Central Bank of Kenya

REPORT OF THE MONETARY POLICY COMMITTEE MARKET PERCEPTIONS SURVEY SEPTEMBER 2018

CONTENTS

BACKGROUND TO THE MARKET PERCEPTIONS SURVEYS………...3

INTRODUCTION..……..4

SURVEY METHODOLOGY……………………...........……………...4

HIGHLIGHTS OF THE SURVEY …………………… …..4

CURRENT ECONOMIC CONDITIONS..........……………..................…………...5

INFLATION EXPECTATIONS…………………………………………..………………...6

EXCHANGE RATE EXPECTATIONS ……………………………………………………...7

PRIVATE SECTOR CREDIT GROWTH EXPECTATIONS……………...………………...8

ECONOMIC GROWTH EXPECTATIONS ….…………………………………………………...10

OPTIMISM ON THE ECONOMY....……………………………………………………...12

PERCEPTIONS ON IMPROVING THE BUSINESS ENVIRONMENT.…..13

BACKGROUND TO THE MARKET PERCEPTIONS SURVEYS

The Central Bank of Kenya (CBK) undertakes a Market Perceptions Survey every two months, prior to every Monetary Policy Committee (MPC) meeting, to obtain the perceptions of banks and non-bank private sector firms on selected economic indicators. Commercial banks, micro-finance banks, as well as a sample of non-bank private sector firms are covered in the Surveys.

Beginning September 2018, the Survey was enhanced to enable respondents to provide their perspectives on the current economic conditions in the country, focusing on economic activity two months before an MPC meeting. The Survey was also expanded to capture perceptions by private sector firms on how the business environment can be improved.

The non-bank private firms are sampled from selected towns across the country including Nairobi, Mombasa, Kisumu, Eldoret, Nakuru, Nyeri and Meru, and are representative of sectors that account for about 70 percent of Kenya's GDP. The sectors covered by the Survey include agriculture, mining and quarrying, manufacturing, electricity and water, trade, hotels and restaurants, Information and Communications Technology (ICT), transport, real estate, building and construction, finance and insurance, and health.

Sensitization engagements with respondents are conducted on annual basis in all the regions to facilitate a better understanding of the survey questions, to enhance the quality of responses, and to increase the response rate.

1. INTRODUCTION

The September 2018 MPC Market Perceptions Survey was conducted in the first three weeks of the month. It sought perceptions on the economic conditions prevailing before the MPC meeting, as well as market expectations for the next two months (September to October 2018), and over the next 12 months (September 2018 to August 2019). The expectations sought covered overall inflation, exchange rate of the Shilling against the U.S. Dollar, demand for credit, private sector credit growth and economic growth. Forward hotel bookings over the next four months (September to December 2018) were also analysed. Other areas interrogated included the levels of optimism on economic prospects and improvement in the business environment, and the response by banks' to the July 2018 MPC decision.

The September 2018 Survey coincided with the commencement of implementation of the VAT on petroleum products. This report therefore provides a summary of the analyses of the responses to the Survey, including reasons behind the expectations, from commercial and microfinance banks (MFBs) and a sample of non-bank private sector firms.

2. SURVEY METHODOLOGY

The Survey was administered through questionnaires sent, through email and hard copy, to the Chief Executives of 377 private sector firms comprising of 39 operating commercial banks, 1 mortgage finance institution, 13 micro-finance banks, and 324 non-bank private firms including 45 hotels. The overall response rate to the September 2018 Survey was 67 percent of the sampled institutions. The respondents comprised of all the 39 commercial banks, 1 mortgage finance institution, 7 micro-finance banks, 34 hotels, and 172 non-bank private sector firms.

The Survey questionnaires were completed by either Chief Executive Officers, Finance Directors, or other senior officers from the sampled institutions who have knowledge about the economy and the business environment. The expectations from commercial and micro-finance banks are compiled using weighted averages based on the market size of the institution. The responses on expectations from the non-bank private firms are aggregated using simple averages.

3. HIGHLIGHTS OF THE SURVEY

According to the September 2018 Market Perceptions Survey:

- Economic activity in the two months before the September 2018 MPC meeting was assessed by respondents as moderate, tending to strong.
- Inflation expectations for the next 2 months (September and October 2018) and over the next 12 months remained well anchored within the target range (2.5 to 7.5 percent).
- There were mixed expectations on the Shilling/ U.S. Dollar exchange rate in September to October 2018.
- Private sector credit growth was expected to remain slow but to increase gradually in 2018 relative to 2017.
- Banks and non-bank private sector firms expected economic growth to remain strong in 2018.
- There was sustained optimism on the economic growth prospects and improvement in the business environment.

4. CURRENT ECONOMIC CONDITIONS

4.1. Overall Economic Activity

Banks and non-bank private firms in Nairobi, Mombasa, Nyeri and Eldoret who participated in the Survey were asked to provide their assessment of economic activity in July and August 2018, the period before the MPC meeting in September 2018 **(Chart 1).**

Sentiments from the respondents to the Survey showed that economic activity in the two months before the September 2018 MPC meeting was assessed as moderate, tending to strong across the regions. Activity was largely driven by increased agricultural output due to favourable weather conditions, strong household demand for goods and services, low inflation, increased activity in the construction sector, and the peak tourism season. The high tourist season was characterised by increased numbers of tourist arrivals, hotel bookings and banqueting events, and reflected enhanced security, marketing activities and political stability.

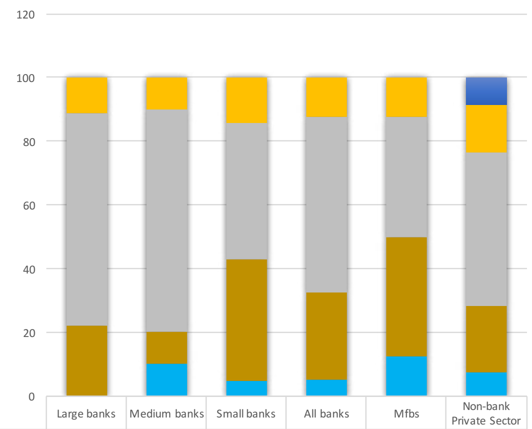
Respondents from Kisumu and Nakuru were divided in their opinions about economic activity, with equal numbers of respondents assessing economic activity in July and August as somewhat strong, moderate or somewhat weak. The challenges around the manufacturing sector with regard to counterfeits, contaminated sugar, sector specific competition, the high cost of labour and lower credit access were the main reasons for the weak activity reported by the respondents.

4.2. Employment

According to the Survey, respondents from across the various regions were of the view that employment remained relatively unchanged in the two months prior to the September 2018 MPC Meeting.

Over 80 percent of the firms responding had maintained all their employees. Nakuru, Eldoret and Mombasa recorded increased numbers of employees during the period under review, which were mostly associated with the hotel sector peak tourist season, and the wildebeest migration.

Chart 1: Economic Activity in the 2 months to the September 2018 MPC Meeting (%)



	Large banks	Medium banks	Small banks	All banks	Mfbs	Non-bank Private Sector
Weak	0	0	0	0	0	8.6
Somewhat Weak	11.1	10	14.3	12.5	12.5	14.8
Moderate	66.7	70	42.8	55	37.5	48.2
Somewhat Strong	22.2	10	38.1	27.5	37.5	21
Strong	0	10	4.8	5	12.5	7.4

5. INFLATION EXPECTATIONS

Participants in the Survey were asked to indicate their expectations of overall inflation rates for the next 2 months (September and October 2018), and in the next 12 months (September 2018 to August 2019).

All respondents expected inflation to increase in September and October 2018, but to remain within the target range of 2.5 to 7.5 percent **(Table 1).** Respondents expected overall inflation to increase on account of the direct impact of higher fuel prices due to the compounded effect of the recently introduced VAT on petroleum products and rising international oil prices, and indirectly following increased cost of goods and services attributed to a rise in production and transportation costs. However, respondents expected food prices to remain low due to the forecast favourable weather conditions in the last quarter of 2018. Lower food prices were expected to moderate the impact of higher fuel prices on inflation.

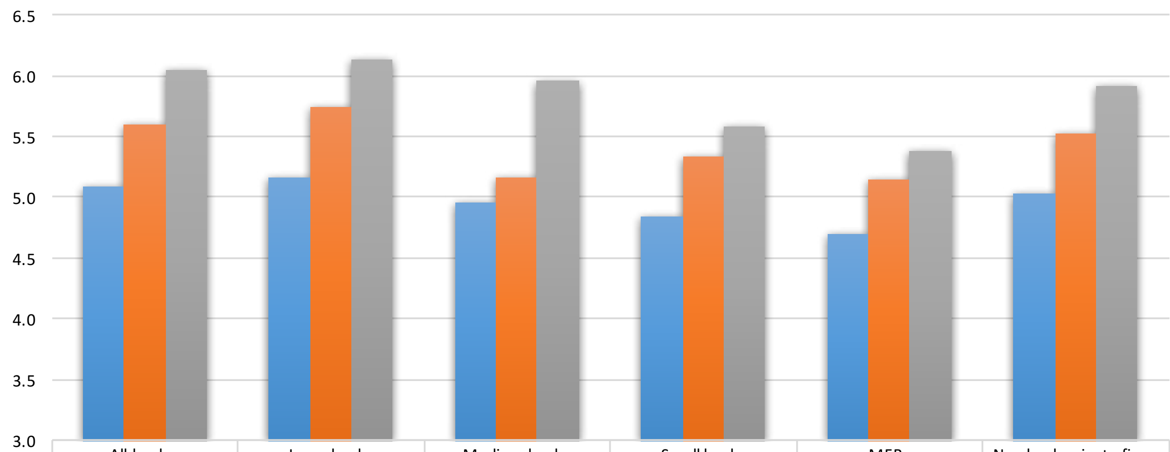
Table 1: Expected Overall Inflation over the next 2 Months (%)

Survey Month	Expected Inflation for:	Large banks	Medium banks	Small banks	All banks (weighted by size of bank)	MFBs	Non-bank private firms
Jul 2017	Jul-Aug 2017	9.8	10.2	10.3	10.0	10.4	10.1
Sep 2017	Sep-Oct 2017	7.7	7.7	8.3	7.6	8.0	8.2
Nov 2017	Nov-Dec 2017	5.9	5.8	5.9	5.9	5.5	5.7
Jan 2018	Jan-Feb 2018	5.5	5.1	4.9	5.3	5.0	5.0
Mar 2018	Mar-Apr 2018	4.4	4.8	4.6	4.5	4.6	4.8
May 2018	May-Jun 2018	4.2	3.9	3.7	4.1	3.9	3.8
Jul 2018	Jul-Aug 2018	4.9	4.6	4.6	4.8	4.8	4.4
Sep 2018	Sep-Oct 2018	5.4	5.1	5.1	5.3	4.9	5.3

The Survey showed that banks and non-bank private sector firms also expected overall inflation to increase in the next 12 months, but to remain within the target range **(Chart 1)**. All respondents expected the increase in inflation to come from the direct impact and second round effects of the VAT on petroleum products, and from the rising international oil prices. Prices of basic consumer goods and services were expected to increase gradually in the next year, reflecting higher production and transportation costs. Additionally, respondents from the non-bank private sector, specifically the labour intensive firms, expressed concerns over a possible increase in wages resulting from the expected rise in inflation.

Inflation over the next 12 months, was however, expected to be moderated by the forecast adequate rainfall in most parts of the country, the stable macroeconomic environment, and the slow private sector credit growth.

Chart 2: Expected Overall Inflation for the period September 2018 to August 2019 (%)



	All banks	Large banks	Medium banks	Small banks	MFBs	Non-bank private firms
September' 18	5.1	5.2	5.0	4.8	4.7	5.0
October '18	5.6	5.7	5.2	5.3	5.2	5.5
Next 12 months	6.0	6.1	6.0	5.6	5.4	5.9

6. EXCHANGE RATE EXPECTATIONS

Participants were asked to indicate their expectations on the direction of change in the exchange rate of the Shilling against the U.S. Dollar in September and October 2018, and in the next 12 months (September 2018 to August 2019).

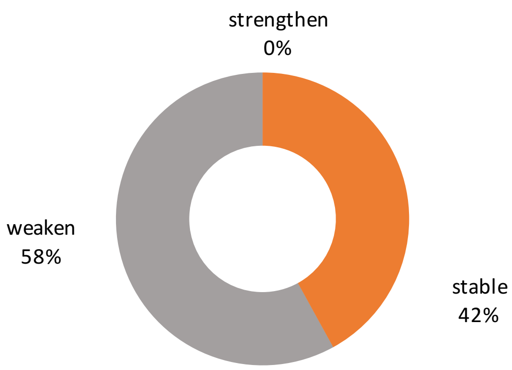
Respondents expected the Shilling to be supported by the strong foreign exchange reserves level, increasing diaspora remittances, strong export flows from tea and horticulture, higher inflows from tourism, lower food imports due to improved domestic production following favourable weather conditions, lower infrastructural development related imports, positive economic outlook, and the stable macroeconomic environment.

The Survey results showed mixed perceptions about the direction of the Ksh/USD exchange rate over the next 2 months. Most banks expected a moderate weakening of the Shilling, while the non-bank private sector were generally divided in their opinions **(Chart 2a).** Respondents expected moderate pressure on the Shilling to weaken due to potential negative sentiments around the expiry of the IMF Precautionary Facility, expected increase in the import bill due to rising international oil prices, increased demand for foreign exchange due to the pick-up in economic activity, strengthening of the U.S. Dollar globally, possible increase in the U.S. Fed rate, and, concerns about higher foreign debt service obligations.

Over the next 12 months, banks and non-bank private sector firms expected moderate pressure on the Shilling to weaken **(Chart 2b).** Respondents attributed this to expectations of increased imports with a pick-up in the economy, increase in international crude oil prices, U.S. trade sanctions against Iran which is one of the major markets for Kenya tea, uncertainties over the resolution of Brexit, and possible pressure from the upcoming dividend payments in the telecommunications sector in November 2018.

Chart 2a: Expected direction of the KSh/USD Exchange rate – September to October 2018

Commercial Banks



Non-Bank Private Sector

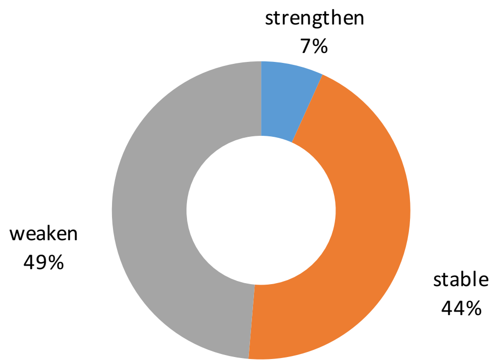
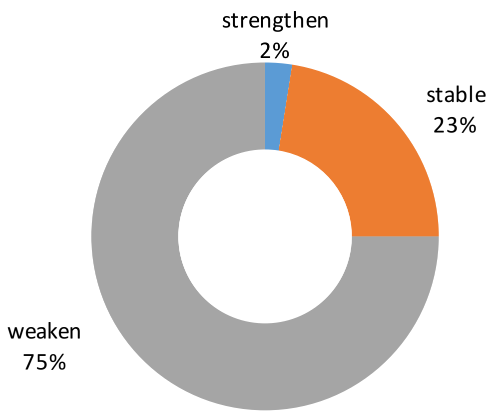
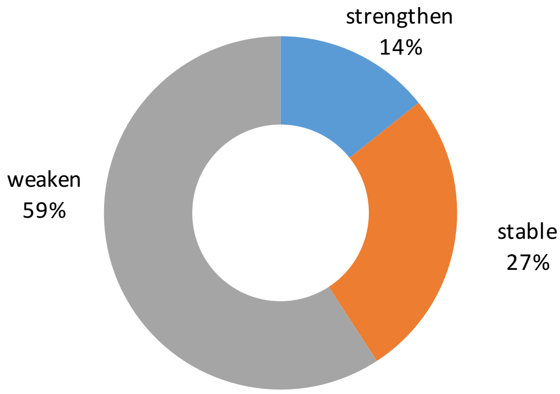


Chart 2b: Expected direction of the KSh/USD Exchange rate - September 2018 to August 2019

Commercial Banks



Non-Bank Private Sector



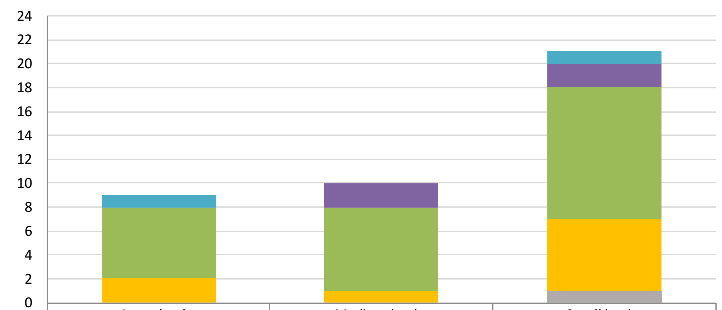
7. PRIVATE SECTOR CREDIT GROWTH EXPECTATIONS

7.1. Growth in Private Sector Credit in 2018

Commercial banks were asked to indicate their expected increase in lending to the private sector in 2018 **(Chart 3a).** Respondents indicated that overall, private sector credit growth was expected to improve gradually in 2018 relative to 2017. Growth in private sector credit was expected to be driven by: the expected improvement in demand for credit in the market as economic activity picks up; and the improved business sentiment and investor confidence.

However, private sector credit growth expectations declined across all the bank tiers relative to the July 2018 Survey with respondents attributing this to interest rate caps and the resultant challenges to effectively price risk. Other factors inhibiting faster credit expansion were largely bank-tier specific. Large banks cited the availability of other lower risk investment options, medium banks indicated the need to minimise exposure to non-performing loans, while small banks cited high cost of funds.

Chart 3a: Commercial Banks' Expected Growth in Private Sector Credit in 2018 (%)



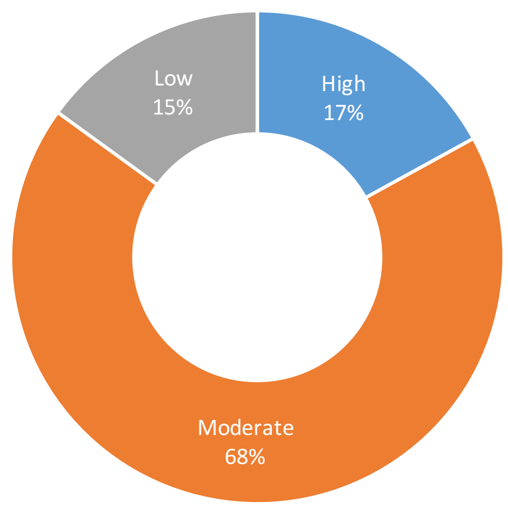
	Large banks	Medium banks	Small banks
Reduce significantly	1	0	1
Reduce marginally	0	2	2
Remain the same	6	7	11
Increase marginally	2	1	6
Increase significantly	0	0	1

7.2 Banks' Expectations on Credit Demand after the MPC Decisions of March and July 2018

Commercial banks were asked to indicate their expectations on credit demand following the MPC decisions of March and July 2018 of lowering the Central Bank Rate (CBR).

The results showed that 17 percent of banks, comprising 1 large bank, 2 medium banks and 4 small banks assessed demand for credit as high **(Chart 3b).** However, 68 percent of banks, comprising 7 large banks, 6 medium banks and 14 small banks felt that demand for credit was moderate.

Chart 3b: Banks' Expectations on Demand for Credit after the MPC Decisions in March and July 2018 (%)



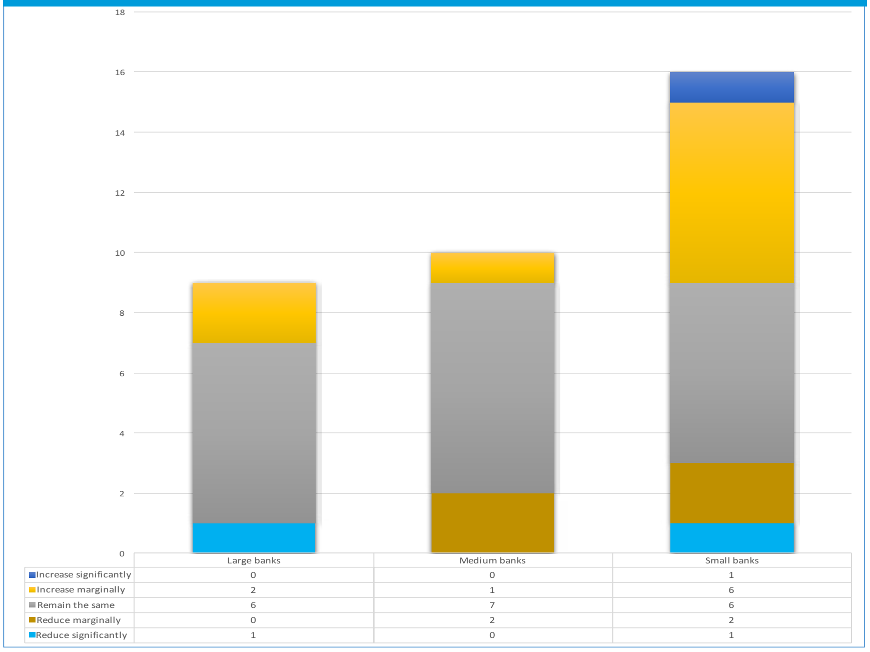
Banks which expected credit demand to increase attributed this to the lower cost of credit, expectations of improved economic growth, improved business environment and growth in business activity. However, banks which expected a moderate increase in demand attributed this to lower customers' expectations of accessing bank lending due to increased requirements after the introduction of interest rate caps, which had resulted in customers resorting to mobile loans. Delays by the county and central governments to pay suppliers had also slowed down demand for loans.

7.3 Expected Impact of the March and July 2018 MPC Decisions to lower the CBR on Lending

Commercial banks were asked to indicate the expected impact of the lowering of the CBR in May and July 2018 by 100 basis points cumulatively, on their lending to the private sector.

The results showed that 25 percent of the banks (2 large, 1 medium and 7 small banks) expected to increase their lending to the private sector due to a reduction in the cost of credit, lower inflation, and expected economic growth **(Chart 3c).**

Chart 3c: Impact of the March and July 2018 MPC Decisions on Expected Bank Lending in the Remainder of 2018



Despite the lower lending rates, most of the respondents, indicated that they would maintain their prevailing levels of lending due to strict loan appraisals attributed to the interest rate caps and high credit risk. Additionally, respondents indicated that availability of other lower risk investment options was cited by banks as another reason for not increasing lending in the remainder of the year. The Survey showed that 6 banks expected their lending to contract, which was contrary to the decision of the MPC.

Analyses of the Survey results across the different bank tiers showed a reduction in lending expectations by some banks. The banks attributed this to the inability to price risk due to the interest rate caps, and narrower margins after the lowering of the CBR.

8. ECONOMIC GROWTH EXPECTATIONS

Participants were asked to indicate their expectations with respect to the economic growth rate for the economy in 2018. The Survey results showed that banks and non-bank private firms expected a strong growth in 2018 **(Table 2).**

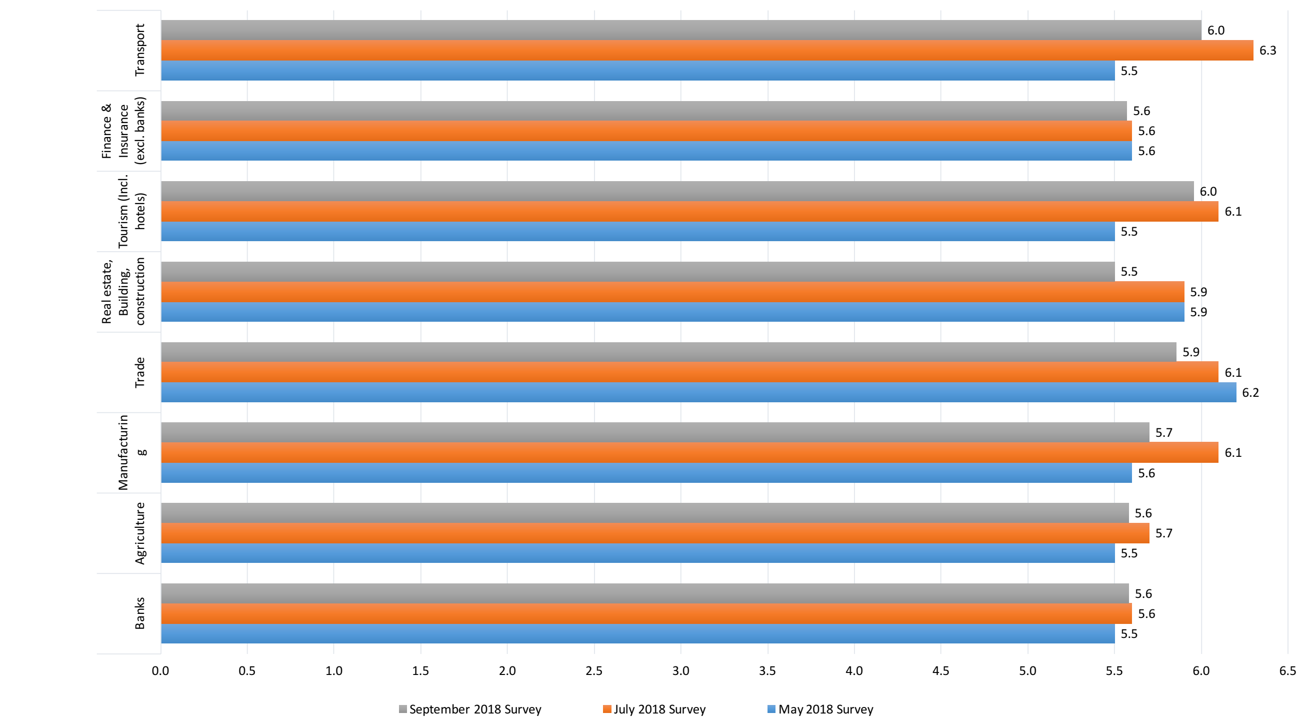
Respondents expected economic growth to be supported mainly by increased agricultural sector output due to improved weather conditions, improved confidence in the economy due to political stability particularly after the 'handshake', improvement in the performance of tourism industry, a resilient services sector, government focus on the Big 4 priority areas, a stronger global economy, and a stable macroeconomic environment.

According to the Survey, the risks to a stronger economic growth included higher fuel costs due to the implementation of the VAT on petroleum products and rising international oil prices, higher costs of production particularly for the manufacturing sector, slowdown in the pace of infrastructure development programmes, reduced private sector lending, and concerns on the level of public debt.

Table 2:Expected Economic Growth in 2018 across Banks and Non-Bank Private Firms (%)

Survey Month	Large banks	Medium banks	Small banks	All banks (weighted by size of bank)	MFBs	Non-bank private firms
Jan-2018	5.5	5.5	5.4	5.5	5.6	5.4
Mar-2018	5.4	5.3	5.4	5.4	5.5	5.4
May-2018	5.5	5.6	5.4	5.5	5.6	5.6
Jul-2018	5.5	5.6	5.8	5.6	5.6	5.9
Sep-2018	5.6	5.4	5.4	5.6	6.0	5.7

Chart 4: Expected Economic Growth in 2018 by Respondent Sectors (%)



The sectoral expectations on economic growth for 2018 remained strong, but varied across the different sectors. Respondents in the transport and tourism sectors showed strong optimism on the growth prospects due to improved tourist arrivals in 2018 relative to 2017, and improved infrastructure particularly road and railway networks **(Chart 4).** Respondents in the agricultural sector indicated that although the sector was benefiting from the favourable weather throughout the year, the new tax measures were likely to impact negatively on growth due to an increase in transportation costs.

Respondents from all sectors revised their growth expectations down slightly from the July 2018 Survey. They attributed this revision mainly to possible negative effects of the VAT on petroleum products on the cost of doing business. Other factors cited as likely to affect growth included low private sector credit growth, the crisis in the emerging markets particularly Turkey and Iran which could effect tea exports, expected rise in inflation due to higher fuel cost, and concerns around the level of public debt.

9. OPTIMISM ON THE ECONOMY

9.1. Economic Prospects and Improvement in the Business Environment

Banks and non-bank private sector firms were asked to indicate their levels of optimism on the country's economic prospects and improvements in the business environment going forward. The Survey results showed that both banks and non-bank private firms remained optimistic on the economic prospects and improvement in the business environment in 2018 **(Chart 5a and 5b).**

Respondents in the banking sector indicated that this optimism was supported by the focus by the Government on the Big 4 agenda, pick-up in economic activity in the private sector, business confidence due to political stability and ongoing fight against corruption, improved agriculture performance due to favourable weather conditions, likely review of the interest rate capping law which will spur credit growth and a stable macroeconomic environment. According to the bank respondents, the recent introduction of VAT on petroleum products was the biggest concern affecting their optimism in the September 2018 survey. They expected the tax to have a ripple effect on prices

Chart 5a: Optimism by Banks on Economic Prospects and Improvement in the Business Environment (%)

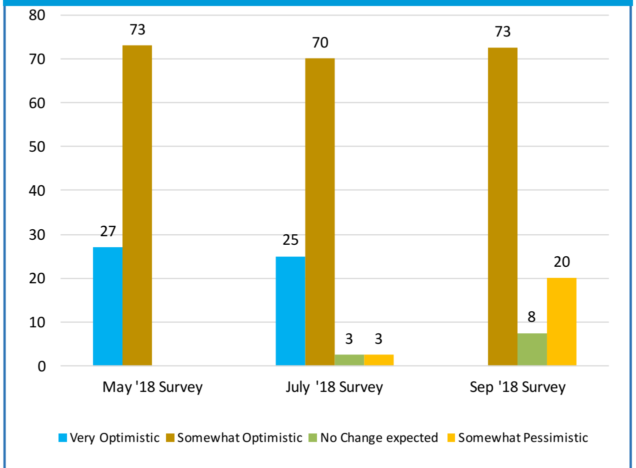
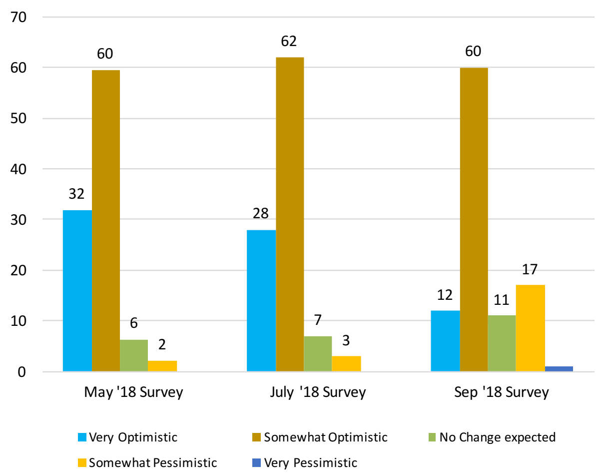


Chart 5b: Optimism by Non-Bank Private Firms on Economic Prospects and Improvement in the Business Environment (%)



of goods and services and thus lead to an increase inflation. Other factors affecting optimism included rising global oil prices, strengthening U.S. Dollar globally, reduction in government spending, concerns on the level of debt service, slow private sector credit growth largely due to the interest rate caps and delays in payments to suppliers and contractors by county and national governments.

Similarly, non-bank private firms remained optimistic about Kenya's economic prospects due to the focus by the Government on the Big 4 agenda, continuing investment in infrastructural, improved food supply and agriculture performance due to favourable weather conditions, the ongoing war against corruption which is expected to increase investor confidence, improved security, the upcoming direct flights to U.S. and France which will enhance tourism and trade, and political stability. The non-bank private sector firms were however concerned on the likely increase in the cost of doing business due to the introduction of new taxes especially the VAT on petroleum products, low access to credit, delayed payments to suppliers by both the county and central governments, and likely increase in external debt service.

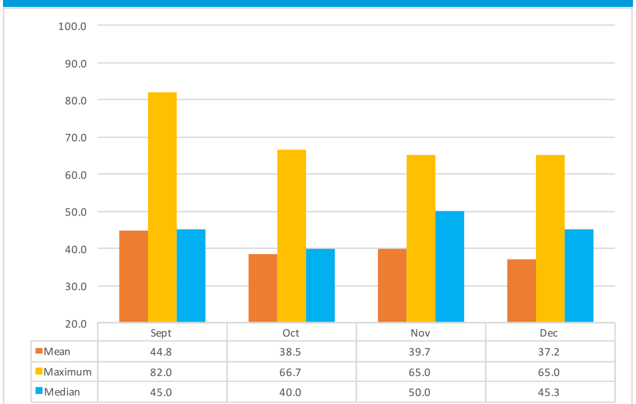
9.2 Forward Hotel Bookings

Hotels were requested to provide the levels of monthly forward bookings for the period September to December 2018, expressed as percentage of their total capacity.

The Survey results showed that the high level of optimism in the economy was reflected in comparably higher forward hotel bookings as shown in **Charts 6a and 6b.**

Chart 6a: Forward Hotel Bookings in the September 2018 Survey (percent of total capacity)

Chart 6b: Forward Hotel Bookings in the September 2017 Survey (percent of total capacity)



Respondents attributed the increase largely to the peak holiday tourism season of July to mid September, increased number of budget airlines which enable visitors working on projects to move across the country for short stays in various towns, upcoming conferences including the Marketing Expo in October 2018, improved security, and a calm political environment.

10. PERCEPTIONS ON IMPROVING THE BUSINESS ENVIRONMENT

Banks and non-bank private firms were asked to indicate the challenges that they were currently encountering, and to suggest how the business environment can be improved.

Banks indicated that there was need for, among others, to: complete the digitalization of the lands records in order to speed up the collateral perfection process and also weed out duplicate titling; reduce the cost of recovery on distressed facilities through speedier resolution in the courts; review the interest rate capping law in order to enable banks to price for risk and differentiate secured and unsecured lending; timely payments to public sector suppliers by both the county and national governments; review some of the taxation measures which may result in a higher cost of doing business; reduction in government domestic borrowing in order to lower the risk of crowding out of private sector borrowing; and to provide tax incentives for banks that finance risky sectors such as agriculture and MSMEs.

Respondents from the non-bank private sector across the surveyed regions indicated that there was need to: speed processing of tax refunds; reduced public domestic borrowing in order to lower interest rates on loans; consideration of alternative credit scoring metrics targeting the SME borrowers to facilitate their loan uptake; to facilitate financial education particularly for the young borrowers before contracting the first loan; deal with corruption; reconsider tax measures which increase the cost of doing business; and introduce a government backed incentive for banks to lend to the tourism sector against their revenues.

Non-bank private firms also highlighted the need for the banking industry and the government to reach a mutual agreement with regards to the interest rate caps law. They observed that following the introduction of the interest rate caps, banks were reluctant to lend to MSMEs which was depriving them of adequate funding to develop themselves and grow.

Respondents also indicated that there was need to implement tax incentives to the manufacturing sector especially on cost of inputs such as electricity and fuel, provide additional incentives for exporters through competitive inland freight costs, easing congestion at the port, as well as efficient export documentation process. Additionally, respondents also suggested the need to continue to address the cost of doing business through innovative ways such as easing legal and regulatory requirements.

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