Central Bank of Kenya

REPORT OF THE MONETARY POLICY COMMITTEE MARKET PERCEPTIONS SURVEY JANUARY 2019

CONTENTS

BACKGROUND TO THE MARKET PERCEPTIONS SURVEYS

The Central Bank of Kenya (CBK) undertakes a Market Perceptions Survey every two months, prior to every Monetary Policy Committee (MPC) meeting to obtain perceptions of banks and non-bank private sector firms on selected economic indicators.

The Survey also enables respondents to report their levels of optimism in the country's economic prospects, improvement in the business environment and perspectives on the current and expected economic conditions in the country, focussing on economic activity, employment and input prices. It also captures suggestions by private sector firms on how the business environment could be improved.

Commercial banks, micro-finance banks, as well as a sample of non-bank private sector firms are covered in the surveys. A sample of non-bank private firms is taken from selected towns across the country namely Nairobi, Mombasa, Kisumu, Eldoret, Nakuru, Nyeri and Meru, and are representative of sectors that account for about 70 percent of Kenya's GDP. The sectors covered by the survey include agriculture, mining and quarrying, manufacturing, electricity and water, trade, hotels and restaurants, Information and Communications Technology (ICT), transport, real estate, building and construction, finance and insurance, and health.

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

1. INTRODUCTION

The January 2019 MPC Market Perceptions Survey was conducted in the first three weeks of the month. It sought perceptions on the economic conditions prevailing in November and December 2018, as well as market expectations for the next two months (January-February 2019), and over the next 12 months (January – December 2019). Respondents were asked to provide their expectations with regard to overall inflation, exchange rate of the Kenya Shilling against the U.S. Dollar, demand for credit, ease of credit access, private sector credit growth and economic growth. Other areas interrogated included the levels of optimism in economic prospects, perceptions of economic activity before and expectations after the MPC meeting, as well as movements in input prices before the MPC meeting.

This report provides a summary of the analyses of the responses to the Survey, including reasons behind the expectations.

2. SURVEY METHODOLOGY

The Survey was administered through questionnaires sent, through email and hard copy, to the Chief Executives of 377 private sector firms comprising of 39 operating commercial banks, 1 mortgage finance institution, 13 micro-finance banks (Mfbs), and 324 non-bank private firms including 45 hotels. The overall response rate to the January 2019 Survey was 66 percent of the sampled institutions. The respondents comprised of 38 commercial banks, 1 mortgage finance institution, 12 micro-finance banks, 38 hotels, and 160 non-bank private sector firms.

The Survey questionnaires were completed by either Chief Executive Officers, Finance Directors, or other senior officers from the sampled institutions who have knowledge on the economy and the business environment.

The expectations from commercial and micro-finance banks are compiled using weighted averages based on the market size of the institution, while those from the non-bank private firms are weighted using the respective sector weights based on the latest available sectoral contributions to GDP from the Economic Survey, 2018.

3. HIGHLIGHTS OF THE SURVEY

According to the January 2019 Market Perceptions Survey:

- Inflation expectations were revised downwards, and remained well anchored within the Government's target range (5 ± 2.5 percent) in the next 2 months (January and February 2019) and over the next 12 months (January to December 2019).
- Banks expected an increase in private sector credit growth in 2019 relative to 2018.
- Banks and non-bank private sector firms expected the Shilling/U.S. dollar exchange rate to remain stable in January and February 2019.
- A stronger economic growth was expected in 2019 relative to 2018.
- There was increased optimism on the economic growth prospects and improvement in the business environment going forward.

4. CURRENT ECONOMIC CONDITIONS

4.1 Overall Economic Activity

Banks and non-bank private firms were asked to provide their assessment of economic activity in November and December 2018 **(Chart 1).** According to the respondents, economic activity during the period was moderate tending to strong, driven by higher consumption, which is typical during the festive season. There was strong demand in most service sector activities, especially tourism, which recorded high hotel bookings during the period. Good rains in the fourth quarter of 2018 buoyed agriculture and utilities sector activities. Respondents from businesses which traditionally close during the holidays, indicated reduced activity in November and December compared to the rest of the year, partly due to book closure. Government spending remained moderate in the period, with respondents attributing this to the suspension of all new projects pending completion of running ones.

Economic activity during this period benefited from lower electricity prices which provided relief to consumers and industries by lowering the overall energy costs. Energy costs had risen following the introduction of VAT on petroleum products in September 2018. Bank activity was slow due to weak lending to the private sector.

Economic activity in the regions varied, with Nyeri and Meru recording moderate to very strong activity. According to respondents in these regions, the rains in November and December boosted agricultural activities, especially tea, while hotel bookings rose due to an increase in domestic tourism during this period **(Chart 2).**

Firms in Nairobi, Eldoret Nakuru and Mombasa recorded moderate to strong activity in the two months under review. Respondents indicated that there was a general increase in demand, and equivalent change in production to meet the demand. The stable macroeconomic and political environment were cited as supportive of economic activity during the period.

Some respondents, however, noted that economic activity had been affected by the negative impact of some of the County government policies such as increased taxes, a general negative sentiment from customers and suppliers of a slow cash flow and constrained credit access in the economy.

Chart 1: Perceptions on Economic Activity for November and December 2018 (percent)

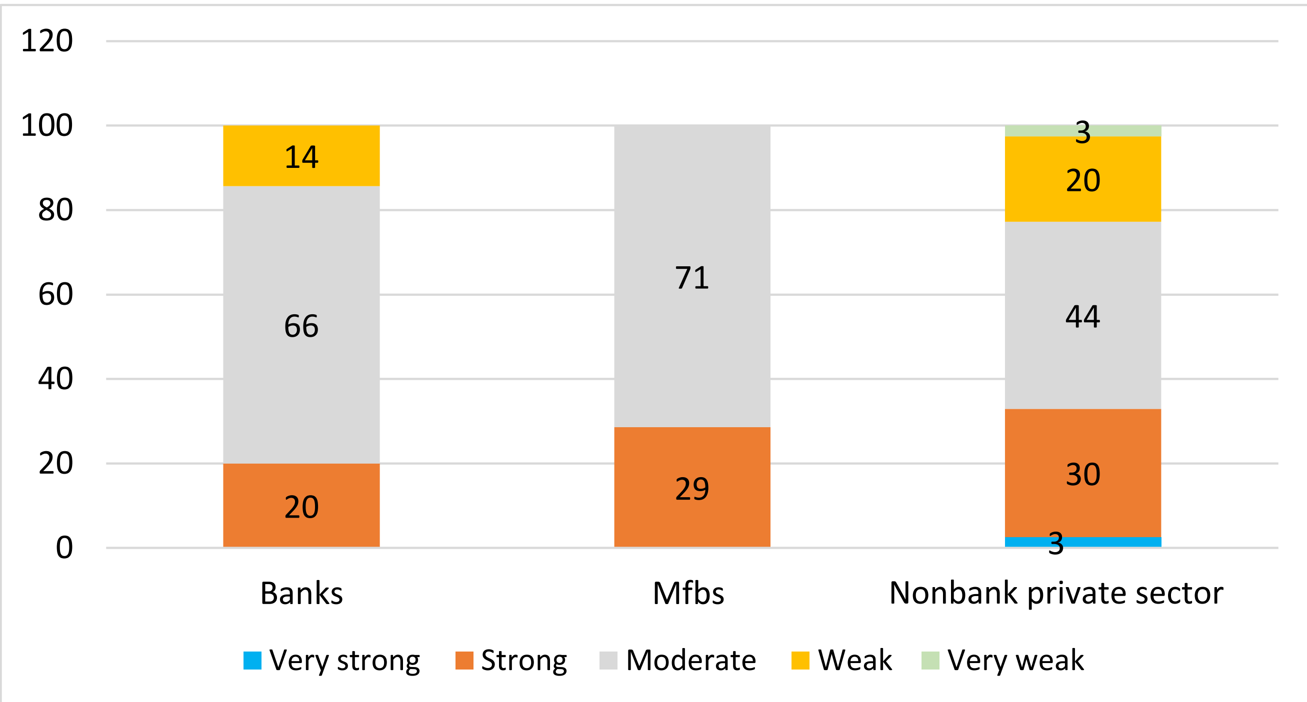
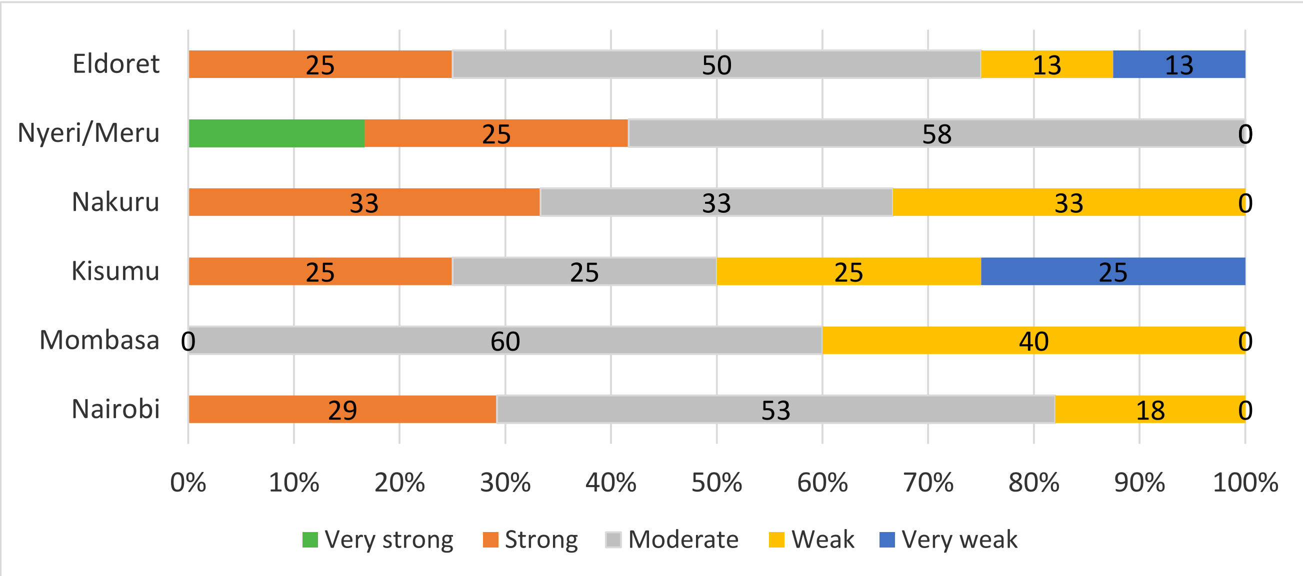


Chart 2: Perceptions on economic activity in November and December 2018 by Region (percent)



4.2: Input prices

Respondents were asked to indicate the direction of change (increase/ decrease), in the prices of various inputs such as fuel, transportation costs, agricultural commodities, manufacturing inputs, freight charges and construction materials, in November and December 2018.

Respondents representing the manufacturing sector across the regions reported that they experienced marginal to significant increases in fuel costs while those in the non-bank financial sector and agricultural sector reported a marginal increase in fuel prices during the period under review. Increased transportation costs were mostly felt by the wholesale and retail, manufacturing and real estate and construction sectors while agricultural input prices remained moderate in November and December 2018 **(Table 1).**

Table 1: Perceptions on Movements in input prices in November – December 2018 (percent of respondents)

	Significant Increase	Marginal Increase	Remain the Same	Marginal Decline	Significant Decline
Fuel costs	30.0	44.0	6.0	16.0	4.0
Transportation costs	34.7	40.8	20.4	4.1	0.0
Agricultural commodities	4.9	36.6	31.7	26.8	0.0
Manufacturing input	26.3	34.2	34.2	5.3	0.0
Freight charges	29.4	44.1	26.5	0.0	0.0
Construction materials	30.0	60.0	10.0	0.0	0.0

5. INFLATION EXPECTATIONS

Participants in the survey were asked to indicate their expectations of overall inflation rates for the next 2 months (January and February 2019), and in the next 12 months (January to December 2019). All respondents revised their inflation expectations downwards for the next two months, and maintained that they expected inflation to remain within the target range (5 ± 2.5 percent) **(Table 2).**

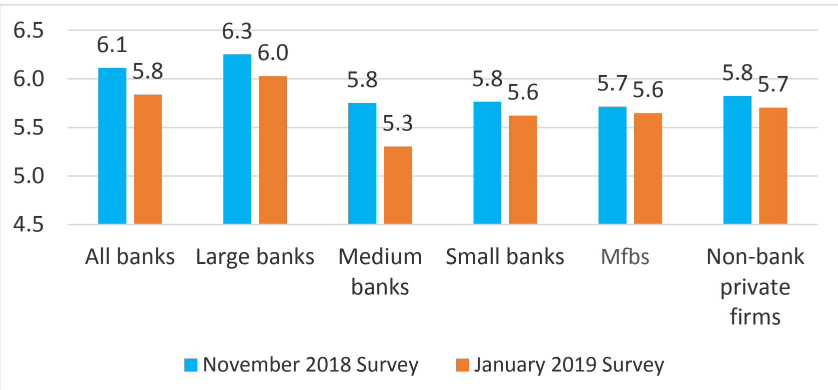
Despite January and February 2019 being typically dry months, respondents expected the current low levels of food prices following the short rains in October to December 2018, the reduction in fuel prices by the Energy Regulatory Commission (ERC) and lower electricity prices as well as improved supply of electricity with the connection of the Turkana Wind Power project to the National grid, to keep inflation under control. Respondents expected the outcome of the on-going harvests from the short rains season to remain key in determining the level of pressure on inflation in the next two months.

Inflation expectations for the 12-month period after the MPC meeting were lower in the January 2019 Survey compared with the November 2018 Survey **(Chart 3).** The anticipation of favourable weather conditions and low food prices, the reduced cost of electricity, the low level of international oil prices and a stable Shilling are expected to support low inflation in the next 12 months. Respondents, however, pointed out that inflation during this period would depend highly on the weather pattern in 2019, which was yet to be published by the Meteorological Department. Upward pressure on inflation would be expected if agricultural production was compromised due to inadequate or delayed rains, and volatility in international oil prices.

Table 2: Inflation expectations for the next 2 months (percent)

Expect Inflation for:	Large banks	Medium banks	Small banks	All banks (weighted by size of bank)	MFBs	Non-bank private firms
Jan-Feb 2018	5.5	5.1	4.9	5.3	5.0	5.0
Mar-Apr 2018	4.4	4.8	4.6	4.5	4.6	4.8
May-Jun 2018	4.2	3.9	3.7	4.1	3.9	3.8
Jul-Aug 2018	4.9	4.6	4.6	4.8	4.8	4.4
Sep-Oct 2018	5.4	5.1	5.1	5.3	4.9	5.3
Nov-Dec 2018	5.6	5.6	5.6	5.6	5.7	5.7
Jan-Feb 2019	5.5	5.3	5.5	5.5	5.5	5.6

Chart 3: Expected Overall Inflation for the next 12 months (percent)



6. EXCHANGE RATE EXPECTATIONS

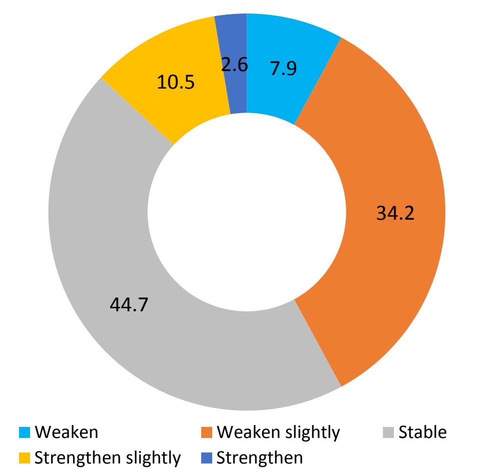
Participants were asked to indicate their expectations on the direction of change in the exchange rate of the Shilling against the U.S. Dollar in January and February, 2019 and in the next 12 months. Results from the Survey showed that banks expected the exchange rate of the Shilling against the U.S. dollar to remain stable in the next two months supported by sufficient foreign exchange reserves, the relatively low international oil prices, higher horticulture inflows and diaspora remittances **(Chart 4).** Risks to stability of the Shilling were cited as the strengthening of the U.S. dollar as the U.S. Federal Reserve Bank tightened monetary policy, fears of a global recession in 2019, increase in import bill with increased demand, slowdown of growth in China, and uncertainties around Brexit. In addition, seasonal pressures on the Shilling were expected to come from U.S. Dollar demand for dividend repatriation and debt repayments.

Non-bank private firms on the other hand expected the Shilling to remain stable in the next 2 months supported mainly by strong foreign exchange reserves which continued to provide adequate cover and a buffer against short-term shocks in the foreign exchange market, increased foreign receipts from horticultural (flowers) sales in February peak season, sustained remittances flows, and lower oil prices **(Chart 5).** According to the non-bank private firms, risks to stability of the Shilling in the next 2 months were cited as expected increase in imports demand as economic activity picked up, likely increase in the Federal Reserve rate, international markets instability depressing exports realization, slowed agricultural exports due to unpredictable weather patterns, and higher foreign debt repayments.

Over the next 12 months, respondents expected that a stronger U.S. dollar, possibility of rising international oil prices, increased imports with pickup in economic activity, concerns about a global recession, slowdown in China and materialization of Brexit could exert some moderate pressure on the Shilling.

Chart 4: Banks expectations on the direction of the Shilling/U.S. dollar Exchange rate in the next two (percent)

January 2019 Survey



November 2018 Survey

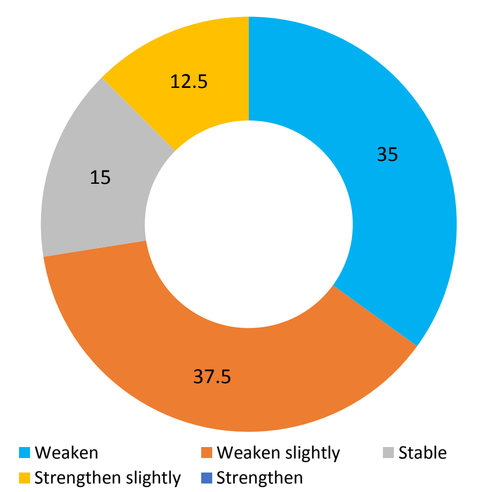
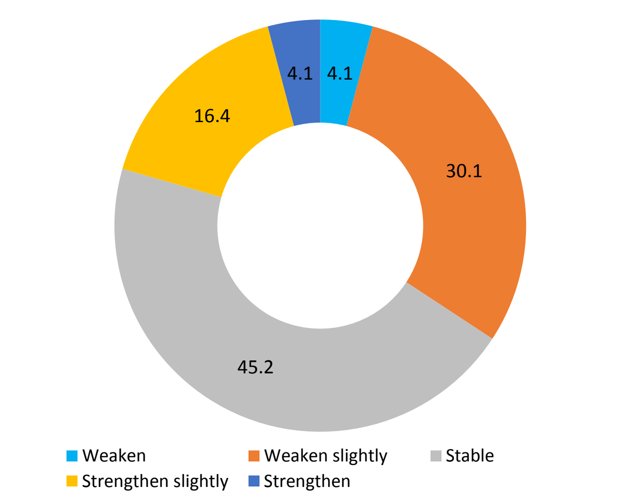
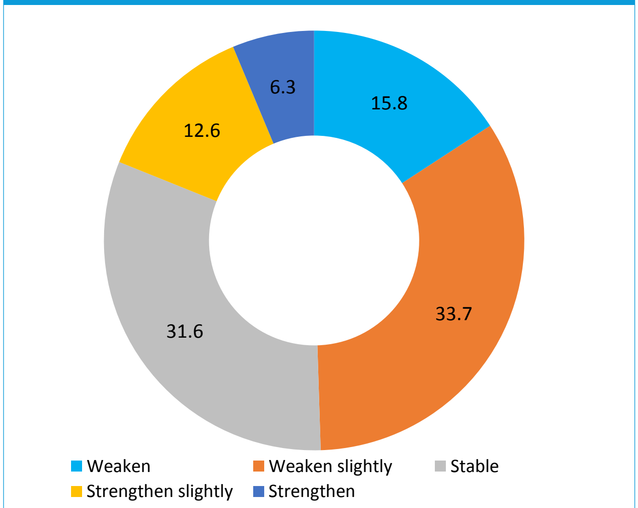


Chart 5: Non-bank private firms expectations on the direction of Shilling/ U.S. dollar Exchange rate in the next two months (percent)

January 2019 Survey



November 2018 Survey



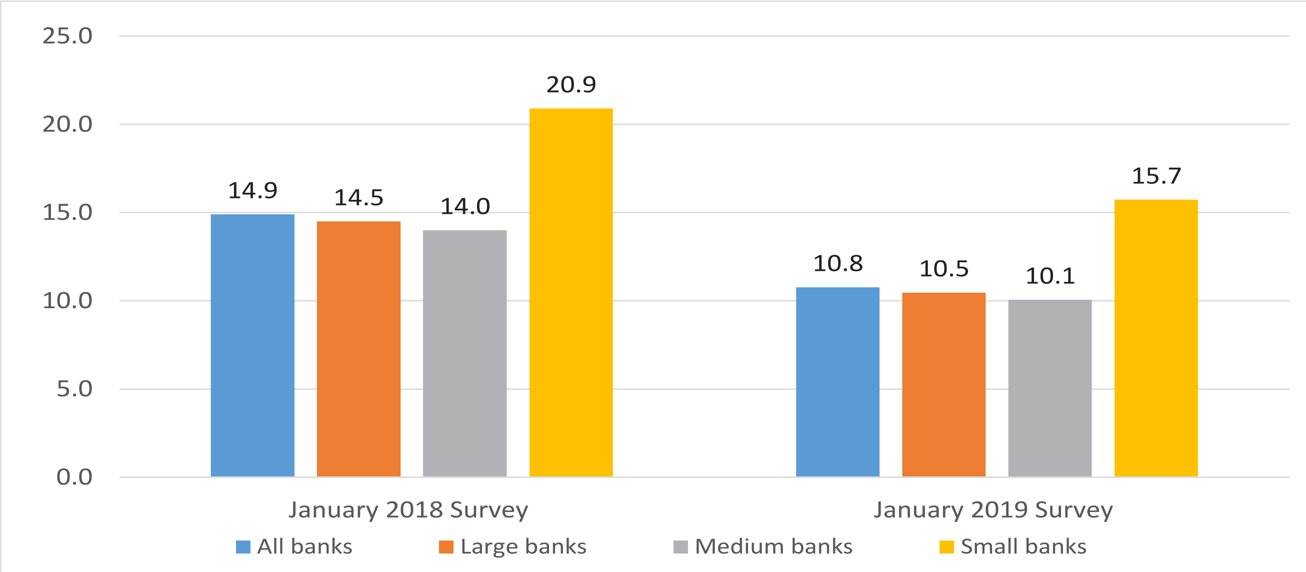
7. PRIVATE SECTOR CREDIT GROWTH EXPECTATIONS

7.1 Growth in Private Sector Credit in 2019

Commercial banks were asked to indicate their expected growth in lending to the private sector in 2019 relative to 2018. Respondents indicated that lending expectations were high despite the existing environment of interest caps. Bank respondents indicated that lending in 2019 was expected to be supported by the stable macroeconomic environment and increased economic activity, which are expected to translate into a higher demand for credit from both firms and households. In addition, the banks pointed out the presence of higher investment appetite by entrepreneurs due to lower interest rates, lower political risk and business opportunities in the Big 4 priority areas.

According to the Survey, the removal of deposit rates cap has lessened the strain on cost of funds for banks but interest rate capping and the resultant inability to effectively price risk continues to constrain supply of credit as lenders diversify their portfolio to higher income and lower risk investments **(Chart 6).**

Chart 6: Expectations on Private Sector Credit Growth (percent)



7.2. Expectations on Demand for Credit

Bank respondents expected an increase in demand for credit in January and February 2019 relative to November and December 2018, due to the lower interest rates, consumer loans growth in the first two months of the year to fund education related needs, optimism by Micro Small and Medium Enterprises (MSMEs) about investing in Big 4 related projects, and expected demand for loans by farmers in February to prepare for the long rains planting season **(Chart 7).** However, respondents indicated that most borrowers were still in the planning stage of their business goals, with execution expected to be in the second quarter and that lower loan approval rates by banks had slightly dampened the demand for credit with some clients resorting to mobile loans.

Chart 7: Expectations on Demand for Credit for the next two months (percent)

NOV-DEC 2018	Large banks	Medium banks	Small banks
Very high	0.0	0.0	0.0
high	11.1	22.2	25.0
moderate	66.7	44.4	45.0
low	22.2	33.3	30.0
very low	0.0	0.0	0.0
JAN-FEB 2019	Large banks	Medium banks	Small banks
Very high	0.0	0.0	5.0
high	22.2	44.4	35.0
moderate	55.6	55.6	50.0
low	22.2	0.0	10.0
very low	0.0	0.0	0.0

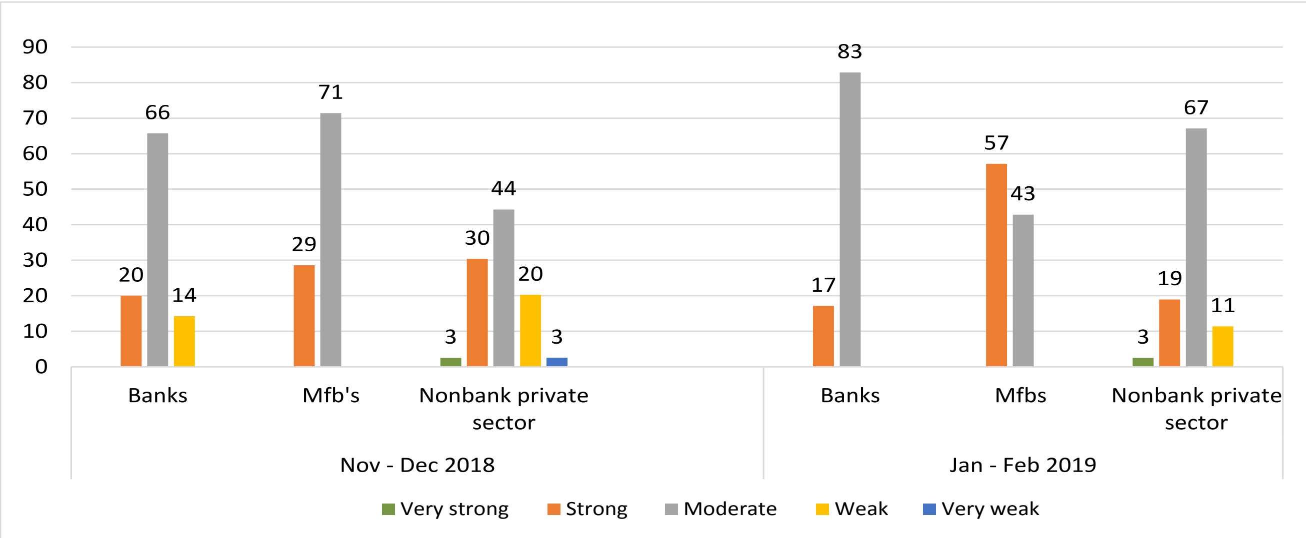
8. ECONOMIC ACTIVITY AND EMPLOYMENT

8.1. Expected Economic Activity

In the January 2019 Survey, respondents expected economic activity (volume of demand/ business activity/ production) to increase in the period January – February 2019 relative to November – December 2018 **(Chart 8).**

The recovery in economic activity began with the opening of schools in the new year and was expected to accelerate as the year progressed, boosted by a stable macroeconomic environment, low oil prices, rebound in tourism, strong remittance inflows, a government led infrastructure development initiative, and an improving Purchasing Managers Index (PMI) which suggested a improved in manufacturing activity. Activities surrounding the Government's Big 4 agenda, were expected to create opportunities for businesses while flower exports were expected to peak in the next 2 months. However, respondents indicated that low access to credit continued to constrain private sector activity.

Chart 8: Expectations on Economic Activity (percent)

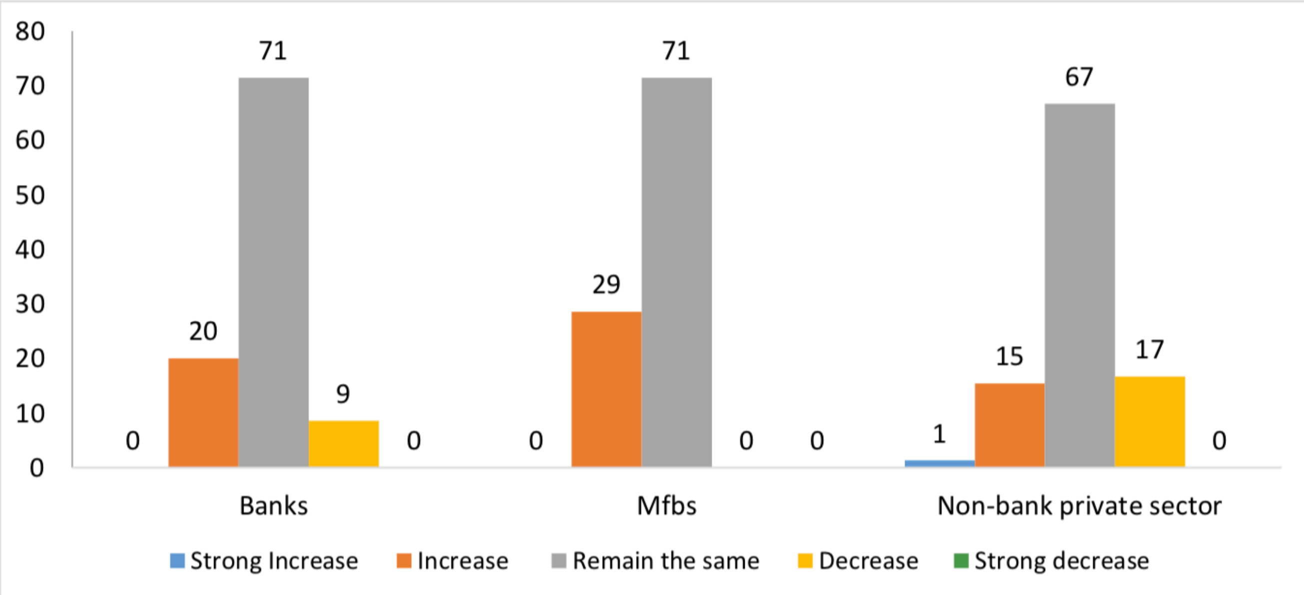


8.2: Employment Expectations

Bank and non-bank private sector firms were asked to indicate the expected trends in employment for their respective institutions in the next 2 months. Respondents indicated that employment was expected to increase in the next 2 months driven by optimism in the business prospects for 2019 and expected growth, which would require additional employees, filling of existing gaps, increases in line with expected expansions (new branches), and in pursuit of more productivity in key operational and business areas.

According to banks, digitization of banking products, processes and business models meant a rise in employee productivity thus dampening demand for new hires while the interest capping law had reduced the need to employ credit officers in sub sectors where the bank is unable to price risk **(Chart 9).**

Chart 9: Expected movements in employment levels in January – February 2019 (percent)



9. ECONOMIC GROWTH EXPECTATIONS

Participants were asked to indicate their estimated economic growth rate for the country in 2018, and their expected growth rate for 2019.

9.1 Expectations on Economic Growth for 2018

The Survey revealed that banks and non-bank private sector firms, expected the growth momentum in the first three quarters of 2018 to be sustained through the fourth quarter, since activity levels were similar to those experienced in the first three quarters. **(Table 3).**

According to the Survey, economic growth in 2018 benefited from improved weather conditions which boosted agricultural output and exports, Government spending on key infrastructure projects, increased remittances from the diaspora, political stability, which resulted in improved foreign investor confidence, increase in the number of tourists and foreign income associated with the sector, and a stable macroeconomic environment.

The effects of interest rate capping continued to be felt in 2018 impeding credit access, the impact of the newly introduced taxes, delays in National and County Governments payments to suppliers, reduced expenditure on development projects and concerns over the level of public debt repayments were cited as the main risks to growth in 2018.

Table 3: Expectations on Economic Growth for 2018 (percent)

Survey month	Large banks	Medium banks	Small banks	All banks (Weighted by size of bank)	Micro-finance banks	Non-bank private firms
Jan - 2018	5.5	5.5	5.4	5.5	5.6	5.4
Mar - 2018	5.4	5.3	5.4	5.4	5.5	5.4
May - 2018	5.5	5.6	5.4	5.5	5.6	5.6
Jul - 2018	5.5	5.6	5.8	5.6	5.6	5.9
Sep - 2018	5.6	5.4	5.4	5.6	6.0	5.7
Nov - 2018	6.1	5.8	6.0	6.0	6.0	6.0
Jan - 2019	6.0	6.0	5.9	6.0	6.0	6.0

9.2 Expectations on Economic Growth for 2019

Respondents indicated expectations of a stronger growth in 2019 relative to 2018 **(Table 4).** Banks and non-bank private sector firms pointed out that they anticipated the year to witness normal weather conditions and a stable macroeconomic environment. They expected that growth would benefit from the completion of the Government's public infrastructure investments, implementation of the Big 4 agenda, favourable weather to boost agriculture production, low international oil prices, improvement in tourism/ hospitality sector and a stable macroeconomic outlook.

According to the Survey, external risks to economic growth included the effects of the Federal Reserve Bank's tightening of monetary policy, fears of a slowdown in global growth, slower growth in China and the uncertainities around Brexit. Domestically, taxation measures such as VAT on petroleum products, the slow private sector credit growth, concerns about the level of public debt and political noise around succession, were mentioned as likely factors which could dampen growth in 2019.

Respondents representing the agricultural sector anticipated a good year for the sector, driven mainly by increased production and lower cost of fuel and electricity. The hotel industry indicated that the swift and expert handling of the terror attack in January 2019 inspired confidence among their target international markets regarding security in the country while the focus on sectors aligned to the Big 4 agenda was expected to improve their contribution to economic growth in 2019. Banks remained hopeful that the interest capping law would be reviewed.

Table 4: Expectations on Economic Growth for 2019 across Sectors (percent)

	2019 AVERAGE	MAXIMUM	MINIMUM
Large banks	5.9	6.2	5.6
Medium banks	6.0	6.2	5.5
Small banks	6.1	6.5	5.8
MFB’s	6.4	6.5	6.0
Agriculture	6.4	7.0	5.9
Manufacturing	6.2	6.8	5.8
Trade	6.3	7.0	6.0
Real estate, Building, construction	6.3	6.5	6.0
Tourism (incl. hotels)	6.2	7.0	5.7
Finance & Insurance (excl. banks)	5.8	6.0	5.0
Transport	6.2	6.2	6.1
Other	6.1	6.1	6.1

10. OPTIMISM ON THE ECONOMY

10.1. Economic Prospects and Improvement in the Business Environment

Banks and non-bank private sector firms were asked to indicate their levels of optimism on the country’s economic prospects and improvements in the business environment going forward. The results showed increased optimism by the respondents relative to the November 2018 Survey **(Chart 10 and 11).**

According to respondents in the banking sector, the increased optimism was attributed to the low inflation levels in the country, the stable Shilling, stable interest rates, Government focus on the Big 4 agenda to drive economic activity, higher economic growth expectations, improvement in World Bank Doing Business Indicators which would attract more investment, commitment by the CBK to achieving and maintaining price stability, favourable weather conditions likely to boost agricultural output, strong exports performance, political stability, improved tourism, expected completion of infrastructure projects, the renewed fight against corruption and expectations of a review of the interest rates capping law. Risks to this optimism, however, included interest rate capping and slow private sector credit growth, and concerns around corruption.

Respondents from the non-bank private firms remained optimistic about the economic prospects and improvements in the business environment, citing political stability in the country, direct flights to the USA and France, infrastructure development investments, the renewed fight against corruption, focus on the Big 4 agenda, low inflation, good weather conditions, enhanced security, expected completion of SGR, improved investor confidence, stable business environment, sustained economic activity and the expectation of better economic growth performance in 2019. The respondents cited security concerns and political noise about succession as risks to their optimism.

Chart 10: Optimism by Banks on Economic Prospects and Improvement in the Business Environment Going Forward (percent)

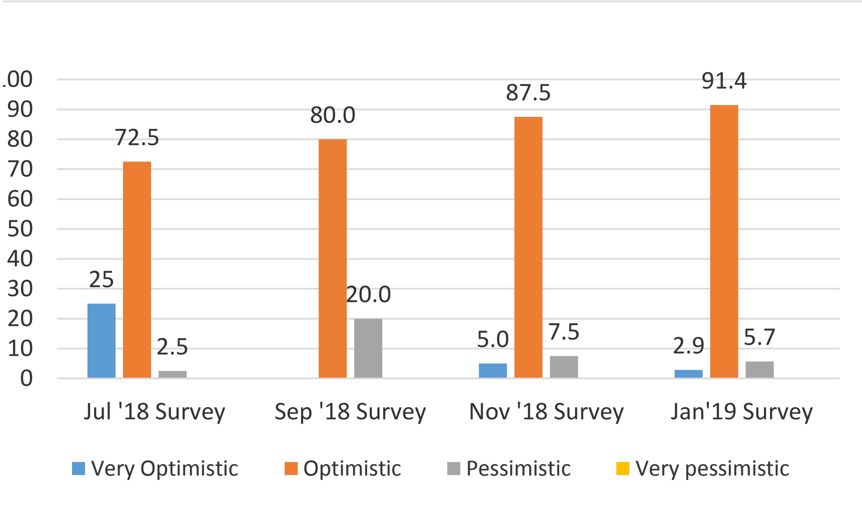
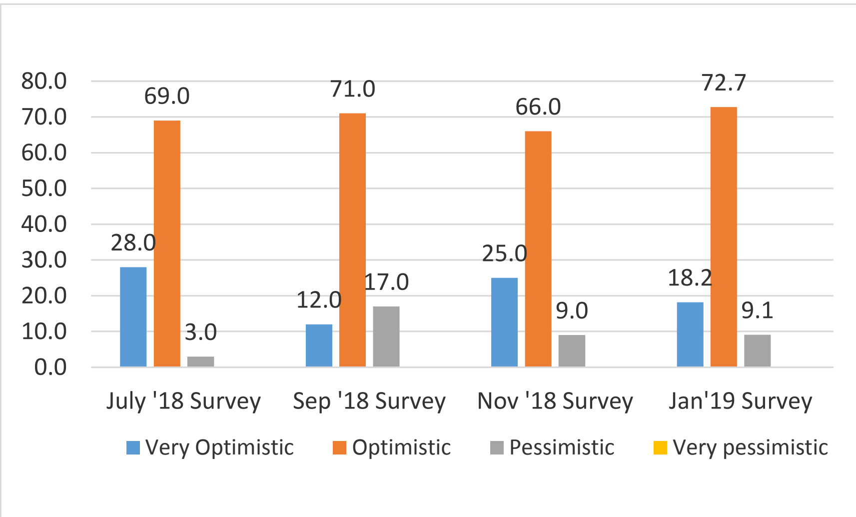


Chart 11: Optimism by Non-Bank Private Firms on Economic Prospects and Improvement in the Business Environment Going Forward (percent)



10.2. Forward Hotel Bookings

Hotels were requested to provide their levels of monthly forward bookings received so far for the period January to April 2019. The Survey showed an increase in the average forward bookings compared to a similar period in 2018 **(Chart 12 and 13).** The increase in average forward bookings in 2019 relative to 2018 was attributed mainly to improved business environment and enhanced security.

Other factors driving the bookings in 2019 included the growing conference and business tourism, the upcoming Valentine's season's bookings and resumption of corporate bookings in the new year. Respondents pointed out that big investments in budget airlines such as Jambo Jet and Silverstone contributed to reducing the cost of travel, and facilitated movement for tourists. The SGR was credited for improved hotel occupancy rates in destinations such as Mombasa, Voi, Taita, Tsavo and Amboseli due to the affordable cost and convenience. According to the hotel respondents, security concerns were cited as a risk to forward bookings.

Chart 12: Forward Hotel Bookings in the January 2019 Survey (percent of total capacity)

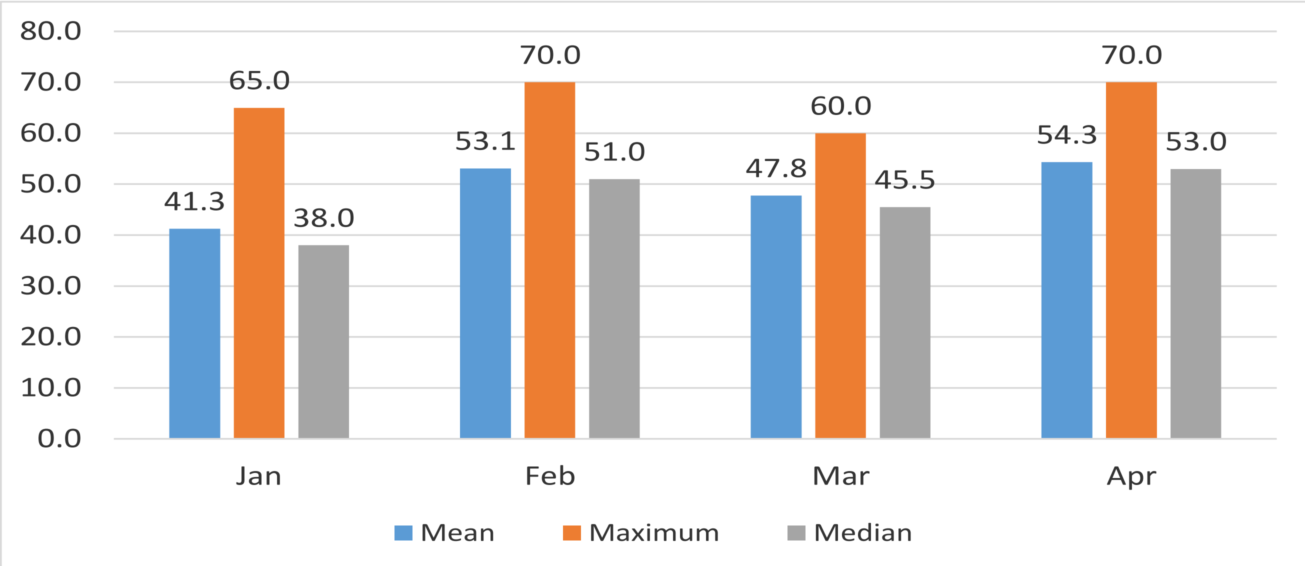
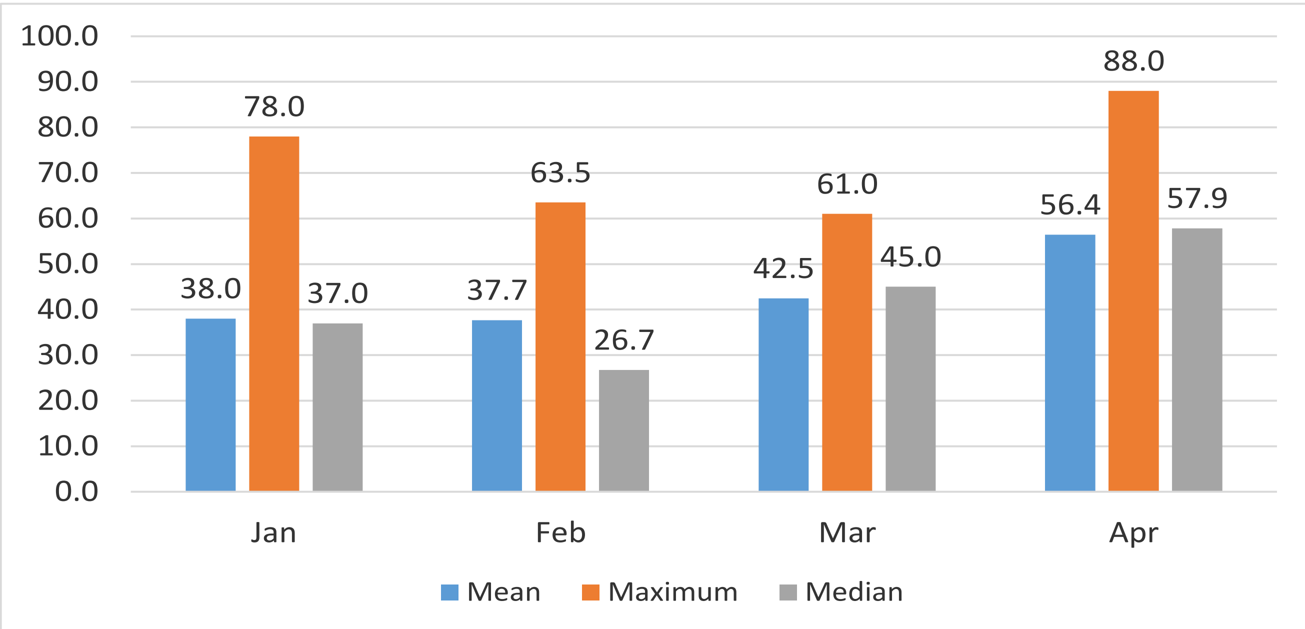


Chart 13: Forward Hotel Bookings in the January 2018 Survey (percent of total capacity)



11. THE IMPACT OF RECENT PUBLIC INVESTMENTS IN INFRASTRUCTURE

In the January 2019 Survey, banks and non-bank private firms were asked to point out the impact of the recent public investments in infrastructure (including SGR) on their company's operations.

Banks indicated that there was increased lending to support functions/industries in the various projects, increased financing to some MSMEs involved in public infrastructure value chains for SGR/ Roads/ Electricity/ Airports /Ports and increased public sector lending opportunities especially in the energy, transport and cargo services sectors. The development of road infrastructure has grown asset finance loans as clients seek facilities to carry out the projects, increased local travel making it easier for mobility of resources and factors of production, increased business activity and efficiency in logistics businesses that are linked by the two cities that are served by SGR, increased export and import activity leading to increased uptake of trade financing, international money transfer services and foreign exchange services.

The non-bank private sector, including hotels, cited the cheaper and convenient transport and business opportunities availed in the establishment of new industries to serve the new railway, improvement in the tourism sector following improved occupancy levels in the towns served by the SGR, easier freight movement between Mombasa and Nairobi, eased pressure on road transport demand, allowing businesses to leverage and negotiate for better transportation rates and reduction in transportation time taken to move goods.

Despite these gains, some respondents reported experiencing some challenges including loss of business for clients involved in cargo containers transit and long distance transporters, and a slight reduction in the number of holiday makers to up-country hotels.

12. IMPROVING THE BUSINESS ENVIRONMENT

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

Banks indicated the need to strive to have the amended interest rates capping law repealed as it had incapacitated the ability of banks to price risks for clients in higher risk subsectors, leading to a reduction in private sector credit to MSMEs, dampened private sector led GDP growth and a lower ability of banks to capitalize from retained earnings. In addition, banks suggested the implementation of favourable policies to provide lenders with incentives to increase lending to the personal/ household and SMEs sectors.

Bank respondents suggested the introduction of a Prompt Payments Bill, indicating that it would ensure MSME's access their payments on time, and would be crucial in managing the risk of Non-Performing Loans (NPLs). They also proposed the implementation of the Nairobi International Financial Centre (NIFC) and a Commodities Exchange that would spur rapid transformation from peasant to commercial agriculture. Introduction of tax and non-tax incentives to encourage export of financial services through internationalization of Kenyan banks, and coordinated efforts to address cybercrime and as a result engendering trust and confidence in the financial sector. Respondents indicated that increased efforts in financial inclusion, digital innovation and reduction in the cost of doing business, particularly the costs of recovery on distressed facilities through speedier resolution in the courts and bringing in-house legal work related to facilities granted to clients would improve the business environment.

They further suggested consideration of guarantees on funding to key economic sectors like Agriculture and MSME's which would de-risk them and improve growth in the sectors.

The establishment of public-private sector partnerships to enable the creation of investment opportunities across all economic sectors, regular consultations with all stakeholders on issues affecting the industry, feedback and agreements on ways to cope with the fast-changing market environment e.g. cybersecurity issues and reduction in government borrowing from domestic market would improve the sector's business environment.

The non-bank private firms' respondents indicated the need to revisit interest rate capping to enable easier access to credit and for banks to extend longer payback periods to reduce monthly repayments. Also suggested was a review of the blanket cap on interest rates and a recommendation to cap interest rates based on industry/sector or customer credit rating. The non-bank private sector respondents indicated that the empowerment of development finance institutions to increase lending would unreachable sectors of the economy.

Haile Selassie Avenue P. O. Box 60000 - 00200 Nairobi
Tel: 20 - 2860000/2861000/ 2863000 Fax: 20 - 340192