November 2012
IMF Country Report No. 12/300

Kenya: Fourth Review Under the Three-Year Arrangement Under the Extended Credit Facility, Request for a Waiver and Modification of Performance Criteria—Staff Report; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Kenya.

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

- The staff report for the fourth review under the three-year arrangement under the Extended Credit Facility, request for a waiver and modification of performance criteria, prepared by a staff team of the IMF, following discussions that ended on September 25, 2012, 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 October 15, 2012. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- A Press Release summarizing the views of the Executive Board as expressed during its October 24, 2012 discussion of the staff report that completed the request and/or review.
- A statement by the Executive Director for Kenya.

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

FOURTH REVIEW UNDER THE THREE–YEAR ARRANGEMENT UNDER THE EXTENDED CREDIT FACILITY AND REQUEST FOR A WAIVER AND MODIFICATION OF PERFORMANCE CRITERIA

October 15, 2012

KEY ISSUES

Background: After a successful implementation of major reforms under the 2010 Constitution, Kenya is preparing for general elections in March 2013 under new rules. There are no significant differences on economic policies among the main presidential candidates, who are part of the current national-unity government and support the ECF program. Economic activity is picking up after slowing down in the first half of 2012 because of monetary tightening and a slowdown in agricultural production. Inflation has fallen within the government's target range (5 ± 2.5 percent), from about 20 percent in November, 2011. The external position has strengthened, but the deficit of the external current account remains high. Increased inflows have allowed the central bank to accumulate international reserves closer to the program target of 4 months of imports. Growth is projected to remain at about 5 percent, inflation to decline further, and the external current account is expected to improve.

Program: The Executive Board approved a three-year Extended Credit Facility (ECF) arrangement for Kenya on January 31, 2011 (120 percent of quota), which was augmented on Dec. 9, 2011 for a total of SDR 488.52 (180 percent of quota). All end-June 2012 quantitative targets were met, except for the emergence of temporary technical arrears on external debt that have been fully repaid, and for which the authorities took corrective measures and request a waiver. The authorities' primary fiscal balance outcome was in line with the program and consistent with a decline in the government debt-to-GDP ratio. Implementation of structural benchmarks has overall proceeded as expected. The National Assembly approved the Public Finance Management bill that introduces a Single Treasury Account (structural benchmark for the fourth review).

Staff views: The staff recommends completion of the review, a waiver for the emergence of temporary external arrears, and modification of performance criteria and indicative targets for the next 12 months to fit the revised macroeconomic outlook. The authorities have consented to publication of the staff report and Letter of Intent and its attachments.

Approved By
Roger Nord (AFR) and Elliot Harris (SPR)

A staff team comprising Messrs. Fanizza (head), Morales, Milkov, Thomas (all AFR) and Ms. Bouza (SPR) visited Nairobi September 12-25, 2012. Mr. Gudmundsson (Resident Representative) participated in the discussions, and Ms. Rose Ngugi from the Executive Director's office joined the mission. The mission met Minister of Finance Githae, Central Bank Governor Ndung'u, other senior officials, representatives of the private sector including financial institutions, and the donor community.

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APPENDIX

MACROECONOMIC OUTLOOK AND PROGRAM IMPLEMENTATION

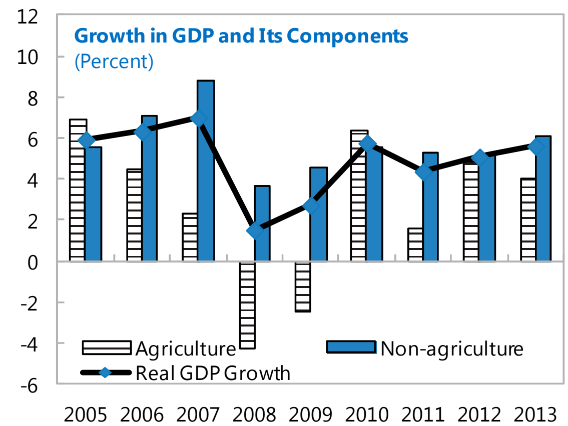
1. **Economic activity is on a rebound, after slowing down in FY 2011/12.** Growth is picking up helped by improved weather conditions and macroeconomic stability. New discoveries of oil and gas reserves have attracted investment and boosted investors' confidence (Box 1).

2. **Inflation is on a clear downward trend, at 5.3 percent (y-o-y) in September after declining for ten consecutive months.** Thanks to tight policies, inflation is now within the authorities target range (5 ± 2.5 percent y-o-y), with converging headline and core inflation. Monetary policy has been the main driver of the decline of inflation (Figure 3), although supply factors contributed to the decline of food inflation, in particular the large food harvest in East Africa, and, to a lesser extent, declining international food prices.

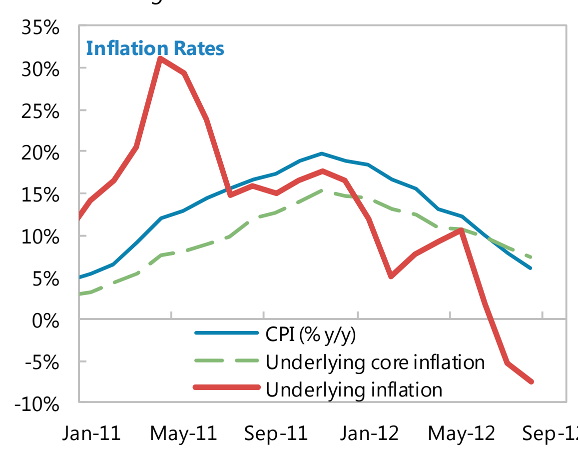
3. **The external position has improved, with international reserves above US$5 billion (3.6 months of projected imports).** Kenya's current account deficit widened to 9.1 percent of GDP in 2011/12 mainly because of oil imports, but is expected to narrow as drought-related oil and grain imports should not recur. Exports to and tourist arrivals from Europe declined in the first 6 months of 2012, as a result of difficulties in the euro area , but were offset by non-traditional markets.

Figure 1. Growth and Inflation

The drought in the Horn of Africa caused a slowdown in economic activity, especially agriculture...



...and tight policies brought inflation down within the authorities' target.



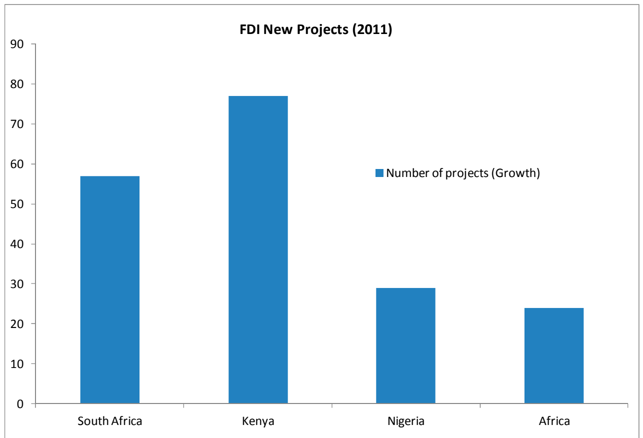
Box 1. FDI in Kenya: New Partners, New Modalities

Kenya was the second destination of announced or started greenfield FDI projects in 2011 in SSA, after South Africa. The number of greenfield projects increased by 77 percent in the year and are equivalent to more than 90 percent of total FDI (estimated at US$5 billion).

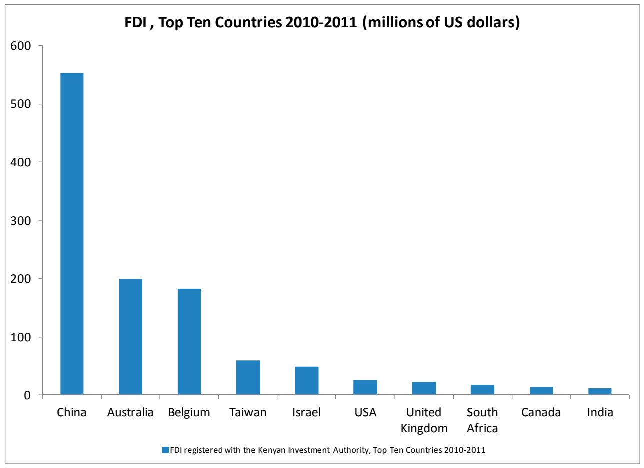
FDI is expected to increase further thanks to the acceleration of investment from China and the discovery of oil and gas in Turkana County:

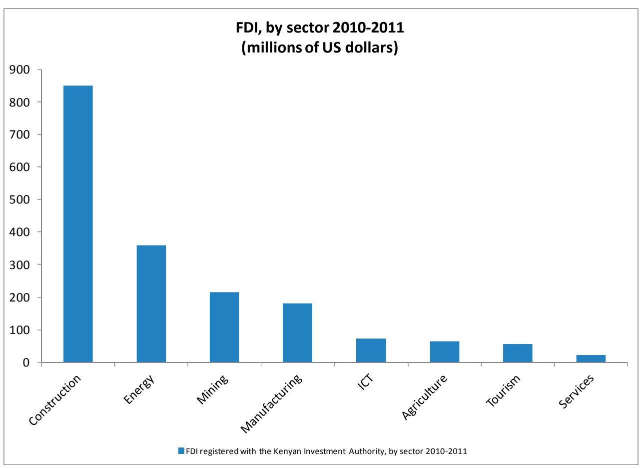
- Kenya's investment stock from China is estimated at US$500 million in 2010, but it has picked up recently in line with increasing trade between the two countries (five-fold increase to US$2.4 billion in the last six years, despite Kenya not being a commodity exporter). China's FDI in Kenya is diversifying away from construction and manufacturing, to communications (Xinhua News and China Central Television have African headquarters in Nairobi), and investment by medium-size enterprises in interior décor, construction, hotels and restaurants. New plans include a new assembly plant by Chery automobile, and coal extraction at the US$40 billion Mui Coal Basin in Kitui.

- The discovery of oil and gas in Turkana County has attracted interest from foreign investors. All 46 exploration blocks in 4 sedimentary basins (Lamu, Mandera, Anza, and Tertiary Rift) occupying 485 thousand square kilometers, have been leased to about 20 companies under a production-sharing contract, with government participation of up to 20 percent in the exploration phase and upon commencement of development and production. Based on information on tax collections, only in July and August 2012 capital goods imports rose by more than 40 percent on account of drilling rigs for exploration.



Source: The fDi Report 2012, fDi Intelligence, Financial Times.





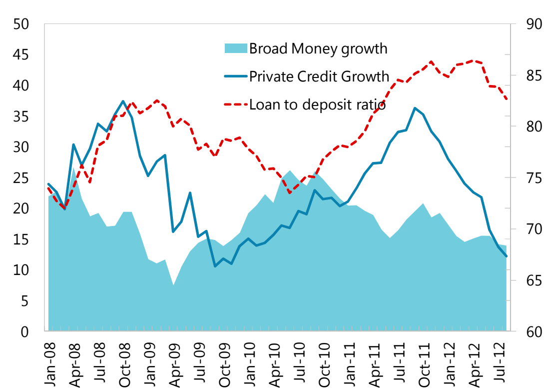
4. Fiscal policy has remained on track, but revenues have underperformed. The 2011/12 primary deficit was in line with the program target of 2.2 percent of GDP, bringing the government debt-to-GDP ratio below 45 percent. Revenue shortfalls arose mainly from the elimination of the VAT withholding regime, but were offset by cuts in both non-priority current and capital outlays. The indicative floor on pro-poor spending has also been met. Contracting of non-concessional external debt has remained within the program ceilings.

5. Monetary policy has succeeded in curbing credit growth and reducing volatility in the interbank market. Personal loans have decelerated, but credit to the corporate sector has held up. Large capital and liquidity buffers and a proactive restructuring of retail loans helped preserve banks' financial soundness. The CBK has kept Net Domestic Assets (NDA) well below the program's ceiling and Net International Reserves (NIR) above the program's floor for June. Following its success against inflation, the CBK reduced its policy rate from 16.5 to 13 percent in September, a level consistent with lower-inflation expectations but sufficient to carry out the needed liquidity absorption.

6. Following the approval of the new constitution, the government has achieved key reform milestones. The National Assembly approved the Public Finance Management (PFM) bill, including the creation of a Treasury Single Account that will enhance transparency in public finances, and a newly approved civil-servants Pensions Act (to be implemented on July 1, 2013) that would contain contingent liabilities. The harmonization of the civil-servants salary scale will ensure consistency of wage structures across government bodies. The VAT bill is currently being discussed by the National Assembly.

Figure 2. Credit and NIR

Monetary tightening has curbed credit growth to sustainable levels



…and the buildup of reserves by the CBK has continued despite a large external current account deficit.

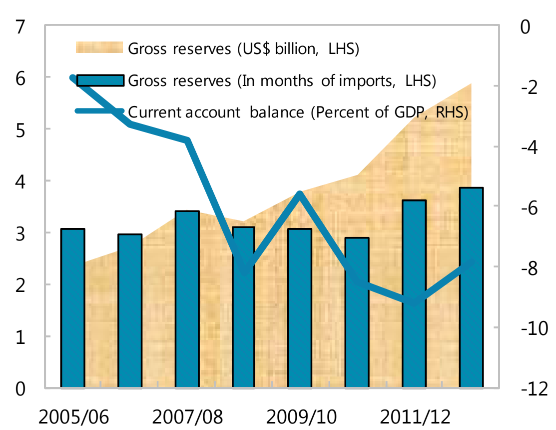
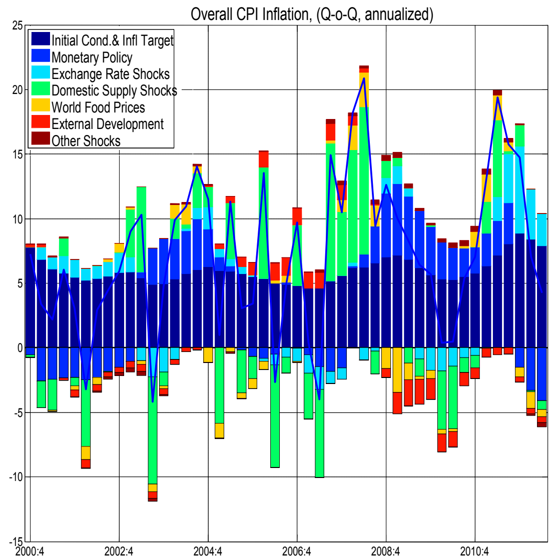
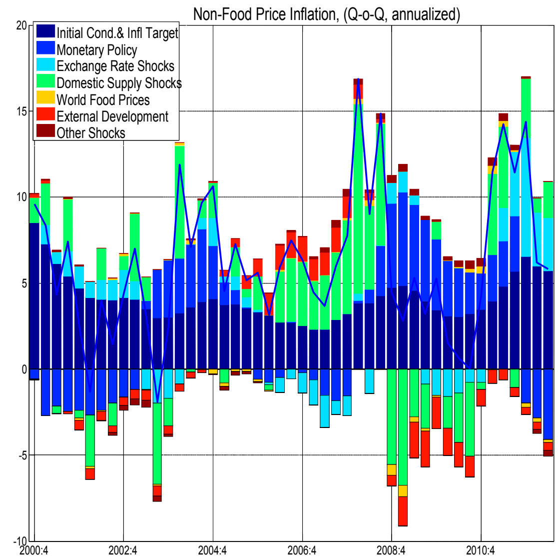


Figure 3. Is Disinflation Supply or Demand Driven?[1]

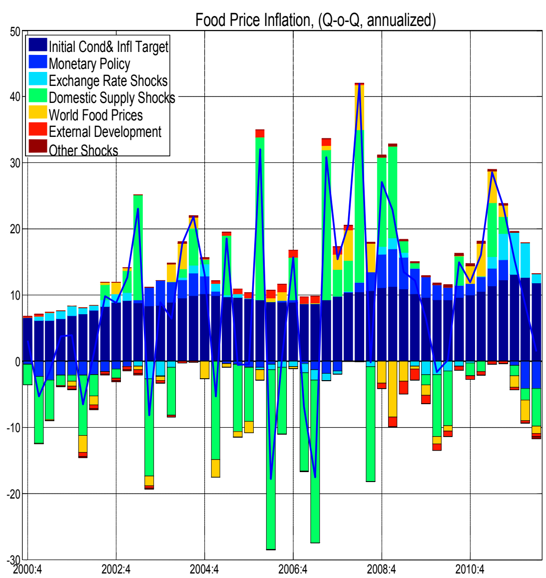
Monetary policy was the main driver of disinflation in 2012 (light blue bar), with supply forces playing a lesser role.



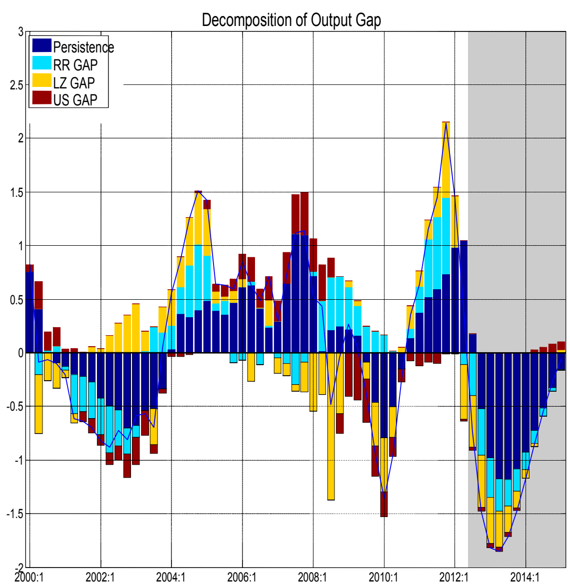
The key role of monetary policy is illustrated in the evolution of non-food inflation, with monetary policy more than offsetting domestic price shocks.



In the case of food inflation, supply factors seem to play a more important role than policy. However, domestic factors appear more significant, possibly associated with above-average harvests.



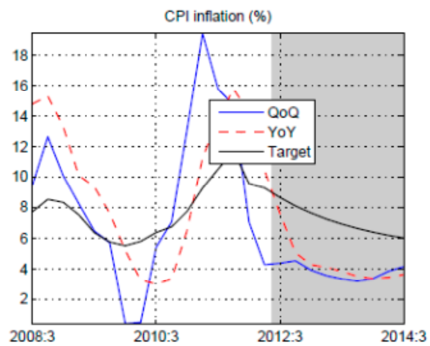
Monetary policy also played a key role in the sharp reversal of the exchange rate depreciation accumulated through 2011, which contributed to reining in domestic demand.



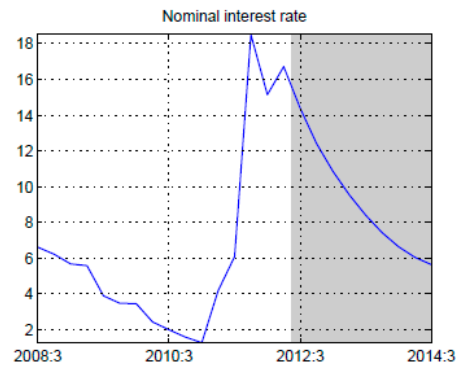
[1] *Based on a model described in Andrle M., A. Berg, A. Morales, R. Portillo and J. Vlcek, Forecasting and Policy Analysis Systems in Low-Income Countries: Food and Non-Food Inflation in Kenya, IMF Working Paper,*

Figure 3. Is Disinflation Supply or Demand Driven? (continued)

Based on WEO assumptions, inflation should continue declining consistent with the authorities' target …



..Still allowing for further reductions of the policy interest rate….



POLICY DISCUSSIONS AND RISKS

Kenya's policy mix has been successful in bringing down excess demand. Monetary policy has curbed inflation and eased pressures on the external current account. Improved expectations allowed the CBK to start reducing its interest rates. The shilling has remained broadly stable, while the CBK scaled up its international reserve accumulation. Despite revenue shortfalls, the authorities have maintained fiscal discipline. Looking ahead, key tax and expenditure reforms will support gradual fiscal consolidation, providing space for the implementation of the constitution and the preparation for the 2013 elections. Financial supervision and overall soundness of the financial system have contained credit risks.

A. Achieving the Medium-term Inflation Target

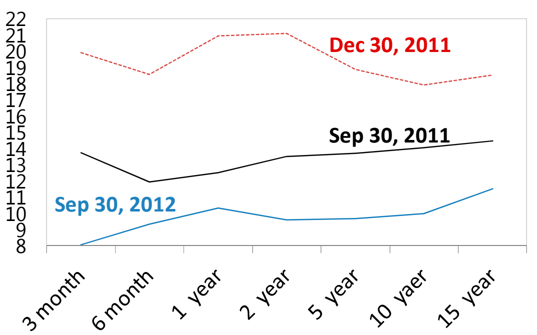
7. **Progress towards price stability has created scope for gradual monetary easing in line with inflation expectations.** Declining market interest rates, a downward shift in the yield curve, and market surveys, suggest that expectations of low inflation have taken hold. However, the CBK plans to avoid a too-rapid reduction in the policy rate that may reverse the hard-won inflation gains and place pressure on the exchange rate. In this regard, the CBK will wait for two monthly CPI realizations before deciding on the size of further policy rate cuts, to make sure that the disinflation trend continues.

8. **The CBK plans to continue using its new framework for monetary operations to guide expectations.** Lower credit expansion and a switch of commercial bank investments to longer maturities boosted liquidity in the money market, bringing the interbank rate well below the CBK policy rate. In response the CBK has stepped up absorption and as a consequence commercial banks' excess reserves at the central bank declined to their

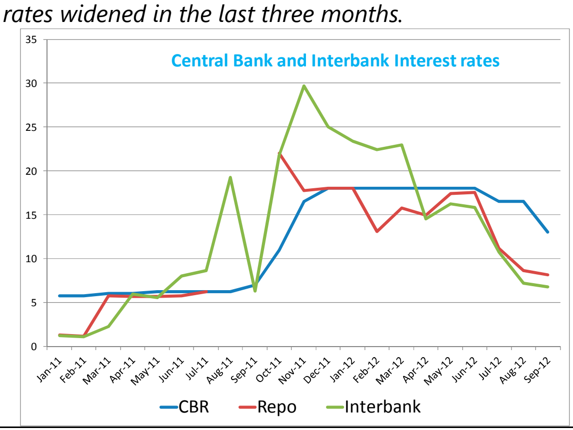
historical lows and the interbank interest rate increased by 180 basis points in the last two weeks of September.

Figure 4: Yield Curve and Interest Rates

The shift of the yield curve and its return to an upward slope suggest that inflationary expectations have reversed.



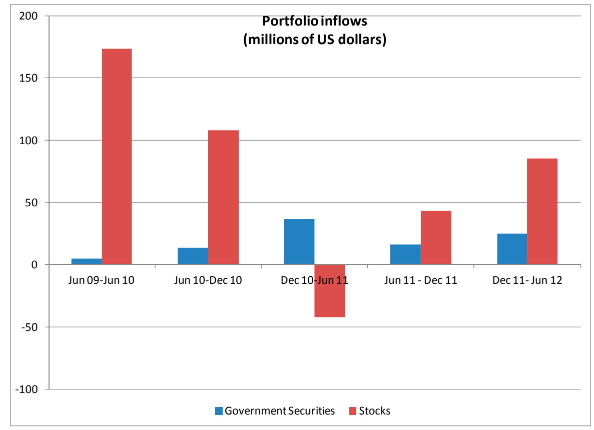
But the gap between central bank rates and interbank rates widened in the last three months.



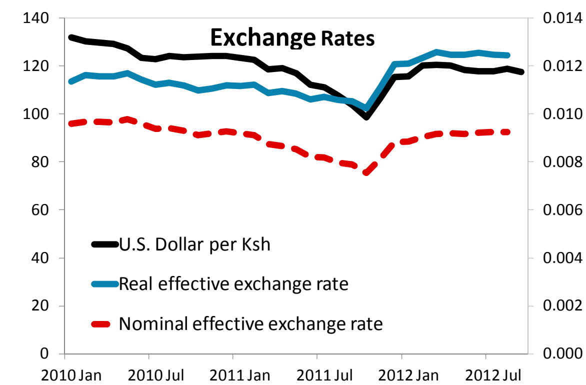
9. Risks to the favorable inflation outlook are limited to adverse external shocks. New global food shortages or a sharp reversal of financial inflows, associated with adverse global developments, may affect the inflation outlook. However, the impact of higher global food prices may be partly mitigated by large maize stocks (Maize represents around 10 percent of the food basket and is a staple food item for the poor).

Figure 5. Capital Inflows and Exchange Rate Developments

Portfolio inflows have resumed as uncertainty subsides.



And the exchange rate has appreciated back to 2010 levels.



10. The CBK intends to further accumulate international reserves, maintaining the floating exchange rate regime. High interest rates have attracted portfolio inflows and supported the shilling that has appreciated somewhat in real effective terms since October 2011. Lower interest rates, lower inflation, and continued purchases of foreign exchange by the central bank should partly reverse this real appreciation. Higher capital-good imports (25 percent y-o-y increase in January-July 2012) are mostly explained by higher foreign investment, partly for oil exploration, and are largely self-financed.

11. Banks' solvency and liquidity have improved as credit growth has decelerated. The quality of the loan portfolio remained broadly unchanged throughout the tightening period (Country Report No. 12/97). To ensure that all banks maintain a prudential framework in line with international standards, the CBK is upgrading financial regulations. (LOI, paragraph 14). Ongoing capital market reforms will deepen financial markets as they would attract new investors and encourage capital inflows into Kenyan financial markets. (LOI paragraph 15).

12. Financial safeguards have been strengthened: (a) on anti-terrorism money laundering (AML), the National Assembly has passed the Prevention of Terrorism bill (LOI paragraph 16); and (b) recent modifications of the central bank act introduce additional oversight functions. The authorities will preserve the autonomy of the central bank, including on licensing and supervision of financial institutions.

B. Pressing Ahead with Fiscal Consolidation and Reform

13. The authorities plan to reduce the central government primary fiscal deficit for FY 2012/13 despite revenue shortfalls and growing expenditure pressures. They have set a primary deficit ceiling of 2 percent of GDP, which is consistent with the program objective to reduce the debt-to-GDP ratio, but accommodates one-off outlays to prepare for the elections. In the medium term, the authorities plan to reduce further the primary deficit to 1.3 percent of GDP, with the objective to bring the government debt –to-GDP ratio below 42 percent by end FY 2014/15 and issue the planned US$1 billion sovereign bond in FY 2013/14 (LOI paragraph 11).

14. The authorities intend to address VAT revenue shortfalls that occurred in FY 2011/12 by strengthening compliance and enforcing sanctions. The elimination of the withholding of VAT on government transactions had a favorable impact on tax compliance costs. However, it has resulted in lower compliance, particularly for large taxpayers previously subject to withholding

Impact of Revenue and Expenditure Measures in FY 2012/13

	2011/12	2012/13	
	Preliminary	Third Review	Proposed Program
	Percent of GDP		
Total Revenues and Grants	**23.3**	**25.8**	**25.9**
Of which:			
VAT	5.6	6.2	6.1
VAT Tax Administration and Policy Measures: Total Impact on Revenue	0	0.6	0.5
Non-recurrent loss from the removal of VAT withholding	0	0.2	0.2
Audit of VAT returns of large taxpayers previously subject to government withholding	0	0	0.1
Implementation of the new VAT law	0	0.4	0.2
Primary Expenditures and Net Lending (Cash Basis)	**25.5**	**27.6**	**27.9**
Expenditure Measures: Total Impact	0	0	0.2
Wage Increase	0	0	0.4
Election expenditure for voting kits	0	0	0.2
Change in non-piority current and capital expenditures	0	0	-0.4
Primary Balance	**-2.2**	**-1.8**	**-2.0**

Source: Authorities projections and IMF staff estimates.

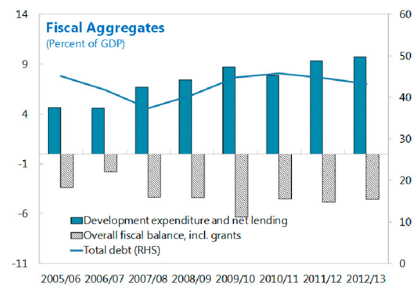
obligations (0.3 percent of GDP lower revenue), while one-off use of accumulated VAT tax credits reduced revenues by 0.2 percent of GDP. The tax administration measures described in the LOI (paragraph 8) should allow the authorities to reverse these shortfalls by end FY 2012/13. (See Table 1)

15. Tax reform is poised to steadily increase tax revenue over the medium term: VAT reforms are expected to be approved before the end of 2012, complemented by reform of the excise and income tax regimes in the next fiscal year.

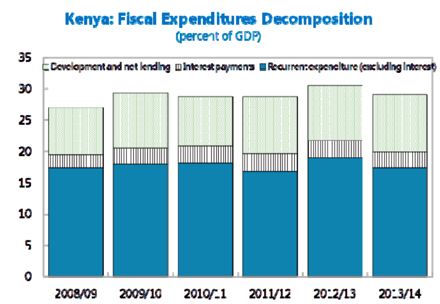
16. Spending pressures have increased in the run up to elections. Civil servants in the education and health sectors have intensified demands for higher wages. The government has agreed to realign teachers' salaries with the rest of the public servants, offsetting budgetary costs with further cuts in non-priority spending that the broader coverage of the Integrated Financial Management System (IFMIS) should make it feasible.[1]

Figure 6. Fiscal Balances, Debt and Capital Expenditure

Revenue shortfalls were offset by expenditure control.



...maintaining priority development expenditure.



17. Structural fiscal reforms are moving ahead: In particular:

- The recently approved PFM Act will provide the foundations of sound financial management both at the central and county government levels.

- The authorities give high priority to improving capacity within the public administration to allow a swift implementation of the PFM Act and forthcoming regulations.

- The budget will maintain priority in continued investment in infrastructure and education, expansion of social safety nets, implementation of the constitution and enhanced investment in security. In particular, priority pro-poor spending will

[1] The reinstatement of excise taxes on diesel and kerosene (0.1 percent of GDP) has been postponed to FY 13/14.

not be affected by the re-allocation of spending needed to offset revenue shortfalls. Kenya remains committed to achieving the Millennium Development Goals and to improving youth employment conditions.

18. Risks to the fiscal outlook relate to the political and security environment. A deterioration of the political outlook in the run-up to elections in 2013 and unforeseen complications in the implementation of fiscal decentralization may compromise political support for the program. Also, a protracted intervention in Somalia may translate into budget pressures and heightened security concerns could affect tourism and tax revenue.

C. Addressing Risks from a Deterioration of the Global Economy

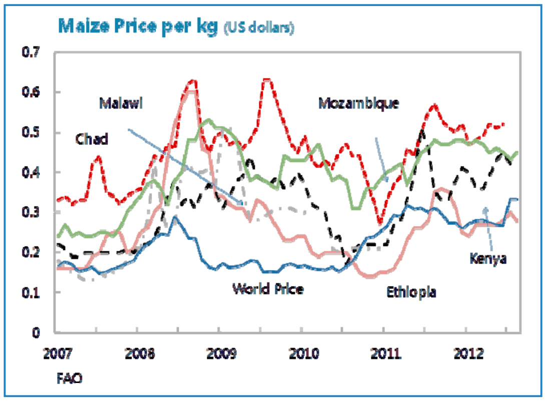
19. Kenya has built up buffers to address vulnerabilities to a decline in external demand and persistent volatility in global commodity prices. An IMF cross-country vulnerability exercise for a food price shock and a further deterioration of the global growth outlook (both in intensity and length), found that Kenya showed low vulnerability. Nevertheless, Kenya's buffers would become inadequate in the event of more extreme shocks.

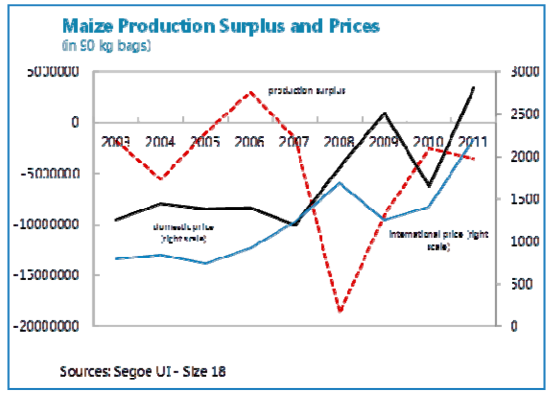
20. The results of the 2011 debt sustainability analysis (DSA) still remain valid (staff supplement in Country Report No. 12/14). Kenya's risk of debt distress on external and domestic debt remains low. The contracting of a $600 million 2-year syndicated loan in May 2012 substitutes part of the planned issuance of a sovereign bond. In addition, fiscal policy has already brought the public debt-to-GDP ratio below 45 percent, an objective that under the original program (Country Report No. 11/48) would have been achieved only at the end of 2013/14. International reserves coverage has increased from 2.9 to 3.6 months of imports of goods and services and will improve Kenya's resilience to external shocks.

21. Main risks to the external outlook are associated with a further deepening of the European crisis. Lower external demand from Europe would tilt risks to the downside for non-traditional agricultural exports, tourism earnings and remittances. Moreover, supply shocks may put pressure on import prices and the external current account. However, Kenya's vulnerability to maize price shocks has lessened, mainly on account of restocking maize (Box 2).

Box 2. Kenya's Vulnerability to Food Inflation

Kenya's maize domestic price has been fairly subdued despite an increase in the US dollar price of maize by about 29 percent since end 2011. Since maize is a food staple for the poor, rising international maize prices are a concern. However, domestic maize prices are expected to be less vulnerable than in the 2008-09 food inflation episode for the following reasons:





- The maize inventory level is expected to remain high as maize production is projected to increase in line with consumption through December 2012.

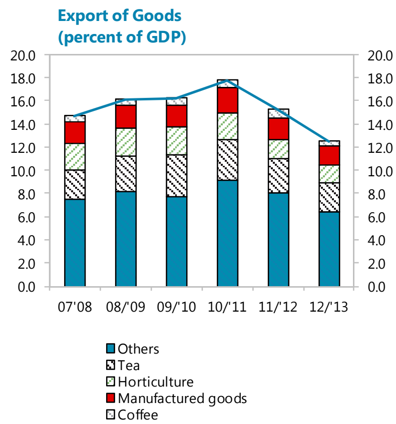
- Historically, domestic maize prices have been more affected by shortfalls in domestic maize production than by international prices (the bumper harvest of 2006 and the 2009 drought).

22. Relative to baseline projections (Figure 7), Kenya's external position would suffer from a sharp downturn in global activity with oil prices staying at the level projected in the baseline WEO, but coupled with an increase in food prices (Figure 8 Scenario 1). In this scenario the external current account would deteriorate by about one percentage point of GDP in the next two years. In the more likely event that a sharp global downturn causes also a decline in oil prices (Figure 8, Scenario 2), the external current account would actually improve given the importance of fuel imports in the trade balance, and the small contribution of exports of goods and services to Europe to GDP. In this scenario, no policy response would be necessary. However, public debt would increase temporarily to 45 percent of GDP.

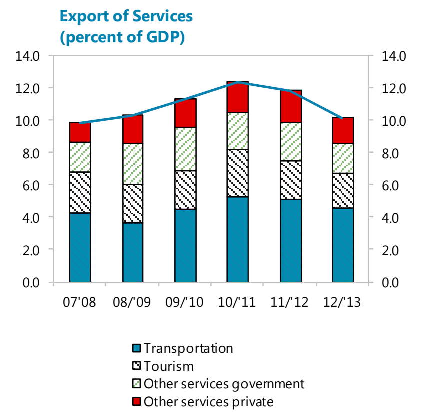
23. If scenario 1 materializes, further adjustment may be needed to achieve the program objectives. Policy space has only partially been re-built, as low inflation has been achieved only recently, and fiscal space is limited because of revenue shortfalls. Risks are: (a) slower growth in emerging markets (slowdown as a result of spillover from the euro area crisis); (b) bad weather conditions may lead to lower growth, higher inflation, and a deterioration of the external position; (c) a further increase in oil prices related to tensions in the Middle East could complicate the external adjustment process; and, (d) a worse-than-expected deterioration of banks' asset quality may lead to further credit supply constraints, magnifying the impact of shocks.

Figure 7. Balance of Payments Developments

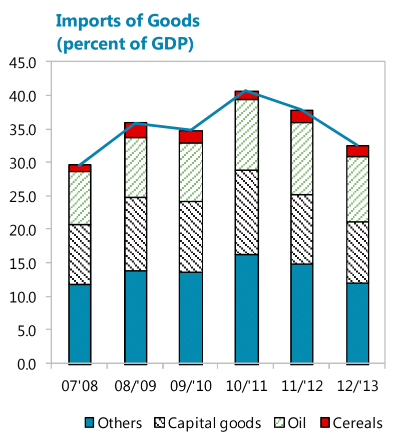
Adverse weather conditions coupled with lower global export prices explain a decline in exports…



… and tourism receipts suffer from security concerns and lower European passenger arrivals.….



However, the import bill is also decreasing because of lower oil prices and oil demand.



…and both the oil and non-oil current account deficit in the first half year of 2012 have started to improve.

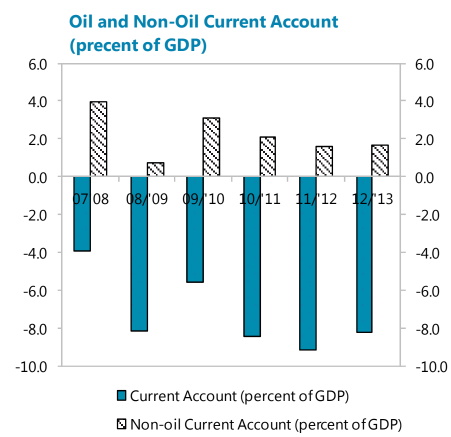
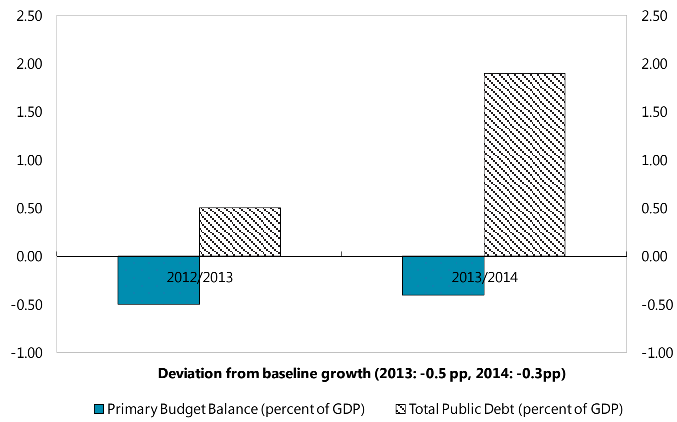


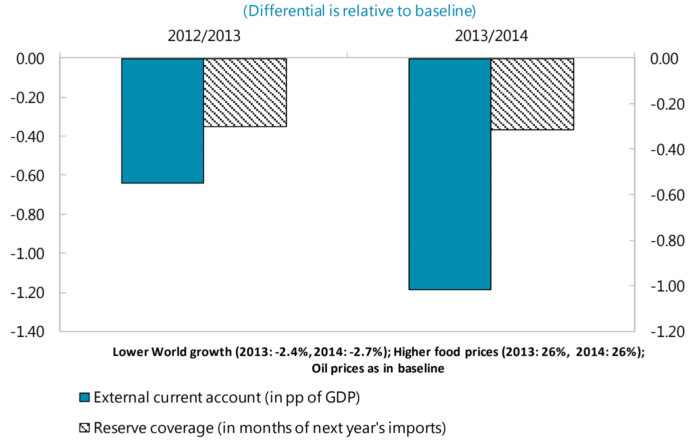
Figure 8. Kenya: Impact Under Alternative Global Downturn Scenarios

Impact on growth may bring public debt back to 45 percent of GDP, but only affect the external current account if oil prices remain high.

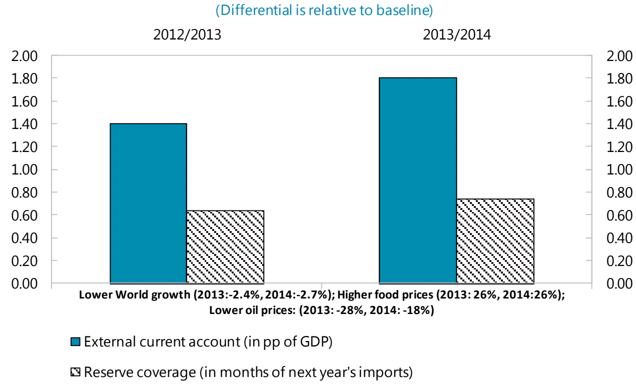
Growth Decline Scenario
(Differential is relative to baseline)



Scenario 1
(Differential is relative to baseline)



Scenario 2
(Differential is relative to baseline)



PROGRAM ISSUES

24. Staff proposes to modify the targets for the next two reviews. All June 2012 targets were met, except for the emergence of temporary technical arrears on external debt (Table 6). For December 2012 and June 2013, NIR and NDA targets need to be revised mainly to anticipate higher demand for currency as elections approach. The fiscal primary balance target has been revised to accommodate new estimates of elections-related outlays. The revised targets take into account changes in the macroeconomic outlook. An adjustor is incorporated in the event expected grants to finance security outlays do not materialize. The terms of the performance criteria on guaranteed debt are redefined to allow the government to settle obligations within 30 days after liabilities emerge, consistent with international payment practices. The ceiling for non-concessional loans remains the same. The direction of macroeconomic policies under the program has not changed.

25. The authorities' reform agenda will prioritize fiscal structural measures and capital market reform. In the fiscal area, these include the following structural reforms: (a) the implementation of the new VAT law; (b) reform of the income tax; (c) a review of the customs and excise regimes; (d) the implementation of a new salary scheme for civil servants; and (e) introduction of the new civil servants pension reform. In the financial sector the main reforms are: (a) strengthening supervision to adapt to rapidly growing financial inclusion; and (b) introduction of a consolidated financial supervision.

26. The authorities request a waiver for the temporary non-observance of the continuous performance criterion on external payment arrears. Following the implementation of the new constitution, temporary arrears emerged because of new procedures, that envisaged the participation of the Attorney General and the Controller of the Budget in the repayment process who until recently were not familiar with common practices in this area. Arrears, that emerged to external creditors between the months of March and September, are now fully repaid.[2] The authorities have since taken corrective measures to prevent the reoccurrence of arrears, comprising: (i) new delegating authorities; (ii) centralized access to original loan documents; (iii) simplification of payment instructions; and (iv) initiation of the repayment process well ahead of the due date.

27. An update safeguards assessment of the Central Bank of Kenya (CBK) was completed in March 2012 with respect to the augmentation of access under the ECF Arrangement approved on December 9, 2011. The assessment found that the temporary governance gaps of the Board and Audit Committee identified in the 2011 assessment

[2] The arrears emerged to the following creditors: (i) three to USAID (two of which are on loans guaranteed by the government) in the amounts of $0.42 million (due on March 1st, cleared on July 12th); $0.33 million (due on August 14th, cleared on September 17th); and $0.44 million (due on September 1st, cleared on September 14th); and (ii) two to JICA, on loans guaranteed by the government, in the amounts of $2.3 million (due on March 20th , cleared on April 23rd) and $5.7 million (due on June 20th, cleared on July 4th); (iii) to ICO-Spain, in the amount of $0.13 million (due on August 20th, cleared on September 18th).

have been rectified. These oversight bodies have now been fully restored to support effective discipline and responsibility. The Audit Committee concluded satisfactorily on its ex-post assessment of the gaps, and the external auditor issued an unqualified audit opinion for 2011. The assessment recommended adopting an action plan to resolve the large stock of pending audit recommendations. Aside from amending the CBK Act, almost all recommendations of the earlier assessment have been implemented on schedule. The authorities have committed to submit revisions to the CBK Act to the National Assembly. Internal audit has resumed certifying reconciliations supporting the monetary data reporting to the Fund.

STAFF APPRAISAL

28. ***Achievements:*** Kenya has made significant progress in reducing its vulnerabilities and is now in a better position to withstand adverse shocks. The external position has strengthened with a rising buffer of international reserves and a current account deficit set to narrow. These factors have dissipated pressures on the exchange rate. The fiscal position has also improved with a declining debt-to-GDP ratio. Inflation has been brought in line with the authorities' target; and economic expansion is picking up. Moreover, key economic reforms, which should improve economic performance and governance, are advancing. Public resources devoted to develop much needed infrastructure have risen, despite the large costs associated with financing both the constitutional transition and security operations in Somalia.

29. ***Challenges and risks:*** The weakened global financial conditions and the unfolding Euro-zone crisis pose threats to the outlook for Kenya. There is no room for complacency as adverse shocks could still derail a favorable economic performance. Further efforts to build policy buffers should enhance Kenya's economic resilience to ensure a sustained and stronger economic expansion, a necessary condition to reduce poverty. If a global slowdown is combined with rising oil prices, the external current account will worsen, and policies should adjust to rein in domestic demand to avoid a deterioration of the external position. However, if domestic growth weakens substantially from a global downturn, the authorities should stand ready to fully exploit the scope for monetary easing, with a pause in their fiscal consolidation efforts to avoid a pro-cyclical fiscal stance. Maintaining fiscal discipline in the run-up to the March elections will prove essential to cement confidence and limit the impact that political uncertainty may have on economic activity.

30. ***Monetary and exchange rate policies:*** The monetary policy tightening that took place since October 2011 has tamed inflationary pressures. Low-inflation expectations appear to have taken hold, and fully justify the CBK decision to cut its policy rate in September. Looking forward, there is scope for further gradual monetary policy easing to bring the policy rate to a level consistent with the prevailing expectations of inflation. Nevertheless, the CBK should watch for new inflationary pressures that may emerge from higher global food and oil prices, and adverse climatic shocks. In the immediate, the CBK needs to bring the interbank rate within the predetermined corridor around its policy rate through increased liquidity absorption. This will enhance the effectiveness of the CBK monetary policy framework that assigns a pivotal role to the policy rate. The CBK should continue gradually accumulating foreign exchange reserves in line with the program targets until international reserve cover 4 months of projected imports, and thereafter intervene only occasionally to smooth excessive volatility in the foreign exchange market.

31. ***Fiscal Policy:*** Strong expenditures pressures have emerged in the run up to the elections, but the authorities still aim at reducing the primary deficit in 2012/13 to achieve a further decline in the debt-to-GDP ratio. In particular, a teachers' strike that paralyzed schools for almost a month has made it necessary to revise upward the wage-bill budgetary allocations with offsetting cuts in non-priority spending. Adhering to the 2012/13 target will provide a strong signal to markets that fiscal discipline is not being compromised and that legitimate claims can be effectively addressed only within the available resource envelope. The authorities' good track record under the program so far augurs well, but the risks and the costs of fiscal slippages should not be understated. The fiscal target for 2012/13 has also been adjusted for additional foreign-financed outlays that will prove essential to ensure that the March 2013 elections take place in orderly and fair manner. The shortfall in VAT collections in 2011/12 did not compromise the achievement of the program targets, but remains a major source of concern. The authorities should move ahead immediately to close the gaps in VAT administration that emerged from the elimination of the withholding regime. In particular, the Kenya Revenue Authority should audit immediately the large taxpayers that were subject to this regime. It will also be important that the new VAT law is implemented starting from January 2013 and that any amendment in the National Assembly do not compromise its revenue potential.

32. ***Expenditure reform:*** The recent enactment of the new PFM law constitutes a game-changer in the management of public resources. Its implementation should reduce the scope for corruption and increase accountability. In particular the establishment of a Treasury Single Account at both the central and county levels should translate into stricter expenditure control. Moreover, it will be essential to ensure an orderly transition to the new decentralized form of government. The authorities should as soon as possible prepare the PFM Act implementing regulations, and staff welcomes the authorities' request for Fund technical assistance in this regard. Progress in preparing the reform of public sector pensions and the review and rationalization of the wage scale in the civil service is underway. The former should reduce future contingent liabilities substantially; the latter should lower the likelihood of sudden bursts in wage claims.

33. ***Financial Sector:*** The high interest rates that prevailed from October 2011 until recently appear to have had little adverse impact on the health of commercial banks that continued to expand their loan portfolios, but at a more sustainable pace. Nevertheless, the CBK should stand ready to take prompt corrective actions in the event of a deterioration in asset quality that may also be brought about by a possible deceleration in economic activity. Staff supports the ongoing upgrade of the CBK prudential guidelines that should help ensure that banks do not take excessive risks in an environment of declining interest rates. Completing the process of opening up of the Nairobi Stock Exchange together with efforts to facilitate the listing of small and medium size enterprises should help deepen financial intermediation.

34. ***Program performance:*** All June 2012 quantitative performance criteria were met, except for the criterion on non- accumulation of external arrears that was temporarily breached for minor technical reasons. Staff supports the authorities' request for waiver on the non-observance of this performance criterion. This breach was minor in nature, temporary, and did not affect the thrust of policies. Moreover, the authorities have already made all the repayments in question and have taken the necessary administrative measures to avoid new arrears. All structural benchmarks and indicative targets for June 2012 were observed. Staff recommends completion of the fourth review under the ECF arrangement, approval of the requests for modifying end-December 2012 and end-June 2013 performance criteria, and the approval of the request for a waiver.

Table 1. Selected Economic Indicators, 2009/10–2014/15

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

	2009/10 [1]	2010/11	2011/12		2012/13	2013/14	2014/15
			Third Review	Preliminary		Projections	
	Actual	Actual					
	(Annual percentage change; unless otherwise indicated)						
National accounts and prices							
Nominal GDP (market prices, in billions of Kenya shillings)	2,458	2,787	3,274	3,281	3,776	4,269	4,787
Real GDP growth (market prices)	4.3	5.1	5.1	4.7	5.4	6.0	6.3
GDP deflator (average) [2]	5.4	7.9	12.2	12.4	9.2	6.7	5.5
Consumer price index (annual average) [2]	6.7	6.9	15.8	16.0	5.4	5.0	5.0
Consumer price index (end of period) [2]	3.5	14.5	10.8	10.0	5.0	5.0	5.0
Import volume growth, goods	6.4	6.2	-1.2	4.7	1.3	7.5	7.5
Import value growth, goods	2.5	20.6	11.6	16.2	0.4	5.6	5.4
Export volume growth, goods	-0.4	-0.3	-0.5	3.6	2.6	8.0	5.2
Export value growth, goods	6.0	13.1	3.1	6.7	-4.3	3.3	4.0
Terms of trade, goods, and services (Base year 2000)	15.4	0.2	-8.0	-6.8	-5.1	-2.0	0.9
Ksh per US$ exchange rate (end of period)	81.9	99.6	…	82.9 [3]			
Nominal effective exchange rate (- depreciation; end of period)	-0.3	-14.3	…	…	…	…	…
Real effective exchange rate (- depreciation; end of period)	-1.6	-6.9	…	…	…	…	…
Money and credit							
M3 (broad money and foreign currency deposits, end period)	26.2	15.2	18.7	15.5	19.9		
Reserve money	31.5	4.8	16.7	17.6	20.1		
	(In percent of GDP; unless otherwise indicated)						
Investment and saving							
Investment	20.6	20.8	23.5	21.6	21.6	22.4	22.4
Central government	8.7	7.8	9.5	9.1	8.7	9.1	9.1
Other	11.9	13.0	14.0	12.5	12.9	13.3	13.2
Gross national saving	15.0	12.3	12.0	12.4	13.8	15.1	16.2
Central government	1.5	2.7	3.3	3.1	2.5	3.9	4.4
Other	13.5	9.6	8.7	9.3	11.3	11.2	11.8
Central government budget [4]							
Total revenue	22.3	23.9	24.4	22.8	24.0	24.1	24.2
Total expenditure and net lending	29.5	29.1	30.7	28.9	30.7	29.4	29.0
Overall balance (commitment basis) excluding grants	-7.2	-5.2	-6.3	-6.1	-6.7	-5.3	-4.8
Overall balance (commitment basis) including grants	-6.4	-4.5	-4.8	-5.6	-4.8	-4.2	-3.6
Primary budget balance	-3.8	-1.5	-2.2	-2.2	-2.0	-1.7	-1.4
Net domestic borrowing	5.4	3.2	1.9	1.9	3.5	1.8	1.9
Balance of payments							
Exports value, goods, and services	27.5	30.2	25.0	27.0	22.6	21.3	20.4
Imports value, goods, and services	40.9	47.2	43.7	43.7	37.9	35.6	33.7
Current external balance, including official transfers	-5.6	-8.5	-11.5	-9.2	-7.8	-7.3	-6.2
Current external balance, excluding official transfers	-5.6	-8.4	-11.4	-9.1	-8.2	-7.3	-6.1
Gross international reserve coverage							
In billions of U.S. dollars (end of period)	4	4.1	5.1	5.2	5.9	6.8	7.7
In months of next year imports (end of period)	3.1	2.9	3.6	3.6	3.9	4.2	4.5
Public debt							
Total public debt, net (percent of GDP)	44.8	45.7	44.6	44.6	43.9	43.1	41.3
Of which: external debt	23.0	23.3	23.5	23.6	22.2	22.1	20.7
Domestic debt, net of deposits	21.8	22.4	21.0	21.0	21.7	21.0	20.6

Sources: Kenyan authorities and IMF staff estimates and projections.

[1] Fiscal year is from July 1st through June 30th.

[2] The consumer price index series was revised in November 2009 based on a new methodology.

[3] Actual as of June 30, 2012.

[4] Revenue plus program grants minus recurrent expenditure.

Table 2a. Central Government Financial Operations, 2009/10-2014/15

	2009/10	2010/11	2011/12 Preliminary Estimate	2012/13 Projections	2013/14 Projections	2014/15 Projections
	(In billions of Kenyan shillings, unless otherwise indicated)					
Revenues and grants	**568.8**	**686.3**	**763.5**	**978.7**	**1,075.8**	**1,216.0**
Revenue	**548.1**	**667.5**	**748.2**	**906.8**	**1,028.9**	**1,158.6**
Tax revenue	466.5	557.2	626.5	748.6	853.8	962.3
Income tax	209.1	258.7	312.5	366.5	418.4	469.2
Import duty (net)	41.3	46.1	51.7	59.1	68.3	76.6
Excise duty	74.1	80.6	78.9	91.1	102.5	114.9
Value-added tax	142.0	171.9	183.4	231.9	264.7	301.6
Nontax revenue	81.6	110.4	121.7	158.2	175.0	196.3
Investment income	8.4	11.1	14.1	16.3	17.1	19.1
Other	32.7	41.0	50.2	57.9	64.0	71.8
LATF	0.0	0.0	16.4	19.3	21.3	23.9
Ministerial and Departmental Fees (AIA) [1]	40.6	58.3	41.0	64.7	72.6	81.4
Grants	**20.7**	**18.8**	15.3	**71.9**	**47.0**	**57.4**
Project grants	20.7	18.8	15.3	56.2	47.0	57.4
Program grants	0.0	0.0	0.0	15.7	0.0	0.0
Expenditure and net lending	**725.2**	**811.8**	**947.9**	**1,160.0**	**1,255.1**	**1,383.6**
Recurrent expenditure	**504.3**	**578.5**	**642.3**	**818.2**	**845.3**	**933.6**
Interest payments	63.5	76.2	91.2	105.8	106.7	105.3
Domestic interest	57.4	69.2	82.3	94.5	93.9	91.0
Foreign interest due	6.1	7.0	8.9	11.3	12.8	14.4
Wages and benefits (civil service)	172.6	198.5	224.6	278.0	303.1	325.5
Pensions, etc.	29.0	25.7	26.1	41.0	59.8	67.0
Other [1]	182.3	217.4	221.7	309.9	303.1	359.1
Defense and NSIS	56.9	60.6	78.7	83.5	72.6	76.6
Development and net lending	**214.7**	**219.4**	**300.7**	**331.8**	**392.8**	**440.4**
Domestically financed	151.9	149.9	211.8	205.6	239.1	263.3
Foreign financed	61.6	67.0	86.1	123.7	150.8	174.1
Net lending	1.2	2.5	2.8	2.5	2.9	3.0
Equalization Fund (grants to marginalized areas)	0.0	0.0	0.0	0.0	4.3	0.0
Contingencies	0.0	0.0	0.0	5.0	4.3	0.0
Drought expenditures	6.2	8.4	4.9	0.0	0.0	4.8
Constitutional Reform [2]	0.0	5.6	0.0	5.0	8.5	4.8
Balance (commitment basis, excluding grants)	**-177.1**	**-144.3**	**-199.7**	**-253.2**	**-226.3**	**-225.0**
Balance (commitment basis, including grants)	**-156.4**	**-125.5**	**-184.4**	**-181.3**	**-179.3**	**-167.6**
Adjustments to cash basis	**0.0**	**6.8**	**22.4**	**0.0**	**0.0**	**0.0**
Balance (cash basis, including grants)	**-156.4**	**-118.8**	**-162.0**	**-181.3**	**-179.3**	**-167.6**
Financing	**156.4**	**118.8**	**162.0**	**181.3**	**179.3**	**167.6**
Net foreign financing	22.9	28.4	98.5	50.9	102.0	77.1
Disbursements	39.8	48.2	122.0	76.6	191.7	119.7
Project loans	39.8	48.2	70.7	70.0	106.7	119.7
Commercial borrowing [3]	0.0	0.0	51.3	6.6	85.0	0.0
Repayments due	-18.7	-20.5	-25.4	-26.2	-90.2	-43.1
Change in arrears	1.4	0.1	1.4	0.0	0.0	0.0
Rescheduling / debt swap	0.5	0.5	0.5	0.5	0.5	0.5
Net domestic financing	133.5	90.4	63.5	130.4	77.3	90.5
Memorandum items:						
Nominal GDP	2,458.4	2,787.3	3,281.2	3,775.6	4,269.2	4,787.5
Primary budget balance including grants	-92.9	-42.6	-70.8	-75.5	-72.6	-62.2
Stock of domestic debt, net (end of period)	534.8	625.2	688.7	819.1	896.4	986.9
Total public debt, net of deposits	1,100.4	1,275.0	1,462.2	1,659.0	1,838.3	1,975.9

Sources: Kenyan authorities and IMF staff estimates and projections.

Fiscal year runs from July to June.

[1] Coverage increased in FY 2010/11 to incorporate tuitions and fees to universities and hospitals, and associated expenditure.

[2] Includes estimated expenditures associated with the implementation of the new constitution.

[3] Includes planned sovereign bonds and proceeds from syndicated loan.

Table 2b. Central Government Financial Operations (percent of GDP), 2009/10-2014/15

	2009/10	2010/11	2011/12 Preliminary Estimate	2012/13 Projections	2013/14 Projections	2014/15 Projections
	(In percent of GDP)					
Revenues and grants	**23.1**	**24.6**	**23.3**	**25.9**	**25.2**	**25.4**
Revenue	**22.3**	**23.9**	**22.8**	**24.0**	**24.1**	**24.2**
Tax revenue	19.0	20.0	19.1	19.8	20.0	20.1
Income tax	8.5	9.3	9.5	9.7	9.8	9.8
Import duty (net)	1.7	1.7	1.6	1.6	1.6	1.6
Excise duty	3.0	2.9	2.4	2.4	2.4	2.4
Value-added tax	5.8	6.2	5.6	6.1	6.2	6.3
Nontax revenue	3.3	4.0	3.7	4.2	4.1	4.1
Investment income	0.3	0.4	0.4	0.4	0.4	0.4
Other	1.3	1.5	1.5	1.5	1.5	1.5
LATF	0.0	0.0	0.5	0.5	0.5	0.5
Ministerial and Departmental Fees (AIA) [1]	1.7	2.1	1.2	1.7	1.7	1.7
Grants	**0.8**	**0.7**	**0.5**	**1.9**	**1.1**	**1.2**
Project grants	0.8	0.7	0.5	1.5	1.1	1.2
Program grants	0.0	0.0	0.0	0.4	0.0	0.0
Expenditure and net lending	**29.5**	**29.1**	**28.9**	**30.7**	**29.4**	**28.9**
Recurrent expenditure	**20.5**	**20.8**	**19.6**	**21.7**	**19.8**	**19.5**
Interest payments	2.6	2.7	2.8	2.8	2.5	2.2
Domestic interest	2.3	2.5	2.5	2.5	2.2	1.9
Foreign interest due	0.2	0.3	0.3	0.3	0.3	0.3
Wages and benefits (civil service)	7.0	7.1	6.8	7.4	7.1	6.8
Civil service reform	0.0	0.0	0.0	0.0	0.0	0.0
Pensions, etc.	1.2	0.9	0.8	1.1	1.4	1.4
Other [1]	7.4	7.8	6.8	8.2	7.1	7.5
Defense and NSIS	2.3	2.2	2.4	2.2	1.7	1.6
Development and net lending	**8.7**	**7.9**	**9.2**	**8.8**	**9.2**	**9.2**
Domestically financed	6.2	5.4	6.5	5.4	5.6	5.5
Foreign financed	2.5	2.4	2.6	3.3	3.5	3.6
Net lending	0.0	0.1	0.1	0.1	0.1	0.1
Equalization Fund (grants to marginalized areas)	**0.0**	**0.0**	**0.0**	**0.0**	**0.1**	**0.0**
Contingencies	**0.0**	**0.0**	**0.0**	**0.1**	**0.1**	**0.0**
Drought expenditures	**0.3**	**0.3**	**0.1**	**0.0**	**0.0**	**0.1**
Constitutional Reform [2]	**0.0**	**0.2**	**0.0**	**0.1**	**0.2**	**0.1**
Balance (commitment basis, excluding grants)	**-7.2**	**-5.2**	**-6.1**	**-6.7**	**-5.3**	**-4.7**
Balance (commitment basis, including grants)	**-6.4**	**-4.5**	**-5.6**	**-4.8**	**-4.2**	**-3.5**
Adjustments to cash basis	**0.0**	**0.2**	**0.7**	**0.0**	**0.0**	**0.0**
Balance (cash basis, including grants)	**-6.4**	**-4.3**	**-4.9**	**-4.8**	**-4.2**	**-3.5**
Financing	**6.4**	**4.3**	**4.9**	**4.8**	**4.2**	**3.5**
Net foreign financing	0.9	1.0	3.0	1.3	2.4	1.6
Disbursements	1.6	1.7	3.7	2.0	4.5	2.5
Project loans	1.6	1.7	2.2	1.9	2.5	2.5
Commercial borrowing [3]	0.0	0.0	1.6	0.2	2.0	0.0
Repayments due	-0.8	-0.7	-0.8	-0.7	-2.1	-0.9
Change in arrears	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
Net domestic financing	5.4	3.2	1.9	3.5	1.8	1.9
Memorandum items:						
Nominal GDP	2,458.4	2,787.3	3,281.2	3,775.6	4,269.2	4,787.5
Primary budget balance	-3.8	-1.5	-2.2	-2.0	-1.7	-1.3
Stock of domestic debt, net (end of period)	21.8	22.4	21.0	21.7	21.0	20.6
Total public debt, net of deposits	**44.8**	**45.7**	**44.6**	**43.9**	**43.1**	**41.3**

Sources: Kenyan authorities and IMF staff estimates and projections.

Fiscal year runs from July to June.

[1] Coverage increased in FY 2010/11 to incorporate tuitions and fees to universities and hospitals, and associated expenditure.

[2] Includes estimated expenditures associated with the implementation of the new constitution.

[3] Includes planned sovereign bonds and proceeds from syndicated loan.

Table 3. Monetary Survey

	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13
	(In billions of Kenyan shillings, unless otherwise indicated)										
Central Bank of Kenya (CBK)											
Net foreign assets	252.4	258.7	282.8	292.0	258.7	291.1	340.4	349.0	351.5	354.0	366.4
(in millions of US dollars) [1]	3,175	3,105	3,040	2,926	3,041	3,505	4,109	4,213	4,243	4,273	4,423
Net domestic assets	-29.8	-49.3	-62.3	-55.9	-3.7	-33.2	-81.1	-73.1	-57.4	-55.9	-55.1
Net domestic credit	13.2	4.9	17.7	50.0	54.8	21.1	-30.2	-22.2	-6.4	-4.9	-4.1
Government (net)	-3.7	-1.5	-7.1	49.6	54.8	21.1	5.2	3.9	6.5	15.0	5.0
Commercial banks (net)	13.9	3.3	19.9	0.4	0.0	0.0	-35.4	-28.6	-15.4	-22.4	-11.6
Other items (net)	-42.9	-54.2	-80.0	-105.8	-58.4	-54.3	-51.0	-51.0	-51.0	-51.0	-51.0
Reserve money	222.6	209.4	220.4	236.2	255.0	257.9	259.3	275.9	294.1	298.1	311.3
Currency outside banks	122.9	114.2	119.0	123.7	137.0	129.3	127.3	139.4	156.8	154.7	156.6
Bank reserves	99.7	95.2	101.5	112.4	118.0	128.6	132.0	136.4	137.2	143.4	154.7
Banks											
Net foreign assets	17.4	27.5	-0.8	18.1	36.5	-15.0	-8.7	-11.8	-5.8	-0.5	5.1
(in millions of US dollars)	216.5	329.6	-9.0	181.1	429.3	-180.0	-105.1	-142.6	-69.8	-6.2	62.0
Reserves	99.7	95.2	101.5	112.4	118.0	128.6	132.0	136.4	137.2	143.4	154.7
Credit to CBK	-13.9	-3.3	-19.9	-0.4	0.0	0.0	35.4	28.6	15.4	22.4	11.6
Net domestic assets	1,033.3	1,081.1	1,170.2	1,219.6	1,209.3	1,260.6	1,291.5	1,415.1	1,435.2	1,483.2	1,567.2
Net domestic credit	1,189.1	1,259.6	1,346.4	1,427.0	1,444.7	1,504.2	1,539.6	1,663.2	1,683.3	1,731.2	1,815.3
Government (net)	281.5	291.2	284.9	250.9	256.8	294.0	287.3	327.3	311.5	359.5	389.2
Other public sector	22.2	17.0	21.7	32.8	30.8	32.2	41.2	39.0	43.0	47.0	51.0
Private sector	885.4	951.3	1,039.7	1,143.2	1,157.1	1,178.1	1,211.1	1,296.9	1,328.8	1,324.8	1,375.1
Other items (net)	-155.8	-178.5	-176.2	-207.3	-235.4	-243.7	-248.1	-248.1	-248.1	-248.1	-248.1
Total deposits	1,136.6	1,200.4	1,251.0	1,349.7	1,363.8	1,374.2	1,450.1	1,568.3	1,582.1	1,648.5	1,738.7
Monetary survey											
Net foreign assets	269.8	286.1	281.9	310.1	295.2	276.2	331.7	337.2	345.7	353.5	371.6
(in millions of US dollars)	3,391.4	3,435.0	3,031.0	3,107.0	3,470.2	3,325.2	4,003.5	4,070.2	4,172.9	4,266.5	4,484.7
Net domestic assets	1,001.8	1,038.6	1,098.8	1,174.1	1,218.9	1,241.0	1,263.3	1,387.7	1,394.4	1,459.7	1,540.9
Net domestic credit	1,188.4	1,261.2	1,344.2	1,482.0	1,505.1	1,530.9	1,550.5	1,669.6	1,692.3	1,748.7	1,822.8
Government (net)	277.8	289.7	277.8	300.5	311.6	315.1	292.5	331.2	318.0	374.5	394.2
Other public sector	22.2	17.0	21.7	32.8	30.8	32.2	41.2	39.0	43.0	47.0	51.0
Private	888.4	954.5	1,044.7	1,148.7	1,162.7	1,183.7	1,216.8	1,299.4	1,331.3	1,327.3	1,377.6
Other items (net)	-222.7	-222.7	-245.4	-307.9	-286.2	-290.0	-287.2	-281.8	-297.8	-289.1	-281.9
M1	577.2	603.4	620.1	627.7	622.7	611.8	624.0	674.9	680.8	709.4	748.2
Money and quasi-money (M2)	1,099.2	1,145.0	1,183.9	1,232.8	1,254.0	1,276.4	1,339.4	1,448.5	1,461.3	1,522.6	1,606.0
M2 plus resident foreign currency deposits (M3)	1,271.6	1,324.7	1,380.7	1,484.2	1,514.2	1,517.1	1,595.0	1,724.9	1,740.2	1,813.2	1,912.4
M3 plus nonbank holdings of government debt (L)	1,569.6	1,637.4	1,720.6	1,819.9	1,876.1	1,906.5	1,970.5	2,131.0	2,149.8	2,240.0	2,362.6
Memorandum items (Annual percent change unless otherwise specified)											
M1	30.5	29.7	21.2	16.9	7.9	1.4	0.6	7.5	9.3	16.0	19.9
M2	22.4	19.4	14.5	14.3	14.1	11.5	13.1	17.5	16.5	19.3	19.9
M3	21.6	19.6	15.2	19.3	19.1	14.5	15.5	16.2	14.9	19.5	19.9
Deposits	21.4	19.8	15.1	20.2	20.0	14.5	15.9	16.2	16.0	20.0	19.9
Reserve money	22.4	18.0	4.8	12.5	14.5	23.2	17.6	16.8	15.3	15.6	20.1
Currency outside banks	21.9	18.5	17.4	18.2	11.4	13.2	7.0	12.7	14.5	19.7	23.0
Net domestic credit	24.3	24.0	23.7	30.1	26.7	21.4	15.3	12.7	12.4	14.2	17.6
Government (net)	35.5	17.4	0.0	8.0	12.2	8.8	5.3	10.2	2.0	18.9	34.8
Private	20.3	25.7	30.7	36.3	30.9	24.0	16.5	13.1	14.5	12.1	13.2
Net domestic assets of the banking sector	24.9	23.7	19.6	21.6	21.7	19.5	15.0	18.2	14.4	17.6	22.0
NDA growth (as percent of the base period M3)	15.6	14.7	12.5	13.7	13.8	12.4	9.6	11.7	9.4	11.5	14.1
Multiplier (Average M3/RM)	5.9	5.9	6.1	6.1	6.2	6.1	6.1	6.1	6.1	6.1	6.1
Velocity (GDP/M2)	2.4	2.5	2.5	2.5	2.5	2.5	2.6	2.6	2.6	2.5	2.5

Source: Kenyan authorities and IMF staff estimates and projections

[1] For historical data, at implicit CBK exchange rate

Table 4. Balance of Payments

	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
				Revised Program		
(In millions of US dollars, unless otherwise indicated)						
Current account	**-1,691.1**	**-2,656.1**	**-3,591.7**	**-3,564.6**	**-3,762.9**	**-3,559.1**
Excluding official transfers	-1,691.1	-2,634.4	-3,571.2	-3,733.2	-3,742.4	-3,538.6
Exports, f.o.b.	4,920.4	5,563.6	5,934.1	5,676.1	5,863.4	6,097.5
Coffee	194.2	212.8	263.0	199.8	214.4	241.8
Tea	1,127.2	1,108.4	1,138.2	1,119.5	1,066.7	1,054.6
Horticulture	714.8	732.0	647.9	708.2	737.2	760.1
Imports, f.o.b	-10,564.5	-12,738.1	-14,797.6	-14,858.4	-15,687.6	-16,540.9
Oil	-2,635.6	-3,299.2	-4,192.3	-4,478.4	-4,619.8	-4,714.6
Other Private	-7,827.6	-9,277.0	-10,293.1	-10,087.3	-10,752.4	-11,483.2
of which: special: maize & sugar	-360.9	-198.9	-326.5	-248.3	-250.3	-252.5
Balance on goods	-5,644.1	-7,174.5	-8,863.6	-9,182.3	-9,824.2	-10,443.3
Balance on services	1,584.8	1,823.2	2,336.9	2,180.2	2,456.9	2,760.2
Credit	3,418.8	3,873.8	4,611.1	4,614.7	5,113.9	5,688.2
of which: foreign travel credit [1]	732.0	909.7	928.2	987.2	1,075.6	1,175.9
Debit	-1,834.0	-2,050.6	-2,274.2	-2,434.4	-2,656.9	-2,927.9
Balance on goods and services	-4,059.3	-5,351.4	-6,526.7	-7,002.1	-7,367.3	-7,683.1
Income (net)	-68.0	23.8	-168.2	-245.0	-312.8	-293.8
Credit	211.5	275.3	186.7	139.7	138.1	215.7
Debit	-279.5	-251.6	-354.9	-384.7	-450.9	-509.5
of which : official interest payments	-71.1	-60.8	-101.6	-142.0	-194.4	-243.6
Other	-208.3	-190.8	-253.4	-242.8	-256.5	-265.9
Current transfers (net)	2,436.2	2,671.5	3,103.2	3,682.5	3,917.2	4,417.8
Private (net)	2,457.9	2,693.2	3,123.7	3,513.9	3,937.7	4,438.3
of which: remittances	1,006.1	1,232.8	1,578.8	1,660.1	1,841.9	2,053.7
Official (net)	-21.7	-21.7	-20.5	168.5	-20.5	-20.5
Capital and financial account	2,262.3	2,957.2	4,421.6	4,036.6	4,601.4	4,521.9
Capital account (incl. capital transfers)	740.0	228.5	172.6	676.8	566.8	622.8
Financial account [2]	1,522.3	2,728.6	4,249.0	3,359.8	4,034.6	3,899.0
Net FDI	578.4	694.0	791.7	840.2	891.8	958.8
In Kenya	604.5	759.2	817.4	879.5	930.4	993.5
Abroad	-26.1	-65.2	-25.7	-39.3	-38.6	-34.7
Net Portfolio investment	-19.2	-12.1	-15.2	-16.8	-19.6	-20.6
Liabilities	4.0	12.8	12.0	11.6	12.4	13.6
Assets	-23.2	-24.9	-27.2	-28.4	-32.0	-34.2
Net other investment	1,328.9	1,962.9	3,023.8	2,536.4	3,162.4	2,960.9
Official, medium and long term	610.5	338.1	1,137.8	606.5	1,225.5	980.1
Inflows	853.4	583.6	1,426.9	922.7	2,314.2	1,500.3
Project loans	505.0	583.6	807.7	843.0	1,288.2	1,208.2
Commercial and Defense loans [3]	0.0	0.0	619.2	79.7	1,026.0	292.1
Monetary Authorities' long-term liabilities (SDR allocations)	348.5	0.0	0.0	0.0	0.0	0.0
Outflows	-242.9	-245.5	-289.1	-316.2	-1,088.7	-520.2
Private, medium and long term	-41.8	-49.7	-36.2	112.8	237.5	322.5
Energy financing	61.1	57.2	53.8	57.6	60.9	65.0
Kenya Airways	-48.2	-76.3	17.8	97.3	214.9	296.7
Other	-54.8	-30.5	-107.8	-42.0	-38.2	-39.2
Short-term capital	760.2	1,674.5	1,922.3	1,817.1	1,699.4	1,658.3
of which: commercial banks	442.7	465.8	95.8	-167.1	-354.3	-150.9
Errors and omissions	-365.8	83.7	448.7	0.0	0.0	0.0
Overall balance	571.2	301.1	829.9	472.0	838.5	962.7
Financing items	-571.2	-301.1	-829.9	-472.0	-838.5	-962.7
Reserve assets (gross)	-579.6	-321.9	-1,120.9	-658.1	-900.0	-900.0
Use of Fund credit and loans to the Fund (net)	-22.1	78.8	285.1	180.0	55.5	-68.7
Disbursements	0.0	103.3	319.7	222.7	111.4	0.0
Repayments	-22.1	-24.4	-34.7	-42.7	-55.9	-68.7
Rescheduling /debt swap	5.8	5.4	6.0	6.0	6.0	6.0
Memorandum items:						
Gross official reserves (end of period)	3,798.6	4,120.5	5,241.4	5,899.5	6,799.5	7,699.5
(in months of following year's imports of goods and services)	3.1	2.9	3.6	3.9	4.2	4.5
(in months of this year's imports of goods and services)	3.7	3.3	3.7	4.1	4.4	4.7
Current account balance (excluding official transfers, percent of GDP)	-5.6	-8.4	-9.1	-8.2	-7.3	-6.1
Import volume growth, goods and services (percent)	10.5	4.4	3.4	2.0	8.1	8.4
Import value growth, goods and services (percent)	2.7	19.3	15.4	1.3	6.1	6.1
Export volume growth, goods and services (percent)	2.3	-0.8	7.5	3.3	10.9	8.7
Export value growth, goods and services (percent)	9.8	13.2	11.7	-2.4	6.7	7.4
Change in the terms of trade (goods and services, percent) [4]	15.4	0.2	-6.8	-5.1	-2.0	0.9

Sources: Kenyan authorities and IMF staff estimates and projections.

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

[2] Historical figures include errors and omissions.

[3] 2012 includes the $600 million syndicated loan.

[4] Base year: 2000.

Table 5. Financial Soundness Indicators of the Banking Sector

	Dec-09	Dec-10	Jun-11	Dec-11	Aug-12
	(Percent)				
Capital adequacy					
Regulatory capital to risk-weighted assets	19.5	20.8	19.0	19.4	20.2
Regulatory tier 1 capital to risk-weighted assets	17.2	18.7	16.9	17.3	17.6
Total capital to total assets	12.7	13.2	12.8	13.2	15.5
Asset quality					
Non performing loans to total gross loans	7.9	6.2	5.4	4.4	4.5
Non performing loans net of provisions to capital	12.6	6.4	5.8	3.5	3.7
Earning assets to total assets	85.0	88.8	89.5	87.8	88.1
Earning and profitability					
Return on assets (ROA)	2.9	3.7	3.3	3.3	3.8
Return on equity (ROE)	24.8	30.7	30.8	32.2	33.2
Interest margin to gross income	35.6	34.7	40.9	38.6	31.7
Non interest expenses to gross income	50.8	48.2	48.2	44.6	36.7
Liquidity					
Liquid assets to total assets	35.9	38.4	34.9	33.3	33.3
Liquid assets to short-term liabilities	39.8	44.5	38.9	37.0	38.1
liquid assets to total deposits	46.3	51.0	46.3	43.8	44.1
Total loans to total deposits	72.4	72.5	76.6	77.4	79.0
Sensitivity to market risk					
Net open position in foreign exchange to capital	4.9	4.3	4.6	3.3	3.4
Interest bearing assets to interest bearing liabilities	113.2	117.8	117.9	115.4	116.8
FX currency denominated assets to total assets	8.1	10.6	12.4	11.8	13.1
FX currency denominated liabilities to total liabilities	18.1	17.1	18.2	21.5	22.0
Spread between lending and deposit rate	8.7	9.3	8.8	8.4	9.8

Source: Central Bank of Kenya.

Table 6. Performance Criteria for the Fourth Review under the 2011–14 ECF Arrangement

(In billions of Kenyan shillings; unless otherwise indicated)

	2012							2013			
	Performance Criteria			Indicative Targets		Performance Criteria		Indicative Targets		Performance Criteria	
	End-June			End-Sept.		End-Dec.		End-March		End-June	
	Program	Actual		Program	Preliminary	Third Review	Proposed Program	Third Review	Proposed Program	Third Review	Proposed Program
Quantitative performance criteria											
Fiscal targets											
Primary budget balance of the central government (-=deficit, floor) [1,2,3,4]	-10.0	-1.0	met	0.0		0.0	-64.0	-5.0	-32.0	0.0	-10.0
Monetary targets [5,6]											
Stock of central bank net international reserves (floor, in millions of US$) [7,8]	4,070	4,191	met	4,115	4,440	4,160	4,460	4210	4490	4,260	4,640
Stock of net domestic assets of the central bank (ceiling)	-55	-72		-45	-73	-25	-50	-40	-50	-40	-50
Public debt targets											
Contracting or guaranteeing of medium- and long-term nonconcessional by the central government (ceiling; millions of US$) [9,10]	1300	1037	met	1500	1037	1,500	1500	1,500	1,500	1,500	1,500
New central government and central government guaranteed external payment arrears (ceiling, millions of US$) [11]	0	8.4	not met	0		0	0	0	0	0	0
Indicative targets											
Priority Social Expenditures of the central government(floor) [2,3,4]	26.1	26.3	met	12.1		15.0	15.0	21.0	21.0	28.3	28.3

[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, and 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] Targets for end-September 2012,end-December 2012, end-March 2013, and end-December 2013 are cumulative flow from July 1, 2012 (beginning of the 2012/13 fiscal year).
[5] For program monitoring, the daily average for the month when testing dates are due.
[6] 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.
[7] Excludes encumbered reserves.
[8] First review targets at September 1, 2010 exchange rates. Second review targets at April 29, 2011 exchange rate.
[9] Cumulative flow of contracted debt, from January 1, 2011.
[10] The targets on the ceiling of non-concessional external debt combine nonconcessional project loans, syndicated loan and sovereign bond.
[11] Continuous.

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

Date of Availability	Conditions for Fund Disbursement	Original ECF disbursement		ECF augmentation		Total disbursement	
		Millions of SDRs	Percent of quota [1]	Millions of SDRs	Percent of quota	Millions of SDRs	Percent of quota
January 31, 2011	Board approval of the arrangement	65.136	24.00	-	-	65.14	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	-	-	43.42	16.00
December 15, 2011	Observance of the end-June 2011 performance criteria and structural benchmarks, and completion of second review	43.424	16.00	48.852	18.00	92.276	34.00
April 17, 2012	Observance of the end-December 2011 performance criteria and structural benchmarks, and completion of third review	43.424	16.00	28.497	10.50	71.921	26.50
October 24, 2012	Observance of the end-June 2012 performance criteria and structural benchmarks, and completion of fourth review	43.424	16.00	28.497	10.50	71.921	26.50
April 15, 2013	Observance of the end-December 2012 performance criteria and structural benchmarks, and completion of fifth review	43.424	16.00	28.497	10.50	71.921	26.50
October 15, 2013	Observance of the end-June 2013 performance criteria and structural benchmark, and completion of the sixth review	43.424	16.00	28.497	10.50	71.921	26.50
Total		**325.680**	**120.00**	**162.840**	**60.00**	**488.520**	**180.00**

[1] Kenya's quota is SDR 271.4 million.

APPENDIX I. LETTER OF INTENT

Nairobi, Kenya

October 5, 2012

Mrs. Christine Lagarde
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mrs. Lagarde,

1. Our economy continues to recover from the challenges faced in 2011, which included the drought that hit the Horn of Africa, the global crisis and double digit increases in import prices. Domestic demand is now growing in line with supply, inflation is well within our target, and economic growth is set to accelerate. Growth in agricultural production is recovering to pre-drought level and adequate rainfall in 2012 has reduced the country's dependence on imported food and expensive oil imports for thermal power generation.

2. Performance under the economic program supported by an arrangement under the Extended Credit Facility of the IMF has remained favorable. We have met all the quantitative performance criteria and indicative targets for end-June 2012, and are requesting a waiver for the temporary non-observance of the continuous performance criterion on external payment arrears for which we have taken corrective measures, that emerged as new administrative arrangements were put in place following constitutional changes. Kenya has maintained fiscal and monetary discipline. We have met the target for primary balance, as well as the ceiling on NDA and the threshold on NIR with large margins. Progress on structural reforms has continued, with recent enactment of Public Financial Management (PFM) Act, that will allow for adoption of a Treasury Single Account, and the submission of the new VAT Bill to Parliament that we expect to implement by the end of this year.

3. This Letter of Intent describes policies we intend to implement for the remainder of 2012/13 and in 2013/14. Policies in the near term will aim at: a) entrenching low inflation expectations; b) preserving fiscal discipline in an election year and the beginning of a devolved system of government in order to lower the debt-to-GDP ratio; and c) narrowing the still high current account deficit. We stay firmly committed to our reform program aimed at achieving higher and sustainable growth in a more equitable environment.

I. RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

4. Economic growth slowed somewhat in the first half of 2012, but we expect it to pick up in the remainder of the year with the return of normal rains and gradual easing of the tight monetary stance. Improved conditions for domestic hydropower generation that reduces reliance on imported oil and adequate food stocks are expected to contribute to an improvement of the external position.

5. The tightening of monetary policy since October 2011 supported by the implementation of a new monetary operations framework has helped in bringing down inflation to single digits. After peaking in November 2011, inflation has declined for nine consecutive months and is now well within our medium-term target. Credit growth has slowed down by more than half over the past year, but remains sufficient to sustain continued economic expansion. The exchange rate has stabilized, allowing the CBK to accumulate international reserves beyond planned levels. The current account position is expected to improve in the remainder of the year as the demand for food and oil imports abates.

6. Economic prospects will benefit from the return of normal weather, continued regional integration, trade diversification to new markets, and the implementation of sound macroeconomic policies that will help attract foreign investment. Continued fiscal consolidation efforts will allow for a reduction in the primary deficit and a further decline in the debt-to-GDP ratio. Sustaining price stability will increase the scope for the gradual easing of monetary policy. Following institutional reforms, we expect successful general elections slated for March 4, 2013 and smooth transition to a decentralized system of governance in line with our new Constitution. This will be key to sustaining foreign direct investment.

7. Risks to the outlook stem from a new round of food price shocks occasioned by the drought in the United States and continued deterioration in the global financial environment that may weaken our exports, tourism, remittances, and capital inflows. Domestic risks include setting up of the new devolved system of government, weather-related shocks, and security challenges arising from developments in Somalia. Should these risks materialize, we will take appropriate actions to safeguard macroeconomic stability.

II. THE ECONOMIC PROGRAM FOR 2012/13.

A. Fiscal Policy

8. We will continue to gradually consolidate our fiscal position while pursuing our long-term development objectives as set out in Vision 2030. Efforts to contain non-priority outlays, enhance spending efficiency, and boost revenue collection should allow us to gradually narrow the primary fiscal deficit. Despite the lower than expected revenue performance in 2011/12, we anticipate strong revenue mobilization as a result of: a) ongoing administrative efforts such as enhanced compliance by the large VAT payers; b) widening of the tax base for rental income; c) reinstatement of import duties on wheat and maize; and d) expected implementation of the new VAT law. To reverse the collection shortfalls observed following the removal of the withholding regime on VAT in July 2011, we will carry out audits of the biggest taxpayers benefiting from the removal. We are also strengthening verification procedures to manufacturers under the Tax Remission for Exports Office (TREO).

9. Our 2012/13 budget remains consistent with the program objectives and envisages a decline in the primary deficit despite the inclusion of one-off expenses to prepare for the elections. We have accommodated a one-off increase in teachers' salaries to realign their salaries with the rest of the public service. Expenditure priorities include continued investment in infrastructure and education, expansion of social safety nets, implementation of the Constitution including catering for the new system of devolved government, and enhanced investment in regional security, for which we expect to be reimbursed as Kenya's intervention operates now under the African Union Mission in Somalia (AMISOM). In anticipation of fiscal decentralization, the budget reflects allocations at the county level based on a costing of their functions. In the event of revenue shortfalls or unanticipated expenditure pressures, we will lower non-priority spending through improved expenditure control as a result of the broader coverage of the Integrated Financial Management Information System (IFMIS).

10. Building on recent successes, we will continue making progress on our ambitious fiscal structural reform agenda. Following the expected adoption of the new VAT regime, we will undertake a comprehensive review of the Income Tax Act and the Customs and Excise Tax Act. We will implement the regulations pertaining to the newly-adopted PFM law, and operationalize the Treasury Single Account at the national level. The Salaries and Remuneration Commission, created under the Constitution, is preparing a new salary scheme for civil servants based on job evaluation and market criteria that will preserve fiscal sustainability in the context of devolution. Looking ahead, the newly approved pension's reform law set to start on July 1, 2013, is expected to reduce contingent liabilities, and we will initiate work on the design of an appropriate fiscal regime for the management of natural resource wealth.

11. We will be updating our Medium Term Debt Strategy which ensures public debt sustainability. Our priority remains to attract concessional financing and concessional guarantees for key energy and infrastructure projects and to strictly monitor borrowing on commercial terms. We are taking administrative steps to ensure timely servicing of external debt. We plan to issue a sovereign bond in 2013/14 or sooner to repay the syndicated loan we contracted in May 2012.

B. Monetary Policy

12. Monetary policy will remain geared at ensuring low and stable prices. The rapid decline in inflation has created scope for a gradual easing of monetary policy in line with improved inflationary expectations. We are, however, aware that a too rapid reduction in the policy rate of the CBK may reverse the hard won inflation gains by placing pressure on the exchange rate, in the context of international food and fuel price shocks. We will therefore monitor emerging inflationary risks and take appropriate action if they materialize. We are enhancing the effectiveness of our new framework for monetary operations by achieving greater convergence between key interest rates and affirm the CBR's leading signal role.

13. We will continue to gradually accumulate international reserves in line with our program, while using open market operations to sterilize any excess liquidity and reduce volatility in the interbank market. This will allow us to build an additional buffer of reserves to cope with the impact of potential external shocks. We remain fully committed to our floating exchange rate regime and will only intervene in the foreign exchange market to accumulate international reserves and to smooth out temporary excessive exchange rate volatility.

C. Financial Policy

14. We will continue pursuing our twin objectives of promoting financial inclusion and strengthening financial stability. The recent decline in the policy rate of the Central Bank is expected to lead to a reduction in commercial bank lending rates. Combined with efforts to promote enhanced competition in the financial sector and promote access to credit we expect that financial inclusion will continue playing a major role in supporting inclusive growth. CBK has proposed new prudential regulations to strengthen banking supervision. These include: (a) raising the minimum risk-weighted capital adequacy ratio to 14.5 percent; (b) introducing reporting requirements for consolidated supervision; and (c) upgrading risk classification criteria. In order to promote the adoption of consolidated supervision, we have supported the establishment of supervisory colleges for banking groups in Kenya.

15. Efforts by the Capital Markets Authority to list small and medium-sized companies on the Nairobi Stock Exchange will promote access to funding at competitive terms for a wider range of businesses, attracting investors to previously isolated sectors of the economy, and deepen our financial markets. We remain committed to finalizing the process of demutualization of the stock exchange, which will help increase transparency and lower financial intermediation costs. We plan to open alternatives for retail investors, including by facilitating access to the securities market through mobile phones, building up on the success of M-Pesa, for which arrangements will be made for a more efficient use of the existing central depository arrangements. Efforts to establish a Futures market and a Commodities Exchange Market are ongoing, and we expect that once in place they will promote better conditions for trade and price discovery, especially in the cereals market.

16. On the AML/CFT front, we have made progress with the passing by Parliament of the Prevention of Terrorism Bill into law. In addition, the Financial Reporting Centre (FRC) that was established in April 2012 is expected to adopt and implement regulations for the Proceeds of Crime and Money Laundering Act by December, 2012. For the CBK and in this context, we reaffirm the Central Bank of Kenya's decision-making powers on matters relating to AML/CFT on the banks it licenses and in support and collaboration with FRC to deal with emerging or existing challenges.

III. PROGRAM ISSUES

17. Safeguards assessment. An update to the 2011 safeguards assessment report was completed in March 2012, which showed that we have almost fully implemented the recommendations of the earlier assessment on schedule. We intend to complete the remainder in time for the next assessment.

18. 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 the remainder of 2012/13. Fiscal performance criteria will cover the budgetary central government, but we will prepare to expand coverage to include the budget of national government and county governments as early as possible in anticipation of fiscal decentralization. The fifth review under the ECF arrangement, assessing end-December performance criteria is expected to be completed by April 15, 2013, and the sixth review will be completed by November 15, 2013, based on end-June 2013 performance criteria.

19. Given our strong program implementation, we request completion of the fourth review of the ECF-supported program approved on January 31, 2011 and augmented on December 9, 2011, and the associated disbursement of SDR 71.921 million. We reiterate that our program is on track with regard to quantitative performance criteria and the indicative target for end-June 2012. The structural benchmark was also met. We request modification of the end-December 2012 and end-June 2013 performance criteria for net international reserves and net domestic assets, as well as for the primary budget of the central government. We request a waiver for the temporary non-observance of the continuous performance criterion on the nonaccumulation of external payment arrears.

20. 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.

21. We authorize the IMF to publish this Letter of intent and its attachments, as well as the accompanying staff report.

Sincerely yours,

/s/	/s/
Robinson N. Githae	Njuguna Ndung'u
Minister for Finance	Governor
	Central Bank of Kenya

Attachment: Updated Technical Memorandum of Understanding

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

(In billions of Kenyan shillings; unless otherwise indicated)

	2012							2013			
	Performance Criteria			Indicative Targets		Performance Criteria		Indicative Targets		Performance Criteria	
	End-June			End-Sept.		End-Dec.		End-March		End-June	
	Program	Actual		Program	Preliminary	Third Review	Proposed Program	Third Review	Proposed Program	Third Review	Proposed Program
Quantitative performance criteria											
Fiscal targets											
Primary budget balance of the central government (-=deficit, floor) [1 2 3 4]	-10.0	-1.0	met	0.0		0.0	-64.0	-5.0	-32.0	0.0	-10.0
Monetary targets [5 6]											
Stock of central bank net international reserves (floor, in millions of US$) [7 8]	4,070	4,191	met	4,115	4,440	4,160	4,460	4210	4490	4,260	4,640
Stock of net domestic assets of the central bank (ceiling)	-55	-72		-45	-73	-25	-50	-40	-50	-40	-50
Public debt targets											
Contracting or guaranteeing of medium- and long-term nonconcessional by the central government (ceiling; millions of US$) [9 10]	1300	1037	met	1500	1037	1,500	1500	1,500	1,500	1,500	1,500
New central government and central government guaranteed external payment arrears (ceiling, millions of US$) [11]	0	8.4	not met	0		0	0	0	0	0	0
Indicative targets											
Priority Social Expenditures of the central government(floor) [2 3 4]	26.1	26.3	met	12.1		15.0	15.0	21.0	21.0	28.3	28.3

[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, and 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] Targets for end-September 2012,end-December 2012, end-March 2013, and end-December 2013 are cumulative flow from July 1, 2012 (beginning of the 2012/13 fiscal year).
[5] For program monitoring, the daily average for the month when testing dates are due.
[6] 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.
[7] Excludes encumbered reserves.
[8] First review targets at September 1, 2010 exchange rates. Second review targets at April 29, 2011 exchange rate.
[9] Cumulative flow of contracted debt, from January 1, 2011.
[10] The targets on the ceiling of non-concessional external debt combine nonconcessional project loans, syndicated loan and sovereign bond.
[11] Continuous.

Appendix Table 2. Structural Benchmarks for 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	Completed. In discussion by the National Assembly.
Expenditure control		
Submit Public Finance Management legislation to the Commission of 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 the fiscal management.*	Third Review	Completed
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	Completed
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 (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 both development of deeper financial markets that will enhance financial stability, and attracting capital inflows to reduce the BOP financing need.*	First Review	Completed in January 2011 (guidelines were introduced as Attorney General ruled that a new Law was not needed)

ATTACHMENT I. UPDATED TECHNICAL MEMORANDUM OF UNDERSTANDING

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

1. Quantitative performance criteria are proposed for December 31, 2011; June 30, 2012; and December 31, 2012; and June 30, 2013 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**).

2. The program sets indicative targets for March 31, 2012, September 30, 2012, and March 2013 with respect to:

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

II. PERFORMANCE CRITERION ON THE PRIMARY BALANCE INCLUDING GRANTS OF THE CENTRAL GOVERNMENT

3. 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.

4. For program purposes, the **central government primary balance excluding external concessional project loans** on cash basis is cumulative from July 1, 2011 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, 2012 and June 30, 2013 test date, the central government primary balance including grants excluding external concessional loans will be measured cumulative from July 1, 2012.

5. 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 domestic 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.

6. **The central government primary balance excluding concessional project loans** will be adjusted downward by the amount of the shortfall of program grants in FY 2012/13, which are expected as refunds for Kenya's participation in African Union Mission in Somalia (AMISOM).

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

7. **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.

8. 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

9. Net domestic assets are defined as reserve money minus NIR converted in shillings at the accounting exchange rate specified in Table 1, 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 specified in Table 1.

- 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

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

- 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.

10. 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

11. 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.

12. 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).

13. 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.

14. 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.

15. The ceiling on nonconcessional external borrowing (see Table 1 in LOI) encompasses commercial loans, including the proceeds of syndicated loans and eventual proceeds from the issuance of a sovereign bond, and non-concessional project financing.

VI. PERFORMANCE CRITERION ON THE STOCK CENTRAL GOVERNMENT AND CENTRAL GOVERNMENT GUARANTEED EXTERNAL PAYMENT ARREARS TO OFFICIAL CREDITORS

16. Central government 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 by the central government. Central government guaranteed external debt payment arrears (principal or interest) to official creditors are defined as overdue payments beyond 30 days after the original contract due date in order to allow the central government sufficient time to process the due repayment after the original debtor has notified of its inability to pay. The definition excludes arrears relating to debt subject to renegotiation (dispute) or rescheduling.

17. 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

18. 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

19. 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.

TMU Table 1. Kenya: Program Exchange Rates

Kenya (Program) Exchange Rates for the ECF Arrangments
(Rates as of February 29, 2012)

Currency	Kenyan Shillings per currency unit	Dollars per currency unit
U.S. DOLLARS	82.85	1.0000
STG. POUNDS	131.99	1.5813
JAPANESE YEN	1.03	0.0124
CANADIAN DOLLARS	83.47	1.0000
EURO	111.57	1.3366
SWISS FRANCS	92.68	1.1102
SWEDISH KRONORS	12.66	0.1516
DANISH KRONORS	15.01	0.1798
S.D.R.	128.81	1.5432

TMU 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.	MoF
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

TMU Table 2. Summary of Data to Be Reported (continued)

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

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FOR IMMEDIATE RELEASE
October 24, 2012

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Fourth Review Under the ECF Arrangement for Kenya and Approves US$110.5 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the fourth review of Kenya's economic program under a three-year arrangement supported by the Extended Credit Facility (ECF). The approval enables an immediate disbursement of an amount equivalent to SDR 71.921 million (about US$110.5 million), bringing total disbursements under the arrangement to an amount equivalent to SDR 344.678 million (about US$529.6 million). In completing the review, the Executive Board approved the request for a waiver for the non-observance of the performance criterion on the non-accumulation of external arrears for end-June 2012, and the modification of performance criteria for the next 12 months to fit the revised macroeconomic outlook.

The Executive Board approved a three-year ECF arrangement for Kenya on January 31, 2011 for a total amount equivalent to SDR 325.68 million (about US$500.4 million), or 120 percent of quota. The arrangement was augmented on December 9, 2011 for a total amount equivalent to SDR 488.52 million (about US$750.6 million), or 180 percent of quota.

Following the Executive Board's discussion on Kenya, Mr. Naoyuki Shinohara, Deputy Managing Director and Acting Chair, issued the following statement:

"Economic activity in Kenya is rebounding after slowing down in 2011/12, helped by improved macroeconomic stability, foreign investment in oil and natural gas exploitation, and favorable weather conditions. Inflation has declined substantially, net international reserves have increased, public debt is low, and pressures on the exchange rate have dissipated. Kenya has also made progress in reducing its economic vulnerabilities. Downside risks remain, however, because of global uncertainties and spending pressures associated with the upcoming elections. Going forward, it will be important to maintain policy discipline to build on the accomplishments so far.

“Fiscal policy has remained on track. Revenue shortfalls in fiscal year 2011/12, arising mainly from the elimination of the VAT withholding regime, were offset by cuts in non-priority current and capital outlays. To boost revenue, the authorities are taking measures to strengthen VAT administration. It will be important to resist spending pressures in the run-up to the forthcoming elections.

“The Central Bank of Kenya’s tight monetary policy stance has helped bring inflation down. Given low inflation expectations, the Central Bank cut its policy rate recently, and there may be scope for further monetary easing if economic conditions warrant. However, the Central Bank should watch for new inflationary pressures that may emerge from higher global food and fuel prices.

“Structural reforms have also moved forward. The recently-approved Public Financial Management Law will help strengthen expenditure management and control, re-orient spending toward priority sectors, and improve fiscal transparency. The new VAT law is being debated in the National Assembly. Financial soundness indicators are healthy. Nevertheless, further efforts are being made to enhance financial regulation and supervision, deepen financial intermediation, and strengthen the regime against money laundering and terrorism financing.

“Looking forward, risks to the program arise from a weakened global financial conditions and rising oil prices, which could derail Kenya’s favorable economic performance. Further efforts to build policy buffers should enhance Kenya’s economic resilience and ensure a sustained and strong economic expansion,” Mr. Shinohara added.

Statement by Mr. Saho on Kenya
Executive Board Meeting
October 24, 2012

1. My authorities remain steadfast in maintaining macroeconomic stability. Given the sustained monetary and fiscal discipline, the inflation rate is in single digit, the exchange rate is stable, and the central bank has managed to accumulate significant amounts of foreign reserves. However, the economy remains vulnerable to external shocks including the continuing sluggish recovery in Europe which is a key market for Kenyan exports. At the domestic level, the expected good rains remain critical in sustaining strong growth. Furthermore, my authorities anticipate a fair and peaceful general election scheduled for March 4, 2013. So far, the performance of the economic program under the Extended Credit Facility (ECF) has been remarkable, and my authorities are committed to its successful implementation. It is in this regard that my authorities are requesting your support in completing this Fourth Review. We thank the staff for their constructive dialogue with the authorities, and the Board and Management for their continued support.

Program performance

2. The economic program remained on track in the period under review. All quantitative performance criteria were met and structural benchmarks completed except for one. The target for the primary balance, as well as the ceiling on net domestic assets, and the threshold on net international reserves were met with large margins. Significant progress was also made on structural reforms with the Public Financial Management (PFM) Act 2012 enacted, and the new Value Added Tax (VAT) Bill 2012 awaiting parliamentary debate. Temporary external arrears emerged on government guaranteed loans because of delays in processing payments occasioned by establishment of a new administrative arrangement under the new constitution. My authorities have since put in place mechanisms to facilitate prompt handling of such payments, and are thus requesting for a waiver.

Recent economic developments and medium term outlook

3. Economic activity slowed down in the first half of 2012 but is expected to bounce back in the rest of the year. The economy expanded by 3.4 percent and

3.3 percent in the first and second quarters of 2012, but is projected to grow by 5 percent in 2012. Inflationary pressures have eased as a result of the tight monetary policy stance, and significant decline in food inflation following the good weather conditions. Inflation came down from a high of 19.7 percent in November, 2011 to 7.7 percent in July, 2012 and 5.3 percent in September. While food inflation is expected to remain low given the current stock of maize in the domestic market, this situation is vulnerable to increases in world food and oil prices.

4. The current account widened mainly because of increases in oil import prices. The shilling has stabilized against major foreign currencies following the tightening of monetary policy since the last quarter of 2011. Further, the central bank has built up foreign reserves to almost 4 months of import cover. However, the continuing sluggish recovery in Europe, a key market for Kenya non-traditional exports, and the slowing emerging markets that are Kenya's new trading partners, are threatening growth of exports.

Fiscal policy and reforms

5. My authorities are committed to gradual fiscal consolidation. They have maintained the fiscal deficit in line with a sustainable debt/output ratio. The primary deficit is estimated at 2.2 percent in the FY2011/12 and projected to narrow to 2.0 percent in 2012/13. While revenue performance has been below target, efforts are being made to enhance tax administration, and widen the tax base. It is also hoped that the parliament will debate and pass the new VAT bill to facilitate its implementation in the beginning of 2013. In the recent period my authorities have experienced pressure to harmonize teachers’ salaries with those of other civil servants. While they have made some concessions, this has not detracted their focus on prioritizing investment expenditures, social spending and implementation of the new constitution.

6. Significant progress has been made in the fiscal reforms. The PFM law is now in place and the authorities are preparing a regulatory framework for its implementation. A request has already been made to the IMF for technical assistance in preparation of this regulatory framework. The new VAT bill that aims to rationalize exemptions and zero-rated items is awaiting debate in parliament. Furthermore, my authorities are gearing to review the income tax act and the customs and excise tax act.

Monetary policy and the financial sector

7. My authorities remain committed to price stability. Thus, although the Monetary Policy Committee reduced the policy rate during their recent meeting in September 2012, in response to signs of easing inflationary pressures, it is expected that monetary policy easing will be gradual, taking into account exogenous shocks. To strengthen further the policy rate signaling effect, efforts are being made to ensure that money market interest rates are well aligned to the policy rate through heightened liquidity management.

8. The banking sector remains stable despite the rise in lending rates occasioned by a tight monetary policy stance adopted since the fourth quarter of 2011. The ongoing efforts to promote financial inclusion have also seen mushrooming of agency banking, and new products for money transfer have entered the market. In an effort to strengthen supervision, the Central Bank has recently proposed new prudential regulations that are currently receiving comments from key stakeholders as required by the new constitution.

9. Significant progress has also been made to put in place structures that will help curb money laundering and financing of terrorism. The Prevention of Terrorism Bill 2012, and the Proceeds of Crime and Anti-Money Laundering (Amendment) Bill 2012 have been enacted.

10. The capital market is being re-energized. The recent enactment of the Capital Market (Amendment) Bill 2012 facilitates the establishment of a futures market, and a hybrid trading of bonds aimed to enhance the liquidity of the bonds market. Further, the Nairobi Securities Exchange is gearing to have listings of its first SMEs by the beginning of 2013. Currently, it is registering nominated advisors to begin scouting for these SMEs.

Implementation of the new constitution

11. My authorities have made significant progress in the implementation of the new constitution, setting stage for major structural reforms that will strengthen governance. All bills due for enactment by the end of the second year of promulgation of the new constitution have been passed by parliament including those related to land, security, devolved government and elections. As a result, my authorities are currently preoccupied with setting up of relevant offices and institutions.

Conclusion

12. While my authorities are committed to maintaining macroeconomic stability, the economy remains vulnerable to external and domestic shocks. Nevertheless, they remain vigilant and are prepared to make appropriate policy adjustments in order to sustain robust growth both in the short and the medium term. My authorities are devoted to having a successful implementation of their economic program to sustain macroeconomic stability and strengthen the institutional structures. They, thus, welcome the Directors' support in completing this Fourth Review under the ECF, granting of a waiver for the emergence of temporary arrears, and modification of performance criteria.