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**LETTER OF TRANSMITTAL TO THE HONOURABLE
MINISTER FOR FINANCE**

I have the honour to present to you the Annual Report and Statement of the Audited Accounts of the Central Bank of Kenya for the financial year ended June 30, 1999 in accordance with Section 54 of the Central Bank of Kenya Act.

The underlying inflation fell to 5% in the financial year from 11.4% the previous year. At this level, inflation was just on the target set at the beginning of the year as a guideline to managing money supply. The achievement of the inflation target was made possible by taking appropriate measures to contain money supply during the year whenever conditions threatening price stability emerged in the economy. Budgetary operations geared towards a more restrained borrowing from the domestic money market during the fiscal year also helped in reducing the rate of inflation to single digits.

The balance of payments position improved to a smaller overall deficit than in the previous year. The improvement was associated with favourable capital account which partially offset the widened current account deficit. The worsening current account position was due to the deterioration in both the trade and services balances. The current account was financed mainly by the private capital inflows as some importers of goods and services used own external resources to finance business transactions.

In terms of banking stability, five commercial banks were brought under statutory management in the year, and a major bank ran into confidence problem, following a run on it by its depositors towards the end of the first half of the fiscal year. A rescue operation however, arrested the situation and the banking industry as a whole remained relatively stable throughout the year.

Yours sincerely,



**MICAH CHESEREM
GOVERNOR**

BOARD OF DIRECTORS



MICAH CHESEREM
*Governor and Chairman
Central Bank of Kenya*



DR. THOMAS KIBUA
*Deputy Governor
Central Bank of Kenya*



THOMAS KITHINJI
*Chairman and Chief Executive
Skylark Africa Insurance Brokers*



PHARES KUINDWA
*Secretary to the Cabinet and
Head of Civil Service*



JOHN MRAMBA
*Chairman, Communication
Concepts Ltd.*



MARGARET CHEMENGICH
*Permanent Secretary
Ministry of Finance*



PROF. FRANCIS KIBERA
University of Nairobi



ANDREW WANYANDE
Businessman

SENIOR MANAGEMENT



MAURICE KANGA
Director, Research



DANIEL KIANGURA
*Director, Management
Information Services*



JONES NZOMO
Director, Banking



MICHAEL CHERWON
Director, Finance



JOHN GIKONYO
*Bank Secretary & Director,
Human Resources*



JACINTA MWATELA (Mrs.)
Director, Supplies & Services



JOHN MURUGU
Director, Bank Supervision



JAMES OGUNDO
*Director, Kenya School of
Monetary Studies*



HENRY NJOROGE
Director, Projects



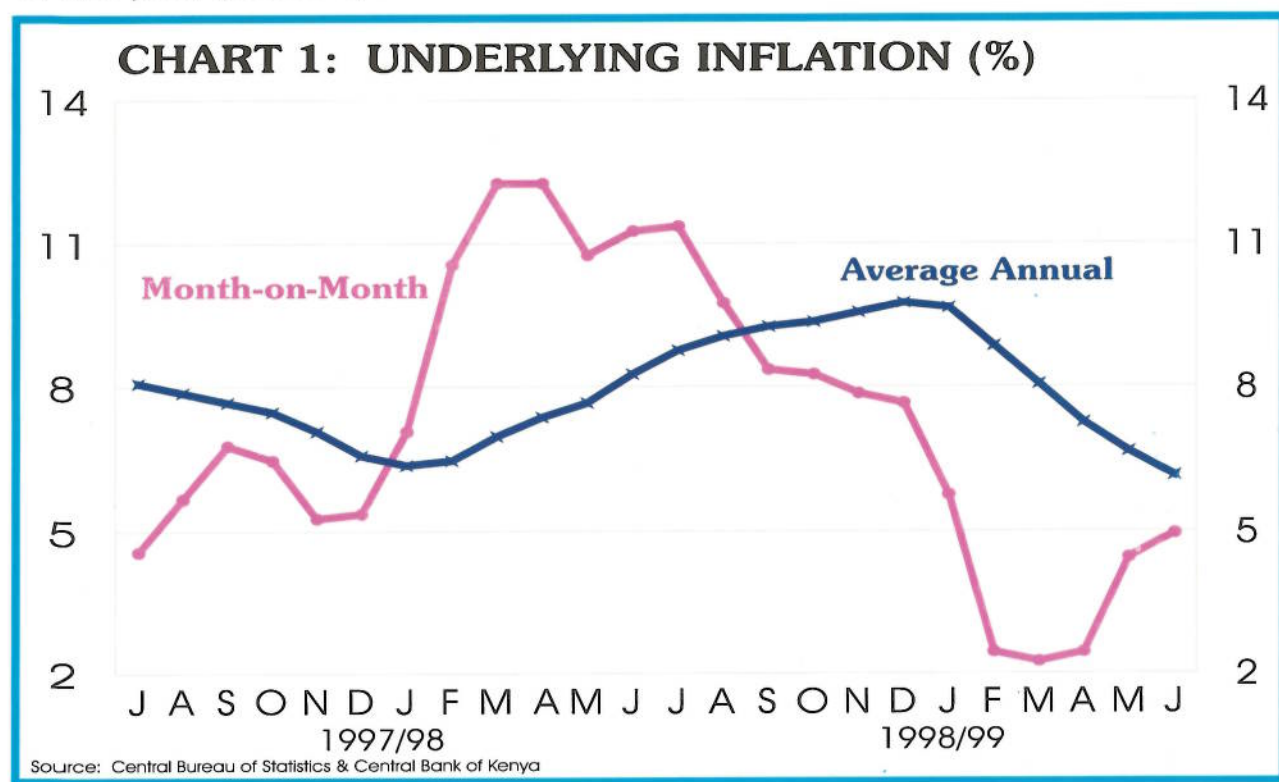
NICHOLAS KIRITU
Chief Internal Auditor

INFLATION

Inflation, measured both as the underlying price changes excluding food prices and as overall price changes, including the food prices, fell and remained in single digit throughout the financial year. At 5.0% for the underlying inflation and 1.8% for the overall inflation, the month-on-month inflation at the end of the year was within the target of 5% for the fiscal year. Inflation fell throughout the first half of the financial year but reversed to an upward trend during the second half of the year. The confinement of inflation to single digits was achieved through use of monetary policy which ensured the supply of money expanded in line with the slow production of goods and services (GDP) during the year.

Underlying Inflation

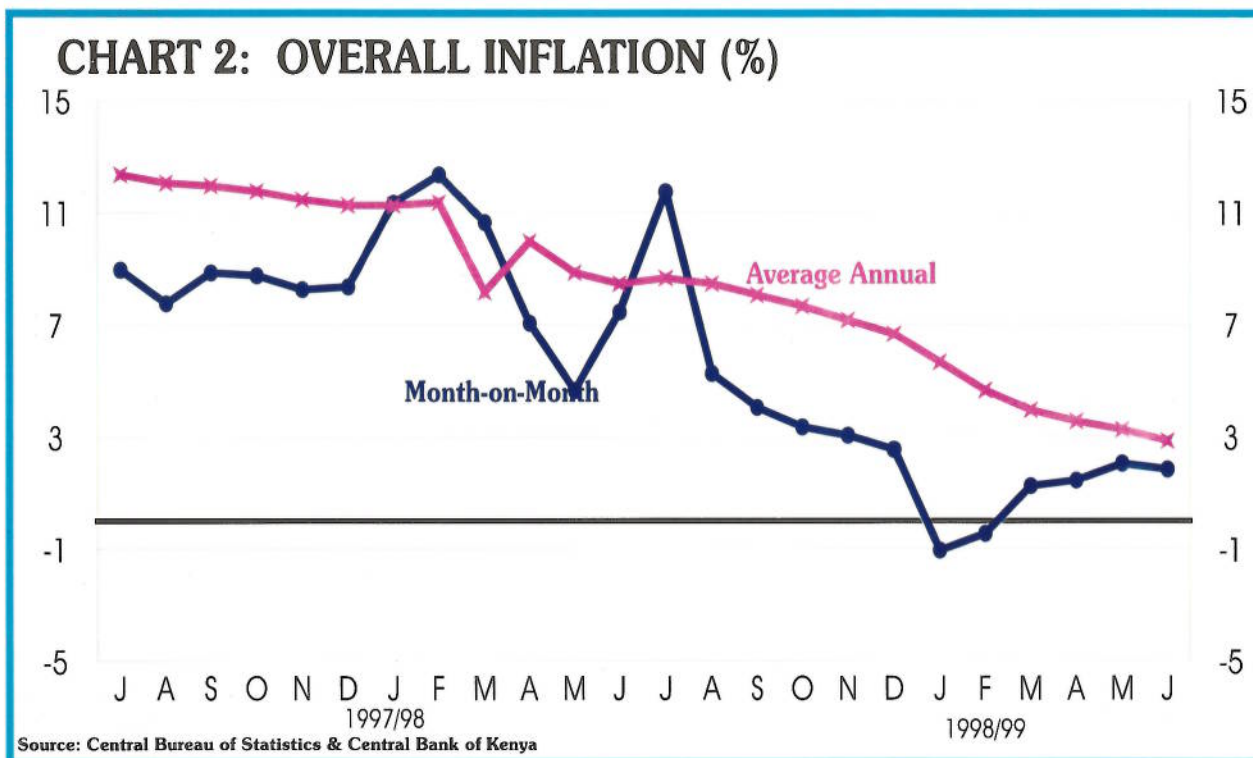
The underlying month-on-month inflation which was targetted at 5% for the fiscal year, fell from 11.4% in July 1998 reaching a low of 2.3% in March 1999. The month-on-month underlying inflation, however, took an upward trend during the last quarter of the year but, at 5% in June 1999, inflation was still low and within the target for the year. The increase in the underlying inflation in the last quarter of the financial year arose from the delayed effects of the weakened shilling exchange rate during the last half of the year (Chart 1).



Overall Inflation

The overall inflation fell through most part of the financial year (Chart 2):

- The month-on-month inflation steadily declined from 11.7% in July 1998 to 2.5% in December 1998 and further to 1.8% in June 1999;
- The average annual inflation also declined from 8.6% in July 1998 to 2.8% by June 1999.

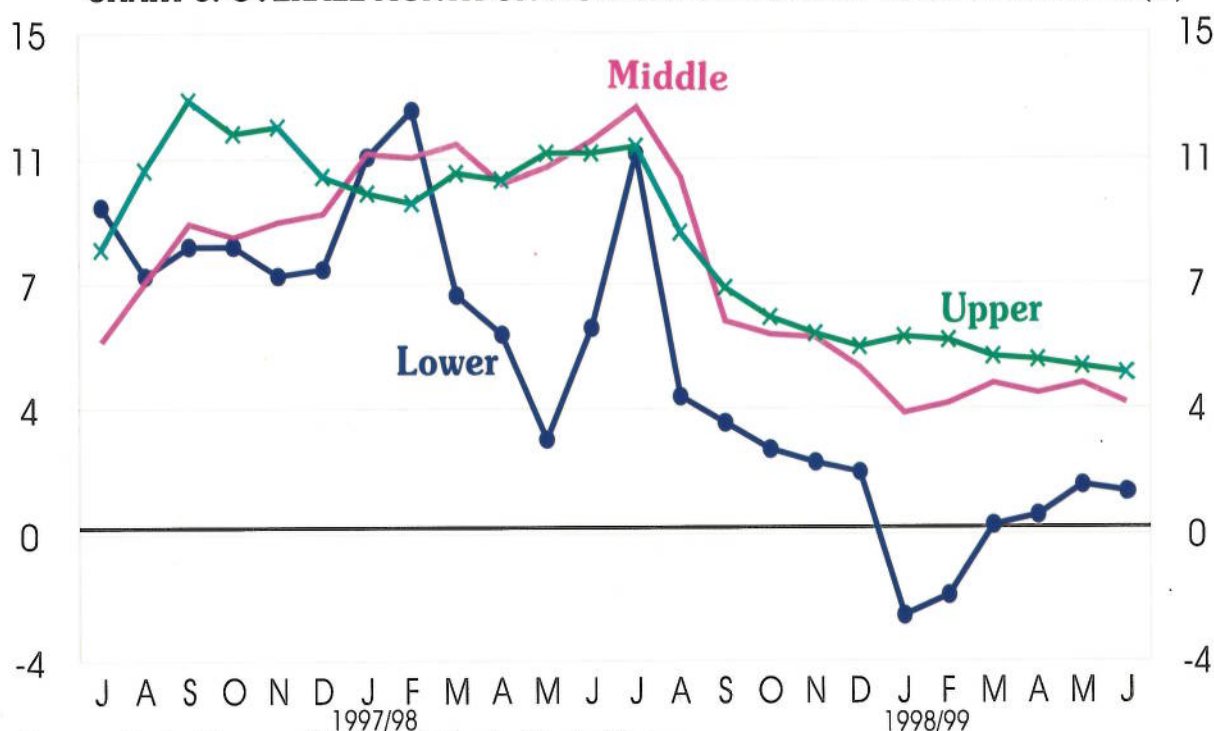


The fall in the overall inflation partly reflected restrained expansion of the money supply, stable shilling exchange rate, improved supplies of basic food items and the fall in the international prices of some essential imports, particularly crude oil during the financial year.

Impact of Inflation on Income Groups in the Financial Year

The fall in inflation was more pronounced for the low income group than for the middle and upper income groups. The month-on-month inflation for the lower group fell from 11.4% in July 1998 to 1.1% in June 1999 while the month-on-month inflation for the middle and upper income groups eased from 12.8% and 11.6% in July 1998 to 3.8% and 4.7% in June 1999, respectively (Chart 3).

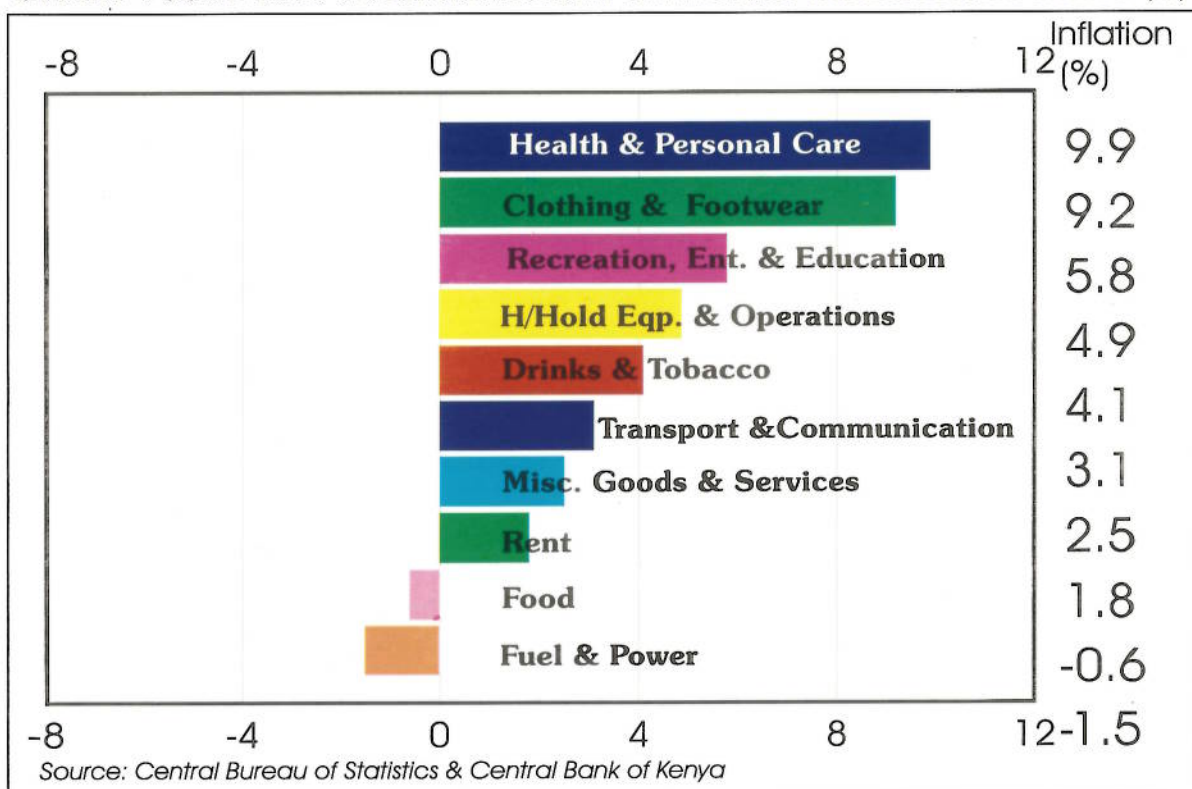
CHART 3: OVERALL MONTH-ON-MONTH INFLATION BY INCOME GROUPS (%)



Source: Central Bureau of Statistics & Central Bank of Kenya

Consumer goods that had the lowest increase in prices during the financial year included basic food items, fuel and power, rent and miscellaneous goods and services (Chart 4).

CHART 4 JUNE 1999 OVERALL MONTH-ON-MONTH INFLATION BY ITEMS (%)



Source: Central Bureau of Statistics & Central Bank of Kenya

Outlook for Inflation in 1999/2000

The single digit inflation experienced in 1998/99 financial year is expected to be maintained throughout the 1999/2000 financial year. This expectation is based on the determination by both the Central Bank and the Government to maintain tight monetary and fiscal policies in order to further improve the macroeconomic environment.

Monetary policy, supported with fiscal policy, will aim at containing underlying month-on-month inflation to below 5% in the year to June 2000. To achieve this objective, broad money supply is programmed to expand by no more than 10% in the year to June 2000. The 10% ceiling on the expansion of the broad money supply is based on less than 2% growth in production of goods and services during the financial year.

INTEREST RATES

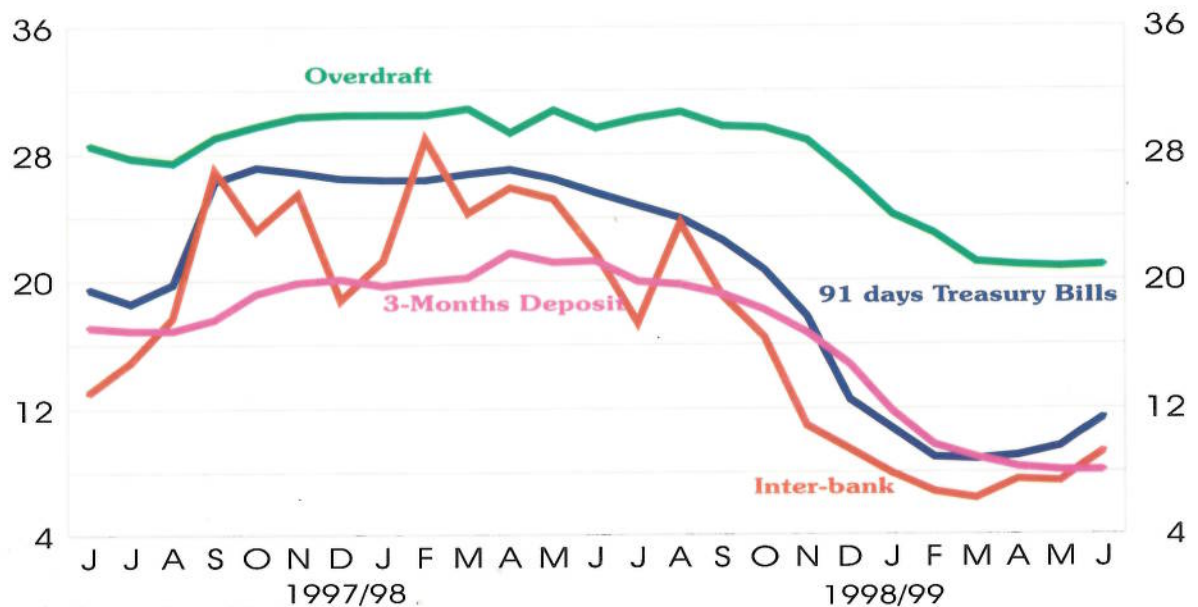
Interest rates fell in the fiscal year as liquidity in the money market increased with the reduction in the mandatory cash ratio and liquidity injection associated with rescue operations of a major commercial bank during the year. The fall in the interest rates was further facilitated by the determination, mainly during the first half of the year, to reduce the Government domestic debt and at the same time shift the balance of the domestic public debt to longer maturities in Treasury bonds (Table 1 and Chart 5).

INTEREST RATES (%)

TABLE 1

	1998						1999					
	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
Overdraft	30.4	30.8	30.7	29.6	29.8	26.7	23.9	22.9	21.1	20.9	20.8	20.9
91-days Treasury bill	24.7	23.7	22.5	20.6	17.7	12.5	10.7	9.0	8.8	9.0	9.6	11.4
182-days Treasury bill	25.4	24.5	22.7	21.1	18.2	13.3	10.3	8.3	7.0	9.5	9.6	10.3
Treasury bond	27.2	-	25.5	24.7	-	22.4	20.1	-	11.9	13.8	-	9.5
Inter-bank rate	17.3	23.6	19.0	16.5	10.9	9.4	7.9	6.7	6.3	7.5	7.4	9.3
3 months deposits	19.6	20.1	21.2	21.2	19.1	14.8	11.7	9.7	8.9	8.3	8.1	8.2
Savings	9.8	9.8	11.2	10.8	10.5	8.0	6.5	5.9	5.5	5.1	4.5	4.6

CHART 5



The decline in the interest rates was also facilitated by the depressed state of the economy in which demand for bank credit, particularly by the private sector, was hardly growing. The decline in the interest rates evolved as follows:

- The 91-day Treasury bill interest rate fell on average from 25.5% at the end of June 1998 to 11.4% at the end of June 1999 and was associated with a fall of about 5% in the outstanding Treasury bills.
- The 3 months deposit interest rate also fell from 21.2% in June 1998 to 8.2% over the year.
- Savings deposit rate fell from 10.8% to 4.6% over the year.
- The interbank interest rate also fell from 21.7% in June 1998 to 9.3% in June 1999. However, the rate being the cost of funds at the shortest end of the market remained more volatile on a daily basis than all other money market interest rates during the year.
- The overdraft interest rate, which is the main lending interest rate in the investible funds market, lagged behind all the other declining interest rates, falling from 29.6% in June 1998 to around 20.9% in June 1999.
- The development in the Treasury bond interest rates followed closely the development in the 91-day Treasury bills rates with the 1-year Treasury bond interest rate falling from 26.8% in June 1998 to 9.5% in June 1999.

The expectation that the decline in the interest rates would eventually encourage increased private sector borrowing and more investment to restart a vigorous economic growth did not materialise in the year. Instead, the decline has to date led to a worsening balance of payment as short-term capital left the country which immediately induced depreciation of the shilling exchange rate and, lately, an upward trend in inflation.

EXCHANGE RATE

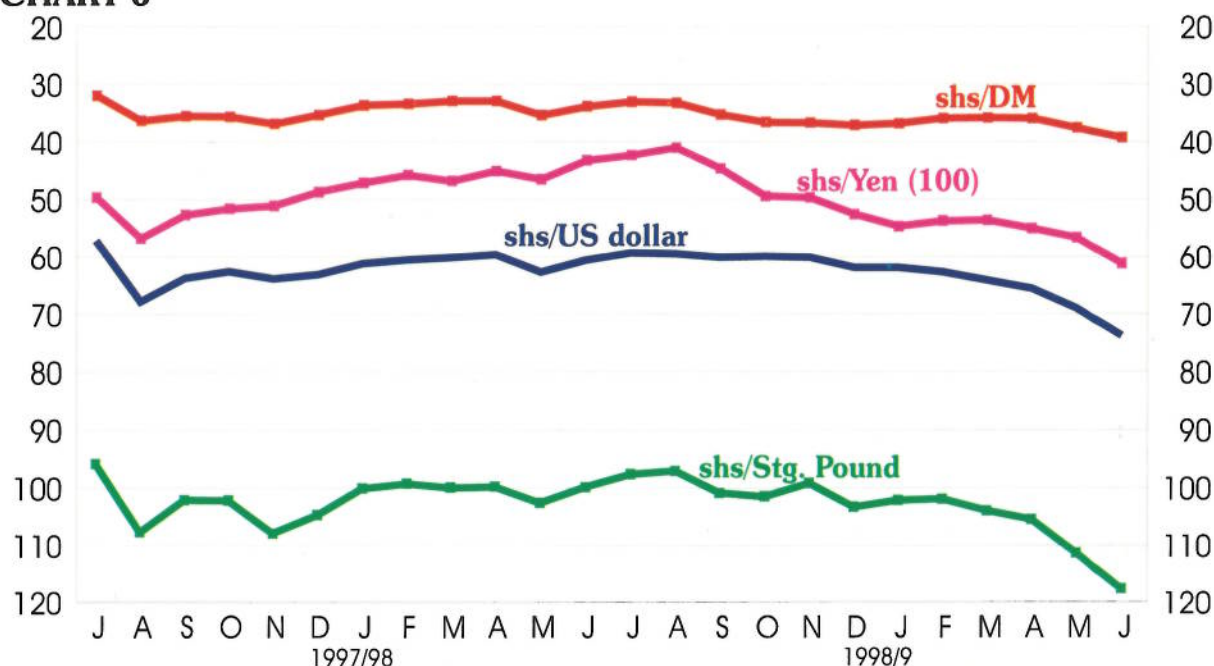
The exchange rate on average depreciated by about 22% in the fiscal year and reflected a shortfall in the foreign exchange market. The shortfall in supply was attributed to capital flight following decline in the interest rate and decline in export receipts following the fall in prices of coffee and tea during the year. The shortfall in supply was also in part due to decline in tourism receipts during the year. The performance of the shilling in the foreign exchange market during the year is shown in Table 2 and Chart 6.

KENYA SHILLING EXCHANGE RATE

TABLE 2

	1998			1999		% Change
	Jun	Sep	Dec	Mar	Jun	
Kshs/US\$	60.5	60.0	61.8	64	73.6	21.7
Kshs/Stg.	99.5	100.8	103.2	103.8	117.5	18.1
Kshs/DM	33.8	35.2	37.0	35.7	39.1	16.7
Kshs/Yen (100)	43.2	44.6	52.5	53.5	61.0	36.8
Kshs/Euro	-	-	-	69.7	75.7	-

CHART 6



Source: Central Bank of Kenya

The weakening of the shilling exchange rate intensified during the second half of the financial year following decline in interest rates and the subsequent short-term capital outflows.

In the international currency market, the US dollar depreciated against the Deutschemark and Japanese yen, but appreciated against the sterling pound (Table 3 and Chart 7). The weakening of the dollar against the Japanese yen followed favourable economic prospects in Japan occasioned by improved confidence in Japan's banking sector. The reduction of interest rates in the US during the year also weakened the US dollar against the other international currencies.

INTERNATIONAL EXCHANGE RATES AGAINST THE US DOLLAR

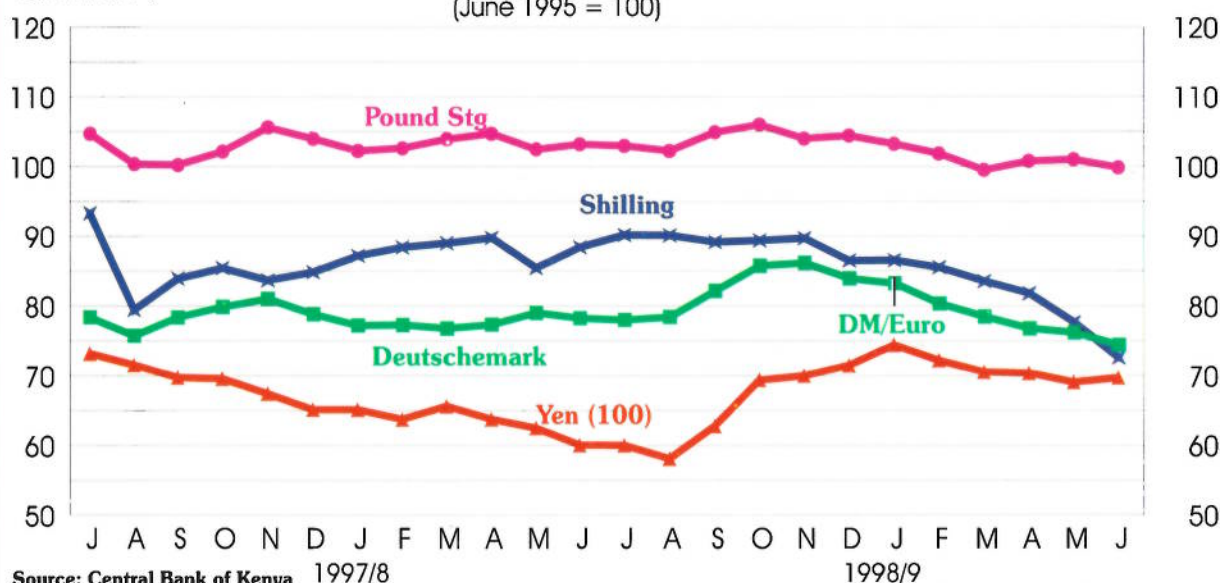
TABLE 3

	1998			1999	
	Jun	Sep	Dec	Mar	Jun
Pound Sterling	0.606	0.595	0.599	0.617	0.626
Deutschemark	1.790	1.705	1.670	1.793	1.882
100 Japanese Yen	140.0	134.5	117.7	119.6	120.7
Uganda Shilling*	1252.4	1278.0	1365.8	1382.4	1442.6
Tanzania Shilling*	677.6	672.0	679.8	691.2	713.9
Euro	-	-	-	0.918	0.963

* units of currency per Kenya shilling

CHART 7

(June 1995 = 100)



Source: Central Bank of Kenya 1997/8

1998/9

GOVERNMENT FISCAL OPERATIONS

The objective of the budget for the fiscal year was to move the fiscal operations towards a balanced budget. This was to be achieved through a more disciplined expenditure policy and stepped-up revenue collection. Both revenue and expenditure as proportions of Gross Domestic Product (GDP), however, fell in the year but the balance, excluding grants, improved compared with the outcome in the previous year. The budget outcome on a commitment including grants, was a surplus equivalent to about 0.5% of the Gross Domestic Product compared with a deficit of 1.6% in the previous year (Table 4).

Expenditure and Net Lending

The expenditure and net lending in absolute terms, increased from shs 195.0bn in the previous fiscal year to shs 197.3bn, falling from 30.6% to 26.7% of GDP. Recurrent expenditure accounted for the whole increase as development expenditure fell both in absolute terms and relative to gross domestic product.

Recurrent expenditure increased by 3.1% from shs 160.3bn in 1997/98 to shs 165.3bn in 1998/99. However, as a percentage of GDP recurrent expenditure fell from 25.2% in the previous fiscal year to 22.3%. The increase in absolute terms reflected increases in major expenditure items during the year as follows:

- Domestic and foreign interest payments rose from shs 30.4bn and shs 7.6bn to shs 31.7bn and shs 8.3bn, respectively;
- The civil service wage bill rose by shs 1.2bn to shs 63.3bn in the year.
- Other expenditures which mainly comprise ministerial expenditures on operations and maintenance rose by 3.0% from shs 60.2bn in the previous fiscal year to shs 62.0bn.

Development expenditure amounted to shs 32.0bn which was shs 2.7bn below the level in the previous fiscal year. This was 4.3% of GDP compared with 5.5% in 1997/98 (Table 4).

TABLE 4: BUDGET OUT-TURN (SHS BN)

	FY 1997/98		FY 1998/99			Over(+)/ Below(-)
	Jun-98 Actual	Share (%)	Jun-99 Actual*	Share (%)	Target	
1. TOTAL REVENUE & GRANTS	184.9		201.2		205.5	-4.4
Revenue	179.6	97.1	196.3	97.6	200.9	-4.6
Ordinary Revenue	168.3	91.1	173.6	86.3	178.2	-4.6
Tax Revenue	144.5	78.2	151.6	75.4	152.9	-1.3
Income Tax	56.0	30.3	55.2	27.5	56.3	-1.0
Value Added Tax	34.8	18.8	39.2	19.5	38.9	0.4
Import Duty	25.0	13.5	28.4	14.1	28.2	0.2
Excise Duty	28.7	15.5	28.7	14.3	29.6	-0.9
Non Tax Revenue	23.8	12.9	21.9	10.9	25.2	-3.3
Investment Income	12.3	6.6	7.3	3.6	7.3	0.0
Investment Income for 1998/99 received in 1997/98			7.6		7.6	
Others	11.5	6.2	7.0	3.5	10.4	-3.3
Appropriations-in-Aid	11.3	6.1	22.7	11.3	22.7	0.0
External Grants	5.3	2.9	4.9	2.4	4.7	0.3
2. TOTAL EXPENDITURE AND LENDING	195.0		197.3		202.2	-4.9
Recurrent Expenditure	160.3	82.2	165.3	83.8	169.5	-4.2
Domestic Interest	30.4	15.6	31.7	16.1	31.0	0.7
Foreign Interest due	7.6	3.9	8.3	4.2	8.3	0.0
Wages and Salaries	62.1	31.9	63.3	32.1	62.0	1.3
Others	60.2	30.9	62.0	31.4	68.2	-6.1
Development Expenditure	34.7	17.8	32.0	16.2	32.7	-0.7
3. DEFICIT ON A COMMITMENT BASIS (1-2)	-10.1		3.8		3.3	0.5
as a ratio of GDP (%)	-1.6		0.5		0.4	
4. ADJUSTMENT TO CASH BASIS	3.0		-9.0		-17.1	
5. DEFICIT ON A CASH BASIS	-7.1		-5.2		-13.8	8.6
As a ratio of GDP (%)	-1.1		-0.7		-1.9	
6. DISCREPANCY: Expenditure (+) / Revenue (-)	0.2		0.0		0.0	
7. FINANCING	7.3		5.2		13.8	-8.6
Domestic (Net)	14.4		11.0		21.0	-9.9
Central Bank	12.0		-2.2			
Commercial Banks	-8.1		16.4			
Other domestic sources:	10.5		-3.2			
Non Banks	8.7		-3.2			
Capital Receipts (privatisation)	1.8		0.0			
External (Net)	-7.1		-5.8		-7.2	1.3
Loan Disbursements	13.9		15.1		15.1	0.0
Loan Repayments	-21.0		-20.9		-22.3	1.3

* Provisional

Source: Treasury and Central Bank of Kenya

Government Revenue and Grants

The Kenyan Revenue Authority stepped up revenue collection during 1998/99. Total revenue amounted to shs 196.3bn which was 9.3% higher than the revenue in the previous fiscal year. However, the revenue in the year under review was 26.5% of GDP compared with 28.2% in 1997/98.

The increase was mainly in tax revenue as non-tax revenue declined during the year. Tax revenue was shs 151.6bn and was 4.9% higher than the amount collected in 1997/98 as a result of the following developments:

- Proceeds from import duty rose from shs 25.0bn to shs 28.4bn mainly because of intensified crackdown on diversion of transit goods into the local market.
- Revenue from VAT increased by 12.6% from shs 34.8bn to shs 39.2bn mainly due to the broadening of the VAT base and enhanced compliance which counteracted the effect of lowering the VAT rate by one percentage point during the year.
- Income tax receipts were shs 0.8bn lower in 1998/99 mainly as a result of reduced corporate tax collections as most companies achieved lower profits in 1998.
- Excise duty collections in 1998/99 remained unchanged at the 1997/98 level of shs 28.7bn.

Other receipts during the year included the following:

- Non tax revenue which amounted to shs 21.9bn, was shs 1.9bn lower than the level in the previous fiscal year.
- Appropriations-in-aid mainly in form of user charges, fees and other levies amounting to shs 22.7bn compared with shs 11.3bn in the previous fiscal year.

In addition to revenue, the Government received grants of shs 4.9bn compared with shs 5.3bn in 1997/98.

Financing

The Government borrowed shs 16.4bn to finance the shortfall in revenue and grants. This was shs 4.3bn less than the amount borrowed in 1997/98. The funds were borrowed wholly from the commercial banks and were used to meet the following payments:

- Net repayment of shs 2.2bn to the Central Bank to redeem some of the debt owed the Bank;
- Net repayment of shs 3.2bn to the non-bank sector mainly to redeem some of the Treasury bonds;
- Net repayment of shs 5.8bn to external creditors; and
- Financing of the budget deficit of shs 5.2bn following less than expected revenue performance in the year.

Domestic Public Debt

The stock of domestic debt stood at shs 150.3bn at the end of 1998/99, representing an increase of shs 4.8bn over the level in 1997/98. This increase arose from budgetary financing requirements as well as net repayment of external debt and resulted from the following changes in the debt structure during the year:

- Government overdraft at the Central Bank increased by shs 0.2bn from shs 5.4bn in June 1998 to shs 5.6bn in June 1999. This was, however, within the statutory limit prescribed in the Central Bank of Kenya Act.
- Outstanding Government securities declined by shs 26.2bn from shs 159.4bn to shs 133.3bn mainly as a result of conversion of shs 31.9bn Government securities to non interest bearing debt.
- Commercial bank advances to Government increased by shs 0.3bn from shs 2.4bn to shs 2.7bn.
- Government deposits declined by shs 2.2bn from shs 20.5bn to shs 18.3bn.

- Payments awaiting clearance to Government accounts fell by shs 3.7bn from shs 4.4bn to shs 0.7bn.
- Non interest bearing debt rose to shs 31.9bn following conversion of Repo securities held by the Bank into non interest bearing debt.

Most of the domestic debt is held in form of Government securities comprising Treasury bills, Treasury bonds and long term stocks. Treasury bills continued to be the major debt instrument. They accounted for 76.3% of the outstanding Government securities while Treasury bonds and stocks accounted for 21.2% and 2.5%, respectively (Table 5).

TABLE 5: GOVERNMENT DOMESTIC DEBT

	June 1998		June 1999	
	shs bn	%	shs bn	%
Overdraft/Advances	12.2	8.4	9.0	6.0
Treasury Bills	121.0	83.2	101.7	67.7
Treasury Bonds	34.7	23.9	28.2	18.8
Government Stocks	3.7	2.5	3.4	2.3
Non-interest bearing debt	-	-	31.9	21.2
Less Deposits	20.5	14.1	18.3	12.2
Advances to Parastatals	5.7	3.9	5.7	3.8
NET DOMESTIC DEBT	145.5	100	150.3	100

Source: Treasury & Central Bank of Kenya

The following developments occurred during the year in the Government securities market:

- Holdings of Treasury bills declined to shs 101.7bn in June 1999 from shs 121.0bn in June 1998. The bills declined by shs 4.5bn between December 1998 and May 1999. This was mainly due to a slack in the market during the second half of the fiscal year associated with a decline in interest rates and consequently a divestiture from Treasury bills. The stock of Treasury bills declined to shs 101.7bn in the month of June 1999 from shs 115.9bn in May 1999, mainly as a result of, transfer by the Bank of shs 12.9bn Repo bills upon maturity, to a non interest bearing debt.

- Treasury bonds declined by shs 6.5bn from shs 34.7bn in June 1998 to shs 28.2 in June 1999. The decline mainly reflected transfer upon maturity, of shs 19.0bn floating rate bonds held by the Bank, to a Government non interest bearing debt. During the year, a new three-year floating rate bond was introduced and 6 issues of one and two-year floating rate bonds floated in an effort to lengthen the maturity structure of domestic debt. Consequently, subscriptions to the issues amounted to shs 27.9bn which more than offset the shs 15.4bn redemptions during the year. Of the shs 27.9bn bonds issued during the year, shs 0.9bn were special fixed interest rate bonds issued in respect of pending Government bills.
- Government long-term stocks declined to shs 3.4bn from shs 3.7bn following redemption of shs 0.3bn stocks during the year. The sale of stocks was suspended in 1986 and the redemption was in line with the policy of gradually phasing out the stocks by the year 2010.

Domestic Debt Service

Domestic debt service amounted to shs 31.7bn in the year compared with shs 30.4bn in the previous fiscal year in spite of the fall in the benchmark 91-days Treasury bills rate from 25.5% in June 1998 to 11.3% in June 1999. This is because of a lag before a fall in interest rates is translated into lower interest payments.

The debt service comprised the following interest payments:

- shs 22.8bn or 71.9% in respect of interest on Treasury bills holdings.
- shs 7.8bn or 24.6% as interest on holdings of Treasury bonds.
- shs 0.7bn or 2.2% as charges on the Government overdraft.
- shs 0.4bn or 1.3% as interest on holdings of long term stocks.

As a proportion of recurrent and total expenditure, domestic interest payments increased from 19.0% and 15.6% in the previous fiscal year to 19.2% and 16.1%, respectively.

BALANCE OF PAYMENTS

The overall balance of payments improved to a deficit of US\$ 63m in the year to June 1999 from a deficit of US\$ 194m in the year to June 1998 (Table 6 and Chart 8). The improvement in the balance of payments followed good performance in the capital account which rose to a surplus of US\$ 269m from a deficit of US\$ 56m. However, the current account deteriorated to a deficit of US\$ 332m or 3.8% of GDP from a deficit of US\$ 138m or 1.6% of GDP.

The Current Account

The current account deficit widened to US\$ 332m in the year to June 1999 from US\$ 138m in a similar period to June 1998. The worsening current account position was attributed to the deterioration in both the trade and services balances. In particular:

- Imports increased to US\$ 3,152m in the year to June 1999 from US\$ 3,061m in the year to June 1998. The increase in imports was partly

TABLE 6: BALANCE OF PAYMENTS (US \$ m)

	1996/97	1997/98	1998/99*
1. Overall Balance (2+3)	291	-194	-63
2. Current Account	-216	-138	-332
Trade Balance	-1,171	-1,055	-1,221
Exports	2,096	2,006	1,930
Imports	3,267	3,061	3,152
Services (net)	955	917	889
of which tourism	455	350	254
3. Capital Account	507	-56	269
Official	-32	-178	-94
Inflows	314	248	283
Outflows	346	426	377
Private & net errors and omissions	539	122	363
Memorandum:			
Gross Reserves	1,322	1,083	969
Official	1,050	771	657
in months of import cover	3.9	3.0	2.5
Commercial Banks	272	311	340

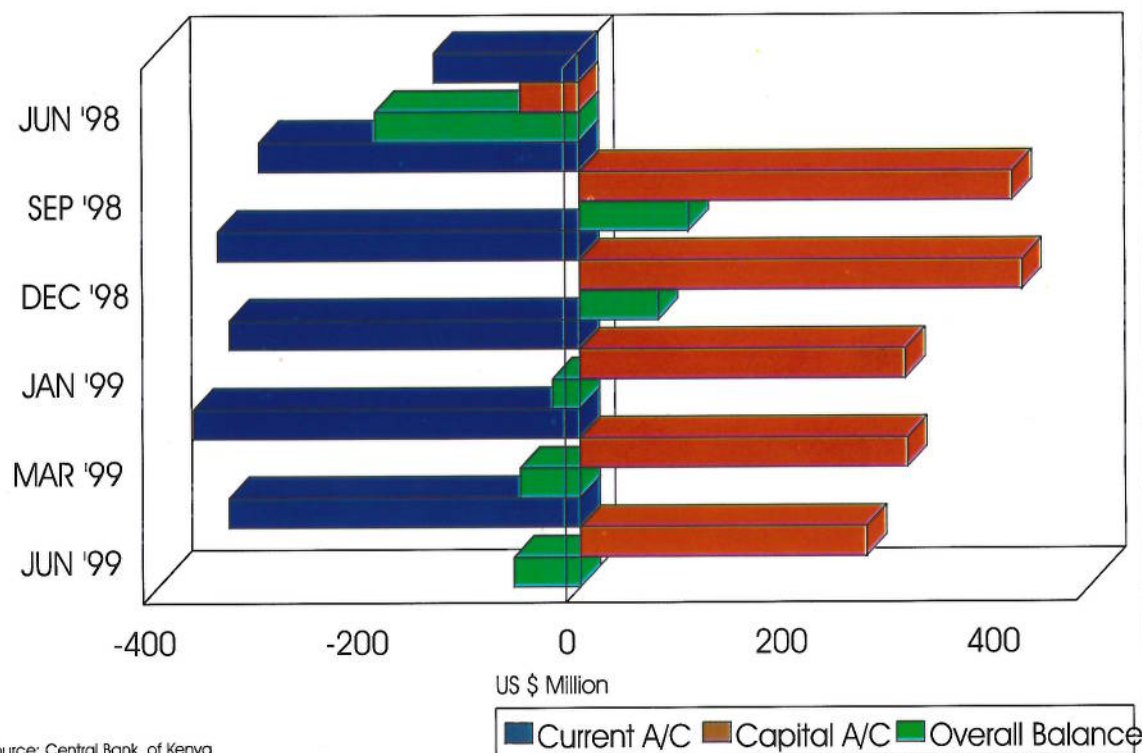
* Provisional

Source: Central Bank of Kenya

attributed to oil imports which increased by 12% to US\$ 522m and partly to an increase in imports of machinery and transport equipment which rose to US\$ 899m from US\$798m. The major decline was in chemicals which fell by 5%.

- Exports decreased to US\$ 1,930m in the year to June 1999 from US\$ 2,006m. All exports except oil products and horticulture declined. Coffee and tea, the main traditional exports, declined by 31% and 10%, respectively to US\$ 160m and US\$ 478m. Coffee exports fell as a result of depressed world coffee prices, while tea exports declined mainly due to reduction in export volume, brought about by unfavourable weather conditions in the second half of the year.
- The services account surplus decreased to US\$ 889m in the year to June 1999 from US\$ 917m over the same period to June 1998. The deterioration in the services account was mainly due to reduced tourism earnings which declined by 23% to US\$ 254m from US\$ 350m. Official transfers also declined from US\$ 85m to US\$ 83m.

CHART 8: OVERALL BALANCE OF PAYMENTS AND ITS COMPONENTS (US\$M)



Capital and Financial Account

The capital account, which had deteriorated to a deficit of US\$ 56m in the year to June 1998, improved to a surplus of US\$ 269m in the year to June 1999. Developments in the capital account were due to a decrease in official long-term capital outflow of US\$ 377m from an outflow of US\$ 426m following reduction in external debt repayment. Official long-term capital inflows from US\$ 248m to US\$ 283m in the year to June 1999. To finance the current account deficit, private capital inflows increased to US\$ 360m from US\$ 122m, including net errors and omissions.

Foreign Exchange Reserves

Foreign exchange reserves held by the banking system stood at US\$ 997m, equivalent to 3.8 months of imports cover at the end of June, 1999 compared with US\$ 1,083m equivalent to 4.2 months of imports cover at the end of June 1998. The decline in the banking system foreign exchange reserves mainly reflected unfavourable developments in the current account of the balance of payments, which worsened by US\$ 194m in the year.

Out of the total reserves, gross official foreign exchange reserves was US\$ 657m at the end of June 1999, equivalent to 2.5 months of imports cover compared with US\$ 771m, equivalent to 3.0 months of imports cover a year earlier. Commercial banks' foreign exchange reserves was US\$ 340m at the end of June 1999 compared with US\$ 311m at the end of June 1998.

External Debt

Kenya's external debt stood at shs 326.1bn, equivalent to US\$ 4.5bn in June 1999, shs 5.8bn lower than the amount outstanding at the end of June 1998. As a proportion of GDP, external debt was 44.1% as at end June 1999 compared with 52.1% at the end of June 1998. Multilateral institutions remained the major creditors accounting for shs 184.5bn or 56.6% of the outstanding external debt. Bilateral creditors were owed shs 127.2bn or 39.0% of the stock. Export credit and commercial external debt accounted for the remaining shs 14.4bn or 4.4% of the external debt (Table 7).

Payments to external creditors in form of debt service in the 1998/99 fiscal year amounted to shs 28.4bn or US\$ 450.7m compared to shs 29.2bn in 1997/98. As a ratio of exports of goods and services, external debt service declined to 12.9%. The debt service comprised shs 20.9bn principal repayments and shs 7.5bn interest payments. Payments to bilateral creditors comprised the largest proportion of debt service, accounting for shs 10.8bn or 38.0% of total debt service. Payments to multilateral and commercial creditors amounted to shs 8.6bn and shs 9.0bn or 30.4% and 31.6% of debt service, respectively.

TABLE 7: DISTRIBUTION OF EXTERNAL PUBLIC DEBT

	June 1998		June 1999*	
	shs bn	%	shs bn	%
BILATERAL	128.0	38.6	127.2	39.0
MULTILATERAL	181.9	54.8	184.5	56.6
COMM. BANKS	21.0	6.3	13.4	4.1
EXPORT CREDIT	1.0	0.3	1.0	0.3
TOTAL	331.9	100	326.1	100

* Provisional

Source: Treasury and Central Bank of Kenya

MONETARY DEVELOPMENTS

In pursuit of price stability, monetary policy aimed at reducing inflation to within 5% by the end of the financial year. Accordingly, the Bank intervened in the domestic money market whenever it was necessary through the Open Market Operations mainly to minimise excess liquidity in the market. The intervention using sales of Treasury bills became increasingly necessary following injection of liquidity through reduction of required minimum cash ratio, and an operation to save a bank during the year. The interventions in the money market ensured that reserve money path remained on track. The expansion of the money supply therefore remained consistent with the growth in production throughout the year. The management of reserve money and money supply also ensured that the domestic foreign exchange market remained stable throughout the year.

Reserve Money Management

Reserve money, comprising currency in circulation and cash balances of commercial banks and non-bank financial institutions at the Central Bank, forms the base on which the monetary authorities influence monetary expansion. During the 1998/99 financial year, the Central Bank regulated reserve money by setting monthly targets. Reserve money remained within target throughout the year except in December 1998 when the target was exceeded following an injection of shs 2.5bn by the Government into one of the banks in which it is a shareholder to provide it with liquidity support.

Reserve money fell by 7.2% to shs 72.8bn in the year and was in the following components of the aggregate:

- Commercial banks' balances at the Central Bank fell by shs 8.2bn to shs 30.6bn.
- Deposits held by non-bank financial institutions (NBFIs) at the Central Bank fell by shs 0.6bn to shs 0.8bn.
- Currency in circulation increased by shs 3.2bn to shs 41.4bn.

The fall in reserves of commercial banks and NBFIs reflected the reduction of the cash ratio requirement during the first half of the fiscal year from

15% in June 1998 to 12% with effect from December 1998. The reduction amounted to an initial injection of shs 7.3bn into the domestic money market. The decline in reserve money in the twelve months to June 1999 was reflected in the NFA falling by shs 3bn and NDA by shs 2.7bn. The fall in the net foreign assets of the Bank reflected the following changes in the foreign exchange position:

- An increase of shs 2bn in the first half of the fiscal year following purchases of foreign exchange from the domestic inter-bank market and;
- A fall of shs 5bn in the latter half of the year arising from payments of official debt using foreign exchange holdings of the Central Bank.

Meanwhile, the fall in the net domestic assets of the Bank reflected the following changes:

- A decline of shs 2.2bn in net credit to the Government which followed shs 0.8bn net redemption of Government securities; a fall of shs 3.7bn in items on transfer to the Paymaster General; shs 2.1bn reduction in Government deposits; and shs 0.2bn increase in the use of Central Bank overdraft facility.
- A fall of shs 5.6bn in advances to commercial banks mainly due to a liquidity mop up of shs 5.3bn through sales of Treasury bills under Open Market Operations, and a repayment of shs 0.3bn of outstanding loans to banks under liquidation.
- An increase of shs 5.1bn in other net domestic assets reflecting increases of shs 17.9bn and shs 12.8bn in other assets and other liabilities of the Bank, respectively.

Money and Credit

Expansion of money supply (M3) increased to 6.4% in 1998/99 from 3.6% in the previous year. The increase was, however, within the target of 10% programmed for the year (Table 8). The growth in the money supply was supported by an expansion of shs 19.6bn or 7.9% in net domestic assets (NDA) of the banking system which more than offset the decline of 2.2% in net foreign assets (NFA).

TABLE 8: MONEY SUPPLY AND ITS SOURCES (ANNUAL BASIS), KSHS BN

	1998	1999	Change		Target	Dev.
	June	June	Absolute	%	Jun '99	
1. Money supply						
Money supply, M2 1/	274.1	292.2	18.1	6.6		
Money supply, M3 (2+3) 2/	291.2	309.9	18.6	6.4	309.5	0.4
Money supply, M3X 3/	314.6	340.7	26.1	8.3		
Money supply, M3XT 4/	376.0	393.5	17.5	4.7		
2. Net foreign assets 5/	43.6	42.7	-0.9	-2.2	39.7	3.0
Central Bank and Treasury	33.6	31.6	-2.0	-6.0	28.4	3.2
Commercial banks	10.1	11.2	1.1	10.4		
NBFIs	-0.1	-0.1	0.0	-35.1		
3. Net domestic assets (3.1+3.2)	247.6	267.2	19.6	7.9	269.8	-2.6
3.1 Domestic credit (3.1.1+3.1.2)	334.5	369.4	35.0	10.5	368.1	1.3
3.1.1 Government (net)	74.4	93.8	19.4	26.0	95.9	-2.1
From Central Bank (net)	31.3	27.7	-3.6	-11.5	27.7	0.0
Overdraft to Government	5.4	5.6	0.2	3.5	7.0	-1.4
Cleared items awaiting posting to PMG	4.4	0.7	-3.7	-85.1	0.0	0.7
Rediscounted Securities	1.0	0.1	-0.8	-2.1	0.1	0.0
Treasury Bills	17.6	5.0	-12.6	-71.6	17.9	-12.9
Treasury Bonds	19.2	0.0	-19.2	-100.0	19.0	-19.0
Non-interest Bearing Govt. Debt	0.0	31.9	31.9	0.0	0.0	31.9
Government Deposits	-16.3	-15.6	0.7	-4.3	-16.3	0.7
From Commercial Banks & NBFIs (net)	43.1	66.1	23.0	53.2	68.2	-2.1
Commercial Banks	41.2	64.3	23.2	56.3		
NBFIs	2.0	1.8	-0.2	-10.7		
3.1.2 Private sector and other public sector:	260.0	275.6	15.6	6.0	272.3	3.3
From Central Bank	1.2	1.3	0.1	11.8		
From Commercial banks	228.3	245.2	16.9	7.4		
From NBFIs	30.5	29.1	-1.5	-4.9		
3.2 Other assets net	-86.8	-102.2	-15.4	17.7	-98.4	-3.8
4. Reserve money	78.5	72.8	-5.7	-7.2	69.7	3.1
Cash in till	5.3	4.8	-0.4	-8.2	5.0	-0.1
Currency outside banks	33.0	36.6	3.6	11.0	36.2	0.4
Deposits with CBK	40.2	31.4	-8.9	-22.1	28.5	2.8
Memorandum items						
Treasury bills outstanding	121.0	115.7	-5.4	-4.4		

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

1/ Money supply M2, is money supplied by Central Bank and commercial banks. It comprises currency outside banking institutions, other nonbanking institutions' deposits with the Central bank, demand, savings and time deposits as well as certificates of deposits held by the private sector and 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 and time deposits as well as certificates of deposits held by the private sector and parastatals with NBFIs. M3 excludes deposits of both the Central and 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 and outstanding Government Treasury securities with the nonbanking public.

5/ NFA at constant exchange rate of Shs 62.025 to the US dollar (September 30th 1997).

Source: Central Bank of Kenya

The increase in NDA was as a result of the following changes in domestic borrowing:

- An increase of shs 23.2bn or 56.3% in Government borrowing from commercial banks compared with a decline of 18.8% in the previous year.
- A fall of shs 3.6bn or 11.5% in Government indebtedness to the Central Bank compared with an increase of 61.9% in the previous year.

- A decline of shs 0.2bn in Government borrowing from NBFIs compared with a decline of shs 1.6bn in the twelve months to June 1998.
- An increase of shs 15.6bn or 6.0% in credit to private and other public sectors compared with increase of 17.9% in the previous year with most of the increase coming from commercial banks.
- A fall of shs 15.4bn or 17.7% in other assets net of other liabilities of the banking system compared with a fall of 28.9% in the previous year.

The net foreign assets of the banking system fell by shs 0.9bn or by 2.2% compared with a decline of 19.5% in the previous year. The fall was reflected in shs 2.0bn decline in the holdings of the Central Bank which offset an increase of shs 1.1bn in NFA of the commercial banks.

Cash and Liquidity of Banks and NBFIs

The minimum liquidity ratio required of deposit-taking institutions remained 20% as in the previous year. All banking institutions met the minimum requirement and maintained ratios above the statutory requirement:

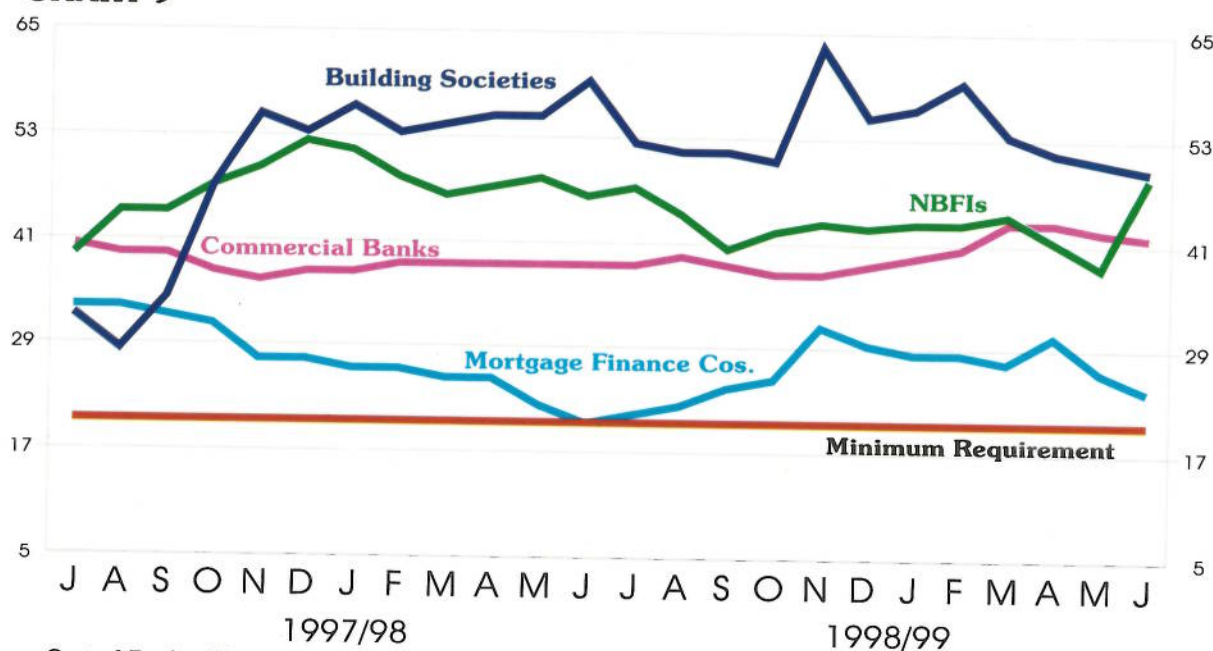
- Commercial banks increased their liquidity ratio from 38% in June 1998 to 41% in June 1999, with an average of 40% during the year.
- NBFIs maintained ratios ranging between 38 and 48%, with an average of 43% during the year.
- Building societies maintained average liquidity ratio of 53% which was 33 percentage points higher than the statutory requirement.
- Mortgage finance companies had an average liquidity ratio of 26% against the statutory minimum of 20%.

The banking system therefore remained solvent despite liquidity problems experienced by some banks during the year.

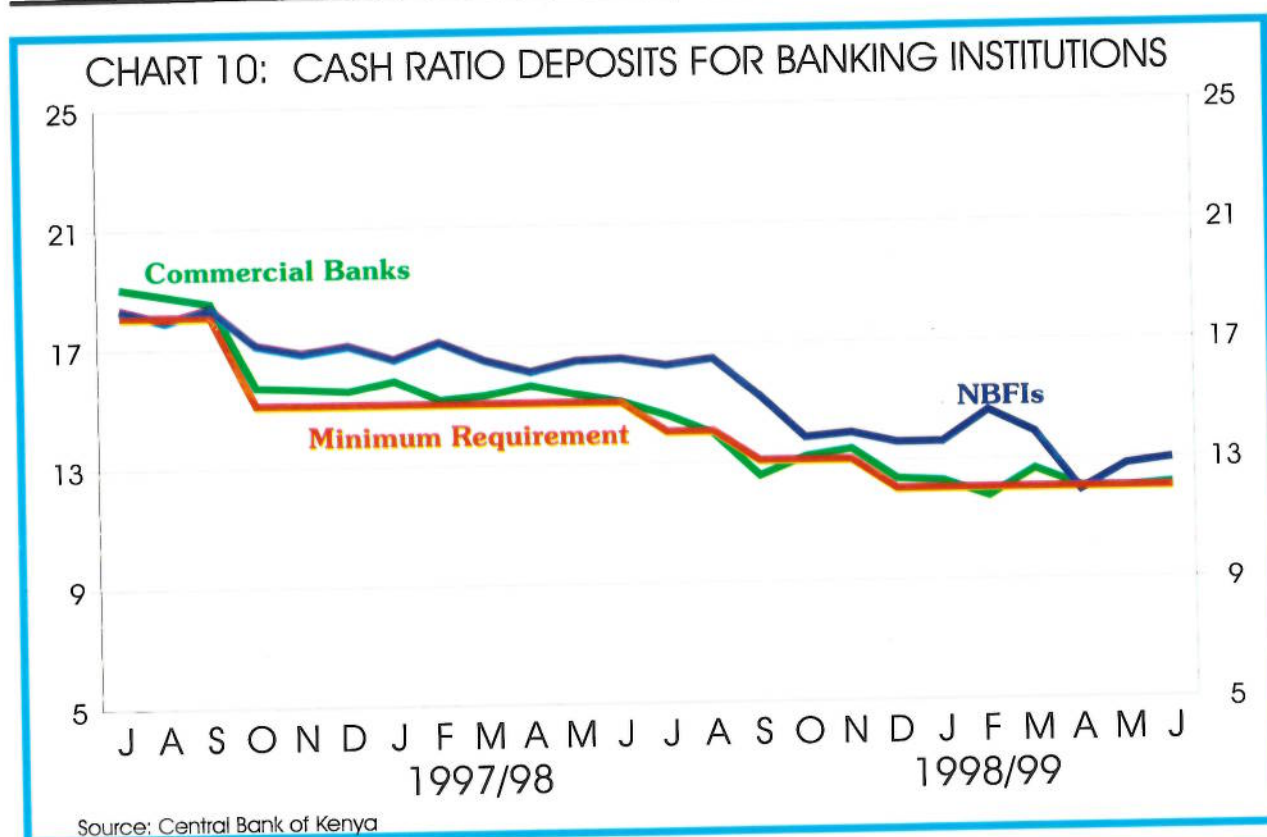
The cash ratio was reduced three times during the year from 15% in June 1998 to 14% in July, and further to 13% and 12% in September and December, 1999 respectively. Commercial banks and NBFIs consequently adjusted their cash ratios downwards while adhering to the minimum requirements (Table 9 and Charts 9 and 10):

BANKING INSTITUTIONS CASH AND LIQUIDITY RATIOS
TABLE 9

	1998						1999					
	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
Cash Ratio (%)												
Commercial Banks	14.6	14.0	12.5	13.1	13.4	12.4	12.3	11.7	12.6	12.0	12.0	12.1
NBFIs	16.2	16.4	15.2	13.8	13.9	13.5	13.6	14.6	13.8	11.9	12.7	12.9
Banking System	15.4	15.2	13.8	13.4	13.6	13.0	12.9	13.2	13.2	12.0	12.4	12.5
Minimum Requirement	14	14	13	13	13	12	12	12	12	12	12	12
Liquidity Ratio (%)												
Commercial Banks	38	39	38	37	37	38	39	40	43	43	42	41
NBFIs	47	44	40	42	43	42	43	43	44	41	38	48
Minimum Requirement	20	20	20	20	20	20	20	20	20	20	20	20
Mortgage Finance Cos.	21	22	24	25	31	29	28	28	27	30	26	24
Building Societies	52	51	51	50	63	55	56	59	53	51	50	49
Minimum Requirement	20	20	20	20	20	20	20	20	20	20	20	20

CHART 9

- The average cash ratio for commercial banks fell from 15.1% in June 1998 to 12.1% in June 1999, thereby remaining slightly above the statutory requirement.
- The average cash ratio for NBFIs fell from 16.5% in June 1998 to 12.9% in June 1999, averaging 14.0% during the year and remaining higher than the statutory requirement.



Monetary Policy Measures 1998/99

The following measures were implemented to enhance efficiency in management of the money supply.

- **Reduction of the Cash Ratio**

The minimum cash ratio was lowered gradually to 12% in December 1998 from 15% in June 1998.

- **Improvement of the Data Base**

The Central Bank required commercial banks and NBFIs to break down loans and advances into 'loans and advances and capitalised interest' at every stage of reporting, in order to improve credit analysis.

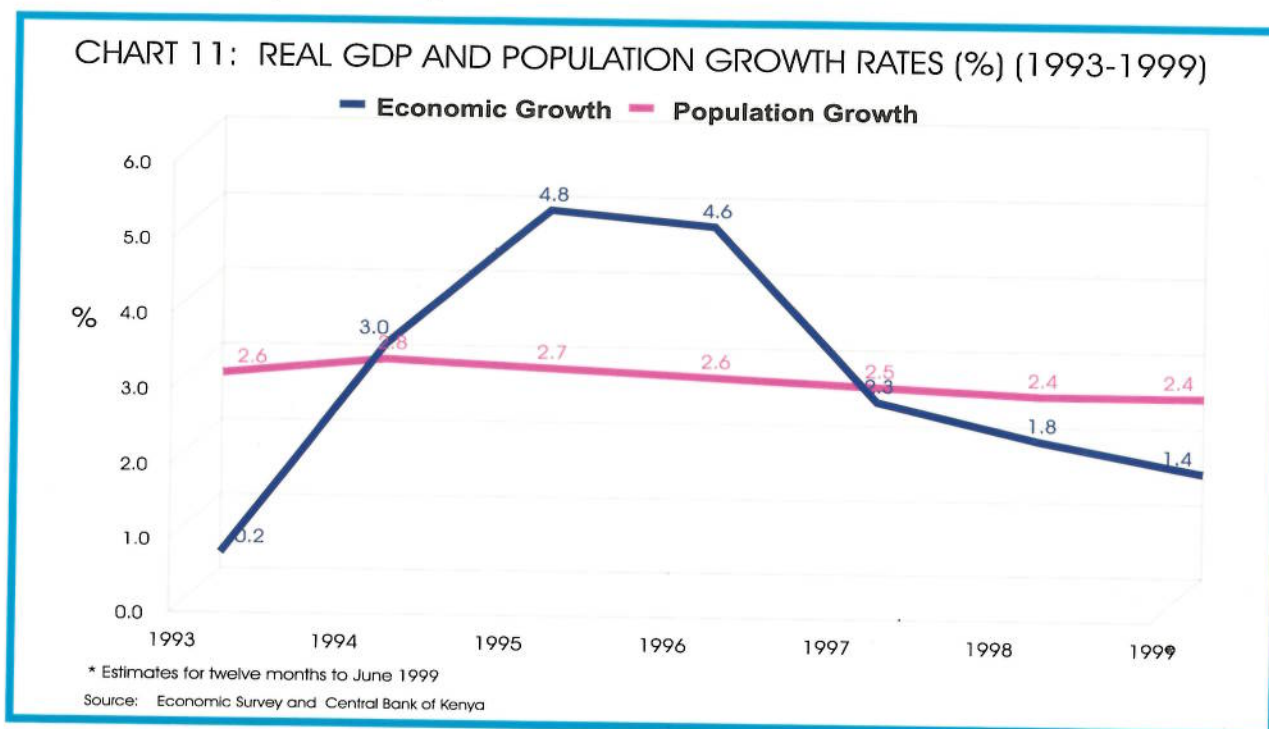
- **Investment in Government Securities**

The Central Bank required commercial banks and NBFIs to include 182-days' Treasury bills among liquid assets for purposes of computing the liquidity ratio. The measure was intended to encourage the holding of longer dated Treasury bills so as to lengthen the maturity structure of Government debt.

PRODUCTION

Overall Growth

The decline in economic growth which started in 1996/97 continued through 1998/99 fiscal year. Output from key sectors reveals that the real Gross Domestic Production (GDP) expanded by **1.4% in the year to June 1999** compared with 2.3% in 1997 and 1.8% in 1998, and remained below the growth of population since 1997. The slowdown in growth was in almost all sectors with agriculture, manufacturing and services being the most affected (Chart 11).



Causes of the Slowdown in Growth

The main cause of the slowdown in growth is the persistent decline in the country's incentives structure attributed to a combination of factors that include poor infrastructure, reduced investor confidence, delays in implementing economic reforms, reduced inflow of donor assistance and incidences of insecurity.

Ministries and Government agencies are currently taking appropriate steps to redress the constraints to economic growth. The road network, for instance, is being rehabilitated throughout the country. Inefficiency in the telecommunications sub-sector has already been addressed through the ongoing divestiture programme while privatisation and commercialisation is underway for some key Government agencies in transport and communication.

The establishment of an anti-corruption authority together with the envisaged improvement in the public sector administration are expected to enhance investor confidence and the country's relationship with main development partners.

Sectoral Performance

Agriculture

Agriculture, which contributed 26.2% of GDP (Table 10), expanded by 1.5% in 1998/99 fiscal year compared with 1.6% in 1998 and 1.2% in 1997 calendar year. The depressed growth in agriculture, a sector with potential to expand by more than 5% per annum, continues to stem from the poor weather especially experienced in the second half of the financial year. Other factors which constrained growth include poor infrastructure, particularly roads that reduced the volume of marketed agricultural output and increased the costs of distributing farm inputs.

TABLE 10: GROSS DOMESTIC PRODUCT & SECTOR SHARES AT CONSTANT 1982 PRICES

Main Sectors	Real GDP in shs m			Ann. GDP Growth (%)		shares of GDP(%)	
	1993	1998	Est. in Year to June '99	1998	Est. in Year to June '99	1993	1998
Agriculture/1	23,084	26,810	26,839	1.6	1.5	26.6	26.2
Manufacturing	11,984	13,582	13,652	1.3	1.2	13.8	13.3
Building & Construction	2,232	2,508	2,541	1.3	1.3	2.6	2.5
Electricity and Water	910	1,036	1,054	2.2	2.1	1.0	1.0
Trade, Restaurant and Hotel	9,591	12,718	12,864	2.5	2.6	11.0	12.4
Transport, Storage & Communication	5,314	6,124	6,162	1.3	1.2	6.1	6.0
Financial Services	8,123	10,690	10,857	3.2	2.9	9.4	10.5
Government Services	13,996	14,974	15,031	0.8	0.7	16.1	14.6
Others/2	11,631	13,828	14,019	2.4	2.2	13.4	13.5
TOTAL GDP (1982 prices)	86,865	102,270	103,019	1.8	1.4	100.0	100.0

1. Includes forestry and fishing.

2. Includes non-monetary, ownership of dwellings, mining and quarrying, domestic and other services less imputed bank charges.

Source: Central Bureau of Statistics and Central Bank of Kenya

Due to these factors, the production of most food crops, particularly maize and wheat, fell to below last year's output. The output of tea, a major export crop, also declined by 11.0% to 253,458 tonnes in 1998/99 from 284,936 tonnes in 1997/98. Earnings from tea exports also declined by 7.5% to shs.25.3bn in the first ten months of 1998/99 fiscal year. The output of coffee however recovered by 20% to 57,903 tonnes in 1998/99 from the depressed level of 47,950 tonnes in 1997/98.

Manufacturing

Manufacturing, whose contribution to GDP has declined to 13.3% in 1998 from 13.8% in 1993, expanded by 1.2% in 1998/99 fiscal year compared with 1.3% in 1997/1998 and 1.9% in 1997. The depressed performance was mainly caused by poor infrastructure, particularly roads, telecommunication services and electric power supply. Operational inefficiency in the main seaports combined with inefficiency in rail transportation also contributed by increasing inefficiency in the manufacturing sector.

Recovery, driven mainly by increased demand for manufactured goods generated by the opening up of trade in the East African Community, is expected in early 2000. Substantial recovery will however continue to depend on the decline in the general costs of manufacturing and conducting business in Kenya. This will only be achieved through the rehabilitation of all infrastructure combined with substantial improvement in the delivery of public services.

Services Sector

Activity in most services sectors remained depressed in fiscal year 1998/99. Growth in output from trade, restaurants and hotels is estimated to have stagnated at 2.6% in the twelve months to June 1999 compared with 2.5% in 1998 and 3.8% in 1997. The poor performance in the sector, which has the potential to expand by over 8.0%, continues to stem from reduced tourism caused by competition from alternative tourist destinations in the sub region. Incidences of insecurity and the negative publicity carried out on Kenya over the past also contributed to the sector's poor performance.

Services extended by Government stagnated at 0.7% in 1998/99 compared with 0.8% in 1998 and 1.1% in 1997. The slowdown in Government services, which accounted for 14.6% of GDP in 1998 from 16.1% in 1993, is expected to continue as privatization and retrenchment is intensified in order to create room for improved efficiency in the sector.

Services by finance, insurance and real estate expanded by 2.9% in 1998/99 compared with 3.2% in 1998 and 5.3% in 1997. The poor performance in the sector was mainly traced to instability in the banking sector. This instability was caused by poor lending policies that increased the portfolios of non-performing loans in a few banks. The problem is being addressed

by enactment of appropriate legislation aimed at strengthening the entire financial system. Due to the reform measures introduced since 1993, the contribution of the sector to GDP rose to 10.5% in 1998 from 9.4% in 1993.

Infrastructural Services

Transport, storage and communications services expanded by 1.2% in the twelve months to June 1999 from 1.3% in 1998 and 2.0% in 1997. The poor performance in the sector continued to rise mainly from both operational inefficiencies and administrative bottlenecks, particularly in roads and telecommunications.

Other Sectors

Building and construction grew by 1.3% in 1998/99, the same rate as in 1998. The low level of activities in the sector was traced to reduced public sector construction activities following the tight fiscal policy pursued in 1998/99. The poor performance in the sector is reflected by the decline in cement production, a key input in the industry, that declined by 7.1% to 1,044,423 tonnes in fiscal year 1998/99 from 1,124,727 tonnes in 1997/98. Residential and non-residential building plans approved by several urban centers also declined over the same period.

Investment and Savings in 1998

The depressed performance is further reflected by the steady decline in investment, which fell to 17.1% of GDP in 1998 from 20.4% in 1996 and 18.5% in 1997. Public sector investment declined following tight fiscal policy. On the other hand, the private sector investment declined with reduced local and foreign investor confidence. A larger proportion of investment continues to be financed using private domestic savings, which however declined to 17.5% of GDP in 1998 from 25.6% in 1995. Foreign financing of investment has remained almost static at around 3.5% of GDP in both 1997 and 1998 (Table 11 and Chart 12).

The decline in savings and investment since 1996 continued to slowdown the process of economic recovery. This problem is expected to reverse in the period ahead as corrective measures are implemented. Investment and savings relative to GDP for the following financial year are expected to be better than for this year.

INVESTMENT AND SAVINGS, 1994-1998**TABLE 11**

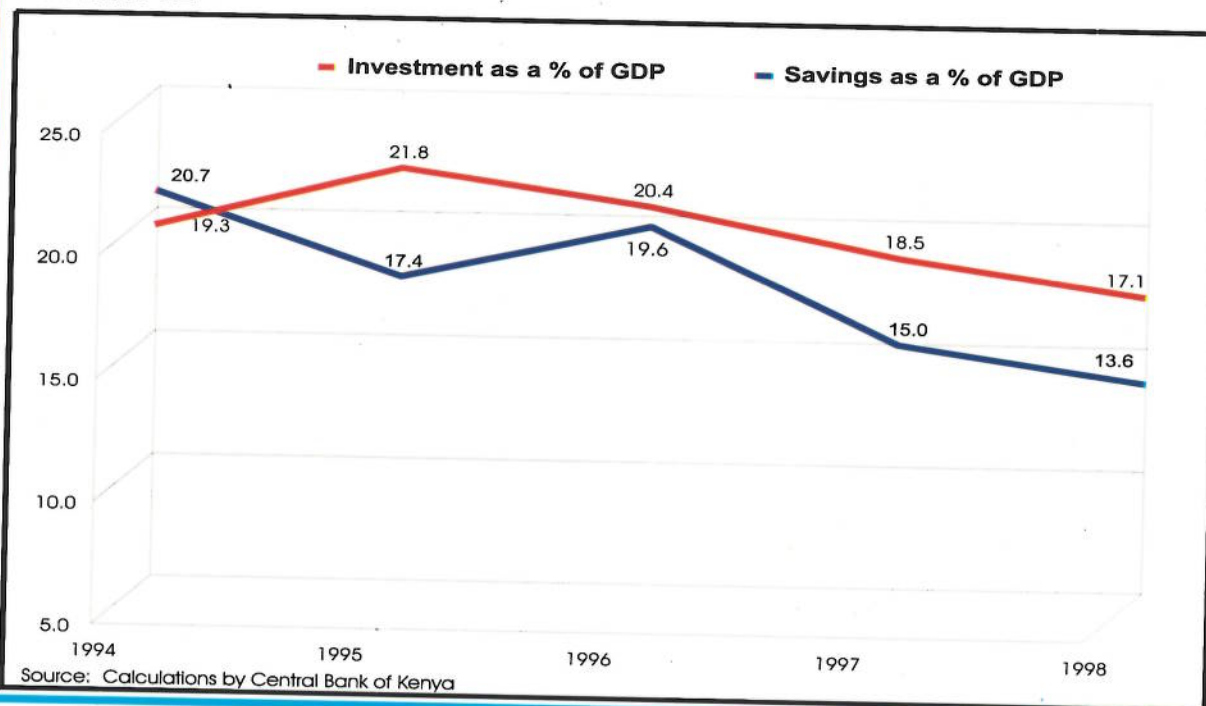
	1994	1995	1996	1997	1998
IN SHS MILLION					
1. Total Investment	77,299.6	101,517.2	107,468.8	115,270.0	120,017.4
Private	41,197.2	64,858.0	67,833.6	73,404.8	78,493.6
Public	36,102.4	36,659.2	39,635.2	41,865.2	41,523.8
FINANCING					
2. Foreign Borrowings	-5,822.0	20,618.0	4,198.0	22,158.0	24,508.2
3. Domestic Savings/1	83,121.6	80,899.2	103,270.6	93,112.0	95,509.2
Private	104,665.0	114,482.4	134,736.4	124,061.2	122,487.0
Public	-21,543.4	-33,583.2	-31,465.8	-30,949.2	-26,977.8
% OF GDP					
4. Total Investment	19.3	21.8	20.4	18.5	17.1
Private	10.3	13.9	12.9	11.8	11.2
Public	9.0	7.9	7.5	6.7	5.9
FINANCING					
5. Foreign Borrowings	-1.5	4.4	0.8	3.6	3.5
6. Domestic Savings/1	20.7	17.4	19.6	15.0	13.6
Private	26.1	24.6	25.6	20.0	17.5
Public	-5.4	-7.2	-6.0	-5.0	-3.9
7. Memorandum Items					
GDP (mkt prices)	400,679	465,272	526,625	620,943	698,958
ICOR/2	6.071	4.284	4.385	8.398	10.862

Notes

1. Figures adjusted from those published in Economic Survey, 1999

2. ICOR is the Incremental Capital Output Ratio, which an indicator of efficiency in use of capital

Source: Economic Survey, 1999 and calculations by CBK

CHART 12**Outlook for Fiscal Year 1999/2000**

Economic growth is expected to remain depressed in early 1999/2000 fiscal year but start to recover in the second half of the year following corrective measures to be implemented. The measures are expected to strengthen investor confidence and get the economy started on the path to recovery.

DEVELOPMENTS IN THE BANKING INDUSTRY

The overall banking sector performance in 1998 was poor with profitability declining by 55% from the 1997 level. The main causes of poor performance were mismanagement, insider self-serving practices, slow recoveries due to ineffective court system, inadequate legal powers vested on CBK and sluggish performance of the economy.

The sector experienced instability and five institutions namely, Trust Bank, Reliance Bank, City Finance Bank, Bullion Bank and Prudential Bank, were placed under statutory management while one building society (Prudential Building Society) was put under an investigator. There was also a run on the National Bank of Kenya which necessitated the Government to pay guaranteed loans so as to inject liquidity into the bank.

Restructuring packages for the banks under statutory management are still being worked out in collaboration with depositors' committees. Plans to re-open Trust Bank were finalised and the bank resumed operations on August 9, 1999. There is optimism that Bullion Bank will also reopen. The revival of the others will depend on the success of the restructuring plans being negotiated with the Depositors' committees.

Response to the Banking Instability

To foster a sound and stable banking system and protect depositors' funds, the Central Bank put in place the following measures:

- The Banking Act was amended to give CBK more powers to enforce banking laws and regulations. This included the power to levy monetary penalties for non-compliance.
- Banks and NBFIs are required to raise their minimum capital to shs 200m and shs 150m, respectively, by 31st December 1999. They will also be required to raise their capital progressively to shs 500m and shs 375m for banks and NBFIs, respectively, by year 2002.
- The Building Societies' Act was also amended to harmonise operations of building societies with those of banking institutions. Minimum

subscription capital for building societies was increased from shs 5 million to shs 150 million.

- Bank Supervision Department was strengthened through recruitment of additional staff and training.
- The setting up of credit reference bureaus and rating agencies was encouraged with one credit reference bureau being launched in February 1999. The bureau collects and disseminates creditor data from many sectors with special emphasis on the banking sector. Ultimately, these data are used to gauge the creditworthiness of prospective borrowers. In this way, lending institutions will be able to avoid dealing with habitual bad debtors and hence stem the increase of non-performing advances.
- Banks and NBFIs are now required to publish their financial statements to provide information on total non-performing loans, provisions for bad and doubtful debts as well as advances to shareholders, directors, employees and associates. Institutions and their directors are thus expected to be more transparent and accountable for their actions.
- Bearer certificates of deposit, which have been observed to be volatile in nature and were being abused as avenues for money laundering and other malpractices are to be phased out by 31st December, 1999.
- A workshop was held in September 1998 to sensitise the banking industry on the Year 2000 date change. Another workshop was held in July 1999 to assess progress and focus on other outstanding issues.
- Seminars to sensitise directors of institutions as to their duties and responsibilities were held in 1998 and 1999. These efforts should enhance effective supervision of institutions by boards of directors.

Future Plans

To sustain the stability in the sector, the Central Bank will do the following:

- Enforce more stringently banking laws and prudential regulations.

- Work with the various stakeholders to encourage mergers of small banks to make them more competitive.
- Encourage Government divestiture from banking institutions. This may include allowing strategic partners to acquire a significant stake.
- Ensure all banking institutions are Y2K compliant well before the end of the year.
- Implement the remaining areas of the Basle committee's core principles for effective banking supervision.
- Continue to strengthen the capacity of Bank Supervision Department in terms of staff and equipment.

Banking Industry Structure

The banking industry hardly changed its structure during the twelve months to June 1999 (Table 12).

TABLE 12: STRUCTURE OF THE BANKING INDUSTRY IN KENYA (SHS BN)

Peer Group Range	Jun-98				Jun-99				Ann. Change (%)	
	Assets	Deposit	No. of	Mkt Share (%)	Assets	Deposit	No. of	Mkt Share (%)		
	Liabilities	Liabilities	Banks	Assets Deposits	Liabilities	Liabilities	Banks	Assets Deposit	Assets	Deposits
COMMERCIAL BANKS										
Over 10	269.2	176.2	8	67.4 66.0	283.5	209.7	9	70.6 71.6	5.3	19.0
5-10	57.1	40.8	9	14.3 15.3	43.3	29.9	7	10.8 10.2	-24.2	-26.7
3-5	17.6	9.6	5	4.4 3.6	33.5	21.7	9	8.3 7.4	90.3	126.0
1-3	51.0	37.6	25	12.8 14.1	34.3	26.5	17	8.5 9.0	-32.7	-29.5
Below 1	4.3	2.8	6	1.1 1.0	7.2	5.1	10	1.8 1.8	67.4	82.1
Total	399.2	267.0	53	100 100	401.8	292.9	52	100 100	0.7	9.7
NBFIS*										
Over 5	17.9	12.2	2	53.9 58.9	19.8	14.1	2	66.1 69.8	10.6	15.6
1-5	11.3	6.2	5	34.1 30.0	7.3	4.5	3	24.3 22.3	-35.4	-27.4
0.5-1	2.8	1.6	4	8.4 7.7	2.5	1.2	4	8.3 5.9	-10.7	-25.0
0.2-0.5	0.8	0.3	2	2.4 1.4	0.0	0.0	0	0.0 0.0	-100.0	-100.0
0.1-0.2	0.3	0.2	2	0.9 1.0	0.3	0.1	2	1.0 0.5	0	-50.0
Below 0.1	0.1	0.2	2	0.3 1.0	0.1	0.3	2	0.3 1.5	0	50.0
Total	33.2	20.7	17	100 100	30.0	20.2	13	100 100	-9.6	-2.4

* Includes two mortgage finance companies

Source: Central Bank of Kenya

There were 52 operational commercial banks as of June 1999, compared to 53 as at the end of June 1998. One bank, which was licensed, was yet to begin operations. Four banks merged during the year while one NBFIs converted into a commercial bank.

The number of NBFIs declined to 13 in June 1999 from 17 in June 1998, following the conversion of one institution into a bank, the merger of two institutions with their parent banks and the voluntary wind up of another. Among the NBFIs, the number of mortgage finance companies remained unchanged numbering two. Building societies also remained unchanged at four by the end of June 1999.

Branch network expansion continued to be more pronounced in the main urban areas, notably Nairobi, Mombasa and Kisumu. In terms of geographical distribution, Nairobi Province had the largest number of branches followed by the Rift Valley Province. Foreign exchange bureaus increased from 43 in June, 1998 to 47 in June 1999 after a few of the applicants who had been issued with conditional letters of intent to commence operations met the set conditions and were authorised to commence business. However, a moratorium was declared on 17th March, 1999.

Assets and Deposit Liabilities

Assets of commercial banks in the year to June 1999 increased marginally by shs 2.6bn or 0.7% to shs 401.8bn from shs 399.2bn in June 1998. The highest percentage growth was in banks with an asset-size of between shs 3bn and 5bn. During the same period the total assets of NBFIs including those of mortgage finance companies decreased by shs 3.2bn or 9.6% to shs 30.0bn from shs 33.2bn. Similarly, deposits held by commercial banks rose by 9.7% to shs 272.9bn in June 1999 from shs 267bn in June 1998 while those held by NBFIs decreased by shs 05bn to shs 20.2bn in June 1999 from shs 20.7bn in June 1998.

Only a few institution's accounted for the bulk of the market share of institutions licensed under the Banking Act. The leading commercial banks with asset-size of more than shs 10bn increased from 8 to 9 in the twelve months ended June 1999. The share of these banks in the total assets of commercial banks rose to 70.6% in June 1999 from 67.4% in June 1998 while their share in deposits increased to 71.6% in June, 1999 from 66% in June 1998.

Among the NBFIs, the 2 largest institutions, with an asset size of over shs 5bn accounted for 66.1% of total assets in the sub-sector having increased from 53.9% in June 1998. This was mainly attributed to the decrease in the number of NBFIs from 15 in June 1998 to 11 in June 1999.

Banking Sector Measures 1998/99

In order to safeguard stability and enhance efficiency in the banking sector institutions, the Central Bank implemented additional measures complementary to those focused on sources of instability during the July to December 1998 period.

- **Launch of 'VSAT' Services in Kenya**

Following the installation of 'VSAT' services by Kenya Posts and Telecommunications Corporation to improve efficiency in communication, the Central Bank encouraged commercial banks and NBFIs to use the facility as it is more reliable compared with telephone wires that often break down.

- **Enhancing Stability of the Banking System**

In reaction to liquidity problems in some banks the Central Bank placed four of the affected banks under statutory management. Another bank, in which the Government is a shareholder, was rescued by injection of additional capital by the Government, replacement of the management and appointment of an advisor.

- **Phasing out Bearer Certificates of Deposit (CDs)**

Following the abuse of bearer certificates of deposits by some banks to evade taxes, launder money and make corrupt payments, the Central Bank issued a time frame for converting existing bearer CDs into ordinary deposits. Banks were instructed not to issue new CDs from 14th September 1998 and to phase out outstanding ones to 25%, 15% and 0% by 31st December 1998, 30th June 1999 and 31st December 1999, respectively.

- **Loans and Advances to Directors and Staff of Commercial Banks and NBFIs**

The Central Bank directed that with effect from 1st January 1999 loans to Directors be:

- Fully approved by the board of directors;
- On the same terms and conditions as for ordinary borrowers;
- Fully secured by tangible assets; and
- Reported to the Central Bank within 7 days of approval.

Lending at concessionary staff rates to executive directors, chief executives and employees of banking institutions was limited to a house loan and a car loan.

- **Provision for Bad and Doubtful Debts**

Banking institutions were required to charge the general and specific provisions for bad and doubtful debt to the profit and loss account. The uniform treatment would facilitate evaluation of performance of various financial institutions in the industry.

- **Public Disclosure**

The Central Bank broadened disclosure of banking conditions to the public by publishing minimum deposit requirements on savings and checking accounts for each bank in addition to the base rates, overdraft and deposit rates.

- **Appointment of Directors and Chief Executives**

The Central Bank directed that with effect from 26th April, 1999:

- Assumption of office by directors be subject to written approval by the Central Bank;
- Appointments of directors be renewed annually together with the renewal of the institution's annual licence;
- Names of proposed directors be forwarded to the Central Bank for vetting prior to holding of the annual General meeting.

• Promotion of Micro-finance Institutions in Kenya

During the financial year, the Central Bank and other stakeholders in the micro-finance subsector took a number of steps aimed at promoting micro-finance business. These steps included the following:

- Establishing a micro-finance unit at the Central Bank to coordinate micro-finance matters at both local and regional levels;
- Licensing the first ever micro-finance bank, K-Rep Bank Limited. The bank is expected to start operations in the next financial year.
- Registering the association of micro-finance institutions (AI). The body will liaise with the Central Bank and other stakeholders in micro-finance to develop regulatory, legal and accounting framework for the subsector.

CENTRAL BANK OF KENYA

BALANCE SHEET

(in millions of Kshs)

	June 1998	June 1999	Movement
ASSETS	122,379	117,491	-4,888
Gold and foreign exchange	45,225	46,797	1,572
Advances and discounts to banks	1,201	905	-296
Investment in Government Securities	37,770	1,682	-36,088
Government Accounts	9,811	6,277	-3,534
Government of Kenya Overdraft	5,436	5,625	189
Clearing Account	4,375	652	-3,723
Other Assets	2,086	2,854	768
Fixed Assets	3,144	3,727	583
Intangible Assets	23,142	55,249	32,107
Revaluation Account	23,142	20,642	-2,500
Non-interest Bearing Government Debt	0	34,607	34,607
LIABILITIES	122,379	117,491	-4,888
Currency in circulation	38,229	41,433	3,204
Deposits	77,884	65,014	-12,870
Government of Kenya	15,272	12,297	-2,975
Commercial banks			
Kenya	38,770	30,391	-8,379
External	99	124	25
Non -banks financial institutions	1,468	970	-498
IMF	14,508	13,271	-1,237
Other public entities and project A/Cs	7,767	7,961	194
Other liabilities and provisions	2,430	6,167	3,737
Capital Account	3,836	4,877	1,041
Capital	1,500	1,500	0
General reserve fund	2,336	3,377	1,041

Source: Central Bank of Kenya

CENTRAL BANK OF KENYA
PROFIT AND LOSS ACCOUNT FOR THE YEAR
ENDED 30TH JUNE 1999

(in millions of Kshs)

	1998	1999
REVENUE	19,473	15,270
Foreign Investment Earnings	2,624	2,269
Local Investment Earnings	11,697	8,123
Other	982	1,153
Revaluation Gain	4,170	3,725
EXPENDITURE	4,001	5,729
Administrative Expenses	1,947	2,231
Currency Expenses	843	919
Banking Expenses	86	79
Amortisation of Revaluation Loss	1,218	2,500
Provisions for bad and doubtful debts - written back during the year	(93)	-
NET SURPLUS	15,472	9,541
	=====	=====
Appropriated as follows:		
Transferred to General Reserve Fund	1,572	1,041
Government of Kenya - Dividend paid	13,900	8,500
	15,472	9,541
	=====	=====

Source: Central Bank of Kenya

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

We have audited the financial statements on pages 41 to 42 which have been prepared under the historical cost convention and on the basis of the set Accounting Policies. We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit and to provide a reasonable basis for our opinion. The financial statements are in agreement with the books of account.

Under the provisions of the Central Bank of Kenya Act, the directors are responsible for the preparation of financial statements which give a true and fair view of the Bank's state of affairs and its operating results. Our responsibility is to express an independent opinion on the accounts based on our audit and to report our opinion to you.

We conducted our audit in accordance with Kenyan Auditing Standards. Those standards require that we plan and perform our audit to obtain reasonable assurance that the accounts are free from 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 an assessment of the accounting policies used and significant estimates made by the directors, as well as an evaluation of the overall presentation of the financial statements.

In our opinion, proper books of account have been kept and the financial statements give a true and fair view of the state of the Bank's financial affairs at 30 June 1999 and of the results of its operations for the period then ended in accordance with the Kenyan Accounting Standards and comply with the requirements of the Central Bank of Kenya Act.

CERTIFIED PUBLIC ACCOUNTANTS

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JOINT AUDITORS

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