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The Centre for Research on Financial Markets and Policy

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CENTRE FOR RESEARCH ON
FINANCIAL MARKETS AND POLICY

About this Report

This *Bulletin* reviews the performance of the Kenyan economy in the first quarter of 2013. The *Bulletin* draws on the performance of 2012 as well as current developments to provide perspectives on the outlook for 2013. The report covers trends in the real economy, government fiscal operations, public debt, inflation and interest rates, balance of payments and exchange rate, as well as activity at the Nairobi Securities Exchange and banking sector performance.

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

CENTRE FOR RESEARCH ON
FINANCIAL MARKETS AND POLICY

Kenya Bankers Economic Bulletin

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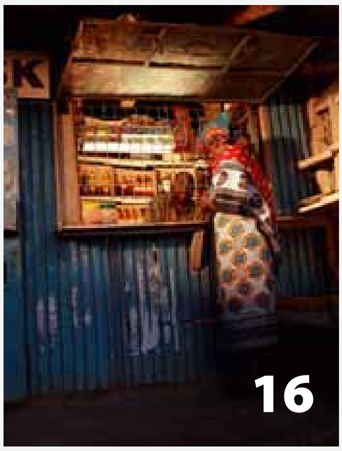


From the CEO's Desk

Welcome to the fifth volume of the *Kenya Bankers Economic Bulletin*. This issue discusses the state of the Kenyan economy during the quarter ending March 2013. The *Bulletin* highlights the fact that amidst the anxiety over the March 2013 general elections by many economic players, especially external investors, there has been a general sense of optimism on the Kenyan economy's future prospects.

The optimism has been reinforced by the successful conclusion of the general election – unlike the previous elections that resulted in violent protests and in the process engendering apprehensiveness that characterised this year's first quarter – and the markets have generally signalled their affirmation of the positive prospects.

This *Bulletin's* review of the economy and its outlook is contextualised in a comprehensive commentary that motivate the case for expecting sustained recovery towards its pre-global economic meltdown real growth rate while at the same time drawing on a number of downside risks that provides reason to pause for a reality check.

It is my hope that you will find this issue of the *Kenya Bankers Economic Bulletin* interesting and useful.

Habil Olaka
CEO, Kenya Bankers Association

Commentary: A Sigh of Relief and a Reality Check

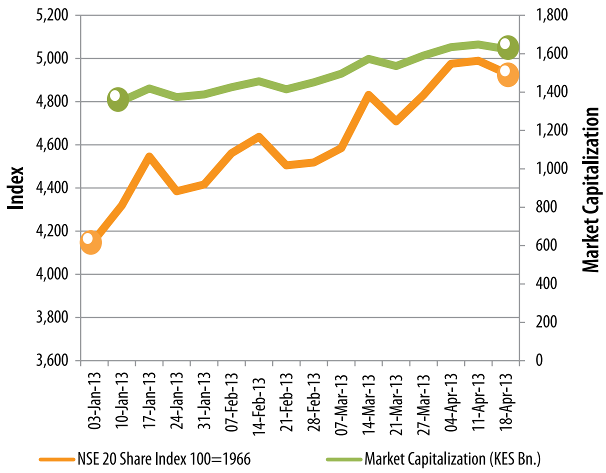
By Jared Osoro

With the first quarter of 2013 over, part of the necessary stock-taking entails posing the question: does the outcome of the general election – characterised by post-election peace and the speedy conclusion of the presidential election petition by the Supreme Court of Kenya – necessarily imply that all is looking up in the economic front?

The markets – in particular the stock market and the foreign exchange market – seem to signal to the affirmative. The Nairobi Securities Exchange (NSE) 20-share index was on an upward trajectory **(Figure 1)**. The foreign exchange market was largely stable with modest appreciation observed, a posture that has typically been observed during the first quarter of the previous years **(Figure 2)**.

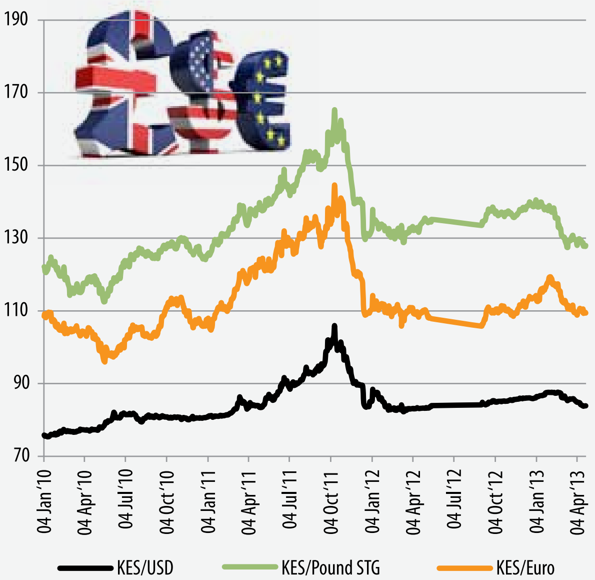
The positive sentiments were evidently critical in occasioning the short-run market outturn. Typically, over the short-run investment horizon, investors tend to keep a tab on every business, economic or political news that could impact their portfolio; thus the market movements are significantly based on sentiments and news.

Figure 1: Nairobi Securities Exchange - 20 Share Index and Market Capitalisation



Source: NSE

Figure 2: Nominal Exchange Rate KES/Foreign Currency



Source: CBK

The trajectory of the stock market is often taken to mirror the posture of the real domestic economy while the foreign exchange market trend is taken to be a reflection of the economy's external position. By implication therefore, the first quarter could superficially be taken as a harbinger for the economy's sustained up-turn. But that, as we argue in this volume of *Kenya Bankers Economic Bulletin*, 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 hazy global environment and a fluid domestic market circumstances.

A hazy global picture …

The Intentional Monetary Fund (IMF), in its April 2013 *World Economic Outlook (WEO)* aptly titled 'Hopes, Realities and Risks', illustrates how hazy the global environment is proving to be. Even though there is recognition that the global economic prospects have improved, recovery in the advanced economies is anticipated to remain constrained. This explains the revision on the growth forecast for 2013 for the global economy to 3.3 percent from the anticipated 3.6 percent in the October 2012 WEO forecast; the real global output growth forecast therefore represents a marginal rise from the 2012 level of 3.2 percent.

The clear message from the IMF, which we depict in **Figure 3**, is as follows: One, even with a start in 2013, the major advanced economies are expected to gradually pick the growth momentum with the US providing an important impetus. Two, even though advanced economies' policymakers so far have been successful in defusing two of the biggest threats to the global recovery – a breakup of the euro area and a sharp fiscal contraction in the United States caused by a plunge off the "fiscal cliff" – old dangers remain and new ones are evident; Of immediate concern are risks mainly related to developments in the Euro area, including uncertainty about the fallout from events in Cyprus. Three, there is an upbeat stance than was the case in October 2012 on the growth prospects of developing Asia, Sub-Saharan Africa and indeed Kenya; this is manifested by the upward revision of the growth outlook for 2013 in the April 2013 forecast compared to the October 2012 forecast.

While the outlook presented above may be a justification for those keeping an eye on the Kenyan economy sighing with relief, we highlight three issues that have not come out prominently but which need to be borne in mind.

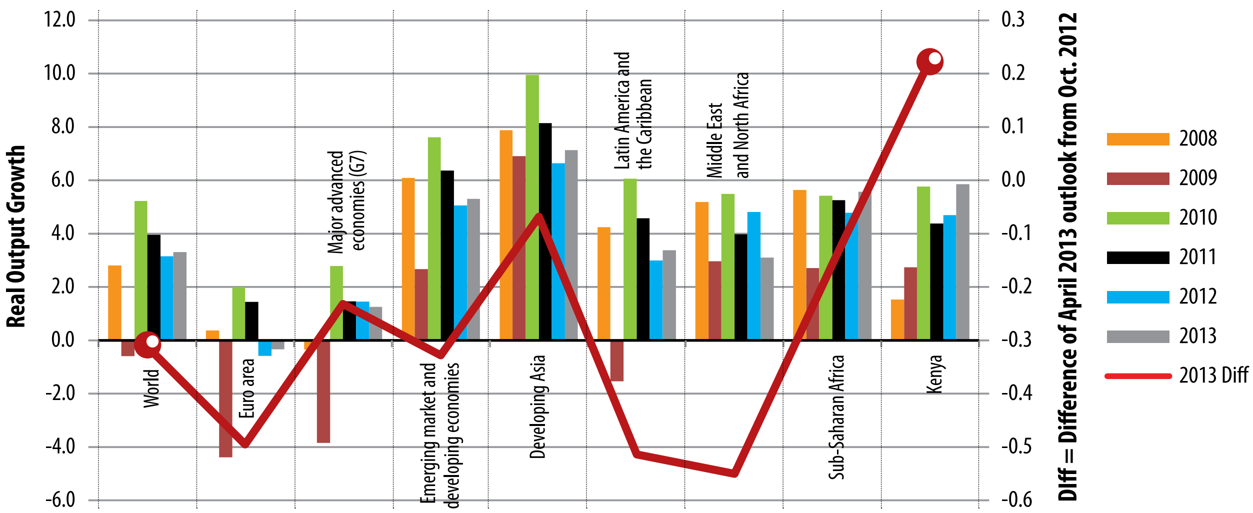
First, it may be too early to safely conclude that the challenges to the Eurozone arising from the crisis in Cyprus' banking industry – and in effect the whole economy – have been adequately addressed and with finality. The IMF is right in its reckoning that the remedies have so far served to 'diffuse' threats. The case for a banking union now needs to be given serious consideration, more so given that the sovereign budget and economic growth challenges have been traced to banks' profligacy and how the regulatory framework has proven to be wanting.

With the Eurozone economy stagnant – even projected to shrink in 2013 – economies such as Kenya and its East African Community (EAC) partners who look up to the region as a model for integration and the Euro as the manifestation of a grand political and economic project are watching. This is because the so-called 'peripheral' states have been taking turns – from Portugal to Ireland, then Greece and Spain, and now Cyprus – in risking the breakup of the monetary union, with popular commentary asserting that "it feels more like a loveless marriage, in which the cost of breaking up is the only thing keeping the partners together" *(The Economist, March 23rd – 29th 2013)*.

Second, the British economy – one of Kenya's leading trading partners – which is outside the Eurozone but is part of the European Union remains weak, a factor that has been attributed to the strategy of tightly focusing on managing the fiscal deficit in the face of a slowdown. The British Chancellor of the Exchequer now seems keen in looking at the looser monetary policy and credit as an avenue of rejuvenating growth.

As we observed in *Kenya Bankers Economic Bulletin*, *Volume Four of 2012*, the Bank of England (BOE) Governor-designate who assumes office in July 2013, has sent unambiguous signals that he is willing to see higher

Figure 3: Real Output Growth(%)



Source: IMF World Economic Outlook Database, April 2013

inflation than the government's 2 percent goal for longer to support economic growth. The Chancellor now seems keen in tweaking the BOE's responsibility such that while the inflation target remains at 2 percent, the interest rate setting would have to bear in mind that when output is constrained – and stands to be further constrained by a rate rise - an inflation rate higher than the target may have to be tolerated.

Third, the economic consequences of North Korea's nuclear ambitions, heightened by the recent threats of missile launches need to be appreciated. If such threats culminate in armed conflict in the Korean Peninsula, it would most likely suck in much of Asia, the risk being a curtailment of the thriving Asia economy.

Kenya is now increasingly looking at the Asian economy, and in particular China, as a principal trading partner. The developments in North Korea, and in particular their potential adverse impact on the Asian economy comes at a time when China's economy – which for some time now has been the pillar for global growth – is experiencing slow growth.

The Chinese economy reported to have grown at 7.7 percent for the year to the first quarter of 2013, which represents a slightly slowdown from the previous quarter and below popular expectations. However, as one could expect, China's economy is maturing, and with maturity comes slow pace. While this may have ramifications on economies that are not just seeing China as an opportunity for market diversification but as an alternative dominant market, it could be seen as a welcome development. For one, consumption-led growth is now surpassing investment-led growth. Further, services are set to overtake industry as a contributor to the economy's output. Finally, as the economy matures, any attempt to flog faster growth may fuel inflation, for "growing faster is a poor alternative to growing up" (*The Economist, April 20th – 26th 2013)*.

… but a bullish domestic posture

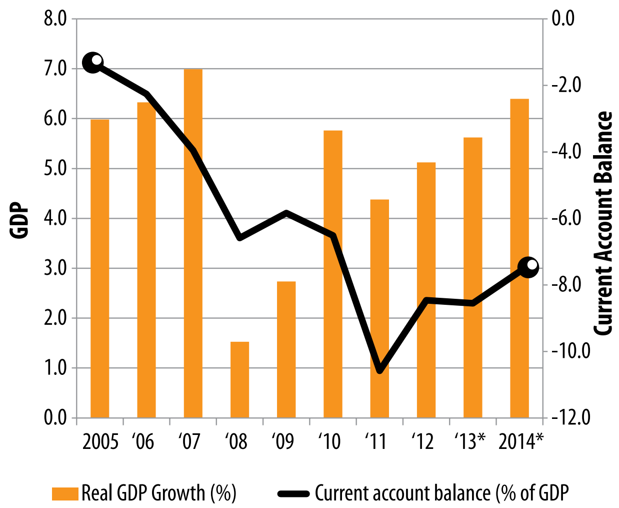
Let's now consider the domestic front. A good indication of the domestic economic perspective can be inferred from the monetary policy stance. The decision by the Monetary Policy Committee (MPC) of the Central Bank Kenya (CBK) to maintain the Central Bank Rate (CBR) at 9.5 percent during its two meetings of the first quarter of 2013 could be interpreted in two ways. On the one hand it represents a reaction to the rate of inflation attaining its trough in November–December 2012 period and could be commencing a mildly increasing trajectory. On the other hand it could be a signal that the economy's recovery is somewhat gaining traction, therefore any further reduction of the CBR could have inflationary ramifications.

We argue 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.

One, while we observe that the foreign exchange market has in the recent past been largely stable during the quarter in review, even showing sights of modest appreciation in the post-election period, 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 being on the back of a current account deficit exceeding an equivalent of 8 percent of GDP **(Figure 4)**. 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.

Figure 4: Real GDP Growth and Current Account Balance



Source: IMF World Economic Outlook Database, April 2013. *=projections

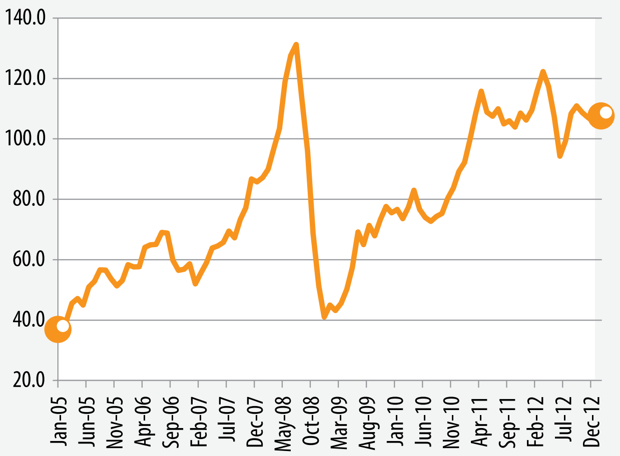
Two, it remains to be seen whether non-inflationary credit expansion can be realised and sustained. On the realisation of non-inflationary credit expansion we can argue that the rate of real GDP growth has largely been below trend and that liquidity build-up during the accommodative monetary policy regime has seen the interbank rates go below the CBR since April 2012, coinciding with a downward shift in the yield in the eight months end of March 2013.

As indicated by the CBK's credit survey for the year 2012 published in March 2013, demand for credit has evidently been positively responsive to the prevailing interest rates. The interbank rate has consistently declined from a high of 29 percent in November 2011, attaining the single-digit level by July 2012 and subsequently sustaining the declining trend; the interbank rate has closely been tracked by the 90-day Treasury Bill rate. The international money markets have been characterised by a near-zero interest rates regime since 2008; given the low inflation expectations in these markets, the interest rates regime is meant to stimulate demand and consequently promote output recovery.

The positive interest rate differential between the local short-term interest rates and short-term rates in the international markets is likely to spur portfolio flows (or at the very least reverse portfolio outflows) given the prevailing post-election positive sentiments. Coupled with inflows to the equities market, the foreign resource inflows are expected to provide mild support to the stability of the foreign exchange market without necessarily leading to a reversal of the earlier observed depreciation bias.

While these are positive developments, the economy's anticipated recovery that the latest IMF outlook seems to confirm has implications on the sustainability of non-inflationary credit expansion. Therefore, any rushed easing of monetary policy on account of a perception of non-inflationary credit expansion could be ill-advised.

Figure 5: Oil, fob Dubai Crude Oil (petroleum) - USD per barrel



Source: IMF Primary Commodities Prices Database

Three, good weather, while being able to provide some respite to potential inflationary pressure, is not likely to offset the negative effect of the international oil prices that have shown signs of mild decline in the last few weeks of the first quarter of 2013 but whose trend still remains on the gradual rise **(Figure 5)**.

There is full recognition that good rains have a positive effect on hydro generation capacity, and consequently on accommodative tariffs. We have, though, to counter that positive development with the likely opposite effect of the application by the Kenya Power and Lighting Company to the Energy Regulatory Commission for Tariff increase which, if approved, will see the non-fuel tariffs increase initially by 21 percent, then by 9 percent, 4 percent and 11 percent in July 2013, July 2014 and July 2015, respectively.

Four, the market liquidity status that has spurred low interest need to be considered alongside the likely effect of the ambitious government expenditure programmes promised by the new government. Given the constrained tax revenue mobilisation to match the proposed expenditure that includes potentially high initial funding requirements for the devolved government, a resort to increased domestic borrowing to complement the government's proposed euro bond could have the implications of putting the domestic interest rates regime under pressure to trend upward.

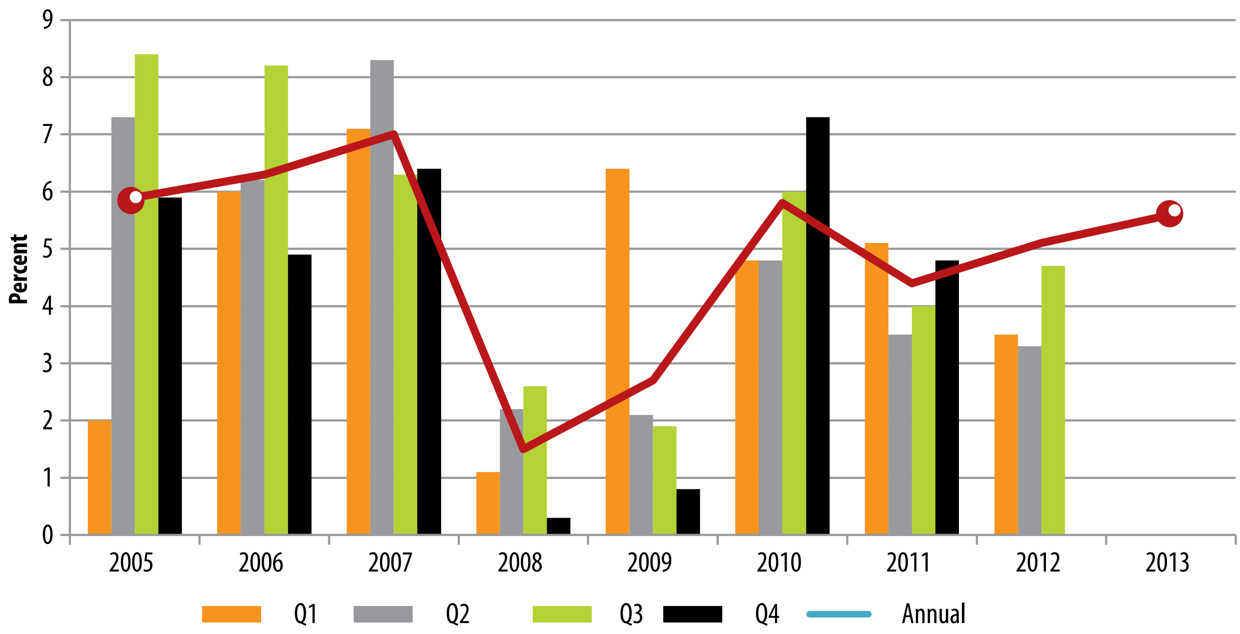
Celebration subject to caution

Observers and analysts of the Kenyan economy seem to converge on a consensus of an upward real growth trajectory for 2013, the IMF leading the pact in projecting an ambitious rate of 5.9 percent – a rate that, ceteris paribus, doesn't seem unattainable. But things will obviously not remain constant, as some parts may move as unexpected, therefore necessitating caution. In particular, it may be necessary to have an eye on the signals that we have pointed out above that could risk upsetting price stability given that they are increasingly becoming evident.

In essence, the policy thrust on price stability shouldn't be overshadowed by the sanguine posture on the economy. This, we argue, does not imply that stability should be pursued as an end, but there has to be a continuous calibration in the strive for a sustainable balance between supporting economic recovery and entrenching stability.

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

Figure 6: Growth in GDP



Source: KNBS

Growth in GDP

The Kenyan economy's first quarter performance has in the past been erratic. Prior to the global economic crisis of 2008 – 2009, the economy's real output growth during the first quarter was on an upward trajectory and aligned to the year's performance. During the economic crisis and the subsequent recovery period the erratic nature of the first quarter growth has been manifest **(Figure 6).** While the decline in the quarter's growth in 2008 was in line with the economy's overall growth tumbling during the year, the drastic up-turn in the next year – with a rise from the previous year's lower base – was not accompanied by an equal upward spring in the year's overall growth.

Similarly, the decline in the first quarter performance in 2010, a modest rise in 2011 and then was accompanied by an annual growth rate rise, then a decline and subsequently a rise. Although the Kenya national Bureau of Statistics has not published the growth numbers for the first quarter of 2013, there are all indications that the wait-and-see attitude by all economic agents would have a slowing effect on growth. Nonetheless, the year's real growth is projected at 5.6 percent as the base case scenario and 5.9 percent as the optimistic case scenario.

Agriculture

Agriculture remains one of the most important sectors in Kenya contributing well over 20% of GDP and over 60% of total employment. Its contribution to the economy is further augmented by its forward and backward linkages to other industries. In this perspective, whenever the sector does well it would be reflected on the overall economy - the converse being also true. One of the key components of the agricultural sector is grain production. Taking wheat for instance, the United Nations Food and Agriculture Organization (FAO) projects a 4.3 percent production increase (equivalent to 690 million metric tonnes) in 2013 compared to 2012 level; the anticipated increase in wheat production is partly signaled by the projected decline in prices as FAO indicates a decline in the food price index to 210 in the January – February 2013 period compared to the corresponding period in 2012.

The growth in the economy's agriculture, and in particular food production, whose effects were observed in the overall economy's performance in 2012 was signaled in the decline in the prices of maize and beans. While this would be a welcome development for consumers – as could be seen in its influence in the overall inflation decline during the year to the CBK's single-digit target – it could act as a disincentive for production hence posing a policy dilemma.

Table 1: Selected Open Air Market Prices for Produce and Inputs (January – March 2013) - KES

	18-Jan	25-Jan	22-Feb	15-Mar
Rosecoco (90kg)	5,382	5,375	5,463	5,424
Redharicot (90kg)	5,201	5,107	5,176	5,327
CAN/50kg	2,438	2,449	2,464	2,492
UREA/50kg	3,172	3,269	3,218	3,238
DAP/50kg	3,667	3,697	3,741	3,809
Maize 90 kg	2,758	2,775	2,777	2,756

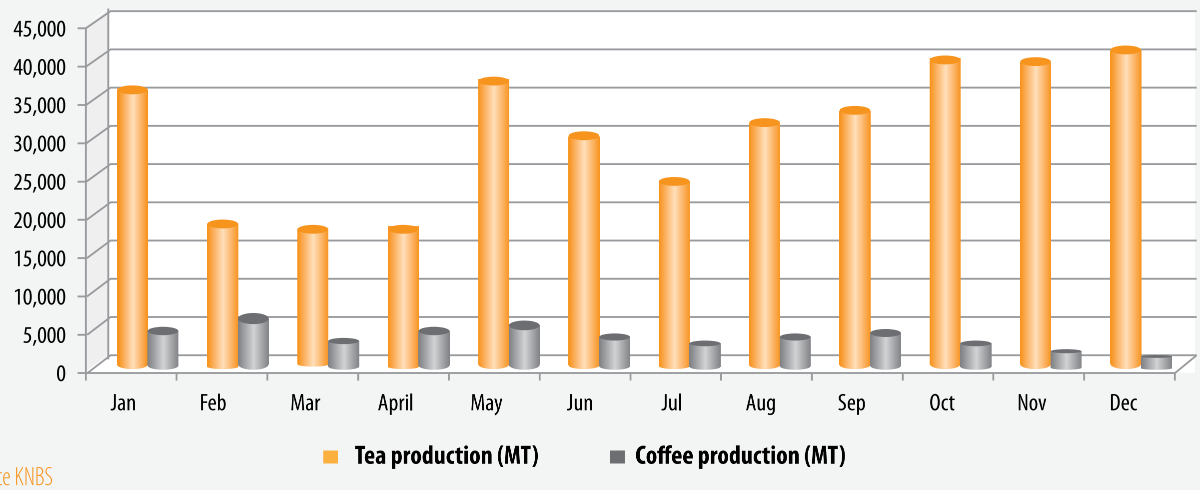
Source: NCPB

Unlike last year, the first quarter of 2013 has been characterized by a rise in the prices of maize and beans (**Table 1**); the price increase arose from a combination of factors, notably the dry spells in the initial period of the quarter and supply is usually constrained during this time of the year that is typically the planting season. As **Table 1** shows, input costs, in particular DAP fertilizer, has rose in first quarter. Government initiatives towards subsidizing as well as availing inputs to framers are a step in the right direction in addressing the issue of food security. Similarly, the long rains that commenced towards the end of the first quarter are considered timely and are expected to boost agricultural production in the current year.

On the cash crop production, the fourth quarter characteristics of favorable weather filtered into the first quarter of 2013 with expectations that it will boost overall production. Production of tea continued to rise during the major part of quarter three and four of 2012 to peak at 41404 Metric tonnes (MT) in December 2012 after showing slightly unpredictable trends during the first two quarters. In contrast, however, coffee production fluctuated slightly around 5000 MT in the first three quarters before assuming a downward trajectory in the last quarter hitting a low of 1075 MT in December 2012 **(Figure 7)**.

One factor that can be attributed to the disparity in production is international price fluctuation. While the price for tea has been almost stable averaging KES 269 per kg in 2012, coffee prices have continued to fluctuate falling drastically from KES 544 in January to KES 258 per kg in June 2012 before improving slightly to KES 308 per kg at the end of the year. Such fluctuations are disincentives to farmers considering the high costs of inputs and other production costs. Second, agriculture in Kenya is mainly dependent on weather conditions especially rain on the back of slow uptake of irrigation.

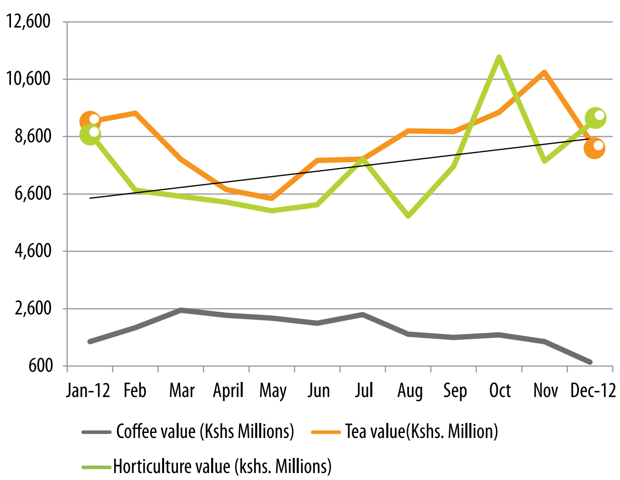
Figure 7: Tea and Coffee production in Metric Tonnes: January – December, 2012



Source KNBS

Agriculture exports continue to be the economy's main export, with tea leading the pack followed by horticulture and coffee **(Figure 8)**. In the fourth quarter 2012, tea earned KES 9,584 Million followed closely by horticulture KES 9,382 million and coffee KES 1,294 million. In comparison to the first three quarters, while tea and horticulture observed an upward trend, coffee forex earnings continued to decline.

Figure 8: Agricultural Exports (KES Millions), January – December 2012



Source: KNBS

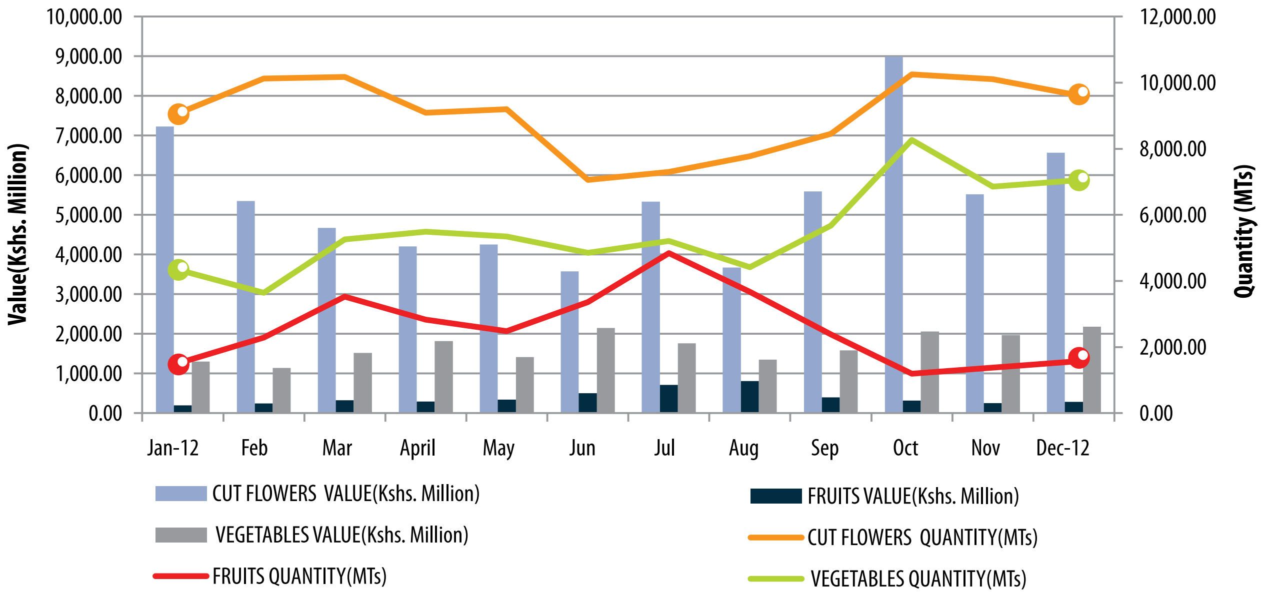
Domestic consumption continues to form a major component of total tea consumption and accounts for 5.28% during the whole year compared with 5.31% and 4.69% in 2011 and 2010, respectively. Increased marketing and branding coupled with sustained efforts on local value addition can be attributed to increasing domestic consumption.

On horticultural exports **(Figure 9)**, in terms of both the quantity exported and foreign exchange earned, cut flowers dominate this subsector contributing on average 72 percent of total exports while fruits have the lowest contribution of 5.2 percent. In the second half of the year, while the quantity of vegetables and cut flowers rose sharply before declining in the Q3 2012, the quantity of fruits exported fell drastically before almost stabilizing at an average of 1379 MTs in the same period.

Manufacturing

The manufacturing sector in Kenya is considered to be one of the pillars for the achievement of vision 2030 goals through shifting away from reliance on the traditional agriculture. The sector is projected to post 5.6% growth in 2013, slightly lower than the growth realized in 2012. Thereafter the sector is projected to sustain the growth trend, hitting 7.0 percent growth in 2016. It is noteworthy that Kenya's manufacturing sector consumes about 60% of the total power generated in the country.

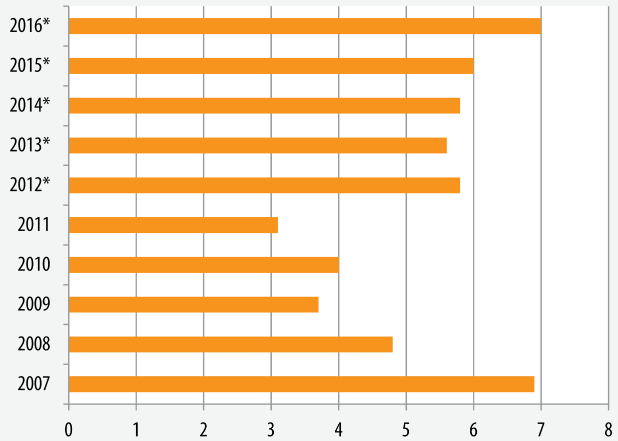
Figure 9: Horticultural Exports



Source: KNBS

As a key input to production, the high power costs in Kenya relative to other competing economies such as Egypt and Ethiopia has implications on the competitiveness of the manufactured exports. That is why during the first quarter of the year, investors in manufacturing sector were explicitly concerned by the application by Kenya Power and Lighting to the Energy Regulatory Commission for the increase in the tariff rate.

Figure 10: Manufacturing Growth Rates (%), 2007-2016*

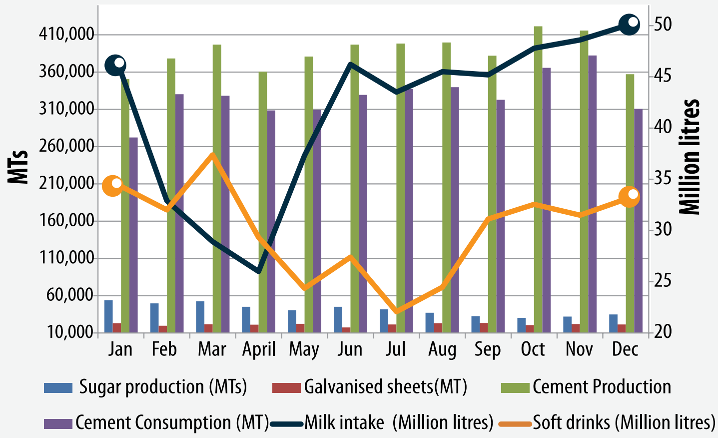


Source: Economist Intelligence Unit*-Projected

A key component of the manufacturing sector is its output that targets the construction industry. While domestic production of galvanized sheets remained constant in 2012, averaging 21318 MT on quarterly basis, that of cement increased by 1%, 3.69% and 1.2% the second, third and fourth quarters. Increased cement production has been associated with faster expansion of building and construction manifested in the increase in cement consumption to peak at 415866 MT in November 2012 from a low of 650315 MT in February 2012. Soft drinks production assumed a downward trend in the first two quarters falling from 35 million liters to 27 million liters and 26 liters before rising slightly to 32 million liters in the fourth quarter of 2012 **(Figure 11)**.

The number of assembled vehicles has been fluctuating from a low of 303 in March 2012 to peak at 654 in May 102 and later fall to 344 in December 2012. On the other hand, milk production has continued to rise rapidly from the second half of 2012 to stand at 50 million liters in December 2012. The effects of seasonality in production resulting from expected mild drought before onset of the long rains in the first quarter are expected to cut milk production and push up prices. This would reverse as the year progresses given the initial signs of improved rains towards the end of the first quarter of 2013.

Figure11: Production and Consumption of Manufacturing

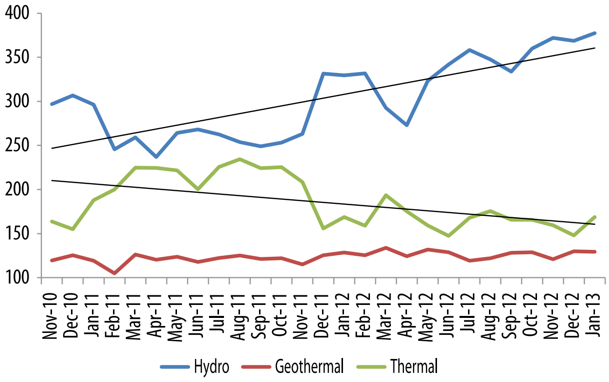


Source: KNBS

Energy

Electricity generation has continued to grow, albeit outpaced by demand. The dominance of hydroelectric power generation is evident, rising from 266.94 Kilowatt hour (KWh) in 2011 (first quarter) to 317.89 KWh, a similar period in 2012 and standing at 377.24 KWh as at January 2013 **(Figure 7)**. Hydroelectric power, which is highly correlated with rainfall intensity, contributed 54.6 percent of the total generation capacity in 2012 compared to 43.1 percent in 2011, therefore confirming observed increasing dominance.

Figure 12: Electricity Generation by source (Million KWh), January 2012 – January 2013



Source: KNBS

The contribution to the national grid by thermal energy has been declining, accounting for 30.1 percent in 2012 of the total generation capacity compared to 36.3% in 2011; this is a positive development given the vulnerability of this energy source to international oil prices. Geothermal power has been quite stable at an average of 123.71 KWh (20.11% of total generation capacity), although this component has substantial potential to play a bigger role and rival hydro generation.

Energy prices have remained high in Kenya. The average cost of products imported as well as locally refined products increased during the first two months of the first quarter **(Table 2)**. The Energy Regulatory Commission (ERC) to effected price increases in fuel effective 15th March - 14th April with petrol prices the most affected followed by kerosene and diesel. This was on account of increasing refining costs that have put the refinery's efficient operations in focus. 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.

Table 2: Crude Oil and Fuel Import Prices

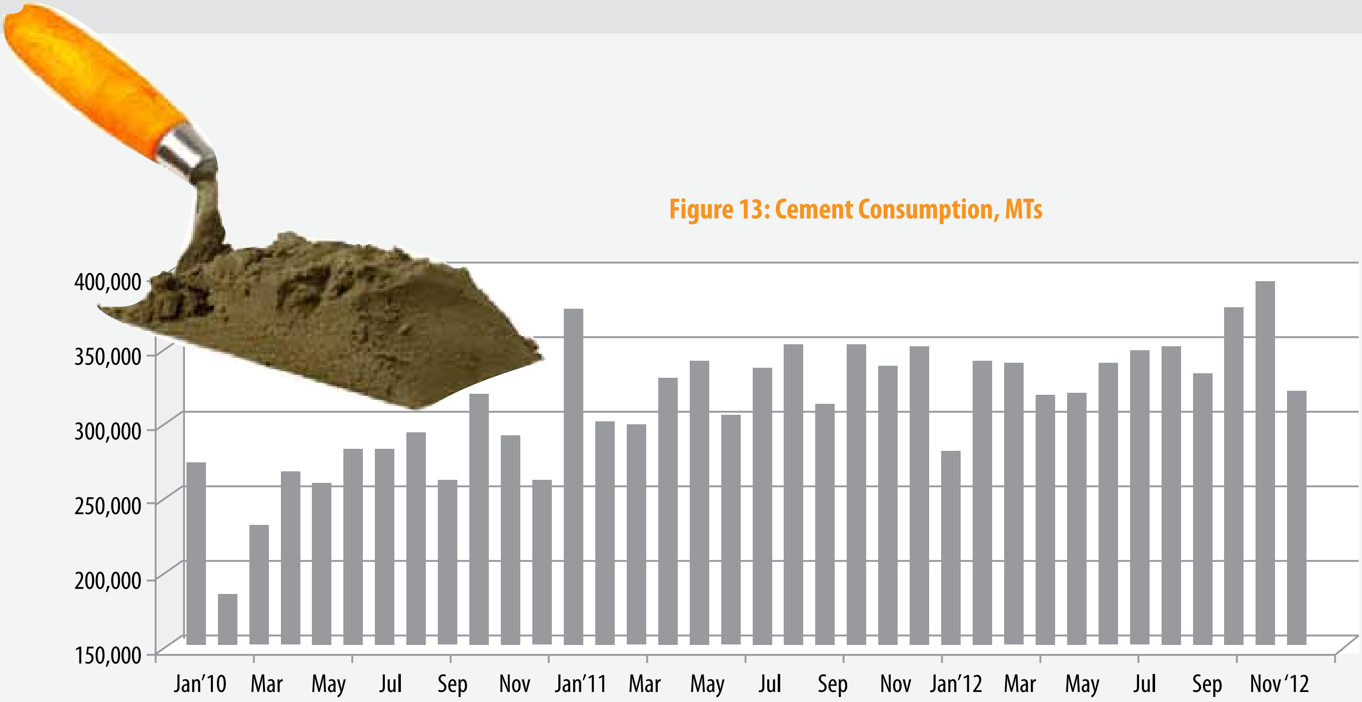
Product	Jan 2013	Feb 2013	Change (%)
Murban crude oil (US$/Barrel)	112.05	115.40	2.99
Super petrol (US$/Tonne)	1054.22	1114.08	5.68
Diesel (US$/Tonne)	975.23	1008.21	3.38
Kerosene (US$/ Tonne)	1031.96	1116.05	8.15

Source: ERC

Building and Construction

Cement consumption, a proxy of activity in the construction industry fell from a record high 382400 MT in November 2012 – the highest since 2010 – to stand at 310639 MT in December 2012. But on a year on year basis, consumption has grown steadily **(Figure 13)**. This trend reflects higher and sustained demand not only for better quality but also affordable housing especially with the expanding middle income and overall growth in population and its composition. With the government's development expenditure programs assumed to remain on course, the trend of cement construction is expected to be maintained in 2013.

Figure 13: Cement Consumption, MTs

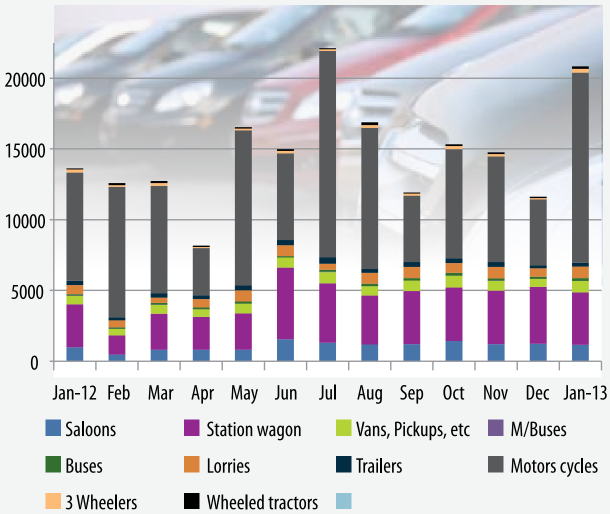


Source: KNBS

Transport and Communications

The total number of new motor vehicle registration, which shows activity in the transport sector, declined from the peak attained in the third quarter to stand at 14,002 units in the fourth quarter 2012 **(Figure 14)**. Between December 2012 and January2013, all new registrations except those of saloon and station wagon cars that account for about 23 percent of total registrations, showed a marked improvement of approximately 50 percent. Motor cycles have become an important aspect of transport both in urban and rural areas; the increased number of motor cycles can partly be attributed to the waiver of duty on their importation. A modest rise was seen in January 2013 from the December levels in the registration of lorries and pickup trucks.

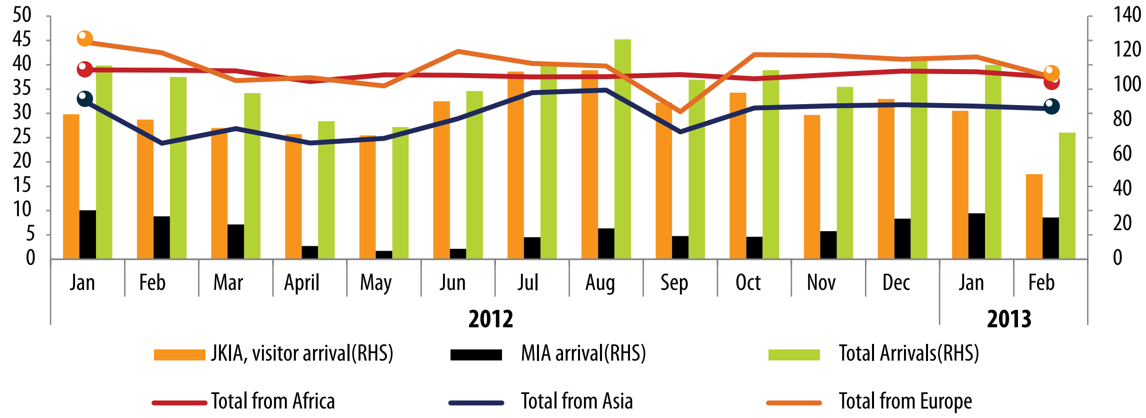
Figure 14: Registration of New Vehicles



ource: KNBS

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, has been characterized by low transaction compared to other payment modes. Between January and February of 2013, there was a 33.3 percent growth in the number of agents to stand at 88,393 compared to an average of 74,370 in quarter 3 of 2012. This reflects the view that mobile transfer has the potential of raising living standards by offering employment.

Figure 14: Trends in Visitor Arrivals (Thousand)



Source: KNBS

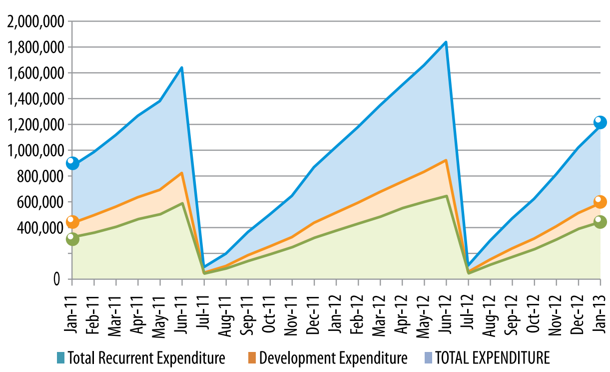
Tourism

Tourism remains the second leading foreign exchange earner after tea exports. During the first quarter of 2013, there was a marked decline in the total number of visitor arrivals in the country in the in relation to the fourth quarter of 2012 largely on account of the uncertainty around the March 2013 general elections. The decline was particularly driven by a reduction in the number of tourists coming in from Europe – the leading tourists' source – as arrivals from Asia and Africa remained steady, albeit at lower levels than from Europe. Most of arrivals were through Jomo Kenyatta International Airport (JKIA) than through Moi International Airport (MIA).

Financing of Government

Public expenditure in recent times has been characterized by the dominance of development expenditure, mainly the ongoing infrastructure projects. Even with concerted efforts towards fiscal consolidation, the onset of the devolved government is set result in increases in both recurrent and development expenditure. The recent evolution of public expenditure is presented in **Figure 15**.

Figure 15: Public Expenditure (KES Million)



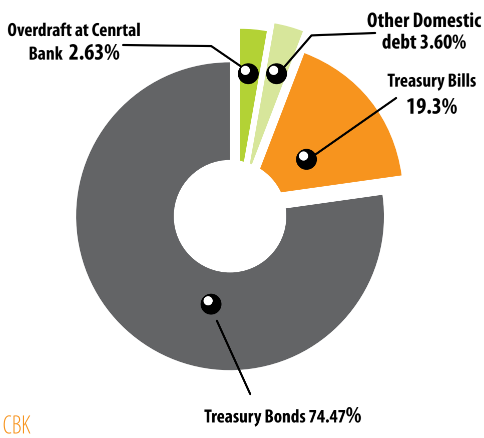
Source: CBK

Public Debt

Government operations resulted in an increase in public debt to stand at KES 1,793 billion in December 2012 from KES 1,742 in October the same year. This represented an increase of about 2.96 percent; total public debt to GDP ratio rose marginally from 45 percent to 46.4 percent over the same period. External debt increased by 1.19 percent from an equivalent of KES 812 billion in October to an equivalent of KES 822 billion in December 2012, dominated by multilateral as well as bilateral debt. In the bilateral creditors segment, there has been increasing participation from China especially in regard to support of infrastructure projects.

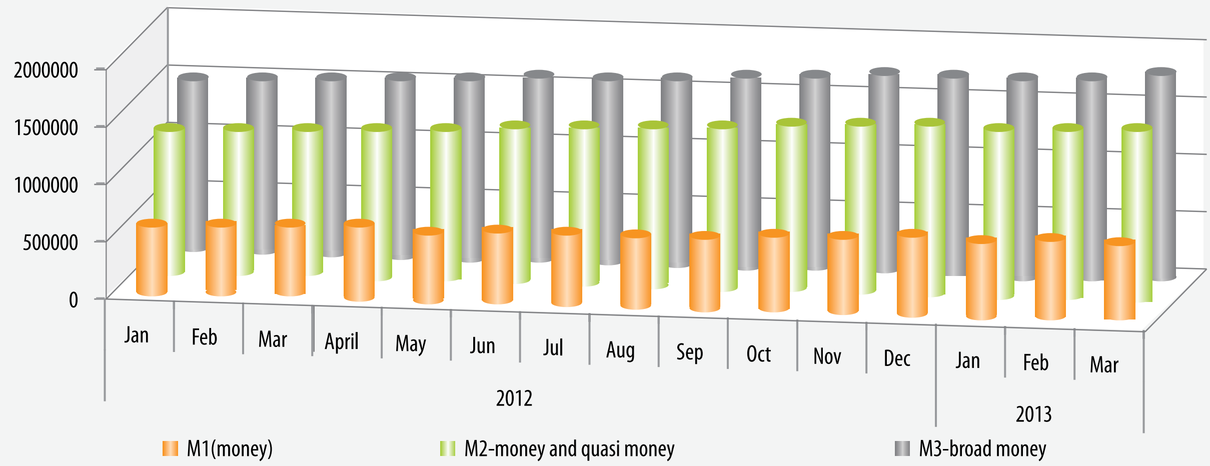
Total domestic debt including interest repayment was at KES 2,934 billion a few days before the March 2013 general elections. In terms of composition, domestic debt instruments were characterized by greater dominance of Treasury bonds followed by treasury bills, the other components being other domestic debt instruments and central bank overdraft **(Figure 16)**.

Figure 16: Composition of Domestic Debt



Source: CBK

Figure 17: Money Supply (KES Million)



Source: KNBS and CBK

Money and Credit

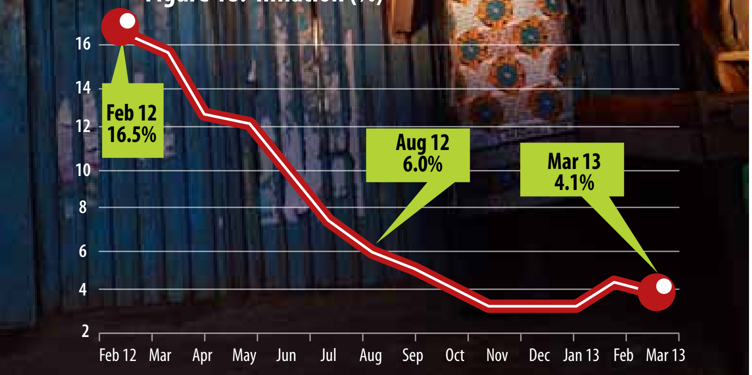
In the first quarter of 2013, total money supply stood at KES 3,649,312 million, with Broad money (M3) dominating the composition at 44.43 percent and currency and demand deposits (M1) coming at the bottom and accounting for 18.17 percent of the total money supply. The evolution of money supply represents a stable, with modest but consistent growth over time **(Figure 17)**.

Total domestic credit rose by 4.62 percent from the third quarter of 2012 to the fourth quarter level of KES 1,681 billion, but was not as robust as the growth in 2011. A large part was associated with; first, continued liquidity tightening meant to mainly put inflation under check and second, the events leading to the general elections increased both investor and domestic economy uncertainty creating a wait and see attitude among stakeholders. In terms of composition, the rise in credit to government was 10.74 percent while that to private sector and public only rose by 3.05 percent. Manufacturing, real estate and trade sectors of the economy dominated credit intake from the banking sector accounting for 56 percent of the total credit to the private sector with consumer durables and business services consisting the smallest share of 10.8 percent of the total credit.

Inflation

Most recent inflation trend indicates a sustained decline from a high of 19.72 percent in November 2011 to 3.2 percent in January 2013, rising slightly to 4.45 percent in February 2013 and declining to 4.11 percent in March 2013 **(Figure 18)**. The downward trend is a reflection of the effectiveness of the CBK's monetary policy, which has been increasingly becoming accommodative as the low inflation expectations become entrenched.

Figure 18: Inflation (%)



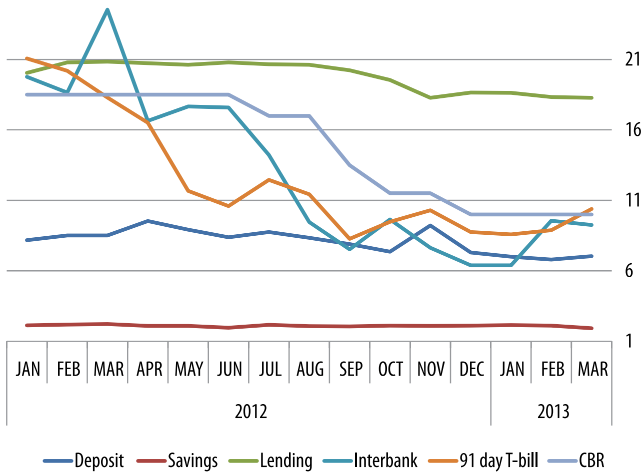
Source: KNBS

Interest Rates

Interest rates have largely been stably during the first quarter of 2013, as was the case in much of the second half of 2012 **(Figure 19)**. This was on the back of monetary policy easing through the reduction of the Central Bank Rate (CBR) as well as other open market operations whose main objective was to increase liquidity and spur credit expansion. The CBR was reduced from 13% to 11% in October 2012 and December 2012, and further to 9.5% in January – a rate that prevailed for the rest of the first quarter of 2013.

Cumulative average weighted lending rates declined mildly from their October 2012 to what prevailed for much of the first quarter of 2013, while deposit rate declined similarly declined over the same period. In this regard, there has been incomplete transmission of monetary policy easing on credit offered to customers by banks as manifested by interest rates which, even though showing signs of slight decline, have remained high. 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.

Figure 19: Interest rates (%)



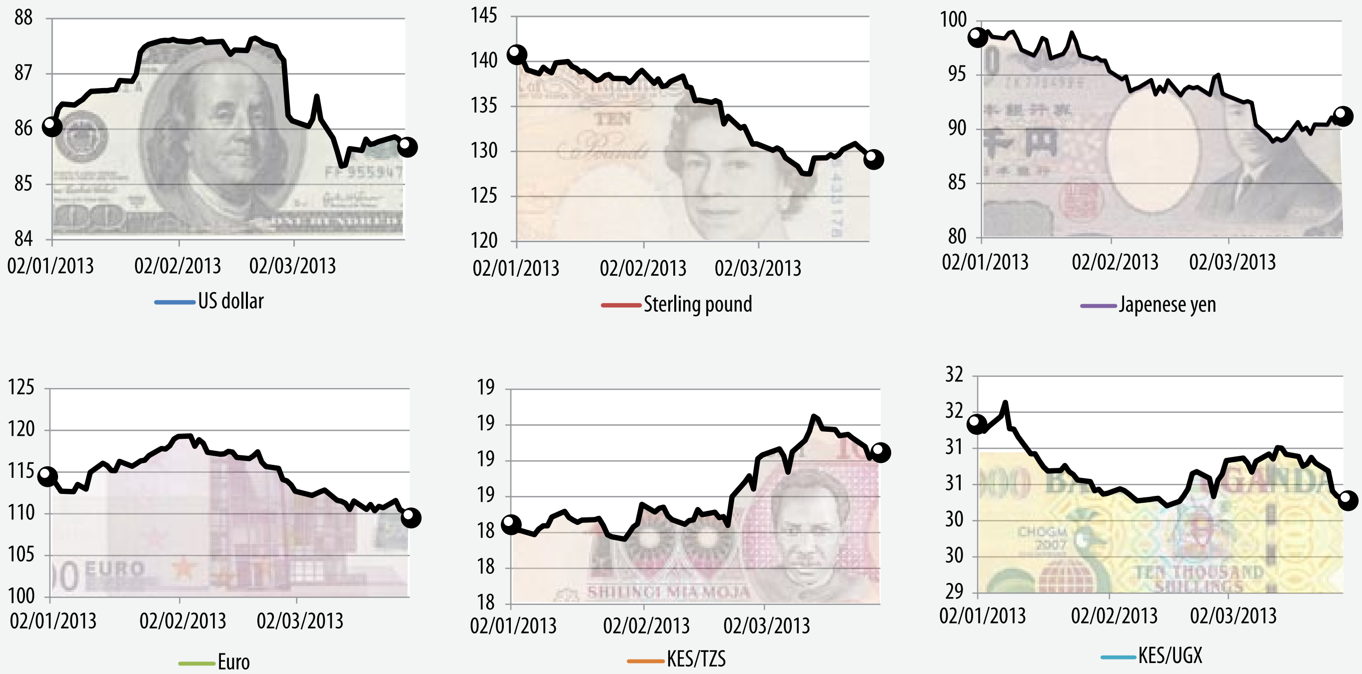
Source: CBK

Balance of Payments

The overall trade balance has maintained a deficit position and has been deteriorating over time, the deficit rising by about 44 percent from an equivalent of KES 5, 7981 million in February 2012 to an equivalent of KES 8,3648 million in December 2012. It is noteworthy though that commercial imports continue to play a large role in the domestic economy and contribute about 98.5 percent of the total imports. In this subset, fuels and lubricants have a large share followed by supplies to industries, transport equipment, and machines and other capital equipment, in that order. Exports have been almost stable rising slowly with beverages and food being the main exports with a share of 43 percent of the total exports in December 2012, followed by non-food industrial supplies. Uganda continues to be the most preferred export destination for domestic exports followed by Tanzania and United Kingdom.

The current account deficit for Kenya is set to worsen slightly from 8.5 percent of GDP in 2012 to 8.6 of GDP in2013 according to the IMF projections. United States, the largest oil importer followed closely by China, according to Economist Intelligence Forecasts, is cutting back on crude oil demands/ imports and fast replacing it with domestic production, what is called tight oil. Notably, US production is set to rise about 20 percent between 2012 and 2017 to stand at 10.9 million barrels per day. With this development and the anticipated stabilization in the crisis of the Middle East, world supply would rise, consequently pushing down international prices. At the same time, successive oil exploration in East Africa and so Kenya would mean a shift in huge foreign exchange used on crude oil and associated imports to other priority investments that could further repair the position of the current account.

Figure 20: Exchange Rates



Exchange Rate

In the first quarter, the Kenyan shilling generally appreciated with respect to major international currencies **(Figure 20)**. Except for the distinct depreciation against the Tanzania shilling (TZS), the appreciation against other currencies attained a peak in the period 10th - 13th March 2013. Oil imports form a large portion of total imports and therefore the demand for foreign exchange for stock acquisition. Crude oil import prices had been stable for some time coupled with falling inflation as well as interest rates, until announcement by ERC that their prices would rise effective 14th March. A higher current account deficit associated with higher crude oil import prices would cause depreciation of the currency.

Nairobi Securities Exchange

All Nairobi Securities Exchange (NSE) indicators exhibited improved performance during the first quarter of 2013 **(Table 3)**. Activity at the NSE increased as indicated by the NSE 20 share index that rose 16.14 percent from 4,159.25 points in January to 4,830.44 points at the end of the quarter, manifesting increased investor confidence and certainty in the economy. Total shareholder wealth as measured by market capitalization rose 23.5 percent from KES 1,288 billion to KES 1,591 billion.

Table 3: Nairobi Securities Exchange

Date	03 Jan	10 -31Jan	07-Feb	14 -28Feb	07-Mar	14-21Mar	27-Mar-13
NSE 20 Share Index 100=1966	4,159.25	4416.76	4,561.16	4553.91	4,585.07	4770.20	4,830.44
Number of Deals	3,407.00	7668.00	7,773.00	7923.67	4,690.00	10281.50	7,258.00
Total Shares Traded(million)	3,250.00	124.60	267.81	141.46	120.86	161.36	106.92
Equity Turnover (KES. million)	4,826.54	2052.56	4,499.71	3398.05	1,738.16	3259.81	2,449.40
Market Capitalization (KES. Bn.)	1,288.00	1383.75	1,425.90	1440.62	1,496.61	1554.47	1,590.62
Bonds Turnover (KES. million)	3,447.90	5172.03	5,189.00	4901.93	4,195.15	7375.18	4,797.75
FTSE NSE Kenya 15 Index	126.74	135.24	139.71	139.91	142.22	152.46	153.78
FTSE NSE Kenya 25 Index	129.60	138.48	143.12	143.08	145.18	155.89	157.07

Source: CBK, Weekly statistics

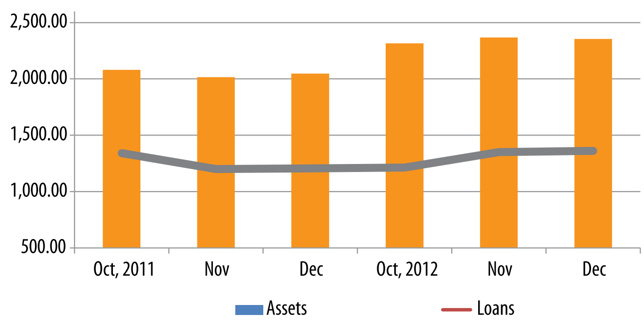
Banking Industry Performance

The banking sector in Kenya sustained positive growth in the fourth quarter of 2012. With the increase in confidence on the economy that largely prevailed and in particular during the second half of 2012 when monetary policy reflected a return to price stability, there was an increase in credit uptake as shown by the CBK credit survey report across all sectors but most prominently to the manufacturing, trade and energy sectors.

Assets and Loans

Loans and advances, securities owned by government and placements comprised a major part of the sectors balance sheet with their shares approximately 55.47 percent, 21.6 percent and 6.13 percent respectively. While total assets have increased, total loans and advances have remained almost stable, rising only slowly **(Figure 21)**.

Figure 21: Bank Assets and Loans (KES Billion)

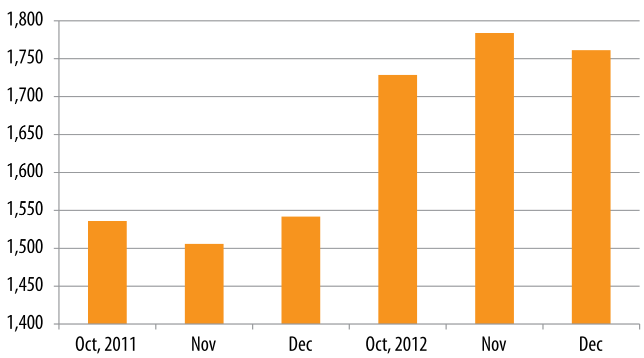


Source: CBK

Deposits

There was been a rapid increase in deposits in quarter four of 2012 as compared to the corresponding quarter in 2011, with deposits rising by about 15 percent from KES 1757.87 billion **(Figure 22)**. The growth in deposits is attributed to increased foreign remittances and efforts by the banking sector aimed at increasing customer deposits that witnessed an in the savings deposit rates, however modest.

Figure 22: Bank Deposits (KES Billion)

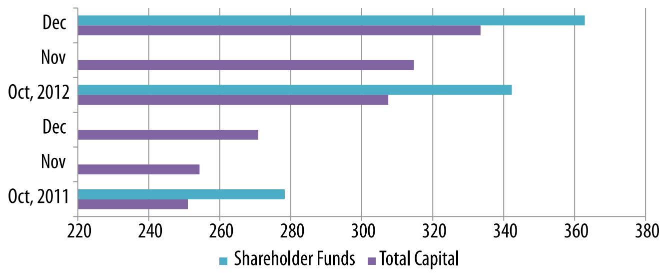


Source: CBK

Total Capital and Shareholder Funds

Total capital stock of the Kenya banking sector sustained its upward trajectory in the fourth quarters of 2011 and 2012, representing an increase of about 23 percent **(Figure 23)**.

Figure 23: Bank Capital and Shareholder Funds (KES Billion)

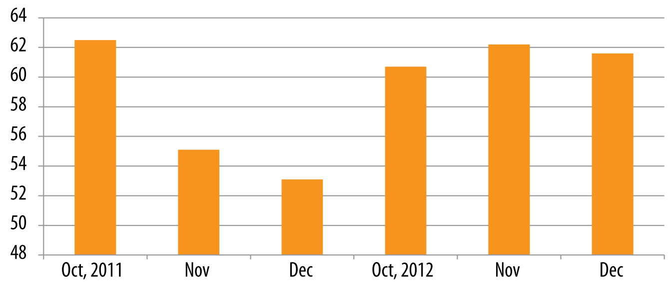


Source: CBK

Gross Non-Performing Loans

There was an increase in gross non-performing loans (NPLs), and with the exception of a slight decline towards the end of 2012, all successive periods of quarter four continued to rise in gross NPLs compared to the corresponding quarter in 2011 **(Figure 24)**.

Figure 24: Bank Gross Non - Performing Loans (KES Billion)

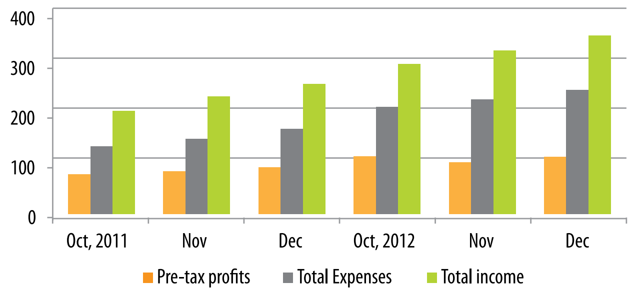


Source: CBK

Bank Profitability

The banking sector recorded positive profit in quarter 4 of 2012, with the profitability trend being on the increase **(Figure 25)**.

Figure 25: Bank Profitability (KES Billion)



Source: CBK

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