

Kenya: Request for a Three-Year Arrangement Under the Poverty Reduction and Growth Facility—Staff Report; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Kenya

In the context of the request for a three-year arrangement under the Poverty Reduction and Growth Facility, the following documents have been released and are included in this package:

- the staff report for the request for a three-year arrangement under the Poverty Reduction and Growth Facility, prepared by a staff team of the IMF, following discussions that ended on **June 16, 2003**, 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 November 7, 2003.** 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 Press Release summarizing the **views of the Executive Board as expressed during its November 21, 2003 discussion** of the staff report that completed the request.
- a statement by the Executive Director for Kenya.

The document(s) listed below have been or will be separately released.

Joint Staff Assessment of the Poverty Reduction Strategy Paper
Preparation Status Report
Letter of Intent sent to the IMF by the authorities of Kenya*
Memorandum of Economic and Financial Policies by the authorities of Kenya*
Poverty Reduction Strategy Paper Preparation Status Report
Technical Memorandum of Understanding*
Debt Sustainability Analysis

*May also be included in Staff Report

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

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INTERNATIONAL MONETARY FUND

KENYA

Request for a Three-Year Arrangement under the Poverty Reduction and Growth Facility

Prepared by the African Department (in consultation with the Fiscal Affairs, Legal, Finance, Monetary and Financial Systems, Policy Development and Review, and Statistics Departments)

Approved by Anupam Basu and Anthony R. Boote

November 7, 2003

- Kenya's previous three-year arrangement under the PRGF expired in August 2003.
- Discussions for a new program that could be supported by a three-year arrangement under the Poverty Reduction and Growth Facility (PRGF) were initiated in May 2003 and concluded in July 2003.
- The staff team consisted of Mr. Kalinga (head), Mr. Maehle, Mr. Schindler (all AFR), Mr. McIntyre (PDR), Ms. Jacobs (FAD), and Mr. Shah (MFD). Mr. Itam, the Fund's Senior Resident Representative in Kenya, also participated in the discussions.
- The mission held discussion with Mr. Mwiraria, Minister of Finance; Mr. Anyang Nyong'o, Minister of Planning and National Development; Dr. Mullei, Governor of the Central Bank of Kenya; and other senior officials. The staff also met with representatives of the donor and business communities, NGOs, and trade unions.
- At the conclusion of the last Article IV consultation on May 2, 2003, Directors commended Kenya for maintaining a measure of financial stability during recent years in difficult circumstances and for the progress made in the governance area. Directors emphasized that the key priorities for a PRGF-supported program should include actions to continue to improve governance and fiscal transparency; fiscal consolidation to address the domestic debt problem and ensure fiscal sustainability over the medium term; a credible strategy to reform tax administration and enhance revenues; measures to restructure public outlays in favor of poverty-related spending and improve the delivery and monitoring of basic social spending; a clear strategy for restructuring and strengthening the banking system; and privatization of public banks and public enterprises.
- The authorities' program outlined in the memorandum of economic and financial policies (MEFP), attached to the letter to the Managing Director dated September 22, 2003, is embedded in the Economic Recovery Strategy for Wealth and Employment Creation (ERSWEC), which outlines the authorities' medium-term development policies. In the coming months, **the government intends to expand the ERSWEC into a full PRSP** by completing the following: first, a detailed discussion of the consultative process that was followed in developing the reform agenda; second, an analysis of the various dimensions of poverty, including a comprehensive review of the determinants of poverty and their evolution over time; third, a medium-term expenditure framework that will spell out how public expenditure would be restructured over time to achieve the twin goals of accelerated growth and poverty reduction; and finally, a comprehensive macroeconomic framework. The government's current macroeconomic framework is consistent with that underpinning the proposed PRGF-supported program. The accompanying PRSP preparation status report describes the actions that the authorities are taking to produce a full PRSP.
- The debt sustainability analysis (DSA) indicates that Kenya does not qualify for debt relief under the enhanced HIPC Initiative.

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EXECUTIVE SUMMARY

1. **With the exception of inflation developments, macroeconomic outcomes in the three-year period 2000/01-2002/03 (July/June) covered by the last PRGF arrangement were well below expectations,** reflecting primarily the persistence of pervasive governance failures and the slow pace of reforms.
2. **Overall economic conditions have remained subdued, owing in part to the negative effects on the tourism industry of the recent terrorism-related travel advisory.** Real GDP growth in 2003 is projected to be about 1 percent. Owing mainly to a sharp increase in food and oil prices, consumer price inflation rose sharply in the nine months to May 2003, but has since trended down. Excluding food and energy, inflation has remained below the 5 percent target. The overall fiscal deficit, before grants, widened by 1.1 percent of GDP to 4.8 percent of GDP in 2002/03, largely because of lower revenues. For this reason, domestic borrowing remained high. Three-month treasury bill rates have declined substantially in recent months, reflecting primarily the persistence of liquid market conditions.
3. **In line with the ERSWEC, the PRGF-supported program aims at accelerating economic growth and reducing poverty. The key elements of the program involve actions to:** (i) strengthen the legal and enforcement mechanisms for governance and anticorruption; (ii) restructure the public finances; (iii) reform the financial sector, public enterprises, labor market, and trade regime; and (iv) restore relations with donors.
4. **Domestic debt consolidation is a central element of the macroeconomic program.** Accordingly, the program for 2003/04 aims at a sharp reduction in domestic borrowing. Over the medium term, the government would be a net contributor of resources to the banking system.
5. **The structural reform agenda for the first year of the arrangement will focus on the following issues:**
 - the enactment of new anticorruption legislation;
 - rebuilding of the integrity and capacity of the Kenya Revenue Authority (KRA);
 - initiation of a restructuring of public expenditure in favor of social and economic outlays;
 - reform of the financial sector—particularly the restructuring of the insolvent National Bank of Kenya (NBK) and the transfer of the licensing authority from the Ministry of Finance to the Central Bank of Kenya (CBK); and
 - accelerated privatization of public enterprises.
6. **There are risks to the program.** An increase in tensions within the ruling coalition could delay the implementation of critical reforms. On the economic front, a weakening of external conditions could slow the growth of the economy and undermine the achievement of the poverty objectives.

I. INTRODUCTION

1. In the attached letter, the Kenyan authorities request a three-year arrangement under the Poverty Reduction and Growth Facility (PRGF) in an amount equivalent to SDR 175 million (64.5 percent of quota). Seven disbursements are contemplated during the three-year period, with one disbursement following the approval of the arrangement in November 2003 and six disbursements in May and October of succeeding years, following satisfactory conclusion of the semiannual reviews under the program (Table 1).

2. **The authorities' case for a new PRGF arrangement is predicated on the need for Kenya to implement, in a systematic manner, a coherent package of economic and structural reforms aimed at decisively addressing Kenya's tepid growth, weak budgetary position, large domestic debt, and fragility in the banking sector.** Implementation of this package will facilitate the realization of its poverty reduction objectives. The authorities' development strategy, which is outlined in the ERSWEC, is expected to require a marked increase in donor assistance. Present indications are that adequate donor assistance will be forthcoming if Kenya pursues a comprehensive poverty reduction program and strong policy reforms, supported by the Fund, and addresses the major weaknesses in governance. Medium-term projections indicate that the external current account gaps would be covered by the expected disbursements of concessional donor assistance, provided that the envisaged measures are fully implemented. The proposed access level takes into account the need to support an ambitious agenda of reforms, particularly in the governance and trade areas, a buildup of foreign reserves from 2.7 months of import cover at end-June 2003 to 4.0 months of import cover by end-June 2006, and an appropriate exit strategy for Kenya from use of Fund resources under the PRGF. Moreover, at the end of the three-year program period, total outstanding Fund credit to Kenya would remain relatively low, amounting to 74.4 percent of quota or about 10.6 percent of gross reserves (Table 2), reflecting the limited drawings under earlier arrangements.

II. REVIEW OF PERFORMANCE UNDER THE LAST PRGF-SUPPORTED PROGRAM

A. Macroeconomic Outcomes

3. **With the exception of inflation and the external current account position, macroeconomic outcomes in the three-year period 2000/01-2002/03 (July-June) covered by the last PRGF arrangement were well below expectations (Table 3).** The key developments were as follows:

- real GDP growth averaged less than 1.0 percent in the three-year period;
- average consumer price inflation (excluding food and energy) slowed down from 5.9 percent in 1999/2000 to 2.7 percent in 2002/03 (Figure 1);
- the overall fiscal deficit before grants was substantially larger than initially projected and net domestic financing expanded from 0.3 percent of GDP in 2000/01 to 5.0 percent in 2002/03, partly on account of a drop in revenue;

- domestic debt increased from 19.6 percent of GDP at end-June 2001 to 25.0 percent of GDP at end-June 2003;
- three-month treasury bill rates declined from 18.9 percent in January 2000 to about 1 percent in September 2003 (Figure 2), despite the large domestic funding requirements of the government (Figure 3);
- The external current account deficit (before grants) narrowed markedly, reflecting in part a contraction in investment; and
- gross international reserves declined from a cover of 3.3 months of import in 2000/01 to 2.7 months of import in 2002/03.

4. **The weak economic performance was mainly the result of persistent governance failures and the slow pace of reforms.** In addition, the external environment, as reflected by the declines in the terms of trade and in donor inflows since 2001, was more difficult than envisaged (Table 3). The strong inflation performance was the result of weak aggregate demand but also benefited from improvements in monetary policy implementation procedures, as well as from increased stability in the nominal exchange rate of the shilling (Figure 4). The decline in the treasury bill rates during 1999/2000-2001/02 reflected the success in lowering the inflation rate and the perceived country risk premium. The sharp decline in the rates since January 2003, however, has been due primarily to the persistence of liquid market conditions on account of a reduction in CBK repurchase operations and the lowering, with effect from July 2003, of banks' required reserves from 8 percent to 6 percent of deposits. Banks have responded to the increase in liquidity by raising the proportion of free reserves held at the CBK.¹

B. Structural Measures

5. **In late 2000, Kenya's PRGF-supported program suffered major setbacks.** First, parliament rejected the Public Service (Code of Ethics) Bill on the grounds that it contravened the principle of the separation of powers among the executive, judiciary, and legislative branches of government. Second, the Constitutional Court ruled that the Kenya Anti-Corruption Authority (KACA) was unconstitutional. Third, parliament passed the so-called Donde Bill, which sets limits on banks' interest rates. Finally, the cabinet put on hold the privatization of the telecommunications company (Kenya Telkom) and the Kenya Commercial Bank (KCB), although both decisions were subsequently reversed. Details of the status of the structural performance criteria and benchmarks under the previous PRGF arrangement are provided in Table 4.

¹ Some of these free reserves are held for transaction purposes necessitated by changes in clearing procedures introduced in July 2003.

6. **To bring the program back on track, understandings were reached with the government on an alternative governance plan**, which was intended to (i) build upon and strengthen the operations of the Anti-Corruption Police Unit (ACPU); (ii) strengthen the Office of the Attorney General (AG); (iii) enact appropriate versions of the Anti-Corruption and Economic Crimes Bill and the Public Officer Ethics Bill; (iv) establish special courts for corruption cases; and (v) demonstrate progress in tackling corruption.² In December 2001, key elements of the new strategy were converted into prior actions for bringing the PRGF-supported program back on track. Most of these prior actions had not been implemented by December 2002, when the previous administration lost the parliamentary and presidential elections.

III. THE MEDIUM-TERM PROGRAM

7. **At the time of the last Article IV consultations, the authorities and the staff largely agreed on the diagnosis of Kenya's principal economic problems**—poor governance and widespread corruption; major structural distortions in the financial, parastatal, and utilities sectors; low savings and investment; and an inward-looking trade system—which have given rise to low economic growth, poverty, and mass unemployment.³ As a result, most poverty indicators have worsened in recent years (Table 5). The ERSWEC outlines a broad economic agenda to address these economic problems over the medium term. The three-year program, as well as the economic reform agenda presented in the MEFP, is fully consistent with the government's economic recovery strategy, which has been evolving since the government took office and since the June 12 budget speech as more information has become available on the underlying weaknesses of the economy.⁴

8. **The main objective of the economic recovery strategy** is to reduce poverty by promoting strong economic and employment growth. The program for 2003/04-2005/06 aims at creating opportunities for productive employment through the rebuilding of sound governance structures, addressing the country's major macroeconomic vulnerabilities, particularly the weak budgetary position, large domestic debt, and distressed financial system;⁵ and reforming the parastatal sector, labor markets and the trade system to foster a more competitive private sector. This is part of a broader reform agenda, which is supported by many donors and development agencies, including the World Bank. To achieve these goals, the program contains a package of policy measures (Box 1). The actions covered by

² See Box 3, IMF Country Report No. 02/85, for details.

³ See IMF Country Report No. 03/199.

⁴ The authorities' policies that are outlined in the attached memorandum are in line with the budget that was approved in August 2003.

⁵ The program will also focus on strengthening macroeconomic management, including policy instruments and institutions.

Box 1. Kenya: Main Actions Under the Program, 2003/04–2005/06	
	Implementation Period during 2003/04–2005/06
High domestic debt burden	
• Elimination of the domestic borrowing requirement by 2004/05, with a significant reduction in 2003/04.	2003/04–2005/06
• Clearance of outstanding pending bills over the three-year program period.	2003/04–2005/06
• Cancellation of stalled projects as announced in the 2003/04 budget, with a provision for paying termination costs.	2003/04–2005/06
• Continued enhancement of governance legal and enforcement framework.	2003/04
Weak financial system	
• Transfer of Ministry of Finance’s power of bank regulation and supervision to the CBK.	2003/04
• Restructuring of the National Bank of Kenya (NBK).	2003/04
• Divestment of government shares in the KCB.	2003/04
• Divestment of public sector ownership and control of other public banks.	2003/04–2005/06
• Strengthening of prudential rules governing foreign currency-denominated lending by banks.	2003/04–2005/06
• Restructuring of nonbank financial institutions in distress.	2003/04–2005/06
• Improved judicial and legal framework for enforcement of creditors’ claims.	2003/04–2005/06
• Strengthen safety net arrangements for Deposit Protection Fund.	2003/2004
Reforms in the parastatal sector (under the World Bank)	
Fiscal	
• Fiscal consolidation to sharply reduce dependence of the budget on domestic borrowing.	2003/04–2005/06
• Tax reform to streamline the tax system, widen the tax base, and remove disincentives to economic activity.	2004/05–2005/06
• Restructuring of public expenditure in favor of social and economic outlays.	2003/04–2005/06
• Civil service restructuring (under the World Bank).	2003/04–2005/06
• Implementation of new mechanisms for setting wages in the public sector that pay close attention to resource constraints and productivity considerations.	2004/05
• Liquidation of nonessential publicly funded parastatals.	2003/04–2005/06
• Improved expenditure monitoring and control, including a move to a Commitment Control System (CCS).	2003/04–2004/05
• Upgrading of the system for tracking poverty reduction expenditures.	2003/04–2005/06
Labor market rigidities	
• Increase in labor market flexibility, including through a review of the labor market regulations, the wage-setting mechanisms, and the role of the minimum wage.	2003/04–2005/06
Governance	
• Enactment of corruption control bill.	May 2003
• Enactment of Public Officer Code of Ethics Bill.	May 2003
• Strengthening of the judiciary.	2003/04–2005/06
• Constitutional reforms.	2003/04–2005/06
• Application and enforcement of corruption laws and regulations.	2003/04–2005/06
Trade regime	
• Reduction of top external tariff rate from 35 percent to 25 percent	2003/04
• Implementation of a customs improvement program designed to speed up the verification and clearance of goods.	2003/04
• Formulation of new trade policy.	2003/04
• Implementation of comprehensive trade reforms.	2004/05–2005/06
Regulatory and investment environment	
• Reform of the regulatory framework in the telecommunications industry.	2003/04
• Rationalization of the investment code.	2004/05–2005/06

structural conditionality under the program are presented in Box 2. The sequencing of the measures is driven by several considerations, including implementation capacity, political feasibility, and the need to rebuild, at an early stage, credible governance institutions.

A. Macroeconomic Framework, Outlook, and Risks

9. **Under the program, the recovery in economic growth is expected to gain momentum over the medium term.** Based on the sustained implementation of fiscal consolidation and restructuring, as well as the governance and other economic reforms described in the MEFP, inflows of donor budgetary assistance are expected to resume. The latter would support the assumed pickup in government investment from 3.6 percent of GDP in 2002/03 to 7.6 percent of GDP in 2005/06, as well as the required increase in public outlays on social and economic infrastructure (Table 6). Private investment is also projected to increase, reflecting improvements in public infrastructure and a rebound in business and consumer confidence in response to reduced political uncertainty. Real GDP growth is forecast to pick up from 1.2 percent in 2002/03 to 3.9 percent in 2005/06, reflecting a forecast improvement in the terms of trade, and the implementation of policies under the program. Initially, the economic recovery is expected to be driven by a resurgence of activity in the manufacturing, construction, transport, telecommunications, and financial sectors, with the construction and transport sectors benefiting from increased public and private investment outlays. The telecommunications and financial sectors would be aided by the ongoing reforms. Over the medium term, the pickup in growth would be more broadly based and would reflect both higher productivity and capital accumulation from reforms in the parastatal, financial, and labor market sectors, as well as from improved terms of trade and infrastructure.

10. **Notwithstanding forecasts of a strong export performance, medium-term projections for the program period (2003/04–2005/06) indicate that Kenya is likely to face external financing needs averaging about US\$1.3 billion a year, as a result of growing deficits in the external current account (excluding grants).**⁶ The needs would stem in large part from the envisaged expansion in investment-related imports, although part of the investment would be financed by an expected pickup in foreign direct investment. Moreover, external resources would be required to achieve the targeted buildup of foreign reserves to about 4.0 months of projected imports by end-2005/06 from 2.7 months of imports at end-2002/03.

11. **There are, however, risks to this outlook:**

- In addition to possible terms of trade shocks, the increased reliance on donor assistance would raise the vulnerability of budget outcomes from shortfalls in such inflows.

⁶ Section V provides more details.

Box 2. Kenya: Structural Conditionality

Coverage of structural conditionality under the proposed PRGF arrangement

The structural conditions in the first year of the proposed new arrangement cover policy measures to promote economic growth and poverty reduction. The key areas include the following:

- **strengthening expenditure management**—by developing an action plan for introducing a Commitment Control System (CCS) to minimize deviations of expenditure outcomes from targets and a buildup of arrears, completing a report on the new mechanism for determining the salaries of public officials to facilitate a reduction of the wage bill in total expenditure, and reaching understandings on the fiscal implications of restructuring the National Social Security Fund (NSSF), as well as strengthening the financial position of NSSF;
- **improving the coverage and timeliness of data on fiscal operations**—by presenting the 2002/03 final budgetary accounts to the Auditor General by March 2004;
- **reducing conflicts of interest and deepening anticorruption measures**—by creating a clear timetable for completing initial asset declarations by all senior public officials, establishing the Kenyan Anti-Corruption Commission, transferring financial sector regulatory functions from the Ministry of Finance to the Central Bank of Kenya, and devising a plan to clear the stock of pending bills and resolve the stalled projects problem; and
- **accelerating the privatization process**—by presenting a bill for the transparent privatization and sale of public assets, and reaching agreement on a time-bound plan for either liquidating or restructuring the National Bank of Kenya (NBK).
- additional trade reforms to be agreed in the context of the first review under the arrangement.

Status of structural conditionality from earlier programs

The status of structural performance criteria and benchmarks for the previous program are presented in Table 4. The first and subsequent reviews under the program were not completed.

Structural areas covered by World Bank lending and conditionality

The following areas are covered:

- public sector financial management and audit system;
- expenditure management;
- judicial system reform;
- procurement systems;
- civil service restructuring and pay reform;
- capacity building in the delivery of public services; and
- reforms in the parastatal sector.

- An increase in tensions within the ruling coalition could delay the implementation of critical reforms, particularly in areas where the government has just begun to build a broad consensus behind the reforms, such as the rationalization of public services, changes in the wage-setting mechanisms of public employees, privatization, and financial sector reforms. Moreover, close coordination between the executive and legislative branches of government will be required to maintain the reform momentum.
- A resurgence of terrorist attacks could also undermine program implementation. However, the authorities, with the assistance of the main donors, have been taking strong and comprehensive steps to address this problem.

B. Fiscal Policy

12. **The authorities' fiscal program aims at restoring debt sustainability, while providing increased resources for priority poverty reduction spending and the realization of the medium-term development objectives.** The repayment of domestic debt and expected inflows of grants and concessional external finance would facilitate the achievement of both the overall development and debt objectives. Accordingly, the program envisages an expansion of the overall deficit, before grants, from 4.8 percent of GDP in 2002/03 to 6.2 percent of GDP in 2005/06 (Table 7). The primary deficit would also widen modestly. The projected significant expansion in donor assistance would facilitate a reduction in domestic debt in percent of GDP from 25.0 percent in 2002/03 to 20.9 percent in 2005/06 and in the net present value (NPV) of total central government debt from 52.6 percent of GDP in 2002/03 to 45.9 percent of GDP in 2005/06.⁷ The resulting reduction in interest payments from 14 percent of total expenditure in 2002/03 to 9 percent in 2005/06 would free up budgetary resources for priority poverty spending. Box 3 outlines the key actions under the program to contain the growth of debt and to restore fiscal sustainability.

13. **The program also includes explicit budget provision for dealing with most known contingent liabilities** and for addressing the main sources of contingent risks, which have hitherto arisen primarily from bank loans, parastatal operations, pending bills, and stalled projects.⁸

14. **A reorientation of public expenditure as well as improvements in public expenditure management is required** to put the economy on a sustainable, rapid, and

⁷ A sensitivity analysis of the fiscal debt dynamics under the program is provided in Box 3.

⁸ Provision has been made for an amount of Ksh 12 billion for the restructuring of the NBK in 2003/04 and Ksh 11 billion over the program period for the securitization of all verified pending bills.

Box 3. Kenya: Central Government Debt Situation and Prospects

Debt dynamics

Kenya's past weak economic growth performance, coupled with decreasing tax revenues (as a share of GDP) and a significant expansion in public sector outlays, has resulted in a fragile fiscal position and large domestic debt. The net present value (NPV) of total debt-to-GDP ratio is estimated to have exceeded 50 percent, with domestic debt accounting for over 48 percent of total debt at end-2002/03 (Table 6).

Under the staff report scenario, which assumes full implementation of the structural and macroeconomic reforms under the program, the ratio of the NPV of total central government debt to GDP is projected to decline to below 37 percent in 2007/08 (Table 6). However, as suggested by the debt sustainability analysis presented in a supplement (to be issued shortly), Kenya's central government debt dynamics are sensitive to the macroeconomic environment. While NPV of total debt remain broadly on a declining path over the medium term under most of the adverse shocks considered, debt-to-GDP ratios could be significantly higher over the medium term than that in the baseline scenario.¹ In particular, negative shocks to the real exchange rate could undermine fiscal sustainability, with the debt-to-GDP ratio in 2010 significantly higher than the level in 2002.

While this analysis is informative, it should be interpreted with caution for several reasons. First, the assumed shocks are relatively short-lived and occur in 2003 and 2004 only, while the analysis ignores the effects of adverse shocks in other years. More persistent adverse shocks would, therefore, pose more substantial risks to debt sustainability. Second, the analysis does not take into consideration the endogenous relationships between economic variables. For example, a slowdown in economic growth would likely reduce fiscal revenues, thereby worsen the primary deficit. Similarly, high interest rates not only raise the debt burden, but also depress investment demand, thus hampering economic growth. These considerations suggest that the potential risks to debt sustainability could possibly be larger than described here. All of these point to the importance of steadfast structural reforms to promote economic growth, and prudent fiscal adjustments to improve budget performance, thereby reducing the vulnerability of Kenya's debt dynamics to exogenous shocks.

Measures to address the debt problem comprise the following:

- elimination of domestic borrowing by the end of the program period;
- substitution of concessional external borrowing and grants for domestic loans;
- improved debt-management practices, including in the management of defense contracts;
- up-front resolution of known contingent liabilities in the financial and parastatal sectors and an acceleration of the public enterprise divestiture program;
- up-front payments of all London Club debts that have hitherto given rise to large default costs;
- improvements in the modalities for external debt payments that have in the past resulted in arrears and the imposition by creditors of high penalty fees;
- cancellation of all stalled projects, as well as planned elimination of all pending bills; and
- completion of a thorough inventory of all external obligations, with a view to ensuring that all prospective payments are budgeted for.

¹The baseline scenario in the supplement (to be issued shortly) differs from the staff report scenario in Table 6 in that in the baseline scenario the financing gap is closed by additional external borrowing.

poverty-reducing growth path. The program includes the following actions aimed at fiscal restructuring and strengthening expenditure management:

- **reductions in the wage bill** through revised modalities for setting public wages and other entitlements, as well as the minimum wage and the ongoing civil service reform;
- **increased spending on priority social and economic outlays;**⁹
- **ongoing reform of the procurement systems**, including defense procurement, that aims at reducing corruption and getting value for money;
- **strengthened connection between the annual budgets and the medium-term expenditure framework** through better forecasting of resources, costing of programs, and a reorientation of the budget management institutions;
- **enhanced modalities for monitoring, tracking, and reporting of budget operations**, particularly the tracking of poverty spending (Box 4); and
- **development of a Commitment Control System** (Box 5).

15. **Comprehensive tax reforms are under way to improve the neutrality, simplicity, and revenue-yielding capacity of the system.** Reforms initially focus on a combination of actions to improve tax administration and to broaden the tax base. The government is introducing several measures designed to rebuild the credibility and capacity of the Kenya Revenue Authority (KRA). These include a reform of the customs administration; the institution of new modalities for managing the taxation of the petroleum sector, and the full application of the law in enforcing compliance with respect to public entities that are tax collection agencies. Over the medium term, the strategy for reform will be based on: (a) merging the income tax and value-added tax (VAT) administrations to create one domestic tax administration organized along functional lines; (b) strengthening the large taxpayers department as a first step towards full integration; and (c) developing an integrated information technology system. Proposed measures to broaden the tax base include the removal of most exemptions, the lowering of some tax rates to align them with rates in neighboring countries, and taxation of a larger proportion of informal transactions.

⁹ Capital expenditure is projected to rise from 3.6 percent of GDP in 2002/03 to 7.6 percent of GDP in 2005/06 (Table 7). Maintenance and operations outlays would increase from 4.6 percent of GDP in 2002/03 to 5.4 percent of GDP in 2005/06. Spending on essential social and economic services is budgeted to rise from 3.4 percent of GDP in 2002/03 to 4.6 percent of GDP in 2005/06. Meanwhile, spending on defense and interest payments is slated to fall.

Box 4. Kenya: Core Poverty Programs and the Tracking of Expenditures

Following on the work already done during the last few years, the **government decided in early 2003 to expand its current system of tracking poverty-related expenditures**. Up to end-2002/03, the Ministry of Finance had been monitoring, on a quarterly basis, a set of “core poverty programs.” These were mainly social expenditures, which could be considered as a **basic social safety net** for the poor. However, this list of expenditures was very limited, and the government, as part of the medium-term expenditure framework, consulted with development partners and spending ministries to expand this list.

The ultimate aim of this exercise is to ensure that core poverty expenditures are fully **embedded in the ERSWEC** and are **derived from specific development targets** (like improving access to primary education, providing safety nets such as training to long-term urban unemployed youth, etc.). This is important because (i) when Kenya completes a full PRSP, the PRSP process will allow continuous monitoring of these expenditures; and (ii) any future changes to the list of expenditures would result from stakeholder consultations.

The government has recently completed a **draft listing of pro-poor expenditures** for both recurrent and development expenditures, which **contains priority programs per sector, linked to their budget codes to enable tracking of these key programs**. As the PRSP process moves forward, this listing could be further refined, if needed, to fully reflect government expenditure priorities.

Some of the main poverty-reduction measures under the program include:

- actions designed to maintain low inflation and promote strong economic growth;
- a reorientation of the budget toward pro-poor expenditure through increased allocations for education, health, roads, water, and sanitation;
- the move to universal free education from January 2003 onward;
- steps to revamp the vocational education and training system;
- an improvement of governance and reduction of corruption, with a view to lowering the costs of service delivery, particularly in rural areas as informal fees and charges are curtailed;
- a strengthening of the civil service and the public service delivery system;
- a restructuring of the trade system, which is expected to reduce the prices of key imported food items (maize and sugar) that feature prominently in the consumption basket of the poor;
- actions to tackle the high prevalence of AIDS/HIV in rural areas, which are expected to positively affect agricultural productivity and rural incomes; and
- a rehabilitation of rural health facilities.

Box 5. Kenya: Public Expenditure Management

Background

Weak public expenditure management (PEM) has been a long-standing issue in Kenya. A recent joint assessment mission by the World Bank, the IMF, the European Commission, the U. K. Department for International Development (DFID), and the Kenyan authorities found Kenya's PEM systems to be satisfactory in only 3 out of 15 areas. Shortcomings in PEM arise in all steps of the budget process, including budget formulation, budget execution, and budget reporting.

Weaknesses in budget preparation, together with poor budget execution and expenditure control, including poor financial compliance and accountability as well as flawed contract design and insufficient costing of policies, have led to the persistent accumulation of expenditure arrears. By December 2002, pending bills amounted to nearly 8 percent of projected 2002/03 recurrent expenditure (excluding wages and interest).

Measures

Measures to improve PEM are important elements of the program. Several structural and quantitative performance criteria and benchmarks target improvements in key areas of PEM. Structural performance clauses in the areas of budget formulation and execution include the development of a Commitment Control System (CCS) to minimize deviations of expenditure outcomes from the approved budget and avoidance of a buildup of new arrears. In the area of budget reporting, presentation of the Auditor General's Report on the 2002/03 public accounts to parliament is another benchmark. Corresponding to these structural measures, quantitative performance criteria include the nonaccumulation of domestic budgetary and external payments arrears.

These measures are consistent with the findings and recommendations of two FAD technical assistance missions in 2000 and 2001 and a PEM assessment mission in 2003. The government is preparing a comprehensive program of public finance reforms that will include the recommendations made by the 2003 PEM mission.

C. Poverty Reduction under the ERSWEC

16. **The ERSWEC aims at tackling poverty by expanding the opportunities available to the poor for productive employment and at improving the quality of life of the poor.** It also outlines special programs aimed at addressing entrenched poverty in specific geographical areas, particularly the arid and semiarid lands. As most of the poor live in rural areas, the focus will be on reforming the agricultural sector and encouraging the growth of

medium- and small-scale enterprises. A key element of the strategy is the budgeted expansion of spending on rural infrastructure, particularly feeder roads, which are essential to the broadening of market opportunities. Moreover, a review of the agricultural extension and research systems is planned to help in the development of crop and input mixes most suitable for different agronomic regions. Plans are under way to upgrade microfinance institutions. Increasing access of the poor to better education and health services would also play a central role in the revitalization of rural areas. Box 4 provides a list of some of the main poverty reducing measures under the program.

D. Governance Strategy

17. **The government has placed its anticorruption strategy at the top of its reform agenda** and has embarked on a major strengthening of Kenya's governance and anticorruption institutions, as corruption has been largely responsible for Kenya's poor economic performance (Box 6). The governance reform agenda that is spelled out in the MEFP includes the following actions:

- Enforcement of the Anti-Corruption and Economic Crimes Bill and the Public Officers Ethics Bill enacted in May 2003.
- Institution of mechanisms for implementing the Public Officer Ethics Act under which all public officials, including members of the judiciary, executive, and legislature, are expected to complete declarations of their assets and those of their families by December 2003. Completion of these declarations by December 2003 is a benchmark under the program.¹⁰
- Establishment of an independent Anti-Corruption Commission, which will be responsible for investigating alleged corruption cases. However, the Constitution Review Commission has proposed that the Anti-Corruption Commission should not have independent powers of prosecution, which will continue to be vested in the Attorney General. Full establishment of the Anti-Corruption Commission, including the filling of the key management positions of the body, is a benchmark under the program.
- Initiation of judicial reform, which has also involved the removal of corrupt judges.
- The cancellation of all stalled projects with effect from June 2003 was one of the 2003/04 budget measures. A provision for covering the resulting penalty fees has been included in the budget. The program also includes clearance of all pending bills during the three-year period. The gestation of stalled projects and pending bills, and the amount and timing of payments on these activities have been driven primarily by corruption.

¹⁰ Significant progress has already been made in these areas.

Box 6. Recent Governance Measures Taken or Announced by the Government

- The government has publicly placed the fight against corruption and the completion of the constitutional review process at the top of its agenda.
- The government has established a Ministry of Justice and Constitutional Affairs, which is spearheading efforts in the governance area. The Ministry has completed a five-year strategic plan, in collaboration with both civil society and development partners, and launched a five-year national anti-corruption campaign in July 2003.
- The government has established a Department of Governance and Ethics in the Office of the President to advise the President on governance matters and, among more specific duties, to oversee the implementation of the Public Officer Ethics Act and provide guidance to public servants on possible conflict of interest and ethical matters in the execution of their duties. The department is headed by a well-respected former head of Transparency International, Kenya.
- The Ministry of Justice and Constitutional Affairs and the Office of the President (Governance and Ethics) launched the Public Complaints Office in April 2003 to receive, process, and act on complaints of maladministration, abuse of office and corruption, and to act as the government's "clearing house" for such complaints. It is a precursor to the anticipated Ombudsman Office that is expected to be established via the constitutional review process.
- In May 2003, Parliament enacted the Anti-Corruption and Economic Crimes Act (2003) and the Public Officer Ethics Act (2003). The Kenya Anti-Corruption Commission (KACC)—with five regional offices—is to be established shortly, following the endorsement by Parliament of the KACC Advisory Board. The administrative procedures for assets disclosures have been published and various codes of conduct and ethics are being finalized.
- All sales of public assets, including housing, have been suspended because of concerns about corruption. The government plans to establish a policy framework for privatization – to be approved by parliament – that will provide a transparent process for determining public assets to be sold and how privatization would be undertaken. A draft bill is before parliament.
- A Commission of Inquiry into the Goldenberg scam has been established with a mandate that covers the seizures of assets acquired with illegally obtained money under the Goldenberg scheme.
- All payments of pending bills have been suspended, pending a thorough audit of the outstanding stock, because of concerns about corruption. The government is reviewing all contracts relating to jobs undertaken for the government and for which payments are pending.
- With the assistance of the World Bank and other donor agencies, the government has initiated an action program to strengthen the judiciary. This reform program is led by the Ministry of Justice and Constitutional Affairs. As part of the reform of the judiciary, a new Chief Justice has been appointed and a High Court Judge, who while under investigation by the Anti-Corruption Police Unit was presiding over the Goldenberg case, has resigned and been charged in court for involvement in corrupt activities. In addition, 42 judicial officers have either resigned or been dismissed on corruption-related suspicion. A committee on "reform and development" of the judiciary that was appointed in March 2003, has issued a report confirming that corruption has been endemic in the judiciary. A nonpublic second part of the report reportedly identifies by name, and with documentation, five out of Kenya's nine Appeal Court judges and 18 of 36 High Court judges as corrupt, and these reportedly have been asked by the Chief Justice to resign or face trial.
- The police force has been reshuffled under a new Police Commissioner.
- All senior public officials under serious investigation for corruption have been suspended. All procurement officers in the public sector have also been suspended, with a view to breaking corruption networks that had emerged in the procurement system.
- Seminars and workshops on corruption prevention for civil servants at all levels are conducted under the auspices of the Public Service Integrity Program (PSIP) and the Anti-Corruption Police Unit (being replaced by the KACC). In July 2003, a national anti-corruption workshop was held with President Kibaki, the World Bank President and the Transparency International President in attendance, with participants from civil society and the private and public sectors.

- Reform of the public sector procurement system, with World Bank assistance. In addition, public officials have been forbidden from supplying goods to the government and from participating in public auctions.

E. Financial System Issues

18. **Over the medium term, the reforms aim at addressing the major weaknesses in the financial system that are discussed in Box 7**, with an initial focus on banks in distress and a strengthening of the regulatory system. Effective implementation of the complex reform agenda that is outlined in Box 8 will be essential to reduce financial sector vulnerabilities and address some of the main problems that have given rise to the large nonperforming loans (NPLs). This will require close consultations between banks and the monetary authorities, the building of a broad consensus behind the reforms, and a comprehensive revision of key banking legislation. In this regard, some of the provisions of the Banking Act provide for the control by the Minister of Finance of the interest rates and charges set by banks. The authorities intend to bring before parliament by June 2005 major revisions to the Banking and CBK Acts, which would, among other things, bring them in line with the market orientation of their economic policies. Pending the revision of the Acts, the authorities will not apply the restrictive provisions of the Acts—a continuous performance criterion under the program. The work of the ongoing Financial Sector Assessment Program (FSAP) will be of considerable assistance in helping the authorities to develop the strategies for addressing the issues mentioned above.

F. Trade Reform and Competitiveness Issues

19. **The authorities recognize that greater attention will need to be devoted to trade policy** to realize the growth and poverty reduction objectives of the ERSWEC. To this end, trade reforms will, over the medium term, focus on:

- **an immediate lowering of the maximum external tariff to 25 percent from 35 percent and a reduction in the number of tariff-bands from 5 to 3**, consistent with the agreement of the East African Community (EAC) customs union (Box 9);
- **a further reduction of the maximum external tariff rate during the program period** from 25 percent to 15 percent to be discussed in the context of the first review; and
- **reduction of current export incentive schemes.**

The authorities are also implementing a variety of **measures designed to improve the efficiency of customs administration, particularly the clearing system to facilitate trade**. These include the following:

Box 7. Kenya: Main Weaknesses in the Financial Sector

The financial sector suffers from the following main weaknesses:

- **High level of nonperforming loans (NPLs).** NPLs were reported at about 30 percent of total loans at end-June 2003, a level arising from political lending at public sector banks, insider or connected lending, especially at smaller private banks, and pervasive legal problems in enforcing creditor rights.
- **Large intermediation margins.** A high level of NPLs, together with high costs related to the need for relatively large spending on security and poor financial infrastructure, results in substantial intermediation margins, with spreads between lending and deposit rates of about 13 percentage points.
- **Undercapitalized banking system.** The banking system is undercapitalized and is therefore vulnerable to negative shocks. An adjustment for loan misclassification and underprovisioning lowers the aggregate capital adequacy ratio from the reported figure of 17 percent to a figure well below the 12 percent minimum requirement. The large banks with government ownership have negative capital after the adjustment.
- **Unhealthy public sector banks.** Public sector banks suffer from low or negative profitability, high costs, and substantial NPLs. The National Bank of Kenya is bankrupt.
- **Weak banking supervision.** The legal frameworks for the supervision of banks and other financial institutions are inadequate and need improvement.
- **Fragile National Social Security Fund (NSSF).** The NSSF has large losses arising from governance problems and unsound investment decisions.
- **Weak insurance companies.** There is a proliferation of insurance companies in Kenya relative to the volume of premiums, and many companies appear to have insufficient reserves to meet their liabilities.
- **Underdeveloped capital market.** There is a shortage of new issues on the Nairobi Stock Exchange. Bond markets, housing finance, insurance, and microfinance appear to be underdeveloped relative to Kenya's potential.
- **Fragmented legal framework for insolvency and creditor rights.** Insolvency laws are outdated.

Box 8. Kenya: Financial Sector Reforms

The program for 2003/04 includes the following measures designed to improve the performance of the financial system:

- amendments of the Banking and Central Bank Acts to facilitate the transfer from the Ministry of Finance (MOF) to the Central Bank of Kenya full powers of licensing, delicensing, regulation, and supervision of banks;
- a tightening of prudential regulations on provisioning, with a view to ensuring conformity with international best practice and ensuring compliance with all prudential norms by all banks;
- commence work on a comprehensive revision of the Banking and CBK Acts, which would also involve the removal of the restrictive provisions of the Acts;
- a budget provision of Ksh 12 billion for the restructuring of the NBK, which should enable the bank to comply with the prudential regulatory requirements by December 2003;
- a restructuring of the National Bank of Kenya, with the assistance of the World Bank, by June 2004 and subsequent privatization;
- placement on the market of government shares in the KCB by December 2003;
- increase the transparency of the banking industry through the regular publication of base fees, commissions, and service charges; and
- initiation of new anti-money-laundering legislation, taking into account relevant findings from the anti-money-laundering/combating the financing of terrorism (AML/CFT) assessment included in the Bank-Fund Financial Sector Assessment Program for Kenya.

Additional medium-term measures to further improve the financial system include the following:

- enactment of revised Banking and CBK Acts;
- divestiture of the government's ownership in the remaining public banks;
- strengthening the judicial system, which should result in better enforcement of creditor rights, and an expansion of the role of commercial courts (the ongoing work of the Law Review Commission will lead to the updating of the Insolvency and Companies Acts);
- expand the outreach and improve the operations of microfinance institutions;
- recapitalize and strengthen the management and oversight of the NSSF; and
- strengthen supervisory frameworks for nonbank financial intermediation.

Box 9. Trade Reform and Competitiveness Issues

Background

Protection has been reduced, but is still relatively high. Following the extensive trade and exchange reforms of the early 1990s, no price and foreign exchange restrictions remain. There are, however, some import controls based on health, environmental, and security concerns, and imports are subject to a preshipment inspection for quality, quantity, and prices. The trade regime is rated as moderately restrictive,¹ but complex with 5 tariff bands and rates ranging from 0-35 percent; highest for domestically produced consumer goods, and lowest for raw materials, capital, and intermediate goods.² In addition, an import declaration fee of 2.75 percent is levied on all imports.

Kenya has developed a wide range of export incentives including a manufacturing-under-bond scheme, the export promotion zones (EPZs),³ and a VAT exemption scheme. Exporters contend that except for the EPZs, the schemes do not function effectively. **Cumbersome and inefficient customs procedures**, moreover, are frequently cited in business surveys as a major impediment to efficiency and the expansion of exports, as well as a source of corruption.

Reforms

The key trade policy actions are the following:

- the immediate lowering of the maximum tariff rate from 35 percent to 25 percent consistent with the agreement on EAC Customs Union;
- the reduction from November 2003 of tariff bands from five (0, 5, 10, 25, 35) to three (0, 10, 25);
- introduction of the electronic and verification systems as part of the ongoing reform and modernization of the customs administration system; and
- addressing the weaknesses in the system of export incentives.

Impact of Reform Agenda

A key concern is the revenue losses associated with trade liberalization. Kenya receives about 43% of its customs revenue from items that attract a tariff rate of 30-35%:

• Tariff bracket	0-5	5-10	10-15	15-20	20-25	25-30	30-35	60-100
• Share of revenues	8%	2%	22%	3%	11%	4%	43%	7%

Current estimates suggest that a lowering of the upper band from 35 percent to 25 percent may result in a near-term reduction of customs revenues by as much as 2.3 billion Kenyan shillings (13 percent of customs revenues). In addition, as regards customs revenues, the authorities highlight the following:

- The major shortfalls in revenues compared to the budget projections for the last three years have been in the customs area, and this has been attributed to weaknesses in customs administration and corruption.
- Improved tax administration, particularly at the port of Mombassa, as well as a reduction in smuggling could result in a substantial increase in revenue. This would facilitate a more ambitious tariff reduction effort.

¹ Kenya's trade regime is rated 6 on the IMF's 10-point trade restrictiveness index, with 10 being the most restrictive.

² With an exception for sugar and wheat that are taxed at 100 percent and 60 percent respectively.

³ Kenya enacted EPZ legislation in 1990, well ahead of most African countries. It now has 23 zones. Some are run by the government but most are privately operated.

- Introduction of **electronic clearance and verification systems; and**
- Institution of work shifts by staff to speed up the turnaround time at Kenyan ports and cope with the requirements of the African Growth and Opportunity Act. This will also help to **reduce the clearance time for goods** destined to neighboring countries to a maximum of two days.

20. The first review of the PRGF-supported program will focus on further reforms of the trade regime.

21. **To complement the trade reforms and ensure that producers face an appropriate structure of economic incentives, the authorities intend to maintain the flexible exchange rate system.** Other actions under the program are expected to influence the evolution of factors determining Kenya's international competitiveness. These include the following:

- the reform of the utility and telecommunications sectors;
- the ongoing improvement of port services and customs procedures;¹¹
- upgrading of the road network;¹² and
- labor market reforms, particularly the wage determination mechanism, to enhance labor market flexibility.

IV. THE PROGRAM FOR 2003/04

22. **The macroeconomic framework for 2003/04 is based on the following:** (i) a modest real GDP growth of 1.9 percent (Table 6), reflecting in part the negative effects of the terrorism-related travel ban, which is expected to lower GDP by slightly over 1 percent in 2003;¹³ (ii) a significant dissipation of price pressure, with CPI falling by 4 percent by end-2003/04 (Table 6), reflecting a projected return of food and fuel prices to trend levels; underlying inflation is projected to remain below 5 percent; and (iii) a modest buildup in gross international reserves to about 2.8 months of import cover. Achievement of these objectives will require concerted implementation of the fiscal and structural measures

¹¹ Surveys indicate that many investors believe that inefficient port operations are Kenya's single most important infrastructural constraint.

¹² Kenya's road system is a serious impediment to export performance, especially since many products need to be transported from remote agricultural areas to main shipping areas (Nairobi and Mombassa).

¹³ Growth was also weakened by the early onset of rains, which hurt agricultural production.

outlined in the MEFP. **Structural conditionality under the program covers key areas such as governance, fiscal policy, and privatization (see Box 2 and Table 1 of Annex I to the Attachment).**

A. Fiscal Policy

23. **Consistent with the objective of debt sustainability, the approved budget for 2003/04¹⁴ targets a substantial reduction in the domestic borrowing requirement from 5.0 percent of GDP in 2002/03 to 3.3 percent of GDP, with about 1.7 percent of GDP of the latter arising from transitory payments, including the recapitalization of banks, a spike in external debt repayments, and the programmed reduction of pending bills. The 2003/04 budget envisages an increase in total revenue collection of 1.5 percent of GDP,¹⁵ with the focus of revenue policy on the enhancement of capacity and integrity of tax administration (Table 7).**

24. **Expenditure is projected to rise by 2.2 percent of GDP in 2003/04, driven primarily by increases in public outlays on education, operations and maintenance, and capital spending. The increased allocations represent the first important step toward implementing the ERSWEC. The budget includes expenditure rationalization measures, which are outlined in the MEFP (paras. 16–18). Details of the expenditure management measures under the program are provided in Box 5 and in the MEFP (para. 19), and the main elements of the system to track expenditure on poverty reduction programs are provided in Box 4.**

25. **An important element of the authorities' development strategy is to raise the proportion of local authorities' spending to at least 20 percent of total expenditure by 2008.¹⁶ To achieve this objective without undermining fiscal prudence, the focus of the program will be on actions to strengthen the local authorities' revenue base, budget management, and program implementation capacity. This will lay the basis for an expanded role for local governments in the implementation of the poverty reduction program.**

¹⁴ The budget for 2003/04 that was passed by parliament in August 2003 is consistent with the macroeconomic framework of the program.

¹⁵ As indicated in the MEFP, most of the increase in revenue is accounted for by the rechanneling to the budget of revenues that were previously used to support extrabudgetary outlays. These identified new revenue sources are expected to more than offset losses in revenue arising from the reduction in VAT from 18 percent to 16 percent and excise duty on soft drinks from 15 percent to 10 percent.

¹⁶ Transfers from the central government under the Local Authorities Transfer Fund (LATF) account for about 25 percent of the resources of local governments. LATF resources are used to fund poverty-reduction outlays.

26. **Public enterprise reform** is an important plank in the government's reform agenda and is critical to enhancing the role of the private sector in the economy. Kenya's large parastatal sector has been a significant source of contingent liabilities and has generally operated inefficiently. The planned reforms include the privatization of most of the enterprises, the concessioning of natural monopolies, and the strengthening of the operations of the remaining few state bodies, such as universities (MEFP, para. 27). To ensure transparency in the privatization process, the government intends to introduce a Privatization Bill in parliament by the end of 2003, which is also a benchmark under the program. An important part of the bill is the establishment of a Privatization Commission to manage the process. The government has decided to accelerate the privatization of key public enterprises and will announce by December 2003 a timetable and list of enterprises to be placed on the market. Already, the government has announced its intention to place on the market its 35 percent shareholding in the KCB.

B. Monetary and Exchange Rate Policies

27. In line with the emphasis of the authorities on the maintenance of low inflation, **the monetary program aims at containing underlying inflation below 5 percent in 2003/04** (Table 8). The inflation objective will be achieved through reserve money targeting, with broad money (M3X) as the intermediate target, and open market (repurchase and reverse repurchase) operations as the main instruments. In this regard, broad money growth will be targeted at 7 percent in 2003/04, consistent with the anticipated gradual increase in economic activity (Table 8). By promoting financial stability and low inflation, the monetary program would be consistent with a continued lowering of the country's risk premium and sustained low interest rates during 2003/04. Together with the planned financial sector reforms, this program would help encourage a gradual 5 percent expansion of bank credit to the private sector. As money demand is expected to display some variability in response to changes in economic conditions, the CBK will continue to use a broad set of indicators to monitor future inflationary pressures and to gauge the appropriateness of the monetary policy stance. Monetary targets will be reassessed at the time of program reviews.

28. **During the first two months of 2003/04, reserve money was well above the target under the program.** However, the authorities have agreed to sterilize the excess reserves by end-December 2003. In discussions with the authorities, the staff has pointed out that the combination of excess liquidity and low interest rates on government securities could induce undue pressure on the balance of payments. In this regard, the timing of the reduction of required cash reserves—before addressing major weaknesses in the judiciary and the banking system that have increased the credit risks, contributed to the high interest rate margins, and caused the banks to be cautious toward new lending—was premature and would likely not result in the envisaged reduction in bank lending rates and increased credit to the private sector. In addition, the staff has pointed out that, in setting monetary policy, consideration should be given to the state of the banking system. In this regard, the environment of low treasury bill interest rates, when set against the large NPL problem and other weaknesses in the banking system, carries major risks; it could lead to widespread bank failures, because government securities comprise a substantial proportion of banks' assets. The staff has also

requested that the authorities expand their coverage of financial statistics to include the regular collection and publication of data on the assets and liabilities of nonbank financial institutions, which would improve the authorities' ability to monitor and manage the financial system. Meanwhile, the monetary authorities have continued to study the monetary transmission mechanism and the scope for introducing inflation targeting in Kenya.

29. **Kenya has a floating exchange rate regime**, which has, thus far, served the economy well. The authorities have expressed their intention to retain this regime. They intend to limit exchange rate interventions to smoothing short-term volatility, offsetting the variability in donor flows, effecting government external debt payments, and meeting the net foreign reserves targets. They are committed to making full use of exchange rate flexibility in response to both medium- and long-term exogenous shocks.

30. **The appreciation of the exchange rate through May 2003 has raised concerns about its likely impact** on the competitiveness of the export sector, particularly at a time of falling export prices for Kenya's traditional export crops: tea and coffee. Export volumes of these commodities have been sluggish in the recent past. However, the strong performance of horticultural and manufacturing exports, which grew at annual average rates of 23 percent and 36 percent, respectively, in the three years to 2002, suggests that some major export operations have remained competitive. In view of this mixed record, exchange rate developments will need to be monitored closely.

C. Safeguards Assessment

31. The recently completed on-site safeguards assessment of the CBK found that the bank had made **notable progress in strengthening its safeguards since the December 2000 assessment**. The principal achievements of the CBK include the following: (i) adoption of an external audit rotation policy and appointment of a new external audit firm to replace a firm that had audited the CBK since 1966, (ii) resolving accounting issues around government transactions, including reaching agreement with the government on regularizing the frozen government loan accounts, (iii) improvements in the internal audit function, and (iv) adoption by the CBK Board of an internal control policy paper. Despite these actions, some vulnerabilities remain, mainly in the areas of financial reporting and in monetary data reporting. The authorities accepted the actions proposed by the staff for addressing these weaknesses, which will be incorporated in the program at the time of the first review.

D. Statistical Issues

32. **While Kenya produces adequate macroeconomic statistics to monitor performance under the program, those statistics have deteriorated over the past decade, and weaknesses in key statistics hamper economic analysis and surveillance (Appendix V)**. The staff expressed concerns about (i) the problems involved with monitoring budgetary data, in particular domestic arrears and pending bills; (ii) the timeliness of foreign trade data; and (iii) the accuracy of national accounts data. The authorities indicated that they

were taking actions, with donor assistance, to improve the quality and timeliness of these data.

V. EXTERNAL FINANCING AND CAPACITY TO REPAY THE FUND

33. **The external current account deficit is expected to widen by about 4 percent of GDP to 4.9 percent of GDP in 2003/04, and to rise further over the medium term, to about 11 percent of GDP in 2005/06** as both private and public investments are projected to register marked increases in response to a pickup in economic rehabilitation activities, causing a strong rebound in imports (Table 9). On the other hand, export volume growth would take place with a lag, and would be modest in 2004 and 2005 before strengthening in later years. Reflecting these projected trends and the programmed buildup in gross international reserves, Kenya would face substantial financing gaps (Table 10). The latter are expected to be largely filled by donor inflows, which are projected to increase markedly, partly in response to the resumption of a Fund-supported program. Also, reflecting a reduction in political uncertainty and the increased integration of the Kenyan economy into global markets, both private transfers and foreign direct investment would rise. Nevertheless, a rescheduling of Kenya's external debt obligations with the Paris Club would be required to fill the financing gaps. Total projected financing needs¹⁷ are expected to average about US\$1.3 billion per year over 2003/04 to 2005/06 (Table 10). For 2003/04, the unidentified gap reflects a possible Paris Club rescheduling, while for 2004/05 and 2005/06, the unidentified gap is expected to be filled by both a Paris Club rescheduling and an expected but unidentified program support.

34. **Overall total donor support is projected to increase from 6.5 percent of GDP in 2003/04 to 9.9 percent of GDP in 2005/06 (Table 6).** While Kenya has received primarily project support in recent years, the share of program support in total donor financing would rise over the program period, so that program and project support would come to comprise roughly equal shares of total donor support.¹⁸ It is also expected that the share of grants in total donor support would rise from about 43 percent in 2000/01 to around 50 percent during the program.¹⁹ The World Bank is expected to provide an average of US\$ 300 million per annum (program and project support) over the period 2003/04 to 2005/06.

35. **Kenya's projected external financing requirements are high but appear achievable,** based on the experience of other low-income countries that have implemented,

¹⁷ Total financing needs are the sum of program support, project support, and the unidentified gap in Table 10; the latter is defined as expected, but unidentified support, and includes possible debt rescheduling.

¹⁸ Budgetary support was withheld on concerns about Kenya's of governance system.

¹⁹ This assumes that the bulk of the expected but not yet identified program support would be in the form of grants.

on a sustained basis, strong policy reforms. Since donor grants (as opposed to concessional loans) would comprise a large share of total external resources over the period during 2003/04–2005/06, and as FDI flows increase in the medium term, Kenya's external debt (in percent of GDP) would be on a declining trend (Tables 10 and 11), despite the large external inflows. Based on the baseline medium-term framework, which foresees increased growth and low inflation, Kenya's external debt is projected to be below the thresholds under the enhanced HIPC Initiative.²⁰ Total Fund credit outstanding to Kenya is projected to rise from 8.3 percent of gross international reserves at end-2003 to 11.0 percent at end-2005 (Table 2) before declining to 5.0 percent by end-2010. Over this period, debt service to the Fund, as a share of exports of goods and services, would rise from 2.3 percent in 2002 to a peak of 6.3 percent in 2006, before declining to 3.3 percent by 2010. Even if the high level of external financing envisioned under the program was delayed or failed to materialize in full, it is expected that Kenya would still be able to meet its repayments to the Fund, as these obligations would not exceed 14 percent of international reserves (even if reserves were to remain at their end-2002 level). Given Kenya's good repayment record to the Fund, the projected increase in its gross international reserves, and the authorities' commitment to economic reforms, Kenya is expected to meet its financial obligations to the Fund in a timely manner.

36. The authorities have indicated their intention to seek a rescheduling from the Paris Club.²¹ In previous reschedulings, Kenya requested Houston (nonconcessional) terms because of concerns about the potential negative impact of concessional terms on export credit flows and aid flows. However, as an IDA only country, Kenya is potentially eligible for more concessional terms (such as Naples terms), although given its debt levels, it would not qualify for assistance under the enhanced HIPC Initiative. The Kenyan authorities are currently discussing with their key creditors/donors possible Paris Club rescheduling terms. A revised debt sustainability analysis (DSA) has been prepared based on updated debt data, including possible assistance to support the poverty-reduction and other Millennium Development goals. The new DSA confirms that the NPV of Kenya's external debt to exports remains below the HIPC threshold. The results also indicate that following the prospective Paris Club rescheduling, Kenya would not require future reschedulings of its external debt, as debt sustainability indicators do not deteriorate significantly under a variety of plausible shock scenarios.

²⁰ A new DSA, based on revised data has just been completed (Table 11). The main results of the new DSA are presented in a supplement that will be issued shortly.

²¹ For program financing purposes, a comprehensive rescheduling of pre-cut-off debt maturities (principal and interest) falling due through end-June 2004 is assumed along with comparable treatment from other creditors.

VI. STAFF APPRAISAL

37. **Notwithstanding the poor implementation of policies and the weak economic performance under the last PRGF-supported program, a new PRGF arrangement is proposed for several reasons.** First, the authorities have implemented all the governance measures that had not been undertaken under the previous arrangement. Second, the government has formulated and begun to implement a development strategy—the ERSWEC—which outlines a broad-based agenda for tackling Kenya’s deep-seated economic problems. Third, the authorities have developed a credible plan for completing a full poverty reduction strategy paper (the Economic Recovery Strategy; ERS), as outlined in the accompanying ERS preparation status report. Finally, balance of payments forecasts indicate that moving the economy to a sustainable long-run growth path will result in large financing gaps over the medium term that will require significant concessional assistance.

38. **Key priorities for the new three-year arrangement include the promotion of strong economic growth** through the implementation of governance and anticorruption measures, public enterprise restructuring, trade liberalization, and financial sector reform; restoration of fiscal sustainability; and the reorientation of public finances, particularly public expenditure, in line with the poverty reduction and growth objectives.

39. **The authorities’ decision to place governance at the center of its development strategy is the right approach in view of the pervasive role that corruption has played in recent years in undermining overall economic performance and the environment for foreign direct investment, and in weakening the fiscal position and Kenya’s relations with the donor community.** The wide-ranging nature of the reforms and the authorities’ determination to implement them fully should help to revitalize the economy, garner broad public support for the reforms, and promote strong donor support. Continued focus on strong enforcement of the anticorruption laws and on reforms of the judiciary and procurement systems is essential and should yield early dividends. Rigorous and sustained implementation of the anticorruption agenda will be necessary to establish credibility for the governance efforts.

40. **The program’s focus on fiscal consolidation is essential if the large domestic debt is to be reduced, real interest rates kept low, and the exchange rate maintained at competitive levels.** The staff supports the strategy of strengthening revenue performance by improving tax administration and broadening the tax base, as well as the planned reorientation of expenditure in favor of priority social and economic spending. To sustain such a shift in expenditure, it will be important to address the forces that have in recent years led to the marked rise in the wage bill. The staff, therefore, welcomes the decision to set up a committee to advise on new mechanisms for determining the wages of civil servants; the committee is expected to complete its work before the conclusion of the first review under the program. Looking ahead, the staff would like to encourage the authorities, with World Bank assistance, to complete the civil service reform expeditiously, as this will also help to ease pressure on the wage bill.

41. **Successful implementation of the poverty reduction program will depend to a large extent on improving public expenditure management, including a better tracking of poverty spending.** The staff commends the authorities on the steps that they have recently taken to enhance their poverty-tracking system, as effective monitoring of expenditure on a regular basis is essential to achieve budget intentions. Success in this area will also depend on establishing an appropriately well-staffed unit in the Ministry of Finance.

42. **Addressing the distortions in the public enterprise sector is essential for growth and fiscal consolidation.** The staff, therefore, commends the authorities' decision to accelerate the privatization process and to set up a Privatization Commission to manage the divestiture program. However, care needs to be taken if this undertaking is to succeed and public support is to be maintained. In the past, the program experienced difficulties in completing divestiture, owing to low offer prices, in part because of deficiencies in managing the sales process and corruption. The staff urges the authorities to engage professionals as a way of generating strong investor interest and to maximize realized values. The staff believes that the measures that have been taken to increase the transparency of the divestiture process will help to make the program successful.

43. **Financial sector policies need to emphasize the strengthening of performance in the sector to promote financial intermediation.** The banking system is in a fragile state and could deteriorate further, with large fiscal costs, if early remedial actions are not taken. The staff, therefore, welcomes the reform strategy elaborated in the MEFP, which, if fully carried out, will help to reduce NPLs and the role of the government in the financial sector and strengthen CBK oversight over the sector. For this to be achieved, a speedy restructuring and subsequent privatization of NBK are crucial. The staff would also urge the authorities to move promptly with the reforms of the pension fund (NSSF) and to strengthen the supervision of nonbank financial enterprises. Effective implementation of these reforms will require close cooperation between the monetary authorities and banks, an early revision of key banking legislation, and the building of a broad consensus behind the reforms.

44. **Monetary policy should remain focused on combating inflation.** The authorities' decision to mop up the outstanding excess liquidity by the end of this year is, therefore, welcome as allowing banks to draw down their large excess reserve position could undermine the effectiveness of monetary policy and generate balance of payments pressures. The CBK should remain vigilant, however, as monetary aggregates are expected to show some variability in response to the changing economic environment and reforms under the program. This will be a major focus of the next program review.

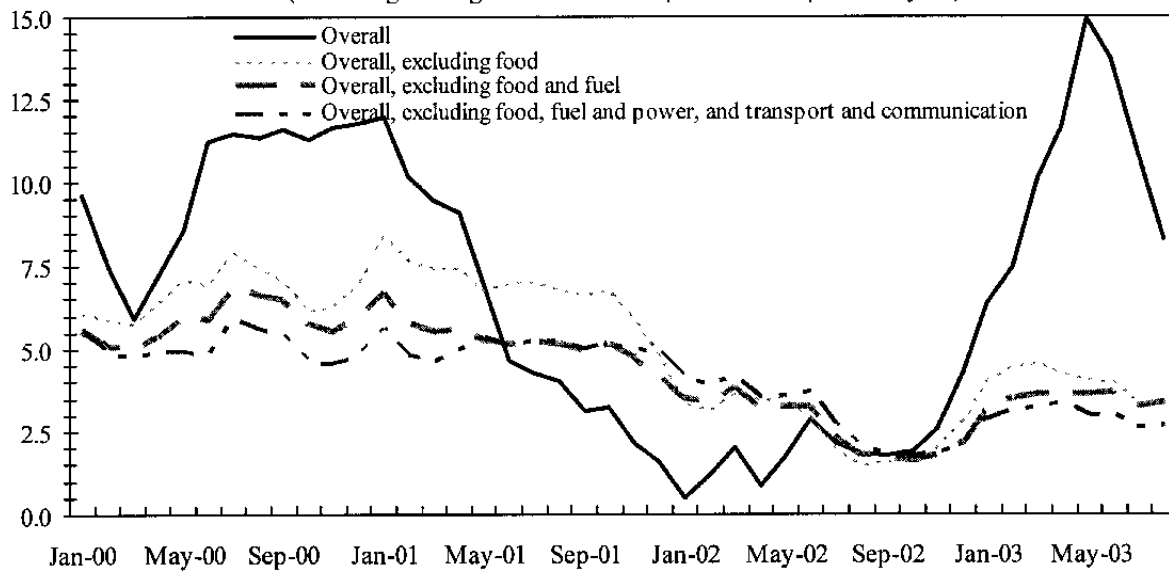
45. **The staff welcomes the increased attention that the authorities are devoting to trade policy and structural reforms to ensure international competitiveness.** This should help to foster a more competitive domestic environment and to expand exports, which are key ingredients to achieving the authorities' poverty reduction and growth objectives. In this regard, further trade reforms will be discussed in the context of the first program review. In addition, it is vital that the authorities take steps to fully implement their regional trade commitments.

46. **The staff welcomes the decision of the authorities to maintain a flexible exchange rate system.** While the exchange rate does not appear to have been a major hindrance to export performance, the appreciation of the currency in the first half of 2003 is potentially a source of concern, and there remains a need to monitor closely exchange rate developments.

47. **The program faces risks** largely centering on possible terms of trade shocks and likely transitory shortfalls in donor inflows, as well as on regional and political developments that need close monitoring. In particular, domestic political developments could necessitate consultations that are wider ranging than normal and that may have a bearing on the pace and intensity of policy implementation.

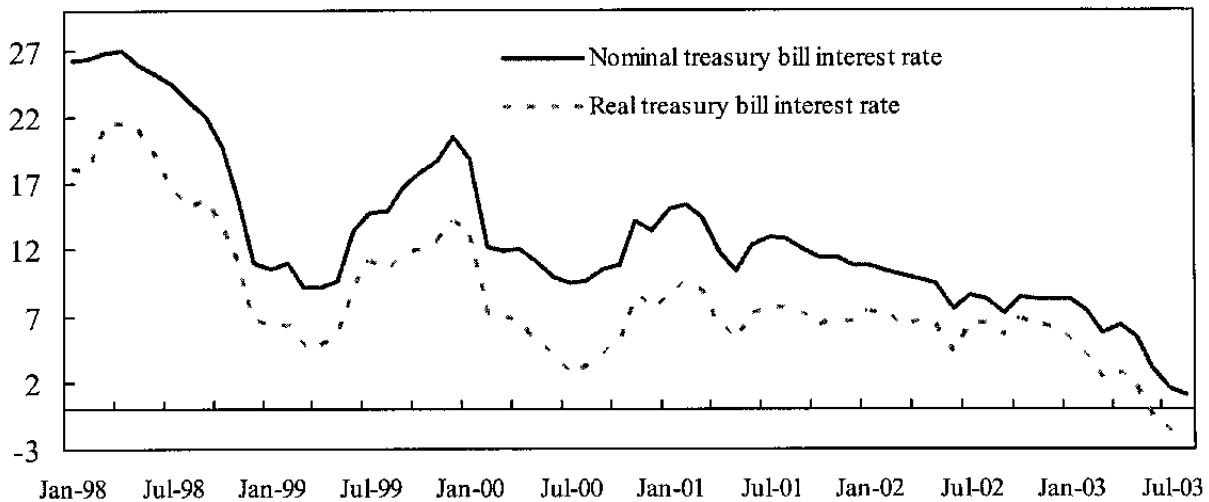
48. In view of the strength of the authorities' program, including the prior actions that have been taken to date, the staff recommends Executive Board approval of the request for a new three-year PRGF arrangement in an amount equivalent to SDR 175 million.

Figure 1. Kenya: Consumer Price Inflation Rates, January 2000 - August 2003
(Percentage changes from the same period of the previous year)



Sources: Kenyan authorities; and staff calculations.

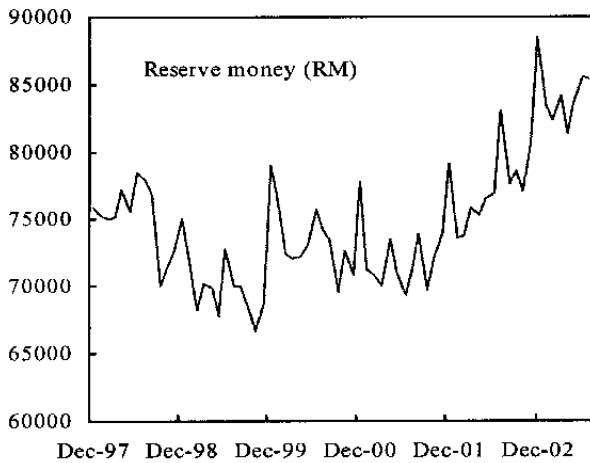
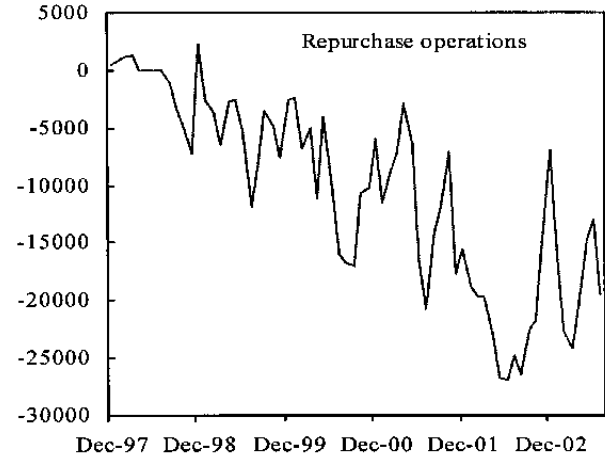
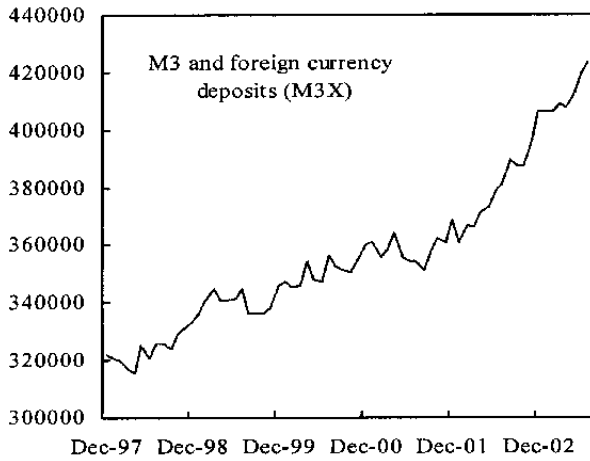
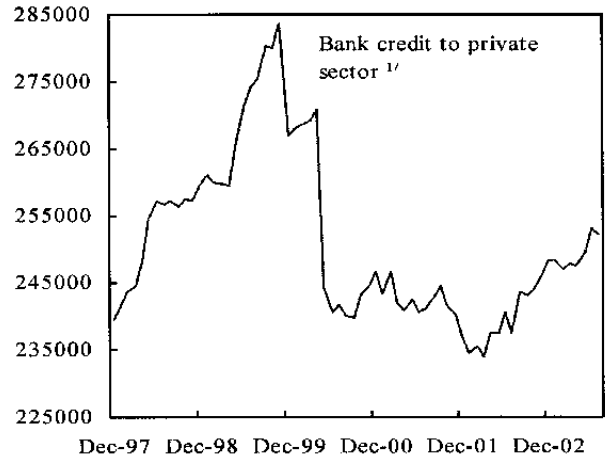
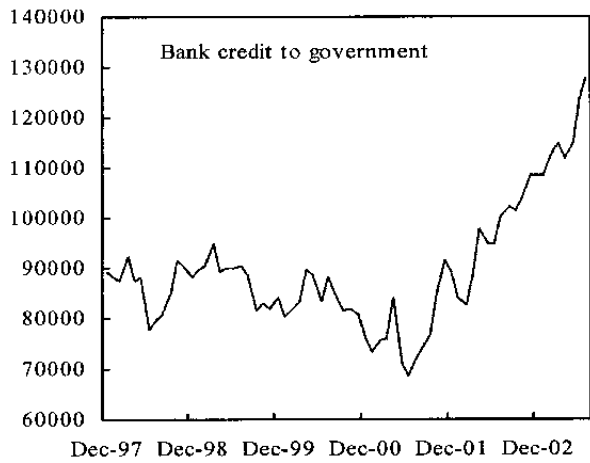
Figure 2. Kenya: Real^{1/} and Nominal 91-Day Treasury Bill Rates, January 1998 - August 2003
(in percent)



Source: Kenyan authorities and staff estimates.

^{1/} Based on the annual changes in the overall CPI excluding food and energy.

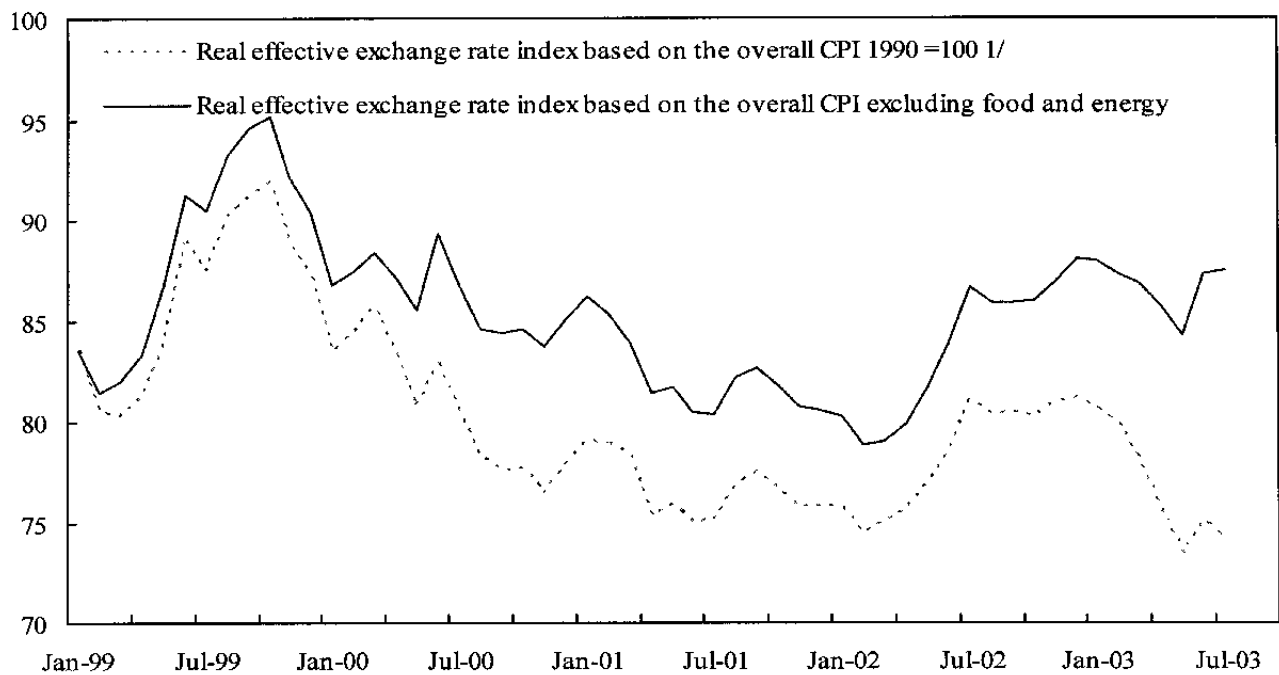
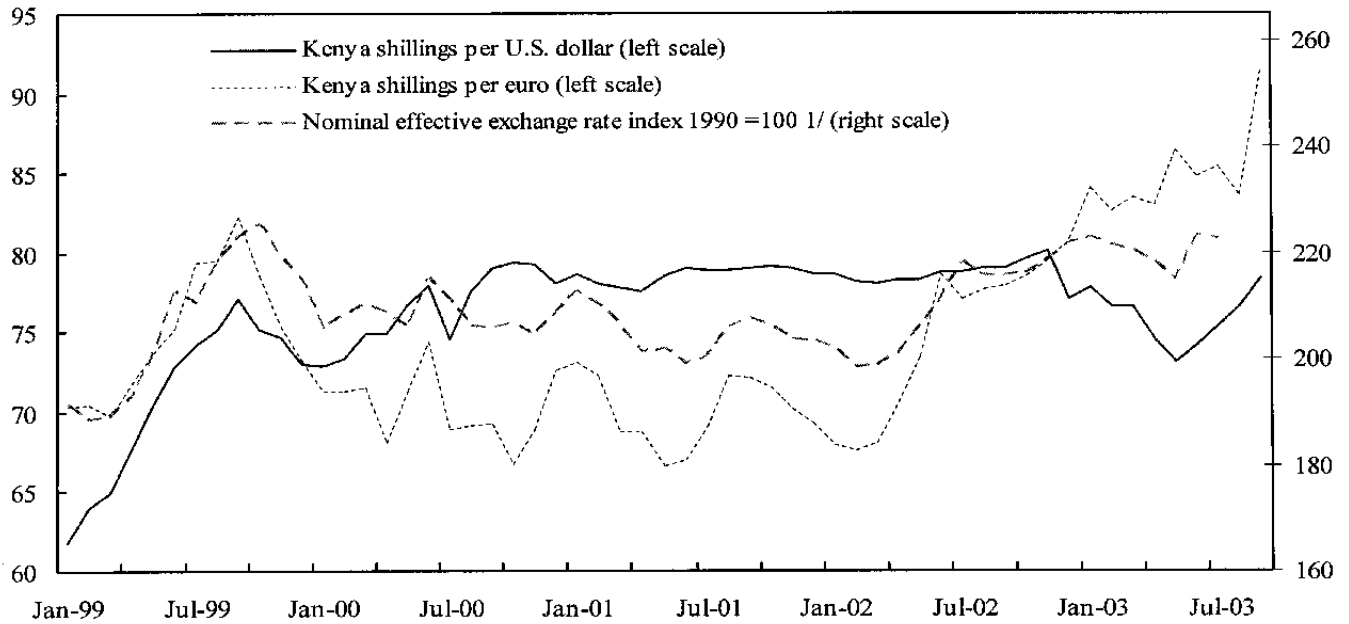
Figure 3. Kenya: Key Monetary Aggregates, December 1997- July 2003
(In millions of Kenya shillings)



Source: Kenyan authorities.

^{1/} There is a break in the series between November and December 1999 and between April and May 2000.

Figure 4. Kenya: Exchange Rate Developments
The Nominal and Real Effective Exchange Rates, and Kenya Shillings per U.S. Dollar and Euro Rates for
End January, 1999 - End September, 2003



Sources: IMF African Department; and IMF Information Notice System.
l/ An increase in the index denotes a depreciation.

Table 1: Kenya. Disbursement Schedule Under the Three-Year PRGF Arrangement

Disbursement	Amount (In millions of SDRs)	Date	Contingent on
1st	25	November-03	Board Approval November 2003
2nd	25	May-04	End-December 2003 PC
3rd	25	October-04	End-June 2004 PC
4th	25	May-05	End-December 2004 PC
5th	25	October-05	End-June 2005 PC
6th	25	May-06	End-December 2005 PC
7th	25	October-06	End-June 2006 PC
Total	175		

Source: IMF staff projections.

Table 2. Kenya: Projected Payments to the Fund, 2003-12
(in millions of SDRs, unless otherwise indicated)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Beyond	Total
Obligations on outstanding disbursements												
Principal												
General Resources Account (GRA) repurchases	...	...	...	...	...	...	...	...	...	...	...	...
Poverty Reduction and Growth Facility (PRGF) repayments	7.0	9.5	5.0	9.2	6.7	6.7	6.7	6.7	0.0	0.0	0.0	57.6
Charges and interest 1/												
PRGF interest	0.1	0.2	0.2	0.2	0.1	0.1	0.0	0.0	0.0	0.0	0.0	1.0
SDR net charges	0.3	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	...	...
Total outstanding obligations	7.4	10.3	5.7	9.9	7.4	7.4	7.3	7.3	0.6	0.6	0.0	63.9
As a percent of quota	2.7	3.8	2.1	3.7	2.7	2.7	2.7	2.7	0.2	0.2	0.0	23.5
Obligations from prospective disbursements												
Principal (PRGF repayments)												
	0.0	0.0	0.0	0.0	0.0	0.0	7.5	17.5	27.5	35.0	87.5	175.0
Interest and charges (PRGF interest)	0.0	0.2	0.5	0.7	0.9	0.9	0.9	0.8	0.7	0.5	0.6	6.7
Total prospective obligations	0.0	0.2	0.5	0.7	0.9	0.9	8.4	18.3	28.2	35.5	88.1	181.7
As a percent of quota	0.0	0.1	0.2	0.3	0.3	0.3	3.1	6.7	10.4	13.1	32.5	67.0
Total obligations (outstanding and prospective)												
Total principal (PRGF repayments)	7.0	9.5	5.0	9.2	6.7	6.7	14.2	24.2	27.5	35.0	87.5	232.6
Total charges and interest (PRGF int. and SDR chg.)	0.4	1.0	1.2	1.4	1.5	1.5	1.5	1.4	1.2	1.1	0.6	7.7
Total outstanding and prospective obligations	7.5	10.5	6.2	10.7	8.3	8.2	15.7	25.6	28.7	36.1	88.1	240.3
As a percent of quota	2.7	3.9	2.3	3.9	3.0	3.0	5.8	9.4	10.6	13.3	32.5	88.5
Outstanding Fund credit												
As a percent of:	75.6	116.1	161.1	201.9	195.2	188.4	174.2	150.0	122.5	87.5	...	...
Exports of goods and services	2.9	4.2	5.4	6.3	5.4	4.7	4.0	3.3	2.5	1.7	...	...
External public debt	2.0	2.9	3.5	4.2	3.8	3.5	3.1	2.6	2.0	1.4	...	...
Gross official reserves	8.3	10.3	11.0	10.6	9.1	7.8	6.2	5.0	3.8	2.6	...	...
GDP	0.7	1.0	1.4	1.6	1.4	1.1	1.0	0.8	0.6	0.4	...	...
Quota	27.8	42.8	59.4	74.4	71.9	69.4	64.2	55.3	45.1	32.2	...	...

Sources: Kenyan authorities; and Fund staff estimates and projections as of August 30, 2003.

1/ Projections are based on current PRGF and SDR interest rates. SDR net charges past 2012 are not included in the analysis.

Table 3. Kenya: Comparison of Projected and Actual Outcomes for Selected Economic Indicators Under the 2000-03 Program, 1999-2003

	1999		2000		2001		2002		2003	
	Est.	Act.	Proj.	Act.	Proj.	Act.	Proj.	Act.	Proj.	Est.
(Annual percentage change)										
National accounts and prices										
GDP volume (factor cost)	1.4	1.4	1.5	-0.2	3.1	1.2	4.4	1.1	5.5	1.3
Consumer price index (end of period) 1/	8.0	10.5	4.2	8.6	4.5	1.6	4.0	4.2	4.0	6.5
External sector										
Export volume, goods and services	-5.2	13.1	4.6	3.8	5.7	5.0	5.6	5.0	5.5	5.7
Import volume, goods and services	-6.3	-5.2	6.2	17.7	15.6	5.8	-3.2	-16.7	9.4	8.8
Terms of trade, goods (- deterioration; based on c.i.f. imports)	-1.4	-1.3	-3.3	-0.6	0.9	-2.6	-0.1	-4.5	-0.8	-1.5
(In percent of GDP)										
Investment and saving										
Investment	15.9	16.2	16.0	15.4	19.9	14.7	19.4	13.6	23.4	15.4
Gross national saving	13.4	13.9	12.7	12.7	13.8	11.1	15.4	14.1	17.5	12.8
Central government budget 2/										
Total revenue	23.9	23.1	24.8	22.8	25.0	21.2	25.1	20.7	25.1	22.2
Total expenditure and net lending	24.5	23.0	26.3	27.6	26.0	24.9	25.6	25.6	25.5	27.8
Overall balance (commitment basis), excluding grants	-0.6	0.2	-1.5	-4.9	-1.0	-3.7	-0.5	-4.8	-0.5	-5.6
Total grants	0.7	0.6	1.7	2.9	1.5	1.2	1.0	1.2	0.9	2.0
Overall balance (commitment basis), including grants	0.1	0.7	0.2	-2.0	0.5	-2.4	0.5	-3.6	0.4	-3.6
Stock of domestic debt, net (end of period)	21.4	21.2	19.2	19.6	17.3	21.9	15.0	25.3	12.6	27.6
Balance of payments										
Current external balance, including official transfers	-2.6	-2.2	-3.3	-2.7	-6.1	-3.5	-3.9	0.5	-5.8	-2.6
Current external balance, excluding official transfers	-3.2	-2.2	-4.5	-3.6	-7.7	-4.3	-5.0	0.5	-6.7	-2.6

1/ 12-month period ending December, except 2000 ending May.

2/ Data are on a fiscal-year basis; e.g., 1999 refers to 1999/2000.

Table 4. Kenya: Structural Performance Criteria and Benchmarks Under the Previous PRGF Arrangement

Performance criteria	Status
1. Issue a treasury circular to shift by December 31, 2000 the responsibility for the supervision of district treasury officers from the Office of the President to the Ministry of Finance.	Done.
2. Issue a treasury circular to bring by December 31, 2000 all financial management units in line ministries under the control and supervision of the finance officer and provide all finance officers with sufficient independence by requiring that their annual performance review be finalized by the Ministry of Finance.	Partially implemented.
3. Develop by December 31, 2000 terms of service that would allow competitive remuneration of the Controller and Auditor General's staff, on terms comparable to those applicable to the pay structure of the KRA and KACA.	Partially addressed.
4. Complete the development of a tariff reform program by March 31, 2001, with a view to implementing it under the 2001/02 (July-June) budget.	Done. (with a delay).
Structural benchmarks	
1. Amend by October 2000 the draft bill containing the code of ethics for public officials, inter alia, to strengthen the independence of the Public Service Committee examining alleged infractions of the code, to extend the requirement to declare assets and liabilities to include immediate families of the officials, and to broaden the definition of the types of assets and liabilities to be declared.	Bill to be discussed in this session of parliament.
2. Publish in the official gazette an Anti-Corruption and Economic Crimes bill that is essentially similar to the one annexed to the report of the Select Committee of Parliament on Anti-Corruption not later than 30 days after the determination by parliament on the report.	Bill to be discussed in this session of parliament.
3. Offer for sale to a strategic investor (to be identified through a bidding process) by September 30, 2000 at least 26 percent of the Kenya Commercial Bank (KCB) with an announcement that the remaining shares of the KCB will be offered for sale to the market by March 31, 2001.	Not done.
4. Submit by September 30, 2000 an amendment to the Banking Act to clearly define "reckless lending" and related activities, as well as any other necessary amendment to relevant legislation, applicable to, inter alia, financial fraud, with a view to enabling the courts to deal more effectively with fraud and realisation of security.	Done.
5. The CBK will by September 30, 2000 issue prudential regulations and policies, including on the amount of risk that banks may incur in lending operations, with a view to clarifying and expanding on prohibited activities.	Done.
6. Set up by December 31, 2000 a system by which the CBK will share debtor information with licensed banking institutions, as provided in the amendment to legislation.	Done.
7. Complete by December 31, 2000 a review of operating procedures and methods of the Deposit Protection Fund (DPF) and produce recommendations, with a view to ensuring efficiency and maximizing asset recoveries. Implement these recommendations by June 30, 2001.	Done Implementing recommendations of March 2001 IMF mission. Done.
8. Submit by March 31, 2001 amendments to the Building Society Act and the Banking Act that will explicitly specify that the CBK is authorized and responsible for supervising and regulating all institutions involved in "banking activities"; require appropriate and specific responses in case a bank is insolvent and formally prohibit directors of restructured problem banks from borrowing from the reopened institution.	Done.
9. Revise by December 31, 2000 the format of the "vote book" and expenditure returns to incorporate information on expenditure commitments and pending bills.	Done. 1998/99 done; 1999/2000 expected shortly.
10. Develop by December 31, 2000, with technical assistance from the Fund, a system to strengthen expenditure control in the districts.	Done.
11. Complete and submit to parliament by June 30, 2001 audited public accounts for fiscal years 1998/99 and 1999/2000.	Done.
12. Issue treasury instructions requiring by July 1, 2000 the Debt-Management Division, the External Resources Department, and the Accountant General's Office to prepare quarterly reconciliations of their external debt data.	Not done.
13. Issue a treasury circular requiring that all noncentral government public institutions develop by December 31, 2000 and subsequently implement a strategy to prevent any further accumulation of pending bills, and to eliminate the outstanding pending bills after appropriate verification.	Done.
14. Prepare by March 31, 2001 a plan for the elimination of major import exemptions awarded to the public sector, with a view to implementing the plan under the 2001/02 budget.	Done.
15. Develop a plan to reform the internal audit system by December 2000. Implement the reform plan of the internal audit system by March 31, 2001.	Done.

Source: Kenya authorities.

Table 5. Key Social Indicators

	Kenya		Sub-Saharan Africa
	1990	2001	
Real GDP per capita (Constant 1995 US\$)	358.0	324.9	571.9
Aid per capita (current \$)	50.8	17.0	20.4
Life expectancy at birth	57.1	47.0	46.5
Fertility rate (births per woman)	5.6	4.4	5.2
AIDS prevalence rate	...	13.0	9.0
For girls (15-24 years)	...	18.7	11.4
Gross primary school enrolment	95.0	90.7	79.3
Girls	93.3	90.0	73.0
Boys	96.6	91.4	85.5
Access to improved water	40.0	49.0	55.4

Source: World Bank

Table 6. Kenya: Macroeconomic Scenario, 2000/01-07/08 ^{1/}

	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
	Actual							
	(Annual percentage change, unless otherwise indicated)							
National accounts and prices								
Nominal GDP (market prices, in billions of Kenya shillings)	840	926	1,011	1,076	1,141	1,229	1,331	1,450
GDP volume (factor cost)	0.5	1.2	1.2	1.9	3.1	3.9	4.5	4.7
GDP volume (factor cost) per capita	-1.7	-0.9	-0.7	0.2	1.4	2.3	3.0	3.2
Consumer price index (annual average)	10.0	2.3	6.6	4.1	2.8	3.5	3.5	3.5
Consumer price index (end of period)	4.6	2.8	13.7	-4.0	3.5	3.5	3.5	3.5
Consumer price index, excl. food, energy (annual average)	5.9	4.1	2.7	3.0	3.5	3.5	3.5	3.5
Consumer price index, excl. food, energy (end of period)	5.1	3.3	3.7	2.7	3.5	3.5	3.5	3.5
Export volume, goods and services	4.4	5.0	5.4	6.0	6.5	7.7	9.8	10.7
Import volume, goods and services	11.3	-5.7	-5.1	15.1	18.6	11.8	7.1	6.6
Terms of trade, goods								
(- deterioration; based on c.i.f. imports)	-1.6	-3.6	-3.0	0.1	2.0	2.0	1.1	0.6
Kenya shilling per US dollar exchange rate (end of period)	78.9	78.7	73.9	76.0	76.6	77.2	77.8	78.5
Nominal effective exchange rate (- depreciation; end of period)	8.3	-5.9	-2.4	...	...	...	...	...
Real effective exchange rate (- depreciation; end of period)	10.6	-4.4	7.5	...	...	...	...	...
Money and credit								
Net domestic assets (end of period)	-6.2	6.7	12.4	5.0	3.6	-1.3	3.6	6.3
Net credit to the government (end of period)	-17.5	38.0	30.7	3.9	-1.4	-15.6	-11.8	-16.7
Credit to the rest of the economy (end of period)	1.2	-1.3	4.9	4.8	6.1	6.3	9.2	12.5
M3X (M3 plus foreign currency deposits; end of period)	2.1	6.7	10.9	7.1	7.9	7.9	8.1	8.1
Reserve money (end of period)	-8.5	10.9	11.2	-5.4 ^{2/}	6.8	6.8	7.0	7.0
Interest rate (90-day treasury bill; end of period)	12.4	7.5	1.8	...	...	...	...	...
	(In percent of GDP, unless otherwise indicated)							
Investment and saving								
Investment	15.0	14.1	14.5	17.9	22.7	25.9	26.9	28.4
Central government	3.6	2.5	3.6	4.8	6.4	7.6	8.4	8.4
Other	11.4	11.6	11.0	13.1	16.3	18.3	18.5	19.9
Gross national saving	11.9	12.7	13.6	13.1	13.5	14.7	16.3	17.5
Central government	1.2	-0.9	-1.2	-0.1	0.0	1.3	2.0	2.2
Other	10.6	13.6	14.8	13.2	13.5	13.4	14.3	15.3
Central government budget								
Total revenue	22.8	21.2	20.7	22.2	22.8	23.2	23.4	23.3
Total expenditure and net lending	27.6	24.9	25.6	27.8	29.2	29.6	29.8	29.5
Overall balance (commitment basis), excluding grants	-4.9	-3.7	-4.8	-5.6	-6.5	-6.4	-6.5	-6.2
Overall balance (commitment basis), including grants	-2.0	-2.4	-3.6	-3.3	-4.3	-3.9	-3.6	-3.2
Net domestic borrowing	0.3	4.2	5.0	3.3	-0.5	-2.1	-2.7	-2.0
Financing gap	0.1	0.1	-0.2	2.7	4.4	5.3	5.4	4.5
Total donor support (grants and loans) ^{3/}	5.0	2.5	1.9	7.0	8.9	10.0	10.3	9.3
Balance of payments								
Current external balance, including official transfers	-3.2	-1.4	-0.9	-4.8	-9.3	-11.1	-10.6	-10.9
Current external balance, excluding official transfers	-4.0	-1.8	-1.1	-5.0	-9.3	-11.1	-10.6	-10.9
Gross international reserve coverage								
in months of next year's imports (end of period)	3.4	3.1	2.7	2.8	3.2	4.0	4.2	4.3
Net present value of central government debt (end of period)	55.5	55.4	56.5	55.6	54.3	51.8	48.0	44.7
Domestic debt, net (end of period)	19.6	21.9	25.0	26.8	24.8	21.0	16.7	13.3
Net present value of external debt (end of period)	36.0	33.5	31.4	28.8	29.4	30.9	31.3	31.3

Sources: Kenyan authorities; and staff estimates and projections.

^{1/} Fiscal year ending June 30.

^{2/} The projected decline in reserve money for 2003/04 is due to a reduction in cash reserve ratio from July 2003 onwards.

^{3/} For the period 2003/04-2007/08, includes unidentified program support (financing gap).

Table 7. Kenya: Central Government Financial Operations, Program Scenario, 1999/2000-2007/08 1/

	1999/00	2000/01	2001/02	2002/03			2003/04				2004/05	2005/06	2006/07	2007/08
	Actual	Actual	Actual	Budget	Revised Budget	Actual	Proj. Q1	Proj. Q2	Proj. Q3	Proj. Q4	Proj.			
	(In millions of Kenya shillings)													
Revenue	178,024	191,160	196,613	218,928	215,272	209,662	54,088	111,132	169,439	239,177	259,660	285,205	310,797	337,895
Income tax	54,402	55,828	55,862	67,529	66,379	70,452	15,580	32,001	45,901	71,565	74,377	79,485	83,737	88,160
Import duty (net)	28,605	28,726	21,584	19,895	19,895	18,477	5,558	10,883	16,100	21,684	26,900	30,793	33,384	37,268
Excise duty	28,493	28,318	32,077	42,671	35,812	35,643	9,094	18,282	28,620	39,499	43,465	47,746	50,679	54,882
Value-added tax	40,945	50,298	50,871	57,184	56,355	56,135	13,090	27,542	42,150	57,124	67,209	73,677	79,530	87,155
Investment income	305	2,478	767	2,123	1,762	1,243	286	826	1,481	1,868	1,980	2,133	2,309	2,516
Other	25,274	25,512	35,452	29,526	35,069	27,712	8,751	18,160	30,000	40,522	36,601	39,080	45,191	49,070
New revenue measures		0	0	0	0	0	1,729	3,458	5,186	6,915	9,128	12,291	15,967	18,844
Expenditure and net lending	176,732	232,117	230,439	266,562	277,251	258,634	65,001	138,700	218,623	299,321	333,563	363,497	396,707	427,543
Recurrent expenditure	157,851	199,289	205,486	218,511	229,495	221,339	57,805	117,068	177,992	244,685	259,736	268,978	284,238	304,114
Interest payments	30,703	26,824	27,139	38,341	35,226	36,026	8,494	16,536	25,341	33,742	34,936	35,357	34,738	32,092
Domestic interest	22,068	19,021	19,543	29,882	26,767	27,567	6,687	13,151	20,600	27,323	27,596	26,759	24,990	23,274
Foreign interest due	8,635	7,803	7,597	8,459	8,459	8,459	1,797	3,385	4,740	6,419	7,340	8,598	9,748	8,818
Wages and benefits (civil service)	65,861	68,119	77,674	82,028	85,744	85,087	21,262	44,326	66,662	93,380	92,624	93,637	100,033	107,526
Civil service reform	443	6,095	1,665	1,600	1,300	0	125	250	375	500	8,283	8,090	6,023	4,709
Pensions, etc.	5,145	6,136	8,995	12,921	12,920	9,450	3,517	7,426	10,485	14,067	15,489	15,454	16,226	19,119
Other	44,777	73,224	69,179	66,328	73,012	67,548	18,349	36,396	56,927	78,726	83,520	92,538	103,192	115,667
Of which: operations and maintenance	30,637	39,172	49,257	...	44,906	40,626	12,184	24,142	38,048	53,549	59,050	66,950	76,353	87,366
Defense and NSIS 2/	12,564	16,919	19,064	17,293	21,293	23,096	6,067	12,135	18,202	24,270	24,884	23,903	24,025	25,001
Of which: IMF adjustment for defense leases	0	0	2,064	...	...	1,803	629	1,257	1,886	2,515	2,259	373	-446	-450
Pending bills 3/	-1,642	1,972	1,770	0	0	132	0	0	0	0	0	0	0	0
Development and net lending	18,881	32,828	24,953	48,051	47,756	37,295	7,196	21,632	40,631	54,636	73,826	94,519	112,469	123,429
Domestically financed	4,253	11,491	5,908	16,103.0	11,398	9,640	2,886	5,842	9,775	15,885	24,991	36,416	46,448	52,947
Foreign financed	13,097	15,341	20,345	26,666.0	30,376	21,992	3,585	14,342	28,683	35,854	48,000	57,000	64,949	69,393
Net lending	1,531	2,805	1,862	5,282	5,982	1,280	724	1,449	2,173	2,897	835	1,103	1,072	1,090
Pending bills 3/	0	3,191	-3,162	0	0	4,383	0	0	0	0	0	0	0	0
Balance (commitment basis, excluding grants)	1,292	-40,957	-33,826	-47,634	-61,979	-48,972	-10,913	-27,548	-49,184	-60,144	-73,902	-78,291	-85,910	-89,649
Grants	4,247	24,080	11,265	15,866	16,924	12,559	3,098	10,415	19,844	25,051	25,000	30,000	38,673	43,333
Food relief grants	0	12,444	0	0	0	0	0	0	0	0	0	0	0	0
Project grants	4,247	5,681	10,315	15,866	16,441	12,559	2,110	8,441	16,882	21,102	25,000	30,000	38,673	43,333
Program grants	0	5,955	950	0	483	0	987	1,975	2,962	3,949	0	0	0	0
Balance (commitment basis, including grants)	5,539	-16,877	-22,561	-31,768	-45,055	-36,413	-7,815	-17,132	-29,340	-35,093	-48,902	-48,291	-47,237	-46,316
Adjustments to cash basis	-3,789	1,512	-8,404	0	-1,243	3,599	-375	-750	-1,125	-1,500	0	0	0	0
Balance (cash basis, including grants)	1,750	-15,365	-30,965	-31,768	-46,298	-32,814	-8,190	-17,882	-30,465	-36,593	-48,902	-48,291	-47,237	-46,316
Financing	-534	14,817	29,871	31,768	46,262	34,395	937	3,376	8,706	7,580	-1,817	-17,225	-24,974	-18,939
Net foreign financing	-18,974	12,601	-10,853	-4,331	-6,790	-11,460	-5,900	-8,850	-10,324	-12,234	7,249	11,898	10,442	10,402
Project loans	8,850	14,042	10,031	16,394	13,935	6,486	1,475	5,901	11,802	14,752	23,000	27,000	26,276	26,060
Program loans	0	4,045	122	0	0	0	931	1,863	2,794	3,726	0	0	0	0
Financial defense lease loan adjustment	0	0	2,064	...	...	1,803	0	0	0	2,515	2,259	373	-446	-450
Repayments due	-31,018	-27,887	-27,672	-17,556	-20,725	-20,724	-4,857	-9,715	-14,572	-19,429	-15,397	-15,475	-15,388	-15,208
Change in arrears	3,194	496	-193	-3,169	0	975	-3,449	-6,899	-10,348	-13,798	-2,613	0	0	0
Rescheduling	0	21,905	4,795	0	0	0	0	0	0	0	0	0	0	0
Privatization proceeds	5,660	0	955	3,500	0	0	0	0	0	0	0	0	0	0
Bank restructuring costs	0	0	0	0	0	0	0	-12,000	-12,000	-12,000	0	0	0	0
Expenditure arrears securitization	...	...	0	0	-4,481	-4,481	0	-1,222	-2,445	-3,667	-3,667	-3,667	-3,667	-3,667
Net domestic borrowing	12,780	2,216	39,769	32,599	57,533	50,336	6,837	25,448	33,474	35,481	-5,400	-25,457	-35,416	-29,341
Of which: excluding bank restructuring costs and excluding expenditure arrears securitization	12,780	2,216	39,769	32,599	57,533	50,336	6,837	13,448	21,474	23,481	-5,400	-25,457	-35,416	-29,341
Financing gap (stat. discrepancy for outturns)	-1,216	548	1,094	0	-36	-1,581	7,253	14,506	21,760	29,013	50,720	65,516	72,211	65,254
Memorandum items:														
Core poverty spending	...	...	23,502	...	...	34,024	0	0	0	43,139	47,453	56,943	62,638	68,901
Free primary education spending	...	...	...	...	2,800	2,800	2,425	4,850	7,275	9,700	10,702	10,705	11,709	11,715
Total project support	13,097	32,167	20,346	32,260	30,376	19,045	3,585	14,342	28,683	35,854	48,000	57,000	64,949	69,393
Total identified and unidentified gross external support	13,097	42,167	21,418	32,260	30,859	19,045	12,757	32,686	56,199	72,542	98,720	122,516	137,160	134,647
Nominal GDP	769,911	839,534	926,039	984,176	984,176	1,010,761	0	0	0	1,076,174	1,140,956	1,229,134	1,330,558	1,449,506
Primary budget balance	32,453	11,459	-3,826	6,573	-11,072	3,212	294	-1,347	-5,124	-2,851	-13,966	-12,935	-12,499	-14,224
Stock of domestic debt, net (end of period)	163,405	164,203	202,775	235,374	260,308	253,111	259,948	278,559	286,585	288,592	283,192	257,736	222,320	192,979

Table 7. Kenya: Central Government Financial Operations, Program Scenario, 1999/2000-2007/08 1/ (concluded)

	1999/00	2000/01	2001/02	2002/03			2003/04	2004/05	2005/06	2006/07	2007/08
	Actual	Actual	Actual	Budget	Revised Budget	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
	(In percent of GDP)										
Revenue	23.1	22.8	21.2	22.2	21.9	20.7	22.2	22.8	23.2	23.4	23.3
Income tax	7.1	6.6	6.0	6.9	6.7	7.0	6.6	6.5	6.5	6.3	6.1
Import duty (net)	3.7	3.4	2.3	2.0	2.0	1.8	2.0	2.4	2.5	2.5	2.6
Excise duty	3.7	3.4	1.5	4.3	3.6	3.5	3.7	3.8	3.9	3.8	3.8
Value-added tax	5.3	6.0	5.5	5.8	5.7	5.6	5.3	5.9	6.0	6.0	6.0
Investment income	0.0	0.3	0.1	0.2	0.2	0.1	0.2	0.2	0.2	0.2	0.2
Other	3.3	3.0	3.8	3.0	3.6	2.7	3.8	3.2	3.2	3.4	3.4
New revenue measures	0.0	0.0	0.0	0.0	0.0	0.0	0.6	0.8	1.0	1.2	1.3
Expenditure and net lending	23.0	27.6	24.9	27.1	28.2	25.6	27.8	29.2	29.6	29.8	29.5
Recurrent expenditure	20.5	23.7	22.2	22.2	23.3	21.9	22.7	22.8	21.9	21.4	21.0
Interest payments	4.0	3.2	2.9	3.9	3.6	3.6	3.1	3.1	2.9	2.6	2.2
Domestic interest	2.9	2.3	2.1	3.0	2.7	2.7	2.5	2.4	2.2	1.9	1.6
Foreign interest due	1.1	0.9	0.8	0.9	0.9	0.8	0.6	0.6	0.7	0.7	0.6
Wages and benefits (civil service)	8.6	8.1	8.4	8.3	8.7	8.4	8.7	8.1	7.6	7.5	7.4
Civil service reform	0.1	0.7	0.2	0.2	0.1	0.0	0.0	0.7	0.7	0.5	0.3
Pensions, etc.	0.7	0.7	1.0	1.3	1.3	0.9	1.3	1.4	1.3	1.2	1.3
Other	5.8	8.7	7.5	6.7	7.4	6.7	7.3	7.3	7.5	7.8	8.0
<i>Of which: operations and maintenance</i>	4.0	4.7	5.3	...	4.6	4.0	5.0	5.2	5.4	5.7	6.0
Defense and NSIS 2/	1.6	2.0	2.1	1.8	2.2	2.3	2.3	2.2	1.9	1.8	1.7
<i>Of which: IMF adjustment for defense leases</i>	0.0	0.0	0.2	...	...	0.2	0.2	0.2	0.0	0.0	0.0
Pending bills 3/	-0.2	0.2	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Development and net lending	2.5	3.9	2.7	4.9	4.9	3.7	5.1	6.5	7.7	8.5	8.5
Domestically financed	0.6	1.4	0.6	1.6	1.2	1.0	1.5	2.2	3.0	3.5	3.7
Foreign financed	1.7	1.8	2.2	2.7	3.1	2.2	3.3	4.2	4.6	4.9	4.8
Net lending	0.2	0.3	0.2	0.5	0.6	0.1	0.3	0.1	0.1	0.1	0.1
Pending bills 3/	0.0	0.4	-0.3	0.0	0.0	0.4	0.0	0.0	0.0	0.0	0.0
Balance (commitment basis, excluding grants)	0.2	-4.9	-3.7	-4.8	-6.3	-4.8	-5.6	-6.5	-6.4	-6.5	-6.2
Grants	0.6	2.9	1.2	1.6	1.7	1.2	2.3	2.2	2.4	2.9	3.0
Food relief grants	0.0	1.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Project grants	0.6	0.7	1.1	1.6	1.7	1.2	2.0	2.2	2.4	2.9	3.0
Program grants	0.0	0.7	0.1	0.0	0.0	0.0	0.4	0.0	0.0	0.0	0.0
Balance (commitment basis, including grants)	0.7	-2.0	-2.4	-3.2	-4.6	-3.6	-3.3	-4.3	-3.9	-3.6	-3.2
Adjustments to cash basis	-0.5	0.2	-0.9	0.0	-0.1	0.4	-0.1	0.0	0.0	0.0	0.0
Balance (cash basis, including grants)	0.2	-1.8	-3.3	-3.2	-4.7	-3.2	-3.4	-4.3	-3.9	-3.6	-3.2
Financing	-0.1	1.8	3.2	3.2	4.7	3.4	0.7	-0.2	-1.4	-1.9	-1.3
Net foreign financing	-2.5	1.5	-1.2	-0.4	-0.7	-1.1	-1.1	0.6	1.0	0.8	0.7
Project loans	1.1	1.7	1.1	1.7	1.4	0.6	1.4	2.0	2.2	2.0	1.8
Program loans	0.0	0.5	0.0	0.0	0.0	0.0	0.3	0.0	0.0	0.0	0.0
Financial defense lease loan adjustment	0.0	0.0	0.2	...	...	0.2	0.2	0.2	0.0	0.0	0.0
Repayments due	-4.0	-3.3	-3.0	-1.8	-2.1	-2.1	-1.8	-1.3	-1.3	-1.2	-1.0
Change in arrears	0.4	0.1	0.0	-0.3	0.0	0.1	-1.3	-0.2	0.0	0.0	0.0
Rescheduling	0.0	2.6	0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Privatization proceeds	0.7	0.0	0.1	0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Bank restructuring costs	0.0	0.0	0.0	0.0	0.0	0.0	-1.1	0.0	0.0	0.0	0.0
Expenditure arrears securitization	...	...	...	0.0	-0.5	-0.4	-0.3	-0.3	-0.3	0.0	0.0
Net domestic borrowing	1.7	0.3	4.3	3.3	5.8	5.0	3.3	-0.5	-2.1	-2.7	-2.0
<i>Of which: excluding bank restructuring costs</i>	1.7	0.3	4.3	3.3	5.8	5.0	2.2	-0.5	-2.1	-2.7	-2.0
and excluding expenditure arrears securitization	...	...	...	3.3	5.4	4.5	1.8	-0.8	-2.4	-2.7	-2.0
Financing gap (stat. discrepancy for outturn)	-0.2	0.1	0.1	0.0	0.0	-0.2	2.7	4.4	5.3	5.4	4.5
Memorandum items:											
Core poverty spending	...	...	2.5	...	...	3.4	4.0	4.2	4.6	4.7	4.8
Free primary education spending	...	...	...	0.0	0.3	0.3	0.9	0.9	0.9	0.9	0.8
Total project support	1.7	3.8	2.2	3.3	3.1	1.9	3.3	4.2	4.6	4.9	4.8
Total identified and unidentified gross external support	1.7	5.0	2.3	3.3	3.1	1.9	6.7	8.7	10.0	10.3	9.3
Nominal GDP	769,911	839,534	926,039	984,176	984,176	1,010,761	1,076,174	1,140,956	1,229,134	1,330,558	1,449,506
Primary budget balance	4.2	1.4	-0.4	0.7	-1.1	0.3	-0.3	-1.2	-1.1	-0.9	-1.0
Stock of domestic debt, net (end of period)	21.2	19.6	21.9	23.9	26.4	25.0	26.8	24.8	21.0	16.7	13.3

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

1/ Fiscal year ending June 30.

2/ Differ from authorities numbers because of different accounting treatment of finance defense leases.

3/ The fiscal accounts are on a cash basis (with the exception of foreign interest due).

To adjust to a commitment basis, the accumulation of pending bills is added and the cash payment of these bills deducted.

Table 8. Kenya: Monetary Survey, 2001-08 1/

	Mar-01	Jun-01	Sep-01	Dec-01	Mar-02	Jun-02	Sep-02	Dec-02	Mar-03	Jun-03	Sep-03	Dec-03	Mar-04	Jun-04	Jun-05	Jun-06	Jun-07	Jun-08
Central Bank of Kenya (CBK)																		
Net foreign assets	63,145	66,806	73,156	75,878	78,032	77,914	76,011	70,105	78,977	80,670	81,460	83,101	89,417	95,644	119,875	163,349	194,435	219,067
Net domestic assets	6,903	2,504	-3,365	3,247	-2,253	-1,033	2,578	18,348	5,136	4,824	-2,790	473	-8,720	-14,791	-33,554	-71,199	-95,817	-113,505
Net domestic credit	479	-2,934	-7,002	1,671	-5,015	-3,205	2,235	19,774	5,863	5,984	-1,563	1,773	-7,340	-13,322	-31,633	-68,616	-92,252	-108,534
Government (net)	18,817	10,807	2,989	14,554	10,740	20,040	17,561	18,011	22,363	14,395	14,791	15,188	15,584	15,980	8,724	-14,648	-39,875	-66,328
Commercial banks (net)	-18,338	-13,741	-9,991	-12,883	-15,755	-23,245	-15,326	1,763	-16,500	-8,411	-18,053	-15,143	-24,674	-31,096	-42,213	-55,890	-54,378	-44,264
Other items (net)	6,424	5,438	3,637	1,576	2,762	2,172	343	-1,426	-727	-1,160	-1,227	-1,300	-1,380	-1,469	-1,921	-2,583	-3,552	-4,972
Reserve money (RM)	70,048	69,310	69,791	79,125	75,779	76,881	78,589	88,453	84,113	85,494	78,670	83,574	80,697	80,853	86,321	92,150	98,618	105,562
Currency outside banks	41,733	42,374	41,706	45,289	46,022	46,920	46,338	53,878	49,390	49,688	51,198	55,824	53,045	53,610	58,342	63,370	68,905	74,829
Bank reserves	28,315	26,936	28,085	33,836	29,757	29,961	32,251	34,575	34,723	35,806	27,472	27,750	27,651	27,244	27,979	28,780	29,713	30,733
Banks and nonbank financial institutions																		
Net foreign assets	26,422	24,390	19,528	18,375	17,777	19,208	20,826	31,876	25,400	22,870	22,642	22,415	22,191	21,969	21,103	20,272	19,473	18,706
Reserves	28,315	26,936	28,085	33,836	29,757	29,961	32,251	34,575	34,723	35,806	27,472	27,750	27,651	27,244	27,979	28,780	29,713	30,733
Credit to CBK	18,338	13,741	9,991	12,883	15,755	23,245	15,326	-1,763	16,500	8,411	18,053	15,143	24,674	31,096	42,213	55,890	54,378	44,264
Net domestic assets	243,703	247,186	258,085	257,955	256,688	258,892	272,577	287,427	282,748	302,952	305,157	308,077	310,663	315,000	334,213	353,055	390,699	439,887
Domestic credit	306,367	306,951	325,735	317,953	317,231	320,364	335,102	345,251	345,962	367,021	370,875	374,453	377,702	382,709	404,672	426,374	466,996	519,282
Government (net)	57,136	57,856	73,727	74,524	77,910	74,694	84,063	90,596	92,496	109,432	109,680	110,671	111,661	112,652	110,579	107,657	104,504	100,995
Other public sector	8,542	9,877	8,959	8,027	6,938	6,630	9,671	8,016	7,513	6,320	10,009	8,297	7,776	6,541	6,770	7,007	7,252	7,506
Private sector	240,690	239,218	243,049	235,402	232,383	239,040	241,369	246,639	245,953	251,269	251,186	255,485	258,265	263,516	287,323	311,710	355,240	411,681
Other items (net)	-62,664	-59,765	-67,651	-59,999	-60,543	-61,472	-62,524	-57,824	-63,214	-64,429	-65,718	-66,375	-67,039	-67,709	-70,458	-73,319	-76,296	-79,394
Total deposits	316,778	312,253	315,688	323,049	319,976	331,306	340,981	352,114	359,371	369,679	373,324	373,386	385,180	395,308	425,508	457,997	494,263	533,590
Monetary survey																		
Net foreign assets	89,567	91,196	92,684	94,253	95,809	97,122	96,838	101,980	104,378	103,540	104,101	105,516	111,608	117,613	140,978	183,621	213,908	237,773
Net domestic assets	269,004	263,487	264,760	274,141	270,242	281,154	290,527	304,029	304,439	315,879	320,915	326,440	326,921	331,686	343,706	339,115	351,257	373,730
Domestic credit	326,559	319,141	330,233	334,004	329,467	341,951	354,304	364,932	370,016	383,149	387,365	391,369	395,036	400,483	415,251	413,648	429,109	455,012
Government (net)	75,953	68,663	76,716	89,078	88,650	94,734	101,624	108,607	114,859	123,827	124,471	125,858	127,245	128,632	119,302	99,010	64,629	33,767
Rest of the economy	250,606	250,478	253,518	244,926	240,817	247,217	252,680	256,325	255,157	259,321	262,893	265,510	267,791	271,850	295,949	320,638	364,480	421,245
Other public sector	8,542	9,877	8,959	8,027	6,938	6,630	9,671	8,016	7,513	6,320	10,009	8,297	7,776	6,541	6,770	7,007	7,252	7,506
Private	242,065	240,601	244,558	236,898	233,879	240,587	243,010	248,309	247,644	253,001	252,884	257,214	260,014	265,309	289,179	313,631	357,228	413,739
Other items (net)	-57,555	-55,654	-65,473	-59,862	-59,225	-60,797	-63,776	-60,903	-65,577	-67,270	-66,450	-64,929	-68,115	-68,797	-71,546	-74,533	-77,852	-81,642
Money and quasi money (M3)	308,791	305,529	310,649	322,325	320,948	331,633	335,873	350,733	352,748	362,596	368,761	376,263	383,393	394,714	432,250	472,368	516,782	564,667
M3 and foreign currency deposits (M3X)	358,571	354,683	357,444	368,394	366,051	378,276	387,365	406,009	408,817	419,419	425,016	431,956	438,529	449,299	484,684	522,736	565,165	611,143
Currency outside banks	41,733	42,374	41,706	45,289	46,022	46,920	46,338	53,878	49,390	49,688	51,198	55,824	53,045	53,610	58,342	63,370	68,905	74,829
Deposits	316,838	312,309	315,738	323,106	320,028	331,356	341,027	352,131	359,426	369,731	373,818	376,132	385,483	395,690	426,342	459,366	496,260	536,314
M3X and nonbank holdings of government debt (M4X)	441,147	446,588	451,356	462,127	466,430	483,886	499,352	521,198	527,417	542,794	552,700	563,206	573,345	587,682	622,030	657,161	696,437	738,006
Memorandum items:																		
M3	-0.1	-1.3	0.8	2.5	3.9	8.5	8.1	8.8	9.9	9.3	9.8	7.3	8.7	8.9	9.5	9.3	9.4	9.3
M3X	3.7	2.1	1.8	2.3	2.1	6.7	8.4	10.2	11.7	10.9	9.7	6.4	7.3	7.1	7.9	7.9	8.1	8.1
M4X	4.8	5.3	6.5	6.1	5.7	8.4	10.6	12.8	13.1	12.2	10.7	8.1	8.7	8.3	5.8	5.6	6.0	6.0
Money base	-2.8	-8.5	0.2	1.8	8.2	10.9	12.6	11.8	11.0	11.2	0.1	-5.5	-4.1	-5.4	6.8	6.8	7.0	7.0
Currency outside banks	8.9	10.0	9.2	4.3	10.3	10.7	11.1	19.0	7.3	5.9	10.5	3.6	7.4	7.9	8.8	8.6	8.7	8.6
Domestic credit	-9.0	-3.5	0.2	0.8	0.9	7.1	7.3	9.3	12.3	12.0	9.3	7.2	6.8	4.5	3.7	-0.4	3.7	6.0
Government (net)	-9.0	-17.5	-5.9	16.5	16.7	38.0	32.5	21.9	29.6	30.7	22.5	15.9	10.8	3.9	-7.3	-22.0	-30.5	-47.8
Rest of the economy	-9.0	1.2	2.2	-3.9	-3.9	-1.3	-0.3	4.7	6.0	4.9	4.0	3.6	5.0	4.8	8.9	8.3	13.7	15.6
Nonbank holdings of government debt (millions of Kenya shillings)	82,576	91,905	93,912	93,733	100,380	105,610	111,987	115,189	118,600	123,374	127,684	131,250	134,817	138,383	137,346	134,425	131,272	126,863
Stock of domestic debt (millions of Kenya shillings)	158,529	160,568	170,627	182,811	189,029	200,344	213,611	223,796	233,459	247,202	252,155	257,108	262,062	267,015	256,649	227,435	195,900	160,630
Multiplier (M3X/RM)	5.1	5.1	5.1	4.7	4.8	4.9	4.9	4.6	4.9	4.9	5.4	5.2	5.4	5.6	5.6	5.7	5.7	5.8
Reserve cover (in months of next year's imports)	3.2	3.3	3.5	3.6	3.2	3.1	3.1	2.9	2.7	2.7	2.8	2.9	2.6	2.8	3.3	4.0	4.2	4.3

Source: Central Bank of Kenya and staff projections

1/ Constant Kenya shilling per U.S. dollar exchange rate prevailing on September 30, 2001

Table 9. Kenya: Balance of Payments, 2001-2008
(In millions of U.S. dollars, unless otherwise indicated)

	2001	2002	2003	2004	2005	2006	2007	2008
	Est							
Current account	-398	-57	-316	-1,051	-1,721	-1,837	-1,814	-2,217
Excluding official transfers	-486	-57	-369	-1,051	-1,721	-1,837	-1,814	-2,217
Exports, f.o.b.	1,881	2,169	2,514	2,640	2,807	3,093	3,494	3,917
Coffee	94	84	95	104	113	127	143	156
Tea	435	437	477	517	551	599	650	695
Oil products	177	54	61	55	52	51	52	54
Other	1,176	1,594	1,880	1,964	2,090	2,316	2,649	3,012
Imports, f.o.b.	-3,176	-3,181	-3,712	-4,527	-5,349	-5,774	-6,208	-7,113
Public	-91	-94	-212	-114	-119	-125	-133	-141
Private	-3,085	-2,964	-3,500	-4,413	-5,230	-5,649	-6,075	-6,972
Oil	-721	-741	-847	-981	-931	-950	-980	-1,069
Other	-2,364	-2,346	-2,654	-3,432	-4,299	-4,700	-5,095	-5,903
Balance on goods	-1,295	-1,012	-1,199	-1,887	-2,542	-2,681	-2,715	-3,196
Services (net)	261	500	456	444	436	461	508	530
Credit	1,087	1,112	1,160	1,225	1,284	1,368	1,479	1,597
Foreign travel	308	286	257	288	305	323	346	370
Other	779	826	903	937	979	1,045	1,133	1,226
Debit	-825	-612	-704	-781	-849	-908	-971	-1,066
Balance on goods and services	-1,033	-512	-743	-1,443	-2,107	-2,221	-2,207	-2,666
Income (net)	-148	-122	-179	-148	-153	-161	-156	-165
Credit	43	35	47	57	72	93	112	126
Debit	-190	-157	-225	-205	-225	-253	-268	-231
Of which: official interest payments	-111	-89	-131	-98	-114	-129	-141	-102
Current transfers (net)	783	577	605	540	539	544	549	554
Private (net)	694	577	552	540	539	544	549	554
Official (net)	88	0	53	0	0	0	0	0
Capital and financial account	418	74	497	884	1,305	1,369	1,431	1,661
Capital account	71	89	232	328	331	448	550	559
Of which: capital transfers	71	89	232	328	331	448	550	559
Financial account	347	-15	265	556	974	921	882	1,102
Investment assets and liabilities (net)	-273	-63	12	149	511	333	412	511
Official, medium and long term	-315	23	-66	77	177	157	158	156
Inflows	136	211	248	306	409	387	385	376
Program loans	3	0	50	0	0	0	0	0
Project loans	101	141	109	237	362	340	338	329
Defense loans	0	30	33	32	21	21	21	21
Government guaranteed/parastatal	32	40	56	36	26	26	26	26
Outflows	-452	-188	-314	-229	-232	-229	-227	-220
Commercial banks (net)	96	-69	0	0	0	0	0	0
Private (net)	-54	-17	78	72	334	175	254	355
Short-term (net) and net errors and omissions 1/	620	49	252	407	463	588	470	591
Overall balance	20	18	180	-167	-416	-469	-382	-556
Financing items	-21	-18	-180	167	416	469	382	556
Reserve assets (gross)	-167	-3	-197	-299	-462	-596	-341	-382
Use of Fund credit and loans to the Fund (net)	-24	-18	16	58	65	59	-9	-14
Change in arrears	46	4	-200	-81	0	0	0	0
Rescheduling	122	0	0	0	0	0	0	0
Rescheduling of arrears 3/	0	0	0	0	0	0	0	0
Cancellation of arrears	0	0	0	0	0	0	0	0
Rescheduling of current maturities	122	0	0	0	0	0	0	0
Cancellation of current maturities	0	0	0	0	0	0	0	0
Remaining gap	0	0	200	488	814	1,006	733	952
Tentatively identified program support	0	0	36	359	472	659	355	385
Unidentified support	0	0	164	129	342	347	378	567
Memorandum items:								
Gross official reserves (end of period)	1,064	1,067	1,264	1,563	2,025	2,621	2,962	3,344
(in months of next year's imports) 2/	3.5	2.9	2.9	3.0	3.6	4.4	4.3	4.6
(in months of this year's imports) 2/	3.2	3.4	3.4	3.5	3.9	4.7	5.0	4.9
(percent of short-term debt by remaining maturity)	129	116	142	177	227	295	333	378
Stock of arrears	276.4	280.4	80.8	0.0	0.0	0.0	0.0	0.0
Current account balance								
(percent of GDP, excluding official transfers)	-4.3	-0.5	-2.6	-7.2	-11.2	-11.1	-10.2	-11.5
(percent of GDP, excluding special imports) 3/	-2.4	0.3	-1.0	-6.0	-9.3	-10.9	-10.0	-11.3
Debt-service ratio after rescheduling 4/ 5/	19.8	9.0	8.2	5.4	5.7	6.2	5.3	4.0
Import volume growth, goods (percent)	7.3	-6.9	9.2	23.3	19.0	8.2	6.9	14.6
Import volume growth, goods (percent, excluding special im	8.4	-3.6	4.7	28.3	17.3	13.1	6.9	14.7
Export volume growth, goods (percent)	11.6	16.7	5.8	4.5	4.8	8.6	11.7	12.1

Sources: Kenyan authorities; and staff estimates and projections.

1/ Includes underrecorded tourism earnings

2/ In months of projected imports of goods and nonfactor services

3/ Special imports include defense-related imports, imports of maize, sugar, and airplanes, and imports related to rehabilitation of the energy sector.

4/ After November 2000 Paris Club rescheduling and assumed rescheduling, under comparable terms, by commercial and non-Paris Club bilateral creditors

5/ In percent of exports of goods and services.

Table 10. Kenya: External Financing Requirements and Resources, 2001/02 - 2007/08 1/
(In millions of U.S. dollars)

	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
	Est.	Projections					
External financing requirements	-755.2	-735.8	-1385.8	-2047.3	-2548.4	-2533.1	-2612.1
Current account (excl.official transfers)	-271.4	-213.1	-710.4	-1386.1	-1779.1	-1825.6	-2015.4
Scheduled amortization (official)	-319.7	-250.6	-271.0	-230.2	-230.5	-228.1	-223.4
IMF payment, gross	-20.9	-18.8	-16.3	-10.1	-9.8	-11.0	-11.8
Reduction in arrears	-58.1	-153.3	-140.2	-40.4	0.0	0.0	0.0
Buildup of gross official reserves	-85.1	-100.1	-247.9	-380.5	-529.0	-468.5	-361.5
Resources	755.0	684.0	1209.3	1811.8	2204.2	2170.7	2139.4
Program support (committed and tentatively identified)	13.6	87.6	302.8	487.0	637.1	542.7	369.7
IMF	0.0	17.9	53.6	71.4	71.4	35.7	0.0
Program loans	1.6	35.0	129.4	232.8	327.9	216.1	55.5
African Development Bank (ADB)	0.0	10.0	31.8	44.9	47.8	51.3	55.5
IDA	1.6	25.0	97.6	188.0	280.1	164.8	0.0
Program grants	12.1	34.7	119.8	182.8	237.7	290.8	314.3
U.K. Department for International Development	0.0	0.0	33.3	87.2	111.5	119.7	129.4
European Union	12.1	34.7	79.7	65.7	78.4	119.7	129.4
Other	0.0	0.0	6.8	29.9	47.8	51.3	55.5
Project Support	200.8	285.0	453.0	629.2	740.1	837.7	887.9
Project loans	120.7	124.6	172.9	299.7	350.9	338.9	333.4
IDA	7.8	7.9	8.1	8.2	13.9	19.6	20.0
ADB/African Development Fund	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Other (including bilateral)	112.4	116.2	164.4	290.9	336.6	318.8	313.0
Project grants	80.1	160.4	280.1	329.5	389.2	498.8	554.4
Government-guaranteed and defence loans	51.3	79.6	78.7	57.5	46.7	46.7	46.7
Private financing	-22.0	-4.1	74.9	203.0	254.9	214.8	304.7
of which, foreign direct investment	50.2	55.0	60.1	81.2	148.3	233.2	322.4
Short-term (net) and net errors and omissions 2/	366.4	180.5	299.9	435.0	525.3	528.9	530.4
Accumulation of arrears	83.9	55.5	0.0	0.0	0.0	0.0	0.0
Rescheduling of debt	61.0	0.0	0.0	0.0	0.0	0.0	0.0
Unidentified gap 3/	0.0	51.8	176.5	235.5	344.2	362.4	472.7

Sources: Kenyan authorities; and staff estimates and projections

1/ Fiscal years ending June.

2/ Short-term (net) and errors and omissions in Kenya are traditionally large and volatile. They are believed to include unreported tourism inflows.

3/ The unidentified gap is defined as program support that is expected but unidentified plus possible rescheduling.

Table 11. Kenya: External Debt Indicators, 2000-08 1/
(In millions of U.S. dollars, unless otherwise indicated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Debt-stock indicators									
Stock of external debt by creditor 2/ 3/	5,496	4,713	5,187	5,106	5,328	6,065	6,869	7,324	7,962
Multilateral creditors	3,001	2,919	3,044	3,057	3,204	3,752	4,380	4,662	5,108
IMF	128	99	88	109	96	169	197	188	179
World Bank	2,356	2,291	2,474	2,424	2,513	2,801	3,209	3,291	3,462
African Development Bank/African Development Fund	355	302	305	314	348	458	580	710	907
Other	162	228	177	210	247	324	394	473	560
Bilateral creditors	1,889	1,600	1,591	1,757	1,877	2,108	2,317	2,524	2,744
Paris Club	1,845	1,552	1,527	1,665	1,754	1,929	2,086	2,241	2,407
Non-Paris Club	44	48	64	92	123	179	231	283	337
Other creditors 4/	606	194	273	293	247	205	171	138	110
Stock of external debt by debtor 2/ 3/	5,723	4,713	5,187	5,106	5,328	6,065	6,869	7,324	7,962
Central government	4,857	4,312	4,491	4,607	4,831	5,490	6,258	6,719	7,361
Government guaranteed	511	303	328	390	401	406	413	418	422
Central bank	128	99	88	109	96	169	197	188	179
Net present value (NPV) of debt 3/ 5/									
In million of U.S. dollars	4,099	3,430	4,189	4,079	4,155	4,677	5,181	5,571	6,052
In percent of exports of goods and services 6/	149	123	140	123	115	121	125	124	121
In percent of government revenue 7/	171	139	157	135	132	141			
In percent of GDP	39	30	34	29	29	30	31	31	31
Stock of arrears 8/	228	276	280	81	-	-	-	-	-
Debt-service indicators									
Principal payments by creditor 3/	425	373	256	332	240	229	232	227	224
Multilateral creditors	156	128	91	122	107	99	111	103	103
IMF	42	24	19	19	13	7	13	9	9
World Bank	70	63	52	66	64	62	67	71	73
AfDB/AfDF	19	19	11	12	11	11	11	12	11
Other	25	23	8	25	20	20	20	12	9
Bilateral creditors	122	151	141	104	87	87	88	91	93
Paris Club	116	149	135	97	84	85	85	88	90
Non-Paris Club	6	1	7	7	3	3	3	3	3
Other creditors 4/	147	95	23	106	46	42	34	33	28
Interest payments by creditor 3/	99	92	89	93	98	114	114	141	156
Multilateral creditors	38	49	29	32	33	40	47	51	57
IMF	1	1	-	2	1	2	2	2	2
World Bank	26	34	19	19	19	21	24	25	26
AfDB/AfDF	8	12	6	5	5	5	6	7	8
Other	4	2	4	6	8	11	14	18	22
Bilateral creditors	37	28	43	48	53	63	67	82	92
Paris Club	36	28	43	41	39	36	31	32	30
Non-Paris Club	1	0	0	7	15	27	36	50	62
Other creditors 4/	24	15	16	13	11	11	0	8	6
Debt-service ratio (in percent of current year exports)	19	16	11	12	9	8	8	7	7
Debt-service to fiscal revenue ratio 7/	22	19	13	14	11	10	10	10	9

Sources: Kenyan authorities; and staff estimates and projections.

1/ Based on a preliminary debt sustainability analysis

2/ Does not include arrears.

3/ After Paris Club rescheduling in November 2000; assumes comparable treatment by non-Paris Club and commercial creditors but also reflects recent agreements with some commercial creditors.

4/ Includes commercial banks' and suppliers' credit; includes stock and repayment of arrears according to the terms agreed with commercial banks. Data on debt service to other creditors beginning in 2003 reflect preliminary information on recent creditor agreements and may be revised.

5/ Refers to the present value of debt service calculated by using the currency-specific commercial interest reference rate (CIRR) as the discount rate.

6/ Three-year backward-looking average.

7/ Central government revenue, excluding grants.

8/ The stocks of arrears at end-2000 and end-2001 are largely composed of arrears to commercial creditors that are assumed to be cleared when Kenya reaches a rescheduling agreement with these creditors.

Kenya: Relations with the Fund

(As of July 31, 2003)

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

II. General Resources Account:	SDR million	Percent of quota
Quota	271.40	100.00
Fund holdings of currency	258.77	95.35
Reserve position in Fund	12.63	4.65
 III. SDR Department:	 SDR million	 Percent of allocation
Net cumulative allocation	36.99	100.00
Holdings	0.31	0.83
 IV. Outstanding Purchases and Loans:	 SDR million	 Percent of quota
Poverty Reduction and Growth Facility (PRGF) arrangements	57.60	21.22

V. Financial Arrangements:

<u>Type</u>	<u>Approval</u> Date	<u>Expiration</u> Date	<u>Amount Approved</u> (SDR million)	<u>Amount Drawn</u> (SDR million)
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):

Forthcoming					
	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>
Principal	7.02	9.51	4.99	9.21	6.72
Charges/interest	<u>0.42</u>	<u>0.79</u>	<u>0.75</u>	<u>0.71</u>	<u>0.68</u>
Total	7.43	10.30	5.74	9.93	7.39

VII. Safeguards Assessments

Under the Fund's safeguards assessment policy, the Central Bank of Kenya is subject to a new safeguards assessment with respect to the anticipated PRGF arrangement. An on-site assessment to follow up on the pending recommendations of the previous safeguards report and to review the CBK's framework of safeguards for any possible new vulnerabilities was conducted in September 2003.

VIII. 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 arrangement that is free of exchange restrictions and multiple currency practices. On August 28, 2003, the exchange rate was K Sh 76.8=US\$1.

IX. Article IV Consultations

Kenya is on the 12-month cycle for Article IV consultations. The 2003 Article IV consultation was concluded on May 2, 2003 (IMF Country Report No. 03/199).

X. FSAP Participation

The first of two joint IMF-World Bank Financial Sector Assessment Program (FSAP) missions visited Nairobi during July 15-24, 2003. The second mission will be held in October.

XI. Technical Assistance

Department	Purpose	Time of Delivery
MAE	Mission on banking supervision	November 1999
MAE	Mission on banking supervision and bank restructuring	February 1999

STA	Resident expert on balance of payments statistics	May-August 1999
MAE	Mission on banking supervision	July 1999
STA	Mission on government finance statistics	November-December 1999
FAD	Mission on improving expenditure management and control	February 2000
MAE	Mission on banking supervision	May 2000
STA	Mission on balance of payments statistics	May-July 2000
FAD	Mission on internal audit	November 2000
FAD	Mission on tax and customs administration	January 2001
MAE	Mission on bank restructuring and review of deposit insurance system	June 2001
MAE	Mission on review of banking conditions and systemic vulnerability	January 2002
STA	Two-year ongoing project on national Accounts	May 2002-May 2004
MAE	Mission on elements of a plan to deal with the nonperforming loan problem	July 2002
FAD	AFRITAC East work plan mission	December 2002
FAD	AFRITAC East/Bank mission on assessment of tracking of public expenditure management system	March 2003

XII. Resident Representative

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

Kenya: IMF-World Bank Relations

(As of August 31, 2003)

A. Partnership in Kenya's Development Strategy

1. Kenya's development strategy is set forth in the Economic Recovery Strategy (ERS) being finalized by the new government that assumed office in December 2002. The ERS draws upon the draft poverty reduction strategy paper (PRSP), prepared by the previous government following large-scale consultations with stakeholders. It is expected to be presented to the Bank and Fund for a joint assessment as Kenya's PRSP later this year. Key themes of the strategy are the following:

- accelerating economic growth in an environment of macroeconomic stability;
- strengthening institutions for governance, including implementation of the recently enacted Anti-Corruption and Economic Crimes Act and the Public Officer Ethics Act; strengthening security and law and order;
- rehabilitating and expanding physical infrastructure, specifically the road network, including rural access roads and the energy sector;
- improving access to, and quality of, education and health services; and
- improving the investment climate particularly for micro- and small enterprises, and reforming the financial sector.

2. Both the Bank and Fund have been involved in commenting on the ERS during its preparation, and this strategy is expected to provide the framework for Bank-Fund support to Kenya's development efforts in the medium term. The government intends to use the ERS to coordinate donor support in general, and it is planning to hold an investment conference and a Consultative Group meeting in November of this year involving donors and other lenders.

3. In supporting Kenya's development strategy, the IMF leads the dialogue on macroeconomic policies and coordinates with the Bank on structural reforms in the areas of public expenditure management, governance, financial sector, and the public wage bill. The Fund is negotiating a three-year arrangement under the poverty reduction and growth facility (PRGF) to help Kenya maintain macroeconomic stability. Prior to this, the Fund had been conducting Article IV consultations with the government, the last one of which was concluded in May 2003. In addition to macroeconomic targets, the PRGF arrangement is expected to include structural performance criteria related to expenditure control, the public wage bill, anticorruption efforts, and the financial sector. The Fund's work complements the Bank's, which takes the lead on sectoral reforms in the context of projects and analytic work in the areas of infrastructure development, social sectors, private sector development, and public enterprise and civil service reforms.

B. Bank Group Strategy

4. A Country Assistance Strategy (CAS) was approved in 1998 that put the Bank's lending program for Kenya in the "low case," with a projected lending program of up to US\$150 million over the following three years. Subsequently, the government undertook a series of governance and public sector reforms, paving the way for the resumption of a base-case lending program in August 2000.

5. A new CAS for fiscal year (FY) 04-07 is expected to be completed by January 2004. It will be aligned closely with the development priorities set forth in the ERS. A key challenge will be to build on the ERS as the basis for much greater harmonization of donor programs, while shifting assistance away from projects and toward increasing levels of budget-based support. The latter will require the following:

- improvements in the public accountability framework, specifically in the areas of procurement and financial management;
- development of a strong participatory monitoring and evaluation system for the ERS objectives;
- improvements in public expenditure management supported by an annual public expenditure review (PER);
- development of a positive reform track record through the implementation of Bank- and IMF-supported reform programs; and
- undertaking of necessary analytical work, such as the cross-cutting assessment of Kenya's social, structural, and key sectoral development policies.

6. As described in the following sections, the Bank's current portfolio of projects and nonlending activities is consistent with the development strategy in ERS and is expected to expand in size and content as the relationship with the new government matures. The CAS will discuss various instruments for delivering aid, including budget support through Poverty Reduction Support Credits.

7. **Economic and public sector management.** The ERS gives high priority to budgetary and public expenditure reforms. The Economic and Public Sector Reform Credit (EPSRC) for US\$150 million, approved in 2000, supports reforms in the areas of economic governance, civil service, expenditure management, and public enterprises. The Bank is also working with the government to institutionalize a process of PERs with a view to strengthening budget management and strategic resource allocation and engendering greater openness and participation in budget matters. A Public Sector Management Technical Assistance Program (PSMTAP) for US\$15 million approved in July 2001 is providing support for reform and capacity building in the areas of civil service restructuring, pay reform, auditing, medium-term expenditure framework (MTEF), the Integrated Financial Management and Information System (IFMIS), and procurement. The project also supports the legal sector reform secretariat and reforms in some key judicial systems.

8. In order to enhance the capacity of the Central Bureau of Statistics and other similar agencies, the bank is preparing a Statistical Capacity-Building Project (STATCAP), to be delivered in FY 04. A Country Economic Memorandum (CEM) has recently been completed that focuses on the issue of growth, in particular on the structural weaknesses that have contributed to the decline in productivity and competitiveness of the economy, and identifies policy and institutional reforms to address these weaknesses.

9. **Financial sector development.** The ERS (a) identifies the urgent need to reform the financial sector in Kenya, which is beset with a high level of nonperforming loans, and wide interest rate spreads, and faces a weak legal and judicial system. The government is considering divestiture of the state's stake in two of the biggest banks and has also announced a number of policy initiatives recently. The Bank, too, places considerable emphasis on financial sector development as a means to improve the functioning of the sector itself and thereby contribute to economic growth and contain mounting contingent fiscal liabilities. To support the government's reform agenda, the Bank is designing a Financial Sector Adjustment Credit (FSAC)—a budget support operation—for a possible delivery in FY 04. As noted in paragraph 23, the Bank is working with the Fund on a Financial Sector Assessment Program (FSAP). The Bank team is also working on a Technical Assistance Credit that will provide support for reforms identified in both the FSAC and the FSAP.

10. **Privatization and private sector participation.** Bank activity in this area has aimed at providing technical advice toward developing and implementing strategies for private sector participation in major public utilities. The Bank completed a report that took stock of progress on parastatal reform and highlighted priorities to be adopted by the government. The report also stressed the need to change the privatization law and made specific recommendations to this end. The Bank is also administering the Public-Private Infrastructure Advisory (PPIAF) grants for setting up an appropriate regulatory and legal framework for private sector participation in roads and railways. The Bank is also providing on-demand technical advice on liberalization of the telecommunications sector.

11. **Private sector development.** In April 2001, the Bank approved a Regional Trade Facilitation Project (US\$25 million) aimed at improving access to financing for productive transactions and cross-border trade between participating countries. The Bank is carrying out an Investment Climate Assessment that will identify key bottlenecks and main constraints on the investment climate in Kenya, including governance, customs administration, regulatory framework, etc. The assessment will feed into a major piece of the economic and sector work (ESW) in FY 04 focusing on constraints on private sector development in the country.

12. **Infrastructure development.** The ERS recognizes the lack of adequate physical infrastructure as a major impediment to private sector development in Kenya. The Bank has three ongoing infrastructure projects: an Urban Transport Project, which finances new and expanded road links, intersections, and public transport facilities in urban areas; the Nairobi-Mombasa Road Rehabilitation Project, which supports rehabilitation of Kenya's chief transport corridor; and the Energy Sector Reform and Power Development Project, which is expected to increase generation capacity, reform energy pricing, and encourage private sector

participation in the sector. Preparation is under way for a transport project, which is currently planned for Board delivery in FY 04. A proposed Power Sector Recovery Credit is also planned for FY 04.

13. **Agriculture.** The Bank's activities in the agriculture sector support the government's development strategy, which aims at realigning the policy framework and the incentive structure, redefining the role and core functions of the government in the sector, and encouraging a more competitive marketing system, with increased participation by the private sector. The government's development strategy also envisages support for the core programs of research and extension. The Bank currently has three ongoing projects in the agriculture and environmental areas, including a second phase of the Arid Lands Resource Management Project for US\$60 million approved in June 2003.

14. **Education and health.** In education, the Bank's emphasis is on (i) supporting the most immediate challenges created by the new policy environment, and particularly the government's commitment to free primary education; (ii) restructuring key institutions and policies to improve the quality and sustainability of primary and secondary education through curriculum reform, better teacher training and redeployment, textbook policy reforms, management strengthening and decentralization; and (iii) carrying out associated analytical work, especially on the restructuring of public expenditure to improve the efficiency of service delivery and enhance access to quality basic education, particularly in remote and slum areas. In health, the emphasis is on (i) the development of prevention programs for sexually transmitted diseases, including AIDS; (ii) a shift in resources from curative to efficient primary care, including reproductive services; and (iii) a clarification of the respective roles of the private and public sectors.

15. The Bank has four ongoing human resource development operations: (i) an early Child Development Project, which aims at reinforcing existing institutions and improving the quality of services offered to children of preschool age; (ii) an HIV/AIDS Disaster Response Project to reduce the spread of HIV/AIDS, to mitigate the socioeconomic impact of the disease, and to increase the access to care and support for people infected or affected by the HIV/AIDS epidemic in Kenya; (iii) a Decentralized Reproductive Health and HIV/AIDS Project aimed at improving mother-and-child health by promoting delivery of comprehensive reproductive health services; and (iv) a quick-disbursing operation for supporting the new government's policy of free primary education. The last project will focus primarily on providing textbooks along with a small capacity-building component. This will be followed up by a larger program of assistance in FY 04, with a broader focus on secondary as well as primary education.

16. **Other nonlending activities.** The Bank has recently completed economic studies on Community-Driven Development, Local Service Delivery and Local Governments, Transport Sector, and Gender Assessment. Sector work on education, energy, health, urban poverty, the linkages between agriculture, poverty, and rural growth, and watershed management is planned for FY 04. The Bank is also supporting the government in

developing and executing an Integrated Household-Based Survey to improve the information base for poverty analysis and monitoring.

Summary of Bank's Lending Portfolio

(As on 31 August, 2003)

Project	Sector	Closing Date	Loan/Credit	Undisbursed on 8/31/03
			Amount (in millions of US dollars)	
Nairobi-Mombasa Road Rehabilitation	Transport	3/04	50.00	6.00
National Agricultural Research Project II	Agriculture	12/03	39.70	1.50
Early Childhood Development	Education	6/04	27.80	10.20
Energy Sector Reform and power development	Power	6/04	125.00	38.10
Urban Transport Infrastructure	Transport	6/04	115.00	24.10
HIV/AIDS Disaster Response	Health	6/05	50.00	32.50
Decentralized AIDS and Reproductive Health Project	Health	6/05	50.00	38.90
Regional Trade Facilitation Project	Private Sector	6/11	25.00	20.10
Public Sector Management TA Program	Public Sector	12/04	15.00	10.30
Arid Lands II	Agriculture	6/09	60.00	60.90
Free Primary Education	Education	12/06	50.00	22.40
Lake Victoria Environment (GEF)	Environment	12/04	11.50	6.10
Economic & Public Sector Reform Credit	Public Sector	4/04	155.37	107.90
Total Active = 13			774.4	379.0

C. IMF-World Bank Collaboration in Specific Areas

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

18. **Joint assessment of government's poverty reduction strategy.** Kenya's interim PRSP, produced by the previous government, was jointly assessed by the Bank and Fund in July 2000. The previous government had also completed a PRSP, which has been incorporated by the present government into its ERS after reconciling it with its own priorities. The government is presently finalizing the ERS, incorporating comments received from the Fund and the Bank, and a final version is expected to be delivered for a joint assessment by Bank and fund staff by end-December. The Bank and Fund have collaborated on a joint assessment of the PRSP preparation status report.

19. **Macroeconomic framework.** The Fund leads the analysis and dialogue on monetary policy, which serves as input into the Bank program. The monetary policy dialogue focuses on issues related to quantitative monetary targets, such as money supply and inflation, exchange rate changes, and central bank operations. The Bank collaborates with the Fund on fiscal policy dialogue, which broadly covers issues related to fiscal sustainability and size of the public sector. Currently, the dialogue focuses on the size of overall fiscal deficit, fiscal risks, public service wage bill, revenue performance, including tax administration and

adjustment to tax policy, and domestic debt financing of the deficit. The Bank takes the lead on the analysis of issues related to economic growth and poverty. The recently concluded CEMs by the Bank, on which the Fund also provided peer review comments, included analysis of sources of growth and determinants of poverty, and the impact of alternative policies and programs on economic growth and poverty reduction. The CEM is expected to serve as an input into policy formulation and advice for both the Bank and Fund.

20. **Budgetary and public expenditure reforms.** The Bank and Fund work closely to support government efforts in budgetary and public expenditure reforms. The Fund contributes largely on financial management and control issues, while the Bank leads the dialogue on planning, MTEF, strategic resource allocation (particularly expenditure on core programs benefiting poor), expenditure restructuring, and issues related to efficiency of public spending, such as expenditure tracking. The Bank conducted a Country Financial Accountability Assessment (CFAA) in November 2001, which was recently updated by the government. Separately, a joint Bank-Fund HIPC Expenditure-Tracking Assessment and Action Plan focusing on financial management issues was completed in June 2003. The government has prepared a broad Public Expenditure Management Reform Program, focusing on institutional and policy reforms in budget management and based on the recommendations of these two analytic works. A technical working group that includes Bank and Fund representatives, along with other donors and stakeholders, monitors the PER process and implementation of the reform program. The Bank's ongoing adjustment credit has conditions related to improving the effectiveness of the Auditor General, public expenditure reporting, and monitoring of programs benefiting the poor. The Bank and Fund also collaborate on issues related to internal audit reform and IFMIS in the context of (PSMTAP).

21. **Debt management and debt sustainability analysis.** As part of the HIPC eligibility exercise, the Bank and Fund jointly carried out a debt sustainability analysis in 1999-2000. The Fund is now updating the external debt sustainability analysis, in which the Bank is helping with reconciliation of debt data. In the context of the Financial Sector Assessment Program (FSAP), 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.

22. **Governance reforms.** High levels of public corruption and a poor security situation were largely seen as the cause of Kenya's poor economic performance in the last decade, and governance reforms are a key element of the government's strategy to promote economic growth and reduce poverty. The Bank's adjustment credit—EPSRC—included conditionality related to strengthening accountability for the use of public resources, making procurement reforms, and establishing a code of conduct for judicial officers. Prior actions for PRGF negotiations with the IMF also included enactment of anticorruption legislation. The PRGF arrangement itself is expected to support a deepening of anticorruption measures. The Bank is supporting the strengthening of legal and judicial institutions in the context of the PSMTAP and is working on an IDF grant to support the Anti-Corruption Commission. A project on legal and judicial reforms is also under preparation.

23. **Financial sector reforms.** The Fund and Bank are collaborating on financial sector reforms in several ways. They are conducting a joint in-depth assessment of the financial sector (banking, insurance, and capital markets) through the FSAP being led by the Fund. The FSAP will produce technical notes on selected topics, detailed assessments of standards and codes, the Fund's Financial System Stability Assessment, and the Bank's Financial Sector Assessment. The FSAP will provide analytical input to the FSAC. There is expected to be close coordination between the Bank and the Fund on the prior actions and conditionality for the FSAC.

24. **Privatization and private sector development.** The dialogue on privatization and regulatory reforms is led by the Bank, and the Fund is a partner in this policy dialogue, particularly from the point of view of fiscal burden issues. The PRGF is expected to have conditionality regarding the legal framework for privatization.

25. With the onset of the Doha development agenda, trade issues have assumed prominence within the government of Kenya's policymaking priorities. Kenya is negotiating a customs union with Uganda and Tanzania as a member of the East African Community (EAC) and is actively involved in Common Market for Eastern and Southern Africa (COMESA) negotiations and activities. While the Fund is focusing on reform of the tariff regime, the Bank is providing technical advice on regional integration issues. The Bank has planned a diagnostic trade study on integration issues, to be completed in FY 04. The Bank is also producing two policy notes on implications of an EAC customs union for revenue and effective protection in member states. The Fund was involved in the Concept Review of these two policy notes. The Bank is undertaking an assessment of nonfiscal investment incentives, which will feed into a report proposing measures to harmonize such incentives in the three EAC member states for the planned customs union. This work is complemented by an IMF assessment of fiscal investment incentives, which will likewise feed into suggestions for harmonization.

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

Kenya: Statistical Issues

1. Weaknesses in key macroeconomic statistics hamper economic analysis and surveillance. Kenya's macroeconomic statistics have deteriorated significantly over the past decade, reflecting primarily managerial and organizational weaknesses, and inadequate resources at the Central Bureau of Statistics (CBS). During the 2002 Article IV consultation discussions, the staff emphasized the need to improve the timeliness and quality of these statistics, and encouraged the authorities to promptly implement the recommendations of past technical assistance missions from the STA.

2. The authorities are taking actions, with donor assistance, to improve the quality and timeliness of the data. Kenya is participating in the General Data Dissemination System project for Anglophone Africa that is funded by the Department for International Development (DFID) of the UK, and metadata and detailed plans for improving the data over the short and medium term have been posted on the Fund's Data Standards Bulletin Board. Kenya received Fund technical assistance in the context of this project, and further assessment of the need for capacity building has been undertaken by the AFRITAC East Statistical Advisor. The authorities, moreover, are preparing a statistical master plan and a new statistical act that would improve the independence of the CBS.

3. A multisector STA mission to Kenya in 1998 undertook a comprehensive review of the major statistical areas and prepared a work program providing a broad time frame for implementing the principal recommendations, which address most of the statistical problems discussed below. A peripatetic STA advisor assisted the authorities in improving the balance of payments statistics in the course of 1999 and 2000, and a peripatetic STA advisor is currently assisting the authorities in improving their national accounts statistics. A revised set of national accounts data is expected to be released in mid-2003.

4. 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

5. 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. Moreover, the constant-price base year is seriously outdated (1982). The authorities urgently need to revise their annual national accounts statistics and strengthen their institutional capacity to improve the quality of data. The latest available official national accounts data are for 2001.

Prices and production

6. The CBS commenced publication in early 2002 of a new national CPI (covering 12 urban areas), with 1997=100 and weights based on the 1992-93 HBS. The index is compiled and published on a timely basis. There is no producer price index, or any short-term export and import price indices produced.

Government finance statistics

7. The 1998 multisector statistics mission found several statistical problems with the cumulative year-to-date monthly and quarterly fiscal data that the Ministry of Finance (MoF) compile and report to the AFR for budget-monitoring purposes. These data, which do not conform to the Fund's government finance statistics (GFS) methodology, do not adequately facilitate economic analysis, mainly because of inappropriate classification of expenditure data. The MoF has not developed a system to adequately monitor expenditure commitments, or domestic arrears, and relies mainly on monitoring cash movements in government accounts at the CBK. The recording of external financing and expenditure directly financed from abroad also remains an area for improvement. The 1998 mission made several recommendations for improving the data, most of which have not been implemented.

8. The CBS compiles and reports to the STA aggregate annual GFS revenue and expenditure data for budgetary central government based on detailed data in the reports of the Controller and Auditor General, using a methodology established by a 1999 STA GFS mission. Lack of proper computerization prevents the CBS from compiling more detailed GFS data. Considerable differences exist between these data and the data compiled by the MoF and reported to the AFR for monitoring purposes.

Monetary statistics

9. Monetary statistics are compiled from a bank reporting system and are broadly adequate for policy, analytical, and supervisory purposes. A STA technical assistance mission in January 2000 observed that the authorities had implemented virtually all recommendations of the previous STA missions, which had led to a number of improvements in Kenya's monetary statistics. However, the mission identified and made recommendations to address further problems in monetary data, in particular (a) asymmetrical interbank positions, (b) the statistical implications on the data of numerous bank closures, and (c) the coverage of international reserves. Since then, the authorities have initiated revisions to monetary statistics in line with the recommendations of the mission.

Balance of payments statistics

10. The CBS compiles and reports balance of payments data in Kenya shillings annually on a regular basis to the STA, although with a considerable lag. The CBK, in addition, compiles a complete set of annual balance of payments statistics in U.S. dollars, which are reported to the AFR and used for programming and surveillance purposes. The two sets of

balance of payments data are not entirely consistent, and the staff has been strongly encouraging the authorities to reconciling the two sets. Recently, the CBK also started to compile and publish discrete quarterly balance of payments estimates.

11. The quality of the data has deteriorated. 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 have emerged in the coverage of balance of payments source statistics. 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 underrecording of current earnings, including tourism receipts, as well as a failure to capture 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 that have emerged in the balance of payments since 1994 raise concerns as to the potential size of external obligations.

12. The MoF compiles data covering Kenya's public and publicly guaranteed external obligations to official and commercial creditors. This database does not take account of nonresident purchases of the government's domestic currency-denominated debt securities. The 2001 STA BOP mission noted that, should the results of the benchmark foreign investment survey become available, the CBS can start compiling and disseminating more comprehensive annual external debt data for Kenya.

Kenya: Debt Statistics

13. While, as part of the 2002 DSA, steps were taken by the authorities to address the main data problems identified in discussions with the staff, significant data weaknesses remain. The loan-by-loan data submitted to the World Bank's DRS database differs from the ones more recently provided to the Fund for an update of the DSA based on end-2002 debt stock numbers. Moreover, the debt service projections for 2003 onwards based on the new DSA differ from the authorities projections.

Kenya: Survey of Reporting of Main Statistical Indicators
(as of September 24, 2003)

	Exchange Rates	Central Bank Balance Sheet	International Reserves	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Central Government Balance	Exports/ Imports	Current Account Balance	External Debt	GDP/ GNP
Date of latest observation	7/31/03	7/31/03/7/31/03	7/31/03	7/31/03	7/31/03	7/31/03	07/2003	12/2002	06/2003	12/31/01	12/2000	2002
Date received	9/17/03	9/17/03	9/17/03	9/17/03	9/17/03	9/17/03	09/2003	1/21/2003	09/2003	8/21/02	3/2001	09/2003
Frequency of data ¹	D	D	D	D	M	W	M	M	M	A	A	A
Frequency of reporting ¹	D/W	D/W	D/W	D/W	M	W/M	M	M	M	A	A	A
Frequency of publication ¹	D	M	M	M	M	D	M	Q	M	M	A	A
Source of data ²	DR	DR	DR	DR	DR	DR	DR	DR	DR	DR	DR	OP
Mode of reporting ³	F	F	F	F	F	F	F	F	F/P	P/SV	P/SV	P/SV
Confidentiality ⁴	E	R	R	R	E	E	E	R	E	E	E	E

¹D = daily; W = weekly; M = Monthly, Q = quarterly; A = annually.

²DR = direct reporting from the Central Bank of Kenya or Ministry of Finance; OP = official publication.

³F = facsimile; P = mail; SV = staff visit.

⁴R = restricted use; E = embargoed for a specified period and then unrestricted use.

September 22, 2003

Mr. Horst Köhler
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Dear Mr. Köhler:

1. On behalf of the government of Kenya, I am transmitting the annexed memorandum of economic and financial policies (MEFP) that outlines the objectives and policies that the government intends to pursue in 2003/04-2005/06. The main goal of our policies and reforms is to reduce poverty and increase economic growth and employment through the pursuit of sound macroeconomic policies and key structural reforms, including the continued fight against corruption, fiscal restructuring, financial sector reform, trade liberalization, and the privatization of public enterprises. These measures will contribute to current real GDP growth of about 1 percent, rising to about 4 percent in 2005/06; underlying inflation of less than 5 percent; and a marked improvement in domestic and overall debt dynamics.
2. The program outlined in the attached MEFP is embedded in the Economic Recovery Strategy for Wealth and Employment Creation (ERSWEC), which outlines our medium-term development policies. Our approach to economic management has continued to evolve since the government took office and since the June 12, 2003 budget speech as more information has become available on the underlying weaknesses of the economy. Moreover, the budget that was passed by parliament in August 2003 is consistent with the attached memorandum. In the coming months, we intend to expand the ERSWEC into a full poverty reduction strategy paper (PRSP) that will include a medium-term expenditure framework, as well as a macroeconomic framework that would be aligned with the Poverty Reduction and Growth Facility (PRGF)-supported program and the 2003/04 budget. A PRSP preparation status report has been prepared that describes the actions we are taking to produce a full PRSP.
3. The prior actions, performance criteria, and benchmarks under the program are set out in Tables 1 and 2 of the MEFP. The first review under the PRGF arrangement is expected to be completed by May 2004, which will also focus on trade liberalization. The second review would be completed by October 2004.
4. In support of the objectives and policies set out in the MEFP, we hereby request a three-year arrangement under the PRGF in an amount equivalent to SDR 175 million (64.5 percent of quota), including one disbursement following Board approval of the arrangement in November 2003 and six equal disbursements in May and October of the

succeeding years, following satisfactory conclusion of the semiannual reviews under the program.

5. We believe the measures outlined in the MEFP to be adequate for the achievement of the growth and poverty objectives, but stand ready to take additional measures to these ends if deemed necessary. During the arrangement period, and subsequently while the government has outstanding financial obligations to the Fund arising from loans under the arrangement, we will consult with the Managing Director on Kenya's economic and financial policies at the initiative of the government or whenever the Managing Director requests such a consultation. We authorize the publication and distribution of this letter and all reports prepared by Fund staff regarding the program under the new PRGF arrangement, including reports regarding the program prepared jointly with the World Bank staff.

Very truly yours,

/s/

David Mwiraria
Minister of Finance

Attachments

KENYA

Memorandum of Economic and Financial Policies for 2003/04 Under the Three-Year Program of the PRGF Arrangement

I. INTRODUCTION AND BACKGROUND

1. Kenya stands at a critical juncture in its post-independence history. After two-and-a-half decades of one-party rule and deteriorating economic opportunities, the recent change in government has raised expectations in the country that an improvement in living standards, in the context of a liberal democratic political order, may be achievable. However, in addition to the democratic political dispensation that the government has begun to entrench, a significant improvement in economic conditions will require the sustained implementation of bold economic reforms to address the major structural dislocations in the economy. To this end, the government has launched a comprehensive economic reform and poverty reduction strategy, the Economic Recovery Strategy for Wealth and Employment Creation (ERSWEC), with the aim of creating an environment conducive to private sector-led growth and the expansion of employment opportunities. Since taking office in December 2002, and notwithstanding severe resource constraints, the government has begun to implement a wide range of reforms, particularly in the areas of governance and education services.

2. Since the 1980s, the economy has performed well below potential, with low economic and employment growth and a decline in productivity. As a result, real per capita GDP was lower in 2002 than it was a decade earlier, and the number of people living below the poverty line is estimated to have risen from 11.3 million in 1990 to 17.1 million in 2001. Moreover, the incidence of HIV/AIDS has increased, thereby imposing an increasing social and economic burden. The factors underlying the weak economic performance and high incidence of poverty include the persistence of pervasive governance failures, the slow pace of economic reforms, low saving and investment, a weak banking system, intermittent shortages and high costs of electric power, and the poor physical and telecommunications infrastructure, together with an inward-looking trade regime that has enabled protected industries to absorb high increases in real wage rates.

3. Weak economic growth has been accompanied by a deterioration in the fiscal position and a growing domestic debt. Government revenue fell from 22.8 percent of GDP in 2000/01 to 20.7 percent in 2002/03, owing mainly to a reduction in tax rates. However, a weakening in tax administration resulting largely from widespread corruption has also contributed to the decline in revenue. Public expenditure came under expansionary pressure on account of increased spending on wages, salaries, and interest, as well as the burden of supporting a large parastatal sector. With donor budgetary support falling concurrently, the resulting fiscal pressures were accommodated by a squeeze in spending on operations and maintenance and public investment, an increase in arrears, including pending bills and stalled projects, and growing domestic borrowing.

II. RECENT ECONOMIC DEVELOPMENTS

4. Recent data indicate that overall economic conditions remain subdued, against the background of the recent terrorism alert, which has taken a heavy toll on the tourism industry. Partly for this reason, real GDP growth in 2003 is projected to remain at the 2002 rate of about 1 percent. Headline consumer price inflation rose sharply to about 14 percent in June 2003 from 1.8 percent in September 2002, driven by a sharp increase in food and oil prices. Excluding food and energy, inflation rose to 3.7 percent in June 2003 from 1.6 percent in October 2002, reflecting in part a loosening of monetary conditions during 2002 that was accompanied by a depreciation in the nominal and real effective exchange rates of the Kenyan shilling. During the first five months of 2003, however, the shilling has appreciated by 5.1 percent against the U.S. dollar. While the exchange rate does not appear to have been a major impediment to export performance in recent years, the government has been monitoring exchange rate developments closely, as a continuation of the recent appreciation trend could have adverse effects on export and output growth. Broad money expanded by 10.9 percent in the 12-month period to June 2003. Three-month treasury bill rates have declined substantially from 25 percent in June 2002 to 3.0 percent in June 2003, despite the large increase in the domestic funding requirements of the government, reflecting primarily the persistence of liquid market conditions and a shift in domestic borrowing toward high-maturity bonds.

5. The provisional fiscal outturn for 2002/03 (July–June) indicates that the overall deficit, before grants, widened by 1.1 percent of GDP relative to 2001/02 on account of both lower revenues and higher expenditures. In addition, domestic borrowing remained high, contributing to a marked buildup in domestic debt to 25 percent of GDP at end-June 2003. Revenue performance was weaker than in 2001/02 and below the budgeted amount, mainly because the expected improvements in excise tax collections and the broadening of the value added tax (VAT) base did not materialize. In addition, considerable problems were experienced in the management of oil reexports as a large volume of these untaxed products reportedly found their way back into the domestic market. Moreover, challenges emerged in the administration of excise taxes on tobacco. Expenditure exceeded the budget and the 2001/02 outcome, primarily on account of an increase in housing allowances for teachers and additional spending associated with the move to universal free primary education in January 2003.

III. MEDIUM-TERM FRAMEWORK AND POLICIES

A. The Economic Recovery Strategy for Wealth and Employment Creation

6. To address Kenya's weak economic fundamentals and thus lay the groundwork for strong economic and employment growth and poverty reduction, the government has developed a broad reform agenda, as outlined in the ERSWEC. During the coming months, the government intends to expand the ERSWEC into a full poverty reduction strategy paper (PRSP) by incorporating a more detailed discussion of the reform agenda and of the consultative process that was followed in its formulation, and by deepening the poverty diagnosis to include a comprehensive review of the determinants of poverty and their

evolution over time, as well as a clarification of the economic, social, and institutional constraints on poverty reduction. A medium-term expenditure framework will also be added that would indicate how public expenditure would be restructured over the medium term to achieve the growth and poverty goals. Moreover, there will be a common macroeconomic framework underpinning the PRSP, the Poverty Reduction and Growth Facility (PRGF)-supported program, and the 2003/04 budget.

7. The ERSWEC elaborates a broad development agenda, encompassing reforms aimed at accomplishing the following: (a) revitalizing the agricultural sector and encouraging the growth of medium- and small-scale enterprises; (b) enhancing the competitiveness of the economy through measures designed to increase labor market flexibility; (c) privatizing and restructuring parastatals; (d) rebuilding the public sector, social institutions, and the social and economic infrastructure; (e) improving the delivery of government services, in part through the establishment of cost benchmarks and services delivery targets for all public bodies; and (f) addressing the special problems of the arid and semiarid lands.

8. The three-year program to be supported by the Fund under the PRGF will focus on the following issues:

- fiscal consolidation to reduce the high domestic debt to a sustainable level;
- fiscal restructuring to achieve the growth and poverty reduction objectives;
- an improvement in governance and transparency, in part through the effective enforcement of the new anticorruption legislation and strict adherence to the public sector budget management and accounting system;
- a strengthening of the financial system by an early resolution of the problems of financial institutions in distress, enhancement of the regulatory and prudential supervisory framework, and the privatization of state banks;
- an acceleration of the privatization process; and
- an elaboration of an ambitious trade liberalization strategy, which would include a simplification of the tariff structure, a phased reduction of the tariff rates, and the elimination of any remaining quantitative restrictions.

B. The Macroeconomic Framework

9. While aiming for sustained growth of 7 percent over the medium term, our macroeconomic framework is based on a steady pickup of real GDP growth to about 4 percent by 2005/06, with gross investment expanding from 14.5 percent of GDP in 2002/03 to 25.9 percent of GDP in 2005/06; gross national savings would initially fall moderately and then rise to 14.9 percent of GDP by 2005/06, with both public and private savings increasing in response to improving economic conditions under the program. In the absence of major adverse exogenous shocks, a prudent monetary policy would help to contain underlying inflation at below 5 percent. With the increase in investment-related imports, the current account deficit would rise to 4.9 percent of GDP in 2003/04 and then to an average of 8.8 percent of GDP in 2004/05 and 2005/06. Given the projected current account deficits and committed net capital inflows, substantial financing needs are foreseen during 2003/04-

2005/06 (averaging US\$1.3 billion a year). The projected inflows of donor support would be expected to cover these gaps, as well as a buildup in foreign reserves from 2.7 months of imports in mid-2003 to 4.0 months of imports in mid-2006.

10. Over the three-year program period, the overall fiscal deficit (excluding grants) is expected to increase from 4.8 percent of GDP in 2002/03 to about 6.2 percent of GDP in 2005/06, reflecting the initial emphasis of the program on expending development outlays for the rehabilitation of key social and economic infrastructure. The latter would be largely funded with concessional donor inflows. For this reason, as well as the sizable external debt repayments and outlays for bank restructuring and arrears reduction, the government's overall financing needs are likely to be quite substantial (9.8 percent of GDP) in 2003/04, falling to an average of 8.0 percent of GDP over the following two years. Since the combined inflows of grants and net foreign financing, based on existing commitments, are estimated to only increase from 1.7 percent of GDP in 2003/04 to 3.3 percent of GDP in 2005/06, substantial additional foreign assistance (including debt relief) will be needed to implement the ERSWEC and maintain financial stability. Such assistance will need to be provided on grant and very concessional terms to maintain debt sustainability.

C. The Governance Strategy

11. A key element of the government strategy to promote strong economic growth and poverty reduction is the prompt and major strengthening, now under way, of the country's governance structures. Over the medium term, these measures are expected to contribute significantly to an improvement of the revenue effort, a reduction in rent-seeking activities, and an increase in the productivity of public investment. The governance and anticorruption reform program has several important elements:

- The ongoing entrenchment of democratic political governance, with its emphasis on (a) the separation of powers among the various branches of government; (b) rule of law; (c) decentralization of the delivery of public services; and (d) promotion of a free press and a robust civil society. These measures are essential to advancing transparency and accountability in the conduct of public operations at all levels of government.
- Building institutions and practices that support market-oriented reforms. The actions under way include the ongoing strengthening of the regulatory framework and the prudential supervision of financial institutions, the planned establishment of a Privatization Secretariat to facilitate the privatization of parastatals in a transparent manner, and judicial reform, which has also involved the institution of a strict code of ethics for the judiciary and the removal of corrupt judges.
- Contracting the size of the public sector, in part through an acceleration of the parastatal privatization process.
- Strengthening the anticorruption legal structures and the enforcement mechanisms, including the enactment in May 2003 of the Anti-Corruption and Economic Crimes and the Public Officer Code of Ethics Bills. In addition, the Law Reform Commission has begun to update several important acts, including the Company and Investment

Laws. To help implement the anticorruption legislation, the government intends to make the Anti-Corruption Commission fully operational by the end of the year. In addition, all public employees are required to declare their assets and those of their families by end-2003.

- Reducing opportunities for corruption and eliminating conflicts of interest. Several measures under the program address these issues, including the transfer of the responsibility for the regulation of the financial sector from the Ministry of Finance to the Central Bank of Kenya; the cancellation of all stalled projects; the elimination of all pending bills; and the reform of the public sector procurement system. Civil servants have already been forbidden from supplying goods to the public sector.
- Improving the coverage and timeliness of data on fiscal operations, including the timely presentation of final accounts on government operations to the Auditor General.

IV. MACROECONOMIC OBJECTIVES AND POLICIES FOR 2003/04

A. Macroeconomic Framework

12. Real GDP growth is expected to pick up to 1.9 percent in 2003/04 from an estimated 1.1 percent in 2002/03, underpinned by strong performance of both the construction and the transport and communications sectors. End-period headline inflation is expected to decline to 4.0 percent in 2003/04 from about 13.7 percent in 2002/03, reflecting primarily a significant easing of price pressures in response to the fall in oil and fuel prices. Underlying inflation is projected to moderate to 2.7 percent by the end of 2003/04 from 3.7 percent at end-2002/03. The current account deficit would widen by 3.8 percent of GDP to 4.9 percent of GDP in 2003/04 as the rehabilitation of plant and equipment gains momentum. Gross international reserves are targeted to rise moderately to 2.8 months of import cover.

13. The principal objective of fiscal policy is to begin to stabilize and eventually reduce the domestic debt in order to stem the increase in interest payments and to ease pressures on real interest rates. Lower domestic debt will also facilitate the absorption of a much larger volume of concessional external credits in a sustainable manner. Accordingly, the budget for 2003/04 targets a substantial reduction in the domestic borrowing requirement from 5.0 percent of GDP in 2002/03 to 3.3 percent of GDP in 2003/04; of the latter, about 1.4 percent of GDP is associated with the need to accommodate some transitory payments, including the recapitalization of banks, the spike in external debt repayments, and the programmed reduction in the amount of pending bills. The realization of the domestic deficit target will be a daunting task for a number of reasons. First, the government has embarked upon a major upgrading of social and economic infrastructure, with a view to achieving the Millennium Development Goals as soon as possible. Second, the new administration has inherited large contingent liabilities that will need to be addressed at the outset of the program. Finally, the resumption of donor assistance is expected to be gradual.

14. Achieving the domestic deficit target while protecting priority spending on essential economic and social services will require some improvement in revenue performance. The

budget for 2003/04 envisages total revenue collection of 22.2 percent of GDP, which would imply a 1.5 percent of GDP increase over the expected outcome for 2002/03. To help achieve the 2003/04 revenue target and to lay the groundwork for a more ambitious medium-term program for rationalizing the tax system, the immediate focus of revenue policy will be on the rehabilitation of capacity and integrity in tax administration. Capacity has been severely eroded by widespread corruption and cronyism in the hiring and promotion of staff, and these developments have resulted in low compliance rates across all tax brackets and the erosion of the tax base, particularly in the petroleum sector, where cheap untaxed products account for a sizable portion of the market. Weak tax administration capacity has greatly circumscribed the scope for new tax policy measures at this stage.

15. The government believes that a major reform of the Kenya Revenue Authority (KRA) could significantly improve revenue collection over and above budget expectations, which mainly reflect the doubling of the VAT on mobile telephone use and the 0.5 percent of GDP of revenue collections that were previously not channeled through the budget—a dividend of the anticorruption effort. The tax administration measures underpinning the program include the following:

- an overhaul of the top management of KRA, particularly heads of key collection centers, such as the port of Mombassa and main airports;
- a restructuring of the port-handling facilities and revenue administration systems at Mombassa;
- the institution of new modalities for managing the taxation of the petroleum sector;
- the full application of the law in enforcing compliance by public entities that are tax collection agencies; and
- a revamping of the bond and warehousing facilities and the management of transit goods.

16. In light of the pressures on the budget, the program includes expenditure reduction measures of around 0.8 percent of GDP. These include continued wage restraint for the civil service, excluding teachers (0.5 percent of GDP); a continuation of the partial freeze on the filling of vacancies that arise from natural attrition (half of the 10,000 vacancies falling due will not be filled); and a cut in noncore outlays on goods and services equivalent to 0.2 percent of GDP. The expenditure measures will not compromise spending on social and economic priorities.

17. The government has initiated a number of actions to facilitate a restructuring of public expenditure in favor of priority spending on social and economic services:

- As part of the measures aimed at reducing the size of the wage bill in total expenditure, a Commission of Enquiry has been established to propose new mechanisms for determining changes in public sector wages. Public sector wage rises for different categories have hitherto been set on an ad hoc basis, with no regard for the overall fiscal position and productivity improvements, resulting in considerable negative effects on pay relativities and the overall wage bill. Understandings on new

wage setting mechanisms for public employees designed to reduce the share of the wage bill in total expenditure will be a benchmark for completion of the first review.

- Spending on defense and security will be rolled back to below 2.0 percent of GDP, beginning in 2005/06, from about 2.3 percent of GDP at present.
- Transfers to parastatals will be cut through the liquidation of nonessential public bodies and the privatization of commercial public entities.
- Other actions being implemented in the context of World Bank programs, including the ongoing restructuring of public services and the introduction of new procurement procedures, are also expected to be cost saving.

18. Total poverty-related expenditure (including wages and salaries), as defined in the Core Poverty Spending Program, is budgeted at 4.0 percent of GDP in 2003/04, compared with an estimated 3.4 percent of GDP in 2002/03.

B. Expenditure Management Issues

19. The government places considerable importance on the effective control and close monitoring of public expenditure as a means of reducing corruption, minimizing deviations of budget outcomes from intentions, promoting budget discipline, and preventing the accumulation of new arrears. Accordingly, the following additional actions will be taken to improve expenditure management:

- The present expenditure Commitment Control System (CCS) will be strengthened, beginning in the second half of 2003/04. In the meantime, during the first half of the year, short-term Fund technical assistance will be sought to assist the government in the identification of the major weaknesses of the system and to develop an action plan for strengthening it. With regard to arrears, the verification of all outstanding arrears, including utility bills, will be completed by end-December 2003. Moreover, new mechanisms for preventing a buildup of new utility arrears are being explored, including prepaying for telephone and electricity use.
- Improvements will be made in the near- and medium-term forecasting of macroeconomic variables, as well as of expected donor assistance, with a view to providing a sound basis for expenditure management and the medium-term expenditure framework.
- The poverty reduction expenditure-tracking system is being improved to ensure that it provides comprehensive data on a timely basis.

C. Exchange Rate and Monetary Policy

20. **The monetary program will be based on a floating exchange rate regime, which has, thus far, served the economy well.** In this regard, exchange rate interventions will

continue to be limited to smoothing short-term volatility and the variability in donor flows, effecting external debt payments, and meeting the net international reserve (NIR) target under the program. The government is committed to making full use of exchange rate flexibility in response to both medium- and long-term exogenous shocks.

21. Monetary policy will continue to be aimed at containing inflation at below 5 percent. The inflation target would be sought largely through reserve money targeting, with broad money (M3X) as the intermediate target, and open market (repurchase and reverse) operations as the main instrument. In line with the anticipated increase in economic activity, broad money growth will be targeted at 7.1 percent in 2003/04. By promoting financial stability and low inflation, the monetary program would be consistent with a continued lowering of the country's risk premium and maintenance of low interest rates during 2003/04. This would, together with the planned financial sector reforms, help to promote an expansion of bank credit to the private sector of about 4.8 percent.

22. **However, since money demand is expected to display considerable instability** in response to changes in economic conditions and the economic reforms under the program, the CBK will continue to use a broad set of indicators of future inflationary pressures to gauge the need for any tightening of monetary policy and, consistent with the objectives of the program, to adjust the stance of policies as appropriate.

D. Financial Sector

23. The reform agenda in the financial sector will focus on the following:

- The transfer of virtually all the licensing, regulatory, and disciplinary authority of the Ministry of Finance over the banking system to the CBK. A bill to this end has already been drafted and will be presented to parliament by March 2004.
- A tightening of provisioning regulations to conform to international best practice. The CBK has already initiated decisive actions aimed at ensuring full enforcement and compliance by banks with prudential requirements by December 2004.
- An audit of the financial position of National Social Security Fund (NSSF).
- The removal of Section 44 of the Banking Act, which seeks to regulate banks' charges and commissions. Pending its removal, the act will be used solely to improve the transparency of the banks' practices in this area. The program is based on the maintenance of a liberal financial system, under which deposit and lending rates, as well as bank charges and commissions, will be market determined.
- A restructuring of the National Bank of Kenya with World Bank assistance by June 2004 and privatization of the bank thereafter.
- Further development of a program for the divestiture of the remaining public banks.

- The initiation of new anti-money-laundering legislation that would also take account of the findings from the anti-money-laundering/combating the financing of terrorism (AML/CFT) assessment that is planned as part of the Fund-Bank Financial Sector Assessment Program (FSAP) for Kenya.
- The promotion of increased bank lending to the private sector, mainly by taking measures to reduce the spread between lending and deposit rates. This will require actions to ease cost pressures in the sector, support secured transactions, lower credit risk, and improve borrower accountability, as well as strong efforts to reduce nonperforming loans (NPLs) and to enhance competition in the industry.

E. External Sector Policies

24. Kenya's medium-term external prospects are mixed. The terms of trade are expected to improve, albeit only moderately, and tourism receipts should rebound in 2003/04 in response to recent actions to improve security and tourism facilities. In addition, a significant resumption of donor assistance is foreseen, which would be growth enhancing, as the resources would be used primarily to build the economy's social and economic infrastructure. However, in the near term, the external sector position is expected to be difficult for a number of reasons. First, imports are expected to rise markedly in response to the recovery in investment. Second, a marked initial slowdown in export growth is envisaged, mainly due to the recent decline in the terms of trade and in response to the tapering off of the export expansion that followed the liberalization of the Common Market for Eastern and Southern Africa (COMESA) regional market. Finally, foreign debt repayments are projected to rise markedly in 2003/04 before coming down sharply over the medium term.

25. The anticipated improvement in the capital and financial account positions would not be adequate to cover the projected increase in the current account deficit. Partly for this reason, and because of the need to build an adequate buffer of reserves against external shocks that could result from the increasing openness of the economy and from the volatility in donor inflows, the government intends to seek a rescheduling of its external debt obligations under the Paris Club.

26. In the context of Kenya's membership in the East African Community (EAC), which the government regards as an inner grouping of COMESA that would move on a "fast track" to achieve the COMESA customs union objective, Kenya's top external tariff will be reduced to 25 percent from 35 percent, following the signing of the EAC customs union protocol on November 30. While this is a step in the right direction, achievement of the strong economic growth objectives under the ERSWEC will require that Kenyan enterprises be competitive in the broader global markets. To this end, the government plans to review the adequacy of the trade regimes under the EAC and COMESA to foster competitive economic conditions, and it will, therefore, seek World Bank technical assistance to conduct a detailed analysis of the reforms to the trade and investment regime that are needed to promote efficiency and international competitiveness and that will, in turn, maximize the gains from globalization.

F. Privatization

27. The government remains committed to the liquidation of defunct public enterprises, privatization of commercial activities, and strengthening of the operations of the remaining public enterprises. Privatization is intended to help in the mobilization of private sector financial, technical, and managerial resources and to improve the efficient utilization of these resources. To set the privatization process on a sound and transparent basis, the government intends to enact a Privatization Bill, which will be placed before parliament by end-2003. The bill will also provide for the establishment of a Privatization Commission, which will manage the privatization process. To assist in meeting the ERSWEC growth objectives, the government has decided to accelerate the privatization process. To this end, the government will announce, before the end of the year, a list of enterprises to be privatized on an expedited basis. The timing of the sale of individual enterprises will be the responsibility of the Privatization Commission and will depend on market conditions. Meanwhile, the government has announced its intention to place on the market its 35 percent stake in the Kenya Commercial Bank. With regard to the telecommunications sector, the government intends to liberalize further the sector and to privatize Kenya Telecom as soon as possible.

V. SAFEGUARDS AND STATISTICS ISSUES

28. The government remains committed to protecting the financial soundness of the CBK, and to adhering to the principles of good governance and best practices, including those encapsulated in the IMF's safeguards policy. A safeguards assessment of the CBK was conducted in September 2003, which found that the Bank had made notable progress in strengthening its safeguards since the December 2000 on-site assessment. The bank is committed to implementing measures to address the remaining vulnerabilities, further strengthen the CBK's operations, and reduce the possibility of misreporting and misuse of Fund resources.

29. **On statistical issues**, the government plans to release a revised set of national accounts data shortly, and is preparing a statistical master plan and a new Statistics Act that is aimed at enhancing the independence of the Central Bureau of Statistics (CBS). The government is also taking steps to improve the monitoring of fiscal data, in particular, the preparation, on a regular basis, of summary statistics on domestic arrears and pending bills. Moreover, the government intends to develop a framework for systematically monitoring productivity changes in the economy, and to produce, on a regular basis, trade data. Kenya participates in the General Data Dissemination System project for anglophone Africa.

VI. PROGRAM MONITORING FOR 2003/04

30. **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.

31. **Prior actions.** The government will undertake a number of prior actions before the issuance of the staff report on the request for a three-year arrangement under the PRGF. The prior actions are described in this memorandum (Table 1).

32. **Performance criteria.** Table 2 shows the quantitative performance criteria and benchmarks to be used in monitoring performance in 2003/04. Structural performance criteria and benchmarks, with corresponding dates, are identified in Table 1.

33. **Program review.** The first review under the PRGF arrangement will be completed by May 31, 2004. This review will focus on the development of actions to restructure expenditure in favor of social and economic spending; the privatization process; progress in rationalizing the financial system; and the fiscal implications of restructuring the National Social Security Fund. The second review under the PRGF arrangement is expected to be completed by October, 2004.

Table 1. Kenya: Structural Performance Criteria and Benchmarks Under the PRGF Arrangement for 2003/04

Policy Action	Implementation Date	Status
Prior Actions		
Presentation to parliament of a budget for 2003/04 consistent with program understandings.	End June 2003	Done
Government to decide on transfer of financial sector regulatory functions from the Ministry of Finance to the Central Bank of Kenya (CBK).	End June 2003	Done
Reaching an understanding with staff on a time bound plan for restructuring the National Bank of Kenya (NBK).	End June 2003	Done
Structural Performance Criteria		
Finalize an audit on the stock of pending bills and adopt measures that provide for the clearing the stock of pending bills over a three-year period.	End December 2003	
Completion of a report of the Committee of Officials on the new mechanism for determining the salaries of public officials to ensure the reduction of the wage bill in total expenditure.	End December 2003	
Completion of an audit on the financial position of National Social Security Fund (NSSF).	End December 2003	
Submission to Parliament of an Banking Act Admendment Bill providing for transfer of all financial sector regulatory functions from the Ministry of Finance to the CBK.	End March 2004	
No imposition of controls by the government or the CBK on the determination by commercial bank of bank fees, charges, or interest rates.	Continuous	
Structural Benchmarks		
Presentation of 2002/03 final budgetary accounts to the Auditor General.	End March 2004	
Reaching an understanding with staff on new wage setting mechanisms for public employees designed to reduce the share of the wage bill in total expenditure.	End March 2004	
Presentation to parliament of a bill to establish a framework for the transparent privatization and sale of public assets.	September/December 2003	
Development of an action plan and timetable for introducing a Commitment Control System (CCS) to minimize deviations of expenditure outcomes from targets and the buildup of arrears.	End December 2003	
Establishment of a clear timetable for completion of initial asset declarations by all senior public officials.	End December 2003	
Establishment of the Kenya Anticorruption Commission, with a credible management.	End December 2003	
Reaching of understandings on the fiscal implications of restructuring the NSSF.	End March 2004	

Table 2. Kenya: Quantitative Performance Criteria and Benchmarks Under the Program for 2003/04 1/ 2/
(In millions of Kenya shillings)

	2003			2004	
	End June Est.	End-September Benchmark	End-December Performance Criterion	End-March Benchmark	End-June Performance Criterion
Cumulative change in net foreign assets of the Central Bank of Kenya (CBK) 3/	...	790	2,431	8,747	14,974
Cumulative change in net domestic assets of the CBK 4/	...	-7,614	-4,351	-13,544	-19,615
Cumulative change in net domestic financing of the central government, excluding government debt issues for any bank restructuring, and the new securitization of expenditure arrears 4/	...	6,836	12,223	19,027	19,814
Central government wages and salaries 4/	...	21,262	44,326	66,662	93,380
New contracted or guaranteed nonconcessional external medium- and long-term debt by the central government or the CBK 4/ 5/	0	Continues zero ceiling throughout the arrangement			
New contracted or guaranteed external short-term nonconcessional debt by the central government or the CBK 4/	0	0	0	0	0
Accumulation of new domestic budgetary arrears 4/ 5/	0	Continues zero ceiling throughout the arrangement			
Accumulation of new external payments arrears 4/ 5/	0	Continues zero ceiling throughout the arrangement			
Memorandum items:					
Programmed external budgetary support 6/	19,045	10,649	28,469	49,874	64,109
Of which: nonproject support 6/	0	7,064	14,127	21,191	28,255
Privatization receipts 6/	0	0	0	0	0
Program exchange rate (Kenya shillings per U.S. dollar)	78.95	78.95	78.95	78.95	78.95

1/ The fiscal year begins on July 1, 2003.

2/ 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.

3/ Floor.

4/ Ceiling.

5/ Continuous performance criterion.

6/ Cumulative.

INTERNATIONAL MONETARY FUND

KENYA

Technical Memorandum of Understanding

VII. INTRODUCTION

1. 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 for the 2003/04 program (July–June) supported by the Poverty Reduction and Growth Facility (PRGF) arrangement, as well as the related reporting requirements.

VIII. QUANTITATIVE PERFORMANCE CRITERIA AND BENCHMARKS

A. Net Foreign Assets (NFA) of the Central Bank of Kenya

2. **Definition.** NFA are defined as the difference between the Central Bank of Kenya (CBK) holdings of gross official reserves (excluding 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). Exchange rates prevailing on September 30, 2001 will be used to convert the NFA into Kenya shillings at the end of each test period. Table 2 of the letter of intent shows the floors on NFA, specified in Kenya shillings, for June 30, September 30, and December 31, 2003, and for March 31 and June 30, 2004.

3. **Adjustment clauses.** The NFA floors will be adjusted upward (or downward) by the sum of (i) excess (or shortfall) in external budgetary support relative to projected amounts (excluding grants and loans for the development budget); (ii) excess (shortfall) in non-project-related external budgetary support relative to the programmed amount; and (iii) excess (shortfall) in privatization proceeds. Excess proceeds are defined as the difference between actual and programmed proceeds. The downward adjustment is capped at the equivalent of U.S. dollar 280 million. All targets are cumulative from July 1, 2003 onward.

4. **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 budgetary support (by donor/creditor and by currency of denomination) will be transmitted on a weekly basis within five working days of the end of each week.

B. Net Domestic Assets (NDA) of the Central Bank of Kenya

5. **Definition.** NDA are defined as the average over the calendar month of the test dates of reserve money, defined as total currency in circulation and reserves of the banking system with the CBK, minus the average over the calendar month of net foreign assets (NFA) plus encumbered foreign assets. Table 2 of the letter of intent shows the ceilings on NDA for June 30, September 30, and December 31, 2003 and for March 31 and June 30, 2004. The authorities will consult with the Managing Director of the Fund on any changes in the ratio of reserve requirements.

6. **Adjustment clauses.** The ceilings on the NDA will be adjusted downward (upward) by the sum of (i) excess (shortfall) in external budgetary support; (ii) excess (shortfall) in non-project-related external budgetary support; (iii) excess (shortfall) in privatization proceeds; and (iv) excess (shortfall) in the holdings of government debt instruments by the nonbank public relative to programmed amounts. Excess privatization proceeds are defined as the difference between actual and programmed proceeds. The upward adjustment is capped at the equivalent of U.S. dollar 280 million, converted to Kenya shillings at the program exchange rate prevailing on September 20, 2001. All targets are cumulative from July 1, 2003 onward.

7. **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.

C. Net Domestic Financing (NDF) of the Central Government

8. **Definition.** NDF includes financing by the banking system (the CBK and commercial banks) and the nonbank 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 2003/04.²² 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, government debt issued for any bank restructuring, and the new securitization of expenditure arrears. NDF is calculated as the cumulative change from July 1, 2003 onward in the sum of (i) loans and advances to the government by the CBK 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 minus all government deposits held with the banks, from the balance sheet of the commercial banks; and (iii) the outstanding stock of domestic debt, excluding principal arrears but including interest arrears; minus (iv) government debt instruments issued for bank restructuring; and minus (v) any new securitization of expenditure arrears. Table 2 of the

²² The 2003/04 Estimates of Revenues, 2003/04 Estimates of Recurrent Expenditures, and 2003/04 Estimates of Development Expenditures.

letter of intent shows the ceilings on NDF for June 30, September 30, and December 31, 2003, and for March 31 and June 30, 2004.

9. **Adjustment clauses.** The ceiling on NDF will be adjusted upward (downward) by the sum of (i) the excess in the cumulative net reduction in domestic budgetary arrears by the central government relative to the programmed amount; and (ii) the cumulative shortfall (excess) in external budgetary support relative to programmed amounts. The value of the cumulative excess or shortfall in external budgetary support will be converted into Kenya shillings at the program exchange rate prevailing on September 30, 2001. The upward adjustment is capped at the equivalent of U.S. dollar 280 million, converted to Kenya shillings at the program exchange rate prevailing on September 20, 2001.

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

D. Central Government Wages and Salaries

11. **Definition.** Central government wages and salaries consist of all compensation of central government employees (excluding social contributions paid by employer). Table 2 of the Letter of intent shows the ceilings on central government wages and salary payments for September 30 and December 31, 2003, and for March 31 and June 30, 2004. For the purpose of this definition, the central government of Kenya is defined as in the Appropriation Accounts and in the parliament approved budget estimates for 2003/04.

12. **Reporting requirement.** Data on central government wages and salaries will be provided on a monthly basis within three weeks of the end of each month.

E. Contracting or Guaranteeing of New Nonconcessional External Medium- and Long-Term Borrowing Public External Debt

13. **Definition.** This performance criterion not only applies 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) but also 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 Kenya Shilling denominated treasury bonds with maturity greater than a year held by non-residents, and debt subject to debt rescheduling and debt reorganization. The ceiling for new nonconcessional external debt will be zero on a continuous basis throughout 2003/04.

14. For program purposes, a debt is concessional if it includes 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.

15. **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 on a monthly basis within three weeks of the end of each month.

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

16. **Definition.** This performance criterion not only applies 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) but also 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 Kenya Shilling denominated treasury bills with maturity of less than a year held by non-residents. Table 2 of the letter of intent shows the ceilings on new external short-term debt for June 30, September 30, and December 31, 2003, and for March 31 and June 30, 2004.

17. **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 on a monthly basis within three weeks of the end of each month.

G. Domestic Budgetary Arrears

18. **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 2003/04, 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., civil service wages 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, 2003. Under the program, the nonaccumulation of new domestic budgetary arrears is a continuous performance criteria.

19. **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 on a monthly basis within four weeks of the end of each month.

H. External Payments Arrears (On Nonreschedulable Debt)

20. **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 debt-rescheduling. Under the program, the nonaccumulation of new external payments arrears is a continuous performance criteria.

21. **Reporting requirement.** Detailed data on repayment and new accumulation of external payments arrears by the CBK and the general government and the remaining previous-year stock of external arrears will be transmitted on a monthly basis within four weeks of the end of each month.

IX. OTHER REPORTING REQUIREMENTS FOR PROGRAM MONITORING

A. Public Finance

22. Monthly data on domestic financing (bank and nonbank) of the budget (including treasury bills and government bonds held by the nonbank public) will be transmitted on a monthly basis within three weeks of the end of each month.

23. Data on the implementation of the development budget, with detailed information on the sources of financing, will be transmitted on a quarterly basis within four weeks of the end of each quarter.

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

B. Monetary Sector

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

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

26. The following data will be transmitted on a monthly basis or as specified below within four 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, respectively, and for individual institutions as needed; and
- net foreign assets of commercial banks and nonbank financial institutions, broken down by instruments.

C. External Sector

27. The following 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 (i) (official exchange rate, quoted daily based on the transactions of the previous day); and (iii) foreign exchange purchases and sales by the CBK on interbank market and other inflows and outflows of foreign exchange to/from the CBK, separately.

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

29. Other balance of payments data, including the data on services, private transfers, official transfers, and capital account transactions, will be transmitted on a quarterly basis within four weeks of the end of each quarter.

D. Real Sector

30. Monthly disaggregated consumer price indices for Nairobi (Central Bureau of Statistics) will be transmitted on a monthly basis within four weeks of the end of each month.

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

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

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

E. Governance and Other Structural Reforms

34. Documentation of all measures undertaken by the government will be transmitted to the IMF's African Department within five working days after the day of implementation.



Press Release No. 03/201
FOR IMMEDIATE RELEASE
November 21, 2003

International Monetary Fund
Washington, D.C. 20431 USA

IMF Approves US\$252.75 Million PRGF Arrangement for Kenya

The Executive Board of the International Monetary Fund (IMF) today approved a three-year Poverty Reduction and Growth Facility (PRGF) arrangement for Kenya in an amount equivalent to SDR 175 million (about US\$252.75 million). As a result of the approval, Kenya can draw an amount equivalent to SDR 25 million (about US\$36.11 million) under the arrangement immediately.

The PRGF is the IMF's concessional facility for low-income countries. PRGF-supported programs are based on country-owned poverty reduction strategies adopted in a participatory process involving civil society and development partners and articulated in a Poverty Reduction Strategy Paper (PRSP). This is intended to ensure that PRGF-supported programs are consistent with a comprehensive framework for macroeconomic, structural, and social policies to foster growth and reduce poverty. PRGF loans carry an annual interest rate of 0.5 percent and are repayable over 10 years with a 5 ½-year grace period on principal payments.

Following the Executive Board's discussion on Kenya, Anne Krueger, First Deputy Managing Director and Acting Chair, stated:

"Kenya's economic program, which is to be supported by the PRGF, reflects the authorities' strong commitment to break with Kenya's past record of uneven economic performance in order to raise living standards and reduce poverty in an environment of macroeconomic stability. The comprehensive reform agenda outlined in the Economic Recovery Strategy for Wealth and Employment Creation (ERSWEC) seeks to address Kenya's major macroeconomic vulnerabilities and lays the groundwork for strong economic and employment growth and poverty reduction. During the coming months, the government intends to expand the ERSWEC into a full Poverty Reduction Strategy Paper (PRSP), in the context of a broad-based consultative process. To realize the ambitious objectives set out in the ERSWEC, sustained implementation of the reform agenda will be needed. Bold reforms will also be essential to encourage significant private investment and to mobilize adequate donor support for the reforms.

"Important objectives of the government's economic strategy include fiscal consolidation to reduce the domestic debt to a sustainable level, and the restructuring of spending in favor of priority poverty reduction outlays and investment. To achieve these objectives the program

appropriately includes a range of measures. These include: (a) strengthening revenue performance through a speedy rebuilding of the integrity and capacity of the Kenya Revenue Authority and rationalization of the tax system; (b) reducing the wage bill as a share of total expenditure by reforming the wage setting mechanism for public servants and continuing civil service reforms; and (c) restructuring the parastatal and financial sectors to increase efficiency and reduce the government's contingent liabilities.

“The authorities have placed the anticorruption strategy at the top of their policy agenda. They have already taken significant steps in their fight against corruption, with the passage of key governance legislation in May 2003 and the setting up of institutions to enforce the legislation. They have also taken bold steps to strengthen the judiciary. These reforms, if implemented consistently and supported by strong enforcement of the rules and regulations, will have a positive impact on the efficiency of resource allocation and support higher economic growth,” Ms. Krueger stated.

ANNEX

Recent Economic Developments

With the exception of inflation and the external current account position, macroeconomic outcomes in the three-year period 2000/03 covered by the last PRGF arrangement were well below expectations. Real GDP growth averaged less than 1.0 percent in the three-year period. Average consumer price inflation slowed down to 2.7 percent in 2002/03 from 5.9 percent in 1999/2000. The overall fiscal deficit before grants was substantially larger than initially projected and net domestic financing expanded to 5.0 percent in 2002/03 from 0.3 percent of GDP in 2000/01, partly on account of a drop in revenue. Domestic debt increased to 25.0 percent of GDP at end-June 2003 from 19.6 percent of GDP at end-June 2001. The external current account deficit (before grants) narrowed markedly, reflecting in part a contraction in investment; and gross international reserves declined to 2.7 months of imports in 2002/03 from 3.3 months in 2002/01. This weak economic performance was mainly the result of persistent governance failures and the slow pace of reforms.

Program Summary

The main objective of the Economic Recovery Strategy for Wealth and Employment Creation (ERSWEC) is to reduce poverty by promoting strong economic and employment growth. The program for 2003/04-2005/06 aims at creating strong opportunities for productive employment through the rebuilding of sound governance structures, addressing the country's major economic vulnerabilities, particularly the weak budgetary position, large domestic debt, and distressed financial system; and reforming the parastatal sector, labor markets and the trade system to foster a more competitive private sector.

Under the program, the recovery in economic growth is expected to gain momentum over the medium term. Based on the sustained implementation of fiscal consolidation and restructuring, as well as the governance reforms, inflows of donor budgetary assistance are expected to resume. Real GDP growth is forecast to pick up to 3.9 percent in 2005/06 from 1.2 percent in 2002/03. Government investment is also expected to pick up to 7.6 percent of GDP in 2005/06 from 3.6 percent in 2002/03.

The macroeconomic framework for 2003/04 is based on a modest real GDP of 1.9 percent, reflecting in part the negative effects of the terrorism-related travel ban, which is expected to lower GDP by slightly over 1 percent in 2003; a significant dissipation of price pressure; and a modest buildup in international reserves to about 2.8 months in import cover.

The authorities' **fiscal program** aims at restoring debt sustainability, while providing increased resources for priority poverty reduction spending and the realization of the medium-term development objectives. The restructuring of the total debt and expected inflows of grants and concessional external finance would facilitate the achievement of both the overall development and debt sustainability objectives. A reorientation of public expenditure as well as

improvements in public expenditure management is required to put the economy on a sustainable, rapid, and poverty-reducing growth path.

Comprehensive tax reforms are under way to improve the neutrality, simplicity, and revenue-yielding capacity of the system. They focus on a combination of actions to improve tax administration and to broaden the tax base.

The Economic Recovery Strategy for Wealth and Employment Creation (ERSWEC) outlines the authorities medium-term development policies. It is expected that the ERSWEC will be expanded into a full PRSP. This strategy aims at **tackling poverty** by expanding the opportunities available to the poor for productive employment and at improving the quality of life of the poor. As most of the poor live in rural areas, the focus will be on reforming the agricultural sector and encouraging the growth of medium and small-scale enterprises.

The government has placed its **anticorruption strategy** at the top of its reform agenda and has embarked on a major strengthening of Kenya's governance and anticorruption institutions. This agenda includes an enforcement of the Anti-Corruption and Economic Crimes as well as the Public Officers Ethics Legislations enacted in May 2003; the institution of mechanisms for implementing those legislations, the establishment of an anti-corruption commission which will be responsible for investigating alleged corruption cases.

Kenya joined the IMF on February 3, 1964. Its quota is SDR 271.40 million (about US\$391.97 million). Its outstanding use of IMF resources totals SDR 57.60 million (about US\$83.19 million).

Kenya: Selected Economic Indicators, June-July Fiscal Year 1998/99-02/03

	1998/99	1999/2000	2000/01	2001/02	2002/03
(Annual percentage change, unless otherwise indicated)					
National accounts and prices					
Nominal GDP (Market prices, in billions of Kenya shillings)	694	743	840	926	1,011
GDP volume (factor cost)	0.0	0.6	0.5	1.2	0.0
GDP volume (factor cost) per capita	-0.7	-1.7	-1.7	-0.8	-0.6
Consumer price index (annual average)	4.1	8.4	10.0	2.3	6.6
Consumer price index (end of period)	5.0	11.2	4.6	2.8	13.7
Export volume, goods and services	3.6	8.1	4.4	5.0	5.4
Import volume, goods and services	-5.3	5.9	11.3	-5.7	-5.1
Terms of trade, goods					
(- deterioration; based on c.i.f. imports)	-3.2	-1.0	-1.6	-3.6	-3.0
Ksh per US \$ exchange rate (end of period)	72.9	77.9	78.9	78.7	73.9
Nominal effective exchange rate (- depreciation; end of period)	-15.8	-9.8	-7.9	-4.2	-5.2
Real effective exchange rate (- depreciation; end of period)	-12.5	7.1	10.3	-4.5	4.9
Money and credit					
Net domestic assets (end of period)	7.3	-4.4	-6.2	6.7	12.4
Net credit to the government (end of period)	15.7	-7.4	-17.5	38.0	30.7
Credit to the rest of the economy (end of period)	4.8	-11.1	1.2	-1.3	4.9
M3 (broad money, end of period)	6.4	-0.1	-1.3	8.5	9.3
M3X (M3 plus foreign currency deposits, end of period)	6.5	1.3	2.1	6.7	10.9
M4X (M3X plus nonbank holdings of government paper)	5.2	5.7	5.3	8.4	12.2
Reserve money (end of period)	-7.3	4.1	-8.5	10.9	11.2
Interest rate (90-day treasury bill; end of period)	13.4	10.0	12.4	7.5	1.8
(In percent of GDP)					
Investment and saving					
Investment	16.7	15.8	15.0	14.1	14.5
Central government	3.9	2.3	3.6	2.5	3.6
Other	12.8	13.5	11.4	11.6	11.0
Gross national saving	13.2	13.3	11.9	12.7	13.6
Central government	4.3	2.6	1.2	-0.9	-1.2
Other	8.9	10.7	10.6	13.6	14.8
Central government budget					
Total revenue	26.7	23.1	22.8	21.2	20.7
Total expenditure and net lending	27.5	23.0	27.6	24.9	25.6
Overall balance (commitment basis) excluding grants	-0.7	0.2	-4.9	-3.7	-4.8
Total grants	0.7	0.6	2.9	1.2	1.2
Overall balance (commitment basis) including grants	0.0	0.7	-2.0	-2.4	-3.6
Balance of payments					
Current external balance, excluding official transfers	-3.5	-2.9	-4.0	-1.8	-1.1
Gross international reserve coverage					
in months of next year imports (end of period)	7.3	-4.4	3.4	3.1	2.7
Central government debt (end of period)	59.4	60.2	55.5	55.4	56.5
Domestic debt, net (end of period)	20.4	21.2	19.6	21.9	25.0
NPV of external debt (end of period)	38.9	39.0	36.0	33.5	31.4

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

**Statement by Ismaila Usman, Executive Director for Kenya
November 21, 2003**

Key Issues

- *The authorities have implemented all the governance measures that had not been undertaken under the previous arrangement.*
- *They have prepared a paper on a three-year programme of Economic Reform Strategy for Wealth and Employment Creation (ERSWEC) that incorporates a medium-term economic strategy to drive the economic recovery process, and later convert into a full PRSP after detailed discussions and after undertaking the consultative process.*
- *The main elements of the new programme to tackle poverty include a reform of the agricultural sector, the growth of medium and small scale enterprises, rehabilitation of rural health facilities, and the expansion of the role and capacity of local governments. There are also other far-reaching policies to address vulnerabilities in fiscal consolidation, monetary management, and international competitiveness, including incentives for private sector participation.*
- *To implement the economic programme effectively, the Kenyan economy will need increased assistance from donors to bridge the financing gap in the external sector.*

Introduction

My Kenyan authorities express their appreciation to the Management and staff of the Fund for their understanding and support in their efforts to establish a realistic and sustainable economic policy framework that will reverse the many years of low growth and rising poverty. In particular, they acknowledge the invaluable contributions of staff towards the preparation of the Economic Recovery Strategy for Wealth and Employment Creation paper, which forms the basis for the current economic development programme and the medium-term strategies.

The Kenyan authorities have implemented all the governance measures that had not been undertaken under the previous arrangement, in addition to the prior actions in the relevant areas identified in the last Article IV staff report.

- They have also prepared and began to implement a three-year development strategy in the form of an Economic Recovery Strategy for Wealth and Employment Creation (ERSWEC), which outlines a broad-based agenda consistent with their memorandum of economic and financial policies (MEFP) to tackle Kenya's deep-seated economic problems.

- This strategy will later be expanded into a full PRSP after a detailed discussion of the various dimensions of poverty, the medium-term expenditure framework and the consultative process.
- The macroeconomic framework contained in the programme is consistent with the measures and policies underpinning the proposed PRGF-supported programme.

With these efforts, the authorities hope that their request for the PRGF-supported programme will be favourably considered.

2. Recent Economic Development

The GDP growth rate for 2003 is projected at about 1.0 per cent, owing to many delimiting factors faced by the authorities in implementing economic development programmes during the year. These include the negative impact on tourism, of the recent terrorism-related incidents. Tourism is one of the major sources of revenue for the economy. Consequently, government revenue fell sharply, the overall deficit before grants widened, and domestic borrowing remained high.

However, the external current account deficit (before grants) narrowed significantly, while inflation rate fell from 5.9 per cent to 2.7 per cent, resulting in a decline in the treasury bill rate. There are indications that the horticultural and manufacturing exports, which grew at annual averages of 23 per cent and 36 per cent, respectively, in the three years up to 2002 will continue to perform well and remain competitive. In the meantime, the 2003/04 budget, which was passed in August 2003, is consistent with the macroeconomic framework of the new programme.

3. Reforms Undertaken

The authorities have continued to enhance their reform programme and to place governance, and particularly, the anticorruption strategy at the top of their reform agenda. In this regard, they have embarked on major strengthening of governance and anti-corruption institutions. The following are the additional measures that have been undertaken since the last staff mission:

- implementation of Public Officer Ethics Act under which all public officials, including the executive and legislative arms of government and the military were to complete the declaration of their assets and those of their families by Dec 2003;
- seminars and workshops on corruption prevention are being organised for civil servants at all levels;
- the police force has been reorganised, while an action plan has been initiated with the assistance of the World Bank and other donor agencies to strengthen the judiciary under a newly appointed Chief Justice;

- a draft listing of pro-poor expenditures for both recurrent and development expenditures has been completed, which contains priority programmes per sector, and linked to their budget codes to facilitate the tracking of the key programmes. Since early this year, the government has embarked on monitoring, on a quarterly basis, a set of these core poverty programmes;
- comprehensive programme of public finance reforms that will incorporate the recommendations made by the 2003 public expenditure management mission has been prepared, while a variety of measures are being designed to improve customs clearing system and the efficiency of customs administration in order to facilitate trade;
- a committee has been set up to advise on new mechanisms for determining the wages of civil servants;
- a Privatisation Commission has been established to accelerate the privatisation process and manage the divestiture programme;
- the Central Bank of Kenya has made notable progress in strengthening its operations since the Dec 2000 safeguards assessment. The bank has improved on the internal audit function and has adopted an external audit rotation policy by appointing a new external audit firm to replace the old one. The pending issues on government transactions and on regularising frozen government loan accounts have also been resolved.

4. Main Elements of the Economic Reform Strategy for Wealth and Employment Creation (ERSWEC)

The Kenyan authorities' development strategy as outlined in the ERSWEC, is part of a broader economic agenda that is supported by donors and development agencies, including the World Bank. The programme contains a package of policy measures that will address the identified economic problems of low growth, low savings and investment, poor public service, large domestic debt, distortions in the financial system, unemployment, and poverty. Embedded in the programme are core poverty expenditures, which are derived from specific development targets that include, among other measures, improving access to primary education, providing safety nets such as training programmes for urban unemployed youths.

More specifically, the following are the policy measures being adopted to achieve the set objectives:

a. Measures to address poverty – The programme identifies that most of the poor live in rural areas, and as a result it focuses on reforming the agricultural sector and encouraging the growth of medium and small scale enterprises, while plans are underway to upgrade microfinance institutions. In addition, there are measures to tackle the high prevalence of HIV/AIDS in rural areas, including the rehabilitation of rural health facilities to positively affect agricultural productivity and rural incomes. Another important element of the rural

development strategy and to lay the basis for the implementation of the poverty reduction programme, is that the role of local governments is being expanded, and it is proposed that the proportion of local authorities' spending will be raised to at least 20 per cent of total expenditure by 2018. Their revenue base and their budget management and programme implementation capacity will also be strengthened.

b. Fiscal programme – Domestic debt restructuring is a central element of the fiscal programme, which aims at debt sustainability and making the government a net contributor of resources to the banking system, without compromising the provision of increased resources for priority poverty reduction spending and for contingent liabilities. To this end, measures at fiscal restructuring and to improve the public expenditure management (PEM) are important elements of the programme. These include, reductions in the wage bill through revised modalities for setting public wages and other entitlements, increasing spending on priority social and economic outlays, reform of all public sector procurement systems, relating the annual budgets to the medium-term expenditure framework and adopting enhanced modalities for monitoring, tracking and reporting of budget operations, particularly poverty spending.

c. International competitiveness – will be addressed through reforms in the utility and telecommunications sectors, in external trade and the labour market, as well as upgrading of infrastructure. Trade reforms in the medium-term will focus on lowering the external tariff from 35 per cent to 15 per cent and the number of tariff bands from 5 to 3, which are consistent with the agreement of the East African Community (EAC) customs union, as well as reducing the current export incentive scheme. It is estimated that improved tax administration under the programme would result in reduction in smuggling and a substantial increase in revenue to facilitate a more ambitious reduction in tariff. The authorities intend to retain the current floating exchange rate regime, and are committed to making full use of the exchange rate flexibility to respond to exogenous shocks.

d. The medium term outlook of the programme – proposes a more broadly based growth, reflecting higher productivity and capital accumulation from reforms in the parastatal and financial sectors and labour markets, as well as from improved terms of trade. Spending on essential social and economic services will rise from 3.4 per cent to 4.6 per cent. Overall, real GDP growth is forecast at 1.9 and 3.9 per cent in 2003/04 and 2005/06, respectively, from the current level of 1.2 per cent.

(i) The growth rates are to be driven by increased activities in all the major sectors of the economy, as well as in private sector investment. The underlying inflation will remain at 5 per cent, with a modest buildup in reserves to about 4.0 months of projected import cover by end-June 2006. The inflation objective is to be achieved through reserve money targeting, with broad money as the intermediate target and open market operations as the main instruments. The Central Bank of Kenya will continue to use a broad set of indicators to monitor future inflationary pressures and to gauge the appropriateness of the monetary policy stance.

(ii) The approved budget for 2003/04 envisages an increase in total revenue collection by 1.5 per cent of GDP and aims at a substantial reduction in the domestic borrowing from 5.0 per cent to 3.3 per cent of GDP, consistent with the objective of debt sustainability under the ERSWEC. It is estimated that the increase in revenue will more than offset the revenue losses arising from the reduction in VAT rate from 18 to 16 per cent and excise duty from 15 per cent to 10 per cent. Expenditure is projected to rise by 2.0 per cent of GDP during the year, in line with the new programme and consistent with increases in pro-poor social spending and other public outlays, and capital spending.

5. Proposed reforms to facilitate implementation of the ERSWEC

My authorities are aware of the challenges they may face in implementing the programme and they have noted staff's comments and recommendations for addressing them. In this regard, in addition to the reforms already undertaken and those that are ongoing, they have identified and incorporated into the ERSWEC programme, other policy measures that will be needed to pre-empt many of the risks and vulnerabilities. These additional measures would include:

- Transferring financial sector regulatory functions from the Ministry of Finance to the Central Bank of Kenya. In addition, the authorities intend to bring major revisions to the Banking and Central Bank of Kenya Acts before the Parliament by June 2005. There will also be reforms on addressing the major weaknesses in the financial system with focus on banks in distress and a strengthening of the financial system, especially concentrating on the main problems that have given rise to nonperforming loans.
- The authorities will initiate a new anti-money laundering legislation that will reflect all relevant recommendations from the Bank-Fund FSAP assessment report for Kenya
- The Kenya Anti-Corruption Commission (KACC) with five regional offices will be established shortly, following the enactment of the Act in 2003, and the endorsement by Parliament of the KACC Advisory Board.
- A plan has been devised to clear the stock of pending bills and resolve the problem of stalled projects.
- A bill for the transparent privatisation and sale of public assets is already before the Parliament.
- In addition to reforms in customs administration, plans are underway to implement a comprehensive tax reform that will improve tax administration and broaden the tax base, through removal of exemptions and through taxation of larger proportion of informal transactions. The authorities are also planning to institute new modalities for managing the taxation of the petroleum sector.

- On statistics, the authorities are taking appropriate actions, with the assistance of donors, to improve the quality and timeliness of data in the areas of the budget, foreign trade and national accounts.

6. Need for Donor Support

Medium-term projections indicate that there will be external account gaps in implementing the new programme arising from an envisaged pickup in government outlays on social and economic infrastructure and other public investment programmes. These outlays will put substantial pressure on the external current account. The deficit on the external current account is estimated to widen to 4.9 per cent of GDP in 2003/04, with the prospects of rising further to 11.0 per cent of GDP by 2005/06. Consequently, the programme will require a marked increase in donor assistance from 6.5 per cent of GDP to 9.9 per cent in 2005/06 to support its implementation. Total financing needs are projected to average about \$1.3 billion per year through 2005/06. Programme support and Paris Club rescheduling are expected to fill the financing gap during the period. The authorities have indicated their intention to seek a rescheduling from the Paris Club and are currently discussing with their key creditors and donors on possible Paris Club rescheduling terms.

7. Conclusion

My authorities wish to reiterate their strong political will and commitment to revive the Kenyan economy and put it back on the path of sustainable and job creating growth and poverty reduction. They hope they can continue to count on the sustained understanding and support of the Fund and the rest of the international community in the form of timely and adequate financial support, advice and technical assistance in the relevant areas to achieve these objectives.