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The Centre for Research on Financial Markets and Policy®
About this Report

This Bulletin reviews the performance of the Kenyan economy for the first half of 2019, drawing on the performance of recent past months as well as current developments to provide perspectives on the outlook for 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.
From the CEO’s Desk

It is my pleasure to present to you the 25th issue of the Kenya Bankers Economic Bulletin. In this issue, we discuss the state of the Kenyan economy during the first half of the year. 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.

Much of the discussions during the period are largely a reflection of the outcomes of the various sectors of the economy and how they have been influenced by the broader risks that the economy has faced, both at the local and international front.

Noteworthy is the observation that much as the Kenyan economy is on a strong growth footing, the external risks are weighing in on the ability to consolidate the economy’s external position at a time when the domestic balance - the need for the Government to undertake fiscal consolidation - is under focus.

The outturn at the broader economic front and in various markets highlighted in this Bulletin should admittedly be seen with the lens of how both legislation and the broader economic policy thrust will shape the economy going forward.

It is my hope that you will find this issue of the Kenya Bankers Economic Bulletin interesting and useful. We welcome feedback on the content of this Bulletin as we continually seek to improve its relevance to you. You can send your feedback to Bulletin’s Editor at research@kba.co.ke

Dr. Habil Olaka
Chief Executive Officer,
Kenya Bankers Association
By Jared Osoro

By the real output growth measure, the performance of the Kenyan economy for first half of 2019 could be assessed as good. But according to the Kenya National Bureau of Statistics (KNBS) it doesn’t measure to the 2018 performance.

The KNBS Quarterly Gross Domestic Product (GDP) Report of June 2019 indicates that the first quarter of the year was characterized by “notably” subdued economic activity, with the economy expanding by 5.6 percent compared to 6.5 percent in the corresponding quarter of 2018.

If the first quarter is a harbinger for the year’s performance, then the downward revision of the growth forecast by many agencies is justifiable. But even the most pessimistic forecasts put the real growth for 2019 at least 5.8 percent. Assuming that the economy outperforms the pessimists, what does that mean to its various segments — enterprises, households and the government — from both an investment and consumption standpoint?

The backdrop against which an answer to that question will be motivated is arguably a representation of a stark contrast between domestic optimism and external pessimism. One of the underpinnings of the domestic optimism is the prevailing sense of macroeconomic stability. Inflation is within the target range, and the exchange rate depicts broad stability (Figure 1).
Rubber and Road

Amidst the domestic optimism is a wide sense of skepticism regarding the impressive growth amidst macroeconomic stability and its nexus with satisfied business and household class on the one hand, and the output performance as an enabler of government to be an agent of welfare maximization on the other. The rubber meets the road when the inspiration of the skepticism is a January 25, 2018 viral tweet by Akinwumi Adesina, president of the African Development Bank, that “nobody eats GDP”.

Ideally, the observed stability and positive output growth sentiments should reflect itself in strong households and enterprise demand. But that is hardly the situation. Weak household demand is reflected in the near muted core inflation. The inflationary expectations are often linked to food prices as would be influenced by weather conditions, and energy costs as influenced by electricity prices on the back of reduced reliance on expensive power sources.

Subdued demand is equally evident on the enterprise side. While the credit market has remained slow on the back of the challenges associated with the Banking (Amendment) Act 2016 (supply side), the deteriorating quality of bank assets reflects weaknesses at enterprise level that affects their ability to meet financier’s obligations.

With the ratio of gross non-performing loans (NPLs) to gross loans standing at 12.7 percent in June compared to 12.9 percent in April, it could seem that recovery efforts by banks are yielding positive results. The broader picture though is that the current NPLs position presents a progressive build-up that reflects the fact that enterprises are operating sub-optimally (KBA, 2019).

If one assumes normal circumstances, weak demand is addressed by a monetary policy that is accommodative. I could argue that monetary policy has largely been accommodative (Figure 2) and described as appropriately so (IMF, 2018). But even those who deem the policy to be appropriately accommodative are quick to add that the CBR “has lost its signaling role as interest rate controls have weakened the link between the CBR and bank lending and deposit rates”.

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The assumption of normalcy is therefore obviously limiting, and this is implicitly acknowledged by the policy makers who, in pursuit of an accommodative stance are quick to throw in sufficient caution of potential adverse effects. On that basis, the appropriateness of the monetary policy decision will be judged upon first, not upsetting the macro-stability even when the ability to stimulate demand is constrained; and two, the ability to support market stability as could be reflected in for instance the foreign exchange market (to obviate volatility) as well as money markets (to ensure that it doesn’t signal price movements that can affect cost of funds for government — the fiscal policy angle).

The fiscal angle to the growth and stability story only makes sense if the two key macro policies are in harmony. If as observed monetary policy is sufficiently accommodative then the fiscal policy is sufficiently expansionary – albeit on the back of a move towards fiscal consolidation. My read of the 2019/20 fiscal year budget leads to three observations:

a. The path to full realization of the fiscal consolidation targets will be slower than projected. The revenue targets — consistently missed in previous projections — still face the same challenges, and more so now that the private sector is facing demand challenges as already outlined.

b. Whilst the ideal strategy of fiscal consolidation is a balance between enhanced revenue mobilization and expenditure rationalization, the initial strategy is apparently expenditure leaning. Government expenditure has been a key growth driver, thus any expenditure cuts — especially of investment type — will undermine the economy’s capacity enhancement.

c. Based on the above two, the Government will remain active in the market. The cost of doing so has to be borne in mind especially as the issue of public debt and its sustainability remains in the fore.

It’s Wobbly Out There

Based on what I outline above, the domestic circumstances need a careful watching. The external environment needs even a more careful watching. The worries about the global economy are getting louder by the day. The IMF’s flagship publication, the World Economic Outlook (WEO), had expressed its gloomy projection of the global economy in its April 2019 edition. Its latest update (July 2019) represents a further downward revision of its growth outlook. At the center of this review is the global trade conditions in view of the trade war between the US and China.

Just as the trade war will affect output, it too is likely to affect global financial flows to the disadvantage of emerging and frontier countries. The initial filtering of the trade war into the financial markets is by way of how markets perceive US producers with significant exposure to Chinese markets and they reflect that in stock market valuations.

Figure 2: Monetary Policy Stance – Central Bank Rate (CBR)

Source: CBK

As Cerutti et al., (2019) observe, the equity price performance of US companies with high sales to China underperformed relative to US businesses exposed to other international markets, after tariffs linked to the USD 34 billion retaliation list by China were implemented. They note that the performance gap narrowed at the beginning of 2019 with a potential trade truce but reopened again after the US tariff increased to 25 percent on the USD 200 billion list was announced.

Arguably, the biggest influence of the trade war on financial flows is hinged on the likely policy response to market behavior. The Federal Reserve has clearly changed course from the anticipated rate hikes in 2019, instead holding the rates in March and June 2019. The reason for that is the gloomy global economic outlook pinned on the inability of the US and China to strike a deal regarding the ongoing trade war. Beyond the equities market the pain of the trade war could be inferred from the decline in the 10-year US Treasury yields as investors anticipate a rate cut and flee for safety (Figure 3).

The response of the Fed is to be seen in the context of the debate as to whether it responds in a manner that gives the notion that its monetary policy stance is influenced by traders — and politicians too seeking a rate cut — or it should stick to a policy direction as would be informed only by the backward-looking economic data that moves slowly.

Figure 3: 10-Year US Treasury Constant Maturity Rates

Source: Federal Reserve

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If the Fed listen to the markets even as it looks at the hard data on growth and inflation, then we are seeking a possibility of a lower interest rates regime — which prevails too at the Eurozone as signaled by the European Central Bank (ECB) in the face of economic challenges in Europe as well as the Bank of England (BOE) in the face of uncertainty over Brexit as a new admiration takes over.

Does this then imply that the trade-war triggered low interest rates regime will lead to portfolio flows to emerging as well as frontier markets as was the case during the 2007 – 2008 global financial crisis and the subsequent period? Superficially, it you take the largely positive short-term spreads between market rates and policy rates in the case of a frontier market such as Kenya compared to the spreads for the same tenor of market rates versus policy rates that are largely negative (Figure 4), then you could expect resource flows to the former from the latter.

However, the clearer picture is seen by looking beyond the superficial implication of positive interest rates differential in favour of emerging and frontier markets. In particular, the role that China will play in the global financial markets going forward is important to appreciate. Just as China is stamping its authority in its influence on the global output, its stature in the global financial space is now noticeable.
Effective October 1, 2016, the Chinese renminbi (RMB) met the criteria for inclusion in the IMF’s Special Drawing Rights (SDR) basket – joining the USD, the euro, the Japanese yen, and the British pound sterling. The SDR basket is reviewed every five years, or earlier if necessary, to ensure that it reflects the relative importance of currencies in the world’s trading and financial systems.

Most notably, China is systematically embedding itself into the global financial markets in a manner that will influence overseas investment, improved liquidity, better governance, and a lead to broader range of instruments. There is a deliberate endeavor to include Chinese stocks and bonds in several global financial-market indices. As Chinese securities are added, investors seeking to match or surpass the returns of the indices will adjust their portfolios to include Chinese stocks and bonds. Thanks to these benchmark-driven asset managers, China’s portfolio flows, are being globalized.

Over the past half a decade, foreign ownership of Chinese government bonds has quadrupled (Chen, Drakopoulos and...
Goel, 2019). Ownership of onshore equities has also increased but remains low compared with other emerging markets. As Chen, et al (2019) argue, this trend of rising foreign ownership is likely to accelerate further.

Evidence to that effect is in the move in April 2019, to include two types of Chinese bonds in the Bloomberg Barclays Global Aggregate Index—local currency-denominated bonds issued by the central government and by state-owned policy banks such as China Development Bank. It is anticipated too that there will be an inclusion of Chinese bonds and equities into FTSE and JP Morgan indexes, a move that will substantially boost portfolio inflows into the economy.

These developments have the real possibility of seeing investors reducing the purchases of other emerging-market assets as they undertake portfolio rebalancing to reflect China’s inclusion. This will be especially so in cases where benchmark-driven holdings constitute a significant amount of their foreign debt.

Cognizant that benchmark-driven investors tend to be more sensitive to changes in global financial conditions than other investors, their greater role in international finance may mean that external shocks propagate to medium-sized emerging and frontier market economies faster than in the past. Even as China has been labelled a “currency manipulator” on account of the renminbi depreciation, an impossible trinity confronts the US: it can not have a strong economy, a trade wars and a weak dollar.

All Said…

All said, the case for a careful watch of the global scene is compelling. And as we do so, and especially as we reflect on how it filters into the local economy, its makes sense to have a deep reflection on how that will influence our external position as an economy.

Jared Osoro is the Director of the KBA Centre for Research on Financial Markets and Policy®

“Even as China has been labelled a “currency manipulator” on account of the renminbi depreciation, an impossible trinity confronts the US: it can not have a strong economy, a trade wars and a weak dollar.”
State of the Economy

Economic growth was subdued and the lowest in quarter four of 2018 having grown by 5.9 percent compared to 6.4 percent in quarter three of 2018 and 6.3 percent in quarter two (Figure 5). The slow down in reflects the muted growth in the key sectors of the economy and more importantly agriculture and manufacturing sector.

The growth within the agriculture sector declined by 300 basis points to grow at 3.9 percent in quarter four of 2018 compared to a 6.9 percent growth registered in quarter three. The slowdown was further exacerbated by a 1.7 percent slowdown in the manufacturing sector which grew by 3.1 percent in quarter four compared to 4.8 percent in quarter three. Similarly, other sectors that contributed to the contraction in the growth were tax revenues which contracted by 1.3 percent and the real estate and health sector whose growth dipped by 1 percent and 1.5 percent respectively.

Despite the muted growth in quarter four of 2018, the economy grew by 6.3 percent in 2018. Kenya’s growth outlook for 2019 is expected to grow at 5.7 percent according to the World Bank’s estimates with the outlook being subject to several downside risks both external and internal headwinds. On the external front, a number of factors including banking sector vulnerabilities, and more importantly the elevated nonperforming loan (NPL) ratios.

**Figure 5: Kenya’s Quarterly Economic Growth Rates – 2009 Base year**

![GDP growth chart](image-url)
From the macroeconomic front, the key macroeconomic indicators were robust. The rate of credit growth to the private sector improved marginally though remains lower than the anticipated rate of between 7 percent to 10 percent enough to support the economy’s projected growth, and well below the historical levels of 15 percent - 20 percent of the period 2012 to the beginning of 2016.

Additional downside risks to growth recovery momentum are rising credit risks reflected in a sharp increase in non-performing loans and persistent decline in credit to the private sector.

Although the banking system has been generally stable, with adequate capital and liquidity buffers, non-performing loan ratios remain elevated (estimated at 12.8 percent by March 2019) which was due to the faster growth in non-performing loans relative to credit growth during the quarter while asset growth remained elevated. This development continues to inform the risk appetite of the market, with the lender taking more caution especially now that they are constrained by the capping law in pricing risk.

Loan-to-deposit ratios (LDRs), the ratio of a bank’s outstanding loans for a period to its total deposit balance over the same period, has been steadily declining, though episodes of slight uptick were evident before normalcy set in and generally the LDRs ratio continues to be within the 80-90 percent threshold an indication of the combination of prudence and regulatory requirements in the industry.

Similarly, on the frontline has been the accommodative monetary policy to the extent that the month-on-month inflation rate is under control and within the central bank’s target range of 2.5 - 7.5.

Overall, the Central Bank of Kenya (CBK) has for the last three quarters since quarter three of 2018 to quarter one of 2019 has maintained its signalling policy rate at 900 basis points. In
response, the interbank, the weighted average lending and the deposit rates have been declining. Where there was a marginal decline in average lending rates, it was matched by a reduction in average deposit rates of almost the same proportion, leaving interest rates spread moderately unchanged. Similarly, the interest rates were stable, with the 91 – Treasury bill rates and the interbank market rates co-evolving together though with some lags in their movements. Despite, the co-evolution both rates appear to be stabilizing.

The overall inflation rate remained within the government medium-term target of 5 percent (+/- 250 basis points and broadly stable though food inflation showed signs of an uptick in part due to reduced food supply because delayed rains that led to a rise in food prices. On the other hand, the fuel inflation was on a general downward path while the non-food-non-fuel inflation was muted and stable. The average annual inflation rate stood at 4.67 percent in March 2019, down from 4.68 percent in January 2019, in line with the monetary policy committee decision to retain the bank rate at 9 percent. The single digit inflation during the period under review is attributed to sound monetary policy, low global food prices and generally low global oil prices that impacted positively on domestic energy prices. Nonetheless, food and non-food inflationary pressures seem to be ticking up in the first half of 2019 though

“Despite the stability of the shilling, it remains weak against major global currencies.

![Figure 7: Overall inflation rate stable though food inflation rising but still rose](image-url)

Source: KNBS
still within the target zone which in part can be attributed to the erratic weather patterns that adversely impacted agriculture.

On the currency market, the exchange rate though relatively stable amidst a healthy debate on whether its nominal rate needs to adjust with a relatively lower import bill, strong remittance inflows, a rebound in tourism, and government borrowing in foreign currency continued to support a stable exchange rate market with a moderate appreciation of the Kenyan shilling against the US dollar. Nonetheless, in the last quarter of 2018 and to some extent the first quarter of 2019, both nominal and real exchange rates have tended to appreciate driven by narrowing current account deficit and improving terms of trade.

A further appreciation of the shilling could have implications on Kenya’s export competitiveness in its main export markets. Over the period of January to March 2019, the currencies were subject to depreciation pressure vis-à-vis major international currencies, especially the United States Dollar (USD). Against, the Japanese yen, the shilling for a significant period during the quarter depreciated. Looking at the Chinese Yen and the Euro, the Kenyan shilling depreciated during the first quarter of 2019. On the regional front, the exchange rate volatility was evident though mild.

Debt levels are on a rapid rise amid widening fiscal deficits so is the composition and structure of debt portfolios and is becoming a source of concern to policymakers given its implication for sustainability. The burgeoning debt not only of Kenya but that of other several African countries may be explained by the fact that they currently have better access to international financial markets, as they continue to register robust levels of economic growth over the past decade. In this regard, investors are seeking better yields and higher rates of return based on the perceived risk of investing in the continent (given low-yield asset investment in advanced countries).

Domestic debt and debt markets have also witnessed significant developments at least with respect to the quantum of debt portfolios over the last couple of years. The domestic debt portfolio structure remains static with government securities comprising a major pie of the structure.

Sources of tax remain non-diversified reflecting the static behaviour in tax mobilization efforts with income tax consistently contributing over 40 percent of the total income over the last three years, with the tax revenue being the highest contributor to revenue compared to non-tax revenue as is usually the trend with the previous quarters.

Balance of payment position has improved on account of a narrowing current account position and this is attributed to the better terms of trade and the stability of the shilling against other global and regional currencies. Nonetheless, while the current account balance is characterized by a narrowing it is still within the deficit zone. However, the capital account is deteriorating. Nonetheless, while the current account balance is characterized by a narrowing it is still within the deficit zone. A similar observation can rightly be made of the overall balance which is also closing though still in the deficit zone. Of concern, however, remains to be that of the closure of the current account position which is on the account of reduced importation bill rather than on account of the country’s export sophistication.

“Strong remittance inflows, a rebound in tourism, and government borrowing in foreign currency continued to support a stable exchange rate market.”
Agriculture

The agricultural sector remains the largest contributor to the economy’s GDP and remains central in poverty alleviation as almost half the country’s populace is reliant on it. Over the period 2017 to 2018 the sector’s performance has been stellar having grown from a low of 1.9 percent in 2017 to 6.4 percent in 2018. This growth was on the back of improved weather conditions that saw the increased supply of crops. Further, the growth was also supported by the improvements in the performance of the other sub-sectors of the agricultural sector.

However, the sector’s continued overreliance on rain-fed agriculture poses downside risks with the delayed rains in the first quarter of 2018 will have a direct negative impact on the activities in the sector and also on the economy.

A number of leading indicators in the sector points to a negative outlook and poses a downside risk to growth. First credit to the agriculture according to data from the Central Bank of Kenya shows that it declined by 2.6 percent to Kshs 82.1 billion as at February 2019, accounting for only 3.4 percent of the total amount of credit allocated to the private sector. In terms of tea production, although production in January 2019 was higher than the similar period of 2018, production declined from 51,829.79 MT in December 2018 to 48,386.47 MT in January 2019. Tea prices similarly declined from Kshs 235.55 per kilogram to Kshs 233.94 within the same period (Figure 8).

This, therefore, calls for the need for a more diversified economy that is not over-reliant on the agricultural sector. Whereas, this assertion has consistently continued to feature, efforts are currently in place to revamp the other sectors of the economy though its fruition is yet to be realised. On agricultural exports, the quantity of tea and coffee exported increased in January 2019 relative to December 2018. Statistics from KNBS indicated that the quantity of tea exported increased from 38,680.96 MT in December 2018 to 48,622.81 MT in January 2019, while its value increased from Kshs 9,781.31 million to Kshs 11,831.30

Figure 8: Tea production and prices continued to wane

Source: KNBS
million over the same period. On the other hand, the quantity of coffee exported increased from 2,311.60 Mt in December 2018 to 3,469.39 Mt in January 2019, while its value increased from Kshs 921.53 million to Kshs 1,498.72 million over the same period (Figure 9).

The quantity of cut-flower horticultural exports in December 2018 was 12,928 Mt while its value of exports was Kshs 8,090 million in March 2019, a decline from the previous year. The volume of vegetable exports similarly declined from 8,819 MT in November 2018 to 5,964 MT in December 2018 while the value of vegetable exports increased from Kshs 2,426 million to Kshs 3,253 million over the same period (Figure 10).

### Manufacturing

The manufacturing sector’s performance in 2018 was robust compared to its constrained performance in 2017 having registered a 4.2 percent growth representing a 3.7 percent improvement on a year-on-year basis. In the fourth quarter of 2018, the sector grew by 3.1 percent. The improvement in the sector was partly attributable to agro-processing activities that benefited substantially from increased agricultural production.

Other indicators in the sector such as cement production and consumption at the start of 2019 increased. In terms of credit allocated to the sector, 13.8 percent of the total credit portfolio to the private sector was to the manufacturing sector. Given that its share of credit allocation is among the top five sectors, it is an indication of the prospects of growth for the sector.

On the downside, the high levels of non-performing loans, estimated at 12.8 percent in March 2019 continue not only to constrain lending to the sector but also other sectors of...
the economy. On a month-on-month basis (Figure xxx), credit advanced to the manufacturing sector in January and February 2019 on average grew by 0.88 percent though higher in January (1.73 percent) than in February (0.03 percent) of 2019. Nonetheless, the slow growth registered is an improvement compared to growth in credit to the sector which in the fourth quarter of 2018 had dipped by 1.98 percent. In January credit to the sector was Kshs 330.3 billion which rose to Kshs 336 billion in February 2019. The improved credit growth to the sector in the first two months of 2019 is a clear indication of the positive market sentiments of the sector’s potential which has seen the reallocation of credit among sectors to the extent that the sector being perceived as being less risky compared to the others has seen it attract more credit.

**Producer Price Index**

The producer price index declined by 1.38 percent from 120.78 points in December 2018 to 118.95 in March 2019 (Figure 12). According to the Kenya National Bureau of Statistics, the decline in the producer price index during the quarter was mainly driven by the decline in prices of food products and electricity. The PPI has been its lowest following a rise in the last three quarters of 2018. The decline in the PPI implies that the prices on intermediated goods eased and hence the pass-through effects being ultimately reflected in the reduced consumer price inflation as reflected by the lower rates of inflation which have been on the decline over the first quarter of 2019.

**Figure 11: Credit to the manufacturing sector on an upward growth trajectory in the first quarter of 2019**

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**Figure 12. Producer Price Index in Q1 of 2019 eases further**

Source: KNBS
Energy

The cost of energy remains a critical component not only for the cost of production but also in influencing the cost of living in general. Over a couple of years, huge investments in the energy sector have been undertaken by the government with a view to increasing the country’s energy capacity. However, despite the huge strides, the composition of the energy mix remains largely dominated by geothermal power generation (Figure 13). In February of 2019, geothermal production stood at 374 Megawatts a slight drop from 417 Megawatts generated in January 2019.

Despite, the huge investments in wind energy, Megawatts generated has been volatile though rising over time with 146 Megawatts generated in February 2019 from a low of 75 Megawatts in October 2018. On the other hand, thermal energy contribution to the national grid has also been characterised by high volatility and on a downward path. The volatility in thermal and wind energy generation is an indication of the unreliable nature of this source of energy in the bridging the production gap whenever the hydro production dwindles in the event of harsh weather conditions.

Oil has entered a bear market as fears of an economic downturn mount. In other words, oil market fundamentals are heading in a bearish direction as the oil prices in the last quarter of 2018 and January 2019 have oscillated between USD 79 and USD 61 (Table 1). The price of Murban crude oil decreased from USD 79.0 per barrel in September to USD 61.0 per barrel in January 2019. On the domestic front, the pump prices continued to drop, an indication of the high correlation between the international and domestic oil prices. The domestic retail oil prices of motor gasoline premium (Super petrol) declines from Kshs 118 per litre in September of 2018 to Kshs 105 per litre in January 2019. The price of light diesel oil declined to retail at Kshs 103 in January 2019 while that of Kerosene also declined to retail at Kshs 103 in January 2019 down from Kshs 109 in September 2018 while the price of a 13-Kg cylinder of gas retailed at Kshs 2,193 in January 2019 which is a slight rise compared to Kshs 2,187 it retailed in September 2018.

Table 1: Average Monthly Crude Oil and Retail Fuel Prices

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<th>Jun-18</th>
<th>Jul</th>
<th>Aug</th>
<th>Sep</th>
<th>Oct</th>
<th>Nov</th>
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<tr>
<td>Murban crude oil (US$/Barrel)</td>
<td>73</td>
<td>76</td>
<td>75</td>
<td>79</td>
<td>81</td>
<td>68</td>
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<td>61</td>
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<td>Super petrol (KES/Litre)</td>
<td>110</td>
<td>113</td>
<td>115</td>
<td>118</td>
<td>116</td>
<td>118</td>
<td>114</td>
<td>105</td>
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<tr>
<td>Diesel (KES/Litre)</td>
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<td>109</td>
<td>111</td>
<td>109</td>
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<td>103</td>
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<tr>
<td>Kerosene (KES/Litre)</td>
<td>85</td>
<td>87</td>
<td>86</td>
<td>109</td>
<td>110</td>
<td>109</td>
<td>106</td>
<td>103</td>
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<tr>
<td>LPG (13Kgs)</td>
<td>2171</td>
<td>2176</td>
<td>2177</td>
<td>2187</td>
<td>2186</td>
<td>2141</td>
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Source: KNBS
Building and Construction

In 2018, the building and construction sector registered a slowdown to grow at 6.3 percent relative to a revised estimate of 8.5 percent in 2017. During the fourth quarter of 2018, the sector grew by 7.3 percent slightly higher than the annual average. Despite the lower annual average growth rate, the performance was mainly supported by the government’s continued support to the sector through its policies and programmes geared towards improving infrastructure to spur economic growth.

Some of the policies and programmes in place include the provision of affordable and decent housing, extension of the Standard Gauge Railway (SGR) line from Nairobi to Naivasha and expansion of the road network across the country. Loans and advances from commercial banks to the construction sector grew by 1.8 percent from Kshs 112.0 billion in 2017 to Kshs 114.0 billion in 2018. Credit allocation has been on an upward trend since the beginning of the first quarter of 2019, reversing the downward trend experienced at the end of the fourth quarter in December 2018.

According to the Central Bank of Kenya, credit allocation to this sector stands at Kshs 116.3 Billion as at February 2019 and is higher than the amount of credit allocated to this sector during the same period of the previous year. In addition, other indicators especially cement production and consumption revealed that at the beginning of the first quarter of 2019, both cement production and consumption increased compared to the production and consumption levels in December of 2018 (Figure 14).

"The performance was mainly supported by the government’s continued support to the sector through its policies and programmes geared towards improving infrastructure to spur economic growth."
Transport and Communication

The total number of vehicles registered decreased to 26,706 in November 2018 from 27,623 in October of the same year but was however an increase compared to the same period of the previous year (Figure 15). Despite the decline in the total number of motor vehicles towards the end of the fourth quarter, the number of motorcycles increased to 18,043 and remained the most dominant in the types of motor vehicles.

Tourism

The tourism sector registered improved performance in 2018 mainly attributed to growth in aviation, investor confidence and withdrawal of travel advisories. The robust performance of tourism in 2018 indicates the sector is poised to achieve the set targets by 2020 as contained in the Third Medium Term Plan (MTP III) 2018-2022 which includes; the number of international arrivals rising to 2.1 million; tourism earnings at KSh 145.0 billion and; hotel bed-night occupancy by Kenyans at 5.5 million. During the first quarter of 2019, the number of international visitor arrivals increased to 115,020 in March 2019 from 90,640 in September 2018 but a decline as compared to tourist arrivals in January 2019 which stood at 128,118. Table 2 presents more details on trends in international arrivals.

Table 2: Trends in Visitor Arrivals

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<tbody>
<tr>
<td>JKIA – Nairobi</td>
<td>81,052</td>
<td>83,241</td>
<td>83,097</td>
<td>87,702</td>
<td>112,460</td>
<td>107,060</td>
<td>94,632</td>
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<td>MIA – Mombasa</td>
<td>9,588</td>
<td>12,192</td>
<td>14,948</td>
<td>20,476</td>
<td>15,658</td>
<td>12,864</td>
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<tr>
<td>Visitors Arrival</td>
<td>90,640</td>
<td>95,433</td>
<td>98,045</td>
<td>108,178</td>
<td>128,118</td>
<td>119,924</td>
<td>115,020</td>
</tr>
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</table>

Source: KNBS
Financing of Government

Tax Revenue

Overtly, sources of tax remain non-diversified reflecting the static behaviour in tax mobilization efforts with income tax consistently contributing over 40 percent of the total income over the last three years (Figure xxx), with the tax revenue being the highest contributor to revenue compared to non-tax revenue as is usually the trend with the previous quarters (Figure 16). As for the tax revenue, income tax maintained its dominant contribution accounting for 44.6 percent of the total tax revenue base during the quarter closely followed by value-added tax (VAT) which has been the second in contribution at 31.1 percent while excise and import duty contributed 15.3 percent and 9.0 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 revenue base and coming up with new revenue sources despite the government’s expenditure continuing to rise with the onset of devolution government.

Figure 16: Income tax contribution to the tax base dominant though on a decline

Source: CBK
Recurrent Expenditure

During the quarter, government expenditure exceeded generated revenues signalling the country’s limited ability to effectively mobilize revenue collection. It has fallen short of its revenue collection to the extent that in the past they have had to cut back on development related spending. In a bid to raise its revenues, the fiscal authorities have tried to impose more taxes rather than broadening the tax base to the extent that the taxpayers now feel over-taxed and which is not without implications - of creating a distortionary effect and widening inequality.

On the expenditure side, recurrent expenditure remains elevated, accounting for the highest expenditure compared to non-recurrent expenditure a clear indication that productive expenditure remains constrained (Figure 17). A closer examination of the recurrent expenditure reveals that during quarter three of 2018, salaries accounted for 36.2 percent, while domestic and foreign interest accounted for 16.8 percent and 9.6 percent respective. On the other hand, pensions accounted for 3.6 percent of the total recurrent expenditure during the quarter.

Public Debt

Debt levels are on a rapid rise amid widening fiscal deficits so is the composition and structure of debt portfolios and is becoming a source of concern to policymakers given its implication for sustainability. The burgeoning debt not only of Kenya but that of other several African countries may be explained by the fact that they currently have better access to international financial markets, as they continue to register robust levels of economic growth over the past decade. In this regard, investors are seeking better yields and higher rates of return based on the perceived risk of investing in the continent (given low-yield asset investment in advanced countries).

An analytical breakdown of debt into external and domestic reveal a tight balance with almost an equal share between them (Figure 18). The external debt is especially on the rise and is predominantly related to reduced export revenue, a widening current account deficit and slower economic growth. The composition, terms and conditions of such debt are changing, with higher interest rates and concessional loans as a share of total debt. The structure and composition of debt are therefore relevant to debt sustainability.

Figure 17: Recurrent expenditure composition

![Figure 17: Recurrent expenditure composition](image)

Source: CBK

Figure 18: External debt dominates the country’s debt outlook

![Figure 18: External debt dominates the country’s debt outlook](image)
Domestic debt and debt markets have also witnessed significant developments at least with respect to the quantum of debt portfolios over the last couple of years. The domestic debt portfolio structure remains static with government securities comprising a major pie of the structure.

During the third quarter of 2018, treasury bonds accounted for 60.45 percent, treasury bills accounted for 38.19 percent, overdraft from the Central Bank with a share of 1.03 percent while advances from commercial banks and other domestic debt accounting for 0.30 percent and 0.03 percent respectively (Figure 19). The debt structure as is an indication of the continued skewness and preference of use of government securities and the less-diversified the basket of domestic debt.

With domestic debt playing an increasingly important role, the country will face new risks as the numbers of creditors and debt instruments continue to expand. Owing to its size and swift growth, the consideration of domestic debt will become important in assessing public debt sustainability.

Other concerns about domestic debt accumulation include the following: the expansion of public sector borrowing in domestic markets may crowd out private sector investments, given the shallow financial markets and low levels of domestic savings; and borrowing in the domestic market is often perceived as being inconsistent with the prospects of achieving and preserving public debt sustainability.

### Money supply

The total money supply (broad money), a key indicator for monetary policy formulation has been stable though with modest growth. During the first quarter of 2019, broad money in circulation drop to Kshs. 3,333 Billion in February 2019 from Kshs. 3,344 Billion in January though higher that the money supply in December 2019 which stood at Kshs. 3,337 Billion. On the other hand, the money supply (M1) has been generally

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**Figure 19: On the domestic front, treasury bonds and treasury bills dominate**

<table>
<thead>
<tr>
<th>Component</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Treasury Bonds</td>
<td>60.45%</td>
</tr>
<tr>
<td>Treasury Bills</td>
<td>38.19%</td>
</tr>
<tr>
<td>Overdraft at CBK</td>
<td>1.03%</td>
</tr>
<tr>
<td>Advances from banks</td>
<td>0.30%</td>
</tr>
<tr>
<td>Other domestic debt</td>
<td>0.03%</td>
</tr>
</tbody>
</table>

Source: CBK

**Figure 20: Money Supply**

- **M1**
- **M2**
- **M3 (Broad Money)**
- **% Change**

Source: CBK
stable though in the first two months of 2019 has been characterised by a decline. On the other hand, money supply (M2) grew by has also been declining (Figure 20).

**Inflation Rates**

The cost of living in the first quarter of 2019 remained below the upper bound of the Central Bank target (Figure 21) and broadly stable though food inflation showed signs of an uptick in part due to reduced food supply because of delayed rains that led to a rise in food prices.

On the other hand, the fuel inflation was on a general downward path while the non-food-non-fuel inflation was muted and stable. The average annual inflation rate stood at 4.67 percent in March 2019, down from 4.68 percent in January 2019, in line with the monetary policy committee decision to retain the bank rate at 9 percent, inflation seems well anchored. The low and stable inflation has often been associated with more stable output and employment and more rapid output growth and investment.

However, this view may not in totality adequately reflect the Kenyan scenario as unemployment rates remain elevated. Despite this observation, stable inflation helps protects the purchasing power of household income and wealth and thus going a long way in ensuring financial stability is maintained.

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**Figure 21: Overall inflation rate stable though food inflation rising but still rose**

Source: CBK

Basket of Goods: Food inflation showed signs of an uptick in part due to reduced food supply because of delayed rains that led to a rise in food prices.
Interest Rates

During the first quarter of 2019, interest rates continued to be stable with the interbank and the 91-day treasury bill rates on a decline (Figure 22) while both weighted average lending and deposit rates declining. The average yield rate for the 91-day Treasury bills, a benchmark for the general trend of interest rates, decreased from 7.64 percent in September 2018 to 7.34 percent in December 2018 and further to 7.08 percent in March 2019 partly driven by uncertainty over interest rate direction and high liquidity in the market.

The average interbank rate in September 2018 stood at 4.28 percent which rose to 8.15 percent in December 2018 before further dropping to 3.72 percent in March 2019; the fact that the interbank rate, the rate at liquidity constrained institutions seeks funds from the market and the fact that the deposit rates are high (Figure xxx) leaves financial institutions with less margin to price the credit risk of the borrowers and the cost-of-funds in the form of interbank borrowing and use of liabilities dries up the margin and leaves credit risk not being priced appropriately. Both the weighted average deposit and lending rate seems to converge (Figure 23).

On the one hand, the weighted deposit rates are on a downward path having declined to 7.3 percent in February 2019, down from 7.4 percent in December 2018 and similar to the rate in January 2019 at 7.3 percent. On the other hand, the weighted average lending rates have also been on a decline with the weighted average rates stagnating at 12.5 percent since December 2018 to February 2019. Similarly, the observed trend is an indication of the changing liquidity positions in the banking industry and a constrained liquidity position in December 2018 which since January 2019 has since further eased as indicated by low interbank market rates.

“Income tax maintained its dominant contribution accounting for 44.6 percent of the total tax revenue base during the quarter.”

Figure 22: Month-on-Month Interbank rates and 91-Day TB Rates generally characterised by a decline
Both the weighted average deposit and lending rate seems to converge declining to 7.28 percent in February 2019 down from 7.76 percent in September 2018 while the weighted average lending rates also on a downward trend having from 12.66 percent in September 2018 to 12.5 percent in January 2019 and further down to 12.47 percent in February 2019.

### Balance of Payments

The balance of payment position has improved on account of a narrowing current account position though the capital account is deteriorating (Figure xxx). During the January 2019, the current account deficit narrowed by USD 276 Million and this is attributed to the better terms of trade that eventually contributed to narrowing of current account deficit. In addition, the Kenya Shilling was stable against both the regional and international currencies in the last half of 2018 and the early part of 2019.

In the EAC region, the Kenya shilling appreciated slightly against all the national currencies and the shilling’s overall stability during this period further explains the narrowing of the current account balance. Nonetheless, while the current account balance is characterized by a narrowing it is still within the deficit zone. A similar observation can rightly be made of the overall balance which is also closing though still in the deficit zone. Of concern remains the closure of the current account position xbill rather than on account of the country’s export sophistication. This does not go without say that, the closure of the current account on this front has adverse consequences on the country’s capacity utilisation as a significant portion of the import bill is usually on account of capital equipment’s.

**Figure 23:** In Q1 of 2019 the Weighted lending and deposit rates on a downward trend

![Graph showing Weighted lending and deposit rates on a downward trend](source: CBK)

**Figure 24:** Current Account deficit and Overall Balance deficit continued to narrow as the shilling stabilised

![Graph showing Current Account deficit and Overall Balance deficit narrowing](source: CBK)
Exchange Rates

The Kenyan shilling has remained generally stable with a slight appreciation. A relatively lower import bill, strong remittance inflows, a rebound in tourism, and government borrowing in foreign currency have continued to support a stable exchange rate market with a moderate appreciation of the Kenyan shilling against the US dollar. Nonetheless in the last quarter of 2018 and to some extent the first quarter of 2019, both nominal and real exchange rates have tended to appreciate driven by narrowing current account deficit and improving terms of trade.

A further appreciation of the shilling could have implications on Kenya’s export competitiveness in its main export markets. Over the period January to March 2019, the currencies were subject to depreciation pressure vis-à-vis major international currencies, especially the United States Dollar (USD).

A similar pattern is also evident in relation with the Sterling Pound though not more pronounced compared to the greenback. Against, the Japanese yen, the shilling for a significant period during the quarter depreciated. Looking at the Chinese Yen and the Euro, the Kenyan shilling depreciated during the first quarter of 2019. On the regional front, the exchange rate volatility was evident though mild. The Kenya Shilling is expected to remain stable going forward on account of strong foreign exchange reserves, upward remittances flows, improving exports and stable import bill. However, some downside risks including; faster than projected increase in global oil prices; global trade wars and geopolitical tensions may have adverse impact on the shilling’s evolution going forward.

Figure 25: Exchange rate Developments Across Major Global and Regional Currencies
Stock Market Performance

Kenya's stock market was less vibrant in the first three months of 2019 compared to the first six months of 2018 on account of market sentiments by investors. Nonetheless, the stock market is on a rebound in the first quarter of 2019 compared to the fourth quarter of 2018. In the period up to March 2019, the stock market performance showed signs of recovery as market capitalization was on an upward trajectory compared to the period ending December 2018 (Table 3).

This is clearly manifested by the general uptick of market capitalization from a low of Kshs 2102.0 Billion in December 2018 to a high of Kshs 2,360.5 Billion in March 2019. Similarly, the NASI and the NSE 25 share index outlook was also improved during the same period. In particular, the NASI Index rose by 1.6 points between January and March 2019 compared to 7.7 points decline between September and December 2018. Similarly, the NSE-25 share Index also registered slight improvement in quarter one of 2018.

In particular, the NSE-25 share index rose by 59 points between January and March 2019 compared to 267.6 points decline between September and December 2018. This generally is an indication of recovery of the stock market performance after closing the year 2018 at its lowest point. Turning on to the equity turnover and market capitalization a similar trend is also observed having registered some growth and reflects the improved in investor participation at the bourse.

<table>
<thead>
<tr>
<th>Table 3: Nairobi Securities Exchange Performance</th>
</tr>
</thead>
<tbody>
<tr>
<td>NASI (2008=100) Points</td>
</tr>
<tr>
<td>NSE 25 Share Index</td>
</tr>
<tr>
<td>NSE 20 Share Index (1966=100)</td>
</tr>
<tr>
<td>Number of Shares Traded (Million)</td>
</tr>
<tr>
<td>Equities Turnover (Kshs. Million)</td>
</tr>
<tr>
<td>Market Capitalization (Kshs. Billion)</td>
</tr>
</tbody>
</table>

Source: CBK
Banking Industry Performance

In Quarter one of 2019, the performance of the banking industry was mixed: loan-to-deposit ratio and asset quality continued to weaken while deposits and loans continued to growth though the rate of growth has been relatively muted.

The depressed performance in the industry is certainly attributed to the enactment of the interest rates capping law that has hampered the financial intermediation role of the banking industry and consequently straining the banks in conversion of their liabilities into assets.

Banking Industry’s Total Assets

Rate of growth of the banking industry’s assets decline though in quantum terms it experienced a marginal increase (Figure 26). During the first quarter of 2019, the banking industry’s asset base grew by 0.9 percent compared to 0.2 percent growth registered during the fourth quarter of 2018. This growth being on the back of higher investments in government securities. On the other hand, the rate of growth of total loans increased marginally by 0.2 percent in quarter one of 2019 compared to a 0.4 percent growth registered during quarter four of 2018. The observed decline in credit growth during quarter one of 2019 is attributed to both supply and demand side factors. Demand side factors include; low household demand for credit and weak corporate sector balance sheets as well as cash flow problems that faced many companies.

Overall, these numbers reveal the limited or rather depressed outlook in the industry’s conversion of conversion of banks’ liability into assets as well as the slowdown in the credit creation process as evidenced by the slow growth in the private sector credit by banks in the wake on interest capping.

Figure 26: Evolution of Banking Industry’s Total Assets and Gross Loans

Source: CBK

<table>
<thead>
<tr>
<th>Total Assets (Ksh Billion)</th>
<th>Gross Loans (Ksh Billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>3,000.00</td>
<td>2,200.00</td>
</tr>
<tr>
<td>3,200.00</td>
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<tr>
<td>4,800.00</td>
<td>2,650.00</td>
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</tbody>
</table>
Loan-to-Deposit Ratio and Asset Quality

Asset quality and loan-to-deposit ratios continue to deteriorate despite the muted credit growth. Since quarter three of 2017, Loan-to-deposit ratios (LDRs), the ratio of a bank’s outstanding loans for a period to its total deposit balance over the same period, has been steadily declining (Figure 27) but with some episodes of a slight uptick between the month of August and November 2017 before normalcy was restored and continued to decline until the first quarter of 2019. In March 2019 the LTD stood at 76.0 percent compared to 76.9 percent and 77.2 percent in January and February of 2019 respectively.

This improvement in the ratio is a clear indication of the industry’s liquidity management position and the increasing preparedness to meet unforeseen fund requirements.

On the other hand, despite the growth in assets, the asset quality continues to deteriorate. In March 2019, the asset quality – the ratio of non-performing loans to total loans and advances – was 12.8 percent compared to 12.5 percent in January 2019. This decline is attributed to the challenging business environment that led to cash flow constraints for borrowers as well as the delayed payments to enterprises by the government.

Asset quality and loan-to-deposit ratios continue to deteriorate despite the muted credit growth.
Loans and Deposits

Despite the industry’s loan and deposits path being upward, the rate of growth of deposits and growth has been muted (Figure 28). In 2018 up to January 2019, gross deposits of the industry have been growing faster than the loans and advances with the rate of growth of deposits over the same period standing at 0.9 percent in contrast with the 0.3 percent growth of loans and advances over the same period. In addition, as at January 2019, the total deposits of the industry diminished by 0.3 percent to stand at Kshs.3,322.20 Billion.

Though deposits dipped during the period, gross loans and advances was also on the same path having declined by 0.5 percent to stand at Kshs.2,553.70 Billion. Overall, this pattern suggests that though both deposits and loans declining, there is a higher preference of cash holding in a bank as indicated by the continued increase in deposits in the financial system.

Commercial Bank's Reserves

The reserve position of commercial banks at the Central Bank of Kenya is characterized by mixed patterns (Figure 29). Since, the beginning of 2018, the official reserves have generally been falling but registered a slight uptick between December 2018 and January 2019 having grown by 0.9 percent before further plunging down by 0.2 percent to grow at 0.7 percent between February and March 2019. On the other hand, the commercial bank’s reserves as a total of total reserves has been generally increasing. Despite, the growth, its position between February and March 2019 was marked with a 1.3 percent dip to close the month at Kshs.3,304.30 Billion compared to Kshs.3,145.60 Billion in January 2019. Nonetheless, the cash reserves position remains above the statutory requirement.
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– Newsweek