

**Kenya: 2006 Article IV Consultation and Second Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, and Requests for Extension and Rephrasing of the Arrangement, Reduction in Access, and Waiver of Performance Criteria—Staff Report; Staff Supplement and Statement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Kenya**

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2006 Article IV consultation with Kenya and the second review under the three-year arrangement under the Poverty Reduction and Growth Facility, and requests for an extension and a rephrasing of the arrangement, reduction in access, and a waiver of performance criteria, the following documents have been released and are included in this package:

- The staff report for the combined 2006 Article IV Consultation and Second Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, and Requests for Extension and Rephrasing of the Arrangement, Reduction in Access, and Waiver of Performance Criteria, prepared by a staff team of the IMF, following discussions that ended on November 15, 2006, with the officials of Kenya on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on March 27, 2007. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- A staff supplement of April 6, 2007, updating information on recent developments.
- A staff statement of April 11, 2007, updating information on recent developments.
- Press Release summarizing the views of the Executive Board as expressed during its April 11, 2007, discussion of the staff report on issues related to the review and the Article IV consultation.
- A statement by the Executive Director for Kenya.

The documents listed below are also included:

- Letter of Intent sent to the IMF by the authorities of Kenya
  - Memorandum of Economic and Financial Policies by the authorities of Kenya
  - Technical Memorandum of Understanding
- \*Also included in the Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

Copies of this report are available to the public from

International Monetary Fund • Publication Services  
700 19<sup>th</sup> Street, N.W. • Washington, D.C. 20431  
Telephone: (202) 623-7430 • Telefax: (202) 623-7201  
E-mail: [publications@imf.org](mailto:publications@imf.org) • Internet: <http://www.imf.org>



INTERNATIONAL MONETARY FUND  
KENYA

**2006 Article IV Consultation and Second Review  
Under the Three-Year Arrangement Under the Poverty Reduction and Growth  
Facility, and Requests for Extension and Rephasing of the Arrangement, Reduction in  
Access, and Waiver of Performance Criteria**

Prepared by the African Department  
(In consultation with other departments)

Approved by Thomas Krueger and Anthony R. Boote

March 27, 2007

**Main topics**

- *Article IV consultation.* This report focuses on how to sustain Kenya's recent strong economic growth and argues that this would require accelerating structural reforms—including concrete governance actions—and upgrading infrastructure, while preserving macroeconomic stability.
- *Program review.* The report recommends completion of the second review under the Poverty Reduction and Growth Facility (PRGF) arrangement, extension of the arrangement to November 20, 2007, and a reduction and rephasing of access. Governance reforms are central in the program for 2006/07.

**Participants**

The mission (November 1–15, 2006) comprised Messrs. Andrews (head), Yang, Cheng (all AFR); John (PDR); and Mses. Lukonga (MCM) and Everaert (FAD). Mr. Rogers, the Fund's resident representative in Nairobi, participated in the discussions, and Ms. Rachel Gesami, advisor in the Executive Director's office, attended policy discussions. Ms. Masha helped prepare the staff report. The mission met with Minister for Finance Kimunya, Acting Governor of the Central Bank of Kenya Mwatela, Minister for Justice and Constitutional Affairs Karua, Attorney General Wako, Director of the Kenya Anti-Corruption Commission Ringera, other senior government officials, representatives of the private sector, nongovernmental organizations, and the donor community.

**Selected Issues Papers**

Three joint selected issues papers (SIPs) were prepared for the Article IV consultations with Kenya, Tanzania, and Uganda.

**Article VIII status**

Kenya has accepted the obligations under Article VIII, Sections 2, 3, and 4 and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions.

Contents	Page
Executive Summary .....	4
I. Introduction.....	5
II. Policy Discussions: Sustaining Growth and Reducing Poverty .....	6
A. Growth, Investment, and the Medium-Term Framework .....	6
B. Tackling Governance Weaknesses.....	9
C. Fiscal Policy for Stability and Growth.....	10
D. Financial Sector Policy to Support Stability and Growth .....	14
E. Ensuring Competitiveness .....	16
Exchange rate policy.....	16
Public enterprise reform.....	18
Trade, investment and regional integration .....	18
Regulatory regime.....	19
III. The PRGF Arrangement: Supporting Growth .....	19
A. Performance under the Arrangement .....	20
B. Program for 2007 .....	20
Macroeconomic policies .....	20
Governance .....	21
Structural measures.....	22
Program monitoring and financing .....	23
IV. Other Issues.....	24
V. Staff Appraisal .....	24
 Boxes	
1. Key 2004 Article IV Policy Recommendations and Implementation .....	5
2. External Competitiveness .....	17
3. Business Licenses .....	19
 Tables	
1. Medium-Term Macroeconomic Framework, 2004/05–2008/09.....	27
2. Central Government Fiscal Operations, 2004/05–2008/09.....	28
3. Monetary Survey, 2004–07.....	30
4. Balance of Payments, 2004/05–2008/09.....	31
5. Financial Soundness Indicators, 2003–August 2006.....	32

6.	Disbursement Schedule under the PRGF Arrangement.....	32
7.	External Financing Requirements and Resources, 2004/05–2008/09 .....	33
8.	External Debt Indicators, 2004–2009 .....	34
9.	Actual and Projected Payments to the Fund, 2003–2011 .....	35
10.	Millennium Development Goals, 1990–2003 .....	36

#### Appendices

I.	Debt Sustainability Analysis.....	37
II.	Letter of Intent .....	53
	Attachment I. Memorandum of Economic and Financial Policies for 2006/07 .....	55
	Attachment II. Technical Memorandum of Understanding.....	74

## EXECUTIVE SUMMARY

**Three years of broad-based economic recovery brought GDP growth to near 6 percent in 2005/06, its highest in two decades.** There was broad consensus on policies for the medium term including the importance of continued macroeconomic stability, faster structural and governance reforms, and major infrastructure improvements, especially to the road and electricity networks. However, the authorities consider their policy framework supportive of growth above 6 percent in the medium term.

**Fiscal policy should continue to aim at a gradual reduction in domestic public debt over the medium term while further reorienting spending towards poverty reduction and development.** A gradual increase in aid flows over the medium term would allow higher spending on these priorities. However, public financial management needs further strengthening to ensure efficient resource use.

**Monetary policy should be tightened to stem emerging inflationary pressures.** The Central Bank of Kenya should strictly target reserve money growth and let repo rates move more freely. Foreign exchange market intervention should not undermine monetary objectives.

**Financial sector reforms should be accelerated.** Priority actions include amending the Banking Act to align Kenya's regulatory and legal framework with international practices, enacting anti-money laundering legislation, privatizing troubled financial institutions, and developing a financial sector reform strategy.

**The recent real appreciation of the Kenyan shilling has so far not undermined export competitiveness.** However, maintaining competitiveness will require better infrastructure and further structural reforms, including streamlining business licenses, reforming public enterprises, and liberalizing trade.

**Governance reform hinges on rigorous implementation of priority measures.** The Governance Action Plan for 2006/07 sets the right priorities and progress has been made in implementation. However, decisive actions are still needed to strengthen institutions and increase transparency and accountability. Slow progress in investigating and prosecuting prominent corruption cases remains a serious concern.

**Despite the need for further progress in governance reforms, the staff recommends completion of the long delayed second review under the PRGF arrangement, and supports the authorities' request for extension of the arrangement, with reduced access, to November 20, 2007.** Kenya's performance under the PRGF-supported program has been mixed, but the authorities have maintained largely prudent macroeconomic policies and are strengthening structural reform.

## I. INTRODUCTION

1. **Economic growth has accelerated since 2003, reaching 5.9 percent in 2005/06, its highest rate in two decades.** Prudent macroeconomic policies and a favorable external environment helped lift the economy after more than a decade of slow growth and declines in per capita income. Article IV discussions (Section II of this report) therefore focused on the key challenge of sustaining and accelerating growth while maintaining macroeconomic stability, consistent with the Executive Board advice at the conclusion of the last consultation (Box 1).

2. **Staff recommends completion of the second review under the PRGF arrangement.** As explained in Section III of this report, the authorities' program<sup>1</sup> aims to safeguard macroeconomic stability in this election year<sup>2</sup> and the momentum of reforms to maintain growth. Governance measures in the PRGF-supported program draw from the authorities' *Governance Action Plan for Building a Prosperous Kenya, 2006–07 (GAP)*, which was developed in close consultation with stakeholders, including World Bank and Fund staffs. Implementation of this plan will strengthen governance and safeguard against the abuse of public resources. However, progress remains slow in investigating and prosecuting prominent corruption cases.

### Box 1. Key 2004 Article IV Policy Recommendations and Implementation

At the conclusion of the 2004 Article IV consultation, Executive Directors commended the authorities for Kenya's economic rebound, but noted that growth remained too slow to make inroads into poverty. Directors stressed the importance of broad structural reforms to promote growth and reduce poverty, and urged the authorities to act decisively to improve governance. They also encouraged the authorities to strengthen public expenditure management, accelerate public enterprise reform, and improve competitiveness. Executive Directors urged the authorities to maintain firm control of monetary aggregates, to address the problem of distressed banks, and to advance bank privatization.

These recommendations have been largely reflected in the authorities' policy agenda, although implementation has been uneven. Macroeconomic policies have been generally prudent, resulting in declining debt ratios, moderating nonfood inflation, and falling interest rates. While public enterprise reform has advanced, there has been little progress in restructuring and privatizing state-owned banks. Progress has also been made in improving public financial management (PFM), but much remains to be done, as with implementing wider governance reforms.

<sup>1</sup> See Appendix II, Letter of Intent and the attached Memorandum of Economic and Financial Policies (MEFP).

<sup>2</sup> Presidential and parliamentary elections will have to be held by December 2007, but could be called earlier.

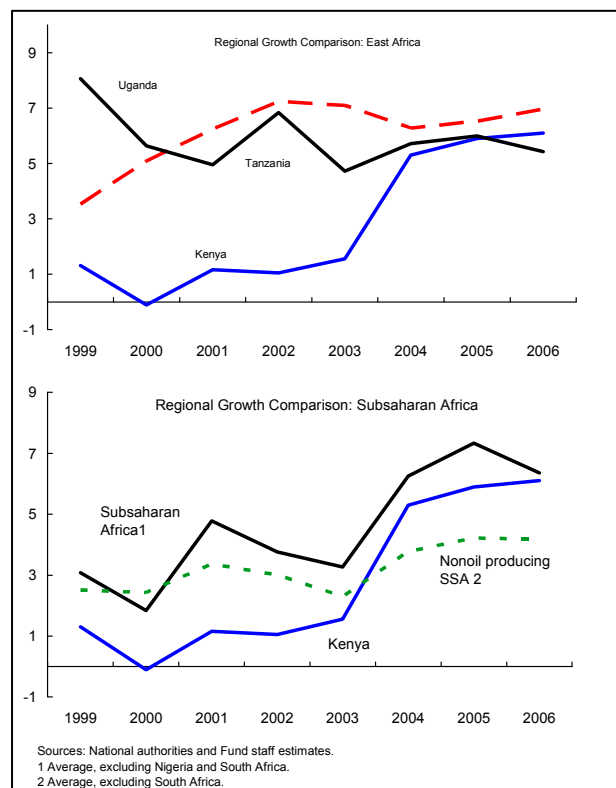
## II. POLICY DISCUSSIONS: SUSTAINING GROWTH AND REDUCING POVERTY

3. **Faster sustained growth is needed to achieve the Millennium Development Goals (MDGs).** Halving poverty by 2015 will require an annual average growth rate of at least 7 percent. Despite important gains in universal primary education and combating HIV/AIDS, malaria, and other diseases, more rapid progress is needed to achieve other MDGs (Table 10), especially in primary health care, which has deteriorated since the early 1990s. The *Kenya Vision 2030*, launched by the authorities in October 2006, also highlights the need to raise living standards and targets average annual growth of 10 percent.

4. **Discussions focused on policies to sustain and accelerate recent growth.** Key issues included: the importance of good governance and improved infrastructure for growth; the appropriate stance of fiscal policy given infrastructure needs and financing constraints; the conduct of monetary policy given the recent inflationary pressure; the challenge of maintaining competitiveness in the face of recent capital inflows and a strengthening shilling; and the need to accelerate financial sector reform. The discussions were facilitated by three joint SIPs for the three original members of the East African Community (EAC)—Kenya, Tanzania, and Uganda. The papers focused on: (i) promoting private sector credit; (ii) further liberalizing trade; and (iii) harmonizing investment incentives.

### A. Growth, Investment, and the Medium-Term Framework

5. **Kenya's recent growth has exceeded the average rate in nonoil-producing Sub-Saharan Africa (SSA) as well as the initial projections in the PRGF-supported program.** This broad-based growth has been supported by a generally favorable external environment. Rising world prices for tea and coffee and continued strong demand for horticultural exports have stimulated agricultural growth; manufacturing has benefited from strong regional demand and the formation of the EAC Customs Union; and robust growth in services has been driven by strong tourism demand. Increased remittances and private capital inflows have contributed to an improvement in the overall external balance, despite strong import growth. Although there are signs of

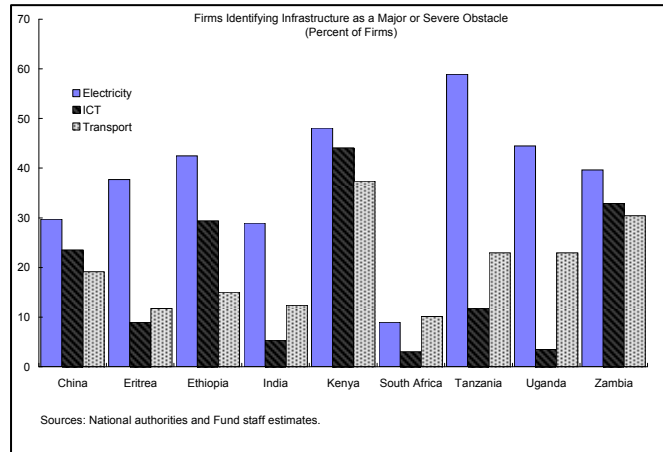




an improved investment climate, private investment has yet to rebound strongly and, particularly in manufacturing, growth appears to have been largely a result of greater capacity utilization.

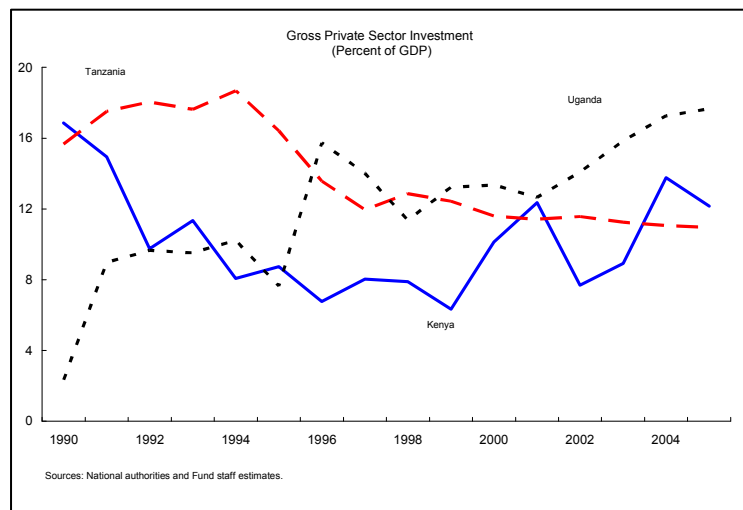
**6. The staff and the authorities agreed that poor infrastructure, if not improved, will become an increasing impediment to growth.** According to the World Bank's

Investment Climate Surveys, 48 percent of Kenyan firms cite infrastructure as a major constraint on business activities. Kenya's road network, which handles 80–90 percent of the country's transport load, is in poor condition after decades of underinvestment. Losses from power failures are estimated at 6–10 percent of firms' sales; work is underway to improve the distribution system and expand generation capacity, which is approaching full utilization.

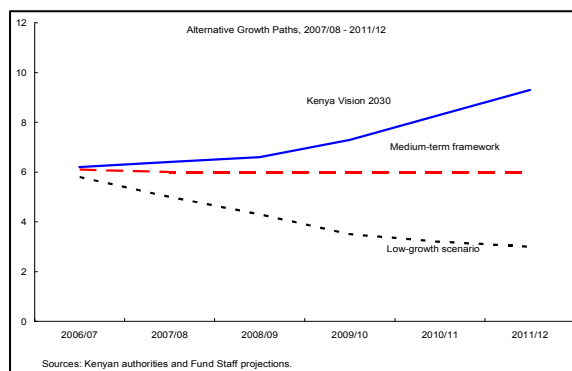


**7. Despite a recent rebound, private sector investment remains too low to sustain growth.** One key to increasing private investment is to reduce the cost of doing business. Thanks to a relatively skilled labor force, Kenya's gross labor productivity in manufacturing

is not far below that of China, whose growth performance Kenya seeks to emulate. According to the World Bank Investment Climate Surveys, however, because of high indirect costs (land, security, insurance, and compliance with regulatory requirements), Kenya's net labor productivity (gross value added minus indirect costs) is only about half of that in China. Much of the high indirect cost of doing business in Kenya is linked to weaknesses in governance, which has also been cited as a major constraint on business activity.



8. **Policy discussions took place around a medium-term macroeconomic framework with growth averaging 6 percent.** This framework would be underpinned by continued macroeconomic stability, with inflation declining to 5 percent; accelerated structural reforms; and significant investment in infrastructure. As discussed below, domestic resources could cover only part



of the required increase in public investment, and the framework envisages a gradual increase in external aid. Failure to secure this assistance would pose a risk to the scenario either by slowing progress in addressing infrastructure bottlenecks or prompting recourse to excessive domestic borrowing with potentially adverse consequences for interest rates and debt sustainability. In the staff's view, if combined with a loss of the momentum of reform, this could gradually return growth to the low rates observed for much of the past two decades.

9. **The authorities took a more optimistic view of growth prospects, but in the interest of fiscal prudence, they have based their medium-term budget planning on growth of 6 percent.** They viewed the economy's recent performance as indicating that Kenya has moved to a higher growth path and considered their current reform agenda supportive of a gradual acceleration in growth from 6 percent to 10 percent over the medium term, in line with the Kenya 2030 vision. While agreeing with the staff that further reforms and investment were needed to support growth, they felt that these could yield greater productivity gains than allowed for in the 6 percent growth scenario.

Main Macroeconomic Indicators

	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
	Actual	Est.	Est.	Proj.	Proj.	Proj.	Proj.
(Annual percentage change)							
<b>National accounts and prices</b>							
Real GDP (market prices)	5.3	5.9	6.1	6.0	6.0	6.0	6.0
Consumer price index (end of period)	11.9	10.9	6.8	5.0	5.0	5.0	5.0
(In percent of GDP)							
<b>Investment and saving</b>							
Investment	16.9	18.1	20.2	20.7	21.7	21.5	22.0
Gross national saving	15.1	14.5	16.6	16.7	17.6	17.4	17.5
<b>Central government budget</b>							
Total revenue	21.5	19.9	21.2	21.5	21.6	21.6	21.6
Total expenditure and net lending	22.5	24.4	25.6	26.1	26.9	26.4	26.7
Overall balance (commitment basis) including grants	0.1	-3.3	-3.3	-3.5	-3.8	-2.8	-2.9
<b>External sector</b>							
Current external balance, excluding official transfers	-1.7	-3.9	-3.5	-4.0	-4.1	-4.1	-4.6
Gross international reserve coverage (in months of imports)	2.5	3.3	3.3	3.4	3.5	3.5	3.6
NPV of central government debt (end of period)	39.7	35.2	34.3	34.1	33.3	32.5	30.4

Sources: National authorities; and Fund staff estimates and projections.

## B. Tackling Governance Weaknesses

10. **The authorities and the staff agreed that weak governance has been a key factor in Kenya's disappointing economic performance of the past two decades.** Weak governance has been reflected in widespread corruption and inefficient use of public resources, which undermined competitiveness and investor confidence. A recent assessment under the New Partnership for Africa's Development (NEPAD)'s African Peer Review Mechanism also noted a general public perception that corruption is endemic in Kenya.<sup>3</sup>

11. **While recognizing major challenges ahead in the fight against corruption, the authorities stressed that extensive governance reforms have been undertaken since the government came to power in 2003.** These reforms aimed to strengthen the three pillars of their governance strategy: (i) corruption prevention and education; ; (ii) investigation; and (iii) restitution. Key steps under the first pillar have included passage of Public Officers Ethics Act, the Anti-Corruption and Economic Crimes Act, the Government Financial Management Act, the Public Audit Office Act, and the Public Procurement and Disposal Act. A Ministerial Code of Conduct requires the submission of wealth declarations, which are verified by the Kenya Anti-Corruption Commission (KACC). The government has abolished *harambees* (coerced fund-raising) and ended land grabbing, which were significant sources of state corruption. The authorities have also advanced public sector and financial management reforms, including parastatal reforms in preventing abuse of public resources, and specific anti-corruption measures in sectoral ministries, such as in education and water.

12. **The authorities noted that the establishment of the KACC in 2004 and the restructuring of the Department of Public Prosecutions have enhanced the capacity to investigate corruption.** In the area of restitution, a far-reaching purge of the judiciary has removed judges and magistrates implicated in the report of the Integrity and Anti-Corruption Committee of the Judiciary. The KACC is pursuing asset recoveries. The government has published the report of the Public Accounts Committee on Anglo-Leasing contracts,<sup>4</sup> as well as the findings of the Goldenberg and Ndungu Commissions, and has initiated action based on the recommendations in these reports.<sup>5</sup> The GAP, which was recently approved by Cabinet, seeks to address immediate governance priorities through the end of 2007.

---

<sup>3</sup> See *Country Review Report of the Republic of Kenya*, <http://www.nepad.org/2005/files/aprm/APRMKenyaereport.pdf>.

<sup>4</sup> So named after one of the firms involved in security-related contracts that have been found to be fraudulent or deeply flawed. A number of senior government officials have been implicated in the scandal.

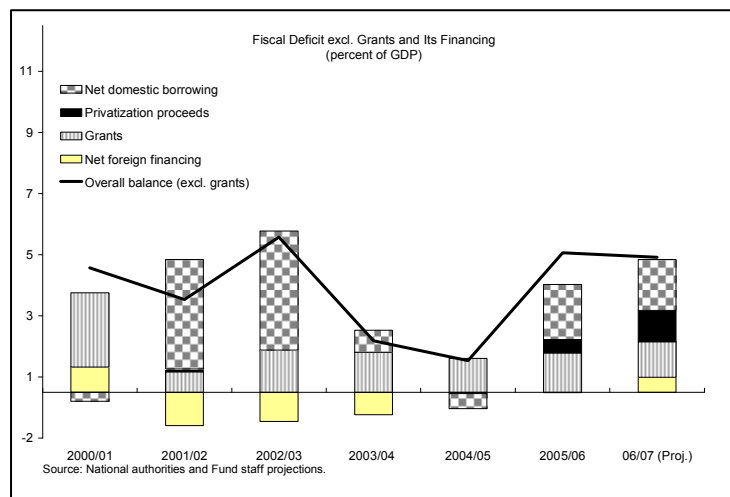
<sup>5</sup> Further details of these reforms are provided in the *Governance Action Plan for Building a Prosperous Kenya, 2006–07* and the attached MEFP, especially paragraphs 7, 8, 12, and 13.

13. **The staff acknowledged these wide-ranging reforms and welcomed the GAP, but noted that serious weaknesses remain.** The governance assessment report that was prepared by World Bank staff with Fund staff participation in 2006 included empirical evidence suggesting that a decline in corruption during 2003–04 has subsequently halted, and that there may even have been a deterioration in operations of the judiciary and in procurement, although not to the pre-2003 levels. The staff considered that implementation of the GAP, which also draws on the findings and recommendations of the report, would be an important step. Significant reforms have been, and are being, taken to strengthen transparency and institutions and thereby prevent corruption. In this regard, the staff welcomed, for example, the decision to post details of procurement contracts on the government website. However, progress in strengthening prosecution and restitution has not lived up to expectations, undermining public confidence in the authorities' determination to root out corruption. In particular, staff expressed serious concern over the slow progress in prosecuting prominent cases of corruption, in which senior officials had been implicated.

14. **The authorities stressed that it would take time to investigate and try prominent corruption cases.** They argued that slow progress in concluding cases is also linked to an under-staffed and under-equipped judiciary, a paucity of courtrooms, an insufficient number of prosecutors, and the application of constitutional stays by defendants. Many of these weaknesses are being addressed in the context of the GAP.

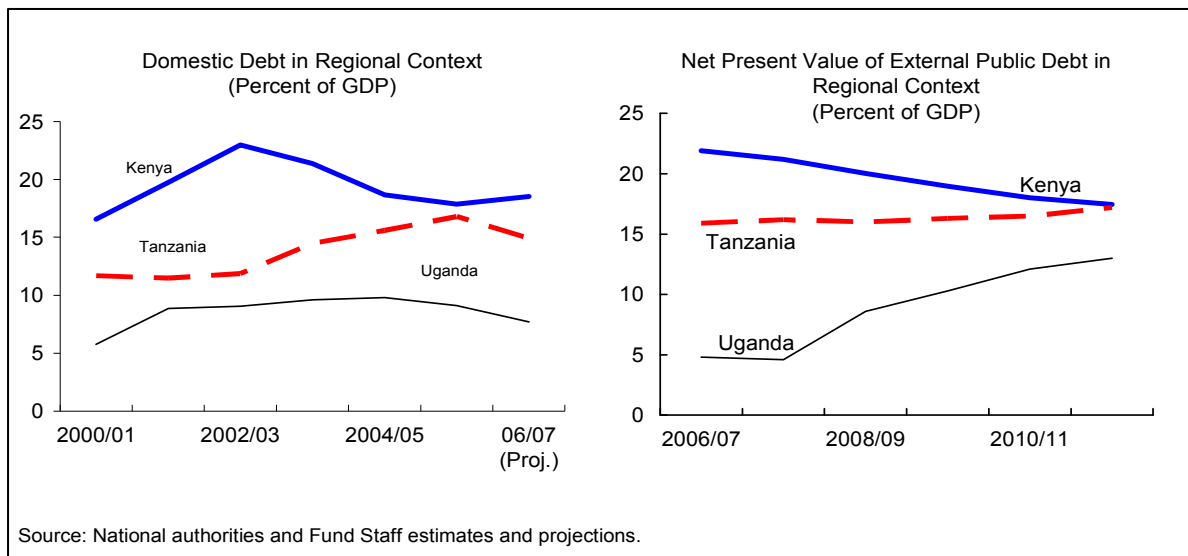
### C. Fiscal Policy for Stability and Growth

15. **The authorities and staff agreed that fiscal policy should maintain its broadly expansionary stance since 2005/06, to allow increased spending on infrastructure and poverty reduction.** In 2005/06 drought-related spending (0.8 percent of GDP) and revenue shortfalls due to problems with the introduction of new customs software (Simba) led to a widening of the overall deficit. However, net domestic borrowing was contained by cutting non-priority outlays; this also helped increase development spending and keep non-wage priority spending above 4.5 percent of GDP for a third year in a row, despite falling external budget support. With Simba problems now resolved and revenue performance set to improve, development spending is projected to increase further over the



medium term while domestic borrowing declines gradually, in line with the authorities' medium-term fiscal framework.

16. **The authorities' medium-term fiscal framework aims at a further gradual reduction in the domestic debt-to-GDP ratio, which has declined significantly in recent years thanks to higher growth, stronger fiscal discipline, and lower interest rates.** The staff supported this objective. While Kenya's debt position leaves some limited room for additional domestic borrowing, especially if used to finance high-yield public investment, it would be more prudent to use largely untapped external concessional resources and enhanced revenue collection, instead of more costly domestic debt, to create fiscal space for priority spending. The mission stressed that Kenya's domestic debt remains higher than in the other EAC countries and the debt stock does not take into account potentially significant but not well-quantified contingent liabilities, including future pension obligations.<sup>6</sup> Moreover, there are risks to the current favorable debt dynamics from slower growth and higher interest rate.



17. **External debt sustainability does not appear to be an immediate concern provided Kenya maintains a prudent approach to borrowing.** Although Kenya has not benefited from HIPC/MDRI, a joint IMF-World Bank debt sustainability analysis (DSA) found the risk of external debt distress in Kenya to be low (Appendix I). While the current account deficit is expected to widen further as Kenya undertakes infrastructure investments,

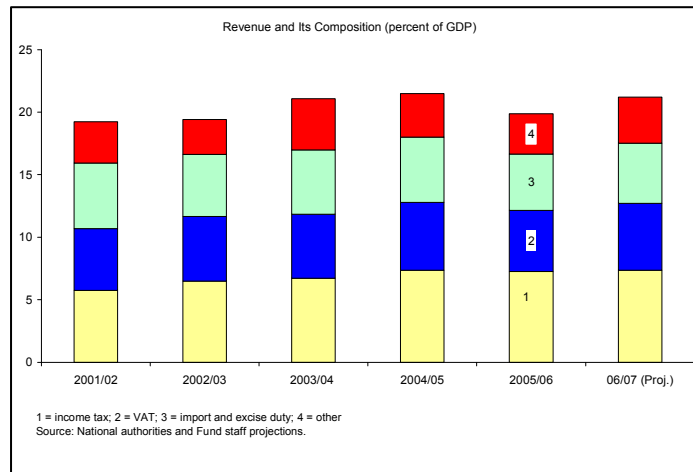
<sup>6</sup> The PRGF-supported program includes structural benchmarks on completing an audit of the NSSF and a study of contingent liabilities in 24 parastatals (MEFP, Table 3).

international reserves are projected to remain at about 3½ months of imports in the medium term. Stress tests suggest that shocks, particularly below-forecast export growth, would significantly increase debt ratios. Safeguarding debt sustainability and reducing vulnerability to external shocks argues for reliance on grants and concessional borrowing. The authorities agreed that concessional resources would be the best means to finance public investment. However, building on the S&P sovereign credit rating Kenya received in 2006 (B+), they are considering the possibility of a sovereign bond issue to establish a benchmark and help provide market discipline. The proceeds of such an issue would not be used to finance additional expenditures, and the authorities recognized that, apart from possible savings that may arise from retiring more costly external debt, the planned retention of bond proceeds in the CBK could entail a net interest cost. The mission discussed how the DSA and a debt management strategy could be used to help maintain debt sustainability, and stressed the importance of appropriately reflecting contingent liabilities from public enterprises in fiscal accounts.

**18. Kenya's revenue-to-GDP ratio compares favorably with other SSA countries, but as the government continues to increase infrastructure and pro-poor spending sustained efforts will be needed to enhance revenue performance.** The authorities

indicated that customs reform is advancing as the new computerized system, Simba, becomes fully operational. The number of large taxpayers has increased substantially, and electronic tax registers have been introduced for medium-size taxpayers. A presumptive tax regime has been developed for small-size taxpayers, although its implementation has been postponed. Steps have been taken to improve governance at the Kenya Revenue

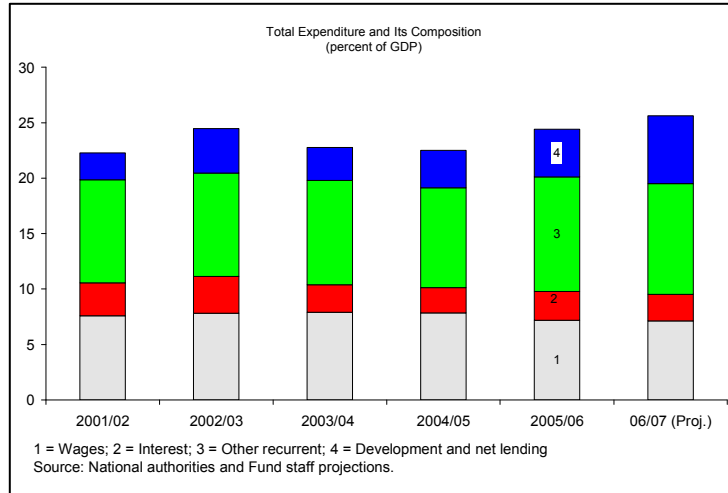
Authority and customs (MEFP, ¶15). The mission encouraged the authorities to scale back VAT withholding because it contravenes the principle of taxing value-added and puts undue pressure on the VAT refund system. However, the authorities argued that this temporary system would improve compliance, although it affects all taxpayers. The mission also advised against further tax exemptions and extension of VAT zero rating, as introduced in the 2006/07 budget. However, the authorities contended that the VAT zero rating and exemption measures were well targeted on poverty and growth and resulting revenue losses were offset by additional measures.



19. **The authorities and the staff agreed that public expenditures should be further re-oriented toward promoting growth and reducing poverty.** The mission supported the

authorities' medium-term plans for reducing outlays on parastatals and noncore activities and containing the public sector wage bill, which has declined by half a percent of GDP over the past two years, while increasing priority spending and improving the efficiency of service delivery, especially in health and education. The mission supported the authorities' plan to increase investment in agriculture and infrastructure, in line with the

priorities of the Investment Program for the Economic Recovery Strategy for Wealth and Employment Creation (IP-ERS) and Kenya Vision 2030.



20. **The authorities recognized the importance of further reforms to improve the efficiency of government spending.** In this connection, they have requested participation in a Report on Observance of Standards and Codes (ROSC) on fiscal transparency. There was agreement that further reform should focus on:

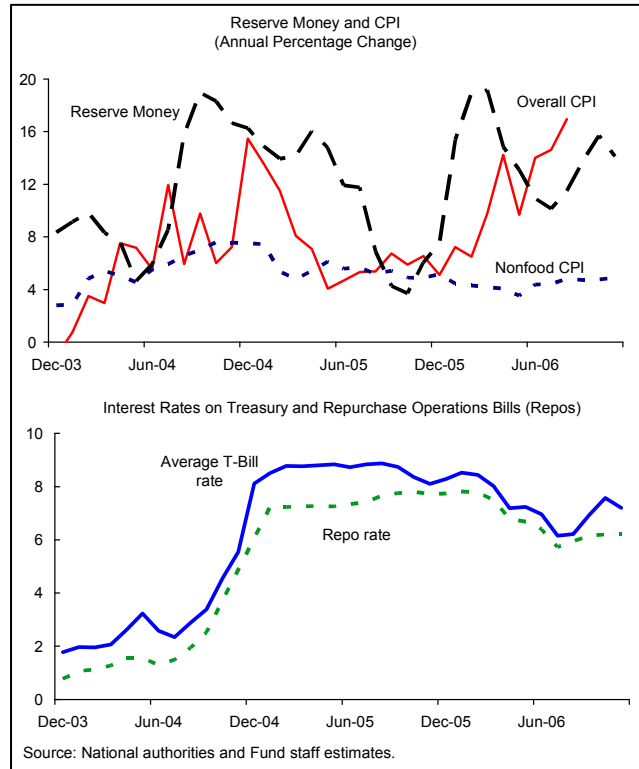
- **Further strengthening public financial management.** Despite considerable progress in recent years (MEFP, ¶17), improvements are needed in budget preparation, accounting and reporting. Priority should also be given to making the Public Procurement Oversight Authority fully operational and implementing the integrated financial management information system (IFMIS), especially given a planned move to program-based budgeting over the medium term.
- **Implementing the new pay policy and pension reforms.** This would require consolidating allowances, shifting staffing toward poverty areas, eliminating various pay review bodies, fully implementing the voluntary retirement scheme, and addressing large contingent liabilities in the public pension system (MEFP, ¶16). The contributory pension scheme for civil servants should become fully operational.

- **Improving governance in managing the Constituency Development Fund (CDF).** CDF expenditures should be more transparent and accountable, and cases of misuse should be dealt with swiftly.<sup>7</sup> CDF-funded infrastructure spending should be coordinated with budget provisions for current spending.

21. **The mission stressed the importance of using resources efficiently in infrastructure projects as public investment is scaled up.** Overcoming capacity constraints and improving governance will be important, particularly in the Ministry of Roads and Public Works, which has not fully used budget allocations. The authorities noted that complex disbursement and procurement procedures for some external funds had contributed to delays in execution. The authorities concurred with staff that a legal and institutional framework for public-private partnership (PPP) is needed to ensure proper costing and prioritization and to minimize fiscal risks.

#### D. Financial Sector Policy to Support Stability and Growth

22. **The staff supported the authorities' monetary policy framework which uses reserve money as an intermediate target for securing low inflation.** While control of monetary aggregates has improved since 2004, reserve money growth has exceeded CBK targets since 2006, partly because interest rates on repos have not been sufficiently flexible to mop up substantial liquidity injected by the CBK's foreign exchange operations in 2006. There have been substantial spikes in overall inflation since late 2005, and nonfood inflation has also edged up recently, to above 6 percent in early 2007.



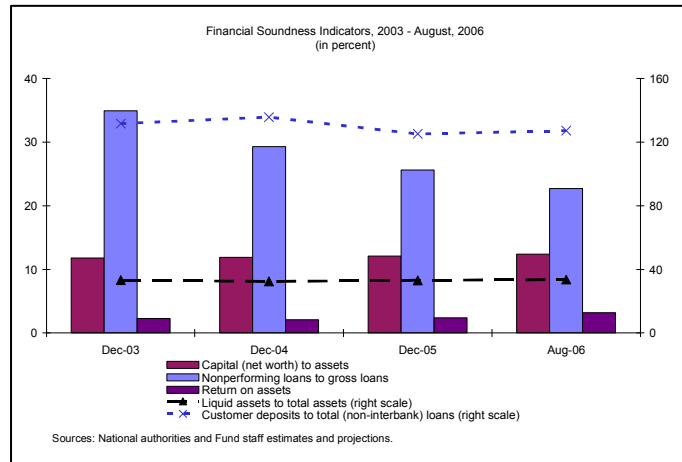
23. **The authorities attributed the inflation spikes largely to the drought in 2005 and the full pass-through of higher world oil prices.** Staff reiterated the need to examine the current monetary stance, as the

<sup>7</sup> The CDF National Management Committee recently forwarded 15 audit reports to the KACC for investigation, noting the late submission of books for audit, irregular procurement, and inadequate accountability.

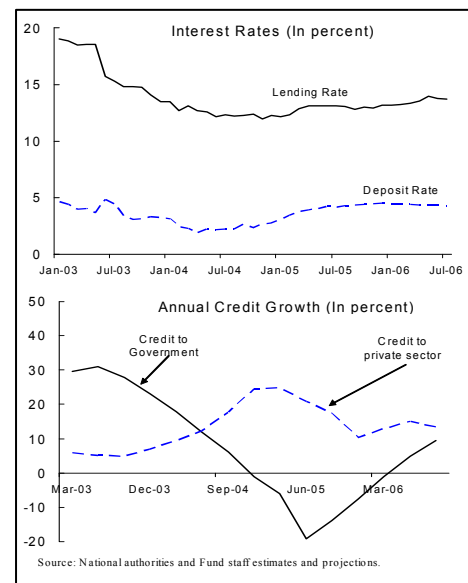


persistently high food inflation may also have a monetary component. The authorities and staff agreed that it is prudent to tighten monetary conditions somewhat in 2007 to reduce inflationary pressure. The mission welcomed the authorities' recent efforts to reiterate to the market the centrality of its reserve money target and, in this connection, urged the authorities to allow interest rates, including repo rates, to move more freely to achieve reserve money targets, and to address the remaining weaknesses in the monetary operations framework.<sup>8</sup>

**24. Kenya's financial system has been stable, but significant risks remain.** Aggregate financial soundness indicators point to a well capitalized, profitable and liquid banking sector. Compliance with prudential regulations has improved markedly since the introduction of financial penalties for violations, except for the NBK, which is under the CBK supervisory management. However, nonperforming loans (NPLs) remain high, and a number of banks are still weak. In addition, recent legal challenges to the CBK's supervisory power by Charterhouse Bank have highlighted the risks to effective supervision posed by problems in the judicial system. The bank, which was allegedly involved in money laundering and tax evasion, was placed under statutory management of the CBK in June 2006 and its license was withdrawn in December (MEFP, ¶22).



**25. Continued efforts are needed to strengthen the financial system.** Staff urged the authorities to amend the Banking Act to align the legal and regulatory framework with international practices, to expedite the passage of anti-money laundering (AML) legislation, to divest shareholding in state-influenced financial institutions, including the National Bank of Kenya (NBK), and to develop a comprehensive financial sector reform strategy. A key objective of this strategy should be to improve private sector access to credit by reducing interest rate spreads. This would require improving the legal system for property and creditor rights, increasing



<sup>8</sup> An MCM technical assistance mission on monetary operations, banking supervision, and payment systems visited Kenya in January-February 2007.

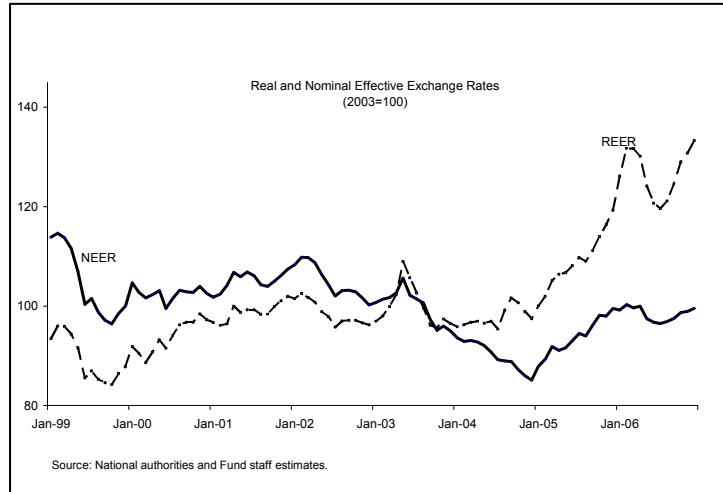
provision of credit information on borrowers, and supporting competition in the banking sector. The mission welcomed improvements in the regulatory regime for microfinance, but advised against regulating interest rates and bank charges and recommended elimination of Section 44 of the Banking Act, which provides for controls on bank charges.

## E. Ensuring Competitiveness

### Exchange rate policy

26. **Kenya has for some time maintained a de facto managed float regime for the shilling, which has appreciated in both nominal and real effective terms over the past two years.**

Increased tourism receipts, remittances, and capital inflows have financed a widening trade deficit and exerted upward pressure on the shilling. The authorities noted that they had at times intervened in the foreign



exchange market to alleviate appreciation pressures. Foreign exchange purchases by the CBK had not been fully sterilized, leading to a significant increase in the growth of reserve money in 2006. The mission advised that intervention be limited to prudent accumulation of reserves and smoothing short-term fluctuations not related to economic fundamentals.

27. **Staff analysis suggests that the shilling's appreciation has been broadly in line with economic fundamentals (Box 2).** A trade analysis shows that Kenya gained competitiveness in merchandise exports over the period 2002–05. This assessment is consistent with the private sector's view that although the appreciation may have had some negative impact on such exports as cut flowers, weak infrastructure, particularly poor roads, remains the most important constraint on competitiveness. In this regard, the authorities and the staff agreed that a fiscal tightening would not help competitiveness because it would be likely at the expense of infrastructure projects, which are important for improving export performance and also often have a large import component.

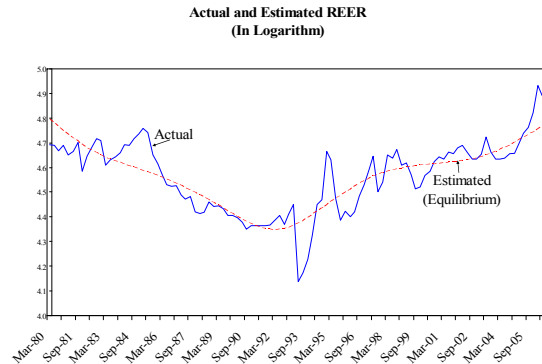
28. **Looking forward, the authorities were confident that exports would remain competitive despite a strong shilling.** They believed that ongoing structural reforms would raise productivity and regional export demand would continue to increase as a result of the

formation and the recent enlargement of the EAC customs union.<sup>9</sup> The mission cautioned that prospects for exports needed to take into account the small size of the EAC market and Kenya's concentration in commodities, which are subject to secular price declines and price volatility.

### Box 2. External Competitiveness

An econometric model was used to study Kenya's equilibrium real exchange rate. Using quarterly data from 1980Q1 to 2006Q3, the results suggest that movements of Kenya's actual REER have been broadly in line with the estimated equilibrium values during the past two years. The shilling's strengthening has been largely driven by economic fundamentals, including higher productivity, rising exports, and increasing net foreign assets of the banking system.

A constant market share analysis<sup>1</sup> shows that Kenya's export competitiveness improved during 2002–05. Kenya's major export commodities, tea, coffee, fruits and vegetables, cut flowers, and garments (which have benefited from the U.S. African Growth and Opportunity Act), all gained market share. Kenya's tourist arrivals have also been growing faster than the world average. Although external demand was the main driver in export growth, enhanced competitiveness accounted for 40 percent of the increase in merchandise exports over the period.



#### Decomposition of Cumulative Changes in Kenyan Exports, 2002-05

	In Millions of US dollars	In Percent of Total
Contribution from:		
Global expansion	1735	88
Export composition	33	2
Market distribution	-591	-30
Competitiveness	801	40
<b>Total</b>	<b>1978</b>	<b>100</b>

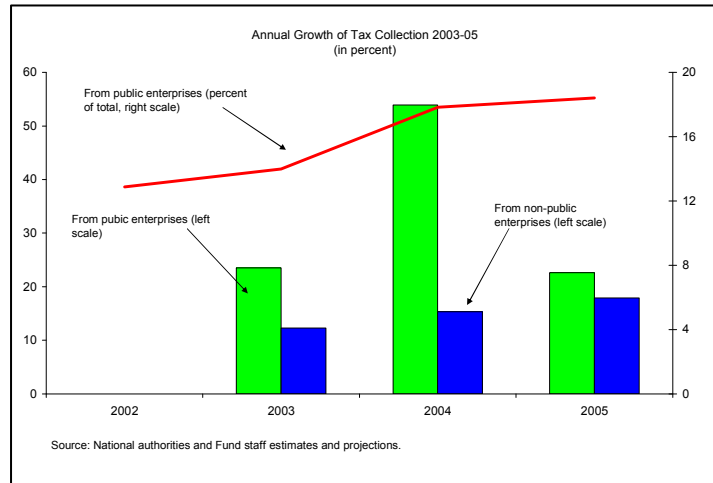
Source: IMF staff estimates based on UN COMTRADE data.

<sup>1</sup> For the model see Edward E. Leamer and Robert M. Stern, *Quantitative International Economics*, Boston, Allyn and Bacon, 1970.

<sup>9</sup> Burundi and Rwanda joined the EAC on November 30, 2006.

## Public enterprise reform

29. **The authorities have made considerable progress in parastatal reform.** Recent advances include the concessioning of Kenya Railways, partial privatization of KenGen and Mumias Sugar Company, and the introduction of a management contract for Kenya Power and Lighting Company and performance contracts for all public commercial enterprises. The financial performance of commercial public enterprises seems to have improved and their tax



payments have increased more rapidly than those of private enterprises over the past three years. The authorities envisaged further divestiture in the insurance, energy, and telecommunications sectors. The mission commended the authorities on these advances, and encouraged expeditious completion of the study of contingent liabilities of 25 parastatals and concessioning of the Mombasa container terminal. The mission also encouraged the authorities to speed up the establishment of the Privatization Commission, and take stock of the numerous autonomous and semiautonomous government agencies and eliminate those without clear public and social objectives (MEFP, ¶17).

## Trade, investment and regional integration

30. **The mission encouraged the authorities to work with EAC partners to reduce the Common External Tariff (CET).** This should be part of Kenya's strategy to build a globally competitive export sector. Staff's SIP shows that even in the short run, lowering the top tariffs and bringing "sensitive" products into the CET would benefit all three original EAC members, especially the urban poor. The authorities agreed that the CET should be lowered but considered it premature, noting the scheduled review of the CET in 2010. The mission encouraged the authorities to remove nontariff barriers, such as trade licenses, road blocks, and checkpoints. The mission also advocated rationalization of regional trade arrangements (RTAs), which give rise to potentially conflicting commitments and hinder tariff reduction.<sup>10</sup>

<sup>10</sup> Kenya and Uganda are members of the Common Market for Eastern and Southern Africa (COMESA), while Tanzania is a member of the Southern African Development Community (SADC).

31. **The mission advocated coordination of investment incentives in the EAC, possibly through a code of conduct.** Drawing on a SIP, it argued that such a code would help avoid a “race to the bottom” in investment incentives, which would entail revenue losses to all countries. While recognizing the potential benefits of such a code, the authorities indicated that there is currently insufficient support in the EAC.

### Regulatory regime

32. **The mission supported the authorities’ efforts to reform Kenya’s regulatory regime to reduce costs of doing business.** A number of business licenses have recently been removed and further streamlining is underway (Box 3). Staff encouraged the authorities to press for bolder labor market reforms, including greater flexibility of employment, less frequent adjustments of minimum wages, and a closer link between wage awards and productivity. The authorities stressed the importance of wage regulation to protect the poor in the absence of a social safety net.

#### Box 3. Business Licenses

Kenya ranks in the middle of the World Bank’s global ease of doing business indicators and sixth within SSA. Although Kenya ranks among the best in SSA in “dealing with business licenses,” the horticultural and tourism sectors provide examples of excessive requirements. Even after the removal of nine business licenses in 2006, a cut flowers business is still required to obtain 60 licenses to operate. A tour operator requires 11 licenses, seven of which are to be displayed on the vehicle windscreen. Some cut flowers businesses hire full-time staff to meet their licensing requirements, adding significantly to costs.

Kenya has a total of about 1,400 business licenses, many of which were introduced by local governments to raise revenue. The authorities have eliminated 118 licenses over the past two years. Based on the recommendations of the Business Regulatory Reform Unit, the 2007/08 Finance Bill will propose elimination of licenses judged not to serve a useful purpose. The World Bank has taken the lead in helping the authorities with these efforts.

#### Ease of Doing Business Indicators, 2006

Ease of...	World Rank <sup>1</sup>	SSA Rank <sup>2</sup>
<i>Doing Business</i>	83	6
Starting a Business	111	15
Dealing with Licenses	24	3
Employing Workers	68	9
Registering Property	115	17
Getting Credit	33	3
Protecting Investors	60	10
Paying Taxes	127	27
Trading Across Borders	145	28
Enforcing Contracts	67	9
Closing a Business	128	25

<sup>1</sup> Rankings are out of 175 countries. The lower the better.

<sup>2</sup> Ranking are out of 45 countries.

Source: World Bank Doing Business Database.

### III. THE PRGF ARRANGEMENT: SUPPORTING GROWTH

33. **Kenya’s three-year PRGF arrangement was approved on November 21, 2003 in the amount of SDR 175 million (64 percent of quota).** At the conclusion of the first review access was augmented by SDR 50 million to mitigate the effects of world oil price increases and a drought on the balance of payments. The arrangement has been extended twice to April 30, 2007.

### A. Performance under the Arrangement

34. **There have been long delays in completing the second review under the arrangement.** These delays were largely due to governance concerns, including issues arising from allegations surrounding security-related procurement (Anglo Leasing) contracts.

35. **As indicated in the attached MEFP (Tables 1 and 2), five of the 13 performance criteria for the second review (2004/05) were not met.** The end-March 2005 quantitative performance criterion (PC) and end-June benchmark on reserve money were missed, as was the continuous PC on nonaccumulation of external payment arrears. The structural PC on non-imposition of controls on banks' fees and charges was not met, but remedial arrangements have been developed for prompt approval of proposed increases in fees and charges. The PC on issuance of new guidelines for wage arbitration by the Industrial Court and the PC on completion of the asset declaration of ministers, permanent secretaries, and heads of state bodies were not observed.<sup>11</sup> The two structural PCs set for the third review were also not met. As noted above, steps were taken to meet the original objectives of the continuous PC on non-imposition of controls on banks' fees and charges. Verification of asset declarations of ministers and senior officials, the second structural PC, is continuing.

### B. Program for 2007

#### Macroeconomic policies

36. **The key objective of the 2006/07 program is to safeguard macroeconomic stability and strengthen the foundations for sustained growth.** Understandings were reached on the macroeconomic framework, which targets GDP growth of 6.1 percent in 2006/07 and inflation under 7 percent by end-June.

37. **The overall deficit is expected to widen, but net domestic borrowing would be contained at 1.7 percent of GDP.** Despite higher projected revenues, increased development spending is expected to result in an overall deficit of 3.2 percent of GDP, to be financed by proceeds (1.0 percent of GDP) from divestment in the sugar, insurance and electricity sectors (¶ 29, and MEFP, ¶ 26) and foreign financing (0.5 percent of GDP), in addition to domestic borrowing. Domestic debt is expected to increase to 18.5 percent of GDP due to the one-off costs associated with the restructuring of NBK.

38. **Revenue is expected to rebound to 21.2 percent of GDP, up by 1.3 percentage points from last year, bringing it in line with the recent trends.** In the first half of 2006/07 monthly VAT and import duty collections rose by an average of 33 and 42 percent

---

<sup>11</sup> The new wage guidelines, which were intended to link wage awards more closely to productivity changes, were eventually issued in November 2005, but they have not been strictly followed. Notably, the minimum wage increase on May 1, 2006 violated the guidelines.

respectively following full implementation of the Simba. However, there were shortfalls in collections of excise and income taxes and the resulting small shortfall in overall revenue was offset by slower spending (including on wages), keeping the overall deficit on target.

39. **The main risks to the fiscal outlook are spending overruns from election-related pressures and a shortfall in financing.** Spending pressures, particularly for wage increases, are building in advance of the general elections. While the program conservatively assumes no new budget support there may be delays in privatization and the third phase of Paris Club rescheduling may not cover all amounts expected.<sup>12</sup> However, the program does not include possible receipts from sales of telecom licenses.

40. **The program targets reserve money growth of 14 percent at end-June and 12 percent at end-September to achieve the inflation objective.** This will require slower growth in net foreign assets of the CBK and absorption of any remaining excess liquidity. Capital inflows are expected to be lower than in 2005/06, but, in the event of higher inflows, the CBK will let the shilling appreciate and give priority to achieving the inflation target. The monetary program accommodates adequate credit to the private sector while meeting the government's borrowing requirements.

## Governance

41. **A key objective of the 2006/07 program is to improve governance by focusing on a forward-looking agenda to strengthen institutions and enhance transparency and accountability.** The centerpiece of this agenda is the implementation of the GAP, focusing on measures that can be undertaken without legislative action, yet with significant payoffs in the short run. The authorities have begun to implement key elements of the GAP, in some cases earlier than envisaged:

- All procurement contracts signed during the second and third quarters of 2005/06 have been web posted and the authorities are committed to posting all subsequent contracts (MEFP ¶13). The Public Procurement and Disposal Act and the public procurement regulations came into effect on January 1, 2007.
- The four main modules of the IFMIS are being used in the ministries of Education, Planning, and Finance.
- Parliament has approved amendments to the Banking Act, strengthening the independence of the CBK in bank licensing and supervision.
- Parliament has passed the Witness Protection Bill.

---

<sup>12</sup> Some debt service already paid may not be refunded.

- The government has published its Freedom of Information Policy Framework.
- The Attorney General's Office has hired 14 new state counsels for the Anti-Corruption Unit of the Director of Public Prosecution, and the Judiciary has hired 16 new magistrates.
- The Chief Justice has issued an administrative circular to prevent filing of multiple suits on the same issue in different courts. The authorities have sought World Bank support to strengthen the judicial system.

42. **Despite these advances, it remains important to prosecute prominent corruption cases and complete the legislative agenda for the GAP.** The authorities are conducting audits of the Anglo Leasing contracts, which may provide additional evidence for subsequent prosecution. The government intends to resubmit to Parliament the Miscellaneous Amendments Bill, which contains key measures to implement the GAP, including hiring 20 more judges and making wealth declarations of senior public officials available to the public. Resubmission of the bill would be a PC for the third review.

#### **Structural measures**

43. **Public financial management.** The program includes several structural PCs and benchmarks to enhance the efficiency of public resource use and to improve governance. Performance criteria relate to (i) establishing the Public Procurement Oversight Authority; and (ii) making the IFMIS operational in four spending ministries (including education and health) for the 2007/08 budget. The program includes benchmarks on fiscal reporting, improving transparency in granting exemptions, subjecting all procurements to transparent and competitive procedures, timely presentation of the Controller and Auditor General's Report for FY2005/06 to Parliament, and completing a survey of the contingent liabilities of 24 parastatals.

44. **Financial sector reforms.** Measures focus on further strengthening the financial system to safeguard macroeconomic stability. The authorities will submit to Parliament a new banking bill establishing a legal and regulatory framework for mandatory supervisory intervention and prompt corrective actions against inadequately capitalized and failing banks. The Ministry of Finance is preparing for cabinet consideration a strategy to divest from the NBK and pending this divestiture, the Bank will remain under the current close supervision by the CBK. The authorities will undertake a diagnostic audit of the National Social Security Fund (NSSF) that will provide a basis to address its financial and governance problems.

45. **Private sector development and public enterprise reform.** To reduce the cost of doing business, licenses found by the Business Regulatory Reform Unit not to serve a useful purpose will be eliminated in the 2007/08 Finance Bill. The program envisages establishment of the Privatization Commission under the Privatization Act.



## **Program monitoring and financing**

46. **The authorities have requested an extension of the arrangement to November 20, 2007 and, reflecting the significant improvement in Kenya's external position, a reduction in access.** Extension of the arrangement would allow time to complete the third review and would help provide a framework for the important period in the run-up to the elections expected in late 2007. The authorities have requested that access under the arrangement be reduced by SDR 75 million. The remaining SDR 75 million would be rephased in two equal disbursements; SDR 37.5 million would be available upon completion of the second review and SDR 37.5 million upon completion of the third review, which would be based on end-June test dates for the quantitative performance criteria (MEFP Table 4). Structural performance criteria and benchmarks have been set for the remainder of the program, and indicative targets have been set for end-September 2007 and end-December 2007 (MEFP Tables 3 and 4).<sup>13</sup>

47. **The authorities have taken a conservative approach to external financing assumptions, and will scale up spending if conditions allow.** The program for 2006/07 is fully financed. The authorities have assumed no new budget support. Should it materialize the authorities will increase spending in priority areas identified in the IP-ERS. Accordingly, the program no longer monitors the central government wage bill, giving the authorities greater flexibility in prioritizing their spending. Completion of the second PRGF review is expected to allow entry into force of the third phase of Kenya's Paris Club rescheduling agreement, which covers payments due in 2006, although some amounts already paid in 2006 may not be refunded. The program does not assume the issuance of an external sovereign bond, but the TMU includes adjusters so that the proceeds of such a bond remain in the CBK or are used to retire foreign debt.

48. **The authorities are working to address external arrears.** External arrears continued to accumulate in 2005/06 on a number of the Anglo Leasing-type contracts and, including interest and penalties, totaled \$237 million at end-June 2006. Given the governance concerns and the fact that these arrears are being disputed by the authorities, the TMU excludes arrears on these contracts from the zero ceiling under the program. Because of high interest and penalty rates on many of the contracts, the authorities are considering refinancing the renegotiated amounts on more favorable commercial terms. After audits have been completed, the program would allow new nonconcessional external borrowing to settle arrears and pre-pay future obligations. Kenya also accumulated a small amount of arrears (slightly less than \$7 million) due to billing information not being provided by a non-Paris Club bilateral creditor, which were cleared in the latter half of 2006.

---

<sup>13</sup> The end-December 2007 indicative targets do not form part of the conditionality for the program under the PRGF arrangement.

#### IV. OTHER ISSUES

49. **A JSAN covering annual progress reports (APRs) on implementation of the IP-ERS for 2003/04 and 2004/05 has been prepared by Bank and Fund staffs and circulated to the respective Boards.**<sup>14</sup> As outlined in the JSAN, the 2004/05 APR improves upon the 2003/04 APR, although staffs stressed the need for more timely reports to provide feedback.

50. **The quality and timeliness of Kenya's economic and financial data are broadly adequate for surveillance and program monitoring.** However, there is further room to improve the quality and timeliness of fiscal data as well as balance of payments statistics, which often show large errors and omissions. The authorities plan to establish an autonomous National Bureau of Statistics. Kenya is a participant of the GDDS.

51. **The CBK has made progress in implementing the recommendations of the 2003 Safeguards Assessment** and is committed to implementing all the remaining recommendations.

#### V. STAFF APPRAISAL

52. **The surge in economic activity since 2003 is a major break from Kenya's lackluster growth performance over the past two decades.** Growth has been broad-based and benefited from macroeconomic stability, a favorable external environment, including strong commodity prices and increased remittance and tourist inflows, as well as from a recent improvement in the business climate. Sustaining growth will be a major challenge as the current favorable external conditions may not endure and domestic gains need to be consolidated through better infrastructure and faster structural reforms, including on governance.

53. **Macroeconomic stability has underpinned the recent growth and must be preserved.** Important progress has been made in containing domestic debt, bringing down inflation, rebuilding international reserves, and strengthening supervision of the financial sector. Staff supports the authorities' objective of gradually reducing domestic debt over the medium term. There is limited scope for additional domestic borrowing to finance infrastructure spending, and untapped external concessional resources should first be explored. The authorities should weigh carefully the benefit of a benchmark sovereign bond issue against the terms available and the potentially adverse consequences for aid flows and debt sustainability. Other nonconcessional external borrowing, except to refinance existing obligations, should be avoided. Moreover, an appropriate legal and institutional framework for PPPs should be put in place to minimize fiscal risks. Monetary policy should continue to

---

<sup>14</sup> IMF Country Report No. 07/160, May 10, 2007.

target reserve money growth. An earlier tightening is desirable to reduce emerging inflationary pressures.

54. **Further reforms are needed to ensure financial stability and development.** Staff welcome the recent enactment of the Banking Amendment Bill that strengthens the supervisory power of the CBK. Staff encourages the authorities to expedite the passage of the AML legislation and the amendments to the Banking Act aimed at aligning the legal and regulatory framework with best international practices, to divest state shareholding in state-influenced financial institutions, and to develop a comprehensive financial sector reform strategy. A diagnostic audit of the NSSF is urgently needed.

55. **Maintaining external competitiveness will be vital for sustained growth.** The managed float exchange rate regime has served Kenya well, and the recent real appreciation of the shilling does not appear to have undermined competitiveness. However, there are risks ahead, including the potential for a reversal in the strong commodity prices and slower productivity growth if efficiency-enhancing structural reforms are not undertaken or infrastructure improvements are delayed. Staff encourages the authorities to continue monitoring competitiveness closely.

56. **Kenya should further reorient public expenditures toward development priorities, including infrastructure and poverty reduction.** Staff supports the authorities' plans to create fiscal space for priority expenditures by reducing outlays on parastatals and noncore activities and by containing the public wage bill. This policy should be supported by continuing efforts to enhance revenue performance, including refraining from granting further tax exemptions, by strengthening capacity in spending ministries, and by improving public financial management. Improving the budget process, making the Procurement Oversight Authority fully operational, and implementing IFMIS in key ministries are among the priorities. Pressure to increase wages in the run-up to the elections should be resisted.

57. **Sustaining growth will require a vibrant private sector supported by a good business climate.** The recent moves to streamline Kenya's business licensing system are welcome, and staff commends the authorities for increased private sector participation in public enterprises. However, continued efforts are needed, especially in the concessioning of inefficient port facilities and addressing contingent liabilities in public enterprises. To build a globally competitive export sector and attract more foreign direct investment, trade reforms need to continue, focusing on lowering the CET, removing nontariff barriers, and streamlining existing RTAs.

58. **Governance reforms play a special role in Kenya's quest for sustained growth.** Staff acknowledges the progress made but urges the authorities to take decisive, concrete actions on corruption cases and to strengthen institutions and increase transparency and accountability. Forceful implementation of the GAP will be a litmus test for this strategy.

59. **Despite the need for further progress in governance reforms, staff recommends completion of the second review under the PRGF arrangement and supports the authorities' request for waivers for nonobservance of five PCs.** Staff supports the

authorities' request for a reduction and rephrasing in access to SDR 75 million, which is consistent with the improvement in Kenya's external position since the approval of the PRGF arrangement.

**60. It is proposed that the next Article IV consultation with Kenya be held in accordance with the decision on consultation cycles approved on July 15, 2002.**

Table 1. Kenya: Medium-Term Macroeconomic Framework, 2004/05-2008/09

	2004/05	2005/06	2006/07	2007/08	2008/09
	Actual	Est.	Projections		
(Annual percentage change, unless otherwise indicated)					
<b>National accounts and prices</b>					
Real GDP	5.3	5.9	6.1	6.0	6.0
Consumer price index (annual average)	15.0	11.1	7.6	5.2	5.0
Consumer price index (end of period)	11.9	10.9	6.8	5.0	5.0
Terms of trade, goods					
(- deterioration; based on c.i.f. imports)	-7.3	-5.4	-3.5	-1.7	-0.1
Ksh per US \$ exchange rate (end of period)	76.4	73.6	69.4	...	...
Nominal effective exchange rate (- depreciation; end of period)	2.5	4.0	0.0	...	...
Real effective exchange rate (- depreciation; end of period)	11.6	11.6	12.2	...	...
<b>Money and credit</b>					
Net domestic assets (end of period)	7.0	12.8	13.7	...	...
Net credit to the government (end of period)	-19.3	5.0	17.7	...	...
M3 (end of period)	11.3	14.9	13.1	...	...
Reserve money (end of period)	4.7	14.0	14.3	...	...
Velocity (GDP/M3X)	2.6	2.5	2.6	...	...
(In percent of GDP, unless otherwise indicated)					
<b>Investment and saving</b>					
Investment	16.9	18.1	20.2	20.7	21.7
Central government	3.3	4.3	5.7	6.2	6.9
Other	13.5	13.8	14.5	14.5	14.8
Gross national saving	15.1	14.5	16.6	16.7	17.6
Central government	2.4	0.0	1.7	1.8	2.0
Other	12.8	14.5	15.0	14.9	15.7
<b>Central government budget</b>					
Total revenue	21.5	19.9	21.2	21.5	21.6
Total expenditure and net lending	22.5	24.4	25.6	26.1	26.9
Overall balance (commitment basis) excluding grants	-1.0	-4.6	-4.4	-4.6	-5.3
Overall balance (commitment basis) including grants	0.1	-3.3	-3.3	-3.5	-3.8
Net domestic borrowing	-0.5	1.8	1.7	1.6	1.3
Total donor support (grants & loans)	1.6	1.9	2.5	3.6	4.7
<b>Balance of payments</b>					
Exports value, goods and services	27.7	25.3	23.7	23.3	22.9
Imports value, goods and services	36.0	36.0	34.0	33.6	33.0
Current external balance, including official transfers	-1.7	-3.6	-3.5	-4.0	-4.1
Current external balance, excluding official transfers	-1.7	-3.9	-3.5	-4.0	-4.1
Gross international reserve coverage					
in months of next year imports (end of period)	2.5	3.3	3.3	3.4	3.5
<b>Public Debt</b>					
Domestic debt, net (end of period)	18.7	17.9	18.5	18.3	17.7
NPV of external debt (end of period)	21.0	17.3	15.7	15.9	15.6
Nominal central government debt (end of period)	47.4	41.7	40.0	40.1	39.7
<i>Of which: external debt (end of period)</i>	28.7	23.8	21.4	21.8	22.0

Sources: Kenyan authorities; and Fund staff estimates and projections.

Table 2a. Kenya: Central Government Financial Operations, 2004/05-2008/09 <sup>1</sup>

	2004/05	2005/06	2006/07	2007/08	2008/09
	Actual	Est.	Prog.	Proj.	Proj.
(In billions of Kenyan shillings)					
<b>Revenue</b>	289.8	311.3	377.4	425.9	477.2
Income tax	99.3	113.9	130.9	147.2	165.2
Import duty (net)	23.5	20.5	29.0	32.4	35.6
Excise duty	47.1	50.3	56.5	67.6	78.2
Value-added tax	73.0	76.3	95.4	106.1	117.7
Other	46.9	50.3	65.7	72.6	80.4
<b>Expenditure and net lending</b>	303.7	382.8	456.2	517.9	593.3
Recurrent expenditure	258.1	306.5	347.5	391.0	439.3
Interest payments	30.8	41.2	42.6	51.2	60.5
Wages and benefits (civil service)	105.6	112.3	129.7	141.1	157.2
Other current expenditure	124.7	153.5	175.1	198.7	221.7
Development and net lending	45.6	63.7	103.7	124.8	152.0
Domestically financed	22.6	40.5	58.5	65.5	74.0
Foreign financed	22.1	23.1	42.4	58.3	78.0
Net lending	0.9	1.0	2.8	1.1	0.0
Exceptional expenditure	0.0	11.6	5.0	2.0	2.0
of which:					
Drought expenditure	0.0	12.6	3.0	0.0	0.0
<b>Balance (commitment basis, excluding grants)</b>	-13.9	-71.6	-78.8	-91.9	-116.1
<b>Grants</b>	14.9	20.1	20.9	23.2	33.2
Food relief grants	0.0	0.0	0.0	0.0	0.0
Project grants	14.9	15.7	20.9	23.2	28.1
Program grants	0.0	4.4	0.0	0.0	5.2
<b>Balance (commitment basis, including grants)</b>	1.0	-51.5	-57.9	-68.7	-82.9
<b>Balance (cash basis, including grants)</b>	1.4	-35.8	-56.4	-68.7	-82.9
<b>Financing</b>	-7.3	35.0	56.4	68.7	82.9
Net foreign financing	-0.6	-0.2	8.7	33.0	54.4
Project loans	7.2	7.4	21.6	35.1	49.9
Program loans	0.0	1.6	1.4	13.6	20.5
Commercial financing (security related contracts) <sup>2</sup>	0.0	0.0	0.0	30.5	0.0
Repayments due	-22.6	-27.5	-16.5	-21.1	-16.1
Exceptional financing <sup>3</sup>	14.8	25.3	-0.1	-21.2	0.0
Privatization proceeds	0.0	7.0	18.2	3.8	0.0
Bank restructuring financing <sup>4</sup>	0.0	0.0	-20.0	0.0	0.0
Expenditure arrears securitization financing <sup>5</sup>	0.0	0.0	-0.5	0.0	0.0
Net domestic borrowing	-6.7	28.3	29.5	31.9	28.5
<b>Financing gap</b> <sup>6</sup>	5.9	0.8	0.0	0.0	0.0
Memorandum items:					
Total project support	22.1	23.1	42.4	58.3	78.0
Total identified and unidentified gross external support	28.1	29.8	43.8	71.8	103.6
Total domestic financing (net) <sup>7</sup>	-6.7	28.3	50.0	31.9	28.5
Nominal GDP (in billions of Kenya shillings)	1,348.8	1,567.5	1,780.3	1,982.0	2,207.2
Primary budget balance	32.2	5.4	-13.8	-17.5	-22.4
Stock of domestic debt, net (end of period)	251.8	280.1	330.1	362.0	390.5

Sources: Kenyan authorities; and Fund staff estimates and projections.

<sup>1</sup> Fiscal year runs July-June.

<sup>2</sup> For 2006/07, this is programmed to be zero, but the program includes an adjuster should the authorities proceed with a sovereign bond issue. For 2007/08 this reflects a commercial loan to finance the clearance of arrears of security-related contracts; and to refinance future debt payment obligations due on these contracts.

<sup>3</sup> Exceptional financing includes rescheduling and change in arrears. Arrears clearance of security related contracts is assumed in 2007/08.

<sup>4</sup> Based on the authorities' estimates of the National Bank of Kenya restructuring costs for 2006/07, as reflected in the budget estimates. Transaction consists of government acquiring parastatals debt portfolio from NBK and financing this by a special bond issue.

<sup>5</sup> Transaction consists of the government acquiring outstanding expenditure arrears and financing this by a special bond issue.

<sup>6</sup> Financing gap includes uncommitted external project and program grants and loans; it reflects statistical discrepancy for the outturn data.

<sup>7</sup> Includes net domestic borrowing, bank restructuring financing and expenditure arrears securitization financing.

Table 2b. Kenya: Central Government Financial Operations, 2004/05-2008/09<sup>1</sup>

	2004/05	2005/06	2006/07	2007/08	2008/09
	Actual	Est.	Prog.	Projections	
	(In percent of GDP, unless otherwise indicated)				
<b>Revenue</b>	21.5	19.9	21.2	21.5	21.6
Income tax	7.4	7.3	7.4	7.4	7.5
Import duty (net)	1.7	1.3	1.6	1.6	1.6
Excise duty	3.5	3.2	3.2	3.4	3.5
Value-added tax	5.4	4.9	5.4	5.4	5.3
Other	3.5	3.2	3.7	3.7	3.6
<b>Expenditure and net lending</b>	22.5	24.4	25.6	26.1	26.9
Recurrent expenditure	19.1	19.6	19.5	19.7	19.9
Interest payments	2.3	2.6	2.4	2.6	2.7
Wages and benefits (civil service)	7.8	7.2	7.3	7.1	7.1
Other current expenditure	9.0	9.8	9.8	10.0	10.0
Development and net lending	3.4	4.1	5.8	6.3	6.9
Domestically financed	1.7	2.6	3.3	3.3	3.4
Foreign financed	1.6	1.5	2.4	2.9	3.5
Net lending	0.1	0.1	0.2	0.1	0.0
Exceptional expenditure	0.0	0.7	0.3	0.1	0.1
<i>of which:</i>					
Drought expenditure	0.0	0.8	0.2	0.0	0.0
<b>Balance (commitment basis, excluding grants)</b>	-1.0	-4.6	-4.4	-4.6	-5.3
<b>Grants</b>	1.1	1.3	1.2	1.2	1.5
Food relief grants	0.0	0.0	0.0	0.0	0.0
Project grants	1.1	1.0	1.2	1.2	1.3
Program grants	0.0	0.3	0.0	0.0	0.2
<b>Balance (commitment basis, including grants)</b>	0.1	-3.3	-3.3	-3.5	-3.8
<b>Balance (cash basis, including grants)</b>	0.1	-2.3	-3.2	-3.5	-3.8
<b>Financing</b>	-0.5	2.2	3.2	3.5	3.8
Net foreign financing	0.0	0.0	0.5	1.7	2.5
Project loans	0.5	0.5	1.2	1.8	2.3
Program loans	0.0	0.1	0.1	0.7	0.9
Commercial financing (security related contracts) <sup>2</sup>	0.0	0.0	0.0	1.5	0.0
Repayments due	-1.7	-1.8	-0.9	-1.1	-0.7
Exceptional financing <sup>3</sup>	1.1	1.2	0.1	-1.3	0.0
Privatization proceeds	0.0	0.4	1.0	0.2	0.0
Expenditure arrears securitization financing <sup>4</sup>	0.0	0.0	0.0	0.0	0.0
Net domestic borrowing	-0.5	1.8	1.7	1.6	1.3
<b>Financing gap<sup>6</sup></b>	0.4	0.0	0.0	0.0	0.0
Memorandum items:					
Total project support	1.6	1.5	2.4	2.9	3.5
Total identified and unidentified gross external support	2.1	1.9	2.5	3.6	4.7
Total domestic financing (net) <sup>7</sup>	-0.5	1.8	2.8	1.6	1.3
Nominal GDP (in billions of Kenya shillings)	1,349	1,567	1,780	1,982	2,207
Primary budget balance	2.4	0.3	-0.8	-0.9	-1.0
Stock of domestic debt, net (end of period)	18.7	17.9	18.5	18.3	17.7

Sources: Kenyan authorities; and Fund staff estimates and projections.

<sup>1</sup> Fiscal year runs July-June.

<sup>2</sup> For 2006/07, this is programmed to be zero, but the program includes an adjuster should the authorities proceed with a sovereign bond issue. For 2007/08 this reflects a commercial loan to finance the clearance of arrears of security-related contracts; and to refinance future debt payment obligations due on these contracts.

<sup>3</sup> Exceptional financing includes rescheduling and change in arrears. Arrears clearance of security related contracts is assumed in 2007/08.

<sup>4</sup> Based on the authorities' estimates of the National Bank of Kenya restructuring costs for 2006/07, as reflected in the budget estimates. Transaction consists of government acquiring parastatals debt portfolio from NBK and financing this by a special bond issue.

<sup>5</sup> Transaction consists of the government acquiring outstanding expenditure arrears and financing this by a special bond issue.

<sup>6</sup> Financing gap includes uncommitted external project and program grants and loans; it reflects statistical discrepancy for the outturn data.

<sup>7</sup> Includes net domestic borrowing, bank restructuring financing and expenditure arrears securitization financing.

Table 3. Kenya: Monetary Survey, 2004-2007

	Jun-04	Jun-05	Jun-06	Mar-07	Jun-07
	Actual			Actual	Program
	At Ksh=73.88				
	(In billions of Kenya shillings)				
<b>Central Bank of Kenya (CBK)</b>					
Net foreign assets <sup>1</sup>	86.7	95.7	141.9	154.0	158.1
In Millions of US \$	1,098	1,212	1,921	2,085	2,140
Net domestic assets	3.6	-1.2	-34.2	-31.8	-35.3
Net domestic credit	11.2	1.7	-37.0	-21.1	-26.6
Government (net)	15.5	5.1	-15.8	-8.8	-7.1
Private sector credit (CBK staff loans)	1.9	2.0	2.2	2.3	2.2
Commercial banks (net REPOS)	-6.1	-5.3	-23.4	-14.6	-21.7
Other items (net)	-7.7	-2.9	2.8	-10.7	-8.7
Reserve money (RM)	90.2	94.4	107.7	122.2	122.8
Currency outside banks	55.7	59.3	67.2	76.5	77.6
Bank reserves	34.6	35.1	40.5	45.7	45.2
Deposits-banks (Kenya)	27.6	27.1	31.5	35.4	35.5
Required Reserves <sup>2</sup>	24.3	26.0	30.3	31.3	34.5
Excess Reserves	3.3	1.1	1.2	4.2	1.0
Total till cash	7.0	8.0	9.0	10.2	9.7
<b>Monetary survey</b>					
Net foreign assets <sup>1</sup>	119.8	148.4	178.6	219.2	199.2
Net domestic assets	353.6	378.3	426.9	465.7	485.8
Domestic credit	432.5	466.3	525.9	595.7	599.3
Government (net)	139.1	112.3	117.9	137.8	138.5
Rest of the economy	293.4	354.0	408.0	457.9	460.8
Other public sector	9.2	10.3	12.2	18.2	12.6
Private	284.2	343.7	395.8	439.7	448.3
Other items (net)	-78.9	-88.0	-98.9	-129.9	-113.5
M3	473.4	526.8	605.5	685.0	685.0
Currency outside banks	55.7	59.3	67.2	76.5	77.6
Deposits	417.8	467.5	538.3	608.4	607.4
<b>Memorandum items:</b>					
	(In percent of annual change)				
M3	12.9	11.3	14.9	16.6	13.1
Reserve Money	5.5	4.7	14.0	18.9	14.0
Currency outside banks	12.0	6.6	13.3	19.2	15.4
Net domestic assets of the banking sector	12.2	7.0	12.8	14.0	13.8
Domestic credit	12.8	7.8	12.8	14.6	14.0
Government (net)	12.0	-19.3	5.0	9.4	17.5
Rest of the economy	13.1	20.6	15.2	16.2	13.0
Non-bank holdings of government debt, billions of Ksh	117	137	160	174	298
Stock of domestic debt, billions of Ksh	256	249	278	312	437
Multiplier (M3/RM)	5.2	5.6	5.6	5.6	5.6
Velocity (GDP/M3)	2.6	2.6	2.5	0.0	2.6

Sources: Central Bank of Kenya; and Fund staff projections.

<sup>1</sup> Constant Kenya shilling per U.S. dollar exchange rate prevailing on June 30, 2006.<sup>2</sup> Calculated as 6% of total deposit excluding those at NBK.



Table 4. Kenya: Balance of Payments, 2004/05-2008/09  
(In millions of U.S. dollars, unless otherwise indicated)

	2004/05	2005/06	2006/07	2007/08	2008/09
		Prel.	Projections		
<b>Current account</b>	-300	-771	-886	-1,146	-1,277
Excluding official transfers	-300	-834	-886	-1,146	-1,297
Exports, f.o.b.	2,994	3,382	3,682	4,057	4,442
Coffee	112	134	154	179	199
Tea	513	612	626	611	634
Horticulture	425	472	548	609	653
Imports, f.o.b.	-5,141	-6,544	-7,306	-8,121	-8,934
Oil	-1,231	-1,545	-1,797	-2,008	-2,276
Balance on goods	-2,148	-3,162	-3,623	-4,064	-4,492
Services (net)	730	877	1,048	1,128	1,292
Foreign travel credit <sup>1</sup>	584	698	801	901	1,009
<b>Balance on goods and services</b>	-1,417	-2,284	-2,576	-2,936	-3,200
Income (net)	-94	-40	-28	-47	-43
Credit	59	89	118	140	156
Debit	-153	-129	-146	-187	-199
Of which : official interest payments	-90	-90	-105	-125	-141
Other	-63	-58	-59	-61	-58
Current transfers (net)	1,212	1,553	1,717	1,838	1,966
Private (net)	1,212	1,490	1,717	1,838	1,947
of which: remittances	495	622	728	779	829
Official (net)	0	63	0	0	19
<b>Capital and financial account</b>	215	1,277	954	1,727	1,622
<b>Capital account (incl. capital transfers)</b>	194	215	298	331	400
<b>Financial account</b>	21	1,061	656	1,397	1,221
Investment assets and liabilities (net)	-123	708	434	1,154	1,127
Official, medium and long term	-58	-38	166	838	808
Inflows	168	185	397	1,178	1,024
Program loans	0	21	20	184	253
Project loans	93	101	309	501	713
Outflows	-226	-222	-231	-340	-215
Commercial banks (net)	-250	172	-60	-67	-69
Private (net)	186	574	328	382	387
Short-term (net) and net errors and omissions <sup>2</sup>	144	353	222	243	94
<b>Overall balance</b>	-85	506	68	582	344
<b>Financing items</b>	85	-506	-68	-582	-344
Reserve assets (gross)	-188	-766	-282	-281	-370
Use of Fund credit and loans to the Fund (net)	61	-9	44	46	-14
Change in arrears	83	150	113	-357	0
Rescheduling	129	118	56	0	0
Remaining gap	0	0	0	10	40
Tentatively identified program support	0	0	0	10	40
Unidentified support	0	0	0	0	0
<b>Memorandum items:</b>					
Gross official reserves (end of period)	1,587	2,353	2,635	2,916	3,286
in months of next year's imports of goods and services	2.5	3.3	3.3	3.4	3.5
Current account balance (excluding official transfers, as a percent of GDP)	-1.7	-3.9	-3.5	-4.0	-4.1
Import volume growth, goods (percent)	12.4	9.6	7.9	8.8	9.9
Import value growth, goods (percent)	31.6	27.3	11.6	11.2	10.0
Export volume growth, goods (percent)	8.9	6.7	6.7	10.6	10.5
Export value growth, goods (percent)	18.3	13.0	8.9	10.2	9.5
Change in the terms of trade (goods, percent)	-7.3	-5.4	-3.5	-1.7	-0.1

Sources: Kenyan authorities; and Fund staff estimates and projections.

<sup>1</sup> The foreign travel credit is comprised of two components, recorded tourism inflows and an estimate of additional under-reported tourism receipts.

<sup>2</sup> This entry is believed to include unrecorded capital flows and remittances from Kenyans working abroad not captured above.

Table 5. Financial Soundness Indicators 2003 - August 2006  
(In percent)

	Dec-03	Dec-04	Dec-05	Aug-06
<b>Capital Adequacy</b>				
Regulatory capital to risk-weighted assets	17.3	16.6	16.4	16.3
Regulatory Tier I capital to risk-weighted assets	16.3	16.2	16.0	15.8
Capital (net worth) to assets	11.8	11.9	12.1	12.4
<b>Asset quality</b>				
Nonperforming loans to gross loans <sup>1</sup>	34.9	29.3	25.6	22.7
Nonperforming loans net of provisions to Total capital	60.7	52.7	40.1	30.4
<b>Earnings and Profitability</b>				
Return on assets	2.3	2.1	2.4	3.2
Return on equity	23.2	22.0	25.0	32.3
<b>Liquidity</b>				
Liquid assets to total assets	33.2	32.4	33.1	33.6
Liquid assets to total short-term liabilities	48.9	41.5	40.6	42.5
Customer deposits to total (non-interbank) loans	131.6	135.7	125.1	127.2
Foreign currency liabilities to total liabilities	14.3	17.8	15.9	15.6
<b>Sensitivity to market risk</b>				
Net open positions in FX to capital	12.0	8.0	6.0	6.9
Net open positions in equities to capital	7.9	7.7	10.3	9.4

Source: Central Bank of Kenya; and Fund staff calculations.

<sup>1</sup> The ratios were computed using gross non performing loans and gross loans.

Table 6. Disbursement Schedule under the PRGF Arrangement

Disbursement	Amount (in millions of SDRs)	Date	Conditions necessary for Disbursement
Ist	25.0	November 2003	Approval of the PRGF arrangement.
2nd	50.0	December 2004	Completion of first review by the Board based on observance of performance criteria for end-December 2003.
3rd <sup>1</sup>	37.5	April 2007	Completion of second review by the Board and observance of performance criteria for end-March 2005.
4th	37.5	November 2007	Completion of third review by the Board by November 1, 2007, and observance of end-June 2007 performance criteria.
Total	150.0		

<sup>1</sup> Assumes a reduction in access of SDR 75 million and rephasing of the remaining SDR75 million outstanding after completion of the second review (third disbursement) into two equal tranches.

Table 7. Kenya: External Financing Requirements and Resources, 2004/05 - 2008/09<sup>1</sup>  
(In millions of U. S. dollars)

	2004/05	2005/06	2006/07	2007/08	2008/09
<b>External financing requirements</b>	-643.5	-1,680.4	-1,298.0	-2,133.8	-1,895.4
Current account (excl.official transfers)	-299.6	-833.6	-886.2	-1,145.7	-1,296.6
Scheduled amortization (official)	-226.2	-222.4	-231.1	-339.6	-215.2
IMF payments, gross	-12.9	-8.6	-12.0	-10.1	-13.9
Change in arrears, net	83.1	150.3	113.3	-357.4	0.0
Buildup of gross official reserves	-187.9	-766.1	-282.0	-281.0	-369.8
<b>Resources</b>	643.7	1,679.7	1,296.8	2,133.3	1,895.9
Program support (committed and tentatively identified)	73.6	83.1	76.3	250.0	311.7
IMF	73.6	0.0	56.3	56.3	0.0
Program loans	0.0	20.6	20.0	193.8	292.5
African Development Bank (ADB)	0.0	20.6	0.0	57.5	107.5
IDA	0.0	0.0	20.0	95.0	145.0
Other	0.0	0.0	0.0	41.3	40.0
Program grants	0.0	62.5	0.0	0.0	19.2
Project Support	287.2	316.9	607.3	831.8	1,113.2
Project loans	93.5	101.4	308.9	501.0	712.8
Project grants	193.7	215.5	298.4	330.7	400.4
Government-guaranteed and defence loans	74.5	62.6	67.7	493.1	58.3
Private financing (incl. short-term (net) and errors & omissions)	79.6	1,099.1	490.0	558.4	412.7
Private financing, net	-64.4	746.1	268.0	315.4	318.7
of which, foreign direct investment	48.2	501.7	322.0	379.8	453.5
Short-term (net) and net errors and omissions 2/	144.0	353.0	222.0	243.0	94.0
Rescheduling of debt	128.8	118.1	55.5	0.0	0.0
<b>Unidentified gap</b>	0.2	-0.7	-1.2	-0.5	0.5

Sources: Kenyan authorities; and Fund staff estimates and projections.

<sup>1</sup> The fiscal year is July/June.

<sup>2</sup> Short-term (net) financing and errors and omissions in Kenya tend to be volatile, reflecting in part weaknesses in reporting, e.g., of tourism receipts.

Table 8. Kenya: External Debt Indicators, 2004-2009 <sup>1</sup>  
(In millions of U.S. dollars, unless otherwise indicated)

	2004	2005	2006	2007	2008	2009
<b>Debt-stock indicators</b>						
Stock of external debt by creditor <sup>2</sup>	5,119	5,068	5,068	5,831	6,516	7,354
Multilateral creditors	3,170	3,144	3,144	3,371	3,891	4,470
IMF	165	158	146	249	240	224
World Bank	2,493	2,460	2,463	2,511	2,803	3,122
African Development Bank/African Development Fund	334	354	359	387	549	724
Other	177	172	176	224	298	400
Bilateral creditors	1,613	1,615	1,639	1,782	1,996	2,293
Paris Club	1,531	1,527	1,539	1,649	1,816	2,052
Non-Paris Club	82	88	100	133	180	242
Other creditors	336	309	284	678	629	590
Stock of external debt by debtor <sup>2</sup>	5,119	5,068	5,068	5,831	6,516	7,354
Central government	4,608	4,539	4,532	5,157	5,816	6,630
Government guaranteed	346	371	390	425	459	500
Central bank	165	158	146	249	240	224
<b>Debt-service indicators <sup>2</sup></b>						
Principal payments by creditor	247	235	246	247	265	265
Multilateral creditors	109	100	112	104	108	121
IMF	14	7	14	10	10	25
World Bank	64	62	67	71	73	73
AfDB/AfDF	11	11	11	12	11	10
Other	20	20	20	12	13	13
Bilateral creditors	87	87	88	91	105	104
Paris Club	84	85	85	88	100	96
Non-Paris Club	3	3	3	3	5	7
Other creditors	52	48	46	52	52	40
Interest payments by creditor	91	90	76	119	132	149
Multilateral creditors	31	30	30	33	39	47
IMF	2	2	2	2	2	2
World Bank	19	19	19	19	21	24
AfDB/AfDF	5	5	4	4	5	6
Other	5	5	5	7	11	15
Bilateral creditors	44	44	40	51	60	72
Paris Club	38	36	31	32	31	29
Non-Paris Club	6	8	8	18	29	43
Other creditors	16	16	6	35	33	31
<b>Debt-Service Ratios</b>						
Before 2004 Paris Club Rescheduling						
Debt-service in percent of current year exports	8	6	6	6	6	5
Debt-service in percent of fiscal revenue	10	8	7	6	6	6

Sources: Kenyan authorities; and Fund staff estimates and projections.

<sup>1</sup> Based on external debt data available from the Kenyan authorities as of October 2004.

<sup>2</sup> Excludes arrears.

<sup>3</sup> Debt service due before the January 2004 Paris Club rescheduling, except where noted.

Table 9. Actual and Projected Payments to the Fund, 2003-2011  
(In millions of SDRs, unless otherwise indicated)

	Overdue	2003	2004	2005	2006	2007	2008	2009	2010	2011
Principal	...	14.0	9.5	5.0	9.2	6.7	6.7	11.7	16.7	15.0
Charges and interest <sup>1</sup>		0.3	0.4	0.6	0.5	2.0	1.9	1.9	1.8	1.7
Outstanding Fund credit <sup>2</sup>	...	70.8	61.3	106.3	97.1	165.3	158.6	146.9	130.2	115.2
FCO in percent of:										
Exports of goods and nonfactor services	...	2.8	2.0	3.0	2.6	3.9	3.4	2.9	2.4	1.9
External public debt	...	1.9	1.7	3.1	2.8	4.2	3.6	3.0	2.4	2.0
Gross official reserves	...	6.7	5.6	8.6	5.9	8.6	7.7	6.3	5.0	4.0
GDP	...	0.7	0.5	0.8	0.6	0.9	0.8	0.7	0.5	0.4
Quota	...	26.1	22.6	39.2	35.8	60.9	58.4	54.1	48.0	42.4
Obligations (principal) in percent of:										
Exports of goods and nonfactor services	...	0.4	0.2	0.1	0.2	0.1	0.1	0.2	0.2	0.2
External public debt	...	0.3	0.2	0.1	0.2	0.1	0.1	0.2	0.2	0.2
Gross official reserves	...	0.9	0.6	0.3	0.4	0.2	0.2	0.3	0.4	0.3
GDP	...	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Quota	...	5.2	3.5	1.8	3.4	2.5	2.5	4.3	6.2	5.5

Source: Fund staff estimates.

<sup>1</sup> Projections are based on current rates of charge, including burden-sharing charges where applicable, for purchases in the General Resources Account, and on current interest rates for Poverty Reduction and Growth Facility (PRGF), and Trust Fund. The current SDR interest rate is assumed for net use of SDRs.

<sup>2</sup> This assumes that the remaining amount of the PRGF arrangement of SDR 75 million will be disbursed in 2 equal installments, with the third disbursement of SDR 37.5 million taking place at around the time of the Executive Board meeting scheduled for April 2007.

Table 10 Kenya: Millennium Development Goals, 1990-2003

	1990	1994	1997	2000	2003
<b>Goal 1: Eradicate extreme poverty and hunger</b>					
Percentage share of income or consumption held by poorest 20%	..	..	6	..	..
Population below \$1 a day (%)	..	26.5	22.8	..	..
Population below minimum level of dietary energy consumption (%)	..	..	38	..	33
Poverty gap ratio at \$1 a day (incidence x depth of poverty)	..	9	5.9	..	..
Poverty headcount, national (% of population)	..	40	52	..	..
Prevalence of underweight in children (under five years of age)	..	22.5	22.1	..	19.9
<b>Goal 2: Achieve universal primary education</b>					
Net primary enrollment ratio (% of relevant age group)	74.3	..	65.8	68.2	66.5
Primary completion rate, total (% of relevant age group)	..	..	..	..	72.5
Proportion of pupils starting grade 1 who reach grade 5	69.8	..	..	59	..
Youth literacy rate (% ages 15-24)	..	..	..	80.3	..
<b>Goal 3: Promote gender equality and empower women</b>					
Proportion of seats held by women in national parliament (%)	1	..	3	4	7
Ratio of girls to boys in primary and secondary education (%)	92.4	..	96.8	97.2	93.8
Ratio of young literate females to males (% ages 15-24)	..	..	..	101.1	..
Share of women employed in the nonagricultural sector (%)	21.4	25.5	32.2	34.4	38.5
<b>Goal 4: Reduce child mortality</b>					
Immunization, measles (% of children ages 12-23 months)	78	84	79	75	72
Infant mortality rate (per 1,000 live births)	63	73	..	77	79
Under 5 mortality rate (per 1,000)	97	111	..	120	123
<b>Goal 5: Improve maternal health</b>					
Births attended by skilled health staff (% of total)	50	45.4	44.3	..	41
Maternal mortality ratio (modeled estimate, per 100,000 live births)	..	..	..	1000	..
<b>Goal 6: Combat HIV/AIDS, malaria, and other diseases</b>					
Contraceptive prevalence rate (% of women ages 15-49)	26.9	32.7	39	..	38
Incidence of tuberculosis (per 100,000 people)	111.6	191.8	307.6	455.8	610.3
Number of children orphaned by HIV/AIDS	..	..	..	500000	650000
Prevalence of HIV, total (% of population aged 15-49)	..	..	..	8	6.7
Tuberculosis cases detected under DOTS (%)	..	52.8	50.1	43.8	45.5
<b>Goal 7: Ensure environmental sustainability</b>					
Access to an improved water source (% of population)	45	..	..	..	62
Access to improved sanitation (% of population)	42	..	..	..	48
Access to secure tenure (% of population)	..	..	..	..	..
CO2 emissions (metric tons per capita)	0.2	0.3	0.2	0.3	..
Forest area (% of total land area)	31.7	..	..	30	..
GDP per unit of energy use (2000 PPP \$ per kg oil equivalent)	2.1	2.1	2.1	1.9	2
Nationally protected areas (% of total land area)	..	..	..	..	8
<b>Goal 8: Develop a global partnership for development</b>					
Aid per capita (current US\$)	50.8	26	16	17	15.1
Debt service (% of exports)	29	27	18	15	14
Fixed line and mobile phone subscribers (per 1,000 people)	7.9	9.3	10.3	14.6	60.5
Internet users (per 1,000 people)	..	0	0.4	3.3	12.7
Personal computers (per 1,000 people)	0.4	0.6	2.8	4.9	6.4
Unemployment, youth female (% of female labor force ages 15-24)	..	..	..	..	..
Unemployment, youth male (% of male labor force ages 15-24)	..	..	..	..	..
Unemployment, youth total (% of total labor force ages 15-24)	..	..	..	..	..
<b>Other</b>					
Fertility rate, total (births per woman)	5.6	..	4.7	..	4.8
GNI per capita, Atlas method (current US\$)	380	250	350	360	400
GNI, Atlas method (current US\$) (billions)	8.8	6.4	9.8	10.7	12.8
Gross capital formation (% of GDP)	19.7	16.4	15.4	15.4	12.9
Life expectancy at birth, total (years)	57.1	..	49.7	47.7	45.4
Literacy rate, adult total (% of people ages 15 and above)	..	..	..	73.6	..
Population, total (millions)	23.4	26	28	30.1	31.9
Trade (% of GDP)	57	70.9	63.6	62.2	54.2

Source: World Development Indicators database, 2005

## APPENDIX I—DEBT SUSTAINABILITY ANALYSIS

1. **The debt sustainability analysis (DSA) was prepared jointly by Fund and Bank staffs in accordance with the standardized methodology for low-income countries.** It is based on the framework approved by the Executive Boards of the Fund and the World Bank in April 2005.<sup>1</sup> **The DSA finds the risk of external debt distress to be low.**

### A. Methodology

2. The DSA uses non-reconciled debt data, a single discount rate, WEO exchange rate projections, and current values for denominators in all debt ratios.

3. **Debt sustainability is assessed in relation to policy-dependent debt burden thresholds.** Kenya is classified as a medium performer in terms of the quality of its policies and institutions as measured by a three-year average of Kenya's score on the World Bank's Country Policy and Institutional Assessment (CPIA) index.<sup>2,3</sup>

4. **The DSA is based on: updated data provided by the authorities, available data on private sector borrowing, and estimates by the staffs.** While every effort has been made to obtain accurate data, the end-2005 external debt stock and associated future debt service as projected in the DSA are likely to be somewhat over-estimated due to the inclusion of some loans that had been committed but not fully disbursed. This largely explains the sizeable residual and jump in the public external debt-to-GDP ratio in 2005. The DSA will be updated as revised debt data become available from the authorities.

5. **This DSA consists of two parts—external and fiscal.** The external DSA covers borrowing by the central government (including parastatal borrowing with a government guarantee) and the central bank, and also includes estimates for private sector borrowing based on available information. The fiscal DSA aims at assessing the sustainability of total debt—external and domestic—incurred or guaranteed by the central government.<sup>4</sup>

---

<sup>1</sup> <http://www.imf.org/external/pubs/ft/dsa/lic.aspx>

<sup>2</sup> <http://siteresources.worldbank.org/IDA/Resources/tablesCPR.pdf>

<sup>3</sup> For a medium performer the indicative thresholds for external debt sustainability are an NPV of debt-to-exports ratio of 150 percent, an NPV of debt-to-GDP ratio of 40 percent, an NPV of debt-to-revenue ratio of 250 percent, a debt service-to-exports ratio of 20 percent, and a debt service-to-revenue ratio of 30 percent.

<sup>4</sup> Public domestic debt includes central government debt. External public debt includes public and publicly guaranteed central government debt

**6. Key assumptions underlying the DSA are consistent with the proposed PRGF-supported program for 2007.**

- *Macroeconomic assumptions:* Annual real GDP growth of about 6.0 percent through 2012, which is in line with recent outcomes, followed by 5.0 percent from 2013 through 2026; inflation of about 6 percent as measured by a GDP deflator, which falls to 5 percent for the 2013–26 period; annual export growth in U.S. dollar terms of about 10 percent such that exports as a share of GDP rise modestly from 15 percent to 16 percent over the forecast period; a primary fiscal deficit of 0.8 percent of GDP in 2006, which gradually narrows to a deficit of 0.4 percent by 2010; a non-interest external current account deficit that rises to about 4½ percent of GDP in 2011 before falling to an average of 2.6 percent of GDP over the 2012–26 period; a sharp increase in new borrowing in the early years (from about 1 percent of GDP in 2005 to almost 4 percent of GDP by 2007) followed by lower borrowing as a share of GDP for an average of 2 percent of GDP over the forecast period; NPV of domestic debt equal to its face value; and continued restraint on nonconcessional external borrowing (grant element below 35 percent) apart from sizeable commercial borrowing in 2007 to refinance existing commercial debt (with little or no net impact) and possibly a small amount of sovereign bond issuance.
- No debt relief is assumed following the 2004–06 Paris Club rescheduling. A recently concluded debt swap agreement with Italy, which could potentially lead to the cancellation of Euro 43 million in external obligations, will be included in future DSAs.
- Continued eligibility for concessional borrowing from IDA is assumed although achievement of assumed growth rates could imply graduation during the forecast period.
- The stress tests do not take into account possible fiscal effort/response to early debt distress signs.

### **B. Recent Developments**

**7. At end-2005, the face value of public external debt is estimated at \$6.8 billion (36 percent of GDP).** Just over 60 percent of this debt is to multilateral creditors (including 48 percent owed to the World Bank). About one-third of the debt is owed to bilateral creditors (largely Paris Club), and a small share (4 percent) is owed to commercial creditors, some of which is in arrears.

**8. Kenya has managed its debt burden relatively well and has regularly met its obligations to most creditors.** Limited external borrowing has left Kenya with more manageable debt ratios than many of its low-income country peers. Kenya's income level led it to be considered in the context of the Enhanced HIPC Initiative, but due to a sustainable



level of debt, Kenya did not qualify to receive HIPC relief. Apart from disputed commercial arrears, described in greater detail below, Kenya has regularly serviced its debts.

9. **Kenya has benefited from Paris Club reschedulings.** In addition to rescheduling agreements in 1994 and 2000, in the context of the current PRGF arrangement Kenya received a rescheduling on Houston terms in 2004 covering US\$353 million falling due from 2004 through 2006. Bilateral agreements with Paris Club creditors have been finalized for amounts falling due in 2004 and 2005, but the third phase of the agreement covering 2006 (roughly US\$100 million) has not entered into force due to delays in the completion of Kenya's second review under the PRGF arrangement. The DSA assumes entry into force of the third phase of the current Paris Club agreement.

10. **Kenya's end-2005 external arrears of about \$143 million were almost exclusively to commercial creditors and are under dispute.** The arrears stem from non-payment on commercial credits for security-related contracts, many of which have been found by Kenya's Controller and Auditor-General to be fraudulent or deeply flawed (these projects are often referred to as the "Anglo-Leasing" scandal). The authorities are disputing the validity of the claims based on the contracts not being fulfilled, have hired an external audit firm to determine the value of the goods and services provided, and intend to renegotiate the amounts owed based on the audit results. It is expected that Kenya will accumulate additional arrears until issues related to these contracts are resolved. Given high interest and penalty rates on many of the contracts, the authorities are also considering refinancing the renegotiated amounts on more favorable commercial terms; such a refinancing operation is assumed in the DSA for 2007 and explains a spike in new commercial borrowing. A very small amount of non-Paris Club bilateral arrears (less than US\$ 6 million at end-2005) began accumulating in 2003 due to technical billing problems, but these arrears were cleared in 2006.

11. **Kenya's net domestic debt reached 17.9 percent of GDP at end-June 2006.** Since end-June 2003, domestic debt has gradually declined as a percent of GDP thanks to strong economic growth, prudent fiscal policies, and lower interest rates, despite a lower than historical primary surplus.<sup>5</sup> About 70 percent of Kenya's domestic debt is longer-term borrowing with maturities extending up to 12 years. Despite the relatively low ratio of reported domestic debt-to-GDP, Kenya's domestic debt is likely to be underestimated due to significant unreported contingent liabilities from a large parastatal sector and unfunded future pension obligations. No reliable estimates exist on the value of these contingent liabilities, and therefore, they have been omitted from this analysis. Future debt sustainability analysis

---

<sup>5</sup> Due to lower real interest rates and higher growth compared to historical averages, debt-to-GDP can be stabilized with a lower primary balance.

will seek to incorporate data on contingent liabilities. Fiscal data, which are based on a July-June fiscal year, are converted to calendar year data for the purposes of the DSA.<sup>6</sup>

### C. External Debt Sustainability

12. **Under the baseline scenario, Kenya’s external debt indicators show a low risk of debt distress.** Although external debt may be overstated, as discussed above, the debt ratios are still well below all of the indicative thresholds for a medium performer. The external debt ratios decline sharply in 2006 and fall further over the forecast period (Table 1). The steep drop in the 2006 public debt-to-GDP ratio is to a large extent explained by the appreciation of the Kenyan shilling against the U.S. dollar and continued strong GDP growth. Over the forecast period, although external borrowing is projected to more than triple in 2007 to 3.8 percent of GDP – a level some other low-income countries regularly borrow – this peak reflects a backlog of delayed loans and would fall gradually as a share of GDP thereafter. In addition to reasonably contained borrowing, the improvement in the baseline scenario reflects favorable real output and export growth projections in comparison to longer-term historical performance. Growth has accelerated significantly since 2003, and the authorities are undertaking substantial infrastructure investments (financed partly through an assumed increase in external assistance) and structural reforms intended to support export and overall growth. It should be noted that the authorities’ *Kenya Vision 2030* targets much faster growth than assumed in the DSA.

13. **The alternative scenarios and stress tests indicate that Kenya’s external debt situation is generally resilient although shocks would lead to a sharp initial worsening in debt stock indicators (Table 2).** The most extreme stress tests are shown in Figure 1 and described here. A shock combining lower GDP growth, weaker exports, a lower GDP deflator, and a fall in non-debt creating flows would push the NPV of debt to almost 32 percent of GDP. Substantially slower exports would push the NPV of debt to about 131 percent of exports. Despite an immediate worsening, the two debt stock measures would then improve on a trajectory similar to that under the baseline scenario. The debt service-to-exports ratio would be most negatively affected under the slower export growth scenario, but none of the shocks would push the debt service burden particularly high. The NPV of public external debt-to-revenue ratio and the public external debt service-to-revenue ratio both remain under the relevant thresholds in all of the alternative and shock scenarios. Perhaps surprisingly, a “historical” scenario, which uses the recent performance of key economic variables instead of the baseline assumptions, yields debt ratios that are not much worse, and at times better, than in the baseline scenario. While growth is much lower under the historical

---

<sup>6</sup> Averaging fiscal year data into calendar year data explains differences with Tables 2a and 2b in the staff report.

scenario, non-debt creating flows are not significantly different, and the historical current account deficit is much lower than the deficit in the baseline. The latter factor reduces the borrowing need, particularly in the 2010–12 period when the current account deficit peaks under the baseline scenario.

<b>Summary -- External Debt Sustainability Assessment</b>							
(in percent of GDP)							
	2005	2006	2007	2008	2009	2010	2011
<b>NPV of PPG external debt</b>							
<b>In percent of GDP (threshold=40)</b>							
Baseline	23.7	20.1	19.2	18.3	17.6	16.9	16.2
Combined Shocks	23.7	20.1	25.2	31.5	30.0	28.6	27.3
<b>In percent of exports (threshold=150)</b>							
Baseline	85.7	83.1	80.6	78.1	75.7	74.1	71.4
Lower Exports	85.7	83.1	102.7	130.6	125.7	122.4	117.2
<b>PPG Debt Service</b>							
<b>In percent of exports (threshold=20)</b>							
Baseline	2.6	4.8	5.8	7.1	6.4	5.9	5.6
Lower Exports	2.6	4.8	6.7	9.6	9.0	8.4	7.9

#### **D. Public Debt Sustainability**

14. **Under the baseline scenario, the NPV of public debt-to-GDP rises substantially after the inclusion of Kenya’s domestic debt, even though all debt indicators remain within comfort levels.** The NPV of total public debt-to-GDP, at 38 percent in 2006, remains below 40 percent under the baseline scenario, and declines gradually to 23 percent by 2026. Given Kenya’s relatively strong revenue performance, the NPV of debt-to-revenue ratio declines from about 172 percent of GDP in 2006 to below 100 percent in 2026, remaining well below 250 percent. Given the large share of longer-term domestic debt, the debt service-to-revenue ratio, which takes into account debt service on longer-term domestic and external debt, is 26.3 percent in 2006, and gradually declines throughout the projection period.

15. **Alternative scenarios and stress tests indicate that Kenya’s debt indicators are particularly vulnerable to slower growth, while being broadly resilient under other alternative assumptions.** A two-year growth shock leads to a rapid increase in the NPV of debt-to-GDP ratio to over 40 percent by 2007, and in the debt service-to-revenue ratio to over 30 percent by 2008, indicating some risk of debt distress under this scenario. While the NPV of debt-to-revenue ratio also rises in the lower growth scenario, it remains below 250 percent over the entire period. Sustained lower growth would cause ratios to approach but not exceed the thresholds. Other scenarios indicate limited or no risk of debt distress and show resilience over the long term to a depreciation shock, a reversion to historical (positive) primary balances, and a 10 percent shock in other debt creating flows. That said, however, it should be noted that large unreported contingent liabilities, which for the purposes of this DSA have been assumed to be zero, could increase the risk of debt distress.

### **E. Public Debt Sustainability Under Higher Nonconcessional Borrowing**

16. **An alternative baseline scenario is included to illustrate the impact of higher commercial borrowing and interest rates on public debt sustainability.** While the authorities' medium term fiscal framework projects a gradual decline in the domestic debt-to-GDP ratio, as assumed under section D of this analysis, this alternative scenario assumes additional public borrowing on nonconcessional terms of the equivalent of 1 percent of GDP per year during the first five years of the projection period (2006–10) to help finance additional public spending on infrastructure. The scenario also assumes that these amounts are raised domestically and result in an increase in domestic interest rates of 200 basis points throughout the projection period.<sup>7</sup> The analysis is carried out for additional commercial domestic borrowing, but equally applies to increasing nonconcessional external borrowing. Alternatively, it illustrates the risk to public debt sustainability when contingent liabilities result in additional nonconcessional debt. This scenario further assumes that on balance additional borrowing has no effect on real GDP growth.

17. **The analysis points to considerable risks to public debt sustainability from higher nonconcessional borrowing if interest rates go up as assumed and there is no growth impact.** With these alternative assumptions for the baseline scenario, the NPV of public debt-to-GDP very closely approaches 40 percent in the early years of the projection period and reaches 34 percent by the end of the projection period. The debt service-to-revenue ratio exceeds 30 percent under the alternative baseline scenario by 2011. Under various shocks or less favorable assumptions, the outlook for debt sustainability worsens significantly. A shock to growth in particular is associated with high levels for all three debt indicators (Tables 3a and 3b, Figure 3).

18. **The alternative case illustrates that small changes to the current favorable debt dynamics can adversely affect the otherwise favorable outlook on public debt sustainability.** Hence, a prudent fiscal policy that aims at a gradual reduction in public-debt-to-GDP seems appropriate. Preferably largely untapped concessional resources should be used effectively to meet infrastructure needs and any attempt to exploit the limited scope to borrow additionally for infrastructure needs should be explicitly linked to projects with unquestionably high rates of return.

---

<sup>7</sup> During the projection period, the average real interest rate of domestic debt of 7.6 percent would still be substantially below the historical average of 10.2 percent.

## F. Conclusions

19. **Reflecting relatively limited reliance on external borrowing and an expected improvement in macroeconomic performance, Kenya faces a low risk of external debt distress although a cautious approach is needed to preserve debt sustainability.** All external public debt indicators remain below the relevant country-specific debt burden thresholds. Standard stress tests reveal an upward trend for the debt indicators but do not result in a breach of the thresholds during the projection period.
20. **Taking all public debt into account, however, the DSA shows some risk of debt distress under the case of a shock to GDP growth.** Potentially large but unreported contingent liabilities pose additional risks to the sustainability of public debt.
21. **The sustainability of Kenya's debt depends on macroeconomic performance and a prudent borrowing strategy.** Achieving or exceeding the ambitious growth and export figures in the baseline scenario depends on: policies to sustain macroeconomic stability, substantial investment in infrastructure; and regulatory and governance reforms to improve the investment climate. Additionally, Kenya's success in avoiding unsustainable debt to date reflects good management, but also limited willingness on the part of creditors to provide financing, at times due to governance concerns. Assuming continued policy improvements, Kenya may have greater access to external financing. It will be important to avoid excessive borrowing and to seek the most concessional resources available. Accessing concessional external finance will also help maintain a prudent fiscal stance, limit an excessive expansion of domestic borrowing, and preserve fiscal debt sustainability.
22. **The staffs encourage Kenya to use tools such as the joint Fund-Bank DSA template to develop a prudent borrowing strategy to maintain both external and fiscal debt sustainability.** Such a strategy should consider the total concessionality and interest costs of Kenya's borrowing, the return on individual projects and overall growth impact, and steps that would help guard against volatility, whether due to shocks such as droughts or to fluctuations in external assistance. Strategies to guard against shocks could include some further build-up in international reserves, fiscal reserves, and restrained domestic borrowing to provide a buffer in case of an unforeseen financing need or a shortfall in external flows. A better understanding of holdings of shilling-denominated debt by non-residents would also help guide efforts to reduce vulnerabilities.

Table 1a. Kenya: External Debt Sustainability Framework, Baseline Scenario, 2006-2026 1/  
(In percent of GDP, unless otherwise indicated)

	Actual			Historical Average 6/	Standard Deviation 6/	Projections									
	2003	2004	2005			2006	2007	2008	2009	2010	2011	2006-11 Average	2016	2026	2012-26 Average
<b>External debt (nominal) 1/</b>	<b>34.7</b>	<b>34.5</b>	<b>38.6</b>			<b>31.9</b>	<b>30.1</b>	<b>29.2</b>	<b>28.4</b>	<b>27.5</b>	<b>26.8</b>		<b>21.6</b>	<b>14.2</b>	
o/w public and publicly guaranteed (PPG)	34.7	34.5	36.3			30.1	28.1	27.5	27.0	26.4	25.6		21.0	14.1	
Change in external debt	-2.9	-0.2	4.1			-6.7	-1.8	-0.9	-0.8	-0.9	-0.7		-1.2	-0.6	
Identified net debt-creating flows	-5.1	-1.7	-3.0			-0.4	1.1	0.7	0.8	1.6	2.1		1.0	0.4	
<b>Non-interest current account deficit</b>	<b>-0.4</b>	<b>1.0</b>	<b>2.8</b>	<b>1.4</b>	<b>2.0</b>	<b>2.9</b>	<b>3.6</b>	<b>3.4</b>	<b>3.3</b>	<b>4.0</b>	<b>4.4</b>		<b>2.8</b>	<b>1.7</b>	2.6
Deficit in balance of goods and services	4.5	7.4	9.7			10.6	10.7	10.3	9.9	10.1	10.2		8.0	6.3	
Exports	23.8	26.7	27.7			24.2	23.8	23.5	23.3	22.8	22.7		22.8	23.3	
Imports	28.3	34.2	37.4			34.9	34.5	33.7	33.1	32.9	32.9		30.8	29.5	
Net current transfers (negative = inflow)	-5.2	-6.8	-7.1	-5.2	1.4	-7.4	-6.7	-6.5	-6.2	-5.8	-5.4		-4.9	-4.2	-4.7
Other current account flows (negative = net inflow)	0.3	0.4	0.1			-0.3	-0.3	-0.4	-0.3	-0.3	-0.3		-0.3	-0.4	
<b>Net FDI (negative = inflow)</b>	<b>-0.7</b>	<b>-0.4</b>	<b>-1.3</b>	<b>-0.6</b>	<b>0.4</b>	<b>-1.8</b>	<b>-1.2</b>	<b>-1.6</b>	<b>-1.4</b>	<b>-1.3</b>	<b>-1.2</b>		<b>-1.0</b>	<b>-0.7</b>	-0.9
<b>Endogenous debt dynamics 2/</b>	<b>-4.0</b>	<b>-2.3</b>	<b>-4.4</b>			<b>-1.5</b>	<b>-1.3</b>	<b>-1.0</b>	<b>-1.1</b>	<b>-1.1</b>	<b>-1.1</b>		<b>-0.8</b>	<b>-0.5</b>	
Contribution from nominal interest rate	0.6	0.3	0.3			0.4	0.5	0.5	0.5	0.4	0.4		0.2	0.2	
Contribution from real GDP growth	-1.0	-1.6	-1.7			-1.9	-1.7	-1.6	-1.6	-1.5	-1.5		-1.0	-0.7	
Contribution from price and exchange rate changes	-3.6	-1.0	-2.9			...	...	...	...	...	...		...	...	
<b>Residual (Δ in ext. debt minus debt-creating flows 3/</b>	<b>2.3</b>	<b>1.5</b>	<b>7.1</b>			<b>-6.3</b>	<b>-3.0</b>	<b>-1.6</b>	<b>-1.6</b>	<b>-2.5</b>	<b>-2.8</b>		<b>-2.3</b>	<b>-1.0</b>	
o/w exceptional financing	0.0	-0.7	-0.7			-0.5	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
NPV of external debt 4/	...	...	26.0			21.9	21.2	20.0	19.0	18.0	17.4		13.6	9.1	
In percent of exports	...	...	94.1			90.5	88.9	85.3	81.5	79.0	76.7		59.8	39.3	
<b>NPV of PPG external debt</b>	<b>...</b>	<b>...</b>	<b>23.7</b>			<b>20.1</b>	<b>19.2</b>	<b>18.3</b>	<b>17.6</b>	<b>16.9</b>	<b>16.2</b>		<b>13.1</b>	<b>9.1</b>	
In percent of exports	...	...	85.7			83.1	80.6	78.1	75.7	74.1	71.4		57.3	39.0	
Debt service-to-exports ratio (in percent)	11.4	5.6	3.6			5.9	7.0	8.3	7.6	6.9	6.5		4.1	2.4	
<b>PPG debt service-to-exports ratio (in percent)</b>	<b>11.4</b>	<b>5.6</b>	<b>2.6</b>			<b>4.8</b>	<b>5.8</b>	<b>7.1</b>	<b>6.4</b>	<b>5.9</b>	<b>5.6</b>		<b>3.6</b>	<b>2.4</b>	
Total gross financing need (billions of U.S. dollars)	0.2	0.3	0.5			0.6	1.4	1.1	1.2	1.6	1.9		1.9	2.7	
Non-interest current account deficit that stabilizes debt ratio	2.4	1.2	-1.3			9.6	5.4	4.2	4.1	4.9	5.1		4.0	2.3	
<b>Key macroeconomic assumptions</b>															
Real GDP growth (in percent)	3.0	4.9	5.8	2.8	2.0	6.0	6.2	5.8	6.2	5.9	6.1	6.0	5.0	5.0	5.1
GDP deflator in US dollar terms (change in percent)	10.7	3.1	9.3	2.6	8.6	16.7	7.2	4.9	5.1	5.2	5.2	7.4	4.8	4.8	4.8
Effective interest rate (percent) 5/	1.8	1.0	0.9	1.6	0.4	1.4	1.6	2.0	1.8	1.7	1.5	1.7	1.2	1.2	1.2
Growth of exports of G&S (US dollar terms, in percent)	9.5	21.4	19.8	6.5	9.9	8.3	12.0	9.3	10.6	9.2	11.3	10.1	10.0	10.4	10.3
Growth of imports of G&S (US dollar terms, in percent)	24.3	30.6	26.6	9.3	16.3	15.4	12.6	8.6	9.5	10.7	11.6	11.4	9.2	9.8	9.3
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	46.9	17.0	46.3	47.6	46.7	44.5	41.5	46.5	41.2	45.5
<i>Memorandum item:</i>															
Nominal GDP (billions of US dollars)	15.0	16.2	18.7			23.2	26.4	29.3	32.7	36.4	40.6		66.3	172.0	

Source: Staff simulations.

1/ Covers both public and private sector external debt, including arrears. The end-2005 public external debt stock and associated debt service are likely overstated due to the inclusion of some agreed but undisbursed amounts. Revised data are being sought.

2/ Derived as  $[r - g - \rho(1+g)] / (1+g+\rho+gp)$  times previous period debt ratio, with  $r$  = nominal interest rate;  $g$  = real GDP growth rate, and  $\rho$  = growth rate of GDP deflator in U.S. dollar terms.

3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; project grants which are included as capital transfers in the balance of payments; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.

4/ Assumes that NPV of private sector debt is equivalent to its face value.

5/ Current-year interest payments divided by previous period debt stock.

6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table 1b. Kenya: Sensitivity Analyses for Key Indicators of Public and Publicly Guaranteed External Debt, 2006-26  
(In percent)

	Projections							2026	2028
	2006	2007	2008	2009	2010	2011	2016		
<b>NPV of debt-to-GDP ratio</b>									
<b>Baseline</b>	20	19	18	18	17	16	<b>13</b>		9
<b>A. Alternative Scenarios</b>									
A1. Key variables at their historical averages in 2007-26 1/	20	20	19	19	18	16	<b>11</b>		10
A2. New public sector loans on less favorable terms in 2007-26 2/	20	20	20	20	20	20	<b>18</b>		15
<b>B. Bound Tests</b>									
B1. Real GDP growth at historical average minus one standard deviation in 2007-08	20	20	20	19	19	18	<b>14</b>		10
B2. Export value growth at historical average minus one standard deviation in 2007-08 3/	20	21	23	22	21	20	<b>16</b>		10
B3. US dollar GDP deflator at historical average minus one standard deviation in 2007-08	20	22	23	22	21	21	<b>17</b>		12
B4. Net non-debt creating flows at historical average minus one standard deviation in 2007-08 4/	20	22	23	22	21	20	<b>16</b>		10
B5. Combination of B1-B4 using one-half standard deviation shocks	20	25	32	30	29	27	<b>21</b>		13
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 5/	20	27	25	24	23	23	<b>18</b>		13
<b>NPV of debt-to-exports ratio</b>									
<b>Baseline</b>	83	81	78	76	74	71	<b>57</b>		39
<b>A. Alternative Scenarios</b>									
A1. Key variables at their historical averages in 2007-26 1/	83	83	82	80	77	71	<b>49</b>		43
A2. New public sector loans on less favorable terms in 2007-26 2/	83	85	86	88	89	89	<b>80</b>		63
<b>B. Bound Tests</b>									
B1. Real GDP growth at historical average minus one standard deviation in 2007-08	83	81	78	76	74	71	<b>57</b>		39
B2. Export value growth at historical average minus one standard deviation in 2007-08 3/	83	103	131	126	122	117	<b>91</b>		56
B3. US dollar GDP deflator at historical average minus one standard deviation in 2007-08	83	81	78	76	74	71	<b>57</b>		39
B4. Net non-debt creating flows at historical average minus one standard deviation in 2007-08 4/	83	90	98	94	92	88	<b>69</b>		42
B5. Combination of B1-B4 using one-half standard deviation shocks	83	102	126	121	118	113	<b>87</b>		52
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 5/	83	81	78	76	74	71	<b>57</b>		39
<b>Debt service ratio</b>									
<b>Baseline</b>	5	6	7	6	6	6	<b>4</b>		2
<b>A. Alternative Scenarios</b>									
A1. Key variables at their historical averages in 2007-26 1/	5	6	8	7	7	7	<b>5</b>		3
A2. New public sector loans on less favorable terms in 2007-26 2/	5	6	6	6	6	6	<b>5</b>		4
<b>B. Bound Tests</b>									
B1. Real GDP growth at historical average minus one standard deviation in 2007-08	5	6	7	6	6	6	<b>4</b>		2
B2. Export value growth at historical average minus one standard deviation in 2007-08 3/	5	7	10	9	8	8	<b>6</b>		4
B3. US dollar GDP deflator at historical average minus one standard deviation in 2007-08	5	6	7	6	6	6	<b>4</b>		2
B4. Net non-debt creating flows at historical average minus one standard deviation in 2007-08 4/	5	6	7	7	6	6	<b>4</b>		3
B5. Combination of B1-B4 using one-half standard deviation shocks	5	6	9	8	8	7	<b>6</b>		3
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 5/	5	6	7	6	6	6	<b>4</b>		2
<i>Memorandum item:</i>									
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	41	41	41	41	41	41	<b>41</b>		41

Source: Staff projections and simulations.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.

2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline, while grace and maturity periods are the same as in the baseline.

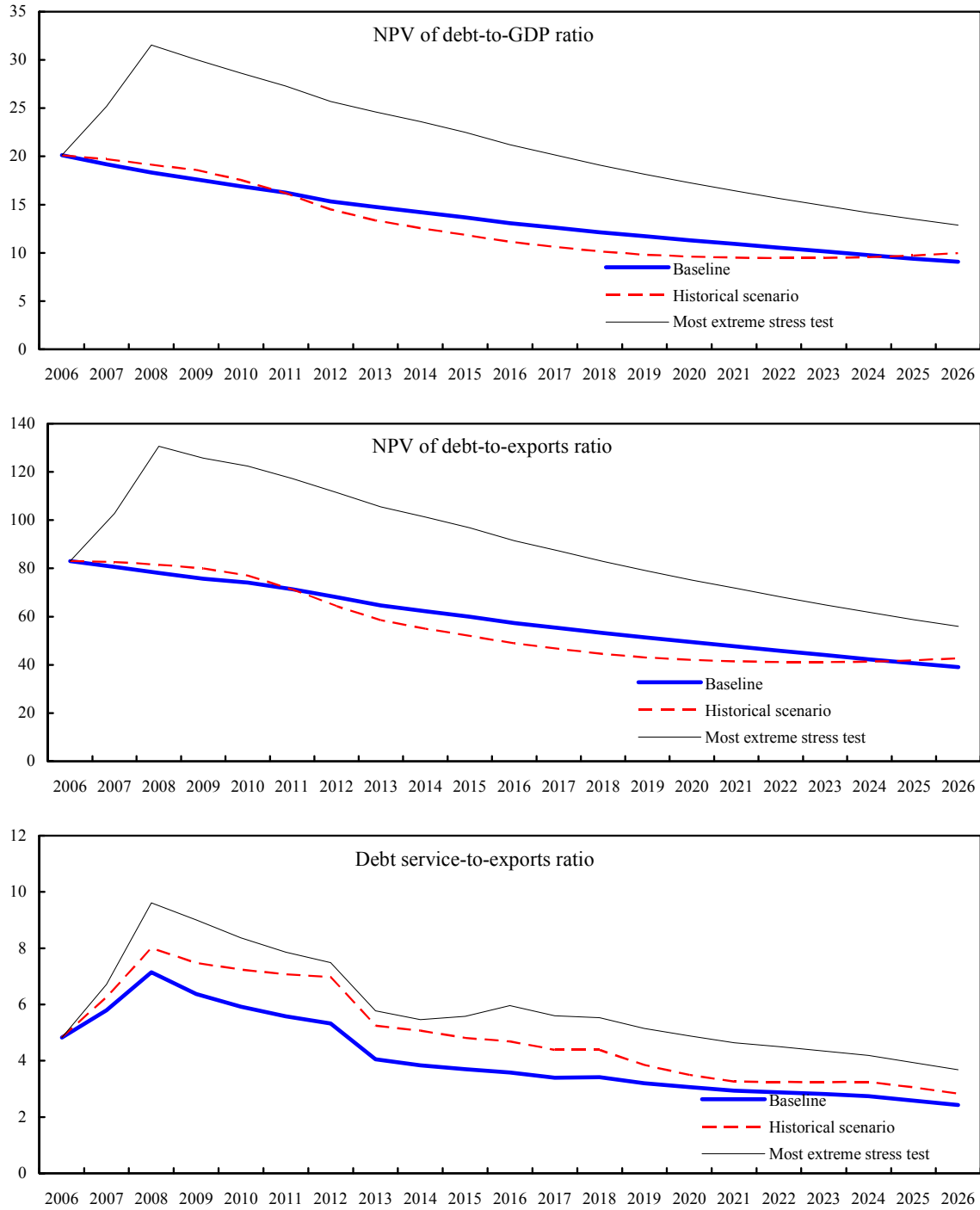
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).

4/ Includes official and private transfers and FDI.

5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.

6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Figure 1. Kenya: Indicators of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2006-2026 (In percent)



Source: Staff projections and simulations.



Table 2a. Kenya: Public Sector Debt Sustainability Framework, Baseline Scenario, 2003-2026  
(In percent of GDP, unless otherwise indicated)

	Actual			Historical Average 5/	Standard Deviation 5/	Estimate					Projections			
	2003	2004	2005			2006	2007	2008	2009	2010	2011	2006-11 Average	2016	2026
<b>Public sector debt 1/</b>	56.5	50.7	44.7			47.3	46.9	45.9	44.9	43.8	42.6		37.4	28.0
o/w foreign-currency denominated	34.2	30.8	25.9			29.0	28.1	27.5	27.0	26.4	25.6		21.0	14.1
Change in public sector debt	-1.9	-5.8	-6.1			2.6	-0.4	-1.0	-1.0	-1.1	-1.2		-1.0	-0.5
Identified debt-creating flows	-3.8	-6.3	-5.6			-4.8	-1.0	-1.1	-1.4	-1.6	-1.6		-1.0	-0.6
Primary deficit	-0.9	-2.2	-0.8	-2.3	1.6	0.8	0.9	1.0	0.7	0.4	0.6	0.7	0.5	0.4
Revenue and grants	21.8	22.4	22.5			21.9	22.9	23.4	23.9	24.2	24.3		23.6	23.2
of which : grants	1.4	1.2	1.2			1.2	1.2	1.4	1.8	2.1	2.2		1.7	0.8
Primary (noninterest) expenditure	20.9	20.2	21.7			22.6	23.8	24.4	24.5	24.6	24.9		24.0	23.6
Automatic debt dynamics	-2.9	-3.5	-4.1			-5.2	-1.7	-2.0	-2.1	-2.0	-2.2		-1.5	-0.9
Contribution from interest rate/growth differential	-0.6	-2.2	-1.4			-2.1	-1.3	-1.1	-1.3	-1.2	-1.4		-1.1	-0.7
of which : contribution from average real interest rate	1.0	0.4	1.4			0.5	1.5	1.4	1.4	1.3	1.1		0.7	0.6
of which : contribution from real GDP growth	-1.7	-2.6	-2.8			-2.5	-2.8	-2.6	-2.7	-2.5	-2.5		-1.8	-1.4
Contribution from real exchange rate depreciation	-2.2	-1.3	-2.6			-3.1	-0.4	-0.8	-0.8	-0.8	-0.8		...	...
Other identified debt-creating flows	0.0	-0.5	-0.8			-0.4	-0.1	-0.1	0.0	0.0	0.0		0.0	0.0
Privatization receipts (negative)	0.0	0.0	-0.2			-0.8	-0.6	-0.1	0.0	0.0	0.0		0.0	0.0
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0
Debt relief (HIPC and other)	-0.2	-0.5	-0.5			-0.3	-0.1	0.0	0.0	0.0	0.0		0.0	0.0
Other (specify, e.g. bank recapitalization)	0.2	0.0	0.0			0.6	0.6	0.0	0.0	0.0	0.0		0.0	0.0
Residual, including asset changes	1.9	0.5	-0.5			7.4	0.6	0.1	0.4	0.6	0.4		0.0	0.1
<b>NPV of public sector debt</b>	47.4	42.5	37.7			37.7	37.9	36.7	35.4	34.3	33.2		29.4	23.0
o/w foreign-currency denominated	25.1	22.6	18.9			19.4	19.2	18.3	17.6	16.9	16.2		13.1	9.1
o/w external	25.1	22.6	18.9			19.4	19.2	18.3	17.6	16.9	16.2		13.1	9.1
NPV of contingent liabilities (not included in public sector debt)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0
Gross financing need 2/	5.0	9.2	9.3			9.7	10.8	11.4	10.7	10.2	10.5		9.6	8.0
NPV of public sector debt-to-revenue ratio (in percent) 3/	217.4	189.2	167.6			172.2	165.4	156.8	148.5	141.7	136.6		124.8	99.0
o/w external	115.1	100.5	84.0			88.6	83.8	78.4	73.8	69.8	66.7		55.4	39.1
Debt service-to-revenue ratio (in percent) 3/ 4/	28.8	26.9	28.2			26.3	25.5	26.6	24.8	23.9	24.8		23.2	19.5
Primary deficit that stabilizes the debt-to-GDP ratio	1.0	3.6	5.3			-1.8	1.3	2.0	1.7	1.5	1.8		1.5	0.9
<b>Key macroeconomic and fiscal assumptions</b>														
Real GDP growth (in percent)	3.0	4.9	5.8	2.9	2.0	6.0	6.2	5.8	6.2	5.9	6.1	6.0	5.0	5.0
Average nominal interest rate on forex debt (in percent)	2.0	1.8	2.2	2.1	0.3	2.1	1.5	1.8	1.8	1.8	1.8	1.8	1.7	0.9
Average real interest rate on domestic currency debt (in percent)	4.3	1.6	6.2	10.2	5.0	1.5	8.5	7.8	7.9	7.4	7.0	6.7	6.1	7.0
Real exchange rate depreciation (in percent, + indicates depreciation)	-6.3	-4.0	-8.9	-1.2	9.4	-12.7	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	6.7	7.5	4.3	5.7	3.1	11.2	4.2	5.0	5.1	5.2	5.2	6.0	4.8	4.8
Growth of real primary spending (deflated by GDP deflator, in percent)	4.0	1.4	13.6	5.1	5.3	10.5	11.8	8.3	6.7	6.4	7.1	8.5	4.5	5.0
Grant element of new external borrowing (in percent)	0.0	0.0	0.0	0.0	0.0	46.9	17.0	46.3	47.6	46.7	44.5	41.5	46.5	41.2

Sources: Country authorities; and Fund staff estimates and projections.

1/ Public sector covers general government; net debt figures are used.

2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

3/ Revenues including grants.

4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.

5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table 2b. Kenya: Sensitivity Analysis for Key Indicators of Public Debt 2006-2026

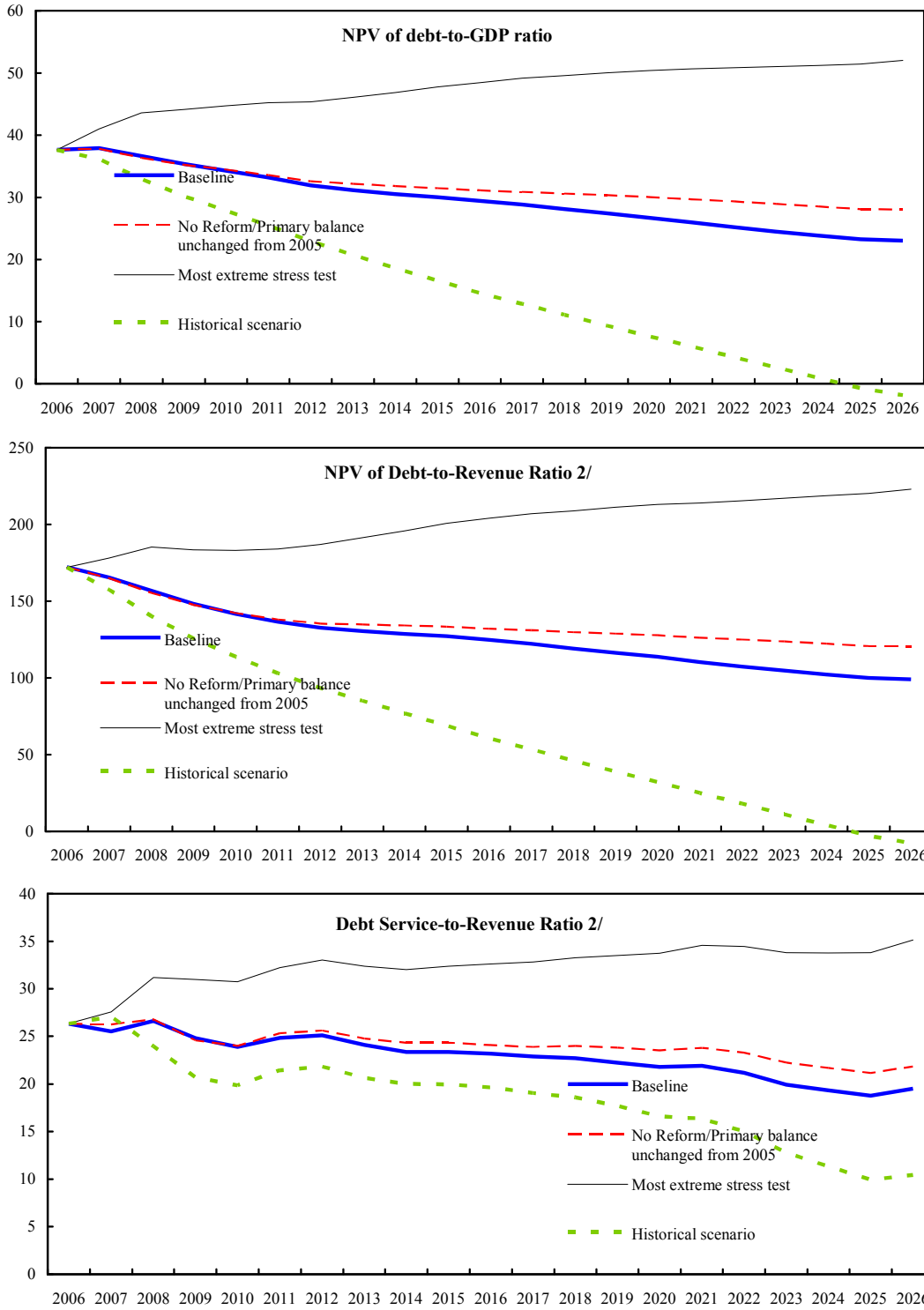
	Projections							
	2006	2007	2008	2009	2010	2011	2016	2026
<b>NPV of Debt-to-GDP Ratio</b>								
<b>Baseline</b>	38	38	37	35	34	33	29	23
<b>A. Alternative scenarios</b>								
A1. Real GDP growth and primary balance are at historical averages	38	36	33	30	28	25	15	-2
A2. Primary balance is unchanged from 2006	38	38	36	35	34	34	31	28
A3. Permanently lower GDP growth 1/	38	38	37	36	36	35	35	39
<b>B. Bound tests</b>								
B1. Real GDP growth is at historical average minus one standard deviations in 2007-2008	38	41	44	44	45	45	48	52
B2. Primary balance is at historical average minus one standard deviations in 2007-2008	38	36	34	33	32	31	28	22
B3. Combination of B1-B2 using one half standard deviation shocks	38	37	35	34	33	32	28	22
B4. One-time 30 percent real depreciation in 2007	38	46	44	41	39	38	32	24
B5. 10 percent of GDP increase in other debt-creating flows in 2007	38	47	45	43	42	40	35	26
<b>NPV of Debt-to-Revenue Ratio 2/</b>								
<b>Baseline</b>	172	165	157	148	142	137	125	99
<b>A. Alternative scenarios</b>								
A1. Real GDP growth and primary balance are at historical averages	172	157	140	126	114	103	61	-8
A2. Primary balance is unchanged from 2006	172	165	155	148	142	138	132	120
A3. Permanently lower GDP growth 1/	172	166	159	152	147	144	147	168
<b>B. Bound tests</b>								
B1. Real GDP growth is at historical average minus one standard deviations in 2007-2008	172	178	185	184	183	184	204	223
B2. Primary balance is at historical average minus one standard deviations in 2007-2008	172	159	144	137	131	126	117	95
B3. Combination of B1-B2 using one half standard deviation shocks	172	162	149	141	134	129	117	93
B4. One-time 30 percent real depreciation in 2007	172	200	187	173	163	155	136	104
B5. 10 percent of GDP increase in other debt-creating flows in 2007	172	203	192	181	172	165	148	113
<b>Debt Service-to-Revenue Ratio 2/</b>								
<b>Baseline</b>	26	26	27	25	24	25	23	19
<b>A. Alternative scenarios</b>								
A1. Real GDP growth and primary balance are at historical averages	26	27	24	21	20	21	20	10
A2. Primary balance is unchanged from 2006	26	26	27	25	24	25	24	22
A3. Permanently lower GDP growth 1/	26	26	27	26	25	26	26	28
<b>B. Bound tests</b>								
B1. Real GDP growth is at historical average minus one standard deviations in 2007-2008	26	28	31	31	31	32	33	35
B2. Primary balance is at historical average minus one standard deviations in 2007-2008	26	26	25	22	23	24	23	19
B3. Combination of B1-B2 using one half standard deviation shocks	26	27	26	22	23	25	24	19
B4. One-time 30 percent real depreciation in 2007	26	27	28	26	25	26	25	21
B5. 10 percent of GDP increase in other debt-creating flows in 2007	26	26	41	30	27	27	25	22

Sources: Country authorities; and Fund staff estimates and projections.

1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of 20 (i.e., the length of the projection period).

2/ Revenues are defined inclusive of grants.

Figure 2. Indicators of Public Debt Under Alternative Scenarios, 2006–26<sup>1</sup>



Sources: Staff projections; and simulations.  
<sup>1</sup> Most extreme stress test is test that yields highest ratio in 2016.  
<sup>2</sup> Revenue including grants.

Table 3a. Public Sector Debt Sustainability Framework, Alternative Baseline Scenario, 2003–2026  
(In percent of GDP, unless otherwise indicated)

	Actual			Historical Average 5/	Standard Deviation 5/	Estimate					Projections				
	2003	2004	2005			2006	2007	2008	2009	2010	2011	2006-11 Average	2016	2026	2012-26 Average
<b>Public sector debt 1/</b>	56.5	50.7	44.7			47.7	48.2	48.1	47.9	47.5	46.7		43.1	38.6	
o/w foreign-currency denominated	34.2	30.8	25.9			29.0	28.1	27.5	27.0	26.4	25.6		21.0	14.1	
Change in public sector debt	-1.9	-5.8	-6.1			3.0	0.5	-0.1	-0.2	-0.4	-0.8		-0.7	0.2	
Identified debt-creating flows	-3.8	-6.3	-5.6			-4.4	-0.1	-0.2	-0.7	-0.9	-1.2		-0.7	0.1	
Primary deficit	-0.9	-2.2	-0.8	-2.3	1.6	1.2	1.6	1.6	1.3	0.9	0.8	1.2	0.5	0.4	0.3
Revenue and grants	21.8	22.4	22.5			21.9	22.9	23.4	23.9	24.2	24.3		23.6	23.2	
of which: grants	1.4	1.2	1.2			1.2	1.2	1.4	1.8	2.1	2.2		1.7	0.8	
Primary (noninterest) expenditure	20.9	20.2	21.7			23.1	24.5	25.0	25.1	25.1	25.1		24.0	23.6	
Automatic debt dynamics	-2.9	-3.5	-4.1			-5.2	-1.6	-1.7	-1.9	-1.8	-1.9		-1.1	-0.2	
Contribution from interest rate/growth differential	-0.6	-2.2	-1.4			-2.1	-1.1	-0.9	-1.1	-1.0	-1.1		-0.8	0.0	
of which: contribution from average real interest rate	1.0	0.4	1.4			0.5	1.7	1.7	1.7	1.6	1.6		1.3	1.8	
of which: contribution from real GDP growth	-1.7	-2.6	-2.8			-2.5	-2.8	-2.6	-2.8	-2.7	-2.7		-2.1	-1.8	
Contribution from real exchange rate depreciation	-2.2	-1.3	-2.6			-3.1	-0.4	-0.8	-0.8	-0.8	-0.8		...	...	
Other identified debt-creating flows	0.0	-0.5	-0.8			-0.4	-0.1	-0.1	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	0.0	0.0	-0.2			-0.8	-0.6	-0.1	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	-0.2	-0.5	-0.5			-0.3	-0.1	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.2	0.0	0.0			0.6	0.6	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	1.9	0.5	-0.5			7.4	0.6	0.1	0.4	0.6	0.4		0.0	0.1	
<b>NPV of public sector debt</b>	47.4	42.5	37.7			38.1	39.3	38.9	38.4	38.0	37.4		35.2	33.5	
o/w foreign-currency denominated	25.1	22.6	18.9			19.4	19.2	18.3	17.6	16.9	16.2		13.1	9.1	
o/w external	25.1	22.6	18.9			19.4	19.2	18.3	17.6	16.9	16.2		13.1	9.1	
NPV of contingent liabilities (not included in public sector debt)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Gross financing need 2/	5.0	9.2	9.3			10.1	12.0	13.0	12.5	12.4	12.8		12.8	13.8	
NPV of public sector debt-to-revenue ratio (in percent) 3/	217.4	189.2	167.6			174.3	171.3	166.4	161.1	157.1	153.7		149.3	144.3	
o/w external	115.1	100.5	84.0			88.6	83.8	78.4	73.8	69.8	66.7		55.4	39.1	
Debt service-to-revenue ratio (in percent) 3/ 4/	28.8	26.9	28.2			26.3	26.8	29.1	28.0	28.1	30.1		31.3	34.7	
Primary deficit that stabilizes the debt-to-GDP ratio	1.0	3.6	5.3			-1.8	1.1	1.8	1.5	1.3	1.5		1.1	0.2	
<b>Key macroeconomic and fiscal assumptions</b>															
Real GDP growth (in percent)	3.0	4.9	5.8	2.9	2.0	6.0	6.2	5.8	6.2	5.9	6.1	6.0	5.0	5.0	5.1
Average nominal interest rate on forex debt (in percent)	2.0	1.8	2.2	2.1	0.3	2.1	1.5	1.8	1.8	1.8	1.8	1.8	1.7	0.9	1.5
Average real interest rate on domestic currency debt (in percent)	4.3	1.6	6.2	10.2	5.0	1.5	9.4	9.0	8.6	8.3	8.0	7.5	7.5	9.4	7.6
Real exchange rate depreciation (in percent, + indicates depreciation)	-6.3	-4.0	-8.9	-1.2	9.4	-12.7	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	6.7	7.5	4.3	5.7	3.1	11.2	4.2	5.0	5.1	5.2	5.2	6.0	4.8	4.8	4.8
Growth of real primary spending (deflated by GDP deflator, in percent)	4.0	1.4	13.6	5.1	5.3	12.7	13.0	7.8	6.5	5.9	5.9	8.6	4.5	5.0	4.6
Grant element of new external borrowing (in percent)	0.0	0.0	0.0	0.0	0.0	46.9	17.0	46.3	47.6	46.7	44.5	41.5	46.5	41.2	...

Sources: Country authorities; and Fund staff estimates and projections.

1/ Public sector covers general government; net debt figures are used.

2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

3/ Revenues including grants.

4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.

5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table 3b. Kenya: Sensitivity Analysis for Key Indicators of Public Debt Under Alternative Baseline and Other Scenarios 2006-2026

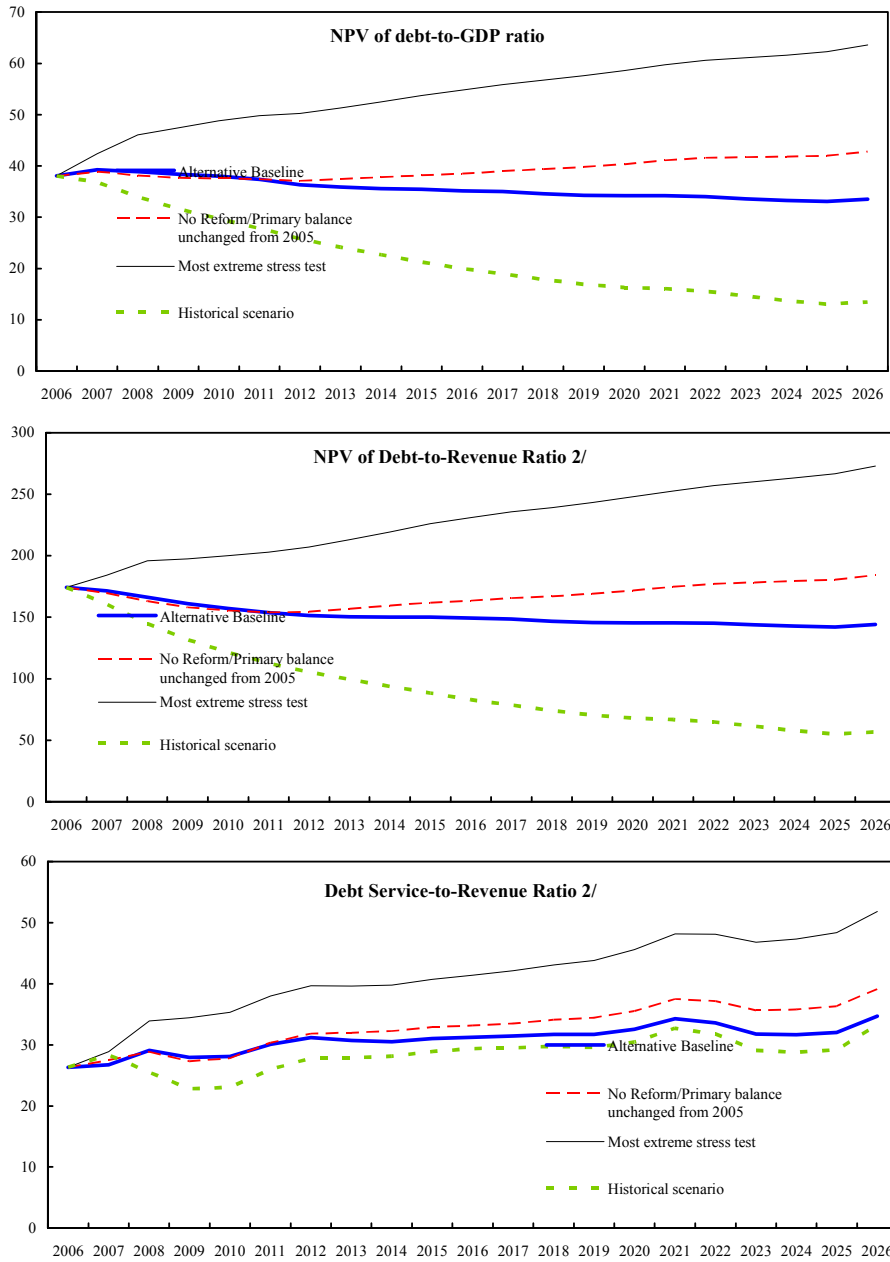
	Projections							
	2006	2007	2008	2009	2010	2011	2016	2026
<b>NPV of Debt-to-GDP Ratio</b>								
<b>Baseline</b>	38	39	39	38	38	37	35	34
<b>A. Alternative scenarios</b>								
A1. Real GDP growth and primary balance are at historical averages	38	37	34	32	30	28	20	13
A2. Primary balance is unchanged from 2006	38	39	38	38	38	37	39	43
A3. Permanently lower GDP growth 1/	38	40	39	39	39	39	41	51
<b>B. Bound tests</b>								
B1. Real GDP growth is at historical average minus one standard deviations in 2007-2008	38	42	46	47	49	50	55	64
B2. Primary balance is at historical average minus one standard deviations in 2007-2008	38	37	35	34	34	34	33	32
B3. Combination of B1-B2 using one half standard deviation shocks	38	38	36	36	35	35	33	33
B4. One-time 30 percent real depreciation in 2007	38	47	46	44	43	42	38	35
B5. 10 percent of GDP increase in other debt-creating flows in 2007	38	48	47	46	45	44	41	37
<b>NPV of Debt-to-Revenue Ratio 2/</b>								
<b>Baseline</b>	174	171	166	161	157	154	149	144
<b>A. Alternative scenarios</b>								
A1. Real GDP growth and primary balance are at historical averages	174	160	145	132	121	113	83	57
A2. Primary balance is unchanged from 2006	174	170	163	158	155	154	163	184
A3. Permanently lower GDP growth 1/	174	172	169	165	163	162	173	217
<b>B. Bound tests</b>								
B1. Real GDP growth is at historical average minus one standard deviations in 2007-2008	174	184	196	197	200	203	231	273
B2. Primary balance is at historical average minus one standard deviations in 2007-2008	174	162	148	144	142	139	138	138
B3. Combination of B1-B2 using one half standard deviation shocks	174	165	154	149	146	143	140	140
B4. One-time 30 percent real depreciation in 2007	174	206	196	186	178	172	160	149
B5. 10 percent of GDP increase in other debt-creating flows in 2007	174	209	201	193	187	182	172	158
<b>Debt Service-to-Revenue Ratio 2/</b>								
<b>Baseline</b>	26	27	29	28	28	30	31	35
<b>A. Alternative scenarios</b>								
A1. Real GDP growth and primary balance are at historical averages	26	28	26	23	23	26	29	33
A2. Primary balance is unchanged from 2006	26	27	29	27	28	30	33	39
A3. Permanently lower GDP growth 1/	26	28	30	29	29	31	35	45
<b>B. Bound tests</b>								
B1. Real GDP growth is at historical average minus one standard deviations in 2007-2008	26	29	34	34	35	38	41	52
B2. Primary balance is at historical average minus one standard deviations in 2007-2008	26	27	26	24	26	29	31	34
B3. Combination of B1-B2 using one half standard deviation shocks	26	29	27	24	27	30	32	35
B4. One-time 30 percent real depreciation in 2007	26	28	30	29	29	31	33	36
B5. 10 percent of GDP increase in other debt-creating flows in 2007	26	27	43	33	31	32	33	37

Sources: Country authorities; and Fund staff estimates and projections.

1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of 20 (i.e., the length of the projection period).

2/ Revenues are defined inclusive of grants.

Figure 3. Kenya: Indicators of Public Debt Under Alternative Baseline and Other Scenarios, 2006-2026 1/



Source: Staff projections and simulations.  
 1/ Most extreme stress test is test that yields highest ratio in 2016.  
 2/ Revenue including grants.

**APPENDIX II—KENYA: LETTER OF INTENT**

April 4, 2007

Mr. Rodrigo de Rato  
Managing Director  
International Monetary Fund  
Washington, D.C. 20431

Dear Mr. de Rato:

1. The attached Memorandum of Economic and Financial Policies (MEFP) describes our recent performance under the program supported by the Poverty Reduction and Growth Facility (PRGF) arrangement and outlines the policies we plan to implement through the end of 2007. We remain fully committed to the goal of reducing poverty by establishing a macroeconomic and institutional framework that is conducive to accelerating growth, as spelt out in the Investment Program for the Economic Recovery Strategy for Wealth and Employment Creation.
2. Progress has been made under the program. Kenya's economic performance has continued to improve since the completion of the first review under the PRGF in late 2004. Growth accelerated to 5.3 percent in 2004/05 and further to 5.9 percent in 2005/06. Overall inflation fell sharply to 6.8 percent in the 12-months to February, as food price inflation eased while non-food inflation continued to hover around 6 percent. In the area of governance and other structural reforms, additional efforts will be required in order to sustain recent growth and move towards the targets set in the Kenya Vision 2030. Our 2006/07 program focuses on the required additional measures.
3. Five out of the 13 performance criteria for 2004/05 for the second review were not met. The end-March 2005 quantitative performance criterion (PC) on the reserve money of the Central Bank of Kenya (CBK) was missed, as was the continuous PC on nonaccumulation of external payments arrears. The structural PCs on non-imposition of controls on banks' fees and charges (Section 44 of the Banking Act) and the issuance of new guidelines for wage arbitration by the Industrial Court were also missed. Finally, the structural PC on completion of the asset declaration of ministers, permanent secretaries, and heads of state bodies was not observed. Remedial actions have been taken to address these slippages. We have developed modalities for implementing Section 44 of the Banking Act that are broadly consistent with the original program objectives, cleared a small amount of bilateral external arrears, and taken steps to improve debt management practices. The Industrial Court eventually issued new guidelines for wage arbitration in November 2005, and verification of asset declarations of ministers and senior officials is continuing.

4. We request waivers for the nonobservance of the five performance criteria detailed above. We also request an extension of the PRGF arrangement to November 20, 2007, which would allow us time to complete the third review under the arrangement after we have reached understandings with Fund staff on the 2007/08 budget. In view of the substantial improvements in Kenya's balance of payments since the approval of the PRGF arrangement, we request a reduction in access of SDR75 million, with the remaining access of SDR75 million to be disbursed in two equal installments (SDR37.5 million each) for the second and third reviews.

5. The attached MEFP spells out the quantitative performance criteria and benchmarks as well as the structural performance criteria and benchmarks to be used in monitoring performance under the program through December 2007. The end-March and end-September quantitative targets are benchmarks, while end-June targets are performance criteria. End-December 2007 targets are indicative. Understandings between the Kenyan authorities and the International Monetary Fund (IMF) regarding the definitions of these quantitative and structural performance criteria and benchmarks, as well as the related reporting requirements, are set out in the attached Technical Memorandum of Understanding. The government has taken a number of prior actions for the issuance of the staff report on the second review of the PRGF arrangement.

6. The government believes that the policies set forth in the attached MEFP are adequate to achieve the objectives of its program, but it will take any further measures that may become appropriate for this purpose. Kenya will consult with the Fund on the adoption of such measures, in advance of revisions to the policies contained in the MEFP, and in accordance with the Fund's policies on such consultation. Kenya will continue to provide the Fund, in a timely manner, all the information required to monitor progress in implementing the policies and achieving the objectives of the PRGF-supported program.

Sincerely yours,

/s/

Amos Kimunya  
Minister of Finance

Attachments: Memorandum of Economic and Financial Policies  
Technical Memorandum of Understanding



**APPENDIX II—ATTACHMENT I**  
**MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES FOR 2006/07**

**I. INTRODUCTION**

1. This memorandum summarizes our government's economic and financial policies for fiscal year 2006/07 (July/June) and the beginning of fiscal year 2007/08, which are supported by the International Monetary Fund under its Poverty Reduction and Growth Facility (PRGF). The broad strategy remains as outlined in our Investment Program for the Economic Recovery Strategy for Wealth and Employment Creation (ERS) and described in the government's previous memorandum of November 2004. The key priorities are to maintain macroeconomic stability; strengthen economic growth and reduce poverty; and advance social policies as well as governance and structural reforms that will benefit the entire population.
2. The government has recently launched the Kenya Vision 2030 program, which calls for accelerating annual GDP growth to 10 percent on a sustained basis, with a view to making Kenya a middle-income country by the year 2030. As a step in this direction, a medium-term economic strategy that builds on the ERS is being developed for the period 2008-2012, aimed at accelerating growth with macroeconomic stability, further reducing poverty, improving equity, and strengthening institutions of governance.
3. This memorandum therefore also reports on progress secured so far and evolving government priorities, including our strengthened focus on improving governance, since this is key to achieving the Millennium Development Goals (MDGs).

**II. RECENT ECONOMIC DEVELOPMENTS AND PROGRESS UNDER THE PROGRAM**

4. **Economic growth increased in 2005/06, but a severe drought and external shocks adversely affected overall inflation.** Real GDP expanded by an estimated 5.9 percent in 2005/06 compared with a target of 3.2 percent under the program. This was the highest growth rate in two decades and represents the third year in a row of an increase in per capita income. Economic growth continued to benefit from prudent macroeconomic policies as well as strong regional and global growth, with exports (including tourism and agriculture) and investment expanding strongly. The impact of the drought on overall economic activity was limited, as good harvests in the main food producing parts of the country counterbalanced the effects of the severe drought in other areas. Nevertheless, shortages in some food products and distribution difficulties resulted in sharply higher food prices, which, coupled with higher fuel prices that resulted from full pass-through of world prices, led to significantly higher overall inflation since the end of 2005. The good rains in the final quarter of 2006 have somewhat eased price pressures, with overall inflation falling sharply to 6.8 percent in the

12 months to February after running at double digits in 2006, and nonfood inflation hovering around 6 percent. On the balance of payments front, even with the large inflows of remittances, the current account deficit widened on account of higher world oil prices and strong import demand in line with stronger growth. At the same time, sizable financial inflows resulted in a significant buildup in foreign exchange reserves and an appreciation of the Kenyan shilling, largely reflecting increased confidence in Kenya's economy. With respect to fiscal policy, its implementation was adversely affected by lower-than-budgeted donor support. However, cuts in non-priority expenditures helped contain domestic borrowing at Ksh 28.3 billion (1.8 percent of GDP) while accommodating additional drought-related spending of Ksh 12.6 billion (0.8 percent of GDP).

5. **Reflecting the progress made in economic management, including prudent macroeconomic policies as well as broad-based economic growth, the country received a favorable initial sovereign credit rating of “B+” for foreign currency and “BB-” for local currency long-term sovereign debt from Standard and Poor’s.** Within sub-Saharan Africa, only mineral-rich countries such as Botswana, South Africa, and Nigeria have a higher sovereign rating.

6. **With respect to structural reforms, important progress has been made in many areas but there were some delays in others.** We initiated a detailed assessment of the financial positions of twenty-five parastatals, including the National Social Security Fund (NSSF), to determine their contingent liabilities. We also introduced performance contracts for public commercial enterprises, which contributed to an improvement in their financial performance and a near 80 percent increase in dividends to the Treasury in 2005/06; substantially advanced reforms in the telecom sector (including the decision to restructure and prepare Telkom Kenya for privatization and the sale of licenses for a second fixed-line provider, a third mobile phone provider and for international telecom gateways); successfully completed divestiture of part of the state's holdings in Kenya Electricity Generating Company (KenGen); completed the concession for Kenya Railways; enhanced the regulatory capacity of the Coffee Board and liberalized coffee marketing; transferred the management of Kenya Power and Lighting Company to a private company; and began implementation of the East African Community (EAC) customs union agreement. The recent highly successful partial divestiture of KenGen has created an impetus for further divestitures and privatization. Importantly, a new Privatization Act is in place that will guide future privatization transactions, and the government plans to take further steps (as outlined below) to advance the privatization agenda. With the exception of IFMIS, virtually all the reforms envisaged in the program have been met, including important steps in improving the budgetary process. With respect to the IFMIS, which is fundamental to strengthening public expenditure management, we have recently made important progress towards making it operational in the ministries of Education, Health, Planning and Finance. With regard to the financial sector, the government has now transferred to the Central Bank all powers to

supervise banks. However, the restructuring of state-owned banks has not progressed as originally envisaged.

**7. On the governance front, appreciable progress has been made in strengthening governance institutions, but more efforts are required in implementation in order to sustain the recent economic growth momentum.** Since 2003, the government has proposed and Parliament has approved laws that have strengthened the fight against corruption: the Public Officers Ethics Act (2003); the Anti-Corruption and Economic Crimes Act (2003); the Government Financial Management Act (2004); the Public Audit Office Act (2004); the Public Procurement and Disposal Act (2005); the Privatization Act (2005); and the Statistics Act (2006). A Ministerial Code of Conduct is now in force, which requires all Ministers and Assistant Ministers to submit wealth declarations, which are then verified by the Kenya Anti-Corruption Commission (KACC). The KACC has reported to the President on this verification process and is seeking clarification concerning declarations that are still to be submitted. The Public Procurement and Disposal Regulations, 2006, to operationalize the Procurement Act, were gazetted on December 29, 2006 and become effective on January 1, 2007. The government is now in the process of making the Public Procurement Oversight Authority fully operational. This will help reduce the incidence of corruption through public procurement and abuses of the type perpetrated in the Anglo-Leasing cases. We also began streamlining the business licensing regime, with 118 licenses already eliminated in FY 2005/06 and 2006/07. With a view to strengthening transparency and accountability, the government published the report of the Public Accounts Committee on Anglo-Leasing contracts, as well as the findings of the Goldenberg and Ndungu Commissions, and has initiated action based on the recommendations contained in these reports. The government has also appointed Special Prosecutors and Civil Litigation Counsel to bolster the capacity of the State Law Office to implement the recommendations of the reports, through criminal prosecutions and civil litigation. To address the challenge of implementation of the governance agenda, the government adopted a detailed Governance Action Plan for the period November 2006 to December 2007, which was drawn from the new three-year National Anti-Corruption Plan launched at the end June 2006, and reflected substantial dialogue with stakeholders inside and outside of government.<sup>1</sup>

**8. Important progress has been made in investigating corruption cases and bringing them to trial, but the pace of concluding cases has been slow.** By March 6, 2007, the KACC had forwarded to the Attorney General 254 files and recommended prosecution in

---

<sup>1</sup> For further details, see the Governance Action Plan for Building a Prosperous Kenya, 2006-07, which covers measures to be taken up to the end of 2007 .

185 files, administrative disciplinary action in 11 files and closure for lack of evidence in 58 files. Of these, the Attorney General has refused only three. There are currently a number of high-profile corruption cases in court, including cases involving three former permanent secretaries charged with crimes linked to Anglo-Leasing contracts, two former central bank governors (one linked to the Goldenberg scandal), and one former minister. The remaining Anglo-Leasing contracts are being investigated by the KACC in tandem with an external audit of the contracts to assess their fair values. The KACC has indicated that it intends to complete its investigations of all Anglo-Leasing contracts before making its recommendations to the Attorney General's office. To date, a total of 67 cases prosecuted under the Anti-Corruption and Economic Crimes Act (ACECA) have been concluded or dismissed, resulting in 14 convictions and 12 acquittals. Further, the Commission has filed 94 civil cases seeking recovery of public funds amounting to Ksh 121,072,800.15, of which Ksh 12,585,583 has already been recovered. KACC has also filed 37 suits for recovery of illegally allocated public land valued at Ksh 909 million; 48 applications for preservation of assets valued at Ksh 1.19 billion and an application to enjoin the Commission so as to protect public property and interests in a suit worth Ksh 50 million. The Commission has also recovered public land measuring 89.5 hectares, valued at Ksh 144 million. The slow progress in concluding cases is linked to a number of factors, including an under-staffed, and under-equipped, judiciary, a paucity of courtrooms, an insufficient number of prosecutors, and the application of constitutional stays by defendants. Many of these weaknesses are being addressed in the context of the "Governance Action Plan for Building a Prosperous Kenya, 2006/07", which was recently approved by Cabinet (a prior action).

9. **Most of the performance targets for the second review under the PRGF arrangement were met, but we are requesting waivers for nonobservance of five performance criteria.** These targets covered only 2004/05 due to the long delay in completing the second review. The end-March 2005 quantitative performance criterion (PC) on reserve money of the Central Bank of Kenya (CBK) was missed, but monetary policy was subsequently tightened, reducing the deviation from the end-June 2005 benchmark. The continuous PC on nonaccumulation of external payments arrears also was missed, but the arrears were quickly cleared and steps have been taken to improve debt management practices. With regard to structural performance criteria, the continuous criterion on the non-imposition of controls on banks' fees and charges (Section 44 of the Banking Act) was not observed, but we have developed remedies which have in practice always resulted in approval by the Ministry of Finance of proposed increases in bank fees and charges. Also, the structural PC on completion of the asset declaration of ministers, permanent secretaries, and heads of state bodies were also not observed, and new guidelines for wage arbitration by the Industrial Court were not issued by end-March, as programmed, but were issued in November 2005. The Letter of Intent (LOI) to which this memorandum is attached requests waivers for the nonobservance of these performance criteria. In addition, two structural benchmarks for end-March 2005 were missed, notably, (i) the simplifications of customs

procedures, which has now been addressed with the introduction of a computerized system since July 2005; and (ii) a financial review of the NSSF and the study of the contingent liabilities of 24 parastatals, which are expected to be completed by May 2007 and September 2007, respectively. The two structural PCs that had been set for the third review were also not met. As noted above, steps were taken to meet the original objectives of the continuous PC on non-imposition of controls on banks' fees and charges. As regards the PC for end-June 2005 on the verification of the asset declarations of ministers and senior officials, the verification process is continuing. In addition the government will resubmit to Parliament proposed amendments to the Public Officer Ethics Act to enable the public to have access to declarations of assets required by public officers under this Act, and to empower the KACC to investigate whether a public officer has contravened the Code of Conduct and Ethics established under the Act.

### III. MACROECONOMIC FRAMEWORK

10. **The updated macroeconomic framework envisages growth rates well above averages observed in the past decade and gradual progress toward achieving the MDGs.** This is based on maintaining macroeconomic stability, accelerating structural reforms, upgrading essential infrastructure, and continuing efforts to rebuild key institutions, including those related to governance. As indicated in our detailed Needs Assessment, achieving the MDGs would also require a major increase in investment and donor support to achieve and sustain economic growth rates of over 7 percent per annum. However, given recent experience, our baseline assumptions for donor support are well below these requirements. In addition, while the government is gearing its policies to accelerate growth towards the target of 10 percent elaborated in the 2030 vision, the medium term macroeconomic framework is guided by the need to be prudent, and therefore based on an average growth rate of 6 percent, which is still well above historically observed rates in Kenya. If we achieve higher than the projected growth rates, the medium-term macroeconomic framework will be adjusted accordingly.

11. **For 2006/07, we expect continued robust economic growth and a significant decline in inflation.** Indications of favorable weather conditions, strong tourism demand, and recent robust income growth are expected to sustain GDP growth at about 6.1 percent—and we see the potential for even faster growth. At the same time, headline inflation should decline to 7 percent by the end of the fiscal year as the drought-related increases in food prices are reversed. On the external side, the current account deficit is likely to widen somewhat as a result of stronger growth and an expected increase in foreign-financed project imports to help address infrastructure bottlenecks. Nonetheless, as in 2005/06, financial inflows should allow for a further accumulation of foreign exchange reserves, reaching the equivalent of 3.3 months of next year's imports by mid-2007. We recognize that these projections are subject to considerable risks, notably those related to a return of adverse

weather conditions and further oil price increases, and stronger-than-expected repercussions from the strong Kenyan shilling.

#### IV. ECONOMIC AND STRUCTURAL POLICIES FOR 2006/07

##### A. Governance

12. **The government is fully committed to implementing its Governance Action Plan for Building a Prosperous Kenya.** As spelled out in the Action Plan, the key governance policy initiatives will focus on four broad areas: (i) prevention; (ii) investigation; (iii) restitution; and (iv) improving governance in priority sectors. In implementing these measures, top priority will be given to administrative and preventive actions, which are expected to result in measurable improvements in governance and anti-corruption efforts in the short run.

13. **The government has taken important actions and will table proposals for legislative reform that will substantially strengthen the governance strategy.** We have already posted on the web all procurement contracts above Ksh 0.5 million awarded in the second and third quarters of 2005/06 (a prior action) and commit to posting on the web all subsequent procurement contracts above the Ksh 0.5 million threshold at the end of each quarter. Parliamentary passage of the proposed reforms would expand the powers of the KACC to place assets of suspected criminals under receivership pending the conclusion of the investigation, prohibit the application for constitutional stays of proceedings in corruption cases, and enable the KACC to take over investigations of corruption commenced by the Police. The Penal Code would be amended to elevate acts that are misdemeanors under the Code to felony offences, as they currently provided for under the ACECA, 2003. The proposed amendments to the Judicature Act will increase the number of High Court judges from 50 to 70 and the number of appellate judges from 11 to 14, while the proposed amendments to the Public Officer Ethics Act will make the information contained in the wealth declarations of public officials accessible to the public. Submission of these proposed amendments to Parliament would constitute a performance criterion for the completion of the third review under the PRGF. To help expedite the prosecution of cases, the 2007/08 budget will provide for the hiring of additional prosecutors and expanding of court facilities. The Chief Justice has indicated that automated recording of court proceedings will be implemented to replace the time-consuming process of manual recording of court proceedings by judges. In addition, the government will strengthen governance through the fiscal and financial sector reforms noted below.

##### B. Fiscal Policy

14. **Safeguarding expenditures for core anti-poverty areas and raising spending for infrastructure programs, while maintaining fiscal soundness, are the key fiscal policy**

**objectives for 2006/07.** The near-term objectives are embedded in our medium-term policy priorities, as described in the Budget Strategy Paper for 2006/07-2008/09 and the recently launched Budget Outlook Paper 2007/08-2009/10. Accordingly, the budget for 2006/07 accommodates drought-relief spending of Ksh 3 billion and doubles the allocation for development spending in the Ministry of Roads and Public Works, with improvements in infrastructure seen to be crucial for enhancing growth. The budget for 2006/07 assumes no foreign budget support (apart from a partial reimbursement of US\$ 20 million by the World Bank for drought-related expenditures carried out in 2005/06), but in the event that budget support is received, we intend to spend it on pro-growth and anti-poverty areas, as set out in the Budget Strategy Paper, which reflects the priorities of the ERS. We assume project support amounting to 2.5 percent of GDP, which comprises 1.2 percent of GDP in foreign grants and 1.3 percent of GDP in loans. The budget also includes 1.0 percent of GDP in privatization receipts. With limited external financing available, the scaling up of core anti-poverty and infrastructure programs will thus require a determined effort to rein in non-priority spending and to ensure strong domestic revenue collection. Achieving our domestic borrowing target of Ksh 29.5 billion (equivalent to 1.7 percent of GDP) should leave adequate room for private sector credit and help safeguard debt sustainability.

15. **Revenues are expected to rise on account of higher incomes and strengthened tax administration.** The projected increase in the revenue-to-GDP ratio is large (exceeding 1 percentage point) but is feasible in light of tax and customs administration measures, designed to reverse the sharp drop in the revenue ratio observed in 2005/06. Specifically, steps have been taken to address earlier problems in implementing the SIMBA2005 system (a customs-processing system introduced in July 2005) which is now fully operational. These steps will enhance not only customs revenues, but also VAT receipts from imports. Indeed, the first half of 2006/07 has seen robust growth of customs revenues and VAT receipts. Governance at customs has been enhanced by introducing electronic queue management and electronic processing, which eliminates face-to-face and oral communication between customs officers and clearing agents; installing CCTV cameras; and more generally, implementing the Kenya Revenue Authority's Integrity Plan and Code of Conduct for employees. The number of taxpayers covered by the Large Taxpayer's Office has been increased from 243 to 812 and problems with VAT refunds have been largely solved. Further reforms to enhance tax administration include the introduction of the Electronic Taxpayer Register (ETR). We introduced a turnover tax for small businesses in the context of the 2006/07 budget. Both measures are expected to contribute in the medium-term to increased revenue and improved tax compliance.

16. **The government remains firmly committed to the reorientation of public expenditures in favor of growth and poverty-related outlays.** Accordingly, development expenditures and net lending are budgeted to increase by about 1.7 percentage point of GDP. Development spending includes increased expenditure on roads and other infrastructure, and

urgently needed investment in new electricity generation capacity that is now underway, as well as spending through the Constituency Development Fund. Aside from an increase in project-related foreign financing, the room for higher priority spending is created by containing spending in other categories, mainly through the new pay policy and efforts to reform the pension scheme for civil servants, and increasingly also through containing transfers to parastatals. Since the approval of the budget, the government has decided to bring forward a wage increase for teachers that was scheduled for 2007/08. The government will offset the resulting cost of this step of Ksh 2.5 billion by making cuts in non priority spending. In addition to total wage-related expenditures of Ksh 130 billion, wage and salary payments for 3,000 nurses are covered by external support and our program allows for this number to be increased. Moreover, those health workers whose externally funded contracts will expire during 2006/07 will thereafter be absorbed into the civil service payroll. Wage bill management is being strengthened by the new centralized Integrated Payroll and Personnel Database (IPPD). Other priorities related to public sector wage and employment reforms include steps to: restrict all salary and wage increases to at most one adjustment per annum, to take place at the beginning of the fiscal year; accelerate efforts to fully implement the Voluntary Early Retirement Scheme, by which over 21,000 employees were to retire over a period of 3 years ending 2007/08. However, a court challenge delayed the scheme's implementation by one year. We plan to fill only half of the vacancies (except in priority areas) created through this scheme and natural attrition.

17. **We intend to accelerate public expenditure management reforms—an area critical for promoting efficient use of public resources and transparency.** The Strategy to Revitalize Public Finance Management (PFM) was launched in June 2006 and highlights recent progress in this area, including better cash management through regular reconciliation of all central government accounts, clearance of the backlog of audits, streamlined budget formulation and budget preparation, and steps taken to strengthen cash flow planning, including establishing zero-balance drawing accounts for all ministries in 2005/06. Further, the introduction of a new economic classification system for public expenditure, based on the GFS 2001 manual, has enhanced transparency. We also intend to request Kenya's participation in a Report on Standards and Codes on fiscal transparency. To align our PFM with international best practice, our immediate focus will be on:

- Operationalizing the Integrated Financial Management Information System (IFMIS), for which about US\$33 million has been made available under the PFM Reform Program, to be effective for the 2007/08 budget implementation. A new steering committee has been established, headed by the Permanent Secretary of the Ministry of Finance, and includes representation from key line ministries. The committee will establish an implementation plan to make the IFMIS operational in four spending ministries (including education and health) for the management of the 2007/08 budget; provide quarterly reports on project implementation to the economic



- committee of the Cabinet; and be responsible for the preparation of comprehensive guidance documentation of the IFMIS for system users;
- Strengthening the legal framework for PFM, drawing on the recommendations of the recent FAD diagnostic PFM mission and submitting the draft legal framework for PFM for cabinet approval;
  - Strengthening the monitoring of exemptions by including a tax expenditure budget along with the regular budget documents from FY 2007/08 onward, and developing and enforcing objective criteria for granting tax exemptions to remove discretionary powers and enhance transparency and accountability in the tax exemption regime;
  - Strengthening budget reporting by ensuring timely production of monthly fiscal accounts (including on pending bills and arrears) based on expenditure returns data and publishing quarterly fiscal data based on expenditure returns no later than 45 days after the end of each quarter;
  - Establishing a database on all extra-budgetary funds as well as semi-autonomous and autonomous government agencies and adopting an action plan to rationalize them and reduce their funding. Starting with financial year 2007/08, the annual budget documents will include details of the operations of these funds and agencies; and
  - Establishing an automated database for parastatals to closely monitor their financial performance and fiscal risks from their operations.

18. **Fully implementing the new Public Procurement and Disposal Act should enhance effective use of public resources and limit the opportunities for corrupt practices by fostering open and competitive bidding processes.** To this end, we will make the autonomous Public Procurement Oversight Authority fully operational under the Act. As noted above, we will post procurement contracts above Ksh 0.5 million on the web. In consultation with stakeholders, we shall develop indicators for monitoring efficiency and transparency of procurements of the central government and, through a new manual, simplify procedures. An independent review of procurement contracts under World Bank-supported projects in the ministries of education, health, and roads and public works has been completed. We shall follow up on its recommendations, including simplifying procurement rules and making them more transparent. In addition, we have concluded our discussions with the Millennium Challenge Corporation (MCC) on how it can help Kenya strengthen overall procurement processes, and in particular, in the medical supplies sector. An action plan has already been agreed and has been approved by the Board of the MCC.

### C. Monetary, Exchange rate, and Financial Sector Policies

19. **Monetary policy operations will be geared toward securing low inflation over the medium term.** The CBK will target reserve money growth with the objective of limiting the rate of inflation to 7 percent by June 2007—provided that there is no recurrence of drought conditions so that the spike in food prices is reversed and international fuel prices moderate. Consistent with the inflation objective, we shall limit the annual growth in both reserve and broad money to 14 percent by end-June and 12 percent by end-September. With a view to further enhancing the transparency of monetary policy and improving the signaling of policy intentions to the market, the central bank will emphasize that policy will be geared to attaining the reserve money target. In that regard, the Central Bank’s semi-annual monetary policy statement to the Minister of Finance will provide added focus on inflation developments vis-à-vis the government’s official inflation objective. To enhance the effectiveness of the Central Bank’s indirect instruments of monetary policy, by deepening the inter-bank money market, the Internal Loans Act will be amended to facilitate the use of a master repurchase agreement for all inter-bank repo transactions, and efforts will be made to achieve delivery versus payment (DVP) in the settlement for securities. We will propose amendments to the Central Bank Act with a view to strengthen CBK’s governance while enhancing the independence and accountability of the institution, particularly with respect to the conduct of monetary policy.

20. **We will maintain a floating exchange rate regime.** Foreign exchange interventions—aside from securing foreign reserve targets—will be limited to smoothing short-term fluctuations unrelated to economic fundamentals. Despite a nominal appreciation of the Kenyan shilling against the U.S. dollar of over 10 percent in the last 2 years, the exchange rate appears to be broadly in line with economic fundamentals, driven by robust export growth, increased remittances, greater investor confidence, and strong capital inflows. However, we will continue to monitor closely developments in our external competitiveness.

21. **The government is committed to developing a financial sector reform strategy that is based on market principles.** The strategy to be considered by Cabinet by September 2007 will encompass reforms to improve access to financial services by the greater majority of Kenyans and strengthen efficiency and stability of the financial system. Important initiatives are underway. Risk management guidelines were adopted in 2005 and revised prudential guidelines for the banking sector were introduced in January 2006, with the latter including changes to enhance provisioning requirements for all classes of non-performing loans and assets. A comprehensive review of the Banking Act is being undertaken and the draft amendments to the Banking Act are being circulated to relevant parties for comment. The amendments are designed to address weaknesses in the regulatory and supervisory framework and align our regulatory practices to international standards. Key among the changes are the provisions to strengthen enforcement of supervisory powers through (i) the

introduction of mandatory supervisory intervention and prompt corrective actions for inadequately capitalized and failing banks, and (ii) the introduction of consolidated supervision.

22. **Charterhouse Bank was put under statutory management of the Central Bank of Kenya in June 2006.** Upon the placement of the bank under statutory management the former managing director of the bank filed an application in the High Court seeking ex-parte injunction to stay statutory management pending full hearing of the application. The High Court dismissed the application for injunction prompting the former managing director to file an appeal. A number of cases were subsequently filed by depositors in various courts seeking injunction against the Central Bank, leading to ex-parte decisions by two Judges ordering the Central Bank to relinquish control of Charterhouse Bank. This then led to citing of contempt and the issuance of warrant of arrest of the statutory manager following the refusal of the Central Bank to comply. The contempt charges and warrant of arrest were stayed pending proceedings before the Honourable Chief Justice and the Court of Appeal. On March 9, 2007, the Court of Appeal rejected the application by Charterhouse Bank to remove the statutory manager. This ruling set a legal precedent and gave direction for the other depositors' cases pending before the Honourable Chief Justice and the Court of Appeal. Despite numerous legal obstacles, the Government has acted forcefully on the case of Charterhouse Bank. In the beginning of December, 2006 the government issued a notice to the former Charterhouse Bank directors of its intention to revoke the bank's licence as required under the Banking Act. The licence, which expired in December 2006, has not been renewed by the government.

23. **The government intends to strengthen the legislation governing financial oversight to help ensure that such problems do not emerge in the future.** Recent amendments to the Banking Act have been effected, transferring all licensing, supervisory, and resolution powers from the Ministry of Finance to the Central Bank. The government intends to further amend the Act to extend the list of infractions for which statutory management and liquidation may be undertaken (currently a bank may be liquidated only if it is insolvent). In addition, the government will resubmit the Proceeds of Crime and Anti-Money Laundering Bill to Parliament. This legislation, together with the Suppression of Terrorism Bill (being drafted), will establish a sound legal foundation to prosecute money laundering and combat the financing of terrorism. In the meantime, the government will be developing regulations for the implementation of the anti-money laundering law and will prepare for the establishment of a Financial Reporting Centre that meets international standards. The Financial Reporting Centre will receive, analyze, and disseminate reports relating to suspicion of money laundering.

24. **Financial sector efficiency will be further enhanced by the divestiture of government shareholding in state-owned banks.** The transfer of ownership to reputable

private sector investors would aim to enhance the capital base, facilitate independent management and provide strategic direction that would lead to improved financial performance of the bank. To this end, the Cabinet has approved the restructuring of the National Bank of Kenya (NBK) which will lead to the cleaning up of the bank's balance sheet by liquidating the non-performing loan portfolio and strengthening the management team. Once the modalities for restructuring have been finalized, we intend to go back to Cabinet for their concurrence with the proposed restructuring plan before the injection of public funds through non-negotiable bonds. Concurrently, we will also present to Cabinet, for consideration a number of possible options of selling government and NSSF shares in NBK. Until the sale of shares is completed, the existing supervisory agreement between the CBK and NBK will be continued. Under this agreement, NBK's new lending will be limited to the amount of its loan recoveries; NBK will seek CBK approval for any single operating expense exceeding 1 percent of its 2005 operating expenses; and as long as NBK's capitalization compliance is dependent on any part of the non-negotiable government securities it holds as an asset, NBK will be operating under CBK bank supervisory intervention.

25. **A diagnostic audit of the NSSF will be undertaken.** This will provide a basis for considering options to address the financial and governance challenges facing the NSSF.

#### **D. Public Enterprise and Other Structural Reforms**

26. **An acceleration of public enterprise reforms is vital to strengthening economic growth.** The sale of part of government shares in Mumias Sugar Company was completed in January 2007, and other specific actions already underway include: the restructuring and preparation for privatization of Telkom and NBK among others; sale of part of government shares in the Kenya Reinsurance Company and KenGen. Efforts to reach consensus will be made on how to facilitate private sector participation in port operations, including the container terminal in Mombasa port, and concessioning of other major utilities and infrastructure providers. Following the enactment of the Privatization Bill, the immediate focus will be to obtain Cabinet approval of a subsequent privatization program. A Privatization Commission will be established and made operational by the end of May 2007. Performance contracts for commercial public enterprises will be closely monitored and enforced, and the accounts of the enterprises will be audited and published in a timely manner. With a view to improving operations of parastatals, we will develop time-bound restructuring plans for key entities in the agricultural sector such as the sugar companies and Pyrethrum Board of Kenya. We will also implement the new coffee rules, develop a reform strategy for development finance institutions, and review the operations of the National Cereals and Produce Board with a view to coming up with recommendations to strengthen its financial position and ensure its sustainability. In these areas, we expect to reach policy understandings under the on-going consultations with the World Bank.

**27. Other structural reforms should also help enhance external competitiveness.**

Inadequate infrastructure, particularly in the areas of roads, railroads, and electricity, as well as obstacles to doing business represent major competitiveness hurdles for Kenyan enterprises. Increased infrastructure spending as well as private operation of some infrastructure should help alleviate some of these bottlenecks. In addition, our government will quickly implement recommendations of the task force on legal and administrative impediments to business activity—in particular by streamlining business licensing procedures. By end-March 2007, over 700 licenses will have been simplified by merging the ones that overlap and rationalizing the ones that remain, taking into account safety, the environment, and health standards. Those licenses found not to serve a useful purpose will be eliminated in the context of the 2007/08 finance bill. A Business Regulatory Reform Unit has been established within the Ministry of Finance, and, subsequently, an electronic consolidated regulatory registry will be established for all valid licenses, including those introduced by local authorities. We are also moving forward with labor market reforms, including updating relevant legislation, with a view to strengthening labor market flexibility and linking more closely wage awards to advances in productivity. With the continuing reforms in licensing and our intended focus on improving our rating in the World Bank's Doing Business indicators, the government plans to further strengthen the business environment in order to spur the investments necessary for achieving growth envisaged in the Vision 2030.

**28. Kenya will continue to pursue trade liberalization to enhance efficiency and strengthen growth prospects.** Within the region, our government will implement its EAC commitments, continue to pursue greater regional economic and social integration, and advocate for further steps to open up the Community with a view to enhancing competition and efficiency. The government will also support efforts to bring the Doha Round of multilateral trade negotiations to a successful conclusion that benefits all countries.

**29. The recent drought has highlighted the need for a stronger response to the vulnerability of our people who live in marginal areas.** Our government responded quickly to the food emergency in early 2006, and we are now developing strategies to reduce vulnerabilities on a sustained basis. In addition to on-going drought mitigation initiatives and development programs in this area, the government will adopt a comprehensive policy for Sustainable Development of the Arid and Semi-Arid Lands. This is aimed at improving the livelihood of nomadic pastoralists, by developing alternative income-generating activities. In addition, we shall work closely with the international community to strengthen timely response and seek mechanisms to ensure adequate donor support in cases of food emergencies, and commit to provide, when domestic resources are needed, adequate support through the budget.

### E. External Financing

30. **External financing requirements are projected to fall somewhat in 2006/07.** Total external financing requirements in 2004/05, at US\$643.5 million, were lower than projected at the time of the first review under the PRGF arrangement, due in part to the freezing of payments related to security and other contracts now under investigation. The investigations are ongoing and we intend to resolve these issues quickly and settle all valid claims. External financing requirements are expected to fall from US\$1,680.4 million in 2005/06 to US\$1,298.0 million in 2006/07, due to somewhat slower import growth, but are expected to rise in the medium term with both public and private sector investment picking up and imports again rising strongly. Meeting the projected external financing requirements is expected to be manageable, as the government's renewed commitment to strengthen governance and implement its economic reform agenda is expected to elicit donor support and sustained private inflows. While the baseline case assumes minimal donor budget support, it envisages a total of US\$607.3 million in bilateral and multilateral grants and concessional financing for project support.

31. **The government will develop a legal and institutional framework for public-private partnerships (PPPs) that takes adequate account of the fiscal risks of such arrangements, including contingent liabilities.** All procurement, including under PPPs, will continue to be subject to the transparent and competitive procedures established under the Procurement and Disposal Act.

### F. Statistical Issues

32. **Improving the compilation and dissemination of economic data remains a priority.** In line with the new Statistics Law, the government will establish in the course of 2006/07 an autonomous National Bureau of Statistics to replace the Central Bureau of Statistics. The new Bureau will collect, compile, analyze, and publish statistical information, and will be guided by explicit provisions for public access and dissemination. The recent update of the national accounts (based on 1993 SNA) expanded coverage to include export processing zones, as well as horticulture and informal sectors, and rebased the accounts from 1982 to 2001. Steps are also underway to improve fiscal data, in particular with the preparation of monthly fiscal summary statistics. In 2006/07, we intend to further improve data collection and dissemination, including production of quarterly data on GDP and balance of payments.

### G. Extension of the PRGF Arrangement and PRGF Access

33. **The government is requesting a further extension of the PRGF arrangement through November 20, 2007.** In combination with the earlier extensions to provide time to

complete the second review, this will extend the current three-year PRGF arrangement by a full year, and facilitate completion of a third review under the arrangement.

34. **Kenya's external position has improved significantly since the first review was completed.** The remaining access of SDR 150 million (55.3 percent of quota) is therefore large in relation to Kenya's balance of payments need. In view of this, we are requesting a reduction in remaining access to SDR 75 million, which would equate to the total disbursements for the second and third reviews as envisaged at the time of the completion of the first review. This access would be available in two equal disbursements of SDR 37.5 million.

#### **H. Program Monitoring**

35. **Technical memorandum of understanding (TMU).** The program will be monitored using the definitions, data sources, and frequency of monitoring set out in the accompanying TMU. The government will make available to Fund staff all data appropriately reconciled and on a timely basis, as specified in the TMU.

36. **Performance criteria and benchmarks.** The quantitative performance criteria and benchmarks to be used in monitoring performance in 2006/07 are provided in Table 4. Structural performance criteria and benchmarks are identified in Table 3.

37. **Safeguards assessment.** Following up on an earlier safeguards assessment, the CBK remains committed to good governance and best practices. The Bank was subject to a safeguards assessment by the Fund in the context of the augmentation of access under the existing PRGF arrangement. The assessment, completed in September 2005, noted that steps had been taken to implement the recommendations of the earlier safeguards assessments and proposed measures to address the remaining vulnerabilities. Arrangements are underway to repeal section 51 (I) of the Central Bank of Kenya Act and replace it with an accounting policy that continues with the current practice which ensures that dividend distributions exclude unrealized gains on exchange revaluations.

38. **Program review.** The third review under the PRGF arrangement will be completed no later than November 15, 2007. This review will focus on performance vis-à-vis the performance criteria and benchmarks described in Tables 3 and 4 in Attachment I of the LOI as well as implementation of other policies outlined in this memorandum, and specific additional policy actions, if warranted by new developments.

Table 1. Kenya: Outcomes of Prior Actions, Structural Performance Criteria, and Benchmarks Under the PRGF-Supported Program for 2004/05

Policy Action	Implementation Date	Status
<b>Prior actions</b>		
Initiate restructuring and strengthening of capacity of the Ministry of Finance to manage macroeconomic and fiscal policies by consolidating budget-management and planning functions in the Ministry.	End-September 2004	Met
Agreement with the government on a revised budget for 2004/05 designed to limit domestic borrowing to below Ksh 32 billion.	End-September 2004	Met
Agreement with the government on a system of annual declarations and verifications of the assets of ministers, permanent secretaries, and heads of state corporations.	End-September 2004	Met
Completion of the Budget Outlook Paper for 2005/06–2007/08.	End-November 2004	Met
<b>Structural performance criteria</b>		
<b>(a) Second Review</b>		
No imposition of controls by the government or the CBK on the determination by commercial banks of bank fees, charges, or interest rates.	Continuous	Not Met
Complete asset declaration of ministers, permanent secretaries, and heads of state bodies.	End-December 2004	Not Met
Initiate detailed assessment of financial and debt positions of key parastatals.	End-December 2004	Met
Completion of the Budget Strategy Paper for 2005/06	End-March 2005	Met
Issuance of new guidelines for wage arbitration by the Industrial Court (third disbursement)	End-March 2005	Not Met
<b>(b) Third Review</b>		
No imposition of controls by the government or the CBK on the determination by commercial bank of bank fees, charges, or interest rates.	Continuous	Not Met
Complete verification of the asset declarations of ministers and senior officials.	End-June 2006	Not Met
<b>Structural benchmarks</b>		
Develop a time-bound plan to restructure/privatize public-sector owned banks.	End-March 2005	Met
Introduce simplified customs processing procedures for import and export, supported by verifiable performance indicators in a pilot office.	End-March 2005	Not Met
Apply new wage setting mechanism for public employees.	Continuous	Met
Completion of detailed financial review of National Social Security Fund (NSSF).	March 2005	Not Met
Limit overdraft position of the NBK with the CBK to the end-June 2004 level.	End of each month	Met
Submit to parliament an amendment to the Public Officers Ethics Act (2003) to provide for the annual verification of asset declarations of ministers, permanent secretaries, and heads of state bodies by the KACC.	April 2005	Met



Table 2: Outcomes on Quantitative Performance Criteria and Benchmarks Under the Program for 2004/05 <sup>1, 2</sup>  
(In millions of Kenya shillings)

	2004				2005							
	December				March				June			
	Benchmark	Adj. Target	Act	Status	PC	Adj. Target	Act	Status	Benchmark	Adj. Target	Act	Status
Cumulative change in net foreign assets of the Central Bank of Kenya (CBK) <sup>3</sup>	-7,022	-7,122	2,688	met	-2,213	-7,132	-5,706	met	9,028	-3,121	5,054	met
Cumulative change in reserve money of the CBK <sup>4</sup>	2,728	2,728	8,606	not met	3,022	3,022	5,120	not met	3,432	3,432	4,216	not met
Cumulative change in net domestic financing of the central government, excluding government debt issued for any bank restructuring, and the new securitization of expenditure arrears. <sup>4</sup>	19,966	19,966	4,253	met	27,252	32,002	9,481	met	26,982	38,931	-6,673	met
Central government wages and salaries <sup>4</sup>	52,064	52,064	53,054	not met	78,096	78,096	77,315	met	104,128	104,128	105,612	not met
New contracted or guaranteed nonconcessional external medium- and long-term debt by the central government or the CBK <sup>4, 5</sup>	0	0	0	met	0	0	0	met	0	0	0	met
New contracted or guaranteed external short-term debt by the central government or the CBK <sup>4</sup>	0	0	0	met	0	0	0	met	0	0	0	met
Accumulation of domestic budgetary arrears <sup>4, 5</sup>	0	0	0	met	0	0	0	met	0	0	0	met
Accumulation of external payments arrears <sup>4, 5</sup>	0	0	0	met <sup>7</sup>	0	0	0	not met <sup>7, 8</sup>	0	0	0	not met <sup>7, 8</sup>
Memorandum items:												
Programmed external budgetary support <sup>6</sup>	0	...	0	...	4,750	...	0	...	11,949	...	0	...
Privatization receipts <sup>6</sup>	100	...	0	...	169	...	0	...	200	...	0	...
Program exchange rate (Kenya shillings per U.S. dollar)	78.95	...	78.95	...	78.95	...	78.95	...	78.95	...	78.95	...

<sup>1</sup> The fiscal year begins on July 1, 2004.

<sup>2</sup> The performance criteria and benchmark under the program, and their adjusters, are defined in the technical memorandum of understanding (TMU). All test dates for the performance criteria and benchmarks are on an end-of-period basis.

<sup>3</sup> Floor.

<sup>4</sup> Ceiling.

<sup>5</sup> Continuous performance criterion.

<sup>6</sup> Cumulative.

<sup>7</sup> Figures reflect new arrears incurred since completion of the first PRGF review and outstanding as of the end of the relevant period. Kenya accumulated two types of arrears that are excluded for the purposes of the program. First, Kenya continued to accumulate arrears on external security-related commercial loans/suppliers' credit contracts; the government is disputing the validity of amounts under the contracts due to governance concerns related to potentially fraudulent procurements. The contracts are being audited and the government intends to settle all payments that are found to be legitimate. Second, Kenya accumulated a small amount of arrears due to billing information not being provided by a bilateral creditor. The arrears to the bilateral creditor (slightly less than \$7 million) were settled in December 2006.

<sup>8</sup> The March PC and June benchmark were not met because arrears of KSh 13.1 million (€ 182,000 converted into KSh using program exchange rates) to a bilateral Paris Club creditor were incurred on January 1, 2005. These arrears were cleared on January 10, 2005 and accordingly zero is shown for the end-March and end-June test dates.

Table 3. Prior Actions, Structural Performance Criteria and Benchmarks Under the PRGF Arrangement for 2006/07

Policy Action	Date
<b>Governance</b>	
** Web-post information on all procurement contracts above KSh 0.5 million that were awarded in the second and third quarters of 2005/06.	
** Cabinet approval of the 2006/07 Governance Action Plan for Building a Prosperous Kenya.	
* Resubmit to Parliament the Proceeds of Crime and Anti-Money Laundering Bill. The draft bill should be consistent with international standards, especially with regard to combating terrorism financing.	May 31, 2007
* Resubmit to Parliament the Statute Law (Miscellaneous Amendments Bill), which provides, among other things, for public disclosure of wealth declarations and the appointment of at least 20 judges to enhance the administration of justice.	May 31, 2007
<b>Fiscal Issues</b>	
Publish quarterly reports based on expenditure returns data no later than 45 days after the end of each quarter.	continuous
Establish objective criteria for granting tax exemptions and waivers.	April 30, 2007
*Make the IFMIS operational in four spending ministries for management of the 2007/08 budget. The four spending ministries in which IFMIS will be made operational for the implementation of the 2007/08 budget are the Ministry of Finance, the Ministry of Planning and National Development, Ministry of Health, and the Ministry of Education.	June 30, 2007
Complete the study of contingent liabilities of twenty-four parastatals' accounts.	September 30, 2007
Present to Parliament the Controller and Auditor General's Report for FY2005/06.	April 30, 2007
*Make the Public Procurement Oversight Authority fully operational under the Procurement and Disposal Act.	April 30, 2007
All procurement, including under PPPs, will continue to be subject to the transparent and competitive procedures established under the Procurement and Disposal Act.	Continuous
<b>Financial Sector</b>	
Submit to parliament an amendment to the Banking Act. The amendments shall include, among other things, (i) the introduction of mandatory supervisory intervention and prompt corrective actions for inadequately capitalized and failing banks; and (ii) the introduction of consolidated supervision.	June 30, 2007
* Submit to Cabinet for approval a strategy to initiate the sale of GoK and NSSF's share in the National Bank of Kenya (NBK).	June 30, 2006
Complete a diagnostic audit of the NSSF that will form the basis for its restructuring and reform of its governance.	May 31, 2007
Finalize draft regulations necessary to implement the Proceeds of Crime and Anti-Money Laundering Bill.	June 30, 2007
<b>Private Sector Development and Public Enterprise Reform</b>	
* Include in the finance bill for 2007/08 the elimination of business licenses found not to serve a useful purpose.	June 30, 2007
Establish the Privatization Commission under the Privatization Act 2005.	May 30, 2007

\*\* Prior action.

\* Performance criterion.

Table 4. Kenya: Quantitative Performance Criteria and Benchmarks Under the Program for Fiscal Year 2006/07 <sup>1</sup>  
(In millions of Kenyan shillings unless otherwise indicated)

	Dec-06	Mar-07 Benchmark	Jun-07 Performance Criteria	Sep-07 Benchmark	Dec-07 Indicative Target
Cumulative change in net foreign assets of the Central Bank of Kenya (CBK) <sup>2,3</sup>	860	11,348	16,194	23,401	26,916
Cumulative change in reserve money of the CBK <sup>2,4</sup>	16,482	15,122	15,397	17,581	31,381
Cumulative change in net domestic financing of the central government, excluding government debt issued for any bank restructuring, and the new securitization of expenditure arrears <sup>2,4</sup>	27,246	47,778	29,507	59,272	72,615
New contracted or guaranteed nonconcessional external medium- and long-term debt by the central government or the CBK (millions of US \$) <sup>4,5</sup>	0	0	150	150	150
New contracted or guaranteed external short-term debt by the central government or the CBK <sup>4,5</sup>	0	0	0	0	0
Accumulation of domestic budgetary arrears <sup>4,5</sup>	0	0	0	0	0
Accumulation of external payments arrears <sup>4,5</sup>	0	0	0	0	0
Memorandum items:					
Programmed external budgetary support (in millions of US \$) <sup>2</sup>	0	20	20	20	20
Privatization receipts <sup>2</sup>	0	5,726	18,226	18,226	18,226
Program exchange rate (Kenyan shillings per U.S. dollar)	73.88	73.88	73.88	73.88	73.88
External debt service net of rescheduling ( in millions of US dollars) <sup>2</sup>	98.1	184.7	269.1	353.6	468

<sup>1</sup> The performance criteria and benchmarks under the program, and their adjusters, are defined in the technical memorandum of understanding (TMU). All test dates for the performance criteria and benchmarks are on an end-of-period basis.

<sup>2</sup> Figures cumulate from the beginning of the fiscal year 2006/07, which began on July 1, 2006.

<sup>3</sup> Floor.

<sup>4</sup> Ceiling.

<sup>5</sup> Continuous performance criterion.

**APPENDIX II—ATTACHMENT II**  
**TECHNICAL MEMORANDUM OF UNDERSTANDING**

**V. INTRODUCTION**

39. This memorandum sets out the understandings between the Kenyan authorities and the International Monetary Fund (IMF) regarding the definitions of the quantitative and structural performance criteria and benchmarks, as well as the related reporting requirements, for the program from July 2006 to November 20, 2007 under the three-year arrangement supported by the Poverty Reduction and Growth Facility (PRGF), which was approved on November 21, 2003 and was initially extended to February 28, 2007, and subsequently to April, 30 2007. A further extension to November 20, 2007 has been requested by the Kenyan Authorities.

40. All quantitative targets referred to in this memorandum are cumulative from July 1, 2006 onward, and the program exchange rates referred to are the rates for June 30, 2006, as published in the IMF's *International Financial Statistics*. Some key rates are reproduced below:

Ksh/SDR	109.30
Ksh/USD	73.88
Euro/USD	0.79
Yen/USD	114.95
UK Pound/USD	0.55
USD/SDR	1.48

**VI. QUANTITATIVE PERFORMANCE CRITERIA AND BENCHMARKS**

**A. Cumulative Change in Net Foreign Assets (NFA) of the Central Bank of Kenya (CBK)**

41. **Definition.** The NFA of the CBK are defined as the difference between the Central Bank of Kenya (CBK) holdings of gross official reserves (excluding crown agents and reserve tranche, pledged, swapped, or any encumbered reserves assets, including but not limited to reserve assets used as collateral or guarantees for third-party external liabilities) and its foreign liabilities (including IMF loans and other short- and long-term liabilities). Table 4 in Attachment I of the Letter of Intent (LOI), dated March 22, 2007, shows the floors on NFA, specified in Kenyan shillings, for March 31, 2007 (benchmark) and June 30, 2007 (performance criterion) as well as indicative targets for September 30, 2007 and December 31, 2007. The program exchange rates listed in Paragraph 2 will be used to convert the NFA into Kenyan shillings at the end of each test period.

42. **Adjustment clauses.** The NFA floors will be adjusted downward by the sum of (i) excess in external debt service payments net of rescheduling; and (ii) shortfall in external budgetary support. Excess and shortfall is defined as the difference between actual and programmed amounts—the latter are set out in Table 4 in Attachment I of the LOI. The value of external debt service payments will be converted into Kenyan shillings at the program exchange rates defined in paragraph 2. The floor for NFA will be adjusted upward by the sum of (i) the full amount of net foreign exchange proceeds from sales of licenses in the telecommunications sector<sup>1</sup>; and (ii) the proceeds of any external sovereign bond issue, both converted into Kenyan shillings at the program exchange rates.

43. **Adjustor for drought and flood relief expenditure.** The NFA floor will also be adjusted downward by an amount up to the additional government expenditure on drought and flood relief in excess of the programmed amount of Ksh 3 billion.

44. **Reporting requirements.** Data on gross international reserves, encumbered reserves, and foreign liabilities of the CBK will be transmitted to the Fund on a weekly basis within five working days of the end of each week. Detailed data on external project-related and non-project-related budgetary support (by donor/creditor and by currency of denomination) will be transmitted on a monthly basis within three weeks of the end of each month.

#### **B. Cumulative Change in Reserve Money (RM) of the Central Bank of Kenya**

45. **Definition.** RM is defined as the sum of total currency outside banks, deposits of the banking system (excluding deposits of the National Bank of Kenya) with the CBK and total cash in till. Table 4 in Attachment I of the Letter of Intent shows the ceilings on RM for March 31, 2007 (benchmark) and June 30, 2007 (performance criterion), as well as indicative targets for September 30, 2007 and December 31, 2007. There will be consultation with the IMF staff on any adjustment in the ratio of reserve requirement during the program period.

46. **Reporting requirement.** The daily balance sheets of the CBK will be transmitted on a weekly basis within five working days of the end of each week.

---

<sup>1</sup> Net proceeds in the telecommunication sector is defined as the difference between foreign exchange proceeds realized from the sale of the second national operator (SNO) licenses and actual government expenditures, incurred in line with Government financial and procurement regulations, on the underwater fiber optic cable, which are to be funded from these proceeds.

### C. Cumulative Change in Net Domestic Financing (NDF) of the Central Government

47. **Definition.** NDF includes financing by the banking system (the CBK and commercial banks), non-bank financial institutions, and the non-bank public of the budget of the central government of Kenya; where the central government is defined as in the Appropriation Accounts and in the parliament approved budget estimates for 2006/07.<sup>2</sup> NDF consists of treasury bills, government stocks and bonds, promissory notes and other domestic debt instruments issued by the government, and loans and advances net of government deposits with the CBK and the banks. For the purposes of the program, NDF excludes privatization proceeds, the securitization of arrears and government debt issued for any bank restructuring. NDF is calculated as the sum of (i) loans and advances to the government by the CBK, including any interest arrears, minus all government deposits with the CBK, from the balance sheet of the CBK; (ii) loans and advances to the government by the commercial banks, including any interest arrears, minus all government deposits held with the banks, from the balance sheet of the commercial banks; and (iii) the changes in the outstanding stock of treasury bills, government stocks and bonds, promissory notes and other domestic debt instruments issued by the government, including any interest arrears. Table 4 in Attachment I of the LOI shows the ceilings on NDF for March 31, 2007 (benchmark) and June 30, 2007 (performance criterion), as well as indicative targets for September 30, 2007 and December 31, 2007.

48. **Adjustment clauses.** The ceiling on NDF will be adjusted upward by the sum of (i) excess in external debt service payments net of rescheduling; (ii) shortfalls in proceeds from privatization; and (iii) shortfall in proceeds from disbursements of external non-project related budgetary support. Excess or shortfall is defined as the difference between actual and programmed amounts. The programmed amounts are set out in Table 4 in Attachment I of the LOI. The cumulative upward adjustment in NDF for shortfalls in proceeds from privatization is capped at the equivalent of US\$ 140 million, converted into Kenyan shillings at the program exchange rates. The ceiling on NDF will be adjusted downward by the sum of net proceeds from sale of licenses in the telecommunication sector, as defined in footnote 1; and (ii) proceeds from any sovereign bond issue, both converted into Kenyan shillings at the program exchange rates. As set out in Table 4 in Attachment I of the LOI, the 2006/07 budget assumes external budgetary support of US\$ 20 million from the World Bank retroactive disbursements for drought-related expenditures carried out in 2005/06. In the event that additional budget support is received in excess of US\$ 20 million, it will be spent

---

<sup>2</sup> The 2006/07 Estimates of Revenues, 2006/07 Estimates of Recurrent Expenditures, and 2006/07 Estimates of Development Expenditures.

in the pro-growth and anti-poverty areas, as set as set out in the MEFP (paragraph 14) and the Budget Strategy Paper, which reflects the priorities of the Investment Program for the Economic Recovery Strategy for Wealth and Employment Creation (IP-ERS).

49. **Adjustor for drought and flood relief expenditure.** The ceiling on NDF will also be adjusted upward by the amount of additional drought and flood relief expenditure in excess of the budgeted amount of KSh 3 billion.

50. **Reporting requirements.** Data on NDF of the central government will be submitted to Fund staff on a monthly basis within three weeks of the end of each month.

**D. New Nonconcessional Medium- and Long-Term External Debt Contracted or Guaranteed by the General Government and the Central Bank Kenya**

51. **Definition.** This performance criterion applies both to debt, as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (see, Decision of the Executive Directors of the IMF No. 12274-00/85, August 24, 2000) and to commitments contracted or guaranteed, for which value has not been received. It applies to debt contracted or guaranteed with original maturities of more than one year by the CBK or the general government of Kenya (as defined by the 2001 IMF Government Finance Statistics Manual). It excludes financial obligations to the Fund, domestically issued Kenyan shilling denominated treasury bonds with maturity greater than a year held by non-residents, and debt subject to rescheduling and restructuring. The ceiling for new nonconcessional external medium- and long-term debt will be USD 150 million on a continuous basis throughout the program period, converted into Kenyan shillings at the program exchange rates. Borrowing under this ceiling will only be in the form of a benchmark sovereign bond and the proceeds of this bond will not be used to finance additional expenditures during the program period (performance criterion). The USD 150 million excludes any new nonconcessional external debt that is used to settle externally audited outstanding external payment arrears and future obligations on suppliers' credits for security-related and other contracts.

52. For program purposes, a debt is concessional if it has a grant element of at least 35 percent, calculated using currency-specific commercial interest reference rates (CIRRs) published by the OECD. For debt with maturity of at least 15 years, the ten-year average CIRR will be used, and for debt with maturity of less than 15 years, the six-month average CIRR will be used.

53. **Reporting requirement.** Data on all new debt and guarantees by the CBK and the general government (including terms of loans and creditors) will be provided to Fund staff on a monthly basis within three weeks of the end of each month.

### **E. New Nonconcessional Short-Term External Debt Contracted or Guaranteed by the General Government or the Central Bank of Kenya**

54. **Definition.** This performance criterion applies both to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign debt (see Decision No. 12274–00/85, August 24, 2000) and to commitments contracted or guaranteed, for which value has not been received. It applies to nonconcessional (see paragraph 14 above) debt with original maturities of up to and including one year contracted or guaranteed by the CBK or the general government (as defined by the 2001 IMF Government Finance Statistics Manual) of Kenya. It excludes financial obligations to the Fund, normal trade-related credits, and domestically issued Kenyan shilling denominated treasury bills with maturity of less than a year held by non-residents. The ceiling for new external nonconcessional short-term debt will be zero on a continuous basis throughout the program period.

55. **Reporting requirement.** Data on all new debt and guarantees by the CBK and the general government (including terms of loans and creditors) will be provided to the Fund staff on a monthly basis within three weeks of the end of each month.

### **F. Accumulation of Domestic Budgetary Arrears**

56. **Definition.** Domestic budgetary arrears are defined as the sum of all due and unpaid obligations of the central government of Kenya, where the central government is defined as in the Appropriation Accounts and in the Parliament approved budget estimates for 2006/07, including, but not limited to, payment obligations from procurement contracts for goods and services and other contracts providing for payment in domestic currency, as well as statutory obligations for payment (e.g., of domestic debt, domestic interest, wages and salaries, and other entitlements). Changes in domestic budgetary arrears are defined as the stock of outstanding domestic arrears on the test date minus the stock of outstanding domestic arrears as of June 30, 2006. Under the program, the non-accumulation of new domestic budgetary arrears is a continuous performance criterion throughout the program period.

57. **Reporting requirement.** Detailed data on repayment and new accumulation of domestic budgetary arrears and the remaining previous-year stock of domestic budgetary arrears will be transmitted to the Fund staff on a monthly basis within three weeks of the end of each month.

### **G. Accumulation of External Payments Arrears**

58. **Definition.** External payments arrears are defined as the non-payment of external obligations of the CBK or the general government of Kenya (general government as defined by the 2001 IMF Government Finance Statistics Manual) both with regard to principal and interest that are valid and due, but shall exclude arrears on obligations that are subject to



rescheduling or restructuring, including arrears on suppliers' credits for security-related and other contracts that have been disputed by the Kenyan authorities. Under the program, the nonaccumulation of new external payments arrears is a continuous performance criterion throughout the program period.

59. **Reporting requirement.** Detailed data on the repayment and new accumulation of external payments arrears by the CBK and the general government and the stock of arrears at the beginning and end of each month will be transmitted on a monthly basis to the Fund staff within three weeks of the end of each month.

## **VII. OTHER REPORTING REQUIREMENTS FOR PROGRAM MONITORING**

### **A. Public Finance**

60. Monthly data on domestic financing (bank and nonbank) of the budget (including treasury bills and treasury bonds held by the nonbank public), proceeds from privatization, net sales of telecommunications licenses, government debt instruments issued for the purpose of bank restructuring, and securitization of expenditure arrears will be transmitted on a monthly basis within three weeks of the end of each month.

61. Data on budget execution based on reconciled accounting data will be transmitted on a monthly basis within three weeks of the end of each month.

62. Detailed information on the sources of financing of the implemented development budget will be transmitted on a quarterly basis within four weeks of the end of each quarter.

63. Data on public sector external and domestic scheduled debt service payments will be transmitted on a monthly basis within three weeks of the end of each month.

### **B. Monetary Sector**

64. The following data will be transmitted on a daily/weekly basis within one/five working day of the end each day/week:

- interbank interest rate (daily); and
- treasury-bill rates (weekly);

65. The following data will be transmitted on a monthly basis within three weeks of the end of the month:

- the consolidated balance sheets of deposit money banks and the individual bank balance sheet, as needed;

- the monetary survey;
- lending and deposit rates;
- standard bank supervision indicators for banks and nonbank financial institutions, and for individual institutions as needed; and
- net foreign assets of commercial banks and nonbank financial institutions, broken down by instruments.

### **C. External Sector**

66. The following information on daily buying, selling, and average exchange rates will be transmitted on a weekly basis within five working days of the end of each week:

(i) exchange rates used in interbank transactions among the commercial banks; (ii) the average of the official exchange rate, quoted daily based on the transactions of the previous day; and (iii) foreign exchange purchases and sales by the CBK on the interbank market and other inflows and outflows of foreign exchange to/from the CBK, separately.

67. Export and import data, including value, volumes, and prices, will be transmitted on a quarterly basis within eight weeks of the end of each quarter.

68. Other balance of payments data, including the data on services, private transfers, official transfers, and capital account transactions, will be transmitted on a monthly basis within three weeks of the end of each month.

### **D. Real Sector**

69. Monthly aggregate and disaggregated consumer price indices for Nairobi and the whole country will be transmitted on a monthly basis within three weeks of the end of each month.

70. Any revisions to the national accounts data will be transmitted within three weeks of the date of revision.

71. Data on real sector leading indicators will be transmitted within three weeks of the end of each month.

72. Data on employment (formal and informal) and wages (including minimum wages and collective wage agreements) will be transmitted within three weeks of the end of each month.

### VIII. GOVERNANCE AND OTHER STRUCTURAL REFORMS

73. **Web-posting information on all procurement contracts above Ksh 0.5 million that were awarded in the second and third quarters of 2005/06.** Information shall include name of the procuring entity, the tender number, a description of the items purchased, the date of contract awarded, the firm to which the contract was awarded and the value of the contract.
74. **Cabinet approval of the 2006/07 Governance Action Plan for Building a Prosperous Kenya.** Once the plan is approved, a copy of instructions for the implementation of the plan issued by the Head of the Public Service and Secretary to the Cabinet shall be transmitted to the Fund staff within five working days of its issuance.
75. **Resubmission to Parliament of the Proceeds of Crime and Anti-Money Laundering Bill.** A copy of the resubmitted bill shall be transmitted to the Fund staff within five working days of resubmission.
76. **Resubmission to Parliament of the Statute Law (Miscellaneous Amendments Bill).** A copy of resubmitted bill shall be transmitted to the Fund staff within five working days of resubmission.
77. **Publication of quarterly expenditure return reports.** A notice of web-posting of the reports shall be communicated to the Fund staff within five working days of posting.
78. **Establishment of objective criteria for granting tax exemptions and waivers.** These criteria shall be established through consultation with key stakeholders. A copy of the document detailing these criteria shall be transmitted to the Fund staff within five working days of its publication.
79. **Making the IFMIS operational in four spending ministries (including education and health) by end of June 2007 for management of the 2007/08 budget.** The four spending ministries in which IFMIS will be made operational for the implementation of the 2007/08 budget refer to the Ministry of Finance and the Ministry of Planning and National Development, in addition to the Ministry of Health and the Ministry of Education. IFMIS's operation by June 30 will be evidenced by submission to Fund staff by end-August 2007 of monthly expenditure returns reports for July 2007 on Headquarters-based expenditures, generated through IFMIS.
80. **Completion of the study of contingent liabilities of twenty-four public enterprise accounts.** A copy of the study shall be transmitted to the Fund staff within five working days of its completion.

81. **Presentation to Parliament the Controller and Auditor General's report for FY2005/06.** A copy of the report or a copy of transmittal of the report from the Controller and Auditor-General shall be transmitted to the Fund staff within five working days of the report's presentation.
82. **Making the Public Procurement Oversight Authority fully operational under the Procurement and Disposal Act.** Making the Authority operational will be evidenced by having the Advisory Board in place and the commencement of quarterly web-posting of information on all procurement contracts above Ksh 0.5 million, as described in Paragraph 35 above. A notice of the establishment of the Advisory Board and the commencement of the posting of procurement contracts, beginning with the contracts for the fourth quarter of 2005/06, shall be transmitted to the Fund staff within five working days of the Authority becoming fully operational, as defined above.
83. **Submission to Parliament of amendments to the Banking Act.** The amendments shall include, among other things, (i) the introduction of mandatory supervisory intervention and prompt corrective actions for inadequately capitalized and failing banks; and (ii) the introduction of consolidated supervision. A copy of the submitted amendments shall be transmitted to the Fund staff within five working days of submission.
84. **Submission to Cabinet for approval of a strategy for the privatization process for the National Bank of Kenya (NBK).** The existing supervisory agreement between the CBK and NBK will be continued until the sale of government and NSSF shares in NBK is completed. The NBK will operate under CBK bank supervisory intervention until the sale of government and NSSF shares is completed. The Central Bank will ensure that NBK's new lending will be limited to the amount of its loan recoveries. Within five working days of the issuance of bonds for restructuring the NBK, a report shall be transmitted to the Fund staff to confirm that the agreement is still, and will continue to be, in force until the NBK is privatized.
85. **Completion of a diagnostic audit of the NSSF that will form the basis for its restructuring and reform of its governance.** A copy of the audit shall be transmitted to the Fund staff within five working days of its completion.
86. **Finalization of draft regulations to implement the Proceeds of Crime and Anti-Money Laundering Act.** A copy of the finalized regulations shall be transmitted to the Fund staff within five working days of its finalization.
87. **Inclusion in the Finance Bill for 2007/08 the elimination of business licenses found not to serve a useful purpose.** A copy of the Finance Bill 2007/08 that includes the list of the licenses to be eliminated by parliamentary action, along with the background report prepared by the Business Regulatory Reform Unit of the Ministry of Finance that lists all

licenses that will be eliminated on the authority of the executive branch of government, shall be transmitted to the Fund staff within five working days of the bill's tabling before Parliament.

88. **Establishment of the Privatization Commission under the Privatization Act.** This will be evidenced by the appointment of the Commissioner and formation of the Committee. A notice on the completion of these tasks shall be transmitted to the Fund staff within five working days of their completion.

INTERNATIONAL MONETARY FUND

KENYA

**2006 Article IV Consultation and Second Review  
Under the Three-Year Arrangement Under the Poverty Reduction and Growth  
Facility, and Requests for Extension and Rephasing of the Arrangement, Reduction in  
Access, and Waiver of Performance Criteria—Informational Annex**

Prepared by the African Department  
(In collaboration with other departments)

Approved by Thomas Krueger and Anthony Boote

March 27, 2007

- **Relations with the Fund.** Describes financial and technical assistance by the IMF and provides information on the safeguards assessment and exchange rate system. At end-January 2007, outstanding PRGF loans amounted to SDR 101.88 million. Completion of the second review would allow a disbursement equivalent to SDR 32.5 million.
- **Relations with the World Bank.** Describes the World Bank Group program and portfolio; and provides a statement of IFC investments.
- **Statistical Issues.** Describes the availability and quality of macroeconomic statistics; and its usefulness for surveillance purpose.

	Contents	Page
I.	Relations with the Fund.....	3
II.	Relations with the World Bank.....	7
III.	Statistical Issues.....	17

**APPENDIX I—RELATIONS WITH THE FUND**

(As of January 31, 2007)

**I. Membership Status:** Joined February 3, 1964; Article VIII.

<b>II. General Resources Account:</b>	<b>SDR million</b>	<b>Percent of quota</b>
Quota	271.40	100.00
Fund holdings of currency	258.64	95.30
Reserve position in Fund	12.78	4.71
 <b>III. SDR Department:</b>	 <b>SDR million</b>	 <b>Percent of allocation</b>
Net cumulative allocation	36.99	100.00
Holdings	1.93	5.21
 <b>IV. Outstanding Purchases and Loans:</b>		 <b>Percent of quota</b>
Poverty Reduction and Growth Facility (PRGF) arrangements	101.88	37.54

**V. Financial Arrangements:**

	Approval	Expiration	Amount Approved	Amount Drawn
<u>Type</u>	<u>Date</u>	<u>Date</u>	<u>(SDR million)</u>	<u>(SDR million)</u>
PRGF	11/21/03	2/28/07	225.00	75.00
PRGF	8/4/00	8/3/03	190.00	33.60
ESAF	4/26/96	4/25/99	149.55	24.93
ESAF	2/22/93	12/21/94	45.23	45.23
ESAF	5/15/89	3/31/93	261.40	216.17



## VI. Projected Obligations to Fund

(SDR million; based on existing use of resources and present holdings of SDRs):

---

	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>
Principal	6.72	6.72	11.72	16.72	15.00
Charges/interest	<u>1.97</u>	<u>1.94</u>	<u>1.89</u>	<u>1.82</u>	<u>1.73</u>
Total	8.69	8.66	13.61	18.5	16.73

---

**VII. Implementation of HIPC Initiative:** Not Applicable

**VIII. Implementation of Multilateral Debt Relief Initiative (MDRI):** Not Applicable

## IX. Safeguards Assessments

Under the Fund's safeguards assessment policy, the Central Bank of Kenya (CBK) was subject to a safeguards assessment with respect to the augmentation of access under the existing PRGF arrangement approved on December 20, 2004. The assessment, completed on September 8, 2005, noted that the CBK has taken steps to implement the recommendations of the earlier safeguards assessments and proposed measures to address the remaining vulnerabilities.

## X. Exchange Arrangements

The currency of Kenya is the Kenya shilling. Kenya has adopted a unitary exchange rate structure in which the exchange rate is determined in the interbank market. The official exchange rate, which is set at the previous day's average market rate, applies only to government and government-guaranteed external debt-service payments and to government imports for which there is a specific budget allocation. The exchange rate regime is a managed float, in which the U.S. dollar is the principal intervention currency. Kenya maintains an exchange system that is free of restrictions on the making of payments and transfers for international current transactions. On March 6, 2007, the exchange rate was K Sh 69.4=US\$1.00

## **XI. Article IV Consultations**

Kenya is on the 24-month cycle for Article IV consultations. The last Article IV consultation was concluded on December 6, 2004 ([www.imf.org](http://www.imf.org)).

## **XII. FSAP Participation**

The joint IMF-World Bank Financial Sector Assessment Program (FSAP) missions took place in Nairobi in July and October, 2003.

## **XIII. Technical Assistance**

Department	Purpose	Time of Delivery
MFD	Banking Sector Restructuring	January/February 2003
FAD	World Bank/AFRITAC East PEM Assessment and Action Plan (AAP) mission	March 2003
STA	Government Finance Statistics (GDDS)	September 2003
FAD	AFRITAC East classifications mission (implementation follow up in June 2004, January, July and October 2005, and January 2006)	November 2003
MFD	Central Bank Accounting	February 2004
STA	Government Finance Statistics (GDDS)	February 2004
FAD	Customs Administration	March 2004
FAD	Tax Administration	March/April 2004
FAD	2 <sup>nd</sup> World Bank/AFRITAC East PEM Assessment and Action Plan (AAP) mission	May 2004
FAD	AFRITAC East Treasury Reforms mission (implementation follow up in July 2004, February-March 2005, September 2005, September 2006)	June 2004

MFD	Banking Supervision/Deposit Insurance /Legislation	July 2004
FAD	AFRITAC East Aid flow tracking mission	July 2004
FAD	Revenue Administration	September/October 2004
MFD	Deposit Insurance/Legislation (with LEG)	October 2004
MFD	Public Debt Management and Monetary Policy Implementation	November 2004
STA	ROSC Mission	January 2005
MFD	Monetary Framework, Monetary Operations, and Banking Supervision	October 2005
FAD	Revenue Administration	November 2005
FAD	AFRITAC East Semi-autonomous agencies and EBFs/Fiscal Reporting mission	March 2006
FAD	HQ Mission: Strengthening the budget and reporting system	August 2006
FAD	AFRITAC East TA: revision of Public Finance Management Act	October/November 2006
MCM	Review of Risk based Supervision Manual	November/December 2006
MCM	Monetary Operations TA	January 2007
STA	External Debt statistics workshop	February / March 2007

#### **XIV. Resident Representative**

The Fund has had a resident representative in Kenya since December 1993. Mr. Scott W. Rogers is the current Senior Resident Representative.

## APPENDIX II—IMF-WORLD BANK RELATIONS

(As of March 5, 2007)

Kenya's development strategy is set forth in the Investment Programme for the Economic Recovery Strategy for Wealth and Employment Creation (IP-ERS), endorsed by the Boards of the IMF and the World Bank in May 2004. The IP-ERS provides a common framework for Bank-IMF support to Kenya's development efforts in the medium term. The government also launched the preparation of Vision 2030 in October 2006, which highlights Kenya's aspiration to achieve the status of a middle-income country by 2030.

**Development strategy and Vision 2030.** In supporting Kenya's development strategy and the development of its Vision 2030, the IMF leads the dialogue on monetary matters and coordinates with the Bank on macro-fiscal issues and reforms in the areas of public expenditure management, governance, financial sector, revenue administration, trade, public enterprises, and the public wage bill. The Bank takes the lead on monitoring progress on implementation of the IP-ERS, dialogue and lending in the areas of infrastructure, human development, private sector development, rural development, and reforms of the civil service. In non-lending work, the Bank takes the lead on growth and poverty analysis, and sectoral work in the areas of Bank's lead, while the two institutions coordinate on trade, labor markets, macro-fiscal work, poverty and social impact analysis, and debt sustainability analysis.

### Bank Group Strategy

A Country Assistance Strategy of reengagement for fiscal 2004–07 was endorsed by the World Bank Board on June 17, 2004. The Bank's strategy was formulated to promote in a carefully sequenced program of growth and poverty reduction. At mid-course, the Bank has prepared a Country Assistance Strategy Progress Report (CAS PR) (to be discussed by its Board on March 27, 2007). The CAS PR discusses key accomplishments over the last three years, including improved macroeconomic management and growth recovery. It documents challenges such as high income inequality and inequitable access to services, and mixed progress on corruption and some structural reforms. In an environment where governance challenges are paramount, it also strives to maintain the balance between dealing effectively with governance and corruption, and continuing to provide vital assistance to the poor.

**Enhanced focus on equity.** Reflecting greater attention to equity, the Bank's support program more directly targets the poorest people (with continuing attention to the drivers of overall growth). In this regard, analytic work such as the ongoing joint poverty assessment will help the government improve the targeting and use of public resources. Lending will target some poverty hotspots, such as Western Kenya, Nyanza Province, and urban and periurban slums, where about 70 percent of poor Kenyans live. New programs will provide

financial and technical resources for poor communities and entrepreneurs to provide economic services and create employment.

**Enhanced focus on governance.** In supporting the government's Governance Strategy for Building a Prosperous Kenya (GSPK) and Governance Action Plan (GAP), the Bank will focus on transparency initiatives (including transparency in the judiciary, and capacity building in the prosecutorial and judicial services); broadening stakeholder involvement, including additional private participation in infrastructure services such as the ports; accelerating public financial management reforms; and improving governance in high-priority sectors—education, HIV/AIDS, health, and roads. Analytic work in such areas as media development, parliamentary and judicial capacity, and police oversight mechanisms will help lay the foundation for the development and governance agenda beyond this GSPK/GAP and for the next CAS.

**Continued attention to accelerated economic growth and improved public sector management.** A major economic study being carried out by the Bank focuses on how Kenya will raise and sustain growth rates from about 6 percent currently to 10 percent as part of its economic, social, and political vision to become a middle income country by the year 2030. This is a multi-sectoral work covering macro-fiscal, infrastructure, trade, human development, and financial sector issues, and is being carried out in close collaboration with the government. Meanwhile, the current IP-ERS's high priority to budgetary and public expenditure reforms is expected to continue. This priority area of work is being informed by a Country Integrated Fiduciary Assessment which the Bank prepared in 2005 in close collaboration with the government and other partners to help strengthen budget preparation and execution, strategic resource allocation, procurement, and financial management.

**Public sector institutional strengthening.** An Institutional Reform and Capacity Building (Technical Assistance) Project is helping the government strengthen capacity for budget formulation and execution, public financial management, internal and external auditing, revenue collection and management, and development of improved procurement practices. To increase accountability of the administration to citizens, the project is strengthening parliamentary committees to enable them to fulfill their oversight role. The project will also build the capacity of key ministries to define, measure, and deliver results by supporting the establishment of a system of results-based management, by building capacity for monitoring and evaluation, and by strengthening mechanisms for citizen feedback. To enhance the capacity of the Central Bureau of Statistics and other agencies, the Bank has prepared a Statistical Capacity-Building Project (StatCap) scheduled for Board presentation in March 2007. In addition, the Bank is helping to build capacity for monitoring and evaluation through a grant from the Institutional Development Fund.

**Poverty reduction.** In addition to supporting growth, the Bank is also targeting its support to some of Kenya's poorest communities. The Bank is in the process of preparing a poverty assessment in close collaboration of the government and other donors based on the recently concluded Kenya Integrated Household Budget Survey. The Arid Lands Resource Management Project Phase Two, effective in September 2003, is using a multisectoral, district based, community driven development approach to reduce poverty in the arid and semiarid districts of Kenya. In August 2006, the World Bank approved a US\$60 million additional financing credit for emergency drought interventions in Kenya's arid and semi-arid lands. The credit will be implemented under the Arid Lands Resource Management Project (ALRMP) II. The additional financing operation would help finance the costs associated with: (a) scaling up both geographically and substantively the successful drought management and long term livelihood activities of the Arid Lands project in 28 districts; (b) reimbursing eligible and audited non-food expenditures associated with the severe drought which has affected the arid and semi-arid districts of Kenya over the last year; and (c) scaling up the drought contingency fund which is operating under the current credit and has been depleted due to the extended nature of the drought. The Executive Board of the World Bank will consider a new operation, the Western Kenya Community Driven Development and Flood Mitigation, late in March 2007. The objective of the proposed project is to empower local communities of men and women to engage in sustainable and wealth creating livelihood activities and reduce their vulnerability to flooding. Progress towards achieving the project development objectives will be monitored through such indicators as: (a) the number of men and women actively participating in decision making at community and district levels; (b) percent of community and youth investment projects rated satisfactory or better by participating communities; (c) percentage increase in real income of households in project intervention areas; and (d) percentage reduction of financial cost induced by average annual flooding in the Budalangi flood plain.

**Sustainable development.** The Bank is supporting measures to increase agricultural productivity and competitiveness through lending and analytical work. The Agricultural Productivity Project, which became effective in October 2004, is assisting the transformation of Kenya's research and extension system to a more demand driven, farmer-led and pluralistic system, while supporting associated policy reforms. In addressing the challenges of natural resource management, the Executive Board of the World Bank is expected to consider a new operation, the Natural Resource Management Project, late in March 2007. The objectives of the project are to enhance the institutional capacity to manage water and forest resources, reduce the incidence and severity of water shocks in river catchments, and improve the livelihoods of communities participating in the co-management of water and forests. Achievements under the project will be measured by indicators tracking changes in organizations and their performance, in the health of the natural resource base, and in welfare of participating communities. Meanwhile, the ongoing multicountry GEF-supported Lake Victoria Environmental Project is helping to establish institutions for the sustainable

management of the lake and its catchment area. The GEF-supported Western Kenya Integrated Ecosystem Management Project seeks to improve management of soils, water, and biodiversity, while raising the productivity of agriculture. The GEF-supported Wildlife Conservation Leasing Demonstration Project, approved recently on August 2006, seeks to motivate and enable landowners to maintain wildlife habitat on their land.

**Education and health.** In education, the Bank is supporting the government's strategy through the ongoing Free Primary Education Support Project. The government is implementing a SWAp, approved by the Bank Board in November 2006, designed to: ensure equity of access to basic education; enhance quality and learning achievement; provide opportunities for further education and training; and strengthen education sector management and governance. This will support the entire sector, but with an initial focus on primary education and the development of acceptable strategies for the other subsectors of the education system. This will lay the groundwork for future support to the sector through SWAps or poverty reduction support credits. The grant-financed Global Development Learning Network project effective in February 2004 is helping to develop enhanced mechanisms of learning and knowledge-sharing among policy makers. In health, the Bank is supporting the government's strategy through the ongoing Decentralized AIDS and Reproductive Health (DARE) Project, which seeks to improve mother and child health through more integrated delivery of child survival, reproductive health, and HIV/AIDS services. The Bank has continued to work in collaboration with development partners on the design of a health sector SWAp following recent government and Bank review which confirmed concerns about corruption risks. The Bank and the Government of Kenya have agreed to undertake the following steps to strengthen governance in the health sector: (a) improving procurement practices, including publishing on websites information on all contracts; (b) establishing a transparent vetting system to pre-qualify companies doing business with the MOH to address conflict of interest and fraudulent companies; (c) blacklisting companies found to have been involved in corruption; (d) rolling out and using IFMIS in the MOH; (e) establishing a functional risk-based internal audit system, with the MOH ministerial audit committees providing oversight effectively; and (f) developing a community-based system for managing and financing local-level health facilities, using the Ministry of Education's successful textbook program as a model.

**HIV/AIDS.** The Bank has been supporting the government's program to control HIV/AIDS. Kenya was the first country to access funds under the Africa Region's Multi-Country AIDS Program (MAP) through the Kenya HIV/AIDS Disaster Response Emergency Project. The KHADREP closed at the end of 2005, and a new project (The Total War on AIDS Project - TOWA) is being designed to support implementation of the Kenya National AIDS Strategic Plan for 2005–2010. This focuses on governance and accountability strengthening, the coordination of the national program following confirmation by government and Bank reviews of corruption in KHADREP, and the provision of grants to implementing agencies

(including local communities and the private sector) to reach vulnerable groups. Through the TOWA and following progress in addressing governance and anticorruption issues in HIV/AIDS, the Bank would support the National AIDS Control Council and its provincial, district, and local-level bodies, as well as selected line ministries in the mainstreaming of HIV/AIDS-related activities. The TOWA is expected to be presented for Board consideration by June 2007. As noted above, the medical response to the HIV/AIDS epidemic will be integrated into the Health SWAP.

**Privatization and private sector participation.** The Bank group is supporting several initiatives aimed at promoting private sector participation in the economy. The IFC was the transaction adviser for concessioning the Kenya Railways jointly with Uganda Railways, established in October 2006. The Energy Sector Recovery Project is supporting the reform of the Kenya Power and Light Company whose management was transferred to a private company in July 2006. IFC is also involved as a transaction adviser for the restructuring of Telkom Kenya Limited. All these actions should lead to an enhanced role for the private sector in managing these key utilities.

**Private sector development.** The investment climate assessment of 2003/04 and the Kenya Growth and Competitiveness study have provided a greater understanding of the obstacles to private sector development in Kenya and the policies needed to address them. The Bank and IFC are supporting implementation of their recommendations, including a far-reaching reform of Kenya's licensing regime that will result in the elimination of numerous unnecessary licenses. An update of the investment climate assessment is planned for June 2007. A joint Bank- and IFC-supported Micro, Small and Medium Enterprise Project aims to increase MSME's access to finance and to business development services. A three-year IFC-supported pilot Small and Medium Enterprises Solutions Center, which started operations in Kenya in March 2005, will help MSMEs access financial resources, information, and advice through a single integrated service center. The IFC-supported multidonor Private Enterprise Partnership for Africa will facilitate small firms' access to financial and business services. The Multilateral Investment Guarantee Authority is supporting private sector development through international comparisons of competitiveness, through the provision of technical assistance and capacity building services to the country's investment promotion intermediaries, and through the offer of political risk guarantees to foreign investors entering the country.

**Regional integration and improvement of trade environment** are priorities of the government. In 2005, Kenya launched a customs union with Tanzania and Uganda in the context of the East African Community (EAC), which includes a common external tariff. Kenya is also actively involved in negotiations and activities of the Common Market for Eastern and Southern Africa, and in negotiations of economic partnership agreements with the European Union. A trade report focusing on behind the border supply-side constraints



was prepared by the Bank in 2006 and is being used in the implementation of Private Sector Development Strategy of the government.

**Infrastructure development.** The IP-ERS recognizes the lack of adequate physical infrastructure as a major impediment to private sector development in Kenya. The Bank is supporting the government's investment program through the Northern Corridor Transport Improvement Project, which is financing the reconstruction of the road network that links Kenya with Uganda, Rwanda, Burundi, and the Democratic Republic of Congo. The project is also helping to upgrade Nairobi's Jomo Kenyatta International Airport to improve passenger facilities and airport security. The joint concessioning of Kenya's and Uganda's railways is expected to be a major catalyst to regional integration and growth. The grant-financed Nairobi Water and Sewerage Institutional Restructuring Project, which became effective in September 2004, aims at building a strong institutional and governance framework that will promote efficient and sustainable delivery of water and sewerage services in Nairobi. The EAC Regional Trade and Transport Facilitation Project is supporting railway concessioning and customs reform at the Mombasa port. In the context of growth analytical work, the Bank is supporting a review of roads portfolio with a view to improve implementation of road projects and ensuring good economic rationale in selection of projects.

**Transparency and communications infrastructure.** The government has been pursuing an ambitious program of ICT reforms. Liberalization of the international voice/data market was achieved with the award of more than eighteen international gateway licenses over the last 14 months, including for the two mobile network operators. Consequently, tariffs have fallen by over 50 percent and critical local market innovations are taking place (for example, Celtel launched in October 2006 a seamless local service across Kenya, Uganda and Tanzania). In late 2006, the Second National Operator license was awarded competitively for US\$169.7 million. Telkom Kenya (TKL), currently a state-owned monopoly, is being restructured in preparation for privatization. As part of the larger program to realize its ICT vision, the government is seeking to create an enabling environment for achieving the following specific goals: (a) tripling the number of telephone lines from 7.5 million to 23 million in three years; (b) increasing the number of Internet users from 1.25 million to 5 million in three years; (c) establishing at least one digital village or e-centre in each constituency within this year; (d) ensuring that every school in Kenya has access to ICT resources by the end of the year; and (e) providing e-government services at district and constituency level. Through a Transparency and Communications Infrastructure Project, the Bank is supporting investments in three areas—the enabling institutional and regulatory environment, connectivity, and transparency—including e-government applications.

**Financial sector development.** The IP-ERS identifies the urgent need to reform the financial sector in Kenya, which is beset with a relatively high level of nonperforming loans and wide

interest rate spreads, and operates within a weak legal and judicial system. To support the government's reform agenda, the Bank and the IMF conducted a joint Financial Sector Assessment Program in 2004 that highlighted the vulnerabilities of the financial sector. A Financial and Legal Sector Technical Assistance Credit that was approved by the Bank's Board in October 2004 is supporting the development of financial and legal sector strategies, the strengthening of financial and legal sector regulations and institutions, and the establishment of a bank restructuring and privatization project within the Ministry of Finance that will guide the process of divesting the state's holdings in banks.

## Summary of Bank's Lending Portfolio

(As of March 5, 2007)

Project ID	FY	Purpose	Original Amount in US\$ Millions		
			IDA	GEF	Undisb.
P087479	2007	Educ Sec Sup Project (FY07)	80	0	81.4
P090567	2006	Inst Reform & Capacity Bldg TA (FY06)	25	0	22
P072981	2005	GEF W KE Int Ecosys Mgmt SIL (FY05)		4.1	3.2
P083131	2005	Energy Sec Recovery Project (FY05)	80	0	77.1
P083250	2005	Financial & Legal Sec TA (FY05)	18	0	16.3
P085007	2005	MSME Competitiveness	22	0	19.7
P049618	2004	Nairobi Wtr & Swg Inst Rst SIL (FY04)	15	0	7.9
P082615	2004	Northern Corridor Transport SIL (FY04)	207	0	184.5
P082396	2004	Agricultural Productivity Project (FY04)	40	0	15.6
P078209	2004	Dev Learning Centre LIL (FY04)	2.7	0	2.1
P082378	2003	Free Primary Educ Support (FY03)	50	0	0.2
P078058	2003	Arid Lands 2 SIL (FY03)	120	0	81.6
P070718	2001	Regional Trade Fac. Project	25	0	27.7
P066486	2001	Decentr Reprod Hlth & HIV/AIDS (FY01)	50	0	27.9
Total:			734.7	4.1	567.1

### IMF-World Bank Collaboration in Specific Areas

The IMF and World Bank staffs maintain a close collaborative relationship in supporting structural reforms in Kenya through lending, analytic work, and technical assistance.

**Joint assessment of the IP-ERS progress report.** The staffs of the Bank and the IMF have jointly prepared the staff advisory note on Kenya's Annual Progress Reports of the IP-ERS. This document will be distributed to the Boards of the Bank and the IMF for information.

**Macroeconomic work.** The IMF leads the analysis and dialogue on monetary issues such as monetary policy, inflation target, nominal exchange rate management, and central bank operations. The Bank coordinates with the IMF on issues related to fiscal policy, debt sustainability, real exchange rate, public sector management etc. and takes the lead on growth and real sector issues. The teams are currently consulting on the growth analytic work being carried out by the Bank in the context of Vision 2030.

**Budgetary and public expenditure reforms.** The Bank and IMF work closely to support government efforts in budgetary and public expenditure reforms. The Bank leads the dialogue on planning, the preparation of the medium-term expenditure framework, strategic resource allocation (particularly aligning budgetary allocations with the priorities laid out in

the IP-ERS), expenditure restructuring, enhanced stakeholder participation, and issues related to efficiency of public spending, such as expenditure tracking. A joint Bank-IMF Public Expenditure Management Assessment and Action Plan was completed in May 2004. The Bank, the IMF, and other development partners have used the public financial management performance measurement framework developed by the Public Expenditure Financial Assessment (PEFA) secretariat to monitor progress in Kenya's in public financial management. This will form part of the strengthened approach to support reforms of public financial management. The Bank and the IMF collaborate on issues related to internal audit reform and on the integrated financial management information system.

**Strengthening revenue collection and administration.** The Bank and the Fund have recently carried out detailed assessments of customs operations and tax administration respectively. The Fund has been providing technical assistance to the Kenya Revenue Authority. The Bank assisted the customs department in carrying out a time release study of clearing containers through customs. The Fund (through AFRITAC) and the Bank collaborated closely in supporting the Kenya Revenue Authority to prepare a reform and modernization plan. The Institutional Reform and Capacity Building Technical Assistance Project will finance capacity building of the Kenya Revenue Authority. The EAC Regional Trade and Transport Facilitation Project is supporting reform of customs.

**Debt management and debt sustainability analysis.** The IMF prepared an external debt sustainability analysis in December 2003, which it updated in December 2004. The Bank and Fund are preparing a joint debt sustainability analysis covering both external and domestic public debt. In the context of the Financial Sector Assessment Program, a joint World Bank/IMF initiative is being undertaken to support capacity-building in the area of sovereign debt management and domestic debt market development.

**Governance reforms.** Governance reforms are a key element of the government's strategy to promote economic growth and reduce poverty. The Fund's PRGF supports a deepening of anticorruption measures. The Bank and the IMF coordinate closely on approach to governance matters in Kenya. They jointly participate in the anticorruption donor group, which is monitoring the implementation of the government's anticorruption action plan. IMF staff also participated in the Governance Missions in June/July 2006 and February 2007.

**Financial sector reforms.** The IMF and Bank are collaborating on financial sector reforms. They have conducted a joint in-depth assessment of the financial sector (banking, insurance, and capital markets) through the Financial Sector Assessment Program.

**Privatization and private sector development.** The dialogue on privatization and regulatory reforms is led by the Bank, and the IMF is a partner in this policy dialogue, particularly on issues of the fiscal implications of parastatal reforms.

**Regional integration and trade reforms.** The IMF and the Bank both provided advice on the implementation of the common external tariff, and the Bank is providing technical advice on regional integration issues. The Bank has finalized a regional assessment of nonfiscal investment incentives in each of the three states of the EAC, complementing an earlier IMF report that advises on the harmonization of incentives in the context of the customs union. The Bank is implementing a Regional Trade Facilitation Project aimed at providing political-risk and export insurance for cross-border trade between participating countries. The Bank together with the African Development Bank is implementing the EAC Regional Transport and Trade Facilitation Project. This project includes support for implementation of the customs union, and institutional and investment support to facilitate transport in the region. The Bank with the Africa Development Bank has prepared a regional integration assistance strategy that will set out priorities for regional interventions in East Africa.

Prepared by World Bank staff. Questions may be addressed to Colin Bruce, Country Director, Kenya, at 5368+3441, or Praveen Kumar, Country Economist, at X-36347.
--

### APPENDIX III—STATISTICAL ISSUES

The quality and timeliness of Kenya's economic and financial data are broadly adequate for surveillance and program monitoring. Weaknesses in macroeconomic statistics reflect managerial and organizational shortcomings, and inadequate resources provided to the Central Bureau of Statistics (CBS). In line with the new Statistics Law, the government plans to establish an autonomous National Bureau of Statistics (NBS) to replace the CBS during the fiscal year 2006/07.

1. The Report on the Observance of Standards and Codes—Data Module (IMF Country Report No. 05/388) published on October 31, 2005 stated that methodological soundness is uneven across datasets and significant improvement is required in government finance statistics and national accounts. Accuracy and reliability do not receive adequate attention in any of the datasets, while accessibility of the disseminated macroeconomic statistics are adequate, except for the balance of payments statistics.

2. Kenya participates in the Fund's General Data Dissemination System (GDDS) and the GDDS project for Anglophone Africa. Metadata and detailed plans for improving the data over the short and medium term have been posted on the Fund's Dissemination Standards Bulletin Board (DSBB). Kenya received Fund technical assistance in this regard, and further assessment of capacity building requirements has been undertaken by the AFRITAC East Statistical Advisor.

3. Monetary, exchange rate, and some external data are published on a monthly and biannual basis by the Central Bank of Kenya (CBK) in its *Monthly Economic Review*. Core financial data are also made available to the Fund on a regular basis. A detailed account of various sectoral activities and the corresponding statistical data are published annually by the CBS in its *Economic Survey*.

#### **National accounts**

4. Data quality, which was previously reported as good, has deteriorated significantly because of budgetary and staff constraints at the CBS. GDP is believed to be significantly underestimated, as important and increasing parts of the economy, such as the informal sector, nonagriculture subsistence, horticulture, and self-employed professionals are not properly covered. An STA peripatetic advisor assisted the authorities in rebasing the national accounts estimates at constant 2001 prices and compiling institutional accounts for the general government sector. National accounts estimates for the years 1996–2005 in current and constant (2001) prices) have been published.

#### **Prices and production**

6. In early 2002, the CBS began publication of a new national CPI (covering 13 urban towns), with 1997 as reference year and outdated weights and basket of items derived from the 1993-94 Household Budget Survey (HBS). Indices are produced for lower and

middle/upper income groups and Nairobi and other cities. The index is compiled and published on a timely basis. No producer, export, or import price indices are produced.

### **Government finance statistics (GFS)**

7. The data ROSC mission emphasized a number of key areas in GFS compilation that should be improved, including: (i) migration to the *GFSM 2001* methodology; (ii) broadening the coverage to include extrabudgetary and social security funds and report on a general government level; (iii) reconciliation of fiscal statistics from various sources to limit discrepancies; (iv) improve information on external financing, particularly on expenditure directly financed from abroad; (v) compilation and dissemination of monthly and quarterly budget execution data; and (vi) training of Ministry of Finance (MOF) staff in the GFS methodology.

8. Since the beginning of FY 2005/06, Kenya has followed a new economic classification of the budget based on *GFSM 2001* (with assistance from the AFRITAC-East). However, serious delays have emerged in reporting, reflecting difficulties in establishing budget execution and accounting systems consistent with the new classification. To ensure timely reconciliation and monitoring of budget execution, the existing systems would need to be promptly upgraded and made operational. Some progress has been made toward moving to the IFMIS. There are still important gaps in ensuring proper reconciliation of fiscal data from different sources, including from various units within the MOF. The discrepancies in budget outturn data (between deficit/surplus and financing) remain significant, and the recording of external financing and expenditure directly financed from abroad is still an important area for improvement. The government has taken some steps to initiate a project to rationalize/eliminate extrabudgetary funds, but the progress in compiling consolidated fiscal statistics has remained limited.

9. Kenya reports data to STA for the budgetary central government for inclusion in the *GFS Yearbook*, albeit with a significant lag—the last data reported were for the year ending June 2004. The CBS compiles the aggregate annual GFS revenue and expenditure data for the budgetary central government based on detailed data in the reports of the Controller and Auditor General. Kenya's submission for publication in the *2006 GFS Yearbook* was reported in *GFSM 2001* format, using bridge tables developed by the technical assistance missions. The recent steps taken in the migration to *GFSM 2001* may help reduce the significant differences between CBS data and the data compiled by the MOF and reported to AFR for surveillance and program monitoring purposes. Kenya also reports regularly monthly and quarterly data for inclusion in the IFS.

### **Monetary statistics**

10. The CBK has a delay in the implementation of the Monetary and Financial Statistics Manual and development of the standardized report forms (SRFs). The authorities submitted

SRF test data; however, there has not been further progress. In March 2007, a STA mission established the standardized report form for the data on the central bank; reviewed and revised the reporting form and compilation notes for the other depository corporations (ODCs) in line with *MFSM* data requirements; and identified the coverage of the ODC subsector. The mission found misclassification of a number of central government deposits as private sector deposits. A major issue for future work relates to the expansion of the coverage of the ODCs to include the Savings and Credit Cooperatives (SACCOS). As of end-March, 2007, there were 3,800 SACCOS, accounting for about 30 percent of the total deposits of the banking system. A follow-up mission is planned for mid-2007.

### **External sector statistics**

The CBS compiles annual balance of payments statistics in Kenya shillings that are regularly reported to STA, although with considerable delay. In addition, the CBK compiles a complete set of annual balance of payments statistics in U.S. dollars, which are reported to AFR and used for programming and surveillance purposes. The two datasets are not entirely consistent, and Fund staff has strongly encouraged the authorities to reconcile them. More recently, the CBK also started to compile and publish quarterly balance of payments estimates.

Although the overall quality of trade data may be reasonably good, data for other current account and many financial account transactions are rather weak. Following the liberalization of the exchange system in 1993–94, gaps emerged in coverage. The compilation system (other than that used for compiling customs statistics), used since 1994, relies on reports from domestic banks and may result in a substantial under recording of current earnings, including tourism receipts; investment flows of the private sector; as well as transactions that are settled via accounts held abroad.

Present estimates of direct and portfolio investment are believed to be substantially understated. The large positive errors and omissions in the central bank data that have emerged in the balance of payments since 1994 raise concerns as to the potential size of external obligations. The MOF compiles data covering public and publicly guaranteed external debt obligations to official and commercial creditors. This database does not take into account nonresident purchases of the government's domestic currency-denominated debt securities. In developing the loan-by-loan debt sustainability analysis (DSA) in 2002, Fund and World Bank staff identified several significant debt data problems that have been addressed by the authorities. Nevertheless, significant debt data management problems remain, along with more general issues in the area of external debt management and its integration in the budget formulation and expenditure management systems.

To help address these issues, the January-February 2006 technical assistance mission recommended introducing a foreign investment survey, enhancing the foreign exchange statistics survey, and using a common methodology, including for estimations, in the use of available data in the CBS and CBK.



**KENYA: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE**  
(as of October 16, 2006)

	Date of latest observation	Date received	Frequency of Data <sup>6</sup>	Frequency of Reporting <sup>6</sup>	Frequency of publication <sup>6</sup>	Memo Items <sup>7</sup> :	
						Data Quality – Methodological soundness <sup>8</sup>	Data Quality – Accuracy and reliability <sup>9</sup>
Exchange Rates	3/5/07	3/6/07	D	D	M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities <sup>1</sup>	3/5/07	3/6/07	D	D	M		
Reserve/Base Money	3/5/07	3/6/07	D	D	M	LO, LO, LO, LO	LO, LO, O, O, NO
Broad Money	1/31/07	2/15/07	M	M	M		
Central Bank Balance Sheet	3/5/07	3/6/07	D	D	M		
Consolidated Balance Sheet of the Banking System	1/31/07	2/15/07	M	M	M		
Interest Rates <sup>2</sup>	3/5/07	3/6/07	D	D	M		
Consumer Price Index	January 2007	2/15/2007	M	M	M		
Revenue, Expenditure, Balance and Composition of Financing <sup>3</sup> – General Government <sup>4</sup>	NA	NA	NA	NA	NA	LNO, LNO, LNO, LO	LNO, LO, LO, LO, NO
Revenue, Expenditure, Balance and Composition of Financing <sup>3</sup> – Central Government	Nov 2006	11/06	M	I	Q		
Stocks of Central Government and Central Government-Guaranteed Debt <sup>5</sup>	Nov 2006	11/06	Q	Q	Q		
External Current Account Balance	Nov 2006	11/06	M	A	A	O, LO, O, LO	LNO, LO, LO, LO, LO
Exports and Imports of Goods and Services	Nov 2006	11/06	M	Q	A		
GDP/GNP	Nov 2006	11/06	M	A	A	O, LNO, LNO, LO	LNO, LO, LNO, LO, LNO
Gross External Debt	Nov 2006	11/06	M	Q	Q		

<sup>1</sup> Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

<sup>2</sup> Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

<sup>3</sup> Foreign, domestic bank, and domestic nonbank financing.

<sup>4</sup> The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

<sup>5</sup> Including currency and maturity composition.

<sup>6</sup> Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).

<sup>7</sup> These columns should only be included for countries for which a Data ROSC (or a Substantive Update) has been prepared.

<sup>8</sup> Reflects the assessment provided in the data ROSC, published on October 31, 2005, and based on the findings of the mission that took place during January 2005, for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).

<sup>9</sup> Same as footnote 8, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

INTERNATIONAL MONETARY FUND

KENYA

**2006 Article IV Consultation and Second Review  
Under the Three-Year Arrangement Under the Poverty Reduction and Growth  
Facility, and Requests for Extension and Rephasing of the Arrangement, Reduction in  
Access, and Waiver of Performance Criteria—Supplementary Information, Revised  
Letter of Intent and Memorandum of Economic and Financial Policies**

Prepared by the African Department  
(In consultation with other departments)

Approved by Thomas Krueger and Anthony R. Boote

April 6, 2007

- 1. This supplement is being issued to reflect the request by the Kenyan authorities for a waiver of nonobservance of the continuous performance criterion on the nonaccumulation of external payments arrears under the PRGF arrangement.**
- 2. Kenya accumulated new external payments arrears of €182,000 to a bilateral Paris Club creditor in January 2005.**<sup>1</sup> The existence of these arrears came to light during the course of a detailed review of debt payments data for the Managing Director's report on a noncomplying disbursement. Staff has concluded that the accumulation of these arrears represents a nonobservance of the continuous performance criterion on the nonaccumulation of external payments arrears.
- 3. The staff supports the authorities' request for a waiver of nonobservance of the continuous performance criterion on the nonaccumulation of external payments arrears.** Kenya's accumulation of a small amount of new external payments arrears after the first review reflects previous weaknesses in its debt management system, but the authorities cleared the arrears in full in January 2005 shortly after missing the payment date and have

---

<sup>1</sup> As noted in MEFP Table 2: Outcomes on Quantitative Performance Criteria and Benchmarks Under the Program for 2004/05, two types of arrears are excluded for the purposes of the program: 1) arrears on external commercial loans/suppliers' credits whose validity is being disputed by the authorities and 2) arrears accumulated due to billing information not being provided by a bilateral creditor, which have since been cleared.

undertaken reforms to strengthen debt management. The Government has been implementing external debt management reforms with support from the World Bank/DFID under the Financial and Legal Sector Technical Assistance Program (FLSTAP). Since 2005, Kenya's external debt database has been updated; records have been validated; back office functions have been consolidated and business procedures formalized; staff were added to the Debt Management Department and capacity building programs have been scaled up; and a loan files registry has been established with arrangements for automated record keeping. The authorities report significant improvements due to these measures: external debt service obligations are being settled on schedule and debt data are being reported more quickly and accurately.

**Statement by the IMF Staff Representative on the Republic of Kenya**  
**April 11, 2007**

1. The following information has become available since the issuance of the staff report for the 2006 Article IV consultation and second review of the three-year arrangement under the Poverty Reduction and Growth Facility ([www.imf.org](http://www.imf.org)). The thrust of the staff appraisal remains unchanged.
2. **Quantitative Benchmarks.** Preliminary information indicates that the quantitative benchmarks on net foreign assets, reserve money and net domestic financing of the central government for end-March 2007 were met by comfortable margins.
3. **Inflation.** Consumer price inflation declined to 5.9 percent (year-on-year) in March 2007 from 6.8 percent in February. This decline was due to lower food price inflation, which primarily reflected the unwinding of earlier drought-related food price increases. Excluding food prices, the twelve-month inflation rate was unchanged in March at 6.1 percent.



INTERNATIONAL MONETARY FUND

EXTERNAL  
RELATIONS  
DEPARTMENT

Press Release No. 07/66  
FOR IMMEDIATE RELEASE  
April 11, 2007

International Monetary Fund  
Washington, D.C. 20431 USA

**IMF Executive Board Completes Second Review Under the PRGF Arrangement for Kenya and Approves US\$ 56.8 Million Disbursement**

The Executive Board of the International Monetary Fund (IMF) today completed the second review of Kenya's economic performance under a three-year Poverty Reduction and Growth Facility (PRGF) arrangement. The completion of the review enables the release of an amount equivalent to SDR 37.5 million (about US\$56.8 million), bringing total disbursements under the arrangement to SDR 112.5 million (about US\$170.4 million).

In completing the review, the Board approved waivers for the nonobservance of five performance criteria. These included two quantitative performance criteria, one on reserve money and one on the accumulation of new external payments arrears; and three structural performance criteria, one against the imposition of controls on banks' fees and charges, one on the issuance of new guidelines for wage arbitration by the Industrial Court, and one on completion of the asset declaration of ministers, permanent secretaries, and heads of state bodies.

The Executive Board also approved the authorities' request for an extension of the arrangement to November 20, 2007. Consistent with the improvement in Kenya's external position, the Executive Board also approved the authorities' request for a reduction in access by SDR 75 million, and rephasing of remaining disbursements under the arrangement, bringing the total amount available under the arrangement to SDR 150 million.

The Executive Board approved the three-year arrangement on November 21, 2003 (see [Press Release No. 03/201](#)), in an amount equivalent to SDR 175 million. On December 20, 2004, the Executive Board approved an augmentation of access under the PRGF arrangement by SDR 50 million (see [Press Release No. 04/270](#)). The arrangement was subsequently extended to April 30, 2007 to allow time to complete the second review (see [Press Release No. 07/37](#)).

Following the Executive Board discussion, Mr. Murillo Portugal, Deputy Managing Director and Chair, said:

“Kenya’s macroeconomic performance has improved markedly since 2004. The authorities are to be commended for their prudent macroeconomic policies and structural reforms, which have helped contain domestic debt, increase international reserves, and strengthen the financial sector.

“Going forward, sustaining strong growth and macroeconomic stability will require continued fiscal discipline to further reduce domestic debt, while increasing priority spending on infrastructure and poverty reduction. To this end, untapped external concessional resources should be explored, revenue efforts enhanced, and public expenditure management strengthened. Priority reforms include operationalizing the Integrated Financial Management Information System in key ministries and making the Public Procurement Oversight Authority fully functional. An appropriate legal and institutional framework for Public Private-Partnerships should be put in place to minimize related fiscal risks.

“Financial sector reforms need to be accelerated to safeguard macroeconomic and financial stability. Recent efforts to allow greater interest rate flexibility and the enactment of the Banking Amendment Bill are welcome steps, but further reforms are needed, including divesting shareholdings in state-influenced financial institutions, expediting the passage of the Anti-Money Laundering Bill, amending the Banking Act to align Kenya’s legal and regulatory framework with best international practices, and developing a financial sector reform strategy.

“The managed float exchange rate regime in conjunction with reserve money targeting has served Kenya well. However, maintaining competitiveness would require faster structural reforms and infrastructure improvements. Reserve money targets would need to be tightened in the months ahead to safeguard macroeconomic stability.

“While recent governance reforms have strengthened institutions and increased transparency, including in the procurement process, the legislative agenda on governance is unfinished and more progress has to be made in the investigation and prosecution of prominent corruption cases. Forceful implementation of the *Governance Action Plan for Building a Prosperous Kenya* will be crucial to improve governance and root out corruption.

“The Executive Board noted the Kenyan authorities’ failure to ensure the accuracy of information provided to the Board on nonconcessional borrowing and external payments arrears, which resulted in a noncomplying disbursement following the conclusion of the first review under the PRGF arrangement in December 2004. The Board took note of the authorities’ explanation for the provision of inaccurate information. In view of the prompt corrective actions taken to improve debt management practices, and the authorities’ commitment to the objectives of the program, the Executive Board decided to waive the two incidents of nonobservance of the continuous performance criteria that gave rise to the noncomplying disbursement,” Mr. Portugal said.

**Statement by Peter Gakunu, Executive Director for Kenya and Rachel Gesami,  
Senior Advisor to Executive Director  
April 11, 2007**

**Introduction**

1. The Kenyan authorities thank the mission team for the extensive consultation and constructive dialogue during recent Fund Missions and for the comprehensive assessment and valuable suggestions on Kenya's economic development, and the implementation of the reform program. The authorities welcome the well written and balanced staff report on the 2006 Article IV Consultation and Second Review Under the Three-Year Arrangement of the Poverty Reduction and Growth Facility (PRGF); and request the Extension and Rephasing of the Arrangement (to November 20, 2007), a Reduction in Access, and a Waiver of Performance Criteria.

2. The Kenya Vision 2030 program launched recently, calls for a sustained increase in GDP growth to an average 10 percent per annum, with a view to making Kenya a middle-income country by the year 2030. As a step in this direction, a medium-term strategy that builds on the Economic Recovery Strategy is being developed for the period 2008-12 aimed at accelerating growth, maintaining macroeconomic stability, reducing poverty, improving equity and strengthening institutions of governance.

**Performance under the PRGF Arrangement**

3. The authorities are committed to the implementation of the vision and the strategy. However, the fact that the current PRGF program was burdened by the introduction of numerous new prior actions in the middle of the program, causing significant delays, has been of concern. Nevertheless, the authorities did not allow the delayed PRGF program to reduce their resolve and determination to improve competitiveness, accelerate growth and reduce poverty. They have instead pursued their reform program vigorously and steadfastly, with impressive results. Despite the difficulties posed by additional conditions and exacerbated by exogenous shocks, notable progress has been made in the main components of the authorities' reform agenda. This includes improvements in tackling governance weaknesses, strengthened fiscal policy for stability and growth, enhanced public financial management, actions to strengthen the financial sector, as well as progress in productive sector reform, public enterprise reform, and the privatization program. My authorities have therefore demonstrated their commitment to reducing poverty and establishing a macroeconomic and institutional framework that is conducive to accelerating growth.

4. Program implementation, supported by the PRGF arrangement remained broadly on track in 2005/06 although five out of the thirteen performance criteria for 2004/05 were not

met. The end-March 2005 quantitative performance criterion on the reserve money of the Central Bank of Kenya was also missed, as was the continuous criterion on non accumulation of external payments arrears. The structural performance criteria on non-imposition of controls on banks' fees and charges (Section 44 of the Banking Act) and the issuance of new guidelines for wage arbitration by the Industrial Court, were also missed as was the structural performance criterion requiring that the declaration of assets by ministers, permanent secretaries, and heads of state bodies be completed.

5. My authorities have, however, taken decisive remedial actions to address these slippages. Among other things, they have developed modalities for implementing Section 44 of the Banking Act that are broadly consistent with the original program objectives. They have cleared a small amount of bilateral external arrears, and taken steps to improve debt management practices. Furthermore, they have begun an audit of external commercial contracts on which payments were suspended due to governance concerns. In addition to this, the Industrial Court issued new guidelines for wage arbitration in November 2005, and the verification of asset declarations of ministers and senior officials is continuing.

6. Given the good performance record achieved under difficult circumstances, and the continued commitment to successful program implementation, the authorities request the completion of the Second Review of the PRGF-supported program and the approval of the associated waivers for the nonobservance of the five performance criteria detailed above. They also seek an extension of the PRGF arrangement to November 20, 2007, which would allow them time to complete the third review under the arrangement after reaching understandings with Fund staff on the 2007/08 budget. In view of the substantial improvements in Kenya's balance of payments since the approval of the PRGF arrangement, the authorities also request a reduction in access of SDR75 million, with the remaining access of SDR75 million to be disbursed in two equal installments for the second and third reviews.

7. On the issue of a noncompliant disbursement for Kenya and accumulated external payments arrears, the authorities agree that in addition to the two non-concessional external loans reported at the time of the second disbursement under the PRGF arrangement, a third loan was contracted on January 20, 2004 which was not concessional. This should have been reported as non-concessional borrowing at the time if information had been available. This information became available following the recent audit by the Auditor and Controller General and the publication of his report. This clearly shows that the governance measures on transparency and accountability introduced by the government are working. The accumulation of external payments arrears during the period monitored for the first PRGF review was greater than the amount reported to the Executive Board in December 2004. The authorities regret the inaccuracy of the information that was provided at the time of the first review, which was attributable to weak institutional arrangements, a debt database shortcoming, changes in key personnel in the Ministry of Finance and inadequate staff in the debt management department at that time. The authorities have since undertaken a number of



actions to address these challenges including implementing external debt management reforms with support from the World Bank/DFID under the Financial and Legal Sector Technical Assistance Program to ensure that additional non-concessional loans are not contracted or guaranteed and that outstanding legitimate external arrears are settled. The authorities request for a waiver for nonobservance of the performance criteria underlying the noncomplying disbursement.

### **Recent Economic Developments and Outlook**

8. The authorities have taken significant steps to secure macroeconomic stability and put in place a strong foundation for growth. The results of this stewardship have been impressive: GDP growth has increased ten-fold from a low of 0.6 percent in 2002 to an estimated 6 percent in 2006; the highest level in two decades. Meanwhile, inflation fell sharply to 6.8 percent in the 12-months to February as food price inflation eased. Non-food inflation continued to hover around 6 percent. Economic growth has also been broad based.

9. This positive outcome can be attributed to prudent macroeconomic policies, a generally favorable external environment, rising world prices for tea and coffee, and continued strong demand for horticultural exports. Manufacturing has also benefited from strong regional demand and the formation of the East African Community Customs Union. There has also been robust growth in the service sector.

10. Last year, Kenya received its first international credit rating. Standard and Poor's Rating Service assigned Kenya a B+ for foreign currency and BB- for local currency. Within Sub-Saharan Africa, only mineral-rich countries have a higher rating. The favorable long-term sovereign credit rating gave the country a positive outlook, emphasizing the authorities' strong political commitment to prudent financial policies and market-oriented structural reforms. The authorities have directed their efforts at reducing inflationary pressures through tighter fiscal and monetary policy, and have taken measures to contain domestic debt and so achieve program targets and maintain debt sustainability.

11. With respect to governance, Kenya also received a moderate rating along side other countries in the recent release of the Global Integrity Index, which assesses the existence and effectiveness of anti-corruption mechanisms that promote public integrity. It is also noteworthy that Kenya is one of the few countries in Sub-Saharan Africa, which has voluntarily subjected itself to the NEPAD's Africa Peer Review Mechanism.

12. The authorities believe that they have made important progress, delivering on objectives outlined in the Economic Recovery Strategy and the Kenya Vision 2030. They recognize, however, that a lot of work remains to be done. They acknowledge that the economy still remains vulnerable to external exogenous shocks and that the government continues to face challenges in a number of areas, including in improving the effectiveness of key institutions, increasing the breadth and quality of infrastructure and pursuing a reform

agenda which continues to buttress strong growth and poverty reduction and improve external competitiveness.

### **Fiscal Policy and Debt Management**

13. On the fiscal front, the authorities continue to pursue a fiscal policy that is supportive of a higher growth path for the economy, while ensuring macroeconomic stability and fiscal sustainability. They are refocusing and increasing expenditure to areas that will enhance infrastructure development and reduce widespread poverty. Despite receiving less external development assistance than expected, they took action to protect priority areas by, among other things, cutting non-priority expenditure. This in turn helped to contain domestic borrowing at 1.8 percent of GDP, while accommodating drought-related spending of 0.8 percent of GDP.

14. The authorities realize that the reallocation of public expenditure is only a beginning and more needs to be done. They will continue taking significant steps, including strengthening revenue performance and tax administration, customs reforms, implementing public expenditure management reforms, and increasing poverty reduction spending by reorienting public expenditure in favor of essential social and economic outlays. Recognizing the importance of infrastructure for continued competitiveness and enhanced growth, the authorities doubled the allocation for development expenditure in the Ministry of Roads and Public Works in the 2006/7 budget. With limited external financing available however, scaling-up expenditure on core anti-poverty programs and expenditure will require a determined effort to rein in non-priority spending and ensure strong domestic revenue collection.

15. Kenya has also managed its debt relatively well and has regularly met its obligations to most of its creditors. The authorities' limited external borrowing has left them with more manageable debt ratios than most low-income country peers. The joint IMF- World Bank debt sustainability analysis (DSA) found Kenya's debt to be low and sustainable.

### **Monetary and Exchange Rate Policy**

16. Under its current monetary policy framework, the Central Bank of Kenya will continue to target reserve money growth. Consistent with inflation objectives, the authorities will control the growth in reserve money in order to achieve the broad money objective. They are committed to further enhancing the transparency of monetary policy and improving the signaling of policy intentions to the market. With respect to exchange rate policy, Kenya maintains an exchange system that is free of restrictions on payments and transfers for international current account transactions. The current floating exchange rate regime is seen as supportive of macroeconomic stability and external competitiveness.

## **External Sector**

17. Despite large inflows of remittances, the current account deficit widened on account of higher world oil prices and the strong import demand in line with stronger growth. Sizeable financial inflows resulted in a significant buildup in foreign exchange reserves and an appreciation of the Kenyan shilling, largely reflecting increased confidence in Kenya's economy. This has not however affected Kenya's external competitiveness. Nevertheless there are risks ahead. Going forward the authorities are committed to continuing streamlining Kenya's business licensing system, pursuing efficiency-enhancing structural reforms and increasing infrastructure spending while reducing outlays on parastatals and containing the wage bill.

## **Financial Sector Policy**

18. The financial sector in Kenya remains stable. Key financial soundness indicators point to a sector that is well capitalized, profitable and liquid. This soundness is the result of strengthened financial regulation and improved compliance with prudential regulations over the last four years. While the value of non-performing loans remains high, the number has been substantially reduced.

19. The authorities will submit a new Banking Bill to Parliament that establishes a legal and regulatory framework for mandatory supervisory intervention and prompt corrective actions against inadequately capitalized and failing banks. My authorities acknowledge the contribution that a strong financial sector can make in the delivery of their objectives and remain committed to implementing measures designed to ensure the stability of the financial system and to develop it further.

20. The Kenyan Government is also committed to accelerating public enterprise reforms, including privatizing troubled financial institutions, and developing a financial sector reform strategy that is based on market principles. The cabinet has approved the restructuring of the National Bank of Kenya and the authorities are now preparing for cabinet consideration of a strategy to divest from the National Bank of Kenya. Pending this divestiture, the bank will remain under the close supervision of the Central Bank of Kenya. The Charterhouse Bank (CHB) was put under management of the Central Bank of Kenya in June 2006. On 9 March 2007, the Court of Appeal rejected the application by CHB to remove the statutory manager, while the license, which expired in December 2006, was not renewed by the government. The authorities will also undertake a diagnostic audit of the National Social Security Fund (NSSF) that will provide a basis to address its financial and governance problems. Meanwhile, the Crime and Anti-Money Laundering Bill that will enable Kenya to comply with international best practice, has been republished and will be submitted to Parliament.

## **Tackling Governance Weaknesses**

21. The authorities have achieved real progress in strengthening governance institutions, but recognize that challenges still remain. Kenya's Governance Action Plan (GAP) has set out very clearly the authorities' priorities. It has been well received and welcomed by citizens, the private sector and donors. The governance policy initiatives will focus on four broad areas namely: i) prevention, ii) investigation, iii) restitution, and iv) improving governance in priority sectors. Top priority is being given to administrative and preventive actions, which are expected to result in measurable improvements in governance and anti-corruption efforts in the short run.

22. A key objective of the 2006/07 program is to improve governance. The centerpiece of this agenda is the implementation of the Governance Action Plan, focusing initially on measures that can be undertaken without legislative action, yet with significant payoffs in the short-run. The authorities have already taken decisive actions on corruption cases and strengthened institutions to further enhance transparency and accountability. In this connection, they have already begun the implementation of the Governance Action Plan, in some cases, earlier than envisaged.

23. The Government is also conducting audits of the Anglo leasing contracts, which could provide additional evidence for subsequent prosecution. They intend to resubmit to Parliament the Miscellaneous Amendment Bill, which contains key measures to support implementation of the Governance Action Plan, including hiring 20 more judges and making asset declarations by senior public officials available to the general public. Resubmission of the bill to parliament will be a performance criterion for the third review.

24. The authorities acknowledge the importance of prosecuting prominent corruption cases and completing the legislative agenda for the Governance Action Plan. They have made important progress in investigating corruption cases and bringing them to trial; however, the pace at which cases are brought to conclusion has been slow. By March 6, 2007, the Kenya Anti-Corruption Commission had forwarded 254 files to the Attorney General and recommended prosecution in 185 files. Of all these, the Attorney General was unable to deal with only three files. There are currently a number of high-profile corruption cases in court including cases involving three former permanent secretaries linked to Anglo-Leasing contracts, two former central bank governors and one former Minister. The remaining Anglo leasing contracts are being investigated by the Kenya Anti-Corruption Commission in tandem with an external audit of the contracts to assess their fair values. The Kenya Anti-Corruption Commission has indicated that it intends to complete its investigations of all Anglo leasing contracts before making its recommendations to the Attorney General's office.

**Structural measures**

25. The authorities have focused on further strengthening and improving public financial management. A number of steps have been taken to enhance the efficiency of public resource management and to improve governance. Important progress has been made in fiscal reporting, improving transparency in granting exemptions, subjecting all procurement to transparent and competitive procedures, timely presentation of the Controller and Auditor General's report to Parliament, and completing a survey of the contingent liabilities of 24 parastatals.

26. On public enterprise reform and private sector development, the authorities have made considerable progress in parastatal reform. This includes the concessioning of Kenya Railways, the partial privatization of KenGen and Mumias Sugar Company, the introduction of a management contract for Kenya Power and Lighting Company, and performance contracts for all public commercial enterprises. The authorities have also made significant progress in streamlining Kenya's business licensing system. The result is a more favorable business environment which will help to sustain growth driven by a vibrant private sector. The reform program further envisages establishment of a Privatization Commission under the Privatization Act.

27. On trade reforms and regional integration, the authorities will continue to pursue trade liberalization to enhance efficiency and strengthen growth prospects. Within the region, the authorities will implement their East African Community (EAC) commitments, continue to pursue greater regional economic and social integration, and advocate for further steps to open up the EAC with a view to enhancing competition and efficiency.

**Conclusion**

28. My authorities are committed to delivering on the objectives set out in the Economic Recovery Strategy, Vision 2030 and the Governance Action Plan. They have taken important steps in this regard. They are also committed to taking further additional steps that may be necessary. They believe that the Fund can play a positive and catalytic role in supporting them in the delivery of their objectives. The authorities intend to remain engaged with the Fund, through an appropriate program, after the completion of the third review.