Central Bank of Kenya

Quarterly Economic Review

July - September 2016
Volume 1 No. 3

OBJECTIVES OF THE CENTRAL BANK OF KENYA

The principal objectives of the Central Bank of Kenya (CBK) as established in the CBK Act are:

1) To formulate and implement monetary policy directed to achieving and maintaining stability in the general level of prices;
2) To foster the liquidity, solvency and proper functioning of a stable, market-based, financial system;
3) Subject to (1) and (2) above, to support the economic policy of the Government, including its objectives for growth and employment.

Without prejudice to the generality of the above, the Bank shall:

- Formulate and implement foreign exchange policy;
- Hold and manage Government foreign exchange reserves;
- License and supervise authorised foreign exchange dealers;
- Formulate and implement such policies as best promote the establishment, regulation and supervision of efficient and effective payment, clearing and settlement systems;
- Act as banker and adviser to, and fiscal agent of, the Government; and
- Issue currency notes and coins.

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QUARTERLY ECONOMIC REVIEW

JULY - SEPTEMBER 2016

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HIGHLIGHTSs

Overall inflation increased to 6.33 percent in the third quarter of 2016 from 5.36 percent in the second quarter of 2016, owing to a rise in food inflation. However, annual average inflation declined by 11 basis points to 6.47 percent from 6.58 percent in the same period.

Money supply (M3) grew marginally by 0.2 percent in the third quarter of 2016 compared with a rise of 3.5 percent in the previous quarter. Deceleration in growth was attributed to decreases of both Net Foreign Assets and Net Domestic Assets of the banking system.

The Central Bank of Kenya eased the Central Bank Rate (CBR) to 10 percent in September 2016 on the back of stable inflation outlook in the short term and low demand pressures. The average commercial banks' lending rate decreased to 13.84 percent in September from 18.15 percent in June 2016 partly on account of the implementation of interest rate capping law effective September 14, 2016.

The economy expanded by 5.7 percent in the third quarter of 2016. This was lower than 6.2 percent growth in the second quarter of 2016. Available economic indicators for agriculture and manufacturing activities point to mixed performance in the third quarter of 2016, while tourism continued to recover.

Kenya's external position remained resilient despite global uncertainties occasioned by modest global growth prospects and relatively subdued commodity prices. The current account deficit improved to USD 1,097 million in the third quarter of 2016 from USD 1,165 million in the preceding quarter. This was occasioned by an improvement in receipts from services, and, resilient remittance inflows, which offset the worsening in the goods account brought about by increased payments for oil imports and lower receipts from exports of tea and horticulture in the third quarter of 2016.

Kenya's official international reserves position was strong at USD 8,200 million by end-September 2016, equivalent to 5.6 months of imports. Kenya's Precautionary Arrangements with the IMF, amounting to USD 1,500 million approved in March 2016, provided additional buffer against short term external and domestic shocks.

Banking sector performance was mixed during the third quarter of 2016 relative to the previous quarter. Total assets grew by 3 percent largely reflecting in placements. Loans and advances accounted for 57.1 percent of total assets, marginally lower than 58.7 percent in the previous quarter. Customer deposits were the dominant source of funding to banks, accounting for 71 percent of total funds and recording 2.3 percent growth during the quarter. However, NPLS increased by 4.2 percent during the quarter, which led to worsening in the quality of loans. The sector raised capital levels to sustain resilience to adverse shocks. Banking sector profits decreased reflecting a steeper fall in incomes relative to the decline in expenses as interest rates declined.

KEPSS availability increased during the review period to on an average of 99.95 percent compared to 99.23 percent availability in the second quarter of 2016.

The government's budgetary operations resulted in a deficit of 1.8 percent of GDP in the first quarter of the FY 2016/17, compared with a surplus of 0.5 percent of GDP in the first quarter of the FY 2015/16. Total Government receipts (that is tax revenue and grants) were KSh 317.6 billion in the first quarter of FY 2016/17 equivalent to 5.1 percent of GDP. Government expenditure and net lending in the first quarter of the FY 2016/17 stood at KSh 430.9 billion (6.9 percent of GDP) against a target of KSh 523.6 billion (8.4 percent of GDP).

Kenya's public and publicly guaranteed debt increased by 2.4 percent during the first quarter[1] *of the FY 2016/17 with external debt accounting for much of the increase. As percentage of GDP, total debt stock at the end of the quarter under review increased by 130 basis points to 53.8 percent compared with the previous quarter.*

Capital markets performance declined in the third quarter of 2016 as reflected in most of the leading market indicators.

1 The quarterly analysis is based on the Fiscal year quarters; Q1: June- September, Q2: October-December, Q3: January-March Q4: April- June

Chapter 1
Inflation

Overview

Overall inflation increased by 97 basis points to 6.33 percent in the third quarter of 2016 from 5.36 percent in the second quarter of 2016, owing to a rise in food inflation **(Table 1.1)**. Food inflation increased by 306 basis points to 10.30 percent in the third quarter of 2016 compared to 7.24 percent in second quarter of 2016. The rise in food inflation was largely driven by increase in prices of a few key but seasonal food items, following declined supply as most food growing regions in the country experienced depressed rainfall.

Fuel and Non-Food Non-Fuel (NFNF) inflation declined in the period under review. Fuel inflation declined by 133 basis points to 0.4 percent in the third quarter of 2016 from 1.73 percent in the second quarter of 2016. This decline is largely attributed to the fairly low international oil prices. Additionally, declining cost of cooking gas and electricity in the third quarter of 2016 supported low fuel inflation. NFNF inflation declined to 4.99 percent from 5.42 percent in the previous quarter. It however, remained elevated on account of the effect of excise tax implemented in December 2015 and further indexation in July 2016.

Annual average inflation declined by 11 basis points to 6.47 percent from 6.58 percent over the review period. Furthermore, the three months annualized inflation rate declined by 37 basis points to 6.98 percent from 7.35 percent.

Contributions of broad categories to overall Inflation

The contribution of food inflation to overall inflation increased significantly to 4.87 percentage points in the third quarter of 2016 from 3.45 percentage points in the second quarter of 2016, driven by rising food prices following declined supply as most parts of the country experienced depressed rainfall **(Chart 1A)**.

The contribution of NFNF to overall inflation declined marginally to 1.36 percentage points in the third quarter of 2016 from 1.47 percentage points in the second quarter of 2016. Though declining, the contribution is significant, reflecting the persistent effect of excise tax imposed on beer and cigarettes in December 2015 and further indexation in July 2016.

Similarly, the contribution of fuel inflation to overall inflation declined to 0.1 percentage points in the third quarter of 2016 from 0.43 percentage points in the second quarter of 2016. The decline is largely on account of fairly low but rising international oil prices, and declining cost of electricity and cooking gas. However, the support from low international prices is expected to wane in the near term as oil prices continue to rise.

Food Inflation

Food inflation increased by 306 basis points to 10.30 percent in the third quarter compared to 7.24 percent in the second quarter of 2016. The rise in food inflation is largely driven by increasing prices of a few key but seasonal food items. The contribution of these food

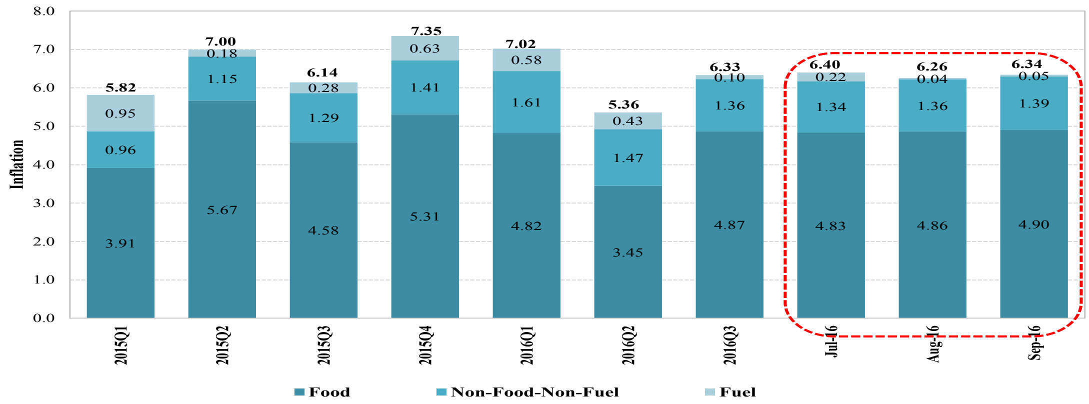
Table 1.1: Recent Developments in Inflation in Percent[1]

	2015				2016					
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Jul-16	Aug-16	Sep-16
Overall Quarterly inflation	5.82	6.99	6.14	7.35	7.02	5.36	6.33	6.40	6.26	6.34
Food Inflation	8.67	12.50	10.06	11.62	10.43	7.24	10.30	10.21	10.31	10.38
Fuel Inflation	3.57	0.68	1.04	2.39	2.25	1.73	0.40	0.89	0.14	0.19
Non-Food Non-Fuel Inflation (NFNF)	3.37	4.10	4.63	5.06	5.81	5.42	4.99	4.89	4.98	5.09
Average annual	6.66	6.66	6.39	6.44	6.84	6.58	6.47	6.44	6.47	6.50
Three months annualised	6.43	14.28	3.10	5.96	5.14	7.35	6.98	9.35	7.28	4.30

Source: Kenya National Bureau of Statistics and Central Bank of Kenya.

1 The specific product categories in inflation measures are: "food and non-alcoholic beverages" and "hotels and restaurants" for Food inflation; "transport" and "housing, water, electricity, gas and other fuels" categories for Fuel inflation while NFNF inflation excludes food and fuel inflation.

Chart 1A: **Contributions of Broad Categories to Overall Inflation in Percent**



Source: Kenya National Bureau of Statistics and Central Bank of Kenya.

items in the food basket to overall inflation increased in the quarter under review, with tomatoes contributing the highest at 1.59 percentage points from 1.13 percentage points. The contribution of cabbages increased more than twofold to 0.56 percentage points in the third quarter from 0.24 percentage points in the second quarter of 2016. Other items that made significant contributions include oranges at 0.24 percentage points from 0.16 percentage points, and carrots at 0.17 percentage points from 0.11 percentage points over the same period. Moreover, kale-sukuma wiki, which had a dampening effect on inflation in the preceding two quarters reversed trend in the quarter under review, recording a contribution of 0.13 percentage points. On the other hand, Irish potatoes exerted a moderating effect, with their contribution easing to 0.44 percentage points from 0.47 percentage points in the second quarter **(Chart 1B)**.

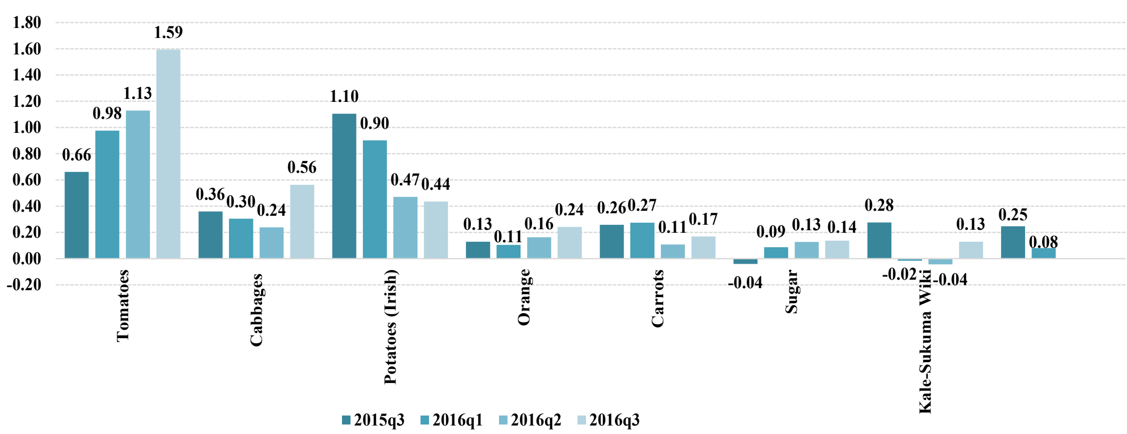
The contribution of sugar to overall inflation remained elevated, increasing to 0.14 percentage points in the period under review from 0.13 percentage points. The elevated sugar prices are on account of low domestic supply of sugar, as some factories underwent routine maintenance. In addition, international sugar prices have risen due to low production in leading global suppliers such as Brazil and India following unfavorable weather conditions.

Fuel Inflation

Fuel inflation declined by 130 basis points to 0.4 percent in the third quarter of 2016 from 1.7 percent in the previous quarter **(Chart 1C)**. This decline is largely attributed to the fairly low international oil prices. Moreover, the cost of cooking gas declined with its exemption from value added tax (VAT), and reduction of import duty on stoves and cookers. The cost of electricity has also been declining following increase in hydro electricity generation which is relatively cheaper.

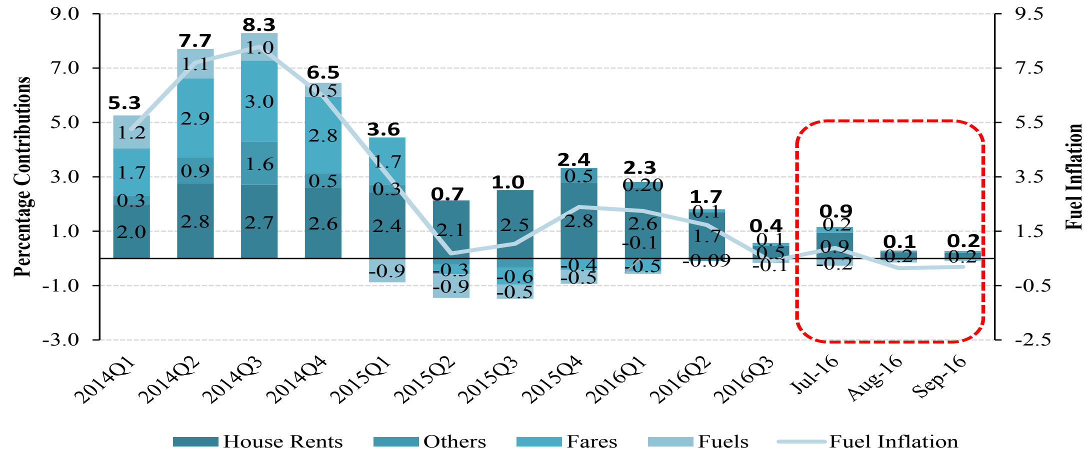
The dampening effect of fuels (petrol, diesel, kerosene and LPG gas) on overall inflation remained stable and minimal. Their contribution stood at -0.1 percentage points in the third quarter compared to -0.09 percentage points in

Chart 1B: **Contribution of Main Food Items to Food Inflation in Percent**



Source: Kenya National Bureau of Statistics and Central Bank of Kenya.

Chart 1C: Components of Fuel Inflation



Source: Kenya National Bureau of Statistics and Central Bank of Kenya.

the second quarter of 2016. Consistent with the low fuel prices and increased competition in the taxi business, transport costs have remained low reflecting the low and stable contribution of fares (taxi and bus fares) to overall inflation in the second and third quarters of 2016.

Non-Food Non-Fuel inflation (NFNF)

Non-Food Non-Fuel (NFNF) inflation declined marginally to 4.99 percent in the period under review from 5.42 percent in the second quarter of 2016 **(Table 1.2)**. Minimal decline was recorded across all the categories of NFNF inflation, except the 'Recreation and Culture' category, whose contribution stabilized at 0.40 percentage points in the second and third quarters of 2016. Notably, alcoholic beverages and narcotics; and clothing and footwear continued to be the main drivers of NFNF inflation.

Overall Quarterly Inflation across Regions

Inflation for the Rest of Kenya increased to 6.39 percent in the third quarter of 2016 from 5.10 percent in the second quarter of 2016, while that of Nairobi increased to 6.25 percent from 5.74 percent over the same period. The contribution of the Rest of Kenya to overall

Table 1.2: Non-Food-Non-Fuel Inflation in Percent

		Alcoholic Beverages, Tobacco & Narcotics	Clothing & Footwear	Furnishings, Household Equipment and Routine Household Maintenance	Health	Communication	Recreation & Culture	Education	Miscellaneous Goods & Services	**Non-Food Non-Fuel Inflation**
2015	Q1	0.08	1.00	0.82	0.40	-0.02	0.19	0.35	0.55	**3.37**
	Q2	0.18	1.13	0.89	0.49	0.07	0.25	0.38	0.72	**4.10**
	Q3	0.29	1.23	0.90	0.55	0.14	0.30	0.43	0.80	**4.63**
	Q4	0.59	1.23	1.05	0.56	0.15	0.27	0.45	0.77	**5.06**
2016	Q1	1.11	1.21	1.03	0.60	0.22	0.37	0.47	0.79	**5.81**
	Jan	1.10	1.20	1.01	0.58	0.11	0.33	0.41	0.73	**5.47**
	Feb	1.08	1.20	1.01	0.62	0.27	0.39	0.49	0.83	**5.89**
	Mar	1.16	1.23	1.05	0.61	0.28	0.40	0.50	0.83	**6.05**
	Q2	1.11	1.08	0.92	0.51	0.24	0.40	0.49	0.65	**5.42**
	Q3	1.10	0.96	0.81	0.43	0.20	0.40	0.46	0.63	**4.99**
	July	1.10	0.92	0.79	0.44	0.20	0.39	0.47	0.59	**4.89**
	Aug	1.10	0.96	0.82	0.42	0.19	0.40	0.46	0.63	**4.98**
	Sept	1.11	1.00	0.82	0.43	0.20	0.40	0.46	0.66	**5.09**

Source: Kenya National Bureau of Statistics and Central Bank of Kenya.

inflation increased to 3.2 percentage points from 2.71 percentage points, while that of Nairobi increased to 3.13 percentage points from 2.65 percentage points over the same period **(Chart 1D)**. This reflects significant increase in food prices whose contribution to inflation in Nairobi increased to 2.48 percentage points from 1.77 percentage points in the period under review. Moreover, the contribution of food to inflation in the rest of the country increased to 2.41 percentage points in the third quarter from 1.71 percentage points in the second quarter of 2016.

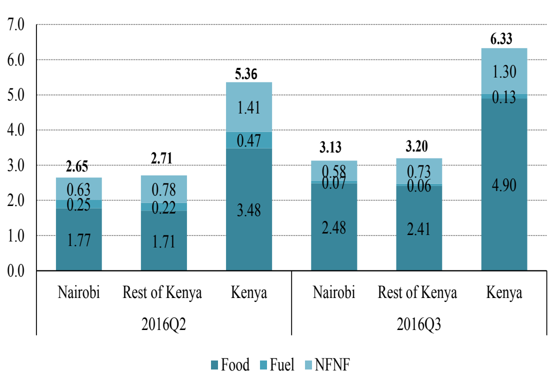
The contribution of NFNF inflation to overall inflation declined in the third quarter compared to the second quarter of 2016. The lower contribution to inflation was reflected in both regions: with the Rest of Kenya at 0.73 percentage points compared to 0.78 percentage points in the second quarter of 2016, and Nairobi at 0.58 percentage points from 0.63 percentage points over the same period

The effect of fuel on inflation remained balanced, with the declining contribution to overall inflation reflecting developments in both regions. Its contribution to inflation in Nairobi declined to 0.07 percentages points in the third quarter of 2016 from 0.25 percentage points in the second quarter of 2016, while that of the Rest of Kenya declined to 0.06 percentages points from 0.22 percentage points over the same period.

Overall Quarterly Inflation across Income Groups in Nairobi

Inflation in Nairobi rose to 6.25 percent in the third quarter of 2016 from 5.74 percent in the second quarter of 2016 reflecting increased inflation in the lower and middle income groups, which more than offset the decline in

Chart 1D: Contributions of Various Regions to Overall Quarterly Inflation in Percent



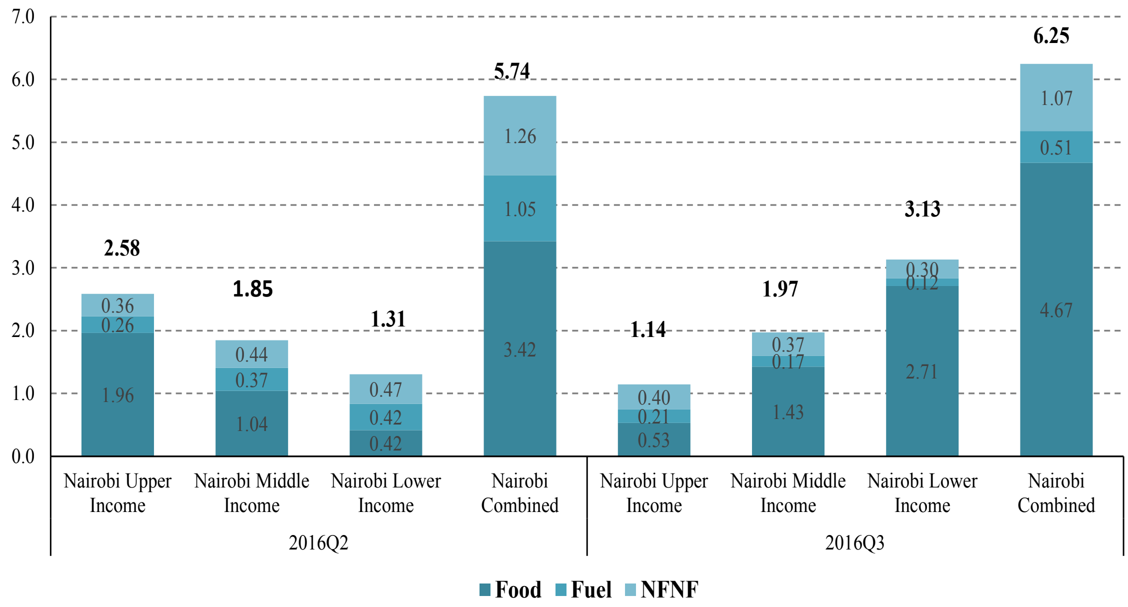
Source: Kenya National Bureau of Statistics and Central Bank of Kenya.

inflation in the upper income group **(Chart 1E)**. Inflation in the lower and middle income groups was predominantly driven by food prices. The contribution of food to inflation in the lower income group increased significantly to 2.71 percentage points from 0.42 percentage points in the second quarter of 2016. In the middle income group, it increased to 1.43 percentage points from 1.04 percentage points in the period under review. However, the contribution of food to inflation in the upper income group declined significantly to 0.53 percentage points in the third quarter from 1.96 percentage points in the second quarter of 2016.

The contribution of NFNF to inflation in Nairobi declined to 1.07 percentage points from 1.26 percentage points in the second quarter of 2016, reflecting declines in the lower and middle income groups that counterbalanced the increase in the upper income group. NFNF inflation contributed 0.3 percentage points to inflation in the lower income group compared to 0.47 percentage points in the second quarter of 2016. Its contribution to inflation in the middle income group declined to 0.37 percentage points from 0.44 percentage points in the period under review. However, its contribution to inflation in the upper income group increased marginally to 0.4 percentage points in the third quarter from 0.36 percentage points in the second quarter of 2016.

The contribution of fuel to inflation in Nairobi declined significantly to 0.51 percentage points compared to 1.05 percentage points in the second quarter of 2016. The decline was reflected across all income groups. In the upper income group, the contribution of fuel to inflation declined marginally to 0.21 percentage points from 0.26 percentage points over the period under review. For the middle income group, it declined from 0.37 percentage points in the second quarter to 0.17 percentage points in the third quarter of 2016, while the contribution of fuel to inflation in the lower income group stood at 0.12 percentage points compared to 0.42 percentage points over the same period.

Chart 1E: Contributions of Income Groups to Overall Inflation in Nairobi in Percent.



Source: Kenya National Bureau of Statistics and Central Bank of Kenya.

Chapter 2

Money, Credit and Interest Rates

Overview

Money supply (M3) decelerated to 0.2 percent growth in the third quarter of 2016 compared with a rise of 3.5 percent in the previous quarter. The slowdown reflects largely a decline of 9.6 percent in time and savings deposits, partly attributable to reclassification of savings accounts into checking accounts by banks following implementation of the interest rates caps on September 14, 2016. Growth of foreign currency deposits held by residents also slowed to 4.3 percent in the third quarter from 5.7 percent in the second quarter **(Table 2.1)**.

Narrow money, M1 recorded an improvement of 9.1 percent in the third quarter of 2016 compared with 5.3 percent growth recorded in second quarter of 2016 reflecting build-up of demand deposits owing to banks' conversion of interest earning deposits to checking accounts to cut down on costs following the reintroduction of interest rate caps. This realignment and further migration of deposits by the nonbank sector into government securities contributed to 0.53 percent decline in money supply, M2 compared with 3.1 percent in the previous quarter.

However, accumulation of government securities by nonbanks during the quarter under review eased to 4.4 percent growth from 8.9 percent in second quarter of 2016 reflecting maturities of government securities acquired in the first quarter **(Table 2.1 and Chart 2A)**.

Table 2.1: Monetary Aggregates (KSh Billion)

	END MONTH LEVEL			QUARTERLY % CHANGE			QUARTERLY ABSOLUTE CHANGE (Ksh Billion)		
1. COMPONENTS OF M3	**Mar-16**	**Jun-16**	**Sep-16**	**Mar-16**	**Jun-16**	**Sep-16**	**Mar-16**	**Jun-16**	**Sep-16**
1.1 Money supply, M1 (1.1.1+1.1.2+1.1.3)	**1,076.8**	**1,133.7**	**1,236.7**	**5.2**	**5.3**	**9.1**	**53.1**	**56.9**	**103.0**
1.1.1 Currency outside banks	183.4	187.9	186.6	-4.0	2.5	-0.7	-7.6	4.5	-1.3
1.1.2 Demand deposits	839.0	878.9	977.8	8.7	4.8	11.3	67.3	39.9	99.0
1.1.3 Other deposits at CBK [1]/	54.1	66.7	71.9	-10.8	23.2	7.9	-6.6	12.5	5.2
1.2. Money supply, M2 (1.1+1.2.1)	**2,262.7**	**2,333.1**	**2,320.8**	**1.2**	**3.1**	**-0.5**	**27.9**	**70.4**	**-12.3**
1.2.1 Time and saving deposits	1,185.9	1,199.4	1,084.1	-2.1	1.1	-9.6	-25.2	13.5	-115.3
1.3. Money supply, M3 (1.2+1.3.1)	**2,662.6**	**2,755.9**	**2,761.8**	**0.2**	**3.5**	**0.2**	**4.5**	**93.3**	**5.9**
1.3.1 Foreign Currency Deposits	399.9	422.8	441.0	-5.5	5.7	4.3	-23.4	22.9	18.2
2. SOURCES OF M3									
2.1 Net foreign assets [2]/	**471.4**	**562.5**	**591.9**	-4.1	19.3	5.2	-20.0	91.1	29.3
Central Bank	640.8	694.6	687.2	3.1	8.4	-1.1	19.4	53.8	-7.4
Banking Institutions	-169.3	-132.0	-95.3	30.3	-22.0	-27.8	-39.4	37.3	36.7
2.2 Net domestic assets (2.2.1+2.2.2)	**2,191.2**	**2,193.4**	**2,169.9**	1.1	0.1	-1.1	24.5	2.2	-23.4
2.2.1 Domestic credit	**2,823.7**	**2,855.1**	**2,851.8**	1.1	1.1	-0.1	29.8	31.4	-3.3
Government (net)	543.6	559.4	517.3	3.7	2.9	-7.5	19.6	15.7	-42.1
Private sector	2,230.6	2,245.3	2,283.9	0.5	0.7	1.7	10.6	14.7	38.6
Other public sector	49.4	50.5	50.6	-0.8	2.1	0.3	-0.4	1.0	0.1
2.2.2 Other assets net	**-632.5**	**-661.7**	**-681.8**	0.8	4.6	3.0	-5.3	-29.2	-20.1
3. Memorandum items									
3.1 Overall liquidity, L (1.3+3.1.1)	**3,430.1**	**3,592.1**	**3,634.6**	**1.2**	**4.7**	**1.2**	**39.3**	**161.9**	**42.6**
3.1.1 Non-bank holdings of government securities	767.5	836.1	872.8	4.8	8.9	4.4	34.9	68.6	36.7

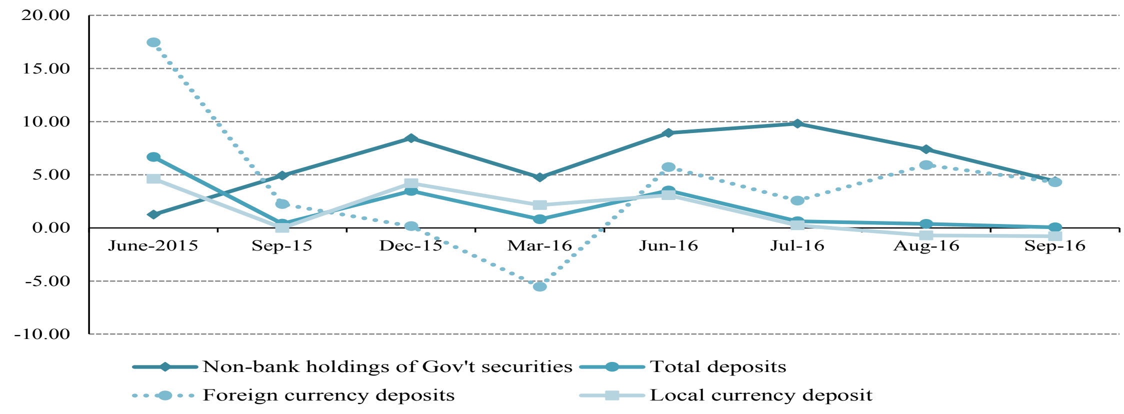
Absolute and percentage changes may not necessarily add up due to rounding

[1] / Includes county deposits and special projects deposit

[2] / Net Foreign Assets at current exchange rate to the US dollar.

Source: Central Bank of Kenya.

Chart 2A: Quarterly Growth in Deposits And Non-Bank Holdings of Government Securities



Source: Central Bank of Kenya

Sources of M3

The Net Foreign Assets (NFA) of the banking system declined to 5.2 percent from an increase of 19.3 percent. The deceleration in growth is attributed to government payments and debt servicing. The NFA held by other banking institutions also declined, on account of increased deposit holdings by banks abroad and other accounts payable.

The Net Domestic Assets (NDA) of the banking system decreased by 0.1 percent in third quarter of 2016 from a growth of 1.1 percent in the previous quarter. The slowdown in growth is mainly reflected in net credit to Government and other items net in the third quarter of 2016.

Developments in Domestic Credit

Net domestic credit decreased by 0.1 percent in third quarter of 2016, compared with an increment of 1.1 percent recorded in the previous quarter. The decline reflects draw down of government deposits, leading to a 7.5 percent decline in net bank credit to government **(Table 2.2)**. Credit growth to the private sector improved albeit at a slower pace to 1.7 percent in the third quarter from 0.7 percent recorded in the previous quarter.

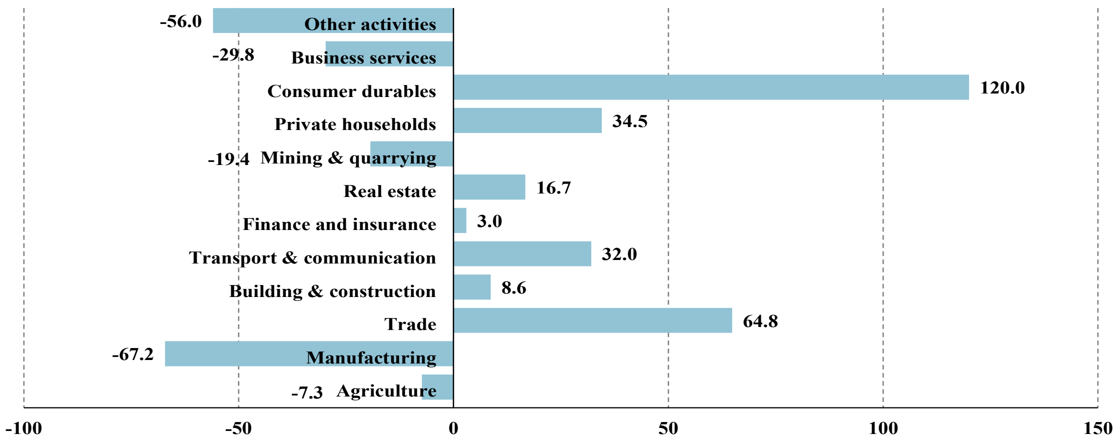
The private sector credit was channeled to the various sectors of the economy, with consumer durables and trade activities recording the largest share of 120 percent and 64.9 percent, respectively. Meanwhile, manufacturing and business services led in loan repayments **(Chart 2B)**.

Table 2.2: Banking Sector Net Domestic Credit (Ksh Billion)

	END MONTH LEVEL			QUARTERLY CHANGES (%)			QUARTERLY CHANGES (KSH BN)		
	Mar-16	Jun-16	Sep-16	Mar-16	Jun-16	Sep-16	Mar-16	Jun-16	Sep-16
1. Credit to Government	**543.6**	**559.4**	**517.3**	**3.7**	**2.9**	**-7.5**	**19.6**	**15.7**	**-42.1**
Central Bank	-80.8	-156.1	-189.9	85.1	93.3	21.6	-37.1	-75.4	-33.7
Commercial Banks & NBFIs	624.4	715.5	707.2	10.0	14.6	-1.2	56.7	91.1	-8.3
2. Credit to other public sector	**49.4**	**50.5**	**50.6**	**-0.8**	**2.1**	**0.3**	**-0.4**	**1.0**	**0.1**
Local government	0.8	0.1	0.9	-33.9	-84.8	690.9	-0.4	-0.6	0.8
Parastatals	48.7	50.3	49.7	-0.1	3.4	-1.3	0.0	1.7	-0.7
3. Credit to private sector	**2,230.6**	**2,245.3**	**2,283.9**	**0.5**	**0.7**	**1.7**	**10.6**	**14.7**	**38.6**
Agriculture	89.6	97.8	95.0	3.6	3.5	-2.9	3.3	3.3	-2.8
Manufacturing	296.6	306.0	280.1	2.3	0.5	-8.5	7.0	1.5	-25.9
Trade	393.1	331.0	356.0	3.6	1.2	7.6	11.5	4.1	25.0
Building and construction	98.5	101.5	104.8	-7.5	0.6	3.3	-8.2	0.6	3.3
Transport & communications	169.6	183.0	195.4	-1.2	-0.1	6.8	-2.2	-0.2	12.4
Finance & insurance	61.7	88.7	89.9	1.3	4.7	1.3	1.1	4.0	1.1
Real estate	286.8	323.2	329.6	1.1	3.3	2.0	3.3	10.2	6.4
Mining and quarrying	22.2	23.6	16.1	9.0	4.2	-31.6	1.9	1.0	-7.5
Private households	369.2	358.3	371.6	1.5	0.1	3.7	5.3	0.4	13.3
Consumer durables	128.0	125.1	171.4	-0.4	-0.4	37.0	-0.5	-0.5	46.3
Business services	208.6	183.7	172.2	2.0	-2.3	-6.3	3.6	-4.3	-11.5
Other activities	106.8	123.3	101.7	-10.8	-4.2	-17.5	-15.5	-5.4	-21.6
4. TOTAL (1+2+3)	**2,823.7**	**2,855.1**	**2,851.8**	**1.1**	**1.1**	**-0.1**	**29.8**	**31.4**	**-3.3**

Source: Central Bank of Kenya

Chart 2A: Share of Credit by Sectors (%) in the third quarter of 2016



Source: Central Bank of Kenya

Table 2.3: Reserve Money and its Sources (Ksh Billion)

	END QUARTER LEVELS			QUARTERLY FLOWS(KSH BN.)			QUARTERLY % CHANGE		
	Mar-16	Jun-16	Sep-16	Mar-16	Jun-16	Sep-16	Mar-16	Jun-16	Sep-16
1. Net Foreign Assets	640.8	694.6	687.2	19.4	53.8	-7.4	3.12	8.40	-1.06
2. Net Domestic Assets	-238.9	-304.4	-294.4	-9.9	-65.5	10.0	4.34	27.43	-3.30
2.1 Government Borrowing (net)	-80.8	-156.1	-189.9	-37.1	-75.4	-33.7	85.14	93.34	21.60
2.2 Commercial banks (net)	-8.2	3.0	42.0	13.5	11.1	39.1	-62.34	-136.39	1315.79
2.3 Other Domestic Assets (net)	-153.5	-154.7	-150.0	13.8	-1.2	4.7	-8.24	0.80	-3.06
3. Reserve Money	401.9	390.2	392.8	9.5	-11.7	2.6	2.41	-2.91	0.68
3.1 Currency outside banks	183.4	187.9	186.6	-7.6	4.5	-1.3	-3.98	2.47	-0.68
3.2 Bank reserves	218.5	202.3	206.2	17.1	-16.2	3.9	8.48	-7.44	1.94

Source: Central Bank of Kenya

Reserve Money

Reserve money (RM) which comprises currency held by the non-bank public and commercial banks reserves[1] increased by 0.7 percent in the third quarter of 2016. The marginal growth however, represents recovery from a 2.9 percent decline in the previous quarter, reflecting upturn in growth of bank reserves **(Table 2.3).** The recovery is attributed largely to liquidity support through reverse repos.

Interest Rates

i). The Central Bank Rate

The Central Bank of Kenya eased its policy rate (CBR) in September 2016 to 10 percent from 10.5 percent in August 2016 on the back of stable inflation outlook in the short term and low demand pressures, particularly given the persistent slowdown in private sector credit growth.

ii). Interbank rate

The weighted average interbank rate rose to 5.16 percent in the third quarter compared to 4.17 percent in the second quarter of 2016 **(Table 2.4)**. Owing to segmentation and uneven distribution of liquidity in the interbank market, the average interbank rate remained below the CBR with Tier I banks trading high volumes at low rates among themselves.

iii). Treasury bill rates

The average 91-day Treasury bill rate declined to 7.98 percent in the third quarter of 2016 compared with 8.11 percent in the previous quarter, and the average 182-day Treasury bill rate increased to 10.49 percent from 10.23 percent over the same period **(Table 2.4)**.

1 Commercial banks reserves comprises of deposits at the Central Bank of Kenya and cash in tills

iv). Lending and Deposit Rates

The average commercial banks' lending rate decreased to 13.84 percent in September from 18.15 percent in June 2016 reflecting the effect of the interest rate capping[2] in implemented in September 2016. Meanwhile, the average deposit rate increased marginally to 6.91 percent in September 2016 from 6.78 percent in June 2016. Consequently, the interest rate spread narrowed from 11.37 percent in June 2016 to 6.93 percent in September 2016 **(Table 2.4)**.

Table 2.4: Interest Rates (%)

	2015							2016								
	June	**July**	**Aug**	**Sep**	**Oct**	**Nov**	**Dec**	**Jan**	**Feb**	**Mar**	**Apr**	**May**	**Jun**	**Jul**	**Aug**	**Sep**
91-day Treasury bill rate	8.26	10.57	11.54	14.61	21.65	12.34	9.81	11.36	10.63	8.72	8.92	8.15	7.25	7.41	8.48	8.06
182-day Treasury bill rate	10.55	11.99	12.06	13.40	21.52	14.02	11.43	13.46	13.19	10.83	10.87	10.25	9.56	9.79	10.84	10.85
Interbank rate	11.77	13.48	18.80	19.85	14.82	8.77	7.27	6.12	4.54	4.10	4.01	3.82	4.56	5.88	4.98	4.47
Repo rate	9.70	10.61	11.50	11.50	11.50		9.23	8.85	9.68	4.31	5.23	6.00	10.04	9.76	7.86	-
Reverse Repo rate	-	-	-		18.12	14.21	11.92	11.44	11.58	11.63	12.49	11.55	10.59	10.57	10.53	10.36
Central Bank Rate (CBR)	10.00	11.50	11.50	11.50	11.50	11.50	11.50	11.50	11.50	11.50	11.50	10.50	10.50	10.50	10.50	10.00
Average lending rate (1)	16.06	15.75	15.68	16.82	16.58	17.16	18.30	17.96	17.86	17.79	17.94	18.08	18.15	18.10	17.71	13.84
Overdraft rate	15.65	16.05	15.98	16.65	16.81	17.44	18.48	18.25	18.25	18.06	18.36	18.25	18.04	17.84	17.96	13.60
1-5years	16.72	16.77	16.64	17.41	16.90	17.72	18.40	18.27	18.01	18.00	18.25	18.46	18.63	18.66	18.16	13.95
Over 5years	15.11	14.44	14.43	15.93	15.87	16.26	18.03	17.33	17.41	17.31	17.20	17.53	17.64	17.53	17.01	13.83
Average deposit rate (2)	6.64	6.31	6.91	7.28	7.54	7.39	8.02	7.54	7.51	7.17	6.70	6.38	6.78	6.64	6.42	6.91
0-3months	8.33	7.89	9.22	10.05	10.55	10.50	11.14	10.32	10.00	9.78	8.68	8.54	8.80	8.43	8.14	8.13
Over 3 months deposit	9.73	9.67	10.03	10.06	10.38	10.35	11.35	10.75	11.15	10.41	10.05	8.93	9.94	9.82	9.45	8.80
Savings deposits	1.85	1.37	1.50	1.71	1.68	1.32	1.56	1.56	1.37	1.32	1.38	1.69	1.60	1.67	1.68	3.79
Spread (1-2)	**9.42**	**9.44**	**8.77**	**9.54**	**9.04**	**9.77**	**10.28**	**10.41**	**10.35**	**10.62**	**11.23**	**11.70**	**11.37**	**11.46**	**11.28**	**6.93**

Source: Central Bank of Kenya

[2] The new law fixes a ceiling on commercial bank lending interest rates at 4 percent above the Central Bank Rate (CBR) and a minimum rate on savings deposits at 70 percent of the CBR.

Chapter 3

The Real Sector

Overview

The economy recorded strong performance in the third quarter of 2016, with real Gross Domestic Product (GDP) growing by 5.7 percent. However, this was lower than 6.2 percent growth in the second quarter of 2016, and 6.0 percent growth in the third quarter of 2015 **(Table 3.1A and Chart 3A)**. GDP growth during the quarter under review was attributed to high government investment in infrastructure which supported the construction sector, low energy prices which supported energy driven sectors of the economy, improved performance of wholesale and retail trade, and the continued recovery of the tourism sector. However, growth of the agriculture sector decelerated while the performance of the manufacturing sector was subdued.

In terms of sectoral contribution to growth in the third quarter of 2016, agriculture declined to 0.8 percentage points from 1.3 percentage points in the second quarter of 2016 while transport and storage increased to 0.8 percentage points from 0.6 percentage points during the same period. Other sectors with significant contribution include wholesale and retail trade (0.6 percentage points); real estate (0.6 percentage points) and; construction (0.5 percentage points) **(Table 3.1C).**

Available economic indicators point to mixed performance in the third quarter of 2016. Production declined in some activities in agriculture and manufacturing, while tourism continued to recover.

The Agriculture Sector

The sector's performance slowed significantly in the third quarter of 2016, recording a growth of 3.9 percent compared to a growth of 5.5 percent in the second quarter of 2016 **(Table 3.1A).** Production of various products in the sector was varied, with reduced output of crops such as maize, tea, coffee and fruits outweighing the improved production in other products such as milk, vegetables and cut flowers.

Tea

Tea production remained depressed, declining by 13.0 percent in the third quarter of 2016; a slight improvement from 21.4 percent decline in the second quarter of 2016 but a reversal compared to 2.3 percent growth in the same quarter of 2015. The decline in the third quarter of 2016 was attributed to industrial action by tea workers in major tea growing areas. Monthly growth rates show a decline of 17.7 percent in July 2016, but production recovered in August and September 2016, growing by 0.6 percent and 24.9 percent, respectively **(Table 3.2).** The average auction price per kilogram of tea rose by 6.4 percent to KSh 241.07 in the third quarter of 2016 from KSh 226.52 recorded in the second quarter of 2016, on account of subdued tea production.

Coffee

Coffee sales fell more steeply, by 31.1 percent, in the third quarter of 2016 compared to 29.0 percent decline in the previous quarter, partly due to the Nairobi Coffee Exchange being in recess for most of July 2016. Furthermore, monthly data shows a decline of 11.8 percent to 3,284 metric tonnes in September 2016 from 3,723 metric tonnes in August 2016, reflecting reduced supply from the early coffee harvest in September following unfavorable weather conditions **(Table 3.2).** Coffee auction prices rose by 10.9 percent in the third quarter of 2016 compared to the same quarter of 2015, as a result of low coffee supply during the period.

Horticulture

Production of horticultural goods for export declined by 8.7 percent in the third quarter of 2016 compared to 19.1 percent fall in the previous quarter. The decline was largely in September 2016 at 1.5 percent, mainly attributed to low production of fruits and nuts **(Table 3.2)**. The share of export volumes of fresh vegetables to total horticultural exports increased to 49.5 percent in the third quarter of 2016 from 45.4 percent in the same quarter of 2015, while the share of export value of cut flowers stabilized at 46.6 percent compared with 46.3 percent in the same quarter of 2015 **(Chart 3A)**.

Other indicators of agriculture performance recorded improvement. Milk intake in the formal sector increased by 11.8 percent over the period July-August 2016 compared to the same period in 2015. Monthly data shows a 21.6 percent increase in July 2016, while intake

Source: Kenya National Bureau of Statistics

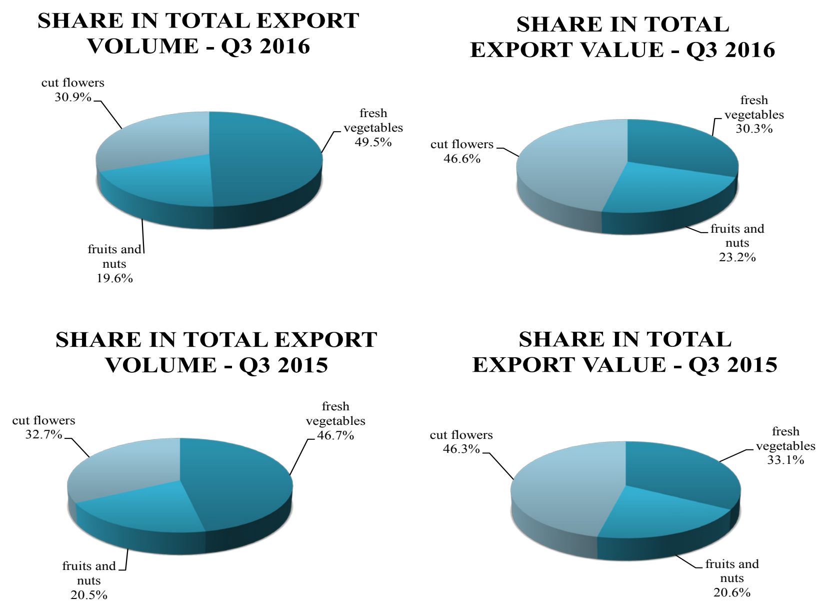
Table 3.2: Quarterly Performance of Key Agricultural Output Indicators

	2015				2016*					
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Jul-16	Aug-16	Sep-16
Tea										
Output (Metric tonnes)	81,617	93,646	95,836	128,112	139,607	109,747	N/A	29,285	29,462	N/A
Growth (%)	*-36.8*	*14.7*	*2.3*	*33.7*	*9.0*	*-21.4*		*-17.7*	*0.6*	
Horticulture										
Exports (Metric tonnes)	74,929	67,050	103,342	69,460	114,563	92,647	84,574	25,398	29,804	29,373
Growth (%)	*11.3*	*-10.5*	*54.1*	*-32.8*	*64.9*	*-19.1*	*-8.7*	*12.1*	*17.3*	*-1.4*
Coffee										
Sales (Metric tonnes)	13,203	6,680	8,015	4,319	15,487	10,996	7,576	568.89**	3,723	3,284
Growth (%)	*92.5*	*-49.4*	*20.0*	*-46.1*	*258.6*	*-29.0*	*-31.1*	*-67.4*	*554.4*	*-11.8*
Milk										
Output (million litres)	130.8	139.6	158.2	182.6	159	152	N/A	58.5	56.1	N/A
Growth %	*-3.3*	*6.7*	*13.3*	*15.4*	*-13.1*	*-4.0*		*21.6*	*-4.1*	
Sugar Cane										
Output ('000 Metric tonnes)	1,878	1,595	1,764	1,613	2,002	1,730	N/A	638	N/A	N/A
Growth (%)	*51.1*	*-15.1*	*10.6*	*-8.6*	*24.1*	*-13.6*		*0.9*		

* Provisional
** The Nairobi Coffee Exchange was in recess for most of June/July 2016
N/A Data not availabe

Source: Kenya National Bureau of Statistics

Chart 3A: Horticultural Exports



Source: Kenya Revenue Authority

in August 2016 declined by 4.1 percent. Cane deliveries improved during the period under review, increasing by 0.1 percent in the third quarter of 2016 compared to a decline of 16.2 percent in the previous quarter **(Table 3.2)**.

The Manufacturing Sector

Output in the manufacturing sector was subdued. The sector recorded growth of 1.9 percent, which was lower than 3.2 percent recorded in the previous quarter, and 3.3 percent growth in the third quarter of 2015. Growth in the sector reflected subdued production of soft drinks, beer and stout, cement and assembled vehicles **(Table 3.3)**.

Production of soft drinks was up slightly by 1.9 percent in July-August 2016 compared to the same period in 2015. This production was largely in August 2016, with growth at 9.9 percent.

Production of sugar improved to 4.1 percent growth in the third quarter of 2016 from a decline of 22.3 percent in the second quarter of 2016 but lower than 9.5 percent growth recorded in the third quarter of 2015. The slow growth was attributed to cane shortages and other structural challenges facing the sector.

Production of cement improved by 0.7 percent in the third quarter of 2016 compared to a 0.5 percent decline in the second quarter of 2016, but was lower than 7.4 percent growth recorded in the third quarter of 2015. The slowdown in cement production is largely attributed to decreasing demand from large infrastructure projects.

Production of assembled vehicles declined by 3.5 percent in the third quarter of 2016 compared 11.4 percent growth in the second quarter of 2016.

Table 3.3 Quarterly Production of Selected Manufactured Goods

	2015				2016*			
	Q1	Q2	Q3	Q4	Q1	Q2	Jul-16	Aug-16
Cement production								
Output (MT)	1,527,325	1,570,150	1,686,068	1,554,642	1,607,294	1,599,046	540,192	552,559
Growth %	*-4.0*	*2.8*	*7.4*	*-7.8*	*3.4*	*-0.5*	*5.6*	*2.3*
Assembled vehicles								
Output (No.)	2,472	2,385	2,717	2,607	1,600	1,782	491	605
Growth %	*12.5*	*-3.5*	*13.9*	*-4.0*	*-38.6*	*11.4*	*1.9*	*23.2*
Galvanized sheets								
Output (MT)	64,179	64,164	59,867	68,726	61,552	65,269	N/A	N/A
Growth %	*-9.7*	*0.0*	*-6.7*	*14.8*	*-10.4*	*6.0*		
Processed sugar								
Output (MT)	184,533	136,459	163,115	147,850	190,270	147,765	56,861	N/A
Growth %	*30.9*	*-26.1*	*19.5*	*-9.4*	*28.7*	*-22.3*	5.6	
Soft drinks								
Output ('000 litres)	135,691	115,265	118,164	125,990	118,829	110,980	35,769	39,316
Growth %	3.7	*-15.1*	2.5	6.6	*-5.7*	*-6.6*	*-7.8*	*9.9*

MT = Metric tonnes
* Provisional
N/A - Not Available

Source: Kenya National Bureau of Statistics

The Electricity and Water Supply Sector

Growth in the electricity and water supply sector decelerated but remained high at 7.0 percent compared to 10.8 percent in second quarter of 2016. The deceleration was attributed to reduced geothermal electricity generation.

Electricity generation increased by 3.0 percent in the third quarter of 2016 compared 0.5 percent growth in the previous quarter. The improvement was largely in hydro and thermal which fully offset a decline in geothermal. Generation of geothermal electricity declined for the third consecutive quarter in 2016, by 5.8 percent in the third quarter of 2016, while that of thermal electricity increased by 24.9 percent **(Table 3.4)**.

The Construction and Real Estate Sectors

The construction sector recorded growth of 9.3 percent in the third quarter of 2016 compared to 8.2 percent in the second quarter. The third quarter of 2016 growth was however significantly lower than the third quarter of 2015, where construction grew by 15.6 percent. The decline reflects reduced activity as the first phase in the construction of the Standard Gauge Railway (SGR) from Mombasa to Nairobi comes to completion. Growth in the sector has mainly been boosted by government investment in infrastructure such as roads and the SGR.

The real estate sector grew by 7.2 percent in the third quarter of 2016 compared to 8.7 percent in the previous quarter and 11.4 percent in the third quarter of 2015. The reduced growth is mirrored in the reduced growth of credit advanced to the sector, which decreased to 14.5 percent in the third quarter of 2016 from 20.4 percent in the previous quarter.

Table 3.4: Quarterly Performance in the Energy Sector

	2015				2016*					
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Jul-16	Aug-16	Sep-16
Electricity Supply (Generation)										
Output (million KWH)	2,235.4	2,297.3	2,403.3	2,379.7	2,421.2	2,433.3	2,506.6	839.6	846.3	820.7
Growth %	*-2.1*	*2.8*	*4.6*	*-1.0*	*1.7*	*0.5*	*3.0*	*4.5*	*0.8*	*-3.0*
Of which:										
Hydro-power Generation (million KWH)	753.8	862.6	930.2	916.9	953.8	985.9	1049.2	336.9	363.6	348.6
Growth (%)	*-13.2*	*14.4*	*7.8*	*-1.4*	*4.0*	*3.4*	*6.4*	*-3.2*	*7.9*	*-4.1*
Geo-Thermal Generation (million KWH)	1117.2	1101.7	1119.6	1182.2	1166.8	1139.9	1073.4	393.0	345.0	335.4
Growth (%)	*7.1*	*-1.4*	*1.6*	*5.6*	*-1.3*	*-2.3*	*-5.8*	*14.9*	*-12.2*	*-2.8*
Thermal (million KWH)	364.5	333.0	353.5	280.7	300.7	307.5	384.0	109.7	137.7	136.7
Growth (%)	*-2.0*	*-8.6*	*6.2*	*-20.6*	*7.1*	*2.3*	*24.9*	*-3.3*	*25.6*	*-0.8*
Consumption of electricity (million KWH)	1,942.6	2,225.4	2,077.3	2,031.5	2,095.6	2,194.6	2,112.3	703.7	728.7	679.9
Growth %	*-3.0*	*14.6*	*-6.7*	*-2.2*	*3.2*	*4.7*	*-3.7*	*-6.3*	*3.6*	*-6.7*
Consumption of Fuels ('000 tonnes)	1,110.2	1,111.1	1,111.9	1,106.2	1,241.4	1,294.8	N/A	572.5	608.8	N/A
Growth %	*21.2*	*0.1*	*0.1*	*-0.5*	*12.2*	*4.3*		*23.1*	*6.3*	
Murban crude oil average price (US $ per barrel)	53.0	63.3	51.1	42.7	33.7	46.1	45.3	44.6	45.8	45.6
Growth %	*-29.3*	*19.5*	*-19.4*	*-16.4*	*-21.0*	*36.8*	*-1.7*	*-9.1*	*2.6*	*-0.2*

N/A - Not Available

Source: Kenya National Bureau of Statistics

Table 3.5: Quarterly Tourist Arrivals by Point of Entry

	2015				2016					
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Jul-16	Aug-16	Sep-16
Total Tourist Arrivals	177,085	170,374	208,397	192,915	206,224	186,685	262,149	89,561	96,958	75,630
Growth (%)	*-46.4*	*-3.8*	*22.3*	*-7.4*	*6.9*	*-9.5*	*40.4*	*30.5*	*8.3*	*-22.0*
o.w. JKIA - Nairobi	152,138	160,564	190,009	170,078	178,283	175,056	236,119	81,729	87,141	67,249
Growth (%)	*-44.4*	*5.5*	*18.3*	*-10.5*	*4.8*	*-1.8*	*34.9*	*26.8*	*6.6*	*-22.8*
MIAM - Mombasa	24,947	9,810	18,388	22,837	27,941	11,629	26,030	7,832	9,817	8,381
Growth %	*-55.9*	*-60.7*	*87.4*	*24.2*	*22.3*	*-58.4*	*123.8*	*87.3*	*25.3*	*-14.6*

Source: Kenya Tourism Board

The Services Sector

Growth in the services sectors was generally subdued in the third quarter of 2016 compared to the previous quarter (Table 3.1A). The financial and insurance sector recorded slower growth at 6.1 percent compared to 7.5 percent growth in the second quarter and 10.3 percent in the third quarter of 2015.

The information and communication sector recorded stable growth at 8.5 percent in the third quarter of 2016 compared to 8.6 percent during the previous quarter **(Table 3.1A).** Furthermore its contribution to overall GDP growth remained stable at 0.3 percent **(Table 3.1C).**

Growth in the accommodation and restaurant sector sustained upward momentum, to record 13.8 percent in the third quarter of 2016. Though subdued compared to the second quarter growth of 15.3 percent, it was significantly higher than the 6.5 percent contraction recorded during the same quarter of 2015. The sector received a considerable boost as Kenya hosted high profile conferences while security was improved during the period under review.

Tourist Arrivals

Tourist arrivals increased significantly by 40.4 percent during the third quarter of 2016 compared to the previous quarter, mainly attributed to increased conference tourism. Kenya hosted the fourteenth session of the United Nations Conference on Trade and Development (UNCTAD) in July 2016, and the sixth Tokyo International Conference on African Development (TICAD) in August 2016. All major entry points recorded increased tourist arrivals, notably 34.9 percent at Jomo Kenyatta International Airport (JKIA), and 123.8 percent at Moi International Airport, Mombasa (MIAM) **(Table 3.5).**

Transport

Transport and storage sector recorded improved performance in the third quarter of 2016, with growth at 10.3 percent from 8.8 percent recorded in the previous quarter **(Table 3.1A)**. Growth in the sector is attributed to low diesel prices, which led to increased road transport for both passengers and freight. In addition, port throughput – that is the volume of goods passing through the various ports in the country – increased by 7.3 percent, mainly boosted by increased passage of imports through the port of Mombasa by 10.2 percent. However, the air transport subsector declined during the period under review.

Total passenger flows through the Jomo Kenyatta International Airport, Nairobi (JKIA) declined by 0.04 percent in the third quarter of 2016 compared with 0.3 percent fall in the second quarter, but remained fairly stable at 1.07 million passengers. The decline was recorded in both incoming and outgoing passengers. However, the volume of oil that passed through the Kenya pipeline increased by 4.2 percent in the third quarter of 2016, with most of the flow recorded in August 2016 **(Table 3.6).**

Table 3.6 : Quarterly Throughput of Selected Transport Companies

	2015				2016					
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Jul-16	Aug-16	Sep-16
Number of Passengers thro' JKIA										
Total passenger flows	1,092,550	1,083,521	1,082,120	1,082,533	1,082,784	1,079,762	1,079,331	360,168	359,558	359,605
Growth (%)	*0.4*	*-0.8*	*-0.1*	*0.0*	*0.0*	*-0.3*	*0.0*	*0.2*	*-0.2*	*0.0*
o.w. Incoming	543,870	542,619	539,865	540,315	541,061	538,720	538,519	179,758	179,551	179,210
Growth (%)	*0.5*	*-0.2*	*-0.5*	*0.1*	*0.1*	*-0.4*	*0.0*	*0.3*	*-0.1*	*-0.2*
Outgoing	548,680	540,902	542,255	542,218	541,723	541,042	540,812	180,410	180,007	180,395
Growth %	*0.3*	*-1.4*	*0.3*	*0.0*	*-0.1*	*-0.1*	*0.0*	*0.0*	*-0.2*	*0.2*
Kenya Pipeline Oil Throughput										
Output ('000 litres)	1,453,716	1,412,774	1,428,822	1,442,630	1,460,007	1,442,315	1,503,160	478,176	523,250	501,733
Growth %	*3.2*	*-2.8*	*1.1*	*1.0*	*1.2*	*-1.2*	*4.2*	*0.1*	*9.4*	*-4.1*

Source: Kenya National Bureau of Statistics and Kenya Pipeline Company Limited

Chapter 4

Global Economy, Balance of Payments And Exchange Rates

Overview

Growth in G7 countries year on year, improved to 1.5 percent in the third quarter of 2016 from 1.3 percent in the preceding quarter (OECD). With the exception of France and Germany where growth declined and remained unchanged, respectively the remaining G7 countries – United States, Japan, Italy, Canada and the United Kingdom – registered improvements of between 0.1 and 0.3 percentage points in the third quarter of 2016 compared with the previous quarter. Growth in the US was supported by consumer spending and improved manufacturing activity while the UK economy benefited from improved exports. Italy's economy continued to perform well on the backdrop of strong investment but concerns over the strength of the banking sector weigh down its outlook.

Meanwhile in emerging market and developing economies, the growth momentum remained modest. This is largely due to the expected slowdown of the Chinese economy to 6.6 percent in 2016 from 6.9 percent in 2015 as the growth drivers' transition from investment and exports to consumption and services. China' economy grew by 6.7 percent in the first, second and third quarters of 2016. The recession in Brazil eased from 3.6 percent in the second quarter to 2.9 percent in the third quarter of 2016. The outlook for emerging and developing economies has improved on the basis of better prospects for Russia and Brazil.

Recent developments supporting favorable growth performance in these countries include the recovery in commodity prices which will benefit commodity exporters.

Balance of Payments Developments

Kenya's overall balance of payments position improved from USD 496 million deficit during the second quarter of 2016 to USD 56 million surplus during the third quarter of 2016 (**Table 4.1**). The improvement is attributed to a decline in the current account deficit.

The current account balance improved to a deficit of USD 1,097 million during the third quarter of 2016 from a deficit of USD 1,165 million during the preceding quarter. The improvement is attributed to increased receipts from services which wholly offset the worsening of the merchandise account.

Table 4.1: Balance of Payments (USD Million)[1]

	2015*		2016**						Q3 2016-Q2 2016	
					Q3			Q3		%
ITEM	Q3	Q4	Q1	Q2	Jul	Aug	Sep	2016*	Change	Change
1. Overall Balance	**503.8**	**-858.7**	**-258.5**	**-495.5**	**99.3**	**21.2**	**-64.0**	**56.4**	**552.0**	**-111.4**
2. Current account n.i.e	**-911.7**	**-1,080.6**	**-376.2**	**-1,164.7**	**-361.1**	**-422.3**	**-313.7**	**-1,097.2**	**67.5**	**-5.8**
Exports (fob)	1,617.8	1,503.1	1,531.2	1,446.5	479.1	469.1	461.3	1,409.5	-37.0	-2.6
Imports (fob)	3,836.1	3,911.4	3,045.2	3,519.3	1,121.8	1,255.4	1,185.8	3,563.0	43.7	1.2
Services: credit	1,099.5	1,101.2	1,042.5	923.5	352.5	331.2	388.9	1,072.7	149.1	16.1
Services: debit	523.3	543.0	708.2	677.9	237.1	254.1	245.6	736.9	59.0	8.7
Balance on goods and services	-1,642.2	-1,850.2	-1,179.7	-1,827.2	-527.4	-709.1	-581.2	-1,817.7	9.5	-0.5
Primary income: credit	78.3	78.9	90.2	87.8	32.3	29.2	29.5	90.9	3.1	3.6
Primary income: debit	197.1	219.9	134.8	199.3	105.5	38.7	19.1	163.4	-36.0	-18.0
Balance on goods, services, and primary income	-1,761.0	-1,991.2	-1,224.2	-1,938.7	-600.7	-718.6	-570.9	-1,890.2	48.6	-2.5
Secondary income, n. i. e.: credit	863.9	925.0	868.0	782.0	242.7	299.3	259.6	801.5	19.5	2.5
Of which: Remittances	392.5	401.9	415.6	436.9	134.7	146.7	143.2	424.6	-12.4	-2.8
Secondary income: debit	14.5	14.4	20.0	8.0	3.1	3.0	2.4	8.6	0.6	7.5
3. Capital Account, n.i.e.	**59.3**	**60.3**	**129.6**	**34.7**	**0.0**	**0.3**	**11.8**	**12.1**	**-22.7**	**-65.2**
4. Financial Account, n.i.e.	**-892.1**	**-1,774.2**	**-1,745.8**	**-1,331.2**	**-567.2**	**-340.9**	**-687.4**	**-1,595.4**	**-264.3**	**19.9**

** Revised*
***Provisional*
n.i.e - not included elsewhere
fob - free on board

[1]/Based on the Balance of Payments and International Investment Position Manual, 6th Edition. Revised Estimates

Source: Central Bank of Kenya

The balance on the goods account worsened by 3.9 percent during the third quarter of 2016 driven by lower receipts from merchandise exports – tea and horticulture – as well as a rise in payments for merchandise imports, in particular oil and manufactured goods (**Table 4.2**). The decline in the value of tea exports is attributed to lower tea production as a result of unfavorable weather conditions in tea growing zones, while the decline in the value of horticulture exports in the third quarter reflected typically lower demand during this season, especially for cut flowers. The value of oil imports increased mainly as a result of the recent rebound in international oil prices. According to the IMF commodity outlook, oil futures markets show prices modestly increasing over the next year. Increased payments for imports of manufactured goods were due to higher import quantities of iron and steel in the third quarter of 2016 compared with the preceding quarter.

Receipts from services increased by 36.7 percent attributed to improvement in travel services from holiday as well as conference tourism, the latter reflecting Kenya's hosting of key international events. The lifting of travel advisories by key Western markets, Kenya Government initiatives which include substantial investment in security, aggressive marketing and charter incentive programs that began in January 2016, have had a positive impact on tourism.

Receipts from the secondary income – mostly other transfers – improved by 2.5 percent. Remittance inflows – under personal transfers in the secondary income account – decreased by 2.8 percent during the third quarter of 2016.

Table 4.2: Balance On Current Account (USD Million)

ITEM	2015* Q3	2015* Q4	2016** Q1	2016** Q2	2016** Q3 Jul	2016** Q3 Aug	2016** Q3 Sep	Q3 2016*	Q3 2016-Q2 2016 Change	Q3 2016-Q2 2016 % Change
2. CURRENT ACCOUNT	**-911.7**	**-1,080.6**	**-376.2**	**-1,164.7**	**-361.1**	**-422.3**	**-313.7**	**-1,097.2**	**67.5**	**-5.8**
2.1 Goods	**-2,218.4**	**-2,408.3**	**-1,514.0**	**-2,072.8**	**-642.7**	**-786.2**	**-724.6**	**-2,153.5**	**-80.7**	**3.9**
Exports (fob) of which:	**1,617.8**	**1,503.1**	**1,531.2**	**1,446.5**	**479.1**	**469.1**	**461.3**	**1,409.5**	**-37.0**	**-2.6**
Coffee	52.5	42.9	49.6	70.3	18.0	16.3	14.0	48.2	-22.1	-31.5
Tea	301.2	385.1	324.8	324.5	105.4	98.5	83.5	287.4	-37.1	-11.4
Horticulture	232.5	172.0	224.6	205.4	61.8	65.2	67.4	194.4	-11.0	-5.4
Oil products	22.1	11.0	7.4	14.5	3.7	5.3	7.5	16.4	1.9	13.4
Manufactured Goods	147.1	116.6	106.2	106.4	35.0	39.8	36.8	111.6	5.3	4.9
Imports (fob) of which	**3,836.1**	**3,911.4**	**3,045.2**	**3,519.3**	**1,121.8**	**1,255.4**	**1,185.8**	**3,563.0**	**43.7**	**1.2**
Oil	617.2	597.9	402.3	541.9	176.9	187.3	190.3	554.5	12.5	2.3
Chemicals	565.3	545.6	544.1	581.4	172.3	195.9	199.1	567.3	-14.1	-2.4
Manufactured Goods	682.6	624.3	567.8	644.9	233.5	248.1	213.9	695.5	50.5	7.8
Machinery & Transport Equipment	1,330.2	1,518.0	956.0	1,168.1	335.6	436.9	361.0	1,133.5	-34.6	-3.0
2.2 Services	**576.2**	**558.1**	**334.4**	**245.6**	**115.3**	**77.1**	**143.3**	**335.8**	**90.2**	**36.7**
Transport Services (net)	**155.0**	**190.0**	**183.0**	**76.9**	**17.2**	**1.9**	**57.8**	**76.9**	**0.1**	**0.1**
Credit	416.6	447.2	402.8	308.0	88.6	89.3	134.1	312.0	4.0	1.3
Debit	261.6	257.1	219.9	231.1	71.4	87.4	76.3	235.1	4.0	1.7
Travel Services (net)	**127.4**	**105.1**	**129.7**	**149.8**	**72.6**	**85.8**	**96.8**	**255.3**	**105.5**	**70.4**
Credit	180.0	176.4	183.8	183.3	85.2	98.5	106.3	290.1	106.8	58.3
Debit	52.6	71.3	54.1	33.5	12.6	12.7	9.5	34.8	1.3	3.9
Other Services (net)	**293.8**	**262.9**	**21.7**	**18.9**	**25.5**	**-10.6**	**-11.3**	**3.6**	**-15.3**	**-81.0**

** Revised*

***Provisional*

fob - free on board

Source: Central Bank of Kenya

Direction of Trade

China was the largest source of imports to Kenya during the third quarter of the year, with the share of imports during the review period increasing to 27.3 percent from 23.9 percent in the second quarter of 2016. The share of Kenya's imports from the European Union decreased to 13.9 percent from 15.9 percent, while that from India decreased to 11.1 percent from 16.1 percent. Imports from Africa accounted for 10 percent in the third quarter of 2016 compared with 9.4 percent in the second quarter (**Table 4.3A**).

Kenya's exports to Africa decreased by 2.8 percent in the third quarter of 2016 (**Table 4.3B**). The decline was largely in exports to the EAC (Tanzania and South Sudan) and the Republic of Sudan. In addition, exports to the rest of the world decreased by 2.4 percent in the quarter under review. The share of exports to China decreased to 1 percent during the third quarter of 2016 from 1.7 percent in the previous quarter, while that to the European Union increased to 24.1 percent from 20.8 percent over the same period.

Table 4.3A: Kenya's Direction of Trade Imports

IMPORTS (in millions of US dollars)									Share of Imports (%)	
	2015		2016						2016	
Country	**Q3**	**Q4**	**Q1**	**Q2**	**Jul**	**Aug**	**Sep**	**Q3**	**Q2**	**Q3**
Africa	**377**	**358**	**296**	**330**	**101**	**112**	**144**	**357**	**9.4**	**10.0**
Of which										
South Africa	164	152	97	128	46	42	49	137	**3.6**	**3.8**
Egypt	62	67	65	64	23	22	33	78	**1.8**	**2.2**
Others	151	139	134	139	33	48	62	142	**3.9**	**4.0**
EAC	**98**	**85**	**68**	**72**	**23**	**27**	**32**	**82**	**2.0**	**2.3**
COMESA	**151**	**173**	**149**	**151**	**41**	**51**	**70**	**163**	**4.3**	**4.6**
Rest of the World	**3,459**	**3,553**	**2,750**	**3,189**	**1,020**	**1,143**	**1,042**	**3,206**	**90.6**	**90.0**
Of which										
India	553	649	560	567	105	156	135	395	**16.1**	**11.1**
United Arab Emirates	286	232	142	237	114	97	102	313	**6.7**	**8.8**
China	929	735	640	841	290	388	294	971	**23.9**	**27.3**
Japan	235	227	201	195	77	81	67	224	**5.6**	**6.3**
USA	129	597	108	143	49	38	36	122	**4.1**	**3.4**
United Kingdom	134	88	72	91	26	30	24	80	**2.6**	**2.2**
Singapore	26	33	7	24	7	13	3	22	**0.7**	**0.6**
Germany	127	92	113	118	38	29	30	97	**3.4**	**2.7**
Saudi Arabia	111	106	128	167	61	50	52	163	**4.7**	**4.6**
Indonesia	125	97	115	102	41	35	45	121	**2.9**	**3.4**
Netherlands	65	45	38	37	11	23	9	43	**1.0**	**1.2**
France	58	58	54	52	20	19	19	58	**1.5**	**1.6**
Bahrain	30	21	11	2	8	5	11	24	**0.0**	**0.7**
Italy	63	51	48	59	19	18	23	59	**1.7**	**1.7**
Others	588	521	511	554	155	163	193	511	**15.7**	**14.4**
Total	**3,836**	**3,911**	**3,045**	**3,519**	**1,122**	**1,255**	**1,186**	**3,563**	**100.0**	**100.0**
EU	627	509	502	561	154	172	169	495	**15.9**	**13.9**
China	929	735	640	841	290	388	294	971	**23.9**	**27.3**

Source: Kenya Revenue Authority

Table 4.3B: Kenya's Direction Of Trade Exports

EXPORTS (in millions of US dollars)									Share of Exports (%)	
	2015		2016						2016	
Country	**Q3**	**Q4**	**Q1**	**Q2**	**Jul**	**Aug**	**Sep**	**Q3**	**Q2**	**Q3**
Africa	**676**	**593**	**613**	**582**	**192**	**189**	**185**	**566**	**40.3**	**40.2**
Of which										
Uganda	236	144	153	151	61	49	47	157	**10.4**	**11.1**
Tanzania	80	95	105	87	21	23	26	70	**6.0**	**5.0**
Egypt	51	58	53	58	21	18	18	57	**4.0**	**4.0**
Sudan	15	15	16	12	3	5	3	11	**0.9**	**0.8**
South Sudan	**33**	**36**	**55**	**41**	**6**	**9**	**10**	**25**	**2.9**	**1.8**
Somalia	**36**	**49**	**39**	**40**	**13**	**15**	**16**	**45**	**2.8**	**3.2**
DRC	**50**	**53**	**46**	**49**	**15**	**20**	**19**	**53**	**3.4**	**3.8**
Rwanda	*58*	*40*	*41*	*44*	14	17	14	45	**3.0**	**3.2**
Others	118	103	106	100	37	34	32	104	**6.9**	**7.4**
EAC	395	292	319	297	104	95	93	292	**20.5**	**20.7**
COMESA	492	370	379	382	142	135	125	402	**26.4**	**28.6**
Rest of the World	942	910	918	864	288	280	276	843	**59.7**	**59.8**
Of which										
United Kingdom	111	103	107	92	34	29	34	98	**6.3**	**7.0**
Netherlands	116	93	137	104	50	29	50	128	**7.2**	**9.1**
USA	122	101	89	100	31	38	31	99	**6.9**	**7.0**
Pakistan	81	131	73	105	23	32	23	78	**7.2**	**5.5**
United Arab Emirates	89	68	82	80	26	27	26	78	**5.5**	**5.5**
Germany	25	27	27	35	13	9	13	35	**2.4**	**2.5**
India	29	20	43	23	14	11	14	40	**1.6**	**2.8**
Afghanistan	39	40	52	35	11	4	11	27	**2.4**	**1.9**
Others	330	327	309	291	85	101	74	261	**20.1**	**18.5**
Total	**1,618**	**1,503**	**1,531**	**1,447**	**479**	**469**	**461**	**1,410**	**100.0**	**100.0**
EU	344	298	349	300	126	87	126	340	**20.8**	**24.1**
China	19	19	17	24	3	11	3	17	**1.7**	**1.2**

Source: Kenya Revenue Authority

Capital and Financial Account

Inflows to the capital account declined by 65.2 percent during the third quarter of 2016 reflecting a decline in project revenue from grants.

The balance on the financial account increased to USD 1,595 million during the third quarter of 2016 from USD 1,331 million in the preceding quarter. This improvement is attributable to an increase in the net incurrence of liabilities under 'other investments' reflecting foreign financing for the Government's infrastructure program (**Table 4.4**).

Table 4.4: Balance on Capital and Financial Account (USD Million)

	2015*		2016**						Q3 2016-Q2 2016	
						Q3		Q3		%
ITEM	**Q3**	**Q4**	**Q1**	**Q2**	**Jul**	**Aug**	**Sep**	**2016***	**Change**	**Change**
3. Capital Account, n.i.e.	**59**	**60**	**130**	**35**	**0**	**0**	**12**	**12**	**-23**	**-65.2**
Capital account, n.i.e.: credit	59	60	**130**	**35**	0	0	12	**12**	-23	-65.2
Capital account: debit	0	0	**0**	**0**	0	0	0	**0**	0	0.0
4. Financial Account, n.i.e.	**-892**	**-1,774**	**-1,746**	**-1,331**	**-567**	**-341**	**-687**	**-1,595**	**-264**	**19.9**
Direct investment: assets	100	100	54	62	20	22	28	70	**9**	**14.0**
Direct investment: liabilities, n.i.e.	363	368	244	72	35	16	11	62	-10	-13.5
Portfolio investment: assets	9	26	9	6	7	2	97	107	100	1,570.8
Portfolio investment: liabilities, n.i.e.	8	16	181	132	89	107	114	310	178	135.2
Financial derivatives: net	0	0	0	0	0	0	0	0	**0**	**0.0**
Other investment: assets	-54	84	-235	248	-9	0	197	187	-60	-24.3
Other investment: liabilities, n.i.e.	577	1,599	1,149	1,443	461	241	886	1,588	144	10.0

** Revised*

***Provisional*

n.i.e - not included elsewhere

Source: Central Bank of Kenya

Foreign Exchange Reserves

The banking system's total foreign exchange holdings increased by 1 percent during the third quarter of 2016. Official reserves held by the CBK constituted 77 percent of gross reserves and decreased to USD 8,200 million, equivalent to 5.6 months of import cover. Foreign exchange reserves held by commercial banks increased by 7.6 percent to USD 2,402 million during the review period (**Table 4.5**). Meanwhile, the Precautionary Arrangements with the IMF amounting to USD 1,500 million continued to provide additional buffer against short term external and domestic shocks.

Exchange Rates

The foreign exchange market has remained stable supported by a narrowing current account deficit and resilient inflows from diaspora remittances.

The Kenya Shilling appreciated against the Pound Sterling and the Euro but depreciated against the US Dollar and the Japanese Yen during the third quarter of 2016. The weakening of the Shilling against the US Dollar is largely attributed to developments on the international markets – appreciation of the US Dollar against most major currencies anchored on positive US economic data during the review period.

In the EAC region, the Kenya shilling strengthened against the Uganda Shilling as well as the Rwanda and Burundi Francs but weakened against the Tanzania Shilling (**Table 4.6 and Chart 4A).**

Table 4.5: Foreign Exchange Reserves and Residents' Foreign Currency Deposits (End of Period, USD Million)

	2015				2016					
	Q1	Q2	Q3	Q4	Q1	Q2	Jul 16	Aug 16	Sep 16	Q3
1. Gross Reserves	**9,834**	**9,473**	**8,899**	**9,794**	**9,809**	**10,499**	**10,381**	**10,354**	**10,602**	**10,602**
of which:										
Official	7,723	7,212	6,711	7,534	7,807	8,267	8,165	8,144	8,200	8,200
*import cover**	*4.8*	*4.5*	*4.2*	*4.8*	*5.0*	*5.5*	*5.5*	*5.5*	*5.6*	*5.6*
Commercial Banks	2,111	2,262	2,188	2,259	2,002	2,232	2,217	2,210	2,402	2,402
2. Residents' foreign currency deposits	**4,154**	**4,488**	**4,278**	**4,389**	**4,191**	**4,443**	**4,455**	**4,630**	**4,723**	**4,723**

**Based on 36 month average of imports of goods and non-factor services*

Source: Central Bank of Kenya

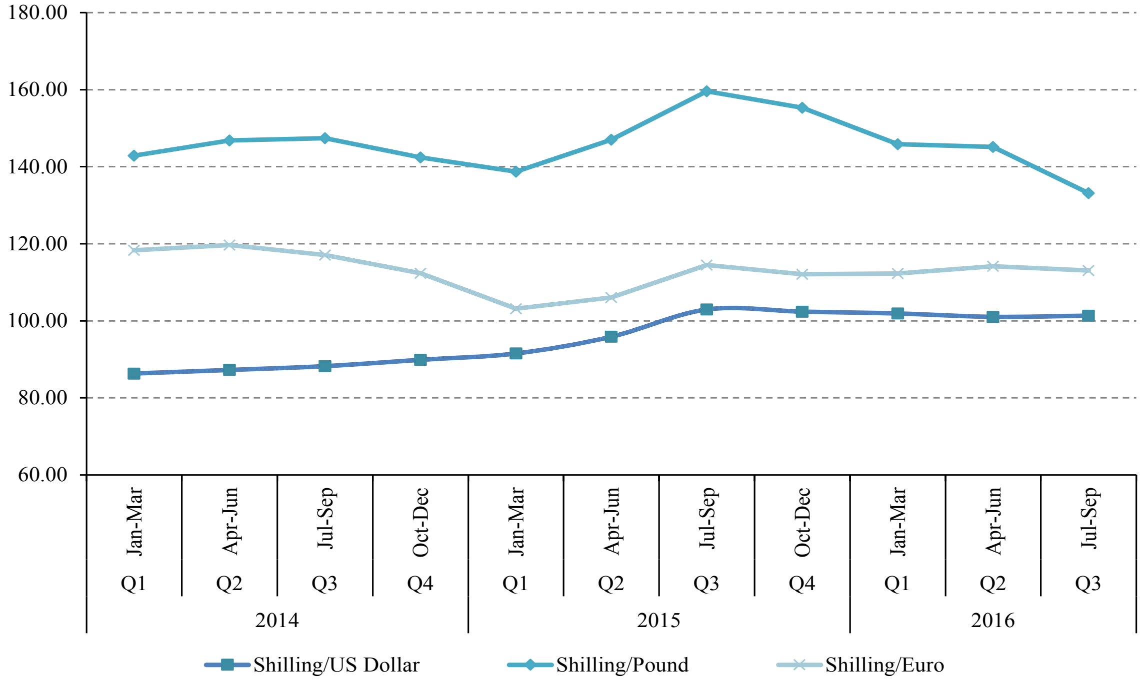
Table 4.6: Kenya Shilling Exchange Rate

	2015				2016						
	Q1	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Jul**	**Aug**	**Sep**	**Q3**	**% change**
											Q3 2016 - Q2 2016
US Dollar	91.53	95.87	102.95	102.38	101.90	101.04	101.33	101.41	101.27	101.34	0.30
Pound Sterling	138.70	147.04	159.58	155.33	145.85	145.12	133.42	132.89	133.15	133.15	-8.25
Euro	103.15	106.05	114.52	112.10	112.26	114.16	112.10	113.66	113.48	113.08	-0.95
100 Japanese Yen	76.84	79.02	84.27	84.32	88.35	93.58	97.24	100.24	99.33	98.94	5.73
Uganda Shilling*	31.62	31.97	34.21	33.95	33.51	33.18	33.34	33.25	33.39	33.33	0.46
Tanzania Shilling*	19.80	21.27	20.73	21.13	21.44	21.69	21.61	21.57	21.56	21.58	-0.50
Rwanda Franc*	7.54	7.30	7.06	7.24	7.38	7.55	7.46	7.58	7.64	7.56	0.20
Burundi Franc*	17.10	16.33	15.25	15.16	15.27	15.61	16.45	16.47	16.49	16.47	5.51

** Units of currency per Kenya Shilling*

Source: Central Bank of Kenya

Chart 4A: **Kenya Shilling Exchange Rate**



Source: Central Bank of Kenya

Chapter 5

The Banking Sector

Structure

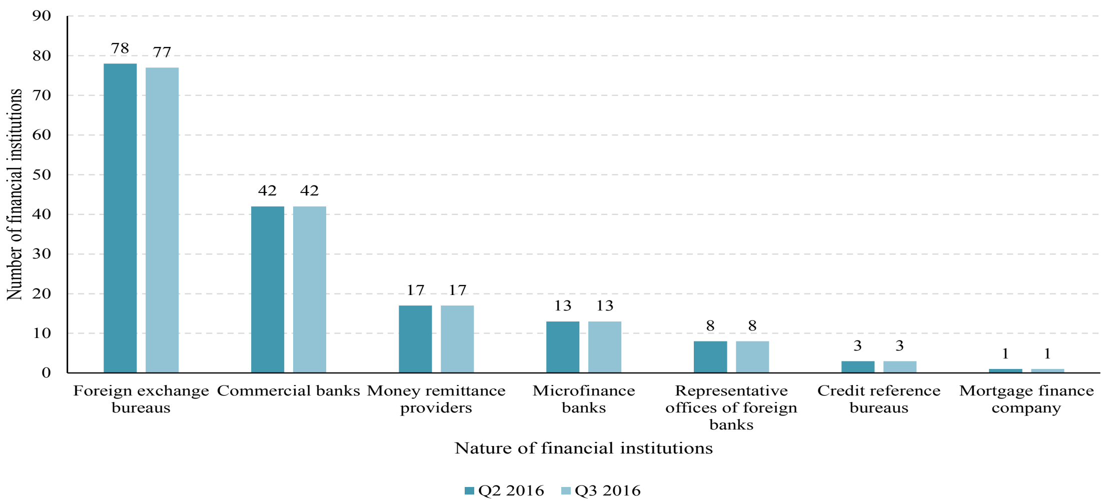
The Kenyan banking sector comprised 42 commercial banks, 1 mortgage finance company, 13 microfinance banks, 8 representative offices of foreign banks, 77 foreign exchange bureaus, 17 money remittance providers and 3 credit reference bureaus as at September 30, 2016 (**Chart 5A**). The number of foreign exchange bureaus declined to 77 during the third quarter of 2016, following voluntary wind up of Net Forex Bureau Ltd. on July 31, 2016.

Balance Sheet

i) Assets.

Total net assets grew by 3.0 percent, from KSh 3,677.9 billion in the second quarter of 2016 to KSh 3,789.6 billion in the third quarter of 2016. This growth reflects largely 19 percent increase in placements. Loans and advances remained the main component of the bank's assets,

Chart 5A: **Structure of Kenyan Banking Sector**



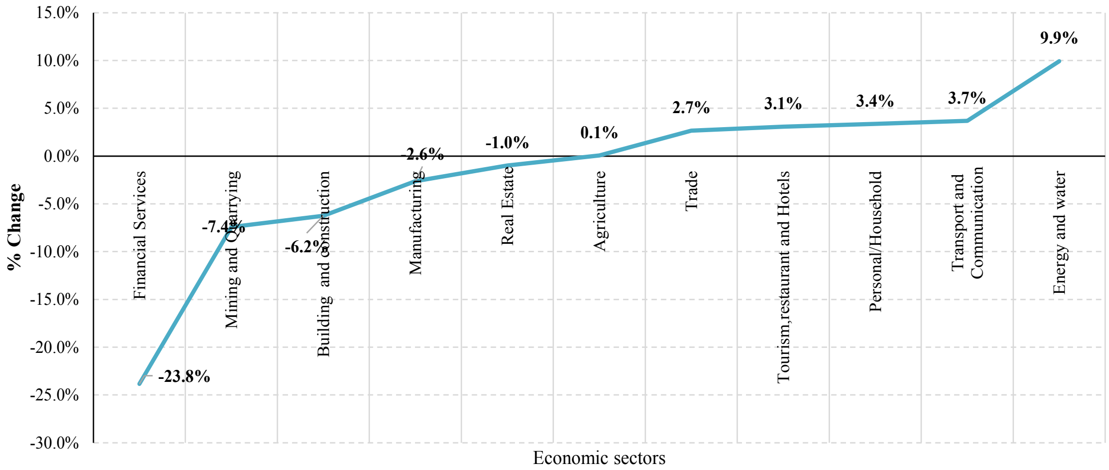
Source: Central Bank of Kenya

accounting for 57.1 percent in the third quarter of 2016, which was a slight decrease from 58.7 percent in the second quarter of 2016.

ii) Loans and Advances

Total banking sector lending increased by 0.2 percent from KSh 2,267.3 billion in the second quarter of 2016 to KSh 2,271.5 billion in the third quarter of 2016. Six out of the eleven economic sectors, registered increase in gross loans (**Chart 5B**);

Chart 5B: **Change in Sectoral Gross Loans Between Q1, 2016 & Q2, 2016**



Source: Central Bank of Kenya

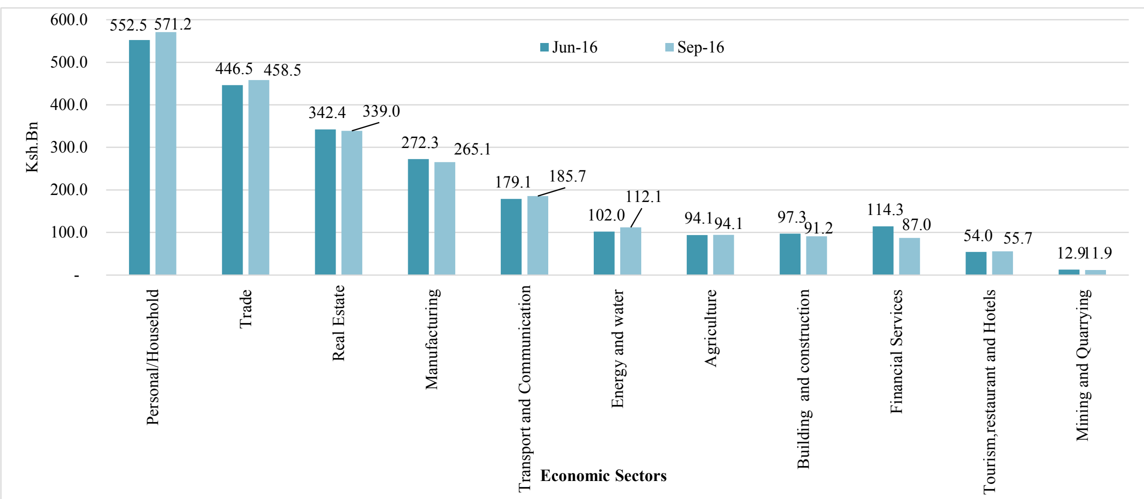
The Energy and Water sector recorded the largest increase in credit, at KSh10.1 billion or 9.9 percent largely to facilitate increased distribution of electricity. Transport and Communication Sector recorded an increase of 3.7 percent or KSh6.6 billion in credit growth, largely reflecting increased loans to communication companies to enhance and expand services. The Financial Services sector recorded the largest loan repayment, by 23.8 percent.

The sectoral distribution of gross loans as at September 30, 2016 is highlighted (**Chart 5C**). In terms of credit outstanding, five sectors namely; personal/ household, trade, real estate, manufacturing and transport and communications were the main recipients of the credit.

iii) Deposit Liabilities

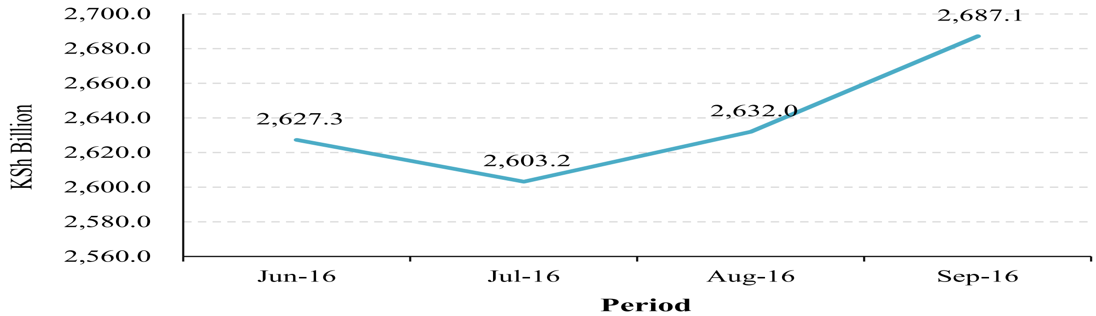
Customer deposits are the main source of funding to the banks and accounted for 71.0 percent of the banking sectors entire funding as at the end of the third quarter of 2016. This was little changed from 71.4 percent share recorded in the second quarter of 2016. Customer deposits grew by 2.3 percent, from KSh 2,627.3 billion in the second quarter of 2016 to KSh 2,687.1 billion in the third quarter(**Chart 5D**) on account of.

Chart 5C: **Kenyan Banking Sector Gross Loans (KSh Billion)**



Source: Central Bank of Kenya

Chart 5D **Customer Deposits (Ksh Billion)**



Source: Central Bank of Kenya

- **Use of technological innovations for deposit mobilization** - The number of commercial banks deposit accounts increased by 1.9 million or 5.0 percent, from 38.2 million in second quarter of 2016 to 40.1 million in third quarter6. This was mainly driven by deposit accounts opened through the mobile phone platforms.
- **Agency banking model** - The number of transactions through agents increased by 0.8 percent or 195,153 transactions to 23.8 million in the third quarter of 2016 compared with 23.6 million in the previous quarter.

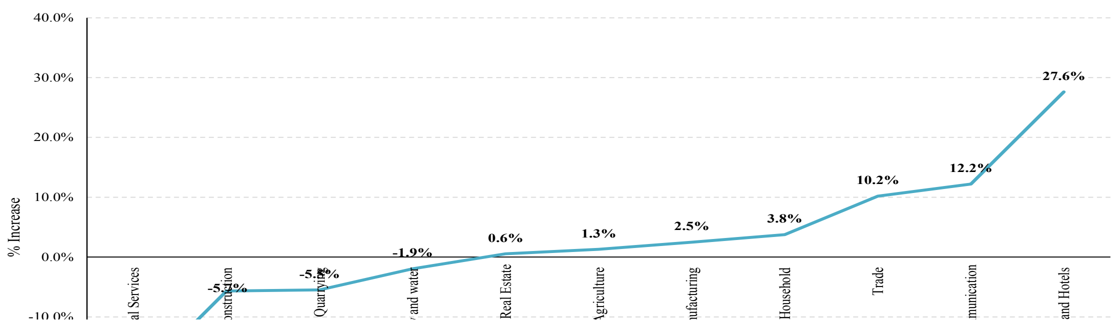
Capital Adequacy for the Sector

The Kenyan banking sector raised capital levels to sustain resilience to adverse shocks. The core capital and total capital increased by 2.2 percent and 2.3 percent, respectively in the third quarter of 2016. The risk-weighted assets increased by 1.8 percent. Meanwhile, the total capital and core capital to total risk weighted assets ratios increased from 18.9 percent and 16.3 percent in the second quarter of 2016 to 19.0 percent and 18.4 percent, respectively in the third quarter, 2016. These levels represent considerable buffer above the prudential ratios of 14.5 percent and 10.5 percent for total capital and core capital, respectively. Furthermore, the ratio of core capital to total deposits eased marginally to18.4 percent from 18.5 percent in the second quarter of 2016, but remained significantly above the statutory 8 percent minimum.

Asset Quality

Gross non-performing loans (NPLs) increased by 4.2 percent, from KSh 191.2 billion as at end of the second quarter of 2016 to KSh 199.2 billion at end of third quarter. Seven out of the eleven economic sectors recorded higher in NPLs in third quarter of 2016 (**Chart 5E**).

Chart 5E: **Sectoral Increase in Gross NPLS**



Source: Central Bank of Kenya

Tourism, Restaurant and Hotels sector recorded the highest percentage increase in NPLs at 27.6 percent (but marginal in volume terms at KSh 0.8 billion). This is mainly attributable to lower than anticipated business volumes. Transport and Communication sector registered 12.2 percent or KSh 1.5 billion growth due to low business volumes which affected loan repayments. Trade sector recorded KSh 5.8 billion or 10.2 percent growth in NPLs, again due to low business volumes and delayed payments, which led to business cash flow challenges and constraints.

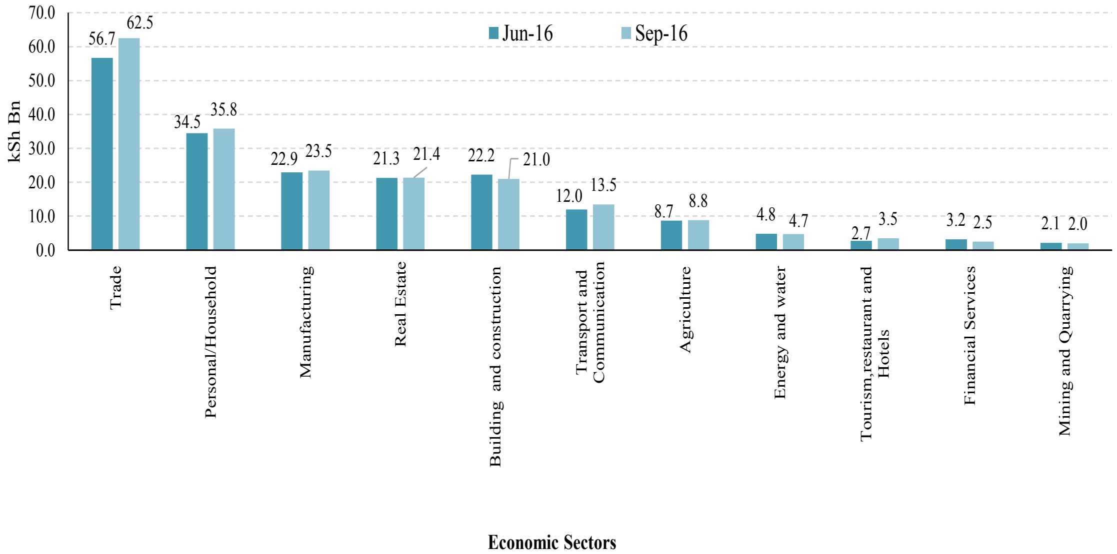
Financial Services sector registered the highest percentage decrease in NPLs of 21.2 percent (but marginal in volume terms at KSh 0.7 billion) due to repayments and write-offs. Building and Construction sector recorded KSh 1.3 billion or 5.7 percent reduction that is attributed to payments to contractors in the building and construction projects by Government after the end of financial year 2015/2016.

Based on the movements of NPLs highlighted above, the gross NPLs to gross loans ratio increased from 8.4 percent in the second quarter of 2016 to 8.8 percent in the third quarter. **Chart 5F** below highlights the detailed sectoral distribution of gross NPLs between the two periods under review.

The banking sector's asset quality, measured by the proportion of net non-performing loans to gross loans, deteriorated from 4.41 percent in the second quarter of 2016 to 4.70 percent in third quarter. Similarly, the coverage ratio, which is measured as a percentage of specific provisions to total NPLs decreased from 35.7 percent in second quarter of 2016 to 35.3 percent in the third quarter due to a higher growth of NPLs relative to the increase in specific provisions.

A summary of asset quality for the banking sector over the period is shown in **Table 5.1**.

Chart 5F: Kenyan Banking Sector Gross Non-Perfoming Loans (KSh Billion)



Source: Central Bank of Kenya

Table 5.1: **Summary of Asset Quality**

		June-16, KSh Billion	Sept-16, KSh Billion
1	Gross Loans and Advances (KSh'Bn)	2,267.25	2,271.47
2	Interest in Suspense (KSh'Bn)	35.72	34.11
3	Loans and advances (net of interest suspended) (KSh'Bn)	2,231.53	2,237.36
4	Gross non-performing loans (KSh'Bn)	191.24	199.18
5	Specific Provisions (KSh'Bn)	55.59	58.30
6	General Provisions (KSh'Bn)	18.00	19.02
7	Total Provisions (5+6) (KSh'Bn)	73.58	77.32
8	Net Advances (3-7) (KSh'Bn)	2,157.95	2,160.04
9	Total Non-Performing Loans and Advances (4-2) (KSh'Bn)	155.52	165.07
10	Net Non-Performing Loans and Advances (9-5) (KSh'Bn)	99.93	106.77
11	Total NPLs as percent of Total Advances (9/3)	6.97%	7.38%
12	Net NPLs as percent of Gross Advances (10/1)	4.41%	4.70%
13	Specific Provisions as percent of Total NPLs (5/9)	35.74%	35.32%

Source: Central Bank of Kenya

Profitability

The banking sector pre-tax profits declined by 6.6 percent, from KSh 42.8 billion in the second quarter of 2016 to KSh 40.0 billion in the third quarter of 2016. The reduction is attributable to a higher decrease in income compared to the decrease in expenses in the period under review. Total income decreased by 2.5 percent from KSh 129.7 billion in the second quarter, 2016 to KSh 126.5 billion in the third quarter, while total expenses decreased by 0.3 percent from KSh 86.9 billion in the second quarter of 2016 to KSh 86.7 billion in the third quarter,

The fall in income is mainly attributed to decrease in interest on loans (by 2.7 percent or KSh2.1 billion). The decrease in expenses largely reflect the 5.6 percent drop in interest on deposits.

Interest on loans and advances, other incomes and interest on government securities were the major sources of income, accounting for 60.9 percent, 15.2 percent and 17.7 percent of total income, respectively. On the other hand, interest on deposits, salaries and wages, and other expenses were the key components of expenses, accounting for 33.9 percent, 23.9 percent and 21.5 percent of total expenses, respectively.

The return on assets decreased from 4.2 percent in the second quarter of 2016 to 3.3 percent in the third quarter, while return on shareholders' funds decreased from 33.8 percent in the second quarter of 2016 to 27.0 percent in the third quarter of 2016. These decreases were as a result of reduced profitability as total assets and shareholders' funds increased over the period.

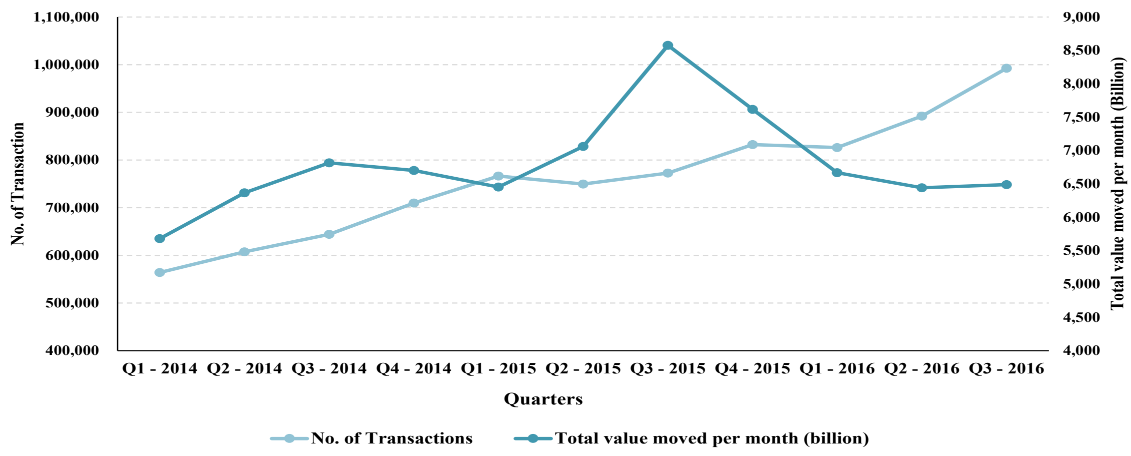
Liquidity

The banking sector's overall liquidity ratio in the third quarter of 2016 was 42.9 percent compared to 40.4 percent recorded in the second quarter of 2016. The banking sector liquidity ratio was above the minimum statutory level of 20 percent.

KENYA ELECTRONIC PAYMENTS AND SETTLEMENT SYSTEM

The Kenya Electronic Payments and Settlement System (KEPSS) is a systemically important payment system used for large value Real Time Gross Settlement (RTGS) payments. It moved a volume of 992,668 transaction messages worth KSh 6.5 trillion in the third quarter of 2016, compared to 892,067 transactions worth KSh 6.4 trillion in the previous quarter. This represented increase of 11.3 percent and 1.6 percent in volume and value, respectively.

Chart5G: Trends in Monthly Flows Through KEPSS



Source: Central Bank of Kenya

Bank Customer Payments Processed Through KEPSS

Commercial banks submit payment instructions in real time vide multiple third party Message Type (MT 102), used for several credit transfers, and single third party Message Type (MT 103) used for single credit transfers.

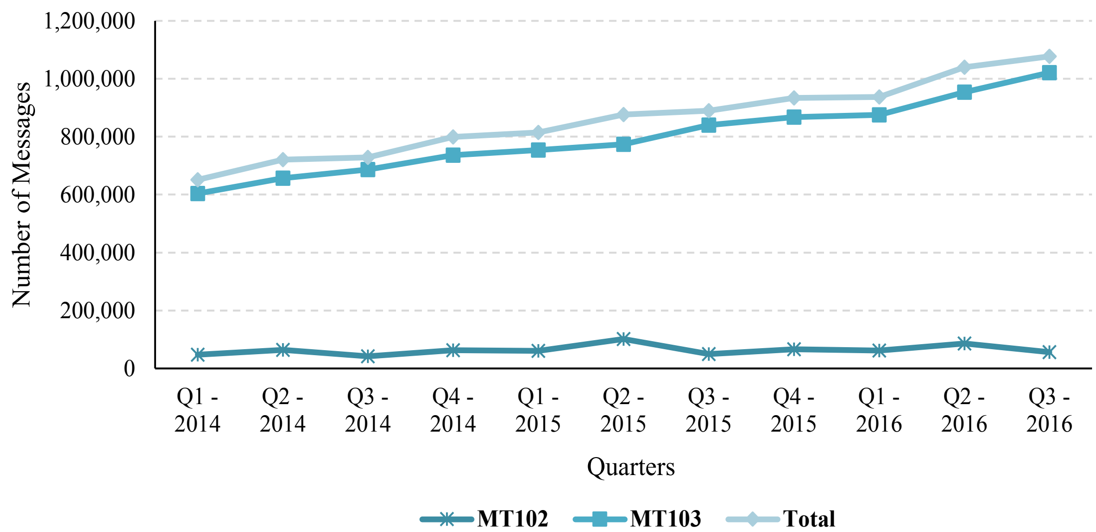
MT 102 usage decreased from 85,650 messages processed in the second quarter of 2016 to 55,812 messages recorded in the third quarter of 2016. However, MT 103 payments increased from 953,810 messages to 1,020,792 messages in third quarter of 2016. This reflects a significant decrease of 34.8 for MT102's and an increase of 7.0 for MT103's (**Chart 5H**).

KEPSS System Availability

To ensure availability of Real Time Gross Settlement services to the public through the commercial banks and other participants, the system operates from 8.30 AM to 4.30 PM in two 'windows'. The system windows enable participants to transmit customer payment requests, settle their obligations and fund their accounts.

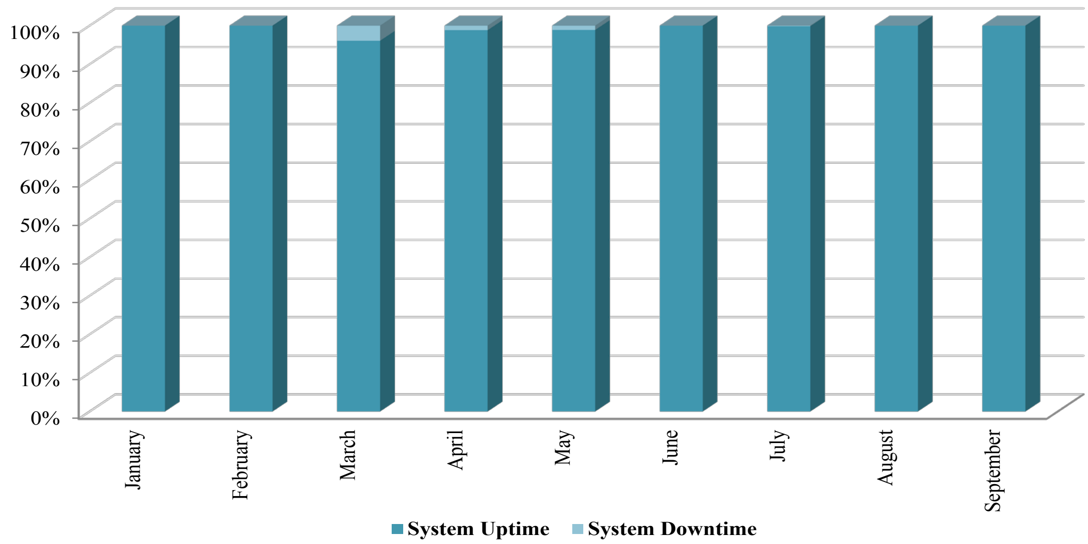
KEPSS availability increased to on an average of 99.95 percent in the third quarter of 2016 compared to 99.23 percent in the previous quarter (**Chart 5I**).

Chart 5H: Trends in MT102 and MT103 Volumes Processed Through KEPSS



Source: Central Bank of Kenya

Chart 5I: **KEPSS Availability January to September 2016**



Source: Central Bank of Kenya

Chapter 6

Government Budget Operations

Overview

The government's budgetary operations resulted in a deficit of 1.8 percent of GDP in the first quarter of the FY 2016/17, compared with a surplus of 0.5 percent of GDP in the first quarter of the FY 2015/16. As is typical of the beginning of the financial year, there was low absorption levels in expenditures as compared to the previous quarter (Q4) (end of the 2015/16 FY), during which government expenditure was more pronounced, indicative of a rush to expedite on outstanding programs and purchases **(Table 6.1)**.

Revenue

Total Government receipts (that is, tax revenue and grants) was KSh 317.6 billion in the first quarter of FY 2016/17 equivalent to 5.1 percent of GDP. Tax revenue alone stood at KSh 280.9 billion (4.5 percent of GDP) and was KSh 11.8 billion below target. The shortfall in the first quarter of 2016/17 reflected in PAYE, Import Duty and VAT on imports collection. Tax revenue in the first quarter of 2016/17 was slightly higher than the KSh 256.6 billion collected in a similar period of the previous fiscal year.

External grants in the quarter under review stood at KSh 1.4 billion, which was KSh 15.1 billion below target due to low absorption of donor funds.

Ministerial Appropriations in Aid (A-in-A) collected in the first quarter was KSh 17.2 billion. This represented a shortfall of KSh 12.5 billion largely on account of under reporting in the ministry expenditure returns. Ministerial A-in-A collections was also lower than target in the fourth quarter of 2015/16 for the same reason.

In the first quarter of 2016/17, the government had collected revenues including grants of KSh 317.6 billion on a cumulative basis against a target of KSh 344.6 billion. As a proportion of GDP, revenue and grants collected through the first quarter amounted to 5.1 percent compared with 5.2 percent of GDP in a similar quarter of FY 2015/16.

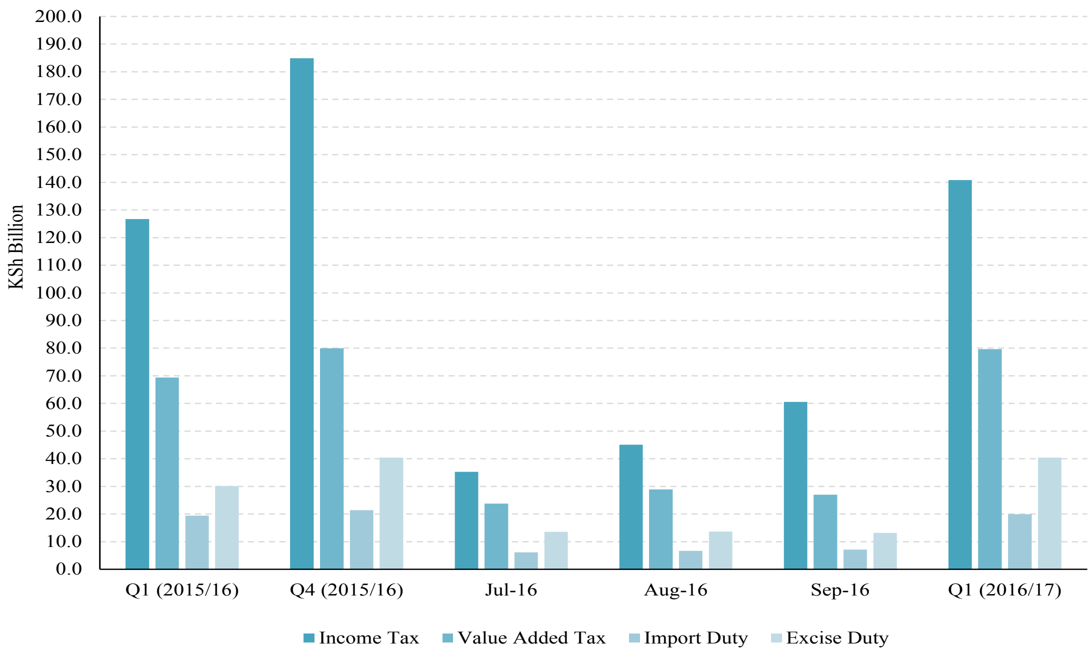
Table 6.1: Statement of Government Operations in FY 2015/16 (Ksh Billion)

	(FY 2015/16)					(FY 2016/17)				Cumulative to Sept 2016	Target	Over (+) / Below (-) Target
	Q1	April	May	June	Q4	July	Aug	Sept	Q1			
1. TOTAL REVENUE & GRANTS	**282.5**	**122.5**	**112.0**	**138.7**	**373.2**	**88.7**	**108.1**	**120.8**	**317.6**	**317.6**	**344.6**	**(27.0)**
Ordinary Revenue	**277.0**	**116.4**	**106.8**	**132.9**	**356.1**	**84.3**	**100.1**	**114.5**	**298.9**	**298.9**	**328.0**	**(29.1)**
Tax Revenue	256.6	109.4	100.3	117.0	326.7	78.7	94.3	107.9	280.9	280.9	292.7	(11.8)
Non Tax Revenue	4.4	7.0	6.4	16.0	29.4	5.5	5.8	6.6	18.0	18.0	5.5	12.5
Appropriations-in-Aid	16.0	4.5	4.8	4.2	13.6	4.4	8.0	4.9	17.2	17.2	29.7	(12.5)
External Grants	5.5	1.6	0.4	1.5	3.5	-	0.0	1.4	1.4	1.4	16.6	(15.1)
2. TOTAL EXPENSES & NET LENDING	**254.2**	**184.3**	**153.1**	**320.8**	**658.1**	**62.1**	**156.6**	**212.2**	**430.9**	**430.9**	**524.9**	**(92.7)**
Recurrent Expenses	181.6	128.7	126.6	160.5	415.8	60.5	122.5	110.8	293.8	293.8	299.1	(5.3)
Development Expenses	41.2	40.6	26.0	113.3	179.9	1.6	4.6	75.6	81.8	81.8	150.7	(68.9)
County Transfers	31.4	15.0	0.5	46.9	62.4	-	29.5	25.9	55.3	55.3	73.9	(18.5)
Others	-	-	-	-	-	-	-	-	-	-	1.3	-
3. DEFICIT ON A COMMITMENT BASIS (1-2)	**28.3**	**(61.8)**	**(41.1)**	**(182.1)**	**(285.0)**	**26.6**	**(48.5)**	**(91.5)**	**(113.3)**	**(113.3)**	**(180.3)**	**(293.7)**
As percent of GDP	0.5	(1.0)	(0.7)	(2.9)	(4.6)	0.4	(0.8)	(1.5)	(1.8)	(1.8)	(2.9)	(4.7)
4. ADJUSTMENT TO CASH BASIS	-	-	-	-	-	-	-	-	-	-	-	-
5. DEFICIT ON A CASH BASIS	**28.3**	**(61.8)**	**(41.1)**	**(182.1)**	**(285.0)**	**26.6**	**(48.5)**	**(91.5)**	**(113.3)**	**(113.3)**	**(180.3)**	**(293.7)**
As percent of GDP	0.5	(1.0)	(0.7)	(2.9)	(4.6)	0.4	(0.8)	(1.5)	(1.8)	(1.8)	(2.9)	(4.7)
6. DISCREPANCY: Expenditure (+) / Revenue (-)	**40.7**	**(40.5)**	**10.1**	**(41.5)**	**(71.9)**	-	-	-	-	-	-	-
7. FINANCING	**12.5**	**6.3**	**50.7**	**93.7**	**150.7**	**2.2**	**40.1**	**43.7**	**86.0**	**86.0**	**180.3**	**(94.4)**
Domestic (Net)	2.8	2.8	48.3	18.6	69.7	(3.8)	41.0	12.5	49.7	49.7	94.6	(45.0)
External (Net)	9.3	3.5	2.4	75.1	80.9	6.0	(0.9)	31.2	36.3	36.3	85.2	(48.9)
Capital Receipts (domestic loan receipts)	0.3	(18.6)	-	0.4	(18.2)	-	-	0.2	0.2	0.2	0.5	(0.3)
Others(Euro Bond sale proceeds)	-	-	-	-	-	-	-	-	-	-	-	-

NB: using the new re-based GDP figures as per 2016 economic survey

Sources: Provisional Budget Outrun from the National Treasury

Chart 6A: Composition of Government Revenue (Ksh Billion)



Source: Provisional Budget Outrun from the National Treasury

Excise tax, VAT on local goods and other income tax performed above their targets **(Chart 6A)**. As observed in previous years, the collection of revenues is usually slow at the start of the fiscal year. The outlook for revenue collection remains optimistic especially with implementation of various legal and administrative measures to seal tax leakages.

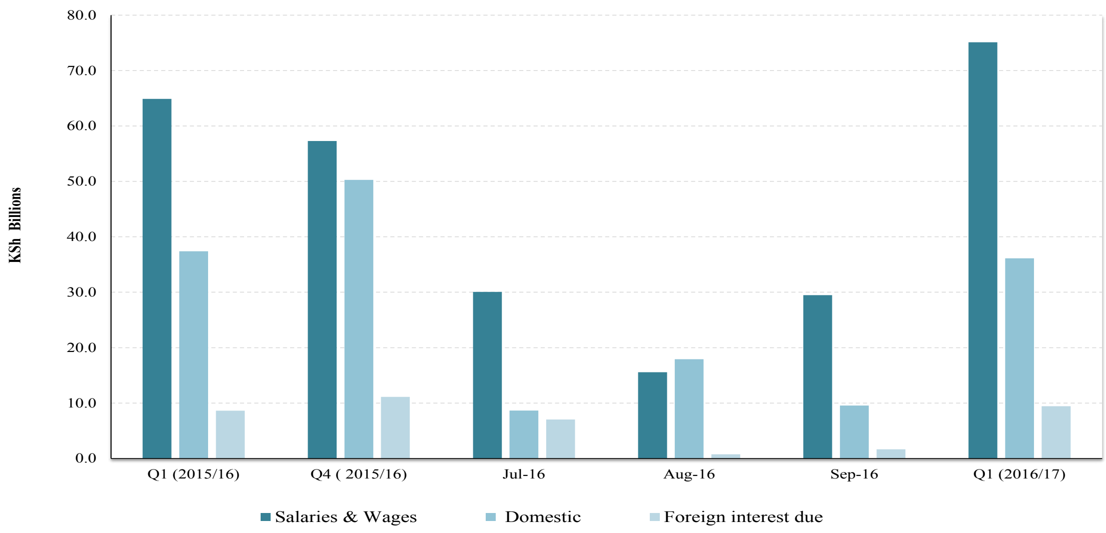
Expenditure and Net Lending

Government expenditure and net lending in the first quarter of the FY 2016/17 stood at KSh 430.9 billion (6.9 percent of GDP) against a target of KSh 523.6 billion (8.4 percent of GDP). The shortfall of KSh 92.7 billion can be attributed to lower absorption recorded in both recurrent and development expenditures by the National and County governments. Expenditures in the first quarter under review, at KSh 430.9 billion, were KSh 176.7 billion higher than the outlay in a similar quarter in the FY2015/16.

In terms of broad categories of expenditure, recurrent expenditure registered a shortfall of KSh 5.3 billion against target, which was largely in the votes: wages and salaries as well as operations and maintenance activities. Domestic interest payments for the first quarter of the FY 2016/17 amounted to KSh 36.1 billion compared to KSh 37.4 billion in the first quarter of the FY 2015/16. Foreign interest payments were KSh 9.4 billion, which was lower than KSh 8.6 billion paid in the first quarter of the FY 2015/16 **(Chart 6B)**. Development expenditure registered a shortfall of KSh 68.9 billion against target. The development expenditures performed below the target on account of non-inclusion of district expenditures and some donor funded projects.

With respect to composition, the share of recurrent expenditure in total government spending was 68.2 percent in the first quarter and that of development expenditure at 19.0 percent. Development expenditures were largely channeled into infrastructure and energy and petroleum ministries. County transfers accounted for 12.8 percent of government spending **(Table 6.1)**.

Chart 6B: Composition of Recurrent Expenses



Sources: Provisional Budget Outrun from the National Treasury

Financing

External financing in the first quarter was KSh 36.3 billion against a target of KSh 85.2 billion. Net domestic borrowing amounted to KSh 49.4 billion over the review period. The borrowing comprised KSh 37.3 billion from commercial banks and KSh 37.5 billion from Non-banking financial institutions, KSh 24.5 billion accumulation of deposits at the CBK and KSh 873 million reduction in debt security holdings by Non-Residents **(Table 6.2)**. In a similar quarter in the previous FY, net domestic borrowing amounted to KSh 2.8 billion.. It comprised KSh 1 billion credit from Non-Residents and a borrowing of KSh 67 billion from the CBK. A repayment of KSh 36 billion was made from commercial banks and KSh 29 billion by Non-banks financial institutions.

Domestic financing in the first quarter performed well compared to a similar quarter in FY 2015/16 when borrowing was constrained. The performance of the government's domestic borrowing programme is consistent with thresholds set in the Medium Term Debt Management Strategy.

Table 6.2 Domestic Financing Ending Sept 30, 2016

	FY 2015/16				FY 2016/17		
	Q1	Q2	Q3	Q4			Q1
NET CREDIT TO GOVERNMENT 2015/2016 (Ksh Million)	**Sep-15**	**Dec-15**	**Mar-16**	**Jun-16**	**Jul-16**	**Aug-16**	**Sep-16**
1. From CBK	**67.48**	**-22,452.04**	**-34,917.22**	**-111,107.35**	**-29,301.60**	**3,769.55**	**-24,582.44**
2.From commercial banks	**-35.91**	**27,925.46**	**88,402.30**	**187,152.42**	**6,250.52**	**3,116.78**	**37,357.00**
4.From Non-banks	**-29.47**	**37,673.42**	**73,247.83**	**139,440.27**	**19,914.47**	**30,354.49**	**37,528.95**
5. From Non-Residents	**0.74**	**1,820.16**	**1,105.93**	**4,575.91**	**-706.22**	**-998.64**	**-872.92**
Change in Credit from banks (From 30th June 2015)*	31,572.85	5,473.42	53,485.08	76,045.07	-23,051.07	6,886.32	12,774.56
Change in Credit from non-banks(From 30th June 2015)*	-29,467.40	37,673.42	73,247.83	139,440.27	19,914.47	30,354.49	37,528.95
Change in Credit from non-residents(From 30th June 2015)*	743.26	1,820.16	1,105.93	4,575.91	-706.22	-998.64	-872.92
6.Total Change in Dom. Credit (From 30th June 2015)	**2,848.72**	**44,967.00**	**127,838.85**	**220,061.24**	**-3,842.82**	**36,242.18**	**49,430.59**

NB. Treasury Bills are reflected at Cost

** the changes in credit for each quarter, reflect the changes within the Fiscal Year 2016/2017*

Source: Central Bank of Kenya

Table 6.3: **Budget Estimates for the Fiscal Year 2016/17 (Ksh Billion)**

	Ksh (Billion)	%age of GDP
1. TOTAL REVENUE (Including Grants)	**1,573.3**	**21.3**
Ordinary Revenue	1,376.4	18.6
Appropriations-in-Aid	124.2	1.7
External Grants	72.7	1.0
2. TOTAL EXPENSES & NET LENDING	**2,264.5**	**30.6**
Recurrent Expenses	1,164.9	15.8
Development Expenses	817.0	11.1
County Transfer	280.3	3.8
3. DEFICIT ON A COMMITMENT BASIS (1-2)	**-691.2**	**-9.4**
4. ADJUSTMENT TO CASH BASIS	**0.0**	**0.0**
5. DEFICIT ON A CASH BASIS	**-691.20**	**-9.4**
6. DISCREPANCY: Expenditure (+) / Revenue (-)	**0.0**	**0.0**
7. FINANCING	**691.50**	**9.4**
Domestic (Net)	229.2	3.1
External (Net)	462.3	6.3

Source: National Treasury Budget Summary for 2016/17

Outlook for FY 2016/17

In the budget estimates for the FY 2016/17, total revenue is estimated at KSh 1,500.6 billion (21.3 percent of GDP) while external grants are estimated at KSh 72.7 billion (1.0 percent of GDP). Government expenditure is estimated at KSh 2,265 billion (30.6 percent of GDP), of which KSh 1,164.9 billion (15.8 percent of GDP) will be in recurrent expenses, KSh 280.3 billion in transfer to the county governments, and KSh 817 billion in development expenses **(Table 6.3)**.

The overall budget deficit including grants on commitment basis is therefore estimated at KSh 691.5 billion (9.4 percent of GDP) in 2016/17. The deficit is expected to be financed through net external borrowing of KSh 462.3 billion and net domestic borrowing of KSh 229.2 billion.

Chapter 7
Public Debt

Overview

Kenya's public and publicly guaranteed debt increased by 2.4 percent in first quarter of the FY 2016/17 with external debt accounting for much of the increase. As percentage of GDP, total debt stock at the end of the quarter under review was 53.8 percent, a 130 basis points increase compared with the previous quarter. Domestic and external debt to GDP ratios increased by 50 basis points and 60 basis points, respectively, during the first quarter of the FY 2016/17 **(Table 7.1)**.

Domestic Debt

Total domestic debt increased by 2.2 percent during the first quarter of the FY 2016/17, a slower build up as compared to the 10.2 percent growth observed in the previous quarter. The increase in Treasury Bills (5.1 percent) and bonds (4.3 percent) holdings was partly offset by 82 percent repayment of the overdraft facility at the Central Bank. However, the absolute build up in holdings of Treasury bonds was faster than that of Treasury bills as investors' appetite shifted towards the relatively longer dated securities following a more normalized debt securities yield curve. Consequently the increase in the share of Treasury Bonds to total domestic debt was larger than that of Treasury Bills. The share of domestic debt to total debt decreased from 50.2 percent at the end of the last quarter of the FY 2015/16 to 50.1 percent by the end of the first quarter of the FY 2016/17 reflecting maturities of government securities during this quarter **(Table 7.2)**.

Table 7.1: Kenya's Public And Publicly Guaranteed Debt (Ksh Billion)

	FY 2015/16				2016/17			
	Q1	Q2	Q3	Q4	Jul-16	Aug-16	Q1	Change Q on Q
EXTERNAL**								
Bilateral	477.5	481.3	522.4	539.1	551.6	557.2	555.0	15.8
Multilateral	759.3	751.2	766.6	812.3	793.9	793.9	840.4	28.2
Commercial Banks	295.6	366.2	360.2	442.6	443.7	443.6	443.2	0.6
Supplier Credits	17.8	16.5	16.4	9.2	8.5	8.5	10.4	1.2
Sub-Total	**1,550.2**	**1,615.2**	**1,665.6**	**1,803.2**	**1,797.7**	**1,803.3**	**1,849.0**	**45.8**
(As a % of GDP)	22.5	23.4	24.2	26.2	26.1	26.2	26.8	
(As a % of total debt)	52.8	51.2	50.3	49.8	49.8	49.8	49.9	
DOMESTIC								
Banks	**790.3**	**865.8**	**932.3**	**1,027.2**	**1,001.6**	**998.4**	**1,028.7**	**1.6**
Central Bank	107.6	101.4	102.6	99.9	69.6	68.9	58.9	-40.9
Commercial Banks	682.7	764.4	829.7	927.3	932.0	929.5	969.8	42.5
Non-banks	**586.1**	**661.7**	**702.2**	**774.9**	**795.4**	**805.6**	**813.8**	**38.9**
Pension Funds	345.4	389.0	417.0	468.9	484.3	486.3	493.8	24.9
Insurance Companies	121.1	129.1	133.0	134.4	137.9	134.1	136.4	2.0
Other Non-bank Sources	119.6	143.6	152.2	171.6	173.3	185.2	183.6	12.0
Non-residents	**11.5**	**12.6**	**12.0**	**13.0**	**12.3**	**11.9**	**12.0**	**-1.0**
Sub-Total	**1,388.0**	**1,540.0**	**1,646.5**	**1,815.1**	**1,809.3**	**1,816.0**	**1,854.6**	**39.4**
(As a % of GDP)	20.1	22.4	23.9	26.4	26.3	26.4	26.9	
(As a % of total debt)	47.2	48.8	49.7	50.2	50.2	50.2	50.1	
GRAND TOTAL	**2,938.2**	**3,155.2**	**3,312.1**	**3,618.3**	**3,607.0**	**3,619.2**	**3,703.6**	**85.2**
(As a % of GDP)	42.7	45.8	48.1	52.5	52.4	52.5	53.8	

Ratios computed using Treasury GDP estimate from the Budget Review Outlook Paper (BROP)
** External debt is inclusive of guaranteed debt

Sources: National Treasury and Central Bank of Kenya

Table 7.2: Government Gross Domestic Debt (Ksh Billion)

	Q3	%	Q4	%	Jul-16	%	Aug-16	%	Q1	%	Change: Q on Q
Total Stock of Domestic Debt (A+B)	**1,646.5**	**100.0**	**1,815.1**	**100.0**	**1,809.3**	**100.0**	**1,816.0**	**100.0**	**1,854.6**	**100.0**	**39.4**
A. Government Securities	**1,568.3**	**95.2**	**1,740.1**	**95.9**	**1,763.9**	**97.5**	**1,771.2**	**97.5**	**1,820.0**	**98.1**	**79.9**
1. Treasury Bills (excluding Repo Bills)	**472.9**	**28.7**	**588.1**	**32.4**	**577.8**	**31.9**	**581.0**	**32.0**	**618.2**	**33.3**	**30.2**
Banking institutions	316.0	19.2	361.9	19.9	352.2	19.5	348.2	19.2	384.2	20.7	22.3
The Central Bank	20.6	1.3	20.6	1.1	20.6	1.1	20.6	1.1	20.6	1.1	0.0
Commercial Banks	295.4	17.9	341.3	18.8	331.6	18.3	327.6	18.0	363.6	19.6	22.3
Pension Funds	85.6	5.2	117.9	6.5	118.9	6.6	119.6	6.6	120.3	6.5	2.3
Insurance Companies	18.1	1.1	18.4	1.0	18.6	1.0	15.0	0.8	16.3	0.9	-2.0
Others	53.2	3.2	89.9	5.0	88.0	4.9	98.3	5.4	97.5	5.3	7.5
2. Treasury Bonds	**1,095.4**	**66.5**	**1,152.0**	**63.5**	**1,186.1**	**65.6**	**1,190.2**	**65.5**	**1,201.8**	**64.8**	**49.7**
Banking institutions	537.2	32.6	569.9	31.4	585.5	32.4	587.1	32.3	591.6	31.9	21.7
The Central Bank	9.4	0.6	9.4	0.5	9.4	0.5	9.4	0.5	9.4	0.5	0.0
Commercial Banks	527.8	32.1	560.5	30.9	576.1	31.8	577.6	31.8	582.1	31.4	21.7
Insurance Companies	114.9	7.0	116.0	6.4	119.2	6.6	119.1	6.6	120.1	6.5	4.0
Pension Funds	331.4	20.1	351.0	19.3	365.3	20.2	366.7	20.2	373.5	20.1	22.6
Others	111.9	6.8	115.1	6.3	116.0	6.4	117.4	6.5	116.6	6.3	1.5
3. Long Term Stocks		**0.0**		**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Banking institutions		0.0		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Others		0.0		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
4. Frozen account	**26.1**	**1.6**	**25.6**	**1.4**	**25.6**	**1.4**	**25.6**	**1.4**	**25.6**	**1.4**	**0.0**
Of which: Repo T/Bills	25.5	1.5	25.0	1.4	25.0	1.4	25.0	1.4	25.0	1.3	0.0
B. Others:	**52.1**	**3.2**	**49.4**	**2.7**	**19.9**	**1.1**	**19.2**	**1.1**	**9.0**	**0.5**	**-40.5**
Of which CBK overdraft to Government	46.5	2.8	44.2	2.4	14.0	0.8	13.3	0.7	3.3	0.2	-40.9

Source: Central Bank of Kenya

Treasury Bills

Treasury bill holdings, excluding those held by the CBK for open market operations (Repos) increased by 5.1 percent during the first quarter of the FY 2016/17. Correspondingly, the proportion of Treasury bills to total domestic debt increased by 90 basis points during the period under review. However the buildup in the stock of Treasury Bills was lower than previous quarter (24.4 percent) reflective of a shift in investors' preferences to longer dated securities. The dominant investors of Treasury Bills were commercial banks (with a share of 58.8 percent) and pension funds (with a share of 19.5 percent) by the end of the first quarter of the FY 2016/17. The persistent dominance of commercial banks in the government debt securities' market characterizes moderate underdevelopment of other institutional investors' sectors (pension funds, foreign investors and insurance companies).

Treasury Bonds

With further stabilization of interest rates, and the subsequent normalization of the Treasury Bonds' yield curve, investors' preferences shifted towards longer dated securities. Consequently, Treasury bonds holdings increased by 4.3 percent during the first quarter of the FY 2016/17, largely reflecting proceeds from the issuance of a 15-year infrastructure Treasury bond and a 5-year fixed rate Treasury bond. The dominant holders of Treasury bonds were commercial banks, pension funds and insurance companies. Commercial banks holdings accounted for about half of the total Treasury Bonds outstanding. Similar to Treasury bills, this dominance of commercial banks in the debt securities market reflects the underdevelopment of institutional investor sectors that include insurance, pension funds and foreign investors **(Table 7.3)**.

TABLE 7.3: OUTSTANDING DOMESTIC DEBT BY TENOR (Ksh billion)

		Q3	%	Q4	%	Jul-16	%	Aug-16	%	Q1	%	Change Q on Q
Treasury bills	91-Day	62.8	3.8	81.8	4.5	66.7	3.7	59.5	3.3	59.9	3.2	-21.9
	182-Day	163.6	9.9	191.8	10.6	184.6	10.2	180.9	10.0	185.0	10.0	-6.9
	364-Day	246.5	15.0	314.5	17.3	326.5	18.0	340.7	18.8	373.4	20.1	58.9
Treasury Bond	1-Year	44.7	2.7	34.5	1.9	34.5	1.9	34.5	1.9	10.2	0.6	-24.3
	2-Year	132.0	8.0	122.1	6.7	122.1	6.7	122.1	6.7	122.1	6.6	0.0
	3-Year	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	4-Year	2.3	0.1	2.3	0.1	2.3	0.1	2.3	0.1	2.3	0.1	0.0
	5-Year	196.4	11.9	215.9	11.9	240.3	13.3	240.3	13.2	263.4	14.2	47.4
	6-Year	31.5	1.9	22.7	1.2	22.7	1.3	8.5	0.5	8.5	0.5	-14.2
	7-Year	8.7	0.5	8.7	0.5	8.7	0.5	8.7	0.5	8.7	0.5	0.0
	8-Year	29.4	1.8	38.2	2.1	38.2	2.1	38.2	2.1	38.2	2.1	0.0
	9-Year	40.2	2.4	76.5	4.2	76.5	4.2	76.5	4.2	76.5	4.1	0.0
	10-Year	183.6	11.2	188.5	10.4	188.5	10.4	206.8	11.4	206.8	11.2	18.3
	11-Year	4.0	0.2	4.0	0.2	4.0	0.2	4.0	0.2	4.0	0.2	0.0
	12-Year	132.1	8.0	132.1	7.3	132.1	7.3	132.1	7.3	132.1	7.1	0.0
	15-Year	168.2	10.2	183.8	10.1	183.8	10.2	183.8	10.1	183.8	9.9	0.0
	20-Year	74.3	4.5	74.3	4.1	84.0	4.6	84.0	4.6	96.8	5.2	22.4
	25-Year	20.2	1.2	20.2	1.1	20.2	1.1	20.2	1.1	20.2	1.1	0.0
	30-Year	28.1	1.7	28.1	1.6	28.1	1.6	28.1	1.5	28.1	1.5	0.0
	Repo T bills	25.5	1.5	25.0	1.4	25.0	1.4	25.0	1.4	25.0	1.3	0.0
	Overdraft	46.5	2.8	44.2	2.4	14.0	0.8	13.3	0.7	3.3	0.2	-40.9
	Other Domestic debt	5.9	0.4	5.8	0.3	6.5	0.4	6.5	0.4	6.3	0.3	0.4
Total Debt		**1,646.5**	**100.0**	**1,815.1**	**100.0**	**1,809.3**	**100.0**	**1,816.0**	**100.0**	**1,854.6**	**100.0**	**39.4**

Source: Central Bank of Kenya

Domestic Debt by Tenor and the Maturity Structure

Government issued both short and medium term dated securities during the period under review. Accordingly, the current debt securities portfolio is dominated by short and medium term domestic debt. The benchmark Treasury Bonds; 2-year, 5-year, 10-year, 15-year and 20-year Treasury Bonds accounted for 72.6 percent of the total of outstanding Treasury Bonds by the end of the first quarter of the FY 2016/17. Other domestic debt consists of uncleared effects, advances from commercial banks and Tax Reserve Certificates.

The average length to maturity of existing domestic debt increased to 4 years and 5 months in the first quarter of the FY 2016/17 from 4 years and 3 months reported in the last quarter of the FY 2015/16. The increase reflects in the proportion of longer-dated debt securities in the domestic debt portfolio during the review period. As a result, the refinancing risk decreased marginally to 32 percent from 32.4 percent in June 2016.

External Debt

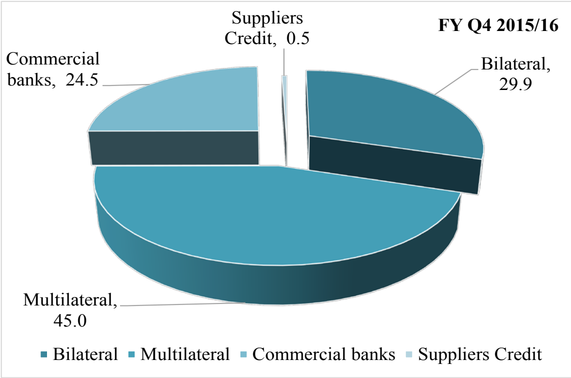
Public and publicly guaranteed external debt increased by 2.5 percent during the first quarter of the FY 2016/17, a slower build up than in the previous quarter (8.3 percent) mainly on account of an offsetting repayment to the International Development Association (IDA). External debt accumulation during the first quarter reflects disbursement of USD 485 million from African Development Bank.

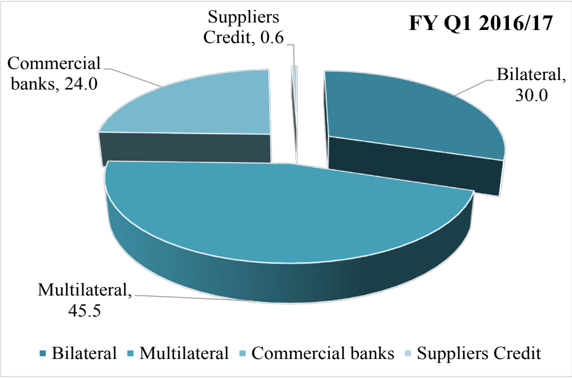
Composition of External Debt by Creditor

Kenya continues to record lower levels of concessional debt and build-up of commercial and semi-concessional borrowing since her elevation to lower middle income economy status in September 2014. However, the first quarter recorded improved concessionality since the share of outstanding debt from official multilateral and bilateral lenders (who provide both concessional and semi-concessional loans) increased by 60 basis points from the 74.9 percent in the last quarter of the FY 2015/16 to 75.5 percent by the end of review period . Consequently, the share of commercial debt decreased by 50 basis points during the review period **(Chart 7A)**.

Debt owed to the International Development Association (IDA), Kenya's largest multilateral lender, amounted to USD 4.8 billion or 26.5 percent of total external debt while that owed to China, Kenya's largest bilateral lender, amounted to USD 3.1 billion, or 16.9 percent of the total external debt in the first quarter of the FY 2016/17 **(Chart 7B)**. The main sources of the buildup of external debt were, African Development Bank (ADB), the United Kingdom government and the International Development Association (IDA).

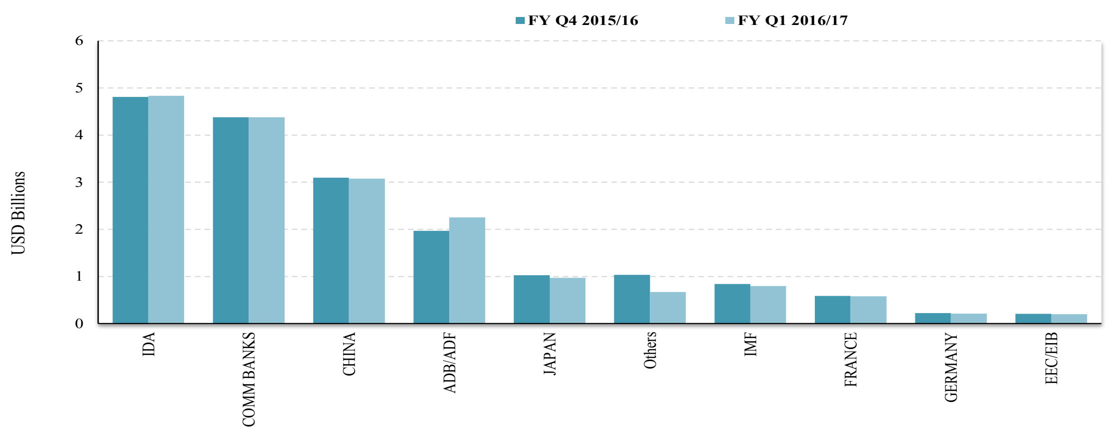
Chart 7A: Composition of External Debt by Lender Classification





Source: The National Treasury

Chart 7B: **External Debt By Creditor**



Source: The National Treasury

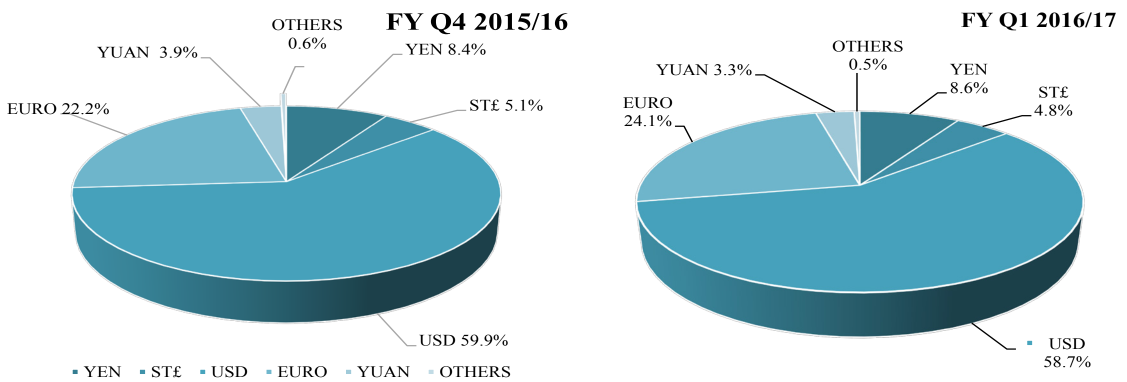
Currency Composition of External Debt

Kenya's public and publicly guaranteed external debt is denominated in various currencies partly to mitigate against currency risk. The dominant currencies included the US dollar and the Euro which accounted for 82.8 percent of the total currency composition at the end of the first quarter of the FY 2016/17. This was consistent with the currency composition of the Central Bank's forex reserve holdings. The proportion held in the Euro and the Japanese Yen increased mainly on account of the Euro denominated loan disbursements from Africa Development Bank and the United Kingdom government as well as disbursements from the Government of Japan denominated in the Japanese Yen **(Chart 7C)**.

Public Debt Service

The ratio of domestic interest payments to revenues stood at 13.4 percent in the first quarter of the FY 2016/17 which was slightly lower than the previous quarter (13.8 percent) due to improved revenue performance. The coupon interest on Treasury Bonds was the largest component of domestic interest payments, which was consistent with the proportion of debt held in Treasury bonds. External debt service stood at Ksh 15.5 billion and was within sustainable levels. Debt service ratios to a flow resource base such as revenues and exports is a liquidity indicator of the level of indebtedness. Analysis of the liquidity indicators of external indebtedness show that Kenya faces low exposure to external debt service default as these ratios are way below the CPIA determined liquidity indicators (25 percent of exports and 22 percent of revenues) **(Table 7.4)**.

Chart 7C: **Debt Composition by Currency**



Source: The National Treasury

Debt Sustainability Analysis

The March 2016 Debt sustainability update showed that Kenya faces a low risk of external debt distress. All the liquidity and solvency debt burden indicators were below the CPIA based thresholds both in the baseline and stress scenario. Public DSA sensitivity analysis shows that if primary deficit were to remain at the current levels, public debt would take an upward trajectory and way above the EAC convergence criterion. Hence, the fiscal authority needs to undertake the intended medium term fiscal consolidation. The update also laid emphasis on the need to strengthen debt management capacity owing to the bunched repayments in the coming years (USD 750 million in 2017, USD 750 million in 2019 and USD 2 billion in 2024).

Outlook for Fiscal Year 2016/17

Total public and publicly guaranteed external debt is expected to reach Ksh1,791.9billion (24.1 percent of GDP) by the end of the fiscal year 2016/17, of which gross and net domestic debt amounts to KSh 1,986.1 billion (26.7 percent of GDP) and KSh 1,577.7 billion (21.2 percent of GDP), respectively (2017 Budget Policy Statement). [2]

Table 7.4: Liquidity External Debt Sustainability Indicators

	Q2 2015/16	Q3 2015/16	Q4 2015/16	FY 2015/16	Q1 FY 2016/17
Debt services to Revenues (22%)	6.9	5.7	6.9	6.2	4.9
Debt services to Exports (25%)	7.9	6.5	10.2	7.4	10.8

Quartely debt service as a ratio of resource flows in similar quarters

Source: Central Bank of Kenya

2 The EAC public debt convergence criterion for PV of Debt/GDP is 50 percent
CPIA stands for Country Policies and Institutions Assessment
The primary deficit is the non-interest budget balance, an increase in the primary deficit leads into an increase in public debt through the debt and deficit vicious cycle

Chapter 8

The Capital Markets

Overview

All the four equity price indices declined in the third quarter of compared with second quarter, highlighting immediate impact of Brexit, interest rate capping law and weaknesses in the domestic banking sector. Shareholders' wealth, measured by market capitalization declined by Ksh 26.17 billion in the third quarter of 2016. However, a pickup in volume of shares traded lifted total equity turnover by KSh 11.11 billion (30 percent) during the quarter **(Table 8.1 and Chart 8A)**.

FTSE NSE Kenya 15 Index, which measures performance of the 15 largest stocks by market capitalization, closed lower by 14.74 points, and the FTSE NSE Kenya 25 Index, which measures performance of 25 most liquid stocks, declined by 9.85 points at the end of third quarter of 2016 compared with the previous quarter.

With regard to share trading by sectors, Telecommunication and Technology, Banking and Energy and Petroleum sectors accounted for 73.04 percent of all shares traded in the third quarter of 2016 signaling sectoral concentration risks. Agricultural sector was least traded, with 4,977,000 shares.

Foreign Investor Participation

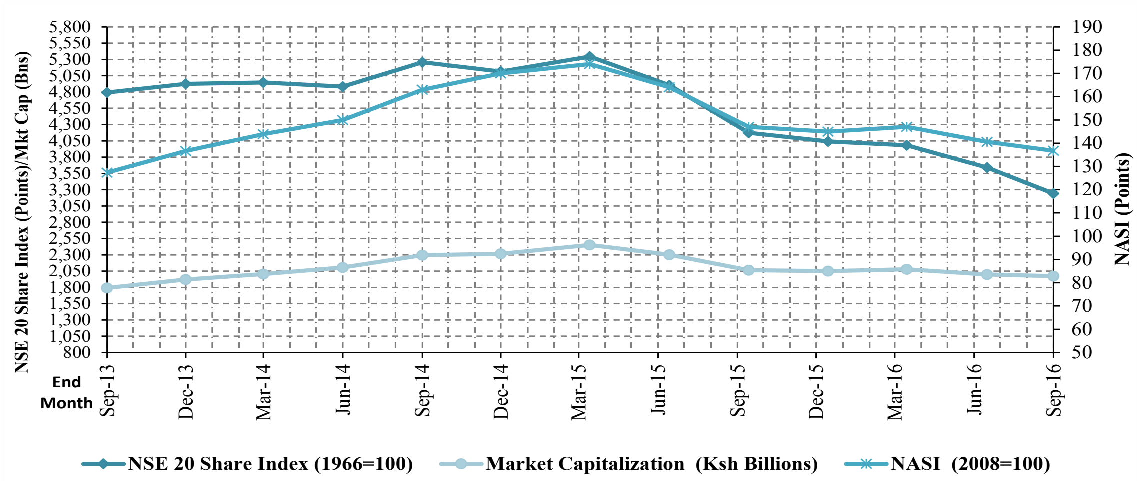
Foreign investors' trading activity at the NSE rose in the third quarter of 2016, with a bias to equities purchases than sales. The average foreign investors' trades at the NSE as a proportion of total equity turnover was 77.1 percent in quarter three of 2016 up from 62.95 percent in previous quarter, reflecting increased activity following low share prices **(Chart 8B and Table 8.1)**.

Table 8.1: Selected Stock Market Indicators

INDICATOR	2014	2015	2015				2016			QUARTERLY CHANGE (Q3-Q2)
			Q1	Q2	Q3	Q4	Q1	Q2	Q3	
NSE 20 Share Index (1966=100)	5,113.00	4,040.00	5,346.00	4,906.00	4,173.00	4,040.00	3,982.00	3,640.61	3,243.21	-10.92
NASI (2008=100)	170.00	145.00	174.00	164.00	147.00	145.00	147.00	140.60	136.75	-2.74
FTSE NSE Kenya 15 Index	217.76	182.55	231.56	216.07	195.09	182.55	185.17	175.70	160.96	-8.39
FTSE NSE Kenya 25 Index	218.70	182.11	231.87	215.28	194.81	182.11	185.47	176.47	166.62	-5.58
Number of Shares Traded (Millions)	8,133.65	6,812.14	1,621.72	1,852.31	1,882.60	1,455.51	1,299.70	1,411.00	1,998.96	41.67
Equities Turnover (Ksh Millions)	215,725.83	209,381.86	46,340.84	60,223.86	56,721.90	46,095.26	36,609.27	37,034.00	48,140.59	29.99
Market Capitalization (Ksh Billions)	2,316.32	2,049.00	2,452.47	2,302.00	2,063.64	2,053.52	2,078.28	1,998.00	1,971.83	-1.31
Foreign Purchase (Ksh Millions)	109,230.00	132,495.00	20,945.00	38,194.00	43,856.00	29,500.00	20,258.00	26,322.00	40,038.00	52.11
Foreign Sales (Ksh Millions)	105,700.00	131,579.00	24,102.00	40,738.00	37,300.00	29,439.00	21,844.00	19,339.00	34,018.00	75.90
Average Foreign Investor Participation to Equity Turnover	49.82%	63.06%	48.60%	65.53%	71.54%	63.93%	57.50%	62.95%	76.92%	13.97%
Bond Turnover (Ksh Millions)	506,050.22	305,099.19	129,369.95	59,897.16	44,511.49	71,320.60	113,400.10	149,808.73	74,808.74	-50.06
FTSE NSE Kenya Govt. Bond Index	93.31	90.04	93.11	92.03	90.41	90.04	89.28	87.98	89.11	1.28

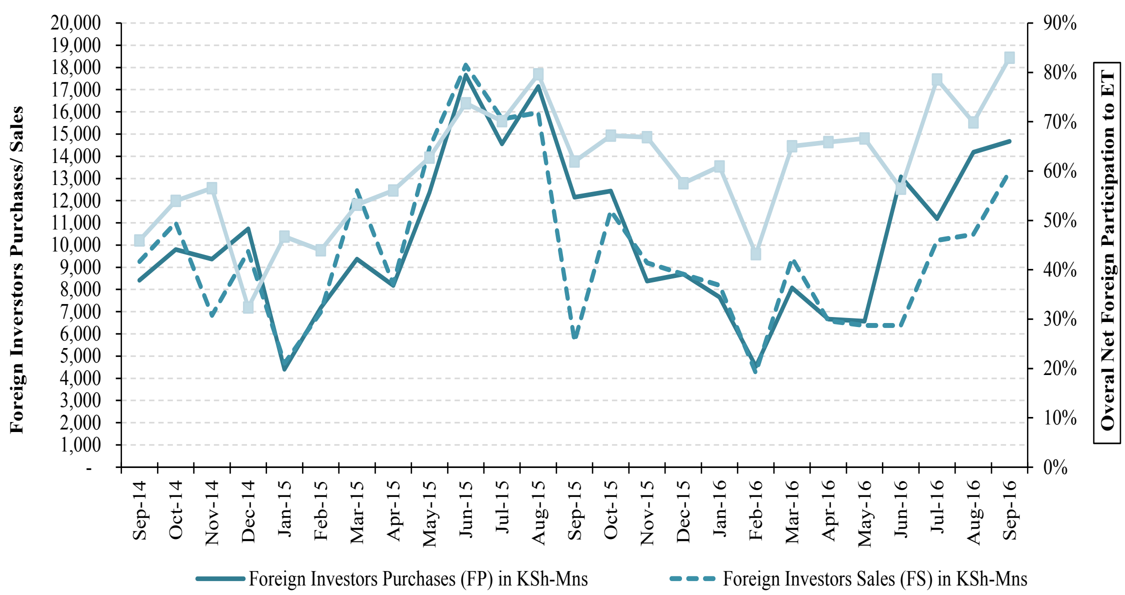
Source: Nairobi Securities Exchange

Chart 8A: Nse 20 Share Index, Nasi And Market Capitalization



Source: Nairobi Securities Exchange

Chart 8B: Foreign Participation



Source: Nairobi Securities Exchange

Chapter 9

Statement of Financial Position of the Central Bank of Kenya

(Kenya shillings million)

		2016					Sept-June	June-March
1.0	**ASSETS**	**MARCH**	**JUNE**	**JULY**	**AUG**	**SEP**	**Change**	**Change**
1.1	RESERVES AND GOLD HOLDINGS	786,202	826,788	817,929	815,444	820,608	(6,180)	40,587
1.2	FUNDS HELD WITH IMF	1,958	1,923	1,914	4,044	4,028	2,105	(35)
1.21	INVESTMENT IN EQUITY (SWIFT SHARES	9	9	9	9	9	0	0
1.3	ITEMS IN THE COURSE OF COLLECTION	65	80	39	35	52	(27)	14
1.4	ADVANCES TO COMMERCIAL BANKS	25,076	44,679	59,337	42,187	47,895	3,216	19,603
1.5	LOANS AND OTHER ADVANCES	2,584	2,483	2,472	2,548	2,540	57	(101)
1.6	OTHER ASSETS	3,129	3,227	3,034	2,822	3,681	454	98
1.7	RETIREMENT BENEFIT ASSET	4,668	5,455	5,455	7,776	7,776	2,321	787
1.8	PROPERTY AND EQUIPMENT	20,638	22,404	22,391	22,990	22,916	512	1,766
1.81	INTANGIBLE ASSETS	191	207	183	164	140	(67)	16
1.9	DUE FROM GOVERNMENT OF KENYA	72,636	69,762	39,630	38,904	29,006	(40,756)	(2,873)
	TOTAL ASSETS	**917,147**	**977,018**	**952,394**	**936,923**	**938,652**	**(38,367)**	**59,871**
2.0	LIABILITIES							
2.1	CURRENCY IN CIRCULATION	231,976	234,751	238,469	238,402	232,685	(2,066)	2,775
2.2	INVESTMENTS BY BANKS - REPOS		7,834	-	7,991	-	(7,834)	7,834
2.3	DEPOSITS	432,203	494,125	473,476	447,824	464,875	(29,250)	61,922
2.4	INTERNATIONAL MONETARY FUND	126,426	122,438	121,860	122,732	122,836	398	(3,987)
2.5	OTHER LIABILITIES	1,753	3,117	3,418	2,464	2,112	(1,005)	1,364
	TOTAL LIABILITIES	792,358	862,265	837,223	819,413	822,509	(39,756)	69,907
3.0	EQUITY AND RESERVES	124,789	114,753	115,171	117,510	116,143	1,390	(10,036)
	Share Capital	5,000	5,000	5,000	5,000	5,000	-	-
	General reserve fund -Unrealized	77,171	77,171	77,171	77,171	57,550	(19,621)	-
	-Realized	12,555	5,679	5,669	4,890	16,909	11,229	(6,875)
	-Capital Projects	7,445	7,445	7,445	7,445	15,047	7,602	-
	Period surplus/(Deficit)	3,160	-	428	438	(929)	(929)	(3,160)
	Asset Revaluation	14,790	14,790	14,790	14,790	14,790	-	-
	Retirment Benefit Asset Reserves	4,668	4,668	4,668	7,776	7,776	3,108	-
4.0	**TOTAL LIABILITIES AND EQUITY**	**917,147**	**977,018**	**952,394**	**936,923**	**938,652**	**(38,366)**	**59,871**

Source: Central Bank of Kenya

Notes on the Financial Position

The balance sheet of the Central Bank of Kenya declined by 3.9 percent in the third quarter of 2016 compared with an increase of 6.5 percent in the previous quarter. The decline is largely reflected in the reduction of advances to government by Central Bank of Kenya.

Assets

Reserves and Gold holdings category comprise of foreign reserves held in external current accounts, deposits and special/projects accounts, domestic foreign currency clearing accounts, gold, special drawing rights and RAMP securities invested with the World Bank. These foreign exchange reserves balance declined by 0.7 percent in the third quarter compared to an increase of 5.2 percent in the second quarter of 2016.

Items in course of collection represent the value of clearing instruments held by the Central Bank of Kenya, while awaiting clearing by respective commercial banks. It improved by 34.2 percent compared to an increase of 22 percent in the second quarter of 2016.

Advances to commercial banks, used by Central Bank of Kenya for liquidity management grew by 7.2 percent in the third quarter compared to a growth of 78.2 percent in the second quarter of 2016. This reflects a decline in the uptake of reverse repo purchases (liquidity support) by banks.

Loans and other advances include outstanding balances on advances to commercial banks under the Overnight Loan Facility (OLF), and IMF funds on-lent to Government. The outstanding balance increased by 2.3 percent in the third quarter compared to a decline of 3.9 percent in the second quarter of 2016.

Other assets, which largely consist of prepayments and sundry debtors, and deferred currency expense increased by 14.1 percent compared to 2.1 percent in the second quarter of 2016.

Debt due from Government of Kenya includes Government utilization of the overdraft facility at the Central Bank of Kenya and overdrawn accounts which were converted to a long term debt with effect from 1 November 1997. In the third quarter, government repaid the total outstanding overdraft at Central Bank of Kenya hence the reduction of the outstanding debt by 58.4 percent.

Liabilities.

Currency in circulation declined by 0.9 percent in the third quarter compared to a marginal growth of 1 percent in the second quarter of 2016.

Deposits held by Central Bank of Kenya for the Government of Kenya, local commercial banks deposit, other public entities and project accounts and local banks' forex settlement accounts, declined by 5.9 percent compared to an increase of 14.3 percent.

Equity and reserves category increased by 1.2 percent in third quarter of 2016 compared to 8.7 percent decline in the previous quarter on account of a fall in general reserve funds.