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STATEMENT OF TRANSMITTAL TO THE MINISTER FOR FINANCE

In accordance with Section 54 of the Central Bank of Kenya Act, I have the honour to present to you, the annual report for the financial year ended June 30, 1996 with the Statement of Audited Accounts of the Central Bank of Kenya.

Adverse effects of the unprecedented high levels of inflation experienced since 1993 forced the Central Bank to focus most of its monetary policy measures on bringing down inflation within single digits. In this regard, the bank continued to pursue tight monetary policy. The monetary policy operations in the financial year 1995/96 were generally successful in containing inflation below 10%. The objective was achieved with the month-on-month and annual inflation averaging 9.7% and 5.2% respectively. However, the three months annualised inflation accelerated to 15.3% by June 1996.

In spite of high interest rates in the face of the generally subdued inflation, a strong demand for bank credit prevailed throughout the year. For instance, borrowing by private sector increased by 26%. Reflecting the buoyant demand conditions, interest rates on loanable funds edged upwards from low levels at the beginning of the year but stabilized at around 28% in the second half of the year. Interest rates on the Treasury bills, the main instrument the Bank uses to conduct monetary policy, had varied movements reflecting mainly the Bank's interventions in the course of managing liquidity in the money market.

In the foreign exchange market, the shilling remained stable with a tendency to appreciate especially in the second half of the year following more than expected inflow of capital and a slowdown in the demand for imports.

The soundness of the banking industry was satisfactory with liquidity of the institutions at well above the minimum requirement of 25%. A few banks and financial institutions, however, showed signs of deep seated distress that required urgent attention by their management.

To consolidate the economic recovery in the last two years, monetary policy is geared towards reducing the rate of inflation in the months ahead to no more than 5%. Meanwhile, adherence to prudential rules is to be more closely enforced in order to safeguard solvency and stability of the financial system.

Yours Sincerely,

September 1996

MICAH CHESEREM
Governor and Chairman
of the Board of Directors

BOARD OF DIRECTORS

Micah Cheserem
Governor and Chairman

Thomas M. Kithinji
Managing Director.
Bain Hogg Insurance
Brokers Ltd

Phares Kuindwa
Secretary to the Cabinet and
Head of Public Service.
Office of the President

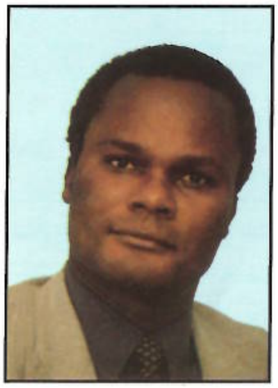
Dr. Thomas N. Kibua
Deputy Governor

Prof. George I. Godia
Associate Professor.
Moi University

Benjamin Kipkulei
Permanent Secretary.
Treasury

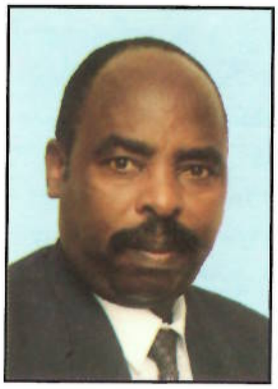
John H. Mramba
Chairman, Communication
Concepts Ltd

SENIOR MANAGEMENT



Maurice J. P. Kanga
Director of Research

Daniel K. Kiangura
Director, Management Information Services



Reuben M. Marambii,
Chief Banking Manager

Samuel N. Kimani
Chief Internal Auditor

Gerishon K. Ndubai
Director, Human Resources

Apollo A. Wanguria
Director, Bank Supervision

Jones M. Nzomo
Director of Finance

James M. Gikonyo
Bank Secretary

James O. Ogundo
Director, Kenya School of Monetary Studies

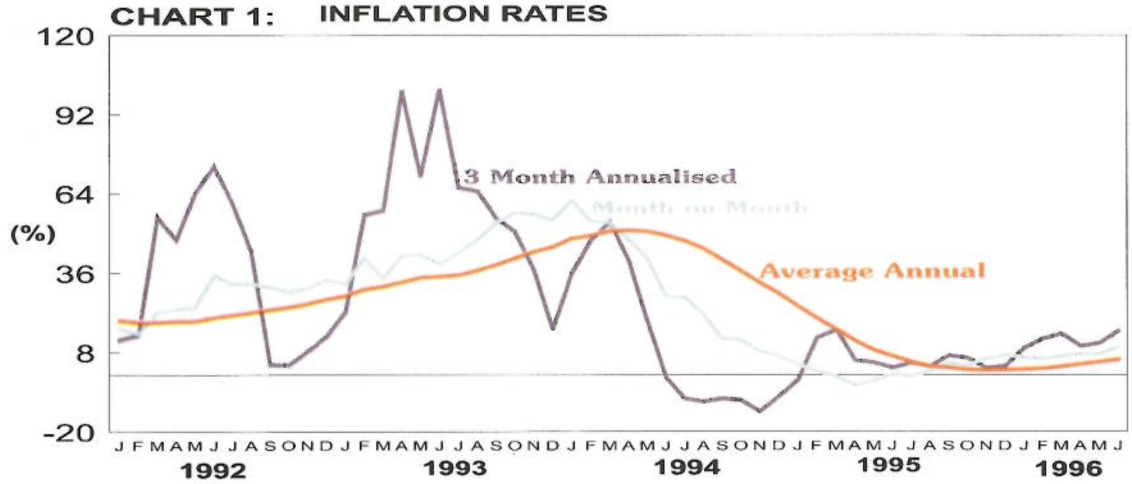
INFLATION

For the third year running, the Central Bank of Kenya pursued price stability as the principal monetary policy objective. The pursuit of this policy facilitated the reduction of inflation from three digits in mid 1993 to single digit in November 1994 and has since helped contain it at low levels. An incipient upward pressure on prices in the later part of the year pushed the three-month-annualised inflation beyond the single digit. It also pushed the month-on-month and the average annual inflation up to higher single digit levels. The month-on-month, three-months-annualised and average annual inflation accelerated from 0.2%, 2.5% and 6.6% respectively at the beginning of the financial year to 9.7%, 15.3% and 5.2% by June 1996 (Chart 1).

The increase in inflation was most pronounced in the last half of the financial year largely in response to a number of new fiscal measures. The measures included gradual extension of Value Added Tax (VAT) to cover more consumer goods and services and increased duty on petroleum and petroleum products. Reinforced by more than expected increase in liquidity during the year, the tax measures contributed immensely to the upward pressure on prices of various consumer items. For instance, prices of food and rent that constitute about 70% of the expenditure for all income groups increased by 7%. The cost of recreation, entertainment and education as a group and health and personal care increased by 11% and 6% respectively. Inspite of the former being outside the single digit range, their total impact was small as they constitute a small share of about 10% of the target items that consumers spend their income on.

The upward trend, particularly of the three months annualised inflation that exceeded the single digit range virtually throughout the second half of the financial year, underscored the case for continued vigilance against resurgence of inflation. In view of this and the associated danger of letting inflation get out of hand, the Bank geared monetary policy operations to run hand-in-hand with fiscal policy in order to contain any excess money supply that put pressure on prices. Monetary policy operations will continue taking into account the manner in which the budget deficit, if any, will be financed in the months ahead.

CHART 1: INFLATION RATES



Source: Central Bureau of Statistics

INTEREST RATES

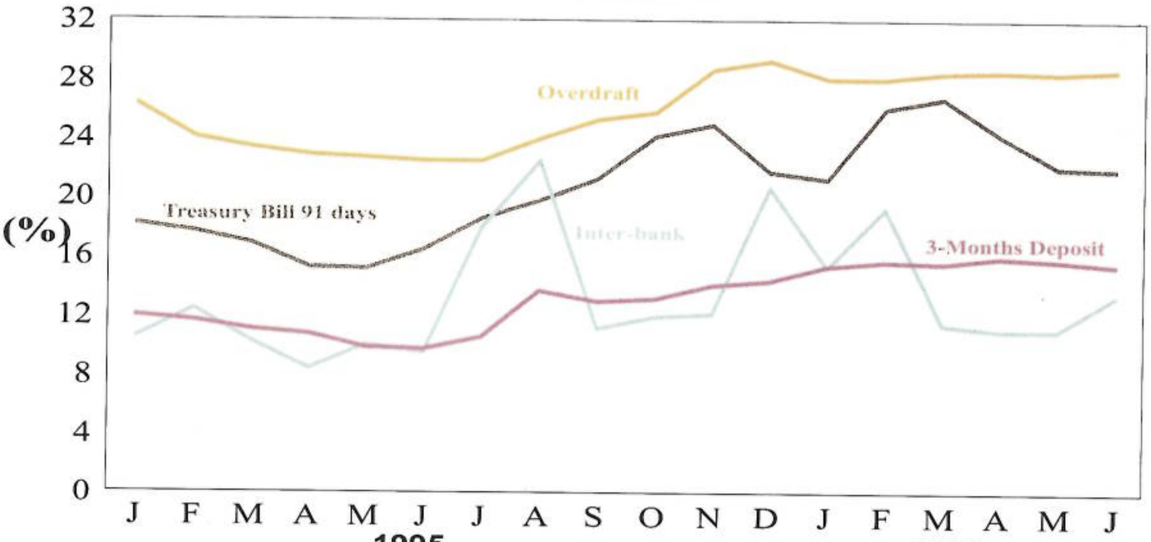
Interest rates, more than any other issue on monetary policy, attracted much attention during the financial year. As in the previous three years, higher interest rates than those in comparable international money markets prevailed throughout the financial year. Interest rates charged by commercial banks, non-bank financial institutions (NBFIs) and other financial institutions on loans and advances exceeded expected inflation by wide margins. Furthermore, the rates that had started easing the previous year reverted back to an upward trend throughout the financial year. This raised concern in the business community that interest rates were shifting investment away from productive economic activity while rewarding financial institutions with unduly high rates of return. There was also concern that the high interest rates were due to the high cash ratio requirement and the high interest rates for Treasury bill offered by the Central Bank at a time when inflation rate was low (Table 1 and Chart 2).

The Bank intervened several times in the money market with Treasury bills sales to mop excess liquidity that was bound to aggrevate pressure on inflation and

TABLE 1: INTEREST RATES

	1995							1996					
	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
Overdraft	22.4	22.4	23.9	25.2	25.7	28.6	29.2	27.9	28.0	28.4	28.5	28.4	28.6
Treasury Bill	16.4	18.5	19.7	21.2	24.1	24.9	21.7	21.3	26.0	26.7	24.2	22.0	21.9
Inter-bank	9.5	17.9	22.4	10.1	11.9	12.1	20.6	15.2	19.2	11.4	11.0	11.0	13.3
3-Months Deposit	9.7	10.4	13.5	12.9	13.1	14.0	14.3	15.3	15.6	15.5	15.9	15.7	15.4
Savings	9.1	8.9	8.7	9.0	8.9	9.3	9.5	9.6	9.7	10.2	10.1	10.7	10.7

CHART 2: TREASURY BILL, OVERDRAFT, DEPOSIT AND AVERAGE INTER-BANK INTREST RATES



Source: Central Bank of Kenya

ultimately interest rates. The intervention necessitated allowing interest rates to move with the required Treasury bill sales.

Increased reliance on the sale of Treasury bills through the Open Market Operations window, underpinned by cash ratio requirement for both commercial banks and NBFIs, to manage liquidity, was bound to put pressure on interest rates. For instance, as signs of inflation resurgence emerged towards the end of the 1995 calendar year, more than expected Treasury bills had to be sold. This, coupled with the need to roll over large stocks of outstanding Treasury bills, was only possible at high interest rates and attractive shorter maturities. Thus higher interest rates on the Treasury bills followed and after a short time, the deviation of actual from expected inflation was expected to decline while the rate of expansion in liquidity would subside. This, to a market in the process of learning to appreciate the dynamics of price mechanism, intensified concern about the upward movement in interest rates.

Other than Treasury bonds whose interest remained at coupon rates, most of the rates, particularly on lending and deposits generally followed, after a short time, the pattern of the Treasury bill interest rate. The Bank floated 12 issues of Treasury bonds at 15% for 1 year, 15.5% for 2 years, 16% for 3 years, 16.5 for 4 years, and 17% for 5 years maturities. At the other end of the spectrum, the inter-bank interest rate fluctuated throughout the year. The fluctuations followed the pattern of intervention by the Central Bank and the revenue collections.

Besides Central Bank intervention in the money market, interest rates were sustained at the high levels by the cost of high non-performing loans carried by some deposit-taking institutions and private sector demand for financing that increased with economic recovery and improved prospects for economic activity. Furthermore, the inclusion of the NBFIs into the cash-ratio net during the year accentuated the pressure on the interest rates they charged and on the interest rates in general. Since these institutions had not been subjected to the mandatory 18% cash ratio balances the imposition of the requirement, though implemented gradually during the year, had the effect of raising their cost of funding, which in turn led to a rise in the institutions' lending rates.

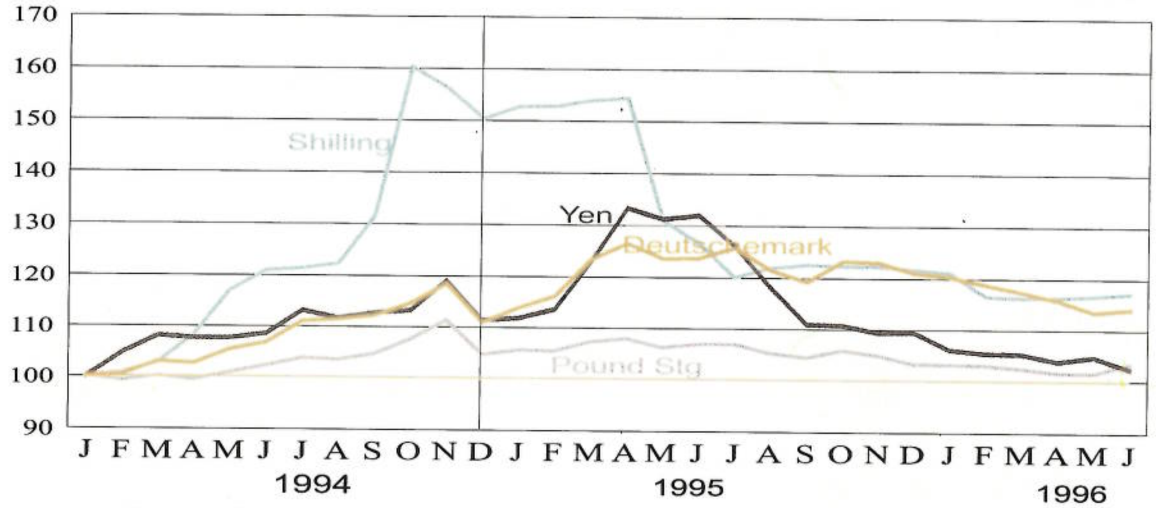
The high interest rates problem calls for continued tight monetary and fiscal policies to reduce both actual and expected inflation. Success in this will reduce the high expected inflation premium that continues to be built into the interest rates expected in the bids for Treasury bills. Measures to speed up recovery of non-performing loans will also go a long way in reducing the level of interest rates. Both international and locally incorporated companies could contribute to easing the pressure on interest rates by borrowing off-shore rather than in the domestic money market. A reduction in the level of domestic stock of government debt, particularly the Treasury bills, and lower profit margins by the deposit-taking institutions would help to a large extent, in bringing down the level of interest rates. But the debate on interest rates neither extends to profit margins, nor does it go far enough to cover the Government's public borrowing requirements.

THE SHILLING EXCHANGE RATE

The Kenya shilling exchanged against international currencies in the interbank market at generally stable rates throughout the financial year. However, owing to general realignment towards a level consistent with the conditions underlying the demand for and supply of foreign exchange, the shilling depreciated over the year. It depreciated by 5.1% against the US dollar, 2.2% against the pound sterling and 12.1% against the Italian lira but gained by 4.5% and 18.8% against the deutschemark and the Japanese yen, respectively (Chart 3).

Sustained moderate depreciation of major currencies against the US dollar characterised the international currency market throughout the year (Chart 4). The currency depreciations represented realignment of exchange rates following marked gains against the US dollar the previous year. Similarly, the shilling that had gained more against the US dollar than the other currencies also moved in line with the trend of the other currencies in the local interbank market for foreign exchange. The movement reduced the misalignment observed throughout the previous year

CHART 3: EXCHANGE RATE INDICES AGAINST THE US DOLLAR



Source: Central Bank of Kenya

The trade weighted average of the shilling exchange rate against all the above currencies consequently depreciated by 4.4%. The overall depreciation mainly reflected the weakening of the shilling against the US dollar and the sterling pound in which over 60% of Kenya's external trade is carried out. In real terms, that is taking into account the differences in inflation between Kenya and her major trading partners, the shilling exchange rate remained more or less constant unlike in the previous year when it appreciated by 5%.

when the shilling exchange rate against the dollar was out of line with the appreciation of all other currencies against the dollar. Consequently, between shs 54.6 and shs 58.4 exchanged against the US dollar compared with an average shs 48.1 the previous year. This represented a depreciation of about 16%. There was, however, a tendency for the shilling to appreciate during the last months of the fiscal year.

The shilling exchange rate in the emerging interbank market for foreign exchange moved during the financial year against a background of:

- tight monetary policy stance that helped contain inflation within a single digit average of 4.4%. The rate of inflation was virtually at par with that prevailing in Kenya's major trading partners, thus leaving the shilling exchange rate constant in real terms. Monetary policy operations successfully supported the shilling exchange rate stability in the second half of the financial year by forestalling incipient depreciation that would have followed the rapid monetary expansion towards the end of 1995.

- free foreign exchange market environment in which the general level and direction of the exchange rate remained market determined. The Central Bank intervened indirectly through monetary operations during the year only to counteract any speculative behaviour that would threaten competitive market determination of the shilling exchange rate. This policy ensured that market forces remained the main determinants of the exchange rate.

- improved balance of payments following strong capital inflows, both private and official, especially with resumed donor disbursements in the second half of the financial year. The inflows of foreign exchange exceeded the increase in demand, and thereby threatened to cause an appreciation of the shilling exchange rate. The Central Bank intervened by buying surplus foreign exchange on the one hand and selling Treasury bills on the other to mop up the subsequent liquidity. This action, to a large extent, forestalled the appreciation of the shilling exchange rate that was increasingly becoming nascent towards the end of the year.

- high interest rates in the money market throughout the year encouraged inflows of short term capital most of which were placed in short-dated Treasury bills and equities in the stock market. The inflows more than met the financing of the sizeable current account deficit, thus, threatening appreciation of the shilling. As noted, the appreciation was avoided with monetary policy operations - involving interventions in both the foreign exchange and domestic money market.

- near balanced budget in the fy 1995/96 supported stability in domestic prices and interest rates. This augured well for the shilling exchange rate stability.

GOVERNMENT FISCAL OPERATIONS

Government fiscal operations during the financial year were characterized by continued commitment to tight fiscal policy pursued over the last few years to reduce, eliminate and eventually turn round the budget deficit into a surplus in support of macroeconomic stability. In this regard, the Government implemented tight control on expenditures incurred by ministries, accelerated privatisation of parastatals and improved collection of tax revenues. In spite of these measures, payment obligations for goods and services, debt servicing and transfers exceeded the receipts from taxes, grants and proceeds from privatization of parastatals, necessiating shs 17.4bn Government borrowing requirement. Finacing the shortfall in a situation of buoyant demand for credit in the money market and the wish to restrain monetary expansion, posed great challenge to the operations of monetary policy and the public debt management during the financial year.

Payments

Despite the efforts to keep expenditure growth under tight control Government payment obligations increased to shs 150.4bn during the financial year from shs 131.5bn the previous year (Table 2). Expenditure on goods and services amounted to shs 154.3bn. All expenditures, except interest on both domestic and external debt, were well within the budgeted levels. Domestic interest payments exceeded expectation

TABLE 2: BUDGET OUT-TURN (SHS BN)

	1994/95	1995/96		1996/97
	Actual	Actual	Printed Budget	Printed Budget
1 Government Payment (2-6)	**131.5**	**150.4**	**157.3**	**159.6**
2 Expenditure and Net Lending	135.2	154.3	156.7	162.5
Recurrent Expenditure	106.2	122.7	117.5	122.4
Development & Net Lending	29.0	31.1	39.2	40.1
Items in Transit	-	0.5	-	-
3 Revenue & Grants	**130.9**	**152.0**	**157.3**	**159.6**
Recurrent Revenue	125.4	145.5	142.4	151.0
Ordinary Revenue	119.1	138.7	136.6	142.7
Direct Taxes	43.3	48.1	50.2	45.6
Indirect Taxes	62.4	72.2	73.5	79.0
Non Tax Revenue	13.4	18.4	12.9	18.1
Appropriations-in-Aid	6.3	6.8	5.8	8.3
Grants	5.5	6.5	14.9	8.6
4 Float adjustment (Rev (+) Exp(-))	0.6	-1.6	0.0	0.0
5 Overall Surplus (+)/Deficit (-) Commitment	-4.3	-2.3	0.6	-2.9
% of GDP	0.9	0.5	0.1	0.6
6 Financing	3.7	3.9	-0.6	2.9
Foreign Borrowing (net)	-4.9	2.1	-1.2	-1.1
Domestic Borrowing	8.6	1.8	0.6	4.0
Central Bank	24.8	7.5	0.3	4.0
Other Domestic	-16.2	-5.7	0.3	0.0
Memorandum Item: Capital Receipts	-	**3.8**	**2.5**	**2.0**

Source: Treasury and Central Bank of Kenya

due to the upward movement in interest rates on Treasury bills.

Revenue and Grants

The Government through the newly established Kenya Revenue Authority collected shs 145.5bn or 2.2% more than expected. The revenue together with receipts of external grants were shs 152.0bn or 16% above the level in the previous financial year. The improvement in revenue reflected the ongoing tax reforms that have reduced rates, widened the tax base and enhanced internal efficiency. Increases were particularly remarkable for ordinary revenue and grants. Most of the increase in revenue came from indirect taxes. Inflows of foreign grants at shs 6.5bn were within target.

Government Borrowing Requirements

The short-fall of receipts on payments resulted in a borrowing requirement of shs 17.4bn during the financial year compared with shs 38.0bn the previous year. The borrowing requirement comprised shs 3.9bn to finance the budget deficit, shs 7.1bn to redeem Treasury bonds and long-term stocks and the rest rediscount securities and build up cash deposits in commercial banks. The required financing during the year was mobilised from domestic and external sources. The Government, however, reduced its indebtedness to the non banking sector by shs 13.5bn. Consequently, all the borrowing requirement was financed from the Central Bank, commercial banks and external sources.

The borrowing from Central Bank led to an increase in reserve money, that is, the deposits of commercial banks at the Central Bank and currency in circulation. As a basis for further credit creation, this continued to present a challenge to effective monetary policy aimed at containing liquidity and, thus, maintaining stability in both domestic prices and the shilling exchange rate and in reducing the level of interest rates.

Domestic Public Debt

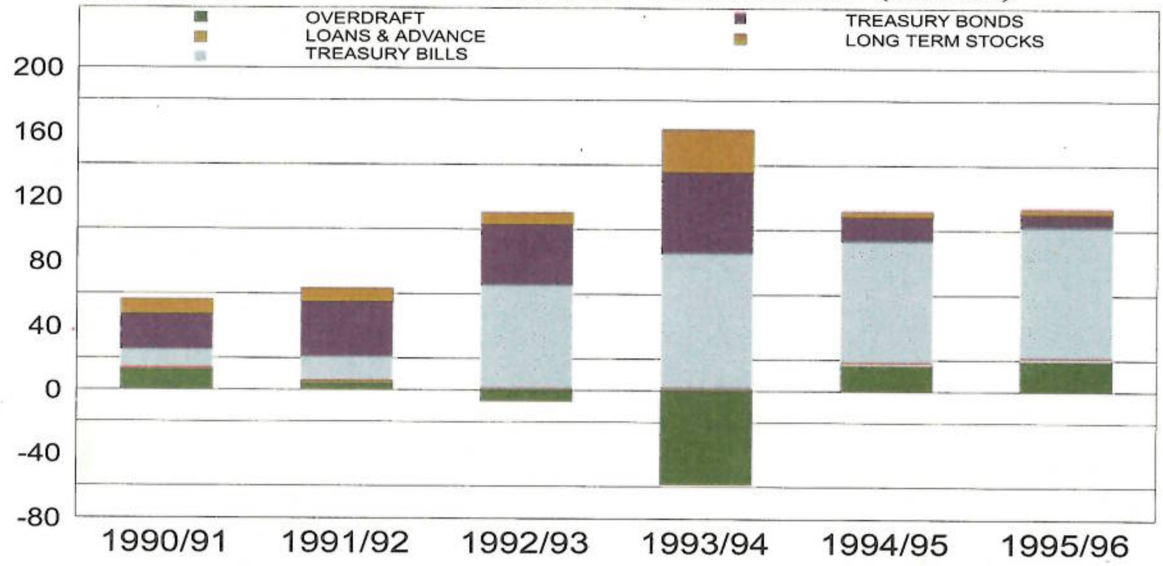
The management of domestic public debt during the financial year was aimed at meeting the needs of both fiscal and monetary policies as well as various maturing government debt. The operations brought outstanding domestic debt in the form of Central Bank overdraft, loans and advances and Government securities to shs 113.2bn at the end of the financial year, an increase of shs 1.8bn over the previous financial year.

Treasury bills dominated the stock of public domestic debt throughout the financial year. The Central Bank issued shs 443.6bn worth of Treasury bills and redeemed shs 437.9bn, thus increasing the outstanding stock of Treasury bills by shs 5.7bn from shs 75.4bn to shs 81.1bn. Treasury bills increased especially in the first half of the financial year when open market operations were enhanced to mop up excess liquidity from the money market. The increase in domestic debt was partially offset by shs 7.1bn redemption of Treasury bonds.

Government borrowing from the Central Bank in the form of overdraft continued to present a major challenge to monetary management in the economy given its effect on money supply and consequently inflation. The overdraft rose from over shs 23.3bn to shs 24.0 bn during the financial year.

The government introduced additional fiscal measures in form of broadened VAT base and higher duty on petroleum and petroleum products during the financial year. This, at a time when the economy was experiencing a higher than expected increase in money supply mainly due to the remarkable performance of the balance of payments, added more pressure on the general price level. In view of these developments it became imperative to contain Central Bank financing of the budget through the overdraft if inflation was to be kept at bay.

CHART 4: STOCK OF DOMESTIC PUBLIC DEBT (SHS BN)



Source: Central Bank of Kenya

Besides changing the structure of public domestic debt away from the Central Bank to the private sector, this move helped harmonise the tight fiscal and monetary policy being pursued in the economy. As a result, the impact of deficit financing on money supply and inflation was reduced, as the sale of government securities served two purposes; financing the deficit and as an instrument of monetary policy to check inflation. While it is hoped that the proposed bill granting Central Bank its autonomy will enable the Bank curb overdraft facilities to the government and thereby force it to resort to open market borrowing at prevailing interest rates for deficit financing, the bill if passed will pose a major challenge to domestic public debt management. This will be necessitated by the ensuing high interest rates on government securities needed to attract the required funds in the absence of overdraft facilities, which will drastically increase recurrent expenditure on domestic interest payments, thereby necessitating further borrowing in future. Alongside this the rising level of domestic debt will have the undesirable effect of further crowding out the private sector from the credit market. This, in an economy that already suffers from inadequate supply of loanable funds will greatly curtail private sector investments and economic growth. The solution to the problem would certainly have to include expenditure cuts without affecting the revenues side of the budget. The choice is poised to be between inflation and crowding out of the private sector.

BALANCE OF PAYMENTS

Trade and other financial transactions with the rest of the world, reinforced by liberal exchange and payments regime and diversification of markets, increased during the year. The combined value of exports and imports increased to 54.8% of GDP from 50.9% the previous year. Both exports and imports expanded with increased openness of the economy to world markets. **Consequently, the overall balance of payments improved from U.S.$255m deficit in the fy 1994/95 to a surplus of U.S.$346m in the fy 1995/96.** The performance reflected improvements in both the capital account and the current account. The capital account surplus improved to U.S.$402m from U.S.$121m while the current account deficit narrowed to U.S.$57m from U.S.$376m in the preceding financial year (Table 3 and Chart 5).

Exports increased by 14.3% compared with 13.3% the previous year. The lower than expected increase reflected generally low world demand for primary exports attributed to recession in the OECD countries and slow pick-up of economic growth in less developed countries. Traditional exports, coffee and tea, increased by 18.9 per cent, mainly in response to favourable international prices for coffee and increased production particularly with respect to tea. Non-traditional exports also responded well to new trading conditions. Exports to non-traditional markets continued to grow and accounted for 80% of the total increase in exports. Most of the increase in exports were destined to Uganda, Tanzania, other neighbouring countries and to the Southern Africa market. Among the non-traditional exports to non-traditional markets were crude vegetable oils, fish, beer, flat-rolled iron products and medicaments.

Meanwhile, imports increased by 8.9% in the year compared with 27.3% in the preceding year. The increase was mainly in intermediate and capital goods (that is, mineral fuels and machinery and transport equipment) that accounted for 61% of imports. The increase in imports during the year reflected increased demand in response to the stability of the shilling in real terms in the face of greater openness of the economy and improved economic growth prospects.

TABLE 3: BALANCE OF PAYMENTS (US$ M)

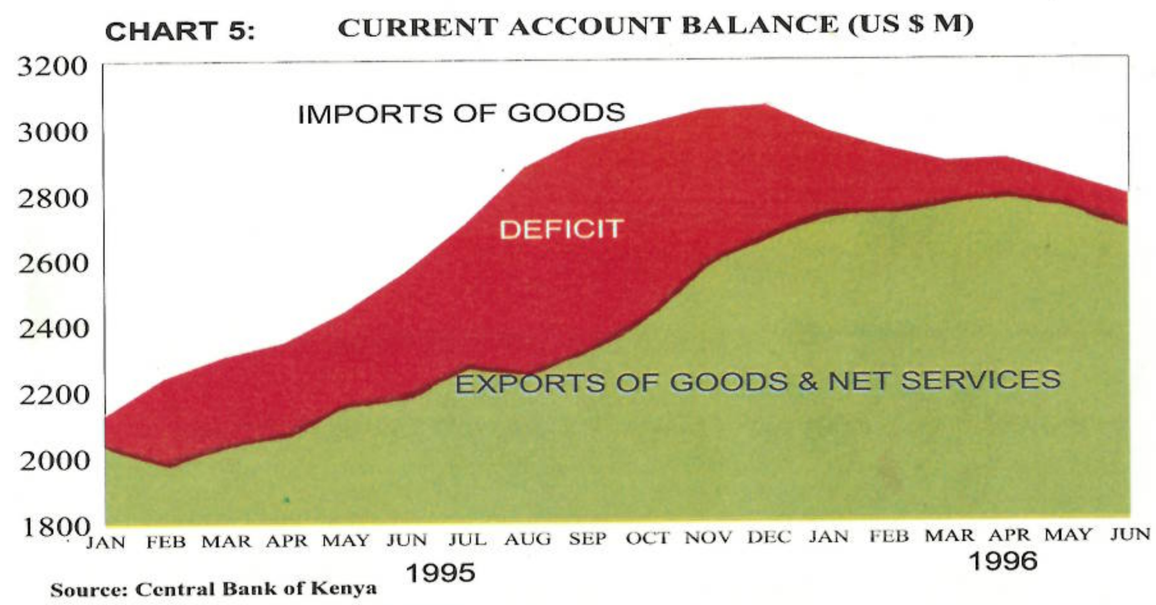
	1994/95	1995/96
Overall Balance	-255	346
Current Account	-376	-56
Trade Balance	-832	-811
Exports	1730	1978
Imports	2562	2789
Services Account	456	755
Tourism	484	445
Other	-28	310
Capital Account	121	402
Official Long Term	-71	-136
Private Long Term	-53	11
Others	245	527
Official Reserves Level	512	806
Months of Imports Cover	2.4	3.5

Source: Central Bank of Kenya

Besides the increase in volume, the sources and range of imports widened. The share of imports from non-traditional sources that had increased from about 9% in fy 1993/94 to 23% in fy 1994/95 eased to 21% in fy 1995/96. Imports, particulary from South Africa and the Far East excluding Japan and India, grew most rapidly.

The surplus in the services account increased by 65% from U.S.$456m in fy 1994/95 to U.S.$755m in the fy 1995/96. Most of the increase was due to official and private grants which increased by 41%. Tourism receipts declined to US $445m from US$484m the previous financial year. The earnings were less than expected owing to reduced foreign travel into the country occasioned by poor infrastructure, over reliance on limited tourist attractions and stiff competition from other tourist destinations, especially South Africa.

public external debt from US $ 6268m in 1995 to US $ 5915m in June 1996. Private sector capital inflows, owing to favourable economic climate, also picked up to a positive net of U.S.$11m from a negative net of U.S.$53m. Short-term investment in shares and equities by locals and foreigners increased considerably during the second half of the financial year partly due to relatively high interest rates compared to the rest of the world and complete liberalisation of the capital account following the repeal of Exchange Control Act in December 1995 and



The capital account balance improved from US $ 121m surplus in fy 1994/95 to US $402m surplus in fy 1995/96 mainly due to private inflows. This followed the favourable macroeconomic environment that has occured with the economic reforms. However, during the period there were heavy external debt repayments owed mainly to multilateral and bilateral institutions which accordingly reduced

opportunities afforded by privatisation of parastatals.

As a result of the balance of payments developments, the country's official reserves increased from U.S.$512m or 2.4 months of imports cover in June 1995 to U.S.$ 806m or 3.5 months of imports cover at the end of June, 1996.

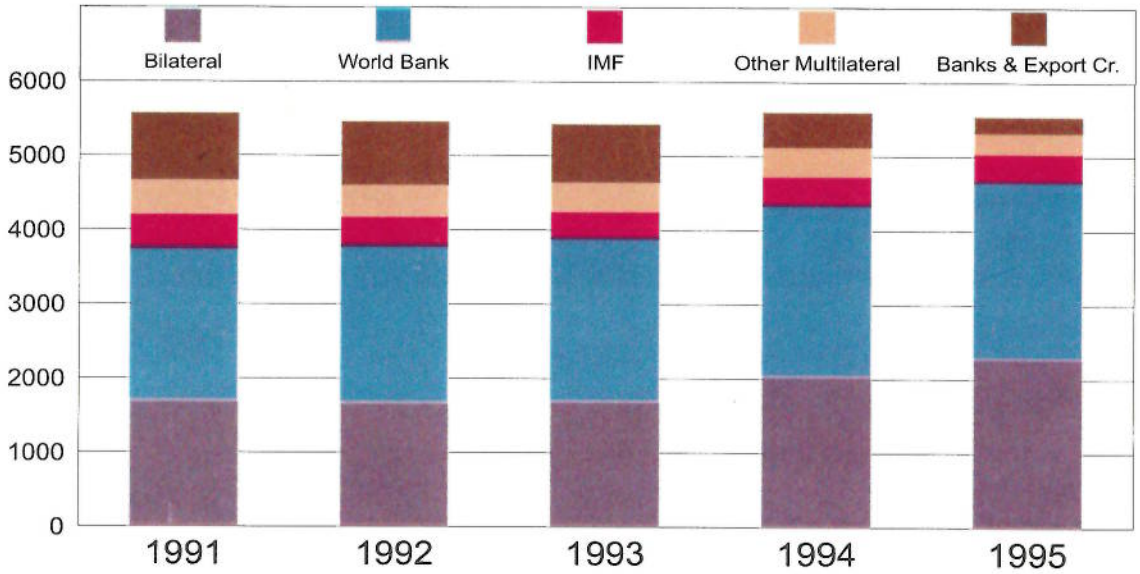
External Debt

Kenya's external debt stock amounted to US$6268m at the end of 1995 from US$ 5582m in 1994 (Chart 6).The structure of the debt stock indicates that nearly 49% or US$ 3055m were multilateral loans and 36% or US$2260m were bilateral loans, leaving only 15% as commercial debt and export credits. The multilateral debt consist mainly of US$2377m World Bank debt and US$382m from the IMF. Of the World Bank debt, 83% is from IDA and the balance from IBRD. SDR 251.5m outstanding IMF debt recorded at the end of December 1995 had increased to SDR 255.5m at the end of June 1996 because of SDR24.9m receipts and SDR20.9m principal payments.

The debt stock is projected to decline to US$5716m by end of 1996 due to heavy external debt servicing and limited contraction of new debt in line with the government policy of not contracting any new debt, unless it is on concessional terms so as to reduce the total debt service payments to sustainable levels.

At the end of 1995 Kenya's external public debt amounted to about 80% of GDP. This is due to the fact that Kenya had borrowed heavily on non-concessional terms in the early 1980s when the country experienced severe balance of payments imbalances. Since then, the country's debt situation has eased with continued reliance on multilateral and bilateral loans whose terms are highly concessional. In line with the projected lower current account deficits and economic reform measures so far undertaken which facilitate long term capital inflows, the country's medium term debt service payments is expected to fall to sustainable levels.

CHART 6: EXTERNAL DEBT, 1991-1995 (In US$ Millions)



Source: Treasury, World Bank Debt Tables, IFS and Central Bank of Kenya

MONETARY CONDITIONS

The management of monetary policy was anchored on the net domestic assets of the Cental Bank, with reserve money as the main variable to monitor on a daily basis (Table 4). The developments in the reserve money against its target formed the basis for the Bank's intervention in the foreign exchange market and in the domestic money market. The domestic money market was, during the financial year, dominated by buoyant demand for credit and interventions by the Central Bank to contain liquidity expansion. In its interventions the Bank sought to slow down the expansion of liquidity in the economy. It particularly strived to reduce the rate of growth of the money supply as undesirable expansion was bound to put

Table 4: MONEY SUPPLY AND ITS SOURCE (SHS BN)

		1995	1996	Change		Target	Deviation
		June	June	Absolute	%	June 1996	
1.	**Money supply**	**215.9**	**255.6**	**39.7**	**18.4**	**222.4**	**33.2**
2.	**Net foreign assets:**	**10.3**	**26.5**	**16.3**	**158.7**	**11.0**	**15.5**
	Gross foreign exchange	51.8	70.5	18.7	36.0		
	Liabilities in foreign exchange	41.6	44.0	2.4	5.8		
3.	**Net domestic assets**	**205.7**	**229.1**	**23.4**	**11.4**	**211.4**	**17.7**
	Domestic credit	224.5	254.4	29.7	13.2	237.7	16.6
	Government (net) :	**75.6**	**69.6**	**-6.0**	**-8**	**69.9**	**-0.3**
	Central Bank	24.4	27.8	3.5	14.2	40.8	-13.0
	Gross borrowing	24.4	31.7	7.3	30.0	43.3	-11.6
	Overdraft thro' Pay Master General(PMG)	16.9	27.2	10.2	60.5	19.2	6.0
	.Borrowing to redeem Treasury bills	6.6	0.9	5.7	-86.8	23.3	-22.4
	Cleared items awaiting posting to PMG	0.3	0.5	0.2	68.0	0.3	0.2
	Rediscounted securities	0.5	3.2	2.6	479.8	0.5	2.6
	Deposits from:	0.0	3.8	3.8	0.0	2.5	1.3
	Treasury bill sales	0.0	0.0	0.0	0.0	0.0	0.0
	Privatisation	0.0	3.8	3.8	0.0	2.5	1.3
	Commercial banks & NBFIs	51.3	41.8	-9.5	-18.5	29.1	12.7
	Commercial banks	34.4	37.9	3.5	10.1		
	NBFIs	16.8	3.9	-13.0	-77.1		
	Private sector and other public sector :	**149.0**	**184.7**	**35.8**	**24.0**	**167.8**	**16.9**
	Commercial Banks	105.9	144.9	38.9	36.7		
	NBFIs	43.0	39.9	3.2	7.4		
4.	**Other items net:**	**-19.0**	**-25.3**	**-6.3**	**33.2**	**-26.3**	**1.1**
5.	**Reserve Money:**	**52.9**	**68.8**	**15.9**	**30.0**	**69.0**	**-0.2**
	Cash in till	3.2	3.5	0.3	9.7	4.9	-1.4
	Currency outside the banking system	25.8	28.7	2.9	11.3	27.8	0.9
	Deposits with CBK	23.8	36.5	12.6	52.9	36.3	0.3
	Memorandum item: Outstanding T. Bills	**75.4**	**81.1**	**5.7**	**7.6**	**58.7**	**22.4**

Source: Central Bank of Kenya

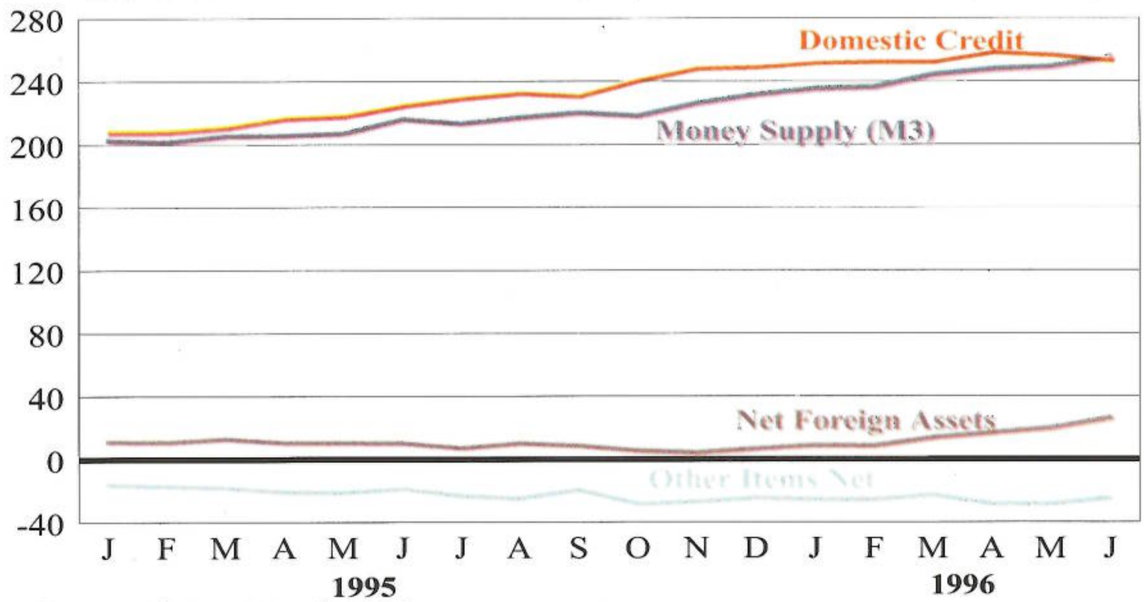
undue pressure not only on prices of goods and services but also on the shilling exchange rate, interest rates, balance of payments, and eventually derail recovery in economic growth. Accordingly, the Bank intensified Open Market Operations (OMO) in Treasury bills including introduction of short-dated maturities in Treasury bills to mop excess liquidity. Furthermore, the Bank kept tight control on commercial banks' access to Central Bank credit facilities, streamlined the management of domestic money market liquidity by having both commercial banks and NBFIs maintain the same cash ratio and realigned the primary and secondary market interest rates on the Treasury bills.

Money and Credit

The monetary policy measures implemented by the Bank helped to ease the expansion of the money supply over the financial year to 18.4% from 25.6% in the previous financial year (Chart 7). Even then, the expansion was six times more than the expectation for the year. In terms of the components of the money supply, the deposits of the private and public sector other than the Central Government with commercial banks and NBFIs increased by 19.3% compared with 26.0% the previous year while currency in circulation outside the banking system increased by 11.3%. The increase in the money supply during the year was supported by increases in both net foreign assets and net domestic assets of the banking system (that is, the Central Bank, commercial banks and NBFIs).

Net foreign assets increased following favourable balance of payments, mainly the capital account. The capital inflows, particularly short-term investment funds increased partly as a result of attractive interest rates in the domestic money market and as a result of increased investor confidence in the economy particularly during the last half of the year following the repeal of the Exchange Control Act and the successful consultations with the donor community.

CHART 7: MONEY SUPPLY (M3) AND ITS SOURCES (SHS BN)



Source: Central Bank of Kenya

Net domestic assets of the banking system, comprising credit to private and other public sector and to Government as well as all other assets less non monetary liabilities, increased by 11.4% compared with the target of 2.8% and an increase of 37.9% the previous year. Most of the growth in net domestic assets was in credit to the private and other public sectors that increased by 24.0% compared with expectation of 12.6%. Though a substantial drop from the 29.5% increase the previous year, the growth remained well above the anticipated level and was increasing for most of the year at a rate well above 30%. There are, however, indications that the increase in credit to the private and other public sectors was to support economic activity.

Other than agriculture whose credit declined by 3.7%, other sectors of the economy, mainly manufacturing, domestic trade, business services, building and construction, real estate and transport and communications benefited from increased financing from commercial banks and non-bank financial institutions. The increase in the money supply to accommodate this demand did not at the begining of the financial year represent any major threat to resurgence in inflationary pressure; neither did it obviate the need for the Central Bank to remain vigilant against undue monetary expansion. This perception, however, changed towards the end of the calendar year 1995 when resurgence of inflation was pronounced.

Banking system credit to the Government declined by 6.0% to shs 69.6bn which was shs 0.3bn within the target for June 1996. Moreover, this decline was in non bank financial institutions credit as the Government repaid shs 13.0bn or 77.4% of their outstanding credits. The repayment offset in full increases in credit from the Central Bank and Commercial Banks. In particular, the money borrowed from the Central Bank was used to pay for domestic goods and services, redeem Treasury bills and repay and service its external debt. The details of the fiscal operations that generated the borrowing requirement by the Government are detailed on page 10.

Monetary Policy Operations

Apart from intensifying the sale of Treasury bills in the second half of the financial year, the Central Bank instituted several measures with effect from 1st May 1996 to improve effectiveness of liquidity management. This included secondary trading in financial instruments, competitive determination of interest rates, and availability of information on the money market. The 60 and 270 days Treasury bills were discontinued owing to their unpopularity to investors, while the 30, 90 and 180 days were replaced with 28, 91 and 182 days respectively because of the convinience of the later maturing on Mondays. At the same time, the Bank moved toward having the bulk of bills sold through the primary rather than the OMO window as a way of encouraging evolution of a secondary market in the Treasury bills. The Bank also introduced a window for non competitive bids in the primary auction for individuals with small tenders of up to shs 100,000 at the average tender rate.

The cash ratio observation, formerly required of commercial banks only, was extended to the newly converting banks which were formerly NBFIs and the remaining NBFIs. The new institutions were required to effect the measure in stages from July and culminating in both types of institutions being subject to the 18% cash ratio requirements for the long established commercial banks by December 1, 1995. With effect from 1st January 1996, the cash ratio eligible deposits were redefined to exclude deposits due to banks and NBFIs. Moreover, the cash ratio requirement was relaxed to allow for fluctuations up to a minimum of 15% but an average of 18% for 14 days, with effect from 1st May 1996. In addition, the 5% interest that commercial banks had been earning on their cash balances at the Bank since 1st December1995 was also discontinued.

Conditions for commercial banks access to Central Bank lending facilities were relaxed by accepting Treasury bills as collateral for either borrowing or rediscounting irrespective of their time to maturity. The amount borrowed, together with interest were made subject to the realisable value of the collateral calculated according to predetermined rediscounting formula. Moreover, the Bank delinked interest rates on its lending from the inter bank rates. Instead, base lending and rediscount rates were pegged at 5 percentage points above the highest prevailing Treasury bills yield. The lending rate was made to apply uniformly on the amount borrowed.

Inspite of the relaxed lending conditions, commmercial banks reduced their borrowing from the Central Bank in 1995/96 financial year. Borrowing in the form of direct advances and discounts declined by shs 4.3bn compared to an increase of shs 1.3bn in the 1994/95 financial year. Rediscounting of government securities proved a popular form of borrowing. The outstanding stock of these rose to shs 3.2bn in June 1996 from shs 0.4bn in June 1995. The declining trend of commercial banks borrowing from the Central Bank indicated the banks' ability to meet the minimum cash ratio requirement and a sound and stable banking system during the year.

The Bank, in line with its commitment to furnish money market participants and the general public with up-to-date, timely and high quality information, provided more information on the Treasury bills market through the Clearing House and the media. Information issued included amounts bid and accepted, average discount and yield rates as well as redemptions for the week. These complemented information availed to the public through the Bank's regular publications such as the Monthly Economic Review and Quarterly Statistical Bulletin. The Bank's monthly review was, starting with the April 1996 issue, put on the internet, thus broadening its readership.

The Bank is committed to introducing further measures to deepen the reforms and strengthen the efficiency of the financial sector. In this regard, the Bank is in the process of introducing a Lombard borrowing facility for commercial banks. The facility will help reduce the volatility of interest rates in the interbank market. It will also improve liquidity conditions in the financial system and thereby help reduce and stabilize interest rates, and enable the banking system have more flexibility in their liquidity management. Repurchase agreements (REPOs) will also be introduced in due course to enhance the liquidity of government securities, encourage secondary trading particularly in Treasury bills and facilitate a reduction in interest rates in the money market. All the measures envisaged will create an environment that would support market determination of interest rates so crucial for a vibrant private sector.

The economy accelerated the growth momentum that started at 3% in 1994 to 4.9% in 1995. The favourable growth stemmed mainly from the good weather conditions experienced in 1994 and the reform measures implemented since 1993. The reforms have reduced the production constraints that took root in the earlier years when the economy was under severe price controls. Of particular importance were the removal of controls on exchange rate and payments system, the abolition of controls on foreign trade and domestic prices, and a wide range of other measures to increase incentives and boost confidence in the economy.

Agriculture, the leading sector of the economy and the base for other sectoral activities, grew by 4.8% in 1995 compared with 2.8% in 1994. The recovery, in turn, boosted output in the manufacturing sector. Total value added in manufacturing sector followed the recovery in the agricultural sector and increased in real terms by 3.9% in 1995 compared with 2.8% in 1994. This growth was the highest for the sector since 1991 and was mainly attributed to the improved macro-economic environment combined with the availability of basic raw materials, especially for the agro-based industries.

The services sector had the most favourable performance in 1995. Particularly significant was trade, restaurant and hotels which grew by 7.9% compared with 5.1% the previous year. Finance, insurance and real estate and business services sector also performed fairly well, with growth accelerating from 6.1% in 1994 to 6.9% in 1995. Consequently, the share of the sector in real GDP increased from 8.2% in 1994 to 9.8% in 1995. The good performance of the sector mainly reflect the now entrenched liberalised economic environment.

The growth experienced in 1995 was also supported by substantial increase in investment, particularly from abroad. Total investments rose to shs 100bn in 1995 from shs 77bn in 1994 and shs 59bn in 1993. Investment from abroad which had dried up in 1993 and 1994 recovered to shs 25bn in 1995. The balance of shs 75bn was financed from domestic savings, that increased by 5.3% in 1995. Investment increased from 19.2% of GDP in 1994 to 21.6% in 1995. The increase was evident in almost all sectors of the economy.

The recovery, though commendable, is still weak and far below the 8% per annum growth needed to be achieved and sustained for at least a decade in order to pull most of our population out of poverty and create employment opportunities for about half a million annual entrants into the labour market. The rate of growth must therefore be increased further.

The forecast for 1996 is that the economy will grow in real terms by around 5.5%. This growth will stem mainly from the larger market, especially for manufactured goods created with the revival of the East African Community. The growth will be reinforced by the Government's determination to maintain and further improve on the existing macroeconomic environment of low single digit inflation rate, relatively stable exchange rates, declining real interest rates and low taxation.

DEVELOPMENTS IN THE FINANCIAL SYSTEM

Further reforms were undertaken during financial year 1995/96 in order to improve efficiency, secure stability and engender healthy competition among the various institutions. The Central Bank encouraged NBFIs to specialise in their activities while additional forex bureaus were licensed. Further amendments to the laws governing banking institutions were undertaken to strengthen their management and enhance effective supervision. Some commercial banks embarked on modernisation programmes to secure their market shares in the face of stiff competition.

With competition and efficiency in mind, coupled with the reforms recently implemented to free the financial system from all official controls, the Central Bank initiated measures to alter the structure of the financial system during financial year 1994/95. The institutional changes during financial year 1995/96, included:

Promoting specialization by institutions: The Central Bank continued to encourage existing non bank financial institutions (NBFIs) to convert to commercial banking, retain financial institution status or specialise in mortgage finance business. Following this, eleven NBFIs converted into commercial banks, bringing the newly converted banks to 17 since January 1995. Seven NBFIs merged with parent commercial banks, raising to 8 the number of mergers since December 1994. Two NBFIs converted to mortgage finance companies one in December 1994 and the other in January 1995. Reflecting these developments, the number of NBFIs declined to 26 in June 1996 from 44 in June 1995, while that of commercial banks rose to 48 from 38 in June 1995 (Table 5). During the same period, total assets of NBFIs also fell by 12.0% to shs 59.5bn in June 1996 while that for commercial banks rose to shs 292.8bn from shs 225.7bn in June

TABLE 5: COMMERCIAL BANKS MARKET SHARE BY TOTAL ASSETS

	JUNE 1995			JUNE 1996		
Peer Group Range (shs m)	Number of Banks	Assets (shs m)	Market share (%)	Number of Banks	Assets (shs m)	Market share (%)
Over 5000	9	175895	77.9	10	214102	73.1
1001-5000	21	45052	20.0	29	73243	25
501-1000	7	4570	2.0	5	3990	1.4
201-500	-	-	-	4	1508	0.5
101-200	1	158	0.1	-	-	-
0-100	-	-	-	-	-	-
TOTAL	38	225677	100	48	292844	100.0

Source: Central Bank of Kenya

1995. However, the distribution of the assets of commercial banks and NBFIs remained biased towards the large institutions. Ten commercial banks with assets above shs 5.0bn held 73.1% of total assets of banks in June 1995. As for the NBFIs, 4 institutions with assets exceeding shs 5.0bn held 49.6% of total assets of NBFIs by June 1996 compared with a market share of 35.7% in June 1995 (Table 6).

Introducing forex bureaus to deal in foreign exchange: The Central Bank licensed 26 forex bureaus during financial year 1995/96, in addition to the 3 in May and June 1995. One forex bureau failed to take off, and one had its license revoked during financial year 1995/96, thereby leaving 27 forex bureaus. The forex bureaus have increased competition leading to the desired narrowing of foreign exchange trading margins.

TABLE 6: NBFIs MARKET SHARE BY TOTAL ASSETS

	JUNE 1995			JUNE 1996		
Peer Group Range (shs m)	Number of NBFIs	Assets (shs m)	Market Share (%)	Number of NBFIs	Asset (shs m)	Market Share (%)
Over 5000	4	24105	37.7	4	29501	49.6
1001-5000	15	33179	49.1	9	24443	41.0
501-1000	10	6582	9.7	5	3754	6.3
201-500	10	3133	4.6	4	1487	2.5
101-200	3	471	0.7	1	176	0.3
0-100	2	100	0.1	3	168	0.3
TOTAL	44	67570	100.0	26	59529	100

Source: Central Bank of Kenya

Performance of the Banking Sector

Overall performance of the banking sector remained satisfactory during financial year 1995/96, unchanged from the previous year:

- **Earnings** remained high.

- **Capital base** improved, as paid-up capital for commercial banks and NBFIs rose by 25.7% to shs 18.1bn in June 1996 from shs 14.4bn in June, 1995. The capital base was boosted by the on-going conversions of NBFIs to commercial banks as capital requirements for banks are normally higher.

- **Liquidity**, as measured by the proportion of liquid assets, i.e. cash in till, net balances with other banks and Government securities to net deposits declined to 40% in June 1996 from 47% in June 1995. This decline is attributed to the reduction in holding of Government securities due to lower yield on the same.

- **Assets quality** remained unsatisfactory as the level of non-performing advances rose to shs 38.1bn in June 1996 from shs 30.2bn in June, 1995. However, the proportion of non-performing advances in the total advances fell to 19% from 20% in June, 1995. Meanwhile, provisions set aside by commercial banks and NBFIs to cushion for non-performing advances increased to shs 17.1bn from shs 14.2bn in June, 1995. The provisions were still inadequate as they amounted to 45% of total non-performing advances in June 1996 compared with 47% in June, 1995.

The Legal Framework

The Central Bank of Kenya Act was amended and the Exchange Control Act was repealed on 27th December 1995 to provide the Bank with residual regulatory powers for the licensing of foreign exchange dealers, monitoring of international payments and supervising of authorised dealers. The objectives of the amendment were to:

- protect the public and the banking system from irregular and unsound practices;
- ensure that international payments are not for illegal activities such as money laundering, tax evasion etc;
- obtain statistical information on transactions with the rest of the world for monitoring developments in the balance of payments;
- ensure that all receipt and payments are effected through authorised dealers.

The Banking Act was amended on 27th October 1995 to enhance ability of the Central Bank to supervise the industry most effectively, protect small depositors, and to foster financial prudence and discipline in the management of banking institutions. The amendments:

- allowed locally incorporated financial institutions to expand branch network outside Kenya.
- reduced credit to a single borrower to 25% of capital and unimpaired reserves of a banking instittution from 100%.
- harmonised to the calender year all financial years for all institutions to 31st to December, beginning 1996.
- reduced the period within which to publish audited accounts to 3 months from 6 months.
- granted the Central Bank powers to approve external auditors.
- raised membership of the Deposit Protection Fund to 7 from 5 and established disclosure requirements

for institutions covered by the Fund.

- stressed professional and moral suit ability for managers of banking institutions.

- sub-ordinated all other law, other than the Central Bank Act, to the Banking Law

The requirements for the cash and liquidity ratio for commercial banks and NBFIs were harmonised during financial year 1995/96. NBFIs and newly converted banks gradually built up their cash ratio from 1.8% in July 1995 to the 18% mandatory level in December 1995. The liquidity ratio applicable to both banks and NBFIs was also harmonised at 25% in July 1995, while that for mortgage finance companies was fixed at 20%.

Many banking institutions embarked on modernization programmes designed to improve their competitiveness by providing more efficient service to their customers, and venturing into new lines of business. Although the new products altered the risk profile for individual institutions, the Central Bank's supervisory approach was reviewed in order to promote the necessary risk management systems to cope with the new environment.

Construction of the Kenya School of Monetary Studies neared completion at the end of the financial year. The institution, which will serve the professional needs of the banking fraternity, will commence operations during financial year 1996/97.

CENTRAL BANK OF KENYA
BALANCE SHEET
(AMOUNT IN KSHS MILLIONS)

As At End	June 1995	June 1996
ASSETS		
Gold and Foreign Exchange	26933	45397
Investment in Government Securities	544	3154
Direct Advances to Kenya Government	200	200
Advances and Discounts to Banks	13613	9316
Uncleared Effects	269	452
Fixed Assets	1457	2126
Other Assets	1884	1374
Revaluation Account	25161	24692
Government of Kenya Overdraft	23285	24016
TOTAL ASSETS	**93346**	**110727**
LIABILITIES		
Currency in Circulation	29032	32265
Deposits	52983	65048
Commercial Banks		
- Kenya	23664	29842
- External	13	22
Non-Banks Financial Institutions	236	6701
IMF	24423	22783
Other Public Entities and Project A/Cs	4647	5700
Other Liabilities and Provisions	8089	7930
Dividend Payable to the Government	2383	3812
CAPITAL AND OTHER RESERVES		
Capital Account	500	500
General Reserve Fund	359	1172
TOTAL LIABILITIES, CAPITAL AND RESERVES	**93346**	**110727**

CENTRAL BANK OF KENYA
BANKI KUU YA KENYA

Profit and Loss Account for the Year Ended 30th June 1996

(Amounts in Kshs Millions)

	1995	1996
REVENUE		
Foreign Investment Earnings	1465	1213
Local Investment Earnings	1735	9117
Other Earnings	1964	1897
Total Revenue	**5164**	**12227**
EXPENDITURE		
Administrative Expenses	1468	1745
Currency Expenses	726	654
Interest on Cash Ratio Deposits	-	789
Banking Expenses	135	111
Foreign Trade Supervision	130	-
Exceptional Items:		
Provisions for Doubtful Debts	56	803
Total Expenditure	**2515**	**4102**
NET SURPLUS	**2649**	**8125**

REPORT OF THE AUDITORS PURSUANT TO SECTION 54 OF THE CENTRAL BANK OF KENYA ACT

We have audited the accounts on pages 22 to 23 which have been prepared under the historical cost convention and on the basis of the set accounting policies. We obtained all the information and explanations which we considered necessary for our audit.

RESPECTIVE RESPONSIBILITIES OF THE DIRECTORS AND AUDITORS

The directors are responsible for the preparation of the accounts. Our responsibility is to express an opinion on the accounts based on our audit.

BASIS OF OPINION

We conducted our audit in accordance with generally accepted auditing standards. We planned and performed our audit so as to obtain a reasonable assurance that the accounts are free from material mis-statement. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the accounts. It also includes an assessment of significant estimates and judgements made by the directors in the preparation of the accounts, and whether the accounting policies are appropriate in the Bank's circumstances, consistently applied and adequately disclosed.

OPINION

The profit for the year ended 30 June 1996 has been ascertained in accordance with Section 9 of the Central Bank of Kenya Act.

In our opinion, proper books of account have been kept and the accounts, which are in agreement therewith, give a true and fair view of the state of affairs of the Bank at 30 June 1996 and of the results of its operations for the year to that date and comply with the requirements of the Central Bank of Kenya Act.

KPMG PEAT MARWICK

BELLHOUSE MWANGI ERNST & YOUNG

JOINT AUDITORS, NAIROBI