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Kenya: First Review Under the Three-Year Arrangement Under the Extended Credit Facility, Request for Waivers and Modification of Performance Criteria—Staff Report; Press Release

In the context of the first review under the three-year arrangement under the Extended Credit Facility, request for waivers and modification of performance criteria, the following documents have been released and are included in this package:

- The staff report for the First Review Under the Three-Year Arrangement Under the Extended Credit Facility, Request for Waivers and Modification of Performance Criteria, prepared by a staff team of the IMF, following discussions that ended on May 24, 2011, with the officials of Kenya on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 15, 2011. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A Press Release summarizing the views of the Executive Board.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Kenya*
Technical Memorandum of Understanding*

*Also included in Staff Report

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

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KENYA

First Review Under the Three-Year Arrangement Under the Extended Credit Facility, Request for Waivers and Modification of Performance Criteria

Prepared by the African Department
(In Consultation with Other Departments)

Approved by Saul Lizondo (AFR) and Dominique Desruelle (SPR)

June 15, 2011

- **Background.** Kenya's growth momentum continues, but adverse weather conditions in recent months hit agricultural output. Inflation accelerated in recent months as a result of the global increase in food and fuel prices, domestic demand pressures, and the impact of a drought on agricultural prices. Strong private investment fueled by high credit growth combined with a deterioration of the terms of trade led to a widening of the external current account deficit that has put pressure on the Kenya Shilling in recent weeks. The fiscal primary balance was above target mainly as a result of the delay in implementing new investment projects and savings in current outlays.

- **Program**. Policies remained in line with the program. March fiscal targets and structural benchmarks were all met, but the March targets on net international reserves (NIR) and net domestic assets (NDA) were missed by small margins.

- **Discussions**. The team comprised Messrs. Fanizza (head), Morales, Milkov, and Ms. Raei (all AFR) and Mr. Liu (SPR). Ms. Hoare (FIN) joined the first part of the mission to clarify safeguards-assessment-related data issues. Discussions were held in Nairobi during May 11−24, 2011. Mr. Gudmundsson (Resident Representative) participated in the discussions, and Ms. Rose Ngugi from the Executive Director's office joined the mission. The mission met Prime Minister Odinga, Deputy Prime Minister and Minister of Finance Kenyatta, Central Bank Governor Ndung'u, the Parliament's Finance and Budget Committees, other senior officials, representatives of the private sector including financial institutions, and the donor community.

- **Staff views**. The staff recommends completion of the review, waivers for performance criteria on NIR and NDA targets for end-March 2011, and modification of all PCs and indicative targets for the next 12 months to fit the balance of payments outlook and the 2011/12 fiscal budget. The CBK has made progress in addressing concerns raised by the safeguards assessment.

- **Publication**. The authorities have consented to publication of the staff report and Letter of Intent.

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GLOSSARY

CBK	Central Bank of Kenya
CPI	Consumer price index
CPIA	Country Policy and Institutional Assessment
ECF	Extended Credit Facility
IFMIS	Integrated Financial Management and Information System
KNBS	Kenya National Bureau of Statistics
KRA	Kenya Revenue Authority
Ksh	Kenyan Shilling
MTDS	Medium-Term Debt Management Strategy
MTP	Medium-Term Plan
NDA	Net domestic assets
NIR	Net international reserves
NPV	Net present value
ODC	Other depository corporation
PC	Performance criteria
PFM	Public financial management
PPG	Public and publicly guaranteed
PPP	Public Private Partnership
SDR	Special Drawing Rights
SSA	Sub-Saharan Africa
TMU	Technical memorandum of understanding
VAT	Value-added tax
WB	World Bank

Executive Summary

Kenya's economic recovery is under way. At 5.6 percent in 2010, GDP growth was broad based, supported by both private and public investment. Strong growth continues in 2011, with the exception of the agricultural sector, expected to decelerate significantly as a result of weather disturbances in the first months of the year. The outlook for private investment remains positive, with new foreign investors reinforcing the upward trend in capital expenditure by firms already operating in the country. However, recent inflationary pressures and insufficient rains present downside risks that will need to be promptly addressed.

Performance under the program in the first quarter of 2011 was satisfactory. Budget execution was strong and the direction of monetary policy remained appropriate. After a hiatus explained by uncertainties surrounding interest rate and exchange rate volatility, the central bank raised the policy rate and suspended the injection of liquidity via reverse repos. The central bank has also resumed its plan to build up international reserves over time with the view to reach coverage of 4 months of imports of goods and services within the program period. Fiscal performance has been stronger than envisaged in the program. The 2011/12 budget proposal maintains a focus on fiscal consolidation despite demands arising from the implementation of the constitution and elections preparation.

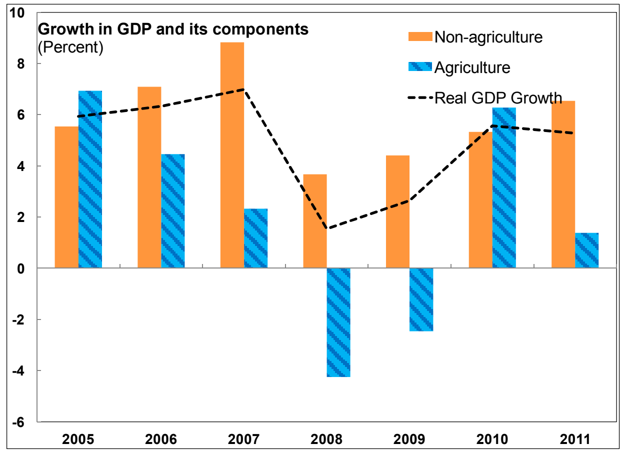
Demand pressures have started to emerge. The surge in global food and oil prices together with a drought that hit the Northeastern part of the country has boosted inflation, which reached 13 percent by May 2011. However, domestic factors have also played a role, as illustrated by an acceleration of credit growth to 27 percent in April, a pickup in imports of capital goods, a significant widening of the external current account, and escalating real estate prices. Inflation expectations are on the rise and combined with balance of payments pressures have contributed to the ongoing weakening of the shilling. Pressures to increase fiscal expenditure in the run up to elections in December 2012 have so far been resisted, as reflected in the draft 2011/12 budget.

The authorities have agreed to step up measures to contain domestic demand. The authorities agreed to stand firm and contain pressures to increase fiscal spending and to cut non-priority current expenditure to maintain the primary fiscal deficit at 2.7 percent in the 2011/12 fiscal year. The central bank has committed to absorb liquidity as needed to keep NDAs in line with the program and bring down inflation from 12 percent currently to below 6 percent at the end of the fiscal year, while resuming the buildup of international reserves.

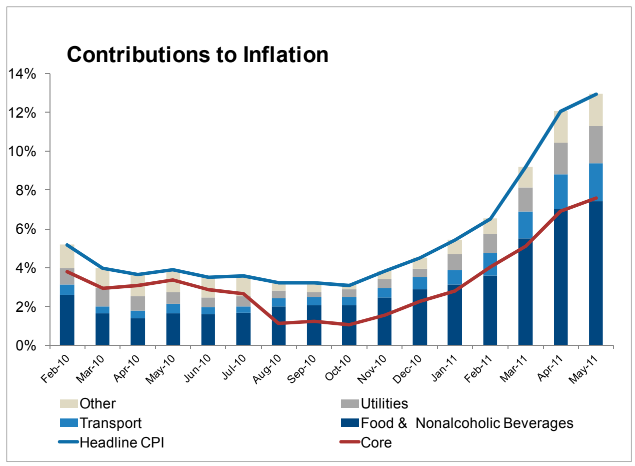
Progress in structural reforms continues. New legislation introduces new capabilities of the central bank to put in place corrective measures in advance of the emergence of bank solvency problems. The recently initiated process of demutualization of the stock exchange will promote an environment of increased transparency and improved governance in capital markets. On fiscal reform, the implementation of the IFMIS has accelerated, preparing the ground for the introduction of a Public Finance Management Law that will strengthen expenditure controls.

I. Macroeconomic Outlook and Program Implementation

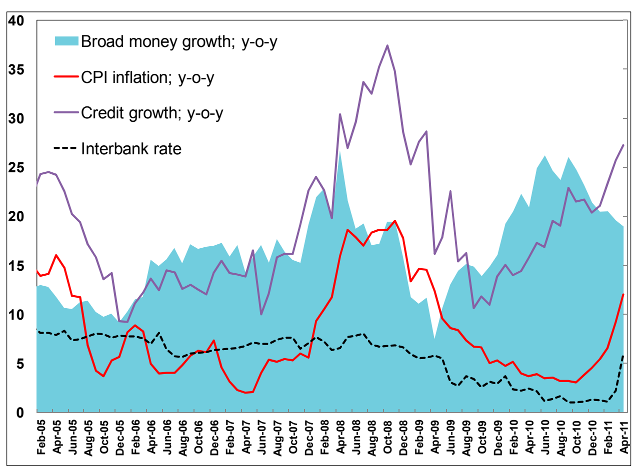
1. **Kenya's economic recovery continues, but inflation has become a concern.** Investment is picking up, spurred by high credit growth and government spending in infrastructure. The surge in global food and oil prices together with a drought that hit the Northeastern part of the country has boosted inflation. The central bank raised the policy rate in March to curb currency depreciation. Pressures on the Kenya Shilling resumed in recent weeks because of the weakening of the external position as a result of higher capital goods imports and the spike in fuel prices:



- **We project GDP growth at 5.7 percent for 2011/12, up from 5.4 percent in 2010/11.** A rebound in regional and global demand supports tourism, and a dynamic private sector has spurred investment and an acceleration of growth across all non-agricultural sectors. Agriculture growth is expected to decelerate sharply because of delayed rains during the main rainy season (April-June).

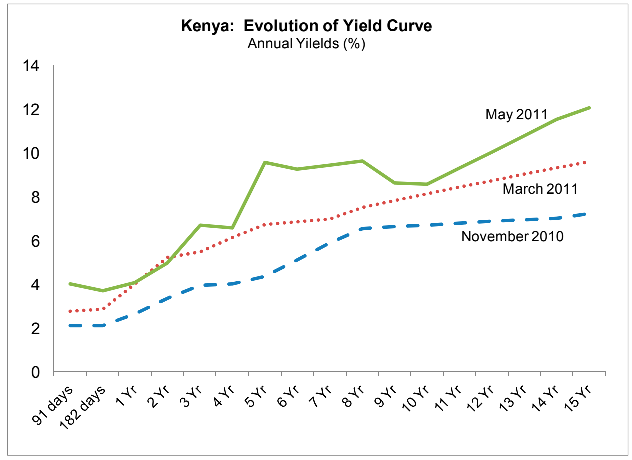


- **Inflation surged to 13 percent in May, and at 7.5 percent core inflation surpassed the high end of CBK target range (5 ± 2 percent).[1]** Assuming an increasingly tight monetary policy stance to limit the second-round effects of food and fuel inflation, a partial reversal of food price hikes, and oil price trends in line with WEO projections, we forecast headline inflation at 8-9 percent at end-2011.



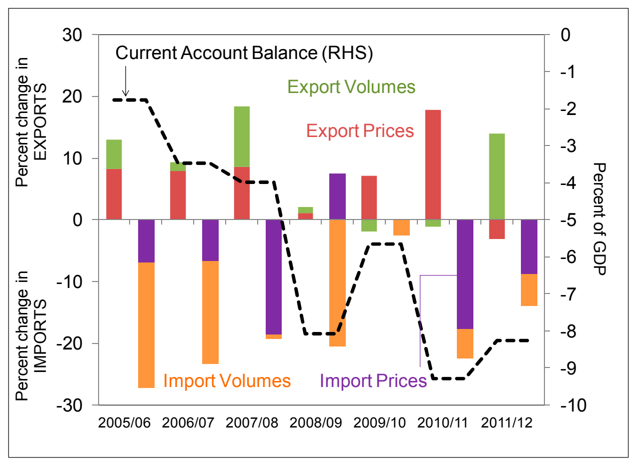
[1] Core inflation is defined as inflation excluding food and energy from the consumer basket.

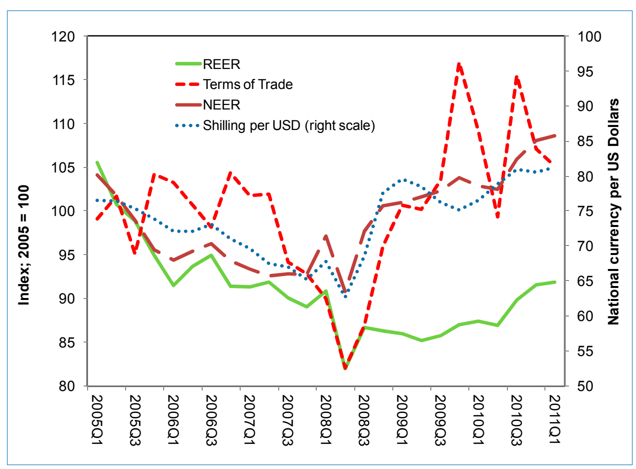
- **High credit growth has narrowed the liquidity slack in money markets.** Thus, interbank interest rates hovered around 6 percent in recent weeks from below 2 percent in January 2011. CBK's NDA declined in the first quarter of 2011, but remained slightly above the program ceiling by KSh 7.4 billion (0.6 percent of M3). The widespread increase in loan-to-deposit ratios across banks has injected dynamism in the interbank market.



- **Inflationary expectations have increased, as shown by the shift in the yield curve.** The yield curve has also flattened at the short end signaling tightened monetary conditions.

- **CBK's NIR in March 2011 were below the program floor by US$187 million.** The breach reflected largely a base-effect measurement issue because the decline in the CBK NIR (US$51 million) during the first quarter of 2011 was lower than that envisaged under the program (US$55 million).[2] We expect the current account deficit to remain large, at about 8 percent of GDP in 2011/12 (9 percent of GDP in 2010/11), as investment will remain strong and food and fuel prices will remain high. Financing is envisaged to come from foreign direct investment, capital goods suppliers and short-term capital inflows attracted by higher interest rates as the central bank tightens monetary policy.

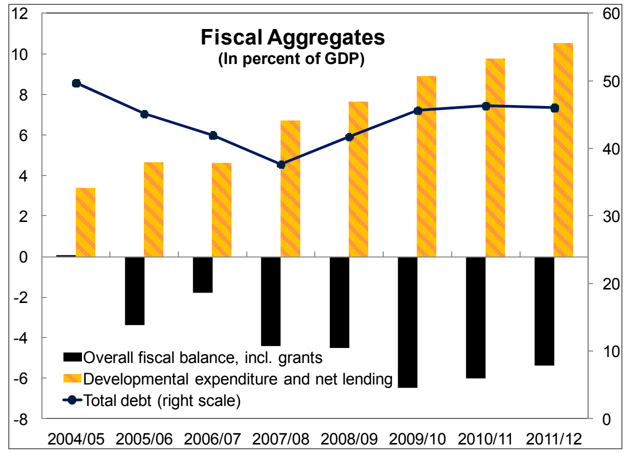




- **Shilling depreciation reflects strong domestic demand and the sharp increase in oil prices.** In the year up to April 2011 the NEER depreciated by 10 percent. Recently, the shilling has firmed up as a response to the CBK's monetary tightening.

[2] Authorities and staff NIR projections for December 2010 were based on very favorable second and third quarter outcomes (NIR increased by US$300 million in that period)

- **The floor on the primary fiscal balance (performance criterion) was met comfortably**. Development expenditures remained below originally projected, but have continuously increased. We expect the primary fiscal deficit to reach 3.4 percent of GDP in FY 2010/11, somewhat lower than projected by the program and below the previous year outcome. The public debt-GDP ratio is expected to start declining in 2011/12.



2. **Structural benchmarks on expanding central bank capabilities to take prompt corrective action, and introducing demutualization of the stock exchange were met as scheduled**. The new finance act allows the central bank to put in place corrective measures well in advance of the emergence of solvency problems. Also, the Attorney General judged that legislation passed in 2009 enabled the Capital Markets Authority (CMA) to start the process of demutualization without the need to introduce a new law. The CMA promptly introduced guidelines to increase transparency and improve governance. The World Bank has recently raised upwards Kenya's CPIA rating.

II. Policy Issues

3. **The authorities' program has so far effectively struck a balance between fiscal discipline, infrastructure spending, and maintained macroeconomic stability, but policies now face new challenges.** Monetary policy needs to ensure that higher growth rates are sustainable by curbing inflation and balance of payments pressures, and by enhancing the central bank international reserve buffer. Fiscal adjustment should continue, incorporating commitments under the new constitution and providing resources for the preparation of elections in December 2012. In order to lessen vulnerabilities further, fiscal consolidation should remain a priority to reduce the debt burden below 45 percent of GDP by the end of the program period. Reforms should continue being implemented to (a) improve public finance management, (b) revamp the VAT, (c) maintain a sound financial system, and (d) improve transparency and governance in capital markets.

4. **Adverse shocks have played a role in widening the current account deficit, raising inflation, and slowing down growth, but domestic demand pressures have also mounted.** Domestic demand has been mainly driven by private sector credit expansion, as improved government savings have offset the increase in public investment in 2010/11:

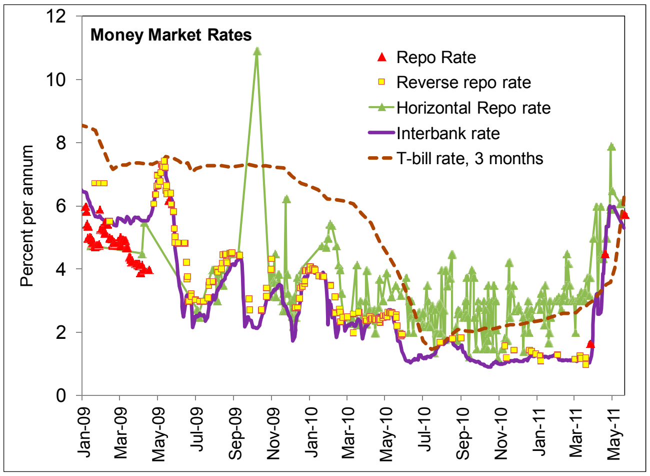
- The deterioration of the current account balance in the first three quarters of 2010/11 reflects roughly an impact of the same proportion of higher prices for oil and chemicals and a surge in demand for manufactured and capital goods.

- Food and fuel price hikes explain most of the recent surge in inflation, but even excluding these items from the CPI inflation has accelerated. Inflation excluding food, fuel, and transport reached 7.2 percent in the twelve months up to May 2011–more than double that of May 2010.

- An acceleration in private-sector credit growth (27 percent in April 2011) has fueled domestic demand and supported buoyant non-agricultural activity. Credit has grown faster than average for real estate, consumer durables and domestic trade–components that are highly correlated with domestic demand.

A. Monetary Tightening to Reign in Inflationary Expectations

5. **Higher inflation makes it urgent to move to a forward-looking monetary policy framework with a view to anchoring inflation expectations.** Some Kenya-specific factors explain higher inflation in recent months, but inflation expectations are clearly on the rise (Box 1). Actions underway to bring NDA growth in line with the program include:



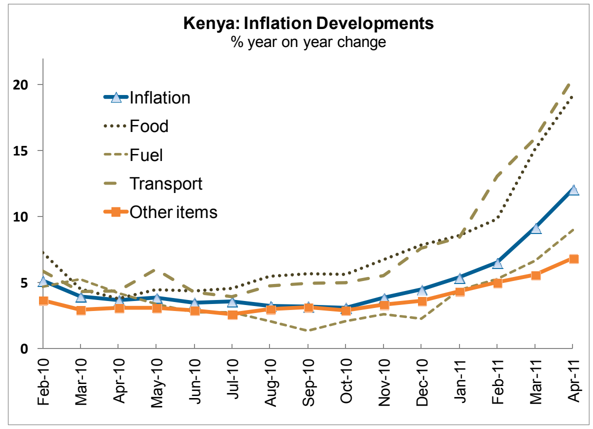
- **Scaling up liquidity absorption.** This requires that the CBK accepts higher interest rates for its repo operations. The CBK also needs to raise its overnight lending rate that now constitutes a cap for interbank interest rates, which currently lie right below the CBK overnight lending rate. In line with program discussions, on May 31, 2011 the CBK Monetary Policy Committee increased the overnight lending rate further by 25 basis points, and increased reserve requirements to 4.75 percent of liabilities from 4.5 percent. The CBK has also intensified repo operations at higher interest rates.

- **The central government needs to take steps to repay overdraft credit obligations to the central bank before the end of the current fiscal year.** In the context of closer monetary-fiscal coordination, the authorities agreed to repay in full overdraft liabilities and minimize the use of the central bank overdraft facility to the central government in the coming fiscal years to facilitate monetary management.

- **The CBK needs to improve its liquidity forecasting framework.** In particular, the CBK should revise the assumptions underlying declining velocity of circulation, originally justified by the pace of financial deepening, since recent information shows that the process may have come to a halt in an environment of rising inflation.

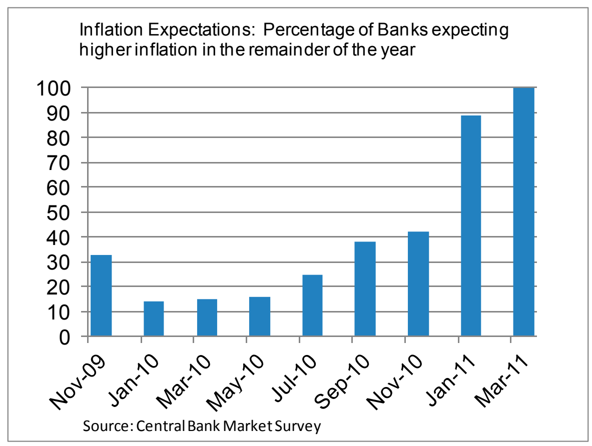
Box 1. Inflation in Kenya: Recent Developments and Outlook

After being subdued in 2010, inflation has picked up as a result of global factors, supply constraints and domestic demand pressures. Non-food and non-fuel inflation have been on steady rise since February 2010. Food and transport inflation reached 20 percent in April 2011:



Global factors and supply constraints

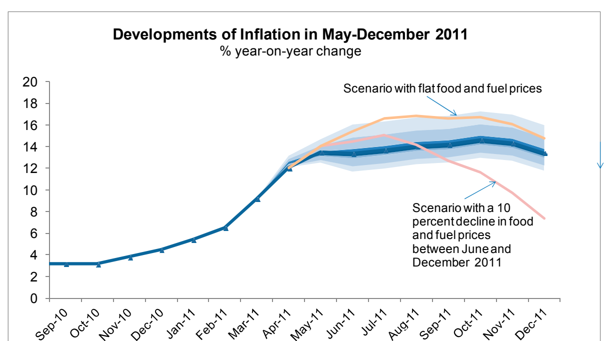
- As a net importer of staple grains such as maize, Kenya was hit by a hike in the price of grain in world markets. In addition, below-normal rainfall in 2011 has reduced the stock of domestically produced maize and other agricultural products. This has heightened expectations of shortage leading to further price pressures.



- The increase in domestic fuel prices is mainly the result of global developments. However, local factors such as deficiencies in the wholesale, storage and the distribution network have created additional costs, delays, and shortages. High fuel and transport costs have also increased the fuel-component of food prices.

Demand pressures and inflation expectations

- **Non-fuel and non-food prices have been steadily rising, pointing to broader demand pressures and second-round effects**. The year-on-year inflation of a basket excluding food, fuel and transport stood at 7.2 percent by May 2011. A Market Survey conducted by CBK shows escalating expectations of higher inflation, which is exemplified in wage increase pressures and an upward shift of the yield curve.



Fan chart of the probability distribution of inflation is constructed from an estimation of an ARIMA regression of overall CPI. The colored ranges represent confidence intervals from 95% to 5%. The two scenarios are based on various assumptions for the movement of food and fuel CPI indices between June and December 2011.

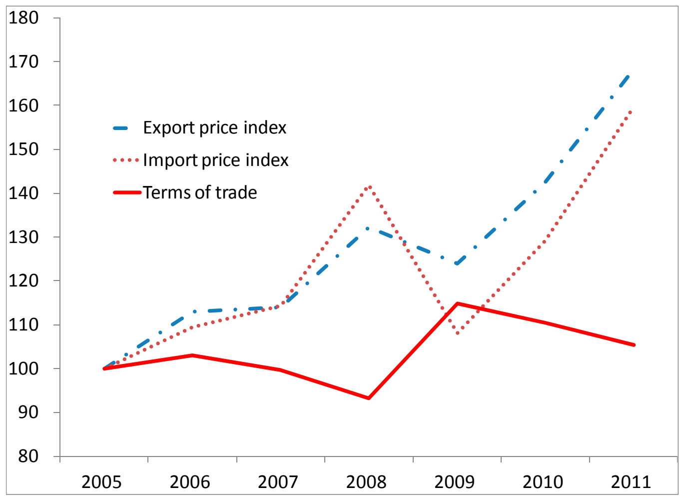
- **If the expectations are not contained through monetary tightening, inflation is unlikely to come down soon.** Based on alternative passive scenarios for food and fuel price trends, inflation by end 2011 is estimated to be above 12 percent in a neutral scenario, and 7 percent under an optimistic scenario of a 10 percent decline in food and fuel prices. Tightening policies agreed under the program may keep inflation at 8-9 percent at end-2011.

B. Boosting International Reserve Buffer over the Medium-Term

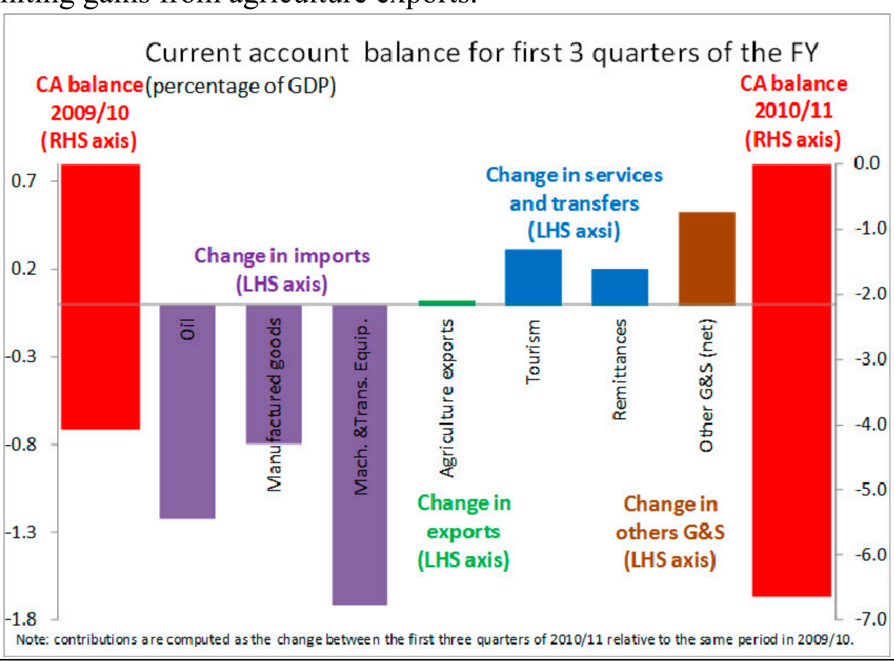
6. **Domestic demand pressures have played a major role in the widening of the external current account deficit** (see Box 2). Pressures from domestic demand combined with higher import prices have more than offset higher foreign exchange earnings from traditional and non-traditional sources. Therefore, demand policies should be effective in narrowing the current account deficit over time.

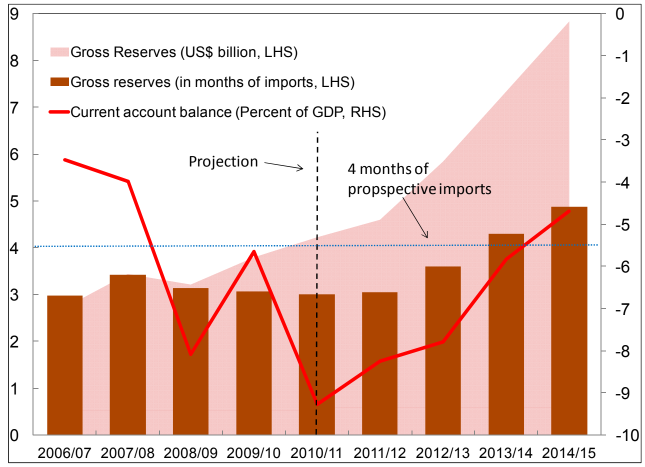
Box 2. Recent Developments of the External Sector

Terms of trade have continued deteriorating from their 2009 peak. The increases in fuel and food prices have driven import prices beyond the peak observed in 2008. Export prices have benefitted from higher global commodity prices, but have increased at a slower pace than that of imports. Moreover, the increase in import prices has had a much larger impact on the current account (CA) balance because imports are currently two times the size of exports.



However, strong domestic demand has also played a major role in the widening of the CA deficit. While higher fuel prices are driving up the import bill, strong domestic demand for capital imports has boosted the CA deficit. Meanwhile, tourism and remittance receipts continue to rise on the back of the global recovery. Despite higher export prices, insufficient rainfall is limiting gains from agriculture exports.





7. **The CBK aims at increasing its international reserve coverage to over 4 months of prospective imports in the medium term.** The pace of reserve accumulation in the near term will reflect the new balance-of-payments outlook, in particular the growing import bill. To avoid undue currency depreciation pressures, reserve accumulation should take place in a framework of overall tightening of monetary policy.

C. Monitoring Eemerging Financial Risks

8. **The financial system remains sound.** Capital adequacy ratios have continuously improved over the last three years up to February 2011, and non-performing loans show a steady decline. Most banks have improved their profitability in 2010. Leading domestic financial institutions continue expanding to neighbor countries, chiefly Uganda, Tanzania, and Sudan.

9. **The Banking Supervision Department has made progress in assessing risks related to financial inclusion.** Banking Supervision assesses the delivery channels for agency banking, focusing on operational risk. It monitors use of the credit information bureau by banks, which should mitigate credit risk. Also, two pilot exercises of consolidated supervision have been carried out. Moreover, Banking Supervision is updating its CAMELS rating and preparing guidelines for financial institutions on the application of prompt corrective action.[3]

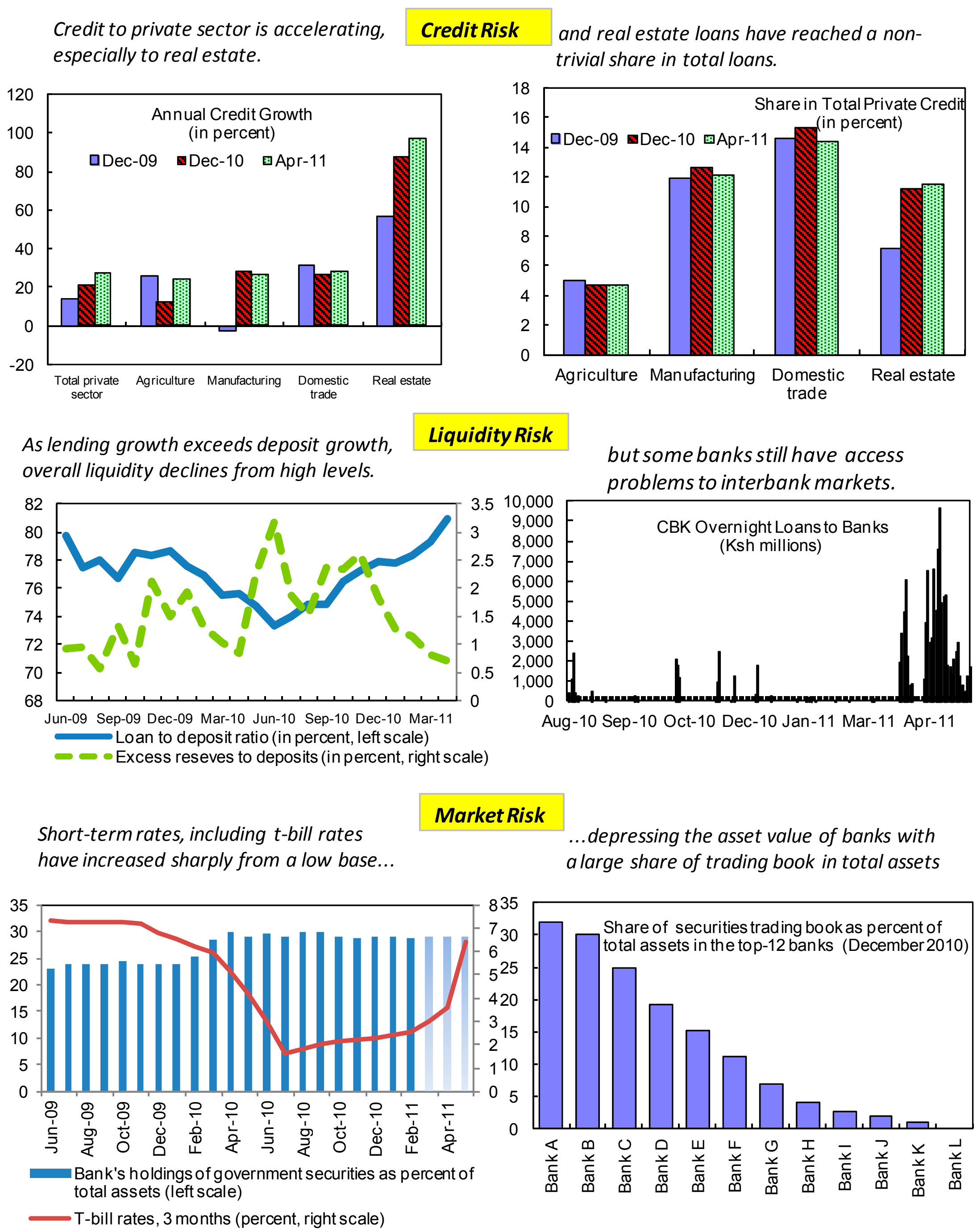
10. **Banking Supervision intends to monitor more closely financial risks heightened by demand pressures (See Figure 1).** High credit growth, in particular real estate loans have become an increasingly important source of risk. Steps have been taken to strengthen the micro and macro stress-testing capabilities of the central bank. Also, the CBK conducted a study jointly with the World Bank assessing the mortgage loan market, including potential risks. Regarding liquidity risk Banking Supervision will be vigilant about frequent resort to the overnight window by specific banks, which may disguise fundamental problems. Also, banking supervision has enhanced monitoring of compliance with mark-to-market rules and the impact of interest rate swings on profitability of banks with a high share of tradable securities in total assets in an environment of increasing interest rates and sizable securities market

The CMA has made rapid progress to improve transparency and governance following the launch of the demutualization of the stock exchange. Self-regulation and trading rules will be introduced in coming months. The CMA is actively enforcing higher minimum capital requirements. New capital requirements for investment banks have been increased

[3] The CAMELS rating allows to assess capital adequacy, asset quality, management, earnings, liquidity and sensitivity to market risk.

significantly, to Sh250 million (US$3 million) from Sh 30 million, and for brokers to Sh 50 million (US$0.6 million) from Sh 5 million.

Figure 1. Kenya: Financial Risks, 2011



Source: Central bank, banks' balance sheets and staff calculations.

D. Gradual Fiscal Consolidation

11. **Fiscal consolidation has taken hold during FY 2010/11.** While revenues have generally been in line with the targets, capital outlays have been lower than projected because of delays in starting new projects. Some of the resulting fiscal space was reallocated towards providing additional resources for implementation of the constitution through the supplementary budget released in March 2011.

12. **The proposed 2011/12 budget is in line with the program consolidation objectives:**

- **The authorities aim at a fiscal primary deficit of 2.7 percent of GDP (down from 3.4 percent in 2010/11), consistent with program objectives**, despite demands arising from (a) the implementation of the constitution and elections preparation; and (b) the need to cushion the impact of higher food and fuel prices on the poor. Total revenue is projected to stay at 2010/11 levels at 24.8 percent of GDP, with total expenditure decreasing to 31.5 percent of GDP, 0.5 percent below the 2010/2011 estimated level. Current expenditures are expected to decline to 20.7 percent of GDP, about 1 percent of GDP down from 2010/11.

- **The budget includes elections-related expenditure (0.3 percent of GDP) and 1 percent of GDP reserved for contingencies associated with the implementation of the constitution**. One-off outlays are offset by a lower-than-expected wage bill and by other current expenditure savings obtained mainly from stricter expenditure control, including through the early implementation of a new government payment system (g-pay).

- **To counter the rapid increase in fuel prices, the government has lowered taxes on kerosene and diesel.** Moreover, the government removed tariffs on maize, and it has proposed to Parliament the elimination of excise taxes on kerosene. Preliminary estimates show that budget impact of these measures will be small (Box 3). The government has expanded famine relief to cover 4 million people, up from 2.4 million currently. It has also rolled out a comprehensive mobile-phone-based targeted cash transfer program to start in July, with the view of incorporating this scheme into the permanent government's social protection program. The reduction of excise and import taxes on kerosene and food staples is targeted to the vulnerable part of the population.

13. **The authorities have made good progress in preparing fiscal reforms that are key for the success of the program:**

- **The government will present a draft Public Finance Management Law (PFM) to the Commission on the Implementation of the Constitution by June 2011,** prepared with technical assistance from FAD and LEG. A complementary strategy for implementing an Integrated Financial Management and Information System (IFMIS) is in place since the beginning of the year, focusing on business process rather than spending unit modules. The authorities believe that the PFM law will help to reduce the scope for corruption.

- **The government plans to introduce VAT legislation during 2011/12 seeking to improve administration and compliance**. Preparation is well under way, and implementation is envisaged to take place in the forthcoming fiscal year. A Tax Reform Commission will be soon appointed to undertake a comprehensive review of tax policy.

14. **Debt management has remained consistent with Kenya's medium-term debt strategy.** The Debt Management Office (DMO) has maintained its policy to provide guarantees only for energy projects (still in the pipeline). A draft PPP Act envisages the review of eventual contingency liabilities arising in PPP contracts by the DMO.

Box 3. Kenya: Fiscal Measures to Offset the Impact of Food and Fuel Price Increases on Household Income

The recent sharp rise in international commodity prices and the drought that hit parts of the country have led to a rapid increase in domestic food and fuel prices. In particular, prices on fuel products used by a wide swath of the population, such as kerosene and diesel have increased by an average of 30 percent. Prices of basic food staples such as maize and wheat have increased by more than 60 percent. In order to mitigate its effects on the vulnerable, the authorities have undertaken the following measures:

- **Kerosene**: authorities approved a 30 percent reduction in excise tax on kerosene. A complete removal of the excise tax has been proposed, but it requires parliament approval. For fiscal year 2010/11, total excise taxes on kerosene were estimated at 0.1 percent of GDP (before measures).

- **Diesel (gas oil)**: a 20 percent reduction of the excise tax on diesel. For fiscal year 2010/11, the total excise taxes on diesel were estimated at 0.6 percent of GDP (before measures).

- **Maize and wheat**: removal of import duty on wheat and maize imported by millers (government imports are not subject to duty). For fiscal year 2010/11, the total import duties on maize and wheat were estimated at 0.1 percent of GDP (before measures).

The overall cost of these measures if applied throughout the whole fiscal 2011/12 is estimated at around 0.3 percent of GDP, excluding the full removal of kerosene excise, which requires approval by parliament.

III. PROGRAM ISSUES

15. **The authorities have requested a waiver for the nonobservance of the performance criteria on NDA and NIR.** The authorities have resumed to build up of foreign exchange reserves and to consistently mop up liquidity in line with the NIR and NDA targets.

16. **Targets for the next 12 months under the program have been updated.** The authorities are on track to meet the revised June 2011 targets. The new targets take into account changes in the macroeconomic outlook and recent information including the new 2011/12 budget, a revised government borrowing plan, and a new base period for the program exchange rate from September 2010 to April 2011. The adjustments reflect: (a) significant changes in international prices that have modified the balance of payments outlook; (b) exchange rate movements to update the valuation of international reserves; and (c) updated fiscal information consistent with the 2011/12 budget that require revisions to the nominal fiscal targets. The direction of macroeconomic policy under the program has not changed. All changes are incorporated in the updated TMU.

17. **The CBK safeguards assessment is substantially complete.** The assessment recommended that the CBK Board, which had not met since September 2010, be fully reconstituted and a new audit committee established. Three board vacancies were filled in April 2011, and audit committee members subsequently nominated; the last two board appointments were made in mid-June. On data, the assessment reviewed the reliability of financial information, which was temporarily hampered during the transition to a new accounting system. It recommended enhanced monitoring of program data reports going forward, along with internal audit review of reporting procedures on a priority basis. The assessment also reviewed controls over currency printing and delivery to the CBK and recommended additional audit measures to ensure security and value. The authorities have committed to implementing the recommendations of the assessment, which will be monitored going forward. The assessment will be completed by the second review.

IV. STAFF APPRAISAL

18. *Achievements*: **Kenya's economic reform program is off to a good start**. Fiscal policy is now reoriented toward gradual medium-term fiscal consolidation, while monetary policy has recently taken a role in keeping domestic demand growth in line with available resources. There are signs of progress in the structural reform front, confirmed by improved institutional quality, as measured by the World Bank CPIA rating. Economic activity has picked up momentum outside the agricultural sector, and growing financial inclusion is helping to provide opportunities to more widely share the benefits of economic growth.

19. *Challenges*: **Inflation has accelerated and the deficit of the external current accounts widened**. The surge in global commodity prices, the strength of private investment, and mixed rainy seasons have translated into strong pressures on both inflation and the external position that, if not managed, could bring to a halt the ongoing recovery. Sustaining

and possibly accelerating Kenya's recent favorable growth performance requires prompt policy actions to avoid the risk of overheating.

20. *Monetary Policy*: **The CBK should tighten policies, within a forward looking monetary framework to anchor inflation expectations**. The ongoing monetary tightening should continue to ensure that the recent inflation burst does not become entrenched. There are no doubts that temporary factors have played a key role in boosting food prices, but rapid credit growth has fueled domestic demand and exacerbated inflationary pressures. CBK's recent actions to absorb liquidity by raising interest rates should continue to reign in these pressures. Tightening the monetary stance as envisaged under the program NDA targets will also help accumulating external reserves and support the shilling. In the event that rising interest rates attract capital inflows and inflation fails to abate, the CBK should refrain from intervening in the foreign exchange, beyond what is needed to attain the programmed reserve accumulation.

21. ***Fiscal Policy*: The overriding objective remains lowering the government debt-to-GDP ratio gradually, while addressing Kenya's pressing development needs.** The 2011/12 budget proposal conjugates progress toward fiscal consolidation with the need to (a) limit the impact of higher fuel and oil prices on the vulnerable portion of the population; (b) provide resources for the implementation of the new constitution, including the financing of the 2012 general elections; and (c) raise public investment to step up the country's geothermal power generation capacity. Thus, to achieve their fiscal objectives, the authorities will need to redouble their efforts to contain non-priority outlays through stricter expenditure measures and controls. The recent proposal to eliminate taxes on kerosene and imports of food staples together with mobile-phone based cash transfers should help mitigate the impact of higher food and fuel prices on the poor.

22. ***Financial Policies*: Broadening financial inclusion should not endanger financial stability.** The increased powers given to the CBK to deal with problem banks constitute an important step toward enhancing stability. However, monitoring of financial operations driven by bank agents and mobile banking must continue to improve, and banking supervision should cover risks from the inclusion of new borrowers into the system. Moreover, the rapid pace of private sector credit growth warrants monitoring banks' portfolio quality closely. The recent demutualization of the Nairobi stock exchange should strengthen capital markets and enhance governance by removing conflicts of interest from its governing body.

23. ***Structural Reforms:*** The authorities should continue to make progress toward the two key fiscal reforms—the adoption of an integrated PFM law and the introduction of a new VAT law. The organic budget law should help strengthen expenditure management and control by establishing a Single Treasury Account, increasing accountability, and reducing the scope for corruption, which remains a concern. The VAT draft legislation will not only help to mobilize additional tax resources, but also improve the business climate by streamlining and rationalizing collection procedures.

24. ***Program Performance:*** All the quantitative PCs and indicative targets for end-March 2011 were observed, with the exception of those on the NIR floor and NDA ceiling for the CBK, which were breached by small amounts. The structural benchmarks were met as programmed. The CBK safeguards assessment is substantially complete and the authorities have already started to implement its recommendations. Staff supports the authorities' request for waivers of the two PCs on the CBK's NDA and NIR. Staff recommends completion of the First Review, approval of the request of the modification of the end-June 2011 PCs and end-December 2011 PCs, and establishment of new PCs for end-June 2012.

Table 1. Kenya: Selected Economic Indicators, 2009/10–2014/2015[1]

	2009/10	2010/11		2011/12		Projections	Projections	Projections
	Actual	EBS/11/9 (ECF)	Revised Program	EBS/11/9 (ECF	Revised Program	2012/13	2013/14	2014/15
	(Annual percentage change; unless otherwise indicated)							
National accounts and prices								
Nominal GDP (Market prices, in billions of Kenya shillings)	2,458	2,713	2,764	3,075	3,181	3,586	4,010	4,484
Real GDP growth (market prices)	4.1	5.4	5.4	6.1	5.7	6.3	6.5	6.5
GDP deflator (average) 2/	6.6	6.9	6.5	6.8	9.0	6.1	5.0	5.0
Consumer price index (annual average) 2/	5.3	3.4	6.8	5.0	7.4	5.0	5.0	5.0
Consumer price index (end of period) 2/	3.5	4.0	13.3	5.0	6.0	5.0	5.0	5.0
Import volume growth, goods	2.3	4.3	3.8	5.9	4.4	11.1	6.0	5.3
Import value growth, goods	2.5	12.3	22.4	8.8	13.9	8.2	7.1	4.6
Export volume growth, goods	-1.7	12.8	-1.1	15.2	15.9	12.0	7.0	8.8
Terms of trade, goods, and services (Base year 2000)	12.3	-7.3	-0.8	-7.4	-9.8	-4.5	-0.5	-3.8
Ksh per US $ exchange rate (end of period) 3/	81.9	81.0	85.7					
Nominal effective exchange rate (- depreciation; end of period)	-0.2	…	…		…	…	…	…
Real effective exchange rate (- depreciation; end of period)	-1.5	…	…		…	…	…	…
Money and credit								
M3 (broad money and foreign currency deposits, end period)	26.2	19.2	16.5	16.6	14.7	13.5	14.6	12.5
Reserve Money	31.5	3.0	3.0	17.5	8.7			
	(In percent of GDP; unless otherwise indicated)							
Investment and saving								
Investment	19.5	23.1	23.5	24.5	24.3	24.6	24.6	24.7
Central government	8.7	10.3	9.8	10.6	10.5	10.5	10.5	10.3
Other	10.9	12.8	13.7	13.9	13.8	14.1	14.1	14.4
Gross national saving	13.9	15.8	14.3	17.0	16.0	16.8	18.7	20.0
Central government	1.5	2.7	2.7	3.7	3.9	4.6	4.9	5.2
Other	12.4	13.1	11.5	13.3	12.1	12.2	13.8	14.9
Central government budget 4/								
Total revenue	22.3	25.2	24.8	25.3	24.8	25.1	25.1	24.9
Total expenditure and net lending	29.5	32.9	32.0	31.8	31.5	31.1	30.7	30.1
Overall balance (commitment basis) excluding grants	-7.2	-7.7	-7.2	-6.6	-6.7	-6.0	-5.6	-5.2
Overall balance (commitment basis) including grants	-6.4	-6.5	-6.1	-5.3	-5.4	-4.7	-4.3	-3.9
Primary Budget Balance	-3.8	-3.8	-3.4	-2.7	-2.7	-2.1	-1.7	-1.4
Net domestic borrowing	5.4	4.6	4.3	3.2	3.8	1.4	1.7	2.2
Balance of payments								
Exports value, goods, and services	25.5	27.9	27.8	26.0	28.4	26.6	25.8	24.1
Imports value, goods, and services	38.4	41.6	44.1	40.0	44.3	42.2	40.4	38.1
Current external balance, including official transfers	-5.7	-7.3	-9.3	-7.5	-8.3	-7.8	-5.8	-4.7
Current external balance, excluding official transfers	-5.6	-7.2	-9.2	-7.5	-8.2	-7.7	-5.8	-4.7
Gross international reserve coverage								
In billions of U.S. dollars (end of period)	3.8	4.2	4.2	4.6	4.6	5.8	7.3	8.8
In months of next year imports (end of period)	3.1	3.3	3.0	3.3	3.0	3.6	4.3	4.9
Public debt								
Total public debt, net (percent of GDP)	44.8	47.1	46.9	46.9	46.8	45.2	44.3	43.1
Of which: external debt	23.0	22.8	23.2	22.2	22.5	22.3	22.0	21.0
Domestic debt, net of deposits	21.8	24.3	23.7	24.6	24.3	23.0	22.3	22.1

Sources: Kenyan authorities; and IMF staff estimates and projections.
1/ Fiscal year is from July 1st through June 30th.
2/ The CPI series was revised in November 2009 based on a new methodology.
3/ Actual as of May 31, 2011.
4/ Revenue plus program grants minus recurrent expenditure.

Table 2. Kenya: Central Government Financial Operations[1]

	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
	Preliminary	Revised Program	Revised Program	Projections	Projections	Projections
(In billions of Kenyan shillings, unless otherwise indicated)						
Revenues and grants	**568.8**	**717.4**	**830.6**	**948.8**	**1,059.2**	**1,171.3**
Revenue	**548.1**	**686.4**	**789.6**	**901.0**	**1,007.6**	**1,116.6**
Tax revenue	466.5	554.3	647.3	731.5	818.3	917.5
Income tax	209.1	248.7	291.8	328.5	363.0	413.5
Import duty (net)	41.3	47.4	55.4	62.5	70.0	73.1
Excise duty	74.1	83.8	98.6	108.3	125.2	140.0
Value-added tax	142.0	174.4	201.5	232.2	260.1	290.9
Nontax revenue	81.6	132.1	142.3	169.5	189.3	199.1
Investment income	8.4	13.9	11.8	14.6	16.4	19.0
Other	32.7	37.7	54.6	58.0	65.0	58.8
LATF	0.0	13.1	15.4	17.2	19.3	21.1
Ministerial and Departmental Fees (AIA) 2/	40.6	67.4	60.5	79.7	88.7	100.2
Grants	**20.7**	**31.0**	**41.0**	**47.8**	**51.6**	**54.7**
Project grants	20.7	31.0	41.0	47.8	51.6	54.7
Program grants	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure and net lending	**725.2**	**884.9**	**1,001.5**	**1,114.4**	**1,231.6**	**1,341.1**
Recurrent expenditure	**504.3**	**603.7**	**663.7**	**728.4**	**806.6**	**878.3**
Interest payments	63.5	74.2	84.1	94.7	104.9	113.3
Domestic interest	57.4	67.2	76.6	82.5	89.6	98.3
Foreign interest due	6.1	7.0	7.5	12.2	15.3	15.0
Wages and benefits (civil service)	172.6	202.3	222.6	250.6	286.3	314.9
Civil service reform	0.0	0.1	0.0	0.2	0.2	0.2
Pensions, etc.	29.0	28.9	34.8	44.8	49.5	54.9
Other 2/	182.3	237.7	263.8	279.3	305.7	329.5
Defense and NSIS	56.9	60.6	58.4	58.8	60.0	65.5
Development and net lending	**214.7**	**273.8**	**335.8**	**380.0**	**419.8**	**462.8**
Domestically financed	151.9	172.3	215.5	207.7	272.0	0.0
Foreign financed	61.6	99.0	117.7	169.7	147.4	462.8
Net lending	1.2	2.5	2.6	2.6	0.4	0.0
Civil Contingency Fund	0.0	0.0	2.0	0.0	0.0	0.0
Drought expenditures	6.2	5.0	0.0	3.0	3.2	0.0
Constitutional Reform 3/	0.0	2.4	0.0	3.0	2.0	3.0
Balance (commitment basis, excluding grants)	**-177.1**	**-198.5**	**-211.9**	**-213.4**	**-224.0**	**-224.5**
Balance (commitment basis, including grants)	**-156.4**	**-167.5**	**-170.9**	**-165.6**	**-172.4**	**-169.8**
Adjustments to cash basis	**0.0**	**-0.5**	**0.0**	**0.0**	**0.0**	**0.0**
Balance (cash basis, including grants)	**-156.4**	**-168.0**	**-170.9**	**-165.6**	**-172.4**	**-169.8**
Financing	**156.4**	**168.0**	**170.9**	**165.6**	**172.4**	**169.8**
Net foreign financing	22.9	48.0	51.4	116.1	103.4	70.4
Disbursements	39.8	68.0	76.7	141.2	132.7	86.9
Project loans	39.8	68.0	76.7	91.8	104.7	86.9
Program loans	0.0	0.0	0.0	8.6	8.6	8.6
Commercial borrowing 4/	0.0	0.0	0.0	40.8	19.4	21.7
Repayments due	-18.7	-20.5	-25.8	-25.1	-29.3	-38.3
Change in arrears	1.4	0.0	0.0	0.0	0.0	0.0
Rescheduling / debt swap	0.5	0.5	0.5	0.0	0.0	0.0
Net domestic financing	133.5	120.0	119.5	49.5	69.0	99.4
Financing gap (stat. discrepancy for outturns)	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:						
Nominal GDP	2,458.3	2,763.9	3,180.8	3,586.4	4,010.5	4,483.8
Primary budget balance including grants	-92.9	-93.8	-86.8	-70.9	-67.5	-56.5
Stock of domestic debt, net (end of period)	534.8	654.8	774.3	823.9	892.9	992.2
NPV of total public debt, net	913.5	1,097.3	1,283.0	1,404.9	1,537.3	1,704.5
Total public debt, net of deposits	1,100.4	1,296.6	1,489.9	1,622.7	1,775.8	1,932.3

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

1/ Fiscal year runs from July to June.
2/ Coverage increased in FY 2010/11 to incorporate tuitions and fees to universities and hospitals, and associated expenditure.
3/ Includes estimated expenditures associated with the implementation of the new constitution.
4/ Includes planned sovereign bonds.

Table 2. Kenya: Central Government Financial Operations[1] (concluded)

	2008/09 Estimate	2009/10 Estimate	2010/11 Revised Program	2011/12 Revised Program	2012/13 Projections	2013/14 Projections	2014/15 Projections
	(In percent of GDP)						
Revenues and grants	**22.9**	**23.1**	**26.0**	**26.1**	**26.5**	**26.4**	**26.1**
Revenue	**22.0**	**22.3**	**24.8**	**24.8**	**25.1**	**25.1**	**24.9**
Tax revenue	18.8	19.0	20.1	20.3	20.4	20.4	20.5
Income tax	8.3	8.5	9.0	9.2	9.2	9.1	9.2
Import duty (net)	1.6	1.7	1.7	1.7	1.7	1.7	1.6
Excise duty	3.1	3.0	3.0	3.1	3.0	3.1	3.1
Value-added tax	5.7	5.8	6.3	6.3	6.5	6.5	6.5
Nontax revenue	3.1	3.3	4.8	4.5	4.7	4.7	4.4
Investment income	0.3	0.3	0.5	0.4	0.4	0.4	0.4
Other	1.4	1.3	1.4	1.7	1.6	1.6	1.3
LATF	0.4	0.0	0.5	0.5	0.5	0.5	0.5
Ministerial and Departmental Fees (AIA) 2/	0.9	1.7	2.4	1.9	2.2	2.2	2.2
Grants	**0.9**	**0.8**	**1.1**	**1.3**	**1.3**	**1.3**	**1.2**
Project grants	0.9	0.8	1.1	1.3	1.3	1.3	1.2
Program grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure and net lending	**27.1**	**29.5**	**32.0**	**31.5**	**31.1**	**30.7**	**29.9**
Recurrent expenditure	**19.6**	**20.5**	**21.8**	**20.9**	**20.3**	**20.1**	**19.6**
Interest payments	2.1	2.6	2.7	2.6	2.6	2.6	2.5
Domestic interest	1.9	2.3	2.4	2.4	2.3	2.2	2.2
Foreign interest due	0.3	0.2	0.3	0.2	0.3	0.4	0.3
Wages and benefits (civil service)	7.0	7.0	7.3	7.0	7.0	7.1	7.0
Civil service reform	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Pensions, etc.	1.2	1.2	1.0	1.1	1.2	1.2	1.2
Other 2/	7.2	7.4	8.6	8.3	7.8	7.6	7.3
Defense and NSIS	0.0	2.3	2.2	1.8	1.6	1.5	1.5
Development and net lending	**7.5**	**8.7**	**9.9**	**10.6**	**10.6**	**10.5**	**10.3**
Domestically financed	4.9	6.2	6.2	6.8	5.8	6.8	0.0
Foreign financed	2.4	2.5	3.6	3.7	4.7	3.7	10.3
Net lending	0.1	0.0	0.1	0.1	0.1	0.0	0.0
Civil Contingency Fund	0.0	0.0	0.0	0.1	0.0	0.0	0.0
Drought expenditures	0.0	0.3	0.2	0.0	0.1	0.1	0.0
Constitutional Reform 3/	0.0	0.0	0.1	0.0	0.1	0.0	0.1
Balance (commitment basis, excluding grants)	**-5.1**	**-7.2**	**-7.2**	**-6.7**	**-6.0**	**-5.6**	**-5.0**
Balance (commitment basis, including grants)	**-4.2**	**-6.4**	**-6.1**	**-5.4**	**-4.6**	**-4.3**	**-3.8**
Adjustments to cash basis	**0.6**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Balance (cash basis, including grants)	**-3.7**	**-6.4**	**-6.1**	**-5.4**	**-4.6**	**-4.3**	**-3.8**
Financing	**4.0**	**6.4**	**6.1**	**5.4**	**4.6**	**4.3**	**3.8**
Net foreign financing	0.8	0.9	1.7	1.6	3.2	2.6	1.6
Disbursements	1.5	1.6	2.5	2.4	3.9	3.3	1.9
Project loans	1.5	1.6	2.5	2.4	2.6	2.6	1.9
Program loans	0.0	0.0	0.0	0.0	0.2	0.2	0.2
Commercial borrowing 4/	0.0	0.0	0.0	0.0	1.1	0.5	0.5
Repayments due	-0.8	-0.8	-0.7	-0.8	-0.7	-0.7	-0.9
Change in arrears	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Rescheduling / debt swap	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net domestic financing	3.1	5.4	4.3	3.8	1.4	1.7	2.2
Financing gap (stat. discrepancy for outturns)	-0.3	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:							
Nominal GDP	2,221.4	2,458.3	2,763.9	3,180.8	3,586.4	4,010.5	4,483.8
Primary budget balance	-1.5	-3.8	-3.4	-2.7	-2.0	-1.7	-1.3
Stock of domestic debt, net (end of period)	18.1	21.8	23.7	24.3	23.0	22.3	22.1
NPV of total public debt, net	31.3	37.2	39.7	40.3	39.2	38.3	38.0
Total public debt, net of deposits	**40.9**	**44.8**	**46.9**	**46.8**	**45.2**	**44.3**	**43.1**

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

1/ Fiscal year runs from July to June.
2/ Coverage increased in FY 2010/11 to incorporate tuitions and fees to universities and hospitals, and associated expenditure.
3/ Includes estimated expenditures associated with the implementation of the new constitution.
4/ Includes planned sovereign bonds.

Table 3. Kenya: Monetary Survey December 09-December 11
(In billions of Kenyan shillings, unless otherwise indicated)

	Dec-09	Mar-10	Jun-10	Dec-10	Mar-11	Jun-11	Dec-11	Jun-12
							Rev. Prog.	
Central Bank of Kenya (CBK)								
Net foreign assets	222.8	218.1	242.9	252.4	270.8	270.9	287.0	286.8
(in millions of US dollars) 1/	2,960.8	2,851.2	2,967.1	3,174.9	3,251.3	3,251.9	3,445.4	3,443.3
Net domestic assets	-40.8	-40.7	-32.6	-29.8	-61.4	-54.4	-32.1	-48.7
Net domestic credit	-6.3	-11.2	10.3	13.2	4.9	0.2	22.5	5.9
Government (net)	-25.5	-24.5	7.5	-3.7	-1.5	-2.0	4.0	3.4
Commercial banks (net)	16.5	10.7	0.0	13.9	3.3	-0.9	16.0	0.0
Other items (net)	-34.5	-29.5	-42.9	-42.9	-66.3	-54.6	-54.6	-54.6
Reserve money	182.0	177.5	210.3	222.6	209.4	216.5	254.9	238.1
Currency outside banks	100.9	96.4	101.3	122.9	114.2	115.0	144.2	120.8
Bank reserves	81.1	81.1	109.0	99.7	95.2	101.4	110.7	117.3
Banks								
Net foreign assets	21.0	50.1	37.4	17.4	27.5	22.2	24.9	23.6
(in millions of US dollars)	276.7	647.4	456.5	216.3	329.6	266.1	299.3	282.9
Reserves	81.1	81.1	109.0	99.7	95.2	101.4	110.7	117.3
Credit to CBK	-16.5	-10.7	0.0	-13.9	-3.3	0.9	-16.0	0.0
Net domestic assets	850.4	881.8	940.6	1,033.3	1,081.1	1,143.4	1,221.8	1,325.1
Net domestic credit	978.6	1,039.0	1,076.5	1,189.1	1,259.6	1,295.8	1,374.2	1,477.4
Government (net)	230.5	271.4	270.2	281.5	291.2	305.8	338.6	330.4
Other public sector	12.5	11.0	9.9	22.2	17.0	20	13.3	10.0
Private sector	735.6	756.7	796.4	885.4	951.3	970.0	1,022.4	1,137.0
Other items (net)	-128.2	-157.3	-135.9	-155.8	-178.5	-152.4	-152.4	-152.4
Total deposits	935.9	1,002.2	1,086.9	1,136.6	1,200.4	1,268.0	1,341.4	1,465.9
Monetary survey								
Net foreign assets	243.8	268.2	280.3	269.8	298.3	293.1	311.9	310.4
(in millions of US dollars)	3,237.5	3,498.6	3,423.6	3,391.2	3,580.9	3,518.0	3,744.7	3,726.2
Net domestic assets	801.9	839.7	918.7	1,001.8	1,026.4	1,103.4	1,164.4	1,291.4
Net domestic credit	955.8	1,017.2	1,086.8	1,188.4	1,261.2	1,296.3	1,380.7	1,483.3
Government (net)	205.1	246.9	277.7	277.8	289.7	303.8	342.6	333.8
Other public sector	12.5	11.0	9.9	22.2	17.0	20.0	13.3	10.0
Private	738.3	759.3	799.2	888.4	954.5	972.5	1,024.9	1,139.5
Other items (net)	-153.9	-177.5	-168.1	-186.6	-234.8	-192.9	-216.3	-192.0
M1	442.2	465.1	511.6	577.2	603.4	635.1	671.9	734.2
Money and quasimoney (M2)	898.1	959.0	1,033.7	1,099.2	1,145.0	1,209.4	1,279.5	1,398.2
M2 plus resident foreign currency deposits (M3)	1,045.7	1,107.9	1,198.9	1,271.6	1,324.7	1,396.5	1,476.3	1,601.8
M3 plus nonbank holdings of government debt (L)	1,280.5	1,350.2	1,443.4	1,569.6	1,637.4	1,726.1	1,824.8	1,979.9
Memorandum items (Annual percent change unless otherwise specified)								
M1	12.6	13.9	27.7	30.5	29.7	24.1	16.4	15.6
M2	17.2	22.9	27.3	22.4	19.4	17.0	16.4	15.6
M3	16.0	22.3	26.2	21.6	19.6	16.5	16.1	14.7
Deposits	17.3	23.8	27.2	21.4	19.8	16.7	18.0	15.6
Reserve Money	11.2	14.2	31.5	22.4	18.0	3.0	14.5	10.0
Currency outside banks	7.6	9.6	16.0	21.9	18.5	13.5	17.3	5.1
Net domestic credit	17.2	21.4	25.8	24.3	24.0	19.3	16.2	14.4
Government (net)	32.0	46.9	59.7	35.5	17.4	9.4	23.3	9.9
Private	13.9	14.4	16.8	20.3	25.7	21.7	15.4	17.2
Net domestic assets of the banking sector	23.1	29.2	34.6	24.9	22.2	20.1	16.2	17.0
NDA growth (as a percent of the base period M3)	13.8	17.1	20.3	15.6	13.8	12.8	10.4	10.9
Multiplier (Average M3/RM)	5.9	6.0	5.9	5.9	5.9	6.1	6.2	6.3
Velocity (GDP/M2)	2.8	2.7	2.6	2.4	2.4	2.4	2.4	2.4

Source: Kenyan authorities; and IMF staff estimates and Projections
1/ For historical data, at implicit CBK exchange rate)

Table 4. Kenya: Balance of Payments, 2008/09 - 2014/15
(In millions of US dollars, unless otherwise indicated)

	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
		Prel.	Revised Program				
Current account	-2,359.7	-1,812.4	-3,128.2	-3,151.7	-3,357.4	-2,808.8	-2,526.8
Excluding official transfers	-2,338.8	-1,793.1	-3,108.4	-3,129.7	-3,335.4	-2,786.8	-2,504.8
Exports, f.o.b.	4,641.6	4,885.5	5,703.2	6,325.2	6,587.3	7,062.5	7,299.5
Coffee	179.4	194.2	260.0	309.1	305.3	269.9	222.8
Tea	876.9	1,127.2	1,133.5	1,216.8	1,143.5	1,140.1	1,202.8
Horticulture	668.2	714.8	789.0	894.3	880.9	933.1	911.0
Imports, f.o.b.	-10,308.4	-10,564.5	-12,931.1	-14,728.8	-15,932.5	-17,062.9	-17,856.3
Oil	-2,555.7	-2,635.6	-3,280.8	-3,884.3	-4,117.8	-4,426.9	-4,796.5
Other Private	-7,615.8	-7,827.6	-9,483.7	-10,645.7	-11,606.1	-12,420.3	-12,836.9
of which: Special: Maize & sugar	-441.5	-360.9	-235.6	-316.8	-288.9	-279.7	-277.5
Balance on goods	-5,666.8	-5,679.0	-7,227.8	-8,403.6	-9,345.2	-10,000.5	-10,556.8
Balance on Services	1,189.5	1,546.8	1,736.9	2,352.7	2,656.6	2,943.5	3,014.4
Credit	2,950.3	3,295.3	3,658.5	4,533.2	4,876.0	5,349.2	5,646.4
of which: foreign travel credit 1/	688.2	711.8	871.8	1,093.5	1,164.8	1,324.3	1,324.8
Debit	-1,760.8	-1,748.5	-1,921.6	-2,180.6	-2,219.4	-2,405.7	-2,632.0
Balance on goods and services	-4,477.3	-4,132.2	-5,490.9	-6,050.9	-6,688.6	-7,056.9	-7,542.4
Income (net)	-76.7	-33.3	-44.1	-89.5	-96.0	-80.5	0.8
Credit	161.6	235.9	217.6	179.0	194.6	248.6	372.7
Debit	-238.3	-269.2	-261.7	-268.5	-290.5	-329.1	-372.0
of which: official interest payments	-83.3	-79.2	-84.1	-106.0	-123.9	-151.6	-178.9
Other	-155.1	-190.0	-177.5	-162.5	-166.7	-177.5	-193.0
Current transfers (net)	2,194.4	2,353.2	2,406.8	2,988.7	3,427.1	4,328.6	5,014.9
Private (net)	2,215.3	2,372.5	2,426.6	3,010.7	3,449.1	4,350.6	5,036.9
of which: remittances	981.4	1,006.1	1,115.0	1,252.0	1,490.4	1,751.8	1,968.7
Official (net)	-20.9	-19.3	-19.8	-22.0	-22.0	-22.0	-22.0
Capital and financial account	1,935.0	2,408.2	3,475.3	3,357.6	4,513.7	4,291.9	4,098.8
Capital account (incl. capital transfers)	258.2	260.4	389.9	506.2	545.7	637.0	637.0
Financial account 2/	1,676.8	2,147.7	3,085.4	2,851.5	3,968.1	3,654.9	3,461.7
Net FDI	652.5	404.5	529.5	655.1	716.1	780.7	728.2
In Kenya	672.0	430.6	541.9	678.1	737.8	802.6	747.8
Abroad	-19.5	-26.1	-12.4	-23.1	-21.7	-21.9	-19.7
Net Portfolio investment	-10.3	-8.6	3.5	2.7	0.3	2.0	2.4
Liabilities	8.9	9.7	15.9	14.6	12.8	13.6	14.5
Assets	-19.2	-18.3	-12.4	-11.9	-12.5	-11.7	-12.0
Net other investment	614.8	1,338.4	1,370.4	2,193.7	3,251.8	2,872.2	2,731.1
Official, medium and long term	204.9	625.8	625.8	668.0	1,456.0	1,346.0	1,145.7
Inflows	417.3	846.1	889.1	946.9	1,739.5	1,634.8	1,497.8
Outflows	-212.4	-220.3	-263.3	-279.0	-283.6	-288.8	-352.1
Private, medium and long term	-23.9	-37.2	-35.8	95.1	358.6	301.0	121.5
Energy financing	65.3	61.1	62.6	67.4	73.3	81.7	87.0
Kenya Airways	-76.5	-48.2	-65.4	27.7	285.3	219.3	34.5
Other	-12.7	-50.2	-33.0	0.0	0.0	0.0	0.0
Short-term capital	433.8	749.9	1,962.4	1,430.6	1,437.2	1,225.2	1,463.9
Errors and omissions	419.9	413.4	0.0	0.0	0.0	0.0	0.0
Overall balance	-424.7	595.7	347.1	206.0	1,156.3	1,483.1	1,572.0
Financing items	424.7	-595.7	-347.1	-206.0	-1,156.3	-1,483.1	-1,572.0
Reserve assets (gross)	224.0	-579.6	-429.7	-374.0	-1,244.4	-1,491.9	-1,502.0
Use of Fund credit and loans to the Fund (net)	194.8	-22.3	76.5	-35.3	-43.5	-56.9	-70.0
Disbursements	209.1	0.0	101.4	0.0	0.0	0.0	0.0
Repayments	-14.4	-22.3	-24.9	-35.3	-43.5	-56.9	-70.0
Rescheduling /debt swap	5.9	6.1	6.1	6.0	0.0	0.0	0.0
IMF ECF financing	0.0	0.0	0	197	132	66	0
Memorandum items:							
Gross official reserves (end of period)	3,219	3,799	4,228	4,602	5,847	7,339	8,841
(in months of following year's imports of goods and services)	3.1	3.1	3.0	3.0	3.6	4.3	4.9
Current account balance (excl. official transfers, percent of GDP)	-8.0	-5.6	-9.2	-8.2	-7.7	-5.8	-4.7
Import volume growth, goods and services (percent)	14.2	7.7	2.4	4.4	10.1	6.1	5.9
Import value growth, goods and services (percent)	10.0	2.0	20.6	13.8	7.3	7.3	5.2
Export volume growth, goods and services (percent)	-1.8	0.9	-1.8	19.0	12.7	7.8	8.9
Export value growth, goods and services (percent)	0.3	7.8	14.4	16.0	5.6	8.3	4.3
Change in the terms of trade (goods and services, percent) 3/	6.6	12.3	-0.8	-9.8	-4.5	-0.5	-3.8

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

1/ The foreign travel credit is comprised of two components, recorded tourism inflows and an estimate of additional under-reported tourism receipts.
2/ Historical figures include errors and omissions.
3/ Base year: 2000

Table 5. Kenya. Financial soundness Indicators of the Banking Sector

	Dec-07	Dec-08	Jun-09	Dec-09	Jun-10	Sep-10	Dec-10	Feb-11
Capital Adequacy								
Regulatory Capital to Risk-Weighted Assets	18.0	18.9	19.8	19.5	19.6	20.6	20.8	21.6
Regulatory Tier 1 Capital to Risk-Weighted Assets	16.8	16.9	17.6	17.2	17.5	18.6	18.7	19.5
Total Capital to Total Assets	12.0	12.6	13.0	12.7	14.0	12.8	13.2	13.7
Asset Quality								
Non Performing Loans to Total Gross Loans	10.6	9.0	9.0	7.9	7.4	7.0	6.2	6.1
Non Performing Loans Net of Provisions to Capital	12.8	11.3	12.4	12.6	10.0	8.0	6.4	5.7
Earning Assets to Total Assets	79.4	88.6	88.1	85.0	85.1	88.7	88.8	89.5
Earning and Profitability								
Return on Assets (ROA)	3.0	2.8	3.1	2.9	3.5	3.4	3.7	3.5
Return on Equity (ROE)	27.5	25.2	28.5	24.8	31.4	31.3	30.7	28.1
Interest Margin to Gross Income	34.6	34.9	35.6	35.6	33.2	33.7	34.7	41.0
Non Interest Expenses to Gross Income	50.6	51.7	49.1	50.8	47.1	49.2	48.2	50.2
Liquidity								
Liquid Assets to Total Assets	37.5	36.4	35.0	35.9	39.7	39.9	38.4	38.6
Liquid Assets to Short-Term Liabilities	40.0	37.0	40.6	39.8	45.1	46.7	44.5	44.3
Liquid Assets to Total Deposits	47.4	46.4	45.7	46.3	50.4	51.5	51.0	51.5
Total Loans to Total Deposits	71.3	73.3	75.7	72.4	68.0	69.2	72.5	72.6
Sensitivity to Market Risk								
Net Open Position in Foreign Exchange to Capital	...	5.6	6.1	4.9	4.9	4.8	4.3	4.3
Interest Bearing Assets to Interest Bearing Liabilities	100.5	113.0	114.4	113.2	111.6	114.4	117.8	119.5
FX Currency Denominated Assets to Total Assets	8.7	9.7	9.9	8.1	10.1	9.7	10.6	10.6
FX Currency Denominated Liabilities to Total Liabilities	16.3	20.2	17.6	18.1	16.3	17.1	17.1	16.9
Spread between lending and deposit rate	7.5	7.8	8.8	8.7	9.4	9.3	9.3	9.9
Total Expenses to Gross Income	68.9	72.0	70.0	71.4	65.6	66.1	64.2	64.4

Source: Central Bank of Kenya

Table 6. Performance Criteria for the First Review under the 2011/2014 ECF Arrangement

(In billions of Kenyan shillings; unless otherwise indicated)

	2010		2011	
	Projection	Actual	Performance Criteria	Actual
	End-Dec.	End-Dec.	End-March	End-March
Quantitative performance criteria				
Fiscal targets				
Primary budget balance of the central government (-=deficit, floor) 1/ 2/ 3/	-20.7	-20.7	-55.0	-11.6
Monetary targets 4/ 5/				
Stock of central bank net international reserves (floor, in millions of US$) 6/	3,505	3,314	3,450	3,263
Stock of net domestic assets of the central bank (ceiling)	-45.0	-27.5	-40.0	-28.0
Public debt targets				
Contracting or guaranteeing of medium- and long-term nonconcessional external debt by the central government (ceiling; millions of US$) 7/ 8/	…	0	450	0
New central government and central government guaranteed external payment arrears (ceiling, millions of US$) 9/	0	0	0	0
Indicative targets				
Priority Social Expenditures of the central government(floor) 10/ 3/	5.9	5.9	17.6	19.6

1/ The primary budget balance of the central government is defined as overall balance including grants, minus concessional project loans, plus interest payments.
2/ For 2010, end-March 2011, and end-June 2011: cumulative flow, from October 1, 2010 (beginning of the second quarter of the 2010/2011 fiscal year).
3/ For end-December 2011: cumulative flow, from July 1, 2011 (beginning of the 2011/2012 fiscal year).
4/ For program monitoring, the daily average for the month when testing dates are due.
5/ The NIR floor will be adjusted upward (downward) by the excess (shortfall) of external budgetary support (grants and loans) and external commercial debt relative to the programmed amounts. The NDA ceiling will be adjusted downward (upward) by the excess (shortfall) of external budgetary support (grants and loans) and external commercial debt relative to the programmed amounts.
6/ Excludes encumbered reserves.
7/ Cumulative flow of contracted debt, from January 1, 2011.
8/ For 2011, the targets do not include the planned issue of sovereign bond that is now scheduled for 2012/13 fiscal year.
9/ Continuous.
10/ For 2010, end-March 2011, and end-June 2011: the target is cumulative from July 1, 2010.

Table 7. Proposed Timing of Disbursements and Reviews under the 2011–14 ECF Arrangement

Date of Availability	Conditions for Fund Disbursement	Disbursements: Millions of SDRs	Disbursements: Percent of quota 1/
January 31, 2011	Board approval of the arrangement	65.136	24.00
June 29, 2011	Observance of the end-March 2011 performance criteria and structural benchmarks, and completion of first review	43.424	16.00
November 15, 2011	Observance of the end-June 2011 performance criteria and structural benchmarks, and completion of second review	43.424	16.00
April 15, 2012	Observance of the end-December 2011 performance criteria and structural benchmarks, and completion of third review	43.424	16.00
October 15, 2012	Observance of the end-June 2012 performance criteria and structural benchmarks, and completion of fourth review	43.424	16.00
April 15, 2013	Observance of the end-December 2012 performance criteria and structural benchmarks, and completion of fifth review	43.424	16.00
October 15, 2013	Observance of the end-June 2013 performance criteria and structural benchmark, and completion of the sixth review	43.424	16.00
		325.680	120.00

1/ Kenya's quota is SDR 271.4 million.

Table 8. Kenya: Indicators of Capacity to Repay the Fund, 2010–2019

		Projections								
	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Fund obligations based on existing credit										
(In millions of SDRs)										
Principal	16.7	10.0	18.8	30.0	25.0	20.0	21.5	24.3	13.0	13.0
Charges and interest	0.0	0.8	2.1	2.0	1.9	1.8	1.7	1.6	1.5	1.4
Obligations to the Fund from existing and prospective credit 1/										
(In millions of SDRs)	2.5	10.8	21.1	32.5	41.2	49.6	51.0	75.3	81.3	80.5
Principal	2.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
ESF Rapid Access Component (RAC)	0.0	10.0	18.8	30.0	38.6	47.1	48.7	73.1	79.3	78.7
ECF Arrangements	2.5	10.0	18.8	30.0	38.6	47.1	48.7	73.1	79.3	78.7
Charges and interest	0.0	10.8	21.1	32.5	41.2	49.6	51.0	75.3	81.3	80.5
Obligations to the Fund from existing and prospective credit 1/										
In millions of U.S. dollars	3.9	17.0	33.1	51.0	64.5	77.8	80.0	118.1	127.4	126.2
In percent of gross international reserves	0.1	0.4	0.6	0.8	0.8	0.8	0.8	1.0	1.0	0.9
In percent of exports of goods and services	0.0	0.2	0.3	0.4	0.5	0.6	0.6	0.7	0.7	0.6
In percent of debt service	1.1	4.3	7.4	10.9	12.3	11.9	9.7	11.4	10.4	9.2
In percent of GDP	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.1
In percent of quota	0.9	4.0	7.8	12.0	15.2	18.3	18.8	27.8	29.9	29.7
Outstanding Fund credit (end-of-period) 1/										
In millions of SDRs	270.7	422.7	509.5	596.4	596.4	596.4	596.4	596.4	596.4	596.4
In millions of U.S. dollars	424.4	662.6	798.8	934.9	934.9	934.9	934.9	934.9	934.9	934.9
In percent of gross international reserves	10.7	14.9	15.4	14.2	12.0	10.0	8.9	8.1	7.5	6.8
In percent of exports of goods and services	4.9	6.5	7.2	7.9	7.2	7.0	6.6	5.7	5.1	4.6
In percent of GDP	1.3	1.7	1.9	2.0	1.8	1.6	1.4	1.3	1.1	1.0
In percent of quota	99.7	155.7	187.7	219.7	219.7	219.7	219.7	219.7	219.7	219.7
Memorandum items:										
Nominal GDP	32,235	40,066	41,792	46,762	52,261	58,450	65,634	73,496	81,868	91,173
Exports of goods and services	8,641	10,187	11,156	11,774	12,900	13,289	14,214	16,520	18,409	20,538
Gross international reserves	3,960	4,450	5,190	6,584	7,782	9,369	10,536	11,487	12,525	13,817
Debt service (in millions of U.S. dollars) 2/	357	393	450	468	526	654	822	1,040	1,221	1,374
Quota (in millions of SDRs)	271.4	271.4	271.4	271.4	271.4	271.4	271.4	271.4	271.4	271.4

Sources: Fund staff estimates; and projections.

1/ Assumes access of 120 percent of quota during 2011–13 and semi-annual disbursements starting in October 2011. Outstanding credit at end-2010 stands at SDR 270.7 million, equivalent to 99.7 percent of quota.

2/ Total debt service includes repayments to the IMF.

APPENDIX. LETTER OF INTENT

Nairobi, Kenya
June 14, 2011

Mr. John Lipsky
Acting Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Lipsky:

1. **Kenya's economy continues to recover steadily despite new challenges stemming from rising international commodity prices including fuel and drought-related concerns.** All sectors of the economy grew strongly in 2010, spurred by a dynamic private sector and the recovery of agricultural production. Recent steep increases in international prices for food and oil products have fueled inflationary pressures which, combined with and insufficient and delayed rainfall in most parts of the country, have implications for growth prospects and macroeconomic management.

2. **Performance under the economic program supported by an arrangement under the Extended Credit Facility of the IMF has been strong.** Our program is on track with regard to quantitative performance criteria and indicative targets for end-March 2011. The target on net international reserves was missed because of a base-effect measurement issue and the net domestic assets target was also missed by a small amount, although the direction of policies remained appropriate. The target on the primary budget balance of the central government was met with a wide margin. The structural benchmarks were all met.

3. **This Letter of Intent (LOI) describes policies we intend to implement for FY 2011/12.** Near–term macroeconomic policies will be geared at containing domestic demand pressures that have emerged on inflation and the external position while remaining on a growth trajectory consistent with the medium-term plan of Vision 2030. The key priorities for the near- and medium-term remain the implementation of our new Constitution, enhancements to the country's infrastructure, investments in the energy sector, and adequate allocations to the social sectors. We stay firmly committed to our reform program aimed at achieving higher and sustainable growth in a more equitable environment.

I. RECENT DEVELOPMENTS AND OUTLOOK

4. **Kenya enjoyed broad-based economic growth in 2010**. Real GDP growth reached 5.6 percent supported by improved weather conditions, increased credit to the private sector, higher investments, and minimal inflationary pressures. These factors allowed for the creation of an estimated 500,000 new jobs, of which about 60,000 in the formal economy. Agriculture, which is the economy's largest sector, experienced strong growth, while the financial sector expanded fast. Strong domestic demand coupled with higher international commodity prices led to a widening of the current account deficit by end-March 2011 and the second round impact of oil price hikes and urban food supply constraints caused inflation to reach double digits in April.

5. **Economic prospects remain strong, but the impact of inflation and potential drought is a source of concern.** Continued strong growth in credit to the private sector, higher-than-anticipated foreign direct investments, rising remittances, and higher tourism receipts all point to favorable growth prospects. However, demand pressures related to ongoing investments and a higher import bill will exert pressure on the current account and on domestic prices. As such we will adjust monetary policy to preserve macroeconomic stability. We will monitor closely developments in the agricultural sector over the coming months, because insufficient and poor distribution of rainfall may contribute to lowering growth prospects and add to existing price tensions.

II. THE ECONOMIC REFORM PROGRAM FOR 2011/12

A. Fiscal Policy

6. **We will continue our focus on gradual fiscal consolidation while taking care of the long term development needs of the country.** As we intensify efforts to contain non-priority recurrent expenditure through greater efficiency, we expect to reduce the primary fiscal deficit to 2.7 percent of GDP in the coming fiscal year. At the same time, we will increase development expenditures to boost the country's growth prospects. In particular, we will maintain adequate scope for investments in transport infrastructure and in renewable energy supply, with the aim of eliminating oil imports for power generation. Priority in the coming year will also ensure sufficient resources are allocated to programs that will assure food security and implementation of our new Constitution, including for the envisaged devolution of administrative powers and fiscal responsibilities to County Governments in 2012.

7. **We have announced a set of measures to shield the poor from the impact of high food and fuel prices.** To provide relief from high food prices, we will expand famine relief to cover 4 million people, up from 2.4 million currently covered, expand our existing safety net programs targeting the poor, and remove duties on imports of wheat and maize. To counter the increase in fuel prices, we have already lowered taxes on kerosene and diesel and

proposed to Parliament to eliminate taxes on kerosene altogether. To cover revenue shortfalls and ensure long-term sustainability of expenditures, we will consider a new set of tax measures to fund safety nets programs. In the context of the 2011/12 Budget, our VAT regime is being reviewed to remove distortions introduced by a number of ad hoc exemptions and zero-rated goods that have undermined revenue collection.

8. **We will remain prudent in approving new project loans to ensure public debt dynamics remain sustainable.** In particular, we will carefully select and prioritize projects to maximize their contribution to economic growth and poverty reduction. We also intend to monitor closely the risks related to contingent liability exposure, including through the integration of projects funded through public private partnerships into the medium-term debt management strategy. Combined with a gradual reduction in the primary fiscal deficit, these measures will help contain the public debt-to-GDP ratio falls below the target of 45 percent by FY 2013/14.

B. Monetary Policy

9. **We will take decisive action to return to low and stable inflation.** We expect pressure on inflation to moderate following the onset of rains in May 2011 in the main food producing regions of the country. However, monetary policy in 2011 will be firmly geared at keeping inflationary expectations under control. In order to meet the net domestic assets target, the Government will repay overdraft outstanding obligations before the end of the fiscal year and absorb liquidity from commercial banks through enhanced repo operations in line with program objectives, allowing interest rates to adjust as needed.. These actions will bring the rate of growth of credit to the private sector to levels that can be sustained while providing adequate support to economic activity.

10. **We will step up efforts to accumulate international reserves through regular purchases of foreign exchange.** We remain committed to our medium-term objective to increase reserve coverage to four months of prospective imports, but the pace of reserve accumulation will need to take into account the impact of the external supply shocks that has created instability in the foreign exchange market. We expect that the ongoing tightening of monetary policy will enhance stability on the foreign exchange market.

C. Financial Policy

11. **We remain committed to the twin objectives of promoting financial inclusion and strengthening financial stability.** Following the introduction of legislation allowing the Central Bank to take prompt corrective action to deal with problem banks, we will sustain ongoing initiatives to upgrade crisis management frameworks to deal with the challenges of cross-border operations and mobile banking. We will notably increase the use of stress testing and improve the evaluation of provisioning practices by financial institutions.

12. **We will make further progress in deepening our financial sector to transform it into a regional hub for financial services.** Following the introduction of legislation allowing for the demutualization of the Nairobi Stock Exchange, we expect the process to be finalized during FY 2011/12. This will convert our stock exchange into a profit-making entity and open it to participation from a wider range of investors, contributing to greater competition and transparency. Other measures we plan to implement in the near term include the raising of capital requirements, deepening of the bond market through a new framework allowing for more issuance and OTC trading, development of a legal framework for the creation of a bond market for SMEs, and harmonization of policy frameworks to promote the regional integration of EAC capital markets.

III. Structural Reforms

13. **We will introduce a new, comprehensive public financial management law.** Building on recent technical assistance received from the Fund, we have made significant progress in the preparation of a draft law covering all aspects of public financial management at both Central and County Government levels. We expect the draft law to be presented to the Commission on the Implementation of the Constitution in June 2011, for consideration by Parliament by end-August 2011. The new law will be a key milestone in our efforts to enhance transparency and promote efficiency in the management of public funds, including through the establishment of a Treasury Single Account.

14. **We will submit comprehensive amendments to the VAT legislation during 2011/12 .** The new legislation will seek to improve administration and compliance, and minimize revenue losses linked to exemptions. Looking forward, we intend to enhance revenue collection through further administrative reforms, including through increased automation of KRA processes at the level of customs. We will also undertake a comprehensive review of tax policy following the appointment of a Tax Reform Commission in 2011/12. The review will aim at simplifying our tax code in line with best practices, in order to help improve tax compliance, minimize delays, and raise revenue.

IV. Program Issues

15. **Safeguards assessment.** The safeguards assessment of the Central Bank of Kenya was initiated in March 2011 and an IMF mission visited Nairobi in May 2011. The central bank is committed to implement the recommendations resulting from that assessment.

16. **Program monitoring.** Our program will be monitored using the definitions, data sources, and frequency of monitoring set out in the accompanying revised TMU. The government will make available to Fund staff all data appropriately reconciled and on a timely basis, as specified in the TMU. Table 1 shows the quantitative performance criteria to be used in monitoring performance in 2011/12. Structural benchmarks, with corresponding dates, are identified in Table 2. Fiscal performance criteria will cover the central government, but the authorities will prepare to expand coverage to include the general government as

early as possible, in anticipation of fiscal decentralization. The second review under the ECF arrangement, assessing end-June performance criteria, is expected to be completed by November 15, 2011. The third review under the ECF arrangement, assessing end-December performance criteria, is expected to be completed by April 15, 2012.

17. **Given our strong program implementation, we request completion of the first review of the ECF-supported program approved on January 31, 2011 and the associated disbursement of SDR 43.424 million.** We reiterate that our program is on track with regard to quantitative performance criteria and indicative targets for end-March 2011. The target on the primary budget balance of the central government was met with a wide margin. The structural benchmarks were all met despite shocks that were not anticipated at the time of the design of our program. The target on net international reserves was missed because of a base effect measurement issue and the net domestic assets target was also missed by a small amount, although the direction of policies remained appropriate. Thus, we request waivers for the end-March performance criteria on net international reserves and net domestic assets of the central bank. We also request modification of the end-June and end-December 2011 performance criteria for net international reserves and net domestic assets, as well as for the primary budget balance of the central government.

18. We will maintain a close policy dialogue with the Fund and stand ready to take additional measures, as appropriate, to ensure the achievement of the government's economic and social objectives under the ECF-supported program. We will maintain a close policy dialogue with the Fund on the adoption of measures, and in advance of revisions of the policies contained in this Letter of Intent, in accordance with the Fund's policies on such consultation.

19. **We authorize the IMF to publish this Letter of Intent and its attachments, as well as the accompanying staff report.**

Sincerely yours,

/s/	/s/
Uhuru M. Kenyatta Deputy Prime Minister and Minister for Finance	Njuguna Ndung'u Governor Central Bank of Kenya

Attachment: Updated Technical Memorandum of Understanding

Table 1. Revised and New Performance Criteria for the 2011/2014 ECF Arrangement

(In billions of Kenyan shillings; unless otherwise indicated)

	2010	2011				2012	
	Actual	Actual	Performance Criteria	Indicative Targets	Performance Criteria	Indicative Targets	Performance Criteria
	End-Dec.	End-March	End-June	End-September	End-Dec.	End-March	End-June
Quantitative performance criteria							
Fiscal targets							
Primary budget balance of the central government (-=deficit, floor) [1/ 2/ 3/]	-20.7	11.6	-25	-30	-30	-50	-15
Monetary targets 4/ 5/							
Stock of central bank net international reserves (floor, in millions of US$) [6/7]	3,314	3,263	3,515	3,600	3,700	3,700	3,700
Stock of net domestic assets of the central bank (ceiling)	-27.5	-28.0	-50	-45	-30	-50	-45
Public debt targets							
Contracting or guaranteeing of medium- and long-term nonconcessional external debt by the central government (ceiling; millions of US$) [8/9]	0	0	700	700	700	700	700
New central government and central government guaranteed external payment arrears (ceiling, millions of US$) [10/]	0	0	0	0	0	0	0
Indicative targets							
Priority Social Expenditures of the central government(floor) [11/ 3/]	5.9	19.6	24.8	12.1	13.5	22.5	26.1

1/ The primary budget balance of the central government is defined as overall balance including grants, minus concessional project loans, plus interest payments.
2/ Targets for end-December 2010, end-March 2011, end-June 2011 are cumulative flow, from October 1, 2010 (beginning of the second quarter of the 2010/2011 fiscal year).
3/ Targets for end-September 2011, end-December 2011, end-March 2012, and end-June 2012 are cumulative flow from July 1, 2011 (beginning of the 2011/2012 fiscal year).
4/ For program monitoring, the daily average for the month when testing dates are due.
5/ The NIR floor will be adjusted upward (downward) by the excess (shortfall) of external budgetary support (grants and loans) and external commercial debt relative to the programmed amounts. The NDA ceiling will be adjusted downward (upward) by the excess (shortfall) of external budgetary support (grants and loans) and external commercial debt relative to the programmed amounts.
6/ Excludes encumbered reserves.
7/ At September 2010 exchange rates up to March 2011, and at April 29, 2011 afterwards.
8/ Cumulative flow of contracted debt, from January 1, 2011.
9/ The targets on the ceiling non-concessional external debt do not include the planned issue of sovereign bond that is now scheduled for 2012/13 fiscal year.
10/ Continuous.
11/ Targets for end-December 2010, end-March 2011, and end-June 2011 are cumulative flow from July 1, 2010.

Table 2. Kenya: Structural Benchmarks for the Request under the ECF Arrangement

Item Measure	Time Frame	Status
Tax measures		
Submit Value Added Tax (VAT) legislation to help improve administration and compliance. *Macro criticality: The VAT reform will allow for higher mobilization of revenue which will reduce the fiscal imbalance.*	Second Review	In Progress
Expenditure control		
Submit Public Finance Management legislation to the Commission for Implementation of the Constitution, to help accelerate reforms in public financial management. *Macro criticality: PFM management legislation is crucial for increasing both spending efficiency and improving fiscal management.*	Third Review	In Progress
Adopt a Single Treasury Account to strengthen cash management and improve resource management. *Macro criticality*: *Single Treasury Account (STA) adoption will improve both liquidity management and expenditure control.*	Fourth Review	In Progress
Banking supervision		
Amend the Banking Act to reinforce prompt corrective action by the banking supervision authority. *Macro criticality: Reinforcing the banking supervision authority is crucial to reducing the risk of macroeconomic instability.*	First Review	Completed on December 24, 2010 (Finance Act)
Capital markets		
Introduce legislation to allow the demutualization of the Nairobi Stock Exchange, to remove the conflict of interest from the governing body of the exchange and to strengthen capital markets. *Macro criticality: Demutualization of the Nairobi Stock Exchange is essential for the development of deeper financial markets that will enhance financial stability.*	First Review	Completed in January 2011 (guidelines were introduced as the Attorney General ruled that a new Law was not needed).

Attachment I. Updated Technical Memorandum of Understanding

1. This memorandum sets out the understandings between the Kenyan authorities and the IMF regarding the definitions of quantitative performance criteria and indicative targets, their adjusters and data reporting requirements for the three-year Extended Credit Facility (ECF) arrangement.

I. Quantitative Performance Criteria and Benchmarks

2. Quantitative performance criteria are proposed for June 30, 2011 December 31, 2011 and June 30, 2012 with respect to:

- the primary balance of the central government including grants, excluding external concessional project loans, cash basis (**floor**);
- the net official international reserves (NIR) of the Central Bank of Kenya (CBK) (**floor**);
- the net domestic assets (NDA) of the CBK (**ceiling**);
- nonconcessional medium- and long-term external debt contracted or guaranteed by the central government or by local and municipal governments without central government guarantee (**ceiling**); and
- medium- and long-term external public debt arrears (**continuous ceiling**).

3. The program sets indicative targets for June 30, 2011; December 31, 2011; and June 30, 2012 with respect to:

- priority social spending of the central government (**floor**).

II. Performance Criterion on the Primary Balance Including Grants of the Central Government

4. The **central government primary balance excluding external concessional project loans** on cash basis is defined as central government revenues and grants minus expenditures and net lending, plus due interest payments and investment expenditure financed through external concessional project loans, adjusted for cash basis.

5. For program purposes, the **central government primary balance excluding external concessional project loans** on cash basis is cumulative from October 1, 2010 and will be measured from the financing side as the sum of the following: (a) the negative of **net**

domestic financing of the central government; (b) the negative of **net external financing of the central government, excluding external concessional project loans;** and (c) **domestic and external interest payments** of the central government. For the December 31, 2011 and June 30, 2012 test dates, the central government primary balance including grants excluding external concessional loans will be measured cumulative from July 1, 2011.

The above items are defined as follows:

- **Net domestic financing** of the central government is defined as the sum of:

  - net domestic bank financing;
  - net nonbank financing;
  - change in the stock of domestic arrears of the central government; and
  - proceeds from privatization.

- **Net external financing excluding external concessional project loans** is defined as the sum of:

  - disbursements of **external nonconcessional project loans**, including securitization;
  - disbursements of **budget support loans;**
  - principal repayments on all **external loans;**
  - net proceeds from issuance of external debt;
  - any exceptional financing (including rescheduled principal and interest);
  - net changes in the stock of short-term external debt; and
  - any change in external arrears including interest payments.

- **External concessional project loans** of the central government are defined as **external project loans** contracted by the central government, which are considered concessional according to the definition in paragraph 11. All other **external project loans** are deemed **nonconcessional external project loans.**

- **Domestic and external interest payments** of the central government are defined as the due interest charges on domestic and external central government debt.

III. PERFORMANCE CRITERION ON THE NET INTERNATIONAL RESERVES OF THE CENTRAL BANK OF KENYA

6. **The net official international reserves** (stock) of the CBK will be calculated as the difference between total gross official international reserves and official reserve liabilities.

- **Gross official international reserves** are defined as the sum of:

  - the CBK's holdings of monetary gold (excluding amounts pledged as collateral);

- holdings of Special Drawing Rights (SDRs), including the August 28, 2009 General allocation and the September 9, 2009 Special allocation;

- CBK holdings of convertible currencies in cash or in nonresident financial institutions (deposits, securities, or other financial instruments).

- **Gross official international reserves** exclude:

  - the reserve position in the IMF;

  - pledged, swapped, or any encumbered reserve assets, including but not limited to reserve assets used as collateral or guarantees for third-party external liabilities;

  - deposits with Crown agents; and

  - precious metals other than gold, assets in nonconvertible currencies and illiquid foreign assets.

- **Official reserve liabilities** are defined as:

  - the total outstanding liabilities of the CBK to the IMF except those arising from the August 28, 2009 SDR general allocation and the September 9, 2009 SDR special allocation;

  - convertible currency liabilities of the CBK to nonresidents with an original maturity of up to and including one year;

  - commitments to sell foreign exchange arising from derivatives (such as futures, forwards, swaps, and options).

- The following **adjustors** will apply to the target for NIR:

  - If budgetary support (external grants and loans) [1] and external commercial debt exceed the programmed amounts, the target for NIR will be adjusted upward by the difference.

  - If budgetary support (external grants and loans) and external commercial debt fall short of the programmed amounts, the target for NIR will be adjusted downward by the difference.

[1] No budgetary support in the form of external grants and loans is expected in the next 12 months.

7. **NIR are monitored in U.S. dollars,** and, for program monitoring purposes, assets and liabilities in currencies other than the U.S. dollar shall be converted into dollar equivalent values, using the exchange rates as specified in Table 1, and net international reserves will be computed as the daily average for the month when the testing date is due.

IV. Performance Criterion on the Net Domestic Assets (NDA) of the Central Bank of Kenya

8. **Net domestic assets** are defined as reserve money minus NIR converted in shillings at the accounting exchange rate of 83.3 shillings for one U.S. dollar, plus medium and long term liabilities (i.e., liabilities with a maturity of one year or more) of the CBK, including those arising from the August 28, 2009 SDR General allocation and the September 9, 2009 SDR Special allocation; minus the value in shillings of encumbered reserves converted at the accounting exchange rate of 83.3 shillings for one U.S. dollar.

- NDA is composed of:

  - net CBK credit to the central government;
  - outstanding net credit to domestic banks by the CBK (including overdrafts); and
  - other items net.

- Reserve money is defined as the sum of:

  - currency in circulation; and
  - required and excess reserves.

- The following **adjustors** will apply to the target for NDA:

  - If budgetary support (external grants and loans) and external commercial debt exceed the programmed amounts, the target for NDA will be adjusted downward by the difference.

  - If budgetary support (external grants and loans) and external commercial debt fall short of the programmed amounts, the target for NDA will be adjusted upward by the difference.

9. **NDA are monitored in shillings, and will be computed as the daily average for the month when the testing date is due.**

V. Performance Criterion on Nonconcessional External Debt Contracted or Guaranteed by the Central Government

10. The definitions of "debt" and "concessional borrowing" for the purposes of this memorandum of understanding are as set out in point 9 of Executive Board Decision No. 6230-(79/140), as subsequently amended, including by Executive Board Decision No. 14416-(09/91), effective December 1, 2009. This definition also includes the following:

- Debt is understood to mean a direct, that is, not contingent, liability, created under a contractual agreement through the provision of value in the form of assets (including currency) or services, which requires the obligor to make one or more payments in the form of assets (including currency) or services at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being as follows:
    - ➢ loans, that is, advances of money to the obligor by the lender made on the basis of a undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans, and buyers' credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements);
    - ➢ suppliers' credits, that is, contracts where the supplier permits the obligor to defer payments until sometime after the date on which the goods are delivered or services are provided; and
    - ➢ leases, that is, arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lesser retains title to the property. For the purpose of this guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair or maintenance of the property.
- Under the definition of debt set out above, arrears, penalties, and judicially awarded damages arising from failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (for example, payment on delivery) will not give rise to debt.

11. Debt is considered concessional if, on the date on which the contract was signed, the ratio of the present value of the loan, based on the commercial interest reference rates

(CIRRs), to the nominal value of the loan is less than 65 percent (that is, the grant element of the loan is at least equal to 35 percent of its nominal value). The present value of the loan will be calculated by discounting future payments of interest and principal using the CIRRs established by the Organization for Economic Cooperation and Development (OECD). Specifically, the 10-year average of CIRRs reported by the OECD will be used for loans with maturities longer than 15 years while the six-month average of CIRRs will be used for loans with shorter maturities. To both the 10-year and 6-month averages of the reference rate, the margin for different repayment periods will be added, as established by the OECD (0.75 percent for repayment periods of less than 15 years; 1 percent for repayment periods of 15–19 years; 1.15 percent for repayment periods of 20–29 years; and 1.25 percent for repayment periods of 30 years or more).

12. The definition of **external debt**, for the purposes of the program, is any debt as defined in paragraph 9, which is denominated in foreign currency, i.e., currency other than Kenyan shillings (Ksh). Similarly, external borrowing is borrowing denominated in foreign currency.

13. The performance criterion on nonconcessional external debt is measured as a cumulative flow from January 1, 2011 and this includes: (i) nonconcessional external debt contracted or guaranteed by the central government; and (ii) nonconcessional external debt contracted by local and municipal authorities without central government guarantee. The authorities should consult with the Fund where public enterprises and other parastatals seek nonconcessional external borrowing without central government guarantee to limit the potential fiscal risk to the government. Medium- and long-term debt refers to debt with maturity of one year or longer.

14. The ceiling on nonconcessional external borrowing (see Table 1 in LOI) excludes the proceeds of the issuance of a sovereign bond up to a maximum amount of US$500 million now scheduled for the fiscal year 2012/13. The authorities will consult with the Fund should they decide to issue the sovereign bond earlier.

VI. Performance Criterion on the Stock of Central Government and Central Government Guaranteed External Payment Arrears to Official Creditors

15. Central government and central government guaranteed external payment arrears to official creditors are defined as overdue payments (principal or interest), which were not made by their contract due date nor during the applicable grace period thereafter, on debt contracted or guaranteed by the central government. The definition excludes arrears relating to debt subject to renegotiation (dispute) or rescheduling.

16. The performance criterion on the stock of central government and central government guaranteed external payment arrears applies only to newly accumulated arrears on or after January 1, 2011.

VII. Indicative Target on Priority Social Spending

17. The program sets a floor on priority social spending of the central government. For the purposes of the program, priority social spending of the government is defined as the sum of:

- cash transfers to orphans and vulnerable children;
- cash transfers to elderly;
- anti-retroviral treatment expenditures;
- free primary education expenditure; and
- free secondary education expenditure**.**

VIII. Coverage

18. All the references to **central government** in the current TMU will be changed to **general government,** in order to include local governments whenever the fiscal decentralization takes place according to the new constitution.

Table 1. Kenya: Program Exchange Rates for the ECF Arrangement
(Rates as of April 29, 2011)

Currency	Kenyan Shillings per curreny unit	Dollars per curreny unit
Canadian dollar	87.54	1.051
Danish krone	16.57	0.199
Euro	123.59	1.484
Japanese yen	1.02	0.012
Pound sterling	138.74	1.666
Swedish krone	13.87	0.166
SDR	134.92	1.620
US dollar	83.30	1.000

Table 2. Summary of Data to Be Reported

Information	**Frequency**	**Reporting Deadline**	**Responsible Entity**
1. Primary balance of the central government including grants			
Net domestic bank financing (including net commercial bank credit to the central government and net CBK credit to the central government)	Monthly	Within 15 days after the end of the month.	CBK
Net nonbank financing	Monthly	Within 15 days after the end of the month.	CBK
Central government arrears accumulation to domestic private parties and public enterprises outstanding for 60 days or longer.	Monthly	Within 15 days after the end of the month.	Ministry of Finance (MoF)
Proceeds from privatization	Monthly	Within 15 days after the end of the month.	CBK
Interest paid on domestic debt	Monthly	Within 15 days after the end of the month.	CBK
Interest paid on external debt	Quarterly	Within 4 weeks after the end of the quarter.	CBK
Disbursements of external nonconcessional project loans, including securitization	Quarterly	Within 45 days after the end of the quarter.	MoF
Disbursements of budget support loans	Quarterly	Within 45 days after the end of the quarter.	MoF
Principal repayments on all external loans	Monthly	Within 15 days after the end of the month.	CBK
Net proceeds from issuance of external debt	Monthly	Within 15 days after the end of the month.	CBK
Any exceptional financing (including rescheduled principal and interest)	Monthly	Within 15 days after the end of the month.	MoF
Net changes in the stock of short-term external debt	Quarterly	Within 45 days after the end of the quarter.	MoF
Net change in external arrears, including interest	Quarterly	Within 45 days after the end of the quarter.	MoF
2. Gross official international reserves			
CBK's holding of monetary gold (excluding amounts pledged as collateral)	Monthly	Within 15 days after the end of the month.	CBK
Holdings of SDRs	Monthly	Within 15 days after the end of the month.	CBK
CBK holdings of convertible currencies in cash or in nonresident financial institutions (deposits, securities, or other financial instruments)	Monthly	Within 15 days after the end of the month.	CBK

3. Official reserve liabilities			
Total outstanding liabilities of the CBK to the IMF except those arising from the August 28,2009 SDR general allocation and the September 9, 2009 SDR special allocation;	Monthly	Within 15 days after the end of the month.	CBK
Convertible currency liabilities of the CBK to nonresidents with an original maturity of up to and including one year	Monthly	Within 15 days after the end of the month.	CBK
Commitments to sell foreign exchange arising from derivatives.	Monthly	Within 15 days after the end of the month.	CBK
4. Net domestic assets			
Net CBK credit to the central government	Monthly	Within 15 days after the end of the month.	CBK
Outstanding net CBK credit to domestic banks (including overdrafts)	Monthly	Within 15 days after the end of the month.	CBK
5. Reserve money			
Currency in circulation	Monthly	Within 15 days after the end of the month.	CBK
Required and excess reserves	Monthly	Within 15 days after the end of the month.	CBK
Nonconcessional medium- and long-term external debt contracted or guaranteed by the central government	Quarterly	Within 45 days after the end of the quarter.	MoF
Accumulation of central government and central government guaranteed external payment arrears.	Quarterly	Within 45 days after the end of the quarter.	MoF
Social priority spending	Quarterly	Within 45 days after the end of the quarter.	MoF

INTERNATIONAL MONETARY FUND

KENYA

First Review Under the Three-Year Arrangement Under the Extended Credit Facility, Request for Waivers and Modification of Performance Criteria—Informational Annex

Prepared by the African Department

Approved by Saul Lizondo and Dominique Desruelle

June 15, 2011

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V. Kenya: Relations with the Fund

(As of April 30, 2011)

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	258.45	95.23
Reserve Tranche Position	12.96	4.78

III. SDR Department:	SDR million	Percent of allocation
Net cumulative allocation	259.65	100.00
Holdings	21.75	8.38

IV. Outstanding Purchases and Loans:	SDR million	Percent of quota
ESF RAC Loan	135.70	50.00
ECF Arrangements	195.14	71.90

V. Latest Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
ECF[/1]	01/31/11	01/30/14	325.68	65.14
ECF[/1]	11/21/03	11/20/07	150.00	150.00
ECF[/1]	08/4/00	08/3/03	190.00	33.60

1/ Former PRGF

In May 2009, the Executive Board approved the disbursement of SDR135.7 under the RAC-ESF to address the impact of exogenous shocks and the balance of payments gap. The last three-year ECF arrangement was approved on January 31, 2011, in the amount of SDR 325.68 million.

VI. Projected Obligations to Fund[/1]
(SDR million; based on existing use of resources and present holdings of SDRs):

	2011	2012	2013	2014	2015
Principal	10.00	18.75	30.00	38.57	47.14
Charges/interest	0.83	2.07	2.01	1.93	1.82
Total	10.83	20.82	32.01	40.50	48.96

[1/] when a member has overdue financial obligations outstanding for more than three months, the amounts of such arrears will be shown in this section

VII. Implementation of HIPC Initiative: Not Applicable

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

IX. Safeguards Assessments

The CBK safeguards assessment is substantially complete. The assessment recommended that the CBK Board, which had not met since September 2010, be fully reconstituted and a new audit committee established. Three board vacancies were filled in April 2011, and audit committee members subsequently nominated; however, two other Board positions remain vacant. On data, the assessment reviewed the reliability of financial information, which was temporarily hampered during the transition to a new accounting system. It recommended enhanced monitoring of program data reports going forward, along with internal audit review of reporting procedures on a priority basis. The assessment also reviewed controls over currency printing and delivery to the CBK and recommended additional audit measures to ensure security and value. The authorities have committed to implementing the recommendations of the assessment, which will be monitored going forward. The assessment will be completed by the second review.

X. Exchange Arrangements

Kenya's currency is the shilling, which floats against other currencies. 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 float, in which the U.S. dollar is the principal intervention currency. Kenya has accepted the obligations of Article

VIII, Sections 2, 3, and 4, and maintains an exchange system free of restrictions on payments and transfers for current international transactions, other than restrictions notified to the Fund under Decision No. 144 (52/51). On April 30, 2011, the exchange rate was KSh 83.42=US$1.00.

XI. Article IV Consultations

The last Article IV consultation with Kenya concluded on December 7, 2009. Kenya is subject to a 12-month consultation cycle.

XII. FSAP Participation

A joint IMF-World Bank mission assessed Kenya's financial sector as part of the Financial Sector Assessment Program (FSAP) update during September 2009. The staff report on the Financial Sector Stability Assessment (FSSA) was issued to the Executive Board concurrently with the 2009 Article IV Consultation Staff Report.

XIII. Technical Assistance

Department	Purpose	Time of Delivery
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
FAD	Tax Administration Workshop	November 2008
FAD	PFM and Fiscal Decentralization	November 2008
STA	Reweighing and Rebasing of CPI	December 2008
STA	Producer Price Index compilation	December 2008
MCM	Risk based Supervision	January 2009
MCM	Capital Market Regulation and Supervision	March 2008
FAD	Several missions on fiscal decentralization, customs administration, and public finance management	2009–2010
FAD	PFM mission on Strengthening Program Budgeting	July 2010
FAD	Several missions on Customs Administration	2010
FAD	PFM mission on IFIMIS and budget module Preparation	September 2010
FAD	Several other review missions on PFM	January 2011
LEG	Missions on Anti-Money Laundering legislation and the Banking Law	2010
MCM	Mission on asset and liability management	May 2010
MCM	Aligning off-site Surveillance	August 2010
MCM	Mission to evaluate financial stability	January 2011
MCM	Mission on insurance and pension supervision	February 2011
MCM	Conducting onsite inspection and consolidated supervision	February 2011
MCM	Several mission on monetary operations, bank supervision, payments system and capital markets development	2009–2010
STA	Several missions on national accounts, CPI, and external sector statistics	2009–2010
STA	Consumer price Indices	May 2010
STA	Train staff on PPI Method	May 2010
STA	Assist with producing QGDP	October 2010
STA	Mission on BOP statistics (DFID III)	November 2010
STA	DFID III follow-up GFS to implement	January 2011
STA	AFRITAC East Mission on Quarterly National Accounts	June 2011
FAD	Tax Administration/VAT	September, 2011

XIV. Resident Representative

Mr. Ragnar Gudmundsson, since August 2010.

VI. WORLD BANK AND IMF COLLABORATION— JMAP IMPLEMENTATION 2010–11

20. **The Fund Kenya team led by Mr. Fanizza (mission chief) met with the World Bank Kenya team led by Mr. Zutt (country director)** on September 21, 2010 to identify macrocritical structural reforms and coordinate the two teams' work for the period October 2010-September 2011.

21. **The teams agreed that Kenya's main macroeconomic challenges are to ensure public debt sustainability while strengthening the investment climate to diversify the economy.** To meet these challenges, Kenya needs to consolidate its fiscal position over the medium term to bring the public debt-to-GDP ratio back to about 45 percent while creating the right environment for investments to unlock the country's growth potential.

22. **Based on this shared assessment, the teams identified the following structural reform areas as macrocritical,** as they will be key to achieving sustained growth, a strengthening of the fiscal position, and debt sustainability:

- **Public financial management reform:** Progress has been made recently in linking expenditure to medium term policy objectives. However, the preparation, execution, and monitoring of the budget need to be strengthened. This is important in light of the planned devolution of at least fifteen percent of government revenues to local levels of government by 2015. Key elements of a reform include: (i) supporting the complete roll out of IFMIS in all ministries through the Institutional Reform and Capacity Building project; (ii) establishing a Single Treasury Account to improve Treasury control; and (iii), implementing a comprehensive Public Finance Administration bill prior to the transfer of resources to decentralized units.

- **Tax reform:** Efforts are under way to enhance tax policy and administration, and will center on the implementation of a new VAT to be modernized and simplified in line with best practice. Customs administration is also set to be strengthened in line with commitments under the EAC Common Market Protocol.

- **Financial sector reform:** The ongoing modernization of the financial system and the growth in the regional activities of financial institutions call for enhanced consolidated and cross-border supervision as well as an upgrade in the crisis management framework. Focus also needs to be placed on strengthening Kenya's capital markets through the demutualization of the stock exchange, enhancing the Capital Markets Authority and further development of debt and capital markets in the regional context. Similar efforts are required to strengthen insurance markets, highlighted by the FSAP update as one of the weaker areas in the system. An additional weak area highlighted by the FSAP update is related to the NSSF and other sustainability aspects of the public pension system.

- **Infrastructure reform:** Infrastructure has been identified as one of the most problematic factors for doing business in Kenya. Reforms focus in three specific areas (i) improvements at the Mombasa port (ii) strengthening Kenya's infrastructure in transportation, energy, water and sanitation and (iii) improving PPP institutional capacity at the ministries.

- **Investment climate reform:** Kenya has made important progress in improving the investment climate**.** Nonetheless, other countries have been reforming even faster, and post-election violence slowed down the reform momentum in Kenya. The slack in reforms partly explains Kenya's (relative) regression in international rankings of investment climate. The authorities need to revive the reform momentum to create a better investment climate, both through interventions in private sector competitiveness as well as financial sector deepening and strengthening.

The teams agreed on the following division of labor:

- **Public financial management reform:** The Fund is providing technical assistance (TA) on a comprehensive Public Financial Management bill, on program budgeting, as well as support on the establishment of a Single Treasury Account. The Bank is supporting the implementation of IFMIS and essential PFM reforms through the Institutional Reform and Capacity Building Project (IRCB) and proposed DPL.

- **Tax reform:** The Fund is providing technical assistance on enhancing customs administration, including through improvements to inspection procedures and information technology.

- **Public Expenditure Review:** The Bank will lead in the PER with specific focus on service delivery in agriculture education and health sectors and building capacity for social accountability, including expenditure tracking and public expenditure analysis.

- **Financial sector reform:** Reform efforts are being supported by the WB through the Financial and Legal Sector Technical Assistance Loan (FLSTAP) since 2005 with a strong agenda on all regulatory and supervisory agents in the market. Support from the Fund has been through technical assistance on focalized aspects such as stress testing. The Bank and the Fund should coordinate technical assistance on the establishment of a crisis management framework, per discussions prior and during the FSAP update. Efforts should also be coordinated on pension markets (particularly with regard to the NSSF). Ad-hoc support related to the insurance sector should be carefully linked to ongoing reform effort through the FLSTAP.

- **Infrastructure reform**: The Bank has been supporting the developments related to PPPs and infrastructure finance for the last few years, intensified early this year with the creation of the PPP secretariat. The authorities have requested support for the growing agenda, including through the preparation of a new PPP/infrastructure finance project. Additional elements are emerging, such as contingent liabilities analysis related to PPP and beyond, which will be coordinated with the Fund.

- **Investment climate reform**: The Bank has been supporting investment climate reforms through the FLSTAP (i.e. support for the drafting, peer reviewing, and sharing of international practices on key laws; reforms to companies and land registries, and legal framework for lending) which the proposed DPL is expected to complement. It also supports targeted interventions related to business environment through the Kenya investment climate program and the MSME competitiveness project. Analytical work on industry mapping/clusters is also ongoing.

- **Fiscal decentralization:** The Bank and Fund will jointly provide TA on fiscal decentralization envisaged in the new Constitution. The TA will focus on setting up equitable and efficient fiscal and public finance management systems and mechanisms that allow county governments to perform their functions effectively over the long term.

- **ECF Arrangement with the Fund**: ECF-supported program will focus on strengthening Kenya's external position, promoting gradual fiscal consolidation while stepping up infrastructure investment and providing sufficient resources to implement the new constitution, bringing back the debt burden to the government's medium-term target, maintaining the floating exchange rate regime, and moving gradually to an inflation targeting framework. The program will seek to strengthen public financial management, modernize and simplify tax policy, and broaden access to financial services.

23. **The teams have the following requests for information from their counterparts:**

- The Fund team requests to be kept informed of progress in the above macrocritical structural reform areas. Timing: when milestones are reached (and at least semi-annually).

- The Bank team requests to be kept informed of the Fund's assessments of macroeconomic policies and prospects. Timing: in the context of Article IV and other missions (and at least semi-annually).

The table below lists the teams' separate and joint work programs during October 2010-September 2011.

Title	Products	Provisional Timing of Mission	Expected Delivery Dates
1. Bank Work Program	Kenya Economic Update (bi-annually)	N/A	Dec 2010 & June 2011
	Institutional Reform and Capacity Building: which has two components (i) PFM, (ii) Institutional reform and capacity building	N/A	Continuous
	Public Expenditure Review	November 2010	April 2011
	Development Policy Loan (DPL)	TBD	July 2011
	PPPs/Infrastructure Finance	N/A	July 2011
	FLSTAP -financial regulators and market development (i.e., insurance, banking, capital markets); housing finance. analysis	N/A	Continuous
	MSME, KICP, analytical work on investment climate		Continuous
2. Fund Work Program	**Missions**		
	Staff mission for negotiations on a financing arrangement	November 2010	January 2011
	Article IV Consultation	October 2011	November 2011
	TA provision on fiscal regulations; program budgeting; fiscal decentralization; IFMIS and treasury single account support	Ongoing	Implementation throughout fiscal year 2011
	TA provision on customs administration and modern risk management	November 2010	TA report in February 2011
	TA provision on crisis management framework	November 2010	January 2011

3. Joint Work Program	Various TA provisions on PFM reforms, fiscal decentralization, crisis management framework (FLSTAP, FIRST) and Pensions (NSSF and contingent liabilities) Public and External Debt Sustainability Analysis	December 2010 as part of the DPL and continous November 2010 October 2011	Continuous January 2011 November 2011

VII. KENYA: KEY STATISTICAL ISSUES

Data provision has some shortcomings, but is broadly adequate for surveillance and program monitoring. Further improvements in the methodology of compiling real, fiscal, and external sector statistics would be desirable in order to facilitate enhanced design and monitoring of economic policies. However, the overall quality, timeliness and coverage of macroeconomic statistics have significantly improved over the past few years. The Fund has substantially facilitated this process through technical assistance from the Statistics Department, the Fiscal Affairs Department and the Monetary and Capital Markets Department. Kenya participates in the Fund's General Data Dissemination System (GDDS) and the GDDS project for Anglophone Africa. Monetary, exchange rate, and some external data are published on a monthly and biannual basis by the Kenya National Bureau of Statistics (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

24. KNBS has made significant efforts to enhance national statistics compilation. An STA 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. KNBS has made progress in developing estimates of quarterly GDP at current prices that are now published. However, there is still need for improvements in the corresponding quarterly GDP in constant prices and from the expenditure side. Additionally, better coverage of the informal sector in GDP estimates is highly desirable.

Prices and production

25. KNBS still faces significant challenges in it is compilation of price indices. In particular, the compilation and dissemination of a CPI series with a historical dimension. 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. 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 released a revised series that is consistent with international best practices in November 2009. By February 2010, KNBS began to publish another series with rebasing and reweighing of the CPI basket using the geometric mean method. The current series does not extend beyond February 2009 and KNBS only plans to publish a historical series based on this methodology in 2012. In addition, KNBS does not compile a producer, export, or import price indices.

Government finance statistics (GFS)

26. 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 extra-budgetary 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.

27. 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 extra-budgetary funds, but the progress in compiling consolidated fiscal statistics has remained limited.

28. 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

29. 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 30percent 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. There is no ongoing TA, but, if needed, Kenya can benefit from participating in the monetary module of the next phase DFID project that will commence in 2010.

External sector statistics

30. 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.

31. 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.

32. 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.

33. 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 2009, a DFID funded enterprise survey failed to materialize. There are plans to conduct a foreign investment survey in 2010, which planned DFID-funded and STA external sector missions will support.

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

VIII. Kenya. Table of Common Indicators Required for Program Monitoring

(As of June 7, 2011)

	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			D	D	M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]			D	D	M		
Reserve/Base Money			D	D	M		
Broad Money			M	M	M	LO, LO, LO, LO	LO, LO, O, O, NO
Central Bank Balance Sheet			D	D	M		
Consolidated Balance Sheet of the Banking System			M	M	M		
Interest Rates[2]			D	D	M		
Consumer Price Index			M	M	M		
Revenue, Expenditure, Balance and Composition of Financing[3]—General Government[4]			NA	NA	NA	LNO, LNO, LNO, LO	LNO, LO, LO, LO, NO
Revenue, Expenditure, Balance and Composition of. Financing[3]—Central Government			Q	I	Q		
Stocks of Central Government and Central Government Guaranteed Debt[5]			Q	Q	Q		
External Current Account Balance			M	A	A	O, LO, O, LO	LNO ,LO, LO, LO, LO
Exports and Imports of Goods and Services			M	Q	A		
GDP/GNP			M	A	A	O, LNO, LNO, LO	LNO, LO, LNO, LO, LNO
Gross External Debt			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 of 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.

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

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International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes First Review Under Extended Credit Facility for Kenya

The Executive Board of the International Monetary Fund (IMF) has completed the first review under a three-year arrangement under the Extended Credit Facility (ECF) for Kenya.[1] The completion of the review enables the disbursement of SDR 43.424 million (about US$65 million), which will bring total disbursements under the arrangement to SDR 108.56 million (about US$163 million). The Executive Board's decision was taken on a lapse of time basis.[2]

Kenya's economic reform program is off to a good start. Economic activity rebounded in 2010 with GDP growth of 5.6 percent, driven by strong agricultural production and a dynamic private sector. The growth was broad-based and the sharing of its benefits was supported by policies to promote financial inclusion. Strong growth continues in 2011, with the exception of the agricultural sector, expected to decelerate significantly as a result of weather disturbances in the first months of the year. The outlook for private investment remains positive, with new foreign investors reinforcing the upward trend in capital expenditure by firms already operating in the country. However, recent inflationary pressures have emerged as a result of the global increase in food and fuel prices, insufficient rains, and growing domestic demand.

Performance under the program has been satisfactory. The fiscal outcome for 2010/11 (July-June) is likely to be better than projected and the Central Bank of Kenya has tightened monetary conditions to deal with the emerging inflationary pressures. The authorities also made good progress with their structural reform efforts and reaffirmed their commitments to the program, including on the adoption of a new public financial management law covering all levels of government that will strengthen expenditure control and increase accountability.

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[1] The IMF's framework for ECF is designed for low-income countries that need IMF financial assistance.

[2] The Executive Board takes decisions under its lapse of time procedures when it is agreed by the Board that a proposal can be considered without convening formal discussions.

Looking forward, the key priorities will be to curb inflation and to strengthen the external position in response to the widening of the current account deficit. The focus of monetary policy should thus be on controlling demand pressures in order to preserve macroeconomic stability and to ensure that the recent burst of inflation does not become entrenched. The 2011/12 budget reflects the authorities' commitment to gradual fiscal consolidation over the medium-term, while addressing the country's development needs and providing sufficient scope for the implementation of the new Constitution. The envisaged improvement of the fiscal primary balance should place the government's debt-to-GDP ratio on a declining path. Welcome efforts to broaden financial inclusion and deepen the financial markets will need to be supported by strengthened banking supervision and enhanced regulatory frameworks.

The Executive Board approved a three-year ECF for Kenya on January 31, 2011 (see Press Release No. 11/21).