About this Report

This Bulletin reviews the performance of the Kenyan economy for the second 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 twelfth volume of the Kenya Bankers Economic Bulletin. This issue discusses the state of the Kenyan economy during the second quarter of 2015. 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.

As the Bulletin illustrates, both local and international circumstances point towards the need for a review of the previous rosy growth outlook. I hope that you will find this issue of the Kenya Bankers Economic Bulletin interesting and useful. As always, we welcome feedback on the content of this Bulletin as we continually seek to improve its relevance to you. Further, we are be happy to consider for publication incisive commentaries on topical issues of interest to the banking industry. For guidelines on submission requirements, please get in touch with the Bulletin’s Editor at research@kba.co.ke.

Habil Olaka
CEO, Kenya Bankers Association
COMMENTARY

The possibility of getting worse before getting better?

By Jared Osoro

As optimistic as one may want to remain, it is increasingly becoming clear that the rosy economic outlook for the Kenyan economy — some projections estimating a real growth of close to 7 percent for 2015 — was based more on faith. The source of the faith was the assumption that the forecast assumptions will hang together.

As at the end of the second quarter, it was evident that faith is not science and the assumptions have to be validated. Let’s start with the assumption that the emerging markets will remain strong and that the soft underbelly of the global economy is the sick Eurozone: While it is true that the Eurozone malady is persistent — with economies such as Greece literally limping from one crisis to the other — the emerging markets are not faring any better.

There are good reasons why this should be of concern for anybody projecting Kenya’s growth, at least in the near term. To the extent that emerging markets literally dragged the global economy in a positive sense during the global economic meltdown such that as the US and the rest of the so-called G7 were at best crawling while some of the emerging market economies — especially China — registered robust performance implies that they are now systemically very important.

Why should Kenyans care about the emerging economies now more that before? Simply because, as I have argued in the past, Kenya is closely linked to Sub-Saharan Africa more that it is to the rest of the world. And as a recent study confirms, Sub-Saharan Africa’s business cycle has not only moved in the same direction as that of the rest if the world, but has also gradually drifted away from the G7 in favour of the so called BRICs — Brazil, Russia, India and China. Trade with the BRICs turns out to be the strongest driver of this shift. Therefore the challenges currently facing the emerging markets should be seen as having potential adverse effects that are more than mild.

The emerging market sandwich

So what are the challenges confronting the emerging markets? On top of the card is the challenge of these economies being sandwiched between the increasingly entrenched recovery of the US economy and the now evident near foundering of Chinese economy, respectively the largest and second largest economies in terms of output.

1 See Commentary — “A breather before the main sprint or a false start?” — in the Kenya Bankers Economic Bulletin Volume 11, Quarter 1, 2015.
There is no doubt that when the world largest economy is on a recovery path that then translates to good prospects for the global economy. You must therefore be wondering how the recovery of the US could be a bane to the emerging markets. The healthier the US economy becomes, the closer it comes to resuming normal monetary policy after close to eight years of unconventional monetary policy – the so-called quantitative easing (QE) regime – where interest rates were close to zero and the Federal Reserve (the US central bank) saw a substantial growth in its balance sheet.

In other words the equivalent of substantial printing of money that the growth in the Federal Reserve’s balance sheet represents, which came to a stop with the then famous “tapering remarks” by the its then Chairman, Ben Bernanke, in May 21st 2013 will give way to the commencement of some tightening of monetary policy.

By indicating that the Federal Reserve will be tapering on the QE, the message was that an indication of the easing of the QE and not necessarily a shift to tightening. With the US economy’s recovery comes the expectations that the Federal Reserve is likely to commence — as soon as September 2015 — an increase in its policy rate, the federal funds rate.

Although some have taken an optimistic posture with arguments such as the markets have already factored in such possibility or recent analyses3 to the effect that markets have now learnt on how to cope with such eventuality, all indications are that the mere prospects of a rate hike by the Federal Reserve will obviously adversely affect emerging markets and any anticipated resilience on account of markets are smaller now will be subject to some test.

Over the past two years, the US dollar has appreciated by more than 10 percent against its major trading partners. This appreciation is a manifestation of emerging markets being pinched from two fronts: One, capital has started retreating to the US in anticipation of higher yields; two, the extensive borrowing by emerging markets based on low costs during the QE regime is subject the severe currency risk.

The Chinese bit of the bitter-sweet sandwich that has been made of the emerging markets arises from the clear slowdown of the economy. Although it can be argued that the slowdown is a positive development as it reflects the economy’s adjustment from one whose growth model is investment — no wonder the reduction in output prices over the past 3 years could be a reflection of over-capacity in China’s heavy industry — to one where growth is consumption led, this comes with some pain for the emerging markets; this is more so for commodity exporters such as South Africa and Brazil.

Ultimately, the general fall in commodity prices (see Figure 1) does not bode well for economies such as Kenya whose export earnings are in the process affected. This decline in prices while to some extent reflects

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abundant supply (e.g. in the case of oil), it is to a large extent an indication of softening demand and therefore a largely weak global economy.

The local economy sandwich

Cognisant of the fact that a reduction in commodity prices – especially those that Kenya and other economies in the region export – at a time when the tourism sector is jolted by the effect of insecurity perceptions, it is hardly surprising that the balance of payment position of the economy and in particular the current account remains in dire straits.

The effect of the current account deficit, estimated at over 8 percent of GDP, are manifest in the Kenya shilling being under depreciation pressure. It doesn’t help that the US dollar, as earlier observed, is on an appreciation path. While we could be expecting good tidings from the declining oil prices (see Figure 2), the expected benefits have been wiped out by the depreciating currency (see Figure 3).

Inflationary pressure arising from the pass-through effect of a fast depreciating currency has underpinned the decisive stance of monetary

Figure 1: Commodity Prices

![Graph showing commodity prices with trend lines and labels for All Commodities Price Index and Non-Fuel Price Index.](Source: IMF Commodity Price Indices)

Figure 2: Oil Prices

![Graph showing oil prices with trend lines and labels for Oil Prices (US$/Bbl) and Month-to-Month % price changes.](Source: Brent)
policy tightening by the Central Bank of Kenya (CBK) in its decision of July 7, 2015 through its Monetary Policy Committee (MPC) increasing the Central bank Rate (CBR) by a further 150 basis points, having increased it by a similar magnitude in its June 9, 2015 decision. In a short one month, the MPC has tightened its monetary policy stance by 3 percentage points signalling a desire to restore macroeconomic stability at all costs.

Picking a pipe wrench

Apparently, the CBK’s MPC is keen to extract liquidity from the financial system especially when it started emerging that money supply and credit growth was mounting pressure on inflation. The tightening bias that has characterised the MPC’s stance, while targeting to address and obviate potential inflationary pressure emanating from the exchange rate, has augmented the CBK’s direct intervention in the foreign exchange market.

With a pipe wrench at hand, the liquidity has quickly adjusted from a flow to a drip and the attendant consequence has been the fast increase in the interbank rate currently about 15 percent having come down from over 20 percent at a time when the pipe squeeze was hardest.

The inevitability of the tightening of the monetary policy is in no doubt. Its short-term effect on growth is equally in no doubt. Through in the glaring fiscal challenges – especially the potential challenge of increase in the wage bill as public school teachers get hefty salary increases — and you see the likely growth stimulus out of government programmes starting to fade.

Taking all the above into account, it is highly probable that the economy’s performance could get worse before getting better.

Jared Osoro is the Director of Kenya Bankers Association Centre for Research on Financial Markets and Policy®
Growth in Gross Domestic Product

The first quarter of 2015 recorded an economic growth rate of 4.9 percent: a slight improvement compared to the same quarter of 2014 whose growth stood at 4.7 percent. This is underpinned on the sound and stable macroeconomic environment that was experienced in quarter one a spill over conditions from the last quarter on 2014. The low oil prices, in the global market which infiltrated in the domestic market boosted the growth in quarter one of 2015, through low energy costs and reduction in the inflationary pressures mainly arising from the food — fuel inflation component of the entire inflation rate.

However, the second quarter of 2015 posted a different encounter especially via the change in the macroeconomic environment. This adversely affected the economic performance of many sector of the economy and in overall the entire quarterly economic growth. To start with the experiences weakening bias on the Kenyan shilling against the major hard world currencies mainly the dollar shocked the economy negatively for the entire part of quarter two. This is in a number of aspects; first is through the increased current account deficit given the rise in the import bills thus increasing the trade balance deficit which directly implies the increased current account deficit. The weakening shilling has also seen the domestic energy prices especially the oil prices surge up thus offsetting the benefits of the low oil prices realized in the first quarter of 2015. More importantly, the loss in the value of the shilling against the dollar has seen the change in the monetary policy stance in the economy during the quarter. The depreciation of the shilling saw the raise in the bank rate for the first time since April 2013 from the 8.50 percent to 10.00 percent as at the end of quarter two. This has in turn inferred into the illiquidity in the credit market leading to the increase in the cost of credit in the market.

The overall month — on month inflation rates was on an upward rise, rising from a low of the 6.31 percent in March 2015 to a high of 7.03 percent as at the end of June 2015; a 0.47 percent below the from the Central Bank’s upper bound of 7.50 percent. This is mainly on the account of the change in the monetary policy stance amid the weakening bias on the shilling. In overall the average, quarterly inflation for quarter two was 6.99 percent compared to 5.82 percent recorded in quarter one of 2015 (see figure 4).

![Figure 4: Average Quarterly Inflation Rates](image)

Source: Central Bank of Kenya
During the second quarter of 2015, the annual government budget for the 2015/2016 financial year was unveiled highlighting the government’s proposed revenues and expenditure over the financial year. A keen analysis of the budget reveals the following aspect which are of impacts to the economy’s performance.

From the estimates for the budget, the national treasury aims at raising the Kes 1,358.0 billion, equivalent to 20.8 Gdp), and Kes 103.2 billion of Appropriations in Aid. In overall the budget for 2015/2016 financial year is estimated at approximately KES 2.1 trillion compared to KES 1.18 trillion in 2014/2015 financial year.

From the budget speech it’s clear that the government is aimed at shifting resources from financing recurrent expenditure to the development expenditure in order to spur economic growth. This is evidenced by Ministerial recurrent and development expenditures of Kes 784.2 billion (12.0 percent of Gdp) and Kes 721.3 billion, respectively; Kes 264.2 billion for county Governments. However what remains to be the challenge is the actual implementation of this plan.

However, the current budgets estimates come with the overall fiscal balance including grants (amounting to Kes 73.4 billion), which is projected at Kes 570.2 billion (equivalent to 8.7 percent of GDP) in

An overview of 2015/2016 financial year Budget

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However, the current budgets estimates come with the overall fiscal balance including grants (amounting to Kes 73.4 billion), which is projected at Kes 570.2 billion (equivalent to 8.7 percent of GDP) in
financial year 2015/16. Excluding expenditures related to the Standard Gauge Railway, the overall deficit would decline to KES 426.3 billion which is equivalent to 6.5 percent of GDP. This represents a 4.6 percent increase in the budget deficit compared to KES 190.8 billion (equivalents to 4.1 percent of GDP) for the 2014/2015 financial year.

As per the budget speech the government seeks to finance the deficit by both the external and domestic borrowing with the net external financing amounting to KES 340.5 billion (5.2 percent of GDP) and domestic financing amounting to KES 229.7 billion (3.5 percent of GDP) thus implying that the overall fiscal deficit is fully financed. Looking at the external financing sought by the government, the proposal is to continue exploring on the use of Euro bonds including from export credit agencies and syndicated loans. From this proposal it’s clear that the types of financing the deficit will imply the increased burden to the economy especially if the borrowing is geared towards financing recurrent expenditure as opposed to the capital expenditure financing.

Moreover, given the current monetary policy stance in the economy in attempts to stabilize the shilling, any domestic borrowing will definitely lead to increase in the cost of credit in the economy which could potentially dampen the projected annual growth in the long run. In addition, the review of the budget leads to a conclusion of limited government innovativeness to broaden the tax base by relying on the same sources of revenue to finance the budget. Lastly some of the measures proposed are likely to be counterintuitive in that in attempt to pursue one goal, they may end up generating adverse effects. For instance, the increase in the Road Maintenance Levy by KES 3 per litre to be collected and paid into the Road Annuity Fund directly feeds into the inflationary pressure through the food – fuel inflation component despite its proceeds being crucial in increasing the road network coverage.

The review of the budget seems to infer into an expansionary fiscal by the government for the year 2015/2016 as revealed by the government’s increased expenditure. In addition the increased borrowing from both the domestic and external sources compared to the 2014/2015 financial year indicates the expansionary fiscal policy for the current financial year. Looking at the monetary policy angle it’s clear the Central bank has pursued the contractionary monetary policy to anchor inflation as well as ensure stability in the forex market. Therefore given this scenario, it is unlikely that both internal and the external balance will be achieved given that the expansionary fiscal policy by the government continues to feed into the current account deficit thus external imbalance.

Agriculture

Agricultural sector continues to play a critical role especially in total number of employments both directly and indirectly in the sector. It’s forward and backward linkages in the economy cannot be emphasized. Of late as a result of weakening shilling and them dwindling tourism sector, agricultural sector has been viewed as the savior in terms of promoting inflow of the foreign currency to stabilize the shilling. A review of the sector’s performance in quarter two of 2015 reveals that
It is also worthy to note that development of real estate market continues to significantly affect the land under tea and coffee production. There is therefore the need for government intervention to formulate policies that will delineate agricultural land from settlement lands if the future of major exports is to be guaranteed in addition to food security.

Agriculture cash crop exports continue to command a good share of the total economy's main export, with tea leading the pack followed by coffee. As revealed in (Figure 7) the quantity of tea exports having declined in the first quarter to 35,700 MT in March 2015 and further down in April to 28,262 MT although there are signs of improvement to 35,915 MT for the month of June. This improvement is attributed to the improvised international prices of tea within the quarter. The quantity of coffee being exported continues to improve as well rising to a total of 12,551 MT in the second quarter of 2015 as compared to a total of 10,017 MT in the first quarter.
The value of cash crop exports; the value of the tea exports increased from Kes 7,189.10 million in March 2015 to Kes 11,262.80 million in June 2015. Similarly value of the coffee exports increased from Kes 3,948.30 million in April 2015 to Kes 4,219.90 million in March 2015. It’s therefore clear that the depreciation ion the shilling boosted the export earnings from tea and coffee for the entire of quarter two. However, given the inelasticity in supply of coffee and tea since their production is pegged on the existing natural conditions, their total earnings cannot be adequate to fully leverage on the advantage of the weak shilling.

On horticultural exports (Figure 8), in terms of quantity exported in quarter two of 2015, cut flowers dominate this sub-sector contributing on average 52 per cent of total quantity of horticultural exports for the entire of quarter two of 2015, followed by vegetables at 27 percent with fruits exports recording the lowest contribution of 15 per cent. Looking at the foreign exchange earned from horticultural exports, cut flowers dominate this sub-sector contributing on average 77 per cent of total horticultural exports for the entire of quarter one of 2015, followed by vegetables at 18 percent with fruits exports recording the lowest contribution of 6 per cent.

Manufacturing

The manufacturing sector in Kenya is poised as one of the foundations in achieving vision 2030; transiting the economy from traditional agriculture to modern manufacturing economy.
A key component of the manufacturing sector is its output that targets the construction industry. Cement production in the second quarter of 2015 increased slightly over quarter two production to an overall total of 1,527,911 Mt compared to 1,510,063 Mt in the first quarter. Similarly, cement consumption in the second quarter of 2015 increased from an overall consumption of 1,510,063 Mt in quarter one to 1,527,911 Mt in quarter two of 2015 giving a clear indication on the increased growth in the real estate sector. However there was a fall in the production of galvanized sheets in the first quarter 2015 from 33,543 MT in January to 19,299 Mt by the end of the quarter in March 2015. The reduction in production may have been occasioned by the increase input prices due to the weakening of the Kenyan shilling over the period.

There was a slowdown in milk consumption starting from the beginning of the first quarter, reducing from 47,300 million liters in January to a low of 30,400 million liters as at the end of June 2015; this reduced demand is due to the rise in the milk prices over the period caused by reduced production occasioned by erratic weather conditions over the period. Despite the policy consideration to support the sector, the desired outcomes of the policy are likely to be realized with time lag. The number of assembled vehicles assembled has increased since the beginning of the first quarter into the second quarter, having had 601 units assembled in January, 2015, 949 units in February and after which it fell to 887 units March and further to 813 units in April. This overall increase show the renewed interest by local investors and also foreign investors to set up assembly shops in Kenya so as to provide the service for the Kenyan market and the larger East African community.

**Energy**

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

The second quarter, 2015 saw a mild increase in total energy production from 2235.43 million KWh in the first quarter of 2015 to 2297.26 million KWh in the second quarter.
thermal production and thermal production the increase in hydro production offset the fall hence the increase in overall production (Figure 10). Comparing quarterly productions, between quarter one of 2015 and quarter two of 2015, thermal power generation declined by 31.52 million Kwh from 364.49 million KWh in quarter one of 2015 to 332.97 million Kwh in quarter two of 2015. Similar trend was portrayed in geothermal production that recorded a decline shedding 15.45 million KWh between quarter one of 2015 and quarter two of 2015. However, hydro production rose by 108.8 million KWh rising from 753.75 million KWh in quarter one of 2015 to a high of 862.55 million KWH by the end of quarter two 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.

In addition new reflections on boosting green energy such as solar energy has come into the limelight especially for households use hence reducing demand pressures on the national grid line. Electricity generation has continued to grow, albeit still outpaced by demand. However, it’s notable that the sector has started realizing the output from the significant investment directed to the sector by the government.

Despite the power production lagging behind the demand, power loses rose over the second quarter of 2015 starting at a low of 47.73 million KWh in April, rising to 101.98 million KWh in May to a high of 145.69 KWh in June.

Figure 10: Electricity Generation by source (Million KWh), Jan 2013 – Dec 2015

There was a general price rise in the energy prices in quarter two of 2015 due to the continues steady rise in the world energy prices coupled with the depreciating Kenyan shilling experienced during the quarter. The crude oil prices rose from $60.55 per barrel in April to $65.75 per barrel in May then falling slightly in June to close at an average of $63.70 per barrel (Table 1). As stated in the last review the failure to agree among the OPEC member countries to cut down on oil production saw the existence of glut in the market, however since then, driven by the demand for the
cheap oil in the market and essentially the strengthening of the dollar, the prices of oil have risen slightly but surely. The emerging economies growth prospects are projected to register positive growth though moderate are also increasing demand pressure for petroleum products.

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

**Building and Construction**

Looking at the production and the consumption of cement as a proxy to measuring the development in the building and construction sector, it is evident that the sector has experienced a mild growth from the first quarter of 2015. The overall demand for cement increased from 1,342,774 MT in the first quarter to 1,377,065 MT in the second quarter of the year, an increase of 2.56%. The overall rise in the cement consumption arises from increased demand for construction mainly in real estate development among the expanding middle income and overall growth in population and its composition as well as increased government construction of the physical infrastructure. However looking at the monthly changes within the quarter, there is a reduced demand trend with the demand moving 463,170 MT in April to 460,981 MT in May and then further down to 452,914 MT in June. The further tightening of liquidity did slow down investment in the second quarter of 2015 and the construction sector was not spared either.

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

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<tbody>
<tr>
<td>Murban crude oil (US$/Barrel)</td>
<td>77</td>
<td>60.65</td>
<td>46.40</td>
<td>56.55</td>
<td>56.10</td>
<td>60.55</td>
<td>65.75</td>
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<td>Super petrol (KES/Litre)</td>
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<td>93.75</td>
<td>85.60</td>
<td>90.34</td>
<td>90.22</td>
<td>93.76</td>
<td>98.14</td>
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<tr>
<td>Diesel (KES/Litre)</td>
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<td>91.79</td>
<td>84.30</td>
<td>76.49</td>
<td>77.16</td>
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<td>LPG (13Kgs)</td>
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<td>3,018.45</td>
<td>2,954.36</td>
<td>2,846.53</td>
<td>2,739.35</td>
<td>2,529.36</td>
<td>2,424.69</td>
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Source: ERC

![Figure 11: Cement Production and Consumption, MTs](image-url)
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 per cent growth. This growth was tremendously contributed to 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. 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 12).

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 Jomo Kenyatta international airport (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 per cent 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.

Source: KNBS

Figure 12: Registration of New Vehicles April 2013 to December 2014

Source: KNBS
Turning in to the government expenditure, the total expenditure for January and February 2015 stood at Kes 1.63 billion. of this, the recurrent expenditure dominated the total expenditure accounting for 74.85 per cent while the development expenditure accounted for 25.15 per cent 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 KES 196.86 million in January to Kes 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.

Financing of Government

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

Public Debt

During the second quarter of 2015, the total public debt increased by a 2.51 per cent from KES 2.68 billion in March 2015 to KES 2.74 billion in April 2015. Looking at the April — May period, it's evident that the public debt rose marginally from KES 2.74 billion in April to KES 2.79 billion as
at the end of May 2015. This was largely contributed by the external debt which grew from KES 1.28 billion to KES 1.33 billion in March – April period and from KES the same period compared to external debt which declined from KES 1.16 billion to KES 1.30 billion in the same period KES 1.33 billion to KES 1.38 billion in April – May period. This signifies the government’s appetite for external debt as opposed to domestic debt. This could be as a result of the tightening monetary policy domestically which has seen the tightening in the credit market implying that any domestic borrowing by the government would further cause further tightening of the credit market leading to high domestic cost of credit. The appetite for external borrowing is likely to expand in the coming quarters with the government’s pronouncement of borrowing externally and utilization of facilities such as euro bonds to finance the 2015/2016 financial year deficit.

Government treasury bonds including the government frozen debt remained the key money market instruments intensively utilized by the government in domestic borrowing accounting for 72.30 per cent of the total government debt for quarter two of 2015. Treasury bills, overdrafts and advances accounted for 25.47%, 2.06% and 0.02% percent of total government debt for the entire of quarter two of 2015 with other domestic debts accounting for 0.01 percent (Figure 16).

**Money and Credit**

In the first quarter of 2015, the monthly total money supply grew substantially in April 2015 from – 0.38 percent growth in March to 2.73 per cent growth in April 2015 (Figure 17). It can be deduced that the total money supply posted a growth that was tandem with the Central Bank’s inflation rate target bound of 5 percent 2.50 basis points. However, the growth in money supply declined in May to register a growth of 1.5 percent. This is attributed to the Central Bank’s action to mop out the excess shilling in the market in attempts to stabilize the weakening shilling. In addition with the month – on – month inflation rate hitting a high of 7.08 percent in April, there was need to reduced money supply to anchor inflation thus the reason for the decline in the money supply growth rate for the month of May 2015.

**Inflation**

The upward trajectory in the month –on - month inflation rates as experienced in the entire quarter two of year 2015 experienced a reversal as compared to quarter one (Figure 18). The first month of the quarter started with a rise in the overall month — on — month inflation rates hitting a high of 6.31 percent in April. This was attributed to the weakening on the shilling leading to increase in the domestic oil prices thus the rise in inflation via the fuel cost inflation component. The trend was replicated in May with inflation surging up to the high 7.08 percent. However in June, the inflationary pressures slowed down to 6.87 percent which was perhaps contributed to stabilization of the food prices following the high rainfall experienced during the quarter. As at the end of the quarter, the quarterly average inflation rates stood at 6.98 percent; – a 1.17 percent rise compared to the quarter one average of 5.82 percent. The rise in the inflation rates in quarter two of 2015 is largely attributed to the instability in the macroeconomic environment experienced during the entire quarter especially the volatility in the shilling and the expectations in the change on the monetary policy stance.
A look at the non-food-non-fuel inflation (FNF) which measures the effects of the monetary policy stance indicate that from April 2015 to June 2015, it has been on an upward movement rising from 3.53 percent in April to 4.2 percent in June. This implies a demand driven inflation for the entire of quarter two of 2015. This probed the change in the monetary policy stance by the Central bank through an upward revision in the central bank rate raising it by 150 basis points from 8.50 percent to 10.00 percent in June 2015.

**Interest Rates**

Interest rates have largely been stably during the first quarter of 2015 (Figure 19). 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. However, in the second quarter of 2015, interest rates assumed an upward trajectory.

The 91-day Treasury bill rate remained fairly stable stagnating at 8.31 per cent 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 15.40 per cent in April 2015 to 15.26 percent as at the end of May 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 two of 2015 as evidenced by the relationship between the average lending rates and the CBR. This signifies the shock in the credit market that arose from the upward revision of the CBR in attempts to ensure stability in the exchange rates.

The interbank rates recorded a significant upward shift from 8.77 percent in March 2015 to 11.78 percent by June 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 two. The failure for the intervention supports the experienced depreciation of the shilling throughout the quarter. The interest rate spread for April 2015 was 8.8 percent compared to 8.71 percent in May 2015.
Balance of Payments

In the second quarter of 2015, the value of imports rose from KES 114,862 billion in March 2015 to KES 129,842 billion in April 2015 and further surging up to KES 144,039 as at the end of May 2015. Domestic imports statistics indicate that machinery and transport equipment accounted for 37.18 per cent of the total imports as at April 2015 with manufactured goods, chemicals and mineral fuels accounting for 15.15%, 13.49% and 17.45% respectively.

Turning on the exports, the value of the exports declined from rose from KES 47,707 billion in March 2015 to 45,966 billion as at the end of May 2015 and further surging up to KES 144,039 as at the end of May 2015. This is a clear indication that, despite the depreciation in shilling, the Kenyan exports have not leveraged on this opportunity that would arise from the exports being cheaper abroad. Out of the major selected exports, tea exports topped the list accounting for 19.85 per cent of the total exports for quarter as at May 2015. Horticulture came second at 17.47 per cent with chemicals and coffee accounting for 9.13 percent and 4.91 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 24.28 per cent of Kenya’s total exports as at May 2015 followed by Tanzania at 16.82 per cent with DRC closing...
third at 8.25 percent. For the major imports within the African market, imports from South Africa accounted for 43.80 percent as at the end of May 2015, followed by Tanzania at 17.20 percent with Egypt coming third at 14.94 percent.

Looking at the Kenya exports destinations globally for April and May 2015, Uganda topped at 11.01 per cent followed closely by Netherlands at 7.93 per cent with USA coming third at 6.63 per cent. Tanzania, United Kingdom and Egypt follow at 6.61, 6.27 and 3.52 per cent respectively.

Turning into the overall monthly trade balance, it’s evident that while the monthly trade balance worsened from KES 67,156 million in March 2015 to KES 98,073 million as at the end of May 2015. This could be mainly attributed to the decline in the weakening shilling against the major currencies such as the dollar which increased the import bills significantly. In addition the massive importation of machinery and transport facilities in wake of continuing major physical infrastructural projects contributed to the worsening of the trade balance. In addition the failure of the exports to fetch enough export earnings despite the depreciating shilling mainly due to the nature of the Kenya exports led to the trade balance deficit in quarter two of 2015. From figure 21, it’s evident that the depreciation in the shilling is directly related to the rise in the trade balance with a sharp rise being evidence in the month of April and May 2015.

**Exchange Rate**

In the second quarter the shilling continued its losing streak against the hard currencies moving from an average of US/KES 91.70 to over US/KES 98 at the end of May and gaining ground slightly in Mid-June to exchange at US/KES 97 range against the dollar. This is still believed to have been brought about the continuous strengthening of the dollar albeit the US economy shows little growth in the first quarter of 2015. The demand for the dollar has gone up as the non-oil producing countries are quick acquiring oil to build up reserves as the price is still favorable, hence exacerbating the problem for the Kenyan shilling against the dollar. The depreciation the shilling has caused Kenya to lose its competitiveness in the world market.

Against the Sterling the shilling has 11.71% from the end of March to mid-June. This could be attributed to the reduced competitive nature of the Kenyan economy and the fact that investors have positive sentiment about the British economy and most of Europe. European economy
Nairobi Securities Exchange

The first quarter of 2015 saw mild growth of 2.57 basis points in the NSE having posted a NSE 20-share index of 5,212 points in January and 5,346 points at the end of the quarter. Despite the growth which was experienced in the first quarter, the NSE started losing ground by the end of the quarter and the trend did continue into the second quarter of the year with the month of April dipping to a low of 5,091 points. The index continued to fall below the 5,000 points mark reaching an average of 4,788 points for the month of May. Though there has been a surge upwards in the month of June the NSE is still trading below the 4000 points mark; at an average of 4,906 for the month of June.

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<tr>
<td>NSE 20 Share Index 100 =1966</td>
<td>5,212</td>
<td>5,491</td>
<td>5,346</td>
<td>5,091</td>
<td>4,788</td>
<td>4,906</td>
</tr>
<tr>
<td>NSE All Share Index (NASI) 100=2008</td>
<td>166</td>
<td>176</td>
<td>174</td>
<td>173</td>
<td>162</td>
<td>164</td>
</tr>
<tr>
<td>Market Capitalization (KES Bn)</td>
<td>2,350</td>
<td>2,461</td>
<td>2,452</td>
<td>2,430</td>
<td>2,341</td>
<td>2,302</td>
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<tr>
<td>Total Shares Traded (Million)</td>
<td>414</td>
<td>593</td>
<td>614</td>
<td>488</td>
<td>684</td>
<td>681</td>
</tr>
<tr>
<td>No. of Equity Transactions</td>
<td>39,813</td>
<td>42,387</td>
<td>44,715</td>
<td>36,148</td>
<td>35,782</td>
<td>33,367</td>
</tr>
<tr>
<td>Bonds Turnover (KES Bn)</td>
<td>38</td>
<td>45</td>
<td>46</td>
<td>25</td>
<td>22</td>
<td>12</td>
</tr>
<tr>
<td>Percent of Foreign Participation to ET</td>
<td>47%</td>
<td>44%</td>
<td>53%</td>
<td>56</td>
<td>63</td>
<td>74</td>
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Source: NSE, Monthly Trading Report
The low performance is a result of dividend pay outs to the foreign investors following the end of financial years for majority of the listed companies. The exchange has experienced a decline of 3.63 basis points since the start of April to the end of the quarter, registering an average NSE 20-share index of 4906 for the month of June. The dismal performance has mainly been caused by the bearish behaviour in the market, driven majorly by the foreign investors. We can see from the figures that the foreign investor activity increased considerably over the quarter from 56 percent at the beginning of the quarter to an average of 74 percent by the end of June. Foreign investor bearish sentiments, driven chiefly by the uncertainty of the Kenyan shilling performance, liquidity tightening in the Kenyan market and improved market outlook of the more developed stock exchanges like the Nigerian and the South African stock exchange has caused the NSE capitalization to also fall consistently throughout the quarter, from an average high of KES 2430 billion in April to a low of KES 2302 Billion in June. The local investors are also feeling a bit jittery about the market and perhaps one may see it as investors consolidating so as to see the direction that the market would take when the Kenyan shilling performance improves.

The NSE All share index fell as well from 173 points in April to 162 points in May having lost 6.36 basis points; then breaking the trend close at an average of 164 points in June, a gain of 1.24 basis points. The equity turnover coupled with the percentage of foreign traders in the market gives a picture of increased foreign participation in the market.

In the fixed income segment, the bond market performed dismally in the second quarter of 2015. The bond turnover having fallen drastically from KES 46 billion at the end of the March to an average KES 25 billion in April and further down in May, to KES 22 billion, to close at an average of KES 12 billion in June. This was widely driven by the contractual monetary policies that reduced liquidity in the market, redirecting demand to more short term instruments in the market.

**Banking Industry Performance**

A highlight of the banking industry for quarter two of 2015 posits that Demand for credit generally grew in a number of sectors namely; personal/household, trade, building and construction, transport and agriculture. However, demand for credit in mining, energy, financial services, manufacturing and real estate remained unchanged for the entire of quarter two of 2015. By the end of quarter two the recovery of the tourism and hotels sector had not picked though some prospects for recovery were evident. In overall, the banking sector remained stable for the entire of the quarter. However this stability for the rest of the year in pegged on the policies and measure undertaken by the central bank and the national treasury with regard to monetary and fiscal policies that will shape the macroeconomic environment which the commercial banks operate in.

**Assets and Loans**

The industry’s assets base registered a mild positive growth of 6.82 percent both as at during the first quarter of 2015 to stand at KES 3.60 trillion as at the end of June 2015 compared to KES 3.37 trillion in March 2015.

**Figure 22: Bank Assets and Loans (KES Billion)**

Similarly, total industry’s loans and advances marginally grew by 6.37 per cent in quarter two of 2015. A quarterly review of growth in the banking industry’s total loans and advances posit that as at the end of June 2015, the total loans and advances stood at KES 2.17 trillion compared to KES 2.04 trillion in March 2015. 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 6.04 per cent in the same period while the total loans and advances grew by 6.37 percent hence signifying the banks’ capability to convert their liabilities into assets. The total demand deposits as at the end of quarter two of 2015 stood at KES 2.57 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 6.64 percent compared to quarter three of 2015. 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 two of 2015 the total industry’s deposits stood at KES 2.57 trillion Compared to KES 2.41 trillion in quarter three of 2015.

Total Shareholder Funds

Total capital stock of the Kenya banking sector sustained its upward trajectory in the second quarter of 2015 thus signifying growth in the shareholders’ wealth in the banking industry albeit minimal. The quarter recorded a growth in shareholders’ wealth of 1.76 percent from KES 533.9 billion as at the end of March 2015 to KES 543.3 billion as at June 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 much could signify the increase in appetite for dividends following the end of financial years for the majority of banks in March.

Gross Non-Performing Loans

The gross non-performing loans increased marginally in quarter one of 2015 by 5.72 percent to average at KES 123.9 billion in quarter two compared to KES 117.2 billion in quarter one. During this quarter, Six 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. Personal and households topped the NPLs followed by trade with real estate coming third on the list. Energy and water sector and mining and quarrying posted the least contribution to the total NPLs.
Bank Profitability

The banking sector recorded an increase in the profit before tax in quarter two of 2015, to stand at KES 39.61 billion against KES 37.3 billion in quarter one (Figure 26). This represents a 6.19 percent rise. Total income rose from KES110.03 in quarter one of 2015 to KES 116.29 in quarter two of 2015. Interest on loans and advances, fees and commissions and government securities were the major sources of income accounting for 60.04 percent, 16.4 percent and 15.5 percent of total income respectively. Contrary, interest on deposits, staff costs and other expenses were the main components of expenses, accounting for 35.6 percent, 26.6 percent and 22.4 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 second quarter of 2015 the cumulative number of active agents stood at 36,080 transacting approximately 175.4 million transactions valued at KES 930.1 billion compared to 34,381 active agents transacting approximately 149.4 million transactions valued at KES 817.7 billion in the first quarter of 2015. This growth is underpinned on continued contracting of varied retail entities to offer basic banking services by commercial banks. These entities include among others;- security companies, courier services, pharmacies, supermarkets and post offices which act as third party agents providing cash-in-cash-out transactions and other services in compliance with the laid down guidelines by the central bank.
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– Newsweek