2012 KENYA BANKERS ECONOMIC BULLETIN

VOLUME FOUR

A report prepared by:

The Centre for Research on Financial Markets and Policy

KENYA BANKERS ASSOCIATION
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CENTRE FOR RESEARCH ON
FINANCIAL MARKETS AND POLICY

About this Report

This *Bulletin* reviews the performance of Kenya's economy in the fourth quarter of 2012 and looks back at the performance during the year, and an outlook for 2013. The report covers production trends in the real sector, government fiscal operations, public debt; inflation, interest rates; balance of payments; exchange rate; activity at the Nairobi Stock Exchange; and banking sector performance.

About the Centre for Research on Financial Markets and Policy

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

CENTRE FOR RESEARCH ON
FINANCIAL MARKETS AND POLICY

Kenya Bankers Economic Bulletin

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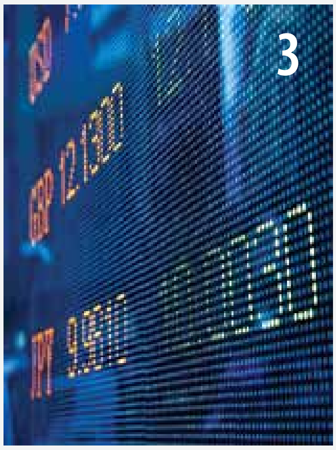
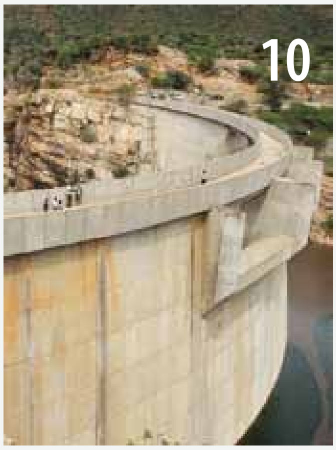
In this Issue



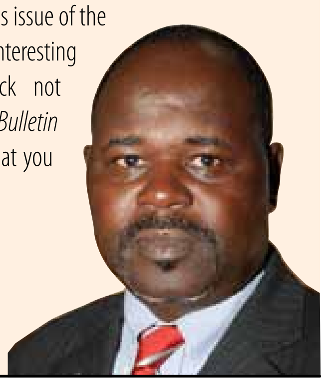


From the CEO's Desk

Welcome to the fourth volume of the *Kenya Bankers Economic Bulletin* for 2012. This issue discusses the state of the Kenyan economy during the last quarter of 2012, highlighting the fact that the economy is now realising a reversal of the declining growth seen in the first half of the year. Like the previous *Bulletins*, this issue covers production trends in the real sector, government fiscal operations and public debt; inflation and interest rates and exchange rate trends; the economy's balance of payments position; the performance of the Nairobi Securities Exchange; and banking sector performance.

It is our endeavour to continously make the *Bulletin* a useful tool that collates key economic information that we consider important to our readership. Beginning with this issue, we will be contextualising the economic and market trends in a forward look incisive commentary. While the economic environment, both global and domestic, has largely been crowded with pessimism, the commentary in this issue argues a case for realistic optimism.

It is my hope that you will find this issue of the *Kenya Bankers Economic Bulletin* interesting and useful. We welcome feedback not just on the areas that you find the *Bulletin* useful, but also on the aspects that you will like us improve on.



Habil Olaka
CEO, Kenya Bankers Association

Commentary: Shoots of Optimism

By Jared Osoro

By the close of the fourth quarter of 2012, there was reasonable evidence to underpin an optimistic outlook for the Kenyan economy's performance. While this by no means downplays the downside risks emanating from both domestic and external circumstances, the case for a positive but cautious stance can be persuasively argued.

The global picture…

Let's start with the external environment. The state of the global economy is anything but robust, but there are shoots of positive developments. The clear signal of this is the market response to a number of developments at the political and economic management front. The major central banks have led the way in building market confidence through their arguably positive policy activism.

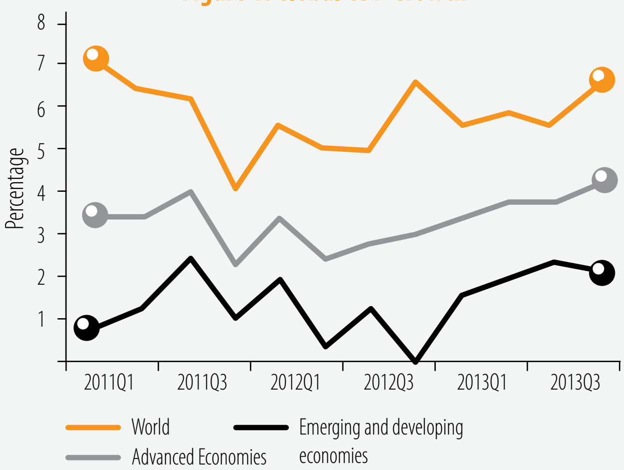
The European Central Bank (ECB) is on course in its promise to buy unlimited bonds if that will keep the Euro zone together. The Federal Reserve is focused on keeping interest rates at their current near-zero level until unemployment in the US falls below 6.5 percent from the current level of slightly below 8 percent. The Bank of England Governor-designate, appointed in November 2012 to assume office in July 2013, has sent unambiguous signals that he is willing to see higher inflation than the government's 2 percent goal for longer to support economic growth. The Bank of Japan seems to have followed the cue, doubling its inflation target from 1 percent to 2 percent and committing to buy assets on an open-ended basis from 2014.

The logic behind the central banks' signals and actions is that their promises to buy more bonds and for a long period will keep yields low, thereby enticing investors to look in the direction of riskier assets such as stocks, and consequently the higher share prices that will lead investors to boost consumption and growth. Combined with the fact that the Euro-zone political leadership has exhibited a determination to save the single currency and that the political leadership in the US managed to avoid the "fiscal cliff", the central banks have given investors and consumers a confidence boost to invest and spend.

With the markets looking up, the wind is on the back of the global economic growth as the emerging markets – in particular China – take the lead. Although some emerging economies such as Brazil and India continue to struggle with weak external demand and domestic bottlenecks that have slowed their recovery, China – the second largest economy in the World – seems to be picking its momentum by returning a 7.9 percent real growth in last quarter of 2012 from the previous quarter's 7.4 percent real growth.

The always-cautious IMF is optimistic, indicating that global growth will increase during 2013 on account of the factors underlying soft global activity being expected to subside. Even then the up-turn could be more gradual than earlier anticipated as the downside risks remain significant, including the possibility of renewed setbacks in the euro area and risks of excessive near-term fiscal consolidation in the US.

Figure 1: Global GDP Growth



Source: IMF

...and what is in it for us.

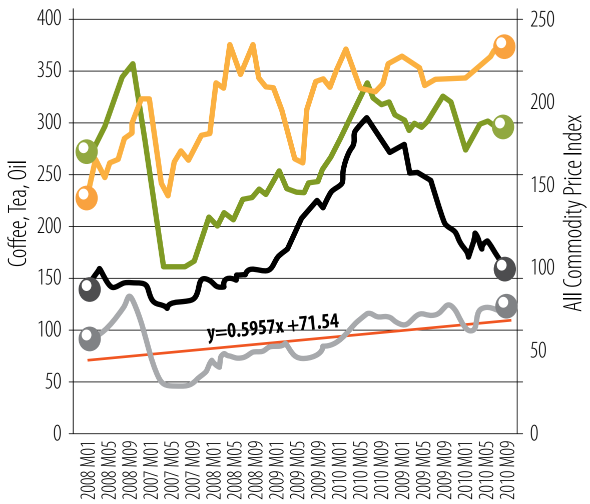
Obviously, a global economic upturn spells good fortunes for the Kenyan economy – just like a downturn would portend bad fortunes. The previous two volumes of *Kenya Bankers Economic Bulletin* (Volumes two and three), have presented the Kenyan economy's recovery as lacking in momentum. We now believe that the softening of growth will give way to the commencement of a positive trajectory on a shared account of the positive global vibes and accommodative domestic circumstances. It is with this lens that we see the sustenance of the growth momentum from a decline of real GDP growth to 3.3 percent in the second quarter of 2012 from the first quarter's 3.5 percent to 3.8 percent in the third quarter.

The contact between the Kenyan economy and the global economy is mirrored by the balance of payment position, and especially the current account. Superficially, the economy's external position may be judged to have improved based on the nominal level of international reserves that were estimated at US$5.2 billion (equivalent to 3.6 months of the following year's imports of goods and services) during the financial year 2011/12. It is noteworthy though that the economy's current account deficit widened to 9.1 percent of GDP during the same period from the previous year's 8.4 percent, arising mainly from oil imports.

But good weather in Kenya comes with good fortunes; on its account alone, we can expect the current account deficit to narrow however mildly because a repeat of drought-related oil and food import is unlikely. As later outlined in this *Bulletin*, the oil imports towards thermal power generation is on the decline as the hydro generation increases. Further, the diversification of power generation has seen the share of geothermal power increase with the goal being to raise that proportion to 30 percent by 2020 from the current level of 20 percent. While exports to and tourist arrivals from Europe declined in the first 6 months of 2012 as a result of difficulties in the euro area, the decline was offset by earnings from exports to non-traditional markets. At worst, Kenya's exports to the Euro zone will stagnate given that the IMF expects a return to recovery in this market, albeit with a delay.

With recovery in the alternative export markets likely to be relatively more buoyant, the economy's current account would be expected to marginally narrow to 8.2 percent of GDP. The improvement however needs to be seen in proper perspective, bringing into context the fact that the global commodity price regime as represented by the all-commodity price index has over the past two years largely portrayed an abatement; but oil prices remain stubbornly over US$100 per barrel and the trend since the 2008 global economic crisis is clearly an increasing one. Thus, unbundling the current account – especially the goods export component that is mainly tea, coffee, and horticulture – should enable the tempering of expectations on the speed of repair of the economy's external position.

Figure 2: Commodity Prices



- Coffee, Other Mild Arabicas International Coffee Organisation New York Cash price, US cents per pound
- Tea, Mombasa, Kenya, Auction Price, US cents per kilogram, From July 1998, Kenya auctions; Prior London auctions
- Oil, Dubal, medium, fob Dubai Crude Oil (petroluem), US$ per barrel
- All commodities Price Index, 2005 = 100, includes both Fuel and Non-Fuel Price Indices

Source: IMF Primary Commodities Prices Database

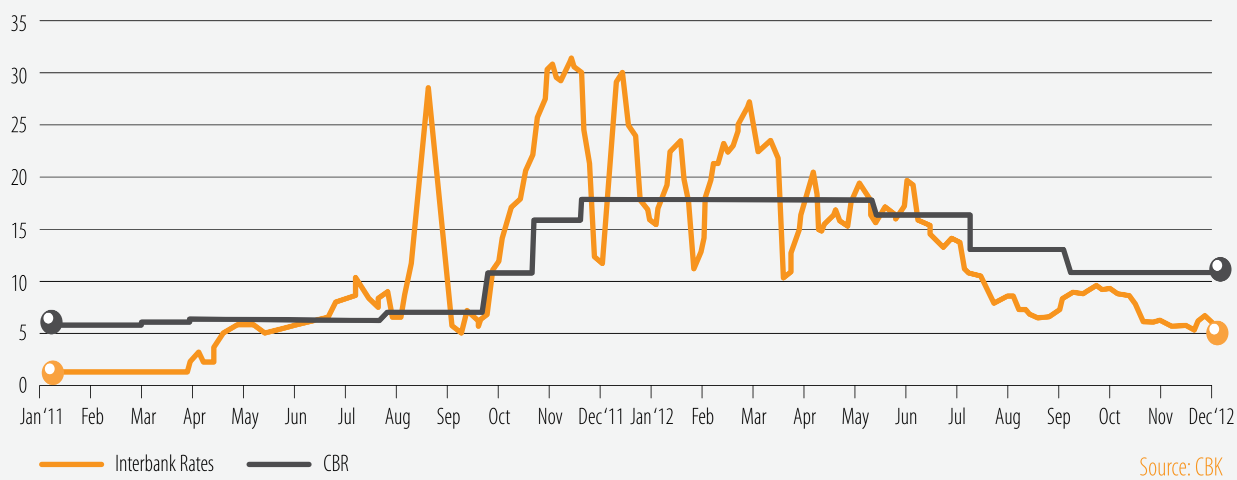
It is not all gloom…

Let's now look at the domestic environment. Although the declining international prices have negative implication on export earnings, they have had a positive influence on local food prices. Such influence has however been of a lesser extent than that of regional supply factors, cognisant of the bumper food harvest in East Africa. While this has contributed to the declining inflation that we delineate in this *Bulletin*, the Central Bank of Kenya's monetary policy stance has been demonstrated to be the key driver of the trend. As the positive influence of monetary policy take root and inflation attains the single digit target, the CBK has scope to take an increasingly accommodative stance in line with inflation expectations.

The fact that a decline in market interest rate – however gradual – and a downward shift in the yield curve is observed, the signal is clear that low inflation expectation is entrenching itself. It is refreshing that the gains so far have not inculcated complacency on the part of the CBK, for the central bank has explicitly indicated that no rapid reductions in the policy signalling rate, the Central Bank Rate (CBR), are likely for fear of upsetting the gains on the inflation front as well as putting the exchange rate market under undue pressure.

It is refreshing too that the CBK is complementing the CBR's signalling with its new framework for monetary operations as a means to guide market expectations. Even preliminarily, progress can be observed. There has been a boost to market liquidity which we can attribute to the lower credit expansion during the tight monetary policy period as well as an indication that there could be a gradual shifting of commercial banks' investments to longer maturities. As a consequence, the interbank rates have been below the CBR since July 2012, a state of affairs that calls for the CBK to enhance absorption so as to ensure that the levels of commercial banks' reserves at the central bank are optimal to support both system stability and credit expansion.

Figure 3: Interbank Rates and the Central Bank Rate (%)



Source: CBK

…but it may not be all good fortunes either.

While we observe that public debt-to-GDP propotion by the end of the third quarter of 2012 was about 45 percent representing an improvement from 57 percent for a corresponding period in 2011, there is a lively debate that tends to point to the conclusion that public debt at its current level is constraining growth. Admittedly, that is a view that we think is arrived at based on quick conjecture and thus necessitates further thought.

A good starting point is the recognition that Kenya is debt sustainable, going by the joint World Bank – IMF debt sustainability analysis of November 2011 and its validation by the IMF's review of October 2012. Therefore, even if there are indications that the Kenya Revenue Authority (KRA) may be falling short of its revenue targets, the fear that a resort to domestic borrowing would result in "crowding out" private investments may be exaggerated.

First, such fear ignores the fact that the current debt-to-GDP level represents a success in fiscal policy given that earlier projections were that such level would only be achieved by the end of 2012/14 fiscal year.

Second, the fact that the government has a debt strategy – however imperfect – seems to have escaped the debate; if it hadn't, then the argument that the contracting of a US$ 600 million 2-year syndicated loan in May 2013 to partly substitute a potentially more expensive sovereign bond could for instance have featured in the debate as a positive development.

The next point of reflection is that Kenya's debt suitability has to confront the risk of a threat on economic growth. In other words it is not debt that may be squeezing growth; instead it is growth that may lead to debt being unsustainable. Given that the domestic and international interest rates regime may currently be appropriate for borrowing, that concessional debt may still be the biggest proportion of any external borrowing, and that such borrowing will principally target projects whose economic viability has been ascertained, then calculated further borrowing would be entrenching sustainable growth. It will thus be working in the direction of promoting debt sustainability and not vice versa as popular commentary seems to imply.

Ultimately…

The Kenyan economy's main risks on the external environment's outlook are tied to the further deterioration of the euro zone crisis. Persistent low external demand would affect non-traditional agricultural exports, tourism and remittances. On the domestic front, the anxiety over the March 2013 general elections may have occasioned investors holding back – although the upward trajectory that we, for instance, see at the Nairobi Securities Exchange is an indication that the mart may have judged any potential political risk as mild and factored that into the pricing. If however there is a presidential election run-off, then investor anxiety may be prolonged and that will filter into the markets and overall economic performance. Save for that, and on account of the arguments we pursue above, the real economic growth projection – by for instance the IMF – of 5.4 percent for the year 2012/13, up from 4.7 percent for the year 2011/12 appears reasonable.

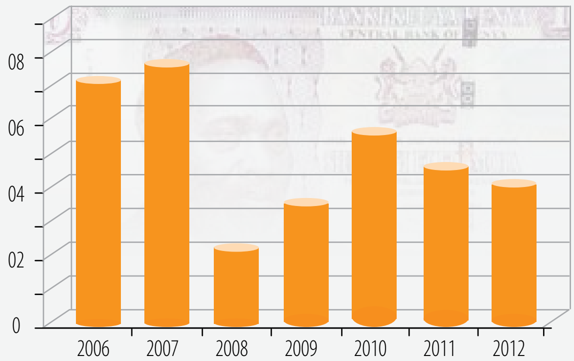
Jared Osoro is the Director of the KBA Centre for Research on Financial Markets and Policy

GDP Growth

The Kenyan economy grew by 3.8 percent in the first three quarters of 2012 compared to a 4.2 percent growth during the corresponding period in 2011. This was the second consecutive year since 2010 that GDP growth slowed down during the review period. Various factors contributed to the slowdown in growth, not least the tight monetary policy as manifested by the high Central Bank Rate (CBR) at 18 percent, a level that the Central Bank of Kenya (CBK) retained through the period December 2011 to July 2012 when it was lowered to 16.5 percent, and subsequently to 13% and 11% in September 2012 and November 2012 respectively. The high CBR as a signal of the tight monetary policy stance was complemented by open market operations and an earlier increase of the increase in the Cash Reserve Ratio from 4.75 percent to 5.25 percent in November 2011.

The CBK's tight monetary policy stance was evidently successful in bringing down inflation from a high of 18.3 percent in January 2012 to 3.2 percent in December 2012. While investors remained largely positive about the prospects of the Kenyan economy, the uncertainties associated with the general elections scheduled for March 2013 occasioned a wait-and-see stance especially from foreign investors. Nevertheless, adequate rainfall during the year boosted agricultural output and enabled increased capacity utilisation in the generation of hydroelectricity consequently boosting both industrial and commercial sectors. The economy is projected to grow by between 3 percent and 5 percent during 2013.

Figure 4: Real GDP Growth Q1-Q3 (2006-2012)



Source: KNBS

Agriculture

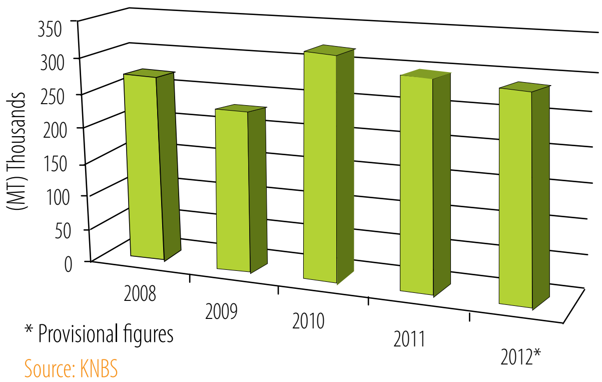
The agricultural sector remains the backbone of the Kenyan economy, accounting for about 21% of the economy's GDP. The sector realised a 3.8 percent output growth in the first three quarters of 2012, an improvement from the sluggish 1.4 percent growth during the corresponding period in 2011. The fact that agricultural output as a percentage of GDP during the first three quarters of 2012 remained at same level as that of a similar period in 2011 implies that despite the increased output, relative growth was not robust enough.

The country received adequate rainfall in 2012, a relief from the drought and subsequent famine in many parts of the country in 2011. However, some areas – notably the Rift Valley and Western Kenya – experienced heavy rains and floods which destroyed crops, displaced families and killed animals while at the same time disrupting agricultural activities for an extended period of time. Furthermore, maize, sugarcane, and wheat crops were attacked by various diseases resulting in substantial financial and productivity losses. Such shocks to agricultural production had an effect on the rest of the economy given the sector's dominant role the economy's performance.

The fishing sub-sector's output grew by 7.0 percent in the first three quarters of 2012 to Ksh. 4,499 million, up from Ksh. 4,204 million in 2011; this was a marked improvement compared to a 3.7 percent growth during the same period in 2011. Notwithstanding the observed performance, the sub-sector's growth has not been vibrant enough to reflect the effects of the efforts to diversify fishing away from conventional commercial fishing methods that face the challenge of declining natural stocks as a result of overfishing, water hyacinth and other water weeds, among other factors.

The total quantity of tea processed between the months of January and October increased by 25.7 percent in 2012 to 288,184 MT, up from 229,276 MT during the same period in 2011, while the average price per kg. at the tea auction increased by 2.9 percent to Ksh. 267.36/kg. up from Ksh. 259.71/kg. in 2011. The rebound in production can be attributed to favourable rainfall conditions in the tea producing areas in 2012, depressed rainfall and frost caused a drop in production in 2011 and consequently a decrease in the volume of exports in 2012. The volume and value of tea exported decreased 4.3 percent and 3 percent respectively during the period under review.

Figure 5: January-October Tea Production (Quantity) 2008-2012



* Provisional figures

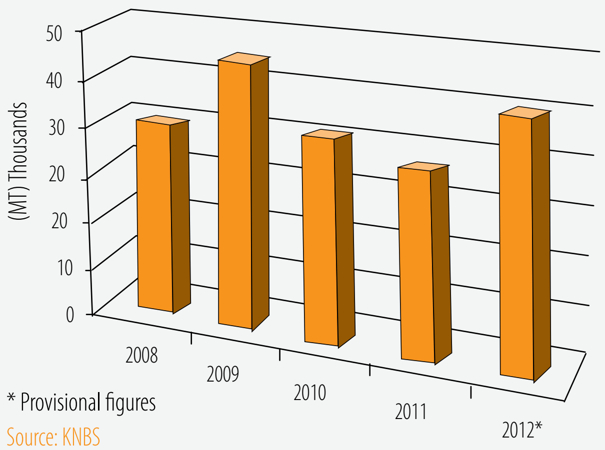
Source: KNBS

The quantity of coffee auctioned at the Nairobi Coffee Exchange increased substantially in 2012. A total of 40,257 MT of coffee was auctioned between January and September 2012, a 58.1 percent increase from 2011, when 25,465 MT were auctioned during the same period. This can be contrasted with a 17.2 percent decrease in production in 2011, down from 30,772 MT in 2010. The International Coffee Organisation (ICO) Composite, a global overall benchmark for the price of green coffee, averaged 156.34 US cents/pound in 2012, down from 210.39 US cents/pound in 2011.

The record high prices global coffee markets experienced in 2011 were bolstered by expectations of diminishing output in major coffee producing countries, Kenya included, coupled with high demand in the

world's major coffee consuming countries. After benefitting from the record high prices in 2011, local coffee producers had to contend with lower prices in 2012, with average prices at the Nairobi Coffee Exchange decreasing 35.8 percent from 527.19 Ksh/kg in 2011 to 338.32 Ksh/kg. With global production expected to grow in 2013, coffee prices are likely to continue falling or at best bottom out.

Figure 6: January-September Coffee Production 2007-2012

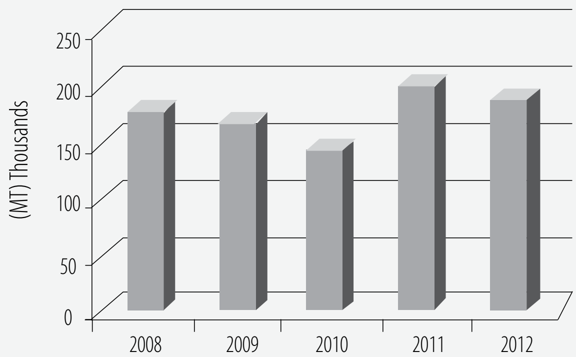


* Provisional figures

Source: KNBS

Horticultural produce continue to be one of the country's leading foreign exchange earners. January to November data show that after increasing by a remarkable 107.2 percent in 2011, the value of horticultural exports increased marginally by 1.73 percent to Ksh 80,831.3 million , up from Ksh 79,454.4 million in 2011. Exports were affected by the Eurozone crisis, which dampened demand for cut flowers in Europe, the biggest importer of the country's horticultural produce.

Figure 7: January – November Horticultural Exports 2008 – 2012



Source: KNBS

Manufacturing

The manufacturing sector grew by 3.9 percent during the first three quarters of 2012 compared to 2.9 percent for the corresponding period in in 2011. The sector's performance picked up in the third quarter with growth during the quarter hitting 4.7 percent, compared to the first half average of 3.4 percent. This was on the strength of increased generation of the cheaper hydroelectric power, a more stable exchange rate market, and slower growth in global petroleum prices.

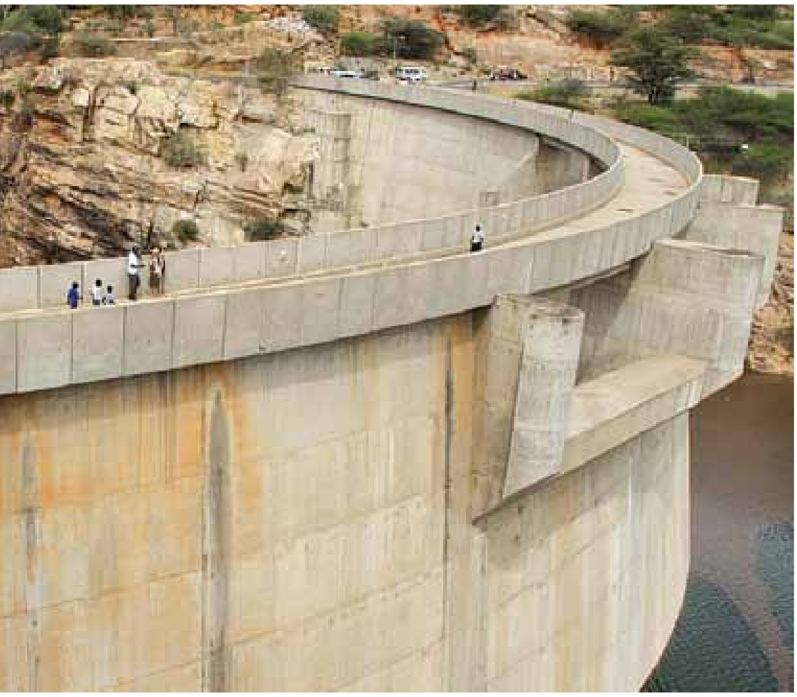
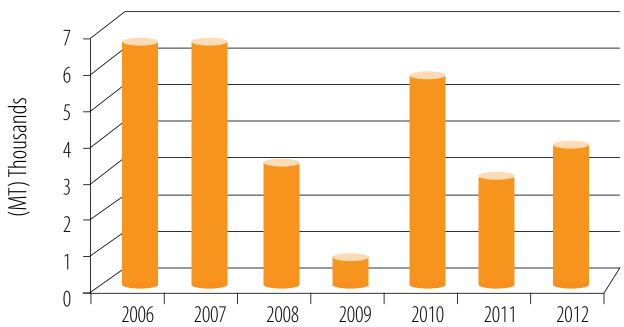


Figure 8: Q1-Q3 Growth in Manufacturing (2007-2012)



Source: KNBS

As at September 2012, credit to the manufacturing sector in absolute terms grew from Ksh. 152 billion in 2011 to Ksh. 163 billion in 2012, meaning that the sector continues to be one of biggest three non-government recipients of banking sector credit in the economy, the others being private households and the trade sector. This meant that the manufacturing sector remained sensitive to the cost of credit and interest rate volatility.

Notwithstanding the increase in competitive hydroelectric power generation in the third quarter of the year, the relatively high cost of energy significantly increases manufacturing costs and negatively affects the country's comparative advantage vis-à-vis South Africa and Egypt, among other competitors. Nevertheless, the sector has the potential to drive Kenya's quest to middle income status given the availability of a well-educated and skilled labour pool, a strategic location in the East African region and a relatively mature services sector.

Energy

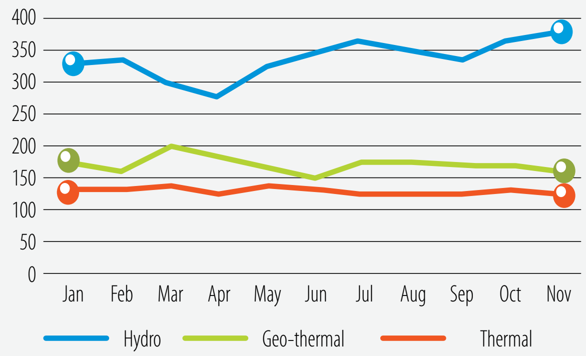
The energy sector registered modest growth in 2012. Provisional data indicate that total electricity consumption increased by 2.3 percent between January and September 2012 to 4682.8 KWh, up from 4,577.9 KWh during a similar period in 2011. This was a slight decline in consumption growth, given that it grew 3.6 percent in 2011, up from 4,418 KWh during a similar period in 2010. Boosted by increased rainfall, hydro-electric power generation increased by 27.02 percent from 2,327.07 KWh between January and September 2011 to 2955.81 KWh during a similar period in 2012.

While the contribution of geo-thermal electricity to the national grid remained constant at 20.2 percent of the total generation, the contribution of hydro-electric power generation to the national grid increased to 52.7 percent in 2012, up from 43.4 percent in 2011 whereas that of the more expensive thermal power declined to 27 percent, down from 36.3 percent in 2011. Domestic consumption of electricity increased by 4.5 percent between January and October 2012 to 5314.2 million KWh, up from 5,087.1 million KWh in 2011, compared to a 3.6 percent increase in 2011, up from 4911.9 KWh. Electricity consumption is expected to increase as both residential and commercial property development increases, and given that the current supply is far outstripped by demand in the manufacturing sector.

In the petroleum sub-sector, fuel prices marginally fluctuated between the years 2011 and 2012. Average prices for gasoline and light diesel, increased by 2 percent and 1 percent respectively while the price of kerosene decreased by 4.4 percent partly as a result of zero-rating of excise duty on kerosene. Petroleum fuel consumption between the months of January and September increased 3.4 percent, from 2,628.33 thousand metric tonnes in 2011 to 2769.35 thousand metric tonnes in 2011, which was a decreased growth rate as the consumption had increased 14.6 percent in 2011, up from 2337.3 metric tonnes during the same period in 2010.

Energy cost remains relatively high in Kenya. Diversification to alternate power generation sources, increased competition among sector players and increased investment in the sector could see costs reduced. The government, in conjunction with development partners and other stakeholders, is taking steps by investing in alternative electricity generation. On-going and planned projects include The Lake Turkana Wind Power Project, which aims at providing an additional 300MW of power to the national grid, expected to be completed towards the end of 2014; expansion of infrastructure at the Olkaria Geothermal Power Plant; a proposed coal power plant in Kilifi; and oil and natural gas exploration in Turkana and off the Kenyan Coast respectively, at least in the medium term to long term, should see the country move towards energy self-sufficiency.

Figure 9: Electricity Generation by Source: Jan –Nov 2012



Source: KNBS

Building and Construction

Growth in the building and construction sector slowed down in 2012. Between January and September 2012, consumption of cement – a key indicator of activity in the construction industry - increased marginally by 1.2 percent to 2,576,351 MT, up from 2,546,375 MT in 2011; during the previous year, the sector's growth for a corresponding period was 12.6 percent. Despite the slowdown in construction due to high interest rates at the beginning of 2012 into the second half of the year, the sector's growth potential remains high on account of robust demand for high quality and affordable housing particularly in the middle income to higher income segment. There is also potential for growth in the low income segment as the government, in conjunction with development partners, continues with its slum upgrading projects that seek to provide affordable quality housing to slum residents. Nevertheless, challenges abound, particularly in urban planning and enforcement as many privately constructed buildings do not conform to building codes and thus compromise quality and consequently safety.

Transport and Communications

The airline industry's operating environment during the year was characterised by high fuel costs and taxes, stiff competition, and declining passenger volumes, particularly due to the Euro zone crisis given that Europe is traditionally the country's biggest source of visitors. The scenario was applicable on both the domestic and international aviation fronts.

Total mobile telephone subscriptions increased by 17.5 percent to 29,430,072 subscriptions as at June 2012, up from 25,048,774 subscriptions as at the same period in 2011. Total internet subscriptions on the other hand increased by 81.7 percent for the same period from 4,258,287 subscriptions in 2011 to 7,738,882 subscriptions in 2012. Data from the Communications Commission of Kenya (CCK) indicate that mobile telephony penetration, as measured by the number of active mobile phone numbers per 100 inhabitants increased by 11.2 percent

as at July 2012 to 75.4 percent, compared to 74.0 percent as the same period in 2011. Cheaper tariffs occasioned by stiff competition among the operators, access to affordable handsets and the increasing necessity of mobile money transfer accounts contributed to the increased penetration.

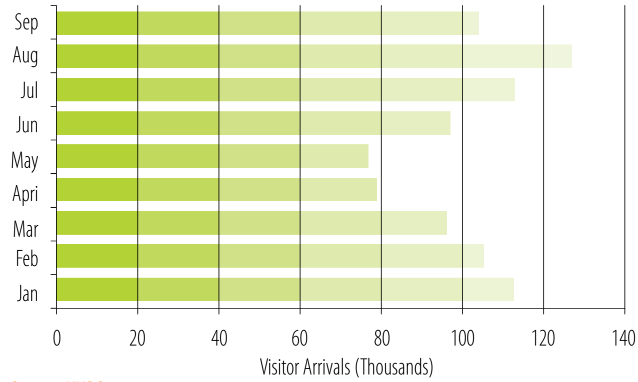
While the decision by the government to deactivate counterfeit handsets, estimated to number about 1 million, will undoubtedly have an impact on the penetration rate, there is need to recognise that consumers and phone manufacturers alike need to be protected from the dangers of counterfeit phone usage through co-ordination by the relevant government agencies. The gradual shift by consumers to smart phones could see a reduction in prices of the older generation phones in the medium term, and hence sustain the growth in penetration rates.

Tourism

Total visitor arrivals declined by 28.3 percent to 906,960 visitors between January and September 2012, down from 1,264,280 visitors during the same period in 2012. The biggest contributor to the decline was the Eurozone crisis that affected the number of visitor arrivals from the country's largest source of tourist. In addition, security concerns in many pockets of the country, but in particular the Coastal region, Northern and North Eastern Kenya, and Nairobi during the course of the year led to security alerts of varying severities.

The lower tourist numbers, among other factors, have led to the withdrawal of a number of international airlines from operating in the Kenyan skies, although cut-throat competition and realignments in the global aviation industry could also have played a role in the withdrawals. Further, the political climate in the run-up to and after the elections of 2013 stands to influence the number of tourist arrivals in 2013.

Figure 10: Visitor Arrivals through Jomo Kenyatta and Moi International Airports Jan-Sep 2012.



Source: KNBS

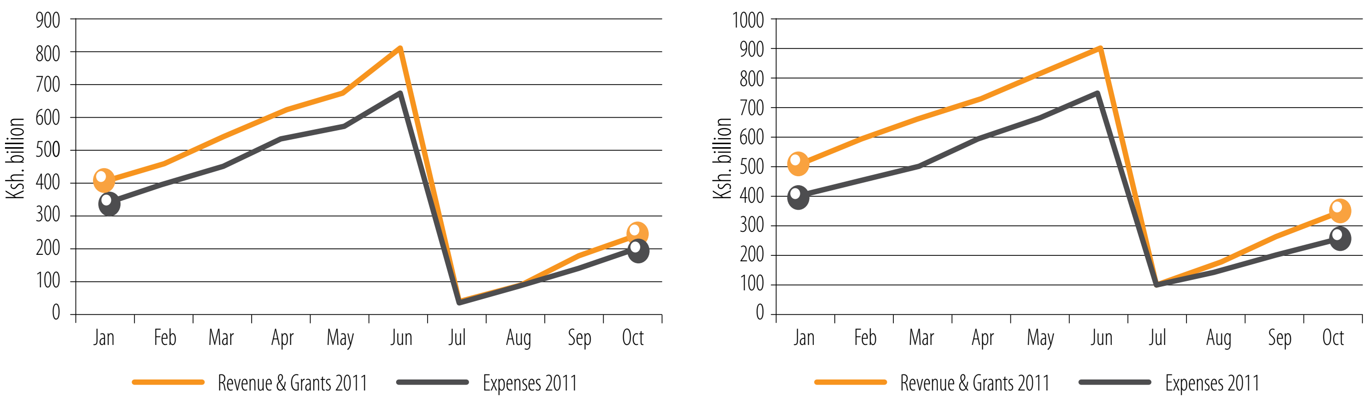
An international dispute over the EU's proposed airline carbon tax on flights to and from Europe threatened to increase travel costs and consequently affect tourist traffic from Europe, although its implementation was suspended in November pending further consultations. All in all, tourism stakeholders are making concerted efforts to market the country; during the London Olympics in July, the "Kenya House" was featured to showcase the country as an attractive tourist destination to the target population of millions of Olympics visitors.

Financing of Government

Provisional figures indicate that total government revenue and grants as at September 2012 increased by 8.9 percent to Ksh. 173.3 billion, up from Ksh. 159.2 billion during the same period in 2011. Total expenditure during the period under review grew faster than total revenue and grants, growing by 29.3 percent to Ksh. 232.3 billion, up from Ksh. 179.6 billion as at the same period in 2011. Thus, the budget deficit decreased by 2.6 percent from Ksh. 15.3 billion in 2011 to Ksh. 14.9 billion in 2012.

The share of development expenditure to total expenditure increased to 27.6 percent up from 24.1percent as at September 2012. Nonetheless, an expected increased wage bill as a result of demands for pay raises by various trade unions is expected to exert pressure on government expenditure. In addition, increased security and other logistical requirements as a result of the impending general elections are also likely to reverse the gains made in deficit reduction. The review of the VAT Act would have opened up opportunities for additional revenue, but it has met resistance from many quarters, given the logistical bottlenecks envisaged in the administration of the tax.

Figure 11: Total Government Revenues and Expenditures in 2011 and 2012

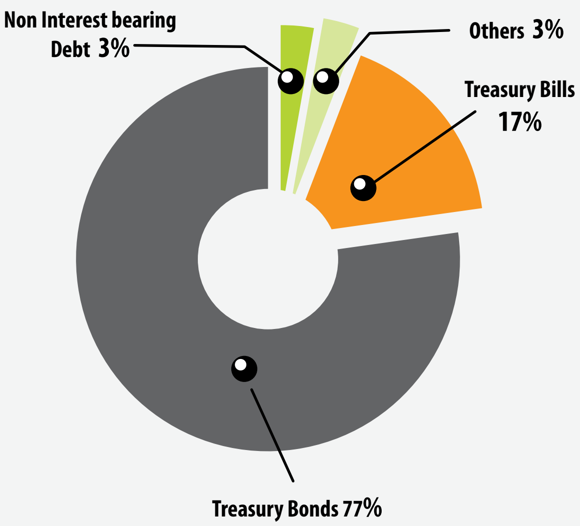


Source: Ministry of Finance

Public Debt

Total public and public guaranteed debt at the end of the third quarter of 2012 stood at US$ 20.25 billion or 44.6 percent of GDP, compared to US$ 15.66 billion or 56.65 percent of GDP at the end of the same period in 2011. This represents a decrease in the debt-to-GDP ratio, an indicator of the sustainability of public debt; public debt is generally viewed as sustainable as long as the debt- to-GDP ratio is non-increasing. As at the end of September 2011, domestic debt as a percentage of total public debt stood at 48.9 percent, increasing to 53.5 percent at the end of September 2012. In terms of its composition, Treasury bond holdings constitute 77 percent of the domestic debt, followed by Treasury bill holdings which constitute 17 percent of the domestic debt.

Figure 12: Composition of domestic Debt

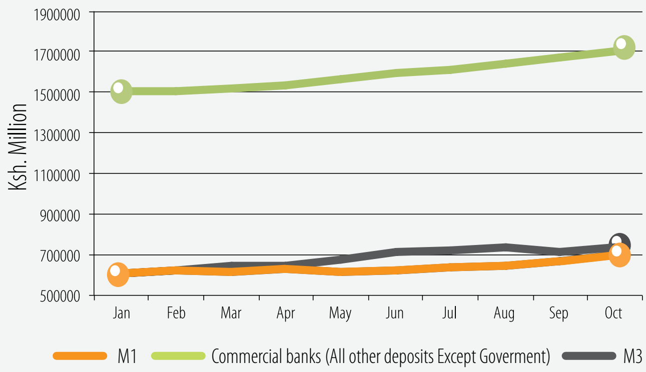


Source: Ministry of Finance

Money and Credit

Broad money supply (M3) in the economy grew by 13.1 percent between January and October 2012, a slight dip, compared to a 15.9 percent growth during the same period in 2011. M1 grew by 15.2 percent while deposits in commercial banks (excluding demand deposits and Central Government deposits) increased by 21.1 percent during the period under review. During the year, there was a perceived shortage of coins which particularly inconvenienced retailers and consumers. The Kenya Bankers Association, the Central Bank and other stakeholders launched a campaign to encourage consumers to use their coins to reduce inconvenience and facilitate smooth circulation of coins in the economy. Total domestic credit as of September increased 11.1 percent in 2012, with the government receiving 21.2 percent of the total credit while the private and other public sector received 78.8 percent.

Figure 13: Components of Money Supply 2012

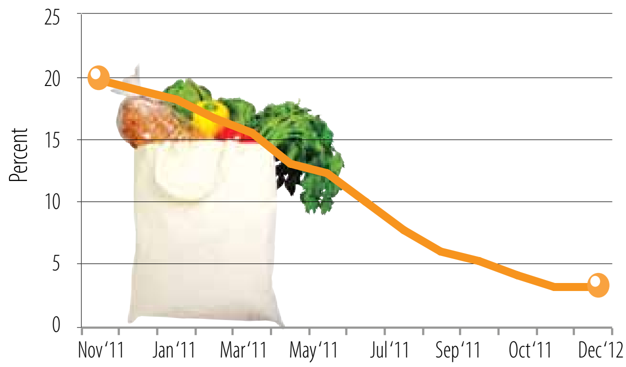


Source: CBK

Inflation

Overall inflation trends in 2012 sustained a declining trend, plummeting from a high 18.3 percent in January to 3.2% by December 2012. Various factors contributed to the drop in inflation: increased rainfall, led to increased food production and consequently lower food prices; an increase hydroelectrically generated power, which is cheaper than thermally generated power, and a tight monetary policy stance by the CBK which dampened aggregate demand and consequently slowed down GDP growth. The contribution of food and non-alcoholic beverage inflation to overall inflation as at the end of December decreased to 1.73 percent in 2012, down from 24.98 percent in 2011, while that of housing and energy decreased to 3.89 percent, down from 16.68 percent as at the end of the same period.

Figure 14: Inflation Trends (September 2011-November 2012)

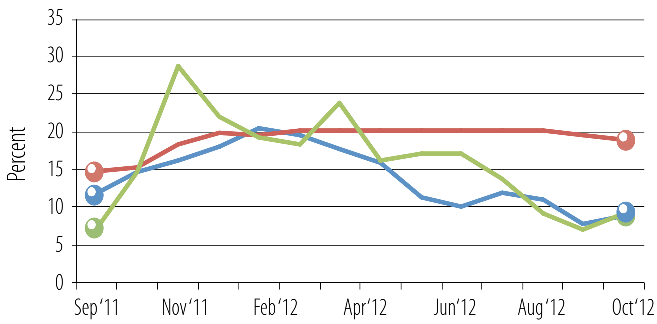


Source: KNBS

Interest Rates

Interest rates were generally on a downward trend, with the 91-day Treasury Bill rate declining by 11.58 percent between January and October 2012, while the Interbank rate declined by 10.22 percent during the same period. More significantly, after staying unchanged at 18 percent during the first half of 2012, the Central Bank Rate (CBR), was reduced to 16.5 percent in July, and subsequently to 11 percent in October, signalling the end of monetary tightening phase after successfully lowering inflation to the targeted range. The average commercial bank lending rate followed suit, decreasing by 6.2 percent between July and October 2012, while the average commercial bank savings rate increased by 9.6 percent during the same period, thus narrowing the interest rate spread as banks sought to mobilise more deposits.

Figure 15: Trends in interest Rates (September 2011 – October 2012)



Source: CBK

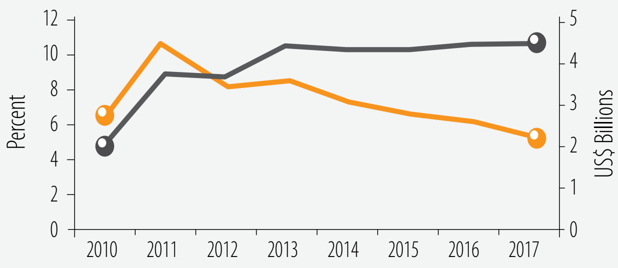
Balance of Payments

The country's current account deficit is expected to hit US$ 3.54 billion in 2012, remaining relatively unchanged compared to 2011 when it stood at US$ 3.6 billion. According to IMF forecasts, the deficit is expected to increase by 20.31 percent in 2013 to US$ 4.26 billion. Between 2010 and 2013 forecasts, the current account deficit and GDP have tended to move in tandem. The deficit as a percentage of GDP is forecast by the IMF to shrink by an annual average of 0.74 percentage points between 2013 and 2017, and is expected to stand at 5.57 percent in 2017. The absolute current account deficit is expected to remain relatively flat, growing marginally at an average annual rate of 0.02 percent.

Partially as a result of tight monetary policy, total exports slowed down substantially in 2012 after experiencing strong growth in 2011. Total exports between January and September were valued at Ksh. 383,090.37 million, barely a 1 percent increase, up from Ksh. 379,318.14 million in 2011, compared to a 28 percent increase in 2011, up from Ksh. 296,440.85 million in 2010. Similarly, imports grew much slower during the same period in 2012, at 7 percent, valued at Ksh. 1,018,925.77, up from Ksh. 956,663.93 million, compared to a 41 percent increase in 2011, up from Ksh. 680,615.11 million in 2010.

Total diaspora remittances between January and September 2012 increased 36.1 percent from US$ 643.77 million in 2011 to US$ 876.31 million in 2012. The slowly improving economic climate in the US likely contributed to the increase with average unemployment between January and November decreasing by 90 basis points from 9.0 percent to 8.1 percent.

Figure 16: Current Account Deficit: 2010-2017*



Source: CBK

Exchange Rate

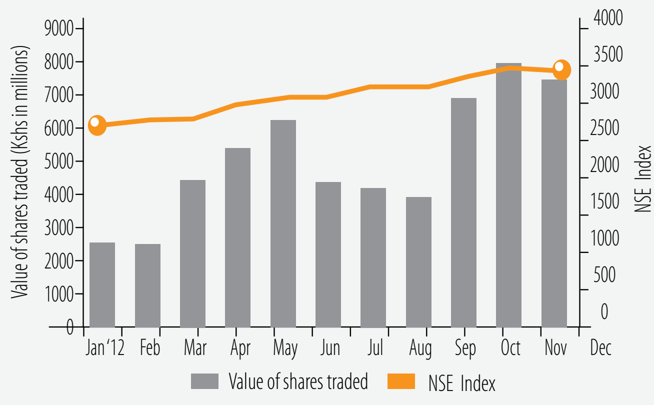
The Kenya Shilling exchanged at an average of Ksh. 84.42, Kshs.108.34 and Ksh. 133.59 against the Euro, US Dollar, and Sterling Pound respectively in 2012, an appreciation of 12.3 percent , 4.9 percent, and 6.2 percent respectively, from an exchange rate of Ksh. 123.6, Ksh. 88.8, and Ksh. 142.5 respectively in 2011. The shilling gained substantially against the Euro relative to the Sterling Pound and US Dollar due to the slow abating of the Eurozone crisis that risked causing an implosion of the Euro. The US had fiscal challenges of its own, arising from disagreements between the legislature and the executive over the economy's budget and the fiscal deficit outlook. Nonetheless, the United States has the advantage of being a "currency union" with a more significant level of banking and fiscal co-ordination among the states than the European has among its sovereign member states.

Figure 17: Exchange Rates with Major Currencies – January-December 2012

Nairobi Securities Exchange

The total value of shares traded at the Nairobi Securities between January and November increased 5 percent in 2012, to Ksh. 79,211 million, up from Ksh. 75,443 million for a similar period in 2011. The total value, however, declined in the second quarter and the third quarter, and only rallied at the end of the third quarter into the fourth quarter. An average of 49.6 percent of equity trading in the capital markets was done by foreigner entities. The decline in the NSE-20 share index observed in the period May 2012 to August 2012 was associated with the uncertainty over the election date and the corresponding likely political and economic instability. With the setting of the election date to March 2013, trading rallied and increased on an average 131.9 percent between September and November 2012 from 2011 levels. Investors are likely to watch closely the run-up to the elections and it is hoped that minimal disruption will occur in the economy before, during and after the elections.

Figure 18: Activity at the Nairobi Securities Exchange



Source: KNBS

Banking Industry Performance

The banking industry recorded improved performance during the quarter ended 30th September 2012 as the size of assets stood at Ksh. 2.3 trillion, loans and advances were worth Ksh. 1.32 trillion ,the deposit base was Ksh. 1.72 trillion and profit before tax of Ksh. 80.8 billion.

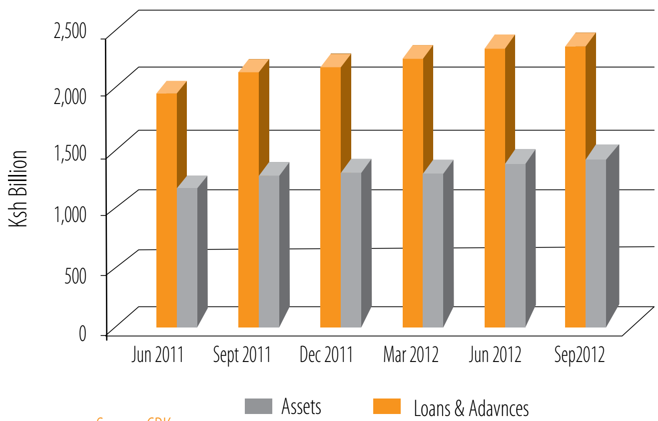
Assets

During the quarter ended September 30 2012, the banking industry registered improved performance with the size of assets standing at 13.6 percent more that the level at an equivalent period in 2011. The assets increased to Ksh. 2,300 billion up from Ksh. 2,024.50 billion in the same period in 2011.

Loans and Advances

Gross loans and advances increased by 11 percent from Ksh. 1,192.50 billion in the quarter ended September 30, 2011 to Ksh. 1,320.00 billion during the quarter ended September 30, 2012.

Figure 19: Total Value of Assets and Loans and Advances: June 2011-September 2012

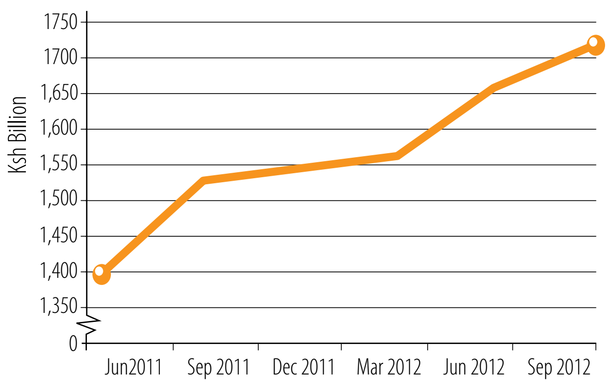


Source: CBK

Deposit Liabilities

Deposits increased by 12.8 percent from Ksh. 1,524.6 billion in the quarter ended September 30, 2011 to Ksh. 1,720 billion in the quarter ended September 2012.

Figure 20: Total Value of Deposits June 2011-September 2012

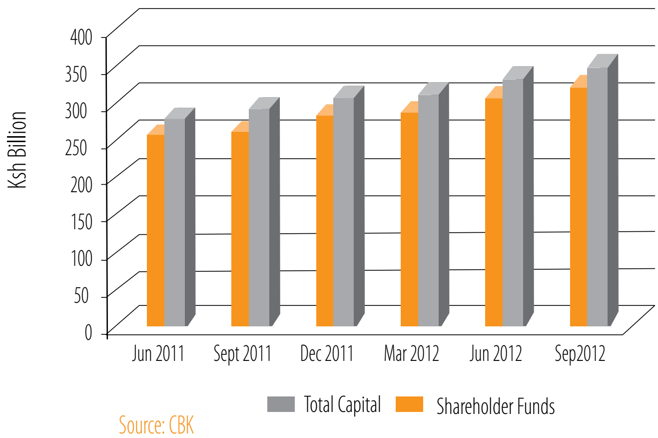


Source: CBK

Total Capital & Shareholder funds

There was an improvement in the banking industry's capital level. The total capital increased by 21.3 percent from Ksh. 251.10 billion in the quarter ended September 30, 2011 to Ksh. 304.50 billion in the quarter ended September 30 2012. Shareholder funds increased to Ksh. 336.90 billion up from Ksh. 280.50 billion in the same period giving, an increase of 22.5 percent.

Figure 21: Total Capital and Shareholder Funds: June 2011-September 2012

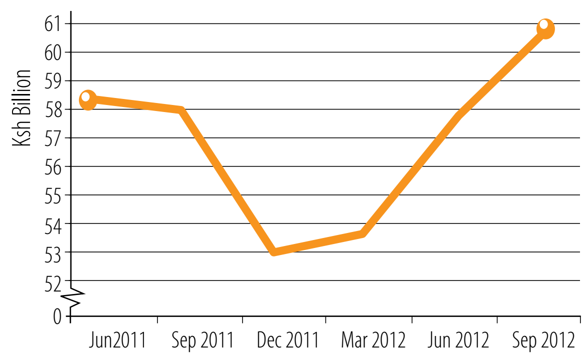


Source: CBK

Gross Non-performing Loans

The stock of gross non-performing loans (NPLs) increased by Ksh. 3.00 billion from Ksh 57.70 billion to Ksh. 60.70 billion, representing a 5.2 percent increase.

Figure 22: Gross Non-Performing Loans (NPLs)



Source: CBK

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