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KENYA BANKERS ECONOMIC BULLETIN

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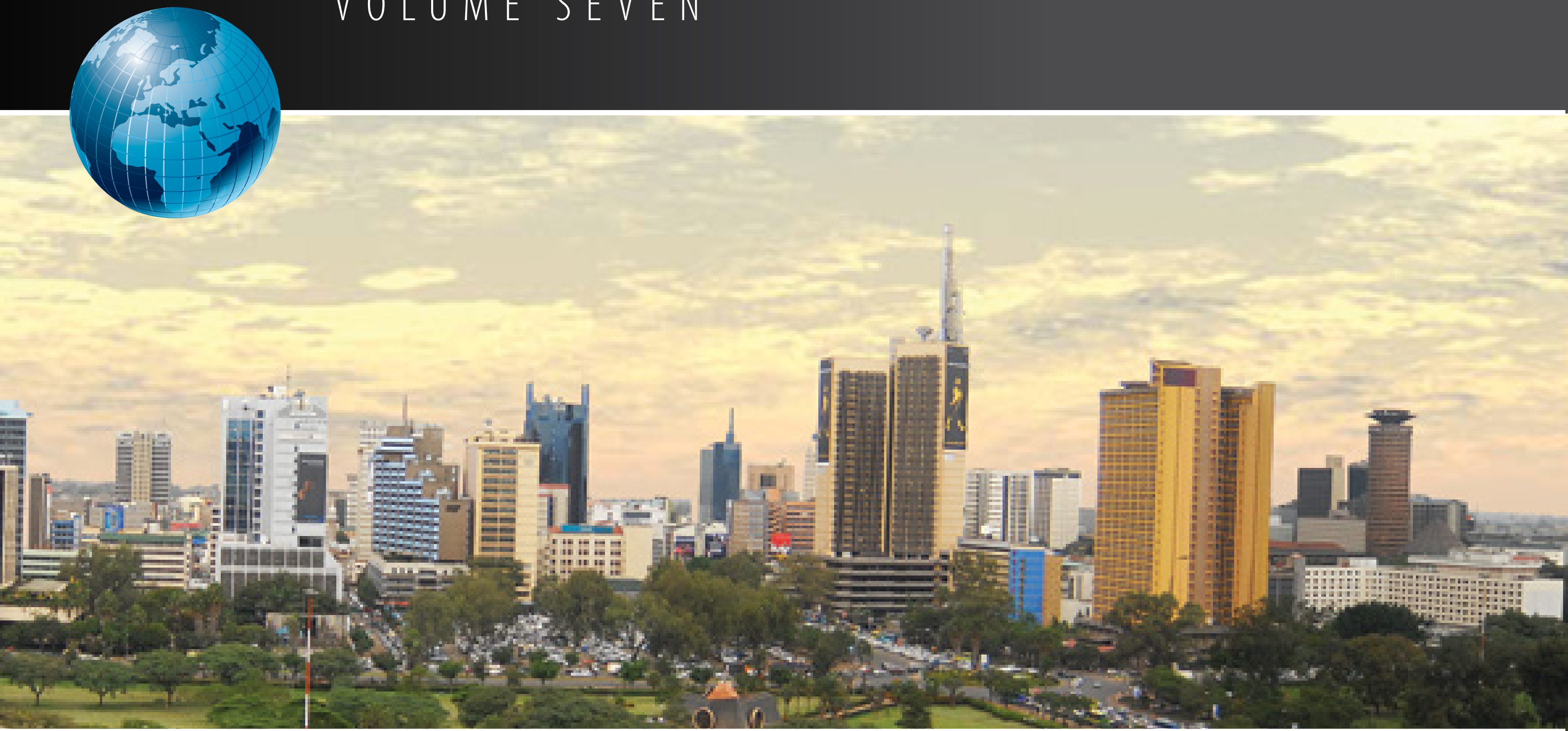

A report prepared by:

The Centre for Research on Financial Markets and Policy®

KENYA BANKERS
ASSOCIATION

CENTRE FOR RESEARCH ON

FINANCIAL MARKETS AND POLICY

About this Report

This *Bulletin* reviews the performance of the Kenyan economy for the first 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

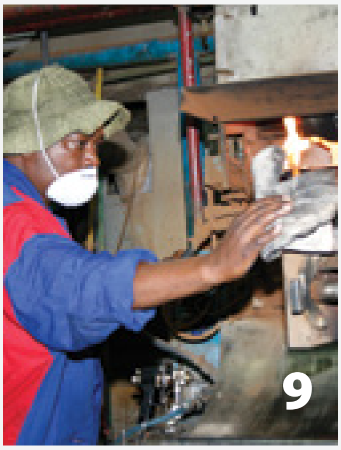


Photo / Fredrick Onyango

A small scale market grocer displays his fresh produce: The economy is making strides out of the 2007/2008 slump.

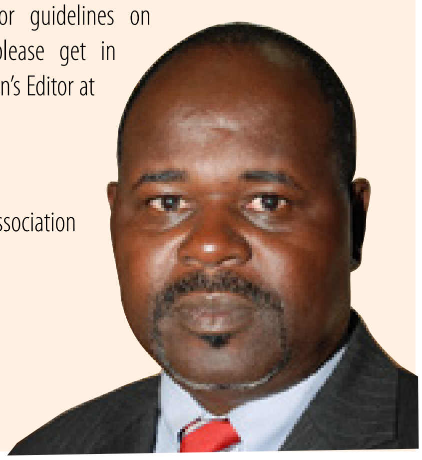
From the CEO's Desk

It is my pleasure to present to you the seventh volume of the *Kenya Bankers Economic Bulletin*. This issue discusses the state of the Kenyan economy during the first quarter of 2014. The *Bulletin* outlines the consolidation by all economic agents that has taken place in the period subsequent to the March 2013 general elections, now that the new administration has been in office for slightly more than one year.

It is notable that while the economy is making strides out of the 2007/2008 slump, there are a number downside risks – both domestic and international – that have curtailed faster growth. It is no wonder that the recovery has been gradual at best. These aspects are encapsulated in the Commentary by Jared Osoro, the Director of the KBA Centre for Research® on Financial Markets and Policy.

It is my 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



Real Output Growth Trajectory – Are We Seeing a "New Normal"?

By Jared Osoro

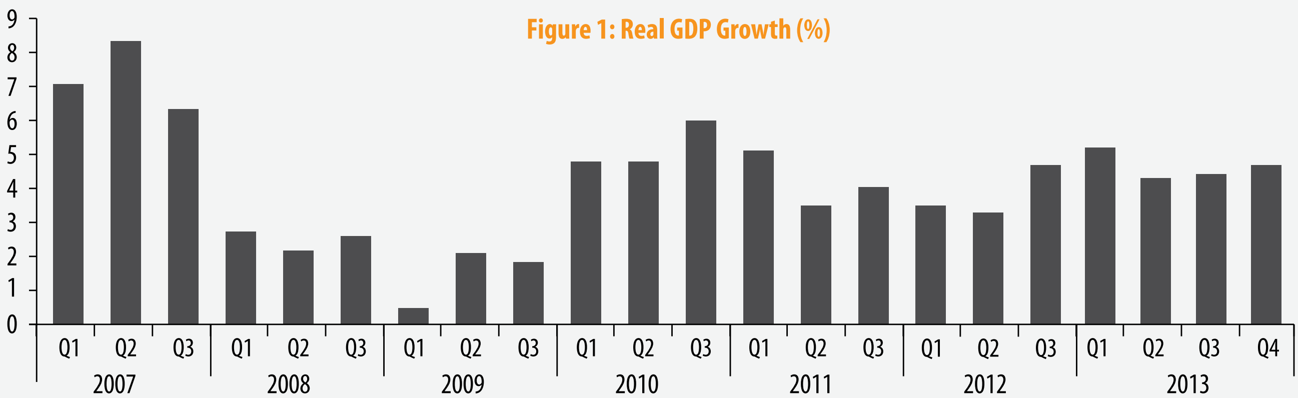
By the end of the first quarter of 2014 it was clear that the growth momentum of the Kenyan economy will at best remain feeble at least in the medium term. The message that remained consistent throughout the year to December 2013 was one where those who stuck there necks out with ambitious growth forecasts were busy revising them downwards.

There was one exception though. The International Monetary Fund (IMF) takes the cake in terms of ambition and sticks to its guns with its projection. Its latest *World Economic Outlook* of April 2014, just like its October 2013 version, maintains a real output growth of 5.6 percent for 2013, rising to 6.3 percent in 2014. An outlook starts looking like a mere wish when it contrasts significantly from the actual performance; and that seems to be the case here.

The economy's real Gross Domestic Product (GDP) for 2013 expanded by 4.7 percent (**Figure 1**)[1] and is likely to remain so during the first quarter, rising modestly to 5.1 percent by the end of 2014. What happened to the economy that its growth over the past 6 years make 2007 look like the

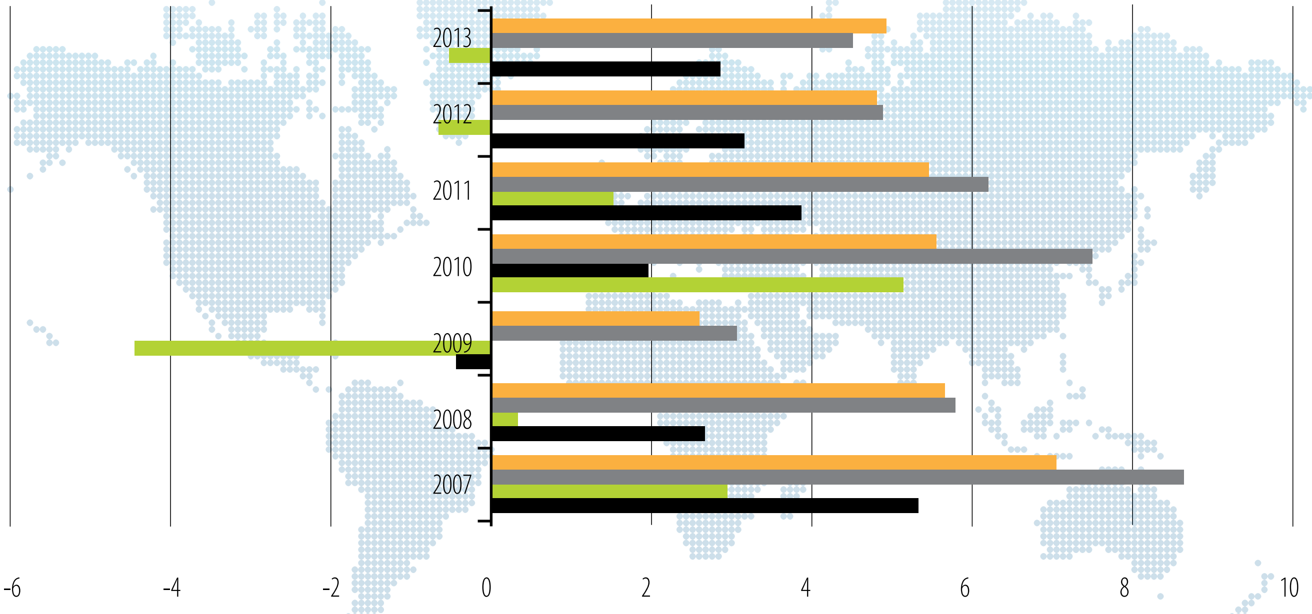
1 The World Bank's Kenya Economic Update (Edition 9), December 2013 had relatively more realistic projection of the economy's real output growth performance, estimating it at 4.7 percent and therefore climbing down from its earlier forecast of 5.5 percent.

Figure 1: Real GDP Growth (%)



Source: KNBS

Figure 2: Global Real Output Growth (%)



Source: IMF

model performance period? Is the economy being a victim of the global dynamics owing to its "small-open" attribute or is it that the domestic circumstances cannot allow a quick break into faster growth? Should the economy resign to a "new normal" where a 5 percent real growth should be celebrated?

Anything but Systematically Important?

The one characteristic of a "small-open-economy" – being an economy that is a price taker for both imports and exports – is that is far from being systematically important in the global context; therefore missing the growth forecast as the IMF does even by a whole 900 basis points will have no ramifications on the global economy. But a weak global economy, driven by developed as well as emerging economies, will have a drag on the pace of growth momentum of such economy.

While it is true that local circumstances will have a big role to play if the recovery pace of the Kenyan economy is to pick, there are lots of expectations on the boost the global economy's recovery will provide. Interestingly, it is the IMF that is providing the basis for such expectations. The April 2014 World Economic Outlook projects a 3.6 percent global output growth in 2014 compared to 2013's 3.0 percent.

The Eurozone, which by the end of 2013 was still in the red, is likely to register positive growth in 2014; and Sub-Saharan growth will remain strong, albeit with the backing of few resource rich economies that continue to benefit from the commodity price boom (**Figure 2**).

If the global economic forecast turns out to be credible, then Kenya's exports could be expected to start picking. That will send a signal to the foreign exchange market that the economy's current account is on the mend, thus boosting the local currency's stability. Such stability will also ride on the market whose disposition is clearly one that has factored in the assumption that the United States tapering off of the economic stimulus will have limited disruptions. This is all fine, until one injects some reality in four respects.

First, while the Euro zone may be moving from the read, the sustainability of its recovery remains in question. If one needed a reason to argue that the Euro zone's recovery may well be an interim outcome and therefore demand remains weak, then the European Central Bank (ECB) provides one. The ECB is sending a strong signals that it will pursue a quantitative-easing-equivalent strategy in the Euro zone. This has been necessitated by the deflationary prospects at the Euro zone with inflation being below the 2 percent target.

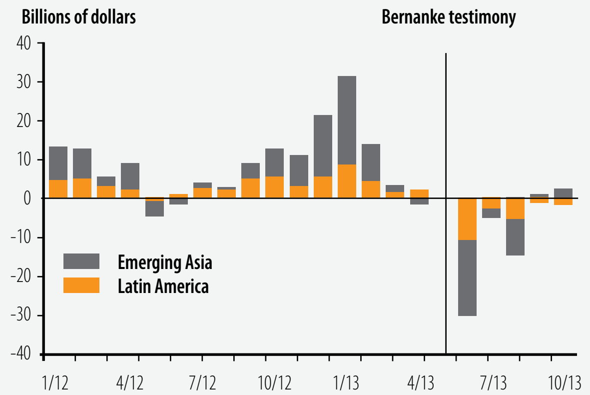
With the Euro area being a key export market for Kenya's exports, a competitive entry strategy will necessitate an increase in the local relative price – which is essentially a gradual depreciation of the local unit that does not portent volatility. How far local unit must adjust to act as one of the levers for correcting the current account imbalance will depend on what happens to the other key markets besides the Euro.

And this leads me to the second respect to which reality has to be injected to our positive comportment. There is a clear signal that in the recent past developing countries are shift their commercial ties from the G7 in favour of the so-called BRICs[2] – Brazil, Russia, India and China – and this has its own implications. This is especially so when China, the biggest of the BRICs, has posted the slowest in 18 months during the first quarter of 2014.

Markets should obviously be expected to factor this in their expectations formation. Markets too are expected to factor in the fact that one "senior" member of the BRICs – Russian – may be stirring up the hornet's nest. The geopolitical development in Eastern Europe involving Russia and Ukraine could potentially upset not just the stability of the internal oil prices but stands to undermine the fragile Eurozone recovery and consequently the global economies' more towards attaining the pre-economic meltdown growth levels.

If our diversification from our traditional market partnerships is seen as a plus, the attendant risks should be appreciated. I argue that based on recent evidence, the challenges of the emerging markets may be deep-rooted than merely representing market reactions to the US's tapering. There are credible arguments to the effect that differentials in market reactions to the tapering signal are an indication of the differences in macroeconomic fundamentals in those economies (**Figures 3** and **4**).

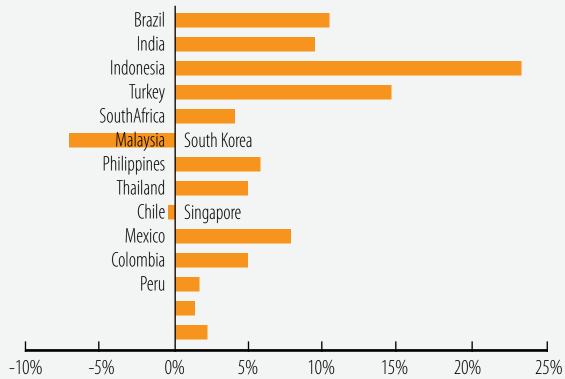
Figure 3: Emerging Market Bond and Equity Fund Flows



Source: Powell (2013) [3]

The Rio Stock Exchange in Brazil: Developing countries are shifting their commercial ties from the G7 in favour of the so-called BRICs (Brazil, Russia, India and China).

Figure 4: Exchange Rate Depreciation, May to December 2013



Source: Nechio (2014)[4]

It is becoming increasingly evident that international capital inflows are related to external factors as well as to a country's internal conditions. Arguments I have seen that I consider sound indicate that monetary policies in developed economies affect investor decisions, although a country's domestic economic conditions also play a role in shaping investment flows. As advanced economies recover, conventional monetary policies will resume.

2 See Oumar Diallo ; Sampawende J.-A. Tapsoba (2014), "Rising BRICs and Changes in Sub-Saharan Africa's Business Cycle Patterns", IMF Working Paper No 14/35

3 Powell, Jerome. 2013a. "Advanced Economy Monetary Policy and Emerging Market Economies." Speech at the Federal Reserve Bank of San Francisco 2013 Asia Economic Policy Conference, San Francisco, CA, November 4.

4 Nechio, Fernanda (2014), "Fed Tapering News and Emerging Markets", Federal Research Bank of San Francisco, Economic Letter, March 3.

The differences from one emerging market economy to another in the difficulties experienced when the Federal Reserve Board began to discuss scaling down asset purchases highlight the sensitivity of global investment patterns to domestic conditions – the Bernanke moment in **Figure 3**. They demonstrate how important it is for emerging market countries to improve their domestic fundamentals as global monetary conditions return to normal. Therefore their recent market conditions that have necessitated monetary policy tightening to defend their respective local currencies should be seen as underlying fundamental weakness.

Third respect is that notwithstanding the Kenyan economy's public debts being considered at least in official circles as sustainable, institutions such as the IMF are sending coded signals that with massive external and internal borrowing in quest to finance infrastructure, and the still weak current account position, the exchange rate stability can only be viewed as short term and whose sustenance rests on the external support. Since the market volatility of late 2011 and early 2012, the IMF's balance of payment support equivalent to KES 65 billion has helped boost the economy's foreign exchange reserves.

The fourth respect is that the anticipated rebasing of Kenya's GDP in September 2014 would have implications if it yields a status for the economy that pushes it out of the concessional lender threshold.

A Fiscal Injection meant to be a Stimulus – or was it at all a Stimulus?

Fully aware of the dicey external environment, the home-grown strategy of stimulating growth could be seen in the ambitious fiscal strategy. National Treasury's 2013/14 proposals to the Budget and Appropriation Committee of the National Assembly of a KES 1.6 trillion expenditure – equivalent to 39 per cent of GDP – was explicitly marketed as strategy that will enable the economy's output growth crawl back to its pre-2008/09 level, which is the medium term target.

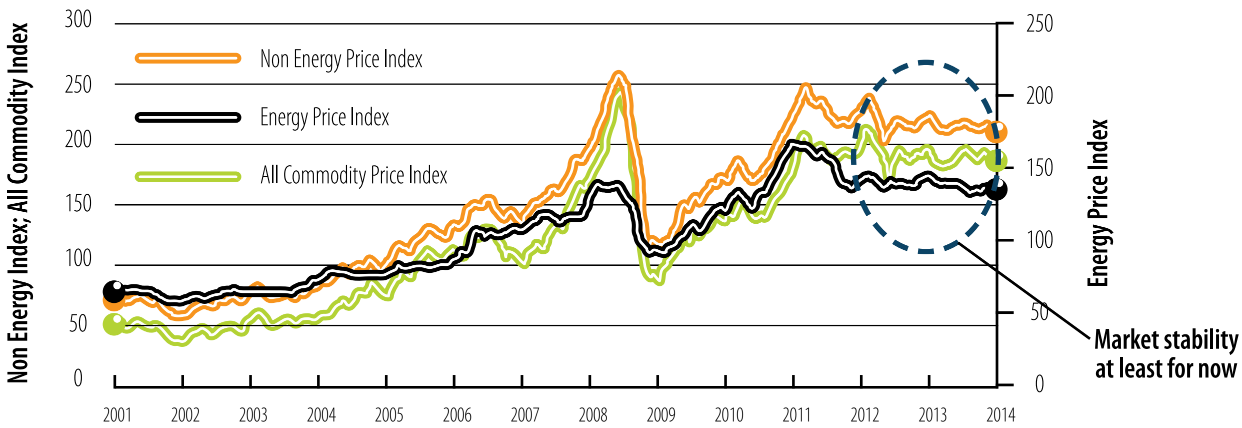
This was all good, except for one "small" matter: absorption capacity is binding constrain that has curtailed the budget from realising the ultimate goal of spurring faster recovery. When this is pointed out, for instance in the 9th Edition of the World Bank's *Kenya Economic Update*, the "official joke is that the economy has turned full cycle – from being accused by the Bretton Woods institutions of excessive spending to spending too little.

The fact that the ambitious growth projections have not come to pass simply indicates that even the revenue projections based on such rosy outlook remain undermined. Perhaps the economy will get a boost from infrastructure projects – the implementation of some of them still way off. But the local security situation is not helping the external sector, especially since tourism earnings are directly affected. And since our exports are largely commodities – except for the regional market – then we have to train our eyes to the international market. On this front, the prices are stabilising (**Figure 5**) – and not rising as has been the case in the recent past years (2009 – 2011 period) – on the back of a weak international market.

A break from the sluggish real growth of the economy seems not to be in the near sight. May be rebasing of GDP in September 2014 will do the trick; but the real influence of that to businesses and households will be nominal at best. This implies that besides the benevolence that accounting may bestow the growth numbers, the 5 percent – 6 percent real growth could end up being our new normal at least for now; unless something radical happens. And that something radical has to confront the reality that insecurity has dented the tourism industry and consequently impaired our ability to repair the current account quickly. This has both growth and stability ramifications.

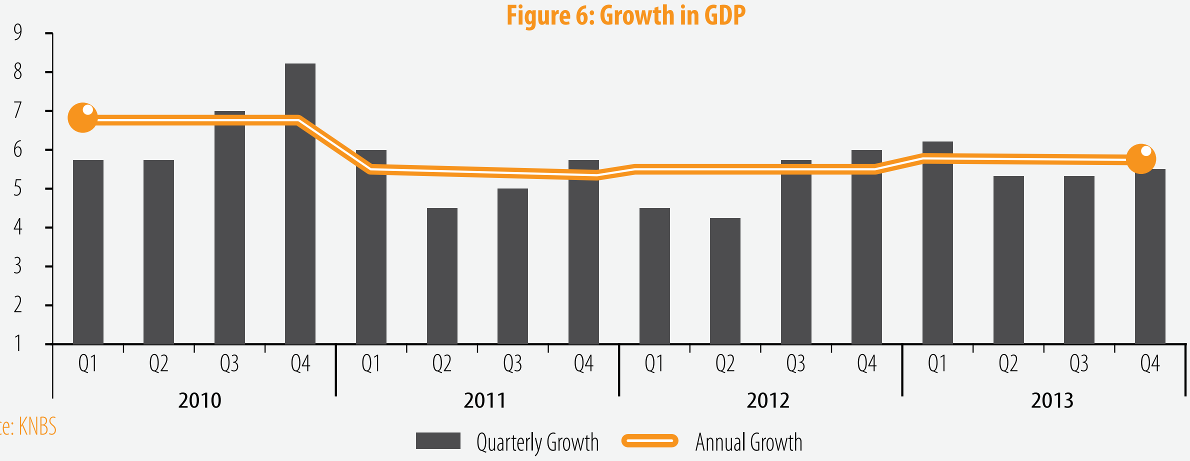
Jared Osoro is the Director of Kenya Bankers Association Centre for Research on Financial Markets and Policy®.

Figure 5: Commodity price Indices (2005 =100)



State of the Economy

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 first quarter of 2010 registered a decline in performance, although a modest rise in 2011 that was accompanied by an annual growth rate rise. Although the Kenya national Bureau of Statistics has not published the growth numbers for the first quarter of 2014, there are all indications that the wait-and-see attitude by all economic agents would have a slowing effect on growth. For the entire 2013 the country's Gross Domestic Product (GDP) expanded by 4.7 percent in 2013 compared to 4.6 percent in 2012. This performance was supported by the stable macroeconomic environment for the better part of the year, Low and stable inflation supported by improved supply of basic foods, lower international oil prices and lower costs of electricity, infrastructural development and growth in the construction sector.

The macroeconomic stability witnessed in 2013 continued into the first quarter of 2014 and is likely to be maintained to the rest of the year. Fruition of the development budget in the counties is expected to spur further economic growth. Private consumption is also likely to improve given the stable interest rates and low inflation regime with the recent discoveries of petroleum oil and natural gas likely to trigger more foreign direct investment if well harnessed.

Agriculture

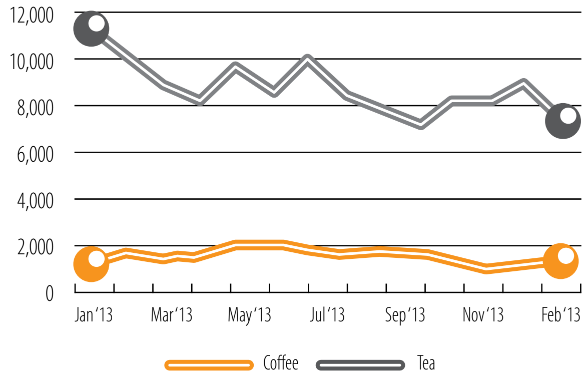
Agriculture remains one of the most important sectors in Kenya contributing 25.3percent of GDP in year 2013 and over 60percent of total employment. Its contribution to the economy is further augmented by its forward and backward linkages to other industries. In this perspective, whenever the sector does well it would be reflected on the overall economy - the converse being also true. However, in 2013 the growth in this sector decelerated to 2.9 percent against the revised growth of 4.2 percent in 2012. In adequate rainfall in most of the grain growing regions was the underpinning factor behind this poor performance.

Notably, maize and coffee production declined significantly in the last quarter of 2013 registering 2 percent and 18.8 percent production decline respectively with rice, wheat and tea registering projectory trends in their production posting 8.3, 19.5 and 17.1 percent respectively as compared to 2012.

kg at the end of February 2014. 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.

Agriculture exports continue to be the economy's main export, with tea leading the pack followed by coffee (**Figure 8**). In the first quarter of 2014 (January and February combined), tea earned KES 16,100 Million approximately 22 percent of the total exports followed closely by horticulture KES 10,028 million and coffee KES 2,172 million.

Figure 8: Agricultural Exports (KES Millions), January2013 – February 2014

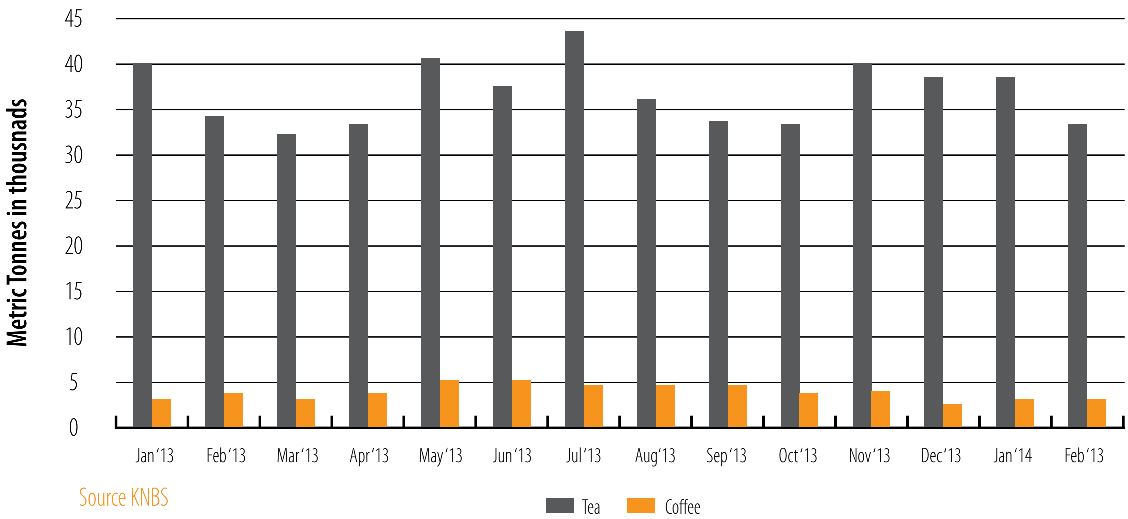


Source: KNBS

On the cash crop production the first quarter of 2014 experienced a decline in tea and coffee production owing to inadequate rainfall in most of the cash crop producing zones in the country. Coffee production fluctuated to around 3,169MT in January before further declining to a low of 3,078 MT in February 2014 (**Figure 7**).

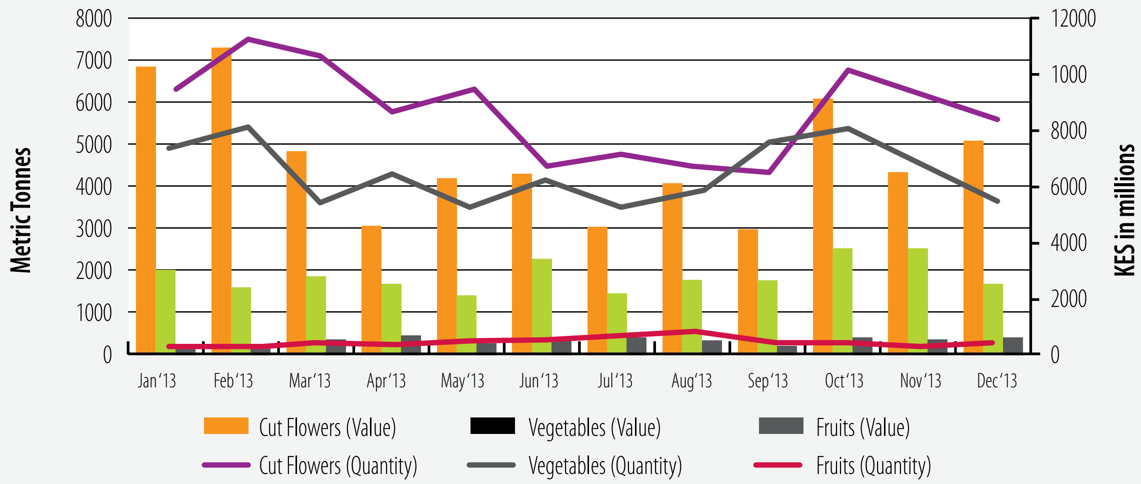
One factor that can be attributed to the disparity in production is international price fluctuation. While the average price for tea fell KES 235.57 per kg in January 2014 to KES 202.55, per kg in February, coffee prices have continued to rise from KES 293.39 in January to KES 258 per

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



Source KNBS

Figure 9: Horticultural Exports



On horticultural exports (**Figure 9**), in terms of both the quantity exported and foreign exchange earned, cut flowers dominate the subsector contributing on average 55.91 percent of entire 2013 total exports while fruits had the lowest contribution of 2.52 percent. In the second half of the year, the quantity of cut flowers declined sharply before picking up in the Q4 2013. The quantity of fruits exported remained significantly low throughout the year.

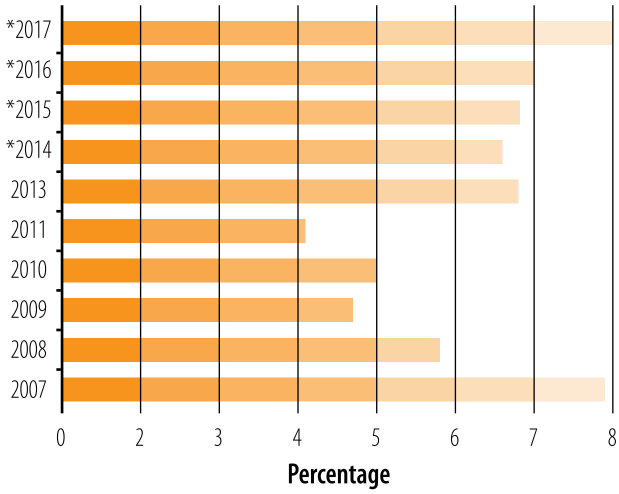
Manufacturing

The manufacturing sector in Kenya is considered to be one of the pillars for the achievement of vision 2030 goals through transiting the economy from traditional agriculture to modern manufacturing economy. The sector grew by 4.8 percent in 2013, slightly higher than the revised growth of 3.2 percent 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 60percent of the total power generated in the country. The 2013 impressive growth was partly attributed to increased investors' confidence, easing in inflation rates as well as stable exchange and lending rates.

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. The government's commitment to increase energy production to 5000MW capacity is likely to boost manufacturing sector by ensuring stead supply and low tariffs on energy.

Photo / Fredrick Onyango

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. The domestic production of galvanized sheets slightly declined in the last quarter of 2013, averaging 25658 MT in quarter four. Likewise, cement production slightly declined in the first quarter of 2014 from 449,386 MT in January to 441,918 MT in February. The decline could be partly attributed to high cost of production as well as slow rate of expansion in building and construction sector given the high cost of construction. Soft drinks production assumed mixed trends with the last quarter of 2014 evidencing an upward trajectory trend from a low of 35,258 thousand litres to a peak of 41,779 thousand litres in December 2013 (**Figure 11**).

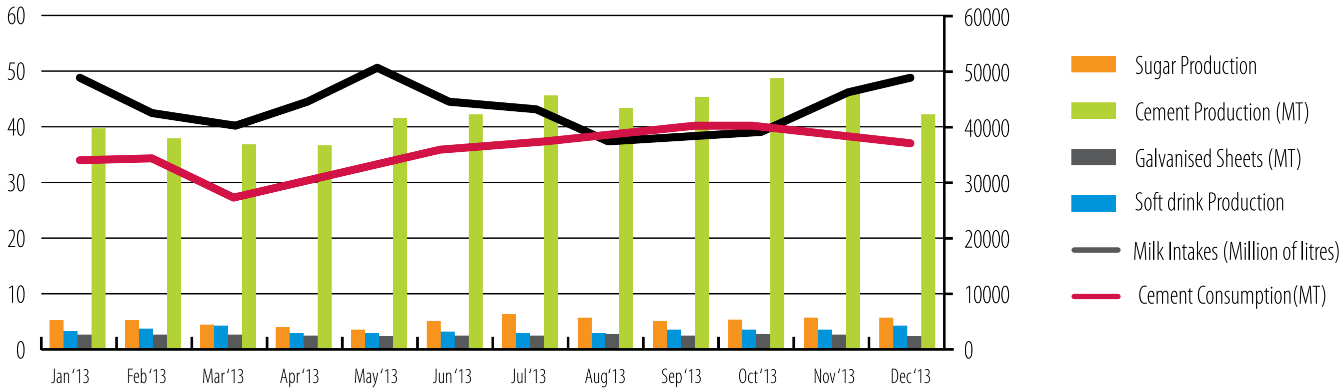
The number of assembled vehicles posted good upward trends throughout 2013 with the exception of March which recorded a decline to stand at 496 vehicles in relation to February's production of 536 vehicles.

On the other hand, milk production has continued to rise rapidly hitting a high of 47 million litres in the fourth quarter of 2013. The results were replicated in the first quarter of 2014 with January posting a high of 54 prior to a slight drop to 52 million litres in February. The period seems to be fairly free from the effects of seasonality in production resulting from mild drought before onset of the long rains in the first quarter that would trigger an upward push in prices. Milk production is therefore expected to post good performance in the entire of first quarter 2014 given the good weather conditions arising from the long rains in milk production zones.

Energy

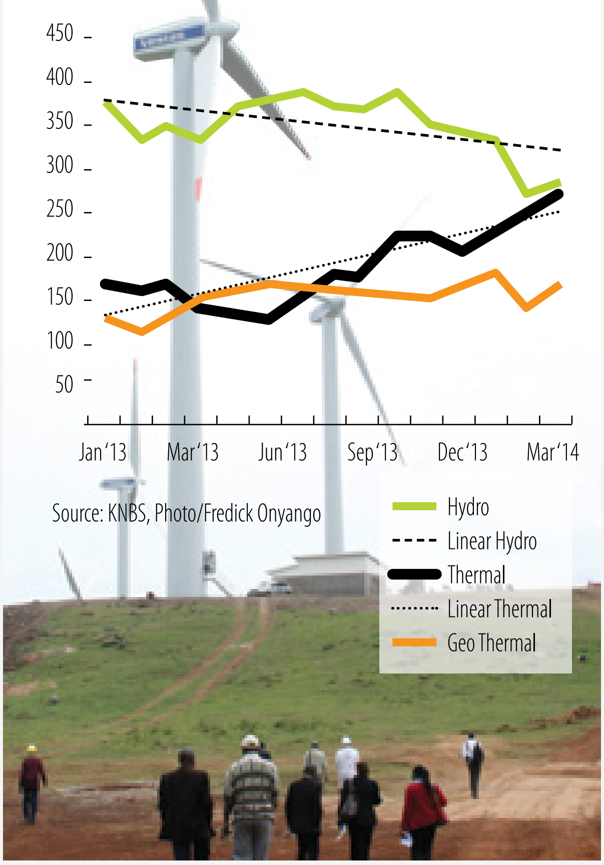
Electricity generation has continued to grow, albeit still outpaced by demand. Total electricity generation increased from 685.24 million KWh in February 2014 to 753.87 million KWh in March 2014 with domestic consumption of electricity declining from 662.30 million KWh in January 2014 to 652.26 million KWh in February 2014. The dominance of hydroelectric power generation is evident, rising from 286.74 Kilowatt hour (KWh) in March followed closely by thermal production at 279.29 KWh (**Figure12**) Hydroelectric power, which is highly correlated with rainfall intensity, contributed 39.76 percent of the total power generation in March 2014 compared to 53.88 percent in March 2013. The contribution to the national grid by thermal and geo - thermal energy has notably been steady in first quarter of 2014 thus signifying governments effort to

Figure11: Production and Consumption of Manufacturing



Source: KNBS

Figure 12: Electricity Generation by source (Million KWh), January 2013 – March 2014



Source: KNBS, Photo/Fredick Onyango

reduce over - reliance on hydroelectric production which is prone weather shocks. For thermal production its contribution to the national grid rose between January and February from 30.53 to 38.24 percent respectively before slightly falling to 37.91 percent in March. For geo – thermal its contribution to national grid declined January and February from 24.11 to 21.63 percent respectively before improving slightly 23.18 percent in March.

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) effected price increases in fuel effective 15th February - 14th March 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. 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.

Table 2: Crude Oil and Fuel Import Prices

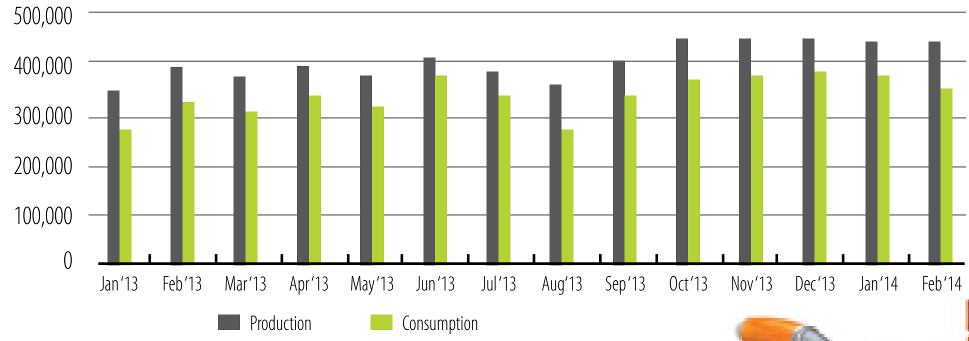
Product	January 2014	February 2014	March 2014
Murban crude oil (US$/Barrel)	109.75	109.95	108.30
Super petrol (KES/Litre)	111.41	112.37	114.43
Diesel (KES/Litre)	105.65	106.72	105.79
Kerosene (KES/Litre)	85.98	83.99	84.82

Source: ERC

Building and Construction

Cement consumption, a proxy of activity in the construction industry declined from 449,386 MT in January 2013 to 441,918 MT in February 2014. Consumption of cement dropped from 382,235 MT recorded in January 2013 to 353,859 MT in February 2014.

Figure 13: Cement Consumption, MTs



(**Figure 13**). This trend reflects low demand given the financial constraints in the real estate development among the expanding middle income and overall growth in population and its composition. With the government's physical infrastructure development expenditure programs assumed to remain on course, the trend of cement construction is expected to rise in 2014.

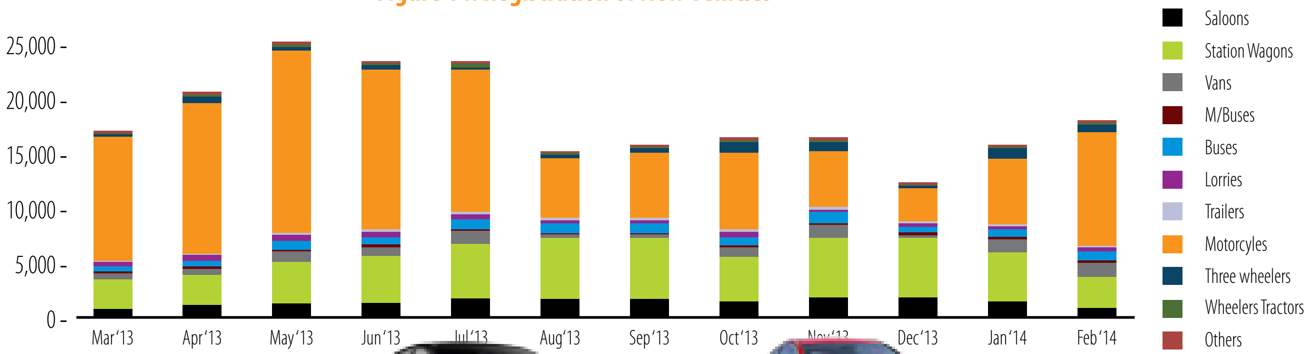
Source: KNBS

Transport and Communications

The sector grew by 6.0 percent contributing to 9.1 percent of the total annual GDP growth in 2013. Road transport accounted for 64.3 percent of the entire transport sector. Cargo throughput handled at the Port of Mombasa increased by 1.8 percent to 22.3 million tonnes. Railway freight tonnage dropped from 1.4 million tonnes in 2012 to 1.2 million tonnes in 2013. Total volume of white petroleum products through Pipeline increased from 4.9 Million cubic metres in 2012 to 5.2 Million cubic metres in 2013

The total number of new motor vehicle registration, which shows activity in the transport sector, significantly increased to a peak of 15,411 units in the in January 2014 and 17, 780 units in February compared to a low of 12,398 units as at the end of the fourth quarter of 2013 (**Figure 14**). Motor cycles have become an important aspect of transport both in urban and rural areas as evidenced by their rapid increase between January and February from 6,437 units to 10, 719 units; the increased number of motor cycles can partly be attributed to the waiver of duty on their importation. A modest rise was seen in February 2014 from the January levels in the registration of Lorries, trailers, wheeled tractors and pickup trucks with registration of saloons, station wagons and buses posting declines over the same period.

Figure 14: Registration of New Vehicles



Source: KNBS

Photo / Fredrick Onyango

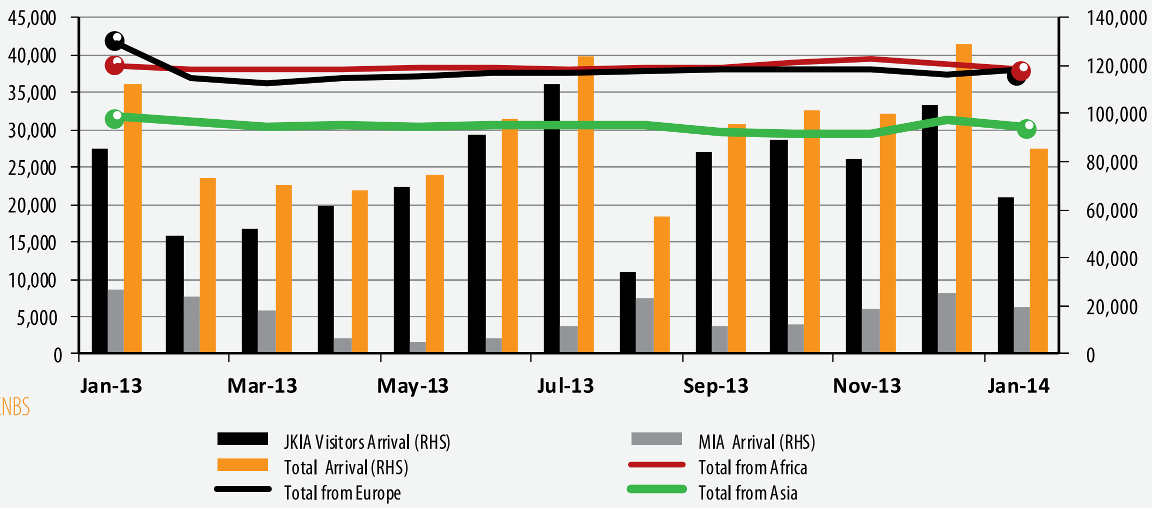
The dominance of mobile telephony in the communications industry continues to be evident. Mobile money transfer has been significant especially in rural areas where banks are not available, inaccessible, or where majority of the population do not hold bank accounts. At the same time this mode of money 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 averaging about 15 percent of the total Gross Domestic Product.

The number of mobile connections rose from 30.4 million in 2012 to 31.2 million in 2013 Internet subscriptions rose significantly from 8.5 million in 2012 to 13.3 million in 2013.

Tourism

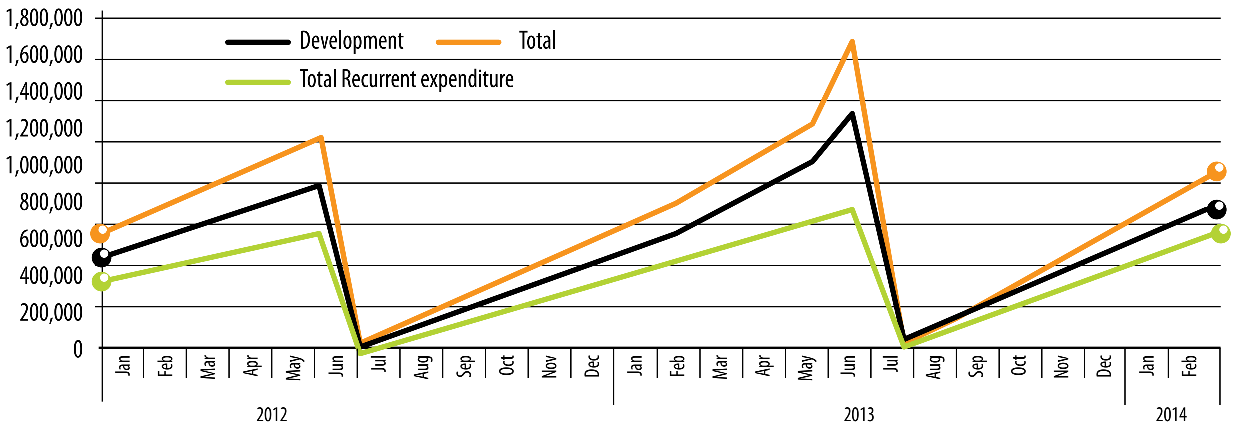
Tourism remains the second leading foreign exchange earner after tea exports. During the first quarter of 2014, there was a marked increase in the total number of visitor arrivals in the country in January the in relation to the fourth quarter of 2013 to stand at 128,673 against 100,310 passengers. However, February recorded a significant reduction in tourist

Figure 14: Trends in Visitor Arrivals



Source: KNBS

Figure 15: Public Expenditure (KES Million)



Source: CBK

arrival to hit a low of 65,388. The decline was particularly driven by a reduction in the number of tourists coming in from Europe – the leading tourists' source following the increased terror threats and domestic insecurity posed by increased rate of crime commitment that led to travel advisories from traditional tourist markets. – 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).

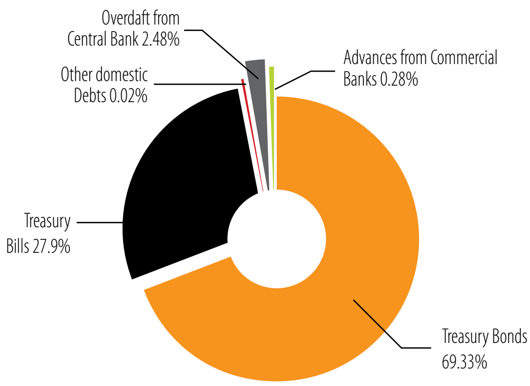
Financing of Government

Public expenditure in recent times has been characterized by the dominance of recurrent expenditure although the ongoing infrastructural projects have seen the expansion in development expenditure over time. Even with concerted efforts towards fiscal consolidation, devolved government has resulted in increases in both recurrent and development expenditure. Recurrent expenditure for January and February 2014, account for 81.33 percent of the total expenditure thus outweighing development expenditure by far. Salaries and wages top the list in the rising recurrent expenditure followed by domestic interest payments. The recent evolution of public expenditure is presented in **Figure 15**.

Public Debt

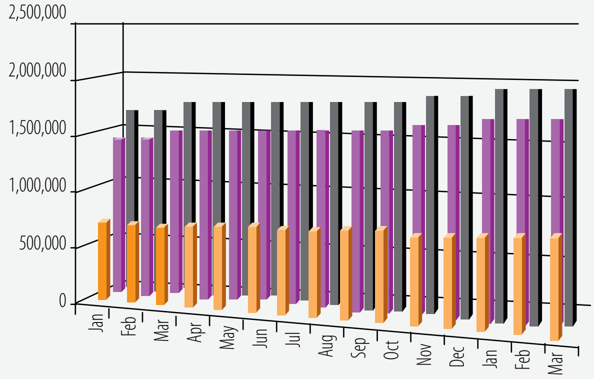
The public debt worsened in the first quarter of 2014 rising with 2.79 percent between January and March. Domestic debt wholly accounts for this increase with external debt remaining constant over the period. This could be attributed to the rising cost of international borrowing following the spillover 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 69.96 percent of the total government debt as at the end of March. Treasury bills, overdrafts and advances accounted for 26.81, 2.77 and 0.44 percent of total government debt respectively by the end of the quarter. This saw the IMF raise a red flag on Kenya's public debt and advised for devising of new mechanism to finance government expenditure rather than reliance on mere borrowing.

Figure 16: Composition of Domestic Debt



Source: CBK

Figure 17: Money Supply (KES Million)



Source: KNBS and CBK

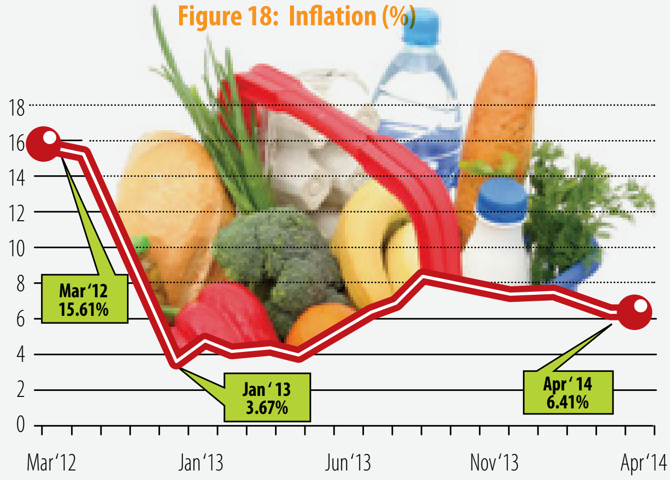
Money and Credit

In the first quarter of 2014, total money supply stood at KES 3,729,178 million, with Broad money (M3) dominating the composition at 54.04 percent and currency and demand deposits (M1) coming at the bottom and accounting for 22.07 percent of the total money supply. The evolution of money supply represents a stable, with modest but consistent growth over time (**Figure 17**).

Inflation

In the beginning of the first quarter, the overall inflation slightly increased from 7.15 percent in December 2013 to 7.21 percent in January 2014, declining significantly to 6.86 percent in February 2014 and further down to 6.27 percent in March 2014 (**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 (%)



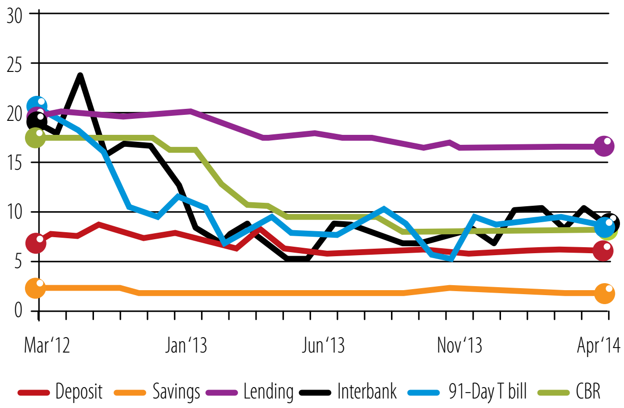
Source: KNBS

The decline in inflation was largely attributed to improved supply of basic foodstuffs and stable domestic prices of petroleum products. The overdraft and maximum lending interest rates dropped by 1.28 and 1.16 percentage points, to 16.51 percent and 16.99 percent, respectively in December 2013, largely due to the lower inflationary pressure and the CBR reduction.

Interest Rates

Interest rates have largely been stably during the first quarter of 2014, as was the case in much of the fourth quarter of 2013 (**Figure 19**). This was on the back of monetary policy being constant as evidenced

Figure 19: Interest rates (%)



Source: CBK

by unchanging Central Bank Rate (CBR) as well as marginal change in interest rates on government securities. The CBR has been pegged at 8.5 percent throughout the first quarter signalling central bank's inflation - anchoring commitment ever since May 2013.

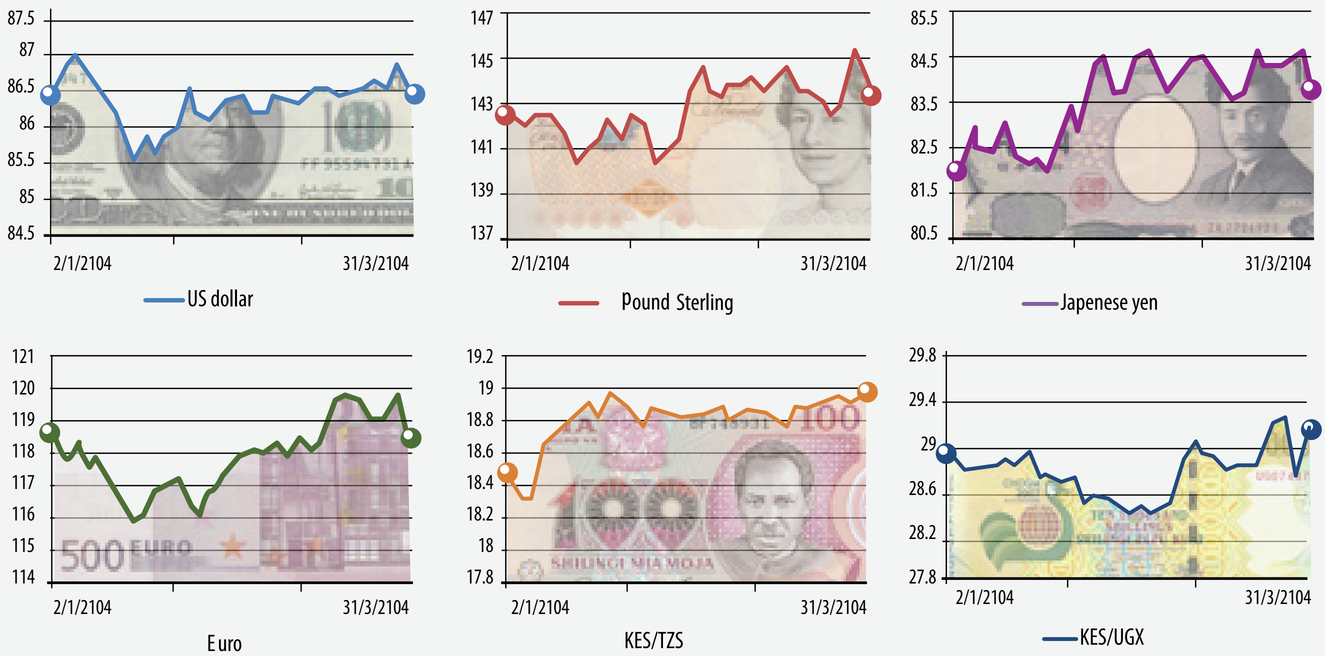
Cumulative average weighted lending rates declined mildly from their January 17.03 percent to 17.06 and 16.91 percent in February and March respectively, while deposit rate have been on a trajectory trend rising marginally for 6.55 percent in January to 6.57 and 6.61 percent in February and March 2014 respectively. In this regard, 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. However, the economy still appears illiquid ever since the third quarter of 2013 a status quo that still presents itself even in the first quarter of 2014.

Balance of Payments

The overall trade balance has maintained a deficit position and has been posting mixed performance over time. The deficit rose by about 10.65 percent from an equivalent of KES 6,950 million in December 2013 to an equivalent of KES 8,380 million in January 2014 an increase attributed to a massive rise in commercial imports from a total of KES 117,988 in December 2013 million to KES 128,942 million in January 2014. It is noteworthy though that commercial import continues to play a large role in the domestic economy and contribute about 99.1 percent of the 2014 January's total imports. In the import set as at February 2014, machinery and transport equipment accounted for the largest share of the total imports equivalent to 25.67 percent. Mineral fuels and related material came second with manufactured goods, chemicals, food and live animals, animal and vegetable oils and fats following in that order.

Exports rose slowly in January to settle at KES 37,962.47 million against KES 35851.67 million in December 2013 albeit marginally declined in February 2014 to a low of KES 36,431.59 million. Tea topped the exports list to account for 20.08 percent between January and February followed by horticulture at 17.94 percent with chemicals, coffee, cement, fish and petroleum products following in that order. Uganda continues to be the most preferred export destination for domestic exports with a high of 13.67 percent of Kenya's total exports as at February 2014 followed by Tanzania, Netherlands, United Kingdom and U.S.A subsequently. 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

Figure 20: Exchange Rates



Exchange Rate

For the first quota of 2014, the shilling has posted resilient good performance against hard currencies in nominal terms with the exchange rate fluctuating between 86.05 and 86.66 against the dollar since January, 2014.

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.

Table 3: Nairobi Securities Exchange

Date	Jan - 2014	Feb-2013	Marc-2013	Dec-2013	Jan-2014	Feb 2014	Mar- 2014
NSE 20 Share Index 100=1966	4,417	4,519	4,861	4,927	4,856	4,933	4,946
Bond Deals	306	461	342	425	486	660	773
Total Shares Traded (million)	519	692.0	571.0	466.0	639.0	545.0	544.0
Equity Turnover (KES. million)	8,464	14,694	1 1,183	11,329.23	15,970	14,743	13,042
Market Capitalization (KES. Bn.)	1,388	1,451	1 ,600	1,921	1,898	1,961	2,003
Bonds Turnover (KES. million)	21	20	26	24	43	28	32

Source: NSE, Monthly Bulletin

Nairobi Securities Exchange

All Nairobi Securities Exchange (NSE) indicators exhibited improved performance during the first quarter of 2014 (**Table 3**) compared to the last quarter of 2013. Activity at the NSE declined as indicated by the NSE 20 share index that increased by 1.85 basis points from 4,856 points in January to 4,946 points at the end of the quarter, manifesting an increase in investors' confidence and certainty in the economy. Total shareholder wealth as measured by market capitalization rose 5.53 percent from KES 1,898 billion to KES 2,003 billion by the end of March 2014. However, volatility remained high give the liquidation of portfolios by foreign investors a move that may be signalling the spill-over effects of US tapering on developing economies' stock markets.

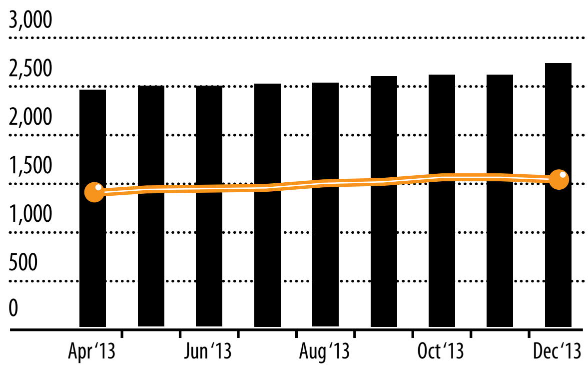
Banking Industry Performance

The banking sector in Kenya sustained positive growth in the fourth quarter of 2013. With the increase in confidence on the economy that largely prevailed and in particular a stable monetary policy that reflected a return to price stability, there was an increase in credit uptake reflected by expansion in private sector credit as evidenced in the CBK credit survey report across all sectors but most prominently to the manufacturing, trade and energy sectors. Financial intermediation grew by 7.2 percent in 2013 contributing to 4.8 percent of the total GDP growth. This good performance was reflected in the entire first quarter of 2014 as evidenced by the industry's financial indicators. The momentum is expected to be maintained for the better part of 2014, mainly on account of enhanced performance and innovations particularly the mobile and agency banking not forgetting the cross border expansion of Kenya banks.

Assets and Loans

The total assets increased by 3.3percent from Kshs 2.73 trillion in December 2013 to Kshs 2.82 trillion in March 2014 compared to a growth of 5.6 percent from Kshs 1.6 trillion in December 2013 to Kshs 1.69 trillion in March 2014. Loans and advances, securities owned by government and placements comprised a major part of the sectors balance sheet. Both total assets and total loans and advances have remained almost stable between the second quarter and the fourth quarters of 2013 albeit rising only slowly (**Figure 21**).

Figure 21: Bank Assets and Loans (KES Billion)



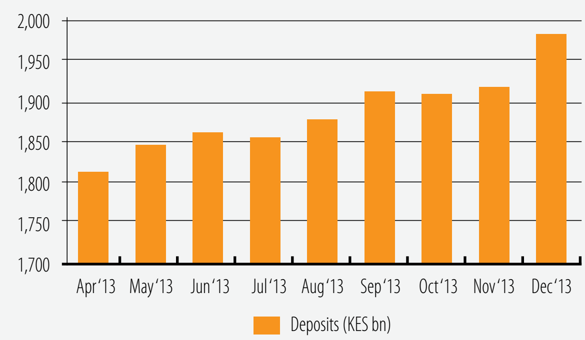
Source: CBK

Photo / Fredrick Onyango

Deposits

Banking sector total deposits increased by 2.5 percent from Kshs 1.98 trillion in December 2013 to 2.03 trillion in March 2014 (**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 not forgetting mobile and agency banking.

Figure 22: Bank Deposits (KES Billion)

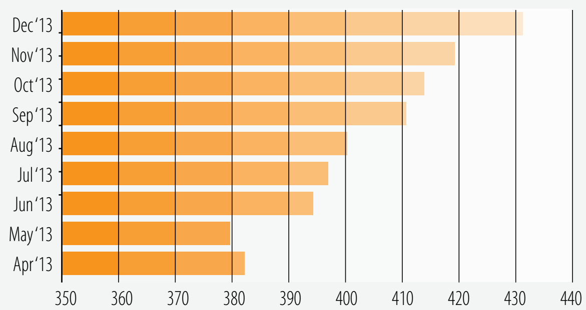


Source: CBK

Total Capital and Shareholder Funds

Total shareholders' fund increased by 5.11 percent from Kshs 431.49 billion in December 2013 to Kshs 453.61 billion in March 2014. Total capital stock of the Kenya banking sector has on an upward trajectory ever since the second quarter of 2013. (**Figure 23**).

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

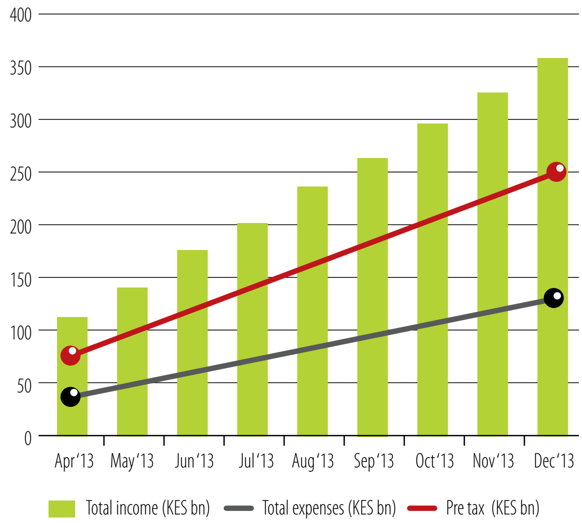


Source: CBK

Bank Profitability

The Pre-tax profit for the industry in the first quarter of 2014 stood at Kshs. 33.4 billion compared to Kshs 28.2 billion for the last quarter of 2013. The banking sector recorded positive profit in quarter 4 of 2013, with the profitability trend being on the increase (**Figure 25**). However, the total expenses were also on an upward trend.

Figure 25: Bank Profitability (KES Billion)

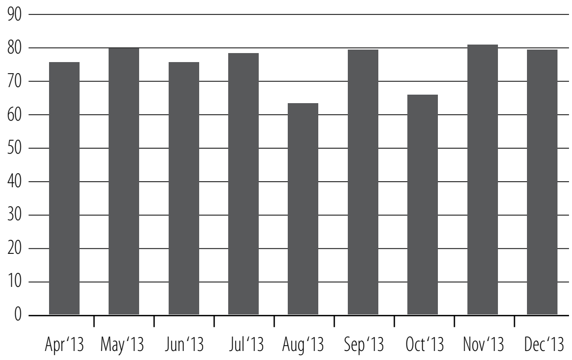


Source: CBK

Gross Non-Performing Loans

There was an increase in gross non-performing loans (NPLs) and with the exception of a slight decline in October 2013 before later rising in November to stabilise at the same level as at the end of December 2013 (Figure 24). From the second quarter of 2013 to the fourth quarter, gross non-performing loans seemed to be capped below KES 81 billion.

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



Source: CBK

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