KENYA BANKERS ECONOMIC BULLETIN

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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 4th quarter of 2016, drawing on the performance of recent past months as well as current developments to provide perspectives on the outlook for 2017. The Bulletin covers trends in the real economy, government fiscal operations, public debt, inflation and interest rates, balance of payments and exchange rate, as well as activity at the Nairobi Securities Exchange and banking sector performance.

About the Centre for Research on Financial Markets and Policy

The Centre for Research on Financial Markets and Policy® was established by the Kenya Bankers Association in 2012 to offer an array of research, commentary, and dialogue regarding critical policy matters that impact on financial markets in Kenya. The Centre sponsors original research, provides thoughtful commentary, and hosts dialogues and conferences involving scholars and practitioners on key financial market issues. Through these activities, the Centre acts as a platform for intellectual engagement and dialogue between financial market experts, the banking sector and the policy makers in Kenya. It therefore contributes to an informed discussion that influences critical financial market debates and policies.
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It is my pleasure to present to you the 18th volume of the Kenya Bankers Economic Bulletin. In this issue, we discuss the state of the Kenyan economy during 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 Federal Reserve Board resuming the conventional monetary policy after a long spell of quantitative easing.

There is clearly fragility in the performance of the global economy even though there are signs of optimism. On the local scene, the focus is on how the Banking (Amendment) Act 2016 will affect the credit market. This is likely to influence the economy’s growth trajectory in the near and medium term.

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
Chief Executive Officer, Kenya Bankers Association
Commentary

Projecting Growth Optimism? Bated Breath Could be a Sure Strategy

By Jared Osoro

Introduction

The International Monetary Fund (IMF) recently published two illuminating analytical chapters of its April 2017 Global Financial Stability Report. Like many analytical reports, these chapters go beyond the headlines of the day, but interesting parallels can be drawn relating to the developments in the Kenyan economy.

Let’s start with one of the chapters, entitled ‘Low Growth, Low Interest Rates, and Financial Intermediation’ that makes a very interesting observation by concluding thus:

"Persistence of a prolonged low interest environment would present a considerable challenge to financial institutions. Over the long term, the scenario would entail significant shifts to the business models of banks, insurers and pension funds and other products offered by the financial sector."

The above conclusion relates mainly to advanced economies. The low interest regime was triggered by the global financial crisis that fed into the economic meltdown; in the low interest rates were a function, not a cause of, the low growth, largely derived from the policy response meant to jump start stagnating output growth.

Over that time, the performance of the emerging markets and developing economies generally has remained largely robust; indeed the global output growth was supported by the emerging markets’ economies in general and the so-called BRICS — Brazil, Russia, India, China and South Africa.

But the BRICS somehow hit the wall at some point. China’s double digit growth reached the stage where rebalancing was inevitable and the investment-led/export-led growth model had to start giving way to a consumption-led model, thus the reduction of the real output growth to a still-respectable 6 percent – 8 percent real GDP growth rate rage.

Russia was hit by the low international oil prices, laying bare the soft underbelly of its undiversified economic structure. Brazil went through a slowdown that forced a change of government. South Africa’s growth remained stuck, partly bedevilled by political economy challenges. India seems to have held its respectable growth momentum, but its chance of doing even better were constrained by the global economy’s malaise.

Systemically easy to ignore?

Evidently, any afflictions to the advanced economies as well as the leading emerging markets economies such as the BRICS is easy to notice. But when the Sub-Saharan economy is on a glide towards the slow global growth levels, it is at the very best easily explained away by the...
low commodity prices affecting the continent’s major economies such as Nigeria (Africa’s largest economy in nominal GDP terms, otherwise it’s barely noticed (Figure 1).

With the picture presented by the global and continental performance, it is easy to see why many are tempted to argue that the Kenyan economy is doing well, despite everybody else’s misery. The quarterly GDP growth, has held its ground, although it is difficult to describe it as robust given that it is stuck at below 6 percent even when the official target remains at ambitious double digit if such growth has a chance of denting poverty levels and taking the economy to a meaningful middle income level (Figure 2).

Unlike the global economy with low growth and low interest rates as illustrated by the Global Financial Stability Report, the Kenyan Growth is happening on the back of a high interest rates regime. The September 2016 law that introduced interest rates capping was, for all intents and purposes, seeking to avoid the pain of deconstructing the underlying determinates — in essence going for a costly short-cut. Its likely adverse implications on the already declining credit to the private sector were easy to fathom; the bottoming out would not be easy (Figure 3).

While the interest rate capping law came into effect at a time when private sector credit was on a slippery downward road, the effect on other markets — especially the capital markets — has been evident and almost instantaneous; both market capitalisation and the key indices on market price evolution at the Nairobi Securities Exchange (NSE) speak with the same voice on the adverse consequences of the new interest rates law (Figures 4 and 5).
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### Figure 4: Market Capitalisation (Total and Banks)

- **Market Capitalisation** (Left hand side)
- **Banks’ Market Capitalisation** (Right hand side)

Source: NSE

### Figure 5: Evolution of NSE Indices

- **NSE 20 Share Index** (left hand side)
- **NSE ASI** (Right hand side)

Source: NSE
Both the private sector credit and the capital markets have an important predictive power on the likely GDP growth rate for the near term\(^1\) — realistically for 2017, but even longer if the dire conditions they pose is compounded by political risks as well as the global economic conditions not showing strong signs of a rebound. In other words, the third aspect in the Global Financial Stability Report, which is on financial intermediation, is clearly at play here in influencing the economy’s growth trajectory albeit adversely.

This brings us to the other analytical chapter of the Global Financial Stability Report entitled: ‘Are Countries Losing Control of Domestic Financial Conditions?’ The conclusion is as interesting as that of the chapter already discussed. The chapter makes two important observations.

The first one is that while global financial conditions loom large, evidence suggests that on average countries still appear to hold sway over their own financial conditions especially through monetary policy. The second one is that even with the sway as could be assured by monetary policy, the rapid speed at which foreign shocks affect domestic financial conditions makes it difficult to react in a timely and effective manner if necessary — therefore global financial conditions matter.

A reflection on the local conditions gives these two observations an interesting twist. We have make an argument elsewhere\(^2\) — in concurrence with the Central Bank of Kenya’s Monetary Policy Committee (MPC)\(^3\) — that the interest rates capping impairs the effectiveness of the monetary policy framework. We can make a further argument that the global influence on the financial flows could be seen more on the net portfolio outflows from the capital markets that have partly occasioned the slump already noted.

**When all is said . . .**

Ultimately, it is easy to pin any expected growth on the expansionary fiscal policy as could be seen from the projected KES 2.6 Trillion budget for the year 2017/18 fiscal year. Indeed the economy may hold its way — albeit with no noticeable positivity to households and businesses — in 2016 largely on account of the fiscal regime. In any case the first three quarters of 2016 have reported sustenance of the previous year’s trend. The downside risks could however weigh down on the 2017 performance.

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During the third quarter of 2016, the economy’s prospects for growth remained positive registering a growth rate of 5.7 percent slightly lower than a growth rate of 6.0 percent in the same quarter in 2015. At the macroeconomic level, the third quarter could be viewed as having relatively stable macroeconomic environment that was necessary for supporting positive growth in quarter four of 2016. In particular, the amendment of the Banking Act in August 2016 capping the rates at 4 percent above the CBR saw a significant decline in the average lending rates to 13.84 percent as at end of September 2016. In addition, the current account deficit narrowed by 10.4 per cent to a deficit Ksh 100,687 million in the third quarter of 2016 from a deficit of Ksh 112,377 million during the same quarter of 2015. The overall balance of payments also improved from a deficit of Ksh 51,356 million in the third quarter of 2015 to Ksh 5,710 million during the quarter under review.

However, despite the appealing picture on the macroeconomic environment posed in quarter three of 2016, the expected good performance in quarter four of 2016 failed to come into fruition. As such the rosy facts portrayed quarter three were not evidenced in quarter four. To start with, despite the amendment of the Banking Act in August 2016 capping the lending rates at 4 percent above the CBR and 7 percent interest rates on deposits thus being interpreted as enhancing credit access to the general public and promoting savings culture, the credit to the private sector in quarter four shrank significantly within the quarter with the banks tightening their credit standards to avoid exposure to the perceived risks. This has had a rippling effect across all the sectors apart from household. In addition, the intention of the new law to mobilize deposits from the public given the 7 percent earnings on the deposits seem to have flopped. The deposits by the public with the banking system declined by 1.54 percent in quarter four of 2016. This simply explains that savings is not a function of anything else rather than the levels of disposal incomes within the public. The mere fact that interest rates were capped at 4 percent above the CBR does not in any way speak to increased disposable income among the public thus the realization of the intended outcome of the law.

Further, we argue that the narrowing of the current account deficit in quarter three of 2016 does not imply that we are exporting more. The mere fact is that there has been slowed imports overtime. This further poses a risk in that slowed importation of capital equipment imply reduced productive capacity of the economy in the future which may end up reversing the gains noted in the current account position. In addition, with the weakening of the shilling the stated gains in current account deficit may not be sustainable in the long run hence these gains cannot be boasted of as achievement. With the world crude oil prices assuming an upwards trend, and on the backdrop of weakening shilling, the obvious expectation is a rise in the oil import bill which will slowly offset the gains realized in the current account deficit. Further,
with the poor performance in the short rains in the last quarter of 2016, the pursuit of the importing food as the alternating to solve the looming food shortage could only mean widening current account deficit given that the country’s agricultural exports have also been adversely affected by poor rains. As a matter of fact, the current account deficit rose from $ 3,709.2 million in September to $ 3,861.4 million in October 2016.

On the forex front, the shilling succumbed to the dollar thus reflecting an element of weakening bias. This occurred given a number of factors; -First with the interest rates having been capped and with the inflation rates being within Central Bank’s target range, the rule of the impossible trinity in economics sets in implying that the instability is likely to reveal itself through the forex market and as such the exchange rate is bound to succumb to depreciation pressure unless the central bank sets in with a tightening monetary Policy. During quarter four, the shilling depreciated against the dollar with the depreciation setting in in the month of October lasting through the quarter.

The month — on — month food inflation perfectly track the month — on — month overall inflation as elucidated by figure. As such the food inflation component largely determines the overall monthly inflation rates implying that any shock in the food production directly feeds into movements in the overall inflation rates. A sharp spike in the food inflation is evidenced in between May 2016 to July 2016. The effect of this spike does not dissipate easily as it’s sustained thereafter till the end of the last quarter of the year. On the non — food — non — fuel inflation (core inflation), it’s clear that it does not mirror the month — on — month overall inflation throughout. However, an interesting observation can be made on the relationship between NFNF and month — on — month overall inflation between September 2016 and December 2016 in that both tend to mirror each other.

Further, the month — on — month overall inflation seems to respond to fuel inflation but with some lags. This can be attributed to the time period it takes for the oil price pass-through effect to be manifested into the cost of living. This is the reason why despite the rise in the fuel inflation in the entire of quarter four of 2016, the month — on — month overall inflation seems to be on the downward trend implying that in the last quarter of 2016, the month — on — month overall inflation was responding to the decline in the fuel inflation experienced from July to September holding other components of inflation constant.

Within the last quarter of 2016, the month — on — month inflation rate portrayed a broad sense of stability even though it remained on the upper bound of the CBK target range. A slump is however experienced in December. This could be partly attributed to consistence in the monetary policy in the last meetings which held CBR at 10 percent. On quarterly basis, the quarterly average inflation for quarter four was 6.5 percent for Q4_16 compared to 7.5 percent in Q4_15.

Figure 8: Average Quarterly Inflation Rates

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

Source: Central Bank of Keny
Agriculture remained to be one of the key sectors driving economic growth in the quarter four 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 sectors of the economy. The performance of the agricultural sector however dipped on the backdrop of poor performance in the short rains for October – December season.

From the production point of view, tea production significantly rose from 95,532 MT in quarter three to 126,346 MT in quarter four. The rise in production could be partly attributed to average rain performance in the tea growing zones during the October – December 2016 short rains period. In terms of prices the average price per kilogramme significantly increased from Ksh. 234 per kilogramme in September 2016 to Ksh. 274 per kilogramme in December 2016.

Milk deliveries to formal processors increased from 158.30 million litres in quarter three of 2016 to 163.7 million litres in quarter four of 2016. The rise in delivery can be attributed to a rise in production following the setting in of short rains in the month of October.

Agriculture cash crop exports continue to command a good share of the total economy’s main export, with tea topping in foreign exchange earning followed by coffee. However, despite the agricultural sector leading in terms of the production of exports, the performance in quarterly production dwindled given the poor rains experienced in quarter four of 2016.
In terms of the leading agricultural exports, the quantity of tea produced significantly increased from 95,532 MT in quarter three to 126,348 MT in quarter four; a 32.26 percent rise. In terms of export quantity, the quantity of tea exports for quarter four was 110,189 MT; a decline from 115,953 MT in quarter three. Similarly, the quantity of coffee exported declined from 10,879 MT in quarter three to 9,931 MT in quarter four of 2016. The decline in the total tea and coffee is attributed to the decline quarterly production following poor long rains for October – December 2016.

The total value of tea exports remained fairly stable in quarter three and four given that the average quarterly prices were fairly stable as well. Quarter four registered total export value of Ksh. 29,482 million slightly above a value of Ksh 29,126 million for quarter three. On the other hand, the quarterly value of coffee export for quarter four declined from Ksh 4,833 million in quarter three to 4,432 million in quarter four.

On horticultural exports (Figure 9), in terms of quantity exported in quarter four of 2016, cut flowers dominate this subsector contributing 53.91 percent of total quantity of horticultural, followed by vegetables at 34.68 percent with fruits exports recording the lowest contribution of 11.41 percent. Turning to foreign exchange earned from horticultural exports for the entire quarter, cut flowers dominate horticultural subsector accounting for 71.03 percent of total horticultural exports value, followed by vegetables at 23.99 percent with fruits exports recording the lowest contribution of 4.98 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 slightly rose from 1,695,299 MT in quarter three to 1,703,770 MT in quarter four of 2016. The increased cement production was in tandem with the cement consumption which registered an increased in the quarterly consumption from 1,524,773 MT in quarter three of 2016 to 1,558,871 MT in quarter four. The increase in production may have been occasioned increased activity in the building and construction industry.
industry as signified also by the increased demand for cement as well and the improvement in the building and construction sector as well.

However, domestic sugar production decline from 153,779 MT in quarter three to 146,649 MT in quarter four of 2016. For the soft drinks domestic production increased from 123,984 thousand litres in third quarter to 140,193 thousand litres in the fourth quarter.

**Energy**

There has been continued concerted efforts to boosts energy production so as to meet the growing demand for energy by the growing economy.

More so, there is continued shift from the conventional sources of energy to concentrate on cheaper, reliable, clean and renewable sources of energy. This shift is observable, seeing that geo - thermal production as well as wind power generation combined have continued to lead the way in adding to the total energy production and hydro production, though significant, continues to relatively drop.

A review of the power generation for in the fourth quarter of 2016 reveals that the total energy production that was injected into the national grid slightly increased from 2506.54 million KWh in the third quarter to 2425.95 million KWh in the fourth quarter of 2016. During the quarter, hydro production posted a drop mainly arising from decline in water volumes following the...
poor short rains in the fourth quarter of 2016. A month – on – month review indicates hydro production substantially fell from 356.88 million KWh in October to 299.08 million KWh as at the end of December 2016. However, data on energy production reveals that thermal and geothermal production significantly rose to bridge the deficit on production arising from hydro production.

However despite the power demand outstripping power supply power losses still continued to persist though on decline. Within quarter four, the total power losses stood at 499.48 million KW a decline from a loss of 551.34 million KW in three of 2016. On the oil prices, the global oil prices assumed an upward trend for the entire of quarter 4. The monthly average crude oil prices for October stood at $ 51.35 per barrel declining to $ 46.15 per barrel in November and rising later to $ 54.15 per barrel as at the end of December 2016. This has been attributed to reduced production as well as supply in the world oil market by the oil producers on the realization that market glut has had consequences especially on their budget financing. However, the situation in the oil market still remains fluid with no certainty on the next move given that the world oil prices assume a random walk. The OPEC meeting’s decision for November 2016 to cut down on daily oil production from 33.8 million barrels a day (b/d) to 32.5 million (b/d) in an effort to prop up price therefore seems to be yielding positive returns in surging the oil prices up.

The daily world oil prices as measured by Brent oil prices and West Texas Intermediate prices are cognisant of the fact that price volatility dominated the entire of last quarter of 2016. It’s also evident that in the last month of

**Figure 14: Electricity Generation by Source (Million KWh), Jan 2016 – Dec 2016**

Source: KNBS
the quarter the prices were volatile but on an upward trend surpassing the 50 dollar mark thus implying some fruition of the intended price hike on the backdrop of decision to cut down the daily oil production by OPEC members.

In the domestic market the pump prices took an upward trend as well given the high correlation between the world oil prices and the domestic market pump prices. Throughout the quarter for the Energy Regulatory Commission reviewed the domestic pump oil prices upwards on the backdrop of rising price of the barrel in the world oil market. In addition, the resurgent of the dollar against other world currencies, slightly twisted the oil prices in the world market upward.

Table 1: Average Monthly Crude Oil and Retail Fuel Prices

<table>
<thead>
<tr>
<th></th>
<th>Jun-16</th>
<th>Jul-16</th>
<th>Aug-16</th>
<th>Sep-16</th>
<th>Oct-16</th>
<th>Nov-16</th>
<th>Dec-16</th>
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<tbody>
<tr>
<td>Murban crude oil (US$/Barrel)</td>
<td>49.05</td>
<td>44.60</td>
<td>48.85</td>
<td>45.50</td>
<td>51.35</td>
<td>46.15</td>
<td>54.15</td>
</tr>
<tr>
<td>Super petrol (KES/Litre)</td>
<td>87.07</td>
<td>93.81</td>
<td>96.01</td>
<td>92.28</td>
<td>92.44</td>
<td>95.82</td>
<td>95.08</td>
</tr>
<tr>
<td>Diesel (KES/Litre)</td>
<td>74.69</td>
<td>84.20</td>
<td>85.47</td>
<td>83.42</td>
<td>83.08</td>
<td>83.14</td>
<td>88.18</td>
</tr>
<tr>
<td>Kerosene (KES/Litre)</td>
<td>59.10</td>
<td>62.42</td>
<td>63.45</td>
<td>60.08</td>
<td>59.68</td>
<td>63.13</td>
<td>64.52</td>
</tr>
<tr>
<td>LPG (13Kgs)</td>
<td>2,231.38</td>
<td>2,097.51</td>
<td>2,078.76</td>
<td>2,029.12</td>
<td>1,989.54</td>
<td>1,987.69</td>
<td>1,983.06</td>
</tr>
</tbody>
</table>

Source: ERC

Figure 15: Crude Oil Prices

Source: US. Energy Information Administration
Building and Construction

Building and construction sector continued to be one of the core sectors supporting economic growth. This is supported by the fact that the sector remained to be one of the four key sectors that topped in terms of private sector credit allocation. Given the ongoing physical infrastructure construction, the sector has remain core in supporting the economy given the amount of the resources being channels to the sector. During quarter four of 2016, the sector registered a rise in demand for credit by 41 percent. However, the potentials of the sector remains untapped given the delayed payments by the government to the contractors with regard to the physical public infrastructural projects that has seen the tightening of the credit standards regarding the lending to this sector. The indicators of growth in this building and construction sector mainly cement production and consumption reveal that during the last quarter of 2016, cement production increased from 1,695,299 MT in quarter three to 1,703,770 MT. However, cement consumption rose marginally from 1,524,773 MT in quarter three to 1,558,871 MT in quarter three signifying low level of absorption as demand increases at a slower pace compared to the pace at which supply is rising at. On annual basis, cement consumption rose by approximately by 5 percent between Q4_2015 and Q4_2016 compared to 9.79 percent growth in production for the same period.

Transport and Communication

The total number of newly registered vehicles in quarter four significantly increased from 60,257 units in quarter three to 67,735 units in quarter four. This is attributed to increase in imported vehicles in the month of November and December 2016. This would imply that the market as at last quarter of 2016 had fully adjusted to introduction of new import charges on the second hand vehicles that were introduced in December 2015. Month — on — month statistics reveal that the number of newly registered vehicles rose from 11,018 units in October to 27,286 units in November and later marginally increasing to 27,431 as at end of December 2016.

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 model
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

In quarter four, tourism continued to post poor performance given the slump in the total quarterly number of visitors which dropped from 262,147 visitors in quarter three to 219,327 visitors in quarter four. Despite the last quarter being a festive season in December, the number of total visitors dwindled. This could be perhaps be attributed to unavailability of bookings for foreigners given that the bookings by the local tourist had rose substantially in the wake of the festive season in December. Within the quarter, it’s evident that though the arrivals via Mombasa International airport remain relatively stable between quarter three and four, arrivals via Jomo Kenyatta International Airport declined substantially by 18.66 percent for the same period.
Financing of Government

Public Debt

During the fourth quarter of 2016, the total quarterly public debt was Kshs 11.30 billion compared to 10.93 billion in quarter three. An analysis on the breakdown of the public debt into domestic and external debt reveals that the government through the National Treasury tried to maintain an equal balance between the two debts to stand at 50.65 percent in favour of domestic debt and 49.35 percent in favour of external for the entire quarter four.

This reflects a tight trade-off on the choice between the two types of borrowing hence limited flexibility of the National Treasury to prefer one at the expense of the other which has existed for a while. 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 account of the strength of the domestic currency against other major currencies.

On the financing of the government’s public debt, open market operations take an upper hand with the preference on government treasury bonds including the government frozen debt remained being evidenced. In quarter four of 2016, the government’s treasury bonds were the key money market instruments intensively utilized by the government in domestic borrowing accounting for 65.39 percent. Treasury bills, on the other hand accounted for 33.62 percent. Overdrafts at central bank and advances from commercial banks accounted for 0.66 percent and 0.03 percent respectively of total government debt for the entire four of 2016.

Money and Credit

During the last quarter of 2016, the monthly total money supply recorded a negative growth of 0.41 percent between October 2016 and November 2016 with a positive growth of 0.61 percent registered in November. As at end of December, money supply | the economy negatively grew by 1.03 percent. This growth therefore did not warrant any demand pressures likely to cause inflationary trends.

Inflation

The cost of living for the fourth quarter of 2016 remained on the upper bound of the Central Bank target with the quarterly average inflation rate being 6.5 percent in quarter four compared to 6.33 percent in quarter three of 2016. The rise in the inflation rates was mainly attributed to a number of factors. First is the rise in the prices of food following them poor performance in the long rains. As a result, the Food and Non-Alcoholic Drinks’ Index increased by 1.31 per cent between November and December 2016 having previously increased by 1.17 percent between October and November 2016. Secondly, the rise in the cost of electricity mainly underpinned on the fuel adjustment charges that rose from Ksh 2.34 per Kwh in November 2016 to Ksh 2.85 per Kwh December 2016 led to the rise in the overall month — on — month inflation.

A review of month – on – month inflation rates in quarter four of 2016 reveals that even though the monetary policy decision adopted on the 28th November, 2016 to retain the bank rate at 10 percent, inflation rate was slightly on the rise in the entire of the quarter despite it being with the target
range. The NFNF inflation was generally stable within the quarter. In overall, the month – on – month inflation rates remained within the upper bound of the Central Bank target range for the entire of quarter four. A review on the year – to – year basis reveals that the annualized inflation rates as at December 2016 stood at 6.30 percent compare to annualized inflation rate of 6.58 percent as at the end of December 2015.

The non – food – non – fuel inflation (NFNF) slightly rose in quarter four from a quarterly average of 5.0 percent in quarter three to a quarterly average of 5.12 percent in quarter four of 2016 signaling the absence of demand pressures in the economy. However, on month-on-month basis within the quarter, the NFNF inflation also declined to 5.5 percent in November to 4.6 percent in December 2016. Significantly, the 3-month annualized NFNF inflation fell from 6.8 percent in March to 4.6 percent in April, indicating that there were no significant demand pressures in the economy. The 3-month annualized NFNF inflation also decreased in December, suggesting that there were no demand pressures in the economy.

**Figure 22: Inflation rate (%)**

Interest rates remained fairly stable during the four quarter of 2016 following the coming into effect of the capping law. The short – term market interest rates as represented by the interbank market rates and the 91 – Treasury bill rates seems to mirror each other from May 2015 to December 2015 although with a one to two months lags.

The average lending rates for the commercial banks in quarter four remained relatively stable around the 14 percent cap rate. As at October 2016, the monthly average weighted lending rate was 13.65 percent rising to 14.31 percent.
percent in November and slightly falling to 13.69 percent as at the end of December 2016. On quarterly basis, the average weighted lending rate significantly dropped to 13.88 percent in quarter four from a high of 16.55 percent in quarter three. This is majorly determined by the introduction of the interest capping bill in September 2016. The short term interest rates, the 91 – Treasury bill rate were fairly stable though the quarterly average evidenced a shoot up trend compared to quarter three rising from 7.57 percent to 8.14 percent in quarter four. This is a manifestation of increased domestic borrowing to finance unplanned expenditure by the government. The interesting scenario here is that with the interest rates capping it would be expected that the 91 – Treasury bill rate presumes a downward trend as the appetite for government securities which have zero default risk would rise relative to lending to the public which would be considered more risky. However, the reverse was evidenced in quarter four of 2016. This implies that despite the capping of interest rates in mid – September 2016, this does not necessarily translates into reduction in the 91 – Treasury bill rate as long as the government appetite for domestic credit to finance deficits remains high.

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 as the commercial banks co – insure each other. It’s evident that the interbank market remained heavily volatile in quarter four of 2016 in both the weighted average market rate and the volumes transacted. Immediately upon the implementation of the interest capping in September, an upward surge is evidence in the overnight market in terms of volumes transacted. Towards December 2016, the market shows some slow down trends with the volumes plugging down while the market rates rise.
With the interest capping law, the interbank market is possibly affected indirectly in a number of ways. One of the most evident ways is that with the reduced lending by the commercial banks to the general public credit to private sector has shrunk four — folds. This implies that commercial banks are more likely to be liquid than before hence the decline in the volumes transacted in the market as at end of quarter four.

**Balance of Payments**

During quarter four, Volume of trade declined from KSh 179.1 billion in November 2016 to KSh 169.8 billion in December 2016. The total value of exports fell to KSh 46.68 billion while the value of imports decreased from KSh 129.5 billion in November 2016 to KSh 123.1 billion in December 2016. Domestic exports by Broad Economic Category (BEC) indicated that food and beverages was the main export category in December 2016 accounting for 42.5 per cent of exports, while the value of non-food industrial supplies and consumer goods not elsewhere specified registered 27.5 and 25.3 per cent shares, respectively. BEC imports indicate that non-food industrial supplies was the main import category in December 2016 with a share of 32.9 per cent, while the values of machinery & other capital equipment, fuel and lubricants and transport registered shares of 23.8, 15.1 and 10.0 per cent, respectively. Food and beverage recorded a share of 9.5 per cent while consumer goods not elsewhere specified recorded a share of 8.5 per cent.

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. 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 Pakistan with United State of America coming third.

**Figure 26: Overall quarterly trade balance**

![Overall quarterly trade balance graph](source: CBK)

**Figure 25: Interbank interest Rates and Volume**

![Interbank interest Rates and Volume graph](source: Central Bank of Kenya)
The overall quarterly trade balance slightly improved worsened from Ksh 233,470 million in quarter three to Ksh 229,369 in quarter four of 2016. This could be mainly attributed to the reduced importation of the visible imports in quarter four. Moreover the failure of the exports to fetch enough export earnings despite the depreciating shilling mainly due to the nature of the Kenya exports reduced propensity to import in quarter four on the backdrop of reduced income from exports.

**Exchange Rate**

During the last quarter of 2016, the shilling succumbed to weakening bias against the world major currencies. This occurred give a number of factors. First with the interest rates having been capped and with then inflation rates being within Central Bank’s target range, the rule of the impossible trinity in economics sets in implying that the instability is likely to reveals itself through the forex market and as such the exchange rate is bound to succumb to depreciation pressure unless the central bank sets in with a tightening monetary Policy. During quarter four, the shilling depreciated against the dollar with the depreciation setting in in the month of October lasting throughout the quarter. The weakening bias of the shilling against the dollar saw both the gross and the official foreign reserves adjust accordingly in an antagonistic trend implying that a depreciation in the shilling leads to the decline in the foreign reserves. This supported the negative correlation between exchange rate and foreign reserves (Figure 28).

Against the Sterling the shilling posted considerable mixed performance. This is evidenced by the appreciation of the shilling against the pound in the beginning of the quarter before later depreciating from the beginning of November. This could be attributed to the reduced competitive 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. As such although the domestic macroeconomic environment were not favorable for the resilience of the pound against the major world currencies, the lowering of competitive edge of Eurozone led to the shilling not depreciating much against the pound. Against the Euro, the shilling revealed mixed performance with the appreciations being more than the depreciations within the entire quarter.

![Figure 27: Nominal Exchange Rate](image)
Turning to the Japanese Yen the shilling posted significant appreciation in the entire quarter four. This is attributed to the shrinking of the Japanese economy which is struggling with the negative interest rates within the year. In the East African context, substantially appreciated against the Ugandan Shilling but weakening against Tanzanian Shilling.

**Nairobi Securities Exchange**

During the last quarter of 2016 the stock market continued to post poor performance as evidenced in the successive months indices during the quarter. A number of factors can be attributed to this performance. First is the enactment of the interest capping bill into law that saw the market capitalization for the entire market fall significantly triggered by a fall in the market capitalization of the listed commercial banks. Consequently, the NSE 20 share index and the Nairobi All Share Index (NASI) were on a downward trend to a low of 3186 points as at end of December 2016. A review of the daily data posits that upon the enactment of the interest capping law on 14th September 2017, the total market capitalization at the NSE and the NSE - 20 index dropped accordingly throughout the quarter (Figure 29). Although an upward surge is evidence in November, it only last for almost a month and fades off with pronounced dip setting in during the entire month of December.

Similar downward trend were evidenced in the total number of shares traded falling approximately three – fold from a high of Ksh. 746 million to a low of Ksh. 289 million throughout the quarter, foreign investors dominated the bourse in the equity transactions with over 60 percent mark throughout the quarter.

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**Figure 28: Foreign Reserves and Exchange Rate**

![Graph showing foreign reserves and exchange rate](image1)

**Source:** Central Bank of Kenya

**Figure 29: Market Capitalisation and NSE 20 share Index**

![Graph showing market capitalisation and NSE 20 share index](image2)

**Source:** NSE
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One Industry. Transforming Kenya.
**Assets and Loans**

The industry’s assets base registered a decline in growth of 0.72 percent during the fourth quarter of 2016 from Kes 3.78 trillion as at the end of September 2016 to Kes 3.76 trillion in December 2016. This could be attributed to a number of factors. First, is the likely effect of the interest rate capping bill which came into effect in the fourth quarter of 2016 which could have affected banks’ conversion of their liabilities (mainly deposits) into assets (mainly loans) arising from slowdown in lending. Second, is the effect of the industry from the placement of the three lenders into receivership with the most recent being Chase bank. This would have also adversely affected the industry’s total assets though negligibly. On the other hand, total industry’s gross loans and advances recorded a growth of 2.64 percent from Ksh 2.27 trillion in September 2016 to Ksh 2.3 trillion in December 2016. The increase in the loan book was contributed by four economic sectors; household/personal (53 percent increase), building and construction (41 percent increase), trade (53 percent increase) and real estate (38 percent increase).

**Bank Deposits**

The total deposits in the last quarter of 2016 recorded a negative growth standing of 1.54 percent from Kshs 2.69 trillion in September 2016 to Kshs 2.66 trillion in December 2016. The results here contradict the incentive on deposits mobilization created by the interest capping law that proposes 7 percent interest rate interest on the deposits. Since deposits by the public is a function of disposable income, this peak to the fact that even with this incentive, the public is unable to make deposits into their banks accounts since their disposable income has not increased. In addition the reduced confidence in the banking system by then public following the placement of three lenders on receivership would have contributed to low deposits by the public who might have preferred holding cash rather than deposits with the bank. In addition, commercial banks may have resulted into reclassification of bank accounts upon the implementation of the interest capping law which places a 7 percent interest on deposits.

**Gross Non-Performing Loans**

The ratio of gross non-performing loans to gross loans increased from 8.7 percent in September 2016 to 9.1 percent in December 2016. The increase in gross non-performing loans was mainly attributable to challenges in the business environment that led to cash flow constraints for borrowers.
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– Newsweek