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LETTER OF TRANSMITTAL

It is my honour to present to you, Honourable Minister, in accordance with Section 54 of the Central Bank of Kenya Act the Annual Report of the Central Bank of Kenya for the Financial Year 2005/06. The report contains economic and financial developments and the Audited Accounts of the Central Bank of Kenya for the Financial Year ended June 30, 2006.

The economy grew by 5.8 percent in 2005 compared with 4.9 percent in the previous year. Production improved in various sectors, particularly tourism, telecommunications, energy and construction in the face of significant improvements in the macroeconomic conditions and various policy reforms undertaken by the Government.

Monetary policy in the financial year was aimed at achieving an underlying inflation of 5 percent by June 2006. Government commitment to fiscal discipline also contributed to price stability in the year. However, overall inflation was negatively affected by high international oil prices and drought in late 2005.

The banking sector remained stable in the year. Non-performing loans and advances, net of provisions, maintained a downward trend while gross loans and advances increased leading to better asset quality and improved profitability.

For the financial year 2006/07, the economy should continue to benefit from a stable macroeconomic environment and growth enhancing policy measures being implemented by the Government. The current growth momentum is therefore expected to continue in the financial year. As was the case in the previous year, the Bank will continue to ensure that monetary expansion supports the desired real GDP growth without undue inflationary pressures.

Acting Governor

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Governor and Chairman
Central Bank of Kenya

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Permanent Secretary,
Ministry of Finance

JACINTA W. MWATELA (Mrs.)
Deputy Governor
Central Bank of Kenya

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GEORGE ONGAYA-OKOTH

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Director Governors Office and Board Secretary

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Executive Director, Kenya School of Monetary Studies

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Director, Banking Services and National Payments Systems

JONES M. NZOMO
Director, Accounting, Budget & Expenditure Contol

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Director, Estates, Supplies & Services

ALOYS B. AYAKO
Director, Rural Finance Development

NICHOLAS B.T. A. KORIR
Director, Economics Department

SENIOR MANAGEMENT

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Director, Financial Institutions Supervisions

JACKSON M. KITILI
Director, National Debt & Financial Markets

CHARLES O. MARANGA
Director, Administration & Human Resources

EDWIN L. OGOLA
Director, Internal Audit & Risk Management

HEZBON MARIWA
Director, Currency Operations and Branch Administration

CHARLES K. CHEPKWONY
Ag. Director, Information Management Systems

BANK REORGANISATION

Appointment of Acting Governor

Jacinta W. Mwatela was appointed Acting Governor of Central Bank of Kenya on 23rd March, 2006. She was previously Deputy Governor, Central Bank of Kenya.

Departmental Re-organization

The Board approved the reorganisation of departmental functions and operations following the report of the Human Resources Consultants. The departmental structure of the Bank was then re-organized as described below:

Governors' Office

Comprises four divisions namely, Board Secretariat, Legal Services, Security Services and Corporate Communications and Protocol Services.

Banking Department

Banking Services and National Payments Systems Department was renamed Banking Department to include Banking Services and National Payments Systems.

Currency Operations and Branch Administration Department

Currency Operations and Branch Administration Department was retained as a department.

External Payments and Reserves Management Department.

External Payments and Foreign Exchange Reserves Division was renamed External Payments and Reserves Management Department.

Monetary Operations & Debt Management Department.

National Debt and Financial Markets Department was renamed Monetary Operations and Debt Management Department.

Human Resources and Administration Department

Human Resources and Administration Department will continue to focus on core Human Resources strategic management and development.

Economics Department

Policy Analysis and Research Department was merged with International Relations and Regional Cooperation Department and renamed Economics Department.

Banking Supervision Department

Financial Institutions Supervisions Department was renamed Banking Supervision Department with the added mandate to supervise micro finance institutions.

Finance and Resource Planning Department

Accounting, Budget & Expenditure Control Department was renamed Finance and Resource Planning Department charged with the responsibility of coordinating strategic planning, business processes review, preparation of annual plans and budgets for the Bank.

Estates Management and Procurement Department.

Estates, Supplies and Services Department was renamed Estates Management and Procurement Department. The Department continued to function as before offering administrative services within the units of Supplies (Procurement), Transport, and Estates Management.

Internal Audit and Risk Management Department

Internal Audit function was separated from Risk Management function. Both report directly to the Board through the Audit Committee of the Board.

Information Management Services Department

Information Management Systems was re-named Information Management Services Department

Autonomous Institutions

The Kenya School of Monetary Studies and the Deposit Protection Fund Board are, autonomous institutions with their own Boards of Directors.

Other Human Resources Department Activities

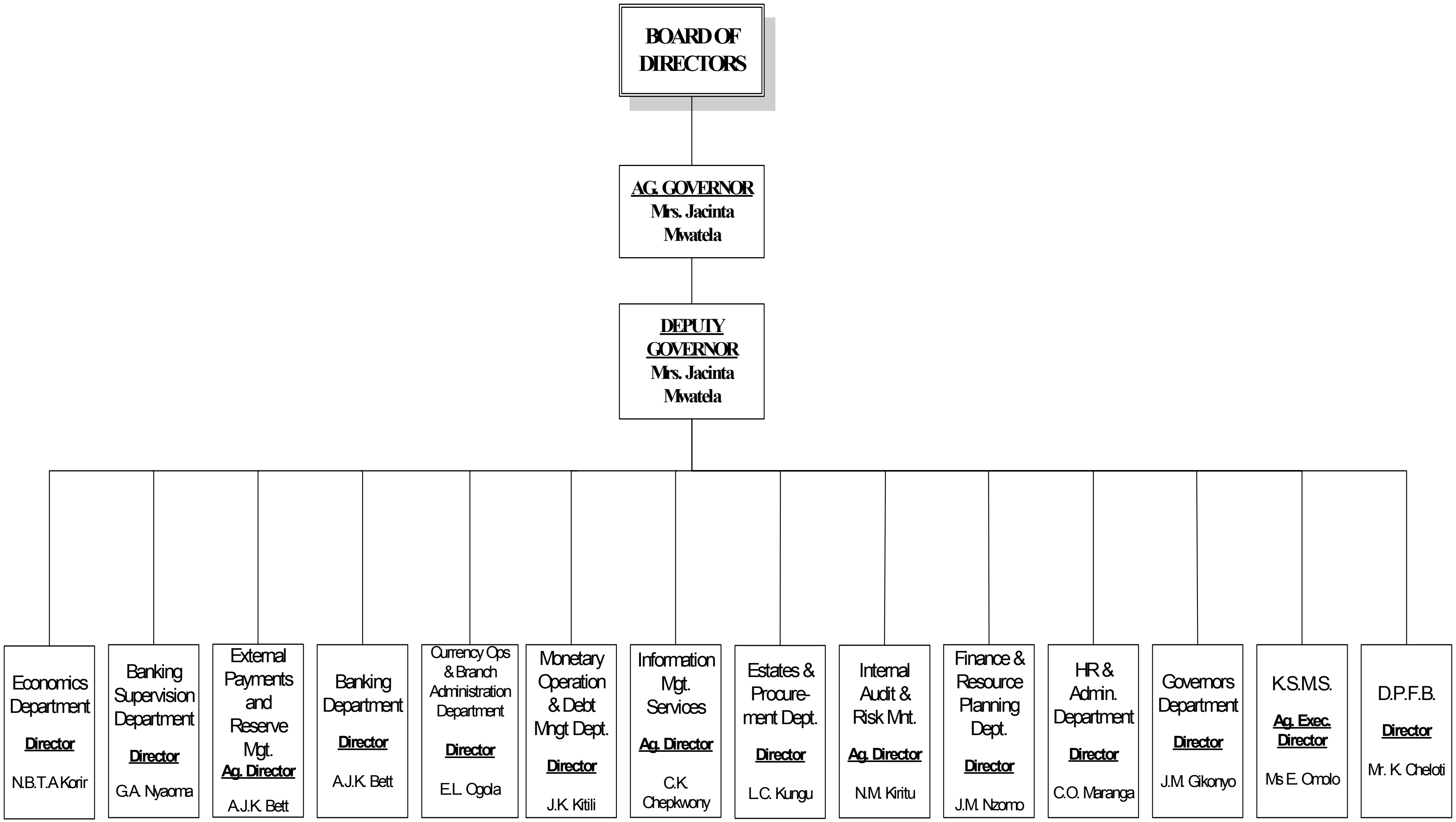
Job Analysis and Evaluation

During the 2006/07 financial year, the Human Resource and Administration Department looks forward to completing the recommendations by the Human Resources Consultants regarding job analysis and evaluation as well as developing a competence based framework for all jobs in the Bank.

Performance Based Management System

The Human Resource and Administration Department is in the process of reviewing the current performance appraisal system for the Bank with a view to placing emphasis on performance. This includes redesigning appraisal forms to ensure that at the senior management level they capture broadly the leadership and management targets and focus more on timely completion of assignments. All staff will be trained on the new performance measurement appraisal system.

CBK ORGANIZATION STRUCTURE June 2006



OVERVIEW

The economy grew by 5.8 percent in 2005 compared with 4.9 percent in 2004, despite high cost of production caused by high and volatile international crude oil prices. Appropriate fiscal and monetary policies pursued during the year, however, resulted in stable macroeconomic conditions, a conducive environment for investment.

In the agricultural sector, there was mixed performance in the production of major cash crops during the fiscal year 2005/06. Horticultural output increased by 0.9 percent from 160,729 metric tonnes in the fiscal year 2004/05 to 162,099 tonnes in the fiscal year 2005/06. At the same time, coffee deliveries declined by 6.1 percent from 51,136 tonnes in the 2004/05 fiscal year to 47,995 tonnes in the fiscal year 2005/06. In the sugar sub-sector, sugar cane deliveries increased by 4.3 percent from 4,751,432 tonnes in the fiscal year 2004/05 to 4,953,329 tonnes in the fiscal year 2005/06.

The growth momentum in the manufacturing sector remained strong in the fiscal year 2005/06 as indicated by increased consumption of the major inputs of the sector. For example, consumption of electricity and fuel oils grew by 5.9 percent and 7.5 percent respectively during the period. Similarly, imports of key intermediate inputs, particularly crude oil, chemicals, machinery and transport equipment grew by 7.5 percent, 5.5 percent and 46.2 percent respectively, in the year to May 2006.

Building and construction increased in the review period. Consumption of cement, a major input in the construction industry, rose by 11.1 percent from 1,464,870 tonnes in the fiscal year 2004/2005 to 1,623,041 tonnes in the fiscal year 2005/06.

Activity in the telecommunications sector picked up in the fiscal year 2005/2006, with the mobile phone sub-sector achieving significant growth to become one of the fastest growing sub-sectors in the economy.

Tourism grew by 17.4 percent in the fiscal year 2005/06. Arrivals through Jomo Kenyatta International Airport, Moi International Airport Mombasa and by cruise ships increased significantly during the year. In 2005/06, cumulative earnings from tourism reached US$ 608 million compared with US$ 482 million in the fiscal year 2004/05.

The Government budgetary operations increased the deficit, both on commitment and cash basis, and reversed the trend of declining deficits in the two preceding fiscal years. The budget deficit, on a commitment basis, amounted to 3.6 percent of GDP, compared with 0.9 percent of GDP in fiscal year 2003/04 and 0.1 percent surplus in fiscal year 2004/05.

The banking sector remained stable in the year, mainly due to favourable macroeconomic conditions prevailing during the period. Non - performing loans and advances, net of provisions, maintained a downward trend while gross loans and advances increased leading to better asset quality and improved profitability. Revised Prudential Guidelines that were issued in November 2005 became effective on 1st January 2006. Under, the revised guidelines, banks are required to discount securities over a period of five years while at the same time maintain higher provisions for performing accounts.

The monetary policy stance for the financial year 2005/06 was directed towards achieving and maintaining inflation below 5 percent. Accordingly, the Central Bank of Kenya set out the path for both reserve money and money supply expansion consistent with the achievement of price stability. Inflation turned out much lower during the year to June 2006 than the year to June 2005. Specifically, the average annual overall inflation declined from 14.97 percent during the year ending June 2005 to 11.1 percent in the year ending June 2006. Similarly, month-on-month overall inflation declined from 11.9 percent in June 2005 to 10.9 percent in June 2006.

All short-term interest rates were lower in June 2006 than in June 2005. For example, the average interest rate on the 91-day Treasury bill declined from 8.50 percent in June 2005 to 6.6 percent in June 2006. Similarly, the average interest rate on the 182-day Treasury bill declined from 9.0 percent in June 2005 to 7.3 percent in June 2006. Unlike short term interest rates, the lending and deposit interest rates were, on average, higher in June 2006 than in June 2005. The overall deposit rate increased from 4.2 percent in June 2005 to 4.4 percent in June 2006.

The Central Bank of Kenya launched the Central Bank Rate (CBR) on 31st May 2006 and the Rate became effective on 2nd June 2006. The introduction of the CBR was done in accordance with Section 36(4) of the Central Bank of Kenya Act which requires the CBK to publish the lowest rate at which the CBK lends to commercial banks. By introducing the CBR, the Bank discontinued the approach of setting the overnight rate on the basis of the prevailing average 91-day Treasury bill rate plus three percentage points.

Kenya's overall balance of payments improved from a surplus of US$ 187 million in the financial year 2004/2005 to US$ 839 million in the financial year 2005/2006. This followed improved capital and financial account as a result of increased private sector financial flows, which more than covered the current account deficit.

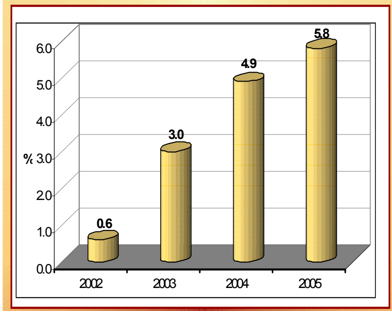
Following increased overall balance of payments, the Central Bank of Kenya was able to build up official foreign exchange reserves, predominantly through purchases of foreign exchange from the domestic inter-bank market. Gross official foreign exchange reserves therefore increased from US$ 1,587 million at the end of June 2005 to US$ 2,353 million, equivalent to 4.8 months of imports cover, at the end of June 2006.

The Kenya shilling strengthened against all major international and regional currencies between June 2005 and June 2006. It appreciated by 4.3 per cent to trade at Ksh 73.4 per US dollar in June 2006 compared with Ksh 76.7 per US dollar in a similar period in 2005. It gained substantially against the currencies of the East African Community countries, to trade at Ush 25.3 and Tsh 17.1 in June 2006 compared with Ush 22.7 and Tsh 14.7 in June 2005, respectively for the Uganda shilling and the Tanzania shilling.

In the period under review, the Bank's Board of Directors approved the Policy Framework for Oversight of Payment Systems in Kenya. The policy outlines the Bank's role, objectives, scope, importance and methodology for payment system oversight in Kenya. Further, the Bank developed the benchmark document for overseeing payment systems in Kenya. In view of the passage of time and the ever changing business environment, the Ministry of Finance requested the Bank to review the draft National Payment System (NPS) and Electronic Funds Transfer (EFT) Bills. The Master Repurchase Agreement and the Intra-day Liquidity Facility agreements were also developed during the year.

REAL GDP GROWTH

CHART 1: REAL GDP GROWTH RATES, 2002 - 2005 (%)



Sources: Economic Survey &Central Bank of Kenya

The economy grew by 5.8 percent in 2005 compared with 4.9 percent in 2004 despite high cost of production induced by soaring and volatile crude oil prices and other challenges posed by poor infrastructure. Sustained appropriate fiscal and monetary policies resulted in affordable interest rates and a stable exchange rate which provided a conducive macroeconomic environment for investment.

Credit to the private sector eased from 20.9 percent expansion in the year to June 2005 to 15.5 percent in June, although there was significant growth in credit to the productive sectors of the

TABLE 1: GROSS DOMESTIC PRODUCT AND SECTOR SHARE AT CONSTANT 2001 PRICES

	Share in Real GDP (%)	Ksh.million		
MAIN SECTORS	**2005**	**2003**	**2004**	**2005**
Agriculture, Forestry & Fishing	24.20	281,077.00	285,905.00	305,226.00
Manufacturing	10.50	105,891.00	110,617.00	116,157.00
Wholesale and retail trade, repairs	10.80	92,805.00	100,655.00	107,155.00
Hotels & Restaurants	1.40	9,903.00	13,747.00	15,581.00
Financial Services	3.10	42,064.00	42,657.00	46,111.00
Construction	4.00	31,538.00	32,790.00	35,143.00
Transport, Storage & Communications	10.90	105,091.00	112,126.00	121,479.00
Government	14.40	143,577.00	146,110.00	146,562.00
Others of which	11.40	130,608.00	134,482.00	137,181.00
Domestic Services	*0.40*	*3,855.00*	*3,932.00*	*4,011.00*
Real estate, renting & Business service	*5.60*	*61,864.00*	*63,740.00*	*65,882.00*
Other-Financial services indirectly measured	*-0.80*	*-10,315.00*	*-10,801.00*	*-11,798.00*
Electricity & Water supply	*2.00*	*27,074.00*	*27,895.00*	*27,924.00*
Mining & Quarrying	*0.50*	*5,213.00*	*5,326.00*	*5,469.00*
Community, social & personal services	*3.70*	*42,917.00*	*44,390.00*	*45,693.00*
Total GDP at basic 2001 prices	**90.70**	**942,554.00**	**979,090.00**	**1,030,597.00**
Taxes less subsidies on products	8.80	113,900.00	128,626.00	141,493.00
Real GDP at 2001 market prices	**100.00**	**1,056,454.00**	**1,107,715.00**	**1,172,090.00**
*** Memorandum item: Tourism earnings /1**		**24,292.62**	**32,848.97**	**31,629.80**
GDP at Mkt Prices		1,136,288.00	1,282,504.00	1,415,155.00
Overall GDP Deflator		107.56	115.78	120.74
Overall Annual Average CPI Less Food CPI, Base = 2001		**106.21**	**113.47**	**121.84**
		Growth Rates %		
Agriculture, Forestry & Fishing		2.6%	1.7%	6.8%
Manufacturing		6.0%	4.5%	5.0%
Wholesale and retail trade, repairs		1.7%	8.5%	6.5%
Hotels & Restaurants		-20.3%	38.8%	13.3%
Financial Services		1.5%	1.4%	8.1%
Building & Construction		1.0%	4.0%	7.2%
Transport & Communications		3.6%	6.7%	8.3%
Government		2.6%	1.8%	0.3%
Others		4.3%	3.0%	2.0%
Domestic Services		2.0%	2.0%	2.0%
Real estate, renting & Business service		2.3%	3.0%	3.4%
Other-Financial services indirectly measured		-3.3%	4.7%	9.2%
Electricity & Water supply		14.0%	3.0%	0.1%
Mining & Quarrying		3.5%	2.2%	2.7%
Community, social & personal services		0.0%	3.4%	2.9%
Real GDP Growth		3.0%	4.9%	5.8%

/1 These data are based on reported foreign exchange earnings from tourism compiled by commercial banks and consolidated by the CBK. The actual earnings are then deflated by the annual average CPI less food CPI to get Tourism earnings at 2001 prices.

Sources: Central Bank of Kenya and Central Bureau of Statistics

economy. For instance, in the year to June 2006, credit to manufacturing, transport and communication and building and construction increased by 5.4 percent, 33.3 percent and 37.5 percent respectively.

As was the case in the fiscal year 2004/05, consumption of inputs and production of goods and services in the fiscal year 2005/06 picked up. In Agriculture, for instance, horticultural exports increased by 0.9 percent to 162,099 metric tonnes boosted by strong growth in the world economy.

The manufacturing sector also achieved strong growth with production of cement, processed milk, cigarettes and beer growing by 7.8 percent, 24.3 percent, 19.9 percent and 8.5 percent respectively in the fiscal year 2005/06. Meanwhile, soda ash production increased by 2.0 percent.

In the energy services sector, consumption of electricity and fuels expanded by 5.9 percent and 7.5 percent respectively during the fiscal year 2005/06, consistent with increased imports of capital goods, namely crude materials, chemicals, machinery and transport equipment which increased by 7.5 percent, 5.5 percent and 46.2 percent, respectively in the year to May 2006.

In the services sector, tourist arrivals by air and sea grew by 20.7 percent compared with 30.7 percent in fiscal year 2004/05. In transport related services, cargo handled through the Port of Mombasa and fuel cargo transported by the Kenya Pipeline Company expanded by 1.3 percent and 4.9 percent, respectively, during the fiscal year 2005/06 while passengers through Jomo Kenyatta International Airport (JKIA) increased by 7.8 percent. Similarly, in communications services, rapid growth was achieved in the mobile phones sub-sector with excise duty on airtime services picking up by 34.3 percent to Ksh 4.0 billion from Ksh 3.0 billion in the fiscal year 2004/05.

Activity also increased in the construction sector, with cement consumption expanding by 11.1 percent compared with 11.0 percent in the fiscal year 2004/05.

The implementation of the Government investment program outlined in the 2005/06 Budget and articulated further in the 2006/07 budget, particularly in the development and rehabilitation of major infrastructure and other projects, is expected to support accelerated economic growth through the medium term.

There was mixed performance in the production of major cash crops during the fiscal year 2005/06 as shown in Table 2.

TABLE 2: OUTPUT GROWTH IN KEY CROPS (%)

PRODUCT	Jun2002/03	Jun2003/04	Jun2004/05	Jun2005/06
Tea				
Output (MT)	280,136	327,281	321,440	295,791
Output Growth %	-1.00%	16.83%	-1.78%	-7.98%
Horticulture				
Output (MT)	137,601	137,084	160,729	162,099
Output Growth %	31.04%	-0.38%	17.25%	0.85%
Coffee				
Output (MT)	56,245	58,795	51,136	47,995
Output Growth %	13.55%	4.53%	13.03%	-6.14%
Sugar cane				
Output (MT)	4,163,415	4,548,881	4,751,432	4,953,329
Output Growth %	5.85%	9.26%	4.45%	4.25%

Sources: Central Bureau of Statistics, Horticultural Crop Development Authority, Sisal, Sugar and Pyrethrum Boards

Government policy measures outlined in the 2006/07 budget are expected to strengthen production in the agricultural sector. The measures include removal of VAT on agricultural implements like tractors, transportation of unprocessed agricultural and agro-forestry products. Re-opening of the Kenya Meat Commission (KMC) Factory in Athi River in June 2006 would boost the livestock sub-sector. Furthermore, the Government will continue to encourage marketing of livestock products with emphasis on external markets.

Tea output declined by 8 percent from 321,440 tonnes in fiscal year 2004/05 to 295,791 tonnes in fiscal year 2005/06. This decline is attributed to severe drought in tea growing areas during the first quarter of 2006. Despite the "long rains" between March and May which led to recovery of tea bushes, the production shortfall in the first quarter may not be offset fully because of subdued amounts of rainfall since June 2006 coupled with the start of the cold season expected to end in September 2006.

In horticultural sector, output increased by 0.9 percent to reach 162,099 tonnes in the fiscal year 2005/06 from 160,729 metric tonnes in the fiscal year 2004/05. The total output of flowers and vegetables increased by 3.1 percent and 3.6 percent respectively while the output of fruits decreased by 16.8 percent in the fiscal year 2005/2006.

At the same time, coffee deliveries declined by 6.1 percent, from 51,136 tonnes in the 2004/05 fiscal year to 47,995 tonnes in the fiscal year 2005/06. The average price of coffee increased by 14.2 percent, from US dollar 2,132 in the period 2004/05 to US dollar 2,435 per tonne.

In the sugar sub-sector, sugar cane deliveries increased by 4.3 percent, from 4,751,432 tonnes in the fiscal year 2004/05 to 4,953,329 tonnes in the fiscal year 2005/06 . Processed sugar output, however, declined by 0.1 percent from 507,306 tonnes in the fiscal year 2004/05 to 506,589 tonnes. Similarly, total sales of sugar during the period increased by 2.2 percent to 498,739 tonnes from 487,846 tonnes in the previous financial year.

Flowers and vegetables shares in horticultural production were 50 percent and 40 percent respectively while that of fruits was 10 percent. To encourage production of more fruits, the Government, as outlined in the 2006/07 budget, will declare mangoes and avocados permanent and semi-permanent crops. Such declaration will enable the fruits to be tax exempt, an advantage available under special crops.

Milk deliveries to the dairy processing factories increased by 24.3 percent from 281,336 million litres in the fiscal year 2004/05 to 349,756 million litres in the fiscal year 2005/06. The improved production is attributed to the favorable weather conditions in the second half of the year 2005 in spite of the drought in the first quarter of 2006. In addition, there has been improved regulatory support of the sector with the revival of the Kenya Cooperative Creameries and a growing regional market for Kenya's dairy produce.

Over the last three years, the Government has implemented structural reforms aimed at general transformation of agricultural activities into more profitable, internationally competitive ventures. These reforms are detailed in the overall 10 year Strategy for Revitalizing Agriculture (SRA).

By improving efficiency and productivity in the coffee, pyrethrum, sugar, cotton and livestock industries, among other sub-sectors, the Government aims at addressing the problem of low productivity, thereby reducing poverty and unemployment in rural areas.

In the fiscal year 2005/06, the Government injected Ksh. 1.5 billion into the Agricultural Finance Corporation for on-lending to farmers. The increased resources are expected to peak at Ksh. 33.5 billion (7.3 percent of total resources) in the fiscal year 2008/09, up from Ksh. 18.6 billion (5.3 percent of the total resources) in the fiscal year 2005/06.

MANUFACTURING

The growth momentum of the manufacturing sector continued in the fiscal year 2005/06 as indicated by the major inputs of the sector. Consumption of electricity and fuel oils grew by 5.9 percent and 7.5 percent respectively. Similarly, imports of key intermediate inputs, particularly crude oil, chemicals, machinery and transport equipment grew by 7.5 percent, 5.5 percent and 46.2 percent respectively, in the year to May 2006.

As shown in Table 3, output of cigarettes increased by 19.9 percent, from 10,052,423 milles in the fiscal year 2004/05 to 12,048,634 milles in the fiscal year under review, while beer production increased by 8.5 percent from 257,123,727 litres to 278,904,814 litres during the same period.

TABLE 3: PRODUCTION OF SELECTED MANUFACTURED GOODS

PRODUCT	Jun2002/03	Jun2003/04	Jun2004/05	Jun2005/06
Processed sugar				
Output (MT)	450,043	509,245	507,306	506,589
Output Growth %	6.94%	13.15%	-0.38%	-0.14%
Cement production				
Output (MT)	1,639,336	1,691,483	1,975,464	2,104,918
Output Growth %	17.35%	3.18%	16.79%	6.60%
Soda ash				
Output (MT)	332,330	355,540	357,521	364,760
Output Growth %	10.46%	6.98%	0.56%	2.02%
Milk				
Output ('000 litres)	178,718	239,705	281,336	349,756
Output Growth %	27.68%	34.12%	17.37%	24.33%
Beer				
Output ('000 litres)	192,992	211,038	257,124	278,905
Output Growth %	2.86%	9.35%	21.84%	8.47%
Cigarettes				
Output (Number of sticks)	7,138,180	8,590,015	10,052,423	12,048,634
Output Growth %	19.38%	20.34%	17.02%	19.86%

Sources: Central Bureau of Statistics, Sugar Board, Dairy Board, Kenya Revenue Authority and Magadi Soda

Soda ash output increased by 2.0 percent from 357,521 tonnes to reach 364,760 tonnes in the financial year 2004/05. Cement production and consumption also increased by 6.6 percent and 11.1 percent to from 1,975,464 tonnes and 1,460,377 tonnes the previous fiscal year to 2,104,918 tonnes and 1,623,041 tonnes, respectively. Sugar production, however, declined by 0.1 percent during the fiscal year.

To promote industrial growth, the Government introduced tax incentives in the fiscal years 2003/04, 2004/05, 2005/06 and 2006/07. The incentives included, duty waivers on capital goods, plant and equipment, and an increase in investment allowance from 60 percent to 100 percent. The Government, therefore, aims at eliminating 118 licenses and further removal of duties on selected imported inputs in the fiscal year 2006/07.

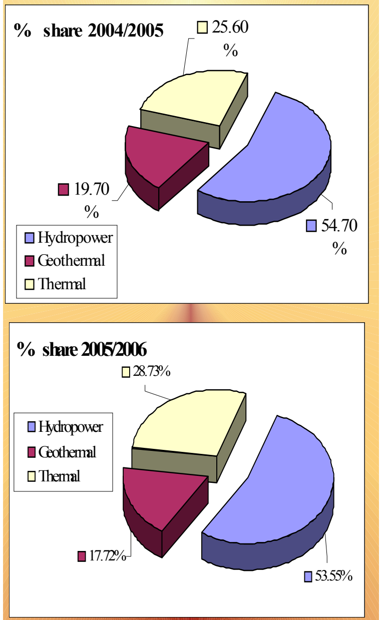
Growth in the manufacturing sector, however, continues to be hampered by high cost of operations due to poor infrastructure, high cost of power, lengthy clearing procedures at the port, and inefficient railway services.

To mitigate these problems, the Government is reforming the Kenya Railways. The reforms are expected to improve efficiency in the railway transport in the fiscal year 2006/07 through the medium term. At the same time, the Government divesture from Ken-Gen is expected to reduce the cost of power in the long run. Similarly, to address the lengthy clearing procedures at the Port of Mombasa, investors from the private sector have been invited to participate in container terminal operations, dredging the channel to accommodate larger vessels and introduction of 24-hour work operations.

ENERGY SECTOR DEVELOPMENTS

Domestic supply of electricity expanded by 7.9 percent per annum in fiscal year 2004/05 and fiscal year 2005/06. Total power generation in the fiscal year 2005/06 reached 5,654 million Kilowatt Hours (KWH), compared with 5,246 million KWH in fiscal year 2004/05. The steady growth in generation over the last two years is attributed to adequate water supply to hydroelectric dams and increased exploitation of thermal and geothermal sources of power.

CHART 2: PERCENTAGE SHARE OF ELECTRICITY SOURCES

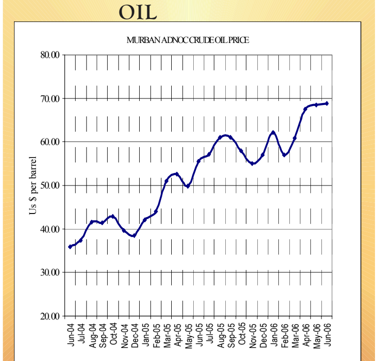


Source: Kenya Power & Lighting Co.

Hydroelectric power remains the main source, accounting for 54.7 percent of total electricity supply, with the shares of geothermal and thermal sources increasing to 17.7 percent and 28.7 percent respectively in fiscal year 2005/06. In the previous fiscal year, hydroelectric power accounted for 54.7 percent of total supply while geothermal and thermal sources accounted for only 19.7 percent and 25.6 percent respectively. Consequently, imported electricity from Uganda declined by 84.9 percent to 14.9 million KWH in fiscal year 2005/06. However, continued growth in consumption of energy at the same rate through the medium term, is likely to lead to power supply shortfalls.

The petroleum sector experienced rapid increases in crude oil prices since 2004. The average price of Murban Adnoc crude oil from Saudi Arabia increased from US $ 35.95 per barrel in June 2004 to US $ 55.5 per barrel in June 2005 and to US $ 68.85 in June 2006.

CHART 3: SAUDI ARABIAN CRUDE OIL



Source: Ministry of Energy

At the domestic level, removal of road license and transfer of the charge to road maintenance levy at Ksh 3.20 per litre triggered a rise in fuel prices.

CONSTRUCTION

Building and construction increased in the fiscal year 2005/06. Consumption of cement, a major input in the construction activity increased by 11.1 percent from 1,464,870 tonnes in the fiscal year 2004/05 to 1,623,041 tonnes.

To reduce road transport costs, the Government has allocated Ksh 15 billion in fiscal year 2006/07 budget for roads and aims to accelerate road repairs and construction by addressing structural complaints and governance challenges facing the sector.

In the 2006/07 budget private sector participation in road repairs and construction including maintenance of specific urban roads will be encouraged by introducing income tax incentives to allow the sector to contribute to infrastructure development. Strict rules and benchmarks are to be developed to ensure contractors deliver quality services within stipulated time frames. Those who fail to meet the standards will be blacklisted and barred from participating in Government procurement. This will contribute to curbing poor workmanship which has led to poor quality roads. Other measures proposed in the budget to support continued rehabilitation and reconstruction of the infrastructure are setting up of Highways, Rural and Urban Roads Authorities respectively. The tax incentives contained in the budget such as making the cost of constructing selected buildings income tax deductible and industrial allowance of 10 percent for educational building will increase economic activity in building and construction sector.

Reforms in the public transport sub-sector have borne noticeable improvement in provision of transport services as shown in Table 4.

TABLE 4: PERFORMANCE OF MAJOR SUB-SECTORS

ACTIVITY	Jun 2002/03	Jun 2003/04	Jun 2004/05	Jun 2005/06
Cargo by KPA				
Output (MT Equivalent)	11,463,864	12,505,385	13,284,921	13,454,631
Output Growth %	9.11%	9.09%	6.23%	1.28%
Passengers through JKIA				
Number of incoming passengers	988,328	1,097,084	1,297,660	1,401,225
Growth %	5.50%	11.00%	18.29%	7.98%
Number of outgoing passengers	1,003,626.00	1,111,067.00	1,327,742.00	1,401,482
Growth %	0.61%	10.70%	19.50%	5.55%
Cargo by Kenya Railways				
Output (MT)	2,165,172	1,995,059	1,790,225	1,958,138
Output Growth %	-2.85%	-7.86%	-10.27%	9.40%
Throughput by Kenya Pipeline				
Output ('000 litres Equivalent)	2,819,998	3,093,366	3,459,298	3,627,232
Output Growth %	3.63%	9.69%	11.83%	4.90%
Excise duty on Airtime				
Output (KSHS Million)	677.00	2,068.00	2,982.00	3,963.00
Growth %		205.47%	44.20%	32.90%

Sources: Kenya Ports Authority, Kenya Railways, Kenya Pipeline and Central Bureau of Statistics

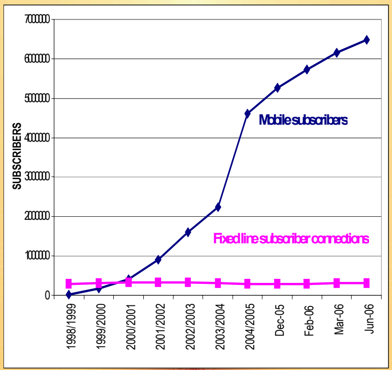
The reforms in public transport sector have attracted increased investment as reflected in increased registration of new motor vehicles by 1.5 percent from 46,035 in the previous fiscal year to 46,737 units in the fiscal year 2005/2006 . Modest growth was also achieved in air transport with the incoming passengers passing through the Jomo Kenyatta International Airport (JKIA) increasing by 8.0 percent in the fiscal year 2005/06 to 1,401,225, while outgoing passengers expanded by 5.6 percent to 1,401,482. The improved growth in air transport was largely supported by the robust growth in the tourism sector over the period.

Pipeline and cargo handling also improved during the financial year. Petroleum products transported by the Kenya Pipeline Company (KPC) increased by 4.9 percent from 3,459,298 cubic units during the fiscal year 2004/05 to 3,627,232 cubic units, while cargo handled by the Kenya Ports Authority (KPA) increased by 1.3 percent to 13,454,631 tonnes compared with 13,283,984 tonnes in the 2004/05 fiscal year.

Cargo handled by the Kenya Railways, however, increased by 9.4 percent in the fiscal year 2005/06 from 1,790,225 tonnes in the previous fiscal year to 1,958,138 tonnes. The concession of the Kenya Railways services is expected to improve railway transport and facilitate faster movement of cargo through the port of Mombasa. There are, therefore, efforts to modernize the port which will include introduction of private sector participation in the container terminal operations as well as dredging the channel to accommodate large vessels. To improve air safety the Government is modernizing Jomo Kenyatta International Airport in addition to upgrading and modernizing most airstrips in the country.

Activity in the telecommunications sector picked up in the fiscal year 2005/2006 with the mobile phone sub-sector achieving significant growth to become one of the fastest growing sub-sectors. Mobile phones subscribers increased by 40.6 percent from 4,611,970 in June 2005 to 6,484,791 in June 2006.

CHART 4: COMPARATIVE GROWTH OF FIXED AND MOBILE NETWORKS



Source: Communication Commission of Kenya

The large growth in mobile phone subscription is reflected in the large new support businesses, including increased public mobile pay phones, increased subscribers and expanded area covered by the services. As a result, excise duty on airtime rose by 34.3 percent from Ksh 2.98 billion in the fiscal year 2004/05 to Ksh 4.0 billion in the fiscal year 2005/06 .

Similarly, fixed lines telephone sub-sector connections increased by 7.9 percent from 281,764 in June 2005 to 303,905 in June 2006.

The e-Government project implemented during the fiscal year 2005/2006 has improved service delivery and promoted accountability. This has enabled the public to access Government services and information efficiently through the use of the internet.

TOURISM

Tourism sector grew by 17.4 percent in the fiscal year 2005/06 as shown in Table 5. A break-down by point of entry indicates that arrivals through Jomo Kenyatta International Airport and Moi International Airport Mombasa increased by 15.2 percent and 25.2 percent compared with the growths of 34.0 percent and 20.6 percent, respectively in the fiscal year 2004/05. However, arrivals by cruise ships in the fiscal year 2005/06 decreased by 33.07 compared with 172.2 percent increase in the previous year. In 2005/06, cumulative earnings from tourism reached US$ 608 million up from US$ 482 million in the fiscal year 2004/05.

TABLE 5: TOURIST ARRIVALS BY POINT OF ENTRY

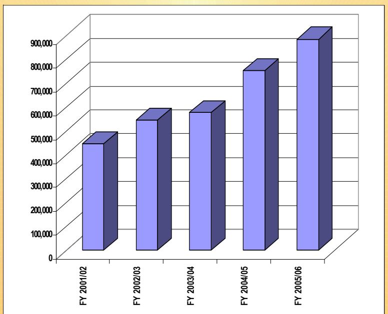
	FY 2003/2004	FY 2004/2005	FY 2005/2006
Cruise ships	2,063.00	5,615.00	3,758.00
Growth %	56.49%	172.180%	-33.07%
JKIA	413,073.00	553,437.00	637,545.00
Growth %	18.14%	33.98%	15.20%
MIAM	161,315.00	194,572.00	243,425.00
Growth %	-14.76%	20.62%	25.11%
Total	**576,451.00**	**753,624.00**	**884,728.00**
Growth %	6.04%	30.74%	17.40%

FY - Fiscal year
Source: Kenya Tourist Board

As in the fiscal year 2004/05, the robust growth can be explained by stepped up marketing efforts particularly in non-traditional markets such as China, Japan, India and locally.

The tourism sector outlook is bright given the heightened promotion of domestic tourism and improved security. Thus growth in the sector is expected to be steady in the coming years.

CHART 4: TOURIST ARRIVALS



Source: Kenya Tourist Board

USES OF AVAILABLE RESOURCES

Resources available in the economy measured as gross national disposable income in 2005 amounted to 104.9 percent of GDP at current prices compared with 103.3 percent of GDP in 2004 (Table 6). The increase resulted from an increase in net current transfers from 4.0 percent of GDP in 2004 to 5.5 percent of GDP, and higher net factor payments as total output by all sectors grew by 5.8 percent compared with 4.9 percent in 2004 and 3.0 percent in 2003.

TABLE 6: USE OF RESOURCES (KSH MILLION)

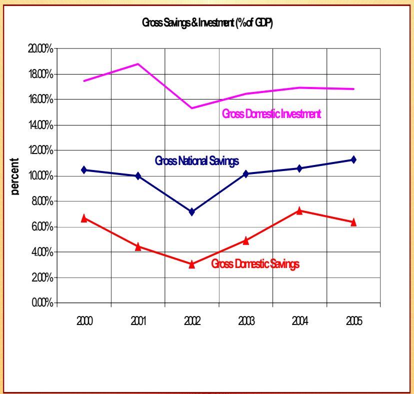
Millions of Kenya Shillings	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
Gross national disposable income	**1,004,503**	**1,076,360**	**1,064,258**	**1,195,651**	**1,324,763**	**1,484,644**
Net current transfers	47,860	65,862	53,325	66,091	52,276	77,683
Gross national income	**956,643**	**1,010,498**	**1,010,933**	**1,129,560**	**1,272,487**	**1,406,961**
Net factor income payments (Y(f))	-11,195	-9,524.00	-11,275	-6,728	-10,017	-8,194
Gross domestic product (at market prices)	**967,838**	**1,020,022**	**1,022,208**	**1,136,288**	**1,282,504**	**1,415,155**
Total Consumption (C)	**903,428**	**974,752**	**991,190**	**1,080,294**	**1,191,544**	**1,319,480**
Government consumption - C(g)	145,701	162,959	176,829	205,140	226,016	242,409
Private consumption - C(p)	757,727	811,793	814,361	875,154	965,528	1,077,071
Gross domestic investment (I)	**168,540**	**191,703**	**156,751**	**186,570**	**217,180**	**237,752**
Gross fixed capital formation	161,714	185,186	178,480	179,282	206,634	263,063
Increase/Decrease in stocks	6,826	6,517	-21,729	7,288	10,546	-25,311
Exports of goods and nfs (X)	**214,831**	**225,172**	**244,468**	**270,118**	**336,360**	**378,068**
Imports of goods and nfs (M)	**-292,493**	**-345,899**	**-313,851**	**-338,394**	**-434,234**	**-529,749**
GDP deflator (2001=100)	98.5	100.0	99.6	107.6	115.8	120.7
Real GDP	982,855	1,020,022	1,025,854	1,056,454	1,107,715	1,172,090
Real GDP growth (annual in %)	**0.60%**	**4.50%**	**0.57%**	**2.98%**	**4.85%**	**5.81%**
Gross National savings	101,075	101,608	73,068	115,357	133,219	165,164
Gross Domestic Savings	64,410	45,270	31,018	55,994	90,960	95,675
Total National Balance(S-I)	**-67,465**	**-90,095**	**-83,683**	**-71,213**	**-83,961**	**-72,588**
CAB (X-M+Y(f)+TR(f))	**-40,997**	**-64,389**	**-27,333**	**-8,913**	**-55,615**	**-82,192**
Discrepancy	**-26,468**	**-25,706**	**-56,350**	**-62,300**	**-28,346**	**9,604**
CAB + DISCREPANCY	**-67,465**	**-90,095**	**-83,683**	**-71,213**	**-83,961**	**-72,588**
Kenya - National Accounts						
In shares of GDP	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
Gross national disposable income	103.79%	105.52%	104.11%	105.22%	103.30%	104.91%
Net current transfers (TR(f))	4.95%	6.46%	5.22%	5.82%	4.08%	5.49%
Gross national income	98.84%	99.07%	98.90%	99.41%	99.22%	99.42%
Net factor income payments (Y(f))	-1.16%	-0.93%	-1.10%	-0.59%	-0.78%	-0.58%
Gross domestic product (GDP)						
Gross Domestic Product (expend)						
Total Consumption ©	93.34%	95.56%	96.97%	95.07%	92.91%	93.24%
Government consumption - C(g)	15.05%	15.98%	17.30%	18.05%	17.62%	17.13%
Private consumption - C(p)	78.29%	79.59%	79.67%	77.02%	75.28%	76.11%
Gross domestic investment (I)	17.41%	18.79%	15.33%	16.42%	16.93%	16.80%
Gross fixed capital formation	16.71%	18.16%	17.46%	15.78%	16.11%	18.59%
Increase/Decrease in stocks	0.71%	0.64%	-2.13%	0.64%	0.82%	-1.79%
Exports of goods and services (X)	22.20%	22.08%	23.92%	23.77%	26.23%	26.72%
Imports of Goods and services (M)	-30.22%	-33.91%	-30.70%	-29.78%	-33.86%	-37.43%
Gross National savings	10.44%	9.96%	7.15%	10.15%	10.39%	11.67%
Gross Domestic Savings	6.66%	4.44%	3.03%	4.93%	7.09%	6.76%

Source: Economic Survey, 2006

The resources were allocated to consumption, investment and savings. Gross fixed capital formation in real terms declined by 7.9 percent in 2003, increased by 6.7 percent in 2004 and 27.4 percent in 2005.

Gross domestic investment increased from 16.4 percent of GDP share in 2003 to 16.9 percent of GDP in 2004 and 2005. The increase in gross domestic investment in 2004 and 2005 was largely in gross fixed capital formation. For instance, gross fixed capital formation increased from 16.1 percent of GDP in 2004 to 18.6 percent of GDP in 2005.

CHART 5: SAVINGS AND INVESTMENT (% OF GDP)

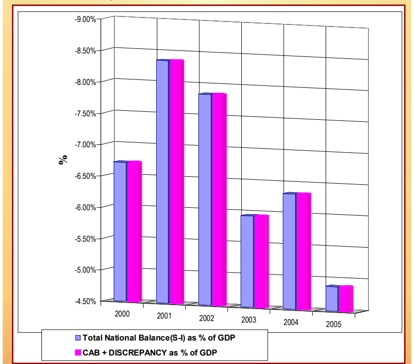


Source: Economic Survey, 2004

As with investment, gross national savings, defined as gross national disposable income less total consumption, increased from 10.4 percent of GDP share in 2004 to 11.7 percent of GDP share in 2005, while gross domestic savings, that is, gross domestic product less domestic consumption, declined from 7.1 percent of GDP in 2004 to 6.8 percent of GDP of GDP in 2005.

The increase in availability of resources in 2005 from 2004 led to a pick up in aggregate demand reflected in the increase in total consumption in 2004 from 92.9 percent of GDP to 93.2 percent of GDP in 2005. Government consumption accounted for 17.1 percent of GDP, down from 17.6 percent of GDP in 2004.

CHART 6:CAB/TOTAL NATIONAL BALANCE GDP RATIO



Source: Central Bank of Kenya

More resources were used for private sector consumption than for consumption in 2004 by Government. Private sector consumption accounted for 76.1 percent of GDP in 2005 compared with 75.3 percent of GDP in 2004.

Official Development Assistance to Developing Countries

Disbursements of official development assistance (ODA) funds rose from US$ 79.6 billion in 2004 to US$ 106.5 billion in 2005 as shown in Table 7, mainly due to increased debt relief. The higher share of debt relief in total ODA disbursements is attributable to emergency and distress relief provided for the 2004 Tsunami victims as well as increased debt relief grants to Iraq and Nigeria. More development assistance was reallocated to countries afflicted by conflict and to the poorest countries. Assistance to the poorest countries was aimed at strengthening their capacity to participate in foreign trade through enhanced trade policy, regulations and infrastructure. The donor community remains committed to providing the assistance needed to support developing countries meet the Millennium Development Goals (MDGs).

TABLE 7: NET OFFICIAL DEVELOPMENT ASSISTANCE TO DEVELOPING COUNTRIES (1990 - 2005)

	US$ billion							
	1990	**1995**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005***
Total ODA	**54.3**	**58.8**	**53.7**	**52.4**	**58.3**	**69.1**	**79.6**	**106.5**
Bilateral ODA	38.5	40.5	36.1	35.1	40.8	49.8	54.4	82.0
Debt Relief	1.5	2.7	1.6	2.0	3.7	6.8	4.2	23.0
Technical Co-operation	11.4	14.3	12.8	13.6	15.5	18.4	18.8	21.6
Emargency Distress / Relief	1.1	3.1	3.6	3.3	3.9	6.2	7.3	12.7
Administrative Costs	2.0	2.9	3.1	3.0	3.0	3.5	4.0	4.0
Special Purpose Grants	15.9	23.0	21.0	21.8	26.1	34.8	34.3	61.3
Multilateral ODA	15.8	18.3	17.7	17.3	17.5	19.3	25.1	24.5
Total ODA less debt Relief	52.7	56.1	52.2	50.5	54.6	62.3	75.4	83.5
Total ODA less Special Purpose Grants	38.4	35.8	32.7	30.6	32.2	34.2	45.2	45.2

* Preliminary

Sources: Global Development Finance (2006) & Central Bank of Kenya

Net Debt Flows to Developing Countries

Net debt flows to developing countries increased from US$ 119.1 billion in 2004 to US$ 120.1 billion in 2005 as indicated in Table 8. Net debt flows to East Asia and Pacific rose from US$ 37.8 billion in 2004 to US$ 43.9 billion in 2005 , while those to the Middle East and North Africa also went up from a net outflow of US$ 1.8 billion in 2004 to US$ 2.2 billion net inflow in 2005. Decreases in net inflows, however, occured in Europe and Central

Asia, Latin America and the Caribbean, South Asia and Sub-Saharan Africa.

Net debt flows to Sub-Saharan Africa decreased from US$ 3.6 billion in 2004 to US$ 0.6 billion in 2005. There was a net inflow to Kenya of US$ 0.2 billion in 2005 compared with a net outflow of US$ 0.1 billion in 2004.

TABLE 8: PRIVATE SECTOR DEBT FLOW TO DEVELOPING COUNTRIES: 1999-2005

	US$ Billion						
	1999	2000	2001	2002	2003	2004	2005*
East Asia & Pacific	-11.7	-16.0	-8.2	-10.3	1.9	37.8	43.9
Europe & Central Asia	18.6	20.0	2.3	27.6	57.9	83.2	82.9
Latin America & Caribbean	12.8	-4.7	6.2	-8.6	10.2	-11.4	-15.9
South Asia	0.5	3.5	-0.9	0.0	0.3	7.7	6.4
Middle East & North Africa	-3.0	-3.8	0.3	2.3	-0.4	-1.8	2.2
Sub-Saharan Africa	**-0.9**	**0.0**	**-1.2**	**-0.3**	**2.9**	**3.6**	**0.6**
Kenya	***0.2***	***0.1***	***-0.4***	***-0.2***	***-0.1***	***-0.1***	***0.2***
Total Net Flows	**16.3**	**-1.0**	**-1.5**	**10.7**	**72.8**	**119.1**	**120.1**

* Estimate

Sources: Global Development Finance (2005) & Economic Survey 2006

Net Foreign Direct Investment (FDI) Flows to Developing Countries

Net foreign direct investment (FDI) flows to developing countries continued to rise with continued expansion in the global economy and improved economic conditions in developing countries. This was reflected in, among other factors, improved corporate governance and higher corporate earnings, liberalization of ownership rules and higher stock market valuations. Net FDI flows to developing countries rose from US$ 211.5 billion in 2004 to US$ 237.5 billion in 2005 as shown in Table 9.

Net FDI flows to Europe and Central Asia grew to US$ 75.6 billion in 2005, accounting for 31.8 percent of net FDI flows to developing countries during the year. East Asia and Pacific countries received 27.5 percent amounting to US$ 65.3 billion, while Latin America and the Caribbean received 25.9 percent or US$ 61.4 billion. South Asian, Middle Eastern and North African countries absorbed

7.4 percent of net FDI flows to developing countries, the same amount as Sub-Saharan Africa. Kenya had net FDI outflows in 2004 and 2005.

TABLE 9: NET FDI INFLOWS TO DEVELOPING COUNTRIES: 1999-2005

	US$ Billion						
	1999	2000	2001	2002	2003	2004	2005*
East Asia & Pacific	50.8	44.3	48.5	57.2	59.8	64.6	65.3
Europe & Central Asia	29.8	30.2	32.7	34.9	35.9	62.4	75.6
Latin America & the Caribbean	88.3	79.3	71.1	48.2	41.1	60.8	61.4
South Asia	3.1	4.4	6.1	6.7	5.7	7.2	8.4
Middle East & North Africa	2.4	4.2	3.4	3.7	5.6	5.3	9.1
Sub-Saharan Africa	**9.0**	**6.5**	**15.0**	**9.5**	**13.6**	**17.6**	**17.6**
Kenya	***0.01***	***0.11***	***-0.10***	***0.01***	***0.06***	***-0.03***	***-0.03***
Total	**183.3**	**168.8**	**176.9**	**160.3**	**161.6**	**211.5**	**237.5**

* Estimate

Sources: Global Development Finance (2005) & Economic Survey 2006

Net Portfolio (Equity) Flows to Developing Countries

Table 10 shows that net portfolio flows to developing countries increased from US$ 37.3 billion in 2004 to US$ 61.4 billion in 2005. The highest shares went to East Asia and Pacific, South Asia, Latin America and Sub-Saharan Africa. Net portfolio equity inflows to Sub-Saharan Africa increased from US$ 6.7 billion in 2004 to US$ 7.2 billion in 2005. Net portfolio flows to Kenya improved from a net outflow of US$ 0.03 billion in 2004 to a net inflow of US$ 0.04 billion in 2005 .

TABLE 10:PORTFOLIO INFLOWS TO DEVELOPING COUNTRIES: 1999-2005

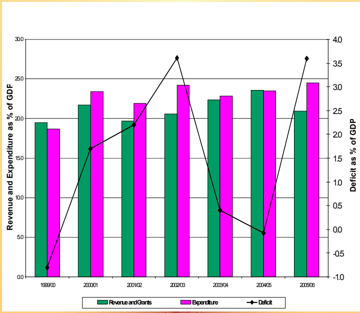
	US$ Billion						
	1999	2000	2001	2002	2003	2004	2005*
East Asia & Pacific	2.2	6.6	2.0	4.0	12.4	17.6	26.5
Europe & Central Asia	2.0	1.3	0.3	-0.1	0.5	4.2	5.8
Latin America	-3.6	-0.6	2.5	1.4	3.4	-1.6	8.5
South Asia	2.4	2.4	2.7	1.0	8.0	8.8	12.2
Middle East & North Africa	0.7	0.2	-0.1	-0.2	0.1	0.6	0.9
Sub-Saharan Africa	**9.0**	**4.2**	**-1.0**	**-0.4**	**0.7**	**6.7**	**7.2**
Kenya	**-0.01**	**-0.01**	**0.01**	**0.00**	**-0.03**	**-0.03**	**0.04**
Total net Flows	**12.6**	**14.1**	**6.4**	**5.8**	**25.2**	**37.3**	**61.4**

* Estimate

Source: Global Development Finance (2006) & Economic Survey 2006

In the financial year 2005/06, the Government budgetary operations resulted in a widening deficit, both on commitment and cash basis, after narrowing in the two preceding fiscal years. The Government budget deficit, on a commitment basis, amounted to 3.6 percent of GDP, compared with 0.9 percent of GDP in the fiscal year 2003/04 and a surplus of 0.1 percent in fiscal year 2004/05 (Table 10 and Chart 7).

CHART 7: GOVERNMENT BUDGET PERFORMANCE



Sources: Central Bank of Kenya and Treasury

On a cash basis, the fiscal operations resulted in a deficit of 2.7 percent of GDP, compared with a budget surplus of 0.1 percent of GDP in the fiscal year 2004/05 and a deficit of 0.8 percent in the fiscal year 2003/04.

TABLE 10: BUDGET OUTTURN (KSH BN)

	FY 2002/2003	FY 2003/2004	FY 2004/2005	FY 2005/2006		
	Actual	Actual	Actual	Actual*	Target	Over(+) / Below (-)
1. TOTAL REVENUE & GRANTS	**225.7**	**270.9**	**304.7**	**330.6**	**360.7**	**-30.1**
Revenue	210.8	254.7	289.8	310.7	325.6	-14.9
Tax Revenue	180.7	201.5	242.9	261.4	269.3	-7.9
Non Tax Revenue	13.6	24.9	27.9	27.4	27.5	-0.1
Appropriations-in-Aid	16.5	28.2	18.9	21.8	28.7	-6.9
External Grants	14.9	16.2	14.9	20.0	35.1	-15.2
2. TOTAL EXPENDITURE AND NET LENDING	**264.1**	**282.2**	**303.7**	**386.9**	**415.1**	**-28.2**
Recurrent Expenditure	220.6	244.5	258.1	318.8	328.2	-9.4
Development Expenditure	43.5	37.7	45.6	68.1	86.9	-18.9
3. DEFICIT ON A COMMITMENT BASIS (1-2)	**-38.5**	**-11.3**	**1.0**	**-56.3**	**-54.4**	**-1.9**
Deficit on a commitment basis as a % of GDP	-3.6	-0.9	0.1	-3.6	-3.5	
4. ADJUSTMENT TO CASH BASIS	**2.7**	**1.5**	**0.4**	**14.1**	**2.8**	**11.3**
5. DEFICIT ON A CASH BASIS	**-35.8**	**-9.8**	**1.4**	**-42.2**	**-51.7**	**9.4**
Deficit on a cash basis as a % of GDP	-3.3	-0.8	0.1	-2.7	-3.3	
6. DISCREPANCY: Expenditure (+) / Revenue (-)	**-1.0**	**-9.9**	**-5.9**	**-5.7**	**0.0**	
7. FINANCING	**34.8**	**-0.1**	**-7.3**	**36.5**	**51.7**	**-15.1**
Domestic (Net)	46.9	8.8	-6.7	28.3	36.6	-8.4
External (Net)	-12.1	-8.9	-0.6	1.3	5.7	-4.5
Capital Receipts (privatisation)	0.0	0.0	0.0	7.0	7.3	-0.3
Others	0.0	0.0	0.0	0.0	2.0	-2.0

* Provisional

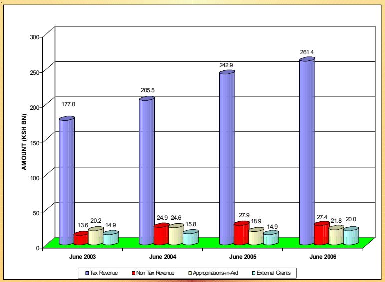
Source: Treasury

The deterioration in the fiscal accounts in the fiscal year 2005/06 reflected a faster increase in Government expenditure than the increase in revenue and grants. The faster growth in expenditure was mainly due to drought related expenses, one-off expenses on the constitutional review and the referendum held in November 2005. There were also increases in expenditure on health and for improvement of terms of service for civil servants and teachers during the fiscal year. It is therefore expected that the performance will improve in the fiscal year 2006/07 given the cost cutting measures implemented in the June 2006 budget. Notable cost cutting measures include the replacement of transport services for civil servants with commuter allowances and limiting to one vehicles assigned to Ministers and Permanent Secretaries. These measures will culminate in the sale of excess Government vehicles in the course of the fiscal year 2006/07.

Revenue and Grants

The robust growth in Government revenue and grants witnessed since the fiscal year 2003/04 continued into the fiscal year 2005/06. Government revenue and grants increased by Ksh 25.9 billion or 8.5 percent from Ksh 304.7 billion in the fiscal year 2004/05 to stand at Ksh 330.6 billion in the fiscal year 2005/06 (Chart 8). This performance was driven by Ksh 20.8 billion increase in revenue and Ksh 5.1 billion increase in external grants during the fiscal year.

CHART 8: COMPOSITION OF REVENUE



Sources: Central Bank of Kenya and Treasury

External grants increased from Ksh 14.9 billion in the fiscal year 2004/05 to Ksh 20.0 billion in the fiscal year 2005/06. The increased inflow of external grants during the year was due to increased absorption capacity of external resources, which has in turn increased utilisation of the donor commitments by the Government. Utilisation of committed external resources has increased from less than 40 percent in the fiscal year 2002/03 to more than 50 percent in the fiscal year 2005/06. Despite the increased absorption the amount of external grants received was only 56.8 percent of the Ksh 35.1 billion target for the fiscal year 2005/06.

Tax revenue grew by 7.6 percent or Ksh 18.5 billion in the fiscal year 2005/06 from the fiscal year 2004/05. Non-tax revenue decreased from Ksh 27.9 billion in the fiscal year 2004/05 to Ksh 27.4 billion in the fiscal year 2005/06, against a target of Ksh 27.5 billion.

However, after declining from Ksh 28.2 billion in the fiscal year 2003/04 to Ksh 18.9 billion in the fiscal year 2004/05, appropriations-in-aid (AIA), that is user fees and charges, increased to Ksh 21.8 billion in the fiscal year 2005/06. This was far below expectation as the targeted AIA was Ksh 28.7 billion in the fiscal year 2005/06.

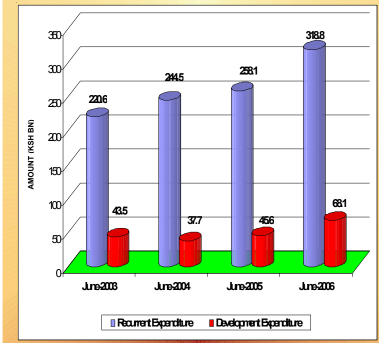
Following these developments, non-tax revenue decreased from 9.2 percent in the fiscal year 2004/05 to 8.3 percent of total revenue and grants in the fiscal year 2005/06. During the year, external grants totalled 6 percent of total revenue and grants, having increased from 4.9 percent the previous year. However, tax revenue collection was 79.1 percent of total revenue and grants compared with 79.7 percent the previous year while Appropriations-in-Aid (AIA) increased to 6.6 percent compared with the 6.2 percent in 2004/05.

Overall the Government revenue and grants, amounted to Ksh 330.6 billion, Ksh 30.1 billion below the target for the fiscal year 2005/2006, but Ksh 104.9 billion higher than the Ksh 225.7 billion realised in the fiscal year 2002/03.

Expenditure and Net Lending

Government expenditure and net lending amounted to Ksh 386.9 billion in the fiscal year 2005/06, an increase of 27.4 percent or Ksh 83.2 billion from the Ksh 303.7 billion spent in the previous fiscal year (Table 10 and Chart 9a). The increase reflected increased recurrent expenditure by Ksh 60.7 billion and a further Ksh 22.5 billion increase in development expenditure. Recurrent expenditure increased due to outlays on drought relief operations, the constitutional review and the referendum in November 2005, coupled with increased outlays for improvement of terms of service for civil servants and teachers. The increase in development expenditure was attributed to increased anti-poverty and

CHART 9a: GOVERNMENT EXPENDITURE



Sources: Central Bank of Kenya and Treasury

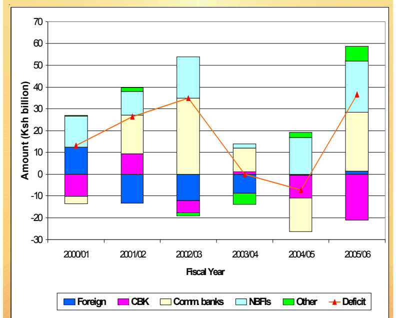
wealth creating interventions by the Government. This increase fulfils the Government policy that aims at progressively increasing the proportion of expenditure allocated to public investment to sustain economic recovery.

As a result of the fast increase in development expenditure, the composition of Government expenditure changed during the fiscal year from the previous year's. Development expenditure increased from 15.0 percent of total expenditure in the fiscal year in 2004/05 to 17.6 percent in the fiscal year 2005/06. Consequently, recurrent expenditure amounted to 82.4 percent of total expenditure in the fiscal year 2005/06 down from 85.0 percent in the fiscal year 2004/05. Overall, the total expenditure amounted to 24.7 percent of GDP in the fiscal year 2005/06 compared with 23.5 percent of GDP in the fiscal year 2004/05 and 23.2 percent in the fiscal year 2003/04.

Financing

Government fiscal operations resulted in Ksh 57.5 billion financing requirement in the fiscal year 2006/07. This was an increase from the Ksh 26.4 billion in the fiscal year 2004/05 and Ksh 16.7 billion in the fiscal year 2003/04. The financing requirement in the fiscal year 2005/06 comprised Ksh 36.5 billion to finance the budget deficit, Ksh 15.4 billion to increase Government deposits at the Central Bank and Ksh 5.6 billion to repay domestic debt owed to the Central Bank. The sources of financing and their contribution during the year were Ksh 1.3 billion external borrowing, Ksh 27.1 billion borrowing from domestic commercial banks, and Ksh 22.1 billion from domestic non-bank sources (Chart 9b). The domestic borrowing was exclusively done through issuance of Treasury bonds and Treasury bills. Furthermore, the Government received Ksh 7 billion from privatisation of the Kenya Electricity Generating Company (KenGen) Ltd.

CHART 9b: BUDGET DEFICIT AND SOURCES OF FINANCING



Sources: Central Bank of Kenya and Treasury

Outlook for the FY 2006/2007

During the fiscal year 2006/07, the Government targets Ksh 375.4 billion revenue collection, equivalent to 21.4 percent of GDP. The target comprises Ksh 336.5 billion of ordinary revenue and Ksh 38.9 billion of appropriations-in-aid. In addition, the Government expects external project grants totalling Ksh 28.4 billion

Government expenditure is expected to amount to Ksh 461.2 billion, with recurrent and development expenditures amounting to Ksh 341.3 billion and Ksh 119.9 billion respectively. The overall budget deficit including grants is projected at Ksh 57.4 billion which will be financed through net external financing totalling Ksh 9.7 billion, privatisation proceeds of Ksh 18.2 billion and domestic borrowing of Ksh 29.5 billion.

Public and Publicly Guaranteed Debt Developments

Kenya's public and publicly guaranteed debt increased by Ksh 39.5 billion or 5.3 percent during the fiscal year 2005/06. The debt rose from Ksh 749.5 billion at the end of June 2005 to Ksh 789.1 billion at the end of June 2006 (Table 11). The debt stock had remained virtually the same in the fiscal years 2003/04 and 2004/05 as it increased from Ksh 749.4 billion to Ksh 749.5 billion. The rise in debt during the fiscal year 2005/06 was due to an increase in domestic debt which amounted to Ksh 357.8 billion or 45.3 percent of total debt compared with Ksh 315.6 billion or 42.1 percent of total debt at the end of June 2005. External debt stood at Ksh 431.2 billion at the end of June 2006, which was 54.7 percent of the overall debt stock. This was a decline from the external debt stock of Ksh 443.2 billion in June 2004 and Ksh 434.0 billion in June 2005.

TABLE 11: PUBLIC DEBT (KSH BN)

	June 2004		June 2005*		June 2006**	
	Ksh bn	%	Ksh bn	%	Ksh bn	%
DOMESTIC DEBT						
Securitised debt	**289.6**	**94.6**	**302.3**	**95.8**	**349.7**	**97.7**
Treasury Bills	99.8	32.6	107.8	34.2	130.3	36.4
of which repo t.bills	36.9	12.0	35.9	11.4	35.5	9.9
Treasury Bonds	188.6	61.6	193.4	61.3	218.4	61.0
Government Stocks	1.1	0.4	1.1	0.3	1.1	0.3
Non Securitised debt	**16.7**	**5.4**	**13.3**	**4.2**	**8.1**	**2.3**
Overdraft/Advances	16.7	5.4	13.3	4.2	8.1	2.3
Non-interest bearing debt	0.02	0.01	0.02	0.01	0.02	0.00
TOTAL DOMESTIC DEBT	**306.2**	**100.0**	**315.6**	**100.0**	**357.8**	**100.0**
(as a % of Total Debt	40.9		42.1		45.3	
EXTERNAL DEBT**						
Bilateral	162.9	36.8	157.7	36.3	154.9	35.9
Multilateral	260.7	58.8	255.3	58.8	255.5	59.3
Comm. Banks	2.9	0.7	1.8	0.4	1.3	0.3
Export Credit	16.7	3.8	19.2	4.4	19.5	4.5
TOTAL EXTERNAL DEBT	**443.2**	**100.0**	**434.0**	**100.0**	**431.2**	**100.0**
(as a % of Total Debt)	59.1		57.9		54.7	
TOTAL PUBLIC DEBT	**749.4**		**749.5**		**789.1**	
(as a % of GDP)	62.0		58.0		50.4	

* External debt stock Revised
** Provisional

Sources: Central Bank of Kenya and Treasury

Despite the significant rise in the stock of debt during the fiscal year 2005/06, the overall debt stock declined from 58.0 percent at the end of June 2005 and 62.0 percent in June 2004 to 50.4 percent of GDP in June 2006. The fall in the overall debt to GDP ratio was mainly due to the decline in external debt to GDP ratio from 33.6 percent at the end of June 2005 to 27.6

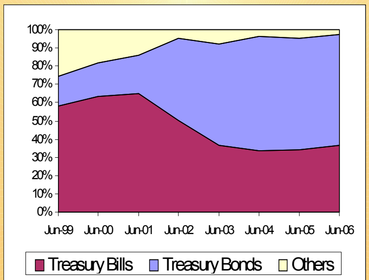
percent at the end of June 2006. In addition, domestic debt to GDP ratio fell from 24.4 percent to 22.9 percent in the same period. The fall in the overall debt to GDP ratio largely reflected a faster growth in GDP than in debt and is consistent with the Government strategy of ensuring a stable or declining debt to GDP ratio for debt sustainability.

Kenya participated in discussions on the choice of debt sustainability indicators held at the 4th Inter-Regional Debt Managers Seminar in Addis Ababa, Ethiopia, in May 2006 after which the Government reviewed its position. Kenya opted for a blend of indicators including the Long Term Debt Sustainability Indicators (LTDs) for external debt and HIPC CBP for domestic debt. Following the adoption of the indicators, Kenya is currently classified as a non-HIPC country with sustainable public debt.

Public Domestic Debt

Public domestic debt increased from Ksh 315.6 billion in June 2005 and Ksh 306.2 billion in June 2004 to Ksh 357.8 billion in June 2006. The rise in the debt stock in the fiscal year 2005/06 resulted from increased domestic borrowing to finance the budgetary operations of the Government. Furthermore, the domestic borrowing programme was very successful during the fiscal year as Treasury bills and bonds auctions realised average oversubscriptions of 36.8 percent and 41.6 percent, respectively. The success of the domestic borrowing programme was due to stability in the Government securities market, as interest rates remained within a narrow range throughout the fiscal year.

CHART 10: COMPOSITION OF GOVERNMENT DOMESTIC DEBT



Sources: Central Bank of Kenya and Treasury

Treasury bonds, representing 61.0 percent of total domestic debt at the end of June 2006, comprised the largest proportion of domestic debt compared with 61.3 percent at the end of June 2005. The stock of Treasury bonds increased from Ksh 193.4 billion at the end of June 2005 to Ksh 218.4 billion at the end of June 2006, while Treasury bills (including Repos) increased from Ksh 107.8 billion to Ksh 130.3 billion in the same period. Reflecting the increase in Treasury bills during the period, the proportion of Treasury bills in the stock of domestic debt increased from 34.2 percent at the end of June 2005 to 36.4 percent at the end of June 2006 (Chart 10).

Despite the decrease in the proportion of Treasury bonds in total domestic debt, the average maturity of domestic debt increased from 1 year and 10 months in June 2005 to 2 years and 2 months in June 2006. This is consistent with the Government debt management strategy of restructuring domestic debt from the short-dated Treasury bills to the longer-dated Treasury bonds. The rise in the average debt maturity during the period followed successful issuance of longer dated Treasury bonds with tenors ranging from 4 to 10 years. Furthermore, the Government made only one issue of a one-year Treasury bond in the fiscal year 2005/06.

As a result, the proportion of outstanding Treasury bonds with tenors ranging from 1 to 3 years in total bonds decreased from 43.2 percent in June 2005 to 30.4 percent in June 2006 while that of bonds with tenors ranging from 4 to 10 years increased from 56.8 percent to 69.6 percent in the same period. In addition, the Government made significant progress towards deepening the bond market as the proportion of 10-year bonds in total bonds increased from 4.5 percent in June 2005 to 7.8 percent at the end of June 2006. Some data on the holders of the outstanding stocks of Treasury Bills and Treasury bonds is given in Tables 12 and 13.

TABLE 12: OUTSTANDING STOCK OF TREASURY BILLS BY HOLDER (KSH BN)

Holders		Jun-04 Ksh	%	Jun-05 Ksh	%	Jun-06 Ksh	%
Banking Institutions		79.0	79.1	68.7	63.7	83.3	63.9
	Central Bank	36.9	37.0	35.9	33.3	35.7	27.4
	Comm. Banks	41.0	41.1	31.9	29.5	47.0	36.1
	NBFIs	1.1	1.1	0.9	0.8	0.5	0.4
Insurance Companies		4.9	4.9	7.7	7.1	11.0	8.5
Parastatals		4.9	4.9	6.9	6.4	11.2	8.6
of which NSSF		0.9	0.9	0.1	0.1	0.6	0.5
Building Societies		0.0	0.0	0.2	0.2	0.5	0.4
Others		11.0	11.1	24.4	22.6	24.2	18.6
Total		**99.8**	**100**	**107.8**	**100.0**	**130.3**	**100.0**

Source: Central Bank of Kenya

TABLE 13: OUTSTANDING STOCK OF TREASURY BONDS BY HOLDER (KSH BN)

Holders		Jun-04 Ksh	%	Jun-05 Ksh	%	Jun-06 Ksh	%
Banking Institutions		89.0	47.2	86.5	44.7	101.0	46.3
	Central Bank	0.0	0.0	0.0	0.0	0.0	0.0
	Comm. Banks	86.9	46.1	84.4	43.6	100.1	45.9
	NBFIs	2.1	1.1	2.1	1.1	0.9	0.4
Insurance Companies		26.6	14.1	26.1	13.5	26.4	12.1
Parastatals		15.9	8.4	16.6	8.6	23.2	10.6
of which NSSF		2.8	1.5	2.8	1.4	4.9	2.2
Building Societies		2.5	1.3	2.7	1.4	1.8	0.8
Others		54.5	28.9	61.5	31.8	65.9	30.2
Total		**188.6**	**100.0**	**193.4**	**100.0**	**218.4**	**100.0**

Source: Central Bank of Kenya

Domestic Debt Service

Government expenditure on interest and other charges on domestic debt increased from Ksh 23.4 billion or 8.1 percent of revenue in the fiscal year 2004/05 to Ksh 31.4 billion or 10.1 percent of ordinary revenue in the fiscal year 2005/06. The rise in the interest cost on domestic debt is attributed mainly to higher domestic borrowing during the fiscal year 2005/06 than in the previous fiscal year. Government net domestic financing increased from a net repayment of Ksh 6.7 billion in the fiscal year 2004/05 to a net borrowing of Ksh 28.3 billion in the fiscal year 2005/06. Interest payments on new borrowing therefore, amounted to Ksh 10.4 billion, an increase from the Ksh 6.9 billion paid in the fiscal year 2004/05.

Public and Publicly Guaranteed External Debt

As shown in Table 14, Kenya's external debt decreased from Ksh 434.0 billion in June 2005 and Ksh 443.2 billion in June 2004 to Ksh 431.2 billion in June 2006. The decrease in the debt during the fiscal year 2005/06 reflected principal repayments totalling Ksh 7.8 billion and a revaluation gain of Ksh 3.9 billion, which more than offset the Ksh 8.9 billion disbursements. The disbursements during the fiscal year comprised Ksh 7.3 billion in project loans, and a Ksh 1.6 billion programme loan from the African Development Bank (ADB) which was disbursed in July 2005.

CHART 11A: COMPOSITION OF EXTERNAL PUBLIC DEBT JUNE 2006

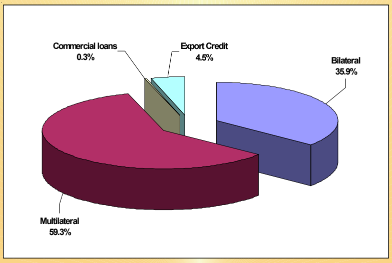
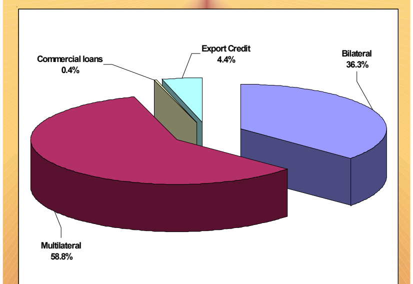


CHART 11B: COMPOSITION OF EXTERNAL PUBLIC DEBT JUNE 2005



Sources: Central Bank of Kenya and Treasury

Most of the outstanding external debt, 59.3 percent of the total stock at the end of June 2006, was owed to multilateral creditors. Bilateral creditors accounted for 35.9 percent of the debt while commercial loans and export credits constituted the remaining 4.8 percent (Charts 11A and 11B).

TABLE 14: DISTRIBUTION OF EXTERNAL PUBLIC DEBT

	Jun-02	%	Jun-03	%	Jun-04	%	Jun-05	%	Jun-06*	%
Bilateral	130.0	34.4	142.6	35.0	162.9	36.8	157.7	36.3	154.9	35.9
Multilateral	222.5	58.9	233.8	57.4	260.7	58.8	255.3	58.8	255.5	59.3
Commercial loans	24.0	6.4	3.6	0.9	2.9	0.7	1.8	0.4	1.3	0.3
Export Credit	1.3	0.3	27.0	6.6	16.7	3.8	19.2	4.4	19.5	4.5
Total	**377.7**	**100.0**	**407.1**	**100.0**	**443.2**	**100.0**	**434.0**	**100.0**	**431.2**	**100.0**

* Provisional

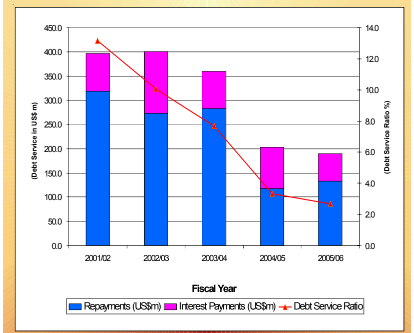
Sources: Central Bank of Kenya and Treasury

External debt held in Euros increased from 11.9 percent in June 2005 to 13.9 percent in June 2006. However, the share of external debt held in US dollars, SDRs, Japanese Yen and Sterling pounds decreased from 55.3 percent, 2.9 percent, 19.5 percent and 0.7 percent to 54.7 percent, 2.6 percent, 18.4 percent and 0.6 percent, respectively.

External Debt Service

External debt service (including IMF loan repayments) decreased from Ksh 16.0 billion or 5.5 percent of ordinary revenue in the fiscal year 2004/05 to Ksh 14.7 billion or 4.7 percent of ordinary revenue in the fiscal year 2005/06. The decline is mainly attributed to accumulation of arrears on commercial loans related to security contracts pending completion of the audit commissioned by the Kenya Anti-Corruption Commission (KACC) to ascertain some of the loans. Furthermore, external debt rescheduling that has been ongoing since 2004 contributed to the lower debt service. External debt repayments totalling Ksh 7.7 billion were rescheduled during the fiscal year 2005/06 while Ksh 9.7 billion were rescheduled in the previous fiscal year. Ksh 26.0 billion external debt repayments are expected to be re-scheduled between January 2004 and December 2006.

CHART 12: EXTERNAL DEBT SERVICE AND DEBT SERVICE RATIO



Sources: Central Bank of Kenya and Treasury

During the fiscal year 2005/06, external debt service payments comprised Ksh 10.5 billion in principal repayments and Ksh 4.2 billion in interest. Of the total amount paid, Ksh 13.7 billion were repayments with respect to the central Government debt while Ksh 1.0 billion were repayments to the IMF by the Central Bank.

As shown in Chart 12, external debt service ratio has been declining since the fiscal year 2001/02. This is attributed to declining debt service payments compared with increasing earnings from exports.

Prospects for FY 2006/2007

The Government has planned to borrow Ksh 29.5 billion from the domestic market in the fiscal year 2006/2007. Consequently, domestic debt is projected to increase by a similar margin during the fiscal year. Furthermore, the Government expects to receive Ksh 30.2 billion through external disbursements of project loans during the fiscal year 2006/07. On the other hand, the Government expects to make principal repayments of Ksh 20.5 billion towards external debt. The resulting net external borrowing of Ksh 9.7 billion is expected to increase the stock of external debt during the fiscal year.

Debt Sustainability Analysis for Kenya will be conducted in March 2007 by the Ministry of Finance, assisted by the Macroeconomic and Financial Management Institute of East and Southern Africa (MEFMI) and Debt Relief International (DRI). The exercise will help in updating the debt sustainability indicators for Kenya.

Overview

The banking sector remained stable, mainly due to favourable macroeconomic conditions prevailing during the review period. Non-performing loans and advances net of provisions continued to decline while gross loans and advances increased leading to better asset quality and improved profitability. The revised Prudential Guidelines issued in November 2005 became effective on 1st January 2006. Under the new guidelines, institutions are required to discount securities for non-performing loans over a period of five years while at the same time maintaining higher provisions for performing accounts.

Structure of the Banking Sector

Financial institutions declined from 49 in June 2005 to 45 in June 2006 as a result of closure of two institutions and acquisition of assets and liabilities of two others. Daima Bank Ltd. and Prudential Building Society, which were under statutory management, were put under liquidation and Deposit Protection Fund appointed the liquidator. Assets and liabilities of First American Bank Ltd. and East Africa Building Society were acquired by Commercial Bank of Africa and EABS Bank respectively. Foreign exchange bureaus increased from 89 to 95 over the same period. The increase in foreign exchange bureaus followed the licensing of new bureaus.

Structure of the Banking Sector Balance Sheet

The balance sheet structure for the banking sector is as shown in Table 15 below. Due to improved economic environment, the banking sector total assets expanded by 14.2 percent or Ksh 85.9 billion from Ksh 606.9 billion as at June 2005 to Ksh 692.8 billion by June 2006. The assets growth was funded by increase in deposits, fresh capital injection and retained profits.

TABLE 15: BALANCE SHEET

	June 2006	June 2005	% Change
Assets			
Cash	11,901	9,612	19.2
Balances from CBK	55,591	28,356	96.0
Placements	40,639	17,070	138.1
Govt. securities	147,620	120,936	22.1
Other Investments	8,875	4,517	96.5
Loans & advances (Net)	363,677	317,951	14.4
Other foreign Assets	4,437	49,631	-91.1
Other assets	60,079	58,858	-2.1
Total Assets	**692,819**	**606,931**	**14.2**
Liabilites and shareholders funds			
Deposits	573,459	488,004	17.5
Foreign Liabilities	2,542	3,138	-19.0
Other liabilities	30,086	42,419	-29.1
Capital & Reserves	86,732	73,370	18.2
Total Liabilities and shareholders funds	**692,819**	**606,931**	**14.2**

Source: Published Financial Statements and Disclosures

Loans and advances constituted 52.5 percent of the total assets while Government securities constituted 21.3 percent of total assets. Investment in government securities increased by 22.1 per cent from Ksh 120.9 billion to Ksh. 147.6 billion in June 2006.

Non –Performing Loans

Non-performing loans stood at Ksh 102.0 billion or 23.1 percent of gross loans, having declined from Ksh 109.6 billion at the end of June 2005. The reduction in non-performing loans is attributed to recoveries and write offs. Non- performing loans net of loan loss provisions, however, stood at Ksh 24.0 billion and accounted for 5.4 percent of gross loans. Consequently, asset quality measured by the ratio of net non-performing loans to gross loans improved from 8.4 percent to 5.4 percent.

Deposit Liabilities

Deposit liabilities including accrued interest increased by 17.6 percent from Ksh 488.0 billion in June 2005 to Ksh 573.5 billion at the end of June 2006. Local currency deposits expanded by 19.3 percent from Ksh 406.3 billion to Ksh 484.6 billion in June 2006, while foreign currency deposits rose by 8.8 percent from Ksh 81.7 billion to Ksh 88.9 billion over the same period. This increase in deposit base was attributed to external donor inflows, remittances from Kenyans living abroad and earnings from tourism and exports. As shown in Table 16, demand deposits accounted for 51.7 percent of total deposits followed by Time and Savings deposits at 29.7 percent and 18.6 percent respectively.

TABLE 16: COMPOSITION OF DEPOSITS (KSH MILLION)

	Jun-06	Jun-05	Share in 2006	% Change
Type of Deposits				
Demand deposits	**296,385**	**247,660**	**51.7**	**19.7**
Kenya shilings	236,943	190,440	41.3	24.4
Foreign currency	59,442	57,220	10.4	38.8
Time deposits	**170,540**	**143,780**	**29.7**	**18.6**
Kenya shilings	169,417	119,780	29.5	41.4
Foreign currency	1,123	24,000	0.2	-95.3
Savings deposits	**106,534**	**73,125**	**18.6**	**10.8**
Kenya shilings	105,860	72,639	18.5	-45.7
Foreign currency	674	488	0.1	38.1
Total	**573,459**	**487,567**	**100**	**17.6**

Source: Central Bank Returns

Capital and Reserves

Capital and reserves of the banking sector increased by 18.2 percent to Ksh 86.7 billion from Ksh 73.4 billion. The increase in capital and reserves in the sector followed fresh capital injection by some institutions and retention of profits. Capital adequacy in the sector, as measured by the ratio of total capital to total risk weighted assets ratio increased to 17.6 percent from 16.1 percent in 2005.

Profitability

Following favourable economic and financial condition of individual institutions, gross un-audited profit before tax of the banking system increased by 36.2 percent or Ksh. 3.3 billion from Ksh 9.0 billion in 2005 to Ksh 12.3 billion in 2006. The increase in profits reflected an increase in interest income on advances which rose by 19.7 per cent or Ksh. 3.4 billion to Ksh. 22.5 billion in June 2006 from Ksh. 18.8 billion in June 2005.

TABLE 16: BANKING INDUSTRY PROFITS (KSH MILLION)

	Jun-06	Jun-05	% Change
Total income	44,793	36,936	21.10%
Expenses before provisions	28,480	24,551	16.00%
Profit before provisions	16,313	12,385	31.70%
Provisions for loans and advances	4,053	3,386	19.70%
Profit before tax	**12,260**	**8,999**	**36.20%**

Source: Published Financial Statements and Disclosures

Outlook for the Banking Sector

The Central Bank will continue to strengthen its supervisory practices and methods in order to enhance stability and soundness of the banking sector. In the twelve months to June 2006, Central Bank issued revised Prudential Guidelines and Risk Management Guidelines aimed at enhancing corporate governance, provisioning levels and risk management in the sector.

The banking sector has witnessed stiff competition forcing banks to re-package their services and products to satisfy the needs of the customers and retain their market share. Institutions are therefore increasingly offering e-banking services for both residents and non–residents.

Islamic banking has emerged as a new market product. In response to this, some of the institutions have redefined their business strategies while leveraging on innovative and affordable products to capture this new market segment. In the long run, the success and soundness of the financial institutions and the entire sector will depend on the achievement of operational efficiency through the application of prudential practices, good corporate governance and robust risk management frameworks.

MICRO FINANCE SECTOR DEVELOPMENTS

The Economic Recovery Strategy for Wealth and Employment Creation (ERSWEC) sets out priorities for the financial sector reforms to facilitate improved access to financial services and efficient intermediation of financial resources. The ERSWEC recognizes that improved access to financial services and products can only be realized by building an inclusive financial system in which alternative financial services providers (microfinance institutions (MFIs), Savings and Credit Cooperative Societies (SACCOs), the Kenya Post Office Savings Bank (KPOSB) and market led Development Finance Institutions (DFIs), together with mainstream financial institutions, all play a role in financial deepening.

These alternative financial services providers, in particular, play a key role in providing increased access to financial services and products to segments of the population including the poor, low-income households and Micro- and Small- scale Enterprises (MSEs) in both rural and urban areas that are largely shunned by mainstream financial institutions, namely commercial banks, non-bank financial institutions and building societies.

In light of recent moves by mainstream financial institutions towards branch rationalisation and consolidation of operations there has been severe decline of access to financial services by the low-income households and MSEs. Over the last few years, the alternative financial institutions such as MFIs, SACCOs, DFIs, KPOSB and other informal financial entities including moneylenders, merry-go-rounds, Accumulation and Rotating Savings and Credit Associations (ASCAs and ROSCAs) have emerged to fill the void and provide a wide range of financial services, particularly to the low-income households and MSEs while employing a variety of appropriate methodologies and delivery channels. To date, access to financial services outside Nairobi and other main urban areas remains limited, and addressing this situation will require, inter alia, building a variety of financial institutions and strengthening existing alternative financial institutions.

Improving access to financial services and products for many more Kenyan households and small businesses is critical given that by December 2005 there were only 2,400,459 bank accounts, 666 Automated Teller Machines (ATMs) including 110 and 63 managed by Pesa Point and Kenswitch respectively, and 537 branches for a population of about 33 million. The percentage of Kenyans holding bank accounts still remains low by international standards. It is estimated that less than 10 percent of the low-income households and MSEs received credit and other financial services from these mainstream financial institutions institutions. With the support of UK Department For International Development (DFID)/ Financial Sector Deepening Trust- Kenya, a joint public-private sector stakeholders' steering committee has initiated an industry wide project to measure access to financial services in Kenya. The outcome of this study is expected before the end of 2006 and will give indication on the magnitude of access to financial services in Kenya, identify constraints and guide policy and strategy development.

Commercial Banks, Building Societies and the Kenya Post Office Savings Bank

In 2005, microfinance services provided by five mainstream institutions, namely Cooperative Bank, Equity Bank, K-Rep Bank, Family Finance Building Society and the Kenya Post Office Savings Bank (KPOSB), had reach of over 3.0 million savings accounts with 278,803 loan clients, and having issued Ksh 38.7 billion loans and advances net of provisioning. The KPOSB, one of the oldest savings institutions had over 1.8 million clients, Ksh 10.8 billion savings accounts. The postal savings Bank has a nationwide network comprising of 35 branches, 31 sub-branches and 396 outlets country wide operated by the Postal Corporation of Kenya (POSTA) on an agency basis.

Microfinance Institutions

Microfinance institutions in Kenya operate in various institutional forms and currently can operate under more than eight Acts of Parliament, namely the Banking Act, Building Societies Act, Societies Act, Cooperative Societies Act, Hire Purchase Act, Companies Act, Trust Act, and NGO Coordination Act. The key umbrella organisations namely: the Association of Microfinance Institutions (AMFI), K-REP Development Agency and MicroNet boast of 25 MFIs and 4 wholesalers, 59 Financial Services Associations (FSAs) and 40 MFIs respectively by end of 2005, totalling 128 institutions.

The 21 of the 25 AMFI members by December 2005 collectively had 841 outlets; 2,073,363 and 493,682 active savers and borrowers with Ksh 16,589 million loans disbursed during the year, and an outstanding loan portfolio of Ksh 16,007 million. The 59 K-REP Development Agency FSAs as at 30th June 2005, had Ksh 1,647 million and Ksh 239 million gross and net aggregate savings respectively with Ksh 669 million total loans and Ksh 146 million outstanding loans respectively and a delinquency rate of 18 percent. Table 18 presents basic data on MFIs.

TABLE 18: SOME BASIC STATISTICS OF MICROFINANCE INSTITUTIONS

	Number of active savers	Savings (Million)	Number of active borrowers	Loan outstanding (Million)	Loans disbursed during the year (Million)	Number of outlets	Number of staff
21 AMFI Members	2,073,363	-	493,682	16,007	16,588	841	4,222
K-REP FSAs	60,999	1,647	15,364	146	669	59	-
Total	2,134,362	1,647	509, 046	16,153	17,257	900	4,222

Source: AMFI and K-REP Development Agency

The lack of an appropriate legal, regulatory and supervisory framework to govern and set out a uniform approach to the operations of MFIs is the major challenge facing the microfinance industry. In this regard, the Government has published the Microfinance Bill, 2006 {Kenya Gazette Supplement, No. 53 (Bill No. 22)} for enactment by Parliament. The principal object of the Bill is to provide a legal framework for licensing, regulating and supervising microfinance business. The Bill sets out two tiers of microfinance businesses, namely the deposit taking and credit-only microfinance institutions. It further splits the deposit-taking microfinance institutions into national and community based microfinance institutions to operate nationally and within a specified region, respectively; with minimum core capital set at Ksh 60 million and Ksh 20 million respectively. The credit only microfinance institutions will be regulated and supervised through regulations to be issued by the Minister.

Development Finance Institutions

These are financial intermediaries that offer sector focused financial services. They include the Agricultural Finance Corporation (AFC), Industrial Development Bank (IDB), Kenya Industrial Estate (KIE), Kenya Tourism Development Corporation (KTDC), and Industrial and Commercial Development Corporation (ICDC). Most of these institutions boast a dynamic sectoral focus with extensive rural, low income households and MSE outreach. Their efficiency and coverage of low-income households and MSEs, however, remained low. These institutions are wholly or partially owned by the Government and continue to experience financial and operational constraints that limit their effectiveness and efficiency.

Savings and Credit Cooperative Societies

The Kenyan Savings and Credit Cooperative Societies (SACCO) sector is the largest in Africa; and the next largest being Uganda. SACCOs constitute a critical part of the financial system in Kenya, making up about 42 percent of the cooperative movement. In 2005, the number of SACCOs increased by 4.6 percent from 4,474 in 2004 to 4,678, with only 3,767 countrywide being active. The SACCO sub-sector provides financial services to over 2 million members and mobilized over Ksh 125 billion and Ksh 103 billion in savings and loans respectively in 2004. Despite the massive potential of increasing access to financial services to the low-income households and MSEs in rural areas, the SACCOs outreach to the rural areas remains relatively low.

The traditional savings and credit services offered by SACCOs are the main cause of the numerous problems faced by SACCOs today. Their main motive is to encourage members to save and obtain loans at three times the amount saved, and in most cases at rates below market rates. This has caused SACCOs to experience liquidity problems. Due to this, most SACCOs have diversified their services and products including providing near-banking services, referred to as Front Office Service Activities (FOSAs), which have led to an unprecedented growth and development of SACCOs. Currently, there are 179 SACCOs with FOSA operations. SACCOs have also embraced modern Information and Communication Technology (ICT) and linkage banking with commercial banks, particularly the Cooperative Bank of Kenya, in their operations, aiming to enhance efficiency, effectiveness and competition .In light of this, there has emerged a need to revise the existing Cooperatives Act to prudently accommodate these developments.

The Ministry of Cooperative Development and Marketing in consultation with stakeholders has prepared a draft SACCO Societies Bill, 2006 that will establish a new regulatory Authority and provide a legal framework for the registration, licensing, regulation and supervision of SACCOs under the oversight of the ministry. Some basic statistics on SACCOs are presented in Table 19.

TABLE 19: SOME BASIC STATISTICS OF SACCOs AS AT DECEMBER 2005

Category/ Type	No. of active SACCOs	No. of active SACCOs	Branches	Membership	Savings (Million)	Loans (Million)	Delinquency	Non –Remittances (Million)	Total Assets (Million)
Salary based	3,411	91	102	1,461,000	114,759	95,029	8%	3,408	153,770
Commodity based (Rural)	201	26	81	501,000	9,985	8,481	48%	-	12,469
Jua kali	47	-	-	82,000	28	22	51%	-	26
Matatu	30	1	1	41,000	148	136	36%	-	185
Others (e.g. traders)	78	5	3	21,000	98	82	22%	-	108
Total	3,767	179	242	2,106,000	125,018	103,750	-	3,408	166,558

Source: Ministry of Co-operative Development and Marketing

Monetary Policy for the Financial Year 2005/06

Monetary policy for the financial year 2005/06 was directed towards achieving and maintaining inflation at 5 percent. Accordingly, the Central Bank of Kenya set the path for both reserve money and money supply expansion consistent with the achievement of price stability. Money supply, M3, and reserve money were targeted to grow by 5 percent and 7.8 percent respectively in the year to June 2006.

Following stronger than expected accumulation of foreign exchange and liquidity leakages due to additional domestic financing occasioned by the Governments' drought relief operations, the paths for the monetary aggregates were modified in October 2005. Money supply was programmed to expand by 10 percent, while reserve money was to increase by 7.6 percent in 2006 as shown in Table 20A.

TABLE 20A: GROWTH TARGETS FOR KEY AGGREGATES FOR 2005/06 MONETARY PROGRAMME

	Act.	Projection			
	Dec'05	Mar'06	Jun'06	Sep'06	Dec'06
Reserve money (Ksh million)	106.4	101.4	101.6	103.5	110.5
NFA of CBK (Ksh million)	114.8	112.4	110.8	114.9	114.1
Memo:					
Annual change in reserve money	5.6	8.3	7.6	7.9	4.0
Annual change in extended broad money	10.7	9.9	10.0	9.5	10.4
Real GDP growth			5.0	5.1	5.1
Overall inflation			5.0	5.0	5.0

Source: Central Bank of Kenya

The Bank used the liquidity forecasting framework to monitor, on a daily basis, the level of reserve money against targets. Open market operations (OMO) was used as the main monetary policy instrument complemented by cash ratio requirement which was maintained at 6 percent throughout the year. In addition, the CBK introduced and used the central bank rate (CBR), the minimum lending rate that it charges on its overnight loans to commercial banks, to supplement monetary targets in indicating to financial market participants the direction and stance of monetary policy.

The monetary policy stance supported macroeconomic developments in the first quarter of 2006 that resulted in a stable rate of underlying inflation. While overall inflation peaked at 19.1 percent in March 2006 due to food shortages, it eased shortly thereafter to 10.9 percent in June 2006. In addition, inspite of escalation of international oil prices, underlying inflation remained well below the target of 5 percent.

Money Supply

Money supply, M3, growth accelerated from 11.3 percent a year ago to 16 percent in the year to June 2006 as shown in Table 20B, and was above the 10 percent target for the June 2006 quarter.

TABLE 20B: PERFORMANCE OF MONETARY AGGREGATES JULY 2004 - JUNE 2005 (Percent)

	RM		M3X	
	Act.	Targ.	Act.	Targ.
2005				
Jun	4.7	3.8	11.3	7.5
Jul	5.3	7.1	12.4	9.8
Aug	5.4	7.1	12.4	9.8
Sep	6.7	7.1	11.8	9.8
Oct	5.9	2.5	11.4	10.5
Nov	6.5	2.5	11.5	10.5
Dec	5.1	2.5	10.2	10.5
2006				
Jan	7.2	5.7	11.2	9.0
Feb	6.5	5.7	12.0	9.0
Mar	9.8	5.7	12.5	9.0
Apr	14.2	7.6	16.8	10.0
May	9.7	7.6	15.9	10.0
Jun	14.0	7.6	16.0	10.0

Source: Central Bank of Kenya

The increase in M3 resulted from the expansion in net foreign assets (NFA) of the banking system and net domestic assets (NDA) as shown in Table 21. NFA expanded by 25.3 percent compared with 24 percent a year earlier, on account of surplus in the capital and financial account of the balance of payments. The NDA of the banking system increased by 12.4 percent compared with 7 percent a year ago, reflecting increased credit to Government in the year to June 2006 compared with a repayment in the previous year.

TABLE 21: MONEY SUPPLY AND ITS SOURCES (KSH BN)

	Jun 2003/04 Act	Jun 2004/05 Act	Jun 2005/06 Act	Annual % change 2004/05	Annual % change 2005/06
1.0 Liability					
Money Supply					
Money supply, M2 1/	407.3	442.4	522.0		
Money supply, M3 2/	473.4	526.8	611.2	11.3	16.0
Overall Liquidity, L 3/	590.3	663.8	771.1		
2.0 Assets (2.1+2.2)	473.4	526.8	611.2		
2.1 Net foreign assets 4 /	119.7	148.4	186.0	24.0	25.3
Central Bank	86.7	95.7	151.6	10.4	58.5
Banking Institutions	33.1	52.8	34.3	59.5	-35.0
2.2 Net domestic assets (2.21+2.22)	353.7	378.3	425.3	7.0	12.4
2.21 Domestic Credit (2.210+2.211)	432.5	466.3	525.9	7.8	12.8
2.210 Government (net)	139.1	112.3	117.9	-19.3	5.0
2.211 Private sector and other public sector	293.4	354.0	408.0	20.9	15.2
2.22 Other assets net	-78.8	-87.9	-100.6	11.6	14.4
Memorandum Item:					
Reserve Money 5/	90.2	94.4	107.7	4.7	14.0

1/ Broad money, M2, comprises M1 and call, 7-days, savings & time deposits as well as certificates of deposits held by the private sector & parastatals with NBFIs. M2 excludes deposits of both the central & local Government with NBFIs, and all cross deposits of both commercial banks and NBFIs.

2/ Broad money, M3, comprises M2 plus foreign currency deposits held by residents with banking institutions.

3/ Overall liqudity L, comprises M3 plus non-bank holdings of government securities.

4/ NFA valued at constant exchange rate of Ksh 78.95 to the US $ (September 30th, 2001)

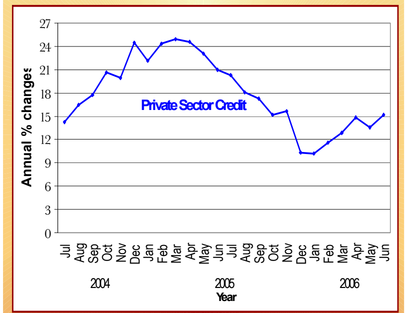
5/ Reserve money comprises currency in circulation & commercial banks balances held with the Central Bank.

Source: Central Bank of Kenya

Domestic Credit

The banking system credit to the domestic economy grew by 12.8 percent in the year to June 2006 compared with 7.8 percent a year earlier. Credit to Government increased by 5 percent in the year to June 2006 compared with a repayment of 19.3 percent in June 2005. Meanwhile, credit to the private sector decelerated from 20.9 percent in June 2005 to 15.2 percent as shown in Chart 13 .

CHART 13: ANNUAL PERCENTAGE CHANGES IN PRIVATE SECTOR CREDIT



Source: Central Bank of Kenya

The growth in credit to the private sector was consistent with economic activity. Most of the credit expansion to the private sector was to business services (17.6 percent), transport and communication (17.1 percent), building and construction (14.3 percent) and Trade (11.9 percent) as shown in Table 22. These sectors accounted for 61 percent of the credit extended during the year.

Reserve Money

Reserve money increased by 13.9 percent in the year to June 2006 compared with 4.8 percent in a similar period in 2005 as

TABLE 22: CREDIT TO PRIVATE AND OTHER PUBLIC SECTORS (KSH BN)

	2005 Jun		2006 Jun		Annual Change		Jun '05 - Jun '06 % dist. of ann. change in credit to private sector
	Ksh bn	Share (%)	Ksh bn	Share (%)	Ksh bn	(%)	
1. Credit to other public sector	**10.3**	**2.2**	**12.2**	**2.3**	**11.8**	**18.5**	
Local government	-1.1	-0.2	-1.8	-0.3	-16.9	56.6	
Parastatals	11.4	2.5	14.0	2.7	8.1	22.3	
2. Credit to private sector	**343.7**	**73.7**	**395.8**	**75.3**	**20.9**	**15.2**	**100.0**
Agriculture	29.5	6.3	34.7	6.6	10.7	17.5	9.9
Manufacturing	67.3	14.4	71.1	13.5	26.6	5.6	7.2
Trade	51.5	11.0	57.7	11.0	4.1	12.0	11.9
Building and construction	23.7	5.1	31.1	5.9	21.9	31.4	14.3
Transport & communications	26.7	5.7	35.6	6.8	38.7	33.4	17.1
Finance & insurance	30.6	6.6	29.7	5.6	30.6	-2.9	-1.7
Real estate	23.6	5.1	25.7	4.9	19.0	8.8	4.0
Mining and quarrying	2.1	0.4	3.1	0.6	4.0	47.8	1.9
Private households	46.3	9.9	45.4	8.6	60.0	-2.0	-1.7
Consumer durables	9.2	2.0	11.8	2.2	37.4	28.0	5.0
Business services	32.6	7.0	41.7	7.9	49.5	28.1	17.6
Other activities	0.7	0.1	8.3	1.6	-95.1	1143.2	14.6
3. TOTAL (1+2) *	**466.3**	**100.0**	**525.9**	**100.0**	**7.8**	**12.8**	

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

Source: Central Bank of Kenya

shown in Table 23. The increased expansion in reserve money was held as currency outside banks and bank reserves which increased by 12.7 percent and 15.9 percent respectively compared with 6.5 percent and 2.1 percent in 2005. The average reserve money in June 2006 was Ksh 106.2 billion or Ksh 5.7 billion above target. The excess was held in currency outside banks (Ksh 5.0 billion) and bank reserves (Ksh 0.7 billion).

TABLE 23: RESERVE MONEY & ITS SOURCES (KSH BN)

		2005 Jun	2006 Jun	Change Absolute	Target Jun-06	Deviation
1	Net Foreign Assets	96.5	152.7	56.2	108.4	44.3
2	Net Domestic Assets	-1.9	-45.0	-43.1	-8.0	-37.0
	2.1 Government Borrowing (net)	5.1	-15.8	-20.8	6.4	-22.2
	2.2 Advances & Discounts	-5.3	-23.3	-18.0	-9.6	-13.7
	2.3 Other Domestic Assets (net)	-1.7	-5.9	-4.3	-4.8	-1.1
3	Reserve Money	94.6	107.7	13.1	100.4	7.3
	3.1 Banks Deposits at CBK	59.3	66.8	7.5	62.0	4.8
	3.3 Currency in Circulation	35.2	40.8	5.6	38.4	2.4

Source: Central Bank of Kenya

The increase in reserve money in the year to June 2006 was supported by increased net foreign assets (NFA) as net domestic assets (NDA) of the Bank declined. NFA expanded by 58.3 percent in the year to June 2006 accounting for 56.0 percent of the increase in reserve money, while NDA accounted for minus 42.7 percent. The increase in NFA was through foreign exchange interbank purchases by the Bank to meet the statutory 4.0 months of imports and receipt of budgetary support from bilateral institutions.

Meanwhile, NDA of the Central Bank declined from Ksh -1.9 billion in June 2005 to Ksh –45.0 billion in June 2006 due to a build up in Government deposits at the Central Bank and increased indebtedness of Central Bank to commercial banks due to mop up operations. Government deposits increased from Ksh 43.8 billion in June 2005 to Ksh 59.2 billion in June 2006 as Government borrowing declined from Ksh 48.8 billion to Ksh 43.4 billion over a similar period. Net indebtedness of the Central Bank to commercial banks increased by Ksh 18.0 billion from Ksh 5.3 billion in June 2005 to Ksh 23.3 billion as a result of increased mop up operations in June 2006.

Other domestic assets net of liabilities of the Central Bank declined by Ksh 4.3 billion in the year to June 2006 to Ksh – 5.9 billion from Ksh – 1.7 billion in June 2005.

Outlook

Over the next year to June 2007, the Bank will target 10 percent growth for both money supply and reserve money as shown in Table 24. In implementing monetary policy through the reserve money targets, the Bank will continue to use open market operations to manage reserve money which is the basis for money supply expansion.

While the pass through of high international oil prices has so far been minimal, further increases in oil prices remains a great threat to price stability. The Bank will however continue to monitor developments and guard against possible risks to price stability in 2007.

TABLE 24: MONETARY PROGRAMME FOR 2006/07

	Jun'06	Jun'06*	Sep'06	Dec'06	Mar'07	Jun'07
Reserve money (Ksh million)	101.6	106.0	106.9	117	114.0	116.6
NFA of CBK (Ksh million)	110.8	142.0	144.9	150.5	158.5	164.1
Memo:						
Annual change in reserve money	7.6	12.3	11.5	10.1	10.9	10.0
Annual change in extended broad money (M3)	10.0	12.3	12.0	11.0	11.1	10.0
Real GDP growth	5.0	5.0				5.8
Overall inflation	5.0	5.0				5.0

* Revised projection

Source: Central Bank of Kenya

INFLATION

Inflation turned out much lower during the year to June 2006 than in the year to June 2005. Average annual overall inflation declined to 11.1 percent in the year ending June 2006, from 15.0 percent during the year to June 2005. Similarly, month-on-month overall inflation declined from 11.9 percent in June 2005 to 10.9 percent in June 2006.

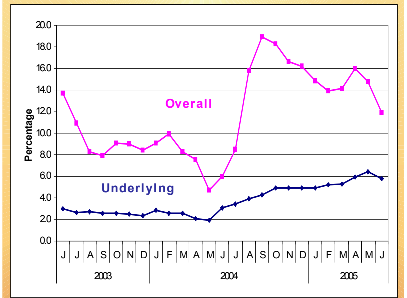
The underlying inflation continued to be maintained at low and stable levels with the month-on-month underlying inflation declining from 5.8 percent in June 2005 to 3.7 percent in June 2006. Similarly, the average annual underlying inflation eased from 5.0 percent in the year to June 2005 to 4.4 percent in the year to June 2006. Between July 2005 and June 2006, the average annual underlying inflation fluctuated between 4.4 percent and 5.5 percent and therefore within the 5 percent objective.

TABLE 25: MONTH-ON-MONTH OVERALL & UNDERLYING INFLATION (%)

	2004					2005					
	Jun	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
Overall	5.94	18.96	18.29	16.65	16.25	14.87	13.94	14.15	16.02	14.78	11.91
Underlying	3.1	4.30	4.94	4.95	4.90	4.93	5.21	5.31	5.90	6.42	5.79

Sources: Central Bureau of Statistics and Central Bank of Kenya

CHART 14: 12-MONTH INFLATION (%)



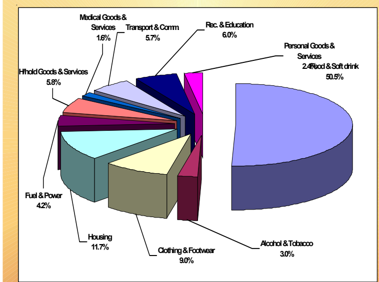
Source: Central Bureau of Statistics

Chart 14 and Table 25 show trends in both overall and underlying inflation rates based on the month-on-month measure of inflation.

Inflation by Category of Goods and Services

The categories of goods and services and their respective weights in the basket are presented in Chart 15.

CHART 15: GOODS AND SERVICES CATEGORY WEIGHTS



Source: Central Bureau of Statistics

Month-on-month inflation turned out lower in June 2006 than in June 2005 with eight of the ten categories of goods and services surveyed by the Central Bureau of Statistics (CBS) recording lower inflation. Only two categories featured higher inflation in June 2006, namely, food and drink category whose inflation increased from 14.7 percent in June 2005, to 14.9 percent in June 2006, and transport and communications whose inflation increased from 4.5 percent in June 2005, to 8.3 percent in June 2006. The higher inflation in the food and drink category reflected the effects of drought in the last quarter of 2005 which adversely affected food prices. Besides, the general increase in oil prices adversely affected transportation costs and by extension inflation for transport and communications category of goods and services rose.

Categories with lower inflation in June 2006 than in June 2005 were alcohol and tobacco with 6.5 percent, down from 9.7 percent, clothing and footwear with 2.8 percent compared with 4.3 percent, housing 4.8 percent from 6.4 percent and fuel and power with 11.4 percent from 28.7 percent. Others were household goods and services with 3.1 percent from 7.2 percent, medical goods and services with 3.8 percent from 5.7 percent, recreation and education at 2.1 percent from 4.2 percent and personal goods and services at 2.5 percent from 3.4 percent.

Inflation Among Income Groups

All the four income groups surveyed by the Central Bureau of Statistics experienced lower inflation in the year to June 2006 than in the year to June 2005. Moreover, inflation declined to single-digit levels for one income group in the year to June 2006. This was unlike in the year to June 2005 when all the four income groups experienced double-digit inflation.

"Nairobi lower income" group continued to be hardest hit by inflation with an average annual inflation of 14.2 percent in the year to June 2006, though a decline from 19.4 percent in the year to June 2005. The high inflation in this income category is on account of the income group spending a higher share of its income on food and drinks whose inflation was high and volatile during the year. This is unlike the "Nairobi upper income" group which spends a smaller share of income on food items and therefore continued to experience lower inflation. In the year to June 2006, average annual inflation in this income category averaged 7.7 percent compared with 11.5 percent in the year to June 2005.

Inflation for the "New Nairobi income" group which combines the incomes of "Nairobi lower" and "Nairobi upper" income groups declined to 13.0 percent in the year to June 2006, from 17.9 percent in the year to June 2005. On the decline also was inflation for the "Rest of Kenya" income group with average annual inflation of 9.9 percent compared with 13.1 percent in the year to June 2005.

Inflation Outlook

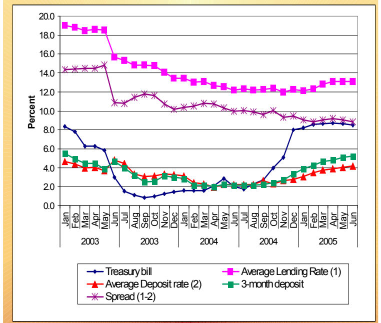
Inflationary pressure is expected to remain subdued because of the expected decline in inflation for food and drink category of goods and services. Because of the large share of this category in overall consumer price index, a modest decline in inflation in this category will have a substantial impact on overall inflation. Thus, this is expected to outweigh the inflationary effects arising from the tax measures introduced in the fiscal year 2006/07 budget.

The rapid increase in crude oil prices in the world market and continued uncertainty over future oil prices remains a major concern because of the critical role oil plays in the production and distribution of commodities. However, the categories most likely to be adversely affected by a rise in oil prices including fuel and power and transport and communications, have a relatively smaller share in the overall CPI and therefore the inflationary impact is likely to be more than offset by the expected decline in food prices.

INTEREST RATES

Short Term Interest Rates

CHART 16: INTEREST RATES (%)



Source: Central Bank of Kenya

All short term interest rates were lower in June 2006 than in June 2005. For example, the average interest rate on the 91-day Treasury bill declined to 6.6 percent in June 2006, from 8.5 percent in June 2005. Similarly, the average interest rate on the 182-day Treasury bill declined to 7.3 percent in June 2006, from 9.0 percent in June 2005.

Over the same period, the average interbank rate declined to 6.4 percent from 7.4 percent. The decline in short term interest rates during the year reflected increased liquidity in the money market that manifested itself in the frequent oversubscriptions for Government securities. Bids for Government securities tended to feature lower and lower interest rate.

The increase in liquidity was mainly due to more than expected improved performance in the balance of payments. This was especially in the capital and financial accounts in which substantial increase in short term inflows of foreign currency due to improvement in the economic conditions in the country.

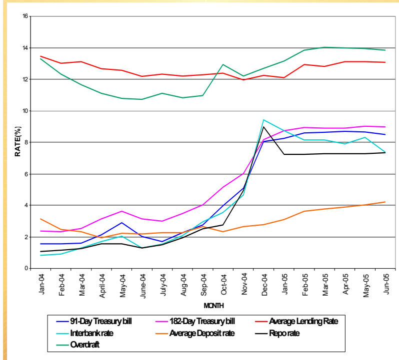
TABLE 26: INTEREST RATES (%)

	2005												2006					
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
Treasury bill 91days	8.25	8.59	8.63	8.68	8.66	8.50	5.17	5.51	5.47	5.55	5.49	5.61	5.61	5.49	5.74	5.28	5.04	5.05
182 days	8.74	8.96	8.91	8.92	9.02	8.96												
Average Lending Rate	12.12	12.35	12.81	13.12	13.10	13.09	13.06	13.03	12.83	12.97	12.93	13.16	13.20	13.27	13.33	13.51	13.95	13.79
Overdraft	13.14	13.82	14.03	14.00	13.94	13.83	13.46	13.81	13.5	13.57	13.33	13.67	13.81	13.34	13.26	13.81	14.02	13.78
Interbank rate	8.72	8.14	8.13	7.91	8.30	7.37	7.51	7.77	8.03	7.98	7.64	7.79	7.78	7.73	7.52	6.97	8.12	6.41
Average Deposit rate	3.08	3.47	3.75	3.90	4.05	4.21	4.14	4.30	4.35	4.43	4.50	4.52	4.48	4.48	4.33	4.35	4.36	4.35
3 - months deposits	3.91	4.24	4.67	4.78	5.08	5.20	5.17	5.51	5.47	5.55	5.49	5.61	5.61	5.49	5.74	5.28	5.04	5.05
Savings	0.97	0.96	0.98	1.09	1.07	1.24	1.3	1.30	1.34	1.32	1.37	1.38	1.33	1.36	1.34	1.33	1.31	1.27
Spread	9.04	8.88	9.06	9.22	9.05	8.88												

Source: Central Bank of Kenya

Lending and Deposit Rates

CHART 17: INTEREST RATES



Source: Central Bank of Kenya

Lending Rates

Unlike short term interest rates, the lending and deposit interest rates were, on average, higher in June 2006 than in June 2005. For example, the commercial banks' overall weighted average lending rate averaged 13.8 percent in June 2006 compared with 13.1 percent in June 2005. Despite the increase, the overall weighted average lending interest rate depicted less volatility with a high of 14.0 percent and a low of 12.8 percent between June 2005 and June 2006.

The increase in the overall lending rate was mainly in lending rates for “1 to 5 year” and for “over 5 year” loans. The increase in lending interest rates for these two categories of loans more than offset the decline in the overdraft interest rate thereby driving up the overall lending rate. Regarding the lending rates applicable to individual borrowers, the average overdraft rate declined to 13.6 percent in June 2006 from 13.8 percent in June 2005. Over the same period, the lending rate for “1 to 5 year” loans recorded the highest increase, rising from 13.6 percent to 15.3 percent. The lending rate for “over 5 year” loans edged up from 11.9 percent to 12.3 percent.

Deposit Rates

The overall weighted average deposit rate increased from 4.2 percent in June 2005 to 4.4 percent in June 2006. The increase was in interest rates on demand deposits, “over three months” deposits and savings deposits. Specifically, the interest rate on demand deposit increased from 1.0 percent in June 2005 to 1.3 percent in June 2006 while the “over three months” deposit interest rate increased from 6.2 percent in June 2005 to 6.7 percent in June 2006. Similarly, the interest rate on savings deposits increased from 1.2 percent to 1.3 percent. The only deposit interest rate that declined was for the “0 to 3 months” deposits. The interest rate averaged 5.1 percent in June 2006 compared with 5.2 percent in June 2005. The decline in the “0 to three months” deposit interest rate could not offset the increase in the other deposit interest rates. Overall, therefore, deposit interest rate edged up.

The increase in the overall lending interest rate in June 2006 was much higher than the increase in the overall deposit rate, the interest rate. Consequently, spread which is measured as the weighted average overall lending rate minus the overall weighted average deposit rate increased from 8.9 percent in June 2005 to 9.4 percent. The spread in June 2006, however, represented a decline from 9.6 percent in May 2006. Chart 17 and Table 26 show data on selected interest rates and the interest rate spread.

Interest Rates Outlook

Interest rates are expected to remain stable, consistent with expected stability in most of the macroeconomic fundamentals.

Specifically, the following factors are supportive of stable interest rates in the near term:

(a) The CBK will continue to ensure monetary expansion is consistent with money demand;

(b) The expected decline in overall inflation will foster expectations for low inflation and thus banks are expected to maintain stable lending rates; and

(c) The inproved revenue collection by KRA will mean stable Government domestic borrowing that will foster stability in interest rates.

The Central Bank Rate

The Central Bank launched the Central Bank Rate (CBR) on 31st May 2006 and the Rate became effective beginning 2nd June 2006. The introduction of the CBR was done in accordance with Section 36(4) of the Central Bank of Kenya Act which requires the CBK to publish the lowest rate at which the CBK lends to commercial banks. By introducing the CBR, the Bank discontinued the approach used previously to set overnight lending rate rate. Prior to launching the CBR, the overnight rate was set on the basis of the prevailing average 91-day Treasury bill rate plus a margin of three percentage points.

With the introduction of the CBR, the CBK overnight lending interest rate comprises two major components. One component is derived as the average of the interbank and Repo interest rates. The other part is discretionary and it constitutes a margin set by the CBK after taking into account the current and future liquidity conditions in the money market, the monetary policy stance of the Bank and inflation, among other factors.

The CBR was initially set at 9.75 percent to be reviewed every eight weeks unless circumstances arose to warrant an earlier review. The CBR was reviewed upwards by 25 basis points from the 9.75 percent to 10.0 percent effective 2nd August, 2006 upon expiry of the eight weeks.

BALANCE OF PAYMENTS

Overview

Kenya's overall balance of payments surplus improved from US$ 187 million in the financial year 2004/2005 to US$ 839 million in the financial year 2005/2006 as shown in Table 27. This followed improved capital and financial account surplus attributable to increased private sector financial flows, which more than covered the current account deficit.

The deficit in the current account increased by US$ 563 million to US$ 1,083 million in the financial year 2005/2006 following the worsening of the trade deficit. The trade deficit widened by US$ 844 million to US$ 3,096 million due to US$ 952 million increase in merchandise imports, which surpassed US$ 108 million increase in merchandise exports. The negative effect of the wider trade deficit on the current account was, however, mitigated by a pick up in exports of services. The increased surplus in the services

TABLE 27: BALANCE OF PAYMENTS (US $ M)

ITEM	Year to Jun 2005	Year to June 2006 Q1 Jul-Sep	Q2 Oct-Dec	Q3 Jan-Mar	Q4 Apr-Jun*	Year to Jun 2006*	Absolute Change
OVERALL BALANCE	187	137	111	201	391	839	653
I. CURRENT ACCOUNT	-521	-133	-88	-377	-485	-1083	-563
Goods	-2252	-593	-652	-867	-985	-3096	-844
Exports (fob)	3071	804	748	781	846	3179	108
Coffee	115	24	26	27	57	133	18
Tea	469	160	150	164	141	615	146
Horticulture	423	96	120	133	126	474	51
Oil products	38	64	13	9	15	101	63
Manufactured Goods	335	88	91	93	98	370	35
Raw Materials	406	75	97	123	100	395	-11
Re-exports	767	141	112	92	103	448	-319
Other	519	155	139	141	207	642	123
Imports (cif)	5324	1396	1400	1649	1831	6275	952
Oil	1215	332	382	445	447	1606	392
Chemicals	799	203	215	237	225	879	81
Manufactured Goods	776	178	179	234	263	854	78
Machinery & Transport Equipment	1561	453	350	368	636	1806	245
Other	972	231	274	365	259	1129	157
Services	1732	459	564	490	500	2013	281
Non-factor services (net)	946	244	316	271	321	1152	206
of which tourism	522	152	163	175	148	638	116
Income (net)	-107	-42	-32	-32	-9	-116	-8
of which official interest	-133	-52	-43	-40	-26	-161	-28
Current Transfers	893	258	280	251	188	977	84
Private (net)	800	235	258	190	188	871	72
Public (net)	94	23	23	61	0	106	12
II. CAPITAL & FINANCIAL ACCOUNT	707	270	199	578	876	1923	1216
Capital Tranfers (net)	190	40	26	69	58	194	4
Financial Account	517	230	172	508	819	1729	1212
Official, medium & long-term	-186	-52	-75	-91	-61	-278	-93
Inflows	102	50	26	19	32	127	25
Outflows	-288	-102	-101	-110	-92	-405	-118
Private, medium & long-term (net)	82	129	10	-58	385	465	383
Commercial Banks (net)	-248	16	26	-29	220	233	482
Other private medium & long-term	330	113	-17	-30	165	231	-99
Short-term (net) incl. errors & omissions	621	153	237	658	494	1542	922
Gross Reserves	2327	2446	2534	2718	2909	2909	583
Official	1587	1708	1799	1981	2353	2353	766
*imports cover***	3.1	3.2	3.3	3.4	4.0	4.0	0.9
*imports cover****	3.9	4.0	4.0	4.2	4.8	4.8	0.9
Commercial Banks	740	739	735	737	556	556	-184

* Provisional

**Based on curreny year's imports of goods and non-factor services

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

Source: Central Bank of Kenya

account reflected good performance in tourism and transportation services as well as increased current inward transfers.

The capital and financial account surplus rose by US$ 1,216 million to US$ 1,923 million in the financial year 2005/2006. This improvement reflected US$ 383 million net increase in private medium and long-term financial inflows and US$ 922 million net increase in short term capital inflows. Net official capital and financial flows, however, worsened by US$ 89 million.

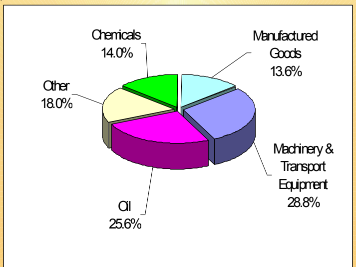
Trade in Goods and Services

Merchandise Account

Kenya's foreign trade largely maintained the same trend during financial year 2005/06 as that of the financial year 2004/05. Growth of merchandise exports, at 3.5 percent continued to lag behind merchandise imports with a growth of 17.9 percent. The major items contributing to both exports and imports remained relatively unchanged. Major exports consisted of light manufactures to neighboring countries and agricultural products to Europe, while imports included, capital goods and other intermediate inputs from Europe, the Middle East and America. The terms of trade continued to deteriorate owing to increased prices of oil and capital goods despite improved export prices particularly for coffee, tea and some horticultural products.

Imports

CHART 18 : COMPOSITION OF KENYA'S IMPORTS



Sources: Customs & Excise Dept. and Central Bank of Kenya

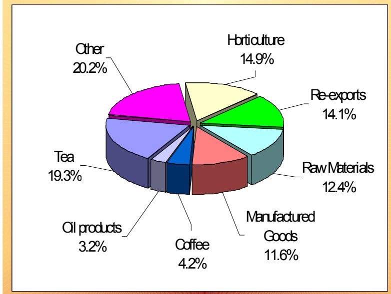
Kenya's merchandise imports rose from US$ 5,324 million in financial year 2004/2005 to US$ 6,275 million during financial year 2005/2006. The major import categories remained machinery and transport equipment, oil, chemicals and manufactured goods. These items respectively accounted for 28.8 percent, 25.6 percent, 14.0 percent and 13.6 percent of the value of imports during the year under review (Chart 18).

Imports of machinery and transport equipment rose by US$ 245 million to US$ 1,806 million, and was mainly due to the import of aircraft, and increased imports of industrial machinery and road vehicles. Oil imports rose by US$ 392 million to US$ 1,606 million, reflecting higher imports of crude oil, jet fuel, diesel, kerosene and gas oil. Imports of manufactured goods, which mainly comprise iron, steel, textiles and paper products, rose by US$ 78 million during the year to US$ 854 million. Imports of chemicals, comprising mainly medicinal and pharmaceutical products, fertilizers and plastics, rose by US$ 81 million. Miscellaneous imports, such as palm oil, wheat and raw materials, rose by US$ 157 million to US$ 1,129 million.

Exports

Merchandise exports increased by US$ 108 million to US$ 3,179 million during the financial year 2005/06. The exports mainly comprise tea, horticulture (vegetables, fruits and cut flowers), re-exports (mainly oil), raw materials, manufactured goods and coffee. Collectively, they accounted for 76.6 percent of Kenya's exports during the year in review (Chart 19).

CHART 19 : COMPOSITION OF KENYA'S EXPORTS



Sources: Customs & Excise Dept. and Central Bank of Kenya

Tea, horticulture and coffee exports made up 38.5 percent of the total value of exports during the financial year 2005/2006, which was higher compared with 32.8 percent in the previous year. The value of tea exports rose by US$ 146 million to US$ 615 million during the financial year 2005/2006 making it Kenya's third largest export earner after transportation and tourism. The increase in tea exports was as a result of a rise in the quantity exported by 57,782 tonnes to 340,804 tonnes, and improvement in export prices by US$ 182 to US$ 1,838 per tonne.

Horticulture exports increased by US$ 51 million to US$ 474 million due to increased exports of vegetables and cut flowers. The rise in exports of vegetables was attributed to higher price and quantity, while the value of exports of cut flowers benefited from increased export volume despite reduced export price. The value of fruits exported declined following a decline in both export price and volume.

Coffee exports rose to US$ 133 million in value thus following improved export price by US$ 428 to US$ 2,536 per tonne. The quantity of coffee exported during the year, however, declined by 509 tonnes to 51,012 tonnes.

Exports of manufactured goods also increased by US$ 35 million, to US$ 370 million during the financial year 2005/2006 following increased exports of cement. Re-exports, mainly to Uganda, Tanzania, Rwanda, Democratic Republic of Congo and Sudan, declined by US$ 319 million to US$ 448 million. Re-exports consisted mainly of oil (71.8 percent), machinery and transport equipment, chiefly road vehicles (9.2 percent), manufactured goods (6.2 percent), chemicals (5.9 percent) and others (6.9 percent).

Services Account

During the financial year 2005/2006 net receipts from non-factor services rose by US$ 206 million to US$ 1,152 million. Non-factor service receipts rose by US$ 233 million from US$ 1,704 million in financial year 2004/2005 to US$ 1,938 million during the financial year 2005/2006, while non-factor service payments rose by US$ 27 million to US$ 786 million.

Gross earnings from tourism and transportation services rose by US$ 116 million and US$ 105 million, respectively. The improved performance of the tourism sector was mainly supported by European tourists particularly from the United Kingdom, Germany and Italy. Increased receipts from transportation services were largely attributed to air transport.

Receipts from other private sector services rose during the period under review, while receipts from other Government services declined. Government service receipts are mainly associated with embassies and consulates, and also include receipts from international bodies and port taxes. Other private service receipts were mainly from communication services.

Net outflows in the income account rose from US$ 107 million in financial year 2004/2005 to US$ 116 million in the financial year 2005/2006, owing to an increase in interest payments on foreign debt by both public and private sectors. Interest payments on official foreign debt increased by US$ 28 million to US$ 161 million, while interest payments by the private sector increased by US$ 9 million to US$ 40 million, resulting in US$ 201 million interest payments during the year under review.

Total interest earnings on foreign investments rose by US$ 32 million to US$ 73 million. Interest earned on official foreign exchange reserves rose by US$ 28 million to US$ 69 million. Interest earnings by the private sector however declined from US$ 15 million to US$ 13 million.

Net current transfers account also improved by US$ 84 million to US$ 977 million in the financial year 2005/2006. Out of this, US$ 871 million was channeled through the private sector, particularly the non-governmental organizations.

Capital and Financial Flows

During the financial year 2005/2006, the current account deficit was financed mainly by private sector financial inflows. The surplus in the capital and financial account improved from US$ 707 million in financial year 2004/2005 to US$ 1,923 million.

In the capital account, project grants to the Government amounted to US$ 194 million in the financial year 2005/2006 compared with US$ 190 million in the previous year, while in the financial account, the Government received US$ 127 million in program, project and Government guaranteed loans. Official loan repayments, however, rose to US$ 405 million thus worsening official financial flows, from a net outflow of US$ 186 million in the financial year 2004/2005 to a net outflow of US$ 278 million in the financial year 2005/2006 .

Private sector flows, however, improved during the year. Private medium and long-term financial inflows improved from a net inflow of US$ 82 million in the financial year 2004/2005 to a net inflow of US$ 465 million in the financial year 2005/2006 . This improvement largely reflected reduced holding of net foreign assets by commercial banks by US$ 233 million and financing of aircrafts imported during the year. Short-term capital inflows increased by US$ 922 million to US$ 1,542 million.

Direction of Trade

As shown in Table 28, Kenya's merchandise exports were mainly destined to Uganda (13.6 percent), United Kingdom (10.4 percent), Tanzania (8.2 percent), the Netherlands (7.8 percent), Pakistan (6.3 percent), Egypt (4.4 percent), Sudan (3.5 percent) and the Democratic Republic of Congo (DRC) (3.2 percent).

TABLE 28: KENYA'S EXPORTS: MAIN DESTINATION COUNTRIES (US $M)

Destination Country	Years Ending Jun 04	Jun 05	Jun-06
Uganda	432	535	434
Tanzania	191	234	259
Egypt	82	82	140
Sudan	51	86	110
DRC	78	132	101
Rwanda	79	94	73
Others	232	309	342
Total Africa	**1144**	**1473**	**1459**
United Kingdom	267	306	332
Netherlands	204	234	249
Pakistan	122	162	199
USA	47	60	121
Germany	62	64	67
United Arab Emirates	26	42	57
France	45	61	55
India	38	54	51
Belgium	31	38	32
Others	519	579	556
Total Exports	**2505**	**3071**	**3179**

Source: Central Bank of Kenya

On the other hand, Kenya sourced most imports from United Arab Emirates (14.6 percent), United Kingdom (10.9 percent), South Africa (8.9 percent), India (6.1 percent), Japan (5.2 percent), China (4.8 percent), Saudi Arabia

(4.8 percent), United States of America (4.1 percent), Germany (3.7 percent) and Ireland (3.4 percent).

TABLE 29: KENYA'S IMPORTS: MAIN SOURCE COUNTRIES (US $M)

Destination Country	Years Ending Jun 04	Jun 05	Jun-06
Uganda	432	535	434
Tanzania	191	234	259
Egypt	82	82	140
Sudan	51	86	110
DRC	78	132	101
Rwanda	79	94	73
Others	232	309	342
Total Africa	**1144**	**1473**	**1459**
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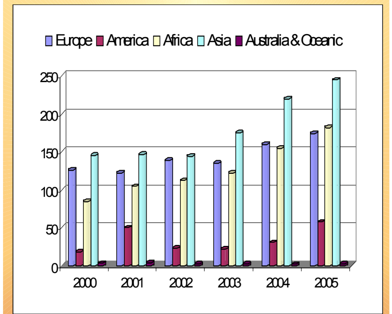
India	38	54	51
Belgium	31	38	32
Others	519	579	556
Total Exports	**2505**	**3071**	**3179**

Source: Central Bank of Kenya

Kenya's Trade Structure

CHART 20: KENYA'S TRADE STRUCTURE



Source: Central Bank of Kenya

Between 2000 and 2005, trade with Asian countries on average accounted for 36.2 percent of Kenya's total trade, while trade with European and African countries accounted for 25.8 percent and 26.9 percent, respectively. Much of the Trade between Kenya and European countries was with the European Union while trade with Comesa and EAC countries accounted for much of Kenya's trade with African countries. Table 30 shows that the share of Kenya's trade with Europe, however, declined between 1999 and 2005 as trade with Asia appeared to slow down after a pick up in

TABLE 30: KENYA'S TRADE STRUCTURE

	Total Trade in Billions of Kenya Shillings							Proportion (%)						
	1999	2000	2001	2002	2003	2004	2005*	1999	2000	2001	2002	2003	2004	2005
Europe	109.6	126.1	122.1	138.3	134.2	159.5	174.1	33.3	33.0	27.9	32.4	28.9	27.5	25.8
Western Europe	105.7	120.4	119.0	135.3	127.0	151.9	165.6	32.1	31.5	27.2	31.7	27.3	26.2	24.5
European Union	101.1	115.7	112.0	128.9	119.0	143.9	155.6	30.7	30.3	25.6	30.2	25.6	24.8	23.1
Others	4.5	4.7	7.0	6.4	8.0	7.9	10.1	1.4	1.2	1.6	1.5	1.7	1.4	1.5
Eastern Europe	3.9	5.7	3.0	3.0	7.2	7.6	8.4	1.2	1.5	0.7	0.7	1.5	1.3	1.2
America	22.3	18.4	49.8	23.3	22.1	30.5	57.8	6.8	4.8	11.4	5.4	4.7	5.3	8.6
U.S.A	16.0	12.9	42.4	18.0	17.2	18.9	47.0	4.8	3.4	9.7	4.2	3.7	3.3	7.0
Others	6.3	5.5	7.4	5.2	4.9	11.6	10.8	1.9	1.4	1.7	1.2	1.0	2.0	1.6
Africa	79.6	84.7	104.3	112.0	122.0	154.2	181.7	24.2	22.1	23.8	26.2	26.2	26.6	26.9
E.A.Community	35.7	36.7	44.8	46.9	47.7	58.0	66.7	10.9	9.6	10.2	11.0	10.2	10.0	9.9
Tanzania	14.2	12.0	14.1	15.0	16.0	19.9	22.8	4.3	3.1	3.2	3.5	3.4	3.4	3.4
Comesa	43.1	49.9	65.6	68.7	73.6	89.3	104.7	13.1	13.0	15.0	16.1	15.8	15.4	15.5
Other Countries	22.1	22.8	24.5	28.3	32.4	45.0	54.2	6.7	6.0	5.6	6.6	7.0	7.8	8.0
Asia	111.8	144.9	146.2	143.9	174.4	219.1	244.1	34.0	37.9	33.4	33.7	37.5	37.8	36.2
Middle East	48.5	80.1	77.8	58.4	82.0	107.7	115.6	14.7	20.9	17.8	13.7	17.6	18.6	17.1
Far East	63.3	64.8	77.4	85.5	92.3	111.4	128.5	19.2	17.0	17.7	20.0	19.9	19.2	19.0
Australia & Oceanic	3.5	3.3	4.3	2.6	2.5	2.1	2.5	1.1	0.9	1.0	0.6	0.5	0.4	0.4
All other Countries N.E.S	2.2	5.0	11.2	7.0	9.9	13.9	14.7	0.7	1.3	2.5	1.6	2.1	2.4	2.2
Grand Total	**329.0**	**382.3**	**437.7**	**427.0**	**465.0**	**579.4**	**674.9**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

*Provisional

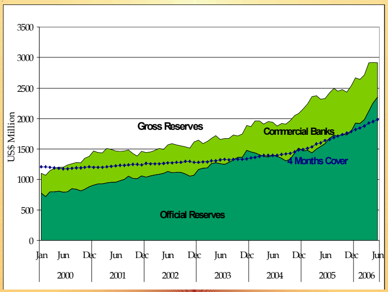
Sources: Economic Survey 2004, 2005 and 2006

2003 and 2004. Trade with Africa and America remained upward during this period.

Foreign Exchange Reserves

Following increased overall balance of payments, the Central Bank of Kenya was able to build up official foreign exchange reserves predominantly through purchases of foreign exchange from the domestic inter-bank market in the amount of US$ 813 million. The Bank also received an additional US$ 290 million being interest earned on foreign exchange reserves, receipts from foreign grants and loans in aid of Government projects. During the year, the bank spent US$ 62 million on its own operations and paid out US$ 316 million to meet Government external obligations. Gross official foreign exchange reserves therefore increased from US$ 1,587 million at the end of June 2005 to US$ 2,353 million, equivalent to 4.8 months of imports cover, at the end of June 2006.

CHART 21: FOREIGN EXCHANGE RESERVES (US $)

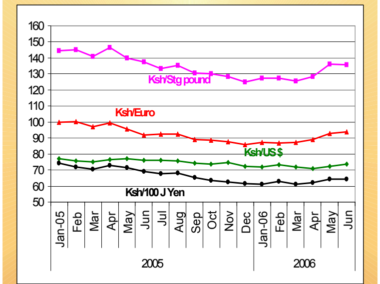


Source: Central Bank of Kenya

Gross foreign assets of commercial banks, on the other hand, declined by US$ 184 million to US$ 556 million at the end of June 2006. This decline was reflected in reduced balances with banks abroad by US$ 206 million, to US$ 397 million. Other foreign assets of commercial banks including cash, foreign loans and foreign currency bills discounted however rose by US$ 23 million to US$ 159 million at the end of June 2006.

Overall total foreign asset holdings of the banking system rose by US$ 583 million from US$ 2,327 million at the end of June 2005 to US$ 2,909 million at the end of June 2006 . Besides these holdings, foreign currency deposits held locally by residents increased from US$ 1,067 million at the end of June 2005 to US$ 1,126 million at the end of June 2006.

CHART 22: KENYA SHILLING EXCHANGE RATES



Source: Central Bank of Kenya

Kenya Shilling Exchange Rate

The Kenya shilling strengthened against all major international and regional currencies between June 2005 and June 2006.

As shown in Table 31, the Kenya shilling appreciated by 4.3 per cent to trade at Ksh 73.4 per US dollar by June 2006 compared with Ksh 76.7 per US dollar in similar period in 2005. Against the Sterling pound and the Japanese Yen, the shilling appreciated by 3.0 per cent and 9.3 per cent to exchange at Ksh 135.4 and Ksh 64.0 in June 2006 from Ksh 139.5 and Ksh 70.6, respectively in June 2005. The shilling also appreciated against the Euro to trade at Ksh 93.0 in June 2006 compared with Ksh 93.2 in a similar period in 2005 . Against the South African Rand, the shilling appreciated by 7.0 per cent from Ksh 11.3 to Ksh 10.5 in June 2006. The Kenya shilling gained substantially against currencies of the East African Community countries, to trade at Ush 25.3 and Tsh 17.1 in June 2006 compared with Ush 22.7 and Tsh 14.7 in June 2005, respectively for the Uganda shilling and the Tanzania shilling. These represent 11.8 percent and 16.3 percent appreciation of the Kenya shilling against the Uganda and Tanzania shilling, respectively.

TABLE 31: KENYA SHILLING EXCHANGE RATES

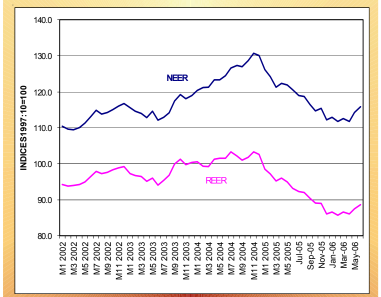
	2004			2005			2006		% Change
	Jan	Jun	Dec	Jan	Jun	Dec	Jan	Jun	Jun-04 to Jun-05
Kshs/US$	76.3	79.3	79.8	77.9	76.7	73.1	72.2	73.4	-4.3%
Kshs/Stg.£	139.0	144.8	153.9	146.5	139.5	127.6	127.5	135.4	-3.0%
Kshs/Euro	96.2	96.2	106.9	102.3	93.2	86.7	87.5	93.0	-0.3%
Kshs/100 Yen	71.7	72.4	76.9	75.5	70.6	61.6	62.6	64.0	-9.3%
Kshs/Rand	11.0	12.3	13.9	13.0	11.3	11.4	11.8	10.5	-7.0%
Ushs/Kshs	25.4	23.0	21.8	22.2	22.7	24.8	25.2	25.3	11.8%
Tshs/Kshs	14.2	14.0	13.2	13.9	14.7	16.0	16.3	17.1	16.3%

Source: Central Bank of Kenya

The strengthening of the shilling exchange rate over the review period reflected increased foreign exchange inflows from key exports, particularly horticulture, tea, coffee and tourism. The shilling was also bolstered by stable and attractive domestic interest rates that resulted in increased capital inflows. In addition, disbursement of budgetary support by the Africa Development Bank, the European Union and improved investor confidence in the economy also contributed to the strengthening of the shilling.

International Trade Competitiveness

CHART 23: KENYA SHILLING REER AND NEER



Source: Central Bank of Kenya

The competitiveness of a country's exports depends on many factors one of which is the international value of the currency. With demand for exports responsive to domestic prices, a stronger currency lowers the demand while a weaker currency encourages demand for the country's exports. As shown in Chart 23, the trade weighted Nominal Effective Exchange rate (NEER) and Real Effective Exchange rate (REER) generally declined between June 2005 and June 2006 with modest increases in June 2006. Thus, on the basis of NEER and REER, Kenya lost international competitiveness over the period under review as the REER appreciated by 23 percent.

Shilling Exchange Rate Outlook

Following the trend that emerged in the last quarter of 2006, it is the value of the Kenya shilling against major international currencies is expected to remain stable. The favourable macro economic conditions that prevailed in the last financial year are also expected to continue to support the Kenya shilling against the major international currencies.

A: Mode of Payments

1. Cash

During the year to June 2006, currency remained the most widely used form of payment. Currency issued into circulation during the year to June 2006 increased by Ksh 8.8 billion, or 13.0 percent from Ksh 67.5 billion in June 2005 to Ksh 76.3 billion (Table 32 below).

TABLE 32: CURRENCY IN CIRCULATION BY TYPE

	Jun-04		Jun-05		Jun-06	
Item	Ksh.bn.	%	Ksh.bn.	%	Ksh.bn.	%
Currency in circulation	62.8	100%	67.5	100%	76.3	100%
Bank Notes	60.2	95.9	64.6	95.7	73.2	95.94
Coins	2.6	4.1	2.9	4.3	3.1	4.06

Source: Central Bank of Kenya

As a proportion of currency in circulation, bank notes made up 95.9 percent while coins comprised 4.1 percent as at 30th June 2006.

TABLE 33: CURRENCY IN CIRCULATION (KSH M)

	Bank Notes			Coins	
Denomination	Ksh (m)	%	Denomination	Ksh (m)	%
1000/=	54,381	74.3	40/=	67	2.1
500/=	6,953	9.5	20/=	1,061	34.1
200/=	4,450	6.1	10/=	819	26.3
100/=	5,186	7.1	5/=	569	18.3
50/=	1,878	2.6	1/=	442	14.2
20/=	208	0.3	=/50	105	3.4
10/=	124	0.2	=/10	36	1.2
5/=	30	0.0	=/05	15	0.4
TOTAL	73,210	100	TOTAL	3,114	100

Source: Central Bank of Kenya

The share of bank notes in currency issued increased from 95.7 percent in June 2005 to 95.9 percent as at June 2006. In June 2006, bank notes of Ksh 1,000 and Ksh 500 denominations were dominant, accounting for 74.3 percent and 9.5 percent respectively. Coins decreased from 4.3 percent in the preceding year to 4.1 percent of total currency in circulation in the year under review. The Ksh 20 and Ksh 10 coins maintained bigger proportions accounting for 34.1 percent and 26.3 percent respectively of the coins in circulation.

Developments of Cash Inflows and Outflows

Commercial banks deposited Ksh 196.8 billion in the Central Bank by June 2006, an increase of Ksh 10.7 billion or 5.8 percent compared with Ksh 186.1 billion in the year to June 2005. Over the same period, commercial banks withdrew Ksh 205.6 billion as compared with Ksh 163.7 billion the previous year. There was therefore a net currency outflow from Central Bank in the year to 30th June 2006 of Ksh 8.8 billion (Table 34 below).

TABLE 34: CURRENCY INFLOWS AND OUTFLOWS (KSH M)

Inflows (Deposits by banks)	2004/05	2005/06
Bank Notes	185,329.07	196,106.29
Coins	813.94	713.07
Total	**186,143.01**	**196,819.36**
Outflows (Withdrawals by banks)		
Bank Notes	162,717.37	204,715.57
Coins	985.99	922.79
Total	**163,703.37**	**205,638.36**
Net Outflows	**-22,439.64**	**8,819.00**

Source: Central Bank of Kenya

Developments in Counterfeiting Practices

Counterfeit notes increased from 1,129 pieces by 30th June 2005 to 4,787 pieces by 30th June 2006 (Table 35). In value terms, they increased by 574 percent from Ksh 502,600 to Ksh 3,387,900. In terms of denominations, there were 2,597 pieces of Ksh 1,000 notes and 1,239 pieces of the Ksh 500 notes or 54 percent and 26 percent of the total counterfeit notes respectively.

TABLE 35: COUNTERFEIT NOTES BY DENOMINATION

Period	No. 2003/04	Amount (Kshs.)	No. 2004/05	Amount (Kshs.)	No. 2005/06	Amount (Kshs.)
1000/=	129	129,000	226	226,000	2,597	2,597,000
500/=	214	107,000	392	196,000	1,239	619,500
200/=	119	238,800	301	60,200	763	152,600
100/-	56	5,600	198	19,800	188	18,800
50/=	-	-	12	600		
20/=	-	-	-	-	-	-
10/=	-	-	-	-	-	-
5/=	-	-	-	-	-	-
Total	518	265,400	1,129	502,600	4,787	3,387,900

Source: Central Bank of Kenya

2. Non-Cash Instruments

Cheques continued to dominate non-cash payment instruments accounting for over 80 percent of all transactions being processed in the Clearing House. In the year to June 2006, the daily volume of cheques cleared through the Nairobi Automated Clearing House averaged 56,000 valued at Ksh 10 billion, an increase from 44,000 cheques valued at Ksh 7.7 billion in a similar period in 2005.

Electronic Funds Transfer (EFT) transactions or credit based payments increased by 35 percent to Ksh 479 million in the year to June 2006 compared with Ksh 355 million in the previous year (Table 36).

(a) The Clearing System Operations

At the end of June 2006, the nominal value of clearing (Debits and Credits) increased to Ksh 3,121 million from Ksh. 2,298 million.

TABLE 36: NATIONAL CLEARING TURNOVER (NOMINAL)

FINANCIAL YEAR	ITEMS	VALUES MILLIONS	VOLUMES THOUSAND
2003	Debit	1,891	12,200
	Credit	168	2,737
	Total	**2,059**	**14,937**
2004	Debit	2,052	12,329
	Credit	230	3,586
	Total	**2,282**	**15,915**
2005	Debit	1,943	11,287
	Credit	355	3,633
	Total	**2,298**	**14,920**
2006	Debit	2,642	14,513
	Credit	479	5,032
	Total	**3,121**	**19,945**

Source: Central Bank of Kenya

During the year to June 2006, there was growth in the respective foreign currency transaction volumes and values processed through the Domestic Foreign Currency Clearing (DFCC) system (Table 37).

TABLE 37: DOMESTIC FOREIGN CURRENCY CHEQUE CLEARING TRANSACTIONS AS AT JUNE 1006

	USD		GBP		EURO	
	Value (m)	Volume ('000')	Value (m)	Volume ('000')	Value (m)	Volume ('000)
2005	1,202.67	159.4	19.83	2	78.37	5.1
2006	1,812.80	240.8	23.07	2.6	114.3	7.2
Growth (%)	50.73	51.07	16.34	30	45.85	41.18

Source: Central Bank of Kenya

In terms of volume and value, the US$ denominated transactions dominated the DFCC clearing house transactions. The US$ transactions grew by over 50 percent in both value and volume and amounted to USD 1.8 billion compared with GBP 23.1 million and € 114.3 million with a value growth of 16.34 percent and 45.85 percent, respectively for the Sterling pound and the Euro.

(b) Plastic Card Usage as at December 2005

Results from a survey conducted by National Payments Systems Division in December 2005 and January 2006 revealed consistent growth in the use of plastic cards. Growth was also observed in Automated Teller Machines (ATMs) and Point of Sales (POS) in the review period (Tables 38, 39, and 40).

ATMs rose from 86 in 1999 to 555 in the year 2005, a 545 percentage increase. This growth is attributed to demand for ATM services and competition among commercial banks to satisfy their customers.

Between 1999 and 2002, the number of transactions processed through ATMs rose from 4.9 million in 1999 to 6.0 million in the year 2002, before rising to 6.7 million and 9.1 million in the years 2004 and 2005, respectively. This represents a phenomenal increase of 4.2 million transactions processed through ATMs.

TABLE 38: NUMBER OF ATMs AND VOLUME OF TRANSACTIONS

	1999	2000	2001	2002	2003	2004	2005
Number of ATM machines	86	94	107	174	215	324	555
Number of transaction "000"	4,915	5,297	5,707	6,005	4,637	6,656	9,103

Source: NPS Survey, December 2005

TABLE 39: USAGE OF POS TERMINALS

	1999	2000	2001	2002	2003	2004	2005
Electronic							
Number of transactions	0	0	0	311	2,318	2,630	6,230
Value of transactions	1,200	1,500	1,600	1,700	8,308	11,306	14,275
Manual							
Number of transactions	0	0	0	0	165	7	3,965
Value of transactions	0	0	0	0	5,048	6,086	13,539

Source: NPS Survey, December 2005

TABLE 40: NUMBER OF CARDS IN CIRCULATION

TYPE	1999	2000	2001	2002	2003	2004	2005
ATM cards	226,000	239,000	262,100	248,247	266,811	332,015	426,110
Debit cards	11,084	62,256	159,498	202,018	330,007	356,989	496,647
Credit cards	16,629	16,531	18,522	18,215	57,146	59,164	69,478
Charge cards	3,217	2,784	3,068	3,301	3,693	3,371	3,142
Total	**256,930**	**320,571**	**443,188**	**471,781**	**657,657**	**751,539**	**995,377**

Source: NPS Survey, December 2005

(c) KEPSS Usage as at June 2006

Since KEPSS was launched, there has been a steady increase in its usage mainly for inter-bank transfers with transactions rising from 8,999 with a value of Ksh 496 billion in August 2005 to 12,360 transactions, valued at Ksh 839 billion in June 2006. This represents a growth in value of 69.2 percent. (Table 41).

TABLE 41: TRENDS IN TOTAL MONTHLY FLOWS AUGUST 2005 - JULY 2006

	Value (m)	No. of transaction	Average value per transaction (m)	Number of working days	Per day	
					Value	No. of transactions
Aug-05	496,250	8,999	55.1	23	21,576	391
Sep-05	639,421	11,729	54.5	22	29,065	533
Oct-05	576,966	9,522	60.6	19	30,367	501
Nov-05	558,206	9,715	57.5	19	29,379	511
Dec-05	615,394	10,733	57.3	21	29,304	511
Jan-06	624,525	10,575	59.1	20	31,226	529
Feb-06	620,315	10,696	58	20	31,016	535
Mar-06	742,922	11,951	62.2	23	32,301	520
Apr-06	632,740	10,484	60.4	17	37,220	617
May-06	1,115,306*	13,487	82.7	22	50,696	613
Jun-06	839,151	12,360	67.9	21	39,960	589

** The upsurge in the month of May 2006 may be attributed to IPO of Kengen shares.*

Source: NPS, Oversight

Over the year that KEPSS has been in operation, direct payments i.e. values posted directly into KEPSS by commercial banks averaged 92.1 percent of the total transactions flow through KEPSS, while the remaining 7.9 percent of the value are processed via the Automated Clearing House – Net Settlement Instruction(NSI). (Table 42).

TABLE 42: COMPOSITION OF KEPSS TRANSACTION

Month	Total value of KEPSS transactions	Settlement proportions			
		Direct		Indirect - NSI	
		Kshs (m)	%	Kshs (m)	%
Aug-05	496,250	450,116	90.7	46,133	9.3
Sep-05	639,421	585,427	91.6	53,994	8.4
Oct-05	576,966	521,844	90.4	55,122	9.6
Nov-05	558,206	512,931	91.9	45,275	8.1
Dec-05	615,394	563,123	91.5	52,270	8.5
Jan-06	624,525	572,816	91.7	51,709	8.3
Feb-06	620,315	581,770	93.8	38,545	6.2
Mar-06	742,922	689,655	92.8	53,267	7.2
Apr-06	632,740	575,206	90.9	57,534	9.1
May-06	1,115,306	1,040,899	93.3	74,407	6.7
Jun-06	839,151	784,441	93.5	54,710	6.5
Jul-06	820,498	765,788	93.3	54,710	6.7
Average	**690,141**	**637,001**	**92.1**	**53,140**	**7.9**

Source: Central Bank of Kenya

Third Party Transactions Processed Through KEPSS

Third party messages through KEPSS have been on the rise since the KEPSS launch on 29th July 2005. Single Third Party Message Type (MT) 103 rose from 1,722 transactions in August 2005 to 2,818 transactions in June 2006 representing a growth of about 63.7 percent. Multiple Third Party Message Type (MT102) also maintained an upward trend over the same period rising from 481 transactions per month in August 2005 to 602 in June 2006 representing a growth of about 25.2 percent. (Table 43 and Chart 24)

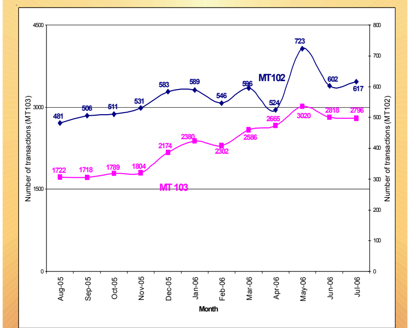
TABLE 43: THIRD PARTY TRANSACTIONS PROCESSED THROUGH KEPSS BY MESSAGE TYPE

	MT102	MT103
Aug-05	481	1,722
Sep-05	506	1,718
Oct-05	511	1,789
Nov-05	531	1,804
Dec-05	583	2,174
Jan-06	589	2,380
Feb-06	546	2,302
Mar-06	596	2,586
Apr-06	524	2,665
May-06	723	3,020
Jun-06	602	2,818

Source: Central Bank of Kenya

Chart 24 below shows how MT102[2] and MT103 messages have grown since KEPSS launch.

CHART 24: THIRD PARTY TRANSACTIONS PROCESSED THROUGH KEPSS



Source: Central Bank of Kenya

B: Payment System Developments

1. Oversight Issues

In the period under review, the Bank's Board of Directors approved the Policy Framework for Oversight of Payment Systems in Kenya. The policy outlines the Bank's role, objectives, scope, importance and methodology for payment system oversight in Kenya. Further, the Bank developed the benchmark document for overseeing payment systems in Kenya. The policy document was shared and harmonized with those of the other two East Africa Central Banks. The document identifies the standards against which payment systems will be assessed in the region. The Monetary Affairs Committee adopted the benchmark document during their meeting held in Arusha in May 2006.

[2] MT 102 message is a multiple third party message while, MT 103 message is a single third party message

2. Legal Framework

In view of the passage of time and the ever changing business environment, the Ministry of Finance requested the Bank to review the draft NPS and EFT Bills that had been forwarded in 2004. It is envisaged that the enactment of the Bills will facilitate the realization of a safe and efficient Payments System in Kenya.

The Master Repurchase Agreement and the Intra-day Liquidity Facility agreements were developed during the year. Execution of these agreements will facilitate the provision of fully collateralized liquidity by the Central Bank to KEPSS participants in accordance with international good practice and as agreed by the Monetary Affairs Committee of the three East African Central Banks.

C: Future Developments

The Bank plans to roll out a campaign to create public awareness about the availability and benefits of KEPSS in making large value and time critical payments.

It is expected that KRA and other Government departments will be connected to KEPSS and reduce the issuance and usage of cheques.

The Bank will continue to work towards the realization of initiatives aimed at improving payment, clearing and settlement systems within the East African and COMESA regions.

OUTLOOK

The recovery in economic activity in the last three years will continue through the fiscal year 2006/07, with real GDP estimated to grow by between 5.5 percent and 6.0 percent in 2006. The current macroeconomic stability and various Government reforms will contribute to increased production in the key sectors of the economy. Agriculture, a key sector of the economy, is expected to improve its production in the year, unlike in the last quarter of 2005 when drought negatively affected output.

As was the case in the previous year, the Bank's Monetary Policy stance will be geared towards achieving and maintaining price stability in the year.

This positive economic outlook assumes that the weather conditions will remain favourable in the year and the high and volatile international prices of crude oil will not significantly disrupt the economy.

CENTRAL BANK OF KENYA
ANNUAL REPORT AND FINANCIAL STATEMENTS
FOR THE YEAR ENDED 30 JUNE 2006

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CENTRAL BANK OF KENYA
DIRECTORS, OFFICERS AND ADMINISTRATION

DIRECTORS

Dr Andrew K. Mullei	Governor and Chairman (Suspended on 23rd March, 2006)
Mrs Jacinta W. Mwatela	Deputy Governor and Ag. Governor
Mr Joseph K. Kinyua	Permanent Secretary – Treasury, Member
Mr. Nicholas A. Nesbitt	Member - Appointed on 28 September, 2006
Mr. Joseph K. Waiguru	Member - Appointed on 28 September, 2006
Dr. William O. Ogara	Member - Appointed on 28 September, 2006
Mr George Ongaya-Okoth	Member - Retired on 15 August, 2006
Prof Henry K. Maritim	Member - Retired on 19 August, 2006
Mr Paul A. Spence	Member - Retired on 19 August, 2006
Mr Owen N. Koimburi	Member - Retired on 19 August, 2006

SENIOR MANAGEMENT

Mrs J.W. Mwatela	Ag. Governor
Mr John M. Gikonyo	Director Governor's Office & Board Secretary
Mr Aggrey J.K. Bett	Director – Banking Services Department
Mr Jackson M. Kitili	Director –Monetary Operations & Debt Management
Mr Jones M. Nzomo	Director – Finance & Resource Planning
Mr Charles K. Chepkwony	Ag. Director – Information Technology
Mr Lawrence C. Kungu	Director – Estates Management & Procurement
Mr Gerald A. Nyaoma	Director – Banking Supervision Department
Ms Elizabeth C. A. Omolo	Ag. Executive Director – Kenya School of Monetary Studies
Mr Nicholas M. Kiritu	Ag. Director – Internal Audit & Risk Management
Mr Nicholas B. T. A. Korir	Director – Economics Department
Mr Edwin L. Ogola	Director – Currency Operations and Branch Administration
Mr Charles O. Maranga	Director – Administration and Human Resources

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Kenya School of Monetary Studies
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CENTRAL BANK OF KENYA
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Central Bank of Kenya
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LAWYERS

Oraro and Co Advocates
ACK Garden House
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PO Box 51236
00200 Nairobi City Square, Kenya

CENTRAL BANK OF KENYA
DIRECTORS' REPORT
FOR THE YEAR ENDED 30 JUNE 2006

The directors submit their report together with the audited financial statements for the year ended 30 June 2006, incorporating Kenya School of Monetary Studies Limited, a company limited by guarantee and wholly owned by the Bank.

1. Establishment

The Bank was established under the Central Bank of Kenya Act (the Act), Cap.491.

2. Principal Activities

The Bank is established and administered under the Central Bank of Kenya Act with the principal object of formulating and implementing monetary policy directed to achieving and maintaining stability in the general level of prices. It is also the responsibility of the Bank to foster the liquidity, solvency and proper functioning of a stable market-based financial system. The Bank acts as banker, advisor and fiscal agent of the Government of Kenya.

3. Results

The results for the year are set out on page 80.

4. Dividend

The board of directors recommend the payment of Kshs 2 billion dividend for the year (2005 – Nil)

5. Directors

The directors who served during the year are listed on page 72.

6. Auditors

KPMG Kenya were appointed the Auditors for two years ending after the approval of the financial statements for the year ending 30 June 2006.

7. Approval of Financial Statements

The financial statements were approved at a meeting of the directors held on 17th October, 2006

BY ORDER OF THE BOARD

John M Gikonyo
Board Secretary

Date: 17th October, 2006

CENTRAL BANK OF KENYA

STATEMENT OF DIRECTORS' RESPONSIBILITIES

We, the directors certify that:

1. We are responsible for the preparation of financial statements for each financial year which present a true and fair view of the state of affairs of the Bank and of its operating results for that year. We are also responsible to ensure that the Bank keeps proper accounting records which disclose with reasonable accuracy, the financial position of the Bank.

2. We accept responsibility for the annual financial statements, which have been prepared using appropriate accounting policies supported by reasonable and prudent judgement and estimates, in accordance with International Financial Reporting Standards and in the manner required by the Central Bank of Kenya Act.

3. We are responsible for safeguarding the assets of the Bank.

4. We are responsible for establishing and maintaining systems of internal control designed to provide reasonable assurance as to the integrity and reliability of the Bank's financial reporting.

5. We are of the opinion that the financial statements for the year ending 30 June 2006 fairly present the financial position and operating results of the Bank.

6. Nothing has come to the attention of the directors to indicate that the Bank will not remain a going concern for at least twelve months from the date of this statement.

Signed on behalf of the Board of Directors by:

Ag. Governor

Director

Date: 17th October, 2006

CENTRAL BANK OF KENYA
STATEMENT OF CORPORATE GOVERNANCE

The Central Bank of Kenya is wholly owned by the Government of Kenya. The Bank is established by and derives its authority and accountability from the Central Bank of Kenya (CBK) Act Cap 491. The Bank is committed to maintaining the highest standards of integrity, professionalism and business ethics in all its operations.

Board of Directors

Section 11 of the CBK Act Cap 491 provides that the Board of Directors shall constitute of the Governor who is also the Chairman, Deputy Governor, who shall also be the Deputy Chairman, the Permanent Secretary to the Treasury, who is a non-voting member and five Non-Executive Directors. Other than the Permanent Secretary to the Treasury, all the others are appointed by the President of the Republic of Kenya for terms of four years each and are eligible for reappointment provided that no Governor, Deputy Governor or director shall hold office for more than two terms.

Mrs. Jacinta W. Mwatela was appointed Acting Governor on 23rd March, 2006 following the suspension of Dr. Andrew K. Mullei as Governor. Currently there are three Non-Executive Directors who are all serving their first term. All the Non-Executive Directors are independent of management and free from any business or other relationship, which could interfere with the exercise of their independent judgement.

Board Meetings

The Board meets once every six weeks and has a formal schedule of matters reserved for it. The Directors are given appropriate and timely information so that they can maintain full and effective control over strategic, financial and operational issues. The Board is not involved in the conduct of day-to-day business as this is a responsibility given to the Governor by the CBK Act Cap 491. It however, retains responsibility for determining the policy of the Bank..

Monetary Policy Advisory Committee

Section 4D of the CBK Act establishes the Monetary Policy Advisory Committee. Members were appointed by the Minister for Finance on 29 July 2005 for three years with effect from 1 August 2005. Section 4D2(d) require that the six independent members shall have knowledge, experience and expertise in matters relating to finance, banking and fiscal and monetary policy. The secretariat of this Committee is based in the Economics Department of the Bank and members have unlimited access to the Bank for purposes of research in any area which they consider useful. The Committee meets once every two months.

The duties of the Committee are to:

(a) Advise the Bank with respect to Monetary Policy and
(b) Perform such other functions as the Minister may prescribe by regulations.

The Committee is currently made up of the following:

(1) The Governor who is also the Chairman
(2) The Deputy Governor who is the Deputy Chairman
(3) Permanent Secretary to the Treasury or his alternate
(4) Professor T. C. Ryan
(5) Professor Francis Mwega
(6) Dr. Rose W. Ngugi

(7) Mrs Sheila S.M.R. M'Mbijjewe
(8) Mr. John Randa
(9) Mr. Wycliffe Mukulu

Committees of the Board

The Board of Directors has two sub committees with specific responsibilities and the chairmen of these sub-committees submit regular reports to the Board through the secretariats. The committees and their respective responsibilities are as follows:

Audit Committee

The Audit Committee has been chaired by Mr. Paul Spence and has three other members who are Non-Executive Directors having experience in Accounting, Auditing, Banking and Financial Management. The committee currently meets on a monthly basis and as necessary. Its responsibilities are to:-

- Keep under review the efficiency and effectiveness of internal controls in the Bank;
- Keep under review financial information and improving the quality of financial reporting with particular attention to compliance with legal and reporting requirements;
- Receive and consider the Bank's annual budget;
- Review the effectiveness of the Internal Audit Function and reports received there-from;
- Review the External Auditors Audit scope timetables and approach; their performance and their findings;
- Recommend on the appointment of the external auditors and their fees;
- Review the Bank's annual financial statements prior to their submission to the Board;
- Review the Banks' Risk Management Policies and Procedures.

Tender Committee

The Committee has been chaired by Mr. Owen N. Koimburi and membership includes two other Non-Executive Directors, the Governor and the Deputy Governor together with three Head of Departments. The Committee meets on monthly basis and as need arises. The roles and responsibilities of the Committee are as under:

- To award contracts through open tender, restricted tenders, request for proposals or direct procurement where the contract value per item exceeds five hundred thousand shillings;
- To approve bids through open tender for sale of Central Bank stores;
- To approve variations of contract conditions previously awarded by the Committee.
- To review tender documents and request for proposals where the estimated contract value exceeds KShs 1 million.

Functionally, the Committee formulates and oversees the implementation of all the procurement and disposal policies of the Central Bank and ensures that all the procurement regulations, standards and best practices are fully complied with in accordance with the Exchequer and Audit Act – Procurement Rules and Regulations (2002).

Management Structure

The Central Bank's Senior Management team is made up of the Governor, the Deputy Governor and the heads of the Bank's various departments as indicated on page 1. The posts of Governor and Deputy Governor are set out by statute in the CBK Act Cap 491 of the Laws of Kenya. The Senior Management meets regularly to review the overall performance of the Bank.

There are various other Management Committees, which advise the Governor on specific issues in order to enable him to discharge his responsibilities as the CEO.

Directors Emoluments and Loans

The remuneration paid to the Directors for services rendered during the financial year 2005/2006 is disclosed in a note to the financial statements. The Non Executive Directors are paid a monthly retainer fee and a sitting allowance for every meeting attended. There were no loans to Non-Executive Directors during the year.

Code of Ethics

The Bank is committed to the highest standards of integrity, behaviour and ethics. A formal code of ethics for all employees has been approved by the Board and is fully implemented. All employees of the Bank are expected to avoid activities and financial interests, which could give rise to conflicts of interest with their responsibilities in the Bank. Strict rules of conduct apply to the entire Bank's staff under the staff rules and regulations.

Internal Controls

The management of the Bank has put in place a series of internal control mechanisms to ensure the reporting of complete and accurate accounting information. Procurement of goods and services is strictly done under the Exchequer and Audit Rules and Regulations (2002). In all operational areas of the Bank, workflows have been structured in a manner that allows adequate segregation of duties.

Authorizations and Internal Audit

All the expenditure of the Bank must be authorized in accordance with a comprehensive set of Bank policies and procedures. There is a budget, which is approved by the Board before commencement of the financial year. The Board receives regular management accounts comparing actual outcomes against budget as a means of monitoring actual performance of the Bank.

The internal audit function is performed by Internal Audit and Risk Management department which is also responsible for monitoring and providing advice on the Bank's risk management framework. All reports of the Internal Audit are available to the Audit Committee of the Board.

Transparency

The Bank publishes an Annual Report, Monthly Economic Review, Weekly Release, Statistical Bulletin and Monetary Policy Statement which explains current monetary policy and also provides the expected monetary policy stance. In addition, the Bank issues policy briefs to the Treasury on both the monetary and fiscal policies. On an annual basis, the Financial Report is published in the Kenya Gazette.

REPORT OF THE INDEPENDENT AUDITORS TO THE MEMBERS OF CENTRAL BANK OF KENYA

We have audited the financial statements set out on pages 80 to 100 for the year ended 30 June 2006. We have obtained all the information and explanations, which to the best of our knowledge and belief were necessary for the purposes of our audit. The financial statements are in agreement with the books of account.

Respective Responsibilities of Directors and Independent Auditors

As stated on page 75, the directors are responsible for the preparation of financial statements that give a true and fair view of the state of affairs of the Bank and its operating results. Our responsibility is to express an opinion on the financial statements based on our audit.

Basis of Opinion

We conducted our audit in accordance with International Standards on Auditing. Those Standards require that we plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting policies used and significant estimates made by the directors, as well as evaluating the overall presentation of the financial statements. We believe that our audit provides a reasonable basis for our opinion.

Opinion

In our opinion, proper books of account have been kept and the financial statements give a true and fair view of the state of the Bank's financial position at 30 June 2006 and of its operating results and cash flows for the year then ended and comply with International Financial Reporting Standards and the Central Bank of Kenya Act.

KPMG Kenya

Date: 17th October, 2006

CENTRAL BANK OF KENYA
INCOME STATEMENT
FOR THE YEAR ENDED 30 JUNE 2006

	Note	2006 KShs million	2005 KShs million
Interest income	2	6,943	5,033
Interest expense	3	(1,039)	(364)
NET INTEREST INCOME		**5,904**	**4,669**
Fee and commission income	4	4,968	3,783
Net foreign exchange expenses	5	(109)	(3,071)
Other operating income	6	255	184
OPERATING INCOME		**11,018**	**5,565**
Operating expenses	7	(6,267)	(5,685)
Impairment losses	9	(4)	(4,014)
PROFIT/(LOSS) FOR THE YEAR		**4,747**	**(4,134)**
Dividends:			
Proposed dividend for the year	10	**2,000**	-

The notes set out on pages 84 to 100 form an integral part of these financial statements.

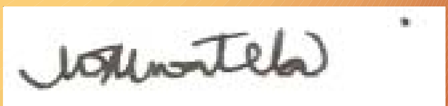
CENTRAL BANK OF KENYA

BALANCE SHEET

AS AT 30 JUNE 2006

	Note	2006 KShs million	2005 KShs million
ASSETS			
Balances due from banking institutions and gold holdings	11	172,997	119,757
Items in the course of collection		537	5,468
Investment in government securities	12	1	7
Loans and advances	13	9,283	9,414
Other assets	14	6,851	2,810
Retirement benefit asset	15	394	478
Property and equipment	16	706	1,193
Prepaid operating lease rentals	17	285	289
Due from Government of Kenya	18	35,549	35,917
TOTAL ASSETS		**226,603**	**175,333**
LIABILITIES			
Currency in circulation	19	76,207	67,322
Deposits	20	100,824	79,897
International Monetary Fund	21	13,588	14,873
Amounts repayable under repurchase agreements	22	23,342	5,334
Other liabilities	23	997	1,009
TOTAL LIABILITIES		**214,958**	**168,435**
EQUITY AND RESERVES (Page 11)			
Share capital	24	1,500	1,500
General reserve fund	25	8,145	5,398
Proposed dividend		2,000	-
TOTAL EQUITY AND RESERVES		**11,645**	**6,898**
TOTAL LIABILITIES AND EQUITY		**226,603**	**175,333**

The financial statements set out on pages 81 to 100 were approved by the Board of Directors for issue on 17th October, 2006 and signed on its behalf by:



Ag. Governor

Director

The notes set out on pages 84 to 100 form an integral part of these financial statements.

CENTRAL BANK OF KENYA
STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED JUNE 30 2006

	Share capital KShs million	General reserve fund KShs million	Proposed dividend KShs million	Total KShs million
YEAR ENDED 30 JUNE 2005				
Balance at start of the year	1,500	9,532	4,500	15,532
Loss for the year	-	(4,134)	-	(4,134)
Dividends:				
- For 2004 paid	-	-	(2,500)	(2,500)
- 2004 Applied to amounts due from Government of Kenya (Note 18)	-	-	(2,000)	(2,000)
BALANCE AT THE END OF THE YEAR	**1,500**	**5,398**	**-**	**6,898**
YEAR ENDED 30 JUNE 2006				
Balance at start of the year	1,500	5,398	-	6,898
Profit for the year	-	4,747	-	4,747
Proposed dividend for 2006	-	(2,000)	2,000	-
BALANCE AT THE END OF THE YEAR	**1,500**	**8,145**	**2,000**	**11,645**

The notes set out on pages 84 to 100 form an integral part of these financial statements.

CENTRAL BANK OF KENYA
CASH FLOW STATEMENT
FOR THE YEAR ENDED JUNE 30 2006

	Note	2006 KShs million	2005 KShs million
OPERATING ACTIVITIES			
Net cash generated by operating activities	26 (a)	43,526	11,142
INVESTING ACTIVTIES			
Receipts from government loan		368	-
Purchase of property and equipment		(241)	(1,177)
Proceeds from disposal of property and equipment		10	9
Proceeds/(Investment) in International Monetary Fund-SDR accounts		37	(9)
NET CASH GENERATED/(UTILISED) FROM INVESTING		**174**	**(1,177)**
FINANCING ACTIVITIES			
Dividends paid		-	(2,500)
Increase in currency in circulation		8,885	4,701
NET CASH FROM FINANCING ACTIVITIES		**8,885**	**2,201**
Net increase in cash and cash equivalents		52,585	12,166
Cash and cash equivalents at start of year		114,106	101,940
CASH AND CASH EQUIVALENTS AT END OF YEAR	26(b)	**166,691**	**114,106**

The notes set out on pages 84 to 100 form an integral part of these financial statements.

NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 30 JUNE 2006

1 SIGNIFICANT ACCOUNTING POLICIES

The principal accounting policies adopted in the preparation of these financial statements are set out below:

(a) Basis of Preparation and Form of Presentation

Basis of Preparation

The financial statements are prepared in accordance with and comply with International Financial Reporting Standards (IFRS). The financial statements are presented in Kenya Shillings (KShs) and are prepared under the historical cost convention except for measurement at fair value of certain investments.

The preparation of financial statements in conformity with IFRS requires the use of estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Although these estimates are based on the directors' best knowledge of current events and actions, actual results ultimately may differ from those estimates. The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period, or in the period of the revision and future periods if the revision affects both current and future periods.

(b) Consolidation Principle

The financial statements include the operations of the Bank and its subsidiary, Kenya School of Monetary Studies, which is a company limited by guarantee and where Central Bank of Kenya has full control.

(c) Revenue Recognition

Income is recognised in the period in which it is earned. Income is not accrued if its recoverability is considered doubtful.

Interest income and expense are recognised in the income statement for all interest bearing instruments on an accrual basis using the effective yield method based on the actual purchase price. Interest income includes coupons earned on fixed income investment and trading securities and accrued discount and premium on treasury bills and other discounted instruments. When loans and advances become impaired, they are written down to their recoverable amounts.

Rental income from lease of property is recognised in the income statement on a straight-line basis over the term of the lease.

(d) Foreign Currency

(i) Translation of Foreign Currencies

Transactions in foreign currencies during the year are converted into Kenya Shillings at the exchange rate ruling at the date of the transaction. Foreign currency monetary assets and liabilities are translated at the exchange rate ruling at the balance sheet date. Resulting exchange differences are recognised in the income statement for the year.

(ii) Functional and Presentation Currencies

Items included in the financial statements of the Bank are measured using the Kenya Shilling which is the currency of the primary economic environment in which the Bank operates ("functional currency"). The financial statements are presented in Kenya Shillings.

(iii) Form of Presentation

In exceptional circumstances, as allowed by Section 36 of the Act, the Bank may act as the "lender of last resort" to financial institutions in difficulty in order to prevent a loss of confidence spreading through the financial system as a whole. In some cases, confidence can best be sustained if the Bank's support is disclosed only when the conditions giving rise to potential instability in the economy have improved. Although the financial effects of such operations are included in the financial statements of the Bank, these statements may not explicitly identify such support.

(e) Employee Benefits

(i) Retirement Benefits

The Bank's employees are eligible for retirement benefits under a defined benefit plan provided through a separate fund scheme administered by Trustees and funded by the Bank. Deposit Protection Fund Board, a related party, reimburses the Bank the costs of contributions relating to staff seconded to it by the Bank.

The Bank's net obligation in respect to the plan is calculated by estimating the amount of future benefits that employees have earned in return for their service in the current and prior periods; that benefit is discounted to determine the present value and the fair value of any plan assets is deducted. The calculation is performed by a qualified actuary using the Projected Unit Credit Method.

Where the calculation results in a benefit to the Bank, the recognised asset is limited to the net total of any unrecognised actuarial losses and past service costs and the present value of any future refunds from the plan or reduction in future contributions to the plan. Actuarial gains and losses are charged to the income statement over the remaining working lives of the employees participating in the scheme.
The Bank also makes contributions to a statutory pension scheme, the National Social Security Fund (NSSF). Contributions to the scheme are determined by statute and are shared between the employer and employee.

(ii) Other Employee Benefits

The Bank provides free medical treatment to staff and their dependants. Contracted staff are eligible to a gratuity based on the employment terms. A provision is made for the estimated liability of such gratuity payable and charged to the income statement. The estimated monetary liability for employees' accrued leave entitlement at the balance sheet date is recognised as an expense accrual.

(f) Property and Equipment

Property and equipment are stated at purchase price less accumulated depreciation and impairment losses.

Depreciation is charged to the Income Statement on a straight-line basis at the following rates:

Building improvements	10%
Motor vehicles, furniture and equipment	50%

The residual value, if not insignificant is reassessed annually.

(g) Financial Assets and Liabilities

Classification

A financial instrument is any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity.

The Bank classifies its financial assets in the following categories: financial assets at fair value through profit or loss, loans and advances, investments that are held to maturity, and financial assets that are available for sale. The Bank determines the classification of its investments at initial recognition.

(i) Financial Assets at Fair Value Through Profit or Loss

A financial asset is classified in this category if it is acquired principally for the purpose of selling in the short term or if so designated by management. Derivatives are classified as held at fair value through profit or loss. The Bank does not currently hold financial assets for trading.

(ii) Loans and Advances

Loans and advances are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They arise when the Bank provides money or services directly to counterparty with no intention of trading the receivable.

(iii) Held to Maturity

Investments classified as held to maturity are non-derivative financial assets with fixed or determinable payments and fixed maturities that the Bank's management has the intention and ability to hold to maturity. Were the Bank to sell other than an insignificant amount of such assets, the entire category would be reclassified as available for sale. The Bank currently classifies repurchase and reverse purchase instruments as held to maturity.

(iv) Available for Sale

These investments are those intended to be held for an indefinite period of time, which may be sold as part of the Bank's official operations or otherwise. The bank does not currently have any assets classified as available-for-sale.

A financial liability is any liability that is a contractual obligation to deliver cash (or another financial asset) to another entity or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavorable to the entity. The bank cannot settle in its own equity instruments.

(g) Financial Assets and Liabilities (continued)

Recognition and Measurement

Loans are recognized when cash is advanced to the borrowers. Purchases and sales of other financial assets are recognized on trade date, the date on which the Bank commits to purchase or sell the asset. Financial assets are initially recognized at fair value, plus transaction costs for financial assets not carried at fair value through the income statement. Financial assets are derecognized when the rights to receive cash flows from the financial assets have expired or where the Bank has transferred substantially all of the risks and rewards of ownership. Financial assets that are available for sale and financial assets at fair value through profit or loss are subsequently carried at fair value.

Loans and advances and investments that are held to maturity are carried at amortised cost using the effective interest method, less provision for impairment.

(h) Loans and Provisions for Loan Impairment

Loans are stated at outstanding amount less provision for impairment.

As the lender of last resort, the Bank may grant loans or advances for fixed periods not exceeding six months to commercial banks that pledge Government securities specified by the Bank.

In its capacity as the fiscal agent and banker to the Government, the Bank may make direct advances to the Government for the purpose of offsetting fluctuations between receipts from the budgeted revenue and the payments of the Government. The total amount of advances to the Government outstanding shall not exceed five percent of the gross recurrent revenue of the Government as shown in the Appropriation Accounts for the latest year for which those financial statements have been audited by the Controller and Auditor-General.

The Bank also operates a staff loans scheme for its employees for the provision of facilities such as house and car loans.

The Bank determines the terms and conditions for granting of the above loans with reference to the prevailing market interest rates and may determine different rates for different classes of transactions and maturities.

Specific provisions for loan impairment are made in respect of advances. The provisions are based on periodic evaluations of advances and take account of past loss experience, economic conditions and the estimated value of any underlying collateral, and are charged to the Income Statement.

When a loan is deemed uncollectible, it is written off against the related provision for impairment. Subsequent recoveries are credited to the income statement if previously written off.

(i) Dividends

Dividends are recognised as a liability in the period in which they are declared. Proposed dividends are disclosed as a separate component of equity until they are declared.

(j) Provisions

Provisions are recognised when the Bank has a present legal or constructive obligation as a result of past events and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate of the amount of the obligation can be made.

(k) Offsetting of Financial Assets and Liabilities

Financial assets and liabilities are offset and the net amount reported on the balance sheet when there is a legally enforceable right to set-off the recognised amount and there is an intention to settle on a net basis, or to realise the asset and settle the liability simultaneously.

(l) Impairment

The carrying amounts of the Bank's assets are reviewed at each balance sheet date to determine whether there is any indication of impairment. If such condition exists, the asset's recoverable amount is estimated and an impairment loss recognised whenever the carrying amount of an asset exceeds its recoverable amount. Impairment losses are recognised through the income statement.

(m) Operating Leases

Leases where a significant portion of the risks and rewards of ownership are retained by the lessor, are classified as operating leases. Payments made under operating leases are charged to the income statement on a straight-line basis over the period of the lease.

(n) Receivables

Amounts due from Government of Kenya and other assets are stated at their cost less impairment losses.

(o) Cash and Cash Equivalents

Cash and cash equivalents comprises of cash balances, bank deposits, current accounts, gold holding, government securities with maturity of upto 3 months from the date of issue.

(p) Comparatives

Where necessary, comparative figures have been adjusted or excluded to conform to changes in presentation in the current year.

	2006 KShs million	2005 KShs million
2 INTEREST INCOME		
Foreign investments earnings	5,372	3,299
Local investments earnings	1,506	1,672
Other interest earnings	65	62
	6,943	**5,033**
3 INTEREST EXPENSE		
Interest on monetary policy issues	991	323
Interest paid to International Monetary Fund	48	40
Interest on customer deposits	-	1
	1,039	**364**
4 FEES AND COMMISSION INCOME		
Commission on sale of government securities	4,967	3,782
Special projects agency fees	1	1
	4,968	**3,783**
5 NET FOREIGN EXCHANGE EXPENSES		
Gains on sale of foreign exchange	378	566
Foreign exchange translation loss	(487)	(3,637)
	(109)	**(3,071)**
6 OTHER OPERATING INCOME		
Rent received	14	15
Profit from disposal of property and equipment	10	9
Tuition fees and other charges	135	125
Miscellaneous income	96	35
	255	**184**
7 OPERATING EXPENSES		
Currency expenses	2,027	1,925
Depreciation	728	609
Property maintenance expenses	371	331
Auditors' remuneration	5	4
Banking expenses	3	4
Operating lease rentals	4	3
Staff costs	2,654	2,130
Other expenses	475	679
	6,267	**5,685**

	2006 KShs million	2005 KShs million

8 STAFF COSTS

The following items are included within staff costs:

Retirement benefit costs - defined benefit scheme (Note 15)	334	271

9 IMPAIRMENT LOSSES

	2006 KShs million	2005 KShs million
Losses and write-offs of loans	4	14
Impairment loss on amount due from Government of Kenya (Note 18)	-	4,000
	4	**4,014**

10 DIVIDENDS

The board of directors recommend the payment of Kshs 2 billion dividend in respect of the year ended 30 June 2006 (2005 –Nil).

11 BALANCES DUE FROM BANKING INSTITUTIONS AND GOLD HOLDINGS

	2006 KShs million	2005 KShs million
Current accounts	2,604	3,059
Term deposits	162,674	109,858
Domestic foreign currency cheque clearing	1,386	1,164
Foreign currency travellers cheques	5	2
Gold holdings	21	16
Cash and cash equivalents	166,690	114,099
Accrued interest on foreign investments	910	446
Special Drawing Rights	13	50
Total own resources	167,613	114,595
Special project accounts	5,384	5,162
	172,997	**119,757**

12 INVESTMENT IN GOVERNMENT SECURITIES

	2006 KShs million	2005 KShs million
Treasury bills	**1**	**7**

All the government securities held have a maturity date of within 90 days from the date of acquisition.

13 LOANS AND ADVANCES

	2006 KShs million	2005 KShs million
Advances to banks under liquidation	8,259	8,259
Government overdraft account (see below and Note 27)	5,202	5,225
Advances to employees (Note 27)	2,150	1,998
Overnight Advances to Commercial Banks	5	-
IMF funds on-lent to the Government (Note 27)	1,948	2,221
	17,564	17,703
Provision for loan impairment	(8,281)	(8,289)
Net Advances as at 30 June	**9,283**	**9,414**

Movement in the provision for loan impairment is as follows:

	2006 KShs million	2005 KShs million
At start of the year	(8,289)	(8,291)
Additional provisions made in the year	(2)	(13)
Recoveries in the year	10	15
At End of the Year	**(8,281)**	**(8,289)**

Section 46(3) of the Central Bank of Kenya Act sets the limit of the Government of Kenya's overdraft facility at 5% of the Gross Recurrent Revenue as reported in the latest audited financial statements. The limit stands at KShs 11,323,869,438.70 based on the Government financial statements for 2003/2004, which are the latest audited financial statements at the date of approval of these financial statements. The limit for the previous year was KShs 8,908,699,851 based on the Government financial statements for 2001/2002.

14 OTHER ASSETS

	2006 KShs million	2005 KShs million
Impersonal accounts	4,545	1,864
Sundry debtors	2,306	946
	6,851	**2,810**

15 RETIREMENT BENEFIT ASSET

The Bank's employees are eligible for retirement benefits under a defined benefit plan provided through a separate fund. The defined benefit plan is funded by the Bank and the Deposit Protection Fund Board, a related party. The retirement benefit asset is wholly recognised in the financial statements of the Bank while the Deposit Protection Fund Board recognises contributions to the fund as if it were a defined contribution scheme.

The amounts recognised in the balance sheet are determined on the basis of an actuarial review carried out by Alexander Forbes Financial Services Limited as at 30 June 2006.

	2006 KShs million	2005 KShs million
Present value of funded obligations	8,126	7,062
Fair value of plan assets	(9,260)	(8,075)
Present value of net asset	(1,134)	(1,013)
Unrecognised actuarial gain	740	535
Net Retirement Benefit Asset	**(394)**	**(478)**

The amounts recognised in the income statement are as follows:

	2006	2005
Current service costs	418	375
Interest costs	641	541
Expected return on plan assets	(725)	(645)
Total Expenses Included in Operating Expenses	**334**	**271**

Movements in the net asset recognised in the balance sheet are as follows:

	2006	2005
Net expense recognised in income statement	334	271
Employer contributions	(250)	(238)
Movement in the asset recognised in the balance sheet	84	33
Actual Return on Plan Assets	**1,235**	**899**

The principal actuarial assumptions at the balance sheet date were:

	2006	2005
Discount rate (p.a)	9%	9%
Salary increase (p.a)	7%	7%
Expected return on plan assets (p.a)	9%	9%
Future pension increases	0%	0%

16 PROPERTY AND EQUIPMENT

	Land and buildings KShs million	Motor vehicles KShs million	Furniture and equipment KShs million	Total KShs million
Cost				
At start of year	1,004	193	2,584	3,781
Adjustments	-	-	247	247
Additions	-	45	196	241
Disposals	-	(33)	(79)	(112)
At end of the year	1,004	205	2,948	4,157
Depreciation				
At start of the year	835	153	1,600	2,588
Adjustments	-	-	247	247
Charge for the year	86	21	621	728
On disposal	-	(33)	(79)	(112)
At end of the year	921	141	2,389	3,451
Net Book Value				
At 30 June 2006	**83**	**64**	**559**	**706**
At 30 June 2005	**169**	**40**	**984**	**1,193**

17 PREPAID OPERATING LEASE RENTALS

Operating lease rentals are carried at historical cost less amortisation over the period of the lease. The breakdown is as follows:

	2006 KShs million	2005 KShs million
Cost		
At beginning and end of the year	300	300
Amortisation		
At start of the year	11	8
Amortisation charge for the year	4	3
At end of year	15	11
Net Carrying Value at End of the Year	**285**	**289**

18 DUE FROM GOVERNMENT OF KENYA

Revaluation Account		
Gross amount Outstanding at the start of the year	15,642	16,642
Recovered through dividends payable	-	(1,000)
Gross Outstanding at the end of year	15,642	15,642
Impairment provision:		
Balance at the start of the year	(15,642)	(11,642)
Additions in the year	-	(4,000)
Impairment provision at the year end	(15,642)	(15,642)
Net at year end	-	-
Loan Due from Government		
At start of the year	35,917	36,917
Receipts during the year	(368)	-
Recovered through dividends payable	-	(1,000)
	35,549	**35,917**

The loan due from Government of Kenya arose from overdrawn accounts which were converted to a loan with effect from 1 July 1997 after an amendment to the Central Bank of Kenya Act Cap 491. The loan which stood at KShs 35,549 million at 30 June 2006 bears interest at the rate of 3% per annum from 1 July 2003. The repayment period is 36 years

	2006	**2005**
19 CURRENCY IN CIRCULATION	**KShs million**	**KShs million**
Kenya notes	73,089	64,416
Kenya coins	3,113	2,901
Commemorative coins	5	5
	76,207	**67,322**

20 DEPOSITS

Banks – Kenya	31,661	27,127
– External	20	19
Domestic forex cheques clearing	1,159	949
Non-bank financial institutions	119	113
Other public entities and project accounts	8,688	7,914
Government of Kenya	59,178	43,775
	100,824	**79,897**

21 INTERNATIONAL MONETARY FUND

Kenya has been a member of the International Monetary Fund (IMF) since 1966. The Central Bank of Kenya (CBK) is the designated depository for the IMF's holdings of Kenya's currency. IMF currency holdings are held in the No.1 and No.2 Accounts, which are deposit

	2006		2005	
	SDRs million	KShs million	SDR's million	KShs million
International Monetary Fund Account no.1	20	2,199	20	2,259
International Monetary Fund Account no.2	-	1	-	1
International Monetary Fund – PRGF Account	87	9,440	94	10,392
International Monetary Fund – On lent to Government of Kenya	18	1,948	20	2,221
	125	**13,588**	**134**	**14,873**
On a custodial basis, CBK holds a non-negotiable, non-interest bearing and encashable on demand security issued by the Treasury in IMF in its capacity as the IMF's depository.				
Security at 30th June, 2006	**238**	**24,947**	**238**	**27,690**

22 AMOUNTS REPAYABLE UNDER REPURCHASE AGREEMENTS

These are securities issued and utilised by the Bank for monetary policy purposes and are shown as a liability to the buyers.

23 OTHER LIABILITIES

	2006 KShs million	2005 KShs million
Sundry creditors	542	564
Refundable deposits	237	258
Development deposits	186	155
Amount pending litigation	32	32
	997	**1,009**

24 SHARE CAPITAL

Authorised share capital	**5,000**	**5,000**
Issued and fully paid	**1,500**	**1,500**

25 GENERAL RESERVE FUND

The general reserve fund is a reserve fund where at least 10% of the net annual profits of the Bank has been transferred at the end of each financial year. This is after allowing for expenses for operation and after provision has been made for bad and doubtful debts, depreciation in assets, contribution to staff benefit fund, and such other contingencies and accounting provisions as the Bank deems appropriate.

26 NOTES TO THE CASH FLOW STATEMENT

(a) Cash Flows from Operating Activities

	2006 KShs million	2005 KShs million
Profit/(loss) for the year	4,747	(4,134)
Adjustments for:		
Impairment losses on amount due from Government of Kenya	-	4,000
Depreciation	728	609
Amortization of prepaid operating leases	4	3
Decrease in defined benefit scheme asset	84	33
Gain on disposal of property and equipment	(10)	(9)
Operating profit before working capital changes	5,553	502
Net decrease in loans and advances	131	4,032
Increase/(Decrease) in amounts repayable under repurchase agreements	18,008	(810)
Increase in deposits	20,927	4,121
(Decrease)/Increase in balance with International Monetary Fund	(1,285)	4,243
(Increase)/Decrease in project accounts	(222)	2,415
Increase in accrued interest on balances due from banking institutions	(464)	(145)
Decrease/(Increase) in items in the course of collectio	4,931	(846)
Increase in other assets	(4,041)	(2,368)
Decrease in other liabilities	(12)	(2)
Net cash generated by operations	43,526	11,142

(b) Cash and Cash Equivalents

Cash and cash equivalents included in the cash flow statement comprise the following:

	2006 KShs million	2005 KShs million
Term deposits	162,674	109,858
Current accounts	2,604	3,059
Domestic forex cheques clearing	1,386	1,164
Travellers cheques	5	2
Gold holdings	21	16
	166,690	114,099
Investment in Government securities	1	7
	166,691	**114,106**

27 RELATED PARTY TRANSACTIONS

In the course of its operations, the Bank enters into transactions with related parties, which include the Government of Kenya, the ultimate owner of the Bank, and The Deposit Protection Fund Board. Unless otherwise stated, all transactions between these entities take place at arm's length.

(i) Loans

The Bank extends loan facilities to its members of staff, the Governor and the Deputy Governor. Loans and advances (Note 13) include advances to employees that as at 30 June 2006 amounted to KShs 2,150 million (2005 - KShs 1,998 million). The advances are at preferential rates of interest determined by the Bank.

	2006 KShs million	2005 KShs million
(ii) Loans to Executive Directors		
At start of the year	12	16
Loans advanced during the year	-	6
Loan repayments	(6)	(10)
At End of the Year	**6**	**12**
(iii) Director's Emoluments		
Fees to non executive directors	9	9
Remuneration to executive directors	41	36

(iv) Government of Kenya

Transactions entered into with the Government include:

(a) Banking services;
(b) Management of issue and redemption of securities at a commission and
(c) Foreign currency denominated debt settlement and other remittances at a fee.

As at the close of business on 30 June, the following balances, which are included in various balance sheet categories, were outstanding:

	2006 KShs million	2005 KShs million
Due from Government of Kenya (Note 18)	35,549	35,917
Overdraft account (Note 13)	5,202	5,225
IMF funds on-lent to the Government (Note 13)	1,948	2,221
Government of Kenya deposits (Note 20)	59,178	43,775
Investments in Government of Kenya securities (Note 12)	1	7

(v) Deposit Protection Fund Board

The Bank has a close working relationship with The Deposit Protection Fund Board, an entity incorporated under the Banking Act, and provides it with staff and office accommodation. Certain costs incurred on behalf of The Deposit Protection Fund Board are fully reimbursed to the Bank.

The balance outstanding from The Deposit Protection Fund Board and included in other assets as at year end was KShs 14 million (2005: KShs 4 million).

(vi) Kenya School of Monetary Studies

The Kenya School of Monetary Studies is a registered legal entity incorporated under the Companies Act as a company limited by guarantee and is wholly owned by the Bank. The School is operated as a department and results of its operations are incorporated in the financial statements of the Bank.

28 LIQUIDITY RISK

The table below analyses assets and liabilities into relevant maturity groupings based on the remaining period at 30 June 2006 to the contractual maturity date:

ASSETS	On demand KShs million	Due within 3 months KShs million	Due between 3-12 months KShs million	Due between 1-5yrs KShs million	Due after 5 years KShs million	Total KShs million
Balances due from banking institutions and gold holdings	10,310	162,674	-	-	13	172,997
Items in the course of collection	537	-	-	-	-	537
Investments in government securities	-	1	-	-	-	1
Loans and advances	5,207	118	746	1985	1,227	9,283
Other assets	-	6,851	-	-	-	6,851
Property and equipment	-	177	529	-	-	706
Prepaid operating leave rentals	-	1	3	16	265	285
Retirement benefit asset	-	-	-	-	394	394
Due from Government of Kenya	-	-	-	5,000	30,549	35,549
TOTAL ASSETS	16,054	169,822	1,278	7,001	32,448	226,603
LIABILITIES						
Currency in circulation	-	-	-	-	76,207	76,207
Deposits	100,824	-	-	-	-	100,824
International Monetary Fund	-	-	413	1,535	11,640	13,588
Amounts repayable under repurchase agreements	-	23,342	-	-	-	23,342
Other liabilities	-	997	-	-	-	997
Equity and reserves	-	-	-	-	11,645	11,645
TOTAL LIABILITIES AND EQUITY	100,824	24,339	413	1535	99,492	226,603
Liquidity Gap at 30 June 2006	**(84,770)**	**145,483**	**865**	**5,466**	**(67,044)**	**-**
As at 30 June 2005:						
Total Assets	20,542	113,220	333	6,808	34,430	175,333
Total Liabilities and Equity	147,219	6,343	413	1,808	19,550	175,333
Liquidity Gap at 30 June 2005	**(126,677)**	**106,877**	**(80)**	**5,000**	**14,880**	**-**

29 INTEREST RATE RISK

This table shows the extent to which the Bank's interest rate exposures on assets and liabilities are matched. Items are allocated to time bands by reference to the earlier of the next contractual interest rate repricing date and maturity date:

As at 30 June 2006	3 months or less KShs million	Between 3-12 months KShs million	Over 1 year KShs million	Non- interest bearing KShs million	Total KShs million
Assets					
Balances due from banking institutions and gold holdings	167,613	-	-	5,384	172,997
Items in the course of collection	-	-	-	537	537
Investment in government securities	1	-	-	-	1
Loans and advances	5,325	746	3,212	-	9,283
Other assets	-	-	-	6,851	6,851
Property and equipment	-	-	-	706	706
Prepaid operating leave rentals	-	-	-	285	285
Retirement benefit asset	-	-	-	394	394
Due from Government of Kenya	-	1,000	34,549	-	35,549
Total Assets	172,939	1,746	37,761	14,157	226,603
Liabilities and Equity					
Currency in circulation	-	-	-	76,207	76,207
Deposits	100,824	-	-	-	100,824
International Monetary Fund	-	-	-	13,588	13,588
Amounts repayable under repurchase agreements	23,342	-	-	-	23,342
Other liabilities	-	-	-	997	997
Equity and reserves	-	-	-	11,645	11,645
Total Liabilities and Equity	124,166	-	-	102,437	226,603
Interest Sensitivity Gap at 30 June 2006	**48,773**	**1,746**	**37,761**	**(88,280)**	**-**
As at 30 June 2005					
Total assets	112,714	405	39,509	19,086	171,714
Total liabilities and equity	6,144	1,186	6,838	157,546	171,714
Interest Sensitivity Gap at 30 June 2005	**106,570**	**(781)**	**32,671**	**(138,460)**	**-**

30 CURRENCY RISK

The various currencies to which the bank is exposed at 30 June 2006 are summarised in the below (all expressed in KShs million):

2006	USD	GBP	EURO	SDR	GOLD	OTHER	TOTAL
Assets							
Balances due from banking institutions	87,980	58,568	26,362	-	-	53	172,963
Special Drawing Rights	-	-	-	13	-	-	13
Gold holdings	-	-	-	-	21	-	21
Total assets	87,980	58,568	26,362	13	21	53	172,997
Liabilities							
Balances due to IMF	-	-	-	13,588	-	-	13,588
Commissions for EEC Development Fund	-	186	-	-	-	-	186
Forex bureaux/Banks deposits	973	222	216	-	-	-	1,411
Total liabilities	973	408	216	13,588	-	-	15,185
Net Foreign Currency Position as at June2006	**87,007**	**58,160**	**26,146**	**(13,575)**	**21**	**53**	**157,812**
2005							
Total assets	42,591	46,198	30,867	50	16	35	119,757
Total liabilities	783	342	231	14,873	-	-	16,229
Net Foreign Currency Position at 30 June 2005	**41,808**	**45,856**	**30,636**	**(14,823)**	**16**	**35**	**103,528**

31 FAIR VALUES AND EFFECTIVE INTEREST RATES OF FINANCIAL ASSETS AND LIABILITIES

In the opinion of the directors, the fair values of the Bank's financial assets and liabilities approximate their respective carrying amounts. Fair values are based on discounted cash flows using a discount rate based on the borrowing rate that directors expect would be available to the Bank at the balance sheet date.

The effective interest rates for the principal financial assets and liabilities at 30 June 2006 and 2004 were in the following ranges:

	2006	**2005**
Assets		
Government securities	6.20%	4.90%
Deposits with overseas correspondent banks		
– current accounts	0.00%	0.00%
– term deposits (USD)	5.10%	2.20%
– term deposits (Pounds Sterling)	4.60%	4.80%
– term deposits (Euro)	2.90%	2.00%
Loans and advances – Commercial banks	9.75%	9.20%
– Government of Kenya	9.75%	6.20%
– Employees	3.00%	3.00%
Due from Government of Kenya	3.00%	3.00%
Liabilities		
Customer deposits	0%	0%

32 CONTINGENCIES AND COMMITMENTS

Contingencies

The Bank is party to various legal proceedings amounting to KShs 447 million at 30 June 2006 (2005 – KShs 532 million). Having regard to the legal advice received, and in all circumstances, the directors are of the opinion that these legal proceedings will not give rise to liabilities, which in aggregate, would otherwise have material effect on these financial statements.

Commitments	**2006 KShs million**	**2005 KShs million**
Contracted for	163	106
Authorised but not contracted for	-	42

33 TAXATION

No provision for tax is made as Section 7 of the Income Tax Act (Cap.470) exempts the Bank from any taxation imposed by law in respect of income or profits. This exemption includes stamp duty in respect of instruments executed by or on behalf of the Bank.