About this Report

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

About the Centre for Research on Financial Markets and Policy

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

It is my pleasure to present to you the eleventh volume of the *Kenya Bankers Economic Bulletin*. This issue discusses the state of the Kenyan economy during the first quarter of 2014. The Bulletin reviews the strides that the economy has made since the beginning of the year, with an emphasis on the opportunities and constraints that continue to shape the economy’s gradual recovery.

The performance of the Kenyan economy has over the years been shaped by both domestic as well as international dimensions. These circumstances have shaped the Bulletin’s economic outlook, as motivated by the commentary that provides perspectives on the state of the economy and the policy environment.

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

Habil Olaka
CEO, Kenya Bankers Association
A breather before the main sprint or a pause after a false start?

By Jared Osoro

What crossed your mind when the Kenya National Bureau of Statistics (KNBS) released the Economic Survey 2015 that confirmed a real output expansion of 5.3 percent? Well, I thought so too. Maybe the economy is “taking a breather” after a jump from 4.6 percent in 2012 to 5.7 percent in 2013; or maybe it was a pause after a false start to the sprint towards vision 2030 real growth target of 10%.

Either way, the performance of the economy’s recovery post the global financial crisis has been anything but consistent (Figure 1). Given the erratic growth trend, I could ask, what will it take for the economy to steady its growth trend towards the medium term target and eventual realisation of the aspirational 10 percent growth?

First of all, it is worth noting that while 5.3 percent real growth is not stellar – we have had better years – it is hardly a disaster; we have had catastrophic years, such as 1992-93 when the economy literally shrunk, and 1997, 2000, 2002 and 2008 when real growth was dismal at best (Figure 2). The common characteristic of these years is that the respective performance was well below trend, meaning that the negative output gap (the difference between actual performance and potential performance) pointed towards idle capacity.

Figure 1: Kenya Real GDP Growth

Figure 2: Kenya’s Historical Trajectory of Real GDP Growth (%)
The ball then moves squarely to how the economy gets to fill the negative output gap. Conceptually, whenever an economy has a negative output gap, private sector demand for new investments is constrained as firms are focused on reducing excess capacity. Under the circumstances, public investments can (and do) help the economy pick up the growth momentum. Such investments translates into increased private sector productivity with a time lag; in the interim credit demand leans more towards working capital requirements meant to boost capacity utilisation.

How is that presently playing out? To have a good idea, start with the fact that the Kenya economy has been hit by shocks emanating from insecurity and plummeting prices of export commodities. Therefore agriculture and export-oriented agribusiness is operating sub-optimally; similarly the tourism industry is evidently hurting. Grated the recent significant oil prices decline has boosted consumer demand; the price are nonetheless on a gradual recovery trajectory.

Health supplement or steroid?

It is a popular view then that the economy needs a stimulus. That requires a careful examination to obviate the confusion between health supplements and steroids. We have an ambitious fiscal budget for the 2015/16 fiscal year on the table estimated at about KES2.2 trillion. The budget has been packaged to be targeting the stimulation of growth in the Keynesian sense — increase in government expenditure at a time when there is no scope for monetary stimulation.

The Central bank of Kenya (CBK) is often quick to allay any insinuations of fiscal dominance — where an expansionary fiscal policy will necessitate monetary policy tightening as a counter to obviate inflationary pressure — indicating that the two macro-policies of monetary and fiscal are attuned towards the common objective of promoting growth without compromising stability.

While evidence may in the interim seem to vindicate the CBK’s position with regard to fiscal expenditure not influencing monetary policy insofar as it could potentially be inflationary, we cannot be sanguine as to the effect of the fiscal position being benign on other market prices and notably interest rates. I say so basing my argument on the funding side of the budget, cognisant of the fact that the revenue base is an ambitious real growth outlook of the economy, as I argue later, may be at odds with the trend already observed.

The implication of overstating the tax base is the possibility of increased domestic borrowing to meet the expenditure needs. There are those inclined to arguing that government’s borrowing programme is often consistent with...
monetary policy and has not crowded out private sector credit. It is to see that as more of conjecture than anything else. When it comes to borrowing needs timings critical. The fiscal year 2014/15 is coming to an end when liquidity in the market is fast tightening.

Further, an expansionary fiscal policy could necessitate that the CBK’s explicit monetary tightening through open market operations (OMO) is sustained into the next fiscal year; it doesn’t help that there are still absorption challenges that remain unaddressed thus will on occasion lead to Government deposit build-up at the CBK and consequently compounding the tight market liquidity.

On the monetary front, I have alluded that there is little scope for accommodation as the macro environment becomes very dicey. Inflation is fast approaching and is likely to breach the government target range. This is on the back of the local currency being on a bungee jump mood (Figure 3). As is evident, the Kenya shilling has for a while had a depreciation bias. Lately though the depreciation pressure is causing anxiety – if public commentary that depicts desperation as manifesting volatility is anything to go by.

Of course there is basis for some measured level of confidence based on the fact that we have usable foreign exchange reserves equivalent to 4.4 months and the precautionary facility from the International Monetary Fund (IMF) will provide a cushion for the foreign exchange market against any temporary volatility. But it is important to acknowledge that the external fundamentals as reflected by the current account position (Figure 4) have been weak and the currency has been appreciating in real terms – meaning that the economy has been losing export competitiveness and therefore a nominal depreciation is a correction.

![Figure 3: Nominal Exchange Rate (KES/USD)](image)

Source: Central Bank of Kenya

![Figure 4: Current account balance (% of GDP)](image)

Source: IMF World Economic Outlook Database (April 2015)
Outlook

Over the past six years, the trend (not magnitude) of real output performance for Kenya has mirrored that of Sub-Saharan Africa (Figure 1 and Figure 5). Indeed the economy’s growth is relatively more correlated with Sub-Saharan African than other regions, reflecting its close integration with the continent (Figure 6). The IMF’s Regional Economic Outlook — Sub-Saharan Africa has had a better record projecting the Sub-Saharan Africa growth, than Kenya’s; it projects a decline in the region’s real growth to 4.5 percent for 2015 from 2014’s 5.0 percent real growth. At the same time it projects Kenya’s real growth to rise to 6.9 percent in 2015 from 5.3 percent in 2014.

This is obviously an ambitious projection — which interestingly is similar to the official projection upon which the fiscal budget for 2015/16 is based. As I have argued in past Bulletins, the best case growth scenario, factoring in all circumstances, is 6 percent for 2015. If that growth were realised, then we could be seeing a pause before the spring; if the ambitious growth faces headwinds, then we could have experienced yet another false start to the attainment of the aspirational growth target.

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State of the Economy

Growth in GDP

During year 2014, the economy is estimated to have grown by 5.4 percent positioning it as one of the fastest growing economies in the Sub Saharan Africa. This growth was mainly supported by improved growth in the manufacturing, agriculture and the industries. The service industry was however sluggish owing to the security challenges that grounded the tourism sector; a major component of the service sector. The decline in the world oil prices may be argued to have been a boon in so far the Kenyan economic growth is concerned particularly in the last quarter of the 2014. This was evidenced by the relatively low levels of inflation rates which oscillated around the Central Banks; target core target of 5 percent.

Owing to the fact, the economy entered the first quarter of 2015 in a very sound state placing the economy at a very opportune level to post impressive growth. The spill over effects of low oil prices continues to infiltrate the economy for the entire quarter one of 2015. This is evidenced by the consecutive reduction in the pump prices within the quarter a turnaround in the upward trend in the oil prices evidenced in other quarters of 2014. Secondly the falling oil prices meant low inflation rates for Kenya in the entire quarter one of 2015. As a fact, the quarterly inflation rates for quarter one of 2015 averaged at 5.82 percent the lowest ever since quarter two of 2013.

However, during the first quarter of 2015, the currency was not in favor of the economy owing to the continued prolonged weakening bias against the major currencies such as the dollar. This was mainly attributed to the resurgent in the US dollar a result arising from the spillover effects of last year’s quantitative easing. As at the end of quarter one, the shilling shed 1.40 percent of its value against the US dollar based on the mean monthly nominal exchange rate. The overall effect of a weakening shilling on the economy was the loss in the international competitiveness of the Kenyan economy. Moreover, the depreciation in the shilling eroded some gains that would have been realized from the decline in the international oil prices given that a weak shilling infer into high importation cost. In addition, the interest payments for the dollar denominated national debt is expected to rise given the weakening shilling.

From the Figure 7, it can be deduced that the average quarterly inflation rates have been on the decline after third quarter of 2014 signifying the spillover effects of the declining world oil price which is a major input in the overall inflation.

Figure 7: Average Quarterly Inflation Rates

Source: Central Bank of Kenya

Figure 8: Quarterly Growth in GDP – 2009 Base Year

Source: KNBS
Upon the revision of GDP in September 2014, following the debasing, the provisional estimates for the GDP posit that the country’s economy expanded by 5.4 percent in 2014. This growth was mainly supported by robust expansion in construction, finance and insurance; wholesale and retail trade; information and communication; and agriculture and forestry. In addition, the declining world oil prices positively impacted on the quarterly growth in the third quarter as well as the fourth quarter in year 2014.

The macroeconomic stability witnessed in the previous quarters of 2014, continued to be experienced in the first quarter of 2015 especially as witnessed by the declining inflation rates. With the declining world oil prices, the overall month — on — month inflation rates interest rates remained steady. However, the erratic rains in October — December 2014 curtailed the sufficient food production which resulted into an upward surge in the food prices. However, the rise in the food prices for quarter four of 2014 was mild hence a modest impact on the overall month — on — month inflation rates. Similarly, the liquid management via the open market operations by the central bank of Kenya helped stabilize the inter — bank rates and consequently, stabilization in the short — term interest rates.

Looking at the forex market, the Kenya shilling continued to experience a weakening bias against the dollar. This was mainly underpinned on the declining world oil prices which implied the appreciation of the US dollar worldwide and the depreciation of other currencies. However, despite the weakening bias on the shilling, the foreign exchange reserves remained stable standing at 4.64 months import cover as at October 2014. From the world outlook, it is clear that it’s not only the shilling that experienced a weakening bias but other currencies such as the Japanese Yen, Nigerian Naira and the Russian Ruble among others.

The average yield rate for the 91- day Treasury bills, which is a benchmark for the general trend of interest rates, declined from an average of 8.82 percent in quarter three to an average of 8.63 percent in the fourth quarter of 2014 signaling some sense of stability in the credit market. The cost of credit declined mildly as evidenced by the mild decrease in the average quarterly lending rates from 16.40 percent in quarter three to a quarterly average of 15.98 percent in quarter four of 2014.

**Agriculture**

Following the harsh climatic conditions experienced in the first quarter of 2015, the agricultural sector posted mixed performance in its subsectors with majority of subsectors posting poor performance.

From the cash crops point of view, the quantity of produced tea decreased from 45,071 MT in December 2014 to a low of 24,276 MT in February 2015 albeit average auction price per kilogram rose significantly from Ksh 181.87 per kilogram in December 2014 to Ksh 221.42 per kilogram in February 2015. The poor bonus pay to tea
farmers with large disparities among various tea growing zones in the country could be a factor underpinning fluctuation in tea production in the fourth quarter of 2014. However, for milk production, milk deliveries to formal processors declined from 46.6 million litres in December 2014 to 46.0 million litres in January 2015 and further declining to 42.4 million litres mainly due to the effect of the dry spell experienced in the first quarter of 2015.

It’s notable that while the prices of tea significantly rose from Ksh 181.87 per kilogram in December to Ksh 221.42 per kilogram as at the end of February 2015, auction prices of coffee at Nairobi coffee exchange fell from Ksh 411.00 per kilogram in December to Ksh 378.17 per kilogram in March 2015 despite it having risen to a high of Ksh 489.32 per kilogram.

The significant decline in the production of coffee and tea is not wholly caused by erratic rains but also the encroachment of tea and coffee production zone for real estate development especially in central province since the rental income from real estate yield higher returns as compared to income from coffee sale. There is therefore the need for government intervention to formulate policies that will delineate agricultural land

Figure 9: Tea production in Metric Tonnes

![Tea production in Metric Tonnes](image)

Source KNBS
average 52 percent of total quantity of horticultural exports for the entire quarter one of 2015, followed by vegetables at 27 percent with fruits exports recording the lowest contribution of 15 percent. Looking at the foreign exchange earned from horticultural exports, cut flowers dominate this subsector contributing on average 77 percent of total horticultural exports for the entire quarter one of 2015, followed by vegetables at 18 percent with fruits exports recording the lowest contribution of 6 percent.

On horticultural exports (Figure 11), in terms of quantity exported in quarter one of 2015, cut flowers dominate this subsector contributing on...
Manufacturing

The manufacturing sector in Kenya is considered to be one of the pillars for the achievement of vision 2030 goals through transiting the economy from traditional agriculture to modern manufacturing economy. As per the debased GDP estimates manufacturing sector grew by 3.4 percent in quarter four of 2014. This growth was supported by modest inflation experienced during the quarter as well as the low oil prices which contributed to a reduction in the cost of production.

For the fourth quarter, assembled vehicles decreased from 887 units in October 2014 to 724 units in November 2014. However, cement production increased from 490,568 metric tonnes in September 2014 to 501,624 metric tonnes this improvement in cement production and consumption following the rapid growth in the real estate sector. Similarly milk intake rose from 42.5 million litres to 44.4 million litres in December 2014. The sector is set for a revolution following the 2014/2015 budget reading which is likely to benefit the sector from tax exemptions for locally manufacturing industries as well as tax imposition on the external manufactured goods to cushion local industry from unfair competition. However following the policy lag — effect, the results of 2014/2015 budget on the manufacturing sector is yet to be realised for the rest of the year. There has been alot of emphasis on energy sector in attempts to lower the cost of energy which adversely affects production costs. Concerted efforts to boosts energy production especially the geo-thermal and reduce over reliance on hydro production continues to be a priority in the central government. In addition new reflections on boosting green energy such as solar energy has come into the limelight especially for households use hence reducing demand pressures on the national grid line. This is evidenced by commissioning of an additional geothermal power plant adding 140 megawatts into the national grid hence lowering the cost of power by 30 percent.
A key component of the manufacturing sector is its output that targets the construction industry. The domestic production of galvanized sheets significantly declined from 26.732 metric tonnes in October 2014 to 18,539 metric tonnes in December 2014. However, cement production increased to hit a high of 533,294 metric tonnes in January 2015.

Turning to the number of assembled vehicles, the total number of vehicles registered expanded from 17,226 in November 2014 to 20,608 in December 2014. Motor cycles and station wagons accounted for 44.58 and 30.8 percent respectively of total motor vehicles registered in December 2014. On the other hand, milk production declined significantly with milk deliveries to formal processors falling from 46.6 million litres in December 2014 to 42.4 million litres in as at the end of March 2015.

**Energy**

Electricity generation has continued to grow, albeit still outpaced by demand. However, it’s notable that the sector has started realizing the output from the significant investment directed to the sector by the government. This is evidenced by the increase in the geothermal production by 74.06 million KWh in quarter one of 2015 compared to quarter four of 2014. During the same period, the thermal and hydro production declined on quarterly basis.

Comparing quarterly productions, between quarter four of 2014 and quarter one of 2015, thermal power generation mildly declined by 7.48 million KWh from 371.97 million KWh in quarter four of 2014 to 364.49 million KWh in quarter one of 2015. Similar trend was portrayed in hydro production that recorded a massive decline in production shedding 114.77 million KWh between quarter four of 2014 and quarter one of 2015. However, geothermal production rose by 74.06 million KWh rising from 1043.13 million KWh in quarter four of 2014 to a high of 1117.19 million KWh by the end of quarter one of 2015. The rise in inter quarterly geothermal production could be mainly attributed to government’s...
effort to boost the power generation from geothermal sources which is more sustainable and environmentally friendly given the high power bills arising from massive generation of power from thermal source which wholly depends on diesel for power generation.

Figure 14: Electricity Generation by source (Million KWh), Jan 2013 – Dec 2014

Energy prices in Kenya for the entire of quarter one were on decline given the declining world oil prices during the first three months of 2015 ranging from a low monthly average of $46 per barrel to a high of $56.55 per barrel before slightly falling to $56.10 per barrel in March 2015 (Table 1). The oil market performance in the first quarter of 2014 was a clear revelation that the economics of oil has really changed beyond being ruled by the forces of demand and supply. This is informed by the outcomes of the geo political crisis with Saudi increasing its production to stand at 10 million barrels per day hence the existing market glut in the entire of quarter one. The worldwide perception that the political tension in the geopolitical zone coupled with the Euro crisis could potentially drive the world oil prices up has proved not to come to fruition. In addition the increase in the production of the shale oil in the US combined by the reduced economic activity in the emerging economies have also contributed to the falling oil prices in world market.

In addition, the failure to agree among the OPEC member saw the failure of a unanimous decision to cut down on oil production come to fruition. This is driven by the major oil producers taking sides with regard to the Russia – Ukraine battle. The Yemen war has further exacerbated the prospect of the oil prices surging up given the Saudi — Iranian conflict over power in Yemen.
Its, however, noteworthy that despite the low oil prices being good news to less developed countries such as Kenya, it has on the other hand adversely affected the oil producers such as Venezuela, Nigeria, Saudi, Russia and Angola among other given the their budgets are substantially financed by oil revenue. Therefore the reverse of a commodity boom in the oil market is seen to have substantially affected the oil producers negatively. The effect of the low world oil prices were fully felt in Kenya for the entire of quarter one of 2015. This was evidenced by a significant decline in the pump prices as well as the decline in the fuel inflation. However, it noteworthy that the weakening bias in the Kenya shilling is likely to erode these benefits and lead to the rise in the pump prices arising from the increased importation cost due to a weak shilling.

Building and Construction

As at the last quarter of 2014, the sector posted a growth of 13.1 percent mainly owing to the increased construction in the real estate for both the office space and home ownership. Looking at the production and consumption of cement as a proxy for measuring the growth in the building and construction sector, it’s evident that cement production increased from 488,407 metric tonnes in January 2015 to 533,294 metric tonnes in March 2015; - a 9.19 percent growth. An insight into cement production also reveals the growth in the building and construction sector especially in both the real estate development and the construction of the major physical infrastructure by the government. Looking at the quarterly growth in cement production, the total quarterly production in the first quarter of 2015 stood at 1,487,172 metric tonnes compared to 1,471,188 metric tonnes in quarter four of 2014; - a mild 1.09 percent in growth. The rise in the cement consumption arises from increased demand for construction mainly in real estate development among the expanding middle income and overall growth in population and its composition as well as increased government construction of the physical infrastructure.

Transport and Communication

The total number of registered vehicles in Kenya recorded an impressive performance in the fourth quarter of 2014 looking at the month – on – month growth. Between the month of November and December 2014 the total number of registered vehicles rose from 17,226 to 20,608; - a 19.63 percent growth. This growth was tremendously contributed to

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<th>Jan - 15</th>
<th>Feb - 15</th>
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<td>2,739.35</td>
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Source: ERC

![Figure 15: Cement Production and Consumption, MTs](source: KNBS)
by station wagons and motor vehicles. However, looking at the total quarterly number of vehicles, it’s evident that quarter four of 2014 recorded a decline in the total number of registered vehicles compared to quarter three of 2014. In quarter three the total number of registered vehicles stood at 71,191 compared to a total of 55,048 vehicles in the fourth quarter (Figure 16).

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

**Tourism**

For the entire of quarter one of 2014, tourism continued to be depressed suffering from the negative shock arising from the travel advisories by the foreign agencies mainly from United States, United Kingdom, France and Australia arising from the insecurity threats in the country. Looking at the number of visitors arrivals via the JKIA and Moi international airport, the JKIA arrivals declines from a total of 192,559 visitors in quarter four of 2014 to 177,085 visitors in quarter one of 2015; a 8.04 percent quarterly drop. However despite this quarterly decline, a review of the quarter indicate an improvement in the JKIA visitors’ arrivals with the numbers rising from 50,953 in January 2015, to 53,053 in February and further significantly rising to a high of 73,079 visitors in March 2015.

Looking to the arrival through the Moi International Airport the quarterly total arrivals slightly improved from 23,046 visitors in quarter four of 2014 to 24,947 visitors in quarter one of 2015; an 8.25 percent increase. However an insight into the quarter reveal that the visitors have been declining throughout the entire quarter. This is evidenced by the decline in visitors in January from a high of 10,107 visitors, declining to 7,882 in February and further falling to 6,958 visitors as at the end of March 2015. This could be attributed to the insecurity within the coastal region at large.
Figure 17: Trends in Visitor Arrivals

Source: KNBS

Financing of Government

Looking at the government revenues, the total revenue for the first quarter of 2015 stood at Ksh 1.28 billion for the month of January and February combined compared to Ksh 1.25 billion in the entire quarter four of 2015. Of this, the total tax revenue accounted for 87.63 percent of the January – February revenue in quarter one with the non – tax revenue accounting for 12.27 percent. Of the tax revenue, income tax topped the list at 51.36 percent followed by value added tax at 28.06 percent with excise duty and import duty coming third and fourth at 12.62 percent and 7.96 percent respectively for January and February 2015.

Figure 18: Tax revenue (Ksh. Million)

Source: CBK

Turning in to the government expenditure, the total expenditure for January and February 2015 stood at Ksh 1.63 billion. Of this, the recurrent expenditure dominated the total expenditure accounting for 74.85 percent while the development expenditure accounted for 25.15 percent of the total expenditure for January – February 2015. The growth in the recurrent expenditure can be attributed to the increment of the county government disbursements following the increase in the county funds allocation them mainly goes to recurrent expenditure. Between January and February 2015, the total development expenditure grew from Ksh 196.86 million in January to Ksh 212.87 million in February. This is attributed to the rolling out of various development projects mainly the physical infrastructure in the road transport networks, the standard gauge railway and airport expansion among others.

Figure 19: Public Expenditure (Ksh. Million)

Source: CBK

Public Debt

The total public debt increased by a 6.09 percent from Ksh 2.49 billion in January 2015 to Ksh 2.65 billion in February 2015. This was largely contributed by the domestic debt which grew from Ksh 1.33 billion to Ksh 1.35 billion in the same period compared to external debt which declined from Ksh 1.16 billion to Ksh 1.30 billion in the same period. This signifies the government’s appetite for domestic debt as opposed to external debt. This could be attributed to the weakening shilling against dollar which could have seen the government shying away from external
borrowing to avoid the debt burden that would arise from a weakening shilling especially for the short term borrowings. On the other hand, the government could be trying to take advantage of the vibrant financial market domestically as evidenced by the frequent over-subscription of the government securities.

Government treasury bonds remained the key money market instruments intensively utilized by the government in domestic borrowing accounting for 71.92 percent of the total government debt for quarter one of 2015. Treasury bills, overdrafts and advances accounted for 25.41%, 2.44% and 0.02% respectively of total government debt for the entire of quarter one of 2015 (Figure 20).

Money and Credit

In the first quarter of 2015, the monthly total money supply grew substantially in February 2015 from 0.09 in January to 2.43 percent in February 2015 (Figure 21). It can be deduced that the total money supply posted a growth that was in tandem with the Central Bank’s inflation rate target bound of 5 percent 2.50 basis points. Therefore expansion in money supply did not impose adverse inflationary pressures in the economy from the money supply side. Given that money supply is derived from money demand within the economy, then the implication here is that demand for money did not impose any inflationary trends in the economy within quarter one of 2015.

Inflation

The upward trajectory in the month –on - month inflation rates as experienced in the entire quarter four of year 2014 experienced a reversal in the subsequent first quarter (Figure 22).

The first month of the quarter started with a fall in the overall month — on — month inflation rates. This was attributed to the realization of gains arising from the falling global oil prices. However in February, the month — on — month inflation rates surged up mainly due to the rise in the food prices thus offsetting the gains of low inflation arising from the low oil prices. As at the end of the quarter, the overall month inflation stood at 6.31 percent up from 5.53 percent in January 2015. The rise in the inflation rates in quarter one of 2015 is largely attributed to the extremely dry weather conditions experienced in entire quarter. It’s notable that during the quarter, prices of Housing, Water, Electricity, Gas and Other Fuels’ Index were on a decline.
Interest Rates

A look at the non-food non-fuel inflation (NFNF) which measures the effects of the monetary policy stance indicate that from November 2014 to the end of February 2015, there was no demand driven inflation. In fact the demand driven inflation was on the decline. However, as at the end of the quarter, the NFNF inflation posit an upward trend signifying some sense of the demand driven inflationary pressures.

Interest Rates

Interest rates have largely been stably during the first quarter of 2015 (Figure 23). This was on the back of monetary policy being constant as evidenced by unchanging Central Bank Rate (CBR) as well as marginal change in interest rates on government securities. The CBR has continued being pegged at 8.5 percent throughout the fourth quarter following the MPC decision in signaling central bank’s commitment to anchor inflation rates ever since May 2013.

The 91—day Treasury bill rate remained fairly stable stagnating at 8.59 percent for the entire of the quarter. Similarly were the rates for the 182 days T-bill and 364 days T-bill continued were very stable throughout the quarter.

The cumulative average weighted lending rates mildly declined from 15.95 percent in January 2015 to 15.68 percent as at the end of March 2015. However, banks still face high costs of operations as manifested by some banks recording declining profit margins and stark changes in their rates would impact their operations adversely. However, the financial market still remained illiquid for the entire quarter four of 2014 as evidenced by the relationship between the average lending rates and the CBR. This implies that the central government’s effort to reduce the domestic borrowing in attempts to avoid crowding out effect and maintain low interest rates has not yielded much in lowering market interest rates.

The interbank rates recorded a significant downward shift from 7.12 percent in January 2015 to 6.85 percent in March 2015. This implies less central bank’s intervention in the money market via repurchase of excess shilling and pumping of foreign exchange into the forex market in attempt to cushion the shilling which was under intense weakening bias for the entire of quarter four. The failure for the intervention supports the experienced depreciation of the shilling throughout the quarter. The interest rate spread for the entire of the quarter averaged at 8.97 percent as opposed to an average of 9.25 percent in quarter four of 2014.
Balance of Payments

In the first quarter of 2015, the value of imports declined from Ksh 127.65 billion in January 2015 to Ksh 114.86 billion in March 2015. Domestic imports statistics indicate that machinery and transport equipments accounted for 26.66 percent of the total imports for quarter one of 2015 with manufactured goods, chemicals and mineral fuels accounting for 18.01%, 16.52% and 15.12% respectively.

Turning on the exports, the value of the exports increased from Ksh 41.16 billion in January 2015 to Ksh 47.71 billion in March 2015. Out of the major selected exports, tea exports topped the list accounting for 23.08 percent of the total exports for quarter one of 2015. Horticulture came second at 17.56 percent with chemicals and coffee accounting for 7.69 percent and 4.05 percent respectively.

Regarding the major destination for the Kenyan exports for the intra African trade, Uganda topped as the most preferred export destination for domestic exports with a high of 27.63 percent of Kenya’s total exports for entire quarter one of 2015 followed by Tanzania at 12.41 percent. Looking at the Kenya exports destinations globally for quarter one of 2015, Uganda topped at 11.52 percent followed closely by Netherlands at 8.70 percent with United Kingdom coming third at 8.02 percent. USA, Pakistan and Tanzania follow at 6.58, 5.19 and 5.17 percent respectively.

Turning into the overall quarterly trade balance, it’s evident that while the quarterly trade balance improved from Ksh. 288,995 million in quarter four of 2014 to Ksh. 224,138 million in quarter one of 2015. This could be mainly attributed to the decline in the world oil prices which reduced the oil import bills significantly despite the weakening bias playing into the contrary through the loss of international competitiveness.
Exchange Rate

During the first quarter of 2015, the shilling has continued to post poor performance against hard currencies in nominal terms given the weakening bias. This implied the loss in the economy’s international competitiveness. During the quarter, the shilling fluctuated between the monthly average rate of 91.36 and 91.70 marks against the US dollar in January and March 2015 respectively. The weakening bias on the shilling was mainly attributed to the declining world oil prices following the oil market glut that saw the resurgent in the US dollar given that oil is traded in the dollars. Although the central bank tried to intervene in the forex market the weakening bias continued to exist throughout the quarter. The depreciation of the shilling can also be attributed to the increased demand for dollar at the global level in attempts of the non-oil importing economies trying to import more oil to build up their reserves. We note that despite the 11.6 percent increase in the foreign remittances to US$ 123,236 thousand in February 2015, this did not help in curbing the depreciation bias on the value of Kenya shilling. However the overall foreign exchange remained stagnant at 4.40 import cover.

Looking at the sterling pound, the shilling gained to a monthly average at 137.51 mark in March up from 138.49 mark in January 2015. This can be attributed to the effects of Euro crisis on the British economy given its European Union membership. Font the Euro and Japanese, the shilling shilling appreciated with the major factors being the geopolitical oil price crises coupled with the slow recovery and then Euro crisis. With the Euro zone facing the deflation, the Euro has been under weakening pressure against other world currencies hence the depreciation (Figure 25). In addition the economic jitters amid the election in May 2015.

For the East African financial market the shilling continued to post resilient performance against the Ugandan and the Tanzanian shilling. For the Ugandan shilling the shilling exchanged at a monthly average of 32.19 in the month of March up from a monthly average of 31.29 in January while for the Tanzanian shilling the monthly average nominal exchange rate oscillated between 19.39 and 20.09 mark in January 2015 and March 2015 respectively.

Source: CBK

Figure 25: Exchange Rates
Nairobi Securities Exchange

The Nairobi Securities Exchange (NSE) performance in the entire of quarter one of 2015 remained high as revealed by all the market indicators which appear to have been on an upward trend. The NSE – 20 share index was still resilient for the entire of quarter remaining at above the 5,000 points mark. However, the inter — month analysis if the index points some decline from a high of 5,491 points in February 2014 to a low of 5,346 points as at the end of March 2015; – a mild decline of 2.64 basis points. The performance of above 5,000 basis points was mainly supported by increased participation of the foreign investors as evidenced by the increase in the foreign investors’ participation as at the end of the quarter from 44 percent in February to 53 percent. This implies that foreign investors turned from being net buyers between February 2015 and March 2015 perhaps in anticipation of the coming dividend pay outs in the second quarter of 2015.

The NSE All share index as well which rose from 166 points in January to 176 points in February before shedding off 2 points in March 2015 to close the quarter at 174 points. The overall market capitalization remained fairly stable throughout the quarter averaging at Ksh 2,421 billion. On the other hand, the volume of the shares traded significantly rose especially in the last month of the quarter owing to the increased demand arising from the increase foreign investors’ participation in the market during the same period. Similar trend were evidenced in the entire market equity turn over.

The newly introduced growth enterprise market segment (GEMs) of the bourse remains challenged given the few listings and the poor performance of the companies listed in the segment.

The fixed income segment as represented by the bond market posted some mild improvements in performance as evidenced by the bond turn over rise from Ksh. 38 billion in January to Ksh. 46 billion in March. Notably, the bullish behaviour dominated the market especially towards the quarter amid the dividend pay-out period due to commence in the second quarter of the year. In addition, the suspension of the 5 percent capital gains tax in January shortly after its introduction saw the reversal in the market performance in February and March.

Banking Industry Performance

A highlight of the banking industry for quarter one of 2015 posits that Demand for credit generally grew in a number of sectors namely: personal / household, trade, building and construction, transport and

Table 2: Nairobi Securities Exchange Market Indicators

<table>
<thead>
<tr>
<th>Date</th>
<th>Jan 2015</th>
<th>Feb 2015</th>
<th>Mar 2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>NSE 20 Share Index 100 =1966</td>
<td>5,212</td>
<td>5,491</td>
<td>5,346</td>
</tr>
<tr>
<td>NSE All Share Index (NASI) 100=2008</td>
<td>166</td>
<td>176</td>
<td>174</td>
</tr>
<tr>
<td>Market Capitalization (Kshs. Bn)</td>
<td>2,350</td>
<td>2,461</td>
<td>2,452</td>
</tr>
<tr>
<td>Total Shares Traded (Million)</td>
<td>414</td>
<td>593</td>
<td>614</td>
</tr>
<tr>
<td>No. of Equity Transactions</td>
<td>39,813</td>
<td>42,387</td>
<td>44,715</td>
</tr>
<tr>
<td>Percent of Foreign Participation to ET</td>
<td>47%</td>
<td>44%</td>
<td>53%</td>
</tr>
</tbody>
</table>

Source: NSE, Monthly Trading Report

Centre for Research on Financial Markets & Policy, KBA 21
Agriculture. However, demand for credit in mining, energy, financial services, manufacturing and real estate remained unchanged for the entire of quarter one of 2015. Tourism and hotels sector continued to register a decline in demand for credit mainly due to the travel advisories by the foreign countries to their citizens as well as the insecurity crisis in the country.

**Assets and Loans**

The industry’s assets base registered positive growth of 19.5 percent during the first quarter of 2015 to stand at Ksh. 3.37 trillion as at the end of March 2015 compared to Ksh. 2.82 trillion in December 2014.

Similarly, total industry’s loans and advances marginally grew by 3.5 percent in quarter one of 2015. A quarterly review of growth in the banking industry’s total loans and advances posit that as at the end of March 2015, the total loans and advances stood at Kshs. 2.03 trillion compared to Kshs. Ksh. 1.97 trillion in December 2014. Comparing the quarterly growth in loans and advances between quarter three and four of 2014 with the growth in the demand deposits, it’s evident that Loans and advances, the difference between the two is dismal. This is because, the total industry’s demand deposits grew by 3.4 percent in the same period while the total loans and advances grew by 3.5 percent hence signifying the banks’ capability to convert their liabilities into assets. The total demand deposits as at the end of quarter one of 2015 stood at Kshs. 2.41 trillion. Securities owned by government and placements comprised a major part of the banking industry’s balance sheet. The growth in loans and advances was buoyed by increased demand for credit mainly in personal and household, trade, agriculture and building and construction. Tourism and hotels industry recorded the lowest uptake of credit given the security challenges that discouraged investment in these sectors.

**Deposits**

The total deposits in quarter one of 2015 recorded a mild growth of 3.5 percent compared to quarter four of 2014. Demand deposits accounted for major source of total banking industry funding liabilities thus implying the short term inflows in terms of demand deposits majorly financed the industry’s total loans and advances. The growth in deposits was majorly attributed to increased branch expansions as banks initially involved in corporate banking continue embracing retail banking to leverage on competition from other players, remittances and receipts from exports. In addition, the tremendous growth in agency banking contributed to the growth in the demand deposits base given that the model has proved to be essential in banking the unbanked population especially in the rural areas. For the entire of quarter one of 2015 the total industry’s deposits stood at Kshs. 2.42 trillion compared to Kshs. 2.33 trillion in quarter four of 2014.

**Total Shareholder Funds**

Total capital stock of the Kenya banking sector sustained its upward trajectory in the first quarter of 2015 thus signifying growth in the shareholders’ wealth in the banking industry albeit minimal. The quarter recorded a growth in share holders’ wealth of 0.72 percent from Ksh 530.09 billion as at the end of December 2014 to Ksh 533.09 billion as at March 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. The decline in the shareholder’s wealth by the end of March 2015 could signify the increase in appetite for dividends following the end of financial years for the majority of banks.
Gross Non-Performing Loans

The gross non-performing loans increased in quarter one of 2015 by 9.4 percent to average at Kshs. 117.2 billion in quarter one compared to Kshs. 107.1 billion in quarter 4 of 2014. During the first quarter, ten out of eleven sectors analysed, recorded an increase in the non-performing loans with the underpinning factors mainly being the spill over effects of high lending rates and the challenges in the business environment. Building and construction topped the NPLs per sector at 27.55 percent followed by real estate at 20.49 percent. Energy and water sector and mining and quarrying posted the least contribution to the total NPLs of 1.1 and 1.3 percent respectively.

Bank Profitability

The banking sector recorded a mild increase of 2.7 percent in the profit before tax during quarter one of 2015, to stand at Ksh. 37.3 billion against Ksh. 36.32 billion in December 2014 (Figure 30). Total income remained unchanged for quarter one of 2015 stood at Ksh. 110.03 billion; - a 1.6 percent decline from quarter four of 2014 while total expenses decreased by 3.7 percent from Ksh. 75.52 billion in December 2014 to Ksh. 72.73 billion as at March 2015. Interest on loans and advances, fees and commissions and government securities were the major sources of income accounting for 61 percent, 16.4 percent and 15.6 percent of total income respectively. Contrary, interest on deposits, staff costs and other expenses were the main components of expenses, accounting for 35.3 percent, 26.7 percent and 22.3 percent of the total expenses respectively.
Agency Banking

Agency banking model in Kenya has become a critical model of branchless expansion in the Kenya banking industry ever since its inception in May, 2010. It has seen tremendous growth as evidenced by the upward trajectory on the total cumulative in the number of active agents, transaction volumes and total value. As at first quarter of 2015 the cumulative number of active agents stood at 34,381 transacting approximately 149.4 million transactions valued at Kshs. 817.7 billion compared to 30,449 active agents transacting approximately 120.6 million transactions valued at Ksh 653.7 billion in the third quarter of 2014. This growth is underpinned on continued contracting of varied retail entities to offer basic banking services by commercial banks.

These entities include among others;- security companies, courier services, pharmacies, supermarkets and post offices which act as third party agents providing cash-in-cash-out transactions and other services in compliance with the laid down guidelines by the central bank.

Figure 30: Bank Profitability (KES Billion)

Source: CBK

Figure 31: Cumulative Agency Banking (no. of agents, transactions volume and Value)

Source: CBK

Figure 32: Quarterly Growth in Agency Banking (no. of agents, transactions volume and Value)

Source: CBK

Figure 32 shows the actual quarterly growth in the agency banking. Quarter one of 2015 registered a positive growth of 3,932 in active agents compared to quarter three of 2014 as the banks try to diversify their products to bank the unbanked as well as reducing operating costs such as rental charges, additional staff and other administration costs that come with the opening of new branches.
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