KENYA BANKERS ECONOMIC BULLETIN

VOLUME ONE 2012




A report prepared by:

The Center for Research on Financial Markets and Policy

KENYA BANKERS ASSOCIATION

KENYA BANKERS ASSOCIATION

About this Report

This report reviews the performance of Kenya's economy and the emerging trends of 2012. The report covers production trends in the real sector, government fiscal and monetary policy operations, financial sector developments, public debt; inflation, interest rates; balance of payments; exchange rate; foreign exchange reserves; and activity at the Nairobi Securities Exchange. It concludes with a brief economic outlook that may be of interest to the banking industry. Any correspondences can be addressed to research@kba.co.ke

About the Center for Research on Financial Markets and Policy

The Center 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 Center sponsors original research, provides thoughtful commentary, and hosts dialogues and conferences involving scholars and practitioners on key financial market issues. Through these activities, the Center 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.

Kenya Bankers Economic Bulletin

Publisher	KBA Centre for Research on Financial Markets and Policy
CEO KBA	Habil Olaka
Chief Editor	Dr. Jacob Oduor
Contributors	Lydia Mbura, Francis Ogula, Nuru Mugambi
Design & Layout	Conrad Karume 0722 884749
Administration	Juliana Mua
Accountant	Nelly Konya
Contacts	KBA Headquarters, International Life House, 13th Floor Mama Ngina Street, Nairobi
Mailing Address	P.O.Box 73100 – 00200 Nairobi
Phone	+254-20-2221704, +254-20-2217757, +254-20-2224014, +254-20-2224015
Email	research@kba.co.ke
Web	www.kba.co.ke.
Ditributed by	Kenya Bankers Association

In this Issue

In the next Issue

- Budget Analysis
- Comentary on Credit Information sharing
- Banking Sector performance
- Monetary Union of East Africa

This bulletin can also be downloaded from: **www.kba.co.ke**

From the CEO's desk

Welcome to the first edition of the Kenya Bankers Economic Bulletin. This report is prepared under the Kenya Bankers Association's Centre for Research on Financial Markets and Policy.

The Centre offers a number of resources to financial industry professionals – primarily in the banking sector – including macroeconomic reports, issues and policy analysis, as well as sponsored research. Through these activities the Centre will collaborate to set and shape the agenda towards a more vibrant and sustainable banking sector.

We plan to publish this Bulletin on a quarterly basis and each issue will cover information and analysis that is pertinent to KBA members, various other stakeholders and the general public.

We thank the Director Dr. Jacob Oduor, who recently joined the Association, as well as our Research Fellows for compiling this material. You can read more about the team in the Profile section.

– Habil Olaka,
CEO, Kenya Bankers Association

Growth of Gross Domestic Product (GDP)

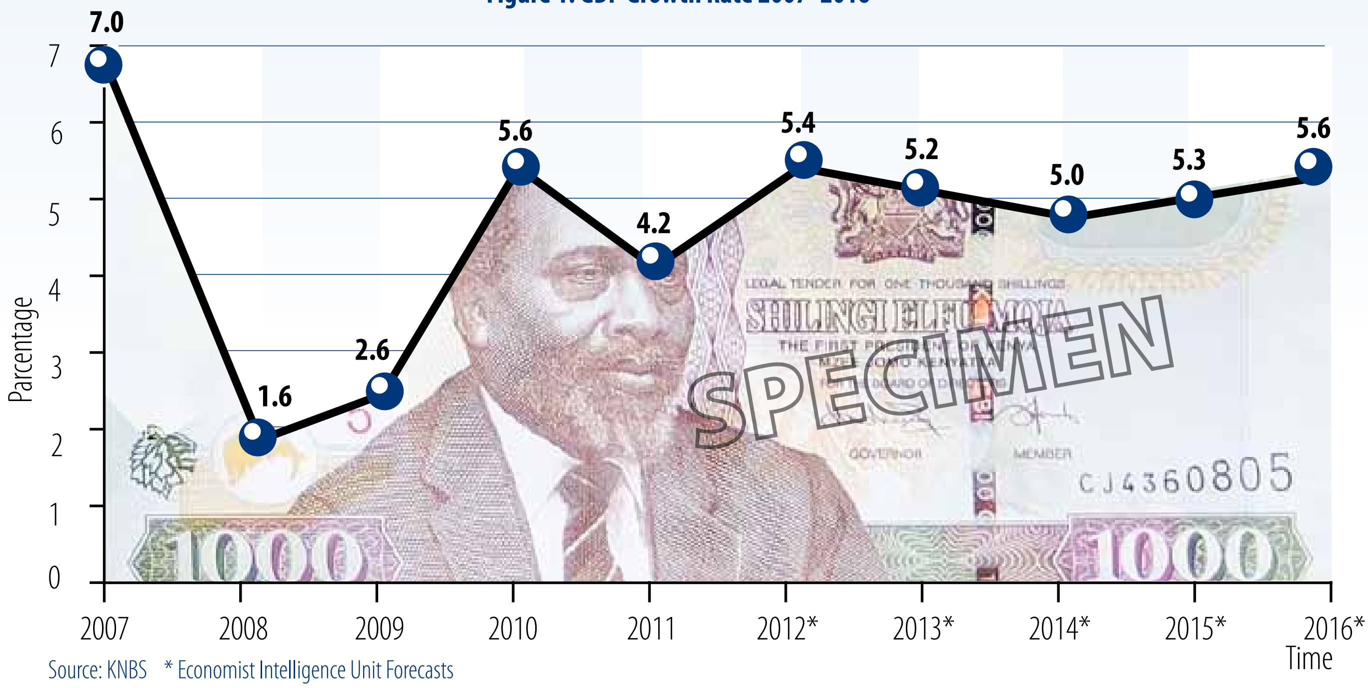
Although official figures are not yet available, growth forecasts estimate that the economy grew by 4.2 percent in 2011 down from 5.6 percent growth achieved in 2010. Several constraints contributed to the growth decline. These include: high global energy prices which increased domestic energy prices and the cost of production generally; the Euro-zone debt crisis; drought in the agricultural areas which partly led to rising inflation and a depreciated Shilling following a widening current account deficit, which also increased inflation as imports became more expensive. The Current account deficit had reached 10.5 percent of GDP by the end of the third quarter of 2011. Insecurity and political instability in Somalia also played a part in several ways. First the intervention of Kenya into Somali led to increased military expenditure drawing funds away from Government's development and recurrent expenditures. This in turn reduced consumption expenditures in the last quarter of 2011. Secondly, the insecurity increased investment risk diverting investment funds to other markets.

Despite these challenges however, domestic demand increased particularly in the first three quarters of 2011, fuelled by expansionary monetary policy which led to low interest rates and expansion of credit. As borrowers take up loans, consumption and capital expenditures increased resulting in a rise in aggregate demand. But the rise in demand was not

met by a rise in supply on account of drought. Ultimately increased credit expansion, increased inflation and increased the demand for imported goods. This was largely to blame for the rapid depreciation of the Kenya Shilling against major currencies between September and November 2011. The Shilling has since stabilized but threats remain. The banking sector must therefore take note and monitor these structural weaknesses to avoid risks to asset quality.

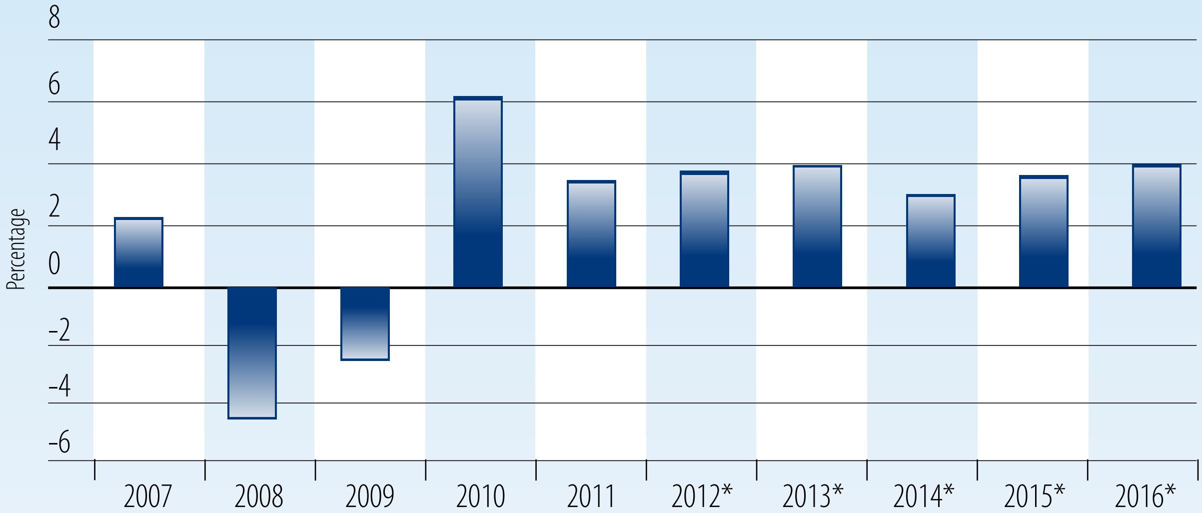
According to analyst reports, real GDP growth is expected to pick up in 2012 and then stabilize roughly at upwards of 5 percent (see figure 1 below).

Figure 1: GDP Growth Rate 2007 -2016



Source: KNBS * Economist Intelligence Unit Forecasts

Figure 2: Agricultural Growth Rates (2007- 2016)



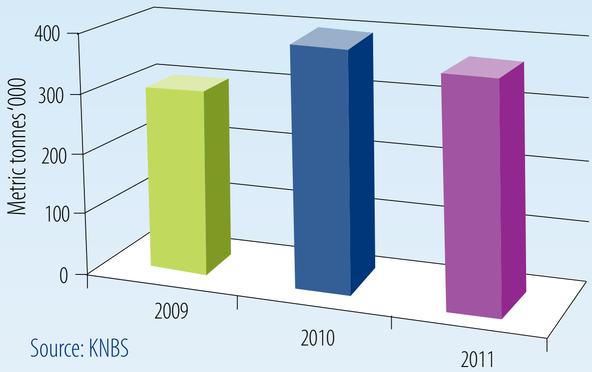
Source: Kenya National Bureau of Statistics *Economist Intelligence Unit Forecasts

Agriculture

The agricultural sector continues to be the backbone of the Kenyan economy. Performance of the agricultural sector is key to the overall growth of the economy as it directly and indirectly contributes over 50 per cent of GDP. In 2011, the sector production was adversely affected by poor rainfall. Though the official figures for the sector's growth in 2011 are not yet out, the overall growth of the sector in the first and second quarters of 2011 is estimated to have stood at 1.8 and 5.2 percent respectively, compared to 5.7 and 3.0 per cent recorded in the same quarters in 2010. The third and fourth quarters of 2011 are expected to perform a little dismally compared to the same quarters of 2010 which stood at 8.6 and 7.4 per cent, respectively. The Government is now focusing attention on the sector as the main route towards poverty reduction. The sector is therefore poised to undergo significant restructuring in the period ahead as Government implements policy and institutional reforms contained in the Strategy for Revitalizing Agriculture. The reforms are aimed at increasing the private sector participation in the management and delivery of services to the sector in order to raise productivity at farm-level. This could be an opportunity for the different private sector players including the banks to partner with the Government in these projects under the Public-Private-Partnerships (PPP) initiatives to invest in the sector. The growth in the sector is shown in figure 2.

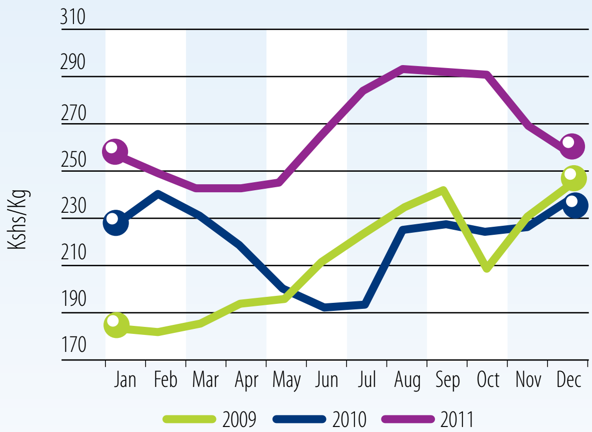
Coffee, tea and maize, recorded decreased production. Increased production was recorded in horticultural crops and sugarcane, up from the figures recorded in 2010. Sugarcane production however was lower than the 2009 production levels. The average retail price of maize rose steeply by 163 percent, from Ksh. 19.43/Kg in June 2010 to Ksh. 51.21/Kg. in June 2011. This was partly because of the increased demand following increased aggregate consumption in 2011. Investors in the production of maize therefore still had good returns on their investments. Overall, the country was unable to meet its domestic demand for maize and had to import the commodity at high prices, at up to USD 299 per metric tonne. Given the unmet demand in maize production, increased financing of maize producers is possibly a good decision for the banks as there is guaranteed market. The banks can therefore venture into the financing of investments in large scale irrigated maize production and milling with assured returns.

Figure 3: Tea production: 2009 - 2011



Source: KNBS

Figure 4: Tea prices: 2009 - 2011



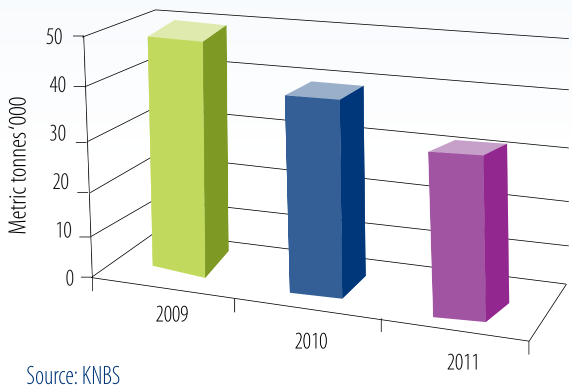
Source: KNBS

Production of tea in 2011 as shown in Figure 3(a) declined by 5.3 percent to 377,913 metric tonnes, compared to 399,006 metric tonnes in 2010. The lower production was mainly due to depressed rainfall in most tea growing regions. Nevertheless, average tea auction prices in 2011 increased by 9.1 per cent from USD 2.74 per kg to USD 2.99 per kg (both were the highest prices in two and a half decades). Tea auction prices increased despite the political unrest in the Middle East, particularly Egypt, which has been Kenya's main tea export destination, but was overtaken by Pakistan in 2011. The number of export destinations also increased by 5 in 2011 compared to 2010. The value of tea exports buoyed by the rise in prices, increased by 11.9 per cent to stand at Ksh 109.4 billion compared to Ksh 97.74 billion in 2010.

Tea Board of Kenya is making concerted efforts to diversify export markets in West Africa and Europe and to promote domestic consumption of tea. Nevertheless, the tea industry remains one of the strong performing sub-sectors within the agricultural sector and would possibly continue to remain so in the near future. Investment in the sub-sector will therefore continue to remain profitable.

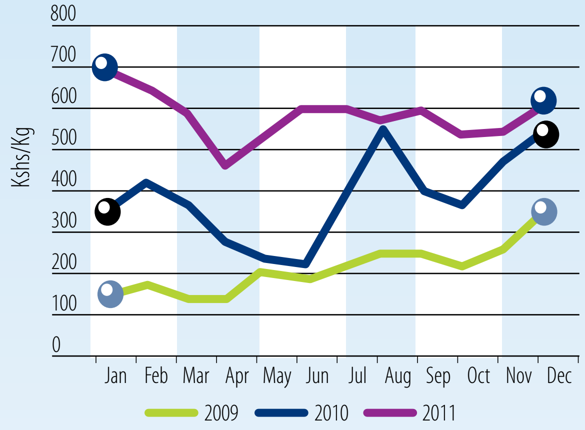
Coffee sales at the Nairobi Coffee Exchange declined by 23 percent from 38,938 metric tonnes in 2010 to 29,984 metric tonnes in 2011. Despite the huge drop in production, the total value of coffee exports from January to November 2011 increased by 29 percent to Ksh 19.858 billion compared to Ksh 15.376 billion for the same period in 2010. The increase in the value of exports was boosted by high coffee prices which increased by 50 per cent from Ksh 396.76 per Kg in 2010 to Ksh 594.53 per kg in 2011. Competition for land has increased from the real estate segment and this has reduced the acreage under coffee. At the same time, prices of coffee at the international markets have not incentivized coffee production. The figure 5 (below) shows the trends in coffee production between 2009 and 2011.

Figure 5: Coffee production: 2009 - 2011



Source: KNBS

Figure 6: Coffee prices: 2012– 2013

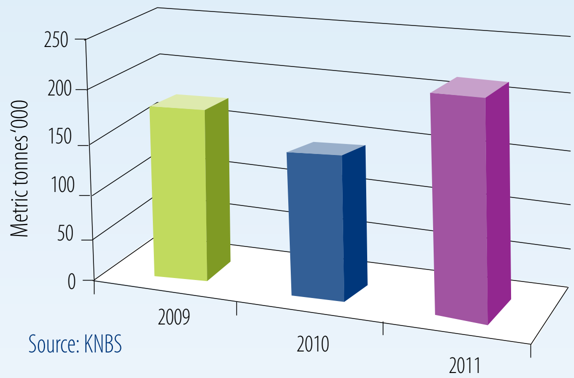


After a slight slump in 2010, both volume and value of horticultural exports rebounded in 2011. Production in the sub-sector had declined by 13.9 per cent in 2010 from 166,067 metric tonnes in 2009 to 142,000 metric tonnes in 2010. The total January to November horticultural export volume increased by 40 per cent to 200,099 metric tonnes. The value of horticultural exports increased by a remarkable 107.9 percent to Ksh 79.71 billion in 2011, up from Ksh 38.35 billion in 2010, compared to a. 15.1 per cent decline in 2010, The tremendous increase in value was in part due to the rapid depreciation of the Shilling in 2011 which increased export earnings.

Cut flowers still constitute the biggest potion of horticultural exports at 51 per cent in 2011. Cut flower exports grew by 126 percent in 2011 to Ksh 51.994 billion, up from Ksh 23.033 billion in 2010. The value of vegetable exports grew by 83 per cent to Ksh 24.356 billion up from Ksh 13.310 billion in 2010. Fruit exports grew 67.5 per cent to Ksh 3.356 billion, up from Ksh 2.0 billion in 2010. Several challenges remain a threat to the sub-sector, however. One such challenge is the prolonged Euro-zone economic crisis which might affect demand for horticultural products.

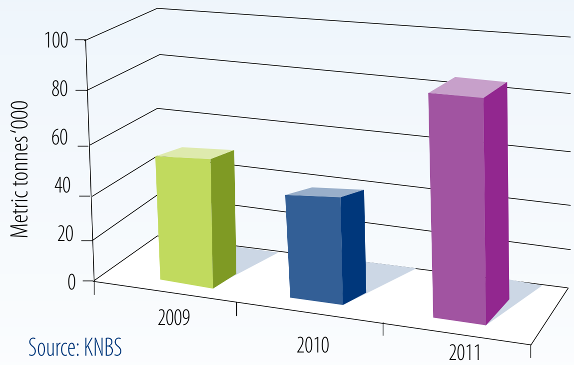
Recently, the European Union (EU) introduced the EU carbon tax which will increase transportation costs to Euro with the potential of increasing prices of the horticultural products in the international markets. Although horticulture remains the major source of growth for the agricultural sector, small-scale growers are particularly vulnerable to the strict European Union minimum residual levels requirement. The other threat to the industry is rising labour and inputs costs and requirements to adhere to international labour practices.

Figure 7: Volume of horticultural exports (2009-2011)



Source: KNBS

Figure 8: Value of horticultural exports (2009-2011)



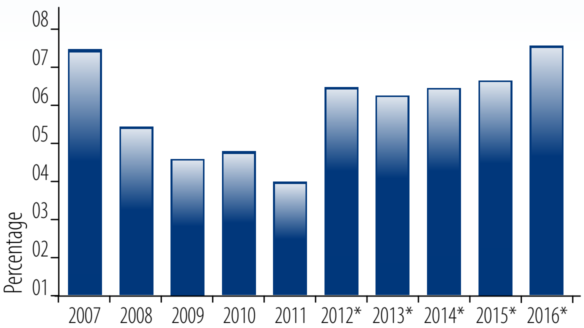
Source: KNBS

Sugar production increased by 8 per cent in 2011 from 327,970 metric tonnes in 2010 to 353,838 metric tonnes in 2011. Sugar production is expected to increase in 2012 as the Government licences additional sugar millers. However, several challenges still remain in the sub-sector. These range from poor management, wrangling among sugar millers over zone encroachment, high input costs, over-reliance on rain-fed production and political interference in the affairs of the sector which has led to the running of the sector by a board with no directors – the Kenya Sugar Board Directors' Board.

Manufacturing

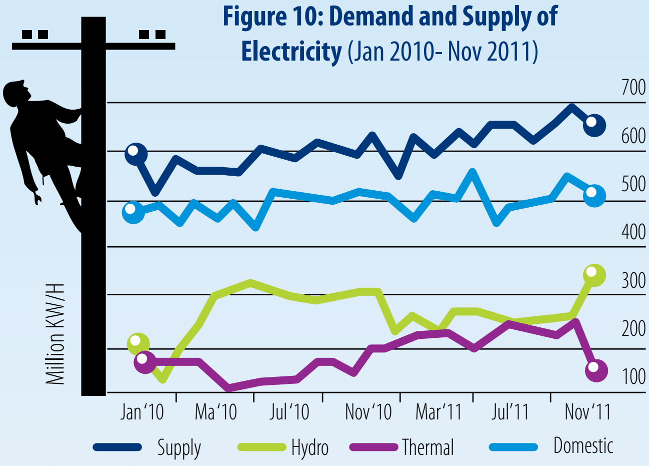
Growth in the manufacturing sector was somewhat dampened by a myriad of problems. The sector grew by 3.2 per cent compared to a growth of 5.5 per cent experienced in 2010. Top on the list were the high energy costs caused by rising oil prices. That fed into electricity costs resulting from increased use of thermally generated power. Compounding the problem was the weak Shilling which led to increased import costs and since a high proportion of Kenya's production input basket is composed of imported inputs, the manufacturing sector was hard hit as machinery and equipment became more expensive. Container backlog at the Port of Mombasa also contributed to the slowing growth in the sector. The sector is expected to recover following the continued appreciation of the Shilling coupled with the stabilization of oil prices. Growth in the sector has a huge potential following the recently signed East African Common Market Protocol and the potential market in the newly independent Republic of South Sudan. If the recent discovered oil in Turkana is commercially viable, then Kenyan Manufacturers are likely to be significant/material beneficiaries as cost of energy comes down. Outside the Customs Union, however, Kenya's manufactured goods face stiff competition particularly in the COMESA region.

Figure 9: Manufacturing Growth Rates (2007-2016)



*Economist Intelligence Unit Forcasts
Source: Economist Intelligence Unit

Figure 10: Demand and Supply of Electricity (Jan 2010- Nov 2011)



Source: KNBS

Energy

As shown in Figure 7, energy demand in the country far much outweighs supply. Because of the frequent drought in the country, the Government has put in place a number of initiatives to diversify sources of energy away from hydro-generated power. Even though hydro-electric power continues to be the main source of electricity, thermal power supply has increased substantially. The problem with thermal power is its dependence on oil for generation. With high oil prices, energy costs therefore went up sharply in 2011. This led to increased tariffs. In 2011, power supply was 7,618.9 million kWh, a 9.2 per cent increase from the 2010 supply of 6,976.5 million kWh. Average monthly consumption increased by 3.5 percent from 3,709.3 million kWh in 2010 to 514.2 million kWh in 2011.

The contribution of thermal power to the national grid increased from 25 per cent in 2010 to 34 per cent in 2011. The contribution of hydro-power stood at 41 per cent. A number of challenges abound in the sub-sector. Vandalism and illegal power connections are the main sources of concern to the power distributor. Some of the important developments in the sector include the introduction of prepaid meters by the Kenya Power and Lighting Company which is expected to reduce pending bills. Underground cabling project as part of efforts to improve efficiency in electricity distribution was also initiated in 2011. On the petroleum front, oil was discovered in the Turkana region of Northern Kenya in March 2012. This is expected to tremendously reduce energy costs and lead to reduced costs of production. If commercially viable, the oil find is going to lead to increased investment in the energy sector as well as increased income and consumption of the communities around Turkana as well as the whole country. The banks and other financial institutions must position themselves early to take advantage of this opportunity.

Building and Construction

Total January to November 2011 consumption of cement which is a key indicator in the construction industry, increased by 10 per cent to 3,137,086 metric tonnes from 2,852,101 metric tonnes in 2010. This signalled a slowdown when compared to a 17 per cent increase in 2010. The last quarter of 2011 was not easy for the construction industry. With the depreciation of the Shilling came high costs of imported inputs which increased the overall cost of construction. The value of building plans approved by Nairobi City Council increased by 64 percent from 128.677 billion in 2010 to 211.3 billion in 2011. This to an extent represents the increased cost of building and therefore valuation of the units. With the reduced interest rates at the beginning of 2011 and the resulting ease of getting loans, credit to the building and construction sector grew by 4.9 per cent in September 2011, compared to 0.6 per cent in September 2010. With the current monetary policy tightening stance, growth in the sector is expected to slow down in 2012 as CBK tries to ease inflationary pressures. With the high interest rates, there are also chances of default on mortgage facilities and banks need to be on the look-out for signs of stress in their books.

Transport and Communications

Growth in the transport sector during the first quarter marginally slowed down, from 6.5 per cent in 2010 to 5.2 per cent during the same period in 2011. The number of new vehicle registrations increased by 4 per cent in 2011 to 205,841 vehicles, up from 196,449 vehicles in 2010, although the growth was slower than that recorded in 2010, which stood at 21 per cent. The number of minibuses registered declined by 87.5 per cent, from 3600 in 2010 to only 451 in 2011. This is despite attempts to phase out 14-seater vans in favour of mini-buses which have a bigger capacity. The reason for this could have been the lack of decisiveness on the part of the Government on whether or not to phase out the 14-seaters. The industry players could have already seen that the phasing out threat was not going to materialize. The suggestion to phase out the 14-seaters has since been reversed.

On the communications sub-sector, mobile phone subscriptions increased to 25.3 million at the end of June 2011, a growth of 25.6 per cent compared to the same period in 2010. During the same period, Internet subscriptions increased by 37.5 per cent to 4.2 million subscriptions. Because of the stiff competition on voice services which has led to declining revenues from that services, players in the communications sub-sector have embarked on alternate service provision including data centres, cloud computing and also skewed to mobile banking services.

Tourism

Total tourist arrivals from January-September 2011 increased by 16 per cent, and stood at 931,607 compared to 796,764 during the same period in 2010. Arrivals in the peak month of July 2011 increased by 22 per cent to 143,556 compared to 116,759 in 2010. Political instability in Somalia continues to negatively affect growth prospects in the tourism industry. Because of the insecurity in Somalia, few kidnappings of tourists at the Kenyan coast in the third quarter of 2011 precipitated mass cancellations of tourist bookings. Travel advisories notable by the US and UK Governments have not made matters easier for the sector. The state of most roads leading to popular tourist attractions are also in very poor state. Even though the Government has embarked on repairing the Narok-Maasai Mara road which has been in deplorable state, significant investments will need to be made to rehabilitate other physical facilities, particularly roads leading to popular tourist attractions. However, even with these challenges, there is still room for improvement in the sector. Investments need to be made on alternative tourist attractions and getting more tourists from non-traditional tourist catchment countries (United States of America, Germany, Italy etc). The potential of domestic tourism also does not seem to have been fully utilized.

Financing of Government

Total revenue for 2010/2011 fiscal year increased by 16 per cent to Ksh 667.339 billion, up from Ksh 586.37 billion in the 2009/2010 fiscal year. Total revenue as a percentage of GDP similarly rose, albeit marginally, from 23.86 per cent of GDP in 2009/2010 to 24.05 per cent of GDP in 2010/2011. At the same time, Government expenditures increased by 11.9 per cent in 2010/2011 to stand at Ksh 811.85 billion, up from Ksh 725.201 billion in 2009/2010. This left a budget deficit which had to be financed from domestic and external borrowing.

Public Debt

The total stock of public debt increased by 17.9 per cent in the 2010/2011 fiscal year, increased to Ksh 16,034 billion up from Ksh 13,594 billion in the 2009/2010 fiscal year. The net public debt to GDP ratio increased from 44.8 per cent in 2009/2010 fiscal year to 48.8 per cent in the fiscal year 2010/2011. The stock of domestic debt increased by 15.7 per cent from Ksh 660.267 billion in June 2010 to Ksh 764.143 billion in June 2011. The external debt grew by 28.6 per cent, from Ksh 565.452 billion in June 2010 to Ksh 727,266.00 billion in June 2011.

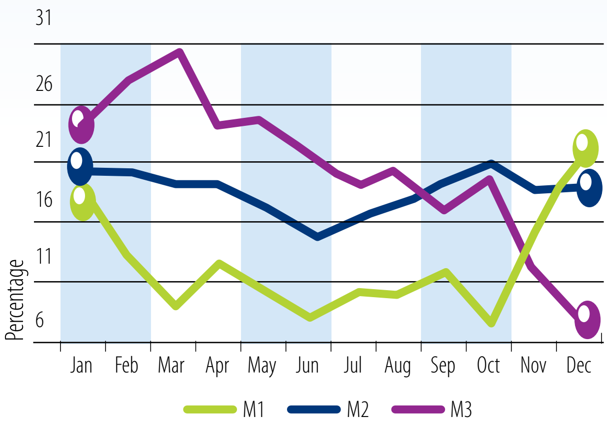
Banking Developments

Total assets of banks increased by 21 per cent to stand at Ksh 1873.77 billion in June 2011 up from Ksh 1,548.4 billion at June 2010. The main component of this increase was loans and advances and foreign assets which increased 32 per cent and 66 per cent respectively. Deposit liabilities for the same period increased by about 16 per cent to 1412.84 billion from Ksh 1219.53 billion. Banks' pre-tax profits increased 16.9 per cent to Ksh 40.8 billion in June 2011 up from Ksh 34.9 billion in June 2010. The improvement in profits is attributed to cost cutting and a reduction in provisions for bad debts. The ratio of gross non-performing loans to gross loans improved from 7.4 per cent to 5.4 per cent. One of the main developments in the sector was the rollout of Agency Banking. It is expected that this concept will increase financial inclusion more particularly to the areas that are not yet well served by the bank branch networks. One threat was the proposed introduction of capping on interest rates. These amendments did not however, pass the floor of the house.

Money and Credit

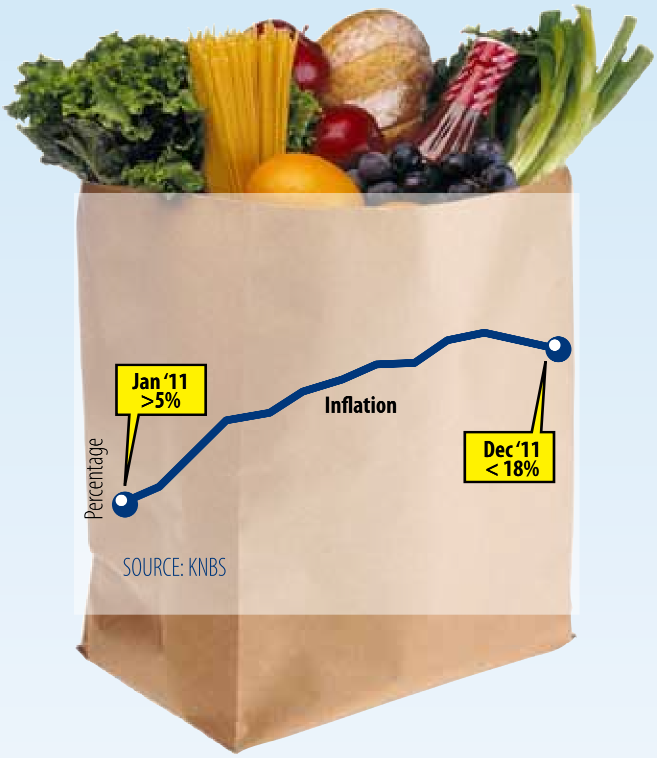
There was a general decline in the main components of money supply in 2011. Growth of Quasi-Money and M3 declined by 57.4 per cent and 25.8 per cent respectively between January and June 2011. Growth of M1 on the other hand declined sharply by 61.5 per cent between October and December. Total credit from the banking system to the private sector increased by 29 per cent in the first half of 2011. Net banking system credit to the Government on the other hand increased by 24.9 per cent from Ksh 1624.76 billion to Ksh 2028.67 billion during the first half of 2011.

Figure 11: Growth in the Components of Money Supply



Source: CBK

Figure 12: BASKET OF GOODS: OVERALL TRENDS OF INFLATION IN 2011



Inflation

The year 2011 saw a very rapid rise in inflation rates. Overall inflation in 2011 averaged 14 per cent. The second half of 2011 saw the most rapid of the increase in inflation with the peak in November at 19.7 per cent. Inflation was primarily fuelled by supply side constraints including high energy prices which increased the cost of production increasing prices and inflation; depressed rainfall which led to a reduction in the supply of basic food commodities and reduced production of the commodities. With high oil prices, came high transport costs which pushed prices to the roof. On the demand side, the increase in credit to the private sector also helped to accelerate the rise in inflation. Average consumer price inflation is forecast to even out from 14% in 2011 to 5.2% in 2016

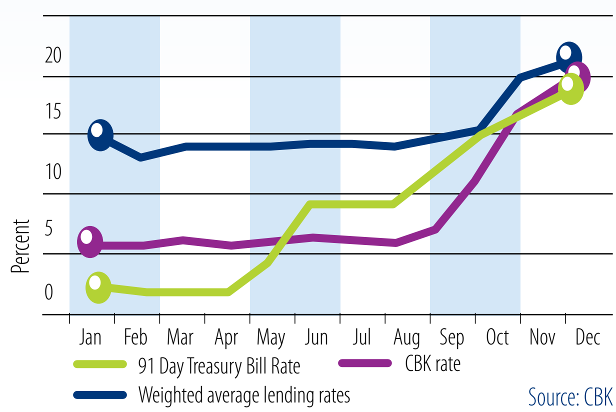
Interest Rates

Interest rates in the first half of 2011 were generally low following the CBK's expansionary monetary policy stance. The second half of 2011 was different. With high inflation rates and depreciating Shilling, the CBK raised the Central Bank Rate (CBR) and the cash ratio in order to fight inflation. The tight policy led to a general rise in interest rates. The average annual 91-day Treasury bill rate increased by 140 per cent from 3.6 per cent in 2010 to 8.7 per cent in 2011. The average monthly rate sharply increased during the year, and was at 17.9 per cent at the end of December 2011, up from 2.44 per cent in January 2011. The 91-day Treasury bill rate increase followed an increase in the CBR from 5.75 per cent to 18 percent over the same period. Commercial bank lending rates also increased as monetary policy tightened. The annual average lending rates increased by 4 per cent from 14.4 percent in 2010 to 15 per cent in 2011. Average monthly savings rates remained relatively unchanged in 2011, averaging at 1.38 per cent. The average lending rates are forecast to decline over the 4 year period 2012-2014 from a high of 16.4 in 2012 to 12% in 2016 as the positive effects of the monetary tightening are felt, allowing for subsequent monetary easing.

In order to alleviate the effects of high interest rates on customers, the KBA, CBK and the Ministry of Finance unveiled a package of short term actions in December 2011 which included: Extension of loan tenors, Capping increase in loan repayment instalment at 20%, Waiving early repayment charges/penalties and banks absorbing some increased costs on loans.

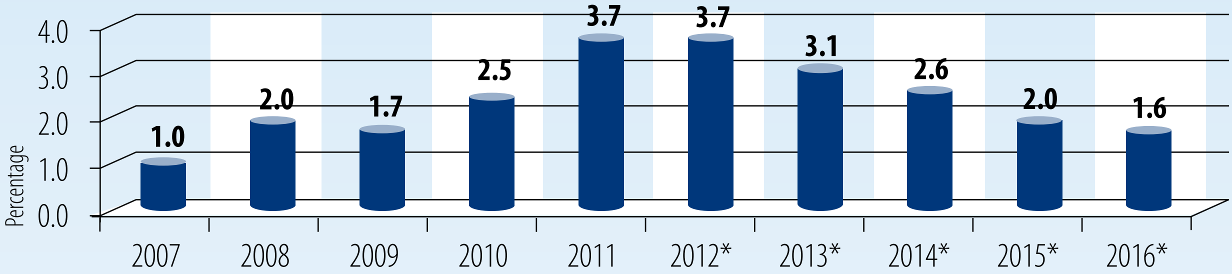
The KBA committed to maintain these short term measures until interest rates fall significantly and inflation reverts to long term target of 5%. In addition the KBA, together with the CBK and the Ministry of Finance, is currently working on a number of medium and long term measures that will result in greater transparency in terms of pricing for financial services as well as considerably lowering the cost of credit. The concerns raised by the consumer public have been picked up by the KBA. And the association is already working on modalities to address the financial education and consumer protection issues.

Figure 13: Trends in interest rates (Jan - Dec 2011)



Source: CBK

Figure 14: Current Account Deficit 2007–2016



*Economist Intelligence Unit Forecasts

Source: CBK

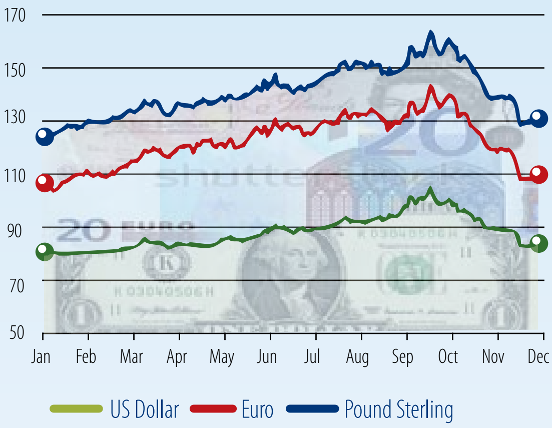
Balance of Payments

The overall balance of payment position for 2011 decreased to a deficit of US$51 million, down from a surplus of US$ 163 million in 2010. This was caused by the widening of the current account deficit by 78.7 per cent from US$ 2,512 million in 2010 to US$ 4,489 million in 2011. This was caused mainly by increased food and oil imports following drought in the country as well as strong demand for imports of machinery and transport equipment. The total value of exports grew by 9.6 per cent to US$5726 million. Raw materials and manufactured goods registered the highest growth in exports, growing at 20 per cent and 78.1 per cent respectively. The total value of imports grew by 19.3 per cent to US$ 14,782 million in the same period. Growth in imports came mainly from increased imports of oil, chemicals and manufactured goods, which grew at 52.7, 21.5 and 26.9 per cent respectively. The current account deficit is forecast to gradually decline to US$ 1.6 Billion or 3.3% of GDP in 2016, supported by growth in regional trade, tourism and remittances from the Diaspora. The capital and financial account registered a growth of 65.9 per cent from 2010. Remittances from the Diaspora in 2011 increased by 39 per cent to stand at US$891.107 million, compared to US$ 641.943 million in 2010. It is worth noting that remittances have continued to grow steadily even in hard economic times. There is need for innovative products from the banking sector to tap into this potential source of funding as an alternative source of funding for the banks. Innovative products could also be introduced in the mortgage market as investment channels for the diaspora. Some banks however have already introduced some products specifically targeted at the Diaspora, but more efforts need to be put in place to tap the funds.

Exchange Rate

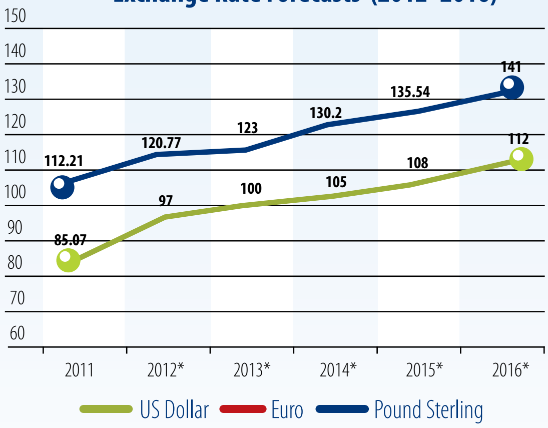
The year 2011 saw a general depreciation of the exchange rates against the major world currencies. The second half of 2011 saw the most rapid depreciation of the exchange rate against almost all major world currencies. By September, the Shilling had depreciated by 23 per cent against the US dollar to exchange at Ksh. 99.8/US$, and 23.7 per cent and 26.2 per cent against the Sterling Pound and Euro respectively, in October, to exchange at Ksh 159.56/Sterling Pound and Ksh 139.6/Euro, respectively. The rapid depreciation of the Shilling in September 2011 was caused by a build-up of issues. First; imports had been growing rapidly following credit expansion which had put more money in the hands of the people. Import growth was clearly outpacing growth in exports. The growth in imports was accelerated by the need to import maize at the height of a severe drought in the middle of 2011 and increased oil and industrial product demand which was worsened by reduced supply of oil globally following the Arab political uprising. The Central Bank intervened by tightening monetary policy, mopping up Ksh 20.65 million between April and May 2011.

Figure 15: Trends in exchange rates 2011



Source: Central Bank of Kenya

Figure 16: End Period Kenya Shilling Exchange Rate Forecasts (2012 -2016)



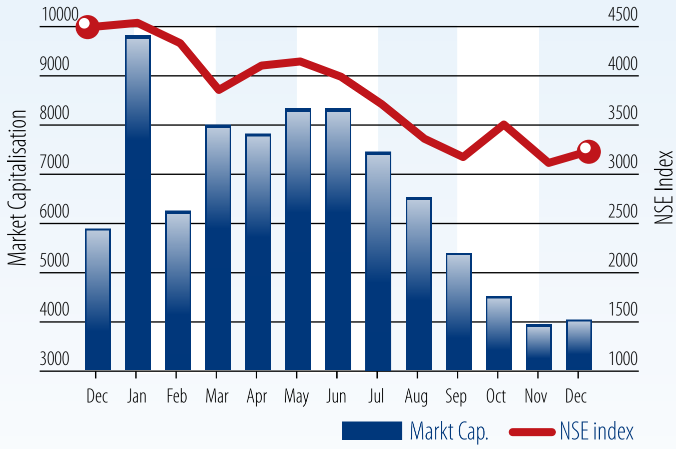
* Economic Intelligence Unit Forcasts

Source: Economist Intelligence Unit

Nairobi Securities Exchange

Market capitalisation at the Nairobi Securities Exchange (NSE) declined steeply by 58 per cent from a high of Ksh 9,460 million in January to Ksh 3973 million in December 2011. The NSE share index similarly, declined by 27.7 points to stand at 3205 points in December, down from 4433 points in January. The tight monetary policy which raised interest rates in the market including T-Bill rates and increased Government borrowing made investment in Government securities more attractive than investment in the equity market. At the same time, there were a number of negative market information that could have caused uncertainty in the equity markets. One such negative information that has been running for quite some time is the CMC board wrangles with allegations of board misconduct and mismanagement.

Figure 16: Activity at the NSE (Dec 2010- Dec 2011)



Source: KNBS

Outlook for 2012

The IMF predicts a global economic growth of 3.5 per cent in 2012. Nevertheless, the global economy is faced with significant challenges, particularly the Euro-zone crisis, where several countries risk defaulting on their sovereign debt and the debt yields increasing. China's economy is also faced with rising inflation and diminished demand for Chinese exports amid quality concerns. High energy prices continue to plague the global economy, especially due to geopolitical tensions in the Middle East and North Africa. The continued tensions and possible conflict between Iran and the rest of the western countries led by the US and Israel is a major concern that is likely to reduce oil supply and increase its price. Financial regulations are expected to be tightened in the post financial crisis era in the Western countries and Europe, and this is expected to have repercussions in the global financial markets.

On the regional front, the dispute between South Sudan and Sudan over boundaries and oil revenues could slow down economic growth in South Sudan. Nevertheless, the commissioning of an oil pipeline from Lamu to South Sudan should help reduce the region's dependence on Middle Eastern oil, benefiting Kenya, South Sudan and Ethiopia. Recently, Kenya discovered its own oil in Turkana Country. Even though the commercial viability of the oil is not yet ascertained, the discovery marks a turning point for Kenya as a regional super-power and global player in the oil supply. It is expected that the discovery will reduce Kenya's reliance on imported oil hence reducing her costs of production. The East African Community presents opportunities for increased trade and economic growth in the region. The current efforts to stabilize Somali also present an opportunity for increased trade. If Somali became stable, it would act as another source of market for Kenyan goods. Opportunities for business expansion into Somali will be numerous beginning with the re-building of the infrastructure. In addition, incidences of piracy and acts of terrorism which have increased sea transport costs would reduce. Kenya's export trade and tourism will therefore benefit with the reduction in piracy and fear of terrorist attacks.

On the domestic level, the IMF favourably reviewed Kenya's economic reforms and injected additional funds under the Extended Credit Facility. This has helped to boost Kenya's foreign exchange reserves. Various projections estimate that the economy will grow by above 5 per cent in 2012. However, the economy is susceptible to risks associated with political uncertainty regarding the impending elections later in the year and a weak supply side including capacity to export.

The level of inflation is expected to gradually fall in 2012 with the coming of the long rains and stabilization of the Shilling. High global energy prices are also likely to keep inflation at double digits. Interest rates are expected to remain high for the first half of 2012 as the effects of the tight monetary policy continue to be felt, but is expected to fall in the second half of 2012.

With the disbursement of the second tranche from IMF under the Extended Credit Facility and the third review that was done in April, foreign exchange reserves are expected to move steadily towards the minimum four months of import cover. The Shilling is expected to exchange at Ksh 80-85/US$ after significantly recovering from record lows at the end of 2011. The expected economic recovery is likely to result in a faster growth of imports than exports leading to a widening in current account deficit. Consequently, the balance of payments position will remain weak.

With strong performance in the NSE-20 index in 2012 after a weak performance in 2011, activity at the NSE is expected to pick up. Nevertheless, with the under-performance of revenue collections, the Government may be forced to turn to the domestic markets to borrow and this will increase rates on Government securities . Investment in Government securities will therefore still be more attractive drawing investors away from the equity market. On the other hand, the Capital Markets Authority must exercise its oversight role and ensure that investors have confidence in the capital markets.

the contributors

Habil Olaka has served as CEO of the Kenya Bankers Association since 2010. He is responsible for the strategic direction of the Association under guidance from the Governing Council. The Association's primary responsibility is the advocacy role on behalf of its membership, in addition to the management of the industrial relations and public affairs. The Association also owns and runs the Automated Clearing House.

He sits on a number of boards representing the KBA, namely the Kenya School of Monetary studies, the Higher Education Loans Board, the Auctioneers Licensing Board, the Federation of Kenya Employers, and the National Task force on AntiMoney Laundering and Countering Financing of Terrorism.

Previously, he was the Director of Operations of the East African Development Bank (EADB); he also has overseen EADB's operations in Kenya. He holds a First Class Honours BSc degree in Electrical Engineering from the University of Nairobi and an MBA in Finance from the Manchester Business School (UK). He is a member of the Institute of the Certified Public Accountants of Kenya (ICPAK) and the CFA Institute. He is an alumnus of the Strathmore School of Accountancy and has a good command of the French language.

Dr. Jacob Oduor is the Director of the Centre for Research on Financial Markets and Policy at KBA. Dr. Oduor has experience in macro-economic policy research and analysis.

He most recently served as senior analyst at Kenya Institute for Public Policy Research and Analysis (KIPPRA) and has served as lecturer of Econometrics and Statistics at Kenyatta University for over seven years. In addition, he has participated in several capacity building activities including as a trainer on Public Policy during a course organised for government officials including officials in the Ministry of Justice, and the Kenya Anti-Corruption Commission (KACC). Moreover, he has helped build the Kenya Revenue Authority (KRA) Tax model as Team Leader.

Dr. Oduor is currently a co-leader of a team of international experts in Macro Modelling, developing a Macroeconomic and Forecasting Manual for use by the Eastern and Southern African (ESA) Countries' central banks and Ministries of Finance. The project commissioned by the Macroeconomic and Financial Management Institute of Eastern and Southern Africa (MEFMI).

He is published in international journals, including the Journal of Policy Modelling (UK) and Journal of Development Effectiveness (USA). He holds a PhD in Economics from Bielefeld University (Germany) and a Master's degree in Economics from Kenyatta University.

Lydia Mbura is a Research Fellow. She has experience in management, business analytics, corporate governance and ethics, and marketing. She currently lectures on performance management and corporate governance and ethics at Cornerstone Training Institute, and has published a research paper on the "Effects of Logistics Outsourcing Strategies on Organisational Performance." in the International journal of business Management. She holds a Master's degree in Business Administration and Strategic Management from Jomo Kenyatta University of Agriculture and Technology of Nairobi; and a Bachelor of Commerce degree in Marketing from Kenyatta University.

Francis Ogula is a Research Fellow. He has experience in banking and card services, primarily in the areas of credit, regulation, and operations. Other industry experience includes retail and security services. He holds a Master of Science in Finance degree from the University of London (UK); a Bachelor of Science in Computer Science from Catholic University of Eastern Africa; a Bachelor of Arts in Economics from Ohio State University (US); and a diploma in French studies.

KENYA BANKERS ASSOCIATION




www.kenyabankers.co.ke