



*Economic & Market Report – 30 September 2009*

A SUBSIDIARY OF CO-OPERATIVE BANK OF KENYA

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## 1. A step backwards?

Economic activity is recovering rather sluggishly owing to high cost of production and low agricultural production occasioned by the ongoing dry-spell. Challenges affecting the country include water and power rationing, high inflation, and insecurity. As a result, the proportion of those living below poverty line has increased significantly over the last couple of years, eroding the gains that had painstakingly been achieved since 2003.

### *1.1. Reversing trend through stimulus packages*

Acknowledging that things are made to happen, the government undertook to implement deliberate measures to stimulate the growth with strategies aimed at pumping more cash to the economy to boost aggregate demand. For example, channeling funds directly to the constituency level to initiate infrastructure/service projects are worthwhile and deemed to spur growth. The stimulus package, totaling Kshs 22 billion has been earmarked as a stop-gap strategy. The major challenge then remains swift and transparent implementation of the projects.

Infrastructure projects including road construction, electricity supply and water projects do all entail massive spending requirements and following from the budget speech, a lot of funds will flow to the *wananchi*'s pockets through salaries and wages then back to the economy via purchase of goods and services. Subtle recovery in the developed economies acts like a buffer for households, as those with relations abroad receive remittances worthy of recognition. The Central Bank of Kenya reports that remittances from Kenyans living in the diaspora do indeed increase when Kenya's economy is facing challenging times.

The private sector is apparently not receiving adequate support from the financial institutions (banks). The Kenya Monthly Economic Review, June 2009 produced by the Central Bank shows that for the first half of 2009, lending to the private sector decelerated to 20.7%, which was worse than that witnessed in the first six months of 2008. Call it the chick and egg paradox, banks have set high interest rates and are reluctant to lend to the private sector in fear of defaults since economic outlook is remotely supportive of business activity. The private sector, however, reckon that the high interest rates charged by banks prohibit them from borrowing to expand their businesses that would ultimately revive the economy.

## **2. Budgetary support**

The donor community continues to support Kenya's economic growth programmes. This is despite the economic turmoil that beset the developed economies. Budgetary support has been received from the Americas, Europe and Asia. These have somewhat facilitated an inclusive development in most rural areas through modest gainful employment. The government stimulus programme that targets setting up of agri-business centres at the rural areas informs our optimism that there will be sustainable growth in the medium term.

Despite the low business confidence levels – resulting from insecurity, high energy costs, poor corporate governance, all is not lost. Road, energy and agricultural projects that have been launched by the government portend a better productive environment. The World Bank and the International Monetary Fund (IMF) in collaboration with the government have sustained the drive towards improving efficiency of the financial markets. This will provide desirable platform to thrust the economy to a higher level of productivity. Progress on the enhancement of security and basic healthcare has remained dismal nonetheless.

## **3. Driving the economy**

The telecommunications sector has remained buoyant in 2009 notwithstanding the challenge of starvation facing a vast majority of the populace. Data from Communications Commission of Kenya (CCK) show that Kenya is becoming phenomenally networked (connected). From 13.8 million subscribers in December 2008, the number shot to 17.1 million in March 2009 and to 17.4 million in June 2009. Although official data is not forthcoming, we estimate that the number of active subscribers is closer to 18 million and still counting rapidly. This is a penetration rate of about 47% compared to 31% two years ago.

There is still immeasurable growth potential. The market's vibrancy is beneficial to consumers as tariffs are becoming more affordable without quality being compromised. There may obviously be reduction in the average revenue per user for the mobile companies, but the penetration compensates for fall. Introduction of cheaper handsets is a major boon for the sector's growth.

The next frontier is the data segment, where companies are aggressively driving sales. The arrival and commissioning of two major fibre optic cables (TEAMS and SEACOM) in July and August 2009 is expected to revolutionise businesses in the medium term by potentially increasing speed and capacity of execution. Due to the legacy problem (erratic

and expensive power cost), consumers may be unable to realize benefits soon as entrepreneurs will be unable to reduce charges in tandem with increased data capacity.

#### **4. Flight to Quality**

At times when the pockets run dry, consumers and other business people have always turned to their banks for solace. They seek loans to bridge the gap between their earnings and consumption (or cash flow) demands. This has become a tricky affair for bankers in the unfolding challenging economic environment. Job security for most of the employed is currently tested as most small and medium size companies are somewhat threatened with closure. Obviously, then, the astute bankers are not at fault for being averse to the private sector. Rigorous credit analysis is undertaken before advancing any credit. Logically this is appropriate to minimize rates of default.

Banks released their trading results for the first six months of 2009. Mixed but modest growth was reported for the industry. As noted above, there was barely any growth in loans and advances for most banks. A few had stellar growth thereby lifting the sector's lending book by 19% to Kshs 712.4 billion. With the slowed business activity, the increase in branch network for banks did not yield noticeable impact. Total deposits of the sector grew by 9.5% to Kshs 954.2 billion. Consequently, total assets of the banking sector grew by 15% to stand at Kshs 1.27 trillion as at June 2009. In the first half of 2009, profitability was stable, recording a rise of 2.7% to Kshs 24.5 billion mainly resulting from cost cutting.

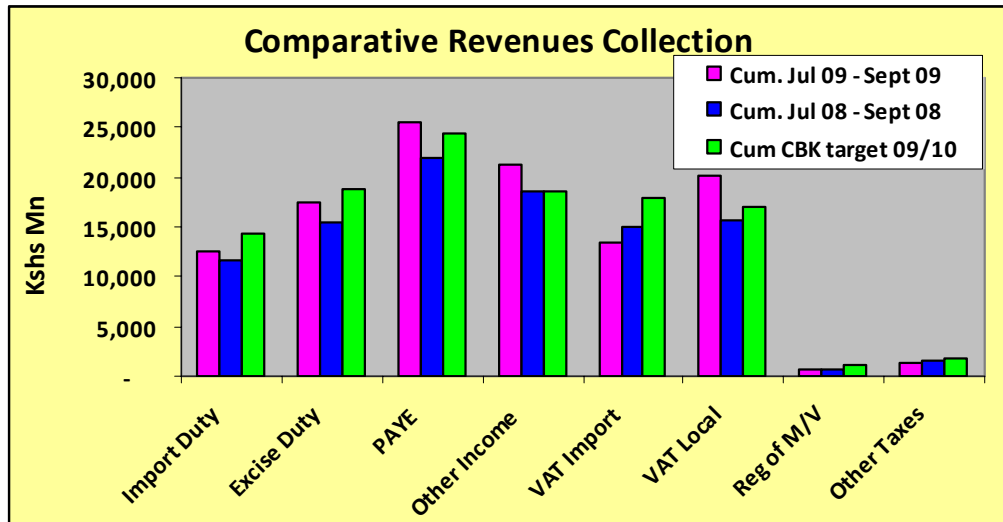
The banking sector marked another milestone in the national payment system. Called Value Capping, the Central Bank has now, with effect from October 1, 2009, limited cheque transactions to amounts less than Kshs 1.0 Million. Any amounts from this figure will have to be done via real time gross settlement (RTGS) system. Apart from the funds being received on the same day, this method also eliminates instances of high valued cheques bouncing and causing inefficiency in the financial system.

Transactions below the cap can be done through cheques (with the normal three business day turnaround) or also be dealt on the RTGS. However, the extension of cheque clearance of transactions above the cap from three days to 21 days is really meant to dissuade the use of cheques and graduate the economy to fuller adoption of RTGS. We expect this move to improve on the circulation of money unlike before where the turnaround time was at least three business days.

CBK continues to closely monitor the banking sector, and has streamlined its stress testing mechanism to ascertain the health of the sector. This may help identify and mitigate any potential threats to the sector and the economy at large.

## 5. Funding the budget

The Kenya Revenue Authority (KRA) collected Kshs 112.2 billion in the three months ending 25<sup>th</sup> September 2009. This was the first quarter of the government's financial year (accounting period). The performance was 98% of the target. For the first quarter, KRA had targeted to collect Kshs 114 billion, having based their forecast on possible acceleration of business activity. The bar graph below depicts results from various income sources.



Source: CBK

From the graph, we can deduce that there was under-performance on import related income sources. Import duty was short of target by Kshs 1.7 billion while value added tax (VAT) on imported products was below target by Kshs 4.5 billion. 'Other Income' group had stellar performance. We note that dividend payment in September (of Kshs 10 billion) by Central Bank of Kenya to the government helped in plugging the financing needs of the government. Inflationary pressure, impacting on most of the locally manufactured goods led to the outperformance of VAT on local goods during the period. Indeed one man's meat is another man's poison. Since consumers could not forego consumption of the goods, the taxman generated more revenues from the highly priced goods.

Domestic production, and the oil industry, despite being choked by a myriad of challenges, remained resilient, with the taxman generating modest revenues in form of excise taxes. It was nonetheless below target by Kshs 1.5 billion in the three months. In summary, the overall tax collection position for the first three months of the financial year was higher by Kshs 12 billion as compared to a similar period of 2008. Enhancement of tax refund processes and sealing of loopholes at the key border points

will mitigate revenue leaks. We are concerned that prolonged stagnation of the economy may inhibit KRA from achieving its ambitious target of Kshs 523 billion by the end of June 2010.

Government borrowing from the domestic market has so been very successful, benefiting from the bearish trend of equities at the NSE. A total of Kshs 40 billion has so far been raised through TBills and TBonds in the three months. With the relatively better absorption rate, we believe that donor funds and much of the domestic borrowing will be used promptly to improve on service delivery. Focus has been on Kenya's governance weaknesses. This is threatening more inflows of aid and foreign debts. Kenya's strategic standpoint for the wider Eastern and Central Africa region continues to be the main impetus for driving change and reforms. Donor institutions are keenly monitoring progress and Kenya's success will unlock cheaper financing and grants.

## **6. Starving and in the dark**

The country is starving and power rationing bit industries during the third quarter. Food prices shot up owing to inadequate supply and high production costs. The drought that has persisted in most parts of the country from the beginning of 2009 impacted negatively on production of Kenya's major cash crops. Tea deliveries and eventually processing declined in the first half of 2009. The quantity of processed tea declined by 11.5% to 139,283 metric tones in the period. Due to this and the general global under-supply, farmers received averagely better prices for the output, at Kshs 192/kg, from Kshs 151/kg in 2008.

The global glut in coffee production did not upset prices during the first half of 2009 as may have been feared. Kenya's coffee production rose by 66% to 37,909 metric tones but the average price rose by 4% to US\$ 2.4/kg. Coffee farmers, long embroiled with middlemen who 'reap where they have not sown' may find sweet relief through their SACCOs which are collaborating under the newly created Kenya Cooperative Coffee Exporters Limited (KCCE). The company will strive to support the full value chain to enhance returns to the local farmers by seeking competitive prices of the output abroad.

The drought menace also hit the horticultural and formal dairy sectors, with output declining by 9% and 2% respectively. Power rationing led to increased cost of production of cut-flowers and fruits for export. Dry spell upset availability of feeds to the dairy sector. We however note that a high proportion of the national milk production is actually handled by the informal market and in an unprocessed form. Lack of capacity for processing projects normally lead to widespread wastages, with high economic loss to the farmers.

Starting the year at its lowest edge in years, the tourism sector has made significant gains so far. The first six months saw international arrivals grow by 48% and the third quarter experienced robust activity both from domestic and foreign tourist visiting major sites. Improvement in global economic conditions has propped international tourism but the outlook is not as rosy as stakeholders would have wished. Aggressive marketing and partnership deals that have been mooted by the government will indeed lead to overall take-off of the sector.

### **6.1. Inflation continues to bite**

Drought, high energy costs and power rationing have all acted to keep product prices exceedingly high. Emergency power generation threatens to push product prices higher, while also forcing consumers to pay higher bills. Transport costs have remained high despite some occasional fall in pump prices. This position confirms the high inflation rate in the past two years.

<b>Month</b>	<b>Overall</b>	<b>Underlying</b>	<b>Annual Average</b>	<b>CPI</b>
Jan 09	21.9%	11.1%	26.5%	318.0
Feb 09	25.1%	7.9%	27.0%	333.2
Mar 09	25.8%	7.7%	27.3%	345.3
Apr 09	26.1%	8.2%	27.3%	355.4
May 09	19.5%	7.0%	26.3%	348.8
Jun 09	17.8%	5.8%	25.3%	349.8
Jul 09	17.8%	4.5%	24.6%	337.6
Aug 09	18.4%	3.5%	23.8%	341.2
Sept 09	17.9%	3.2%	23.0%	345.0

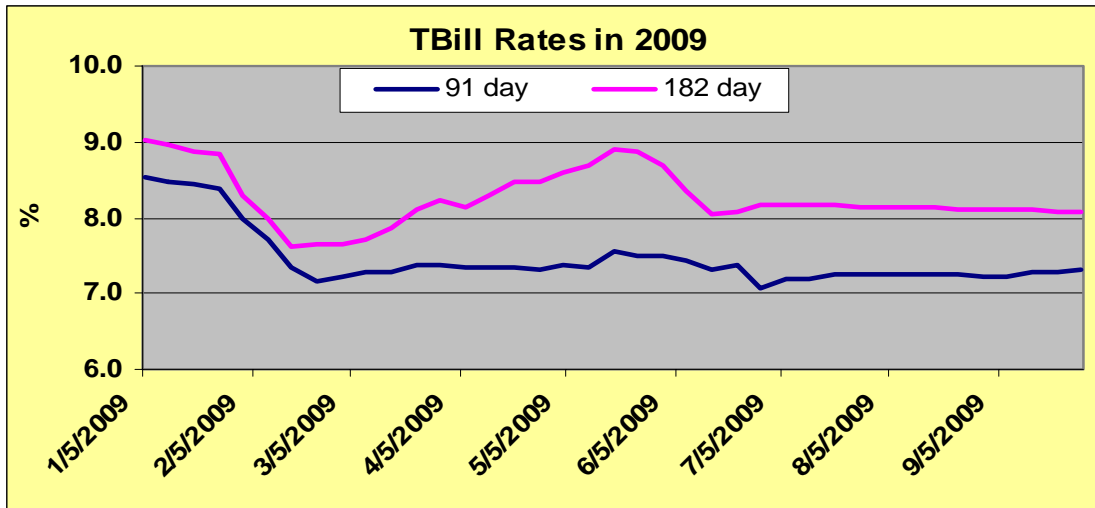
*Source: Kenya National Bureau of Statistics*

We are concerned that the rate may keep rising (or stabilize at high levels) in the short to medium term notwithstanding the monetary policies of the Central Bank or the expected (in) famous El Nino rains. This is due to potential imbalance in food production and heightened costs. Transportation cost from Kenya's granary (of Western and Rift Valley regions and parts of Central provinces) to the other urban areas will make prices sticky at their current high levels even when there is over-supply in the agricultural regions.

## **7. Financial markets**

There has been relative stability in interest rates since July 2009. This is despite the high inflation and continued government borrowing in the domestic market. This scenario can

be attributed to the Central Bank's actions in managing cash in circulation (liquidity) through short term tools (the repo and reverse repo markets).



Source: Central Bank of Kenya

91-days Treasury bill rate has steadied at 7.2% while 182-days TBill was at an average of 8.1% as investors sought to put their cash on safer investments. This was largely for nominal capital preservation rather than sustainable gains. With average inflation rate above 20% in the past twelve months, the real value of the investments is negative. The performance rate during the auctions however remained mixed, with a cocktail of under and oversubscriptions, almost in the same frequency.

Auction Date	CBK Offer (Kshs Bn)	Total Bids	Performance
6-Jul-09	5,500	2,331	42%
13-Jul-09	5,500	8,800	160%
20-Jul-09	6,000	4,714	79%
27-Jul-09	6,000	8,654	144%
3-Aug-09	6,000	5,250	87%
10-Aug-09	6,500	10,072	155%
17-Aug-09	8,500	17,389	205%
17-Aug-09	4,500	2,241	50%
24-Aug-09	6,500	4,143	64%
31-Aug-09	5,000	1,560	31%
7-Sep-09	7,000	11,401	163%
14-Sep-09	6,500	2,828	44%
21-Sep-09	7,000	13,898	199%
28-Sep-09	4,000	5,909	148%

Source: Central Bank of Kenya

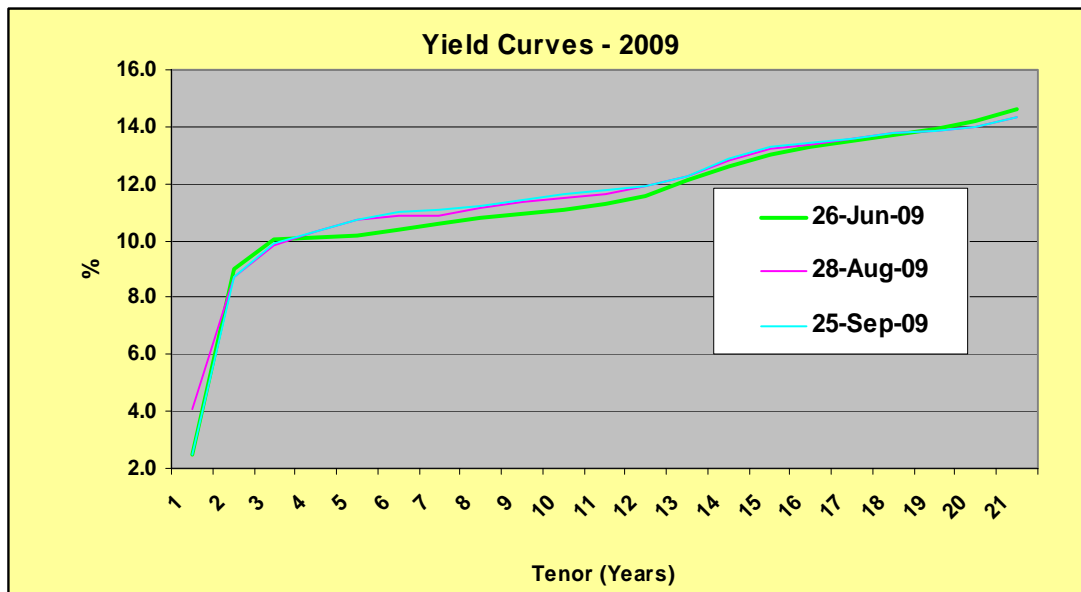
The Central Bank's Monetary Policy Committee (MPC) met on 23rd September 2009 and retained the key benchmark rate (CBR) at 7.75%. At this meeting, the Committee

also retained the cash reserve ratio (CRR) at 4.5% and the repo-tenors at 7 days as were set in July 2009. These actions were taken as the Committee aims at allowing the previous decisions to impact on the economy. The rationale has so far been to release more funds (liquidity) to the economy through private sector lending at reduced rates.

We however note that with the current high (non-monetary) inflation and depressed demand, the intended goals may not be fully attained in the short term. A few banks have shown some effort in responding to the moral suasion of the government. With the increased volumes traded in the interbank and reverse repo markets, it is evident that the situation is precarious and banks may remain more cautious in lending to the private sector.

### 7.1. *The Bond Market*

There has been marginal movement of the yield curve, especially in the long end during the third quarter of 2009. The short end has experienced volatility (as shown in the graph below) owing to the liquidity imbalance in the banking sector, which made interbank rates to spike to a high of 4.5% at the beginning of September 2009. Medium term issues have seen some upward shift with robust activity witnessed.



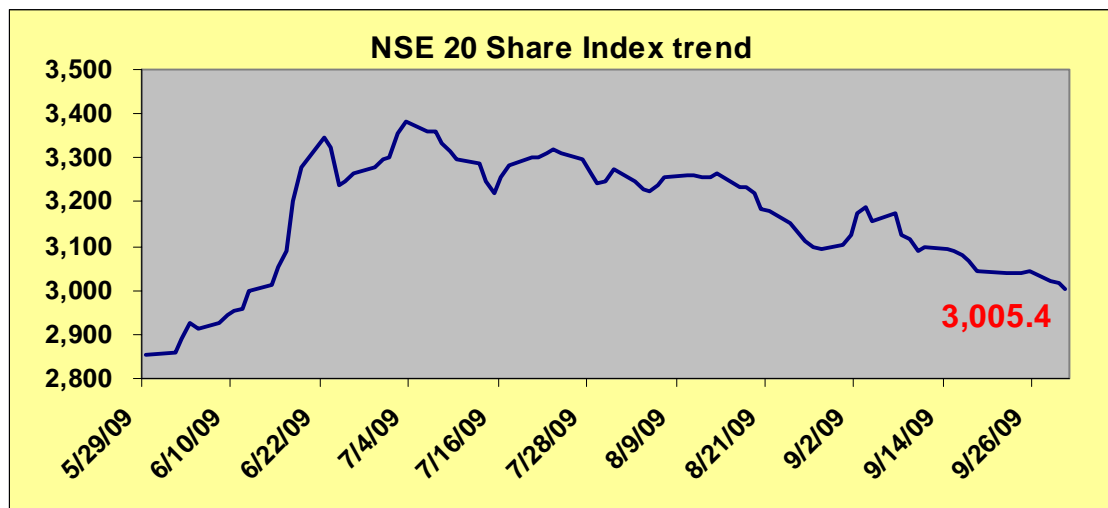
Source: NSE, Equity

The bonds market continues to be bullish, resulting from the depressed activity in the equities markets. The phenomenal flight to safety is being witnessed, with occasional market upturn on equities driven by re-entry of (foreign) investors. In preparation for the corporate bonds and other Treasury bond issues, the market witnessed robust activity, with bonds totaling Kshs 26.2 billion being transacted in the third quarter.

Corporate bonds market is gaining more attraction for companies to raise funds. Shelter Afrique raised Kshs 1.0 billion through a three-year bond; the KENGEN Public Infrastructure Bond Issue (PIBO), intending to raise Kshs 25 billion (maximum) was greatly welcomed by investors, with subscription estimated to be above target and a couple of other blue chip companies are angling to join the move. Automated bond trading system is being finalized. This will also be a significant step for the segment and will attract high interest from foreign investors who had previously loathed the current manual trading of bonds. Getting to the elite, modern trading platform will also enhance efficiency in price discovery and settlement.

## 8. The Nairobi Stock Exchange...confounded by the Bear

The exuberance that punctuated the end of June 2009 was nowhere in sight for the whole of the third quarter. The NSE slid consistently during the quarter, losing 8.8% to close at 3,005.4 points. Market capitalization slipped by 5% to Kshs 769 billion as most blue-chip companies remained fairly firm in the period. Dealers reported moderation in foreign investors' participation at the NSE. It was noted that the drying of demand by the foreigners led to a build up of supply and owing to the hard economic times, most retail investors had to make ends meet by disposing the shares notwithstanding losses.



Source: NSE

Volume of shares dealt during the quarter (808 million) was counter to that of the second quarter (893 million). The value traded (turnover) was however higher in the third quarter at Kshs 10.0 billion compared to Kshs 9.6 billion in the second quarter. Both of them are nonetheless dismal as compared to the fixed income market. Most companies tabled their six months operating results. The banking sector remained resilient while the oil sector was badly hit (Total Kenya (-94%), KenolKobil (-184%)). The market had somewhat anticipated these results hence no impact across the board. We also note that the bearish trend was sustained by the continued flight to safety (in Treasury Bills and Bonds).

However, there is a silver lining in the decline of share prices. The outlook is not grim and so with the depressed prices, most counters are indeed at a bargain currently.

Investors who lost their funds through collapsed Nyaga Stockbrokers Limited got some relief as the genuine claims of upto Kshs 50,000 were compensated. Obviously a majority was disillusioned by the cap as it meant any funds above it just went to the drain, leaving investors plainly helpless. Well, it is so far the law about the Investors Compensation Fund. This weakness has been identified and market stakeholders are keen to revise it and have a more representative approach for redress. Financial reporting for market intermediaries (brokers, investment banks/advisors and fund managers) took effect. A step in the right direction, yes, but the nature of disclosures fell below desirable format for transparency and true picture to be painted. Once addressed by the CMA, investors may have some criteria in choosing at least credible links.

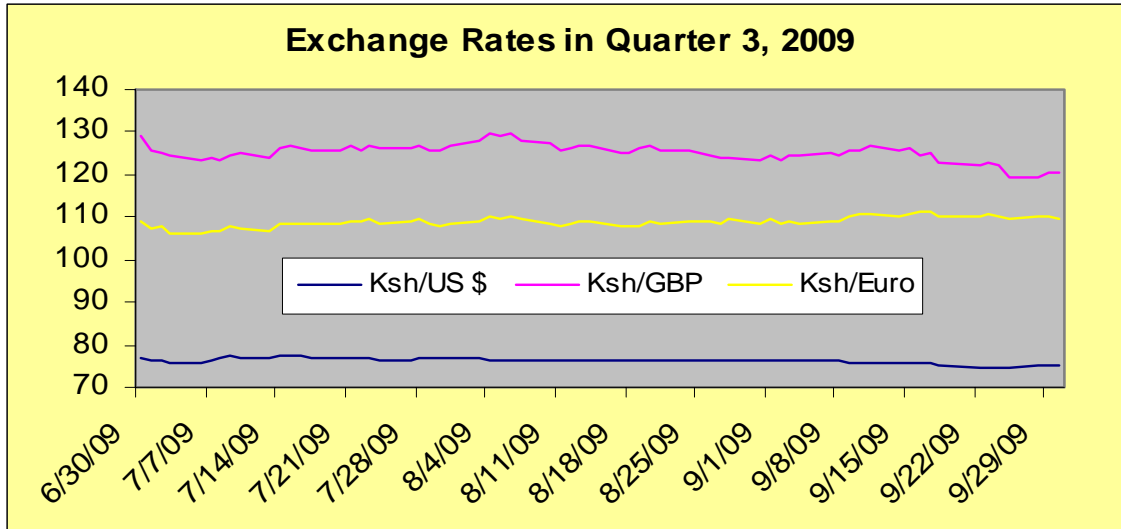
The market may remain cornered by the bear in the short term and we expect a strong recovery in tandem with economic rebound in 2010. The current mispricing will definitely attract fundamental and long term investors who are able to sustain the volatility dosages. With the current developments, cash is no longer king and sooner there will be scramble for shares.

## **9. The Shilling and its strength**

For most of the third quarter of 2009, the Kenya shilling traded in a narrow range to the US Dollar. However, it gathered momentum from mid-September, closing the quarter 2.8% stronger. It was propelled by the interest elicited by KenGen PIBO and the general weakening of the US Dollar against other major currencies. Official data from CBK indicate a surge in remittances from the diaspora in the months of July and August 2009. This also lays credence to the temerity of the shilling in the quarter.

The exchange rate trend was beneficial to large scale importers (who paid relatively less Kenya shilling amounts for the same US Dollar denominated merchandise). For the exporters (of goods and services like tourism), this scenario was detrimental as they received less value for the exports (the exports could be viewed as expensive especially in the existing economic challenges). The shilling also strengthened, by 7% against the Sterling Pound but was barely changed against the Euro.

CBK participated in the market on several occasions in a bid to raise more foreign exchange reserves (for meeting import demands and repayment of foreign debts). This was done strategically such that no major ripples in the exchange rate were caused. The purchase of the US Dollars from the forex market also enabled the CBK to pump in more cash into the economy.



Source: CBK

With the ongoing developments in the world markets, wherein the US Dollar is coming under intense pressure and scrutiny, the shilling may trade within a narrow bound in the fourth quarter. Further, opportunities at the capital markets may also determine the extent of capital inflows, which could lead to the shilling's resilience.

## 10. Going forward,

From the foregoing, we note that the economy is still grappling with several challenges, mainly structural and governance. Effort is being put in addressing these constraints, with proposed implementation of large scale irrigation projects, increased power production and initiating labour intensive employment opportunities.

Mitigating the effects of prolonged drought (mainly inflation) to the economy will unlock great potential via the increased disposable income. Increasing productive capacity in the rural areas is also a pre-requisite to sustainable growth and we foresee a gradual recovery in the fourth quarter of 2009 before rapid growth in 2010.

CBK, remaining vigilant on economic stability, is likely to continue with its operations regarding managing liquidity and interest rates. The renewed optimism, especially for 2010, is likely to prompt increased lending to the private sector thereby lubricating the recovery trajectory in the fourth quarter of 2009. The trade and manufacturing sectors are also seen as going to provide great input as the festive season beckons. We therefore maintain our earlier (second quarter) estimated economic growth rate of 2.7% for 2009.

The vibrant telecommunications sector, the recovering tourism industry and the resilient construction segment will provide key support for the economy going forward. We also believe the diversified agricultural production and technology based financial sector will gain their domineering positions in the medium term.

## 11. Global markets budding again

The US economy is stabilizing as the crisis is gradually drawing to an end. Most of the European countries have also experienced some recovery while the Asian countries have led the perk with a swift rebound of economic activity. With this came the stellar rewards for risk takers in the equities markets. Bond markets were however depressed owing to the increased government participation in the debt markets, via the massive purchase of toxic assets.

During the quarter, equity markets rallied, with the MSCI World Index gaining 16.9% while MSCI Emerging Markets Index added a further 20.1% to the previous gains since the beginning of 2009. Better than expected corporate results and improving economic outlook prompted investors' risk appetite, wherein most stocks were (and are still being) viewed as undervalued.

### *11.1. Which currency?*

Currency swings have generally been caused by capital flows and expectations about the economy. The US Dollar came under intense pressure across the world. A couple of high level consultative meetings have been held to gauge suitability of the currency in global business framework. The spotlight resulted from the spectacular 'near' collapse of the US economy under the financial crisis. The Far Eastern countries (China, Japan) which were able to withstand the shocks and actually pulled out of recession much faster are elevating their currencies to the global scene. Pricing of commodities on other currencies may be on the test mills and favourable adoption is unlikely to be achieved without substantial volatility associated with the changeover in the global markets.

Investors have become more bullish on the Euro, the Yen and the Chinese renminbi (RMB). These have upstaged the US Dollar especially in the third quarter of 2009. During the third quarter, the US Dollar appreciated by 2.9% against the Sterling Pound but depreciated sharply by 4.2% and 7.1% against the Euro and the Japanese Yen respectively. Due to the ongoing weakness (although modest recovery has been reported) in the US economy, the government is tolerating weakness in the dollar. The rationale is that the weak Dollar shall make exports attractive thereby boosting trade revenues and the linkages to the economy.

Nonetheless, since the US debt position is largely comprised of foreign funds, the slump in the currency exposes the Treasury to some imminent shortfall. Central bankers have become more nervous and been noted to accumulate more reserves mainly in other currencies, with the Dollar's weighting sliding phenomenally. The credibility of the US Dollar has indeed been tested but it may remain a formidable currency in the near term; as the search for a more appealing reserve currency heats up. A deep compromise is inevitable as the latest dynamics in the political and economic fronts do not make any particular currency dominant and acceptable.

US\$/Euro exchange rate trend



*Source: BBC, October 12, 2009*

Most governments have started to realign their monetary and fiscal policies to sustain a rebound from recession. This has partly entailed a keener focus to stem any inflationary threats and the need to achieve sustainable debt levels. There is a drive for the governments to gradually unwind from participating heavily in the financial markets as economic recovery is achieved.