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May 5, 1998

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Kenya—Staff Report for the 1998 Article IV Consultation**

Attached for consideration by the Executive Directors is the staff report for the 1998 Article IV consultation with Kenya, which is tentatively scheduled for discussion on Friday, May 22, 1998. A draft decision appears on page 30.

Mr. Gondwe (ext. 36957), Mr. Georgiou (ext. 36009), or Mr. Cowen (ext. 37207) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Wednesday, May 13, 1998; and to the African Development Bank (AfDB) and the European Commission (EC), following its consideration by the Executive Board.

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INTERNATIONAL MONETARY FUND

KENYA

Staff Report for the 1998 Article IV Consultation

Prepared by the Staff Representatives for the
1998 Consultation with Kenya

Approved by Evangelos A. Calamitsis and Susan M. Schadler

May 5, 1998

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Executive Summary

1. While some progress has been made by the Kenyan authorities in implementing measures designed to address the outstanding governance issues that prevented completion of the midterm review under the first annual ESAF arrangement, substantial further progress is needed. The mission highlighted the remaining actions that had to be taken before negotiations on a second annual ESAF arrangement could begin.

2. Economic growth began to slow down in 1996 as macroeconomic performance faltered, the pace of structural reform decelerated, and problems of corruption continued to complicate the management of public finances and to undermine investor confidence. High real interest rates persisted and inflation increased in 1996. Moreover, large capital inflows that fed purchases of government paper made government finances increasingly vulnerable to changes in perceptions about policies and prospects.

3. In 1997, fiscal excesses, preelection violence, and the expiry of the first annual ESAF arrangement exacerbated the effects of longer term factors on real GDP growth, which slowed down further, from 4.2 percent in 1996 to 2 percent. At the same time, monetary policy did not sufficiently constrain the growth of monetary aggregates and, in combination with inclement weather, led to average inflation increasing from 9 percent in 1996 to 11.2 percent. The balance of payments was also weaker than targeted due to considerable capital flow reversals in the context of market instability in the second half of 1997 and a larger than expected current account deficit at 3.2 percent of GDP, owing to both strong import growth and a reduction in exports of goods and services. The exchange rate depreciated by about 20 percent at the time of the expiry of the ESAF, but has since partially recovered to about 9 percent below its pre-devaluation level on account of expectations that negotiations with the Fund could resume and a rise in interest rates.

4. The overall fiscal deficit, excluding grants, widened to 3.4 percent of GDP in 1996/97 (July-June) compared with a target of 1.2 percent of GDP. Moreover, due mainly to the large wage increases for teachers and civil servants as well as the sizable downturn in economic activity in the first half of 1997/98, the budget deficit was seen widening further to 3.9 percent of GDP this fiscal year, in the absence of compensating measures, compared with a target of 1.7 percent of GDP. The authorities recognized the risks arising from the fiscal deterioration in 1997 and, in March 1998, adopted an ambitious fiscal package for the remainder of 1997/98 to contain the expanding deficit to 2.4 percent of GDP. This would allow a resumption in the medium term of the path of fiscal adjustment envisaged under the original ESAF-supported program. Beyond 1997/98, it will be important to proceed rapidly and consistently with further fiscal adjustment and reductions in the stock of government domestic debt. In this context, the authorities would need to renegotiate the wage agreement with teachers (of a 200 percent increase in salaries over five years) as its full implementation would render the path of fiscal adjustment unattainable, with grave consequences for macroeconomic stability and economic growth.

5. Monetary policy should be aimed at securing monetary control. The Central Bank of Kenya (CBK) could usefully set its targets taking into account a number of financial aggregates, including unanticipated portfolio shifts of the public, and reduce the automaticity with which it provides liquidity to banks so as to control reserve money more effectively. The monetary program adopted for the remainder of 1997/98 is consistent with averting a further deterioration in the inflation and external sector performance, and can set the stage for improvements in these areas in 1998/99. At the same time, it is important to permit exchange rate flexibility and to avoid intervention so as to discourage the reappearance of short-term speculative inflows. The recent practice of smoothing out of short-term fluctuations may diminish the exchange risk faced by short-term capital and could thereby encourage such volatile inflows. In order to avoid excessive pressure on the exchange rate, it is essential to reduce interest rates through a tightening of fiscal policy.

6. The banking supervision department of the CBK should be given authority to apply penalties and be strengthened to enable more frequent on-site examinations to verify the accuracy and reliability of reported data. Particular attention needs to be paid to the adequacy of the provisioning levels for nonperforming loans and the fact that some banks have experienced a sharp increase in nonperforming loans. The incidence of insider lending calls for improvements in disclosure requirements and the enforcement capacity of the CBK.

7. Understandings were reached with the authorities on quantitative and structural targets for the current fiscal year ending in June 1998, with a view to monitoring policies aimed at maintaining macroeconomic stability and accelerating the pace of structural reform. The targets are prior actions to presenting a possible ESAF-supported program to the Board.

I. INTRODUCTION

1. The 1998 Article IV consultation discussions with Kenya were held in Nairobi during February 9-27, 1998. The Kenyan representatives included Mr. Nyachae, Minister for Finance; Mr. Cheserem, Governor of the Central Bank of Kenya; Mr. Wako, Attorney-General; Mr. Kuindwa, Secretary to the Cabinet and Head of the Civil Service; and other senior officials. The mission also held discussions with the Economic Subcommittee of the Cabinet, and met with members of the political opposition and of the private sector. The head of the mission was received by President Moi.[1]

2. Kenya's three-year arrangement under the Enhanced Structural Adjustment Facility (ESAF) was approved by the Board on April 26, 1996, for an amount equivalent to SDR 149.5 million (75 percent of quota). The first and only disbursement under the arrangement (SDR 24.9 million) was made on May 15, 1996. The first annual arrangement expired on July 31, 1997 without completion of the review because of the authorities' failure to address outstanding governance issues. The program supported by the first annual ESAF arrangement had advocated good economic governance as essential for promoting a favorable investment climate and boosting growth, as well as preventing irregular financial transactions from destabilizing macroeconomic management. The program, therefore, had sought to improve financial discipline mainly through the reinforcement of accountability and transparency in the use of public funds.

3. At the conclusion of the last Article IV consultation (3/26/97), Directors urged the authorities to pursue vigorously fiscal consolidation and civil service reform; accelerate public enterprise reform and privatization; pursue tight monetary policy and a more flexible exchange rate management in response to capital inflows; and strengthen efforts to eliminate corruption and improve discipline and transparency in the management of public finances. Directors also stressed the need to strengthen budgetary expenditure control and to resist pressures for spending in the run-up to the elections.

4. National elections for the presidency and the parliament held on December 29-30, 1997 saw President Moi returned to office for a fifth term, but the majority of his KANU party was reduced to 4 out of the enlarged parliament of 222 parliamentary seats (compared with 44 out of 200 seats in the previous parliament). Despite some incidents of preelectoral violence, logistical problems that led the Electoral Commission to extend voting to a second day, and accusations from both KANU and the opposition parties of vote irregularities, the results of the elections appear to have been widely accepted both domestically and internationally.

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[1]The staff team comprised Mr. Gondwe (head), Mr. Georgiou, Mr. Cowen (all AFR), Mr. Andrews (PDR), Mr. Gordon (LEG), Mr. Schwidrowski (FAD), and Ms. Haddi (assistant-AFR). Mr. Messec—an MAE consultant—worked on bank supervision issues. The mission was assisted by Mr. Carstens, the Fund's Senior Resident Representative in Nairobi.

5. Kenya accepted the obligations of Article VIII, Sections 2, 3, and 4, of the Fund's Articles of Agreement on June 30, 1994 (EBD/94/116; 7/11/94). Kenya maintains a multiple currency practice subject to Article VIII, Section 3 (EBS/94/141; 7/6/94), arising from outstanding commitments under the now abolished Exchange Risk Assumption Fund. The Executive Board approved the retention of this multiple currency practice until the earlier of the next Article IV consultation with Kenya or May 31, 1998 (EBD/98/17; 2/27/98). As of March 31, 1998, Kenya's outstanding use of Fund credit amounted to SDR 179.2 million, or 89.9 percent of quota. Although reporting of the core financial data to the Fund is generally timely, the quality of Kenya's official macroeconomic statistics has deteriorated over time. Deficiencies in national accounts, money and banking, government finance, and balance of payments statistics complicate economic analysis, and technical assistance is being provided by the Fund to address them. Kenya's relations with the Fund and the World Bank are discussed in Appendixes I and II while a detailed assessment of the quality and timeliness of the statistics is provided in Appendix III.

II. Background

6. Macroeconomic performance, which improved significantly in Kenya in the period 1993-95, became increasingly fragile in 1996. Economic growth began to slow, declining from 4.8 percent in 1995 to 4.2 percent in 1996, and average annual inflation rose from 1.5 percent to 9 percent over the same period (Table 1). In the background, large capital inflows put pressure on the exchange rate, which the central bank moderated by intervening in the foreign exchange market. The accompanying sterilization, however, was only partial and contributed to the rising inflation. Moreover, the capital inflows fed purchases of short-term government paper, making government finances increasingly vulnerable to changes in perceptions about economic policies and prospects. Progress in areas important for generating the desired supply response of the economy was less than intended. Privatization and restructuring of parastatals in many cases lagged, problems in economic governance remained unresolved, and high real lending interest rates (near 20 percent) continued to crowd out private investment. Contributing substantially to the high lending rates was the persistence of relatively large domestic borrowing by the government at short maturity. Thus, as power shortages intensified, railways and roads continued to deteriorate, and business confidence weakened in the course of the year, economic growth began to slow in 1996.

7. In the first half of 1997, a large fiscal slippage was added to the unfavorable trends that had become visible in 1996. The overall fiscal deficit (on a commitment basis), which was targeted at 1.2 percent of GDP in 1996/97 (July-June), in fact rose to 3.4 percent of GDP in that fiscal year (Tables 2 and 3). The large slippage was due mostly to weaker-than-expected tax revenue (by 1.5 percent of GDP), and higher than programmed recurrent spending (by 1.4 percent of GDP) that was only partially offset by cutbacks in development spending (of 0.4 percent of GDP). Considerable overruns in recurrent spending occurred in the last quarter of the fiscal year as ministries entered into unbudgeted spending commitments in anticipation

of tighter cash limits during 1997/98. The magnitude of the overruns became clear only during the recent Article IV consultation discussions when it was discovered that about 1.3 percent of GDP in payments for commitments entered into in 1996/97 was cleared in 1997/98, giving rise to an unanticipated increase in the government's borrowing requirement in the latter year.

8. Large capital inflows persisted in the first half of 1997, and the central bank continued to intervene to contain the appreciation of the Kenya shilling while simultaneously sterilizing purchases of foreign exchange. The conduct of monetary policy in this period was further complicated by shifts by the nonbank public from money into direct holdings of government paper, implying a weakening in the underlying money demand. In the absence of an adjustment of the monetary targets to accompany these shifts, growth in liquid financial assets in the first half of 1997 was probably too rapid. Thus, despite a fall in the international prices of imported goods and a nominal effective appreciation of the shilling in the first half of 1997, the loosening of financial policies, in combination with food shortages, caused the annual average inflation rate to rise to 12.6 percent by June 1997, well above both the targeted 5 percent, and the 9 percent recorded at end-1996. The external current account also widened significantly during this period, reflecting a relaxation in financial policies, an appreciating exchange rate, and drought-related imports. The overall result was a further slowdown in economic activity, as annual GDP growth was estimated to have fallen to 3 percent by June 1997.

9. Economic events during the second half of 1997 were dominated by the suspension of the ESAF arrangement and reduced disbursements from donors, including the World Bank and the African Development Bank, and by ethnic and political tensions. In this context, the economy experienced an abrupt loss of confidence, and investors in shilling-denominated government paper pulled about US$250 million out of the country or otherwise converted it into foreign currency deposits, leading to a decline in official reserves equivalent to one month of imports,[2] a depreciation of the currency from K Sh 54.5 per U.S. dollar to K Sh 70 per U.S. dollar, and a sharp increase in the treasury bill rate from 18 percent to 27 percent.

10. In response to this situation, in August 1997, a staff team held discussions with the authorities on the governance issues that prevented completion of the midterm review under the first annual ESAF arrangement. Following these discussions, understandings were reached on measures to address economic governance issues, the implementation of which would be prior actions to the initiation of negotiations on an economic program that could be supported by a second annual ESAF arrangement. The agreed actions included (a) establishing accountability and transparency regarding financial infractions related to the gold and diamond export compensation payments; (b) safeguarding the independence of the Kenya Revenue Authority (KRA); (c) establishing an independent Kenya Anti-Corruption Authority (KACA); and (d) addressing outstanding issues in the energy sector. To date, the government has taken

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[2]Official reserves fell to about US$788 million at end-1997, equivalent to 2.9 months of imports.

some steps toward the completion of the agreed prior actions in economic governance (see Box 1), but a number of important actions still need to be implemented (see Section III A).

11. In response to the announcement at the end of the August mission that conditions had been set for resuming negotiations on a second-year ESAF arrangement, and in the context of high interest rates, a fragile stability was restored to the financial markets. In the period since, the shilling partially recovered to about K Sh 59-61 per U.S. dollar—some 9 percent below its predevaluation level—as capital outflows dried up and official reserves broadly stabilized at about three months of imports of goods. To underpin this stability, the authorities implemented some modest fiscal measures, including increases in the standard value added tax (VAT) rate from 15 percent to 16 percent and in duties on petroleum products. However, the fiscal situation continued to deteriorate during the remainder of 1997, mostly because of large wage increases for teachers and civil servants[3] and a further slowdown in economic activity. It was estimated that the overall budget deficit could reach 3.9 percent of GDP in 1997/98 (July/June), compared with a target of 1.7 percent of GDP, if additional compensating measures were not taken. This fiscal slippage would reflect the higher government wage bill (by 1.3 percent of GDP), spending overruns for the elections (of 0.3 percent of GDP), continued shortfalls in revenue (of 0.4 percent of GDP), and larger-than-originally-projected domestic interest payments (by 1.6 percent of GDP). These factors would be partially offset by the measures taken by the government in the first half of 1997/98, equivalent to 1.5 percent of GDP. The considerable domestic financing need of the government on account of the fiscal deficit of 3.9 percent of GDP would be further exacerbated by the carryover of payment commitments (equivalent to 1.3 percent of GDP) from the previous fiscal year.

12. The increasing financing needs of the government throughout 1997 kept, and even exacerbated, the pressure on interest rates throughout the economy, contributing to a significant weakening in economic activity and to a deterioration of bank portfolios. At the same time, the government's financing needs, as well as the need to shore up the liquidity of certain banks, contributed to a somewhat looser-than-appropriate monetary policy stance in 1997. The central bank increased its holdings of government paper and reduced the required reserve ratio from 18 percent to 15 percent on October 1, 1997. M3X[4] grew by 12 percent, and, as the nonbank public shifted significantly from deposits into direct holdings of liquid government paper, money growth rates most likely underestimated the degree of monetary

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[3]Following a two-week strike in October, teachers received a salary award amounting to a 200 percent increase over a five-year period, starting with an average 35 percent increase in 1997/98. Allowances were also increased substantially. Moreover, other civil servants received salary increases of about 18 percent for 1997/98, exceeding the budgeted amounts.

[4]M3X includes currency in circulation and deposits, in domestic and foreign currency, of residents with domestic banks and nonbank financial institutions.

Box 1. Kenya: Governance Issues

The first annual ESAF arrangement expired at end-July 1997 without completion of the midterm review, because of a lack of agreement with the government on credible measures to resolve outstanding economic governance issues. There were four principal remaining issues: enforcing full accountability with respect to financial infractions related to gold and diamond export compensation payments; establishing the Kenya Anti-Corruption Authority; safeguarding the independence of the Kenya Revenue Authority (KRA); and strengthening management of the energy sector.

In the weeks that followed the expiry of the first annual ESAF arrangement and the ensuing financial instability, the authorities requested the Fund to reopen discussions on measures to resolve outstanding governance issues. Listed below are brief descriptions of the background of and actions agreed on each governance issue at end-August 1997.

1. *The enforcement of full accountability with regard to financial infractions related to gold and diamond export compensation payments*

In 1993, financial irregularities totaling K Sh 21.6 billion (equivalent at the time to approximately US$400 million, or 6.4 percent of GDP) were uncovered. The most significant one, as it had an immediate impact on the government's budget, involved K Sh 5.8 billion in gold and diamond export compensation payments under a scheme originally designed to subsidize the exportation of Kenyan goods. These payments appear to be irregular in that (a) no legal basis or budgetary provision existed for a significant portion of the payments, (b) no evidence was found that any significant amount of gold was exported, and (c) the payments were effected without following existing financial regulations. A second irregularity arose from payments made by the central bank totaling K Sh 15.8 billion for foreign exchange that was never delivered. Court documents suggest that in each instance high-level government officials were involved.

While the government had recovered K Sh 15.9 billion in misused public funds by end-December 1997 (K Sh 5.2 billion of which represents the seizure of assets, whose validity is still being contested in court), little progress was made on other corrective measures envisaged under the first annual ESAF arrangement. Specifically, the culpability of public officials for these irregularities was not established, and weaknesses that gave rise to the infractions were not fully addressed. In addition, the High Court prohibited the criminal charges as filed by the government in the export compensation case from being heard on procedural grounds in mid-June 1997.

The following actions were agreed:

- Prepare a report by the Attorney-General to include (a) for all of the public officials associated with the irregular export compensation payments identified in the Auditor-General's Reports on the 1992/93 and 1993/94 government accounts, an assessment as to whether they were potentially responsible and/or potentially liable for the loss of public funds, and if liable, under what causes of action; (b) a recommendation to proceed against those who are potentially civilly liable; and (c) for those civilly liable against whom civil process was not recommended, a legal opinion as to the procedural reasons that prevented the commencing of civil action;

- Publish the full report (except those parts that refer to pending criminal, civil, or administrative actions, and that must remain confidential so as not to prejudice those actions); and

- Commence promptly any civil or administrative actions recommended in the report.

2. *The establishment of the Kenya Anti-Corruption Authority (KACA)*

To prevent future abuses involving the use of public funds, the government agreed to establish the KACA in July 1997.

Box 1. Kenya: Governance Issues (concluded)

The following actions were agreed:

- Upon enactment of legislation creating the KACA, the government agreed to issue regulations that establish the procedures for creating an independent advisory board on the KACA and to implement those regulations. These regulations would require an open consultative process between the government and civil society to ensure that appointments to the advisory board had the confidence of the public. The board would in turn be charged with the task of advising the President on the appointment of a Director and Assistant Director of the KACA. At the time, it was agreed that while discussions on a second annual ESAF arrangement could begin, the regulations would need to be issued before these discussions could be concluded.

3. *The safeguarding of the independence of the Kenya Revenue Authority*

In July 1997, the KRA began taking steps to prevent the long-standing problem of tax evasion by sugar importers. Specifically, the KRA attempted to collect upon an outstanding customs bond that had been posted for transit sugar imports that it alleged had been illegally diverted into the domestic market. In response, the government fired the Commissioner of the Customs and Excise Department at the KRA and removed three dissenting KRA Board members, in contravention of the original KRA Act. Subsequently, 11 other cases of illegally diverted sugar imports were discovered.

The following actions were agreed:

- Either amend section 8.(f) of the KRA Act so that the appointment of Board members could be revoked only for serious cause, or, in the alternative, issue a legal opinion interpreting section 8.(f) such that the result is substantially the same; or (2) amend section 6.(1) of the KRA Act to remove from the Board all of its ex officio members except for a representative of the Attorney-General's Chambers and the Ministry for Finance, both of whom would be nonvoting;

- Issue a public announcement that would (a) emphasize the importance of the government's not interfering in the operation of any independent body, including the KRA; (b) reaffirm the government's commitment to ensuring that the rule of law will be respected; and (c) set out the legislative amendments described above; and

- Continue to collect on overdue outstanding customs bonds for unpaid sugar import duties. In this regard, the government agreed to provide an inventory of these bonds as at July 31, 1997 and propose a timetable for their collection.

4. *The strengthening of energy sector management*

In the face of worsening power shortages, the ESAF-supported program aimed at ensuring greater private sector participation in supplying cheap, readily available sources of power. Key to achieving this objective was the implementation of energy sector reforms as agreed between the government and the World Bank. The process was slow, in part because of the government's failure to present new energy sector legislation to parliament deemed satisfactory by the Bank, including provisions establishing an independent regulatory authority. Also, corrective action on the tendering process and contractual terms of two independent power producer (IPP) contracts, which the Bank identified as flawed in 1996, continued to lag. Specifically, the government agreed to undertake independent evaluations and subsequently renegotiate these contracts. Lastly, concerns remained about the managerial and operational strength and the commitment to reform in the energy sector as they pertained to the Ministry of Energy and the Kenya Power and Lighting Company (KPLC).

The following actions were agreed:

- Present to parliament energy sector legislation satisfactory to the World Bank;

- Ensure that, in consultation with the World Bank, the new IPP contracts would be fully renegotiated and the original contracts duly evaluated by an independent audit firm; and

- Specify and implement credible measures to strengthen the management of the Ministry of Energy and the KPLC after passage of the new energy sector legislation.

looseness in 1997 (Tables 4 and 5). This, in combination with inclement weather, contributed to an increase in inflation which reached 11.2 percent on average in that year. The balance of payments was also weaker than targeted in 1997, owing to the developments in the capital account in the second half of the year,[5] which more than offset inflows in the first half, and a larger-than-expected current account deficit of 3.2 percent of GDP, compared with a target of 1.2 percent (Table 6). The larger-than-targeted current account deficit reflected, *inter alia*, drought-related grain imports, weak tourism receipts, and the relaxation in financial policies.

13. The weakening economic performance in 1997 was reflected in the slowdown of annual GDP growth from 4.2 percent in 1996 to 2 percent, which also amounted to a significant underperformance vis-á-vis the target of 5.3 percent. The slowdown was attributable mostly to lower-than-anticipated output in agriculture, industry, and tourism. The declining GDP growth was manifested in a reduction in exports and a robust growth of imports, as domestic demand increased by about 8 percent in real terms. Contributing to the poor output performance were the preelection violence and uncertainty, the expiry of the first annual ESAF arrangement, unseasonal weather conditions, the persistence of high interest rates, currency overvaluation for at least part of 1997, and the long-standing and increasing inadequacies in energy, transportation, and communications infrastructure.

14. An important factor underlying the deficiencies in macroeconomic performance in 1997 was the further slowdown in structural reform in that year. Civil service reform lagged because the data collected in recent censuses were not processed and the formulation of a new civil service reform plan and the undertaking of the envisaged ministerial rationalizations were delayed. Public enterprise reform and privatization continued but lagged in terms of divesting key enterprises. In particular, the lack of private sector participation as had been envisaged in the Kenya Ports Authority and Kenya Railways led to a further deterioration in the quality of services and in financial performance. As for other privatizations, divestiture was completed for 22 enterprises in 1997, compared with a target of 16 enterprises. However, final action was taken on only three of the seven companies mentioned by name.

III. Report on Policy Discussions

15. The 1998 Article IV policy discussions focused on reviewing the implementation of agreed measures to address the outstanding governance issues that are prior actions to the resumption of negotiations on an ESAF-supported program; identifying the means of containing the deterioration in the macroeconomic situation; and agreeing on quantitative macroeconomic targets and structural reforms that would serve as prior actions to the presentation of a request for a second annual ESAF arrangement to the Executive Board.

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[5]The outflows took place mostly in the third quarter of 1997.

A. Governance Issues

16. Extensive discussions were held with the authorities to assess progress made in implementing measures designed to address outstanding governance issues. While a number of the prior actions required for the start of negotiations for a second annual ESAF arrangement have been taken, substantial further progress is needed.

17. In particular, considerable work remains regarding enforcing accountability with respect to financial irregularities surrounding the **gold and diamond export compensation payments** (the so-called Goldenberg case). The authorities completed a draft of a report that was supposed to establish such accountability. Upon reviewing the report, however, the staff team concluded that it was inadequately comprehensive in both its investigative scope and legal reasoning. The authorities concurred with this assessment, and agreed to prepare another, more comprehensive draft once they had gathered additional facts. The government noted that these facts could be revealed during testimony in the ongoing court case.

The authorities have agreed to complete and publish a final draft of the report establishing accountability with regard to gold and diamond export compensation payments as the criminal case progresses.

18. Because the legislation establishing the **Kenya Anti-Corruption Authority** (KACA) did not include procedures necessary to ensure that the KACA Advisory Board would have the confidence of the public, it was agreed that as a prior action to the completion of negotiations for a second annual ESAF arrangement, the government would promulgate and implement regulations that ensured independence of members selected for the board. However, following enactment of the KACA legislation in November 1997, the President appointed members of the Advisory Board without first having issued any regulations. The Advisory Board then proceeded to select one of its own members as a candidate for KACA Director, whom the President summarily appointed in early December 1997. These appointments have been severely criticized by the public in Kenya and have undermined its confidence in the government's declared policy against corruption. The staff emphasized that the government must issue adequate regulations and reconstitute the board pursuant to those regulations before negotiations on a second annual arrangement could begin.

The authorities have agreed to promulgate regulations ensuring the independence of the KACA Advisory Board but have not committed themselves to reconstituting the board on the basis of the regulations.

19. With respect to the agreed actions to safeguard the independence of the **Kenya Revenue Authority** (KRA), the amendments removing most ex officio members from the KRA Board and protecting the tenure of board members have been tabled in parliament. However, the government has not yet issued the public announcement concerning government noninterference in the operations of independent bodies or affirming its commitment to the

rule of law. The authorities assured the mission that such an announcement would soon be made. The KRA has also begun to collect on outstanding customs bonds for unpaid sugar duties, and it is investigating other claims currently in dispute, as well as one important case in which an outstanding customs bond was canceled rather than collected. The authorities assured the staff that they would take all necessary steps to recover unpaid duties. In this regard, the government undertook a major step to strengthen customs administration by reappointing to the same post the former Commissioner for Customs and Excise at the KRA, who was highly regarded for his earlier efforts to collect outstanding customs bonds. It is also noteworthy that the outstanding import duties on the sugar consignment that had triggered the removal of the Commissioner have now been paid. An agreement on a timetable for settling all remaining claims would be part of a program to be supported by a second annual ESAF arrangement.

The authorities have agreed to continue investigating the cancellation of outstanding sugar bonds, and to issue a public announcement on the importance of government noninterference in the operations of independent bodies and affirming its commitment to the rule of law.

20. Several measures have been taken to **strengthen the management of the energy sector**. Draft energy sector legislation satisfactory to the World Bank was resubmitted to parliament in November 1997. A major provision of the new Electric Power Bill enacted in January 1998 is the establishment of an independent Energy Regulatory Board. The government is currently reviewing candidates for the Board, which, once constituted, is expected to strengthen management of the energy sector. In addition, the Kenya Power and Lighting Company (KPLC), in consultation with the World Bank, is close to completing the renegotiation of power purchase agreements (PPAs) to be awarded to two independent power producers (IPPs)—IberAfrica and Westmont. Following World Bank review, one contract has been signed, and the second is expected to be agreed shortly. The renegotiation of these contracts followed an independent auditor's report on the awarding of the original PPAs, which had been viewed as flawed by the Fund and the World Bank. The report, issued at end-October 1997, noted that the tendering of the original PPAs did not follow international norms in setting prequalification criteria or inviting bids from potential IPPs. However, the subsequent evaluation, negotiation, and award of contracts were adjudged to be broadly in line with accepted standards. As for the contracts themselves, the auditor's report indicated, *inter alia*, that the KPLC had assumed too much project risk and extended too generous terms on capital cost recovery to the IPPs. These issues are being addressed in the subsequent renegotiation of these contracts.

The authorities have agreed to ensure that, in consultation with the World Bank, the renegotiation of the remaining IPP contract be concluded quickly, and that the Energy Regulatory Board be constituted in strict compliance with new energy sector legislation.

21. In the discussions, the staff emphasized that, while it was crucial to address these outstanding governance issues as prior actions for the initiation of discussions on a second annual ESAF arrangement, efforts to deal with corruption in support of the government's declared policy to establish good governance will need to be continued in the context of further ESAF-supported programs. In this context, the mission pointed out that Kenya has its own Financial Regulations and Procedures with a time-proven system of checks and balances that is sufficient to prevent most financial malfeasances, by providing guidelines for the sound management of public finances. As an important reason for which corruption has thrived in Kenya has been that these regulations and procedures have been ignored, the mission noted that any future ESAF arrangement would include as part of its conditionality that the government apply in a nonarbitrary and systematic way its own financial rules and regulations.

B. Fiscal Issues

22. Discussions on fiscal policy were conducted against the backdrop of large fiscal slippages in 1996/97 and the first half of 1997/98. In the absence of any further measures, the overall budget deficit (on a commitment basis and excluding grants) was projected at K Sh 25.7 billion, or 3.9 percent of GDP, compared with an original target of 1.7 percent of GDP. The authorities readily accepted that new measures would be needed to counter the loosening of the fiscal stance during the period leading up to the elections. Measures discussed with the mission and implemented on March 1 are expected to limit the budget deficit to K Sh 15.8 billion in 1997/98, or 2.4 percent of GDP. At this level, the deficit target was seen to contain upward pressure on interest rates and ensure modest growth in private sector credit through the end of the current fiscal year, and to allow Kenya in the medium term to resume the path of fiscal adjustment envisaged under the original ESAF supported program. In the event, net domestic debt of the government is still expected to rise from about 22 percent of GDP at end-June 1997 to 24 percent of GDP at end-June 1998, compared with an original budget target of 19 percent of GDP.

23. On the revenue side, the measures undertaken in March amounted to K Sh 5.4 billion, or 0.8 percent of GDP in 1997/98. They include (a) an increase in the standard VAT rate from 16 percent to 17 percent and in the minimum rate from 10 percent to 12 percent (0.1 percent of GDP); (b) an increase in excise duties on premium gasoline and other petroleum products by an average of K Sh 2 per liter, as well as in the road maintenance levy on gasoline (0.2 percent of GDP); and (c) the collection of income tax and VAT arrears from state-owned enterprises (0.2 percent of GDP).[6] In addition, the central bank paid the government a larger dividend (0.3 percent of GDP), most of which represents an advancement of the expected payment in 1998/99. Other revenue increases mostly come from a projected rise in the collection of withholding tax on interest income (0.1 percent of GDP). Expenditure measures, which amount to K Sh 4.5 billion, or 0.7 percent of GDP, were also agreed. They include (a) selective cuts in recurrent spending, including those needed to free resources to eliminate domestic arrears (0.5 percent of GDP); and (b) a freeze on domestically financed new and low-priority projects,

[6] The VAT and excise duty increases are expected to be maintained over the medium term.

awaiting, as discussed below, a review of the public sector's investment portfolio (0.2 percent of GDP).[7] In addition, the wage bill was cut slightly because of a hiring freeze through end-June 1998 on teachers and civil servants. The government also expects to receive at least K Sh 1.6 billion from the sale of Kenya Commercial Bank. Notwithstanding these measures, net credit to the government is still expected to exceed the original budget target by K Sh 26 billion (4.0 percent of GDP) in 1997/98.

24. Regarding the upcoming fiscal year and beyond, the staff advised the authorities to aim at reducing the fiscal deficit to at most 1.5 percent of GDP in 1998/99 and the stock of domestic government debt to 21 percent of GDP (K Sh 154 billion) by end-June 1999, and to carry out further reductions in the following years. The aim would be to reverse at least part of the unprogrammed buildup in domestic government debt in 1996/97 and 1997/98, in an effort to put sustained downward pressure on interest rates and to redirect resources to the private sector. The staff explained in discussions with the Ministries of Finance and Education, as well as with the cabinet subcommittee on economic policy, that implementation of the recent wage agreement with teachers (which increases their average wage by about 200 percent over a five-year period) would render these targets unfeasible and the fiscal stance unsustainable over the medium term. The staff noted that, were the government to proceed with full implementation of the wage agreement, the total wage bill would rise from about 10 percent of GDP in 1997/98 to 15 percent of GDP in 2000/01.[8] If this were to transpire—recognizing that the ratio of government revenue to GDP is already among the highest in Africa—spending on basic infrastructure and social services, which is already at low levels, would have to bear the brunt of cuts for fiscal adjustment. Moreover, the very large fiscal deficits that would likely result from the implementation of the wage agreement with teachers, and the accompanying domestic financing need, would have grave consequences for macroeconomic stability and growth beyond the effects of the misallocation of government spending. For these reasons, the staff noted that it is imperative to renegotiate the wage agreement with teachers as part of the preparation of the 1998/99 budget. In this context, any increase in the real wage for teachers would need to be linked to the reform of the education sector, and in particular to the reduction in the number of teachers (see Appendix IV).

25. The mission discussed with the authorities the fiscal implications of the damage done to infrastructure by the heavy rains at the end of 1997 and the beginning of 1998 associated with the El Niño weather phenomenon. With reliable estimates of the apparently extensive damage not yet available, the mission urged the authorities to redirect resources, to the extent possible, from other

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[7]The medium-term sustainability of these spending cuts depends on the authorities' willingness to carry out the cuts in areas other than basic education, preventive health care, and operations and maintenance.

[8]The total wage bill of the government would rise to about 18 percent of GDP in 2000/01 if a similar wage agreement were extended to the civil service.

areas to cover any new commitments arising from the floods. The authorities have been discussing with the World Bank a possible loan that would help finance rehabilitation of the vital road links.

26. The surge in spending commitments at the end of fiscal year 1996/97 and the loosening of the fiscal stance in 1996/97 and 1997/98 highlight the need to strengthen the capacity to monitor and execute the budget. Discussions were held on strategies that the government could devise to improve tax administration and expenditure composition and control, including the elimination of pending bills. On tax administration, the KRA is concentrating its efforts on (a) controlling the illegal diversion of transit goods to domestic consumption by enhancing collaboration with the tax authorities in neighboring countries and evaluating the possible use of preshipment agencies to verify reexports; (b) coordinating VAT and income tax collection and audit procedures; (c) collecting arrears owed by public enterprises in the next 18 months; and (d) rationalizing its staff.

27. On the composition of public expenditure, the authorities recognized the need to overhaul the public sector investment portfolio by focusing available resources on projects with the greatest effect on economic activity and by ceasing all nonperforming projects. As a first step, the authorities will undertake a review of the public sector's project portfolio by May 1, 1998. The authorities also agreed that nonwage spending on primary and secondary education and preventive health care needed to be protected and, if possible, further increased. Finally, on expenditure control, an audit of the stock of pending bills at the Ministry of Public Works has been initiated. Indications are that these bills may include a large number of unfunded claims by the private sector generated by improper tendering procedures and inadequate project oversight, which raises new governance concerns. The authorities agreed to clear the outstanding stock of pending bills that constitute legally established commitments by end-June 1998, within existing cash limits to individual ministries. More generally, strict enforcement of established expenditure ceilings for new commitments would be needed for the remainder of 1997/98 to avoid the large spending overruns that occurred at the end of 1996/97. The staff noted that this would require strengthening the monitoring of the composition of spending commitments, including the implementation of plans to improve the timeliness and accuracy of detailed monthly spending reports by ministries.

C. Monetary and Exchange Rate Policy

28. A major concern of the authorities, and one that pervaded the discussions, is the high level of interest rates in Kenya, given that real lending rates have persisted at levels close to 20 percent in recent years. The mission agreed that the high interest rates were an important constraint on growth and posed risks for financial stability by stimulating volatile capital inflows and weakening the balance sheets of enterprises and banks. However, views of the authorities on how to bring about the needed reduction in interest rates varied; although they agreed that the most appropriate and effective approach involved the reduction of the financing needs of the government and, hence, the stock of domestic government debt, they strongly felt that additional ways of achieving this objective should be contemplated.

29. In this context, the authorities saw merit in externalizing a significant part of the domestic debt by issuing dollar-denominated eurobonds.[9] The mission argued that, although the interest rate on a eurobond issue could be lower than that on shilling-denominated debt, the government would also be assuming the exchange risk on the new borrowing and that the potential costs of this external borrowing could be substantially higher. Investors might also interpret such a move as a weakening of the commitment to take the necessary fiscal measures and impede a reduction in domestic interest rates as investors would request a higher risk premium on domestic public debt. The retirement of large amounts of domestic debt could also complicate the conduct of monetary policy as there could be large injections of liquidity upon redemption of the domestic paper and which would require sterilization. Finally, externalizing a significant amount of domestic debt could distort exchange rate policy, by creating incentives to keep the exchange rate constant even when it would not be warranted.

30. The mission, on its part, suggested a number of measures that could be taken in combination with the **fiscal adjustment** and which might assist in decreasing interest rates. One such measure would involve **increasing competition** among the suppliers of funds to the government. The mission noted that the government had been unable to attract low-cost funds with its current financing instruments and was relying heavily on the intermediation of banks that had access to funds deposited by small savers in low-interest savings accounts.[10] In these circumstances, rates on government paper are being maintained at high levels and banks are reaping significant profits from the segmentation of the loanable funds market. The mission suggested to increase competition in the market for government debt by making widely available to small savers a low-denomination bond with an attractive fixed interest rate. The mission also suggested that a more general effort be made to **lengthen the average maturity of government liabilities**.[11] The rolling over of a large percentage of total debt every week has revealed the vulnerability of the government and has put upward pressure on interest rates on government paper, and consequently, on lending rates. Gradually lengthening the maturity of government debt could potentially contribute in restraining interest rates,[12] especially if

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[9]At end-1997, gross domestic government debt amounted to K Sh 158 billion (about US$2.5 billion) or 26 percent of GDP.

[10]Currently, the differential between the rates of interest earned on those savings accounts and on government paper is about 15 percent.

[11]As 68 percent of the domestic government debt is in the form of short-term treasury bills (56 percent in 91-day paper and 12 percent in 182-day bills) and the remaining 32 percent in the form of one-year bonds and other instruments, the debt has to be rolled over every six months. Four percent of the debt on average has to be rolled over every week.

[12]Issuing government paper of longer maturity would result in a reduction in the <u>gross</u> financing requirement in any given period, and, to the extent that gross financing needs have

(continued...)

credible and effective policies are adopted and consistently followed.[13] The mission also felt that interest rates could be moderated over time via **a reduction in banks' costs arising from impaired portfolios** as such costs were increasing bank margins and thus lending rates. Improvements in bank supervision, by leading to more prudent lending, would contribute to a shrinking of margins and a decline in interest rates over the long run.

31. The mission urged the Central Bank of Kenya (CBK) to avoid any loosening of monetary policy in an attempt to lower interest rates, arguing that—if anything—greater vigilance was needed to keep monetary developments under control. The mission pointed out that, while a certain degree of monetary control had been maintained in 1997, the monetary policy stance had been somewhat looser than developments had warranted, as evidenced by the higher-than-targeted inflation and the larger-than-anticipated deficits in the external accounts. The mission noted that, although domestic currency deposits had grown modestly in 1997, the wider monetary aggregates that included foreign currency deposits by residents had shown higher growth. Moreover, as large shifts by the nonbank public[14] from deposits into direct holdings of liquid government paper took place in 1997, monetary growth rates most likely understated the growth in liquidity.[15] The CBK agreed that monetary targets would be set by taking the projected behavior of a number of financial aggregates into consideration, incorporating unanticipated portfolio shifts of nonbanks into revisions[16] of these targets.

32. The CBK representatives also agreed that the monetary and macroeconomic situation could deteriorate rapidly if the CBK were to accommodate the large financing requirements of the government and the pressure from the private sector for lower interest rates by loosening its policy stance. The mission urged the CBK to pursue monetary policy independent of such pressures and to implement a monetary program for the remainder of fiscal year 1997/98 that would aim to avert further deterioration in inflation and external performance, and set the stage for significant improvements on both fronts in 1998/99. Agreement was reached on a

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[12](...continued)
an additional effect on interest rates beyond that of the net financing requirement, the lengthening of the maturity of debt could contribute to restraining interest rates.

[13]In the context of an ongoing stabilization effort that is credible, it is possible to have lower interest rates on government paper of longer maturity compared to that of shorter maturity.

[14]These shifts involved mostly large depositors and not small-scale savers. Growing consideration by these large depositors of government paper and bank deposits as close substitutes implies that the demand for a monetary aggregate like M3 has become unstable.

[15]The aggregate of M3X and nonbank holdings of government paper grew by 16 percent.

[16] Leaving monetary targets unchanged in the face of unanticipated shifts can lead to injections of excess liquidity or to excessively tight policy, depending on the direction of the shift.

monetary program for the remainder of fiscal year 1997/98 that would be consistent with a modest buildup of net international reserves by end-June 1998, a 12-month rate of inflation of 10 percent, and GDP growth of about 1 percent. Growth of M3X would be limited to 11 percent and of credit to the economy to 12 percent, on the assumption that nonbank holdings of government paper would amount to K Sh 57 billion at end-June 1998.

33. The CBK representatives noted that it had often been difficult to control the growth of reserve money. The mission saw this as a result of the relative automaticity with which the CBK provided liquidity to banks and holders of government paper. While access to the CBK lending and refinancing is at a cost of 3-5 percentage points above the last treasury bill auction rate, this does not discourage banks from making very regular use of these CBK windows rather than just in extraordinary circumstances. The result is that reserve money growth is to a large extent under the control of banks, some of which may also be distressed and therefore unresponsive to price signals. The mission recommended that the CBK either set higher rates on its lending and refinancing to discourage regular usage (which may still not solve the problem in the case of distressed banks) or adopt limits on the amount that can be injected so as to be consistent with the reserve money target.[17] The mission also urged the CBK to identify banks that are in distress and/or are excessively dependent on volatile funds and have them adopt restructuring programs that would, *inter alia*, decrease their reliance on CBK windows and lessen the present constraints on monetary policy imposed by the weaknesses of such banks.[18] The CBK representatives emphasized the need to continue being (as often as demanded) the "lender of last resort" and to provide liquidity for government paper without a limit. They agreed, however, on the need to establish firmer control over monetary aggregates and will consider increasing the cost of liquidity obtained from the CBK to achieve this goal.

34. As regards the exchange rate, there was agreement that the range in which the currency had moved since September 1997 was broadly consistent with the maintenance of competitiveness.[19] The mission advised the authorities to permit exchange rate flexibility in the range recently observed and to avoid intervention so as to discourage short-term speculative

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[17]Steps against excessive use of CBK windows will also enhance the development of the interbank market in Kenya.

[18]Losses of deposits by at least one major bank in the third quarter of 1997 contributed to the lowering of the required reserve ratio from 18 percent to 15 percent on October 1, 1997.

[19]In real effective terms, the Kenya shilling appreciated strongly in the first half of 1997 and by midyear was more than 30 percent above its level a year earlier. However, most of this appreciation was reversed in the third quarter of 1997 and, at the end of the year, the real effective exchange rate was at the same level as at end-1996.

inflows, were they to reappear.[20] The CBK representatives emphasized that they did not see the CBK as a "buyer or seller of last resort," with the task of maintaining a certain exchange rate over time, and in that sense they felt that the market participants would have to count with exchange rate risk. They also noted, however, that exchange rate policy had been aimed at smoothing out short-term fluctuations in the rate. The mission stressed that smoothing out those fluctuations might diminish the exchange risk faced by short-term capital and could thereby encourage volatile inflows in the presence of high domestic interest rates, including on liquid government paper. The mission acknowledged, however, that, while in most cases intervention—in any form—should be avoided, difficult choices could potentially arise between engaging in sterilized intervention and allowing an excessive appreciation of the Kenya shilling. In this context, the mission argued that in order to avoid excessive pressure on the exchange rate and competitiveness, that might arise through a possible resumption of capital inflows, it was by far preferable to reduce interest rates by further tightening fiscal policy. In contrast, a loosening of monetary policy (e.g. through unsterilized intervention) could reduce interest rates in the short run but at the risk of higher inflation or a potentially destabilizing reduction in foreign official reserve cover.

D. Bank Supervision

35. The mission held preliminary discussions on the status of banking supervision and loan portfolios in the Kenyan banking system, benefiting from the initial findings of a consultant from the Monetary and Exchange Affairs Department. The mission felt that, although the banking supervision department of the CBK had adequate legal authority to conduct its operations and aimed to adhere to the core principles of the Basle committee,[21] it should have independent authority to apply penalties and be strengthened—through more staff and training—to enable more frequent on-site examinations. In the short term, a task force may need to be created to address the significant backlog of on-site examinations. The mission strongly recommended that emphasis be placed on on-site inspections as a means of verifying the accuracy and reliability of reported data, including compliance with prudential regulations. Particular attention needs to be paid to the adequacy of provisioning for nonperforming loans, especially in view of the long delays and low returns experienced in liquidating the assets of closed banks. The mission also noted with concern the sharp increase in nonperforming loans of some banks.[22] Strengthened supervision would be essential in fully understanding and responding to this development. Finally, the mission discussed with CBK representatives the

[20]Intervention has in the past also taken the form of drawing down official reserves instead of purchasing foreign exchange to service the government's foreign debt. The mission advised to view activities that affect either the supply or the demand side of the market as intervention.

[21]Bank supervision in Kenya has adopted *inter alia* the Basle committee prudential ratios.

[22]Nonperforming loans rose by 61 percent in 1996-97, reaching 20.5 percent of total loans.

incidence of insider and connected lending in Kenyan banks, and identified a need to improve disclosure requirements and the enforcement capacity of the CBK.

36. The CBK representatives agreed with the recommendation to give the banking supervision department independent authority to apply penalties. However, they were somewhat skeptical of the usefulness of increasing the number of staff in the banking supervision department, as they felt that, in principle, the movement ought to be away from labor-intensive on-site examinations and toward more self-supervision and off-site surveillance of the banks. They recognized, however, that it was essential to understand the full magnitude and causes of the growing problem of nonperforming loans. They also agreed with the mission that current levels of provisioning might be inadequate given the very long delays in collecting debts, and they felt that this problem should be addressed, *inter alia*, by an amendment of legislation so as to streamline the foreclosure process. In view of the issues identified in these areas, both the CBK representatives and the mission agreed that urgent consideration should be given to developing a strategy to deal with the issues in a timely manner. The mission pointed out that these matters would also need to be addressed in depth in any future ESAF-supported program. There was also full agreement that steps should be taken to avert insider and connected lending, including by amending the Banking Act to enhance the disclosure requirement and the capacity of CBK to levy penalties for noncompliance.[23]

E. External Sector Policies

37. The mission noted with concern periodic delays encountered in the payment of external obligations. The authorities have made efforts to improve the management of external debt service payments, especially of the obligations of parastatals that are subject to a government guarantee. However, during 1997/98, delays have become more frequent, and arrears on public and publicly guaranteed obligations rose to US$34 million at end-1997. In the face of the deteriorating fiscal position and the outflow of short-term capital that had been invested in treasury bills, the payments have increasingly been delayed. The mission urged the authorities to ensure timely payment of all external obligations and the comparable treatment of all creditors. The CBK representatives agreed that external arrears should be avoided and said that this issue would be given clear priority. The mission welcomed the agreement reached in principle in February between the authorities and commercial banks on the restructuring of external arrears to commercial banks of US$70.2 million dating from 1993.[24]

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[23]In this context, shortly after the mission's departure, top managers and board directors of the state-majority-owned Kenya Commercial Bank (KCB) were dismissed on charges of receiving and not repaying unsecured loans from that bank.

[24]The terms agreed with commercial banks are described in Appendix V.

38. The mission noted that the recent disturbances in emerging financial markets, and in Kenya specifically, had underscored the need for timely and accurate economic information to improve both the functioning of markets and the consistency of macroeconomic policies. The mission saw an urgent need to improve the information available on foreign currency and foreign-currency-tied borrowing by the private sector, as well as on the nonresident claims on the government and the banking system denominated in domestic currency.[25] The authorities noted that the liberalization of the exchange system contributed to shortcomings of information in these areas, and they agreed on the importance of improving data collection.

39. In 1997 some progress was made in trade reform but there was also backtracking in specific areas. With effect from July 1, 1997, the number of tariff bands (including the zero rate but excluding supplement rates) was reduced from five to four, and the highest rate from 35 percent to 25 percent. As a result, the weighted-average ad valorem tariff rate (including duty free) was reduced from 14.1 percent in 1996/97 to 12.3 percent in 1997/98. Also on July 1, 1997, supplemental duties on several petroleum products were lowered by one-half, and the authorities indicated that these would be lifted with the expected completion of an import facility for liquid petroleum gas in 1999. At the same time, however, supplemental duties on selected intermediate inputs and final goods were raised from 5 percent to 10 percent.

40. While welcoming the general trend toward a more liberal trade regime, the mission urged the authorities not to resort to provisions of the type made in the 1997 finance bill to impose stand-by supplemental duties.[26] The mission noted that, in addition to their distortionary effects, discretionary changes in duty levels run counter to the objectives of liberalization of the agricultural sector and transparency in tax policy. The authorities explained that the discretionary changes in duty levels were aimed at enhancing the capacity to provide adequate food for the population, given the unpredictability of harvests. They did agree, however, that there was room for streamlining the system of stand-by duties.

41. Kenya maintains a multiple currency practice subject to Fund approval under Article VIII, Section 3, arising from outstanding obligations created under the Exchange Risk Assumption Fund (ERAF) before its abolition in June 1994. Obligations are being settled as they fall due, no new commitments have been entered, and the last of the valid claims identified by the authorities will mature in 2003. Accordingly, the authorities have requested approval of the retention of this multiple currency practice.

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[25]These views were reinforced by the conclusions of an overlapping STA mission.

[26]In the finance bill, stand-by duties were imposed on selected fruits (10 percent) and on milk, maize, rice, sugar, and wheat (70 percent), in addition to the normal tariff rate of 25 percent. From March to September 1997, the import duty on maize was temporarily lifted to encourage imports in the wake of a drought-induced decline in production, while duties were also temporarily lifted for noncommercial imports of milk, rice, and wheat. Upon the reimposition of these duties, the rate applicable to wheat imports was increased to 50 percent.

F. Structural Issues

Privatization and public enterprise reform

42. Considerable progress was expected to be made in 1997 to improve public services in energy, telecommunications, and transportations sectors that are key to achieving high and sustained rates of growth. At the time of the last Article IV consultation, the authorities indicated it would be more effective to focus privatization on a few key enterprises, rather than on small, "nonstrategic" enterprises. However, progress in reforming public enterprises fell well short of expectations in 1997, as improvements in the financial performance of several key enterprises were smaller than expected.[27] The Kenya Ports Authority and Kenya Railways, as well as the National Cereals and Produce Board (NCPB), continued to be involved in noncommercial activities, and the former two enterprises accumulated new tax arrears.

43. The authorities noted that the strategy of focusing on the divestiture of key enterprises was still being pursued, and they agreed to accelerate public enterprise reforms to reestablish a track record in this area in advance of a possible second annual ESAF arrangement. The actions agreed include the sale by the government of 25 percent of the total shares in the Kenya Commercial Bank by May; the finalization of an agency agreement with the NCPB by end-June,[28] and the offer for sale of the Kenya Reinsurance Company, African Tours and Hotels, and the Mumias and Chemelil sugar companies. Parliament's approval of a resubmitted communications Bill, which is needed to formalize the split of Kenya Post and Telecommunications and subsequently to privatize partially the telecommunications branch, is expected by end-June; an action plan to improve the economic situation of Kenya Railways is to be completed by July. Finally, the formal separation of assets and liabilities of the newly created Kenya Power Company (power generation) and Kenya Power and Lighting Company (power distribution and marketing) is expected by end-September.

Civil service reform

44. The civil service reform program, which started in 1993, aimed at streamlining the civil service through voluntary reductions in staffing levels, the elimination of "ghost" workers, and implementation of ministerial rationalization plans. In all areas, only modest progress was made in 1997. By end-1997, the net reduction in the size of the civil service since the beginning of 1996 (excluding teachers) had reached 17,129 positions, compared with

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[27]In 1996/97, the operating surplus of these enterprises was K Sh 6.2 billion (1.1 percent of GDP), compared with a projected K Sh 9.1 billion (1.6 percent of GDP) as shown in Table 7.

[28]The agreement would ensure that the rules governing the relationship between the government and the NCPB were effectively implemented, including the way the NCPB would be compensated in the event it undertook a social function on behalf of the government.

the reduction of 19,500 positions, or 8 percent, that had been targeted for end-June 1997.[29] About 18,100 ghost workers were identified in a payroll-cleansing exercise concluded in October 1997, but, as of February 1998, only about 2,400 workers had been removed from the payroll because of the slow pace at which census records have been incorporated into a new payroll system. Lastly, ministerial rationalization commenced only at the Ministry of Agriculture in 1997. Plans for 11 ministries are awaiting consideration by cabinet, but at least four plans may have to be reformulated, as the functions of some ministries were changed following the elections in late 1997. Plans for the remaining 16 ministries are still in the discussion stage.

45. The authorities agreed to act swiftly on most of the previously agreed actions on civil service reform. By May 1, 1998, the remaining ghost workers identified in the civil service are to be removed from the payroll, and the cabinet plans to consider a strategy paper on ministerial rationalizations and civil service reform and to publish a policy statement indicating the need for further substantial retrenchment. The government aims at achieving the targeted reduction of 19,500 civil servants by end-June 1998. In addition to a possible renegotiation of the wage award to teachers, the authorities agreed to begin taking steps to rationalize their number.[30] A census of teachers was conducted in March to eliminate ghost teachers from the payroll by May 1, 1998. The authorities also agreed to take measures to cease the policy of automatically hiring graduates of teachers' colleges and to redeploy teachers, who are concentrated in major urban areas. Lastly, measures are being explored to ensure the removal of unqualified teachers and to rationalize the curriculum to meet core educational needs.

IV. Quantitative Targets

46. With a view to monitoring the policies committed to by the authorities for the period through end-June 1998, the mission agreed with the authorities on a number of quantitative and structural targets. Observance of these targets would be a condition for presenting a request for a second annual ESAF arrangement to the Executive Board. The quantitative targets comprise monthly targets for the period March-June 1998 on ordinary central government receipts and expenditures, net credit to government from the banking system, net domestic assets of the banking system, domestic arrears (pending bills) of the government, and arrears on public and publicly guaranteed external debt. These targets, as well as the targets in the area of structural reform, are described in detail in Tables 8 and 9.

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[29]As of end-1997, there were 215,414 civil servants—19 percent less than at mid-1993.

[30]At end-1997, there were 258,735 school teachers on government payroll.

V. Medium-Term Economic Outlook

47. The staff has assessed Kenya's medium-term prospects on the assumption that understandings will be reached in the second half of 1998 on a program supported by a second annual ESAF arrangement. Financial policies and structural reforms would aim to stimulate a strong and sustainable supply response while maintaining macroeconomic stability. In particular, fiscal adjustment would strive to reduce the stock of domestic debt and, at the same time, shift resources to nonwage recurrent and development outlays, especially in basic education and preventive health care. The real effective exchange rate would be maintained at current levels, but competitiveness would be bolstered by the rehabilitation of infrastructure and by an acceleration of privatization and public enterprise reform. Strict enforcement of regulations to ensure accountability and transparency in the use of public resources and a stable regulatory environment would also be essential to raising investor confidence.

48. Under this scenario, real GDP growth would rise from about 2 percent in 1997 and 1998[31] to 5-6 percent by 2000. The initial upturn would be driven by a recovery in agricultural production, particularly of foodstuffs and of coffee, after two years of adverse weather. Coffee, tea, and horticulture would sustain this growth, along with manufacturing and services, which are expected to benefit from the maintenance of a competitive exchange rate, lower interest rates, and more reliable electricity supplies. A stable political environment and improvements in security would enable tourism to recover strongly. Output growth is expected to be buoyed by a rise in investment from 19.7 percent of GDP in 1997 to 23.2 percent of GDP in 2000, reversing the declines in investment since 1995. Initially, this recovery would reflect public and private investment in the energy sector under an IDA project; thereafter, gross national savings would rise from 17.4 percent of GDP in 1997 to 21.5 percent of GDP in 2000 (with about three-fourths of the increase coming from higher public saving) and would finance a growing proportion of investment. Declines in interest rates and improvements in the business environment would underpin the pickup in investment.

49. To raise public saving, the government balance would move from a deficit of 2.4 percent of GDP in 1997/98 to a modest fiscal surplus by 2000/01.[32] This improvement would also facilitate a reduction in the stock of domestic debt from 23 percent of GDP in 1997/98 to 17 percent in 2000/01 and support a prudent monetary stance aimed to lowering inflation to 5-6 percent in 2000 while accommodating the needed growth in credit to the private sector.

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[31]Output growth in 1998 is expected to be subdued by, *inter alia*, the adverse effects of the floods on agriculture and, through the damage to infrastructure, on other sectors.

[32]This fiscal adjustment path is based on the assumption that the wage agreement with teachers would be renegotiated and that the total civil service wage bill would be kept under 10 percent of GDP in 1998/99 before declining further thereafter.

50. In 1998, the external current account deficit (excluding official transfers) is expected to remain close to the level of 3.2 percent of GDP recorded in 1997, as a decline in tourism earnings is offset by weak import demand. In 1999, food imports are expected to decline sharply as cereal production recovers, and earnings would be buoyed by a recovery in tourism. However, a sharp rise in imports related to energy sector investments would temper the contraction in the current account deficit and postpone a narrowing in the deficit from a level of 2.6 percent of GDP until after 2000. Official capital inflows would rise sharply in 1998, reflecting disbursements under an IDA structural adjustment credit and accelerated project disbursements to repair infrastructure damaged by El Niño rains. The latter inflows would continue in 1999 when large disbursements under the energy sector credit would begin and be sustained through 2000. Private inflows, including those captured within errors and omissions, are expected to remain close to the level seen in 1998.[33] The overall balance of payments would register moderate surpluses during the period 1998-2000, allowing a buildup in international reserves to the equivalent of 4.5 months of imports by 2000.

51. Kenya's external debt burden is projected to decline significantly over the next five years, as a large proportion of debt contracted on nonconcessional terms are retired (Appendix V). As a result, debt service could decline from the equivalent of 22 percent of exports of goods and services in 1997 to 17 percent in 2000 and to 10 percent in 2002. Similarly, the present value of external debt would decline from 135 percent of exports of goods and services in 1997 to 88 percent in 2002. Thus, Kenya should be able to meet its debt-service obligations without recourse to debt relief.

52. The main risk to this scenario would stem from a failure to take decisive action to return fiscal policy to a sustainable path. In the absence of such action, rising domestic debt would result in further pressure on interest rates and increased vulnerability to a loss of investor confidence. An appropriate fiscal adjustment would reduce these risks, but a resumption of sustainable and more rapid growth would also require concerted action to remove structural impediments and improve governance.

VI. STAFF APPRAISAL

53. The Kenyan economy has the capacity to achieve high and sustainable growth with financial stability, in view of its diversified production base, strong entrepreneurial

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[33]The large errors and omissions item that has emerged since the liberalization of the exchange system includes unrecorded capital inflows but also underreported earnings (see Appendix III). Extant sources, including data from the Bank for International Settlement, also suggest that the large errors and omissions seen in recent years are not indicative of a large increase in unrecorded obligations. Efforts are under way to identify unrecorded inflows, but the projection assumes, for consistency, that errors and omissions will continue to reflect substantial underrecording.

endowment, well-developed financial markets, open external accounts, and favorable geographic location. The goals of the ESAF-supported program approved in April 1996 were therefore ambitious, especially in view of the promising economic stabilization and reforms undertaken during 1993-95. Kenya's recent economic performance, however, has been weak, as growth has virtually ground to a halt and financial stability has been put under strain because of the slow pace of structural reform, the loosening of financial policies, and the persistence of corruption and financial indiscipline. The staff believes that, unless these issues are addressed vigorously and consistently, Kenya's potential will remain unrealized. It is encouraging that the authorities themselves have now identified the same constraints to growth and financial stability, and declared their commitment to move rapidly in all the needed areas.

54. The program supported by the first annual ESAF arrangement advocated good **economic governance** as essential for promoting a favorable investment climate and boosting growth. The program, therefore, sought to improve financial discipline mainly through the reinforcement of accountability and transparency in the use of public funds. The discussions held to assess progress made in implementing measures to resolve outstanding governance issues, which prevented completing the midterm review under the first annual ESAF arrangement, showed that while a number of the agreed actions had been taken, substantial further progress was needed. The staff, therefore, urges the authorities to carry out the following remaining actions: complete and publish the report establishing accountability with regard to gold export compensation payments; promulgate regulations ensuring the independence of the KACA Advisory Board and reconstitute the board on the basis of the regulations; continue to investigate the cancellation of outstanding sugar bonds, and issue a public announcement on the importance of government noninterference in the operations of the KRA and other independent bodies; and quickly conclude the renegotiation of the remaining IPP contract, and constitute the Energy Regulatory Board in strict compliance with the new energy sector legislation.

55. While it is crucial to address these outstanding governance issues as prior actions for the initiation of discussions on a second annual ESAF arrangement, efforts to deal with corruption should continue. The staff is encouraged by the declared policy of the new government to fight corruption and establish good governance, and it is planned that future Fund-supported programs should continue to focus on economic governance issues, which are now a cornerstone of the Kenyan government's economic policy. Kenya already has its own Financial Regulations and Procedures with a time-proven system of checks and balances, sufficient to prevent most financial malfeasances; however, these regulations and procedures have often been ignored. As a result, corruption has thrived. It is therefore necessary that the government begin to enforce in a nonarbitrary and systematic way its own rules and regulations, while simultaneously addressing other causes of corruption.

56. A fundamental part of a credible strategy to achieve high growth, coupled with financial stability, would be the pursuit of consistently prudent financial policies and the avoidance of stop-go stabilization. However, financial policies in Kenya have not followed

such a consistently prudent approach in recent years. After a period of significant **fiscal adjustment** through 1995/96, large fiscal slippages occurred in 1996/97 and in the first half of 1997/98. The authorities recognize the risks arising from the fiscal deterioration and have adopted an ambitious fiscal package for the remainder of 1997/98 to contain the expanding deficit. The staff believes that the fiscal deficit target for 1997/98 would allow Kenya to resume in the medium term the path of fiscal adjustment envisaged under the original ESAF-supported program. Beyond 1997/98, it will be important to proceed rapidly and consistently with further fiscal adjustment and reductions in the stock of government debt relative to GDP. In this context, it is imperative that the authorities renegotiate the wage agreement with teachers, as its full implementation would render the needed fiscal targets unattainable. The staff is encouraged by the authorities' public commitments to take ambitious steps along these lines. Failure to renegotiate the agreement would imply large spending cuts for the already compressed basic infrastructure and social services, and would have grave consequences for macroeconomic stability and growth.

57. The excessively high **interest rates** in Kenya have been an important constraint on economic growth and pose risks for financial stability by stimulating volatile capital inflows and by weakening the balance sheets of enterprises and banks. The most effective way to lower interest rates would be to reduce the financing need of the government and, hence, the stock of domestic government debt. The staff notes that among additional measures that could be taken to reduce interest rates are efforts to increase competition among the suppliers of funds to the government, lengthen the maturity of government debt, and narrow bank margins through strengthened bank supervision and bank portfolios. The staff, however, recommends against externalizing domestic debt because of the significant risks involved.

58. It is important that the central bank avoid any loosening of **monetary policy** in an attempt to lower interest rates and be vigilant in its efforts to secure monetary control. The CBK could usefully set its targets by taking into account a number of financial aggregates, as well as unanticipated portfolio shifts of the public when revising these targets. The CBK should also reduce the automaticity with which it provides liquidity to banks and holders of government paper, so as to control reserve money more effectively. Moreover, banks that are in distress and/or dependent on volatile funds could adopt restructuring programs that may lead to a lessening of the present related constraints on monetary policy. The staff believes that the monetary program adopted for the remainder of 1997/98 is consistent with averting a further deterioration in inflation and external performance despite the constraints imposed by fiscal policy, and that it can set the stage for improvements in these areas in 1998/99.

59. On **exchange rate policy**, it is important to permit exchange rate flexibility and to avoid intervention, so as to discourage the reappearance of short-term speculative inflows. The staff also notes that the smoothing of short-term fluctuations may diminish the exchange risk faced by short-term capital and thereby encourage such volatile inflows in the presence of high interest rates, including on liquid government paper. At the same time, however, the staff acknowledges that, while in most cases intervention should be avoided, difficult policy choices

could arise between engaging in sterilized intervention and allowing an excessive appreciation of the shilling. In this context, in order to avoid excessive pressure on the exchange rate and competitiveness, arising from a resumption of capital inflows, it is essential to reduce interest rates by tightening fiscal policy and sizably reducing the stock of government debt.

60. The **banking supervision** department of the CBK should be given independent authority to apply penalties and be strengthened to enable more frequent on-site examinations to verify the accuracy and reliability of reported data. Particular attention needs to be paid to the adequacy of the provisioning levels for nonperforming loans and the sharp increase in nonperforming loans experienced by some banks. The staff has also noted the incidence of insider and connected lending in Kenyan banks, and it urges the authorities to improve disclosure requirements and the enforcement capacity of the CBK. The recent dismissals in KCB on account of such lending attests to progress in this area.

61. The staff has noted with concern the periodic delays in the payment of external obligations and urges the authorities to ensure timely payment of all external obligations and the comparable treatment of all creditors. The staff welcomes the agreement reached in February 1998 between the authorities and commercial banks on the restructuring of **external arrears** to commercial banks incurred in 1993. While there has been a positive trend toward a more liberal **trade regime**, the staff urges the authorities not to resort to the provisions of the type made in the 1997 finance bill for the imposition of stand-by duties.

62. Kenya's macroeconomic statistics have deteriorated over time. The staff urges the authorities to speedily implement the remedial measures agreed with the recent Fund technical assistance mission to improve a broad range of macroeconomic statistics, including through the commitment of adequate resources to the Central Bureau of Statistics. Moreover, the recent disturbances in emerging financial markets, and in Kenya specifically, underscore the need for timely and accurate information to improve both the functioning of markets and the consistency of macroeconomic policies. In this light, the staff urges the authorities to improve the information available on foreign currency borrowing by the private sector, as well as on the nonresident claims denominated in domestic currency.

63. Given their importance in producing the needed supply response and reducing the financial burden on the economy, the staff urges the authorities to accelerate **public enterprise and civil service reforms**, and to complete the agreed actions in a timely manner the agreed actions.

64. It is recommended that the next Article IV consultation with Kenya be held on the standard 12-month cycle.

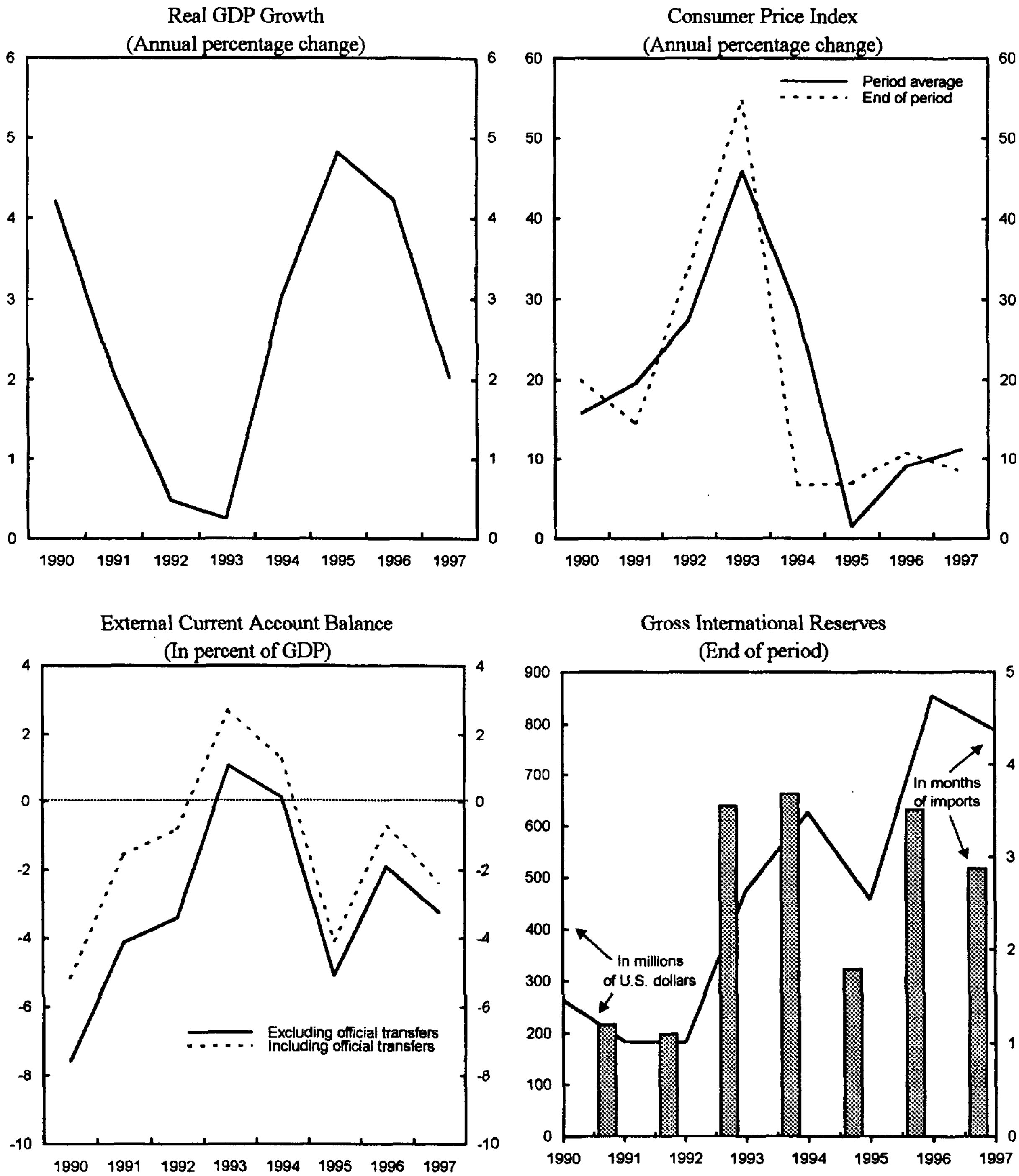
VII. PROPOSED DECISION

The following draft decision is proposed for adoption by the Executive Board:

1. The Fund takes this decision relating to Kenya's exchange measure subject to Article VIII, Section 3, in the light of the 1998 Article IV consultation with Kenya conducted under Decision No. 5392-(77/63), adopted April 29, 1996, as amended (Surveillance over Exchange Rate Policies).

2. As described in SM/97/70, Kenya's outstanding commitments under the Exchange Risk Assumption Fund (ERAF), which was abolished in June 1994, give rise to a multiple currency practice subject to the Fund's approval under Article VIII, Section 3. In view of the abolition of the ERAF, and of Kenya's intention not to enter into any new commitments under the ERAF, to clear all outstanding commitments as they mature, and to eliminate the multiple currency practice by 2003, the Fund grants approval of the retention of the multiple currency practice until December 31, 2003.

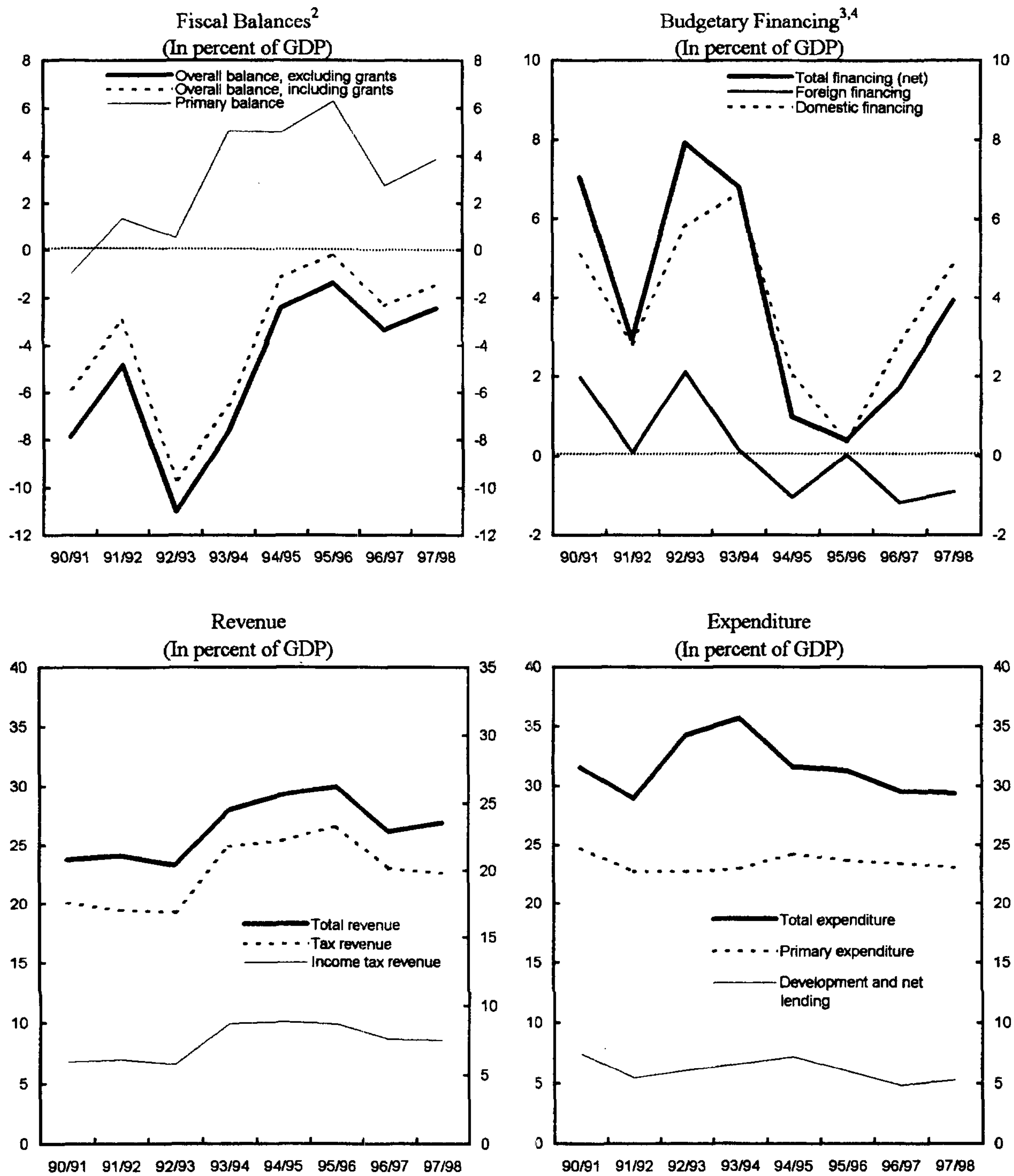
Figure 1. Kenya: Macroeconomic Indicators, 1990-97[1]



Sources: Kenyan authorities; and Fund staff estimates.

[1]Data for 1997 are estimates, except consumer price index and level of gross international reserves.

Figure 2. Kenya: Fiscal Developments, 1990/91-1997/98[1]



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

[1]Fiscal year beginning July 1; data for 1997/98 are projections.

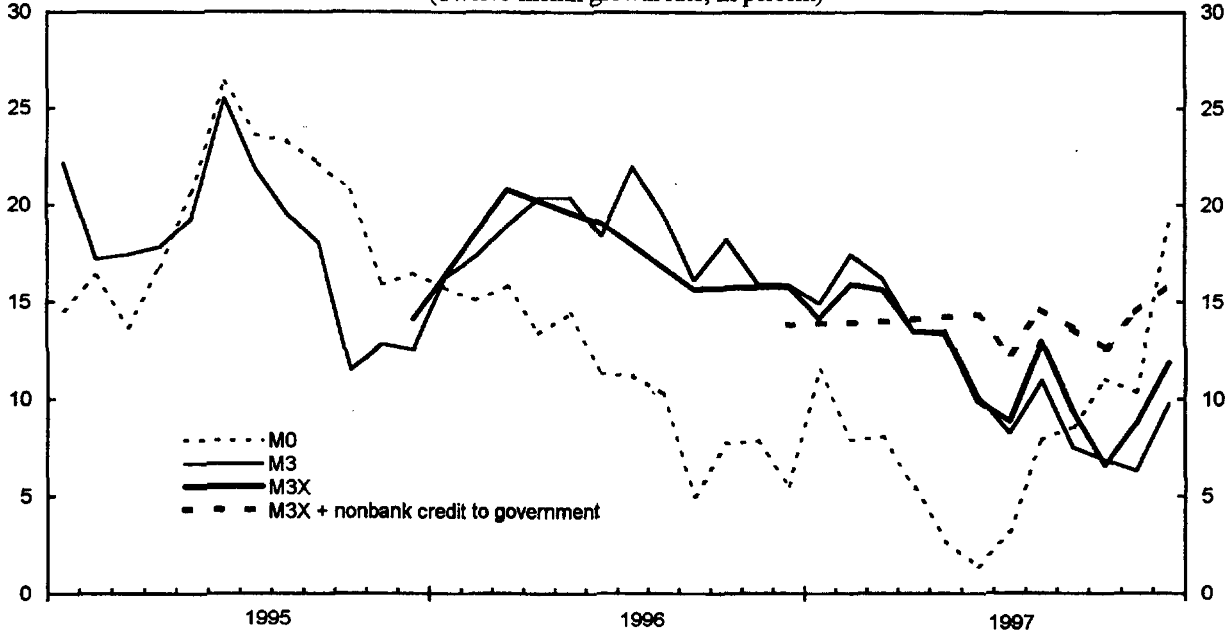
[2]Overall balances on a commitment basis.

[3]Excludes grants.

[4]Domestic financing includes privatization receipts..

Figure 3. Kenya: Monetary Developments, January 1995-December 1997

Money[1]
(Twelve-month growth rate, in percent)

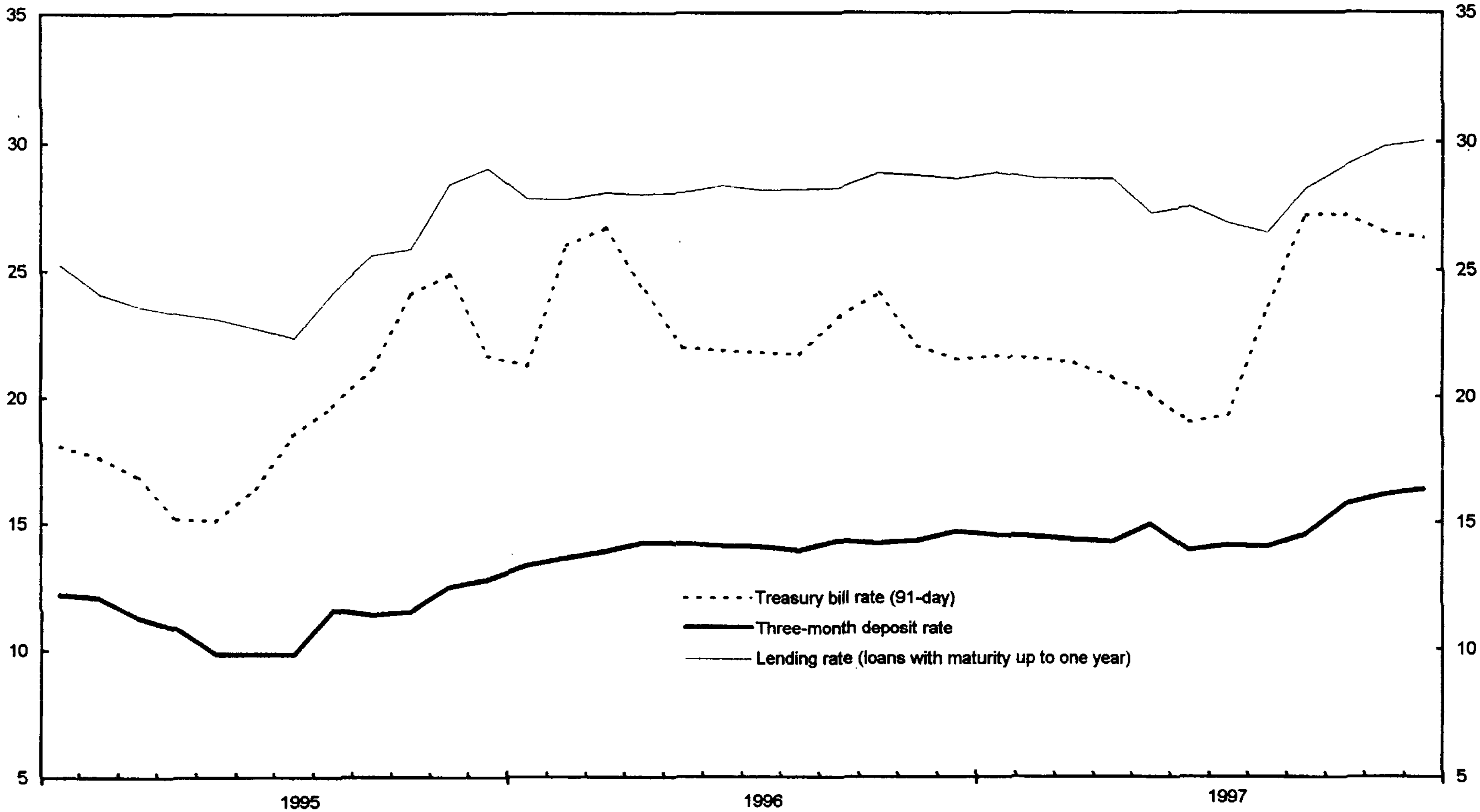


Private Sector Credit
(Twelve-month growth rate, in percent)

Sources: Kenyan authorities; and Fund staff estimates.

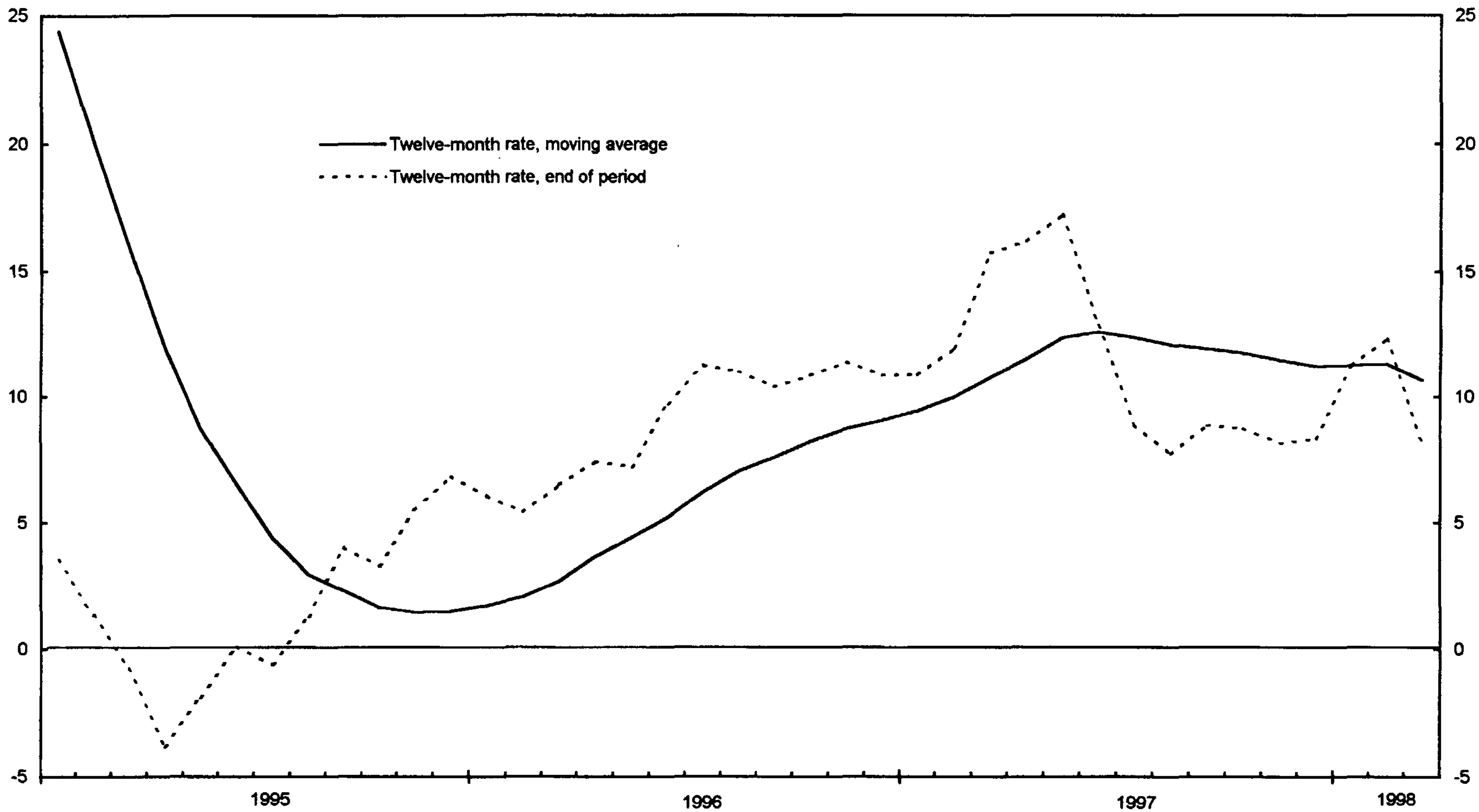
[1]M3X is defined as currency in circulation (M0) plus resident domestic and foreign currency deposits in commercial banks and nonbank financial institutions.

Figure 4. Kenya: Interest Rate Developments, January 1995-December 1997
(In percent)



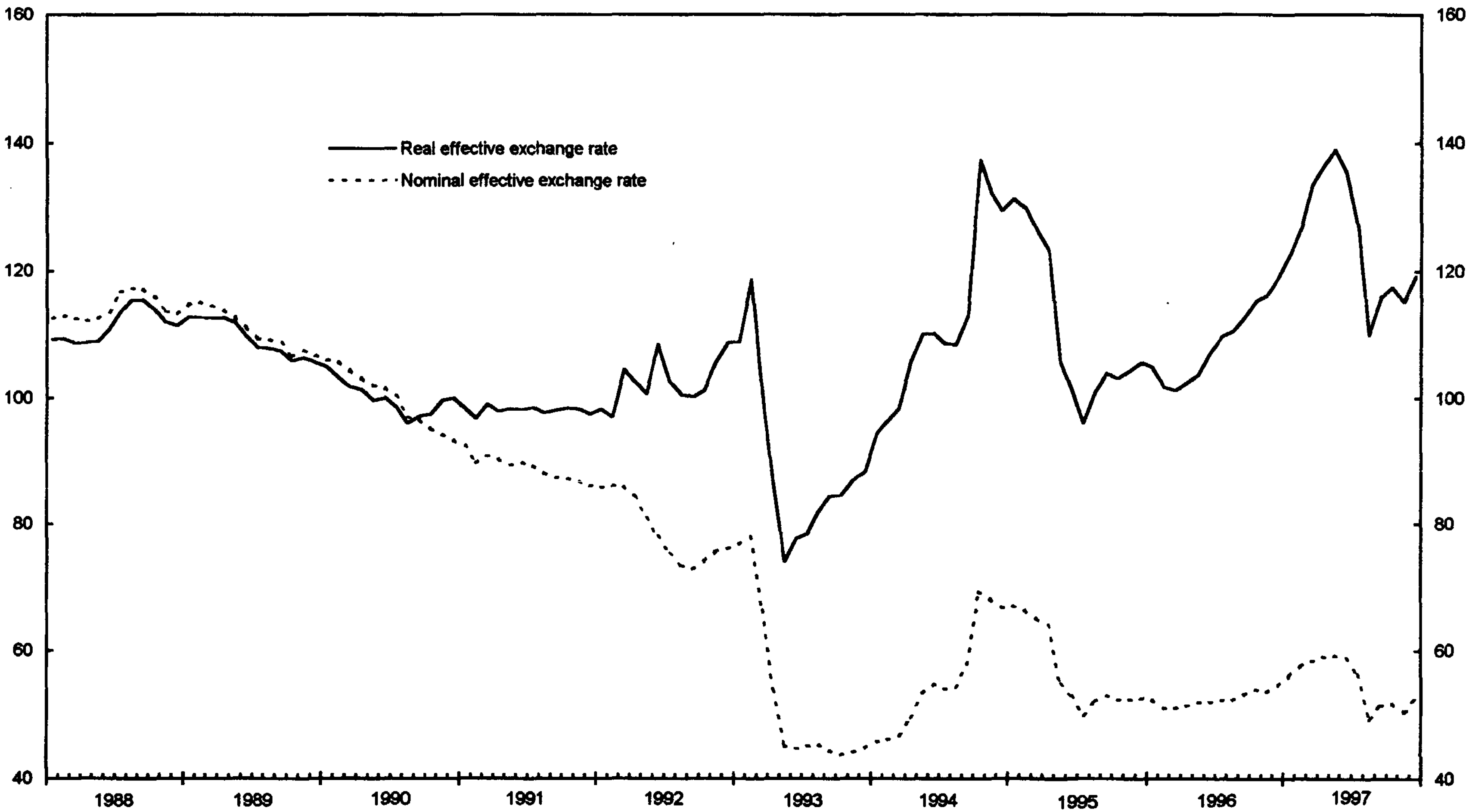
Sources: Kenyan authorities; and Fund staff estimates.

Figure 5. Kenya: Inflation, January 1995-March 1998
(In percent)



Source: Kenyan authorities.

Figure 6. Kenya: Effective Exchange Rates, January 1988-December 1997
(1990 = 100)



Source: IMF, Information Notice System

Table 1. Kenya: Selected Economic and Financial Indicators and Medium-Term Adjustment Framework, 1994-2000

	1994	1995	1996 Program EBS/96/62	1996 Estimate	1997 Program EBS/96/62	1997 Proj.	1998 Projected	1999 Projected	2000 Projected
	(Annual percentage changes, unless otherwise specified)								
National income and prices									
GDP (at factor cost and constant prices)	3.0	4.8	5.0	4.2	5.3	2.0	2.2	4.1	5.5
GDP deflator	17.0	8.9	9.6	9.1	10.3	15.9	10.7	6.4	5.6
Consumer price index (December to December)	6.6	6.9	5.0	10.8	5.0	8.3	9.3	7.5	5.0
Consumer price index (period average)	28.8	1.5	5.0	9.0	5.0	11.2	9.6	6.7	5.7
External sector (on the basis of U.S. dollars)									
Exports, f.o.b.	34.5	26.4	0.3	5.0	5.8	6.6	1.0	3.5	6.4
Imports, c.i.f.	27.1	50.2	-5.6	-4.5	6.0	12.5	2.5	0.9	8.2
Export volume	18.9	19.0	4.1	6.9	4.3	-7.9	4.8	6.2	8.2
Import volume	25.6	50.2	-5.2	0.3	5.2	16.3	6.3	0.2	7.3
Import volume (excluding special imports)	11.6	8.2	...	2.5	...	9.2	2.0	5.8	6.8
Terms of trade (deterioration -)	11.8	6.2	-3.4	3.1	0.6	19.7	0.0	-3.3	-2.5
Nominal effective exchange rate (depreciation -)	49.3	-21.3	...	3.9	...	-4.0	...	...	...
Real effective exchange rate (depreciation -)	46.7	-18.4	...	12.6	...	0.2	...	...	...
Money and credit (end of period)									
Reserve money	31.3	28.7	0.0	8.1	...	-1.5	...	...	...
Net domestic assets of the central bank[1]	29.3	38.8	-9.8	-26.0	...	-14.8	...	...	...
Broad money (M3)	27.4	12.5	2.4	15.9	...	9.8	...	...	...
Net domestic assets of the banking system[2]	31.3	15.4	-14.6	6.5	...	7.4	...	...	...
Credit to the private sector	23.5	35.4	2.0	15.9	...	16.4	...	...	...
Velocity (GDP/M3; period average)	2.2	2.1	...	2.0	...	2.1	...	...	...
Interest rate									
(90-day treasury bills; average rate in percent)	23.3	18.3	...	22.3	...	23.1	...	...	...
	(In percent of GDP, unless otherwise specified)								
Gross national saving	20.5	18.2	23.2	20.4	23.6	17.4	18.3	19.7	21.5
Central government	3.2	6.7	7.6	6.2	7.6	3.9	4.0	5.3	7.1
Other	17.4	11.5	15.6	14.1	15.9	13.4	14.2	14.4	14.4
Gross investment	19.3	22.3	22.9	21.1	23.3	19.7	20.5	21.3	23.2
Fixed capital formation	18.9	21.8	22.2	20.2	22.6	19.4	20.2	21.1	23.0
Central government	6.3	6.3	7.6	5.4	7.6	4.7	5.3	5.6	6.0
Other	12.6	15.5	14.6	14.7	14.9	14.7	14.9	15.4	17.0
Net change in stocks	0.4	0.4	0.7	1.0	0.7	0.3	0.3	0.3	0.2
External current account, incl. official transfers	1.3	-4.1	0.8	-0.7	0.3	-2.3	-2.2	-1.6	-1.7
Saving-investment (central government)	-3.1	0.4	0.1	0.8	0.0	-0.8	-1.3	-0.3	1.1
Saving-investment (private sector)	4.3	-4.4	0.3	-1.5	0.3	-1.6	-0.9	-1.3	-2.8
External current account, excl. official transfers	0.1	-5.1	-1.3	-1.9	-1.2	-3.2	-3.3	-2.5	-2.6
Central government finance[3,4]									
Revenue	29.2	29.9	31.7	26.3	30.9	26.9	27.5	26.8	26.3
Total expenditure	31.6	31.3	33.3	29.6	32.3	29.4	29.0	27.1	26.1
Overall balance, excluding grants	-2.3	-1.4	-1.6	-3.4	-1.5	-2.4	-1.5	-0.3	0.2
Overall balance, including grants	-1.1	-0.2	0.3	-2.4	0.0	-1.4	-0.5	0.6	1.1
Primary balance, excluding grants	5.1	6.3	0.0	2.8	3.0	3.9	5.3	5.0	4.4
Current balance, excluding grants	4.6	4.7	0.1	1.7	6.6	2.9	2.8	5.6	6.5
External debt inclusive of Fund credit	88.9	73.5	79.9	68.5	74.7	55.6	52.4	50.1	46.3
Debt-service ratio[5]	26.2	24.8	23.9	24.8	21.8	22.1	20.4	19.0	16.9
Interest payments[5]	8.3	8.7	7.3	7.6	6.5	6.0	5.5	5.0	4.3
	(In millions of U.S. dollars, unless otherwise specified)								
Overall balance of payments	102.7	-139.1	149.0	438.2	116.7	-0.7	231.3	241.7	185.7
Gross international reserves (end of period)	625.3	457.6	595.4	854.8	803.9	788.0	956.2	1,206.2	1,381.9
Gross international reserves (in months of imports)	3.7	1.8	2.9	3.5	3.7	2.9	3.4	4.3	4.5
Nominal GDP at market prices (in billions of K Sh)	400.7	455.7	446.6	516.1	492.7	607.8	692.2	770.5	856.4
Exchange rate (K Sh/US$, period average)	56.1	51.4	...	57.1	...	58.7	...	...	...

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

[1] In percent of beginning-of-period reserve money stock.
[2] In percent of beginning-of-period broad money stock.
[3] Fiscal year starting July 1 of the calendar year indicated.
[4] For 1996 and 1997, see Tables 3 and 4 for revised program targets for fiscal year 1996/97 (revised projection) and 1997/98 (finance bill), respectively.
[5] In percent of exports of goods and services.

Table 2. Kenya: Central Government Financial Operations, 1994/95-1997/98

(In millions of Kenya shillings; fiscal year ending June 30)

	1994/95	1995/96	1996/97		1997/98	
			Revised projection	Estimate	Finance bill	Projected
Revenue and grants	130,639	151,316	160,818	155,032	178,153	180,909
Revenue	125,131	145,502	154,636	149,249	171,547	174,351
Tax revenue	108,516	123,008	136,584	129,230	147,576	146,308
Income tax	43,287	48,054	50,956	49,266	56,804	55,394
Import duty	18,598	21,176	23,215	22,773	23,950	22,976
Value-added tax	24,298	28,404	29,954	29,049	31,455	34,543
Excise tax	19,332	22,612	25,598	24,788	29,293	27,809
Other tax revenue	3,001	2,762	6,861	3,354	6,074	5,586
Nontax revenue	10,361	15,631	9,652	11,137	12,306	16,789
Appropriations-in-aid (AIA)[1]	6,254	6,863	8,400	8,882	11,665	11,255
Grants	5,508	5,814	6,182	5,783	6,606	6,558
Expenditure and net lending	135,160	152,187	161,664	168,403	182,815	190,188
Recurrent expenditure	105,487	122,907	131,071	139,742	143,667	155,786
Wages and salaries	42,830	45,886	48,170	48,171	54,783	63,545
Pensions	2,347	3,086	4,692	4,648	5,100	5,100
Interest payments	31,823	37,245	35,047	34,786	30,678	40,941
Domestic	22,588	25,928	26,494	26,569	21,567	31,430
Foreign	9,235	11,317	8,553	8,217	9,111	9,511
Other recurrent expenditure[2]	22,053	30,256	37,092	45,652	45,809	40,741
Of which						
Civil service reform	2,720	1,990	1,000	1,011	1,000	800
Election costs	...	..	...	...	2,322	4,522
Recurrent AIA	6,491	7,223	6,920	7,401	8,297	7,887
Change in pending bills (recurrent)	-57	-789	-850	-917	-1,000	-2,429
Development expenditure and net lending	29,673	29,280	30,593	28,661	39,148	34,403
Of which						
Development AIA[3]	11,495	12,866	14,961	13,112	19,462	19,372
Other foreign-financed expenditure	3,846	7,066	1,133	1,131	5,972	212
Change in pending bills (development)	728	56	-1,855	-60	-1,500	-1,487
Net lending	1,592	2,848	1,676	2,476	1,600	1,637
Overall balance (commitment basis)						
Excluding grants	-10,029	-6,685	-7,028	-19,154	-11,268	-15,837
Including grants	-4,521	-871	-846	-13,371	-4,662	-9,279
Adjustment to cash basis	327	-1,026	-4,529	3,518	-2,500	-16,190
Of which						
Change in pending bills (reduction -)	671	-733	-2,705	-977	-2,500	-3,916
Overall balance (cash basis)						
Excluding grants	-9,702	-7,711	-11,557	-15,636	-13,768	-32,027
Including grants	-4,194	-1,897	-5,375	-9,853	-7,162	-25,469
Financing	4,194	1,897	5,375	9,853	7,162	25,469
Foreign financing	-4,420	138	-4,475	-6,634	2,766	-5,785
Domestic financing	8,614	-2,087	8,715	15,352	3,396	29,592
Privatization receipts	0	3,846	1,135	1,135	1,000	1,662
Financing gap	0	0	0	0	0	0
Memorandum items:						
GDP at market prices	428,166	485,875	565,521	568,152	646,401	647,688
Net domestic debt at end of period	110,178	108,091	116,806	123,443	121,391	153,035
Stock of pending bills at end of period[4]	5,626	4,893	2,188	3,916	0	0
Primary expenditure	103,337	114,942	126,617	133,617	152,137	149,247
Primary balance (commitment basis)	27,302	30,560	28,019	15,632	19,410	25,104

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

[1]Revenue received by an individual line ministry for the provision of services, which is credited directly to the ministry's vote to defray part of its expenditure.
[2]For 1996/97 estimate, includes unclassified spending commitments of K Sh 7,638 million (1.3 percent of GDP).
[3]Includes funding provided by project grants and loans.
[4]Stock of pending bills estimated at end-June 1997 excludes Ministry of Public Works, the pending bills for which are being audited.

Table 3. Kenya: Central Government Financial Operations, 1994/95-1997/98

(In percent of GDP; fiscal year ending June 30)

	1994/95	1995/96	1996/97		1997/98	
			Revised projection	Estimate	Finance bill	Projected
Revenue and grants	30.5	31.1	28.4	27.3	27.6	27.9
Revenue	29.2	29.9	27.3	26.3	26.5	26.9
Tax revenue	25.3	25.3	24.2	22.7	22.8	22.6
Income tax	10.1	9.9	9.0	8.7	8.8	8.6
Import duty	4.3	4.4	4.1	4.0	3.7	3.5
Value-added tax	5.7	5.8	5.3	5.1	4.9	5.3
Excise tax	4.5	4.7	4.5	4.4	4.5	4.3
Other tax revenue	0.7	0.6	1.2	0.6	0.9	0.9
Nontax revenue	2.4	3.2	1.7	2.0	1.9	2.6
Appropriations-in-aid (AIA)[1]	1.5	1.4	1.5	1.6	1.8	1.7
Grants	1.3	1.2	1.1	1.0	1.0	1.0
Expenditure and net lending	31.6	31.3	28.6	29.6	28.3	29.4
Recurrent expenditure	24.6	25.3	23.2	24.6	22.2	24.1
Wages and salaries	10.0	9.4	8.5	8.5	8.5	9.8
Pensions	0.5	0.6	0.8	0.8	0.8	0.8
Interest payments	7.4	7.7	6.2	6.1	4.7	6.3
Domestic	5.3	5.3	4.7	4.7	3.3	4.9
Foreign	2.2	2.3	1.5	1.4	1.4	1.5
Other recurrent expenditure[2]	5.2	6.2	6.6	8.0	7.1	6.3
Of which						
Civil service reform	0.6	0.4	0.2	0.2	0.2	0.1
Election costs	...	...	...	...	0.4	0.7
Recurrent AIA	1.5	1.5	1.2	1.3	1.3	1.2
Change in pending bills (recurrent)	0.0	-0.2	-0.2	-0.2	-0.2	-0.4
Development expenditure and net lending	6.9	6.0	5.4	5.0	6.1	5.3
Of which						
Development AIA[3]	2.7	2.6	2.6	2.3	3.0	3.0
Other foreign-financed expenditure	0.9	1.5	0.2	0.2	0.9	0.0
Change in pending bills (development)	0.2	0.0	-0.3	0.0	-0.2	-0.2
Net lending	0.4	0.6	0.3	0.4	0.2	0.3
New measures	...	...	...	...	...	...
Overall balance (commitment basis)						
Excluding grants	-2.3	-1.4	-1.2	-3.4	-1.7	-2.4
Including grants	-1.1	-0.2	-0.1	-2.4	-0.7	-1.4
Adjustment to cash basis	0.1	-0.2	-0.8	0.6	-0.4	-2.5
Of which						
Change in pending bills (reduction -)	0.2	-0.2	-0.5	-0.2	-0.4	-0.6
Overall cash balance including grants	-1.0	-0.4	-1.0	-1.7	-1.1	-3.9
Financing	1.0	0.4	1.0	1.7	1.1	3.9
Foreign financing	-1.0	0.0	-0.8	-1.2	0.4	-0.9
Domestic financing	2.0	-0.4	1.5	2.7	0.5	4.6
Privatization receipts	0.0	0.8	0.2	0.2	0.2	0.3
Financing gap	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:						
Net domestic debt at end of period	25.7	22.2	20.7	21.7	18.8	23.6
Stock of pending bills at end of period[4]	1.3	1.0	0.4	0.7	0.0	0.0
Primary expenditure	24.1	23.7	22.4	23.5	23.5	23.0
Primary balance (commitment basis)	6.4	6.3	5.0	2.8	3.0	3.9

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

[1]Revenue received by an individual line ministry for the provision of services, which is credited directly to the ministry's vote to defray part of its expenditure.
[2]For 1996/97 estimate, includes unclassified spending commitments of K Sh 7,638 million (1.3 percent of GDP).
[3]Includes funding provided by project grants and loans.
[4]Stock of pending bills estimated at end-June 1997 excludes Ministry of Public Works, the pending bills for which are being audited.

Table 4. Kenya: Central Bank of Kenya Balance Sheet, December 1994-June 1998

(In millions of Kenya shillings, unless otherwise specified)

	1994	1995	1996	1997				1998	
	December	December	December	March	June	September	December	March	June
	Actual	Actual	Actual	Actual				Projected	
Net foreign assets[1]	7,854	2,275	25,982	36,302	38,655	29,886 #	32,402	34,150	38,668
Net domestic assets	47,462	68,926	51,010	45,294	35,460	50,806	43,451	47,101	40,927
Domestic credit	31,849	59,893	41,650	37,683	28,424	47,542	46,243	48,703	45,886
Government (net)	21,777	50,127	32,594	28,619	19,160	34,872	37,119	39,703	36,886
Advances and discounts to commercial banks	10,072	9,766	9,056	9,064	9,264	12,670	9,124	9,000	9,000
Other items (net)	15,613	9,033	9,360	7,611	7,036	3,264	-2,792	-1,602	-4,959
Reserve money	55,316	71,201	76,992	81,596	74,115	80,692	75,853	81,251	79,595
Currency outside banks	24,725	28,795	30,332	31,057	29,158	30,132	36,182	36,695	35,109
Bank reserves[2]	30,591	42,406	46,660	50,539	44,957	50,560	39,671	44,556	44,486
Of which									
Required reserves	23,292	35,722	39,936	42,622	43,447	43,572	34,600	38,004	37,944
Memorandum items:									
Reserve money (annual percentage change)	31.3	28.7	8.1	19.3	7.7	9.4	-1.5	-0.4	7.4
Statutory reserve requirement (in percent)									
Commercial banks	16.0	18.0	18.0	18.0	18.0	18.0	15.0	15.0	15.0
Finance houses	10.0	18.0	18.0	18.0	18.0	18.0	15.0	15.0	15.0

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

[1]Valued at current exchange rates, except the projections for March-June 1998, which are valued at September 30, 1997 rates.
[2]From June 1995 onward includes nonbank financial institutions.

Table 5. Kenya: Monetary Survey, December 1994-June 1998[1]

	1994	1995	1996	1997				1998	
	December	December	December	March	June	September	December	March	June
	Actual	Actual	Actual	Actual				Projected	
				(In millions of Kenya shillings)					
Net foreign assets[2]	13,291	6,913	28,645	38,225	40,070	35,756	34,849	36,773	40,062
Net domestic assets	192,531	224,732	239,844	245,623	241,568	239,029	259,846	269,017	265,230
Domestic credit	204,187	249,513	272,521	285,761	285,682	295,991	315,213	334,041	335,114
Government (net)	76,117	78,486	74,794	81,166	72,942	72,315	83,559	98,041	95,624
Other public sector	5,752	5,368	5,697	5,543	5,628	6,681	8,171	8,000	8,000
Private sector	122,318	165,659	192,030	199,052	207,112	216,995	223,483	228,000	231,490
Other items (net)	-11,656	-24,781	-32,677	-40,138	-44,114	-56,962	-55,367	-65,024	-69,884
Money and quasi money (M3)	205,822	231,645	268,489	283,848	281,637	274,785	294,694	305,790	305,292
Currency outside banks	24,725	28,795	30,394	31,012	29,158	30,132	36,182	36,695	35,109
Deposits	181,097	202,850	238,095	252,836	252,479	244,653	258,513	269,095	270,183
				(Annual percentage change, unless otherwise indicated)					
Memorandum items:									
Currency outside banks (M0)	16.7	16.5	5.6	8.0	1.4	2.6	19.0	18.2	20.4
Money and quasi money (M3)	27.4	12.5	15.9	16.2	10.2	7.5	9.8	7.7	8.4
M3 and foreign currency deposits (M3X)	...	14.1	15.9	15.6	9.9	9.4	11.9	10.2	10.8
M3 and nonbank credit to government	...	...	13.8	14.4	14.8	12.2	14.3	13.1	9.2
M3X and nonbank credit to government	...	...	13.8	14.0	14.3	13.6	15.9	15.0	11.2
Credit to private sector	23.5	35.4	15.9	15.2	14.6	17.1	16.4	14.5	11.8
Currency-deposit ratio (in percent)	13.7	14.2	12.8	12.3	11.5	12.3	14.0	13.6	13.0
Nonbank credit to government (in K Sh million)	...	36,044	36,012	36,180	50,379	52,565	53,298	56,046	57,289

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

[1]Includes nonbank financial institutions.
[2]Valued at current exchange rates, except the projections for March-June 1998, which are valued at September 30, 1997 rates.

Table 6. Kenya: Balance of Payments, 1994-2000

(In millions of U.S. dollars, unless otherwise indicated)

	1994	1995	1996		1997		1998	1999	2000
			Program[1]	Estimated	Program[1]	Estimated	Projected		
Current account	66	-397	64	-116	26	-243	-244	-185	-214
Excluding official transfers	-14	-487	-109	-221	-110	-336	-370	-293	-323
Exports, f.o.b.	1,484	1,875	1,788	1,969	1,891	2,100	2,122	2,195	2,335
Coffee	233	282	237	287	238	300	223	213	253
Tea	301	331	357	396	400	431	479	466	449
Oil products	64	95	71	97	76	164	147	160	169
Other	886	1,168	1,123	1,189	1,177	1,205	1,271	1,357	1,464
Imports, c.i.f.	-2,042	-3,067	-2,460	-2,928	-2,607	-3,294	-3,375	-3,406	-3,685
Public	-78	-212	-91	-142	-97	-111	-121	-126	-130
Private	-1,964	-2,855	-2,368	-2,786	-2,510	-3,183	-3,254	-3,280	-3,555
Oil	-333	-401	-343	-448	-365	-515	-450	-488	-519
Other	-1,631	-2,454	-2,025	-2,338	-2,145	-2,667	-2,803	-2,793	-3,036
Services (net)	759	620	763	531	783	558	536	608	721
Of which									
Foreign travel	501	486	480	453	500	388	330	379	455
Income (net)	-362	-320	-329	-226	-309	-203	-182	-162	-139
Of which									
Official interest payments	-220	-257	-221	-225	-205	-190	-175	-165	-153
Current transfers (net)	228	495	302	538	269	596	655	580	555
Private (net)[2]	147	405	129	433	133	503	529	472	445
Official (net)	80	90	173	105	136	93	126	108	110
Capital account	36	258	86	555	91	242	470	426	400
Investment assets and liabilities (net)	-268	-46	47	-11	51	-139	91	55	69
Official, medium- and long-term	-207	-61	43	-92	50	-176	19	-46	-48
Inflows	252	378	478	359	461	264	425	362	361
Outflows	-460	-439	-434	-452	-412	-440	-406	-408	-409
Debt buy back	0	0	-32	0	0	0	0	0	0
Commercial banks	-17	23	0	88	-34	3	0	0	0
Other private (net)[3]	-43	-8	35	-7	36	34	73	102	117
Short term (net) and net errors and omissions[3]	304	304	39	566	40	382	379	371	330
Overall balance	103	-139	149	438	117	-1	227	242	186
Financing items	-103	139	-149	-438	-117	1	-227	-242	-186
Reserve assets (gross)	-123	172	-138	-389	-209	49	-163	-250	-176
Use of Fund credit and loans (net)	19	-39	12	-25	1	-67	-29	8	-10
Accumulation of arrears	-499	6	-95	-25	0	19	-105	0	0
Rescheduling of arrears[4]	501	0	0	0	0	0	70	0	0
Remaining gap	0	0	72	0	90	0	0	0	0
Memorandum items:									
Gross official reserves (end of period)[5]	625	458	595	855	804	788	956	1206	1382
(in months of imports of goods)	3.7	1.8	2.9	3.5	3.7	2.9	3.4	4.3	4.5
Current account balance[6]									
Including official transfers	1.3	-4.1	0.8	-0.7	0.3	-2.3	-2.2	-1.6	-1.7
Excluding official transfers	0.1	-5.1	-1.3	-1.9	-1.2	-3.2	-3.3	-2.5	-2.6
Debt-service ratio[7]	26.2	24.8	...	24.8	...	22.1	20.4	19.0	16.9

Sources: Kenyan authorities; and Fund staff estimates and projections

[1] EBS/96/62 (4/12/96).
[2] Beginning 1998, includes private capital inflows relating to the rehabilitation of the energy sector.
[3] Includes unrecorded foreign earnings and direct investment as well as short-term inflows.
[4] In 1998, reflects the restructuring of arrears to commercial banks.
[5] At current exchange rates.
[6] In percent of GDP.
[7] In percent of exports of goods and services.

Table 7. Kenya: Operating Profits and Cash Position of Selected Public Enterprises, 1993/94-1997/98 (July/June)

(In millions of Kenya shillings, unless otherwise indicated)

	1993/94	1994/95	1995/96		1996/97		1997/98
			Program EBS/96/62	Actual	Projected	Estimate	Projected
I. Operating balances[1]							
Kenya Power and Lighting Corporation (KPLC)	680	1,574	3,854	4,163	4,932	3,911	2,458
Kenya Posts and Telecommunications Company (KPTC)	5,308	2,886	2,400	4,142	5,576	3,456	9,224
Kenya Railways (KR)[2]	429	421	381	-1,179	-1,010	-1,604	-1,994
National Cereals and Produce Board (NCPB)	-2,522	-2,281	-2,301	-2,030	-724	-72	-447
Kenya Ports Authority (KPA)	3,304	801	1,515	1,276	313	541	380
Total	7,199	3,400	5,849	6,372	9,088	6,231	9,621
(in percent of GDP)	2.0	0.8	1.4	1.3	1.6	1.1	1.5
Total excluding KPTC	1,891	515	3,449	2,230	3,511	2,776	397
(in percent of GDP)	0.5	0.1	0.8	0.5	0.6	0.5	0.1
Total excluding NCPB	9,721	5,681	8,150	8,402	9,811	6,304	10,068
(in percent of GDP)	2.6	1.3	1.9	1.7	1.7	1.1	1.6
II. Cash position[3]							
Kenya Power and Lighting Corporation (KPLC)	-105	2,389	2,937	3,973	4,249	3,742	2,341
Kenya Posts and Telecommunications Company (KPTC)	124	-888	-318	312	566	675	607
Kenya Railways (KR)	-180	-312	-528	-222	-190	-604	-1,322
National Cereals and Produce Board (NCPB)	864	-525	-385	-177	434	1,243	-162
Kenya Ports Authority (KPA)	1,240	202	-400	144	112	-281	-432
Total	1,943	866	1,306	4,030	5,171	4,776	1,033
Total excluding KPTC	1,819	1,754	1,624	3,718	4,605	4,101	425
Total excluding NCPB	1,079	1,391	1,691	4,207	4,737	3,532	1,195
Memorandum item:							
GDP at current market prices	367,146	428,166	427,014	485,875	565,521	568,152	647,688

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

[1]Excludes foreign exchange losses/gains.
[2]Excludes land sales.
[3]As at end of period.

Table 8. Kenya: Quantitative Targets, March-June 1998

	1997	1998				
	December	March		April	May	June
		Target	Estimate	Target	Target	Target
Total ordinary revenue[1]	73,904	114,904	114,493	133,062	145,122	163,096
Total expenditure and net lending[1, 2]	71,061	118,440	116,608	134,901	149,185	164,462
Net credit to the central government from the banking system[3, 4, 5]	...	14,482	...	13,545	13,820	12,065
Stock of domestic arrears (pending bills)[6]	5,058	2,529	5,874	1,686	843	0
Net domestic assets of the banking system[3, 5, 7]	...	9,172	...	6,435	6,790	5,385
Stock of arrears on public and publicly guaranteed external debt[8]	34.3	0.0	...	0.0	0.0	0.0
Memorandum items:						
Nonbank holdings of government debt[3, 9]	...	2,749	...	3,049	6,009	3,992
Privatization receipts[1]	62	62	62	62	62	1,662
Program grants and loans[3]	...	49	89	65	82	98
External debt service payments[3]	...	11,444	11,355	13,516	14,933	16,646

[1]Cumulative from July 1, 1997.
[2]Excluding expenditure financed from project grants and loans.
[3]Cumulative from December 31, 1997.
[4]Defined as the stock of financial liabilities of the central government held by the banking system less deposits of the central government with the banking system. Liabilities include overdraft balances with the Central Bank of Kenya (CBK), cleared items awaiting transfer to the Paymaster General's (PMG) account, treasury bills, floating rate treasury bonds, bearer bonds, nonbearer bonds, and long-term government stocks. The banking system is defined to include the CBK, the commercial banks, and the nonbank financial institutions.
[5]To be adjusted downward (upward) for unanticipated increases (decreases) in nonbank holdings of government debt; downward for higher-than-expected privatization receipts and disbursements of program grants and loans, for spending commitments entered in the current fiscal year but not paid for until the next fiscal year in excess of K Sh 500 million, and for lower-than-expected external debt service payments
[6]Recurrent and development pending bills; excluding the stock of pending bills at the Ministry of Public Works.
[7]Defined as the difference between M3 and net foreign assets of the banking system (NFA). For the purpose of calculating the flows of net domestic assets of the banking system, the stocks of NFA at end-December 1997 are valued at actual exchange rates, while stocks in 1998 are valued at end-September 1997 exchange rates.
[8]Excluding arrears to commercial banks that were outstanding as of end-1993 and have been rescheduled.
[9]Defined as the difference between the total net domestic financing of the central government and net credit to government by the banking system.

Table 9. Kenya: Structural Targets, March-June 1998

	Timing
Elimination of "ghost" civil service workers from the central government's payroll	May 1, 1998
Completion of a head count of teachers and identification and elimination of all ghost teachers from the central government's payroll	May 1, 1998
Initiation and completion of a comprehensive review of the public sector's project portfolio	May 1, 1998
Consideration by the Cabinet of a strategy paper on ministerial rationalizations and civil service reform and publication of a policy statement on the matter indicating the need for substantial retrenchment	May 1, 1998
Completion of the sale by the central government of a 25 percent stake in the Kenya Commercial Bank	May 1, 1998
Completion of the cumulative net reduction of 19,500 civil service positions[1,2]	June 30, 1998
Finalization of an agency agreement between the National Cereals and Produce Board and the government	June 30, 1998
Divestiture by the government of the Kenya Reinsurance Company, Mumias and Chemelil Sugar Companies, and African Tours and Hotels	Prior to Board presentation of a request for a second annual ESAF arrangement

[1]Cumulative from January 1, 1996.

[2]Excluding retrenchments to be financed from external resources.

Kenya: Relations with the Fund

(As of March 31, 1998)

I. **Membership Status**: Joined February 23, 1964; Article VIII.

II. **General Resources Account**:	**SDR Million**	**% Quota**
Quota	199.40	100.0
Fund holdings of currency	187.02	93.8
Reserve position in Fund	12.40	6.2

III. **SDR Department**:	**SDR Million**	**% Allocation**
Net cumulative allocation	36.99	100.0
Holdings	0.57	1.5

IV. **Outstanding Purchases and Loans**:	**SDR Million**	**% Quota**
Enhanced Structural Adjustment Facility arrangements	179.24	89.9

V. **Financial Arrangements**:

Type	Approval date	Expiration date	Amount approved (SDR million)	Amount drawn (SDR million)
ESAF	4/26/96	4/25/99	149.55	24.93
ESAF	12/22/93	12/21/94	45.23	45.23
ESAF	5/15/89	3/31/93	261.40	216.17

VI. **Projected Obligations to Fund** (SDR million; based on existing use of resources and present holdings of SDRs):

	Overdue	Forthcoming				
	3/31/98	1998	1999	2000	2001	2002
Principal	0.0	46.1	43.7	32.2	18.6	14.0
Charges/interest	0.0	1.9	2.2	2.0	1.8	1.8
Total	0.0	41.6	45.9	34.2	20.4	15.8

VII. **Exchange Rate Arrangement**:

Independently floating. The exchange rate on March 31, 1997 was K Sh 59.8 = US$1.

Kenya: Relations with the Fund (continued)

VIII. Article IV Consultation:

Kenya is on the 12-month cycle for Article IV consultations. The 1996 Article IV consultation was concluded on March 21, 1997 (SM/97/70).

IX. Technical Assistance (since 1994):

LEG staff advice on foreign exchange legislation	February 1994
FAD advice on government expenditure management through short-term visit by a panel expert	February 1994 and July 1994
MAE/LEG mission on banking legislation	April 1994
MAE mission on foreign exchange management	July 1994
FAD technical expert to follow up on advice on government expenditure management	July-December 1995
MAE mission on improving financial markets and instruments	February and December 1996
STA mission to review data standards	March 1996
MAE/LEG advice on amending the Central Bank of Kenya (CBK) Act to make the CBK more independent	May-July 1996
FAD resident advisor at the Kenya Revenue Authority, financed by the World Bank and under Fund supervision, to provide assistance on strengthening tax administration	September 1996-present
FAD mission on strengthening expenditure management and control	April 1997
MAE mission on improving management of market liquidity	May 1997
STA multisector mission	January-February 1998
MAE consultant on bank supervision	February 1998

Kenya: Relations with the Fund (concluded)

X. Resident Representative:

The Fund has had a resident representative in Kenya since December 1993. Mr. Reimer Carstens has been the Senior Resident Representative since November 1996.

Kenya: Relations with the World Bank Group

As of February 28, 1998, the World Bank had committed to Kenya around US$3.7 billion, of which US$3.1 billion had been fully disbursed (see attached Statement A). As of January 31, 1998, outstanding commitments (loans and equity net of repayments, cancellations, exchange rate adjustments, write-offs, terminations, and sales) by the IFC totaled US$75.6 million, of which US$59.5 million had been fully disbursed (see attached Statement B).

Agriculture

The Bank's activities in this sector are in support of the government's sector development strategy aimed at realigning the policy framework and the incentive structure, and at encouraging a more competitive marketing system with increased participation of the private sector in marketing and distribution. The government's development strategy also envisions support for the core programs of research and extension.

The Bank currently has seven ongoing projects in the agriculture and environmental area. These projects support the development of agricultural extension (Second National Agriculture and Extension) and enhance agricultural diversification and export orientation (Second Coffee Improvement Project). The Bank is also supporting the reorganization of the Ministry of Agriculture, Livestock Development, and Marketing (MALDM) to enhance its management and policy analysis capacity (Second Agricultural Sector Management), and the development of a sustainable agricultural research program (Second National Agricultural Research Project). However, most of these projects will close on June 30, 1998. To replace them, the Bank is preparing an Agriculture Sector Investment Project, which will aim at providing funding to rationalize expenditure by the MALDM, rather than undertake specific projects.

On environmental/natural resource management, the Bank financed the preparation of the National Environmental Action Plan and is providing funds for wildlife conservation and management (Wildlife Services). In the area of natural resource management, the Bank approved an Arid Lands Resource Management Project in December 1995, which seeks to ameliorate economic and environmental conditions in the more fragile arid areas. In addition, the Bank approved a Lake Victoria Environmental Management Project in July 1996 to support efforts by the Kenyan, Ugandan, and Tanzanian governments to improve management of the Lake Victoria ecosystem.

Infrastructure and private sector development

A major impediment to private sector development is inadequately maintained and inefficiently operated physical infrastructure. Public sector, including parastatal, inefficiency is at the heart of many of these problems. Addressing these deficiencies requires an appropriate framework of sectoral priorities and policies, together with institutional and organizational reforms to implement them, including an appropriate role for the private sector. Bank activity in this sector has aimed at financing critical infrastructure needs while putting in place policy and budgetary reforms to increase long-term sustainability.

The Bank has five ongoing infrastructure projects. The Third Nairobi Water Supply Project includes major production, treatment, and distribution works for Nairobi, and supports efforts by the Nairobi Water and Sewerage Department to operate as a financially autonomous entity. The Second Mombasa Water Project supports rehabilitation of the coastal water system and is financing preparatory work to increase water availability in the coastal area in the long term. In January 1996, the Bank approved two additional infrastructure projects: an Urban Transport Project, which will finance new and expanded road links, intersections, and public transport facilities in urban areas, and a Nairobi-Mombasa Road Rehabilitation Project, which will support rehabilitation of Kenya's chief transport corridor. The Bank also approved an Energy Sector Reform and Power Development Project in June 1997, which is expected to increase generating capacity, reform energy pricing, and encourage private sector participation in the sector. In addition, the Bank is preparing with the government a local government reform project aimed at increasing the capacity of local authorities to undertake critical infrastructure investments.

Education and health

In these two sectors, the Bank's emphasis has been on enhancing financing and management capacity to increase the effectiveness and sustainability of public sector expenditures. In education, this has involved (a) improving the quality of primary, secondary, and university education, including technical training; (b) restructuring key sectoral institutions and policies to enhance the efficiency of service delivery; and (c) shifting public expenditure to improve access to quality basic education, especially in rural areas. In health, this has involved (a) the development of prevention programs for sexually transmitted diseases, including AIDS; (b) a shift in resources from curative to efficient primary care; and (c) a clarification of the respective roles of the private and public sectors.

The Bank has six ongoing human resource operations. The Universities Investment Project focuses on consolidating and developing the university system, with particular emphasis on limiting the growth of government budgetary resources devoted to the public universities through cost sharing and improved investment planning. The Micro- and Small Enterprise Training and Technology Project aims to enhance entrepreneurial development by reducing administrative constraints and increasing human capital in the informal sector. The Fourth Population Project provides support for the government's family planning services, as well as financing drugs and information/education activities to address the rising incidence of sexually transmitted infections. In the same vein, the Sexually Transmitted Infections Project, approved in March 1995, has as an objective reducing both the incidence and impact of such infections, including HIV/AIDS, and to reduce the direct costs of AIDS and the workload of health facilities. In addition, the project will strengthen institutional capacity at the national and provincial/district levels The Bank's Health Rehabilitation Project supports the government's reform of the health sector by rehabilitating Kenyatta National Hospital, thereby reducing its burden on the overall budget, and by improving the delivery of health services in the Nairobi area. The Bank approved an Early Child Development Project in April 1997, which will aim at reinforcing existing institutions and improving the quality of services offered to pre-school age children. In addition, the Bank is discussing with the government an education sector project aimed at strengthening primary and secondary education.

Public sector management

The Bank has provided two credits to improve public sector management in Kenya. A Parastatal Reform and Privatization Technical Assistance Project provides overall technical support for the government's privatization program, as well as for the preparation of specific restructuring plans for those enterprises remaining in the public portfolio. A Civil Service Reform Project provides support for the government's efforts to reduce the size of the civil service and rationalize specific ministries.

Adjustment lending

After two structural adjustment loans and a series of sectoral adjustment credits, the Bank ceased adjustment lending in Kenya in the early 1990s. However, the policy framework paper (PFP) for 1996-98 has provided a basis to move forward on new policy-based lending. On the basis of government commitments in the PFP, the Bank approved in June 1996 a new SAC equal to US$126.8 million, including US$36.8 million in IDA reflows. This SAC supports specific policy actions in the areas of improved budgetary control and public expenditure allocations, and civil service and parastatal reform. The first tranche (equal to US$81.8 million) was disbursed in June 1996. The second tranche (US$45 million, to which is linked US$44.1 million in additional IDA reflows) remains to be disbursed, depending on completion of agreed actions.

Status of World Bank Group Operations in Kenya

A. Statement of World Bank Loans and IDA Credits

(In millions of U.S. dollars, as of February 28, 1998)

Credit No.	Fiscal Year	Purpose	Bank (Less Cancellations)	IDA (Less Cancellations)	Undis-bursed
Sixty (60) loans and seventy-three (73) credits closed			985.9	1,682.9	3.6
of which: SAL/SECAL loans and credits			60.9	999.4	
Cr.20600	1990	Third Nairobi Water Supply		64.8	10.5
Cr.20620	1990	Coffee Improvement II		46.8	4.9
Cr.21110	1990	Population IV		34.7	24.6
Cr.21990	1991	National Agric. Ext. II		24.9	9.8
Cr.23090	1992	Universities Investment		55.0	30.2
Cr.23100	1992	Health Rehabilitation		31.0	14.4
Cr.23330	1992	Mombasa and Coastal Water II		43.2	4.9
Cr.23340	1992	Wildlife Services		60.5	13.4
Cr.24400	1993	Parastatal Reform TA		23.3	7.8
Cr.24450	1993	Agric. Sect. Mngt. II		17.9	5.2
Cr.25960	1994	Micro & Small Enterprise		21.8	18.7
Cr.26710	1995	Institutional Development		25.4	15.8
Cr.26860	1995	Sexually Transmitted Infections		40.0	26.6
Cr.27970	1996	Arid Lands		22.0	16.9
Cr.28110	1996	Urban Transport		115.0	98.8
Cr.28120	1996	Nairobi Mombasa Road		50.0	45.0
Cr.28840[1]	1996	SAC I		90.0	41.7
Cr.28842[1]	1996	SAC I		26.6	25.0
Cr.28843[1,2]	1996	SAC I		17.5	16.9
Cr.29070	1997	Lake Victoria Env.		12.8	11.8
Cr.N0150	1997	Early Childhood Development		27.8	25.3
Cr.29350	1997	NARP II		39.7	33.6
Cr.29660[2]	1997	Energy Sector Reform		125.0	117.0
		Total	985.9	2,698.5	618.6
		of which: repaid	839.4	81.7	
		Total held by Bank and IDA	146.5	2,616.8	
		Amount sold 11.74			
		of which: repaid 11.74			
		Total undisbursed			622.2

[1]Indicates SAL/SECAL loans and credits.
[2]Not yet effective.

Status of World Bank Group Operations in Kenya (concluded)

B. Statement of IFC's Committed and Disbursed Portfolio

(In millions of U.S. dollars, as of January 31, 1998)

Fiscal Year Approval	Type of Business	Committed				Disbursed			
		Loan	Equity	Quasi	Partic.	Loan	Equity	Quasi	Partic.
1970[1]	Panafrican	27.9	4.5	0.0	0.0	22.9	4.5	0.0	0.0
1972	TPS(Kenya)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
1976	RIVATEX	0.0	0.0	2.1	0.4	0.0	0.0	2.1	0.4
1980/83	DBK	0.0	1.3	0.0	0.0	0.0	1.3	0.0	0.0
1982	Diamond Trust	0.0	0.8	0.0	0.0	0.0	0.8	0.0	0.0
1982	IPS(K)	0.0	0.6	0.0	0.0	0.0	0.6	0.0	0.0
1983/91	LIK	0.0	0.6	0.0	0.0	0.0	0.6	0.0	0.0
1985	EBP	4.5	0.0	0.0	0.0	4.5	0.0	0.0	0.0
1986	IPS(K)-Allpack	0.0	0.4	0.0	0.0	0.0	0.4	0.0	0.0
1986	IPS(K)-AL	0.0	0.6	0.0	0.0	0.0	0.0	0.0	0.0
1986	IPS(K)-Frigoken	0.0	0.1	0.0	0.0	0.0	0.1	0.0	0.0
1986	IPS(K)-Novaskins	0.0	0.1	0.0	0.0	0.0	0.1	0.0	0.0
1986	IPS(K)-Prem Food	0.0	0.1	0.0	0.0	0.0	0.1	0.0	0.0
1992	AEF Future Hotel	0.3	0.0	0.0	0.0	0.3	0.0	0.0	0.0
1994	AEF Capital Fish	0.5	0.0	0.0	0.0	0.5	0.0	0.0	0.0
1994	AEF Mosi	0.1	0.0	0.0	0.0	0.1	0.0	0.0	0.0
1994	EARC	0.0	1.1	0.0	0.0	0.0	0.8	0.0	0.0
1994	Intl Hotels-Ken	6.0	0.0	0.0	0.0	6.0	0.0	0.0	0.0
1995	AEF Bawan Roses	0.5	0.0	0.0	0.0	0.5	0.0	0.0	0.0
1995	AEF Kihingo Rose	0.4	0.0	0.0	0.0	0.4	0.0	0.0	0.0
1995	AEF Vegpro	0.6	0.0	0.0	0.0	0.6	0.0	0.0	0.0
1995	Magadi Soda Co.	9.0	0.0	0.0	0.0	8.1	0.0	0.0	0.0
1996	AEF Jacaranda	0.5	0.0	0.0	0.0	0.5	0.0	0.0	0.0
1996	AEF K-Rep Bank	0.0	1.0	0.0	0.0	0.0	0.0	0.0	0.0
1997	AEF Ceres	0.9	0.0	0.0	0.0	0.9	0.0	0.0	0.0
1997	AEF Makini	0.6	0.0	0.0	0.0	0.6	0.0	0.0	0.0
1997	AEF Redhill Flrs	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0
1997	CFC	10.0	0.0	0.0	0.0	2.0	0.0	0.0	0.0
	Gross commitments[2]	61.9	11.2	2.1	0.4	47.7	9.3	2.1	0.4
	Approvals pending commitment								
1997	AEF DERAS LTD.	1.0	0.0	0.0	0.0				
1996	AEF EQUITEA	0.3	0.1	0.0	0.0				
1996	AEF RAFIKI EXPORT	0.4	0.0	0.0	0.0				
1996	AEF WAKATE CENT	0.0	0.0	0.9	0.0				
1998	AEF AAR HOSPITAL	0.0	0.5	0.0	0.0				
1998	GBHL	7.0	0.0	3.0	0.0				
	Total	8.7	0.6	3.9	0.0				

[1]The sum of commitments made in 1970, 1974, 1977, 1979, 1981, 1988, 1989, 1994, and 1996.
[2]Gross commitments consist of approved and signed projects.

Kenya: Statistical Issues

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* and *Statistical Bulletin*. Core financial data are also available to the Fund on a regular basis. The Ministry of Finance (MoF) publishes its *Quarterly Budget Review*. A detailed account of various sectoral activity and the corresponding statistical data are published annually by the Central Bureau of Statistics in its *Economic Survey*.

A multisector STA mission visited Kenya in January-February 1998. It undertook a comprehensive review of the major statistical areas and prepared a work program providing a broad time frame for implementing the principal recommendations that address most of the statistical problems discussed below.

National accounts

National accounts (annual only) and the supporting sectoral data are prepared by the CBS. Data quality, which was previously reported as good, has deteriorated significantly as a result of budgetary and staff constraints. The recent liberalization and transformation of the Kenyan economy have resulted in the emergence of new sectors, such as horticulture, which are not fully reflected in the national accounts. Moreover, national accounts data at constant prices use an outdated base year (1982). The authorities intend to rebase their constant price national accounts and strengthen their institutional capacity to improve the data quality. The latest available national accounts data reported for publication in *International Financial Statistics (IFS)* are for 1996.

Prices and production

A consumer price index (CPI) for Nairobi is compiled by the CBS and is reported on a monthly basis without significant lags. The CBS intends to commence publication of a newly rebased national CPI (12 urban areas) starting in May 1998. There is no producer price index, but the authorities intend to compile one. The index on manufacturing production needs to be rebased, as it uses an outdated base year and is available only with a significant lag. The latest available figure reported for publication in *IFS* is for July 1996.

Government finance statistics

The staff is provided with current information on central government fiscal accounts on a monthly basis with a four to six-week lag. The data are fairly comprehensive, although expenditure items that are reported need to be further disaggregated, especially nonwage recurrent outlays, and do not necessarily comply with standard *Government Finance Statistics*

(GFS) methodology. The recording of external financing and expenditure directly financed from abroad also remains an area for improvement. Annual government finance data, covering the central government, have been reported in *IFS* up to 1994/95 (July-June). These data are as reported by the CBS for publication in the *GFS Yearbook* and are compiled according to the GFS methodology. As a result, considerable differences exist between these data and annual data compiled by the MoF.

Monetary statistics

Monetary statistics are compiled from a bank reporting system and are broadly adequate for policy, analytical, and supervisory purposes. At the same time, their quality continues to be compromised by various methodological problems, such as an arbitrary application of the residency criterion, a partial incorporation of Fund-related accounts and of government deposits, and the exclusion of resident foreign currency deposits from the coverage of domestic liquidity. As most of these problems derive from the inability of the prevailing bank reporting system to deliver properly differentiated data, the January-February 1998 STA mission recommended revisions to introduce clarification of the statistical definition of residency and a currency-based differentiation of accounts.

Balance of payments statistics

Balance of payments data are reported annually on a regular basis to the *IFS*, although with a considerable lag. Monthly trade values are reported for publication in *IFS* with a lag of about five to seven months. Trade volume and price indices are available annually, but use 1982 as a base period. At present, data are available through 1996. There currently exist numerous sources of monthly information that would permit the development and dissemination of quarterly balance of payments statistics. The overall quality of data is reasonably good for trade transactions. However, data for other current account and financial account transactions are less robust. Following liberalization of the exchange system in 1993-94, gaps have emerged in the coverage of balance of payments statistics. The compilation system, used since 1994, relies on reports from domestic banks and may result in a substantial underrecording of current earnings, including tourism receipts, as well as a failure to capture transactions that are settled via accounts held abroad. The large positive errors and omissions that have emerged in the balance of payments since 1994 also raise concerns as to the potential size of external obligations.

The MoF compiles data covering Kenya's public and publicly-guaranteed foreign external obligations to official and commercial creditors. This database does not take account of nonresident purchases of government's domestic currency denominated debt; however, estimates are being developed by the National Debt Office using data on the operation of client accounts by the largest banks in Kenya. There is also, at present, no systematic reporting or recording of the external obligations of the nonfinancial private sector, and the use of annual survey data to capture foreign direct investment is hampered by a poor response rate.

Table 1. Kenya: Survey of Reporting of Main Statistical Indicators as of April 15, 1998

	Exchange Rates	Central Bank Balance Sheet	International Reserves	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Central Government Balance	Exports/ Imports	Current Account Balance	External Debt	GDP/ GNP
Date of latest observation	4/15/98	4/10/98	4/10/98	4/10/98	2/98	4/9/98	3/98	2/98	1/98	1996	end-1996	1996
Date received	4/15/98	4/15/98	4/15/98	4/15/98	4/98	4/9/98	4/98	4/98	4/98	6/97	6/97	6/97
Frequency of data[1]	D	D	D	D	M	W-M	M	M	M	A	A	A
Frequency of reporting[1]	D-W	D-W	D-W	D-W	M	W-M	M	M	M	A	A	A
Source of data[2]	DR	DR	DR	DR	DR	DR	DR	DR	DR	DR	DR	OP
Mode of reporting[3]	F	F	F	F	F	F	F	F	F-P	P-SV	P-SV	P-SV
Confidentiality[4]	E	R	R	R	E	E	E	R	E	E	E	E

[1]D = daily; W = weekly; M = monthly; A = annually.

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

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

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

Kenya: Social Issues

1. Social and development indicators point to the need for major improvements in social welfare standards in Kenya, most particularly in education and health, both of which have declined in recent years (see attached Table 1). The government, with continued support from donors and nongovernmental organizations (NGOs), would appear to have sufficient resources to address many of the social ills that affect Kenya.[1] However, in the case of education, resources are currently being directed too heavily toward wage outlays, while health service delivery is suffering from inadequate planning and administration. Major symptoms include declining enrollment rates in primary and secondary education, inadequate promotion or awareness of basic health information (including nutritional standards), and the lack of access to clean water and sanitation services (especially in rural areas).

2. Although primary and secondary school enrollment has grown more than tenfold in the past 30 years, the annual rate of increase has slowed considerably in the past decade.[2] As a result, total school enrollment as a share of the school-aged population (ages 5-19) has declined by an estimated 13 percentage points to 56 percent during the period 1989-96. This may be due in part to the fact that an increasing portion of the nonwage costs of education are being borne directly by individual households. The new wage agreement with teachers has put a further squeeze on nonwage spending, and threatens to strip future budgets of outlays for books and other essential teaching materials. Nevertheless, the number of primary and secondary school teachers continues to rise. Student-teacher ratios are currently at about 30 to 1 at the primary and 16 to 1 at the secondary level, among the very lowest in the region.[3] In line with the staff's and the World Bank's views, officials in the Ministry of Education explained that the quality of education services would not likely suffer from a strategically planned reduction in the overall number of teachers, coupled with a regional redeployment. In addition, budgetary savings were expected to be found in the medium term through the elimination of "ghost" teachers, the enforcement of the mandatory retirement age, and the restructuring of the curriculum to emphasize basic skills and learning.

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[1]During the period 1987/88-1995/96 (July-June), total spending on social services was about 9.0 percent of GDP, of which education consumed an average of 6.3 percent.

[2]For the period 1977-86, the number of students enrolled in primary and secondary education grew at an average 4.8 percent per annum. However, growth slowed to 1.4 percent per annum during the period 1987-96.

[3]The number of teachers grew by an average of 3.7 percent per annum during the period 1987-96 (equivalent to an average of 7,435 teachers per year), and by another 8.1 percent in 1997, or 19,379 teachers. As of end-1997, there were an estimated 258,835 teachers. The wage component of total recurrent expenditure in primary and secondary education is expected to be 83 percent in 1997/98, compared with 77 percent in 1996/97.

3. A key health issue is the huge increase in the rate of HIV infection, which has risen from 3 percent to 8 percent of the population in just six years.[4] In parts of Nairobi, over 30 percent of the adult working population is infected. The government's efforts to control the spread of HIV have so far suffered from a lack of adequate planning and implementation of measures to promote prevention, in addition, some methods are facing local resistance. The adverse consequences of the government's failures, in addition to human suffering, will be severe additional strains on the economy as workers fall ill and require medical services. Kenya also continues to experience periodic outbreaks of malaria and cholera, which have increased the strain on health resources, especially in late 1997 as a result of severe flooding in many parts of the country. Another major problem has been the lack of access to clean water, which, while nearly tripling in the past 20 years, is still less than 50 percent in rural areas. The government, in cooperation with the World Bank, has adopted a medium-term strategy that gives high priority to preventive health care and to improving service delivery in rural areas. As part of these reforms, the authorities will focus their efforts on major public health issues, such as preventing the spread of communicable diseases and improving access to adequate maternity and child care services. Emphasis is also being placed on improving district- and local-level health facilities.

[4] The Ministry of Health estimates that 200,000 persons died of AIDS in Kenya between 1984 and 1995.

Table 1. Kenya: Selected Social and Demographic Indicators[1]

Area	
Total land area (square kilometers)	582,600
Population and vital statistics	
Total population (1996, in millions)	27.4
Population growth rate (1980–96 average, in percent)	3.2
Urban population (percent of total)	27
Population density (1996, per square kilometer)	47.0
Population age structure (1995, in percent)	
0-14 years	46.0
15-64 years	51.1
65 and above	2.9
Crude birth rate (per thousand)	37
Crude death rate (per thousand)	10
Infant mortality rate (per thousand)	66
Life expectancy at birth (years)	59
Health and nutrition	
Access to safe water (in percent of population)	
Urban (1989)	61
Rural (1989)	21
Population per physician (in thousands) (1990)	10
Per capita supply of	
Calories (per day) (1989)	1,973
Proteins (grams per day) (1989)	55
Labor force	
Total employment outside small-scale rural agriculture (in millions)	3.4
Male (in percent)	77.1
Female (in percent)	22.9
Education	
Enrollment rates (in percent)	
Primary (1993)	91
Secondary (1993)	25
Pupil-teacher ratio (in percent)	
Primary (1996)	30
Secondary (1996)	16

Sources: World Bank STARS Data Base; Kenyan authorities and Republic of Kenya *Economic Survey*, 1997.

[1]Unless otherwise indicated, estimates refer to 1995, the latest available data.

Kenya: Sustainability of External Debt

The medium-term scenario underlying the analysis of the sustainability of external debt summarized in this annex was developed using the policy framework and key assumptions set out in Section IV in main text. Thus, after an initial period of recovery, GDP growth is expected to stabilize at 6 percent over the medium term. On the export side, recent investments in coffee and tea are expected to yield further gains in output, while nontraditional exports, including manufactured exports, are expected to enjoy robust growth. After an initial surge in imports related to energy sector investments, total import growth will stabilize. Aided by an initial recovery in tourism receipts, these trends would yield a narrowing of the current account deficit to 1 percent of GDP by 2003, and, with both imports and exports assumed to grow broadly in line with GDP, the current account deficit would remain close to this level thereafter. Gross disbursements of official lending would initially rise, in part reflecting energy sector investments, and then fall back somewhat and decline in real terms over the medium term. The scenario also assumes that inflows of foreign direct investment gather momentum, but these are conservatively estimated to rise only gradually to reach the equivalent of 0.6 percent of GDP by 2015. Gross reserves would initially increase to the equivalent of 5 months of import cover by 2005, but with increased diversification of the export base, reserve cover would be allowed to fall back slightly to 4.5 months of imports by 2015.

At the end of 1997, Kenya's external debt amounted to US$5.8 billion, or about 55 percent of GDP.[1] The present value of debt-service payments on this stock was equivalent of 135 percent of exports of goods and services, and debt-service payments in 1997 amounted to 22.1 percent of exports of goods. About 55 percent of this debt was owed to multilaterals, 38 percent to bilaterals, and the remaining 7 percent to commercial creditors.[2] Despite the

[1]External debt refers to all public and publicly guaranteed foreign currency debt, including debt to the IMF. Debt in the form of nonresident holdings of government domestic currency debt, the bulk of which is at maturities of one year or less, is not included.

[2]Debts to commercial creditors include arrears outstanding since 1993. Under a preliminary agreement reached with these creditors, the total stock of arrears of US$70.2 million, including penalties and late interest, was reduced by debt relief to US$49 million. A down payment of US$4 million will be due when the agreement becomes effective; the remaining US$45 million was rescheduled over ten years, with a three-year grace period and graduated repayments thereafter. Interest is payable at 3.5 percent for the first five years and at the London interbank offered rate (LIBOR) plus 13/16 percent thereafter. Although the arrears were principally denominated in French francs, the agreement also converted these into U.S. dollar obligations.

small share of debt to commercial creditors in the total debt stock, in 1998 these obligations are projected to account for 17 percent of total debt service due (see attached Table 1).

Over the next few years, Kenya will continue to face relatively high annual debt-service payments, as nonconcessional debt incurred in the second half of the 1980s and the early 1990s falls due. However, the retirement of these obligations and a continuation of the more prudent external debt management policy of the last three to four years should bring an overall improvement in the terms of Kenya's debt and, hence, a sharp reduction in debt-service payments. The debt-service ratio is projected to fall from 22 percent of exports of goods and services in 1997 to 17 percent in the year 2000 (see attached Table 2). Debt-service payments are projected to fall particularly sharply in 2002, bringing a decline in the debt-service ratio to 10 percent; by that year, Kenya will have repaid most of its nonconcessional debt to the World Bank, all of the arrears of US$500 million to Paris Club creditors that were rescheduled on nonconcessional terms in 1994, and the bulk of its debt to commercial creditors. Thereafter, the debt-service ratio would continue to decline to 7 percent in 2005 and to under 5 percent in 2010.

The impact of the improved terms on Kenya's loan portfolio is also reflected in a projected rapid decline in the present value of future debt-service payments from 135 percent of exports of goods and services in 1997 to 74 percent of exports of goods and services in 2005, and to 56 percent in 2010. A similar pattern is also evident in the ratio of the projected debt-service payments of the central government to government revenues. Assuming some streamlining in the operations of the government so that revenues decline to 25 percent of GDP over the medium term, the central government's external debt service payments would decline to 7 percent of revenues in 2005 from 20 percent in 1998.

This projected strong decline in Kenya's debt indicators points to a sharp reduction the debt burden over the medium term. Moreover, this debt profile serves to reaffirm the conclusion presented in SM/97/70 (2/28/97) that, with appropriate policies and prudent debt management, Kenya's debt burden is sustainable.

Table 1. Kenya: Public External Debt Service Obligations, 1998-2015

(In millions of U.S. dollars)

	1998	1999	2000	2001	2002	2003	2004	2005	2010	2015	Average 1996-2005	Average 2006-2015
Total debt service due	642.9	632.9	606.1	582.0	416.8	368.1	344.5	353.5	307.4	375.9	438.5	345.0
Principal	468.7	468.1	453.3	450.7	301.4	262.5	245.2	259.4	227.4	294.1	323.3	262.7
Interest	174.3	164.8	152.8	131.3	115.4	105.6	99.2	94.1	80.0	81.8	115.3	82.3
Debt service due on stock outstanding at end-1997	638.3	615.6	578.9	548.0	373.9	319.4	277.1	253.6	174.0	179.9	400.5	194.6
Principal	468.7	463.4	445.1	440.2	285.3	243.9	211.2	196.0	143.6	160.4	953.6	163.2
Multilateral creditors	209.0	205.7	180.4	153.2	125.1	114.7	103.2	95.6	81.6	98.4	484.3	88.5
IMF	62.7	59.7	44.2	25.5	19.3	19.3	13.1	6.9	0.0	0.0	56.2	0.3
World Bank	98.8	101.8	99.2	93.1	77.7	67.2	62.1	61.6	74.5	91.3	339.8	74.7
Other	47.5	44.2	37.0	34.6	28.1	28.2	28.0	27.1	7.1	7.1	88.3	13.4
Bilateral creditors	177.7	195.7	204.7	222.7	112.7	101.7	96.7	89.1	62.0	62.0	382.2	71.7
Paris Club	168.0	187.0	198.0	217.0	107.0	99.0	94.0	87.0	62.0	62.0	372.0	71.3
Other	9.7	8.7	6.7	5.7	5.7	2.7	2.7	2.1	0.0	0.0	10.2	0.4
Other creditors[1]	82.0	62.0	60.0	64.3	47.5	27.5	11.3	11.3	0.0	0.0	87.0	3.0
Interest	169.7	152.3	133.8	107.9	88.6	75.5	65.8	57.6	30.3	19.4	94.6	31.3
Multilateral creditors	64.5	56.4	50.0	40.1	35.1	29.5	26.9	22.3	13.9	10.6	36.1	14.1
IMF	3.3	3.0	2.7	2.6	2.5	2.3	2.3	2.2	0.0	0.0	2.3	0.2
World Bank	45.7	37.9	33.8	27.6	23.3	19.9	17.6	15.3	12.9	9.8	24.6	12.5
Other	15.5	15.5	13.5	9.9	9.3	7.3	6.9	4.9	1.0	0.8	9.2	1.4
Bilateral creditors	80.4	73.3	63.2	52.2	42.1	37.1	32.8	30.6	16.2	8.6	45.7	16.5
Paris Club	79.0	72.0	62.0	51.0	41.0	36.0	32.0	30.0	16.2	8.6	44.8	16.5
Other	1.4	1.3	1.2	1.2	1.1	1.1	0.8	0.6	0.0	0.0	1.0	0.0
Other creditors[1]	24.8	22.6	20.6	15.5	11.4	8.9	6.2	4.7	0.3	0.3	12.7	0.7
Debt service on disbursements from 1998	4.6	17.2	27.1	34.0	42.9	48.7	67.4	99.9	133.4	196.1	38.0	150.5
Principal	0.0	4.8	8.1	10.5	16.0	18.6	34.0	63.4	83.8	133.7	17.3	99.5
Interest	4.6	12.5	19.0	23.5	26.8	30.1	33.4	36.5	49.6	62.4	20.7	50.9

Sources: Kenyan authorities; and staff estimates and projections.

[1] Includes commercial banks' and suppliers' credit.

Table 2. Kenya: External Debt Indicators, 1998-2015

	1998	1999	2000	2001	2002	2003	2004	2005	2010	2015	Average 1998-2005	Average 2006-2015
						(In percent)						
In percent of exports of goods and services												
Debt outstanding	183.6	173.3	159.0	143.9	135.4	128.6	122.6	116.5	90.7	70.0	145.4	89.2
Debt service due	20.4	19.0	16.9	15.0	10.1	8.4	7.4	7.1	4.5	3.9	13.0	4.9
of which: multilaterals	8.7	8.0	6.6	5.2	4.3	3.9	3.7	3.8	2.8	2.6	5.5	3.0
In percent of GDP												
Debt outstanding	52.4	50.1	46.3	41.7	39.1	36.9	34.9	32.9	24.9	18.7	41.8	24.5
of which: multilaterals	30.1	30.0	28.9	27.3	26.2	25.1	24.1	23.0	17.7	12.3	26.8	17.1
Debt service due	5.8	5.5	4.9	4.4	2.9	2.4	2.1	2.0	1.2	1.1	3.7	1.3
of which: multilaterals	2.5	2.3	1.9	1.5	1.2	1.1	1.1	1.1	0.8	0.7	1.6	0.8
In percent of government tax revenue												
Public sector external debt service[1]	20.9	19.4	17.7	16.4	10.9	8.9	7.6	7.1	4.8	4.2	13.6	5.1
Excluding government guaranteed	16.7	15.5	14.5	13.5	8.5	7.0	6.3	6.1	4.6	3.9	11.0	4.7
In percent of government expenditure												
Public sector external debt service[1]	20.0	18.6	17.0	15.7	10.4	8.5	7.3	6.8	4.6	4.0	13.1	4.9
Excluding government guaranteed	16.0	14.9	13.9	13.0	8.2	6.8	6.1	5.9	4.4	3.8	10.6	4.5
						(In million U.S. dollars, unless otherwise specified)						
Stock of external debt by creditor	5,797	5,759	5,702	5,571	5,595	5,659	5,744	5,818	6,249	6,688	5,706	6,295
Multilateral creditors	3,333	3,446	3,558	3,642	3,750	3,861	3,970	4,061	4,442	4,406	3,703	4,376
Bilateral creditors	2,141	2,057	1,952	1,801	1,764	1,745	1,733	1,727	1,807	2,282	1,865	1,915
Other creditors[2]	322	256	192	128	80	53	41	30	0	0	138	3
Stock of external debt by debtor	5,797	5,759	5,702	5,571	5,595	5,659	5,744	5,818	6,249	6,688	5,706	6,295
Central government	5,047	5,024	5,007	4,940	5,017	5,125	5,245	5,352	5,859	6,208	5,095	5,873
Public enterprises (government guaranteed)[3]	523	500	470	431	396	373	361	362	390	480	427	409
Central bank	226	235	225	200	181	162	138	104	0	0	184	13
Present value of debt service[4]												
In million of U.S dollars	4,139	4,014	3,866	3,663	3,620	3,615	3,658	3,702	3,905	4,164	3,785	3,946
In percent of exports of goods and services	131	121	108	95	88	82	78	74	57	44	97	56
In percent of GDP	37	35	31	27	25	24	22	21	16	12	28	15

Sources: Kenyan authorities; and staff estimates and projections.

[1]Excludes IMF.

[2]Includes commercial banks' and suppliers' credit; includes stock and repayment of arrears according to the terms agreed with commercial banks.

[3]Calculated by using the currency specific commercial interest reference rate (CIRR) as the discount rate.

[4]All government-guaranteed external debt is owed by public enterprises. Calculated using currency-specific CIRRs.