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CENTRE FOR RESEARCH ON

FINANCIAL MARKETS AND POLICY®

About this Report

This *Bulletin* reviews the performance of the Kenyan economy for the 4rd quarter of 2015, drawing on the performance of recent past months as well as current developments to provide perspectives on the outlook for the rest of the year. The *Bulletin* covers trends in the real economy, government fiscal operations, public debt, inflation and interest rates, balance of payments and exchange rate, as well as activity at the Nairobi Securities Exchange and banking sector performance.

About the Centre for Research on Financial Markets and Policy

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

CENTRE FOR RESEARCH ON
FINANCIAL MARKETS AND POLICY

KENYA BANKERS ECONOMIC BULLETIN

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In this Issue

FOREWORD

Photo/Fredrick Onyango

From the CEO's Desk

It is my singular pleasure to present to you the 14th volume of the *Kenya Bankers Economic Bulletin*. The *Bulletin* reviews the strides that the economy has made since the beginning of the year, with an emphasis on the opportunities and constraints that continue to shape the economy's gradual recovery.

The performance of the Kenyan economy has over the years been shaped by both domestic as well as international dimensions. These circumstances have shaped the *Bulletin's* economic outlook. On the international front, all eyes are trained on now the softening of China's growth is likely to affect the global economic prospects. This is on the back of the US's Federal Reserve Board taking a pause after a clear signal of resumption of conventional monetary policy.

There is clearly fragility in the performance of the global economy on account of the weaknesses in the Emerging Market Economies and the Eurozone. While the low international oil prices are a boon to the domestic economy, other factors – notably money and foreign exchange markets – have tended to shape expectations on broad macroeconomic stability and how that will shape economic outlook.

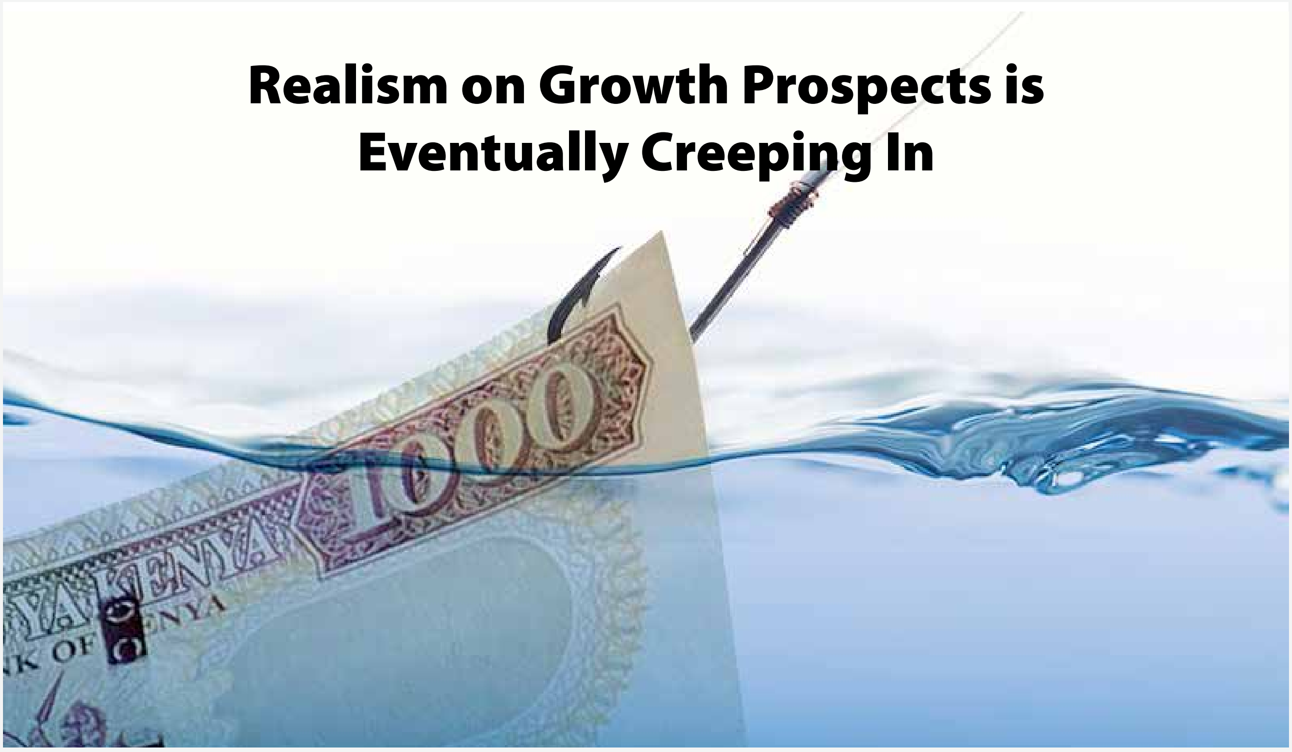
I hope that you will find this issue of the *Kenya Bankers Economic Bulletin* interesting and useful. We will be happy to consider for publications incisive commentaries on a topical issue of interest to the banking industry. For guidelines on such submissions, please get in touch with the Bulletin's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

We welcome feedback on the content of this *Bulletin* as we continually seek to improve its relevance to you.

Habil Olaka
CEO, Kenya Bankers Association

COMMENTARY

Realism on Growth Prospects is Eventually Creeping In



Angling out the shiling from the deep waters: It is clear that the performance of the economy during the period subsequent to the global economic meltdown has depicted an erratic trend. We can however note that in the recent past, growth is picking momentum.

By Jared Osoro

Every new year comes with expectations of great things and 2016 has not been any different. It is expected to be a year of "continued robust performance", only that the overly optimistic real output projections that characterised 2015 are now giving way to more realistic outlook.

The clearest sign of that come-down is in the March 2016 review by the International Monetary Fund (IMF) that underpinned the approval of a new USD989.8 million 24-month Stand-By Arrangement (SBA) and a USD494.9 million 24-month Standby Credit Facility (SCF) – a combined USD 1.5 billion precautionary arrangements.

The IMF now projects a real GFDP growth of 5.6 percent for 2015, down from the initial 6.9 percent and a subsequent revision to 6.5 percent. The real GDP growth for 2016 is projected at 6.0 percent. So what has caused the change of tune?

To appreciate what is going on here, one needs to take come historical context. It is clear that the performance of the economy during the period subsequent to the global economic meltdown has depicted an erratic trend. We can however note that in the recent past, growth is picking momentum (**Figure 1**). If this is sustained, the consequence will be the narrowing the output gap – the difference between the economy's actual real growth level and its potential level.

Taking the government's 7.0 percent medium term real growth target as an approximation of the economy's potential output expansion rate, then the observed growth trajectory implies that the output gap will dwindle over time. There are clear implications from a policy standpoint arising from the narrowing of the output gap.

First, it could be signalling positive vibes in the sense that firms that were previously operating at excess capacity are now scaling up capacity utilisation. With that comes increased utilisation of labour and other inputs to production, hence entrenching the upward growth momentum.

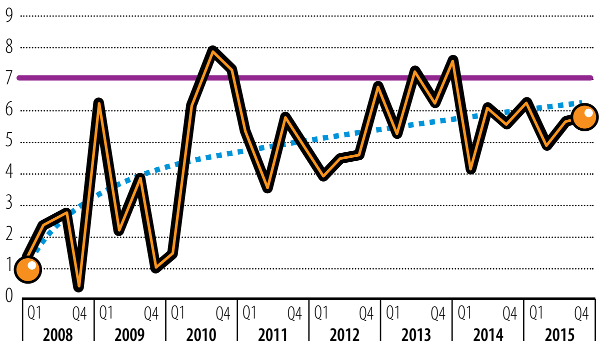
Second, it could necessitate a deeper reflection on how policy – more so monetary policy – will play out going forward. Whenever the output gap is widening, there is scope for the Central Bank of Kenya (CBK) to pursue

Low oil prices are seen by many as a shot in the arm for the domestic and global economy is in no doubt.

an accommodative monetary policy without the risk of jeopardising stability in the form of inflationary pressure.

While the output gap narrowing in itself has evidently not been a source of inflationary pressure – coming at a time of expectations of the resumption of an accommodative monetary policy stance – it could be a strong pointer to the argument that the CBK's monetary policy Committee (MPC) will be more than keen to continue bolstering its policy credibility. That will necessitate a careful consideration on when the tightening bias should give way to the resumption of an accommodative stance.

Figure 1: Real GDP Growth (%)



Source: Kenya National Bureau of Statistics

Riding on the stability wave

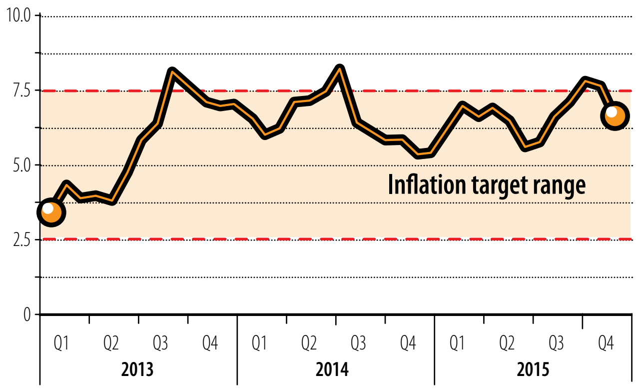
We are now seeing clear evidence of macroeconomic stability. When in the CBK's MPC meeting of March 2016 the decision was to retain the Central Bank Rate (CBR) at 11.5 percent, two signals were being sent to the market.

The first is that the monetary policy decisions over the recent past ten months are meeting the policy objective. The signalling of the change of stance in June 2015 by way of increasing the CBR from 8.5 percent to 10.0 percent and subsequently to 11.5 percent in July 2015 has been a clear demonstration of the CBK's readiness to act in defence of monetary policy credibility. The CBR has been retained at that level for six consecutive meeting.

To the extent that inflation at 6.8 percent in February 2016 represented has reversion to the government's 5.0 percent (+-2.5 percent) target after a two month breach (December 2015's inflation rate of 8.0 percent and January 2016's rate of 7.8 percent) the MPC's decision to hold the CBR was a representation of policy prudence that any other stance could have compromised (**Figure 2**).

The second is that any expectations of a change in policy stance will have to acknowledge the known imperfections in the monetary policy transmission mechanism such that the effect of its decisions as would be manifested by market prices reaction – especially money market prices – are realised with a time lag. That is why the MPC had to lean, arguably rightly so, against popular but unlitigated expectations that the CBR needed to be lowered.

Figure 2: inflation (%)



Source: Kenya National Bureau of Statistics

We can take comfort of the fact that calm has finally returned to the foreign exchange market (**Figure 3**). While the prevailing market conditions follow an aggressive central Bank interventions – both in terms of market participation and monetary policy tightening – towards restoration of stability, the sustenance of the stable streak will hinge on how the broader economic dynamics play out towards the repair of the external position.

The mild narrowing of the current account deficit has been attributed to improved diaspora remittances and export earnings at time when lower oil prices have lessen the fuel import bill. The evidently adequate foreign exchange reserves coupled with the earlier-mentioned US$1.5 billion IMF precautionary facility gives the comfort against short-term shocks.

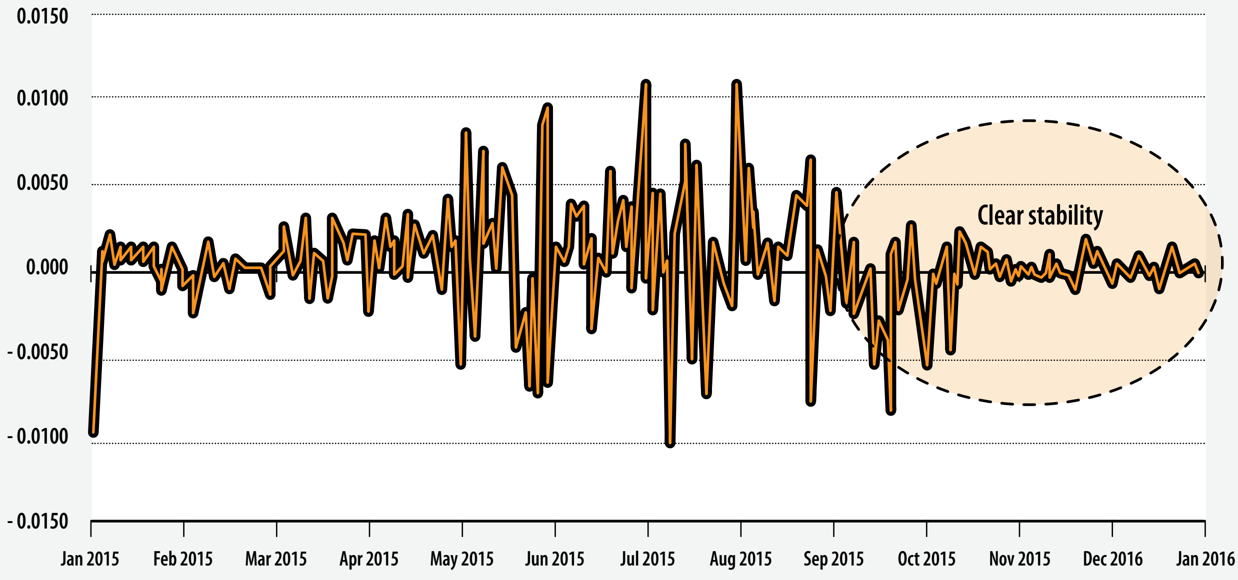
It is worth to note that there is a strong correlation between the exchange rate and oil prices (**Figure 4**); the link between the two is the effect of oil prices on the import bill and therefore the overall current account position given that fact that oil is a significant component of that bill. Therefore, low oil prices tend to be associated with the strengthening of the local currency and vice versa. That low oil prices are seen by many as a shot in the arm for the domestic and global economy is in no doubt.

There are however new arguments – especially in the forthcoming *IMF's World Economic Outlook* of April 2016 – to the effect that the oil prices and global economic prospects present a complicated affair. The global benefits from low oil prices, goes the argument, will likely appear only after the prices have somewhat recovered and the advance economies have made progress surmounting the low interest rate environment. It

is not clear how soon that will happen; it is clear though that the domestic foreign exchange market dynamics – both on the account of the oil-price exchange rate correlation and the interest rates channel – will be subjected to some testing.

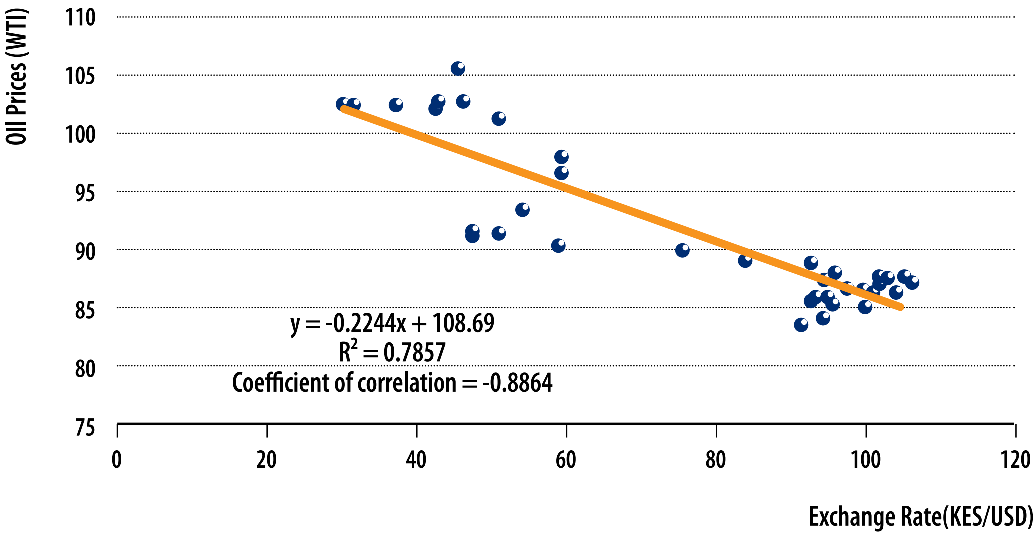
Even as we ride on the stability wave, it is important to keep an eye on the global developments. The global economic circumstances are far from. It is generally observed that the "risks to the global outlook remain tilted to the downside and relate to ongoing adjustments in the global economy: a generalized slowdown in emerging market economies, China's rebalancing, lower commodity prices, and the gradual exit from extraordinarily accommodative monetary conditions in the United States. If these key challenges are not successfully managed, global growth could be derailed".

Figure 3: Nominal Exchange Rate (KES/USD) Changes



Source: Central Bank of Kenya

Figure 4: Correlation between exchange rate and oil prices



The fact that the US's Federal Reserve appears to have slowed the pace of its stride towards a conventional monetary policy stance is a signal that there are soft patches both in the US and global economy that policy makers from developing and emerging markets need to keenly be aware of. These include the dangers of deflation that stands to derail a return to policy normalcy.

On the back of a slippery global economic path, the local fiscal programme is deserving of attention too. The 2015/16 fiscal programme has to some extent been embedded with proliferation of tax proposals which, if enacted, will have inflationary implications. The challenge is compounded by the wage demands amongst a section of the public service that could put pressure on the Government wage bill, and consequently the overall fiscal position.

It therefore remains to be seen whether a reduction in domestic borrowing requirement will sustainably be realised; this is especially so considering that the revised budget estimates currently under consideration by the National Assembly lean more towards expenditure reduction, thus likely to encounter political headwinds as the country heads towards general elections in 2017. This is on the back of constrained revenue collections by the Kenya Revenue Authority (KRA).

Ultimately…

As the economy's growth momentum picks, one has to be clear how that plays out with regard to the output gap – difference between full potential and actual growth – and how that relates to inflation expectations. While stability is evident in the foreign exchange market, there is need to closely watch the external position (especially the current account) so as to have a grounded view with regard to the sustenance of the stable market conditions.

The global economy remains weak and this has implications on the domestic economy generally and the financial markets in particular. While this remains so, we wait to see whether a reduction in domestic borrowing requirement will sustainably be realised. This is especially so considering that the revised budget estimates currently under consideration by the National Assembly lean more towards expenditure reduction, thus likely to encounter political headwinds as the country heads towards general elections in 2017.

The foregoing therefore builds towards inculcating a sense of realism insofar as economic growth expectations are concerned.

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®.

State of the Economy

Growth in Gross Domestic Product

The third quarter of 2015 recorded an economic growth rate of 5.8 percent:- a 0.3 percent rise in the quarterly growth rate compared to quarter two of 2014 whose growth stood at 5.5 percent. This improvement was mainly supported by strong expansions in Agriculture; Construction; Financial and Insurance; Wholesale and Retail Trade; and Transport and Storage.

However, an insight into quarter four of 2015 poses some mixed outcomes with regard to the performance of the economy given the abrupt changes in some macroeconomic variables which are core to economic growth. To start with, the inflation rates were on the upward trend hitting a high of 8.01 percent as at the end of December. This was above the upper bound of the Central Bank target of 5 percent ± 2.5 percent. Looking at the month – on – month inflation rates throughout the quarter, it's evident that the general prices levels rose significantly throughout the successive months. As at the beginning of the quarter the rates rose from 5.97 percent in September to 6.72 percent in October and further to 7.32 percent in November before hitting a high of 8.01 as at the end of December.

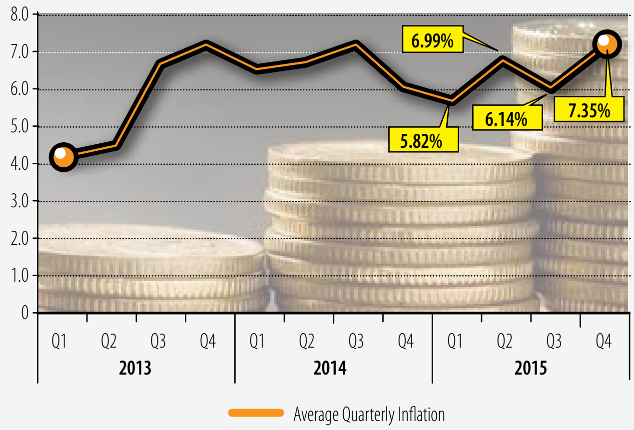
A review into the quarterly average inflation rates indicates that the quarterly average inflation rates for quarter four was 7.35 percent against 6.14 percent for quarter three. Its therefore evident that the cost of living was high during the entire of quarter four given that the quarterly average rate was 7.35; just 0.15 below the upper bound of the Central Bank's target. The non – food – non – fuel remained to be high at 5.06 percent compared to an average of 4.6 percent in quarter three (**see figure 1**).

On the forex front, the weakening bias on the Kenyan shilling against the major hard world currencies mainly the dollar stabilized as compared to quarter three. This could be attributed to the rise in the foreign flows in quarter four that led to surplus in the capital account thus lessening the pressure on the shilling through increased supply for foreign currency. The shilling oscillated around the 102 mark against the dollar for the entire quarter.

Quarter four saw the reverse of the cash crunch experienced in the economy in third quarter which was a unique phenomenon that adversely shocked the economy. There was a rise in the government domestic revenue collections from various sources as compared to quarter three. However, we acknowledge that for quarter three is a special case given that it's the quarter when the new budget comes in place following the new government financial year..

Photo/Fredrick Onyango

Figure 5: Average Quarterly Inflation Rates

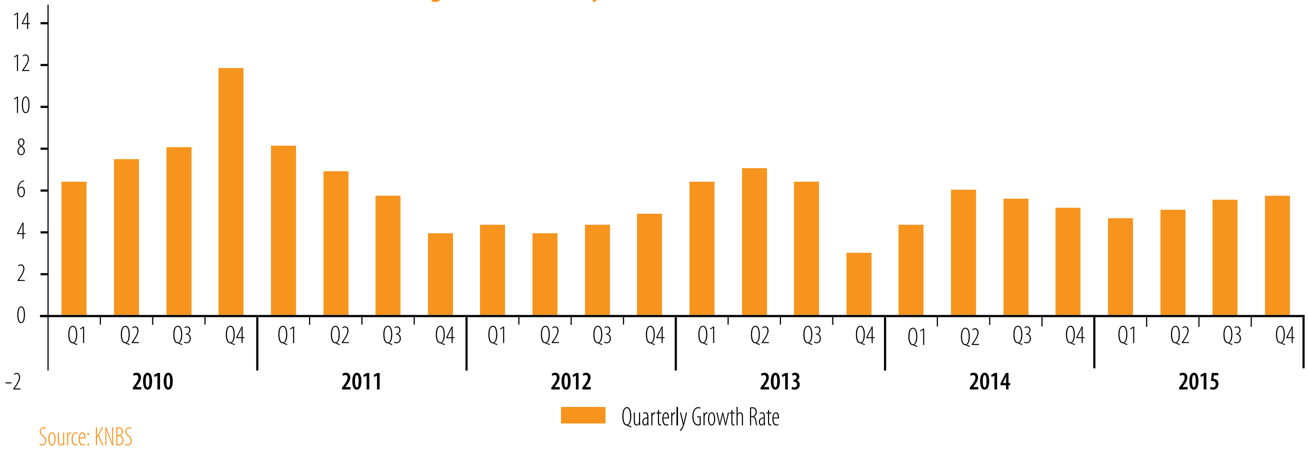


Source: Central Bank of Kenya

From the **figure 5**, it can be deduced that the average quarterly inflation rates have been on the increased in the fourth quarter to a high of 7.35 percent up from an average of 6.14 percent in quarter three.

During the quarter jitters were experienced in the interest rates with high volatility being evidence. The average yield rate for the 91- day Treasury bills, which enters into the determination benchmark for the

Figure 6: Quarterly Growth in GDP – 2009 Base Year



Source: KNBS

general trend of interest rates (KBRR), rose significantly from single digit to a double digit figure recording the highest ever month average rate of 21.65 percent in October. This was the highest ever spike in the 91 – Treasury bill rate since January 2012 where it recorded a high of 20.56 percent. On quarterly basis, the rate averaged at 14.6 percent compared to 12.24 percent in quarter three. High volatility can be seen in the short term interest rates within the quarter with the rates rising to a high of 21.65 percent in the beginning on the quarter and falling through the quarter to a single digit of 9.81 percent as at the end of the quarter (December 2015).

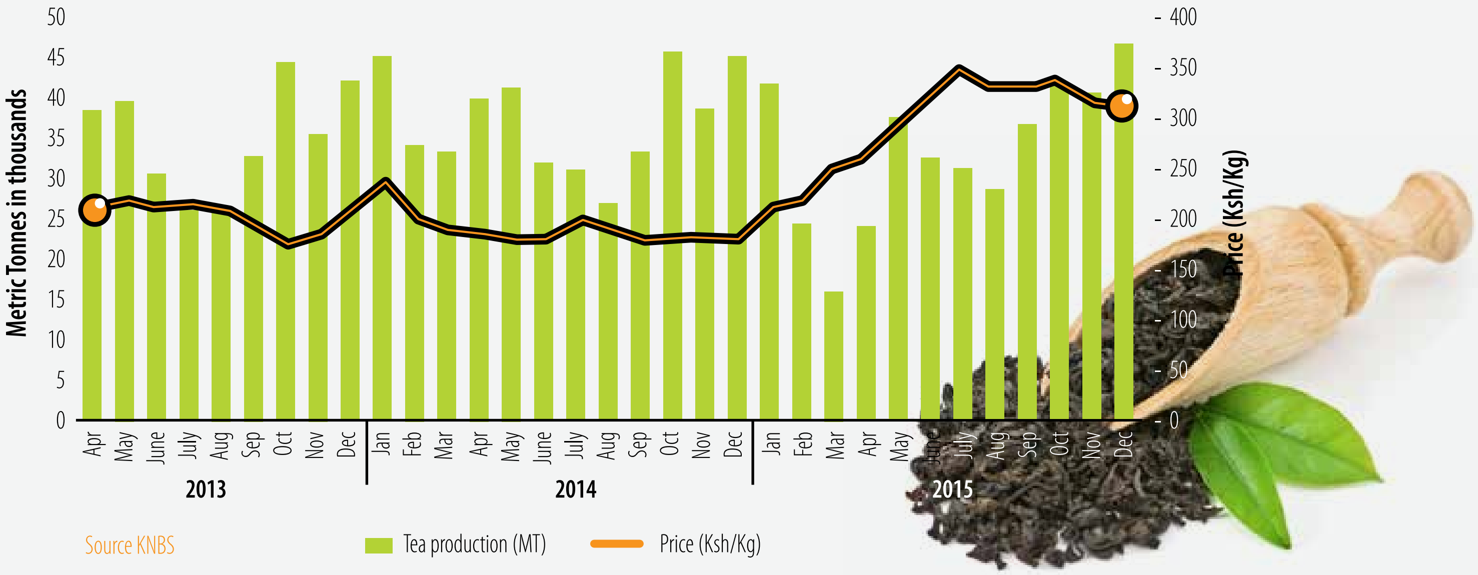
Sectoral performance

Agriculture

Agriculture remained a key sector driving economic growth in the fourth quarter of 2015. This is evidenced by the fact that the main exports for the country were majorly from the agricultural sector and accounted for the largest portion of the total exports. In addition the sector still remained to be the highest employer given its forward and backward linkages with the other sector of the economy. The performance of the agricultural sector improved given the onset of the short rain in the beginning of the fourth quarter that continued till quarter one of 2016.

From the production point of view, tea production significantly increased in the fourth quarter compared to the third quarter; from 95,836 MT in quarter three to 128,112 MT in quarter four. This was a 33.68 percent increment from the third quarter's production. The production increment could be attributed to the short rains that performed well. In terms of the prices, the average price per kilogramme declined shedding off Ksh14.91 per kilogramme between quarter

Figure 7: Tea production in Metric Tonnes and Prices per Kilograms



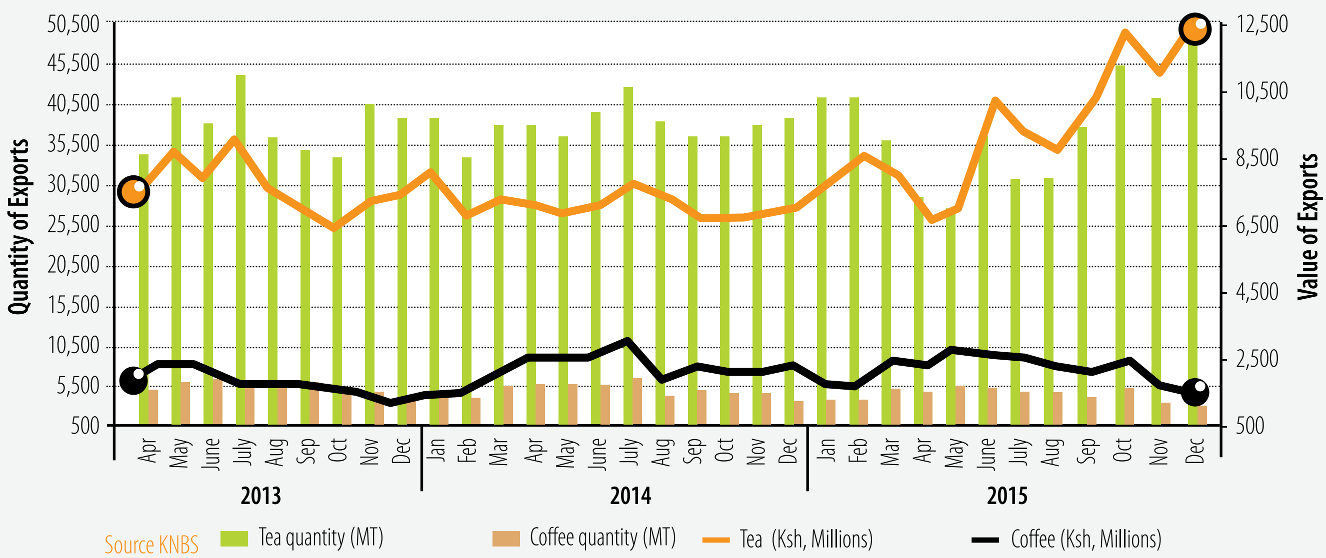
Source KNBS

three and quarter four. As at the end of quarter four the prices stood at Ksh 309.26 down from Ksh 326.69 as at the end of quarter three. The decline in the average prices in quarter four could be attributed to increased production that led to increased supply in the market. This is an evidence that even though tea is the leading agricultural export for the country, is still remain to be supply elastic hence increased production of tea for export could not be much relied on to improve our current account deficit through increased foreign exchange earnings.

Milk deliveries to formal processors increased from 159.39 million liters in quarter three to 162.28 million liters in quarter four. The slight increased production is as a result of increased milk delivery to the formal production plants following good short rains that saw increased animal feeds production.

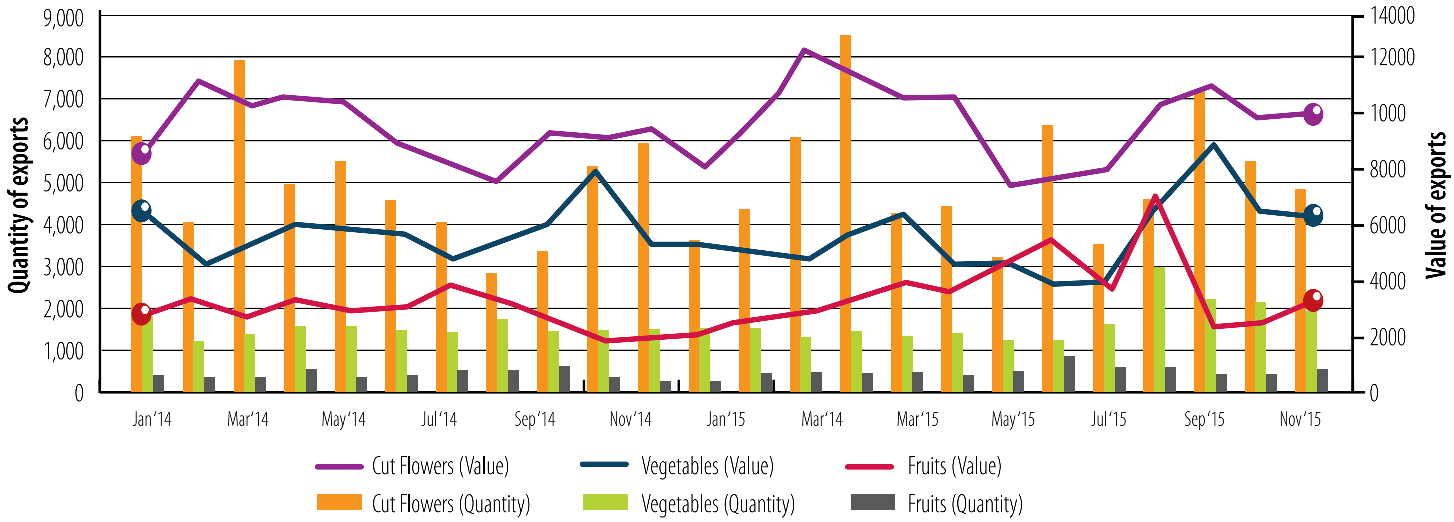
Agriculture cash crop exports continue to command a good share of the total economy's main export, with tea leading the pack followed by coffee. As revealed in (**Figure 8**) the quantity of tea exports having significantly increased from 91,838.52 MT in quarter three to a total of 119,739.71MT in quarter four. This improvement is attributed to the

Figure 8: Value of Tea and Coffee Exports, April 2013 – December 2015



Source KNBS

Figure 9: Horticultural Exports Jan 2014 – December 2015



improved production in quarter four following the short rains.

On the contrary, the quantity of coffee being exported continuously declined throughout the quarter to stand at 9,697.34 MT in quarter four down from 11,334.28 MT in quarter three of 2015. The decline in the total coffee exports is attributed to the decline in the quarterly production as well. This arises from the shift to alternative cash crops as well as real estate development by the former coffee farmers given the dwindling returns earned from coffee farming.

Looking at the total value of exports, the total value from tea exports for the entire quarter four was Ksh 39,432.44 Million was against Ksh 31,040.02 Million in quarter three; 27.04 percent increase. On the other hand total value from coffee exports for quarter four stood at Ksh 4,354.65 million against Kshs. Ksh 5,350.65million in quarter three of 2015; a 1.86 percent reduction.

On horticultural exports (**Figure 9**), in terms of quantity exported in quarter four of 2015, cut flowers dominate this subsector contributing 51.01 percent of total quantity of horticultural, followed by vegetables at 35.96 percent with fruits exports recording the lowest contribution of 13.03 percent. Looking at the foreign exchange earned from horticultural exports for the entire quarter, cut flowers dominate this subsector accounting for 68.70 percent of total horticultural exports value, followed by vegetables at 25.33 percent with fruits exports recording the lowest contribution of 5.96 percent.

Manufacturing

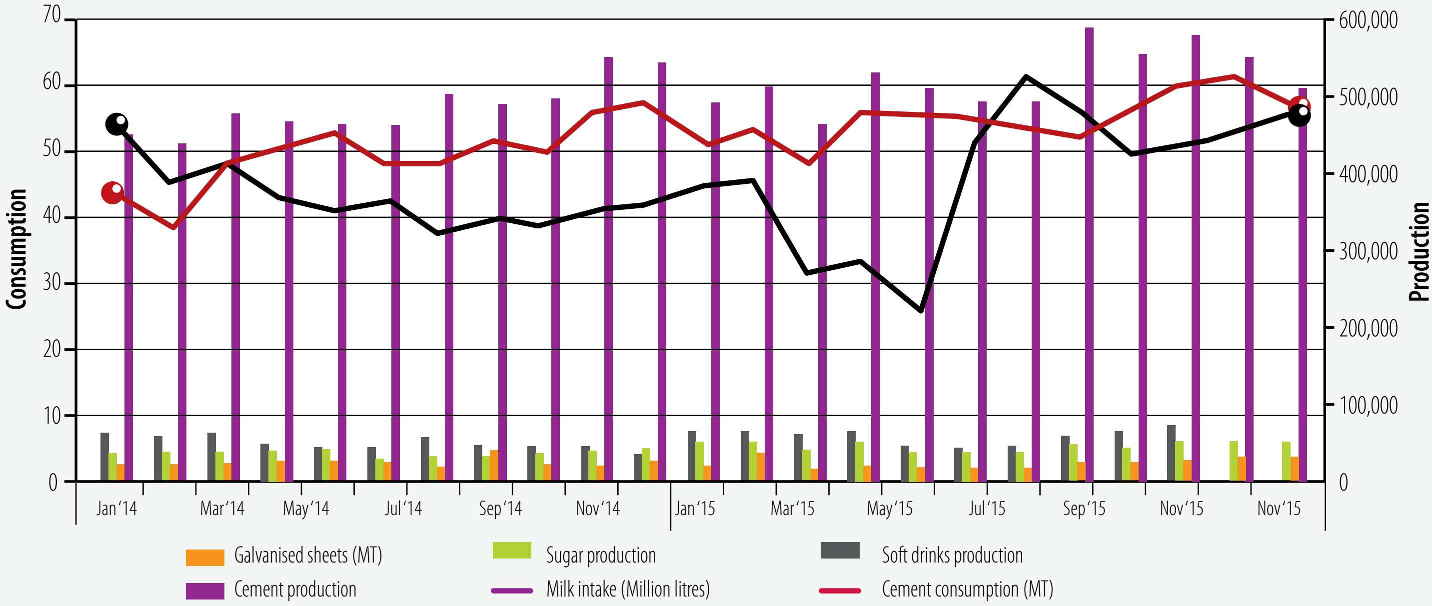
The manufacturing sector in Kenya is considered to be one of the foundations in achieving vision 2030; transiting the economy from traditional agriculture to modern manufacturing economy.

A key component of the manufacturing sector is its output that targets the construction industry. Cement production in the fourth quarter of 2015 declined to 1,551,812 MT compared to quarter three production to an overall total of 1,681,706 MT; an 8 percent decline in total production. However, on contrary, cement consumption in the fourth quarter of 2015

increased from an overall quarterly consumption 1,443,544 MT in quarter three to 1,464,069 MT in quarter four of 2015 signaling a clear indication of the increased expansion in building and construction industry. For galvanized sheets, production increased from 20,564 MT in September to 21,170 MT to 26,008 MT in October but later dropping to 25,726 MT as at the end of November 2015. The increase in production may have been accessioned increased activity in the building and construction industry as signified also by the increased demand for cement as well.

There was an increase in milk consumption in quarter four of 2015 to stand at 162.28 million litres compared to 159.39 million litres in quarter three. This was perhaps occasioned by fall in prices following increased production arising for the good short rains experienced in quarter four. For assembled vehicles production decreased from 996 units in October 2015 to 820 units in November 2015.

Figure 10: Production and Consumption of Manufacturing



Source KNBS

Wind Energy: New reflections on boosting green energy such as solar energy has come into the limelight especially for households use hence reducing demand pressures on the national grid.

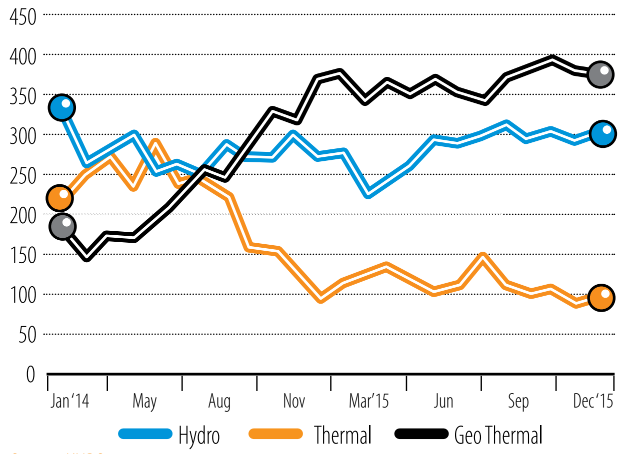
Energy

There has been continued concerted efforts to boosts energy production so as to meet the growing demand for energy by the growing economy. More so, there is continued shift from the conventional sources of energy to concentrate on cheaper and more reliable, clean and renewable sources of energy. This shift is observable, seeing that geo - thermal production as well as wind power generation combined have continued to lead the way in adding to the total energy production and hydro production, though significant, continues to relatively drop.

A review of the power generation for in the fourth quarter of 2015 reveal that the total energy production that was injected into the national grid declined from 2,403.28 million KWh in the third quarter to 2,379.66 million KWh in the fourth quarter. Its notable that while both the hydro and the thermal production recorded a decline of 13.35 million KWh and 72.81 million KWh respective between quarter three and quarter four, geothermal production on the other hand recorded and increase in production of 62.54 million KWh over the same period. (**Figure 12**). The rise in inter quarterly geothermal production could be mainly attributed to government's continued efforts to boost the power generation from geothermal sources which is more sustainable and environmentally friendly given the high power bills arising from massive generation of power from thermal source which wholly depends on diesel for power generation.

In addition new reflections on boosting green energy such as solar energy production and wind energy production have come into the limelight especially for households' use hence reducing demand pressures on the national grid line. Electricity generation has continued to grow, albeit still outpaced by demand. However, it's notable that the sector has started realizing the output from the significant investment directed to the sector by the government.

Figure 11: Electricity Generation by source (Million KWh), Jan 2014 – Dec 2015



Source: KNBS

However despite the power demand outstripping power supply power losses still continued to persist. Within quarter four the power losses rose to 416.24 KW million as opposed to 334.81 KW million in quarter three.

Table 1: Crude Oil and Fuel Import Prices

	Jun- 15	Jul- 15	Aug- 15	Sep-15	Oct - 15	Nov -15	Dec - 15
Murban crude oil (US$/Barrel)	63.70	57.70	48.85	46.60	47.30	43.55	37.25
Super petrol (KES/Litre)	98.14	99.45	103.50	103.49	94.16	91.34	90.94
Diesel (KES/Litre)	84.26	85.51	84.30	80.94	83.38	80.61	79.47
Kerosene (KES/Litre)	62.73	63.69	58.94	53.52	57.00	55.77	54.23
LPG (13Kgs)	2,387.04	2,376.22	2,374.92	2,393.8	2,401.31	2,386.66	2,369.46

Source: ERC

On the oil prices, there was a decline in the world oil prices in quarter four falling to below the $40 per barrel. The crude oil prices declined from $47.40 per barrel in the beginning of the quarter (October 2015) to a low of $37.24 per barrel as at the end of the quarter (December 2015). This accounted for 21.37 percent reduction in the global world oil prices (**Table 2**). The decline was mostly accounted for by the glut in the world oil market basically arising from the geopolitical crisis which have led to the major oil produce failing to agree on cutting down production to trigger the rise in the oil prices. In addition the slowdown in the growth prospect in both the developed and the emerging markets have failed to trigger the increase in oil demand hence another reason for low oil prices.

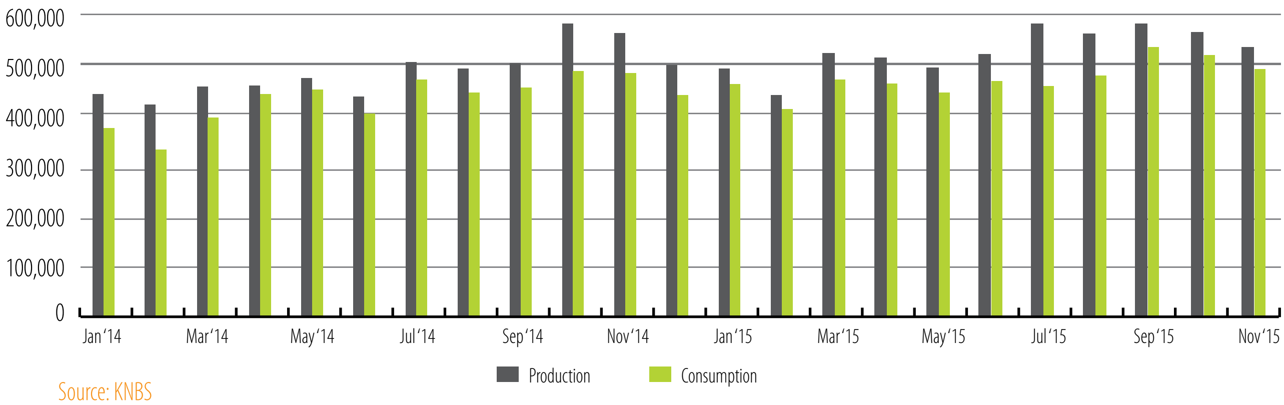
The reverse of a commodity boom in the oil market was seen to have substantially affected the oil producers negatively. However, the opposite is true for the oil importers where for instance the spill over effect of the low world oil prices have begun to be felt in Kenya ever since quarter three and even through quarter four of 2015 through reduced pump prices at the retail market segment.

Building and Construction

Looking at the production and the consumption of cement as a proxy to measuring the development in the building and construction sector, it is evident that the sector has experienced a mild growth in quarter four of 2015. The overall demand for cement increased from 1,443,544 MT in the third quarter to 1,464,069 MT in the fourth quarter of the year, an increase of 1.42 percent. The overall rise in the cement consumption arises from increased building and construction activities mainly in real estate development among the expanding middle income and overall growth in population and its composition as well as increased government construction of the physical infrastructure. From the production - consumption analysis, it's evident that the production within the quarter was capable of meeting the demand. In quarter three the production outstripped demand for cement by 238,162 MT. However, in quarter four the production – consumption gap declined to 87,743 MT signifying perhaps the rise in the building and construction activities which are

Construction of the Standard Guage Railway line.
Photo/Kenya Railways

Figure 12: Cement Production and Consumption, MTs



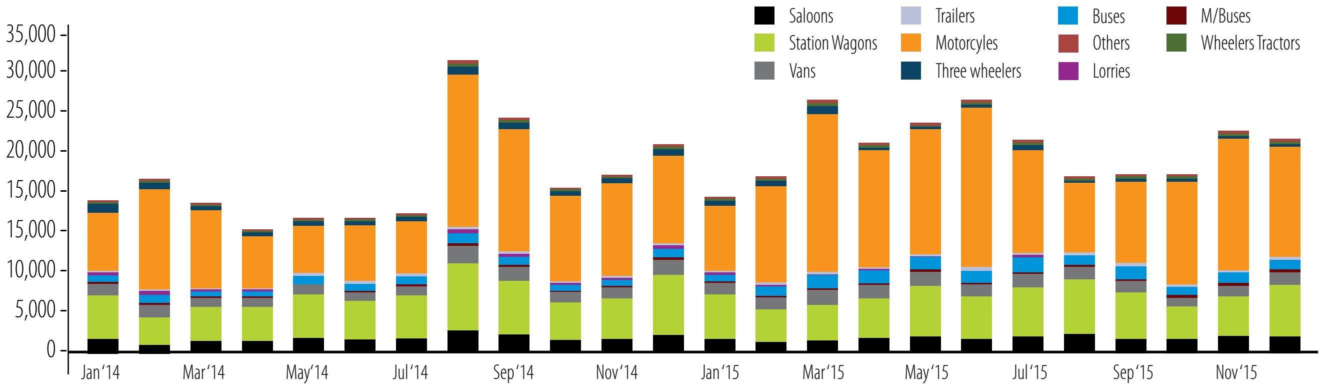
Source: KNBS

major trigger to increased cement consumption. Thus was therefore an evidence of growth in building and construction industry.

Transport and Communication

The total number of registered vehicles in Kenya recorded mixed performance in the fourth quarter of 2015 looking at the month – on – month growth. Between October and November 2015, the number of assembled vehicles decreased from 996 units in October 2015 to 820 units in November 2015; - a 17.67 percent growth. On the new registration of vehicles, quarter four recorded a rise of 12.55 percent in new registration. During the quarter, a total of 64,257 new vehicles were registered compared to a total of 57,809 new vehicles in quarter three. Of the total new vehicles registered in quarter four, motor cycles accounted for the largest portion at 56.82 percent (**Figure 14**).

Figure 13: Registration of New Vehicles April 2013 to December 2015



Source: KNBS

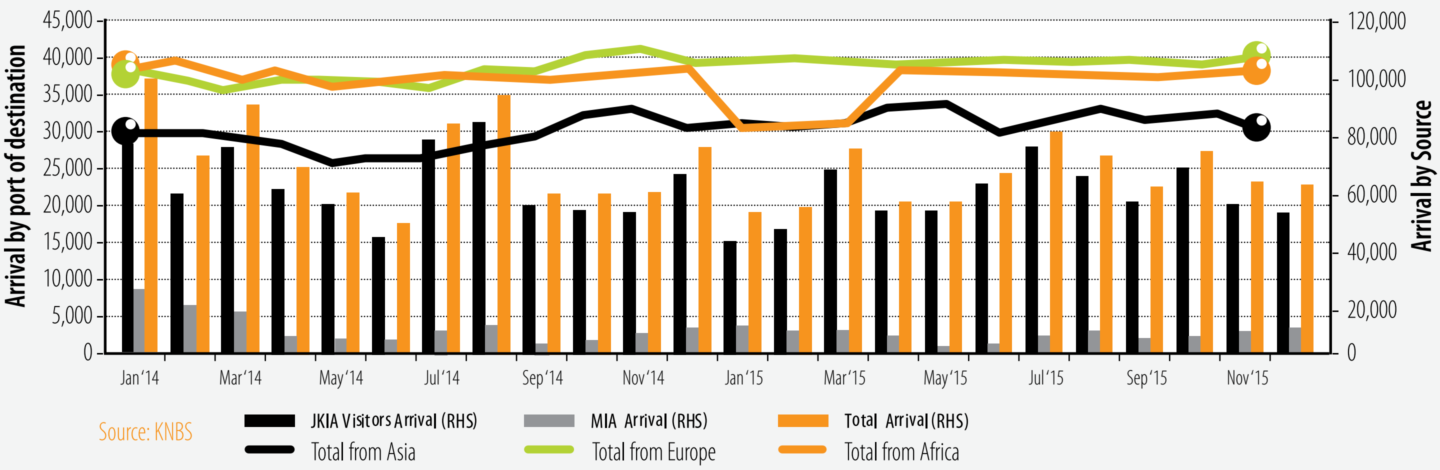
The dominance of mobile telephony in the communications industry continued to be evident. Mobile money transfer has been significant especially in rural areas where banks are not available, inaccessible, or where majority of the population do not hold bank accounts. At the same time this mode of money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

Tourism

For the entire of quarter four of 2015, tourism performance posted a bit of poor performance despite the lift of travel advisories by foreign agencies mainly from United States, United Kingdom, France and Australia arising from improved security status. Looking at the number of visitors arrivals via the JKIA and Moi international airport, the JKIA arrivals significantly declined from a total of 190, 009 visitors in quarter three of 2015 to 170,078 visitors in quarter four of 2015; a 10.49 percent decline.

Looking to the arrival through the Moi International Airport the quarterly total arrivals mildly improved from 18,338 visitors in the third quarter to 22,837 visitors as at the end of quarter four. The insight into the quarter reveal that the upward trend in the visitors arrivals via Moi International airport was sustained on the monthly basis rising from 6,049 visitors in October to 7,718 visitors in November and further to 9,070 visitors as at

Figure 14: Trends in Visitor Arrivals (Thousand) for Apr 2013 – December 2015



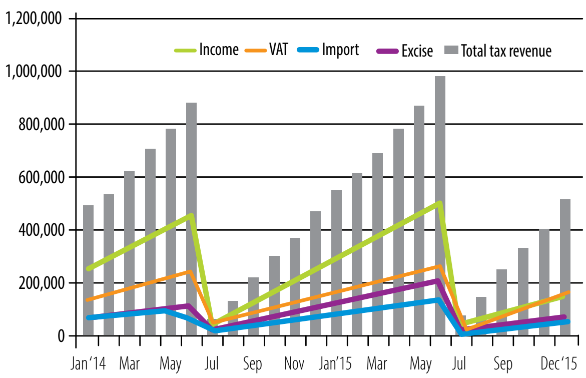
Source: KNBS

the end of December. This was contrary to the trends at the JKIA which saw the monthly visitor's arrival declining from 66,441 visitors in October to 53,662 in November and further to 50,015 visitors as at the end of December 2015.

Financing of Government expenditure

On the government revenues, the total revenue for the fourth quarter of 2015 stood at Ksh 1,392,010 million. Of this, the total tax revenue accounted for 87.83 per cent of the total quarterly revenue with the non – tax revenue accounting for 12.17 per cent. Of the tax revenue, income tax topped the list at 50.86 percent followed by value added tax at 28.22 percent with excise duty and import duty coming third and fourth at 12.89 percent and 8.03 percent respectively. From the previous analysis the government tax base seems to have remained constant with the contribution of each revenue stream changing marginally. This is an indication of the government's constraint in terms of widening the tax base and coming up with new sources of revenue despite of the government's expenditure continuing to rise with the onset of devolution government.

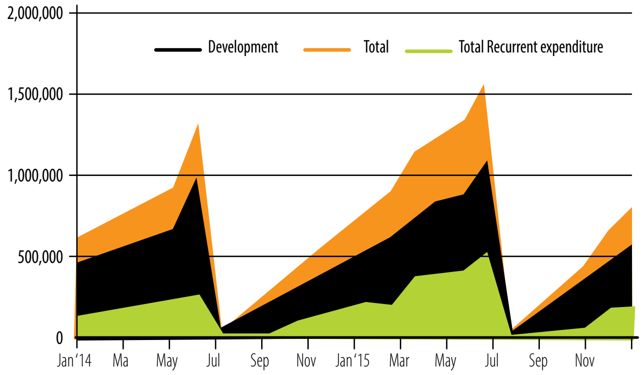
Figure 15: Tax revenue (Ksh Million)



Source: CBK

Turning in to the government expenditure, the total expenditure for quarter four of 2015 stood at Ksh 1.775 billion much higher compared to 0.216 billion in quarter three (beginning of financial year 2015/2016). Of this total expenditure, the recurrent expenditure dominated the total expenditure accounting for 76.91 per cent while the development expenditure accounted for 23.09 per cent of the total expenditure for entire quarter four. The growth in the recurrent expenditure can be attributed to the increment of the county government disbursements following the increase in the county funds allocation that mainly goes to recurrent expenditure.

Figure 16: Public Expenditure (Ksh Million)



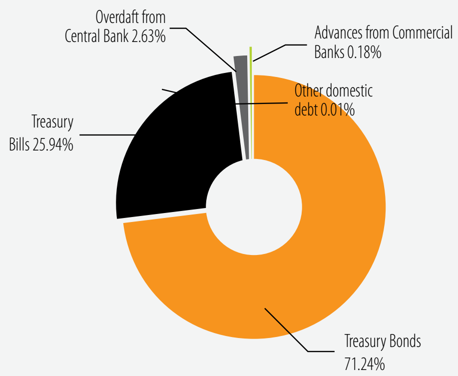
Source: CBK

Public Debt

During the fourth quarter of 2015, the total quarterly public debt was Kshs. 9.179 billion compared to a public debt of Kshs. 8.763 billion in quarter three of 2015; - a 4.74 percent increase. An analysis on the breakdown of the public debt into domestic and external debt reveals that the government through the National Treasury tried to maintain an equal balance between the two debts to stand at 50.62 percent in favour of external debt as opposed to 49.38 percent for domestic debt for October, a 50.75 percent in favour of external debt as opposed to 49.25 percent for domestic debt for November and a 51.18 percent in favour of external debt as opposed to 48. 82percent for domestic debt for December 2015. This reflects a tight trade – off and balancing act in the choice between the two types of borrowing hence limited flexibility of the National Treasury to prefer one at the expense of the other. Given the weakening bias of the Kenya shilling, more preference of external borrowing would imply increased foreign exchange burden for dollar – denominated debts hence increased interest burden. On the other hand, a tendency to prefer domestic borrowing to external borrowing would cause possibilities of crowding out - effects as well as increase cost of credit domestically. As such a tight balancing between the two types of borrowing mean the balancing between crowding out effect and increased debt burden for foreign currency denominated debt arising from weakening bias on Kenya shilling.

On the financing of the government's public debt, Open market operations take an upper hand with the preference on government treasury bonds including the government frozen debt remained being evidenced. In the last quarter for 2015, the government's treasury bonds were the key money market instruments intensively utilized by the government in domestic borrowing accounting for 71.24 percent though slightly lower than 74.51 percent o for quarter three of 2015. Treasury bills, overdrafts and advances on the other hand accounted for 25.94 percent, 2.63 percent and 0.18 percent respectively of total government debt for the entire of quarter four (**Figure 17**).

Figure 17: Composition of Domestic Debt



Source: CBK

Money and Credit

During the fourth quarter of 2015, the monthly total money supply recorded a positive growth of 1.03 percent in November, an increase from 0.41 percent in October. The growth was a contrast of the negative growth in money supply recorded in quartet three.

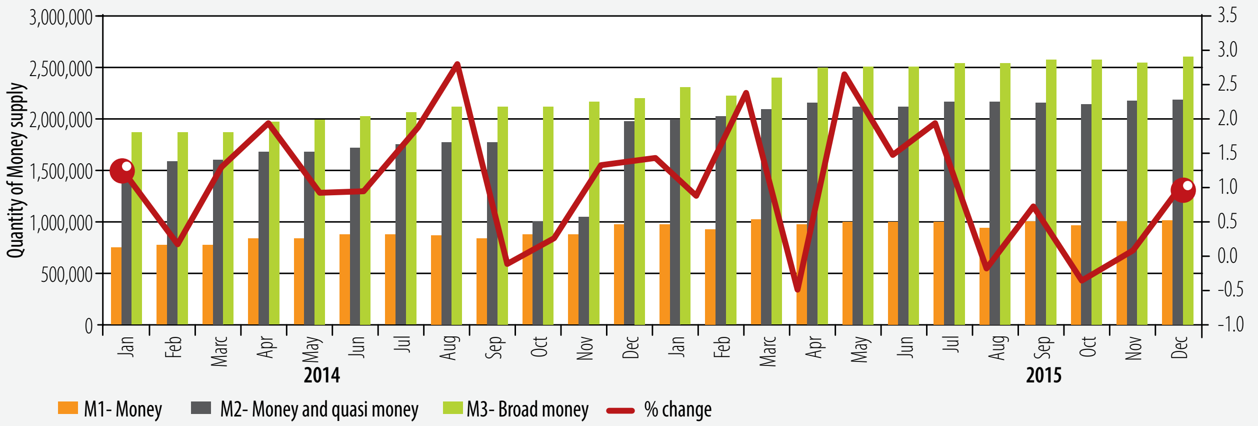
Inflation

The in the month –on - month inflation rates for quarter four of 2015 was on an upward trend, as opposed to quarter three (**Figure 9**). During October the inflation rates rose a high of 6.72 percent up from 5.97 percent in September 2015. More inflationary pressure set in to a high of 7.32 percent in November before settling at 8.01 percent in December: - 0.51 above the Central Bank of Kenya upper bound limit. The increase in inflation rates was attributed to adoption of the tightening monetary policy by the central bank in attempt to anchor inflation in the wake of a depreciation bias on the shilling and the deteriorating current account balance in the previous months. On average, the quarterly inflation rates for quarter four increased to 7.32 percent compared to 6. 14 percent for quarter three.

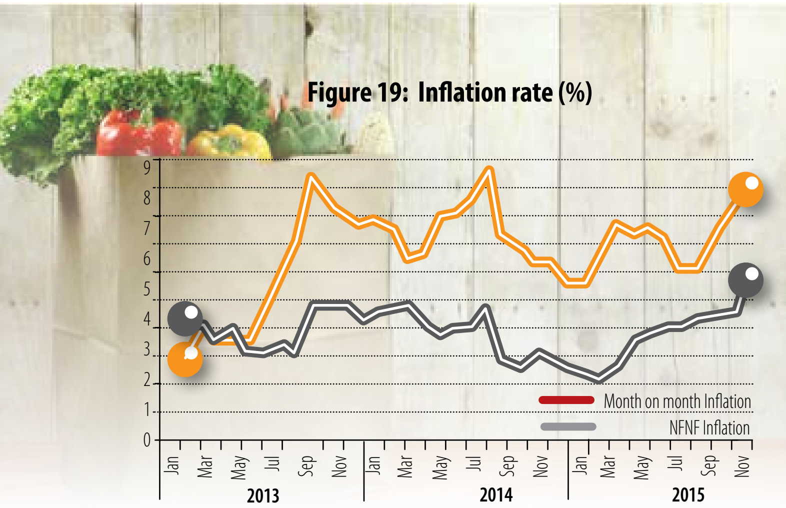
During the quarter, the rise in the inflation rates was majorly accounted for by rise in the food and non - alcoholic drinks whereby the rise in the prices of the some commodities in this category outweighed the decline in the prices of some commodities in the same category. The significant rise in the general prices in the month of December is majorly attributed to the introduction of the new excise duty levy on beer and cigarettes. Consequently, the Alcoholic Beverages, Tobacco & Narcotics index recorded an increase of 11.46 per cent hence the overall monthly inflation of 8.01 percent in December.

A review on the year – to – year basis reveals that the annualized inflation rates for year 2015 was 6.56 percent compared to 6.88 percent in year 2014. In addition, the news on the possibilities of rise in the federal rates in US market in the first quarter of 2015 could have been factored in the market hence causing a rise in the interest rates.

Figure 18: Money Supply (KES Million)



Source: KNBS and CBK



Source: CBK

A look at the non - food - non – fuel inflation (NFNF) which measures the effects of the monetary policy stance indicate that in October 2015, it marginally rose to from 4.8 percent from 4.7 percent in September. The rate remained the same in November 2015 before rising to 5.6 percent in December. This rise was probed by the increase in the introduction of new excise duty on alcoholic beverages and tobacco products, introduced on December that accounted for a 1.2 percentage points to the non-food-non-fuel (NFNF) inflation.

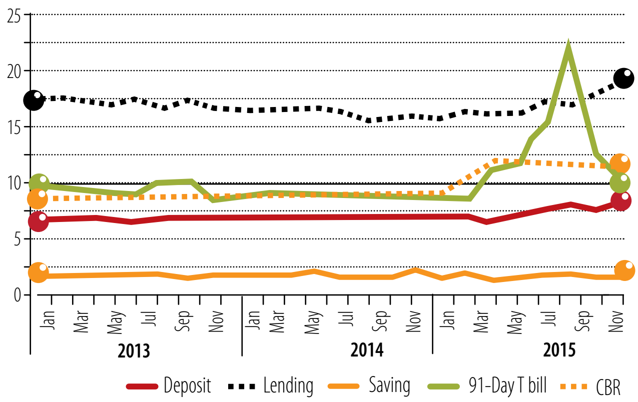
Interest Rates

Interest rates have largely been unstable during the fourth quarter of 2015 (**Figure 20**). This could be attributed to a number of factors. First is the fact that the banking industry is still trying to fully adjust to the new pricing model upon the introduction of KBRR. Secondly the industry was trying to adjust to the change in the monetary policy stance which led to an upward revision in the central bank rate which ultimately led into the increase in the lending rates via increased base rate on the onset of quarter three. Thirdly, were the external pressures towards the end of quarter where there were speculations of the adjustment in the federal rates in the first quarter of 2016.

There were some jitters in the interest rates with the short term interest rates rising sharply during quarter four in addition to the high volatility as well. The average yield rate for the 91- day Treasury bills, which is a benchmark for the general trend of interest rates, rose significantly from single digit to a double digit figure recording the highest ever month average rate of 21.65 percent in October. This was the highest ever spike in the 91 – Treasury bill rate since January 2012 where it recorded a high of 20.56 percent. On quarterly basis, the rate averaged at 14.6 percent compared to 12.24 percent in quarter three. High volatility can be seen in the short term interest rates within the quarter with the rates rising to a high of 21.65 percent in the beginning on the quarter and falling through the quarter to a single digit of 9.81 percent as at the end of the quarter (December 2015).

The cumulative average weighted lending rates rose successively throughout the quarter from 16.58 percent in October to 17.16 percent in November 2015 and further to 18.30 percent as at the end of December 2015. This was perhaps in process of the banking industry adjusting to the new monetary policy stance that saw the rise in the Central Banking Rate in quarter three. However, banks still face high costs of operations as manifested by some banks recording declining profit margins and such changes in their rates would impact their operations adversely. However, the financial market still remained illiquid for the entire quarter four of 2015 as evidenced by the relationship between the average lending rates and the CBR as well as the high interbank rates within the quarter. This signifies the shock in the credit market that arose from the upward revision of the CBR in attempts to ensure stability in the exchange rates in addition to trying to adjust to the new pricing mechanism under the KBRR regime that continues to be challenging given its frequent review in quarter two and quarter three.

Figure 20: Interest rates (%)



Source: CBK

The interbank rates recorded a significant downward shift from 14.82 percent in October 2015 to 8.77 percent by November and further down to 7.27 percent as at the end of December. This implies reduced central bank's intervention in the money market via repurchase of excess shilling and pumping of foreign exchange into the forex market in attempt to cushion the shilling which was under intense weakening bias for the entire of quarter four. The shilling gained some sense of stability in quarter four thus calling for the reduced central bank's interventions in the money market hence to reduced interbank rates over the quarter.

Balance of Payments

On the level of trading during quarter four, the volume of trade contracted from KSh 211.6 billion in November 2015 to KSh 175.3 billion in December 2015. The total value of exports rose to KSh 50.90 billion. The value of imports decreased from KSh 162.9 billion in November 2015 to KSh 124.5 billion in December 2015.

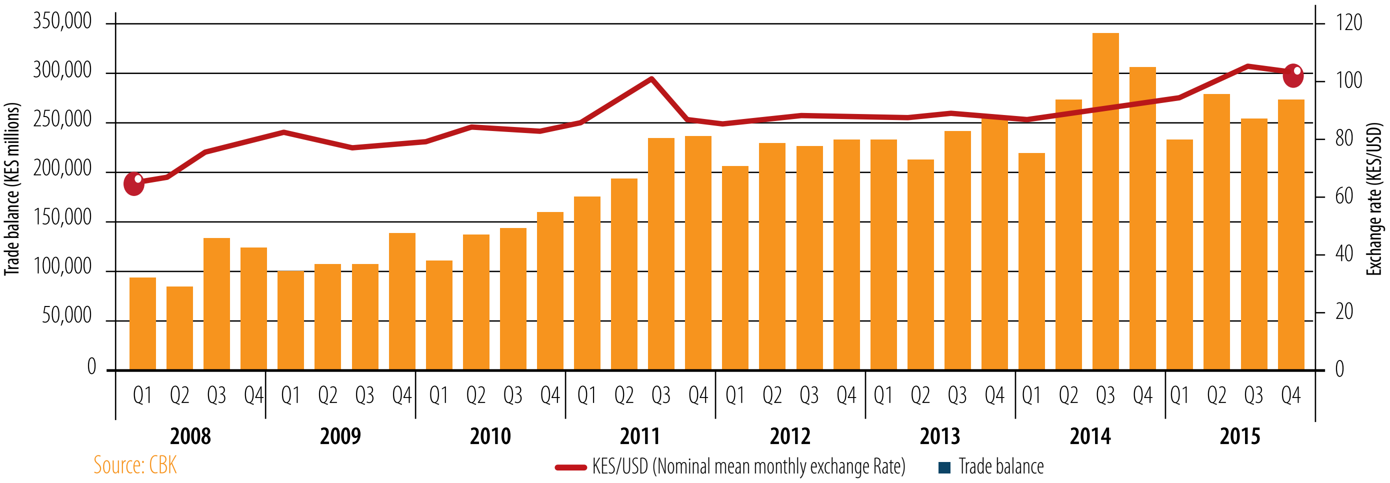
Domestic exports by Broad Economic Category (BEC) indicated that food and beverages was the main export category in December 2015 accounting for 48.2 per cent of exports, while the value of non-food industrial supplies and consumer goods not elsewhere specified registered 24.5 and 23.7 per cent shares, respectively. BEC imports indicate that industrial supplies not elsewhere specified was the main import category in December 2015 with a share of 30.4 per cent, while the values of machinery & other capital equipment, fuel and lubricants and transport registered shares of 16.4, 16.0 and 15.7 per cent, respectively. Food and beverage recorded a share of 7.8 per cent while consumer goods not elsewhere specified recorded a share of 10.5 per cent.

Turning on the exports, the value of the exports the decline in exports is a clear indication that, despite the depreciation in shilling, the Kenyan exports have not leveraged on this opportunity that would arise from the exports being cheaper abroad. The total quarterly value of the major selected exports declined from Ksh 139,594.63 million in quarter three to Ksh 129,591.38 in quarter four of 2015. Out of the major selected exports, tea exports topped the list accounting for 30.43 percent of the total exports for quarter four. Horticulture came second at 15.32 percent with chemicals and coffee accounting for 8.19 percent and 3.38 percent respectively.

Regarding the major destination for the Kenyan exports for the intra African trade, Uganda topped as the most preferred export destination for domestic exports with a high of 24.20 percent of Kenya's total exports quarter four of 2015 followed by Somalia at 18.68 percent with Tanzania coming third at 16.00 percent. For the major imports within the African market, imports from South Africa accounted for 42.40 percent of total imports for quarter four 2015 followed by Egypt at 18.74 percent with Uganda coming third at 16.11 percent. Looking at the Kenya exports destinations globally for quarter four of 2015, Uganda topped at 9.69 percent followed closely by Pakistan at 8.86 percent with United Kingdom coming third at 7.40 percent.

Turning into the overall monthly trade balance, it's evident that the quarterly trade balance worsened from Ksh 244,172 million in quarter three to Ksh 262,348 in quarter four. This could be mainly attributed to the weakening shilling against the major currencies such as the dollar which increased the import bills significantly. In addition the massive importation of machinery and transport facilities in wake of continuing major physical infrastructural projects contributed to the worsening of the trade balance. Moreover the failure of the exports to fetch enough export earnings despite the depreciating shilling mainly due to the nature of the Kenya exports led to the trade balance deficit in quarter four of 2015.

Figure 21: Overall trade balance and exchange rate



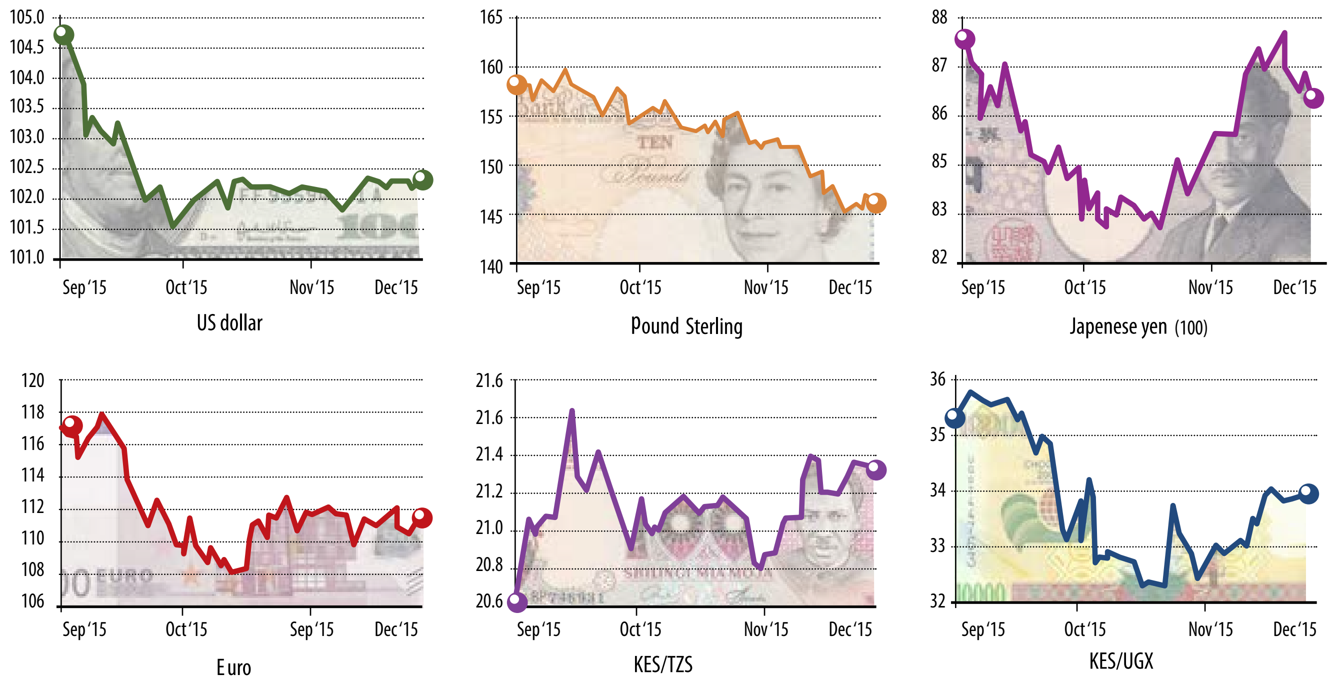
Source: CBK

Exchange Rate

During the fourth quarter the shilling continued its losing streak against the hard currencies though the weakening bias seemed to ease relative to the depreciation experienced in the third quarter. During quarter four the monthly average of US/KES displayed some stability oscillating aound102 mark. In October, the Us dollar exchanged at 102.79 against the Kenya shilling while in November the mean monthly rate was at 102.15 and later slightly depreciating to 102.19. This is still believed to have been brought about the continuous strengthening of the dollar albeit the US economy shows little growth in the first quarter of 2015. The demand for the dollar has gone up as the non-oil producing countries are quick acquiring oil to build up reserves as the price is still favorable, hence exacerbating the problem for the Kenyan shilling against the dollar. The stability in the rate could also be attributed to the monetary policy stance undertaken in the beginning on quarter three by the central bank of Kenya as well as the reserves acquired by the Central bank from the International Monetary Fund to cushion against any further undesirable depreciation.

Against the Sterling the shilling appreciated by about 2.67 percent between the third and the fourth quarter. This could be attributed to the reduced competitive of the British economy within the entire Europe

Figure 22: Nominal Exchange Rate



market mainly within the Euro zone. The European economy is still struggling with deflationary pressures thus reducing its competitiveness in the global market hence the strength in the shilling against the pound and the euro at large. The emerging markets, including the Asian market have also been experiencing lower growth numbers and the Japan economy has had a very slow recovery process that it has lost ground consistently against the Kenyan shilling over the past six quarters albeit showing signs of recovery in the entire fourth quarter of 2015. For the East African scene the shilling was more stable compared to the Ugandan shilling and Tanzanian shilling against the world's hard currencies.

The Kenyan shilling continued to perform considerably well against other East African currencies. However, this can be attributed to the weak performance of the other economies in the region as well.

Photo/ Donald Kogai, KBA

Nairobi Securities Exchange

During the fourth quarter of 2015 the stock market continued to post poor performance as evidenced in the successive months indices. However, performance based on the NSE -20 Share index reveal that the market's performance dipped very low in October but later recovered in November and December with the index of 3869 points and 4040 points respectively. However, the improvement in the market was dismal given that the bearish behaviour was still on the run with a number of the listed firms giving warnings of low earnings.

The dismal performance can be attributed to bearish behaviour in the market, driven majorly by the foreign investors. The volatility in the market arising from the bearish behavior was mainly accounted for by the liquidation of the portfolios held by the foreign participants. This is clearly revealed by the drastic reduction in the percentage of foreign investors' participation from a high of 79.63 as at end of quarter three to a low of 58 percent as at the end of quarter four. Foreign investor bearish sentiments, driven chiefly by the uncertainty of the Kenyan shilling performance, liquidity tightening in the Kenyan market making the returns of equity low compared to other markets.

A comparison between the equity market and the bond market clearly indicate and support the facts the equity and the fixed income segments of the market operate antagonistically. While the equity market performance declined from 4173 points in September to 3869 points in October, the fixed income segment performance rose from Ksh13.69 billion to Ksh 30 billion as implied by the activity in the bond market. However with the recovery in the equity market in November and December, the bond market activity declined accordingly.

The NSE All share index fell as well from 147 points in September to 137 points in October before marginally rising to 145 points s at the end of

Table 3: Nairobi Securities Exchange Market Indicators

Date	Jul-15	Aug-15	Sep-15	Oct - 15	Nov- 15	Dec - 15
NSE 20 Share Index 100 =1966	4405	4176	4173	3869	4016	4040
NSE All Share Index (NASI) 100=2008	140	143	147	137	143	145
Market Capitalization (KES. Bn)	2270	2005	2063	1931	2018	2049
Total Shares Traded (Million)	715	734	434	540	441	474
No. of Equity Transactions	33598	31973	30706	27975	27068	23100
Equity Turnover (ET) KES. (Million)	21,554	20,792	14,375	17,837	13,149	15,109
Bonds Turnover (KES. Bn)	12.40	18.42	13.69	30	19	21
Percent of Foreign Participation to ET	70.13	79.63	61.95	67	67	58

Source: NSE, Monthly Trading Report

December 2015. The significant fall in the equity turnover is also a clear evidence that the market has not been active with the total number of shares traded falling considerably to a low of 434 million as at September 2015. The month of October, saw the market register a very low market capitalization of Ksh 1,931 billion down from Ksh 2,063 billion in September.

Banking Industry Performance

A highlight of the credit survey in the banking industry for quarter three of 2015 posits that the ratio of total loans to total assets for the industry grew slightly from 61.38 percent is quarter two to 62.68 percent in quarter three. On the credit demand side, Cost of borrowing, depreciation of the shilling, security risks, increased Central Bank Rate and Kenya Banks Reference Rate were cited as the main driving factors for the quarter three of 2015. These factors led into the tightening of credit standards among some banks to caution themselves from unforeseen risks.

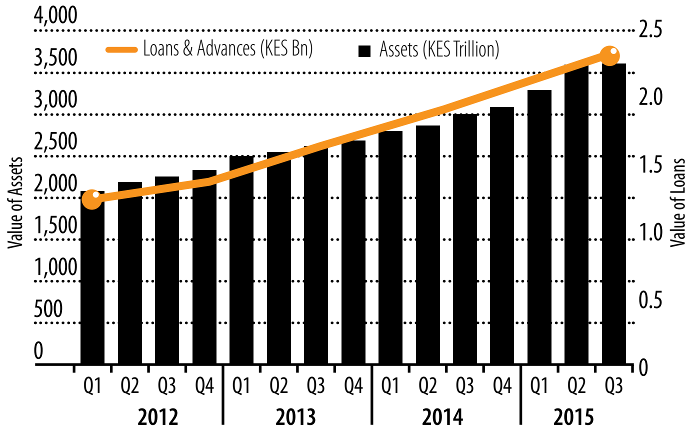
On the non – performing loans, increase of the Central Bank Rate and Kenya Banks Reference Rate, increased interest rates, volatile exchange rates, delayed contractor payments from the central and county governments and adverse weather conditions were cited as some of the factors attributable to increased NPLs as per the credit survey for the third quarter of 2015.

We note that for the last quarter of 2015, the stability for the banking sector is likely to be influenced by policies and measure undertaken by the central bank and the national treasury with regard to monetary and fiscal policies that will shape the macroeconomic environment which the commercial banks operate in.

Assets and Loans

The industry's assets base registered a mild positive growth of 1.4 percent during the third quarter of 2015 to stand at KES 3.65 trillion as at the end of September 2015 compared to KES 3.60 trillion in June 2015. Similarly, total industry's loans and advances marginally grew by 6.9 per cent in quarter two of 2015. A quarterly review of growth in the banking industry's total loans and advances posit that as at the end of September 2015, the total loans and advances stood at KES 2.32 trillion compared to KES 2.17 trillion in June 2015. Comparing the quarterly growth in loans and advances between quarter two and three of 2015 with the growth in the demand deposits, it's evident that Loans and advances, the difference between the two is substantial. This is because, the total industry's demand deposits registered a negative growth of 0.2 percent in the same period while the total loans and advances grew by 6.9 percent hence signifying the banks' capability to convert their liabilities into assets.

Figure 23: Bank Assets and Loans (KES Trillion)

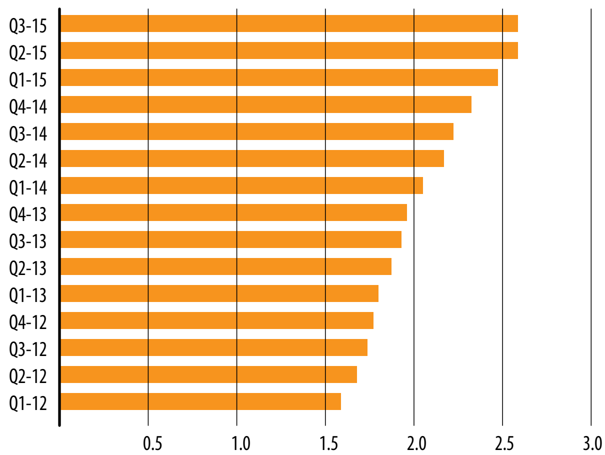


Source: CBK

Deposits

The total deposits in quarter three of 2015 recorded a negative growth of 0.2 percent compared to quarter two of 2015. Demand deposits accounted for major source of total banking industry funding liabilities standing at 70.3 percent as quarter three implying that the short term inflows in terms of demand deposits majorly financed the industry's total loans and advances. As at the end of quarter three the total bank deposits were 2.568 trillion compared to Ksh 2.574 trillion as at the end of quarter two.

Figure 24: Bank Deposits (KES Trillions)

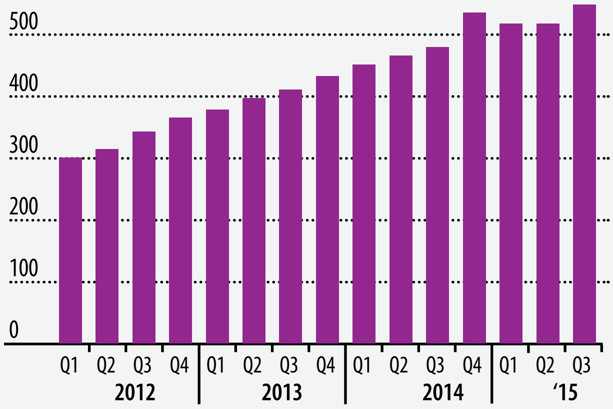


Source: CBK

Total Shareholder Funds

Total capital stock of the Kenya banking sector sustained its upward trajectory in the third quarter of 2015 though mild. The quarter recorded a growth in share holders' wealth of 2.2 percent from KES 543.3 billion as at the end of June 2015 to KES 555.5 billion as at September 2015. This increases confidence in the banking industry given that the increase in the shareholders' funds represents a trade - off of equity for debts financing.

Figure 25: Shareholder Funds (KES Billion)

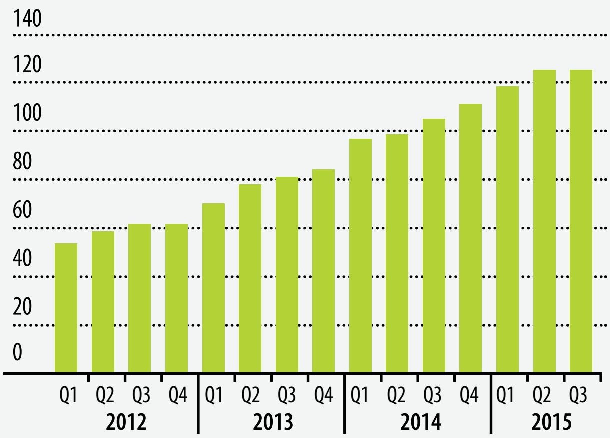


Source: CBK

Gross Non-Performing Loans

The gross non – performing loans increased marginally in quarter three of 2015 by 0.7 percent to average at KES 124.8 billion in quarter three compared to KES. 123.9 billion in quarter two. During this quarter, 8 out of 11 economic sectors registered marginal increases recorded a marginal increase in the non – performing loans. The sectors which experienced the highest increase in NPLs in the quarter were financial services and energy and water sectors whose non – performing loans increased by 11.5% and 11.6% respectively. The main underpinning factor for the marginal growth in is likely to be tightening of the banks' credit standards amid the rise in the cost of credit following the upward revision in the KBRR and the central bank rate within the quarter. This enabled the cushion against the rise in the non – performing loans in the event of a rise in the cost of credit.

Figure 26: Bank Gross Non - Performing Loans (KES Billion)

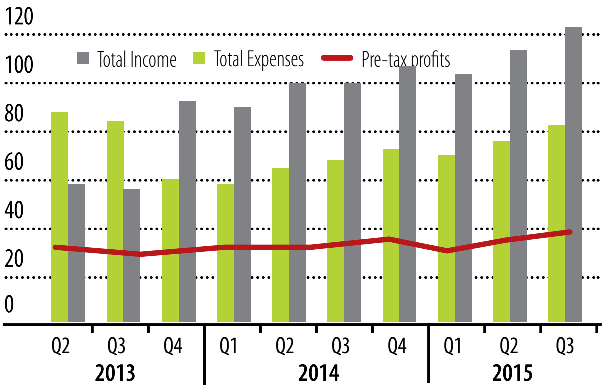


Source: CBK

Bank Profitability

The banking sector recorded a drop in the profit before tax in quarter three of 2015, to stand at KES billion 37.31 against KES 39.61 billion in quarter two (**Figure 27**). This represents a 5.8 percent decrease in the profits before tax. However, the total income generated within the quarter rose from KES 116.29 in quarter two of 2015 to KES 121.52 in quarter three of 2015: - a 4.5 percent growth. Interest on loans and advances, fees and commissions and government securities were the major sources of income accounting for 60.7 percent, 15.0 percent and 16.1 percent of total income respectively. Contrary, interest on deposits, staff costs and other expenses were the main components of expenses, accounting for 35.8 percent, 25.7 percent and 21.9 percent of the total expenses respectively.

Figure 27: Bank Profitability (KES Billion)

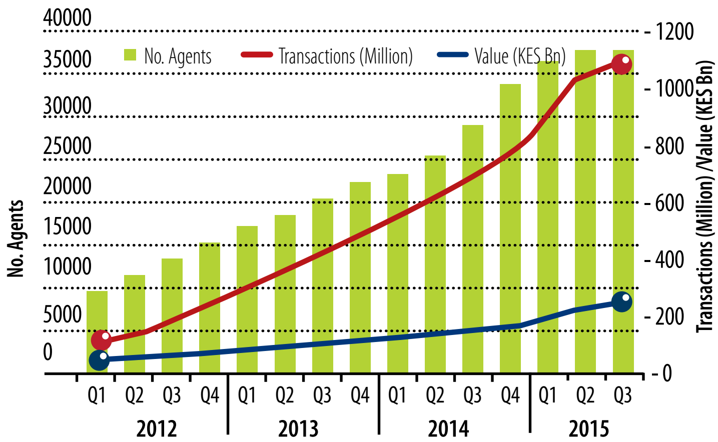


Source: CBK

Agency Banking

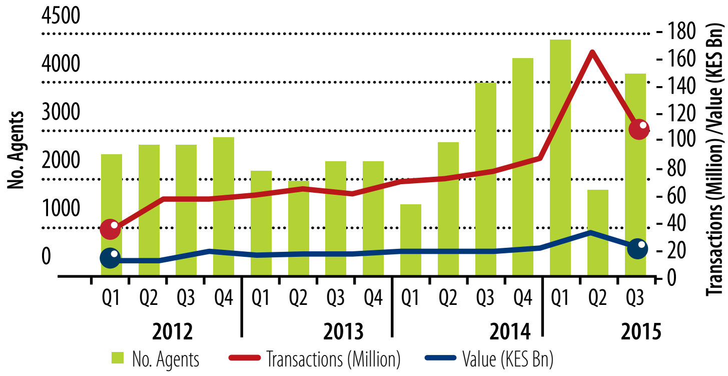
Agency banking model in Kenya has become a critical model of branchless expansion in the Kenya banking industry ever since its inception in May, 2010. It has seen tremendous growth as evidenced by the upward trajectory on the total cumulative in the number of active agents, transaction volumes and total value. As at third quarter of 2015 the cumulative number of active agents stood at 39,871 transacting approximately 193.4 million transactions valued at over 1.0 trillion compared to 36,080 active agents transacting approximately 175.4 million transactions valued at KES 930.1 billion in the second quarter of 2015. This growth is underpinned on continued contracting of varied retail entities to offer basic banking services by commercial banks. These entities include among others;- security companies, courier services, pharmacies, supermarkets and post offices which act as third party agents providing cash- in -cash-out transactions and other services in compliance with the laid down guidelines by the central bank.

Figure 28: Cumulative Agency Banking (no. of agents, transactions volume and Value)



Source: CBK

Figure 29: Quarterly Growth in Agency Banking (no. of agents, transactions volume and Value)



Source: CBK

Figure 29 shows the actual quarterly growth in the agency banking. Quarter three of 2015 registered a significant positive growth of 3,791 active agent compared to a growth of 1,699 active agents in quarter two. Thus, the banks continue to diversify their products to bank the unbanked as well as reducing operating costs such as rental charges, additional staff and other administration costs that come with the opening of news branches while at the same time retaining their market shared using the agency banking model.

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