Central Bank of Kenya

QUARTERY ECONOMIC REVIEW (QER)

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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.

The Quarterly Economic Review is prepared by the Research Department of the Central Bank of Kenya.

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QUARTERLY ECONOMIC REVIEW

OCTOBER - DECEMBER 2017

The Quarterly Economic Review, prepared by the Central Bank of Kenya starting with the January - March 2016 edition, is available on the internet at:
http://www.centralbank.go.ke

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HIGHLIGHTS

Overall 12- month inflation declined significantly to 5.0 percent, the midpoint of the government target band, in the fourth quarter of 2017, from 7.5 percent in the third quarter of 2017, on account of declining food prices following favorable weather conditions and government interventions.

Growth in broad money, M3, decelerated to 0.8 percent in the fourth quarter of 2017 from 1.7 percent in the third quarter of 2017, reflecting slower growth of deposits.

Growth in net domestic credit nearly doubled to 4.2 percent or KSh 128.6 billion in the fourth quarter of 2017, with credit to government accounting for 63.3 percent of the total increase.

Monthly flow of credit to the private sector increased by 49.5 percent in the fourth quarter of 2017 with net new loans of KSh 48.6 billion compared to KSh 32.5 billion in the previous quarter. Overall annual credit growth, however, remained subdued at 2.1 percent through December 2017.

The interbank rate increased to an average of 8.1 percent in the fourth quarter of 2017 reflecting tight liquidity conditions in the money market coupled with segmentation and uneven distribution of liquidity. However, the dispersion narrowed to 58 basis points from 147 basis points in the previous quarter, thereby underlining improvement in liquidity distribution.

The lending, savings and Treasury bill interest rates remained relatively stable during the fourth quarter of 2017.

Global economic growth is projected to have strengthened to 3.7 percent in 2017 from 3.2 percent in 2016 and is projected at 3.9 percent in 2018 anchored on momentum created in 2017.

Kenya's current account balance stood at USD 1,162 million during the fourth quarter of 2017 from USD 1,405 million deficit during the third quarter of 2017 reflecting an improvement of the trade balance.

Kenya's official international reserves position was strong at USD 7,346 million by end December 2017, equivalent to 4.9 months of imports.

The foreign exchange market remained stable largely on account of resilient inflows from diaspora remittances, tourism receipts, and tea and horticulture exports.

The banking sector was stable in the fourth quarter of 2017. Total net assets increased by 0.4 percent while the deposit base increased by 1.6 percent. The sector was well capitalized and met the minimum capital requirements. Profitability improved supported by increase in income from investments in Government securities and loans and advances. Credit risk remained elevated with gross non-performing loans (NPLs) to gross loans ratio at 10.6 percent in the fourth quarter of 2017.

The Government's budgetary operations in the second quarter of FY 2017/18 resulted in a deficit of 1.6 percent of GDP compared with a deficit of 0.7 percent of GDP in the first quarter of FY 2017/18. Revenue collection improved but remained below target, as was the case with the expenditure.

Kenya's public and publicly guaranteed debt recorded a moderate increase of 1.9 percent during the second quarter of the FY 2017/18, with both domestic and external debt increasing by 2.1 percent and 1.7 percent, respectively.

The capital markets recorded mixed performance in the fourth quarter of 2017. The Equities Market recorded growth in market capitalization on account of improved share prices, while the bond market turnover declined. The market recorded reduced supply of shares and secondary trading of securities partly on account of the effects of the end year season.

CHAPTER 1
Inflation

Overview

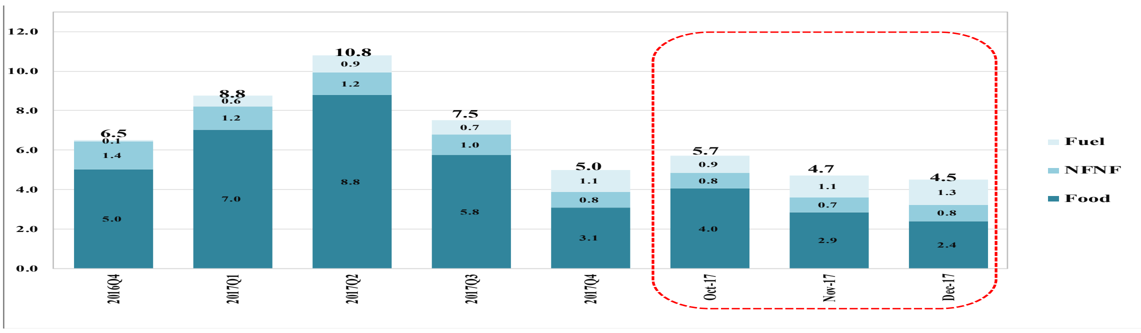
Overall 12- month inflation declined to 5.0 percent in the fourth quarter of 2017, the midpoint of the government target band, from 7.5 percent in the third quarter of 2017, largely on account of declining food prices (**Table 1.1**). Food inflation declined significantly to 6.3 percent in the fourth quarter of 2017 from 11.7 percent in the third quarter of 2017, largely driven by declining prices of key food items owing to favorable weather conditions during the quarter, as well as government interventions. In addition, Non-Food-Non-Fuel (NFNF) inflation declined to 2.9 percent from 3.8 percent. However, fuel inflation increased to 4.6 percent from 3.1 percent following rising energy prices. The three months annualized inflation remained muted thereby signaling minimal inflationary pressures in the economy **(Table 1.1)**.

Table 1.1: Recent Developments in Inflation (Percent)

	2016				2017						
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Oct	Nov	Dec
Quarterly Overall Inflation	7.0	5.4	6.3	6.5	8.8	10.8	7.5	5.0	5.7	4.7	4.5
Food Inflation	10.4	7.2	10.3	10.6	14.7	18.1	11.7	6.3	8.2	5.8	4.9
Fuel Inflation	2.2	1.7	0.4	0.3	2.3	3.5	3.1	4.6	3.7	4.8	5.4
Non-Food Non-Fuel Inflation (NFNF)	5.8	5.4	5.0	5.2	4.2	4.3	3.8	2.9	3.0	2.7	3.1
Average annual inflation	6.8	6.6	6.5	6.4	6.5	7.7	8.3	8.2	8.3	8.2	8.0
Three months annualised inflation	5.1	7.4	7.0	6.6	14.7	15.4	-5.1	-3.1	-2.4	-5.6	-1.3

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

Chart 1.1: Contribution of Broad Categories to Overall Inflation (Percentage Points)



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

Food inflation

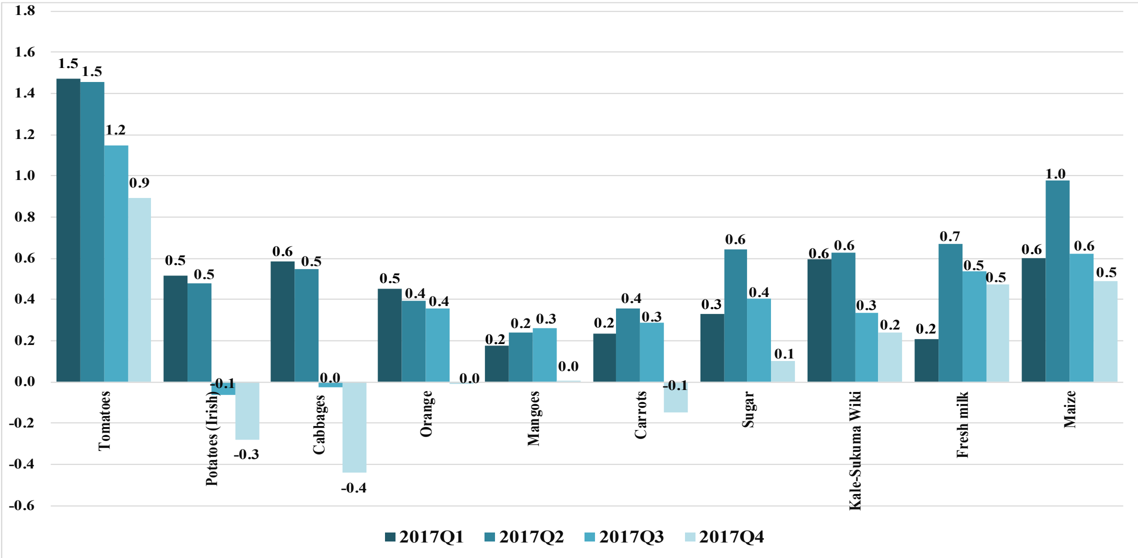
Food inflation declined significantly to 6.3 percent in the fourth quarter of 2017 from 11.7 percent in the third quarter of 2017, supported by declining prices of selected key food items following improved weather conditions during the period. Moreover, government interventions that facilitated increased importation of sugar, powdered milk and subsidized maize flour enhanced supply, resulting in lower prices for these food items (**Chart 1.2**). Consequently, the contribution of food inflation to overall inflation declined to 3.1 percentage points in the quarter under review from 5.8 percentage points in the third quarter of 2017 (**Chart 1.1**).

The contribution of most key food items to overall inflation declined during the quarter under review. Significant declines were recorded in: tomatoes (0.3 percentage points), Irish potatoes (0.2 percentage points), cabbages (0.4 percentage points), oranges (0.4 percentage points), mangoes (0.3 percentage points), carrots (0.4 percentage points), and sugar (0.3 percentage points). Mild declines were recorded in maize[1] (0.1 percentage points), fresh milk[2] (0.1 percentage points) and kale-sukuma wiki (0.1 percentage points) (**Chart 1.2**).

[1]Maize comprises of green maize, loose maize grain, sifted maize flour and loose maize flour.

[2]Fresh milk comprises of fresh packeted and unpacketed milk.

Chart 1.2: Contribution of Broad Categories to Overall Inflation (Percentage Points)



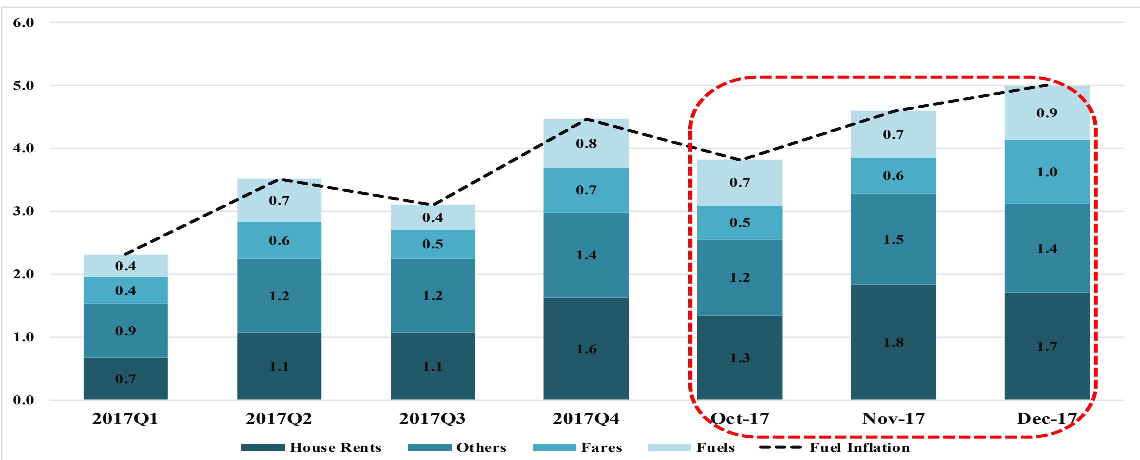
Source: Kenya National Bureau of Statistics and Central Bank of Kenya.

Fuel Inflation

Fuel inflation increased significantly to 4.6 percent in the fourth quarter of 2017 from 3.1 percent in the third quarter of 2017, driven by rising energy[3] prices (**Chart 1.3**). Fuel prices increased in line with the rising international oil prices, whereas electricity cost went up due to the upward adjustment of forex, inflation and fuel cost charges during the period. The contribution of fuel inflation to overall inflation rose to 1.1 percentage points during the quarter under review, from 0.7 percentage points in the previous quarter, pointing to mild inflationary pressures in this component of inflation (**Chart 1.1**).

The contribution of all components of fuel inflation increased in the fourth quarter of 2017 (**Chart 1.3**). The contribution of house rents increased to 1.6 percentage points from 1.1 percentage points in the previous quarter. The contribution of 'Other' items in the fuel basket increased to 1.4 percentage points from 1.2 percentage points, while that of energy increased to 0.8 percentage points from 0.4 percentage points. Fares contributed 0.7 percentage points during the quarter under review, an increase from 0.5 percentage points in the previous quarter. This increase mainly reflected the rising energy prices and hiked fares owing to increased demand for transport services around the Christmas festive season.

Chart 1.3: Contribution of Key Items to Fuel Inflation



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

[3] Energy comprises Gas - (LPG), Kerosene, Petrol, Diesel, Charcoal and Firewood.

Non-Food Non-Fuel inflation (NFNF)

Non-Food Non-Fuel (NFNF) inflation remained below the mid-point of the Government's medium term target of 5 percent. It declined further to 2.9 percent in the fourth quarter of 2017 from 3.8 percent in the third quarter of 2017, reflecting muted demand pressures in the economy. Consequently, the contribution of NFNF to overall inflation declined to 0.8 percentage points from 1.0 percentage points in the third quarter of 2017 **(Chart 1.1)**.

The decline was reflected in the 'Clothing and Footwear' category, and the 'Miscellaneous Goods & Services' category. Inflation for 'Alcoholic Beverages, Tobacco & Narcotics', 'Furnishings, Household Equipment and Routine Household Maintenance' as well as for the 'Recreation & Culture' categories remained relatively stable. However, inflation in the 'Health', 'Communications' and 'Education' categories increased marginally **(Table 1.2)**.

Table 1.2: Inflation of various Baskets under Non-Food-Non-Fuel Inflation

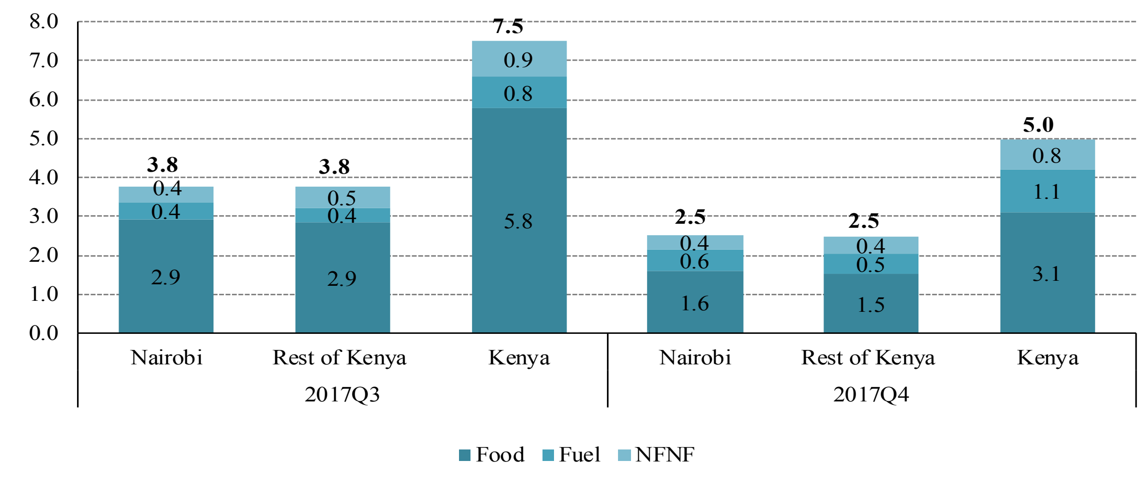
		Alcoholic Beverages, Tobacco & Narcotics	Clothing & Footwear	Furnishings, Household Equipment and Routine Household Maintenance	Health	Communi cation	Recreation & Culture	Education	Miscellaneous Goods & Services	Non-Food Non-Fuel Inflation
2016	Q3	14.3	3.6	3.6	3.5	1.8	4.3	4.2	3.8	**5.0**
	Q4	10.3	4.4	3.3	3.2	1.7	4.4	4.0	3.8	**5.2**
2017	Q1	3.2	4.2	3.0	3.1	0.6	2.1	2.9	3.5	**4.2**
	Q2	3.4	4.0	3.3	3.0	0.1	1.8	2.8	3.9	**4.3**
	Q3	3.0	3.8	3.2	3.1	0.3	1.2	2.9	3.6	**3.8**
	Q4	3.0	2.9	3.2	4.1	0.5	1.2	3.2	3.5	**2.9**
	Oct	3.0	2.9	3.2	3.2	0.4	1.0	3.1	3.3	**3.0**
	Nov	3.0	2.9	3.0	4.4	0.4	1.0	3.1	3.6	**2.7**
	Dec	3.0	3.0	3.3	4.8	0.5	1.6	3.2	3.6	**3.1**

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

Overall Inflation across Regions

Inflation for the Rest of Kenya declined significantly to 4.3 percent in the fourth quarter of 2017, from 7.8 percent in the third quarter of 2017, while that of Nairobi declined to 6.0 percent from 7.2 percent over the same period. The contribution of the Nairobi region and the Rest of Kenya to overall inflation declined during the period under review and remained even in both regions. The contribution of inflation for both regions declined to 2.5 percentage points each from 3.8 percentage points each in the third quarter of 2017. This decline was largely reflected in the subdued contribution of food inflation in both regions. The contribution of fuel and NFNF inflation was stable and evenly distributed across the regions in the third and fourth quarters of 2017 (**Chart 1.4**).

Chart 1.4: Contribution of Various Regions to Overall Inflation (Percentage Points)



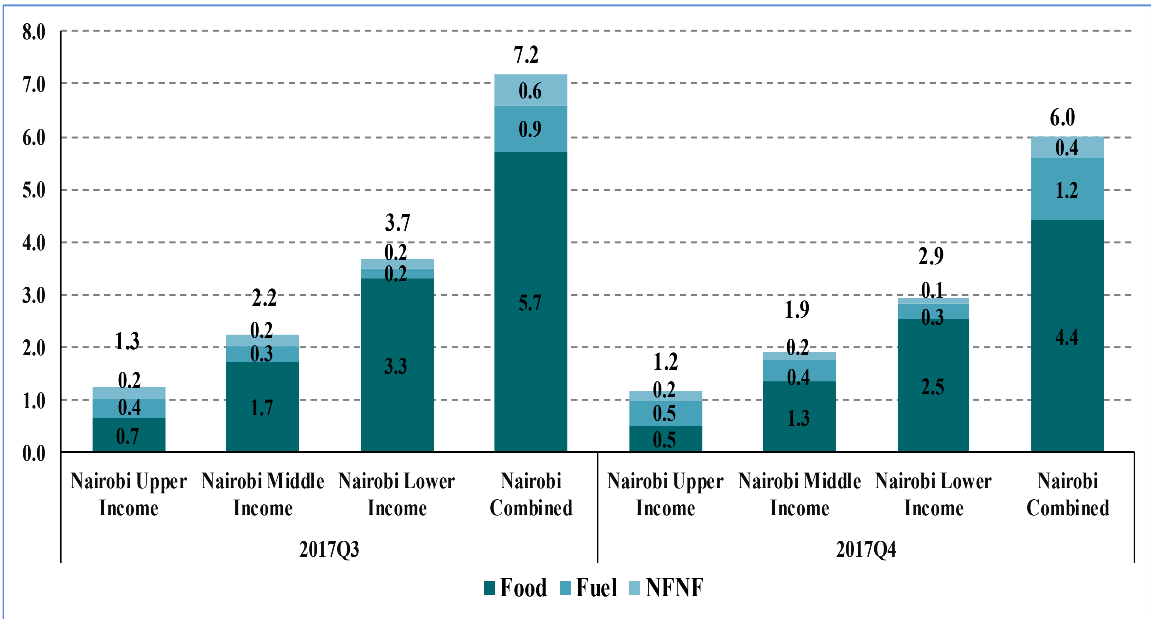
Source: Kenya National Bureau of Statistics and Central Bank of Kenya.

Overall Inflation across Income Groups in Nairobi

Overall inflation in Nairobi declined to 6.0 percent in the fourth quarter of 2017 from 7.2 percent in the third quarter of 2017. The decline was experienced in the 'lower income' group whose inflation declined to 6.2 percent from 7.8 percent, largely supported by the declining food inflation. However, inflation in the 'middle income' group and the 'upper income' group rose during the period under consideration. Inflation in the 'middle income' group rose to 6.0 percent from 5.6 percent in the third quarter, whereas inflation in the 'upper income' group rose to 3.0 percent from 2.5 percent over the same period. This increase in inflation mirrored the rising energy prices (**Chart 1.5**).

Across the income groups, the contribution of food component to overall inflation declined in the fourth quarter compared to the third quarter of 2017. However, the contribution of the fuel component increased, while that of the NFNF remained relatively stable during the third and fourth quarters of 2017.

Chart 1.5: Contribution of Income Groups to Overall Inflation in Nairobi (Percentage Points)



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

Chapter 2

Money, Credit and Interest Rates

I. Monetary Aggregates and its Components

Growth in broad money, M3, slowed down to 0.8 percent in the fourth quarter of 2017 from 1.7 percent in the third quarter of 2017, reflecting deceleration in the rate of increase in time and savings deposits, foreign currency deposits and other public sector deposits at the Central Bank of Kenya (**Table 2.1 and Chart 2.1**). The deceleration in the growth of time, savings and foreign currency deposits largely fell on corporates, partly due to diversion of funds to purchase government securities (**Table 2.2**). The utilization of county government deposits and special projects deposits largely explain the significant decline in other deposits at the Central Bank. Meanwhile, the currency outside banks increased, largely reflecting seasonality attributed to the end of year festivities.

On 12-month basis, money supply, M3 growth improved to 8.9 per cent in December 2017 from 7.7 percent in September 2017 and 3.7 percent in December 2016, largely reflecting increase in lending to the government and to the private sector.

Table 2.1: Monetary Aggregates

	END MONTH LEVEL				QUARTERLY GROWTH RATES (%)				QUARTERLY CHANGES (KSH BN)			
	Mar-17	Jun-17	Sep-17	Dec-17	Mar-17	Jun-17	Sep-17	Dec-17	Mar-17	Jun-17	Sep-17	Dec-17
COMPONENTS OF M3												
1. Money supply, M1 (1.1+1.2+1.3)	**1317.2**	**1391.3**	**1382.7**	**1397.3**	**0.5**	**5.6**	**-0.6**	**1.1**	**7.2**	**74.1**	**-8.6**	**14.6**
1.1 Currency outside banks	200.6	206.7	208.9	225.1	-4.2	3.0	1.0	7.8	-8.9	6.1	2.1	16.2
1.2 Demand deposits	1062.7	1102.9	1113.7	1130.4	1.7	3.8	1.0	1.5	17.7	40.2	10.8	16.7
1.3 Other deposits at CBK 1/	53.5	81.2	59.7	41.4	-3.0	51.9	-26.5	-30.7	-1.6	27.7	-21.5	-18.3
2. Money supply, M2 (1+2.1)	**2412.1**	**2480.5**	**2515.1**	**2538.2**	**2.2**	**2.8**	**1.4**	**0.9**	**51.9**	**68.4**	**34.6**	**23.1**
2.1 Time and saving deposits	1094.9	1089.2	1132.4	1140.9	4.3	-0.5	4.0	0.8	44.7	-5.7	43.2	8.5
3. Money supply, M3 (2+3.1)	**2846.6**	**2936.1**	**2986.4**	**3010.9**	**3.0**	**3.1**	**1.7**	**0.8**	**82.1**	**89.5**	**50.2**	**24.6**
3.1 Foreign Currency Deposits	434.5	455.6	471.27	472.7	7.5	4.8	3.4	0.3	30.2	21.1	15.7	1.5
SOURCES OF M3												
1. Net foreign assets 2/	**603.0**	**644.1**	**611.6**	**517.9**	**21.8**	**6.8**	**-5.0**	**-15.3**	**107.8**	**41.1**	**-32.5**	**-93.8**
Central Bank	697.8	738.3	694.6	627.1	12.3	5.8	-5.9	-9.7	76.2	40.5	-43.7	-67.5
Banking Institutions	-94.8	-94.2	-83.0	-109.3	-25.0	-0.7	-11.9	31.6	31.6	0.6	11.2	-26.2
2. Net domestic assets (2.1+2.2)	**2243.7**	**2292.0**	**2374.7**	**2493.1**	**-1.1**	**2.2**	**3.6**	**5.0**	**-25.7**	**48.3**	**82.7**	**118.3**
2.1 Domestic credit	**2952.6**	**3002.2**	**3069.7**	**3198.3**	**-0.7**	**1.7**	**2.2**	**4.2**	**-20.6**	**49.6**	**67.4**	**128.6**
2.1.1 Government (net)	583.5	646.2	674.3	755.7	-1.6	10.8	4.3	12.1	-9.3	62.8	28.1	81.4
2.1.2 Private sector	2263.2	2249.1	2281.6	2330.2	-0.5	-0.6	1.4	2.1	-12.5	-14.0	32.5	48.6
2.1.3 Other public sector	105.9	106.9	113.7	112.4	1.2	0.9	6.4	-1.2	1.2	0.9	6.9	-1.3
2.2 Other assets net	**-708.9**	**-710.3**	**-694.9**	**-705.2**	**0.7**	**0.2**	**-2.2**	**1.5**	**-5.1**	**-1.3**	**15.3**	**-10.3**
MEMORANDUM ITEMS												
4. Overall liquidity, L (3+4.1)	**3816.7**	**3935.0**	**4012.3**	**4085.1**	**2.9**	**3.1**	**2.0**	**1.8**	**108.0**	**118.3**	**77.4**	**72.8**
4.1 Non-bank holdings of government securities	970.0	998.9	1026.0	1074.2	2.7	3.0	2.7	4.7	25.9	28.8	27.1	48.2

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

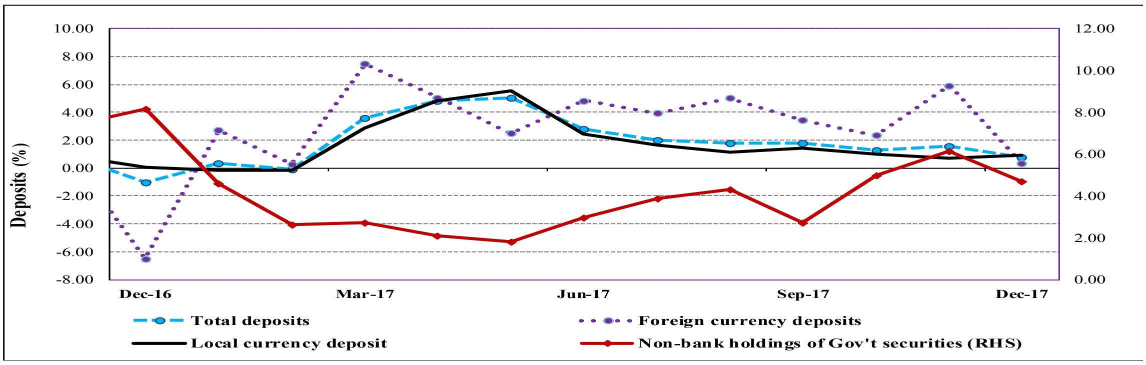
Table 2.2: Deposits Holdings of Corporates and Household Sectors

	END MONTH LEVEL				QUARTERLY GROWTH RATES (%)				QUARTERLY CHANGES (KSH BN)			
	Mar-17	Jun-17	Sep-17	Dec-17	Mar-17	Jun-17	Sep-17	Dec-17	Mar-17	Jun-17	Sep-17	Dec-17
1. Household Sector 1/	**1245.8**	**1265.5**	**1300.4**	**1308.9**	**2.2**	**1.6**	**2.8**	**0.7**	**27.0**	**19.7**	**34.9**	**8.5**
1.1 Demand Deposits	543.5	546.9	573.2	566.7	3.6	0.6	4.8	-1.1	19.1	3.5	26.3	-6.5
1.2 Time and Saving Deposits	567.1	580.1	590.6	601.6	0.1	2.3	1.8	1.9	0.6	13.0	10.6	11.0
1.3 Foreign Currency Deposits	135.3	138.5	136.5	140.5	5.7	2.4	-1.4	2.9	7.3	3.2	-2.0	4.0
2. Corporate Sector	**1332.5**	**1373.0**	**1408.4**	**1427.9**	**5.0**	**3.0**	**2.6**	**1.4**	**63.5**	**40.4**	**35.4**	**19.5**
2.1 Time and saving deposits	508.0	549.2	534.4	558.6	-0.5	8.1	-2.7	4.5	-2.6	41.2	-14.7	24.1
2.2 Time and Saving Deposits	525.6	507.1	539.8	537.7	8.9	-3.5	6.4	-0.4	43.1	-18.5	32.7	-2.1
2.3 Foreign Currency Deposits	298.9	316.7	334.1	331.6	8.4	5.9	5.5	-0.7	23.1	17.8	17.5	-2.5

1/ Household Sector includes individuals, unincorporated businesses serving households and non-profit institutions

Source: Central Bank of Kenya

Chart 2.1: Quarterly Growth in Deposits and Non-Bank Holdings of Government Securities in Percent



Source: Central Bank of Kenya

II. Sources of Broad Money

The primary source of M3 expansion in the fourth quarter of 2017 was the increase in Net Domestic Assets (NDA) of the banking system, largely reflected in growth of net domestic credit to the government and private sector **(Table 2.1)**. The contribution of NDA to the increase of M3 was partly offset by a decline of the Net Foreign Assets (NFA) of the banking system. The decline in NFA of the Central Bank largely reflected payments of government debt service, while reduction in commercial Banks's NFA reflected increase in their non-resident deposit liabilities mainly related to international organizations, and cut down on foreign deposit assets.

III. Developments in Domestic Credit

Domestic credit increased by 4.2 percent in the fourth quarter of 2017 compared to 2.2 per cent in the third quarter of 2017, reflecting increased credit flows to government and private sector. Growth in banks net credit to the private sector increased to 2.1 percent from 1.4 percent over the same period **(Table 2.3 and Chart 2.2)**. The increase in private sector credit was reflected across households and corporates **(Table 2.4).**

A sectoral analysis shows that manufacturing, trade and real estate sectors recorded strong recovery in credit uptake, accounting for about 60 percent of the flow in the fourth quarter of 2017.

On 12-month basis, private sector credit growth improved to 2.4 percent in December 2017 from 1.7 percent in September 2017. The sluggish pace of private sector credit growth partly reflected reduced credit demand due to weak performance of some sectors of the economy, tightening of banking sector's credit standards and increased alternative funding sources such as joint ventures in real estate as well as raised threshold of risk attributed to the interest rate capping law.

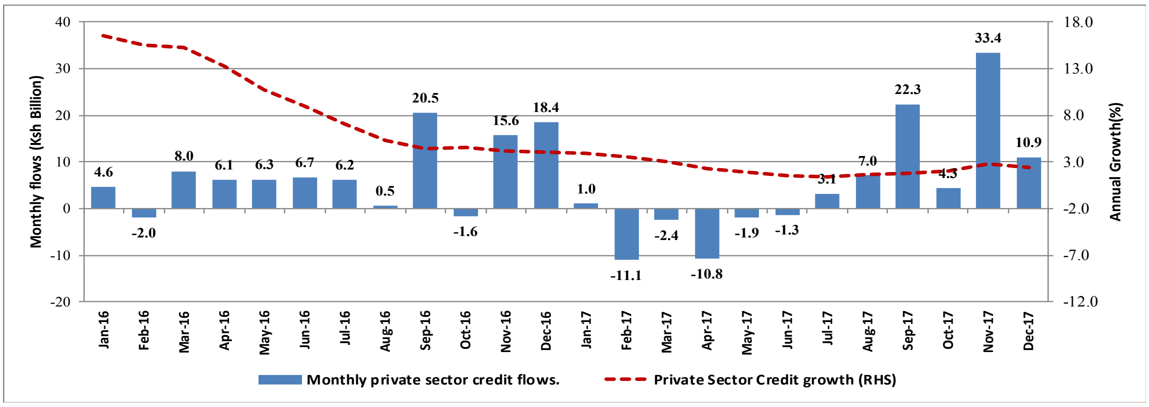
The banking system net credit to the government grew by 12.1 percent in the fourth quarter of 2017 compared with 4.3 percent in the third quarter of 2017, largely reflecting the utilization of the government deposits at the Central Bank. Meanwhile, the commercial banks' net lending to the government declined, largely reflecting reduced holdings of government securities.

Table 2.3: Banking Sector Net Domestic Credit

	END MONTH LEVEL				QUARTERLY GROWTH RATES (%)				QUARTERLY CHANGES (KSH BN)			
	Mar-17	Jun-17	Sep-17	Dec-17	Mar-17	Jun-17	Sep-17	Dec-17	Mar-17	Jun-17	Sep-17	Dec-17
1. Credit to Government	**583.5**	**646.2**	**674.3**	**755.7**	**-1.6**	**10.8**	**4.3**	**12.1**	**-9.3**	**62.8**	**28.1**	**81.4**
Central Bank	-117.2	-178.9	-167.6	-67.0	2.9	52.6	-6.3	-60.0	-3.3	-61.7	11.3	100.6
Commercial Banks & NBFIs	700.7	825.1	841.9	822.7	-0.8	17.8	2.0	-2.3	-6.0	124.4	16.7	-19.2
2. Credit to other public sector	**105.9**	**106.9**	**113.7**	**112.4**	**1.2**	**0.9**	**6.4**	**-1.2**	**1.2**	**0.9**	**6.9**	**-1.3**
Local government	3.8	3.9	4.2	2.9	1.1	1.2	8.1	-31.4	0.0	0.0	0.3	-1.3
Parastatals	102.1	103.0	109.5	108.4	1.2	0.9	6.3	-1.0	1.2	0.9	6.5	-1.1
3. Credit to private sector	**2,263.2**	**2,249.1**	**2,281.6**	**2,330.2**	**-0.5**	**-0.6**	**1.4**	**2.1**	**-12.5**	**-14.0**	**32.5**	**48.6**
Agriculture	86.8	85.5	88.8	83.0	-3.6	-1.6	3.9	-6.5	-3.3	-1.4	3.3	-5.8
Manufacturing	278.6	282.8	295.6	310.6	1.3	1.5	4.5	5.1	3.6	4.1	12.8	15.1
Trade	382.0	388.2	408.7	414.9	0.4	1.6	5.3	1.5	1.3	6.2	20.5	6.2
Building and construction	101.4	100.8	106.7	109.9	-3.3	-0.6	5.9	2.9	-3.5	-0.6	5.9	3.1
Transport & communications	196.8	185.5	182.7	186.7	-2.2	-5.8	-1.5	2.2	-4.5	-11.3	-2.8	4.1
Finance & insurance	77.3	84.9	83.5	81.6	-9.3	9.9	-1.7	-2.3	-7.9	7.6	-1.4	-1.9
Real estate	351.1	355.7	358.8	366.5	4.1	1.3	0.9	2.1	13.7	4.7	3.1	7.7
Mining and quarrying	14.9	14.7	16.0	15.9	-11.0	-1.8	9.1	-0.8	-1.9	-0.3	1.3	-0.1
Private households	394.8	386.7	384.0	387.1	0.4	-2.0	-0.7	0.8	1.7	-8.0	-2.8	3.1
Consumer durables	172.5	168.2	170.9	172.5	-1.6	-2.5	1.6	0.9	-2.8	-4.3	2.7	1.6
Business services	145.7	136.7	134.6	137.8	-1.0	-6.2	-1.5	2.3	-1.4	-9.0	-2.0	3.2
Other activities	61.3	59.5	51.4	63.7	-11.1	-2.9	-13.6	24.1	-7.7	-1.8	-8.1	12.4
4. TOTAL (1+2+3)	**2,952.6**	**3,002.2**	**3,069.7**	**3,198.3**	**-0.7**	**1.7**	**2.2**	**4.2**	**-20.6**	**49.6**	**67.4**	**128.6**

Source: Central Bank of Kenya

Chart 2.2: Private Sector Credit Growth



Source: Central Bank of Kenya

Table 2.4: Gross Bank Loans to the Private Sector Credit Growth

	END MONTH LEVEL				QUARTERLY GROWTH RATES (%)				QUARTERLY CHANGES (KSH BN)			
	Mar-17	Jun-17	Sep-17	Dec-17	Mar-17	Jun-17	Sep-17	Dec-17	Mar-17	Jun-17	Sep-17	Dec-17
Gross Credit to the Private Sector												
1. Household	652.1	656.7	665.4	679.8	-3.3	0.7	1.3	2.2	-21.9	4.6	8.7	14.4
2. Corporate	1645.5	1632.2	1660.4	1692.3	1.0	-0.8	1.7	1.9	16.8	-13.4	28.2	31.9
Gross Loans	2297.6	2288.9	2325.8	2372.1	-0.2	-0.4	1.6	2.0	-5.1	-8.7	36.9	46.3

Source: Central Bank of Kenya

IV. Reserve Money

Reserve money (RM), which comprises currency held by the non-bank public and commercial bank reserves, grew by 3.4 percent in the fourth quarter compared to an increase of 6.2 percent in the previous quarter. The slowdown was largely reflected in bank reserves which decreased by KSh 2.0 billion compared to an increase of KSh 22.8 billion in the previous quarter. Meanwhile, the currency outside banks increased in the fourth quarter largely due to the end of year festivities **(Table 2.5)**.

The primary source of reserve money expansion in the fourth quarter of 2017 was an increase in NDA of Central Bank, largely reflecting utilization of deposits by the government. The CBK net lending to commercial banks decreased to 28.3 billion in the fourth quarter from KSh 63.2 billion in the previous quarter, reflecting improved liquidity conditions.

Table 2.5: Reserve Money and its Sources

	END MONTH LEVEL				QUARTERLY GROWTH RATES (%				QUARTERLY CHANGES (KSh BN			
	Mar-17	Jun-17	Sep-17	Dec-17	Mar-17	Jun-17	Sep-17	Dec-17	Mar-17	Jun-17	Sep-17	Dec-17
1. Net Foreign Assets	697.8	738.3	694.6	627.1	12.3	5.8	-43.7	-67.5	76.2	40.5	-43.7	-67.5
2. Net Domestic Assets	-282.9	-338.7	-270.1	-188.4	34.4	19.7	68.6	81.8	-72.4	-55.9	68.6	81.8
2.1 Government Borrowing (net)	-117.2	-178.9	-167.6	-67.0	2.9	52.6	11.3	100.6	-3.3	-61.7	11.3	100.6
2.2 Commercial banks (net)	-18.4	23.6	63.2	28.3	-142.5	-228.5	39.6	-34.9	-61.6	42.0	39.6	-34.9
2.3 Other Domestic Assets (net)	-150.7	-186.8	-169.2	-153.1	5.2	24.0	17.6	16.1	-7.5	-36.2	17.6	16.1
3. Reserve Money	414.9	399.6	424.5	438.8	0.9	-3.7	24.9	14.3	3.8	-15.3	24.9	14.3
3.1 Currency outside banks	200.6	206.7	208.9	225.1	-4.2	3.0	2.1	16.2	-8.9	6.1	2.1	16.2
3.2 Bank reserves	214.3	192.9	215.7	213.7	6.3	-10.0	22.8	-2.0	12.7	-21.4	22.8	-2.0

Source: Central Bank of Kenya

V. Interest Rates

a. Central Bank Rate

The Monetary Policy Committee (MPC) retained the Central Bank Rate (CBR) at 10.0 percent at its meeting in November 2017 in order to continue anchoring inflation expectations. The Committee had concluded that inflationary pressures in the economy were muted as the overall inflation was within the government target range, and non-food-non-fuel inflation was below 5 per cent.

b. Interbank Rate

The interbank rate increased to an average of 8.14 percent in the fourth quarter of 2017 compared to an average of 6.87 percent in the third quarter of 2017 **(Table 2.6)**. This increase indicates skewed liquidity conditions in the money market compounded by interbank market segmentation along bank tiers.

c. Treasury Bill Rates

The interest rates on government securities were largely stable in the fourth quarter of 2017, an indication that the implementation of government domestic borrowing program supported market stability. The average 91-day Treasury bill rate declined slightly to 8.04 percent in the fourth quarter of 2017 compared with 8.18 percent in the previous quarter. The average 182-day Treasury bill rate increased slightly to 10.44 percent in the fourth quarter of 2017, from 10.32 percent in previous quarter **(Table 2.6).**

d. Lending and Deposit Rates

Commercial banks' lending interest rates remained relatively stable within the interest rate caps through December 2017. The average deposit rate increased to 8.22 percent in December 2017 from 7.7 percent in September 2017, reflecting increased cost of funds.

Table 2.6: Interest Rates (%)

	2016				2017											
	Mar	Jun	Sep	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
91-day Treasury bill rate	8.72	7.25	8.06	8.44	8.58	8.64	8.69	8.77	8.73	8.42	8.22	8.17	8.13	8.09	8.01	8.01
182-day Treasury bill rate	10.83	9.56	10.85	10.55	10.50	10.53	10.53	-	10.41	10.38	10.32	10.32	10.32	10.33	10.47	10.53
Interbank rate	4.10	4.56	4.47	5.55	7.70	6.41	4.46	5.34	4.93	3.99	6.99	8.10	5.52	7.85	8.86	7.27
Repo rate	4.31	10.04	0.00	0.00	9.95	9.88	7.23	5.32	5.29	4.13	8.29	8.90	7.24	0.00	9.21	7.75
Reverse Repo rate	11.63	10.59	10.36	10.04	10.02	10.01	10.04	10.02	10.01	10.05	10.25	10.29	10.12	10.11	10.10	10.10
Central Bank Rate (CBR)	11.50	10.50	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00
Average lending rate (1)	**17.79**	**18.15**	**13.84**	**13.69**	**13.66**	**13.69**	**13.61**	**13.61**	**13.71**	**13.66**	**13.70**	**13.65**	**13.69**	**13.71**	**13.68**	**13.64**
Overdraft rate	18.06	18.04	13.60	13.49	13.30	13.32	13.29	13.30	13.44	13.38	13.65	13.66	13.65	13.68	13.60	13.54
1-5years	18.00	18.63	13.95	13.86	13.88	13.89	13.81	13.82	13.85	13.80	13.78	13.86	13.87	13.88	13.86	13.83
Over 5years	17.31	17.64	13.83	13.59	13.60	13.66	13.55	13.52	13.68	13.64	13.62	13.39	13.51	13.51	13.51	13.46
Average deposit rate (2)	**7.17**	**6.78**	**6.94**	**7.33**	**7.20**	**7.65**	**7.12**	**6.97**	**7.07**	**7.15**	**7.72**	**7.67**	**7.66**	**8.01**	**8.07**	**8.22**
0-3months	9.78	8.80	8.21	7.16	7.19	7.32	7.28	7.22	7.25	7.76	7.83	7.80	7.71	8.17	8.19	8.43
Over 3 months deposit	10.41	9.94	8.82	8.45	8.33	8.84	8.18	8.01	8.11	8.04	8.05	8.13	8.02	8.17	8.35	8.39
Savings deposits	1.32	1.60	3.78	6.37	6.09	6.81	5.89	5.67	5.85	5.63	6.40	5.94	6.43	6.92	6.93	6.91
Spread (1-2)	**10.62**	**11.40**	**6.93**	**6.36**	**6.46**	**6.04**	**6.49**	**6.64**	**6.64**	**6.52**	**5.98**	**5.98**	**6.04**	**5.70**	**5.61**	**5.41**

Source: Central Bank of Kenya

Chapter 3

Global Economy

Global economic activity in 2017 is estimated to have increased by 3.7 percent in 2017 from 3.2 percent in 2016 supported by a rebound in investment boosted by favorable financial conditions, rising profits, and improved business sentiment across both advanced economies and emerging market and developing economies. In addition, improving manufacturing and trade driven by the recovery in investment is expected to provide extra impetus to the global growth outlook. The upward trend is expected to continue in 2018, with growth projected at 3.9 percent **(Table 3.1)**.

Economic activity among the advanced economies is estimated to have improved to 2.3 in 2017 from 1.7 percent in 2016 reflecting strengthening business investment, private consumption and external demand. Building on his momentum, growth in 2018 is expected to stabilise at 2.3 percent. In the United States, growth is estimated at 2.3 percent in 2017 from 1.5 percent in 2016 and is projected to recover to 2.7 percent with the improvement attributed to growth in consumption and investment driven by buoyant asset prices and strong business and consumer confidence and the recent fiscal stimulus.

In the Euro Area, growth in many countries was driven by policy stimulus, strengthening global demand, rising employment, and reduced political uncertainty. In 2017, growth accelerated to 2.4 percent from 1.8 percent in 2016 and is forecast to moderate to 2.2 in 2018. However, growth in the United Kingdom is projected to slow down to 1.5 percent in 2018 from 1.7 percent in 2017 and 1.9 percent in 2016, reflecting the after-effects of the Brexit.

Output in Japan is estimated at 1.8 percent in 2017 from 0.9 percent in 2016. This momentum is attributed to the strengthening of global demand and policy actions to sustain private consumption. However, growth in 2018 is projected to weaken to 1.2 percent due to a cyclical slowdown in business fixed investment and the effects of the scheduled consumption tax hike.

Growth in emerging market and developing economies is estimated to have increased by 4.7 percent in 2017 compared with 4.4 percent in 2016 and is projected at 4.9 percent in 2018 with the sustained recovery premised on improvement in commodity prices and increased economic growth in commodity exporting economies. Economic activity in China increased to 6.8 percent in 2017 from 6.7 percent in 2016. Chinese growth is projected to slow down to 6.6 percent in 2018 on account of continued domestic rebalancing of the economy. Growth in India is also expected to slow down to 6.7 percent in 2017 from 7.1 percent in 2016 due to ongoing taxation and financial sector reforms.

In sub-Saharan Africa (SSA) growth picked up from 1.4 percent in 2016 to 2.7 percent in 2017 and is expected to rise further to 3.3 percent in 2018 driven largely by easing macroeconomic challenges, recovery in oil production in Nigeria, easing of drought conditions in Eastern and Southern Africa and improving external commodity demand. Nigeria's economy is estimated to have expanded by 0.8 percent in 2017 from a decline of 1.6 percent in 2016 as a result of recovery in oil production, improved output in the agricultural sector through the Central Bank of Nigeria (CBN'S) Anchor Borrowers' Programme, and higher public investment. In South Africa, growth is projected to pick up moderately in 2018-19 largely due to stronger activity among trading partners, which is expected to boot her exports. Investment will also support growth in 2019, hinged on increasing business confidence and decreasing policy uncertainty. Despite persistently high unemployment, private consumption will expand as wages increase moderately and food prices stabilize.

Table 3.1: **Global Economic Outlook**

REAL GDP GROWTH (%) YEAR OVER YEAR						
			Projections		Difference from October 2017 WEO	
Country/Region	**2016**	**2017**	**2018**	**2019**	**2018**	**2018**
World Output	**3.2**	**3.7**	**3.9**	**3.9**	**0.2**	**0.2**
Advanced economies	**1.7**	**2.3**	**2.3**	**2.2**	**0.3**	**0.4**
United States	1.5	2.3	2.7	2.5	0.4	0.6
Euro Area	1.8	2.4	2.2	2.0	0.3	0.3
Germany	1.9	2.5	2.3	2.0	0.5	0.5
France	1.2	1.8	1.9	1.9	0.1	0.0
Italy	0.9	1.6	1.4	1.1	0.3	0.2
Spain	3.3	3.1	2.4	2.1	-0.1	0.1
Japan	0.9	1.8	1.2	0.9	0.5	0.1
United Kingdom	1.9	1.7	1.5	1.5	0.0	-0.1
Emerging market and Developing economies	**4.4**	**4.7**	**4.9**	**5.0**	**0.0**	**0.0**
Russia	-0.2	1.8	1.7	1.5	0.1	0.0
China	6.7	6.8	6.6	6.4	0.1	0.1
India	7.1	6.7	7.4	7.8	0.0	0.0
Brazil	-3.5	1.1	1.9	2.1	0.4	0.1
Middle East, North Africa, Afghanistan and Pakistan	**4.9**	**2.5**	**3.6**	**3.5**	**0.1**	**0.0**

Source: IMF, World Economic Outlook (WEO), January 2018 update

Downside risks to global economic outlook

In spite of the positive outlook, risks at a global level are still high. Notably the tightening of global financing terms has implications for global asset prices and capital flows leaving economies with high gross debt refinancing needs and unhedged dollar liabilities. The rich asset valuations and very compressed term premiums also raise the possibility of financial market corrections, which could dampen growth and confidence.

Other notable risks include inward-looking policies, the policy stance of the US, geopolitical tensions and political uncertainty in some countries as well as the looming trade war between the US and other countries.

Chapter 4

Balance of Payments and Exchange Rates

Developments in the Balance of Payments

The current account deficit narrowed by 17.3 percent to USD 1,162 million in the fourth quarter of 2017 from USD 1, 405 million in the third quarter, driven by an improvement of the balance on goods and services; and the secondary income (i.e. recurrent transfers) (**Table 4.1**).

Table 4.1: Balance of Payments (USD Million)

ITEM	2017**							Q4 2017-Q3 2017	
	Jan-Mar	Apr-Jun	Jul-Sep	Q4			Total		%
	Q1	Q2	Q3	Oct	Nov	Dec	Q4	Change	Change
1. Overall Balance	**-814**	**-224**	**677**	**310**	**108**	**100**	**518**	**-159**	**-23.5**
2. Current account	**-1,193**	**-1,306**	**-1,405**	**-454**	**-357**	**-351**	**-1,162**	**243**	**-17.3**
Exports (fob)	1,470	1,453	1,413	479	496	484	1,459	**46**	**3.3**
Imports (fob)	3,979	3,977	4,211	1,389	1,300	1,337	4,026	**-185**	**-4.4**
Services: credit	1,270	1,238	1,318	411	427	471	1,309	**-10**	**-0.7**
Services: debit	783	863	887	290	273	277	840	**-47**	**-5.3**
Balance on goods and services	-2,023	-2,149	-2,366	-789	-651	-658	-2,098	**269**	**-11.4**
Primary income: credit	122	130	115	41	41	42	124	**8**	**7.2**
Primary income: debit	279	372	315	70	103	207	379	**64**	**20.5**
Balance on goods, services, and primary income	-2,180	-2,391	-2,566	-817	-713	-823	-2,353	**213**	**-8.3**
Secondary income : credit	1,000	1,123	1,173	368	360	478	1,206	**33**	**2.8**
o.w Remittances	433	455	495	186	175	204	565	**69**	**14.0**
Secondary income: debit	14	39	14	4	5	6	15	**1**	**6.4**
3. Capital Account	**96**	**39**	**14**	**30**	**43**	**30**	**102**	**88**	**605.7**
4. Financial Account	**-2,388**	**-1,267**	**-270**	**-482**	**-182**	**-371**	**-1,035**	**-765**	**283.9**

** Revised*
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Fob - free on board

Source: Central Bank of Kenya

The Current Account

During the fourth quarter of 2017, the trade balance improved by 11.4 percent to USD 2,098 million from USD 2,366 million in the third quarter of 2017 reflecting lower merchandise imports (mainly food) and an increase in merchandise exports **(Table 4.2).**

The value of merchandise exports increased by 3.3 percent to USD 1,459 million during the fourth quarter of 2017 mainly driven by increases in exports of raw materials, tea, horticulture, re-exports and other exports. The value of tea exports increased by 9.0 percent to USD 382 million supported by relatively higher tea prices in the international market. Horticulture exports increased by 4.0 percent to USD 210 million, attributed to increased export volumes of cut flowers. The value of merchandise imports declined by 4.4 percent to USD 4,026 million from USD 4,211 million, over the same period, largely on account of lower importation of food which decreased by 31.9 percent from USD 857 million to USD 584 million. Imports of chemicals, machinery and transport equipment also declined during the quarter. However, imports of oil and manufactured goods increased. The increase in imports of oil was occasioned by higher oil prices in the global market.

Net services recorded an improvement of 8.6 percent and increased to USD 469 million in the fourth quarter of 2017, mainly on account of lower payments during the period. Receipts from transport and travels also increased during the period, but the increase was offset by lower receipts from other services **(Table 4.2).**

The deficit in the primary income widened from USD 199 million in the third quarter of 2017 to USD 255 million in the fourth quarter of 2017, mainly on account of higher payments on foreign interest. On the other hand, the balance on secondary income marginally improved by USD 2.6 million to USD 1,191 million, on account of higher remittance inflows.

Direction of Trade

China remains Kenya's largest source of imports accounting for 21.4 percent of total imports in the fourth quarter of 2017. In value terms, Kenya's imports from China was USD 861 million, mainly in the form of machinery and transport equipment for the Standard Gauge Railway. Imports from the European Union accounted for 11.7 percent of total imports, however, it declined by 14.4 percent to USD 472 million in fourth quarter of 2017, mainly on account of reduced imports from Germany, France and the Netherlands. The share of imports from Africa increased to 13.3 percent in the fourth quarter from 12.5 percent in the third quarter of 2017, reflecting increased imports from both the EAC and COMESA. The share of imports from India also increased to 9.7 percent from 7.9 percent over the same period (**Table 4.3**).

Table 4.2: Balance on Current Account (USD Million)

ITEM	2017**							Q3 2017-Q2 2017	
	Jan-Mar	Apri-Jun	Jul-Sep	Q4			Total		%
	Q1	Q2	Q3	Oct	Nov	Dec	Q4	Change	Change
CURRENT ACCOUNT	**-1,193**	**-1,306**	**-1,405**	**-454**	**-357**	**-351**	**-1,162**	**243**	**-17.3**
Goods	**-2,509**	**-2,524**	**-2,798**	**-910**	**-804**	**-853**	**-2,567**	**231**	**-8.3**
Exports (fob)	**1,470**	**1,453**	**1,413**	**479**	**496**	**484**	**1,459**	**46**	**3.3**
o.w Coffee	67	81	47	11	16	8	34	-13	-26.9
Tea	345	347	351	127	123	132	382	32	9.0
Horticulture	205	213	201	72	69	68	210	8	4.0
Oil products	13	14	12	4	5	4	12	0	2.0
Manufactured Goods	98	94	102	29	36	33	98	-4	-3.9
Raw Materials	142	133	115	50	41	44	135	20	17.4
Chemicals and Related Products (n.e.s)	100	98	110	29	37	34	100	-10	-9.2
Miscelleneous Man. Articles	147	134	157	37	49	48	133	-24	-15.1
Re-exports	153	185	143	57	55	46	158	15	10.4
Other	199	155	175	63	66	68	197	22	12.5
Imports (fob)	**3,979**	**3,977**	**4,211**	**1,389**	**1,300**	**1,337**	**4,026**	**-185**	**-4.4**
o.w Oil	636	651	667	238	277	259	774	106	15.9
Chemicals	621	561	563	202	169	186	557	-6	-1.1
Manufactured Goods	619	671	615	213	209	197	619	5	0.7
Machinery & Transport Equipment	1,329	1,179	1,106	423	309	334	1,066	-40	-3.6
Machinery	857	764	728	210	187	219	616	-111	-15.3
Transport equipment	471	415	378	213	122	115	449	71	18.9
Other								0.0	#DIV/0!
o.w Food	371	556	850	196	186	202.1	584	-273.4	-31.9
Services	**487**	**375**	**432**	**121**	**153**	**194**	**469**	**37**	**8.6**
Transport Services (net)	**200**	**204**	**226**	**90**	**92**	**152**	**335**	**108**	**48.0**
Credit	440	459	504	175	172	235	581	77	15.3
Debit	241	255	278	84	79	83	247	-32	-11.3
Travel Services (net)	**199**	**162**	**151**	**51**	**56**	**45**	**152**	**1**	**0.7**
Credit	262	227	216	73	78	70	221	5	2.3
Debit	62	65	65	23	22	25	69	4	6.0
Other Services (net)	**87**	**8**	**55**	**-19**	**5**	**-3**	**-17**	**-72**	**-131.3**
Primary Income	**-157**	**-242**	**-199**	**-29**	**-62**	**-165**	**-255**	**-56**	**28.1**
Credit	122	130	115	41	41	42	124	8	7.2
Debit	279	372	315	70	103	207	379	64	20.5
Secondary Income	**987**	**1,085**	**1,161**	**364**	**356**	**472**	**1,191**	**30**	**2.6**
Credit	1,000	1,123	1,173	368	360	478	1,206	33	2.8
Debit	14	39	12	4	5	6	15	3	27.3

** Revised*

***Provisional*

Fob - free on board

Source: Central Bank of Kenya

Table 4.3: Kenya's Direction of Trade: Imports

IMPORTS (USD M)									Share of Imports (%)	
	2017				2017					
	Oct-Dec	Jan-Mar	Apri-Jun	Jul-Sep	Q4					
Country	**Q4**	**Q1**	**Q2**	**Q3**	**Oct**	**Nov**	**Dec**	**Q4**	**Q3 2017**	**Q4 2017**
Africa	**397**	**401**	**475**	**526**	**149**	**199**	**189**	**537**	**12.5**	**13.3**
Of which										
South Africa	129	136	166	165	47	44	41	132	3.9	3.3
Egypt	89	89	76	91	23	35	28	86	2.2	2.1
Others	179	177	234	270	78	119	121	319	6.4	7.9
									0.0	
EAC	**102**	**106**	**126**	**139**	**44**	**93**	**81**	**218**	**3.3**	**5.4**
COMESA	**222**	**211**	**258**	**299**	**86**	**133**	**128**	**347**	**7.1**	**8.6**
Rest of the World	**3,101**	**3,578**	**3,501**	**3,685**	**1,240**	**1,101**	**1,148**	**3,489**	**87.5**	**86.7**
Of which										
India	503	463	466	331	126	145	117	389	7.9	9.7
United Arab Emirates	210	222	284	471	82	130	150	362	11.2	9.0
China	872	1,098	962	855	386	239	237	861	20.3	21.4
Japan	191	183	211	189	73	58	77	207	4.5	5.1
USA	97	140	156	130	33	48	49	129	3.1	3.2
United Kingdom	89	71	73	71	21	25	30	76	1.7	1.9
Singapore	13	21	8	7	10	7	2	20	0.2	0.5
Germany	99	85	104	132	37	27	31	95	3.1	2.4
Saudi Arabia	224	352	225	194	147	101	89	337	4.6	8.4
Indonesia	109	153	123	157	25	46	46	116	3.7	2.9
Netherlands	45	37	38	71	10	17	16	43	1.7	1.1
France	48	56	84	68	16	17	19	51	1.6	1.3
Bahrain	43	24	26	16	8	3	8	19	0.4	0.5
Italy	68	62	52	58	14	12	18	44	1.4	1.1
Others	489	611	689	936	253	227	258	738	22.2	18.3
Total	**3,498**	**3,979**	**3,977**	**4,211**	**1,389**	**1,300**	**1,337**	**4,026**	**100.0**	**100.0**
EU	491	444	517	552	147	154	172	472	13.1	11.7
China	872	1,098	962	855	386	239	237	861	20.3	21.4

Source: Kenya Revenue Authority

The share of exports to Africa dropped marginally to 37.2 percent in the fourth quarter of 2017 from 38.4 percent in the third quarter of 2017 **(Table 4.4).** The decline reflected lower exports to the EAC (Uganda and Rwanda) and COMESA region, with the decline attributed to reduced exports of chemicals and manufactured goods. Exports to the rest of the world, however, increased by 5.3 percent. The share of exports to China increased to 1.2 percent during the fourth quarter of 2017, while that to the European Union decreased marginally to 19.8 percent during the fourth quarter of 2017 from 19.9 percent during the third quarter of 2017.

Table 4.4: Kenya's Direction of Trade: Exports

EXPORTS (USD M)									Share of Exports (%)	
	2017				2017					
	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Q4					
Country	**Q4**	**Q1**	**Q2**	**Q3**	**Oct**	**Nov**	**Dec**	**Q4**	**Q3 2017**	**Q4 2017**
Africa	**557**	**564**	**516**	**543**	**164**	**191**	**187**	**543**	**38.4**	**37.2**
Of which										
Uganda	155	163	140	151	39	54	51	144	**10.7**	**9.9**
Tanzania	82	75	53	73	25	28	22	75	**5.1**	**5.1**
Egypt	35	42	35	47	13	21	25	60	**3.3**	**4.1**
Sudan	13	13	17	14	12	6	6	23	**1.0**	**1.6**
South Sudan	40	45	47	35	6	15	14	35	**2.5**	**2.4**
Somalia	53	58	46	44	14	14	15	42	**3.1**	**2.9**
DRC	51	48	45	44	17	11	18	46	**3.1**	**3.2**
Rwanda	44	37	41	48	14	13	12	39	**3.4**	**2.7**
Others	83	82	93	88	24	29	25	78	**6.2**	**5.3**
EAC	**298**	**293**	**257**	**290**	**82**	**100**	**89**	**271**	**20.5**	**18.6**
COMESA	**359**	**364**	**349**	**368**	**111**	**128**	**129**	**367**	**26.0**	**25.2**
Rest of the World	**813**	**906**	**937**	**870**	**315**	**305**	**297**	**917**	**61.6**	**62.8**
Of which									**0.0**	
United Kingdom	85	97	88	93	34	29	31	95	**6.6**	**6.5**
Netherlands	99	119	111	89	33	35	36	104	**6.3**	**7.2**
USA	109	105	121	127	35	37	32	105	**9.0**	**7.2**
Pakistan	124	151	146	152	56	57	57	170	**10.8**	**11.7**
United Arab Emirates	63	52	78	56	27	19	23	69	**4.0**	**4.7**
Germany	27	33	34	21	8	10	7	25	**1.5**	**1.7**
India	18	16	13	14	4	6	5	14	**1.0**	**1.0**
Afghanistan	4	7	11	9	2	1	2	4	**0.6**	**0.3**
Others	285	325	334	310	116	111	104	330	**21.9**	**22.6**
Total	**1,370**	**1,470**	**1,453**	**1,413**	**479**	**496**	**484**	**1,459**	**100.0**	**100.0**
EU	280	334	307	281	95	97	97	289	**19.9**	**19.8**
China	31	24	39	15	7	7	3	18	**1.1**	**1.2**

Source: Kenya Revenue Authority

Capital and Financial Account

The capital account recorded an improvement of USD 88 million to USD 102 million in the fourth quarter of 2017, reflecting an increase in project grants.

Meanwhile, the financial account recorded higher net inflows of USD 765 million to USD 1,035 million in the fourth quarter of 2017, mainly due to increase in net incurrence of other investment liabilities following higher uptake of loans by government, mostly in the form of project and commercial loans **(Table 4.5)**. Loans to government increased by USD 402 million, to USD 474 million in the fourth quarter of 2017. Direct investment to Kenya declined by USD 17 million to USD 119 million, while portfolio investment declined to USD 8 million from USD 4 million over the review period. The reduced inward direct investment and portfolio investment was mainly attributed to the prolonged electioneering period as investors adopted a wait and see attitude.

Table 4.5: Balance on Capital and Financial Account (USD Million)

ITEM	2017**							Q4 2017-Q3 2017	
	Jan-Mar	Apr-Jun	Jul-Sep	Q4			Total		%
	Q1	Q2	Q3	Oct	Nov	Dec	Q4	Change	Change
Capital account credit	**96**	**39**	**14**	**30**	**43**	**30**	**102**	**88**	**606**
Capital account credit	96	39	14	30	43	30	102	88	606
Capital account: debit									
Financial Account	**-2,122**	**-1,267**	**-270**	**-482**	**-182**	**-371**	**-1,035**	**-765**	**284**
Direct investment: assets	59	82	33	5	7	9	21	-13	-38
Direct investment: liabilities	156	134	136	38	26	55	119	-17	-12
Portfolio investment: assets	227	254	268	88	77	57	222	-47	-17
Portfolio investment: liabilities	6	4	9	3	2	3	8	-1	-14
Financial derivatives: net									
Other investment: assets	406	11	41	-73	-70	35	-108	-149	-363
Other investment: liabilities	2,652	1,476	467	-73	-70	35	-108	-575	-123

***Provisional*

Source: Central Bank of Kenya

Foreign Exchange Reserves

The banking system's total foreign exchange holdings decreased by 4.9 percent during the fourth quarter of 2017, while the official reserves declined by 7.1 percent over the same period. The official reserves held by the Central Bank constituted 76 percent of gross reserves and stood at USD 7,338 million, equivalent to 4.9 months of import cover **(Table 4.6)**.

Table 4.6: Foreign Exchange Reserves and Residents' Foreign Currency Deposits (End of Period, USD Million)

`	2017						
	Jan-Mar	Apri-Jun	Jul-Sep				
	Q1	Q2	Q3	Oct	Nov	Dec	Q4
1. Gross Reserves	**10,786**	**10,984**	**10,332**	**9,698**	**9,649**	**9,652**	**9,652**
of which:							
Official	8,379	8,580	7,899	7,341	7,367	7,338	7,338
*import cover**	*5.5*	*5.7*	*5.3*	*4.9*	*4.9*	*4.9*	*4.9*
Commercial Banks	2,407	2,405	2,433	2,357	2,283	2,314	2,314
2. Residents' foreign currency deposits	**4,503**	**4,733**	**5,021**	**4,870**	**5,112**	**4,949**	**4,949**

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

Source: Central Bank of Kenya

Exchange Rates

The foreign exchange market remained relatively steady during the fourth quarter of 2017, which was largely supported by resilient inflows from diaspora remittances and receipts from tourism, tea and horticulture exports. The Kenya Shilling strengthened marginally by 0.16 percent against the US Dollar to exchange at an average of KSh103.35/USD during the fourth quarter compared with KSh103.52/ USD in the third quarter of 2017. The Kenya Shilling also strengthened against the Japanese Yen but weakened against the Pound Sterling and the Euro. In the EAC region, the Kenya Shilling strengthened against all the currencies during the period under review (**Table 4.7 and Chart 4.1**).

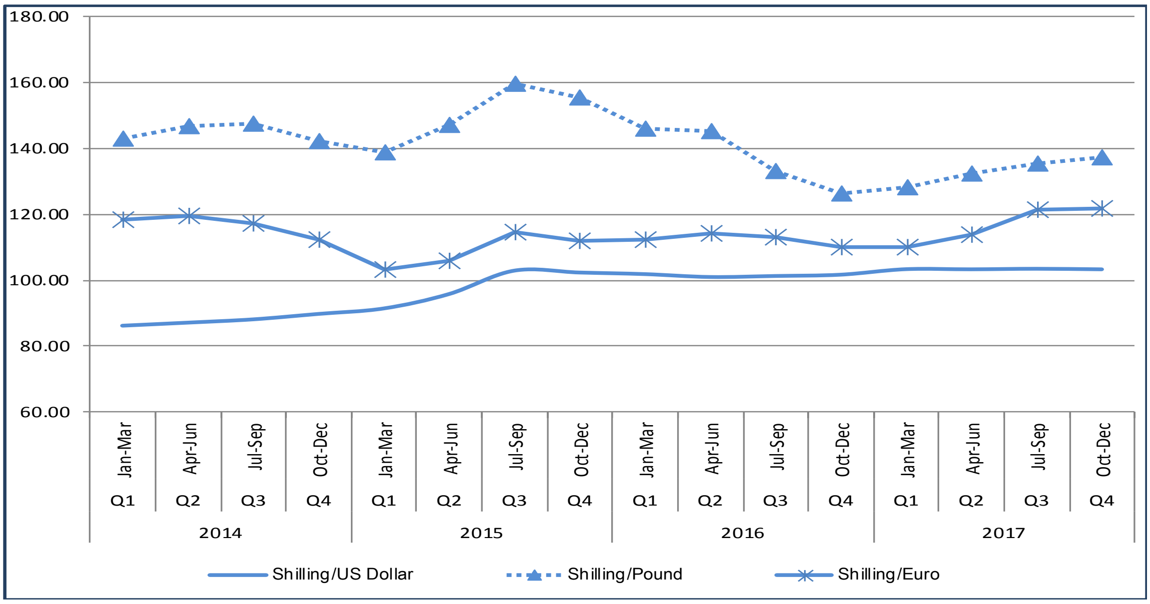
Table 4.7: Kenya Shilling Exchange Rate

	2017			2017			2017	
	Q1	Q2	Q3	Oct	Nov	Dec	Q4	% change Q4 2017 - Q3 2017
US Dollar	**103.39**	**103.36**	**103.52**	103.39	103.57	103.10	**103.35**	**-0.16**
Pound Sterling	**128.05**	**132.22**	**135.40**	136.44	136.78	138.24	**137.15**	**1.30**
Euro	**110.12**	**113.75**	**121.50**	121.59	121.42	121.97	**121.66**	**0.13**
100 Japanese Yen	**90.95**	**92.98**	**93.28**	91.70	91.77	91.31	**91.60**	**-1.80**
Uganda Shilling*	**34.79**	**34.94**	**34.80**	35.16	35.14	35.14	**35.15**	**1.00**
Tanzania Shilling*	**21.57**	**21.63**	**21.64**	21.71	21.66	21.73	**21.70**	**0.28**
Rwanda Franc*	**7.99**	**8.04**	**8.02**	8.09	8.16	8.22	**8.16**	**1.77**
Burundi Franc*	**16.35**	**16.56**	**16.79**	16.94	16.95	17.08	**16.99**	**1.19**

** Units of currency per Kenya Shilling*

Source: Central Bank of Kenya

Chart 4.1: Kenya Shilling Exchange Rate



Source: Central Bank of Kenya

Chapter 5
The Banking Sector

1. Introduction

The Kenyan banking sector comprised 42 commercial banks[1], 1 mortgage Finance Company, 13 microfinance banks, 8 representative offices of foreign banks, 74 foreign exchange bureaus, 18 money remittance providers and 3 Credit Reference bureaus as at December 31, 2017, **Chart 5.1.**

2. Structure of the Balance Sheet

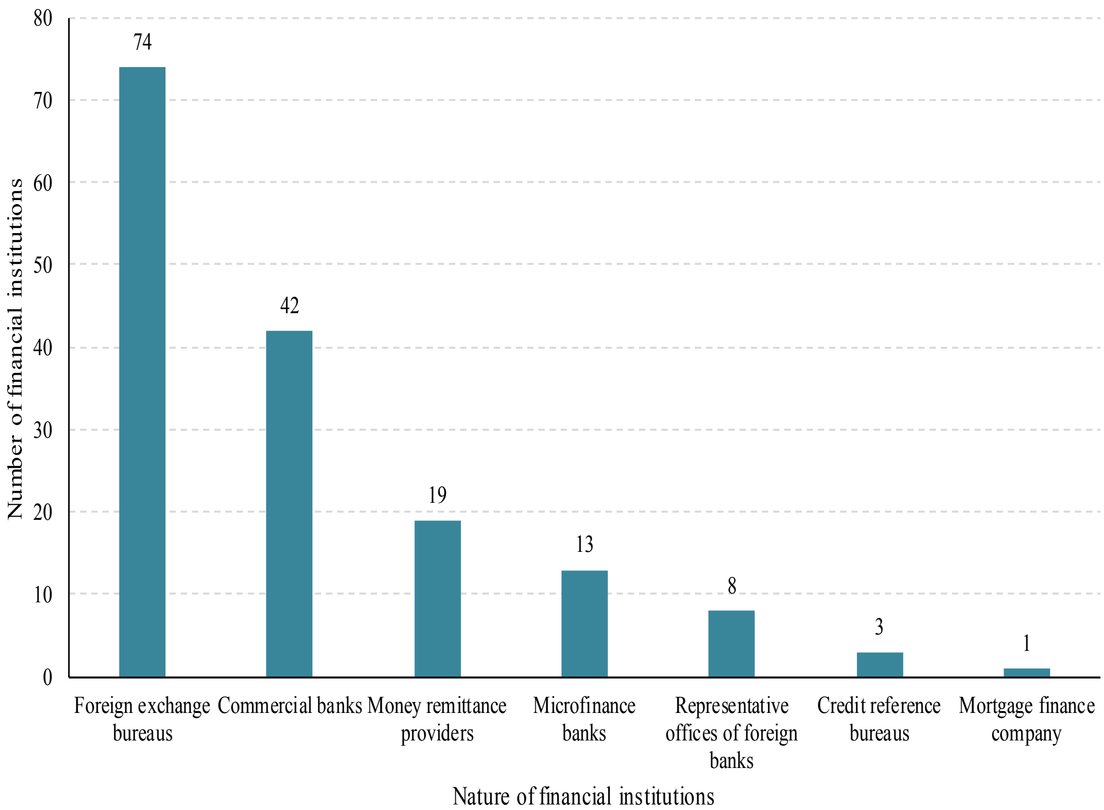
i) Growth in banking sector assets

Total net assets increased by 0.4 percent from KSh 4,035.0 billion in the third quarter of 2017 to KSh 4,051.8 billion in the fourth quarter of 2017. Asset categories that recorded increases included investment in government securities (3.6 percent), and loans and advances (2.6 percent). Meanwhile, loans and advances remained the main component of assets, accounting for 57.1 percent in the fourth quarter of 2017, a slight increase from 55.9 percent recorded in the third quarter of 2017.

ii) Loans and Advances

Total banking sector lending increased by 2.6 percent, from KSh 2,390.4 billion in the third quarter of 2017 to KSh 2,452.7 billion in the fourth quarter of 2017. The increase in gross loans and advances was largely witnessed in the Manufacturing, Real Estate, Trade, Personal/ Household, Energy and Water, and Building and Construction sectors. The gross loans of the banking sector as at December 31, 2017 are highlighted in **Chart 5.2.**

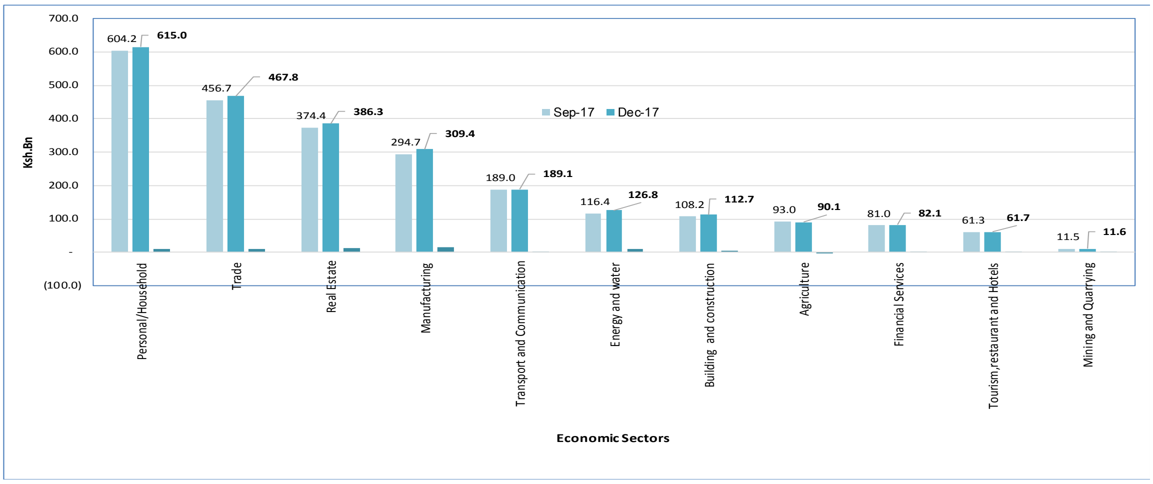
Chart 5.1: Structure of the Banking Sector in Kenya



Source: Central Bank of Kenya

[1] Charterhouse Bank is under Statutory Management, while Chase Bank Limited and Imperial Bank are in Receivership. The three banks have been excluded in this report.

Chart 5.2: Gross Loans of the Banking Sector by Economic Sector



Source: Central Bank of Kenya

The Manufacturing sector recorded the highest increase in lending by KSh 14.8 billion (5.0 percent) followed by the Real Estate sector which recorded an increase of KSh 11.9 billion (3.2 percent) and the Trade sector with an increase of KSh 11.2 billion (2.5 percent) between the third and fourth quarters of 2017. The Agriculture sector recorded a decreased lending of KSh 3.0 billion (3.2 percent) during the period under review due to higher repayments **(Chart 5.3)**.

iii) Deposit Liabilities

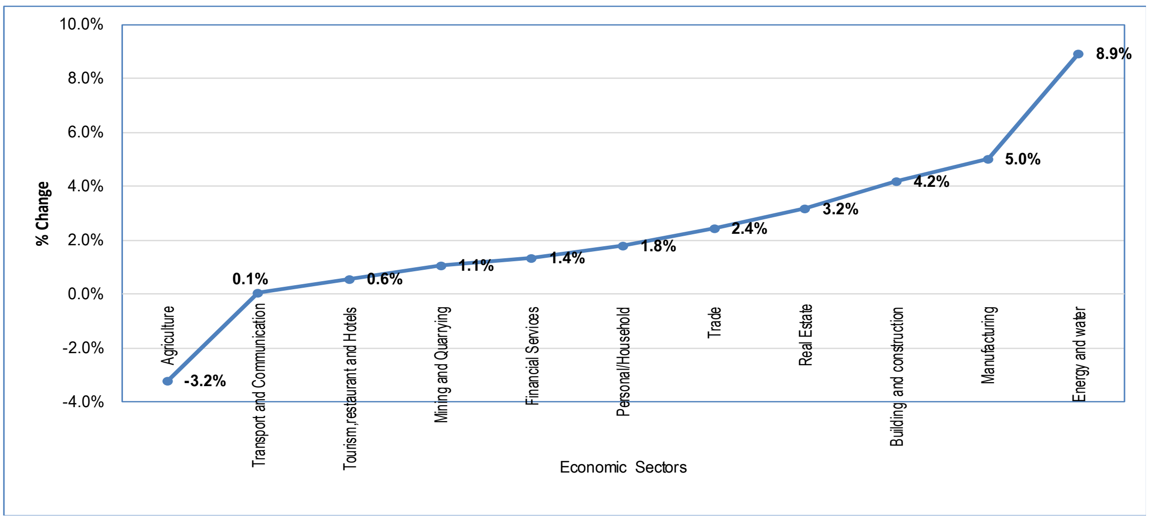
Customer deposits remained the main source of funding to the banks and accounted for 72.7 percent of the banking sector total liabilities and shareholders' funds as at the end of the fourth quarter of 2017. This was an increase from 71.9 percent recorded as at end of the third quarter of 2017. The customer deposit base increased by 1.7 percent from KSh 2,898.5 billion in the third quarter of 2017 to KSh 2,946.7 billion in the fourth quarter of 2017 **(Chart 5.4).**

3. Capital Adequacy

Kenya's banking sector was well capitalized and met the minimum capital requirements. The sector's capital adequacy ratios remained above the minimum capital regulatory ratios of core capital and total capital to total risk weighted assets of 10.5 percent and 14.5 percent, respectively.

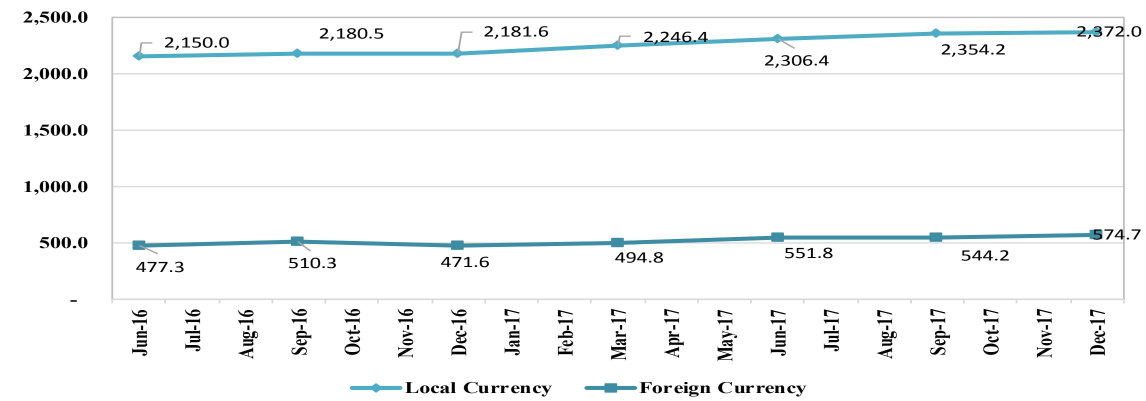
Core capital increased slightly by 1.3 percent

Chart 5.3: Quarterly Changes in Gross Loans in the Fourth Quarter of 2017



Source: Central Bank of Kenya

Chart 5.4 **Customer Deposits (Ksh Billion)**



Source: Central Bank of Kenya

from KSh 532.7 billion in third quarter of 2017 to KSh 539.6 billion in the fourth quarter. In additional, total capital increased slightly by 0.8 percent from KSh 616.0 billion to KSh 620.9 billion over the same period.

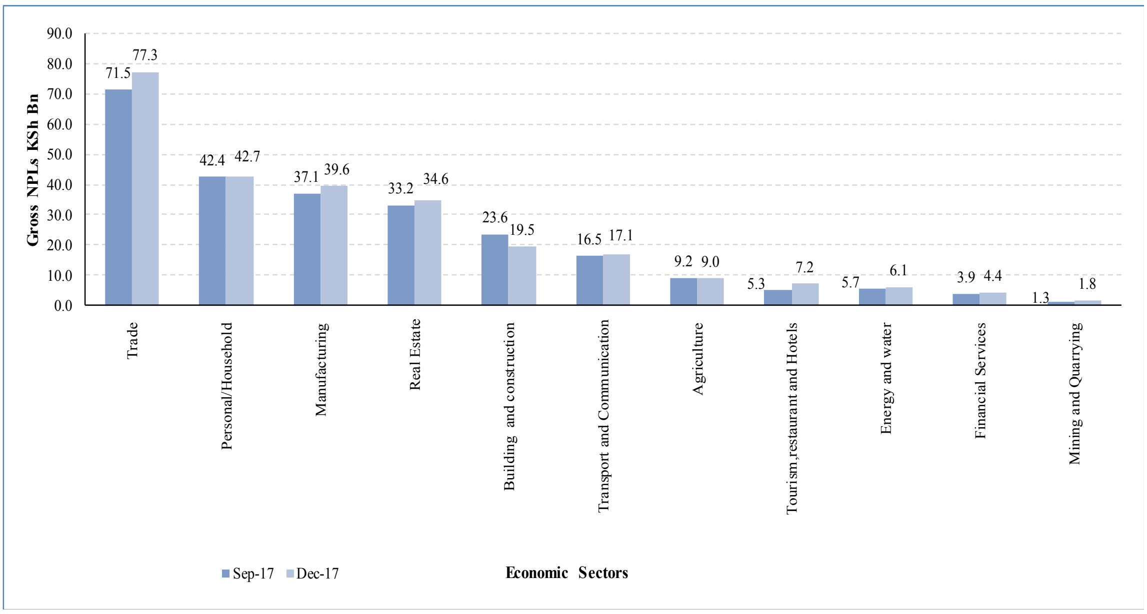
Core capital to total risk-weighted assets ratio decreased from 16.2 percent in the third quarter of 2017 to 16.0 percent in the fourth quarter of 2017. Total capital to total risk-weighted assets ratio decreased from 18.8 percent to 18.5 percent over the same period. The decline was due to a relatively larger increase in the total risk weighted assets (2.5 percent) compared to the increase in total capital (0.8 percent) and core capital (1.3 percent) in the fourth quarter of 2017.

The minimum core capital to total deposits ratio is set at 8 percent. Commercial banks maintained an adequate buffer, with the ratio standing at 18.3 percent in the fourth quarter compared to 18.4 percent in the third quarter of 2017. Total deposits increased by KSh 48.3 billion (1.7 percent) and core capital increased by KSh 6.8 billion (1.3 percent).

4. Asset Quality

The gross non-performing loans (NPLs) increased by 2.1 percent from KSh 249.7 billion as at the end of the third quarter of 2017 to KSh 259.2 billion at the end of the fourth quarter. The increase was spread across most sectors as highlighted in **Chart 5.5**.

Chart 5.5: **Kenyan Banking Sector Gross Non-Performing Loans**

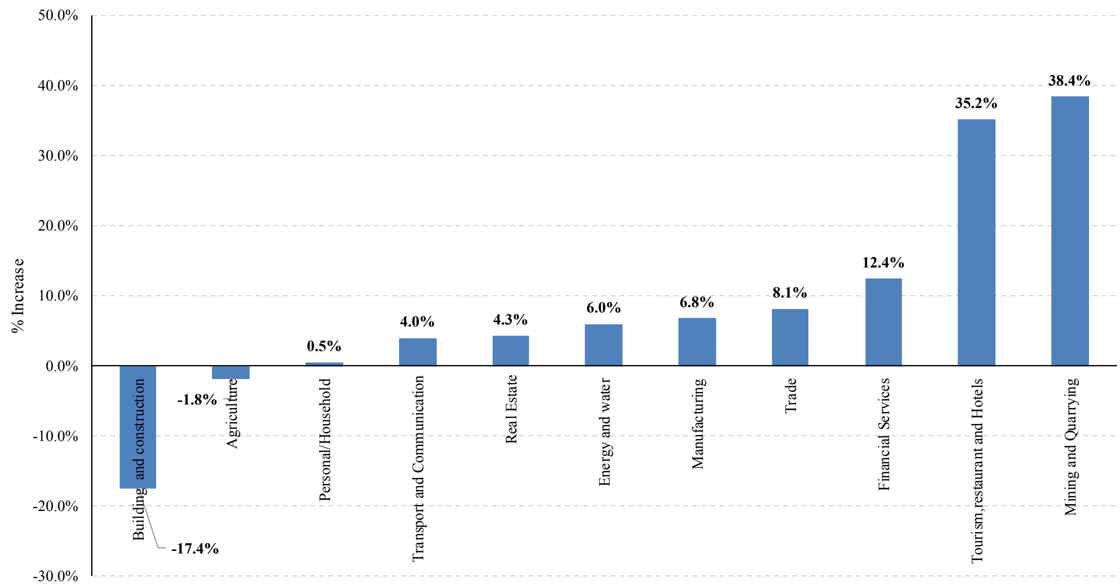


Source: Central Bank of Kenya

The Trade sector registered the highest increase in NPLs by KSh 5.8 billion (8.1 percent) due to slow down in business which led to delayed and partial loan re-payments. The Manufacturing sector registered an increase in NPLs of KSh 2.5 billion (6.8 percent) in the fourth quarter of 2017. This was attributed to delayed payments as a result of a challenging business environment. The gross NPLs to gross loans ratio increased from 10.4 percent in the third quarter of 2017 to 10.6 percent in the fourth quarter of 2017. **Chart 5.6** highlights the sectoral distribution of gross NPLs.

The banking sector's asset quality, as measured by the proportion of net non-performing loans to gross loans, deteriorated slightly from 5.6 percent in the third quarter of 2017 to 5.7 percent in the fourth quarter of 2017. The coverage ratio, which is measured as a percentage of specific provisions to total NPLs, was stable at 34.5 percent in third quarter and fourth quarters of 2017.

Chart 5.6: Movement in Gross NPLs - in the Fourth Quarter of 2017



Source: Central Bank of Kenya

5. Profitability

The banking sector recorded growth in pre-tax profits KSh 6.9 billion (23.6 percent) from KSh 29.6 billion in the third quarter of 2017 to KSh 36.5 billion in the fourth quarter of 2017. The growth in profitability was mainly attributed to increased interest on government securities by 30.2 percent and loans and advances by 29.2 percent, in the fourth quarter of 2017. Supporting growth in profits, total income increased by 25.5 percent, from KSh 109.6 billion in the third quarter to KSh 137.6 billion in the fourth quarter of 2017.

Total expenses increased by 26.2 percent from KSh 80.0 billion in the third quarter to KSh 101.0 billion in the fourth quarter of 2017. The increase in expenses was largely attributable to interest on deposits and bad debts charge which increased by 32.8 percent and 21.4 percent, respectively in the fourth quarter of 2017.

Interest income on loans and advances, interest on government securities and other incomes were the major sources of income accounting for 54.5 percent, 21.3 percent and 17.5 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 31.0 percent, 25.3 percent and 22.5 percent of total expenses respectively.

The return on assets (ROA) remained constant at 2.7 percent in the third quarter and fourth quarter of 2017. Return on equity (ROE) decreased from 21.2 percent in the third quarter of 2017 to 20.8 percent in the fourth quarter of 2017 due to a higher increase in shareholders' funds as compared to the increase in profitability.

Table 5.1: **Summary of Asset Quality**

		September 2017, KSh'Billion	December 2017, KSh'Billion
1	Gross Loans and Advances (KSh'Bn)	2,390.4	2,452.7
2	Interest in Suspense (KSh'Bn)	43.6	44.3
3	Loans and advances (net of interest suspended) (KSh'Bn)	2,346.8	2,408.4
4	Gross non-performing loans (KSh'Bn)	249.7	259.2
5	Specific Provisions (KSh'Bn)	71.2	74.1
6	General Provisions (KSh'Bn)	21.3	19.5
7	Total Provisions (5+6) (KSh'Bn)	92.5	93.6
8	Net Advances (3-7) (KSh'Bn)	2,254.4	2,314.8
9	Total Non-Performing Loans and Advances (4-2) (KSh'Bn)	206.1	214.9
10	Net Non-Performing Loans and Advances (9-5) (KSh'Bn)	134.9	140.9
11	Total NPLs as percent of Total Advances (9/3)	0.09	0.09
12	Net NPLs as percent of Gross Advances (10/1)	0.06	0.06
13	Specific Provisions as percent of Total NPLs (5/9)	0.35	0.35

Source: Central Bank of Kenya

6. Liquidity

The banking sector's overall liquidity ratio decreased from 45.4 percent in the third quarter of 2017 to 43.7 percent recorded in the fourth quarter of 2017. The banking sector liquidity ratio remained above the minimum statutory level of 20 percent.

7. Outlook of the Sector

The banking sector is projected to remain stable and maintain an upward growth trend in the near term. Credit risk and liquidity risk are expected to remain elevated in the short to medium term.

KENYA SHILLING FLOWS IN KEPSS

Kenya Electronic Payments and Settlement System (KEPSS) used for large value Real Time Gross Settlement (RTGS) payments moved a volume of 1.14 million transaction messages worth KSh 7.6 trillion in the fourth quarter of 2017, compared to the third quarter of 2017 which recorded 1.03 million transactions worth KSh 7.4 trillion. The volume and value increased by 2.29 percent and 9.69 per cent, respectively. **Chart 5.7** below highlights recent trends in KEPSS transactions.

Bank Customer Payments Processed through KEPSS

In transmitting payments through the RTGS for customers, commercial banks submit the payment instructions 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.

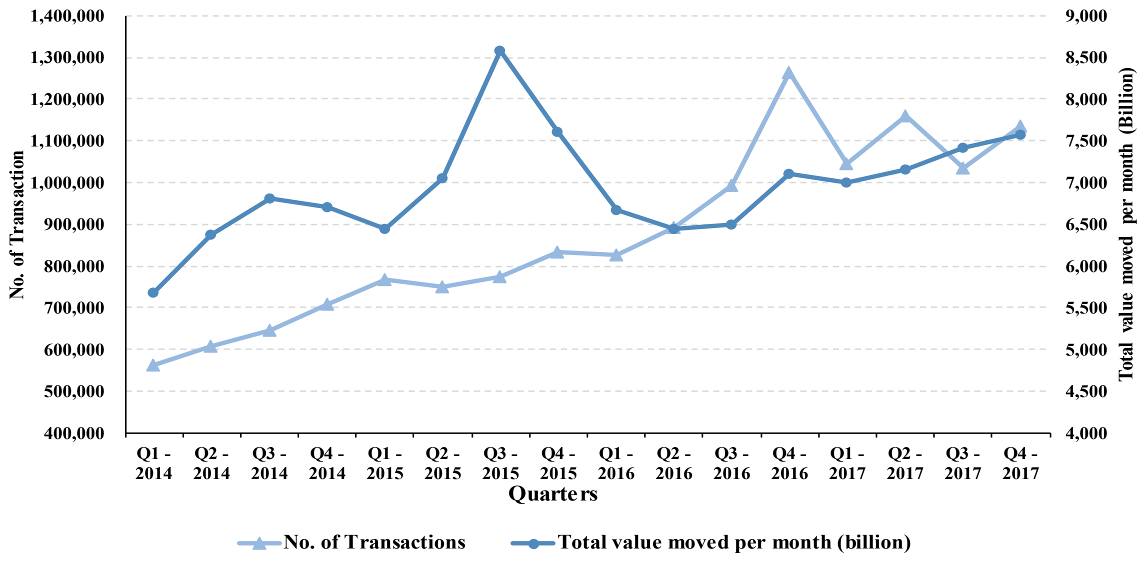
During the period under review, MT 102 usage increased by 23.58 per cent, to 32,940 messages recorded in the fourth quarter of 2017 from 26,654 messages processed in the previous quarter. The MT 103 payments increased by 0.91 per cent, to 1,062,433 messages in the fourth quarter of 2017 from 1,052,828 messages in the previous quarter **(Chart 5.8)**.

System Availability

The KEPSS system is available for use 8 hours per day from 8.30 a.m to 4.30 p.m. However, the operating time can be extended to enable participants settle their obligations and fund their accounts.

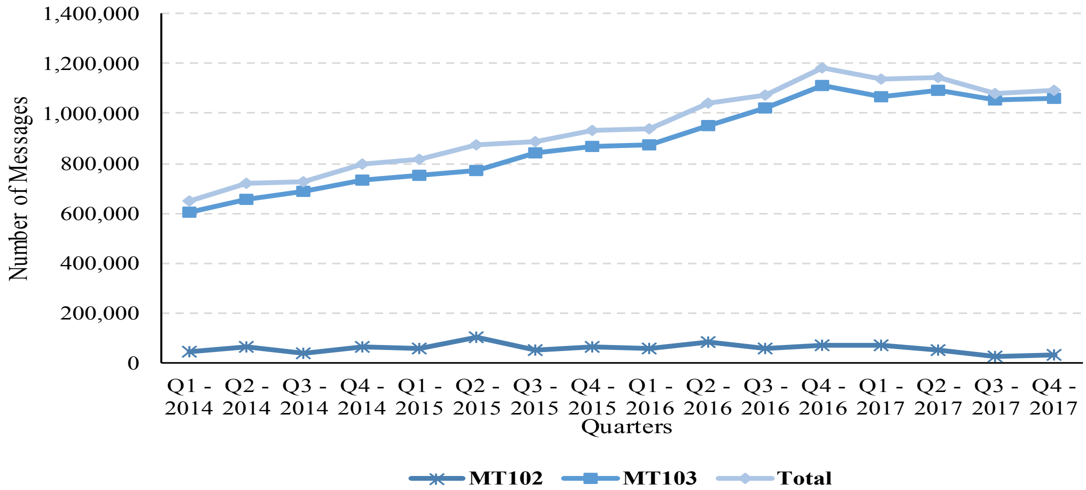
During the quarter under review, KEPSS availability maintained an average 99.98 percent.

Chart 5.7: **Trends in Monthly Flows Through KEPSS**



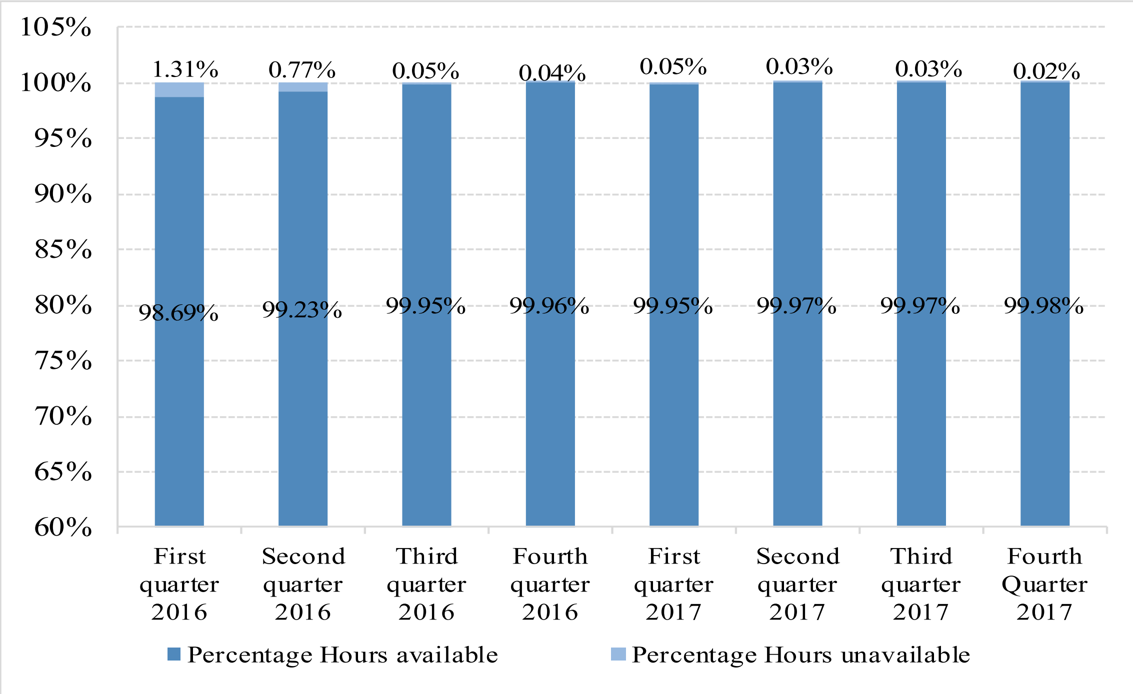
Source: Central Bank of Kenya

Chart 5.8: **Trends in MT102 and MT103 Volumes Processed Through KEPSS**



Source: Central Bank of Kenya

Chart 5.9: **Availability of KEPSS in Kenya (%)**



Source: Central Bank of Kenya

Chapter 6

Government Budgetary Performance

The Government's budgetary operations in the second quarter of FY 2017/18 resulted in a deficit of 1.6 per cent of GDP which was within the target of 2.5 percent of GDP **(Table 6.1).** Both revenues and expenditures were below their targets for the quarter with the shortfall in total revenues and grants at 10.6 per cent and that in total expenses and net lending at 9.7 percent.

Table 6.1: Statement of Government Operations in FY 2017/18 (KSh Billion)

	(FY 2017/18)										Over (+) /	%
	July	Aug	Sept	Q1	Oct	Nov	Dec	Q2	Cumulative to Dec' 2017	Target	Below (-) Target	Variance
1. TOTAL REVENUE & GRANTS	**95.5**	**110.2**	**145.4**	**347.2**	**101.6**	**119.6**	**152.7**	**373.9**	**721.0**	**806.6**	**(85.63)**	**(10.62)**
Ordinary Revenue	**87.9**	**101.8**	**131.2**	**320.9**	**91.1**	**105.0**	**139.8**	**336.0**	**656.9**	**705.3**	**(48.37)**	
Tax Revenue	87.8	100.0	129.7	317.4	87.8	103.5	121.7	313.0	630.4	680.4	(50.05)	
Non Tax Revenue	0.1	1.8	1.6	3.5	3.3	1.5	18.2	23.0	26.5	24.8	1.68	
Appropriations-in-Aid	7.5	6.8	9.6	24.6	7.4	9.3	8.0	24.7	49.3	76.0	**(26.67)**	
External Grants	0.1	1.6	4.6	1.6	3.1	5.3	4.9	13.2	14.8	25.4	**(10.59)**	
2. TOTAL EXPENSES & NET LENDING	**84.0**	**145.5**	**147.0**	**412.3**	**137.3**	**170.6**	**208.8**	**516.7**	**929.0**	**1,029.3**	**(100.29)**	**(9.74)**
Recurrent Expenses	69.5	117.9	109.8	299.9	91.3	119.0	124.3	334.6	634.5	616.2	**18.27**	
Development Expenses	5.7	18.5	33.4	90.7	31.1	21.5	66.5	119.1	209.8	262.0	**(52.25)**	
County Transfers	8.8	9.1	2.5	20.4	14.9	30.1	19.2	64.2	84.7	148.5	**(63.82)**	
Others	-	-	**1.3**	1.3	-	-	-	-	-	2.5	**(2.50)**	
3. DEFICIT (INCL. GRANTS) (1-2)	**11.5**	**(35.3)**	**(1.6)**	**(65.1)**	**(35.7)**	**(51.0)**	**(56.1)**	**(142.8)**	**(208.0)**	**(222.6)**	**14.66**	**(6.58)**
As percent of GDP	0.1	(0.4)	(0.0)	(0.7)	(0.4)	(0.6)	(0.6)	(1.6)	(2.4)	(2.5)	0.17	
4. ADJUSTMENT TO CASH BASIS	-	-	-	7.96				-			-	
5. DEFICIT INCL .GRANTS ON A CASH BASIS	**11.5**	**(35.3)**	**(1.6)**	**(57.2)**	**(35.7)**	**(51.0)**	**(56.1)**	**(142.8)**	**(208.0)**	**(222.6)**	**14.66**	
As percent of GDP	0.1	(0.4)	(0.0)	(0.6)	(0.4)	(0.6)	(0.6)	(1.6)	(2.4)	(2.5)	0.17	
6. DISCREPANCY: Expenditure (+) / Revenue (-)	-	-	-	-				-			-	
7. FINANCING	**1,801.7**	**(1,760.2)**	**3.6**	**57.2**	**65.1**	**41.8**	**36.3**	**143.2**	**200.3**	**291.7**	**(91.36)**	**(31.32)**
Domestic (Net)	1,801.8	(1,761.4)	1.8	49.2	27.6	37.1	(6.8)	57.9	107.1	229.0	(121.9)	
External (Net)	(3.9)	4.5	1.8	7.5	37.5	4.7	42.0	84.2	91.6	61.5	30.2	
Capital Receipts (domestic loan receipts)	-	-	-	-	-	-	1.0	1.0	1.6	1.3	0.3	
Others	**3.8**	**(3.3)**	-	0.5	-	-	-	-	-	-	-	

GDP figures from the Budget Review and Outlook Paper (BROP)-September 2017

Sources: Provisional Budget Outturn from The National Treasury (as at Dec 2017)

Revenue

The Government receipts, comprising revenue and grants grew by 7.7 percent to KSh 373.9 billion in the second quarter of FY 2017/18, from KSh 347.2 billion in the first quarter of the FY 2017/18. The improvement was mainly in external grants which increased to KSh 13.2 billion compared to KSh 1.6 billion recorded in the first quarter of the fiscal year. Tax revenue collection, declined slightly by 1.4 percent to KSh 313.0 billion in the second quarter of the FY 2017/18 from KSh 317.4 billion in the first quarter of FY 2017/18.

Ministerial Appropriations in Aid (A-in-A) collected in the second quarter of the FY 2017/18 was largely unchanged at KSh 24.7 billion compared to KSh 24.6 billion collected in the first quarter.

The composition of revenues did not change much between the first quarter and the second quarter of FY 2017/18 **(Chart 6.1).**

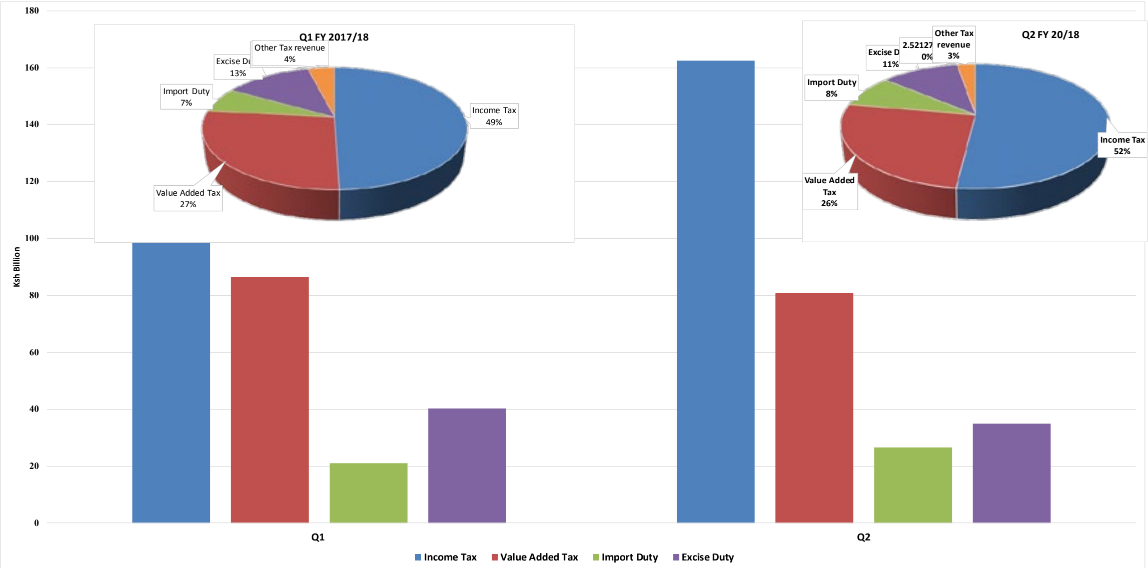
Cumulatively, the Government receipts, were KSh 721.0 billion (8.2 percent of GDP) in the first half of FY2017/18 against a target of KSh 806.6 billion (9.2 percent of GDP). All taxes fell below set targets in the first half FY2017/18, due to a slowdown in the economy which affected revenue collection adversely. But as observed in previous years, the collection of revenue is usually slow at the start of the fiscal year. The outlook for revenue for the fiscal year has been revised downwards cognizant of the challenges of prolonged drought and a repeat Presidential election, which affected economic activity in the first half of the fiscal year.

Expenditure and Net Lending

Government expenditure and net lending rose by 25.3 percent to KSh 516.7 billion in the second quarter of the FY 2017/18 compared with KSh 412.3 billion in the first quarter of the FY 2017/18. The increase in expenditures reflected both recurrent and development expenditures of the national government, which rose by 11.6 percent and 31.4 percent, respectively, and County transfers which more than doubled in the second quarter of 2017/18.

In terms of composition, the share of recurrent expenditure in total government expenditure dominated, accounting for 69.8 percent in the second quarter of the FY2017/18, but lower than 72.7 percent in the first quarter. The share

Chart 6.1: Composition of Government Revenue FY 2017/18 (Ksh Billion)

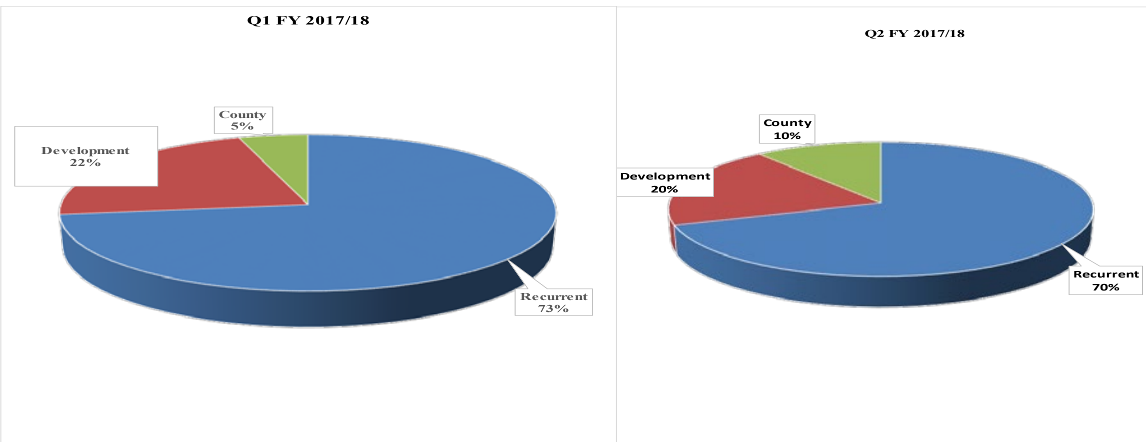


Source: Provisional Budget Outturn from The National Treasury

of development expenditure declined in the second quarter of the FY2017/18 to 19.6 percent compared with 22 percent in the first quarter while the share of County transfers increased to 10.6 percent from 5 percent in the first quarter of the FY **(Chart 6.2)**. Development expenditures were largely channeled to infrastructure and energy and petroleum ministries for implementation of key infrastructure projects.

Cumulatively, expenditure and net lending in the first half of the FY 2017/18 amounted to KSh 929.8 billion (10.6 percent of GDP), against a target of KSh 1,029.3 billion (11.7 percent of GDP). The shortfall of KSh 100.3 billion can be attributed to lower absorption of development expenditures by the National Government and County Governments. Meanwhile, the recurrent expenditures were above target by KSh 18.3 billion in the first half of 2017/18, largely reflecting increased spending related to the Repeat Presidential Election and spending on Government measures to increase food supply to mitigate the spillover effects of drought experienced in the first half of 2017. In terms of components of recurrent expenditures, domestic interest payments rose by 29.9 percent to KSh 64.8 billion in the second quarter of the FY 2017/18 compared to KSh 49.9 billion in the first quarter. Foreign interest payments increased by 38.7 percent to KSh 24.0 billion in the second quarter of the FY 2017/18, while expenditure on salaries and wages rose by 13.8 percent to KSh 104.1 billion in the quarter under review.

Chart 6.2: Composition of Recurrent Expenses FY 2017/18



Sources: Provisional Budget Outturn from The National Treasury

Table 6.2 Domestic Financing

	NET CREDIT TO GOVERNMENT (Ksh Bn)					
	2017/18					
			Q1			Q2
	Jul-17	Aug-17	Sep-17	Oct-17	Nov-17	Dec-17
1. From CBK	57.9	60.9	8.3	60.6	77.4	108.9
2.From commercial banks	(3.8)	(14.8)	12.6	9.8	2.9	(2.9)
4.From Non-banks	2.6	14.2	26.3	51.2	75.7	74.4
5. From Non-Residents	0.4	1.0	1.9	2.8	2.7	3.2
Change in Credit from banks (From 30th June 2017)	54.0	46.1	20.9	70.4	80.4	106.0
Change in Credit from non-banks(From 30th June 2017)	2.6	14.2	26.3	51.2	75.7	74.4
Change in Credit from non-residents(From 30th June 2017)	0.4	1.0	1.9	2.8	2.7	3.2
6.Total Change in Dom. Credit (From 30th June 2017)	57.1	61.3	49.2	124.4	158.8	183.6

Source: Central Bank of Kenya

Financing

The budget deficit in the first half of FY 2017/18 amounted to KSh 208 billion or 2.4 percent of GDP. It was financed largely from domestic sources, by KSh 107.1 billion (or 53.5 percent). The domestic borrowing comprised KSh 108.9 billion draw down of Government deposits held at the Central Bank, KSh 74.4 billion from Non-banking financial institutions and KSh 3.2 billion from Non-Residents. Government made net repayment of KSh 2.9 billion of outstanding debt to commercial banks **(Table 6.2)**. Net domestic borrowing in the second quarter of FY 2017/18 was higher by 17.8 percent compared to the level recorded in the first quarter, however it remained below target. Meanwhile, external financing in the first half of the FY 2017/18 amounted to KSh 91.6 billion against a target of KSh 61.5 billion.

The uptake of Government securities was low during the first half of FY 2017/18, reflecting under-performance at the auction, as investors adopted a wait and see attitude in view of the Repeat Presidential Elections in October 2017. However, the performance of the Government's domestic borrowing programme has been consistent with thresholds set in the Medium Term Debt Management Strategy.

Outlook for FY 2017/18

In the budget estimates for the FY 2017/18, total revenue including grants is projected at KSh 1,702.3 billion (19.7 per cent of GDP), while external grants are projected at KSh 59.2 billion (0.7 per cent of GDP). Government expenditure is projected at KSh 2,323.1 billion (26.8 per cent of GDP), of which KSh 1,392.8 billion (16.1 per cent of GDP) is for recurrent expenses, KSh 345.7 billion (4.0 percent of GDP) for transfers to county governments, and KSh 579.6 billion (6.9 percent of GDP) for development expenses **(Table 6.3).**

The overall budget deficit including grants on commitment basis is projected at KSh 620.8 billion (7.2 per cent of GDP) in 2017/18. The deficit is expected to be financed through net external borrowing of KSh 323.2 billion and net domestic borrowing of KSh 293.8 billion.

Table 6.3: Budget Estimates for the Fiscal Year 2017/18 (KSh Billion)

	Ksh (Billion)	%age of GDP
1. TOTAL REVENUE (Including Grants)	**1,702.3**	**19.7**
Total Revenue	1,643.1	19.0
Appropriations-in-Aid	135.6	1.6
External Grants	59.2	0.7
2. TOTAL EXPENSES & NET LENDING	**2,323.1**	**26.8**
Recurrent Expenses	1,392.8	16.1
Development Expenses	579.6	6.7
County Transfer	345.7	4.0
Contigency Fund	5.0	
3. DEFICIT INCL. GRANTS (1-2)	-620.8	**-7.2**
4. FINANCING	**620.8**	**7.2**
Domestic (Net)	293.8	3.4
External (Net)	323.2	3.7

Source: The National Treasury : Budget Policy Statement February 2018

Chapter 7

Public Debt

Overall Public Debt

Kenya's public and publicly guaranteed debt recorded a moderate increase of 1.9 percent during the second quarter of the FY 2017/18 with both domestic and external debt increasing by 2.0 percent and 1.7 percent, respectively. The buildup in public debt was slower than the projected rate of economic expansion, hence the decline in the ratio of public and publicly guaranteed debt to GDP to 55.7 percent compared with 56.3 percent in the previous quarter. Correspondingly, the ratio of external debt to GDP decreased from 29 percent to 28.6 percent, while that of domestic debt decreased from 27.3 percent to 27 percent, in the second quarter of the FY 2017/18 **(Table 7.1).**

Domestic Debt

Total domestic debt increased by 2.0 percent during the quarter and this was lower than the 3.1 percent increase observed in the previous quarter. The reduced uptake of government securities was associated with the uncertainties surrounding the long electioneering period in the first half of the FY 2017/18. The share of domestic debt to total debt increased marginally to 48.6 percent by the end of the second quarter of the FY 2017/18 compared to 48.5 percent in the first quarter. Conversely, the proportion of debt securities to total domestic debt decreased by 0.3 percent during the quarter under review. The decrease in the share of debt securities to total domestic debt was due to a slight increase in utilization of the Government overdraft facility at the Central Bank.

Table 7.1: Kenya's Public and Publicly Guaranteed Debt (KSh Billion)

	2015/16	2016/17				2017/18						
	Q4	Q1	Q2	Q3	Q4	Jul-17	Aug-17	Q1	Oct-17	Nov-17	Q2	Change Q on Q
EXTERNAL												
Bilateral	548.4	580.4	577.8	689.1	722.6	744.5	742.0	742.1	787.1	792.5	782.6	40.5
Multilateral	798.8	799.7	781.3	806.9	844.4	831.7	842.5	842.8	838.1	839.8	841.8	-1.0
Commercial Banks	432.4	442.8	458.1	594.1	712.1	712.1	708.2	708.2	710.8	707.9	707.8	-0.5
Supplier Credits	16.6	15.5	15.3	11.2	15.3	17.2	17.1	17.1	17.2	17.1	17.1	0.0
Sub-Total	**1,796.2**	**1,838.4**	**1,832.4**	**2,101.4**	**2,294.4**	**2,305.5**	**2,309.8**	**2,310.2**	**2,353.1**	**2,357.2**	**2,349.3**	**39.1**
(As a % of GDP)	26.9	26.4	25.6	28.0	29.6	29.7	29.4	29.0	29.1	29.1	28.6	
(As a % of total debt)	49.7	49.8	48.7	51.9	52.1	52.1	52.0	51.5	51.8	51.4	51.4	
DOMESTIC												
Banks	**1,027.2**	**1,028.7**	**1,032.6**	**1,061.1**	**1,196.4**	**1,205.1**	**1,200.4**	**1,223.5**	**1,213.1**	**1,228.6**	**1,221.7**	**-1.7**
Central Bank	99.9	58.9	85.5	85.3	54.5	63.7	75.7	79.2	71.9	95.1	96.8	17.6
Commercial Banks	927.3	969.8	947.0	975.8	1,141.9	1,141.4	1,124.7	1,148.3	1,141.3	1,133.5	1,124.9	-23.3
Non-banks	**774.9**	**813.8**	**884.8**	**862.3**	**893.2**	**896.1**	**912.4**	**925.0**	**950.4**	**974.9**	**973.2**	**48.2**
Pension Funds	468.9	493.8	544.9	549.2	593.5	575.7	586.1	592.7	609.2	615.8	611.2	18.5
Insurance Companies	134.4	136.4	143.2	138.9	138.9	130.1	133.3	134.7	136.4	139.5	142.7	7.9
Other Non-bank Sources	171.6	183.6	196.7	174.2	160.8	190.3	193.1	197.5	204.9	219.6	219.3	21.7
Non-residents	**13.0**	**12.0**	**13.6**	**21.5**	**22.1**	**22.6**	**23.1**	**24.1**	**25.0**	**24.9**	**25.4**	**1.3**
Sub-Total	**1,815.1**	**1,854.6**	**1,931.0**	**1,945.0**	**2,111.7**	**2,123.8**	**2,135.9**	**2,176.6**	**2,188.5**	**2,228.4**	**2,220.3**	**43.8**
(As a % of GDP)	27.2	26.6	27.0	26.0	27.2	27.4	27.1	27.3	27.0	27.5	27.0	
(As a % of total debt)	50.3	50.2	51.3	48.1	47.9	47.9	48.0	48.5	48.2	48.6	48.6	
GRAND TOTAL	**3,611.3**	**3,693.0**	**3,763.4**	**4,046.3**	**4,406.1**	**4,429.3**	**4,445.7**	**4,486.8**	**4,541.6**	**4,585.7**	**4,569.6**	**82.8**
(As a % of GDP)	54.0	53.0	52.6	54.0	56.8	57.1	56.5	56.3	56.1	56.7	55.7	

Source: The National Treasury and Central Bank of Kenya

Table 7.2: Government Gross Domestic Debt (KSh Billion)

	Ksh (Billion)							Change: Q on Q		Proportions						
	2016/17			2017/18						2016/17			2017/18			
	Q2	Q3	Q4	Q1	Oct-17	Nov-17	Q2	Ksh (Bn)	%	Q2	Q3	Q4	Q1	Oct-17	Nov-17	Q2
Total Stock of Domestic Debt (A+B)	**1,931.0**	**1,945.0**	**2,111.7**	**2,176.6**	**2,188.5**	**2,228.4**	**2,220.3**	**43.8**	**2.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
A. Government Securities	**1,869.5**	**1,883.9**	**2,076.1**	**2,111.4**	**2,138.3**	**2,155.2**	**2,146.0**	**34.6**	**1.6**	**96.8**	**96.9**	**98.3**	**97.0**	**97.7**	**96.7**	**96.7**
1. Treasury Bills (excluding Repo Bills)	**620.2**	**615.8**	**744.2**	**724.8**	**735.8**	**704.0**	**684.7**	**-40.1**	**-5.5**	**32.1**	**31.7**	**35.2**	**33.3**	**33.6**	**31.6**	**30.8**
Banking institutions	349.5	328.6	436.5	412.5	409.3	374.6	363.9	-48.6	-11.8	18.1	16.9	20.7	19.0	18.7	16.8	16.4
The Central Bank	20.6	20.6	20.6	20.6	20.6	20.6	20.6	0.0	0.0	1.1	1.1	1.0	0.9	0.9	0.9	0.9
Commercial Banks	329.0	308.0	415.9	391.9	388.8	354.0	343.3	-48.6	-12.4	17.0	15.8	19.7	18.0	17.8	15.9	15.5
Pension Funds	147.8	152.6	179.5	171.4	176.5	168.9	159.2	-12.2	-7.1	7.7	7.8	8.5	7.9	8.1	7.6	7.2
Insurance Companies	14.7	16.0	13.7	15.0	15.7	16.8	18.2	3.2	21.4	0.8	0.8	0.7	0.7	0.7	0.8	0.8
Others	108.1	118.5	114.4	125.9	134.3	143.7	143.4	17.4	13.9	5.6	6.1	5.4	5.8	6.1	6.4	6.5
2. Treasury Bonds	**1,249.3**	**1,268.2**	**1,332.0**	1,386.6	1,402.5	1,451.2	1,461.2	**74.7**	**5.4**	**64.7**	**65.2**	**63.1**	**63.7**	**64.1**	**65.1**	**65.8**
Banking institutions	601.1	650.9	724.5	749.8	753.7	780.9	783.5	33.7	4.5	31.1	33.5	34.3	34.5	34.4	35.0	35.3
The Central Bank	9.4	9.4	9.4	9.4	9.4	9.4	9.4	0.0	0.0	0.5	0.5	0.4	0.4	0.4	0.4	0.4
Commercial Banks	591.6	641.5	715.1	740.4	744.2	771.4	774.1	33.7	4.5	30.6	33.0	33.9	34.0	34.0	34.6	34.9
Insurance Companies	128.5	122.9	138.9	119.7	120.7	122.7	124.4	4.7	3.9	6.7	6.3	6.6	5.5	5.5	5.5	5.6
Pension Funds	397.1	396.5	414.1	421.4	432.7	446.9	452.1	30.7	7.3	20.6	20.4	19.6	19.4	19.8	20.1	20.4
Others	122.8	97.8	54.5	95.7	95.4	100.7	101.2	5.6	5.8	6.4	5.0	2.6	4.4	4.4	4.5	4.6
3. Long Term Stocks	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**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	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	0.0	0.0	0.0	0.0	0.0	0.0	0.0
4. Frozen account	**25.6**	**25.0**	**25.0**	**24.4**	**24.4**	**24.4**	**24.4**	**0.0**	**0.0**	**1.3**	**1.3**	**1.2**	**1.1**	**1.1**	**1.1**	**1.1**
Of which: Repo T/Bills	25.0	24.4	23.8	23.8	23.8	23.8	23.8	0.0	0.0	1.3	1.3	1.1	1.1	1.1	1.1	1.1
B. Others:	**35.9**	**36.0**	**10.6**	**40.8**	**25.8**	**48.8**	**49.9**	**9.1**	**22.4**	**1.9**	**1.9**	**0.5**	**1.9**	**1.2**	**2.2**	**2.2**
Of which CBK overdraft to Government	29.9	26.0	0.0	24.7	17.4	40.7	42.3	17.6	71.2	1.6	1.3	0.0	1.1	0.8	1.8	1.9

Source: Central Bank of Kenya

Treasury Bills

Treasury bill holdings, excluding those held by the CBK for open market operations (Repos) recorded 5.5 percent decline during the second quarter of the FY 2017/18 as investors' appetite for longer dated securities increased after the electioneering period. Similarly, the proportion of Treasury bills to total domestic debt decreased by 2.5 percent during the period under review. The dominance of commercial banks in the Treasury bills market persisted with their holdings standing at 50.1 percent by the end of the second quarter of the FY 2017/18. Other significant holders of Treasury bills included Pension funds (23.3 percent) and parastatals-included in other holders (16.6 percent). The persistent dominance of commercial banks in the government securities' market characterizes moderate under representation of other institutional investors (pension funds, foreign investors and insurance companies).

Treasury Bonds

Treasury bond holdings increased by 5.4 percent during the second quarter of the FY 2017/18, a faster build up compared to the 4.1 growth observed in the previous quarter. This increase was driven by the shift in investor preference towards more longer dated securities following the upholding of results of the October 2017 repeat presidential elections by the Supreme Court. The largest component of this buildup was the proceeds from a 7- year infrastructure bond. The dominant holders of Treasury bonds by the end of the period under review were commercial banks, pension funds and insurance companies. Commercial banks holdings accounted for about half of the total Treasury Bonds outstanding.

Table 7.3: Outstanding Domestic Debt by Tenor (KSh Bllion)

		Kshs (Billions)							Change Q on Q		Proportions						
		2016/17			2017/18				Q2 2017/18		2016/17			2017/18			
		Q2	Q3	Q4	Q1	Oct-17	Nov-17	Q2	Kshs(Bn)	%	Q2	Q3	Q4	Q1	Oct-17	Nov-17	Q2
	91-Day	51.1	48.7	92.2	35.9	37.0	43.3	46.0	10.1	28.2	2.6	2.5	4.4	1.6	1.7	1.9	2.1
Treasury	182-Day	201.1	212.4	234.3	254.9	273.1	232.8	190.9	-63.9	-25.1	10.4	10.9	11.1	11.7	12.5	10.4	8.6
bills	364-Day	368.0	354.7	417.7	434.0	425.7	428.0	447.8	13.7	3.2	19.1	18.2	19.8	19.9	19.5	19.2	20.2
	1-Year	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	2-Year	116.8	100.9	82.1	102.8	113.9	113.9	113.9	11.1	10.8	6.1	5.2	3.9	4.7	5.2	5.1	5.1
	3-Year	0.0	0.0	0.2	0.4	0.4	0.4	0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	4-Year	2.3	2.3	2.3	4.8	4.8	4.8	4.8	0.0	0.0	0.1	0.1	0.1	0.2	0.2	0.2	0.2
	5-Year	263.4	288.3	272.7	302.3	315.8	323.0	323.0	20.7	6.9	13.6	14.8	12.9	13.9	14.4	14.5	14.5
	6-Year	8.5	8.5	8.5	8.5	8.5	8.5	8.5	0.0	0.0	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Treasury	7-Year	8.7	8.7	8.7	8.7	8.7	50.1	50.1	41.4	476.4	0.5	0.4	0.4	0.4	0.4	2.3	2.3
Bond	8-Year	38.2	33.7	33.7	33.7	33.7	33.7	33.7	0.0	0.0	2.0	1.7	1.6	1.5	1.5	1.5	1.5
	9-Year	76.5	76.5	76.5	76.5	76.5	76.5	76.5	0.0	0.0	4.0	3.9	3.6	3.5	3.5	3.4	3.4
	10-Year	206.8	206.8	256.9	280.9	267.1	267.1	272.5	-8.4	-3.0	10.7	10.6	12.2	12.9	12.2	12.0	12.3
	11-Year	4.0	4.0	4.0	0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.2	0.2	0.0	0.0	0.0	0.0
	12-Year	132.1	146.4	146.4	133.2	133.2	133.2	133.2	0.0	0.0	6.8	7.5	6.9	6.1	6.1	6.0	6.0
	15-Year	238.8	238.8	286.7	286.7	286.7	286.7	291.4	4.7	1.6	12.4	12.3	13.6	13.2	13.1	12.9	13.1
	20-Year	104.9	104.9	104.9	104.9	104.9	104.9	104.9	0.0	0.0	5.4	5.4	5.0	4.8	4.8	4.7	4.7
	25-Year	20.2	20.2	20.2	20.2	20.2	20.2	20.2	0.0	0.0	1.0	1.0	1.0	0.9	0.9	0.9	0.9
	30-Year	28.1	28.1	28.1	28.1	28.1	28.1	28.1	0.0	0.0	1.5	1.4	1.3	1.3	1.3	1.3	1.3
	Repo T bills	25.0	24.4	23.8	23.8	23.8	23.8	23.8	0.0	0.0	1.3	1.3	1.1	1.1	1.1	1.1	1.1
	Overdraft	29.9	30.3	0.0	24.7	17.4	40.7	42.3	17.6	100.0	1.6	1.6	0.0	1.1	0.8	1.8	1.9
Other Domestic debt		6.6	6.4	11.7	11.5	9.0	8.7	8.2	-3.3	-28.8	0.3	0.3	0.6	0.5	0.4	0.4	0.4
Total Debt		**1,931.0**	**1,945.0**	**2,111.7**	**2,176.6**	**2,188.5**	**2,228.4**	**2,220.3**	**43.8**	**2.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: Central Bank of Kenya

Domestic Debt by Tenor and the Maturity Structure

The government floated both short and long dated securities during the period under review. The current debt securities portfolio is dominated by medium and long term debt securities, underscoring the Public Debt Management Office's goal of reducing the refinancing risk. The benchmark Treasury Bonds comprising 2-year, 5-year, 10-year, 15-year and 20-year Treasury Bonds accounted for 75.7 percent of the total of outstanding Treasury Bonds, a 2.0 percent decline from the position in the previous quarter. Other domestic debt consists of uncleared effects, advances from commercial banks and Tax Reserve Certificates.

The average time to maturity of existing domestic debt decreased further to 4 years in the second quarter of the FY 2017/18 from 4 years and 1 months in the first quarter of FY 2017/18 and 4 years 2 months in the Fourth quarter of the FY 2016/17, respectively. This marginal decline was attributed to the issuance of more short term Treasury bonds during the second quarter of 2017/18 compared to the issuance of medium term Treasury bonds during the first quarter of FY 2017/18 and the fourth quarter of the FY 2016/17.

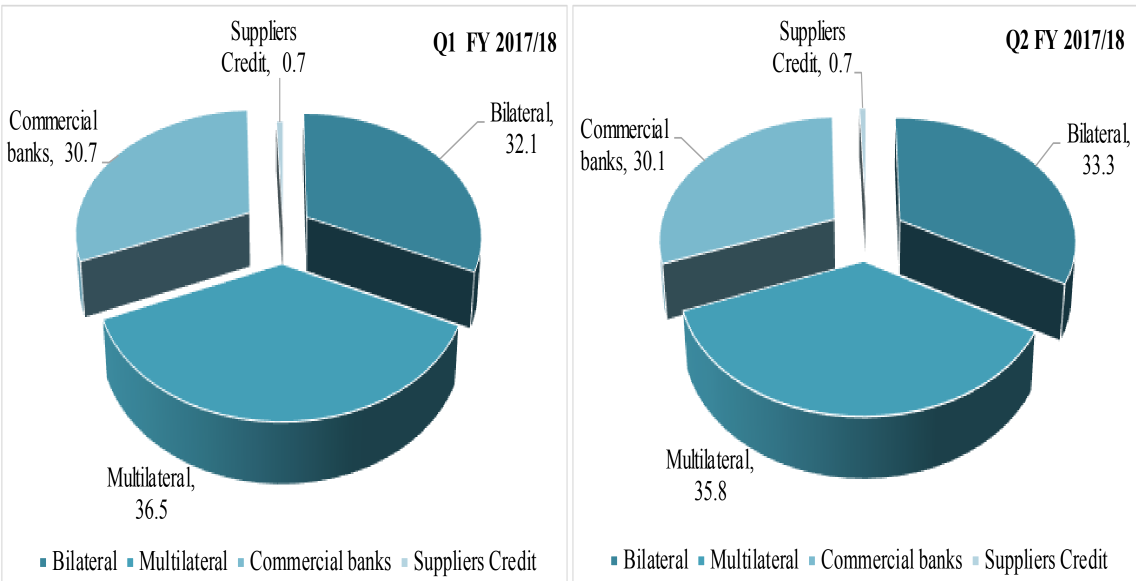
External Debt

Public and publicly guaranteed external debt increased by 1.7 percent during the second quarter of the FY 2017/18. External debt accumulation largely arose from disbursements of bilateral debt from China to finance phase II of the Standard Gauge Railway (SGR) project. Principal amortization of debt owed to International Development Association (IDA) and Japan and the partial repayment of the 2015 syndicated loan had an offsetting effect on the overall external debt build up. Foreign exchange risk on external debt remained low due to relatively stable exchange rate during the quarter under review.

Composition of External Debt by Creditor

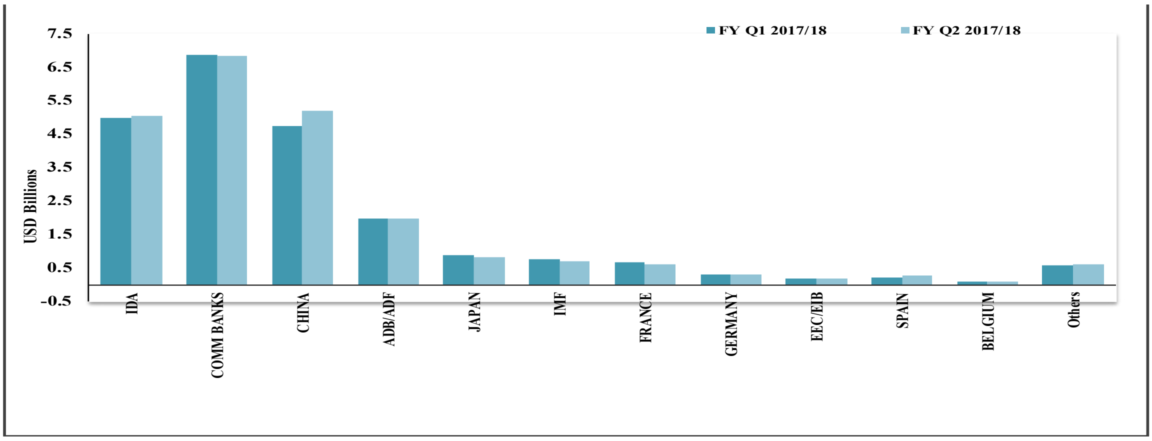
Kenya continues to record declining levels of concessional debt and build-up of commercial and semi-concessional borrowing since elevation to a lower middle income economy status in September 2014. The quarter under review recorded a slight reversal of this trend, with the share of outstanding debt from official multilateral and bilateral lenders (who provide both concessional and semi-concessional loans) increasing by 0.5 percent from the 68.6 percent in the previous quarter to 69.1 percent by the end of the second quarter of the FY 2017/18. Consequently, the share of commercial debt decreased by 0.6 percent during the review period. This shift in the composition of external debt was mainly on account of disbursements from China (**Chart 7.1**).

Chart 7.1: Composition of External Debt by Lender



Source: The National Treasury

Chart 7.2: **External Debt By Creditor**



Source: The National Treasury

Debt owed to the International Development Association (IDA), Kenya's largest multilateral lender, amounted to USD 5.0 billion or 22.8 percent (compared to 22.9 percent in the previous quarter) of total external debt; while that owed to China, Kenya's largest bilateral lender, amounted to USD 5.2 billion, or 22.9 percent compared to 21.2 percent in the previous quarter of the total external debt in the second quarter of the FY 2017/18. The increase observed in the proportion of external debt held by leading multilateral and bilateral lenders underscores government's commitment to ensuring sustainable debt levels (**Chart 7.2**).

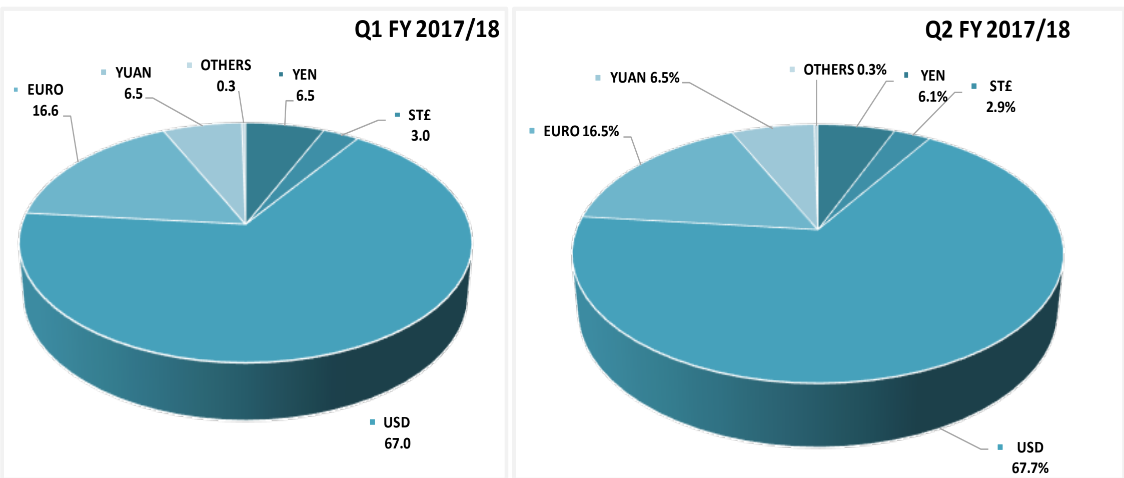
Currency Composition of External Debt

Kenya's public and publicly guaranteed external debt is denominated in various currencies to mitigate against currency risk. The dominant currencies included the US dollar and the Euro, which accounted for 84.2 percent of the total currency composition at the end of the second quarter of the FY 2017/18. This was consistent with the currency composition of the Central Bank's forex reserve holdings. The proportion held in the US dollar increased mainly on account disbursements of dollar- denominated loan advanced by the Chinese government to finance Phase II of the Standard Gauge Railway (**Chart 7.3**).

Public Debt Service

The ratio of domestic interest payments to revenues stood at 17.3 percent in the second quarter of the FY 2017/18 which was higher than the previous quarter (14.2 percent). The largest component of domestic interest payments was coupon interest on Treasury Bonds, which was consistent with the proportion of debt held in Treasury bonds. External debt service for the second quarter of the FY 2017/18 amounted to Ksh 42.3 billion and was within sustainable levels. Analysis of the liquidity indicators of external indebtedness show that Kenya faces

Chart 7.3: **Debt Composition by Currency**



Source: The National Treasury

Table 7.4: Liquidity Indicators of External Debt Sustainability

	Q2 FY 2016/17	Q3 FY 2016/17	Q4 FY 2016/17	Q1 FY 2017/18	Q2 FY 2017/18
Debt service to Revenues (23%)	7.0	7.3	7.3	7.2	11.4
Debt service to Exports (21%)	10.3	8.3	8.3	9.1	14.8

Source: Central Bank of Kenya

low exposure to external debt service default as the ratios were below the Country Policy and Institutional Assessment (CPIA) determined liquidity indicators (21 percent of exports and 23 percent of revenues) **(Table 7.4).**

Debt Sustainability Analysis (DSA)

The December 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 alternative scenarios. However, there is a temporary breach of debt service to exports ratio under standardized stress tests. Public DSA sensitivity analysis show 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. This points to the need for fiscal consolidation in the medium term.

Chapter 8

The Capital Markets

Equities Market

The equities market recorded mixed performance in the fourth quarter of 2017. The NASI Index rose by 5.54 percent reflecting the increase in the overall share price. However, the increase in share prices was not spread across all counters has reflected in the NSE 20 Index that declined by 1.1 percent during the quarter under review **(Table 8.1 and Chart 8.1).** Equities turnover declined by 32.8 percent compared to the third quarter of 2017 on account of a 36.1 percent drop in shares traded. The mixed performance reflects reduced trading activity during the quarter due to end of year festive season.

Foreign Investors Participation at the NSE

The value of shares bought by foreign investors at NSE declined by 1.5 percent in the fourth quarter of 2017, while the value of shares sold by foreign investors declined by 33.0 percent, compared to the third quarter of 2017. Overall, net foreign investors' participation at NSE to equity turnover averaged 63.4 percent up from 53.5 percent, reflecting low participation by local investors, which reaffirms the impact of the holiday season **(Chart 8.2 and Table 8.1).**

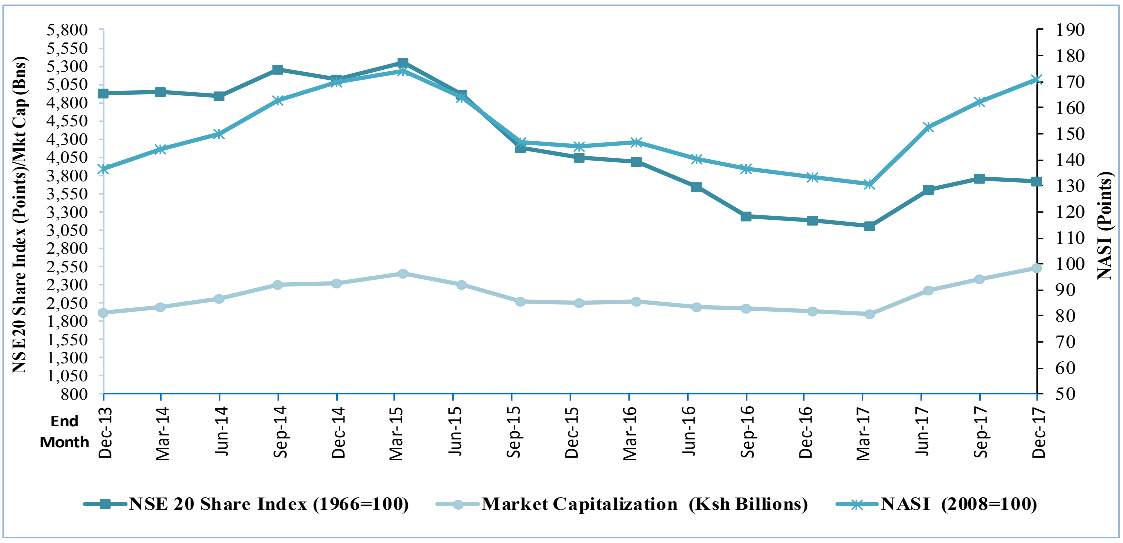
Table 8.1: Selected Stock Market Indicators

INDICATOR	2015	2016				2017				% QUARTERLY CHANGE (2017Q4-2017Q3)
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	
NSE 20 Share Index (1966=100)	4040.0	3982.0	3640.6	3243.2	3186.0	3112.5	3607.2	3751.5	3711.9	-1.05
NASI (2008=100)	145.00	147.00	140.60	136.75	133.30	130.51	152.92	162.21	171.20	5.54
Number of Shares Traded (Millions)	1455.5	1299.7	1411	1999	1101	1859.8	1892.1	2019.72	1291.2	-36.07
Equities Turnover (Ksh Millions)	46,095	36,609	37,034	48,141	25,392	37,095	44,902	53,577	36,019	-32.77
Market Capitalization (Ksh Billions)	2,054	2,078	1,998	1,972	1,931	1,894	2,224	2,377	2,522	6.11
Foreign Purchase (Ksh Millions)	29,500	20,258	26,322	40,038	17,652	29,421	27,424	23,099	22,759	-1.47
Foreign Sales (Ksh Millions)	29,439	21,844	19,339	34,018	16,703	27,433	29,692	34,219	22,941	-32.96
Ave. Foreign Investor Participation to Equity Turnover (%)	63.93	57.50	61.65	76.92	67.65	76.64	63.60	53.49	63.44	9.95
Bond Turnover (Ksh Millions)	71,321	113,400	149,809	74,809	94,367	103,997	134,633	108,168	78,049	-27.84
FTSE NSE Kenya Govt. Bond Index	90.04	89.28	87.98	89.11	90.05	89.73	91.54	91.67	92.83	1.27
5-Year Eurobond Yield (%)	7.93	6.48	6.23	4.59	4.95	4.20	4.47	4.28	3.76	*-0.512
10-Year Eurobond Yield (%)	9.05	7.81	8.31	6.84	7.86	7.10	6.64	6.46	5.67	*-0.786

* Percentage points

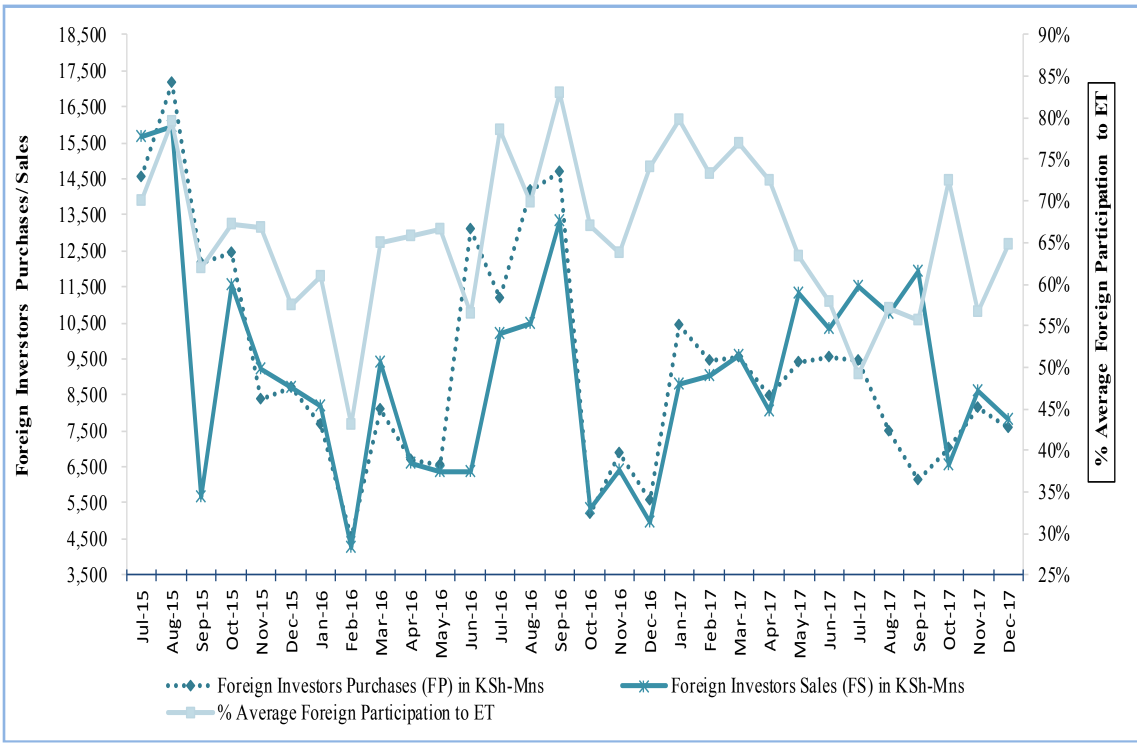
Source: Nairobi Securities Exchange

Chart 8.1: NSE 20, NASI and Market Capitalization



Source: Nairobi Securities Exchange

Chart 8.2: Foreign Investors Participation at the NSE



Source: Nairobi Securities Exchange

Bond Market

The value of bonds traded in the fourth quarter of 2017 declined by 27.8 percent compared to the third quarter of 2017, perhaps a reflection of low activity associated with the festive season, usually characterized by reduced local investor appetite. The FTSE NSE Kenyan Government Bond Index increased by 1.3 percent in the period under review, reflecting a marginal decline in secondary market yields. The 5- and 10-year Kenya Eurobonds yields reduced by 0.51 percentage points and 0.79 percentage points, respectively, reflecting positive investor sentiments.

Chapter 9

Statement of Financial Position of the Central Bank of Kenya

(Kenya Shillings Million)

1.0	ASSETS	2017 MAR	MAY	JUNE	SEPT	DEC	Q4, 2017 Change	Q3, 2017 Change	Q4, 2017 % change	Q3, 2017 % change
1.1	RESERVES AND GOLD HOLDINGS	835,899	884,904	870,325	830,309	753,350	(76,959)	(40,016)	(9.3)	(4.6)
1.2	FUNDS HELD WITH IMF	1,199	118	1,877	253	1,487	1,234	(1,624)	487.8	(86.5)
1.21	INVESTMENT IN EQUITY (SWIFT SHARES	9	9	9	10	10	0	0	1.3	2.8
1.3	ITEMS IN THE COURSE OF COLLECTION	28	18	43	22	19	(3)	(21)	(14.7)	(48.9)
1.4	ADVANCES TO COMMERCIAL BANKS	41,870	33,013	34,870	75,773	39,645	(36,128)	40,903	(47.7)	117.3
1.5	LOANS AND OTHER ADVANCES	2,531	2,515	2,575	2,650	2,645	(4)	74	(0.2)	2.9
1.6	OTHER ASSETS	2,480	2,338	2,923	2,486	2,354	(132)	(437)	(5.3)	(15.0)
1.7	RETIREMENT BENEFIT ASSET	7,776	7,776	8,197	8,197	8,197	-	-	-	-
1.8	PROPERTY AND EQUIPMENT	22,430	22,285	22,703	21,983	22,003	20	(720)	0.1	(3.2)
1.81	INTANGIBLE ASSETS	(72)	(96)	52	49	47	(2)	(3)	(4.4)	(6.6)
1.9	DUE FROM GOVERNMENT OF KENYA	55,395	25,067	24,449	49,350	66,887	17,537	24,902	35.5	101.9
	TOTAL ASSETS	**969,545**	**977,947**	**968,024**	**991,081**	**896,643**	**(94,438)**	**23,057**	**(9.5)**	**2.4**
2.0	**LIABILITIES**									
2.1	CURRENCY IN CIRCULATION	245,513	247,204	253,787	250,695	279,159	28,464	(3,092)	11.4	(1.2)
2.2	INVESTMENTS BY BANKS - REPOS	14,164	9,991	-	-	-		-		
2.3	DEPOSITS	465,079	470,837	470,109	483,815	364,325	(119,489)	13,706	(24.7)	2.9
2.4	INTERNATIONAL MONETARY FUND	116,168	117,246	115,125	114,659	110,416	(4,243)	(466)	(3.7)	(0.4)
2.5	OTHER LIABILITIES	3,329	5,505	(5,059)	1,859	1,497	(363)	6,918	(19.5)	(136.7)
	TOTAL LIABILITIES	844,254	850,783	833,962	851,029	755,397	(95,632)	17,066	(11.2)	2.0
3.0	EQUITY AND RESERVES	125,292	127,164	134,062	140,053	141,246	1,193	5,991	0.9	4.5
	Share Capital	5,000	5,000	5,000	5,000	5,000				
	General reserve fund -Unrealized	57,550	57,550	57,550	65,195	65,195	-	7,645		13.3
	-Realized	16,909	16,909	16,909	23,690	23,690	(0)	6,782		40.1
	-Capital Projects	15,047	15,047	15,047	17,189	17,189	-	2,142		14.2
	Period surplus/(Deficit)	8,219	10,092	16,569	5,991	7,185	1,194	(10,578)	19.9	(63.8)
	Asset Revaluation	14,790	14,790	14,790	14,790	14,790	-	-		-
	Retirment Benefit Asset Reserves	7,776	7,776	8,197	8,197	8,197	(0)	-		
4.0	**TOTAL LIABILITIES AND EQUITY**	**969,545**	**977,947**	**968,024**	**991,081**	**896,643**	**(94,438)**	**23,057**	**(9.5)**	**2.4**

Source: Central Bank of Kenya

Notes on the Financial Position

Assets

The balance sheet of the Central Bank of Kenya (CBK) reduced by 9.5 percent in the fourth quarter of 2017 compared to an increase of 2.4 percent in the previous quarter. On the asset side, the decrease was reflected in foreign exchange reserves and gold holdings as well as in advances to commercial banks. Liquidity conditions in the money market improved as indicated by the decline in net advances to commercial banks.

Reserves and Gold holdings which comprise foreign reserves held in external current accounts, deposits and special/project accounts, domestic foreign currency clearing accounts, gold, special drawing rights and RAMP securities invested with the World Bank decreased in the fourth quarter due to government debt service and Central Bank operations.

Growth in debt due from Government of Kenya, which includes Government utilization of the overdraft facility at the Central Bank, and balances in the overdrawn accounts converted to a long term debt with effect from 1 November 1997, decelerated in the fourth quarter to 35.5 percent compared to 101.9 percent in quarter three. This deceleration was a result of the slowdown in the uptake of the overdraft.

Items in the course of collection, which represent the value of clearing instruments held by the CBK while awaiting settlement by respective commercial banks, decreased by 14.7 percent, compared to the decrease of 48.9 percent in the third quarter of 2017.

Other assets, which largely consist of prepayments and sundry debtors, and deferred currency expense decreased by 5.3 percent compared to a decrease of 15.0 percent in the third quarter of 2017.

Liabilities

Currency in circulation increased by 11.4 percent in the fourth quarter of 2017 compared to a 1.2 percent decline in the previous quarter. This was largely due to demand for cash during the end of year holidays.

Deposits by Government of Kenya, local commercial banks, other public entities and project accounts and local banks' forex settlement accounts declined by 24.7 percent compared to a growth of 2.9 percent in the previous quarter. This was largely due to government accessing its deposits at the Central bank.

Equity and reserves increased by 4.5 percent in the third quarter of 2017 compared to a growth of 4. 5 percent in the previous quarter, reflecting an increase in the period's surplus.

Central Bank of Kenya

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