About this Report

This Bulletin reviews the performance of the Kenyan economy for the 3rd 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.
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Publisher KBA Centre for Research on Financial Markets and Policy®
KBA CEO Habil Olaka
Chief Editor Jared Osoro
Contributors David Muriithi
Gabriel Thirikwa
Design & Layout Conrad Karume
Contacts KBA Headquarters,
International Life House,
13th Floor Mama Ngina
Street, Nairobi
Mailing Address P.O. Box 73100
00200 - Nairobi
Phone +254-20-2221704,
+254-20-2217757,
+254-20-2224014
E-mail research@kba.co.ke
Web www.kba.co.ke
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STATE OF THE ECONOMY
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It is my pleasure to present to you the 13th volume of the Kenya Bankers Economic Bulletin. This issue discusses the state of the Kenyan economy during the third quarter of 2014. The Bulletin reviews the strides that the economy has made since the beginning of the year, with an emphasis on the opportunities and constraints that continue to shape the economy’s gradual recovery.

The performance of the Kenyan economy has over the years been shaped by 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 likely possibility of the US’s Federal Reserve Board resuming conventional monetary policy as the year comes to a close.

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 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
Based on the first two quarters of this year, 2013 and 2014 look like great years even though the respective real growth rates of 5.7 percent and 5.3 percent are modest — if by no other comparison — when judged against the aspirational double digit growth rate necessary for the realisation of Vision 2030.

If therefore the rosy forecast for 2015 is to be realised, then the economy must spectacularly grow by nearly 8 percent in each of the last two quarters of the year. And the buoyant momentum has to be maintained if the 2016 is to be realised.

An Injection of realism

How realistic is such expectation? Very unrealistic, I could contend. If for no any other reason, the Central Bank of Kenya (CBK) adopted a tight monetary policy stance during the third quarter of 2015 going into the fourth quarter of the year. The aim was to stem inflationary pressure and assure medium term stability. The inevitable consequence of the justifiable monetary policy stance is short-term cost in terms of real growth, but the focus remains anchoring medium term inflation expectations.

we have not seem much help from the fiscal front. Fiscal policy remains expansionary — more expenditure that is premised on more resources. Unfortunately, both expenditure and revenue are based on the very ambitious growth projection whose realism we question. Consequently, one easily sees some imagined self-fulfilling prophecy on real GDP growth that may not crystallise.

Even the most optimistic outlook of the Kenyan economy is likely to factor in the reality that the economy’s growth trajectory in the recent past has not provided the springboard for a true bounce-back. The evidently feeble recovery has been underpinned by a not-so-clear pattern of quarterly real growth performance.

The campion of optimism is the International Monetary Fund (IMF) whose latest forecast (October 2015 World Economic Outlook (WEO)) of the Kenya’s real growth is 6.5 percent in 2015 before that rate rises to 6.8 percent in 2016.

It is increasingly becoming clear that any overly sanguine outlook clear has not fully benefited from the latest data on the economy’s performance by the Kenya National Bureau of Statistics (KNBS). The KNBS indicates that that the economy’s real output expanded by 5.5 percent during second quarter of 2015 the compared to 6.0 percent during the corresponding quarter in 2014. The first quarter of the year registered a 4.9 percent growth compared to the previous 4.7 percent during the first quarter of 2014.

By Jared Osoro

The Persistent Lull or the Darkness before the Dawn?

Photo/curacaoswegenbouw
This is how such prophesy envisioned to work: project that the economy will grow at between 6.5 percent and 6.9 percent; let these rosy projection be the basis for government revenue and expenditure projections; then assume that the projected expenditure will support the realisation of the growth projection, especially expenditure on infrastructure.

One can easily agree to the argument that the on-going upscaling of public infrastructure investment is critical in boosting the economy’s growth potential if there is a strong qualification: the economic viability of these investments against which financing is secured need not be in doubt. As it is, though, such viability could be either a wish or an assumption, or anything in between the two.

But then even the optimists let the cat out of the bag when they observe that “maintaining fiscal sustainability requires significant efforts to mobilise additional revenue and contain current spending”. That amounts to a covert admission that the self-fulfilling growth prophesy is not crystallising. That is more the reason why it is easy to argue that caution is the victim if the same rosy growth assumption are built into the economy’s latest debt sustainability analysis (DSA).

**Short-term pain as a precursor to long-term benefits**

If flogging the robust growth message is drawing no realistic traction, then the focus need to be on what short-run macro policy agenda. The Monetary Policy Committee (MPC) of the CBK remained engaged in seeking to provide a clear signal that its gun is aimed at anchoring inflation expectations and not doing the fiscal policy bidding.

The MPC signalled the changed in policy stance from accommodative to tight in July 2015 through an increase in the Central Bank Rate from 8.50 percent to 10 percent in June 2015 and 11.50 percent by July 2015, a level at which it has since been maintained. Figure 1 indicates that inflation was within target at the time of the change of the policy stance. This can only mean expectations of simultaneity of two effects:

One is the view that pressure from a fast depreciating currency (Figure 2) could lead to the breaching of the targeted inflation range of 2.5 percentage points over (or below) the 5 percent medium term target. The other is the argument that resumption of a rising interest rates regime will provide some support in the effort to stabilise the foreign exchange based on the assumption that the uncovered interest rates parity (UIRP) principle — where foreign resource inflows are attracted by positive interest rates differential — holds.

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**Figure 1: Central Bank Rate; Inflation Rate**

![Figure 1: Central Bank Rate; Inflation Rate](chart.png)
A notable development as the year 2015 came to a close was the “urgent” resource requirement to fill the fiscal gap saw a steep rise in the Treasury bill rates (Figure 3). Superficially, the high rates on fiscal instruments could be seen to be reinforcing the monetary policy tightening. Realistically though, it was in all respects masking a policy conflict that buttressed some level of fiscal dominance – where the fiscal policy action forces the hand of the monetary policy. That is why the need for continued strengthening of monetary and fiscal policy coordination towards supporting overall macroeconomic stability as a policy imperative needs to take centre stage even if that were to be at a short-run cost in terms of real growth.

**Figure 3: Short-term Interest Rates**

As could be observed, there has been relative calmness in the foreign exchange market as the year came towards a close. This has largely been on account of the high interest rates as well as the CBK's intervention in the foreign exchange market when it deems that appropriate. At the same time we are seeing a quick reversal of the short-term interest rates. There have been arguments that the steep rise was an over-reaction and therefore a reversal could be seen more as a correction than anything else.

One question comes to mind: are we seeing calm before the storm? To be sure, one need to look at what has changed at the broad macroeconomic parameters. The projected fiscal deficit remains large and the measures being put in place are geared towards bringing the fiscal gap and not reducing it. Those that gives a favourable review of the syndicated loan that was concluded by the National Treasury in November 2015, arguing that it will ease pressure on the government's domestic borrowing and interest rate; it is silent though on its implication on the foreign exchange market.

As argued, the resemblance of stability in the foreign exchange market has been more on account of the CBK's monetary policy operations than anything else. That in instances the narrowing of the current account deficit is attributable to a lower import bill and not necessarily export inflows is a pointer to the challenges associated with the economy's international competitiveness. In any case, over the past decade or so the Kenyan currency has been appreciating in real terms.
Furthermore, the external position as reflected in a current deficit in excess of an equivalent of 9 percent of GDP is still weak (Figure 4). That is why we could argue that to look at the narrowing as an end in itself without looking at the process will only serve a short-term purpose. We contend that there is no symmetry in the current account narrowing on the basis of imports declining and the narrowing on account of exports rebounding; the latter obviously reflects a rejuvenation of growth in the exportable and therefore an indication of improvement in competitiveness.

Ultimately, there is a general feeling that clear signals of how fast the economy will revert back to robust performance is not evident. Unfortunately, this happens on the back of the softening of the performance of the global economy; the uncertainty around the timing return to conventional monetary policy in the US and hence the risk of portfolio outflows with interest rates hike; and then fact that the risks for emerging markets are not simply slow growth but debt challenges that seem to be on the move initially from the US to the Eurozone and now to emerging markets. One can only hope that all these point to a lull before a bright dawn, but hasten to add that hope has never been a forecast!

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
Growth in Gross Domestic Product

The second quarter of 2015 recorded an economic growth rate of 5.5 percent: a 0.5 percent decline in the quarterly growth rate as compared to the same quarter of 2014 whose growth stood at 6.0 percent. However, looking at the successive quarter’s growth the growth for quarter 2 was a slight improvement from quarter one’s growth of 4.9 percent. This improvement was underpinned on the sound and fairly stable macroeconomic environment that was experienced in quarter one a spill over conditions from the first quarter of 2015 which was manifested in low inflation rates and fairly stable cost of funds in the economy.

This was trend were manifested in quarter three of 2015 since the core macroeconomic environment were in favorable of the economy. More specifically the inflation rates were on a downward trend hitting a low of 5.84 percent in August: which is on lower bound of the Central Bank’s target range. In fact, the quarterly average inflation rates for quarter 3 stood at 6.14 percent against 6.99 percent in quarter two. However, the real effects of the low inflation rates within the quarter were not felt given that the keys issues such as cost of credit continued to be on the rise. The non — food — non — fuel inflation rate for quarter 3 averaged at 4.6 percent against the 3.96 percent in quarter 2 (see figure 5).

On the forex front, the weakening bias on the Kenyan shilling against the major hard world currencies mainly the dollar continued to persist and worsen thus shocking the economy negatively for the entire part of quarter three. This is in a number of aspects; — first is through the increased current account deficit given the rise in the import bills thus increasing the trade balance deficit which directly implies the increased current account deficit. The weakening shilling has also seen the domestic energy prices especially the oil prices surge up thus offsetting the benefits of the low oil prices realized in the first quarter of 2015. More importantly, the loss in the value of the shilling against the dollar has seen the change in the monetary policy stance in the economy during the quarter. On the monetary policy stance, the depreciation pressure on the Kenya shilling saw the raise in the bank rate for the second time in the quarter from 10.00 percent as at the end of quarter two to 11.5 percent to anchor inflation expectations. This has in turn inferred into the illiquidity in the credit market leading to the increase in the cost of credit in the market.

The cash crunch experienced in the economy in third quarter was also a unique phenomenon that adversely shocked the economy albeit in the short run. This was mainly due to the short fall in the government domestic revenue collections from the projected revenues leading to short term domestic borrowing by the government to finance the budget deficits. This further constrained the credit market by increasing the cost of funds via high short term interest rates such as the 91 — Treasury bill rates and the interbank lending rates.

![Figure 5: Average Quarterly Inflation Rates](source: Central Bank of Kenya)
Agricultural sector continues to play a critical role especially in total number of employments both directly and indirectly in the sector. It's forward and backward linkages in the economy cannot be emphasized. Of late as a result of weakening shilling and them dwindling tourism sector, agricultural sector has been viewed as the savior in terms of promoting inflow of the foreign currency to stabilize the shilling. A review of tea production posits that it's increased significantly in the second quarter compared to the first quarter; from 32,286 Mt in June to 36,484 Mt in September with the prices also improving significantly over the period from Kes 319.40 per kilogram in June to Kes 326.69 per kilogram as at the end of September 2015. The production within the sector also significantly increased increasing from 28,410 Mt in August 2015 to 36,484 Mt in September 2015. however there was a decrease in the total quantity produced between July and August where the total production declined from 30,942 MT in July 2015 to 28,410 Mt in August 2015. the increase in the production was mainly attributed to good rains in quarter two of 2015.

The macroeconomic stability the third quarter of 2015, experienced relatively low monthly inflation rates ranging from 6.62 percent in July to 5.84 percent in August and slightly rising to 5.97 percent as at September 2015. This is perhaps due to the tightening of monetary policy stance by raising the central bank rate from 10.00 percent to 11.50 percent within the quarter in attempts of stabilizing the shilling and anchoring inflation rates. However, this was not backed with a complementary fiscal policy for it to be successful. The end result was a surge in the short term interest rates mainly the 91 — Treasury bill rates and the interbank lending rates and ultimately the increase in the cost of credit in the economy.

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 a month average rate of 11.54 percent as at August from a low of 8.26 percent in June 2015: – a 39.71 percent rise. Similarly the interbank rates followed suite rising from a mean monthly rate of 11.78 percent in June to a high of 18.49 percent as at the end of August 2015: - a 56.96 percent rise within the quarter. This is a one — on — one bearing on the average lending rates in the economy given that the short term interest rates enter into the determination of the lending base rate: – Kenya Bankers Reference Rate (KBRR)

From the figure 5, it can be deduced that the average quarterly inflation rates have been on the decline after third quarter of 2015 signifying the spillover effects of good rainfall in quarter two which led to increased food production and consequently stability in food prices.

The market therefore remained volatile at best with the sporadic weather between quarter two and quarter three being the biggest contributor to this volatility.
It is also worthy to note that development of real estate market continues to significantly affect the land under tea and coffee production despite the increase in the total production posted in quarter three of 2015. There is therefore the need for government intervention to formulate policies that will delineate agricultural land from settlement lands if the future of major exports is to be guaranteed in addition to food security.

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 declined in the third quarter to 30,623 MT in July 2015 before declining in August to 27,687.46 MT and thereafter significantly increasing to 33,528.09 MT by the end of September. This improvement is attributed to the improved international prices of tea within the quarter. On the contrary, the quantity of coffee being exported continuously declined throughout the quarter from a high of 2,068.09 MT in June to a low of 1,617.40 MT as at the end of September 2015. The declined is evidences on monthly basis within the sector where July recoded a decline in production to stand at 1,942.96 MT against 2,068.09 MT in June, and further declining in August to stand at 1,790.29 MT and further declining to 1,617.40 MT in September. The total value from tea exports for the entire quarter three was Ksh 31,040.02
Million against Ksh. 25,957.60 million in quartet two. On the other hand, total value from coffee exports for quarter three stood at Ksh. 5,350.65 million against Kshs. 6,204.35 million in quarter two of 2015.

On horticultural exports (Figure 9), in terms of quantity exported in quarter three of 2015, cut flowers dominate this subsector contributing on average 48.20 percent of total quantity of horticultural exports for July and August 2015, followed by fruits at 28.01 percent with vegetables exports recording the lowest contribution of 23.79 percent. Looking at the foreign exchange earned from horticultural exports, cut flowers dominate this subsector contributing on average 69 percent of total horticultural exports value for July and August 2015, followed by vegetables at 20.60 percent with fruits exports recording the lowest contribution of 10.41 percent.

Figure 9: Horticultural Exports Jan 2013 – June 2015
Manufacturing

The manufacturing sector in Kenya is poised as 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 third quarter of 2015 increased slightly over quarter two production to an overall total of 1,681,706 MT compared to 1,527,911 MT in the second quarter. Similarly, cement consumption in the third quarter of 2015 increased from an overall consumption of 1,419,304 MT in quarter two to 1,443,544 MT in quarter three of 2015 giving a clear indication on the increased growth in the real estate sector. However there was a fall in the production of galvanized sheets from 23,268 MT in June to 21,170 MT by the end of July 2015. The reduction in production may have been accessioned by the increase input prices due to the weakening of the Kenyan shilling over the period.

There was an increase in milk consumption starting from the beginning of the third quarter, from 43,400 million liters in June to a high of 49,700 million liters as at the end of July 2015; this was occasioned by fall in

Figure 10: Production and Consumption of Manufacturing

Source KNBS
Milk production: The Dairy industry has seen an increase in consumption of milk products ocassioned by a fall in prices due to the onset of the El-Nino rains in quarter 2. Photo/Lydur Skulason

prices following increased production arising for the good rains for in quarter two. However the overall milk consumption fell to 39,900 million litres in August 2015 this reduced demand is due to the rise in the milk prices over the period caused by reduced production occasioned by the hard dry conditions experienced in the month of August. Despite the policy consideration to support the sector, the desired outcomes of the policy are likely to be realized with time lag. The number of assembled vehicles assembled slightly increased in the beginning of the quarter from 764 vehicles in June to 778 vehicles as at the end of July and further to 849 vehicles in August in 2015. This overall increase show the renewed interest by local investors and also foreign investors to set up assembly shops in Kenya so as to provide the service for the Kenyan market and the larger East African community.

Energy

There has been continues concerted efforts to boosts energy production so as to meet the growing demand for energy by the growing economy. There is continues shift from the traditional 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 has continued to lead the way in adding to the total energy production and hydro production, though significant, continues to relatively drop. The commissioning of an additional geothermal power plant adding 140 megawatts to the national grid will cement the shift even further; this will make power costs go down by 30 percent.

The third quarter of 2015 saw a significant increase in total energy production from 2,297.26 million KWh in the second quarter of 2015 to 2,403.28 million KWh in the third quarter; - a 4.62 percent increase. While there was increase in all energy production forms within the quarter with hydro production increasing by 67.65 million KWh from 862.55 million KWh in quarter two to 930.2 million KWh in quarter three. Geo – thermal production rose by 17.87 from 1,101.74 million KWh in quarter two to 1119.61 million KWh in quarter three three while thermal production increasing by 20.5 million KWh from 332.97 million KWh in quarter two to 353.47 million KWh in quarter three (Figure 11). The rise in inter quarterly geothermal production could be mainly attributed to government’s effort 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 has 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.
The monthly power loses declined in the third quarter of 2015 from 182.86 KW million in July to 105.63 KW million in August and a further significant decline to 46.32 KW million as at the end of September.

There was a world oil price in quarter three of 2015 due to the continued fall. The crude oil prices declined from $63.70 per barrel in June to $67.70 per barrel in July then falling significantly in June to close at an average of $48.85 per barrel in August and further to a low of $46.60 per barrel as at September 2015 (Table 1). As stated in the last review the failure to agree among the OPEC member countries to cut down on oil production saw the existence of glut in the market, however since then, driven by the demand for the cheap oil in the market and essentially the strengthening of the dollar, the prices of oil have not risen as it was expected. The slow down in the growth prospect among the have not created enough demand to cause the prices surge up.

### Table 1: Crude Oil and Fuel Import Prices

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<tr>
<td>Murban crude oil (SSF/Barrel)</td>
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<td>60.55</td>
<td>65.75</td>
<td>63.70</td>
<td>57.70</td>
<td>48.85</td>
<td>46.60</td>
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<td>Super petrol (KES/Litre)</td>
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<td>90.22</td>
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<td>98.14</td>
<td>99.45</td>
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<td>85.51</td>
<td>84.30</td>
<td>80.94</td>
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<tr>
<td>Kerosene (KES/Litre)</td>
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<td>62.73</td>
<td>63.69</td>
<td>58.94</td>
<td>53.52</td>
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<tr>
<td>LPG (13Kgs)</td>
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<td>2,529.56</td>
<td>2,424.69</td>
<td>2,387.04</td>
<td>2,376.22</td>
<td>2,374.92</td>
<td>2,393.8</td>
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Source: ERC

### Figure 11: Electricity Generation by source (Million KWh), Jan 2013 – Sep 2015

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.
The reverse of a commodity boom in the oil market was seen to have substantially affected the oil producers negatively. The effect of the low world oil prices have began to be felt in Kenya quarter three of 2015 but with the changing tides in the third quarter given the weakening shilling which has increased the oil import bills, as well as the widening deficit in the current account since we are exclusive importers of petroleum products. The evidence is in the increased pump prices across board for all petroleum products given the inelasticity in price demand for oil.

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 experience a mild growth from the third quarter of 2015. The overall demand for cement increased from 1,419,304 MT in the second quarter to 1,443,544 MT in the third quarter of the year, an increase of 1.71 percent. The overall rise in the cement consumption arises from increased demand for construction 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. On the monthly basis within the quarter, the trend of increasing cement demand is evidenced with demand rising from 451,461 MT in July to 478,011 MT in August and further to 514,072 MT in September 2015.

Transport and Communication

The total number of registered vehicles in Kenya recorded mixed performance in the third quarter of 2015 looking at the month — on — month growth. Between the month of July and July total number of newly registered vehicles declined from 25,070 to 21,133; a 15.70 percent growth. However, August saw a significant decline in the newly

Figure 12: Cement Production and Consumption, MTs

Source: KNBS
registered vehicles to stand at 17,365 vehicles before slightly increasing to 18,596 vehicles as at the end of September 2015. On quarterly basis the total number of the newly registered vehicles in the third quarter was 57,094 vehicles against 68,637 vehicles in quarter two (Figure 13).

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

**Tourism**

For the entire of quarter three of 2015, tourism performance continued to be below its potential performance mainly due to negative shock arising from the travel advisories by the foreign agencies mainly from United States, United Kingdom, France and Australia arising from the insecurity threats in the country. However, there are some prospects of recovery with some countries lifting their travel advisories. Looking at the number of visitors arrivals via the JKIA and Moi international airport, the JKIA arrivals significantly increased from a total of 160,564 visitors in quarter two of 2015 to 190,009 visitors in quarter three of 2015; - a 18.34 per cent quarterly rise. However despite this quarterly rise, a review of the quarter indicate a significant improvement in the JKIA visitors’ arrivals with the numbers rising from 59,867 in June 2015, to 72,515 visitors in July but declining to 63,332 visitors in August and further to a low of 54,162 visitors in September 2015.
Turning in to the government expenditure, the total expenditure for July and August 2015 stood at Ksh 0.216 billion. This was low given that it was just the beginning of the new financial year for the government following the reading of the 2015/2016 budget. Of this, the recurrent expenditure dominated the total expenditure accounting for 83.85 per cent while the development expenditure accounted for 16.15 per cent of the total expenditure for July – August 2015. 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 them mainly goes to recurrent expenditure. Between July and August 2015, the total development expenditure grew from Ksh 5,156 million in July to Ksh 29,773 million in August. This is attributed to the rolling out of various ongoing development projects mainly the physical infrastructure in the road transport networks, the standard gauge railway and airport expansion among others.

Looking to the arrival through the Moi International Airport the quarterly total arrivals significantly improved from 9,749 visitors in quarter two of 2015 to 18,388 visitors in quarter three of 2015; - an 88.62 per cent increase. 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 3,218 visitors in June to 5,728 in July and further to 5,114 visitors as at the end of September.

**Financing of Government**

Looking at the government revenues, the total revenue for the third quarter of 2015 stood at Ksh 243,399 million for the month of July and August 2015 combined. Of this, the total tax revenue accounted for 90.29 per cent of the July – August 2015 revenue in quarter three with the non – tax revenue accounting for 9.71 per cent. Of the tax revenue, income tax topped the list at 43.46 percent followed by value added tax at 27.21 per cent with excise duty and import duty coming third and fourth at 12.01 per cent and 7.61 per cent respectively for July – August 2015

**Public Debt**

During the third quarter of 2015, the total monthly public debt was Kshs 1.388 billion as at the end of September 2015. Looking at the July – September period, it’s evident that the public debt declined from Ksh 2.89 billion in July to Ksh 1.388 billion as at the end of September 2015. This was largely contributed by the government shying away from the external borrowing which is evidenced by zero external borrowing in the months of August and September 2015. However, domestic borrowing was Ksh. 1.418 billion in July, Ksh 1.403 billion in August and Ksh. 1.388 billion in September. As such domestic borrowing accounted for 100 percent of the total public debt for the months of Augusts and September 2015. The third quarter of 2015 saw the increase in the government’s domestic borrowing to finance the budget deficit thus shocking the credit market negatively via increased short term interest rates mainly the 91 – Treasury bill rates.
Government treasury bonds including the government frozen debt remained the key money market instruments intensively utilized by the government in domestic borrowing accounting for 74.51 percent of the total government debt for quarter three of 2015 against 72.30 per cent of the total government debt for quarter two of 2015. Treasury bills, overdrafts and advances on the other hand accounted for 22.13%, 3.18% and 0.17% respectively of total government debt for the entire of quarter three of 2015 against 25.47%, 2.06% and 0.02% respectively of total government debt for the entire of quarter two of 2015 (Figure 17).

![Figure 17: Composition of Domestic Debt](image)

In the second quarter of 2015, the monthly total money supply recorded a negative growth of 0.11 percent in July before a positive growth of 0.82 percent in August and further a negative growth of 0.26 percent in September (Figure 18). A comparison on the third quarter to the second quarter reveals that M1 money grew by 0.90 percent while M2 grew by 1.98 percent. On the other hand, the broad money supply increased by 2.26 percent.

![Figure 18: Money Supply (KES Million)](image)

**Inflation**

The in the month –on – month inflation rates for quarter three of 2015 was on downward trend, a reverse of the second quarter trend through with minimal decrease (Figure 19). The first month of the quarter started with a decline in the overall month — on — month inflation rates hitting a low of 6.62 percent in July against 7.02 percent in June. This 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. The trend was replicated in August with inflation declining further to the high 5.84 percent. However in September inflationary pressures set into marginally rise to 5.97 percent. However in September inflationary pressures set into marginally rise to 5.97 percent. As at the end of the quarter, the quarterly average inflation rates for quarter three stood at 6.14 percent; - a 12.11 percent fall compared to the quarter one average inflation rate of 6.99 percent in quarter two. The fall in the inflation rates in quarter three of 2015 is largely attributed to the stabilization in the macroeconomic environment.
experienced towards the end of quarter three especially the stabilization in the exchange rates following the rise in the bank rate from 10 percent to 11.50 percent in the beginning of the third quarter.

**Figure 19: Inflation rate (%)**

A look at the non-food non-fuel inflation (NFNF) which measures the effects of the monetary policy stance indicate that in July 2015, it rose from 4.2 percent in June to 4.6 percent in July and further to 4.7 percent in August. This implies a demand driven inflation between June and August 2015. This probed the change in the monetary policy stance by the Central bank through an upward revision in the central bank rate from 10.00 percent to 11.50 percent in beginning of the third quarter. However, the rate slightly declined to 4.5 percent as at the end of September 2015. The slight fall in the NFNF inflation rates could be partly be seen as arising from the outcome of increased central bank in the beginning of the quarter.

**Interest Rates**

Interest rates have largely been unstable during the third quarter of 2015 (Figure 20). This was on the back of monetary policy an upward revision in the central bank rate and the Kenya Banks Reference Rate (KBRR) which ultimately lend into the increase in the lending rates via increased base rate. Secondly the increased government’s domestic borrowing to finance the short term budget deficits saw the 91 – day Treasury bill rates rise significantly in quarter three which directly impacted on the lending base rates.

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 a month average rate of 11.54 percent as at August from a low of 8.26 percent in June 2015: – a 39.71 percent rise.

The cumulative average weighted lending rates mildly increased from 15.48 percent in June to 15.75 percent in July2015 and further declining to 15.68 as at the end of August 2015. 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 financial market still remained illiquid for the entire quarter three 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.

The interbank rates recorded a significant upward shift from 11.78 percent in June 2015 to 18.49 percent by August 2015 a 56.96 percent rise within the quarter. This implies increased 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 three.

**Balance of Payments**

In the third quarter of 2015, the volume of trade went up from Ksh 180.8 billion in August 2015 to Ksh 188.7 billion in September 2015. The total value of exports fell to Ksh 49.9 billion. The value of imports expanded from Ksh 125.7 billion in August 2015 to Ksh 138.7 billion in September 2015.

Domestic exports by Broad Economic Category (BEC) indicated that food and beverages was the main export category in September 2015 accounting for 42.2 per cent of exports, while the value of non-food industrial supplies and consumer goods not elsewhere specified registered 23.7 and 25.1 per cent shares, respectively. BEC imports indicate that industrial supplies (non-food) was the main import category in September 2015 with a share of 36.2 per cent, while the values of
fuel and lubricants, machinery & other capital equipment and transport equipment registered shares of 11.6, 19.7 and 15.6 per cent respectively. Food and beverage recorded a share of 7.5 per cent while consumer goods not elsewhere specified recorded a share of 8.2 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.

Out of the major selected exports, tea exports topped the list accounting for 20.18 percent of the total exports for July and August 2015. Horticulture came second at 14.89 percent with chemicals and coffee accounting for 9.41 percent and 3.84 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 37.65 percent of Kenya’s total exports for July and August 2015 followed by Tanzania at 10.37 percent with Rwanda closing third at 8.60 percent. For the major imports within the African market, imports from South Africa accounted for 43.85 percent for July and August 2015 followed by Egypt at 15.99 percent with Tanzania coming third at 14.04 percent.

Looking at the Kenya exports destinations globally for April and May 2015, Uganda topped at 16.20 percent followed closely by USA 8.14 with coming third Netherlands at 7.31 percent. United Kingdom, Tanzania and Pakistan follow each other at 7.03, 4.64 and 4.21 percent respectively.

Turning into the overall monthly trade balance, it’s evident that while the monthly trade balance worsened from Ksh. 80,638 million in June 2015 to Ksh. 84,748 million as at the end of July 2015. This could be mainly attributed to the decline in 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. In addition 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 three of 2015. However, the trade balance improved in August to Ksh. 70,621 million. This could be attributed to the stabilization in the shilling from mid-August towards the end of the quarter upon the adoption of tightening monetary policy to caution the shilling against further depreciation.

**Exchange Rate**

In the third quarter the shilling continued its losing streak against the hard currencies moving from an average of US/KES 101.2 in July to US/KES 105.27 at the end of September. 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 depreciation the shilling has caused Kenya to lose its competitiveness in the world market. However, towards the end of the quarter, the shilling showed some aspects of stability against the dollar.

Against the Sterling the shilling depreciated by about 2.442 percent for July — September period. This could be attributed to the reduced competitive nature of the Kenyan economy and the fact that investors have positive sentiment about the British economy and most of Europe. European economy may be getting out of the deflation it has been experiencing causing more depreciation pressure on the shilling. We also see that the Kenyan shilling has in overall lost ground against the Euro. 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 third 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.

![Figure 21: Overall trade balance and exchange rate](image1)

![Figure 22: Nominal Exchange Rate](image2)
The Kenyan shilling has behaved considerably well against its East African counterparts despite its weak turn against the majors. However, this can be attributed to the weak performance of the other economies in the region as well.

**Nairobi Securities Exchange**

During the third quarter of 2015 the stock market continued to post poor performance as evidenced in the successive months indices. The NSE – All Share index shed 10.21 percent from 4906 in June to 4405 in July 2015 and further declining to 4176 points in August before settling at a low of 4173 point as at the end of September.

The dismal performance can be attributed to bearish behaviour in the market, driven majorly by the foreign investors. We can see from the figures that the foreign investor activity increased considerably over the quarter from which was above 70 percent on average. Foreign investor bearish sentiments, driven chiefly by the uncertainty of the Kenyan shilling performance, liquidity tightening in the Kenyan market and improved market outlook of the more developed stock exchanges like the Nigerian and the South African stock exchange has caused the NSE capitalization to also fall consistently throughout the quarter, from an average high of KES 2,302 billion in June to a low of 2,063 Billion in September. The local investors are also feeling a bit jittery about the market and perhaps one may see it as investors consolidating so as to see the direction that the market would take when the Kenyan shilling performance improves.

### Table 2: Nairobi Securities Exchange Market Indicators

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<tbody>
<tr>
<td>NSE 20 Share Index 100 = 1966</td>
<td>5,091</td>
<td>4788</td>
<td>4906</td>
<td>4405</td>
<td>4176</td>
<td>4173</td>
</tr>
<tr>
<td>NSE All Share Index (NASI) 100=2008</td>
<td>173</td>
<td>162</td>
<td>164</td>
<td>140</td>
<td>143</td>
<td>147</td>
</tr>
<tr>
<td>Market Capitalization (KES. Bn)</td>
<td>2430</td>
<td>2341</td>
<td>2302</td>
<td>2270</td>
<td>2005</td>
<td>2063</td>
</tr>
<tr>
<td>Total Shares Traded (Million)</td>
<td>488.0</td>
<td>684.0</td>
<td>681.0</td>
<td>715.0</td>
<td>734.0</td>
<td>434.0</td>
</tr>
<tr>
<td>No. of Equity Transactions</td>
<td>36148</td>
<td>35782</td>
<td>33367</td>
<td>33598</td>
<td>31973</td>
<td>30706</td>
</tr>
<tr>
<td>Equity Turnover (ET) KES. million</td>
<td>14,642</td>
<td>21,331</td>
<td>24,251</td>
<td>21,554</td>
<td>20,792</td>
<td>14,375</td>
</tr>
<tr>
<td>Bonds Turnover (KES. Bn)</td>
<td>25.38</td>
<td>22.34</td>
<td>12.18</td>
<td>12.40</td>
<td>18.42</td>
<td>13.69</td>
</tr>
<tr>
<td>Percent of Foreign Participation to ET</td>
<td>56.06</td>
<td>62.70</td>
<td>73.74</td>
<td>70.13</td>
<td>79.63</td>
<td>61.95</td>
</tr>
</tbody>
</table>

Source: NSE, Monthly Trading Report
The NSE All share index fell as well from 164 points in June to 140 points in July before marginally rising to 147 points as at the end of September 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.

In the fixed income segment, the bond market performed dismally in the third quarter of 2015. The bond turnover having fallen drastically from KES 18.42 billion at the end of the August to an average KES 13.69 billion in September. The poor performance of both the equity and bond market despite of them supposed to perform in contrast, is a clear indication that the capital market has been in deed performing poorly.

Banking Industry Performance

A highlight of the credit survey in the banking industry for quarter three of 2015 posits the ratio of total loans to total assets for the industry grew slightly from 61.38 percent in 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 2013. 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 asset 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 percent 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.
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 shareholders’ 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.

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 caution against the rise in the non—performing loans in the event of a rise in the cost of credit.

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.
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 billion 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 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 new branches while at the same time retaining their market shared using the agency banking model.
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– Newsweek