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KENYA BANKERS ECONOMIC BULLETIN

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KENYA BANKERS
ASSOCIATION

CENTRE FOR RESEARCH ON

FINANCIAL MARKETS AND POLICY

About this Report

This *Bulletin* reviews the performance of the Kenyan economy for the second quarter of 2014, drawing on the performance of recent past months as well as current developments to provide perspectives on the outlook for the rest of the year. The *Bulletin* covers trends in the real economy, government fiscal operations, public debt, inflation and interest rates, balance of payments and exchange rate, as well as activity at the Nairobi Securities Exchange and banking sector performance.

About the Centre for Research on Financial Markets and Policy

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

CENTRE FOR RESEARCH ON
FINANCIAL MARKETS AND POLICY

KENYA BANKERS ECONOMIC BULLETIN

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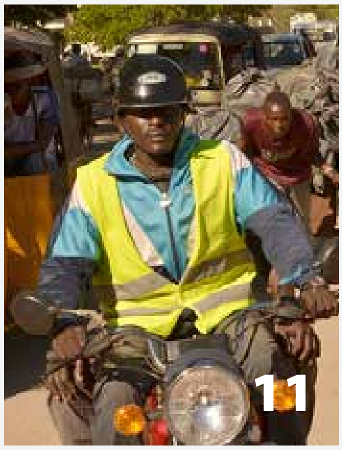
In this Issue



FOREWORD

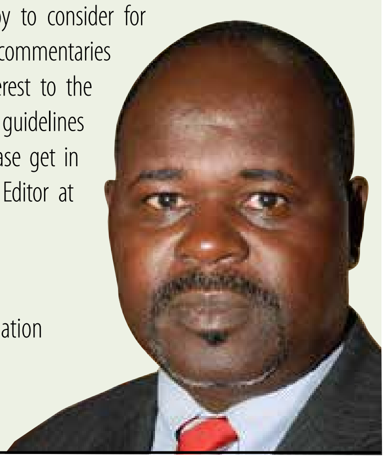
The performance of the Kenyan economy has over the years been shaped by domestic as well as international conditions

From the CEO's Desk

It is my pleasure to present to you the eight volume of the *Kenya Bankers Economic Bulletin.* This issue discusses the state of the Kenyan economy during the second quarter of 2014. The *Bulletin* reviews the strides that the economy has made since the beginning of the year, with an emphasis on the opportunities and constraints that continue to shape the economy's gradual recovery.

The performance of the Kenyan economy has over the years been shaped by domestic as well as international conditions. Domestically, the challenges of insecurity and erratic climate conditions have respectively influenced both the current account position given the impact on tourism industry which is a key foreign exchange earner and food production. Internationally, the slow recovery especially in the Eurozone has influenced the demand, and consequently the prices, of key commodity exports. These circumstances have shaped the Bulletin's economic outlook for the rest of the year.

I hope that you will find this issue of the *Kenya Bankers Economic Bulletin* interesting and useful. We welcome feedback on the content of this *Bulletin* as we continually seek to improve its relevance to you. We will be happy to consider for publications incisive commentaries on a topical issue of interest to the banking industry. For guidelines on such submissions, please get in touch with the Bulletin's Editor at research@kba.co.ke .



Habil Olaka
CEO, Kenya Bankers Association

COMMENTARY

Anything But a Bounce-Back!

By Jared Osoro

Even the most optimistic outlook of the Kenyan economy is likely to factor in the reality that the economy's growth trajectory to the levels pre-global financial crisis of 2008 will be anything but a bounce-back. What could be easily described as feeble recovery has been underpinned by a not-so-clear pattern of quarterly real growth performance.

It is therefore interesting that the World Bank, in its June 2014 issue of Kenya Economic Update, describes a projected real output growth of 4.7 percent for 2014 and 2015 as "robust". If indeed the World Bank's projected first quarter performance of 2.7 percent will translate into an annual growth of slightly below 5 percent, then there are two possible meanings to the world "robust".

One possibility is that the remaining three quarters of the year will return stellar performance. Evidence is scant to support such a position. Even such evidence must confront the fact that momentum for the current account repair has received a slow puncture in the form of the effect of insecurity on the tourism sector earnings at a time when prices of commodity exports are clearly softening.

Furthermore, the ripple effects of insecurity are not restricted to the external sector. They have a bearing on local consumption and investment decisions. Households and businesses realignments to cope with the security situation will obviously manifest itself in constrained recovery

The other possibility is that the economy's "potential growth" has declined meaning that it is unrealistic to expect anything dramatic on the growth front. As I argued in the *Kenya Bankers Economic Bulletin* Volume Seven, we may be seeing a "new normal" emerging where even a modest growth of 5 percent – 6 percent is celebrated as robust! Even on this front evidence is scant to support such a position.

That speck of evidence may be in the form of the upward tick in inflation that by the end of July 2014 had overshoot the official target of 5 percent plus a 2.5 percentage points range on either side. If indeed we have a new normal, then it means that the output gap – the difference between actual growth and potential growth – is narrowing, and that lessens the scope for the Central Bank of Kenya to continue pursuing an accommodative monetary policy stance.

But even such evidence has to countenance the argument that you cannot have a shrinking full employment level of income when the economy is in the investing in capacity. There is apparent infrastructure expansion that widens the country's economic capacity.

The right to feel good

The true state of affairs would therefore be somewhere between the two possibilities of the meaning of "robust" performance. And that has inevitably engendered a feel-good factor. This is particularly seen in the stock market. In the Nairobi Securities Exchange, it is positivity galore. This is hardly surprising. Positive sentiments are clearly critical in occasioning the short-run market outturn; that is why it requires more than a casual consideration to appreciate that sometimes the market may be looking up based short-rum considerations even when the economy is not looking very health – and that may speak more to the level of (under) development of the market than to the inability of the market to provide a signal on the state of the economy.

Typically, over the short-run investment horizon, investors tend to keep an eye on every business, economic or political news that could impact their portfolio; thus the market movements are significantly based on sentiments. Ordinarily, the trajectory of the stock market is often taken to mirror the posture of the real domestic. That is when the observed positive market outturn could be taken as a harbinger for the economy's sustained up-turn.

But as I have argued before, that will be a hasty inference. A careful consideration of the international and domestic economic circumstance necessitates that the optimistic outlook on the economy's performance – while justifiable on account of the unrealism of its discounting based on political developments, now that the transaction has defied negative expectations – needs to factor in the foggy global environment and a fluid domestic market circumstances.

A foggy international arena…

A combination of both economic factors and the dynamic geo-political environment has complicated the recovery of the global economy. The 'Hopes, Realities and Risks' that the Intentional Monetary Fund (IMF) identified in its April 2013 *World Economic Outlook* (WEO) seem to be reverberating across the global economy a year on. The emerging market economies – which typically propelled the global growth during the great recession – are clearly slowing down.

The performance of the developed economies is mixed, with consensus seen only in the verdict that policy stimuli are still important to avoid frustrating the feeble momentum of recovery – especially in the US. Even with the consensus, the nature of the stimulus package differs; this is a reflection of the different perceptions of the problem of mild recovery on the back of depressed prices that are almost leading to a state of deflation.

The major central banks – the Federal Reserve Board, the Bank of England, the Bank of Japan and the European Central Bank – have been the epicentres of policy to support recovery. Given the nature of the problem, the policy prescriptions have been unconventional; but what has been considered unconventional is now becoming the standard practice.

Creating money to buys financial assets – so-called quantitative easing – has been the policy centrepiece for the Federal Reserve, Bank of England and Bank of Japan, and never the European Central Bank. The Eurozone is now suffering from what can be described as 'lowflation' – with prices rising by 0.5 percent in May and June 2014, far below the target of 2 percent.

Even then, the European Central Bank is taking the quantitative easing as a "last resort" tool to the disdain of critics such as *The Economist* (August 2nd 2014). The argument is that the European Central Bank may be understating the risk of deflation and that the interventions through the banking system – for instance bringing down the main lending rate to a new low of 0.15 percent and giving negative interest rates for deposits by commercial banks – while notable may not help curb deflation.

It doesn't help that the dicey geopolitical environment is the arena on which global recovery is to be plotted. The Russia-Ukraine debacle, the Syrian civil war and the Iraq crisis all play towards unpredictability that is not healthy for economic recovery.

… and a domestic posture of positivity.

A good indication of the domestic economic posture can be inferred from the monetary policy stance. The decision by the Monetary Policy Committee (MPC) of the Central Bank Kenya (CBK) to maintain the Central Bank Rate (CBR) at 8.5 percent for close to two years could be interpreted to mean that stability is anchored and therefore recovery should be gaining traction. I contend that on account of domestic as well as international factors, CBK's policy decision to halt further reduction of the CBR even when inflation is within the de facto target of 5(+/-2.5) percent is justified, not less because it portrays a stance meant to correct past policy missteps.

But even with a general cautious stance, the tone of the motivation of the monetary policy stance seems to portray a sanguine posture on both the markets and the state of the economy. Based on the implications of the international economic outlook as alluded above and a number of domestic factors that we shortly outline, the sanguine posture need not necessarily occasion the trading of the cautious stance for growth pursuance.

While we observe that the foreign exchange market has in the recent past been largely stable the Kenya shilling (KES) has on a historical perspective maintained a general depreciating trend. This is on account of the economy's external position remaining weak, with the fragile real output growth that is yet to achieve the 2008 levels. Inevitably, the KES has a depreciation bias and its stability in the recent past has hinged on liquidity management and foreign exchange operations, as well as public expectations' management by the CBK.

It remains to be seen whether non-inflationary credit expansion can be realised and sustained. On the realisation of non-inflationary credit expansion one can argue that the rate of real GDP growth has largely been below trend and that liquidity build-up during the accommodative monetary policy regime has seen the interbank rates go below the CBR excerpt on few instances when market liquidity is tight. The positive interest rate differential between the local short-term interest rates and short-term rates in the international markets is likely to continue spur portfolio flows – riding on the so-called uncovered interest rate parity.

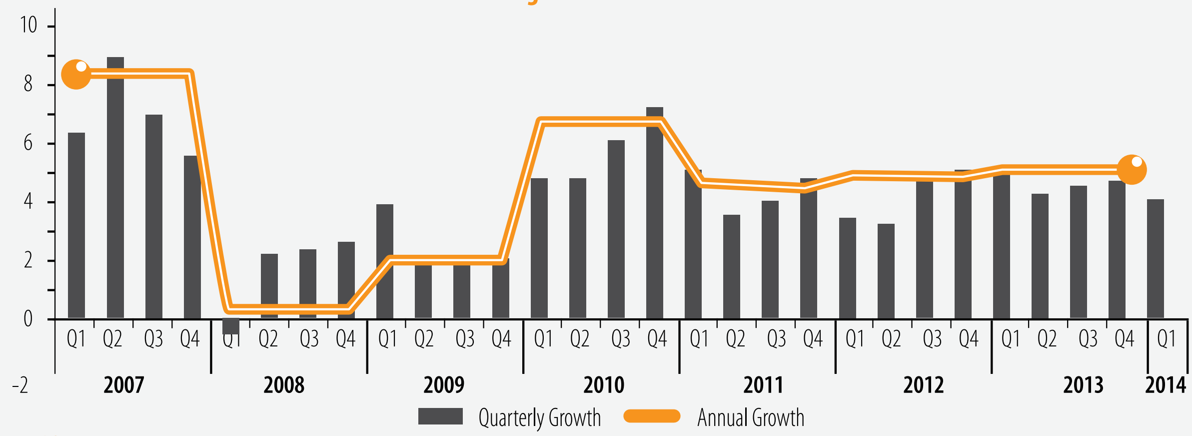
Ultimately, the positivity must be qualified

That the World Bank, having projected the economy's first quarter real growth at 2.7 percent and it turned out at 4.1 percent may be tempting enough that all is heading well. It is persuasive to resist such temptation. Inflation is creeping out of target. The weather conditions are promising to change for the worse, with *El Nino* rains projects during the last quarter of the year. How it plays out with regard to real growth could be a function of the efficiency of public investments to create capacity, streamlining of county governments to enhance absorption of budgetary allocations towards capital expenditure, and the measures put in place to assure continued macroeconomic stability. As things stand, a 5 percent real growth for 2014 seems to be the very best case scenario.

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

State of the Economy

Figure 1: Growth in GDP



Source: KNBS

Growth in GDP

The Kenyan economy's posted a real GDP growth rate of 4.1 percent during the first quarter of 2014 (**Figure 1)**, representing a 1.1 percent below the first quarter of 2013. Despite this performance, the quarter experienced a relatively stable macroeconomic environment with the inflation rates being contained within the Central Bank monetary target range, with expectations that the stability will prevail into the second quarter. However, the second quarter posted mixed results with inflation rates taking an upward trajectory hitting a high of 7.39 percent by end of June 2014. In addition, the shilling experienced a weakening bias that adversely affected the net exports contributing to current account deficit.

The erratic long rains adversely shocked the economy from the supply side of food stuffs thus fueling inflationary pressure. Increased incidences of insecurity adversely affected investors' confidence with the major foreign exchange earning sectors such as tourism registering poor performance. Unlike the goods and foreign exchange markets, money markets portrayed a sense of stability during the second quarter, with the yield on government treasury bills averaging at 8.81 percent for the 91 day Treasury Bills. Tea and coffee exports registered poor results owing the erratic rains. Expectations of growth impetus from a devolved government system did not materialize as Country Governments lacked the capacity to absorb and appropriately allocate budgetary provisions. Overall, the country's economic performance remained below its potential with total consumption and production falling far much below to spur any meaningful growth.

The 2014/2015 Budget Highlights

During the second Quarter, the Government presented the 2014/15 fiscal year budget whose thrust was the continuation of an expansionary expenditure programme to support the economy's growth recovery. In total the budget was estimated at Kshs. 1.757 trillion, about 84 percent of which is to be funded through domestic taxation. With the recurrent expenditure for the national government projected at Kshs. 654.1 billion and development expenditure at Kshs. 476.4 billion it is evident that there should be a focus on realigning resource allocation towards enhancing the economy's future growth capacity. Therefore, the recurrent expenditure is estimated to decline from 20.4 percent in 2013/2014 budget to 18.7 percent in 2014/2015 as the budget is being reoriented towards development of major physical infrastructure especially roads, railway and energy production plants with a lot of emphasis being on geothermal power production.

Several taxation amendments were proposed in the budget in attempt to spur growth ranging from tax exceptions for domestic manufacturing to imposition to new taxation to cushion domestic industries from external competition. Debt management also remained core in the budget in line with the government's medium term debt management strategy with the government being cautious on external borrowing as well as internal borrowing to ensure a balance between the two.

With the Kshs. 1,180.8 billion of the total budget being funded by ordinary revenue and only Kshs. 94.1 billion coming from– Appropriation Aid – In, the overall budget deficit inclusive of grants is estimated at Kshs. 342.4 billion. Once the net external financing of Kshs. 149.6 billion as well as the loan repayments receipts of Kshs. 2 billion is taken into account, the budget deficit narrows down to Kshs. 190.8 billion equivalents to 4.1 percent of GDP.

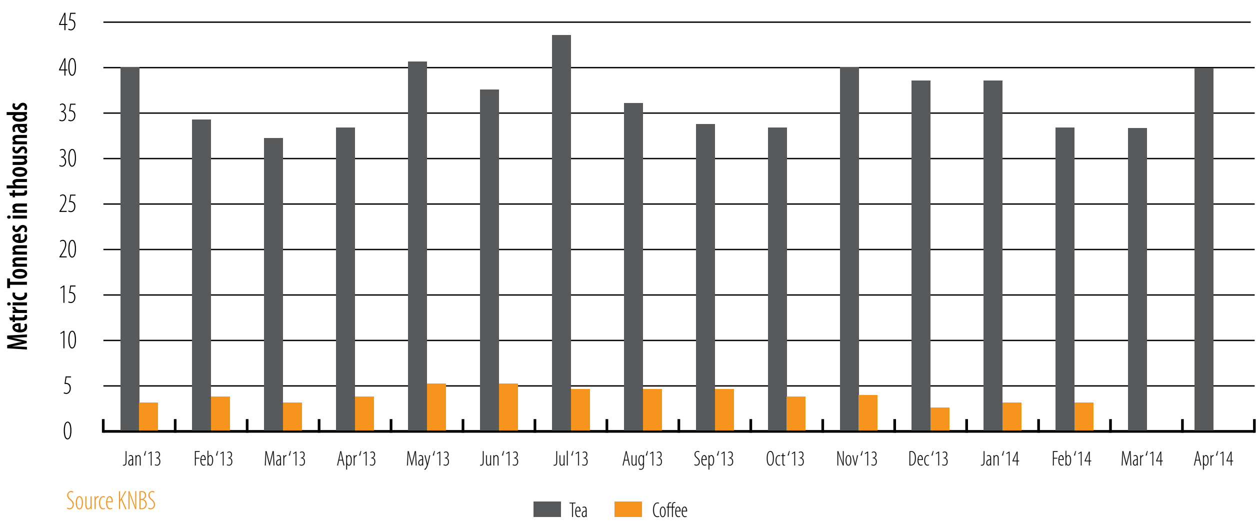
Despite the erratic long rain season, an increase in tea production was realized while coffee production was characterized by declining production.

Agriculture

Despite agriculture being the major contributor to the overall GDP growth, the first quarter of 2014 saw a slowed growth, with the sector registering a 2.7 percent growth compared to 6.8 percent in quarter one of 2013. Erratic long rain in the first quarter one whose spillover effects were felt in the second quarter remained the underpinning factor for the sector's slow growth. Production of cereals, especially maize, noticeably declined, the attend consequence being a rise in the price per kilogram from Kshs. 37.37 per kilogram in April to Kshs.39.38 per kilogram in May 2014.

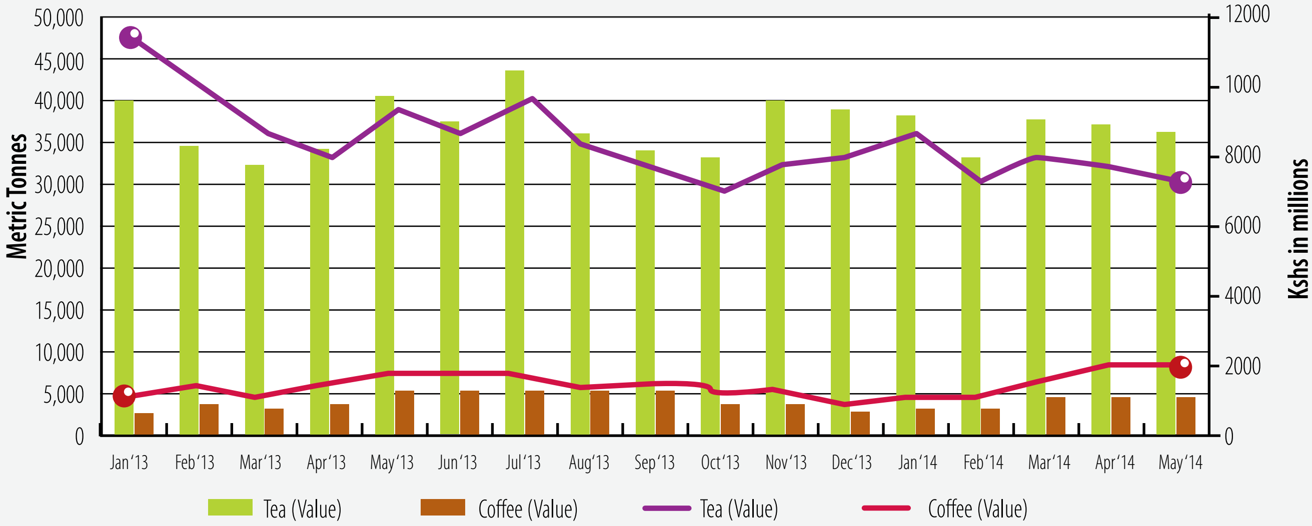
The performance of food production was not replicated in cash crop production where an increase in tea production was realized (**Figure 2**) while coffee production was characterized by declining production. The state of cash crop production, which was a reflection of the global supply conditions, manifested itself in the global prices; while the average price for coffee declined from Kshs 392.22 per kg in April 2014 to Kshs 372.94 per kg in May, tea prices rose from Kshs 186.92 in April to Kshs 187.59 per kg at the end of May2014. Agriculture in Kenya is mainly dependent on weather conditions as the uptake of irrigation remains low. Given the inelasticity of tea supply to changes in the international prices, tea exports could not benefit from the improved international prices.

Figure 7: Tea and Coffee production in Metric Tonnes: January 2012 – April 2014



Source KNBS

Figure 3: Quantity and Value of Tea and Coffee Exports, January 2013 – May 2014



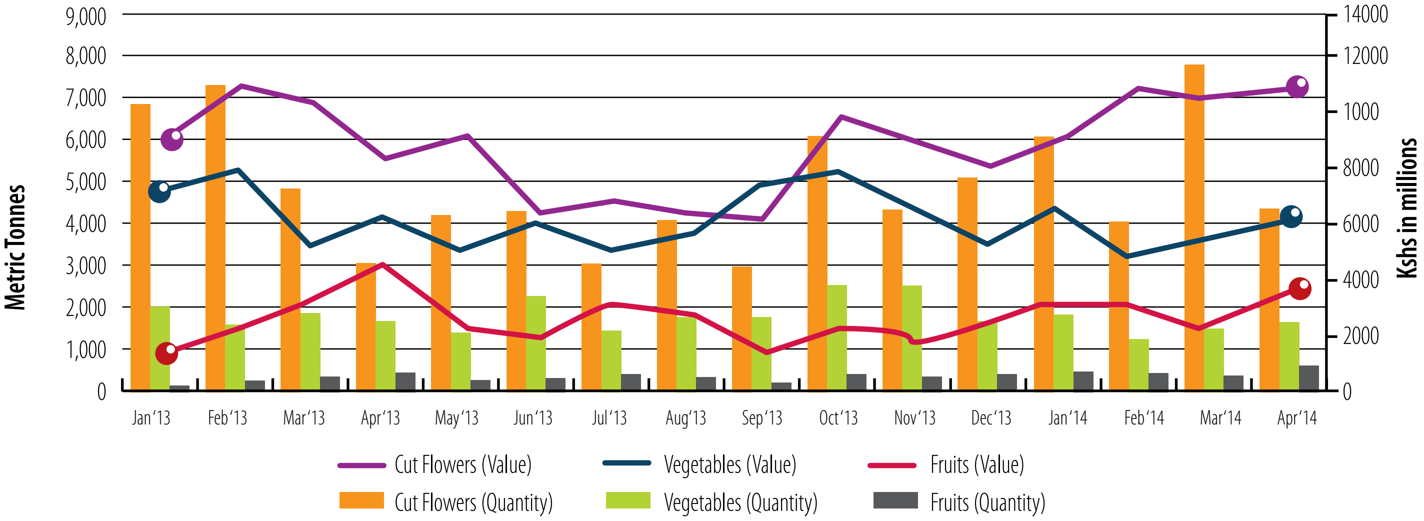
The setting in of decline in the production of coffee is not wholly attributable to erratic rains; there has been an encroachment of coffee production zone for real estate development especially in the central part of the country occasioned by rental income from real estate yielding higher returns as compared to income from coffee. There is therefore need for the government intervention to formulate policies that will delineate agricultural land from settlement lands if the future of major cash crop exports is to be guaranteed in addition to food security. Wrangles and cases of mismanagement of coffee mill coupled with enormous theft of coffee beans from the factories have adversely affected accuracy in reporting on the total production statistics. As results the gains from Kenyan coffee as a result of drop in Brazil's production arising from frost may be negligible.

Even with the observed mixed performance, agriculture exports continue to be the economy's main export, with tea leading the pack followed by coffee. As **Figure 3** shows, the value of tea exports declined two months consecutively from March 2014 to May 2014. In the second quarter of 2014 (April and May combined), tea earned Kshs 15,161.7 Million compared to 4,037.5 million from coffee exports.

Horticulture continued to play an important role in the economy's export earnings (**Figure 4.**) Cut flowers dominate this subsector contributing on average 75.27 percent of total horticultural exports for April and May

A fresh cut-flowers vendor at Nairobi's City Market: Cut flowers dominate horticultural subsector contributing on average 75.27 percent of total horticultural exports for April and May combined.

Figure 9: Horticultural Exports



combined, followed by vegetables with 18.92 percent and fruits exports recording the lowest contribution of 5.81 percent. It is noteworthy though that the production and exports for cut flowers drastically declined in the second quarter of 2014 despite of it leading the horticulture sub-sector.

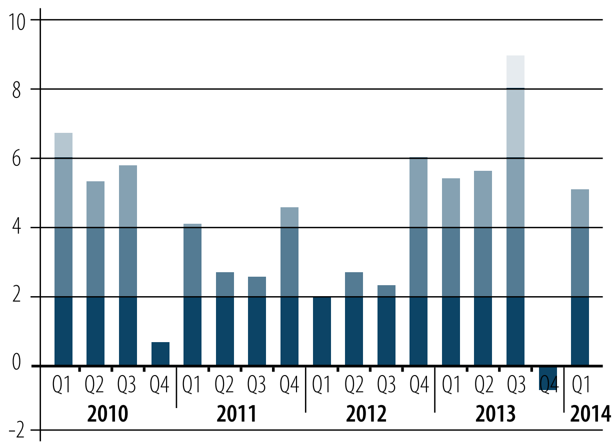
Manufacturing

The manufacturing sector is considered to be one of the pillars for the achievement of Kenya's vision 2030 goals through transiting the economy from a traditional agriculture to a modern manufacturing economy. In the first quarter of 2014, the sector grew by 5 percent with the expansion mainly driven by a 6.2 percent growth in non-food manufacturing, notably the production of cement production and assembly of motor vehicles (**Figure 5**).

The second quarter of 2014 saw improvements in cement production and consumption following the rapid growth in the real estate sector. This was replicated in soft drink production and other non – food manufacturing factors that buoyed growth in the sector for quarter 2. The sector is set benefit from the 2014/2015 budget through tax exemptions for locally manufacturing industries as well as tax imposition on the external manufactured goods to cushion local industry from unfair competition. A further boost to the sector will arise from investments in energy that will ultimately lead to lowering the cost production costs. There are some concerted efforts to boosts energy production especially the geo-thermal and reduce over reliance on hydro production. In addition there are initiatives to promote green energy sources such as solar as a way of generation diversification.

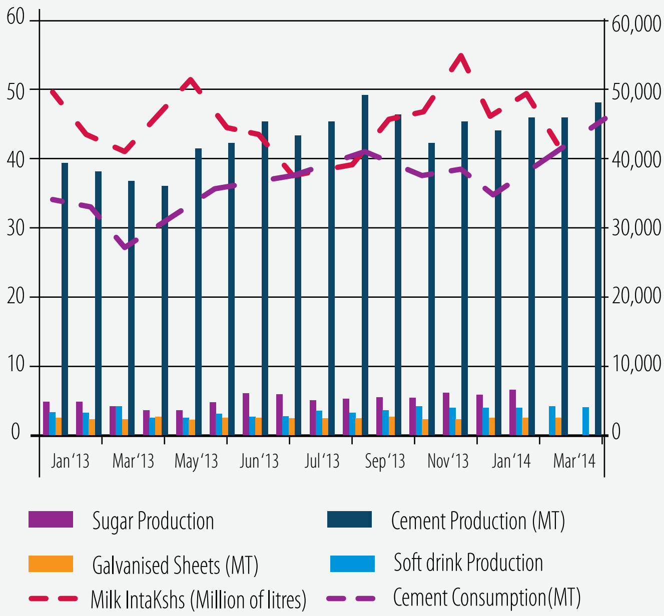
Figure 5: Manufacturing Growth Rates (%)

A key component of the manufacturing sector is its output that targets



Source: CBK

Figure 6: Production and Consumption of Manufacturing



Source: Source: KNBS

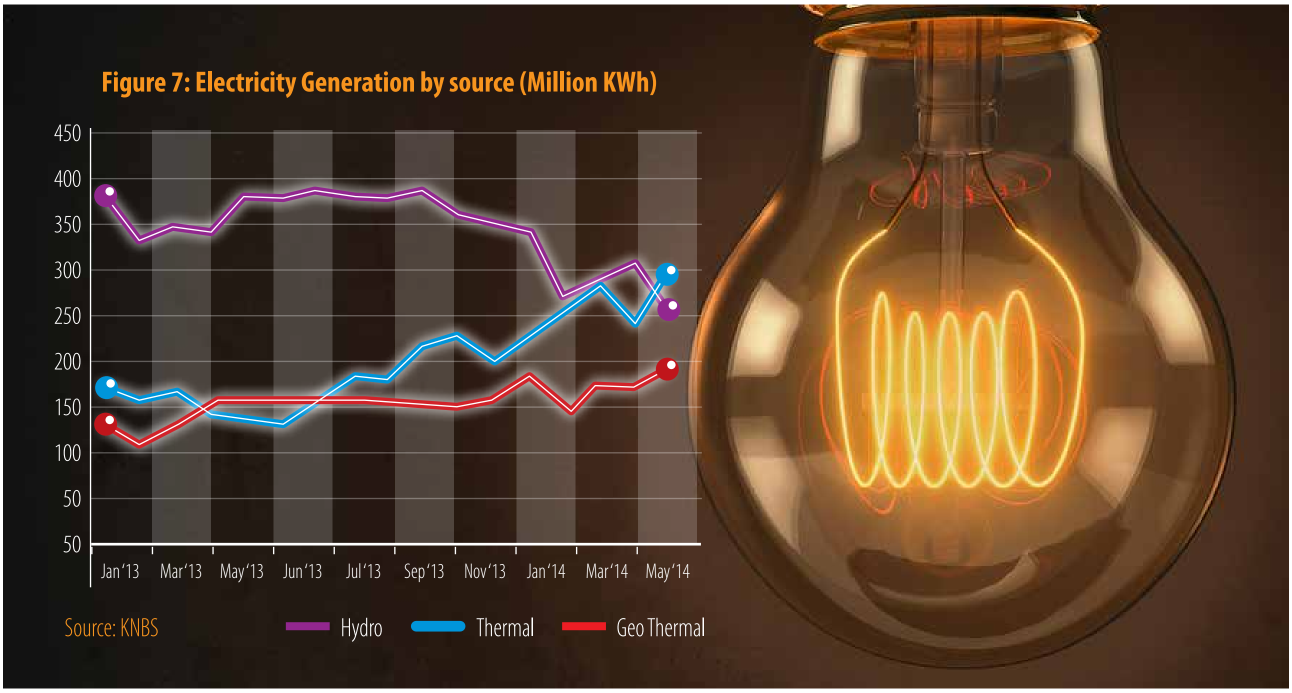
the construction industry. The domestic production of galvanized sheets slightly declined in the last quarter of 2013, averaging 25658 MT in quarter four. Cement production increased in the second quarter of 2014 from 459,901 MT in March to 460,758 MT in April before rising to hit 476,959 MT in May 2014. The growth is attributed to the expansion in real estate development as evidenced by the increases credit demand for real estate sector of the second quarter of 2014.

Soft drinks production registered mixed trends with the second quarter of 2014 by marginally declining from 40, 783 in March to a low of 40,260 in April and thereafter taking an upward trajectory in May to record a high of 41,352 thousand litres (**Figure 6**). Milk production has continued to decline drastically from the first quarter of 2014; 49.3 million liters in March to 43.4 million liters in May 2014. This was mainly due to seasonality in milk production given the erratic long rains that curtailed milk production. The number of assembled vehicles posted good upward trend increasing marginally from 737 vehicles in March 2014 to 798 vehicles in April 2014.

Energy

Electricity generation has continued to grow, albeit still outpaced by demand. Both thermal and geo-thermal production increased in April and May while hydro production experiencing a decline in production. Total electricity generation declined from 755.88 million KWh in March 2014 to 735.97 million KWh in April before surging up to 766.56 million KWh in May 2014 mainly as a result of increased thermal and geo-thermal production. Domestic consumption of electricity rose from 546.60 million KWh in March 2014 to 618.44 million KWh in May 2014. The dominance of hydroelectric power generation is evident, with its contribution to total energy production for April and May combined accounting for 38.36 percent, closely followed by thermal production at 36.84 percent with geo – thermal production coming third at 24.80 percent.

A sharp decline in hydro production is evident in April and May with the production falling form 307.53 million KWh in April to 250.18 million KWh in May following the onset of low rainfall. This was a reversal of



March – April trend where hydro production shoot from 286.74 53 million KWh in March to 307.53 million KWh in April with the onset of long rains. To bridge the gap in supply, thermal and geothermal production have been increased with thermal production rising from 239.79 million KW in April to 295.89 million KW in May while the geo –thermal production shot from 169.88 million KW in April to 190.75 million KW in May. This represents 23.40 percent and 12.29 percent inter – month increase in thermal and geo –thermal production for April – May production respectively.

Energy prices have remained high in Kenya. The average cost of imported refined oil as well as locally refined oil increased during the first two months of the second quarter (**Table 1**). The Energy Regulatory Commission (ERC) effected price increases in fuel effective 15th March - 14th April with petrol prices being the most affected followed by diesel and kerosene. This was on account of increasing refining costs that have put the refinery's efficient operations in focus as well as increase in world oil price. Partly though, the increase has been attributed to forward shifting of prices by oil marketers due to penalties they face from shippers on account of delays. In addition, imports of refined petroleum products remain significantly restricted in Kenya with the oil company winning the Open Tender System bid required to import more crude oil than refined products to sell to the other oil marketers. Further, the geo-political tension between Russian and Ukraine contributed to the high international oil prices. It didn't help that all this was happening when the Kenya shilling was under depreciation pressure against the US dollar, thereby compounding the oil import bill.

Table 1: Crude Oil and Fuel Import Prices

Product	April 2014	May 2014	June 2014
Murban crude oil (US$/Barrel)	109.75	109.95	108.30
Super petrol (Kshs/Litre)	111.41	112.37	114.43
Diesel (Kshs/Litre)	105.65	106.72	105.79
Kerosene (Kshs/Litre)	85.98	83.99	84.82

Source: ERC

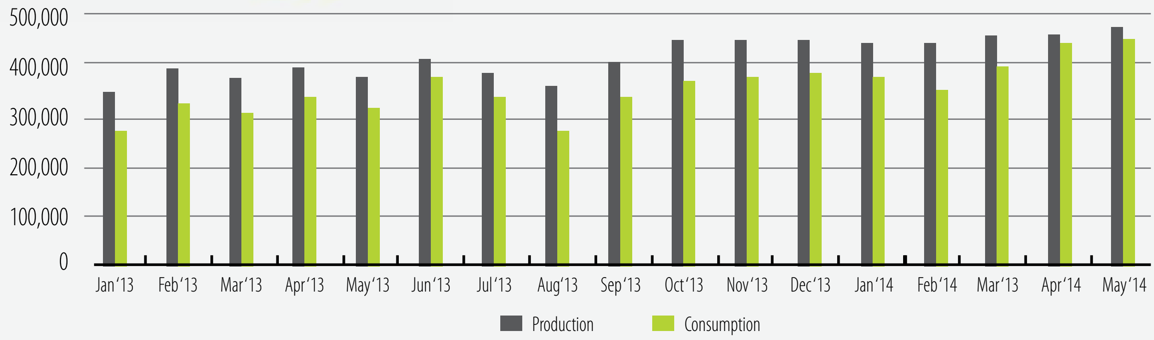
Building and Construction

Building and construction recorded an impressive performance in the first two months of quarter two as evidenced by increased production and consumption of cement. Cement consumption, a proxy of activity in the construction industry, increased from 387,266 MT in March 2014 to 426523 MT in April 2014 and further to 450,379MT by May 2014 (**Figure 8**). This trend reflects increased demand for construction mainly real estate development among the expanding middle income and overall growth in population and its composition as well as increased government construction of the physical infrastructure.

Transport and Communications

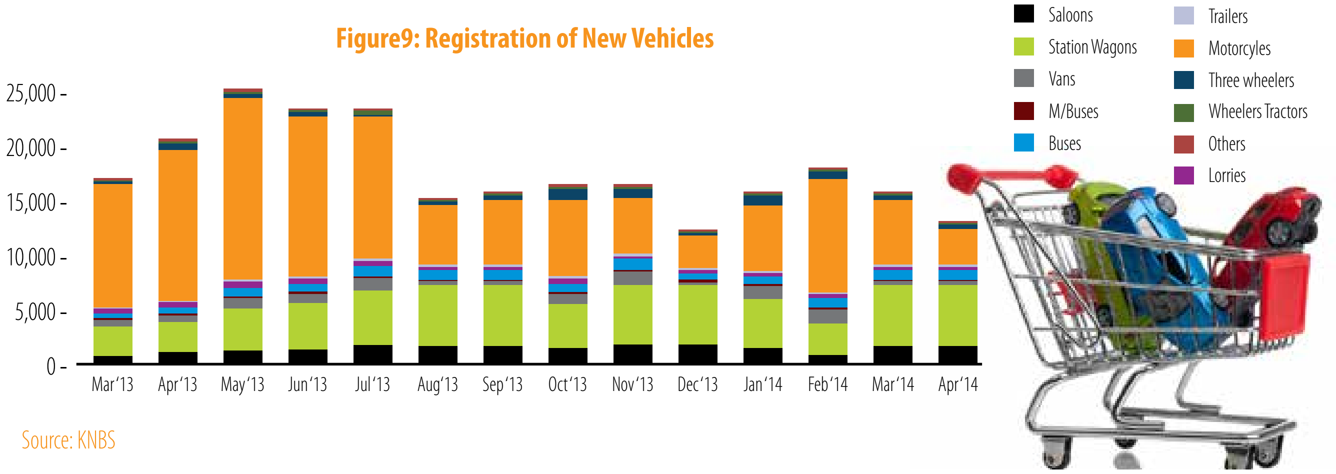
The total number of new motor vehicle registration, which shows activity in the transport sector, significantly declined from 15,629 vehicles in March 2014 to 12,789 vehicles in April 2014. Station Wagon and Motor cycles accounted for 27.3 per cent and 43.9 per cent respectively of the total motor vehicles registered in April 2014 (**Figure 9**). Motor cycles still remain an important aspect of transport both in urban and rural areas. A modest rise was seen in April 2014 from the March levels in the registration of Lorries, saloons and buses with registration of motor cycles, station wagons, vans, and trailers posting declines over the same period.

Figure 8: Cement Consumption, MTs



Source: KNBS

Figure9: Registration of New Vehicles



Source: KNBS

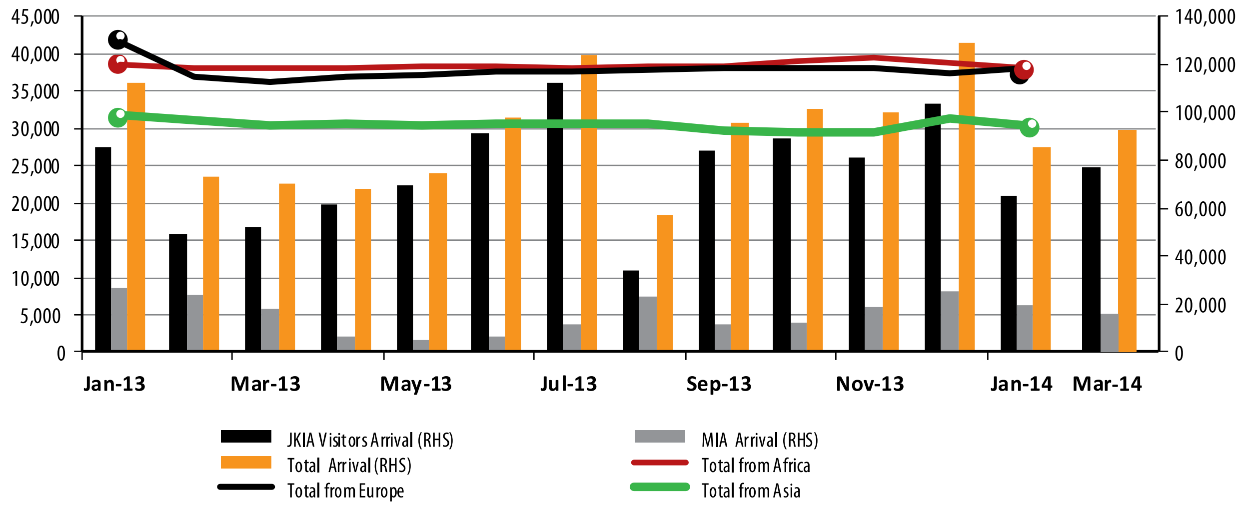
The East Africa cargo cleared at the Mombasa port grew by 120 percent in June 2014 compared to June 2013 to stand at 158,085 tonnes in 2014 against 71,995 tonnes in June 2013. For the entire half of 2014, the home-bound cargo rose by 12.8 percent with the highest growth being registered by volumes destined for Uganda. The growth in the cargo cleared at the Mombasa port is attributed to the setting up of extra berth, improved cargo handling efficiency and removal of non – tariff barriers cargo destined to East African member states.

The dominance of mobile telephony in the communications industry continues to be evident. Mobile money transfer has been significant especially in rural areas where banks are not available, inaccessible, or where majority of the population do not hold bank accounts. At the same time this mode of money transfer has been characterized by ease of use and, despite recent revision of charges on transactions. This reflects the view that mobile transfer has the potential of raising living standards by offering employment with the entire value of mobile banking transactions. The facility has also been greatly adopted by commercial banks in offering mobile banking services in pursuit of reaching the unbanked.

Tourism

Tourism sector was adversely affected in the second quarter of 2014 by the travel advisories issued by The United States, United Kingdom, France and Australia to their citizens following terror threats in the country especially in the coastal region. This is arguably the sector that

Figure 10: Trends in Visitor Arrivals



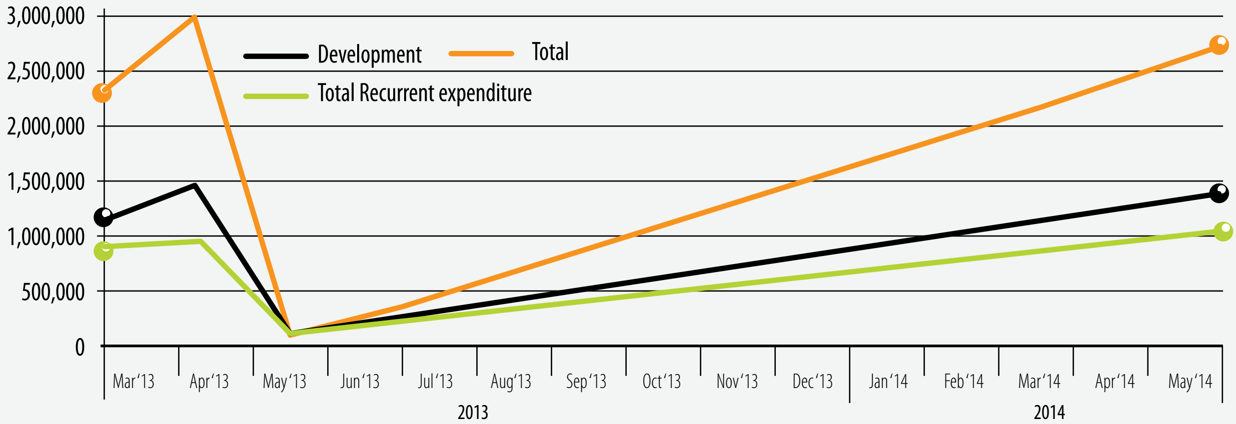
registered a noticeable loss for quarter two of 2014. The sector registered a high number of non -performing loans given the increased credit risk associated with the sector as a result of increased insecurity in major tourist destinations mainly along the Kenyan coast. The poaching menace still continues to put the tourism sector in jeopardy through reduction in the wildlife population.

From the KNBS statistics, the number of arrivals from Asia declined from 30,009 in March to 29,174 in April 2014. Given the reduced foreign tourism, the government has for the better part of quarter two embarked on measures promoting domestic tourism such as allowing all corporate and business entities to pay vacation trip expenses for their staff on annual leave in Kenya and deduct such expenditures in their taxes, subjecting all ticketing services supplied by travel agents to tax exemption to enhance our competitiveness in the region.

Financing of Government

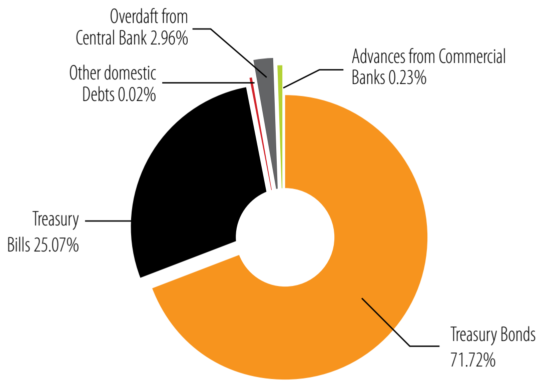
In quarter 2 of 2014, the total tax revenue for April and May grew tremendously to stand at Kshs. 708,790 and Kshs. 783,107 respectively. However, the recurrent expenditure for April and May 2014 stood at 815,652 and 919,792 respectively while the development expenditure was 209,479 and 237,985 respectively. This therefore shows that the government still continued to struggle with budget deficit. In addition recurrent expenditure continues to take the large share of financial resources leaving a few for any meaningful development expenditure a trend that cannot guarantee sustainable growth and development of the economy. A similar trend is was replicated in the 2014/2015 budget estimates with the national government expenditure of Kshs. 654.1 billion and Kshs. 476.4 billion for recurrent and development respectively. Although development expenditure seems to have increased as per the FY 2014/2015 budget estimates, only Kshs. 289.2 billion will be mobilised from the domestic resources with a chunk of Kshs.187.2 billion projected to be mobilised from external loans and grants.

Figure 11: Public Expenditure (Kshs Million)



Source: CBK

Figure 12: Composition of Domestic Debt



Source: CBK

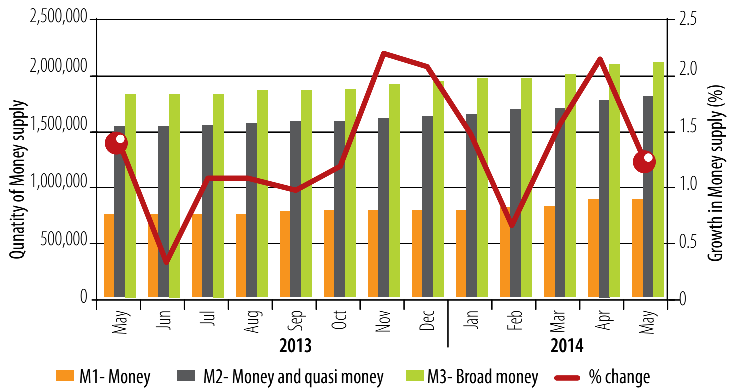
Public Debt

The total public debt increased marginally with 1.920 percent from Kshs. 3,661,501.24 million in the first quarter of 2014 to Kshs. 3,731,869.61million in the second quarter. This could be attributed to the rising cost of international borrowing following the spillover effects of the US tapering coupled with the ballooning public wage bill and other recurrent expenditure. Government treasury bonds remained the key money market instruments intensively utilized by the government in domestic borrowing accounting for 71.72 percent of the total government debt as at the end of June 2014. Treasury bills, overdrafts and advances accounted for 25.07, 2.96 and 0.23 percent of total government debt respectively by the end of the quarter two. This has seen the IMF on occasion raise a red flag on Kenya's public debt and advice for devising of new mechanism to finance government expenditure rather than reliance on mere borrowing. The month of June 2014 saw the government increase its overdraft ceiling form Sh. 34.2 billion to Sh. 39.1 billion in attempts to finance the short term expenditure. The move is seen to be government's efforts to avoid locking itself in high interests risks associated with long term borrowing.

Money and Credit

During the second quarter of 2014, total money supply grew marginally as shown by the percentage change with April and May registering 2.07 and 1.02 percent respectively (**Figure 13**). M1 registered the highest growth between March and May to grow at 7.35 percent with M2 and M3 following each other closely at 5.68 and 5.64 percent respectively. It can be deduced that all the components of money supply posted a growth that was in tandem with the Central Bank's inflation rate target bound of 5 percent (+-2.50 basis points). Therefore expansion in money supply did not impose adverse inflationary pressures in the economy.

Figure 13: Money Supply (Kshs Million)

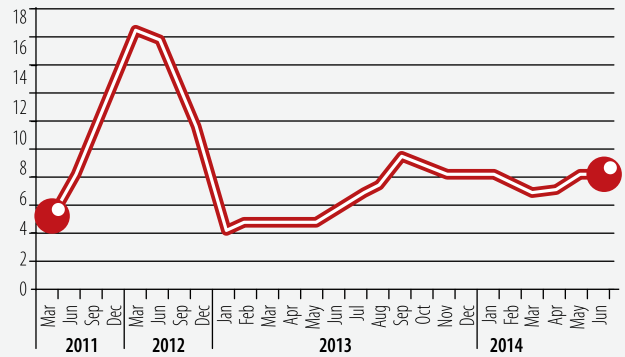


Source: KNBS and CBK

Inflation

The year 2014 began with low inflationary pressures, with the headline Consumer Price Index rising by 6.27 percent in March 2014. The low inflation expectations prevailing then hinged on adequate food supply and low cost of power as generation was expected to arise with the onset of long rains. However, a reversal trend set in April following the realization of erratic and inadequate rains. Inflation rate took an upwards trajectory for the entire second quarter, hitting a high of 7.39 percent in June 2014, only 0.11 basis points below the CBK upper bound limit of 7.5 basis points. The erratic rains led into food shortage hence a supply side shock. Similarly the high energy prices coupled with the expectations on oncoming new electricity rates have fed into cost-push inflation through fuel inflation mechanism. This trend has reversed the earlier gains of the monetary policy stance, although the Central Bank of Kenya's monetary policy committee remains committed to anchoring lower inflation expectations.

Figure 14: Inflation rate (%)



Source: KNBS

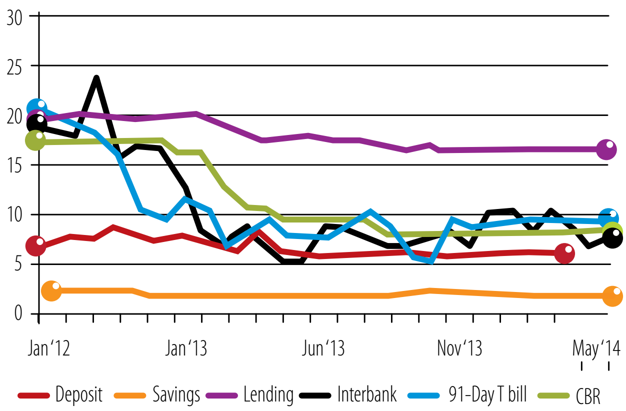
Interest Rates

Interest rates have largely been stable during the second quarter of 2014 (**Figure 15**). This was on the back of the monetary policy stance being stable as evidenced by unchanging Central Bank Rate (CBR) as well as marginal change in interest rates on government securities. The CBR has been held at 8.5 percent throughout the second quarter signaling central bank's commitment to anchor inflation rates ever since May 2013. Treasury bill rate remained fairly low and stable in April and May averaging at 8.81 percent. This follows the reduced government domestic borrowing and the move to borrow externally through the euro bond issued in June.

Cumulative average weighted lending rates rose mildly from 16.70 percent in April to 16.97 percent in May 2014. Therefore, there has been a fair transmission of monetary policy easing on credit offered to customers by banks as manifested by interest rates. However, banks still face high costs of operations as manifested by some banks recording declining profit margins and stark changes in their rates would impact their operations adversely. The financial market still remained illiquid for the entire quarter two of 2014 as evidenced by the relationship between the average lending rates and the CBR.

The interbank rates remained closely correlated to the CBR though an upward turn set in by mid-March 2014. In the second quarter, the government remained committed to lowering the lending rates. This saw the issue of the debut euro bond in June 2014, an issuance that has been expected to contribute towards lowering lending rates through increased market liquidity. In addition, the banking industry rolled out the total cost of credit and the Annual Percentage Rate to enhance disclosure a move that the government believes will lower lending rate in the long run, as well the coming into effect of the Kenya Banks Reference Rate (KBRR) with the aim of having a common base rate for all players in the market.

Figure 15: Interest rates (%)



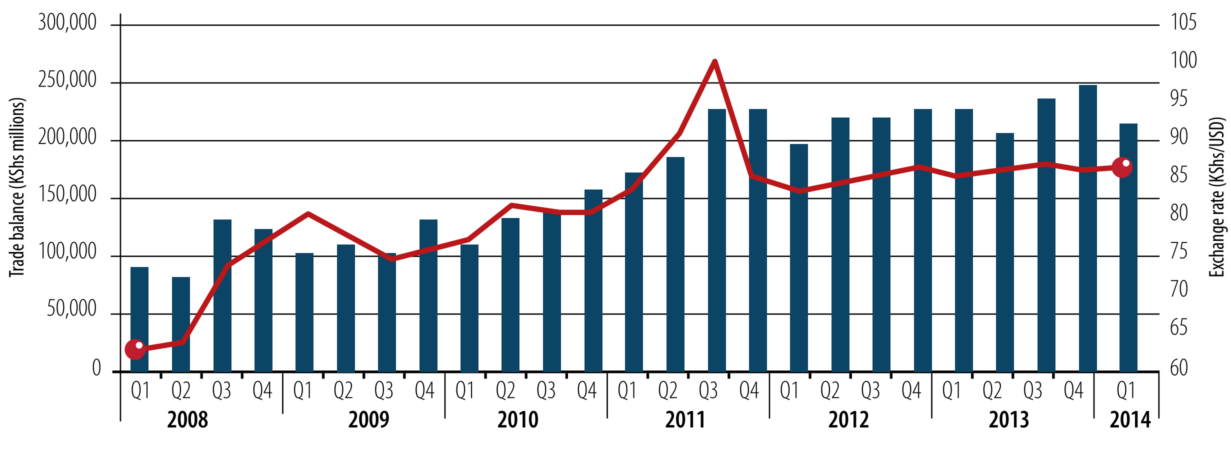
Source: CBK

Balance of Payments

Kenya's total trade volume expanded from KSh 188.3 billion in April 2014 to KSh 198.3 billion in May 2014. The total value of exports decreased from KSh 48,995.4 million to 47,866.0 million during the same period. Value of imports rose to KSh 150,477.6 million in May 2014 from KSh 139,284.6 in April 2014. Exports by Broad Economic Category (BEC) indicated that food and beverages was the main export category in May 2014 and accounted for 40.5 per cent of exports, while the value of non-food industrial supplies and consumer goods not elsewhere specified registered 25.4 and 30.0 per cent shares, respectively. Imports by Broad Economic Category (BEC) was such that industrial supplies (non-food) was one of the main import category in May 2014 with a share of 25.1 per cent, while the values of fuel and lubricants, machinery & other capital equipment and transport equipment registered shares of 25.2, 15.0 and 19.6 per cent respectively. Food and beverage recorded a share of 5.9 per cent while Consumer goods not elsewhere specified recorded a share of 6.2 per cent.

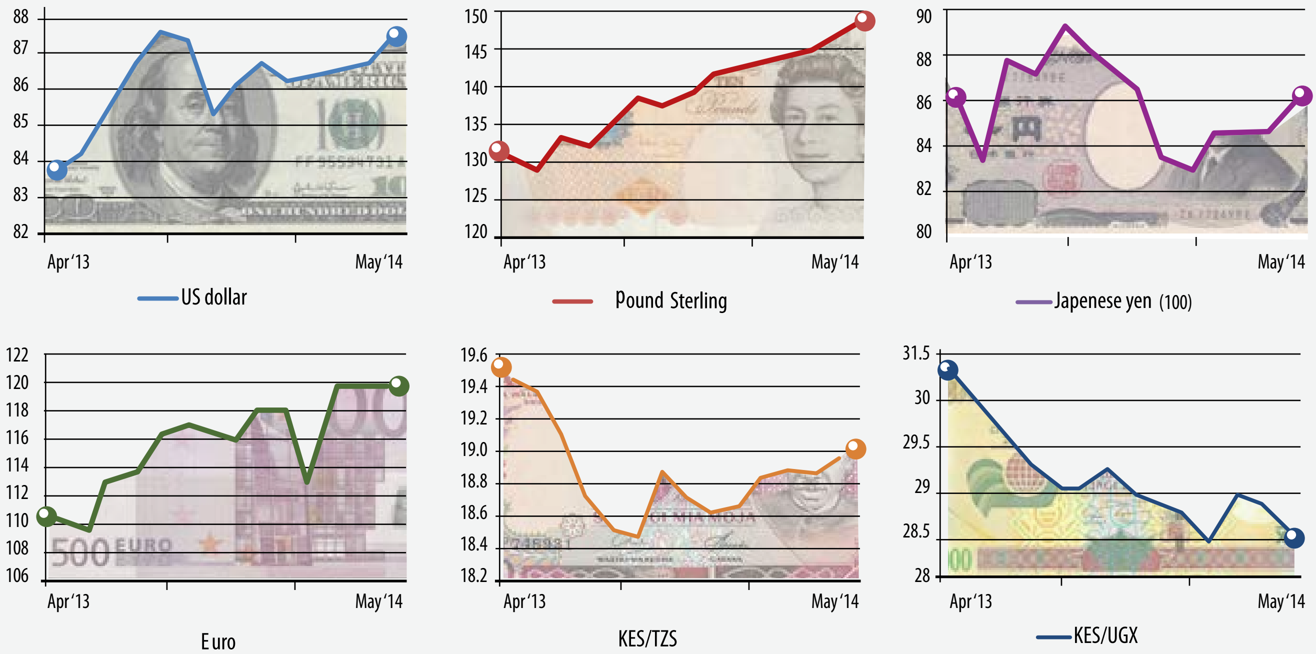
Exports declined in May to settle at Kshs 38,872.75 million against Kshs 41,012.40 million in March 2014. Tea topped the exports list to account for 19.54 percent of the total value of exports for April and May combined followed closely by horticulture at 17.16 percent with chemicals, coffee, cement, petroleum products and fish following in that order. Uganda continued to be the most preferred export destination for domestic exports with a high of 9.64 percent of Kenya's total exports as at May 2014 a drop from first quarter's contribution followed by Tanzania, Netherlands, United Kingdom and U.S.A subsequently. This trend in exports' destination is similar to that of quarter one of 2014 and the entire 2013 reflecting lack of diversification in our export destinations. The depressed performance of the rains that affected the agriculture sector which is the single largest contributor to our GDP led to the decline in exports resulting to worsening of trade balance. The weakening shilling against the US dollar also contributed towards deteriorating trade balance, and consequently a weaker current account position. From **Figure 16**, trade balance deficit responded to the weakening bias on the Kenya Shilling with period lags.

Figure 16: Overall trade balance and exchange rate



Source: CBK

Figure 17: Exchange Rates



Exchange Rate

During the second quarter of 2014, the Kenya shilling manifested a sense of stability, albeit with a depreciation bias. The local unit's nominal exchange rate fluctuated between 86.72 and 87.41 against the US dollar. Notably though, the shilling depreciated sharply against the dollar in April and May partly owing to the dividend pay-out period to the foreign investors at the Nairobi Securities Exchange. A similar trend was replicated for the sterling pound where the shilling posted poor performance against the pound. For the Euro, the shilling performed fairly with the exchange rate being fairly stable given the crisis at the Euro zone that have seen the monetary authority signal adoption of quantitative easing to spur growth and avoid deflation crisis. For the East African financial market the shilling posted resilient performance against the Ugandan and the Tanzanian shilling. However, the trend was different for the local unit against Tanzanian shilling with the on-going importation of maize from Tanzania that is likely to see the Kenya shilling weaken against the Tanzanian shilling.

Nairobi Securities Exchange

All Nairobi Securities Exchange (NSE) indicators exhibited mixed performance during the second quarter of 2014 (**Table 2**). Activity at the NSE was largely reflected in the NSE 20 share index that increased with the investors actively eyeing to reap the benefits of the dividend payout period. Increased demand for equities especially for the companies whose end of financial year is in quarter two was evidenced. As a result of rush to buy and sell before the book closure for the companies whose financial year fall in March – June period, the market experienced high volatility with a combination of bullish and bearish behavior evident. The bond market posted poor performance in terms of both the bond deals and turn over.

Table 2: Nairobi Securities Exchange

Date	March - 2014	April- 2014	May- 2014	June - 2014
NSE 20 Share Index 100=1966	4,946	4,949	4,882	4,885
NSE All Share Index (NASI) 100=2008	144	151	150	150
Market P/E Ratio		16	15	15
Total Shares Traded (Million)	544	728	854	731
Equity Turnover (ET) Kshs. million	13,042	15,750	23,022	18,192
Market Capitalization (Kshs. Bn.)	2,003	2,106	2,092	2,107
Bonds Turnover (Kshs. million)	32	59	39	29
Bond Deals	773	797	391	365
Percent of Foreign Participation to ET	52	58	55	56

Source: NSE, Monthly Bulletin

Given that equity and bond markets perform antagonistically, equity market performed well at the expense of the bond market. The market's price – earnings ratio stabilized at around 15 for the entire quarter. May recorded the largest total number of shares traded as investors off loaded their equities prior to commencement of dividend payments in June. This is the reason behind the high market capitalization in May 2014.

From **Table 2** it can be deduced that while the equity market performed well in terms of high total number of shares traded as well as the high market capitalization bond market posted the poorest performance with the total deals dropping from 797 in March 2014 to 391 in May 2014. Foreign investors dominated the market given the high returns that they are guaranteed as compared to developed stock markets since Nairobi Securities exchange portrays features of a weak – efficient market thus one cannot predict future prices from the current and previous prices. It's expected that with the demutualization of NSE coming into effect, the market performance is likely to change.

Banking Industry Performance

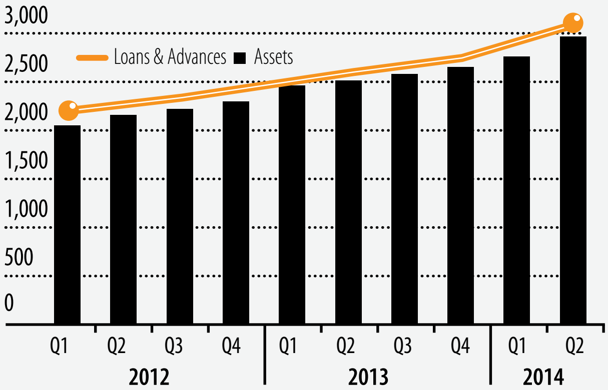
The Banking industry recorded a slowed growth of 8.3 per cent in quarter 1 of 2014 compared to 12.1 per cent growth in the first quarter of 2013 albeit higher compared to 7.2 percent in the entire 2013. The industry in Kenya sustained positive and resilient growth in the second quarter of 2014 compared to quarter 1. The industry continued to support economic growth by providing the bulk of private sector credit to the key sectors of the economy with credit to personal household topping the list. As at the end of quarter 2 the total loans to total assets for the Kenyan banking sector stood at 59.47%, a marginal increase from 59.3%, in the quarter ended March, 2014.

A highlight of the banking industry for quarter 2 of 2014 point towards demand for credit generally remaining constant in six economic sectors and increased in the other five economic sectors. The perceptions on political risk suppressed the possible growth potentials in private sector credit growth. The tightening in credit standards was enormous for tourism and agricultural sector owing to increased insecurity incidences and erratic rains respectively hence increasing credit risks to the two sectors. The third quarter of 2014 is therefore likely to experience incidences of non – performing loans in tourism as the banks embark on intensifying their credit recovery effort to mitigate on non – performing loans. In addition, the upward momentum in the industry's growth in quarter 1 of 2014 was sustained with agency banking enhancing the growth given its excellent performance in quarter 2.

Assets and Loans

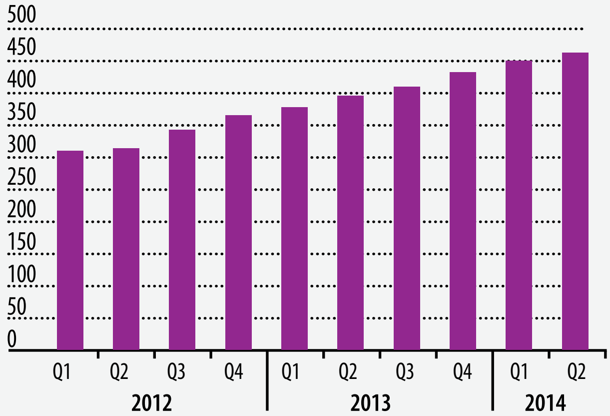
The industry's assets base and loan book registered positive growth of 5.3 percent as at June 2014. With reference to quarter 2 of 2013, industry's assets for second quarter of 2014 grew by approximately 18.32 percent in assets from 2.51 to 2.97 trillion Kshs. Loans and advances, securities owned by government and placements comprised a major part of the sector's balance sheet. The growth in loans and advances was buoyed by increased demand for credit mainly in personal and household, trade and transport. Tourism, quarrying and mining recorded the lowest uptake of credit given the security challenges that discouraged investment in these sectors.

Figure 18: Bank Assets and Loans (Kshs Billion)



Source: CBK

Figure 20: Shareholder Funds (Kshs Billion)

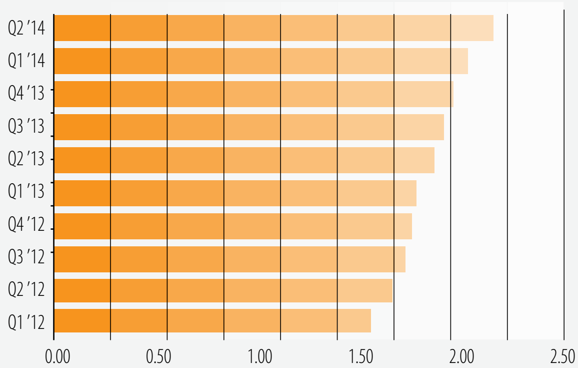


Source: CBK

Deposits

Quarter 2 recorded a growth of 5.4 percent compared to previous quarter. Demand deposits accounted for major source of funding of approximately 72.3 percent of total banking industry funding liabilities. The growth in deposits was majorly attributed to increased branch expansions as banks initially involved in corporate banking continue embracing retail banking to leverage on competition from other players. There was a tremendous growth in agency banking as well as increased foreign remittances inflows. For quarter 2 total deposits stood at Kshs. 2.15 trillion compared to Kshs. 2.03 trillion in quarter 1 of 2014.

Figure 19: Bank Deposits (Kshs Billion)



Source: CBK

Total Shareholder Funds

Total capital stock of the Kenya banking sector sustained its upward trajectory in the second quarter of 2014 thus signifying growth in the shareholders' stake in the industry.

Gross Non-Performing Loans

The gross non – performing loans increased in quarter 2 of 2014 by 6.9 percent to average at Kshs. 101.7 billion in quarter 2 compared to Kshs. 95.1 billion in quarter 1. Eight out of eleven sectors the banks are actively involved in lending to recorded increase in the non – performing loans with the under-pinning factors mainly being the spill over effects of high lending rates. Trade topped the NPLs per sector at 26.9 percent followed by personal and household while real estate came third. Energy and water sector and mining and quarrying posted the least contribution to the total NPLs of 1.1 and 0.6 percent respectively.

Figure 21: Bank Gross Non - Performing Loans (Kshs Billion)

Source: CBK

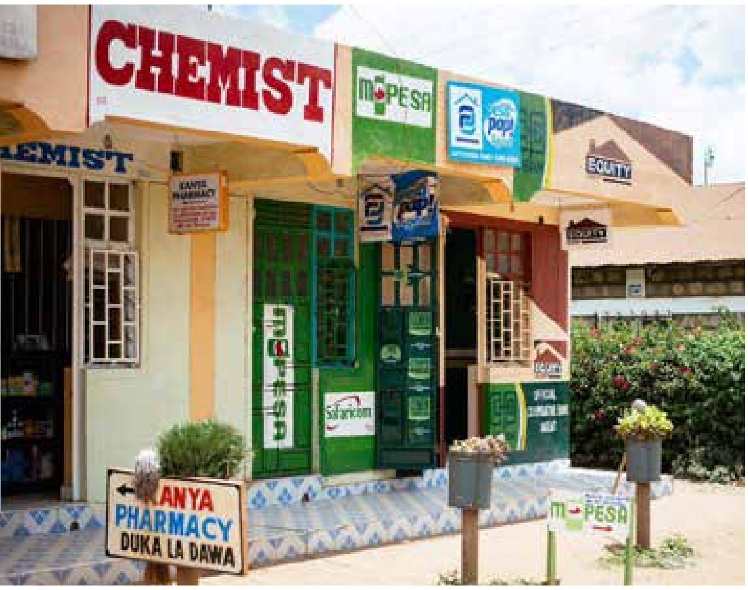
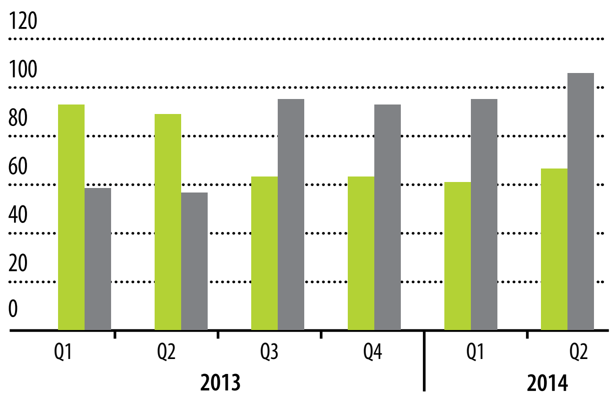


Photo / Fredrick Onyango

Bank Profitability

The banking sector recorded positive profit before tax in quarter 2 of 2014, to stand at Kshs. 37.61 billion (**Figure 22**). This represents a 12.5 percent from Ksh. 33.42 billion registered in the quarter one. Similarly, total income stood at Ksh. 104.0 billion in the second quarter being an increase of 9.4 percent from Ksh. 95.05 billion in the first quarter of 2014 while total expenses increased by 8.3 percent from Ksh. 61.46 billion in March 2014 quarter to Ksh. 66.56 billion in June 2014 quarter. On an annual basis, the profitability of the sector increased by 15.6 percent from the Ksh. 61.47 billion registered in June 2013 to Ksh. 71.03 billion in June 2014. Interest on loans and advances, fees and commissions and government securities were the major sources of income accounting for 58.5 percent, 19.4 percent and 15.1 percent of total income respectively. Contrary, interest on deposits, staff costs and other expenses were the main components of expenses, accounting for 32.7 percent, 28.4 percent and 24.3 percent respectively.

Figure 22: Bank Profitability (Kshs Billion)

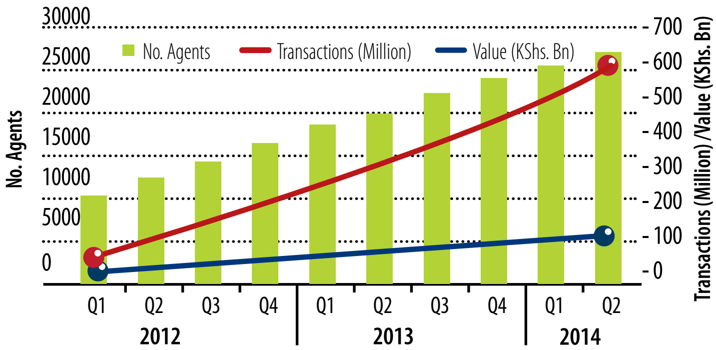


Source: CBK

Agency Banking

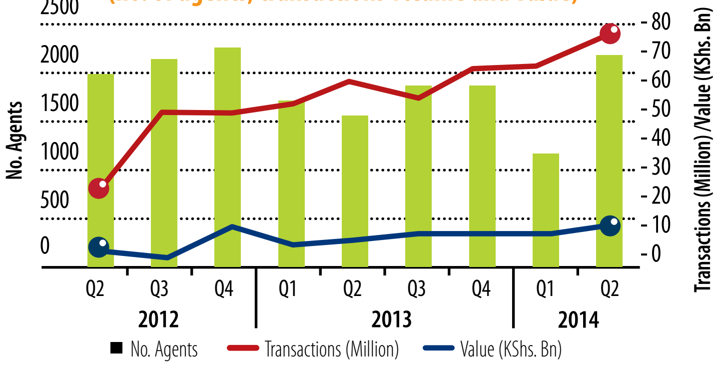
Agency banking model in Kenya has become a critical model of branchless expansion in the Kenya banking industry ever since its inception in May, 2010. It has seen tremendous growth as evidenced by the upward trajectory on the total cumulative in the number of active agents, transaction volumes and total value. As at second quarter of 2014 the cumulative number of active agents stood at 26,750 transacting approximately 106.1 million transactions valued at Kshs. 571.5 billion compared to 24,645 active agents transacting approximately 92.6 million transactions valued at Kshs. 499 billion in the first quarter of 2014. This growth is underpinned on continued contracting of varied retail entities to offer basic banking services by commercial banks. These entities include among others;- security companies, courier services, pharmacies, supermarkets and post offices which act as third party agents providing cash- in -cash-out transactions and other services in compliance with the laid down guidelines by the central bank.

Figure 23: Cumulative Agency Banking (no. of agents, transactions volume and Value)



Source: CBK

Figure 24: Quarterly Growth in Agency Banking (no. of agents, transactions volume and Value)



Source: CBK

Figure 24 shows the actual quarterly growth in the agency banking. Quarter 1 of 2014 registered a decline in the growth in the active agents. However, an upward surge is event in the second quarter of 2014 with the banks trying to diversify their products to bank the unbanked as well as reducing operating costs such as rental charges, additional staff and other administration costs that come with the opening of news branches.

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