

**FOR
AGENDA**

SM/08/276
Supplement 2

August 20, 2008

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Kenya—Staff Report for the 2008 Article IV Consultation—
Informational Annex**

The attached informational annex is being issued as a supplement to the staff report for the 2008 Article IV consultation with Kenya (SM/08/276, 8/20/08), which is tentatively scheduled for discussion on **Wednesday, September 10, 2008**. At the time of circulation of this paper to the Board, the Secretary's Department has not received a communication from the authorities of Kenya indicating whether or not they consent to the Fund's publication of this paper; such communication may be received after the authorities have had an opportunity to read the paper.

Questions may be referred to Mr. Yang (ext. 34339) and Ms. Masha (ext. 35939) in AFR.

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 Thursday, August 28, 2008; and to the African Development Bank, the Common Market for Eastern and Southern Africa, and the European Commission, following its consideration by the Executive Board.

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INTERNATIONAL MONETARY FUND

KENYA

Staff Report for the 2008 Article IV Consultation

Information Annex

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

Approved by Saul Lizondo and Anthony R. Boote

August 20, 2008

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I. Kenya: Relations with the Fund
(As of July 31, 2008)

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

| II. General Resources Account: | SDR million | Percent of quota |
|---|--------------------|------------------------------|
| Quota | 271.40 | 100.00 |
| Fund holdings of currency | 258.59 | 95.28 |
| Reserve position in Fund | 12.82 | 4.73 |
| III. SDR Department: | SDR million | Percent of allocation |
| Net cumulative allocation | 36.99 | 100.00 |
| Holdings | 1.96 | 5.29 |
| IV. Outstanding Purchases and Loans: | | Percent of quota |
| Poverty Reduction and Growth Facility (PRGF) arrangements | 166.80 | 61.46 |

V. Latest Financial Arrangements:

| | Approval | Expiration | Amount Approved | Amount Drawn |
|-------------|-------------|-------------|----------------------|----------------------|
| <u>Type</u> | <u>Date</u> | <u>Date</u> | <u>(SDR million)</u> | <u>(SDR million)</u> |
| PRGF | 11/21/03 | 11/20/07 | 150.00 | 150.00 |
| PRGF | 8/4/00 | 8/3/03 | 190.00 | 33.60 |
| ESAF | 4/26/96 | 4/25/99 | 149.55 | 24.93 |
| ESAF | 2/22/93 | 12/21/94 | 45.23 | 45.23 |
| ESAF | 5/15/89 | 3/31/93 | 261.40 | 216.17 |

The last three-year PRGF arrangement was approved on November 21, 2003, in the amount of SDR 175 million. Access was augmented to SDR 225 million at the time of the first review on December 20, 2004, to address the impact of a drought and higher oil prices. In light of a balance of payments improvement and at the request of the authorities, access was reduced to SDR 150 million at the time of the second review. The arrangement expired on November 20, 2007.

VI. Projected Obligations to Fund

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

| | <u>2008</u> | <u>2009</u> | <u>2010</u> | <u>2011</u> | <u>2012</u> |
|------------------|-------------|-------------|-------------|-------------|-------------|
| Principal | 3.36 | 11.72 | 16.72 | 15.00 | 18.75 |
| Charges/interest | <u>0.95</u> | <u>1.87</u> | <u>1.80</u> | <u>1.71</u> | <u>1.63</u> |
| Total | 4.31 | 13.59 | 18.52 | 16.71 | 20.38 |

VII. Implementation of HIPC Initiative: Not Applicable

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

IX. Safeguards Assessments

Under the Fund's safeguards assessment policy, the Central Bank of Kenya (CBK) was subject to a safeguards assessment with respect to the augmentation of access under the existing PRGF Arrangement approved on December 20, 2004. The assessment, completed on September 8, 2005, noted that the CBK has taken steps to implement the recommendations of the earlier safeguards assessments and proposed measures to address the remaining vulnerabilities. There was one outstanding issue from previous recommendations to modify the CBK act to state that the Bank will follow IFRS in its financial reporting framework, this is to be part of the audit program for follow up with CBK.

X. Exchange Arrangements

The currency of Kenya is the Kenyan shilling. Kenya has adopted a unitary exchange rate structure in which the exchange rate is determined in the interbank market. The official exchange rate, which is set at the previous day's average market rate, applies only to government and government-guaranteed external debt-service payments and to government imports for which there is a specific budget allocation. The exchange rate regime is a managed float, in which the U.S. dollar is the principal intervention currency. Kenya maintains an exchange system that is free of restrictions on the making of payments and

transfers for international current transactions. On August 18, 2008, the exchange rate was Kshs 67.42 =US\$1.00.

XI. Article IV Consultations

Upon expiration of the PRGF program in November 2007, Kenya has now reverted back to a standard 12-month cycle for Article IV consultations. The last Article IV consultation was concluded on April 11, 2007 (EBS/07/30).

XII. FSAP Participation

The joint IMF-World Bank Financial Sector Assessment Program (FSAP) missions took place in Nairobi in July and October, 2003. The staff report on the Financial Sector Stability Assessment (FSSA) was issued on November 29, 2004 (SM/04/401).

XIII. Technical Assistance

| Department | Purpose | Time of Delivery |
|------------|--|------------------------|
| MFD | Banking Sector Restructuring | January/February 2003 |
| FAD | World Bank/AFRITAC East PEM | |
| | Assessment and Action Plan (AAP) Mission | March 2003 |
| STA | Government Finance Statistics (GDDS) | September 2003 |
| FAD | AFRITAC East classifications mission | November 2003 |
| | (implementation follow up in June 2004, January, July and October 2005, and January 2006) | |
| MFD | Central Bank Accounting | February 2004 |
| STA | Government Finance Statistics (GDDS) | February 2004 |
| FAD | Customs Administration | March 2004 |
| FAD | Tax Administration | March/April 2004 |
| FAD | 2 nd World Bank/AFRITAC East PEM | |
| | Assessment and Action Plan (AAP) Mission | May 2004 |
| FAD | AFRITAC East Treasury Reforms mission | June 2004 |
| | (implementation follow up in July 2004, February-March 2005, September 2005, September 2006) | |
| MFD | Banking Supervision/Deposit Insurance /Legislation | July 2004 |
| FAD | AFRITAC East Aid Flow Tracking Mission | July 2004 |
| FAD | Revenue Administration | September/October 2004 |
| MFD | Deposit Insurance/Legislation (with LEG) | October 2004 |
| MFD | Public Debt Management and Monetary | November 2004 |

Policy Implementation

| | | |
|---------|--|------------------------|
| STA | ROSC Mission | January 2005 |
| MFD | Monetary Framework, Monetary Operations, and Banking Supervision | October 2005 |
| FAD | Revenue Administration | November 2005 |
| FAD | AFRITAC East Semi-Autonomous Agencies and EBFs/Fiscal Reporting Mission | March 2006 |
| FAD | HQ Mission: Strengthening the Budget and Reporting System | August 2006 |
| FAD | AFRITAC East TA: Revision of Public Finance Management Act | October/November 2006 |
| MCM | AFRITAC East TA: Review of Risk-Based Supervision Manual | November/December 2006 |
| MCM | Monetary Operations TA | January 2007 |
| STA | External Debt Statistics Workshop | February / March 2007 |
| FAD | AFRITAC East TA: Customs Administration | July 2007 |
| FAD | Fiscal ROSC | July 2007 |
| MCM | Payment Systems | February 2008 |
| STA | Consumer Price Statistics | March 2008 |
| MCM | Monetary Operations/Banking | April 2008 |
| STA | National Accounts | April 2008 |
| FAD | AFRITAC East TA: Budget | May 2008 |
| STA/MCM | Financial Soundness Indicators | June 2008 |
| FAD | Budgeting | July 2008 |
| MCM | Bond-Pricing Techniques Workshop | July 2008 |
| FAD | AFRITAC East TA: Regional PFM Advisor: Budget and Tax review | August 2008 |
| FAD | AFRITAC East TA: Customs Administration | |
| MCM | Payment Systems | August 2008 |
| STA | AFRITAC East TA: Monetary and Financial Statistics | August 2008 |

XIV. Resident Representative

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

II. Kenya: IMF-World Bank Joint Management Action Plan 2008 - 2009

| Title | Products /Activity | Provisional timing of mission (if relevant) | Expected delivery date |
|---|--|---|------------------------|
| I. Mutual Information on Relevant Work Program | | | |
| Bank Work Program | <u>A. Strategy and Analytical Work</u> | | |
| | Country Assistance Strategy (and Joint Portfolio Performance Review) | September/October 2008 | March 2009 |
| | Country Economic Memorandum (Growth Report) | June/July 2008 | August 2008 |
| | Poverty and Inequality Assessment | July 2008 | August 2008 |
| | Public Expenditure Notes | To be decided | March 2009 |
| | Staff Advisory Note on the Medium-Term (2008–2012) Strategy for National Transformation | No mission needed | |
| | Agricultural Policy Review | To be decided | December 2008 |
| | Land Reforms Study | | June 2009 |
| | Parliament's Role in Governance | | December 2008 |
| | Police Oversight Mechanisms | | December 2008 |
| | <u>B. Ongoing and New Projects</u> | | |
| | Several projects on public sector reforms including legal and judicial, capacity building, agriculture, natural resource management, transportation, energy, urban services, small and medium scale enterprises, education and health (including HIV/AIDS) | Several | Ongoing |
| IMF Work Program | <u>A. Missions</u> | | |
| | Article IV Consultation and Ex Post Assessment | June 23 – July 2 | September 2008 |
| | Possible discussion of an IMF-supported program | March 2009 | June 2009 |
| | <u>B. Analytical Work</u> | | |
| | Selected Issues Paper on External Stability and Competitiveness | No mission needed | September 2008 |
| | Selected Issues Paper on Public Debt Thresholds | No mission needed | September 2008 |
| | EAC Selected Issues Paper on Inflation and Exchange Rate Pass-Through in the EAC | No mission needed | |
| | EAC Selected Issues Paper on Capital Markets, Capital Accounts Integration and Monetary Policy in the EAC | No mission needed | |
| | <u>C. Technical Assistance</u> | | |
| | Budget (General) | August 2008 | October 2008 |
| | Tax Review | August 2008 | October 2008 |
| | Customs Administration (6) | August 2008 - 2009 | |
| | Kenya School of Monetary Study Workshop (3) | August - December 2008 | |
| | Organic Budget law | | |
| | Payment System Regulatory Interface | September 2008 | |

| Title | Products /Activity | Provisional timing of mission (if relevant) | Expected delivery date |
|--|---|--|-------------------------------|
| | Bank Supervision: Capital Adequacy rules | September 2008 | |
| | Government Finance Statistics | September 2008 | |
| | Balance of Payments Statistics | November 2008 | |
| | Monetary and Capital Markets | February 2009 | |
| II. Request for Work Program Inputs (as needed) | | | |
| Bank Request to Fund | Medium-term macro-economic and fiscal framework to inform Public Expenditure Notes | To share when requested | Ongoing |
| | Profile of government's contingent liabilities in non-financial public sector | To share data when available | 2008/09 |
| Fund Request to Bank | Food and fuel price increases – impact on poverty and growth, policy assessment and response. | To share work done for the Region; No Kenya-specific work planned. | Ongoing |
| | Investment needs and their implications for development spending; quality of spending | To share work being done in response to specific requests. | Ongoing |
| | MTEF for growth and equity and PFM issues relating to key social sectors | Some analytical work already shared. Other work as described in Bank Work Program will be made available once completed. | Ongoing |
| | Financial sector development issues | Work in partnership with other donors such as DFID will be shared. | Ongoing |
| | Regional trade policy in the context of the EAC, COMESA and EPA | To share TA/Analytical work being prepared for the EAC secretariat. | Ongoing |
| III. Agreement on Joint Products | | | |
| Joint products | Public and External Debt Sustainability Analysis | | September 2008 |

III. KENYA: KEY STATISTICAL ISSUES

1. Data provision has some shortcomings, but is broadly adequate for surveillance and program monitoring. Weaknesses in macroeconomic statistics reflect organizational and skill shortcomings, and inadequate resources. In line with the new Statistics Law, the government established the autonomous Kenya National Bureau of Statistics (KNBS) in 2007 to replace the Central Bureau of Statistics (CBS).
2. The Report on the Observance of Standards and Codes—Data Module (IMF Country Report No. 05/388) published on October 31, 2005 stated that methodological soundness is uneven across datasets and significant improvement is required in government finance statistics and national accounts. Accuracy and reliability do not receive adequate attention in any of the datasets, while accessibility of the disseminated macroeconomic statistics are adequate, except for the balance of payments statistics.
3. Kenya participates in the Fund's General Data Dissemination System (GDDS) and the GDDS project for Anglophone Africa. Metadata and detailed plans for improving the data over the short and medium term are posted on the Fund's Dissemination Standards Bulletin Board (DSBB). Kenya has received Fund technical assistance. Further assessment of capacity building requirements has been undertaken by the AFRITAC East Statistical Advisor.
4. Monetary, exchange rate, and some external data are published on a monthly and biannual basis by the KNBS in its *Monthly Economic Review*. Core financial data are also made available to the Fund on a regular basis. A detailed account of various sectoral activities and the corresponding statistical data are published annually by the KNBS in its *Economic Survey*.

National accounts

5. Data quality has deteriorated significantly because of budgetary and staff constraints at the KNBS. GDP is believed to be significantly underestimated, as important and increasing parts of the economy, such as the informal sector, nonagriculture subsistence, horticulture, and self-employed professionals are not properly covered. An STA peripatetic advisor assisted the authorities in rebasing the national accounts estimates at constant 2001 prices and compiling institutional accounts for the general government sector. As a result, national accounts estimates for the years 1996–2005 in current and constant (2001) prices have been published. Quarterly national accounts are being developed with the assistance of the AFRITAC East. Quarterly GDP estimates are now published.

Prices and production

6. In early 2002, the KNBS (then CBS) began publication of a new national CPI (covering 13 urban towns), with 1997 as reference year and outdated weights and basket of items derived from the 1993-94 Household Budget Survey (HBS). Indices are produced for lower and middle/upper income groups in Nairobi and other cities. The index is compiled and published on a timely basis. No producer, export, or import price indices are produced. In March 2008, a TA mission assisted the authorities in identifying the methodological issues relating to the measurement of inflation. The current methodology of aggregating prices at the elementary level was found to impart a substantial upward bias on CPI measurement. In line with STA recommendations, the KNBS plans to switch to a formula consistent with international best practices later in 2008, together with a rebasing and reweighing of the CPI basket.

Government finance statistics (GFS)

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

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

9. The country reports data to STA for the budgetary central government for inclusion in the *GFS Yearbook*, albeit with a significant lag—the last data reported were for the year ending June 2005. The KNBS compiles the aggregate annual GFS revenue and expenditure data for the budgetary central government based on detailed data in the reports of the

Controller and Auditor General. The data submitted for publication in the *2007 GFS Yearbook* was reported in *GFSM 2001* format, using bridge tables developed by the technical assistance missions. The recent steps taken in the migration to *GFSM 2001* may help reduce the significant differences between KNBS data and the data compiled by the MOF and reported to AFR for surveillance and program monitoring purposes. Monthly and quarterly data are regularly reported for inclusion in the IFS.

Monetary statistics

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

External sector statistics

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

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

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

14. To help address these issues, in 2006 a technical assistance mission recommended introducing a foreign investment survey, enhancing the foreign exchange statistics survey, and using a common methodology, including for estimations, in the use of available data in the KNBS and CBK. In 2007, a DFID funded enterprise survey failed to materialize. There are plans to conduct a foreign investment survey in 2008, which planned DFID-funded and STA external sector missions will support.

15. Kenya does not report international investment position statistics to STA.

KENYA: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
(as of August 19, 2008)

| | Date of latest observation | Date received | Frequency of Data ⁶ | Frequency of Reporting ⁶ | Frequency of publication ⁶ | Memo Items ⁷ | |
|---|----------------------------|---------------|--------------------------------|-------------------------------------|---------------------------------------|--|--|
| | | | | | | Data Quality – Methodological soundness ⁸ | Data Quality – Accuracy and reliability ⁹ |
| Exchange Rates | 8/18/08 | 8/18/08 | D | D | M | | |
| International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹ | 8/18/08 | 8/18/08 | D | D | M | | |
| Reserve/Base Money | 8/18/08 | 8/18/08 | D | D | M | LO, LO, LO, LO | LO, LO, O, O, NO |
| Broad Money | 6/30/08 | 7/15/08 | M | M | M | | |
| Central Bank Balance Sheet | 8/18/08 | 8/18/08 | D | D | M | | |
| Consolidated Balance Sheet of the Banking System | 6/30/08 | 7/15/08 | M | M | M | | |
| Interest Rates ² | 6/30/08 | 7/20/08 | D | D | M | | |
| Consumer Price Index | 6/30/08 | 7/20/08 | M | M | M | | |
| Revenue, Expenditure, Balance and Composition of Financing ³ – General Government ⁴ | 6/2008 | 7/2008 | NA | NA | NA | LNO, LNO, LNO, LO | LNO, LO, LO, LO, NO |
| Revenue, Expenditure, Balance and Composition of Financing ³ – Central Government | 6/2008 | 7/2008 | Q | I | Q | | |
| Stocks of Central Government and Central Government-Guaranteed Debt ⁵ | 6/30/08 | 7/15/08 | Q | Q | Q | | |
| External Current Account Balance | December 2007 | 6/08 | M | A | A | O, LO, O, LO | LNO, LO, LO, LO, LO |
| Exports and Imports of Goods and Services | December 2007 | 6/08 | M | Q | A | | |
| GDP/GNP | 2008 Q1 | 6/07 | M | A | A | O, LNO, LNO, LO | LNO, LO, LNO, LO, LNO |
| Gross External Debt | March 2008 | 6/07 | M | Q | Q | | |

¹ Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

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

³ Foreign, domestic bank, and domestic nonbank financing.

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

⁵ Including currency and maturity composition.

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

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

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

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