About this Report

This Bulletin reviews the performance of the Kenyan economy for the 1st quarter of 2016, 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.
KENYA BANKERS ECONOMIC BULLETIN

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It is my pleasure to present to you the 15th volume of the Kenya Bankers Economic Bulletin. This issue discusses the state of the Kenyan economy during the first quarter of 2016. The Bulletin reviews the strides that the economy has made since the beginning of the year, with an emphasis on the opportunities and constraints that continue to shape the economy’s gradual recovery.

The performance of the Kenyan economy has over the years been shaped by both domestic as well as international dimensions. These circumstances have shaped the Bulletin’s economic outlook. On the international front, all eyes are trained on now the softening of China’s growth is likely to affect the global economic prospects. This is on the back of the US’s Federal Reserve Board taking a pause after a clear signal of resumption of conventional monetary policy. The consequences of United Kingdom’s decision to vote to exit the European Union are yet to fully play out. But the market reaction has been negative, and its ramifications are likely to influence our economy’s performance going forward.

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

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

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

Habil Olaka
CEO, Kenya Bankers Association
Commentary

Real Output Growth Trajectory – A signal of better days ahead or a harbinger for a “New Normal”?

By Jared Osoro

The Kenya National Bureau of Statistics data for the first quarter of 2016 indicates that the economy registered a 5.6 percent growth during the period. This is the most impressive first quarter performance since 2014 (Figure 1). Before we start celebrating, it is worth noting that we have had better first quarter growth in the past – the recent being 2011. It then merits to ask: does the first quarter represent the requisite momentum that influences the year's performance?

One can make a casual inference that the first quarter's performance has a strong correlation with the annual performance. The seasonal performance of the economy has been that the second and third quarters have registered stronger performance than the first and the last. So a relatively good start is a pointer to a potentially good year ahead. I say potentially advisedly. There are a number of downside risks that could derail the pattern.

Let's start with the global economy whose performance since the meltdown that followed the financial crisis of 2008 has been lacklustre at best. The International Monetary Fund (IMF), which usually takes the cake in terms of ambition and with its often rosy projection, is increasingly manifesting a candour of frustration. Its latest World Economic Outlook of April 2016 asserts that the global economy is basically crawling, characterising it as “too slow for too long”.

The projected growth of 3.2 percent is a downward 0.2 percentage points from the Fund’s October 2015 outlook. The emerging markets, and especially the so-called BRICS – Brazil, Russia, India, China and South Africa, have hit the wall. Brazil is in a recession. Russian is caught in...
a sticky and low oil price vicious cycle. India seems to be faring well but China is slowing down.

What does this mean for the Kenyan economy? Well, when the BRICS hit the wall, we hurt. There is a clear signal that in the recent past developing countries are shifting their commercial ties from the G7 in favour of the BRICS and the slowdown of this block has obvious negative consequences. This is especially so when China, the biggest of the BRICS, has become systemically important to the extent of its problems becoming everybody’s problems.

Even a look across the Sub-Saharan Africa tells us that the realism of “Africa Rising” narrative that presented the optimistic view of the continent is now increasingly becoming under scrutiny. The biggest economy in the continent — Nigeria — is a victim of the plunging oil prices; oh, more accurately, it is a victim of its own limited diversification of both its output and government revenue sources. Other major economies such as Angola are also at a performance bind.

Over the past 7 years, the Kenyan economy’s overall growth has been such that anything above 5 percent is celebrated. This makes 2007, when the economy grew at over 7 percent, look like a model year. This begs for two questions: Is the economy being a victim of the global dynamics owing to its “small-open” attribute or is it that the domestic circumstances cannot allow a quick break into faster growth? Should the economy resign to a “new normal” where a 5 percent real growth should be celebrated?

**A case of “we-are-victims-of-their-challenges”?**

One characteristic of a “small-open-economy” — that of being an economy that is a price taker for both imports and exports — makes it far from being systemically important in the global context; therefore when the global economy is projected to be stuck in the mud insofar as performance is concerned, it is an obvious sign of worry. A weak global economy, driven by developed as well as emerging economies, will have a drag on the pace of growth momentum of such economy (Figure 2).

While it is true that local circumstances will have a big role to play if the recovery pace of the Kenyan economy is to pick, there are lots of expectations on the boost the global economy’s recovery will provide. Interestingly, it is the IMF that is providing the basis for such expectations. An area to note as you form those expectations is the Eurozone, taking into account two perspectives.

First, those who imagined that Euro zone may be moving from the red would have think again for the sustainability of the modest recovery seen in part of 2014 and early 2015 is now clearly in question. If one needed a reason to argue that the Euro zone’s recovery may well be an interim outcome and therefore demand remains weak, then the European Central Bank (ECB) provides one.

The ECB is sending a strong signals that it will pursue a quantitative-easing-equivalent strategy in the Euro zone. This has been necessitated by the deflationary prospects at the Euro zone with inflation being below the 2 percent target. The other reason is the United Kingdom’s decision to vote for an exit from the European Union, a decision that is quickly being regretted even by those who championed it.

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

Second, markets are obviously to take cognisance of weaknesses in both emerging as well as developed economies this in their expectations formation. Markets too are expected to factor in the geopolitical

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**Figure 2: Global Real Output Growth (%)**

Source: IMF

development in Eastern Europe and the dynamics of the oil market could potentially upset the fragile Eurozone recovery and consequently the global economies’ more towards attaining the pre-economic meltdown growth levels.

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

It is becoming increasingly evident that international capital inflows are related to external factors as well as to a country’s internal conditions. Arguments I have seen that I consider sound indicate that monetary policies in developed economies affect investor decisions, although a country’s domestic economic conditions also play a role in shaping investment flows. It seems, based on various factors that drive uncertainties, that advanced economies move towards resuming conventional monetary will have to wait.

An equally compelling local story

But the international picture tells half the story. The local story is equally interesting. Let’s start with the public debt position. Notwithstanding the Kenyan economy’s public debts being considered at least in official circles as sustainable, institutions such as the IMF are sending coded signals that with massive external and internal borrowing in quest to finance infrastructure, and the still weak current account position, the exchange rate stability can only be viewed as short term and whose sustenance rests on the external support.

Since the market volatility of late 2011 and early 2012, the IMF’s balance of payment support has helped boost the economy’s foreign exchange reserves. This means that if all was well on the external front, we wouldn't be seeking the helping hand of the IMF, just like one couldn’t be seeking a doctor’s help if one is healthy. From a stability standpoint, we can argue that the foreign exchange market has been able to move out of the volatile phase of 2015 (Figure 3). At the same time, as this Bulletin indicates, inflation seems to be responding in line with the expectations of the monetary policy stance of the Central Bank of Kenya (CBK).
Fully aware of the dicey external environment, the home-grown strategy of stimulating growth could be seen in the ambitious fiscal strategy. National Treasury’s 2016/17 has been explicitly marketed as strategy that will enable the economy’s output growth crawl back to its pre-2008/09 level, which is the medium term target. This is all good except for one “small” matter: absorption capacity is binding constrain that has curtailed the budget from realising the ultimate goal of spurring faster recovery.

Absorption challenges are not new. As for instance was pointed out in the 9th Edition of the World Bank’s Kenya Economic Update, the “official joke is that the economy has turned full cycle — from being accused by the Bretton Woods institutions of excessive spending to spending too little”. The fact that the ambitious growth projections have not come to pass simply indicates that even the revenue projections based on such rosy outlook remain undermined.

Perhaps the economy will get a boost from infrastructure projects — the implementation of some of them still way off. But since our exports are largely commodities — except for the regional market — we have to train our eyes to the international market. On this front, the decline see in the recent past years on the back of weak global demand is not expected to have a drastic reversal (Figure 4).

It is probable that the sluggish real growth of the economy seems not to be giving way to a sustained upward trend. The trend may not be represent a drastic correction, a fact that could be pushing us to a new normal where a 5 — 6 percent real growth is celebrated at the expense losing sight if the ambitious target of double that the economy aspires to.

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The fourth quarter of 2015 recorded an economic growth rate of 5.6 percent - a 0.2 percent decline in the quarterly growth rate as compared to quarter three of 2015 whose growth stood at 5.8 percent. The growth in quarter four of 2015 was mainly supported by a stable macroeconomic environment and improvement in outputs of agriculture; construction; finance and insurance and real estate. Improvement in agriculture was mainly on the back of good weather conditions that favoured increased crop production both the food production and cash crop production. Growth in the building and construction and real estate at large was underpinned on increased construction activities mainly driven by the ongoing public infrastructure development coupled with the resilient private sector credit expansion geared towards real estate sector. Finance and insurance sector growth was supported by expansion in the domestic credit.

In the first quarter of 2016, the economy’s prospects for growth remained positive. The overall key macroeconomic indicators remained positive and supportive of growth in the entire of quarter one. More specifically, the foreign exchange market was fairly stable with the shilling remaining stable and resilient against the major world hard currencies. The jitters in the foreign exchange market as evidenced by the weakening bias on the Kenya shilling in the early and mid-2015 eased towards the end of 2015 a condition that was passed on to quarter one of 2016. Stability in the shilling was mainly supported by a number of factors. First, is the increase in the reserves arising from the increase in diaspora remittances within the quarter as well as the Precautionary Arrangements between central bank and the International Monetary Fund of USD1.5 billion (equivalent of SDR1.06 billion) covering 2 years that provided an adequate buffer against short-term shocks in the forex market. As at March 2016, the foreign reserves stood at USD 7,379.3 million equivalent of 4.7 months import cover up from USD 6,777.2 million (4.3 months of import cover) in November 2015. Secondly is the decline in the import bill mainly arising from the low oil prices in the global oil market helped ease pressure on the shilling in addition to lowering the current account deficit.

On the general prices levels, inflation rates during the quarter took a downward trend in quarter one of 2016 compared to quarter four of 2015. The month – on month inflation rates fell from a high of 8.01 percent in December 2015 to 7.78 percent in January falling further to 6.84 percent and 6.45 percent in February and March 2016 respectively. However, it’s clear that within the first quarter of 2016, inflation rates remained on the upper bound Central Bank target range despite the downward trends. This is further supported by the quarterly average inflation rates that indicate the quarterly average inflation rates for quarter one was 7.02 percent against 7.35 percent in the previous quarter four of 2015. Its therefore evident that the cost of living was high during the entire of quarter one given that the quarterly average rate was 7.02; just 0.48 below the upper bound of the Central Bank target. The non – food – non – fuel remained to be high at 5.06 percent compared to an average of 4.6 percent in quarter three (see figure 5).

Figure 5: Average Quarterly Inflation Rates

<table>
<thead>
<tr>
<th>Year</th>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>7.35</td>
<td>7.02</td>
<td>6.14</td>
<td>6.45</td>
</tr>
<tr>
<td>2014</td>
<td>7.35</td>
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<tr>
<td>2015</td>
<td>7.35</td>
<td>7.02</td>
<td>6.14</td>
<td>6.45</td>
</tr>
</tbody>
</table>

Source: Central Bank of Kenya
A review on the interest rates scenario for quarter one of 2016 presents an interesting phenomenon. The average lending rates for commercial banks remained stable within the quarter averaging at 17.90 percent for the entire quarter. This was replicated in the central banking rate which remained pegged at 11.50 percent throughout the quarter. The 91 – Treasury bill rates averaged at 11.00 percent for the quarter. However, a very unique situation was evidenced in the interbank market in quarter one of 2016. The rates at the interbank market drastically fell to 6.12 percent in January and further to 4.54 percent in February. This was also evidenced by a drastic fall in the volumes transacted in the interbank market within the quarter causing jitters on the possible collapse of the interbank market. The scenario is attributed to the jitters facing the industry falling the placement of Imperial bank into the receivership by the Central Bank. The situation is likely to shock the credit market negatively by making the market more illiquid. This is from the fact that the facilitation role of the interbank market in necessitating the credit availability is limited given the status the interbank market is in.

### Sectoral performance

#### Agriculture

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

From the production point of view, tea production significantly increased in the first quarter of 2016 to 50,300 MT from 46,387 MT in December 2015. However production declined to 43,969 MT in February. The decline in production are partly due to the dry spell witnessed experienced
between January and February prior to the setting in of the long rains at the end of March. In terms of prices the average price per kilogramme significantly declined by Ksh30.76 per kilogramme between December 2015 and January 2016 and further falling by Ksh25.7 per kilogramme between January and February. This could be attributed to the oversupply of tea in the market amid the increased production in quarter four of 2015 following the good performance in the October – December short rains in 2015. Even though tea was the leading agricultural export cash-crop for the country, it still remained to be supply elastic hence increased production of tea for export could not be much relied on to improve our current account deficit. It further calls for the attention towards value chain addition to boost the earnings and reduce the reliance on the sale of raw tea.

Milk deliveries to formal processors increased from 162.28 million litres in quarter four of 2015 to 167.70 million litres in quarter one of 2016. The slight increased production is as a result of increased milk delivery to the formal production plants following good short rains that saw increased animal feeds production. However, looking into the monthly data within the quarter, the actual milk deliveries for formal processors declined in consecutive months from 62.6 million litres in January to 55.5 million litres in February and farther down to 50.0 million litres. This could be attributed to the setting in of the dry spell in February and March before the setting in of long rains in the end of March 2016.

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

![Figure 7: Tea production in Metric Tonnes and Prices per Kilograms](image)

Source: KNBS
significantly declined from 119,739.71 Mt in quarter four to 117,432.70 Mt in quarter one. The decline in the quantity exported was as a result of reduced production in February and March. In addition, the low auction prices of tea led to reduced exports.

On the contrary, the quantity of coffee exported continuously increased throughout the quarter to 9,894.40 Mt in quarter one up from 9,697.34 Mt in quarter four of 2015. The increase in the total coffee exports is attributed to the increased quarterly production as well as increased auction prices for coffee.

Looking at the total value of exports, the total value from tea exports for the entire quarter one was Ksh 33,098.40 Million against Ksh 39,432.44 Million in quarter four; a 16.06 percent decline. On the other hand, total value from coffee exports for quarter one stood at Ksh 5,026.70 against Ksh 4,354.65 Million in quarter four of 2015; a 15.45 percent increase.

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

The manufacturing sector in Kenya is 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 quarter one of 2016 rose to 1,627,294 Mt compared to quarter four production of 1,551,812 Mt; a 3.58 percent rise in total production.

The increased cement production was in tandem with the cement consumption which registered an increased in the quarterly consumption from 1,484,630 Mt in quarter four of 2015 to 1,489,101 Mt in quarter one of 2016. The increase in production may have been occasioned by increased activity in the building and construction industry as signified also by the increased demand for cement as well and the improvement in the building and construction sector as well. For galvanized sheets production rose from 16,938 Mt in December 2015 to 21,330 Mt in January and 20,102 MT in February.

In addition, the domestic sugar production increased from 48,089 MT in December 2015 to 64,499 MT in January 2016 before declining to 59,863 MT as at the end of February. For the soft drinks domestic production decreased from a high of 44,467 thousand litres to 37,670 thousand litres in January and later slightly rising to 38,771 thousand litres in February. Production of assembled vehicles significantly declined from 2,607 units in quarter four of 2015 to 1,600 units in quarter one of 2016.

Energy

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

A review of the power generation for in the first quarter of 2016 reveals that the total energy production that was injected into the national grid declined from 2421.19 million KWh in the fourth quarter to 2,379.66
However, the opposite remains true for the oil importers where for instance the spillover effect of the low world oil prices have begun to be felt in Kenya ever since quarter three and even through quarter four of 2015 through reduced pump prices at the retail market segment.

The world oil prices in quarter one remained below the $40 mark per barrel going by the mean monthly crude oil prices averaging at $29.95 in January, $33.00 in February and $38.20 in March. The decline was mostly accounted for by the glut in the world oil market basically arising from the geopolitical crisis which have led to the major oil producers failing to agree on cutting down production to trigger the rise in the oil prices. In addition the slowdown in the growth prospect in both the developed and the emerging markets have failed to trigger the increase in oil demand hence another reason for low oil prices.

The reverse of a commodity boom in the oil market continues to have a substantially negative effect among the oil producers negatively. However, despite the power demand outstripping power supply power losses still continued to persist. For quarter one the total power losses were 328.88 million KW a decline from 416.24 million KW in the previous quarter four of 2015. It’s also notable that within the quarter, the overall energy consumption remained below the overall production.

The world oil prices in quarter one remained below the $40 mark per barrel going by the mean monthly crude oil prices averaging at $29.95 in January, $33.00 in February and $38.20 in March. The decline was mostly accounted for by the glut in the world oil market basically arising from the geopolitical crisis which have led to the major oil producers failing to agree on cutting down production to trigger the rise in the oil prices. In addition the slowdown in the growth prospect in both the developed and the emerging markets have failed to trigger the increase in oil demand hence another reason for low oil prices.

A look at the daily prices presents a more volatile state in the global oil market. The daily crude oil prices seem to have surpassed the $40 mark in March but slumped again to below $40 mark. As such as long as the geopolitical crisis persist this phenomenon is likely to persist for a while.

In addition the Eurozone crisis coupled with the constrained demand in the world demand for commodity are likely to continue contributing to the low oil prices in the world market.

<table>
<thead>
<tr>
<th>Table 1: Average Monthly Crude Oil and Retail Fuel Prices</th>
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<tr>
<td>46.60</td>
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<tr>
<td>103.49</td>
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<td>80.94</td>
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<tr>
<td>53.52</td>
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<tr>
<td>2,393.8</td>
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<tr>
<td><strong>Super petrol (KES/Litre)</strong></td>
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<tr>
<td><strong>Diesel (KES/Litre)</strong></td>
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<tr>
<td><strong>Kerosene (KES/Litre)</strong></td>
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<tr>
<td><strong>LPG (13Kgs)</strong></td>
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</table>

Source: ERC
Building and Construction

Building and construction sector continues to thrive well rising to be one of the core sectors upon which the growth is anchored. As evidence in 2015, the sector was among the key sectors that were attributed towards the 5.6 percent recorded in the year. The sector have attracted a lot of support from the financial services with the banks advancing Ksh 106.4 billion to the sector as at 2015. With the increased government physical infrastructure coupled with the thriving real estate sector, the sector recorded a 9.9 percent growth in quarter one of 2016.

The quantity of cement produced increased from 533,773 MT in February 2016 to 540,792 MT in March 2016. Consumption of cement went up from 483,275 MT in February 2016 to 492,764 MT in March 2016.

Transport and Communication

The total number of registered vehicles as at quarter one significantly declined from 64,257 units in quarter four of 2015 to 37,741 units in quarter one of 2016. This substantial decline is attributed to the introduction of the new import charges on the imported second hand vehicles in December 2015. The month – on – month statistics reveal that the number of newly registered vehicles declined from 22,308 units in December 2015 to 14,690 units in January falling further to 12,771 units and 10,280 units in February and March respectively. Motor cycles continued to account for the biggest share of the total motor vehicles registered in the quarter.
The dominance of mobile telephony in the communications industry continued to be evident. Mobile money transfer has been significant especially in rural areas where banks are not available, inaccessible, or where majority of the population do not hold bank accounts. At the same time this mode of money transfer has been characterized by ease of use and, despite recent revision of charges on transactions. This reflects the view that mobile transfer has the potential of raising living standards by offering employment with the entire value of mobile banking transactions. The facility has also been greatly adopted by commercial banks in offering mobile banking services in pursuit if banking the unbanked.

Tourism

During quarter one, tourism performance improved performance mainly following the lift of travel advisories by foreign agencies mainly from United States, United Kingdom, France and Australia arising from improved security status in last year. Looking at the number of visitors arrivals via the JKIA and Moi international airport, the JKIA arrivals significantly increased from a total of 170,078 visitors in quarter four of 2015 to 179,037 visitors in quarter one of 2015; a 5.27 percent rise. For the arrival through the Moi International airport the quarterly total arrivals mildly improved from 22,837 visitors in the fourth quarter in 2015 to 27,941 visitors as at the end of quarter one in 2016. The insight into the quarter however reveals some upward and downward trends in the visitors’ arrivals in both the JKIA and the Moi International airport. Despite the rise in the total number of visitors during the quarter, the number of visitors within the months was on decline for both the airports with the numbers for JKIA falling from 66,185 visitors in January to 62,856 and 49,996 in February and March respectively. Similarly for the MIA, the monthly figures rose from 9,407 visitors in January to 9,983 in February but fell later to 8,551 in March. It’s therefore likely that within the looming political tension in the country, the sector is set for a decline in the number of visitors in the near future as the trend in quarter one depict.

Looking at visitors’ arrivals by their origin, it’s evident that Europe registered the highest number of arrivals via JKIA at 116,370 visitors followed closely by Africa at 113,814 visitors with Asia coming third at 98,998 visitors.
On the government revenues, the total revenue for quarter one of 2016 was Ksh 2,204,197 million. Of this, the total tax revenue accounted for 87.08 per cent of the total quarterly revenue with the non – tax revenue accounting for 12.92 per cent. For the tax revenue, income tax topped the list at 50.90 per cent followed by value added tax at 27.98 per cent with excise duty and import duty coming third and fourth at 13.22 per cent and 7.89 per cent 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 of the government’s expenditure continuing to rise with the onset of devolution government.

The total government expenditure for quarter one of 2016 stood at Ksh 2,986,288 million. The total recurrent expenditure accounted for 74.29 per cent with the development expenditure accounting for 25.71 per cent of the total government expenditure in the quarter. On the recurrent expenditure, wages and salaries as a single item accounted for the largest proportion at 30.07 per cent.

During the first quarter of 2015, the total quarterly public debt was Ksh 9,741 billion compared to 9,179 billion in quarter four of 2015. An analysis on the breakdown of the public debt into domestic and external debt reveals that the government through the National Treasury tried to maintain an equal balance between the two debts to stand at 49.01 per cent in favour of domestic as opposed to 50.99 per cent in favour of external for the entire quarter.
This reflects a tight trade—off and balancing act in the choice between the two types of borrowing hence limited flexibility of the National Treasury to prefer one at the expense of the other. Given the stability in the Kenya shilling in the quarter, more preference for external borrowing can be seen in quarter one of 2016 in addition to trying to avert crowding out effects in the domestic market. As such a tight balancing between the two types of borrowing mean the balancing between crowding out effect and increased debt burden for foreign currency denominated debt.

On the financing of the government’s public debt, open market operations took an upper hand with the preference on government treasury bonds including the government frozen debt remained being evidenced. In quarter one of 2015, the government’s treasury bonds were the key money market instruments intensively utilized by the government in domestic borrowing accounting for 65.29 percent though slightly lower than 71.24 percent of quarter four of 2015. Treasury bills, On the other hand accounted for 31.68 percent up from 25.94 percent in quarter four of 2015, while overdrafts and advances 2.67 percent and 0.32 percent respectively of total government debt for the entire of one of 2016.

Money and Credit

During the fourth quarter of 2015, the monthly total money supply recorded a positive growth of 2.06 percent between December 2015 and January 2016 before declining by 1.67 in February. As at March 2016 the actual money supply grew by 0.56 percent. This growth was fairly stable signalling no demand pressures likely to cause inflationary trends.

Inflation

The cost of living for the first quarter of 2016 saw the reversal of the upward trend evidence in the fourth quarter of 2015. The month—on—month inflation decline to a low of 6.45 percent as at the end of quarter one of 2016 down from a high of 8.01 percent as at the end of quarter four of 2015. An insight into the inflation rates within the quarter, the inflation rates fell to 7.78 percent in January 2016 from 8.01 percent in December 2015 and further down to 6.84 percent and 6.45 percent as at end of February 2016 and March 2016 respectively.

The decline in the inflation rates could be attributed to a number of first. First is the consistency in the monetary policy stance by the monetary policy committee over the quarter. The decision by the monetary policy committee to retain the bank rate at 11.50 percent in 20th January 2016 after adopting the same decision in November 17th 2015 was a clear indication of consistency in the monetary policy and the urge to anchor inflation. The fall in the inflation rates is therefore a revelation of the realization in the outcome of the monetary policy decision adopted in November 2015 and January 2016 thus evidencing an element of a lag between the policy adoption time and the time when the intended policy outcomes are realized. Secondly the decline in the cost of living could
be attributed towards the decline in the transport index following the continued fall in the domestic pump oil prices amid the falling oil prices in the international oil market with the transport index falling by 0.94 percent in January, 1.62 percent in February and further by 0.34 percent in March 2016. On average, the quarterly index for quarter one of 2016 stood at 7.02 percent against an average of 7.35 percent in quarter four 2015.

However, a review of the year – to – year basis reveals that the annualized inflation rates as at March 2016 stood at 6.88 percent compare to annualized inflation rate of 6.64 percent as at the end of March 2015.

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

The non – food – non – fuel inflation (NFNF) remained fairly stable in quarter one falling from 5.6 percent in December to 5.5 percent in January and later rising to 5.9 percent in February 2016 and further to 6.0 percent as at the end of March 2016. The rise in the NFNF inflation in the quarter clearly reflects the effect of the revision in the excise tax for habitual goods mainly the alcoholic drinks and tobacco products towards the end of quarter four of 2015. On average the quarterly average NFNF inflation rose from 5.1 percent in last quarter of 2015 to 5.8 percent in quarter one of 2016. From figure 19 it’s notable that within the quarter, the month – on – month inflation and the NFNF inflation moved antagonistically as oppose to the previous quarter implying some elements of demand pressures in quarter one despite the overall inflation rates falling.

**Interest Rates**

Interest rates remained fairly stable during the first quarter of 2016. This was attributed to a number of factors. First, the jitters in the exchange rate have eased with the shilling stabilizing and being resilient against the major world’s currencies. This follows a number of measures being taken including but not limited the acquisition of cautionary fund from IMF to cushion against any short term shocks in the currency. In addition, the monetary policy stances adopted in 2nd July 2015 remained unchanged as at the end of quarter one. This stability could have facilitated the stability in the interest rates markets given that policies have a time period — lag period before realising their intended targets. Thirdly, were the external pressures towards the end of 2015 where by speculations on the adjustment in the federal rates in the first quarter of 2016 seem to have been already factored in the market pricing in quarter four of 2015 thus posing no shocks to the interest rates market in quarter one.

With regard to the short term interest rates, the 91 – Treasury bill rate averaged at 9.86 percent. This scenario shows a calm in the high volatility in the 91 TB rate experienced in the fourth quarter of 2015 given that the quarterly average stood at a single digit figure as at quarter one.

However, based on weekly data as opposed to mean monthly data, the scenario here is whether the jitters in the interbank market have had a significant visible effects on the 91 – Treasury bill rates and thereby affecting the yield curve, from figure 20 There has been a decline in the interbank market rates in the onset of quarter three of 2015 perhaps following the adoption of the monetary policy stance of rising the CBR to 11.50 mark which was triggered by the sharp rise in the interbank rates in quarter two. This decline in the interbank rates has in turn led to the fall in the 91 – Treasury bill rates. The explanation for this phenomenon could be as follows. The collapse in the interbank market imply illiquidity in the credit bank. This is because the big players in the interbank market tend to handle large reserves of excess funds. On the other hand the small players in the interbank bank tend to face liquidity deficit. As such given the cost involved in handle large surplus funds, the big players will tend to divert the surplus funds in purchase of securities. Of course the
purchased securities ought to be liquid enough to be converted into cash on short span and secondly must be viable enough meaning the level of risk attached to them is quite low. As such financial sector players with surplus funds will direct the funds to purchase of government securities such as 91 – Treasury bill which are risk free assets. This leads to the oversubscription of the bills and as such the yield curve of the treasury bills will be skewed to the lower end. This is the scenario that we see in the last quarter of 2015 that spills over to the first quarter of 2016. This has seen the 91-day treasury bill rates fall successfully from 11.17 percent in January 2016 to 10.63 percent in February and lastly to 8.72 percent as at the end of March 2016.

Turning to the average lending rates for the commercial banks, we find that the cumulative average weighted lending rates posted mixed trends within the quarter though quite stable. At first, the rates rose from 18.30 in December 2015 to 19.96 percent in January 2016. February recorded a fall in the rates to 17.86 percent and further to 17.76 percent as at March 2016. This movement in the average lending rates from December 2015 to March 2016 mimic the movements in the 91 – Treasury bill rates for the same period. This is for the mere fact that the average lending rates are pegged on the 91 – Treasury bill rates in so far as the determination of the base rate is concerned. The credit market still remained illiquid for the entire quarter one of 2016 as evidenced by the relationship between the average lending rates and the CBR.
The interbank market has been crucial given that it facilitate overnight lending and borrowing among the banks hence helping banks meet short term cash challenges. A vibrant interbank market core in facilitating banking system deal with liquidity challenges by availing resources from the banks with excess liquidity to the banks with liquidity challenges. Even though, the interbank market is generally volatile given that its market determined and driven, the revelations in quarter one of 2016 is worrying hence calling for a need to reflect on it with keen. In the first quarter the interbank market almost came to a standstill to a point of completely crashing given the new developments in the banking sector upon the placement of Chase bank under receivership. The interbank market volumes of transaction drastically declined in quarter one of 2016 compared to the previous quarter four of 2015.

Balance of Payments

The volume of trade contracted from Ksh 175.3 billion in December 2015 to Ksh 145.5 billion in February 2016 but later improved to Ksh 168.5 billion in March 2016. The total value of imports in the quarter rose from Ksh 100.6 billion in February 2016 to Ksh 114.4 billion in March 2016 while the imports for February – March period rose to Ksh 54.03 billion. Domestic exports by Broad Economic Category (BEC) indicated that food and beverages was the main export category in March 2016 accounting for 43.00 per cent of total exports, while the value of non-food industrial supplies and consumer goods not elsewhere specified registered 25.78 and 28.39 per cent shares, respectively. BEC imports indicate that industrial supplies not elsewhere specified was the main import category in March 2016 with a share of 37.23 percent, while the values of machinery & other capital equipment, fuel and lubricants and transport equipment accounted for 21.14, 12.47 and 10.47 percent of the total imports respectively. Food and beverage recorded a share of 6.79 percent while consumer goods not elsewhere specified recorded a share of 9.38 percent.

The value of the total exports; – both the domestic exports and the re – exports the declined a clear indication that, despite the depreciation in shilling, the Kenyan exports have not leveraged on this opportunity that would arise from the exports being cheaper abroad. The total quarterly value of the exports declined from Ksh 151,687.93 million in quarter four of 2015 to Ksh 146,967.07 million in quarter one of 2016. Regarding the major destination for the Kenyan exports globally, as at the end of quarter one of 2016, Uganda topped as a major destination followed by Netherlands with Kingdom coming third.

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

Exchange Rate

During the first quarter of 2016, the shilling portrayed resilience against other currencies both at the international and at the regional level. As for the dollar the shilling posted good performance maintaining stability against the dollar for the entire of quarter one. During the month of January, the shilling traded at a mean monthly rate of 102.3 against the dollar improving to 102.00 mark in February before appreciating further to 101.5 mark in March. This could be attributed to the continued falling in the oil prices that reduced the demand for the dollars to finance the oil importation. Secondly, the increase in the foreign reserves at the central bank of Kenya hitting a high of 4.7 month – on – month import cover as at the end of March 2016. In addition the precautionary loan facility from IMF amounting to $1.5 million aided cushioning against any short-term shocks in the value of shilling.
Against the Sterling the shilling appreciated considerably. This is evidenced by the successive appreciation in the shilling against the pound from a mean monthly rate of 153.3 mark in December 2015 to 147.6 mark in January, 146.00 in February and eventually settling at 144.20 mark in March. This could be attributed to the reduced competitiveness of the British economy within the entire Europe market mainly within the Euro zone which has seen Britain pursuing options for exit from the Euro zone. The Euro zone is still struggling with deflationary pressures with Greece being worst hit again thus reducing its competitiveness in the global market. For the East African scene the shilling was more stable as evidenced in its performance against the Ugandan shilling and Tanzanian shilling.

**Nairobi Securities Exchange**

During the first quarter of 2016 the stock market continued to post poor performance as evidenced in the successive months indices for quarter one compared to the monthly indices for quarter four of 2015. Performance based on the NSE – 20 Share index reveal that the market’s performance dipped very low in January 2016 to 3773 points down from 4040 mark as at the end of December 2015. However, modest improvement was evidenced in February and March 2016 with the index rising to 3871 and 3982 points respectively. Similar results were replicated in the All Share Index with the index falling to 136.7 points in January 2016 from 145 points in December 2015 and later rising to 141 points and 147 points in February and March 2016 respectively. The main reason for the drop in the performance in terms of the two indices could be the profit warnings by
the listed companies by the end of 2015 which implied shock to both the capital gain translating from downward movement in the stock prices.

The dismal performance can also be attributed to bearish behaviour in the market, driven majorly by the foreign investors given their increased market participation mainly as net sellers rather that bet buyers in the wake of reduced dividends following the profit warnings by a number of firms. This is evidenced by the sharp rise in the foreign investor participation from 43 percent in February to 65 percent in March ahead of the books closure for the firms whose financial year ends at 31st March of the year.

On the fixed income segments the trading activities were modest with the bond turnover stagnating at Ksh 21 billion for December 2015 and January 2016 are slightly rising to Ksh 24 billion in February 2016. March 2016 however saw a significant re-bounce in the bond market activity increasing from Ksh 24 billion to Ksh 67 billion. The month of March 2016 recorded a turnover of Sh67.5 billion which stood out as the highest monthly total since June 2013. This could be mainly attributed to higher trading on the five year, 10-year and infrastructure bonds issued by the government in the local market. March 2016 represented a 168 per cent month-on-month increase from the turnover of Sh25 billion recorded in February to Ksh 67.5 billion mark. The uptum in activity in the secondary market has coincided with the fall of primary issue yields, where that on the 91-day, 182-day and 364-day Treasury bills has come down to 9.0, 10.8 and 11.9 per cent from 11.7, 14.4 and 14.5 per cent respectively since the beginning of the year on account of the declining yields on short-term securities making the longer dated papers more attractive.

Table 2: Nairobi Securities Exchange Market Indicators

<table>
<thead>
<tr>
<th>Date</th>
<th>Oct - 15</th>
<th>Nov - 15</th>
<th>Dec - 15</th>
<th>Jan - 16</th>
<th>Feb - 16</th>
<th>Mar - 16</th>
</tr>
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<tbody>
<tr>
<td>NSE 20 Share Index 100 =1966</td>
<td>3869</td>
<td>4016</td>
<td>4040</td>
<td>3773</td>
<td>3871</td>
<td>3982</td>
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<tr>
<td>NSE All Share Index (NASI)</td>
<td>137</td>
<td>143</td>
<td>145</td>
<td>136</td>
<td>141</td>
<td>147</td>
</tr>
<tr>
<td>Market Capitalization (KES. Bn)</td>
<td>1931</td>
<td>2018</td>
<td>2049</td>
<td>1926</td>
<td>1988</td>
<td>2078</td>
</tr>
<tr>
<td>Total Shares Traded (Million)</td>
<td>540</td>
<td>441</td>
<td>474</td>
<td>422</td>
<td>341</td>
<td>536</td>
</tr>
<tr>
<td>No. of Equity Transactions</td>
<td>27975</td>
<td>27068</td>
<td>23100</td>
<td>26857</td>
<td>25727</td>
<td>30789</td>
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<tr>
<td>Equity Turnover (ET) KES. (Mill)</td>
<td>17,837</td>
<td>13,149</td>
<td>15,109</td>
<td>12999</td>
<td>10161</td>
<td>13449</td>
</tr>
<tr>
<td>Bonds Turnover (KES. Bn)</td>
<td>30</td>
<td>19</td>
<td>21</td>
<td>21</td>
<td>24</td>
<td>67</td>
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<tr>
<td>Percent of Foreign Participation to ET</td>
<td>67</td>
<td>67</td>
<td>58</td>
<td>61</td>
<td>43</td>
<td>65</td>
</tr>
</tbody>
</table>

Source: NSE, Monthly Trading Report
A highlight of the credit survey in the banking industry for quarter four of 2015 posits the ratio of total loans to total assets for the industry grew marginally from 62.68 percent in quarter three to 62.3 percent in quarter four of 2015. On the credit demand side, internal financing, loans from other banks and non-banks, issuance of debt securities, issuance of equity, available investment opportunities, retention of CBR and KBRR as well as political risk were cited as the main driving factors for the quarter four of 2015. These factors led into the tightening of credit standards among some banks to caution themselves from unforeseen risks.

During the quarter, turbulences were evidenced in the banking industry following the placement of Imperial bank under the receivership by the regulator. However, despite the turbulences, the industry remained sound and stable given that the problem was not systemic but rather an individual bank related problem.

**Assets and Loans**

The industry’s assets base registered a mild positive growth of 1.37 percent during the fourth quarter of 2015 to stand at KES 3.70 trillion as at the end of December 2015 compared to KES 3.65 trillion in September 2015. On the other hand, total industry’s loans and advances marginally declined by 0.86 per cent in quarter four of 2015. A quarterly review of growth in the banking industry’s total loans and advances posit that as at the end of December 2015, the total loans and advances stood at KES 2.30 trillion compared to KES 2.32 trillion in September 2015.

![Figure 25: Bank Assets and Loans (KES Trillion)](source: CBK)

**Deposits**

The total deposits in quarter four of 2015 recorded a negative growth of 2.02 percent compared to quarter three of 2015. Demand deposits accounted for major source of total banking industry funding liabilities standing at 70.6 percent as quarter three implying that the short term...
inflows in terms of demand deposits majorly financed the industry’s total loans and advances. As at the end of quarter four of 2015, the total bank deposits were 2.62 trillion on compared to Ksh 2.568 trillion as at the end of quarter three.

**Total Shareholder Funds**

Total capital stock of the Kenya banking sector sustained its upward trajectory in the fourth quarter of 2015 though mild. The quarter recorded a growth in share holders’ wealth of 3.42 percent from Ksh 555.5 billion as at the end of September 2015 to Ksh 574.5 billion as at December 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 in quarter four of 2015 by 11.70 percent to average at KES 139.40 billion compared to Ksh 123.9 billion in quarter three. 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 is the 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.

Source: CBK

Figure 28: Bank Gross Non - Performing Loans (KES Billion)
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– Newsweek