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LETTER OF TRANSMITTAL

In accordance with Section 54 of the Central Bank of Kenya Act, I am pleased to submit to the Honourable Minister the Annual Report of the Central Bank of Kenya for the Financial Year 2003/04. The report reviews economic and financial developments and contains the Audited Accounts of the Central Bank for the Financial Year ended June 30, 2004.

During the year under review, economic performance improved markedly from that witnessed in recent years. Growth in real Gross Domestic Product (GDP) improved to 1.8% in 2003 from 1.2% in 2002. The recovery remained on track during the first half of 2004, with the economy estimated to have achieved an annualized growth of 2.3%. Performance of agriculture and the services sector, particularly telecommunications, and tourism, improved significantly during the first half of 2004, making them the economy's key growth sectors. Reforms in economic and political governance, favourable weather conditions, and improved relationships with the development partners, as well as the conducive and stable macroeconomic environment characterized by low interest rates, relatively stable exchange rates and low inflation rates underpinned the improved economic output. Investor confidence also improved with interest showing up in areas such as telecommunications.

The financial sector remained stable over the fiscal year 2003/04, the Central Bank successfully implemented monetary policy geared towards containing underlying inflation within 3.5% thereby supporting the maximum growth possible with the available resources. On the fiscal front, improved fiscal discipline coupled with financing of the budget deficit from non-inflationary domestic sources kept the Government recourse to Central Bank for overdraft within the stipulated statutory limit.

Overall, operations of the Central Bank in the year ended June 30, 2004 resulted in Kshs. 5,133m net profit compared with Kshs 4,448m realised in the year ended June 30,

2003. The improved performance was largely due to better income from foreign exchange investment.

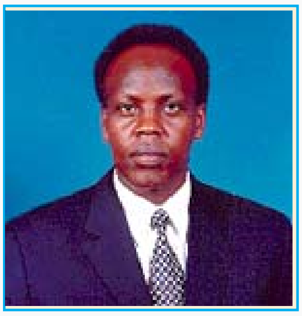
Looking ahead, and despite the damaging impact of the drought and the delay in disbursement of donor funds, economic recovery is expected to remain on track as the Government continues to implement the Economic Recovery Strategy for Wealth and Employment Creation. Real GDP growth will also benefit from faster world and regional growth, the extension of third-party textile sourcing under the African Growth Opportunity Act (AGOA) until 2007, and the anticipated tourism "boom". The Central Bank on its part will continue to ensure a conducive macroeconomic environment of low and stable inflation and interest rates to further enhance growth performance.

GOVERNOR

BOARD OF DIRECTORS

ANDREW K. MULLEI
Governor and Chairman
Central Bank of Kenya

JOSEPH M. MAGARI
Permanent Secretary,
Ministry of Finance



EDWARD SAMBILI
Deputy Governor
Central Bank of Kenya

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OWEN N. KOIMBURI

PAUL A. SPENCE

GEORGE ONGAYA-OKOTH

SENIOR MANAGEMENT

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Director, Management Information Services

JACINTA W. MWATELA (Mrs.)
Director, Financial Markets

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JOHN K. MURUGU
Director, Banking & Currency

JONATHAN A. BETT
Director, Finance

JONES M. NZOMO
Director, Banks Supervision

LAWRENCE C. KUNGU
Ag. Director, Supplies & Services

MR. GERALD A. NYAOMA
Ag. Director, Internal Audit

INTRODUCTION

The year under review covers twelve of the first eighteen months of NARC Government. Upon assuming the reigns of power, the NARC coalition Government initiated various economic policy measures and reforms in the context of the Economic Recovery Strategy for Wealth and Employment Creation (ERSWEC). In essence, the measures were aimed at improving economic growth, governance, equity and poverty reduction, and employment generation.

Reflecting the impact of the various policy measures over the period, the economy recovered during the financial year with real GDP growth improving to 1.8% in 2003, and further by an estimated annual rate of 2.3% during the first half of 2004. Agriculture and services, especially telecommunications, finance and tourism, emerged the key growth sectors. Economic growth in the period was underpinned by positive changes in economic and political governance, favourable weather conditions, improved donor support, conducive and stable macroeconomic environment characterized by low interest rates, and relatively stable exchange rate. Investor confidence improved following the resumption of IMF support under Poverty Reduction and Growth Facility Programme (PRGF), and the signing of agreements with the World Bank and other bilateral donors.

During the financial year 2003/04, the Central Bank pursued a monetary policy programme geared to keeping inflation low and achieving price stability. During the financial year, broad money supply, M3X, grew by 12.9% compared with 7.2% target. Most of the growth in money supply, originated in increased credit advanced to the private sector, which expanded by 13.1% up from 4.9% in the financial year 2002/03. Over the same period, the underlying inflation rose only modestly from 2.3% in July 2003 to 3.0% in June 2004, well within the 3.5% target. Food inflation, however, edged up to double digit levels during the first ten months of the financial year, while, fuel and power, inflation edged up from 3.8% at the beginning of the financial year to 7.9% in June 2004. These developments reflected the reduced supply relative to demand occasioned by bad weather that caused shortfalls in food supply and disrupted crude oil supply due to tensions in the Middle East. Similarly, as a result of increased fuel prices and a major reorganisation of the public transport sector, fares surged upwards and thus caused substantial acceleration in inflation in the “transport and communication” category from single digits in first half of the financial year, to between 19.5% and 24.7% during the second half of the financial year.

On the fiscal front, the government made significant progress in restructuring the profile of its domestic debt in favour of long maturity instruments in order to lower borrowing costs in the medium and long-term. As a result, the share of Treasury bills and bonds in government securities was transformed to 25% and 75% respectively, by June 2004, from 32.6% and 66.9% in June 2003. Concurrently, the average maturity of securitised domestic debt increased from1.6 years in June 2003 to 2.2% in June 2004.

In the external sector, the overall balance of payments position remained favourable though shrinking to US dollar 138 million surplus in the year to June 2004 from US dollar 196 million over the year to June 2003. The narrowing of the surplus mainly occurred as a result of a deterioration of the current account by US dollar 211 million, compared with a surplus of US dollar 15 million realised in the previous year. The deficit of US dollar 211 million in the current account was attributed mainly to the high growth of imports to support economic growth which offset inflows from the exports of goods and services. Exports of goods grew by 8.4% while imports of goods grew by 19.0%.

Despite the decline in the overall balance, gross official foreign exchange reserves rose by US dollar 139 million to stand at US dollar 1,399 million (equivalent to 4.3 months of import cover) at the end of June 2004. Gross foreign asset holdings of commercial banks rose by US dollar 146 million to US dollar 541 million resulting in an increase in gross foreign reserves of the entire banking system by US dollar 285 million to US dollar

1,940 million equivalent to 5.0 months of import cover at the end of June 2004 while the Central Bank reserves stood at 3.6 months of imports cover.

In the financial sector, commercial banks, non-banking financial institutions and building societies experienced relative stability during the financial year 2003/04. Overall, the performance of the Central Banking sector improved in 2003/04 with net profits increasing to Ksh 14.1 billion from Ksh 6 billion in 2002/03. Financial institutions remained relatively healthy with none placed under either liquidation or statutory management compared with two banks placed under liquidation in the first half of 2003.

During the year, commercial banks increasingly adopted modern technology thus enhancing the payments system. Currently, there are over 200 automated teller machines in the country including KENSWITCH, a joint venture among a group of small banks. Settlement system also improved significantly with cheque clearing currently taking only one day and three days within the same bank and between different banks, respectively.

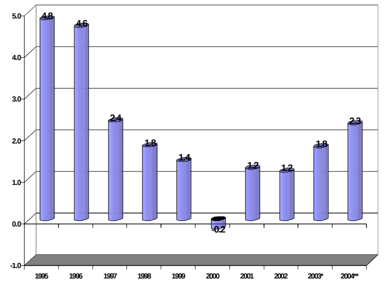
At the time of writing this report, available economic performance data for July and August 2004 indicated significant changes in two of the macro prices - inflation and exchange rates. It is against the background of these changes that the forecast is made.

REAL GDP GROWTH

As ready indicated, the financial year 2003/2004 represents twelve of the first eighteen months of the economy under the stewardship of the NARC Government. Upon ascending to political leadership, the NARC Government, initiated various economic policy measures and programmes, including Economic Recovery Strategy for Wealth and Employment Creation designed to improve economic growth, governance, equity and poverty reduction, and employment generation. The Government has made concerted efforts on many fronts and improved public affairs management, and restored the relationship with development partners with resumption of a poverty reduction and growth facility (PRGF) programme with the IMF.

Over the period, the economy recovered from a sluggish growth of 1.2% in 2002 to 1.8% in 2003, and further by an estimated 2.3% in the first half of 2004 as shown in Chart 1. The modest recovery was achieved after the economy had had its growth decelerate persistently in real terms from 4.8% in 1995 to negative 0.2% in 2000.

CHART 1: REAL GDP RATES, 1998 - JUNE 2004



* Provisional
** Estimates
Sources: Economic Survey &Central Bank of Kenya

TABLE 1: GROSS DOMESTIC PRODUCT & SECTOR SHARE AT CONSTANT 1982 PRICES

Main sectors	Shares in GDP (%) 2003	Annual Growth (%) 2002/[1]	2003/[2]	FY 2002/03[2]	FY 2003/04
Agriculture	24.0	0.81	1.51	1.2	2.4
Manufacturing	13.0	1.19	1.40	1.3	1.6
Trade, Restaurants & Hotels	12.6	1.60	1.40	1.5	1.4
Financial Services	10.5	0.80	3.00	1.9	3.0
Building & Construction	2.4	0.34	2.20	1.3	2.4
Transport & Communications	6.3	2.62	1.50	2.1	4.0
Government Services	14.5	0.86	1.60	1.2	2.0
Others of which	16.6	1.36	2.02	1.7	2.2
Non-monetary	5.7	*1.66*	*1.68*	1.7	0.7
Domestic services	3.0	*2.30*	*2.40*	2.4	2.2
Ownership of dwelling	5.7	*1.50*	*1.70*	1.6	3.4
Other[3]	2.2	*-1.00*	*3.26*	1.1	3.2
TOTAL	**100.0**	**1.2**	1.8	**1.5**	**2.3**

Notes

1 *From the Economic Survey, 2004.*
2 *Financial year estimates*

3 *Includes forestry and fishing, mining and quarrying, electricity and water, and other sectors less imputed bank charges*

Sources: Central Bureau of Statistics and Central Bank of Kenya

Real gross fixed capital formation, which declined persistently over the previous eight years, grew by 3.6% in 2003, indicating a turn around in wealth creation. Similarly, following the implementation of various measures to deal with inefficiency in the economy, the incremental capital output ratio, that is, the change in capital stock required to produce a given unit of output declined from 5.4 in 2002 to 3.7 in 2003. This implies that additional capital invested in 2004 resulted in more output than in the previous year.

Economic recovery in the period under review was supported by good weather, improved donor support, conducive and stable macroeconomic environment characterized by low inflation, low interest and relatively stable exchange rate, and improved investor confidence following the resumption of the IMF Poverty Reduction and Growth Facility Programme and the signing of agreements with the World Bank and other bilateral donors.

Interest rates declined substantially resulting in an expansion of credit to the private sector by 12.3% in the year to June 2004 from 5.2% in the year to June 2003. During the financial year, the weighted average lending interest rate declining by 3.3 percent to 12.2% from 15.3% in the financial year 2002/2003. The significant growth in credit to the private sector augurs well for economic recovery after a long period of stagnation. At the same time, the Kenya shilling remained market determined, thus becoming more predictable, and balancing the interests of both importers and exporters.

In agriculture, for instance, output of tea, sugar cane, coffee, horticulture and pyrethrum grew by 16.8%, 6.6%, 4.5%, 9.0% and 13.2% respectively. In manufacturing, production of cigarettes, beer, processed sugar and soda ash increased by 32.3%, 19.7%, 13.09% and 6.98% respectively in the second half of the financial year.

Remarkable growth was also achieved in the services sector. In the energy sector, both domestic generation and consumption of electricity increased by 7.9% and 5.2% respectively, while subscriptions for fixed delined by 8.9% and while mobile telephone services in the telecommunications sub-sector increased 57.9% respectively between July 2003 and June 2004. Similarly, tourist arrivals increased by 5.5% in 2003/04 while cargo handled by the port of Mombasa and the Kenya Pipeline Company expanded by 7.7% and 9.7% respectively over the period. Notable investment has also been realized in the public transport sub-sector since the reorganization of the sub-sector by the government.

Looking ahead, there are good economic prospects for the financial year 2004/2005 and into the medium term. At both the regional and international front, forecasts point at strong global economic growth of 4.8% in 2004, the strongest performance since 1984. Growth in the world economy will boost Kenya’s overall growth prospects in 2004 with major export categories such as horticulture, tourism, tea, coffee and textiles expected to grow faster during the year.

At the regional level, the peaceful resolution of armed conflicts particularly the recent signing of a peace agreement in Southern Sudan is expected to provide business opportunities for the Kenyan economy in the medium term particularly given the planned extension of the railway line to the region and construction of a pipeline to Mombasa for crude oil exports from Southern Sudan. Besides, Kenyan exporters stand to gain from the widened European Union market following the recent enlargement of the trading bloc to include ten other countries making the largest market bloc in the world, bigger than the US, Canada and Mexico combined. A number of Kenyan goods access the market duty free through preferential trade agreements.

Other positive developments include the reversal of the adverse travel advisory by the UK and the downgrading of the negative advice by the USA. In addition, implementation of government investment programme outlined in the 2004/05 Budget Speech and the Economic Recovery Strategy Paper, and in particular, the construction and rehabilitation of major infrastructure and other projects will further boost growth prospects in the year and into the medium term.

This optimistic overview is undermined by the current drought and the slower than anticipated disbursement of the balance of payments support by the IMF and programme aid from other bilateral donors. Similarly, the sharp rise in world prices of oil and other raw materials poses a near–term risk to global growth, while possibility of a more general rise in inflationary pressure and policy reactions thereto pose a greater medium-term risk. Besides, the volatility in world travel due to terrorism threat will also continue to undermine economic growth in tourism and service sectors.

During the financial year 2003/04, major cash crops namely, tea, horticulture, sugarcane and pyrethrum grew significantly as shown in Table 2 below. The improvement in agricultural sector output during the financial year mainly reflects the favourable weather conditions during the period, and enhanced investor confidence in the sector following reforms and changes in management and governance of major institutions.

TABLE 2: OUTPUT GROWTH IN KEY CROPS (%)

Crop	Jun 2001/2002	Jun 2002/2003	Jun 2003/2004
Tea			
Output (ton)	282,952.00	280,136.00	327,281.00
Output Growth	0.14	-1.00	16.83
Horticulture			
Output (ton)	105,009.00	135,600.00	147,799.00
Output Growth	4.10	29.13	9.00
Coffee			
Output (ton)	47,248.00	56,245.00	58,796.00
Output Growth	-39.19	19.04	4.54
Sugarcane			
Output (ton)	3,933,147.00	4,163,415.00	4,438,020.00
Output Growth	-3.78	5.85	6.60
Pyrethrum			
Output (ton)	3,808.00	3,758.00	4,255.00
Output Growth	-38.90	-1.31	13.24
Sisal			
Output (ton)	22,927.00	23,402.00	24,447.00
Output Growth	4.21	2.07	4.47

Sources: CBS, HCDA, Sisal, Sugar and Pyrethrum Boards

In the tea sub-sector, output grew by 16.8% during the financial year 2003/04 to 327,281 tonnes from 280,136 tonnes in the financial year in 2002/03. The impressive growth in production is attributed to favourable rain patterns experienced in tea growing areas particularly during the last quarter of 2003 and the timely and good distribution of the long rains in the first four months of 2004. This is unlike the meager and erratic rain patterns experienced in 2002/03. In particular, the good weather experienced West of the Rift Valley accounted for much of the growth in the last quarter of 2004 while areas in the East of Rift Valley experienced cold and dry weather during the period.

Average tea auction prices also increased to US dollar 1,583 per tonne during the financial year from US dollar 1,454 per tonne in the FY 2002/03. The increase in tea prices were supported by the entry of non-traditional buyers namely, Russia, Kazakhstan, USA, Poland, India and Nigeria pushing prices upwards. During the second half of the financial year 2003/04, the leading importers of Kenyan tea were; Egypt (25.95%), Pakistan (23.07%), United Kingdom (15.31%), Afghanistan (12.15%) and Sudan (4.79%). Three new tea-processing factories currently under construction, are due for completion. This will reduce tea wastage and improve output.

Production of horticultural exports increased by 9.0% in the financial year 2003/04 to 147,799 tonnes from 135,600 tonnes in the financial year 2002/03. The remarkable growth was largely in flowers and vegetables whose export volumes grew by 28.3% and 31.8% respectively during the second half of the financial year. Fruits however, declined by 14.2% during the same period. Europe continued to absorb the bulk of the produce, though the Middle East particularly United Arab Emirates and Saudi Arabia and South Africa are emerging export markets. Prospects for further growth in the horticultural sector remain positive in the medium term following the expansion of the European Union market to include ten new members to the trading bloc. Kenya is a leading exporter of cut flowers to the European Union and enjoys tariff preferences and European investments. Horticultural producers continue to explore opportunities in the Far East market.

In the sugar sub-sector, cane deliveries increased by 6.6% to 4,438,020 tonnes compared with a 5.85% increase in 2002/03. The increase in cane deliveries resulted in improved production of processed sugar by 13.1% to 508,965 tonnes from 450,043 tonnes in the financial year 2002/03. Total sales of sugar during the period increased slightly by 2.8% to 480,525 tonnes from

467,440 tonnes in the financial year 2002/03. Exports amounted to 8,106 tonnes in June 2004 under the ACP-EU protocol compared with 11,375 tonnes in June 2003 while stocks stood at 4,576 tonnes in June 2004 compared with 19,901 tonnes in June 2003. Inability to maintain a sustainable level of competitiveness against cheaper imports from more efficient producers (particularly Sudan, Zambia and Egypt) remains the major challenge facing the sugar sector remains. It costs on average in most of these COMESA countries Kshs. 20,000 to produce a tonne of sugar compared with Ksh 22,000 for the most efficient company in Kenya. Given the inefficiency in domestic production, imported sugar continues to be relatively cheaper leading to substitution of domestic consumption in favour of imports. Moreover, imports often exceed the deficit thereby resulting in a large stock of processed domestic sugar in the warehouses. The survival of the local industry, therefore, is tied to the improvement of competitiveness through the reduction of production costs and improvement in productivity.

In the pyrethrum sub-sector, output increased by 13.24% to 4,255 tonnes from 3,758 tonnes in 2002/03. During 2003/04 period, export earnings from the crop increased to US dollar 14.9 million from US dollar 10 million earned in the corresponding period of 2003. Pyrethrum production is expected to improve in the coming months following upward trend in prices, and efforts by the government to clear payment arrears to farmers.

In the coffee sector, deliveries rose by 4.54% to 58,796 tonnes in the financial year 2003/04, up from 56,245 tonnes in the financial year 2002/03. The average price of coffee also increased to US dollar 1,454 per tonne from US dollar 1,333 in the same period of 2003. The sector is expected to recover following improvements in the international prices. There is also an observed improvement in the use of farm inputs following the disbursements of stabex funds to farmers. Coffee production is also expected to benefit from the recent preferential access to the US market given to Kenyan coffee under the African Growth and Opportunity Act (AGOA). Kenya Planters Cooperative Union (KPCU) plans to invest Ksh 30 million on value addition to export processed coffee to the US market under a Kenyan brand name.

Sisal production on the other hand increased by 4.47% to 24,447 tonnes in the review period from 23,402 tonnes the previous financial year. The increased production was attributed to expansion in the production capacity by sisal estates in response to increased demand for sisal fibre that saw the reopening of two sisal estates that had closed down and the increase in acreage under cultivation.

To reform agriculture, the government plans to transform agricultural activities into more profitable ventures, commercially viable and internationally competitive by identifying key priority activities including reforming the legal framework, research and extension and access to credit, inputs and markets. This will be done under a 10 year Strategy for Revitalising Agriculture (SRA). The project is expected to be funded by the government with the support of the World Bank. The first three-year phase, has been negotiated and funding level agreed at US dollar 40 million, of which US dollar 13 million is a grant. In addition, through the Agricultural Finance Corporation, credit has been extended to maize, wheat, dairy and horticultural farmers at attractive interest rates are expected to support further growth in the sector.

MANUFACTURING

Growth in the manufacturing sector, during the financial year 2003/04 was supported by the AGOA treaty. The companies operating in the Export Processing Zones increased to 70 by June 2004 from 54 in the previous year, while private investment shot up from Ksh 2.7 billion to Ksh 15.7 billion in the same period. Consequently, exports from the Zones increased to Ksh 9.8 billion from Ksh 6.6 billion in 2003, while direct employment increased to 35,935 from 27,148 in the same period. Textiles are expected to grow further following the recent extension of the third-party country sourcing of fabric by the US senate to 2007 and the extension of AGOA to 2015.

Growth in the manufacturing sector will also continue to benefit from favourable tax incentives introduced in the financial year 2002/03 and 2003/04, plus enhanced enforcement of compliance by the government to stamp out dumping of counterfeit goods as spelt out in the 2004/05 Budget. During the financial year 2002/03 and 2003/04, various tax measures were introduced including duty waivers on capital goods, plant and equipment; and an increase in investment allowance from 60% to 100%. The sector is also expected to expand into the wider regional and international markets within the East African Community, COMESA, and United States through AGOA.

There was significant improvement in the production of selected manufactures (Table 3). Cigarette production increased by 30% in the financial year 2003/04 to 9,446,694 milles from 7,138,180 milles in 2002/03 while production of beer increased by 19.7% to 231,038,000 litres from 192,992,000 litres in the same period.

Production of processed sugar, cement , soda ash and assembled vehicles increased by 13.1%, 2.9%, 6.7%, and 47.1% respectively in the financial year 2003/04 as indicated in the Table 3 below.

TABLE 3: PRODUCTION OF SELECTED MANUFACTURES

PRODUCT	Jun2001/02	Jun2002/03	Jun2003/04
Processed sugar			
Output (MT)	420,855	450,043	508,965
Output Growth %	25.79	6.94	13.09
Cement production			
Output (MT)	1,363,984	1,597,983	1,643,836
Output Growth %	5.11	17.16	2.87
Soda ash			
Output (MT)	300,870	332,330	354,580
Output Growth %	12.10	10.46	6.70
Galvanised sheets			
Output (MT)	144,075	154,484	149,611
Output Growth %	3.86	7.22	- 3.15
Assembled motor vehicles			
Output (Number)	2,877	3,685	5,419
Output Growth %	21.29	28.08	47.06

Source: Central Bureau of Statistics, Sugar Board and Magadi Soda

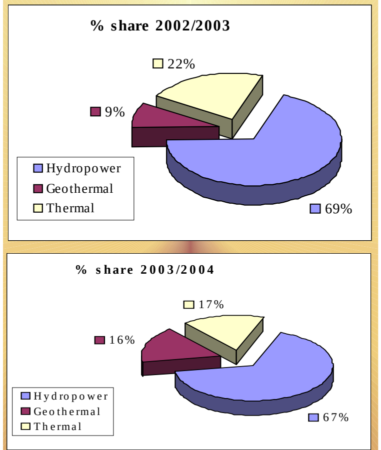
Kenyan exporters stand to gain from the widened European Union market following the recent enlargement of the common market bloc to include ten other countries. Several Kenyan goods access the market through preferential trade agreements under the ACP-EU Cotonou Agreement. Under the Cotonou regime, Kenya benefits from duty-free market access for nearly all of its products including fish, tea, coffee, sugar and textiles. Kenyan exporters to the EU will now deal with only a single set of rules, a single customs tariff which in the new ten countries will decrease from 9 percent to an average of 4 percent; and a single set of administrative procedures for the 25 EU countries.

CONSTRUCTION AND ENERGY

Activity in the building and construction sector picked up during the financial year 2003/04, with cement consumption increasing by 5.8% to 1,323,105 tonnes from 1,251,042 tonnes in the financial year 2002/03. The construction sector is expected to pick up substantially in the current financial year and into the medium term following renewed donor support to Kenya for the rehabilitation and reconstruction of the country's infrastructure.

Overall commitments for the roads and transport sectors over the next five years include US $ 207 million from the World Bank and Ksh 4 billion counterpart funds from the government. Additional resources are also expected from the Nordic Development Fund and the European Union to the tune of US $ 15 million and US $ 70 million respectively. In the financial year 2004/05, the World Bank is expected to disburse US $ 11 million, which will be complemented by Ksh 400 million counterpart funds from the government for reconstruction and improvement of the Northern Corridor. These resources are expected to improve the state of road infrastructure in the country and hence support the envisaged economic recovery in the medium term.

CHART 2: PERCENTAGE SHARE OF ELECTRICITY SOURCES

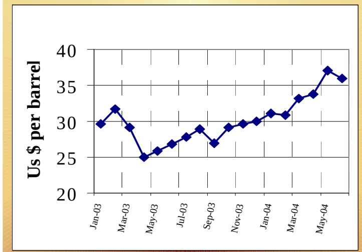


Source: Kenya Power & Lighting Co.

In the energy sector, domestic supply of electricity rose by 7.9% to 4,864 million Kilowatt Hours (KWH) during the financial year 2003/04, up from 4,509KWH in 2002/03. Increased power generation over the last two years reflected both steady supply of water to hydro dams and increased exploitation of alternative sources. Hydroelectric power, however, remains the main source of supply, accounting for 67% of total electricity supply while geothermal and thermal sources accounted for 16.2% and 16.8% respectively. Compared with the financial 2002/03, hydroelectric source of electricity accounted for 69.2% while geothermal and thermal sources accounted for 8.5% and 22.3% respectively, indicating that geothermal has increasingly become an important source of power while thermal sources are becoming less important.

During the 2003/04 financial year, oil prices shot up significantly to over US dollar 40 per barrel, the highest level in 13 years, due to risks associated with instability in the Middle East including disruptions in supplies from Iraq (the fourth largest producer in the world) and the pick up in global demand to support global economic expansion particularly in China, India Japan and the USA states. Despite efforts by some OPEC producers to increase supply particularly Saudi Arabia, Russia and Iran, oil prices are expected to remain high for most of 2004, and this will likely slow down the pace of economic growth in non oil producing countries such as Kenya through high production costs.

CHART 3: SAUDI ARABIAN CRUDE OIL



Source: Ministry of Energy

Despite the increase in domestic power generation, the energy sector is yet to achieve high efficiency levels and continues be plagued by high cost of power and unreliability in supply. The cost of electricity in Kenya is about US 8.0 cents per unit compared with US 2.0 cents and US 2.7 cents in South Africa and Egypt respectively. Egypt and South Africa are major competitors to Kenyan goods in the region. It is estimated that about 20% of electric power is lost in transmission while about 11,000 outages occur in one month.

The Government is restructuring KPLC and KenGen with a view to restoring sound financial status and efficiency. KPLC has already procured the critical components needed to improve quality and reliability of power supply. In addition, the Government is due to receive resources from development partners to the tune of US dollar 250 million in the medium term to reform the energy sector, particularly KPLC.

TRANSPORT, STORAGE AND COMMUNICATION

Since the liberalization of the mobile phones sub-sector, telecommunications has become the fastest growing sector in the economy. This phenomenal growth is reflected in the large number of new support businesses involved in mobile telephony, the large number of subscription to the services provided by Kencell and Safaricom and the widened area covered by the services. By the end of June 2004, active subscriptions to mobile service providers totaled 2,525,894 from 1,600,000 subscriptions in June 2003, representing a remarkable growth of over 57.9% during the financial year. In addition, significant growth was notable in the provision of community pay phone services.

During the financial year, mobile phone providers extended their services to parts of the country, which had for a long time been neglected of telecommunication services including the North Eastern province and other remote parts of the country. Growth prospects for 2004/05 remain good with the expected licensing of a third operator during the year.

TABLE 4: PERFORMANCE OF MAJOR SUB-SECTORS

Activity	Volume and % Change	
	FY 2002/03	FY 2003/04
Cargo by KPA (Mt)	11,239,589.0	12,109,051.0
	6.7	7.7
Passengers thro JKIA	1,991,573	2,206,887
	7.1	10.8
Cargo by KR (Mt)	2,165,172	1,995,059
	-2.9	-7.9
Througput by KPC (M^3)	2,819,998	3,093,366
	3.6	9.7

Source: Kenya Ports Authority, Kenya Railways, Kenya Pipeline and CBS

In the fixed lines sub-sector, total subscriptions declined by 8.9% to 299,225 lines from 328,358 at the end of the last financial year 2002/2003. The poor performance in the fixed lines sub-sector is attributed to lack of competition, given that until now Telkom Kenya retains its monopoly in the sub-sector. Investment in fixed line telephone operations is set to improve with the expected licensing of the second operator.

To improve telecommunications, the postal corporation has also installed Vsat (a satellite based technology used for long range communication) in more than 500 facilities throughout the country to enhance communication.

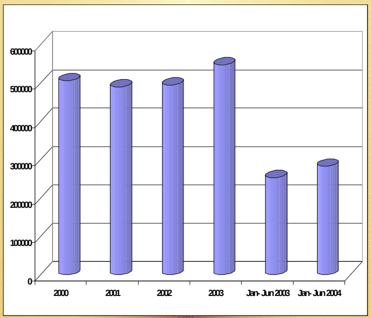
The transport sub-sector, on the other hand, had mixed trends during the financial year. Crude oil products transported by the Kenya Pipeline Company (KPC) increased by 9.7% to 3,093,336 cubic units from 2,819,998 cubic units during the financial year 2002/03. Cargo handled by Kenya Ports Authority (KPA) also increased by 7.7% to 12,109,051 tonnes from 11,239,589 tonnes in the previous financial year. Cargo handled by the Kenya Railways declined by 7.9% in the 2003/04 financial year to 1,995,059 tonnes from 2,165,172 tonnes the previous financial year. The decline was attributed to the removal of dispensations and introduction of upfront payments for all goods transported as from August 2003, which made customers seek alternative modes of transport.

Rail transport is the second most important mode of transport after road and an alternative to transporting bulky produce for both local and export markets. Kenya Railways has since put in place various measures that have enhanced service delivery including entering into an agreement with Kenya Ports Authority to transport more traffic to Inland Container Depots in Embakasi and Kibos with Through Bill of Lading using block trains and rationalization of passenger services to release more locomotives for freight business. Kenya Railways has also introduced, with Uganda Railways, a seamless train service that operates three times a week between the Port of Mombasa and Kampala to serve the transit market. The government is expected to complete the on-going restructuring of Kenya Railways through long term concession of passengers and cargo transport.

The Governments of Kenya and Uganda have already agreed on a joint concessioning venture for which prequalified bids are expected to be out by September this year with a completion date of August 2005. There are also plans to extend the railway line to Southern Sudan upon the conclusion of the peace pact, which will promote trade within the region.

In the public transport sub-sector notable investment has been realized during the third quarter of 2004 following the successful restructuring of the industry.

CHART 4 : TOURIST ARRIVALS



Source: Kenya Tourist Board

The tourism sector improved its performance during the financial year 2003/04 despite adverse global events that have afflicted the sector in the past particularly terrorism threats and the negative travel advisories issued by key tourist markets to Kenya. During the financial year under review, arrivals increased by 5.5% to 573,254 tourists from 543,634 tourist in the financial year 2002/03. During the period, earnings are estimated to have reached US dollar 376m from US dollar 288m in the financial year 2002/03.

The improvement was largely attributed to improved marketing of the country's potential particularly in non-traditional market sources such as China, Japan and India and diversification away from traditional beach and wildlife tourism to new circuits in the western and northern parts of the country. Arrivals picked up following an increase in capacity by international carriers noteably British Airways, KLM, Kenya Airways and Emirates into Kenya's international airports.

Growth prospects for the sector have been further enhanced following the recent reversal of the negative travel advisory by the UK government to its citizens and the down grading of the travel advisory by the US government. Similarly, with increased promotion of domestic and conference tourism and improved security surveillance and particularly in the airports and areas visited by tourists, tourism is bound to pick up significantly to be among the fastest growing sectors in the economy during the coming year into the medium term.

Nevertheless, the ability to quickly regain the country's past glory in the US, UK and other European markets are, however, considered key partly due to the high capita income of visitors from these sources relative to other markets and the fact that the American and European markets currently account for over 70% of total tourists to Kenya.

TABLE 5: TOURIST ARRIVALS BY REGION

REGION	2002	2003	Jan -Jun	Jan -Jun	% Jan-
Africa	84,925	126,860	57,389	64,892	13.1
America	48,065	50,805	23,575	30,655	30.0
Asia	40,508	52,661	23,102	29,105	26.0
Europe	312,754	310,114	146,660	154,987	5.7
Oceania	5,426	6,640	2,770	3,167	14.3
Others	4,073	234	217	6	-97.2
Total	**495,751**	**547,314**	**253,713**	**282,812**	**11.5**

Source: Kenya Tourist Board

USES OF AVAILABLE RESOURCES

Total resources available to the economy in 2003 comprised output produced by all sectors, net imports, net current transfers and non-factor income payments, that is, gross national disposable income which amounted to 105.07% of GDP in current prices from 103.99% of GDP in 2002.

Resources were either allocated to investment, savings or consumption. In real terms, gross fixed capital formation increased by 3.6% in 2003 after declining consistently for 8 years implying that the economy was on a recovery path.

In real terms, gross domestic product during the year, measured at 1982 prices, grew by 1.8% compared with 1.2% growth in 2002, implying an improvement in growth of real resources available for use in the domestic economy.

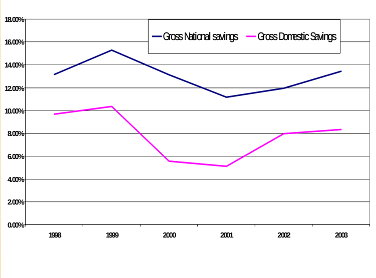
TABLE 6: USE OF RESOURCES (KSH MILLION)

Kenya - National Accounts						
Millions of Kenya Shillings	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**
Gross national disposable income	**718,218**	**780,144**	**856,342**	**932,182**	**1,001,065**	**1,147,025**
Net current transfers	34657	47,860.00	70,140.00	62,975.00	49,629.00	61,985.00
Gross national income	**683,561**	**732,284**	**786,202**	**869,207**	**951,436**	**1,085,040**
Net factor income payments (Y(f))	-10,467.89	-11,195	-10,140.70	-9,524	-11,250	-6,600
Gross domestic product	**694,029**	**743,479**	**796,343**	**878,731**	**962,686**	**1,091,640**
Total Consumption (C)	**626,817**	**666,343**	**751,923**	**833,939**	**886,159**	**1,000,630**
Government consumption - C(g)	113,568	125,943	139,159	168,731	184,337	195,467
Private consumption - C(p)	513,249	540,400	612,765	665,208	701,822	805,163
Gross domestic investment (I)	**120,089**	**120,103**	**122,510**	**128,361**	**128,856**	**141,155**
Gross fixed capital formation	113,879	112,961	116,369	123,079	124,313	136,567
Increase/Decrease in stocks	6,210	7,142	6,142	5,282	4,542	4,588
Exports of goods and nfs (X)	**171,895**	**189,265**	**211,433**	**234,176**	**250,429**	**271,785**
Imports of goods and nfs (M)	**-224,772**	**-232,232**	**-289,523**	**-317,745**	**-302,758**	**-321,929**
GDP deflator (1982=100)	678.7	716.9	769.7	839.0	908.7	1012.6
Real GDP	102,253	103,702	103,456	104,731	105,945	107,801
Real GDP growth (annual in %)		**1.42%**	**-0.24%**	**1.23%**	**1.16%**	**1.75%**
Gross National savings	91,401	113,800	104,419	98,242	114,906	146,396
Gross Domestic Savings	67,212	77,135	44,420	44,791	76,527	91,011
Total National Balance(S-I)	**-28,688**	**-6,302**	**-18,091**	**-30,118**	**-13,950**	**5,241**
CAB (X-M+Y(f)+TR(f))	**-28,688**	**-6,302**	**-18,091**	**-30,118**	**-13,950**	**5,241**
Kenya - National Accounts						
In shares of GDP	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**
Gross national disposable income	103.49%	104.93%	107.53%	106.08%	103.99%	105.07%
Net current transfers (TR(f))	4.99%	6.44%	8.81%	7.17%	5.16%	5.68%
Gross national income	98.49%	98.49%	98.73%	98.92%	98.83%	99.40%
Net factor income payments (Y(f))	-1.51%	-1.51%	-1.27%	-1.08%	-1.17%	-0.60%
Gross domestic product (GDP)						
Gross Domestic Product (expend)						
Total Consumption ©	90.32%	89.63%	94.42%	94.90%	92.05%	91.66%
Government consumption - C(g)	16.36%	16.94%	17.47%	19.20%	19.15%	17.91%
Private consumption - C(p)	73.95%	72.69%	76.95%	75.70%	72.90%	73.76%
Gross domestic investment (I)	17.30%	16.15%	15.38%	14.61%	13.39%	12.93%
Gross fixed capital formation	16.41%	15.19%	14.61%	14.01%	12.91%	12.51%
Increase/Decrease in stocks	0.89%	0.96%	0.77%	0.60%	0.47%	0.42%
Exports of goods and services (X)	24.77%	25.46%	26.55%	26.65%	26.01%	24.90%
Imports of Goods and services (M)	-32.39%	-31.24%	-36.36%	-36.16%	-31.45%	-29.49%
Gross National savings	13.17%	15.31%	13.11%	11.18%	11.94%	13.41%
Gross Domestic Savings	9.68%	10.37%	5.58%	5.10%	7.95%	8.34%

*** Adjusted from those in the Economic Survey**
Source: Economic Survey, 2003

However, in nominal terms, total gross domestic investment slowed down slightly to 12.93% of GDP in 2003 from 13.39% of GDP in 2002 as shown in Chart 5. This was the ninth consecutive year of continuous decline in total gross investment as a proportion of GDP and was both in gross fixed capital formation and changes in stocks, which fell to 12.51% and 0.42% of GDP respectively from 12.91% and 0.47% of GDP in 2002. The slowdown in total gross fixed capital formation in the year occured in the public sector investment, which accounted for 35.18% of total gross investment from 35.98% in 2002. Gross investment of the private sector, however improved to account for 64.82% of total gross fixed capital formation in 2003 from 64.02% in 2003.

CHART 5: CONSUMPTION AND INVESTMENT (% OF GDP)

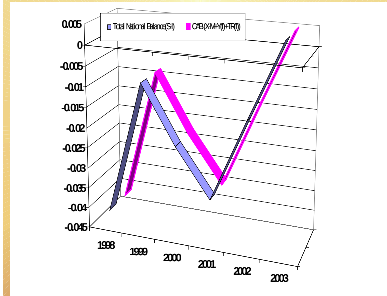


Source: Economic Survey, 2004

Gross national savings, that is, gross national disposable income less total consumption, increased to 13.40% of GDP in 2003 from 11.94% in 2002, while gross domestic savings, that is, gross domestic product less domestic consumption increased to 8.34% of GDP from 7.95% in the period.

Following the slow down in aggregate demand reflected in the narrowing of the trade balance, that is exports of goods and non factor services receipts less imports of goods and non factor services payments and increase in savings, the current account recorded a surplus of 0.5% of GDP from a deficit of 1.4% in 2002.

CHART 6: KENYA CAB AND S-I GAP (1998-2003)



Source: Central Bank of Kenya

The improvement in availability in economic resources in 2003 relative to 2002, led to a slowdown in aggregate demand reflected in the decline in total consumption in the economy to 91.66% of GDP from 92.05% of GDP in 2002 as shown in Table 6. The decline was in government consumption, which accounted for only 17.91% of GDP down from 19.15% of GDP in 2002. The decline in government consumption more than offset by an increase in private consumption of resources. A greater share of resources was utilised for private sector consumption relative to the government, which accounted for 73.76% of GDP from 72.90% of GDP in 2002.

The slowdown in government consumption largely reflected the slower than expected disbursement in external resources and a reduction in government borrowing from the domestic money market. The increase in private consumption, on the other hand, largely reflected increased availability of credit to the private sector. In particular, credit to the private sector expanded by 6.94% in 2003/04 compared with 4.82% in 2002/03.

The incremental capital output ratio (ICOR), that is, the change in capital stock required to generate one unit of output declined from 5.4 in 2002 to 3.7 in 2003, and as high as 28.0 in 2000, implying that additional capital resulted in higher output in the 2003 relative to 2000 and 2002. It was therefore possible to improve economic growth in the year through efficient use of resources. Thus, with the implementation of measures aimed at addressing the weaknesses in the economy, even with lower levels of investment, the economy could achieve higher level of economic growth. Therefore, improvements in economic efficiency and higher investment in excess of 20% of GDP, as envisaged, sustained over time, real economic growth is bound to accelerate even faster, to the tune of over 5% per annum leading to increased wealth creation that can address the twin problems of poverty and unemployment currently inflicting Kenyans.

TABLE 7: INCREMENTAL CAPITAL OUTPUT RATIO (ICOR)

	GDP	Total Capital (K)	Public	Private	Change in K - Stock	Change in output	ICOR
2000	103,456	280,180	126,041	154,139	6,864	- 246 -	**28.0**
2001	104,731	287,051	129,105	157,946	6,872	1,275	**5.4**
2000	105,945	293,635	132,010	161,625	6,584	1,214	**5.4**
2000	107,801	300,430	134,949	165,481	6,795	1,856	**3.7**

Source: Economic Survey, 2004 and CBK computations

Net Official Financing of Developing Countries

Net official financing to developing countries in 2003 was estimated at US dollar 28 billion, a drop of US dollar 7 billion from previous year, and just over half of the level of 2001 (Table 8). The sharp decline is due to reduced energy financing by the International Monetary Fund (IMF). Net bilateral lending remained negative, as bilateral donors continued to reduce their lending in favour of grants and as some developing countries made further repayments of loans to the Paris Club under past rescheduling agreements. Grants increased, reflecting donor efforts to increase development assistance in general.

Net lending from the World Bank fell from US dollar 4.1 billion in 2002 to US dollar negative 6.3 billion in 2003, largely due to repayments of outstanding IBRD loans. The repayments have been made possible by the steady rise in developing countries' reserves in recent years and the decline in interest rates.

TABLE 8: NET OFFICIAL DEVELOPMENT ASSISTANCE TO DEVELOPING COUNTRIES: 1997-2003

	US $ billions							
	1990	1997	1998	1999	2000	2001	2002	2003*
Total	**54.2**	**38.4**	**60.9**	**42.2**	**22.8**	**54.8**	**35.3**	**28.0**
Grants	27.7	25.3	26.7	28.5	28.7	27.9	31.2	34.3
Net Lending	26.5	13.2	34.2	13.7	-5.9	26.9	4.1	-6.3
Multilateral[b]	15.5	19.8	37.4	15.9	0.9	34.6	14.7	6.5
Concessional	6.7	7.6	7.4	7.0	5.6	7.3	7.5	6.4
Nonconcessional	8.8	12.3	30.0	8.8	-4.7	27.3	7.2	0.1
Bilateral	11.0	-6.6	-3.2	-2.2	-6.8	-7.7	-10.6	-12.8
Concessional	8.5	0.2	2.0	5.0	0.7	1.6	-1.8	-1.0
Nonconcessional	2.4	-6.9	-5.2	-7.2	-7.5	-9.3	-8.8	-11.8

* Estimate

b includes IMF

Source: Global Development Finance (2004) & Central Bank of Kenya

Net Debt Flows to Developing Countries

Net debt flows to developing countries increased from US dollar 7.3 billion in 2002 to US dollar 44.3 billion in 2003. This was mainly on account of net debt flows to developing countries with flows to Europe and Central Asia increasing from US dollar 24.9 billion in 2002 to US dollar 29.5 billion and those to Latin America and Caribbean increasing from a net outflow of US dollar 7.9 billion in 2002 to US dollar 19.5 billion in 2003. Net debt flows to Sub-Saharan Africa increased from a net outflow of US dollar 0.1 billion to US dollar 4.9 billion in 2003 with Kenya's net debt inflows increasing from a net outflow of US dollar 0.1 billion in 2002 to a net inflow of US dollar 0.3 billion in 2003 (Table 9).

TABLE 9: PRIVATE SECTOR DEBT & PORTFOLIO FLOW TO DEVELOPING COUNTRIES: 1999-2003 (US DOLLAR

	(US$ Billion)				
Year	**1999**	**2000**	**2001**	**2002**	**2003***
East Asia & Pacific	-12.2	-17.7	-8.1	-10.9	0.5
Europe & Central Asia	16.1	21.0	2.0	24.9	29.5
Latin America & Caribbean	12.1	-9.7	6.3	-7.9	19.5
South Asia	0.5	3.4	-0.7	0.4	-2.3
Middle East & North Africa	-1.8	-6.1	0.9	0.9	-7.8
Sub-Saharan Africa	**-1.0**	**-0.7**	**-1.8**	**-0.1**	**4.9**
Kenya	***0.2***	***0.3***	***0.3***	***-0.1***	***0.3***
Total Net Flows	**13.8**	**-9.8**	**-1.2**	**7.3**	**44.3**

*** Estimate**

Source: Global Development Finance (2004) & Economic Survey 2004

Net Foreign Direct Investment (FDI) Inflows to Developing Countries

Foreign Direct Investment (FDI) to developing countries for the second consecutive year declined to US dollar 135.2 billion in the year 2003 from US dollar 175.0 billion in 2001. Geographically, the decline was mainly in the Latin America &

the Caribbean as well as the Middle East and North Africa. Direct investors reduced their FDI exposure in developing countries by calling back inter-company loans and increasing repatriation of their earnings. In Sub-Saharan Africa, however, FDI remained resilient though FDI inflows to Kenya remaining low at US dollar 0.1 billion in 2003 (Table 10).

TABLE 10: NET INWARD FDI FLOWS TO DEVELOPING COUNTRIES: 1999-2003

Year	1999	2000	2001	2002	2003*
East Asia & Pacific	2.30	4.80	1.00	3.50	4.80
Europe & Central Asia	2.00	1.20	0.30	-0.40	0.70
Latin America	-3.60	-0.50	2.30	1.50	1.40
South Asia	2.40	2.80	1.90	1.00	7.00
Middle East & North Africa	0.60	0.20	-0.10	-0.30	0.00
Sub-Saharan Africa	9.00	4.10	-0.10	-0.40	0.50
Kenya	**-0.01**	**-0.01**	**0.00**	**0.00**	**-0.04**
Total net Flows	12.60	12.60	4.40	4.90	14.30

* Estimate

Source: Global Development Finance (2004) & Economic Survey 2004

Net Portfolio Investment Inflows to Developing Countries

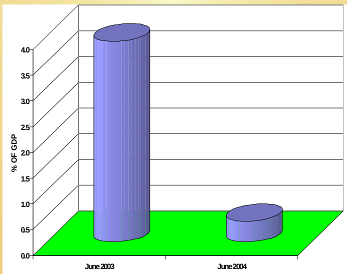
Net Portfolio equity flows to developing countries rose sharply in 2003 to an estimated US dollar 14.3 billion from US dollar 4.90 billion in 2002 (Table 10). This recovery was mainly in East Asia and pacific, and South Asia regions and was attributed to the rise in stock prices which rose by more than 50% in 2003, supported by low interest rates, stable exchange rates, and the general recovery of their economies after the 1997-1998 Asia financial crisis.

Portfolio investment inflows in Kenya, however, declined in 2003 to an outflow of US dollar 0.04 billion despite increased flows to the Sub-Saharan region.

FINANCING OF THE GOVERNMENT

Government budgetary operations improved during the fiscal year 2003/04 from the fiscal year 2002/03. This was reflected by a much smaller deficit, both on commitment and cash basis compared with the previous fiscal year. As shown in Table 11 and Chart 7, the budget deficit on a commitment basis decreased significantly to 0.4% of GDP in the fiscal year 2003/04 from 3.9% in the fiscal year 2002/03. On a cash basis, the fiscal operations similarly resulted in a much smaller budget deficit of 0.3% of GDP, compared with 3.6% of GDP in the fiscal year 2002/03.

CHART 7: BUDGET DEFICIT ON A COMMITMENT BASIS



Source: Central Bank of Kenya and Treasury

The good performance was attributed to improved tax administration reflected in higher tax revenue collection. The Government also restrained increases in expenditure and was able to mobilize more external grants than in the previous fiscal year. Non-tax revenue, however, fell short of the budget target for the fiscal year, as did inflows of external grants. The shortfalls were, however, more than offset by the increase in tax revenue, which also surpassed the increase in Government expenditure.

TABLE 11: BUDGET OUTTURN (KSH BN)

	FY 2002/03 Actual	FY 2003/04 Actual*	Target	Over(+)/ Below (-)
1. TOTAL REVENUE & GRANTS	**225.7**	**264.6**	**264.2**	**0.4**
Revenue	210.8	248.8	239.2	9.6
Tax Revenue	180.7	205.5	189.9	15.7
Non Tax Revenue	13.6	24.9	29.4	-4.5
Appropriations-in-Aid	16.5	18.3	19.9	-1.6
External Grants	14.9	15.8	25.1	-9.3
2. TOTAL EXPENDITURE AND NET LENDING	**264.1**	**269.1**	**299.3**	**-30.2**
Recurrent Expenditure	220.6	233.2	244.7	-11.5
Development Expenditure	43.5	35.9	54.6	-18.7
3. DEFICIT ON A COMMITMENT BASIS (1-2)	**-38.5**	**-4.6**	**-35.1**	**30.5**
	(-3.9)	(-0.4)	(-3.0)	
4. ADJUSTMENT TO CASH BASIS	**2.7**	**1.5**	**-1.5**	**3.0**
5. DEFICIT ON A CASH BASIS	**-35.8**	**-3.1**	**-36.6**	**33.5**
	(-3.6)	(-0.3)	(-3.2)	
6. DISCREPANCY: Expenditure (+) / Revenue (-)	**-1.1**	**-3.0**	**0.0**	
7. FINANCING	**34.8**	**0.1**	**36.6**	**-36.5**
Domestic (Net)	46.9	9.0	19.8	-10.8
External (Net)	-12.1	-8.9	-27.9	19.0
Capital Receipts (privatisation)	0.0	0.0	0.0	0.0
Financing gap	0.0	0.0	44.7	-44.7

* Provisional

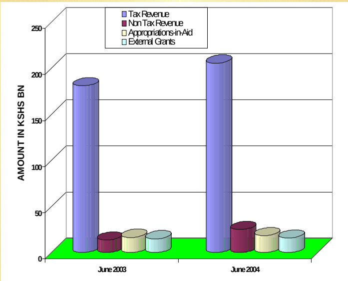
** Figures in parentheses are deficit to GDP Ratio (%)

Sources: Central Bank of Kenya and Treasury

Revenue and Grants

As a consequence of the improved tax revenue collection during the fiscal year and improved disbursements of external grants, total Government revenue and grants increased to Ksh 264.6bn in the fiscal year 2003/04 from Ksh 225.7bn in the fiscal year of 2002/03 (Chart 8). The single largest contributor to this increase was tax revenue, which rose by 13.7% or Ksh 24.8bn on account of improvements of tax administration, followed by non-tax revenue contributing Ksh 11.3bn, with external grants accounting for Ksh 0.9bn and appropriations-in-aid (AIA) Ksh 1.9bn. As mentioned above the increased inflow of external grants was an outcome of the resumption of IMF and World Bank programme support, while the increase in tax collection was a result of improved administration resulting in increased compliance.

CHART 8: COMPOSITION OF REVENUE



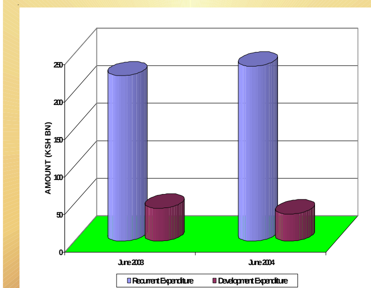
Source: Central Bank of Kenya and Treasury

In spite of improved tax collection, the share of tax revenue decreased to 77.7% of total receipts in the fiscal year 2003/04 from 80.1% in the previous fiscal year, a phenomenon that was attributed to increase in non-tax revenue. Tax revenue collection during the year was Ksh 15.7bn above the budget target while the non-tax revenue during the year was Ksh 4.5bn below the budget target, a phenomenon attributed to failure to realise the expected receipts from licence fees in the communications sector.

Expenditure and Net Lending

Total Government expenditure and net lending during the fiscal year 2003/04 increased to Ksh 269.1bn from Ksh 264.1bn in the previous fiscal year (Chart 9). The increase occurred only in the recurrent expenditure, which rose by Ksh 12.6bn, as development expenditure decreased by Ksh 7.6bn from the level recorded in the fiscal year 2002/03. The increase in recurrent expenditure was due to an increase in salaries and wages following adjustment of emoluments to various cadres of central Government employees, including teachers and the uniformed forces. A substantial increase was also reflected in other recurrent expenditure.

CHART 9: COMPOSITION OF EXPENDITURE



Source: Central Bank of Kenya and Treasury

The share of recurrent expenditure in total expenditure amounted to 86.7% in fiscal year 2003/04 compared with 83.5% in fiscal year in 2002/03, while development expenditure accounted for 13.3% of total expenditure in the fiscal year 2003/04 down from 16.5% in the fiscal year 2002/03. Overall, the total expenditure amounted to 20.1% of GDP in the fiscal year 2003/04 compared with 22.4% of GDP in the fiscal year 2002/03. The lower ratio was due to a faster increase in nominal GDP than the increase in expenditure.

Financing

The Government fiscal operations in the fiscal year 2003/04 resulted in Ksh 16.6bn financing requirement , a much lower figure than Ksh 54.9bn in fiscal year 2003/04. The total financing requirement during the year 2003/04 comprised Ksh 8.9bn to finance net repayments of external debt, Ksh 3.2bn to reduce Government debt with non-bank institutions, Ksh 0.1bn to finance the budget deficit, and Ksh 4.5bn to build Government deposits at the Central Bank. Of the Ksh 16.6bn financing requirement, the Government borrowed Ksh 10.9bn from commercial banks by issuing Treasury bonds and Ksh 5.7bn overdraft from Central Bank.

Prospects For 2004/05

While year 2004/05 Budget envisaged a substantial improvement in revenue collection accompanied by moderate increases in both development and recurrent expenditures and an overall deficit of 5.2% of GDP with net domestic financing limited to fiscally sustainable levels. Unless the implications of the nationwide drought experienced subsequent to the preparation of the Budget, in expenditure is offset against other budget line item, net domestic financing is likely to exceed the budget target.

Kenya's public debt increased to Ksh 709.7bn at the end of June 2004 from Ksh 689.0bn in June 2003 (Table 12). Of the outstanding public debt, Ksh 306.2bn or 43.2% was domestic while Ksh 403.4bn or 56.8% was external debt. In spite of the increase in the debt, the share of domestic debt in GDP decreased to 26.4% in June 2004 from 29.4% in June 2003, while that of external debt declined to 34.8% in June 2004 from 40.6% in June 2003. Overall, the ratio of total public debt to GDP decreased to 61.2% in June 2004, from 70.0% in June 2003. The lower ratio in relation to GDP in spite of an increase in both the external and domestic debt is explained by a higher forecast for nominal GDP for the fiscal year 2003/04.

TABLE 12: PUBLIC DEBT (KSH BN)

	June 2003		June 2004*	
	shs bn	%	shs bn	%
DOMESTIC DEBT				
Securitised debt	**268.4**	**92.8**	**289.6**	**94.6**
Treasury Bills	105.7	**36.5**	99.8	32.6
of which repo t.bills	27.0	**9.3**	36.9	12.0
Treasury Bonds	161.5	**55.8**	188.6	61.6
Government Stocks	1.1	**0.4**	1.1	0.4
Non Securitised debt	**21.0**	**7.2**	**16.7**	**5.4**
Overdraft/Advances	11.1	**3.8**	16.7	5.4
Non-interest bearing debt	9.9	3.4	0.0	0.0
TOTAL DOMESTIC DEBT	**289.4**	**100.0**	**306.2**	**100.0**
EXTERNAL DEBT				
Bilateral	142.6	35.7	153.9	38.1
Multilateral	226.4	56.7	236.9	58.7
Comm. Banks	3.6	0.9	2.3	0.6
Export Credit	27.0	6.8	10.4	2.6
TOTAL EXTERNAL DEBT	**399.6**	**100.0**	**403.4**	**100.0**
TOTAL PUBLIC DEBT	**689.0**		**709.7**	
(as a % of GDP)		70.0		61.2

* Provisional

Sources: Central Bank of Kenya and Treasury

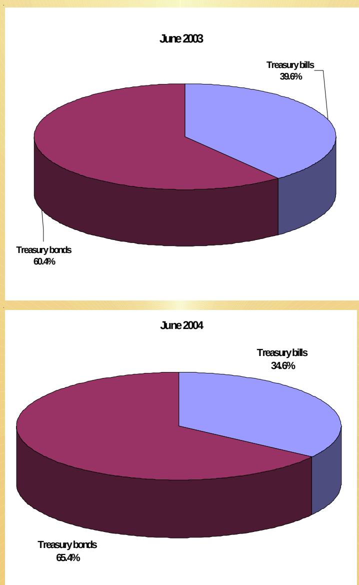
Public Domestic Debt

Public gross domestic debt increased to Ksh 306.2bn in June 2004 from Ksh 289.4bn in June 2003, reflecting Government borrowing to service external debt and to build up Government deposits at the Central Bank. The increase in the debt was incurred through the sale of Treasury bonds to commercial banks and the non-banks; and through utilisation of the overdraft facility at the Central Bank of Kenya.

As in the previous year, the Government debt management objective during the fiscal year 2003/04 was to maintain stability in Treasury securities interest rates, lengthen the average maturity of the domestic debt through sustained efforts to restructure the debt away from the short-dated Treasury bills to longer-dated Treasury bonds and develop a yield curve to provide a basis for pricing corporate bonds.

Following the successful introduction by the Government of long tenor Treasury bonds (i.e. 7, 8, 9 and 10 year) since March 2003, the average maturity of domestic debt lengthened to 2 years and 2 months at the end of June 2004 from 1 year and 7 months in June 2003. Consequently, the stock of Treasury bills (including Repos) declined to Ksh 99.8bn in June 2004 from Ksh 105.7bn in June 2003, while the stock of Treasury bonds increased to Ksh 188.6bn in June 2004 from Ksh 161.5bn in June 2003 (Table 12 and Table 13), reflecting the continued success in domestic debt restructuring. The composition of Government securitized domestic debt is shown in Chart 10.

CHART 10: COMPOSITION OF GOVERNMENT SECURITIES



Source: Central Bank of Kenya and Treasury

Following the announcement by the Minister for Finance in the June 2003 budget that the use of Treasury bills in fiscal operations will be restricted to cash flow management, this subsequently reflected in reduced volumes of Treasury bills issued at the weekly auctions. The downward trend in the share of Treasury bills in securitized Government debt continued through to June 2004. The share of Treasury bonds of 5 years tenor and above in the total outstanding bonds increased to 42.2% at the end of June 2004 from 25.7% at the end of June 2003, while that of the 10-year bonds increased from 1.7% of the outstanding bonds in June 2003 to 4.6% in June 2004. The challenge for the Government is to sustain this achievement and extend the maturity profile further.

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

Holders		Jun-03		Jun-04	
		Ksh	%	Ksh	%
Banking Institutions		63.2	59.8	79.0	79.1
	Central Bank	27.0	25.5	36.9	37.0
	Comm. Banks	35.2	33.3	41.0	41.1
	NBFIs	1.0	0.9	1.1	1.1
Insurance Companies		5.9	5.5	4.9	4.9
Parastatals		6.2	5.8	4.9	4.9
of which NSSF		1.8	1.7	0.9	0.9
Building Societies		0.2	0.2	0.0	0.0
Others		30.2	28.6	11.0	11.1
Total		**105.7**	**100.0**	**99.8**	**100.0**

Source: Central Bank of Kenya

Domestic Debt Service

As a result of the low interest rates on Government securities during the 2003/04 fiscal year, interest payments on domestic debt decreased to Ksh 23.3bn or 8.8% of total revenue from Ksh 27.6bn or 12.2% of revenue in the 2002/03 fiscal year. The lower interest rates on Treasury securities in the 2003/04 fiscal year resulted from excess liquidity in the interbank market and reduced volume of new issues of Treasury bills at the weekly auctions. The decline was further facilitated by the resumption of donor budget support in November 2003, which helped reduce the level of Government domestic borrowing.

TABLE 14: OUTSTANDING STOCK OF TREASURY BONDS BY HOLDER (KSH BN)

Holders		Jun-03		Jun-04	
		Ksh	%	Ksh	%
Banking Institutions		76.4	47.3	86.5	45.9
	Central Bank	0.0	0.0	0.0	0.0
	Comm. Banks	74.5	46.1	84.4	44.7
	NBFIs	2.0	1.2	2.1	1.1
Insurance Companies		20.6	12.8	26.1	13.8
Parastatals		7.2	4.5	16.6	8.8
of which NSSF		0.8	0.5	2.8	1.5
Building Societies		1.9	1.2	2.7	1.4
Others		55.4	34.3	56.7	30.1
Total		**161.5**	**100.0**	**188.6**	**100.0**

Source: Central Bank of Kenya

Public External Debt

The stock of external debt increased to Ksh 403.4bn in June 2004 from Ksh 399.6bn in June 2003 (Table 15). The increase in external debt was due to Ksh 11.6bn disbursement of budget support by Kenya's development partners of SDR 25mn from the International Monetary Fund for balance of payments support, rescheduling of Ksh 4.2bn bilateral debt both principal and interest- owed to Paris club creditors and depreciation of the Kenya shilling against major world currencies (especially the US dollar and Euro). Of the outstanding stock at the end of June 2004, 58.7% was debt owed to multilateral creditors and 38.1% to bilateral creditors as shown in Table 15 and Chart 11.

The estimated share of external debt held in US dollar increased from 54.5% in June 2003 to 55.8% in June 2004, while that held in Yen increased from 19.9% to 20.4%. The share of external debt held in Euros and SDRs also increased from 11.3%

and 1.5% to 13.0% and 2.0%, respectively. On the other hand, the share of external debt held in Sterling pounds decreased from 0.7% to 0.6%.

TABLE 15: DISTRIBUTION OF EXTERNAL PUBLIC DEBT

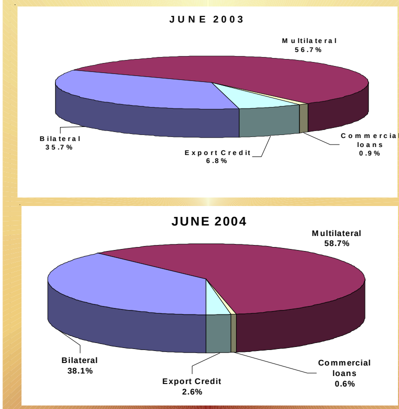
	Jun-01		Jun-02		Jun-03		Jun-04*	
	Ksh bn	%	Ksh bn	%	Ksh bn	%	Ksh bn	%
Bilateral	132.3	33.6	130.0	34.4	142.6	35.7	153.9	38.1
Multilateral	228.5	58.0	222.4	58.9	226.4	56.7	236.9	58.7
Commercial loans	29.4	7.5	24.0	6.4	3.6	0.9	2.3	0.6
Export Credit	3.8	1.0	1.3	0.3	27.0	6.8	10.4	2.6
Total	**394.0**	**100.0**	**377.8**	**100.0**	**399.6**	**100.0**	**403.4**	**100.0**

* Provisional

Sources: Central Bank of Kenya and Treasury

External Debt Service

CHART 11: EXTERNAL PUBLIC DEBT



Sources: Central Bank of Kenya and Treasury

Government external debt service in the fiscal year 2003/04 decreased to Ksh 28.3bn from Ksh 30.9bn in the previous fiscal year, reflecting the rescheduling of both principal and interest on external debt in December 2003. The external debt service absorbed 10.7% of total revenue compared with 13.7% in the previous fiscal year. The external repayments comprised Ksh 20.5bn in central Government debt; Ksh 0.7bn in Government guaranteed debt; and Ksh 1.3bn in Central Bank repayments to International Monetary Fund. In addition, the Government paid interest of Ksh 5.4bn on central Government debt, Ksh 0.2bn on public guaranteed debt and Ksh 0.1bn on central Bank debt with the International Monetary Fund.

Prospects for 2004/05

The forecasts for fiscal year 2004/05 indicate less pressure on external debt service following the rescheduling of debt owed to Paris Club creditors. It is estimated that the central Government debt service will amount to Ksh 22.5 bn, which is the net amount after offsetting Ksh 10.36 bn rescheduled debt from Ksh 32.9 bn comprising Ksh 25.2 bn in principal and Ksh 7.7 bn in interest that would have been paid during the year. In line with budgetary provisions for a net domestic borrowing of Ksh 22 bn in FY 2004/05 the domestic debt stock is expected to increase by the same amount during the fiscal year provided the impact of the drought experienced during the year, on the budget, does not result in increased domestic borrowing.

Overview

Following improved economic performance, the banking sector grew strongly in the financial year 2003/2004. Profitability, deposits and capital, all grew significantly and a higher rate of compliance with statutory and prudential regulations was achieved. The improvement in the performance of the sector was also manifested in the reduced level of non-performing loans.

Composition of the Banking Sector

The banking sector comprised 51 financial institutions with 43 commercial banks, 2 non-bank financial institutions (NBFIs), 2 mortgage finance companies and 4 building societies. No new institutions were set up during the year and none was placed under CBK statutory management or under liquidation during the financial year. However, Devna Finance Ltd had its license revoked for failure to meet capital adequacy requirements. Following the lifting of the moratorium on the licensing of foreign exchange bureaus in June 2003, foreign exchange bureaus increased to 75 in June 2004 from 48 in June 2003. Ten other foreign exchange bureaus have been licensed and are expected to begin operations during the financial year 2004/2005.

Structure of the Balance Sheet

At the end of June 2004, the balance sheet of the banking sector expanded with total assets increasing by 14% to Ksh 546.7 bn as at the end of June 2004 from Ksh 477.7 bn in June 2003 (Table 16). The assets mainly comprised of 40% in loans and advances, 24% in investment in government securities, 8% in foreign assets and 7% in cash and balances with the Central Bank. Loans and advances rose by 19% mainly due to reduced lending rates and increased lending by commercial banks of particularly unsecured personal loans, following aggressive marketing campaigns.

Despite the decline in the yields on government securities, banks continued to invest in Government Treasury bills and Treasury bonds partly due to relatively less risks of default associated with Government papers.

TABLE 16: BALANCE SHEET

	June 2004	June 2003	% Change
Assets			
Cash	8,715	7,117	22
Balances from CBK	27,786	30,070	-8
Placements	14,859	8,167	82
Govt. securities	131,254	117,177	12
Investments	4,800	6,549	-27
Loans & advances (Net)	218,424	183,172	19
Foreign Assets	44,013	39,698	11
Other assets	96,831	85,768	13
Total Assets	**546,682**	**477,718**	**14**
Liabilities and shareholders funds			
Deposits	445,177	381,757	17
Foreign Liabilities	5,180	4,763	9
Other liabilities	33,901	31,806	7
Capital & Reserves	62,424	59,392	5
Total Liabilities and shareholders funds	**546,682**	**477,718**	14

Source: Central Bank of Kenya

Non-performing loans (NPLs) were estimated at Ksh 72.6 bn or 24.5% of all loans, at the end of June 2004, compared with Ksh 75.4 bn or 29.4% of total loans at the end of June 2003. The relative decline in NPLs, was attributed to the repayment and write offs of previously non-performing advances and increase in new lending. With provisions amounting to Ksh 35.7bn and securities worth Ksh 32.9bn, net exposure of the sector stood at Ksh 3.8bn or 5.2% of total NPLs as at 30th June 2004 compared with Ksh 7.7 bn or 10.2 % as at 30th June 2003.

Deposit Liabilities

Deposit liabilities increased by 17% to Ksh 382.5 bn as at the end of June 2004 from Ksh 326 bn in June 2003. This increase was attributed to external inflows from development partners mainly to support the free primary school programmes and other government development activities and enhanced deposits associated with increased lending to private sector. As shown in Table 17, deposits were evenly spread across the various categories and comprised 41.6% demand deposits, 31.4% time deposits and 27% savings deposits.

TABLE 17: COMPOSITION OF DEPOSITS (KSH M)

Banks	2004 June	2003 June	% change
TYPE OF DEPOSITS			
Demand deposits	183,420	134,923	36
Kenya shillings	141,120	102,439	38
Foreign Currency	42,300	32,484	30
Time Deposits	113,105	103,043	11
Kenya shillings	92,053	86,358	7
Foreign Currency	21,052	15,685	34
Saving Deposits	85,963	87,663	-2
Kenya shillings	85,662	87,247	-2
Foreign Currency	301	416	-28
Total	**382,488**	**324,629**	**18**

Note: Figures exclude accrued interest in deposits

Source: Central Bank of Kenya

Capital and Reserves

The banking industry remained well capitalised during the year to June 2004 with total capital to total risk weighted assets ratio of 17.4% compared with 17.2% in June 2003 and was above the 12% statutory minimum requirement. The increase in capitalisation over the period was attributed to fresh capital injections and retention of profit made in year 2003 by a few banks. In the twelve -month period to June 2004, capital and reserves of the banking system increased by 9.3%, from Kshs 58.6 bn to Kshs 64.0bn.

Profitability

During the six-months period ending June 2004, the pre-tax profit of the banking sector increased by 7.0% to Ksh 7.1bn from Ksh 6.6bn over a similar period in 2003. The improved profitability was mainly attributed to 46% reduction in interest on deposits.

TABLE 18: BANKING INDUSTRY PROFITS (KS M)

	Jun-04	Jun-03	%Change
Total income	**29,816**	**30,939**	**-4**
Expenses before provisions	19,477	21,102	-8
Profit before provisions	10,339	9,837	5
Provisions for bad debts	3,263	3,217	1
Profit before tax	7,076	6,620	7

Source: Central Bank of Kenya

Progress on Compliance with the Requirements of the Banking Act and Prudential Regulations

Central Bank's enforcement of compliance requirements particularly through introduction of penalties resulted in reduced incidences of non-compliance with the frequency of non-compliance reducing from 38 in June 2003 to 15 in June 2004. Similarly, the number of institutions that were non-compliant declined from 14 in June 2003 to 10 as at the end of June 2004. The Central Bank will continue to monitor the level of compliance in the banking sector with a view to ensuring that institutions are consistently compliant with the requirements of the Banking Act and Central Bank prudential regulations.

Outlook of the Banking Industry

The banking sector is expected to improve further in 2004/2005 as the economy recovers and banking institutions continue to comply with the requirements of the Banking Act and Central Bank prudential regulations. The Central Bank will also continue to publish bank charges thereby increasing customer awareness of products and services available and their associated costs and consequently enhance competition in the sector as customers opt for the most competitive charges.

MONEY SUPPLY

The Central Bank continued to pursue prudent monetary policy in the twelve months to June 2004. Monetary policy was formulated within the context of economic recovery from stagnation in 2002 and 2003, under the poverty reduction and growth facility (PRGF) programme. As envisaged in the Budget statement for the year to June 2004, the monetary programme incorporated recovery in GDP growth from 1.1% in 2002 to 1.9% in 2003 and 3.5% in 2004; and 2.9% in the fiscal year 2003/04. Inflation was targeted at 3.5%.

TABLE 19: MONEY SUPPLY AND ITS SOURCES (KSH BN)

	Jun 2001/02 Act	Jun 2002/03 Act	Jun 2003/04 Act	Jun-04 Targets
1.0 Liability				
Money Supply				
Money supply, M2 1/	318.5	350.0	388.6	
Money supply, M3 2/	331.6	362.6	407.3	394.7
Money supply, M3X 3/	378.3	419.4	473.4	449.3
Money supply, M3XT 4/	483.9	542.8	592.9	587.7
2.0 Assets (2.1+2.2)	378.3	419.4	473.4	449.3
2.1 Net foreign assets 5 /	97.0	104.4	119.7	117.6
Central Bank	77.8	81.5	86.7	95.6
Banking Institutions	19.2	22.8	33.1	22.0
2.2 Net domestic assets (2.21+2.22)	281.2	315.1	353.7	331.7
2.21 Domestic Credit (2.210+2.211)	342.0	383.5	430.1	400.5
2.210 Government (net)	94.7	124.2	136.7	128.6
2.211 Private sector and other public sector	247.2	259.3	293.4	271.9
2.22 Other assets net	-60.7	-68.5	-76.5	-68.8
Memorandum Item:				
Reserve Money 6/	76.9	85.5	89.9	80.9

1/ Money Supply, M2, is money supplied by CBK and commercial banks. It comprises currency outside banking institutions, other non-banking institutions' deposits with the CBK, demand, savings & time deposits as well as certificates of deposits held by the private sector & parastatals with commercial banks. It excludes deposit placement of the central and local Government.

2/ Broad money, M3, comprises M2 and call, 7-days, savings & time deposits as well as certificates of deposits held by the private sector & parastatals with NBFIs. M3 excludes deposits of both the central & local Government with NBFIs, and all cross deposits of both commercial banks and NBFIs.

3/ Broad money, M3X, comprises M3 plus foreign currency deposits held by residents with banking institutions.

4/ Broad money, M3XT, includes M3X & outstanding Government Treasury securities with the non-banking public.

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

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

Source: Central Bank of Kenya

Consistent with the inflation and growth objectives, the Central Bank used a reserve money framework to implement monetary policy. Within the framework, the Bank lowered the cash ratio to 6% from 10% effective 1st July 2003 to allow more credit extension in support of the expected recovery. It was envisaged that the released deposits previously sterilized under repo sales would encourage banks lower interest rates thereby boosting demand for bank credit by the private sector. However, commercial banks did not immediately utilize the additional resources in extending credit to the private sector but accumulated them in the clearing accounts. In line with this development, the Bank adjusted its monetary programme to incorporate excess reserves held by commercial banks. The programme review incorporated a reduction of economic growth to 1.9% in 2003 and 2.6% in 2004 following adverse travel advisories and delays in securing IMF programme support as initially anticipated.

With the resumption of IMF support on 21st November 2003 under the Poverty Reduction and Growth Facility (PRGF) 2003-2008, the Bank adopted the PRGF's monetary programme for the year to June 2004. By not providing for commercial bank excess reserves, the PRGF programme adopted a tighter outlook for money supply and reserve money. The expansion in money supply, M3X, was limited to 6.4% in 2003 compared with 8.3% under the Central Bank's monetary programme as revised in August 2003. The inflation target was retained at 3.5%. Under the programme, the Bank relied on Open Market Operations (OMO), cash ratio requirement and rediscount facilities to influence money supply and contain inflation.

Implementation of the monetary programme involved day- to- day monitoring of developments in reserve money components with a view to ensure programme targets are achieved. In this respect, the Bank closely monitored and implemented financial quantitative performance criteria set on both the maximum average net domestic assets (NDA) and minimum end of the month net foreign assets (NFA) of the Central Bank. In the process, the Bank intervened in the domestic money market largely through the OMO to influence the NDA path.

Money Supply

Broad money supply (M3X), increased rapidly by 12.9% in the year to June 2004 compared with 10.9% annual increase to June 2003 and 7.1% PRGF monetary programme target for the June quarter as shown in Table 20. The expansion in the M3X, comprised of 12.4% increase in resident private sector deposits with banks and non bank financial institutions (NBFIs) and stock of Kenya currency held by non-bank public, or M3, compared with 9.3% growth over a similar period in 2003 and 8.9% target growth in the year to June 2004. The nature of M3 growth implied increased demand for narrow money, M1, which closely reflects the demand for money to cover increased transactions. This reflected the pickup in economic growth. At the same time, the growth of residents' foreign currency denominated accounts decelerated to 16.4% in the year to June 2004 from 21.8% increase over a corresponding period in 2003.

TABLE 20: PERFORMANCE OF MONETARY AGGREGATES JULY 2002 - JUNE 2003 (Ksh M)

	RM		M3		M3X		M3XT	
	Act.	Targ.	Act.	Targ.	Act.	Targ.	Act.	Targ.
2003								
Jun	11.2	6.6	9.3	7.0	10.9	7.0	12.1	11.8
Jul	-2.9	-4.2	11.0	8.8	11.7	7.5	12.9	12.8
Aug	9.8	12.1	9.3	8.5	8.9	8.2	10.0	8.8
Sep	4.1	10.0	10.3	9.5	9.6	9.1	9.6	9.5
Oct	15.8	11.5	12.2	9.6	12.5	8.9	11.1	10.3
Nov	10.4	10.4	11.9	9.3	12.0	8.1	9.9	9.4
Dec	-1.1	-5.5	12.7	7.3	11.7	6.4	9.3	8.1
2004								
Jan	0.8	-4.1	12.4	8.7	11.4	7.3	8.9	8.7
Feb	3.5	-4.1	11.4	8.7	11.9	7.3	9.7	8.7
Mar	3.0	-4.1	11.9	8.7	12.7	7.3	10.0	8.7
Apr	7.5	-5.4	13.9	8.9	13.6	7.1	9.8	8.3
May	7.2	-5.4	13.8	8.9	13.5	7.1	9.2	8.3
Jun	4.1	-5.4	12.3	8.9	12.9	7.1	9.3	8.3

Source: Central Bank of Kenya

The expansion in M3X resulted from 14.7% increase in net foreign assets (NFA) and 12.3% increase in net domestic assets (NDA). The NDA expansion, which accounted for 72% of the overall expansion in M3X, reflected 12.1% increase in net domestic credit to the government and the private sector. On the other hand, the NFA expansion comprised 44.6% build up in the holdings of commercial banks and 6.4% increase in the holdings of the Central Bank. The increase in commercial banks' NFA resulted from improved export earnings. Meanwhile, the modest increase in foreign exchange reserves of the Central Bank reflected interbank purchases and donor budgetary support.

At 11.7% in July 2004, M3X expansion was below the 12.2% target for the September quarter under the PRGF monetary programme. The moderation in money supply, M3X, growth since May 2004 and robust growth in credit to the private sector is a positive indication that excess liquidity was being extended to real sector activities, and therefore unlikely to generate inflationary pressures.

Domestic Credit Developments

Domestic credit expanded by 12.1% in the year to June 2004 compared with a 4.5% target growth for the June Quarter under the PRGF programme and 12.2% increase in the year to June 2002. The credit expansion amounting to Ksh 46.6bn increase over the review period, was channelled as follows: Ksh 12.5bn or 10.1% to the government, and Ksh 34.1bn or 13.1% to the private and other public sector. At 10.1%, Government domestic borrowing was consistent with 12% limit set in the Budget statement for the FY 2003/04. On the other hand, credit to the private sector expanded considerably by 12.3%, well above the 4.8% targeted expansion over the year to June 2004 as shown in Table 21.

TABLE 21: CREDIT TO PRIVATE AND OTHER PUBLIC SECTORS (KSH BN)

	2003 Jun		2004 Jun		Annual Change		Jun '03 - Jun '04 % dist. of ann. change in credit to private sector
	Ksh bn	Share (%)	Ksh bn	Share (%)	Ksh bn	(%)	
1. Credit to other public sector	**6.3**	**2.4**	**9.2**	**3.1**	**2.9**	**46.7**	
Local government	-0.2	-0.1	-1.4	-0.5	-1.2	641.0	
Parastatals	6.5	2.5	10.6	3.6	4.1	63.6	
2. Credit to private sector	**253.0**	**97.6**	**284.2**	**96.9**	**31.2**	**12.3**	**100.0**
Agriculture	25.1	9.7	26.7	9.1	1.6	6.3	5.0
Manufacturing	50.7	19.6	53.2	18.1	2.4	4.8	7.8
Trade	41.5	16.0	49.5	16.9	7.9	19.1	25.5
Building and construction	19.7	7.6	19.4	6.6	-0.3	-1.3	-0.8
Transport & communications	16.7	6.5	19.2	6.6	2.5	15.0	8.0
Finance & insurance	22.2	8.6	23.4	8.0	1.2	5.4	3.8
Real estate	21.1	8.1	19.9	6.8	-1.2	-5.7	-3.9
Mining and quarrying	2.3	0.9	2.0	0.7	-0.2	-10.8	-0.8
Private households	20.7	8.0	28.9	9.9	8.2	39.8	26.4
Consumer durables	5.8	2.2	6.7	2.3	0.9	15.6	2.9
Business services	23.1	8.9	21.8	7.4	-1.3	-5.6	-4.1
Other activities	4.1	1.6	13.5	4.6	9.4	228.7	30.2
3. TOTAL (1+2) *	**259.3**	**100.0**	**293.4**	**100.0**	**34.1**	**13.2**	

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

Source: Central Bank of Kenya

On an annual basis, bank credit to the private sector initially stagnated in August 2003, before picking up gradually through December 2003, and rapidly thereafter to June 2004 as seen in Chart 12. Credit expansion to the private sector partly reflected the pick up in real GDP growth. In addition, aggressive marketing of credit facilities by commercial banks, which coincided with the general decline in interest rates as a consequence of the reduction in the mandatory cash ratio requirement in July 2003, contributed to private sector credit growth. This was also a positive indication that excess liquidity that manifested in the banking system in the second half of 2003 was being extended to private sector activities. Further, in the year to July 2004, credit to the private sector increased by 14.2% exceeding the 13.5% target envisaged in the 2004/05 budget that would have been adequate to support real GDP growth of 3.0%.

CHART 12: ANNUAL PERCENTAGE CHANGES IN PRIVATE SECTOR CREDIT

Source: Central Bank of Kenya

The credit expansion in the year to June 2004, was largely reflected in private households and can tentatively be seen as an indication that consumption was picking up. Substantial expansion was also achieved in agriculture, domestic trade, manufacturing, and, transport and communication.

Net lending to the private sector increased by Ksh 31.2bn in the year to June 2004 largely on account of Ksh 34.2bn expansion channelled to other activities (Ksh 9.4bn), private households (Ksh 8.2bn), trade (Ksh 7.9bn), transport and communication (Ksh 2.5bn), manufacturing (Ksh 2.4bn), agriculture (Ksh 1.5bn), finance and insurance (Ksh 1.2bn) and consumer durables (Ksh 0.9bn). On the other hand, building and construction, mining and quarrying, real estate and business services repaid loans amounting to Ksh 3.0bn.

Outlook

The current expansion in credit to the private sector is set to provide the impetus for GDP growth, which would consolidate economic gains witnessed and further accelerate growth. However, downside risks present themselves in the budget outlook for the FY 2004/05. In the event that the Government resorts to domestic borrowing to close the financing gap, the additional borrowing will out crowd out private sector investment and lead to interest rate increases.

Reserve Money

The reserve money programme for the FY 2003/04 was implemented on the basis of ensuring that money supply, M3X, expansion was in line with overall inflation and growth objectives. Under the FY 2003/04 PRGF programme, reserve money was programmed to decline to an annual growth rate of –5.4% for the June quarter. In the year to June 2004, reserve money decelerated to an annual growth of 5.5% compared with 11.2% in the twelve months to June 2003 and a target decline of -5.4% as shown in Table 19. The slow expansion in reserve money in the year to June 2004 was in 13.4% increase currency in circulation while deposits of commercial banks and non-bank financial institutions (NBFIs) declined by 8.8% following the reduction in cash ratio requirements to a minimum of 6%, from 10% average with effect from July 1, 2003.

Net foreign assets (NFA) and net domestic assets (NDA) of the Central Bank supported the 5.5% expansion in reserve money during the year to June 2004. The NFA increased by Ksh 5.2 bn or 39.0% to Ksh 86.7 bn from Ksh 81.5 bn in June 2003. The improvement in NFA during the year to June 2004 reflected forex purchases made by the Bank from the interbank market in the first half of FY 2004/2005 as well as receipts of bilateral donor funds for budgetary support for the FY 2004/2005.

During the year to June 2004, Ksh 0.4 bn or 11.1% decline in NDA moderated the expansion in net foreign assets. The NDA closed the FY 2003/2004 at Ksh 3.6 bn from Ksh 4.0 bn in June 2003. Of the components of NDA, other domestic assets net of liabilities increased fully offsetting the increases in net indebtedness to commercial banks and Government borrowing from the Bank net of deposits. The Bank's other domestic assets net of liabilities declined by Ksh 6.3 bn to Ksh negative 8.7 bn in June 2004 from Ksh negative 2.5 bn in June 2003. The fall in other domestic assets of the Bank in the year to June 2004 reflected improvements in the year's surplus by Ksh 12.5 bn to Ksh 16.9 bn as well as an increase of Ksh 2.8 bn in suspense accounts.

At the same time, Government borrowing from the Bank net of deposits increased by Ksh 1.1 bn or 7.4% to Ksh 15.6 bn in the year to June 2004 from Ksh 14.6 bn in June 2003. During the period under review, the Government borrowed an additional Ksh 5.6 bn comprising of Ksh 4.9 bn through the overdraft facility, Ksh 0.4 bn through clearing items awaiting transfer to PMG and Ksh 0.3 bn through revaluation gain on IMF funds on let to Government during the calendar year 2000. The additional Government borrowing was fully offset by a build up of Ksh 4.3 bn deposits which stood at Ksh 37.4 bn in June 2004 from Ksh 33.1 bn in June 2003.

Performance of Quantitative Financial Criteria under the Reserve Money

The reserve money programme under the 3-year PRGF programme, outlined financial quantitative performance criteria and benchmarks on maximum ceilings (maximum) on net domestic assets (NDA) and floors (minimum) on net foreign assets (NFA) of the Central Bank of Kenya. The NDA was set at a maximum (ceiling) average of Ksh -1,237m as a benchmark for September, 2003; Ksh 2,026m as performance criteria for December 2003, Ksh –7,167m as a benchmark for March 2004 and Ksh –13,238m as performance criteria for June 2004. Similarly, the NFA was set at a minimum (floor) of Ksh 75,921m as benchmark for end September 2003, Ksh 77,562m as performance criteria for end December 2003, Ksh 83,878m as benchmark for end March 2004 and Ksh 90,105m as performance criteria for end June 2004.

The PRGF programme further allowed adjusters on the NDA and NFA components of reserve money with respect to quarterly shortfalls and excesses (actual less programmed) in budget support for the fiscal year June 2003/2004.

TABLE 22: RESERVE MONEY & ITS SOURCES (KSH BN)

		2003 Jun	2004 Jun	Change Absolute	%	Target Jun-04	Deviation
1	Net Foreign Assets	81.5	86.7	5.2	6.4	95.6	-9.0
2	Net Domestic Assets	4.0	3.6	-0.4	-11.1	-14.8	18.4
	2.1 Government Borrowing (net)	14.6	15.6	1.1	7.4	21.0	-5.4
	2.2 Advances & Discounts	-8.1	-6.1	2.0	-24.3	-29.2	23.1
	2.3 Other Domestic Assets (net)	-2.5	-8.7	-6.3	254.2	-6.6	-2.1
3	Reserve Money	85.5	90.2	4.7	5.5	80.9	9.4
	3.1 Banks Deposits at CBK	30.1	27.5	-2.6	-8.7	24.2	3.3
	3.2 NBFIs Deposits at CBK	0.2	0.1	0.0	-23.2	0.1	0.0
	3.3 Currency in Circulation	55.2	62.6	7.4	13.4	56.5	6.1

Source: Central Bank of Kenya

Performance of net domestic assets

During the fiscal year 2003/2004 actual donor budgetary support was below PRGF programme targets in all quarters and in line with the requirements of the Technical Memorandum of Understanding (TMU), under the PRGF programme, Central Bank made the allowed adjustments to NDA targets as shown in Table 22a below. As a result of the adjustments and the effort of the Bank in mopping excess reserves from the system through Open Market Operations the Bank succeeded in achieving all the set maximum quarterly NDA benchmarks and performance criteria in the fiscal year to June 2003/2004.

TABLE 22A: SUMMARY OF NDA PERFORMANCE IN KSH MILLION

		Sept 2003**	Dec 2003***	Mar 2004**	Jun 2004***
1	Program Target	-1,237	2,026	-7,167	-13238
2	Shortfall in non project budget support	2,789	5,378	12,442	17,879
3	Shortfall in non bank public holding government securities	5,176	15,170	15,299	8,961
4	Adjusted Program Target (1+2+3)	6,728	22,106*	20,574	13,602
5	Actual NDA	967	3,670	858	4,274
6	Deviation (5-4)	-5,761	-18,436	-19,716	-9,328
	Performance Criteria met	Yes	Yes	Yes	Yes

* Kshs.22,106m is the max. equivalent allowed adjuster of USD 280 million in the programme.
The actual of Kshs 22,574m is higher than Kshs.22,106m

** Benchmark dates

*** Test dates

Source: Central Bank of Kenya

Performance of net foreign assets

Similar adjustments from shortfalls in budgetary support for the fiscal year 2003/2004 were made to all the quarterly NFA targets as shown in Table 22b below in line with the requirements of the TMU under the PRGF programme. As a result of the adjustments to NFA targets, the effort of the Bank in purchasing foreign exchange from commercial banks during the first half of the fiscal year 2003/2004, and receipt of bilateral donor inflows for budget support enabled the Bank succeed in achieving all the set minimum quarterly NFA benchmarks and performance criteria in the fiscal year to June 2003/2004.

TABLE 22B: SUMMARY OF NFA PERFORMANCE IN KSH MILLION

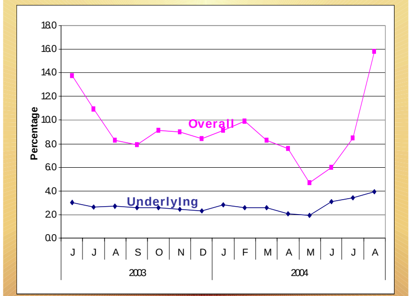
		Sept 2003*	Dec 2003**	Mar 2004*	June 2004**
1	NFA Program Target	75,921	77,562	83,878	90,105
2	Shortfall in non project budget support	2,789	5,378	12,442	17,879
3	Adjusted Program Target (1+2)	73,132	72,184	71,436	72,226
4	NFA Actual (unencumbered)	78,784	82,452	80,707	80,333
5	Deviation (4-3)	5,652	10,268	9,271	8,107
6	Performance met	Yes	Yes	Yes	Yes

* Benchmark dates
** Test dates
Source: Central Bank of Kenya

Inflation was higher during the year ending June 2004 than during the year ending June 2003. For example, annual average inflation rose from 2.28% in the year ending June 2003 to 8.18% during the year ending June 2004. Month-on-month overall inflation increased to 5.94% in June 2004 compared to 2.83% in June 2003. The three months annualized inflation also increased from 13.3% to 18.0%.

In comparison, month-on-month underlying inflation rose marginally from 3.01% in June 2003 to 3.06% in June 2004. More importantly, at 3.06% month-on-month underlying inflation fell below the 3.5% monetary policy target. Besides, variability of month-on-month underlying inflation was limited to the range 1.95%-3.06% during the year ending June 2004. Annual average underlying inflation rate rose marginally from 2.47% to 2.52% during the year ending June 2004. Its variability ranged between 2.48% and 2.81%. Thus, prudent monetary policy formulation and implementation secured low and stable month-on-month underlying inflation thereby stabilizing overall month-on-month inflation.

CHART 13: 12-MONTH INFLATION (%)



Source: Central Bureau of Statistics

Chart 13 and Table 23 shows trends in both month-on-month overall and month-on-month underlying measures of inflation.

Inflation By Category of Goods and Services

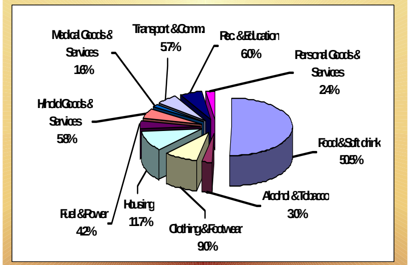
Since month-on-month underlying inflation was basically constant during the year ending June 2004 while overall inflation rose relatively more, it implies that most of the

TABLE 23: MONTH-ON-MONTH INFLATION (%)

	2003						2004					
	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
Overall	10.9	8.3	7.9	9.1	9.0	8.4	9.1	9.9	8.3	7.6	4.7	5.9
Underlying	2.6	2.7	2.6	2.6	2.5	2.3	2.9	2.6	2.6	2.1	2.0	3.1

Source: Central Bureau of Statistics

CHART 14: SHARE OF CATEGORIES OF GOODS & SERVICES IN THE CPI



Source: Central Bureau of Statistics

increase in inflation during the year to June 2004 owing to food, energy and transport price increments. Consistently, inflation in June 2004 was highest among three categories of goods and services, namely: “transport and communications”, “food and non-alcoholic drink”, and “fuel and power” bearing month-on-month inflation rates of 21.3%, 6.1% and 7.9%, respectively.

The increase in “food and drink” prices was due to drought that adversely affected the supply of major food items. Higher inflation in the “fuel and power” category resulted from the persistent increase in world oil prices as well as the depreciation of the Kenya shilling exchange rate against major foreign currencies. Higher prices of the transport and communications goods and services largely owed to the implementation of a new transport policy in February 2004 that among other things entailed major modifications in public service vehicles.

Distribution of the Inflation Impact

It is not easy to measure the precise amount of impact arising from higher inflation experienced among different income groups. This is because, as noted, higher inflation stemmed from higher prices of goods and services consumed across the income divide. Fuel, energy, and food items are the best examples of these commodities. Residents in urban centers doubtlessly suffered most considering the range of fuel, energy and transportation goods and services at their disposal relative to residents in rural area.

Inflation Outlook

Although the inflation outcome for July and August 2004 show higher rates than observed during the last quarter of the financial year (i.e. 8.5% and 15.8% for overall inflation and 3.4%

and 3.9% for underlying inflation respectively), inflation is expected to ease in the medium to long-term for two main reasons. First, the Kenya shilling exchange rate is expected to gain against the major currencies on the back of the anticipated release of donor "deferred" funds during the fourth quarter of 2004. This will help reduce the inflationary pressure arising from a depreciating shilling exchange rate.

There are also signs that world oil prices will stabilize at lower prices than currently experienced. Increased economic integration among COMESA countries and East Africa will herald freer trade flows that could reduce food shortages among member countries. This will forestall higher food prices. For instance, inflows of cheaper dry maize from Uganda have already moderated the price of dry maize in the Western part of Kenya.

As shown in the next chapters, interest rates have been increasing gradually. This is likely to reduce financing of consumption expenditures and that will ease inflationary pressures. It is, however, expected that the extent of increase in lending interest rates will not substantially reduce investment meant for further real economic growth.

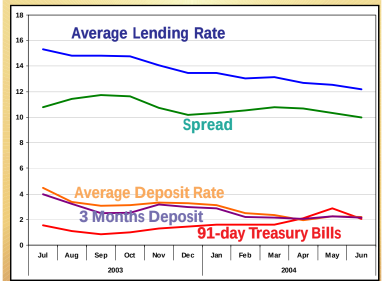
However, increased trade union movement agitation for increased wages may undermine the realization of lower inflation rates through lost output because of work stoppages and go-slows. Unless matched with productivity, awards of higher wages will only serve to compound the inflation problem. It is however, hoped that once awarded higher wages and salaries the employees will be motivated to enhance work performance and output.

INTEREST RATES

During the first half of the year ending June 2004, short-term interest rates generally declined largely because of reduced government borrowing in the domestic financial market. At interest rates of 2.014% and 3.146% for 91-day and 182-day Treasury bills, respectively, in June 2004 compared with 2.99% and 4.12% in June 2003, short-term interest rates were substantially lower. Reduced government borrowing also served to promote liquidity in the money market and as a result the inter-bank interest rate was at a much lower level in June 2004 compared with its level in June 2003.

Similarly, commercial bank lending and deposit rates were on a general decline with the overall weighted lending rate declining to 12.17% from an average of 15.7% in June 2003. Over the same period, the average deposit interest rate declined to 2.20% from 4.8% in June 2003. Possibly, in defending their profit margins, commercial banks lowered the average deposit rate in line with the falling lending rate. As a result, the interest rate spread between average lending and average deposit interest rates declined albeit marginally. The interest rate spread remained between 10.30% and 10.81% for the period February - May 2004, before declining to 9.98% in June 2004.

CHART 15: INTEREST RATES (%)



Source: Central Bank of Kenya

As shown in Chart 15 and Table 24, interest rates generally rose gradually during the second half of the year ending June 2004. This was because of negative sentiments associated with expectations among some financial market players that government was likely to increase borrowing from the domestic financial market should donor fund disbursements fail to take place. As a result of this, some of the financial institutions tended to bid treasury bill interest rates high and higher in their weekly quotations under the weekly Ksh 4 Billion Treasury bill auctions.

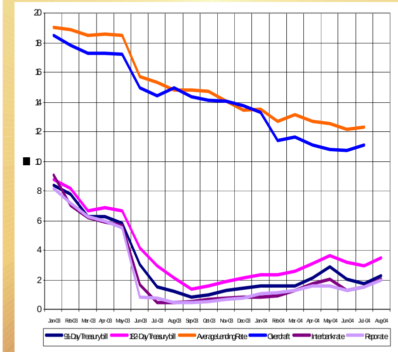
TABLE 24: INTEREST RATES (%)

	2003						2004					
	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
Treasury bill 91days	1.54	1.11	0.83	1.00	1.28	1.46	1.58	1.57	1.59	2.11	2.87	2.01
182 days	2.95	2.12	1.35	1.61	1.88	2.09	2.35	2.33	2.53	3.12	3.61	3.15
Average Lending Rate	15.30	14.81	14.82	14.75	14.07	13.47	13.48	13.01	13.12	12.67	12.55	12.17
Overdraft	14.43	14.96	14.31	14.13	14.02	13.74	13.30	12.30	11.65	11.08	10.75	10.72
Interbank rate	0.45	0.43	0.54	0.69	0.73	0.81	0.82	0.90	1.27	1.72	2.05	1.29
Average Deposit rate	4.49	3.37	3.07	3.13	3.32	3.29	3.12	2.47	2.32	1.96	2.22	2.20
3 - months deposits	3.96	3.23	2.50	2.56	3.17	2.99	2.86	2.17	2.15	2.02	2.22	2.14
Savings	1.79	1.72	1.44	1.43	1.44	1.38	1.22	1.47	1.30	1.24	1.15	1.15
Spread	10.81	11.44	11.75	11.62	10.75	10.18	10.36	10.54	10.80	10.71	10.33	9.97

Source: Central Bank of Kenya

It is informative to note that the current gradual increase in interest rates is not surprising considering that the rate of interest factored into the Government Budget for the financial year 2004/05 is higher.

CHART 16: STRUCTURE OF INTEREST RATES IN KENYA



Interest Rates Outlook

It is expected that before the current pressures on interest rates dissipate, interest rates will continue to increase gradually. However, increasing nominal interest rates will to some extent support in the restoration of current levels of real interest rates considering the recent increase in inflation.

Expected confirmation of continued budgetary financial support by the International Monetary Fund (IMF) and Project Funding by the World Bank (WB) will calm speculative market sentiments that are driving the rates higher.

Overall, short-term interest rates will be relatively higher in the medium term to long term than they are currently. However, the rates will not increase to the extent of compromising secondary trading of government securities. This is because, the securities are appropriately priced based on a market based yield curve.

Overview

Kenya's overall balance of payments resulted in US dollar 138 million surplus in the year to June 2004. However, the current account deficit widened by US dollar 226 million, which more than offset the increase of US dollar 168 million in the capital and financial account, thus reducing the overall balance of payments surplus by US dollar 58 million.

The current account deficit of US dollar 211 million was attributed mainly to the high growth of imports which offset inflows from the exports of goods and services. Exports of goods grew by 9.1% while imports of goods registered a higher growth of 18.0%. Services account balance registered a positive growth of 16% from US dollar 1,027 million for the year to June 2003 to US dollar 1,189 million during the year to June 2004.

TABLE 25: BALANCE OF PAYMENTS (US DOLLAR M)

ITEM	Year to Jun 2003	Year to June 2004: Q1 Jul-Sep	Q2 Oct-Dec	Q3 Jan-Mar	Q4 Apr-Jun**	Year to Jun-04
OVERALL BALANCE	**196**	**81**	**142**	**-55**	**-31**	**138**
I. CURRENT ACCOUNT	**15**	**-3**	**-25**	**-76**	**-107**	**-211**
Goods	**-1012**	**-312**	**-309**	**-365**	**-415**	**-1401**
Exports (fob)	**2326**	571	596	690	682	**2538**
Coffee	**85**	20	10	20	33	**83**
Tea	**433**	99	106	122	116	**443**
Horticulture	**296**	75	102	108	103	**387**
Oil products	**22**	1	1	1	1	**3**
Other	**1489**	376	377	440	429	**1621**
Imports (cif)	**3338**	883	905	1055	1096	**3939**
Oil	**743**	237	194	276	256	**963**
Chemicals	**527**	156	155	159	203	**673**
Manufactured Goods	**462**	130	128	159	173	**590**
Machinery & Transport Equipment	**792**	202	225	250	289	**966**
Other	**814**	159	203	211	175	**747**
Services	**1027**	**309**	**284**	**289**	**308**	**1189**
Non-factor services (net)	**446**	81	138	201	246	**665**
of which tourism	**322**	80	92	107	97	**376**
Income (net)	**-101**	-35	-23	-19	-17	**-94**
of which official interest	**-79**	-29	-24	-21	-18	**-93**
Current Transfers	**681**	263	169	107	79	**618**
Private (net)	**663**	199	168	107	80	**554**
Public (net)	**18**	64	1	-1	-1	**64**
II. CAPITAL & FINANCIAL ACCOUNT	**181**	**84**	**168**	**22**	**76**	**349**
Capital Tranfers (net)	**189**	**38**	**40**	**29**	**41**	**148**
Financial Account	**-8**	**46**	**128**	**-7**	**34**	**201**
Official, medium - & long-term	**-145**	-84	-38	-62	-37	**-220**
Inflows	**156**	35	91	17	34	**177**
Outflows	**-301**	-119	-128	-79	-70	**-397**
Private, medium - & long-term (net)	**125**	-19	-14	-170	28	**-176**
Commercial Banks (net)	**-45**	-7	-5	-162	44	**-130**
Other private, medium - & long-ter	**170**	-12	-9	-8	-16	**-45**
Short Term and Errors & Omissions (ne	**11**	149	180	225	43	**597**
Gross Reserves	**1655**	**1731**	**1887**	**1962**	**1940**	**1940**
Official	**1260**	1326	1480	1400	1399	**1399**
in months of goods and non-factor	3.8	3.8	4.2	3.8	3.6	**3.6**
Commercial Banks	**395**	405	408	562	541	**541**

* Revised to reflect the new BOP presentation format

** Provisional

Source: Central Bank of Kenya

Slower growth of exports than that of imports resulted in the deficit in the merchandise account widening by US dollar 388 million. Imports increased by US dollar 601 million mainly due to increased spending on imports of machinery and transport equipment, oil, chemicals and manufactured goods, which increased, respectively, by US dollar 174 million, 219 million, 146 million and 128 million. The growth in exports was mainly in horticulture (vegetables & cut flowers), raw materials, re-exports of mineral fuels, manufactured goods, and tea which rose, respectively, by US dollar 96 million, 83 million, 67 million, 17 million and 10 million.

Services account surplus increased by US dollar 163 million owing to inflows associated with non-factor services and investment income, which increased, respectively, by US dollar 219 million and 7 million. The increase in net receipts from non-factor services is partly attributed to increased earnings from tourism, which rose by US dollar 54 million.

In the capital account, capital transfers in support of Government projects decreased by US dollar 41 million. The financial account however improved by US dollar 209 million owing to increased short-term financial inflows by US dollar 583, which offset a deterioration of US dollar 76 million and 301 million, respectively, in the official and private medium and long-term accounts; with deterioration of these accounts being attributed to increased repayment of public debt and reduced inflows to the private sector and those related to government project loans and government guaranteed parastatal loans.

Despite the decline in the overall balance, gross official foreign exchange reserves rose by US dollar 139 million to close at US dollar 1,399 million (equivalent to 3.6 months of import cover) at the end of June 2004. Gross foreign asset holdings of commercial banks rose by US dollar 146 million to US dollar 541 million resulting in an increase in gross foreign reserves of the entire banking system by US dollar 285 million to close at US dollar 1,940 million at the end of June 2004.

Overall Balance

Kenya's overall balance of payments declined by US dollar 58 million to a surplus of US dollar 138 million in the year to June 2004 from US dollar 196 million in the year ended June 2003. The decline in the overall balance was mainly in widening of the current account by US dollar 224 million, which more than offset an increase of US dollar 165 million in the capital and financial account.

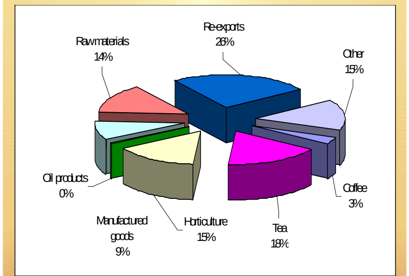
The Current Account

The current account moved to a deficit of US dollar 211 million in the year ended June 2004 from a surplus of US dollar 15 million in the year to June 2003. This deficit was attributed mainly to the high growth of imports particularly Machinery and Transport equipment, Oil products, Chemicals, and Manufactured goods, which offset inflows from the export of goods and non-factor services.

Merchandise Account

The deficit in the merchandise account widened by US dollar 388 million to US dollar 1,401 million in the year ended June 2004 from US dollar 1,012 million in the previous year. Both exports and imports in the merchandise account remarkably grew over the year under review although the growth of exports was relatively lower than imports. Imports amounted to US dollar 3,939 million while exports amounted to US dollar 2,538 million in the year to June 2004 compared with US dollar 3,338 million and 2,326 million, respectively, in the previous year.

CHART 17 : COMPOSITION OF KENYA'S EXPORTS (US DOLLARM)

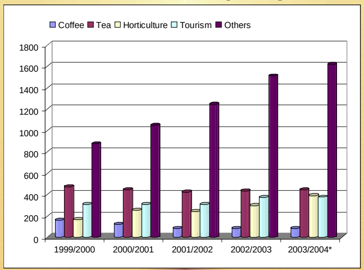


Sources: Central Bank of Kenya

Exports

Export earnings grew by 9.1% to US dollar 2,538 million in the year ended June 2004 from US dollar 2,326 million in the year to June 2003. The improvement was mainly in horticulture (vegetables & cut flowers), raw materials (raw hides and skins, textile fibres, and soda ash), chemicals (perfume materials), manufactured goods (iron and steel, and paper and paperboards), re-exports (mineral fuels) and tea and this was attributed to improved prices and the depreciation of the Kenya shilling. In the service sector, Tourism earnings and Current Transfers in the public sector, had remarkable improvement, growing to US dollar 376 million and US dollar 64 million in the year to June 2004 from US dollar 322 million and US dollar 18 million in 2003 respectively.

CHART 18: FOREIGN EXCHANGE EARNINGS (US $)

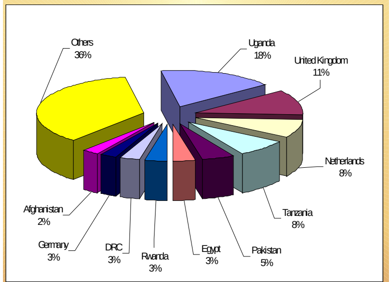


*** Provisional**
Source: Customs & Excis Dept. and Central Bank of Kenya

Tea exports increased marginally by US dollar 10 million to US dollar 443 million from US dollar 433 million in the previous year while the volumes declined by 8.2% from 281,859 tonnes in the year to June 2003 to 258,628 tonnes in the year to June 2004. Prices however, registered an increase of 9.8% from US dollar 1,537 per tonne to US dollar 1,688 per tonne in this period.

The earnings from coffee however, decreased to US dollar 83 million from US dollar 85 million in the previous year. There was an increase of 1.4% in the volume of coffee exported but a decrease of 4.2% in the export price thus the decrease in earnings was largely due to price decrease.

CHART 19: KENYA'S EXPORTS DESTINATION COUNTRIES



Sources: Central Bank of Kenya

Horticultural export prices increased by 35.1% as volumes declined by 3.0%, resulting in an increase of earnings by US dollar 92 million to US dollar 387 million in the year to June 2004 compared to US dollar 296 million in the previous period. Horticultural export earnings originated from vegetables, cut flowers and fruits, which increased by US dollar 30 million, 53 million and 9 million, respectively.

Export earnings from raw materials rose by US dollar 83 million to US dollar 367 million from US dollar 285 million, while earnings from re-exports rose by US dollar 67 million to US dollar 641 million. The value of manufactured goods exports increased by US dollar 17 million to US dollar 230 million in the year to June 2004 compared to US dollar 213 million in the previous year due to increased export earnings from paper and paperboards

TABLE 26: KENYA'S EXPORTS: MAIN DESTINATION COUNTRIES (US $M)

Source Country	Yr to June 03	Yr to June 04	% Change
Uganda	399	432	8.3
United Kingdom	269	267	-1.0
Netherlands	164	204	24.1
Tanzania	193	191	-0.9
Pakistan	114	122	7.5
Egypt	75	82	9.8
Rwanda	60	79	31.0
DRC	61	78	26.7
Germany	68	62	-9.9
Afghanistan	60	57	-4.1
Others	865	881	1.8
Total	**2329**	**2454**	5.4

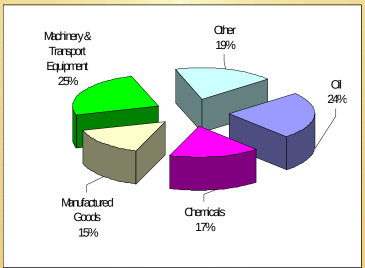
Source: Central Bank of Kenya

and iron and steel. Re-exports were mainly of refined fuel products to neighboring countries.

The main export destinations in the year to June 2004 as shown in Table 26 and Chart 19, were Uganda, United Kingdom, Netherlands, Tanzania, Pakistan, Egypt, Rwanda, Democratic Republic of Congo, Germany and Afghanistan. African countries accounted for 46.6% of the total exports in the year to June 2004 compared to 46.5% in the year to June 2003.

Imports

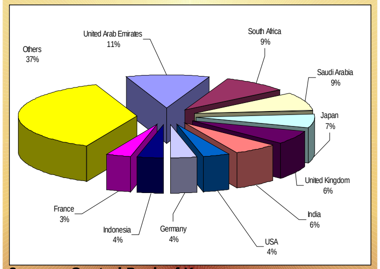
CHART 20 : COMPOSITION OF KENYA'S IMPORTS



Source: Customs & Excis Dept. and Central Bank of Kenya

Imports increased by US dollar 601 million to US dollar 3,939 million from US dollar 3338 million in June 2003. There was particularly increased spending on imports of machinery and transport equipment, oil, chemicals and manufactured goods. The value of oil imports increased by US dollar 219 million while imports of machinery and transport equipment grew by US dollar 174 million, thus accounting for much of the increase in the total value of imports during the year. Oil imports rose to US dollar 963 million in the year ended June 2004 from US dollar 743 million in the previous period. Mineral fuel imports particularly of crude oil reflected increased prices and quantity. Imports of machinery and transport equipment rose to US dollar 966 million in the year ended June 2004 from US dollar 792 million in the previous year as a result of the expansion in the air and shipping industries. There was also notable increase in the imports of chemicals, food and manufactured goods. Chemical imports increased by US dollar 146 million to US dollar 673

CHART 21: KENYA'S IMPORT SOURCE COUNTRIES



Source: Central Bank of Kenya

TABLE 27. KENYA'S IMPORTS : MAIN SOURCE COUNTRIES (US DOLLAR M)

Source Country	Yr to June 03	Yr to June 04	% Change
United Arab Emirates	371	458	23.4
South Africa	271	357	32.0
Saudi Arabia	235	350	48.5
Japan	233	271	16.5
United Kingdom	257	253	-1.6
India	190	248	30.2
USA	256	148	-42.3
Germany	142	144	1.3
Indonesia	177	141	-20.2
France	119	140	17.4
Others	1190	1501	26.2
Total	**3442**	**4011**	16.5

Source: Central Bank of Kenya

million while food and manufactured goods increased by US dollar 51 million and 128 million to US dollar 273 million and 590 million, respectively, in the year ended June 2004.

Over the year to June 2004 United Arab Emirates, South Africa, Saudi Arabia, Japan, United Kingdom, India, United States of America, Germany, Indonesia, and France were the main import origins (Chart 21 and Table 27).

Services Account

The surplus in the services account increased by US dollar 165 million to US dollar 1,192 million from US dollar 1,027 million in the previous year, reflecting increased inflows related to non-factor services and investment income. Net receipts from non-factor services increased by US dollar 219 million from US dollar 446 million to US dollar 665 million in the year to June 2004, following increased earnings from tourism as well as net receipts from other services, government and private sector. Revenue from tourism rose by US dollar 54 million to US dollar 376 million.

Net outflows from the income account declined to US dollar 91 million from US dollar 101 million following reduced private sector foreign interest payments by US dollar 20 million to US dollar 49 million and increased earnings on official foreign exchange reserves by US dollar 3 million to US dollar 50 million. Interest payments on official foreign debt, however, increased to US dollar 93 million during the year from US dollar 79 million.

Current transfers increased by US dollar 64 million to US dollar 618 million from US dollar 681 million, most of which was from the private sector.

The Capital and Financial Account

In the capital account, capital transfers in support of Government projects decreased by US dollar 41 million to US dollar 148 million during the year ended June 2004. The financial account however improved by US dollar 207 million to a net inflow of US dollar 199 million in the year ended June 2004 from a net outflow of US dollar 8 million in the year ended June 2003. The improvement in the financial account reflected increased short-term financial inflows by US dollar 583 million.

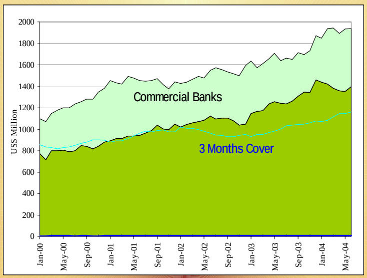
Official medium and long-term flows deteriorated to an outflow of US dollar 220 million in the year ended June 2004 compared to an outflow of US dollar 145 million in the previous year. The outflow reflected increased repayment of public debt and reduced inflows related to project loans and government guaranteed parastatal loans. However, program loans increased by US dollar 78 million. There was an increase in official inflows by US dollar 21 million to US dollar 177 million as official outflows increased by US dollar 97 million to US dollar 397 million in the year ended June 2004 from US dollar 301 million in the previous period.

Net private medium and long-term financial flows declined by US dollar 216 million from an inflow of US dollar 170 million in the year ended June 2003 to an outflow of US dollar 45 million in the current period due to decreased inflows to the private sector. Commercial banks net foreign assets holdings however, declined to an outflow of US dollar 130 million from an outflow of US dollar 45 million in the year to June 2003. Short-term financial inflows, including errors and omissions, increased by US dollar 583 million to US dollar 595 million.

FOREIGN EXCHANGE RESERVES

Despite the decline in the overall balance, gross official foreign exchange reserves rose by US dollar 139 million to US dollar 1,399 million, equivalent to 3.6 months of import cover, at the end of June 2004 from US dollar 1,260 million at the end of June 2003 as shown in Chart 22. Gross foreign asset holdings of commercial banks similarly rose by US dollar 146 million to US dollar 541 million at the end of June 2004 from US dollar 395 million at the end of June 2003. Consequently, gross foreign reserves of the entire banking system rose by US dollar 285 million to US dollar 1,940 million or 4.3 months of import cover at the end of June 2004 from US dollar 1,655 million or 4.5 months of import cover at the end of June 2003.

CHART 22: FOREIGN EXCHANGE RESERVES (US $)



Source: Central Bank of Kenya

The increase in the Central Bank foreign exchange reserves mainly resulted from inflows from the IMF and other donors, amounting to US dollar 94 million. In addition, earnings from Central Bank foreign exchange reserves investments rose by US dollar 2 million to US dollar 33 million in the year to June 2004 from US dollar 31 million in the year to June 2003. This increase was attributed to increased interest rates in the international financial markets as well as the built up of the official reserves from US dollar 1,260 million in the year to June 2003 to US dollar 1,399 million in the year to June 2004.

EXCHANGE RATES

The Kenya shilling was much weaker by the close of June 2004 than it was at the end of June 2003. Three major factors explained the depreciation of the shilling between June 2003 and June 2004: increased demand for hard currencies in the domestic money market as businesses tried to increase production owing to increased optimism; increased pressure on the shilling in the foreign currency market, particularly for US dollar as oil importers covered their positions in the wake of rising oil prices and speculation on the exchange rate associated with positions taken by some traders about future prospect for continued donor financial support.

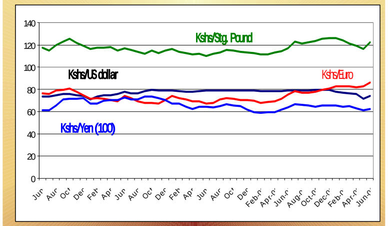
As shown in Table 29, the average exchange rate for June 2004 was Ksh 79.27 per US dollar, from an average of Ksh 74.18 per US dollar in June 2003. The shilling also depreciated against the British Pound Sterling and the Euro to trade at an average of Ksh 144.81 and Ksh 96.14, respectively, in June 2004, from an average of Ksh 122.54 and Ksh 84.76 in June 2003.

TABLE 29: KENYA SHILLING EXCHANGE RATES

	2002			2003			2004	
	Jan	Jun	Dec	Jan	Jun	Dec	Jan	Jun
Kshs/US$	78.6	78.7	79.5	77.7	73.7	76.0	76.3	79.3
Kshs/Stg.£	112.8	116.6	126.1	125.7	122.5	132.9	139.0	144.8
Kshs/Euro	69.5	75.1	81.0	82.6	86.1	93.3	96.2	96.1
Kshs/100 Yen	59.3	63.7	65.1	65.4	62.3	70.5	71.7	72.4
Kshs/Rand	6.8	7.8	8.9	8.9	9.3	11.6	11.0	12.3
Ushs/Kshs	22.2	22.9	23.2	24.1	27.1	25.5	25.4	23.0
Tshs/Kshs	11.8	12.2	12.3	12.8	14.1	13.9	14.2	14.0

Source: Central Bank of Kenya

CHART 23: KENYA SHILLING EXCHANGE RATES



Source: Central Bank of Kenya

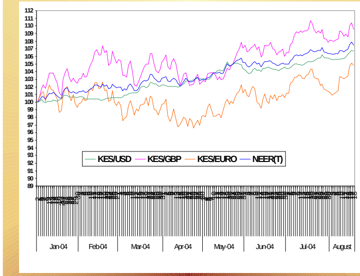
Regarding the South African Rand, the depreciation was modest with the exchange rate settling at an average of Ksh 12.27 per Rand in June 2004, from an average of Ksh 9.88 in June 2003. However, the Kenya currency emerged stronger within the East African Community with the average exchange rate for June 2004 being Ksh 22.14 and Ksh 14.03, respectively, for the Uganda shilling and Tanzania shilling. The gain was quite substantial with respect to Tanzania shilling but very small with respect to the Uganda shilling, with the respective exchange rates for June 2003 averaging Ksh 27.00 and Ksh. 14.05.

The depreciation of the shilling benefited exporters who earned more in shilling terms while importers had to raise more shillings to purchase the appreciated hard currencies. Higher cost of imported commodities particularly oil partially contributed to fuelling up inflation. The depreciated shilling also affected government finances by raising the cost of servicing foreign debt.

External Competitiveness

The competitiveness of a country's exports is a function of many factors of which the international value of its currency is one. If foreign demand is responsive to domestic prices, a strong currency lowers demand while a weaker currency has the opposite effect. On the basis of the nominal effective exchange rate and real effective exchange rate, Kenya gained international competitiveness between June 2003 and June 2004. This is because, overall, the external value of the Kenya shilling was much lower by end of June 2004 relative to its value by end of June 2003. Much of the depreciation of the shilling occurred between January and June 2004 whereby the shilling lost 5.44% of its external value.

CHART 24: KES/US DOLLAR, KES/GBP AND KES/EURO EXCHANGE RATE INDICES



Source: Central Bank of Kenya

Chart 24 shows the Kenya shilling exchange rate movements between January 02, 2004 and June 30, 2004. It also shows the overall behaviour of the shilling as measured by a basket of currencies of major trading partners, that is, the nominal effective exchange rate (NEER). The chart shows the Euro and the British Pound trading at very high levels compared to the Kenya shilling-US dollar trend. This is, however, moderated by the NEER that closely tracks the US-dollar, due to the large share of the US dollar in foreign trade.

Exchange Rate Outlook

Overall, the Kenya shilling remained relatively stable during the FY 2003/04. Although available data for July and August 2004 shows that the shilling weakened further, the Central Bank calmed the market following the release of US dollar 40 million towards the purchase to famine relief maize. Consequently, the shilling realised appreciable gains against major hard currencies.

In the forecast period, the value of the Kenya shilling against the major currencies will largely depend on two factors. Firstly, it will depend on the real rate of economic growth in Kenya relative to real rates of economic growth among Kenya's trading partners. In turn, increased real economic growth will depend on increased productivity. Currently, there are indications that Kenya is on the path to economic recovery and expectations are that these recent trends will be sustained throughout the medium term to long term. As such, CBK is optimistic that the recently observed accelerated depreciation of the Kenya shilling will be short lived. Secondly, it is also expected that much of the negative market segments that brought about the weakening of the Kenya shilling in the recent past will be corrected in view of the anticipated restoration and sustenance of donor budgetary and project support. Already, the World Bank has approved financing amounting to US dollar 263 million (Kshs 20.4 billion) for development projects in transport, agriculture and water sectors. Besides, the Kenya shilling is expected to stabilize in the near future since there has been no major changes in the financial and economic fundamentals that underlie its determination in the foreign exchange market.

Overall, given movements in the US dollar, exchange rate against the other major currencies in the international foreign exchange market, and considering the stable demand for and supply of US dollar in the domestic foreign currency market, it is expected that the Kenya shilling exchange rate against the US dollar will experience a stable trend.

MODES OF PAYMENT

1. CASH

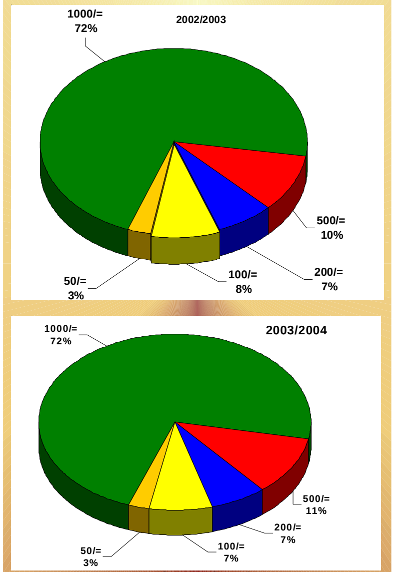
Cash comprising currency in circulation remained the most widely used form of payment during the period under review. The amount currency of issued into circulation at the end of June 2004 was Ksh 62.8 billion indicating a growth of Ksh 7.4 billion or 13.4% over the previous year's issued currency of Ksh 55.4 billion as indicated in Table 30 below:

TABLE 30: CURRENCY IN CIRCULATION BY TYPE

	Jun-02		Jun-03		Jun-04	
Item	Ksh.bn.	%	Ksh.bn.	%	Ksh.bn.	%
Currency in circulation	51.9	100%	55.4	100%	62.8	100%
Bank Notes	49.6	95.5	55.4	95.8	60.2	95.9
Coins	2.3	4.5	2.3	4.2	2.6	4.1

Source: Central Bank of Kenya

CHART 25: COMPOSITION OF ISSUED BANK NOTES BY DENOMINATION (KSH BN)



Source: Central Bank of Kenya

Viewed by type of currency, the proportion of bank notes and coins as at 30th June 2004 stood at 95.9% and 4.1% respectively.

TABLE 31: CURRENCY IN CIRCULATION (KSH M)

Bank Notes			Coins		
Denomination	Ksh (m)	%	Denomination	Ksh (m)	%
1000/=	43,370	72.1	40/=	57.2	2.2
500/=	6,346	10.6	20/=	958.5	36.2
200/=	4,059	6.7	10/=	646	24.4
100/=	4,400	7.3	5/=	437.1	16.5
50/=	1,552	2.6	1/=	394.2	14.9
20/=	252	0.4	=/50	102	3.9
10/=	159	0.3	=/10	36.8	1.4
5/=	40	0.1	=/05	15.2	0.6
TOTAL	60,178	100	TOTAL	2647	100

Source: Central Bank of Kenya

The share of banknotes in total issued currency increased from 95.8% in June 2003 to 95.9% as at June 2004. By denomination, banknotes were dominated by the Ksh 1,000 and Ksh 500 each accounting for 72.1% and 10.6% respectively. Coins as a proportion of the total currency in circulation declined marginally from 4.2% in the preceding year to 4.1%. The insignificant use of coins mainly stems from the public preference for use of banknotes. The Ksh 20 and Ksh 10 coins maintained bigger proportions accounting for 36.2% and 24.4% respectively.

Development of Cash Inflows/Outflows

Cash inflows as deposits by banks on a national basis decreased from Ksh 130.2 billion as at 30th June 2003 to Ksh 96.3 billion as at June 2004 a decrease of Ksh 33.9 billion or 26.0%. Cash outflows also decreased from Ksh 134.6 billion in the previous year to Ksh 100.2 billion during the period under review. There was therefore a net currency issue during the period ending 30th June 2004 of Ksh 3.9 billion as depicted in Table 32 below:

TABLE 32: CURRENCY INFLOWS AND OUTFLOWS (KSH M)

Inflow (deposit by banks)	2002/03	2003/04
Bank Notes	129,266.00	95,749.00
Coins	891.00	68.30
Total	130,157.00	96,318.00
Outflows (Withdrawals by banks)		
Bank Notes	133,646.00	99,419.00
Coins	943.00	813.00
Total	134,589.00	100,232.00
Net Outflows	**- 4,432.00**	**- 3,914.00**

Source: Central Bank of Kenya

Developments in Counterfeiting Practices

Counterfeit notes dropped drastically from 1,227 notes as at 30th June, 2003 to 518 notes as at 30th June 2004 while the respective amounts declined by 70.2% from Ksh 889,800 to Ksh 265,400 as indicated in Table 33. This is partly attributed to the preventive measures undertaken by the industry in coordinating with the Banking Fraud Unit of the Kenya Police.

It terms of denomination, there were 129 pieces of Ksh 1,000 note (24%) of counter feited notes, and 462 pieces of the Ksh 500 note (41.3%).

TABLE 33: COUNTERFEIT NOTES BY DENOMINATION

Period	No. 2002/2003	Amount (Kshs.)	No. 2003/2004	Amount (Kshs.)
1000/=	635	635,000	129	129,000
500/=	462	231,000	214	107,000
200/=	108	21,600	119	238,000
100/-	22	2,200	56	5,600
50/=	-	-	-	-
20/=	-	-	-	-
10/=	-	-	-	-
5/=	-	-	-	-
Total	**1,227**	**889,800**	**518**	**265,400**

Source: Central Bank of Kenya

2. NON-CASH INSTRUMENTS

Cheques continued to dominate the non-cash payment instruments accounting for over 80% of total transactions. In the year to June 2004 the average daily volume of cheques settled through the Nairobi Automated Clearing House averaged 52,000 cheques valued at Ksh 7.8 billion an increase from 48,000 cheques valued at Ksh 8.5 billion in similar period in 2003.

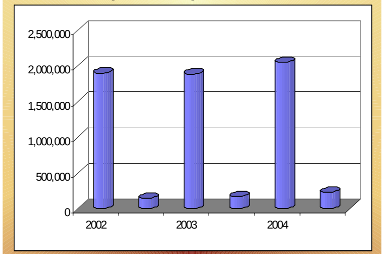
The use of card based payment instruments continued to rise with the increase in the Automated Teller Machines (ATMs) from 230 ATMs in June 2003 to over 245 in June 2004 after the launch of KenSwitch shared ATMs in November 2003.

Electronic Funds Transfer (EFT) transactions or credit based payments increased by 36.7% during the year to Ksh 229,681 million as compared to Ksh 167,595 million in the previous year ending June 2003.

The Clearing System Operations

The operations of the automated clearinghouse went on smoothly during the year under review. As at the end of June 2004 the

CHART 26: NATIONAL CLEARING TURNOVER (NOMINAL)



Source: Central Bank of Kenya

nominal value of clearing activities (Debit and Credit) on a national basis remained relatively stable from the previous year at around Ksh 2,281,656 million.

TABLE 34: NATIONAL CLEARING TURNOVER (NOMINAL)

FINANCIAL YEAR	ITEMS	VALUES	VOLUMES
		MILLIONS	THOUSAND
2002	Debit	1,901,368	12,177
	Credit	144,381	2,311
	Total	**2,045,749**	**14,488**
2003	Debit	1,890,753	12,200
	Credit	167,959	2,737
	Total	**2,057,712**	**14,937**
2004	Debit	2,051,975	12,329
	Credit	229,681	3,586
	Total	**2,281,656**	**15,915**

Source: Central Bank of Kenya

The Central Bank jointly with the Kenya Bankers Association (KBA) is working on modalities to implement Domestic Foreign Cheque Clearing on the same basis as the Kenya shillings clearing.

PAYMENT SYSTEM DEVELOPMENTS

The National Payments System (NPS) Operations Committee continued in its implementation plans for NPS modernization. Projects that were completed during the period include the introduction of direct debits for paying recurring utility bills and the official launching of the shared Automated Teller Machines (ATMs) switch (Kenswitch) in November 2003. To date Kenswitch has a total of 15 ATMs in 4 towns. Other projects planned for implementation include local foreign cheque clearing arrangements and the Real Time Gross Settlement (RTGS) System.

Legal Framework

In the Budget speech for fiscal year 2004/2005, the Minister for Finance underlined the need for Kenya to develop payments infrastructure to achieve an efficient, safe and reliable national payment and settlement systems. The Minister thus proposed to table the National Payments System and Electronic Funds

Transfer Bills in Parliament and to amend the Bills of Exchange Act CAP 27, to facilitate Cheque Truncation System (CTS). Cheque truncation is a process in which clearing cheques remain at the bank of deposit and their images electronically moved to the bank of issue for fate determination. This will speed up clearing of such cheques in addition to reducing costs of transporting these cheques from one bank to another.

Real Time Gross Settlement (RTGS) System

As part of the continuing efforts to modernize the Payments System, the Bank has initiated the process to implement an RTGS System. RTGS ensures transactions are electronically settled with finality and irrevocability on a gross (i.e. item by item) and continuous basis throughout the day. It will be the core mechanism of the entire Kenyan Payment System, ensuring the settlement of Large-value inter-bank payments and the final settlement of such systems as the Automated Clearing House (ACH) , EFT, Local Foreign Cheque Clearing and the Card switch transactions. The system is expected to be operational before the end of 2005. Once operational, the system will significantly reduce systemic risk in Kenya's payment environment, enabling participants in the system to make immediate settlement and monitor their Central Bank settlement account balances and payment flows in real time on a trading day.

Other Initiatives of NPS

During the year ending June 2004, the Bank continued to be represented in the East African Payment Systems Committee, which is charged with the development and harmonization of payment systems within the region. In their harmonization efforts, two surveys were carried out on Cross Border transactions and E-banking practices, respectively.

The findings of the survey on E-Banking practices indicated that e-banking has taken root in Kenya. As at the year ending 30th June 2004, 10 banks were providing mobile and Internet banking services.

The future outlook indicates good economic prospects for the financial year 2004/2005 and the medium term. At the international level, economic forecast point at a strong global economic performance in 2004 with a projected growth of 4.8%, the strongest performance since 1984. The projected high growth of the world economy is expected to boost Kenya's overall growth prospects in 2004 with major exports such as horticulture, tourism, tea, coffee and textiles expected to grow faster during the year. At the regional level, the peaceful resolution of armed conflicts particularly the recent signing of a peace agreement in Southern Sudan is expected to provide business opportunities for the Kenyan economy in the medium term particularly given the planned extension of the railway line to the region and construction of a pipeline to Mombasa for crude oil exports from Southern Sudan. The recent inauguration of a new Parliament in Somali offers a ray of hope for increased security in the region and this should provide the necessary environment for increased growth in the medium term.

In addition, the recent enlargement of the European Union should provide Kenyan exporters with a larger market. A number of Kenyan goods access the market duty free through preferential trade agreements. Other positive developments include the reversal of the adverse travel advisory by the UK and the downgrading of the negative travel advisory by the US. The implementation of Government investment programme outlined in the 2004/05 Budget speech and the Economic Recovery Strategy Paper, and in particular, the construction and rehabilitation of major infrastructure including the Northern

Corridor road and other projects will further boost growth prospects in the year and in the medium term.

However, the optimism is threatened by the unfavourable weather conditions and the slower than anticipated disbursement of the balance of payments support by the IMF and Programme aid from other bilateral donors. Similarly, the sharp rise in world prices of oil and other raw materials poses a near–term risk to global growth, while possibility of a more general rise in inflationary pressure and policy reactions thereto pose a greater medium-term risk. Besides, the volatility in world travel due to terrorism threat will also continue to undermine economic growth in tourism and service sectors.

The remarkable performance of the agricultural sector during the financial year under review is expected to be slowed down by the on-going drought during the financial year 2004/05. The delay in procurement of fertilizers during the year is also expected adversely affect agricultural production.

To boost economic performance the Government, through the on-going reforms in the agricultural sector expects to transform most activities into more profitable, commercially viable and internationally competitive ventures particularly by identifying key priority legal reforms. Besides, increased attention is being given to research, extension services, access to credit, inputs and markets under the 10 year Strategy for Revitalising Agriculture (SRA). The project will be funded by the Government with the support of the World Bank. The first - three year phase, has been negotiated and funding level agreed at US dollar 40 million, of which US dollar 13 million is a grant. In addition, through the Agricultural Finance Corporation, credit has been extended to maize, wheat, dairy and horticultural farmers at attractive interest rates which are expected to support further growth in the sector.

In the tourism sector growth prospects have been enhanced following the recent reversal of the negative travel advisory by the UK Government to its citizens and the down grading of the travel advisory by the US Government. Similarly, with increased promotion of domestic and conference tourism and improved security surveillance and particularly in the airports and areas visited by tourists, tourism is bound to pick up significantly to be among the fastest growing sectors in the economy during the coming year into the medium term. Nevertheless, the ability to quickly regain the country's past glory in the US, UK and other European markets are, however, considered key partly due to the high per capita income of visitors from these sources relative to other markets and the fact that the American and European markets currently account for over 70% of total tourists to Kenya.

On the fiscal front a substantial improvement in revenue collection accompanied by moderate increases in both development and recurrent expenditures are envisaged for fiscal operations over 2004/05. An overall deficit of 5.2% of GDP is planned in the budget, with net domestic financing to be limited to fiscally sustainable levels. In addition, the forecasts for fiscal year 2004/05 indicate less pressure on external debt service following the rescheduling of debt owed to Paris Club creditors. It is estimated that the central Government debt service will amount to Ksh 22.5 billion reflecting the net effects of repayments of Ksh 25.2 billion, interest payments of Ksh 7.7 billion and rescheduling of Kshs 10.3 billion. In line with budgetary provisions for a net domestic borrowing of Ksh 22 billion in

2004/05 the domestic debt stock is expected to increase by the same amount during the fiscal year.

On the other hand, the banking sector is expected to improve further in 2004/2005 as the economy recovers and banking institutions continue to comply with the requirements of the Banking Act and Central Bank prudential regulations. The Central Bank will also continue to publish bank charges thereby increasing customer awareness of products and services available and their associated costs and consequently enhance competition in the sector as customers opt for the most competitive charges.

Inflation is expected to ease in the medium to long-term following the Central Bank of Kenya's intervention in the domestic foreign exchange market, which has stabilised the Kenya shilling exchange rate against the major currencies. This will reduce the inflationary pressure arising from a depreciating shilling exchange rate.

In addition, there are signs that world oil prices will stabilize at lower levels than currently experienced while increased economic integration among countries of the COMESA and the East Africa will herald freer trade flows that could even out food shortages among member countries thereby forestalling higher food prices. For instance, inflows of cheaper dry maize from Uganda have moderated the price of dry maize in the Western part of Kenya. Furthermore, interest rates have been increasing gradually and this is likely to reduce financing of consumption expenditures inturn easing inflationary pressures. It is expected that the extent of increase in lending interest rates will not substantially reduce investment meant for further real economic growth. However, increased trade union movement agitation for increased wages may undermine the realization of lower inflation rates through lost output due to work stoppages and go-slows. Unless matched

with productivity, awards of higher wages will only serve to compound the inflation problem.
The interest rates are expected to continue to increase gradually before stabilizing. This will help in the restoration of current levels of real interest rates considering the recent increase in inflation. Expected confirmation of continued budgetary financial support by the International Monetary Fund (IMF) and Project Funding by the World Bank (WB) will stem negative market sentiments that are driving the rates higher.

While the shilling weakened in July and August 2004, the participation of the Central Bank in the foreign exchange market towards the end of August 2004 helped to calm the intensive speculation of the market. Consequently, the shilling realised appreciable gain against major hard currencies and hence the shilling exchange rate is expected to stabilise around its market value.

In the months ahead, the value of the Kenya shilling against the major currencies will largely depend on two factors. Firstly, it will depend on the real rate of economic growth in Kenya relative to real rates of economic growth among Kenya's trading partners. In turn, increased real economic growth will depend on increased productivity. Currently, there are indications that Kenya is on the path to economic recovery and expectations are that these recent trends will be sustained throughout the medium term to long term. As such, the Central Bank is optimistic that the recently observed accelerated depreciation of the Kenya shilling will be short lived. Secondly, it is also expected that much of the negative market segments that brought about the weakening of the Kenya shilling in the recent past will be corrected in view of the anticipated restoration and sustenance of donor budgetary and project support. Already, the World Bank has approved financing amounting to US dollar 263 million (Kshs 20.4 billion) for development projects in transport, agriculture and water sectors. Besides the Kenya shilling is expected to stabilize in the near future in response to the major change in the financial and economic fundamentals that underlie its determination in the foreign exchange market.

Overall, given movements in the US dollar exchange rate against the other major currencies in the international foreign exchange market, and considering the matched demand for and supply of US dollar in the domestic foreign currency market, it is expected that the Kenya shilling exchange rate will fall within the range of Kshs 78 to 79 against the US dollar.

The overall balance of payments position is expected to remain favourable in 2004. Growth in the value of Kenyan exports which had slowed down in the past, picked up considerably in 2003/2004 fiscal year to a remarkable growth of 9.1%. The export growth momentum is expected to continue into 2004/2005 competitive shilling exchange rate with improved prices of leading export commodities, notably tea and horticulture; increased volumes of coffee owing to reforms being undertaken in the sector; and improved growth prospects of the world economy. With the global recovery strengthening and broadening, the IMF forecasts global GDP growth of 4.6% in 2004 and 4.4% in 2005. Progress towards tariff harmonization in East Africa is expected to improve Kenya's export performance since about a third of the country's exports are sold to the East Africa region, while a half of the exports are sold to African countries. In the services account, tourism is expected to register better performance in 2004/2005 as the effects of the travel advisories imposed by U.S.A. and Britain in 2003 subside. Indications are strong that recent recovery trends in the tourism sector will be sustained, and further promotional campaigns will have further positive impact on tourism receipts.

Growth in the value of imports in 2003/2004 reached a record high of 18%, an indication that economic recovery is underway. However, the recent increase in world oil prices whose effects are felt worldwide, represents a major challenge.

In the capital account, capital transfers in support of Government is expected to improve in 2004/2005 as the Government implements remaining governance reforms, which will unlock donor programme and project funds disbursements. However, the recent upward trend in interest rates of major world economies may affect the direction of flow of short-term capital flows, especially in view of low domestic interest rates.

Official foreign exchange reserves are expected to increase following increased in disbursements by major development partners as the Government meets required governance benchmarks. The second and third tranche of the current Poverty Reduction and Growth Facility amounting to over US dollar 60 million are due before end of 2004. Disbursements of IMF funds will unlock other multilateral and bilateral programme and projects funds leading to substantial growth in official reserves.

CENTRAL BANK OF KENYA
DIRECTORS' REPORT
FOR THE YEAR ENDED 30 JUNE 2004

The directors submit their report together with the audited financial statements for the year ended 30 June 2004, which disclose the state of affairs of the Bank.

INCORPORATION

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

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.

RESULTS

The results for the year are set out on page 79.

DIVIDEND

The Board of Directors recommends the payment of a dividend of KShs 4,500 million (2003: KShs 3,500 million) to the Government of Kenya of which KShs 2,000 million is proposed to be applied to recover the amounts due from the Government of Kenya in respect of revaluation account (KShs 1,000 million) and pre-1997 government overdrawn account (KShs.1,000 million).

DIRECTORS

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

AUDITORS

The auditors of the Bank for the year ended 30 June 2004 were Ernst & Young. In line with the Exchequer and Audit Act (Public Procurement Regulations, 2001), Ernst & Young, having to retire at the conclusion of the current audit, have indicated their willingness to tender for the provision of audit services for the year to 30 June 2005.

By order of the Board

J.M. Gikonyo

BOARD SECRETARY

10th September, 2004

CENTRAL BANK OF KENYA
STATEMENT OF DIRECTORS' RESPONSIBILITIES
ON THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 30 JUNE 2004

We, the directors certify that:

1. We are responsible for the preparation of financial statements which present a true and fair view of the state of affairs of the Bank and of its operating results.

2. The financial statements have been prepared in accordance with International Financial Reporting Standards and 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 2004 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

10th September 2004

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

We have audited the financial statements of the Central Bank of Kenya set out on pages 79 to 97. The balance sheet of the Bank is in agreement with the books of account. We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purpose of our audit.

Respective responsibilities of directors and auditors

The directors are responsible for the preparation of financial statements as set out on page 77. Our responsibility is to express an independent opinion on the financial statements based on our audit.

Basis of opinion

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

Opinion

In our opinion, proper books of account have been kept and the financial statements, which are in agreement therewith, give a true and fair view of the state of the Bank's financial affairs at 30 June 2004 and of its profit and cash flows for the year then ended and comply with International Financial Reporting Standards and the Central Bank of Kenya Act.

Ernst & Young

ERNST & YOUNG
Certified Public Accountants

NAIROBI

September 13, 2004

CENTRAL BANK OF KENYA
PROFIT AND LOSS ACCOUNT
FOR THE YEAR ENDED 30 JUNE 2004

	Note	2004 KShs million	2003 KShs million
Interest income	1	3,844	3,170
Interest expense	2	(130)	(1,547)
Net interest income		3,714	1,623
Fee and commission income	3	4,374	5,416
Foreign exchange income	4	12,781	1,501
Other operating income	5	274	316
Operating income		21,143	8,856
Operating expenses	6	(4,333)	(4,383)
Impairment losses	8	(11,677)	(25)
Profit for the year		5,133	4,448
Dividends:			
Proposed dividend for the year	9	4,500	3,500

Source: Central Bank of Kenya

CENTRAL BANK OF KENYA

BALANCE SHEET

AS AT 30 JUNE 2004

ASSETS	Note	KShs million	KShs million
Balances due from banking institutions			
and gold holdings	10	109,856	92,017
Items in the course of collection		4,622	4,037
Investment in government securities	11	3	713
Loans and advances	12	13,446	11,993
Other assets	13	442	118
Retirement benefit asset	14	511	420
Property and equipment	15	625	751
Prepaid operating lease rentals	16	292	295
Due from Government of Kenya	17	41,917	54,559
TOTAL ASSETS		171,714	164,903
LIABILITIES			
Currency in circulation	18	62,621	55,231
Deposits	19	86,406	82,545
Amounts repayable under repurchase agreements	20	6,144	12,668
Other liabilities	21	1,011	560
TOTAL LIABILITIES		156,182	151,004
EQUITY AND RESERVES			
Share Capital	23	1,500	1,500
General reserve fund		9,532	8,899
Proposed dividend		4,500	3,500
TOTAL EQUITY AND RESERVES		15,532	13,899
TOTAL LIABILITIES AND EQUITY	171,714	164,903	

The financial statements were approved by the Board of Directors for issue on September 10, 2004 and signed on its behalf by:

Governor

Director

Source: Central Bank of Kenya

CENTRAL BANK OF KENYA
STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 30 JUNE 2004

	Share capital KShs million	General reserve fund KShs million	Proposed dividend KShs million	Total KShs million
Year ended 30 June 2003				
Balance at start of the year	1,500	7,951	2,110	11,561
Profit for the year	-	4,448	-	4,448
Dividends:				
-For 2002 paid	-	-	(1,110)	(1,110)
-Applied amounts due from Government of Kenya (Note 17)	-	-	(1,000)	(1,000)
-Proposed for 2003	-	(3,500)	3,500	-
Balance at end of the year	1,500	8,899	3,500	13,899
Year ended 30 June 2004				
Balance at start of the year	1,500	8,899	3,500	13,899
Profit for the year	-	5,133	-	5,133
Dividends:				
- For 2003 paid	-	-	(2,500)	(2,500)
- Applied to amounts due from Government of Kenya (Note 17)	-	-	(1,000)	(1,000)
- Proposed for 2004	-	(4,500)	4,500	-
Balance at end of the year	1,500	9,532	4,500	15,532

Source: Central Bank of Kenya

CENTRAL BANK OF KENYA
CASH FLOW STATEMENT
FOR THE YEAR ENDED 30 JUNE 2004

	Note	2004 KShs million	2003 KShs million
Operating activities			
Net cash absorbed by operating activities	22 (a)	(256)	(1,423)
Investing activities			
Liquidation of government securities		710	906
Purchase of property and equipment		(189)	(391)
Proceeds from disposal of property and equipment		3	1
(Investment in)/ liquidation of IMF-SDR accounts		(9)	39
Net cash generated from investing activities		515	555
Financing activities			
Dividends paid		(2,500)	(1,110)
Currency in circulation		7,390	3,364
Net cash from financing activities		4,890	2,254
Net increase in cash and cash equivalents		5,149	1,386
Cash and cash equivalents at start of year		84,855	82,683
Foreign exchange translation gains on cash and cash equivalents		11,933	786
Cash and cash equivalents at end of year	22 (b)	101,937	84,855

Source: Central Bank of Kenya

CENTRAL BANK OF KENYA
ACCOUNTING POLICIES
FOR THE YEAR ENDED 30 JUNE 2004

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

(a) Basis of preparation and form of presentation

(i) Basis of preparation

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

The preparation of financial statements in conformity with International Accounting Standards (IAS) 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.

(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.

(b) Revenue recognition

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

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

(c) Translation of 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 profit and loss account in the year in which they arise.

(a) Employee benefits

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 profit and loss account 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.

Other employee benefits

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

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

(b) Property and equipment

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

(f) Financial assets and liabilities

The Bank presents financial assets and liabilities, and the associated income and expense streams, by distinguishing between foreign currency and local currency activities. Foreign currency activities mainly arise from the Bank's foreign reserves management function. Local currency activities mainly reflect the assets and liabilities associated with monetary policy implementation, issuance of currency in circulation and banking activities.

All financial assets and liabilities are recognised on a trade date basis. The purchases and sales of financial assets and liabilities are recognised from the date the Bank commits to purchase/ sell the financial instrument.

(i) Investment securities

Investment securities include debt securities which management intends to hold until maturity and are stated at cost adjusted for amortisation of premiums and discounts over the period to maturity. Premium and discounts earned on investment securities are reported as interest income.

Financial assets and liabilities (continued)

(ii) 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 on the balance sheet.

(iii) Repurchase and reverse-purchase transactions

Securities issued by the Bank for monetary policy operations with an agreement to repurchase are disclosed in the balance sheet as liabilities and are stated at sales price. The difference between the sales price and the face value (repurchase price) represents interest expense and is accrued and amortised over the term of the contract.

(g) Loans and provisions for loan impairment

Loans are stated at outstanding amount less provision for impairment.

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

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

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

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

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

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

(h) Dividends payable

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

CENTRAL BANK OF KENYA
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 30 JUNE 2004

		2004 KShs million	2003 KShs million
1	**Interest Income**		
	Foreign investments earnings	2,556	2,323
	Local investments earnings	1,220	761
	Other interest earnings	68	86
		3,844	3,170
2	**Interest expense**		
	Interest on monetary policy issues	102	1,517
	Interest paid to IMF	27	24
	Interest on customer deposits	1	6
		130	1,547
3	**Fees and commission income**		
	Commission on sale of government securities	4,316	5,360
	Special projects agency fees	58	56
		4,374	5,416
4	**Foreign exchange income**		
	Gains on sale of foreign exchange	848	715
	Foreign exchange translation gain	11,933	786
		12,781	1,501
5	**Other operating income**		
	Rent received	16	17
	Proceeds from disposal of property and equipment	3	1
	Tuition fees and other charges	87	101
	Miscellaneous income	168	197
		274	316
6	**Operating expenses**		
	Currency expenses	1,145	1,160
	Depreciation	281	181
	Property maintenance expenses	262	287
	Auditors' remuneration	4	5
	Banking expenses	5	6
	Operating lease rentals	3	5
	Provision for fraud, theft and forgery	-	254
	Staff costs	2,128	1,992
	Other expenses	505	493
		4,333	4,383

CENTRAL BANK OF KENYA
NOTES TO THE FINANCIAL STATEMENTS (Continued)
FOR THE YEAR ENDED 30 JUNE 2004

		2004 KShs million	2003 KShs million
7	**Staff costs**		
	The following items are included within staff costs:		
	Retirement benefit costs - defined benefit scheme	230	245

		2004	2003
8	**Impairment losses**		
	Losses and write-offs	35	25
	Impairment loss on amount due from government	11,642	-
		11,677	25

9 Dividends

The directors have proposed a dividend of KShs 4,500 million (2003: KShs 3,500 million) in respect of the year ended 30 June 2004.

		2004 KShs million	2003 KShs million
10	**Balances due from banking institutions and gold holdings**		
	Current accounts	2,202	3,294
	Term deposits	99,718	81,549
	Forex travellers cheques	2	-
	Gold holdings	15	12
	Cash and cash equivalents	101,937	84,855
	Accrued interest on foreign investments	301	187
	Special Drawing Rights	41	32
	Total own resources	102,279	85,074
	Special project accounts	7,577	6,943
		109,856	92,017

		2004	2003
11	**Investment in government securities**		
	Government stock	-	402
	Treasury bills	3	311
		3	713

All the government securities held have a maturity date of within 90 days from the date of acquisition. See note 28 for effective interest rate on government securities.

CENTRAL BANK OF KENYA
NOTES TO THE FINANCIAL STATEMENTS (Continued)
FOR THE YEAR ENDED 30 JUNE 2004

12	**Loans and advances**	**2004 KShs million**	**2003 KShs million**
	Advances to banks under liquidation	8,259	8,234
	Other advances to banks	-	3,898
	Government overdraft account (see below and Note 24)	9,232	4,319
	Advances to employees (Note 24)	1,915	1,733
	IMF funds on-lent to the Government (Note 24)	2,331	2,072
		21,737	20,256
	Provision for loan impairment	(8,291)	(8,263)
	Net advances as at 30 June	13,446	11,993

Movement in the provision for loan impairment is as follows:

	2004	2003
At start of the year	(8,263)	(8,275)
Additional provisions made in the year	(28)	(25)
Recoveries in the year	-	37
At end of the year	(8,291)	(8,263)

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 9,232,144,273.60 based on the Government financial statements for 2000/2001, which are the latest audited financial statements at the date of approval of these financial statements. The limit for the previous year was KShs 8,270,571,883,based on the Government financial statements for 1998/1999.

13	**Other assets**	**2004 KShs million**	**2003 KShs million**
	Impersonal accounts	-	25
	Sundry debtors	442	93
		442	118

CENTRAL BANK OF KENYA

NOTES TO THE FINANCIAL STATEMENTS (Continued)

FOR THE YEAR ENDED 30 JUNE 2004

14 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 2004.

	2004 KShs million	2003 KShs million
Present value of funded obligations	5,932	4,942
Fair value of plan assets	(7,146)	(5,933)
Present value of net asset	(1,214)	(991)
Unrecognised actuarial gain	703	571
Asset in the balance sheet	(511)	(420)

The amounts recognised in the profit and loss account are as follows:

	2004	2003
Current service costs	323	277
Interest costs	459	403
Expected return on plan assets	(552)	(435)
Total expenses included in operating expenses	230	245

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

	2004	2003
Net expense recognised in the profit and loss account	230	245
Employer contributions	(321)	(378)
Movement in the asset recognised in the balance sheet	(91)	(133)
Actual return on plan assets	934	1,070

The principal actuarial assumptions at the balance sheet date were:

	2004	2003
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%

CENTRAL BANK OF KENYA
NOTES TO THE FINANCIAL STATEMENTS (Continued)
FOR THE YEAR ENDED 30 JUNE 2004

		Land and buildings KShs million	Motor vehicles KShs million	Furniture and equipment KShs million	Total KShs million
15	**Property and equipment**				
	Cost				
	At start of year	1,004	169	1,310	2,483
	Additions	-	17	172	189
	Adjustments	-	-	(34)	(34)
	Disposals	-	(7)	-	(7)
	At end of the year	1,004	179	1,448	2,631
	Depreciation				
	At start of the year	665	145	922	1,732
	Charge for the year	85	26	170	281
	Eliminated on disposal	-	(7)	-	(7)
	At end of the year	750	164	1,092	2,006
	Net book value				
	At 30 June 2004	254	15	356	625
	At 30 June 2003	339	24	388	751

16 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:

	2004 KShs million	2003 KShs million
At beginning of the year	295	290
Reversal of depreciation on leasehold land	-	10
Amortisation charge for the year	(3)	(5)
At end of year	292	295

17 Due from Government of Kenya

Recoverable from dividends:		
Revaluation account	17,642	18,642
Loan due from Government	36,917	36,917
Impairment loss	(11,642)	-
Recovery in the year	(1,000)	(1,000)
	41,917	54,559

a) The Revaluation account due from the Government of Kenya is repayable within 17 years from 1 July 2003. The amount is currently interest free, and is being recovered from dividend payable to the Government of Kenya.

b) Pursuant to Section 46(4) of the Act, the overdrawn accounts of the Kenya Government were converted to a loan with effect from 1 July 1997. The loan, which stood at KShs 36,917 million at 30 June 2004, bears interest at the rate of 3% p.a. from 1 July 2003. The repayment period is 37 years from 1 July 2003.

CENTRAL BANK OF KENYA
NOTES TO THE FINANCIAL STATEMENTS (Continued)
FOR THE YEAR ENDED 30 JUNE 2004

18 Currency in circulation

	2004 KShs million	2003 KShs million
Kenya notes	59,973	52,923
Kenya coins	2,643	2,304
Commemorative coins	5	4
	62,621	55,231

19 Deposits

	2004	2003
Banks -Kenya	27,491	30,105
-External	29	705
Non-bank financial institutions	124	162
Other public entities and project accounts	10,491	10,518
International Monetary Fund	10,630	8,088
Government of Kenya	37,641	32,967
	86,406	82,545

20 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.

21 Other liabilities

	2004 KShs million	2003 KShs million
Impersonal accounts	478	-
Sundry creditors	390	257
Refundable deposits	58	26
Commission for EEC Development deposits	36	1
Amount pending litigation	32	-
Sundry suspense accounts	17	22
Provision for misappropriated treasury bonds	-	254
	1,011	560

CENTRAL BANK OF KENYA

NOTES TO THE FINANCIAL STATEMENTS (Continued)

FOR THE YEAR ENDED 30 JUNE 2003

		2004 KShs million	2003 KShs million
22 (a)	**Cashflows from operating activities**		
	Net profit for the year	5,133	4,448
	Adjustments for:		
	Losses and write-offs	11,677	-
	Depreciation	281	181
	Amortization of prepaid operating leases	3	5
	Charge for reclassification of leasehold property	-	(10)
	Increase in defined benefit scheme asset	(91)	(133)
	Gain on disposal of property and equipment	(3)	(1)
	Foreign exchange revaluation gains	(11,933)	(786)
	Operating profit before working capital changes	5,067	3,704
	Net decrease in loans and advances	(1,453)	(6,084)
	Decrease in amounts repayable under repurchase agreements	(6,524)	(14,459)
	Increase in deposits	3,861	15,219
	Decrease in project accounts	(635)	(1,465)
	Decrease (increase) in accrued interest on balances due from banking institutions	(114)	44
	Decrease (increase) in items in the course of collection	(585)	1,632
	Decrease (increase) in other assets	(324)	109
	Increase in other liabilities	451	(123)
	Net cash absorbed by operations	(256)	(1,423)

22 (b) Cash and cash equivalents

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

	2004	2003
Current accounts and term deposits	101,920	84,843
Travellers Cheques	2	-
Gold holdings	15	12
	101,937	84,855

23 Share capital

	2004	2003
Authorised share capital	5,000	5,000
Issued and fully paid	1,500	1,500

24 Related party transactions

In the course of its operations, the Bank enters into transactions with related parties, which include t Government of Kenya, the ultimate owner of the Bank, and The Deposit Protection Fund Board. Unle otherwise stated, all transactions between these entities take place at arm's length.

(i) Loans

The Bank extends loan facilities to its members of staff, the Governor and the Deputy Governor. Loans and advances (Note 12) include advances to employees that as at 30 June amounted to KShs 1,915 million (2003: KShs 1,733 million). The advances are at preferential rates of interest determined by the Bank.

CENTRAL BANK OF KENYA

NOTES TO THE FINANCIAL STATEMENTS (Continued)

FOR THE YEAR ENDED 30 JUNE 2003

Related party transactions (continued)

	2004 KShs million	2003 KShs million
(ii) Loans to executive directors		
At 1 July	9	11
Loans advanced during the year	11	-
Loan repayments	(4)	(2)
At 30 June	16	9
(iii) Directors emoluments:		
Fees to non executive directors	4	1
Other remuneration to executive directors	26	26

(iv) Government of Kenya

Transactions entered into with the Government include:

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

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

	2004 KShs million	2003 KShs million
Due from Government of Kenya (Note 17)	41,917	54,559
Overdraft account (Note 12)	9,232	4,319
IMF funds on-lent to the Government (Note 12)	2,331	2,072
Government of Kenya deposits (Note 19)	37,641	32,967
Investments in GOK Securities (Note 11)	3	713

(v) Deposit Protection Fund Board

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

The balance outstanding from The Deposit Protection Fund Board and included in other assets as at year end was KShs 8 million (2003: KShs18 million).

(vi) 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.

CENTRAL BANK OF KENYA

NOTES TO THE FINANCIAL STATEMENTS (Continued)

FOR THE YEAR ENDED 30 JUNE 2004

25 Liquidity risk

The table below analyses assets and liabilities into relevant maturity groupings based on the remaining period at 30 June 2004 to the contractual maturity date.

	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
ASSETS						
Balances due from banking institutions and gold holdings	9,795	100,019	-	-	42	109,856
Loans and advances	9,232	122	314	324	3,454	13,446
Investments in government securities	-	3	-	-	-	3
Items in the course of collection	4,622	-	-	-	-	4,622
Other assets	-	442	-	-	917	1,359
Retirement benefit asset	-	-	-	-	511	511
Due from Government of Kenya	-	2,000	-	10,000	29,917	41,917
TOTAL ASSETS	23,649	102,586	314	10,324	34,841	171,714
LIABILITIES						
Currency in circulation	62,621	-	-	-	-	62,621
Deposits	75,776	-	1,031	9,323	-	86,406
Amounts repayable under repurchase agreements	-	6,144	-	-	-	6,144
Other liabilities	-	1,011	-	-	-	1,011
Equity and reserves	-	4,500	-	-	11,032	15,532
TOTAL LIABILITIES AND EQUITY	138,397	11,655	1,031	9,323	11,308	171,714
Liquidity gap 2004	(114,412)	90,931	(717)	1,001	18,609	-
As at 30 June 2003:						
Total assets	22,584	83,667	173	11,369	47,110	164,903
Total liabilities and equity	129,687	16,728	1,031	7,058	10,399	164,903
Liquidity gap 2003	(107,103)	66,939	(858)	(4,311)	36,711	-

CENTRAL BANK OF KENYA
NOTES TO THE FINANCIAL STATEMENTS (Continued)
FOR THE YEAR ENDED 30 JUNE 2004

26 Currency risk

The various currencies to which the bank is exposed at 30 June 2004 are summarised in the below (all expressed in KShs million):-

	USD	GBP	EURO	SDR	GOLD	OTHER	TOTAL
Assets							
Balances due from banking institutions	34,460	39,230	36,021	-	-	89	109,800
Special Drawing Rights	-	-	-	41	-	-	41
Gold holdings	-	-	-	-	15	-	15
Total assets	34,460	39,230	36,021	41	15	89	109,856
Liabilities							
Balances due to IMF	-	-	-	10,630	-	-	10,630
Commissions for EEC Development Fund	-	36	-	-	-	-	36
Forex bureaux deposits	52	-	-	-	-	-	52
Total liabilities	52	36	-	10,630	-	-	10,718
Net balance sheet position 2004	**34,408**	**39,194**	**36,021**	**(10,589)**	**15**	**89**	**99,138**
As at 30 June 2003							
Total assets	27,429	37,703	26,808	321	12	33	92,306
Total liabilities	19	1	-	8,377	-	-	8,397
Net balance sheet position 2003	**27,410**	**37,702**	**26,808**	**(8,056)**	**12**	**33**	**83,909**

CENTRAL BANK OF KENYA
NOTES TO THE FINANCIAL STATEMENTS (Continued)
FOR THE YEAR ENDED 30 JUNE 2004

27 Interest rate risk

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

	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	102,262	-	-	7,594	109,856
Loans and advances	10,449	405	2,592	-	13,446
Investment in government securities	3	-	-	-	3
Items in the course of collection	-	-	-	4,622	4,622
Other assets	-	-	-	1,359	1,359
Retirement benefit asset	-	-	-	511	511
Due from Government of Kenya	-	-	36,917	5,000	41,917
Total assets	112,714	405	39,509	19,086	171,714
Liabilities and equity					
Currency in circulation	-	-	-	62,621	62,621
Deposits	-	1,186	6,838	78,382	86,406
Amounts repayable under repurchase agreements	6,144	-	-		6,144
Other liabilities	-	-	-	1,011	1,011
Equity and reserves	-	-	-	15,532	15,532
Total liabilities and equity	6,144	1,186	6,838	157,546	171,714
Interest sensitivity gap 2004	106,570	(781)	32,671	(138,460)	-
As at 30 June 2003					
Total assets	94,420	273	2,422	67,788	164,903
Total liabilities and equity	12,668	1,037	4,981	146,217	164,903
Interest sensitivity gap 2003	81,752	(764)	(2,559)	(78,429)	-

CENTRAL BANK OF KENYA

NOTES TO THE FINANCIAL STATEMENTS (Continued)

FOR THE YEAR ENDED 30 JUNE 2003

28 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 the respective carrying amounts. Fair values are based on discounted cash flows using a discount rate based c 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 2004 and 2003 were i the following ranges:

		2004	2003
Assets			
Government securities		4.9%	9.4%
Deposits with overseas correspondent banks			
	- current accounts	0.0%	0.0%
	- term deposits (USD)	1.1%	1.4%
	- term deposits (Pounds Sterling)	3.9%	3.8%
	- term deposits (Euro)	2.1%	2.9%
Loans and advances	- Commercial banks	4.6%	10.2%
	- Government of Kenya	1.6%	7.2%
	- Employees	3.0%	5.0%
Due from Government of Kenya		3.0%	0.0%
Liabilities	-Customer deposits	0%	0-5%

29 Contingencies and commitments

<u>Contingencies</u>

The Bank is party to various legal proceedings with potential liability of KShs 334 million at 30 June 200 Having regard to the legal advise received, and in all circumstances, the directors are of the opinion that thes legal proceedings will not give rise to liabilities, which in aggregate, would otherwise have material effect c these financial statements.

Commitments	**2004 KShs million**	**2003 KShs million**
Contracted for	977	-

Capital commitments contracted for relates to currency disintegration and briquetting system for Kisumu ar Eldoret bank notes and sorting system.

30 Employees

The average number of employees during the year was 1,255 (2003: 1,265).

31 Taxation

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

32 Comparatives