TABLE OF CONTENTS

LETTER OF TRANSMITTAL

I am pleased to submit to the Honourable Minister the Annual Report of the Central Bank of Kenya for the Financial Year 2004/05 in accordance with Section 54 of the Central Bank of Kenya Act. The report reviews economic and financial developments and contains the Audited Accounts of the Central Bank of Kenya for the Financial Year ended June 30, 2005.

Economic performance during the year improved markedly from that witnessed in recent years. Growth in real Gross Domestic Product (GDP) improved to 4.3% in 2004 from 2.8% in 2003, and is projected to grow by 5% in 2005. Agriculture and the services sector, particularly telecommunications and tourism, are expected to improve in 2005, making them the economy's key growth sectors. Reforms in economic and political governance, favourable weather conditions, and improved relations with development partners, as well as the conducive stable macroeconomic environment that was characterized by stable interest and exchange rates and low inflation, underpinned the improved economic output. Investor confidence also improved, particularly in such areas as telecommunications.

Improved fiscal discipline kept the Government recourse to the Central Bank for overdraft within the stipulated statutory limit, and the Central Bank implemented a monetary policy stance geared towards containing underlying inflation to the targeted levels. There were, however, some setbacks due to increased oil prices and drought in the earlier part of the financial year. The drought led to a rise in food prices and this, coupled with higher oil prices, created increased inflationary pressures.

The banking sector remained stable during the year to June 2005 as a result of the favourable macroeconomic environment. Non-performing loans continued on a downward trend, leading to improved profitability and hence, strong capital adequacy ratios.

Overall, Central Bank operations in the year ended June 30, 2005 resulted in Ksh 4,134 million net loss compared with Ksh 5,133 million net profit realised in the year ended

June 30, 2004. The loss was mainly occasioned by revaluation of foreign exchange holdings and recognition of impairment loss due to a non-performing asset in the Bank's balance sheet in compliance with the International Financial Reporting Standards.

Looking ahead, and despite the impact of the drought and the delay in disbursement of donor funds, economic recovery is expected to remain on track as the Government continues to implement its policies under the Economic Recovery Strategy for Wealth and Employment Creation. Real GDP growth will be boosted by faster world and regional growth, the extension untill 2007 of third-party textile sourcing under the African Growth and Opportunity Act (AGOA), the tourism "boom" and increased tea, horticulture and coffee exports. On its part, the Central Bank will endevour to contain inflation within levels consitent with the macroeconomic targets that the Government has set to further enhance the performance of the economy.

GOVERNOR

BOARD OF DIRECTORS

ANDREW K. MULLEI
Governor and Chairman
Central Bank of Kenya

JOSEPH M. KINYUA
Permanent Secretary,
Ministry of Finance

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

HENRY K. MARITIM

OWEN N. KOIMBURI

PAUL A. SPENCE

GEORGE ONGAYA-OKOTH

SENIOR MANAGEMENT

JOHN M. GIKONYO
Director Governors Office and Board Secretary

JAMES OGUNDO
Executive Director, Kenya School of Monetary Studies

JONATHAN A. BETT
Director, Banking Services and National Payments Systems

JONES M. NZOMO
Director, Accounting, Budget & Expenditure Contol

LAWRENCE C. KUNGU
Director, Estates, Supplies & Services

ALOYS B. AYAKO
Director, Rural Finance Development

NICHOLAS B.T. A. KORIR
Director, Policy Analysis and Research

SENIOR MANAGEMENT

GERALD A. NYAOMA
Director, Financial Institutions Supervisions

JACKSON M. KITILI
Director,International Relations & Regional Co-operation

CHARLES O. MARANGA
Director, Administration & Human Resources

CHELOTI KAKAI
Director, National Debt & Financial Markets

HEZBON MARIWA
Director, Currency Operations and Branch Administration

EDWIN L. OGOLA
Director, Intrnal Audit & Risk Management

CHARLES K. CHEPKWONY
Ag. Director, Information Management Systems

BANK REORGANISATION

EXECUTIVE APPOINTMENT

Mrs. Jacinta W. Mwatela was appointed Deputy Governor of the Central Bank of Kenya on May 13, 2005 following the expiry of Dr. Edward Sambili's tenure. The appointment of Mrs. Mwatela is of great importance to the Central Bank fraternity given her long experience, dedicated service and exemplary performance within the Central Bank.

DEPARTMENTAL REORGANIZATION AND SENIOR STAFF CHANGES

Departmental functions and operations were reorganised and staff changes made in all the departments of the Bank in order to improve and sustain the quality and promptness of service delivery.

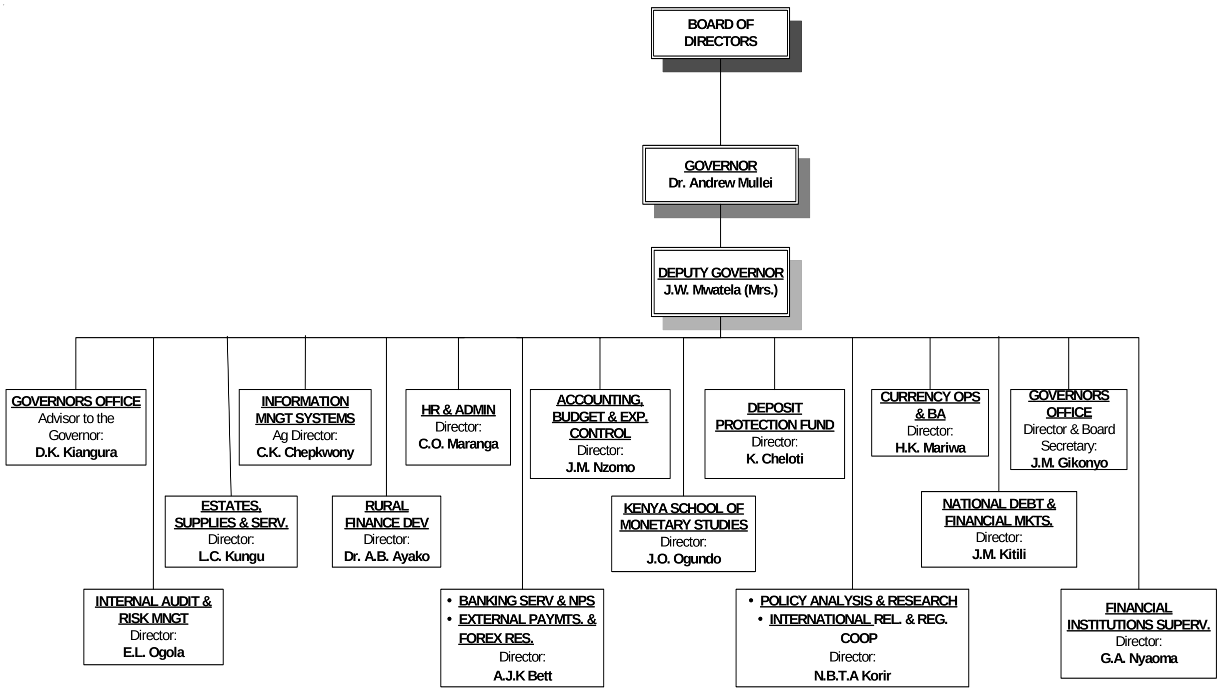
HIGHLIGHTS

Accounting, Budget and Expenditure Control Department

Finance Department was reorganised and renamed Accounting, Budget and Expenditure Control Department. The new-look department will focus more on expenditure control, provide efficient, reliable and effective accounting and financial services to the Bank and it's customers against the background of the Central Bank's overall objectives, as well as prepare timely management accounts.

Banking Services and National Payments System Department

The department was reorganised to enable it deliver effectively and efficiently, banking and related financial services to the Bank's clients in an integrated and technologically modern and up-to-date payments, clearing and settlement environment.



Governor's Office

The department was created to manage the affairs of the Governors Office by providing legal and administrative support and ensuring that service delivery, implementation of Board and Management decisions including compliance and handling of feedback process, are timely, efficient and professionally performed within the confines of the law for maximum benefit to staff, customers, Government and other stakeholders.

Internal Audit and Risk Management Department

The department's mandate was expanded to include identification, assessment and evaluation of risks in the Bank's operations. It will also advise management on appropriate corrective and preventive measures in addition to independently appraising the Bank's processes, procedures and systems for adequacy and effectiveness of internal controls.

Kenya School of Monetary Studies

A new Board of Directors for the School was created comprising stakeholders to place the School in a better position to effectively offer and/or facilitate high quality market driven capacity building training in the fields of economics, banking, finance, IT, and business management, in addition to upgrading the skills of Central Bank staff. The School boasts of a wide range of conferencing facilities together with accommodation, sports and recreation facilities.

International Relations and Regional Cooperation Department

This new department was created in recognition of the deliberate effort by the Governments of East Africa to transform the region into a viable common market for East Africa. The department's role is to support the Bank in conducting policy analyses and formulating proposals for uniform trade tariffs and monetary union for East Africa.

Rural Finance Development Department.

In view of mushrooming micro-finance institutions in the country, it was considered necessary to create a fully-fledged department to urgently work on a policy and regulatory framework for this industry. Its input will go a long way in supporting Government job and wealth creation policies of achieving general economic development at grass-root level by fostering proper functioning of micro-finance institutions.

Human Resources and Administration Department.

This department was hived off the Bank Secretary's department to provide administrative support and integrated human resources services. By isolating and focusing on this function, the department will be better placed to efficiently and effectively formulate and implement the Bank's HR management and development policies critical to the effective and efficient operations in the core and support departments of the Bank. The department encompasses the Human resources development division.

Policy Analysis and Research Department

This department was created when the original Research Department was divided into Policy Analysis and Research and the International Relations and Regional Cooperation departments.

The department's key objective is to conduct policy analyses and research in support of formulation and implementation of sound monetary policy. The ultimate objective is to maintain macroeconomic stability with emphasis on inflation. It also collects, analyses and disseminates real and financial sector statistics through various Bank publications.

JOB EVALUATION AND REWARD SYSTEM OF THE BANK

The Bank recognizes that achievement of its vision and mission depends on the quality and ability of the human resources at its disposal. In this regard, the Board of Directors, in December 2003 engaged a human resources consultant to review and make recommendations on:

- Management job descriptions
- Benchmarking jobs against market best-practice
- Performance appraisal system
- Ideal organization structure and establishment
- Remuneration structure befitting the Bank as regulator of the financial sector with a self-adjusting mechanism to take into account future changes in the job market.

STAFF TRAINING AND DEVELOPMENT

It is the policy of the Bank to develop the skills, knowledge, and attitude of its human resources in the most effective and efficient manner. Through training, the Bank endeavors to continuously build or improve the capacity of its human resources by keeping all members of staff updated on new developments in their areas of operations within the Bank. The Human Resources and Administration Department therefore works closely with other departments in order to understand their operations, job skills and their training needs.

While the Bank is keen to facilitate improvement of staff through training in order to enhance their individual output, members of staff are expected to take the initiative to acquire additional skills and keep abreast of developments in their areas of interest.

Team spirit is very important in achieving high productivity within the organisation as it creates a sense of belonging among the staff and hence loyalty to the organisation. The Bank therefore introduced staff retreats programmes in its training menu. The inaugural staff retreat was mounted in 2003. The second phase is scheduled for the current financial year (2005-2006).

To enhance skills the Bank adopted e-learning designed to improve staff performance in a most efficient and cost-effective manner. The pilot phase of e-learning commenced in 2003-2004, and the second phase is already on course, offering a wide range of courses in information technology, business administration and management. For staff to identify with this new mode of learning, the second phase has been branded **“Banki Kuu E-learning Campus”.** It is expected that enrollment rate will significantly improve in the current phase with a completion target of least 50%.

OVERVIEW

The economy grew by 4.3% in the fiscal year 2003/04, and is estimated to have grown further by 5.0% in the 2004/05 financial year. Significant performance occured in most sectors of the economy, notably hotels and restaurants, wholesale and retail trade, transport and communications, and building and construction which grew by 15.1%, 9.5%, 9.7% and 3.5%, respectively during 2004.

There was mixed performance in production in the agricultural sector, with significant decreases in production and deliveries of some major crops, notably coffee, pyrethrum and tea which declined by about 13%, 7% and 2%, respectively. Horticultural crops (mainly cut flowers) and sugarcane, however, increased by 14% and 4% respectively. In spite of reduced production and deliveries, there were increases in value terms in all the major export crops on account of improved prices. Overall, the agricultural sector grew by 1.4%, during the period under review, down from 2.4% the previous period.

The manufacturing sector grew by 4.1% compared with the 4.9% in the previous period. Growth in the sector continues to be hampered by high costs of production, including power, poor infrastructure and lengthy clearance procedures at the port of Mombasa. To address these problems, the Government has, progressively introduced incentives which include duty waivers on capital goods, increased investment allowances, and more recently, in the 2005/06 Budget Speech, additional measures aimed at simplifying the business licencing process, and harmonising the tax regime with those of the other East African countries.

The tourism sector achieved an impressive performance during the fiscal year 2004/05. Arrivals rose by 31% during fiscal year 2004/05 compared with 6% in the previous year. This is partly attributable to improved marketing of the country in non-traditional markets, for example, China, Japan and India, as well as improved security surveillance.

The Government's fiscal operations during the year resulted in a budget surplus on commitment basis of 0.3% of GDP compared with a deficit of 0.4% of GDP the previous period. This was mainly due to more than targeted tax revenue resulting from the strong growth in GDP and improved tax administration as well as increased inflow of external grants from development partners. Overall public debt also declined to 57.6% of GDP during the fiscal year 2004/05 compared with 62.9% as at June 2004. This is also the result of higher GDP coupled with the fall in the stock of debt.

The banking sector remained stable during the year to June 2005 as a result of the favourable macroeconomic environment. Non-performing loans continued on a downward trend, leading to improved profitability and hence, strong capital adequacy ratios.

During the fiscal year 2004/05, the Bank's monetary policy aimed at keeping inflation below 5%. Consistent with this objective, growth in money supply (M3X) and reserve money were targeted at 7.5%, and 3.8% respectively, and as a result private sector credit was expected to grow by 8.9%. Pursuant to this monetary policy stance, growth in M3X declined from 12.9% in the previous year to 11.3% in the fiscal year 2004/05. The growth in M3X was due mainly to increased NFA attributable to improved export earnings, higher capital inflows, and to a lesser extent growth in NDA. Credit to the private sector, however, expanded by 20.9%, way above the target of 8.9%.

The month-on-month underlying inflation was constrained to 5.8% by June 2005. The relatively low and stable underlying inflation during the year reflected the tight monetary policy stance adopted by the Central Bank, otherwise the overall month-on-month inflation rose to

11.9% by June 2005 reflecting escalating oil prices and adverse weather conditions .

Interest rates generally rose during the period under review. Average interest on 91-day Treasury bills rose to 8.50% in June 2005 from 2.01% in June 2004. On the exchange rate front, the Kenya shilling strengthened against all major international currencies during the period, and also against the South African Rand and the Tanzania shilling. It, however, depreciated against the Uganda shilling. The strengthening of the Kenya shilling, particularly during the second half of the financial year, is attributable to higher interest rates, increased foreign exchange inflows, and a better than expected economic growth outcome for 2004.

The balance of payments recorded a surplus of US$ 212 million during the fiscal year 2004/05 compared with the previous year's US$ 170 million. The improvement is mainly due to increased short term capital flows, and substantial earnings from non-factor services including tourism. The combined surpluses in the services account (US$ 1,235 million) and the capital and financial account (US$ 1,299 million) more than offset the trade deficit of US$ 2,322 million.

The Central Bank official reserves rose by US$ 188 million during the period to US$ 1,587 million as at end of June 2005, representing 3.9 months import cover. The build up in reserves was achieved through purchases of foreign currency from the domestic foreign exchange market, and receipts of foreign aid in support of Government projects. Overall, foreign asset holdings of the banking system amounted to US$ 2,327 million which is US$ 388 million above the June 2004 level.

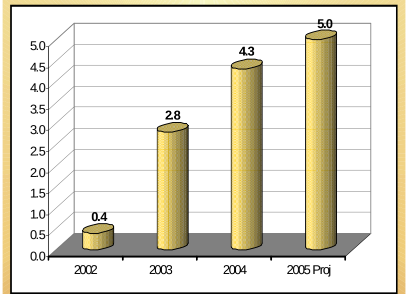
The National Payments System registered significant development during the year with the implementation of the Real Time Gross Settlement (RTGS) system which went live on July 29th, 2005. All commercial banks in Kenya are participants in the real time gross settlement system.

While microfinance institutions and Savings and Credit Co-operative Societies (SACCOs) are filling a gap in the provision of funds, the major challenge facing these institutions is the lack of appropriate legal and regulatory framework to govern their specific operations. Two Bills, the Deposit Taking Microfinance Bill, 2005 and the SACCO Societies Regulatory Bill, 2005, which were drafted with the participation of the Central Bank, have been processed and are in the Attorney General's Office for finalisation.

REAL GDP GROWTH

In spite of the high cost of production inherent in steady rise in wages, crude oil prices and structural bottlenecks associated with inadequate infrastructure, the economy grew by 4.3% in 2004, up from 2.8% in 2003 (Chart 1). Appropriate fiscal and monetary policies pursued resulted in a conducive macroeconomic environment for investment, particularly affordable interest rates and a stable exchange rate. Credit to the private sector expanded by 20.9% up from 12.3% in the year to June 2004. There was also significant growth in credit to the productive sectors such as manufacturing, transport and communication and building and construction in the year to June 2005. Credit to these sectors increased by 26.6%, 38.7% and 21.9%, respectively

CHART 1: REAL GDP RATES, 2002 - 2005 (%)



Sources: Economic Survey &Central Bank of Kenya

TABLE 1: GROSS DOMESTIC PRODUCT AND SECTOR SHARE AT CONSTANT 2001 PRICES

	Share in Real GDP (%)	Ksh.million		
MAIN SECTORS	2004	2002	2003	2004
Agriculture,Forestry & Fishing	24.20	274,037	280,726	284,670
Manufacturing	9.90	100,387	105,284	109,571
Wholesale and retail trade, repairs	10.10	91,391	92,454	101,218
Hotels & Restaurants	1.10	12,425	9,899	11,391
Financial Services	3.80	41,355	42,060	42,674
Construction	3.60	31,002	31,528	32,619
Transport, Storage & Communications	10.30	105,442	110,629	121,338
Government	14.80	135,937	141,032	143,020
Others of which	11.60	125,402	130,813	134,164
Domestic Services	*0.40*	*3,780*	*3,855*	*3,932*
Real estate, renting & Business service	*5.70*	*60,452*	*61,864*	*63,516*
Other-Financial services indirectly measurec	*-0.70*	*-10,665*	*-10,315*	*-10,801*
Electricity & Water supply	*1.80*	*23,848*	*27,359*	*27,943*
Mining & Quarrying	*0.50*	*5,002*	*5,147*	*5,267*
Community,social & personal services	*3.90*	*42,985*	*42,903*	*44,307*
Total GDP at basic 2001prices	89.40	917,367	944,425	980,663
Taxes less subsidies on products	10.60	112,611	114,045	123,693
Real GDP at 2001 market prices	100.00	1,029,978	1,058,470	1,104,356
GDP at Mkt Prices		1,038,764.00	1,141,780.00	1,273,716.00
Overall GDP Deflator		100.85	107.87	115.34
			6.96	6.92
		Growth Rates %		
Agriculture,Forestry & Fishing		0.1	2.4	1.4
Manufacturing		0.6	4.9	4.1
Wholesale and retail trade, repairs		-2.3	1.2	9.5
Hotels & Restaurants		4.7	-20.3	15.1
Financial Services		-1.8	1.7	1.5
Building & Construction		-2.6	1.7	3.5
Transport & Communications		6.8	4.9	9.7
Government		0.0	2.6	1.8
Others		1.4	4.3	2.6
Domestic Services		2.0	2.0	2.0
Real estate, renting & Business service		3.0	2.3	2.7
Other-Financial services indirectly measured		-9.4	-3.3	4.7
Electricity & Water supply		21.3	14.7	2.1
Mining & Quarrying		1.8	2.9	2.3
Community,social & personal services		2.7	-0.2	3.3
Real GDP Growth		0.4	2.8	4.3

Scource: Central Bureau of Statistics and Central Bank of Kenya

Tourism and transport and communications sectors recovered, growing by 15.1% and 9.7%, respectively in 2004. Value added in manufacturing, trade, and building and construction was also strong with an expansion of 4.1%, 9.5% and 3.5%, respectively. The export sector also performed well with horticulture and tea exports expanding by 13.2% and 10.5% respectively. The growth in exports was boosted by strong growth in the world economy.

In the fiscal year 2004/05, consumption of inputs and production of goods and services in the economy made major gains. In Agriculture, for instance, sugar cane deliveries increased by 4.5% while horticultural exports increased by 13.8%. The positive impact of the favourable long rains is expected to lead to a rebound in agriculture, that will provide important forward and backward linkages, thereby stimulating growth in other related sectors of the economy. In particular, output of maize and other crops, are expected to reach their potential in 2005.

The manufacturing sector also achieved strong growth. Production of cement, processed milk, cigarettes and beer grew by 17.4%, 17.4%, 17% and 21.8% respectively in the fiscal year 2004/05, while soda ash production increased by 0.6%.

Increased demand for utilities, particularly energy services was also a sign of increased economic activity. Consumption of electricity and fuels expanded by 7.0% and 13.6%, respectively during the fiscal year 2004/05. This was consistent with increased imports of capital goods, namely crude materials, transport, machinery and chemical products which went up by 32.7%, 13.2% and 36%, respectively in the year to May 2005.

In the services sector, tourist arrivals by air and sea grew by 30.7% compared with 6.0% in fiscal year 2003/04. In transport related services, cargo handled through the Port of Mombasa and fuel cargo transported by the Kenya Pipeline Company expanded by 6.2% and 11.8%, respectively, during the fiscal year

2004/05, while passengers through Jomo Kenyatta International Airport (JKIA) increased by 18.9% during the same period. Similarly, in communications services, rapid growth was achieved in the mobile phones sub-sector with excise duty on airtime services picking up by 44.4% to Ksh 2.99 billion from Ksh 2.07 billion in the fiscal year 2003/04.

Good performance was also achieved in the construction sector, with cement consumption expanding by 11.4% compared with 5.2% in the 2003/04.

With the envisaged implementation of the Government investment programme outlined in the 2005/06 Budget Speech, particularly the development and rehabilitation of major infrastructure and other projects which have so far been the major bottleneck for accelerated economic growth, additional growth impetus will be provided in the financial year and into the medium term.

There was mixed performance in the production of major cash crops during the fiscal year 2004/05 as shown in Table 2.

TABLE 2: OUTPUT GROWTH IN KEY CROPS (%)

PRODUCT	Jun2001/02	Jun2002/03	Jun2003/04	Jun2004/05
Tea				
Output (MT)	282,952	280,136	327,281	321,440
Output Growth %	0.14%	-1.00%	16.83%	-1.78%
Horticulture				
Output (MT)	105,009	137,601	145,005	164,993
Output Growth %	4.10%	31.64%	5.38%	13.78%
Coffee				
Output (MT)	49,532	56,245	58,795	51,387
Output Growth %	-36.25%	13.55%	4.53%	-12.60%
Sugar cane				
Output (MT)	3,933,147	4,163,415	4,548,881	4,751,432
Output Growth %	-3.78%	5.85%	9.26%	4.45%
Pyrethrum				
Output (MT)	3,808	3,758	4,255	3,946
Output Growth %	-38.90%	-1.31%	13.24%	-7.26%

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

Tea output declined by 1.8% to 321,440 tonnes from 327,281 tonnes in fiscal year 2003/04. Despite the decline in tea output, particularly in the East of Rift Valley, performance in the sub-sector remains good given that production remained above the 300,000 tonnes achieved in fiscal year 2003/04. The declines during the year occurred in March, April and May 2005 due to the hot and dry weather before the onset of the long rains. The strong performance over the two financial years is attributed to reforms, including the licensing of 10 new factories, which led to increased leaf handling capacity.

Coffee deliveries declined by 12.6% to 51,387 tonnes in the fiscal year 2004/05, from 58,795 tonnes in the 2003/04 fiscal year. The average price of coffee, however, increased to US dollar 2,108 per tonne from US dollar 1,454 in the period.

In the sugar sub-sector, sugar cane deliveries increased by 4.5% to 4,751,432 tonnes in the fiscal year 2004/05 from 4,548,881 tonnes in the fiscal year 2003/04. Processed sugar output, however, declined by 0.4% to 507,306 tonnes from 509,245 tonnes in the fiscal year 2003/04, while total sales of sugar during the period declined slightly by 5.2% to 487,856 tonnes from 514,742 tonnes in the previous financial year. Inability to maintain competitiveness against cheaper imports from more efficient producers, particularly Sudan, Zambia and Egypt, remains the major challenge facing the sugar sector. It costs on average Ksh. 20,000 to produce a tonne of sugar in most of these COMESA countries compared with Ksh 22,000 for the most efficient company in Kenya. Given the inefficiency in domestic production, imported sugar continues to be cheaper and hence it is favoured by consumers over the domestically produced sugar.

Pyrethrum output declined by 7.3% to 3,946 tonnes from 4,255 tonnes in fiscal year 2003/04. Consequently, export earnings from the crop fell to US dollar 14.8 million from US dollar 14.9 million in 2003/04.

Milk deliveries to the formal handling facilities increased by 17.4% to 281,336 million litres in the fiscal year from 239,705 million litres in the fiscal year 2003/04. The improved performance is attributed to the favourable weather conditions, especially the short rains, in the last quarter of 2004 and the long rains in the first half of 2005. In addition, there has been improved regulatory support of the sector with the revival of the Kenya Cooperative Creameries and a growing regional market for Kenya's dairy produce.

Under the 10 year Strategy for Revitalising Agriculture (SRA), plans are under way to transform agricultural activities into more profitable, internationally competitive ventures. The Government, therefore, introduced several measures in the fiscal year 2005/06 Budget, including injection of Ksh 1.5 billion to the Agricultural Finance Corporation for on lending to farmers,. The Government has also revived key institutions such as the Kenya Farmers Association, the Kenya Meat Commission and the Kenya Cooperative Creameries. Major reforms have also been undertaken to improve productivity in the coffee, pyrethrum and cotton sub-sectors.

MANUFACTURING

The manufacturing sector improved significantly during the fiscal year 2004/05, evidenced by increased demand for major inputs which include energy fuel, machinery and chemical products, and increased output in the sector.

Consumption of electricity and fuel oils, the largest share of which is consumed by manufacturing, grew by 7.0% and 13.6% respectively. Similarly, imports of key intermediate inputs, particularly crude oil, transport machinery and chemical products grew by 29.5%, 32.9% and 28.7% respectively, in the year to May 2005.

As shown in Table 3, output of cigarettes increased by 17.0% to 10,052,423 milles in the fiscal year under review from 8,590,015 milles in the fiscal year 2003/04, while beer production increased by 21.8% to 257,123,727 litres from 211,037,913 litres during the same period.

TABLE 3: PRODUCTION OF SELECTED MANUFACTURES

PRODUCT	Jun2001/02	Jun2002/03	Jun2003/04	Jun2004/05
Processed sugar				
Output (MT)	420,855	450,043	509,245	507,306
Output Growth %	25.79%	6.94%	13.15%	-0.38%
Cement production				
Output (MT)	1,396,927	1,639,336	1,691,483	1,985,996
Output Growth %	7.65%	17.35%	3.18%	17.41%
Soda ash				
Output (MT)	300,870	332,330	355,540	357,521
Output Growth %	12.10%	10.46%	6.98%	0.56%
Milk				
Output ('000 litres)	139,978	178,718	239,705	281,336
Output Growth %	30.10%	27.68%	34.12%	17.37%
Beer				
Output ('000 litres)	187,619	192,992	211,038	257,124
Output Growth %	-3.67%	2.86%	9.35%	21.84%
Cigarettes				
Output (Number of sticks)	5,979,551	7,138,180	8,590,015	10,052,423
Output Growth %	0.06%	19.38%	20.34%	17.02%

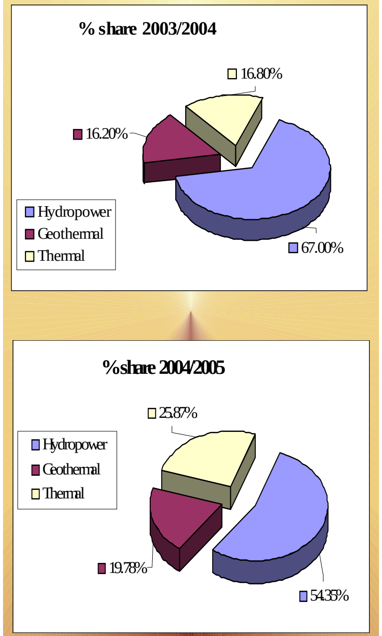
Sources: Central Bureau of Statistics, Sugar Board, Dairy Board, Kenya Revenue Authority and Magadi Soda

Likewise, soda ash output increased by 0.6% to 357,521 tones from 355,540 tones in the financial year 2003/04, while production of processed milk grew by 17.4%. Cement production and consumption also increased by 17.4% and 11.4% to 1,985,996 tonnes and 1,464,870 tonnes respectively, from 1,691,483 tonnes and 1,315,415 tonnes the previous year. Production of sugar, however, declined by 0.4% during the fiscal year.

To promote industrial growth, the Government introduced tax incentives in the fiscal years 2003/04 and 2004/05 which include duty waivers on capital goods, plant and equipment, and an increase in investment allowance from 60 percent to 100 percent. In the Budget for the fiscal year 2005/06, the Government also introduced additional measures including removal of some 17 trading licences aimed at simplifying the licensing process and reducing the cost of doing business as well as harmonising tax regimes with those of the other East African countries.

Growth in the manufacturing sector, however, continues to be hampered by high cost of operations due to poor infrastructure, high cost of power, lengthy clearing procedures at the port, and inefficient railway services.

CHART 2: PERCENTAGE SHARE OF ELECTRICITY SOURCES



Source: Kenya Power & Lighting Co.

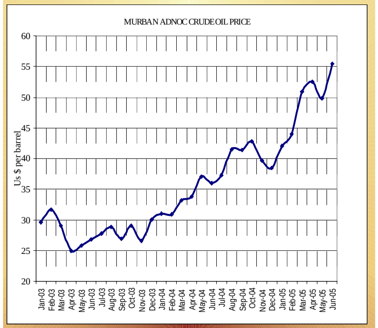
In the energy sector, domestic supply of electricity remained steady, expanding by an average of 7.9% per annum in fiscal year 2003/04 and fiscal year 2004/05. Total generation in the fiscal year 2004/05 reached 5,246 million Kilowatt Hours (KWH), up from 4,864 million KWH in fiscal year 2003/04. The steady growth in generation over the last two years is attributed to good supply of water to hydroelectric dams and increased exploitation of the other two alternative sources of power.

Although hydroelectric power remains the main source, accounting for 54.35% of total electricity supply, the shares of geothermal and thermal sources increased to 19.3% and 25.9% respectively in fiscal year 2004/05. In the previous year, hydroelectric power accounted for 67% of total supply while geothermal and thermal sources accounted for only 16.2% and 16.8% respectively.

The 7.9% growth in electricity generation over the last two financial years was higher than the increase in consumption which grew by an average of 7.6% in fiscal years 2003/04 and 2004/05. Consequently, electricity imports from Uganda declined by 42.2% to 99 million KWH in fiscal year 2004/05. However, if growth in consumption of energy continues at the same rate to the medium term, the economy is likely to face supply shortfalls, given the high cost of installing new capacity. To address the situation, the Government plans to install an additional 423 mega watts by 2008 through projects which include the Sondu Miriu hydro-power plant and Olkaria Geothermal extension projects. These projects are expected to provide an additional 95 Mega Watts.

Since the beginning of 2004, the energy sector has been experiencing rapid increases in crude oil prices. The average price of Murban Adnoc crude oil from Saudi Arabia increased from US $ 35.95 per barrel in June 2004 to US $ 55.5 per barrel in June 2005. The sharp increase in crude oil prices is associated with the

CHART 3: SAUDI ARABIAN CRUDE OIL



Source: Ministry of Energy

political risks in the Middle East, particularly in Iraq (the fourth largest producer in the world) and the increase in global demand to support the rapidly expanding economies like China, India, Japan and USA. Despite efforts by some OPEC producers to increase supply, particularly Saudi Arabia, Russia and Iran, oil prices have remained high and are expected to be high for most of the fiscal year 2005/06.

CONSTRUCTION

Building and construction activity picked up during the fiscal year 2004/2005. Consumption of cement, a major input in construction, increased by 11.4% to 1,464,870 tonnes from 1,315,415 tonnes in the fiscal year 2003/2004.

During the period under review there was increased activity in the roads sector. The Roads Department of the Ministry of Public Works had 59 projects funded by the Roads Maintenance Levy Fund in 2004. Out of these, 36 were on-going projects covering rehabilitation, resealing and gravelling at various stages of completion. During the year, 275 kilometers of roads were graveled, 91 kilometers of bitumen roads rehabilitated, including pavement reconstruction, and 98 kilometers of bitumen roads resealed or recarpeted. The Department also graded 8,910 kilometers, while another 9,559 kilometers of roads were maintained on routine basis.

The construction sector is expected to pick up further and be a major contributor to growth in the current financial year and into the medium term following renewed donor support. The continued rehabilitation and reconstruction of the country's infrastructure will also be facilitated by the increased budget allocation for roads in the fiscal year 2005/06, which went up by 44%. In addition, Ksh 1.0 billion was allocated to unfinished projects. The Government is also implementing the Roads 2000 Programme involving participation of local communities in 34 districts. The Programme endeavours to improve the road network using local resources and labour based methods wherever they are cost effective. The upgrading of many rural roads to gravel standards will give a major boost to productive activities in rural areas.

TRANSPORT

Following reforms in the public transport sub-sector, noticeable improvement in provision of transport services has been achieved as shown in Table 4.

TABLE 4: PERFORMANCE OF MAJOR SUB-SECTORS

ACTIVITY	Jun2001/02	Jun2002/03	Jun2003/04	Jun2004/05
Cargo by KPA				
Output (MT Equivalent)	10,506,851	11,463,854	12,505,385	13,283,984
Output Growth %	-0.06%	9.11%	9.09%	6.23%
Passengers through JKIA				
Number of People	1,874,241	1,991,573	2,208,714	2,615,254
Growth %	-0.56%	6.26%	10.90%	18.90%
Cargo by Kenya Railways				
Output (MT)	2,228,684	2,165,172	1,995,059	1,709,225
Output Growth %	-4.35%	-2.85%	-7.86%	-10.27%
Throughput by Kenya Pipeline				
Output ('000 litres Equivalent)	2,721,212	2,819,998	3,093,366	3,459,298
Output Growth %	-5.87%	3.63%	9.69%	11.83%
Excise duty on Airtime				
Output (KSHS Million)		677.00	2,068.00	2,987.00
Growth %			205.47%	44.44%

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

The reform of the public transport sector attracted new investors as reflected in increased registration of new motor vehicles by 18.9% in the first half of 2005 to 21,427 units from 18,026 units the first half of 2004. The robust growth was particularly noted in commercial vehicles, particularly wheeled tractors, minibuses, buses and motorcycles.

In air transport, remarkable growth was achieved in the financial year with passengers passing through the Jomo Kenyatta International Airport (JKIA) increasing by 18.9% in the fiscal year 2004/05. The improved growth in air transport was largely supported by the robust growth in the tourism sector over the period.

Pipeline and cargo handling activities also improved during the financial year. Petroleum products transported by the Kenya

Pipeline Company (KPC) increased by 11.8% to 3,459,298 cubic units from 3,093,366 cubic units during the fiscal year 2003/04, while cargo handled by the Kenya Ports Authority (KPA) increased by 6.2% to 13,283,984 tonnes compared with 12,505,385 tonnes in the 2003/04 fiscal year.

Cargo handled by the Kenya Railways, however, declined by 10.3% in the fiscal year 2004/05 to 1,790,225 tonnes from 1,995,059 tonnes in the previous fiscal year. The poor performance in rail transport despite its importance in transporting bulky cargo reflects inefficiency in the services that lead to a shift of business to road and pipeline modes of transport.

The telecommunications sector displayed mixed performance in the fiscal year 2004/2005 with the mobile phone sub-sector achieving significant growth to become one of the fastest growing sub-sectors in the economy, while the fixed line sub-sector slowed down.

The phenomenal growth in mobile telephone is reflected in the large new support businesses, including increased public mobile pay phones, increased subscribers and the expanded area covered by the services. As a result, total excise duty on airtime rose by 44.4% to Ksh 2.99 billion in the fiscal year 2004/05 from Ksh 2.07 billion in the fiscal year 2003/04.

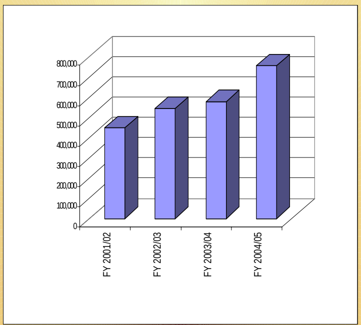
Poor performance has, however, persisted in the fixed lines telephone sub-sector, with connections declining by 16.8 percent from 328,000 in 2003 to 273,000 in 2004. The decline partly reflects inefficiency of Telkom Kenya in the provision of fixed line services, and partly due to the availability of inexpensive alternatives offered by the mobile telephone service providers. Investment in fixed line telephone operations is, however, expected to increase with the planned licensing of a second operator.

The e-Government project is expected to be implemented during the fiscal year 2005/2006 to improve service delivery and hence promote accountability. This will enable the public to access Government services and information efficiently through the use of the internet and other channels of communication.

TOURISM

Tourism achieved an impressive performance during fiscal year 2004/05 as shown in Table 5. Arrivals through Jomo Kenyatta International Airport, Moi International Airport Mombasa and by cruise ships increased by 20.6%, 34% and 170.8% respectively. During the period, earnings from Tourism are estimated at US$ 498 million up from US$ 404 million in the fiscal year 2003/04, making it Kenya's leading foreign exchange earner.

CHART 4 : TOURIST ARRIVALS



Source: Kenya Tourist Board

TABLE 5: TOURIST ARRIVALS BY REGION

	FY 2002/2003	FY 2003/2004	FY 2004/2005
Cruise ships	4,741.00	2,063.00	5,586.00
Growth %		-56.49%	170.77%
JKIA	189,258.00	161,315.00	194,572.00
Growth %		-14.76%	20.62%
MIAM	349,635.00	413,073.00	553,437.00
Growth %		18.14%	33.98%
TOTAL	543,634.00	576,451.00	753,595.00
Growth %		6.00%	30.73%

Source: Kenya Tourist Board

The robust growth was attributed to stepped up marketing efforts, particularly in non-traditional markets such as China, Japan, India and locally. Diversification away from traditional beach and wildlife tourism to new circuits in the western and northern Kenya also contributed to the growth in the sector. Increased capacity by international carriers, notably British Airways, KLM, Kenya Airways and Emirates in and out of Kenya's international airports, also contributed to the increase in tourist arrivals.

Looking ahead, with increased promotion of domestic and conference tourism and improved security , particularly in the airports and areas visited by tourists, tourism is expected to pick up further and remain among the fastest growing sectors in the economy during the coming year and into the medium term.

USES OF AVAILABLE RESOURCES

Resources available for the economy measured as gross national disposable income in 2004 were made up of output produced by all sectors, net imports, net current transfers and net-factor incomes, and amounted to 103.3% of GDP at current prices compared with 104.8% of GDP in 2003 (Table 6). The decline largely resulted from a drop in net current transfers to 4.0% of GDP from 5.4% of GDP in 2003, and higher net factor payments as total output by all sectors grew by 4.3% compared with 2.8% growth in 2003.

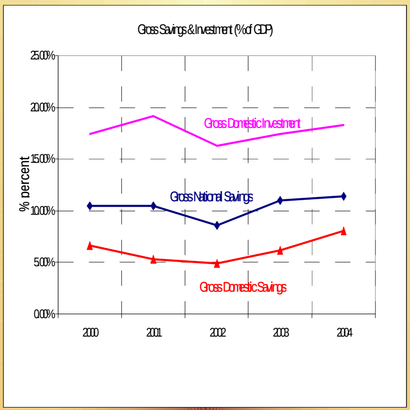
TABLE 6: USE OF RESOURCES (KSH MILLION)

Millions of Kenya Shillings	2000	2001	2002	2003	2004
Gross national disposable income	1,004,503	1,079,369	1,077,143	1,197,069	1,316,026
Net current transfers	47,860	62,975	49,629	61,985	51,367
Gross national income	**956,643**	**1,016,394**	**1,027,514**	**1,135,084**	**1,264,659**
Net factor income payments (Y(f))	-11,195	-9,524.00	-11,250	-6,696	-9,057
Gross domestic product (at market prices)	**967,838**	**1,025,918**	**1,038,764**	**1,141,780**	**1,273,716**
Total Consumption (C)	**903,428**	**971,805**	**988,216**	**1,071,484**	**1,171,212**
Government consumption - C (g)	145,701	159,536	173,297	202,937	216,563
Private consumption - C (p)	757,727	812,269	814,919	868,547	954,649
Gross domestic investment (I)	**168,540**	**196,782**	**169,377**	**198,767**	**232,844**
Gross fixed capital formation	161,714	185,186	177,781	179,248	208,248
Increase/Decrease in stocks	6,826	11,596	-8,404	19,519	24,596
Exports of goods and nfs (X)	**214,831**	**228,054**	**252,207**	**281,394**	**357,243**
Imports of goods and nfs (M)	**-292,493**	**-345,899**	**-326,340**	**-360,960**	**-473,982**
GDP deflator (2001=100)	98.5	100.0	100.9	107.9	115.3
Real GDP	982,855	1,025,918	1,029,978	1,058,470	1,104,356
Real GDP growth (annual in %)	**0.60%**	**4.38%**	**0.40%**	**2.77%**	**4.34%**
Gross National savings	101,075	107,564	88,927	125,585	144,814
Gross Domestic Savings	64,410	54,113	50,548	70,296	102,504
Total National Balance (S-I)	**-67,465**	**-89,218**	**-80,450**	**-73,182**	**-88,030**
CAB (X-M+Y(f)+TR(f))	**-40,997**	**-64,394**	**-35,754**	**-24,277**	**-74,429**
Discrepancy	**-26,468**	**-24,824**	**-44,696**	**-48,905**	**-13,601**
CAB + DISCREPANCY	**-67,465**	**-89,218**	**-80,450**	**-73,182**	**-88,030**
Kenya - National Accounts					
In shares of GDP	**2000**	**2001**	**2002**	**2003**	**2004**
Gross national disposable income	103.79%	105.21%	103.69%	104.84%	103.32%
Net current transfers (TR(f))	4.95%	6.14%	4.78%	5.43%	4.03%
Gross national income	98.84%	99.07%	98.92%	99.41%	99.29%
Net factor income payments (Y(f))	-1.16%	-0.93%	-1.08%	-0.59%	-0.71%
Gross domestic product (GDP)					
Gross Domestic Product (expend)					
Total Consumption ©	93.34%	94.73%	95.13%	93.84%	91.95%
Government consumption - C (g)	15.05%	15.55%	16.68%	17.77%	17.00%
Private consumption - C (p)	78.29%	79.17%	78.45%	76.07%	74.95%
Gross domestic investment (I)	17.41%	19.18%	16.31%	17.41%	18.28%
Gross fixed capital formation	16.71%	18.05%	17.11%	15.70%	16.35%
Increase/Decrease in stocks	0.71%	1.13%	-0.81%	1.71%	1.93%
Exports of goods and services (X)	22.20%	22.23%	24.28%	24.65%	28.05%
Imports of Goods and services (M)	-30.22%	-33.72%	-31.42%	-31.61%	-37.21%
Gross National savings	10.44%	10.48%	8.56%	11.00%	11.37%
Gross Domestic Savings	6.66%	5.27%	4.87%	6.16%	8.05%

Source: Economic Survey, 2005

The resources were allocated to consumption, investment and savings. In real terms, gross fixed capital formation increased by 8.1% in 2004 having declined by 6.4% and 7.5% in 2002 and 2003, respectively.

CHART 5: SAVINGS AND INVESTMENT (% OF GDP)

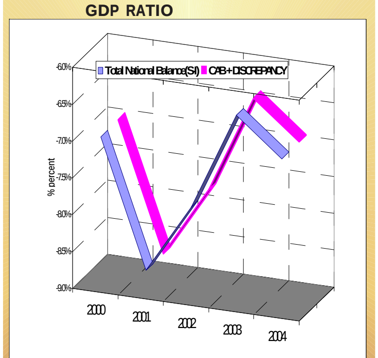


Source: Economic Survey, 2004

Gross domestic investment increased to 18.3% of GDP in 2004 from 17.4% of GDP in 2003. The increase in the projection of gross investment was both in gross fixed capital formation and changes in stocks, which increased to 16.4% and 1.9% of GDP respectively from 15.7% and 1.7% of GDP in 2003.

Like investment, gross national savings, defined as gross national disposable income less total consumption, increased to 11.4% of GDP in 2004 from 11.0% in 2003, while gross domestic savings, that is, gross domestic product less domestic consumption, increased to 8.1% of GDP from 6.2%.

CHART 6: CAB/TOTAL NATIONAL BALANCE GDP RATIO



Source: Central Bank of Kenya

The decline in availability of resources in 2004 relative to 2003 led to a slowdown in aggregate demand reflected in the fall in total consumption to 92.0% of GDP from 93.8% of GDP in 2003, and was both in government and private consumption. The latter accounted for 17.0% of GDP, down from 17.2% of GDP in 2003. A greater share of resources was utilised for private sector consumption relative to consumption by the government, which accounted for 75.0% of GDP, down from 76.1% of GDP in 2003.

The slowdown in government consumption largely reflected the slower than expected disbursement of external resources and reduction in government borrowing from the domestic money market.

Net Official Financing of Developing Countries

As shown in Table 7, net official development assistance to developing countries is estimated to have risen to US$ 33 billion in 2004, up from US$ 29 billion in 2003. This was mainly as a result of increased grants which more than offset the decline in net official lending. The increase in grants reflected donor efforts to increase development assistance as more resources are needed to support efforts to meet Millennium Development Goals (MDGs).

TABLE 7: NET OFFICIAL DEVELOPMENT ASSISTANCE TO DEVELOPING COUNTRIES

	US $ billions								
	1990	1997	1998	1999	2000	2001	2002	2003	2004*
Total	**54.1**	**35.1**	**47.0**	**44.6**	**33.6**	**35.4**	**23.4**	**29.1**	**32.8**
Grants	27.7	25.3	26.7	28.5	28.7	27.9	32.2	43.4	47.2
Net Lending	26.4	9.8	20.3	16.1	4.9	7.5	-8.8	-14.3	-14.4
Multilateral[b]	15.4	16.4	23.4	18.3	11.8	15.3	1.4	1.8	-1.2
Concessional	5.9	7.4	7.0	6.8	5.6	7.0	7.4	8.0	7.4
Nonconcessional	9.5	9.0	16.4	11.5	6.2	8.4	-6.0	-6.3	-8.6
Bilateral	11.0	-6.6	-3.1	-2.2	-6.9	-7.8	-10.2	-16.0	-13.2
Concessional	8.5	0.2	2.0	5.0	0.6	1.6	-1.7	-3.8	-3.6
Nonconcessional	2.4	-6.9	-5.2	-7.2	-7.5	-9.4	-8.6	-12.3	-9.6

* Estimate
b includes IMF

Sources: Global Development Finance (2005) & Central Bank of Kenya

Net bilateral lending remained negative, as donors continued to reduce their lending in favour of grants and as some developing countries made further repayments of earlier debt obligations to the Paris Club. Net lending to developing countries fell from negative US$ 14.3 billion in 2003 to negative US$ 14.4 billion in 2004, largely due to repayments of outstanding IBRD loans and a reduction in net lending by International Monetary Fund (IMF). This situation is mainly the result of net repayments to the IMF of loans disbursed as emergency financing during the international financial crisis in the late 1990s, and unscheduled repayments of multilateral and bilateral loans by some developing countries. The repayments have been made possible by the steady rise in developing countries' reserves in recent years and the decline in interest rates on loans.

Net Debt Flows to Developing Countries

Private sector debt and portfolio flows to developing countries increased from US$ 60 billion in 2003 to US$ 83.6 billion in 2004 (Table 8). This was mainly on account of increased net debt and portfolio inflows to East Asia and Pacific from US$ 1.7 billion in 2003 to US$ 17.2 billion in 2004. Increases were also in South Asia and Middle East and North Africa regions. However, flows to Europe and Central Asia decreased to US$ 56 billion from US$ 56.9 billion in the previous year. Similarly, net inflows to Latin America and Caribbean declined from US$ 3.3 billion to US$ 2.5 billion.

TABLE 8: PRIVATE SECTOR DEBT & PORTFOLIO FLOW TO DEVELOPING COUNTRIES: 1999-2004 (US DOLLAR BILLION)

	(US$ Billion)					
Year	**1999**	**2000**	**2001**	**2002**	**2003**	**2004***
East Asia & Pacific	-12.2	-16.2	-9.1	-13.2	1.7	17.2
Europe & Central Asia	16.1	19.9	2.7	28.0	56.9	56.0
Latin America & Caribbean	12.1	-8.6	5.4	-8.6	3.3	2.5
South Asia	0.5	3.5	-0.9	0.4	-4.0	4.4
Middle East & North Africa	-1.8	-4.5	0.1	2.1	-0.7	-0.1
Sub-Saharan Africa	**-1.0**	**-0.5**	**-1.7**	**-0.3**	**2.7**	**3.6**
Kenya	***0.2***	***0.1***	***-0.4***	***0.1***	***0.2***	***0.1***
Total Net Flows	**13.7**	**-6.5**	**-3.5**	**8.5**	**60.0**	**83.6**

* Estimate

Sources: Global Development Finance (2005) & Economic Survey 2005

Net inflows to Sub-Saharan Africa increased from US$ 2.7 billion in 2003 to US$ 3.6 billion in 2004, with net inflows to Kenya decreasing from a net inflow of US$ 0.2 billion in 2003 to a net inflow of US$ 0.14 billion in 2004.

Net Foreign Direct Investment (FDI) Flows to Developing Countries

Net Foreign Direct Investment (FDI) to developing countries increased to US$ 165.5 billion in 2004 from US$ 151.8 billion in 2003 (Table 9). This is attributed mainly to improvement in economic conditions in developing countries during the year, which was reflected in, among other factors, higher corporate earnings, liberalization of foreign ownership rules, and a stronger global recovery.

Increase in net FDI inflows was spread across the entire developing world. East Asia and Pacific countries had the highest share of net FDI inflows, increasing from US$ 59.6 billion in 2003 to US$ 63.6 billion in 2004, which represented 38.4 percent of total net FDI inflows to developing countries during 2004. Similarly, net FDI inflows to sub-Saharan Africa increased by 12 percent to US$ 11.3 billion in 2004 from US$ 10.1 billion in 2003. This raised Sub-Sahara's share of net FDI inflows, from 6.65% in 2003 to 6.83% in 2004. Net FDI inflows to Kenya declined to US$ 0.04 billion in 2004 from US$ 0.08 billion in 2003.

TABLE 9: NET FDI INFLOWS TO DEVELOPING COUNTRIES: 1999-2004

(US$ Billion)

Year	1999	2000	2001	2002	2003	2004*
East Asia & Pacific	50.00	44.20	48.20	55.60	59.60	63.60
Europe & Central Asia	28.40	29.20	31.40	35.00	35.60	37.60
Latin America & the Caribbean	88.20	78.90	70.20	45.70	36.50	42.40
South Asia	3.10	3.30	4.40	4.80	5.20	6.50
Middle East & North Africa	3.70	4.30	5.70	3.80	4.80	4.10
Sub-Saharan Africa	***9.10***	***6.30***	***14.90***	***9.00***	***10.10***	***11.30***
Kenya*	***0.01***	***0.11***	***0.01***	***0.03***	***0.08***	***0.04***
Total	**182.40**	**166.20**	**174.80**	**154.00**	**151.80**	**165.50**

* Estimate

Sources: Global Development Finance (2005) & Economic Survey 2005

Net Portfolio (Equity) Flows to Developing Countries

Table 10 shows that net Portfolio equity flows to developing countries increased from US$ 24.81 billion in 2003 to US$ 26.75 billion in 2004. This is attributed mainly to large swings in the emerging market equity prices. Regions that had high increases in net portfolio equity inflows are East Asia and Pacific, Europe and Central Asia, South Asia and Sub-Saharan Africa regions. Net portfolio equity inflows to Sub-Saharan Africa increased from US$ 0.7 billion in 2003 to US$ 3.5 billion in 2004. This raised Sub-Sahara's share of net portfolio investment from 2.8% in 2003 to 13.2% in 2004. Portfolio investment inflows to Kenya, however, declined in 2004 to a net outflow of US$ 0.07 billion despite increased flows to the Sub-Saharan region.

TABLE 10:PORTFOLIO INFLOWS TO DEVELOPING COUNTRIES: 1999-2004 (US$ BILLION)

Year	1999	2000	2001	2002	2003	2004*
East Asia & Pacific	2.32	4.77	1.35	4.01	11.85	13.55
Europe & Central Asia	1.96	1.26	0.45	-0.10	0.59	3.59
Latin America	-3.62	-0.57	2.51	1.44	3.38	-1.54
South Asia	2.38	2.51	2.78	1.09	8.20	7.47
Middle East & North Africa	0.64	0.24	-0.12	-0.23	0.10	0.16
Sub-Saharan Africa	**9.03**	**4.16**	**-0.95**	**-0.37**	**0.70**	**3.52**
Kenya	**-0.01**	**-0.01**	**0.00**	**0.00**	**0.00**	**-0.07**
Total net Flows	**12.71**	**12.38**	**6.02**	**5.85**	**24.81**	**26.75**

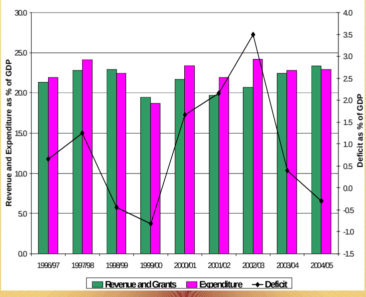
* Estimate

Source: Global Development Finance (2005) & Economic Survey 2005

FINANCING OF THE GOVERNMENT

The Government budget registered a surplus, both on commitment and cash basis in the fiscal year 2004/05, after progressively declining deficits in the previous financial years. As shown in Table 10 and Chart 7, the budget deficit on a commitment basis decreased from 3.5% of GDP in fiscal year 2002/03 to 0.4% of GDP in the fiscal year 2003/04, and then improved further to a 0.3% budget surplus of in the fiscal year 2004/2005. Similarly, on a cash basis, the fiscal operations resulted in a budget surplus of 0.1% of GDP, compared with budget deficits of 0.3% of GDP in the fiscal year 2003/04 and 3.3% in fiscal year 2002/03.

CHART 7: GOVERNMENT BUDGET PERFORMANCE



Sources: Central Bank of Kenya and Treasury

TABLE 10: BUDGET OUTTURN (KSH BN)

	FY 2002/2003 Actual	FY 2003/2004 Actual	FY 2004/2005 Actual*	FY 2004/2005 Target	Over(+)/ Below (-)
1. TOTAL REVENUE & GRANTS	**225.7**	**270.9**	**300.5**	**298.6**	**1.9**
Revenue	210.8	255.1	283.7	277.8	5.9
Tax Revenue	177.0	205.5	242.9	230.8	12.1
Non Tax Revenue	13.6	24.9	27.9	25.3	2.7
Appropriations-in-Aid	20.2	24.6	12.9	21.8	-8.9
External Grants	15.0	15.8	16.8	20.8	-4.0
2. TOTAL EXPENDITURE AND NET LENDING	**264.1**	**275.6**	**296.4**	**331.7**	**-35.3**
Recurrent Expenditure	220.6	239.7	252.2	276.1	-23.9
Development Expenditure	43.5	35.9	44.2	55.6	-11.4
3. DEFICIT ON A COMMITMENT BASIS (1-2)	**-38.4**	**-4.7**	**4.2**	**-33.1**	
Deficit on a commitment basis as % of GDP	-3.5	-0.4	0.3	-2.6	
4. ADJUSTMENT TO CASH BASIS	**2.7**	**1.5**	**-2.8**	**-0.3**	
5. DEFICIT ON A CASH BASIS	**-35.7**	**-3.2**	**1.3**	**-33.4**	
Deficit on a cash basis as % of GDP	-3.3	-0.3	0.1	-2.6	
6. DISCREPANCY: Expenditure (+) / Revenue (-)	**-1.0**	**-3.3**	**-5.8**	**0.0**	
7. FINANCING	**34.8**	**-0.1**	**-7.1**	**33.4**	
Domestic (Net)	46.9	8.8	-6.7	32.0	-38.7
External (Net)	-12.1	-8.9	-0.5	1.2	-1.7
Capital Receipts (privatisation)	0.0	0.0	0.0	0.2	-0.2
Financing gap	0.0	0.0	0.0	0.0	0.0

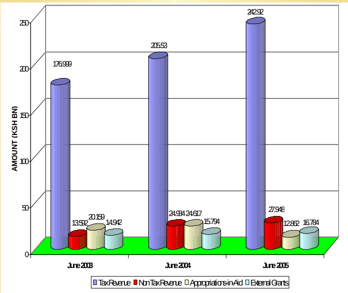
* Provisional

Source: Treasury

The good performance in the fiscal year 2004/05 followed improved tax administration which resulted in higher tax revenue. Restrained Government spending also contributed to the budget surplus in the review period. The improvement in budgetary performance was achieved despite the implementation of free primary education, increased healthcare budget, and higher salaries for teachers and mainstream civil servants, all of which increased Government expenditure commitments. This development therefore, marks a trend towards fiscal sustainability and a fulfillment of the pledge in the budget speech of June 2004 to the effect that the Government would improve targeting, prioritisation and more efficient use of public expenditure. The good performance is also significant in that it was achieved at a time when the Government also implemented the budget structure of the East African Community Common External Tariff (CET). The CET took effect on January 1, 2005 and the Government adopted most of its principles at the beginning of the fiscal year 2004/05. This included lowering of the top customs tariff rate from 35% to 25%, which had a direct impact on the level of Government revenue.

Revenue and Grants

CHART 8: COMPOSITION OF REVENUE



Sources: Central Bank of Kenya and Treasury

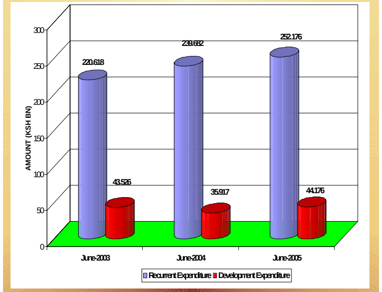
Along with increased tax revenue, external grants from our development partners also went up mainly due to the resumption of IMF funding. Total Government revenue and grants increased to Ksh 300.5 billion in the year from Ksh 270.9 billion in the fiscal year 2003/04 (Chart 8). Tax revenue, which rose by 18.2% or Ksh 37.4 billion, contributed most to the increase, followed by non-tax revenue which went up by Ksh 3 billion, and external grants, which increased by Ksh 1 billion. The Tax Amnesty extended by the KRA to defaulters of previous years also resulted in a Ksh 4 billion additional tax revenue. Appropriations -in-aid (AIA), otherwise known as user fees and charges, however, declined by ksh 11.8 billion.

The share of tax revenue increased to 80.8% of total receipts in the fiscal year 2004/05 from 75.9% in the fiscal year 2003/04. During the year, tax revenue collection was Ksh 12.1 billion above the budget target while non-tax revenue was Ksh 2.7 billion above the budget target. Appropriations-in-Aid (AIA) and external grants did not meet the expected targets. While external grants registered a marginal increase from the previous financial year, AIA fell below the previous year's total as the Government relinquished collection of some AIA to newly created institutions, particularly those under the Ministry of Water Resources Management and Development, where responsibility for collection was transferred to the Water Services Boards. The increase in tax and non-tax revenue offset the underperformance of both grants and AIA.

Consequently, the increase in Government receipts at Ksh 29.6 billion exceeded the increase in Government expenditure.

Expenditure and Net Lending

CHART 9: COMPOSITION OF EXPENDITURE



Sources: Central Bank of Kenya and Treasury

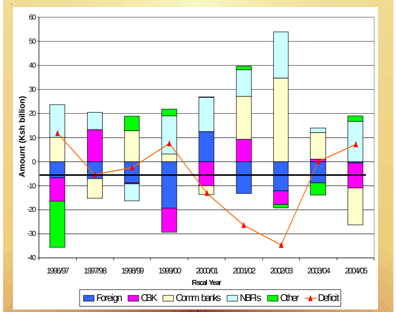
During the fiscal year 2004/05, Government expenditure and net lending increased to Ksh 296.4 billion from Ksh 275.6 billion in the previous fiscal year (Chart 9). The increase was primarily due to a rise in recurrent expenditure by Ksh 12.5 billion, and a Ksh 8.3 billion increase in development expenditure compared with the levels recorded in the fiscal year 2003/2004. The increase in recurrent expenditure was due to a rise in salaries and wages following adjustment of emoluments for various cadres of central Government employees. The increase in development expenditure reflects an increase in development projects being undertaken by the Government, including rehabilitation of infrastructure.

Consistent with the Government policy of progressively increasing the proportion of development expenditure in the budget, the share of recurrent expenditure in total expenditure reduced to 85.1% in fiscal year 2004/05 compared with 87.0% in fiscal year 2003/04, while development expenditure accounted for 14.9% of total expenditure in the fiscal year 2004/05, up from 13.0% in the fiscal year 2003/04. Overall, the total Government expenditure amounted to 22.9% of GDP in the fiscal year 2004/05 compared with 22.8% of GDP in the fiscal year 2003/04.

Financing

Government operations in the fiscal year 2004/05 resulted in Ksh 26.2 billion financing requirement, up from Ksh 16.7 billion in fiscal year 2003/04. Financing requirement in fiscal year 2004/05 comprised Ksh 0.5 billion to finance net repayments of external debt, Ksh 6.1 billion to increase Government deposits at the Central Bank, Ksh 4.3 billion to repay domestic debt owed to the Central Bank and Ksh 15.3 billion to repay domestic debt owed to commercial banks. To raise the Ksh 26.2 billion financing requirement, the Government borrowed Ksh 15.33 billion from commercial banks by issuing Treasury bonds and bills, and also utilised the budget surplus. The Ksh 0.2 billion targeted privatisation proceeds in the fiscal year 2004/05 was not realised. There were no privatisation transactions during the year because the Privatisation Bill that was pending in the National Assembly was not enacted.

CHART 9b: BUDGET DEFICIT AND SOURCES OF FINANCING



Sources: Central Bank of Kenya and Treasury

The Government generally financed the budget deficit through domestic borrowing since the fiscal year 1996/97 (Chart 9b). The main sources of financing over the period were borrowings in the form of Government securities from commercial banks, non-bank financial institutions and individual investors. However, in the fiscal year 2004/05, the Government had a budget surplus which resulted in a net repayment to commercial banks. The chart also shows that the Government made net foreign repayment from fiscal year 1996/97 to fiscal year 2004/05 with the exception of fiscal year 2000/01. The net inflow in the fiscal year 2000/01 is explained by drought related support for the energy sector. In the fiscal year 2004/05, external loan repayments almost equalled loan disbursements resulting in almost zero net external repayments.

Prospects for the Fiscal year 2005/2006

The fiscal year 2005/2006 budget has a revenue target of Ksh 326.1 billion, or 22.8% of GDP. The Kenya Revenue Authority expects to raise the revenue by implementing new revenue measures that include the introduction of Electronic Tax Registers to monitor VAT collections, and rolling out of the new electronic customs clearing system.

During the fiscal year 2005/2006 recurrent and development expenditure targets are Ksh 316.4 billion and Ksh 104.2 billion respectively. The Government expects to receive external project grants amounting to Ksh 27.9 billion. Therefore, the financing of the deficit is expected to comprise borrowing of Ksh 23.4 billion and Ksh 25.3 billion from external and domestic sources respectively, as well as utilisation of Ksh 8 billion privatisation proceeds.

Kenya's overall public and publicly guaranteed debt stood at Ksh 745.0 billion at the end of June 2005 compared with Ksh 749.4 billion in June 2004 (Table 11). As a percentage of GDP it decreased to 62.9% in June 2004 from 63.9% in June 2003, and further to 57.6% in June 2005. The decline in debt to GDP ratio was a result of a decline in the debt stock, coupled with a proportionately higher increase in GDP.

TABLE 11: PUBLIC DEBT (KSH BN)

	June 2003		June 2004		June 2005*	
	shs bn	%	shs bn	%	shs bn	%
DOMESTIC DEBT						
Securitised debt	**268.4**	**92.7**	**289.6**	**94.6**	**302.3**	**95.8**
Treasury Bills	105.7	36.5	99.8	32.6	107.8	34.2
of which repo t.bills	27.0	9.3	36.9	12.0	35.9	11.4
Treasury Bonds	161.5	55.8	188.6	61.6	193.4	61.3
Government Stocks	1.1	0.4	1.1	0.4	1.1	0.3
Non Securitised debt	**21.0**	**7.3**	**16.7**	**5.4**	**13.3**	**4.2**
Overdraft/Advances	11.1	3.8	16.7	5.4	13.3	4.2
Non-interest bearing debt	9.9	3.4	0.0	0.0	0.0	0.0
TOTAL DOMESTIC DEBT	**289.4**	**100.0**	**306.2**	**100.0**	**315.6**	**100.0**
(as a % of Total Debt	41.6		40.9		42.4	
EXTERNAL DEBT**						
Bilateral	142.6	35.0	162.9	36.8	155.3	36.2
Multilateral	233.8	57.4	260.7	58.8	253.2	59.0
Comm. Banks	3.6	0.9	2.9	0.7	3.2	0.7
Export Credit	27.0	6.6	16.7	3.8	17.7	4.1
TOTAL EXTERNAL DEBT	**407.1**	**100.0**	**443.2**	**100.0**	**429.4**	**100.0**
(as a % of Total Debt	58.4		59.1		57.6	
TOTAL PUBLIC DEBT	**696.5**		**749.4**		**745.0**	
(as a % of GDP)	63.9		62.0		57.6	

* Provisional

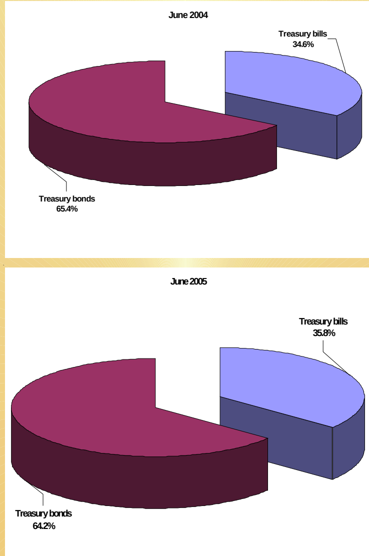
** External debt stock Revised for June 2003 and June 2004

Sources: Central Bank of Kenya and Treasury

Public Domestic Debt

Government securities performed well in the second half of the fiscal year 2004/2005, resulting in an increase in domestic debt which went up to Ksh 315.6 billion in June 2005 from Ksh 306.2 billion in June 2004, and from Ksh 289.4 billion in June 2003. However, as a percent of GDP, it decreased to 25.4% in June 2004 from 26.5% in June 2003 and further to 24.4% in June 2005. The largest component of domestic debt was Treasury bonds, which is consistent with the Government strategy of restructuring domestic debt away from short-dated Treasury bills to longer-term Treasury bonds. Treasury bills comprised 35.8% of Government securities while Treasury bonds comprised 64.2% as at June 2005 (Chart 10).

CHART 10: COMPOSITION OF GOVERNMENT SECURITIES



Sources: Central Bank of Kenya and Treasury

Due to a substantial increase in the stock of Treasury bills, during the last fiscal year, there was a drop in the average maturity from 2 years and 2 months in June 2004 to 1 year and 10 months in June 2005. The stock of Treasury bills (including Repos) increased from Ksh 99.8 billion in June 2004 to Ksh 107.8 billion in June 2005, while the stock of Treasury bonds increased from Ksh 188.6 billion to Ksh 193.4 billion in the same period.

Investor preference for shorter-dated Treasury bonds also contributed to the shorter average maturity of Government securities. Treasury bonds of 1 and 2 year tenor increased from Ksh 37.6 billion, or 19.2% of the Treasury bonds in June 2004 to Ksh 55.6 billion, or 28.8% in June 2005. This implied a decline in the stock of Treasury bonds with tenors of 3 years and above from Ksh 151 billion or 80.8% of total bonds in June 2004 to Ksh 137.7 billion or 71.2% of all bonds in June 2005. The share of Treasury bonds of 5 years tenor and above in the outstanding bonds, however, increased to 43.3% at the end of June 2005 from 42.3% at the end of June 2004. On the other hand, the share of 10-year bonds decreased from 4.6% of the outstanding bonds in June 2004 to 4.5% in June 2005.

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

Holders		Jun-03		Jun-04		Jun-05	
		Ksh	%	Ksh	%	Ksh	%
Banking Institutions		63.2	59.8	79.0	79.1	68.7	63.7
	Central Bank	27.0	25.5	36.9	37.0	35.9	33.3
	Comm. Banks	35.2	33.3	41.0	41.1	31.9	29.5
	NBFIs	1.0	0.9	1.1	1.1	0.9	0.8
Insurance Companies		5.9	5.5	4.9	4.9	7.7	7.1
Parastatals		6.2	5.8	4.9	4.9	6.9	6.4
of which NSSF		1.8	1.7	0.9	0.9	0.1	0.1
Building Societies		0.2	0.2	0.0	0.0	0.2	0.2
Others		30.2	28.6	11.0	11.1	24.4	22.6
Total		105.7	100	99.8	100.0	107.8	100.0

Source: Central Bank of Kenya

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

Holders		Jun-03 Ksh	%	Jun-04 Ksh	%	Jun-05 Ksh	%
Banking Institutions		79.1	48.9	89.0	47.2	86.5	44.7
	Central Bank	0.0	0.0	0.0	0.0	0.0	0.0
	Comm. Banks	77.0	47.6	86.9	46.1	84.4	43.6
	NBFIs	2.1	1.3	2.1	1.1	2.1	1.1
Insurance Companies		20.6	12.8	26.6	14.1	26.1	13.5
Parastatals		7.2	4.5	15.9	8.4	16.6	8.6
of which NSSF		0.8	0.5	2.8	1.5	2.8	1.4
Building Societies		1.9	1.2	2.5	1.3	2.7	1.4
Others		52.8	32.7	54.5	28.9	61.5	31.8
Total		161.5	100.0	188.6	100.0	193.4	100.0

Source: Central Bank of Kenya

Domestic Debt Service

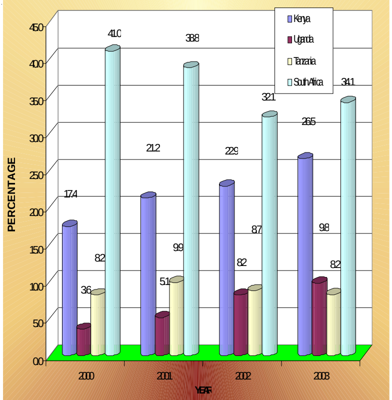
Due to less than expected domestic borrowing during the fiscal year 2004/05, interest payments on domestic debt amounted to Ksh 22.3 billion or 7.9% of revenue compared with Ksh 23.3 billion or 9.1% of revenue in the fiscal year 2003/04. The less than targeted domestic borrowing in the fiscal year 2004/2005 was occasioned partly by poor performance of Treasury bill auctions in the second quarter of fiscal year 2004/2005, and partly due to increased Government revenue which necessitated less borrowing.

Kenya's Domestic Debt in a Comparative Perspective

Comparative data on domestic debt to GDP ratio (Chart 11) indicates that Kenya has the highest domestic debt as a proportion of GDP among the East African countries. However, Kenya has a lower debt to GDP ratio than South Africa. At the end of 2002, Kenya's public domestic debt amounted to 22.9% of GDP compared with 32.2%, 8.7% and 8.2% for South Africa, Tanzania and Uganda respectively. By the end of 2003, Kenya's domestic debt had risen to 26.5% of GDP while that of South Africa edged to 34.1% of GDP. The same trend was exhibited by stock of domestic debt in Uganda, which rose to 9.8% of GDP. However, Tanzania's domestic debt declined to 8.2% of GDP.

Public and Publicly Guaranteed External Debt

CHART 11: COMPARATIVE DEBT TO GDP RATIO



Sources: Central Bank of Kenya and KIPPRA

External debt decreased to Ksh 429.4 billion in June 2005 from Ksh 443.2 billion in June 2004 (Table 14). The decrease resulted from Ksh 7.63 billion repayments and a revaluation gain of Ksh 19.12 billion, which more than offset the Ksh 12.99 billion disbursements. The disbursements comprised Ksh 7.04 billion project loans and Ksh 5.95 billion received from the IMF in January 2005. Of the outstanding stock at the end of June 2005, 59.0% was debt owed to multilateral creditors while 36.2% was debt owed to bilateral creditors as shown in Table 14 and Chart 11.

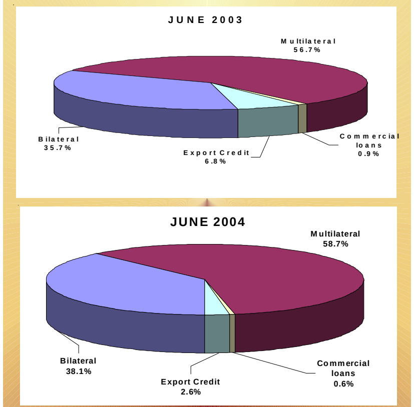
TABLE 14: DISTRIBUTION OF EXTERNAL PUBLIC DEBT

	Jun-01	%	Jun-02	%	Jun-03	%	Jun-04	%	Jun-05*	%
Bilateral	132.3	33.6	130.0	34.4	142.6	35.0	162.9	36.8	155.3	36.2
Multilateral	228.5	58.0	222.5	58.9	233.8	57.4	260.7	58.8	253.2	59.0
Commercial loans	29.4	7.5	24.0	6.4	3.6	0.9	2.9	0.7	3.2	0.7
Export Credit	3.8	1.0	1.3	0.3	27.0	6.6	16.7	3.8	17.7	4.1
Total	393.97	100.0	377.7	100.0	407.1	100.0	443.2	100.0	429.4	100.0

* Provisional

Sources: Central Bank of Kenya and Treasury

CHART 12A: EXTERNAL PUBLIC DEBT



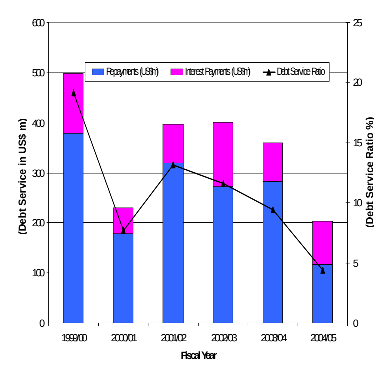
Sources: Central Bank of Kenya and Treasury

The proportion of external debt held in US dollars decreased from 55.9% in June 2004 to 55.3% in June 2005, and that held in Yen also decreased from 19.3% to 19.0% of total debt. Similarly, the share of external debt held in Euros and Sterling pounds also decreased from 12.6% and 0.7% to 12.2% and 0.6%, respectively. On the other hand, external debt held in SDRs increased from 1.9% to 2.9%, following the disbursement of an equivalent of Ksh 5.95 billion in January 2005.

External Debt Service

Government external debt service in the fiscal year 2004/05 totalled Ksh 15.9 billion compared with Ksh 27.7 billion in the previous fiscal year. The reduction in the external debt service payments was the result of rescheduling of both principal and interest on Paris Club external debt which started in January

CHART 12B: EXTERNAL DEBT SERVICE AND DEBT SERVICE RATIO



Sources: Central Bank of Kenya and Treasury

2004. A total of Ksh 26.0 billion is expected to be re-scheduled between January 2004 and December 2006. The external debt service absorbed 5.6% of total revenue compared with 10.9% in the previous fiscal year. As shown in Chart 12B, the external debt service ratio has also declined substantially. This is because the value of exports has been increasing while the debt service is declining. The external debt principal repayments comprised Ksh 7.5 billion in central Government debt, Ksh 0.9 billion in Government guaranteed debt and Ksh 0.9 billion repayments to International Monetary Fund. In addition, the Government paid interest of Ksh 6.5 billion on central Government debt and Ksh 0.1 billion on debt with the International Monetary Fund.

Prospects for Fiscal Year 2005/2006

The Government has planned to borrow Ksh 25.3 billion from the domestic market in the fiscal year 2005/2006. This is expected to increase the stock of domestic debt by a similar margin during the fiscal year 2005/2006.

The Government expects to receive Ksh 29.0 billion in project loans and Ksh 9.6 billion in programme loans during the fiscal year 2005/2006. On the other hand, the Government expects to make principal payments of Ksh 23.6 billion towards external debt. External debt repayments amounting to Ksh 8.5 billion is expected to be re-scheduled during the fiscal year. The resulting net external borrowing of Ksh 23.4 billion is expected to increase the stock of external debt during the fiscal year.

Overview

The banking sector remained stable during the year to June 2005, mainly due to the favourable macroeconomic environment during the period. Non-performing loans, net of provisions and value of securities, maintained a downward trend leading to improved profitability. Consequently, capital adequacy ratios were sustained at high levels throughout the year. The continued enforcement of prudential and legislative supervisory requirements also supported the stability of the sector. The strengthened balance sheet also enabled the sector to expand credit for economic activities.

Composition of the Banking Sector

Financial institutions in the sector declined to 48 in June 2005 from 51 in June 2004 following liquidation of one bank and one building society, and conversion of one commercial bank into a development finance institution. Of the 48 financial institutions, there were 42 commercial banks, 1 non-bank financial institution, one non-bank financial institution in the process of self-liquidation, 2 mortgage finance companies and 2 building societies. Among the financial institutions referred to above, six were locally incorporated foreign banks and four were branches of foreign owned institutions. There were 532 branches across the country.

The moratorium on licensing of foreign exchange bureaus that had been in place since 1999 was lifted, leading to an increase in their number to 89 in June 2005 from 85 in June 2004. In order to strengthen the supervision of foreign exchange bureaus, the Bank issued revised foreign exchange bureau guidelines. It is worth noting that the new guidelines include a provision for penalty on any foreign exchange bureau which fails to comply with any directions or guidelines issued by the Central Bank.

Structure of the Balance Sheet

Reflecting the improved economic environment, the banking sector expanded its asset portfolio by 11.0% or Ksh 60.2 billion from Ksh 546.7 billion at the end of June 2004 to Ksh 606.9 billion at the end of June 2005. The growth in assets was mainly the result of increases in local and foreign currency deposits, fresh capital injection and retained profits. While loans at 52.4% and Government securities at 20% continued to be a major portion of the banking sector investments, the financial institutions substantially reduced investment in Government securities during the year. Investments in Government securities declined by 7.9% or Ksh 10.4 billion from Ksh 131.3 billion in June 2004 to Ksh 120.9 billion in June 2005.

TABLE 15: BALANCE SHEET

	June 2005	June 2004	% Change
Assets			
Cash	9,612	8,715	10
Balances from CBK	28,356	27,786	2
Placements	17,070	14,859	15
Govt. securities	120,936	131,254	-8
Other Investments	4,517	4,800	-6
Loans & advances (Net)	317,951	218,424	45
Foreign Assets	49,631	44,013	13
Other assets	58,858	96,831	-39
Total Assets	**606,931**	**546,682**	**11**
Deposits	488,004	445,177	9
Foreign Liabilities	3,138	5,180	-39
Other liabilities	42,419	33,901	25
Capital & Reserves	73,370	62,424	18
Total Liabilities and shareholders funds	**606,931**	**546,682**	**11**

Source: Central Bank of Kenya

Non-Performing loans

The stock of non-performing loans (NPLs) decreased to Ksh. 69.5 billion, in June 2005 from Ksh.70.7 bn at the end of June 2004. Consequently, the ratio of total non-performing loans to total loans declined to 19.3% from 23.5% over the same period. The decline is attributable to the repayment of previously non-performing advances and increased new lending. The Ksh. 32.7 billion value of securities together with provisions amounting to Ksh. 38.3 billion at the end of June 2005, were considered adequate to cover the banking system credit exposure.

Deposit Liabilities

Table 16 presents an analysis by type of commercial bank deposits. Banking system deposit liabilities, including interbank balances, rose by 9.6% to Ksh 488.0 billion at the end of June 2005 from Ksh 445.2 billion in June 2004, reflecting an increase in credit to the private sector and external inflows due to improved balance of payments position. Demand deposits accounted for 51% of commercial bank deposits, followed by Time and Savings deposits at 29% and 15% respectively. Local currency deposits expanded by Ksh 28.8 billion from Ksh 377.5 billion in 2004 to Ksh 406.3 billion in 2005, while foreign currency deposits also rose by Ksh 14.0 billion from Ksh 67.7 billion to Ksh 81.7 billion over the same period.

TABLE 16: COMPOSITION OF COMMERCIAL BANK DEPOSITS (KSH M)

Banks	2005 June	2004 June	Share in 2005	% Change
TYPE OF DEPOSIT				
Demand deposits	**247,660**	**208,325**	**51**	**19**
Kenya shillings	190,440	161,949	39	18
Foreign Currency	57,220	46,376	12	23
Time Deposits	**143,780**	**113,105**	**29**	**27**
Kenya shillings	119,780	92,053	25	30
Foreign Currency	24,000	21,052	5	14
Saving Deposits	**73,125**	**85,963**	**15**	**-15**
Kenya shillings	72,639	85,662	15	-15
Foreign Currency	488	301	0	62
Others	23,439	37,784	5	-38
Total	**488,004**	**445177***	**100.0**	**10**

Others: Include accrued interest on deposits, interbank balances and deposits from NBFIs & Building Societies

* Call and 7-days deposits excluded in June 2004 restated

Source: Central Bank of Kenya

Profitability

Supported by favourable economic and financial conditions, profit before tax of the banking system increased by 27.1% or Ksh 1.9 billion to Ksh 9.0 billion in 2005 from Ksh 7.1 billion in 2004. The increase in profits reflected increased interest income on advances which rose by 39.3% or Ksh 5.3 billion to Ksh 18.8 billion in June 2005 from Ksh 13.5 billion in June 2004.

TABLE 17: BANKING INDUSTRY PROFITS (KSh M)

	Jun-05	Jun-04	% Change
Total income	**36,936**	**29,819**	**23.9**
Expenses before provisions	24,551	19,476	26.1
Profit before provisions	12,385	10,343	19.7
Provisions for bad debts	3,386	3,263	3.8
Profit before tax	8,999	7,080	27.1

Source: Central Bank of Kenya

Capital and Reserves

The capital position of the institutions during the year remained strong due to increased profits and additional injection of capital. This enhanced the capacity to absorb losses, expand operations and hence the scope of financial intermediation.

Total capital to total risk weighted assets ratio stood at 16.1% in June 2005 compared with 16.5% in June 2004, well above the 12% statutory minimum. In the twelve months to June 2005, paid up capital in the sector rose by 7.6% or Ksh 3.0 billion, while reserves rose by 37.2% or Ksh 6.4 billion during the year. The combined capital and reserves of the banking system increased by 17.6%, from Ksh 62.4 billion to Ksh 73.4 billion.

Supervisory Enforcement Action

Enforcement of compliance requirements by the Central Bank, particularly through introduction of penalties, resulted in reduced incidences of non-compliance. Consequently, incidences of non-compliance reduced from 15 in June 2004 to 10 in June 2005. Similarly, non-compliant institutions declined from 10 in June 2004 to 5 at the end of June 2005. In addition to the penalties, enforcement actions included withholding of corporate approvals for institutions that did not comply with the requirements of the Banking Act and Prudential Regulations. Some of the institutions that are non-compliant are undergoing restructuring in order to address structural problems associated with non-compliance.

Outlook for the Banking Sector

The Central Bank continues to improve its supervisory role to enhance stability and soundness of the banking system. To this end, the following are some of the measures being instituted:

- Enforcement of compliance with the banking laws and prudential regulations. Penalties will continue to be imposed as a deterrence mechanism.
- Full implementation of the Risk Based Supervision by the end of 2005. This is being done with the technical assistance from IMF-East Afritac. Financial Institutions Supervision department will issue risk management guidelines to the sector during the third quarter of 2005, and implement pilot Risk Based Examinations by end of 2005.
- Introduction of more advanced inspection techniques. Central Bank Supervisors are currently embracing the use of Computer Assisted Audit Techniques-CAATS. Bank examiners use Audit Command Language-ACL to interrogate computer files in the banking institutions and produce exception reports.
- The parallel run of the Banking Supervision Application (BSA) system is expected to be completed by third quarter of 2005. With full implementation of the system, it is expected that data processing and monitoring of work flows will be enhanced.
- Implementation of the remaining Basle I Core Principles for Effective Banking Supervision in order to improve supervisory oversight and ensure compliance with international best practice.
- Strengthening the inspection follow up process to ensure that financial institutions promptly address weaknesses observed during on-site examination.
- Continued publication of bank charges to increase customer awareness of products and services offered and their associated costs with a view to increasing competition in the sector.
- Working closely with other Government agencies in addressing the problem of Non-performing Loans (NPLs) in five public sector institutions, which also constitute the largest proportion of the sector's NPLs.

Introduction

The Economic Recovery Strategy for Wealth and Employment Creation (ERSWEC) sets priorities for the financial sector reforms to facilitate mobilization of financial resources. Within the ERSWEC, it is recognized that improved access can only be realized by fostering alternatives to mainstream banks, that include micro finance institutions (MFIs), savings and credit co-operative societies (SACCOs), the Kenya Post Office Savings Bank (KPOSB) and market led development finance institutions. These institutions operate at a much lower cost than banks, and thus have a proven ability to reach a large segment of un-banked population.

In the face of the ongoing branch rationalision access to financial services of mainstream commercial banks by the low income house holds and by micro and small enterprises (MSEs) in the rural areas has been on the decline over the years. It is estimated that less than 10% of the low income households and MSEs received credit and other financial services from these institutions during the year. However, alternative financial institutions like NGO - microfinance institutions, SACCOs and informal financial organisations continue to deliver a limited range of financial services to the low income house holds and MSEs by employing a variety of appropriate methodologies.

Commercial Banks, Building Societies and Kenya Post Office Savings Bank

During 2005, microfinance services to urban and rural areas were mainly provided by the mainstream institutions, namely, Co-operative Bank, Equity Bank, K-Rep Bank, Family Finance Building Society and KPOSB. The five institutions together had 4.2 million savings clients and 1.35 million loan clients. The

KPOSB, one of the oldest institutions specialising in providing services to small savers, operates 55 branches, 16 sub-branches and 384 outlets country wide. KPOSB alone has over 2 million savings clients.

Non-bank Microfinance Institutions

These are grouped under one umbrella body, namely, the Association of Microfinance Institutions (AMFI) which has 25 members. Of these, 21 members are NGOs and private companies. The 21 members combined had about 700,000 loan clients and an outstanding loan portfolio of Ksh 3.27 million during 2004. However, estimates indicate that less than 20% of their loan portfolio was allocated to the rural areas.

Development Finance Institutions

These include Agriculture Finance Corporation (AFC), Industrial Development Bank (IDB), Kenya Industrial Estates (KIE), Kenya Tourism Development Corporation (KTDC) and Industrial and Commercial Development Corporation (ICDC). They have always boasted of a sectoral focus with extensive rural coverage. However, their efficiency and outreach to low-income house holds and to the MSEs remained largely low during 2004/05. All of these institutions continue to experience financial and operational contraints that limit their efficiency and effectiveness.

Savings and Credit Co-operative Societies (SACCOs)

There are over 4,400 SACCOs with over five million members. In the fiscal year 2004, share contributions amounted to over Ksh 70 billion, with savings of over Ksh 115 billion, while outstanding loans were in excess of Ksh 90 billion. There were over 155 rural based SACCOs, with shares and loans amounting to over Ksh 1.9 billion and Ksh 2.3 billion, respectively, as at the end of 2004. Given their potential, SACCOs outreach in the rural areas is still low.

The SACCO societies continued to diversify their products and services including provision of near retail banking services based on what is popularly known as Front Office Service Activities (FOSAs). Currently, there are about 110 SACCO societies with FOSA operations.

SACCO societies have embraced modern Information and Communication Technology (ICT) in their operations aimed at enhancing efficiency and effectiveness, such as computerization and use ATMs. Most ATMs used by SACCO societies are either obtained directly by the SACCO societies from a service provider or in partnership with commercial banks e.g. the Co-operative Bank of Kenya Ltd. The Co-operative Bank of Kenya has developed a strategy to provide Cash Withdrawal Points (ATMs) to SACCO Societies.

Development of Policy, Legal, Regulatory and Supervisory Frameworks for MFIs and SACCOs

The major challenge facing micro finance industry and the SAACO movement in Kenya is the lack of appropriate legal and regulatory framework to govern their specific operations. The draft Deposit Taking Micro Finance Bill, 2005 and the SACCO Societies Regulatory Bill, 2005 are with the Attorney General's Office for finalisation.

Under the Deposit Taking Microfinance Bill, only deposit taking microfinance institutions will be regulated and supervised by the Central Bank of Kenya while the Minister for Finance will prescribe regulations to govern the non-deposit taking micro finance institutions. Under the SACCO societies Regulatory Bill, on the other hand, a regulatory framework for all SACCO societies will be set up under a new regulatory authority established under the Bill.

The U.N. International Year of Micro-credit (IYMC)

During the Year, Kenya formed a National Committee to spearhead various activities to celebrate the International Year of Micro Credit (IYMC). The Committee, consisting of the United Nations Agencies; the Government of Kenya; umbrella organisations like AMFI, KUSCCO, NGOs, civil society, MFIs and the private sector in Kenya, was officially launched on November 18, 2004. The committee organised and facilitated the program of national activities directed towards accomplishing the goals of the IYMC. These activities were aimed at raising public awareness on micro finance activities and contributions to the Millennium Development Goals (MDGs); integrating microfinance into the formal financial system; enhancing partnership building for more efficient microfinance service delivery and strengthening financial linkages between microfinance practitioners and commercial banks.

One of the major activities being carried out under the IYMC is a project to measure access to financial services in Kenya. This industry wide initiative is being implemented under the auspices of the Financial Access Partnership (FAP), a joint public and private steering committee of stakeholders, with the support of the DFID/Financial Sector Deepening - Kenya, Trust.

Monetary Policy Objective for the Fiscal Year 2004/2005

The overall aim of monetary policy is to ensure price stability. The Central Bank pursued this by managing the growth of money supply so as to be consistent with the highest possible economic growth while keeping inflation moving towards the desired rate. In particular, the Bank managed growth of broad money supply (M3X) to ensure that it did not create excess demand for goods and services and thus push prices up. To regulate the money supply growth, the Bank targets reserve money, that is deposits of commercial banks at the Central Bank and currency issued into circulation by the Central Bank, to constrain it to expand in a pre-determined path in order to curb excessive credit in the economy. During the fiscal year 2004/05, the Bank aimed at keeping inflation below 5%. To achieve this, money supply (M3X), was targeted to gradually fall to 7.5% and reserve money to 3.8% by June 2005. In line with these growths, credit to the private sector was expected to grow by 8.9% by the end of June 2005.

Open market operations (OMO) was used as the main monetary policy instrument in pursuit of the inflation objective complemented by rediscount facilities at the Bank and cash ratio requirement maintained at 6% throughout the year.

Money Supply

Broad money, M3X, grew by 11.3% in June 2005 compared with 12.9% a year ago and 7.5% target for the year to June 2005 (Table 18). The less rapid expansion of M3X is associated with the monetary policy stance taken by the Central Bank to limit growth in reserve money to 3.8% in the year to June 2005. The 11.3% expansion in M3X was due to increases in both net foreign assets (NFA) and net domestic assets (NDA) as shown in Table 19. The NDA expansion, which accounted for 46% of the

TABLE 18: PERFORMANCE OF MONETARY AGGREGATES JULY 2004 - JUNE 2005 (Percent)

	RM		M3X	
	Act.	Targ.	Act.	Targ.
2004				
Jun	5.5	-5.4	12.9	7.1
Jul	11.9	10.1	11.6	12.2
Aug	5.9	10.1	13.9	12.2
Sep	9.8	10.1	14.5	12.2
Oct	6.0	8.5	14.3	8.9
Nov	7.2	8.5	13.0	8.9
Dec	15.5	6.2	13.2	8.9
2005				
Jan	13.5	7.7	12.8	8.8
Feb	11.5	7.7	13.3	8.8
Mar	8.2	7.7	13.4	8.8
Apr	7.1	3.8	12.2	7.5
May	4.1	3.8	11.1	7.5
Jun	4.8	3.8	11.3	7.5

Source: Central Bank of Kenya

overall expansion in M3X, reflected growth in net domestic credit by 8%, as other items net declined by 15%. NFA expansion accounted for 54% of M3X expansion, following the build up of foreign exchange holdings by both the commercial banks and the Central Bank. The increase in commercial banks' NFA resulted from improved export earnings, while the increase in foreign exchange reserves of the Central Bank is attributable to

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

	Jul - Jun 2002/03 Act	Jul - Jun 2003/04 Act	Jul - Jun 2004/05 Act	Jun-05 Target
1.0 Liability				
Money Supply				
Money supply, M2 1/	350.0	394.5	430.2	
Money supply, M3 2/	362.6	407.3	442.4	439.3
Money supply, M3X 3/	419.4	473.4	526.8	508.8
2.0 Assets (2.1+2.2)	419.4	473.4	526.8	508.8
2.1 Net foreign assets 4/	104.4	119.7	148.4	129.2
Central Bank	81.5	86.7	95.7	95.7
Banking Institutions	22.8	33.1	52.8	33.5
2.2 Net domestic assets (2.21+2.22)	315.1	353.7	378.3	379.6
2.21 Domestic Credit (2.210+2.211)	383.5	430.1	466.3	466.0
2.210 Government (net)	124.2	136.7	112.3	148.8
2.211 Private sector and other public sector	259.3	293.4	354.0	317.2
2.22 Other assets net	-68.5	-76.5	-87.9	-86.5
Memorandum Item:				
Reserve Money 5/	85.5	90.2	94.6	93.7

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

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

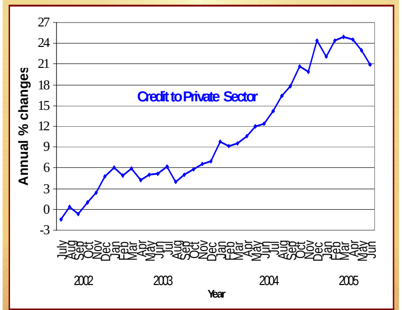
Source: Central Bank of Kenya

purchases from interbank foreign exchange market and US$ 76 million disbursements from the IMF in support of the PRGF programme.

Domestic Credit

Domestic credit extended by the banking system expanded by 7.8% in the year to June 2005 compared with a 12.8% a year earlier. Credit to the Government declined by 19.3% compared with a target of 8.9%, while credit to the private sector expanded by 20.9%, against 8.9% target and 12.3% increase in the year to June 2004 (Table 20). Most of the credit expansion was to private

CHART 13: ANNUAL PERCENTAGE CHANGES IN PRIVATE SECTOR CREDIT



Source: Central Bank of Kenya

TABLE 20: CREDIT TO PRIVATE AND OTHER PUBLIC SECTORS (KSH BN)

	2004 Jun		2005 Jun		Annual Change		Jun '04 - Jun '05
	Ksh bn	Share (%)	Ksh bn	Share (%)	Ksh bn	(%)	% dist. of ann. change in credit to private sector and other public sectors
1. Credit to other public sector	**9.2**	**3.1**	**10.3**	**2.9**	**1.1**	**11.8**	**1.8**
Local government	-1.4	-0.5	-1.1	-0.3	0.2	-16.9	0.4
Parastatals	10.6	3.6	11.4	3.2	0.9	8.1	1.4
2. Credit to private sector	**284.2**	**96.9**	**343.7**	**97.1**	**59.5**	**20.9**	**98.2**
Agriculture	26.7	9.1	29.5	8.3	2.9	10.7	4.7
Manufacturing	53.2	18.1	67.3	19.0	14.1	26.6	23.4
Trade	49.5	16.9	51.5	14.5	2.0	4.1	3.3
Building and construction	19.4	6.6	23.7	6.7	4.3	21.9	7.0
Transport & communications	19.2	6.6	26.7	7.5	7.4	38.7	12.3
Finance & insurance	23.4	8.0	30.6	8.6	7.2	30.6	11.8
Real estate	19.9	6.8	23.6	6.7	3.8	19.0	6.2
Mining and quarrying	2.0	0.7	2.1	0.6	0.1	4.0	0.1
Private households	28.9	9.9	46.3	13.1	17.3	60.0	28.6
Consumer durables	6.7	2.3	9.2	2.6	2.5	37.4	4.1
Business services	21.8	7.4	32.6	9.2	10.8	49.5	17.8
Other activities	13.5	4.6	0.7	0.2	-12.9	-95.1	-21.2
3. TOTAL (1+2) *	**293.4**	**100.0**	**354.0**	**100.0**	**60.6**	**20.6**	**100.00**

Source: Central Bank of Kenya

households (60%), business services (49.5%), consumer durables (37.4%), transport and communication (38.7%), finance and insurance (30.6%), manufacturing (26.6%), and building and construction (21.9%) (Table 20).

Reserve Money

An analysis of reserve money is presented in Table 21. During the year to June 2005, reserve money increased by 4.8% (or Ksh 4.3 billion) to Ksh 94.6 billion from Ksh 90.2 billion in June 2004. The increase in reserve money comprised Ksh 4.7 billion rise in currency in circulation and a decline of Ksh 0.4 billion in deposits of commercial banks and NBFIs at the Central Bank.

TABLE 21: RESERVE MONEY & ITS SOURCES (KSH BN)

		2004 Jun	2005 Jun	Change Absolute	Target Jun-05	Deviation
1	Net Foreign Assets	86.7	95.7	9.0	95.7	0.0
2	Net Domestic Assets	3.6	-1.1	-4.7	-2.0	0.9
	2 Government Borrowing (net)	18.3	5.1	-13.2	19.1	-14.0
	2 Advances & Discounts	-6.1	-5.3	0.8	-18.3	13.0
	2 Other Domestic Assets (net)	-8.5	-0.8	7.7	-2.8	2.0
3	Reserve Money	90.2	94.6	4.3	93.7	0.9
	3 Banks Deposits at CBK	27.6	27.2	-0.4	27.2	0.1
	3 Currency in Circulation	62.6	67.3	4.7	66.5	0.8

Source: Central Bank of Kenya

The increase in reserve money in the twelve months to June 2005 was supported by increased net foreign assets of the Central Bank which rose by Ksh 9.0 billion from Ksh 86.7 billion in June 2004 to Ksh 95.7 billion in June 2005.

NDA of the Central Bank declined by Ksh 4.7 billion to Ksh negative 1.1 billion, from Ksh 3.6 billion in June 2004. The decline in NDA largely reflected reduced Government borrowing, coupled with Ksh 6.1 billion increased Government deposits with the Central Bank. Net indebtedness of commercial banks to the Central Bank reduced to Ksh 5.3 billion in June 2005, from Ksh 6.1 billion in June 2004, with redemption of maturing repos. Other domestic assets net of liabilities of the Central Bank increased by Ksh 7.7 billion in the year to June 2005 to Ksh negative 0.8 billion from Ksh negative 8.5 billion in June 2004.

Performance Criteria and Benchmarks Under the Monetary Program for the Fiscal Year 2004/2005

Under the monetary program for fiscal year 2004/2005, a floor on unencumbered net foreign assets of the Central Bank (adjusted for any shortfall in programmed budgetary support) and a ceiling on reserve money, were set to be observed on the basis of monthly averages in the quarters of December 2004 and March and June, 2005.

TABLE 22A: PERFORMANCE OF RESERVE MONEY IN KSH BILLION

	Dec 2004*			Mar 2005**			Jun 2005*		
	Actual	Targ	Dev	Actual	Targ	Dev	Actual	Targ	Dev
Reserve money	97.7	93.0	4.7	94.2	93.3	0.9	93.9	93.7	0.2
Commercial Banks Deposits	26.3	26.9	-0.6	26.2	27.2	-1.0	26.6	28.6	-2.0
NBFIs Deposits	0.1	1.0	-0.9	0.1	1.0	-0.9	0.1	0.1	0.0
Currency in Circulation	71.2	65.1	6.1	67.9	65.0	2.9	67.2	65.0	2.2
Cash in Till	8.2	7.2	1.0	7.8	7.3	0.5	7.7	7.3	0.4
Cash Outside Banks	63.0	57.9	5.1	60.1	57.7	2.4	59.4	57.7	1.7

* Benchmark dates

** Test dates

Source: Central Bank of Kenya

As shown in Table 22, the reserve money target for December 2004 was missed. For the March and June 2005 quarters, reserve money targets were, however, broadly observed. In June 2005, average reserve money was Ksh 93.9 billion compared with the target of Ksh 93.7 billion. Overall, excess reserve money against target in all the quarters was in currency outside banks which could not be accessed through open market operations (OMO).

Net Foreign Assets (NFA)

As shown in Table 22B, targets for the NFA of the Central Bank (excluding any encumbered reserves), adjusted for shortfalls in non-project budget support and external privatisation proceeds, were achieved in all the quarters in the fiscal year 2004/05. Unencumbered NFA of Central Bank was above target by Ksh 8.6 billion in December 2004, Ksh 4.1 billion in March 2005 and Ksh 12.8 billion in June 2005. The strong NFA position of the Bank reflected purchases of foreign exchange from the interbank market and disbursement of funds by the IMF in early 2005.

TABLE 22B: PERFORMANCE OF UNENCUMBERED NFA IN KSH MILLION

		Dec-04	Mar-05	Jun-05
1	NFA Program Target	74,408	78,120	89,320
2	Shortfall in non project budget support	100	4,919	10,577
3	Adjusted Program Target (1+2)	74,308	73,201	78,743
4	Average NFA Actual (unencumbered)	82,706	77,335	89,942
5	Deviation (4-3)	8,398	4,134	11,199

Source: Central Bank of Kenya

Outlook

Over the next twelve months to June 2006, the Bank will target 7.8% growth in broad money supply and 5.0% growth in reserve money as shown in Table 22c. In implementing monetary policy through the reserve money targets, the Bank will continue to use the instruments available including open market operations to realign reserve money and its components to the set targets.

TABLE 22C: MONETARY PROGRAMME FOR 2005/06

		Sep-05	Dec-05	Mar-06	Jun-06
1	Reserve Money	96.1	101.6	97.8	99.3
2	Net Foreign Assets	94.5	95.1	98.6	102.9

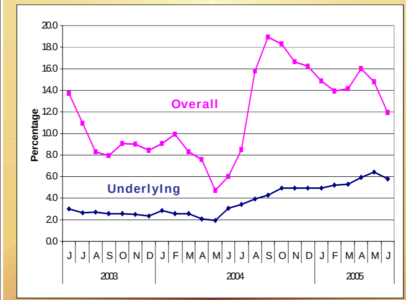
Source: Central Bank of Kenya

INFLATION

Average overall annual inflation increased from 8.2% in the year ending June 2004 to 15.0% during the year ending June 2005, while overall month-on-month inflation increased to 11.9% from 5.9% over the same period. However, the three months annualized inflation declined to 9.0% from 18.0%, an indication of easing in inflationary pressure towards the end of the year to June 2005.

Month-on-month underlying inflation increased to 5.8% in June 2005 from 3.1% in June 2004. This was above the monetary policy target of 5%. Despite the rise in underlying inflation, it remained stable, confined within the 3.1% - 6.4% range during the year ending June 2005. Consistent with the 12-month underlying inflation, average annual underlying inflation rose from 2.5% in the year ending June 2004 to 5.0% during the year ending June 2005. The relatively low and stable underlying inflation during the year reflected the stance of monetary policy adopted and implemented by the Central Bank which helped stabilize the overall month-on-month inflation. Chart 14 and Table 23 show trends in both overall and underlying inflation rates based on the 12- month measure of inflation. The overall month-on-month inflation peaked in September 2004 and started to decline thereafter through June 2005

CHART 14: 12-MONTH INFLATION (%)



Source: Central Bureau of Statistics

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

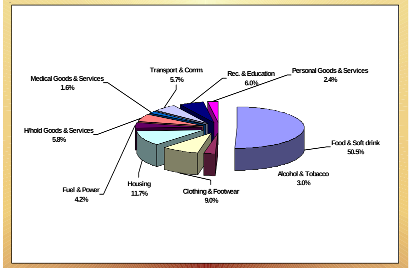
	2004					2005					
	Jun	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
Overall	5.94	18.96	18.29	16.65	16.25	14.87	13.94	14.15	16.02	14.78	11.91
Underlying	3.1	4.30	4.94	4.95	4.90	4.93	5.21	5.31	5.90	6.42	5.79

Sources: Central Bureau of Statistics and Central Bank of Kenya

Inflation by Category of Goods and Services

Of the ten categories of goods and services surveyed by the Central Bureau of Statistics (CBS), seven realised consistently low and stable inflation while three experienced double digit levels. For instance, just as in the year to June 2004, most of the

CHART 15: GOODS AND SERVICES CATERGORY WEIGHTS



Source: Central Bureau of Statistics

increase in inflation was in prices of food, energy, transport and communications goods and services.

The food and drink index rose by 16% from 181.9 in July 2004 to 211.0 in June 2005. The general increase in food and drink prices in the year to June 2005 mainly reflects seasonal shortages of basic foodstuffs in February and March 2005, following delayed rains, and a temporary sugar shortage in the first quarter of 2005 due to distribution hitches from the port of Mombasa.

Since the food and drink index accounts for over 50% of the overall CPI, changes in food prices have a correspondingly large influence on overall inflation. This partly explains why high food inflation translated into high overall inflation in the year to June 2005. Increased world oil prices led to an increase in the fuel and power prices, particularly of paraffin and electricity. Transport and communications prices, particularly of diesel, petrol and air, road and railway increased with increased world oil prices. Thus, in the year to June 2005, food and drink inflation increased to 14.7% from 6.1% in June 2004, while fuel and power inflation increased to 28.7% from 7.9% in June 2004. However, transport and communications inflation fell to 4.5% in the year to June 2005, from 21.3% in June 2004 mainly because of easing of adverse impact on public transport fares arising from the introduction of the new public transport pricing in February 2004.

Distribution of the Inflation Impact

The "Nairobi lower income" group had the highest incidence of inflation in the year to June 2005, having increased to 14.2% from 5.1% in June 2004. Inflation for the "Nairobi income" group, which combines the "Nairobi lower" and "Nairobi upper" income groups, edged up to 13.6% from 5.1% in June 2004. For the "Nairobi upper income" group, inflation increased to 11.0% from 5.4% in June 2004 while for the "Rest of Kenya" income group, inflation was 10.9% compared with 6.5% in June 2004.

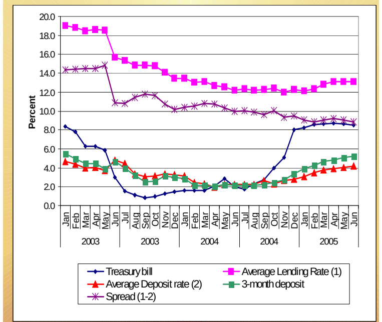
Inflation Outlook

Food and drink , fuel and power and transport and communications prices significantly contributed to the observed overall inflation in the year to June 2005. Favourable rains in most parts of the country and removal of VAT for selected food items is expected to ease pressure on food prices and, with it, the overall CPI. However, further increases in crude oil prices could drive up the fuel and power prices as well as transport and communications prices. However, considering the huge influence that food prices have on overall inflation, it is expected that continued reduction in food prices will offset any adverse effects on inflation arising from increased world oil prices. Inflation, therefore, is expected to decline steadily at least during the first quarter of the fiscal year 2005/06.

INTEREST RATES

Interest rates edged up in the year to June 2005. Other than the commercial banks' average lending rates, all other interest rates increased substantially between June 2004 and June 2005. The average interest rate on the 91-day Treasury bill increased to 8.5% in June 2005 from 2.0% in June 2004. Similarly, the average interest rate on the 182-day Treasury bill moved up to 9.0% in June 2005 from 3.2% in June 2004. The average interbank rate increased to 7.4% in June 2005 from 1.3% in June 2004.

CHART 16: INTEREST RATES (%)



Source: Central Bank of Kenya

Commercial banks' average lending rate increased to 13.09% in June 2005, from 12.17% in June 2004. The highest and lowest lending rates respectively, were 13.12% and 11.97%, between June 2004 and June 2005. All other commercial bank lending rates, except for the "1 to 5 year" loans, which on average dropped from 14.4% in June 2004 to 13.6% in June 2005, trended upwards. Interest rate on overdraft increased to 13.8% in June 2005 from 10.7% in June 2004, while the lending rate for "over 5 Year" loans increased to 11.9% from 11.5%.

The average deposit rate almost doubled during the year rising from 2.2% in June 2004 to 4.2% in June 2005. This was mainly due to increases in "0 to 3 months" and "over 3 months" deposit rates. From an average of 2.1% in June 2004, the interest rate on "0 to 3 months" deposits increased to 5.2% in June 2005. Similarly, the interest rate on "over 3 months" deposits increased to 6.18% from 3.3% during the period. Also on the increase was the average rate on demand deposits which was 1.0% in June 2005 compared with 0.5% in June 2004, and the average interest rate on savings deposits which increased to 1.2% in June 2005 from 1.2% in June 2004.

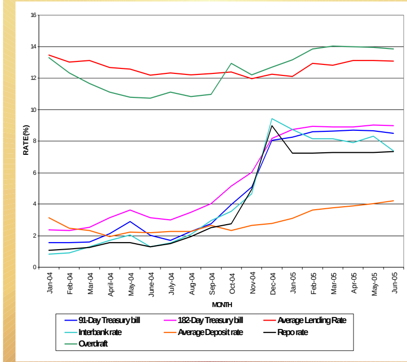
The increase in the average deposit rate resulted in the narrowing of the interest rate spread (the average lending rate minus the average deposit rate), which declined from 9.97% in June 2004 to 8.88% in June 2005. Selected interest rates and the interest rate spreads are presented in Table 24 and Chart 17.

TABLE 24: INTEREST RATES (%)

	2004	2004				2005					
	Jun	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
Treasury bill 91days	2.01	2.75	3.95	5.06	8.04	8.25	8.59	8.63	8.68	8.66	8.50
182 days	3.15	4.03	5.16	6.03	8.19	8.74	8.96	8.91	8.92	9.02	8.96
Average Lending Rate	12.17	12.27	12.39	11.97	12.25	12.12	12.35	12.81	13.12	13.10	13.09
Overdraft	10.72	10.95	11.85	12.21	12.69	13.14	13.82	14.03	14.00	13.94	13.83
Interbank rate	1.29	2.95	3.56	4.66	9.41	8.72	8.14	8.13	7.91	8.30	7.37
Average Deposit rate	2.20	2.63	2.33	2.66	2.77	3.08	3.47	3.75	3.90	4.05	4.21
3 - months deposits	2.14	2.22	2.43	2.74	3.34	3.91	4.24	4.67	4.78	5.08	5.20
Savings	1.15	1.03	1.07	1.30	0.98	0.97	0.96	0.98	1.09	1.07	1.24
Spread	9.97	9.64	10.06	9.31	9.48	9.04	8.88	9.06	9.22	9.05	8.88

Source: Central Bank of Kenya

CHART 17: INTEREST RATES IN KENYA



Source: Central Bank of Kenya

Interest Rates Outlook

In the near term, the term structure of interest rates should remain steady on account of moderate Government domestic borrowing. This is because of improved Government revenue collection due to improved tax administration. Besides, external financing was not factored into the Government budget and it is expected that any shocks to disbursement of external budgetary support will not affect the domestic interest rates. It is also expected that, because of easing in inflation, pressure on the term structure of interest rates will be minimal.

Overview

The overall balance of payments improved by US$ 41 million to a surplus of US$ 212 million in the financial year 2004/2005 mainly due to increased short-term capital inflows. As a result of the increase in short-term financial flows, the capital and financial account turned out US$ 1299 million surplus. However, the current account, deteriorated to a deficit of US$ 1,087 million or 6.5 percent of GDP from US$ 157 million or 1.1 percent of GDP in the previous period. The deterioration in the current account was mainly in the widening of the trade deficit which, at US$ 2,322 million during the fiscal year, was almost double that of the previous year. Earnings from non-factor services including tourism increased substantially during the year. Consequently, the surplus in the services account increased to US$ 1,235 million which, however, could not match the widening of the trade deficit.

TABLE 25: BALANCE OF PAYMENTS (US DOLLAR M)*

ITEM	Year to Jun 2004	Year to June 2005: Q1 Jul-Sep	Q2 Oct-Dec	Q3 Jan-Mar	Q4 Apr-Jun**	Year to Jun 2005**	Absolute Change
OVERALL BALANCE	**170**	**-65**	**234**	**-134**	**176**	**212**	**41**
I. CURRENT ACCOUNT	**-157**	**-164**	**-79**	**-327**	**-517**	**-1087**	**-930**
Goods	**-1324**	**-438**	**-452**	**-518**	**-914**	**-2322**	**-998**
Exports (fob)	**2509**	670	717	831	850	**3067**	**558**
Coffee	**82**	20	17	23	55	**115**	33
Tea	**444**	101	117	125	126	**469**	25
Horticulture	**387**	96	110	105	112	**423**	35
Oil products	**4**	5	9	15	9	**38**	33
Manufactured Goods	**237**	88	76	78	93	**335**	97
Raw Materials	**358**	86	110	108	102	**406**	49
Re-exports	**637**	180	176	208	202	**767**	130
Other	**358**	93	103	168	150	**515**	157
Imports (cif)	**3832**	1107	1168	1349	1765	**5389**	**1557**
Oil	**963**	314	274	286	342	**1215**	252
Chemicals	**673**	186	198	231	185	**799**	126
Manufactured Goods	**590**	179	175	210	212	**776**	187
Machinery & Transport Equipment	**908**	269	250	268	712	**1499**	591
Other	**699**	160	272	354	314	**1100**	401
Services	**1167**	**273**	**373**	**191**	**397**	**1235**	**68**
Non-factor services (net)	**532**	151	223	118	244	**736**	205
of which tourism	**404**	112	151	109	126	**498**	95
Income (net)	**-109**	-28	-37	-23	-9	**-97**	12
of which official interest	**-85**	-22	-19	-27	-12	**-80**	5
Current Transfers	**744**	150	187	97	162	**595**	-149
Private (net)	**679**	150	187	97	162	**595**	-84
Public (net)	**65**	0	0	0	0	**0**	-65
II. CAPITAL & FINANCIAL ACCOUNT	**327**	**100**	**313**	**193**	**693**	**1299**	**971**
Capital Tranfers (net)	**154**	**42**	**26**	**62**	**141**	**272**	**118**
Financial Account	**174**	**57**	**287**	**131**	**552**	**1027**	**853**
Official, medium- & long-term	**-220**	-48	-49	-58	-31	**-186**	35
Inflows	**177**	30	28	32	13	**102**	-75
Outflows	**-397**	-77	-76	-90	-44	**-288**	110
Private, medium- & long-term (net)	**-140**	-60	24	-409	529	**84**	225
Commercial Banks (net)	**-130**	-44	40	-388	143	**-248**	-118
Other private, medium- & long-term	**-10**	-16	-16	-21	386	**333**	343
Short Term and Errors & Omissions (net)	**534**	164	311	598	54	**1128**	594
Gross Reserves	**1939**	**1906**	**2078**	**2358**	**2327**	**2327**	**388**
Official	**1399**	1309	1519	1436	1587	**1587**	**188**
*imports cover****	3.7	3.3	3.6	3.2	3.1	3.1	-0.6
Commercial Banks	**540**	597	560	922	740	**740**	**200**

* Revised to reflect the new BOP presentation format
** Provisional
*** In months of goods and non-factor services
Source: Central Bank of Kenya

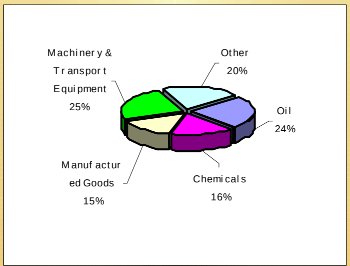
Trade in Goods and Services

Merchandise Account

The merchandise account deteriorated by US $ 998 million to a deficit of US$ 2,322 million during the year under review from US$ 1,324million in the previous year. This was occasioned by a substantial increase in imports of US$ 1,557 million, which far exceeded the increase in exports of US$ 558 million.

The value of imports of machinery and transport equipment was the highest at US$ 1,499 million, and was due mainly to the import of aircraft by Kenya Airways. Imports of oil rose by US$ 252 million to US$ 1,215 million reflecting higher imports of crude oil, jet fuel and gas oil. Chart 18 shows that imports of machinery and transport equipment plus imports of petroleum products accounted for half of all the value of merchandise imports in the fiscal year 2004/2005. Imports of chemicals and manufactured goods rose by US$ 126 million and US$ 187 million respectively during the year to US$ 799 million and US$ 776 million. Miscellaneous imports, which mainly include palm oil, wheat, maize, textiles, tobacco products and rice, rose to US$ 1,100 million. Imports of industrial machinery, road vehicles, telecommunication and sound recording equipment was also significant.

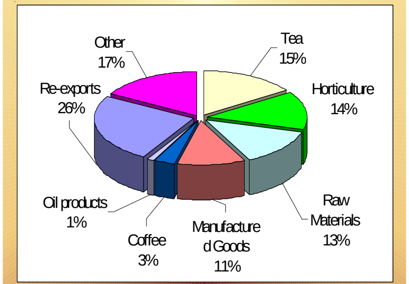
CHART 18 : COMPOSITION OF KENYA'S IMPORTS



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

Export earnings went up significantly by US$ 558 million or 22.2% in the fiscal year 2004/2005. The largest increase was in exports of manufactured goods followed, by raw materials, horticulture, coffee, oil products and tea in that order. The value of manufactured goods exported increased by US$ 97 million to US$ 335 million during the fiscal year 2004/2005. Earnings from raw materials, horticulture, coffee, oil products and tea exports increased during the fiscal year by US$ 49 million, US$ 35 million, US$ 33 million, US$ 33 million and US$ 25 million, respectively. There were also notable increases in exports of manufactured goods, including iron, steel and textile products. Raw materials exports consisted mainly of crude animal and vegetable materials. Higher average price of horticultural products, which rose by 11.3% to US $ 2,549 per tonne, more than off-set the marginal decline in export volume, resulting in an increase in export value to US$ 423 million in the fiscal year 2004/2005, from US$ 387 million in the previous year. The volume of coffee exported also declined to 52,000 from 54,000 tonnes in the fiscal year 2003/2004. However, coffee export price increased by 42.8% to 2,108 dollars per tonne, leading to a rise in the value of coffee exports, to US$ 115 million in fiscal year 2004/2005 from US$ 82 million the previous year. The value of tea exports rose to US$ 469 million, mainly as a result of an increase in export volume from 264,000 to 283,000 tonnes or 7.2% in the fiscal year 2004/2005. The average price of tea, however, declined to US$ 1,656 from US$ 1,683 per tonne. Exports of agricultural products i.e. tea, horticulture and coffee accounted for a third of total exports.

CHART 19 : COMPOSITION OF KENYA'S EXPORTS



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

Re-exports[1] increased significantly and accounted for a quarter of the value of total merchandise exports in the fiscal year 2004/ 2005 (Chart 19). Total re-exports during the year rose by US$ 130 million to US$ 767 million and constituted oil (80.5%), machinery and transport equipment, mainly road vehicles (5.9%), manufactured goods (4.5%), chemicals (3.7%) and others (5.4%).

Services Account

In the fiscal year 2004/2005, earnings from tourism and other non-factor services rose by 38.5% to US$ 736 million. Tourism earnings increased by US$ 95 million to US$ 498 million reflecting increased tourist arrivals by 31% to 754,000. Receipts from transportation services also increased by US$ 72 million while other Government and private sector service

[1] Re-exports are goods that are imported into the country and subsequently exported, mainly to neighboring countries (Uganda, Tanzania, Rwanda and Democratic Republic of Congo).

receipts rose by US$ 17 million and US$ 63 million, respectively.

In the income account, interest earnings on official foreign exchange reserves amounted to US$ 41 million compared with US$ 33 million in the previous year. On the other hand, foreign interest payments declined by US$ 19 million to US$ 143 million comprising US$ 80 million paid by the Government and US$ 63 million paid by the private sector.

Current transfers (cash transfers and gifts to the Government and the private sector) declined by US$ 149 to US$ 595 million from US$ 744 million in the previous period.

On a net basis, non-factor services and income accounts increased by US$ 205 million and US$ 12 million respectively while the current transfers account declined by US$ 149 million, resulting in a net improvement of US$ 68 million in the services account in the fiscal year 2004/2005.

Capital and Financial Flows

In the fiscal year 2004/2005, the current account deficit was largely financed by increased surplus in the capital and financial account, which went up from US$ 327 million in the fiscal year 2003/2004 to US$ 1,299 million in the current year. The capital account surplus expanded to US$ 272 million from US$ 154 million in the fiscal year 2003/2004, as a result of increased project grants to Government (Table 25).

Long-term loans to the public sector which consisted mainly of project loans declined from US$ 177 to US $ 102 million. Private medium and long-term financial inflows increased to US $ 468 million from US $ 114 million, out of which US$ 411 million represented financing of the purchase of aircraft by Kenya Airways. Short-term capital inflows increased to US$ 1128 million from US$ 534 million in the fiscal year 2003/2004. On the outflows side, Government repayment of foreign loans declined to US$ 288 million from US$ 397 million in the previous period following the rescheduling of Paris Club debt equivalent to US$ 124 million. Repatriation of private capital increased to US$ 78 million from US$ 35 million. Following the pick up in economic activity and greater demand for imports, commercial banks increased their net foreign assets by US$ 248 million compared with US$ 130 million increase in the previous period. Therefore, official and private medium and long-term accounts improved by US$ 35 and US$ 225 million respectively as the short-term capital account increased by US$ 594 million, altogether producing a surplus in the financial account of US $ 1027 million.

Direction of Trade

African countries absorbed 48% of Kenya's merchandise exports while the rest of the world absorbed 52%. On the other hand, Kenya imported goods mainly from Europe and the Middle East.

As shown in Table 26, the main destination countries for Kenya's merchandise exports were Uganda (17%), United Kingdom (10%), Tanzania (8%), the Netherlands (8%), Pakistan (5%), the Democratic Republic of Congo (4%), Rwanda (3%) and Sudan (3%). The main sources of Kenya's merchandise imports (Table 27) remained United Arab Emirates (12%), United States of America (11%), United Kingdom (10%), South Africa (9%),

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

Destination Country	Years Ending Jun 03	Jun 04	Jun 05
Uganda	399	432	535
Tanzania	193	191	234
DRC	61	78	132
Rwanda	60	79	94
Sudan	54	51	86
Egypt	75	82	82
Others	241	232	309
Total (Africa)	**1083**	**1144**	**1473**
United Kingdom	269	267	306
Netherlands	164	204	234
Pakistan	114	122	162
Germany	68	62	64
France	33	45	61
USA	35	47	60
India	30	38	54
United Arab Emirates	31	26	42
Belgium	28	31	38
Others	471	523	575
Total Exports	**2326**	**2509**	**3067**

Source: Central Bank of Kenya

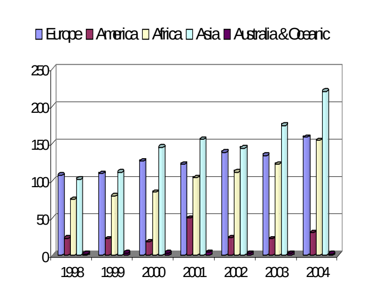
TABLE 27: KENYA'S IMPORTS: MAIN SOURCE COUNTRIES (US $M)

Source Country	Years Ending Jun 03	Jun 04	Jun 05
South Africa	271	357	487
Egypt	52	80	77
Tanzania	14	18	32
Swaziland	23	34	32
Uganda	16	8	24
DRC	6	1	15
Others	58	73	65
Total (Africa)	**440**	**571**	**733**
United Arab Emirates	371	458	650
USA	256	148	579
United Kingdom	257	253	536
Saudi Arabia	235	350	467
Japan	233	271	319
India	190	248	290
China	95	117	203
Germany	142	144	175
France	119	140	157
Others	998	1133	1280
Total Imports	**3338**	**3832**	**5389**

Source: Central Bank of Kenya

Saudi Arabia (9%), Japan (6%), India (5%), China (4%), Germany (3%) and France (3%).

CHART 20: KENYA'S TRADE STRUCTURE



Source: Central Bank of Kenya

Kenya's Trade Structure

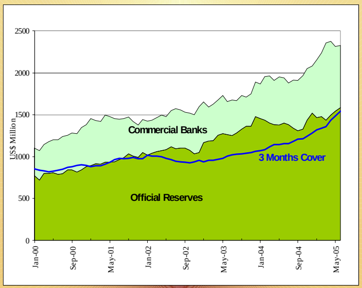
Trade with traditional European and US markets has been declining in favour of increased trade with African and Asian countries over the last two years. Trade between Kenya and European countries, dominated by the European Union, has declined from an average of 31.4 % of all trade in 1999-2001, to 29.5% in 2002-2004. Similarly, trade with America, dominated by USA, declined from 6% to 3.7%. Trade with African countries, on the other hand, increased from 23.4% to 26.4% in 1999-2001, and 2002-2004, respectively. Asian countries' trade with Kenya increased from 35.8% to 36.4%, which was mainly the result of increased trade with the Far East countries from an average of 18% in 1999-2001 to 20% in 2002-2004.

TABLE 28: KENYA'S TRADE STRUCTURE

	Total Trade in billions of Kenya Shillings							Proportion (%)						
	1998	1999	2000	2001	2002	2003	2004	1998	1999	2000	2001	2002	2003	2004
Europe	107.4	109.6	126.1	122.1	138.3	134.2	158.0	33.7	33.3	33.0	27.9	32.4	28.9	27.3
Western Europe	104.7	105.7	120.4	119.0	135.3	127.0	151.1	32.8	32.1	31.5	27.2	31.7	27.3	26.1
European Union	100.7	101.1	115.7	112.0	128.9	119.0	143.7	31.6	30.7	30.3	25.6	30.2	25.6	24.8
Others	4.0	4.5	4.7	7.0	6.4	8.0	7.4	1.3	1.4	1.2	1.6	1.5	1.7	1.3
Eastern Europe	2.6	3.9	5.7	3.0	3.0	7.2	6.9	0.8	1.2	1.5	0.7	0.7	1.5	1.2
America	22.8	22.3	18.4	49.8	23.3	22.1	30.4	7.1	6.8	4.8	11.4	5.4	4.7	5.3
U.S.A	19.6	16.0	12.9	42.4	18.0	17.2	18.9	6.1	4.8	3.4	9.7	4.2	3.7	3.3
Others	3.2	6.3	5.5	7.4	5.2	4.9	11.5	1.0	1.9	1.4	1.7	1.2	1.0	2.0
Africa	75.0	79.6	84.7	104.3	112.0	122.0	154.3	23.5	24.2	22.1	23.8	26.2	26.2	26.7
E.A.Community	35.9	35.7	36.7	44.8	46.9	47.7	58.0	11.2	10.9	9.6	10.2	11.0	10.2	10.0
Tanzania	16.7	14.2	12.0	14.1	15.0	16.0	19.9	5.2	4.3	3.1	3.2	3.5	3.4	3.4
Comesa	39.4	43.1	49.9	65.6	68.7	73.6	89.4	12.3	13.1	13.0	15.0	16.1	15.8	15.4
Other Countries	19.5	22.1	22.8	24.5	28.2	32.4	45.0	6.1	6.7	6.0	5.6	6.6	7.0	7.8
Asia	102.1	111.8	144.9	155.2	143.9	174.4	220.0	32.0	34.0	37.9	35.5	33.7	37.5	38.0
Middle East	40.7	48.5	80.1	77.8	58.4	82.0	107.8	12.8	14.7	20.9	17.8	13.7	17.6	18.6
Far East	61.4	63.3	64.8	77.4	85.5	92.3	112.2	19.3	19.2	17.0	17.7	20.0	19.9	19.4
Australia & Oceanic	2.3	3.5	3.3	4.3	2.6	2.5	2.1	0.7	1.1	0.9	1.0	0.6	0.5	0.4
All other Countries N.E.S	9.4	2.2	5.0	2.2	7.0	9.9	13.9	2.9	0.7	1.3	0.5	1.6	2.1	2.4
Grand Total	319.0	329.0	382.3	437.7	427.0	465.0	578.6	100	100	100	100	100	100	100

Sources: Economic Survey 2004 and 2005

CHART 21: FOREIGN EXCHANGE RESERVES (US $)



Source: Central Bank of Kenya

Foreign asset holdings of the entire banking system rose by US$ 388 million to US$ 2,327 million at the end of June 2005 from US$ 1,939 million at the end of June 2004. Foreign currency deposits held locally by residents also increased to US$ 1,067 million at the end of June 2005 from US$ 836 million at the end of June 2004.

The Central Bank of Kenya built up foreign exchange reserves by US$ 188 million to US$ 1,587 million at the end of June 2005 from US$ 1,399 million at the end of June 2004. This was achieved through purchases of foreign exchange from the domestic inter-bank foreign exchange market and receipts of foreign aid in support of Government projects. However, due to the surge in merchandise imports by 41% during the year, the reserves were sufficient to cover only 3.1 months of imports of goods and services compared with 3.7 months of imports at the end of June 2004. The import cover at the end of June 2005 turned out to be 3.9 months when computed using average imports for the preceding three years as stipulated in the Central Bank of Kenya Act.

In the fiscal year 2004/2005, the Bank bought US$ 381 million worth of foreign exchange from the domestic inter-bank foreign exchange market. This was to be used to meet external obligations on behalf of the Government which amounted to US$ 377 million, to cover expenses arising from its own operations amounting to US$ 199 million and to build reserves towards achieving the legal requirement of a minimum of 4 months of imports. In addition to the purchases, the Bank received US$ 76 million from the IMF for balance of payments support under the PRGF, and foreign grants and loans to the Government to finance various projects amounting to US$ 273 million. Included in the CBK reserves is interest earned on investment of foreign exchange reserves which increased to US$ 41 million in the fiscal year 2004/2005, from US$ 33 million in the previous period.

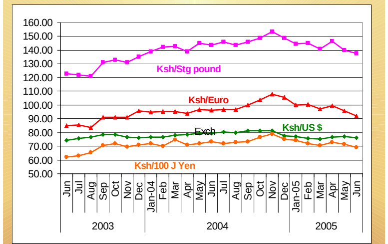
Gross foreign assets of commercial banks, on the other hand, increased by US$ 200 million to US$ 740 million as at the end of June 2005. These assets were largely composed of balances held in banks abroad in the amount of US$ 603 million, and other foreign assets including cash, foreign loans and foreign currency bills discounted amounting to US$ 137 million as at the end of June 2005.

Kenya Shilling Exchange Rate

Between July 2004 and June 2005, the Kenya shilling strengthened against all major international and regional currencies, except the Uganda shilling. It initially weakened between June and November 2004 before strengthening in December 2004 through June 2005.

The movement of the Kenya shilling against the major currencies is presented in Table 29. The shilling depreciated from Ksh. 79.27 to the US dollar in June 2004 to Ksh. 79.77 in December 2004, before appreciating to Ksh 76.68 in June 2005, reflecting appreciation of 3% overall. Against the Sterling pound, it appreciated by 3% from Ksh. 144.81 to Ksh. 139.52 in June 2005. The shilling also appreciated against the Euro by 30%, against the Japanese Yen by 2.5%, and by 7.6% against the South African Rand over the same period. Against the currencies of the East African Community countries, it weakened vis-a-vis the Uganda shilling by 1.4% from USh 22.97 per Kenya shilling in June 2004 to USh 22.66 in June 2005, but strengthened by 4.6% against the Tanzania Shilling from of TSh 14.03 per Kenya shilling to TSh 14.68 over the same period.

CHART 22: KENYA SHILLING EXCHANGE RATES



Source: Central Bank of Kenya

Among the factors driving the movements in the shilling exchange rate during the July to December 2004 period were speculative activities by some market players, low interest rates amidst rising consumer prices, as well as increased demand for foreign currency by oil importers as world oil prices soared towards the end of 2004. As speculative activities fizzled out, traders relaxed their dollar positions, and this, coupled with rising interest rates, increased foreign exchange inflows, better than expected economic growth outturn for 2004 and better forecast for 2005,helped the shilling strengthen against all major international currencies during the period between December 2004 and June 2005.

TABLE 29: KENYA SHILLING EXCHANGE RATES

	2003			2004			2005		
	Jan	Jun	Dec	Jan	Jun	Dec	Jan	Jun	% change Jun 04-Jun 05
Kshs/US$	77.72	73.72	76.02	76.29	79.27	79.77	77.93	76.68	3.27
Kshs/Stg.£	125.66	122.53	132.93	138.95	144.81	153.94	146.51	139.52	3.65
Kshs/Euro	82.60	86.08	93.28	96.22	96.14	106.88	102.33	93.25	3.01
Kshs/100 Yen	65.41	62.34	70.50	71.66	72.36	76.90	75.48	70.57	2.46
Kshs/Rand	8.94	9.35	11.64	11.00	12.27	13.88	13.05	11.34	7.55
Ushs/Kshs	24.08	27.12	25.49	25.39	22.97	21.79	22.21	22.66	1.38
Tshs/Kshs	12.81	14.09	13.90	14.18	14.03	13.17	13.94	14.68	-4.64

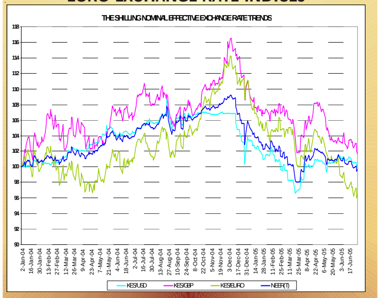
Source: Central Bank of Kenya

International Trade Competitiveness

The real effective exchange rate appreciated between August 2004 and March 2005 following the strenthening of the Kenya shilling and rise in inflation. This means that Kenya's international trade competitiveness based on the real effective exchange rate deteriorated between August 2004 and March 2005. Steadily declining inflation between September 2004 and June 2005, on the face of a stable nominal effective exchange rate, made the shilling depreciate in real effective terms. Consequently, Kenya's international trade competitiveness improved during the March 2004 - June 2005 period, compared to the preceding period.

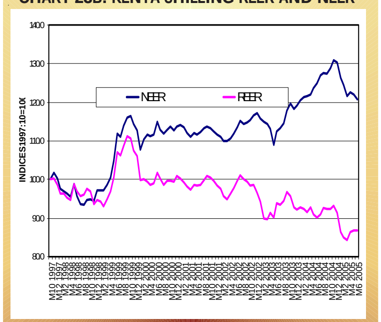
The shilling real exchange rate indices and real effective exchange rate movements, with October 1997 as the base, are shown in Chart 23B. The chart shows a general depreciation of the real effective exchange rate between October 2004 and June 2005. The depreciation was largely because of falling inflation and depreciation of the shilling real exchange rates vis-a-vis the South African Rand, the Euro, the Sterling pound and the Uganda shilling.

CHART 23A: KES/US DOLLAR, KES/GBP AND KES/EURO EXCHANGE RATE INDICES



Source: Central Bank of Kenya

CHART 23B: KENYA SHILLING REER AND NEER



Source: Central Bank of Kenya

Shilling Exchange Rate Outlook

The trend in the last quarter of the 2004/05 financial year, when shilling exchange rate remained stable against all major international currencies, especially the US dollar, is expected to continue. The US dollar has been losing ground against the Euro and Sterling Pound since December, 2004, leading to relative appreciation of the Ksh/US dollar exchange rate. Recent and expected trends in other macroeconomic indicators are also expected to continue to support the Kenya shilling against the major international currencies.

MODE OF PAYMENTS

1. Cash

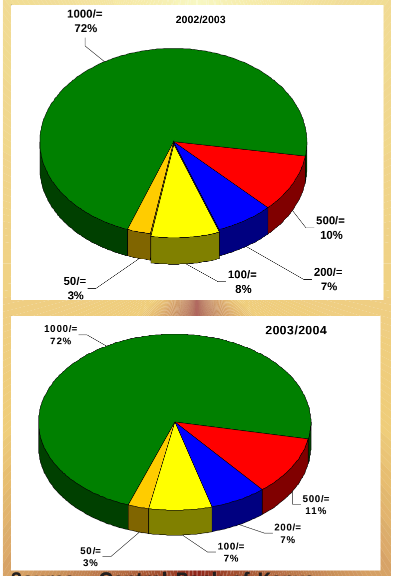
During the year to June 2005, currency remained the most widely used form of payment. The amount of currency issued for circulation during the year to June 2005 increased by Ksh 4.7 billion, or 7.5% to Ksh 67.5 billion from Ksh 62.8 billion in June 2004 (Table 30 and 31).

TABLE 30: CURRENCY IN CIRCULATION BY TYPE

Item	Jun-03 Ksh.bn.	Jun-03 %	Jun-04 Ksh.bn.	Jun-04 %	Jun-05 Ksh.bn.	Jun-05 %
Currency in circulation	55.1	100%	62.8	100%	67.5	100%
Bank Notes	49.6	95.8	60.2	95.9	64.6	95.7
Coins	2.3	4.2	2.6	4.1	2.9	4.3

Source: Central Bank of Kenya

CHART 24: COMPOSITION OF ISSUED BANK NOTES BY DENOMINATION (KSH BN)



Source: Central Bank of Kenya

As a proportion of total currency in circulation, bank notes made up 95.7% while coins comprised 4.3% as at 30th June 2005.

TABLE 31: CURRENCY IN CIRCULATION (KSH M)

Bank Notes Denomination	Ksh (m)	%	Coins Denomination	Ksh (m)	%
1000/=	47,317	73.2	40/=	61	2.1
500/=	6,278	9.7	20/=	1012	34.9
200/=	3,967	6.1	10/=	748	25.8
100/=	4,976	7.7	5/=	512	17.6
50/=	1,684	2.6	1/=	415	14.3
20/=	214	0.3	=/50	103	3.5
10/=	129	0.2	=/10	36	1.2
5/=	32	0	=/05	15	0.5
TOTAL	64,602	100	TOTAL	2902	100

Source: Central Bank of Kenya

The share of banknotes in currency issued decreased to 95.7% as at June 2005 from 95.9% in June 2004. In June 2005, banknotes of Ksh 1,000 and Ksh 500 denominations were dominant, accounting for 73.2% and 9.7% respectively. Coins increased from 4.1% in the preceding year to 4.3% of total currency in circulation in the year under review. The Ksh 20 and Ksh 10 coins maintained bigger proportions accounting for 34.9% and 25.8% respectively of the coins in circulation.

Developments of Cash Inflows and Outflows

Commercial banks deposited Ksh 186.1 billion in the Central Bank as at June 2005, an increase of Ksh 89.8 billion or 93.4.0% compared with Ksh 96.3 billion in the year to June 2004. Over the same period, commercial banks withdrew Ksh 163.7 billion in the year to June 2005 as compared with Ksh 100.2 billion. There was therefore a net currency inflow to Central Bank during the period ending 30th June 2005 of Ksh 22.44 billion (Table 32).

TABLE 32: CURRENCY INFLOWS AND OUTFLOWS (KSH M)

Inflow (deposit by banks)	2003/04	2004/05
Bank Notes	95,749.00	185,329.07
Coins	68.30	813.94
Total	96,318.00	186,143.01
Outflows (Withdrawals by banks)		
Bank Notes	99,419.00	162,717.37
Coins	813.00	985.99
Total	100,232.00	163,703.37
Net Outflows	**- 3,914.00**	**22,439.64**

Source: Central Bank of Kenya

Developments in Counterfeiting Practices

Counterfeit notes increased from 518 pieces as at 30th June, 2004 to 1,129 pieces as at 30th June 2005 (Table 33). In value terms, they went up by 89.4% from Ksh 265,400 to Ksh 502,600. In terms of denominations, there were 226 pieces of Ksh 1,000 notes and 392 pieces of the Ksh 500 notes or 20% and 34.7 % of the total counterfeit notes respectively.

Non- Cash Instruments

Cheques continued to dominate the non-cash payment instruments accounting for over 80% of all transactions. In the year to June 2005 the average daily volume of cheques settled through the Nairobi Automated Clearing House averaged 44,437 cheques valued at Ksh 7.65 billion, a decrease from 52,000 cheques valued at Ksh 7.8 billion in a similar period in 2004.

TABLE 33: COUNTERFEIT NOTES BY DENOMINATION

Period	No. 2003/2004	Amount (Kshs.)	No. 2004/2005	Amount (Kshs.)
1000/=	129	129,000	226	226,000
500/=	214	107,000	392	196,000
200/=	119	238,000	301	60,200
100/-	56	5,600	198	19,800
50/=	-	-	12	600
20/=	-	-	-	-
10/=	-	-	-	-
5/=	-	-	-	-
Total	**518**	**265,400**	**1,129**	**502,600**

Source: Central Bank of Kenya

Electronic Funds Transfer (EFT) transactions or credit based payments increased by 54.6% to Ksh 355,192 million in the year to June 2005 compared with Ksh 229,681 million during the previous year.

The Clearing System Operations

At the end of June 2005, the nominal value of clearing (Debits and Credits) on a national basis remained relatively stable at around Ksh 2,297,697 million (Table 34).

TABLE 34: NATIONAL CLEARING TURNOVER (NOMINAL)

FINANCIAL YEAR	ITEMS	VALUES MILLIONS	VOLUMES THOUSAND
2003	Debit	1,890,753	12,200
	Credit	167,959	2,737
	Total	**2,057,712**	**14,937**
2004	Debit	2,051,975	12,329
	Credit	229,681	3,586
	Total	**2,281,656**	**15,915**
2005	Debit	1,942,505	11,287
	Credit	355,192	3,633
	Total	**2,297,697**	**14,920**

Source: Central Bank of Kenya

During the year to June 2005, the Domestic Foreign Currency Clearing (DFCC) System took off successfully. The respective transaction volumes and values through the system as at the end of June 2005 are presented in Table 35.

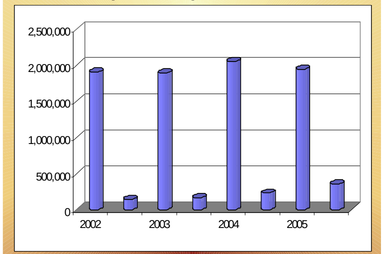
TABLE 35: FOREIGN CURRENCY TRNSACTIONS - JUNE 2005

Currency	USD	GBP	EURO
Volume ('000')	159.4	2	5.1
Value (m)	1,202.67	19.83	78.37
Kshs equiv (m)	94,469.73	2,892.99	7,830.73

Source: Banking Services Division.
Average Rates USD=78.55, GBP=145.89, EURO=99.92

Source: Central Bank of Kenya

CHART 25: NATIONAL CLEARING TURNOVER (NOMINAL)



Source: Central Bank of Kenya

In terms of volume and value US$ denominated transactions dominated the DFCC clearing house transactions. The US$ transactions amounted to Ksh 94.5 billion compared with Ksh 2.9 billion and Ksh 7.8 billion respectively for the Sterling pound and the Euro.

Payment System Developments

The National Payment System (NPS) Operations Committee continues to guide NPS modernization. During the year under review, the Domestic Foreign Currency Clearing System (DFCC) continued to operate alongside the Kenya Shilling clearing and settlement process at the Central Bank of Kenya through use of commercial banks settlement accounts. This made the system more accessible to all commercial banks and subject to closer oversight by the Central Bank.

The framework and strategy document outlining Kenya's Payments System modernization strategies was officially launched in September 2004. To further develop the National Payments System, the Bank in collaboration with the Kenya Bankers Association (KBA), will continue with the project on cheque truncation whose background work is underway. This will ensure that clearing cheques remain at the bank of deposit and their images electronically transferred to the bank of issue for authentication. This process will speed up clearing of such cheques in addition to reducing costs of transporting them from one bank to another.

Legal Framework

In the Budget speech for fiscal year 2004/2005, the Minister for Finance underlined the need for Kenya to develop a payments infrastructure to achieve an efficient, safe and reliable national payment and settlement system. He proposed to table the National Payments System and Electronic Funds Transfer Bills in Parliament, and to amend the Bills of Exchange Act CAP 27, to facilitate the Cheque Truncation System (CTS). The Bills have been forwarded to the Attorney General in readiness for publishing and subsequent tabling in the National Assembly. These Bills will facilitate the realization of a safe and efficient Payments System in Kenya.

Real Time Gross Settlement (RTGS) System

Kenya's Real Time Gross Settlement System (RTGS), also referred to as the Kenya Electronic Payment and Settlement System (KEPSS) was implemented during the year. The Bank, in an international competitive tendering process in August 2004, identified the Montran Corporation to provide an RTGS system. A contract for the supply and installation of the RTGS system was entered into on 1st March 2005 and the system successfully went live on July 29, 2005. All commercial banks in Kenya are participants in this system.

Other Initiatives of NPS

During the year ending June 2005, the East African Payment Systems Harmonization (EAPSH) Committee, held a meeting at the Kenya School of Monetary Studies, to discuss the Payment System Oversight benchmarks developed by member countries. The Committee prepared a joint status report on the benchmarks.

In the Monetary Affairs Committee (MAC) meeting of the three East African Central Bank governors, held in Arusha in May 2005, EAPSH Committee was directed to harmonize their Payments Systems Oversight benchmarks.

OUTLOOK

Economic recovery is expected to sustain momentum through the fiscal year 2005/06, with real GDP projected to grow by 5 percent during the period, up from the 4.6 percent estimated growth in the fiscal year 2004/05.

The improved economic performance in the fiscal year 2005/06 will be underpinned by continued macroeconomic stability, rising exports of goods and services in the context of strong global growth, improved agricultural performance given the good weather conditions, and the vibrant tourism sector. The agricultural sector in particular, which accounts for nearly a quarter of GDP and over 50 percent of exports, is poised to realise improved growth in the fiscal year 2005/06 following favourable weather conditions realized with the onset of the good long rains between April and July, and the positive expectations on the short rains in the last quarter of 2005. This scenario will be complemented by the Government's efforts directed at fixing the poor state of infrastructure in the road, power and railway sectors, and minimizing the lengthy clearing procedures at the Port of Mombasa.

On the macroeconomic front, inflation is expected to ease with improved supplies of food and the stability of the shilling that continues to check imported inflation. Monetary policy will continue to focus on containing inflation within levels consistent with the other macroeconomic targets.

ANNUAL REPORT AND FINANCIAL STATEMENTS
FOR THE YEAR ENDED 30 JUNE 2005

Table of Contents | Page

DIRECTORS' REPORT
FOR THE YEAR ENDED 30 JUNE 2005

The directors submit their report together with the audited financial statements for the year ended 30 June 2005, incorporating Kenya School of Monetary Studies Limited, a company limited by guarantee and wholly owned by the Bank.

1. Establishment

The Bank was established under the Central Bank of Kenya Act (the Act), Cap.491.

2. Principal activities

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

3. Results

The results for the year are set out on page 80.

4. Dividend

The board of directors do not recommend the payment of a dividend (2004 – KShs 4,500 million)

5. Directors

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

6. Auditors

KPMG Kenya were appointed in the year in place of Ernst & Young, and will continue in office upto the conclusion of the financial statements for the year ending 30 June 2006.

7. Approval of financial statements

The financial statements were approved at a meeting of the directors held on 9 September 2005.

BY ORDER OF THE BOARD

John M Gikonyo
Board Secretary

Date: 9 September 2005

STATEMENT OF DIRECTORS' RESPONSIBILITIES

We, the directors certify that:

1. We are responsible for the preparation of financial statements for each financial year which present a true and fair view of the state of affairs of the Bank and of its operating results for that year. We are also responsible to ensure that the Bank keeps proper accounting records which disclose with reasonable accuracy, the financial position of the Bank.

2. We accept responsibility for the annual financial statements, which have been prepared using appropriate accounting policies supported by reasonable and prudent judgement and estimates, in accordance with International Financial Reporting Standards and in the manner required by the Central Bank of Kenya Act.

3. We are responsible for safeguarding the assets of the Bank.

4. We are responsible for establishing and maintaining systems of internal control designed to provide reasonable assurance as to the integrity and reliability of the Bank's financial reporting.

5. We are of the opinion that the financial statements for the year ending 30 June 2005 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

Date: 9 September 2005

STATEMENT OF CORPORATE GOVERNANCE

The Central Bank of Kenya is wholly owned by the Government of Kenya. The Bank is established by and derives its authority and accountability from CBK Act Cap 491. The Bank is committed to maintaining the highest standards of integrity, professionalism and business ethics in all its operations.

Board of Directors

Section 11 of the CBK Act Cap 491 provides that the Board of Directors shall constitute of the Governor who is also the Chairman, Deputy Governor, who shall also be the Deputy Chairman, the Permanent Secretary to the Treasury, who is a non-voting member and five Non-Executive Directors. Other than the Permanent Secretary to the Treasury, all the others are appointed by the President of the Republic of Kenya for terms of four years each and are eligible for reappointment provided that no Governor, Deputy Governor or director shall hold office for more than two terms.

The current Governor, Dr. Andrew K. Mullei, took up his appointment on 4th March 2003 while Mrs. Jacinta W. Mwatela was appointed Deputy Governor on 12th May 2005 replacing Dr. Edward Sambili. Currently there are four Non-Executive Directors who are all serving their first term. All the Non-Executive Directors are independent of management and free from any business or other relationship, which could interfere with the exercise of their independent judgement.

Board Meetings

The Board meets once every six weeks and has a formal schedule of matters reserved for it. The Directors are given appropriate and timely information so that they can maintain full and effective control over strategic, financial and operational issues. The Board is not involved in the conduct of day-to-day business as this is a responsibility given to the Governor by the CBK Act Cap 491. It however, retains responsibility for determining the policy of the Bank.

The Board has appointed two sub committees with specific responsibilities and the chairmen of these sub-committees submit regular reports to the Board through the secretariats. The committees and their respective responsibilities are as follows:

Audit Committee

The Audit Committee is chaired by Mr. Paul Spence and has three other members who are Non-Executive Directors having experience in Accounting, Auditing, Banking and Financial Management. The committee currently meets on a monthly basis and as necessary. Its responsibilities are to:-

- Keep under review the efficiency and effectiveness of internal controls in the Bank;
- Keep under review financial information and improving the quality of financial reporting with particular attention to compliance with legal and reporting requirements;
- Receive and consider the Bank's annual budget;
- Review the effectiveness of the Internal Audit Function and reports received there-from;
- Review the External Auditors Audit scope timetables and approach; their performance and their findings;
- Recommend on the appointment of the external auditors and their fees;
- Review the Bank's annual financial statements prior to their submission to the Board;
- Review the Banks' Risk Management Policies and Procedures.

Tender Committee

The Committee is presently chaired by Mr. Owen N. Koimburi and membership includes two other Non-Executive Directors, the Governor and the Deputy Governor together with three Heads of Departments. The Committee meets on monthly basis and as need arises. The roles and responsibilities of the Committee are as under:

- To award contracts through open tender, restricted tenders, request for proposals or direct procurement where the contract value per item exceeds five hundred thousand shillings per item;
- To approve bids through open tender for sale of Central Bank stores;
- To approve variations of contract conditions previously awarded by the Committee.
- To review tender documents and request for proposals where the estimated contract value exceeds KShs 1 million.

Functionally, the Committee formulates and oversees the implementation of all the procurement and disposal policies of the Central Bank and ensures that all the procurement regulations, standards and best practices are fully complied with in accordance with the Exchequer and Audit Act – Procurement Rules and Regulations (2002).

Management Structure

The Central Bank's Senior Management team is made up of the Governor, the Deputy Governor and the heads of the Bank's various departments as indicated on page vi and vii. The posts of Governor and Deputy Governor are set out by statute in the CBK Act Cap 491 of the Laws of Kenya. The Senior Management meets regularly to review the overall performance of the Bank.

There are various other Management Committees, which advise the Governor on specific issues in order to enable him to discharge his responsibilities as the CEO.

Directors Emoluments and Loans

The remuneration paid to the Directors for services rendered during the financial year 2004/2005 is disclosed in a note to the financial statements. The Non Executive Directors are paid a monthly retainer fee and a sitting allowance for every meeting attended. There were no loans to Non-Executive Directors during the year.

Code of Ethics

The Bank is committed to the highest standards of integrity, behavior and ethics. A formal code of ethics for all employees has been approved by the Board and is fully implemented. All employees of the Bank are expected to avoid activities and financial interests, which could give rise to conflicts of interest with their responsibilities in the Bank. Strict rules of conduct apply to the entire Bank's staff under the staff rules and regulations.

Internal Controls

The management of the Bank has put in place a series of internal control mechanisms to ensure the reporting of complete and accurate accounting information. Procurement of goods and services is strictly done under the Exchequer and Audit Rules and Regulations (2002). In all operational areas of the Bank, workflows have been structured in a manner that allows adequate segregation of duties.

Authorizations and Internal Audit

All the expenditure of the Bank must be authorized in accordance with a comprehensive set of Bank policies and procedures. There is a budget, which is approved by the Board before commencement of the financial year. The Board receives regular management accounts comparing actual outcomes against budget as a means of monitoring actual performance of the Bank.

The internal audit function is performed by Internal Audit and Risk Management department which is also responsible for monitoring and providing advice on the Bank's risk management framework. All reports of the Internal Audit are available to the Audit Committee of the Board.

Transparency

The Bank publishes an Annual Report, Monthly Economic Review, Weekly Release, Statistical Bulletin and Monetary Policy Statement which explains current monetary policy and also provides the expected monetary policy stance. In addition, the Bank issues policy briefs to the Treasury on both the monetary and fiscal policies. On an annual basis, the Financial Report is published in the Kenya Gazette.

REPORT OF THE INDEPENDENT AUDITORS TO THE MEMBERS OF

We have audited the financial statements set out on pages 80 to 99 for the year ended 30 June 2005. We have obtained all the information and explanations, which to the best of our knowledge and belief were necessary for the purposes of our audit. The financial statements are in agreement with the books of account.

Respective responsibilities of directors and independent auditors

As stated on page 75, the directors are responsible for the preparation of financial statements that give a true and fair view of the state of affairs of the Bank and its operating results. Our responsibility is to express an 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 the audit to obtain reasonable assurance as to whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting policies used and significant estimates made by the directors, as well as evaluating the overall presentation of the financial statements. We believe that our audit provides a reasonable basis for our opinion.

Opinion

In our opinion, proper books of account have been kept and the financial statements give a true and fair view of the state of the Bank's financial position at 30 June 2005 and of its operating results and cash flows for the year then ended and comply with International Financial Reporting Standards and the Central Bank of Kenya Act.

Date: 9 September 2005

PROFIT AND LOSS ACCOUNT
FOR THE YEAR ENDED 30 JUNE 2005

	Note	2005 KShs million	2004 KShs million
Interest income	2	5,033	3,844
Interest expense	3	(364)	(130)
Net interest income		4,669	3,714
Fee and commission income	4	3,783	4,374
Foreign exchange (expenses)/income	5	(3,071)	12,781
Other operating income	6	184	274
Operating income		5,565	21,143
Operating expenses	7	(5,685)	(4,333)
Impairment losses	9	(4,014)	(11,677)
(Loss)/profit for the year		(4,134)	5,133
Dividends:			
Proposed dividend for the year	10	-	4,500

The notes set out on pages 84 to 99 form an integral part of these financial statements.

BALANCE SHEET
AS AT 30 JUNE 2005

	Note	2005 KShs million	2004 KShs million
ASSETS			
Balances due from banking institutions and gold holdings	11	119,757	109,856
Items in the course of collection		5,468	4,622
Investment in government securities	12	7	3
Loans and advances	13	9,414	13,446
Other assets	14	2,810	442
Retirement benefit asset	15	478	511
Property and equipment	16	1,193	625
Prepaid operating lease rentals	17	289	292
Due from Government of Kenya	18	35,917	41,917
TOTAL ASSETS		175,333	171,714
LIABILITIES			
Currency in circulation	19	67,322	62,621
Deposits	20	79,897	75,776
International Monetary Fund	21	14,873	10,630
Amounts repayable under repurchase agreements	22	5,334	6,144
Other liabilities	23	1,009	1,011
TOTAL LIABILITIES		168,435	156,182
EQUITY AND RESERVES (Page 11)			
Share capital	24	1,500	1,500
General reserve fund	25	5,398	9,532
Proposed dividend		-	4,500
TOTAL EQUITY AND RESERVES		6,898	15,532
TOTAL LIABILITIES AND EQUITY		175,333	171,714

The financial statements set out on pages 77 to 99 were approved by the Board of Directors for issue on 9 September 2005 and signed on its behalf by:

Governor

Director

The notes set out on pages 13 to 28 form an integral part of these financial statements.

STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED JUNE 30 2005

	Share capital KShs million	General reserve fund KShs million	Proposed dividend KShs million	Total KShs million
Year ended 30 June 2004				
Balance at start of the year	1,500	8,899	3,500	13,899
Profit for the year	-	5,133	-	5,133
Dividends:				
- For 2003 paid	-	-	(2,500)	(2,500)
- 2003 Applied to amounts due from Government of Kenya (Note 18)	-	-	(1,000)	(1,000)
- Proposed for 2004	-	(4,500)	4,500	-
Balance at end of the year	1,500	9,532	4,500	15,532
Year ended 30 June 2005				
Balance at start of the year	1,500	9,532	4,500	15,532
Loss for the year	-	(4,134)	-	(4,134)
Dividends:				
- For 2004 paid	-	-	(2,500)	(2,500)
- *2004 Applied to amounts due from* Government of Kenya (Note 18)	-	-	(2,000)	(2,000)
Balance at end of the year	1,500	5,398	-	6,898

The notes set out on pages 84 to 99 form an integral part of these financial statements.

CASH FLOW STATEMENT
FOR THE YEAR ENDED 30 JUNE 2005

	Note	2005 KShs million	2004 KShs million
Operating activities			
Net cash generated by operating activities	26 (a)	11,142	11,677
Investing activities			
Liquidation of government securities		-	402
Purchase of property and equipment		(1,177)	(189)
Proceeds from disposal of property and equipment		9	3
Investment in International Monetary Fund-SDR accounts		(9)	(9)
Net cash (utilised)/generated from investing activities		(1,177)	207
Financing activities			
Dividends paid		(2,500)	(2,500)
Currency in circulation		4,701	7,390
Net cash from financing activities		2,201	4,890
Net increase in cash and cash equivalents		12,166	16,774
Cash and cash equivalents at start of year		101,940	85,166
Cash and cash equivalents at end of year	26(b)	114,106	101,940

The notes set out on pages 84 to 99 form an integral part of these financial statements.

NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 30 JUNE 2005

1. SIGNIFICANT ACCOUNTING POLICIES

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 Kenya Shillings (KShs) and are prepared under the historical cost convention except for measurement at fair value of certain investments.

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

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period, or in the period of the revision and future periods if the revision affects both current and future periods.

(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) Consolidation principle

The financial statements include the operations of the Bank and its subsidiary, Kenya School of Monetary Studies, which is a company limited by guarantee and where Central Bank of Kenya has full control.

(c) 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.

Rental income from lease of property is recognised in the profit and loss account on a straight-line basis over the term of the lease.

(d) 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.

(e) Employee benefits

(i) Retirement benefits

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

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

Where the calculation results in a benefit to the Bank, the recognised asset is limited to the net total of any unrecognised actuarial losses and past service costs and the present value of any future refunds from the plan or reduction in future contributions to the plan. Actuarial gains and losses are charged to the 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.

(ii) Other employee benefits

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

Contracted staff are eligible to a gratuity based on the employment terms. A provision is made for the estimated liability of such gratuity payable and charged to the profit and loss account.

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

(f) Property and equipment

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

Depreciation is charged to the profit and loss account on a straight-line basis at the following rates:

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

(g) 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.

(h) Loans and provisions for loan impairment

Loans are stated at outstanding amount less provision for impairment.

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

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

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

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

(h) Loans and provisions for loan impairment (continued)

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 uncollectible, it is written off against the related provision for impairment. Subsequent recoveries are credited to the income statement if previously written off.

(i) Dividends payable

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

(j) Provisions

Provisions are recognised when the Bank has a present legal or constructive obligation as a result of past events and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate of the amount of the obligation can be made.

(k) Offsetting of financial assets and liabilities

Financial assets and liabilities are offset and the net amount reported on the balance sheet when there is a legally enforceable right to set-off the recognised amount and there is an intention to settle on a net basis, or to realise the asset and settle the liability simultaneously.

(l) Impairment

The carrying amounts of the Bank's assets are reviewed at each balance sheet date to determine whether there is any indication of impairment. If such condition exists, the asset's recoverable amount is estimated and an impairment loss recognised whenever the carrying amount of an asset exceeds its recoverable amount.

(m) Operating leases

Leases where a significant portion of the risks and rewards of ownership are retained by the lessor, are classified as operating leases. Payments made under operating leases are charged to the profit and loss account on a straight-line basis over the period of the lease.

(n) Receivables

Amounts due from Government of Kenya and other assets are stated at their cost less impairment losses.

(o) Cash and cash equivalents

Cash and cash equivalents comprises of cash balances, bank deposits, current accounts, gold holding, government securities with maturity of upto 3 months from the date of issue.

(p) Comparatives

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

		2005 KShs million	2004 KShs million
2.	**INTEREST INCOME**		
	Foreign investments earnings	3,299	2,556
	Local investments earnings	1,672	1,220
	Other interest earnings	62	68
		5,033	3,844
3.	**INTEREST EXPENSE**		
	Interest on monetary policy issues	323	102
	Interest paid to International Monetary Fund	40	27
	Interest on customer deposits	1	1
		364	130
4.	**FEES AND COMMISSION INCOME**		
	Commission on sale of government securities	3,782	4,316
	Special projects agency fees	1	58
		3,783	4,374
5.	**FOREIGN EXCHANGE (EXPENSES)/INCOME**		
	Gains on sale of foreign exchange	566	848
	Foreign exchange translation gain	(3,637)	11,933
		(3,071)	12,781
6.	**OTHER OPERATING INCOME**		
	Rent received	15	16
	Proceeds from disposal of property and equipment	9	3
	Tuition fees and other charges	125	87
	Miscellaneous income	35	168
		184	274
7.	**OPERATING EXPENSES**		
	Currency expenses	1,925	1,145
	Depreciation	609	281
	Property maintenance expenses	331	262
	Auditors' remuneration	4	4
	Banking expenses	4	5
	Operating lease rentals	3	3
	Staff costs	2,130	2,128
	Other expenses	679	505
		5,685	4,333

		2005 KShs million	2004 KShs million
8.	STAFF COSTS		

The following items are included within staff costs:

	2005 KShs million	2004 KShs million
Retirement benefit costs - defined benefit scheme (Note 15)	271	230

9. IMPAIRMENT LOSSES

	2005	2004
Losses and write-offs of loans	14	35
Impairment loss on amount due from Government of Kenya (Note 18)	4,000	11,642
	4,014	11,677

10. DIVIDENDS

The board of directors do not recommend the payment of a dividend in respect of the year ended 30 June 2005 (2004 – KShs 4,500 million).

11. BALANCES DUE FROM BANKING INSTITUTIONS AND GOLD HOLDINGS

	2005 KShs million	2004 KShs million
Current accounts	3,059	2,202
Term deposits	109,858	99,718
Domestic forex currency cheque clearing	1,164	-
Forex travellers cheques	2	2
Gold holdings	16	15
Cash and cash equivalents	114,099	101,937
Accrued interest on foreign investments	446	301
Special Drawing Rights	50	41
Total own resources	114,595	102,279
Special project accounts	5,162	7,577
	119,757	109,856

12. INVESTMENT IN GOVERNMENT SECURITIES

	2005	2004
Treasury bills	7	3

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

13. LOANS AND ADVANCES

	2005 KShs million	2004 KShs million
Advances to banks under liquidation	8,259	8,259
Government overdraft account (see below and Note 27)	5,225	9,232
Advances to employees (Note 27)	1,998	1,915
IMF funds on-lent to the Government (Note 27)	2,221	2,331
	17,703	21,737
Provision for loan impairment	(8,289)	(8,291)
Net advances as at 30 June	9,414	13,446

Movement in the provision for loan impairment is as follows:

	2005	2004
At start of the year	(8,291)	(8,263)
Additional provisions made in the year	(13)	(28)
Recoveries in the year	15	-
At end of the year	(8,289)	(8,291)

Section 46(3) of the Central Bank of Kenya Act sets the limit of the Government of Kenya's overdraft facility at 5% of the Gross Recurrent Revenue as reported in the latest audited financial statements. The limit stands at KShs 8,908,699,851 based on the Government financial statements for 2001/2002, which are the latest audited financial statements at the date of approval of these financial statements. The limit for the previous year was KShs 9,232,144,274 based on the Government financial statements for 2000/2001.

14. OTHER ASSETS

	2005 KShs million	2004 KShs million
Impersonal accounts	1,864	-
Sundry debtors	946	442
	2,810	442

15. RETIREMENT BENEFIT ASSET

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

The amounts recognised in the balance sheet are determined on the basis of an actuarial review carried out by Alexander Forbes Financial Services Limited as at 30 June 2005.

	2005 KShs million	2004 KShs million
Present value of funded obligations	7,062	5,932
Fair value of plan assets	(8,075)	(7,146)
Present value of net asset	(1,013)	(1,214)
Unrecognised actuarial gain	535	703
Asset in the balance sheet	(478)	(511)

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

	2005	2004
Current service costs	375	323
Interest costs	541	459
Expected return on plan assets	(645)	(552)
Total expenses included in operating expenses	271	230

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

	2005	2004
Net expense recognised in the profit and loss account	271	230
Employer contributions	(238)	(321)
Movement in the asset recognised in the balance sheet	33	(91)
Actual return on plan assets	899	934

The principal actuarial assumptions at the balance sheet date were:

	2005	2004
Discount rate (p.a)	9%	9%
Salary increase (p.a)	7%	7%
Expected return on plan assets (p.a)	9%	9%
Future pension increases	0%	0%

16. PROPERTY AND EQUIPMENT

	Land and buildings KShs million	Motor vehicles KShs million	Furniture and equipment KShs million	Total KShs million
Cost				
At start of year	1,004	179	1,448	2,631
Additions	-	41	1,136	1,177
Disposals	-	(27)	-	(27)
At end of the year	1,004	193	2,584	3,781
Depreciation				
At start of the year	750	164	1,092	2,006
Charge for the year	85	16	508	609
On disposal	-	(27)	(27)	
At end of the year	835	153	1,600	2,588
Net book value				
At 30 June 2005	169	40	984	1,193
At 30 June 2004	254	15	356	625

17. PREPAID OPERATING LEASE RENTALS

Operating lease rentals are carried at historical cost less amortisation over the period of the lease. The breakdown is as follows:

	2005 KShs million	2004 KShs million
Cost		
At beginning and end of the year	300	300
Amortisation		
At start of the year	8	5
Amortisation charge for the year	3	3
At end of year	11	8
Net carrying value at end of the year	289	292

18. DUE FROM GOVERNMENT OF KENYA

	2005	2004
Recoverable from dividends:		
Revaluation account	16,642	17,642
Loan due from Government	36,917	36,917
Impairment loss	(15,642)	(11,642)
Recovery in the year	(2,000)	(1,000)
	35,917	41,917
Impairment provision:		
Balance at start of the year	11,642	-
Additions in the year	4,000	11,642
Balance at end of the year	15,642	11,642

The loan due from Government of Kenya arose from overdrawn accounts which were converted to a loan with effect from 1 July 1997 after an amendment to the Central Bank of Kenya Act Cap 491. The loan which stood at KShs 35,917 million at 30 June 2005 bears interest at the rate of 3% per annum from 1 July 2003. The repayment period is 36 years from 1 July 2004.

19. CURRENCY IN CIRCULATION

	2005 KShs million	2004 KShs million
Kenya notes	64,416	59,973
Kenya coins	2,901	2,643
Commemorative coins	5	5
	67,322	62,621

20. DEPOSITS

	2005 KShs million	2004 KShs million
Banks – Kenya	27,127	27,491
– External	19	29
Domestic forex cheques clearing	949	-
Non-bank financial institutions	113	124
Other public entities and project accounts	7,914	10,491
Government of Kenya	43,775	37,641
	79,897	75,776

21. INTERNATIONAL MONETARY FUND

Kenya has been a member of the International Monetary Fund (IMF) since 1966. The Central Bank of Kenya (CBK) is the designated depository for the IMF's holdings of Kenya's currency. IMF currency holdings are held in the No.1 and No.2 Accounts, which are deposit accounts of the IMF with the CBK.

	2005 SDRs million	2005 KShs million	2004 SDR's million	2004 KShs million
International Monetary Fund Account no.1	20	2,259	20	2,376
International Monetary Fund Account no.2	-	1	-	-
International Monetary Fund – PRGF Account	94	10,392	51	5,923
International Monetary Fund – On lent to Government of Kenya	20	2,221	20	2,331
	134	14,873	91	10,630

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

	2005 SDRs million	2005 KShs million	2004 SDR's million	2004 KShs million
Security at 30 June	238	27,690	216	24,552

22. AMOUNTS REPAYABLE UNDER REPURCHASE AGREEMENTS

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

23. OTHER LIABILITIES

	2005 KShs million	2004 KShs million
Impersonal accounts	-	478
Sundry creditors	564	407
Refundable deposits	258	58
Development deposits	155	36
Amount pending litigation	32	32
	1,009	1,011

24. SHARE CAPITAL

	2005 KShs million	2004 KShs million
Authorised share capital	5,000	5,000
Issued and fully paid	1,500	1,500

25. GENERAL RESERVE FUND

The general reserve fund is a reserve fund where at least 10% of the net annual profits of the Bank has been transferred at the end of each financial year. This is after allowing for expenses for operation and after provision has been made for bad and doubtful debts, depreciation in assets, contribution to staff benefit fund, and such other contingencies and accounting provisions as the Bank deems appropriate.

26. NOTES TO THE CASH FLOW STATEMENT

	2005 KShs million	2004 KShs million
(a) Cash flows from operating activities		
(Loss)/profit for the year	(4,134)	5,133
Adjustments for:		
Impairment losses on amount due from Government of Kenya	4,000	11,677
Depreciation	609	281
Amortization of prepaid operating leases	3	3
Decrease/(increase) in defined benefit scheme asset	33	(91)
Gain on disposal of property and equipment	(9)	(3)
Operating profit before working capital changes	502	17,000
Net decrease/(increase) in loans and advances	4,032	(1,453)
Decrease in amounts repayable under repurchase agreements	(810)	(6,524)
Increase in deposits	4,121	1,319
Increase in balance with International Monetary Fund	4,243	2,542
Decrease/(increase) in project accounts	2,415	(635)
Increase in accrued interest on balances due from banking institutions	(145)	(114)
Increase in items in the course of collection	(846)	(585)
Increase in other assets	(2,368)	(324)
(Decrease)/increase in other liabilities	(2)	451
Net cash generated by operations	11,142	11,677

(b) Cash and cash equivalents

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

	2005 KShs million	2004 KShs million
Term deposits	109,858	99,718
Current accounts	3,059	2,202
Domestic forex cheques clearing	1,164	-
Travellers cheques	2	2
Gold holdings	16	15
	114,099	101,937
Investment in Government securities	7	3
	114,106	101,940

27. 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.

(i) Loans

The Bank extends loan facilities to its members of staff, the Governor and the Deputy Governor. Loans and advances (Note 13) include advances to employees that as at 30 June 2005 amounted to KShs 1,998 million (2004 - KShs 1,915 million). The advances are at preferential rates of interest determined by the Bank.

	2005 KShs million	2004 KShs million
(ii) Loans to executive directors		
At start of the year	16	9
Loans advanced during the year	-	11
Loan repayments	(10)	(4)
At end of the year	6	16
(iii) Director's emoluments		
Fees to non executive directors	9	4
Remuneration to executive directors	36	26

(iv) Government of Kenya

Transactions entered into with the Government include:

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

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

	2005 KShs million	2004 KShs million
Due from Government of Kenya (Note 18)	35,917	41,917
Overdraft account (Note 13)	5,225	9,232
IMF funds on-lent to the Government (Note 13)	2,221	2,331
Government of Kenya deposits (Note 20)	43,775	37,641
Investments in Government of Kenya securities (Note 12)	7	3

(v) Deposit Protection Fund Board

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

The balance outstanding from The Deposit Protection Fund Board and included in other assets as at year end was KShs 4 million (2004: KShs 8 million).

(vi) Kenya School of Monetary Studies

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

28. Liquidity Risk

The table below analysises assets and liabilities into relevant maturity groupings based on the remaining period at 30 June 2005 to the contractual maturity date.

ASSETS	On demand KShs million	Due within 3 months KShs million	Due between 3-12 months KShs million	Due between 1-5yrs KShs million	Due after 5 years KShs million	Total KShs million
Balances due from banking institutions and gold holdings	9,849	109,858	-	-	50	119,757
Loans and advances	5,225	546	333	1,808	1,502	9,414
Investments in government securities	-	7	-	-	-	7
Items in the course of collection	5,468	-	-	-	-	5,468
Other assets	-	2,809	-	-	1,483	4,292
Retirement benefit asset	-	-	-	-	478	478
Due from Government of Kenya	-	-	-	5,000	30,917	35,917
TOTAL ASSETS	**20,542**	**113,220**	**333**	**6,808**	**34,430**	**175,333**
LIABILITIES						
Currency in circulation	67,322	-	-	-	-	67,322
Deposits	79,897	-	-	-	-	79,897
International Monetary Fund	-	-	413	1,808	12,652	14,873
Amounts repayable under repurchase	-	5,334	-	-	-	5,334
Other liabilities	-	1,009	-	-	-	1,009
Equity and reserves	-	-	-	-	6,898	6,898
TOTAL LIABILITIES AND EQUITY	**147,219**	**6,343**	**413**	**1,808**	**19,550**	**175,333**
Liquidity gap 2005	**-126,677**	**106,877**	**-80**	**5,000**	**14,880**	**-**
As at 30 June 2004:						
Total assets	23,649	102,586	314	10,324	34,841	171,714
Total liabilities and equity	138,397	11,655	1,031	9,323	11,308	171,714
Liquidity gap 2004	**-114,748**	**90,931**	**-717**	**1,001**	**23,533**	**-**

29. CURRENCY RISK

The various currencies to which the Bank is exposed at 30 June 2005 are summarised in the table below (all expressed in Kshs million).

	USD	GBP	EURO	SDR	GOLD	OTHER	TOTAL
Assets							
Balances due from banking institutions	42,591	46,198	30,867	-	-	35	119,691
Special Drawing Rights	-	-	-	50	-	-	50
Gold holdings	-	-	-	-	16	-	16
Total assets	42,591	46,198	30,867	50	16	35	119,757
Liabilities							
Balances due to IMF	-	-	-	14,873	-	-	14,873
Commissions for EEC Development Func	-	342	-	-	-	-	342
Forex bureaux deposits	783	-	231	-	-	-	1,014
Total liabilities	783	342	231	14,873	-	-	16,229
Net balance sheet position 2005	**41,808**	**45,856**	**30,636**	**-14,823**	**16**	**35**	**103,528**
As at 30 June 2004							
Total assets	34,460	39,230	36,021	41	15	89	109,856
Total liabilities	52	36	-	10,630	-	-	10,718
Net balance sheet position 2004	**34,408**	**39,194**	**36,021**	**-10,589**	**15**	**89**	**99,138**

30. 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	Between 3-12 months	Over 1 year	Non- interest bearing	Total
	KShs million	KShs million	KShs million	KShs million	KShs million
Assets					
Balances due from banking institutions and gold holdings	114,577	-	-	5,180	119,757
Loans and advances	5,226	488	3,700	-	9,414
Investment in government securities	7	-	-	-	7
Items in the course of collection	-	-	-	5,468	5,468
Other assets	-	-	-	4,292	4,292
Retirement benefit asset	-	-	-	478	478
Due from Government of Kenya	-	-	35,917	-	35,917
Total assets	119,810	488	39,617	15,418	175,333
Liabilities and Equity					
Currency in circulation	-	-	-	67,322	67,322
Deposits	-	-	-	79,897	79,897
International Monetary Fund	-	413	12,200	2,260	14,873
agreements	5,334	-	-	-	5,334
Other liabilities	-	-	-	1,009	1,009
Equity and reserves	-	-	-	6,898	6,898
Total liabilities and equity	5,334	413	12,200	157,386	175,333
Interest sensitivity gap 2005	**114,476**	**75**	**27,417**	**-141,968**	**-**
As at 30 June 2004					
Total assets	112,714	405	39,509	19,086	171,714
Total liabilities and equity	6,144	1,186	6,838	157,546	171,714
Interest sensitivity gap 2004	**106,570**	**-781**	**32,671**	**-138,460**	**-**

31. FAIR VALUES AND EFFECTIVE INTEREST RATES OF FINANCIAL ASSETS AND LIABILITIES

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

The effective interest rates for the principal financial assets and liabilities at 30 June 2005 and 2004 were in the following ranges:

	2005	2004
Assets		
Government securities	4.9%	4.9%
Deposits with overseas correspondent banks		
current accounts	0.0%	0.0%
term deposits (USD)	2.2%	1.1%
term deposits (Pounds Sterling)	4.8%	3.9%
term deposits (Euro)	2.0%	2.1%
Loans and advances – Commercial banks	9.2%	4.6%
Government of Kenya	6.2%	1.6%
Employees	3.0%	3.0%
Due from Government of Kenya	3.0%	3.0%
Liabilities		
Customer deposits	0%	0%

32. CONTINGENCIES AND COMMITMENTS

Contingencies

The Bank is party to various legal proceedings amounting to KShs 532 million at 30 June 2005 (2004 – KShs 334 million). Having regard to the legal advice received, and in all circumstances, the directors are of the opinion that these legal proceedings will not give rise to liabilities, which in aggregate, would otherwise have material effect on these financial statements.

Commitments	2005 KShs million	2004 KShs million
Contracted for	106	977
Authorised but not contracted for	42	-

33. EMPLOYEES

The average number of employees during the year was 1,253 (2004 – 1,255).

34. 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.