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April 2013
IMF Country Report No. 13/107

Kenya: Fifth Review Under the Three-Year Arrangement Under the Extended Credit Facility and Request for a Waiver and Modification of Performance Criteria—Staff Report; Staff Supplement; and Press Release.

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

- The staff report on the fifth review under the three-year arrangement under the Extended Credit Facility and request for a waiver and modification of performance criteria, prepared by a staff team of the IMF, following discussions that ended on February 14, 2013, 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 April 1, 2013. 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 supplement dated April 1, 2013 on the Joint IMF/World Bank Debt Sustainability Analysis.
- A Press Release dated April 16, 2013.

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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INTERNATIONAL MONETARY FUND

KENYA

April 1, 2013

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

KEY ISSUES

Background: Kenya has implemented major reforms under the 2010 Constitution that have so far allowed for a smooth political transition. Largely peaceful elections took place on March 4, 2013. Mr. Kenyatta was confirmed by the Supreme Court as the election winner on March 30. Mr. Odinga, his main opponent, who had challenged the election results with the Supreme Court, has now conceded. The International Criminal Court has delayed the trial of Mr. Kenyatta for crimes against humanity until July. Economic growth edged up in 2012 despite political uncertainty, the impact of the European crisis, and Somalia-related security concerns, and is expected to accelerate following the elections. Inflation has fallen below the mid-point of the government's inflation target range (5 ± 2 percent), from about 20 percent in November 2011. Intensive foreign direct investment (FDI) in oil exploration boosted capital-goods imports partly offsetting the significant improvement in the underlying external current account. After a period of sustained accumulation of international reserves, the central bank intervened in the foreign exchange market to contain depreciation pressures associated with some market jitters as elections approached. Once surrounding uncertainties subside, international reserves are expected to rise to the program target of four months of imports towards the end of 2014.

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 488.520 (180 percent of quota). All end-December 2012 quantitative targets were met, except for the emergence of temporary and minor technical arrears on external debt caused by staffing constraints for which the authorities request a waiver. These arrears did not affect the thrust of policies, and the authorities have already fully repaid these obligations and adopted corrective measures. The authorities' primary fiscal balance outcome was in line with the program and consistent with a decline in the government debt-to-GDP ratio. Priority social expenditure was below the program's indicative target in December because of delays in the identification of beneficiaries. Implementation of structural benchmarks has overall proceeded as expected. The final discussion of the VAT Bill was delayed because the pre-election climate raised pressures that could have weakened key provisions in the draft law. In light of that, the authorities agreed to incorporate a new structural benchmark for the sixth review on the auditing of compliance with VAT obligations by 50 large taxpayers before June 2013.

Staff views: The staff recommends completion of the review, disbursement of SDR 71.921 million, a waiver for the non-compliance with the performance criterion on external arrears, and modification of all 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 (all AFR), Alshahrani (FAD) and Ms. Bouza (SPR) visited Nairobi during February 4-14, 2013. 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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MACROECONOMIC OUTLOOK AND PROGRAM PERFORMANCE

1. **Economic activity in FY 2012/13 has remained resilient to uncertainty surrounding the elections, the impact of the European crisis, and security-related concerns.** Growth is already picking up helped by improved weather conditions and positive sentiment associated with the discovery of oil and gas (Box 1).

2. **Inflation appears to have bottomed out in December 2012, and reached 4.5 percent in February (y-o-y), remaining below the authorities' 5 percent target for five consecutive months.** Good harvests and tight macroeconomic policies have brought both core and headline inflation down.

Box 1. New Sources of Wealth in Kenya: Oil and Coal

Oil:

- Big oil discoveries in the northern Turkana region have now made Kenya a major venue for oil exploration in East Africa.
- Kenya expects to start producing oil in 6-7 years.
- Oil exploration is being undertaken in four sedimentary basins, divided into smaller blocks for effective exploration. The discovery of commercially viable oil reserves made in May 2012 in the Tertiary Rift by Tullow Oil has led to the entry of major foreign oil companies. Out of 46 blocks made available by the Minister for Energy under the Petroleum Act, 45 have been licensed to 23 international oil companies. The companies are at different stages of exploration, and the productive capacity of two oil wells is currently being assessed. Gas has also been discovered on one of the offshore wells in the Lamu Basin.

Table 1: Basins and Wells Drilled

Basin	Area (km^2)	Wells Drilled	Average sediment thickness (m)
Lamu	261,000	16	12,000
Mandera	43,404	3	10,000
Anza	81,319	11	10,000
Tertiary Rift	105,673	3	4,000

Source: Ministry of Energy, National Energy Policy 3rd Draft

Coal:

Coal exploration is concentrated in the Mui Basin (400 Km^2) of Kitui and Mwingi districts in Eastern Kenya, and is subdivided into four blocks. Seventy wells have so far been drilled. Coal has been found at various depths in several of these wells ranging from lignite to sub-bituminous types. They compare well with the sub-bituminous type being used for power generation in South Africa.

According to the Ministry of Energy, four hundred million tons of coal reserves were confirmed in one block (Block C). The government is also carrying out exploratory work in the Taru Basin in the coastal region.

Table 2: Blocks in Mui Basin and Wells Drilled

Block	Area (km^2)	Wells Drilled	Coal intercepted
A: Zombe-Kabati	121.5	5	4 wells
B: Itiko-Mutito	117.5	7	2 wells
C: Yoonye-Kateiko	131.5	54	32 wells
D: Isekele-Karunga	120.0	4	2 wells

Source: Ministry of Energy, National Energy Policy 3rd Draft

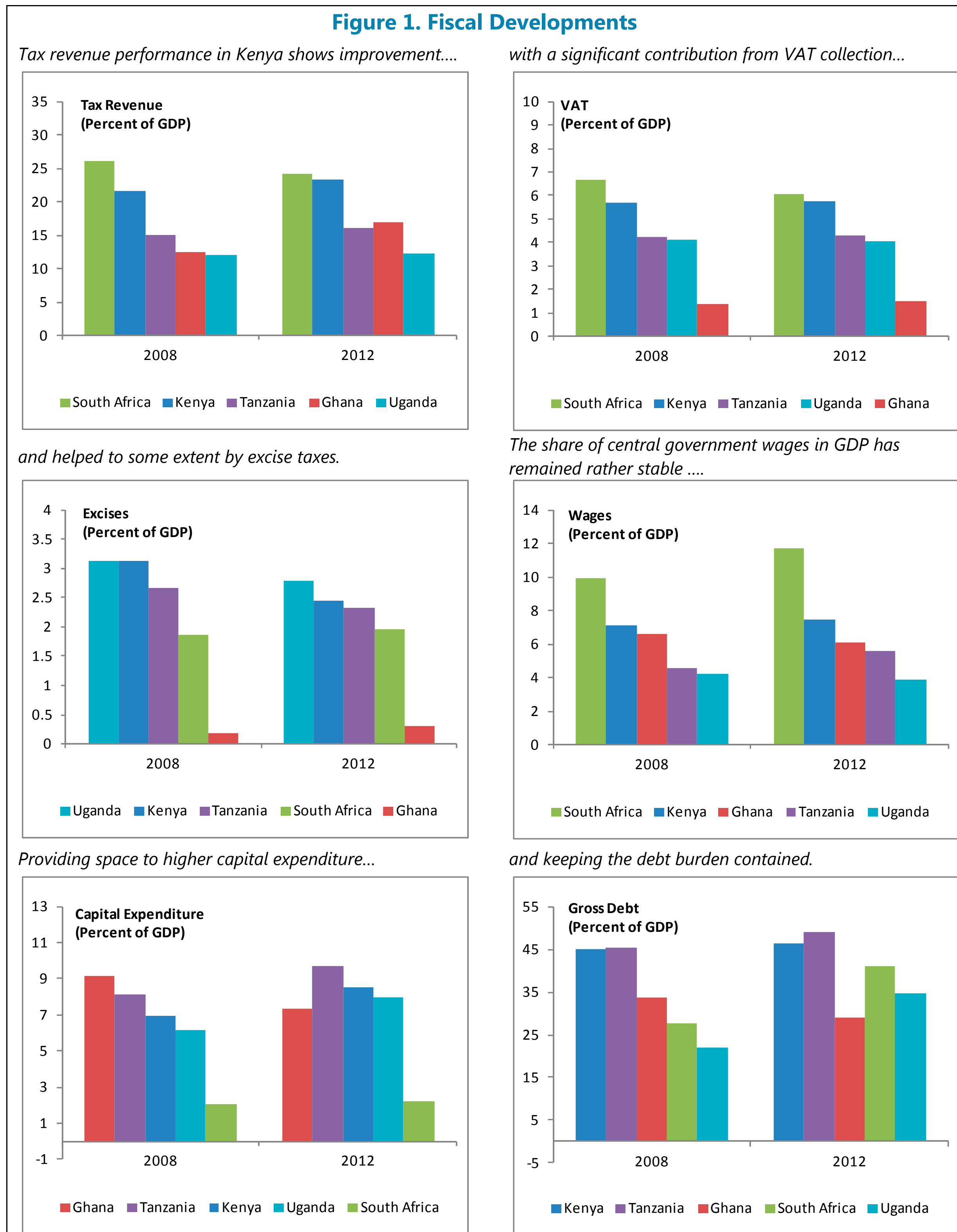
The legal framework:

The Production Sharing Contracts that govern exploration activities are based on the Petroleum Act, Petroleum Regulations, the Income Tax Act and the Environmental Management and Coordination Act. The government intends to update the Petroleum Act in the near future, and is reviewing its energy policy to facilitate prudent management of commercial oil and gas discoveries with technical assistance from the International Monetary Fund.

3. **Fiscal policy has remained in line with the program despite difficulties in meeting revenue projections in the first half of FY 2012/13.** The December 2012 performance criterion on the primary deficit was met, in line with the program target of 2.0 percent of GDP for FY 2012/13, bringing the government debt-to-GDP ratio below 44 percent. Revenue shortfalls from the delay in the introduction of the VAT Act and the elimination of VAT withholding regimes were partly offset by the introduction of a tax on financial transfer fees (including M-Pesa transfer fees) —expected to raise 0.1 percent of GDP in revenue— and cuts in both non-priority current and capital outlays. The government raised wages for doctors, nurses, teachers, and lecturers in separate negotiations by a total of 1 percent of GDP compared to the previous fiscal year—these salaries had not been adjusted since the current government took office in 2008. The indicative floor on pro-poor spending was not met because of difficulties in identifying the beneficiaries of some new schemes, but most of the shortfall appears to have been overcome in January 2013. Contracting of non-concessional external debt remains within the program ceilings.[1] However, two external debt payments due in December 2012 for small amounts were made after the due date mainly because

[1] The arrears are as follows: (i) A total of EUR 1.6 million, in principal and interest payments, was due to the European Investment Bank on December 10, 2012, and was paid off on January 23, 2013; and (ii) EUR 0.3 million in interest payments was due to the Netherlands on December 31, 2012 and was paid off on February 15, 2013.

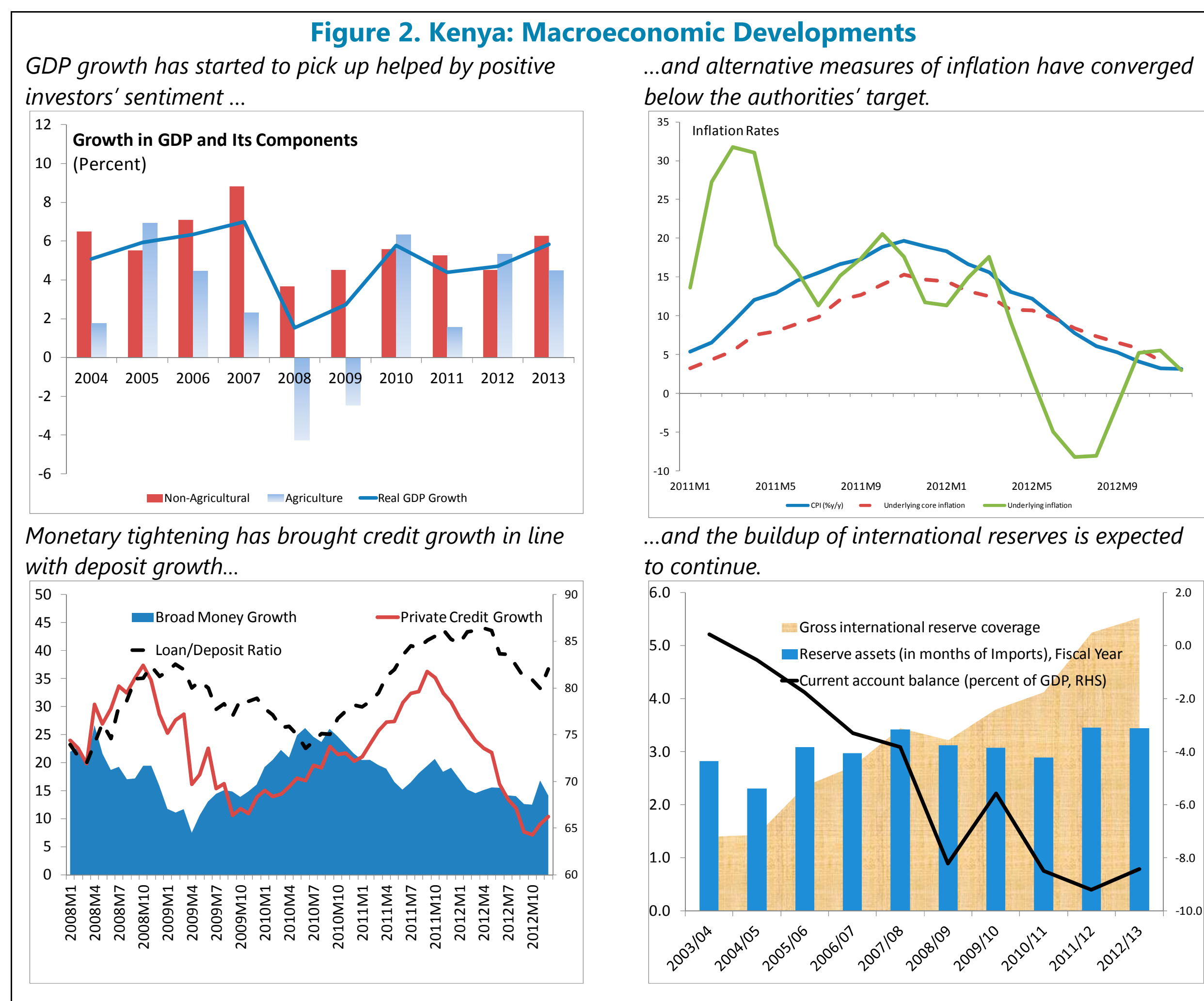
of staffing constraints during the holiday season at the Debt Management Department. These were cleared within less than two months.



Source: Authorities' data and IMF staff

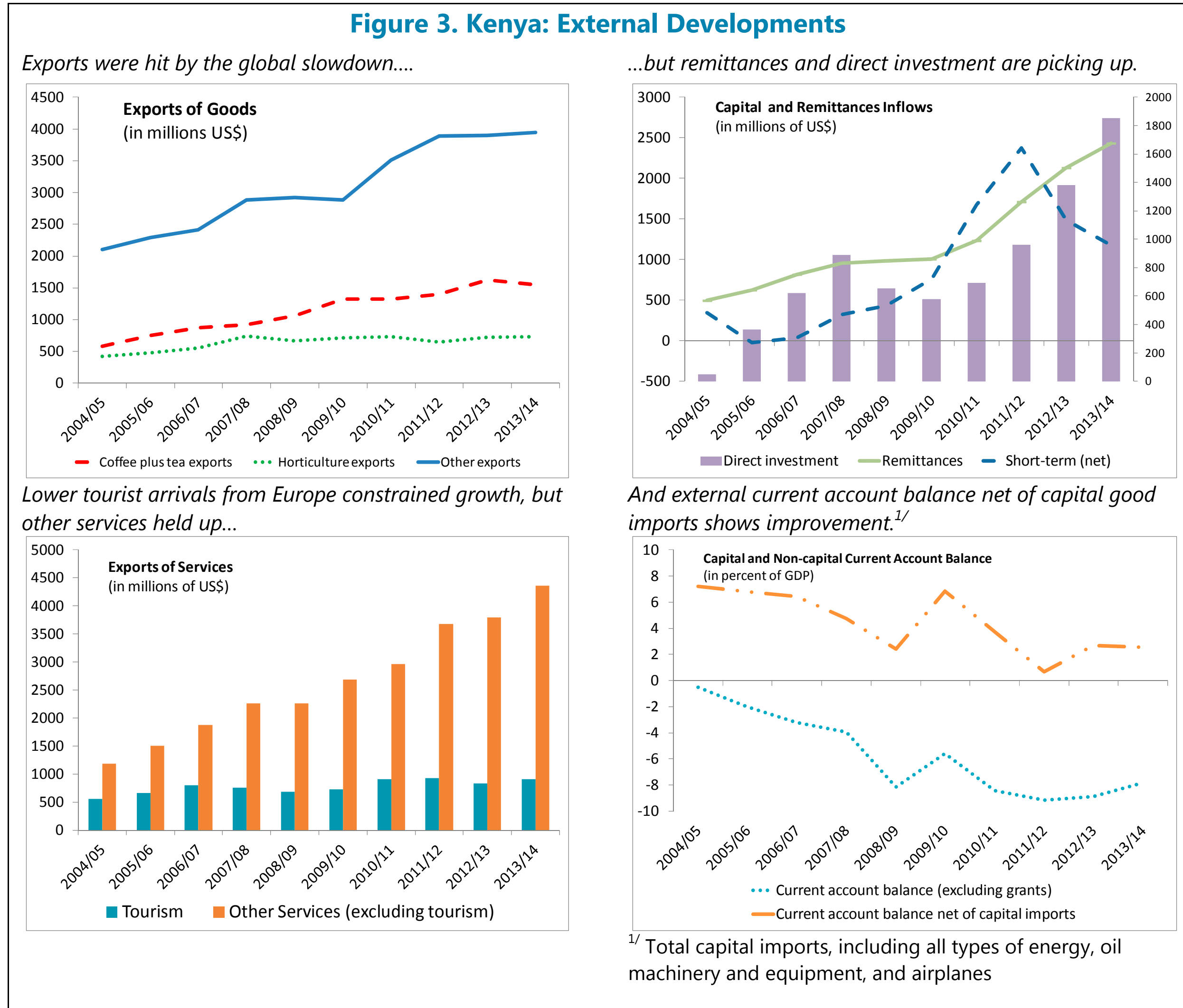
4. **The authorities have eased monetary policy gradually, consistent with falling inflationary expectations.** The Central Bank of Kenya (CBK) has kept Net Domestic Assets (NDA) well below the program's ceiling for December and Net International Reserves (NIR) above the program's floor, helped by private capital inflows in particularly to the equity market. The CBK has lowered its policy rate by a cumulative 850 basis points since July 2012 to 9.5 percent. Annual private sector credit growth declined to 10 percent in January 2013 (down from 36 percent in September 2011). However, cumulative credit growth in the last four years is still consistent with a structural increase in financial intermediation supported by mobile-banking (Box 2). Corporate loans are rising faster than personal loans, especially to the construction and manufacturing sectors. Commercial banks remain sound and profitable, with stable non-performing loans in relation to total loans (4.5 percent in December 2012).

Figure 2. Kenya: Macroeconomic Developments



Source: Authorities' data and IMF staff estimates.

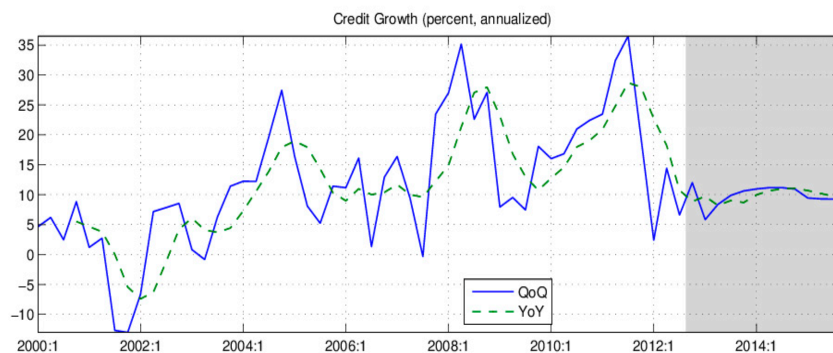
5. **Kenya's external position remains solid with international reserves above US$5.5 billion (3.4 months of projected imports).** The CBK intervened in the foreign exchange market in the first quarter to mitigate depreciation pressures arising from political uncertainties. Thanks to tight policies, benign weather, and a sharp increase in remittances, Kenya's current account deficit is projected to narrow to 8.9 percent of GDP in 2012/13 despite a substantial increase in capital-goods imports financed by foreign direct investment in oil-exploration equipment. Difficulties in the euro area caused a decline of exports to Europe and European tourist arrivals in 2012.



Source: Authorities' data and IMF staff estimates.

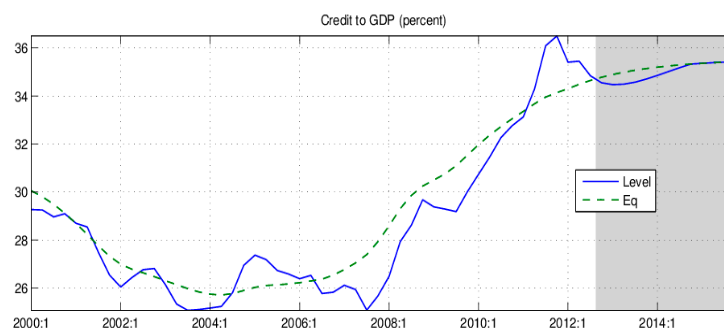
Box 2. Kenya: Does the Sharp Decline in Credit Growth Signal Excessive Monetary Tightening?

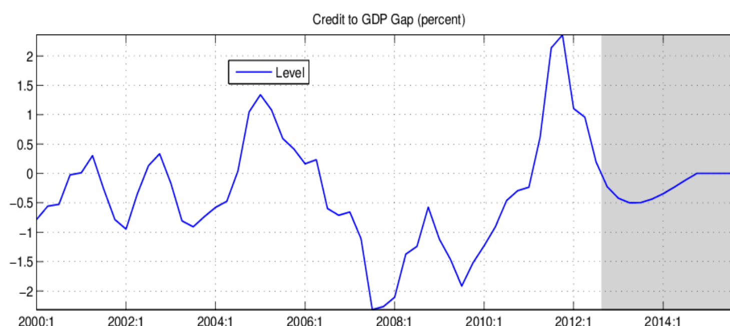
Throughout the last decade Kenya has experienced three episodes of credit growth acceleration followed by a sharp reversal. High credit growth volatility has led to periods of instability and increased financial risk at times. Recently, the significant decline in credit growth has played a key role in bringing down inflation. However, concerns about low credit growth constraining economic recovery have emerged.



We used a monetary policy model to disentangle the structural trends from the cyclical factors affecting credit growth in Kenya and found the following:

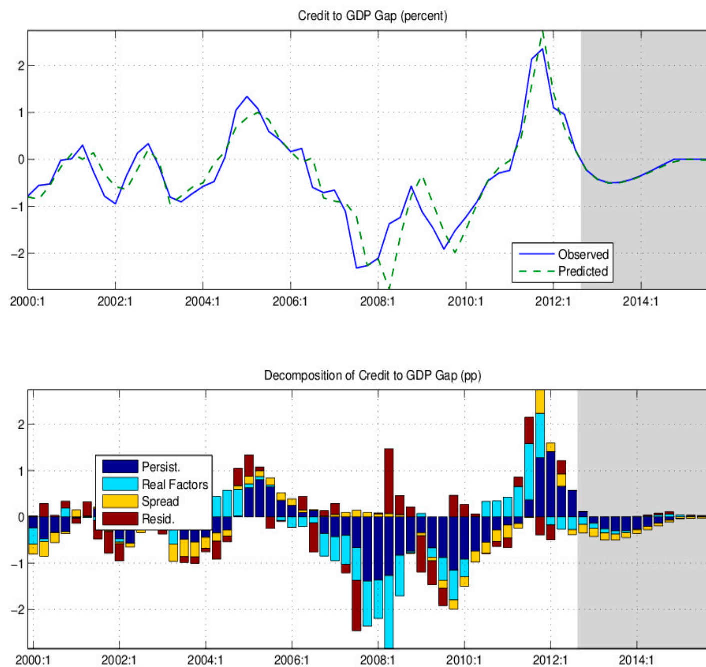
- A structural shift towards a higher credit-GDP ratio is consistent with financial deepening spurred by the mobile banking revolution and has had a lasting impact on financial intermediation as measured by the credit-to-GDP ratio.





- However, in 2011 credit growth accelerated well beyond the level explained by the above-mentioned structural factors, spurred by expansionary policies.

- The recent deceleration of credit growth is largely explained by the impact of monetary tightening on economic activity and a persistently high lending interest rate spread.[1]



[1]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 13/61. Research for this paper was conducted under the joint DFID-IMF project on monetary policy analysis in low-income countries.

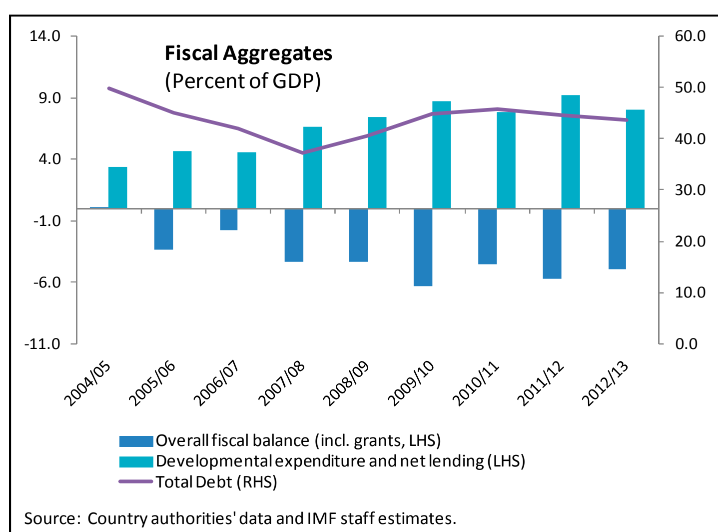
6. **Key structural reforms to strengthen the institutional framework are underway.** The Public Finance Management (PFM) Act includes provisions that should ensure an orderly process of decentralization, and the authorities are in the process of finalizing implementing regulations. The CBK is already preparing the ground work to make the Treasury Single Account operational, with the view of starting next fiscal year. The adoption of the new VAT Act was delayed because the pre-election climate raised pressures that could have weakened key provisions in the draft law, but the authorities are committed to re-open the discussion at the outset of the new National Assembly. Other structural measures aim at improving the efficiency of capital markets, facilitating access to financial services to households and SMEs, and enhancing the quality of the business climate.

POLICY DISCUSSIONS AND RISKS

The recent elections took place in an environment of macroeconomic stability and visible progress in the modernization of institutions and markets. Fiscal policy has succeeded in reducing the public debt. Monetary policy has curbed inflationary pressures, with inflation well within the authorities' target range. Capital inflows and the narrowing of the external current account deficit have helped to keep the shilling largely stable, allowing the CBK to improve Kenya's external position. The authorities should protect those gains, maintaining fiscal discipline while providing sufficient resources for the political transition, keeping monetary policy in line with their inflation target, and further building up foreign exchange buffers to deal with unexpected shocks.

A. Maintaining Fiscal Discipline During the Political Transition

7. **The authorities are still committed to reducing the primary deficit by about 0.2 percent of GDP in FY 2012/13.** The primary deficit ceiling of 2 percent of GDP is consistent with the program objective to reduce the debt-to-GDP ratio, and accommodates one-off outlays to prepare for the elections. Over the medium term, the authorities plan to reduce the primary deficit further to 1.3 percent of GDP, to bring the government debt-to-GDP ratio close to 41 percent by 2015/16 (below the original program target of 45 percent when the program was approved). The Debt Sustainability Analysis shows that Kenya remains at a low risk of debt distress (both external and public debt). The authorities' projections do not include potential revenue from the new discoveries of natural resources.



Source: Country authorities' data and IMF staff estimates.

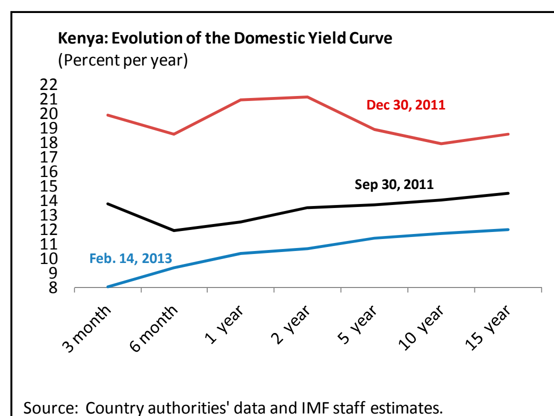
8. **The authorities regard boosting tax revenue as crucial to achieving their medium-term fiscal targets.** They give high priority to seeking approval of the new VAT Act as soon as the new National Assembly convenes (LOI, paragraph 10). In the short run, the new tax on financial transfer fees would provide additional revenue, and the intensification of the audit of large taxpayers would enhance compliance with VAT provisions. For FY 2013/14, plans to enforce tax collection from rental and real estate activities will be fully implemented.

9. **The Salaries and Remuneration Commission created by the new constitution will soon enact a rationalization of the salary scheme for civil servants based on job evaluation and market criteria** (LOI, paragraph 13). The commission is currently discussing with the Ministry of Finance the consistency of alternative proposals with the medium-term fiscal framework. In the meantime, the government will offset the impact of recent wage increases and additional expenditure associated with constitutional reform by cuts in non-priority expenditure such as non-wage allowances for civil servants and non-essential budgets for some of the Constitution-mandated commissions. Complementarily, the implementation of a defined-contribution pension system for civil servants should reduce related contingent liabilities from FY 2013/14 onward.

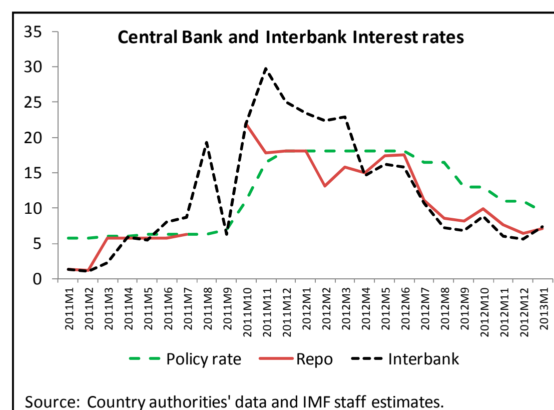
10. **Kenya's Medium-Term Debt Management Strategy remains in place** (LOI, paragraph 14). The government has started to prepare for the planned issuance of a US$ 1 billion dollar sovereign bond in FY 2013/14, of which US$600 million would be used to retire the 2012 syndicated loan and the remainder to co-finance infrastructure and energy projects. New capabilities under the recently approved Private-Public Partnership Law would be strengthened by a new comprehensive framework to manage contingent liabilities, with World Bank support. Contingent liabilities related to non-viable state-owned enterprises will be further reduced with the privatization of remaining government interests in sugar companies and hotels, recently approved by the cabinet.

11. **Key reforms already in place would facilitate the devolution process.** Public Financial Management reform would be ready to roll out in parallel with the transition to a new form of government. Sound financial management through broadened coverage of the Integrated Financial Management Information System (IFMIS) would ensure that transfers to the counties will not disrupt the allocations for priority pro-poor spending, and would contribute to expanding the social safety nets.

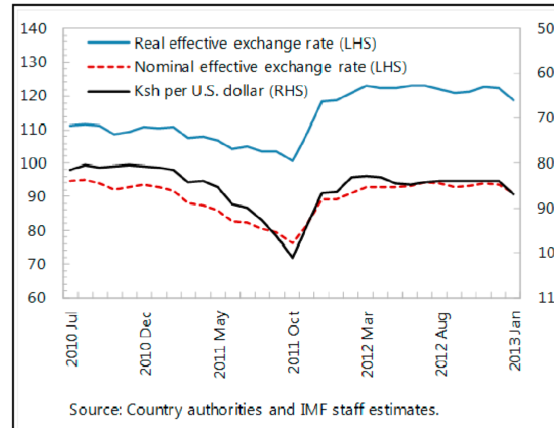
B. Easing Monetary Policy with Caution



12. **The CBK has eased its monetary policy stance with caution.** Declining market interest rates, a downward shift in the yield curve, and market surveys, suggest that expectations of low inflation have taken hold. The yield on longer-term bonds has declined to the level of 18 months ago, and has remained low despite a spike in refinancing needs in February 2012.



13. **CBK-Treasury coordination has improved in the run up to the elections.** The CBK increased absorption by allowing the repo interest rate to rise closer to the policy rate. As a result interest rates on government securities increased slightly by 80-100 basis points in February.



14. **The CBK intends to further accumulate international reserves.** Foreign reserves dropped temporarily following CBK intervention in the foreign exchange market in January to allay market uncertainty. Following that, the CBK shifted its foreign exchange policy to rely on increased absorption through repo operations to support the Shilling. The exchange rate has depreciated gradually in recent weeks as banks and large corporations intensified currency risk hedging prior to the elections. The real effective exchange rate now is approaching its pre-tightening level.

15. **The supervisory authorities remain vigilant as banks adapt to an updated regulatory framework.** Banks remain solvent and profitable, and maintain high liquidity during the electoral period**.** Lending interest rates are gradually coming down as funding costs decline. Banks are raising capital to comply with new capital requirements (14.5 percent of risk-weighted assets) and upgraded risk classification criteria. High profitability and an improved prudential framework are

attracting foreign banks to open representative offices, including from China, India and the United States.

16. **Government policies have made financial services largely accessible to the low-income population.** Banks have intensified the use of agencies in remote areas (14 thousand throughout Kenya) supported by the widespread use of the mobile-based transfer platform (M-Pesa accounts) (See Box 3). Also, Kenyan banks are exploiting their comparative advantage in retail banking by expanding overseas, with 10 Kenyan banks with 269 branches in subsidiaries in all EAC countries, South Sudan, and Mauritius. Recent changes to the Banking Act grant the CBK new capabilities as the lead supervisor to facilitate consolidated supervision of groups. The CBK has established a supervisory college for one regional bank that has discussed its plans and strategies with a joint group of relevant supervisors from six jurisdictions. The CBK plans to extend this approach to cross-border supervision of all major regional banking groups.

Box 3. Kenya's Mobile Banking Revolution

In April, 2007, Safaricom, the dominant Kenyan mobile phone service provider, launched a mobile phone-based payment and money transfer system called M-Pesa. The platform was born out of an earlier Safaricom product, which allowed users to transfer airtime via a simple SMS text. The ease of use and the low cost of this new payment system led to its rapid adoption. More importantly, it had the potential to reach millions of Kenyans in need of an inexpensive transfer system. M-Pesa's main advantages over retail banks are:

- Instant money transfer across the country at a fraction of the cost of retail banks.
- An alternative deposit facility for low-income households, accessible at a low cost
- An existing and rapidly growing network of agents also covering rural and poor areas.

M-Pesa adoption grew exponentially, with 15 million out of 19 million mobile phone users having M-Pesa accounts. Small businesses, farmers, and agricultural workers, which are the bulk of the Kenyan economy, were among the biggest beneficiaries of M-Pesa, with payments close to KSh. 80 billion a month (equivalent to 31 percent of GDP). The government has recently switched some of its direct cash transfer programs to M-Pesa; remittances from abroad are starting to use M-Pesa capabilities; and, retail banks are increasingly adapting their service platform to M-Pesa users' preferences.

Table 1. Mobile Banking Revolution: Mobile Transfers, Number of Agents, and Number of Users 2007-2012

	Sep-07	Sep-08	Sep-09	Sep-10	Sep-11	Sep-12
Monthly Value Moved (KShs billion)	0.9	9.6	22.7	36.2	55.0	80.0
Number of Agents (cumulative)	960	4,230	13,326	20,563	32,021	45,540
Number of Users (cumulative millions)	0.6	4.1	8.0	13.5	14.9	15.2

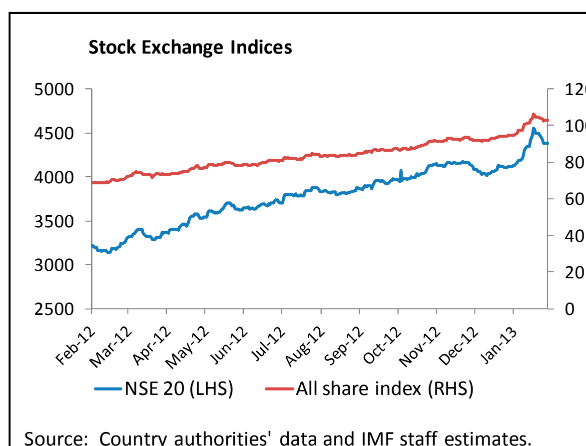
Source: Safaricom Financial Reports.

Box3. Kenya's Mobile Banking Revolution (continued)

M-Shwari

The success of M-Pesa spurred the other telecoms and retail banks to offer similar mobile transfer products, which increased competition and further lowered transaction costs. In November 2012, Safaricom together with the Commercial Bank of Africa launched a mobile banking product using M-Pesa's infrastructure, allowing low-income customers to open an interest-bearing deposit account via a phone and to borrow up to US $250. In just three months, M-Shwari deposits reached 1 percent of total deposits.

17. **Improved expectations and supportive policies have made Kenyan capital markets increasingly attractive to foreign investors** (LOI, paragraphs 20 and 21). Foreign investors' increased their participation in the stock exchange, accounting for 50 percent of outstanding holdings and 70 percent of inflows in recent months, supporting a bullish market. New opportunities will arise from the listing of medium-size enterprises under simplified provisions for the Growth Enterprise Market Segment (GEMS), the planned introduction of Real Estate Investment Trusts (REIT), and the finalization of the demutualization process for which the Nairobi Securities Exchange (NSE) has already formally applied.



Source: Country authorities' data and IMF staff estimates.

18. **Kenya has taken significant steps towards improving its anti-money-laundering and combating the financing of terrorism (AML/CFT) regime.** These include the enactment of the Proceeds of Crime and Anti-Money Laundering (Amendment) Act—which strengthened provisions on the criminalization of money laundering and freezing/seizing/confiscation of assets—and the issuance of revised AML Guidelines by the CBK. The Financial Action Task Force (FATF) found that Kenya should continue to work on implementing its action plan to address remaining deficiencies, including by: (a) adequately criminalizing terrorist financing; (b) ensuring a fully operational and effectively functioning Financial Intelligence Unit; (c) establishing and implementing an adequate legal framework for the identification and freezing of terrorist assets; (d) implementing effective, proportionate and dissuasive sanctions in order to deal with natural or legal persons that do not comply with the national AML/CFT requirements; (e) implementing an adequate and effective AML/CFT supervisory program for all financial sectors; and (f) further improving and broadening customer due diligence measures.

C. Assessing the Risk Outlook

19. **The main risks to Kenya's macroeconomic stability arise from domestic issues.** Political uncertainty could hamper economic growth and deter investors and capital inflows, putting pressure on the currency and foreign exchange reserves. Moreover, further revenue shortfalls or further delays in the approval of the new VAT Act, or, alternatively, higher-than-expected devolution costs, could reverse the recent gains in fiscal sustainability. Risks to the external outlook stemming from a protracted slowdown in Europe appear to have lessened. Its impact would be more significant on horticulture, tourism earnings, remittances, and FDI inflows. However, it would be more than offset in the likely event of further declines in fuel prices (see Country Report No. 12/300 for a detailed analysis of various risk scenarios).

Box 4. Kenya: Risk Assessment Matrix

Source of Risk	Relative Likelihood	Impact if Realized
Protracted period of slower European growth (larger than expected deleveraging, or negative surprise on potential growth)	***Medium***	***Medium*** • Lower exports to Europe, lower tourism arrivals, foreign direct investment (FDI) and economic growth.
Global oil shock triggered by geopolitical events (driving oil prices to $140 per barrel)	***Low***	***High*** • A surge in the current account deficit, inflation and pressure on the currency.
Heightened political tension in the transition to a new government	***Low***	***High*** • Lower official transfers, tourist arrivals, and FDI, and as a result, lower overall economic growth. • FX reserves buffers would be depleted
Larger than expected revenue shortfall together with increased spending as a result of fiscal decentralization	***Low to Medium***	***Medium*** • Unsustainable fiscal balance, increasing public debt, higher government borrowing costs, and an overall unstable macroeconomic environment.

PROGRAM ISSUES

20. **Staff proposes to modify the targets for the next review.** All December 2012 targets were met, except for the emergence of temporary technical arrears on external debt (Table 6). For June 2013, NIR and NDA targets were revised mainly to reflect new information on monetary aggregates and foreign exchange flows. The fiscal primary balance target has been revised to incorporate the last supplementary budget. The revised targets take into account changes in the macroeconomic outlook. The ceiling for non-concessional loans is consistent with the Debt-Sustainability Assessment (DSA) and has been raised to incorporate possible new requests for guarantees in coming months and the possible issuance of a sovereign bond within the FY 2013/14 if market conditions justify it. The direction of macroeconomic policies under the program has not changed.

21. **The authorities' reform agenda will continue prioritizing fiscal structural measures and capital market reform (See Box 5).** Many of these reforms are consistent with the government's medium-term plan Vision 2030, which is endorsed by all major political parties. In the fiscal area these include (LOI, paragraph 12): (a) approving and implementing the VAT Act; (b) reforming the income tax; (c) reviewing the customs and excise regimes; (d) implementing a new salary scheme for civil servants; and, (e) introducting the defined-contribution scheme for civil servants. In the financial sector the main reforms are: (a) strengthening supervision to adapt to rapidly growing financial inclusion; and, (b) implementing consolidated supervision, at the group and cross-border levels.

22. **The authorities request a waiver for the temporary non-observance of the continuous performance criterion on external payment arrears.** Small external arrears have emerged in December mainly because of staffing constraints during the holiday season at the Debt Management Department. These were cleared within less than two months.

Box 5. Kenya: Structural Reform Measures 2010–2013

AREA/POLICY MEASURE		**STATUS**
EXPENDITURE MANAGEMENT AND SOCIAL PROTECTION REFORMS		
1.	Improve efficiency in public financial management, introducing regulations in line with Constitution	• **Public Financial Management (PFM) Act** enacted in 2012. • **Controller of Budget** is fully operational. • **Commission on Revenue Allocation** helps to prepare for devolution. • **Integrated Financial Management Information System (IFMIS)** implemented across key ministries and departments, to be implemented at the county level. • **Single Treasury Account** to be implemented at national and county level.
2,	Harmonize procedures in managing aid flows.	• **Electronic Project Monitoring Information System** (e-ProMIS) introduced; plans are underway to integrate e-ProMIS with IFMIS
3.	Strengthen debt management	• **Medium term debt management strategy** updated on annual basis, • **National Loans and Guarantee Act**, 2011 establishes requirement for county governments to seek a guarantee from central government to borrow.
4.	Integrated Tax Management Systems	• ***itax*** launched by the Kenya Revenue Authority in February 2009, the implementation is at an advanced stage.
5.	Civil servants pension reform	• Replaces a defined-benefits scheme with a **comprehensive defined-contribution scheme.**
6	Social protection	• **National Social Protection Policy** approved by Cabinet • **Single Registry of cash transfer program beneficiaries** being finalized.
FINANCIAL SECTOR REFORMS		
7.	Financial supervision	• **Banking Act** amended to include prompt corrective action (2011) and consolidated supervision (2013). • **Credit Reference Bureaus:** Two licensed credit reference bureaus operating.
8.	Regulation and supervision of payment systems and payment service providers.	• The **National Payment System Act**, 2011 enhances CBK's oversight powers for non-bank based payment and clearing settlement systems, and incorporates mobile-based transfers. • **Regulations and guidelines for the retail payments sub-sector (Mobile Money and Electronic Money)** of the National Payments System aim at ensuring that E-Money Issuers and Payment Service Providers conduct their businesses prudently.
9.	Financial access and financial sector deepening	• **Banking Act** amended to include agency banking. • **Capital Markets Act** amended in 2012 to establish **a Growth Enterprise Market Segment** within the Nairobi Stock Exchange (NSE) targeting small and medium enterprises (SMEs).
10.	Demutualization of the Nairobi Stock	• **Capital Markets Act amended** to facilitate demutualization of the NSE by gradually separating ownership and trading rights.
BUSINESS REGULATORY REFORMS		
11.	Institutionalize Public Private Partnerships (PPPs) to enhance provision of quality infrastructure	• **Government Public-Private Partnership (PPP) Policy** issued in December, 2011 • **PPP Secretariat** has been set up within the Ministry of Finance. • **New PPP Act** adopted by Parliament in December, 201.
12.	Reduce legal, regulatory and administrative barriers	• **Competition Act** enacted in 2011, **Competition Authority** established.
13.	Improving private sector competitiveness	• **National Single Window System** approved by Parliament • **Kenya Trade Network Agency** established to implement the Kenya **Electronic Single Window System** and to facilitate trade.

STAFF APPRAISAL

23. **Achievements:** Kenya has stayed the course of economic reforms, with good results. Inflationary pressures have been tamed. Economic growth has kept a good pace, despite the slowdown of exports to and tourism from Europe. International reserves are on the rise and the deficit of the external current account has shrunk significantly –excluding capital goods imports that have surged because of oil exploration. The public debt-to-GDP ratio has declined, despite the large budgetary costs of implementing the new constitution, preparing for the March elections, and the recent wage increases in the civil service. Both external and public debt sustainability has improved from a year ago. Financial inclusion is moving fast, making millions of people who did not have access to financial services less vulnerable to adverse shocks. Interest rates are on a declining trend. Foreign investment flows have risen and boosted the performance of the stock market.

24. **Challenges and Risks:** In the short term, Kenya still faces some risks linked to the completion of the political transition, but risks from global financial and economic conditions have lessened. On the positive side, a peaceful political transition, in a context of strengthened macroeconomic conditions and structural reforms, could unleash Kenya's growth potential, further attract foreign investment, and lay the basis for transforming the country into an emerging-market economy. In the medium term, major fiscal risks include: (a) the possibility of an unsuccessful devolution of fiscal responsibilities to the newly established counties; and (b) tax administration difficulties that could translate into continued lower compliance and a persistent shortfall in revenue collections. If these risks materialize, they could derail the authorities' fiscal adjustment efforts, threaten the country's hard-won achievements, and set back its growth prospects. Thus, to raise the economy's resilience the authorities should maintain the momentum of their economic reforms. However, the prospects for commercially-viable oil discoveries could further improve the medium and long-term outlook, which will however require policies to promote diversified and balanced growth to avoid excessive reliance on natural resources.

25. **Fiscal stance:** The authorities have demonstrated their commitment to fiscal discipline by adhering to their targets for improving the primary fiscal balance. In fact, the public debt-to-GDP ratio has declined more than envisaged at the beginning of the program. The run up to the elections intensified expenditure pressures that proved difficult to resist. At the same time, tax collections lagged behind expectations because of both tax-administration problems and the delay in securing parliamentary approval of the new VAT Act. Under these circumstances, the authorities have given priority to their consolidation efforts by cutting low-priority spending. This resolve augurs well for

the success of their medium-term fiscal plans, but will require efforts to rein in the recent rise in current outlays and limit risks on the revenue side.

26. **Expenditure:** The recent decision to increase wages in the civil service is a cause for concern, because it raises current outlays at the expense of development spending. The authorities should take steps to gradually reverse the increase of the wage bill as a percent of GDP by: (a) rationalizing the salary scheme for the civil service within the available medium-term resource envelope building on the work of the Salaries and Remunerations Commission; and (b) ensuring that the devolution process does not generate any overlapping of government functions that could unduly boost public employment.

27. **Revenue:** Kenya's pressing spending needs require additional revenue mobilization. In the authorities' plans, the new VAT Act constitutes the first step of a comprehensive tax reform aiming at both raising revenue and reducing distortions. Thus, it is unfortunate that the bill was not discussed by the National Assembly before it was dissolved. Government should seek approval of the bill as soon as possible by the new National Assembly and push forward with the rest of the broad tax-reform agenda. In the immediate future, it will be essential to step up tax administration efforts particularly in the Large Taxpayers Unit to ensure that a sufficient number of tax returns are audited to secure compliance by tax-payers previously subjected to the now eliminated withholding regime.

28. **Monetary and exchange rate policies:** Monetary policy has successfully entrenched expectations of low inflation. Consistent with the recently-adopted framework for monetary operations the CBK policy rate has become the key reference for money markets, greatly improving the effectiveness of monetary policy. Looking forward, there is scope for further monetary easing, but the CBK should continue in its cautious approach by closely monitoring inflation expectations and anticipating possible adverse shocks and sudden reversal of capital inflows. If exchange rate pressures emerge in the aftermath of the elections, the CBK should preferably respond by mopping up liquidity and resorting to foreign exchange sales only in the event of extreme volatility. More generally, the CBK should refrain from resisting the likely depreciation that may result from lower interest rates, because it could help to restore competitiveness in a low inflation context.

29. **Financial sector:** Kenya's vibrant and rapidly expanding financial sector constitutes a major asset to support economic growth and reduce the vulnerabilities of low-income portions of the population. Nevertheless, despite the favorable financial soundness indicators, there is a need to closely monitor the health of the banking system and adapt banking supervision to growing regionalization. In particular, the recent rapid pace of private credit expansion should not impair the

quality of banks' loan portfolios. The government should also seek to complete the demutualization of the stock exchange that would enhance transparency and further attract investment flows.

30. **Structural Reforms:** The authorities have made significant progress in implementing their broad structural agenda. The recently improved World Bank country policy and institutional assessment (CPIA) rating reflects important achievements. In particular, the ongoing implementation of the new Public Financial Management Law should help limit the risks of a disorderly devolution process and greatly improve expenditure management and control, as well as accountability and transparency. The implementing regulations for the Treasury Single Account should aim at making it operational with the fiscal year starting in July 2013. The reform of the pension system has already started and is set to reduce government contingent liabilities substantially. It is also encouraging that the authorities have already started to review the fiscal regime for the extractive industry, with IMF technical assistance, in view of strong prospects for natural resource wealth.

31. **Program performance**: All December 2012 quantitative performance criteria were met, except for the criterion on the non-accumulation of external arrears that was temporarily breached for technical reasons. Staff supports the authorities' request for a waiver on the non-observance of this criterion. This breach was minor in nature, temporary and did not affect the thrust of policies. The authorities have already taken steps to address the staffing constraints that were behind the late payments. All structural benchmarks and indicative targets for December 2012 were observed. Staff recommends completion of the fifth review under the ECF arrangement, approval of modifying end-June 2013 performance criteria, and the approval of the request for the waiver.

Table 1. Kenya: Selected Economic Indicators, 2010/11–2015/16 [1]

	2010/11	2011/12	2012/13		2013/14	2014/15	2015/16
			Fourth	Projection		Projections	
	Actual	Preliminary	Review				
	(Annual percentage change; unless otherwise indicated)						
National accounts and prices							
Nominal GDP (market prices, in billions of Kenya shillings)	2,787	3,250	3,776	3,728	4,233	4,746	5,301
Real GDP growth (market prices)	5.1	4.5	5.4	5.3	6.1	6.3	6.5
GDP deflator (average) [2]	7.9	11.5	9.2	8.9	7.0	5.5	4.9
Consumer price index (annual average) [2]	6.9	16.0	5.4	4.4	5.0	5.0	5.0
Consumer price index (end of period) [2]	14.5	10.0	5.0	5.0	5.0	5.0	5.0
Import volume growth, goods	6.2	4.8	1.3	9.5	6.0	10.5	7.4
Import value growth, goods	20.6	16.2	0.4	7.0	4.8	8.1	6.1
Export volume growth, goods	-0.3	1.2	2.6	6.9	3.9	7.6	8.5
Export value growth, goods	13.1	6.7	-4.3	5.3	-0.2	6.2	6.1
Terms of trade, goods, and services (Base year 2000)	0.2	-5.0	-5.1	0.9	-2.2	1.1	-0.6
Ksh per US$ exchange rate (end of period)	99.6	82.9		86.6 4/			
Nominal effective exchange rate (- depreciation; end of period)	-14.3	18.2	…	…	…	…	…
Real effective exchange rate (- depreciation; end of period)	-6.9	12.4	…	…	…	…	…
Money and credit							
M3 (broad money and foreign currency deposits, end period)	15.2	15.5	19.9	16.8	…	…	…
Reserve money	4.8	16.7	20.1	14.9	…	…	…
	(In percent of GDP; unless otherwise indicated)						
Investment and saving							
Investment	20.8	21.5	21.6	20.7	21.9	22.6	22.8
Central government	7.8	9.2	8.7	8.0	8.9	8.9	9.0
Other	13.0	12.3	12.9	12.7	13.0	13.6	13.8
Gross national saving	12.3	12.3	13.8	12.3	14.0	14.9	15.7
Central government	2.7	3.1	2.5	1.7	3.6	4.0	4.3
Other	9.6	9.2	11.3	10.6	10.4	10.9	11.4
Central government budget [3]							
Total revenue	23.9	23.0	24.0	24.5	24.2	24.5	24.5
Total expenditure and net lending	29.1	29.2	30.7	31.5	29.6	29.5	29.2
Overall balance (commitment basis) excluding grants	-5.2	-6.1	-6.7	-6.9	-5.4	-5.0	-4.7
Overall balance (commitment basis) including grants	-4.5	-5.7	-4.8	-4.9	-4.3	-3.8	-3.7
Primary budget balance	-1.5	-2.2	-2.0	-2.0	-1.8	-1.5	-1.3
Net domestic borrowing	3.2	2.0	3.5	4.4	1.9	2.1	1.6
Balance of payments							
Exports value, goods, and services	30.2	27.5	22.6	24.8	23.1	22.1	21.2
Imports value, goods, and services	47.2	44.6	37.9	41.5	38.7	37.4	35.6
Current external balance, including official transfers	-8.5	-9.2	-7.8	-8.4	-7.9	-7.7	-7.0
Current external balance, excluding official transfers	-8.4	-9.1	-8.2	-8.9	-7.8	-7.6	-7.0
Gross international reserve coverage							
In billions of U.S. dollars (end of period)	4.1	5.2	5.9	5.5	6.7	7.7	8.9
In months of next year imports (end of period)	2.9	3.5	3.9	3.4	3.8	4.1	4.5
Public debt							
Total public debt, net (percent of GDP)	45.7	44.5	43.9	43.7	42.6	41.9	41.2
Of which: external debt	23.3	23.4	22.2	20.8	20.6	20.1	20.1
Domestic debt, net of deposits	22.4	21.2	21.7	22.9	22.0	21.7	21.0

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] Revenue plus program grants minus recurrent expenditure.

[4] March 7. 2013.

Table 2a. Kenya: Central Government Financial Operations 2010/11–2015/16

	2010/11	2011/12	2012/13		2013/14	2014/15	2015/16
		Estimate	Fourth Review	Proposed Program		Projections	
	(In billions of Kenyan shillings, unless otherwise indicated)						
Revenues and grants	**686.3**	**763.5**	**978.7**	**990.8**	**1,070.9**	**1,219.6**	**1,372.9**
Revenue	**667.5**	**748.2**	**906.8**	**914.4**	**1,024.3**	**1,162.7**	**1,309.3**
Tax revenue	557.2	626.5	748.6	739.9	846.5	968.1	1,081.4
Income tax	258.7	312.5	366.5	370.6	423.3	474.6	530.1
Import duty (net)	46.1	51.7	59.1	61.5	72.0	85.4	95.4
Excise duty	80.6	78.9	91.1	91.8	97.4	109.1	121.9
Value-added tax	171.9	183.4	231.9	216.0	254.0	299.0	334.0
Nontax revenue	110.4	121.7	158.2	174.5	177.8	194.6	227.9
Investment income	11.1	14.1	16.3	19.1	16.9	19.0	21.2
Other	41.0	50.2	57.9	65.6	72.0	71.2	95.4
LATF [1]	0.0	16.4	19.3	20.2	21.2	23.7	26.5
Ministerial and Departmental Fees (AIA) [2]	58.3	41.0	64.7	69.6	67.7	80.7	84.8
Grants	**18.8**	15.3	**71.9**	**76.4**	**46.6**	**56.9**	**63.6**
Project grants	18.8	15.3	56.2	56.5	46.6	56.9	63.6
Program grants	0.0	0.0	15.7	19.9	0.0	0.0	0.0
Expenditure and net lending	**811.8**	**947.9**	**1,160.0**	**1,172.9**	**1,252.9**	**1,395.2**	**1,558.5**
Recurrent expenditure	**578.5**	**642.3**	**818.2**	**854.4**	**855.0**	**958.6**	**1,076.1**
Interest payments	76.2	91.2	105.8	105.8	105.8	109.1	116.6
Domestic interest	69.2	82.3	94.5	94.5	93.1	94.9	100.7
Foreign interest due	7.0	8.9	11.3	11.3	12.7	14.2	15.9
Wages and benefits (civil service)	198.5	224.6	278.0	292.2	325.9	360.7	402.9
Pensions, etc.	25.7	26.1	41.0	41.0	59.3	66.4	68.9
Other [2]	217.4	221.7	309.9	325.7	283.6	341.7	402.9
Defense and NSIS	60.6	78.7	83.5	89.7	80.4	80.7	84.8
Development and net lending	**219.4**	**300.7**	**331.8**	**300.7**	**380.9**	**427.1**	**471.8**
Domestically financed	149.9	211.8	205.6	207.2	228.6	251.5	259.7
Foreign financed	67.0	86.1	123.7	93.5	149.5	172.6	206.7
Net lending	2.5	2.8	2.5	2.5	2.9	3.0	5.3
Equalization Fund (grants to marginalized areas)	0.0	0.0	0.0	3.0	4.2	0.0	0.0
Contingencies	0.0	0.0	5.0	5.0	4.2	0.0	10.6
Drought expenditures	8.4	4.9	0.0	0.0	0.0	4.7	0.0
Constitutional Reform [3]	5.6	0.0	5.0	9.8	8.5	4.7	0.0
Balance (commitment basis, excluding grants)	**-144.3**	**-199.7**	**-253.2**	**-258.5**	**-228.6**	**-232.5**	**-249.1**
Balance (commitment basis, including grants)	**-125.5**	**-184.4**	**-181.3**	**-182.1**	**-182.0**	**-175.6**	**-185.5**
Adjustments to cash basis	**6.8**	**22.4**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Balance (cash basis, including grants)	**-118.8**	**-162.0**	**-181.3**	**-182.1**	**-182.0**	**-175.6**	**-185.5**
Financing	**118.8**	**162.0**	**181.3**	**182.1**	**182.0**	**175.6**	**185.5**
Net foreign financing	28.4	98.5	50.9	17.9	103.1	76.0	100.7
Disbursements	48.2	122.0	76.6	43.6	192.8	118.6	148.4
Project loans	48.2	70.7	70.0	37.0	105.8	118.6	148.4
Commercial borrowing [4]	0.0	51.3	6.6	6.6	87.0	0.0	0.0
Repayments due	-20.5	-25.4	-26.2	-26.2	-90.2	-43.1	-47.7
Change in arrears	0.1	1.4	0.0	0.0	0.0	0.0	0.0
Rescheduling / debt swap	0.5	0.5	0.5	0.5	0.5	0.5	0.0
Net domestic financing	90.4	63.5	130.4	164.2	78.9	99.5	84.8
Memorandum items:							
Nominal GDP	2,787.3	3,250.2	3,775.6	3,728.3	4,232.6	4,745.5	5,301.0
Primary budget balance including grants	-42.6	-70.8	-75.5	-76.3	-76.2	-66.4	-68.9
Stock of domestic debt, net (end of period)	625.2	688.7	819.1	852.9	931.8	1,031.3	1,115.4
Total public debt, net of deposits	1,274.0	1,447.9	1,659.0	1,630.0	1,802.0	1,987.5	2,182.5

Sources: Kenyan authorities and IMF staff estimates and projections.

Fiscal year runs from July to June.

[1] Local Authorities Trust Fund (LATF)

[2] Coverage increased in FY 2010/11 to incorporate tuitions and fees to universities and hospitals, also called Appropriations in Aid (AIA), and associated expenditure.

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

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

Table 2b. Kenya: Central Government Financial Operations 2010/11–2015/16

	2010/11	2011/12	2012/13		2013/14	2014/15	2015/16
		Estimate	Fourth Review	Proposed Program	Projections		
	(In percent of GDP)						
Revenues and grants	**24.6**	**23.5**	**25.9**	**26.6**	**25.3**	**25.7**	**25.9**
Revenue	**23.9**	**23.0**	**24.0**	**24.5**	**24.2**	**24.5**	**24.7**
Tax revenue	**20.0**	**19.3**	**19.8**	**19.8**	**20.0**	**20.4**	**20.4**
Income tax	9.3	9.6	9.7	9.9	10.0	10.0	10.0
Import duty (net)	1.7	1.6	1.6	1.6	1.7	1.8	1.8
Excise duty	2.9	2.4	2.4	2.5	2.3	2.3	2.3
Value-added tax	6.2	5.6	6.1	5.8	6.0	6.3	6.3
Nontax revenue	**4.0**	**3.7**	**4.2**	**4.7**	**4.2**	**4.1**	**4.3**
Investment income	0.4	0.4	0.4	0.5	0.4	0.4	0.4
Other	1.5	1.5	1.5	1.8	1.7	1.5	1.8
LATF [1]	0.0	0.5	0.5	0.5	0.5	0.5	0.5
Ministerial and Departmental Fees (AIA) [2]	2.1	1.3	1.7	1.9	1.6	1.7	1.6
Grants	**0.7**	**0.5**	**1.9**	**2.0**	**1.1**	**1.2**	**1.2**
Project grants	0.7	0.5	1.5	1.5	1.1	1.2	1.2
Program grants	0.0	0.0	0.4	0.5	0.0	0.0	0.0
Expenditure and net lending	**29.1**	**29.2**	**30.7**	**31.5**	**29.6**	**29.4**	**29.4**
Recurrent expenditure	**20.8**	**19.8**	**21.7**	**22.9**	**20.2**	**20.2**	**20.3**
Interest payments	2.7	2.8	2.8	2.8	2.5	2.3	2.2
Domestic interest	2.5	2.5	2.5	2.5	2.2	2.0	1.9
Foreign interest due	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Wages and benefits (civil service)	7.1	6.9	7.4	7.8	7.7	7.6	7.6
Pensions, etc.	0.9	0.8	1.1	1.1	1.4	1.4	1.3
Other [2]	7.8	6.8	8.2	8.7	6.7	7.2	7.6
Defense and NSIS	2.2	2.4	2.2	2.4	1.9	1.7	1.6
Development and net lending	**7.9**	**9.3**	**8.8**	**8.1**	**9.0**	**9.0**	**8.9**
Domestically financed	5.4	6.5	5.4	5.6	5.4	5.3	4.9
Foreign financed	2.4	2.6	3.3	2.5	3.5	3.6	3.9
Net lending	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Equalization Fund (grants to marginalized areas)	**0.0**	**0.0**	**0.0**	**0.1**	**0.1**	**0.0**	**0.0**
Contingencies	**0.0**	**0.0**	**0.1**	**0.1**	**0.1**	**0.0**	**0.2**
Drought expenditures	**0.3**	**0.2**	**0.0**	**0.0**	**0.0**	**0.1**	**0.0**
Constitutional Reform [3]	**0.2**	**0.0**	**0.1**	**0.3**	**0.2**	**0.1**	**0.0**
Balance (commitment basis, excluding grants)	**-5.2**	**-6.1**	**-6.7**	**-6.9**	**-5.4**	**-4.9**	**-4.7**
Balance (commitment basis, including grants)	**-4.5**	**-5.7**	**-4.8**	**-4.9**	**-4.3**	**-3.7**	**-3.5**
Adjustments to cash basis	**0.2**	**0.7**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Balance (cash basis, including grants)	**-4.3**	**-5.0**	**-4.8**	**-4.9**	**-4.3**	**-3.7**	**-3.5**
Financing	**4.3**	**5.0**	**4.8**	**4.9**	**4.3**	**3.7**	**3.5**
Net foreign financing	1.0	3.0	1.3	0.5	2.4	1.6	1.9
Disbursements	1.7	3.8	2.0	1.2	4.6	2.5	2.8
Project loans	1.7	2.2	1.9	1.0	2.5	2.5	2.8
Commercial borrowing [4]	0.0	1.6	0.2	0.2	2.1	0.0	0.0
Repayments due	-0.7	-0.8	-0.7	-0.7	-2.1	-0.9	-0.9
Net domestic financing	3.2	2.0	3.5	4.4	1.9	2.1	1.6
Memorandum items:							
Nominal GDP	2,787.3	3,250.2	3,775.6	3,728.3	4,232.6	4,745.5	5,301.0
Primary budget balance	-1.5	-2.2	-2.0	-2.0	-1.8	-1.4	-1.3
Stock of domestic debt, net (end of period)	22.4	21.2	21.7	22.9	22.0	21.7	21.0
Total public debt, net of deposits	**45.7**	**44.5**	**43.9**	**43.7**	**42.6**	**41.9**	**41.2**

Sources: Kenyan authorities and IMF staff estimates and projections.

Fiscal year runs from July to June.

[1] Local Authorities Trust Fund (LATF)

[2] Coverage increased in FY 2010/11 to incorporate tuitions and fees to universities and hospitals, also called Appopriations in Aid (AIA), and associated expenditure.

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

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

Table 3. Kenya: Monetary Survey 2010–2013

	Dec-10	Jun-11	Dec-11	Jun-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13
(In billions of Kenyan shillings, unless otherwise indicated)									
Central Bank of Kenya (CBK)									
Net foreign assets	252.4	282.8	258.7	330.5	364.1	328.0	335.9	345.0	352.9
(in millions of US dollars) [1]	3,175	3,147	3,041	3,923	4,234	3,959	4,054	4,162	4,257
Net domestic assets	-29.8	-62.3	-3.7	-73.2	-70.5	-39.1	-40.3	-39.4	-8.7
Net domestic credit	13.2	17.7	54.8	-24.7	-13.4	14.3	13.2	14.0	44.8
Government (net)	-3.7	-7.1	54.8	10.7	10.9	12.0	15.0	15.0	10.0
Commercial banks (net)	13.9	19.9	0.0	-35.4	-24.2	-0.2	-4.3	-3.5	34.8
Other items (net)	-42.9	-80.0	-58.4	-48.5	-57.2	-53.5	-53.5	-53.5	-53.5
Reserve money	222.6	220.4	255.0	257.3	293.6	288.9	295.589	305.6	344.2
Currency outside banks	122.9	119.0	137.0	126.9	147.8	147.8	144.5	146.7	178.7
Bank reserves	99.7	101.5	118.0	130.3	145.9	141.0	151.1	158.9	165.5
Banks									
Net foreign assets	17.4	-0.8	36.5	-8.7	-38.2	-8.3	-4.1	4.1	12.4
(in millions of US dollars)	216.0	-9.3	429.3	-103.4	-443.6	-100.0	-50.0	50.0	150.0
Reserves	99.7	101.5	118.0	130.3	145.9	141.0	151.1	158.9	165.5
Credit to CBK	-13.9	-19.9	0.0	35.4	24.2	0.2	4.3	3.5	-34.8
Net domestic assets	1,033.3	1,170.2	1,209.3	1,293.1	1,433.2	1,488.3	1,536.8	1,608.9	1,706.1
Net domestic credit	1,189.1	1,346.4	1,444.7	1,539.6	1,689.4	1,744.5	1,793.0	1,865.1	1,962.3
Government (net)	281.5	284.9	256.8	287.3	358.0	384.0	388.9	400.0	420.0
Other public sector	22.2	21.7	30.8	41.2	49.8	53.8	57.8	61.8	65.8
Private sector	885.4	1,039.7	1,157.1	1,211.1	1,281.6	1,306.6	1,346.3	1,403.3	1,476.5
Other items (net)	-155.8	-176.2	-235.4	-246.4	-256.2	-256.2	-256.2	-256.2	-256.2
Total deposits	1,136.6	1,251.0	1,363.8	1,450.1	1,565.1	1,621.3	1,688.1	1,775.5	1,849.3
Monetary survey									
Net foreign assets	269.8	281.9	295.2	321.8	326.0	319.7	331.7	349.2	365.3
(in millions of US dollars)	3,390.9	3,137.3	3,470.2	3,820.1	3,790.6	3,858.8	4,003.9	4,211.8	4,406.9
Net domestic assets	1,001.8	1,098.8	1,218.9	1,272.9	1,401.3	1,469.6	1,531.3	1,610.3	1,675.6
Net domestic credit	1,188.4	1,344.2	1,505.1	1,552.4	1,702.5	1,759.0	1,810.5	1,880.1	1,972.3
Government (net)	277.8	277.8	311.6	297.9	368.8	396.0	403.9	415.0	430.0
Other public sector	22.2	21.7	30.8	41.2	49.8	53.8	57.8	61.8	65.8
Private	888.4	1,044.7	1,162.7	1,213.2	1,283.9	1,309.1	1,348.8	1,403.3	1,476.5
Other items (net)	-222.7	-245.4	-286.2	-279.5	-301.2	-289.4	-279.2	-269.8	-296.7
M1	577.2	620.1	622.7	623.7	710.7	736.2	766.6	806.3	839.8
Money and quasi-money (M2)	1,099.2	1,183.9	1,254.0	1,339.1	1,469.0	1,521.7	1,584.5	1,666.5	1,735.7
M2 plus resident foreign currency deposits (M3)	1,271.6	1,380.7	1,514.2	1,594.7	1,727.3	1,789.3	1,863.0	1,959.5	2,040.9
M3 plus nonbank holdings of government debt (L)	1,569.6	1,720.6	1,876.1	1,970.1	2,129.5	2,205.8	2,296.8	2,415.7	2,516.1
Memorandum items (Annual percent change unless otherwise specified)									
M1	30.5	21.2	7.9	0.6	14.1	20.3	22.9	20.8	18.2
M2	22.4	14.5	14.1	13.1	17.2	19.2	18.3	18.2	18.2
M3	21.6	15.2	19.1	15.5	14.1	17.9	16.8	17.3	18.2
Deposits	21.4	15.1	20.0	15.9	14.8	18.0	16.4	16.4	18.2
Reserve money	22.4	4.8	14.5	16.7	15.1	12.0	14.9	18.0	17.2
Currency outside banks	21.9	17.4	11.4	6.7	7.9	14.3	13.8	12.3	20.9
Net domestic credit	24.3	23.7	26.7	15.5	13.1	14.9	16.6	16.0	15.8
Government (net)	35.5	0.0	12.2	7.2	18.4	25.7	35.6	24.7	16.6
Private	20.3	30.7	30.9	16.1	10.4	10.6	11.2	13.4	15.0
Net domestic assets of the banking sector	24.9	19.6	21.7	15.8	15.0	18.4	20.3	22.1	19.6
NDA growth (as percent of the base period M3)	15.6	12.5	13.8	10.1	9.7	12.0	13.1	14.1	12.9
Multiplier (Average M3/RM)	5.9	6.1	6.2	6.1	6.1	6.2	6.2	6.2	6.2
Velocity (GDP/M2)	2.4	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.4

Source: Kenyan authorities and IMF staff estimates and projections

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

Table 4. Kenya: Balance of Payments 2010/11–2015/16

	2010/11	2011/12	2012/13	2012/13	2013/14	2014/15	2015/16
			Fourth Review	Projections			
	(In millions of US dollars, unless otherwise indicated)						
Current account	**-2,656.1**	**-3,523.4**	**-3,564.6**	**-3,696.5**	**-3,927.4**	**-4,289.6**	**-4,390.6**
Excluding official transfers	-2,634.4	-3,502.8	-3,733.2	-3,906.5	-3,906.9	-4,269.0	-4,370.0
Exports, f.o.b.	5,563.6	5,934.1	5,676.1	6,251.1	6,236.8	6,622.2	7,024.9
Coffee	212.8	263.0	199.8	277.2	281.8	317.3	321.0
Tea	1,108.4	1,138.2	1,119.5	1,347.2	1,270.1	1,287.3	1,316.0
Horticulture	732.0	647.9	708.2	725.5	735.3	767.1	793.2
Imports, f.o.b	-12,738.1	-14,799.0	-14,858.4	-15,833.0	-16,585.2	-17,921.0	-19,012.5
Oil	-3,299.2	-4,192.3	-4,478.4	-4,126.9	-4,305.3	-4,418.7	-4,571.0
Other Private	-9,277.0	-10,294.4	-10,087.3	-11,515.1	-12,006.0	-13,206.0	-14,118.4
of which: Capital Imports[1]	-2,976.5	-3,116.8	-3,366.5	-4,209.4	-4,519.8	-5,122.8	-5,545.9
Balance on goods	-7,174.5	-8,864.9	-9,182.3	-9,581.9	-10,348.5	-11,298.8	-11,987.6
Balance on services	1,823.2	2,319.5	2,180.2	2,246.7	2,615.3	2,783.8	3,025.3
of which: foreign travel credit[2]	909.7	927.7	987.2	832.8	911.7	970.6	1,040.1
Balance on goods and services	-5,351.4	-6,545.5	-7,002.1	-7,335.2	-7,733.2	-8,515.0	-8,962.3
Income (net)	23.8	-168.2	-245.0	-258.4	-281.1	-307.6	-318.6
Current transfers (net)	2,671.5	3,190.3	3,682.5	3,897.2	4,086.8	4,533.1	4,890.3
Private (net)	2,693.2	3,210.8	3,513.9	3,687.1	4,107.3	4,553.6	4,910.8
of which: remittances	1,232.8	1,711.3	1,660.1	2,130.8	2,432.6	2,737.4	2,992.7
Capital and financial account	2,957.2	4,353.3	4,036.6	3,788.6	5,016.1	5,352.4	5,655.5
Capital account (incl. capital transfers)	228.5	173.4	676.8	654.0	542.6	600.1	598.7
Financial account[3]	2,728.6	4,179.9	3,359.8	3,134.7	4,473.4	4,752.4	5,056.7
Net FDI	694.0	962.8	840.2	1,382.6	1,852.8	2,261.5	2,547.8
In Kenya	759.2	988.5	879.5	1,422.3	1,882.8	2,294.2	2,581.6
Abroad	-65.2	-25.7	-39.3	-39.8	-30.0	-32.6	-33.9
Net other investment	1,962.9	3,468.9	2,536.4	1,756.2	2,624.7	2,492.1	2,507.5
Official, medium and long term	338.1	1,127.9	606.5	204.3	1,197.3	1,046.8	1,121.8
Inflows	583.6	1,416.1	922.7	508.5	2,235.3	1,541.7	1,695.9
Project loans	583.6	807.0	843.0	431.8	1,233.3	1,280.7	1,437.0
Commercial loans[4]	0.0	609.0	79.7	76.7	1,002.0	261.1	256.0
Outflows	-245.5	-288.1	-316.2	-304.2	-1,037.9	-494.9	-574.0
Private, medium and long term	-49.7	-30.0	112.8	72.7	252.4	339.1	317.4
Energy financing	57.2	60.0	57.6	70.4	75.8	81.6	88.6
Kenya Airways	-76.3	17.8	97.3	97.3	214.9	296.7	268.6
Other	-30.5	-107.7	-42.0	-95.0	-38.2	-39.2	-39.8
Short-term capital	1,674.5	2,370.9	1,817.1	1,479.2	1,175.0	1,106.2	1,068.3
of which: commercial banks	465.8	94.1	-167.1	-55.6	-238.4	-94.5	-93.9
Errors and omissions	83.7	-242.4	0.0	0.0	0.0	0.0	0.0
Overall balance	301.1	830.0	472.0	92.2	1,088.7	1,062.9	1,264.9
Financing items	-301.1	-830.0	-472.0	-92.2	-1,088.7	-1,062.9	-1,264.9
Reserve assets (gross)	-321.9	-1,120.9	-658.1	-280.6	-1,150.0	-1,000.0	-1,200.0
Use of Fund credit and loans to the Fund (net)	78.8	285.1	180.0	182.6	55.5	-68.7	-64.9
Disbursements	103.3	319.7	222.7	225.3	111.4	0.0	0.0
Repayments	-24.4	-34.7	-42.7	-42.7	-55.9	-68.7	-64.9
Rescheduling /debt swap	5.4	5.9	6.0	5.9	5.9	5.9	0.0
Memorandum items:							
Gross official reserves (end of period)	4,120.5	5,241.4	5,899.5	5,522.0	6,672.0	7,672.0	8,872.0
(in months of following year's imports of goods and services	2.9	3.5	3.9	3.4	3.8	4.1	4.5
(excluding capital imports)[1]	3.5	4.5	4.8	4.5	5.1	5.5	6.1
Current account balance (excluding official transfers, percent of GDP)	-8.4	-9.1	-8.2	-8.9	-7.8	-7.6	-7.0
Import volume growth, goods and services (percent)	4.4	3.6	2.0	9.0	7.0	11.0	7.9
Import value growth, goods and services (percent)	19.3	15.6	1.3	6.6	5.7	8.3	6.4
Export volume growth, goods and services (percent)	-0.8	5.4	3.3	4.6	9.7	8.7	9.3
Export value growth, goods and services (percent)	13.2	11.7	-2.4	3.2	5.8	7.2	7.2
Change in the terms of trade (goods and services, percent)[5]	0.2	-5.0	-5.1	0.9	-2.2	1.1	-0.6

Sources: Kenyan authorities and IMF staff estimates and projections.

[1] Excludes power generation related machinary and airplanes but includes oil-exploration related machinery and equipment.

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

[3] Historical figures include errors and omissions.

[4] 2012 includes the $600 million syndicated loan.

[5] Base year: 2000.

Table 5. Kenya: Financial Soundness Indicators of the Banking Sector 2010–2012

	Dec-10	Jun-11	Dec-11	Jun-12	Dec-12
(Percent)					
Capital adequacy					
Regulatory capital to risk-weighted assets	20.8	19.0	19.4	20.3	21.9
Regulatory tier 1 capital to risk-weighted assets	18.7	16.9	17.3	17.7	18.9
Total capital to total assets	13.2	12.8	13.2	15.3	16.3
Asset quality					
Non performing loans to total gross loans	6.2	5.4	4.4	4.5	4.5
Non performing loans net of provisions to capital	6.4	5.8	3.5	3.6	3.5
Earning assets to total assets	88.8	89.5	87.8	87.7	87.4
Earning and profitability					
Return on assets (ROA)	3.7	3.3	3.3	3.8	3.7
Return on equity (ROE)	30.7	30.8	32.2	33.7	29.7
Interest margin to gross income	34.7	40.9	38.6	31.5	32.7
Non interest expenses to gross income	48.2	48.2	44.6	36.2	37.8
Liquidity					
Liquid assets to total assets	38.4	34.9	33.3	34.2	35.2
Liquid assets to short-term liabilities	44.5	38.9	37.0	38.1	41.9
liquid assets to total deposits	51.0	46.3	43.8	45.0	46.8
Total loans to total deposits	72.5	76.6	77.4	77.2	76.9
Sensitivity to market risk					
Net open position in foreign exchange to capital	4.3	4.6	3.3	3.4	2.6
Interest bearing assets to interest bearing liabilities	117.8	117.9	115.4	115.3	116.2
FX currency denominated assets to total assets	10.6	12.4	11.8	12.8	13.2
FX currency denominated liabilities to total liabilities	17.1	18.2	21.5	22.3	20.9
Spread between lending and deposit rate	9.3	8.8	8.4	9.9	9.8

Source: Central Bank of Kenya.

Table 6. Kenya: Performance Criteria for the Fifth 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	Indicative Targets
	End-Dec.			End-March	End-June	End-Sept.	End-Dec.
	Program	Actual	met/not met	Program	Program	Proposed	Proposed
Quantitative performance criteria							
Fiscal targets							
Primary budget balance of the central government (-=deficit, floor) [1,2,3]	-64.0	-60.7	met	-62.0	-40.0	-15	-35
Monetary targets [4,5]							
Stock of central bank net international reserves (floor, in millions of US$) [6,7]	4,460	4,530	met	4,150	4,250	4,350	4,450
Stock of net domestic assets of the central bank (ceiling)	-50	-81	met	-40	-35	-35	-10
Public debt targets							
Contracting or guaranteeing of medium- and long-term nonconcessional by the central government (ceiling; millions of US$) [8,9]	1,500	1,130	met	1,500	2,500	2,500	2,500
New central government and central government guaranteed external payment arrears (ceiling, millions of US$) [10]	0	2.47	not met	0	0	0	0
Indicative targets							
Priority Social Expenditures of the central government(floor) [2,3]	15.0	11.9	not met	21.0	28.3	8	16

[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-September 2012,end-December 2012, end-March 2013, and end-June 2013 are cumulative flow from July 1, 2012 (beginning of the 2012/13 fiscal year).

[3] Targets for end-September 2013 and end-December 2013 are cumulative flow from July 1, 2013 (beginning of the 2013/14 fiscal year).

[4] For program monitoring, the daily average for the month when testing dates are due.

[5] The NIR floor will be adjusted upward (downward) by the excess (shortfall) of external budgetary support (grants and loans) and external commercial debt relative to the programmed amounts. The NDA ceiling will be adjusted downward (upward) by the excess (shortfall) of external budgetary support (grants and loans) and external commercial debt relative to the programmed amounts.

[6] Excludes encumbered reserves.

[7] First review targets at September 1, 2010 exchange rates. Second review targets at April 29, 2011 exchange rate.

[8] Cumulative flow of contracted debt, from January 1, 2011.

[9] The targets on the ceiling of non-concessional external debt combine nonconcessional project loans, syndicated loan and sovereign bond.

[10] Continuous.

Table 7. Kenya: 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 9, 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 16, 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
March 28, 2013

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

Dear Mrs. Lagarde,

1. Our economy continued to grow at a satisfactory pace in 2012. Stagnating demand for our exports in traditional export markets was offset by better than expected rains, which contributed to good harvests and hydropower generation, and increased demand for our goods in new markets. A tightening of monetary policy helped bring inflation under control and led to an accumulation of higher foreign exchange reserves. This success has provided scope for easing of monetary policy conditions, which should benefit economic activity in 2013.

2. Performance under the economic program supported by the arrangement under the IMF's Extended Credit Facility was in line with its objectives. We have met all the quantitative performance criteria for end-December 2012, except for the continuous performance criterion on external payment arrears for which we have taken corrective measures, such as strengthening the staffing, and for which we are requesting a waiver for its temporary non-observance. The indicative target on priority social spending, which was not met for end-December, was fully made up in January. On the structural front, we are finalizing the regulations necessary to implement the 2012 PFM Act and are establishing the Treasury Single Account that will become operational in FY 2013/14. The new VAT bill will be resubmitted for debate to the new National Assembly as soon as it convenes, following the March 4 general elections.

3. This Letter of Intent describes the policies that we intend to implement for the remainder of 2012/13 and in 2013/14. Policies in the near term will aim at strengthening revenues, rationalizing the wage bill in the context of devolution, and re-orienting expenditures towards development priorities. Monetary policy will continue to aim at a low and stable price environment, consistent with a sustained pace of private-sector credit expansion. We will further bolster our foreign exchange reserves as we undertake policies to strengthen the external position. We stay firmly

committed to our reform program aimed at achieving higher and equitable growth consistent with our long-term Development Strategy - of Vision 2030.

RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

4. Economic growth was satisfactory in 2012, despite the impact of the European crisis on exports, including tourism. The return of normal rains provided for strong harvests of our main crops and increased generation of hydro-power, which in turn served to limit costly diesel power generated by imported oil. As a result, the underlying external current account—after excluding capital imports that have surged because of oil exploration—narrowed. Under challenging circumstances, including wage demands and revenue shortfalls, we continued to maintain fiscal discipline, which helped to further lower the public debt-to-GDP ratio.

5. The tightening of monetary policy in the first half of 2012 helped entrench low inflationary expectations. Since then, the central bank has eased its monetary policy stance, by reducing its policy rate by a cumulative 850 basis points, as inflation fell to well below the government's medium-term target. Meanwhile, lending rates remain sticky at high rates and as such private sector credit expansion has slowed down helping domestic demand to grow more in line with supply, consistent with both macroeconomic and financial stability. The financial sector has remained vibrant and well-capitalized throughout the high interest rate environment as structural reforms take root and new financial instruments stimulate investment.

6. The exchange rate reversed the nominal depreciation that took place in 2011, but in the presence of still high inflation it appreciated in real effective terms for most of 2012. Recently, the stable exchange rate and low inflation has helped reverse this appreciation. This will allow for an improvement in the current account deficit throughout 2013 and continued build up of foreign exchange reserves by the CBK.

7. We expect economic growth to accelerate in 2013 supported by continued favorable weather, a healthy pace of private sector credit expansion as the recent easing of monetary policy takes effect, an increase in foreign direct investment, and further integration of regional markets. Continued fiscal discipline will allow for a slight reduction in the primary deficit and a further improvement in our public debt to GDP ratios. At the same time we will protect investments in infrastructure and the social sectors, while allocating sufficient resources to facilitate the transition to a devolved system of government.

8. From the external side, risks to the outlook stem mainly from a protracted period of slower European growth (larger than expected deleveraging, or negative surprise in potential growth) that

would further undermine tourism earnings, and from global oil shock triggered by geopolitical events. On the domestic side risks include challenges in setting up of the new devolved system of government and vulnerability to drought. Should these risks materialize we will take appropriate actions to safeguard macroeconomic stability.

THE ECONOMIC PROGRAM FOR 2013

A. Fiscal Policy

9. We will continue to maintain fiscal discipline while pursuing our long-term development strategy as outlined in the draft Second Medium-Term Plan of Vision 2030. We note that the recent wage bill increase has placed an excessive burden on our limited domestic revenue resources. Hence, we will take steps to contain the wage bill, supported by the ongoing work of the Salaries and Remuneration Commission, which will advise on a new salary scheme for civil servants. Mobilizing additional revenue will be another key priority. In this regard, we will take the following steps: a) strengthen VAT audit functions which should lead to enhanced compliance by large tax payers--fifty of the 100 largest VAT tax payers will have been audited by end-June 2013; b) enforce measures towards improving tax collection from rental and real estate activities; c) implement an automated excise tax management system to eliminate possibilities of mis-declaration of excisable tax products in FY 2013/14; and d) make the excise tax on mobile financial transfers operational, which was already approved by the National Assembly in January 2013. In addition we plan to seek approval of the new VAT Bill as soon as the new National Assembly convenes.

10. The Supplementary Budget for FY 2012/13 that was approved by Parliament in January 2013 remains consistent with an improvement in the primary budget balance. We have accommodated wage increases for doctors, nurses, teachers, and lecturers, while reprioritizing expenditures and preserving the expanded coverage of the social safety nets. We plan to submit an updated budget to Parliament in March/April 2013, when the new administration is in place following the general elections. The updated budget will remain consistent with the fiscal program, with revenue shortfalls being offset by a reduction in non-priority expenditures such as travel budgets and allowances for civil servants, and budgets for some of the Constitutionally-mandated commissions, as well as postponement of domestically financed capital outlays such as government built housing and administration buildings.

11. In addition, we will continue to lower non-priority spending through improved expenditure control, supported by broadened coverage of IFMIS. We will ensure an orderly transition to devolved government, while maintaining fiscal sustainability. The new PFM law provides a sound

regulatory framework for fiscal decentralization including transparent budget formulation, execution and reporting a major step to increase accountability in the management of public resources.

12. Building on recent successes, we will continue making progress on our structural reform agenda. We will undertake a comprehensive review of the Income Tax Act and the Customs and Excise Act. We will revamp our natural resource taxation framework to bring it in line with international best practices as our country is poised to become a significant producer of oil, gas and minerals. Following the enactment of the new PFM law, we will finalize its implementing regulations, and operationalize the Treasury Single Account at both national and county level.

13. The Salaries and Remuneration Commission has presented its recommendations, regarding the remuneration of State Officers. They will be finalized following discussions with stakeholders before being published in the National Register and implemented. This will be followed by a comprehensive review of the remuneration for civil servants, which will ensure that the fiscal sustainability of the wage bill in line with the PFM law and limit the scope for one-off wage increases. The pension reform, which replaces a defined-benefit pension scheme with a defined-contribution scheme for civil servants, is set to start on July 1, 2013. It will reduce contingent liabilities by half over the medium term. Any excess transitional costs of pension reform will be offset by lower non-priority spending.

14. We will be updating our Medium-Term Debt Management Strategy that ensures public debt sustainability. The ongoing reorganization of the institutional framework of the National Treasury will lead to an improvement in the monitoring of contingent liabilities from state owned enterprises, semi-autonomous government agencies, and the newly created counties. Our priority remains to attract concessional loans for key energy and infrastructure projects and to strictly limit borrowing on commercial terms to those viable projects that can generate a cash-flow sufficient to finance the loan repayments. We plan to issue a sovereign bond in 2013/14 to repay the syndicated loan we contracted in May 2012. In the short term, through effective CBK-Treasury coordination, we will ensure that redemptions and new government domestic borrowing requirements are fully met in the market through the sale of government securities.

B. Monetary Policy

15. Monetary policy has succeeded in curbing inflationary pressures and cementing low inflation expectations. Moreover, the tight monetary policy reduced the demand for imports and attracted portfolio inflows, allowing the CBK to build up foreign exchange reserves during the second half of 2012. At the same time, the exchange rate has remained generally stable.

16. The rapid decline in inflation, combined with deceleration in credit growth, has allowed the CBK to ease its monetary policy stance. We expect this stance to be maintained, helped by normal weather conditions and stable oil prices. However, the CBK will remain vigilant, giving more weight to monitoring inflation expectations and anticipating possible price shocks.

17. The framework for monetary operations has been effective, establishing the CBR as the pivot rate for the transmission of rates in the banking system. In particular, money market rates have declined in tandem with the policy rate. Monetary operations will remain geared at managing liquidity effectively, leading to further convergence between interbank rates and the central bank policy rate.

18. We will maintain our international reserves coverage in line with the program, while using open market operations to sterilize any excess liquidity and reduce volatility in the interbank market. We remain fully committed to our floating exchange rate regime and we will only intervene in the foreign exchange market to accumulate international reserves and to smooth out temporary excessive exchange rate volatility.

C. Financial Policy

19. With the return of macroeconomic stability our financial sector has recovered its dynamism, as reflected by the strong performance of the stock exchange, buoyed by foreign investor interest. We are currently in the final stages of demutualizing and listing the stock exchange in order to further diversify the investor base. In addition, our stock exchange has developed a new growth enterprise market segment (GEMS), which will allow small and medium-sized companies to access financial markets.

20. Continued financial innovation has allowed a rapid increase in access to banking services. Over the last six months we have seen a one third increase in M-Pesa transactions and witnessed the development of a new mobile-based savings and loan product (M-Shwari) geared toward the unbanked part of the population.

21. Our efforts to deepen the financial sector will intensify with the expected approval of a real-estate investment trust (REIT) by the Capital Markets Authority. New prudential guidelines are under implementation in our banking system, which will help promote financial stability in an environment of financial expansion. We are starting to coordinate with stakeholders to move ahead with plans to establish a futures market and a commodity exchange.

22. We have also made substantial progress on the AML-CFT front, by addressing the concerns of the Financial Action Task Force (FATF). The Prevention of Terrorism Act 2012 and the Proceeds of Crime and Anti-Money Laundering (Amendment) Act 2012 were enacted in 2012. The CBK has issued a revised Guideline on the Proceeds of Crime and Money Laundering (Prevention) and Combating the Financing of Terrorism, which take into account the revised FATF recommendations. The Financial Reporting Centre (FRC), Kenya's financial intelligence unit, has become operational and has begun receiving suspicious transaction reports from financial institutions that fall under the purview of the CBK. Arrangements are at an advanced stage to get other reporting entities outside the banking sector, particularly those in the capital markets and insurance sectors, to commence submitting suspicious transaction reports to the Centre.

PROGRAM ISSUES

23. 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 and indicative targets to be used in monitoring performance in the remainder of 2012/13 and first half of 2013/14. Fiscal performance criteria will cover the budgetary central government for the remainder of 2012/13. The sixth review under the ECF arrangement, assessing end-June 2013 performance criteria, is expected to be completed by November 15, 2013.

24. Given our strong program implementation, we request completion of the fifth 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, except for the temporary non-observance of the continuous performance criterion on the non-accumulation of external payment arrears and the indicative target for end-December 2012. We request modification of the end-June 2013 performance criteria for net international reserves, net domestic assets, the primary budget balance of the central government, and the continuous ceiling for non-concessional external debt. We request a waiver for the temporary non-observance of the continuous performance criterion on the non-accumulation of external payment arrears.

25. 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 objective under the ECF-supported program. We will also 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.

Sincerely yours,

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

Attachments: Updated Technical Memorandum of Understanding

Appendix Table 1. Kenya: 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	Indicative Targets
	End-Dec.			End-March	End-June	End-Sept.	End-Dec.
	Program	Actual	met/not met	Program	Program	Proposed	Proposed
Quantitative performance criteria							
Fiscal targets							
Primary budget balance of the central government (-=deficit, floor) [1,2,3]	-64.0	-60.7	met	-62.0	-40.0	-15	-35
Monetary targets [4,5]							
Stock of central bank net international reserves (floor, in millions of US$) [6,7]	4,460	4,530	met	4,150	4,250	4,350	4,450
Stock of net domestic assets of the central bank (ceiling)	-50	-81	met	-40	-35	-35	-10
Public debt targets							
Contracting or guaranteeing of medium- and long-term nonconcessional by the central government (ceiling; millions of US$) [8,9]	1,500	1,130	met	1,500	2,500	2,500	2,500
New central government and central government guaranteed external payment arrears (ceiling, millions of US$) [10]	0	2.47	not met	0	0	0	0
Indicative targets							
Priority Social Expenditures of the central government(floor) [2,3]	15.0	11.9	not met	21.0	28.3	8	16

[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-September 2012,end-December 2012, end-March 2013, and end-June 2013 are cumulative flow from July 1, 2012 (beginning of the 2012/13 fiscal year).

[3] Targets for end-September 2013 and end-December 2013 are cumulative flow from July 1, 2013 (beginning of the 2013/14 fiscal year).

[4] For program monitoring, the daily average for the month when testing dates are due.

[5] The NIR floor will be adjusted upward (downward) by the excess (shortfall) of external budgetary support (grants and loans) and external commercial debt relative to the programmed amounts. The NDA ceiling will be adjusted downward (upward) by the excess (shortfall) of external budgetary support (grants and loans) and external commercial debt relative to the programmed amounts.

[6] Excludes encumbered reserves.

[7] First review targets at September 1, 2010 exchange rates. Second review targets at April 29, 2011 exchange rate.

[8] Cumulative flow of contracted debt, from January 1, 2011.

[9] The targets on the ceiling of non-concessional external debt combine nonconcessional project loans, syndicated loan and sovereign bond.

[10] Continuous.

Appendix Table 2. Kenya: 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. To be discussed by the National Assembly.
	VAT Audits of the 50 largest taxpayers. *Macro criticality: Restore compliance with VAT by large taxpayers following the phasing out of withholding requirements.*	Sixth Review	
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 balance of payments financing need.*	First Review	Completed in January 2011 (guidelines were introduced Attorney General ruled that a new law was not needed).

Attachment. Updated Technical Memorandum of Understanding

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

I. QUANTITATIVE PERFORMANCE CRITERIA AND BENCHMARKS

2. Quantitative performance criteria are proposed for December 31, 2011; June 30, 2012; and December 31, 2012; and June 30, 2013 with respect to:

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

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

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

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

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

5. For program purposes, the **budgetary 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 budgetary central government; (b) the negative of **net external financing of the budgetary central government, excluding external concessional project loans;** and (c) **domestic and external interest payments** of the budgetary central government. For the December 31, 2012 and June 30, 2013 test date, the budgetary central government primary balance including grants excluding external concessional loans will be measured cumulative from July 1, 2012.

The above items are defined as follows:

- **Net domestic financing** of the budgetary 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 budgetary 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 budgetary central government are defined as **external project loans** contracted by the budgetary 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 budgetary central government are defined as the due interest charges on domestic and external central government debt.

6. The budgetary central government primary balance excluding concessional project loans will be adjusted downward by the amount of the shortfall of program grants, 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) and external commercial debt exceed the programmed amounts, the target for NIR will be adjusted upward by the difference, for up to US$100 million.
  - 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, for up to US$100 million.

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

- Reserve money is defined as the sum of:

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

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

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

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

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 budgetary 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. Kenya: African Mission in Somalia (AMISOM) Grant Schedule

(Billions of Kenyan shillings)

	FY 2012/13			
	Q1	Q2	Q3	Q4
Program Amount (cumulative	3.5	8.3	8.3	19.9
Received Amount (cumulative)	0	1.1	2.4	N/A

Source: Authorities' data

TMU Table 3. Kenya: 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
4. Net domestic assets			
Net CBK credit to the central government	Monthly	Within 15 days after the end of the month.	CBK
Outstanding net CBK credit to domestic banks (including overdrafts)	Monthly	Within 15 days after the end of the month.	CBK
5. Reserve money			
Currency in circulation	Monthly	Within 15 days after the end of the month.	CBK
Required and excess reserves	Monthly	Within 15 days after the end of the month.	CBK
Nonconcessional medium- and long-term external debt contracted or guaranteed by the central government	Quarterly	Within 45 days after the end of the quarter.	MoF
Accumulation of central government and central government guaranteed external payment arrears.	Quarterly	Within 45 days after the end of the quarter.	MoF
Social priority spending	Quarterly	Within 45 days after the end of the quarter.	MoF

INTERNATIONAL MONETARY FUND

KENYA

FIFTH REVIEW UNDER THE THREE–YEAR ARRANGEMENT UNDER THE EXTENDED CREDIT FACILITY AND REQUEST FOR A WAIVER AND MODIFICATION OF PERFORMANCE CRITERIA—DEBT SUSTAINABILITY ANALYSIS

April 1, 2013

Approved By
Roger Nord and Elliott Harris (IMF) and Marcelo Giugale and Jeffrey Lewis (World Bank)

Prepared by the staffs of the International Monetary Fund and the World Bank.

Since the last Debt Sustainability Analysis (DSA) was published in December 2011 (supplement in Country Report No. 12/14), Kenya's debt outlook has strengthened. Despite weaker than projected economic growth, all debt indicators have improved as a result of lower fiscal and current account deficits in 2011 and 2012, and more favorable exchange rate developments. Kenya's risk of external debt distress remains low, while overall public sector debt dynamics continue to be sustainable.[1] Moreover, under the baseline scenario and all the stress tests, Kenya's external debt burden indicators do not breach any of the relevant policy-dependent thresholds.

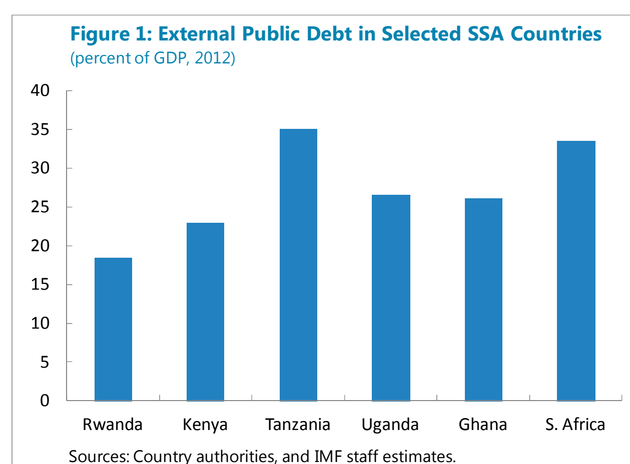
[1] World Bank classifies Kenya as a "medium performer" in terms of the quality of its policies and institutions as measured by a three-year average of the World Bank's Country Policy and Institutional Assessment (CPIA) Index. The relevant indicative thresholds for this category are: 40 percent for the NPV of debt-to-GDP ratio, 150 percent for the NPV of debt-to-exports ratio, 250 percent for the NPV of debt-to-revenue ratio, 20 percent for the debt service-to-exports ratio, and 30 percent for the debt service-to-revenue ratio. These thresholds are applicable to public and publicly guaranteed external debt.

BACKGROUND

1. **Kenya's overall net public debt-to GDP-ratio has declined over the past two years as a result of prudent fiscal policy and a stable macroeconomic environment.** At end-2012, this ratio stood at 43 percent, down from 48 percent at end-2011. Overall public debt is almost evenly split between domestic and external creditors.

2. **Most of Kenya's external debt remains on concessional terms, although its commercial component has increased.** At end-2012, nominal public external debt stood at 23 percent of GDP (USD 9.1 billion)—a ratio below that of comparable SSA countries (Figure 1). Multilaterals continue to be the largest source of external credit to Kenya, though their relative share has declined since 2011 (Table 1). Similarly, the share of bilateral creditors, the second most important source of external credit, has declined since 2010. The share of commercial debt has increased to about 10 percent at end-2012, mainly as a result of a syndicated loan of about US $600 million-on which Kenya managed to negotiate favorable conditions thanks to the strengthened macroeconomic environment and investment climate.[3] Kenya has not benefitted from debt relief under either the HIPC or MDRI initiatives.

Figure 1: External Public Debt in Selected SSA Countries
(percent of GDP, 2012)



Sources: Country authorities, and IMF staff estimates.

Table 1. Kenya: External Debt

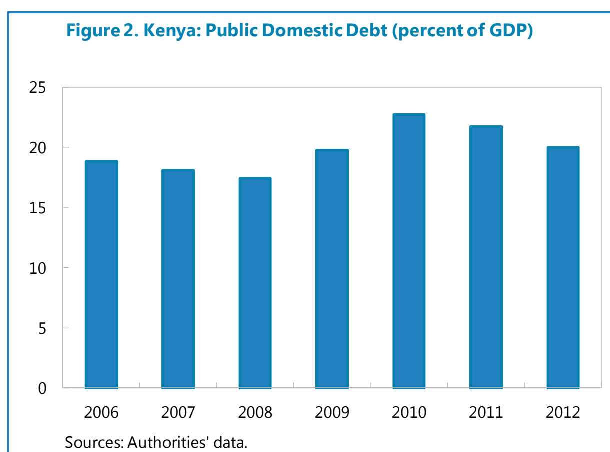
	2011		2012	
	Billion USD	Share	Billion USD	Share
Multilateral creditors	6.12	65.7	5.58	61.3
Bilateral creditors	2.96	31.7	2.65	29.2
Commercial Banks	0.24	2.5	0.86	9.5
Total	9.32	100.0	9.09	100.0

Source: Authorities' data.

[3] For the first time, Moody assigned Kenya a rating B1, and S&P a rating of B+, with a stable outlook, which should enable Kenya to negotiate a favorable rate for the planned sovereign bond issuance in 2013-2014.

3. Kenya's net domestic debt[4] **stood at 20 percent of GDP (KShs 708 billion) at end-2012, around the average for 2006-2012 (Figure 2).** It is mostly held by commercial banks in the form of T-bills and government bonds (comprising of 30 percent and 70 percent of domestic debt, respectively). However, the share of domestic debt held by non-banks has increased from 40.8 percent to 43 percent of the total between 2011 and 2012, reflecting a diversification of the domestic investor base. Despite the relatively large size of the domestic debt, rollover risks appear moderate as Kenya has focused on extending the average maturity of its debt, which is now 5.6 years.

Figure 2. Kenya: Public Domestic Debt (percent of GDP)



Sources: Authorities' data.

4. The authorities have continued to improve debt management. In July 2012, a new PFM law was approved, which raised the Debt Management Office to the level of agency within the Ministry of Finance, with overarching responsibility on managing Kenya's public debt. In fact, the 2012 PEFA assessment highlighted the improved debt and budget management capacities.[5] In 2012, the Debt Management Department produced on its own, the Medium Term Debt Strategy (MTDS).[6]

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[4]Net domestic debt refers to net of public sector assets (deposits).

[5] http://www.treasury.go.ke/index.php/resource-center/doc_download/505-public-expenditure-and-financial-accountability-pefa-assessment-final-report

[6] On Budget Management the following improvements were made: (i) a new independent Office of the Comptroller of the Budget was established, which has sole authority to authorize debt payments. In addition, this office audits budget execution and produces independent reports; (ii) a new Attorney General has been appointed, using a new constitutionally-mandated vetting process. The Attorney General Office has broad PFM functions, including the authorization of signing any new external loans (such as the syndicated loan); and (iii) the new PFM law has been approved and enacted in August, 2012.

UNDERLYING ASSUMPTIONS

5. This DSA is based on macroeconomic assumptions that are consistent with the framework outlined in the staff report for the Fifth Review under the Extended Credit Facility.[7] Notable revisions compared to the December 2011 DSA include:

- Real GDP growth is projected to be somewhat lower over the short and medium term to reflect the impact of the weaker global economic environment. (Table 2)
- The primary fiscal deficit is projected to be lower in the medium and long term, reflecting the authorities' revised fiscal consolidation path.
- The GDP deflator is projected to be lower in the short term as a result of the recent success in bringing down inflationary expectations.
- The projected current account deficit in the short and medium term is wider because of surging imports associated with oil exploration-related investment.
- The discount rate in the DSA template, used to calculate the present value (PV) of external debt, was reduced from 4 percent to 3 percent.

Table 2. Kenya: Selected Macroeconomic Assumptions

	2011	2012	2013	2014	Long term
Real GDP Growth					
Current DSA	4.4	4.7	5.8	6.1	6.0
Previous DSA	5.0	5.6	6.0	6.4	6.1
Primary Fiscal Deficit (percent of GDP)					
Current DSA	1.9	2.2	2.0	1.6	1.1
Previous DSA	2.5	2.3	1.9	1.2	1.6
Non-interest Current Account Deficit (percent of GDP)					
Current DSA	9.4	8.7	7.1	7.8	3.9
Previous DSA	9.9	9.5	5.9	6.8	2.4

[7] This DSA consists of two parts: external and public. The external DSA covers external debt of the central government and the central bank. The public DSA covers total debt-external and domestic-incurred or guaranteed by the central government. Public domestic debt comprises central government debt. In this analysis, total public debt refers to the sum of public domestic and public external debt, but does not cover the entire public sector (e.g., parastatal borrowing without a government guarantee is not covered).

Box 1. Kenya: Macroeconomic Assumptions for 2013-2033

- **Real GDP growth** in 2011 and 2012 remained at an average 4.5 percent, lower than the last DSA, because of the Horn of Africa drought that hit agricultural production and hydro-power generation, and the weak global economic environment. In 2013, real GDP growth is projected to recover close to its projected long-term average (6 percent), similar to the last DSA.
- **Inflation**, measured by the GDP deflator, dropped down from 14 percent in 2011 to 10 percent in 2012, lower than projected in the last DSA, thanks to successful monetary tightening and the reversal of the large depreciation of the Kenyan shilling experienced in 2011. It is assumed to average about 6 percent over the medium term.
- The **growth of exports of goods and services** averages about 7 percent in the medium term, broadly unchanged from the previous DSA. Despite assuming continued strong import volume growth, the overall import growth of goods and services is smaller than in the previous DSA thanks to projected lower commodity prices, in particular, fuel.
- The **noninterest current account deficit** in 2011 hit a high 9.4 percent of GDP, because the drought in the Horn of Africa reduced hydropower generation and increased fuel imports. It is projected to remain at 9 percent in 2012 because of rising capital imports associated with oil-exploration-related investment, financed by foreign direct investment inflows. Both our average long-run projections of the non-interest current account deficit and net FDI inflows are higher than under the previous DSA reflecting the assumed acceleration in oil-exploration-related investments and the improved business climate.
- **The external DSA has been revised to reflect the following:** (a) A loan of US $80 million (to finance the Biometric Voter Registration Kits) contracted in 2012; and (b) a planned sovereign bond in the amount of $1 billion to be disbursed in 2013-2014 (as opposed to $500 million assumed in the 2011 DSA), part of which will be used to repay the 2012 syndicated loan.
- A lower **grant element on new public sector borrowing** in 2013 and 2014 that reflects the planned issuance of a sovereign bond. The grant element on new borrowing is projected to decline gradually as the country develops and relies more on commercial borrowing. [8]
- The **primary fiscal deficit** in percent of GDP averages around 1.4 percent of GDP during 2013–18 and to 1.1 percent in the longer term projections, lower than under the previous DSA, reflecting the favorable developments in fiscal accounts in recent years.

[8] The grant element on new borrowing in the medium term is projected at 11 percent and in the long-term is 12 percent compared to 19 and 23 percent, respectively, in the last DSA, reflecting more conservative assumptions for access to concessional financing. The projected share of commercial external borrowing increases from 15 percent in 2015 to 43 percent by 2033. In 2012, the share of external debt stock contracted from multilateral institutions was 60 percent; from official bilateral institutions was 30 percent, and 10 percent from commercial creditors and other.

EXTERNAL DEBT SUSTAINABILITY ANALYSIS

6. **All external debt indicators remain well below the policy-dependent debt burden thresholds under the baseline scenario, and no thresholds are breached under any of the standard stress tests.** The main results of the external DSA are the following:

- **The debt burden would decline substantially over the 20-year projection period (Table 1a) under the baseline scenario.** As a result of the planned issuance of a sovereign bond, the NPV of external debt to GDP ratio would rise to 20 percent at end-2013 (1 percentage point of GDP higher than the last DSA), but by 2033, this ratio would decline to 8 percent of GDP (well below the 40 percent indicative threshold). The NPV of debt-to-exports ratio would rise to about 90 percent by 2018 but then would gradually decline to 49 percent by 2033 (compared to an indicative threshold of 150 percent).

- **Standard stress tests do not reveal any significant vulnerability (Table 1b and Figure 1) as even the shocks with the highest impact would maintain debt levels below the relevant indicative thresholds.** The shock that would have the largest impact on external debt dynamics results from a one-time 30 percent nominal depreciation of the exchange rate (similar to the previous DSA) in 2014 and from a permanent shock to the terms of new public sector loans, increasing the PV of debt to GDP ratio from 16 to 22 percent, still well below the relevant threshold.

PUBLIC DEBT SUSTAINABILITY ANALYSIS

7. **The debt dynamics for public debt are now more favorable than under the last DSA.** At 43 percent, the public debt-to-GDP ratio in 2012 was lower than the originally projected 48 percent. The PV of public debt-to-GDP ratio would edge down from 40 percent in 2013 to 39 percent by end-2018 (Table 2b). The PV of public debt-to-revenue ratio gradually would decline from 166 percent to 157 between 2013 and 2018.

8. **The alternative scenarios and bound tests indicate that the projected paths for all debt indicators do not breach the relevant thresholds (Table 2b and Figure 2).** The shock with the highest negative impact on debt dynamics is a two-year growth shock in 2014-2015, which pushes the ratio of PV of debt-to-GDP to 54 percent in 2023 from the baseline 36 percent; the PV of

debt-to-revenue ratio to 213 percent from 144 percent, and the PV of debt service-to-revenue ratio to 28 percent from 22 percent by 2023.

MAIN FINDINGS AND CONCLUSIONS

9. **The analysis of this DSA shows that Kenya continues to face low risk of external debt distress.** Moreover, total public debt dynamics have improved compared to the last DSA as a result of significant fiscal consolidation and still prudent external borrowing as well as a strengthened macroeconomic environment.

10. **The biggest risks to external debt sustainability come from exchange rate shocks and less favorable terms on new public sector loans.** For the overall public debt, sustainability could deteriorate if a significantly lower than anticipated growth materializes. In particular, this could be triggered by the following adverse developments:

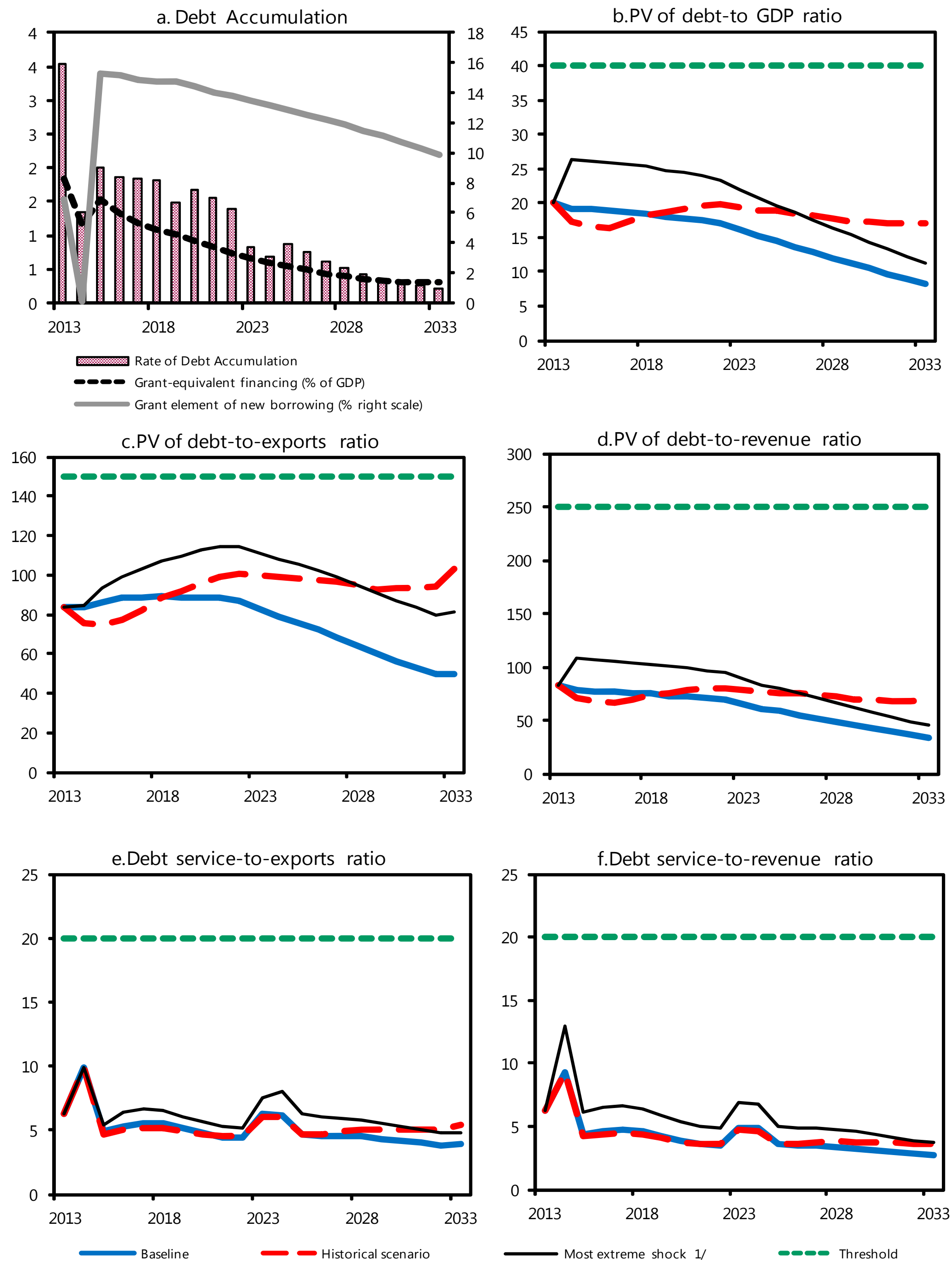
- a repeated and more severe drought could adversely affect agricultural production and hydro-power generation that would reduce economic growth, increase food and oil-related imports and lead to a widening of the current account deficit.

- a protracted slowdown in trading partner growth, in particular, in the Euro area, coupled with declining commodity prices that would lower tourism and main export earnings (e.g. tea, horticulture and coffee), reduce remittance and FDI inflows, with a significant impact on economic growth. However, in the external balances, these effects would be more than offset by a likely decline in oil prices.

- an increase in global food and fuel prices would raise the import bill and put pressure on the current account and the exchange rate.

11. **The DSA has been produced jointly with the authorities, who fully concur with its conclusions.** The Kenyan authorities have used it to analyze alternative policy scenarios to help maintain a prudent borrowing strategy. They concur on the importance of relying further on concessional financing, analyzing the impact of new borrowing on debt sustainability, maintaining fiscal discipline, and continuing to build up international reserves to mitigate adverse effects from exogenous shocks to the economy.

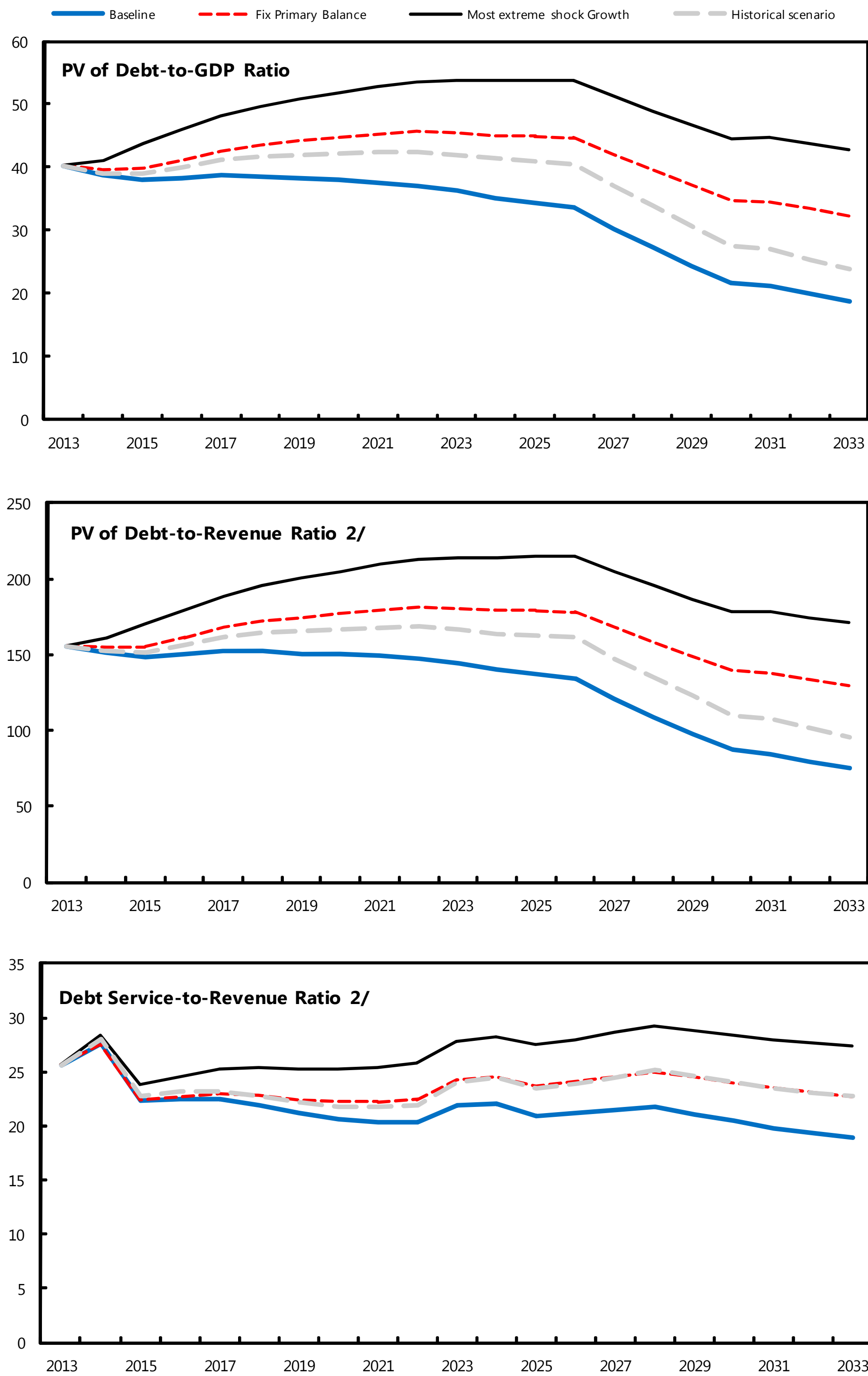
Figure 1. Kenya: Indicators of Public and Publicly Guaranteed External Debt under Alternatives Scenarios, 2013-2033 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in 2023. In figure b. it corresponds to a One-time depreciation shock; in c. to a Terms shock; in d. to a One-time depreciation shock; in e. to a Non-debt flows shock and in figure f. to a One-time depreciation shock

Figure 2.Kenya: Indicators of Public Debt Under Alternative Scenarios, 2013-2033 1/



Sources: Country authorities; and staff estimates and projections.
1/ The most extreme stress test is the test that yields the highest ratio in 2023.
2/ Revenues are defined inclusive of grants.

Table 1a.: External Debt Sustainability Framework, Baseline Scenario, 2010-2033 1/

(In percent of GDP, unless otherwise indicated)

	Actual			Historical 6/	Standard 6/	Projections									
				Average	Deviation							2013-2018			2019-2033
	2010	2011	2012			2013	2014	2015	2016	2017	2018	Average	2023	2033	Average
External debt (nominal) 1/	**23.1**	**26.2**	**22.5**			**23.3**	**21.8**	**21.8**	**21.6**	**21.5**	**21.4**		**18.9**	**9.8**	
of which: public and publicly guaranteed (PPG)	23.1	26.2	22.5			23.3	21.8	21.8	21.6	21.5	21.4		18.9	9.8	
Change in external debt	0.2	3.1	-3.7			0.8	-1.5	-0.1	-0.2	-0.1	-0.1		-1.0	-0.8	
Identified net debt-creating flows	4.5	6.2	1.7			2.8	2.9	2.1	1.5	0.5	0.3		0.6	0.1	
Non-interest current account deficit	**6.5**	**9.4**	**8.7**	**4.1**	**3.8**	**7.1**	**7.8**	**7.1**	**6.5**	**5.2**	**4.9**		**4.4**	**2.3**	3.9
Deficit in balance of goods and services	14.5	18.1	17.0			15.7	16.0	15.2	14.3	13.0	12.6		11.7	8.6	
Exports	26.9	29.1	26.4			24.1	23.0	22.2	21.3	21.1	20.7		19.4	16.7	
Imports	41.4	47.2	43.4			39.8	39.0	37.4	35.6	34.1	33.3		31.1	25.3	
Net current transfers (negative = inflow)	-7.6	-8.5	-8.5	-7.4	0.9	-8.8	-8.3	-8.2	-7.8	-7.7	-7.6		-7.0	-5.5	-6.6
of which: official	0.1	0.1	0.0			-0.4	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other current account flows (negative = net inflow)	-0.4	-0.3	0.3			0.2	0.1	0.1	0.0	-0.1	-0.1		-0.3	-0.9	
Net FDI (negative = inflow)	**-1.2**	**-2.2**	**-2.8**	**-1.8**	**1.0**	**-3.5**	**-4.0**	**-4.2**	**-4.2**	**-4.0**	**-3.9**		**-3.2**	**-1.8**	-2.8
Endogenous debt dynamics 2/	**-0.9**	**-1.0**	**-4.2**			**-0.8**	**-0.8**	**-0.8**	**-0.8**	**-0.7**	**-0.7**		**-0.6**	**-0.4**	
Contribution from nominal interest rate	0.3	0.3	0.3			0.4	0.4	0.4	0.5	0.5	0.5		0.4	0.2	
Contribution from real GDP growth	-1.3	-1.0	-1.0			-1.2	-1.3	-1.2	-1.3	-1.1	-1.2		-1.1	-0.6	
Contribution from price and exchange rate changes	0.1	-0.3	-3.5			...	...	...	...	...	...		...	...	
Residual (3-4) 3/	**-4.2**	**-3.1**	**-5.4**			**-2.0**	**-4.4**	**-2.2**	**-1.7**	**-0.5**	**-0.5**		**-1.6**	**-1.0**	
of which: exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		-0.1	0.0	
PV of external debt 4/	...	...	19.0			20.1	19.2	19.1	18.8	18.7	18.5		16.1	8.2	
In percent of exports	...	...	72.1			83.6	83.3	86.0	88.1	88.5	89.5		82.9	49.4	
PV of PPG external debt	**...**	**...**	**19.0**			**20.1**	**19.2**	**19.1**	**18.8**	**18.7**	**18.5**		**16.1**	**8.2**	
In percent of exports	**...**	**...**	**72.1**			**83.6**	**83.3**	**86.0**	**88.1**	**88.5**	**89.5**		**82.9**	**49.4**	
In percent of government revenues	**...**	**...**	**79.7**			**82.9**	**78.5**	**77.3**	**76.4**	**75.7**	**75.0**		**65.1**	**33.2**	
Debt service-to-exports ratio (in percent)	**5.0**	**5.0**	**4.8**			**7.3**	**11.0**	**6.0**	**6.8**	**6.9**	**6.6**		**6.9**	**4.0**	
PPG debt service-to-exports ratio (in percent)	**4.0**	**3.7**	**4.1**			**6.3**	**9.8**	**4.9**	**5.3**	**5.6**	**5.5**		**6.2**	**4.0**	
PPG debt service-to-revenue ratio (in percent)	**4.5**	**4.7**	**4.6**			**6.3**	**9.3**	**4.4**	**4.6**	**4.8**	**4.6**		**4.9**	**2.7**	
Total gross financing need (Billions of U.S. dollars)	2.1	2.9	3.0			2.5	3.3	2.4	2.4	1.9	1.9		3.4	4.4	
Non-interest current account deficit that stabilizes debt ratio	6.3	6.3	12.4			6.3	9.3	7.2	6.7	5.2	5.1		5.4	3.1	
Key macroeconomic assumptions															
Real GDP growth (in percent)	5.8	4.4	4.7	4.6	1.8	5.8	6.1	6.3	6.6	5.8	6.1	6.1	6.0	6.1	6.0
GDP deflator in US dollar terms (change in percent)	-0.6	1.4	15.3	7.3	6.3	6.1	5.7	4.7	4.5	4.6	4.8	5.1	4.7	4.7	4.7
Effective interest rate (percent) 5/	1.3	1.4	1.5	1.7	0.6	1.8	2.1	2.2	2.4	2.4	2.5	2.2	2.5	2.3	2.4
Growth of exports of G&S (US dollar terms, in percent)	16.8	14.5	9.4	13.1	9.4	2.6	7.2	7.2	7.3	9.4	8.8	7.1	10.0	2.5	9.5
Growth of imports of G&S (US dollar terms, in percent)	18.4	20.7	10.9	17.4	11.0	2.9	10.0	6.7	6.1	5.9	8.5	6.7	9.5	1.9	9.0
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	6.8	0.1	15.3	15.2	14.9	14.8	11.2	13.5	9.9	12.4
Government revenues (excluding grants, in percent of GDP)	23.8	23.4	23.9			24.3	24.4	24.6	24.6	24.7	24.6		24.7	24.8	24.7
Aid flows (in Billions of US dollars) 7/	0.2	0.2	0.5			1.2	1.0	1.3	1.3	1.3	1.4		1.4	1.7	
of which: Grants	0.2	0.2	0.5			0.7	0.6	0.6	0.6	0.5	0.5		0.6	0.9	
of which: Concessional loans	0.0	0.0	0.0			0.5	0.4	0.7	0.7	0.8	0.8		0.9	0.8	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			1.8	1.2	1.5	1.3	1.2	1.1		0.7	0.3	0.5
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			30.9	28.3	39.1	36.1	33.5	32.3		30.5	32.6	30.4
Memorandum items:															
Nominal GDP (Billions of US dollars)	32.2	34.1	41.1			46.1	51.8	57.6	64.2	71.1	79.0		132.8	378.8	
Nominal dollar GDP growth	5.2	5.8	20.7			12.2	12.2	11.3	11.4	10.7	11.1	11.5	11.0	11.2	11.0
PV of PPG external debt (in Billions of US dollars)			7.7			9.1	9.8	10.8	11.9	13.0	14.3		21.0	30.7	
(PVt-PVt-1)/GDPt-1 (in percent)						3.5	1.3	2.0	1.9	1.8	1.8	2.1	0.8	0.2	0.8
Gross workers' remittances (Billions of US dollars)	1.1	1.4	2.0			2.3	2.6	2.9	3.1	3.4	3.7		5.7	12.8	
PV of PPG external debt (in percent of GDP + remittances)	...	...	18.1			19.2	18.3	18.1	17.9	17.8	17.7		15.4	8.0	
PV of PPG external debt (in percent of exports + remittances)	...	...	60.9			69.4	68.4	70.1	71.8	72.2	73.0		67.9	41.1	
Debt service of PPG external debt (in percent of exports + remittanc	...	...	3.5			5.3	8.1	4.0	4.4	4.6	4.5		5.1	3.3	

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

2/ Derived as [r - g - ρ(1+g)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in U.S. dollar terms.

3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.

4/ Assumes that PV of private sector debt is equivalent to its face value.

5/ Current-year interest payments divided by previous period debt stock.

6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

7/ Defined as grants, concessional loans, and debt relief.

8/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the PV of new debt).

Table 1b.Kenya: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2013-2033

(In percent)

	Projections							
	2013	2014	2015	2016	2017	2018	**2023**	2033
PV of debt-to GDP ratio								
Baseline	20	19	19	19	19	18	**16**	8
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2013-2033 1/	20	17	17	16	17	18	**19**	17
A2. New public sector loans on less favorable terms in 2013-2033 2	20	19	21	21	22	22	**22**	14
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2014-2015	20	19	20	20	20	19	**17**	9
B2. Export value growth at historical average minus one standard deviation in 2014-2015 3/	20	20	21	20	20	20	**17**	8
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014-2015	20	20	20	20	20	20	**17**	9
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014-2015 4/	20	24	28	27	26	26	**21**	9
B5. Combination of B1-B4 using one-half standard deviation shocks	20	24	28	27	27	26	**21**	10
B6. One-time 30 percent nominal depreciation relative to the baseline in 2014 5/	20	26	26	26	26	25	**22**	11
PV of debt-to-exports ratio								
Baseline	84	83	86	88	89	89	**83**	49
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2013-2033 1/	84	76	75	77	82	88	**100**	103
A2. New public sector loans on less favorable terms in 2013-2033 2	84	85	93	99	103	107	**111**	81
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2014-2015	84	82	84	86	87	88	**81**	48
B2. Export value growth at historical average minus one standard deviation in 2014-2015 3/	84	88	100	102	101	102	**93**	53
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014-2015	84	82	84	86	87	88	**81**	48
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014-2015 4/	84	103	127	128	126	124	**107**	56
B5. Combination of B1-B4 using one-half standard deviation shocks	84	98	117	118	116	115	**100**	53
B6. One-time 30 percent nominal depreciation relative to the baseline in 2014 5/	84	82	84	86	87	88	**81**	48
PV of debt-to-revenue ratio								
Baseline	83	78	77	76	76	75	**65**	33
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2013-2033 1/	83	71	68	67	70	74	**79**	69
A2. New public sector loans on less favorable terms in 2013-2033 2	83	80	84	86	88	90	**87**	55
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2014-2015	83	80	81	80	79	78	**68**	35
B2. Export value growth at historical average minus one standard deviation in 2014-2015 3/	83	80	84	83	81	80	**68**	33
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014-2015	83	81	82	81	81	80	**69**	35
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014-2015 4/	83	97	115	111	107	104	**84**	37
B5. Combination of B1-B4 using one-half standard deviation shocks	83	97	115	112	109	106	**86**	39
B6. One-time 30 percent nominal depreciation relative to the baseline in 2014 5/	83	108	106	105	104	103	**89**	45

Table 1b.Kenya: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2013-2033 (continued)

(In percent)

Debt service-to-exports ratio								
Baseline	6	10	5	5	6	5	**6**	4
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2013-2033 1/	6	10	5	5	5	5	**6**	5
A2. New public sector loans on less favorable terms in 2013-2033 2	6	10	4	5	6	6	**6**	5
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2014-2015	6	10	5	5	6	5	**6**	4
B2. Export value growth at historical average minus one standard deviation in 2014-2015 3/	6	10	5	6	6	6	**7**	4
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014-2015	6	10	5	5	6	5	**6**	4
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014-2015 4/	6	10	5	6	7	6	**8**	5
B5. Combination of B1-B4 using one-half standard deviation shocks	6	10	5	6	6	6	**7**	5
B6. One-time 30 percent nominal depreciation relative to the baseline in 2014 5/	6	10	5	5	6	5	**6**	4
Debt service-to-revenue ratio								
Baseline	6	9	4	5	5	5	**5**	3
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2013-2033 1/	6	9	4	4	4	4	**5**	4
A2. New public sector loans on less favorable terms in 2013-2033 2	6	9	4	5	5	5	**4**	4
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2014-2015	6	10	5	5	5	5	**5**	3
B2. Export value growth at historical average minus one standard deviation in 2014-2015 3/	6	9	4	5	5	5	**5**	3
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014-2015	6	10	5	5	5	5	**5**	3
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014-2015 4/	6	9	5	6	6	5	**6**	3
B5. Combination of B1-B4 using one-half standard deviation shocks	6	10	5	6	6	6	**6**	3
B6. One-time 30 percent nominal depreciation relative to the baseline in 2014 5/	6	13	6	6	7	6	**7**	4
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	4	4	4	4	4	4	**4**	4

Sources: Country authorities; and staff estimates and projections.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in the baseline.
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).
4/ Includes official and private transfers and FDI.
5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.
6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Table 2a.Kenya: Public Sector Debt Sustainability Framework, Baseline Scenario, 2010-2033

(In percent of GDP, unless otherwise indicated)

	Actual					Estimate	Projections								
	2010	2011	2012	Average 5/	Standard Deviation 5/	2013	2014	2015	2016	2017	2018	2013-18 Average	2023	2033	2019-33 Average
Public sector debt 1/	45.8	47.2	42.9			43.5	41.4	40.8	41.1	41.5	41.4		39.0	20.3	
of which: foreign-currency denominated	23.1	26.2	22.5			23.3	21.8	21.8	21.6	21.5	21.4		18.9	9.8	
Change in public sector debt	3.2	1.3	-4.3			0.6	-2.1	-0.6	0.2	0.5	-0.1		-1.0	-1.3	
Identified debt-creating flows	3.4	-2.0	-1.4			-0.9	-1.2	-1.0	-1.0	-0.9	-1.2		-1.0	0.1	
Primary deficit	2.8	1.9	2.2	0.9	1.8	2.0	1.6	1.4	1.2	1.1	1.1	1.4	1.1	1.2	1.1
Revenue and grants	24.6	24.0	25.2			25.9	25.6	25.7	25.5	25.4	25.3		25.2	25.1	
of which: grants	0.8	0.6	1.3			1.5	1.2	1.1	0.9	0.8	0.7		0.4	0.2	
Primary (noninterest) expenditure	27.5	25.8	27.4			27.8	27.2	27.1	26.8	26.5	26.4		26.2	26.2	
Automatic debt dynamics	0.5	-3.9	-3.6			-2.9	-2.8	-2.3	-2.3	-2.0	-2.3		-2.1	-1.0	
Contribution from interest rate/growth differential	-0.8	-2.7	-2.0			-1.9	-1.9	-1.7	-1.8	-1.5	-1.8		-1.5	-0.7	
of which: contribution from average real interest rate	1.6	-0.8	0.1			0.4	0.6	0.7	0.8	0.7	0.6		0.7	0.5	
of which: contribution from real GDP growth	-2.3	-1.9	-2.1			-2.4	-2.5	-2.5	-2.5	-2.3	-2.4		-2.3	-1.2	
Contribution from real exchange rate depreciation	1.3	-1.2	-1.6			-1.0	-0.9	-0.6	-0.5	-0.5	-0.5		...	...	
Other identified debt-creating flows	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	-0.2	3.3	-2.9			1.5	-0.9	0.4	1.3	1.4	1.1		0.0	-1.4	
Other Sustainability Indicators															
PV of public sector debt	...	...	39.4			40.3	38.7	38.1	38.3	38.7	38.6		36.2	18.8	
of which: foreign-currency denominated	...	...	19.0			20.1	19.2	19.1	18.8	18.7	18.5		16.1	8.2	
of which: external	...	...	19.0			20.1	19.2	19.1	18.8	18.7	18.5		16.1	8.2	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	14.8	15.2	15.5			15.5	15.5	13.9	13.6	13.6	13.5		13.5	9.6	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	156.5			155.9	151.3	148.0	150.1	152.0	152.2		144.0	74.9	
PV of public sector debt-to-revenue ratio (in percent)	...	...	165.1			165.7	158.5	154.6	155.6	156.7	156.5		146.5	75.6	
of which: external 3/	...	...	79.7			82.9	78.5	77.3	76.4	75.7	75.0		65.1	33.2	
Debt service-to-revenue and grants ratio (in percent) 4/	25.5	26.1	25.2			25.6	27.6	22.3	22.4	22.4	21.9		21.9	19.0	
Debt service-to-revenue ratio (in percent) 4/	26.3	26.8	26.6			27.3	28.9	23.3	23.3	23.1	22.5		22.2	19.1	
Primary deficit that stabilizes the debt-to-GDP ratio	-0.3	0.6	6.5			1.4	3.6	1.9	1.0	0.7	1.1		2.1	2.4	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	5.8	4.4	4.7	4.6	1.8	5.8	6.1	6.3	6.6	5.8	6.1	6.1	6.0	6.1	6.0
Average nominal interest rate on forex debt (in percent)	1.0	1.2	1.3	1.6	0.7	1.5	1.8	2.0	2.1	2.1	2.2	1.9	2.4	2.3	2.3
Average real interest rate on domestic debt (in percent)	8.7	-2.6	1.1	1.6	3.3	2.0	3.0	3.7	4.1	3.8	3.3	3.3	3.0	4.3	3.6
Real exchange rate depreciation (in percent, + indicates depreciation)	6.0	-5.3	-6.3	-3.9	7.4	-4.5	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	1.9	13.7	9.7	7.9	3.7	8.2	6.0	5.0	4.8	4.9	5.1	5.7	5.0	5.0	5.0
Growth of real primary spending (deflated by GDP deflator, in percent	0.1	0.0	0.1	0.1	0.1	0.1	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Grant element of new external borrowing (in percent)	...	...	...	...	...	6.8	0.1	15.3	15.2	14.9	14.8	11.2	13.5	9.9	...

Sources: Country authorities; and staff estimates and projections.

1/ [Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.]

2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

3/ Revenues excluding grants.

4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.

5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table 2b.Kenya: Sensitivity Analysis for Key Indicators of Public Debt 2013-2033

	Projections							
	2013	2014	2015	2016	2017	2018	2023	2033
PV of Debt-to-GDP Ratio								
Baseline	40	39	38	38	39	39	36	19
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	40	39	39	40	41	42	42	24
A2. Primary balance is unchanged from 2013	40	40	40	41	43	44	45	32
A3. Permanently lower GDP growth 1/	40	39	39	40	42	42	45	38
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2014-2015	40	41	44	46	48	50	54	43
B2. Primary balance is at historical average minus one standard deviations in 2014-2015	40	40	41	42	42	42	40	23
B3. Combination of B1-B2 using one half standard deviation shocks	40	40	41	43	45	46	49	37
B4. One-time 30 percent real depreciation in 2014	40	47	46	46	46	46	43	26
B5. 10 percent of GDP increase in other debt-creating flows in 2014	40	49	48	48	49	48	45	25
PV of Debt-to-Revenue Ratio 2/								
Baseline	156	151	148	150	152	152	144	75
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	156	153	152	157	161	164	167	95
A2. Primary balance is unchanged from 2013	156	155	155	161	168	172	180	129
A3. Permanently lower GDP growth 1/	156	154	153	159	164	167	177	151
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2014-2015	156	161	170	180	189	195	213	171
B2. Primary balance is at historical average minus one standard deviations in 2014-2015	156	157	161	164	166	167	161	92
B3. Combination of B1-B2 using one half standard deviation shocks	156	157	161	169	176	182	195	147
B4. One-time 30 percent real depreciation in 2014	156	185	180	181	182	182	172	102
B5. 10 percent of GDP increase in other debt-creating flows in 2014	156	191	187	189	191	191	178	101
Debt Service-to-Revenue Ratio 2/								
Baseline	26	28	22	22	22	22	22	19
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	26	28	23	23	23	23	24	23
A2. Primary balance is unchanged from 2013	26	28	22	23	23	23	24	23
A3. Permanently lower GDP growth 1/	26	28	22	23	23	23	24	25
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2014-2015	26	28	24	25	25	25	28	27
B2. Primary balance is at historical average minus one standard deviations in 2014-2015	26	28	23	23	23	23	22	19
B3. Combination of B1-B2 using one half standard deviation shocks	26	28	23	24	24	24	26	25
B4. One-time 30 percent real depreciation in 2014	26	30	24	25	25	25	25	22
B5. 10 percent of GDP increase in other debt-creating flows in 2014	26	28	24	27	27	26	24	20

Sources: Country authorities; and staff estimates and projections.
1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of the length of the projection period.
2/ Revenues are defined inclusive of grants.

INTERNATIONAL MONETARY FUND EXTERNAL RELATIONS DEPARTMENT

Press Release No. 13/125
FOR IMMEDIATE RELEASE
April 16, 2013

IMF Executive Board Completes Fifth Review Under the ECF Arrangement for Kenya and Approves US$108.5 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) has completed the fifth review under a three-year arrangement under the Extended Credit Facility (ECF) for Kenya.[1] The completion of the review enables the disbursement of an amount equivalent to SDR 71.921 million (about US$108.5 million), which will bring total disbursements under the arrangement to SDR 416.6 million (about US$628.2 million). The Executive Board's decision was taken on a lapse of time basis.[2] In completing the review, the Executive Board also granted a waiver for the nonobservance of the continuous performance criterion on new central government and central government guaranteed external payment arrears.

Kenya has stayed the course in its economic reforms, with good results. Inflationary pressures have been tamed. Economic growth has kept a good pace despite the slowdown of exports to and tourism from Europe. International reserves are on the rise and the deficit of the external current account has shrunk significantly—excluding capital-goods imports that have surged because of oil exploration. The public debt-to-gross domestic product ratio has declined, despite the large budgetary costs of implementing the new constitution, preparing for the March elections, and the recent wage increases in the civil service.

Performance under Kenya's economic program was favorable through end-December 2012. The fiscal outcome was in line with the program, international reserves exceeded the target, while

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

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

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monetary policy was eased appropriately. The authorities have also made good progress with their structural reform efforts in the areas of public financial management and tax reform. Financial sector reforms and the reform of the pay for civil servants have also recently advanced.

Stronger growth is expected in 2013 supported by good weather conditions. With firmer expectations of low inflation, there is scope for further monetary easing, although the Central Bank of Kenya will need to remain vigilant to the risks of possible adverse shocks or a reversal of capital flows. Fiscal consolidation should continue by lowering non-priority expenditures and boosting revenue mobilization through improvements in tax administration, the introduction of a new value-added tax law and a financial transaction tax. Financial soundness indicators have remained favorable. Nevertheless, policies should focus on closely monitoring the health of the banking system and adapting banking supervision to growing regionalization, while the government seeks to complete the demutualization of the Nairobi Stock Exchange.

Looking forward, the risks from global financial and economic conditions have lessened. In addition, the prospects for commercially-viable oil discoveries could further improve the medium- to long-term outlook, which will require policies to promote diversified and balanced growth to avoid excessive reliance on natural resources.

The three-year SDR 325.68 million (then about US$508.7 million) ECF arrangement with Kenya was approved by the IMF's Executive Board on January 31, 2011 (see Press Release No. 11/21). The Executive Board subsequently approved augmentation of financing under the ECF arrangement to SDR 488.52 million (then about US$760.6 million) on December 9, 2011 (see Press Release No. 11/457).