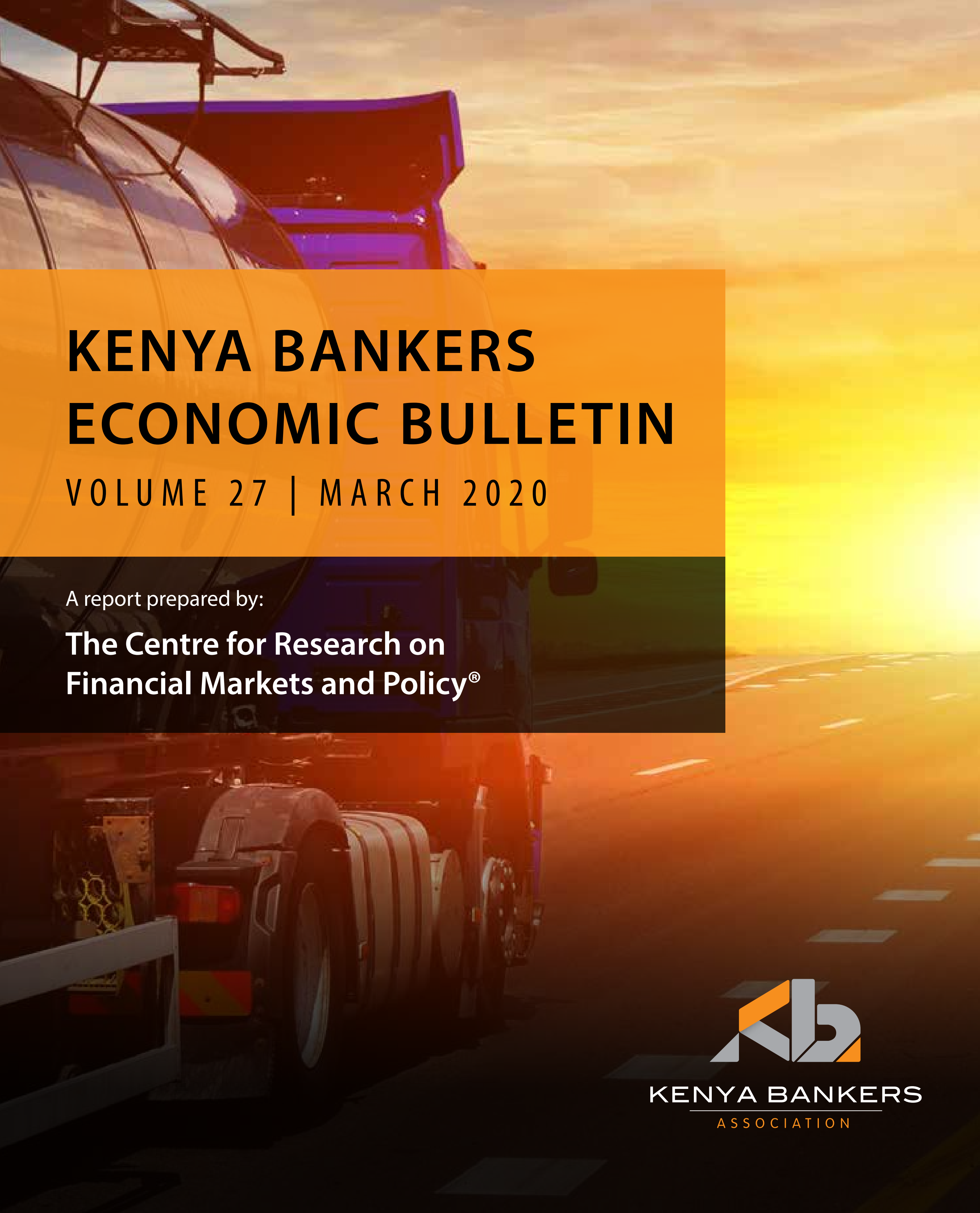

KENYA BANKERS ECONOMIC BULLETIN

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A report prepared by:

The Centre for Research on Financial Markets and Policy®

KENYA BANKERS ASSOCIATION

CENTRE FOR RESEARCH ON
FINANCIAL MARKETS AND POLICY®

About this Report

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

About the Centre for Research on Financial Markets and Policy®

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

CENTRE FOR RESEARCH ON
FINANCIAL MARKETS AND POLICY®

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FOREWORD

From the CEO's Desk

It is my pleasure to present to you the 27th issue of the *Kenya Bankers Economic Bulletin*. This is the first issue for 2020. The *Bulletin* is being issued at a time when the economy, like almost every other economy in the world, is staring at a possible drastic slowdown.

While a section of the *Bulletin* gives highlights of the performance of the economy for the period ending December 2019 and the current market developments it offers a compressive commentary on the expectations for the year 2020 on the back of the COVID 19 pandemic. It is my hope that he Bulletin offers insights meant to support readers' near-term perspectives on how the economic circumstances are likely to evolve going forward.

For avoidance of any doubt, the COVID-19 has presented us with unprecedented economic challenges that not only require partnerships and creative interventions, it also tests the structures, institutions and linkages of economic systems. That is why the *Bulletin's* main commentary argues a case for trading growth discussions for a discourse on survival.

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

Dr. Habil Olaka
Chief Executive Officer,
Kenya Bankers Association

COMMENTARY

The Quick Shift: From Growth Concerns to Survival Strategies

By Jared Osoro

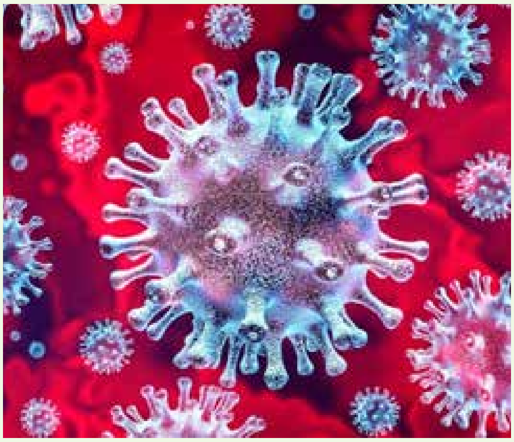
In less than one month, there has been a quick shift from discussions on the possible slowdown in economic growth to deep reflections on economic survival. The outlook of the Kenya Bankers Association Economic Bulletin of December 2019 was downward leaning. Then, our concerns were, on the one hand, a weak global economy and on the other a local economy with an evident disconnect between rosy headline growth numbers and weak demand at household and enterprise level.

The negative outlook was validated by the invasion of locusts at the beginning of 2020, meaning an obvious interruption in agriculture performance and its attendant challenges of food supply. With agriculture accounting for more than 30 percent of Kenya's output, any hit on production and distribution goes directly to denting overall economic performance.

Now we have a new concern. With the entry of the COVID-19 (coronavirus), locusts have disappeared, not in the literal sense but only from the conversation. It is now evident that the COVID-19, whose epicenter was initially in China, is now a global pandemic. The measures that have so far been put in place by various authorities have correctly put health considerations and the control of the epidemic ahead of any short-run economic considerations.

“ With the entry of the COVID-19 (coronavirus), locusts have disappeared, not in the literal sense but only from the conversation. It is now evident that the COVID-19, whose epicenter was initially in China, is now a global pandemic.

That is not to say that there is no recognition that there are potentially substantial economic costs associated with the disruptions associated with the pandemic; far from it. At business levels, the transmission channels of such costs need to be understood so that appropriate remedial proposals are formulated to help minimize such costs. That is imperative as it is a precursor to the determination of what kind of support, policy and financial, would be necessary to obviate any damage.



Finance – one of the lines of defense?

Fully appreciating that the COVID-19 is foremost a health pandemic, finance is still at the center of supporting the entire medical chain – in some cases the setting up of temporary medical infrastructure. At the next level, finance being at the center of all transactions by the various economic agents – firms, households and the Government - the effect of the COVID-19 will be felt across the economic system.

Parallels have been drawn between the likely effect of the coronavirus pandemic and the global financial crisis of 2007 – 2008. While the latter largely manifested itself as a demand problem – hence the remedial measures leaning heavily towards the nonconventional monetary policy in the form of Quantitative Easing (QE) accompanied financial regulation measures – the former has three dimensions that necessitate creative remedial measures. Like the global financial crisis, it has a demand angle; but it has important differences in that it has a supply angle and a confidence angle to it.

How does it play out? First, disruptions in supply chains will limit international trade activities. Enterprises will potentially run out of supplies or experience delayed deliveries, thus affecting their ability to meet the obligations with banks. Then there is the link between international trade delays and a slowdown in infrastructure projects which consequently elevates credit risk across the board.

Kenyan Crude oil arrives by truck at the Kenya Pipeline Corporation in Nairobi where it will be piped to the port of Mombasa for export, this within the backdrop of falling global crude prices.

Further, restrictions will affect spending power, affecting sectors such as tourism. At the same time, reduced transactions by foreigners mean reduced foreign exchange earnings to the economy. Even remittances, a major source of foreign exchange earnings, will be affected by the likelihood of the COVID-19 pandemic leading to a global recession. Cancellation of business-related travels may have a link to reduced future foreign direct investments (FDI).

At the local level, the imminent effect on the key sectors of the economy especially manufacturing, transport, and trade affecting their creditworthiness. The highest risk leans towards micro small and medium enterprises (MSMEs). With businesses operating sub-optimally as they face possible cash crunches, there will be an obvious effect of job redundancies; this will have an implication on those individuals that have obligations with banks.

Besides redundancies, the unique aspect of the coronavirus shock to the labour supply is the fact that it is a health pandemic that necessitates quarantines that may mean workplaces shut entirely. The demand-supply angles here are that sick people will not be available for work, nor do they go out or buy goods like under normal times. This means that labour market normalcy is possible only when the outbreak has been contained.

Then what awaits us?

First, the Coronavirus pandemic is a shock to the global economic system that is arguably likely to be more severe than the global financial crisis of 2007-08. Significant negative market movements at the international and local level are an obvious reaction to the adverse news. Major central banks have made demand-side policy responses and fiscal resources in advanced economies are being deployed in support.

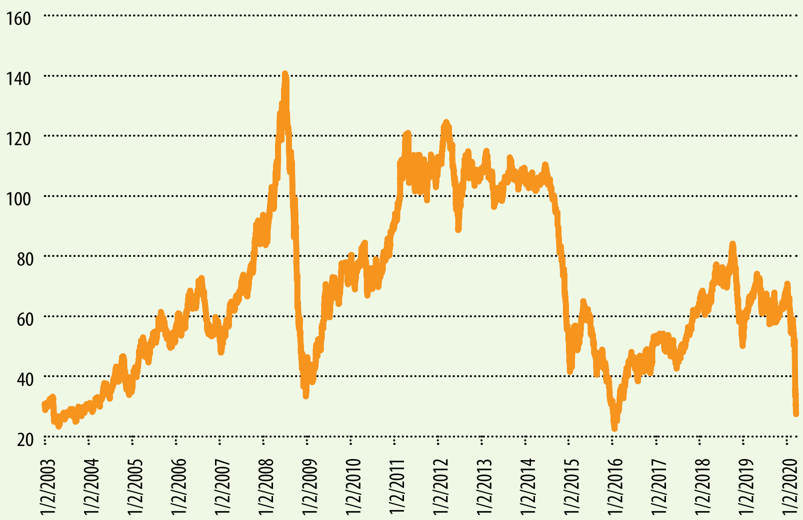
The anticipated weak demand, coupled with differences in strategy on quantity by major oil producers, has seen the oil prices drastically decline to the levels last seen in 2002, 2009 and 2016 (**Figure 1**). All these points to a potential global recession. Unlike the global economic slowdown of 2007-08 when some markets – especially emerging markets –

sustained good growth, there is a possibility of a synchronized slowdown amongst developed, emerging and developing markets.

Second, the immediate impact to economies such as Kenya may seem limited; but the implications are potentially dire. Disruption of travel will affect key sectors such as tourism. The momentum of FDI growth may wane. Trade (both exports and imports) will be disrupted, and so will global financial resource flows. The Kenyan banking industry is keenly watching and evaluating the risks it can take on board while supporting its existing clients. Already some initial measures have been put in place by the banks and the Central Bank of Kenya (CBK)[1].

The pandemic will slow credit uptake, a situation where low demand will be matched by credit supply that is keen on mitigating emergent global risks. This is at a time when the

Figure 1:
Daily OPEC Basket Prices *(US$/Barrel)*

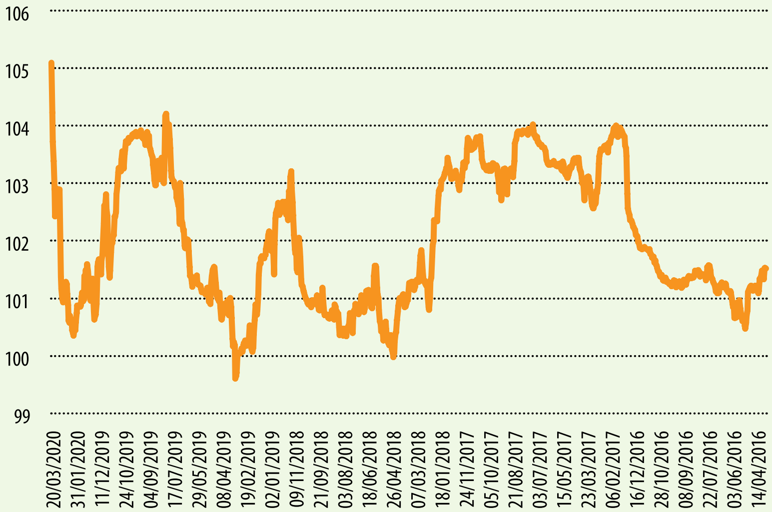


Source: OPEC Data

A raft of measures have been pronounced to bail out the economy

1. See https://www.centralbank.go.ke/uploads/press_releases/1908080057_Press%20Release%20-%20Emergency%20Measures%20to%20Mitigate%20the%20Adverse%20Economic%20Effects%20on%20Bank%2 Borrowers%20from%20the%20Coronavirus%20Pandemic.pdf

Figure 2:
Nominal Exchange Rate *(KES/US$)*



Source: Central Bank of Kenya

economy was gearing to put in place measures to spur private sector credit after a three-year slump during the interest rates capping period. Noteworthy, the quality of the banking industry loan book – presently an issue of concern – will be adversely affected.

As we critically ponder on the possible remedial measures to put in place to manage the emergent shocks, it would be instructive to take a nuanced view of some of the measures taken elsewhere. As already noted, major global central banks have moved to lower interest rates. Those economies have very low – in instances – negative inflation; in our case, the shortages that may arise from the supply side could lead to inflationary pressure.

The justifiable effort to boost foreign currency reserves through the market amidst a weak external environment could lead to demand pressure and a weakening (not necessarily a volatile) local currency. Already the currency is yielding to pressure arising from the CBK's move on foreign currency reserves as well as anxious investors exiting the local equities and fixed income markets (Figure 2). There is no telling how far this will go, but if sustained the ramifications are serious.

If monetary measures as could be put in place by banks and the CBK are the second line of defense – of course, the first being medical interventions – there obviously need to be complementing measures. Monetary policy alone cannot do it. Fiscal measures will definitely be needed even amidst the stated policy of fiscal consolidation that the government has embarked on.

For both the workers and MSMEs, the government would consider designing support programmes to complement the remedial restructuring by banks. Acknowledging its budgetary constraints and bearing in mind its medium-term fiscal targets under the fiscal consolidation stance, the government can apply as appropriate measures that other countries have used under similar circumstances: tax breaks; rental and tax rebates for commercial property; tax credits for SMEs whose turnover drops beyond a certain threshold.

“ The justifiable effort to boost foreign currency reserves through the market amidst a weak external environment could lead to demand pressure and a weakening (not necessarily a volatile) local currency.

Any silver linings?

It is clear that in these circumstances, there is hardly any scope to see how the economic outlook will be anything than negative. When the international markets are at zero or even negative interest rates territory, we ordinarily expect portfolio flows in search of yield. These are not ordinary circumstances. If the recent reaction is anything to go by, then investors are inclined to safety than returns. Equally, there is little possibility of the low oil price being a boon given that production, travel, even consumption is limited by the circumstances occasioned by the COVID-19 pandemic.

It's noteworthy too that the medical and pharmaceutical industry will have to look outward for supplies to address the pandemic. The conundrum is that the supply logistics are disrupted. The broadly weak global economy makes the situation worse since the economy relies substantially on

Figure 3:
Diaspora Remittances - FX Reserve Accumulation

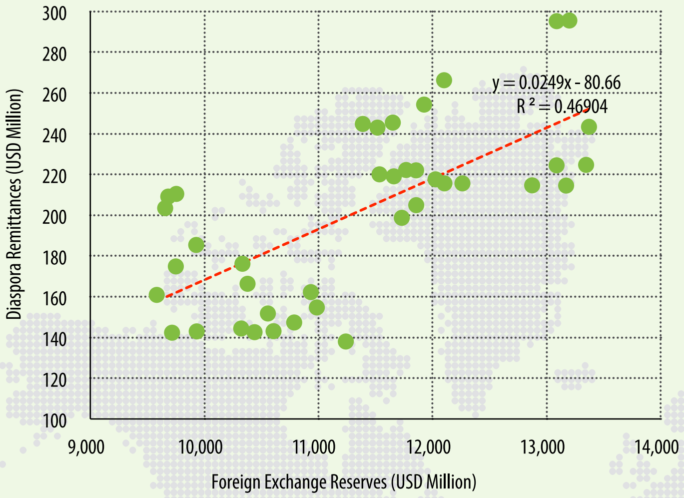


Figure 4:
Exports- FX Reserve Accumulation

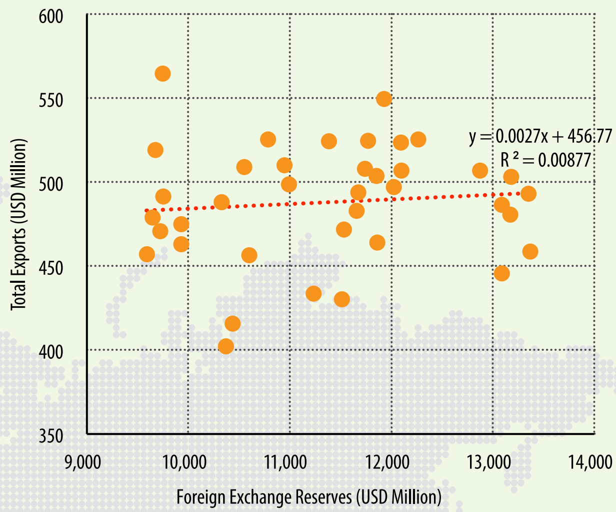


Figure 5:
Nominal Exchange Rate- FX Reserve Accumulation

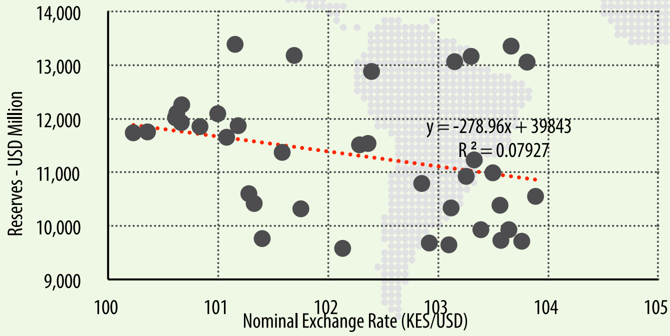
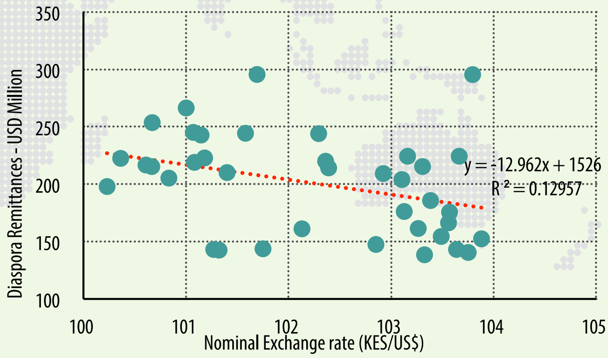


Figure 6:
Diaspora Remittances - Nominal Exchange Rate



remittances for its foreign currency reserves more than it does on exports (**Figures 3 and 4**), hence the respective extent of association to foreign currency reserves.

Given the association between reserves and nominal exchange rate on the one hand (**Figure 5 and 6**) and the remittances and nominal exchange rate on the other, there is every reason to hold our breaths and hope for the pandemic to see its end soon. But hope is not a forecast. We can only trade growth for survival if our diagnosis of the current circumstances is to be considered credible.

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

During the third quarter, the economy grew at 5.1 percent compared to 5.6 percent growth it registered the second quarter of 2019 (Figure 7). The slowdown in economic activity was as a result of the synchronized slowdown in most of the sectors especially the agricultural, industrial and services output (Figure 8).

During the quarter, the agricultural output grew by 3.2 percent compared to 6.9 percent growth in the same quarter in 2018. It was further driven by slower industrial and services growth with the manufacturing sector grew by 3.1 percent. Nonetheless, the growth was supported by higher activity in the mining and quarrying sector (4.3 percent), financial and insurance sector (5.6 percent) and real estate sector (4.9 percent).

While the economy is growing at a rate that could be characterised as strong, a tight fiscal policy limits the scope for fiscal programmes to continue being a growth driver as fiscal consolidation becomes a priority providing some scope for monetary policy to support growth.

Figure 7:
Output Growth – 2009 Base Year *(Percentage)*

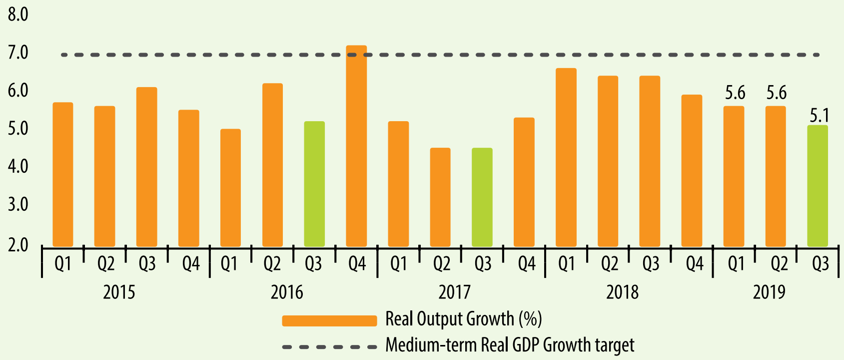
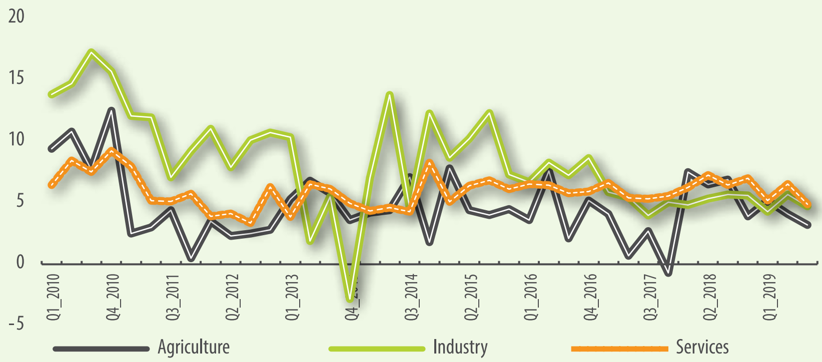


Figure 8:
Sectoral Output Growth *(Percentage)*



Inflation is stable and within the target, albeit with signs of upward bias. The annual average inflation declined by 0.04 percentage points from 5.24 percent in September to 5.2 percent in December 2019. However, the 12-month inflation rose from 3.83 percent to 5.82 percent over the same period (**Figure 9**) but remains within the CBK's target range of 5 ± 2.5 percent.

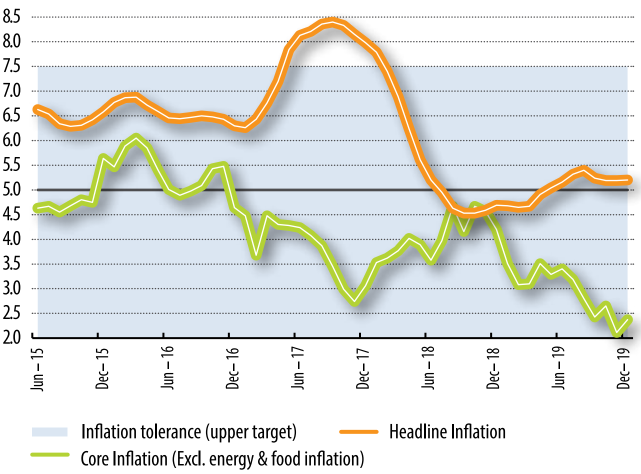
Non-food-non-fuel (NFNF) also remained below 5 percent indicative of muted demand pressures. Food inflation rose to 9.3 percent in December 2019 from 8.9 percent in November, reflecting increases in food prices, particularly non-vegetable crops driven by higher prices of maize grain and sifted flour. On the other side, fuel inflation has remained low partly due to relatively stable international oil prices.

The money market rates have been characterised by broad stability (**Figure 10**) with monetary policy being accommodative with the central bank rate being reduced by 0.5 percentage points from 9.0 percent in September to 8.5 percent in November 2019. The reduction being justified on the observation that inflation expectations were well anchored, and is within the government's target range.

Both the interbank market and short-term government securities rates trended upwards suggesting a tightening of market liquidity. The interbank market rate rose from 6.59 percent in September to 6.86 percent in October and declined to 4.2 percent in November but edged up to 6.0 percent in December 2019. Similarly, the average yield rate for short-term government securities was also on the rise. The 91-day Treasury bill rate rose from 6.6 percent in September to 7.2 percent in December. A similar trend chacterised the 182-day Treasury bill rate having arisen from 7.34 percent to 8 percent over the same period.

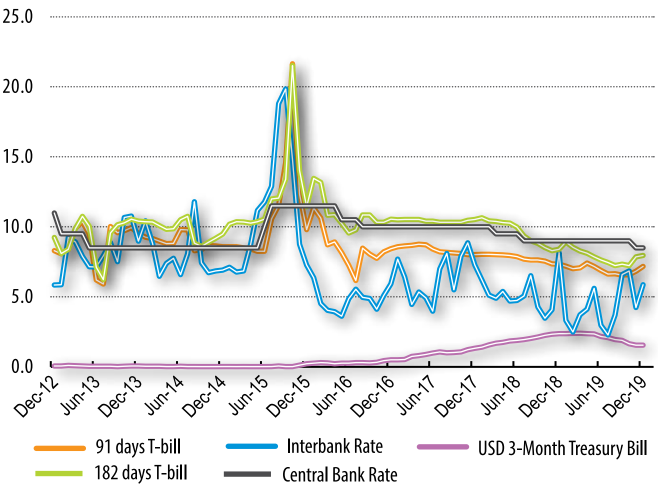
Private sector credit grew by 7.1 percent in the 12 months to December 2019, supported by strong growth in the manufacturing, trade, transport and communication and consumer durables sectors. Further, the lending to the public sector exceeds credit to the private sector, albeit with signs of a decline in public sector credit. The revival of private sector growth must be seen in the light of both the supply and demand-side interactions. Whereas the supply-side may be willing to provide credit, the demand side remains weak.

Figure 9:
Inflation Rates: Consumer Prices *(Percentage)*



Source: KNBS

Figure 10:
Evolution of Short-term Securities, Interbank Rate and Central Bank Rate *(Percentage)*



Source: CBK

The current account deficit continued to narrow in 2019 reflecting the reduction in imports of machinery and transport equipment, particularly SGR-related equipment, and supported by higher remittance inflows arising from reduced costs as banks leverage on technology, resilient exports of goods and services.

The Kenya Shilling, albeit stable was characterised mixed performance with the shilling appreciating by 0.75 percent against the US dollar, 0.50 percent against the Euro, 1.32 percent against the Japanese Yen (JPY), and 0.28 percent against the Chinese Yuan, however, it depreciated by 1.20 percent against the Sterling Pound. On the regional front, the shilling depreciated by 0.12 percent against the South African Rand and by 0.74 percent against the Tanzanian shilling and Ugandan shilling. Overall, the stability of the exchange rate follows a narrowing of the current account deficit, increased diaspora remittances, reduced imports bill and a modest increase in exports.

The equities market was on a recovery mode as reflected in the performance of three key aggregate market indicators - NSE 20 Share Index, Equity Turnover and Market Capitalization. The NASI index rose by 6.5 percent quarter-on-quarter, the NSE-25 share index edged up by 8.1 percent and the NSE-20 share index increased by 2.9 percent. Similarly, the number of shares traded increased by 16.9 percent while the equities turnover and market capitalization increased by 31.7 and 7.4 percent respectively.

The banking sector remains stable and resilient with the average commercial banks' liquidity and capital adequacy ratios standing at 49.7 percent and 18.8 percent, respectively, in December 2019. The ratio of gross non-performing loans (NPLs) to gross loans declined further to 12.0 percent in December from 12.3 percent in October 2019. There were decreases in NPLs in the trade, real estate, financial services, manufacturing and personal/household sectors reflecting repayments due to enhanced recovery efforts by banks, as well as write-offs.

Sectoral Performance

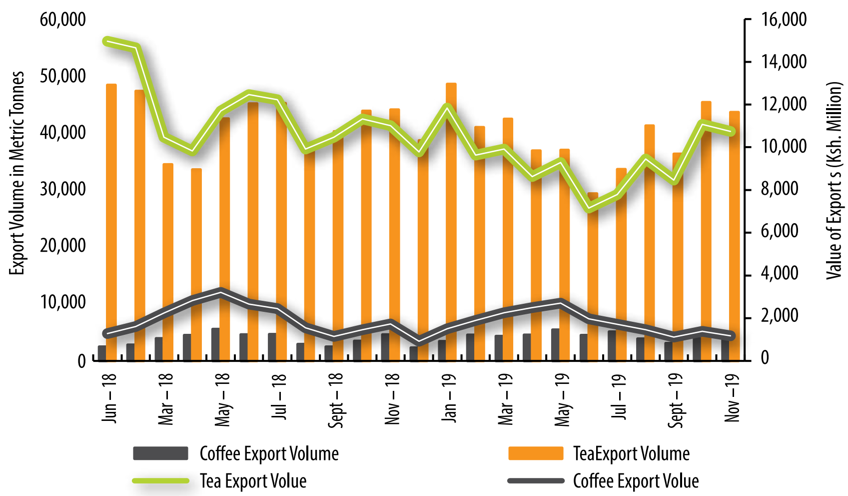
Agriculture, Kenya's largest economic sector in recent quarters has been contracting due to its vulnerability to the erratic weather conditions. Whereas the sector's output growth has been shrinking, this has been accompanied by synchronised slow down in the industrial and services sector.

Agriculture

During the third quarter of 2019, the sector registered a 3.2 percent growth compared to a 6.4 percent growth in the same period in 2018. The slow down was inpart due to a decline in the production of tea and the easing of agricultural export prices. In particular, the production of tea declined by 9.6 per cent but was supported by a 19.8 percent increase in coffee production. In addition, it was also supported by a 10.6 percent rise in the volume of cut flowers and a 15.8 percent rise in the milk deliveries.

The export of tea and coffee during the fourth quarter of 2019 was modest (**Figure 11**) compared to that of the previous quarter. The quantity of produced tea increased from 35,533.31 MT in September 2019 to 46,305.41 MT in October 2019 while the quantity of coffee auctioned at the Nairobi Coffee Exchange in November 2019 was 1,116.76 MT.

Figure 11:
Tea and Coffee Exports Performance *(Metric Tonnes)*



similarly, the price of processed tea edged up from Kshs. 229.32 in September 2019 per kilogram to Kshs. 241.62 in October 2019 while the average auction price stood at Kshs. 331.71 per kilogram in November 2019.

The horticultural exports performance was mixed (**Figure 12**) with the quantity of cut-flower exported on the rise. In September 2019 the value of cut-flowers exported was 14,157.26 Metric Tonnes fetching a Kshs.s. 6,611.52 million. However, the export of both vegetables and fruits declined. In September the volume of vegetable exports decreased from 5,312.26 MT in August 2019 to 5,061.47 MT in September 2019 with the value of the exports declining from Kshs.s. 2,173.38 million to Kshs.s. 1,679.77 million during the same period.

Exports of fruits similarly declined from 6,408.57 MT in August 2019 to 4,035.10 MT in September 2019 with the value of the exports declining by two-fold from Kshs.s. 1,158.65 million to Kshs.s. 522.03 million during the same period.

Manufacturing

Growth in the manufacturing sector, a key pillar in the government's Big 4 agenda, contracted by 1.5 percentage points from 4.6 percent in the third quarter of 2018 to 3.1 percent in the same period in 2019. The sector's outlook was constrained by a decline in the food and non-food products, particularly the production of cement, manufacture of galvanized iron sheets, manufacture of sugar, processing of tea, processing and preservation of fish and manufacture of biscuits. Despite the slump, the positive outlook was supported by improved performance in the processing of grain mill products, manufacture of beer, and edible fats and margarine.

The quantity of cement produced decreased from 497,930 MT in October 2019 to 458,902 MT in November 2019 while its consumption rose from 479,177 MT in September 2019 to 492,670 MT in October 2019. Sugar production increased from 33,365 Metric tonnes in September 2019 to 35,259 Metric tonnes in October 2019 (**Figure 13**).

Similarly, milk uptake in the formal sector rose from 63.21 million litres in September 2019 to 68.30 million litres in October 2019. In addition, the production of galvanised sheets was also on the rise. In addition, the monthly lending to the sector has been rising (**Figure 14**) with the credit growing from 6.4 percent in October 2019 to 7.5 percent in November and further to 9.2 percent in December 2019.

Figure 12:
Horticultural Exports Performance *(Metric Tonnes)*

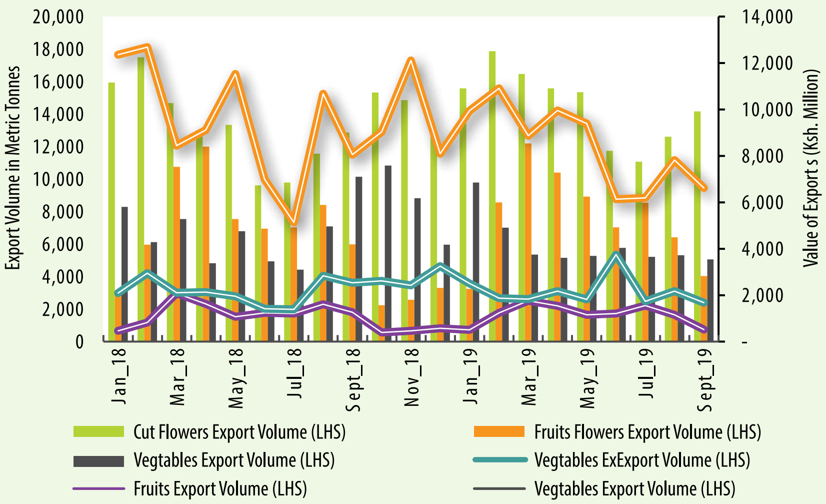
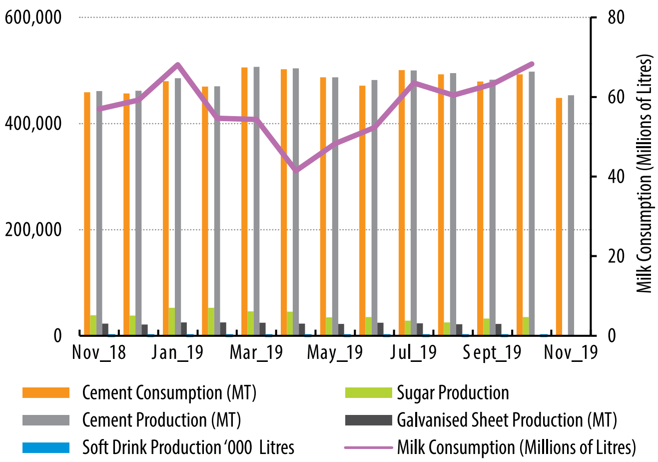
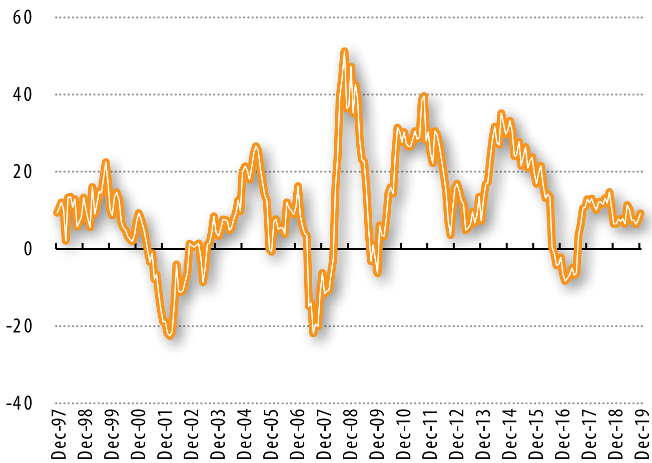


Figure 13:
Manufacturing Sector Leading Indicators *(Metric Tonnes)*



Source: KNBS

Figure 14:
Credit Distribution to the Manufacturing Sector *(Year-on-year Percentage change)*

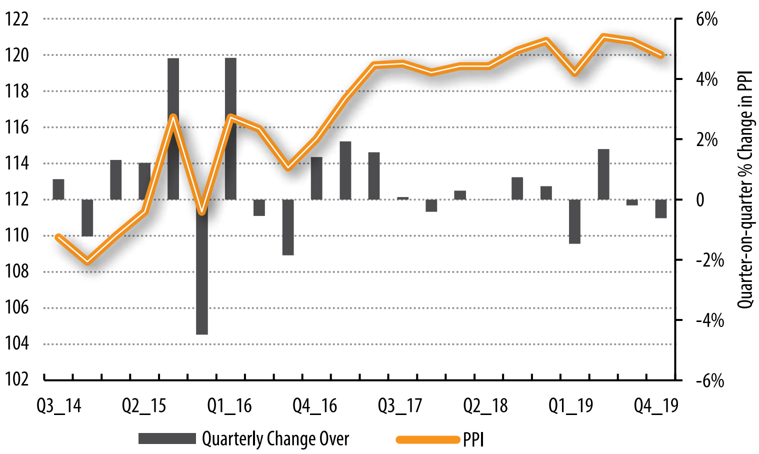


Source: CBK

Producer Price Index

The producer price index (PPI) decreased by 0.66 per cent from September 2019 to December 2019 (**Figure 15**) driven by the cost of electricity and manufacture of paper and paper products which declined at 6.4 per cent and 3.8 per cent from September 2019 to December 2019, respectively. However, during the same period, the highest increases were registered in mining and quarrying and in the manufacture of beverages at 10.1 per cent and 3.0 per cent, respectively.

Figure 15:
Producer Price Index and Percentage Changes *(Base Period June 2011=100)*



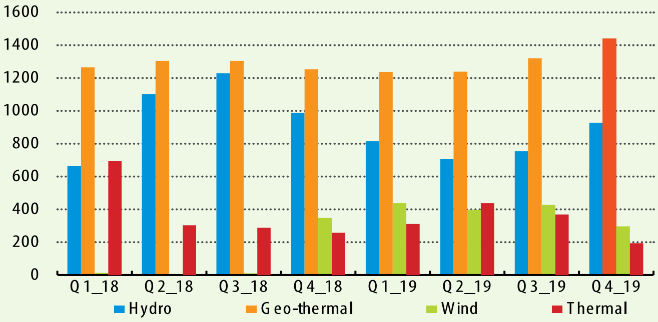
Energy

Energy is a critical component for industrial as well as domestic activity however the sector registered a depressed outlook having expanded at 4.9 percent in quarter three of 2019 compared to a 7.8 percent growth it registered over the same period in 2019.

The subdued outlook was driven that the negative outlook in the electricity sub-sector arising from insufficient rains during the second quarter of 2019. As a result, this necessitated the use of expensive thermal energy compared to cheaper hydro-electric generation sources. Consequently, the shift resulted in constrained growth of value-added for electricity generation. The total local electricity generation decreased from 965.42 million KWh in November 2019 to 940.40 million KWh in December 2019 with the geothermal electricity generation dominating followed by hydro-electricity generation and wind and lastly thermal (**Figure 16**).

During the quarter, the generation of hydro-electric power as a share of the total energy generated rose from 30.9 percent in quarter three to 36.2 percent in quarter four of 2019. Similarly, geothermal generation also rose marginally from 54 percent to 56.2 percent while thermal generation declined from 15.1 percent to 7.6 percent over the same period.

Figure 16:
Electricity Genertion by Source *(Million KWh)*



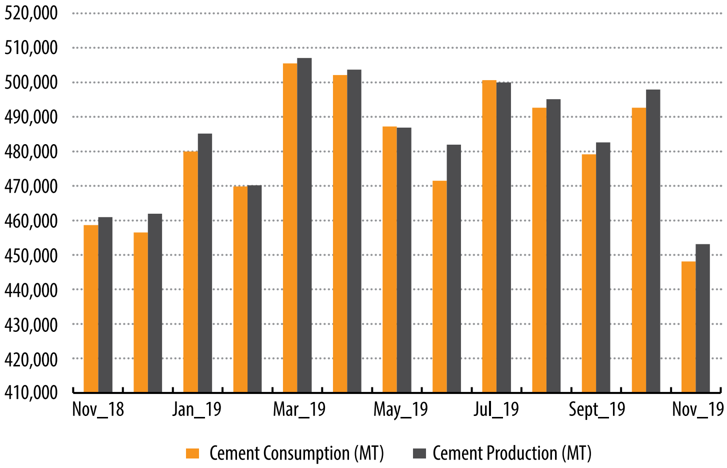
In the international market, the price of Murban crude oil increased from an average of US Dollars 60.88 per barrel in October 2019 to US Dollars 63.48 per barrel in November 2019. The national average domestic retail oil prices of motor gasoline premium dropped from Kshs. 110.99 per litre in November 2019 to Kshs. 109.91 in December 2019. The price of light diesel oil dropped from Kshs. 105.10 in November 2019 to retail at Kshs. 102.28 in December 2019. On the other hand, the average price for Kerosene dropped from Kshs. 104.53 to retail at Kshs. 102.81 in December 2019. The price of a 13-Kg cylinder of gas averaged Kshs. 2,101.16 in December 2019.

Table 1: Average Monthly Crude Oil and Retail Fuel Prices

	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec-19
Murban crude oil (US$/Barrel)	68.60	73.05	69.70	62.75	64.86	60.16	60.88	63.48	
Super petrol (KES/Litre)	107.57	112.79	115.82	116.14	111.7	113.57	108.83	110.99	109.91
Diesel (KES/Litre)	103.09	105.23	105.57	104.74	104.92	103.9	102.82	105.10	102.28
Kerosene (KES/Litre)	100.31	102.49	105.48	105.11	100.6	101.44	101.94	104.53	102.81
LPG (13Kgs)	2,184.85	2,193.17	2,192.25	2,171.47	2,150.27	2,141.31	2,124.79	2,100.88	2,101.16

Source: KNBS

Figure 17:
Cement Production and Consumption *(Metric Tonnes MT)*



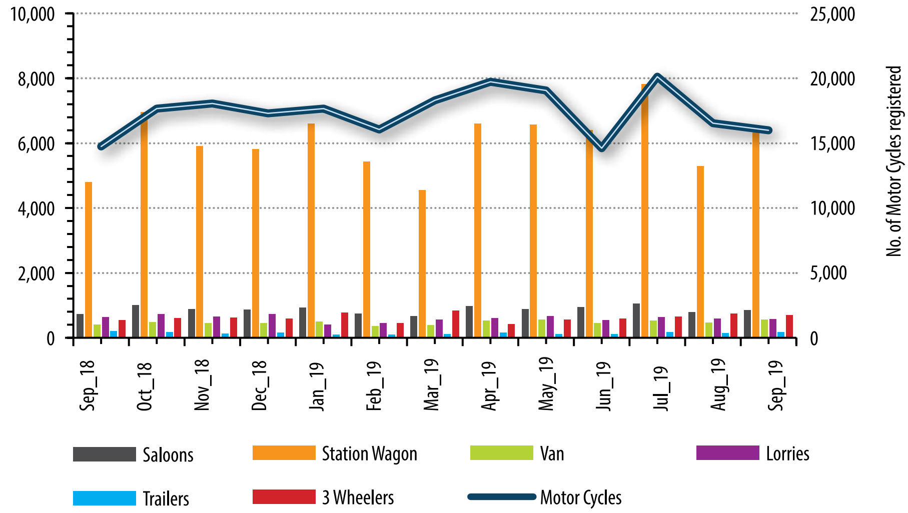
Building and Construction

The construction sector grew by 6.6 per cent in the third quarter of 2019 compared to 7.0 per cent growth recorded in the same period of 2018. The subdued outlook of the sector during the period spillover to quarter four of 2019 (**Figure 17**). The depressed growth of the sector was partly driven by the decline in cement production as it declined from 497,930 MT in October 2019 to 458,902 MT in November 2019. The contraction was further buttressed by the negative credit growth of 5.2 and 6.1 percent in October and November of 2019 before picking up to 1.6 percent. Nonetheless, the net negative credit growth for the quarter dampened the sector's output. However, modest growth was supported by the rise in consumption of cement from 479,177 MT in September 2019 to 492,670 MT in October 2019.

Transport and Communication

In the third quarter of 2019, the transportation and Storage sector recorded a slower growth of 7.1 per cent compared to 9.0 per cent growth registered in the same period of 2018. This growth was supported by improvements in air transportation and road freight transportation that grew by 16.3 per cent and 4.3 per cent, respectively during 5 the quarter under review. Among the indicators of the sector, the total number of vehicles registered in September 2019 stood at 26,281 out of which 6,322 were Station Wagons (**Figure 18**) while the production of assembled vehicles increased from 603 units in September 2019 to 614 units in October 2019.

Figure 18:
Registration of New Vehicles *(Numbers)*



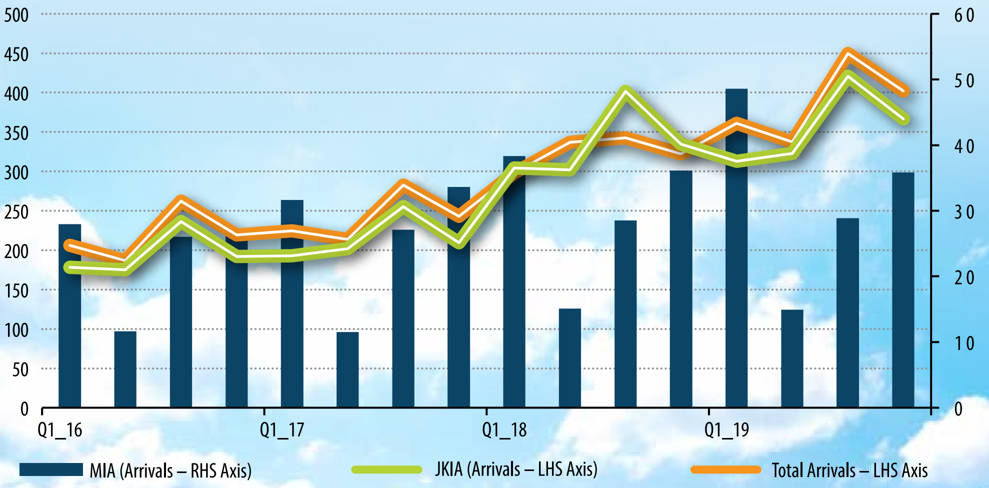
Tourism

Tourism is an important driver of growth for the Kenyan economy. Tourist arrivals through Jomo Kenyatta International Airport (JKIA) and Moi International Airport (MIA) in 2019 registered a substantial growth of 6.07% and 8.56% respectively compared with the overall growth of 1.167%. however, the other entry points registered a decline most significantly the land borders at -12.69% and an indication that air connectivity will continue to be a major driver for the growth of international arrivals.

During quarter four of 2019 however, the tourist arrivals during declined to 402 thousand from 405 thousand in quarter three of 2019. During quarter three the total number of visitors arriving through Jomo Kenyatta (JKIA) declined to 366 thousand from 421 thousand in quarter three. However, the arrivals through Moi International Airports (MIA) increased from 29 thousand persons in quarter three to 36 thousand in quarter four of 2019 **(Figure 19)**.

Land border entry points registered significant decline at -12.69% and an indication that air connectivity will continue to be a major driver for the growth of international arrivals.

Figure 19:
Trends in Tourist Arrivals by Port of Entry *(Thousands)*



Financing of Government

The fiscal space remains tight albeit easing in recent times. Nonetheless, the fiscal position continues to be constrained as expenditures and public debt levels remain elevated and domestic revenue collections constrained. A look at the sources of revenues, tax revenues accounts for over 90 percent, while the non-tax revenue accounts for less than 10 percent of the total revenue base (Figure 20).

Clearly, the high share of tax revenues is an indicator of its strong correlation with economic activity such that a reduction in revenues would be associated with softening of economic growth.

Disaggregating the tax revenue by source, income tax accounts for over 40 percent of the total tax revenues, underscoring its importance in funding government expenditures. With the income tax already saturated, this suggests that the government's ability to raise additional revenue is constrained and to contain the rising fiscal deficits it must cut back on its spending.

On the other hand, the Value added tax (VAT) accounts for less than 30 percent of the tax revenue with excise duty accounting for less than 15 percent. Import duty accounts for less than 10 percent while other tax incomes and non-tax revenues account for less than percent respectively (**Figure 21**).

On the expenditure side, the current expenses account for over 75 percent of the total spending and 15 percent of the spending is on development expenditure. Drilling into the components of current expenditure reveals over 30 percent is on wages and salaries, approximately 22.5 percent on domestic interest payments, 11 percent on foreign interest payments, with pensions accounting for less than 5 percent of the total current expenditure.

Figure 20:
Composition of Tax Revenues *(% Tax Revenues)*

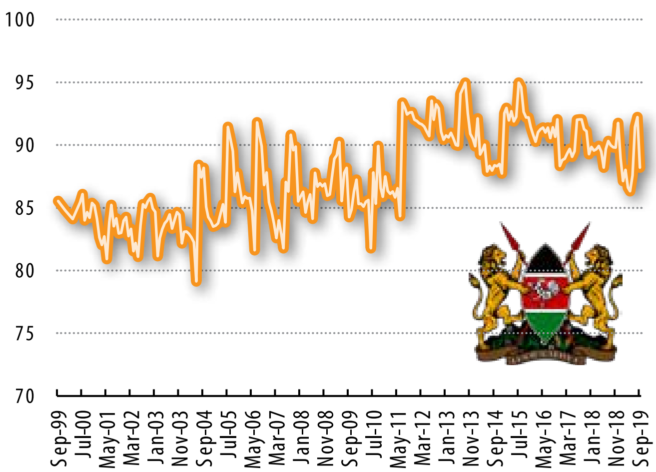


Figure 21:
Composition of Tax Revenues *(% Tax Revenues)*

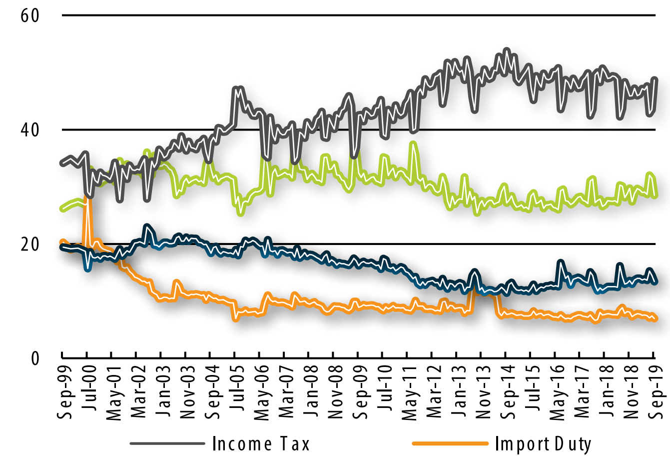
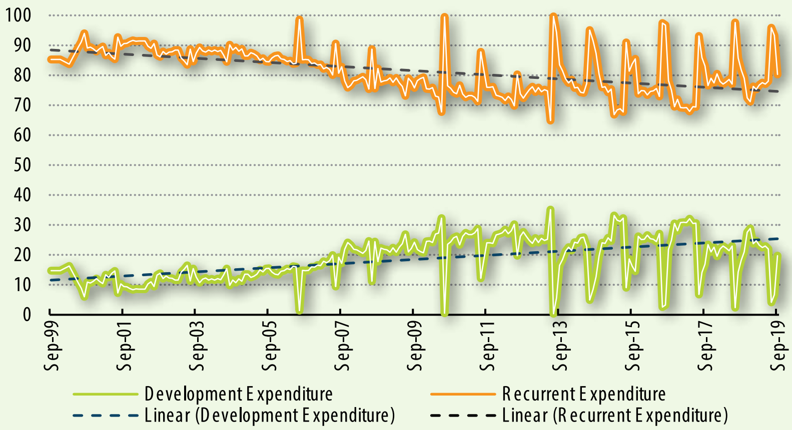


Figure 22:
Composition of Expenditures *(% of Total Expenditure)*



Public Debt

Kenya's public debt stock has increased but more importantly its debt composition and tenure. In recent years, the domestic debt and external debt composition stand at 50:50 ratio has declined from around 68 percent in 2000 to approximately 50 percent in 2019 (**Figure 23**). The external debt has tended to rely on expensive commercial debt rather than concessional debt. More importantly, the debt is being contracted from non-Paris Club creditors, notably China, raising concerns about debt transparency as well as debt collateralization.

On the domestic front, treasury bonds accounted for 64.19 percent of the total domestic debt while treasury bills accounted for 33.25 percent of the total domestic debt while overdrafts at the Central bank accounted for 2.39 percent of the total domestic debt. Similarly, advances from commercial banks and other domestic debt accounted for 0.12 percent and 0.04 percent of the total domestic debt respectively (**Figure 24**).

The growing debt-to-GDP has several implications. First, it could erode investor confidence, requiring the government to pay a rising risk premium on its debt. Second, reduces the effectiveness of the fiscal policy[1]. Specifically, high government debt can reduce the size of fiscal multipliers through the Ricardian channel[2] and investor sentiment channel[3]. Third, it slows growth and investment

1 See, for example Adam & Bevan (2005). *"Fiscal deficits and growth in developing countries".* Journal of public economics, 89(4), 571-597 and Debrun & Kinda, (2016). *"That squeezing feeling: the interest burden and public debt stabilization".* International Finance, 19(2), 147-178.

2 Under the Ricardian channel, a fiscal stimulus under a high debt scenario is likely to lead to a cut in consumption and higher saving (the "Ricardian" reaction to government dis-saving) as consumers expects taxes to increase than when debt is low.

3 Equally, under the investor sentiment channel, economies with higher sovereign debt are more likely to have to pay a risk premium to borrow as it increases creditors' concerns about sovereign credit risk and thus raising sovereign bond yields and, consequently the borrowing costs for the economy.

Figure 23:
Evolution of Domestic Debt Composition *(% of Total Domestic Debt)*

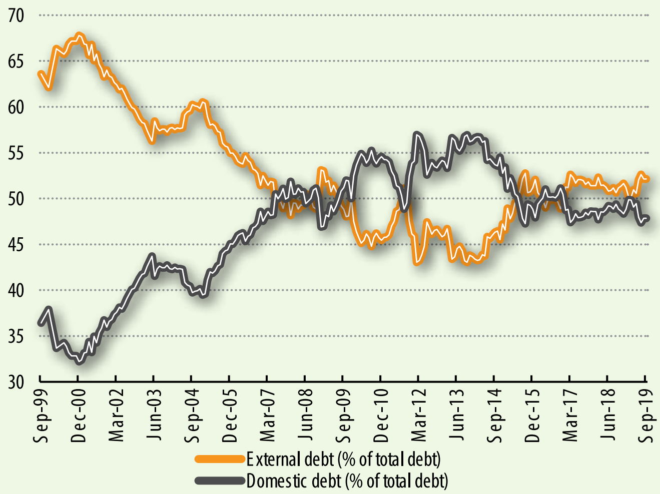
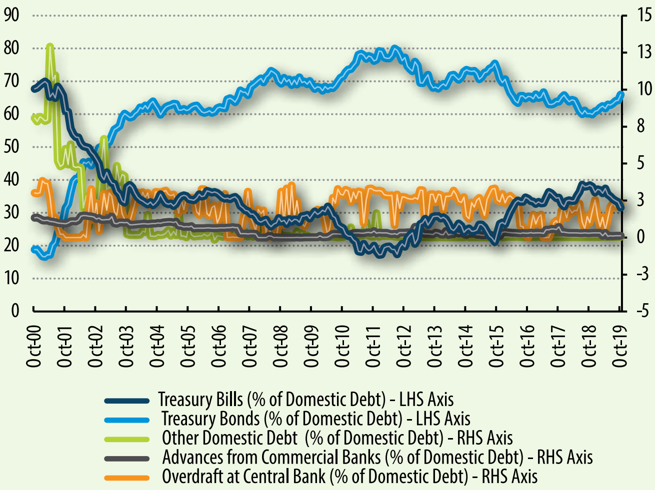


Figure 24:
Evolution of Domestic Debt Composition *(% of Total Domestic Debt)*



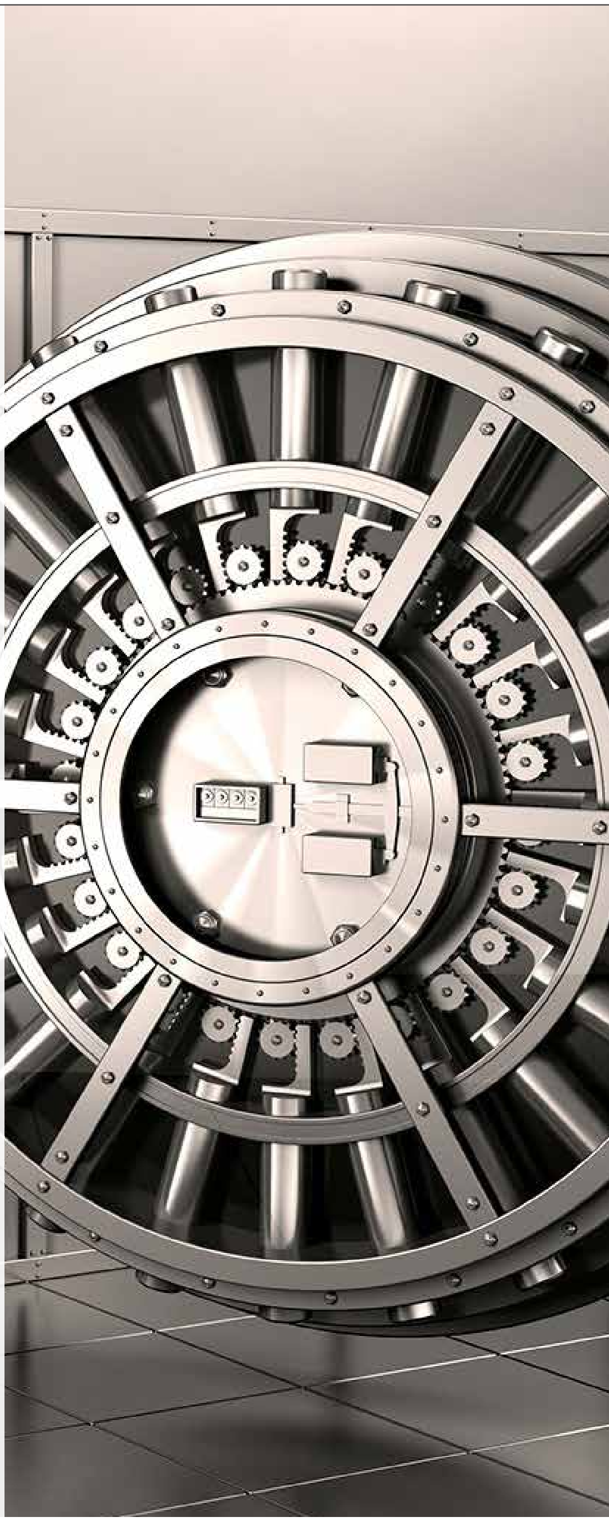


Figure 25:
Monetary Aggregates and its Components (*KES Millions*)

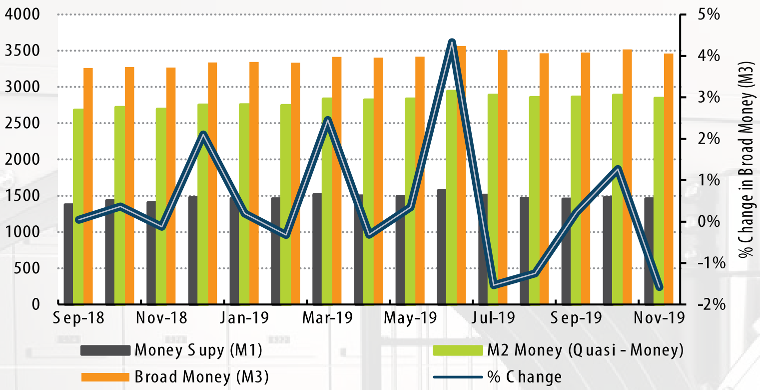


Figure 26:
Private Sector Growth Rate (*% Change*)

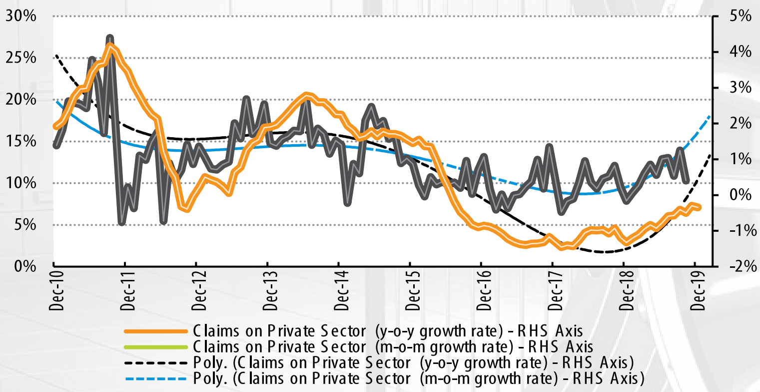
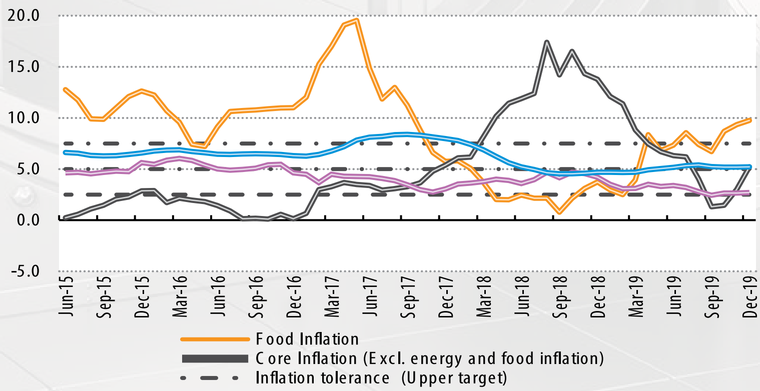


Figure 27:
Evolution of Inflation Rates and its Components (*Percentage*)



Money Supply and Domestic Credit

In the third and fourth quarter of 2019, the monetary aggregates, especially narrow money (M1), quasi money (M2) and broad money (M3), were on a modest decline (Figure 19). Broad money supply (M3), a key indicator for monetary policy formulation, decreased from Kshs. 3,517.54 million in October 2019 to Kshs. 3,461.98 million in November 2019.

On the other hand, the value of Gross Foreign Exchange Reserves decreased from Kshs. 1,376.12 billion in October 2019 to Kshs. 1,318.41 billion in November 2019 while the value of Net Foreign Exchange Reserves dropped from Kshs. 858.46 billion in October 2019 to 797.58 billion in November 2019.

The private sector credit is still trapped in a low equilibrium position (**Figure 26**) albeit growing by 7.1 percent in the 12 months to December 2019, supported by strong growth in the manufacturing, trade, transport and communication and consumer durables sectors. The revival of private sector growth must be seen in the light of both the supply and demand-side interactions. Whereas the supply-side may be willing to provide credit, the demand side remains weak as the economy is operating at excess capacity and household demand is weak. Further, the lending to the public sector exceeds credit to the private sector, albeit with signs of a decline as commercial bank's subscription of government securities slightly declined.

Inflation

Inflation has remained within the government of Kenya's target band of 5±2.5 percent (**Figure 27**), supported by low energy and food prices and a stable local currency. Overall inflation has remained stable within the target range, albeit rising from 5.56 per cent in November 2019 to 5.82 percent in December 2019. Headline inflation averaged 5.2 percent in the twelve months to December 2019.

"Inflation has remained within the government of Kenya's target band of 5±2.5 percent, supported by low energy and food prices and a stable local currency.

Food inflation rose to 9.3 percent in December 2019 from 8.9 percent in November, reflecting increases in food prices, particularly non-vegetable crops as reflected by higher prices of maize grain and sifted flour. Non-food-non-fuel (NFNF) remained below 5 percent indicative of muted demand pressures while fuel inflation has remained low partly due to relatively stable international oil prices.

Additionally, core inflation (which excludes energy and food prices) decreased to 2.4 percent in September 2019 (from 4.7 percent in September 2018), reflecting an economy where underlying demand pressures are still benign. The low inflationary pressure has also been supported by a stable local currency, however, the recent increase in international oil prices is expected to exert moderate upward pressure on fuel prices, but with limited pass-through effects on inflation.

Interest Rates

The money market rates have been characterised by broad stability (**Figure 28**). During the third quarter monetary policy was more accommodative with the central bank rate being reduced by 0.5 percentage points from 9.0 percent in September to 8.5 percent in November 2019. The reduction in the CBR was anchored on the observation that inflation expectations were well anchored, and inflation is within the government's target range.

Figure 28:
Evolution of short-term Securities, Interbank Rate and Central Bank Rate *(Percentage)*

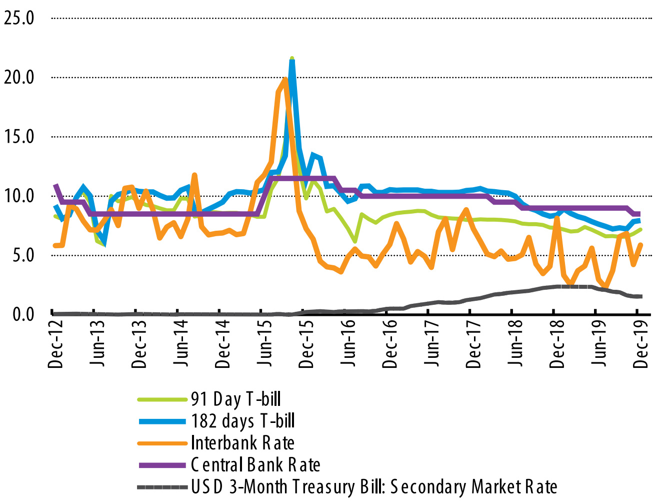


Figure 29:
Weighted Average Lending and Deposit Rates and Interest Spread *(Percentage)*

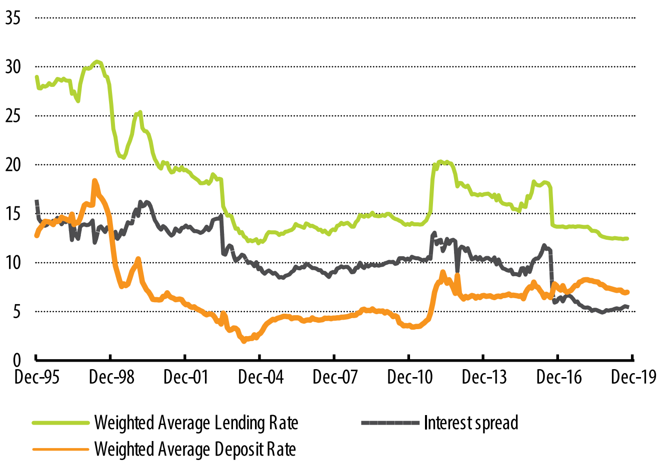
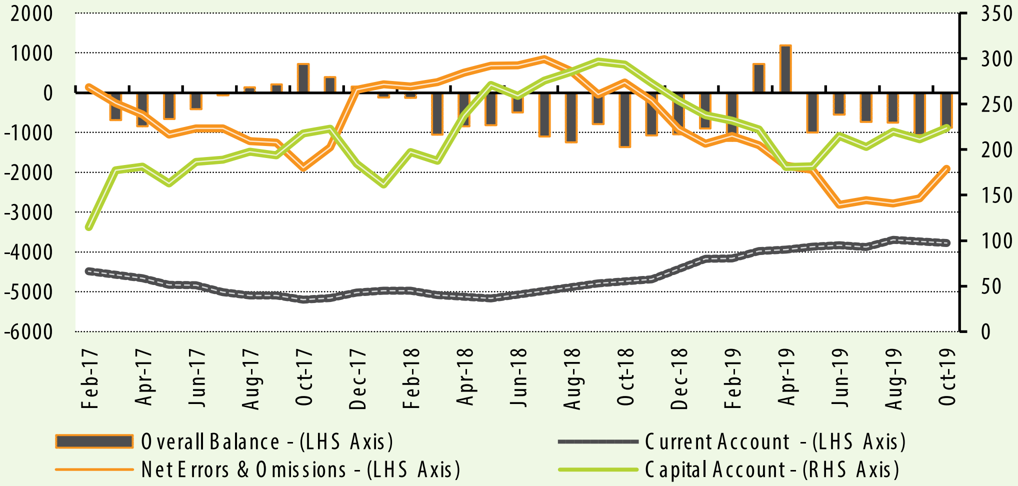


Figure 30:
Balance of Payments Position *(USD Million)*



Both the interbank market and short-term government securities rates which largely reflects the government's borrowing profile declined trended upwards suggesting a tightening liquidity position in the market.

The interbank market rate rose from 6.59 percent in September to 6.86 percent in October and declined to 4.2 percent in November and edged to 6.0 percent in December 2019. Similarly, the average yield rate for short-term government securities was also on the rise. The 91-day Treasury bill rate rose from 6.6 percent in September to 7.2 percent in December. The 182-day Treasury bill rate rose from 7.34 percent to 8 percent over the same period.

Both the weighted average deposit and lending rate has been on a stable since 2016 (**Figure 29**). The stability of the stickiness of interest rates due to the capping of interest rates introduced by the Banking Amendment Act (2016) that set the interest rate chargeable on loans at no more than 400 basis points above the CBR. Post-real of the interest rate controls the interest rates (lending or deposit) has also been characterised by stability with the interest rate spread also on a decline pointing to increasing intermediation efficiency in the banking industry.

Balance of Payments

The balance of payments position improved by 21 percent between September and October of 2019 narrowing from USD 1,060 billion to USD 873 billion over the same period (**Figure 30**).

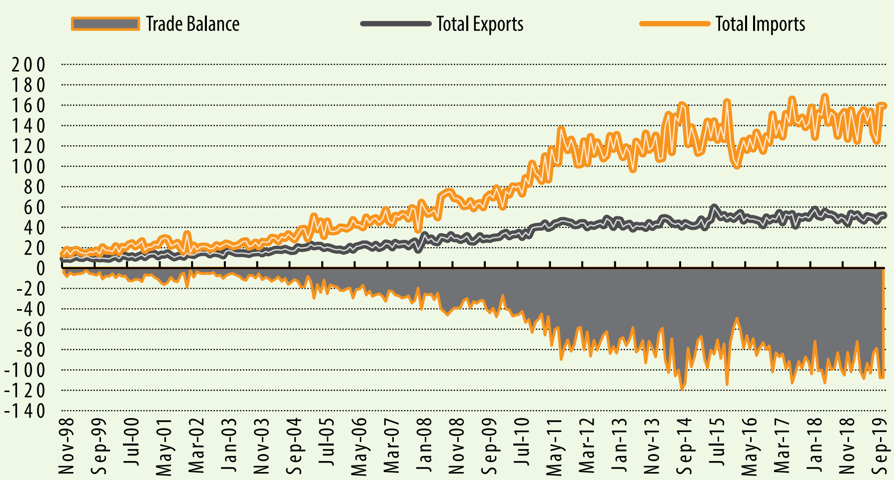
The improvement is on the back of improved financial account position, a lower import bill and strong remittance inflows contributing to a narrower current account deficit compared to other periods and consequently a containment of the external vulnerabilities. However, the current account deficit edged up at the beginning of quarter four of 2019 by 0.81 percent to USD 3,783.2 billion in October from USD 3,752.5 billion in September 2019.

Despite the slight deterioration, the current account deficit continues to be adequately financed by official borrowing and private investment inflows (portfolio and direct investment), resulting in a year-on-year increase in official foreign reserves and thus this is expected to provide a comfortable buffer against external short-term shocks.

"Overall, the stability of the exchange rate follows a narrowing of the current account deficit, increased diaspora remittances, reduced imports bill and a modest increase in exports.

Looking at the trade balance position, the volume of imports increased marginally at the beginning of the fourth quarter of 2019 (**Figure 31**). This improvement was driven by low food and SGR related imports. On the other hand, exports registered modest growth which was supported by the country's exports of the first crude oil in August of 2019 reflecting a recent diversification of Kenya's exports along the product space. Nonetheless, Kenya's manufacturing exports to the EAC and other regional markets have contracted. However, the weakness in the trade balance was mitigated by a strong surplus in the secondary income account due to a steady rise in remittance inflows

Figure 31:
Historical Evolution of Trade Balance *(USD Million)*



Exchange Rates Developments

The Kenya Shilling was stable albeit mixed performance against both the international (**Figure 32**) and regional currencies (**Figure 33**) in the fourth quarter of 2019. The shilling appreciated by 0.75 percent against the US dollar, 0.50 percent against the Euro, 1.32 percent against the Japanese Yen (JPY), and 0.28 percent against the Chinese Yuan, however, it depreciated by 1.20 percent against the Sterling Pound.

On the regional front, the shilling albeit being broadly stable was characterised by depreciation. Against the South African rand, the shilling depreciated by 0.12 percent. On the EAC currencies front, the shilling depreciated by 0.74 percent against the Tanzanian shilling and Ugandan shilling. Overall, the stability of the exchange rate follows a narrowing of the current account deficit, increased diaspora remittances, reduced imports bill and a modest increase in exports.

Figure 32:
Evolution of Kenyan Currency vis-a-vis International Currencies

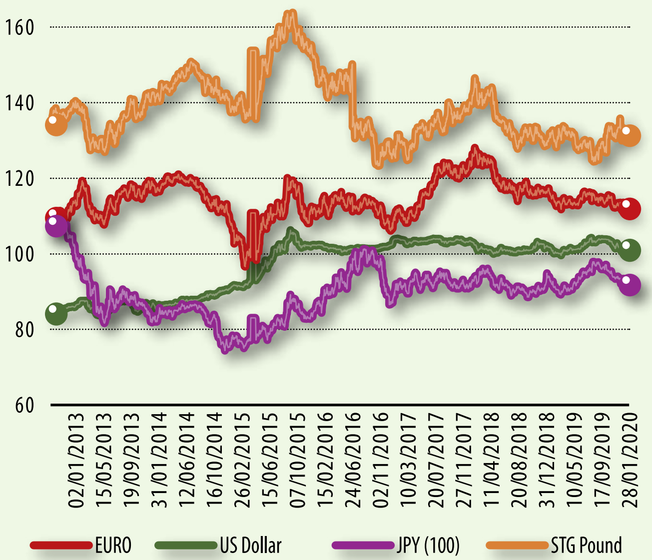
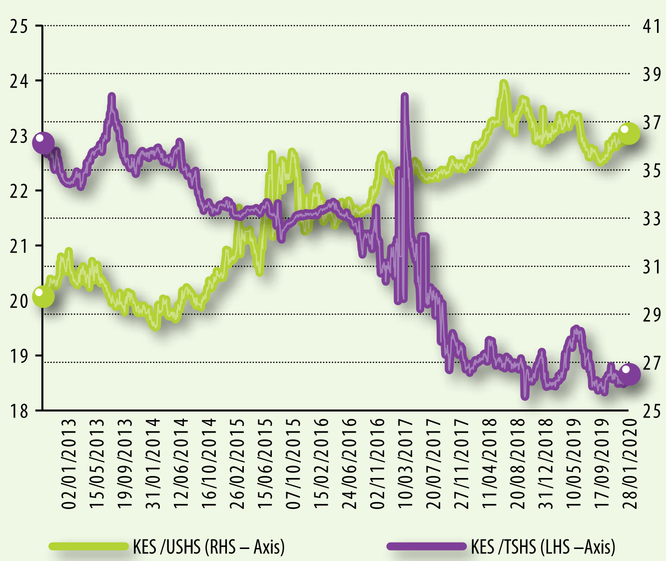


Figure 33:
Evolution of Kenyan Currency vis-a-vis Regional Currencies



Nairobi Securities Exchange

The equities market was generally on a recovery mode in the fourth quarter of 2019 compared to the third quarter of the same period. The recovery is reflected in the performance of three key aggregate market indicators - NSE 20 Share Index, Equity Turnover and Market Capitalization (**Table 2**).

The NASI index rose by 6.5 percent quarter-on-quarter, the NSE-25 share index edged up by 8.1 percent and the NSE-20 share index increased by 2.9 percent. Similarly, the number of shares traded increased by 16.9 percent while the equities turnover and market capitalization increased by 31.7 and 7.4 percent respectively.

The volatility of the NSE 20 share and NASI index remained muted though with a slight increase in December 2019. The reduced level of volatility is attributed to the stable economic, regulatory and political outlook of the economy. In addition, the repeal of Section 33B of the Finance Act 2019 was positive to the securities exchange as banking stocks gained momentum. However, on the downside, however, the market concentration remains a key risk given that the top five companies by market capitalization accounted for 73.35% in the four quarters of 2019.

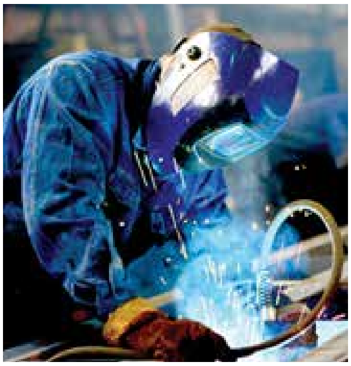


Table 2: Nairobi Securities Exchange 2019

	Mar-19	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec-19
NASI (2008=100)	157.7	157.3	149.9	149.6	148.3	147.6	145.5	149.2	159.0	163.8
NSE 25 Share Index	3976.3	3908.7	3616.4	3586.6	3583.1	3521.8	3475.0	3571.9	3913.9	4031.1
NSE 20 Share Index (1966=100)	2846.4	2796.8	2676.9	2633.3	2627.8	2467.7	2432.0	2478.2	2655.5	2616.6
Number of Shares Traded (Million)	446.0	295.0	452.4	334.0	374.2	322.0	367.6	450.5	446.7	383.6
Equities Turnover (KSh Billion)	15.9	9.9	12.5	10.5	11.5	8.7	10.6	16.0	15.9	12.9
Market Capitalization (KSh Billion)	2360.5	2354.0	2268.3	2278.9	2258.0	2222.0	2172.0	2257.5	2426.6	2499.6

Source: CBK

Banking Industry Performance

Given the central role of the financial sector in promoting economic growth and development, this section reviews the performance of the banking industry given its dominance within the financial sector. The banking industry performance during quarter four of 2019 was characterised by improvements on the back of the repeal of Section 33B of the Finance Act, 2019 that saw the removal of interest rate controls that had been in place for three years since 2016. Overall, the banking sector remains stable, resilient despite and well capitalised.

According to the latest available statistics, the industry's asset position edged up by 0.53 percent to Kshs. 4.82 Trillion in October from Kshs. 4.80 Trillion in October 2019 (**Figure 34**). Despite the slight increase in the growth rate of total assets, this growth remains lower than those registered in earlier quarters and especially in the third quarter.

Like the growth pattern of assets, the gross loans and deposits over the recent years have been rising albeit from a lower base. The gross loans rose by 2.11 percent from Kshs. 2.77 billion in September to Kshs. 2.83 billion in October 2019. Similarly, gross deposits grew by 1.82 percent and stood at Kshs. 3.57 billion in October 2019 from Kshs. 3.49 billion in September 2019 (**Figure 35**). Whereas the removal of interest rate controls is a welcome decision, the tepid performance of the economy will continue to have a drag on household and firm's balance sheets and thus on aggregate demand.

However, the growth in credit distribution remains constrained by the high levels of non-performing loans (NPLs), at 12.3 percent in October and further declined to 12 percent in December 2019 (**Figure 36**). The improvement in asset quality was supported by the reduction in NPLs especially in the trade, real estate, financial services, manufacturing and personal/household sectors arising from improved repayments due to enhanced recovery efforts by banks, as well as write-offs.

Figure 34:
Banking Industry Total Assets and Growth Rate *(KES Billion)*

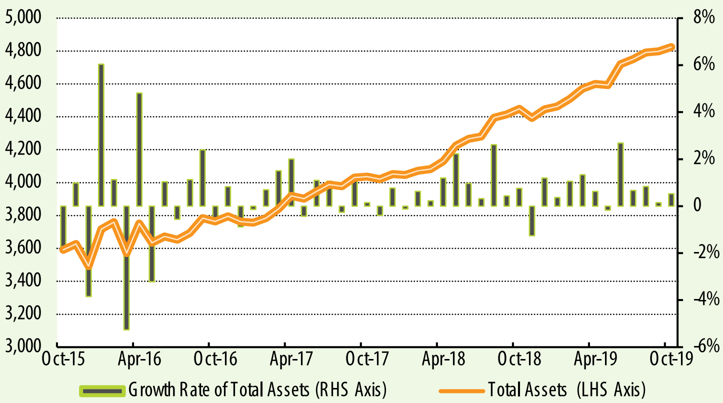


Figure 35:
Banking Industry Gross Loans and Deposits *(KES Billion)*

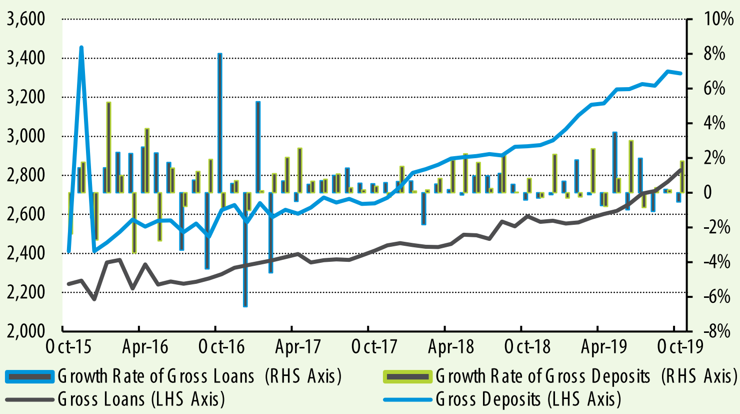


Figure 36:
Banking Industry Asset Quality and Growth Rate *(KES Billion)*

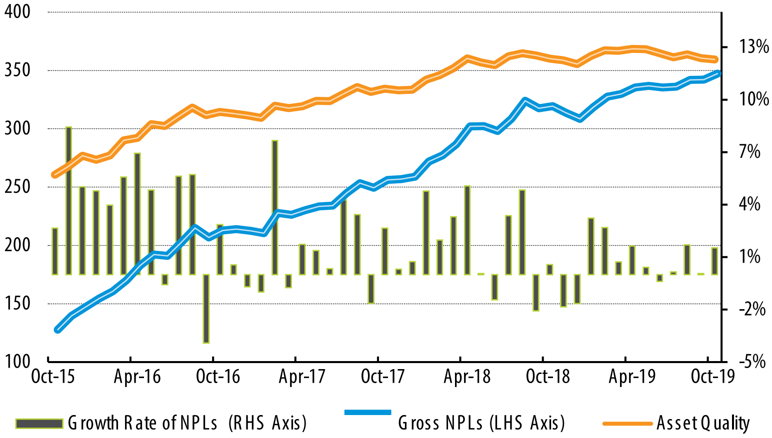


Figure 37:
Shareholder's Funds and Growth Rate *(KES Billion)*

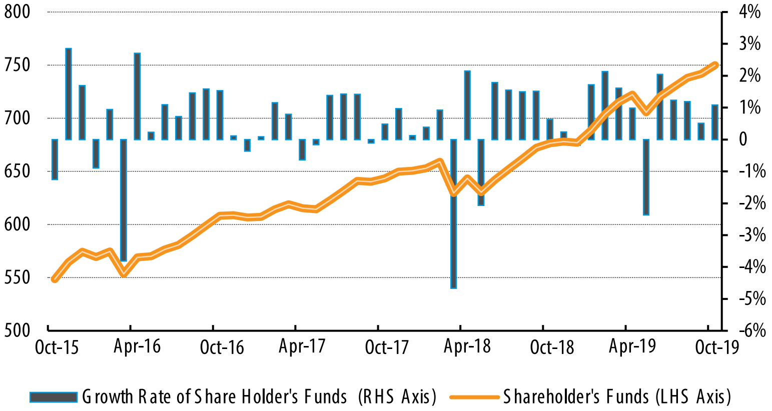
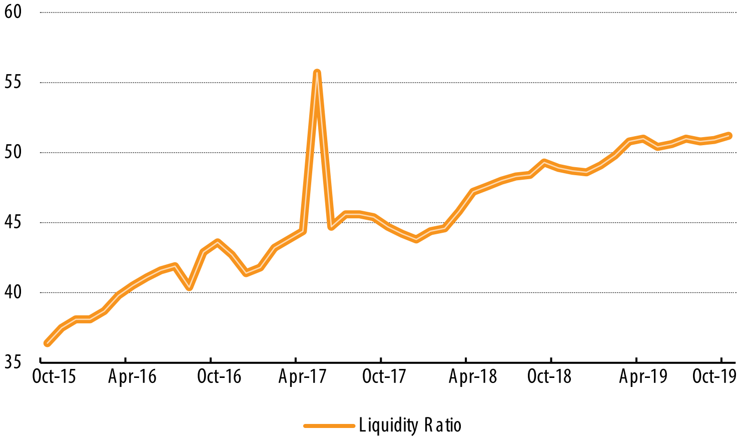


Figure 38:
Banking Industry Liquidity Ratio *(%)*



Nonetheless the growth rate of NPLs and asset quality generally reflects the challenges besetting macro-financial conditions arising from slowdown in the economy. It is also worth that despite the commitment by the government to clear pending bills the asset quality continues to deteriorate and continues to feed into the risk-appetite of commercial banks.

Turning on to the evolution of the shareholder's funds, it is evident that it continues to maintain its growth momentum (**Figure 37**). Whereas the equity position of the industry had been marked by a decline, it rebounded in October to grow by 1.01 percent to stand at Kshs. 750 billion compared to a 0.51 percent growth registered in September 2019 with the equity position being Kshs. 742 billion.

Liquidity is key to the stability of the banking industry stability given that it signifies the ability to fund assets and meet obligations as they fall due. The industry's average liquidity ratio has been over time been on the rise (**Figure 38**) with the bank's liquidity ratio increasing from 50.90 percent in September to 51.20 percent in October, however, it declined marginally to close the fourth quarter at 49.7 percent. Overall, the industry's liquidity position always remains above the minimum liquidity ratio of 20 percent required to be observed by all commercial banks.

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