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LETTER OF TRANSMITTAL

In accordance with Section 54 of the Central Bank of Kenya Act, it is my honour to present to you, Honourable Minister, the Annual Report of the CBK for the Financial Year 2007/08. The Annaul report contains economic and financial developments and the Audited Accounts of the CBK for the Financial Year ended June 30, 2008.

Njuguna Ndung'u

Governor

PREFACE

During the first half of the fiscal year 2007/08, all key sectors of the economy improved their performance. During this period the economy which grew by 6.4 percent in 2006, improved further to grow by 7.0 percent in 2007. Improved production in the transport and communications, building and construction and tourism sectors contributed to the good performance. However, in the second half of 2007/08, the performance of the economy declined following the post election crisis, unfavourable weather conditions and high costs of production due to high international crude oil prices.

Monetary policy remained focused on maintaining price stability. Overall inflation was, however, negatively affected by rising international oil and food prices and the post election crisis that created distributional constraints early in the year 2008. Consequently, the monetary policy objective of maintaining underlying inflation at 5 percent was not realised during the fiscal year 2007/08.

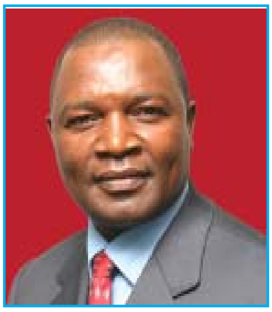
The performance in the banking sector remained strong in the year. Non performing loans generally maintained a downward trend with minimal reversals during the months of the post election crisis. Gross loans and advances increased leading to better asset quality and improved profitability.

The Central Bank of Kenya continued to be actively involved in serveral regional integration initiatives particularly those relating to monetary integration. The Bank participated in the implementation of monetary co-operation programmes of the East African Community (EAC), Common Market for Eastern and Southern Africa (COMESA) and the Association of African Central Banks (AACB).

The operationalization of the Micro-finance Act in May 2008, is expected to lead to orderly growth and development of the microfinance industry, which continues to meet the needs of the increasing number of un-banked and under-served segment of the Kenyan population.

Although the economy suffered major setbacks in the months following the December, 2007 elections, some sectors such as tourism have started recovering. The outlook for the fiscal year 2008/09 is therefore positive, supported by growth enhancing policies being implemented by the Coalition Government. It is also expected that the transient inflationary pressures caused by effects of the post election crisis and high international prices will soon dissipate and subsequently unlock any postponed investment ventures.

BOARD OF DIRECTORS



NJUGUNA NDUNG'U
Governor and Chairman
Central Bank of Kenya

JOSEPH M. KINYUA
Permanent Secretary,
Ministry of Finance

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

WILLIAM O. OGARA

NICHOLAS A. NESBITT

AGNES WANJIRU KAMIRI

WANZA KIOKO

JOSEPH K. WAIGURU

SENIOR MANAGEMENT

JONES M. NZOMO
Director, Human Resources & Services Department

ELIZABETH C.A. OMOLO (Ms)
Executive Director, Kenya School of Monetary Studies

JONATHAN A. BETT
Director, Finance, Resource Planning & Strategic Management

KENNEDY ABUGA
Director, Governor's Office

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

ROSE A. DETHO
Director, Bank Supervision Department

SENIOR MANAGEMENT

GERALD A. NYAOMA
Director, Banking, NPS,External Payments & Reserve Management

JACKSON M. KITILI
Director, Monetary Operations and Debt Management

CHARLES O. MARANGA
Director, Human Resources (Perfomance Management Systems)

DANIEL M. CHEGE
Director, Currency Operations and Branch Administration

WILLIAM NYAGAKA
Director, Internal Audit & Risk Management

BANK REORGANISATION

The following new appointments to the Central Bank Senior Management Team were effected during the year:

Appointed	Position	Date
Daniel Macharia Chege	Director, Currency Operations	11.08.2007
William Nyagaka	Director, Internal Audit & Risk Mgt.	26.11.2007
Kennedy Abuga	Director, Governors Office	07.04.2008
Prof. Kinandu Muragu	Executive Director, KSMS	02.05.2008

The following members of the Central Bank Senior Management Team retired during the year:

Retired

Edwin Luke Ogola
Nicholas Maina Kiritu
John Macharia Gikonyo
Charles Onami Maranga
Ms Elizabeth Christine Adhiambo Omolo

DEPARTMENTAL RESTRUCTURING

The Bank continued restructuring departments and divisions as part of a wider strategy to achieve better efficiency and effectiveness in service delivery. The following changes were effected during the year:

Human Resources and Services Department

Effective 5th February, 2008 the Staff Clinics Division was brought under Director, Human Resources & Services Department.

Finance, Resource Planning, Strategic Management & IMS Department

The Information Security Office (ISO) was established within IMS Division. Effective 4th April, 2008 the IMS Division was brought under Director, Finance, Resource Planning & Strategic Management Department.

Kenya School of Monetary Studies Research Centre

A Research Centre was established at KSMS to generate frontier ideas for the Eastern and Southern African region through research and dissemination on policy relevant issues on economic development and financial management to solve the myriad of challenges facing Kenya and the region.

An Internal Audit Unit was established at KSMS to appraise the School's processes, procedures and systems and advise on the adequacy and effectiveness of the internal controls. The Unit will also conduct Risk Management and Business Continuity Planning (BCP) for the School.

CBK Charity Fund Management Committee

Mr. Jackson Kitili was appointed the Chairman of the Fund to replace Mr. Lawrence Kungu who retired.

Regional Games

Central Bank of Kenya successfully hosted regional games between National Bank of Rwanda and CBK on 20th -21st October, 2007 at KSMS.

Bank Policy on Official Travel

The Bank approved policy on official travel aimed at availing the most cost effective travel arrangements to members of staff effective 26th October, 2007.

Donations for Internally Displaced Persons

The Board of Directors, members of staff and CBK Charity Fund Management Committee donated Ksh 11 million towards the Presidential Fund for Internally Displaced Persons.

CBK Staff Benevolent Fund (SBF)

CBK Staff Benevolent Fund (SBF) which handles personal welfare funds on behalf of staff held its Annual General Meeting on 17th May, 2008 at CBK Head Office 6th Floor Conference Hall.

OVERVIEW

Kenya's economy grew by 7.0 percent in 2007 compared with 6.4 percent in 2006. This was mainly attributed to the economy's buoyancy, improved business confidence, a stable macroeconomic environment and a rebound of the global economy in the first half of fiscal year 2007/2008. Transport and communication, building and construction and tourism contributed to this performance. However, in the second half of the fiscal year, the performance of the economy declined following post election crisis and unfavourable weather conditions. The worst hit sectors during this period were agriculture and tourism.

Agricultural sector slowed down to grow by 2.3 percent in 2007, compared with 4.4 percent in 2006, as a result of the delay in the long rains. Tea and coffee output declined by 12.5 percent and 21.7 percent, respectively, while horticultural output and sugarcane deliveries increased by 23.1 percent and 5.6 percent, respectively, during the same period.

Growth in the manufacturing sector declined from 6.3 percent in 2006 to 6.2 percent in 2007. The growth during the period was mainly driven by improvements in the manufacture of beverages, cement, coffee and cigarettes as well as increased exports of manufactured goods to regional markets.

Building and construction sector sustained impressive growth, of 6.9 percent in 2007 compared with 6.3 percent in 2006. As a result, cement consumption increased by 24.2 percent, from 1,858,133 tonnes in 2006/07 to 2,308,289 tonnes in 2007/08.

Transport and communication sector also achieved a remarkable growth of 14.9 percent in 2007 compared with 11.4 percent in 2006, with the telecommunications sub-sector being the main driver. The mobile phone industry expanded its subscription base by 4.1 million, mainly boosted by money transfer services through mobile phones.

Tourism sector continued the upward momentum in 2007 by registering a 16.3 percent growth in 2007 compared with 14.9 percent in 2006. However, in the second half of 2007/2008, the sector suffered a major blow as a result of the post election crisis.

Although, there was improved performance in revenue receipts in the fiscal year 2007/2008, Government budgetary operations during the period resulted in an increased budget deficit of Ksh 87.5 billion or 4.3 percent of GDP on commitment basis compared with Ksh 31.0 billion or 1.8 percent of GDP in the fiscal year 2006/07.

Despite the rise in the stock of debt during the fiscal year 2007/08, the percentage of overall debt stock to GDP decreased from 46.7 percent in June 2007 to 42.3 percent in June 2008. External debt to GDP ratio dropped from 23.1 percent to 21.1 percent while domestic debt to GDP ratio fell from 23.6 percent to 21.2 percent during the period. The drop in the debt to GPD ratio during the period was attributed mainly to faster growth in GDP in the first half of the 2007/08 fiscal year.

The overall performance of the banking sector remained strong during the year, due mainly to stringent supervision and diversification of financial products. Non-performing loans continued to decline while loans and advances increased resulting to better asset quality and improved profitability.

Monetary policy for the fiscal year 2007/08 was directed towards achieving and maintaining inflation at 5 percent. Due to stronger accumulation of foreign exchange reserves and the need to adjust to the distubances to the economy following the post election crisis, the Central Bank revised the path for money supply and reserve money growth from 15 percent and 14 percent to 16.9 percent and 18.2 percent, respectively.

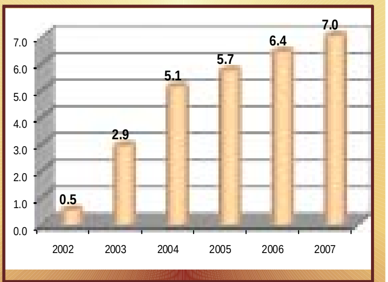
Inflation ended up higher during the last half of the fiscal year 2007/2008 than similar period last year. In particular, the average annual overall inflation declined from 10.4 percent in the year to June 2007 to 9.8 percent in the year to December 2007, before rising to 18.5 percent in the year ending June 2008. Similar upward trends were observed for the 12-month overall inflation that increased from 13.6 percent in July 2007 to 29.3 percent in June 2008. The annual average underlying inflation was 7.6 percent in June 2008 which was above the 5 percent objective. The increase was mainly due to supply shocks emanating from adverse climatic conditions which affected food supplies, sharp increases in international crude oil prices and the effects of post-election crisis.

Short term interest rates ended up higher in June, 2008 than in June 2007. The average interest rate on the 91-day Treasury bill increased from 6.53 percent in June 2007 to 7.73 percent in June 2008, while that for the 182-day Treasury bill rose from 7.19 percent in June 2007 to 8.84 percent in June 2008. The lending and deposit rates were also higher, averaging 13.1 percent and 4.18 percent, respectively in June 2007, and rising to an average of 14.1 percent and 4.48 percent, respectively in June 2008. The Central Bank Rate (CBR) was reviewed from 8.75 to 9 percent in June, 2008.

Kenya's balance of payments surplus resulted in a build up of gross foreign assets of the banking system from US$ 3,767 million at the end of June 2007 to US$ 5,786 million at end of June 2008. Of this, gross official foreign exchange reserves held by the CBK amounted to US$ 3,445 million (equivalent to 4.5 months of imports) at the end of June 2008, compared with US$ 2,723 million (4.3 months of imports) at the end of June 2007.

The Kenya shilling had mixed performance against major world currencies in the 2007/2008 fiscal year. Against the US dollar, the shilling appreciated to an average of Ksh 63.8 per US dollar in June 2008 compared with Ksh 66.6 per US dollar in June 2007. Against the East African Community member states, the Kenya shilling gained by 0.7 percent against the Uganda shilling to exchange at Ush 25.1 per Kenya shilling in June 2008, but depreciated by 1.7 percent against the Tanzanian shilling to exchange at Tsh 18.6 per Kenya shilling in June 2008.

CHART 1A: REAL GDP GROWTH RATES, 2002 - 2007 (%)



Sources: Economic Survey & Central Bank of Kenya

The economy continued on an upward momentum in 2007, with 7.0 percent growth in real Gross Domestic Product (GDP) compared with 6.4 percent in 2006. This was mainly attributed to the economy's buoyancy, improved business confidence, stable macroeconomic conditions and a rebound of the global economy. There were remarkable improvements in transport and communications, mining and quarrying, electricity and water, and tourism sectors.

TABLE 1.1: REAL GROSS DOMESTIC PRODUCT AND RELATED AGGREGATES

	Share in 2007	Kshs Million				
MAIN SECTORS	Real GDP (%)	2003	2004	2005	2006	2007
Agriculture, Forestry & Fishing	***23.95***	276,089	280,518	299,749	312,820	319,894
Mining	***0.47***	5,213	5,195	5,334	5,554	6,272
Manufacturing	***9.78***	105,822	110,544	115,698	122,953	130,637
Electricity and water supply	***2.25***	27,074	27,877	27,862	27,475	29,999
Wholesale and retail trade, repairs	***9.88***	92,604	100,486	106,091	118,363	131,948
Hotels & Restaurants	***1.56***	9,899	13,741	15,572	17,894	20,814
Construction	***3.01***	31,530	32,932	35,401	37,648	40,229
Transport, Storage & Communications	***11.71***	104,915	112,260	122,316	136,206	156,458
Financial intermediation	***3.69***	42,064	42,657	43,826	46,256	49,240
Real estate, renting and business services	***5.31***	61,864	63,740	65,882	68,421	70,902
Public administration and defense	***3.35***	46,991	47,062	46,460	45,722	44,788
Education	***5.63***	71,045	72,268	72,813	73,409	75,240
Health and social work	***2.19***	25,431	26,408	27,249	28,146	29,247
Other community, social and personal services	***3.72***	42,917	44,514	45,829	47,856	49,694
Private households with employed persons	***0.31***	3,855	3,932	4,011	4,091	4,173
Less : Financial services indirectly measured	***(0.90)***	(10,315)	(10,801)	(11,261)	(11,835)	(12,066)
Total GDP at basic 2001 prices	***86.40***	941,763	978,565	1,028,584	1,087,229	1,154,058
Taxes less subsidies on products	***13.60***	113,895	130,795	145,143	161,604	181,705
Real GDP at 2001 market prices	***100.00***	1,055,658	1,109,373	1,173,727	1,248,833	1,335,763
GDP at Mkt Prices		1,055,658	1,109,373	1,173,727	1,248,833	1,335,763
Overall GDP Deflator		107	115	121	130	136
	Share in Real GDP in 2007 (%)	2003	2004	2005	2006	2007
Agriculture, Forestry & Fishing	24.44	0.7	1.6	6.9	4.4	2.3
Mining & Quarrying	0.47	3.5	-0.3	2.7	4.1	12.9
Manufacturing	9.78	6.0	4.5	4.7	6.3	6.2
Electricity and water supply	2.25	14.0	3.0	-0.1	-1.4	9.2
Wholesale and retail trade, repairs	9.88	1.5	8.5	5.6	11.6	11.5
Hotels & Restaurants	1.56	-20.3	38.8	13.3	14.9	16.3
Building & Construction	3.01	1.0	4.4	7.5	6.3	6.9
Transport & Communications	11.71	3.5	7.0	9.0	11.4	14.9
Financial intermediation	3.69	1.5	1.4	2.7	5.5	6.5
Real estate, renting and business services	5.31	2.3	3.0	3.4	3.9	3.6
Public administration and defense	*3.35*	0.6	0.2	-1.3	-1.6	-2.0
Education	*5.63*	9.7	1.7	0.8	0.8	2.5
Health and social work	*2.19*	2.8	3.8	3.2	3.3	3.9
Other community, social and personal services	*3.72*	-0.0	3.7	3.0	4.4	3.8
Private households with employed persons	*0.31*	2.0	2.0	2.0	2.0	2.0
Less : Financial services indirectly measured	*(0.90)*	-3.3	4.7	4.3	5.1	2.0
Total GDP at basic 2001 prices	***86.40***	3.1	3.9	5.1	5.7	6.1
Taxes less subsidies on products	*13.60*	1.3	14.8	11.0	11.3	12.4
Real GDP at 2001 market prices	***100.00***	2.9	5.1	5.8	6.4	7.0

Sources: Economic Survey 2008

AGRICULTURE

The agricultural sector slowed down in 2007 to 2.3 percent growth, compared with 4.4 percent in 2006. There were mixed performances in the first half of 2007 as a result of unfavourable weather conditions coupled with disruptions of agricultural activities by the post election crisis that adversely affected agricultural output.

TABLE 1.2: OUTPUT GROWTH IN KEY CROPS

PRODUCT	Jun 2004/05	Jun 2005/06	Jun 2006/07	Jun 2007/08
Tea				
Output (MT)	321,440	295,791	375,226	328,216
Output Growth %	*-1.78%*	*-7.98%*	*26.81%*	*-12.53%*
Horticulture				
Output (MT)	160,729	162,099	167,959	206,719
Output Growth %	*17.25%*	*0.85%*	*6.24%*	*23.08%*
Coffee				
Output (MT)	51,436	47,995	50,899	39,842
Output Growth %	*13.03%*	*-6.14%*	*6.05%*	*-21.72%*
Sugarcane				
Output (MT)	4,751,432	4,953,329	4,953,167	5,228,645
Output Growth %	*4.45%*	*4.25%*	*0.00%*	*5.56%*

Sources: Kenya National Bureau of Statistics, Horticultural Crop Development Authority, Tea and Coffee Boards and Sugar Boards

As shown in Table 1.2, tea output declined by 12.53 percent, from 375,226 metric tonnes in 2006/07 to 328,216 metric tonnes in 2007/08. This was attributed to drier weather conditions and displacement of labour following the post election crisis in tea growing areas, especially in the first quarter of 2007.

Coffee output declined in the year 2007/08, with production falling by 21.72 percent, from 50,899 metric tonnes in 2006/07 to 39,842 metric tonnes during the review period.

The horticultural sub-sector realized a remarkable growth of 23.1 percent in the year 2007/08, with horticultural output increasing from 167,959 metric tonnes in 2006/07 to 206,719 metric tonnes in 2007/08. Most of the growth was in fruits and vegetables, whose export volumes grew by 20.0 percent and 43.9 percent, respectively, during the year 2007/08. Output of flowers also increased by 8.2 percent in 2007/08 compared with 6.9 percent in 2006/07.

Sugarcane deliveries to factories increased by 5.6 percent, from 4,953,167 metric tonnes in 2006/07 to 5,228,645 metric tonnes in 2007/08. Processed sugar output also increased by 11.3 percent in 2007/08, from 474,944 metric tonnes in 2006/07 to 528,399 metric tonnes. Total sales of sugar during the period also increased by 1.8 percent, from 431,736 metric tonnes in 2006/07 to 439,430 metric tonnes in 2007/08.

The Government has continued to implement a wide range of structural reforms aimed at improving efficiency and productivity in the agricultural sector. In 2007/08, the Government increased its budgetary allocation to this sector and deepened reforms in the co-operative sector so as to improve governance and encourage growth to support farmers.

MANUFACTURING

Manufacturing output, grew by 6.2 percent in 2007 compared with 6.3 percent in 2006. The growth in the sector was mainly attributed to opening up of new processing plants, diversification of products and a construction boom that led to increase in cement production. The improved performance in the sector was driven by growth in the manufacture of beverages, cement, coffee and cigarettes as well as increased exports of manufactured goods to regional markets.

Sugar production increased by 11.3 percent in 2007/08, from 474,944 metric tonnes to 528,399 metric tonnes in 2007/08, while cement production increased by 11.2 percent, from 2,371 metric tonnes to 2,637 metric tonnes as shown in Table 1.3. Soda ash output increased from 385,756 metric tonnes in 2006/07 to 439,958 metric tonnes in 2007/08, representing a 14.1 percent growth, while beer production increased by 16.1 percent, from 328,345 metric tones to 381,164 metric tonnes during the period. Similarly, cigarette output increased by 13.5 percent in 2007/08. However, milk production declined by 1.2 percent, from 402,009 million litres in 2006/07 to 397,209 million litres in 2007/08.

In order to enhance competitiveness through production of high quality manufactured goods, the Government also introduced tough administrative and legislative measures in 2007/08, against trading in counterfeit and substandard goods.

TABLE 1.3: PRODUCTION OF SELECTED MANUFACTURED GOODS

PRODUCT	Jun 2003/04	Jun 2004/05	Jun 2005/06	Jun 2006/07	Jun 2007/08
Processed Sugar					
Output (MT)	509,245	507,306	504,589	474,944	528,399.00
Output Growth %	*13.15%*	*-0.38%*	*-0.54%*	*-5.88%*	*11.26%*
Cement Production					
Output (MT)	1,691,483	1,975,464	2,104,918	2,370.98	2,636.93
Output Growth %	*3.18%*	*16.79%*	*6.60%*	*12.64%*	*11.22%*
Soda Ash					
Output (MT)	355,540	357,521	364,760	385,756	439,958
Output Growth %	*6.98%*	*0.56%*	*2.02%*	*5.76%*	*14.05%*
Milk					
Output ('000 litres)	241,279	284,144	351,609	402,009	397,209
Output Growth %	*35.01%*	*17.77%*	*23.74%*	*14.33%*	*-1.20%*
Beer					
Output ('000 litres)	212,430	257,124	278,905	328,345	381,164
Output Growth %	*9.96%*	*21.04%*	*8.47%*	*17.73%*	*16.09%*
Cigarettes					
Output (Number of sticks)	8,590,015	10,052,423	12,048,634	13,280,558	15,075,078
Output Growth %	*20.34%*	*17.02%*	*19.86%*	*10.22%*	*13.51%*

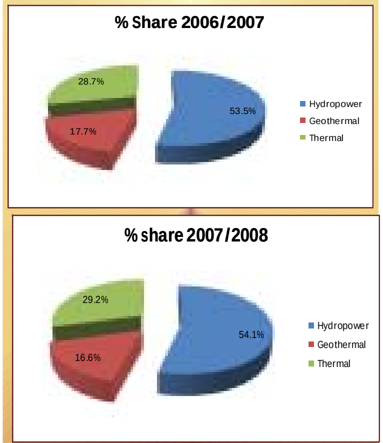
Sources: Kenya National Bureau of Statistics, Sugar Board, Dairy Board, Kenya Revenue Authority and Magadi Soda

ENERGY SECTOR DEVELOPMENTS

Electricity generation declined by 0.5 percent in 2007/08, from 6,098.6 million Kilowatt Hours (KWH) in the previous fiscal year to 6,066.5 million KWH. This was mainly as a result of a 12.6 percent decline in the thermal generation, from 1,782.9 million KWH in 2006/07 to 1,558 million KWH. In contrast, hydropower generation increased by 5.7 percent in 2007/08 due to adequate rainfall in areas where hydro electricity generation plants are situtated. Geothermal power generation also increased by 0.6 percent, from 1,014.9 million KWH in 2006/07 to 1,020.5 million KWH. Electricity consumption, increased by 5.6 percent in 2007/08, reflecting increased economic activity (Table 1.4).

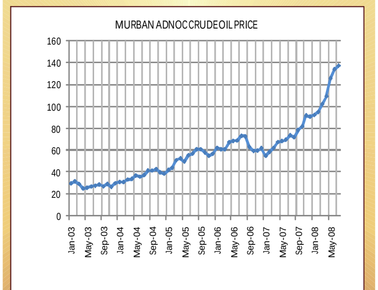
International crude oil prices escalated in response to strong demand from emerging economies like China and India,as well as instability in the oil producing nations. International prices for Murban Adnoc crude oil, the main crude oil imported into Kenya, increased from US$ 69.7 per barrel in June 2007 to US$ 134 per barrel in June 2008, a 92.3 percent increase, leading to high and volatile domestic prices.

CHART 1B: PERCENTAGE SHARE OF ELECTRICITY SOURCES



Source: Kenya Power & Lighting

CHART 1C: SAUDI ARABIAN CRUDE OIL



Source: Ministry of Energy

TABLE 1.4: PERFORMANCE OF MAJOR SUB-SECTORS

	2004/2005	2005/2006	2006/2007	2007/2008
Electricity Supply (Generation)				
Output (KWH Millions)	5,246.20	5,654.00	6,098.60	6,066.50
Growth %	*7.9%*	*7.8%*	*7.9%*	*-0.5%*
Of which:				
Hydro-power Generation (KWH Millions)	2,867.80	3,025.30	3,300.10	3,488.10
Growth (%)	*-12.0%*	*5.5%*	*9.1%*	*5.7%*
Geo-Thermal Generation (KWH Millions)	1,034.30	1,003.40	1,014.90	1,020.50
Growth (%)	*31.3%*	*-3.0%*	*1.1%*	*0.6%*
Thermal (KWH Millions)	1,344.00	1,625.30	1,782.90	1,558.00
Growth (%)	*64.5%*	*20.9%*	*9.7%*	*-12.6%*
Consumption of electricity (KWH Millions)	4,351.40	4,618.20	4,969.90	5,242.90
Growth %	*7.0%*	*5.8%*	*7.8%*	*5.6%*
Consumption of Fuels (Metric Tonnes)	2,549	2,742	3,002	2,939
Growth %	*13.2%*	*7.6%*	*9.5%*	*-2.1%*

Sources: Kenya National Bureau of Statistics

BUILDING AND CONSTRUCTION

The building and construction sector sustained an impressive 6.9 percent growth in 2007, compared with 6.3 percent in 2006. This followed a boom in the housing sector mainly as a result of attractive interest rates. Cement consumption, a major input in the construction industry, increased by 24.2 percent, from 1,858,133 tonnes in 2006/07 to 2,308,289 tonnes in 2007/08. This was partly due to an increase in the budgetary allocation to roads in the 2007/08 budget, for the rehabilitation and construction of new road networks and completion of those in progress.

TRANSPORT AND COMMUNICATION

Transport

The performance in the Transport and communication sector is shown in Table 1.5. Cargo transported by the Kenya Pipeline Company (KPC) declined by 1.6 percent from 3,963,076 cubic metres in 2006/07 to 3,899,804 cubic metres in 2007/08. Over the same period, the volume of cargo throughput handled by Kenya Ports Authority (KPA) increased by 7.2 percent from 15,198,435 metric tonnes in 2006/07 to 16,290,399 metric tonnes in 2007/08.

New registration of motor vehicles increased from 68,257 units in 2006/07 to 96,127 units in 2007/08. The transport sub-sector also experienced increased road transport activities boosted by the thriving tourism industry.

Telecommunications

The telecommunications sub-sector was the main driver of the transport and communications sector. The mobile phone industry expanded its subscription base by 4.1 million to 11.4 million in 2008. The introduction of money transfer services through the mobile phones boosted the growth of this industry. Consequently, excise duty on airtime services, increased by 19.4 percent from Ksh 5.36 billion in 2006/07 to Ksh 6.4 billion in 2007/08.

TABLE 1.5: PERFORMANCE OF MAJOR SUB-SECTORS

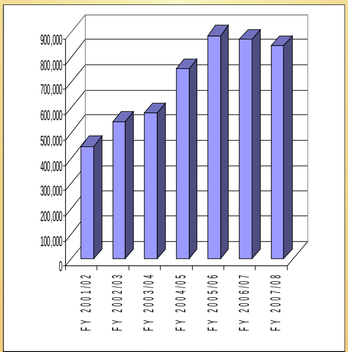
Activity	Jun 2003/04	Jun 2004/05	Jun 2005/06	Jun 2006/07	Jun 2007/08
Cargo by KPA					
Output (MT)	12,505,385	13,284,921	13,524,051	15,198,435	16,290,399
Output Growth %	*9.09%*	*6.23%*	*1.28%*	*12.38%*	*7.18%*
Throughput by Kenya Pipeline					
Output ('000 litres Equivalent)	3,093,366	3,459,298	3,627,232	3,963,076	3,899,804
Output Growth %	*9.69%*	*11.83%*	*4.90%*	*9.26%*	*-1.60%*
Excise duty on Airtime					
Output (Ksh Million)	2,068	2,982	3,963	5,360	6,397
Growth %	*205.47%*	*44.20%*	*32.90%*	*35.25%*	*19.36%*

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

TOURISM

The tourism sector maintained an upward trend in 2007, realising a 16.3 percent growth in 2007 compared with 14.9 percent in 2006. This was attributed to aggressive marketing in the traditional markets and in the Far East. However, in the first half of 2008, the tourism sector suffered a major blow as a result of the post election violence. This led to negative effects in the tourism industry, and as a result, there was an average decline of 15.9 percent in 2007/08 as shown in Table 1.6.

CHART 1D: TOURIST ARRIVALS



Source: Kenya Tourist Board

TABLE 1.6: TOURIST ARRIVALS BY POINT OF ENTRY

	FY 2004/05	FY 2005/06	FY 2006/07	FY 2007/08
Cruise ships	5,615	6,161	5,849	3,531
Output Growth %	*172.18%*	*9.72%*	*-5.06%*	*-39.63%*
JKIA	553,437	637,545	731,252	667,640
Output Growth %	*33.98%*	*15.20%*	*14.70%*	*-8.70%*
MIAM	194,572	243,425	273,877	179,285
Output Growth %	*20.62%*	*25.11%*	*12.50%*	*-34.54%*
Total	753,624	884,728	1,010,978	850,456
Output Growth %	*30.74%*	*17.40%*	*14.28%*	*-15.88%*

FY - Fiscal year
Source: Kenya Tourist Board

Tourism arrivals through Jomo Kenyatta International Airport declined from 731,252 visitors in 2006/07 to 667,640 visitors in 2007/08 representing 8.7 percent decline. Arrivals through the Moi International Airport declined by 34.5 percent in 2007/08 compared with 12.5 percent growth in 2006/07, while tourist arrivals by cruise ships in 2007/08 declined further by 39.6 percent compared with a decline of 5.1 percent in 2006/07.

USES OF AVAILABLE RESOURCES

Total resources available to the economy measured in gross national disposable income amounted to 107.2 percent of GDP at current prices in 2007 compared with 107.7 percent in 2006 as shown in Table 1.7. Total output by all sectors grew by 7.0 percent in 2007 compared with 6.4 percent in 2006.

TABLE 1.7: USE OF RESOURCES (KSH MILLION)

	2002	2003	2004	2005	2006	2007
Gross national disposable income	1,077,425	1,192,664	1,344,814	1,505,745	1,745,595	1,944,497
Net current transfers	53,325	67,609	80,856	95,868	129,646	143,152
Gross national income	1,024,099	1,125,055	1,263,958	1,409,877	1,615,679	1,801,346
Net factor income payments (Y(f))	-11,275	-6,728	-10,017	-8,194	-5053 -	12,897
Gross domestic product (at market prices)	1,024,099	1,131,783	1,273,975	1,418,071	1,620,732	1,814,243
Total Consumption (C)	990,774	1,078,028	1,189,979	1,311,878	1,486,849	1,697,058
Government consumption - C(g)	176,821	205,207	227,618	246,102	269,214	311,225
Private consumption - C(p)	813,953	872,821	961,974	1,066,471	1,217,635	1,385,833
Gross domestic investment (I)	156,737	186,542	217,742	239,446	291,209	366,073
Gross fixed capital formation	178,466	179,254	207,196	264,728	309,592	354,173
Increase/Decrease in stocks	-21,729	7,288	10,546	-25,282	-18,383	11,900
Exports of goods and nfs (X)	244,468	270,118	336,360	396,363	440,788	482,455
Imports of goods and nfs (M)	-314,884	-339,301	-435,844	-523,970	-615,283	-703,386
GDP deflator (2001=100)	101.0	108.0	116.0	123.0	131.98	131.98
Real GDP	1,025,584	1,055,658	1,109,373	1,173,727	1,248,833	1,335,763
Real GDP growth (annual in %)	0.03%	2.90%	5.10%	5.80%	6.40%	7.00%
Gross National savings	86,651	114,636	154,835	193,867	258,746	247,439
Gross Domestic Savings	33,325	47,027	73,979	97,999	128,830	104,288
Total National Balance(S-I)	-70,086	-71,906	-62,907	-45,579	-32,463	-118,634
CAB (X-M+Y(f)+TR(f))	-28,366	-8,302	-28,645	-39,933	-49,902	-90,676
Discrepancy	-41,720	-63,604	-34,262	-5,646	17,439	-27,958
CAB + DISCREPANCY	-70,086	-71,906	-62,907	-45,579	-32,463	-118,634
Kenya - National Accounts						
In shares of GDP	2002	2003	2004	2005	2006	2007
Gross national disposable income	105.21%	105.38%	105.56%	106.18%	107.70%	107.18%
Net current transfers (TR(f))	5.21%	5.97%	6.35%	6.76%	8.00%	7.89%
Gross national income	100.00%	99.41%	99.21%	99.42%	99.69%	99.29%
Net factor income payments (Y(f))	-1.10%	-0.59%	-0.79%	-0.58%	-0.31%	-0.71%
Gross domestic product (GDP)						
Gross Domestic Product (expend)						
Total Consumption ©	96.75%	95.25%	93.41%	92.51%	91.74%	93.54%
Government consumption - C(g)	17.27%	18.13%	17.87%	17.35%	16.61%	17.15%
Private consumption - C(p)	79.48%	77.12%	75.51%	75.21%	75.13%	76.39%
Gross domestic investment (I)	15.30%	16.48%	17.09%	16.89%	17.97%	20.18%
Gross fixed capital formation	17.43%	15.84%	16.26%	18.67%	19.10%	19.52%
Increase/Decrease in stocks	-2.12%	0.64%	0.83%	-1.78%	-1.13%	0.66%
Exports of goods and services (X)	23.87%	23.87%	26.40%	27.95%	27.20%	26.59%
Imports of Goods and services (M)	-30.75%	-29.98%	-34.21%	-36.95%	-37.96%	-38.77%
Gross National savings	8.46%	10.13%	12.15%	13.67%	15.96%	13.64%
Gross Domestic Savings	3.25%	4.16%	5.81%	6.91%	7.95%	5.75%
Total National Balance(S-I)	-6.8%	-6.4%	-4.9%	-3.2%	-2.0%	-6.5%
Trade Balance (TB=X-M)	-6.9%	-6.1%	-7.8%	-9.0%	-10.8%	-12.2%
CAB (X-M+Y(f)+TR(f))	-2.8%	-0.7%	-2.2%	-2.8%	-3.1%	-5.0%
CAB + DISCREPANCY	-7.7%	-6.4%	-6.9%	-6.9%	-6.9%	-6.9%

Source: Economic Survey, 2008

The resources were allocated to either investment, savings or consumption. Gross domestic investment increased by 20.2 percent of GDP in 2007 compared with 18.0 percent of GDP in 2006, following an increase in the gross fixed capital formation, which increased from 19.1 percent of GDP in 2006 to 19.5 percent of GDP.

Gross national savings, that is, gross national disposable income less total consumption, grew by 13.6 percent of GDP in 2007 compared with 16.0 percent of GDP in 2006, while gross domestic savings (gross domestic product less domestic consumption) grew by 5.6 percent of GDP in 2007 compared with 8.0 percent of GDP in 2006.

The increase in availability of resources in 2007 led to a pick up in aggregate demand, reflected in the increase in total consumption in 2007. Government consumption accounted for 17.2 percent of GDP, up from 16.6 percent of GDP in 2006. A greater share of resources was utilised for private sector consumption relative to the government, which accounted for 76.4 percent of GDP in 2007 compared with 75.1 percent of GDP in 2006.

2. CAPITAL FLOWS

Official Development Assistance to Developing Countries

Net disbursements of Official Development Assistance (ODA) by the Development Assistance Committee (DCA) of the OECD is estimated to have increased from US$ 85.4 billion in 2006 to US$ 87.4 billion in 2007 (Table 2.1). The volume of assistance disbursed through multilateral institutions remained stable at US$ 20 billion. In contrast, changes have occurred in net ODA disbursements by bilateral donors which have become dominated by grants. The shift from bilateral ODA loans to grants has significantly reduced the debt burdens (debt-to-GDP ratios) of many low-income countries especially those which receive debt relief from the Multilateral Debt Relief Initiative (Global Development Finance 2008)

TABLE 2.1: NET DISBURSEMENTS OF OFFICIAL DEVELOPMENT ASSISTANCE EXCLUDING DEBT RELIEF: 2000-2007 (CONSTANT 2005 US$ BILLIONS)

		2002	2003	2004	2005	2006	2007*
All Donors		73.9	73.7	80.8	89.0	90.4	...
DAC Donors**		69.8	69.8	77.0	85.1	85.4	87.4
of which	United States	13.9	15.9	20.2	23.9	21.3	20.6
	United Kingdom	5.7	7.3	7.2	7.3	9.6	9.4
	Germany	6.5	6.3	7.1	6.7	7.6	8.4
	France	7.6	6.0	7.0	7.0	7.0	7.4
	Japan	10.1	9.1	8.6	10.0	9.2	7.0
Non-DAC Donors		4.1	3.9	3.8	3.9	5.0	...

* Estimate
**DAC - OECD Development Assistance Committee

Source: Global Development Finance (2008)

Net Private Capital Flows to Developing Countries

Net capital flows to developing countries increased from US$ 690 billion in 2006 to US$ 1,025 billion in 2007, which was reflected in both equity and debt flows (Table 2.2). Net debt flows to developing countries increased by US$ 192 billion to US$ 409 billion following increased cross-border lending by commercial banks and increased external bond issuance by developing countries. The largest borrowers in 2007 were Russia, India, Mexico, Brazil, Turkey and China. The highest increase in net short term debt flows to developing countries was from Latin America, the Caribbean, Europe and Central Asia.

TABLE 2.2: NET PRIVATE CAPITAL FLOWS TO DEVELOPING COUNTRIES: 2000-2007 (US$ Billion)

	2000	2001	2002	2003	2004	2005	2006	2007*
Net private and official flows	**181.2**	**191.3**	**174.0**	**262.4**	**386.4**	**479.7**	**689.8**	**1025.0**
of which:								
Net equity flows	179.0	178.6	166.2	186.0	265.9	357.4	472.3	615.9
Net debt flows	-0.4	4.5	8.9	72.8	128.8	152.4	217.5	409.1
o.w. Official creditors	-5.8	26.8	4.9	-11.7	-26.1	-71.7	-70.5	-3.9
Private creditors	5.8	-23.0	3.8	84.4	155.2	222.7	288.0	413.0
medium- & long-term	12.2	1.9	0.7	30.9	87.7	133.1	193.8	283.3
short-term debt flows	-6.4	-24.9	3.1	53.5	67.5	89.6	94.2	129.7

* Estimate

Sources: Global Development Finance (2008)

Net Foreign Direct Investment (FDI) Flows to Developing Countries

Net Foreign Direct Investment (FDI) flows to developing countries rose from US$ 367 billion in 2006 to US$ 471 billion in 2007. This accounted for more than 25 percent of global FDI inflows. Of the net FDI flows to developing countries in 2007, Europe and Central Asia accounted for 34 percent, while Latin America and the Carribbean and East Asia and Pacific countries accounted for 23 percent and 25 percent, respectively. South Asia, Middle East and North African countries collectively absorbed 12 percent of the net FDI flows to developing coutries, while Sub-Saharan Africa absorbed 5 percent (Table 2.3). The top destination countries from these regions were China, Russia, Brazil, Mexico, Turkey and India. The largest recipient from Sub-Saharan Africa was South Africa.

TABLE 2.3: NET FDI INFLOWS TO DEVELOPING COUNTRIES: 2000 - 2007 (US & BILLION)

	2000	2001	2002	2003	2004	2005	2006	2007*
East Asia & Pacific	45.2	48.9	59.4	56.8	70.3	104.2	105.0	117.4
Europe & Central Asia	24.8	26.6	26.1	34.9	63.5	72.2	124.6	161.6
Latin America & the Caribbean	79.5	72.1	53.0	42.3	64.6	70.4	70.5	107.2
Middle East & North Africa	4.8	4.2	4.9	8.2	7.1	14.4	27.5	30.5
South Asia	4.4	6.1	6.7	5.4	7.6	10.0	22.9	28.9
Sub-Saharan Africa	***6.8***	***15.1***	***10.5***	***14.4***	***12.5***	***17.3***	***17.1***	***25.3***
Kenya	***0.11***	***0.01***	***0.03***	***0.08***	***0.05***	***0.02***	***0.05***	***0.73***
Total	**165.5**	**173.0**	**160.7**	**161.9**	**225.5**	**288.5**	**367.5**	**470.8**

* Estimate

Sources: Global Development Finance (2008) & Economic Survey 2008

Net Portfolio (Equity) Flows to Developing Countries

Net portfolio flows to developing countries increased from US$ 105 billion in 2006 to US$ 145 billion in 2007. The highest shares of these flows went to East Asia and Pacific and South Asia (Table 2.4). Net portfolio flows to South Asia increased from US$ 10 billion to US$ 35 billion in 2007 while net flows to East Asia and Pacific countries declined from US$ 55 billion to US$ 49 billion. Net portfolio equity flows to Sub-Saharan Africa also decreased from US$ 15 billion in 2006 to US$ 10 billion in 2007.

TABLE 2.4: NET PORTFOLIO EQUITY FLOWS TO DEVELOPING COUNTRIES: 2000-2007 (US$ BILLION)

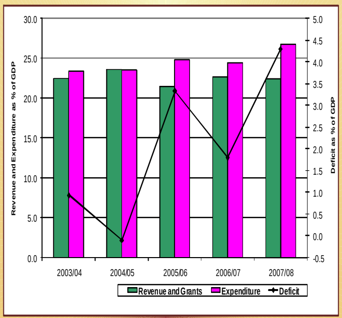
	2000	2001	2002	2003	2004	2005	2006	2007*
East Asia & Pacific	6.6	1.8	3.8	12.5	19.3	26.1	54.8	48.6
Europe & Central Asia	0.7	-0.4	0.1	-0.7	5.1	7.9	11.1	20.7
Latin America & the Caribbean	-0.6	2.5	1.4	3.3	-0.6	12.5	11.4	28.1
Middle East & North Africa	0.2	0.0	-0.6	0.2	0.9	2.6	2.0	2.1
South Asia	2.4	2.7	1.0	8.0	9.0	12.4	10.4	35.4
Sub-Saharan Africa	**4.2**	**-0.9**	**-0.4**	**0.7**	**6.7**	**7.4**	**15.1**	**10.2**
Kenya	**0.004**	**0.005**	**0.005**	**0.001**	**0.005**	**0.015**	**0.003**	**0.001**
Total net Flows	13.5	5.7	5.3	24.0	40.4	68.9	104.8	145.1

Source: Global Development Finance (2008) & Economic Survey 2008

3. FINANCING OF THE GOVERNMENT

Government budgetary operations in the fiscal year 2007/08 resulted in a budget deficit of Ksh 87.5 billion or 4.3 percent of GDP on commitment basis compared with Ksh 31.0 billion or 1.8 percent of GDP in the fiscal year 2006/07. The higher deficit was attributed mainly to increased expenditure on road infrastructure development projects and the December 2007 general elections. In addition, the performance of receipts from external grants and Appropriations in Aid (AIA) was lower than budgeted. However, as shown in Table 3.1 and Chart 3A, the deficit was well within the revised budget target of Ksh 125.8 billion or 6.2 percent of GDP for the fiscal year.

CHART 3A: GOVERNMENT BUDGET PERFORMANCE



Sources: Central Bank of Kenya and Treasury

TABLE 3.1: STATEMENT OF CENTRAL GOVERNMENT OPERATIONS

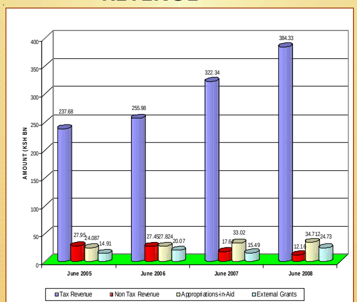
	FY 2004/2005	FY 2005/2006	FY 2006/2007	FY 2007/2008		
	Actual	Actual	Actual	Prov.	Target	Over(+) / Below (-)
1. REVENUE	**304.6**	**331.3**	**388.5**	**455.9**	**471.4**	**-15.5**
Revenue	289.7	311.3	373.0	431.2	434.5	-3.3
Tax Revenue	237.7	256.0	322.3	384.3	375.5	8.8
Non Tax Revenue	27.9	27.4	17.7	12.2	13.5	-1.3
Appropriations-in-Aid	24.1	27.8	33.0	34.7	45.5	-10.7
External Grants	14.9	20.1	15.5	24.7	36.9	-12.2
2. EXPENSES	**303.4**	**382.8**	**419.6**	**543.5**	**597.2**	**-53.7**
Recurrent Expenditure	257.7	315.2	339.2	412.6	429.5	-16.9
Development Expenditure	45.6	67.7	80.4	130.9	167.7	-36.8
3. DEFICIT ON A COMMITMENT BASIS (1-2)	**1.2**	**-51.5**	**-31.0**	**-87.5**	**-125.8**	**38.3**
Deficit on a commitment basis as a % of GDP	0.1	-3.3	-1.8	-4.3	-6.2	
4. ADJUSTMENT TO CASH BASIS	**6.1**	15.0	-5.6	29.5	**1.2**	**28.3**
5. DEFICIT ON A CASH BASIS	**7.3**	**-36.5**	**-36.6**	**-58.0**	**-124.6**	**66.6**
Deficit on a cash basis as a % of GDP	0.6	-2.4	-2.1	-2.8	-6.1	
6. DISCREPANCY: Expenditure (+) / Revenue (-)	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	
7. FINANCING	**-7.3**	**36.5**	**36.6**	**58.0**	**124.6**	**-66.6**
Domestic (Net)	-6.7	28.3	34.7	-13.9	34.0	-47.8
External (Net)	-0.6	1.3	-2.0	4.4	24.6	-20.3
Capital Receipts (privatisation)	0.0	7.0	4.0	67.5	66.0	1.5
Others	0.0	0.0	0.0	0.0	0.0	0.0

Sources: Treasury and Central Bank of Kenya

Revenue

Government revenue and grants grew by 17.4 percent from Ksh 388.5 billion in the fiscal year 2006/07 to Ksh 455.9 billion in the fiscal year 2007/08 (Chart 3B). However, as a percentage of GDP, the revenue and grants declined from 22.6 percent to 22.4 percent during the period following a faster growth of GDP. The improved revenue performance in the fiscal year 2007/08 was attributed largely to improved economic growth, implementation of tax administration reforms which increased efficiency, and increased compliance.

CHART 3B: COMPOSITION OF REVENUE



Sources: Central Bank of Kenya and Treasury

Tax revenue increased from Ksh 322.3 billion (18.8 percent of GDP) in the fiscal year 2006/07 to Ksh 384.3 billion (18.9 percent of GDP) in the fiscal year 2007/08. This represented an increase of Ksh 62.0 billion or growth of 19.2 percent in the revenue during the period. Similarly, AIA and external grants grew by 5.1 percent and 59.6 percent respectively during the period to stand at Ksh 34.7 billion and Ksh 24.7 billion respectively. However, non-tax revenue declined by 5.5 percent during the period to stand at Ksh 12.2 billion.

Government receipts of external grants increased during the period reflecting improved absorption capacity of external resources which resulted in a higher utilisation of donor commitments. As a result, the disbursement of the grants was 67.0 percent of the expected Ksh 36.9 billion in the fiscal year 2007/08 compared with only 44.9 percent in the fiscal year 2006/07. The government has developed an External Aid Policy document which will address, among others things, the low absorption of external loans and grants.

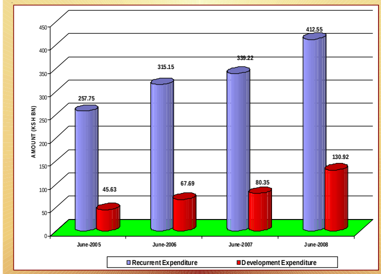
As a result of the above developments, tax revenue and external grants in total revenue and grants increased from 83.0 percent and 4.0 percent in the fiscal year 2006/07 to 84.3 percent and 5.4 percent respectively in the fiscal year 2007/08. However, non-tax revenue and AIA declined from 4.5 percent and 8.5 percent to 2.7 percent and 7.6 percent respectively during the period.

Expenditure and Net Lending

As shown in Chart 3C, Government expenditure increased by 29.5 percent from Ksh 419.6 billion (24.4 percent of GDP) in the fiscal year 2006/07 to Ksh 543.5 billion (26.7 percent of GDP) in the fiscal year 2007/08. The rise in the overall expenditure during the period was attributed to increases of 21.6 percent and 62.9 percent in recurrent and development expenditures respectively. Recurrent expenditure increased from Ksh 339.2 billion to Ksh 412.6 billion during the period mainly to meet increased outlays for improvement of terms of service for civil servants, free secondary education, domestic debt service, and resettlement of the internally displaced people (IDPs) following the post poll crisis in December 2007.

Development expenditure increased from Ksh 80.4 billion to Ksh 130.9 billion in the period largely to finance the increased expenditure towards improvement of roads, access to water, energy, and telecommunications. Consequently, the share of development expenditure in total expenditure increased from 19.2 percent in the fiscal year 2006/07 to 24.1 percent in the

CHART 3C: GOVERNMENT EXPENDITURE



Sources: Central Bank of Kenya and Treasury

fiscal year in 2007/08, while recurrent expenditure declined from 80.8 percent to 75.9 percent of total expenditure during the period. This development is in line with the Government fiscal policy objective of allocating more resources towards infrastructure development in order to create an environment conducive to doing business and promote investment to achieve and sustain high economic growth rates.

Financing

The budgetary operations of the Government in the fiscal year 2007/08 resulted in a higher financing requirement of Ksh 90.7 billion compared with Ksh 44.3 billion in the fiscal year 2006/07 (Table 3.2). These funds were required to finance a budget deficit of Ksh 58.0 billion, increase Government deposits at the Central Bank of Kenya by Ksh 26.4 billion, and repay domestic debt totalling Ksh 6.2 billion owed to commercial banks. The Ksh 90.7 billion financing requirement was sourced through net external borrowing of Ksh 4.4 billion, net domestic borrowing of Ksh 18.8 billion and privatisation proceeds (net of restructuring costs) of Ksh 67.5 billion from sale of government shares in Safaricom, TELKOM Kenya and Kenya Re-Insurance Company.

TABLE 3.2: GOVERNMENT OVERALL BORROWING REQUIREMENTS AND ITS SOURCES (KSH BN)

I. FINANCING REQUIREMENTS	2004/05	2005/06	2006/07	2007/08
1. Budget deficit	-	36.5	37.0	58.0
2. External debt reduction	0.6	-	1.7	-
3. Domestic debt reduction	19.6	5.6	5.6	6.2
3.1 Central Bank (incl. items in transit)	4.3	5.6	5.6	-
3.2 Commercial banks (net of deposits)	15.3	-	-	6.2
3.3 Non-bank sources	-	-	-	-
4. Increase in GoK deposits at CBK	6.1	15.4	-	26.4
TOTAL	26.4	57.5	44.3	90.7
II. FINANCING SOURCES	**2004/05**	**2005/06**	**2006/07**	**2007/08**
1. Budget surplus	7.3	-	-	-
2. External debt increase	-	1.3	-	4.4
3. Increase in domestic debt	19.1	49.3	22.2	18.8
3.1 Central Bank	-	-	-	9.3
3.2 Commercial banks	-	27.1	7.3	-
3.3 Non-bank sources	19.1	22.1	14.9	9.5
4. Reduction in GoK deposits at CBK	-	-	18.1	-
5. Privatisation proceeds	-	7.0	4.0	67.5
TOTAL	26.4	57.5	44.3	90.7

Source: Treasury and Central Bank of Kenya

Outlook for the Fiscal Year 2008/09

The fiscal year 2008/09 budget has a total revenue (excluding grants) target of Ksh 512.8 billion (21.4 percent of GDP) while external grants are projected at Ksh 33.8 billion (1.4 percent of GDP). Total government expenditure is projected at Ksh 673.5 billion (28.1 percent of GDP) comprising Ksh 474.7 billion (19.8

percent of GDP) in recurrent expenditure and Ksh 198.8 billion (8.3 percent of GDP) in development expenditure.

Consequently, the overall budget deficit (including grants) in the fiscal year 2008/09 is projected at Ksh 127.0 billion (5.3 percent of GDP). The deficit will be financed through net external borrowing of Ksh 25.2 billion (1.1 percent of GDP); net domestic borrowing of Ksh 54.5 billion (2.3 percent of GDP) including Ksh 18.8 billion in long term domestic infrastructure bonds; privatization receipts totalling Ksh 8 billion (0.3 percent of GDP); Ksh 33.6 billion from issuance of a sovereign bond to finance infrastructure development and Ksh 5.7 billion additional financing from TELKOM Kenya and Kenya Petroleum Refineries.

4 PUBLIC DEBT

Kenya's public and publicly guaranteed debt increased from Ksh 801.3 billion in June 2007 to Ksh 860.3 billion in June 2008 (Table 4.1). This represented Ksh 59.1 billion or 7.4 percent growth during the fiscal year. The increase in the stock of debt during the fiscal year followed increases of Ksh 25.9 billion and Ksh 33.2 billion in external and domestic debts respectively. Domestic debt increased during the fiscal year mainly due to planned domestic borrowing to finance the budget deficit, while external debt increased during the period due to improved external loans disbursements.

TABLE 4.1: PUBLIC DEBT (KSH BN)

	June 2004		June 2005		June 2006		June 2007*		June 2008**	
	Ksh bn	%	Ksh bn	%	Ksh bn	%	Ksh bn	%	Ksh bn	%
DOMESTIC DEBT										
Securitised debt	**289.6**	**94.6**	**302.3**	**95.8**	**349.7**	**97.7**	**402.9**	**99.6**	**427.2**	**99.2**
Treasury Bills	99.8	32.6	107.8	34.2	130.3	36.4	130.0	32.1	111.3	25.8
Of which Repo Treasury bills	36.9	12.0	35.9	11.4	35.5	9.9	35.5	8.8	34.4	8.0
Treasury Bonds	188.6	61.6	193.4	61.3	218.4	61.0	272.2	67.3	315.2	73.2
Government Stocks	1.1	0.4	1.1	0.3	1.1	0.3	0.8	0.2	0.8	0.2
Non Securitised debt	**16.7**	**5.4**	**13.3**	**4.2**	**8.1**	**2.3**	**1.8**	**0.4**	**3.4**	**0.8**
Overdraft/Advances	16.7	5.4	13.3	4.2	8.1	2.3	1.1	0.3	0.4	0.1
others	0.0	0.0	0.0	0.0	0.0	0.0	0.7	0.2	3.0	0.7
TOTAL DOMESTIC DEBT	**306.2**	**100.0**	**315.6**	**100.0**	**357.8**	**100.0**	**404.7**	**100.0**	**430.6**	**100.0**
(as a % of GDP	25.4		24.4		23.2		23.6		21.2	
(as a % of Total Debt	40.9		42.1		45.3		50.5		50.1	
EXTERNAL DEBT**										
Bilateral	162.9	36.8	157.7	36.3	154.9	35.9	137.9	34.8	150.3	35.0
Multilateral	260.7	58.8	255.8	58.9	255.5	59.3	240.3	60.6	261.1	60.8
Comm. Banks	2.9	0.7	1.8	0.4	1.3	0.3	0.3	0.1	0.3	0.1
Export Credit	16.7	3.8	19.2	4.4	19.5	4.5	18.0	4.5	18.0	4.2
TOTAL EXTERNAL DEBT	**443.2**	**100.0**	**434.5**	**100.0**	**431.2**	**100.0**	**396.6**	**100.0**	**429.7**	**100.0**
(as a % of GDP	36.7		33.6		27.9		23.1		21.1	
(as a % of Total Debt	59.1		57.9		54.7		49.5		49.9	
TOTAL PUBLIC DEBT	**749.4**		**750.0**		**789.1**		**801.3**		**860.3**	
(as a % of GDP)	62.0		58.0		51.1		46.7		42.3	

* External debt stock Revised
** Provisional

Sources: Central Bank of Kenya and Treasury

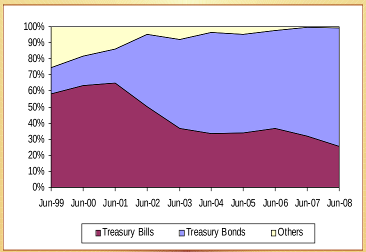
Domestic debt continued to account for the largest proportion of public and publicly guaranteed debt. However, the percentage of domestic debt in total debt decreased from 50.5 percent in June 2007 to 50.1 percent in June 2008 while external debt increased from 49.5 percent to 49.9 percent during the period.

Although the stock of debt increased during the fiscal year 2007/08, the percentage of the overall debt stock to GDP decreased from 46.7 percent in June 2007 to 42.3 percent in June 2008 (Table 4.1). The ratios of external and domestic debts to GDP fell from 23.1 percent and 23.6 percent to 21.1 percent and 21.2 percent, respectively. The debt-to-GDP ratio declined in 2007/08 following a faster growth in GDP. The falling debt-to-GDP ratio reflects the government's debt management objective of ensuring a sustainable overall debt level.

The overall objective of the debt management strategy is to meet the central government borrowing requirements at minimal costs and with a prudent degree of risk. The strategy also aims at facilitating the government's access to the financial market, and supporting the development of a well functioning domestic financial market.

Public Domestic Debt

CHART 4A:COMPOSITION OF GOVERNMENT DOMESTIC DEBT



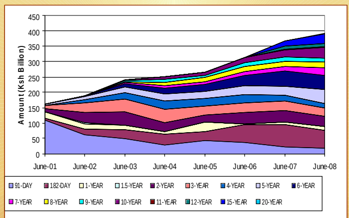
Sources: Central Bank of Kenya and Treasury

Public domestic debt increased from Ksh 404.7 billion in June 2007 to Ksh 430.6 billion in June 2008. This represented 6.4 percent growth in the debt during the fiscal year 2007/08. The increase in domestic debt during the period was attributed mainly to a significant rise in Treasury bonds as the government resorted largely to using long term instruments to finance its deficit. Furthermore, Treasury bonds and bills auctions had average oversubscriptions of 25.9 percent and 8.0 percent, respectively during the fiscal year 2007/08. As shown in Chart 4A, the percentage of Treasury bonds in total domestic debt increased from 67.3 percent in June 2007 to 73.2 percent in June 2008 while Treasury bills decreased from 32.1 percent to 25.8 percent.

Outstanding Treasury bonds increased from Ksh 272.2 billion in June 2007 to Ksh 315.2 billion in June 2008. The significant rise in the stock of Treasury bonds during the period was also partly attributed to issuance of Treasury bonds totalling Ksh 9.0 billion by the government in December 2007. However, Treasury bills (including Repos) decreased significantly from Ksh 130.0 billion to Ksh 111.3 billion during the period.

The significant rise in the stock of Treasury bonds resulted in the average maturity of domestic debt increasing from 3 years and 1 month in June 2007 to 3 years and 6 months in June 2008. These developments are consistent with the government debt management strategy of restructuring domestic debt to longer dated instruments in order to minimise the risks associated with short term domestic borrowing. The average domestic debt maturity increased during the fiscal year 2007/08 following successful issuance of longer dated Treasury bonds with tenors of up to 20-years. The successful issuance of the 20-year bond in June 2008 reflects increased appetite for longer dated Treasury bonds by institutional investors comprising mainly of pension funds and insurance companies in their effort to match their long term liabilities with long term assets.

CHART 4B: OUTSTANDING TREASURY BILLS & BONDS BY TENOR



Sources: Central Bank of Kenya

As shown in Chart 4B, the government made significant progress in deepening the bond market during the fiscal year 2007/08. As a result, the percentage of Treasury bonds with tenors of 10-years and above in the overall stock of Treasury bills and bonds increased from 14.1 percent in June 2007 to 20.7 percent in June 2008. The largest share of outstanding Treasury bonds as at June 2008 was held in 6-year bonds which accounted for 12.1 percent down from 13.2 percent in June 2007.

The trends in the holdings of Treasury bills and bonds by creditor categories are depicted in Tables 4.2 and 4.3. Treasury bills holdings by commercial banks decreased from 34.7 percent in June 2007 to 23.7 percent in June 2008 while their holdings of Treasury bonds decreased from 51.7 percent to 49.5 percent during the period. The declining proportion of Treasury bills and bonds held by commercial banks is a positive development as excessive domestic borrowing by the Government could crowd out private sector investment as the Government and the private sector competes for limited loanable funds.

TABLE 4.2: OUTSTANDING STOCK OF TREASURY BILLS BY HOLDER (KSH BN)

Holders		Jun-05		Jun-06		Jun-07		Jun-08	
		Ksh	%	Ksh	%	Ksh	%	Ksh	%
Banking Institutions		68.7	63.7	83.3	63.9	80.8	62.2	69.4	62.4
	Central Bank*	35.9	33.3	35.7	27.4	35.6	27.4	43.0	38.6
	Comm. Banks	31.9	29.5	47.0	36.1	45.1	34.7	26.4	23.7
	NBFIs	0.9	0.8	0.5	0.4	0.2	0.2	0.0	0.0
Insurance Companies		7.7	7.1	11.0	8.5	13.5	10.4	17.0	15.3
Parastatals		6.9	6.4	11.2	8.6	9.0	6.9	7.2	6.4
of which NSSF		0.1	0.1	0.6	0.5	0.2	0.1	0.1	0.0
Building Societies		0.2	0.2	0.5	0.4	0.6	0.5	1.1	0.9
Others		24.4	22.6	24.2	18.6	26.0	20.0	16.7	15.0
Total		**107.8**	**100.0**	**130.3**	**100.0**	**130.0**	**100.0**	**111.3**	**100.0**

* Includes Repo Treasury bills

Source: Central Bank of Kenya

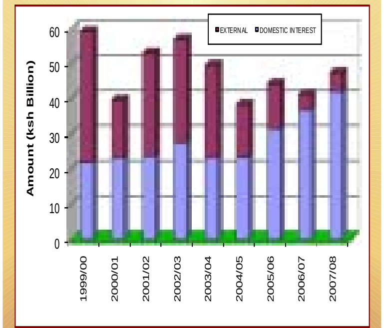
TABLE 4.3: OUTSTANDING STOCK OF TREASURY BONDS BY HOLDER (KSH BN)

Holders		Jun-05		Jun-06		Jun-07		Jun-08	
		Ksh	%	Ksh	%	Ksh	%	Ksh	%
Banking Institutions		86.5	44.7	101.0	46.3	141.5	52.0	156.8	49.8
	Central Bank	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	Comm. Banks	84.4	43.6	100.1	45.9	140.7	51.7	156.1	49.5
	NBFIs	2.1	1.1	0.9	0.4	0.9	0.3	0.7	0.2
Insurance Companies		26.1	13.5	26.4	12.1	27.5	10.1	31.9	10.1
Parastatals		16.6	8.6	23.2	10.6	27.3	10.0	29.5	9.4
of which NSSF		2.8	1.4	4.9	2.2	6.8	2.5	11.3	3.6
Building Societies		2.7	1.4	1.8	0.8	1.3	0.5	0.9	0.3
Others		61.5	31.8	65.9	30.2	74.6	27.4	96.0	30.5
Total		**193.4**	**100.0**	**218.4**	**100.0**	**272.2**	**100.0**	**315.2**	**100.0**

Source: Central Bank of Kenya

Domestic Debt Service

CHART 4C: INTEREST PAYMENTS ON PUBLIC DEBT



Sources: Central Bank of Kenya and Treasury

As shown in Chart 4C, cumulative Government expenditure on interest and other charges on domestic debt increased from Ksh 36.9 billion in the fiscal year 2006/07 to Ksh 42.2 billion in the fiscal year 2007/08. However, as a percentage of ordinary Government revenue, domestic interest payments decreased from 9.9 percent to 9.8 percent during the period following a faster growth in the revenue. This is an indication that despite the rise in the stock of domestic debt, the capacity of the Government to service the debt has also increased. Furthermore, domestic interest payments on new domestic borrowing decreased from Ksh 13.3 billion in the fiscal year 2006/07 to Ksh 10.1 billion in the fiscal year 2007/08 due to lower interest rates.

Public and Publicly Guaranteed External Debt

Kenya's external debt increased by 8.4 percent, from Ksh 396.6 billion in June 2007 to Ksh 429.7 billion in June 2008 reflecting increased access to external financing and weakening of the Kenya shilling (Table 4.4). The rise in the debt during the fiscal year 2006/07 was attributed to external loans disbursements totalling Ksh 24.5 billion and revaluation losses of Ksh 25.4 billion which more than offset principal repayments of Ksh 16.9 billion. The external loans disbursements in the fiscal year 2007/08 comprised Ksh 19.2 billion and Ksh 5.3 billion in project and programme loans respectively. Programme loans received in the period comprised Ksh 4.0 billion (USD 59.3 million or SDR 37.5 million) from the IMF in November 2007 and Ksh 1.3 billion (USD 20 million) from the European Union in December 2007.

As a result of the above developments, the percentage of external debt owed to multilateral and bilateral creditors increased from 60.6 percent and 34.8 percent in June 2007 to 60.8 percent and 35.0 percent respectively in June 2008 (Table 4.4, and Charts 4D and 4E). Export credits, however, decreased from 4.5 percent of total external debt to 4.2 percent while commercial debts remained unchanged at 0.1 percent.

CHART 4D: COMPOSITION OF EXTERNAL PUBLIC DEBT JUNE 2008

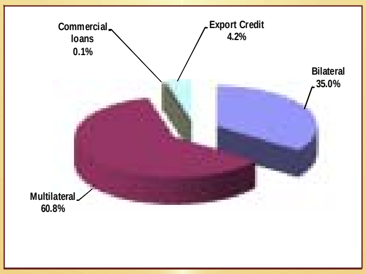
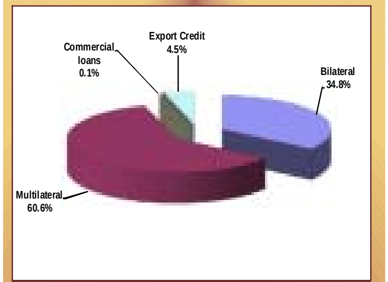


CHART 4E: COMPOSITION OF EXTERNAL PUBLIC DEBT JUNE 2007



Sources: Central Bank of Kenya and Treasury

TABLE 4.4: DISTRIBUTION OF EXTERNAL PUBLIC DEBT

	Jun-04	%	Jun-05	%	Jun-06	%	Jun-07	%	Jun-08	%
Bilateral	162.9	36.8	157.7	36.3	154.9	35.9	137.9	34.8	150.3	35.0
Multilateral	260.7	58.8	255.3	58.8	255.5	59.3	240.3	60.6	261.1	60.8
Commercial loans	2.9	0.7	1.8	0.4	1.3	0.3	0.3	0.1	0.3	0.1
Export Credit	16.7	3.8	19.2	4.4	19.5	4.5	18.0	4.5	18.0	4.2
Total	443.2	100.0	434.0	100.0	431.2	100.0	396.6	100.0	429.7	100.0

Sources: Central Bank of Kenya and Treasury

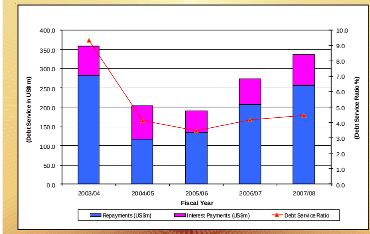
In addition, the share of external debt held in US dollars, Sterling pounds and Japanese Yens decreased from 31.9 percent, 6.0 percent and 25.4 percent in June 2007 to 29.4 percent, 5.9 percent and 25.1 percent respectively in June 2008. However, the proportion of external debt held in Euros and other currencies including SDRs increased from 33.7 percent and 2.9 percent to 34.2 percent and 5.3 percent respectively during the period.

External Debt Service

External debt service increased from Ksh 18.3 billion or 4.9 percent of ordinary revenue in the fiscal year 2006/07 to Ksh 22.2 billion or 5.1 percent of ordinary revenue in the fiscal year 2007/08. The rise in external debt service in the fiscal year 2007/08 followed the end of Paris Club debt re-scheduling in December 2006. The external debt service in the fiscal year 2007/08 comprised Ksh 16.9 billion in principal repayments and Ksh 5.3 billion in interest.

The debt service ratio, which is the ratio of external debt service payments to export earnings of goods and services, increased from 4.2 percent in the fiscal year 2006/07 to 4.5 percent in the fiscal year 2007/08. As shown in Chart 4F, the debt service ratio has generally been stable at an average of 4.0 percent since the fiscal year 2004/05, and much lower than that in the fiscal year 2003/04 which stood at 9.3 percent.

CHART4F: EXTERNAL DEBT SERVICE AND DEBT SERVICE RATIO



Sources: Central Bank of Kenya and Treasury

Prospects for FY 2008/09

Government domestic and external borrowings during the fiscal year 2008/09 are projected at Ksh 25.2 billion and Ksh 54.5 billion respectively. As indicated in the Budget Strategy Paper for 2008/09 to 2010/11, however, gross domestic debt-to-GDP ratio is projected to fall from 22.0 percent in June 2008 to 21.0 percent in June 2009 as GDP is expected to grow at a faster rate compared with domestic debt. The government plans to issue a sovereign bond in the international market totalling Ksh 33.6 billion in addition to the expected external borrowing in the fiscal year 2008/09. Consequently, external debt-to-GDP ratio is expected to increase from 19.5 percent to 21.9 percent during the period, which will however be lower than the 23.1 percent in June 2007.

5. MONEY SUPPLY

Monetary Policy for 2007/08

Monetary policy for the fiscal year 2007/08 was directed towards achieving and maintaining inflation at 5 percent. Accordingly, the Central Bank of Kenya set out the optimal 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 15 percent and 14.0 percent respectively in the year to June 2008.

This path was, however, modified to accomodate stronger accumulation of foreign exchange reserves, a gradual approach to the inflation pressures that faced the economy and some of the macroeconomic risks following the post election crisis experienced in early 2008. As a result, money supply was programmed to expand by 16.9 percent, while reserve money was targeted to increase by 18.2 percent by June 2008 as shown in Table 5.1.

TABLE 5.1: GROWTH TARGETS FOR KEY AGGREGATES FOR 2007/08 MONETARY PROGRAMME

	Sep'07	Dec'07	Mar'08	Jun'08
Reserve money (Ksh million)	131.3	141.6	139.2	149.5
NFA of CBK (Ksh million)	179.3	186.4	193.0	218.2
Memo:				
Annual change in reserve money	17.0	14.0	14.0	18.2
Annual change in extended broad money	18.4	15.0	15.0	16.9
Real GDP growth				
Overall inflation				

Source: Central Bank of Kenya

Implementation of monetary policy in the year to June 2008 was through daily monitoring of reserve money under the monetary program. The Bank used the liquidity forecasting framework to monitor daily the level of reserve money against targets. Monetary policy was mainly implemented through open market operations (OMOs) using repurchase agreement securities (REPOs). In addition to OMO, the Bank introduced the Term Deposit Facility as an additional open market operations instrument. These instruments were complemented by cash ratio requirement maintained at 6 percent throughout the year. Open market operations were guided by comparing the forecast reserve money with the target reserve money on a daily basis. The CBK also used the central bank rate (CBR), which is the minimum lending rate that it charges on its overnight loans to commercial banks, to guide financial market participants on the direction of short term interest rates. The CBR is reviewed every eight weeks by the Monetary Policy Committee (MPC) in light of ensuing financial and economic developments.

Macroeconomic developments in the first half of 2008 provided support for the monetary policy stance adopted. In particular, inflation, though high, started decreasing consistent with expectations. While overall inflation peaked at 31.5 percent in May 2008, it started easing thereafter.

Money Supply

Money supply, M3 growth increased from 18.8 percent in the year to June 2007 to 19.3 percent in the twelve months to June 2008 as shown in Table 5.2. The expansion in M3 was higher than the 16.9 percent June 2008 target.

TABLE 5.2: PERFORMANCE OF MONETARY AGGREGATES JUNE 2007 - JUNE 2008 (Percent)

	RM		M3	
	Act.	Targ.	Act.	Targ.
2007				
Jun	17.5	14.3	18.8	13.1
Jul	17.9	17.0	16.7	18.4
Aug	19.0	17.0	19.0	18.4
Sep	17.0	17.0	17.7	18.4
Oct	17.6	14.0	16.7	15.0
Nov	19.8	14.0	16.7	15.0
Dec	25.3	14.0	20.9	15.0
2008				
Jan	23.5	14.0	21.9	15.0
Feb	23.1	14.0	23.0	15.0
Mar	23.2	14.0	21.4	15.0
Apr	14.8	18.2	28.5	16.9
May	16.7	18.2	23.2	16.9
Jun	19.3	18.2	19.3	16.9

Source: Central Bank of Kenya

The increase in M3 followed the expansion of the banking systems' net foreign assets (NFA) (Table 5.3). NFA grew by 31.7 percent compared with 25.2 percent a year earlier. Growth in NDA of the banking system decelerated to 13.2 percent compared with 16.0 percent a year ago reflecting a repayment of credit to government in the year to June 2008.

TABLE 5.3: MONEY SUPPLY AND ITS SOURCES (KSH BN)

	Jun-06 Act	Jun-07 Act	Jun-08 Act	Annual % Change 2006/07	2007/08
1.0 Liability					
Money Supply					
Money supply, M2 1/	522.0	605.5	716.0		
Money supply, M3 2/	605.5	719.8	859.0	18.9	19.3
Money supply, M3X 3/	765.4	894.9	1,055.4		
2.0 Assets (2.1+2.2)	532.7	605.5	719.5		
2.1 Net foreign assets 4 /	191.6	239.8	315.7	25.2	31.7
Central Bank	159.5	174.2	213.9	9.2	22.8
Banking Institutions	32.1	65.6	101.8	104.4	55.1
2.2 Net domestic assets (2.21+2.22)	413.9	480.0	543.3	16.0	13.2
2.21 Domestic Credit (2.210+2.211)	521.7	607.1	713.5	16.4	17.5
2.210 Government (net)	117.9	157.2	133.4	33.3	-15.1
2.211 Private sector and other public sector	403.8	450.0	580.1	11.4	28.9
2.22 Other assets net	-107.8	-127.1	-170.2	17.9	33.9
Memorandum Item:					
Reserve Money 5/	107.7	126.5	150.8	17.5	19.3

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 liquidity L, comprises M3 plus non-bank holdings of government securities.

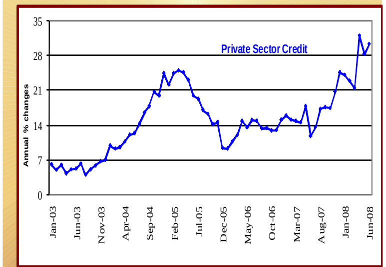
4/ NFA valued at constant exchange rate of Ksh 78.95 to the US $ (September 30th, 2001)

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

Source: Central Bank of Kenya

Domestic Credit

CHART 5A: ANNUAL PERCENTAGE CHANGES IN PRIVATE SECTOR CREDIT



Source: Central Bank of Kenya

The banking system credit to the domestic economy grew by 17.5 percent in the year to June 2008 compared with 16.4 percent a year earlier. Credit to government, however, declined by 15.1 percent in the year to June 2008 compared with an increase of 33.3 percent in June 2007. On the other hand, credit to the private sector accelerated to 28.9 percent from 11.4 percent in June 2007 as shown in Chart 5A.

Most of the credit to private sector expansion was to private households (34.7 percent), other activities (27.9 percent), and business services (12.0 percent) as shown in Table 5.4. These sectors accounted for 74.6 percent of the credit extended during the year.

TABLE 5.4: CREDIT TO PRIVATE AND OTHER PUBLIC SECTORS (KSH BN)

	2007 Jun		2008 Jun		Annual Change		Jun '07 - Jun '08 Change in credit to private sector	
	Ksh bn	Share (%)	Ksh bn	Share (%)	Ksh bn	(%)	Absolute	(%)
1. Credit to other public sector	11.5	1.9	8.9	1.2	-2.7	-23.2		
Local government	-1.4	-0.2	-2.6	-0.4	-1.2	86.5		
Parastatals	13.0	2.1	11.5	1.6	-1.5	-11.3		
2. Credit to private sector	437.5	72.2	570.0	80.0	132.5	30.3		100.0
Agriculture	28.7	4.7	27.1	3.8	-1.5	-5.3	-1.5	-1.1
Manufacturing	60.5	10.0	70.1	9.8	9.6	15.8	9.6	7.2
Trade	55.1	9.1	63.8	9.0	8.7	15.8	8.7	6.6
Building and construction	37.0	6.1	35.2	4.9	-1.7	-4.7	-1.7	-1.3
Transport & communications	37.3	6.2	44.3	6.2	7.0	18.7	7.0	5.3
Finance & insurance	27.5	4.5	26.6	3.7	-0.9	-3.1	-0.9	-0.6
Real estate	25.3	4.2	26.9	3.8	1.6	6.5	1.6	1.2
Mining and quarrying	4.1	0.7	5.3	0.7	1.2	30.4	1.2	0.9
Private households	58.9	9.7	104.9	14.7	46.0	78.0	46.0	34.7
Consumer durables	17.4	2.9	27.0	3.8	9.6	55.2	9.6	7.2
Business services	45.4	7.5	61.3	8.6	16.0	35.2	16.0	12.0
Other activities	40.5	6.7	77.4	10.9	36.9	91.3	32.0	27.9
3. TOTAL (1+2) *	606.2	100.0	712.3	100.0	106.1	17.5		

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

Source: Central Bank of Kenya

Reserve Money

The reserve money, comprising currency in circulation and commercial banks deposits at the Central Bank, grew more rapidly, by 19.3 percent in the twelve months to June 2008 compared with 17.5 percent expansion in a similar period in 2007. Reserve money growth during the period was higher than the 18.2 percent target. As shown in Table 5.5, the expansion in reserve money was caused by increases in both commercial banks reserves and cash outside banks. Commercial bank reserves increased by 39.1 percent in the year to June 2008 while cash outside banks increased by 7.0 percent.

TABLE 5.5: RESERVE MONEY AND ITS SOURCES (KSH BN)

		2007 Jun	2008 Jun	Change Absolute	%	Target Jun-08	Deviation
1	Net Foreign Assets	174.1	213.8	39.7	22.8	202.5	11.3
2	Net Domestic Assets	-47.7	-63.0	-15.3	32.1	-58.3	-4.7
2.1	Government Borrowing (net)	-4.6	-27.6	-23.0	496.9	-4.2	-23.4
2.2	Advances & Discounts	-15.6	4.5	20.2	-129.0	-27.1	31.6
2.3	Other Domestic Assets (net)	-27.4	-39.9	-12.5	45.5	-29.4	-10.5
3	Reserve Money	126.5	150.8	24.3	19.3	144.2	6.6
3.1	Bank Reserves	48.3	67.2	18.9	39.1	54.3	12.9
3.2	Cash Outside Banks	78.1	83.6	5.5	7.0	89.9	-6.3

Source: Central Bank of Kenya

Most of the reserve money expansion in the twelve months to June 2008 was in increased net foreign assets (NFA) of the Central Bank. NFA increased by Ksh 39.7 billion to Ksh 213.8 billion during the year to June 2008. The expansion in NFA reflected purchases of foreign exchange by the Bank for the purposes of reserve build up. Meanwhile, net domestic assets (NDA) of CBK declined by Ksh 15.3 billion during the year to June 2008. The decline in the NDA reflected Ksh 23.0 billion decline in net credit to Government and a Ksh 12.5 billion decline in other domestic assets. There was, however, a decrease in the Bank's net liabilities to commercial banks of Ksh 20.2 billion after redemptions to commercial banks of funds previously held under Repos.

Outlook

Over the twelve months to June 2009, the Bank will target 17.1 percent expansion in money supply, M3, and 16.2 percent growth in reserve money as shown in Table 5.6. In implementing monetary policy through the reserve money targets, the Bank will continue to mainly use open market operations to realign reserve money which is the basis for money supply expansion.

TABLE 5.6: MONETARY PROGRAMME FOR 2008/09

	June 08 Estimate	June 09 Proj.
Reserve money (Ksh million)	149.2	173.5
NFA of CBK (Ksh million)	220.6	265.6
Memo:(percentage charge)		
Annual change in reserve money	18.0	16.2
Annual change in extended broad money (M3)	17.5	17.1
Real GDP growth	5.7	5.8
Overall inflation	28.5	7.5

Source: Central Bank of Kenya

6. BANKING SECTOR DEVELOPMENTS

Overview

Performance of the banking sector in the period to June 2008 was overall rated strong as institutions achieved satisfactory financial conditions and improved operations results. The system remained well capitalised. Shareholders' funds, deposits and assets increased by 35.2 percent, 27.7 percent and 31.9, respectively. Liquidity in the banking sector was strong, with liquid assets as a proportion of total deposit liabilities of 42.4 percent, well above the statutory minimum requirement of 20 percent.

Structure of the Banking Sector

Financial institutions remained 45 in number between June 2007 and June 2008. During the period under review CFC Bank and Prime Capital Bank merged with Stanbic Bank, and Prime Capital and Credit, respectively. Two new banks, Gulf African Bank and First Community Bank were licensed in November 2007 and May 2008, respectively. The two banks offer Sharia compliant products. The sector experienced rapid expansion with branch network increasing by 44.6 percent from 534 branches in June 2007 to 772 branches in June 2008. Operating forex bureaus increased from 96 to 109 as at the end of June 2008.

Structure of the Balance Sheet

The aggregate balance sheet of the banking sector expanded significantly in June 2008 compared with the previous period in 2007. Deposits, comprising 82 percent of total liabilities were the major source of funding accounting for the increase in the aggregate balance sheet. The banking sector's assets increased by 31.9 per cent from Ksh. 833.4 billion in June 2007 to Ksh 1,099.1 billion in June 2008. Major components of total banking assets were loans and advances, which accounted for 50.5 percent of total assets followed by Government securities and placements at 17.8 percent and 15.0 percent of total assets, respectively

TABLE 6.1: BALANCE SHEET (KSH MILLION)

	June 2008	June 2007	% Change
Assets			
Cash	19,318	13,744	40.5
Balances from CBK	56,490	57,890	-2.4
Placements	164,326	80,249	104.8
Govt. securities	195,209	184,522	5.8
Other Investments	8,649	6,868	26
Loans & advances	555,062	417,498	32.9
Foreign Assets	7,115	4,484	58.7
Other assets	92,921	68,193	36.3
Total Assets	1,099,090	833,448	31.9
Deposits	871,200	682,147	21.7
Foreign Liabilities	13,453	4,753	183
Other liabilities	73,234	42,102	73.9
Capital & Reserves	141,203	104,445	35.2
Total Liabilities and shareholders funds	1,099,090	833,447	31.9

Source: Published Financial Statements and Disclosures

Non–Performing Loans

Non-performing loans (NPLs) declined by 17.5 percent, from Ksh 70.7 billion in June 2007 to Ksh 58.3 billion at the end of June 2008. This was attributed to write-offs and recoveries by some institutions. The ratio of gross non-performing loans to gross loans was 9.6 percent in June 2008 compared with 15.1 per cent as at the end of June 2007. Though NPLs have been declining, the impact of the December 2007 post-election crisis reversed the gains in the first half of year 2008. Consequently, NPLs increased from Ksh 57.2 billion in December 2007 to Ksh 58.3 billion at the end of June 2008. Despite the increase in NPLs, the ratio of net non-performing loans to gross loans improved from 4.8 percent in June 2007 to 3.4 percent in June 2008.

Deposit Liabilities

The banking sector's total deposits, a major component of the banking sector funding grew by 27.7 percent from Ksh 682.1 billion as at the end of June 2007 to Ksh 871.2 billion as at June 2008. The increase in deposit base was partly attributed to inflows for Safaricom IPO, aggressive marketing campaigns for new deposits by some institutions coupled with rapid expansion of branch network as well as external donor inflows.

Capital and Reserves

Capital and reserves of the banking sector increased by 35.2 percent from Ksh 104.4 billion in June 2007 to Ksh 141.2 billion in June 2008. Total capital comprising core and supplementary capital also increased by 35 percent to Ksh 129.0 billion compared with Ksh 95.7 billion in June 2007. Total capital to total risk weighted assets ratio stood at 18.1 percent compared with 17.3 percent in June 2007. Core capital increased by 28.3 per cent from Ksh 91.3 billion in June 2007 to Ksh 117.1 billion as at the end of June 2008. The increase was due to injection of additional capital and retention of profits.

Profitability

Banking sector pre-tax profit increased by 46.6 percent from Ksh 16.3 billion in June 2007 to Ksh 23.9 billion in June 2008. Income before tax for the period ended June 2008 was Ksh 70.8 billion, an increase of 38.3 percent compared with Ksh 51.2 billion in June 2007. Interest income amounted to Ksh 47.7 billion and accounted for 67.4 percent of the total income in June 2008. Total expenses of the sector were Ksh 46.9 billion, which comprised interest expenses (28 percent), bad debt charges (5 percent) and non-interest expenses (67 percent). Salaries and wages constituted 34 per cent of total expenses as institutions recruited more staff to match the expansion of their branch network. Return on equity and return on assets was 40.7 percent and 4.2 percent, respectively.

TABLE 6.2: BANKING INDUSTRY PROFITS (KSH BILLION)

Item	June-08	June-07	% Change
Total income	70.8	51.2	38.2
Expenses before provisions	44.7	32.1	39.3
Profit before provisions	26.2	19.1	37.2
Provisions for bad debts	2.2	2.8	-21.4
Profit before tax	**23.9**	**16.3**	**46.6**

Source: Published Financial Statements and Disclosures

Outlook for the Banking Sector

The banking sector is dominated by 6 large banks which account for approximately 58 per cent of the market share. The remaining banks are small and have limited outreach. In view of this, there are enormous opportunities in the economy to expand banking services to parts of the population that do not hold bank accounts, particularly in the rural areas. This will provide a greater pool of savings to finance the productive investments of Vision 2030.

Banking institutions will need to cope with continuously changing business environment and a continuous flood of new requirements via robust ICT platforms, while staying sufficiently agile. Secondly, the world is undergoing a “Knowledge Revolution” whose consequences will exceed even those of the industrial revolution. Hence banks will be expected to continue aggressively designing new products that leverage on ICT to remain competitive. Down streaming into the retail market segment is also expected to continue particularly with the anticipated licensing of deposit taking Microfinance Institutions in 2008.

Additional capital injection is also expected as banking institutions expand into the region in search of growth opportunities in line with trends towards regional and economic integration. Competition will also intensify as Pan-African banking groups from South and West Africa target Kenya as their East and Central Africa regional hub.

Diversification into other financial services such as insurance, securities and financial advisory services is also anticipated as consumers increasingly seek ‘’one stop financial supermarkets.’’ These developments are expected to enhance banking products being offered and bring more Kenyans into the banking space.

Lifting of the moratorium on the licensing of new Foreign Exchange Bureaus will lead to new entrants in the Forex Bureau sector, in year 2008. This is expected to improve service delivery and generate more competition and efficiency in the market sector.

Enactment of the Proceeds of Crime and Anti-Money Laundering Bill expected in 2008 will require the establishment of appropriate systems by institutions to identify and prevent anti-money laundering and combat financing of terrorism activities in Kenya. Kenya as a regional trade and financial hub, is highly exposed to money laundering threats, therefore, it is imperative that the Kenyan financial system aims at building very robust anti-money laundering systems.

7. MICRO FINANCE SECTOR DEVELOPMENTS

Status of the Microfinance Industry

The Microfinance industry in Kenya continues to meet the needs of an increasing number of un-banked and underserved segments of the Kenyan population including the poor and low-income households, farmers, traders and micro-entrepreneurs. Microfinance business in Kenya is carried out under several institutional forms ranging from formal, semi-formal and informal financial service providers such as commercial banks, the Kenya Post Office Savings Bank (Postbank), microfinance institutions (MFIs), savings and credit co-operative societies (SACCOs), rotating and savings and credit associations and accumulating and savings and credit associations (ROSCAs and ASCAs), money lenders and shopkeepers, among many others.

There are currently four commercial banks engaged in microfinance business in Kenya. They are: Equity Bank, K-REP Bank, Co-operative Bank and Family Bank. The number of banks involved in microfinance is expected to increase over the coming years.

The Association of Microfinance Institutions (AMFI) has 36 members. Twenty seven of these institutions are retail lending microfinance institutions with about 800 outlets and outstanding loan portfolio amounting to Ksh.4.6 billion with an estimated 1.2 million and 300,000 savers and borrowers, respectively. As at 31st December, 2007, there were 5,122 registered SACCOs serving an estimated membership of 3.3 million with an outstanding loan portfolio and shares and deposit base amounting to about Ksh.110 billion and Ksh.165 billion, respectively. Postbank has about 1.3 million customers with savings volume amounting to Ksh.12 billion. Postbank has a network of 80 branches, 5 sub-branches, 395 outlets and over 400 locations operated on an agency basis by the Postal Corporation of Kenya (POSTA) countrywide. As at June 2008, it was estimated that commercial banks, microfinance institutions, SACCOs and Postbank that were engaged in microfinance had over 8 million savings accounts.

Access to Financial Services and Products

According to the *Finaccess* survey study of 2006, only 19 percent of Kenyans have access to financial services and products through commercial banks and the Kenya Post Office Savings Bank (Postbank). An additional 8 percent are served by SACCOs and microfinance institutions, while a majority of people, 35 percent depend primarily on informal financial services such as ASCAs, ROSCAs, shopkeepers and money lenders, among many others. These survey results indicated that 38 percent of Kenyans have no access to financial services and products, hence classified as 'un-banked' or financially excluded. This indicates a big gap in access to financial services and products by Kenyans. The Government expects the deposit-taking microfinance institutions (MFIs) to boost access to financial services through innovative and client driven products and delivery channels.

The Microfinance Legislation

The Microfinance Act and operational regulations came into force on 2nd May 2008. As a result, the Central Bank has commenced licensing deposit-taking microfinance institutions. The Act applies to both deposit-taking and non-deposit taking microfinance institutions. The Bank is already processing a number of applications for licences.

It is expected that several existing credit-only microfinance institutions will be transforming to regulated status under the Act in order to: -

- Gain increased access to additional sources of funds to support growth, profitability and sustainability;
- Offer a wider range of financial services and products including savings/ deposit mobilization, lending, money transfer and micro-insurance to meet the various needs of their clients;
- Increase private sector ownership and enhance internal controls and corporate governance;
- Improve efficiency and overall financial performance and competition in the financial markets;
- Focus more attention on their customers' needs and desires (customer satisfaction);
- Improve financial transparency and accountability; and

- Unlock the unrealized potential of the un-banked and under served segments of the population.

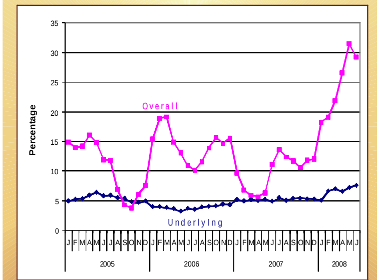
The Microfinance Act is, therefore, expected to set a new dawn in the orderly growth and development of the microfinance industry that ensures stability and enhanced efficiency. These quasi-banking institutions are expected to enhance access to financial services and products particularly to the poor, low-income households and Micro- and Small- scale Enterprises (MSEs) including informal micro-businesses. The Microfinance Act will, therefore, go a long way in fulfilling the Kenya Vision 2030 goals.

8. INFLATION

The 12-month overall inflation fell from 13.6 percent in July 2007 to 12 percent in December 2007, peaked at 31.5 percent in May 2008 before easing to 29.3 percent in June 2008. The increase was mainly on account of supply shocks resulting from adverse climatic conditions that led to food shortage, effects of the post election crisis and sharp increases in international crude oil prices. Average annual overall inflation also declined from 10.4 percent in the year to June 2007 to 9.8 percent in the year to December 2007, and then rose to 18.5 percent in the year ending June 2008.

The 12-month underlying inflation increased from 4.9 percent in June 2007 to 7.6 percent in June 2008. The average annual underlying inflation also increased from 4.6 percent in the year to June 2007 to 6.0 percent in the year to June 2008. Over the same period, the average annual underlying inflation rose above the 5 percent target between November 2007 and June 2008. Inflation in the alcohol and tobacco category was higher partly due to increased taxation rates, as well as higher inflationary pressures from other categories such as household goods and services, medical goods and services, and recreation and education. Chart 8A and Table 8.1 show trends in both overall and underlying inflation rates based on the month-on-month measure of inflation.

CHART 8A:12-MONTH INFLATION (%)



Source:Kenya National Bureau of Statistics

TABLE 8.1: MONTH-ON-MONTH OVERALL AND UNDERLYING INFLATION (%)

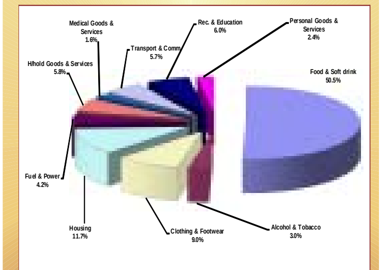
	2007					2008					
	Jun	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
Overall	11.1	11.72	10.55	11.83	12.03	18.22	19.13	21.83	26.63	31.54	29.26
Underlying	4.9	5.34	5.41	5.3	5.25	5.07	6.64	6.98	6.54	7.24	7.6

Sources: Kenya National Bureau of Statistics and Central Bank of Kenya

Inflation by Category of Goods and Services

The categories of goods and services and their respective weights in the basket are presented in Chart 8B. All categories of goods and services recorded higher 12-month inflation in June 2008 compared with June 2007, with the exception of the housing category, which decreased from 5.8 percent in June 2007 to 5.5 in June 2008.

CHART 8B: GOODS AND SERVICES CATEGORY WEIGHTS



Source: Kenya National Bureau of Statistics

The food and drink category experienced the highest inflation of 40.1 percent in June 2008, up from 15.0 percent in June 2007. The fuel and power category also witnessed a big jump, from 8.5 percent in June 2007 to 20.1 percent in June 2008 as a result of increases in the prices of electricity and petroleum products. Inflation in the transport and communications category increased from 3.1 percent in June 2007 to 21.0 percent in June 2008, due to increases in the fuel prices. Inflation for the alcohol and tobacco category increased from 8.0 percent in June 2007 to 14.2 percent in June 2008, while that for medical goods and services increased from 4.7 percent to 10.3 percent during the same period. Other categories experienced price increases over the period under review as follows: Household goods and services from 5.9 percent to 8.6 percent, recreation and education from 3.1 percent to 6.9 percent, personal goods and services from 3.6 percent to 6.8 percent,and clothing and footwear from 3.3 percent in June 2007 to 5.3 percent in June 2008.

Inflation Among Income Groups and Areas

All the four income groups experienced higher inflation in the year to June 2008 than in the year to June 2007. The Nairobi lower income group experienced an average of 29.8 percent in the year to June 2008, compared with 12.9 percent in the year to June 2007. The high inflation in this income category is explained by the group’s higher income expenditure share on food and drinks whose inflation is usually high and volatile. The other income groups experienced price increases over the period under review as follows: Nairobi middle/upper income group increased from 7.4 percent in June 2007 to 16.0 percent in June 2008; the ‘’Combined Nairobi’’ income group increased from 12.0 percent in June 2007 to 27.7 percent in June 2008; the ‘’Rest of Kenya’’ income group averaged 30.3 percent in June 2008 compared with 10.5 percent in June 2007. Thus high inflation continues to hit harder on the urban lower income groups and the poor in general.

Inflation Outlook

The volatility in international oil prices continues to pose a threat to price stability. Similarly, the upsurge in food as well as energy prices is a major challenge to monetary policy. The Bank will, however, continue to monitor developments so as to be on guard against possible risks to price stability, and make any necessary adjustments to policy instruments as may be warranted.

Inflation in the future will, therefore, depend on the developments in the food and fuel prices, as well as the prevailing weather conditions.

9. INTEREST RATES

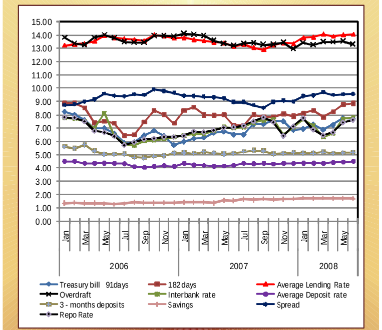
The Central Bank Rate

The Central Bank Rate (CBR) was reviewed upwards in August 2007 from 8.50 percent to 8.75 percent on recommendation from the Monetary Policy Advisory Committee (MPAC). It was retained at 8.75 in October 2007 through to December 2007. In June 2008 the Monetary Policy Committee (MPC) advised that it be adjusted upwards to 9.00 percent to bring it in line with other short term interest rates.

Short Term Interest Rates

As a result of the upward review of the CBR in August 2007, short term interest rates rose during the period January to June 2008, with the 91–day Treasury bill rate increasing from an average of 6.68 percent in December 2007 to 7.73 percent in June 2008. The average interbank rate increased from an average of 7.05 percent in December 2007 to 7.79 percent in June 2008, while the Repo rate increased from 7.12 percent in December 2007 to 7.61 percent in June 2008. The average 182-day Treasury bill rate, also rose over the same period from 7.87 percent in December 2007 to 8.84 percent in June 2008.

CHART 9A: INTEREST RATES



Source: Central Bank of Kenya

TABLE 9.1: INTEREST RATES (%)

	2007						2008					
	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
Treasury bill 91days	6.52	7.30	7.32	7.55	7.52	6.87	6.95	7.28	6.89	7.25	7.76	7.73
182 days	7.17	7.99	7.82	7.84	8.04	7.87	8.09	8.3	7.82	8.2	8.75	8.84
Average Lending Rate	13.29	13.04	12.87	13.24	13.39	13.32	13.78	13.84	14.06	13.91	14.01	14.06
Overdraft	13.34	13.39	13.26	13.29	13.43	12.96	13.41	13.26	13.48	13.46	13.53	13.30
Interbank rate	7.07	7.38	7.59	7.65	6.50	7.05	7.66	7.18	6.35	6.59	7.72	7.79
Average Deposit rate	4.33	4.31	4.34	4.27	4.33	4.32	4.37	4.37	4.35	4.41	4.45	4.48
3 - months deposits	5.24	5.34	5.28	5.05	5.1	5.18	5.1	5.11	5.21	5.1	5.14	5.18
Savings	1.65	1.60	1.67	1.64	1.65	1.67	1.72	1.70	1.72	1.71	1.71	1.70
Spread	8.96	8.73	8.53	8.97	9.06	9.00	9.41	9.47	9.72	9.50	9.56	9.58

Source: Central Bank of Kenya

On an annual basis, short term interest rates were higher in June 2008 than in June 2007. The annual average interest rate on the 91-day Treasury bill increased from 6.53 percent in June 2007 to 7.73 percent in June 2008. Similarly, the average interest rate on the 182-day Treasury bill rose from 7.19 percent in June 2007 to 8.84 percent in June 2008. The increase in short term interest rates during the year reflected tight liquidity in the money market, especially towards the end of the year as a result of the Safaricom IPO which led to undersubscription of Government securities during the IPO period. Over the same period, the average interbank rate increased from 6.98 percent in June 2007 to 7.79 percent in June 2008. The Repo rate also increased from 7.07 percent to 7.61 percent in June 2008.

Lending Rates

Average lending and deposit interest rates were slightly higher in June 2008 than in June 2007. The commercial banks' overall weighted average lending rate rose from 13.1 percent in June 2007 to 14.1 percent in June 2008. The rise in the overall lending rate reflected the increase in lending rates for the "over 5 year" loans category which rose by 177 basis points. This was mainly owing to the over 5 year corporate lending rate that increased by 110 basis points. Lending rates for virtually all categories of loans went up except the overdraft category that declined for both personal and business categories. The 1-5 year lending category for Business also fell slightly by 5 basis points. The rise in lending rates can be attributed to rising inflationary pressures, caused by supply-side disruptions, resulting from the crisis that rocked the country in the earlier months of 2008.

Deposit Rates

Overall weighted average deposit rate rose from 4.18 percent in June 2007 to 4.48 percent in June 2008. The "over three months" category went up by 64 basis points, which was much higher than the increase in the other deposit interest rates. The interest rate on demand deposit remained unchanged at 1.5 percent in June 2007, while the savings deposit interest rate increased from 1.54 percent to 1.67 percent in June 2008.

The increase in the overall lending interest rate in June 2008 was much higher than the increase in the overall deposit rate. Consequently, the interest rate spread rose from 8.96 percent in June 2007 to 9.58 percent in June 2008. Chart 9A and Table 9.1 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. They are expected to remain stable in the medium term as they tend towards the CBR which is expected to signal the monetary conditions in the economy. The stable interest rate will be supported by the continued implementation of prudent monetary policy by the Bank.

10. BALANCE OF PAYMENTS

Overview

Kenya's balance of payments surplus improved from US$ 372 million in the 2006/07 fiscal year to US$ 708 million during the 2007/08 fiscal year (Table 10.1). The improvement resulted from foreign direct investment inflows associated with privatization of a state corporation and strategic investments in the banking sector. The surplus in the capital and financial account therefore rose by US$ 988 million to US$ 2,059 million during the 2007/08 fiscal year. This improvement more than offset the current account deficit, which had widened by US$ 652 million to US$ 1,351 million during the year in review owing to increased merchandise imports.

TABLE 10.1: BALANCE OF PAYMENTS (US $ M)

ITEM	Year to Jun 2007*	Year to June 2008* Q1 Jul-Sep	Q2 Oct-Dec	Q3 Jan-Mar	Q4 Apr-Jun	Year to Jun 2008*	Absolute Change
1. OVERALL BALANCE	372	111	490	79	27	708	336
2. CURRENT ACCOUNT	-699	-333	-367	-359	-292	-1351	-652
2.1 Goods	-4295	-1263	-1298	-1363	-1301	-5224	-930
Exports (fob)	3873	1038	1065	1225	1281	4610	737
Coffee	143	43	36	39	51	169	27
Tea	727	166	150	201	238	755	27
Horticulture	552	139	166	226	208	739	187
Oil products	166	47	29	41	28	145	-21
Manufactured Goods	474	137	134	148	153	571	97
Raw Materials	224	65	69	99	86	320	96
Re-exports	218	44	52	52	65	213	-4
Other	1370	397	429	419	453	1698	329
Imports (cif)	8168	2302	2363	2588	2582	9834	1667
Oil	1755	454	563	692	739	2448	693
Chemicals	1102	292	303	359	363	1318	215
Manufactured Goods	1234	383	386	357	379	1505	271
Machinery & Transport Equipment	2662	710	677	709	666	2762	100
Other	1415	462	435	471	434	1802	387
2.2 Services	3595	930	931	1004	1008	3873	278
Non-factor services (net)	1751	445	492	393	389	1719	-32
of which tourism	810	218	214	154	197	783	-27
Income (net)	-112	-45	-47	54	18	-20	93
of which official interest	-126	-32	-40	-26	-26	-123	4
Current Transfers	1957	530	486	557	601	2174	217
Private (net)	1870	481	437	502	601	2021	150
Public (net)	87	49	49	55	0	153	66
3. CAPITAL & FINANCIAL ACCOUNT	1071	444	857	438	320	2059	988
3.1 Capital Tranfers (net)	224	18	109	32	166	326	102
3.2 Financial Account	847	426	749	405	153	1733	886
Official, medium & long-term	-83	-34	50	6	42	65	148
Inflows	154	24	110	78	105	317	163
Outflows	-237	-58	-60	-71	-63	-252	-15
Private, medium & long-term (net)	-345	33	477	27	-523	14	359
Commercial Banks (net)	-446	75	19	-82	-504	-493	-47
Other private medium & long-term (net)	100	-42	458	109	-19	507	406
Short-term (net) incl. errors & omissions	1276	427	221	372	635	1654	379
memo:							
Gross Reserves	3767	3870	4557	4743	5786	5786	2019
Official	2723	2820	3355	3422	3445	3445	722
*imports cover***	*3.6*	*3.5*	*4.0*	*3.9*	*3.7*	*3.7*	0.2
*imports cover****	*4.3*	*4.3*	*4.8*	*4.7*	*4.5*	*4.5*	0.2
Commercial Banks	1044	1050	1202	1321	2341	2341	1297

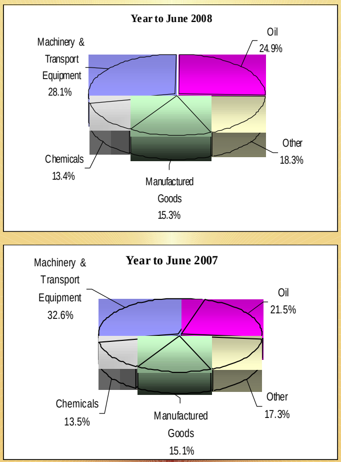
* Provisional
** Based on current year's imports of goods and non-factor services
*** Based on 36 months average of imports of goods and non-factor services

Source: Central Bank of Kenya

Merchandise Account

Kenya's trade deficit widened by 21.7 percent during the 2007/08 fiscal year. This was attributed to US$ 1,667 million increase in the value of merchandise imports compared with US$ 737 million growth in the value of merchandise exports. The growth in the value of merchandise imports was reflected in increased imports of capital and intermediate goods, while the value of merchandise exports increased due mainly to increased exports of horticulture and manufactured goods.

CHART 10A: COMPOSITION OF KENYA'S IMPORTS

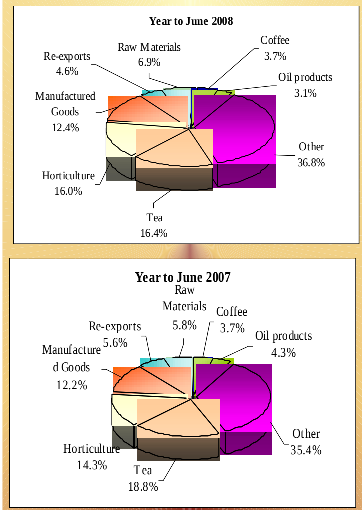


Sources: Central Bank of Kenya

Imports

Kenya's merchandise imports increased to US$ 9,834 million during the 2007/08 fiscal year from US$ 8,168 million in the 2006/07 fiscal year. Increases were in all import categories, namely, machinery and transport equipment, manufactured goods, chemicals and oil. These items respectively accounted for 28.1 percent, 15.3 percent, 13.4 percent and 24.9 percent of the total value of imports during the period in review (Chart 10A).

CHART 10B: COMPOSITION OF KENYA'S EXPORTS



Sources: Central Bank of Kenya

Exports

Merchandise exports which mainly comprise horticulture, tea, manufactured goods, raw materials and coffee (Chart 10B), rose to US$ 4,610 million during the 2007/08 fiscal year from US$ 3,873 million in a similar period in the previous year.

The higher value of horticulture exports reflected increased export volume for vegetables, fruits and cut flowers. The export prices for fruits and cut flowers also increased while the export price for vegetables declined. The value of tea exports rose during the review period following an increase in export price from an average of US$ 1,971 per tonne in the 2006/07 fiscal year to an average of US$ 2,100 per tonne in the 2007/08 fiscal year. This price increase compensated for a decline in tea export volume from 371,635 tonnes to 357,646 tonnes. The value of coffee exports rose due to improved export price from an average of US$ 2,769 per tonne to an average of US$ 3,190 per tonne and increased export volume from 50,796 tonnes to 53,791 tonnes. The value of manufactured goods exported increased during the 2007/08 fiscal year reflecting increased exports of processed leather, cement and metal manufactures. The decline in the value of oil exported reflected reduced exports of diesel.

Other miscellaneous exports rose to US$ 1,698 million reflecting increased exports of chemical products, electrical machinery, tobacco products and sugar.

Services Account

In the services account the surplus increased by US$ 278 million in the 2007/08 fiscal year reflecting increased current transfers. Net current transfers receipts rose by US$ 217 million to US$ 2,174 million in the 2007/08 fiscal year reflecting in part increased external remittance receipts. The value of external remittances received through commercial banks increased from US$ 453 million in the 2006/07 fiscal year to US$ 664 million in the 2007/08 fiscal year.

Net receipts from non-factor services, however, declined by US$ 32 million to US$ 1,719 million in the 2007/08 fiscal year. reflecting increased payments for services. Gross non-factor service payments rose by US$ 271 million to US$ 1,206 million reflecting mainly increased payments for transportation services, foreign travel, insurance, royalties and license fees. Gross receipts from non-factor services rose by US$ 239 million to US$ 2,925 million in the 2007/08 fiscal year reflecting increased receipts from transportation, Government services and other private sector services particularly communication. Inflows related to foreign travel declined by US$ 27 million to US$ 783 million, in the 2007/08 fiscal year.

On the income account the balance improved to a net outflow of US$ 20 million in the 2007/08 fiscal year compared with a net outflow of US$ 112 million in the 2006/07 fiscal year. This improvement was attributed to increased interest earnings on official foreign exchange reserves which grew by US$ 37 million to US$ 157 million, increased income earned by the private sector to US$ 98 million and marginally reduced interest payments on official foreign debt by US$ 3 million to US$ 123 million. Income payments by the private sector however increased by US$ 34 million to US$ 124 million reflecting increased payments of interest on foreign debt, dividends and distributed profits.

Capital and Financial Flows

The capital and financial account improved from US$ 1,071 million in the 2006/07 fiscal year to US$ 2,059 million in the 2007/08 fiscal year, mainly due to increased foreign direct investment inflows.

Private medium and long-term financial flows improved to a net inflow of US$ 14 million in the 2007/08 fiscal year compared with a net outflow of US$ 345 million a year earlier. The increase in foreign direct investment inflows was associated with privatization of a state corporation and strategic investments in the banking sector. Other private medium and long-term financial flows, however, deteriorated as net foreign loan repayments, capital repatriation and commercial banks' holding of net foreign assets increased. Net short term financial inflows, including errors and omissions in recorded transactions, increased to US$ 1,654 million in the 2007/08 fiscal year.

Official medium and long-term financial flows improved to a net inflow of US$ 65 million in the 2007/08 fiscal year, mainly due to increased foreign loans to the Government by US$ 163 million to US$ 317 million. Official loans repayments however, rose by US$ 15 million to US$ 252 million. The balance on the capital account increased by US$ 102 million to US$ 326 million owing to increased project grants to the Government.

Direction of Trade

As shown in Table 10.2, the main destination countries for Kenya's merchandise exports in the 2007/08 fiscal year were Uganda (12.4 percent), United Kingdom (11.3 percent), the Netherlands (8.1 percent), Tanzania (8.0 percent), United States

TABLE 10.2: KENYA'S EXPORTS: MAIN DESTINATION COUNTRIES (US$ M)

Destination Country	Fiscal Years		
	2005/06	2006/07	2007/08
Uganda	434	435	571
Tanzania	259	291	367
Sudan	110	166	200
Somalia	75	115	179
Egypt	140	151	157
DRC	101	116	130
Others	339	432	494
Total Africa	**1,459**	**1,705**	**2,098**
United Kingdom	332	396	520
Netherlands	249	299	372
USA	121	294	283
Pakistan	199	223	169
United Arab Emirates	57	85	151
India	51	65	97
Germany	67	69	94
France	55	50	70
Afghanistan	17	33	53
Others	713	653	704
Total Exports	**3,321**	**3,873**	**4,610**

Source: Central Bank of Kenya

of America (6.1 percent), Sudan (4.3 percent), Somalia (3.9 percent), Pakistan (3.7 percent), and Egypt (3.4 percent).

Kenya sourced most of her imports from the United Arab Emirates (16.3 percent), India (10.9 percent), China (8.3 percent), Japan (6.6 percent), South Africa (6.1 percent), United Kingdom (4.2 percent), United States of America (4.0 percent), Germany (3.6 percent), Indonesia (3.4 percent), Saudi Arabia (2.9 percent) and France (2.5 percent) (Table 10.3).

TABLE 10.3: KENYA'S IMPORTS: MAIN SOURCE COUNTRIES (US$ M)

Source Country	Fiscal Years		
	2005/06	2006/07	2007/08
South Africa	561	454	597
Egypt	99	148	144
Tanzania	44	81	107
Uganda	6	41	93
Swaziland	51	56	57
Djibouti	2	0	50
Others	62	187	118
Total Africa	**825**	**967**	**1,166**
United Arab Emirates	940	1,194	1,600
India	382	703	1,069
China	302	540	817
Japan	324	503	653
United Kingdom	684	432	409
USA	256	643	393
Germany	232	304	351
Indonesia	145	227	335
Saudi Arabia	302	316	289
Others	2,027	2,338	2,750
Total Imports	**6,419**	**8,168**	**9,834**

Source: Central Bank of Kenya

Kenya's Trade Structure

Kenya's total trade with Asia and America increased from 42.0 percent and 7.0 percent respectively, in 2006 to 43.2 percent and 8.6 percent, respectively, in 2007. The proportion of trade with European countries, however, declined to 25.1 percent in 2007 while trade with African countries was stable at 22.3 percent (Table 10.4).

TABLE 10.4: KENYA'S TRADE STRUCTURE

	Total Trade in Billions of Kenya Shillings					Proportion (%)				
	2003	2004	2005	2006	2007*	2003	2004	2005	2006	2007*
Europe	134.2	159.5	172.5	206.9	220.4	28.9	27.5	24.5	26.8	25.1
Western Europe	127.0	151.9	165.8	194.5	207.2	27.3	26.2	23.6	25.2	23.6
European Union	119.0	143.9	155.7	180.2	193.7	25.6	24.8	22.1	23.3	22.0
Others	8.0	7.9	10.1	14.3	13.5	1.7	1.4	1.4	1.8	1.5
Eastern Europe	7.2	7.6	6.7	12.4	13.1	1.5	1.3	1.0	1.6	1.5
America	22.1	30.5	65.1	53.8	76.0	4.7	5.3	9.3	7.0	8.6
U.S.A	17.2	18.9	54.6	45.1	63.7	3.7	3.3	7.8	5.8	7.2
Others	4.9	11.6	10.5	8.8	12.2	1.0	2.0	1.5	1.1	1.4
Africa	122.0	154.3	183.5	171.9	196.0	26.2	26.6	26.1	22.3	22.3
E.A.Community	56.4	67.2	78.3	59.1	77.0	12.1	11.6	11.1	7.7	8.8
Tanzania	16.0	19.9	23.1	22.8	29.0	3.4	3.4	3.3	3.0	3.3
Uganda	31.7	38.1	44.1	28.8	39.5	6.8	6.6	6.3	3.7	4.5
Comesa	33.2	42.1	49.8	56.7	66.8	7.1	7.3	7.1	7.3	7.6
Other Countries	32.4	45.0	55.4	56.1	52.2	7.0	7.8	7.9	7.3	5.9
Asia	174.4	219.1	257.6	324.2	380.3	37.5	37.8	36.6	42.0	43.2
Middle East	82.0	107.7	116.8	129.5	143.6	17.6	18.6	16.6	16.8	16.3
Far East	92.3	111.4	140.8	194.7	236.7	19.9	19.2	20.0	25.2	26.9
Australia & Oceanic	2.5	2.1	2.5	3.8	3.1	0.5	0.4	0.4	0.5	0.4
All other Countries N.E.S	9.9	13.9	22.3	11.8	3.9	2.1	2.4	3.2	1.5	0.4
Grand Total	**465.0**	**579.4**	**703.5**	**772.5**	**879.7**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

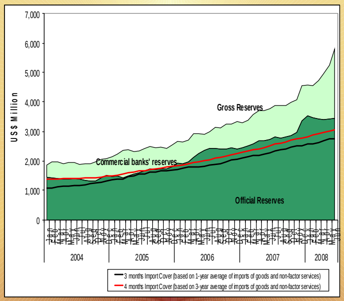
*Provisional

Source: Economic Survey, 2008

Increased trade with Asian countries reflected increased trade with China, Japan, and India (Economic Survey 2008). Much of the trade between Kenya and European countries was with the European Union, the share of which however declined. Trade with African countries remained unchanged with the trade concentrated in the EAC and COMESA regions.

Foreign Exchange Reserves

CHART 10C: FOREIGN EXCHANGE RESERVES



Source: Central Bank of Kenya

Following the favorable outturn in the balance of payments, gross foreign assets of the banking system rose from US$ 3,767 million at the end of June 2007 to US$ 5,786 million at end of June 2008 (Chart 10C).

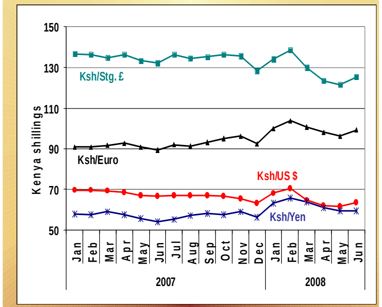
Foreign exchange reserves held by the Central Bank of Kenya increased from US$ 2,723 million at the end of June 2007 to US$ 3,445 million (equivalent to 4.5 months of imports) at the end of June 2008. The build up in official reserves during the 2007/08 fiscal year was largely achieved through purchases of foreign exchange by the Bank from the domestic inter-bank market amounting to US$ 217 million. The purchases were made to cover Government's external obligations amounting to US$ 558 million and the Bank's own expenses amounting to US$ 44 million. Forex purchases were also required to maintain official reserve levels above the statutory minimum in view of growing imports. During the year, the Bank also received US$ 1,149 million being privatization proceeds, interest earned on foreign exchange reserves and foreign aid to the Government.

Gross foreign assets of commercial banks also rose from US$ 1,044 million at the end of June 2007 to US$ 2,341 million at the end of June 2008. These assets were largely held as balances with banks abroad amounting to US$ 1,920 million in addition to other foreign assets including cash, foreign loans and foreign bills discounted. Besides these holdings, foreign currency deposits held locally by residents increased by US$ 380 million to US$ 1,924 million at the end of June 2008.

11. EXCHANGE RATES

The Kenya shilling had mixed performance against major world currencies in the 2007/08 fiscal year as shown in Table 11.1 and Chart 11A. The shilling appreciated against the US dollar by 4.2 percent between June 2007 and June 2008 to exchange at an average of Ksh 63.8 per US dollar in June 2008, compared with Ksh 66.6 per US dollar in June 2007. The appreciation of the shilling against the US dollar was largely supported by foreign investment inflows.

CHART 11A: KENYA SHILLING EXCHANGE RATES



Source: Central Bank of Kenya

The shilling gained against the Sterling Pound but depreciated against the Euro to exchange at Ksh 125.3 per Sterling Pound and Ksh 99.2 per Euro in June 2008, compared with Ksh 132.3 per Sterling Pound and Ksh 89.3 per Euro in June 2007. The shilling also lost against the Japanese Yen during the period under review, and exchanged at an average of Ksh 59.6 per 100 Yen in June 2008.

Against African currencies, the Kenya shilling gained against the South African Rand by 13.6 percent and the Uganda shilling by 0.7 percent in the 2007/08 fiscal year to exchange at Ksh 8.0 per Rand and Ush 25.1 per Kenya shilling in June 2008. The Kenya shilling, however, depreciated against the Tanzania shilling from Tsh 19.0 per Kenya shilling in June 2007 to Tsh 18.6 per Kenya shilling in June 2008.

TABLE 11.1: KENYA SHILLING EXCHANGE RATES

	2006			2007			2008		% Change
	Jan	Jun	Dec	Jan	Jun	Dec	Jan	Jun	Jun-07 to Jun-08
Kshs/US$	72.2	73.4	69.6	69.9	66.6	63.3	68.1	63.8	-4.2[a]
Kshs/Stg. £	127.5	135.4	136.8	136.9	132.3	128.5	134.0	125.3	-5.3[a]
Kshs/Euro	87.5	93.0	92.0	90.9	89.3	92.2	100.2	99.2	11.1[b]
Kshs/Yen	62.6	64.0	59.5	58.1	54.3	56.5	63.2	59.6	9.8[b]
Kshs/Rand	11.8	10.5	9.9	9.7	9.3	9.3	9.8	8.0	-13.6[a]
Ushs/Kshs*	25.2	25.3	26.1	26.0	25.0	27.1	25.2	25.1	0.7[a]
Tshs/Kshs*	16.3	17.1	18.6	18.6	19.0	18.4	17.1	18.6	-1.7[b]

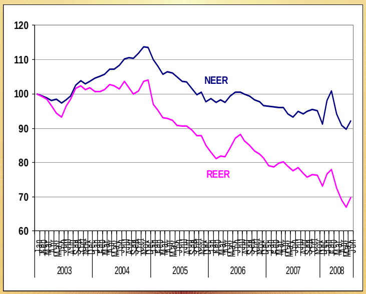
*Currency per Kenya shilling

[a] --appreciation

[b] --depreciation

Source: Central Bank of Kenya

CHART 11B: KENYA SHILLING REER AND NEER



NEER: Nominal Effective Exchange Rate Index (2003=100)
REER: Real Effective Exchange Rate Index (2003=100)

Source: Central Bank of Kenya

International Trade Competitiveness

The performance of the Kenya shilling against bilateral currencies was reflected in the basket of Kenya's major trading partner country currencies. The trade-weighted nominal exchange rate index (NEER) declined by 1.1 percent between June 2007 and June 2008 as shown in Chart 11B. The real effective exchange rate index (REER), which is a measure of external competitiveness, appreciated by a larger magnitude of 10.1 percent reflecting higher inflation in Kenya relative to inflation in trading partner countries.

Outlook for the Kenya Shilling

The Kenya shilling is expected to remain stable albeit weaker in the next fiscal year due to expectations for higher import demand arising from growing domestic production. The continued pursuit of prudent monetary policy by the Central Bank is expected to reduce the negative effect of domestic inflation on the country's external competitiveness.

A. MODE OF PAYMENTS

1. CASH

Currency in circulation increased from Ksh 89.9 billion at the end of June 2007 to Ksh 99.9 billion at the end of June 2008 reflecting Ksh 10.0 billion or 11.1 percent growth from the previous year's issued currency as indicated in Table 12.1 below:

TABLE 12.1: CURRENCY IN CIRCULATION BY TYPE

	Jun-06		Jun-07		Jun-08	
Item	Ksh bn.	%	Ksh bn.	%	Kshs bn.	%
Currency in circulation	76.3	100	89.94	100	99.89	100
Bank Notes	73.20	95.9	86.45	96.1	96.14	96.2
Coins	3.10	4.1	3.49	3.9	3.75	3.8

Source: Central Bank of Kenya, Currency Operations & Branch Administration Department

Bank notes accounted for 96.2 percent of the Ksh 99.9 billion currency in circulation on June 30, 2008 while coins accounted for only 3.8 percent of this value (Table 12.1).

TABLE 12.2: CURRENCY IN CIRCULATION

	Bank notes				Coins		
	2006/2007 Pieces (m)	2007/2008 Pieces (m)	% change		2006/2007 Pieces (m)	2007/2008 Pieces (m)	% change
1000/=	64.66	72.26	11.7	40/=	1.90	1.65	(13.16)
500/=	16.40	18.86	15.1	20/=	59.45	66.35	11.61
200/=	26.81	28.84	7.6	10/=	94.90	98.50	3.79
100/=	57.59	62.40	8.4	5/=	128.60	140.40	9.18
50/=	42.12	41.72	-0.9	1/=	469.00	499.00	6.40
20/=	10.25	10.15	-1.0	/50=	218.00	248.00	13.76
10/=	12.20	12.10	-0.8	/10=	360.00	360.00	0.00
5/=	5.80	5.80	0.0	/05=	300.00	300.00	0.00
	235.83	252.13	6.9		1,631.85	1,713.90	5.0

Source: Central Bank of Kenya, Currency Operations & Branch Administration Department

Notes in circulation grew by 6.9 percent, from 236 million pieces in the year to June 30, 2007 to 252 million pieces in the year to June 30, 2008. There was a notable increase in the usage of Ksh 1,000, Ksh 500, Ksh 200 and Ksh 100 notes, that increased by 11.7 percent, 15.1 percent, 7.6 percent and 8.4 percent respectively. Coins in circulation grew by 5.0 percent in the same period from 1,632 million pieces to 1,714 million pieces, with the Ksh 20 coin, Ksh 5 coin, Ksh 1 coin, and Ksh 0.50 coin increasing by 11.61 percent, 9.18 percent, 6.40 percent, and 13.76 percent, respectively. Public preference for bank notes may explain the high proportion of bank notes in circulation.

Cash Inflows and Outflows

Deposits by banks (i.e cash inflows) increased by 18.3 percent from Ksh 227.5 billion as at June 30, 2007 to Ksh 269.1 billion as at June 2008, while withdrawals (ie cash outflows) increased by 15.8 percent from Ksh 241.1 billion to Ksh 279.1 billion in the same period. Consequently, there was a net currency outflow in the year to June 30, 2008 amounting to Ksh 9.96 billion as indicated in Table 12.3 below. This may be attributed to increased economic activity in the period under review.

TABLE 12.3: CURRENCY INFLOWS AND OUTFLOWS (KSH M)

Inflow by banks	2005/2006	2006/2007	2007/2008
Bank Notes	196,106	226,747	268,543
Coins	713	705	562
Total	**196,819**	**227,452**	**269,105**
Outflows by banks			
Bank Notes	204,716	239,983	278,236
Coins	923	1,077	831
Total	**205,638**	**241,060**	**279,066**
Net Outflows	**-8,819**	**-13,608**	**-9,961**

Source: Central Bank of Kenya, Currency Operations & Branch Administration Department

Development in Counterfeiting Practices

Counterfeit notes increased by 13.14 percent from 997 notes in the year to June 30, 2007 to 1,128 notes in the year to June 30, 2008 (Table 12.4). The resultant impact in value terms was an increase of 42.31 percent in the value of counterfeits from Ksh 561,800 in the previous year to Ksh 799,500 in the year to June 30, 2008.

TABLE 12.4: COUNTERFEIT NOTES BY DENOMINATION

	Pieces		Proportion
	2006/2007	2007/2008	2007/2008
1,000/=	395	653	57.89
500/=	184	205	18.17
200/=	336	172	15.25
100/=	70	94	8.33
50/=	12	4	0.35
20/=	0	0	0.00
10/=	0	0	0.00
5/=	0	0	0.00
Total	**997**	**1,128**	**100.00**

	Amounts (KSH)		Proportion
	2006/2007	2007/2008	2007/2008
1,000/=	395,000	653,000	81.68
500/=	92,000	102,500	12.82
200/=	67,200	34,400	4.30
100/=	7,000	9,400	1.18
50/=	600	200	0.03
20/=	0	0	0.00
10/=	0	0	0.00
5/=	0	0	0.00
Total	**561,800**	**799,500**	**100.00**

Source: Central Bank of Kenya, Currency Operations & Branch Administration Department

There were 653 pieces of Ksh 1,000 counterfeit notes making up 57.89 percent, 205 pieces of Ksh 500 or 18.17 percent, 172 pieces of Ksh 200 or 15.25 percent, and 94 pieces of the Ksh 100 or 8.33 per cent of the counterfeit notes, respectively.

2. NON-CASH INSTRUMENTS

The Clearing System Operations

The Automated Clearing House (ACH) operated smoothly during the year to June 30, 2008. The ACH Kenya shilling value throughput for the period under review was Ksh 4.29 billion with a volume of 24.17 million worth of transactions for both Debit and Credit instruments. This represents an increase of 7.6 percent in value moved compared with the same period last year as indicated in Table 12.5.

Cheques continued to dominate the non-cash payment instruments accounting for 77.2 percent of total transactions. In the year to June 2008, the average daily volume of cheques settled through the Nairobi ACH averaged 51,800 cheques valued at Ksh 10 billion, an increase from 48,833 cheques valued at Ksh 8.51 billion in similar period in 2007.

Electronic Funds Transfer (EFT) transactions or credit based payments increased by 14.1 percent during the year to Ksh 676 million as compared with Ksh 592 million in the previous year as indicated in Table 12.5.

TABLE 12.5: CLEARING HOUSE KSH TRANSACTIONS AS AT JUNE, 2008

Financial Year	Items	Values (Ksh bn)	Volumes ('000')
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**	**19,545**
2007	Debit	3,063	16,859
	Credit	592	5,601
	Total	**3,655**	**22,460**
2008	Debit	3,616	18,670
	Credit	676	5,496
	Total	**4,293**	**24,166**

Source: Central Bank of Kenya, Banking Services Division

The ACH witnessed increased activity in Domestic Foreign Currency Cheque Clearing (DFCCC) transactions in the year to June 30, 2008 compared with the same period last year. The US dollar, GBP, and Euro Cheques processed through the clearing house increased by 2.1 percent, 3.0 percent, and 5.8

percent from 272.4, 2.6, and 7.5 thousand Cheques to 278.0, 2.7, and 7.9 thousand Cheques respectively. While the US dollar and the Sterling pound cheques recorded an increase in the value moved, the Euro cheques recorded a decline in the value moved as indicated in Table 12.6. The US dollar continued to be the preferred currency in the domestic foreign exchange market.

TABLE 12.6: DOMESTIC FOREIGN CURRENCY CHEQUE CLEARING TRANSACTIONS TO JUNE 30, 2008

Currency	USD		GBP		EURO	
	Value (m)	Volume ('000')	Value (m)	Volume ('000')	Value (m)	Volume ('000')
2005	1,202.67	159.4	19.83	2.0	78.37	5.1
2006	1,812.80	240.8	23.07	2.6	114.30	7.2
2007	2,124.75	272.4	23.86	2.6	108.13	7.5
2008	2,457.48	278.0	35.82	2.7	99.06	7.9
Growth (percent)	15.66		50.14		(8.39)	

Source: Central Bank of Kenya, National Payments Systems

KEPSS Usage to June 30, 2008

Kenya Electronic Payments and Settlement System (KEPSS) moved a volume of 232,516 transactions worth Ksh 14,507 billion in the year to June 30, 2008, representing 49.6 percent increase in volume and 83.0 percent increase in value compared with the period to June 30 2007. The average amount moved per transaction increased from Ksh 51.4 million to Ksh 62.3 million, reflecting an increase of 21.6 percent. The number of transactions moved per day also increased by 51.3 percent in the year to June 30, 2008 to 949 transactions compared with 627 transactions in the year to June 30, 2007. This increase is attributed to increased awareness of KEPSS as a safe and efficient mode of payment for both high value and time critical payments and to a lesser extent the Safaricom Initial Public Offer related transfers. The proportion of Direct payments through KEPSS increased from 91.2 percent to 93.8 percent while Clearing House Net Settlement Instructions (NSI) proportion processed through KEPSS decreased from 8.8 percent to 6.2 percent in the same period (Tables 12.7 and 12.8).

TABLE 12.7: TRENDS IN TOTAL ANNUAL FLOWS

Year to June 30	Total value moved per year (Ksh m)	No. of Transactions	Average value per transaction (Ksh m)	Days worked	Per day	
					Value (Ksh m)	Transactions
2006	7,641,197	120,249	61.4	227	32,919	532
2007	7,929,003	155,131	51.4	249	32,038	627
2008	14,506,951	232,516	62.3	247	59,419	949

Source: Central Bank of Kenya, National Payments Systems

TABLE 12.8: DIRECT PAYMENTS VERSUS NET SETTLEMENT INSTRUCTIONS (NSI)

Year to June 30	Total value moved	Settlement proportions			
		Direct (Ksh m)	%	Indirect {NSI (Ksh m)}	%
2006	7,461,197	6,878,229	92.2	582,968	7.8
2007	7,929,003	7,234,837	91.2	694,166	8.8
2008	14,506,951	13,606,759	93.8	900,193	6.2

Source: Central Bank of Kenya, National Payments Systems

Multiple third party Message Type (MT) 102 increased by 12.1 percent from 8,147 messages in the year to June 30, 2007 to 9,132 messages in the year to June 30, 2008. In the same period, single third party Message Type (MT) 103 increased by 62.4 percent from 46,587 messages to 75,674 messages. Overall, total third party messages processed through KEPSS increased by 54.9 percent from 54,734 messages to 84,806 messages in the year to June 30, 2008 (Table 12.9 below).

TABLE 12.9: THIRD PARTY TRANSACTIONS PROCESSED THROUGH KEPSS BY MESSAGE TYPE

Year to June 30	MT102	MT103	TOTAL
2006	6,192	24,978	31,170
2007	8,147	46,587	54,734
2008	9,132	75,674	84,806

Source: Central Bank of Kenya, National Payments Systems

Mobile Phone Usage for Funds Transfer

The two mobile phone companies, Safaricom and Celtel, continued to offer their innovative remittances services through M-pesa and Sokotele, respectively. These innovative products have gained acceptance in the Kenyan market with a strong growth in customer registrations and uptake across the country.

An important development in this industry is that there has been an upsurge of enquiries from other private firms wishing to provide money transfer/remittances services. The Bank is working on a policy to guide money transfer systems based on the Bank for International Settlement recommendations for remittances service providers.

Automated Teller Machines and Plastic Card Usage

Demand for plastic cards continued to grow with the number of ATMs increasing by 46.3 percent from 737 ATMs by December 2006 to 1,078 ATMs by December 2007. ATM rollout by commercial banks as at December 31st, 2007 stood at 957, while non-banks stood at 121 in the same period. A notable observation on ATM rollout by banks is that more than 60 percent of the ATM market share is controlled by Equity, Barclays, Kenya Commercial Bank (KCB), and Co-operative bank with market shares of 20.5 percent, 17.9 percent, 13.2 percent, and 12.2 percent, respectively. The remaining banks with ATMs command less than 6 percent of the market share each.

The growth in ATMs may be attributed to commercial banks' branch expansion strategies in the last one year driven by the desire to capture new market segments and counter the increasing competition for customers in the banking sector while retaining or increasing market share. The sharp increase in the number of ATMs could also be attributed to PesaPoint with a rollout of 110 machines representing 10.2 percent of the total ATMs in the country.

The structure of ATMs distribution across the country remained relatively the same compared to that of the year 2006. By 31st December 2007, Nairobi province had the highest number of ATMs standing 463 (42.9 percent) followed by Rift Valley province 163 (15.1 percent), Central province 143 (13.3 percent), Coast province 116 (10.8 percent), Eastern province 78 (7.2 percent), Nyanza province 62 (5.8 percent), Western province 45 (4.2 percent), and North Eastern province 8 (0.7 percent) respectively, as indicated in Table 12.10 A.

TABLE 12.10A: ATMs AND CORRESPONDING BANK NETWORK STRUCTURE

	Number of ATM's			Bank Presence
	Banks	Non-Banks	Total	
Nairobi province	405	58	463	18
Central province	134	9	143	10
Rift Valley province	147	16	163	11
Western province	41	4	45	7
Nyanza Province	53	9	62	8
Coast province	99	17	116	17
Eastern province	71	7	78	9
North Eastern province	7	1	8	3
Total	957	121	1,078	

Correspondingly, the total number of cards in use rose from 1,657,054 cards in December 2006 to 2,078,362 cards in December 2007, representing an increase of 25.1 percent. This expansion is in line with recent developments in the banking sector including branch network expansion, new ATMs acquisitions and installation, outsourcing of card services, and technological innovations that facilitate multipurpose usage of cards. Tables 12.10B - 12.12 highlight these developments.

TABLE 12.10B: NUMBER OF ATMS AND USAGE (VOLUME & VALUE OF TRANSACTIONS)

	2000	2001	2002	2003	2004	2005	2006	2007
Number of ATM machines	94	107	174	215	324	555	737	1,078
Number of transactions '000'	5,297	5,707	6,005	4,637	6,656	9,103	14,222	42,076

TABLE 12.11: USAGE OF POS TERMINALS

	2000	2001	2002	2003	2004	2005	2006	2007
Electronic								
Number of transactions	0	0	311	2,318	2,630	3,524	3,607	3,774
Value of transactions	1,500	1,600	1,700	8,308	11,306	14,275	13,995	11,876
Manual								
Number of transactions	0	0	0	165	557	3,965	3,645	2,765
Value of transactions	0	0	0	5,048	6,086	7,973	8,452	8,354

TABLE 12.12: NUMBER OF CARDS IN CIRCULATION

	2000	2001	2002	2003	2004	2005	2006	2007
ATM cards	239,000	262,100	248,247	266,811	332,015	426,110	829,962	943,359
Debit cards	62,256	159,498	202,018	330,007	356,989	496,647	750,085	971,449
Credit cards	16,531	18,522	18,215	57,146	59,164	69,478	73,238	152,779
Charge cards	2,784	3,068	3,301	3,693	3,371	3,142	3,769	5,775
Total	320,571	443,188	471,781	657,657	751,539	995,377	1,657,054	2,073,362

Source: Central Bank of Kenya, National Payments Systems

B. CURRENT AND FUTURE DEVELOPMENTS

Legal Framework

The Bank together with the Ministry of Finance and the Attorney General's office held consultations on the draft NPS Bill in preparation for its presentation to Parliament. It is envisaged that the enactment of the Bill will facilitate the realization of a safe and efficient payment system in Kenya as it will widen the Bank's oversight function on institutions currently not licensed under the Banking and Micro Finance Acts, but are engaged in money transfer services.

The Bank participated in a Government led initiative aimed at enacting an e-Transactions Bill. The Bill seeks to facilitate and promote the use of electronic transactions in Kenya by creating legal certainty and public trust around transactions which are conducted with various forms of information and communications technologies.

Policy on Retail Payment Systems

The Bank commenced working on a policy for retail payments as an input towards the realization of an appropriate policy and regulatory framework for electronic money products, mobile phone banking, and money remittance systems to ensure their safety, efficiency and reliability while promoting accessibility to banking services by Kenyans, and deepening the financial sector.

Connectivity to KEPSS

The Bank in consultation with the Ministry of Finance continued with the initiative to process Government outward payments through KEPSS using the proposed electronic G-pay system. The system will improve efficiency in Government payment processing and mitigate risk associated with issuance and usage of cheques.

East African Cross Border Payment System

The East African Community's Central Banks harmonized the technical specifications and the legal framework for the proposed East Africa Cross Border Payment System that will involve connectivity of the Real Time Gross Settlement (RTGS) systems in the region. The system is aimed at ensuring efficient and safe settlement of intra-regional financial transactions and it is expected to be operational by the 2nd quarter of 2008/2009 financial year.

Cheque Capping and Cheque Truncation System

The Bank in liaison with the Kenya Bankers Association commenced initiatives to reduce Automated Clearing House (ACH) risks through cheque capping and cheque truncation.

Cheque capping involves the setting of an upper limit for cheques processed through the clearing house with a view to removing high value cheques from the clearing house in order to reduce the systemic significance of the ACH.

Cheque truncation will replace the physical flow of the cheques with electronic images throughout the entire clearing cycle. The system is expected to improve safety and efficiency in the cheque clearing and settlement process within the broad context of modernizing payment systems in Kenya. It is expected that Cheque truncation system will reduce the clearing cycle, reduce clearing costs and risks and increase the overall flow of value in the economy.

13. REGIONAL INTEGRATION DEVELOPMENTS

INTRODUCTION

During 2007, the Central Bank of Kenya (CBK) continued to be actively involved in several regional integration initiatives and programmes, particularly those relating to monetary integration. In particular, the CBK participated in the implementation of monetary cooperation programmes of the East African Community (EAC), Common Market for Eastern and Southern Africa (COMESA) and the Association of African Central Banks (AACB). This chapter reviews the status of macroeconomic convergence and other developments related to monetary cooperation in EAC, COMESA and AACB in 2007.

THE EAC MONETARY CO-OPERATION PROGRAMME

Background Information

Under Articles 5, 82 to 85 of EAC Treaty, Partner States have undertaken to co-operate in monetary and fiscal matters in accordance with the approved macro-economic policies, harmonization programmes and convergence framework of the Community in order to establish monetary stability within the Community aimed at facilitating economic integration efforts. The Monetary Affairs Committee (MAC) is one of the committees that were formed to steer these aspects of the EAC treaty. In particular, MAC is tasked with the mandate of laying the foundation for a common monetary union, which encompasses one currency and one central bank among other monetary related issues in East Africa. The MAC is also in the process of commissioning an independent study to take stock of the current state of preparedness of EAC to have a Monetary Union.

EAC Macroeconomic Convergence Criteria and Progress in 2007

Governors of EAC Partner States adopted a new set of convergence criteria in May 2007 which were classified into primary criteria, and secondary criteria. The primary criteria are the primary preconditions for convergence, which need to be met while secondary criteria reinforce the primary criteria.

The Primary Criteria are:

(a) Overall budget deficit/GDP ratio (excluding grants); of not more than 3 percent;
(b) Annual average inflation rate not exceeding 5 percent;
(c) Minimization of central bank financing to 0 percent target; and
(d) Foreign exchange reserves equivalent to six months of imports of goods and non-factor services.

The Secondary Criteria are:

(a) Achievement and maintenance of Stable Real Exchange Rates;
(b) Achievement and maintenance of Market Based Interest Rates;
(c) Achievement of sustainable Real GDP Growth Rate of not less than 7.0 percent;
(d) Sustained pursuit of debt reduction initiative on domestic and foreign debt i.e. reduction of total debt as a ratio of GDP to sustainable level;
(e) National Savings to GDP Ratio of not less than 20 percent;
(f) Reduction of Current Account Deficit (Excluding grants) as a percentage of GDP to sustainable level consistent with debt sustainability;
(g) Implementation of the 25 Core Principles of Bank Supervision and Regulation based on agreed Action Plan for Harmonization of Bank Supervision; and
(h) Adherence to the Core Principles for Systematically Important Payment Systems by modernizing payment and settlement systems.

An assessment of the progress made in 2007 regarding the implementation of the EAC MAC Convergence Criteria by member countries indicates that all Partner States made good progress in achieving targets outlined in the EAC macroeconomic convergence criteria, particularly those relating to price stability and the soundness of the financial sector. The Partner States managed to achieve a considerable level of macroeconomic stability as evidenced in their relatively low and stable inflation in recent years. Among the challenges that the region is facing are large budget deficits, high domestic debt, high interest rate spreads and relatively high levels of non-performing loans. The developments in the global economy especially the turbulence in the international financial markets and rising world oil and commodity prices pose challenges to the management of the regional economies. Kenya has met all the primary criteria in addition to satisfying a good number of secondary criteria. The performance of Kenya and other countries of EAC in respect to each convergence criteria are provided in Table 13.1.

TABLE13.1: MACROECONOMIC PERFORMANCE AND CONVERGENCE UNDER THE EAC CRITERIA

Criteria	Target level and Date	Country	2003	2004	2005	2006	2007
Budget Deficit (Excl. Grants) / GDP	< 6% by 2010	Uganda	-11.1	-9	-7.3	-7	-7
		Kenya	-4.7	-2.1	-1	-4.6	-2.5
		Tanzania	-6.9	-8.1	-9.3	-11.2	-9
		Burundi	-37.3	-50.2	-40.5	-42.6	-18.9
		Rwanda	-9.6	-11.2	-12	-10.5	-13.1
Budget Deficit (Incl. Grants) / GDP	<3% by 2010	Uganda	-1.5	-0.7	-0.8	-2.3	-2
		Kenya	-3.4	-0.9	-0.1	-3.3	-1.2
		Tanzania	-1.3	-2.8	-2.7	-5	-4.1
		Burundi	-14.5	-13.9	-6.4	-9.7	-3
		Rwanda	-2.1	-0.2	-0.3	-0.2	-0.4
Headline Inflation – Annual averages	not > 5% per year by 2010	Uganda	8.7	3.7	8.6	7.2	6.1
		Kenya	9.8	11.6	10.3	14.5	9.8
		Tanzania	3.5	4.2	4.4	7.3	7
		Burundi	10.7	8.3	13.2	2.7	8.3
		Rwanda	7.4	12	9.2	8.9	9.1
Gross Foreign Exchange Reserves in Months of Imports of goods & non-factor services	Equivalent to more than 4 months of imports of goods and non-factor services by 2010	Uganda	6.3	4.9	5	6.7	9.4
		Kenya	4.2	3.4	3.2	3.5	4
		Tanzania	9.4	7.7	6.4	5.3	5.1
		Burundi			3.9	3.4	5.1
		Rwanda	6.2	7.3	7.3	6.8	6.9
GDP Growth Rate At Factor Cost-constant prices	At least 7% p.a. by 2010	Uganda	6.4	5	5.5	6.8	7.1
		Kenya	3	4.9	5.8	6.4	7
		Tanzania	6.9	7.8	7.4	6.7	7.1
		Burundi	-1.1	4.3	1.3	5.1	3.6
		Rwanda	0.3	5.3	7.1	5.5	6
Stable Real exchange rates	Achieve and maintain stable exchange rates (REER. 2000 = 100) Rwanda REER (1995=100) by 2010	Uganda	115.3	117.6	115.7	119.9	118.1
		Kenya	98.6	102	91.1	83.8	77.5
		Tanzania	120	132	140	156	159
		Burundi					
		Rwanda	72.6	69.6	75.4	79.6	79.5
Current Account Deficit (Excl. Grants) / GDP	Sustainable levels by 2010	Uganda	-12.7	-12.8	-11.3	-8.3	-8.8
		Kenya	0.6	-1.4	-1.8	-2.7	-4.4
		Tanzania	-5.5	-7.5	-9.6	-13.5	-15.9
		Burundi	-2.6	-10.1	-14.7	-37.8	-36.9
		Rwanda	-18.7	-19.2	-17.5	-15.2	-17.7
Gross National Savings/GDP	at least 20% by 2010	Uganda	17.8	10.6	13.8	15.9	15
		Kenya	9.3	10.1	12.3	11.5	
		Tanzania	18.3	19.9	19.3	18.3	20.2
		Burundi	9.5	10.9	1.3	6.4	9.4
		Rwanda	-0.8	2.3	4.1	5.1	4.8

Source: EAC Monetary Affairs Committee Reports

THE COMESA MONETARY COOPERATION PROGRAMME

Background Information

The mandate to establish a Monetary Union in COMESA is derived from Article 4 (4) of the COMESA Treaty signed at Kampala, Uganda on 5th November, 1993, which states that the

Member States shall “in the field of monetary affairs and finance, co-operate in monetary and financial matters and gradually establish convertibility of their currencies and a payments union as a basis for the eventual establishment of a monetary union”. This mandate is further reinforced in Articles 76-78 which respectively deal with the: COMESA Monetary and Fiscal Policy Harmonisation (MHP); Establishment of Currency Convertibility; and Formation of an Exchange Rate Union.

In accordance with the mandate provided in the COMESA Treaty, the Authority of Heads of State and Government of COMESA member countries adopted the monetary cooperation programme of COMESA in 1992. The Programme was intended to eventually lead to full regional monetary integration by 2025 through establishment of a Monetary Union involving the use of one common currency issued by a common Central Bank. However, the implementation of the original Programme did not proceed as planned and the progress had mixed results. The council decided that implementation of the monetary integration programme should be accelerated to achieve monetary union by 2018, in order to be consistent with the target date of the African Monetary Union which will be operational before year 2021. In view of this, and the need to fast track African Monetary Union by 2021, the Seventh Meeting of the Ministers of Finance held in Lusaka, Zambia on November, 2004 adopted revised macroeconomic convergence criteria that aimed at establishing a monetary union in COMESA by 2018. The committee revised a set of convergence criteria, which were categorized into primary (preconditions for convergence) and secondary (reinforcement conditions) criteria. The details of these criteria are as follows:

Primary Criteria:

(a) Overall budget deficit/GDP ratio (excluding grants) of not more than 5 percent;
(b) Annual average inflation rate not exceeding 5 percent;
(c) Minimize the central bank financing of the budget towards 0 percent target; and
(d) External reserves of equal to or more than 4 months of imports of goods and non-factor services;

Secondary Criteria

(a) Achievement and maintenance of stable real exchange rates;
(b) Achievement and maintenance of market based positive real interest rates;
(c) Pursuit of debt reduction initiative on domestic and foreign debt i.e. reduction of total debt as a ratio of GDP to sustainable level;
(d) Total domestic revenue to GDP ratio of not less than 20 percent;
(e) Reduction of current account deficit (excluding grants) as a percent of GDP to sustainable level;
(f) Achievement and maintenance of domestic investment rate of at least 20 percent;
(g) Difference between local currency denominated broad money growth and real GDP growth should not exceed 7.0 percent;
(h) Implementation of the 25 Core Principles of Bank Supervision and Regulation based on agreed Action Plan for Harmonization of Bank Supervision for the COMESA region; and
(i) Adherence to the Core Principles for Systematically Important Payments Systems, by modernizing the payment and settlements system.

The COMESA Monetary Union, with a common Central Bank and a Single Currency, would then be created at the end of a process comprising three stages, namely; Stage 1: (Year 2005-10); Stage 2: (Year 2011-15) and Stage 3: (Year 2016-18). In an effort to fast track the attainment of a single monetary zone, the committee of Governors of Central Banks of COMESA commissioned a study in 2005 which recommended among other things the establishment of a COMESA Monetary Institute (CMI). The committee of Governors has now accepted to establish a CMI and will decide on where to host the Institute during their annual meeting scheduled to be held in October, 2008.

Kenya's Progress in the Implementation of COMESA Monetary Harmonization Programme

In 2007, Kenya continued to meet both the primary and secondary criteria for Stage 1 (Year 2005-2010) of the COMESA Monetary Harmonization Programme. The overall budget deficit as ratio to GDP continued to be below the 5 percent target. Underlying inflation remained around the 5 percent target while Central Bank financing of budget deficit was within target. As at the end of December 2007, months of import cover reached the required level of 4 months of imports of goods and services. On the secondary criteria, real GDP continued to improve, reaching 7.0 percent in 2007. The real interest rate, however, was negative due to high inflation. Table 13.2 contains data on Kenya's performance under Stage 1 (Year 2005-2010) of the COMESA Monetary Harmonization Programme.

TABLE 13.2: KENYA'S PROGRESS IN IMPLEMENTATION OF COMESA MONETARY COOPERATION PROGRAMME DURING STAGE 1 (YEAR 2005-2010)

Primary Criteria	Target for Stage I (2005-2010)	Year				
		2003	2004	2005	2006	2007
1. Overall budget deficit/GDP ratio (excluding grants)	< 5 percent	-4.7	-2.1	-1	-4.6	-2.5
2. Inflation rate– average annual underling inflation	< 5 per cent	2.8	3.5	5.4	3.9	5.2
3. Minimization of Central Bank financing of budget	towards 0 percent	2.1	-4.1	1.8	1.8	0.01
4. External reserves in months of imports of goods and non-factor services	= or > 4 months	4.2	3.4	3.2	3.5	4
Secondary Criteria	**Target Stage I (2005-2010)**	**2003**	**2004**	**2005**	**2006**	**2007**
1. Real GDP growth rate	> 7 percent	3	4.9	5.8	6.4	7
2. Domestic fiscal receipts/GDP ratio	= or > 20 percent	19.4	21	21.5	20.6	22.5
3. Current account deficit (excluding grants) as percent of GDP	Sustainable level	0.6	-1.7	-2.3	-2.6	-4.8
4. Achievement and maintenance of domestic investment rate	at least 20 percent	16.4	17.1	16.9	18	20.2
5. Maintenance of positive real interest rates	Positive real interest rate	-8.4	-3.6	-2.2	-8.7	
6. Maintenance of real exchange rate stability - REER Index	Maintenance of REER stability - REER Index	98.6	102	91.1	83.8	77.5

Source: COMESA Committee of Central Bank Governors Reports

THE AFRICAN MONETARY COOPERATION PROGRAMME (AMCP)

Background Information

The AMCP was adopted during the 26th ordinary Assembly of the Association of African Central Banks (AACB) Governors held in Algiers on September 4, 2002. The programme involves the adoption of collective policy measures aimed at implementing a harmonized monetary system in Africa. It envisages the harmonization of the monetary cooperation programme of the various sub-regional groupings as building blocks with the ultimate aim of evolving to a single monetary zone by the year 2021 with a common currency and a common central bank at the continental level. It has both primary and secondary convergence criteria under the AMCP which should be attained by at least 51 percent of the AACB Membership before the launching of the African Monetary Union by 2021:

i) ***Primary Criteria***

- Overall budget deficit (excluding grants)/GDP ratio, < 3 percent;
- Inflation rate, < 3 percent;
- Minimization of Central Bank financing of budget deficit;
- External Reserves of equal to or more than 6 months of imports of goods and services.

ii) Secondary Criteria

- Elimination of domestic arrears and non-accumulation of new arrears;
- Tax revenue/GDP ratio at least 20 percent;
- Wage bill/total tax revenue ratio, of not more than 35 percent;
- Maintenance of real exchange rate stability;
- Public investments financed by domestic sources/tax revenue ratio equal to or more than 20 percent
- Maintenance of positive real interest rates

Progress in Implementation of the AMCP

As indicated in Table 13.3 Kenya performed well in the implementation of the AMCP. It met all the primary criteria and most of the secondary criteria for stage two of the AMCP covering the period 2004 – 2008.

TABLE 13.3: KENYA'S MACRO-ECONOMIC PERFORMANCE AND CONVERGENCE CRITERIA UNDER THE AMCP

Primary Criteria	Target for Stage II (2004-2008)	Year 2004	2005	2006	2007
1. Overall budget deficit/GDP ratio (Excluding grants)	< 5 percent	-2.1	-1	-4.6	-2.5
2. Inflation rate	< 10 per cent	11.6	10.3	14.5	9.8
3. Contain Central Bank financing of budget	< 10 per cent	-4.1	1.8	1.8	0
4. External reserves of equal to or more than 3 months of imports of goods and services	= or > 3 months	3.4	3.2	3.5	4
Secondary Criteria	**Target for Stage II (2004-2008)**	**2004**	**2005**	**2006**	**2007**
1. Domestic fiscal receipts/GDP ratio	= or > 20 percent	21	21.5	20.6	22.5
2. Salary mass/total domestic fiscal receipts ratio	<35 percent	37.6	36.4	35.8	34.5
3. The sourcing of minimum of 20% government investment capital from fiscal receipts	= or > 20 percent	14.8	16.4	23.3	24
4. Maintenance of positive real interest rates	positive real interest rates	-3.6	-2.2	-8.7	-2.9
5. Maintenance of real exchange rate stability	Maintenance of REER stability – REER Index	102	91.1	83.8	77.5
	REER Changes (%)	3.3	-10.6	-7.9	-7.5

Source: Association of African Central Banks Reports

OUTLOOK

Following the December, 2007 elections, the economy fell into challenges that necessitated revision of projected economic growth for 2008 downwards from 8 percent to between 4.5 and 6 percent. Recent data published by the Kenya National Bureau of Statistics, however, indicates that real GDP fell by -1.0 percent in the first quarter of 2008 compared with growth of 6.3 percent in the first quarter of 2007. Nevertheless, some sectors such as tourism have started showing signs of recovery, following the signing of the National Peace and Reconcilliation Accord, and aggressive marketing efforts by the Coalition Government. It is also expected that the ongoing implementation infrastructure projects will restore the economy to a rapid growth path as earlier projected.

CENTRAL BANK OF KENYA
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FOR THE YEAR ENDED 30 JUNE 2008

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BANK INFORMATION
FOR THE YEAR ENDED 30 JUNE 2008

DIRECTORS

Prof.Njuguna Ndungu	-	Governor and Chairman
Mrs Jacinta W. Mwatela	-	Deputy Governor and Deputy Chairman
Mr Joseph K. Kinyua	-	Permanent Secretary-Treasury, Member
Mr Joseph K. Waiguru	-	Member
Dr. William O. Ogara	-	Member
Mr. Nicholas A. Nesbitt	-	Member
Ms Agnes Wanjiru	-	Member
Ms Wanza Kioko	-	Member

SENIOR MANAGEMENT

Prof. Njuguna Ndungu	-	Governor
Mrs Jacinta W. Mwatela	-	Deputy Governor
Mr Kennedy K. Abuga	-	Director –Governors office & Board Secretary–appointed on 7 April,2008
Mr John M. Gikonyo	-	Director –Governors office & Board Secretary-Retired on 1 April, 2008
Mr Aggrey J.K. Bett	-	Director – Finance, Resource Planning and Strategy Management
Mr Jones M. Nzomo	-	Director – Human Resources and Services Department
Ms Rose Detho	-	Director – Banking Supervision Department
Ms Elizabeth C. A. Omolo	-	Executive Director – Kenya School of Monetary Studies-Retired on 30 June, 2008
Prof. Kinandu Muragu	-	Executive Director – Kenya School of Monetary Studies –appointed on 30 June, 2008
Mr William Nyagaka	-	Director – Internal Audit & Risk Management- appointed on 17 April, 2008
Mr Nicholas M.Kiritu	-	Director – Internal Audit & Risk Management- Retired on 30 November, 2007.
Mr Nicholas N. B. T. Korir	-	Director –Research Department
Mr Daniel M.Chege	-	Director – Currency Operations and Branch Administration
Mr Gerald Nyaoma	-	Director – Banking Department
Mr Jackson M. Kitili	-	Director – Monetary Operations & Debt Management
Mr. Charles Maranga	-	Director- Human Resources (Performance Management System)-Retired on 30 June, 2008

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CENTRAL BANK OF KENYA
DIRECTORS' REPORT
FOR THE YEAR ENDED 30 JUNE 2008

The directors submit their report together with the audited financial statements for the year ended 30 June 2008, which shows the state of affairs of the Bank.

1. INCORPORATION

The Bank is incorporated under the Central Bank of Kenya Act Cap 491(the Act).

2. PRINCIPAL ACTIVITIES

The Bank is established and administered under the 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. FINANCIAL PERFORMANCE

3.1 Financial Results

The results for the year set out on page **74** show that the Bank recorded a profit of KShs 8,995 million against a loss of KShs 386 million in the previous year. This substantial improvement from the previous year is attributable mainly to a substantial reduction in foreign exchange translation losses which dropped to KShs 1.3 billion in the year from KShs 9.8 billion in the previous year. Contributing to this performance also are foreign interest earnings which was KShs 1,991 million (24%) higher than the previous year due to higher levels of foreign currency reserves available for investing in the year at interest rates that were also higher than the previous year. Operating expenses were also lower by KShs 441 million (8%) mainly due to currency printing expenses which were lower by 68% owing to the shifting of planned deliveries of banknotes for 20007/2008 to year 2008/2009. There were savings also on other operating expenses such as depreciation and property maintenance as a result of delayed procurements and cancellation of scheduled maintenance works.

The above positive revenue and expenditure performances were tempered by commission on sale of Government securities that was nearly 40% lower than the previous year due to the capping of this commission by Government to a maximum of KShs 3.0 billion during the year under review. Monetary policy (Mop Up) expenses also went up by 69% during the year due to the need to mop up undesirable liquidity generated by economic and political activities during 2007 and part of 2008. Slight increases in staff costs and other operating expenses also impacted negatively on the profit.

3.2 Financial Position

The financial position of the Bank is set out in the Balance Sheet shown on page **75**. During the year, total assets of the Bank increased by KShs 51,687 million (23%). This increase is attributed mainly to an increase of KShs 42,608 million (24%) in balances due from international banking institutions and gold holdings (foreign currency reserves), items in the course of collection and investments in government securities amounting to KShs 2,296 million and KShs 8,535 million respectively.

During the year, the Bank built up its foreign currency reserves by KShs 42 billion (24%) mainly through purchases and foreign investment earnings. The increase of KShs 8,535 million in investment in government securities represents the magnitude of discounting of these investments by the public at Central Bank compared to the previous year.

On the other hand, total liabilities increased by KShs 42,692 million (20%). This was attributed mainly to increases in deposits of commercial banks of KShs 39,802 million (44%), IMF loans to the Bank of KShs 3,957 million (25%) and currency in circulation of KShs 9,951 million (11%). General Reserves Fund increased by KShs 8,995 million (11%) being the net profit for the year. The Board of Directors has recommended the payment of a dividend of KShs 4 billion and KShs 3.5 billion of general reserves has been utilised to increase the paid up capital to KShs 5 billion subsequent to the year end.

CENTRAL BANK OF KENYA
DIRECTORS' REPORT
FOR THE YEAR ENDED 30 JUNE 2008

4. DIVIDEND

The Board of Directors recommend payment of a dividend of KShs 4 billion for the year ended 30 June 2008 (2007: nil).

5. DIRECTORS

The directors who served during the year and up to the date of this report are listed on page **66**.

6. AUDITORS

The auditors, Ernst & Young, were appointed in 2007 in line with the Public Procurement and Disposal Act, 2005 for a period of three years.

By order of the Board

K. K. Abuga
BOARD SECRETARY

25th September 2008

CENTRAL BANK OF KENYA
STATEMENT OF DIRECTORS' RESPONSIBILITIES
ON THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 30 JUNE 2008

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 in ensuring 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. The directors are of the opinion that the financial statements for the year ended 30 June 2008 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:-

Governor	**Director**
September 25 --------------------------------2008	September 25 -----------------------2008

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 CBK Act Cap 491 of the laws of Kenya. 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 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 who is ex-officio, all the others are appointed to the Board 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.

Currently there are five Non-Executive Directors namely Messrs Waiguru, Nesbitt, Ogara, Kioko and Wanjiru 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 agenda items due for deliberations. The Directors are given appropriate and timely information to maintain full and effective control over strategic, financial and operational issues of the Bank. 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 Committee (MPC)

Section 4D of the CBK (amendment) Act 2008 establishes the Monetary Policy Committee (MPC) which replaces the Monetary Policy Advisory Committee (MPAC). According to the CBK Act, the Monetary Policy Committee of the Central Bank is responsible for formulating monetary policy. The Committee consists of the following members:-
a) The Governor, who is the chairman;
b) The Deputy Governor, who is the deputy chairman;
c) Two members appointed by the Governor from among the staff;
d) Four other members who have knowledge, experience and expertise in matters relating to finance, banking and fiscal and monetary policy, appointed by the Minister for Finance.

The Minister for Finance appointed the four external members of the Committee through *The Kenya Gazette Notice* Number 3771. They will hold office for a period of three (3) years with effect from 1st May 2008. The four members are:

(1) Rose W. Ngugi (Dr)
(2) Sheila M'Mbijjewe
(3) Terry Ryan (Prof) and
(4) Wycliffe Mukulu.

Of the two members appointed from within the Bank, one has the executive responsibility within the Bank for monetary policy analysis; and the other has the responsibility within the Bank for monetary policy operations.

CENTRAL BANK OF KENYA
STATEMENT OF CORPORATE GOVERNANCE (continued)

Audit Committee

The Audit Committee is chaired by Dr. William O. Ogara and has three other members who are Non-Executive Directors having experience in Accounting, Auditing, Banking, Information Technology 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 improves 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.

Human Resources Committee

The Committee is presently chaired by Ms Agnes Wanjiru and membership includes three other Non-Executive Directors with the Governor and the Deputy Governor in attendance. The Committee meets regularly as and when need arises to review human resource policies and make suitable recommendations to the Board.

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 **66**. The positions 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 Chief Executive Officer of the Bank.

Directors' Emoluments and Loans

The remuneration paid to the Directors for services rendered during the financial year 2007/2008 is disclosed in note 28 (iv) of 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 while Executive Directors are paid monthly and are eligible for the staff loans.

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 conflict 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 in accordance with the Public Procurement & Disposal Act, 2005. In all operational areas of the Bank, workflows have been structured in a manner that allows adequate segregation of duties.

CENTRAL BANK OF KENYA
STATEMENT OF CORPORATE GOVERNANCE (continued)

Authorisations

All the expenditure of the Bank must be authorised 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 financial performance of the Bank.

Internal Audit

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 Releases, Statistical Bulletin and Bi-annual 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

Report on the Financial Statements

We have audited the accompanying financial statements of the Central Bank of Kenya, as set out on pages **74** to **107** which comprise the balance sheet as at 30 June 2008, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Directors' Responsibility for the Financial Statements

The directors are responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal controls relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal controls. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by directors, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the accompanying financial statements give a true and fair view of the state of financial affairs of the Bank as at 30 June 2008 and of the profit and cash flows for the year then ended in accordance with the International Financial Reporting Standards and the requirements of the Central Bank of Kenya Act.

Report on other matters

We also report to you, based on our audit, that:

i) 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;

ii) In our opinion, proper books of account have been kept by the Bank, so far as appears from our examination of those books; and,

iii) The Bank's income statement and balance sheet are in agreement with the books of account.

Nairobi

29 / 9 / 2008

CENTRAL BANK OF KENYA
INCOME STATEMENT
FOR THE YEAR ENDED 30 JUNE 2008

	Note	2008 KShs million	2007 KShs million
Interest income	2	12,108	9,872
Interest expense	3	(1,716)	(1,016)
Net interest income		**10,392**	**8,856**
Fee and commission income	4	3,156	5,243
Net foreign exchange gain/ (loss)	5	54	(9,337)
Other operating income	6	421	321
		14,023	**5,083**
Operating expenses	7	(5,028)	(5,469)
Profit/ (loss) for the year		8,995	(386)
Dividends:			
Proposed dividend for the year	8	4,000	-

CENTRAL BANK OF KENYA

BALANCE SHEET

AS AT 30 JUNE 2008

ASSETS	Note	2008 KShs million	2007 KShs million
Balances due from banking institutions and Gold holdings	9	223,486	180,878
International Monetary Fund	10	206	5
Items in the course of collection	11	2,885	589
Investment in government securities	12	8,539	4
Loans and advances	13	3,460	3,742
Other assets	14	1,244	1,562
Retirement benefit asset	15	55	240
Property and equipment	16	568	591
Prepaid operating lease rentals	17	278	282
Intangible assets	18	18	49
Due from Government of Kenya	19	34,439	35,549
TOTAL ASSETS		275,178	223,491
LIABILITIES			
Currency in circulation	20	99,750	89,799
Deposits	21	131,141	91,339
International Monetary Fund	10	19,697	15,740
Amounts repayable under repurchase agreements	22	1,807	15,626
Other liabilities	23	4,529	1,728
TOTAL LIABILITIES		256,924	214,232
EQUITY AND RESERVES			
Share capital	24	1,500	1,500
General reserve fund	25	12,754	7,759
Proposed dividend	8	4,000	-
TOTAL EQUITY AND RESERVES		18,254	9,259
TOTAL LIABILITIES AND EQUITY		275,178	223,491

The financial statements were approved by the Board of Directors for issue on Sept 25 2008 and signed on its behalf by:

Governor

Director

CENTRAL BANK OF KENYA
STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED JUNE 30 2008

	Share capital KShs million	General reserve fund KShs million	Proposed dividend KShs million	Total KShs million
Year ended 30 June 2007				
Balance at start of the year	1,500	8,145	2,000	11,645
Loss for the year	-	(386)	-	(386)
2006 dividends paid	-	-	(2,000)	(2,000)
Balance at end of the year	1,500	7,759	-	9,259
Year ended 30 June 2008				
Balance at start of the year	1,500	7,759	-	9,259
Profit for the year	-	8,995	-	8,995
Proposed dividend	-	(4,000)	4,000	-
Balance at end of the year	1,500	12,754	4,000	18,254

CENTRAL BANK OF KENYA
CASH FLOW STATEMENT
FOR THE YEAR ENDED JUNE 30 2008

	Note	2008 KShs million	2007 KShs million
Operating activities			
Net cash generated from/(absorbed by) operating activities	27 (a)	39,214	(2,826)
Investing activities			
Receipts of government loan		1,110	-
Purchase of property and equipment		(120)	(151)
Purchase of intangible assets		-	(55)
Proceeds from disposal of property and equipment		81	6
Proceeds in International Monetary Fund -SDR accounts		(201)	8
Net cash from /(used in) investing activities		870	(192)
Financing activities			
Dividends paid		-	(2,000)
Currency in circulation		9,951	13,592
Net cash from financing activities		9,951	11,592
Net increase in cash and cash equivalents		50,035	8,574
Cash and cash equivalents at start of year		175,265	166,691
Cash and cash equivalents at end of year	27 (b)	225,300	175,265

CENTRAL BANK OF KENYA
ACCOUNTING POLICIES
FOR THE YEAR ENDED 30 JUNE 2008

1. SIGNIFICANT ACCOUNTING POLICIES

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

(a) Basis of preparation of financial statements

(i) Basis of preparation

The financial statements are prepared in compliance with International Financial Reportir Standards (IFRS) and Interpretations of those Standards. The financial statements a presented in millions of Kenya Shillings (KShs million) and are prepared under tl historical cost convention except for measurement at fair value of certain investments.

(ii) 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.

(iii) Changes in accounting policies

The accounting policies adopted are consistent with those of the previous financial year except as follows:

IFRS 7 Financial Instruments: Disclosures
This standard requires disclosures that enable users of the financial statements to evaluate the significance of the Bank's financial instruments and the nature and extent of risks arising from those financial instruments. The new disclosures are included throughout the financial statements. While there has been no effect on the financial position or results, comparative information has been revised where needed.

IAS 1 Presentation of Financial Statements
This amendment requires the Bank to make new disclosures to enable users of the financial statements to evaluate the Bank's objectives, policies and processes for managing capital.

(iv) Standards, Amendments and Interpretations Effective In 2008 but not Relevant

The following standards, amendments and interpretations are mandatory for accounting periods beginning on 1 April 2007 but are not relevant to the Bank's operations:

- IFRIC 11, IFRS 2 – Group and Treasury Share Transactions (effective from 1 March 2007);
- IFRIC 12, Service Concession Agreements (effective from 1 January 2008).
- IFRIC 14, IAS 19 - The limit on a defined benefit asset, minimum funding requirements and their interaction (effective from 1 January 2008)

CENTRAL BANK OF KENYA
ACCOUNTING POLICIES
FOR THE YEAR ENDED 30 JUNE 2008 (continued)

(v) Standards, Amendments and Interpretations that have been issued and are not yet Effective for the Bank's Operations

At the date of authorisation of these financial statements, the following Standards and Interpretations were in issue but not yet effective for the Bank's operations:

- IFRS 2, Amendments to IFRS 2 Share-based Payment - Vesting Conditions and Cancellations (effective from 1 January 2009)
- IFRS 3, Business Combinations (effective from 1 July 2009)
- IFRS 8, Operating Segments (effective from 1 January 2009)
- IAS 1, Presentation of Financial Statements amendment (effective from 1 January 2009)
- IAS 23 Borrowing Costs (effective from 1 January 2009)
- IAS 27, Consolidated and Separate Financial Statements (effective from 1 July 2009)
- IAS 32, Amendments to IAS 32 Financial Instruments: Presentation and IAS 1 Presentation of Financial Statements - Puttable Financial Instruments and Obligations Arising on Liquidation (effective from 1 January 2009)
- IFRIC 13, Customer Loyalty Programmes (effective from 1 July 2008)

The directors anticipate that the adoption of these standards will have no material effect on the financial statements of the Bank.

(a) Significant accounting judgements and estimates

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. The most significant use of judgement and estimates are as follows:

(i) Impairment losses on loans and advances

The Bank reviews its loans and advances at each reporting date to assess whether an allowance for impairment should be recognised in the income statement. In particular, judgement by the directors is required in the estimation of the amount and timing of future cash flows when determining the level of allowance required. Such estimates are based on the assumptions about a number of factors and actual results may differ, resulting in future changes in the allowance.

In addition to specific allowances against individual significant loans and advances, the Bank makes a collective impairment allowance against exposures which, although not specifically identified as requiring a specific allowance, have a greater risk of default than when originally granted. This takes into consideration such factors as any deterioration in industry, technological obsolescence, as well as identified structural weaknesses or deterioration in cash flows.

CENTRAL BANK OF KENYA
ACCOUNTING POLICIES
FOR THE YEAR ENDED 30 JUNE 2008 (continued)

(b) Significant accounting judgement and estimates (continued)

(ii) Pensions

The cost of the defined benefit pension plan is determined using actuarial valuation. The actuarial valuation involves making assumptions about discount rates, expected rates of return on assets, future salary increases, mortality rates and future pension increases. Due to the long term nature of these plans, such estimates are subject to significant uncertainty. See note 15 for assumptions used.

(iii) Property, equipment and intangible assets

Critical estimates are made by the management in determining depreciation and amortisation rates for property, equipment and intangible assets. The rates used are set out in the accounting policy (f) and (g) below.

(iv) Fair value of financial instruments

Where the fair values of financial assets and financial liabilities recorded on the balance sheet cannot be derived from active markets, they are determined using a variety of valuation techniques that include the use of mathematical models. The input to these models is taken from observable markets where possible, but where this is not feasible, a degree of judgement is required in establishing fair values.

(a) Revenue recognition

Income is recognised in the period in which it is earned.

(i) Interest income and expenses

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.

(ii) Fees and commission income

Fees and commission income, which arise from financial services provided by the Bank, are recognised when the corresponding services are provided.

(b) Translation in foreign currencies

Transactions in foreign currencies during the year are converted into Kenya Shillings at rates ruling at the transaction dates. Assets and liabilities at the balance sheet date which are expressed in foreign currencies are translated into Kenya Shillings at rates ruling at that date. The resulting differences from conversion and translation are dealt with in the income statement in the year in which they arise.

Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rates as at the dates of the initial transactions. Non-monetary items measured at fair value in a foreign currency are translated using the exchange rates at the date when the fair value was determined.

CENTRAL BANK OF KENYA
ACCOUNTING POLICIES
FOR THE YEAR ENDED 30 JUNE 2008 (continued)

(a) Currency printing and minting expenses

Notes printing and coins minting expenses which include ordering, printing, minting, freight, insurance and handling costs are expensed upon delivery of currency stock.

(b) 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 local statute and are shared between the employer and employee. The Bank's contributions in respect of retirement benefit costs are charged to the income statement in the year to which they relate.

(ii) Other employee benefits

The Bank provides free medical treatment to staff and their dependants. The cost is 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.

(c) Property and equipment

Property and equipment are stated at purchase price less accumulated depreciation less any accumulated impairment losses. Depreciation is computed on the straight line basis over the estimated useful lives of the assets at the following rates:

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

An item of property and equipment is derecognised upon disposal or when no future economic benefits are expected from its use or disposal. Any loss or gain on derecognition of the asset (calculated as the difference between the net disposal proceeds and the carrying amount of the asset) is recognised in other operating income in the income statement in the year the asset is derecognised

CENTRAL BANK OF KENYA
ACCOUNTING POLICIES
FOR THE YEAR ENDED 30 JUNE 2008 (continued)

The asset's residual values , useful lives and methods of depreciation are reviewed, and adjusted if appropriate at each financial year end.

(a) Intangible assets

Intangible assets consist of computer software. Intangible assets acquired separately are measured on initial recognition at cost. Following initial recognition, intangible assets are carried at cost less accumulated amortisation and any accumulated impairment loss.

The useful lives of intangible assets are assessed to be finite and are amortised over the useful economic life. The useful life is reviewed at least at each financial year end. The amortisation expense on intangible assets is recognised in the income statement. Amortisation is calculated using the straight line method to write down the cost of intangible assets to the residual values over the estimated useful life as follows:

Computer software	50%

(b) Impairment of other assets

Impairment of property, plant and equipment are assessed at each balance sheet date or more frequently where any events or changes in circumstances dictate for indications of impairment. If significant indications are present, these assets are subject to an impairment review by estimating the recoverable amount. An impairment loss is charged to income statement when the carrying amount of an asset exceeds the recoverable amount.

Previously recognised impairment loss of related asset may be reversed in part or in full when a change in circumstances leads increase of recoverable amount. The carrying amount of the fixed asset will only be increased up to the amount that it would have been had the original impairment not been recognised. For the purpose of measuring and accounting for impairment loss; either fair value or value in use of an asset is compared with carrying amount.

(c) Financial Instruments

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.

(i) Date of recognition
Purchases or sales of financial assets that require delivery of assets within the time frame generally established by regulation or convention in the marketplace are recognised on the trade date, which is the date that the Bank commits to purchase or sell the asset.

(ii) Recognition and initial measurement
The classification of financial instruments at initial recognition depends on the purpose for which the financial instruments were acquired and their characteristics. All financial instruments are measured initially at their fair value plus, in the case of financial assets and financial liabilities not at fair value through profit or loss, any directly attributable incremental costs of acquisition or issue.

(iii) Classification and measurement
The Bank classifies its financial assets in the following categories: loans and advances and investments that are held to maturity.The Bank determines the classification of its investments at initial recognition.

CENTRAL BANK OF KENYA
ACCOUNTING POLICIES
FOR THE YEAR ENDED 30 JUNE 2008 (continued)

(j) Financial Instruments (continued)

(1) Loans, advances and receivables

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. The Bank has classified the following financial assets as loans and receivables originated by the entity: loans and advances, amounts due from the Government, other assets, IMF related assets and cash and cash equivalents. After initial measurement, loans and receivables are carried at amortised cost using effective interest method less any allowance for impairment.

As the lender of last resort, the Bank may grant loans or advances for fixed periods n exceeding six months to commercial banks that pledge Government securities specifie by the Bank.

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

The Bank also operates a staff loans scheme for its employees for the provision facilities such as house and car loans. The Bank determines the terms and conditions f granting of the above loans with reference to the prevailing market interest rates ar may determine different rates for different classes of transactions and maturities.

(2) 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 has the intention and ability to hold to maturity. After initial measurement, held-to-maturity financial investments are subsequently measured at amortised cost using the effective interest rate method, less allowance for impairment. Amortised cost is calculated by taking into account any discount or premium on acquisition and fees that are an integral part of the effective interest rate. The amortisation is included in 'Interest income' in the income statement. The losses arising from impairment of such investments are recognised in the income statement line 'Impairment losses on financial investments'. 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 Government securities, repurchase and reverse purchase instruments as held to maturity.

(3) Financial liabilities

Financial liabilities are measured at amortised cost except for financial liabilities designated at fair value through profit and loss. Financial liabilities are initially recognised at fair value less, in the case of liabilities carried at amortised cost (including due to banks, due to International Monetary Fund other deposits and other funds borrowed), transaction costs incurred and any difference between the proceeds net of transaction costs and the redemption amount is recognised in the income statement as interest expense over the period to maturity using the effective interest rate method. Financial liabilities which are repayable on demand are recorded at nominal value. Financial liabilities are derecognised when they are extinguished. Deposits represent reserve deposits of depository institutions' participants and current accounts of the Bank. The Bank has classified the following financial instruments as financial liabilities: currency in circulation, deposits, IMF Related liabilities and other liabilities.

CENTRAL BANK OF KENYA
ACCOUNTING POLICIES
FOR THE YEAR ENDED 30 JUNE 2008 (continued)

(j) Financial Instruments (continued)

(iv) Derecognition

Financial assets are derecognised 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.
The gains and losses on investments held to maturity and loans and receivables are recognized in the income statement when the investments are derecognized.

(v) Gains and losses on subsequent measurement

Gains and losses on amortisation of premiums or discounts of financial instruments carried at amortised cost are recognised in the income statement of the period in which they arise. Gains and losses due to impairment are recognised as stated in the paragraph dealing with impairment.

(vii) Offsetting

Financial assets and financial liabilities are offset and the net amount reported on the balance sheet where 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.

(viii) Impairment of financial assets

Loans are stated at outstanding amount less provision for impairment.

A review for impairment is carried out at each financial year-end. A financial asset is impaired if its carrying amount is greater than its estimated recoverable amount.

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.

If there is objective evidence that an impairment loss on assets carried at amortised cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future expected credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (which is the effective interest rate computed at initial recognition). The carrying amount of the asset is reduced through use of an allowance account. The amount of the loss shall be recognised in the income statement
.

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed, to the extent that the carrying value of the asset does not exceed its amortised cost at the reversal date. Any subsequent reversal of an impairment loss is recognized in the income statement.

CENTRAL BANK OF KENYA
ACCOUNTING POLICIES
FOR THE YEAR ENDED 30 JUNE 2008 (continued)

(a) Amounts Repayable under Repurchase Agreements (REPOs)

REPO is an arrangement involving the sale for cash, of security at a specified price with a commitment to repurchase the same or similar securities at a fixed price either at a specific future date or at maturity.

(i) The Bank treats REPOs as collateralized loans for accounting purposes. In this case, a Repo is recorded as a secured advance and is shown separately as REPO Agreement.
(ii) REPOs continue to be recognised in the balance sheet and are measured in accordance with policies for non-trading investment.
(iii) The difference between sales and repurchase price is treated as interest expenditure and is recognised in the income statement.

(b) Currency in circulation

Currency issued by the Bank represents a claim on the Bank in favour of the holder. The liability for currency in circulation is recorded at face value in these financial statements. Currency in circulation represents the face value of notes and coins in circulation. Notes and coins held by the Bank as cash in main vault, intermediary vault, and cashier at the end of financial year are netted off against the liability for notes and coins in circulation because they do not represent currency in circulation.

(c) 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 when they are declared.

(d) Provisions

Provisions are recognised when the Bank has a present obligation/ (legal or constructive) 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 can be made of the amount of the obligation.

The calculated monetary liability for employees' accrued annual leave entitlement at the balance sheet date is recognised as an expense accrual.

(e) 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.

(f) Leasing

The determination of whether an arrangement is, or contains a lease is based on the substance of the arrangement and requires an assessment of whether the fulfilment of the arrangement is dependent on the use of a specific asset or assets and the arrangement conveys a right to use the asset.

CENTRAL BANK OF KENYA
ACCOUNTING POLICIES
FOR THE YEAR ENDED 30 JUNE 2008 (continued)

(p) Leasing(continued)

(a) Bank as a lessee

Finance leases, which transfer to the Bank substantially all the risks and benefits incidental to ownership of the leased item, are capitalised at the inception of the lease at the fair value of the leased property or, if lower, at the present value of the minimum lease payments and included in 'Property and equipment' with the corresponding liability to the lessor included in 'Other liabilities.' Lease payments are apportioned between the finance charges and reduction of the lease liability so as to achieve a constant rate of interest on the remaining balance of the liability. Finance charges are charged directly against income in 'Interest and similar expense.'

Capitalised leased assets are depreciated over the shorter of the estimated useful life of the asset and the lease term, if there is no reasonable certainty that the Bank will obtain ownership by the end of the lease term.

Operating lease payments are not recognised in the balance sheet. Any rentals payable are accounted for on a straight-line basis over the lease term and included in 'Other operating expenses'.

(b) Bank as a lessor

Leases where the Bank does not transfer substantially all the risk and benefits of ownership of the asset are classified as operating leases. The Bank leases out all of its investment properties as operating leases, thus generating rental income. Initial direct costs incurred in negotiating operating leases are added to the carrying amount of the leased asset and recognised over the lease term on the same basis as rental income. Contingent rents are recognised as revenue in the period in which they are earned.

(a) Other assets

Other assets are stated at fair value and subsequently at amortised cost using effective interest rate method less allowance for impairment. Due to their short term nature, the nominal value or cost are considered to approximate the fair value and as such stated at cost less any impairment loss.

(b) Other liabilities

Other liabilities are stated at their nominal value/cost, which approximates fair value due to the short term nature thereof.

(c) 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. Gold holdings is measured at the closing market price at the end of the year.

NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 30 JUNE 2008

		2008 KShs million	2007 KShs million
2	**INTEREST INCOME**		
	Foreign investments earnings	10,431	8,440
	Local investments earnings	1,604	1,363
	Other interest earnings	73	69
		12,108	9,872
3	**INTEREST EXPENSE**		
	Interest on monetary policy issues	1,640	968
	Interest paid to IMF	76	48
		1,716	1,016
4	**FEES AND COMMISSION INCOME**		
	Commission on sale of government securities	3,152	5,236
	Special projects agency fees	4	7
		3,156	5,243
5	**NET FOREIGN EXCHANGE GAIN/(LOSS)**		
	Gains on sale of foreign exchange	1,319	508
	Foreign exchange translation loss	(1,265)	(9,845)
		54	(9,337)
6	**OTHER OPERATING INCOME**		
	Rent received	16	17
	Proceeds from disposal of property and equipment	81	6
	Tuition fees and other charges	33	43
	Hospitality services	159	156
	Miscellaneous income	132	99
		421	321
7	**OPERATING EXPENSES**		
	Currency printing expenses	403	1,248
	Depreciation on property and equipment	144	254
	Property maintenance expenses	519	388
	Auditors' remuneration	4	4
	Banking expenses	4	4
	Operating lease rentals	3	3
	Amortisation on intangible assets	31	19
	Staff costs	3,261	2,956
	Other expenses	659	593
		5,028	5,469

8 DIVIDENDS

The Board of Directors recommend payment of a dividend of KShs 4 billion for the year ended 30 June 2008. (2007: Nil).

9 BALANCES DUE FROM BANKING INSTITUTIONS AND GOLD HOLDINGS

	2008 KShs million	2007 KShs million
Current accounts	4,423	2,333
Term deposits	210,866	171,262
Domestic forex currency cheque clearing	1,438	1,641
Forex travellers cheques	6	5
Cash and cash equivalents	216,733	175,241
Accrued interest on foreign investments	2,274	1,132
Total own resources	219,007	176,373
Special project accounts	4,451	4,485
	223,458	180,858
Gold holdings	28	20
	223,486	180,878

The Gold Holdings held amounted to 474 volume in Troy Ounces (2007- 474).

10 INTERNATIONAL MONETARY FUND

Special Drawing Rights (SDR) is an internal reserve asset credited by the IMF and allocated to member countries in order to increase international liquidity. The SDR is defined in terms of a basket of currency and its value is determined as the weighted sum of exchange rates of few currencies such as US dollars, Sterling Pound, Euro and the Yen.

Kenya has been a member of the International Monetary Fund (IMF) since 1966. The Bank 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 accounts of the IMF with the Bank.

	2008 SDR 000'	2008 KShs million	2007 SDR 000'	2007 KShs million
IMF balances (SDR Account)	2	206	0.5	5
International Monetary Fund Account No. 1	20	2,134	20	2,042
International Monetary Fund Account No. 2	-	-	-	1
International Monetary Fund–PRGF Account	122	16,510	122	12,287
International Monetary Fund On-lent to Government of Kenya	10	1,053	14	1,410
	152	19,697	156	15,740

On a custodial basis, the Bank holds a non-negotiable, non-interest bearing and en cashable on demand security issued by the Treasury in favour of the IMF in its capacity as the IMF's depository.

11 ITEMS IN THE COURSE OF COLLECTION

	2008 KShs million	2007 KShs million
Items in the course of collection	2,885	589

The balance represents values of clearing instruments which are held by the Bank while awaiting clearing by respective commercial banks.

12 INVESTMENT IN GOVERNMENT SECURITIES

	2008 KShs million	2007 KShs million
Reverse REPOS Treasury Bonds	7,042	-
Treasury Bills and Treasury Bonds discounted	1,497	4
	8,539	4

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

13 LOANS AND ADVANCES

	2008 KShs million	2007 KShs million
Advances to banks under liquidation	8,337	8,259
Government overdraft account (see below and Note 28)	-	42
Advances to employees (Note 28)	2,422	2,312
IMF funds on-lent to the Government (Note 28)	1,053	1,410
	11,812	12,023
Provision for loan impairment	(8,352)	(8,281)
Net advances as at 30 June	3,460	3,742

Movement in the provision for loan impairment is as follows:

	2008	2007
At start of the year	(8,281)	(8,281)
Additional provisions made in the year	(78)	(2)
Recoveries in the year	7	2
At end of the year	(8,352)	(8,281)

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 14,818,521,441 based on the Government financial statements for 2005/2006 which are the latest audited financial statements at the date of approval of these financial statements. The limit for the previous year was KShs 13,268,817,798 based on the Government financial statements for 2004/2005.

14 OTHER ASSETS

	2008 KShs million	2007 KShs million
Prepayments	966	1,290
Advances	278	272
	1,244	1,562

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 as at 30 June 2008.

	2008 KShs million	**2007 KShs million**
Present value of funded obligations	(10,496)	(9,416)
Fair value of plan assets	12,136	10,774
Present value of net asset	1,640	1,358
Unrecognised actuarial gain	(1,585)	(1,118)
Asset in the balance sheet	55	240

The amounts recognised in the income statement are as follows:

Current service costs	532	498
Interest costs	847	738
Expected return on plan assets	(955)	(845)
Net actuarial gains recognised in the year	(5)	-
Total expenses included in operating expenses	419	391

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

Net expense recognised in the income statement	419	391
Employer contributions	(234)	(237)
Movement in the asset recognised in the balance sheet	(185)	(154)
Actual return on plan assets	**1,679**	**1,451**

The principal actuarial assumptions at the balance sheet date were:

	2008	**2007**
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
30 JUNE 2008				
Cost				
At start of year	1,004	184	3,065	4,253
Additions	-	54	66	120
Disposals	(17)	(23)	(1)	(41)
At end of the year	987	215	3,130	4,332
Depreciation				
At start of the year	942	157	2,563	3,662
Charge for the year	9	34	100	143
Eliminated on disposal	(17)	(23)	(1)	(41)
At end of the year	934	168	2,662	3,764
Net book value At 30 June 2008	53	47	468	568
30 JUNE 2007				
Cost				
At start of year	1,004	205	2,824	4,033
Additions	-	-	151	151
Adjustments	-	-	90	90
Disposals	-	(21)	-	(21)
At end of the year	1,004	184	3,065	4,253
Depreciation				
At start of the year	921	141	2,277	3,339
Charge for the year	21	37	196	254
Adjustments	-	-	90	90
Eliminated on disposal	-	(21)	-	(21)
At end of the year	942	157	2,563	3,662
Net book value At 30 June 2007	62	27	502	591

In 2007, the Bank carried out a physical verification of its property and equipment. As a result computer equipment previously written off from the books were reinstated in the general ledger. These amounted to KShs 90 million and had been fully depreciated.

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:

	2008 KShs million	2007 KShs million
Cost		
At 30 June	300	300
Amortisation		
At 1 July 2007 and 2006	18	15
Amortisation for the year	4	3
At end of the year	22	18
Net carrying value at end of the year	278	282

18 INTANGIBLE ASSETS

	2008 KShs million	2007 KShs million
Cost		
At 1 July 2007 and 2006	179	125
Additions	1	55
At end of the year	180	180
Amortisation		
At 1 July 2007 and 2006	131	112
Amortisation for the year	31	19
At end of the year	162	131
Net carrying value at end of the year	18	49

19 DUE FROM GOVERNMENT OF KENYA

Loans due from the Government

	2008 KShs million	2007 KShs million
At start of the year	35,549	35,549
Receipts during the year	(1,110)	-
At end of the year	34,439	35,549

The loan due from the 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.

On 24 July 2007, a deed of guarantee was signed between the Government of Kenya and the Bank in which the Government agreed to repay KShs 1.11 billion per annum over 32 years at 3% interest per annum. The security held is lien over cash balances, stock, treasury bonds and such other government securities as are specified in Section 46(5) of the Central Bank of Kenya Act.

20 CURRENCY IN CIRCULATION

	2008 KShs million	2007 KShs million
Kenya notes	95,993	86,310
Kenya coins	3,752	3,484
Commemorative coins	5	5
	99,750	89,799

21 DEPOSITS

	2008	2007
Banks -Kenya	53,868	39,441
-External	21	25
Local Banks forex settlement accounts	1,239	1,444
Non-bank financial institutions	-	119
Other public entities and project accounts	8,506	9,244
Government of Kenya	67,507	41,066
	131,141	91,339

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

	2008 KShs million	2007 KShs million
Impersonal accounts	3,467	991
Sundry creditors	728	513
Refundable deposits	234	187
Development deposits	100	37
	4,529	**1,728**

24 SHARE CAPITAL

	2008	2007
Authorised share capital	5,000	5,000
Issued and fully paid	1,500	1,500

Subsequent to the year end, the Board in consultation with the Minister for Finance has approved to increase the paid up capital to KShs 5 billion by capitalising KShs 3.5 billion from the general reserve fund.

25 GENERAL RESERVE FUND

The general reserve fund is a fund where at least 10% of the net annual profits of the Bank is 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 CAPITAL MANAGEMENT

Capital includes the share capital and the general reserve fund.

	2008 KShs million	2007 KShs million
Share capital	1,500	1,500
General reserve fund	16,754	7,759
	18,254	**9,259**

Movements in equity capital during the year are explained in the Statement of Changes in Equity on page **76**.

The Bank is not subject to any regulatory requirements concerning the level of capital it must maintain, although the Central Bank Act sets out how the statutory annual net profit for the year shall be allocated. The principal source of capital increase is through retention of the undistributed element of the profit. The Bank is not a not-for-profit organization, nor does it seek profit maximization. Instead it seeks to make a profit commensurate with normal market returns in areas where it conducts normal commercial operations.

Capital is not actively managed and the relatively low risk nature of most of the Bank's activities means that it is not capital intensive. Its purpose is to cover unexpected losses. The most significant unexpected losses are likely to arise out of support operations and the Bank's role as lender of last resort or from losses on the foreign exchange reserves should the Kenya shilling appreciate significantly against other world currencies.

27 NOTES TO THE CASH FLOW STATEMENT

(a) Cashflows from operating activities

	2008 KShs million	2007 KShs million
Net profit /(loss) for the year	8,995	(386)
Adjustments for:		
Depreciation of property and equipment	143	254
Amortisation of prepaid operating leases	4	3
Amortisation of intangible assets	31	19
Decrease in defined benefit scheme asset	185	154
Gain on disposal of property and equipment	(81)	(6)
Operating profit before working capital changes	**9,277**	**38**
Net decrease in loans and advances	282	5,541
Decrease in amounts repayable under repurchase agreements	(13,819)	(7,716)
Increase/(decrease) in deposits	39,802	(9,479)
Increase in balance with International Monetary Fund	3,957	2,152
Increase in project accounts	34	899
Increase in accrued interest on balances due from banking institutions	(1,142)	(222)
Increase in items in the course of collection	(2,296)	(52)
Decrease in other assets	318	5,289
Increase in other liabilities	2,801	724
Net cash generated from/(absorbed by) operations	**39,214**	**(2,826)**

27 NOTES TO THE CASH FLOW STATEMENT (continued)

(b) Cash and cash equivalents

	2008 KShs million	2007 KShs million
Cash and cash equivalents included in the cash flow statement comprise the following:		
Term deposits	210,866	171,262
Current accounts	4,423	2,333
Domestic forex cheques clearing	1,438	1,641
Travellers Cheques	6	5
Gold holdings	28	20
	216761	175,261
Investment in Government securities	8,539	4
	225,300	**175,265**

28 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.

(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 2008 amounted to KShs 2,422 million (2007: KShs 2,312 million). The advances are at preferential rates of interest determined by the Bank.

(ii) Loans to executive directors	2008 KShs million	2007 KShs million
At start of the year	2	6
Loans advanced during the year	-	14
Loan repayments	(1)	(18)
At end of the year	1	2

(iii) Loans to key management personnel

At start of the year	22	30
Loans advanced during the year	34	8
Loan repayments	(23)	(16)
At end of the year	33	22

(iv) Directors' emoluments:

Fees to non executive directors	13	13
Other remuneration to executive directors	35	26
	48	39

(v) Key management personnel remuneration:

Remuneration to senior management	134	109

28 RELATED PARTY TRANSACTIONS(continued)

(vi) 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:

	2008 KShs million	2007 KShs million
Due from Government of Kenya (Note 19)	34,439	35,549
Overdraft account (Note 13)	-	42
IMF funds on-lent to the Government (Note 10)	1,053	1,410
Government of Kenya deposits (Note 21)	67,507	41,066
Investments in GOK Securities (Note 12)	8,539	4

(vii) 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 15 million (2007: KShs 23 million).

(viii) Kenya School of Monetary Studies

The Kenya School of Monetary Studies is a registered legal entity 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.

29 RISK MANAGEMENT

i) Structure and Reporting

The Board of Directors is responsible for the overall risk management approach and for approving the risk management policy and strategies. There are other organs that monitor the assessment and management of risks within the Bank including;

a) Audit Committee of the Board

The Audit Committee assists the Board in the fulfilment of its oversight responsibilities. Regarding risk management, the Committee oversees the process of risk management by receiving and discussing risk management reports and guiding and monitoring the implementation of recommended mitigating controls/ initiatives.

29 RISK MANAGEMENT (continued)

Bank Risk Management Committee

The purpose of the Bank Risk Management Committee is to identify the nature of risks affecting the Bank and the processes by which these risks are to be managed. The Committee monitors external developments relating to all financial, business and strategic risks associated with the operations of the Bank. The Committee is further, charged with the responsibility of reviewing the adequacy and overall effectiveness of the Bank's risk management and business continuity management frameworks and oversees the inculcation of a risk philosophy and implementation of a risk strategy and policy across the Bank. In executing its mandate, the Committee receives and considers risk assessment reports from Internal Audit and Risk Management Department.

a) Internal Audit and Risk Management Department (IARM)

The Internal Audit arm of IARM Department employs risk-based audit approach in planning and carrying out its audit engagements. The Risk Management function facilitates risk assessments by individual departments where risks are identified, analyzed and mitigating measures agreed upon.

The business processes are assessed with regard to business continuity procedures, physical safety, system safety, conformity to legal requirements and regulations, sufficiency of human resources and information safety. In addition, the financial risks and reputation risks are also determined. Controls that are designed to reduce these risks to acceptable levels are assessed in terms of sufficiency and effectiveness; additional controls are recommended in order to increase effectiveness. Following the risk assessments, the major risks and recommendations are used to update the Bank's risk register and regularly reported to the Bank Risk Management Committee and the Audit Committee. Action plans that are taken to reduce the risks to acceptable levels are monitored.

i) Strategy in Using Financial Instruments

The Bank holds foreign exchange reserves for the purposes of servicing official foreign debt, paying non-debt government and Central Bank of Kenya expenditures abroad, and occasional intervention in the foreign exchange market to smoothen exchange rate movements. The Bank can only intervene in the foreign exchange market when there are sharp exchange rate movements which are likely to destabilize the financial market.

In view of the Bank's reserve management policy of safe investment, liquidity and return, respectively, the Bank, with a prudent approach, subjects its foreign exchange reserves to investments in international markets.

In this framework, almost all the financial risks to which the Bank is exposed arise while fulfilling its duties of managing foreign exchange reserves and rendering certain banking services to the banking sector and the Government of the Republic of Kenya. The Bank is exposed to credit, market and liquidity risks due to the aforementioned operations. The financial risks that arise during the management of foreign exchange reserves are the outcome of an investment choice. Nevertheless, the Bank endeavours to minimize such risks by managing them with a conservative approach. Foreign exchange reserves are managed by observing the investment criteria defined in the Bank's Guidelines on Foreign Exchange Reserves Management.

29 RISK MANAGEMENT(continued)

i) Risks facing the Bank

The following are the main types of risks that the Bank is exposed to in the course of executing its operations:
Financial Risks include:
1) Credit risk
2) Market risk
   - Interest risk
   - Foreign currency exchange risk
3) Liquidity risk

Non financial Risks include:
4) Operational risk
5) Human resource risk
6) Legal risk
7) Reputational risk

Financial Risk
a) Credit risk

During its financial operations, the Bank is exposed to credit risk, defined as the probability of a complete or partial failure of counterparty to fulfil its obligations arising from a financial transaction. The credit risk basically originates from the investments made of deposit placements, if on their maturity the depository bank is unable to pay.

The management of the credit risk that the Bank is exposed to during the foreign exchange reserve management is based on the principle of minimizing default probabilities of the counterparties and the financial loss in case of default. The choice of depository banks for deposit placements is a crucial consideration in credit and sovereign risk management. Currently, the Bank's choice of depository banks is confined to the top 200 international banks that meet the set eligibility criteria of financial soundness on long-term credit rating, short-term credit rating, composite rating and capital adequacy. The current active approved depository banks holding the Bank's deposits number twenty one (21) and their performance is reviewed periodically, based on performance ratings provided by international rating agency, Fitch IBCA. Deposit placement limits are allocated to individual banks based on their financial strength, and no individual bank holds more than 10% of the entire deposit portfolio.

To minimize the sovereign risk exposure, the eligible banks are distributed among 10 countries under the following set criteria; long-term credit rating of A+, short-term credit rating of F1, composite rating of B and BIS capital adequacy ratio of 8%.
The Bank undertakes its operations in the Republic of Kenya. An analysis of the Bank's assets and liabilities by geographical area is given below:

	2008/2007	2007/2006
	KShs Millions	KShs Millions
Assets		
Republic of Kenya	51,612	43,047
United Kingdom	124,291	112,097
Rest of Europe	95,413	65,474
United States of America	3,338	2,857
Rest of the World	524	16
	275,178	223,491
Liabilities		
Republic of Kenya	275,178	223,491

a) Interest 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.

	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	219,035	-	-	4,451	223,486
International Monetary Fund(SDR Account)	206	-	-	-	206
Items in the course of collection	-	-	-	2,885	2,885
Investment in government securities	8,539	-	-	-	8,539
Loans and advances	74	933	2,453	-	3,460
Other assets	-	-	-	1,244	1,244
Property, plant and equipment	-	-	-	568	568
Prepaid leasehold land	-	-	-	278	278
Intangible assets	-	-	-	18	18
Retirement benefit asset	-	-	-	55	55
Due from Government of Kenya	-	1,110	33,329	-	34,439
Total assets	227,854	2,043	35,782	9,499	275,178
Liabilities and equity					
Currency in circulation	-	-	-	99,750	99,750
Deposits	131,141	-	-	-	131,141
International Monetary Fund	-	-	-	19,697	19,697
Amounts repayable under repurchase agreements	1,807	-	-	-	1,807
Other liabilities	-	-	-	4,529	4,529
Equity and reserves	-	-	-	18,254	18,254
Total liabilities and equity	132,948	-	-	142,230	275,178
Interest sensitivity gap 2008	**94,906**	**2,043**	**35,782**	**(132,731)**	**-**
Total Assets	176,476	2,044	37,173	7,798	223,491
Total liabilities and equity	106,971	-	-	116,520	223,491
Interest sensitivity gap 2007	**69,505**	**2,044**	**37,173**	**(108,722)**	**-**

a) Market risk

Market risk signifies the probability of incurring a loss stemming from adverse market movements, usually in interest rates, currency exchange rates and asset prices.

For the purpose of managing market risk, the Bank holds a diversified portfolio that spreads over the major world currencies with the following features; stability, widely traded, international acceptability and offering the best range of investment instruments. Guided by these features and the need to minimize transaction costs in external payments, the Bank invests its reserves in four key international currencies, namely, US dollar (USD), British pound (GBP), Euro (EUR) and the Swiss Franc (CHF).

The distribution of these currencies in the portfolio is subject to review from time to time. However, to allow for flexibility in portfolio management, the mix benchmarks are allowed+ 5% within the following ranges:

USD: 30 - 40%
GDP: 45 - 55%
EUR: 10 - 20%
CHF: 0 - 5%

The net foreign currency position of the Bank as of 30 June 2008 and 2007 is summarized below. The table presented below provides the Bank's assets, and liabilities, at carrying amounts, categorized by currency:

c) Market risk (continued)

The various currencies to which the Bank is exposed at 30 June 2008 are summarised below (all expressed in KShs million):-

	USD	GBP	EURO	SDR	GOLD	OTHER	TOTAL
Assets							
Balances due from banking institutions	73,789	108,802	40,326	-	-	541	223,458
Special Drawing Rights	-	-	-	206	-	-	206
Gold holdings	-	-	-	-	28	-	28
Total assets	73,789	108,802	40,326	206	28	541	223,692
Liabilities							
Balances due to IMF	-	-	-	19,697	-	-	19,697
Commissions for EEC Development Fund	-	100	-	-	-	-	100
Forex bureaux deposits	1,112	123	161	-	-	-	1,396
Total liabilities	1,112	223	161	19,697	-	-	21,193
Net balance sheet position 2008	**72,677**	**108,579**	**40,165**	**(19,491)**	**28**	**541**	**202,499**
As at 30 June 2007							
Total assets	90,458	69,003	21,365	5	20	32	180,883
Total liabilities	1,227	145	290	15,740	-	-	17,402
Net balance sheet position 2007	89,231	68,858	21,075	(15,735)	20	32	163,481

a) Liquidity risk

Liquidity risk is defined as having difficulty in finding sufficient cash to meet the commitments that are due or being compelled to convert assets into cash at a price lower than their fair value. The choice of the types of instruments to invest the reserves in is part of liquidity risk management. The available instruments are governed by Section 26 of the Central Bank of Kenya Act which specifies the eligible instruments in which the Bank can invest its reserves including; gold, demand or time deposits and convertible and marketable securities of or, guaranteed by foreign governments or international financial institutions.

In order to manage liquidity risk, the Bank invests its surplus reserves in time deposits with maturities concentrated in short-term maturity span of one to three months. The portfolio is structured in such a manner that a mix of deposits matures every week to ensure availability of funds to meet scheduled government and the Bank's obligations.

a) Liquidity risk (continued)

The table below analyses assets and liabilities into relevant maturity groupings based on the remaining period at 30 June 2008 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	12,798	210,660	-	-	28	223,486
International Monetary Fund(SDR Account)	206	-	-	-	-	206
Loans and advances	41	118	701	1,772	828	3,460
Investments in government securities	-	8,539	-	-	-	8,539
Items in the course of collection	2,885	-	-	-	-	2,885
Other assets	-	1,244	-	-	-	1,244
Property, plant and equipment	-	148	366	54	-	568
Prepaid leasehold land	-	1	3	14	260	278
Intangible assets	-	9	9	-	-	18
Retirement benefit asset	-	-	-	-	55	55
Due from Government of Kenya	-	-	1,110	4,440	28,889	34,439
TOTAL ASSETS	15,930	220,719	2,189	6,280	30,060	275,178
LIABILITIES						
Currency in circulation	-	-	-	-	99,750	99,750
Deposits	131,141	-	-	-	-	131,141
International Monetary Fund	-	-	413	1,535	17,749	19,697
Amounts repayable under repurchase agreements	-	1,807	-	-	-	1,807
Other liabilities	-	4,529	-	-	-	4,529
Equity and reserves	-	-	-	-	18,254	18,254
TOTAL LIABILITIES AND EQUITY	131,141	6,336	413	1,535	135,753	275,178
Liquidity gap 2008	**(115,211)**	**214,383**	**1,776**	**4,745**	**(105,693)**	**-**
Total assets	10,246	173,103	1,096	7,429	31,617	223,491
Total liabilities and equity	91,345	17,348	413	1,535	112,850	223,491
Liquidity gap as at 30 June 2007	**(81,099)**	**155,755**	**683**	**5,894**	**(81,233)**	**-**

Non Financial Risk

a) Operational risk

Operational risk is the risk of loss due to human or system errors, incompatibility or failure of internal business processes, or external events. The Bank seeks to minimize losses from operational risk by establishing effective internal control systems which prevent or detect all errors and situations which might cause loss through failure of people or processes in such a way that losses are avoided or reduced to the minimum possible extent. The Bank has assigned the responsibility for managing operational risks to the management of the departments.

The assessment of risks in terms of their effects and probabilities of occurrence and the adequacy, effectiveness and efficiency of the controls established to mitigate the risks is done vide audits and risk assessments conducted by the Internal Audit and Risk Management Department(IARM).

b) Human Resource Risk

The particular nature of the activities of the Bank necessitates specialized knowledge in many areas.

The Bank ensures that there is an adequate knowledge base for all specialized job requirements by investing significantly in human resource development in terms of capacity building and practical exposure. The Bank also organizes workshops, seminars, conferences and job attachments to its staff as an effort to improve its human resource requirements.

c) Legal Risk

Legal risks arise from any uncertainty of enforceability, whether through legal or judicial processes, of the obligations of the Bank's clients and counter parties. These are the risks that the Bank may not be complying fully with the relevant laws and legislations. The Bank aims at minimizing such uncertainties through continuous consultations with all relevant parties.

In mitigating these types of the risks, the Bank ensures that all business agreements are subjected to extensive legal reviews before contracting.

d) Reputational Risk

The concern about reputation flows from the fact that the Bank is a public institution with important responsibilities for stability in the value of money, the soundness and efficiency of the financial system and the issue of currency (notes and coins). All of these matters have direct impact on all citizens and the credibility and the reputation of the Bank is an important factor in the successful fulfilment of these responsibilities.

In managing this risk, the Bank adheres to the best practices and applies principle of sound corporate governance. It also ensures that all relevant staff have a clear understanding of the appropriate processes in respect of the best practice and principles of good corporate governance.

The Bank therefore, sets out policies and guidelines that govern sound functional operations within the Bank. The performance of these policies and guidelines are periodically reported to different levels of the Bank's Management for Control and Compliance Monitoring.

SENSITIVITY ANALYSIS

The Bank uses models to assess the impact of possible changes in market risks. These risks include interest rate risk and foreign exchange risk. The Board is yet to establish limits on exposure gaps; these limits will be utilised to ensure risk positions are effectively managed. The limits will provide possible alternative assumptions to be applied as well as professional judgement to an analysis of the data available to support each assumption.

0 SENSITIVITY ANALYSIS (continued)

(i) Interest rate risk

Interest rate risk is the risk of loss resulting from changes in interest rates, including changes in the shape of yield curves. The Bank bases its analysis on the interest sensitivity gap (Note 29). The sensitivity computations assume that financial assets maintain a constant rate of return from one year to the next. The effect on profit due to reasonable possible changes in interest rates, with all other variables held constant, is as follows:

	2008 KShs million	2007 KShs million
Effect on profit before tax of a +13% change in interest rates	1,339	1,081
Effect on profit before tax of a -13% change in interest rates	(1,339)	(1,081)

(ii) Currency risk

Currency risk is the risk of loss resulting from changes in exchange rates. The Bank bases its analysis on the interest sensitivity gap (Note 29). The Bank has assets and liabilities in various currencies; however, the most significant exposure arises from assets denominated in the US dollar, GBP and Euro currencies. The following table demonstrates the sensitivity to reasonably possible change in the KShs/ US dollar exchange rate, with all other variables held constant, of the Bank's profit earned.

	2008 KShs million	2007 KShs million
Effect on profit before tax of a +7% change in exchange rates	488	410
Effect on profit before tax of a -7% change in exchange rates	(488)	(410)

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 2008 and 2007 were in the following ranges:

		2008	2007
Assets			
Government securities		6.64%	6.64%
Deposits with overseas correspondent banks			
	- current accounts	0.0%	0.0%
	- term deposits (USD)	3.22%	5.29%
	- term deposits (Pounds Sterling)	5.68%	5.65%
	- term deposits (Euro)	4.54%	4.10%
Loans and advances	- Commercial banks	8.50%	8.50%
	- Government of Kenya	8.50%	8.50%
	- Employees	3.0%	3.0%
Due from Government of Kenya		3.0%	3.0%
Liabilities	-Customer deposits	0%	0%

32 CONTINGENCIES

Pending legal suits

The Bank is party to various legal proceedings with potential liability of KShs 2.427 billion at 30 June 2008. 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.

33 EVENTS AFTER BALANCE SHEET DATE

In 1993, the Bank created a charge for KShs 2.5 billion over the Grand Regency Hotel, a property owned by Uhuru Highway Development Limited, to secure a debt owing from Exchange Bank Ltd. The debt arose out of inter-bank transactions between Exchange Bank Ltd and the Bank during the period 1992 and 1993. During the year, the Bank sold its security for US$ 45 million in satisfaction of the KShs 2.5 billion debt. The sale was completed in July 2008.

To address public interest and anxiety in the matter, in July, 2008 H. E. the President appointed a Commission of Inquiry to, inter alia, investigate the circumstances surrounding the sale of the Hotel. The Commission was yet to complete its work and submit a report of its findings to the President by the time the audit of the Bank's financial statements for year 2007/2008 was completed. Owing to these uncertainties, the down payment (10% or $4.5 million) of the sale price received during the year has been treated as part of the balances due from banking institutions in Note 9 and other liabilities in Note 23. The balance (90% or $40.5 million) that was received in July 2008 has been similarly treated in the Bank's books subsequent to year end.

34 COMMITMENTS

	2008 KShs million	2007 KShs million
Contracted for	-	10

Capital commitments contracted for in the previous year relates to currency disintegration and briquetting system for Kisumu and Eldoret bank notes and sorting system.

OPERATING LEASE COMMITMENTS

AS LESSEE:

The total future minimum lease payments due to third parties under non-cancellable operating leases are as follows:

	2008 KShs million	2007 KShs million
One year	12	11
Between two and five years	7	7
Over five years	139	140
	158	**158**

Lease commitments relate to lease rentals for NAIROBI L.R No. 209/11441.

35 EMPLOYEES

The average number of employees during the year was 1,230 (2007: 1,255).

36 TAXATION

No provision for tax is made as Section 7 of the Income Tax Act 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.

37 COMPARATIVES

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