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LETTER OF TRANSMITTAL

As required by section 54 of the Central Bank of Kenya Act, I am pleased to submit to you, Honourable Minister, the Annual Report of the Central Bank of Kenya for the financial year 2002/03. The report reviews economic and financial developments and contains Audited Accounts of the Bank for the financial year ended June 30, 2003.

As indicated in the report, the first half of the financial year 2002/03 was a very difficult period with poor economic performance and uncertainties relating to the general elections held at the end of 2002. Following its formation in January 2003, the NARC Government implemented, in the second half of the financial year, a wide range of policy measures primarily aimed at bringing about economic recovery, restoring investor confidence and reforming public institutions and services. Against this background the economy is estimated to have achieved growth of 1.4% in the financial year 2002/03 compared with 1.2% in the previous financial year. The recovery was supported by increased credit in the face of falling interest rates, low inflation and competitive exchange rate.

Agriculture, manufacturing and services contributed significantly to improved production in the real sector during the financial year. A favourable overall balance of payments owing to expansion of horticultural exports and low import demand was also turned out by external sector. The banking sector remained stable during the financial year except for two institutions that were placed under statutory management and one under liquidation.

To support the economic growth process, the Central Bank pursued a monetary policy stance geared towards containing inflation within 5% and providing stability in both the macroeconomic environment and financial markets. Improved fiscal discipline together

with financing of the budget deficit from non-inflationary domestic sources kept Government recourse to the Central Bank within the stipulated statutory limits.

Operations of the Central Bank resulted in net profit of Ksh 4,448m in the financial year ended June 30, 2003. The surplus was Ksh 1,365m lower than in the previous financial year, largely as a result of lower earnings from investment of foreign reserves and a high revaluation loss arising from translation of foreign assets and liabilities into Kenya shillings in a period when the shilling was relatively strong against the dollar.

Looking ahead, economic recovery is expected to continue and sustained by the tax incentives announced in the Budget statement for the financial 2003/04. Achievement of improved growth performance will also be enhanced by low inflation, low interest rates and the expected resumption of financial support from development partners.



GOVERNOR

BOARD OF DIRECTORS



ANDREW K. MULLEI
*Governor and Chairman
Central Bank of Kenya*



JOSEPH M. MAGARI
*Permanent Secretary,
Ministry of Finance*



EDWARD SAMBILI
*Deputy Governor
Central Bank of Kenya*



HENRY K. MARITIM



OWEN N. KOIMBURI



PAUL A. SPENCE



GEORGE ONGAYA-OKOTH

SENIOR MANAGEMENT



ALOYS B. AYAKO
Director, Research



DANIEL K. KIANGURA
*Director, Management
Information Services*



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



JAMES OGUNDO
*Executive Director, Kenya
School of Monetary Studies*



JOHN M. GIKONYO
*Bank Secretary & Director,
Human Resources*



JOHN K. MURUGU
Director, Banking & Currency



JONATHAN A. BETT
Director, Finance



JONES M. NZOMO
Director, Banks Supervision



MATILDA ONYANGO (Mrs.)
Ag. Director, Supplies & Services



NICHOLAS M. KIRITU
Director, Internal Audit

INTRODUCTION

This Annual Report is a unique one since, unlike the previous ones, it covers a period, which involved the first political transition since independence when power moved from the ruling to the then opposition party. The first six months of the financial year 2002/03, and indeed the entire 2002, were challenging with unfavourable economic conditions and political uncertainties relating to the General Elections held at the end of 2002. Following the formation of the NARC Government in January 2003, the second half of the financial year experienced the impact of a wide range of policy changes.

The new Government initiatives, may be summarised as primarily aimed at entrenching economic recovery, establishing a basis for wealth and employment creation through the provision of free primary education; institutional and legal reforms to stamp out corruption and improve delivery of public services; creation of a conducive environment for investors and normalization of relations with development partners.

Although most of the new Government's policy measures were yet to bear fruit, against the background, the economy is estimated to have grown by 1.4% in the financial year 2002/03 compared with 1.2% in the previous financial year. The recovery in economic performance was attributed to positive changes in economic and political governance, increased investor confidence and favourable weather conditions. The performance was also supported by the prevailing stable macroeconomic environment, characterised by falling interest rates, low inflation and a competitive exchange rate .

Agriculture, manufacturing and services grew significantly during the year. Agriculture is estimated to have grown by 1.3% in the year compared with 1.0% in the financial year 2001/02, following favourable weather conditions and increased investment in horticultural production. The growth in the manufacturing sector, estimated at 1.2% in the financial year 2002/03, was largely explained by increased access to export markets within the East African Community (EAC), the Common Market for Eastern and Southern Africa (COMESA) and the United States through the African Growth and Opportunities Act (AGOA). In the services sector, financial services grew by an estimated 1.1% mainly in the second half of the financial year, reflecting stability in the financial sector and increased profitability of commercial banks and non-bank financial institutions.

Reflecting the momentous changes in Kenya's political life against a background of a weak economy, the fiscal situation over the financial year ended June 2003, inevitably became expansionary with Government operations turning out a wider budget deficit on both commitment and cash basis. This trend reflected the combined effect of reduced tax revenue arising from a slower economic growth, laxity in expenditure controls prior to the 2002 General Elections, introduction of free primary education and increases in emoluments in sections of the public sector at the beginning of 2003. Given the limited scope for external financing, most of these expenditures, including foreign debt repayments were funded by domestic borrowing. Consequently, public domestic debt increased to Ksh 289.4bn in June 2003 from 236.0bn in June 2002.

Monetary policy however kept the macroeconomic conditions well anchored. The primary objective for monetary policy in the year was to contain inflation within 5% while providing a stable environment for financial markets and supporting real GDP growth of 2.2%. Following this monetary policy stance and a relatively stable shilling exchange rate, the underlying inflation remained below 3.5% during the year. However, broad money growth picked up though not as much as programmed largely as a result of increases in net foreign assets and net domestic assets of the banking system. This expansion in money supply, in the face of weak economic performance, caused interest rates on Government securities to decline during the period, with the 91-day Treasury bill rate falling to 3.0% in June 2003 from 7.3% in June 2002. Despite this downward trend in the rates, the average lending rate remained unchanged at about 18% against a declining average deposit rate.

In the external sector, the overall balance of payments (BOP) position remained favourable in the year to June 2003 due to an expansion in horticultural exports against low import demand. However, a reduction in private short-term capital flows and increased net foreign asset holdings by commercial banks led to deterioration in the financial account in the year. As a result of improved surplus in the balance of payments, foreign exchange reserve held by the Central Bank, comprising foreign currency, gold, special drawing rights, Government deposits at the crown agents and reserve position in the Fund,

was US\$1,260m at the end of June 2003 compared with US\$ 1,137m at the end of June, 2002. Except for the sharp appreciation of the Kenya shilling against the US dollar at the beginning of 2003, the shilling was generally stable against major foreign currencies in the year. This was due to a firm monetary policy stance and weak demand for imports observed during this period.

The banking sector generally remained stable during the financial year 2002/03, with only two institutions placed under statutory management and one under liquidation. Despite the not so impressive performance of the economy during the period, the banking sector registered improved asset portfolio, deposits, capitalization and liquidity. This scenario resulted from lower bad debts charge, reduced operational costs and a significant inflow of foreign deposits into local banks.

During the year, the Bank also continued with its efforts to develop an efficient clearing, settlement and national payments system. A notable development in this area was the significant rise in the use of card based instruments, namely, credit, debit and Automated Teller Machine (ATM) Cards. The Bank also participated in the on-going East African National Payment Systems initiatives aimed at harmonizing the payment practices within the region.

In view of the comprehensive policy strategy adopted by the Government in its Economic Recovery Strategy for Wealth

and Employment creation for the period 2003-2007, future prospects for strong economic growth are bright. The focus of the strategy is economic recovery and poverty reduction through increased public and private savings and investment as well as improvement in the management of public affairs. The implementation of this strategy should lead to improved sectoral performance and enable the economy to grow by an estimated 2.2% in the financial year 2003/04 and 4.7% annually in the medium term.

REAL GDP GROWTH

Real GDP is estimated to have grown by 1.4% in the financial year 2002/03 compared with 1.2% in the financial year 2001/02, as shown in Table 1 and Chart 1. This indicates that the economy was on a recovery path though at a slower pace than earlier envisaged.

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

Main sectors	Shares in GDP (%) 2002	Annual Growth (%)			
		2001/1 ¹	2002/1 ¹	Y 2001/02 ²	Y 2002/03 ²
Agriculture	24.0	1.3	0.7	1.0	1.3
Manufacturing	13.0	0.8	1.2	1.0	1.2
Trade, Restaurants & Hotels	12.7	1.3	1.6	1.5	3.5
Financial Services	10.5	1.0	0.7	0.9	1.1
Building & Construction	2.3	-0.5	0.3	-0.1	0.1
Transport & Communications	6.3	3.2	2.5	2.9	3.0
Government Services	14.6	0.7	0.9	0.8	1.2
Others of which	16.6	1.6	1.4	1.5	1.0
<i>Non-monetary</i>	5.7	1.7	1.7	1.7	1.7
<i>Domestic services</i>	3.0	2.6	2.3	2.5	2.0
<i>Ownership of dwellings</i>	5.7	1.8	1.5	1.7	1.0
<i>Other</i> ³	2.2	-0.5	-1.0	-0.8	0.1
TOTAL	100.0	1.2	1.1	1.2	1.4

Notes

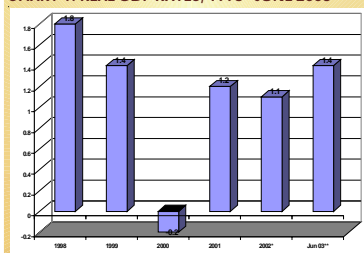
¹ From the Economic Survey, 2003.

² Financial year estimates

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

Sources: Central Bureau of Statistics and Central Bank of Kenya

CHART 1: REAL GDP RATES, 1998 - JUNE 2003



* Provisional

** Estimates

Sources: Economic Survey and Central Bank of Kenya

The recovery in economic performance was reinforced by improvements in economic and political governance that increased investor confidence and favourable weather conditions that enhanced agriculture and other related economic activities. It also reflects the benefits accruing from stable macroeconomic environment characterised by easing inflation and interest rates and maintenance of competitively market determined exchange rate. The average annual underlying inflation eased to 2.7% in June 2003 from 4.6% in June 2002 while the 91-day Treasury bill interest rate declined significantly from 7.3% in June 2002 to 3.0% in June 2003.

AGRICULTURE

Agriculture, which accounts for 24.0% of GDP, contributed substantially to the overall growth of the economy in the financial year 2002/03. The sector as a whole is estimated to have grown by 1.3% in the financial year compared with 1.0% in the financial year 2001/02.

Major sub-sectors of agriculture recorded mixed performance in the financial year as shown in Table 2. Horticultural crop production for export increased by 30.2% in the financial year compared with an increase of 4.1% in the financial year 2001/02. The increase in production of horticultural export crops reflected increasing dominance of the more reliable irrigation in the sector than the generally rain-fed agriculture and the discovery of new markets in the middle East, USA and Australia besides the traditional market in Europe.

TABLE 2: PERFORMANCE OF MAJOR AGRICULTURAL COMMODITIES (%)

Commodity	Changes in Output	
	FY 2001/02	FY 2002/03
Tea	0.1	-1.0
Horticulture	4.1	30.2
Coffee	-39.2	19.0
Sugar cane	-3.8	5.9
Pyrethrum	-38.9	-1.3
Sisal	4.2	2.1

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

Following improved crop husbandry motivated by improved governance, coffee output which had been on the decline since 2001, recovered to increase by 19.0% in the financial year from a decline of 39.2% in financial year 2001/02. The average export price of coffee however, declined to 1,513 US dollars per tonne

in the financial year 2002/03 from 1,692 US dollars in the financial year 2001/02, reflecting a glut in the world market.

Sisal production increased by 2.1% compared with an increase of 4.2% in the previous financial year. The increase in sisal production is attributed to the reopening of two sisal estates which had closed down and extension of acreage under cultivation by one estate. Sugarcane output also increased by 5.9% in the period under review compared with a decline of 3.8% in the previous year due to favourable weather conditions in the sugar belt.

Tea output, however, declined by 1.0% in the financial year 2002/03 compared with an increase of 0.1% in the financial year 2001/02, reflecting delays in the onset of the long rains in major tea growing areas. The average export price per tonne of tea, however, increased to 1,615 US dollars in the financial year 2002/03 from 1,532 US dollars in the previous financial. Pyrethrum output also declined by 1.3% compared with a decline of 38.9% in the period, largely due to mismanagement including delays in payment of farmers.

Production in the food crop sub-sector remained weak in 2002 due to poor weather conditions that prevailed during the year. Maize production, as a result, declined by 4.0 million bags in 2002 to 26 million bags while wheat production declined by 16.6% from 617.5 thousand tonnes in 2001 to 515.2 thousand tonnes in 2002.

MANUFACTURING

Manufacturing, which accounts for 13.0% of GDP, recovered slightly to record a growth of 1.2% in the financial year 2002/03 compared with a growth of 1.0% in the financial year 2001/02. Manufactured exports in value terms however, increased substantially by 15.0% during the financial year compared with an increase of 11.9% during the financial year 2001/02. In part, the improved performance in the sector reflected increased access to export markets in the EAC, COMESA and the AGOA. In tandem with increased manufactured exports over the period, import of key raw materials, namely, crude materials; minerals and lubricants; and chemicals and related products increased in value by 16.0%, 38.8% and 3.3%, respectively during the second half of the financial year 2002/03. The consumption of electricity, an important indicator of industrial growth, increased by 2.6% in the period.

As shown in Table 3 below, the production of manufactures like processed sugar, soda ash, soft drinks and galvanized iron sheets experienced robust growth of 6.9%, 10.5%, 9.8% and 3.5% respectively in the financial year 2002/03 compared to respective growth rates of 25.8%, 12.1%, 7.8% and 3.5% in the financial year 2001/02. Cement production also recovered to increase by 9.9% in the financial year 2002/03 from a major decline of 17.5% in the previous financial year. The production of assembled motor vehicles, however, declined over the two financial years, reflecting a switch to relatively cheap imported motor vehicle units.

Export Processing Zones (EPZs), which offer attractive incentives to local and foreign investors, proved to be the major vehicle of growth in the manufacturing sector during the financial year. The

TABLE 3: PRODUCTION OF SELECTED MANUFACTURES

Commodity	Changes in Output (%)	
	FY 2001/02	FY 2002/03
Processed sugar	25.8	6.9
Soda ash	12.1	10.5
Soft drinks	7.8	9.8
Cement	-17.5	9.9
Assembled vehicles	-7.7	-20.4
Galvanized sheets	7.1	3.8

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

EPZs performed impressively, with the number of companies operating under the programme rising by 157% from 21 in 2001 to 54 in 2002. Consequently, direct employment in the EPZs in the year virtually doubled from 13,444 in 2001 to 26,447 in 2002. Indirect jobs in sub-contracting and supplies were estimated at 8,816, bringing the total employment associated with the EPZs to over 35,263. Local investor participation in the EPZs has grown significantly with 11% of the companies now wholly owned by Kenyans and 76% of them operating under venture arrangements with foreign investors.

ENERGY

Electricity generation increased by 2.2% to 4,509 million Kilowatt Hours (KWH) in the financial year 2002/03 compared with an increase of 13.0% in the financial year 2001/02, when total generation was 4,412 million KWH, reflecting increased water supply in hydro-power dams over the financial year due to improved rain conditions. Consequently, hydro-power became the main source of supply, accounting for 69.2% of total electricity supply while geothermal and thermal sources accounted for 22.3% and 8.5% compared with 54.8%, 34.3% and 10.9% respectively, in the financial year 2001/02.

Imports of electricity from Uganda also increased by 27.2% to 174.2 million KWH in the financial 2002/03 from 221.5 million KWH in the previous year. Consequently, electricity consumption increased by 2.2%.

Throughput of fuels handled by the Kenya Pipeline Company (KPC) increased by 3.6% in the financial year 2002/03 compared to a decline of 5.9% in the previous year. The increase was partly the result of increased use of KPC by the neighbouring countries such as Uganda to transport their crude oil products.

There was an increase in pump prices on average to 27.2 US dollar per barrel in the financial year 2002/03 from 22.8 US dollar in the previous financial year, following tensions and subsequently war in Iraq which put pressure on the oil prices.

BUILDING AND CONSTRUCTION

Building and construction, which contributes 2.3% of GDP performed poorly during the financial year 2002/03. The slowdown in the sector was mainly attributed to the low budgetary allocations by the Government to building and construction due to budgetary constraints and partly due to delayed investment in the sector accruing from political uncertainty on the likely outcome of the last General Elections and the slow pace of credit extension. A logging ban, which caused an acute shortage of timber, resulting in higher timber prices, also contributed to the slowdown in the sector.

Weak economic performance in the building and construction sector kept the economy below the highest possible growth, that was predicated on the rehabilitation of the country's dilapidated infrastructure. Due to inadequate resources, the Government continued to utilise most of the available revenue on recurrent expenditure, leaving the envisaged economic recovery, dependent on the availability of resources from development partners.

Many Government projects, therefore, either stalled or remained in disrepair for lack of provisions for operations and maintenance. For instance, the Housing Department of the Ministry of Roads, Public Works and Housing was unable to complete most of the planned projects including the urban pool housing venture started in 4 major urban towns. The National Housing Corporation (NHC) completed only two housing projects in 2002. As a result of the slowdown in the performance of the sector, cement consumption increased by only 3.8% in the financial year 2002/03 compared with an increase of 7.4% in the financial year 2001/02.

TRANSPORT ,STORAGE AND COMMUNICATION

Transport, storage and communications sector, which accounts for 6.3% of GDP, expanded by 3.0% over the financial year 2002/03 comparable to the 2.9% in the previous financial year. Mobile phone services continued to be the major source of growth. This has been the case since the liberalization of the telecommunications sector in 2000. Subscriptions to mobile phone services stood at 1.6 million in June 2003 compared to 975,500 in June 2002.

As indicated in Table 4, throughput of cargo by Kenya Ports Authority (KPA) and Kenya Pipeline Company (KPC) respectively increased by 6.7% and 3.6% in the financial year 2002/03 compared with declines of 0.1% and 5.9% in financial year 2001/02, reflecting increased use of the facilities. As a sign of increased confidence, the number of passengers passing through the Jomo Kenyatta International Airport (JKIA) increased by 6.1% in the financial year 2002/03 compared with a decline of 0.6% in financial year 2001/02.

TABLE 4: PERFORMANCE OF MAJOR SUB-SECTORS

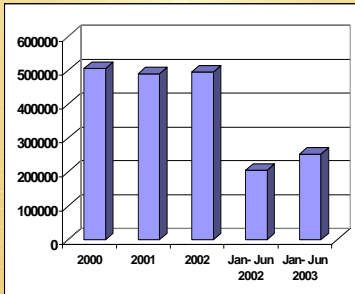
Activity	% Change FY 2001/02	FY 2002/03
Cargo by KPA	-0.1	6.7
Passengers thro JKIA	-0.6	7.1
Cargo by KR	-4.4	-2.8
Througput by KPC	-5.9	3.6

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

Cargo handled by the Kenya Railway, (KR) however, continued to slowdown, declining by 2.8%, which was less than the decline of 4.4% in the previous year. Road transport continues to be the preferred means of transporting cargo in the country due to the inefficiency in the Kenya Railways.

TOURISM

CHART 2 : TOURIST ARRIVALS



Source: Kenya Tourist Board

Tourism experienced notable improvement in the financial 2002/03. The number of visitors entering through the country's airports and by cruise ships increased by 21.7% compared with a decline of 17.7% in the financial year 2001/02 as shown in Chart 2. Foreign exchange earnings from the sector is estimated to have increased by 18.2% to US \$ 329.7m compared to US \$ 279.0m in the previous financial year. The improved performance of the sector during the period was attributed to the success in marketing of the country's tourist potential, particularly after the adverse effects of the recent terrorist attacks in the country and increased competition facing the country from emerging tourist destinations with competitive packages such as South Africa. In addition, the image of the country as a destination of choice by holiday makers improved significantly abroad following the peaceful General Elections and smooth political transition.

As indicated in Table 5 below, tourists to the country from virtually all regions increased during the first half of 2002. Only tourists from the United States reduced by 5.9% in the face of travel advisory caution by the American Government due to global terrorism threats. The United States is the third most

TABLE 5: TOURIST ARRIVALS BY REGION

Region	Jan - Jun	
	2002	2003
Africa	45,125	63,151
America	28,065	26,415
Asia	22,434	25,966
Europe	158,626	160,576
Oceanic	2,327	3,067
Others	18	222
Total	256,595	279,397

Source: Kenya Tourist Board

important source of tourists visitors to Kenya after Europe and Africa.

As a result of concerns raised by the United States and United Kingdom over the state of the country's security, the Government put in place several measures especially at the airports to enhance security and help boost tourism. To develop the sector the Government has continued to promote exploration of new tourists markets including domestic tourism and to foster strategic partnership between the public and the private sector in marketing the country abroad. The national carrier, Kenya Airways, has also started flights to new and potential markets in Asia and the Government is encouraging local and international conferences to boost tourism.

USES OF AVAILABLE RESOURCES

Resources available to the economy in 2002 were made up of output produced by all sectors and net exports, that is, real gross domestic product (GDP). Growth in real GDP eased to 1.1% in the year from 1.2% in 2001, thus indicating slowdown in the of resources available for use in the domestic economy.

There was a slowing down in aggregate demand in 2002 with total consumption declining to 90.5% of GDP from 96.8% in 2001 as shown in Table 6. The decline was mainly in private consumption which fell to 71.5% of GDP from 77.7% in 2001.

Government consumption, on the other hand, at 19.0% of GDP, hardly changed from 19.1% in 2001. The stagnation in Government consumption largely reflected budgetary constraints faced by the Government partly due to continued delay in the resumption of donor assistance. The slowdown in private consumption, on the other hand, was in part attributed

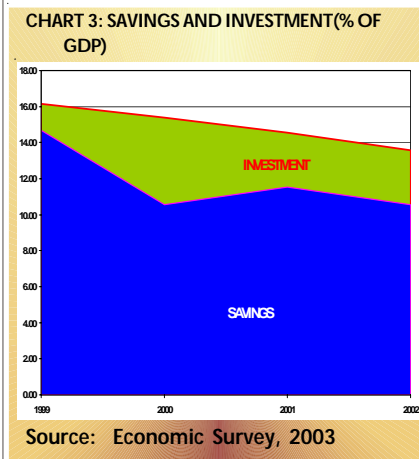
TABLE 6: USE OF RESOURCES (KSH MILLION)

	1999	2000	2001	2002
1. TOTAL RESOURCES (2+3)	786,446	871,531	982,699	1,009,192
2. CONSUMPTION	666,343	749,021	854,338	877,508
Private	540,400	609,862	685,607	693,171
Public	125,943	139,159	168,731	184,337
3. GROSS INVESTMENT	120,103	122,510	128,361	131,684
Private	71,822	72,255	78,010	80,962
Public	41,139	44,113	45,069	46,180
4. FINANCING	120,103	122,510	128,361	131,684
Domestic Savings*	109,131	84,034	101,845	102,330
Net borrowings from abroad	10,972	38,476	26,516	29,354
% of GDP				
5. TOTAL RESOURCES	105.8	109.4	111.3	104.1
6. CONSUMPTION	89.6	94.1	96.8	90.5
Private	72.7	76.6	77.7	71.5
Public	16.9	17.5	19.1	19.0
7. GROSS INVESTMENT	16.2	15.4	14.5	13.6
Private	9.7	9.1	8.8	8.4
Public	5.5	5.5	5.1	4.8
8. FINANCING	16.2	15.4	14.5	13.6
Domestic Savings	14.7	10.6	11.5	10.6
Net borrowing from abroad	1.5	4.8	3.0	3.0
9. MEMORANDUM ITEM				
GDP (Market Pices)	743,479	796,343	882,725	969,354

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

to the uncertainty surrounding the outcome of the 2002 General Elections.

Similarly, gross investment slowed down to 13.1% of GDP in 2002 from 13.9% in 2001 as shown in Chart 3. This was the eighth consecutive year of continuous decline in investment. The slowdown in investment in the year was in both private and public investment. Private investment fell to 8.4% of GDP from 8.8% in 2001 while public investment dropped to 4.8% of GDP from 5.1%, reflecting partly the moderation in investment in the face of excess capacity in industry and weak investor confidence brought about by poor economic and political governance, inefficient infrastructure and security concerns. Budgetary constraints, on the other hand, continued to hold back Government investment.



As a result, the amount of resources absorbed into gross investment and consumption slowed down from 111.3% of GDP in 2001 to 104.1% in 2002. Following the slowdown in inflows of resources into the country in form loans and grants, pending resumption of donor financial support, the financing of investment in 2002 was largely from of domestic sources. The net outcome of the slowdown in investment, largely financed by domestic savings, was a significant narrowing of the current account deficit in the year.

While it was possible to improve the economic growth through efficient use of the resources available then, the economy required investment of above 20% GDP sustained over time, to raise real economic growth to above 5% per annum that would be necessary to create wealth and address the twin problems of poverty and unemployment. In appreciation of the importance of these fact, the Government began earnestly implementing measures aimed at addressing the weaknesses in the economy to revive investor confidence and boost investment and growth.

CAPITAL FLOWS TO KENYA

Net Official Development Assistance

As shown in Table 7, official funding to developing countries, in general, declined in 2002, mainly because the IMF made fewer disbursements. The net official development assistance (ODA), that is, foreign aid and debt financing to Sub-Saharan Africa, however, improved by 17.6 % of the US\$ 12.0 billion in 2002. Of this, Kenya received only 0.4 % (equivalent to about US\$ 47m), reflecting an improvement over the net outflow of US\$ 155m in 2001. Increased official capital inflows and reduced official capital outflows accounted for the improvement in net ODA in 2002. Bilateral and multilateral ODA disbursements increased to US\$ 211m in 2002 mainly due to US\$ 39m increase in project loan inflows largely to the energy sector and increase of US\$ 8m in Government guaranteed loans. There was also an increase of US\$ 17m in inflows of grants from official sources for capital expenditure mostly in the social sectors, such as health and education. Official capital outflows, on the other hand, declined, by US\$199m to US\$ 253m in 2002.

TABLE 7: NET OFFICIAL DEVELOPMENT ASSISTANCE TO DEVELOPING COUNTRIES: 1999-2002

	(US\$ Billion)			
Year	1999	2000	2001	2002
East Asia & Pacific	15.3	9.5	5.7	-0.2
Europe & Central Asia	7.2	8.2	10.2	13.5
Latin America & Caribbean	4.5	-8.6	23.4	15.8
South Asia	4.9	2.8	6	6
Middle East & North Africa	0.6	0.9	2	1.8
Sub-Saharan Africa	10.3	10.6	10.2	12
Kenya	-0.242	-0.073	-0.155	0.047
<i>Net current transfers</i>	-0.002	0.091	0.089	-0.002
<i>Net capital transfers</i>	0.064	0.056	0.072	0.089
<i>Net official loan inflows</i>	-0.304	-0.22	-0.315	-0.042
Total Net Flows	42.8	23.4	57.5	48.9

Source: Global Development Finance (2003) & Central Bank of Kenya

The low share of ODA to Kenya relative to other African countries in 2002 and over the past decade has been due to withdrawal of donor funding since early 1990s. This was attributed to failure to sustain prudent macroeconomic policies, the slow pace of structural reform, and the persistent governance problems. The lapse of IMF's Enhanced Structural Adjustment Program (ESAF) that was negotiated in mid 1990s and the suspension of the subsequent Poverty Reduction and Growth Facility (PRGF) program negotiated towards the end of 1990s have adversely affected both bilateral and multilateral ODA disbursements to the country.

The low share of ODA to Kenya is, however, expected to improve in years ahead following the successful holding of peaceful elections and subsequent smooth transition of power to a newly elected Government. By bolstering expectations of improved macroeconomic management, a faster pace of structural reform, and improvement in governance, these events are expected to lead to higher ODA to Kenya.

Private Sector Debt and Portfolio Flows

Private capital flows to Kenya represent an important supplement to the ODA. As shown in Table 8, debt and portfolio flows to Kenya from the private sources were weak in 2002. Net private loans to Kenya improved in 2002 from a net outflow of US\$ 0.10 billion in 2001 to a net outflow of US\$ 0.07 billion. Net portfolio flows to Kenya, however, declined in 2002 from a net inflow of US\$ 0.62 billion in 2001 to a net inflow of US\$ 0.07 billion (about 0.10% of total net debt and portfolio flows to Sub-Saharan countries) in 2002. The decline in net portfolio flows to Kenya was on account of lower yields in portfolio investments, reflecting reduction in the general level of interest rates, particularly of short-term dated Government

securities. During the year 2002, Treasury bill interest rates declined substantially to 8.38% from 11.1% a year earlier. The Treasury bill interest rates were even lower, standing at 1.2% at the end of June 2003. Uncertainty related to the outcome of the General Elections held in December 2002 also accounted for the decline in net portfolio flows to Kenya.

TABLE 8: PRIVATE SECTOR DEBT & PORTFOLIO FLOW TO DEVELOPING COUNTRIES: 1999-2002 (US\$ BILLION)

Year	1999	2000	2001	2002
East Asia & Pacific	-19.5	-5.7	-12.6	-0.6
Europe & Central Asia	18.6	23.4	0.8	11.2
Latin America	7.1	9.6	-6.4	-8.1
South Asia	0.4	4.6	-1.1	-0.2
Middle East & North Africa	0.5	-3.6	2.9	1.3
Sub-Saharan Africa	7.7	2.6	-2.3	-0.7
Kenya	0.4	0.55	0.52	-0.0014
<i>Net private sector</i>	<i>-0.04</i>	<i>-0.04</i>	<i>-0.1</i>	<i>-0.07</i>
<i>Net portfolio inflows*</i>	<i>0.44</i>	<i>0.58</i>	<i>0.62</i>	<i>0.07</i>
Total net Flows	15.2	31.4	-18.2	2.9

* Net short term flows, mainly to money markets, includes statistical discrepancy, that is, errors and omissions, in recorded transactions

Source: Global Development Finance (2003) & Central Bank

As shown in Table 8, private sector flows to Sub-Saharan Africa during the year 2002 improved from a net outflow of US\$ 2.3 billion in 2001 (about 12.6% of total net debt and portfolio flows to developing countries) to a net outflow of US\$ 0.7 billion (about 24.1% of total net debt and portfolio flows to developing countries). Of the US\$ 0.7 billion net debt and portfolio outflow from Sub Saharan Africa in 2002, Kenya's share was only 0.2 % (equivalent to about US\$ 14m). Like the ODA, the low share of private sector flows to Kenya relative to other African countries in 2002 and over the past decade was attributed to withdrawal of donor funding in the early 1990s.

Net Foreign Direct Investment (FDI)

Foreign Direct Investment (FDI) flows to developing countries shown in Table 9 fell by 16.9 % in 2002 to a net inflow estimated at US\$ 143 billion or 2.4% of GDP, mainly reflecting weak economic growth, tumbling stock markets which contributed to slowdown in privatization and mergers and acquisitions transactions. Net inward FDI flows to Sub-Saharan Africa, in particular, declined by 49.3 % to US\$ 7 billion in 2002.

FDI to Kenya during this period is estimated to have been US\$ 50 million, a mere 0.7 % of the entire US\$ 7 billion FDI to Sub-Saharan Africa. Like in many African countries, FDI to Kenya – averaging about \$62 million a year during the last five years – has, largely been concentrated in a few sectors, namely manufacturing, telecommunications and tourism sectors.

**TABLE 9: NET INWARD FDI FLOWS TO DEVELOPING COUNTRIES:
1999-2002**

	(US\$ Billion)			
Year	1999	2000	2001	2002
East Asia & Pacific	49.9	44	48.9	57
Europe & Central Asia	28.3	29.2	30.1	29
Latin America & the Caribbean	87.8	75.8	69.3	42
South Asia	3.1	3.1	4.1	5
Middle East & North Africa	3.2	2.5	5.5	3
Sub-Saharan Africa	8.1	6.1	13.8	7
<i>Kenya</i>	<i>0.042</i>	<i>0.127</i>	<i>0.05</i>	<i>0.05</i>
Total	179.3	160.6	171.7	143

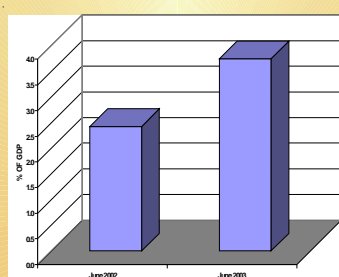
Source: Global Development Finance (2003) & Central Bank

FINANCING OF THE GOVERNMENT

Kenya's political developments over the year 2002 significantly impacted on the Government fiscal operations over the 2002/03 financial year with the peaceful political transition that saw the then ruling party cede power to the new NARC Government. The responsibility of fiscal management, therefore, was shared by two administrations, confronting essentially similar challenges of poverty, unemployment and poor growth performance but with different policies, priorities and implementation strategies.

Inevitably, the new Government inherited commitments entered to by the previous one and coupled with its own priorities and active fiscal stance turned out more expansionary. Thus, the overall Government fiscal operations in the 2002/03 financial year resulted in wider deficit both on commitment and cash basis. In spite of the widening, the deficit was financed almost entirely from non-inflationary domestic sources. On a commitment basis, the deficit widened to 3.7% of GDP from 2.4% of GDP in the previous fiscal

CHART 4: BUDGET DEFICIT ON A COMMITMENT BASIS



Source: Central Bank of Kenya and Treasury

TABLE 10: BUDGET OUTTURN (KSH BN)

	FY 2001/02 Actual	FY 2002/03 Actual*	Target	Over(+) Below (-)
1. TOTAL REVENUE & GRANTS	204.6	225.7	235.5	-9.8
Revenue	197.8	210.8	217.0	-6.3
Tax Revenue	160.4	177.0	181.1	-4.1
Non Tax Revenue	18.5	17.3	14.5	2.8
Appropriations-in-Aid	18.9	16.5	21.4	-4.9
External Grants	6.8	14.9	18.5	-3.6
2. TOTAL EXPENDITURE AND NET LENDING	226.9	262.6	278.0	-15.4
Recurrent Expenditure	202.0	224.1	230.4	-6.3
Development Expenditure	25.0	38.5	47.6	-9.1
3. DEFICIT ON A COMMITMENT BASIS (1-2)	-22.3	-36.9	-42.5	5.6
	(2.4)	(-3.7)	(-4.3)	
4. ADJUSTMENT TO CASH BASIS	-5.6	1.1	-5.7	6.8
5. DEFICIT ON A CASH BASIS	-27.9	-35.8	-48.2	12.4
	(-3.0)	(-3.6)	(-4.9)	
6. DISCREPANCY: Expenditure (+) / Revenue (-)	-0.6	-1.0	0.0	-1.0
7. FINANCING	27.3	34.8	48.2	-13.4
Domestic (Net)	39.7	46.9	55.0	-8.1
External (Net)	-13.3	-12.1	-6.8	-5.3
Capital Receipts (privatisation)	1.0	0.0	0.0	0.0

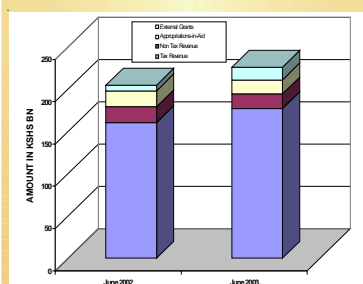
* Provisional

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

Sources: Central Bank of Kenya and Treasury

year as shown in Table 10 and Chart 4. Over a similar period, the deficit on a cash basis, widened to 3.6% of GDP from 3.0% of GDP. The developments also reflected the effect of reduced tax revenue associated with lower than initially forecast economic growth and higher Government expenditure as explained above. The introduction of free primary school education program and adjustments in emoluments in parts of the public sector by the new Government were the major changes in the structure of spending.

CHART 5: COMPOSITION OF REVENUE



Source: Central Bank of Kenya and Treasury

Revenue and Grants

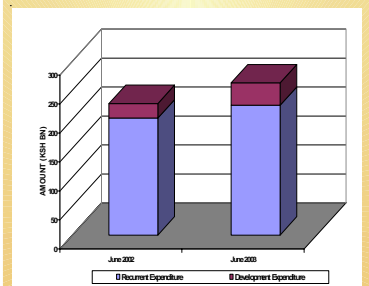
Government revenues including grants improved to Ksh 225.7bn from Ksh 204.6bn in the previous financial year as shown in Chart 5. Revenues were, however, Ksh 9.8bn lower than the estimate of Ksh 235.5bn in the revised budget. All categories of receipts underperformed, with significant shortfalls in appropriations-in-aid and in inflows of external grants. The shortfall in tax revenue was attributed to lower economic growth than was forecast in the budget while the shortfall in grants was attributed to withholding of donor funds earlier pledged for the budget.

Tax revenues accounted for 78.4% compared with 78.3% of total Government receipts in the previous fiscal year. Most of the increase in tax collections reflected improvements in tax administration, particularly in areas of follow-up of non-filers and arrears, and audits and controls on both remissions and counterfeit goods.

Expenditure and Net Lending

Government expenditure increased to Ksh 262.6bn in financial year 2002/03 from Ksh 226.9bn in the previous financial year as shown in Chart 6. As a result, the share of recurrent expenditure in GDP increased by 0.8% to 22.8% in financial

CHART 6: COMPOSITION OF EXPENDITURE



Source: Central Bank of Kenya and Treasury

year 2002/03 from 21.9% in the previous financial year while that of development expenditure increased to 3.9% from 2.7% over the same period, implying that the increase in expenditure went more towards recurrent expenditure.

Most of the increase in expenditure resulted from higher allocations to the Review of the Constitution and General Elections. Elected on a platform of promises made for better financial management and greater attention to social sector problems, the new Government has had to cope with increased expenditure associated with free primary education in public schools and adjusted emoluments for segments of the public service including implementing salary awards to teachers. In spite of the upward revision of Government expenditure estimate, the actual expenditure outturn was Ksh 15.4bn below the ceiling in the revised estimates, as the Government realised savings from non-wages and non-interest recurrent expenditure and from lower development expenditure than targeted following the continued withholding of donor pledges for the budget.

Financing

The Government fiscal operations during the 2002/03 financial year resulted in an overall financing gap of Ksh 54.9bn. The gap was wholly financed from domestic sources with the Government borrowing Ksh 2.4bn from the Central Bank, Ksh 34.8bn from commercial banks and Ksh 17.7bn from the non-bank sector. Foreign borrowings, amounting to Ksh 7.5bn while repayments amounting to Ksh 19.6bn were made, implying net foreign financing was negative at Ksh 12.1bn. The borrowed domestic funds were utilised to increase government deposits at the Central Bank by Ksh. 8.0bn, make net external debt repayment of Ksh 12.1bn and finance a budget deficit of Ksh 34.8bn.

PUBLIC DEBT

Increased borrowing to finance budget deficit and to service external debt, resulted in an increase in Government public debt to Ksh 647.0bn in June 2003 from 613.8bn in June 2002, as shown in Table 11. Of the outstanding public debt, Ksh 289.3bn or 44.7% was domestic while Ksh 357.7bn or 55.3% was foreign.

TABLE 11: PUBLIC DEBT (KSH BN)

	June 2002		June 2003*	
	shs bn	%	shs bn	%
DOMESTIC DEBT				
Securitised debt	225.9	95.7	268.4	92.8
Treasury Bills	118.1	50.0	105.7	36.6
of which repo t.bills	36.0	15.3	27.0	9.3
Treasury Bonds	106.3	45.1	161.6	55.8
Government Stocks	1.5	0.6	1.1	0.4
Non Securitised debt	10.1	4.3	21.0	7.2
Overdraft/Advances	9.2	3.9	11.0	3.8
Non-interest bearing debt	0.9	0.4	9.9	3.4
TOTAL DOMESTIC DEBT	236.0	100.0	289.3	100.0
EXTERNAL DEBT				
Bilateral	130.0	34.4	118.6	33.2
Multilateral	222.5	58.9	214.7	60.0
Comm. Banks	24.0	6.4	23.7	6.6
Export Credit	1.3	0.3	0.6	0.2
TOTAL EXTERNAL DEBT	377.8	100.0	357.7	100.0
TOTAL PUBLIC DEBT	613.8		647.0	
(as a % of GDP)		66.7		65.7

* Provisional

Sources: Central Bank of Kenya and Treasury

Domestic Debt

Public domestic debt increased to Ksh 289.4bn in June 2003 from Ksh 236.0bn in June 2002, reflecting Government borrowing to finance the budget deficit and service external debt. The increase in domestic borrowing requirement was necessitated by the external budgetary support shortfalls which had to be financed domestically following the continued withholding of donor support. Except for Ksh 4.3bn in Central Bank overdraft,

the rest of the increase in the debt was incurred through the sale of Treasury bonds to commercial banks and the non-bank public.

Government securities market policy during the financial year was to reduce the benchmark 91 days Treasury bill rate and facilitate reduction in the money market interest rates. The policy also aimed at developing a yield curve to encourage the issuance of corporate bonds by providing a basis for their pricing at the primary issue and in the secondary market; providing an alternative long term investment avenue in the domestic financial market; improving management of the domestic debt; and achieving a reduction in the domestic interest cost of the debt in the medium and long-term.

In pursuit of the above objectives, the Government introduced and successfully placed with investors Treasury bonds of 7, 8, 9 and 10 years tenor in the months of March, April, May and June 2003, respectively. As a result, the average maturity of the domestic debt lengthened to 1 years 7 months in June 2003 from 1 year and 1 month in June 2002. Concomitantly, the stock of Treasury bills declined to Ksh 105.7bn in June 2003 from Ksh118.1bn in June 2002 while the stock of Treasury bonds

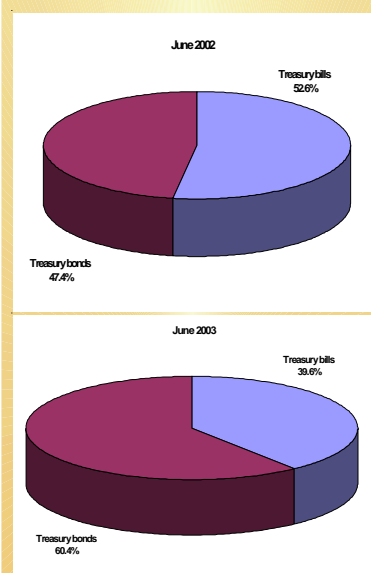
TABLE 12: OUTSTANDING STOCK OF TREASURY BILLS BY HOLDER (KSH BN)

Holders	Jun-02		Jun-03	
	Ksh	%	Ksh	%
Banking Institutions	66.5	56.3	63.2	59.8
Central Bank	36.3	30.7	27.0	25.5
Comm. Banks	28.7	24.3	35.2	33.3
NBFIs	1.5	1.3	1.0	0.9
Insurance Companies	8.7	7.4	5.9	5.5
Parastatals	5.8	4.9	6.2	5.8
of which NSSF	1.1	1.0	1.8	1.7
Building Societies	0.4	0.3	0.2	0.2
Others	36.7	31.0	30.2	28.6
Total	118.1	100.0	105.7	100.0

Source: Central Bank of Kenya

increased to Ksh 161.6bn in June 2003 from Ksh 106.3bn in June 2002, as shown in Tables 12 and 13.

CHART 7: COMPOSITION OF GOVERNMENT SECURITIES



Source: Central Bank of Kenya and Treasury

As the stock of Treasury bonds increased, the stock of Treasury bills, including Repo bills declined to Ksh 105.7bn in June 2003 from Ksh 118.1bn in June 2002. The change in the structure of Government securitized domestic debt is as shown in Chart 7. It is expected that the downward trend will continue, particularly in view of the announcement by the Minister for Finance in June 2003 that Treasury bills issues will be used for cash flow management only. Another notable development during the fiscal year was the significant increase in the share of Treasury bonds of 5 years and longer maturities to 26.7% from only 5.8% in the previous fiscal year. Outstanding Government long-term stocks continued to decline during the year to June 2003, falling by Ksh 0.4bn to stand at Ksh 1.1bn.

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

Holders	Jun-02		Jun-03	
	Ksh	%	Ksh	%
Banking Institutions	66.5	56.3	63.2	59.8
Central Bank	36.3	30.7	27.0	25.5
Comm. Banks	28.7	24.3	35.2	33.3
NBFIs	1.5	1.3	1.0	0.9
Insurance Companies	8.7	7.4	5.9	5.5
Parastatals	5.8	4.9	6.2	5.8
of which NSSF	1.1	1.0	1.8	1.7
Building Societies	0.4	0.3	0.2	0.2
Others	36.7	31.0	30.2	28.6
Total	118.1	100.0	105.7	100.0

Source: Central Bank of Kenya

Domestic Debt Service

As a result of the increase in domestic borrowing mainly through the relatively high yield Treasury bonds, interest payments on the domestic debt increased to Ksh 27.6bn from KSh 23.7bn in the previous year. In effect, interest on the debt absorbed 15.6%

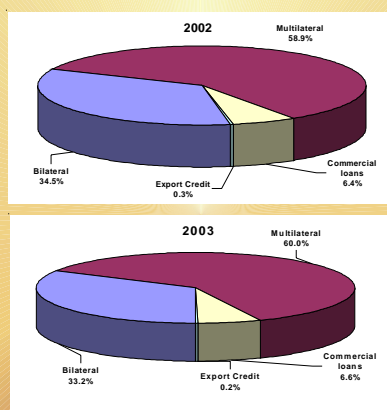
of tax revenue and accounted for 12.3% of recurrent expenditure compared with 14.8% and 11.7%, respectively, in the previous financial year. Yields on Treasury bonds, however, eased significantly during the second half of the year as liquidity in the domestic money market increased due to low credit demand from the private sector and lack of alternative avenues of lending.

External Debt

External debt decreased to Ksh 357.7bn or 36.3% of GDP in June 2003 from Ksh 377.8bn or 41.0% of GDP in June 2002, following debt repayments of Ksh 27.4bn and revaluation gains of Ksh 0.2bn. The decline in the stock of external debt reflected the amortisation of external debt obligations by the Government and minimal contracting of new debt. As shown in Table 14 and Chart 8, multilateral and bilateral creditors continued to account for most of the external debt, holding Ksh 214.7bn and Ksh 118.6bn, respectively.

External Debt Service

CHART 8: EXTERNAL PUBLIC DEBT



Sources: Central Bank of Kenya and Treasury

TABLE 14: DISTRIBUTION OF EXTERNAL PUBLIC DEBT

	Jun-00		Jun-01		Jun-02		Jun-03*	
	Kshbn	%	Kshbn	%	Kshbn	%	Kshbn	%
Bilateral	138.6	35.0	132.3	33.6	130.0	34.4	118.6	33.2
Multilateral	230.7	58.3	228.5	58.0	222.5	58.9	214.7	60.0
Commercial loans	24.9	6.3	29.4	7.5	24.0	6.4	23.7	6.6
Export Credit	1.5	0.4	3.8	1.0	1.3	0.3	0.6	0.2
Total	395.7	100.0	394.0	100.0	377.8	100.0	357.7	100.0

* Provisional

Sources: Central Bank of Kenya and Treasury

Government external debt service in the financial year 2002/03 increased to Ksh 38.4.bn from Ksh 33.0bn in the previous financial year, reflecting payment of arrears on both interest and principal. The external debt service absorbed 18.2% of revenue compared with 16.8% in the previous year. The service payments comprised Ksh 19.1bn in Central Government debt; Ksh 6.9bn in Government guaranteed debt, Ksh 1.4bn in Central Bank repayments to the International Monetary Fund and Ksh 0.2bn in revaluation gains. In addition, the Government made payments in interest of Ksh 9.8bn on Central Government debt, Ksh 1.1bn on public guaranteed debt and Ksh 0.1bn on Central Bank debt with the International Monetary Fund.

BANKING DEVELOPMENTS

Overview

The banking sector remained generally stable during the financial year 2002/2003. Despite the lacklustre performance of the economy, the banking sector improved its asset portfolio, deposits, and capitalization and retained high liquidity. The improved performance resulted from lower bad debts charge, reduced operational costs and a significant inflow of foreign deposits into the local banking system. Two institutions were however, placed under statutory management and one under liquidation.

Structure of the Banking System

At the end of June 2003, the banking system comprised 43 commercial banks, 2 non-bank financial institutions (NBFIs), 2 mortgage finance companies and 4 building societies. Banking and non-bank financial institutions declined to 51 in June 2003 from 55 in June 2002 due to the merging of six institutions into three and the liquidation of another. However, the sector remained highly concentrated with 9 of the 43 banks controlling 74% of total assets in the sector.

A number of banks closed some branches as part of their cost and business rationalisation measures. As a result, the branch network of commercial banks declined to 488 at the end of June 2003 from 497 in June 2002.

Foreign exchange bureaus stood at 47 in June 2003 from 48 at the end of June 2002 following the closure of one up-country foreign exchange bureau. In order to enhance competition in the foreign exchange market, the moratorium imposed in October 1999 on the licensing of new foreign exchange bureaus was lifted during the year to allow entry of more foreign exchange bureaus.

Structure of Commercial Banks' Balance Sheet

Assets of the banking sector at the end of June 2003 were mainly made up of loans and advances (47%), investment in Government securities (25%) and balances with Central Bank (6%), foreign assets (6%) and cash and other assets (16%). As shown in Table 15, total assets which stood at Ksh 467.6bn in June 2003 were 7% above the level in June 2002. The increase in assets was both due to increased lending to Government in form of Treasury bills and bonds and marginal increase in lending to the private sector. Being

TABLE 15: BALANCE SHEET

	June 2003	% (share)	June 2002	% (share)	% Change
Assets					
Cash	6,993	1	5,941	1	17.7
Balances from CBK	30,070	6	25,519	6	17.8
Placements	6,195	1	8,910	2	-30.5
Govt. securities	114,759	25	89,127	20	28.8
Investments	5,961	1	3,877	1	53.8
Loans & advances (Net)	219,667	47	212,670	49	3.3
Foreign Assets	25,887	6	30,636	7	15.5
Other assets	58,039	13	59,868	14	3.1
Total Assets	467,571	100	436,548	100	7.1
Liabilities and shareholders funds					
Deposits	373,570	80	343,827	79	8.7
Foreign Liabilities	4,763	1	10,146	2	-53.1
Other liabilities	31,434	7	29,837	7	5.4
Capital & Reserves	57,804	12	52,738	12	9.6
Total Liabilities and shareholders funds	467,571	100	436,548	100	

Source: Central Bank of Kenya

averse to the risks of default in lending to the private sector, the banking sector continued to invest heavily in Government securities despite the sharp decline in Treasury bills rates. Consequently, their liquidity rose to 49%, well above the 20% minimum requirement and higher than the 44% level at the end of June 2002.

The sector, continued to carry undesirably high non-performing loans (NPLs). While the proportion of NPLs to total loans declined to 28.8% in June 2003 from 29.2% in June 2002, the absolute amounts of NPLs increased to Ksh 73.2bn from Ksh 71.5bn. Their threat to banking system stability was however mitigated by provisions already made amounting to Ksh 32.3bn and securities held by banks estimated at Ksh 33.8bn.

Total Liabilities and Shareholders Funds

Deposits, as shown in Table 16, continued to be the major component of the liability portfolio of the banking system constituting 96.7%. They increased by 8.7% during the period

TABLE 16: COMPOSITION OF DEPOSITS (KSH M)

Banks	2002 % (share)		2003 Share in		% change
	June	June	2003 (%)	June	
TYPE OF DEPOSITS					
Demand deposits	115,332	33.5	137,913	36.9	19.6
Kenya shillings	87,721	25.5	102,974	27.6	17.3
Foreign Currency	27,611	8	34,939	9.4	26.5
Time Deposits	137,747	40.1	138,052	37	0.2
Kenya shillings	119,083	34.6	117,463	31.4	1.4
Foreign Currency	18,664	5.4	20,589	5.5	10.3
Saving Deposits	79,060	23	90,522	24.2	13.1
Kenya shillings	78,840	22.9	90,190	24.1	13
Foreign Currency	220	0.1	332	0.1	50.9
Sub-Total	332,139	96.7	366,487	98.1	10.3
Kenya shillings	285,644	83.1	310,627	83.2	8.7
Foreign Currency	46,495	13.5	55,860	15	20.1
Others	11,689	3.4	7,083	1.8	-39.4
Total	343,827		373,570	100	8.7

Source: Central Bank of Kenya

under review. The increase in deposit base reflected increase in credit to Government and private sector and a build up of net foreign assets in the banking system.

Capital and Reserves

Capital and reserves of the banking sector increased by 9.6% in the year to June 2003 to Ksh 57.8bn from Ksh 52.7bn in June 2002. Measured by the ratio of total capital to total risk-weighted assets the level of capitalization, also strengthened to 17.7% from 16.8% in June 2002. The improvement in the ratio over the period is attributed to the increase in total capital by Ksh 3.2bn that offset Ksh 1.8bn increase in total risk weighted assets. The increase in total capital reflected both the improved profitability of the banking institutions and fresh capital injections by a few institutions in order to meet the minimum capital requirements.

Although interest rates in the year declined drastically over the last six months, the banking sector experienced an impressive 97% increase in pre-tax profit to Ksh 6.5bn for the six months ending June 2003, up from Ksh 3.3bn in a similar period in 2002. Most of the improvement in profitability in the sector is attributed to reduced provisions against bad debts as most of the provisions were made in the past year. As shown in Table 17, forty-four institutions made profits of Ksh 6.9bn, while three made losses of Ksh 0.4bn. The largest two banks made the highest pre-tax profits of Ksh 3.7bn or 57% of the total profits of the sector. Non-funded income from commissions, charges, penalties and foreign exchange trading

increased by 14% to Ksh 10.3bn, against Ksh 9.0bn increase in the same period in the previous year and contributed to the good performance. The sector also benefited from significant reduction in interest expenses incurred on deposits.

TABLE 17: BANKING INDUSTRY PROFITS (KS M)

	Jun-02	Jun-03
Total income	29,610	30,255
Expenses before provisions	21,798	20,636
Profit before provisions	7,814	9,619
Provisions for bad debts	4,530	3,155
Profit before tax	3,284	6,464

Source: Central Bank of Kenya

MONEY SUPPLY

For the year to June 2003 the Central Bank's monetary policy stance aimed at containing inflation within 5% and supporting 2.2% real GDP growth. Consistent with the inflation objective, the monetary expansion was implemented using a reserve money programme. Largely driven by bank credit growth, an overly large broad money growth, M3X, from July through October 2002 led to a revision of the reserve money programme in November 2002. The revised targets are shown in Table 18.

TABLE 18: MONEY SUPPLY AND ITS SOURCES (KSH BN)

	Jun 2000/2001 Act	Jun 2001/02 Act	Jun 2002/03 Act	Jun 2003 Targets	
				Original	Revised
1.0 Liability					
Money Supply					
Money supply, M2 1/	290.1	318.5	350.0		
Money supply, M3 2/	305.5	331.6	362.6	342.3	354.8
Money supply, M3X 3/	354.7	378.3	419.4	395.4	404.9
Money supply, M3XT 4/	446.6	483.9	542.8	526.1	541.0
2.0 Assets (2.1+2.2)	354.7	378.3	419.4	395.4	404.9
2.1 Net foreign assets 5/	91.2	97.0	104.2	103.2	102.1
Central Bank	66.8	77.8	81.5	86.0	81.7
Banking Institutions	24.4	19.2	22.8	17.2	20.4
2.2 Net domestic assets (2.21+2.22)	263.5	281.2	315.2	292.2	302.8
2.21 Domestic Credit (2.210+2.211)	324.6	342.0	383.1	402.8	363.7
2.210 Government (net)	68.7	94.7	123.8	94.7	98.6
2.211 Private sector and other public sector	255.9	247.2	259.3	308.1	265.1
2.22 Other assets net	-61.1	-60.7	-67.9	-110.6	-61.0
Memorandum Item:					
Reserve Money 6/	69.3	76.9	85.5	84.1	76.0

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

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

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

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

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

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

Source: Central Bank of Kenya

Under the programme, the bank relied on Open Market Operations (OMO), cash ratio requirement and rediscount facilities to influence money supply and keep inflation in check. Implementation of the monetary program involved day-to-day monitoring of developments in reserve money with a view to managing its growth in line with the desired money supply targets. In the process, the Bank intervened in the domestic money market largely through the OMO.

Reserve Money

Reserve money growth accelerated in the twelve months to June 2003 by 11.2% compared with the 6.6% target increase and 10.9% expansion in a similar period in 2002 as shown in Table 20. The expansion in the reserve money in the year to June 2003 was in both commercial bank reserves with the Central Bank and currency in circulation.

As shown in Table 19, commercial bank reserves increased by 21.0% in the year to June 2003 while currency in circulation increased by 6.5% over the same period. The increase in bank reserves reflected release of substantial liquidity previously held by the Central Bank for monetary policy management under OMO. Reflecting the release of these funds, the stock of Treasury bills held by commercial banks under Repo decreased by 52% to Kshs 13.0bn in June 2003 from Ksh 27.1bn in June 2002. In the process, liquidity in the inter-bank market, as measured by commercial banks deposits at the Central Bank, expanded.

TABLE 19: RESERVE MONEY & ITS SOURCES (KSH BN)

	2002 Jun	2003 Jun	Change Absolute	%	Target Jun	Deviation
1 Net Foreign Assets	77.8	81.5	3.6	4.7	81.7	-0.2
2 Net Domestic Assets	-1.0	4.0	5.0	-521.8	0.3	3.8
2.1 Government Borrowing (net)	20.0	14.6	-5.5	-27.4	18.8	-4.2
2.2 Advances & Discounts	-23.4	-8.4	15.0	-64.0	-21.0	12.6
2.3 Other Domestic Assets (net)	2.4	-2.2	-4.6	-190.0	2.5	-4.6
3 Reserve Money	76.9	85.5	8.6	11.2	82.0	3.5
3.1 Banks Deposits at CBK	25.0	30.3	5.3	21.0	28.5	1.7
3.2 NBFIs Deposits at CBK	0.2	0.2	0.0	-14.8	0.2	0.0
3.3 Currency in Circulation	51.9	55.2	3.4	6.5	53.3	2.0

Source: Central Bank of Kenya

On the sources side, the expansion in reserve money in the twelve months to June 2003 was mirrored in the expansion of the Bank's net domestic assets (NDA) and net foreign assets (NFA). The NDA increased by Ksh 5.0bn, in contrast with the decline of Ksh 3.5bn in the year to June 2002. This expansion was occasioned largely by net redemptions of Ksh 14.1bn by commercial banks of funds previously held under Repo with commercial banks. The Central Bank advances to commercial banks also increased by Ksh 0.9bn.

The liquidity injected through the Central Bank transactions with commercial banks was particularly offset by a net build up of Government deposits at the Bank and an increase in other liabilities of the Bank. Over the year to June 2003, the Government accumulated Kshs 8.1 bn in additional deposits at the Bank, fully offsetting Ksh 2.4bn new borrowing acquired largely through the overdraft facility, as other domestic assets of the Central Bank declined by Ksh 4.6bn. On the other hand, the Bank's NFA increased by 4.7% to Ksh 81.5bn in June 2003 and was within the 5.0% target growth.

Money Supply

Broad money supply (M3X) expanded by 10.9% in the year to June 2003 compared with the 6.7% increase in the year to June 2002 and 7.0% target growth as shown in Table 20. Of the expansion in the M3X, the deposits in residents' foreign currency denominated accounts increased by 25.5% in the year to June 2003 compared with 10.3% increase over similar period in 2002; while the deposits made in shillings and the stock of Kenya currency held by non-bank public, or M3, increased by 9.3% compared with the 7% target growth in the year to June 2003. The expansion in M3X resulted from 7.5% increase in banking system net foreign assets (NFA) and 12% increase in net domestic assets (NDA). The NFA expansion, which accounted for 18% of the increase in the M3X, comprised 19.1% build up in the holdings of commercial banks and 4.7% increase in the holdings of the Central Bank. Meanwhile, the NDA increased by Ksh 33.8bn in the year to June 2003, through additional lending to the private sector of Ksh 12.1bn and Ksh 29.1bn to Government and a partially offsetting Ksh 7.4bn decline in other domestic assets of the banking system.

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

	RM		M3		M3X		M3XT	
	Act.	Targ.	Act.	Targ.	Act.	Targ.	Act.	Targ.
2002								
Jun	10.9	9.7	8.5	6.4	6.7	4.9	8.4	6.3
Jul	16.7	10.4	8.7	4.7	7.6	4.4	8.6	5.7
Aug	5.0	6.6	11.3	5.6	10.9	5.2	11.6	8.5
Sep	12.6	11.4	8.1	3.1	8.4	3.0	10.6	8.0
Oct	6.9	6.3	7.2	1.2	7.0	1.5	9.5	7.4
Nov	9.1	6.4	8.4	1.6	9.6	1.9	13.6	6.5
Dec	11.8	4.9	8.8	6.8	10.2	6.5	12.8	10.3
2003								
Jan	13.4	13.1	10.8	9.6	12.7	9.0	13.8	10.0
Feb	11.7	10.6	9.6	9.3	10.8	8.9	11.7	9.5
Mar	11.0	8.1	9.9	9.5	11.7	9.1	13.1	12.3
Apr	8.0	7.7	7.7	8.1	9.7	7.9	11.9	11.9
May	9.4	5.7	8.5	8.1	10.6	7.9	12.8	12.8
Jun	11.4	6.6	9.3	7.0	10.9	7.0	12.2	11.8

Source: Central Bank of Kenya

Domestic Credit Developments

Domestic credit expanded by 12.0% in the year to June 2003 compared with a 6.4% target growth and 7.1% increase in the year to June 2002. Most of the increase in credit was to Government. Credit to Government increased by 30.7% or Ksh 29.1bn to Kshs 123.8bn in the year to June 2003. Credit to Government by the Central Bank, however, dropped by Ksh 5.6bn due to a build up of Ksh 8.1bn in Government deposits at the Central Bank.

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

	2002 Jun		2003 Jun		Annual Change		Jun '02 - Jun '03 %dist. of ann. change in credit to private sector
	Ksh bn	Share (%)	Ksh bn	Share (%)	Ksh bn	(%)	
1. Credit to other public sector	6.6	2.7	6.3	2.4	-0.3	-5.2	
Local government	-0.5	-0.2	-0.2	-0.1	0.3	-60.1	
Parastatals	7.1	2.9	6.5	2.5	-0.6	-8.8	
2. Credit to private sector	240.6	97.3	253.0	97.6	12.4	5.2	100.0
Agriculture	23.0	9.3	25.1	9.7	2.1	9.2	17.0
Manufacturing	55.5	22.5	50.7	19.6	-4.8	-8.6	-38.4
Trade	43.7	17.7	41.5	16.0	-2.2	-4.9	-17.4
Building and construction	20.0	8.1	19.7	7.6	-0.3	-1.5	-2.4
Transport & communications	11.7	4.7	16.7	6.5	5.1	43.3	40.8
Finance & insurance	14.9	6.0	22.2	8.6	7.3	49.4	59.2
Real estate	20.2	8.2	21.2	8.2	1.0	5.0	8.2
Mining and quarrying	2.0	0.8	2.3	0.9	0.3	15.5	2.4
Private households	10.6	4.3	20.7	8.0	10.0	94.3	80.8
Consumer durables	5.6	2.3	5.8	2.2	0.2	3.0	1.4
Business services	25.6	10.3	23.1	8.9	-2.5	-9.7	-20.0
Other activities	7.8	3.2	3.9	1.5	-3.9	-49.9	-31.6
3. TOTAL (1+2) *	247.2	100.0	259.3	100.0	12.1	4.9	

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

Source: Central Bank of Kenya

As shown in Table 21 above, credit to the private sector expanded moderately by 4.9%, well below the 7.2% targeted expansion over the year to June 2003. The below target credit to the private sector partly reflected the sluggish economic recovery and the credit supply constraints including cautious approach to risk management by commercial banks. Credit to the private sector expanded more rapidly between August 2002 and January 2003, with 4.6% growth well above that of 1.1% between February to June 2003.

The credit expansion to the private sector in the six months to January 2003 reflected financing for the expansion of the mobile phone services within the transport and communications sub sector and increased consumer credit to households sub sector, by commercial banks. Of the Ksh 26.0bn credit extended in the year to June 2003, Ksh 10.0bn was to private households, Kshs 7.3 bn to finance and insurance, Ksh 5.1bn to transport and communication, Ksh 2.1bn to agriculture, Ksh 1.0bn to real estate, Ksh 0.3bn to mining and quarrying and Ksh 0.2bn to consumer durables. Over the same time, Ksh 13.6bn was repaid, with Ksh 4.8bn by manufacturing, Ksh 2.2m by trade, Ksh 2.5bn by business services and Ksh 4.2 bn by other activities.

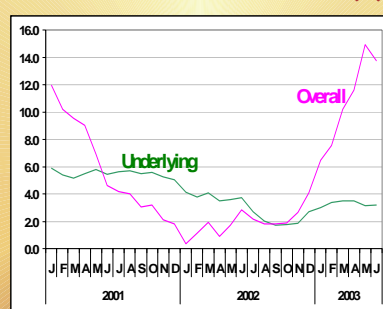
INFLATION

Underlying and Overall Inflation

The Central Bank successfully contained the underlying inflation¹ below 5% in the financial year 2002/03 as shown in Table 22 and Chart 9. Underlying inflation is the key rate that the Bank monitors to gauge the success of monetary policy in containing inflation within the set target. This favourable inflation outcome was attributed to the prudent monetary policy stance implemented by the Bank. The relative stability in the shilling exchange rate during the financial year also supported the achievement of low inflation through lower prices of imports.

The overall inflation,² however, picked up to 14.9% in May 2003 from 6.5% in January 2003, with upsurge attributed to increases in both food and fuel prices. To a large extent, the sharp rise in food prices was occasioned by inadequate rainfall experienced in 2002 through the first quarter of 2003.

CHART 9: 12-MONTH INFLATION (%)



Source: Central Bureau of Statistics

TABLE 22: MONTH-ON-MONTH INFLATION (%)

	2002						2003					
	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
Overall	2.1	1.8	1.8	1.9	2.7	4.1	6.5	7.5	10.2	11.6	14.9	13.7
Underlying	2.7	2.0	1.7	1.8	1.9	2.7	3.0	3.4	3.5	3.5	3.2	3.2

Source: Central Bureau of Statistics

¹ Underlying inflation is computed by excluding food and energy inflation from the overall inflation. This reflects the fact that food and energy prices are mostly influenced by transitory and external factors such as droughts rather than the stance of monetary policy.

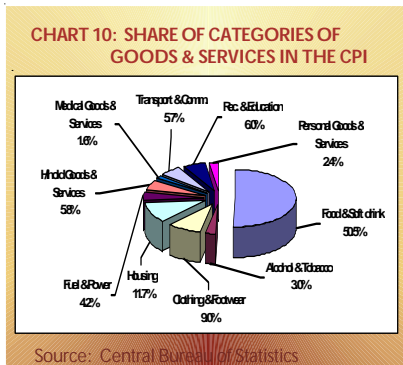
² Overall inflation is computed by the Central Bureau of Statistics (CBS) as the percentage change in the Consumer Price Index (CPI) over any two periods. Kenya's CPI is based on the market prices of a basket comprising 10 categories of goods and services, which represent the consumption profile for an average urban household.

Fuel price hikes, on the other hand, accrued from geopolitical factors particularly the war in Iraq.

With the timely onset of the long rains and the subsequent improvement in basic food supplies, the overall inflation declined to 13.7% in June. The reductions in select excise duties and in the standard Value Added Tax (VAT) from 18% to 16% announced by the Minister in this year's Budget statement also contributed to the decline in the overall inflation at the end of June 2003.

Inflation by Categories of Goods and Services

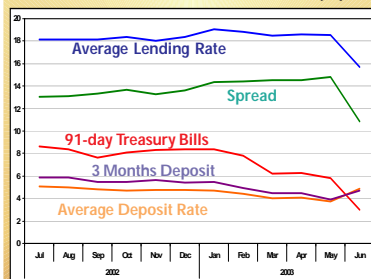
During the financial year 2002/03, the food category of consumer commodities registered the highest inflation, increasing rapidly from 5.7% in December 2002 to 24.5% in May 2003 before easing to 22.2% in June 2003. Food is the main item in the CPI as shown in Chart 10. The pressure on food prices in the period was attributed to low production of most essential food items following inadequate rainfall in 2002 and up to the first quarter of 2003. The prices of fuel and power category of goods and services also came under intense pressure in the third quarter of the financial year as crude oil prices soared up due to uncertainty in supply caused by the war in Iraq. Pressure on fuel and power prices, however, eased during the last quarter of the financial year, reflecting early conclusion of the war, reductions of excise duty on fuel oil by 50% and the reduction of standard VAT from 18% to 16% announced in this year's budget statement. Other categories of consumer goods and services registered relatively lower inflation rates during the fiscal year.



INTEREST RATES

All principal money market interest rates declined in tandem with the 91-day Treasury bills interest rate which eased from 8.6% in June 2002 to less than 3% in June 2003 as shown in Table 23 and Chart 11, reflecting in a large part excess liquidity in the money markets. The excess liquidity resulted from reduction in the Government's weekly demand for resources from Ksh 5.5bn to Ksh 4.5 bn in an environment where private sector demand for credit remained subdued. The reduction in the weekly demand for short term borrowing was consistent with the continuing policy of restructuring Government domestic debt in favour of the longer dated Treasury bonds.

CHART 11: INTEREST RATES (%)



Source: Central Bank of Kenya

Interest rates on the longer dated 182-day Treasury bills continued to mirror that of the 91-day Treasury bill rate. It declined from 9.4% in July 2002 to 4.1% by June 2003. However, while the average rate on the 3-month time deposit declined to 4.7% by June 2003, the average overdraft rate only marginally declined to 17.7% over the same period manifesting persistence of wide interest rate spreads.

Interbank interest rates, also followed on a declining trend throughout the year to June 2003. It initially declined to 7.3% in September 2002 from 7.6% in July 2002 before rising to 9.0% in January 2003. Thereafter, the rate declined to 5.7% in May and closing at 1.6% by June 2003. Interest rates on overdraft facilities and 3-month time deposits also maintained a downward trend in line with the fall in the 91-day Treasury bill rate.

TABLE 23: INTEREST RATES (%)

	2002						2003					
	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
Treasury bill 91days	8.6	8.3	7.6	8.1	8.3	8.4	8.4	7.8	6.2	6.3	5.8	3.0
182 days	9.4	9.5	8.6	8.5	8.8	8.8	8.7	8.1	6.6	6.8	6.7	4.1
Average Lending Rate	18.1	18.1	18.1	18.3	18.0	18.3	19.0	18.8	18.5	18.6	18.5	15.7
Overdraft	18.3	18.6	18.5	18.9	18.6	18.6	18.5	17.8	17.3	17.3	17.2	14.9
Interbank rate	7.6	8.3	7.3	8.3	8.1	8.7	9.0	7.1	6.2	5.9	5.7	1.6
Average Deposit rate	5.1	5.0	4.8	4.7	4.7	4.7	4.7	4.4	4.0	4.1	3.7	4.8

Source: Central Bank of Kenya

The average rate charged by commercial banks on overdraft facilities declined by 22.81% to 14.91% in June 2003 while that paid on 3 months deposits fell by 20.3% to 5.9%, implying interest rate spread of 10.2%. Consistent with the decline in all interest rates, the average savings rate on bank deposits declined by 21% to 3.1% over the review period.

BALANCE OF PAYMENTS

Kenya's balance of payments (BOP) position remained favourable in the year to June 2003. As shown in Table 24, the overall BOP, though in surplus, declined to US\$ 123m from a surplus of US\$ 143m in the year to June 2002, reflecting deterioration in the capital and financial account, that more than offset the improvement in the current account.

TABLE 24: BALANCE OF PAYMENTS (US\$ M)

ITEM	Year to Jun 2002	Year to June 2003				Year to Jun-03
		Q1 Jul-Sep	Q2 Oct-Dec	Q3 Jan-Mar	Q4 Apr-Jun	
OVERALL BALANCE	143	-7	-32	100	62	123
I. CURRENT ACCOUNT	-169	-48	1	1	-39	-85
Goods	-1306	-273	-371	-311	-368	-1322
Exports (fob)	1991	557	513	633	586	2290
Coffee	85	22	13	21	29	85
Tea	421	113	91	121	108	433
Horticulture	241	55	66	92	82	296
Oil products	114	13	7	1	1	22
Other	1129	355	335	398	366	1454
Imports (cif)	3298	830	884	944	954	3612
Oil	699	212	161	235	213	820
Chemicals	498	120	127	149	131	527
Manufactured Goods	411	106	116	118	121	462
Machinery & Transport Equipment	665	159	230	200	300	888
Other	1024	233	251	242	189	914
Services	1137	225	372	312	329	1237
Non-factor services (net)	577	149	238	227	165	778
of which tourism	279	70	91	94	75	330
Income (net)	-148	-36	-20	-30	-12	-98
of which official interest	-106	-23	-8	-24	-11	-65
Current Transfers	708	113	154	114	176	557
Private (net)	665	113	154	115	176	558
Public (net)	43	0	0	0	0	-1
II. CAPITAL & FINANCIAL ACCOUNT	312	41	-33	99	101	208
Capital Transfers (net)	66	32	11	49	97	189
Financial Account	245	9	-44	51	4	20
Official, medium- & long-term	-152	-38	-4	-52	16	-77
Inflows	193	49	36	27	53	164
Outflows	-345	-87	-40	-79	-36	-242
Private, medium- & long-term (net)	74	8	-118	146	96	132
Commercial Banks (net)	60	-21	-141	83	33	-45
Other private, medium- & long-term	13	28	23	63	63	177
Short Term and Errors & Omissions (net)	324	39	78	-44	-109	-35
Gross Reserves	1563	1548	1614	1627	1656	1656
Official	1137	1119	1067	1188	1260	1260

Source: Central Bank of Kenya

Current Account

The current account deficit narrowed to US\$ 85m in the year to June 2003 from US\$ 169m in the year to June 2002. As a share of the GDP, the deficit in the current account decreased to 0.7% from 1.4% over similar period. The developments in the current account reflected US\$ 100m improvement in the services account as the trade deficit widened by US\$ 15m.

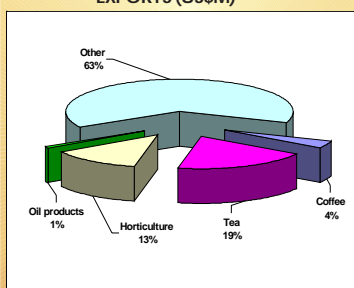
Merchandise Account

The deficit in the merchandise account widened to US\$ 1,322m in the year to June 2003 from US\$ 1,306m over a similar period to June 2002, reflecting increased payments for imports that more than offset increased exports earnings.

Exports

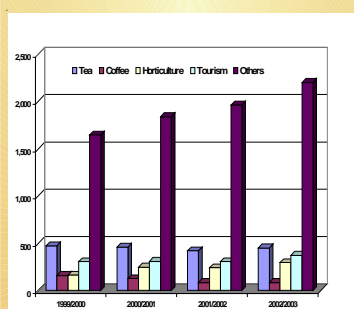
Receipts from exports increased by US\$ 299m to US\$ 2,290m in the year to June 2003 from US\$ 1,991m in the year to June 2002. Much of this increase was attributed to exports of tea, horticulture and non-traditional commodities, particularly manufactured goods and raw materials. Exports of textiles also increased by US\$ 4m to US\$ 24m during the period. Tea export receipts increased by US\$ 12m to US\$ 433m due to 5.4% improvement in prices in the year to June 2003. Export volume of the tea, however, declined by 2.3%. Horticultural exports also performed well, increasing from US\$ 241m in the year to June 2002 to US\$ 296m. This was attributed to increased export volume by 29.9%, which more than offset 4.8% fall in prices. The improvement in horticultural exports, especially in vegetables and cut flowers was attributed to increased investment, better crop husbandry as well as tax incentives. Coffee export remained stable at US\$ 85m in the year to June 2003, reflecting increased volume by 11.5% as prices declined by 10.6%. Composition of major export commodities are shown in Charts 12 and 13.

CHART 12 : COMPOSITION OF KENYA'S EXPORTS (US\$M)



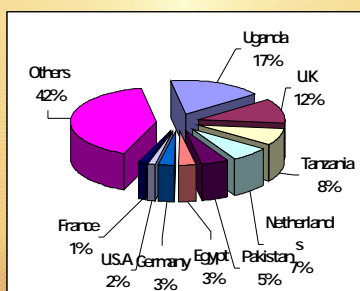
Sources: Central Bank of Kenya

CHART 13: FOREIGN EXCHANGE EARNINGS (US \$)



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

Kenya's main export markets in the year to June 2003 as shown in Table 25 and Chart 14, remained Uganda, United Kingdom, Tanzania and the Netherlands. Exports to the regional markets

CHART 14: KENYA'S EXPORTS
DESTINATION COUNTRIES

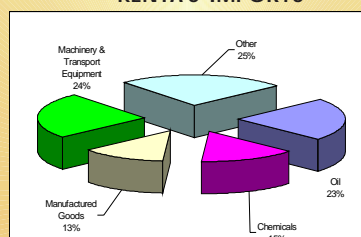
Sources: Central Bank of Kenya

of Uganda and Tanzania increased by 4.9% and 7.5%, respectively, while they increased by 30.5% to the United Kingdom, 20.0% to Germany, 15.8% to the Netherlands and by 9.0% to Pakistan. Of notable concern, however, is the exports to Egypt and the United States, which, declined by 19.0% and 18.6%, respectively compared with previous year's performance.

TABLE 25: KENYA'S EXPORTS: MAIN DESTINATION COUNTRIES (US \$M)

Source Country	Yr to June 02	Yr to June 03	% Change
Uganda	381	399	4.9
U.K	206	269	30.5
Tanzania	179	192	7.5
Netherlands	142	164	15.8
Pakistan	104	114	9.0
Egypt	92	75	-19.0
Germany	57	68	20.0
U.S.A	44	36	-18.6
France	32	33	0.8
Belgium	28	28	1.2
Others	726	911	25.6
Total	1991	2290	15.0

Source: Central Bank of Kenya

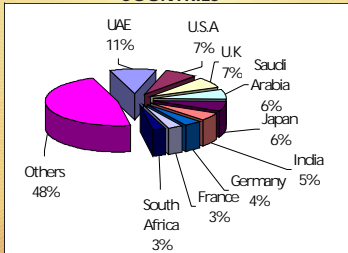
CHART 15 : COMPOSITION OF
KENYA'S IMPORTS

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

Imports

Imports increased by US\$ 314m from US\$ 3,298m to US\$ 3,612m during the period under review. Machinery and transport equipment increased by US\$ 223m, reflecting increased imports of vehicles and industrial machinery. A strong growth was also realised in imported fuels which rose by US\$ 121m, mainly reflecting increased imports of motor spirit, kerosene and gas oil. Imports of manufactured goods also increased by US\$ 51m to US\$ 462m, largely due to increased imports of metal manufactures, such as iron and steel, and textiles. Miscellaneous imports, however, declined by US\$ 110m to US\$ 914m. Composition of exports are shown in Chart 15.

CHART 16: KENYA'S IMPORT SOURCE COUNTRIES



Source: Central Bank of Kenya

United Arab Emirates, United States of America (USA), United Kingdom and Saudi Arabia as shown in table 26 and Chart 16 continued to be the main sources of imports during the year to June 2003. There was mixed performance of imports from these sources with increased imports of 39.2% from Saudi Arabia, 20.9% from India, 19.4% from Japan and 12.6% from South Africa. Imports from the United Arab Emirates, USA and United Kingdom however declined by 3.7%, 8.5% and 5.0%, respectively.

Services Account

In the services account, the surplus increased by US\$ 100m to US\$ 1,237m from US\$ 1,137m in the year to June 2002. The improvement in the services account was largely due to increase of US\$ 201m in net non-factor service receipts and reduction of US\$ 49m in interest payments both of which more than offset the decline of US\$ 151m in grants to both private and public sectors.

Net non-factor service receipts increased due to: improved earnings from tourism by 18.2% to US\$ 330m; increased export earnings by the insurance and communication services sectors and; reduced payments of royalties and licence fees. Implementation of the strategy of promoting Kenya as a tourism destination and the enhanced security measures put in place by the Government impacted positively on the sector despite heightened global security threats. Net outflows from the income account declined from US\$ 148m to US\$ 98m, reflecting

TABLE 26. KENYA'S IMPORTS : MAIN SOURCE COUNTRIES (US\$ M)

Source Country	Yr to June 02	Yr to June 03	% Change
UAE	386	371	-3.7
U.S.A	282	258	-8.5
U.K	271	257	-5.0
Saudi Arabia	169	235	39.2
Japan	195	233	19.4
India	157	190	20.9
Germany	163	142	-13.3
France	131	119	-8.6
South Africa	90	101	12.6
Italy	66	66	-0.6
Others	1388	1639	18.1
Total	3298	3612	9.5

Source: Central Bank of Kenya

reduced interest payments by the private sector as well as reduced payments of dividends and profits to external shareholders. Interest payments on external official debt similarly declined to US\$ 65m from US\$ 106m in the year to June 2002. Interest income on official foreign exchange reserves also declined by US\$ 6m following the general decline in the international interest rates.

Net inflows of grants to both private and public sectors, decreased to US\$ 557m in the year to June 2003 from US\$ 708m in the year to June 2002. The decline in net grants to the private sector amounted to US\$ 95m while those to the public sector amounted to US\$ 44m. The decline in grants reflected improved food situation in the country, which reduced the need for food grants to cope with famine in some parts of the country.

Capital and Financial Account

Transactions relating to capital transfers, improved with non-financial assets increasing to a net inflow of US\$ 189m from a net inflow of US\$ 66m in the year to June 2002. The capital account inflows were entirely accounted for by project grants to Government which increased from US\$ 66m to US\$ 189m during the year to June 2003, mainly in support of the education sector.

Transactions in the financial account relating to the country's foreign assets and liabilities on the other hand deteriorated in the year to June 2003 to a net inflow of US\$ 20m from a net inflow of US\$ 245m in a comparable period in the previous year. The deterioration in this account reflected worsening private short-term capital flows and increased net foreign asset holdings by commercial banks.

Transactions related to official inflows and outflows improved with net outflow of US\$ 77m being much lower than the net outflow of US\$ 152m during the year under review. Principal loan repayments decreased by US\$ 103m, reflecting decrease in the stock of external debt while inflows of both project and Government guaranteed loans fell by US\$ 28m. Private sector medium- and long-term capital net inflows improved to US\$ 132m from US\$ 74m in the year to June 2002 due to increased investment by Kenya Airways in aircrafts, increased investment in equity capital, reduced loan repayments and other capital repatriation. Energy financing, however, declined following improved weather conditions and continued recovery from the

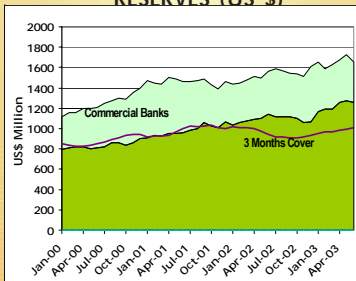
drought of 2000. During the period, foreign assets of commercial banks decreased from US\$ 427m at end of June 2002 to US\$ 395 at end of June 2003, a fall of US\$ 32m while foreign liabilities similarly declined by US\$ 77m to US\$ 107m at end of June 2003. Net foreign asset holdings of commercial banks therefore increased by US\$ 45m to US\$ 288m at end of June 2003, reflecting an outflow of funds. Short-term private capital flows (including errors and omissions), however, declined to record a net outflow of US\$ 62m in the year to June 2003 from a net inflow of US\$ 324m in the year to June 2002 mainly due to reduced foreign investment in local equity securities and Government securities, and private loan receipts. Reduced foreign investment in Treasury bills and bonds followed the historical decline in interest rates on these securities.

FOREIGN EXCHANGE RESERVES

Development of Foreign Exchange Reserves

Like other central banks in countries with liberalised foreign exchange markets, the Central Bank of Kenya continued to hold foreign exchange reserves for the following reasons: as an assurance against the potential risk of serious liquidity crises in the foreign exchange market occasioned by either external or domestic shocks or speculative activities; to maintain the solvency or the degree of the country's creditworthiness; to serve as collateral for external borrowing by Government; and to keep investor confidence in the economy.

CHART 17: FOREIGN EXCHANGE RESERVES (US \$)



Source: Central Bank of Kenya

Foreign exchange reserves held by the Central Bank, comprising foreign currency assets, gold, special drawing rights, Government deposits at the Crown Agents and reserve position in the Fund, - increased to US\$ 1,260m, equivalent to 3.8 months of imports cover as at the end of June 2003 from US\$ 1,137m or 3.6 months of imports cover at the end of June 2002 as shown in Chart 17. As discussed earlier, the improvement in the level of reserves resulted from the surplus in the balance of payments. Over the period, however, foreign exchange reserves of commercial banks, decreased from US\$ 427m at end of June 2002 to US\$ 396m at the end of June 2003. The decline in commercial bank reserves was less than the increase in Central Bank of Kenya reserves. Consequently, total foreign exchange reserves held by the banking system, increased to US\$ 1,656m as at the end of June 2003 from US\$ 1,563m at end of June 2002.

Foreign Reserve Adequacy

Although there are many indicators that could be used to gauge the adequacy of foreign exchange reserves over the 2002/03 financial year, it is appropriate to consider their level against the legal requirements for prudent management. During the financial year, the Central Bank was guided by two legal requirements. Under section 26(1) of the CBK Act, the Bank was required to at all times to use its best endeavours to maintain a reserve of external assets at an aggregate amount of not less than the value of four months' imports as recorded and averaged for the last three preceding years. In effect, the requirement meant that should economic circumstances or external borrowing conditions turn adverse, the country would have at least 4 months at the start of the crisis in which to make decisions on its future policy without disrupting normal economic activities or making the decision of changing the entire economic program in place.

While fully committed to managing foreign exchange reserves to comply with the 4 months of import cover requirement during the year, the Central Bank pursuit was however, tempered by the necessity to avoid prejudicing the achievement of the overriding principal objective of the Bank stipulated in section 4(1) of the same Act, namely that of formulating and implementing monetary policy directed to achieving and

maintaining stability in the general level of prices. The Bank's build up of foreign exchange reserves was therefore maintained at levels consistent with the monetary policy framework pursued in the year to June 2003.

Earnings from Foreign Exchange Reserves

Throughout the financial year, the Central Bank followed a conservative policy to guide the management of official international reserves. Accordingly, the Central Bank largely invested foreign exchange reserves in low-risk investment instruments. The basic investment tool of the Central Bank was short-term fixed deposits with foreign commercial banks. Sharp declines in interest rates in the international financial markets during the year to June 2003 affected earnings from the invested international reserves. Consequently, earnings from international reserves were lower at US\$ 33m during the year to June 2003 from US\$ 39m in a similar period to June 2002.

EXCHANGE RATES

Over the year, the Bank maintained a market based exchange rate policy, intervening only once in the foreign exchange market to smooth significant depreciation in the shilling due to speculative pressures in the run up to the General Elections held in December 2003.

Overall, the Kenya shilling had a mixed performance against major international currencies as shown in Table 27 and Chart 18. It appreciated by 1.8% against the US dollar but depreciated by 8.0% against the Pound Sterling. It also depreciated by 14.8% against the Euro and by 3.3% against the Japanese Yen during the period under review. Against major African trading partner currencies, the shilling also had a mixed performance gaining by 10.1% against the Tanzania shilling and by 9.4% against the Uganda shilling but losing by 9.5% against the South African Rand.

TABLE 27: KENYA SHILLING EXCHANGE RATES

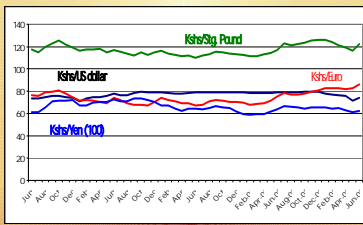
	2001			2002			2003	
	Jan	Jun	Dec	Jan	Jun	Dec	Jan	Jun
Kshs/US\$	78.6	78.6	78.7	78.6	78.7	79.5	77.7	73.7
Kshs/Stg.£	116.3	110.3	113.2	112.8	116.6	126.1	125.7	122.5
Kshs/Euro	73.8	67.2	70.2	69.5	75.1	81.0	82.6	86.1
Kshs/100 Yen	67.3	64.4	61.9	59.3	63.7	65.1	65.4	62.3
Kshs/Rand	10.1	9.8	6.9	6.8	7.8	8.9	8.9	9.3
Ushs/Kshs	23.2	22.6	21.9	22.2	22.9	23.2	24.1	27.1
Tshs/Kshs	10.2	11.3	11.6	11.8	12.2	12.3	12.8	14.1

Source: Central Bank of Kenya

Although overall the shilling strengthened against the US dollar during the year to June 2003, its movements were, however, mixed. It lost about 87 cents against the US dollar between July 2002 and December 2002, predominantly due to

precautionary and speculative activities in the domestic inter-bank foreign exchange market in the run up to the general elections. Thereafter, however, the shilling appreciated against the dollar, gaining approximately 8 shillings to reach a high of 71.6 shillings per dollar in May 2003 compared with 79.5 shillings in December 2002. The strong appreciation of the shilling against the US dollar was attributed to positive sentiments related to the successful holding of peaceful elections and subsequent smooth transition of power to a newly elected Government. These events bolstered expectations of increased liquidity in the domestic foreign exchange market, particularly in renewed prospects for donor support. Some of the expected inflows actually did materialize. Project grants to the Government increased to US\$ 145m between January and June of 2003 from US\$ 90m received during the entire year of 2002.

CHART 18: KENYA SHILLING EXCHANGE RATES



Source: Central Bank of Kenya

Speculative activities by currency dealers especially in May 2003 also supported the strengthening of the shilling, as domestic corporate and other importers' foreign exchange demand, generally, remained subdued. Corporate demand for foreign exchange, however, picked up in June 2003 and caused the shilling to weaken exchanging at an average of Ksh 73.7 per dollar. Overall, the strengthening of the Kenya shilling against the US dollar during the year to June 2003 was explained by a relatively higher supply of foreign exchange compared to demand. Foreign exchange earnings during the year to June 2003 predominantly came from agricultural exports, particularly of tea, coffee and horticulture. Earnings from tourism together with transfers from aid agencies also contributed to the increase. Much of the demand during the period on the other hand came from corporate bodies in the energy and manufacturing sectors and the Central Bank to meet official external obligations. The appreciation of the shilling against the US dollar was also attributed to the weakening of the US

dollar against other currencies in the international currency markets during the year.

The depreciation of the shilling against other major foreign currencies during the year to June 2003 reflected the appreciation of these currencies against the US dollar in international foreign exchange markets. During this period, the US dollar lost by 10.0% against the Sterling Pound, 17.1% against the Euro, 5.2% against the Japanese Yen and 11.9% against the South African Rand.

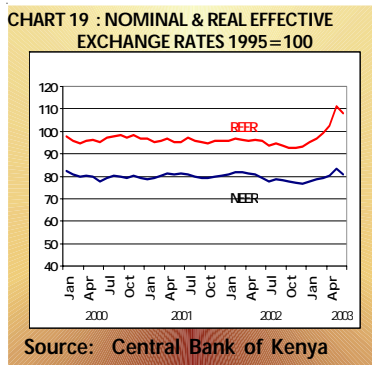
Some of the factors that accounted for depreciation of the US dollar against major international currencies included increased uncertainties associated with the conflict in Iraq, and widening current account and fiscal deficits and relatively low interest rates in the USA. Reduced economic recovery prospects as well as improper accounting practices by some accounting firms at the beginning of the period under review, also accounted for the weakening of the US dollar as they led to increased risk premium on US assets, thus discouraging capital inflows to the US economy. Relatively higher interest rates in the Euro area and Japan buoyed their respective currencies against the US dollar. Likewise, stronger growth prospects for the UK and relatively higher interest rates supported the strength of the Sterling Pound. Interest rate cut by the Bank of England in February 2003, however, caused the sterling pound to weaken, although this reversed in May 2003.

External Competitiveness

In an effort to track the performance of export led growth strategy, the Bank sustained efforts to monitor the country's external competitiveness using the real effective exchange rate

index (REER), that is trade-weighted nominal effective exchange rate (NEER) adjusted for inflation differential between Kenya and its trading partners. As shown in Chart 19, the REER's upward trend reflects the appreciation of the shilling in real terms during the period under review. It appreciated by 1.9% compared with 0.7% depreciation in the year to June 2002. The appreciation of the REER reflected higher domestic inflation compared with that of Kenya's trading partners, a differential that offset a decline in nominal effective exchange rate index.

During the period under review, Kenya's consumer price index increased by 6.5% while that of its trading partners increased by 2.5%, resulting in a 4% inflation differential in favour of trading partners. The nominal effective exchange rate (NEER) index, derived by weighing the bilateral shilling exchange rates of all Kenya's major trading partner currencies using the value of Kenya's total trade (imports plus exports), however, declined by 2.0%, representing depreciation of the shilling in nominal terms. The depreciation of the NEER, in turn, reflected the depreciation of the Kenya shilling against the Sterling Pound, the Euro, the Japanese Yen, and the South African Rand, which more than offset the appreciation of the shilling against the US dollar and the regional currencies during the period under review. Thus, the 4% widening in inflation differential offset the 2% depreciation in NEER index, resulting in a 2% appreciation of the REER. Kenya's competitiveness in international export markets therefore declined during the period under review.



NATIONAL PAYMENTS SYSTEM

Cash Payment Instruments

Cash payments continued to dominate the country's payment system with currency in circulation equivalent to 5.7% of GDP. The currency in circulation increased by 6.8% to Kshs 55.4 billion by June 2003 from Kshs 51.9 billion in June 2002, reflecting the increased demand during the 2002 General Elections and the December festivities.

As shown in Tables 28, 29 and Chart 20, the currency in circulation continued to be dominated by Bank notes, accounting for about 96% of the total. The Ksh 1,000 and Ksh 500 notes also continued to dominate the currency in circulation with their shares in total currency respectively standing at 71% and 9.9% at the end of June 2003.

CHART 20: COMPOSITION OF ISSUED BANK NOTES BY DENOMINATION (KSH BN)

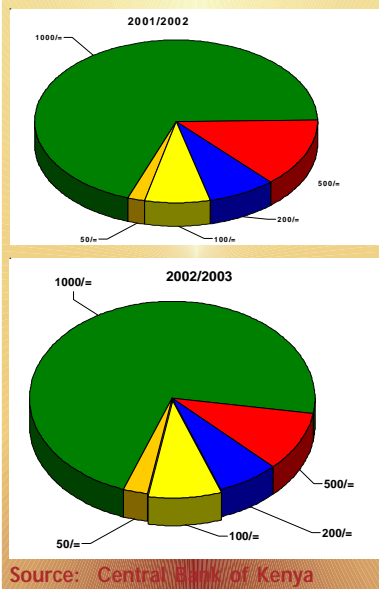


TABLE 28: CURRENCY IN CIRCULATION BY TYPE

Item	Jun-01		Jun-02		Jun-03	
	Shs.bn.	%	Shs.bn.	%	Shs.bn.	%
Currency in circulation	46.7	100	51.9	100%	55.4	100%
Bank Notes	44.7	95.7	49.6	95.5	55.4	95.8
Coins	2	4.3	2.3	4.5	2.3	4.2

Source: Central Bank of Kenya

During the year to June 2003, reported currency counterfeiting declined to 1,227 pieces valued at Ksh 889,800, from 1,378 pieces valued at Kshs 756,800 in a similar period ending June

2002 as shown in Table 30. This reflected the Bank's sustained efforts to enhance integrity of the currency. Of that total, 635 or 51.8% were in shs 1000/ denomination while 462 or 37.7% were of the shs 500/ denomination.

TABLE 29: CURRENCY ISSUED BY DENOMINATIONS (KSH M)

Denomination	Bank Notes		Denomination	Coins	
	Shs. (m)	%		Shs. (m)	%
1000/=	37,700	71	20/=	850.4	36.9
500/=	5,268	9.9	10/=	539.1	23.4
200/=	3,724	7	5/=	394.2	17.1
100/=	4,403	8.3	1/=	366.9	15.9
50/=	1,393	2.6	=/50	102.7	4.5
20/=	348	0.7	=/10	35.9	1.6
10/=	215	0.4	=/05	15.3	0.6
5/=	46	0.1			
TOTAL	53,097	100		2304.5	100

Source: Central Bank of Kenya

TABLE 30: COUNTERFEIT NOTES BY DENOMINATION

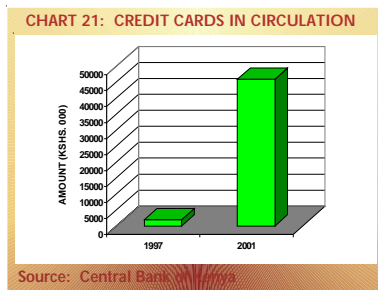
Period	2001/2002		2002/2003	
	No.	Amount (kshs.)	No.	Amount (kshs.)
1000/=	425	425,000	635	635,000
500/=	486	243,000	462	231,000
200/=	421	84,200	108	21,600
100/-	46	4,600	22	2,200
50/=	-	-	-	-
20/=	-	-	-	-
10/=	-	-	-	-
5/=	-	-	-	-
Total	1,376	756,800	1,227	889,800

Source: Central Bank of Kenya

Non-Cash Payment Instruments

Cheques continued to dominate non-cash payments, accounting for 90% of the total. In the year to June 2003, the average daily volume of cheques settled through the Nairobi Clearing House averaged 48,000, amounting to Kshs 8.5 billion, representing a decrease from the cleared volume of 50,000 cheques valued at Kshs 10 billion during the year ended June 2002.

Despite lack of an explicit regulatory framework, the use of card based payment instruments, namely credit, debit and Automated Teller Machines (ATM) cards increased significantly. Widening ATM network countrywide facilitated the growth of this mode of payments. There were 230 ATMs operating at end of June, 2003 and the number is expected to increase with the implementation of Kenswitch, a shared ATM network comprising a consortium of eighteen small and medium sized banks which went live during December 2002 with four banks in operation.



The use of credit cards, similarly, increased both in terms of number of transactions and value as shown in Chart 21. The number of cards in circulation rose from a total of 20,338 in 1998 to 45,893 in 2001, representing an increase of over 100%. This trend continued during the review period. At the end of June 2003, the outstanding value of credit cards in circulation was Kshs 1.95 billion.

Introduced into the money market in August 2000, Electronic Funds Transfers (EFTs) or credit based payments continued to expand, steadily rising in value to Kshs 167,957 in June 2003 from 144,381 in the previous financial year ending June 2003.

Direct debits for payment of utilities and insurance premiums continued to be introduced in the market. The KBA launched their scheme in June 2003 and issued comprehensive rules and guidelines for its operations.

The Clearing System Operations

The Central Bank continued to provide clearing facilities to commercial banks for both debit and credit instruments. During the year ending June 2003, the value of clearing activities, remained relatively stable at Ksh 2,058 billion compared with Ksh 2,045 billion in a similar period in 2002 as shown in Table 31 and Chart 22

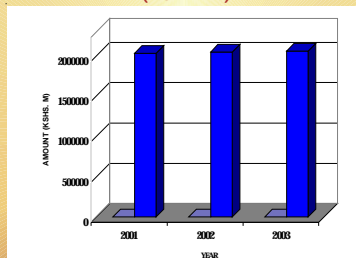
TABLE 31: NATIONAL CLEARING TURNOVER (NOMINAL)

FINANCIAL ITEMS	VALUES		VOLUMES	
	MILLIONS		THOUSAND	
2001				
Debit	1,913,348		12,231	
Credit	114,649		1,883	
Total	2,027,997		14,114	
2002				
Debit	1,901,368		12,177	
Credit	144,381		2,311	
Total	2,045,749		14,488	
2003				
Debit	1,890,753		12,200	
Credit	167,959		2,737	
Total	2,057,712		14,937	

Source: Central Bank of Kenya

During the year, the Kenya Bankers Association (KBA) strengthened Clearing House rules and regulations in order to minimise risks by being strict on the requirements for prudential capital level maintenance. The rules were further enhanced to allow members to be unwound only once in a month, failure to which a bank would be expelled from the Clearing House. The KBA also started working on modalities for implementing **Failure to Settle Mechanism** which will eliminate the need for Central Bank to take the responsibility of settling obligations arising from the unwinding of clearing effects. When fully implemented, the mechanism will eliminate the need for the

CHART 22: NATIONAL CLEARING TURNOVER (NOMINAL)



Source: Central Bank of Kenya

Central Bank to take the responsibility of settling obligations arising from the unwinding of clearing effects.

Regional NPS Initiatives

The Central Bank continued to cooperate with the member Central Banks of the East African Community (EAC) to harmonize the payment system practices within the region. The Bank remained committed to the objectives of the Monetary Affairs Committee (MAC), which operates under the auspices of East Africa Co-operation protocol in promoting an efficient payments system within the region. The East Africa Payment Systems Harmonization Committee (EAPSHC) has initiated surveys on internet banking, e-commerce, e-banking practices, and cross-border payments transactions.

ECONOMIC OUTLOOK

Looking ahead, the prospects for the economy seems to be bright, considering the measures outlined by the Government in its Economic Recovery Strategy for Wealth and Employment Creation for the period 2003/2004. The economy is forecast to pick up from the 1.2% growth achieved in financial year 2002/03 to 2.2% in financial year 2003/04 and to accelerate further to over 5% every year over the medium-term. The momentum for this upturn has already began with the positive changes undertaken by the Government at the beginning of this year. This has been further strengthened by greater prospects for budgetary and project support from the Bretton Woods Institutions and other development partners.

Agriculture will remain the linchpin in the country's economic growth prospects. Its performance will over the financial year 2003/04 be the main engine leading the other sectors in economic growth. With continued good weather, the performance of the sector will be boosted by economic recovery strategy measures instituted by the Government in the 2003/04 budget. There is already evidence of increased investment in production of horticulture for export. In spite of poor prices, coffee is benefiting from improved husbandry and better marketing. Pyrethrum and sugarcane are also having their problems addressed through careful restructuring, improved management and

elimination of illegal sugar imports. All the agricultural activities are also benefiting from the zero-rating of imported inputs.

Manufacturing has picked up momentum as evidenced by increased importation of raw materials particularly unprocessed materials, mineral lubricants and increased use of electricity. Furthermore, activity in the sector is being boosted by the zero-rating of imports from Uganda, duty waivers on capital goods, plant and equipment, removal of excise duty on locally assembled motor vehicles and the increase in investment allowance from 60% to 100%. Manufacturing is also expected to expand to take advantage of greater access to outside markets with reduced restrictive trade practices brought about by regional economic initiatives within the EAC, COMESA and to US markets under AGOA.

Although the tourism sector was recently adversely affected by insecurity associated with terrorism and subsequent travel warnings issued by the USA and other European countries, tourism will remain one of the key sectors in terms of foreign exchange earnings and employment creation. It is forecast to grow even further following improved security, the substantial marketing efforts and the removal of both excise duty on fuel and of 20% withholding tax on aircraft leasing.

Demand in the energy sector is expected to pick up with the recovery of the economy. In spite of the expected

increase in demand, the cost of electricity should ease over the financial year 2003/04 following the zero rating of bulk electricity imports from Uganda, 50% reduction on excise duty on fuel oils and duty waivers on equipment used in generation. The KPLC is also undergoing significant restructuring aimed at improving its performance and provision of cheaper power.

The external sector is expected to remain strong with a favourable balance of payments position, a growing level of reserves and a competitive exchange rate. The Central Bank plans to build unencumbered gross foreign exchange reserves from US \$1.0.bn as at end June to 2003 US \$1.2bn by end of September 2003. Virtually all the build up will be achieved with expected donor inflows for budgetary support. The measures announced by the Minister for Finance in 2003/2004 Budget are expected to support the export sector. These include the removal of withholding tax for horticultural produce; zero rating of raw coffee; downward revision and removal of development levy and export duty on raw hides and skins. In addition, the Minister proposed in the Budget Speech the construction of additional tea factories, which will further support tea production.

Among the other sectors, building and construction is poised to contribute significantly to the overall growth prospects of the economy. Road rehabilitation and construction together with the completion of the stalled projects will play a key role in unlocking potential economic activities, through the lowering of business costs in the country. Transport and

communication is also set to see increased activity with the incoming of a third mobile telephone service provider in the near future.

In the public sector, prudent fiscal management, particularly restraint in expenditure and greater efforts in collecting all due revenues will guide the fiscal policy stance of the Government over the financial year 2003/04. In this regard, the Government's has already demonstrated its commitment to withstand pressures to have unduly expansionary fiscal policy, that would destroy the prevailing macroeconomic stability. It is with this in mind that the Government has to adjust to near inflexible revenue base against higher expenditure. This has been necessitated by additional expenditure arising from the strong commitment to provide free universal primary education in public schools, increased emoluments for public sector employees, increased allocation to public building and construction sector for the rehabilitation of the road network and the provision of affordable general health care. Inevitably, the Government will have to cope with the budget deficit expected to widen from Ksh 33.9bn in financial year 2002/03 to Ksh 62.4bn in the financial year 2003/04. In view of the pressure, full domestic financing of deficit would have on inflation, interest and exchange rates, the Government has programmed to finance Ksh 32.4bn from domestic sources and Kshs 30.0bn from external sources.

The performance of the banking sector is expected to improve following the implementation of the measures

proposed by the Minister for Finance in the budget for financial year 2003/04. Determined enforcement of compliance requirements by the Central Bank are expected to ensure prudence and higher efficiency in the sector thereby leading to increased solvency and continued stability of the banking sector. Furthermore, measures to streamline regulation and supervision of micro finance institutions will enhance extension of financial services to small borrowers. Overall, the financial sector is expected to grow and operate more efficiently, contributing to the improved performance of all sectors of the economy. To enhance transparency on bank charges, the Central Bank of Kenya will encourage disclosure of all charges by specified institutions in the local press. The disclosures will increase customer awareness of products and services available and their associated costs. This would, *inter alia*, widen customer choice and hence improve competition amongst institutions. This anticipated competition would most likely exert downward pressure on bank charges.

The increased economic activity forecast for financial year 2003/04 will be appropriately supported by monetary policy, which is designed to allow broad money supply to expand by 6.4% over the year to June 2004. The monetary expansion will be achieved with increased accumulation of net foreign assets and credit expansion to both the public and private sectors by the banking system. Credit to support increased economic activity in the private sector will expand by 9% compared with 4.9% in the year to June 2003. Over the medium term, the general stance of monetary policy will be

to gear monetary expansion to accommodate the maximum growth possible with all the productive resources of the economy without letting undue pressure on inflation to creep in. With the economy forecast to pick up supported by a prudent monetary policy stance, the overall inflation which was under pressure in financial year 2002/03 is forecast to ease. The underlying inflation, the key inflation influenced by monetary policy, will be kept at 3.5%. The achievement of the objective will be facilitated by the relative stability in the shilling exchange rate and the downward trend in expected inflation in the major trading partner countries.

Development of an efficient settlement and payment system (NPS) will also be given greater emphasis in the course of the financial year 2003/2004. New legislation on the payment system operations and governance is expected to be enacted. The Bank will also continue to monitor and coordinate developments in the banking industry to support measures that will enhance the efficiency of the NPS. In this year's budget, the Minister for Finance proposed to amend the Central Bank of Kenya Act in order to give the Bank oversight powers over the NPS. To incorporate the NPS into law, the Minister proposed to bring an appropriate bill before parliament, in the course of the 2003/2004 financial year. He also proposed to bring an Electronic Fund Transfer (EFT) Bill, to the House. The objectives of the proposed changes in legislation are to modernise and bring the national payments system at par with international standards and best practice. When implemented, the NPS will have the legal framework together with rights and

responsibilities of participants and players in place. These will increase transactions and enhance confidence for foreign investors.

The zero-rating of computers, computer accessories and other raw materials announced by the Minister will also boost modernisation of the NPS by encouraging adoption of e-banking and web based banking practices. The measure will, therefore, enhance our policy of moving from paper-based payments. These measures will promote electronic funds transfer based system and facilitate the proposed introduction of the RTGS by end 2004. The RTGS is expected to enhance the effectiveness, security, and reliability of the NPS settlement arrangement on a real time basis in the country as well as cross border payments in the region.

FINANCIAL PERFORMANCE

CENTRAL BANK OF KENYA DIRECTORS' REPORT FOR THE YEAR ENDED 30 JUNE 2003

The directors submit their report together with the audited financial statements for the year ended 30 June 2003, which disclose the state of affairs of the Bank.

INCORPORATION

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

PRINCIPAL ACTIVITIES

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

RESULTS

The results for the year are set out on page 69.

DIVIDEND

The Board of Directors recommends the payment of a dividend of KShs 3,500 million (2002: KShs 2,110 million) to the Government of Kenya of which KShs 1,000 million is to be applied to recover the amounts due from the Government of Kenya.

DIRECTORS

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

AUDITORS

The joint auditors of the Bank for the year ended 30th June 2003 were Messrs PricewaterhouseCoopers and Ernst & Young. In accordance with the Bank's policy of rotating audit firms every four years, Ernst & Young are due to retire as auditors of the Bank after the conclusion of the current audit.

By order of the Board



SECRETARY

9 September 2003

**CENTRAL BANK OF KENYA
STATEMENT OF DIRECTORS' RESPONSIBILITIES
ON THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 30 JUNE 2003**

We, the directors certify that:

1. We are responsible for the preparation of financial statements which present a true and fair view of the state of affairs of the Bank and of its operating results.
2. The financial statements have been prepared in accordance with International Financial Reporting Standards and the Central Bank of Kenya Act (CAP 491).
3. We are responsible for safeguarding the assets of the Bank.
4. We are responsible for establishing and maintaining systems of internal control designed to provide reasonable assurance as to the integrity and reliability of the Bank's financial reporting.
5. The directors are of the opinion that the financial statements for the year ended 30th June 2003 fairly present the financial position and operating results of the Bank.
6. Nothing has come to the attention of the directors to indicate that the Bank will not remain a going concern for at least twelve months from the date of this statement.

Signed on behalf of the Board of Directors by:-



Governor



Director

9 September 2003

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

We have audited the financial statements of the Central Bank of Kenya set out on pages 69 to 88. The balance sheet of the Bank is in agreement with the books of account.

Respective responsibilities of directors and auditors

The directors are responsible for the preparation of financial statements as set out on page 67. Our responsibility is to express an independent opinion on the financial statements based on our audit.

Basis of opinion

We conducted our audit in accordance with International Standards on Auditing. Those standards require that we plan and perform our audit to obtain reasonable assurance that the financial statements are free 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.

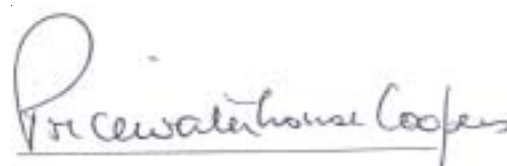
We have obtained all the information and explanations that to the best of our knowledge and belief were necessary to provide a reasonable basis for our opinion.

Opinion

In our opinion, proper books of account have been kept and the financial statements give a true and fair view of the state of the Bank's financial affairs at 30 June 2003 and of its profit and cash flows for the year then ended and comply with International Financial Reporting Standards and the Central Bank of Kenya Act.



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9 September 2003

**CENTRAL BANK OF KENYA
PROFIT AND LOSS ACCOUNT
FOR THE YEAR ENDED 30 JUNE 2003**

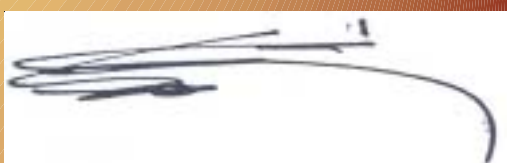
	Note	2003 KShs m	2002 KShs m
Interest income	1	3,170	3,413
Interest expenses	2	<u>(1,547)</u>	<u>(2,266)</u>
Net interest income		1,623	1,147
Fee and commission income		5,416	4,256
Net foreign exchange income	3	1,501	5,390
Other operating income	4	<u>316</u>	<u>149</u>
Operating income		8,856	10,942
Operating expenses	5	(4,383)	(3,326)
Bad and doubtful debts expense	10	<u>(25)</u>	<u>(2)</u>
Net profit from ordinary activities		4,448	7,614
Charge in respect of deferred receivable		<u>-</u>	<u>(1,801)</u>
Net profit		4,448	5,813
		<u><u> </u></u>	<u><u> </u></u>
Dividends:			
Proposed final dividend for the year	8	3,500	2,110
		<u><u> </u></u>	<u><u> </u></u>

Source: Central Bank of Kenya

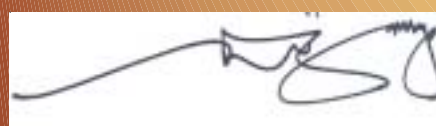
CENTRAL BANK OF KENYA
BALANCE SHEET
AS AT 30 JUNE 2003

ASSETS	Note	2003 KShs m	2002 KShs m
Balances due from banking institutions and gold holdings	7	92,017	88,463
Items in the course of collection		4,037	5,669
Investment in government securities	9	713	1,619
Loans and advances	10	11,993	5,909
Other assets	11	118	228
Retirement benefit asset	12	420	287
Property and equipment	13	751	540
Prepaid operating lease rentals	14	295	290
Due from Government of Kenya	15	<u>54,559</u>	<u>55,559</u>
TOTAL ASSETS		<u>164,903</u>	<u>158,564</u>
LIABILITIES			
Currency in circulation		55,231	51,867
Deposits	16	82,545	67,326
Amounts repayable under repurchase agreements	17	12,668	27,127
Other liabilities	18	<u>560</u>	<u>683</u>
TOTAL LIABILITIES		<u>151,004</u>	<u>147,003</u>
EQUITY AND RESERVES			
Capital	20	1,500	1,500
General reserve fund		8,899	7,951
Proposed dividend		<u>3,500</u>	<u>2,110</u>
TOTAL EQUITY AND RESERVES		<u>13,899</u>	<u>11,561</u>
TOTAL LIABILITIES AND EQUITY		<u>164,903</u>	<u>158,564</u>

The financial statements were approved by the Board of Directors for issue on 9 September 2003 and signed on its behalf by:



Governor



Director

Source: Central Bank of Kenya

CENTRAL BANK OF KENYA
STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 30 JUNE 2003

	Share KShs m	General reserve KShs m	Propose d KShs m	Total KShs m
Year ended 30 June 2002				
Balance at start of year	1,500	4,248	290	6,038
Net profit for the year	-	5,813	-	5,813
Dividends:				
- Final for 2001 paid	-	-	(290)	(290)
- Final proposed for 2002	<u>-</u>	<u>(2,110)</u>	<u>2,110</u>	<u>-</u>
Balance at end of year	<u>1,500</u>	<u>7,951</u>	<u>2,110</u>	<u>11,561</u>
Year ended 30 June 2003				
Balance at start of year	1,500	7,951	2,110	11,561
Net profit for the year	-	4,448	-	4,448
Dividends:				
- Final for 2002 paid	-	-	(1,110)	(1,110)
- Applied to amounts due from Government of Kenya - 2002 (Note 15)	-	-	(1,000)	(1,000)
- Final proposed for 2003	<u>-</u>	<u>(3,500)</u>	<u>3,500</u>	<u>-</u>
Balance at end of year	<u>1,500</u>	<u>8,899</u>	<u>3,500</u>	<u>13,899</u>

Source: Central Bank of Kenya

CENTRAL BANK OF KENYA
CASH FLOW STATEMENT
FOR THE YEAR ENDED 30 JUNE 2003

	Note	2003 KShs m	2002 KShs m
Operating activities			
Net cash (absorbed by) /generated from operating activities	19 (a)	(1,423)	4,864
Investing activities			
(Investment in)/ liquidation of government securities		906	(199)
Purchase of property and equipment		(391)	(386)
Proceeds from sale of property and equipment		1	4
(Investment in)/ liquidation of IMF-SDR accounts		39	(49)
Net cash generated from/ (absorbed by) investing activities		<u>555</u>	<u>(630)</u>
Financing activities			
Dividends paid		(1,110)	(290)
Currency in circulation		<u>3,364</u>	<u>5,190</u>
Net cash from financing activities		<u>2,254</u>	<u>4,900</u>
Net increase in cash and cash equivalents		1,386	9,134
Cash and cash equivalents at start of year		82,683	68,822
Foreign exchange translation gains/ (losses) on cash and cash equivalents		<u>786</u>	<u>4,727</u>
Cash and cash equivalents at end of year	19 (b)	<u>84,855</u>	<u>82,683</u>

Source: Central Bank of Kenya

CENTRAL BANK OF KENYA
ACCOUNTING POLICIES
FOR THE YEAR ENDED 30 JUNE 2003

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

(a) Basis of preparation and form of presentation

(i) Basis of preparation

The financial statements are prepared in accordance with and comply with International Financial Reporting Standards (IFRS). The financial statements are presented in millions of Kenya shillings (KShs million) and are prepared under the historical cost convention as modified by the revaluation of certain investments.

The preparation of financial statements in conformity with generally accepted accounting principles requires the use of estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Although these estimates are based on the directors' best knowledge of current events and actions, actual results ultimately may differ from those estimates.

(ii) Form of presentation

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

(b) Revenue recognition

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

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

(c) Translation of foreign currencies

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

(a) Employee benefits**Retirement benefits**

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

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

Where the calculation results in a benefit to the Bank, the recognised asset is limited to the net total of any unrecognised actuarial losses and past service costs and the present value of any future refunds from the plan or reduction in future contributions to the plan. Actuarial gains and losses are charged to the profit and loss account over the remaining working lives of the employees participating in the scheme.

The Bank also makes contributions to a statutory pension scheme, the National Social Security Fund (NSSF). Contributions to the scheme are determined by local statute and are shared between the employer and employee.

Other employee benefits

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

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

(b) Property and equipment

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

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

(f) Financial assets and liabilities

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

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

(i) Investment securities

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

(ii) Currency in circulation

Currency issued by the Bank represents a claim on the Bank in favour of the holder. The liability for currency in circulation is recorded at face value on the balance sheet.

(iii) Repurchase and reverse-purchase transactions

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

(g) Loans and provisions for loan impairment

Loans are stated at outstanding amount less provision for impairment.

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

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

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

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

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

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

(h) Cash and cash equivalents

For purposes of presentation of cash flows in the financial statements, cash and cash equivalents consist of balances held in current accounts, term deposits, investments in treasury bills and gold holdings.

(i) Taxation

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

(j) Dividends payable

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

(k) Comparatives

Where necessary, comparative figures have been adjusted or extended to conform with changes in presentation in the current year. In particular, the comparatives have been adjusted in respect of the reclassification of leasehold land (note 14).

CENTRAL BANK OF KENYA
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 30 JUNE 2003

	2003	2002
	KShs m	KShs m
1 Interest Income		
Foreign investments earnings	2,323	2,738
Local investments earnings	761	583
Other interest earnings	86	92
	<u>3,170</u>	<u>3,413</u>
2 Interest expense		
Interest on monetary policy issues	1,517	2,229
Interest paid to IMF	24	31
Interest on customer deposits	6	6
	<u>1,547</u>	<u>2,266</u>
3 Foreign exchange income		
Gains on sale of foreign exchange	715	663
Foreign exchange translation gain	786	4,727
	<u>1,501</u>	<u>5,390</u>
4 Other operating income		
Rent received	17	16
Proceeds from disposal of property and equipment	1	4
Tuition fees and other charges	101	85
Miscellaneous receipts	197	44
	<u>316</u>	<u>149</u>
5 Operating expenses		
The following items are included within operating expenses:		
- Depreciation	181	188
- Auditors' remuneration	5	5
- Profit on sale of property and equipment	1	4
- Operating lease rentals	5	-
- Provision for misappropriated treasury bonds (note 18)	254	-
- Staff costs	1,982	1,762
	<u>1,982</u>	<u>1,762</u>

The average number of employees during the year was 1,265 (2002: 1,260).

	2003	2002
	KShs m	KShs m
6 Staff costs		
The following items are included within staff costs:		
Retirement benefit costs - defined benefit scheme	245	239
	<u>245</u>	<u>239</u>

CENTRAL BANK OF KENYA
NOTES TO THE FINANCIAL STATEMENTS (Continued)
FOR THE YEAR ENDED 30 JUNE 2003

7 Balances due from banking institutions and gold holdings	2003	2002
	KShs m	KShs m
Current accounts	3,294	2,720
Term deposits	81,549	79,951
Gold holdings	12	12
	<hr/>	<hr/>
Cash and cash equivalents	84,855	82,683
Accrued interest on foreign investments	187	231
Special Drawing Rights	32	71
	<hr/>	<hr/>
Total own resources	85,074	82,985
Special project accounts	6,943	5,478
	<hr/>	<hr/>
	92,017	88,463

8 Dividends

Proposed dividends are accounted for as a separate component of equity until they have been ratified by the Bank's Board of Directors. The Directors have proposed a first and final dividend of Shs 3,500 million (2002: Shs 2,110 million) in respect of the year ended 30 June 2003.

9 Investment in government securities

	2003	2002
	KShs m	KShs m
Government stock	402	742
Treasury bonds	0	120
Treasury bills	311	757
	<hr/>	<hr/>
	713	1,619

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

10 Loans and advances

	2003	2002
	KShs m	KShs m
Advances to banks under liquidation	8,234	8,245
Other advances to banks	3,898	2,313
Government overdraft account (see below and Note 21)	4,319	-
Advances to employees (Note 21)	1,733	1,547
IMF funds on-lent to the Government (Note 21)	2,072	2,079
	20,256	14,184
Provision for loan impairment	(8,263)	(8,275)
Net advances as at 30 June	<hr/> 11,993	<hr/> 5,909
Movement in the provision for loan impairment is as follows:		
At start of year	(8,275)	(8,302)
Additional provisions made in the year	(25)	(2)
Recoveries in the year	37	29
At end of year	<hr/> (8,263)	<hr/> (8,275)

Section 46(3) of the Central Bank of Kenya Act sets the limit of the Government of Kenya's overdraft facility at 5% of the Gross Recurrent Revenue as reported in the latest audited accounts. The limit stands at KShs 8,270,571,883, which is based on the Government accounts for 1998/1999, which are the latest audited accounts at the date of approval of these financial statements. The limit for the previous year was KShs 8,753,160,998, based on the Government accounts for 1997/1998.

CENTRAL BANK OF KENYA
NOTES TO THE FINANCIAL STATEMENTS (Continued)
FOR THE YEAR ENDED 30 JUNE 2003

11 Other assets	2003	2002
	KShs m	KShs m
Impersonal accounts	25	-
Sundry debtors	93	228
	<u>118</u>	<u>228</u>

12 Retirement benefit asset

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

The amounts recognised in the balance sheet are determined on the basis of an actuarial review carried out by Alexander Forbes Financial Services as at 30 June 2003.

	2003	2002
	KShs	KShs
Present value of funded obligations	4,942	4,384
Fair value of plan assets	<u>(5,933)</u>	<u>(4,713)</u>
Present value of net asset	(991)	(329)
Unrecognised actuarial gain	571	42
Asset in the balance sheet	<u>(420)</u>	<u>(287)</u>

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

Current service costs	277	269
Interest costs	403	349
Expected return on plan assets	<u>(435)</u>	<u>(379)</u>
Total expenses included in operating expenses	<u>245</u>	<u>239</u>

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

Net expense recognised in the profit and loss account	245	239
Under/(over) statement of asset in previous year	1	(1)
Employer contributions	<u>(377)</u>	<u>(236)</u>
Movement in the asset recognised in the balance sheet	<u>(133)</u>	<u>2</u>
Actual return on plan assets	<u>957</u>	<u>422</u>

The principal actuarial assumptions at the balance sheet date were:

	2003	2002
Discount rate (p.a)	9%	9%
Salary increase (p.a)	7%	7%
Expected return on plan assets (p.a)	9%	9%
Future pension increases	0%	0%

CENTRAL BANK OF KENYA
NOTES TO THE FINANCIAL STATEMENTS (Continued)
FOR THE YEAR ENDED 30 JUNE 2003

13 Property and equipment	Land and buildings KShs m	Motor vehicles KShs m	Furniture and KShs m	Total KShs m
Cost				
At start of year (as previously stated)	1,300	142	949	2,391
- reclassification of leasehold land (note 14)	(300)	-	-	(300)
-as restated	1,000	142	949	2,091
Additions	4	27	361	392
At end of year	<u>1,004</u>	<u>169</u>	<u>1,310</u>	<u>2,483</u>
Depreciation				
At start of year (as previously stated)	591	124	846	1,561
- reclassification of leasehold land	(10)	-	-	(10)
-as restated	581	124	846	1,551
Charge for the year	84	21	76	181
At end of year	<u>665</u>	<u>145</u>	<u>922</u>	<u>1,732</u>
Net book value				
At 30 June 2003	<u>339</u>	<u>24</u>	<u>388</u>	<u>751</u>
At 30 June 2002 (as restated)	<u>419</u>	<u>18</u>	<u>103</u>	<u>540</u>

14 Prepaid operating lease rentals

Following clarification issued by the International Accounting Standards Board (IASB) in January 2002 and further guidance from the Institute of Certified Public Accountants of Kenya (ICPAK), the Bank has reclassified leasehold land from property and equipment to prepaid operating lease rentals to be carried at historical cost less amortisation over the period of the lease. The effect of the reclassification is as follows:

	2003 Shs'000	2002 Shs'000
Net book amount reclassified from property and equipment (Note 13)	290	290
Reversal of depreciation on leasehold land	10	-
Amortisation charge for the year	(5)	-
At end of year	<u>295</u>	<u>290</u>

CENTRAL BANK OF KENYA
NOTES TO THE FINANCIAL STATEMENTS (Continued)
FOR THE YEAR ENDED 30 JUNE 2003

15 Due from Government of Kenya	2003 KShs m	2002 KShs m
Recoverable from dividends:		
Balance at start of year	18,642	19,642
Recovery in the year	<u>(1,000)</u>	<u>(1,000)</u>
Balance at end of year	17,642	18,642
Loan due from Government	<u>36,917</u>	<u>36,917</u>
	<u>54,559</u>	<u>55,559</u>

The amount of Shs 17,642 million due from the Government of Kenya is repayable within 16 years from 1 July 2003. This amount is currently interest free, and is being recovered from dividends payable to the Government of Kenya.

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

16 Deposits	2003 KShs m	2002 KShs m
Banks -Kenya	30,105	24,594
-External	705	16
Non-bank financial institutions	162	424
Other public entities and project accounts	10,518	7,767
International Monetary Fund	8,088	9,579
Government of Kenya	<u>32,967</u>	<u>24,946</u>
	<u>82,545</u>	<u>67,326</u>

17 Amounts repayable under repurchase

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

18 Other liabilities	2003 KShs m	2002 KShs m
Impersonal accounts	-	398
Sundry creditors	257	217
Refundable deposits	26	33
Commission for EEC Development deposits	1	15
Sundry suspense accounts	22	20
Provision for misappropriated T/Bonds (see below)	<u>254</u>	<u>-</u>
	<u>560</u>	<u>683</u>

The Bank has made a provision in respect of amounts incurred following a fraudulent transfer of treasury bonds that occurred during the year.

CENTRAL BANK OF KENYA
NOTES TO THE FINANCIAL STATEMENTS (Continued)
FOR THE YEAR ENDED 30 JUNE 2003

	2003	2002
	KShs m	KShs m
19 (a) Cashflows from operating activities		
Net profit for the year	4,448	5,813
Adjustments for:		
Charge in respect of deferred receivable	-	1,801
Depreciation	181	188
Amortization of prepaid operating leases	5	-
Charge for reclassification of leasehold property	(10)	-
(Increase)/decrease in defined benefit scheme asset	(133)	2
Gain on sale of property and equipment	(1)	(4)
Foreign exchange revaluation gains	<u>(786)</u>	<u>(4,727)</u>
Operating profit before working capital changes	3,704	3,073
Net (decrease)/increase in loans and advances	(6,084)	1,486
(Decrease)/increase in amounts repayable under repurchase agreements	(14,459)	10,249
Increase/(decrease) in deposits	15,219	(12,450)
Decrease in project accounts	(1,465)	(235)
Decrease in accrued interest on balances due from banking institutions	44	416
Decrease in items in the course of collection	1,632	1,682
Decrease in other assets	109	212
(Decrease)/ increase in other liabilities	(123)	431
Net cash generated from operations	<u>(1,423)</u>	<u>4,864</u>
19 (b) Cash and cash equivalents		
Cash and cash equivalents included in the cash flow		
Current accounts and term deposits	84,843	82,671
Gold holdings	12	12
	<u>84,855</u>	<u>82,683</u>
20 Share capital		
Authorised share capital	<u>5,000</u>	<u>5,000</u>
Issued and fully paid	<u>1,500</u>	<u>1,500</u>

CENTRAL BANK OF KENYA
NOTES TO THE FINANCIAL STATEMENTS (Continued)
FOR THE YEAR ENDED 30 JUNE 2003

21 Related party transactions

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

(i) Staff loans

The Bank extends loan facilities to its members of staff including the Governor and the Deputy Governor. Loans and advances (Note 10) include advances to employees which as at 30 June amounted to KShs 1,733 million. (2002: KShs 1,547 million). The advances are at preferential rates of interest determined by the Bank.

	2003	2002
	KShs m	KShs m
(ii) Loans to directors		
At 1 July	11	1
Loans advanced during the year	0	13
Loan repayments	(2)	(3)
	<hr/>	<hr/>
At 30 June	9	11
	<hr/> <hr/>	<hr/> <hr/>
(iii) Directors emoluments:		
Fees	1	1
Other remuneration	26	13
	<hr/> <hr/>	<hr/> <hr/>

(iv) Government of Kenya

Transactions entered into with the Government include:

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

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

	2003	2002
	KShs m	KShs m
Due from Government of Kenya (Note 15)	54,559	55,559
Overdraft account (Note 10)	4,319	-
IMF funds on-lent to the Government (Note 10)	2,072	2,079
Government of Kenya deposits (Note 16)	32,967	24,946
Investments in GOK Securities (Note 9)	713	1,619
	<hr/> <hr/>	<hr/> <hr/>

CENTRAL BANK OF KENYA
NOTES TO THE FINANCIAL STATEMENTS (Continued)
FOR THE YEAR ENDED 30 JUNE 2003

21 Related party transactions (continued)

(v) Deposit Protection Fund Board

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

The balance outstanding from the Deposit Protection Fund Board and included in other assets as at year end was KShs18 million (2002: KShs 8 million).

(vi) Kenya School of Monetary Studies

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

CENTRAL BANK OF KENYA
NOTES TO THE FINANCIAL STATEMENTS (Continued)
FOR THE YEAR ENDED 30 JUNE 2003

22 Liquidity risk

The table below analyses assets and liabilities into relevant maturity groupings based on the remaining period at 30 June 2003 to the contractual maturity date.

ASSETS	On demand KShs m	Due within 3 months KShs m	Due between 3-12 KShs m	Due between 1-5yrs KShs m	Due after 5 years KShs m	Total KShs m
Balances due from banking institutions and gold holdings						
	10,249	81,736	-	-	32	92,017
Loans and advances	8,298	100	173	819	2,603	11,993
Investments in government securities	-	713	-	-	-	713
Items in the course of collection	4,037	-	-	-	-	4,037
Other assets	-	118	-	-	-	118
Retirement benefit asset	-	-	-	-	420	420
Property and equipment	-	-	-	-	751	751
Prepaid operating lease rentals	-	-	-	-	295	295
Due from Government of Kenya	-	1,000	-	10,550	43,009	54,559
TOTAL ASSETS	22,584	83,667	173	11,369	47,110	164,903
LIABILITIES						
Currency in circulation	55,231	-	-	-	-	55,231
Deposits	74,456	-	1,031	7,058	-	82,545
Amounts repayable under repurchase agreements	-	12,668	-	-	-	12,668
Other liabilities	-	560	-	-	-	560
Equity and reserves	-	3,500	-	-	10,399	13,899
TOTAL LIABILITIES AND EQUITY	129,687	16,728	1,031	7,058	10,399	164,903
Liquidity gap 2003	(107,103)	66,939	(858)	(4,311)	36,711	-
As at 30 June 2002:						
Total assets	16,389	81,010	1,058	886	59,325	158,564
Total liabilities and equity	102,530	27,127	729	16,617	11,561	158,564
Liquidity gap 2002	(84,594)	53,883	329	(15,731)	47,660	-

CENTRAL BANK OF KENYA
NOTES TO THE FINANCIAL STATEMENTS (Continued)
FOR THE YEAR ENDED 30 JUNE 2003

23 Currency risk

The various currencies to which the bank is exposed at 30 June 2003 are summarised in the table below (all expressed in KShs m):-

	USD	GBP	EURO	SDR	GOLD	OTHER	Total
Assets							
Balances due from banking institutions	27,429	37,703	26,808	-	-	33	91,973
Special Drawing Rights	-	-	-	32	-	-	32
Gold holdings	-	-	-	-	12	-	12
Total assets	27,429	37,703	26,808	32	12	33	92,017
Liabilities							
Balances due to IMF	-	-	-	8,088	-	-	8,088
Commissions for EEC Development Fund	-	1	-	-	-	-	1
Forex Bureaux Deposits	19	-	-	-	-	-	19
Total liabilities	19	1	-	8,088	-	-	8,108
Net balance sheet position 2003	27,410	37,702	26,808	(8,056)	12	33	83,909
As at 30 June 2002							
Total assets	26,339	38,439	23,504	71	12	98	88,463
Total liabilities	20	15	-	9,579	-	-	9,614
Net balance sheet position 2002	26,319	38,424	23,504	(9,508)	12	98	78,749

CENTRAL BANK OF KENYA
NOTES TO THE FINANCIAL STATEMENTS (Continued)
FOR THE YEAR ENDED 30 JUNE 2003

24 Interest rate risk

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

	3 months or less Kshs m	Between 12 Kshs m	Over 1 year Kshs m	Non- interest bearing Kshs m	Total Kshs m
Assets					
Balances due from banking institutions and gold holdings	84,409	-	-	7,608	92,017
Loans and advances	9,298	273	2,422	-	11,993
Investment in government securities	713	-	-	-	713
Items in the course of collection	-	-	-	4,037	4,037
Other assets	-	-	-	118	118
Retirement benefit asset	-	-	-	420	420
Property and equipment	-	-	-	751	751
Prepaid operating lease rentals	-	-	-	295	295
Due from Government of Kenya	-	-	-	54,559	54,559
Total assets	94,420	273	2,422	67,788	164,903
Liabilities and equity					
Currency in circulation	-	-	-	55,231	55,231
Deposits	-	1,037	4,981	76,527	82,545
Amounts repayable under repurchase agreements	12,668	-	-	-	12,668
Other liabilities	-	-	-	560	560
Equity and reserves	-	-	-	13,899	13,899
Total liabilities and equity	12,668	1,037	4,981	146,217	164,903
Interest sensitivity gap 2003	81,752	(764)	(2,559)	(78,429)	-
As at 30 June 2002					
Total assets	87,501	196	4,221	67,122	157,564
Total liabilities and equity	27,127	729	16,617	113,091	157,564
Interest sensitivity gap 2002	58,898	(533)	(12,396)	(45,969)	-

CENTRAL BANK OF KENYA
NOTES TO THE FINANCIAL STATEMENTS (Continued)
FOR THE YEAR ENDED 30 JUNE 2003

25 Fair values and effective interest rates of financial assets and liabilities

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

The effective interest rates for the principal financial assets and liabilities at 30 June 2003 and 2002 were in the following ranges:

	2003	2002
Assets		
Government securities	9.40%	12.20%
Deposits with overseas correspondent banks		
- current accounts	0.00%	0.00%
- term deposits (USD)	1.40%	2.30%
- term deposits (Pounds Sterling)	3.80%	4.30%
- term deposits (Euro)	2.90%	3.50%
Loans and advances		
- Commercial banks	10.20%	13.80%
- Government of Kenya	7.20%	10.90%
- Employees	5.00%	5.00%
Due from Government of Kenya	0.00%	0.00%
Liabilities		
Customer deposits	0-5%	0-5%

26 Contingencies and commitments

Contingencies

The Bank is party to various legal proceedings at 30 June 2003. In the opinion of the Directors, no material liability will arise from those proceedings.

Commitments

There was no capital expenditure contracted but not recorded in the financial statements at the balance sheet date.