CONTENTS **PAGE**

LETTER OF TRANSMITTAL TO THE HONOURABLE MINISTER FOR FINANCE

It is with pleasure that we submit the Annual Report of the Central Bank of Kenya and the Statement of the Audited Accounts for the financial year ended June 30th, 1997, in accordance with section 54 of the Central Bank of Kenya Act.

Overall, macroeconomic stability was maintained throughout the 1996/97 financial year. Inflation remained under control with underlying inflation confined within single digit range. The overall inflation, however, increased to double digits as food supplies fell short of demand following the drought in the first three quarters of the financial year. On the external front, the balance of payments was a surplus of US$ 314m following the turn-around from a deficit to a surplus in the current account and, for the third consecutive year, a surplus in the capital account. The favourable balance of payments enabled the Bank to build up record foreign exchange reserves of over one billion US dollars.

Economic growth, estimated at 4.6% for 1996, was less than in the previous year, and short of the 5.5% target. The main cause of the shortfall was the drought during the first three quarters of the year. The condition of infrastructure also remained a major impediment to accelerated economic growth.

The banking environment was generally sound throughout the year with many banks declaring record profits. The profitability in the banking industry was mainly from high lending interest rates.

Your sincerely,

MICAH CHESEREM

Governor

BOARD OF DIRECTORS

MICAH CHESEREM
Governor and Chairman
Central Bank of Kenya

THOMAS KITHINJI
Chairman & Chief Executive
Skylark Africa Insurance Brokers

PHARES KUINDWA
Secretary to the Cabinet & Head of Civil Service

DR. THOMAS KIBUA
Deputy Governor
Central Bank of Kenya

PROF. GEORGE GODIA
Moi University

SIMON LESRIMA
Permanent Secretary
Ministry of Finance

JOHN MRAMBA
Chairman
Communication Concepts Ltd.

SENIOR MANAGEMENT

MAURICE KANGA
Director, Research

DANIEL KIANGURA
Director, Management Information Services

REUBEN MARAMBII
Director, Banking

JONES NZOMO
Director, Finance

JOHN GIKONYO
Bank Secretary and Director, Human Resources

JACINTA MWATELA (Mrs)
Director, Supplies & Services

SIMON ANZAGI
Director, Bank Supervision

MATILDA ONYANGO (Mrs)
Chief Internal Auditor

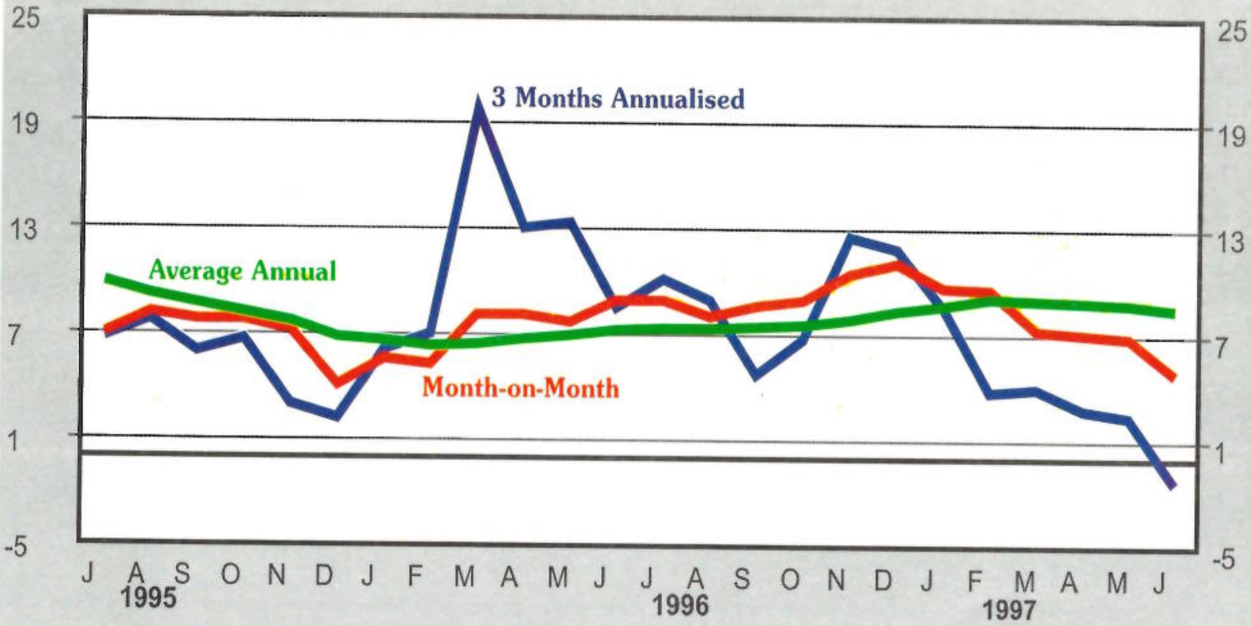
JAMES OGUNDO
Director, Kenya School of Monetary Studies

INFLATION

The overriding objective of monetary policy in 1996/97 financial year was to foster price stability. The pursuit of the objective was expected to promote a stable macroeconomic framework for sustainable economic growth, employment generation and poverty reduction. With effect from January 1997, the Central Bank began focusing more on monitoring and ensuring that the underlying inflation, that is the general price level increase in response to monetary conditions, was contained within single digits.

The underlying inflation was stable and in the single digits range during most part of the financial year. The underlying average annual inflation ranged between 7.4% in July 1996 and 8.5% in June 1997 (Chart 1). The underlying month-on-month inflation increased from 9.0% in July to 11.1% in December 1996, before easing to 7.3% and 4.8% in April and June 1997, respectively. The underlying 3-months annualised inflation steadily declined from 12.6% in November 1996 to 2.6% and negative 1.4% by May and June

CHART 1: UNDERLYING INFLATION (%)



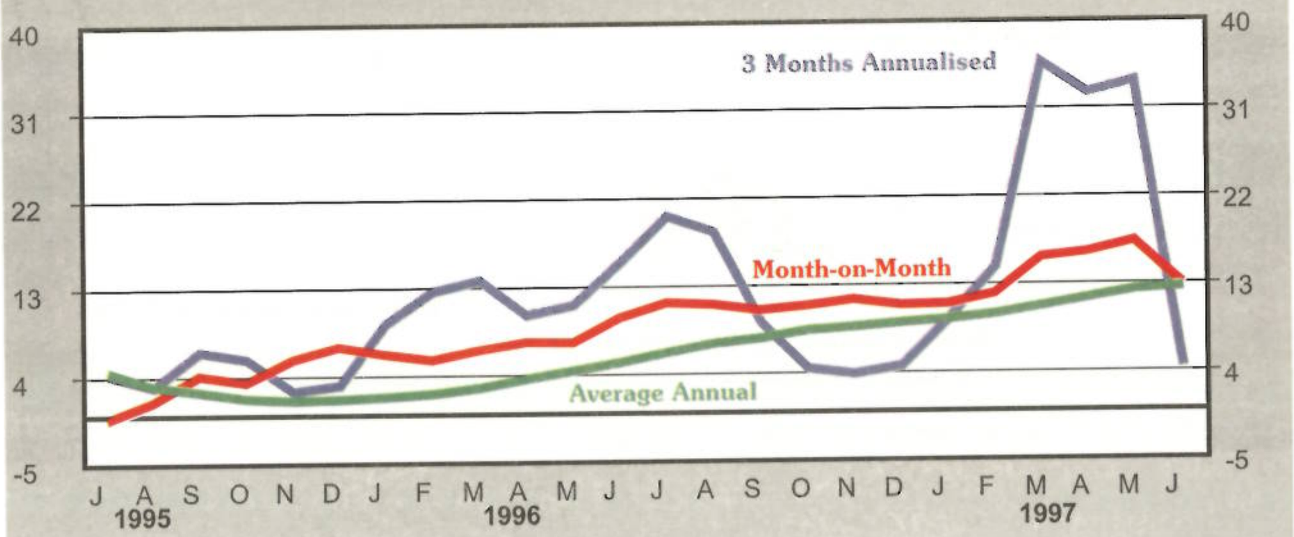
Source: Central Bureau of Statistics & Central Bank of Kenya

1997, respectively. The easing of inflation during the financial year was attributed to the tight monetary and fiscal policies and the stable shilling exchange rate. Overall inflation, that is the increase in the general level of prices due to both monetary and non-monetary factors, however, continued to increase in the year due to the effect of drought. The overall 3-months annualised inflation accelerated from 3.8% in November 1996 to 35.7% in March 1997 before easing to 4.3% in June 1997 (Chart 2).

from 6.3% in July 1996 to 12.3% and 12.6% in May and June 1997 respectively, thus exceeding single digit for the first time since April 1995.

The increase in the overall inflation was most pronounced in the second half of the financial year following the shortfall in agricultural output caused by the widespread drought in early 1997. Food items, on which consumers spend most of their income were the most affected by price increases. Consumers spend about 39% of their

CHART 2: OVERALL INFLATION (%)



Source: Central Bureau of Statistics & Central Bank of Kenya

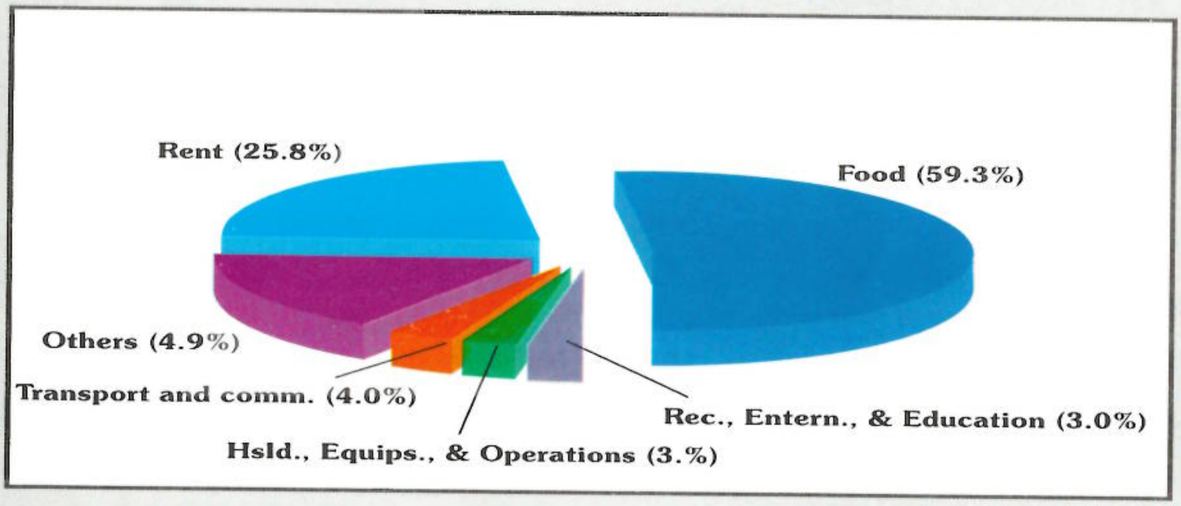
Similarly, overall month-on-month inflation steadily rose from 11.2% in July 1996 to 17.2% in May before easing to 12.8% in June 1997. The overall average annual inflation rose

income on food. The lower, middle and high income earners spend about 44%, 21% and 14% of their income on food, respectively. By June 1997, prices of the food items purchased by the three income groups had on average increased by 36.1% compared with 23% over the same period last year.

Increases in food prices accounted for 59.3% or 7.6 percentage points of the month-on-month inflation in June 1997. Apart from food, large increases were experienced in rents and prices of clothing and footwear, and transport and communications (Chart 3).

banks and NBFIs plus deposits of the private sector with the deposit taking institutions), is consistent with the expected growth in gross domestic product (GDP). Monetary policy effectiveness will be reinforced by appropriate fiscal policy measures and by the expected stability in the shilling exchange rate. The new Central Bank of Kenya (Amendment) Act, 1996 that became law on 18th April 1997 will limit Government's borrowing from the Central Bank and

CHART 3 :PERCENTAGE DISTRIBUTION OF THE JUNE 1997 MONTH-ON-MONTH INFLATION



Source: Central Bureau of Statistics and Central Bank of Kenya

Underlying inflation is expected to remain below 5% throughout the 1997/98 financial year. Monetary policy will ensure that monetary expansion, particularly money supply (M3 - that is money comprising currency outside

thereby contribute to easing inflationary pressures. Overall inflation is forecast to remain single-digit as normalcy returns to the food supply situation with continued favourable weather since April 1997.

Interest rates remained high and stable during 1996/97 financial year in contrast to sharp increases in the 1995/96 financial year (Table 1 and Chart 4). Interest rates in the money market changed modestly during the year. Among principal commercial bank interest rates:

- the average interest on overdraft rose to 28.9% in December 1996 but eased to 28.5% by June 1997. The interest on overdraft had risen by 6.2 percentage points to 28.5% in the year to June 1996.

- the average interest on 3 months deposit rose by 1.5 percentage points to 17.0% in the year to June 1997 compared with 5.7 percentage points increase in the previous year.

- the average interest on savings deposit fell by 0.1 of a percentage point to 10.6% in the year to June 1997 compared with an increase of 1.6 percentage points to 10.7% in the previous year.

Meanwhile:

- the average interest on the 91 days Treasury bill eased by 2.5 percentage points to 19.4% in June 1997 from 21.9% in June 1996, compared with an increase of 5.5 percentage points in 1995/96 financial year . The average interbank rate fell by 0.4 of a

TABLE 1: INTEREST RATES

Facility	1996 Jun.	Jul.	Aug.	Sept.	Oct.	Nov.	Dec.	1997 Jan.	Feb.	Mar	Apr.	May.	Jun.
Overdraft	**28.5**	27.9	28.0	28.1	28.9	28.9	28.9	28.7	28.4	28.5	28.2	28.8	**28.5**
Treasury bill	**21.9**	21.8	21.6	22.5	24.1	22.1	21.5	21.6	21.4	21.4	21.1	20.4	**19.4**
Interbank	**13.3**	13.7	16.2	19.7	15.1	16.7	16.0	14.4	11.2	12.9	13.2	15.1	**12.9**
3 - Months deposit	**15.5**	15.5	15.5	15.6	15.8	15.7	16.0	16.1	15.8	15.9	15.7	18.1	**17.0**
Savings	**10.7**	10.7	10.6	10.7	10.8	11.0	11.2	10.9	10.9	10.9	11.0	12.4	**10.6**

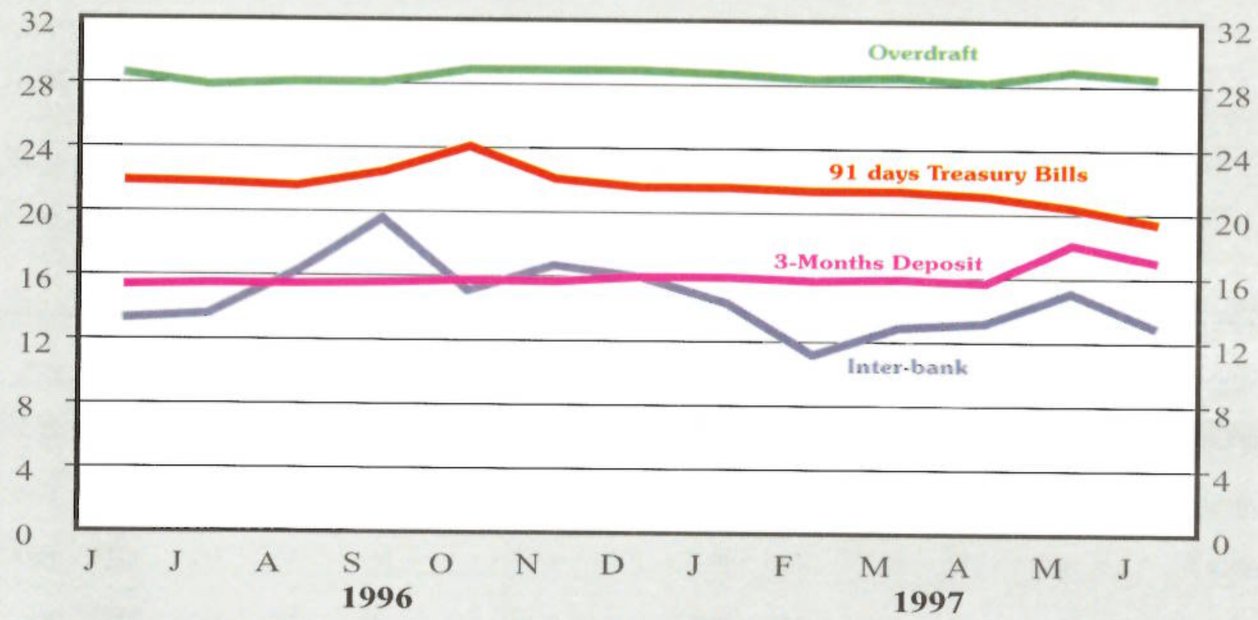
Source: Central Bank of Kenya

percentage point to 12.9% in the twelve months to June 1997, compared with 3.8 percentage points increase during the previous year.

It was generally felt that interest rates by June 1996 were too high to support the desired growth in output of the private sector. Measures, therefore, had to be put in place to ensure that the rates declined substantially during 1996/97 financial year . Towards this goal, the Central Bank urged banking institutions to lower interest rates to facilitate economic growth, and encouraged borrowers to bargain for lower rates.

On its part, the Central Bank managed to sustain a reduction in the interest rate on 91 days Treasury bill between November 1996 and June 1997. Reflecting this development commercial banks lowered their indicative interest rates from January 1997 through April. However, commercial banks' interest rates rose in May and June 1997 inspite of further decline in the interest rate on the 91 days Treasury bill. This reversal partly reflected the change in the way the rates are computed. Indicative interest rates for all banks were previously the average maximum and minimum deposit or loan rates weighted by each bank's share in total

CHART 4: INTEREST RATES (%)



Source: Central Bank of Kenya

deposit liabilities or credit. The new method of computing interest rates commenced in May 1997 adopts an average of average approach where for each interest rate category the indicative interest rate:

- at the individual bank level is the sum of the interest rates on the various transactions weighted by their respective shares in the total transactions for the category.
- at the banking industry level is the sum of the average interest rates at the individual bank level weighted by the share of the banks' volume of transaction for the category in the total transactions for the industry.

The wider coverage in the new method resulted in relatively higher average interest rate for all banks than a simple average of the maximum and minimum interest rates in the former approach.

The easing of the interest rate on Treasury bills during 1996/97 financial year was not at the expense of unwarranted money supply expansion. On the contrary, the growth in the money supply was steadily reduced. This brought money supply stock at end June 1997 well within the target. This reduction was achieved through rolling over maturing bills and mopping up excess liquidity in the domestic money market following improved performance in the balance of payments. As interest on the 91 days Treasury bill remained higher than that on the comparable 3 months deposit rate, the Central Bank was able to attract more funds from private foreign capital inflows inspite of the reduction in the difference between the 91 days Treasury bill and the 3 months deposit rates. Efforts to contain growth in the money supply contributed shs 16.5bn or 46.5% of shs 35.5bn build-up in outstanding Treasury bills stock during the twelve months to June 1997. The balance of shs 19.0bn was formerly the Central Bank overdraft to the Government converted into Treasury bills and held by the Bank as at end June 1997.

Several factors explain the persistent high interest rates:

- **expectations of higher inflation.** Borrowers and lenders alike tend to settle for higher than desired interest rates whenever the expected inflation exceeds actual inflation. Increases in overall month-on-month inflation since July 1995 kept alive the fears for high inflation. The fears are, however, not founded as movements in overall inflation capture both stances of monetary and fiscal policies as well as transitory factors such as weather conditions and changes in import prices. The policy sensitive underlying inflation declined during the year without dampening expectations of inflation because non policy factors kept the overall inflation rising.

- **monetary and fiscal policies.** Interest rates are influenced by the stances of monetary and fiscal policies. Interest rates rose to unprecedented levels from mid-1993 following aggressive sales of Treasury bills at high interest rates to withdraw excess liquidity. Interest rate on Treasury bills is used by the market as the basis for setting other rates. The liquidity had been injected into the money market in 1991 and 1992 largely through loose monetary policy and weak enforcement of banking laws. During the first nine months of the current financial year, the Bank concentrated on stabilising the exchange rate which was threatened by large foreign capital inflows. The Bank had to absorb surplus foreign exchange from the inter bank market and sterilise the counterpart shillings injected by selling Treasury bills.

- **excess demand for loans.** Supply and demand conditions for loans normally determine the interest on lending. Under market conditions, the interest on loans increases when demand for funds exceeds supply and vice versa. The decline in lending rates during the year could only be sustained by reduced demand for funds. During the twelve months to

June 1997, credit to the private and other public sectors rose by 15.7% compared with 24.0% in the previous year. However, the slowdown was partially offset by an increase of 33.7% in commercial bank and NBFIs lending to government, compared with a decline of 18.5% during the year to June 1996. The additional lending to Government was in Treasury bills sold at interest rates higher than those payable on 3 months' deposits at banks.

- **inadequate competition.** The banking system was dominated by 7 banks which held 63.6% of total deposits and 63.5% of total assets as at June 1997. These banks dominated the interest rate setting, with smaller banks adopting the established pattern of interest rates. Interest rates among large banks were high with fairly large and stable spreads between lending and deposit rates during the year.

- **non performing loans**. The share of non-performing loans in total loan portfolio remained large at 18%, with only 8.3% provided for. Non performing loans are a cost that banks cover by raising lending rates on the good portion of debt. Banks were urged to ensure that bad and doubtful debts are well provided for.

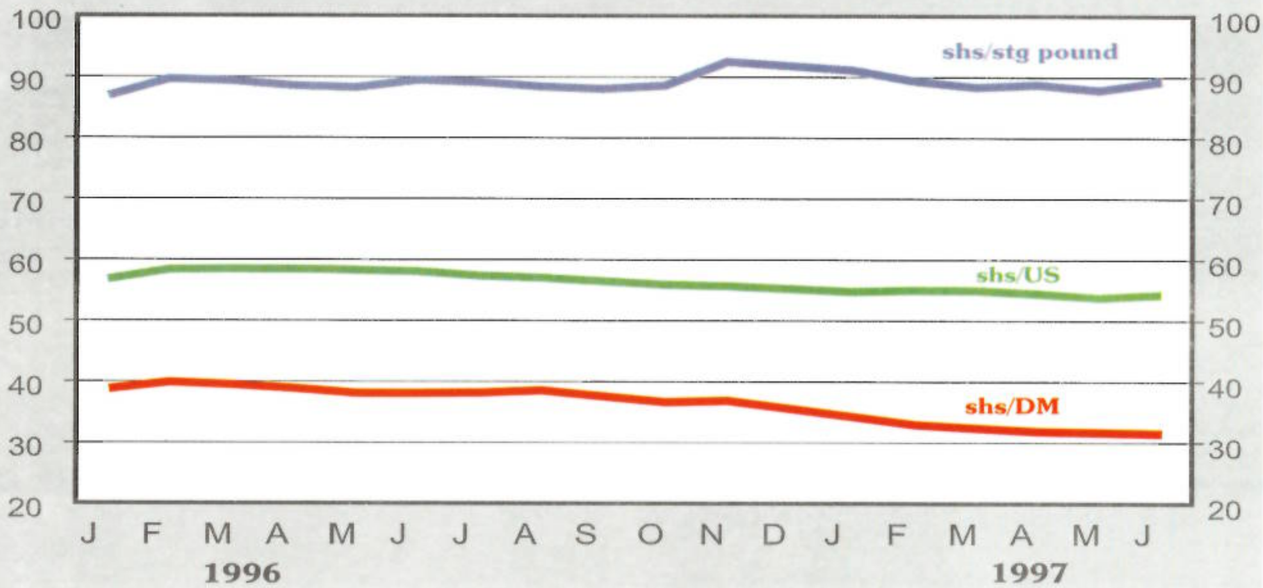
- **exchange rate risk.** The fear of a rapid weakening of the shilling also discourages borrowing from abroad. Heavy losses may be incurred when a company which borrowed abroad has to service the debt at a more depreciated shilling exchange rate than at the time of borrowing.

SHILLING EXCHANGE RATE

The Kenya shilling appreciated against major currencies throughout the year following improved balance of payments and the Bank's actions to contain inflation. Sale of Treasury bills at relatively high interest rates attracted substantial capital inflows that only moderated towards the end of the year. The inflows could have substantially strengthened the shilling against the major international currencies but the Central Bank intervened by buying the excess foreign currency in the interbank market.

Against the US dollar, the deutschemark and the yen, the shilling gained by 6.5%, 17.3% and 10.8%, respectively, in the year compared with losses of 18.2%, 20.6% and 8.9% in the last financial year. It, however, remained at the same level vis-a-vis the sterling pound compared with a depreciation of 15.7% last year (Chart 5).

CHART 5: KENYA SHILLING EXCHANGE RATE



Source: Central Bank of Kenya

Consequently, the trade weighted average shilling exchange rate appreciated by 5.8% compared with a depreciation of 4.4% in the preceding year.

The underlying economic conditions affecting the shilling exchange rate movement during the year included:

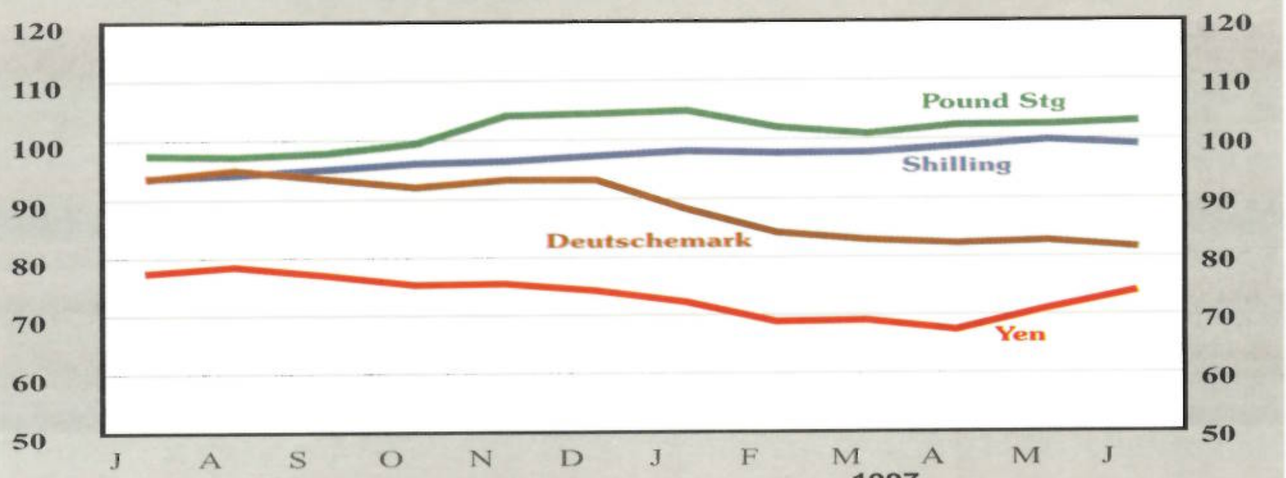
- tight monetary policy pursued to achieve low and stable single digit inflation. Monetary restraint supported the appreciation and stability of the shilling exchange rate.

- high domestic interest rates that were the prime cause of the short-term capital inflows. The inflows, alongside the surplus in the current account, threatened an appreciation of the shilling but was pre-empted by sterilised intervention by the Bank.

- Central Bank commitment to a greater flexibility in the determination of the exchange rate by market forces. This augured well for investors as yield differentials are generally affected not only by the differentials between domestic and foreign interest rates but also by expectations of exchange rate changes.

Trading in the international currency markets led to a modest appreciation of the US dollar against major currencies reflecting a buoyant US economy and persistently low interest rates in US trading partners (Chart 6). The US dollar appreciation was also in line with the underlying economic conditions prevailing in other economies.

CHART 6: DOLLAR EXCHANGE RATE INDICES, JUNE 1995 = 100



Source: Central Bank of Kenya

GOVERNMENT FISCAL OPERATIONS

The Government continued to pursue tight fiscal policy that entailed curbing expenditures, enhancing revenue collection and continuing privatisation of parastatals. Despite these measures, Government obligations to pay for goods and services, debt servicing and transfers to public institutions exceeded the receipts from taxes, other charges, privatisation proceeds and inflows of foreign grants by shs 27.8bn.

The shortfall in receipts, particularly during the first seven months, was financed from domestic bank sources mainly in form of direct advances from the Central Bank. This presented a challenge to both monetary policy and debt management as the subsequent increase in sales of Treasury bills to sterilise the monetary impact of the Central Bank financing occasioned higher interest payments on domestic debt. The trend however reversed during the last three months of the fiscal year when the Government increasingly resorted to borrowing from commercial banks and the non banking sector to finance its budget deficit.

Expenditure

Government expenditure during the financial year amounted to shs 160.6bn compared with shs 152.2bn the previous year, an increase of 5.5% compared with 12.6% in 1995/96 fiscal year (Table 2). The slowdown in expenditure growth reflected the tight stance of fiscal policy. This was manifested mainly in declining development expenditure. The Government at the same time directed most of its recurrent expenditures to operations and maintenance of existing infrastructure instead of undertaking new investments.

Except for pending bills and interest payments on domestic debt, other expenditures were within their budgeted levels. Domestic interest payments exceeded the budget target mainly due to increased Treasury bill sales for budget financing and to mop up excess liquidity from the domestic money market, generated by purchases, by the Central bank of surplus foreign exchange.

Revenue and Grants

Revenue collected by the Government during the year

TABLE 2: BUDGET OUT-TURN (SHS BN)

	Fy 1995/96 Actual	Fy 1996/97 Actual*	Fy 1996/97 Target	Over(+)/ Below(-)
1. TOTAL REVENUE & GRANTS	**151.3**	**155.0**	**161.7**	**-6.7**
Ordinary Revenue	138.6	140.4	146.6	-6.2
Tax Revenue	120.3	125.9	130.1	-4.2
Income Tax	48.1	49.3	51.0	-1.7
Value Added Tax	28.4	29.0	30.0	-0.9
Customs Duty	21.2	22.8	23.8	-1.0
Excise Duty	22.6	24.8	25.4	-0.6
Non Tax Revenue	18.3	14.5	16.5	-2.0
Appropriations-in-Aid	6.9	8.9	8.9	0.0
External Grants	5.8	5.8	6.2	-0.4
2. TOTAL EXPENDITURE**	**152.2**	**160.6**	**162.7**	**-2.1**
Recurrent Expenditure	122.4	132.2	132.1	0.2
Domestic Interest	25.9	26.6	25.9	0.7
Foreign Interest	11.3	7.9	8.6	-0.7
Wages and Salaries	45.9	48.2	48.2	0.0
Others	39.3	49.6	49.4	0.2
Development Expenditure	29.3	27.8	30.6	-2.8
Cleared Items Awaiting Transfer to PMG	0.5	0.6	0.0	0.6
3. DEFICIT ON A COMMITMENT BASIS (1-2)	**-0.9**	**-5.5**	**-1.0**	**4.5**
as a ratio of GDP (%)	-0.2	-1.0	-0.2	
Adjusted for:				
3.1 Foreign interest arrears paid	0.2	0.0	0.0	0.0
3.2 Foreign interest due but not paid	0.0	0.0	0.0	0.0
3.3 Change in pending bills	-0.7	-0.9	-2.7	-1.8
3.4 1995/96 expenditure financed				0.0
in 1996/97	0.0	3.3	3.3	0.0
3.5 1996/97 expenditure to be paid in 1997/98	0.0	0.0	-1.5	-1.5
4. DEFICIT ON A CASH BASIS				
((3-3.1-3.4-3.5)+(3.2+3.3))	**-1.8**	**-9.7**	**-5.5**	**4.2**
As a ratio of GDP (%)	-0.4	-1.7	-1.0	
5. FLOAT (4+6): Expenditure(+)/Revenue (-)	**-0.2**	**4.8**	**0.0**	**4.8**
6. FINANCING	**1.6**	**14.6**	**5.5**	**9.0**
Domestic (Net)	**1.6**	**21.4**	**10.2**	**11.2**
Central Bank	3.5	-7.5	-	-
Commercial Banks	7.8	13.7	-	-
Other domestic sources:	-9.7	15.2	-	-
Non Banks	-13.5	14.1	-	-
Capital Receipts (privatisation)	3.8	1.1	1.1	0.0
External (Net)	**-0.1**	**-6.8**	**-4.7**	**2.1**
Loan Disbursements	19.8	12.5	15.5	-3.0
Loan Repayments	19.8	19.3	20.2	-0.9

* Provisional

** Expenditure is net of Central Government loans to public enterprises less repayments amounted to shs 149.2 bn, or 2.5% more than receipts in the previous year, but 4.2% below budget estimate. Government receipts including foreign grants were shs 155.0 bn or 2.4% more than in the previous financial year. However, this was shs 6.7bn below target mainly as a result of shortfalls in tax receipts.

Despite falling short of the estimates in the budget, the revenue from major taxes was higher than in the previous year. Indirect taxes accounted for most of the increase in revenue. The revenue gains from various taxes reflected the impact of the continuing tax reforms. The reforms have strengthened tax administration and improved taxpayer compliance. They have also enhanced revenue inflow through lower rates and broader tax bases. Appropriations-in-Aid comprising user charges, fees and other levies at shs 8.9bn was on target and 29% higher than in the previous year. The improvement reflected Governments continued effort to cut expenditure through cost sharing. External grants amounted to shs 5.8 bn, the same level as in the previous year but less than shs 6.2 bn estimate in the budget.

Government Borrowing Requirements

The borrowing required to finance Government payments in excess of receipts was shs 27.8 bn during the financial year compared with shs 11.3bn the previous year. The Government mobilised the required funds from the domestic bank and non-bank sources. The borrowed funds together with privatisation proceeds of shs 1.1bn were used as follows:

- shs 14.6 bn to finance the budget deficit.
- shs 7.5 bn to repay Government debt due to the Central Bank.
- shs 6.8 bn to repay external debt.

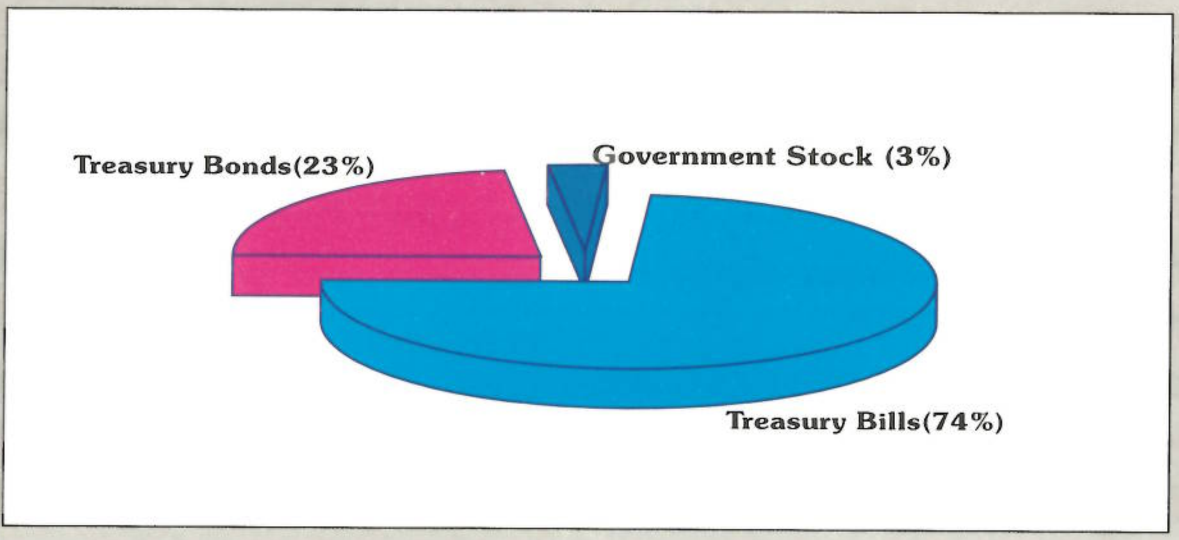
Financing the payments in excess of revenue by way of domestic borrowing at high rates of interest continued to undermine Government efforts to curb expenditure and to effectively tackle the problem of high interest rates prevailing in the economy. Interest payments on domestic debt continued to claim a large share of Government payments, accounting for 20.1% of recurrent expenditure in the financial year.

Domestic Public Debt

Domestic public debt operations during the year were geared to raising funds for the budget, managing liquidity in the economy, and improving debt management. Consequently, the stock of debt in form of loans and advances from commercial banks and Government securities increased from shs 110.5bn in June 1996 to shs 130.8 bn in June 1997.

Treasury bills continued to dominate the debt stock, accounting for 74% as at end June, 1997 (Chart 7). Treasury bills worth shs 390.3bn were issued while bills worth shs 354.8bn were redeemed during the year. Consequently, the outstanding Treasury bills increased by shs 35.5bn to shs 116.6bn. The increase in the stock of Treasury bills reflected conversion of part of Government overdraft at the Central Bank to Treasury bills, and stepped up sales to mop up excess liquidity brought about by purchases of foreign exchange in the inter-bank market by the Central Bank. The increase

CHART 7 : DISTRIBUTION OF DOMESTIC PUBLIC DEBT , JUNE 1997



Source: Treasury and Central Bank of Kenya also reflected increased domestic borrowing for budget financing as foreign financing in the year declined to a net repayment of shs 6.8bn.

During the year, the Government introduced one year floating interest rate Treasury bond to facilitate the restructuring of the domestic debt from high concentration in short-term to medium term debt, streamline the interest rates structure on government domestic debt and harmonise redemption with revenue inflows. The outstanding stock of the new floating interest rate bond rose to shs 30.5bn by June 1997, following securitisation of shs 19.0bn of Government overdraft at the Central Bank with the bonds and direct sales worth shs 11.5bn to the economy. During the year, fixed rate Treasury bonds worth shs 3.5bn were redeemed. Consequently, the outstanding stock of Treasury bonds increased by shs 27.0bn to shs 35.6bn in June 1997.

Government overdraft at the Central Bank rose from shs 24.5bn in June 1996 to shs 38bn at the end of June 1997. The overdraft was, however, eliminated on June 30th 1997 when the Government issued to the Central Bank Treasury bonds and Treasury bills worth 38bn instead. The build up in the overdraft over the first seven months of the financial year posed a challenge to the Bank's efforts to keep growth in the money supply within target. Subsequent increases in Treasury bills and bonds sales to mop up the excess liquidity posed further challenge to the management of domestic debt as well as to efforts to influence a reduction in interest rates.

The amendment of the Central Bank of Kenya Act, that set a statutory limit for Central Bank overdraft to the Government at 5% of gross recurrent revenue in the most current audited appropriation accounts is expected to ease the pressure of financing the budget deficits on the money supply. The move will further facilitate prudent management of the domestic debt as the Government endeavours to harmonise expenditure growth with that of revenue and foreign receipts.

BALANCE OF PAYMENTS

The current account balance improved to US$ 90m surplus in the year to June 1997 mainly reflecting a reduced trade deficit as a result of favourable terms of trade. Meanwhile, the capital account surplus fell to US$ 224m, thereby, resulting in US$ 314m surplus in the overall balance of payments (Table 3). The slowdown in capital inflows occurred against a background of high but falling domestic interest rates especially in the latter part of the year. Despite increased international confidence in Kenya's economy and foreign exchange reserves covering

TABLE 3: BALANCE OF PAYMENTS ON YEARLY BASIS (US$ M)

	1996			1997					
	Jun	**Sep**	**Dec**	**Jan**	**Feb**	**Mar**	**Apr**	**May**	**Jun***
Overall Balance	**346**	322	398	427	504	511	504	438	**314**
Current Account	**-341**	-113	-93	-93	-76	9	79	47	**90**
Trade Balance	**-1150**	-965	-961	-953	-930	-845	-767	-691	**-582**
Exports	**1949**	1974	1969	1963	1986	2069	2128	2181	**2237**
Imports	**3099**	2939	2929	2916	2916	2914	2895	2872	**2819**
Services Account (net)	**809**	852	868	860	854	854	846	738	**672**
Tourism	**439**	447	448	447	451	451	452	452	**454**
Other	**370**	405	420	413	403	403	394	286	**218**
Capital Account	**687**	435	491	520	580	502	425	391	**224**
Long Term (net)	**-46**	6	38	1	23	-7	10	54	**7**
Official	**-63**	-27	33	24	50	24	56	64	**-23**
Private	**17**	33	5	-23	-27	-31	-46	-10	**30**
Short Term & Others (net)	**733**	429	453	519	557	509	415	337	**217**
Gross Reserves	**1246**	1179	1299	1264	1370	1516	1568	1552	**1551**
Official	**806**	777	855	845	913	1029	1064	1058	**1050**
Banks	**440**	402	444	419	457	487	504	494	**501**
in months of Import Cover: Gross Reserves	***4.8***	***4.9***	***5.4***	***5.1***	***5.7***	***6***	***6.5***	***6.5***	***6.6***
Official	***3.1***	*3.2*	*3.5*	*3.4*	*3.8*	*4.1*	*4.4*	*4.4*	***4.5***
Banks	***1.7***	*1.7*	*1.9*	*1.7*	*1.9*	*1.9*	*2.1*	*2.1*	***2.1***

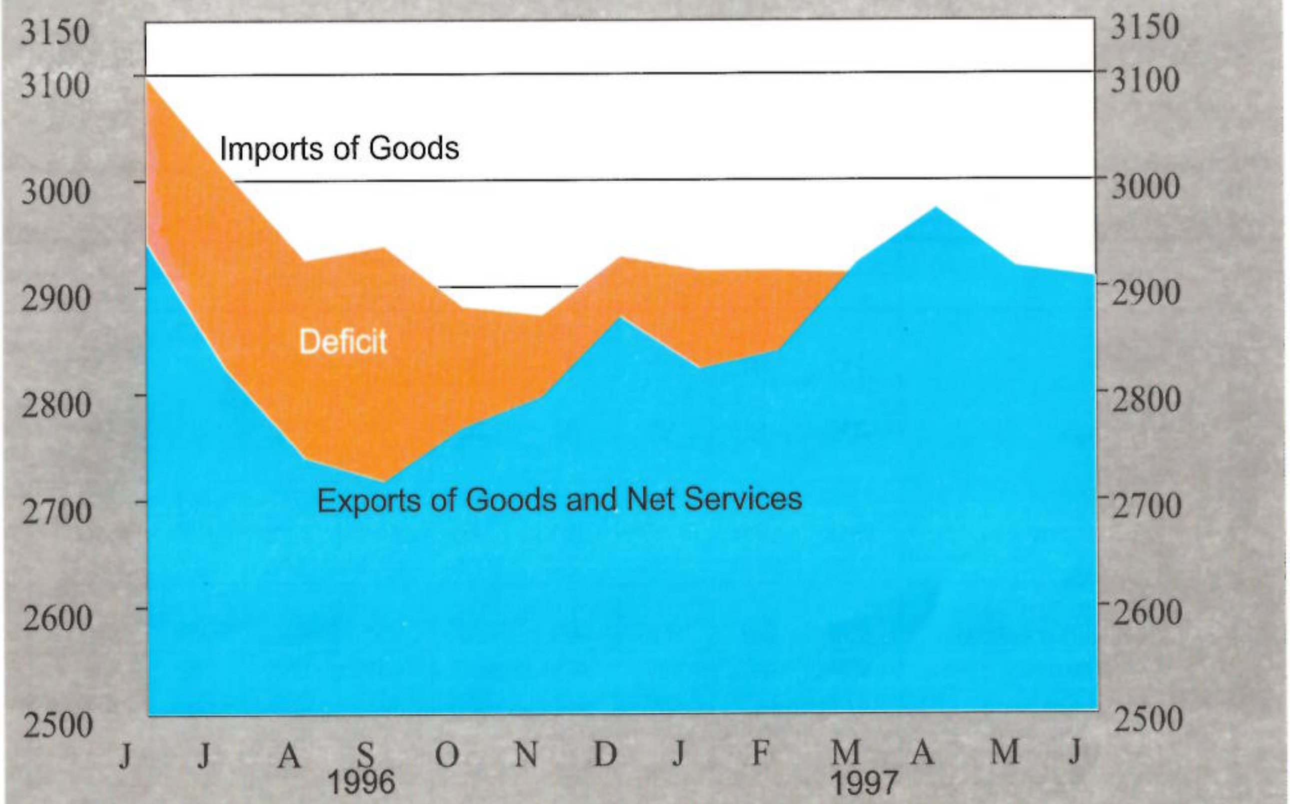
* Provisional

Source: Central Bank of Kenya

6.6 months of imports, sustaining the emerging surplus in the current account may be elusive especially against the backdrop of low investment rates by both the public and the private sectors.

fall in other services net. Tourism earnings, however, improved by 3.4% but was not large enough to offset the deteriorating services account (Chart 8).

CHART 8: CURRENT ACCOUNT BALANCE (US $ M)



Source: Central Bank of Kenya

The current account balance improved by US$ 431m to a surplus of US$ 90m in the year. The improvement was due to the US$ 568m narrowing in the trade deficit, as the services account surplus declined by US$ 137m following the

The improvement in the terms of trade was a major factor behind the fall in the trade deficit. Kenya's terms of trade improved as a result of the decline in world prices of industrial goods and an increase in world coffee prices. The terms of trade improved by about 8 percentage points in the year compared with a deterioration of 1.6% in the previous year. It is estimated that the improvement accounted for about 20% of the narrowing in the trade deficit.

The volume of exports fell by about 2% in the year, after increasing by 16% in the previous year and 30% in 1994/95. This was in line with the expansion of world trade. Kenya maintained its share of world trade. It is expected that the vigorous promotion of exports in recent years and the opening up of new markets will increase the share in the coming years. Non-traditional exports grew by 8% in volume, compared with 9% and 25% in 1995/96 and 1994/95, respectively. Traditional exports, particularly tea and coffee, slowed down in the year in spite of improved dollar prices. This was due to drought which adversely affected the export volume for these commodities during the year.

Exports to regional markets continued to exceed those to the traditional European markets for the third consecutive year. About 45% of the exports were to Africa, mostly Uganda and Tanzania, and 32% to the European Union.

The volume of merchandise imports eased by 8% in the year, after increasing in the preceding two years. Their prices fell by 1%, compared with 5% and 8% increase in 1995/96 and 1994/95, respectively. Consequently, the value of imports, notably capital goods that accounted for over 60% of imports, fell by 4% compared with increases in the preceding two years. Merchandise imports from all countries, except South Africa, slowed down in growth. Imports from the European Union, Middle East, Japan and India had the least growth.

Recent liberalisation of the payments system has allowed imports from foreign countries to compete with Kenyan products. This has forced local producers to increase their efficiency and specialise in areas where they have comparative advantage. As a result, growth has been stimulated. Increased competitiveness has also prevented imports being sourced from unnecessarily expensive sources thus acting as a brake on price increases while widening the variety available to customers. There has, therefore, been faster growth in imports from the Far East excluding Japan and India.

The services account had a surplus of US$ 672m reflecting:

- considerable fall in the growth of the volume of imports and an increase in exports;
- 3.4% growth in tourism;
- a further 25% fall in net investment income outflows. Major factors behind this include the increase in earnings from Central Bank investment of foreign exchange reserves following the rise in reserve holdings and interest rates on short-term dollar deposit; and the fall by 22% in interest payments on loans by the Government.

Capital inflows which in the last financial year exceeded the amount required to finance the current account deficit, continued throughout the year but at a slower pace. The US$ 224m surplus in the capital account was much lower than US$ 687m surplus the previous year.

Net official long term capital was a smaller deficit of US$ 23m in the year. This was due to a reduction in official debt repayments. Non financial private sector capital was a surplus of US$ 30m reflecting an improvement in net investment by non-residents. Notable long term private capital inflow in the year included US$ 52m for the lease of two new aircraft by Kenya Airways.

Short term capital inflows that had risen to an unprecedented level of US$ 733m in the last financial year, eased to US$ 217m. The slowdown in short term capital inflows in the year mainly reflected easing in domestic interest rates and expectations of shilling depreciation. Like in the previous year, most inflows were invested in Treasury bills and shares in the stock market following the liberalisation of the capital markets.

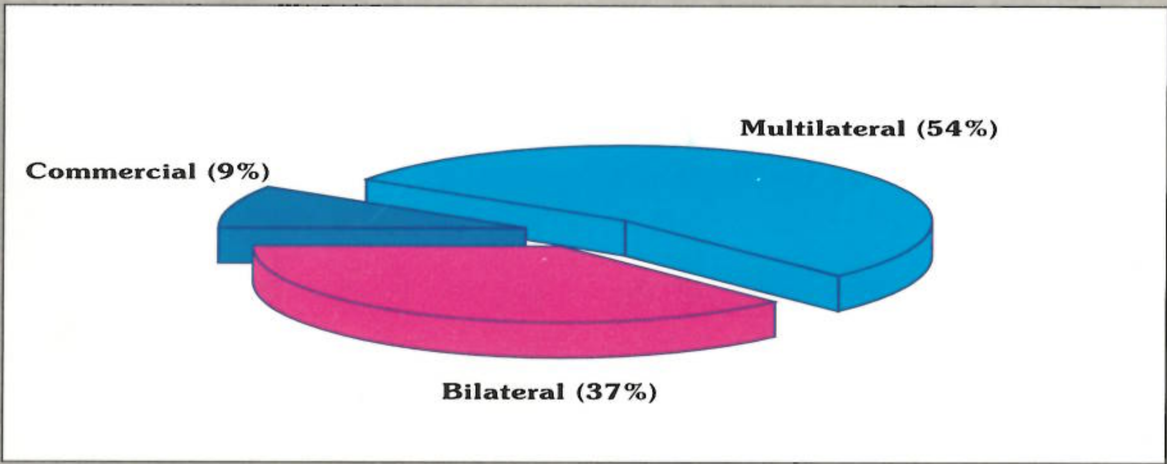
With the favourable developments in the balance of payments, official foreign exchange reserves increased by US$ 244m during the year to US$ 1050m by the end of June 1997, covering approximately 4.5 months imports.

External Debt

Kenya's stock of external debt at the end of 1996 stood at US$ 6,241m.

The largest proportion of the debt is owed to multilateral creditors, mainly the World Bank, which accounts for over 30% of Kenya's external debt. Debt due to bilateral creditors has remained fairly stable constituting about 37% of the total while that owed to commercial creditors including export credit has been declining in the recent past reaching 9% in 1996 (Chart 9).

CHART 9 : DISTRIBUTION OF EXTERNAL PUBLIC DEBT , 1996



Source: Treasury and Central Bank of Kenya

This represented a reduction of US$ 218m during the year compared with an increase of US$ 79m in 1995. Most of the debt is long and medium term and 8% of it is due to be repaid in 1997.

Following the decline in the debt stock and the expansion in nominal GDP by 4.8% , the debt to GDP ratio fell to 68.0% in 1996 from 84% and 72% in 1994 and 1995, respectively. The external debt service ratio declined by 0.8 percentage points to 24% in 1996.

MONETARY DEVELOPMENTS

The Central Bank continued to pursue a tight monetary policy with maintenance of a low stable inflation as the main objective throughout the twelve months to June 1997. Monetary policy in particular took into account the fact that in the previous financial year, the month-on-month underlying inflation, that is the policy sensitive inflation, had risen to 9.0% in June 1996 from 6.4% in June 1995. Although single-digit, the inflation in 1995/96 financial year was higher and more unstable than expected. The tight monetary policy entailed measures that reduced the growth in money supply to 10.2% at the end of the financial year, down from 18.4% in the year to June 1996 reversed the rise in inflation with the month-on-month underlying inflation declining to 4.8% in June 1997.

Reserve Money Management

Monetary policy during the year to June 1997 focused on stabilising, on a daily basis, the level of reserve money (that is, currency outside both commercial banks and NBFIs plus deposits of the institutions at the Central Bank) at its quarterly targets in order to reduce and stabilise the growth of the money supply.

As in the previous financial year, reserve money management was anchored on net domestic assets (NDA) of the Central Bank. While the average NDA was well within target throughout the year, reserve money tended to exceed its target due to foreign exchange inflows. The Bank's net foreign assets (NFA) rose rapidly to shs 40.3 bn in June 1997 from shs 23.8 bn in June 1996 largely because of surplus foreign exchange in the local inter-bank market. The Bank purchased the surplus foreign exchange in the first nine months of the financial year to pre-empt destabilisation of the shilling exchange rate. In turn, the stable shilling and the relatively high interest rates on Treasury bills sustained a steady inflow of private short term capital into the country.

The Bank neutralised the shillings injected into the economy through foreign exchange purchases by sales of Treasury bills. Partly due to these operations, outstanding Treasury bills rose from shs 81.1bn in June 1996 to shs 116.6 bn in June 1997.

A further cause of the rise in outstanding Treasury bills was the repurchase agreements (Repos) introduced in September 1996 to improve efficiency of the Bank in the day to day management of banking system liquidity. Repos are basically agreements made by the Central Bank to buy back at short notice earmarked Treasury bills sold to a bank. This facilitates temporary withdrawal of liquidity from banks upon sale but the situation normalises when the Central Bank buys back the Treasury bills or reverses the repo. Repos, therefore, provide market participants with an alternative channel for either borrowing or lending. Currently, repos are only allowed between Central Bank and commercial banks with the Treasury bills paper certificates being retained at the Bank. Commercial banks only endorse the master repurchase agreements. Repo cut off primarily depends on monetary policy considerations with liquidity considerations as a secondary goal.

The outstanding stock of Treasury bills initially rises by the amount of purchase of repo bills in any Treasury bill issue. Thereafter, the Central Bank either reduces or restores commercial banks' balances through repo sales or reverse repos from the initial purchase of Treasury bills. The resulting change in commercial banks' deposits would in turn be wholly reflected in the reserve money. The Bank on occasions used rediscounted Treasury bills to conduct repos to achieve simultaneous reduction in its outstanding net lending to Government and in reserve money. The Bank increased its holding of Treasury bills for conducting repos through conversion of shs 19bn of Central Bank overdraft to the Government at the end of June 1997. The Bank also acquired as at end June 1997 shs 19 bn Treasury bonds for repo purposes from the conversion of a similar balance of the overdraft.

Cash and Overall Liquidity of Banks and NBFIs.

Both commercial banks and NBFIs were required to maintain balances at the Central Bank equivalent to at least 18% of their deposit liabilities. This ratio, unchanged from the previous year, complemented Open Market Operations (OMO) in regulating credit expansion. Commercial banks and NBFIs maintained average cash balances in excess of the required minimum.

Liquid assets to deposit liabilities ratio, mainly required for prudential purposes, stabilised at levels considerably higher than the 25% minimum requirement. Most liquid assets were held in Treasury bills and balances at the Central Bank for commercial banks and as balances at the Central Bank and local commercial banks for NBFIs. Liquidity of mortgage finance companies and building societies also stabilised above their respective minimum requirement of 20%.

Money Supply and Aggregates

Monetary policy measures taken over the twelve months to June 1997 reduced growth in the money supply to 10.2% from 18.4% in the year to June 1996 (Table 4). The slowdown was reflected in the reserve money, the base for money supply expansion, that rose by 7.8% compared with 30.0% over the same period in the previous year. The slowdown in the expansion of money supply was most welcome as the aggregate was well within expectation of the target of shs 289.4bn for June 1997. The monetary expansion during the year to June 1997 was supported by increases in both net foreign assets (NFA) and net domestic assets (NDA) of the banking system.

The NFA of the banking system rose by shs 14.0bn or 50.5% and accounted for 53.8% of the increase in the money supply. The NFA increase during the year was largely in Central Bank holdings, which rose by shs 16.5bn to shs 40.3bn in June 1997. The NFA build-up at the Central Bank largely reflected purchases of surplus foreign exchange from the interbank market.

The NDA of the banking system rose

by 5.3% during the year to June 1997 compared with 14.3% in the year to June 1996. The slowdown was in both credit to the private sector and other assets net of other liabilities of the banking system. Credit to the Government increased more rapidly while lending by commercial banks and NBFIs to the private and other public sectors increased by 15.7% in the year to June 1997 compared with 24.0% in the year to June 1996. The slowdown in the demand for credit continued throughout the year due to

TABLE 4: MONEY SUPPLY AND ITS SOURCES (SHS BN)

	1996 Jun	1996 Sep	1997 Jun	Change Absolute	%	Revised Target Jun-97	Dev.
1. Money supply, M3 (1+2)	**255.6**	**255.6**	**281.6**	**26.0**	**10.2**	**289.4**	**-7.8**
Money supply, M2	220.1	221	258.5	38.4	17.4		
2. Net foreign assets:	**27.8**	**25.5**	**41.8**	**14.0**	**50.5**	**39.7**	**2.1**
Gross foreign exchange	68.6	64.8	85.1	16.5	24.0		
Liabilities in foreign exchange	40.8	39.3	43.3	2.5	6.0		
3. Net domestic assets (3.1+3.2)	**227.9**	**230.2**	**239.9**	**12.0**	**5.3**	**249.7**	**-9.8**
3.1 Domestic credit (3.1.1+3.1.2)	**254.4**	**270.2**	**289.9**	**35.5**	**14.0**	**288**	**1.9**
3.1.1 Government (net)	69.6	78.9	76.2	6.5	9.4	79.6	-3.4
From Central Bank	27.8	37.2	20.3	-7.5	-27.1	27.5	-7.2
Overdraft to the Government	24.2	30.2	-19.4	-43.7	-180.3	25.1	-44.5
Cleared items awaiting posting to PMG	0.5	3.5	1.1	0.7	147.6	0	1.1
Rediscounted securities	3.2	3.5	38.6	35.4	1123.9	2.4	36.2
From Commercial Banks & NBFIs	41.8	41.8	55.9	14.1	33.7	52.1	3.8
Commercial Banks	37.9	37.3	52.3	14.4	37.9		
NBFIs	3.9	4.5	3.6	-0.3	-7.7		
3.1.2 Private sector and other public sector:	184.7	191.3	213.7	29.0	15.7	208.4	5.3
From Commercial banks	144.9	151.7	181.8	37.0	25.5		
From NBFIs	39.9	39.6	31.9	-8.0	-20.1		
3.2 Other items net:	**-26.5**	**-40.1**	**-50.0**	**-23.6**	**88.9**	**-38.3**	**-11.7**
4. Reserve money	**68.8**	**73.8**	**74.2**	5.4	7.8	**80.1**	**-5.9**
Cash till	3.5	4.7	4.5	1.0	27.2	5.1	-0.6
Currency outside banks	28.7	27.8	29.1	0.4	1.3	29.2	-0.1
Deposits with CBK	36.5	41.3	40.6	4.0	11.1	45.8	-5.2
Memorandum items							
Treasury bills outstanding	**81.1**	**82.6**	**116.6**	**35.5**	**43.7**		

Source: Central Bank of Kenya

the high interest rates that prevailed during the year with overdraft interest charged by commercial banks ranging between 28% and 29%.

On a sectoral basis, credit to the private sector during the twelve months to June 1997 rose by shs 29.0bn or 15.7% while that to other public sector institutions increased by shs 1.5bn. Within the private sector, transport and communication, real estate, finance and insurance, building and construction, manufacturing, domestic trade and agriculture, took shs 19.9bn, or 72.6% of the increase in outstanding credit to the sector.

The banking system increased net lending to Government during the twelve months to June 1997 by 9.4% compared with 8.0% reduction in the year to June 1996. The increase was largely in credit from commercial banks, which increased by 37.9% compared with 10.1% in the year to June 1996. Most of the lending was in form of Treasury bills, a consequence of monetary policy considerations that required sales of Treasury bills to banks and other investors in order to reduce the growth in money supply. For the same reasons, lending by NBFIs to Government declined by 20.1% in the year to June 1997 compared with 77.1% decline in the previous twelve months. Central Bank lending to Government declined by 27.1% compared with 14.2% increase in the year to June 1996. This was partly a reflection of Government efforts to reduce its overdraft to the statutory 5% of gross recurrent revenue in the latest audited appropriations accounts and partly a result of efficiency gains in tax administration and cuts in Government expenditures.

Policy Reforms

Measures implemented over the twelve months to June 1997 were intended to:

- enhance stability and confidence in banking system.
- enhance efficiency in the market for Government securities.
- streamline foreign exchange transactions.

- increase securities available in the money market.

- broaden maturity of Government domestic debt from short term to long term.

The Central Bank moved towards securing stability in the banking system by broadening responsibilities of external auditors for commercial banks and NBFIs to cover the interest of depositors in addition to the traditional focus on shareholders' interest. To discharge the new responsibility, external auditors were required to ensure that banks and NBFIs made adequate provisions for bad and doubtful debt. Inadequate provisions for non-performing loans often result in overstated profits, high tax and dividend payments and eventually insolvency, financial distress especially to small depositors, and instability in the financial system. External auditors were also required to ensure adequate checks and balances existed in the institutions they audit to avoid concentration of powers in one person.

To avoid compromising professionalism, external audit firms, partners and senior staff were urged to avoid seeking facilities from their client institutions. To ensure compliance, external audit firms found negligent in discharge of professional duties would be disciplined by being blacklisted or taken to court according to section 24 of the Banking Act.

Banking institutions were on their part required to increase disclosure of information in published accounts according to Accounting Standards Exposure Draft No. 20 with effect from 31st December 1996. These institutions were encouraged to establish audit committees composed entirely of external directors to liaise with their external auditors. The Bank offered to forward banking circulars to external audit firms to acquaint them with new developments in the banking environment.

The Bank computerised the handling of Treasury bills, by introducing a Central Depository System (CDS) in January 1997. The new system aims to increase efficiency in the market for Government securities, especially the secondary market. Under the system:

- Treasury bill prices are quoted per shs100 at intervals of 0.125%.

- reference to discount rate was discontinued in favour of interest rates.

- investors open accounts at the Central Bank and provide instructions for the disposal of the proceeds from investments in Treasury bills.

At the same time the Bank shifted the focus of trading in Treasury bills away from retail to wholesale with the minimum investment in both OMO and primary markets raised from shs 50,000 to shs 1,000,000 since January 1997. The Central Bank also broadened money market instruments with the introduction of repurchase agreement (REPOS) initially among select banks on 23rd September 1996, and to all commercial banks from November 1996.

Another measure intended to enhance efficiency of banking operations involved laying the ground for the launching of the magnetic ink character recognition (MICR) system in April 1997. The process involves computerised cheque clearing and electronic fund transfer (EFT) between banks. It is expected to reduce local cheque clearing to 2 days. The Central Bank encouraged large banks to acquire their own in-house processing equipment in readiness for interbranch clearing and item sorting. The Central Bank will procure its own software, with spare capacity to assist smaller banks at a modest charge. The MICR will commence in July 1997.

The Bank as a lender of last resort to banks revised lending and rediscount interest rates as follows:

- overnight lending rates on the Lombard (window 1), a cheaper facility, which had been raised effective 19th November 1996 to 4 from 2 percentage points above the prevailing Treasury bill tender interest rate was lowered to 3 percentage points above the same base effective 3rd June, 1997.

- interest rates on rediscounting and overnight loans (window 2) which had been raised effective 19th November 1996 to 6 from 5 percentage points above 91 days Treasury bill tender rate was reduced to 5 percentage points over the same base effective 3rd June, 1997.

The Central Bank of Kenya (Amendment) Act, 1996 became law in April 1997. This act allows the Central Bank more autonomy in the formulation and implementation of monetary policy aimed at achieving and maintaining low and stable inflation. The Act limits the level of the overdraft to the Government at the Bank to no more than 5% of gross recurrent revenue in the latest audited appropriations accounts.

A number of measures were taken to streamline foreign exchange transactions with a view of enhancing efficiency of operations effective September 1996. The Bank charged commercial banks with the responsibility for managing foreign exchange business and set as sufficient legal requirement the possession of the normal annual licence to conduct banking operations. Banks were allowed to engage in spot and forward deals so long as they prominently displayed counter exchange rates to the public. Commercial banks were also encouraged to open correspondent banking accounts in Africa and overseas and especially in Uganda and Tanzania in order to promote regional trade within the framework of regional cooperation. Both residents and non residents in Kenya were allowed to open foreign currency accounts in accordance with normal banking procedures while banks were given authority to extend foreign currency denominated loans and residents encouraged to borrow overseas. Limits on outward and inward foreign investments were also removed culminating in full liberalisation of the capital account.

PRODUCTION

The growth momentum started in 1994 slowed down in 1996 mainly because of severe drought in the second half of the year in most parts of the country. Real GDP growth declined to 4.6% in 1996 from 4.8% in 1995. The growth was below the 5.5% target but higher than the 0.2% and 3.0% in 1993 and 1994, respectively.

The economic growth in 1996 was largely a product of reform measures implemented since 1993. The measures have resulted in a fairly stable exchange and inflation rates. These reforms included:

- the removal of foreign exchange controls on exchange and payments system.
- the abolition of foreign trade licensing.
- the removal of price controls and the provision of an enabling environment to foster development of private sector enterprises.
- the larger market arising from the establishment of the East African Co-operation in 1996.

Agriculture, the main sector of the economy and the base for other economic activities, expanded by 4.4% in 1996 compared with 4.8% in 1995. The slowdown in agricultural activities in 1996 was attributed to the drought that affected virtually the whole country.

Manufacturing sector output declined to 3.7% in 1996 from 3.9% in 1995. The decline was caused by:

- reduced supplies of raw materials, especially for the agro-based industries.
- reduced rural incomes and purchasing power for manufactured products.
- the drought induced power shortages in 1996 that compromised efficiency and increased costs per unit of output

in the sector, especially in the first half of the year.

The growth of the sector is expected to improve to 4.2% in 1997 on account of:

- increased domestic demand.
- the wider market created by the East African Co-operation.
- improved availability of raw materials following recovery in agriculture.

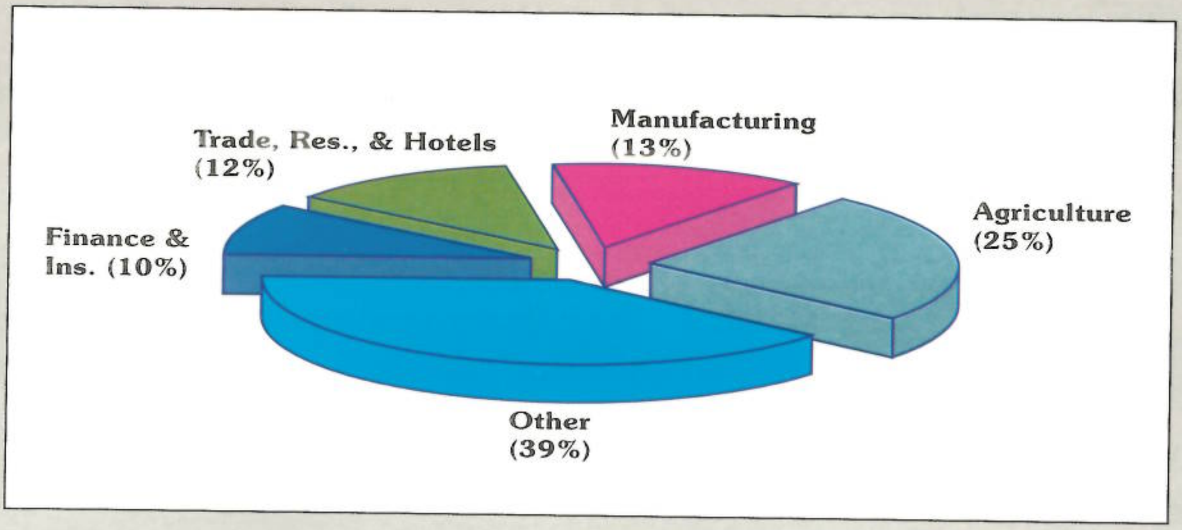
The share of the various sectors in the economy are shown in Chart 10.

The services sector had the most favourable performance in 1996:

- finance and insurance expanded by 7.1% in 1996 compared with 6.9% and 6.1% in 1995 and 1994.
- the provision of Government services expanded by 1.6% in 1996 compared with 1.8% in 1995. This expansion is expected to decline further with the on-going restructuring of the public sector.

Other sectors of the economy performed fairly well with:

CHART 10 : THE ECONOMY IN 1996



Source: Central Bureau of Statistic, Economic Survey 1997

- building and construction expanding by 3.5% in 1996 compared with 3.8% in 1995.

- the utilities sector of electricity and water supply expanding by 3.1% in 1996 compared with 1.6% in 1995. The expansion is attributed to the Government's initiative and donor support in extending the provision of utilities and in rehabilitating the existing ones.

Economic growth in 1996 was supported by increased investments financed from domestic and foreign sources. Total investments rose to shs 109bn in 1996 from shs 102bn in 1995. Foreign investment declined to shs 26.7bn in 1996 from shs 38.3bn in 1995. The balance of shs 82.3bn was financed from domestic savings that increased by 30.4% in 1996 compared with a decrease of 12.9% in 1995.

While the growth is commendable, given the impact of drought, it is still weak and far below the average 8% per annum required for at least a decade in order to steadily increase the per capita incomes of the Kenyan population and create employment opportunities for over half a million entrants into the labour market each year. The rate of growth must therefore be accelerated further in 1997 and in the medium term.

The economy is expected to grow by 5.2% in real terms in 1997. This growth is expected from:

- agriculture and

- agro-based food processing industries.

The rest of the manufacturing sector is expected to expand in view of the wider market created by the East African Co-operation and the larger Common Market for Eastern and Southern Africa. Economic growth in 1997 will be reinforced by the Government's determination to maintain and improve on the existing macroeconomic environment by maintaining low single digit inflation, relatively stable exchange rates and adequate foreign exchange for importation of raw materials and other intermediate inputs.

DEVELOPMENTS IN THE BANKING INDUSTRY

The banking industry remained stable and continued to realise relatively high profits during the twelve months to June 1997. Overall, banking institutions met both the monthly minimum liquid assets to deposit liabilities ratio of 25% and the ratio of daily minimum cash balances at the Central Bank to the institutions' net deposit liabilities of 18%. Non bank financial institutions (NBFIs) continued either converting into commercial banks or merging with existing banks. A few institutions continued to dominate total assets and total deposits liabilities of commercial banks and NBFIs, while the deposit structure of commercial banks changed in favour of term deposits.

Banking institutions pursued provision of quality service as an important objective during the year. Towards this goal, banking institutions launched new products and embarked on modernisation programmes geared towards shortening the cheque clearing process.

The Central Bank Act was amended to streamline and enhance pursuit of the Bank's objectives in order to contribute fully to the growth of the economy.

Banking System Liquidity

Banking institutions in general met both the minimum cash and liquidity ratio requirements of 18% and 25% respectively (Table 5). The cash ratio requirement is a tool of monetary policy which effectively limits the maximum credit that commercial banks and NBFIs can extend to the economy. Regulation of credit in turn constrains expansion of deposits, especially by commercial banks, which directly impacts on money supply. During the year to June 1997 commercial banks placed 18.6% of their net deposit liabilities as average

TABLE 5: BANKING INSTITUTIONS CASH AND LIQUIDITY RATIOS June1996 - June 1997

	1996			1997					
	Jun	Sep	Dec	Jan	Feb	Mar	Apr	May	Jun
Cash ratio (%)									
Commercial Banks	18.4	18.3	18.5	18.6	18.7	18.7	18.5	18.9	24.1
NBFIs	19.8	18.8	18.9	19.0	19.2	19.3	18.7	18.2	18.4
Minimum Requirement	18.0	18.0	18.0	18.0	18.0	18.0	18.0	18.0	18.0
Liquidity Ratio (%)									
Commercial Banks	42.0	42.0	42.0	40.0	43.0	43.0	44.0	43.0	42.0
NBFIs	38.0	35.0	37.0	37.0	43.0	42.0	41.0	37.0	38.0
Minimum Requirement	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0
Mortgage Finance Cos.	29.0	31.0	32.0	33.0	31.0	34.0	40.0	35.0	35.0
Building Societies	58.0	58.0	53.0	56.0	53.0	52.0	51.0	49.0	41.0
Minimum Requirement	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0

Source: Central Bank of Kenya

monthly cash balances at the Central Bank while NBFIs placed an average 18.7% of similar deposits.

The broader liquidity ratio requirement is monitored largely for prudential purposes. Commercial banks liquidity ratio averaged 42% and ranged between 40% and 44%. The liquid assets were dominated by Treasury bills holdings that accounted for 49.5% and 52.7% of outstanding liquid assets in June 1996 and June 1997, respectively and cash ratio balances at the Central Bank that accounted for 40% and 42% over the same period. The increase in the share of Treasury bills in liquid assets during the year was a result of aggressive sales of Treasury bills in order to reduce the growth in the money supply to that required to lower inflation and support productive activities.

The average liquidity ratio for NBFIs was also high at 37.5% per month and within the range of 34% and 43% during the year compared to the minimum requirement of 25%. The mortgage finance companies and building societies also maintained liquidity ratios well above the minimum requirements.

Banking Industry Structure

NBFIs continued to either convert into commercial banks or merge with parent and other commercial banks. Seven conversions and one merger were effected during the year to June 1997 while two commercial banks were placed under liquidation. A development finance company also converted into a bank. As a result of these changes commercial banks increased to 53 in June 1997 from 48 in June 1996 while NBFIs fell to 19 from 26 during the same period. Building societies and mortgage finance companies remained unchanged during the year at 4 and 2 respectively by June 1997.

Assets and Deposit Liabilities

Total assets of commercial banks rose by shs 65.7bn or 22.4% to shs 358.5bn in June 1997 from shs 292.8bn in June 1996 (Table 6a). During the twelve months, assets of NBFIs fell by shs 15.6bn to shs 43.9bn from shs 59.5bn (Table 6b). Meanwhile, deposits of commercial banks rose by shs 41.4bn or 21.5% to shs 233.7bn in the twelve months to June 1997 as those of NBFIs declined by shs 14.2bn or 33.3% to shs 28.4bn. The decline in the assets and domestic deposits of NBFIs reflected the seven conversions to banks and merger with a bank that occurred during the year. A notable

TABLE 6a: COMMERCIAL BANKS MARKET SHARE BY TOTAL ASSETS AND DEPOSIT LIABILITIES

Peer Group Range (By Assets) (Shs m)	JUNE 1996 No. of Banks	Assets (Shs m)	Deposit Liabilities (Shs m)	JUNE 1997 No. of Banks	Assets (Shs m)	Deposits (Shs m)	Market Share Assets (%)	Market Share Deposits (%)
Over 10000	5	174,542	116,057	7	227,738	148,580	63.5	63.6
5001-10000	5	39,560	20,372	7	47,671	28,585	13.5	12.2
3001-5000	9	35,684	26,017	8	30,320	17,853	8.5	7.6
1001-3000	20	37,559	25,725	24	48,254	35,449	13.5	15.2
101-1000	9	5,498	4,181	7	4,527	3,268	1.3	1.4
TOTAL	**48**	**292,843**	**192,352**	**53**	**358,510**	**233,736**	**100.0**	**100.0**

Source: Central Bank of Kenya

TABLE 6b: NBFIS MARKET SHARE BY TOTAL ASSETS AND DEPOSIT LIABILITIES

Peer Group Range (By Assets) (Shs m)	JUNE 1996 No. of NBFIs	JUNE 1996 Assets (Shs m)	JUNE 1996 Deposit Liabilities (Shs m)	JUNE 1997 No. of NBFIs	JUNE 1997 Assets (Shs m)	JUNE 1997 Deposits (Shs m)	1997 Market Share Assets (%)	1997 Market Share Deposits (%)
Over 5000	4	29,501	22,705	3	25,389	18,751	57.8	66.0
1001-5000	9	24,443	15,663	6	15,013	7,500	34.2	26.4
501-1000	5	3,754	2,883	4	2,612	1,751	5.9	6.2
201-500	4	1,487	1,028	1	357	67	0.8	0.2
101-200	1	176	170	2	367	149	0.8	0.5
0-100	3	168	170	3	181	192	0.4	0.6
TOTAL	**26**	**59,529**	**42,619**	**19**	**43,918**	**28,411**	**100.0**	**100.0**

Source: Central Bank of Kenya

development is the heightened dominance by a few institutions over assets and deposit liabilities. The largest commercial banks that held assets above shs 10bn rose to 7 in June 1997 from 5 in June 1996. These banks raised their market shares in total bank deposits and total bank assets to 63.6% and 63.5% respectively in June 1997 from 60.3% and 59.6% in June 1996. Among NBFIs, the larger institutions that held assets above shs 5bn declined to 3 in June 1997 from 4 in June 1996. However, this segment consolidated its control of the subsector by raising their market share in total assets and total deposit liabilities to 57.8% and 66.0% respectively in June 1997 from 49.6 and 53.5% in June 1996.

Deposits

The composition of deposits of commercial banks changed as the share of demand deposits fell to 20.3% in June 1997 from 23.4% in June 1996. The shift was occasioned by high deposit rates for term deposits paid by banks to enable them attract more deposits to invest in Treasury bills during the year to June 1997.

A number of institutions embarked on modernisation programmes designed to improve their competitiveness in the industry through providing quality services to their customers while venturing into new lines of business to broaden their scope of operations. The banking institutions agreed in April 1997 to acquire the software for launching the magnetic ink character recognition (MICR) process in July 1997. The MICR facility will computerise cheque clearing and electronic fund transfer (EFT) between banks and is expected to reduce local cheque clearing process to 2 days from the present 4 days.

Banking Legislation

Major changes to the banking legislation were introduced through the amendments to the Central Bank of Kenya Act in April 1997. These amendments are aimed at enhancing the efficiency of operations of the financial system and thereby maximising the systems' impact on economic growth. The amendments were timely as they followed extensive reforms undertaken in the operations and structure of banking institutions. In the amendments:

- the principal objectives of the Bank were set as:
  - formulating and implementing monetary policy that is focused on securing price level stability.
  - fostering a stable market based financial system.
- secondary objectives of the Bank were listed as:
  - formulation and implementation of foreign exchange policy.
  - management of official foreign exchange reserves.
  - licensing and supervising dealers in the money market.
  - promotion of efficient payments, clearing and settlement systems
  - banker and adviser to Government and fiscal agent of Government.
  - issuing of currency notes and coins.

- the Bank is required to:

  - submit to the Minister for Finance every 6 months, a monetary statement for the next 12 months. The Minister will in turn present the statement to the appropriate committee of Parliament within the subsequent session of Parliament. The statement shall specify policies and means to attain them and evaluate past policy implementation.

  - disseminate key financial data and information on monetary policy to the public.

  - consult regularly with the Minister on monetary policy matters to ensure consistency of policy with the Bank's principal objects.

- the Bank is to maintain minimum capital of shs 5bn and any additions must be sanctioned by the Board in consultation with the Minister.

- the Bank is to establish and maintain a General Reserve Fund into which it will transfer at least 10% of its net annual profits or any other amount as determined by the Board in consultation with the Minister. The balance of the net profits is payable to the consolidated fund.

- the Bank management is entrusted to a board of directors appointed by the President. The members of the Board include:

  - the Governor who is also the Chairman of the Board

  - the Deputy Governor, also the Deputy Chairman of the board.

  - the Permanent Secretary to the Treasury who is a non-voting member

- five other non executive directors.

- the Governor or Deputy Governor and any 3 directors constitute quorum for any Board meeting.

- the period of service for any Board member is limited to maximum of two terms of 4 years each. Their tenure of office is secure unless found incompetent or incapable of holding office. In the case of the Governor, the appointment can only be terminated by a tribunal appointed by the President to investigate his conduct.

- the shilling exchange rate is determined by market forces.

- the Bank lending operations are limited to commercial banks and Government with the following conditions:

  - term for loans to banks is limited to a maximum six months.

  - all loans must be secured by Treasury bills or other Government debt instrument specified by the Bank.

  - Bank advances to Government must be secured with negotiable Government securities that mature within twelve months and at market interest rates.

  - the maximum outstanding advance to Government at any time is limited to 5% of the Gross recurrent revenue of Government in the Appropriation Accounts pertaining to the latest audit. The limit excludes securities held by the Bank for purposes of regulating money supply.

CENTRAL BANK OF KENYA
BALANCE SHEET
(Amounts in Kshs Millions)

	Jun-96	Jun-97
ASSETS	**110,727**	**133,570**
Gold and foreign exchange	45,397	56,245
Advances and discounts to banks	9,316	9,214
Fixed Assets	2,126	2,837
Other Assets	1,374	1,193
Revaluation Accounts	24,692	24,360
Government Accounts	27,822	39,721
Overdraft to Government of Kenya	24,216	-
Clearing Account	452	1,119
Investment in Government securities	3,154	38,602
LIABILITIES AND CAPITAL	**110,727**	**133,570**
Currency in circulation	32,265	33,632
Deposits	65,048	84,239
Government of Kenya	-	19,443
Commercial Banks		
Kenya	29,842	37,303
External	22	163
Non -Banks financial institution	6,701	3,285
IMF	22,783	17,426
Other Public securities and project A/Cs	5,700	6,619
Other liabilities and provisions	7,930	8,099
Dividend payable to the government	3,812	5,336
Capital Account	1,672	2,264
Capital	500	1,500
General reserve fund	1,172	764

Source: Central Bank of Kenya

CENTRAL BANK OF KENYA
BANKI KUU YA KENYA

Profit and Loss Account for the year Ended 30th June 1997
(Amounts in Kshs Millions)

	1996	1997
REVENUE		
Foreign Investment Earnings	1,213	2,177
Local Investment Earnings	9,117	6,442
Other Earnings	1,897	1,337
Total Revenue	**12,227**	**9,956**
EXPENDITURE		
Administrative Expenses	1,745	2,071
Currency Expenses	654	826
Interest on Cash RAtio Deposits	789	-
Banking Expenses	111	99
Revaluation Loss-Gold and Deposits	-	156
Exceptional Items:		
Provision for Doubtful Debts	803	-
Voluntary Early Retirement Costs	-	876
Total Expenditure	**4,102**	**4,028**
NET SURPLUS	**8,125**	**5,928**

Source: Central Bank of Kenya

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

We have audited the accounts on pages 42 to 43 which have been prepared under the historical cost convention and on the basis of set accounting policies. We obtained all the information and explanations which we considered necessary for our audit.

RESPECTIVE RESPONSIBILITIES OF THE DIRECTORS AND AUDITORS

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

BASIS OF OPINION

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

OPINION

In our opinion, proper books of account have been kept and the accounts, which are in agreement therewith, give a true and fair view of the state of affairs of the Bank at 30 June 1997 and of the results of its operations for the year to that date and comply with the requirements of the Central Bank of Kenya Act.

KPMG PEAT MARWICK **BELLHOUSE MWANGI ERNST & YOUNG**

JOINT AUDITORS

NAIROBI