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Kenya: Third Review Under the Poverty Reduction and Growth Facility Arrangement and Request for Waivers of Nonobservance of Performance Criteria—Staff Report; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Kenya

In the context of the third review under the Poverty Reduction and Growth Facility Arrangement and request for waivers of nonobservance of performance criteria for Kenya, the following documents have been released and are included in this package:

- The staff report for the Third Review Under the Poverty Reduction and Growth Facility Arrangement and Request for Waivers of Nonobservance of Performance Criteria, prepared by a staff team of the IMF, following discussions that ended on September 21, 2007 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 5, 2007. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- A Press Release summarizing the views of the Executive Board as expressed during its November 16, 2007 discussion of the staff report that completed the review.
- A statement by the Executive Director for Kenya.

The document listed below has been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Kenya.*
*Also included in the Staff Report

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

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KENYA

Third Review Under the Poverty Reduction and Growth Facility Arrangement and Request for Waivers of Nonobservance of Performance Criteria

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

Approved by Thomas Krueger and Anthony R. Boote

November 5, 2007

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EXECUTIVE SUMMARY

Strong economic growth continued in 2006/07, supported by prudent macroeconomic management and structural reforms. Further structural reforms and improvements in infrastructure in a stable macroeconomic environment would be essential to achieve sustained high growth, as called for by the government's Vision 2030 strategy.

The sharp spending increase budgeted for 2007/08 could exert pressures on domestic prices and compromise project quality, but the authorities are taking steps to mitigate these risks. Expenditures, which are heavily backloaded, would be curtailed if privatization receipts fall short so that domestic financing would stay within the annual ceiling. The authorities are also committed to fully implementing the budget only if nonfood inflation remains low and project quality is maintained. A sovereign bond is to be issued to retire more costly external debt as well as to serve as an international benchmark and fund infrastructure projects.

Monetary policy has been looser than targeted. After persistently missing reserve money targets, the authorities have taken action, with significant increases in interest rates since August. Sustained efforts are required, including continued interest rate flexibility.

Some aspects of governance have improved, but challenges remain. Progress is evident in business license reforms, improvements in Doing Business Indicators, and the Kenya Revenue Authority's improved governance. The recent enactment of the Miscellaneous Amendments Bill was another major step forward in implementing the *Governance Action Plan for Building a Prosperous Kenya*. However, more progress is needed in investigating and prosecuting high-profile corruption cases.

Structural reforms in public financial management need to be broadened and financial sector reforms accelerated. Considerable progress has been made in implementing the Integrated Financial Management Information System, and the authorities are now working on an organic budget law that would strengthen the legal framework for public financial management and improve accountability and transparency of the budget process. However, there have been delays in completing the review of the Banking Act and in developing a financial sector reform strategy. Priority is now being given to these issues.

In view of the authorities' achievements in macroeconomic management and structural reforms and the steps they have taken to address program slippages, staff recommends that waivers be granted for the four missed performance criteria for the third review.

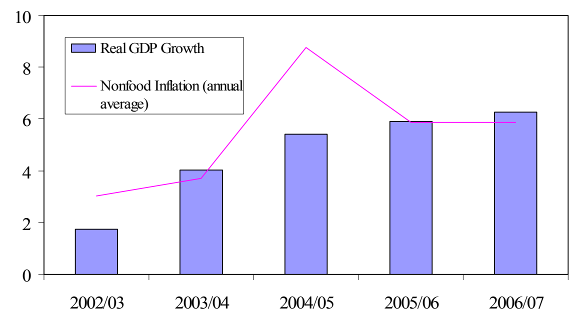
I. Introduction

1. **This review focuses on performance under the program supported by the Poverty Reduction and Growth Facility (PRGF), fiscal and monetary policies for fiscal year 2007/08 (July-June), and key governance and structural reforms**.[1] Addressing risks from the expansionary 2007/08 budget and reducing monetary expansion to contain inflation are key to safeguarding macroeconomic stability in this election year (general elections are scheduled for December 27). Sustaining growth will require continued progress on key governance and structural reforms.

II. Solid Macroeconomic Achievements

2. **Macroeconomic developments in 2006/07 were generally positive**. Real GDP growth reached 6.3 percent, a fourth consecutive year of growth above 4 percent. While overall inflation continued to be well above the official target of 5 percent, nonfood inflation remained stable and below 6 percent. A recent household survey showed that nation-wide poverty declined from 52 percent in 1997 to 46 percent in 2006.

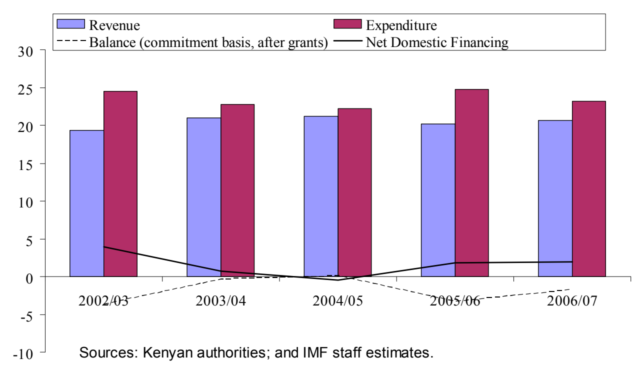
Figure 1. Real Sector Developments, 2002/03-2006/07
(Annual percentage change)



Sources: Kanyan authorities; and IMF staff estimates.

3. **Cautious budget execution led to a tighter fiscal stance than in 2005/06 and kept net domestic financing within the program target (a performance criterion—PC)**. Revenue collection in value terms was on track, but fell short of program projections as a percent of GDP. Delays in procurement caused significant under-execution of foreign-financed development spending. Privatization receipts were well below program projections, but nonpriority spending cuts reduced domestic financing requirements and kept domestic debt at 18.5 percent of GDP. Some external arrears to official creditors were incurred, in breach of a continuous PC, but were subsequently cleared.

Figure 2. Fiscal Developments, 2002/03-2006/07
(percent of GDP)



Sources: Kenyan authorities; and IMF staff estimates.

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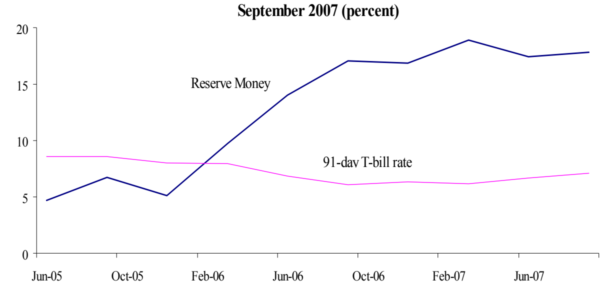
[1] The mission took place during September 10–21, 2007 and comprised Mr. Andrews (head), Mr. Yang, Ms. Masha (all AFR), Mr. John (PDR), and Ms. Everaert (FAD). Mr. Rogers, Senior Resident Representative, assisted the mission. Staff met the Minister for Finance, Mr. Kimunya, Governor of the Central Bank of Kenya, Mr. Ndung'u, other senior officials, and representatives of donors, civil society, and the business community.

4. **Reserve money growth persistently exceeded program targets and the end-June PC was not observed**. Despite continued low nonfood inflation, the rapid reserve money growth in the second half of the fiscal year, driven in large part by the accumulation of CBK net foreign assets, may have created a monetary overhang that will need to be addressed if inflation is to be contained. In response, the CBK raised the Central Bank Rate by 25 basis points to 8.75 percent in August to signal a tighter monetary stance and took measures to enhance its open market operations (see ¶17).

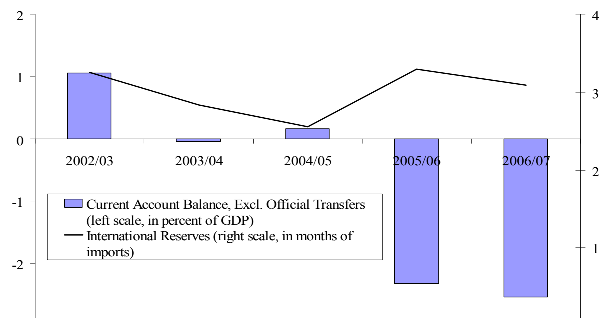
Figure 3. 12-month Reserve Money Growth and Interest Rates, June 2005 - September 2007 (percent)



Sources: Kenyan authorities; and IMF Staff estimates.

5. **The external current account deficit widened slightly as a result of strong domestic investment, but the overall balance of payments remained in surplus thanks to large foreign exchange inflows**. Import coverage of international reserves fell somewhat, but remained fairly strong at 3.1 months. The recent global financial turmoil has so far had no discernable impact on the domestic financial market.

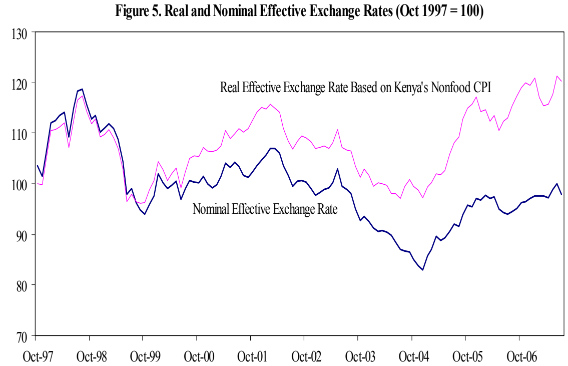
Figure 4. External Sector Developments, 2002/03 - 2006/07



Sources: Kenyan authorities; and IMF staff estimates.

6. **Both the nominal and real effective exchange rates have appreciated over the past three years**. The former has appreciated by 18 percent since a trough at end-2004, and the latter, based on Kenya's nonfood CPI, by 24 percent. Despite an appreciating shilling, Kenya's export growth remains strong. Higher capacity utilization that has accompanied economic recovery and reduced costs of doing business have helped raise productivity and maintain competitiveness (¶10). Staff shared the authorities' view that competitiveness remains broadly adequate, and, looking forward, removing infrastructure bottlenecks would be critical.

Figure 5. Real and Nominal Effective Exchange Rates (Oct 1997 = 100)



Sources: Kenyan authorities; and IMF staff estimates.

III. UNEVEN PROGRESS IN GOVERNANCE AND STRUCTURAL REFORMS

7. **Parliament recently approved the Miscellaneous Amendments Bill, which was submitted in May in line with a structural PC**. The bill contained important measures to implement the *Governance Action Plan for Building a Prosperous Kenya (GAP)*. Parliament initially rejected most of these measures but assented after the President returned the bill in late September. While not all reform measures were adopted—most notably, the public will have only restricted access to wealth declarations of public officials—the final law includes important steps to strengthen the legal platform to fight corruption and enhance prosecutorial capacity, including by increasing the number of judges (LOI, ¶18). External audit reports on security-related (Anglo-Leasing) contracts were completed in August and have since been passed to the Kenya Anti-Corruption Commission (KACC) to facilitate investigation and potential prosecution of corruption cases. While KACC's investigations of the international aspects of these cases are continuing, no new cases have been brought for prosecution over the past year.

8. **Considerable progress has been made in implementing other aspects of the GAP**. The government resubmitted the Proceeds of Crime and Anti-Money Laundering (AML) Bill to parliament in May (PC). The Media Bill 2007 recently became law, the Political Parties Bill 2007 was approved by parliament and assented to by the President in October, and the Witness Protection Act 2006 is now being implemented. A Public Complaints Standing Committee was established in June, and a public information network in districts and constituencies is being developed. Surveys have shown that as a result of governance improvements, the Kenya Revenue Authority (KRA) has dropped off Transparency International's bribery index.

9. **Reforms in public financial management (PFM) and the financial sector continued to advance, but there have been delays, especially in the latter**. While the Integrated Financial Management Information System (IFMIS) is now operational in four ministries in line with a structural PC and is being phased-in in another 20 ministries, the Public Procurement Oversight Authority (PPOA) was not fully operational by end-April (structural PC), and submission to cabinet of a strategy to initiate the sale of government and National Social Security Fund (NSSF) shares in the National Bank of Kenya (NBK) (structural PC) was delayed. However, corrective actions have been taken in both cases: the authorities have appointed an interim Director General and Advisory Board, making the PPOA fully operational, and a memorandum was submitted to cabinet in early November to initiate the process of NBK privatization. Actions have also been taken to address five missed structural benchmarks (see Box 1).

10. **Significant progress has been made in improving the business environment and public service efficiency**. In the context of the 2007/08 budget, 205 business licenses (out of a total of 1,325) deemed to serve no useful purpose will be eliminated while another 371 will be simplified. In the World Bank's Doing Business Report 2008, Kenya was ranked as one of the top 10 reformers. Earlier in June, Kenya won the United Nations' Public Service Award for introducing performance contracts throughout the public service.

Box 1. Missed Policy Targets and Corrective Actions

Missed Targets	Corrective Actions (LOI reference)
Quantitative PCs	
End-June reserve money ceiling	Greater interest rate flexibility and improved open market operations (¶6 & 36)
Non-accumulation of external payment arrears	Arrears cleared (¶2)
Structural PCs	
Make PPOA fully operational	PPOA operational with an interim Advisory Board and Director General (¶10)
Submit to cabinet a strategy to privatize NBK	Submitted in early November (¶11)
Quantitative benchmarks	
End-September reserve money ceiling	Greater interest rate flexibility and improved open market operations (¶6 & 36)
End-September net foreign assets floor	Priority given to meeting reserve money target (¶36)
Structural benchmarks	
Complete the study of contingent liabilities of 24 parastatals' accounts	Inception report completed in September (¶14)
Present to parliament the Controller and Auditor General's 2005/06 report	Presented in September (¶13)
Submit to parliament an amendment to the Banking Act	Comprehensive revision of the Act is at an advanced stage (¶16)
Complete a diagnostic audit of the NSSF	Inception report completed in September (¶14)
Establish the Privatization Commission	Expected by December (¶12)

Sources: Kenyan authorities; and IMF staff compilation.

IV. Safeguarding Macroeconomic Stability for 2007/08

11. **The authorities' 2007/08 economic program is geared toward their Vision 2030 objectives**. The vision aims to achieve annual GDP growth of 10 percent on a sustained basis by 2012. However, guided by the principle of prudence, the authorities' medium-term macroeconomic framework assumes annual GDP growth of 6-7 percent, although they see clear upside potential to the growth projections and intend to adjust the framework if higher growth materializes.

A. Fiscal Policy and PFM

12. **The sharp increase in expenditure (by 4.8 percent of GDP) and a widening fiscal deficit (to 5.4 percent of GDP, commitment basis, including grants) in the 2007/08 budget pose risks**. The increased spending, most of which is devoted to infrastructure (notably roads and energy) where bottlenecks are constraining growth, would be financed by official external resources, domestic borrowing, privatization receipts, and proceeds from a sovereign bond issue planned for early 2008. While public debt ratios are projected to decline in line with the government's medium-term strategy, such a large increase in spending could exert pressures on domestic prices, even with considerable import content for development projects and a possible increase in private savings as the public participates in privatization opportunities. A shortfall in privatization receipts could lead to increased domestic borrowing and capacity constraints could jeopardize project quality.

Text Table 1. Key Fiscal Indicators (percent of GDP)

	2006/07	2007/08	
	Est.	Budget	Proj.
Total revenue	20.6	20.7	20.6
Total expenditure	23.2	28.0	26.8
of which:			
Recurrent expenditure	18.5	19.6	19.4
Development and net lending	4.4	8.2	7.1
of which:			
Domestically financed	3.0	3.9	3.9
Foreign financed	1.4	3.9	2.9
Grants	0.9	1.9	1.5
of which:			
Project grants	0.9	1.7	1.3
Program grants	0.0	0.2	0.2
Overall balance, incl. grants and adjustment to cash	-1.6	-5.3	-4.8
Financing	2.0	5.3	4.8
of which:			
Project loans	0.6	2.2	1.6
Program loans	0.0	0.0	0.1
Commercial foreign financing	0.0	1.0	1.0
Arrears clearance	0.0	-0.4	-0.4
Privatization proceeds	0.2	2.2	2.2
Telkom restructuring cash costs	...	-0.4	-0.4
Net domestic borrowing	1.9	1.6	1.6

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

13. **The authorities recognize that execution of foreign-financed projects is likely to fall short of the tripling of last year's outturn assumed in the budget**. They agree with staff that even with major efforts that have been made to strengthen implementation capacity, the outturn of foreign-financed development spending is more likely to be a doubling of last year's level, reflecting remaining constraints (LOI, ¶32). Overall, the budget deficit agreed with staff is now projected to be 4.8 percent of GDP with net domestic financing remaining at 1.6 percent of GDP. A sovereign bond of 1.0 percent of GDP is to be issued, with half of the proceeds to finance spending and the remainder used to clear external arrears on security-related and other contracts. The sovereign bond would only modestly increase the net present value (NPV) of debt.[2]

14. **The authorities realize the challenges and risks in implementing the projected development spending, and are taking steps to address them**. They are improving the procurement process and monitoring infrastructure spending to ensure that expenditure quality does not deteriorate. The authorities will consider implementing the budget in full only if expenditure quality is maintained, and inflation and interest rates remain stable.

[2] Debt sustainability analysis suggests that Kenya's risk of debt stress is low.

15. **The authorities also plan to mitigate risks from potential delays in privatization**. Expecting that the bulk of privatization receipts are to arrive after 2007, they will backload expenditures. In the event of a receipts shortfall, they stand ready to restrain spending, so that net domestic financing stays within its target throughout the year.

Text Table 2. Privatization Receipts in 2007/08 (percent of GDP)

Privatization Receipts in 2007/08 budget	2.2
Safaricom	1.6
Kengen	0.3
Telkom Kenya	0.3

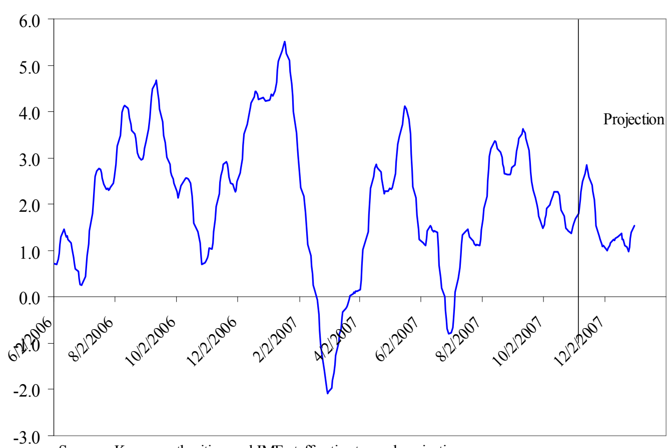
Sources: Kenyan authorites; and IMF staff projections.

16. **The authorities are committed to following their Strategy to Revitalize Public Finance Management**. A draft organic budget law to be submitted to cabinet for approval will address weaknesses in the legal framework for PFM identified in the recent draft fiscal Report on the Observance of Standards and Codes and help increase accountability and transparency of the budget process. The authorities are also working on a legal and institutional framework for public-private partnerships to reduce fiscal risks.

B. Monetary, Exchange Rate, and Financial Sector Policies

17. **The CBK aims to maintain nonfood inflation below 6 percent through June 2008**. To achieve this goal and ensure a smooth transition from the high monetary expansion through September, the CBK aims to limit annual reserve money growth to 14 percent and broad money to 15 percent by end-December 2007 and end-June 2008. The easing of the end-December target (from 12 percent in the program) also reflects the consideration that nonfood inflation, which remains low, should be given greater weight in setting the targets in light of volatile overall inflation.

Figure 6. Reserve Money Growth, June 2006-December 2007
(Percentage change in 30-day moving average)



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

18. **The CBK is on track to achieve these targets**. It has absorbed technical assistance well and taken steps to achieve these targets: the minimum bid threshold for central bank repos was reduced from Ksh 50 million to Ksh 20 million; repos now count toward bank liquidity requirements; a late-day repo window was opened; and interest rates on repos have become more flexible. However, reserve money growth has been volatile. After declining through most of October, the growth rate of reserve money unexpectedly rose to 18.3 percent at the end of the month before falling to 16.7 percent on November 1. Based on the 30-day moving average trend, reserve money is expected to meet the end-December target. The authorities remain fully committed to meeting this target, and are fine tuning their open market operations to this end. Moving forward, the CBK will:

- improve coordination with the Treasury to reduce the liquidity impact of government use of its CBK overdraft facility;
- aim to clear daily auctions by accepting all reasonable bids unless the offer is oversubscribed; and
- give priority to reserve money targets over the NFA targets.

19. **The authorities intend to accelerate development of the much-delayed financial sector reform strategy**. In addition to promoting stability and development of the financial system, this long-term strategy will also aim to develop financial services into one of the six economic pillars under Vision 2030.

C. Governance and Structural Reforms

20. **For the remainder of 2007/08, the authorities plan to give priority to governance actions that do not require legislation**. These include measures to:

- expand court facilities, hire additional prosecutors, and accelerate training of judges and automation of recording of court proceedings;
- make current the web-posting of all procurement contracts above Ksh 5 million; and
- audit the Constituency Development Fund, Local Authority Transfer Funds, and other devolved funds.

21. **The authorities intend to continue with their structural reform agenda**. Building on recent advances, an ambitious privatization program will include the restructuring and preparation for privatization of Telkom and NBK and the sale of a 41.7 percent government stake in Safaricom and a further stake in KenGen after the initial public offering of 30 percent in 2006. A consolidated electronic business registry is being established.

D. External Financing

22. **External financing requirements are projected to rise in 2007/08**. This mainly results from higher infrastructure spending and a larger current account deficit, as well as from higher debt service following the end of the consolidation period under the Paris Club rescheduling agreement and the clearance of arrears on security-related and other contracts. It is expected that donor support, particularly for projects, a sovereign bond, and private inflows will fully meet the increased financing requirements.

V. Staff Appraisal

23. **Kenya's robust economic growth has been underpinned by prudent macroeconomic management and structural reforms**. Together with improved infrastructure, further structural reforms in the context of macroeconomic stability will help

maintain Kenya's external competitiveness and lay the foundation for moving toward the ambitious growth objectives of Vision 2030.

24. **The authorities have designed an implementation strategy to mitigate the risks posed by the 2007/08 budget**. A more realistic budget, reflecting implementation capacity, would have been preferable. However, the authorities' commitment to phase the expected level of development spending in line with available financing and to fully implement the budget only if inflation remains low and expenditure quality is maintained will be important in safeguarding macroeconomic stability and project quality. Although the planned sovereign bond would have limited effect on the NPV of Kenya's debt, going forward, staff encourages the authorities to seek more concessional financing as a first best approach to safeguarding debt sustainability and meeting infrastructure needs. It is regrettable that further external payment arrears were incurred.

25. **A continued tightening of monetary policy will help secure low inflation**. The actions taken by the authorities to make open market operations more effective have begun to bear fruit. Sustained commitment, including to interest rate flexibility, will be needed to achieve the CBK's reserve money targets.

26. **Important strides have been made in improving some aspects of governance, but challenges remain**. Staff welcomes the significant progress made in strengthening legislation, enhancing transparency, and improving governance in the KRA, but encourages the authorities to continue with their efforts to implement the Governance Action Plan in full and move forward with investigating and prosecuting high-profile corruption cases.

27. **The authorities should build upon their advances in strengthening business regulation and public financial management and accelerate financial sector reform**. Following the progress in reforming business licenses and public enterprises and in implementing the IFMIS, greater efforts are needed to improve the legal framework for PFM, and to expedite the review of the Banking Act and develop a financial sector reform strategy.

28. **In view of the authorities' achievements in macroeconomic management and structural reforms and the corrective actions they have taken to address program slippages, staff recommends that waivers be granted for the four missed PCs for the third review**.

Table 1. Kenya: Selected Economic Indicators, 2005/06-2009/10

	2005/06	2006/07		2007/08		2008/09	2009/10
	Actual	Prog.	Est.	Prog.	Proj.	Staff	Projections
	(Annual percentage change, unless otherwise indicated)						
National accounts and prices							
Real GDP	5.9	6.1	6.3	6.0	6.4	6.4	6.4
Consumer price index, overall (annual average)	11.1	7.6	10.2	5.2	7.6	5.0	5.0
Consumer price index, overall (end of period)	10.9	6.8	11.1	5.0	5.8	5.0	5.0
Consumer price index, nonfood (annual average)	5.8		5.9	3.5	4.8	5.0	5.0
Consumer price index, nonfood (end of period)	5.3		5.2	3.5	5.7	5.0	5.0
Terms of trade, goods							
(- deterioration; based on c.i.f. imports)	-5.9	-3.5	-5.5	-1.7	-4.0	-0.3	0.9
Ksh per US $ exchange rate (end of period)	73.6	...	69.6	...	...	...	...
Nominal effective exchange rate (- depreciation; end of period)	4.0	...	6.0	...	...	...	...
Real effective exchange rate (- depreciation; end of period)	6.1	...	8.0	...	...	...	...
Money and credit							
Net domestic assets (end of period)	9.4	13.7	16.0	...	...	...	...
Net credit to the government (end of period)	5.0	20.9	33.3	...	...	...	...
M3 (end of period)	14.9	13.1	18.9	...	...	...	...
Reserve money (end of period)	14.0	14.3	17.5	...	...	...	...
Velocity (GDP/M3X)	2.5	2.6	2.6	...	...	...	...
	(In percent of GDP, unless otherwise indicated)						
Investment and saving							
Investment	18.2	20.2	18.9	20.7	21.4	21.0	21.6
Central government	4.4	5.7	4.4	6.2	6.8	6.3	6.8
Other	13.8	14.5	14.5	14.5	14.6	14.7	14.8
Gross national saving	16.2	16.6	16.4	16.7	17.1	17.3	18.0
Central government	0.0	1.7	1.9	1.8	1.2	2.5	2.6
Other	16.1	15.0	14.5	14.9	15.9	14.9	15.4
Central government budget							
Total revenue	20.2	21.2	20.6	21.5	20.6	20.8	21.0
Total expenditure and net lending	24.8	25.6	23.2	26.1	26.8	25.0	25.4
Overall balance (commitment basis) excluding grants	-4.6	-4.4	-2.6	-4.6	-6.3	-4.1	-4.4
Overall balance (commitment basis) including grants	-3.3	-3.3	-1.7	-3.5	-4.8	-2.9	-2.6
Net domestic borrowing	1.8	1.7	1.9	1.6	1.6	1.6	1.5
Total donor support (grants & loans)	1.9	2.5	1.4	3.6	3.1	3.2	3.5
Balance of payments							
Exports value, goods and services	26.1	23.7	23.6	23.3	23.1	23.3	23.8
Imports value, goods and services	35.4	34.0	33.2	33.6	34.2	33.6	33.6
Current external balance, including official transfers	-2.0	-3.5	-2.5	-4.0	-4.3	-3.7	-3.6
Current external balance, excluding official transfers	-2.3	-3.5	-2.5	-4.0	-4.5	-3.8	-3.7
Gross international reserve coverage							
in months of next year imports (end of period)	3.3	3.3	3.1	3.4	3.2	3.2	3.3
Public Debt							
NPV of central government debt (end of period)	35.6	34.3	32.2	34.1	31.9	31.9	31.4
Domestic debt, net (end of period)	18.1	18.5	18.5	18.3	18.4	18.0	17.7
NPV of external debt (end of period)	17.5	15.7	13.7	15.9	13.5	13.8	13.7
Nominal central government debt (end of period)	42.2	40.0	37.3	40.1	37.0	37.0	36.7
Of which: external debt (end of period)	24.0	21.4	18.8	21.8	18.7	19.0	19.0

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

Table 2a. Kenya: Central Government Financial Operations, 2005/06-2009/10 1/

(In billions of Kenyan Shillings)

	2005/06	2006/07		2007/08			2008/09	2009/10
	Actual	Prog.	Actual	Prog.	Budget	Proj.	Staff	Projections
Revenue	311.3	377.4	373.0	425.9	428.9	427.2	483.6	543.8
Income tax	113.9	130.9	131.5	147.2	151.8	151.8	169.7	189.4
Import duty (net)	20.5	29.0	27.5	32.4	32.3	32.3	37.4	42.6
Excise duty	50.3	56.5	56.4	67.6	65.6	65.6	74.0	83.4
Value-added tax	76.3	95.4	96.3	106.1	111.8	112.2	127.2	143.4
Investment income	2.2	5.7	6.6	6.4	4.7	2.7	5.3	5.9
Other	25.2	27.9	28.4	30.6	30.6	30.6	35.1	39.8
Ministerial and Departmental Fees (AIA)	22.8	32.0	26.4	35.6	32.0	32.0	35.1	39.2
Expenditure and net lending	382.8	456.2	419.5	517.9	580.4	557.3	579.9	659.1
Recurrent expenditure	306.5	347.5	335.5	391.0	405.5	403.8	426.6	476.5
Interest payments	41.2	42.6	42.5	51.2	50.7	49.7	50.3	54.3
Domestic interest	31.4	37.3	36.9	42.5	44.0	44.0	44.7	47.7
Foreign interest due	9.8	5.3	5.7	8.8	6.8	5.7	5.6	6.6
Wages and benefits (civil service)	112.3	129.7	127.3	141.1	144.3	144.0	153.5	167.7
Civil service reform	1.3	0.9	1.4	0.5	0.5	0.5	0.5	0.5
Pensions, etc.	19.8	21.4	20.4	23.0	24.4	24.4	27.4	31.0
Other 2/	103.2	119.4	115.2	137.3	139.9	139.6	149.9	174.6
Defense and NSIS 3/	29.3	33.5	28.7	38.0	45.7	45.7	44.9	48.4
Pending bills	-0.5	0.0	-0.1	0.0	0.0	0.0	0.0	0.0
Development and net lending	67.7	103.7	80.3	124.8	169.2	147.8	148.5	177.7
Domestically financed	44.5	58.5	53.5	65.5	81.1	81.1	80.5	94.3
Foreign financed	23.1	42.4	26.1	58.3	81.7	60.3	65.9	81.4
Net lending	1.0	2.8	1.4	1.1	2.4	2.4	2.1	2.0
Pending bills	-1.0	0.0	-0.7	0.0	0.0	0.0	0.0	0.0
Drought Development Expenditure	0.0	0.0	0.0	0.0	4.0	4.0	0.0	0.0
Civil Contingency Fund	0.0	2.0	0.0	2.0	2.0	2.0	2.0	2.0
Drought/flood expenditures	8.6	3.0	3.7	0.0	3.7	3.7	2.9	2.9
Balance (commitment basis, excluding grants)	-71.6	-78.8	-46.5	-91.9	-151.6	-130.1	-96.3	-115.3
Grants	20.1	20.9	15.5	23.2	40.3	30.7	28.3	47.3
Food/debt relief grants 4/	0.0	0.0	0.0	0.0	0.4	0.4	0.4	0.4
Project grants	15.7	20.9	15.5	23.2	36.1	26.5	25.0	45.0
Program grants	4.4	0.0	0.0	0.0	3.8	3.7	2.9	1.9
Balance (commitment basis, including grants)	-51.5	-57.9	-31.0	-68.7	-111.3	-99.4	-68.0	-67.9
Adjustments to cash basis	14.2	1.5	1.6	0.0	1.5	0.4	0.0	0.0
Balance (cash basis, including grants)	-37.2	-56.4	-29.4	-68.7	-109.8	-99.0	-68.0	-67.9
Financing	35.0	56.4	35.5	68.7	109.8	99.0	68.0	67.9
Net foreign financing	-0.2	8.7	-3.1	33.0	39.8	29.0	30.5	28.1
Project loans	7.4	21.6	10.6	35.1	45.2	33.4	40.9	36.4
Program loans	1.6	1.4	0.0	13.6	0.0	1.3	5.0	7.1
Commercial (including security refinancing) 5/	0.0	0.0	0.0	30.5	20.4	20.2	0.0	0.0
Repayments due	-27.5	-16.5	-16.7	-21.1	-17.8	-17.1	-15.4	-15.4
Change in arrears	12.7	0.0	0.7	-25.0	-8.1	-8.8	0.0	0.0
Rescheduling	5.6	2.2	2.2	0.0	0.0	0.0	0.0	0.0
Privatization proceeds	7.0	18.2	4.0	3.8	44.9	44.9	…	…
Bank restructuring costs 6/	0.0	-20.0	-20.0	…	-1.1	-1.1	…	…
Expenditure arrears securitization costs	0.0	-0.5	0.0	…	-0.1	-0.1	…	…
Telkom restructuring costs (cash) 7/	…	…	…	…	-8.8	-8.8	…	…
Telkom restructuring costs (bond) 8/	…	…	…	…	-11.5	-11.5	…	…
Telkom restructuring costs (tax arrears) 9/	…	…	…	…	-15.0	-15.0	…	…
Bank restructuring financing 6/	…	20.0	20.0	…	1.1	1.1	…	…
Expenditure arrears securitization financing	…	0.5	0.0	…	0.0	0.0	…	…
Telkom restructuring financing 8/	…	…	…	…	11.5	11.5	…	…
Telkom restructuring financing (tax arrears) 9/	…	…	…	…	15.0	15.0	…	…
Net domestic financing	28.3	29.5	34.7	31.9	34.0	34.0	37.6	39.8
Financing gap (stat. discrepancy for outturns)	2.2	0.0	-6.2	0.0	0.0	0.0	0.0	0.0
Memorandum items:								
Nominal GDP	1,543.9	1,780.3	1,809.5	1,982.0	2,072.4	2,077.8	2,322.7	2,594.0
Primary budget balance	4.0	-13.8	13.2	-17.5	-59.0	-49.3	-17.7	-13.6
Stock of domestic debt, net (end of period)	280.1	330.1	334.7	362.0	381.3	381.3	418.8	458.6

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

1/ Fiscal year ending June 30.
2/ Expenditures on Strategic Grain Reserve and Famine Relief (Ksh 2.65 billion in 2007/08) are excluded from other recurrent expenditures and included as drought/flood expenditures.
3/ Includes a one-time allocation for payment of security-related arrears of Ksh 2 billion in 2007/08.
4/ Includes debt relief from a debt swap deal with Italy.
5/ In 2007/08, this includes a US$ 300 million sovereign bond, of which half is used to clear security related arrears.
6/ Consists of recapitalization of National Bank of Kenya and financing this through issuance of a special purpose bond.
7/ Consists of recapitalization of Kenya Telkom on account of its pension obligations and other restructuring operations, financed through cash injection.
8/ Consists of recapitalization of Kenya Telkom on account of its pension obligations and other restructuring operations, financed through issuance of a special purpose bond.
9/ Consists of clearance of tax arrears of Kenya Telkom to KRA and Ministry of Finance.

Table 2b. Kenya: Central Government Financial Operations, 2005/06-2009/10 1/

(In percent of GDP, unless otherwise indicated)

	2005/06	2006/07		2007/08			2008/09	2009/10
	Actual	Prog.	Actual	Prog.	Budget	Proj.	Staff	Projections
Revenue	20.2	21.2	20.6	21.5	20.7	20.6	20.8	21.0
Income tax	7.4	7.4	7.3	7.4	7.3	7.3	7.3	7.3
Import duty (net)	1.3	1.6	1.5	1.6	1.6	1.6	1.6	1.6
Excise duty	3.3	3.2	3.1	3.4	3.2	3.2	3.2	3.2
Value-added tax	4.9	5.4	5.3	5.4	5.4	5.4	5.5	5.5
Investment income	0.1	0.3	0.4	0.3	0.2	0.1	0.2	0.2
Other	1.6	1.6	1.6	1.5	1.5	1.5	1.5	1.5
Ministerial and Departmental Fees (AIA)	1.5	1.8	1.5	1.8	1.5	1.5	1.5	1.5
Expenditure and net lending	24.8	25.6	23.2	26.1	28.0	26.8	25.0	25.4
Recurrent expenditure	19.9	19.5	18.5	19.7	19.6	19.4	18.4	18.4
Interest payments	2.7	2.4	2.4	2.6	2.4	2.4	2.2	2.1
Domestic interest	2.0	2.1	2.0	2.1	2.1	2.1	1.9	1.8
Foreign interest due	0.6	0.3	0.3	0.4	0.3	0.3	0.2	0.3
Wages and benefits (civil service)	7.3	7.3	7.0	7.1	7.0	6.9	6.6	6.5
Civil service reform	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Pensions, etc.	1.3	1.2	1.1	1.2	1.2	1.2	1.2	1.2
Other 2/	6.7	6.7	6.4	6.9	6.8	6.7	6.5	6.7
Defense and NSIS 3/	1.9	1.9	1.6	1.9	2.2	2.2	1.9	1.9
Pending bills	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Development and net lending	4.4	5.8	4.4	6.3	8.2	7.1	6.4	6.9
Domestically financed	2.9	3.3	3.0	3.3	3.9	3.9	3.5	3.6
Foreign financed	1.5	2.4	1.4	2.9	3.9	2.9	2.8	3.1
Net lending	0.1	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Pending bills	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Drought Development Expenditure	0.0	0.0	0.0	0.0	0.2	0.2	0.0	0.0
Civil Contingency Fund	0.0	0.1	0.0	0.1	0.1	0.1	0.1	0.1
Drought/flood expenditures	0.6	0.2	0.2	0.0	0.2	0.2	0.1	0.1
Balance (commitment basis, excluding grants)	-4.6	-4.4	-2.6	-4.6	-7.3	-6.3	-4.1	-4.4
Grants	1.3	1.2	0.9	1.2	1.9	1.5	1.2	1.8
Food/debt relief grants 4/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Project grants	1.0	1.2	0.9	1.2	1.7	1.3	1.1	1.7
Program grants	0.3	0.0	0.0	0.0	0.2	0.2	0.1	0.1
Balance (commitment basis, including grants)	-3.3	-3.3	-1.7	-3.5	-5.4	-4.8	-2.9	-2.6
Adjustments to cash basis	0.9	0.1	0.1	0.0	0.1	0.0	0.0	0.0
Balance (cash basis, including grants)	-2.4	-3.2	-1.6	-3.5	-5.3	-4.8	-2.9	-2.6
Financing	2.3	3.2	2.0	3.5	5.3	4.8	2.9	2.6
Net foreign financing	0.0	0.5	-0.2	1.7	1.9	1.4	1.3	1.1
Project loans	0.5	1.2	0.6	1.8	2.2	1.6	1.8	1.4
Program loans	0.1	0.1	0.0	0.7	0.0	0.1	0.2	0.3
Commercial (including security refinancing) 5/	0.0	0.0	0.0	1.5	1.0	1.0	0.0	0.0
Repayments due	-1.8	-0.9	-0.9	-1.1	-0.9	-0.8	-0.7	-0.6
Change in arrears	0.8	0.0	0.0	-1.3	-0.4	-0.4	0.0	0.0
Rescheduling	0.4	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Privatization proceeds	0.5	1.0	0.2	0.2	2.2	2.2	…	…
Bank restructuring costs 6/	0.0	-1.1	-1.1	0.0	-0.1	-0.1	…	…
Expenditure arrears securitization costs	0.0	0.0	0.0	0.0	0.0	0.0	…	…
Telkom restructuring costs (cash) 7/	…	…	…	…	-0.4	-0.4	…	…
Telkom restructuring costs (bond) 8/	…	…	…	…	-0.6	-0.6	…	…
Telkom restructuring costs (tax arrears) 9/	…	…	…	…	-0.7	-0.7	…	…
Bank restructuring financing 6/	…	1.1	1.1	…	0.1	0.1	…	…
Expenditure arrears securitization financing	…	0.0	0.0	…	0.0	0.0	…	…
Telkom restructuring financing 8/	…	…	…	…	0.6	0.6	…	…
Telkom restructuring financing (tax arrears) 9/	…	…	…	…	0.7	0.7	…	…
Net domestic financing	1.8	1.7	1.9	1.6	1.6	1.6	1.6	1.5
Financing gap (stat. discrepancy for outturns)	0.1	0.0	-0.3	0.0	0.0	0.0	0.0	0.0
Memorandum items:								
Nominal GDP (in billions of Kenyan Shillings)	1,543.9	1,780.3	1,809.5	1,982.0	2,071.9	2,077.8	2,322.7	2,594.0
Primary budget balance	0.3	-0.8	0.7	-0.9	-2.8	-2.4	-0.8	-0.5
Stock of domestic debt, net (end of period)	18.1	18.5	18.5	18.3	18.4	18.4	18.0	17.7

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

1/ Fiscal year ending June 30.
2/ Expenditures on Strategic Grain Reserve and Famine Relief (Ksh 2.65 billion in 2007/08) are excluded from other recurrent expenditures and included as drought/flood expenditures.
3/ Includes a one-time allocation for payment of security-related arrears of Ksh 2 billion in 2007/08.
4/ Includes debt relief from a debt swap deal with Italy.
5/ In 2007/08, this includes a US$ 300 million sovereign bond, of which half is used to clear security related arrears.
6/ Consists of recapitalization of National Bank of Kenya and financing this through issuance of a special purpose bond.
7/ Consists of recapitalization of Kenya Telkom on account of its pension obligations and other restructuring operations, financed through cash injection.
8/ Consists of recapitalization of Kenya Telkom on account of its pension obligations and other restructuring operations, financed through issuance of a special purpose bond.
9/ Consists of clearance of tax arrears of Kenya Telkom to KRA and Ministry of Finance.

Table 3. Kenya: Monetary Survey, June 2006 - December 2007

	2006	2007					
	June	June			September		December
	Actual	Prog.	Revised Program [1]	Actual	Program	Actual	Staff Projection
	(In billions of Kenya shillings)						
Central Bank of Kenya (CBK)							
Net foreign assets [2]	159.5	158.1	175.7	174.2	182.9	179.7	186.3
In Millions of US $	2,159	2,140	2,378	2,357	2,475.5	2,432.1	2,521.2
Net domestic assets	-51.8	-35.0	-52.6	-47.7	-57.5	-48.4	-44.7
Net domestic credit	-37.0	-26.3	-27.5	-16.8	-32.0	-16.4	-10.1
Government (net)	-15.8	-7.2	-8.9	-3.5	-7.4	-3.0	9.4
Private sector credit (CBK staff loans)	2.2	2.2	2.2	2.3	2.3	2.3	2.3
Commercial banks (net REPOS)	-23.4	-21.3	-20.9	-15.7	26.8	-15.7	-21.8
Other items (net)	-14.8	-8.8	-25.1	-30.9	-25.6	-32.0	-34.6
Reserve money (RM)	107.7	123.1	123.1	126.5	125.3	131.3	141.6
Currency outside banks	67.2	77.6	77.5	78.1	76.9	80.1	90.5
Bank reserves	40.5	45.5	45.6	48.3	48.5	51.3	51.1
Deposits-banks (Kenya)	31.5	35.5	35.6	36.5	37.3	38.7	39.4
Required Reserves [3]	30.0	34.5	34.5	35.2	36.1	75.6	38.2
Excess Reserves	1.5	1.0	1.1	1.4	1.2	-37.0	1.2
Total till cash	9.0	10.0	10.0	11.7	11.2	12.6	11.7
Monetary survey							
Net foreign assets [2]	191.6	199.2	237.7	239.8	225.6	240.1	253.3
Net domestic assets	413.9	485.4	447.2	480.0	485.6	503.8	505.4
Domestic credit	521.7	598.8	577.1	607.1	619.9	610.5	641.4
Government (net)	117.9	138.8	138.3	157.2	143.0	160.4	178.2
Rest of the economy	403.8	460.0	438.8	450.0	476.9	450.1	463.2
Other public sector	12.2	12.6	12.6	12.5	15.6	12.6	19.0
Private	391.6	447.5	426.2	437.5	461.3	437.5	444.2
Other items (net)	-107.8	-113.5	-129.9	-127.1	-134.4	-106.7	-136.0
M3	605.5	684.5	685.0	719.8	711.1	743.9	758.7
Currency outside banks	67.2	77.6	77.5	78.1	76.9	80.1	90.5
Deposits	538.3	606.9	607.5	641.7	634.2	663.8	668.2
Memorandum items:							
	(Annual percentage change)						
M3	14.9	13.1	13.1	18.9	12.5	17.7	15.0
Reserve Money	14.0	14.3	14.3	17.5	12.0	17.0	14.0
Currency outside banks	13.3	15.4	15.2	16.2	12.0	16.6	18.4
Net domestic assets of the banking sector	9.4	13.7	8.0	16.0	13.7	18.0	14.3
Domestic credit	11.9	13.9	10.6	16.4	14.6	12.9	12.2
Government (net)	5.0	17.7	17.3	33.3	9.9	23.3	29.3
Rest of the economy	14.1	12.8	8.7	11.4	16.1	9.6	6.8
Multiplier (M3/RM)	5.6	5.6	5.6	5.7	5.7	5.7	5.4
Velocity (GDP/M3)	2.5	2.6	2.6	2.5	2.4	2.5	2.5

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

[1] In May 2007, programmed net foreign asset stock beginning from end-June 2006 was revised to adjust for cross exchange rate movement. The program flows did not change.

[2] Converted into Kenyan Shillings using U.S. dollar and other cross exchange rates prevailing on June 30, 2006.

[3] Calculated as 6% of total deposits excluding those at NBK.

Table 4. Kenya: Balance of Payments, 2005/06-2009/10
(In millions of U.S. dollars, unless otherwise indicated)

	2005/06	2006/07	2007/08	2008/09	2009/10
		Est.	Staff Projections		
Current account	-426	-656	-1,333	-1,276	-1,381
Excluding official transfers	-489	-656	-1,387	-1,318	-1,409
Exports, f.o.b.	3,501	3,712	4,204	4,792	5,516
Coffee	134	152	170	184	201
Tea	612	663	704	775	857
Horticulture	472	550	620	691	780
Imports, f.o.b.	-6,295	-7,392	-8,870	-9,762	-10,964
Oil	-1,545	-1,805	-2,147	-2,382	-2,519
Balance on goods	-2,794	-3,680	-4,665	-4,970	-5,448
Services (net)	839	1,215	1,237	1,443	1,660
Foreign travel credit [1]	631	786	937	1,035	1,149
Balance on goods and services	-1,955	-2,465	-3,429	-3,527	-3,788
Income (net)	-38	-31	-22	10	44
Credit	86	118	148	170	195
Debit	-124	-149	-171	-160	-151
Of which : official interest payments	-85	-82	-92	-83	-75
Other	-58	-68	-79	-77	-75
Current transfers (net)	1,566	1,839	2,118	2,241	2,362
Private (net)	1,504	1,839	2,064	2,200	2,334
of which: remittances	625	816	955	1,012	1,062
Official (net)	63	0	54	41	28
Capital and financial account	933	912	1,814	1,605	1,923
Capital account (incl. capital transfers)	215	227	381	359	647
Financial account	717	685	1,433	1,246	1,277
Investment assets and liabilities (net)	634	107	1,303	1,179	1,105
Official, medium and long term	-38	-19	593	433	561
Inflows	185	223	856	681	830
Program loans	21	0	20	38	103
Project loans	101	155	480	588	671
Defence / Commercial loans [2]	21	21	300	0	0
Government guaranteed/parastatal	42	47	56	56	56
Outflows	-222	-242	-263	-248	-269
Commercial banks (net)	234	-454	-36	170	-51
Private (net)	438	580	746	577	596
Short-term (net) and net errors and omissions [3]	83	578	131	67	172
Overall balance	506	255	481	329	542
Financing items	-506	-255	-481	-329	-542
Reserve assets (gross)	-766	-370	-353	-349	-584
Use of Fund credit and loans to the Fund (net)	-9	46	48	-14	-18
Change in arrears [4]	150	18	-176	0	0
Rescheduling	118	50	0	0	0
Remaining gap	0	0	0	34	60
Tentatively identified program support	0	0	0	34	0
Unidentified support	0	0	0	0	60
Memorandum items:					
Gross official reserves (end of period)	2,353	2,723	3,076	3,425	4,010
in months of next year's imports of goods and services	3.3	3.1	3.2	3.2	3.3
Current account balance (excl. official transfers, as a percent of GDP)	-2.3	-2.5	-4.5	-3.8	-3.7
Import volume growth, goods (percent)	11.7	10.2	12.1	10.2	13.9
Import value growth, goods (percent)	28.7	17.4	20.0	10.1	12.3
Export volume growth, goods (percent)	7.7	2.0	11.6	14.7	14.8
Export value growth, goods (percent)	12.8	6.0	13.3	14.0	15.1
Change in the terms of trade (goods, percent)	-5.9	-5.5	-4.0	-0.3	0.9

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

[1] The foreign travel credit is comprised of two components, recorded tourism inflows and an estimate of additional under-reported tourism receipts.

[2] Includes 2007/08 sovereign bond issuance, of which roughly half would be used to clear arrears on suppliers' credits for security-related and other contracts.

[3] This entry is believed to include unrecorded capital flows and remittances from Kenyans working abroad not captured above.

[4] Arrears clearance amount in 2007/08 reflects latest estimate from Kenyan authorities based on preliminary audit of security-related and other contracts.

Table 5. Kenya: Financial Soundness Indicators December 2003 - August 2007
(In percent)

	Dec-03	Dec-04	Dec-05	Jun-06	Aug-06	Dec-06	Aug-07
Capital Adequacy							
Regulatory capital to risk-weighted assets	17.3	16.6	16.4	16.7	16.3	16.5	16.7
Regulatory Tier I capital to risk-weighted assets	16.3	16.2	16.0	15.7	15.8	16.4	15.9
Capital (net worth) to assets	11.8	11.9	12.1	12.5	12.4	12.4	12.6
Asset quality							
Nonperforming loans to gross loans [1]	34.9	29.3	25.6	22.9	22.7	21.3	14.7
Nonperforming loans net of provisions to total capital [2]	60.7	52.7	40.1	28.8	30.4	28.6	22.7
Earnings and Profitability							
Return on assets	2.3	2.1	2.4	2.8	3.2	2.8	3.2
Return on equity	23.2	22.0	25.0	28.9	32.3	28.6	32.4
Liquidity							
Liquid assets to total assets	33.2	32.4	33.1	33.100	33.6	35.2	33.3
Liquid assets to total short-term liabilities	48.9	41.5	40.6	41.6	42.5	44.5	42.6
Customer deposits to total (non-interbank) loans	131.6	135.7	125.1	125.3	127.2	130.1	138.4
Foreign currency liabilities to total liabilities	14.3	17.8	15.9	15.0	15.6	16.1	15.2
Sensitivity to market risk							
Net open positions in FX to capital	12.0	8.0	6.0	6.8	6.9	5.4	6.6
Net open positions in equities to capital	7.9	7.7	10.3	9.4	9.4	9.7	7.4

Sources: Central Bank of Kenya; and Fund staff calculations.
[1] The ratios were computed using gross nonperforming loans and gross loans.
[2] NPL figures for 2005 have been adjusted to reflect audited position.

Table 6. Disbursement Schedule under the PRGF Arrangement

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

Table 7. Kenya: External Financing Requirements and Resources, 2005/06 - 2008/09 [1]

(In millions of U. S. dollars)

	2005/06	2006/07	2007/08	2008/09
External financing requirements	-1,335.7	-1,262.3	-2,189.1	-1,929.1
Current account (excl.official transfers)	-488.9	-656.3	-1,386.9	-1,317.6
Scheduled amortization (official)	-222.4	-242.4	-263.2	-248.4
IMF payments, gross	-8.6	-12.0	-10.1	-13.9
Change in arrears, net [2]	150.3	18.5	-176.0	0.0
Buildup of gross official reserves	-766.1	-370.2	-353.0	-349.2
Resources	1,335.7	1,261.3	2,189.1	1,929.1
Program support (committed and tentatively identified)	83.1	57.7	131.6	113.0
IMF	0.0	57.7	57.7	0.0
Program loans	20.6	0.0	20.0	71.8
African Development Bank (ADB)	20.6	0.0	0.0	17.5
IDA	0.0	0.0	20.0	20.0
Other	0.0	0.0	0.0	34.3
Program grants	62.5	0.0	54.0	41.2
Project Support	316.9	381.7	860.4	947.1
Project loans	101.4	155.2	479.6	587.6
Project grants	215.5	226.5	380.8	359.4
Government-guaranteed, commercial & defence loans [3]	62.6	67.7	356.3	56.3
Private financing (incl. short-term (net) and errors & omissions)	755.1	704.6	840.9	812.7
Private financing, net	671.8	126.3	710.2	746.2
of which, foreign direct investment	365.7	622.7	744.1	642.7
Short-term (net) and net errors and omissions [4]	83.3	578.3	130.7	66.5
Rescheduling of debt	118.1	49.7	0.0	0.0
Unidentified gap	0.0	-1.0	0.0	0.0

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

[1] The fiscal year is July/June.

[2] Arrears clearance amount in 2007/08 reflects latest estimate from Kenyan authorities based on preliminary audit of security-related and other contracts.

[3] Includes 2007/08 sovereign bond issuance, of which roughly half would be used to clear arrears on suppliers' credits for security-related and other contracts.

[4] Short-term (net) financing and errors and omissions in Kenya tend to be volatile, reflecting in part weaknesses in reporting, e.g., of tourism receipts.

Table 8. Kenya: External Debt Indicators, 2005-2010 [1]
(In millions of U.S. dollars, unless otherwise indicated)

	2005	2006	2007	2008	2009	2010
Debt-stock indicators						
Stock of external debt by creditor [2]	5,068	5,000	5,236	5,912	6,771	7,389
Multilateral creditors	3,144	3,098	3,284	3,515	3,864	4,261
IMF	158	146	252	243	227	196
World Bank	2,460	2,429	2,462	2,573	2,772	2,982
African Development Bank/African Development Fund	354	354	371	432	511	638
Other	172	169	199	268	354	446
Bilateral creditors	1,615	1,618	1,709	1,906	2,157	2,420
Paris Club	1,527	1,522	1,591	1,744	1,943	2,153
Non-Paris Club	88	96	118	162	214	268
Other creditors	309	284	242	491	750	708
Stock of external debt by debtor [2]	5,068	5,000	5,236	5,912	6,771	7,389
Central government	4,539	4,464	4,559	5,210	6,045	6,653
Government guaranteed	371	390	425	459	500	541
Central bank	158	146	252	243	227	196
Debt-service indicators [2]						
Principal payments by creditor	235	246	247	265	266	297
Multilateral creditors	100	112	104	108	122	145
IMF	7	14	10	10	25	48
World Bank	62	67	71	73	73	75
AfDB/AfDF	11	11	12	11	10	8
Other	20	20	12	13	13	14
Bilateral creditors	87	88	91	105	104	110
Paris Club	85	85	88	100	96	100
Non-Paris Club	3	3	3	5	7	10
Other creditors	48	46	52	52	40	43
Interest payments by creditor	90	74	92	117	145	160
Multilateral creditors	30	29	31	35	41	47
IMF	2	2	2	2	2	2
World Bank	19	18	19	20	21	23
AfDB/AfDF	5	4	4	4	4	5
Other	5	5	6	9	13	17
Bilateral creditors	44	39	48	56	66	76
Paris Club	36	31	32	31	29	27
Non-Paris Club	8	7	15	25	37	49
Other creditors	16	6	13	26	39	37
Debt-Service Ratios						
Debt-service in percent of current year exports	6%	6%	5%	5%	5%	5%
Debt-service in percent of fiscal revenue	8%	7%	6%	6%	5%	6%

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

[1] Due to data discrepancies, debt indicators will be updated in the context of the next Article IV or DSA.
[2] Excludes arrears.

Table 9. Actual and Projected Payments to the Fund, 2005-2010
(In millions of SDRs, unless otherwise indicated)

	2005	2006	2007	2008	2009	2010
Principal	5.0	9.2	6.7	6.7	11.7	16.7
Charges and interest [1]	1.5	1.8	2.1	2.1	2.1	2.0
Outstanding Fund credit [2]	111.1	101.9	170.2	163.4	151.7	135.0
FCO in percent of:						
Exports of goods and nonfactor services	3.1	2.7	4.0	3.3	2.7	2.2
External public debt	3.2	3.1	5.0	4.3	3.5	2.8
Gross official reserves	9.0	6.4	9.2	7.8	6.4	4.9
GDP	0.9	0.7	0.9	0.8	0.6	0.5
Quota	40.9	37.5	62.7	60.2	55.9	49.7
Obligations (principal) in percent of:						
Exports of goods and nonfactor services	0.1	0.2	0.2	0.1	0.2	0.3
External public debt	0.1	0.3	0.2	0.2	0.3	0.4
Gross official reserves	0.4	0.6	0.4	0.3	0.5	0.6
GDP	0.0	0.1	0.0	0.0	0.0	0.1
Quota	1.8	3.4	2.5	2.5	4.3	6.2

Source: Fund staff estimates.

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

[2] This assumes that the remaining amount of the PRGF arrangement of SDR 37.5 million will be disbursed upon completion of the third review in November 2007.

Nairobi, November 2, 2007

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Strauss-Kahn:

1. This letter describes recent performance under Kenya's economic program supported by the Poverty Reduction and Growth Facility (PRGF) arrangement and outlines the policies we plan to implement in the fiscal year 2007/08. Our broad strategy remains as outlined in our Investment Program for the Economic Recovery Strategy for Wealth and Employment Creation (ERS). The Kenya Vision 2030 program, which was recently launched, has three pillars, namely economic, social and political. The economic pillar calls for accelerating annual GDP growth to 10 percent on a sustained basis, with a view to making Kenya a middle-income country by the year 2030; the social pillar calls for a cohesive society enjoying equitable social development; and the political pillar calls for an issue-based, accountable democratic political system. As a step to achieve the Vision 2030 objectives, a medium-term economic strategy is being developed for the period 2008–12.

2. **Most of the 13 performance criteria (PCs) for the third review under the PRGF arrangement were met.** We are requesting waivers for nonobservance of four PCs and completion of the third review under the PRGF arrangement. The end-June quantitative performance criterion (PC) on the reserve money of the Central Bank of Kenya (CBK) was missed but, as described below, we have taken steps to slow reserve money growth. The continuous PC on the non-accumulation of external arrears was breached by a small margin, but all overdue obligations have since been settled. The structural PC on making the Public Procurement Oversight Authority (PPOA) fully operational by end-April was not met but, as described below, an interim Director-General and Advisory Board are now in place, making the PPOA fully operational. A strategy to initiate the sale of the shares of the government and the National Social Security Fund (NSSF) in the National Bank of Kenya (NBK) was submitted to cabinet for approval in November, rather than end-June (PC).

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

A. Recent Economic Developments and Progress Under the Program

4. **The Kenyan economy continues to grow strongly**. Real GDP expanded by 6.6 percent and by 7.1 percent in the first and second quarters of 2007, respectively, on the back of strong growth in manufacturing, tourism, transport and communications, and financial services. Nonfood inflation has remained under 6 percent but, reflecting unexpected increases in food prices, overall inflation rose to 10.6 percent in the year to October.

5. **Fiscal performance was generally satisfactory in 2006/07**. The overall deficit (commitment basis, including grants) remained at 1.7 percent of GDP, compared to 3.3 percent of GDP under the program. In shilling terms, revenues grew in line with the program projections after difficulties experienced last year with the new customs system (SIMBA) were resolved. However, in relation to GDP, revenues increased modestly by 0.4 percent of GDP compared with the program target of 1 percent of GDP, mainly because of the higher inflation outturn. A significant shortfall in privatization receipts was only partially accommodated by program adjustors. However, budget execution was cautious and cuts in non-priority areas allowed the net domestic financing (NDF) target to be met by a comfortable margin. Core poverty spending was maintained at around 4 percent of GDP. Despite an improvement in the execution of the domestically financed development budget over the past years, there continued to be delays in the implementation of foreign financed development projects, in part due to problems with slow procurement. Delays in the hiring of some 7,000 teachers kept the wage bill below program levels, notwithstanding the additional increase of teachers' salaries that was partially brought forward from 2008/09.

6. **Despite steps taken by the Central Bank to strengthen money market operations, monetary growth exceeded program targets**. Reserve money grew by 17.5 percent in the year to June, more than 3 percentage points above the PC under the program, and broad money expanded by 18.9 percent in the same period despite increases in interest rates on repos and 91-day treasury bills, which rose by about 70 to 80 basis points in the first half of the year. To strengthen the monetary instrument, the CBK lengthened the maturity profile of repos in early June, and has since lowered the threshold on repo bids, introduced a second window for late repos, and clarified to banks that repos count towards liquidity requirements. In August, following the recommendation of the Monetary Policy Advisory Committee, the CBK increased the Central Bank Rate by 25 basis points, to 8.75 percent, to signal a tighter monetary stance. The CBK has become more flexible in accepting higher interest rate bids, and reserve money growth fell to17 percent by end-September before unexpectedly bouncing back to 18.3 percent at end-October. However, the authorities remain committed to observing the proposed end-December target and the CBK is fine tuning its open market operations to ensure that this target is achieved.

7. **The current account deficit widened slightly in 2006/07 to about 2.5 percent of GDP from 2.3 percent in 2005/06**. Higher imports more than offset strong tourism and remittance flows, as well as growth in tea, horticulture, and manufactured exports. The CBK increased foreign reserves sufficiently to maintain 3.1 months of import cover. Despite this accumulation, continued strength in the balance of payments resulted in a further appreciation of the Kenyan shilling against most major currencies, albeit at a slower rate than in the previous year.

8. **In September 2007, Standard and Poor's Ratings Services maintained Kenya's initial sovereign credit rating of "B+" for foreign currency and "BB-" for local currency long-term sovereign debt, and observed that the outlook is stable**. Fitch is expected to provide a sovereign credit rating for Kenya in November. Within sub-Saharan Africa, only mineral-rich countries such as Botswana, South Africa, and Nigeria have higher sovereign ratings.

9. **Important progress has been made in implementing structural reforms, including those monitored under the program, but there were some delays**. The Integrated Financial Management Information System (IFMIS) is now operational in four ministries (the Ministries of Finance, Health, Education, and Planning and National Development)—a PC for end-June under the program—while it is being phased in in another 20 ministries out of 43 accounting units. Arrangements are in place to roll-out to seven more accounting units. The operational modules include the accounts payable, general ledger and the purchasing modules. IFMIS is capable of producing expenditure returns reports on headquarters-based transactions. The system is running alongside existing accounting systems. Arrangements to create an interface with the district data system are underway. Coverage is being extended and problems with the reliability of the network and availability of back-up servers are being addressed.

10. **The Public Procurement Oversight Authority (PPOA) is now operating as intended (after the end-April PC was missed), despite delays in establishing the Advisory Board**. We have appointed an interim Director-General and Parliament has approved members of the Advisory Board, as provided for under the Public Procurement and Disposal Act; this Board will then appoint a Director General. All procurement, including under public private partnerships (PPPs), has continued to be subject to the transparent and competitive procedures established under the Procurement and Disposal Act (a benchmark).

11. **A strategy to initiate the sale of the shares of the government and the NSSF in the NBK was submitted to cabinet for approval in early November, rather than end-June (a structural PC)**. The transfer of ownership to reputable private sector investors would aim to enhance the bank's capital base, facilitate independent management and provide strategic direction that would lead to improved financial performance of the bank. In preparation for this, financial restructuring of the bank was effected in June through the placement of nonnegotiable government bonds and the corresponding liquidation of the non-performing loan portfolio. The supervisory agreement between the CBK and NBK was renewed, and is expected to remain in force until recapitalization and divestiture by shareholders have been completed. It is expected that under the agreement, NBK would, by end-December 2007, fully comply with the provisions of the Banking Act, the Central Bank of Kenya Act, and prudential regulations, unless recapitalization and divestiture by shareholders will not have been completed. In addition, NBK will not initiate any new transactions that would increase its capital, other than normal trading activities. It will seek CBK prior approval for any single operating expense exceeding 1 percent of its 2006 operating expenses; limit new lending to the amount of loan recoveries; and submit monthly projections for the following month's corporate and retail lending to the CBK for approval no later than the 15th of each month.

12. **The establishment of the Privatization Commission has been delayed, and is now expected to be in place by December, rather than end-May (a benchmark)**. The process for recruitment of the Executive Director of the Commission is ongoing.

13. **The Controller and Auditor General's Report for FY2005/06 was submitted to parliament in September 2007, rather than end-April (a benchmark)**. An initial delay in completion of the report was compounded by protracted delays in printing.

14. **Delays have occurred in completing the diagnostic audit of the NSSF and the study of the contingent liabilities of 24 other parastatals (benchmarks)**. Consultants delivered an inception report for these studies in September. The audit of the NSSF, now expected to be completed in November, will provide a basis for considering options to address its financial and governance challenges. The study of the other parastatals is expected to be concluded in January 2008.

15. **The CBK Act has been amended to extend the objectives of the CBK to include promoting output and employment growth, although price stability will remain the overriding objective**. A planned enhancement of the core capital of banks from the current Ksh 250 million to Ksh 1 billion by 2010 in order to encourage mergers of small local banks so as to enable them to expand and compete with foreign owned banks, and take advantage of the emerging regional opportunities, has been rejected by Parliament. The proposal to improve the financial strength of insurance companies by increasing their paid up capital from Ksh 50 million to Ksh 450 million (depending on the types of insurance business) was approved.

16. **A comprehensive revision of the Banking Act is now expected to be submitted to the first session of the new parliament (after the June benchmark was missed)**. The revised bill, which will be put to a further round of stakeholder consultation, is designed to strengthen the regulatory and supervisory framework and align our regulatory practices to international standards. Key among the changes are the provisions to strengthen enforcement of supervisory powers through the introduction of (i) mandatory supervisory intervention and prompt corrective actions for inadequately capitalized and failing banks, and (ii) consolidated supervision.

17. **Charterhouse Bank has remained under statutory management of the Central Bank of Kenya since June 2006**. In December 2006, the Ministry of Finance issued a notice to the former Charterhouse Bank directors of its intention to revoke the bank's license as required under the Banking Act. The license, which expired in December 2006, has not been renewed by the government. In June 2007, the CBK's statutory management of the bank was extended for 12 months. It is expected that the High Court will consolidate the various court decisions concerning the CBK's authority in this case. The case is scheduled to come before the Chief Justice in November for further direction. The government intends to strengthen the legislation governing financial oversight to help ensure that such problems do not emerge in

the future. The government intends to further amend the Banking Act to extend the list of infractions for which statutory management and liquidation may be undertaken. Recent amendments to the Act have transferred all licensing, supervisory, and resolution powers from the Ministry of Finance to the Central Bank.

18. **Progress has been made in implementing the *Governance Action Plan for Building a Prosperous Kenya (GAP)***. The Miscellaneous Amendments Bill, which contained important governance reforms, was submitted to parliament in May in line with a program commitment (a structural PC). After rejecting most of the reform measures in the bill in September—with the notable exception of the proposed amendments to increase the number of High Court judges from 50 to 70 and the number of Appellate Court judges from 11 to 14—parliament has recently approved most of the President's recommended changes to restore the bill, including retaining the powers of the Kenya Anti-Corruption Commission (KACC) to investigate crimes committed before its establishment and to attach property. Wealth declarations of public officials will be available to the public upon application by interested persons, but publication of the information cannot be made without the approval of the responsible commission. The classification and penalties for corruption-related offences in The Anti-Corruption and Economic Crimes Act 2003 and The Penal code were substantially harmonized; the powers, privileges and immunities of the Director and investigators of the KACC vis-à-vis the detection, prevention and investigation of offences relating to corruption and economic crime were clarified in relation to The Evidence Act, The Criminal Procedure Code and The Police Act. Unfortunately, the proposals to give KACC premises the status of a Police Station and to vest Commission investigators with the rank of Chief Inspector were not enacted; and the KACC's powers of investigation vis-à-vis provision of information by suspects and their associates were curtailed.

19. **The government resubmitted the Proceeds of Crime and Anti-Money Laundering (AML) Bill to Parliament in May (a structural PC)**. Draft regulations for the implementation of the AML law have been developed (an end-June benchmark). However, the AML bill was in its second reading when parliament was dissolved; the government intends to resubmit the bill in the first session of the new parliament.

20. **In other key areas of governance reform, progress has been steady**. To strengthen the legal platform against corruption, the Chief Justice issued a Legal Notice in February 2007 to prevent applications for constitutional references from acting as automatic stay of proceedings in cases involving economic crimes and corruption. The Political Parties Bill 2007 was approved by Parliament and assented to by the President in October 2007. The Witness Protection Act 2006 is now in force and being implemented. To increase transparency and public access to government information, a Public Complaints Standing Committee was established in June 2007. With World Bank support, a comprehensive network of wireless-based public information hubs in districts and constituencies is being developed.

21. **Investigation and prosecution of corruption cases have continued, albeit slowly, while capacity is being strengthened**. Title deeds for 179 illegally and irregularly allocated parcels of public land have been surrendered to the Ministry of Lands. Two Anglo Leasing cases are in court, and investigations on other dimensions are ongoing. Further investigations into five files returned to the KACC by Attorney General's office are at an advanced stage, and investigations on other cases are ongoing. An administrative circular has been issued to address the problem of multiple suits on the same issue being filed in different courts. Procurement for automation of recording of court proceedings is in progress. Workshops have been held to sensitize judges and magistrates on new anti-corruption legislation, and a training committee is now in place.

22. **Public financial management reforms have deepened while the role of government in the economy has been scaled down**. All of the 10 targeted benchmarks of the Public Expenditure Management Action Plan have been met and the risk-based audit approach has now been rolled out. IFMIS is now operational in four ministries and is being phased in in another 20 ministries, and criteria for the granting of exemptions and waivers have been established and await ministerial approval while already being implemented by the Kenya Revenue Authority (KRA). A final report on developing and implementing a payment plan for pending bills is well advanced, and all claims that have been assessed as payable have already been paid. Quarterly budget execution reports have been published within 45 working days of the end of the quarter.

23. **205 business licenses were eliminated and another 371 simplified under the recently enacted Licensing Laws, bringing the total number of licenses eliminated to 315 and those simplified to 607 (out of a total of 1325) since 2006**. A consolidated electronic business license registry is being established, providing a useful base for the recently created Business Regulatory Reform Unit to monitor and evaluate existing and new licenses. Reforms in business licensing have been part of an overall effort to improve our business environment. The World Bank’s annual Doing Business Report 2008 (covering developments in 2006/07) records significant improvements in Kenya’s overall ranking, making the country one of the top 10 global reformers in 2006/07. Notable gains included reducing the number of days to start a business from 54 in 2006 to 44 in 2007. Aided by the electronic customs system, the Port of Mombasa has cut its average clearance time from 17 to 5–7 days. The KRA has dropped off Transparency International’s bribery index as a result of its improvements in governance.

24. **In August, external auditors completed their reports on security-related contracts**. The audit reports have been passed to the KACC to facilitate investigation and potential prosecution of corruption cases. The government expects that the audit reports will also provide a basis for negotiation with creditors on disputed claims under the contracts.

25. **Our forward-looking governance reform efforts have won international recognition**. In June this year, Kenya won the United Nations' Public Service Award in the

category "Improving Transparency, Accountability and Responsiveness in the Public Service" for comprehensively introducing performance contracts across all cadres in the public service. This latest award is in recognition of the government's efforts to make itself more accountable to its people through initiatives such as the "rapid results," whereby ministries deliver results in 100 days, as well as other reforms including performance contracts for government officials. In September, the Kenyan government was nominated for an international award for improved performance in the public service by the Ash Institute for Democratic Governance and Innovation at Harvard University's John F. Kennedy School of Government.

B. Macroeconomic Framework

26. **The medium term framework envisages growth rates of about 6½ percent, well above averages observed in the past decade**. While the government is gearing its policies to accelerate annual GDP growth towards the Vision 2030 target of 10 percent, the current baseline framework is guided by the need to be prudent. If we achieve higher than the projected growth rates, the medium-term macro-economic framework will be adjusted accordingly.

27. **For 2007/08, we expect continued robust economic growth and a significant decline in inflation**. Favorable weather conditions, strong tourism demand, and recent robust income growth are expected to sustain GDP expansion at about 6.4 percent. At the same time, inflation should decline to 5.8 percent by the end of the fiscal year. On the external side, the current account deficit is likely to widen as growth strengthens and foreign-financed project imports increase. Nonetheless, financial inflows should allow foreign exchange reserves to be maintained at an equivalent of 3.2 months of the following year's imports by mid-2008.

C. Economic and Financial Policies For 2007/08

Fiscal Policy and Public Financial Management

28. **While strictly limiting recourse to domestic financing, the 2007/08 budget would significantly increase expenditures on infrastructure and the anti-poverty programs**. To move towards the growth objectives under the Vision 2030, spending in priority areas, including roads and a number of flagship projects identified in the Vision 2030, would be increased. The budget also provides resources for the introduction of free tuition for public secondary schools, scaling up of spending on preventive health care, and agricultural development. While this leads to a loosening of the fiscal stance relative to the 2006/07 outturn, the fiscal framework continues to be anchored on a gradual reduction in domestic debt as percent of GDP over the medium term.

29. **The budget envisages a widened deficit of 5.3 percent of GDP (including grants) but a net domestic borrowing requirement of no more than 1.6 percent of GDP, in line**

with our commitment under the PRGF-supported program. While revenues are projected to increase to 20.7 percent of GDP, expenditures would increase to 28.0 percent of GDP, mostly on account of a sharp increase in development spending, which would increase from 4.4 percent of GDP in 2006/07 to 8.2 percent of GDP in 2007/08. The increase in development spending consists of about 1 percent of GDP of the domestically financed development budget and a tripling of foreign financed spending. The recurrent budget includes one-off outlays for the general elections (0.3 percent of GDP) and defense (0.4 percent of GDP), in addition to wage increases, hiring of more teachers (0.4 percent), and tuition fees for secondary schools (0.1 percent of GDP). The budget deficit would be financed by project loans estimated at 2.2 percent of GDP, receipts from the sale of shares in KenGen and Safaricom, and the Telkom privatization (2.2 percent of GDP), half of the proceeds (0.5 percent of GDP) from a planed sovereign bond issue (see below), and domestic borrowing. Some one-off costs related to the restructuring and privatization of Telkom and Safaricom are also included in the budget (1.0 percent of GDP), and these are partly financed by the issuance of a special purpose bond (0.6 percent of GDP). The budget includes only a limited amount of program support (0.2 percent of GDP) that has already been committed. Net domestic debt, including the securitization of contingent liabilities from Kenya Telkom, is expected to fall moderately from 18.5 percent of GDP in 2006/07 to 18.4 percent of GDP.

30. **We recognize that there are some risks to this budget**. Delays in the realization of the privatization receipts could lead to more domestic borrowing than budgeted and increase risks to debt sustainability. The risk of more borrowing could be compounded by the substantial restructuring costs related to the Telkom-Safaricom privatization that will be incurred before privatization receipts are realized. The magnitude of the increased spending could place pressures on domestic prices given constraints in infrastructure and the productive capacity of investment goods, although this risk is mitigated by the relatively high import content of this additional spending and private sector consumption may also be reduced as Kenyans increase their savings to buy shares in privatized companies. On the other hand, infrastructure bottlenecks, if not addressed, would constitute a risk to sustained growth.

31. **However, we believe these risks can be managed**. Some of the budgeted development spending, especially foreign financed, is likely to be carried over to 2008/09 due to constraints in implementation capacity and supply bottlenecks, including the availability of construction material. Based on past experience with the execution of the development budget, we now expect that the outturn of foreign financed development spending would more likely be double the 2006/07 level, or about 1 percent of GDP lower than budgeted. An expected revenue shortfall of Ksh 2 billion as a result of the absence of CBK dividends this year would be offset by a small expected increase in VAT collection and some other expected savings. Taking all these into account, the deficit would be lowered to 4.8 percent of GDP, making it possible to limit net domestic borrowing to 1.6 percent of GDP. A sovereign bond of 1 percent of GDP will be issued, with half of the proceeds to be used to finance spending and the remainder to clear arrears on security-related contracts.

32. **We are confident that the reduced development spending—albeit still sharply higher than in 2006/07—can be executed**. Procurement has improved with the establishment of the PPOA. We have received assistance from the Millennium Challenge Corporation to improve the procurement process, although the full impact of this assistance will take some time to materialize. We now monitor disbursements weekly through a newly established monitoring working group, and have intensified our engagement with donors through portfolio meetings to address problems that arise in the procurement process. We have also set up a team to monitor the implementation of infrastructure spending through monthly meetings, with an objective to ensure that infrastructure ministries spend their allocations this fiscal year and maintain their project quality. Efforts are also being made to improve data reporting on development spending through appropriations-in-aid. In early September we launched the Kenya Joint Assistance Strategy whose objective is to work with donors on improving coordination and harmonization of donor support. These efforts continue to bear fruit, and important projects such as road construction in the Northern Corridor that were long delayed are now underway.

33. **Risks from delays in privatization can also be mitigated to ensure that the government stays within the budget ceiling on NDF throughout the year**. The bulk of privatization receipts are expected to be received by January 2008. Given this profile, development spending will be significantly back loaded to allow us to scale back spending in the event of a shortfall in receipts and to strictly limit NDF to 1.6 percent of GDP during the year. In this manner, roughly 1 percent of GDP of spending will be contingent on the availability of privatization receipts. We have developed a cash plan that forms the basis for cash ceilings and spending limits to implementing ministries, and have been able to restrict end-September NDF below the planned level. We expect to issue a supplementary budget early in 2008 to formalize this contingency plan in the event of a shortfall in receipts and take into account other developments in budget execution. At that time, if it turns out that development projects can be implemented more rapidly than projected above, and there are no constraints on donor disbursements and no signs of macroeconomic instability or deteriorating project quality, we will consider higher development spending up to the budgeted amounts. In this case, we will closely monitor nonfood inflation and interest rate pressures, the availability of skills and construction material, and overall project quality and unit cost. In the event that privatization receipts and revenues are higher than budgeted, we will save the proceeds and reduce NDF.

34. **The government expects to issue an international sovereign bond in 2008**. Building on the favorable credit ratings received, we intend to issue a sovereign bond of approximately \$300 million in the first or second quarter of 2008. The bond would provide an international benchmark for Kenya and the proceeds would be used to finance high-return infrastructure projects (0.5 percent of GDP) as well as to refinance obligations under security-related and other contracts after renegotiation of disputed amounts based on the PricewaterhouseCoopers (PWC) audit of the contracts. At a time close to issuance, we will reassess the size of the bond issue based on prevailing market conditions, revenue performance, privatization receipts, and budget execution. Should the bond issue exceed the budgetary needs after refinancing security and other contract obligations, remaining bond proceeds would be saved.

35. **Public expenditure management reforms remain critical to our goal of promoting the efficient use of public resources and transparency**. Reforms will continue in line with the Strategy to Revitalize Public Finance Management (PFM) that was launched in June 2006. A key priority, which was noted by the Fund mission in July 2007 that prepared the draft Report on Standards and Codes on fiscal transparency, is to strengthen the legal framework for PFM. A draft organic budget law has been prepared and will be submitted for cabinet approval. The law takes into account the need to improve accountability and to increase the transparency of the budget process. It will also give Parliament a greater role of oversight.

Monetary, Exchange Rate, and Financial Sector Policies

36. **Monetary policy operations will be geared toward securing low inflation over the medium term**. The CBK will aim to limit the annual inflation rate to 5.8 percent by June 2008—provided that there is no recurrence of extreme weather conditions. To set monetary expansion on a trajectory consistent with this inflation objective, we will limit the annual growth of reserve money to 14 percent and broad money to 15 percent by end-December—considering that it will take some time to bring down the high monetary expansion in September. The targets for reserve and broad money for June 2008 are respectively set at 14 percent and 15 percent. The central bank will continue to gear monetary operations towards the achievement of the reserve money target. To this end, we will:

- enhance coordination of monetary and fiscal policy operations to minimize the liquidity impact of short-term fluctuations in net government borrowing from the CBK;
- reduce the threshold of a single T-Bill purchase to Ksh 100,000 from the current Ksh 1,000,000. This move should encourage smaller nonbank public investors to hold T-bills and enhance competition for liquidity in the banking system and a gradual shift away from the holding of currency;
- aim to clear the repo market in daily auctions by accepting all reasonable bids unless the offer is oversubscribed; and
- maintain a floating exchange rate regime to support the monetary policy objective. Foreign exchange interventions will be limited to smoothing short-term fluctuations unrelated to economic fundamentals. Priority will be given to achieving the reserve money targets vis-à-vis the NFA targets.

37. **We will continue to monitor real exchange rate developments and external competitiveness**. Measures to tighten the monetary stance described above should help reduce pressures on real appreciation. Meanwhile, we will continue to focus on improving productivity by tackling infrastructure bottlenecks and by continuing with reforms to reduce costs of doing business. Past experience shows these measures can offset the negative effect of real exchange rate appreciation on export competitiveness.

38. **The government is committed to developing a financial sector reform strategy that is based on market principles**. The Kenya Vision 2030 identifies financial services as

one of six sectors that are key to achieving faster and sustained growth. Work that is already underway on a strategy for long-term development of the sector will therefore be extended in the elaboration of the Vision 2030. The medium-term strategy (2008-2012), which is expected to be finalized in early 2008, will encompass reforms to improve access to financial services by the greater majority of Kenyans and strengthen efficiency and stability of the financial system. Improving governance of the financial sector will also be a key reform objective.

Governance and Structural Reforms

39. **The government is fully committed to implementing the strategy laid out in its GAP**. Key governance policy initiatives will continue to focus on four broad areas: (i) prevention; (ii) investigation; (iii) restitution; and (iv) improving governance in priority sectors. In implementing these measures, top priority will be given to administrative and preventive actions, which are expected to result in measurable improvements in governance and anti-corruption efforts in the short run and also in the long term.

40. **For the remainder of 2007/08, priority will be given to areas where legislation is not required**. To help expedite the prosecution of cases, we will continue to expand court facilities and hire additional prosecutors using the 2007/08 budget allocation. We will speed up the training of judges and the automation of recording of court proceedings to replace the time-consuming process of manual recording of court proceedings by judges. Following the posting of all procurement contracts above Ksh 5 million that were awarded during the second and third quarters of 2005/06, the PPOA is now posting all subsequently awarded contracts and monitoring and enforcing ministerial compliance. We will strive to improve accountability through audit and increased involvement of stakeholders in decisions impacting on the Constituency Development Fund (CDF) and Local Authority Transfer Fund (LATF) expenditure and other devolved funds, including funding of free primary education. In addition, the government will strengthen governance through the fiscal and financial sector reforms noted below. The process is underway to ensure that security-related organs are complying with the procurement law.

41. **An ambitious privatization program is planned, building on significant progress made over the past few years**. The initial public offering (IPO) of Kenya Reinsurance Co. was completed in July 2007 following the second offer of shares of Mumias Sugar Co. in December 2006. Several other initiatives are underway, including the restructuring and preparation for privatization of Telkom and NBK, with an aim of attracting strategic investors; the sale of a 41.7 percent government stake in Safaricom (25 percent of Safaricom shares); and a further stake in KenGen after the IPO of 30 percent in 2006. Total privatization receipts for 2007/08 are expected to amount to 2.2 percent of GDP. We will continue developing a privatization program in line with the Privatization Act. Performance contracts for commercial public enterprises will be closely monitored and enforced, and the accounts of the enterprises will continue to be audited and published in a timely manner.

With a view to improving operations of parastatals, we will develop time-bound restructuring plans for key entities in the agricultural sector such as the sugar companies and Pyrethrum Board of Kenya. We will also implement the new coffee rules, develop a reform strategy for development finance institutions, and review the operations of the National Cereals and Produce Board with a view to coming up with recommendations to strengthen its financial position and ensure its sustainability.

42. **Improving the compilation and dissemination of economic data is an integral part of the government's strategy to increase transparency as well as to enhance social and economic analysis**. In line with the new Statistics Law, the government established in February 2007 the autonomous Kenya National Bureau of Statistics (KNBS), replacing the former Central Bureau of Statistics. The new Bureau collects, compiles, analyzes, and publishes statistical information, guided by explicit provisions for public access and dissemination. Starting from August 2007, the KNBS began publishing quarterly GDP estimates. Steps are underway to improve fiscal data, in particular with the preparation of monthly fiscal summary statistics. The Bureau will launch a new consumer price index based on a new basket derived from the recently completed household survey and will at the same time update the methodology for the computation of the index. The Government has requested Technical Assistance from the Fund to assist in this area. We intend to further improve data collection and dissemination, including production of quarterly data on balance of payments.

43. **The government also plans to further strengthen the business environment in order to spur the investments necessary for achieving the growth envisaged in the Vision 2030 strategy**. Building on the progress made in reforming business licenses over the past two years, we will continue to improve our licensing regime, including by expeditiously establishing the consolidated electronic business registry. We will also move forward with labor market reforms, including updating relevant legislation, with a view to strengthening labor market flexibility and linking more closely wage awards to advances in productivity.

44. **Kenya will continue to pursue trade liberalization to enhance efficiency and promote growth**. Within the region, the government will continue implementing its East African Community (EAC) commitments, pursuing deeper regional economic and social integration, and advocating for further opening up of the Community with a view to enhancing competition and efficiency. The government will also support efforts to bring the Doha Round of multilateral trade negotiations to a successful conclusion that benefits all countries. Kenya, in conjunction with regional partners, continues to seek agreement on an Economic Partnership Agreement with the EU to ensure favorable and stable market access for Kenya's exports.

D. External Financing

45. **External financing requirements are projected to rise in 2007/08**. The total external financing requirement in 2006/07 (US$1.3 billion) was slightly lower than projected at the time of the second review under the PRGF arrangement in April 2007, due primarily to a smaller than projected current account deficit. External financing requirements are expected to rise significantly in 2007/08 to US$2.2 billion due to much higher infrastructure spending and a wider current account deficit, but also reflecting somewhat higher debt service payments following the end of the consolidation period under the Paris Club rescheduling agreement in 2006 and clearance of arrears on security-related and other contracts. External financing needs would remain relatively high in the medium-term, in line with higher infrastructure spending and investment-related imports. Meeting the projected external financing requirements is expected to be manageable. Stronger economic policies in recent years as well as some progress on governance has increased confidence in the economy and donor commitments, particularly for project support. Stronger private flows following favorable credit ratings and enhanced exposure to the international financial markets from our debut sovereign bond will also help meet the external financing need.

46. **The government is continuing to develop a legal and institutional framework for PPPs that takes adequate account of the fiscal risks of such arrangements, including contingent liabilities**. A consultant's report on PPPs was completed in September. A PPP unit within the Ministry of Finance will be established to act as a "gate keeper", evaluating and monitoring PPP projects, with an aim to reduce fiscal risks.

E. Other Issues

47. **The CBK continues to address issues raised in the safeguards assessment**. The assessment that was completed in September 2005, noted that steps had been taken to implement the recommendations of the earlier safeguards assessments and proposed measures to address the remaining vulnerabilities. CBK agreed in principle to the recommendations of the follow up safeguards assessment mission of 2006, which suggested that CBK formalize, in a memorandum of understanding with the government, the policy on exclusion of unrealized revaluation gains from profit distribution. The CBK Board of Directors has passed a resolution adopting the recommendation.

Sincerely yours,

______/s/______

Amos Kimunya
Minister for Finance

Table 1. Status of Prior Actions, Structural Performance Criteria and Benchmarks
Under the PRGF Arrangement for 2006/07

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

* Performance criterion.

Table 2. Outcomes on Quantitative Performance Criteria and Benchmarks Under the Program for 2007 [1, 2]
(In millions of Kenya shillings, unless otherwise indicated)

	March		June				September			
	Benchmark		Performance Criteria				Benchmark			
	Prog.	Actual	Prog.	Adj. Target	Actual	Status	Prog.	Adj. Target	Actual	Status
Cumulative change in net foreign assets of the Central Bank of Kenya (CBK) [4, 5, 6]	11,348	11,933	16,194	14,716	15,297	met	23,401	20,958	20,355	not met
Cumulative change in reserve money of the CBK [6, 7]	15,122	14,495	15,397	15,397	18,791	not met	17,581	17,581	23,653	not met
Cumulative change in net domestic financing of the central government, excluding government debt issued for any bank restructuring, and the new securitization of expenditure arrears [6, 7]	47,778	36,239	29,507	41,328	34,661	met	59,272	72,058	45,940	met
New contracted or guaranteed nonconcessional external medium- and long-term debt by the central government or the CBK [7, 8]	0	0	150	150	0	met	150	150	0	met
New contracted or guaranteed external short-term debt by the central government or the CBK [7, 8]	0	0	0	0	0	met	0	0	0	met
Accumulation of domestic budgetary arrears [7, 8]	0	0	0	0	0	met	0	0	0	met
Accumulation of external payments arrears [7, 8]	0	0	0	0	223 [9]	not met	0	0	234	not met
Memorandum items:										
Programmed external budgetary support (in millions of U.S. dollars) [6]	20	0	20	...	0	...	20	...	0	...
Privatization receipts [6, 10]	5,726	4,000	18,226	...	4,000	...	18,226	...	6,000	...
Program exchange rate (Kenya shillings per U.S. dollar)	73.88	73.88	73.88	73.88	73.88	...	73.88	73.88	73.88	...
External debt service net of rescheduling (in millions of U.S. dollars) [6]	184.7	194.3	269.1	...	264.0		353.6	...	366.7	...

[1] The fiscal year runs July 1 - June 30.

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

[3] Provisional estimate.

[4] Floor.

[5] Excludes encumbered reserves.

[6] Figures cumulate from the beginning of the fiscal year 2006/07, which began on July 1, 2006.

[7] Ceiling.

[8] Continuous performance criterion.

[9] Excluded from the amount shown above are Ksh 1,779 million in obligations due on June 30, 2007 but not paid on time due to technical factors. The amounts were owed to Paris Club creditors as well as one multilateral creditor and were paid in July 2007.

[10] The maximum upward adjustment to NDF from shortfalls in privatization receipts is capped at US$140 million or Ksh 10.34 billion.

INTERNATIONAL MONETARY FUND

KENYA

Third Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility and Request for Waivers of Nonobservance of Performance Criteria

Informational Annex

Prepared by the African Department

December 20, 2007

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I. KENYA: RELATIONS WITH THE FUND

(As of September 30, 2007)

I. Membership Status: Joined February 3, 1964; Accepted the obligations of Article VIII, Section 2, 3, & 4: June 30, 1994.

II.	**General Resources Account:**	**SDR million**	**Percent of quota**
	Quota	271.40	100.00
	Fund holdings of currency	258.64	95.30
	Reserve position in Fund	12.78	4.71
III.	**SDR Department:**	**SDR million**	**Percent of allocation**
	Net cumulative allocation	36.99	100.00
	Holdings	0.81	2.19
IV.	Outstanding Purchases and Loans:		**Percent of quota**
	Poverty Reduction and Growth Facility (PRGF) arrangements	134.66	49.62

V. Financial Arrangements:

Type	Approval **Date**	Expiration **Date**	Amount Approved (SDR million)	Amount Drawn (SDR million)
PRGF	11/21/03	11/20/07	150.00	112.50
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

The current three-year PRGF arrangement was approved on November 21, 2003, in the amount of SDR 175 million (64 percent of quota), of which SDR 112.5 million has been disbursed. Access was augmented to SDR 225 million at the time of the first review on December 20, 2004, to address the impact of a drought and higher oil prices. In light of a balance of payments improvement and at the request of the authorities, access was reduced to SDR 150 million at the time of the second review, which was delayed extensively as a result of governance concerns and eventually completed on April 11, 2007. The arrangement was extended to November 20, 2007 at that time.

VI. Projected Obligations to Fund

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

	2007	2008	2009	2010	2011
Principal	2.00	6.72	11.72	16.72	15.00
Charges/interest	0.70	2.02	1.98	1.91	1.82
Total	2.70	8.74	13.70	18.63	16.82

VII. Implementation of HIPC Initiative: Not Applicable.

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

IX. Safeguards Assessments

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

X. Exchange Arrangements

The currency of Kenya is the Kenya shilling. Kenya has adopted a unitary exchange rate structure in which the exchange rate is determined in the interbank market. The official exchange rate, which is set at the previous day's average market rate, applies only to government and government-guaranteed external debt-service payments and to government imports for which there is a specific budget allocation. The exchange rate regime is a managed float, in which the U.S. dollar is the principal intervention currency. Kenya maintains an exchange system that is free of restrictions on the making of payments and transfers for international current transactions. On October 31, 2007, the exchange rate was Ksh 67.00 =US$1.00.

XI. Article IV Consultations

Kenya is on the 24-month cycle for Article IV consultations. The last Article IV consultation was concluded on April 11, 2007.

XII. FSAP Participation

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

XIII. Technical Assistance

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

	Assessment and Action Plan (AAP) mission	May 2004
FAD	AFRITAC East Treasury Reforms mission (implementation follow up in July 2004, February-March 2005, September 2005, September 2006)	June 2004
MFD	Banking Supervision/Deposit Insurance /Legislation	July 2004
FAD	AFRITAC East Aid flow tracking mission	July 2004
FAD	Revenue Administration	September/October 2004
MFD	Deposit Insurance/Legislation (with LEG)	October 2004
MFD	Public Debt Management and Monetary Policy Implementation	November 2004
STA	ROSC Mission	January 2005
MFD	Monetary Framework, Monetary Operations, and Banking Supervision	October 2005
FAD	Revenue Administration	November 2005
FAD	AFRITAC East Semi-autonomous agencies and EBFs/Fiscal Reporting mission	March 2006
FAD	HQ Mission: Strengthening the budget and reporting system	August 2006
FAD	AFRITAC East TA: revision of Public Finance Management Act	October/November 2006
MCM	Review of Risk based Supervision Manual	November/December 2006
MCM	Monetary Operations TA	January 2007
MCM	Multi-Topic Mission—Monetary Operations, Money Market Development, Banking Supervision, Payment Systems	January 2007

STA	External Debt Statistics Workshop	February / March 2007
MCM	Banking Supervision	May 2007
MCM	Banking Supervision—AFRITAC-East	May 2007
FAD	Customs Administration	July 2007
FAD	Fiscal ROSC	July 2007
MCM	Banking Supervision	October 2007
MCM	Money Market Development	October 2007
MCM	Monetary Operations	October 2007
MCM	Payment Systems	October 2007
MCM	Monetary Operations, Money Market Development, Monetary Research	October 2007

XIV. Resident Representative

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

II. Kenya: Relations with the World Bank Group

(As of October 9, 2007)

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

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

Bank Group Strategy

3. A Country Assistance Strategy of reengagement for fiscal 2004–07 was endorsed by the World Bank Board on June 17, 2004. At mid-course, the Bank prepared a Country Assistance Strategy Progress Report (CAS PR) which was discussed by the Bank Board in March 2007. The CAS PR discussed key accomplishments over the last three years, including improved macroeconomic management and growth recovery. It documented challenges such as high income inequality and inequitable access to services, and mixed progress on corruption and some structural reforms. The CASPR emphasized the continued emphasis on growth and poverty reduction as key pillars in the Bank's engagement, but it also attached enhanced attention to equity and governance:

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

5. **Enhanced focus on governance.** In supporting the government's Governance Strategy for Building a Prosperous Kenya (GSPK) and Governance Action Plan (GAP), the

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

6. **Continued attention to accelerated economic growth and improved public sector management.** A major economic study being carried out by the Bank focuses on how Kenya could raise and sustain growth rates from about 6 percent currently to 10 percent as part of its economic, social and political vision to become a middle income country by the year 2030. This is a multi-sectoral work covering macro-fiscal, infrastructure, trade, human development and financial sector issues, and is being carried out in close collaboration with the government. Meanwhile, the current IP-ERS's high priority to budgetary and public expenditure reforms is expected to continue despite some delays.

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

8. **Poverty reduction.** In addition to supporting growth, the Bank is also targeting its support to some of Kenya's poorest communities. The Bank is in the process of preparing a poverty assessment in close collaboration of the government and other donors based on the Kenya Integrated Household Budget Survey. The Arid Lands Resource Management Project Phase Two, effective in September 2003, is using a multisectoral, district based, community driven development approach to reduce poverty in the arid and semiarid districts of Kenya. In August 2006, the World Bank approved a US$60 million additional financing credit for emergency drought interventions in Kenya's arid and semi-arid lands. The credit will be implemented under the Arid Lands Resource Management Project (ALRMP) II. The Executive Board of the World Bank approved a new operation, the Western Kenya Community Driven Development and Flood Mitigation, in March 2007. The objective of the proposed project is to empower local communities of men and women to engage in sustainable and wealth creating livelihood activities and reduce their vulnerability to flooding.

9. **Sustainable development.** The Bank is supporting measures to increase agricultural productivity and competitiveness through lending and analytical work. The Agricultural Productivity Project, which became effective in October 2004, is assisting the transformation of Kenya's research and extension system to a more demand driven, farmer-led and pluralistic system, while supporting associated policy reforms. In addressing the challenges of natural resource management, the Executive Board of the World Bank is expected to consider a new operation, the Natural Resource Management Project, late in March 2007. The objectives of the project are to enhance the institutional capacity to manage water and forest resources, reduce the incidence and severity of water shocks in river catchments, and improve the livelihoods of communities participating in the co-management of water and forests. Meanwhile, the ongoing multicountry GEF-supported Lake Victoria Environmental Project is helping to establish institutions for the sustainable management of the lake and its catchment area. The GEF-supported Western Kenya Integrated Ecosystem Management Project seeks to improve management of soils, water, and biodiversity, while raising the productivity of agriculture. The GEF-supported Wildlife Conservation Leasing Demonstration Project, approved recently on August 2006, seeks to motivate and enable landowners to maintain wildlife habitat on their land.

10. **Education and health**. In education, the Bank is supporting the government's strategy through the ongoing Free Primary Education Support Project. The government is implementing a SWAp, approved by the Bank Board in November 2006, designed to: ensure equity of access to basic education; enhance quality and learning achievement; provide opportunities for further education and training; and strengthen education sector management and governance. This will support the entire sector, but with an initial focus on primary education and the development of acceptable strategies for the other subsectors of the education system. This will lay the groundwork for future support to the sector through SWAps or poverty reduction support credits. The grant-financed Global Development Learning Network project effective in February 2004 is helping to develop enhanced mechanisms of learning and knowledge-sharing among policy makers. In health, the Bank is supporting the government's strategy through the ongoing Decentralized AIDS and Reproductive Health (DARE) Project, which seeks to improve mother and child health through more integrated delivery of child survival, reproductive health, and HIV/AIDS services. The Bank has continued to work in collaboration with development partners on the design of a health sector SWAp following recent government and Bank review which confirmed concerns about corruption risks.

11. **HIV/AIDS**. The Bank has been supporting the government's program to control HIV/AIDS. Kenya was the first country to access funds under the Africa Region's Multi-Country AIDS Program (MAP) through the Kenya HIV/AIDS Disaster Response Emergency Project (KHADREP). The KHADREP closed at the end of 2005, and a new project (The Total War on AIDS Project - TOWA) approved by the Bank Board in June 2007 is designed to support implementation of the Kenya National AIDS Strategic Plan for 2005–2010. This focuses on governance and accountability strengthening, the coordination of the national program following confirmation by government and Bank reviews of corruption in KHADREP, and the provision of grants to implementing agencies (including local communities and the private sector) to reach vulnerable groups. Through the TOWA and following progress in addressing governance and anticorruption issues in HIV/AIDs, the

Bank would support the National AIDS Control Council and its provincial, district, and local-level bodies, as well as selected line ministries in the mainstreaming of HIV/AIDS-related activities. As noted above, the medical response to the HIV/AIDS epidemic will be integrated into the Health SWAp.

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

13. **Private sector development**. The Bank and IFC are supporting implementation of their recommendations, including a far-reaching reform of Kenya's licensing regime that will result in the elimination of numerous unnecessary licenses. An update of the investment climate assessment has recently been carried out. A joint Bank- and IFC-supported Micro, Small and Medium Enterprise Project aims to increase MSME's access to finance and to business development services. A three-year IFC-supported pilot Small and Medium Enterprises Solutions Center, which started operations in Kenya in March 2005, will help MSMEs access financial resources, information, and advice through a single integrated service center. The IFC-supported multidonor Private Enterprise Partnership for Africa will facilitate small firms' access to financial and business services. MIGA is supporting the country's agribusiness, infrastructure, manufacturing and services sectors. The total gross exposure from these investments, sponsored by investors from the Cayman Islands, South Africa, United States, is US$58.3 million. In June 2007, the Agency provided additional coverage toward the expansion of a greenfield sugar factory in western Kenya. This is a south/south investment, financed by the Industrial Development Corporation of South Africa, and aims to rejuvenate the economy of the sugarcane industry in the Kisumu region. In FY08, MIGA will continue its support of the power sector in Kenya by underwriting the second phase (expansion) of a geothermal project that it is currently insuring. The anticipated gross exposure for this investment is up to US$200 million and would be the Agency's single largest project in Africa.

14. **Regional integration and improvement of trade environment** are priorities of the government. In 2005, Kenya launched a customs union with Tanzania and Uganda in the context of the East African Community (EAC), which includes a common external tariff. Kenya is also actively involved in negotiations and activities of the Common Market for Eastern and Southern Africa, and in negotiations of economic partnership agreements with the European Union. A trade report focusing on behind the border supply-side constraints was prepared by the Bank in 2006 and is being used in the implementation of Private Sector Development Strategy of the government.

15. **Infrastructure development.** The IP-ERS recognizes the lack of adequate physical infrastructure as a major impediment to private sector development in Kenya. The Bank is supporting the government's investment program through the Northern Corridor Transport

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

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

17. **Financial sector development.** The IP-ERS identifies the urgent need to reform the financial sector in Kenya, which is beset with a relatively high level of nonperforming loans and wide interest rate spreads, and operates within a weak legal and judicial system. To support the government's reform agenda, the Bank and the IMF conducted a joint Financial Sector Assessment Program in 2004 that highlighted the vulnerabilities of the financial sector. A Financial and Legal Sector Technical Assistance Credit that was approved by the Bank's Board in October 2004 is supporting the development of financial and legal sector strategies, the strengthening of financial and legal sector regulations and institutions, and the establishment of a bank restructuring and privatization project within the Ministry of Finance that will guide the process of divesting the state's holdings in banks.

Summary of Bank's Lending Portfolio

(As of March 5, 2007)

Project ID	FY	Purpose	Original Amount in US$ Millions IDA	GEF	Undisb.
P085414	2007	National Statistical Capacity Development	20.5	0	20.3
P081712	2007	Total War Against HIV/AIDS	80.0	0	81.1
P074106	2007	Western Kenya CDD/Flood Mitigation	86.0	0	88.4
P095050	2007	Natural Resource Management Project	68.5	0	69.7
P087479	2007	Educ Sec Sup Project (FY07)	80	0	65.9
P090567	2006	Inst Reform & Capacity Bldg TA (FY06)	25	0	22.5
P072981	2005	GEF W KE Int Ecosys Mgmt SIL (FY05)	0	4.1	3.2
P083131	2005	Energy Sec Recovery Project (FY05)	80	0	76.9
P083250	2005	Financial & Legal Sec TA (FY05)	18	0	16.4
P085007	2005	MSME Competitiveness	22	0	19.4
P049618	2004	Nairobi Wtr & Swg Inst Rst SIL (FY04)	15	0	3.2
P082615	2004	Northern Corridor Transport SIL (FY04)	207	0	180.4
P082396	2004	Agricultural Productivity Project (FY04)	40	0	15.8
P078209	2004	Dev Learning Centre LIL (FY04)	2.7	0	1.3
P082378	2003	Free Primary Educ Support (FY03)	50	0	0.2
P078058	2003	Arid Lands 2 SIL (FY03)	120	0	74.4
P070718	2001	Regional Trade Fac. Project	25	0	27.7
P066486	2001	Decentr Reprod Hlth & HIV/AIDS (FY01)	50	0	12.3
		Total:	989.7	4.1	779.1

IMF-World Bank Collaboration in Specific Areas

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

19. **Joint assessment of the IP-ERS progress report.** The staffs of the Bank and the IMF jointly prepared a staff advisory note on Kenya's Annual Progress Reports of the IP-ERS in March 2007.

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

21. **Budgetary and public expenditure reforms.** The Bank and IMF work closely to support government efforts in budgetary and public expenditure reforms. The Bank leads the dialogue on planning, the preparation of the medium-term expenditure framework, strategic resource allocation (particularly aligning budgetary allocations with the priorities laid out in the IP-ERS), expenditure restructuring, enhanced stakeholder participation, and issues related to efficiency of public spending, such as expenditure tracking. The Bank and the IMF collaborate on issues related to internal audit reform and on the integrated financial management information system.

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

23. **Debt management and debt sustainability analysis**. The IMF prepared an external debt sustainability analysis in December 2003, which it updated in December 2004. The Bank and Fund prepared a joint debt sustainability analysis covering both external and domestic public debt in March 2007. In the context of the Financial Sector Assessment Program, a joint World Bank/IMF initiative is being undertaken to support capacity-building in the area of sovereign debt management and domestic debt market development.

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

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

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

27. **Regional integration and trade reforms**. The IMF and the Bank both provided advice on the implementation of the common external tariff, and the Bank is providing technical advice on regional integration issues. The Bank has finalized a regional assessment of nonfiscal investment incentives in each of the three states of the EAC, complementing an earlier IMF report that advises on the harmonization of incentives in the context of the customs union. The Bank is implementing a Regional Trade Facilitation Project aimed at

providing political-risk and export insurance for cross-border trade between participating countries. The Bank together with the African Development Bank is implementing the EAC Regional Transport and Trade Facilitation Project. This project includes support for implementation of the customs union, and institutional and investment support to facilitate transport in the region. The Bank with the Africa Development Bank has prepared a regional integration assistance strategy that will set out priorities for regional interventions in East Africa.

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

III. KENYA: STATISTICAL ISSUES

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

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

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

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. An STA peripatetic advisor assisted the authorities in rebasing the national accounts estimates at constant 2001 prices and compiling institutional accounts for the general government sector. National accounts estimates for the years 1996–2005 in current and constant (2001) prices have been published. Quarterly national accounts are being developed with the assistance of the AFRITAC East.

Prices and production

6. No producer, export, or import price indices are produced. In early 2002, the CBS began publication of a new national CPI (covering 13 urban towns), with 1997 as reference year and outdated weights and basket of items derived from the 1993-94 Household Budget Survey (HBS). Indices are produced for lower and middle/upper income groups and Nairobi and other cities. The index is compiled and published on a timely basis. No producer, export, or import price indices are produced.

7. Kenya is making progress in updating the weights of their CPI using the results of the 2004/5 integrated HBS. This would facilitate a revamping of the CPI to conform to international standards, as outlined in the *CPI Manual* 2004. There is a need to review the formula used at the elementary aggregate level, as the NBS currently uses for the "food and non-alcoholic beverage" product group, a chained average of relatives and this does not conform with international standards. Also, there is a need to examine the treatment of seasonal goods and services and the adequacy of the CPI compilation software.

Government finance statistics (GFS)

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

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

10. The country reports data to STA for the budgetary central government for inclusion in the *GFS Yearbook*, albeit with a significant lag—the last data reported were for the year

ending June 2005. The CBS compiles the aggregate annual GFS revenue and expenditure data for the budgetary central government based on detailed data in the reports of the Controller and Auditor General. Submission for publication in the *2007 GFS Yearbook* was reported in *GFSM 2001* format, using bridge tables developed by the technical assistance missions. The recent steps taken in the migration to *GFSM 2001* may help reduce the significant differences between CBS data and the data compiled by the MOF and reported to AFR for surveillance and program monitoring purposes. Monthly and quarterly data are regularly reported for inclusion in the *International Financial Statistics (IFS)*.

Monetary statistics

11. The CBK has experienced delays in the implementation of the Monetary and Financial Statistics Manual and adoption of the IMF's standardized report forms (SRFs). The authorities submitted SRF test data; however, there has not been further progress. In March 2007, a STA mission established the standardized report form for central bank data, reviewed and revised the reporting form and compilation notes for the other depository corporations (ODCs) in line with *MFSM* data requirements, and identified the coverage of the ODC subsector. The mission found misclassification of a number of central government deposits as private sector deposits. A major issue for future work relates to the expansion of the coverage of the ODCs to include the Savings and Credit Cooperatives (SACCOS). As of end-March, 2007, there were 3,800 SACCOs, accounting for about 30 percent of the total deposits of the banking system. Legislation for increased supervision over SACCOs has been prepared and it is hoped that it will be enacted shortly. Monthly data would also be generated as part of the supervisory function. A follow-up mission in June 2007 conducted a workshop for officials of ODCs and established a system for reporting Form 1SR to the IMF. The new Standardized Reporting System for reporting ODCs' data to the central bank was also finalized.

External sector statistics

12. The CBS compiles annual balance of payments statistics in Kenya shillings that are regularly reported to STA, although with considerable delay. In addition, the CBK compiles a complete set of annual balance of payments statistics in U.S. dollars, which are reported to AFR and used for programming and surveillance purposes. As the two datasets are not entirely consistent, reconciliation should be a priority. More recently, the CBK also started to compile and publish quarterly balance of payments estimates.

13. Although the overall quality of trade data may be reasonably good, data for other current account and many financial account transactions are rather weak. Following the liberalization of the exchange system in 1993–94, gaps emerged in coverage. The compilation system (other than that used for compiling customs statistics), used since 1994, relies on reports from domestic banks. This may result in a substantial underrecording of current

earnings (including tourism receipts), investment flows of the private sector, and transactions that are settled via accounts held abroad.

14. Estimates of direct and portfolio investment are believed to be substantially understated. The MOF compiles data covering public and publicly guaranteed external debt obligations to official and commercial creditors. This database does not take into account nonresident purchases of the government's domestic currency-denominated debt securities. In developing the loan-by-loan debt sustainability analysis (DSA) in 2002, Fund and World Bank staffs identified several significant debt data problems that have been addressed by the authorities. Nevertheless, significant debt data management problems remain, along with more general issues in the area of external debt management and its integration in the budget formulation and expenditure management systems.

15. The January-February 2006 mission recommended introducing a foreign direct investment survey, enhancing the foreign exchange statistics survey, and using a common methodology, including for estimations, in the use of available data in the CBS and CBK. Workers' remittances estimates are now included in the CBS annual BOP following the advice of the mission. The GDDS website has identified plans for dissemination of documentation of methodology, joint work by Ministry of Finance, CBK, and CBS on external debt, and compilation of international investment position data.

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

International Monetary Fund
Washington, D.C. 20431 USA

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FOR IMMEDIATE RELEASE
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IMF Executive Board Completes Third and Final Review Under the Poverty Reduction and Growth Facility for Kenya and Approves US$59.3 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the third and final review of Kenya's economic performance under a three-year Poverty Reduction and Growth Facility (PRGF) arrangement. The completion of the review enables the release of an amount equivalent to SDR 37.5 million (about US$59.3 million), bringing total disbursements under the arrangement to SDR 150 million (about US$237.4 million).

In completing the review, the Board approved waivers for the nonobservance of four performance criteria and one prior action. These included one quantitative performance criterion on the reserve money of the Central Bank of Kenya (CBK), one quantitative performance criterion pertaining to the non-accumulation of new external payment arrears, one structural performance criterion on the submission to Cabinet for approval of a strategy to initiate the sale of the government and the National Social security Fund (NSSF) shares in the National Bank of Kenya, and one structural performance criterion on making the Public Procurement Oversight Authority fully operational under the Public Procurement and Disposal Act. The prior action related to dissemination of information on procurement contracts.

The three-year PRGF arrangement for Kenya was originally approved on November 21, 2003 (see Press Release No. 03/201), in an amount equivalent to SDR 175 million (about US$276.9 million). On December 20, 2004, the Executive Board approved an augmentation of access under the PRGF arrangement of SDR 50 million (about US$79.1 million) (see Press Release No. 04/270). The arrangement was subsequently extended to April 30, 2007 to allow time to complete the second review (see Press Release No. 07/37). An additional extension of the arrangement to November 20, 2007 was approved on April 11, 2007 (See Press Release 07/66), along with a reduction in access by SDR 75 million (about US$118.7 million), consistent with an improvement in Kenya's external position. On that occasion, remaining disbursements under the arrangement were rephased, bringing the total amount available under the arrangement to SDR 150 million (about US$237 million).

Following the Executive Board discussion on Kenya’s economic performance under the PRGF, Mr. John Lipsky, First Deputy Managing Director and Acting Chair, stated:

“The Kenyan economy is growing strongly against the background of sound macroeconomic management and progress in structural reforms. At the same time, the external position has strengthened.

“The sharp increase in spending envisaged in the 2007/08 budget entails some risks. However, the authorities are taking steps to address these risks, including by backloading development spending in line with available financing and fully implementing the budget only if inflation remains low and project quality is maintained.

“The planned sovereign bond would have limited effect on the net present value of Kenya’s debt. The authorities should consider allocating a higher share of the planned proceeds to debt reduction, and should draw upon the debt management expertise available in the Fund. The temporary accumulation of external payment arrears is regrettable.

“Monetary policy should remain focused on securing low inflation. To this end, it will be essential that the Central Bank of Kenya achieve its reserve money targets.

“Concerning governance, challenges remain despite some important progress. Efforts to fully implement the Governance Action Plan should continue, and more progress is needed in investigating and prosecuting high-profile corruption cases.

“Business regulation has been streamlined and public financial management has been strengthened, as evidenced by advances in implementing the Integrated Financial Management Information System and continuous progress in public enterprise reform. Looking forward, greater efforts are needed to improve the legal framework for public finance management and to accelerate financial sector reform.”

Statement by Peter Gakunu, Executive Director for Kenya and Rachel Gesami, Senior Advisor to Executive Director
November 16, 2007

Introduction

1. On behalf of my Kenyan authorities, I would like to thank Executive Directors and Management for their support to Kenya's efforts towards sustained growth and economic development and the successful implementation of the reform program. I would also like to thank staff for the constructive policy dialogue and fruitful exchanges during their recent visit to Nairobi. I welcome the well written and balanced staff report on the third and last review under the PRGF arrangement.

2. Supported by prudent macroeconomic management and strong progress in implementing governance and structural reforms, the Kenyan economy recorded strong growth over the recent years, that has resulted in a downward trend in poverty levels. The authorities' broad development strategy remains as outlined in the Kenya Vision 2030 and the country's Investment Program for the Economic Recovery Strategy for Wealth and Employment Creation (ERS). The Kenya Vision 2030 program launched recently calls for a sustained increase in GDP growth to an average of 10 percent per annum, with a view to making Kenya a middle-income country by the year 2030. As a step in this direction, the authorities are developing a medium-term strategy covering the period 2008-12 aimed at accelerating growth, maintaining macroeconomic stability, reducing poverty, improving equity and strengthening good governance.

Performance under the PRGF Arrangement

3. Notable progress has been made in implementing the main components of the reform program despite the difficulties posed by exogenous shocks. In particular significant progress has been made in tackling governance weaknesses; strengthening fiscal policy for stability and growth; enhancing public financial management; strengthening the financial sector, as well as progress in productive sector and public enterprise reforms, and the privatization program. The authorities' commitment to good governance and structural economic transformation has started to yield results. The business environment has been improved substantially, including halving the number of days to start a business. The implementation of the Governance Action Plan for Building a Prosperous Kenya has been deepened with the enactment of the Miscellaneous Amendments Bill. With the ongoing business license reforms, the authorities expect further improvement in Kenya's doing business indicators.

4. In sum, program implementation supported by the PRGF arrangement remained on track, as most of the 13 performance criteria (PCs) for the third review under the PRGF arrangement were met. However, two quantitative and two structural performance criteria were not observed on time, but appropriate corrective measures have been taken. The end-June quantitative PC on the reserve money of the Central Bank of Kenya (CBK) was missed, but the authorities have initiated convincing measures to tighten further monetary policy since August and slowdown the annual reserve money growth within its target range. The continuous PC on the non-accumulation of external arrears was breached by a negligible margin, but all arrears have been cleared since then. The structural PC on making the Public Procurement Oversight Authority (PPOA) operational was not met at end-April, but it is now fully operational with an interim Advisory Board and Director General. Also, the end-June PC on the submission to the Cabinet of a strategy to initiate the privatization of the National Bank of Kenya (NBK) was not met, but the strategy was submitted in November.

5. Given the achievements in macroeconomic management and structural reforms and the commitment to successful program implementation, the authorities request the completion of the Third Review of the PRGF-supported program, and the granting of the associated waivers.

Recent Economic Developments and Outlook

6. The authorities have commendably maintained macroeconomic stability and put in place a strong foundation for sustained growth. GDP expanded above 6 percent in the 2006/07, and is broad-based with strong growth in manufacturing, tourism, transport and communications, and financial services. Nonfood inflation was contained at below 6 percent, but due to increases in food prices, the overall inflation rose to 10.6 percent (y/y) at end October. The fiscal performance was better than programmed, as the overall deficit (commitment basis, including grants) was reduced to 1.7 percent of GDP, compared to the program target of 3.3 percent of GDP. The authorities' strong political commitment to prudent financial policies and market-oriented structural reforms led Standard and Poor to maintain Kenya's good sovereign credit rating of "B+" for foreign currency and "BB-" for local currency long-term sovereign debt.

7. The economic prospects are favorable for 2007/08 and in the medium-term. The authorities expect that real GDP will continue growing at a robust level and inflation will decline significantly. Favorable weather conditions, strong tourism demand, and recent robust income growth are expected to sustain GDP expansion at about 6-7 percent. At the same time, inflation should decline to 5.8 percent by the end of the fiscal year. On the external side, the current account deficit is likely to widen as growth strengthens and foreign-financed project imports increase. Nonetheless, financial inflows should allow foreign exchange reserves to be maintained at an equivalent of 3.2 months of imports by

mid-2008. Overall, the strong economic progress shows that the authorities are pursuing diligently the ERS's objectives and the Kenya Vision 2030. They are aware that a lot of work remains to be done, as the economy is still vulnerable to exogenous shocks and that the government continues to face challenges in a number of areas. These include the need to improve the effectiveness of key public institutions, increase the breadth and quality of infrastructure, improve external competitiveness, sustain high economic growth and reach the MDGs by 2015.

Fiscal Policy and Debt Management

8. The authorities are committed to fiscal consolidation and continue to put emphasis on the need to limit recourse to domestic financing, while accommodating appropriate increases of expenditures for productivity-enhancing infrastructure and poverty-reducing programs, with a view to supporting the growth objectives under the ERS and the Vision 2030. In this connection, priority areas for spending include roads, energy and other projects identified in the Vision 2030; the introduction of free tuition for public secondary schools; scaling up of spending on preventive health care, and agricultural development. The authorities are conscious of the challenges of increasing absorptive capacity and maintaining the quality and efficiency of spending associated with the expenditure increases projected in the 2007/08 budget. They will therefore continue improving the procurement process and monitoring spending to preserve its quality. They will also deepen the implementation of the PFM reform, and are making progress towards promoting public-private partnerships (PPPs). The authorities are confident that the NDF target will be observed and that donors' concessionnal financing will continue increasing to complement their domestic revenue collection in support of their development strategy. In this connection, they have taken strong steps to improve aid coordination and harmonization, including through the recently launched Joint Assistance Strategy; improved data reporting on development spending; and intensified portfolio and disbursements monitoring.

9. The favorable international credit ratings provide an opportunity to issue a sovereign bond of about 1.0 percent of GDP, with a part of the proceeds going to finance high return development projects, while the other part would be used to settle external arrears on previously disputed contracts. The authorities are receiving TA from the Fund on how best to proceed with the issuance of the bond. Kenya has managed its debt relatively well and has regularly met its obligations to most of its creditors. The authorities' limited external borrowing has left them with more manageable debt ratios than most low-income country peers. The joint IMF-World Bank debt sustainability analysis (DSA) found Kenya's debt to be low and sustainable.

Monetary, Exchange Rate and Financial Sector Policies

10. The authorities' main monetary policy objective is to continue maintaining low inflation levels. To this end, the CBK is committed to meeting its reserve money targets.

It will continue to fine tune its open market operations and promote interest rate flexibility. It is also committed to improve coordination with the Treasury to reduce the liquidity impact of government use of CBK overdraft facility, stimulate participation of smaller public investors in T-bills purchases, and maintain a floating exchange rate regime. In addition, CBK will continue to monitor real exchange rate developments to preserve the economy's external competitiveness.

11. Expanded access to financial services is key to achieving the growth objectives. In this regard, a long term strategy for financial sector development is being formulated, and the medium-term development strategy expected to be finalized in early 2008 will include reforms to improve access by majority of Kenyans to financial services and enhance governance, efficiency and stability of the financial system. The authorities are also committed to accelerating public financial enterprise reforms and developing a financial sector reform strategy that is based on market principles.

Structural reforms

12. In addition to the PFM and financial sector reforms, the authorities are determined to make further progress in implementing the governance and private sector development reforms. Tackling governance weaknesses remains a top priority. To this end, the Kenya Governance Action Plan (GAP) has been well received by citizens, the private sector and cooperating partners. The implementation of the GAP pillars will be deepened with emphasis on prevention, investigation, restitution, and improvement of governance in priority sectors. Priority is being accorded to administrative and preventive actions, which are expected to result in measurable improvements in governance and anti-corruption efforts in the short run. Going forward, the authorities will give priority to governance actions that do not require legislation. These include in particular expanding court facilities, hiring additional prosecutors, and accelerating training of judges, as well as automation of recording of court proceedings, auditing of Constituency Development Fund and Local Authority Transfer Funds and other development funds.

13. Promoting private sector led growth remains a priority, and the authorities are committed to continuing streamlining Kenya's business licensing system and promoting a more open trade regime. Trade liberalization will be pursued to enhance efficiency and strengthen growth prospects, and Kenya is playing a leading role in regional economic integration. In this regard the authorities will implement in full the East African Community (EAC) commitments, and continue to push for further steps to open up the EAC with a view to enhancing competition and efficiency. Kenya has been an active member in the Doha Round and supports efforts to bring the Round to a successful conclusion.

Conclusion

14. Implementation of sound macroeconomic policies and deepened structural reforms have contributed to robust growth, reduced poverty levels, and established a

good track record in program performance. My authorities are committed to continue delivering on the objectives set out in the Economic Recovery Strategy, Vision 2030 and the Governance Action Plan. They are confident that the Fund would continue to play a positive and catalytic role in supporting the country's development strategy. The authorities intend to remain engaged with the Fund through an appropriate program to be determined after the general elections scheduled for 27th December 2007.