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LETTER OF TRANSMITTAL TO THE HONOURABLE MINISTER FOR FINANCE

In accordance with Section 54 of the Central Bank of Kenya Act, I have the honour to present to you the Annual Report and Statement of the Audited Accounts of the Central Bank of Kenya for the financial year ended June 30, 1998.

There were severe challenges in the year including poor weather conditions, dilapidated transport and communication infrastructure, power supply interruptions, insecurity and reduced foreign investor confidence which served to lower overall economic growth to 2.3% in 1997 from 4.6% in 1996.

Inflation remained low and within target, except for some acceleration that occurred towards the third quarter of the financial year following shortfall in supply of some goods and services, particularly food and transport. The shortfalls were direct consequences of adverse weather conditions. Tax measures introduced during the quarter and weakening of the shilling in the earlier part of the year also exerted pressure on prices. Monetary policy pursued over the financial year restrained expansion in the money supply to within target for the year.

The Government budget deficit deteriorated to 1.2% of GDP in 1997/98 from 1.0% of GDP in 1996/97 and impacted adversely on interest rates, investment and ultimately on economic growth. On the external front, the balance of payments recorded a deficit of US$ 197m in 1997/98 from a surplus of US$ 252m in the previous year. The turnaround in the balance of payments was as a result of deterioration in the capital account. Consequently, the Central Bank's reserves declined to US$ 770m, which was equivalent to 3.0 months of imports cover.

A generally sound banking environment was maintained throughout the financial year with many banks operating within the existing banking rules and regulations. The Central Bank reduced the cash ratio requirement from 18% to 15% to allow the banks more funds to lend.

Yours sincerely,

MICAH CHESEREM
GOVERNOR

BOARD OF DIRECTORS

MICAH CHESEREM
Governor and Chairman
Central Bank of Kenya

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Deputy Governor
Central Bank of Kenya

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Secretary to the Cabinet and
Head of Civil Service

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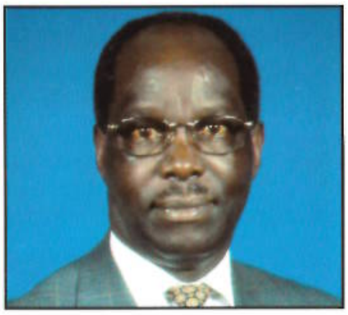
PROF. FRANCIS KIBERA
University of Nairobi

ANDREW WANYANDE
Businessman

SENIOR MANAGEMENT

MAURICE KANGA
Director, Research



DANIEL KIANGURA
Director, Management Information Services

REUBEN MARAMBII
Director, Banking

JONES NZOMO
Director, Finance

JOHN GIKONYO
Bank Secretary & Director, Human Resources

JACINTA MWATELA (Mrs)
Director, Supplies & Services

JOHN MURUGU
Director, Bank Supervision

SIMON ANZAGI
Director, Special Projects

JAMES OGUNDO
Director, Kenya School of Monetary Studies

NICHOLAS KIRITU
Chief Internal Auditor

INFLATION

Single digit inflation was the target of monetary policy for the financial year 1997/98 with the underlying inflation, that is inflation excluding changes in food prices, as the main indicator of price stability. The underlying month-on-month inflation accordingly, was successfully confined to a range of 4-7% throughout the first half of the financial year. The underlying month-on-month inflation however, reached double digit range during the second half of the year despite tight monetary policy stance pursued throughout the year. The entry of inflation into double digit range during the second half of the year was expected following the depreciation of the Kenya shilling earlier in the financial year. The impact of exchange rate depreciation on inflation was further reinforced by fiscal measures particularly the increase in Value Added Tax that became necessary following shortfalls in external financing of the budget.

The overall inflation which, unlike the underlying inflation, incorporates changes in food prices, also remained in single digit and above underlying inflation most of the first half of the year. The indicator however accelerated to double digit at the beginning of the second half of the year as a result of constraints in food supply occasioned by "El-nino" weather and transport problems.

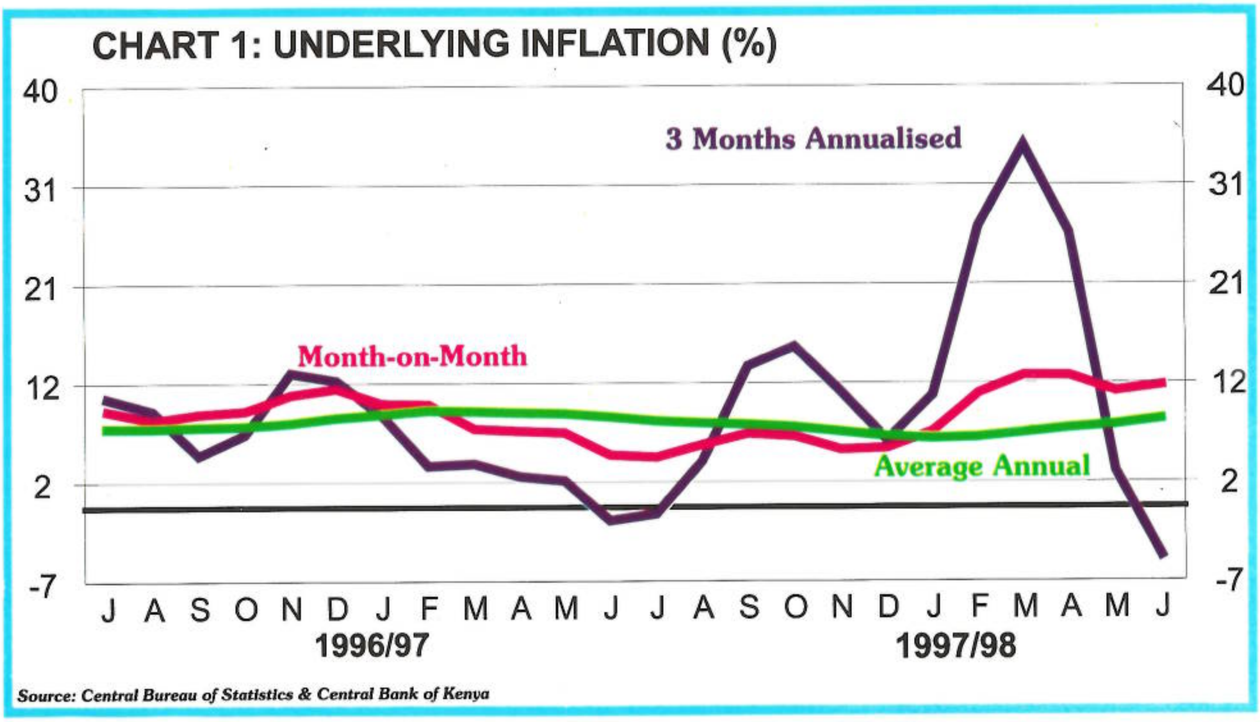
Underlying Inflation

Underlying inflation remained relatively low, but fluctuated substantially over the financial year:

- The underlying month-on-month inflation remained single digit throughout the first half of the financial year, but increased to 12.3% in the third quarter of the financial year before easing to 11.4% in June 1998.
- The underlying average annual inflation declined in the first half of the financial year before rising to 8.3% by June 1998 (Chart 1).

The rise in underlying inflation, during the second half of the financial year, was attributed to the following factors:

- Depreciation of the shilling exchange rate, that resulted in a loss of around 15.0% against the dollar in the financial year; and



- Additional tax measures, the Value Added Tax (VAT) and duties on petroleum products in particular, that were introduced to help contain the Government budget deficit.

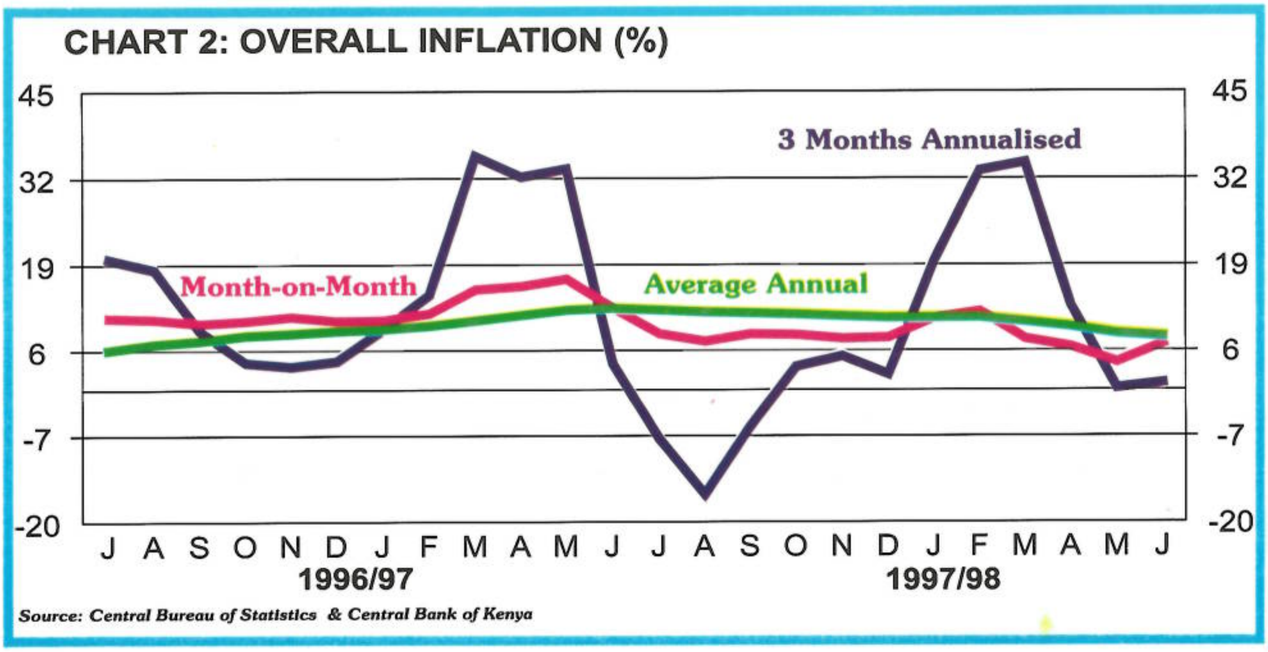
The inflationary pressures generated by these factors were, however, partly offset by the tight monetary policy in place that confined the expansion of broad money supply to well within the target of 11.0% during the financial year.

Overall Inflation

Overall inflation was on a downward trend during most of the financial year:

- Month-on-month inflation increased from 8.9% in July, 1997 to 12.3% in February, 1998, but eased to 7.4% by June, 1998;
- Three - months annualized inflation also increased from negative 7.1% in July, 1997 to 34.7% in the third quarter, then eased to 1.5% by end of financial year;
- Average annual inflation meanwhile declined steadily from 12.3% at the beginning of the financial year to 8.4% in June, 1998 (Chart 2).

The short lived increase in overall inflation during the third quarter of the financial year was mainly attributed to two factors:



- Shortfall in the supply of basic food following the "El-nino" weather condition; and
- Rising transport costs that still continue to affect most sectors of the economy including manufacturing and trade where pricing of products is more directly influenced by the transport costs.

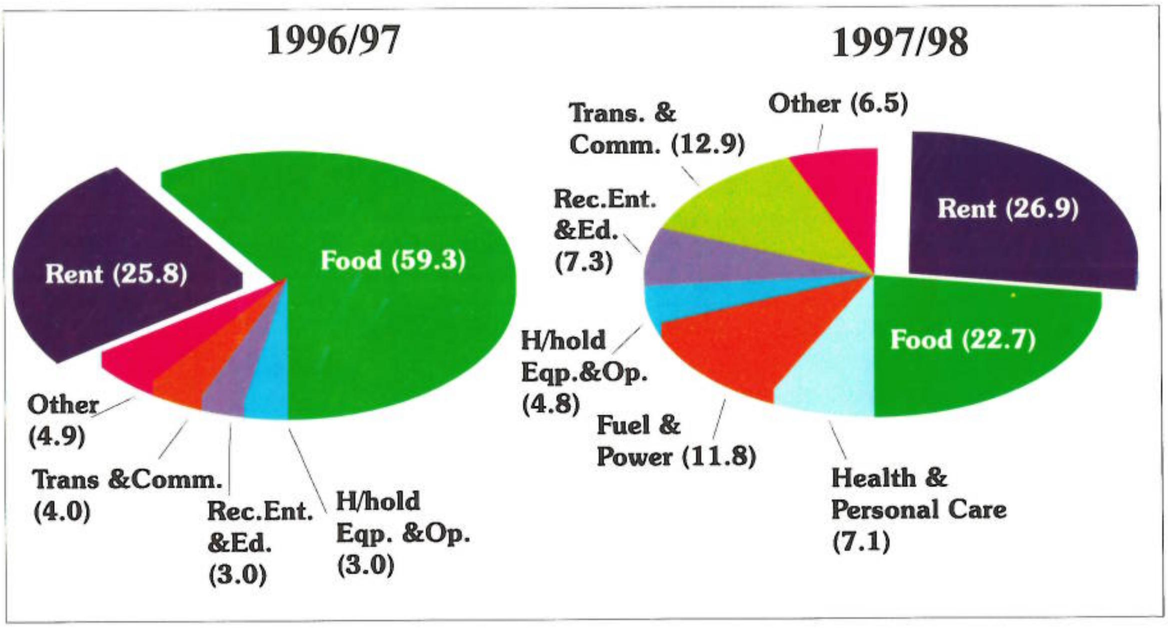
Income Groups and Inflation over the Financial year

The decline in inflation over the financial year was more pronounced in the goods and services purchased by the lower income group than for middle and upper income groups:

- The overall month-on-month inflation for the lower income group fell to 6.1% in June, 1998 from 9.8% in July, 1997:
- The month-on-month inflation for the middle and upper income groups however increased to 11.8% and 11.4% in June 1998 from 5.7% and 8.5% in July 1997, respectively.

The consumer items with the highest inflation over the financial year were rent, food items , fuel and power, and general transport (Chart 3).

CHART 3: DISTRIBUTION OF MONTH-ON-MONTH INFLATION (%) IN FINANCIAL YEAR 1996/97 AND 1997/98



Source : Central Bureau of Statistics & Central Bank of Kenya

Outlook on Inflation

A decline in inflation is expected in the current financial year. This decline is forecast on the basis of the restrained monetary and fiscal policies in place. These policies target an underlying month-on-month inflation of less than 5% by June, 1999. The restrained monetary and fiscal policies in 1998/99 will reinforce stability in the foreign exchange market which in turn will further help in achieving the objective of price stability.

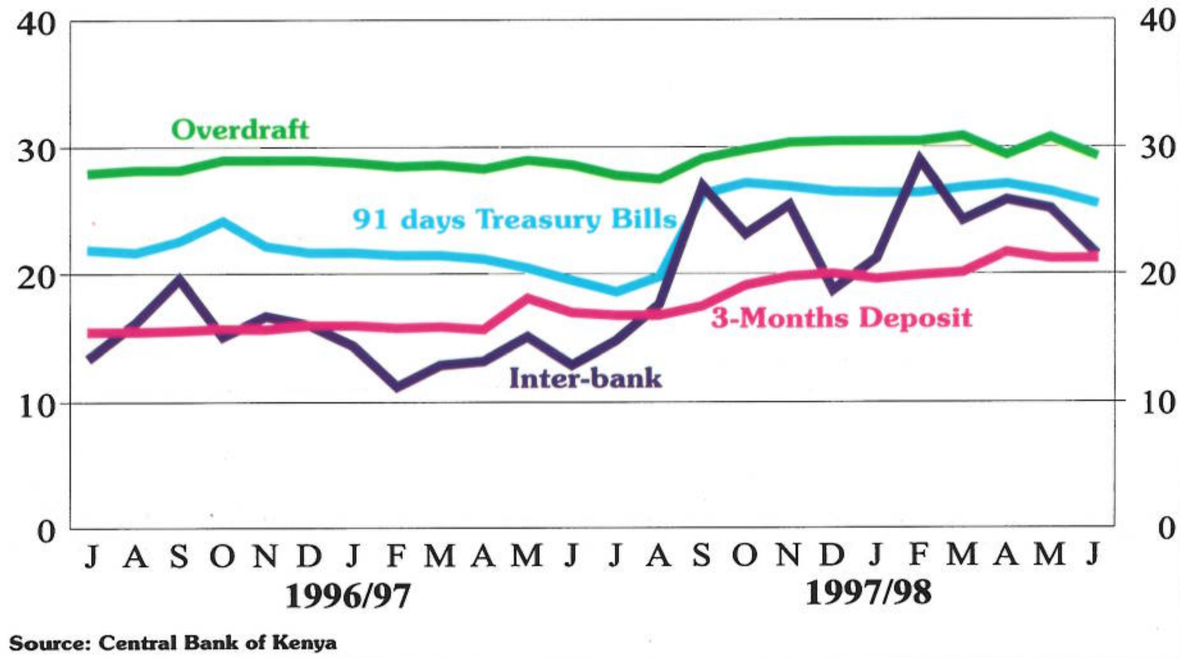
Interest rates adopted a rising trend early in the financial year (Table 1 and Chart 4). The upward trend commenced immediately upon implementation of tighter monetary policy that had become necessary to stabilize the foreign exchange market which had become volatile following suspension of Extended Structural Adjustment Facility (ESAF) program with the International Monetary Fund.

TABLE 1: INTEREST RATES (%)

	1997							1998					
	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
Overdraft	28.5	27.7	27.4	29.0	29.7	30.3	30.4	30.4	30.4	30.8	29.3	30.7	29.6
91 days Treasury bill	19.4	18.5	19.7	26.2	27.1	26.8	26.4	26.3	26.3	26.7	27.0	26.4	25.5
Inter-bank rate	12.9	14.8	17.6	26.9	23.1	25.4	18.7	21.2	28.9	24.2	25.8	25.1	21.7
3 months deposits	17.0	16.8	16.8	17.5	19.1	19.8	20.0	19.6	19.9	20.1	21.7	21.2	21.2
Savings	10.6	10.8	10.8	10.7	11.1	11.8	9.7	9.8	11.7	9.8	10.8	11.2	10.8

Source: Central Bank of Kenya

CHART 4: INTEREST RATES (%)



Source: Central Bank of Kenya

The rising trend in the interest rates was further reinforced in the year by increased demand pressure from the Government's borrowing needs, not only to meet the originally planned domestic financing but also to compensate for the external shortfall. The rising inflation in the second half of the financial year also exerted more pressure on the interest rates.

- The average interest on the 91 days Treasury bill which was 18.5% in July 1997 rose steadily to 27.1% in October 1997. The sharp increase was attributed to two related factors, namely:

    - desire to curb outflow of short term capital in the wake of confidence crisis following IMF suspension of further aid under the ESAF facility in July 1997; and

    - desire to cover shortfall in external financing of the budget deficit when the budget supporting shilling counterpart disbursement was frozen from other external sources following the suspension of financial assistance from the IMF.

    After intervening and resolving the crisis in the foreign exchange market, the Central Bank re-introduced tap sales of Treasury bills, alongside the primary auction, in order to curb the rising trend of the Treasury bill interest rate. Consequently, the Treasury bill interest rate stabilized at an average 27% from November 1997 to April 1998, before easing to 25.5% by June 1998.

- The average inter-bank rate increased from 12.9% in June 1997 to 26.9% by September 1997 following a shift of investible funds from deposits to Treasury bills and bonds to cash-in on the higher interest rates.

    - A liquidity shortfall developed in the inter bank money market, with some commercial banks resorting to borrowing from the Central Bank to meet the mandatory cash ratio requirement.

    - The Central Bank responded by reducing the mandatory cash requirement from 18% to 15% effective 1st October 1997 as a way of alleviating the liquidity crisis in the inter bank money market on a more permanent basis.

    - The inter-bank rate however, remained high averaging 24% between October 1997 and June 1998

- Commercial banks increased interest charged on overdrafts from 28.5% in June 1997 to 29.6% in June 1998 with the monthly overdraft rate averaging 29.6% in the year
- Commercial bank three month's deposits rate increased gradually to 21.2% in June 1998 from 17% in June 1997.

The Central Bank adopted two measures to ease pressure on interest rates during the twelve months to June 1998:

- reduction of the minimum liquidity ratio requirement for banks and NBFIs from 25% to 20% in July 1997;
- re-introduction of tap sales of Treasury bills in November 1997 which allowed unsuccessful investors in the primary market to invest in the bills at interest rates below those accepted in the primary market auctions.

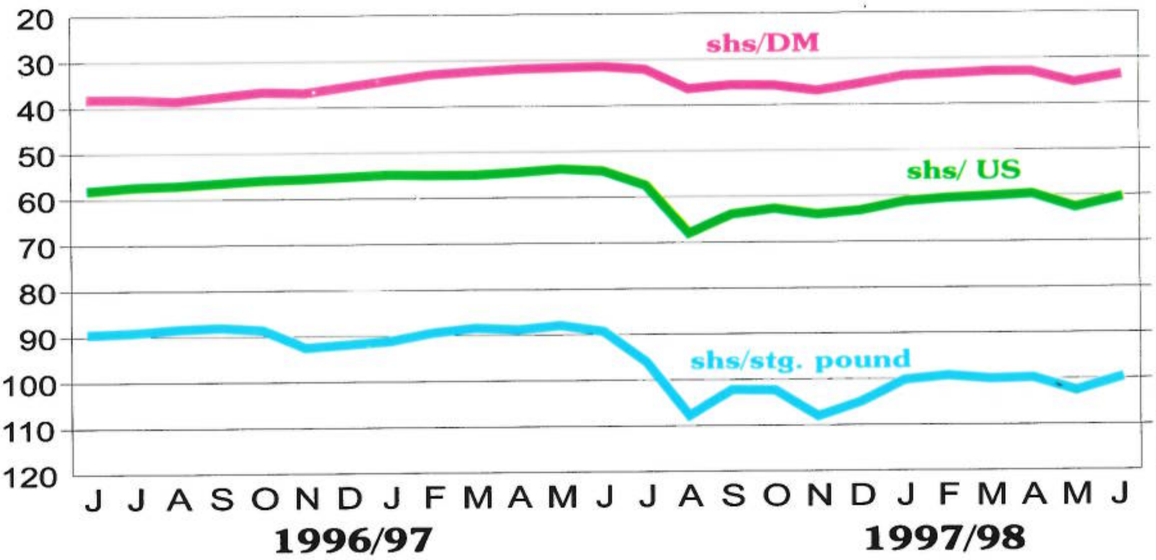
These measures hardly brought down lending rates, as loan rates during the twelve months to June 1998 were dominated by developments in the Treasury bill market which, in turn, reflected the financing requirements for Government budgetary deficit. Thus, although Government revenues were increasing following implementation of revenue enhancing measures during the year, expenditures ran out of pace. Consequently, the Government had to resort to both the domestic banking and non-banking sectors for the finances to cover the revenue shortfall. In order to raise the required financing, the Bank inevitably had to accept higher interest rate bids on Treasury bills in the weekly primary auctions.

EXCHANGE RATE

The Kenya shilling weakened in the year against the major international currencies following balance of payments deterioration and the Bank's commitment to limited intervention in the foreign exchange market. Reduced investor confidence and resurgence of inflationary pressures also contributed to the weakening of the shilling. Owing to pressure to meet Government external debt obligations, particularly in the second half of the year where most of the debt servicing was through drawing down the country's official reserves, the Central Bank minimised participation in the foreign exchange market to influence the rate. Even then, the Bank injected about US $ 100m in August 1997 when the shilling sharply weakened to trade at about shs 70 to the US dollar. With the intervention and return to normalcy of expectation, the shilling later stabilised at around shs 60 to the US dollar.

Against the US dollar, Sterling pound and the Japanese yen, the shilling weakened by 11.7%, 13.9% and 1.7%, respectively to trade at shs 61.9, shs 101.8, shs 49 in the year to June 1998 compared with shs 55.4, shs 89.4, and shs 48.2 a year earlier (Chart 5). It, however, gained against the Deutschemark by 0.7% relecting the weakening of the Deutschesmark against the US dollar in the international currency markets. The trade weighted average nominal exchange rate, consequently, depreciated by 13.2% compared with an appreciation of 1% in the preceding year. In real terms, however, the trade weighted shilling exchange rate depreciated by 7.9% reflecting the high domestic inflation relative to those of Kenya's major trading partners.

CHART 5 : KENYA SHILLING EXCHANGE RATE



Source: Central Bank of Kenya

Developments in the shilling exchange rate during the year were against a background of:

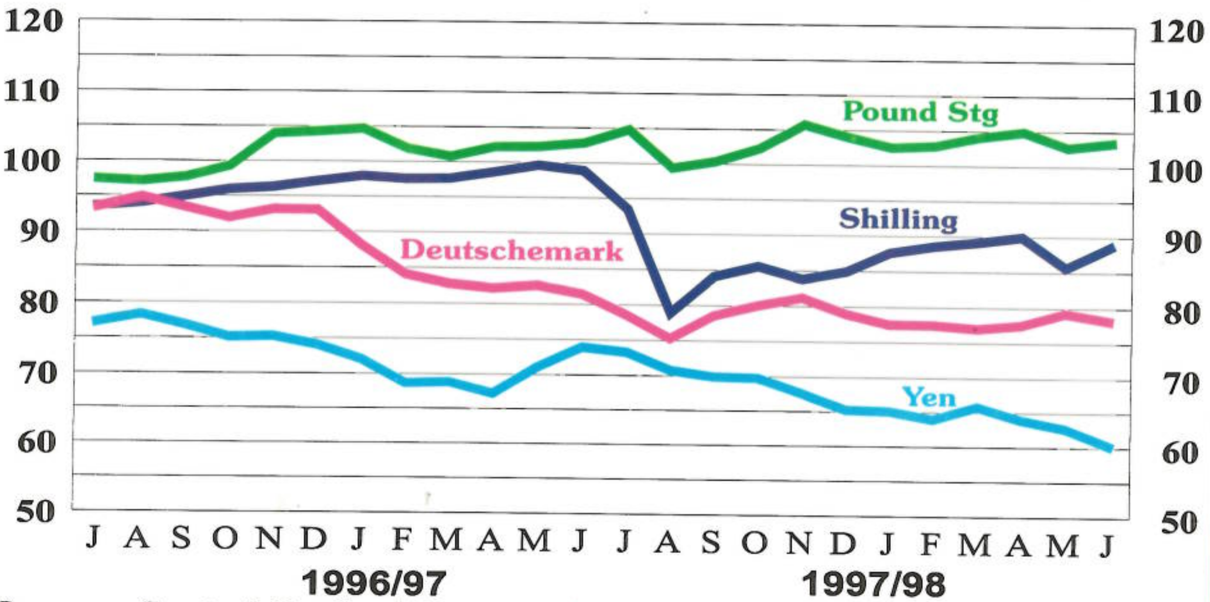
- mounting inflationary pressures especially in the first half of the year, inspite of the tight monetary policy aimed at achieving low and stable inflation.

- investor uncertainity regarding the shilling exchange rate following the lapse of the IMF's ESAF programme in July 1997 and the run-up to the 1997 General Elections, inspite of the relatively high interest rate differential on Government securities between Kenya and other countries. The anticipated depreciation of the shilling was however mitigated by large inflow of receipts from coffee and tea exports whose prices during the year increased substantially in the international market.

- the Bank's minimal participation in the foreign exchange market. Intervention in the early part of the year, however, was aimed at smoothing out the adverse effect caused by the suspension of IMF's ESAF at a period when the shilling was expected to depreciate.

In the intenational currency market, the US dollar appreciated moderately against the other major world currencies, notably the Deutschemark, Sterling pound and Japanese yen (Chart 6). The dollar performance was mainly supported by the relatively vibrant US economy, and the redirection of financial flows towards US markets following Asia's financial crisis in the early part of the year.

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



Source: Central Bank of Kenya

Fiscal policy was aimed at public debt reduction by running budget surpluses in the medium term. Accordingly the Government budget for the financial year 1997/98 was aimed at reducing the budget deficit excluding grants on a commitment basis from 2.1% of the Gross Domestic Product (GDP) in the previous year to 1.7%. To achieve this objective, the fiscal operations sought to enhance revenue collection and to tighten expenditure during the year.

Despite the policy focus on reducing the deficit, Government fiscal operations in the first six months of the financial year resulted in more than budgeted expenditure. This followed additional demands on the Exchequer to finance the 1997 general elections, increased operations and maintenance expenditures, salary awards to public sector employees and public debt service.

The developments in expenditure reduced the chances of achieving 1.7% of GDP deficit target. The Government therefore revised the target to 2.5%. However, following the steps taken in the second half of the financial year to enhance revenue collection, the Government managed to achieve a lower deficit of 1.9% of GDP for the year (Table 2). When external grant receipts are included, the deficit was even lower, amounting to only 1.0% of GDP while on a cash basis it was 1.1% of GDP.

Expenditure and Lending

Government expenditure including lending to parastatals and other Government agencies amounted to shs 199.2bn during the financial year. At this level, the expenditure was shs 38.2bn more than in the previous year and shs 9.0bn more than the budget target. The increase in expenditure over the previous year and the overrun on the budget reflected higher recurrent demands on the Exchequer to finance:

- the 1997 general elections expenses;
- salary increases awarded during the year to civil servants, teachers, university lecturers, the police and prison services;
- relief operations following the crop damage associated with the "El-nino" weather;

TABLE 2: BUDGET OUT-TURN (SHS BN)

	FY 1996/97		FY 1997/98			Over (+)/ Below(-)
	Actual	% of GDP	Actual*	% of GDP	Target	
1. TOTAL REVENUE & GRANTS	**155.1**	**27.4**	**192.5**	**29.9**	**180.9**	**11.6**
Ordinary Revenue	140.4	24.8	175.9	27.3	163.0	12.9
Tax Revenue	125.9	22.3	144.5	22.5	140.7	3.8
Income Tax	49.3	8.7	56.0	8.7	55.4	0.6
Value Added Tax	29.0	5.1	34.8	5.4	34.5	0.3
Customs Duty	22.8	4.0	25.0	3.9	23.0	2.0
Excise Duty	24.8	4.4	28.7	4.5	27.8	0.9
Non Tax Revenue	14.5	2.6	31.4	4.9	22.3	9.1
Appropriations-in-Aid	8.9	1.6	11.3	1.8	11.3	0.0
External Grants	5.8	1.0	5.3	0.8	6.6	-1.3
2. TOTAL EXPENDITURE & LENDING	**161.0**	**28.5**	**199.2**	**31.0**	**190.2**	**9.0**
Recurrent Expenditure	132.6	23.5	161.1	25.1	155.8	5.3
Domestic Interest	26.6	4.7	30.4	4.7	31.4	-1.0
Foreign Interest	8.2	1.5	7.6	1.2	9.5	-1.9
Wages and Salaries	48.2	8.5	62.1	9.7	63.5	-1.4
Operations and Maintenance	44.9	7.9	48.9	7.6	45.5	3.4
Other	4.7	0.8	12.1	1.9	5.9	6.2
Development Expenditure & Lending	27.8	4.9	34.8	5.4	34.4	0.4
Cleared Items Awaiting Transfer to PMG	0.6	0.1	3.3	0.5	0.0	3.3
3. DEFICIT ON A COMMITMENT BASIS (1-2)	**-5.9**	**-1.0**	**-6.7**	**-1.0**	**-9.3**	**2.6**
Adjusted for:						
3.1 Foreign interest arrears paid	0.0	0.0	0.2	0.0	0.2	0.0
3.2 Foreign interest due	0.2	0.0	0.1	0.0	0.0	0.1
3.3 Shift to interest accounting on redemption	0.0	0.0	5.0	0.8	5.0	0.0
3.4 Change in pending bills	-0.9	-0.2	4.0	0.6	-3.9	7.9
3.5 1995/96 expenditure financed in 1996/97	3.3	0.6	0.0	0.0	0.0	0.0
3.6 1996/97 expenditure financed in 1997/98	0.0	0.0	7.6	1.2	7.6	0.0
3.7 1997/98 expenditure to be paid in 1998/99	0.0	0.0	0.0	0.0	-0.5	0.5
3.8 Change in PMG balances	0.0	0.0	-8.1	-1.3	0.0	-8.1
4. DEFICIT ON A CASH BASIS ((3-3.1-3.3-3.5-3.6-3.8)+(3.2+3.4+3.7))	**-9.9**	**-1.8**	**-7.3**	**-1.1**	**-25.5**	**18.2**
5. DISCREPANCY(4+6):Expenditure(+)/Rev.(-)	**5.0**	**0.9**	**-0.1**	**0.0**	**0.0**	**-0.1**
6. FINANCING	**14.9**	**2.6**	**7.2**	**1.1**	**25.5**	**-18.3**
Domestic (Net)	21.5	3.8	14.2	2.2	31.3	-17.1
Central Bank	-7.5	-1.3	12.0	1.9		
Commercial Banks	13.7	2.4	-8.1	-1.3		
Other Sources	15.3	2.7	10.3	1.6		
Non Banks	14.2	2.5	8.5	1.3		
Capital Receipts (privatisation)	1.1	0.2	1.8	0.3	1.7	0.1
External (Net)	-6.6	-1.2	-7.0	-1.1	-5.8	-1.2
Loan Disbursements	15.5	2.7	14.1	2.2	16.3	-2.2
Loan Repayments	-22.1	-3.9	-21.1	-3.3	-22.1	1.0

* Provisional

Source: Treasury and Central Bank of Kenya

- security operations which became necessary in the clash-hit areas; and
- expenditure on interest payment in respect of public debt.

Overall, Government recurrent expenditure for the year was shs 161.1bn while development expenditure was shs 34.8bn. A further shs 3.3bn expenditure was captured as items on transit to the Paymaster General account. These were to be categorised either as development or recurrent expenditure once the Central Bank finalised the transactions.

Revenue and Grants

Revenue and grants amounted to shs 192.5bn which was shs 37.4bn more than in the previous year. The improvement reflected increase in receipts from all categories of revenue including improved income tax that followed upward review of public sector wages and salaries. Value added tax (VAT) and road maintenance levy receipts also increased as a result of increase in respective tax rates. Customs duty receipts increased due to enhanced control over diversion of transit and export goods into the local markets while excise duty receipts rose mainly because of improved administration of the tax. The general improved performance by the various taxes and non tax receipts also in part, reflected enhanced revenue collection by the Kenya Revenue Authority. Overall, the adjustment in tax rates and improved tax administration led to revenue out-turn for the year exceeding budget target by shs 12.9bn.

Receipts of external grants were shs 5.3bn compared with shs 5.8bn the previous year and shs 6.6bn budget target. The fall was a result of reduced disbursement of donor aid, following the lapse in the financial programme with the IMF under the enhanced structural adjustment facility (ESAF) in July 1997.

Government Borrowing Requirements

The Government required shs 22.3bn over and above revenue and grants to meet payment obligations during the financial year. This was shs 6.7bn less than the amount borrowed in 1996/97. The Government borrowed the required funds from domestic sources with shs 8.5bn from the non-bank sector and shs 12.0bn from the Central Bank. The financing from the Central Bank comprised:

- Shs 4.2bn run down of Government deposits at the Bank;
- Shs 0.6bn build up in rediscounted Government securities previously held by other sectors of the economy;
- Shs 5.4bn increase in overdraft which, at this level, was still within the statutory limit;
- Shs 3.3bn increase in cleared items awaiting transfer to the Paymaster General Account; and
- Shs 0.2bn increase in the Bank's holding of Treasury bonds.

The borrowing from the Central Bank was partially offset by the Bank's sale of shs 1.7bn Repo Treasury bills to commercial banks. The Government used the borrowed funds of shs 20.5bn and receipts of shs 1.8bn from privatisation to finance the budget deficit, reduce foreign debt and indebtedness to commercial banks to the tune of shs 7.2bn, shs 7.0bn and shs 8.1bn respectively.

The 1998/99 Government Budget

The 1998/99 budget is a surplus budget designed to address mainly, the problems of unsustainable budget deficit, high public sector debt, high interest rates, as well as allow savings to improve infrastructure as a basis for revamping the economy. Although presented to Parliament as a balanced budget, it provides for additional shs 4.0bn inflows of foreign grants which if disbursed, will be used to reduce the domestic debt.

The budget underscores that fiscal restraint will be maintained throughout the year. It proposes the implementation of the following fiscal and debt management measures as part of the policy package and structural changes to resolve the prevailing economic problems:

- rationalising public sector employment, particularly of teachers and civil service, to contain the expansion of recurrent expenditure;
- reviewing the project portfolio with various ministries to improve the efficiency of public investment and the sector's contribution to economic growth;
- improving the efficiency of civil service;
- curbing tax evasion;
- reducing Government borrowing requirement and start retiring the

current stock of Treasury bills; and

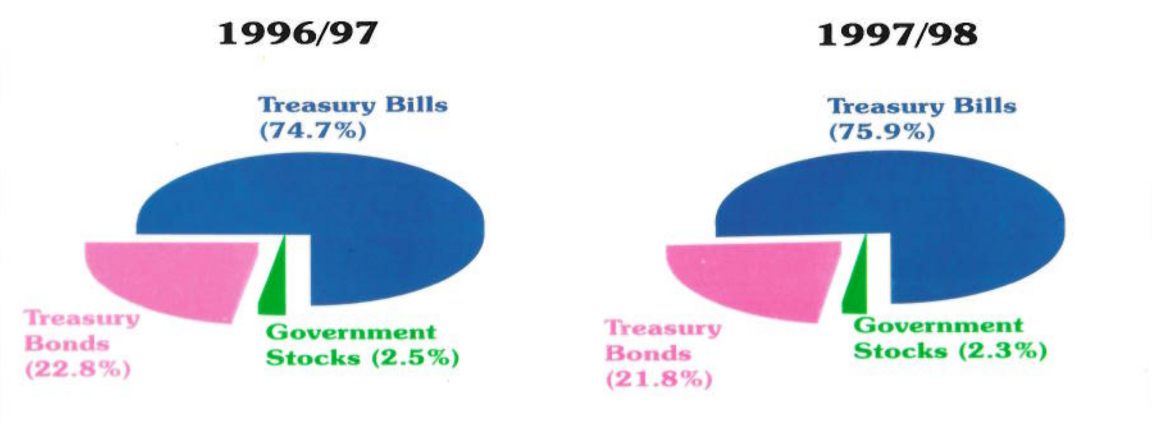
- lengthening maturity of domestic debt by encouraging conversion of Treasury bills to Treasury bonds.

Domestic Public Debt

Net domestic debt increased to shs 145.5bn in June 1998 from shs 130.8bn in June 1997. The increase was as a result of borrowing to finance the budget deficit and net repayment of public external debt.

The Government relied mainly on Treasury bills to mobilise the required funds with the result that the stock of Treasury bills rose to shs 121.0bn in June 1998 from shs 116.6bn in June 1997. Most Treasury bills issued during the year were of 91 days maturity. This category of bills accounted for shs 88.7bn of the outstanding Treasury bills with the balance of shs 32.3bn being bills of 182 days maturity. Overall, Treasury bills accounted for 75.9% of the shs 159.5bn Government securities outstanding in June 1998 (Chart 7).

CHART 7 : DISTRIBUTION OF DOMESTIC PUBLIC DEBT, 1997 AND 1998



Source:Treasury & Central Bank of Kenya

The Government had to frequently issue new bills to roll-over maturities because investors preferred the 91 days Treasury bills to those of 182 days and Treasury bonds. The roll-over was necessary to keep banking liquidity at levels consistent with the desired expansion of money supply. Consequently, a total of shs 46.9bn worth of Treasury bills were issued to investors during the year. These comprised shs 42.5bn bills to roll-over those that matured and shs 4.4bn to finance the budget deficit.

The required large sales of Treasury bills could only be achieved at high interest rates. As a result, interest rate on the bills remained high, averaging

26% throughout the financial year. The interest rate on the floating rate Treasury bond also remained high since the former is the benchmark for setting the latter.

Total interest payments on the instrument during the year amounted to shs 24.4bn or 64.2% of the shs 38.0bn total interest payments on public debt. At this level, total interest paid on public debt was shs 3.4bn more than in the previous year. The high interest expenditure with even higher expenditure on salaries of shs 62.1bn accounted for 50% of total expenditure. In view of the pressure to reduce and ultimately eliminate the budget deficit, the high salaries and interest payments prompted the Government to curb disbursements to other activities like operations, maintenance and development projects.

Three issues of one year floating interest rate Treasury bonds were floated by the Government during the financial year. The sales were primarily aimed at raising funds for the budget and to lengthen the maturity structure of the domestic debt. Total subscriptions to the three issues amounted to shs 35.6bn. Over the same period, the Government redeemed Treasury bonds worth shs 36.5bn. These comprised shs 4.8bn fixed interest rate Treasury bonds and shs 31.7bn floating interest rate Treasury bonds. The stock of Treasury bonds, therefore, declined to shs 34.7bn in June 1998.

Government long term stocks outstanding declined by shs 0.3bn to shs 3.7bn in 1997/98. The decline reflected suspension of new sales that has been in place since August 1986.

Government overdraft at the Central Bank increased by shs 5.4bn in 1997/98. The overdraft, however, remained within the statutory limit throughout the financial year. The legal limit as prescribed in the Central Bank of Kenya Act is 5% of gross recurrent revenue in the most current audited appropriation accounts. Between July 1997and February 1998 the limit was shs 6bn based, on the 1995/96 audited appropriation accounts. The limit was, however, adjusted upwards to shs 7bn in March 1998 following finalisation of audits on the 1996/97 appropriation accounts.

The overall balance of payments position worsened to a deficit of US $ 194m in the year to June 1998 from a surplus of US $ 252m in the year to June 1997 (Table 3 and Chart 8). The turnaround was mainly due to deterioration of the capital account which offset the improvement in the current account. The improvement in current account reflected the moderation of imports occasioned by sluggish economic performance and decline in food imports. The slowdown in capital inflows during the year was due to reduced international confidence in Kenya's economy following the suspension of Enhanced Structural Adjustment Facility (ESAF) with the International Monetary Fund (IMF) in July 1997.

The Current Account

The current account deficit narrowed to US $ 76m in the year to June 1998 from US $ 249m in the previous year. This followed improvement in the trade account by US$ 107m and increase in the services account surplus by US $ 65m. The reduction in the trade deficit mainly reflected a substantial fall in imports as exports declined marginally.

TABLE 3: BALANCE OF PAYMENTS (US $ m)

	1995/96	1996/97	1997/98*
1. Overall Balance (2+3)	346	252	-194
2. Current Account	-352	-249	-76
Trade Balance	-1,150	-1,169	-1,062
Exports	1,949	2,104	1,961
Imports	-3,099	-3,273	-3,023
Services (net)	798	920	985
of which tourism	439	455	349
3. Capital Account	698	501	-118
Long term (net)	-63	-42	-167
Official	-63	-73	-156
Private	17	31	-10
Short term & net errors and ommissions	761	543	49
Memorandum:			
Gross Reserves	1,246	1,551	1,305
Official	806	1,050	771
in months of import cover	*3.1*	*3.9*	*3.1*
Commercial Banks	440	501	533

* Provisional

Source: Central Bank of Kenya

- Exports fell by 7% to US$ 1,961m in the year, after increasing by 8% in the previous year. Most of the decline was in non-traditional exports whose volume dropped owing to adverse weather conditions and increased competition in the world market. Traditional exports which account for about 47% of total exports, however, improved substantially as a result of improved world prices for coffee and tea. Coffee export volume, however, fell substantially partly due to adverse weather conditions in the first half of the year and partly because of poor crop husbandry attributed to increased cost of inputs.

- Imports declined by 8% from US$3,273m to US$ 3,023m in the year to June 1998 compared with increases of 6% and 21% in the preceding two years, respectively. The decline was mainly in drought-related food imports which eased in the year. Capital goods imports that had persistently increased in the recent past also slowed down. With the sluggish expansion in economic activity in the year, the slowdown in imports growth was expected following the sharp increases in the last two years.

- The services account surplus increased to US $ 985m from US $ 920m and US $ 798m in the year to June 1997 and 1996, respectively. The improvement in the services account surplus reflected the reduction in interest payments relating to official external loans following the gradual decline of the stock of external public debt over the past two years. Tourism reciepts however, declined by 23% from shs 455m to shs 349m in the year to June 1998.

- Private transfers increased to US$ 505m from US$ 475m while that of the public sector declined by 24% as relations with the major bilateral donors continued to remain uncertain.

Capital and Financial Account

The capital account deteriorated to a deficit of US $ 118m from a surplus of US $ 501m in the previous year.

- Official long term capital inflows which had risen rapidly in the last three years to an average of US $ 330m per year, fell to US $ 239m in the year to June 1998. The decline in these inflows is mainly attributed to the suspension of International Monetary Fund's Enhanced Structural

Adjustment Facility (ESAF). Other related official inflows consequently slowed down during the year.

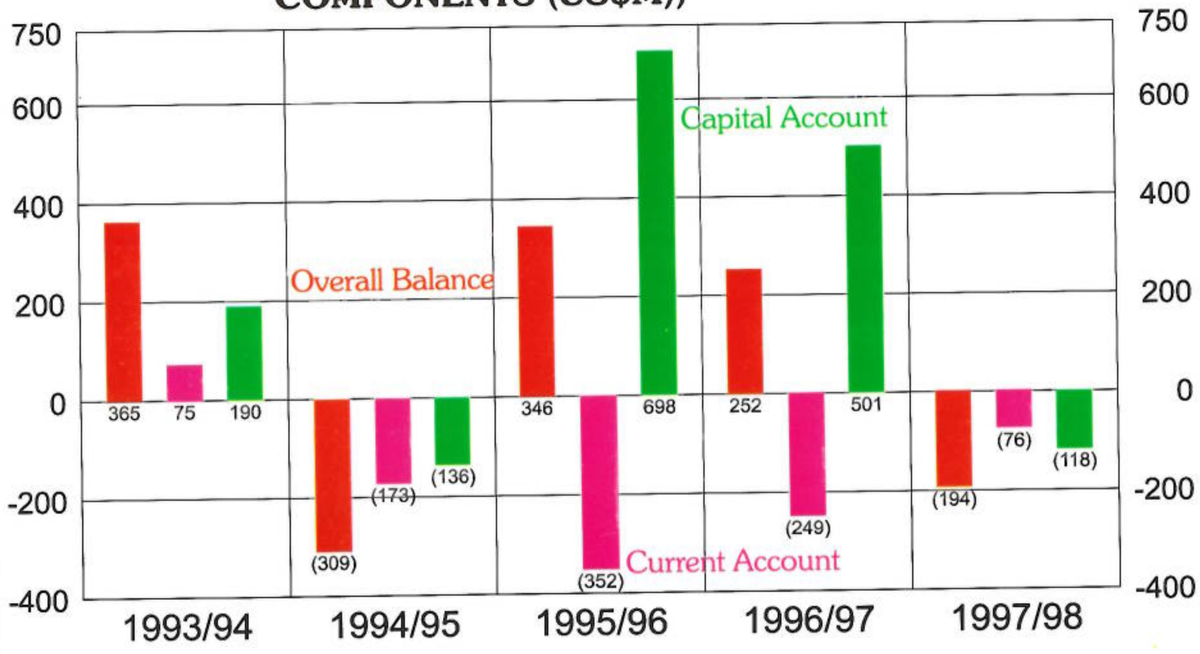
- Private capital inflows which had started increasing in the recent past following improvement in macroeconomic conditions and the liberalisation of capital flows and foreign trade fell by US $ 31m in the year.

- Short term capital inflows eased partly due to the diminishing investor confidence caused by the lapse of the ESAF arrangement with the IMF and partly due to deterioration of economic and political developments in the country ahead of the run-up to the 1997 General Elections.

Foreign Exchange Reserves

As a result of the balance of payments developments, the official foreign exchange reserves declined by US $ 279m to US $ 771m at the end of June 1998 and was equivalent to 3.1 months of imports cover. At the end of June 1997, official reserves stood at US$ 1,050m covering 3.9 months of imports. Foreign reserves held by commmercial banks, however, rose by US$ 32m to US$ 533m as residents increased their foreign currency holdings in commercial banks.

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

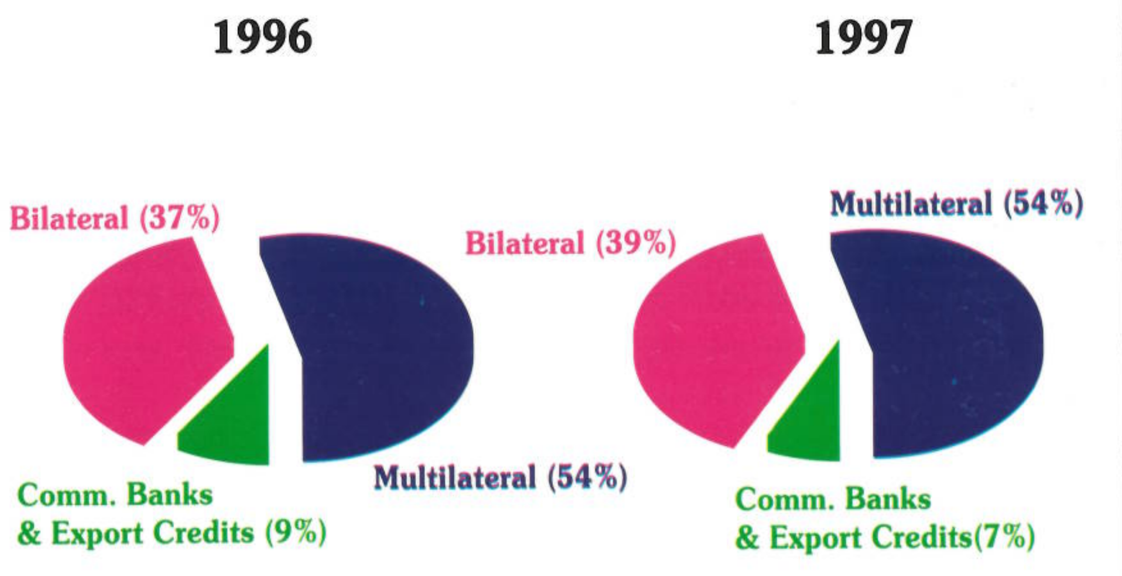


Source: Central Bank of Kenya

External Debt

Kenya's external debt at the end of 1997 amounted to US$ 5,863m. This represented a decline of US$ 378m compared with a decline of US$ 218m in 1996. Multilateral debt accounted for 54% while bilateral debt accounted for 39% of the total external debt. Debt owed to commercial creditors declined to 7% in 1997 from 9% in 1996 (Chart 9).

CHART 9: DISTRIBUTION OF EXTERNAL PUBLIC DEBT



Source :Treasury & Central Bank of Kenya

Following the decline in external debt and the expansion in nominal GDP by 15.0%, the debt fell to 65% of GDP in 1997 from 68% and 72% in 1996 and 1995, respectively. External debt service as a percentage of exports of goods and services declined by 3.1 percentage points to 21.5% in 1997.

Monetary policy sought to support a stable macroeconomic environment throughout the twelve months to June 1998. The Central Bank aimed at confining inflation to single digit throughout the year. In pursuit of this objective, the Bank targeted money supply (M3) to grow at 11% by June 1998. This target was revised to 8.3% in the year following implementation of measures introduced in the course of the year to address shortfalls in the foreign exchange market which had become volatile after the suspension of financial program and assistance from the International Monetary Fund (IMF).

Two major adverse developments emerged in the course of implementation of monetary policy during the twelve months to June 1998.

- The month-on-month underlying inflation which had stabilized around 5-6% between July and December 1997, picked up in the latter half of the financial year to 11% by June 1998; and

- The average Treasury bill rate increased from 19% in June 1997 to 26% by June 1998.

The upward trend in inflation and interest rates was contrary to the expectation at the beginning of the financial year. The unexpected outcome of the two indicators was atributed to the large domestic financing requirement by the Government.

Reserve Money Management

As in the previous year, the Central Bank managed monetary expansion by constraining the daily expected outcome for reserve money, that is by managing currency in circulation and deposits of commercial banks and NBFIs at the Central Bank, to specific monthly targets over the twelve months to June 1998. This way, the Bank was able to regulate the base on which the banking institution supply credit to the economy. In particular, the Bank managed the money supply using the cash ratio and Open Market Operations (OMO) to influence monetary base of both commercial banks and NBFI's.

Reserve money management was anchored on the net domestic assets (NDA) of the Central Bank. The reserve money target for the period July to September 1997 was based on a cash ratio of 18%. Thereafter, the Bank revised downwards the monthly reserve money targets in line with the lower cash ratio of 15% that was brought into effect in October 1997. The reduction in the cash ratio requirement was intended to ease liquidity in the inter-bank market after the tightness following the weakening of the shilling vis-a-vis other major currencies; and to reduce pressure on commercial banks lending interest rates.

The reserve money remained within target except in December 1997 when the target was exceeded by shs 1.7bn because of end year festivities and spending associated with General Elections at that time. On average, the net foreign assets (NFA) of the Bank remained within the expected range while the NDA exceeded target during the twelve months to June 1998.

The NFA of the Bank fell within target mainly because of large outflows of foreign reserves triggered by the suspension of financial assistance by the IMF in July 1997, and use of official reserves to service the Government's foreign debt.

Meanwhile, the NDA exceeded the target during the year to June 1998. The above target target NDA during the July - September 1997 period was reflected as Central Bank lending to Government which was, largely in rediscounted securities comprising Treasury bonds and bills. Rediscounting of Government securities was more pronounced between July and October 1997 in the wake of the suspension of further lending to the country by the IMF. Government securities worth shs 9.7bn were rediscounted during this period. The readiness of the Central Bank to rediscount these securities together with sales of its foreign exchange to commercial banks restored stability in the inter-bank foreign exchange market beginning September 1997. Resumption of consultations between IMF and the Government in September also helped in restoring confidence in the shilling which regained strength against other currencies and thus prompted exporters to off-load their foreign currency holdings in the subseqent months:

- The shilling appreciated to exchange at shs 63.8 to the US$ from shs 67.1 in August following foreign exchange inflows.

- Speculative rediscounting of Government securities also eased with calm restored in the foreign exchange market, and the Banks' net holding of these securities declined as redemptions fell due.

By June 1998, the NDA exceeded target largely due to an advance payment of dividends to Government from profits made by the Central Bank during the year. The dividend payment helped confine net Government indebtedness to the Bank to within the June 1998 target.

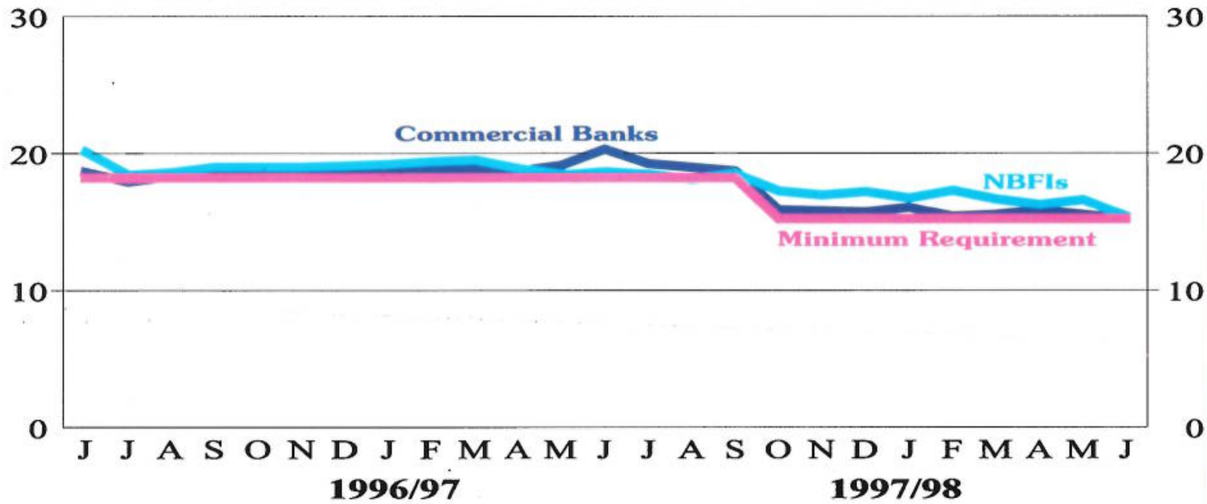
As fiscal agent of the Government, the Central Bank continued to manage Government debt operations over the twelve months to June 1998. The Bank regularly issued Treasury bills as well as one year floating rate Treasury bonds, based on the requirements for both monetary policy and financing of the Government budget deficit. Accordingly, the outstanding stocks of both Treasury bills and one year floating rate Treasury bonds increased during the financial year by 5.6% to shs 155.4bn in June 1998 from shs 147.2bn in June 1997. Treasury bills accounted for 53.5% of the increase in outstanding investments in these securities during the year.

Cash and Overall Liquidity of Banks and NBFIs

The Bank lowered the cash ratio from 18% to 15% with effect from October 1997 to ease tightness in the money market during the second quarter of the financial year.

On average, commercial banks and NBFIs kept cash deposits at the Central Bank just above the daily and monthly requirements over the twelve months to June 1998 (Chart 10).

CHART 10: CASH RATIO DEPOSITS FOR BANKING INSTITUTIONS



Source: Central Bank of Kenya

Prior to its reduction to 15% in October 1997, the cash ratio had gradually converged to the then 18% minimum requirement during the first quarter of the financial year. As the liquidity squeeze eased thereafter, banks and NBFIs managed to maintain stable cash ratio margins above the revised 15% minimum requirement. It was however, observed that nearly all the liquidity which was released from the reduction in the cash ratio was invested in the Treasury bills.

On average, banking institutions met their monthly liquidity requirements throughout the year. Mortgage finance companies and building societies also kept their liquidity above their respective mandatory requirements. Liquid assets required for prudential purposes were reduced to 20% of deposit liabilities from 25% effective mid-July 1997. The reduction was aimed at encouraging commercial banks to lower interest rates on their lending.

Money Supply and other Monetary Aggregates

The expansion of money supply (M3) slowed down to 3.6% in the twelve months to June 1998 from 10.2% in the year to June 1997 (Table 4). The slow expansion however, was less evident when money supply is more broadly defined to include both foreign currency denominated deposits and Kenya Government Treasury bills held by the private sector in addition to M3. The Money Supply (M3XT) so broadly defined, increasingly became more relevant in measuring liquidity of the private sector during the year. It became evident that the private sector, guided by developments in Treasury bill interest rate and the shilling exchange rate, was partly shifting away from holding demand and term deposits to holding foreign currency denominated deposits and Treasury bills (Table 4).

The expansion in the money supply was wholly supported by the increase in net domestic assets (NDA) of the banking system. The NDA increased by 9.5% in the year to June 1998 compared with 3.6% growth in the previous year. The expansion was reflected in banking system credit to both Government and private sector.

The lending to Government increased by 1.2% compared with 7.3% in the previous year. The increase was wholly from the Central Bank and was mainly through the overdraft. The overdraft however, remained within the 5% limit of the most recent audited gross recurrent revenues as required by law.

TABLE 4: MONEY SUPPLY AND ITS SOURCES (ANNUAL BASIS), KSHS BN

	1997 Jun	1998 June	Change Absolute	Change %	Target Jun '98	Dev.
1. Money Supply :						
Money supply, M2 1/	**258.0**	**274.1**	**16.1**	**6.2**		
Money supply, M3(2+3) 2/	281.0	**291.2**	10.2	3.6	305.3	-14.1
Money supply M3X 3/	296.6	**314.6**	18.0	6.1	329.3	-14.7
Money supply M3XT 4/	346.5	**376.0**	29.5	8.5		
2. Net foreign assets 5/	**65.4**	**55.1**	**-10.3**	**-15.7**	**39.9**	15.2
Central Bank	46.0	33.5	-12.5	-27.2	38.6	-5.1
Commercial banks	20.1	21.7	1.6	7.7		
NBFIs	-0.7	-0.1	0.7	-88.4		
3. Net domestic assets (3.1+3.2)	**215.6**	**236.1**	**20.5**	**9.5**	**265.4**	-29.2
3.1 Domestic credit (3.1.1+3.1.2)	**285.4**	**324.4**	**39.0**	**13.7**	**335.1**	-10.7
3.1.1 Government (net)	73.6	75.4	1.9	2.5	91.7	-16.2
From Central Bank	19.3	32.3	13.0	67.2	32.9	-0.6
Overdraft to Government	0.0	5.4	5.4	-	7.0	-1.6
Cleared items awaiting posting to PMG	1.1	4.4	3.3	291.0	0.0	4.4
Rediscounted securities	38.6	37.8	-0.8	-2.2	40.7	-2.9
PMG deposits	-20.4	-15.3	5.1	-25.1	-14.7	-0.5
From Commercial Banks & NBFIs	54.2	43.1	-11.1	-20.5	58.7	-15.6
Commercial Banks	50.7	41.2	-9.5	-18.8		
NBFIs	3.6	2.0	-1.6	-44.8		
3.1.2 Private sector and other public sector:	211.9	249.0	37.1	17.5	243.4	5.5
From Central Bank	1.0	1.2	0.2	19.8		
From Commercial banks	179.1	217.2	38.1	21.3		
From NBFIs	31.8	30.5	-1.2	-3.8		
3.2 Other assets net	**-69.8**	**-88.3**	**-18.5**	26.4	**-69.8**	-18.5
4. Reserve money	**74.2**	**78.5**	**4.3**	5.8	**77.5**	1.0
Cash in till	4.5	5.3	0.8	17.5	5.1	0.2
Currency outside banks	29.1	33.0	3.8	13.2	36.6	-3.6
Deposits with CBK	40.6	40.2	-0.3	-0.8	35.8	4.4
Memorandum items						
Treasury bills outstanding	**116.6**	**121.7**	**5.1**	4.4		

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

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

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

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

4/ Broad money, M3XT includes M3X and outstanding Government Treasury securities with the nonbanking public.

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

Source: Central Bank of Kenya

The lending to the private and other public sectors increased by 17.5% compared with 14.5% in the year to June 1997. The increase in credit to the private sector was wholly from commercial banks as lending by NBFIs to the sector fell, mainly because of conversion of NBFIs to commercial banks.

The net foreign assets of the banking system on the other hand, fell by shs 10.3bn or 15.7% in the year compared with an increase of 40% in the previous year. The decline was wholly in the holdings of the Central Bank as those of the commercial banks and NBFIs increased in the year. The fall in the Central Bank holding of foreign exchange was attributed to:

- large outflows of foreign reserves of the Bank following suspension of financial assistance from the IMF in July 1997
- subsequent sales of foreign reserves to commercial banks to calm the foreign exchange market volatility generated by the suspension of financial support from IMF
- servicing of Government external debt during the financial year.

Policy Reforms

The Central Bank instituted several reforms during the year. The reforms were aimed at enhancing efficiency in the conduct of monetary policy, increasing protection of depositors and boosting stability of the banking system in line with new developments in the banking. The reforms included the following:-

- Launching of a two way Repurchase Agreement (REPO) between the Central Bank and the commercial banks.
- Harmonisation of the regulatory environment for the banking institutions including:
    - adoption of end December as single date of expiry of the annual licenses issued to commercial banks, NBFIs, building societies and foreign exchange bureaux with effect from 1997
    - streamlining of licensing procedures for banks, NBFIs and building societies to conform with international practice
    - requirement that banking institutions hold only one licence for both the Head office and branches, with branches displaying certified copies of both the licence and schedule, while new branches display a copy of the approval letter from Central Bank
    - broadening of disclosure requirements for banks and NBFIs to include publication of both the audited balance sheet and profit and loss statement in a national newspaper, and ensuring that the format of presentation conform with Kenya Accounting Standard number 18

– requirement for banks and NBFIs to declare specific base lending rates as a means to enhance transparency and competitiveness in the industry; with loan offers to customers based on the base lending rate plus a margin

- strengthening the capital bases of both commercial banks and NBFIs from shs 37.5m and shs 150m to shs 75m and shs 200m by December 1999 respectively

- enhancing compliance with cash ratio requirement by raising penalty for defaulters to 0.25% per day with daily penalty doubling to 0.5% for continuous defaulting exceeding 15 days. Institutions that default for 30-days within a 60-day period would be brought under Central Bank management

- enhancing depositor protection by introducing the requirement that the directors and chief executives of financial institutions licensed under the Banking Act secure all insider loans to themselves as well as ensuring that the loans are serviced regularly; defaulters would now have to relinquish their positions and clear all outstanding loans and advances

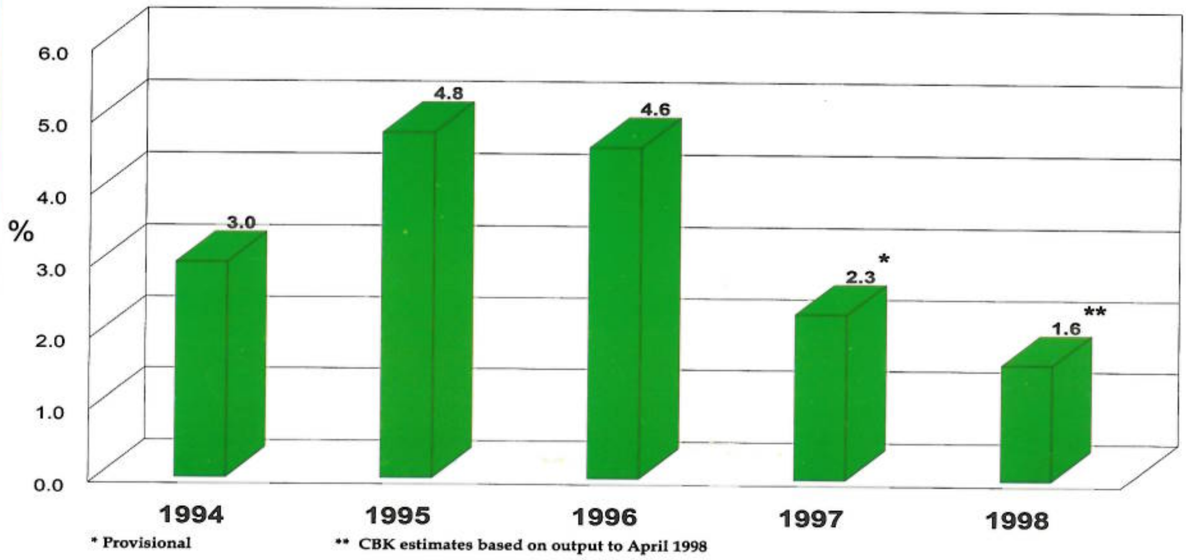
- encouraging commercial banks to reduce lending interest rates. Towards this end the Central Bank lowered both the broad liquidity ratio requirement for prudential purposes and the cash ratio requirement to 20% and 15% respectively, from the previous 25% and 18%.

In view of increased trade within East Africa and the request from the business community, the Central Bank increased the non-declarable volume of local currency notes on persons either entering or leaving the country to Kshs 500,000 from the Kshs 100,000 imposed from 25 May, 1994. Holding of foreign currency notes remained unchanged at the equivalent of US$ 5,000. Any amounts in excess of these limits were subject to declaration at the point of entry or departure. The Bank also urged the business community to economise on cash holdings for other safer means of payments such as travellers cheques, credit and debit cards and bank transfers.

Overall Growth

The slowdown in economic growth that started in 1996 continued in 1997. Gross Domestic Product (GDP) expanded in real terms by only 2.3% in 1997 compared with 4.6% in 1996. With the population increasing by 2.6% per annum, the slowdown in economic growth in 1997 implies that no gains were made in the fight against the problems of poverty and unemployment which continue to confront the country (Chart 11).

CHART 11 : GROWTH RATE OF REAL GDP (1994-1998)



* Provisional ** CBK estimates based on output to April 1998

Source: Economic Survey, 1998

The slowdown in economic growth in 1997 was caused by several factors including:

- Adverse weather conditions;
- Drought induced irregularity in power supply, experienced in the first quarter of the year;
- The rapidly deteriorating infrastructure namely, roads, water supply, telephone, and sanitation which reduced production efficiency by increasing the costs per unit of output;

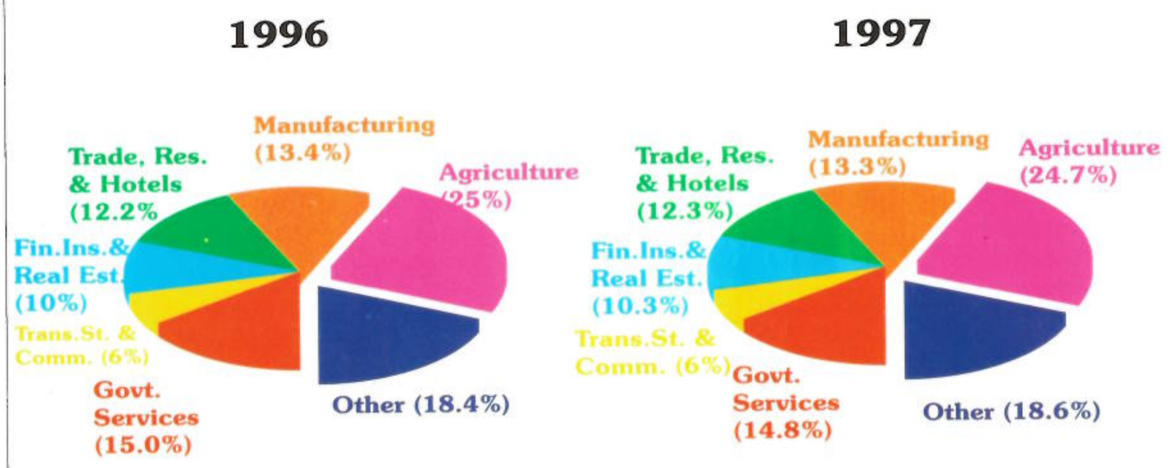
- Depressed investments, caused by the high costs of domestic funds and the low investor confidence; and

- Increased insecurity, the rising incidences of labour unrest and the poor delivery of public services.

Sectoral Performance

Despite the slowdown in production, the structure of the economy remained basically the same with agriculture and manufacturing contributing about 40% of the total GDP (Chart 12).

CHART 12: STRUCTURE OF THE ECONOMY IN 1996 AND 1997



*Includes forestry, fishing, mining & quarrying, building & construction, utilities, domestic services and non-monetary sector

Source Economic Survey, 1998

Output in agriculture, the leading sector of the economy and the base for other economic activities, expanded by 1.2% in 1997 compared with the growth of 4.8% and 4.4% in 1995 and 1996.

The slowdown in agricultural production was partly as a result of adverse weather conditions and partly due to infrastructural and other cost factors:

- Drought in the first quarter of 1997 and the "*El-nino*" rains towards the end of 1997 that destroyed food and cash crop production;

- The rising cost of farm inputs and low returns also that constrained agricultural production;

Recovery in the sector is expected to begin in 1998 following improved weather, increased availability of credit, and a continuation of favourable international prices for coffee and tea.

Growth in the manufacturing sector fell to 1.9% in 1997 from 3.7% in 1996, mainly due to:

- The stiff competition from cheaper imports;

- The poor state of infrastructure that continue to impact negatively on production efficiency and distribution;

- The reduced aggregate demand following poor performance in agriculture; and

- The reduced investment in manufacturing partly caused by the high cost of domestic funds and partly due to the uncertainties associated with the 1997 general elections.

Economic recovery in the sector is forecast to begin after the second half of 1998. The recovery hinges on increased exports to the emerging regional markets, such as the Common Market for Eastern and Southern Africa (COMESA) and the East African Co-operation. Performance in the sector will also be boosted, in the medium term, by the on-going measures to increase the market share of manufactured products imports from Africa, particularly in the United States and the European union.

Apart from finance, depressed economic activities were also recorded in all the service sectors of the economy, with growth in output from:

- Trade, restaurant and hotel declining to 3.9% in 1997 from 8.0% in 1996. The poor performance in the sector partly stems from increased competition from neighbouring tourism destinations and partly from the negative publicity carried on the country abroad;

- Transport, storage and communication falling to 1.8% in 1997 from 4.0% in 1996. The fall in performance was traced to the poor state of the country's road network that continue to limit the utilization of the country's transport capacity; and

- Performance of Government services declining to 1.1% in 1997 from 1.6% in 1996. The performance of this sector is forecast to improve with increased privatization and as employment from the sector is rationalized in order to increase efficiency in the delivery of public services.

The growth attained in 1997 was supported by a nominal investment of shs 115.1bn; an increase of 7.1% from the investment of shs 107.4bn in 1996. The investment was mainly financed from domestic savings, which rose by 10.4% to shs 89.5bn in 1997 from shs 81.1bn in 1996. Investment financed from foreign sources, however, declined by 2.7% to shs 25.6bn from shs 26.3bn in 1996. The decline was caused by the low investor confidence following uncertainties with donor financing in 1997 and the insecurity sentiments associated with the 1997 general elections.

Outlook for Growth in the Medium Term

The economic growth of 2.3% achieved in 1997 is far below the potential annual growth of 8.0% that could be achieved with more efficient utilisation of the existing production base. Economic growth is expected to deteriorate further in 1998 given that performance in the year to April 1998 is only 1.6%. Over the medium term, however, economic growth is expected to pick up to more than 5.0%. This optimism about recovery is based on:

- Expected improvement in weather conditions and the continued favourable prices of the principal export crops and the associated impact on agriculture and the rest of the economy;
- Increased efficiency and capacity utilisation, particularly in the leading sectors of agriculture, manufacturing, and trade;
- Improved infrastructure and the continued restoration of general investor confidence;
- Enhanced macroeconomic stability, particularly in respect of stability in domestic prices.

The implementation of the fiscal measures contained in the 1998/99 budget will also assist in increasing the pace of economic recovery in the medium term.

The banking system performed satisfactorily in the twelve months to June 1998. Institutions remained stable and maintained high levels of profitability. In many instances, however, returns were high due to under-provisioning for bad debts by banking institutions as the share of non-performing loans in total advances increased during the year to June 1998. Overall, the banking system had both cash and liquidity in excess of the minimum requirements, as well as strong capitalisation. Universal banking encouraged by the Central Bank was enhanced further by conversion of one more NBFI into a commercial bank and the merger of two commercial banks during the current financial year. Commercial banks expanded their branch network – both locally and into countries in the eastern and southern African region – while the number of licensed foreign exchange bureaus increased. Many institutions in the banking sector, commercial banks in particular, invested substantially in new information technology in order to improve customer service during the twelve months to June 1998. The Central Bank also organised seminars for directors of banking institutions with the objective of enhancing corporate governance.

Banking System Liquidity

Banking institutions generally met requirements for liquidity ratio as well as cash ratio during the twelve months to June 1998.

- Previously, the liquid assets to deposits ratio was observed purely for prudential purposes only. However, the purpose was broadened in July 1997 when the minimum requirement was reduced by 5 percentage points to 20% for both commercial banks and NBFIs as an incentive for the institutions to reduce the interest they charge on loans.
    - Liquidity for both banks and NBFIs over the twelve months to June 1998 remained strong at 38% and 47% of their deposit liabilities, respectively, compared with the minimum 20%.
    - Government debt instruments continued to dominate the liquid assets, as well as cash ratio deposits at the Central Bank for commercial banks and deposits with banks for NBFIs.

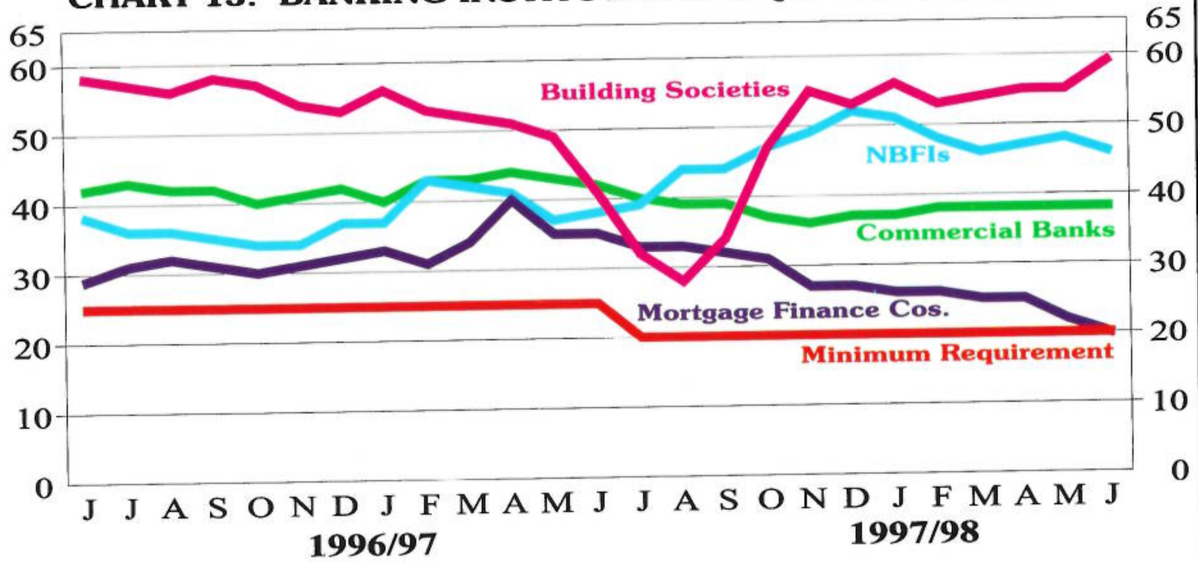
Mortgage finance companies and building societies liquidity ratios were high at an average 27% per month respectively, compared with the minimum 20%. The high liquidity in the banking industry underscores the stability of the banking system during the year to June 1998 (Table 5 and Chart 13).

TABLE 5: BANKING INSTITUTIONS CASH AND LIQUIDITY RATIOS

	1997							1998					
	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
Cash Ratio (%)													
Commercial Banks	20.1	19.0	18.8	18.5	15.7	15.6	15.5	15.8	15.2	15.3	15.6	15.3	15.1
NBFIs	18.5	18.3	17.9	18.3	17.1	16.8	17.0	16.5	17.1	16.5	16.1	16.4	16.5
Banking System	19.3	18.6	18.3	18.4	16.3	16.2	16.2	16.2	16.1	15.9	15.8	15.9	15.8
Minimum Requirement	18	18	18	18	15	15	15	15	15	15	15	15	15
Liquidity Ratio (%)													
Commercial Banks	42	40	39	39	37	36	37	37	38	38	38	38	40
NBFIs	38	39	44	44	47	49	52	51	48	46	47	46	46
Minimum Requirement	25	20	20	20	20	20	20	20	20	20	20	20	20
Mortgage Finance Cos.	35	33	33	32	31	27	27	26	26	25	25	22	20
Building Societies	41	32	28	34	47	55	53	56	53	54	55	55	59
Minimum Requirement	20	20	20	20	20	20	20	20	20	20	20	20	20

Source: Central Bank of Kenya

CHART 13: BANKING INSTITUTIONS LIQUIDITY RATIOS



Source: Central Bank of Kenya

- The cash ratio, that is, the cash deposits of banks and NBFIs at the Central Bank as a proportion of their deposit liabilities, is applied to influence monetary conditions in the economy. During the year to June 1998:

- the ratio was lowered from 18% to 15% effective 1st October 1997 to ease both liquidity in the inter bank money market and interest rates
- banking institutions complied with the requirement, with commercial banks and NBFIs maintaining monthly averages of 16.2% and 17%, respectively, during the year. Commercial banks, however, economized on their deposits at the Central Bank by operating close to the minimum requirement in order to maximize earnings from investing surplus funds in the high interest earning Government securities.

Banking Industry Structure

The banking industry hardly changed its structure during the twelve months to June 1998 (Table 6).

- There were 53 commercial banks as of June 1998, the same as at the end of June 1997. Two banks merged in December 1997.
- Mortgage finance companies and building societies remained unchanged numbering 2 and 4 respectively, by June 1998.
- NBFIs declined to 15 in June 1998 from 17 as at June 1997, following one institution converting into a bank and one being put under Central Bank management after experiencing liquidity problems.

TABLE 6: STRUCTURE OF THE BANKING INDUSTRY IN KENYA (SHS BN)

	Jun-97					Jun-98						
	Assets	Deposit	No. of	Market Share (%)		Assets	Deposit	No. of	Market Share (%)		Annual Change (%)	
Peer Group Range		Liabilities	Banks	Assets	Deposits		Liabilities	Banks	Assets	Deposits	Assets	Deposits
COMMERCIAL BANKS												
Over 10	227.7	148.6	7	63.5	63.6	269.2	176.2	8	67.4	66.0	18.2	18.6
5-10	47.7	28.6	7	13.3	12.2	57.1	40.8	9	14.3	15.3	19.8	42.6
3-5	30.3	17.9	8	8.5	7.6	17.6	9.6	5	4.4	3.6	-42.0	-46.3
1-3	48.3	35.4	24	13.5	15.2	51.0	37.6	25	12.8	14.1	5.6	5.9
Below 1	4.5	3.3	7	1.3	1.4	4.3	2.8	6	1.1	1.1	-5.9	-13.8
Total	358.5	233.7	53	100	100	399.1	266.9	53	100.0	100.0	11.3	14.2
NBFIS												
Over 5	15.8	11.1	2	52.4	63.8	6.9	3.6	1	36.6	37.5	-56.5	-68.0
1-5	10.8	4.2	5	35.9	23.8	7.9	3.6	4	42.2	38.3	-26.8	-12.4
0.5-1	2.6	1.8	4	8.7	10.0	2.8	1.6	5	14.8	16.5	5.8	-10.5
0.2-0.5	0.4	0.1	1	1.2	0.4	0.8	0.3	3	4.1	3.4	112.9	379.1
0.1-0.2	0.4	0.1	2	1.2	0.9	0.3	0.2	1	1.6	2.2	-16.1	40.9
Below 0.1	0.2	0.2	3	0.6	1.1	0.1	0.2	2	0.7	2.1	-30.9	5.2
Total	30.1	17.4	17	100	100	18.7	9.5	15	100.0	100.0	-37.8	-45.5

Source: Central Bank of Kenya

Commercial banks expanded their branch network during the twelve months to June 1998. One local bank opened a branch in Tanzania, bringing to four the number of locally owned banks with branches/subsidiaries outside Kenya so far. There are now seven branches: one in Malawi, three in Tanzania, two in Uganda and one in Pakistan. Locally, the branch network of banks expanded with the on-going conversion of NBFIs to commercial banks.

Foreign exchange bureaus increased from 34 in June 1997 to 43 in June 1998. These bureaus are set to increase once 17 new applicants who have been issued with Conditional Letters of Intent commence operations.

Assets and Deposit Liabilities

Assets of commercial banks in the year to June 1998 increased by shs 40.6bn or 11.3% to shs 399.1bn from shs 358.5bn (Table 6). During the same period the total assets of NBFIs excluding those of mortgage finance companies fell by shs 11.4bn or 37.8% to shs 18.7bn from shs 30.1bn. Meanwhile, deposits of commercial banks rose by shs 33.2bn or 14.2% to shs 266.9bn in June 1998 from shs 233.7bn in June 1997, as those of NBFIs declined by shs 7.9bn or 45.5% to shs 9.5bn from shs 17.4bn over the same period. The decline in the assets and deposits of NBFIs was attributed to the fall in the operational NBFIs to 15 in June 1998 from 17 in June 1997.

A few institutions continued to dominate the balance sheets of deposit taking institutions registered under the Banking Act, namely commercial banks and NBFIs.

- The leading commercial banks with assets worth more than shs 10bn, increased from 7 to 8 in the twelve months to June 1998. These banks share in total assets of commercial banks rose to 67.4% in

June 1998 from 63.5% in June 1997, while their share in total deposits liabilities increased to 66% in June 1998 from 63.6% in June 1997

- Among the NBFIs, the largest institutions with assets above shs 5bn declined from 2 to 1 in the twelve months to June 1998. As a result the share of the remaining institution in the total assets of NBFIs declined to 36.6% in June 1998 from 52.4% in June 1997, while its share in total deposits with NBFIs fell to to 37.5% from 63.8% over the same period. The loss of command over the peer groups' balance sheet during the twelve months to June 1998 reflects the conversion of a major NBFI into a commercial bank and the placement of another under the management of the Central Bank.

Although there were a few incidents of weak management of institutions, banking regulations remained unchanged during the twelve months to June 1998. Existence of weak institutions underscore the need to tighten laws on banking, enhance disclosures and strengthen banking supervision. To foster a sound banking system and protect depositors' funds, the Banking Act will be amended in the next twelve months to June 1999 to provide for the enforcement of:

- sound corporate governance of all institutions; directors and senior managers of banks and NBFIs will be required to ensure that accepted commercial and banking principles are adhered to at all times.
- adequate provision for non-performing loans; this will be the responsibility of bank auditors; and
- more accountability; an independent rating agency will be formed for assessing and ranking banking institutions. In particular, banking institutions seeking to issue commercial paper or corporate bonds will require rating by such an agency with regards to status of disclosure and credit worthiness.

CENTRAL BANK OF KENYA
BALANCE SHEET

(in millions of Kshs)

	Jun'97	Jun'98
ASSETS	**126,042**	**122,379**
Gold and foreign exchange	56,245	45,225
Advances and discounts to banks	1,686	1,201
Fixed assets	2,837	3,144
Others assets	1,193	2,086
Revaluation account	24,360	23,142
Government accounts	39,721	47,581
Overdraft to Government of Kenya	-	5,436
Clearing account	1,119	4,375
Investment in Government securities	38,602	37,770
LIABILITIES	**126,042**	**122,379**
Currency in circulation	33,632	38,229
Deposits	84,239	77,884
Government of Kenya	19,443	15,272
Commercial banks		
Kenya	37,303	38,770
External	163	99
Non- bank financial institutions	3,285	1,468
IMF	17,426	14,508
Other public entities and project a/cs	6,619	7,767
Other liabilities and provisions	571	2,430
Dividend payable	5,336	-
Capital account	2,264	3,836
Capital	1,500	1,500
General reserve fund	764	2,336

Source: Central Bank of Kenya

CENTRAL BANK OF KENYA

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 30TH JUNE 1998

(in millions of Kshs)

	1997	1998
REVENUE	**9,956**	**19,566**
Foreign Investment Earnings	2,177	2,623
Local Investment Earnings	6,442	11,697
Other	1,337	5,246
EXPENDITURE	**4,028**	**4,094**
Administrative Expenses	2,071	1,947
Currency Expenses	826	843
Banking Expenses	99	86
Revaluation Loss - Gold and Deposits	156	-
Amortization of Revaluation Loss	-	1,218
Exceptional Items	876	-
Provision for Doubtful Debt	-	-
Voluntary Early Retirement Costs	876	-
NET SURPLUS	**5,928**	**15,472**

Source: Central Bank of Kenya

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

We have audited the financial statements on pages 40 and 41 which have been prepared under the historical cost convention and on the basis of the set Accounting Policies. We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit and to provide a reasonable basis for our opinion. The financial statements are in agreement with the books of account.

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

We conducted our audit in accordance with Kenyan Auditing Standards. Those standards require that we plan and perform our audit to obtain reasonable assurance that the accounts are free from material misstatement. An audit includes an examination, on a test basis, of evidence supporting the amounts and disclosures in the financial statements. It also incudes an assessment of the accounting policies used and significant estimates made by the directors, as well as an evaluation of the overall presentation of the financial statements.

In our opinion, proper books of accounts have been kept and the financial statements give a true and fair view of the state of the Bank's financial affairs at 30 June 1998 and of the results of its operations for the period then ended in accordance with the Kenyan Accounting Standards and comply with the requirements of the Central Bank of Kenya Act.

CERTIFIED PUBLIC ACCOUNTANTS

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JOINT AUDITORS

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