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KENYA

October 2014

2014 ARTICLE IV CONSULTATION—STAFF REPORT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR KENYA

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2014 Article IV consultation with Kenya, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on September 22, 2014, following discussions that ended on July 9, 2014, 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 September 8, 2014.
- An **Informational Annex** prepared by the IMF.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and the World Bank.
- An **External Stability Assessment** of September 8, 2014.
- A **Press Release** summarizing the views of the Executive Board as expressed during its September 22, 2014 consideration of the staff report that concluded the Article IV consultation with Kenya.
- A **Statement by the Executive Director** for Kenya.

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

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KENYA

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION

September 8, 2014

KEY ISSUES

Context: Kenya has embarked on major reforms in line with the 2010 constitution. The new government has started the process of devolution at a fast pace, introducing a reporting framework that allows for monitoring progress and challenges. Macroeconomic stability in a market-friendly environment continues attracting the interest of foreign investors. Kenya placed its first US$2 billion Eurobond at favorable terms, with proceeds to be used to upgrade power generation and transportation. Promising commercial prospects of oil discoveries have the potential of providing significant foreign exchange and fiscal resources. Kenya is actively participating in the integration of East Africa, showing progress in reducing delays from the port of Mombasa to Kampala and Kigali. Kenyan banks export their successful business models through East Africa and other countries in the region, while complying with upgraded prudential regulations. The Central Bank of Kenya (CBK) maintains proactive financial inclusion policies that have been effective in facilitating access to credit by small and medium enterprises. Thanks to legal reforms, the Financial Action Task Force has removed Kenya from its watch list. Recent terrorist attacks and threats have raised security concerns, especially in coastal areas bordering Somalia.

Outlook and policies: Growth is projected to accelerate to 5.8 percent in 2014/15 on the back of higher public and private investment and measures to improve the business environment. The 2014/15 budget aims at rebalancing recurrent and development spending. Medium-term fiscal policies intend to bring down the debt burden consistent with the East African Community Monetary Union (EAMU) Protocol convergence criteria. Inflation remains broadly in check, but rising food prices and rapid credit growth require careful monitoring by the CBK.

Focus: Discussions centered on the implementation of devolution, in particular on the enforcement of accountability provisions. Some checks and balances are proving effective, such as the required Treasury approval of guarantees for county borrowing. However, a more systematic framework is needed. Staff and the authorities agreed that the scale of transfers to counties magnified government's cash management problems that need to be addressed with the help of the recently introduced Treasury Single Account (TSA). This would also contribute to more effective monetary operations. Discussions also focused on the design of the legal framework for natural resource management aimed at ensuring consistency with public finance management provisions.

Approved By
Roger Nord (AFR) and Chris Lane (SPR)

A staff team comprising Messrs. Mecagni (head), Alper, Morales, (all AFR), Aljabrin (MCM), Moore (SPR), Abdallah and Ms. Fisher (FAD) visited Nairobi during June 25-July 9, 2014. Mr. Gudmundsson (Resident Representative) participated in the discussions, and Ms. Rose Ngugi from the Executive Director's office joined the mission. The mission met with President Kenyatta, the Treasury Cabinet Secretary Rotich, Central Bank Governor Ndung'u, other senior officials, representatives of the private sector including financial institutions, and the donor community.

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BACKGROUND

1. **Kenya is poised to reap the rewards of extensive institutional reforms and prudent macroeconomic policy in a market-friendly environment.** A surge in public investment in infrastructure; renewed interest of foreign investors in domestic and regional opportunities using Nairobi as a hub; and lower transaction costs helped by improvements in information technology, are expected to lift economic activity. Convergence of interbank rates toward the central bank policy rate, and stability of the market-determined exchange rate reflect a positive impact of macroeconomic policies on credibility and expectations.

2. **The successful debut Eurobond issuance suggests a promising outlook for Kenya to further integrate to global financial markets and reach over time emerging market status.** Long-term financing opportunities to the private sector are opening up in the form of project financing and private equity investment, including for small and medium enterprises (SMEs). Kenya is already taking steps to adapt its policies to rising middle-income-country type challenges.

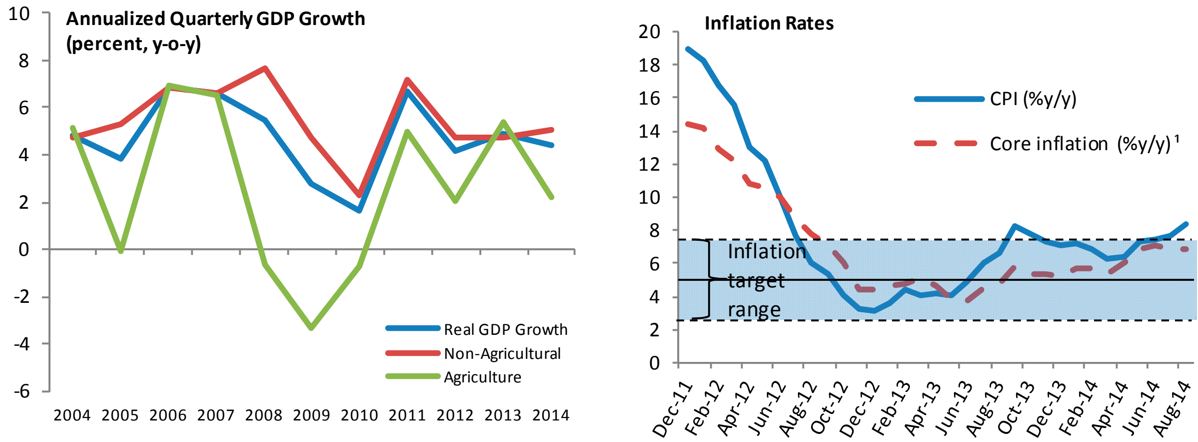
3. **Kenya's external buffers and the fiscal plans outlined in the Budget Policy Statement are consistent with meeting the EAMU convergence criteria by 2021.** Kenya's foreign reserves, which have continued to increase despite the large current account deficit, appear broadly adequate. In the immediate horizon, fiscal space should be used to improve security conditions, still complicated by terrorist threats. In addition, devolution needs to be managed carefully to overcome transitional problems. In the medium term, decisive action in containing the wage bill and widening the tax base would further increase the room for much needed priority social and infrastructure spending.

GROWTH PICKING UP, WITH VULNERABILITIES

4. **Non-agriculture growth has remained robust, but agriculture has stayed subdued because of poor rains.** Manufacturing, transport, and communications supported non-agriculture growth of 5.1 percent in January-March 2014, compared with 2.0 percent for agriculture in the same period (Figure 1)**.** However, security concerns following terrorist attacks and threats have hit tourism. Weather-related food price hikes and higher electricity rates pushed headline inflation above the upper bound of the inflation target range in recent months (7.7 percent in July; 8.4 percent in August 2014). However, current inflation rates still reflects the one-off impact of higher VAT rates introduced in September 2013.

5. **Monetary policy has remained focused on the inflation target (5 ± 2.5 percent).** The central bank has kept the policy rate (CBR) unchanged at 8.5 percent since May 2013 consistent with broadly stable inflation expectations. However, the potential impact of the recent spike in food and energy prices and rapid credit growth on inflation expectations remains a concern. Money market interest rates have remained close to the CBR despite the impact on interest rate volatility of the government's cash management problems.

Figure 1. GDP Growth and Inflation

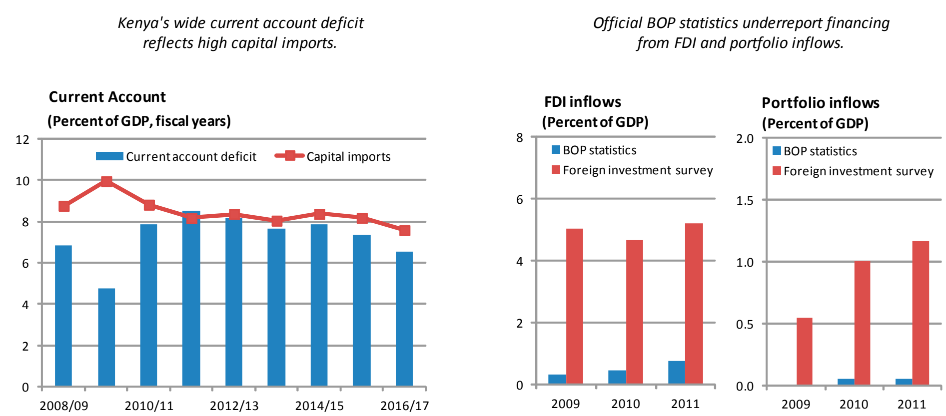


[1] Excludes food and fuels.

Source: Kenyan authorities and staff projections.

6. **The relatively high external current account deficit (7.7 percent in 2013/14) reflects strong capital-goods imports and a decline in agricultural exports (Figure 2).** Sizable imports of equipment for oil exploration, largely self-financed, respond to an improved outlook for commercial exploitation of hydrocarbons, with a mute impact on the exchange rate. Service exports to the rest of the East African Community (EAC) region, in particular transportation services, have continued accelerating.

Figure 2. External Current Account and FDI

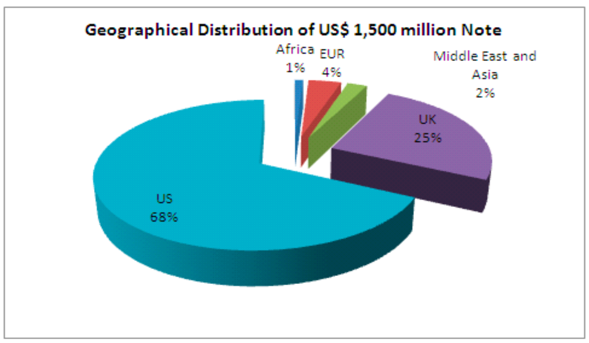


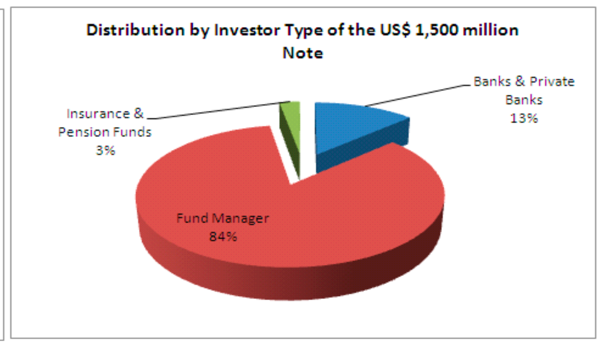
Source: Kenyan authorities and staff projections

7. **Kenya successfully tapped international capital markets with a debut US$2.0 billion Eurobond.** Investors' confidence translated into favorable terms (see Box 1). Of the proceeds, US$600 million were used to repay a syndicated loan contracted in 2012 and the remaining will substitute for domestic financing of energy and infrastructure projects. In addition, the government signed a loan with China in May 2014 for the construction of the Mombasa-Nairobi standard gauge railway (US$3.6bn), expected to start in October 2014 and to be implemented in around 5 years.[1]

Box 1. Kenya's Debut Eurobond Sale

Kenya successfully issued its debut sovereign bond at the end of June. The US$2.0bn issuance was more than four times oversubscribed, with a strong response by foreign investors reflecting Kenya's good debt management practices.[1] Demand from US investors was dominant with a share of 68 percent of total placement, followed by British investors with 25 percent (see charts below for more details). To spread out rollover risk, the Eurobond was issued in two tranches: a five-year $500 million bond at a yield of 5.875 percent, and a 10-year $1.5 billion bond at 6.875 percent.





Sources: Kenyan Authorities and staff projections

[1] The contract comprises two loans: a 15-year US$2 billion loan from Eximbank China at Libor plus 3.6 percent, and a 20-year US$1.6 billion loan from the Chinese government at 2 percent. The government will repay these obligations with resources from Kenya Railways dividends and proceeds from the 1.5 percent railway levy on imports already in place.

Box 1. Kenya's Debut Eurobond Sale (concluded)

The favorable terms of Kenya's first-ever Eurobond, the largest so far in Sub-Saharan Africa, reflects the unique position of Kenya relative to other frontier markets: (a) Nairobi is a recognized hub in an expanding EAC regional market; (b) the issuance was justified on the basis of new infrastructure projects in energy, transport, and agriculture that aim at supporting growth in the medium term; (c) sound policies, a strong tax base and an active market for government securities reflect a fiscal policy framework largely independent of grants; (d) a conscientious preparation included making difficult decisions such as adapting legislation and assuming minor liabilities previously in litigation. Following issuance, the bond yield in the secondary market has declined below comparable securities such as Zambia's and Ghana's (see chart below).

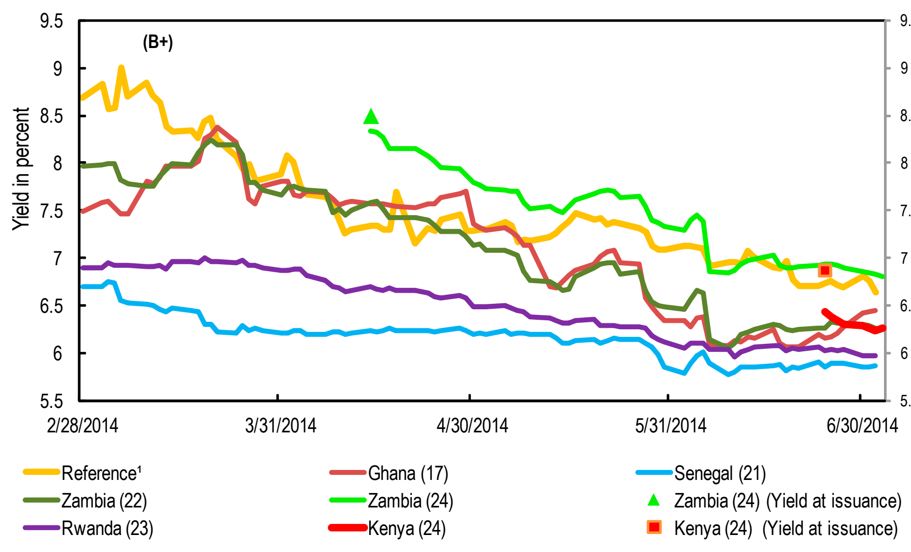
Recent Sovereign Bond Issues by comparators in Sub Saharan Africa

	Date	Year	Yield at issue	Tenor	Spread (in bps.)	Size ($ mn.)	S&P (rating at issue)	Currency	Governing laws	Bond type[1]	Coupon type[2]
Nigeria	1/21/2011	2011	7.126	10	369	500	B+	USD	England	Bullet	Fixed
Senegal	5/6/2011	2011	9.125	10	594	500	B+	USD	Luxembourg	Bullet	Fixed
Namibia	10/27/2011	2011	5.835	10	342	500	Not rated	USD	England	Bullet	Fixed
Zambia	9/13/2012	2012	5.625	10	388	750	B+	USD	England	Bullet	Fixed
Tanzania	2/27/2013	2013		7	600	600	Not rated	USD	England	Sinkable	Floating
Rwanda	4/16/2013	2013	6.746	10	500	400	B	USD	England	Bullet	Fixed
Gabon	12/4/2013	2014	6.375	11	354	1500	BB-	USD	England	Sinkable	Fixed
Zambia	4/7/2014	2014	8.500	10	574	1000	B+	USD	England	Bullet	Fixed
Kenya	**6/24/2014**	**2014**	**6.875**	**10**	**429**	**1500**	**B+**	**USD**	**England**	**Bullet**	**Fixed**
Kenya	**6/24/2014**	**2014**	**5.875**	**5**	**418**	**500**	**B+**	**USD**	**England**	**Bullet**	**Fixed**

Sources: Dealogic; Bloomberg and Kenyan authorities.

[1] Sinkable = Bond backed by a fund, which sets aside money on a regular basis to ensure investors are paid principal and interest. Bullet = Entire face value of bond is paid at maturity.

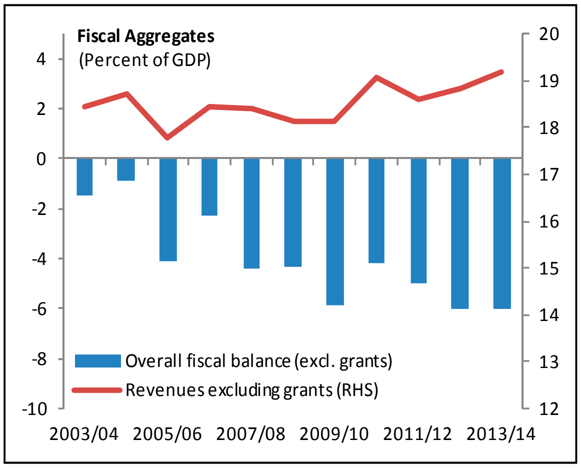
[2] Fixed = Fixed percentage of face value payed in interest. Floating = Variable percentage, often calculated as fixed spread above LIBOR.



Sources: Bloomberg; and IMF staff calculations.
[1] Reference is the average yield of the following B+ rating countries: Vietnam, Venezuela, and Egypt with identical maturity.

[1]According to the Eurobond prospectus, "The Agency Agreements, the Deeds of Covenant and the Notes (including any non-contractual obligations arising from or in connection with any of them) are governed by, and will be construed in accordance with, English law."

8. **The fiscal deficit in 2013/14 remained unchanged from the previous year.** This reflects higher revenue offset by sizeable transfers to counties and a larger-than-envisaged wage bill. On the other hand, capacity constraints faced by counties during the first year of devolution resulted in low execution rates of their development budget. Consequently, the general government fiscal balance is more favorable than that of the central government in 2013/14.[2]



Sources: Kenyan authorities and IMF staff

9. **Devolution was rolled out during FY2013/14 at a fast-track pace (Box 2; Annex I).** The government established the new counties in line with the 2010 Constitution, and introduced a reporting framework on budget execution by counties through detailed quarterly reports published by the Office of the Controller of the Budget. However, this fast-track approach has introduced strains in government's cash management, inducing interest rate volatility. Moreover, it complicated teething problems (common to devolution episodes), and the enforcement of the public financial management (PFM) framework. Other challenges have also emerged and —if left unaddressed— could negatively affect fiscal sustainability in the medium term, including wage and payroll issues, debt inherited from previous local authorities, and unfavorable spending composition. The authorities recognize these challenges, and agree with staff's concerns. In particular, they are of the view that revamping the cash management framework and staffing the Intergovernmental Fiscal Relations Department (which would support capacity building at the county level), are crucial steps to mitigate the risks involved.

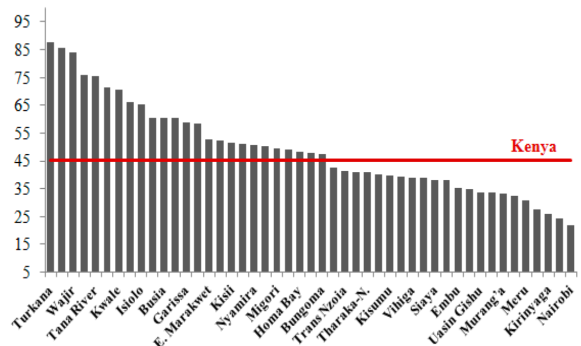
[2] Staff estimates of the general government fiscal balance are based on county fiscal outturns for the first three quarters.

Box 2. Devolution And Poverty in Kenya

The ongoing roll out of devolution in line with the 2010 constitution provides an important vehicle to reduce poverty across the counties while fostering improvements in the delivery of key services. The redistributive impact of fiscal policies at the local level will hinge on fiscal policies that will be put in place by the 47 newly formed counties and on the efficiency and accountability in the use of devolved resources.

While the share of Kenya's population living in poverty decreased in recent years, considerable differences among counties remain. Kenya's 2014 Economic Survey shows a decline in poverty rate from 46.6 percent in 2005/06 to 45.2 percent in 2009, with a larger decline in urban areas.[1] The urban poverty ratio in 2009 is estimated to be 33.5 percent (about 3.9 million individuals), while rural poverty ratio is 50.5 percent, with about 13.1 million individuals living below the poverty line.

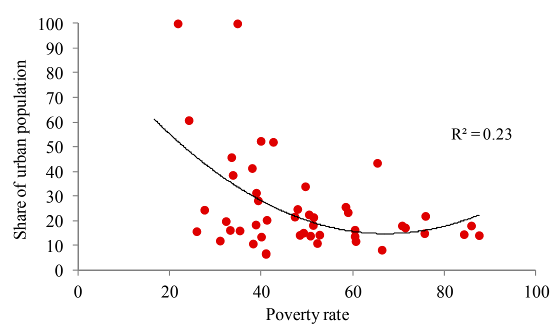
Poverty rates in Kenya, 2009



Sources: Kenyan authorities and IMF staff projections.

In line with the 2010 Constitution, central government transfers to counties have increased significantly as part of the devolution process. The new revenue sharing arrangement (involving no less than 15 percent of national revenues) intends to increase per capita transfers to poorer counties (located in Northern, Eastern and Coastal parts of Kenya) that previously receiving less provision of public services. The process is expected to empower county governments to improve the delivery of key services, including education and health, and invest in much needed social and infrastructure spending.

County poverty and urbanization, 2009

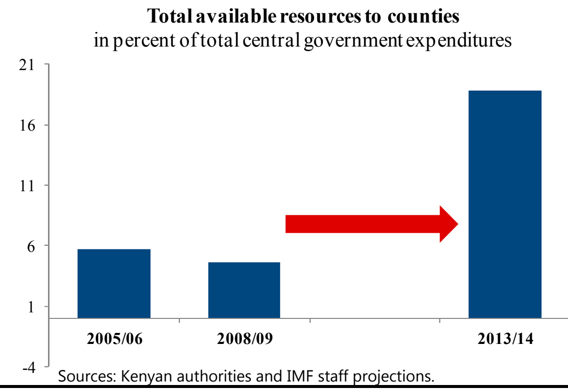


Sources: Kenyan authorities and IMF staff projections.

[1] A recent World Bank report estimates a further reduction in Kenya's poverty rate to 39 percent in 2012/13 (see World Bank's "Kenya—Country Assistance Strategy FY2014-18."

Box 2. Devolution and Poverty in Kenya (concluded)

Over time, devolution is expected to help reduce inequality across counties. Reducing poverty will depend on the efficient use of large central government transfers at the county level, with appropriate accountability for spending allocations and outcomes. Efforts to raise own revenues at the local level will further increase room for higher social and infrastructure spending.

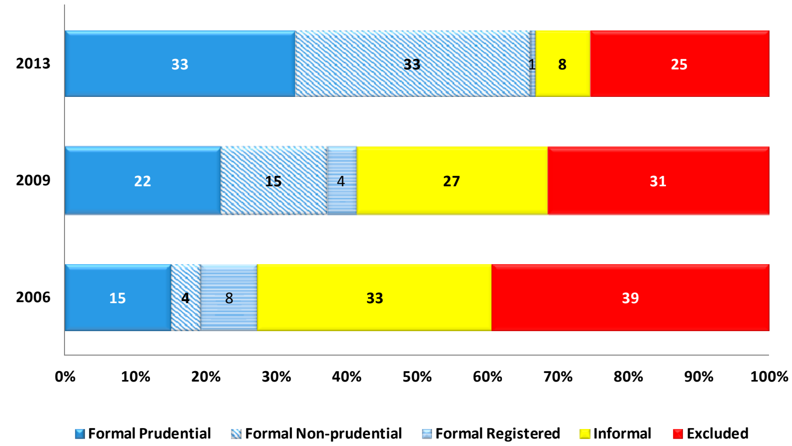


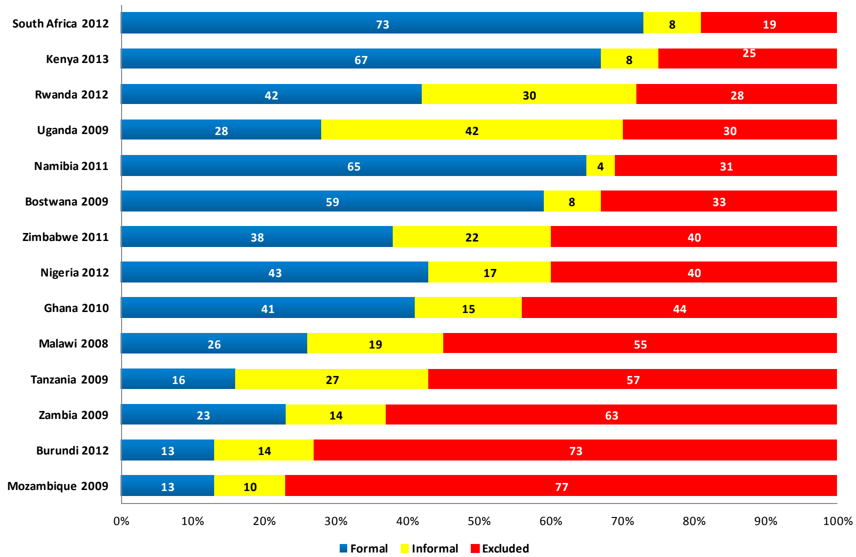
Sources: Kenyan authorities and IMF staff projections.

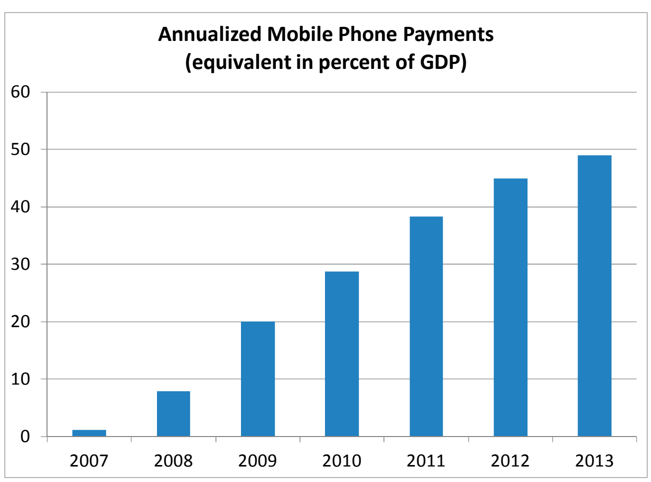
10. **Kenyan banks are expanding by raising domestic credit, providing access to new borrowers, and increasing operations beyond Kenyan borders.** Banks remain sound and profitable despite a moderate increase in the non-performing loans (NPL)-to-total loans ratio to 5.6 percent in May 2014 (from 4.6 percent a year before). A pick up in credit growth has been increasingly funded externally, mainly because of a more intensive use of medium-term mostly concessional foreign currency lines for SME project financing, and increased credit limits by international banks to their subsidiaries. Financial inclusion continues progressing (Figure 3) with mobile-banking loans and deposits driven by M-Shwari (7 million customers in its first year of operations) and higher SME access to credit (Box 3).

Figure 3. Financial Inclusion in Kenya

Kenya has a strong record on financial inclusion, helped by the rapid growth of mobile banking.





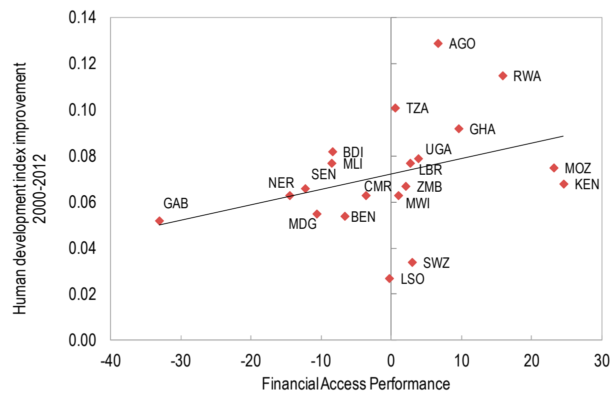


Source: Central Bank of Kenya and FinAccess.

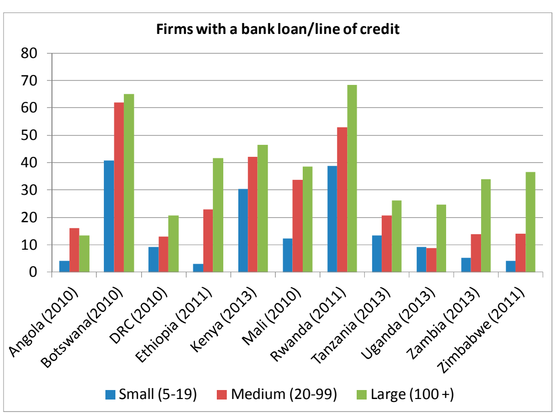
Box 3. Impact of Mobile Banking and Financial Inclusion on Welfare

M-Pesa was introduced in 2007 as a means to transfer money via mobile phones. M-Pesa users deposit money into a "cell phone account", and use SMS technology for transfers and "on demand" payments. Thanks to its use of low-cost technology, overall transaction costs have declined as bills can be paid remotely. Even more importantly, the poor have benefitted the most: M-Pesa reaches 84 percent of population earning less than US$2 a day. Financial access has increased substantially thanks to M-Pesa: The number of micro accounts in formal financial institutions (deposit accounts below US$1,200) has increased more than 10 times over the past 10 years.

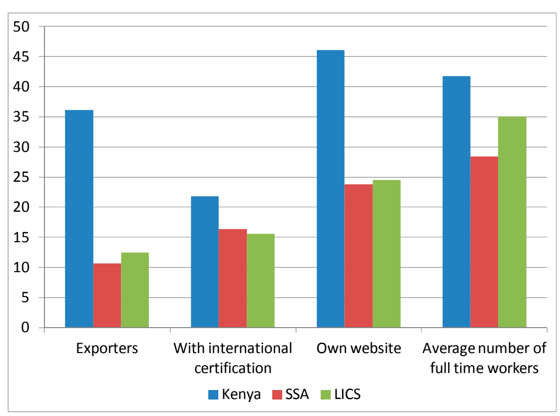
Lower transaction costs, higher financial access, and continuous innovation, with many products using the mobile payment platform already in place, have an impact on welfare: M-Shwari, a deposit-lending facility tailored to the poor, has 7 million active customers in over a year of operations. Kenyan farmers benefit from schemes to acquire equipment, like water pumps, with repayments being made through M-Pesa; M-Kopa allows the use of solar panels in areas not served by the power grid, with repayments in small installments; small scale health care management systems are able to track procedures, lab tests, drug inventories, via mobile phone devices. The IMF April 2014 SSA Regional Economic Outlook finds a strong relationship between financial access and improvement in Human Development Indicators (see right-hand chart). Kenya also stands out among the best performers in SSA in access to credit by SMEs together with Botswana and Rwanda, according to the World Bank Enterprise Surveys (see bottom left chart). Access to credit by SMEs increased to 36 percent in 2013 from 25 percent six years before. The Surveys also show that Kenyan SMEs are more competitive, innovative and more labor intensive than average SSA countries and LICs (see bottom right chart).



Sources: Kenyan authorities and IMF staff projections.



Sources: Kenyan authorities and IMF staff projections



Sources: Kenyan authorities and IMF staff projections

FAVORABLE OUTLOOK, BUT WITH RISKS

11. **The outlook is favorable.** Rising domestic and foreign investment are expected to boost economic activity in the short term. The government has embarked on large-scale projects with large impact on domestic value added, including the construction of the Mombasa-Nairobi railway, geothermal plants, irrigation projects, and new oil pipelines. A pickup in private investment explains high credit growth, especially to manufacturing and SMEs. GDP growth is projected to reach 5.8 percent in FY2014/15 from 5.0 percent in the previous year. Over the medium term, public and private investments are expected to rise further providing an additional boost to economic growth. Drivers of growth underlying baseline projections include: (a) improved business conditions owing to the removal of bottlenecks by rising infrastructure investment in energy and transportation; (b) the expansion of the EAC market thanks to decisive steps towards regional integration; (c) reduced social strife as a result of devolution; (d) a more dynamic SME sector thanks to financial inclusion; (e) higher agricultural productivity and reduced medium-term vulnerability of agricultural production to weather shocks reflecting the implementation of large size irrigation projects. A boost in investor confidence following the successful Eurobond issuance could further improve the outlook. An acceleration of regional integration beyond baseline assumptions, marked improvements in security conditions, and possible new discoveries raising oil, gas and mining potential, could have a large impact on investors' sentiment.

12. **Nevertheless, the Kenyan economy remains vulnerable to risks affecting the external and fiscal positions (see Risk Assessment Matrix).** Near-term risks include the potential further deterioration of security conditions, new weather-related shocks following poor rains, and/or additional difficulties in implementing devolution that could complicate PFM. Vulnerability to weather-related shocks would remain high if infrastructure investments in geothermal energy and irrigation do not progress as planned. Rising private medium-term foreign currency liabilities could also increase corporate sector vulnerability to sharp movements in the exchange rate. Protracted slow growth in advanced and emerging economies may also constrain remittances and foreign demand for Kenyan exports. On the other hand, vulnerability to capital flow reversals appears limited; excluding the Eurobond, portfolio inflows have been mostly equity-based.

Kenya: Risk Assessment Matrix, September 2014 [1]

Potential Deviations from Baseline

Risk	Relative Likelihood	Potential Impact	Recommended Policy Response
Domestic and regional			
Return of drought conditions • **The frequency of droughts has increased in Kenya in recent times**, increasing the risk of weather-related shocks.	**Medium**	**High** Past shock triggered 2009 disbursement under the Rapid-Access Component of the Exogenous Shocks Facility	• Maintain exchange rate flexibility. • Use external buffer. • Guard against second-round effects on inflation. • Use targeted cash transfers to vulnerable groups and reprioritize spending. • Continue infrastructure spending (irrigation and geothermal).
Deterioration in security situation • **Terrorist activity could escalate,** especially in the area bordering Somalia.	**Medium**	**High** Hits to tourism/exports, FDI; risk of reversal of portfolio inflows	• Reprioritize fiscal spending to accommodate security needs.
Implementation risk from devolution • **Delays in addressing transitional problems** because of political considerations could complicate public finance management further.	**Medium**	**Medium** Transitional devolution risks and potential medium-term challenges	• Maintain fiscal discipline. • Adhere to PFM Act provisions.
Global			
Side-effects from global financial conditions: • **Surges in global financial market volatility**, triggered by geopolitical tensions or revised market expectations on UMP exit/emerging market fundamentals. • **Distortions from protracted period of low interest rates continue to build:** excess leverage, especially for corporates; delays in fiscal and structural reforms	**High** **Medium**	**Medium** **Medium**	• Maintain exchange rate flexibility. • Strengthen financial sector supervision.
Protracted period of slower growth in advanced and emerging economies: • **Advanced economies:** Lower-than-anticipated potential growth and persistently low inflation due to a failure to fully address legacies of the financial crisis, leading to secular stagnation. • **Emerging markets:** Maturing of the cycle, misallocation of investment, and incomplete structural reforms leading to prolonged slower growth.	**High** **High**	**Medium** **Low**	• Accelerate reforms to address structural weaknesses affecting competitiveness.
Growth slowdown in China: • **Continued buildup and eventual unwinding of excess capacity,** eventually resulting in a sharp growth slowdown and large financial and fiscal losses (medium-term)	**Medium**	**Low**	• Improve business environment to diversify sources of FDI.
Regional geopolitical risks (financial flows, commodity prices, and supply chains) • **Heightened geopolitical risks in the Middle East,** leading to a sharp rise in oil prices, with negative spillovers to the global economy.	**High**	**High** Kenya is currently a net fuel importer, though recent discoveries suggest potential for future energy exports	• Maintain exchange rate flexibility. • Use external buffer. • Guard against second-round effects on inflation.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

FOSTERING ECONOMIC TRANSFORMATION BY ADDRESSING VULNERABILITIES

13. **Policy discussions focused on the government's strategy for "Economic Transformation for Shared Prosperity" in its Medium-Term Budget Policy Statement for 2014-17.** The government's plan contains measures to entrench devolution, improve the business environment, and raise investment in key sectors. In order to make this plan sustainable, the authorities intend to curb fiscal deficits in line with their medium-term debt strategy, complete the devolution process addressing transition challenges promptly, consolidate macroeconomic stability by further modernizing their monetary policy framework, and take steps to continue upgrading capital markets.

A. Fiscal Policy: Making Devolution Work

The central objective of fiscal policy is to maintain gross public debt below Kenya's strategic ceiling (40 percent of GDP in present value (PV) terms), consistent with the EAMU convergence criterion (50 percent of GDP in PV terms). After the initial boost in project spending in FY2014/15, the pace of deficit reduction is consistent with meeting the EAMU convergence criteria by 2021 (ceiling on fiscal deficit including grants of 3 percent of GDP). In the near term, fiscal policy focuses on rebalancing current and development expenditure and increasing fiscal space for social programs, while facing challenges emerging from the ongoing devolution.

14. **The government's FY2014/15 budget aims at containing recurrent expenditure and at allocating additional resources to development spending, social programs and security upgrades.** The authorities are of the view, shared by staff, that fiscal discipline will provide an orderly framework for a successful and sustainable devolution. In the medium term, fiscal consolidation would help contain external imbalances, while bringing down the net present value of public debt closer to the government's medium-term target. Debt is expected to rise in percent of GDP in the near term mainly because of the Eurobond placement and the large loan from China to finance the Standard Gauge Railway. However, debt remains sustainable and resilient to standard shocks (See Debt Sustainability Analysis Annex). The government plans to set up a sinking fund to build up resources for the eventual repayment of the Eurobond.

15. **The 2014/15 budget incorporates important revenue measures.** These measures include (a) a revision of the Excise and Income Tax Acts (with LEG technical assistance), (b) higher duties on iron and steel products, (c) improved tax administration, especially in the case of VAT (by implementing LEG and FAD recommendations), and (d) amendments to the Income Tax Act to address tax avoidance by multinationals. Expected higher revenue will also reflect the full-year effects of VAT reforms introduced in September 2013, as well as the impact of adopted measures to

incorporate landlords into the tax base.[3] The authorities expect the measures to yield about 1.3 percent of GDP in 2014/15. Staff supports these efforts to widen the tax base and considers the expected yields reasonable.

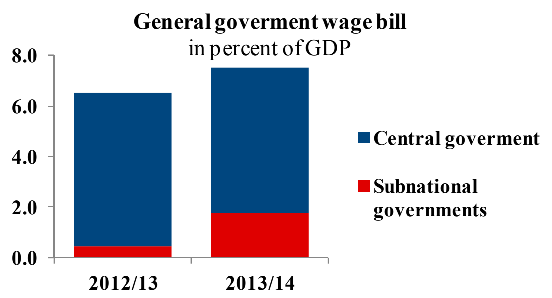
16. **A hiring freeze for this fiscal year and the start of a rationalization process aim at containing the wage bill.** The general government wage bill has been rising in recent years, on account of higher-than-projected wage spending by counties and increases in the central government wage bill.[4] Staff noted that the rising wage bill is crowding out priority infrastructure spending (See Figure 4). The authorities agreed and emphasized that the planned payroll audits would help identify potential sources of savings, and that streamlining allowances would reduce the observed disparities in gross pay between the private and public sector. The authorities also noted that, based on the findings of the Salaries and Remuneration Commission, the government had launched a process of staff rationalization that will also encompass county governments, to be based on a wage grid that allows comparability with private sector wages. These reforms will be implemented gradually over time, but with a clear timetable of implementation, and in the context of a social dialogue to ensure that they are not reversed.

[3] Some specific tax reduction measures with a rather limited impact on revenue were also introduced, such as exempting imports of inputs for the processing and preservation of seeds, and for the generation of wind and solar energy.

[4] The 2013/14 initial Budget envisaged a lower central government wage bill on account of cost savings related to the staff that were devolved to counties. However, this was more than offset by salary increases and additional recruitment at the central government level in the course of the year.

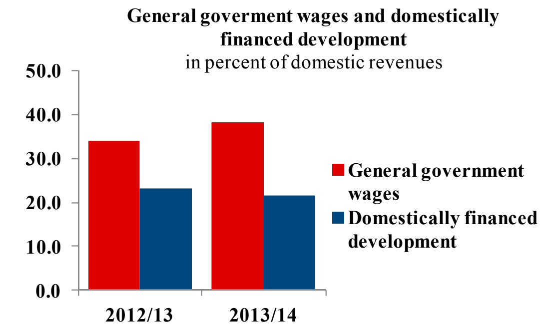
Figure 4. The General Government Wage Bill in Kenya

General government wages are rising in Kenya…



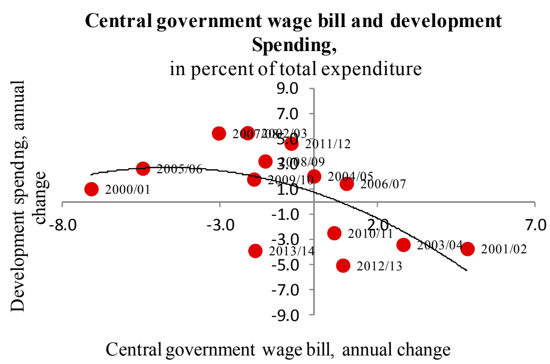
Sources: Kenyan authorities and IMF staff

…and are limiting the fiscal space for priority infrastructure spending…



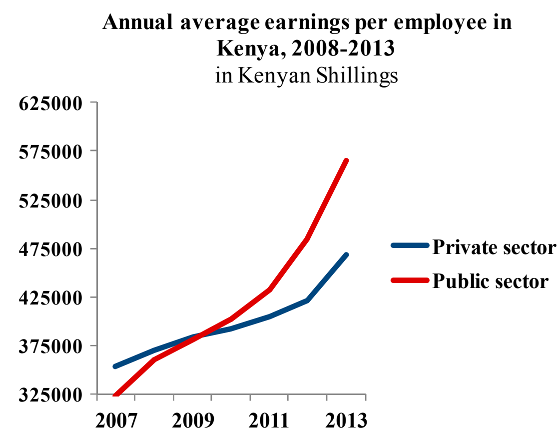
Sources: Kenyan authorities and IMF staff

…leading to a crowding out over time.



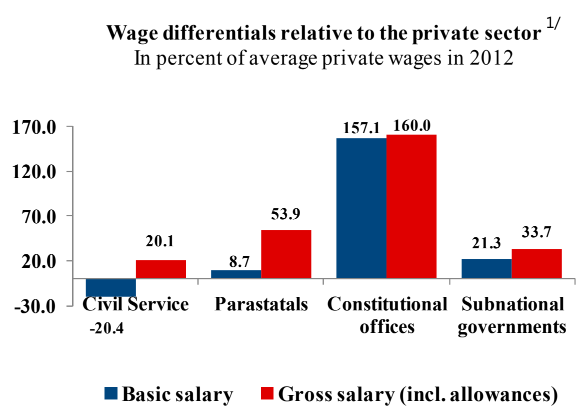
Sources: Kenyan authorities and IMF staff estimates.

Wages are higher in the public sector and the wage gap has been widening in recent years…



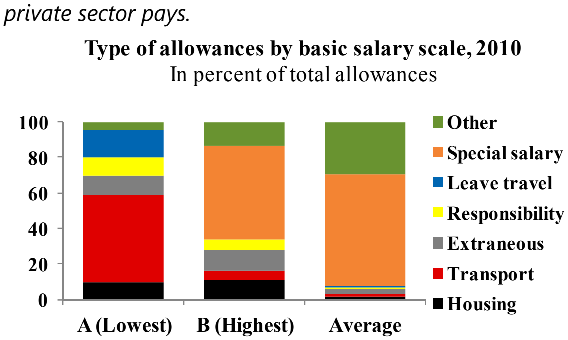
Sources: Kenyan authorities and IMF staff estimates.

…and this is mainly due to allowances, even after accounting for socio-economic characteristics of workers.



1/ Excludes informal sector wages.
Source: Salaries and Remunerations Commission report (2013) and KIPPRA (2013)

Streamlining allowances and tightening eligibility are key priorities to gradually reduce the gap between public and private sector pays.



Source: Salaries and Remunerations Commission (SRC)

17. **The authorities consider poverty reduction a key priority**. Despite Kenya's generally better social indicators relative to Sub-Saharan Africa's averages (see Text Table), and notwithstanding the progress made in recent years towards reducing poverty, significant challenges remain. To this end, the 2014/15 budget accomodates additional resources for social programs that support inclusive growth. Specifically, the budget allocation for social programs was increased by about 11 percent in real terms, to finance well-targeted cash transfer programs benefiting the elderly, the disabled, and the orphans. Given the considerable differences across counties (see Box 2), staff shares the view that devolution provides an important opportunity to help alleviate poverty and inequalty, through social and development programs at the county level.

Poverty and Social Indicators

	Kenya	Sub-Saharan Africa
Most Recent Estimate (latest year available, 2006-2012)		
Urban Population (percent of total population)	24	37
Life Expectancy at birth (years)	61	56
Infant Mortality (per 1000 live births)	49	64
Child malnutrition (percent of children under 5)	16	21
Access to an improved water source (percent of total population)	62	64
Literacy (percent of population age 15)	72	60
Gross primary enrollment (percent of school age population)	112	100
Male	113	104
Female	111	96

Source: World Bank: Kenya--Country Partnership Strategy FY2014-18.

18. **The authorities give high priority to accelerating development expenditure.** The initiation of large projects is to be complemented by improved absorption capacity, especially in geo-thermal power generation, and by a recomposition of counties' spending to increase the share of development spending. The new Public Private Partnership framework will be fully in place this fiscal year after the forthcoming introduction of regulations and the implementation of the framework to assess contigent liabilities, under preparation with support from the World Bank.

19. **The introduction of the TSA will contribute to more efficient cash and debt management**. This was significantly complicated in 2013/14 by the fast rollout of devolution and by delays in the issuance of the Eurobond relative to original plans. Staff highlighted the importance of putting in place an effective TSA ensuring a cash management system with clear accountability, closely coordinated with debt management functions. The authorities recognize the cash management challenges and are keen on addressing them.Other budget measures aiming at improving efficiency include the introduction of the procurement module of the Integrated Financial Management and Information System (IFMIS) to help reduce the risk of inflated prices in public contracts, and the creation of the Digital Government Payment Gateway to link spending with service delivery online.

20. **The government has identified emerging challenges in the devolution process.** The Controller of the Budget has recommended counties to: (a) make efforts to boost their own revenue collection; (b) put in place all budget execution systems; (c) have annual financial statements audited; (d) empower county assemblies; (e) settle payroll management problems between counties and central government, and (f) fully use IFMIS. Staff recommended, and the authorities agreed, to introduce other measures including (a) adequately staffing the Intergovernmental Fiscal Relations Department to make it fully operational; (b) enhancing accountability using the PFM framework; (c) revising the revenue allocation formula to give more weight to fiscal performance and accountability; and, (d) properly identifying and verifying county assets and liabilities that were inherited from former local authorities. Additionally, the authorities reiterated their commitment to

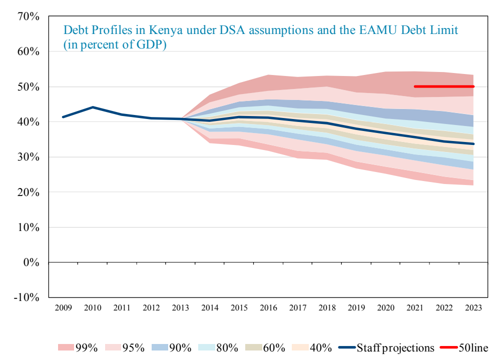
enforce the procedures for controlling borrowing by counties. These include the requirement for counties to obtain government-approved guarantees channelled through the Debt Management Department of the National Treasury and the Intergovernmental Budget and Economic Council, for which clear procedures will be established.

21. **The medium-term budget policy statement includes an assessment of specific fiscal risks.** It analyzes fiscal sensitivity to changes in macroeconomic assumptions and identifies risks and mitigating policies related to public-private partnerships, financial sector stability and, possible droughts. In this regard, staff stressed the importance of capturing institutional risks, especially related to devolution (see Box 4). The authorities agreed and noted that they also aim at addressing contingent liabilities risk emanating from government-owned entities by implementing a comprehensive reform that reduces the number of entities (from close to 300 to 187) and introduces a new structure for their operations. To this end, two institutions are to be created: the Government Investment Corporation in charge of commercial entities and the National and County Agencies Oversight Office in charge of other agencies. To avoid new fiscal risks, staff noted these institutions' financial operations should be fully incorporated into the budget.

Box 4 Monitoring and Managing Fiscal Risks in Kenya

Main fiscal risks in Kenya include the following:

Macroeconomic shocks. A prolonged decline in the baseline projections of economic growth under adverse macro-conditions based on historical data would worsen debt dynamics, but the probability that the PV of gross debt in percent of GDP over the next 10 years would exceed the 50 percent EAMU ceiling during 2021/2023 remains low (5 percent).



Sources: Kenyan authorities and IMF staff estimates

Oil and gas discoveries. The fiscal position could deteriorate if government expenditures were to increase on account of expectations for high oil and gas revenues, which do not eventually materialize. The current medium-term budget envelope does not include potential revenues from these sources.

Liabilities of sub-national governments. The nature and magnitude of existing debt of previous local authorities has yet to be verified, and is being disputed by some counties, which entails a risk for the central government. Some counties, such as Nairobi, have inherited some relatively large pending bills that−if not resolved−may pose risks to fiscal sustainability going forward. New borrowing by counties can only take place with a guarantee by the central government. The National Treasury is in the process of developing guidelines on county borrowing, and establishing a database of county financial information to assess the fiscal capacity of counties and their debt sustainability.

Public Private Partnerships (PPPs). Although the PPP Act was approved only in 2013, some PPPs were introduced before its approval, mostly in the energy sector. In addition, a list of 47 national-priority PPP projects have already been identified in various sectors including health, transport, electricity and ports. All contingent liabilities arising from existing and new PPPs need to be assessed by the Department of Debt Management of the National Treasury. An assessment framework will be established with technical assistance from the World Bank.

Box 4. Monitoring and Managing Fiscal Risks in Kenya (concluded)

Contingent liabilities. Contingent liabilities in Kenya beyond those from PPPs represent an additional fiscal risk. They include guaranteed loans to various public entities that have reached KSh43.5bn (1 percent of GDP), of which 15 percent have been called to date.

State corporations. Transfers to SOEs reached KSh354.3bn (8 percent of GDP) in 2013/14, of which 66 percent for development spending. The national government is in the process of reforming parastatals and other government-owned agencies, including by changing its organizational structure and privatizing some public enterprises. New laws should not create dual budgets during this process.

Wage bill challenges. Public wages are high and have been rising in recent years, crowding out social and infrastructure spending. Wage setting by counties could magnify this problem. The government has embarked on a comprehensive rationalization of the payroll.

22. **The government has initiated institutional and legal reforms for extractive industries.** The Extractive Industry Tax Regime and a new Mining Bill, incorporating inputs from FAD and LEG technical assistance, are already on the Parliament's agenda. Recent oil and gas discoveries have improved prospects for their commercial exploitation (see Box 5). Staff noted that some initiatives require careful design before being introduced: (a) the planned Sovereign Wealth Fund proposed by the Task Force on Parastatal Reform appears premature as long as the fiscal position is projected to remain in deficit, and its eventual introduction would require that provisions are fully consistent with transparent management rules and resources fully integrated into the budget; and (b) the terms of sharing of revenues from natural resource exploitation between the central government and counties should be decided once the volume and expected timespan for the exploitation of available resources are known. The authorities recognize the validity of these concerns. They underscored the importance of safeguarding most natural resource revenues for development purposes, while balancing the need for infrastructure and social spending at the local level to ensure equitable sharing of natural wealth.

Box 5. Managing Natural Resources Wealth

Recent discoveries have showcased Kenya's oil, gas and mining potential. Tullow, one of the main investors in oil fields in Kenya, estimates reserves to be well above the 600 millions of barrels of oil equivalent (mboe), comparable to Equatorial Guinea and the Republic of Congo. If this is confirmed, it could bring Kenya's external current account to surplus soon after exploitation starts. Morgan Stanley estimates that the country could become self-sufficient in oil production within 3-5 years.

Overall, 23 international oil companies are conducting exploration activities in all 44 blocks currently licensed. Companies have been drilling 15 exploration wells between March 2012 and June 2014, an average drilling rate of about 7 wells per year (compared to one every two years in the past). Crude oil has been found in 7 wells (Tullow Oil with Africa Oil as Joint Venture Partner), and natural gas and oil were found in onshore and offshore blocks (Apache and British Gas Group).

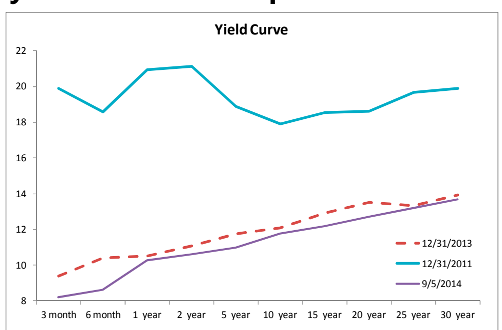
The government plans to undertake reforms of the legal and regulatory framework for natural resources exploitation to enable Kenya to manage its oil and gas resources in a prudent manner. It is in the process of redesigning the framework for oil exploration, the model for production sharing contracts, and the model for terms for natural gas contracts, with FAD and LEG technical assistance. In particular, the petroleum regulatory and fiscal regime dates from 1986 and is in need of modernization. Also, the production-sharing scheme for oil does not reflect properly costs, prices, and production volumes, and needs to be revised. New production-sharing terms for gas need to be specified. For the medium term, a full gas-specific regulatory framework is needed.

The government has also rolled out the Kenya Petroleum Technical Assistance Program (KEPTAP) with World Bank support, to build capacity across the public sector in a number of areas such as geotechnical data acquisition, and implementation of environmental, social and health and safety standards.

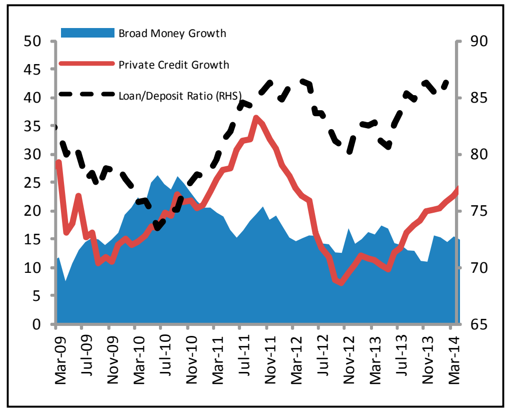
B. Enhancing Monetary Policy Effectiveness

Monetary policy has been effective in keeping inflation expectations in check, despite food and energy price shocks in recent months. Monetary operations have kept money markets liquid despite complications stemming from government's cash management problems partly related to devolution.

23. **Monetary policy has been consistent with broadly stable inflation expectations.** Recent CBK surveys and a stable yield curve suggest that inflation expectations remain contained despite recent price shocks. However, headline inflation has breached the upper band of the target range in recent months and core inflation has been trending up. In addition, credit growth has risen above 20 percent for the last few months, increasing the risk that domestic demand pressures could combine with new price shocks to fuel inflation expectations. The CBK regards the pick up in credit growth as a healthy sign of strengthening of the real economy, especially in the manufacturing sector. Even so, staff recommends that the CBK stands ready to tighten monetary policy to keep inflation expectations anchored around the mid-point of the target band.

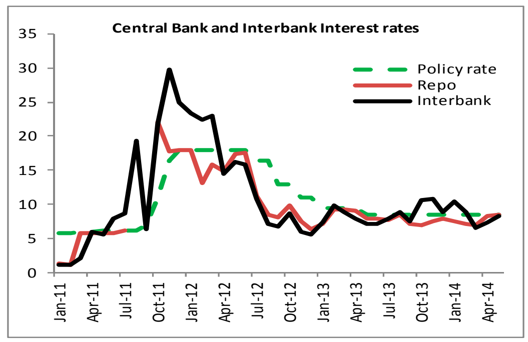


Source: Bloomberg.



Sources: Kenyan authorities and IMF staff estimates.

24. **Monetary operations have been successful in maintaining interbank rates close to the CBK policy rate despite government's cash management deficiencies.** The introduction of the TSA provides an opportunity to upgrade cash management by separating Treasury responsibilities from central bank operations, allowing the central bank to focus on managing operations consistent with its monetary policy framework.



Sources: Kenyan authorities and IMF staff estimates.

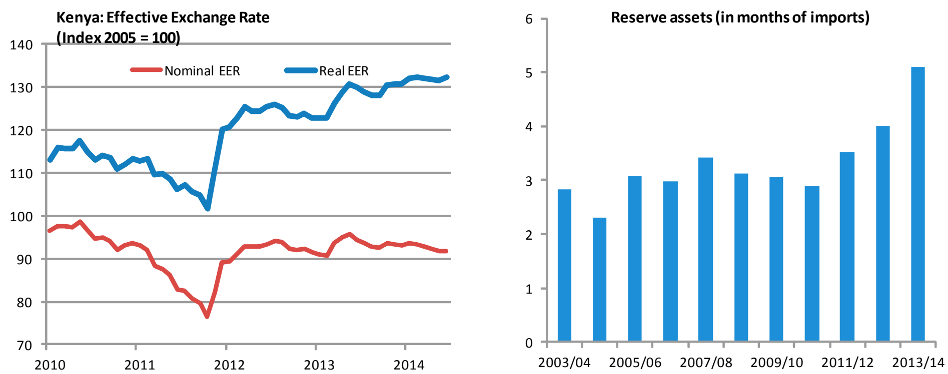
25. **The CBK continues working towards modernizing its monetary policy framework.** A draft Central Bank Act (prepared with LEG technical assistance) will be discussed in Parliament in the current fiscal year. The current draft makes achieving and maintaining domestic stability in the general level of prices the overriding objective of monetary policy, and eliminates ambiguities regarding other objectives (financial stability and supporting the economic policy of the government). The CBK's analytical framework has improved significantly as Kenya's forecasting model has evolved quickly into a practical guide for monetary policy Further improvements prior to the eventual adoption of inflation targeting would include entrenching the forecasting and policy analysis framework into the processes and structure of the CBK, including establishing a forecasting unit at the Research Department, and committing to maintain CBK financing of government operations at a minimum, including by using the existing overdraft strictly to address temporary shortfalls.

26. **Capital inflows, especially to the stock market, have continued, attracted by a stable macroeconomic environment and a promising regional outlook.** These inflows have contributed to stability in the market-determined exchange rate, with the CBK largely staying out of the foreign exchange market other than to build reserves gradually in line with its reserve cover target. The authorities estimate that these inflows are consistent with a minor real exchange rate overvaluation of about 5 percent. Standard Fund approaches show moderate, albeit a bit larger, deviations from fundamentals. However, the flexibility of the exchange rate and uncertainties surrounding the balance of payments data raise doubts about the possibility of a large departure from fundamentals (see External Stability assessment). The share of foreign investors in the stock exchange's annual US$2 billion turnover has remained slightly above 50 percent, while foreign inflows to the bond market have increased but remain modest partly because of macro-prudential regulations limiting the term for currency swaps by non-residents to one year or more.

Figure 5. Exchange Rate and International Reserves

Kenya's nominal exchange rate has been stable since end-2011; the real effective exchange rate has gradually appreciated.

The authorities have taken opportunities to build a reserve buffer, while leaving the exchange rate largely market-determined.



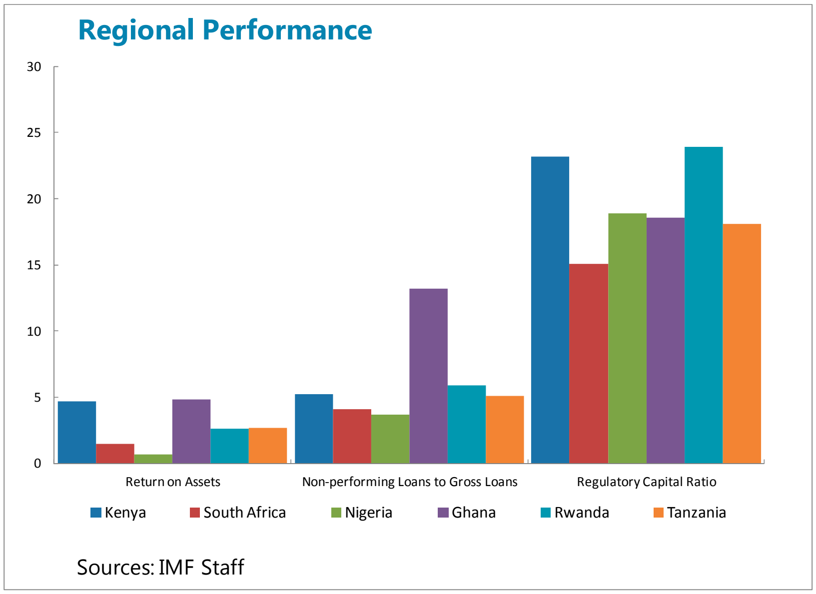
Sources: Kenyan authorities and IMF staff projections.

27. **The authorities' recent introduction of a reference rate for floating interest rate bank facilities aims at increasing transparency in credit markets**. Following the recommendation of a task force on measures to reduce the cost of borrowing, the government introduced the Kenya Bank Reference Rate (KBRR) to allow customers to better compare lending rates across banks. The KBRR is defined as the 60-day average of the CBK policy rate and the 90-day T-bill rate, and is set for 6 months unless market conditions change significantly. Staff noted, however, that its design may lead to undesirable side effects. In particular, the use of the policy rate in the computation of the KBRR would put an additional burden on monetary policy decisions as the public could perceive that lending rates are set by the CBK. Moreover, fixing the reference rate for floating rate loans for six months would paradoxically act against transparency, as banks would be required to adjust the risk premium for the same borrowers as market conditions change during the six-month period.

C. Financial Policy: Supporting Banks' and Capital Markets' Expansion

Financial policies have facilitated financial inclusion and supported the development of capital markets. Prudential supervision needs to adapt to challenges arising from this expansion, as reflected in high credit growth, the incorporation of new users of financial services, and the growing operations of Kenyan banks abroad.

28. **Kenya's impressive record on financial sector development may entail new risks in an environment of high credit growth.** Staff noted that rapid financial deepening, while welcome, may raise risks for financial stability. The authorities concurred that credit growth had accelerated sharply in lending to manufacturing, real estate, telecommunications, business services and individuals. They noted, however, that to a large extent, this acceleration on credit growth is explained by an upward shift in credit demand consistent with the initiation of new projects. On the other hand, NPLs have increased only moderately, especially in sectors affected by external shocks: agriculture (bad weather), tourism (lower arrivals), and construction (delays in payments to contractors). The Banking Supervision Department closely monitors these risks, and regards the impact of rising NPLs on banks' financial statements as largely manageable.



29. **Capital requirements have increased as market and operational risks are incorporated into the prudential framework.** Systemic banks have been moving ahead of new regulations, increasing capital through capital injections or bond issuance. They also have been adopting internal capital adequacy assessment processes in line with CBK regulations introduced in 2013. Despite higher capitalization, Kenyan banks have shown higher profitability than their peers in other SSA countries.

30. **Proactive inclusion policies have been effective.** The CBK recently introduced upgraded credit bureau regulations to facilitate the use of borrowers' information following a review of recent experience. Also, a new Microfinance Act allows microfinance institutions to expand their scope of operations and extends CBK's prompt corrective action capabilities to the supervision of microfinance institutions. The CBK also introduced payments system regulations for the provision of electronic retail transfers, with reference to relevant Anti-Money Laundering (AML) requirements to guide the operations of mobile payment service providers.

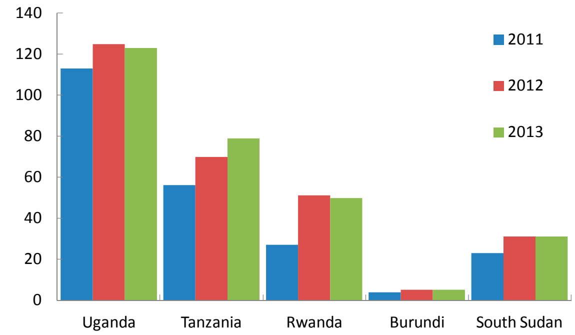
31. **The authorities concur with the view that cross-border expansion of Kenyan banks has been largely driven by a follow-your-customer strategy in the region.** In addition, opportunities have opened in markets showing higher potential (South Sudan), while high penetration in Kenya limits the scope for further expansion. In order to address challenges in this area, the CBK has established three supervisory colleges to conduct joint assessments of the most important Kenyan financial groups. Initial discussions on crisis management and banking resolution coordination are already taking place with other regional supervisors. However, the authorities recognize that differences in capacity between home and host supervisors, especially those from high risk jurisdictions, which may translate into information quality problems and delays that would place a greater burden of vigilance on the home supervisors to ensure that risks are contained (See Box 6).[5]

[5] The CBK has also introduced guidelines on non-operating holding companies to simplify organization structures and strengthen capital requirements at the financial group level.

Box 6. Cross-Border Activities of Kenyan Banks

Kenyan banks have expanded throughout East Africa, becoming dominant players in some markets. Kenya Commercial Bank, Kenya's leading financial institutions, was the first Kenyan bank expanding to Tanzania in 1997. Today, eleven Kenyan banks with 288 branches operate in the East Africa, including South Sudan. Kenyan banks have entered East African markets mainly through subsidiaries. Kenyan banks are currently exploring opportunities in countries out of East Africa including DR Congo, Ethiopia, Malawi, Somalia, and Zambia.

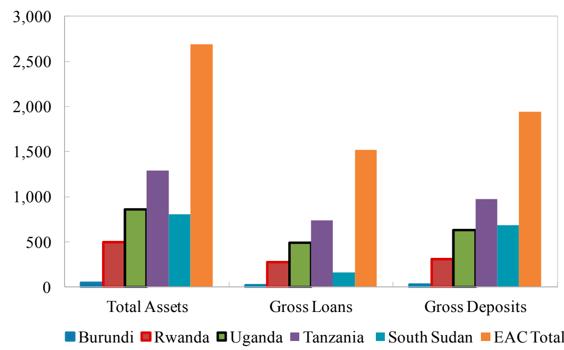
Branches of Kenyan banks in EAC



Source: Central Bank of Kenya

Cross-border expansion of Kenyan banks has been driven by market considerations. Following customers is a strong motive for Kenyan banks serving the regional corporate sector, in sectors such as agricultural commodities, manufactured products, and retail trade. Risk diversification and greater profit opportunities in unexplored markets (South Sudan) also provide opportunities to banks serving the retail sector. Transnational Kenyan bank assets have increased by 35 percent annually on average since 2011. Cross-border activities of Kenyan banks account for 10-12 percent of their banking operations in terms of assets, loans, and deposits. Eight subsidiaries in four countries registered losses, mainly banks at the initial stages of expansion in markets showing intermediate penetration, such as Uganda.

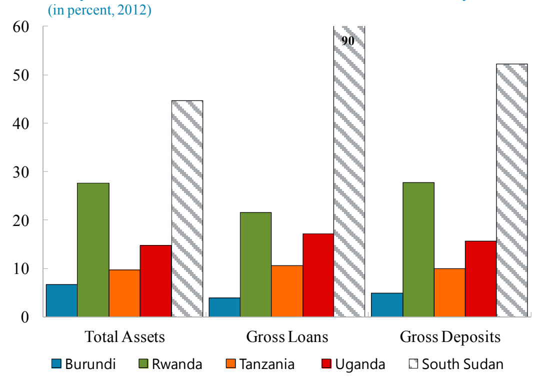
Kenyan Banks activities in EAC and South Sudan
(in million USD, 2013)



Source: Central Bank of Kenya

Kenyan banks are becoming systemically important in the region. East African banking systems other than Kenya's are less developed and capitalized, which gives a competitive advantage to Kenyan banks. Kenyan banks are dominant in South Sudan with 45 percent of banking assets, and in Rwanda with 28 percent, a high share compared with South African and Nigerian banks, operating in 25 and 9 countries respectively, with an average share of 10 percent of assets each in host markets.

Kenyan Banks' Shares in Host Economies' Financial System
(in percent, 2012)



Source: EAC authorities and IMF staff.

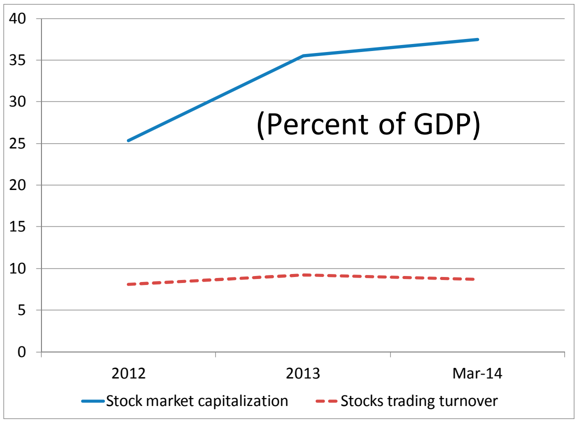
CBK continues its efforts to establish strong relationships with regional regulators to enhance surveillance of Kenya's transnational banks. The CBK has set up supervisory colleges for Kenya Commercial Bank, Equity Bank, and Diamond Trust to conduct joint inspections, and plans to establish 2 more supervisory colleges in 2014. The CBK has also signed Memoranda of Understanding (MOUs) with regulators in EAC countries, South Africa, Nigeria, and Mauritius to promote supervisory cooperation.

32. **Supported by reforms, capital markets activity is picking up driven by both foreign and domestic investors.** Stock market capitalization increased by 25 percent in the year up to March 2014 because of higher valuation, to an equivalent of 40 percent of GDP, with trading driven by foreign investors. The much larger secondary market for government securities continues being driven by domestic investors, with institutional investors largely buying to hold. Recent reforms would continue to support the expansion of capital markets: The recently released capital market master plan will encourage infrastructure financing and the use of derivatives; the recently concluded process of demutualization of the stock exchange will facilitate the entry of new players to the stock exchange; the planned unification of financial regulators under the Financial Service Authority intends to facilitate coordination to assess cross-over risks; and the automation of over-the-counter trading of treasury bills would attract new investors to the government securities market (Figure 6).

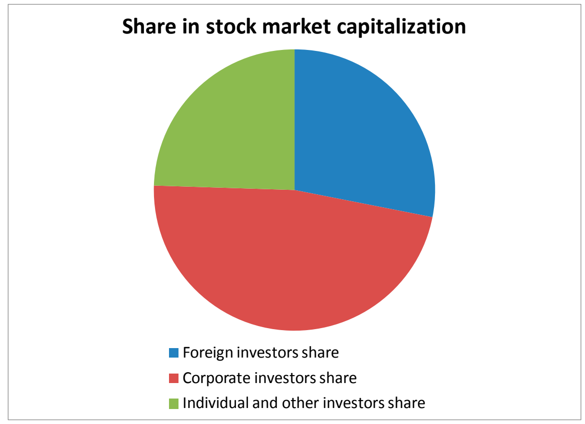
33. **Kenya was removed from the Financial Action Task Force (FATF) watch list in June 2014.** The FATF considered that recent legal and regulatory reforms and the establishment of an operational Financial Reporting Center merited the removal of Kenya from the list of countries subject to a monitoring process aimed at addressing AML/CFT deficiencies. The authorities are encouraged to continue their efforts in effectively implementing the AML/CFT framework to facilitate the government's plans to establish Nairobi as a robust international financial center.

Figure 6. Kenya: Capital Market Indicators

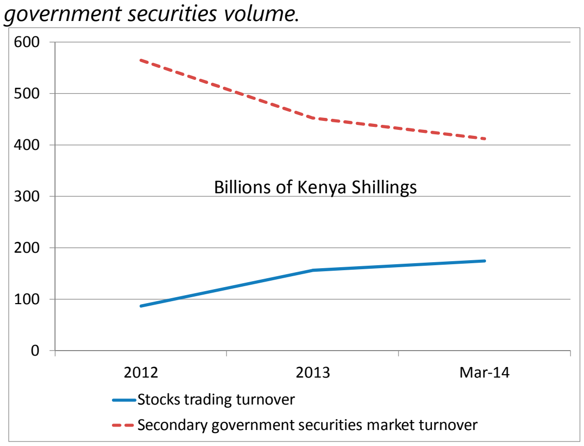
Stock market capitalization reached a record high in March 2014



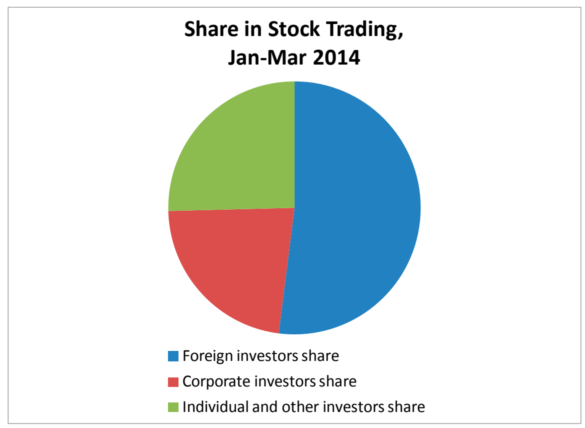
With corporate investors holding a large share



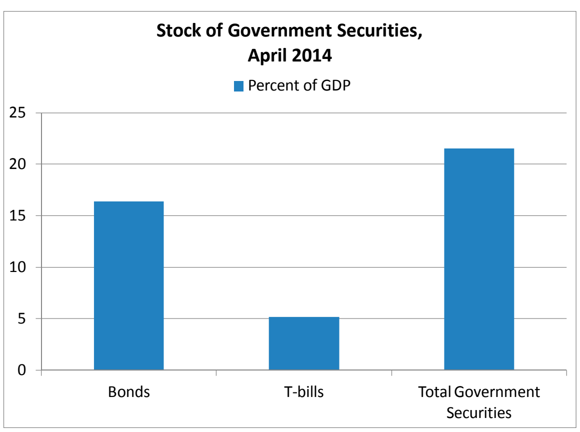
Stock trading is growing, but it is still way below government securities volume.



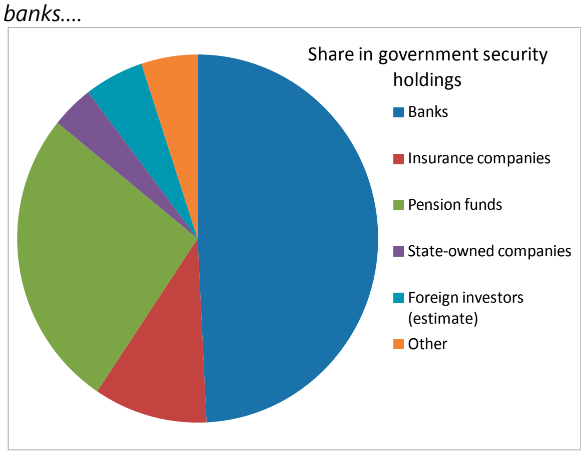
With trading dominated by foreign investors....



Bonds are the dominant form of securities in the market...



And institutional investors are almost as important as banks....



Sources: Capital Markets Authority and Central Bank of Kenya.

D. Transition to Frontier/Emerging Market Status

A successful transition to emerging market status will require continued macroeconomic stability, improved security, and better quality of data. With Kenya more active in international financial markets, regulatory bodies need to strengthen monitoring of market, currency and liquidity risks in the financial and non-financial sectors.

34. **The authorities intend to take measures to upgrade the business environment and improve security conditions.** Their plans include simplifying regulations, rationalizing procedures, removing barriers to entry, and improving the delivery of government services to business. The government has announced the establishment of: (a) an investors relations office, (b) a one-stop investment shop, and (c) the expansion of one-stop public-service centers (Huduma centers) to lighten the bureaucratic burden on firms. The security modernization program that started last year includes the expansion of the police force and the upgrade of its equipment.

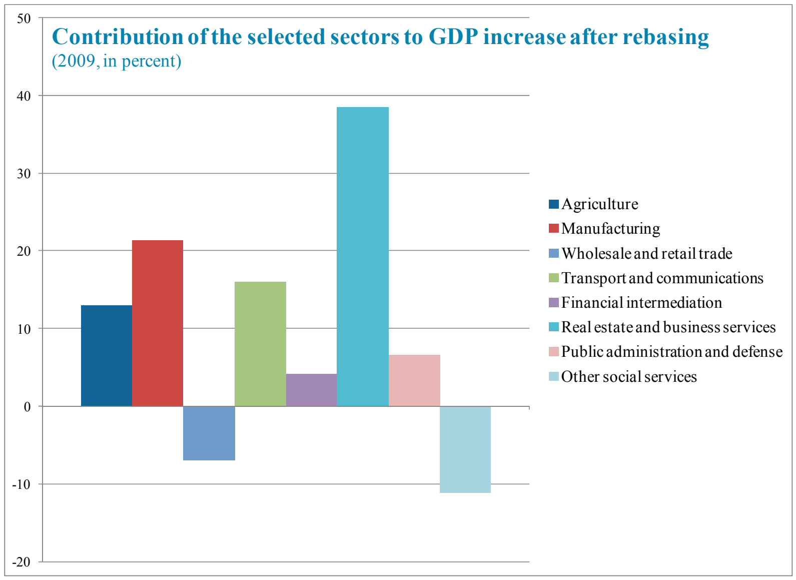
35. **Compilation and dissemination of economic information is high, but data quality in some key sectors is low.** The authorities are taking steps to address these limitations. One important step in this regard was the national accounts revision, that lifts nominal GDP by 20-25 percent (Box 7). However, data availability is more limited in other areas, chiefly: (a) key social indicators are only available for 2005/06 (the year of the last household survey); and, (b) balance of payments data fail to differentiate short-term from long-term inflows properly (see annex in Staff Report for the Sixth Review under the ECF). Further areas for improvement include the availability and timeliness of production indices, labor market information, and the international investment position, especially private debt information.

Box 7. National Accounts Revision

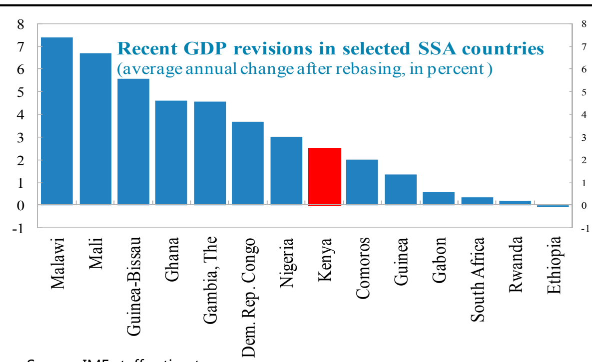
The Kenya National Bureau of Statistics (KNBS) is revising Kenya's national accounts for the period 2006-2013. The revision was supported by STA technical assistance under the Enhanced Data Dissemination Initiative. Release of a full time series consistent with this revision is scheduled for September 2014. Based on details provided in the KNBS 2014 Economic Survey released in May 2014, estimates used in this report take into account that:

- The revised 2013 GDP will be higher by about 25 percent than the 2001-based GDP, reaching about $55bn.;
- The revised 2013 per capita GDP would reach about $1,325, closer to middle-income status.

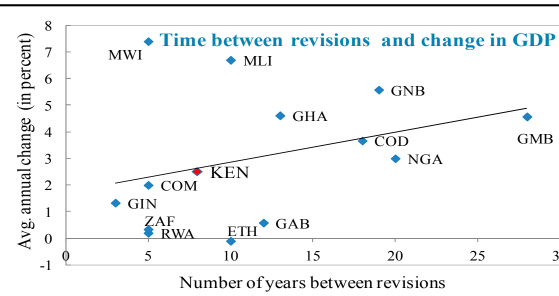
The KNBS revision, initiated in 2010, will change the base year from 2001 to 2009. Because of improved coverage and upgraded sources of information, the value added of agriculture, financial activities and the informal sector are being revised upwards, while more appropriate measurement result in a reduction in the contribution of wholesale and retail trade.



Other Sub-Saharan countries have recently concluded national account revisions. Their revisions were of a larger magnitude relative to Kenya, reflecting significant changes in the structure of their economies, for example because of the incorporation of booming sectors such as banking, telecoms and entertainment to the spectrum of economic activities, and significant expansions in coverage



Source: IMF staff estimates



Source: IMF staff estimates

36. **Kenya has also taken important steps to support East African integration.** Customs revenue collection for some EAC members (Rwanda, Uganda) already takes place in Mombasa, with preliminary indicators showing improved revenue for Uganda and Rwanda. Delays in border posts are sharply reduced. The government has committed to streamline port services in Mombasa, with commitment to specific targets by all entities involved.

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37. **Kenya's economy has continued to grow in a broadly stable macroeconomic environment.** Credit to the manufacturing sector has picked up and foreign investor interest is growing, notably in the extractive industries. However, headline inflation has risen above the upper band of the inflation range in recent months, and further food price shocks in the context of rapid credit growth may fuel inflation expectations. The CBK should stand ready to tighten monetary policy to keep inflation expectations anchored around the mid-point of the target band. The market determined exchange rate has remained stable. A successful sovereign bond issue and its recent exit from the FATF's monitoring process attest to the authorities' progress in establishing Kenya as a robust financial center.

38. **Kenya faces a positive outlook, but remains vulnerable to important risks.** Domestic risks related to devolution and security concerns are important, and, if not addressed decisively, could turn into long-term drags to sustained growth. Kenya remains vulnerable to weather-related shocks in the short term and to the possibility of a renewed downturn in advanced and emerging economies.

39. **Maintaining a strong foreign exchange reserves position with exchange rate flexibility will help cushion the impact of potential shocks.** A comfortable foreign reserve buffer will continue playing a key role in minimizing uncertainty. Likewise, improving liquidity forecasting will support continued prudent monetary policy, which should stand ready to anticipate changes in inflation expectations when taking monetary policy decisions.

40. **Kenya's debt remains sustainable, but rising contingent liabilities are a fiscal risk.** It is important to maintain a prudent fiscal stance consistent with Kenya's medium-term debt target while pursuing a shift in the composition of expenditure towards development priorities. Controlling the wage bill at both national and county level should be a priority. Together with improving the quality and efficiency of public spending, these policies will be essential to create sufficient fiscal space for well-targeted social programs and increasing infrastructure investment. Continued efforts to mobilize domestic revenue are also required to fund these priorities. Reform of government-owned agencies to reduce contingent liabilities is welcome. Its implementation should maintain consistency with the overall PFM framework.

41. **Devolution holds great promise for promoting inclusive growth and improving social conditions for the Kenyan population.** Considerable progress has been made during the first year of the process. However, accountability, compliance with the legal framework and implementation capacity need to be further strengthened to effectively maximize the benefits of devolved resources, improve the provision of public services and mitigate fiscal risks. Strengthening capacity-building in

public financial management is key to ensure that the high expectations raised by devolution are met, and underscores the importance of making the Intergovernmental Fiscal Relations Department fully operational. Priority areas are the adoption of the PFM Act regulations, a formal agreement between the central government and counties on outstanding liabilities, and stronger oversight on the use of public resources.

42. **The launching of the Treasury Single Account provides an opportunity to overhaul the government's cash management systems.** Strengthening cash management will help to avoid undue pressure on payment flows and interest rates, and reduce borrowing costs for the government and the private sector. Also, it allows the central bank to focus on their monetary operations when participating in money markets through monetary operations.

43. **Putting in place an effective natural resource management of recent oil and gas discoveries will pay high dividends in terms of available foreign exchange and fiscal resources.** Once confirmed to be commercially viable, these findings have the potential to further accelerate economic growth and reduce drought-related and geopolitical risks. A sound fiscal framework consistent with the PFM Act, including transparent management rules and the full integration of these resources into the budget, is required for Kenya to fully realize this potential.

44. **Banks are expanding beyond borders and at the same time facilitating financial inclusion.** Continued efforts in consolidated supervision of systemic groups are needed, accompanied by cross-border cooperation with regional supervisors in information sharing, joint prudential oversight and resolution procedures. Domestically, the rapid increase in financial inclusion has opened up the possibility of extending credit at more affordable rates to small and medium-sized enterprises. The policy of maintaining an enabling environment, while improving the prudential framework, has served Kenya well and its experience striking this difficult balance is an example to LICs and even emerging market countries.

45. **Accelerating the regional integration process will contribute to positive investor sentiment and the diversification of Kenya's export base.** Commitment to the East African Monetary Union Protocol's convergence criteria supports the integration process. Kenya's role in reducing shipment delays to neighbor countries enhances the benefits of integration. It is essential that non-tariff barriers are removed to bring down significantly the cost of doing business in the region.

46. **Data quality improvement should be given higher priority.** Transitioning to emerging market status will make Kenya subject to more intensive monitoring by private investors, rating agencies, international banks, and multinational companies. Improved availability of data should be complemented by upgrading in particular the quality and scope of information on the balance of payments, social indicators, and the labor market.

47. **It is proposed that the next Article IV consultation for Kenya takes place within 12 months, subject to the decision on consultation cycles.**

Table 1. Kenya: Selected Economic Indicators, 2012/13–2018/19[1]

	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
	Act.	Prelim.	Projections				
(Annual percentage change; unless otherwise indicated)							
National accounts and prices							
Nominal GDP (market prices, in billions of Kenya shillings)	4,497	5,051	5,734	6,525	7,420	8,416	9,504
Real GDP growth (market prices)	4.6	5.0	5.8	6.3	6.5	6.5	6.6
GDP deflator (average) [2]	6.7	6.9	7.2	7.0	6.7	6.4	5.9
Consumer price index (annual average) [2]	4.6	7.1	6.5	5.2	5.0	5.0	5.0
Consumer price index (end of period) [2]	4.9	7.4	5.3	5.0	5.0	5.0	5.0
Import volume growth, goods	6.8	3.6	8.3	11.2	7.6	8.8	8.8
Import value growth, goods	3.2	5.0	11.2	9.2	7.8	8.7	9.6
Export volume growth, goods	8.2	0.7	6.2	10.3	10.0	10.6	10.7
Export value growth, goods	2.8	-5.3	4.1	9.1	10.4	11.1	11.3
Terms of trade, goods, and services (Base year 2000)	-4.2	-6.2	-1.3	1.5	0.6	1.2	0.7
Ksh per US$ exchange rate (end of period)	85.8	87.6					
Nominal effective exchange rate (- depreciation; end of period)	1.2	-2.7		…	…	…	…
Real effective exchange rate (- depreciation; end of period)	3.6	1.9		…	…	…	…
Money and credit							
M3 (broad money and foreign currency deposits, end period)	14.2	21.4	…	…	…	…	…
Reserve money	11.7	16.0	…	…	…	…	…
(In percent of GDP; unless otherwise indicated)							
Investment and saving							
Investment	18.7	18.7	22.3	22.6	23.2	23.1	22.8
Central government	6.6	6.2	8.6	8.7	9.0	8.8	8.5
Other	12.1	12.5	13.7	14.0	14.2	14.3	14.3
Gross national saving	10.6	11.0	13.9	14.7	16.1	16.5	16.5
Central government	0.8	0.2	2.1	2.9	3.6	4.0	4.1
Other	9.8	10.8	11.8	11.7	12.5	12.6	12.5
Central government budget							
Total revenue	18.8	19.2	20.5	20.5	20.6	20.9	20.9
Total expenditure and net lending	24.8	25.4	27.2	26.4	26.1	25.8	25.3
Overall balance (commitment basis) excluding grants	-6.0	-6.2	-6.7	-5.9	-5.5	-4.9	-4.4
Overall balance (commitment basis) including grants	-5.5	-5.7	-6.2	-5.5	-5.1	-4.6	-4.1
Primary budget balance	-2.5	-3.0	-3.7	-3.0	-2.7	-2.2	-1.7
Net domestic borrowing	3.8	4.0	2.7	2.8	2.4	2.2	1.5
General government overall balance including grants [3]	-5.2	-4.7	-5.7	-5.4	-5.3	-4.8	-4.5
Balance of payments							
Current account balance	-8.1	-7.8	-8.4	-8.0	-7.1	-6.5	-6.3
Current account balance, excl. capital imports and official transfers	-0.2	0.0	0.0	0.4	0.9	1.2	1.3
Exports value, goods, and services	20.8	18.8	18.1	17.9	17.8	17.8	17.9
Imports value, goods, and services	34.1	32.0	32.2	31.6	30.8	30.3	30.0
Gross international reserve coverage							
In billions of U.S. dollars (end of period)	6.2	7.5	8.3	9.3	10.3	11.2	12.5
In months of next year imports (end of period)	4.0	4.3	4.4	4.6	4.6	4.6	4.6
Public debt							
Total public debt, gross (percent of GDP)	42.1	42.2	45.8	45.5	45.4	45.0	44.3
Of which: external debt	18.8	19.4	19.0	19.3	19.7	19.7	20.1
Of which : domestic debt, gross	23.4	22.8	26.8	26.2	25.7	25.2	24.2
Total public debt, net of deposits (percent of GDP)	37.6	38.2	40.7	41.3	41.4	41.1	40.5

Sources: Kenyan authorities and IMF staff estimates and projections.

[1] Incorporates Staff estimates for pending upward revisions to GDP, which the authorities expect to release in September 2014. Fiscal years are from July 1 to June 30.

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

[3] General government includes central government and county government, and excludes extra budgetary funds (EBFs) and central government units with individual budgets for which regularly published data are not available.

Table 2a. Kenya: Central Government Financial Operations 2012/13–2018/19

	2012/13	2013/14		2014/15		2015/16	2016/17	2017/18	2018/19
	Act.	Budget	Estim	Budget	Proj	Proj	Proj	Proj	Proj
	(in billions of Kenyan Shillings, unless otherwise indicated)								
Revenues and grants	**868.2**	**1,106.2**	**994.4**	**1,238.4**	**1,204.8**	**1,363.8**	**1,555.8**	**1,785.2**	**2,016.4**
Revenue	**847.2**	**1,028.5**	**969.2**	**1,180.5**	**1,175.5**	**1,335.5**	**1,529.5**	**1,758.5**	**1,986.3**
Tax revenue	701.2	862.9	851.8	1,006.5	1,006.5	1,145.9	1,313.7	1,508.7	1,703.2
Income tax	373.4	459.0	449.6	541.9	541.9	619.8	712.0	812.5	917.5
Import duty (net)	57.7	69.0	67.6	77.7	77.7	89.6	102.4	116.4	134.7
Excise duty	85.5	113.1	102.0	119.8	119.8	132.5	151.8	177.1	203.4
Value-added tax	184.6	221.8	232.6	267.1	267.1	304.0	347.5	402.7	447.5
Nontax revenue	146.1	165.6	117.4	174.0	169.0	189.6	215.8	249.9	283.1
Investment income	15.3	17.7	10.2	17.4	17.4	19.8	22.5	25.5	28.8
Other	63.0	67.1	57.0	62.5	62.5	71.1	80.9	96.7	109.2
Ministerial and Departmental Fees (AIA)	49.7	67.3	30.5	71.2	66.2	72.3	82.3	93.3	105.4
Railway Levy	0.0	13.5	19.7	22.9	22.9	26.4	30.2	34.3	39.7
Grants	**21.0**	**77.7**	**25.3**	**57.9**	**29.3**	**28.3**	**26.3**	**26.7**	**30.2**
Project grants	15.1	67.4	20.1	51.3	23.2	21.3	26.3	26.7	30.2
Program grants	5.8	0.0	4.7	0.0	6.1	7.0	0.0	0.0	0.0
Expenditure and net lending	**1,117.0**	**1,439.7**	**1,281.2**	**1,581.0**	**1,559.4**	**1,719.5**	**1,936.6**	**2,172.2**	**2,408.8**
Recurrent expenditure	**808.3**	**990.6**	**965.9**	**1,102.8**	**1,054.8**	**1,145.8**	**1,256.2**	**1,418.4**	**1,591.2**
Transfer to counties	0.0	210.0	169.4	226.7	178.7	168.0	175.0	198.1	229.8
Interest payments	121.2	120.5	134.1	147.4	142.1	162.8	183.4	203.9	230.4
Domestic interest	110.2	109.4	119.2	122.9	122.9	138.0	153.4	168.0	186.8
Foreign interest due	11.1	11.1	14.9	24.5	19.2	24.8	30.0	35.9	43.6
Wages and benefits (civil service)	274.4	263.0	288.5	302.4	303.3	338.0	368.9	416.3	468.8
Civil service reform	0.0	0.0	0.0	1.0	1.0	0.0	0.0	0.0	0.0
Pensions, etc.	27.0	48.6	31.2	36.6	36.6	41.5	46.2	55.7	62.7
Other	294.5	263.8	252.8	298.0	302.4	331.9	363.6	410.7	450.7
of which: Education (free primary and secondary)	30.1	31.2	30.9	41.2	41.2	52.6	68.2	87.9	101.3
of which: Ministerial recurrent AIA	88.2	53.2	28.7	61.7	58.3	66.2	70.1	73.1	74.2
Defense and NSIS	91.2	84.7	89.9	90.7	90.7	103.5	119.0	133.6	148.8
Development and net lending	**298.9**	**439.1**	**315.3**	**478.5**	**496.2**	**568.1**	**673.9**	**746.4**	**809.3**
Domestically financed	201.8	196.1	214.6	289.2	336.0	371.0	441.4	519.7	562.8
of which: spending by counties	--	--	24.0	--	48.0	71.0	96.4	109.7	127.8
Foreign financed	94.7	240.6	98.4	187.2	157.3	194.1	229.2	222.9	242.1
Net lending	2.4	2.4	2.3	2.1	2.9	3.0	3.4	3.8	4.3
Balance (commitment basis, excluding grants)	**-269.8**	**-411.2**	**-312.0**	**-400.5**	**-383.8**	**-384.1**	**-407.1**	**-413.7**	**-422.5**
Balance (commitment basis, including grants)	**-248.8**	**-333.5**	**-286.7**	**-342.6**	**-354.6**	**-355.7**	**-380.8**	**-387.0**	**-392.3**
Adjustments to cash basis	**16.4**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Balance (cash basis, including grants)	**-232.4**	**-333.5**	**-286.7**	**-342.6**	**-354.6**	**-355.7**	**-380.8**	**-387.0**	**-392.3**
Financing	**232.4**	**333.5**	**286.7**	**342.6**	**354.6**	**355.7**	**380.8**	**387.0**	**392.3**
Net foreign financing	62.7	226.3	83.7	149.8	198.7	173.2	201.2	199.0	251.5
Disbursements	86.2	314.9	165.3	177.3	227.5	208.1	240.2	244.8	305.2
Project loans	79.6	189.8	78.3	135.9	134.1	173.2	203.4	201.7	218.1
Program loans	0.0	0.0	0.0	5.4	5.4	0.0	0.0	0.0	0.0
Commercial borrowing [2]	6.6	125.1	87.0	36.1	88.0	34.9	36.8	43.1	87.1
Other loans (incl. Standard Gauge Railway loan from China)	0.0	0.0	0.0	0.0	96.5	73.0	74.5	49.4	38.8
Repayments due	-24.0	-88.6	-82.8	-27.5	-29.3	-34.8	-39.0	-45.8	-53.7
Change in arrears	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net domestic financing	169.8	106.7	203.0	190.8	155.9	182.5	179.6	188.0	140.8
Memorandum items:									
Nominal GDP	4,497.5	5,051.1	5,051.1	5733.7	5,733.7	6,524.6	7,420.4	8,415.7	9,504.0
Primary balance incl. grants	(111.2)	(213.0)	(152.6)	(195.2)	(212.5)	(192.9)	(197.3)	(183.1)	(161.9)
Total gross public debt, gross [4]	1856.5	2180.5	2130.8	2370.3	2624.3	2971.7	3371.6	3784.7	4213.3
of which: external debt	805.9	962.3	977.6	1153.3	1088.3	1261.6	1462.7	1661.8	1913.3
of which: domestic debt	1050.6	1097.0	1153.1	1217.0	1536.0	1710.1	1908.9	2122.9	2300.0
Total net public debt [5]	1695.0	2028.6	1929.0	--	2336.3	2692.0	3072.8	3459.8	3852.2
Government deposits	161.4	--	61.0	--	288.0	279.7	298.8	324.9	361.1

Sources: Kenyan authorities and IMF staff estimates and projections.

[1] Fiscal year runs from July to June.

[2] Includes proceeds from (i) syndicated loans, (ii) US$2.0bn Eurobond , and (iii) planned sovereign bonds.

[3] General government includes central government, counties, and excludes central government units with individual budgets for which regularly published data are not

[4] Total gross debt in 2013/14 includes the proceeds from US$2.0bn Eurobond

[5] Total net debt in 2013/14 includes US$400mil. proceeds from US$2.0bn Eurobond

Table 2b. Kenya: Central Government Financial Operations 2012/13–2018/19

	2012/13	2013/14		2014/15		2015/16	2016/17	2017/18	2018/19
	Act.	Budget [2]	Estim	Prov. Budget	Proj	Proj	Proj	Proj	Proj
	(in percent of GDP, unless otherwise indicated)								
Revenues and grants	**19.3**	**21.9**	**19.7**	**21.6**	**21.0**	**20.9**	**21.0**	**21.2**	**21.2**
Revenue	**18.8**	**20.4**	**19.2**	**20.6**	**20.5**	**20.5**	**20.6**	**20.9**	**20.9**
Tax revenue	15.6	17.1	16.9	17.6	17.6	17.6	17.7	17.9	17.9
Income tax	8.3	9.1	8.9	9.5	9.5	9.5	9.6	9.7	9.7
Import duty (net)	1.3	1.4	1.3	1.4	1.4	1.4	1.4	1.4	1.4
Excise duty	1.9	2.2	2.0	2.1	2.1	2.0	2.0	2.1	2.1
Value-added tax	4.1	4.4	4.6	4.7	4.7	4.7	4.7	4.8	4.7
Nontax revenue	3.2	3.3	2.3	3.0	2.9	2.9	2.9	3.0	3.0
Investment income	0.3	0.4	0.2	0.3	0.3	0.3	0.3	0.3	0.3
Other	1.4	1.3	1.1	1.1	1.1	1.1	1.1	1.1	1.1
Ministerial and Departmental Fees (AIA)	1.1	1.3	0.6	1.2	1.2	1.1	1.1	1.1	1.1
Railway Levy	0.0	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Grants	**0.5**	**1.5**	**0.5**	**1.0**	**0.5**	**0.4**	**0.4**	**0.3**	**0.3**
Project grants	0.3	1.3	0.4	0.9	0.4	0.3	0.4	0.3	0.3
Program grants	0.1	0.0	0.1	0.0	0.1	0.1	0.0	0.0	0.0
Expenditure and net lending	**24.8**	**28.5**	**25.4**	**27.6**	**27.2**	**26.4**	**26.1**	**25.8**	**25.3**
Recurrent expenditure	**18.0**	**19.6**	**19.1**	**19.2**	**18.4**	**17.6**	**16.9**	**16.9**	**16.7**
Transfer to counties	0.0	4.2	3.4	4.0	3.1	2.6	2.4	2.4	2.4
Interest payments	2.7	2.4	2.7	2.6	2.5	2.5	2.5	2.4	2.4
Domestic interest	2.4	2.2	2.4	2.1	2.1	2.1	2.1	2.0	2.0
Foreign interest due	0.2	0.2	0.3	0.4	0.3	0.4	0.4	0.4	0.5
Wages and benefits (civil service)	6.1	5.2	5.7	5.3	5.3	5.2	5.0	4.9	4.9
Civil service reform	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Pensions, etc.	0.6	1.0	0.6	0.6	0.6	0.6	0.6	0.7	0.7
Other	6.5	5.2	5.0	5.2	5.3	5.1	4.9	4.9	4.7
of which: Education (free primary and secondary)	0.7	0.6	0.6	0.7	0.7	0.8	0.9	1.0	1.1
of which: Ministerial recurrent AIA	2.0	1.1	0.6	1.1	1.0	1.0	0.9	0.9	0.8
Defense and NSIS	2.0	1.7	1.8	1.6	1.6	1.6	1.6	1.6	1.6
Development and net lending	**6.6**	**8.7**	**6.2**	**8.3**	**8.7**	**8.7**	**9.1**	**8.9**	**8.5**
Domestically financed	4.5	3.9	4.2	5.0	5.9	5.7	5.9	6.2	5.9
of which: spending by counties	--	--	0.5	--	0.8	1.1	1.3	1.3	1.3
Foreign financed	2.1	4.8	1.9	3.3	2.7	3.0	3.1	2.6	2.5
Net lending	0.1	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0
Balance (commitment basis, excluding grants)	**-6.0**	**-8.1**	**-6.2**	**-7.0**	**-6.7**	**-5.9**	**-5.5**	**-4.9**	**-4.4**
Balance (commitment basis, including grants)	**-5.5**	**-6.6**	**-5.7**	**-6.0**	**-6.2**	**-5.5**	**-5.1**	**-4.6**	**-4.1**
Adjustments to cash basis	**0.4**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Balance (cash basis, including grants)	**-5.2**	**-6.6**	**-5.7**	**-6.0**	**-6.2**	**-5.5**	**-5.1**	**-4.6**	**-4.1**
Financing	**5.2**	**6.6**	**5.7**	**6.0**	**6.2**	**5.5**	**5.1**	**4.6**	**4.1**
Net foreign financing	1.4	4.5	1.7	2.6	3.5	2.7	2.7	2.4	2.6
Disbursements	1.9	6.2	3.3	3.1	4.0	3.2	3.2	2.9	3.2
Project loans	1.8	3.8	1.6	2.4	2.3	2.7	2.7	2.4	2.3
Program loans	0.0	0.0	0.0	0.1	0.1	0.0	0.0	0.0	0.0
Commercial borrowing [3]	0.1	2.5	1.7	0.6	1.5	0.5	0.5	0.5	0.9
Other loans (incl. Standard Gauge Railway loan from China)	0.0	0.0	0.0	0.0	1.7	1.1	1.0	0.6	0.4
Repayments due	-0.5	-1.8	-1.6	-0.5	-0.5	-0.5	-0.5	-0.5	-0.6
Change in arrears	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net domestic financing	3.8	2.1	4.0	3.3	2.7	2.8	2.4	2.2	1.5
Memorandum items:									
Primary balance incl. grants (Central government)	-2.5	-4.2	-3.0	-3.4	-3.7	-3.0	-2.7	-2.2	-1.7
Total gross public debt, gross [5]	41.3	43.2	42.2	41.3	45.8	45.5	45.4	45.0	44.3
of which: external debt	17.9	19.1	19.4	20.1	19.0	19.3	19.7	19.7	20.1
of which: domestic debt	23.4	21.7	22.8	21.2	26.8	26.2	25.7	25.2	24.2
Total net public debt [6]	37.7	40.2	38.2	--	40.7	41.3	41.4	41.1	40.5
Government deposits (in months of domestically financed expenditures)	1.9	--	0.6	--	2.5	2.2	2.1	2.0	2.0

Sources: Kenyan authorities and IMF staff estimates and projections.

[1] Fiscal year runs from July to June.

[2] For comparability, the staff estimates of rebased GDP are used in computing figures for both the budget and the projections.

[3] Includes proceeds from (i) syndicated loans, (ii) US$2.0bn Eurobond , and (iii) planned sovereign bonds.

[4] General government includes central government, counties, and excludes central government units with individual budgets for which regularly published data are not available.

[5] Total gross debt in 2013/14 includes the proceeds from US$2.0bn Eurobond

[6] Total net debt in 2013/14 includes US$400mil. proceeds from US$2.0bn Eurobond.

Table 2c. Kenya: General Government 2012/13 – 2018/19

	2012/13	2013/14		2014/15	2015/16	2016/17	2017/18	2018/19
	Act.	Budget	Estim	Proj	Proj	Proj	Proj	Proj
	(in billions of Kenyan Shillings, unless otherwise indicated)							
Revenues and grants	**906.0**	**1,384.0**	**1,211.9**	**1,459.9**	**1,636.8**	**1,866.2**	**2,140.9**	**2,427.5**
Central Government revenues and grants	**868.2**	**1,106.2**	**994.4**	**1,204.8**	**1,363.8**	**1,555.8**	**1,785.2**	**2,016.4**
Tax revenue	701.2	862.9	851.8	1,006.5	1,145.9	1,313.7	1,508.7	1,703.2
Nontax revenue	146.1	165.6	117.4	169.0	189.6	215.8	249.9	283.1
Grants	21.0	77.7	25.3	29.3	28.3	26.3	26.7	30.2
County revenues and grants	**37.8**	**277.8**	**217.5**	**255.1**	**273.0**	**310.4**	**355.7**	**411.1**
Local revenue (Property tax, Single Business Permits, etc…) [2]	19.7	67.8	24.1	28.5	34.0	39.0	47.9	53.5
Grants from central government	18.1	210.0	193.4	226.7	239.0	271.4	307.8	357.6
Expenditure and net lending [3]	**1,154.8**	**1,716.9**	**1,450.6**	**1,785.9**	**1,987.1**	**2,258.0**	**2,543.8**	**2,850.9**
Recurrent expenditure	**843.1**	**1,165.0**	**1,135.3**	**1,281.4**	**1,413.3**	**1,577.7**	**1,790.0**	**2,033.3**
Transfer to counties	18.1	210.0	193.4	226.7	239.0	271.4	307.8	357.6
Wages and salaries	294.3	373.9	382.3	400.6	442.6	481.2	538.7	600.0
of which: counties	19.9	110.9	93.8	97.3	104.6	112.3	122.4	131.2
Other	530.7	581.1	559.6	654.1	731.8	825.1	943.5	1075.7
of which: counties	14.9	53.5	51.6	81.3	92.0	112.8	139.5	183.1
Development and net lending	**301.9**	**541.9**	**315.3**	**496.2**	**568.1**	**673.9**	**746.4**	**809.3**
Domestically financed	201.8	196.1	214.6	336.0	371.0	441.4	519.7	562.8
of which: counties	3.0	102.8	24.0	48.0	71.0	96.4	109.7	127.8
Foreign financed	94.7	240.6	98.4	157.3	194.1	229.2	222.9	242.1
Net lending	2.4	2.4	2.3	2.9	3.0	3.4	3.8	4.3
Balance (cash basis, including grants)	**-232.4**	**-332.9**	**-238.6**	**-326.0**	**-350.3**	**-391.9**	**-402.9**	**-423.4**
Memorandum items:								
Nominal GDP	4,497.5	5,051.1	5,051.1	5,733.7	6,524.6	7,420.4	8,415.7	9,504.0
Central government balance (cash basis, including grants)	-232.4	-333.5	-286.7	-354.6	-355.7	-380.8	-387.0	-392.3
County government deposits	--	--	48.1	76.6	82.1	71.0	55.1	24.0
in months of county expenditures	--	--	3.4	4.1	3.7	2.6	1.8	0.7

Sources: Kenyan authorities and IMF staff estimates and projections.

[1] Preliminary IMF staff estimates. General government includes central government and county government, and excludes extra budgetary funds (EBFs) and central government units with individual budgets for which regularly published data are not available.

[2] Actual local revenues of counties for 2012/13 are obtained using a Local Government database that was provided by department of devolution and planning.

[3] County expenditures in 2012/13 are imputed based on the assumption of a balanced budget.

Table 2d. Kenya: General Government 2012/13 – 2018/19

	2012/13	2013/14		2014/15	2015/16	2016/17	2017/18	2018/19
	Act.	Budget	Estim	Proj	Proj	Proj	Proj	Proj
	(in percent of GDP, unless otherwise indicated)							
Revenues and grants	**20.1**	**27.4**	**24.0**	**25.5**	**25.1**	**25.1**	**25.4**	**25.5**
Central Government revenues and grants	**19.3**	**21.9**	**19.7**	**21.0**	**20.9**	**21.0**	**21.2**	**21.2**
Tax revenue	**15.6**	**17.1**	**16.9**	**17.6**	**17.6**	**17.7**	**17.9**	**17.9**
Nontax revenue	**3.2**	**3.3**	**2.3**	**2.9**	**2.9**	**2.9**	**3.0**	**3.0**
Grants	**0.5**	**1.5**	**0.5**	**0.5**	**0.4**	**0.4**	**0.3**	**0.3**
County revenues and grants	**0.8**	**5.5**	**4.3**	**4.4**	**4.2**	**4.2**	**4.2**	**4.3**
Local revenue (Property tax, Single Business Permits, etc...) [2]	**0.4**	**1.3**	**0.5**	**0.5**	**0.5**	**0.5**	**0.6**	**0.6**
Grants from central government	**0.4**	**4.2**	**3.8**	**4.0**	**3.7**	**3.7**	**3.7**	**3.8**
Expenditure and net lending [3]	**25.7**	**34.0**	**28.7**	**31.1**	**30.5**	**30.4**	**30.2**	**30.0**
Recurrent expenditure	**18.7**	**23.1**	**22.5**	**22.3**	**21.7**	**21.3**	**21.3**	**21.4**
Transfer to counties	**0.4**	**4.2**	**3.8**	**4.0**	**3.7**	**3.7**	**3.7**	**3.8**
Wages and salaries	**6.5**	**7.4**	**7.6**	**7.0**	**6.8**	**6.5**	**6.4**	**6.3**
of which: counties	**0.4**	**2.2**	**1.9**	**1.7**	**1.6**	**1.5**	**1.5**	**1.4**
Other	**11.8**	**11.5**	**11.1**	**11.4**	**11.2**	**11.1**	**11.2**	**11.3**
of which: counties	**0.3**	**1.1**	**1.0**	**1.4**	**1.4**	**1.5**	**1.7**	**1.9**
Development and net lending	**6.7**	**10.7**	**6.2**	**8.7**	**8.7**	**9.1**	**8.9**	**8.5**
Domestically financed	**4.5**	**3.9**	**4.2**	**5.9**	**5.7**	**5.9**	**6.2**	**5.9**
of which: counties	**0.1**	**2.0**	**0.5**	**0.8**	**1.1**	**1.3**	**1.3**	**1.3**
Foreign financed	**2.1**	**4.8**	**1.9**	**2.7**	**3.0**	**3.1**	**2.6**	**2.5**
Net lending	**0.1**	**0.0**	**0.0**	**0.1**	**0.0**	**0.0**	**0.0**	**0.0**
Balance (cash basis, including grants)	**(5.2)**	**(6.6)**	**(4.7)**	**(5.7)**	**(5.4)**	**(5.3)**	**(4.8)**	**(4.5)**
Memorandum items:								
Central government balance (cash basis, including grants)	(5.2)	(6.6)	(5.7)	(6.2)	(5.5)	(5.1)	(4.6)	(4.1)
County government deposits	--	--	48.1	76.6	82.1	71.0	55.1	24.0
in months of county expenditures	--	--	3.4	4.1	3.7	2.6	1.8	0.7

Sources: Kenyan authorities and IMF staff estimates and projections.

[1] Preliminary IMF staff estimates. General government includes central government and county government, and excludes extra budgetary funds (EBFs) and central government units with individual budgets for which regularly published data are not available.

[2] Actual local revenues of counties for 2012/13 are obtained using a Local Government database that was provided by department of devolution and planning.

[3] County expenditures in 2012/13 are imputed based on the assumption of a balanced budget.

Table 3. Kenya: Monetary Survey June 2013 – June 2015

	Jun-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15
				Prel.		Projections		
(In billions of Kenyan shillings, unless otherwise indicated)								
Central Bank of Kenya (CBK)								
Net foreign assets	402.1	432.0	442.1	429.7	461.0	492.3	541.2	590.1
(in millions of US dollars) [1 2 3]	4,676	5,005	5,114	4,905	5,263	5,620	6,178	6,736
Net domestic assets	-114.7	-111.2	-130.1	-96.3	-114.2	-112.0	-166.5	-190.6
Net domestic credit	-62.5	-1.9	-3.9	-24.5	-42.4	-40.1	-94.7	-118.8
Government (net)	-20.9	-11.9	12.3	-24.5	-60.0	-40.0	-70.0	-80.0
Commercial banks (net)	-41.7	10.0	-16.2	0.0	15.1	-2.6	-27.2	-41.3
Other items (net)	-52.2	-109.3	-126.2	-71.8	-71.8	-71.8	-71.8	-71.8
Reserve money	287.4	320.8	312.0	333.3	346.8	380.4	374.7	399.5
Currency outside banks	148.0	163.2	156.8	163.3	179.9	185.8	183.1	201.4
Bank reserves	139.5	157.6	155.2	170.0	166.9	194.6	191.5	198.1
Banks								
Net foreign assets	-40.9	-44.7	-71.5	-72.7	-74.5	-76.2	-78.0	-78.8
(in millions of US dollars)	-475.7	-518.1	-827.5	-830.0	-850.0	-870.0	-890.0	-900.0
Reserves	139.5	157.6	155.2	181.0	166.9	194.6	191.5	198.1
Credit to CBK	41.7	-10.0	16.2	0.0	-15.1	2.6	27.2	41.3
Net domestic assets	1,512.8	1,699.2	1,774.9	1,903.0	2,008.6	2,041.5	2,112.7	2,255.1
Net domestic credit	1,800.0	1,986.6	2,081.8	2,209.9	2,315.5	2,348.4	2,419.6	2,562.0
Government (net)	400.4	409.0	437.5	451.1	470.6	509.6	529.0	548.5
Other public sector	36.2	39.6	33.7	43.6	45.0	50.0	50.0	50.0
Private sector	1,363.4	1,537.9	1,610.5	1,715.2	1,799.9	1,788.8	1,840.5	1,963.5
Other items (net)	-287.2	-287.4	-306.9	-306.9	-306.9	-306.9	-306.9	-306.9
Total deposits	1,653.0	1,802.1	1,874.8	2,011.3	2,085.9	2,162.5	2,253.5	2,415.6
Monetary survey								
Net foreign assets	361.2	387.3	370.5	356.9	386.5	416.1	463.2	511.2
(in millions of US dollars)	4,199.9	4,487.2	4,286.7	4,074.7	4,412.5	4,750.4	5,288.2	5,836.1
Net domestic assets	1,459.7	1,608.9	1,689.8	1,853.4	1,905.8	1,960.4	2,013.2	2,143.4
Net domestic credit	1,783.0	1,978.5	2,096.6	2,187.9	2,258.0	2,310.9	2,352.1	2,484.5
Government (net)	379.5	397.2	449.9	426.6	410.6	469.6	459.0	468.5
Other public sector	36.2	39.6	33.7	43.6	45.0	50.0	50.0	50.0
Private	1,367.2	1,541.7	1,613.0	1,717.7	1,802.4	1,791.3	1,843.0	1,966.0
Other items (net)	-323.3	-369.6	-406.8	-334.5	-352.2	-350.5	-338.8	-341.1
M1	752.8	827.1	868.1	931.3	965.8	1,001.3	1,043.4	1,118.5
Money and quasi-money (M2)	1,547.9	1,671.6	1,758.8	1,886.9	1,956.8	2,028.7	2,114.0	2,266.1
M2 plus resident foreign currency deposits (M3)	1,820.9	1,996.2	2,060.3	2,210.4	2,292.3	2,376.5	2,476.5	2,654.6
M3 plus nonbank holdings of government debt (L)	2,278.3	2,523.2	2,604.2	2,592.5	2,688.7	2,787.5	2,904.7	3,113.6
Memorandum items (Annual percent change unless otherwise specified)								
M1	20.7	16.4	20.4	23.7	20.4	21.1	20.2	20.1
M2	15.6	13.8	19.0	21.9	21.0	21.4	20.2	20.1
M3	14.2	15.6	17.3	21.4	21.6	19.1	20.2	20.1
Deposits	14.0	15.1	17.9	21.7	21.8	20.0	20.2	20.1
Reserve money	11.7	9.2	8.5	16.0	19.5	18.6	20.1	19.9
Currency outside banks	16.6	10.4	4.5	10.4	23.0	13.8	16.8	23.4
Net domestic credit	14.9	16.2	19.7	22.7	20.4	16.8	12.2	13.6
Government (net)	27.4	7.7	15.1	12.4	7.3	18.2	2.0	9.8
Private	12.7	20.1	22.6	25.6	24.1	16.2	14.3	14.5
Net domestic assets of the banking sector	14.7	14.8	17.7	27.0	26.0	21.8	19.1	15.6
NDA growth (as percent of the base period M3)	9.5	9.7	11.6	17.3	16.3	13.9	12.4	11.2
Multiplier (Average M3/RM)	6.2	6.3	6.4	6.5	6.5	6.5	6.5	6.5
Velocity (GDP/M2)	3.0	3.0	3.0	2.9	2.9	2.8	2.8	2.7

Sources: Kenyan authorities and IMF staff estimates and projections

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

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

[3] Starting in June 2014, it includes government deposits abroad on account of the Eurobond issuance, as an asset and as a liability.

Table 4a. Kenya: Balance of Payments 2012/13–2018/19

(in millions of US dollars, unless otherwise indicated)

	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
	Act.	Est.			Projections		
Current account	**-4,240.3**	**-4,504.3**	**-5,371.8**	**-5,718.1**	**-5,672.7**	**-5,786.4**	**-6,158.7**
Exports, f.o.b.	6,018.2	5,823.3	6,039.3	6,586.9	7,270.0	8,075.1	8,985.8
Coffee	230.1	216.4	248.5	265.1	292.5	323.6	351.5
Tea	1,207.1	1,124.7	1,069.4	1,155.2	1,286.1	1,453.7	1,641.5
Horticulture	717.8	770.3	825.2	882.3	963.1	1,070.5	1,190.7
Imports, f.o.b	-15,568.0	-16,308.2	-18,168.3	-19,829.4	-21,391.2	-23,244.9	-25,487.8
Oil	-3,776.5	-3,899.4	-4,338.0	-4,577.2	-4,807.7	-5,172.8	-5,666.0
Other private	-11,610.6	-12,293.3	-13,707.9	-15,122.8	-16,441.3	-17,915.5	-19,649.5
of which: Chemicals	-2,076.6	-2,338.2	-2,624.0	-2,822.4	-3,063.2	-3,337.7	-3,635.7
Manufactured goods	-2,349.0	-2,677.9	-3,103.2	-3,489.4	-3,871.6	-4,313.7	-4,793.1
Power generation-related machinery & aircraft	-809.4	-830.2	-990.4	-1,035.2	-976.5	-843.5	-834.9
Other capital imports 1/	-3,530.3	-3,803.2	-4,468.5	-5,008.6	-5,403.0	-5,977.1	-6,599.6
Other	-2,845.4	-2,643.7	-2,521.8	-2,767.2	-3,127.0	-3,443.5	-3,786.3
of which: maize & sugar	-232.2	-219.5	-246.3	-287.4	-340.7	-387.5	-429.8
Balance on goods	-9,549.8	-10,484.9	-12,129.1	-13,242.5	-14,121.3	-15,169.8	-16,502.0
Balance on services	2,563.1	2,823.4	3,090.7	3,391.1	3,749.0	4,172.6	4,653.8
Credit	4,881.7	5,105.9	5,565.8	6,183.7	6,923.7	7,732.6	8,574.1
of which: transportation	2,168.7	2,276.4	2,486.4	2,808.7	3,204.1	3,680.8	4,197.4
of which: foreign travel credit	907.7	933.1	1,038.4	1,150.6	1,264.9	1,380.0	1,505.6
Balance on goods and services	-6,986.7	-7,661.5	-9,038.3	-9,851.4	-10,372.3	-10,997.2	-11,848.1
Income (net)	-226.7	-364.9	-412.5	-284.8	-100.0	-26.5	-6.1
Current transfers (net)	2,973.1	3,522.1	4,079.0	4,418.1	4,799.6	5,237.4	5,695.5
Private (net)	2,765.5	3,391.7	4,021.6	4,386.4	4,805.4	5,262.5	5,720.5
of which: remittances	2,088.7	2,409.8	2,651.6	2,905.1	3,202.2	3,527.4	3,842.8
Capital and financial account	4,838.2	5,166.6	6,654.3	6,886.6	6,752.9	7,086.8	7,634.4
Capital account (incl. capital transfers)	166.5	175.6	255.0	256.2	274.7	294.9	311.9
Financial account	4,671.7	4,991.0	6,399.4	6,630.4	6,478.2	6,791.9	7,322.5
Net FDI	375.7	802.5	1,242.8	1,399.1	1,505.7	1,706.0	1,884.6
In Kenya	386.5	861.1	1,371.3	1,566.2	1,724.3	1,927.4	2,087.0
Abroad	-10.8	-58.6	-128.5	-167.1	-218.6	-221.4	-202.4
Net portfolio investment	105.8	2,101.9	160.2	372.4	379.0	441.2	1,238.3
Liabilities	145.3	2,147.6	208.8	418.8	426.8	487.3	1,284.2
Assets	-39.5	-45.7	-48.6	-46.5	-47.8	-46.1	-45.8
Net other investment	3,453.7	2,610.8	3,971.7	4,861.3	4,589.6	4,641.5	4,548.5
Official, medium and long-term	725.4	-48.7	1,264.4	1,485.0	1,779.3	1,899.4	1,763.5
Inflows	1,005.5	905.1	1,595.3	1,833.1	2,150.8	2,294.0	2,157.3
Outflows	-280.1	-953.8	-330.9	-348.1	-371.5	-394.6	-393.8
Private, medium and long-term	957.9	1,506.1	649.4	1,065.8	1,002.6	899.8	914.5
Energy financing	86.9	108.9	117.1	126.0	137.8	151.7	167.0
Kenya Airways	99.0	195.0	297.2	272.7	129.2	-68.1	-143.8
Other	771.9	1,202.2	235.1	667.1	735.5	816.3	891.3
Short-term capital	1,770.4	1,153.4	2,057.9	2,310.5	1,807.7	1,842.3	1,870.5
of which: commercial banks	372.3	354.3	61.7	58.9	-19.1	0.0	0.0
Errors and omissions	732.3	471.7	0.0	0.0	0.0	0.0	0.0
Overall balance	872.6	937.0	1,282.5	1,168.5	1,080.3	1,300.4	1,475.7
Financing items	-872.6	-937.0	-1,282.5	-1,168.5	-1,080.3	-1,300.4	-1,475.7
Reserve assets (gross)	-1,081.4	-1,000.7	-1,211.7	-1,073.6	-939.6	-1,142.1	-1,075.7
Use of Fund credit and loans to the Fund (net)	203.1	49.1	-76.4	-94.9	-140.7	-158.3	-151.0
Disbursements	225.3	111.4	0.0	0.0	0.0	0.0	0.0
Repayments	-22.1	-62.3	-76.4	-94.9	-140.7	-158.3	-151.0
Memorandum items:							
Gross official reserves (end of period)	6,222.0	7,475.0	8,275.0	9,325.0	10,325.0	11,209.7	12,484.7
(in months of following year's imports of goods and services)	4.0	4.3	4.4	4.6	4.6	4.6	4.6
Import volume growth, goods and services (percent)	6.1	2.4	8.9	11.6	8.2	9.1	8.8
Export volume growth, goods and services (percent)	5.6	4.2	9.7	11.3	10.8	11.0	10.6
Change in the terms of trade (goods and services, percent)	-4.2	-6.2	-1.3	1.5	0.6	1.2	0.7

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

1/ Includes oil exploration-related machinery and equipment.

Table 4b. Kenya: Balance of Payments (percent of GDP) 2011/12–2018/19

(in percent of GDP, financial years)

	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
	Act.	Est.			Projections		
Current account	-8.1	-7.8	-8.4	-8.0	-7.1	-6.5	-6.3
Exports, f.o.b.	11.5	10.0	9.4	9.2	9.1	9.1	9.2
Coffee	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Tea	2.3	1.9	1.7	1.6	1.6	1.6	1.7
Horticulture	1.4	1.3	1.3	1.2	1.2	1.2	1.2
Imports, f.o.b.	-29.7	-28.1	-28.3	-27.7	-26.8	-26.2	-26.0
Oil	-7.2	-6.7	-6.8	-6.4	-6.0	-5.8	-5.8
Other private	-22.2	-21.2	-21.4	-21.1	-20.6	-20.2	-20.0
of which: Chemicals	-4.0	-4.0	-4.1	-3.9	-3.8	-3.8	-3.7
Manufactured goods	-4.5	-4.6	-4.8	-4.9	-4.9	-4.9	-4.9
Power generation-related machinery & aircraft	-1.5	-1.4	-1.5	-1.4	-1.2	-1.0	-0.9
Other capital imports 1/	-6.7	-6.6	-7.0	-7.0	-6.8	-6.7	-6.7
Other	-5.4	-4.6	-3.9	-3.9	-3.9	-3.9	-3.9
of which: maize & sugar	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4
Balance on goods	-18.2	-18.1	-18.9	-18.5	-17.7	-17.1	-16.8
Balance on services	4.9	4.9	4.8	4.7	4.7	4.7	4.7
of which: foreign travel credit	1.7	1.6	1.6	1.6	1.6	1.6	1.5
Balance on goods and services	-13.3	-13.2	-14.1	-13.8	-13.0	-12.4	-12.1
Income (net)	-0.4	-0.6	-0.6	-0.4	-0.1	0.0	0.0
Current transfers (net)	5.7	6.1	6.4	6.2	6.0	5.9	5.8
Private (net)	5.3	5.8	6.3	6.1	6.0	5.9	5.8
of which: remittances	4.0	4.2	4.1	4.1	4.0	4.0	3.9
Capital and financial account	9.2	8.9	10.4	9.6	8.5	8.0	7.8
Capital account (incl. capital transfers)	0.3	0.3	0.4	0.4	0.3	0.3	0.3
Financial account	8.9	8.6	10.0	9.3	8.1	7.7	7.5
Net FDI	0.7	1.4	1.9	2.0	1.9	1.9	1.9
In Kenya	0.7	1.5	2.1	2.2	2.2	2.2	2.1
Abroad	0.0	-0.1	-0.2	-0.2	-0.3	-0.2	-0.2
Net portfolio investment	0.2	3.6	0.2	0.5	0.5	0.5	1.3
Liabilities	0.3	3.7	0.3	0.6	0.5	0.6	1.3
Assets	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	0.0
Net other investment	6.6	4.5	6.2	6.8	5.8	5.2	4.6
Official, medium and long-term	1.4	-0.1	2.0	2.1	2.2	2.1	1.8
Inflows	1.9	1.6	2.5	2.6	2.7	2.6	2.2
Outflows	-0.5	-1.6	-0.5	-0.5	-0.5	-0.4	-0.4
Private, medium and long-term	1.8	2.6	1.0	1.5	1.3	1.0	0.9
Energy financing	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Kenya Airways	0.2	0.3	0.5	0.4	0.2	-0.1	-0.1
Other	1.5	2.1	0.4	0.9	0.9	0.9	0.9
Short-term capital	3.4	2.0	3.2	3.2	2.3	2.1	1.9
of which: commercial banks	0.7	0.6	0.1	0.1	0.0	0.0	0.0
Errors and omissions	1.4	0.8	0.0	0.0	0.0	0.0	0.0
Overall balance	1.7	1.6	2.0	1.6	1.4	1.5	1.5
Financing items	-1.7	-1.6	-2.0	-1.6	-1.4	-1.5	-1.5
Reserve assets (gross)	-2.1	-1.7	-1.9	-1.5	-1.2	-1.3	-1.1
Use of Fund credit and loans to the Fund (net)	0.4	0.1	-0.1	-0.1	-0.2	-0.2	-0.2
Disbursements	0.4	0.2	0.0	0.0	0.0	0.0	0.0
Repayments	0.0	-0.1	-0.1	-0.1	-0.2	-0.2	-0.2
Memorandum items:							
Gross official reserves (end of period)	11.9	12.9	12.9	13.0	13.0	12.7	12.7
Current account balance excluding official transfers and capital imports	-0.2	0.0	0.0	0.4	0.9	1.2	1.3
Exports of goods and nonfactor services	20.8	18.8	18.1	17.9	17.8	17.8	17.9
Imports of goods and nonfactor services	-34.1	-32.0	-32.2	-31.6	-30.8	-30.3	-30.0

Sources: Kenyan authorities; and staff estimates and projections.
1/ Includes oil exploration-related machinery and equipment.

Table 5. Kenya: Financial Soundness Indicators, 2009-2013

	2009	2010	2011	2012	2013
Capital Adequacy					
Regulatory Capital to Risk-Weighted Assets	19.6	20.8	19.4	21.9	23.2
Regulatory Tier 1 Capital to Risk-Weighted Assets	17.4	18.7	17.3	18.9	19.4
Core Capital to Total Deposits	14.5	15.7	15.5	16.3	17.1
Total Capital to Total Assets	12.7	13.2	13.2	14.2	14.9
Asset Quality					
Non-performing Loans to Total Gross Loans	7.9	6.3	4.4	4.5	5.0
Non-performing Loans Net of Provisions to Capital	11.8	6.4	3.5	3.5	5.8
Bank Provisions to Non-performing Loans	66.3	75.3	82.2	80.9	70.7
Earning Assets to Total Assets	87.9	88.8	87.8	87.4	88.9
Earning and profitability					
Return on Assets	2.3	3.7	3.3	3.8	3.6
Return on Equity	20.1	30.7	32.2	34.2	28.9
Interest Margin to gross income	35.6	34.7	38.6	32.7	37.2
Non interest expense to gross income	50.8	48.2	44.6	37.8	41.7
Liquidity					
Liquid Assets to Total Assets	36.0	38.4	33.3	35.2	34.3
Liquid Assets to Short Term Liabilities	39.8	44.5	37.0	41.9	38.6
Liquid Assets to Total Deposits	46.3	51.0	43.8	46.8	47.0
Total Loans to Total Deposits	72.4	72.5	77.5	76.9	80.4
Sensitivity to Market Risk					
Net Open Position in Foreign Exchange to Capital	4.9	4.3	3.3	2.6	2.2
Interest Bearing Assets to Interest Bearing Liabilities	113	117	115	116	121
Foreign-Currency-Denominated Assets to Total assets	8.1	10.6	11.8	13.2	13.7
Foreign-Currency-Denominated Liabilities to Total Liabilities	18.1	17.1	21.5	20.9	22.9
Spread Between Lending and Deposit Rates	7.7	9.3	8.4	10.3	8.9
Total Expenses to Gross Income	71.4	64.2	65.2	69.5	65.2

Sources: Central Bank of Kenya

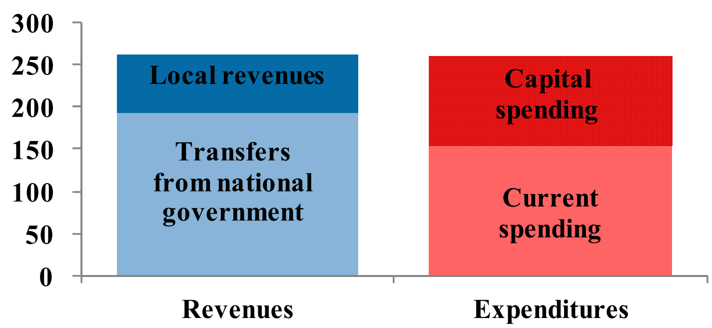
Annex I. Devolution: Recent Developments, Transitional Challenges, and the Medium-Term Outlook

The first year of devolved government has been successful in implementing the basic institutional framework, in a context of improved transparency. Common teething problems have their roots in capacity constraints of the counties, transitional issues in establishing adequate coordination between the two layers of government, and weak accountability at the county level. However, other challenges that are specific to devolution in Kenya have also emerged and could—if left unaddressed —negatively affect fiscal sustainability in the medium-term, including (i) devolution related wage bill issues, (ii) resolution of debt inherited from previous local authorities, (iii) unfavorable composition of spending and (iii) unclear guidelines on potential county borrowing and contingent liabilities. The staffing of the Intergovernmental Fiscal Relations Department is crucial in helping to address the observed challenges, especially through assisting in capacity building at the county level.

A. BACKGROUND AND RECENT DEVELOPMENTS

1. **Large transfers to counties show a political will to introduce devolution quickly.** County budgets for FY 2013/14 amount to KSh261bn, or 5.2 percent of Kenya's GDP (Figure 1).[1] Budgets are financed by equitable share transfers from the national government (74 percent of total county budgets), conditional grants (1 percent of total), and own-source revenue collections (25 percent of total). In aggregate, counties have allocated around 63 percent of their budgets to current spending, and the remaining to development spending.

Figure 1: County-level Budgets, FY 2013/14
In billions of Kenyan Shillings



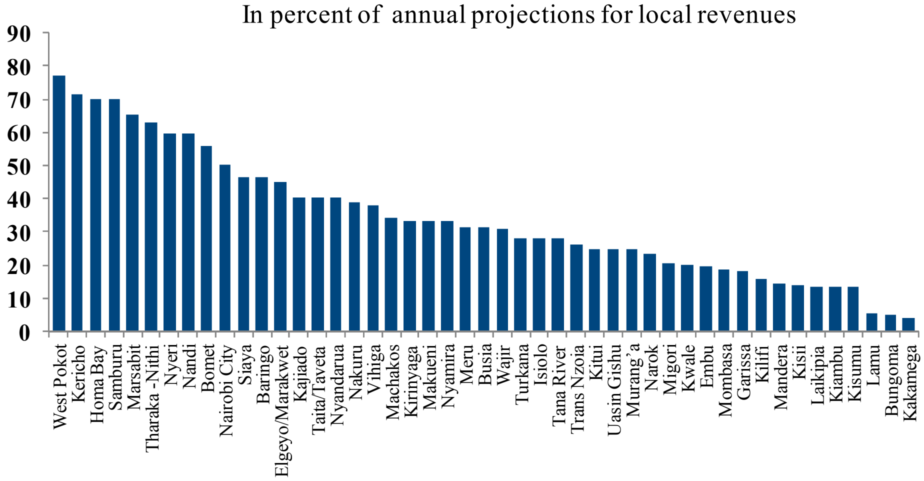
Sources: Kenyan authorities and IMF staff estimates.

[1] Counties are entitled to receive a minimum of 15 percent of nationally raised revenues. The current allocation significantly exceeds this number due to a fast-track approach to devolution. In the medium term, improvement of own source revenue collection by counties should, in principle, reduce dependency on intergovernmental transfers.

2. **Own-source revenue collection was initially low but improved slightly during the third quarter of FY 2013/14, relative to annual budgeted amounts (Figures 2 and 3).** In aggregate, counties projected that local revenue collections will reach KSh68bn during the current fiscal year. However, some counties may have initially inflated their local revenue projections to achieve balanced budgets.[2] Actual revenue collections amounted to only around KSh19.1bn during the first three quarters of the fiscal year. However, there has been a noticeable improvement in revenue collections during the third quarter, owing to greater revenues from single business permits. It is expected that revenues will reach around KSh24bn at the end of the current fiscal year, registering an increase from the KSh19.7bn that was collected by the defunct local authorities in 2012/13.

Figure 2: Actual local revenues, first half of FY 2013/14

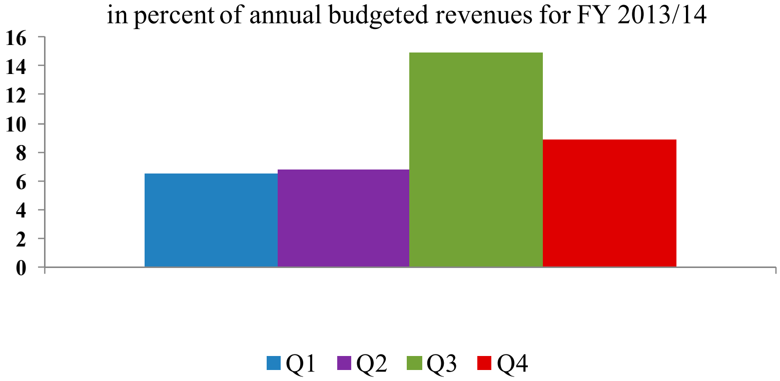
In percent of annual projections for local revenues



Sources: Kenyan authorities and IMF staff estimates.

Figure 3: Quarterly local revenue by counties

in percent of annual budgeted revenues for FY 2013/14



Sources: Kenyan authorities and IMF staff estimates

3. **During the first nine months of FY 2013/14, counties experienced an improvement in their absorption capacity (Figure 4).** However, absorption remains low: counties received

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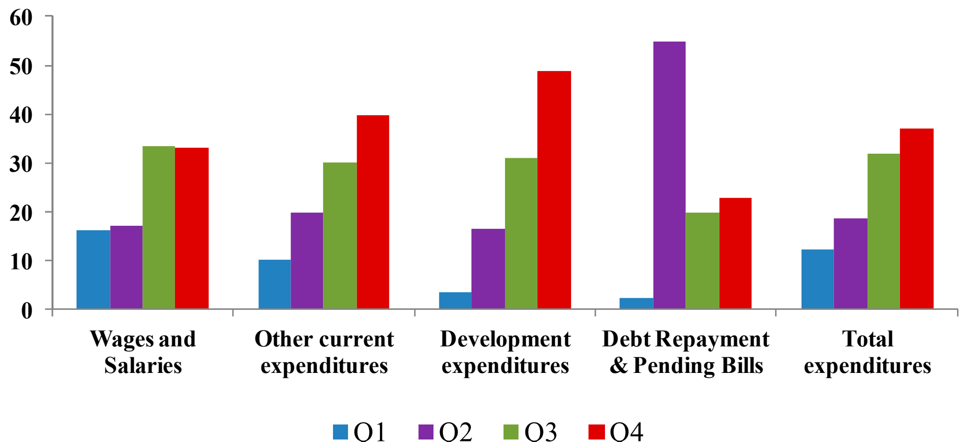
[2] This is based on information from the Local Government database that was provided by the Department of Devolution and Planning.

KSh133.3bn during the first three quarters of the fiscal year (KSh110.1bn in national transfers and the remaining in local revenue collections), but spent only KSh106.6bn, which include wage spending on devolved staff, initially paid on their behalf by the central government .[3] Total spending is expected to rise to around KSh169bn by the end of the fiscal year, on account of higher current and development spending (Figure 4). Based on projected transfers and local revenue collections for the full fiscal year, counties would still accumulate around KSh50bn in bank deposits because of under-spending (about 1 percent of GDP).

Figure 4: Actual quarterly spending by counties
in percent of total spending for FY 2013/14



Sources: Kenyan authorities and IMF staff estimates.

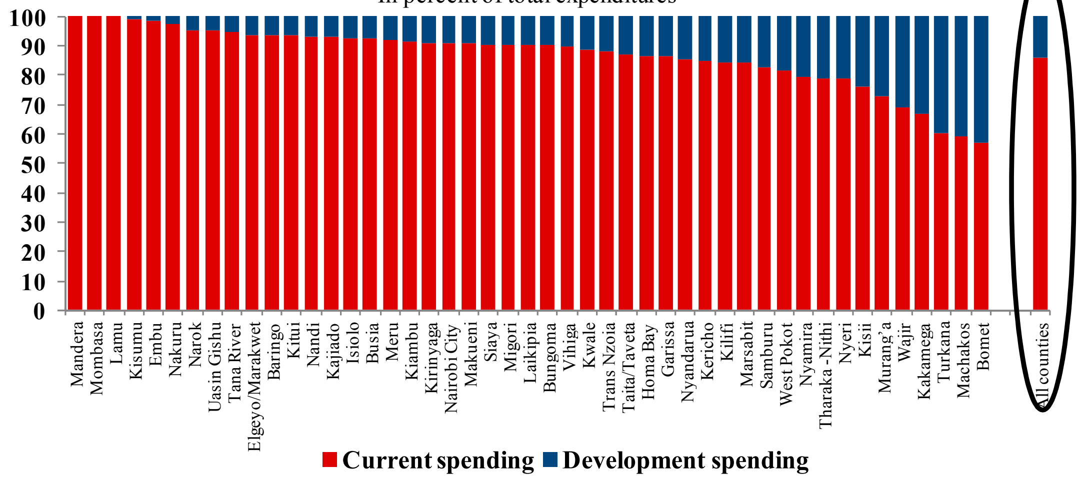
4. **Development spending is far below the envisaged goal of 30 percent of total expenditure.** Lagging development spending is explained by still inadequate procurement systems and some initial delays in disbursements by the central government. By contrast, during the first three quarters of FY 2013/14, current spending amounted to 86.1 percent of total county spending (Figure 5). However, development spending absorption rate has been gradually improving and is expected to continue improving over time, with the exception of a few large counties facing structural high costs inherited from the previous local authorities.[4]

5. **The high current spending by counties consists largely of wages and salaries.** Counties spent more than half of their resources during the first three quarters of 2013/14 on wages, including wages paid to devolved staff on their behalf by the central government. The high wage bill reflects a large number of staff inherited from previous local governments, new recruitment by counties, wage increases, and high salaries of county assembly support staff.

[3] An initial delay in the enactment of the County Allocation of Revenue Act (2013) resulted in a delay in the disbursement of transfers to the counties. Counties are now receiving regular monthly cash disbursements.

[4] Nairobi, Mombasa, Kisumu, and Nakuru. .

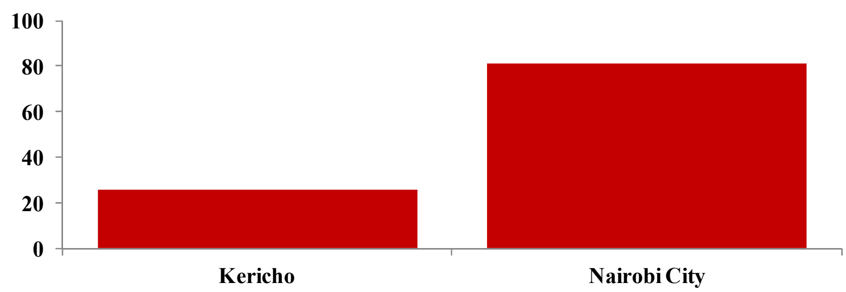
Figure 5: County-level expenditures, Third quarter (cumulative) of FY 2013/14
In percent of total expenditures



Sources: Kenyan authorities and IMF staff estimates.

6. **Some counties may have spent funds from own-sources revenue without following legal provisions.** In particular, some counties recorded expenditures that were higher than actual funds released to their accounts, most notably to finance current activities (Figure 6). This implies that these counties may have spent resources from local revenues without seeking the required authorization from the Office of the Controller of the Budget.[5]

Figure 6: Current spending in excess of funds released to county operational accounts, Third quarter (cumulative) of FY 2013/14
In percent of funds released



Sources: Kenyan authorities and IMF staff estimates.

7. **Some counties dispute the assumption of existing liabilities from former local authorities.** However, the attorney-general has issued a legal opinion that county governments are the successors of former local authorities and bear the obligations of the defunct local authorities. County debt repayments of inherited debt from previous local authorities during the first three quarters of 2013/14 amounted to around KSh3bn (3 percent of total expenditure). The Transition Authority is expected to verify assets and quantify all liabilities by end-December 2014.

[5] The fact that some counties spent outside of funds released to their operational accounts does not imply an accumulation of arrears since budgets are on a cash basis.

8. **Some devolution-related wage bill issues could have negative fiscal implications on general government finances.** First, counties have embarked on an ambitious hiring process, potentially duplicating positions of national staff in counties and adding to already large redundancies. Second, the FAD TA report states that around 4,200 new staff (legislative officials and county executives) may be added to the 2,600 staff already in place. Third, former local authority staff and members of county assemblies have awarded themselves substantial wage increases during 2013/14. All this could create significant pressures on general government finances in the medium term unless the national government adopts clear wage and remuneration polices and guidelines ideally in the context of a rationalization program.

9. **Distortions created by the formula for the allocation of resources among counties need to be addressed**. During the first year of implementation, county budgets had already been adopted before specific functions were transferred to the counties. Moreover, some functions remained within the national government even though the funds had been transferred to counties. These distortions result in further pressures on central government finances.

10. **County borrowing should be consistent with the medium-term fiscal framework.** At the moment, borrowing by counties requires government guarantees according to the constitution and should only be used to finance development projects. The National Treasury is determined to provide guarantees to counties only after they develop an adequate capacity to monitor their fiscal risks, with resources being made available in line with the counties' capacity to repay and debt sustainability. This approach should be formalized to avoid potential impact on fiscal sustainability if these guarantees are de-facto called.

11. **Accountability for public resources at counties remains weak.** Counties are independent according to the Constitution, but their policies should be consistent with national government policies. Current spending includes non-negligible allocations to domestic and foreign travel, purchase of motor vehicles and MCA allowances to members of the county assemblies with unclear justification. Accountability in this regard should be strengthened by county assemblies, the Kenya Audit Office and the Parliament.

12. **The Intergovernmental Fiscal Relations Department could help address transitional challenges.** A first step would be to fully staff the Department as early as possible. Once the Intergovernmental Fiscal Relations Department is staffed, it will provide fiscal oversight over country budgets, fiscal reporting and fiscal policy, develop a repository of fiscal data for counties, and help to improve accountability of counties for public resources.[6] Complementary policy actions would also cover areas such as wage bill sustainability, composition of spending, legacy debt and potential borrowing by counties.[7] The National Treasury has proposed a structure to provide financial oversight of counties.

[6] The Public Service Commission has approved recruitment of the top three officials for this department.

[7] This role will be especially significant when counties start applying for loan guarantees.

INTERNATIONAL MONETARY FUND

KENYA

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

September 8, 2014

Prepared By

The African Department
(In consultation with other departments)

CONTENTS

RELATIONS WITH THE FUND

(As of June 30, 2014)

Membership Status: Joined: February 03, 1964; Article VIII

General Resources Account:	**SDR Million**	**%Quota**
Quota	271.40	100.00
Fund holdings of currency (Exchange Rate)	258.12	95.11
Reserve Tranche Position	13.29	4.90

SDR Department:	**SDR Million**	**%Allocation**
Net cumulative allocation	259.65	100.00
Holdings	5.12	1.97

Outstanding Purchases and Loans:	**SDR Million**	**%Quota**
ESF RAC Loan	135.70	50.00
ECF Arrangements	547.27	201.65

Latest Financial Arrangements:

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
ECF	Jan 31, 2011	Dec 16, 2013	488.52	488.52
ECF [1/]	Nov 21, 2003	Nov 20, 2007	150.00	150.00
ECF [1/]	Aug 04, 2000	Aug 03, 2003	190.00	33.60

[1/] Formerly PRGF.

Projected Payments to Fund [2/]
(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2014	2015	2016	2017	2018
Principal	26.07	47.14	48.65	85.75	103.27
Charges/Interest	0.11	1.80	1.69	1.52	1.29
Total	26.18	48.94	50.34	87.27	104.56

[2/] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Implementation of HIPC Initiative: Not Applicable

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

Implementation of Post-Catastrophe Debt Relief (PCDR): Not Applicable

Safeguards Assessments:

An update safeguards assessment of the Central Bank of Kenya (CBK) was completed in March 2012 with respect to the augmentation of access under the ECF Arrangement approved on December 9, 2011. The assessment found that the temporary governance gaps of the Board and Audit Committee identified in the 2011 assessment have been rectified. These oversight bodies have now been fully restored to support effective discipline and responsibility. The Audit Committee concluded satisfactorily on its ex-post assessment of the gaps, and the external auditor issued an unqualified audit opinion for 2011. The assessment recommended adopting an action plan to resolve the large stock of pending audit recommendations. Aside from amending the CBK Act, almost all recommendations of the earlier assessment have been implemented on schedule. The authorities have committed to submit revisions to the CBK Act to the National Assembly. Internal audit has resumed certifying reconciliations supporting the monetary data reporting to the Fund.

Exchange Rate Arrangement:

Kenya's currency is the Kenyan Shilling. Kenya's de jure exchange rate arrangement is free floating and its de fact exchange rate arrangement is classified as floating. The official exchange rate, which is set at the previous day's average market rate, applies only to government and government-guaranteed external debt-service payments and to government imports for which there is a specific budget allocation. On August 28, 2014, the exchange rate was KSh88.3786=US$1.00.

Kenya accepted the obligations of Article VIII, Sections 2, 3, and 4 of the IMF Articles of Agreement with effect from June 30, 1994, and maintains an exchange system free of restrictions on payments and transfers for current international transactions, other than restrictions notified to the Fund under Decision No. 144 (52/51).

Article IV Consultation:

The last Article IV consultation with Kenya concluded on November 23, 2011. The next Article IV consultation with Kenya is expected to take place on a 12-month cycle,

FSAP Participation:

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

Technical Assistance:

Technical assistance activities provided to Kenya since 2011 are listed below.

	Year of Delivery
Fiscal Affairs Department (FAD)	
AFRITAC East: Several PFM review missions	2014
AFRITAC East: Harmonizing PFM among EAC partners	2014
Workshop on medium-term budget frameworks	2014
Fiscal decentralization support	2013
Workshop on FARI model	2013
Revenue administration	2013
Natural resource management	2013
AFRITAC East: Improving efficiency in customs	2013
AFRITAC East: Several PFM review missions	2013
Workshop on public sector wages	2013
AFRITAC East: Several PFM review missions	2012
PFM Act implementation	2012
Pension reform	2011
Tax Administration/VAT	2011
Several PFM review missions	2011
Monetary and Capital Markets Department (MCM)	
AFRITAC East: ICAAP/SREP implementation	2014
Inflation targeting	2014
Pensions supervision	2014
Enhancing CMA's investigative techniques and enforcing capacity	2013
Bank stress testing	2013
Monetary operations and Instruments	2012
AFRITAC East: Several missions on consolidated supervision	2012
Insurance stress testing/Early warning system	2012
AFRITAC East: Several missions to CBK on liquidity forecasting	2012
AFRITAC East: Strengthening surveillance systems	2011

Bank stress testing	2011
Conducting onsite inspection and consolidated supervision	2011
Insurance and pension supervision	2011

Legal Department (LEG)

Strengthening AML/CFT regime	2013-14
VAT regulations, excise law and regulations, tax procedures	2013
Natural Resources Law	2013
Central Bank Law	2013
Tax legislation	2011

Research Department (LEG)

Modernizing Monetary Policy by developing an FPAS	2012-14

Statistics Department (STA)

Several missions on National Accounts	2014
AFRITAC East: GFS mission	2014
Price Statistics (XMPIs, PPI, construction	2013
National Accounts	2013
Government Finance Statistics	2012
National Accounts	2012
Price Statistics (CPI)	2011
Government Finance Statistics Mission	2011
AFRITAC East Mission on Quarterly National Accounts	2011
DFID III follow-up GFS to implement	2011

XV. Resident Representative:

Mr. Ragnar Gudmundsson, since August 2010.

STATISTICAL ISSUES APPENDIX

(as of July 31, 2014)

I. Assessment of Data Adequacy for Surveillance
General: Data provision has some shortcomings because of capacity constraints, but is broadly adequate for surveillance and program monitoring. Although the overall quality, timeliness and coverage of macroeconomic statistics have improved over the past few years, further improvements in the methodology of compiling real, fiscal, and external sector statistics would be desirable in order to facilitate enhanced design and monitoring of economic policies.
National Accounts: The Kenya National Bureau of Statistics (KNBS) has made significant efforts to enhance national statistics compilation. Limited funding for data collection activities, a long-term funding strategy, and a lack of trained staff remain major constraints. The East AFRITAC statistics advisor is assisting with improving and rebasing the annual and quarterly national accounts estimates at current and constant (from 2001 to 2009) prices, and developing 2009 supply and use tables (SUTs) to better anchor the annual GDP estimates, along with other methodological changes. Improved source data and the balancing of economic flows via the SUTs will result in improved coverage, more robust estimates, and an expected increase in estimated levels of measured GDP. The KNBS is participating in the Quarterly National Accounts (QNA) Statistics Module of the IMF-U.K. Department for International Development (DFID).
Price Statistics: KNBS still faces significant challenges in its compilation of price indices. In particular, the compilation and dissemination of CPI series at a detailed level with a historical dimension. Three East AFRITAC TA missions in 2010— 2013 advised on improvements to all KNBS price statistics. The KNBS released rebased export and import price indexes (XMPIs) using Customs unit value trade data in May 2012 (previously compiled on a base year of 1982). Recommendations have been made for improving the methodology along with proposals for a major rebase, of the construction price index (currently 1972). The KNBS commenced dissemination of a new quarterly producer price index for mining and quarrying, manufacturing and utilities from October 2012.
Government Finance Statistics: A GFS TA mission under the GFS Module of the Enhanced Data Dissemination Initiative (EDDI) project funded by DFID visited Nairobi in October 2011. It identified a number of shortcomings and made recommendations to address them: set-up a tripartite technical working group (MOF, CBK, and KNBS) to determine the institutional coverage of the general government sector (public sector) and subsectors; disseminate the monthly budget outturn on the MOF's website, and report regularly these data to STA for publication in International Financial Statistics (IFS); reconcile on a regular basis the monthly, quarterly, and annual fiscal statistics; investigate the causes of the large discrepancy between net lending and financing; compile and disseminate fiscal statistics for budgetary central government following GFSM 2001 classifications

and tables, and gradually expand the coverage to include the major extra-budgetary units and social security funds; and prepare a migration plan with a detailed timetable for gradual migration to the GFSM 2001 methodology. An October 2012 follow-up GFS TA mission under the EDDI project found that some progress had been made implementing the recommendations of the earlier mission and assisted the authorities to further implement those recommendations. East AFRITAC (AFE) has begun collaborating closely with the EAC Secretariat to support efforts to improve compilation and dissemination of GFS based on the Government Finance Statistics Manual 2014 (GFSM 2014) to achieve the fiscal data requirements associated with the East African Monetary Union (EAMU) Protocol. A series of AFE TA missions are expected to take place to further support efforts to improve GFS.
Monetary and Financial Statistics: Progress has been shown in the compilation of monetary data. Kenya benefited from participation in the monetary statistics module in Phase II of the DFID Project. The main objectives of the Project were the adoption of internationally accepted methodologies and best practices as recommended by the *Monetary and Financial Statistics Manual* (*MFSM*) in monetary data compilation, and establishment of an Integrated Monetary Database (IMD) that meets the needs of all users on monetary data. However, Kenya's monetary and financial statistics (MFS) do not include data on other financial corporations, a growing sector in the country.
Financial sector surveillance: Kenya does not participate in the IMF's Coordinated Direct Investment Survey (CDIS) and the Coordinated Portfolio Investment Survey (CPIS). Kenya reports 11 core FSIs and 10 encouraged FSIs for deposit takers. Data on the household debt to gross domestic product ratio is also reported. However, FSIs on other financial corporations and nonfinancial corporations are not available.
External sector statistics: The KNBS compiles annual balance of payments statistics in Kenya shillings that are regularly reported to STA. In addition, the Central Bank of Kenya (CBK) compiles a complete set of annual balance of payments statistics in U.S. dollars, which are reported to AFR and used for programming and surveillance purposes. The two datasets are not entirely consistent, and Fund staff has strongly encouraged the authorities to reconcile them. Although the overall quality of trade data may be reasonably good, data for other current account and many financial account transactions are rather weak. The financial account is largely drawn from the International Transactions Reporting System (ITRS) which suffers from a large and growing element of unclassified inflows and outflows that might well include settlements of current account transactions. Kenya participates in phase II of the external sector module of the DFID Project. Four TA missions have been conducted under the auspices of this project to undertake a comprehensive enterprise survey of cross-border financial flows and stocks on an annual basis with a view to significantly improving the quality of balance of payments and to compile international investment position statistics.

During 2013, the KNBS completed its second Foreign Investment Survey (FIS). It is expected that this survey could be undertaken on an annual basis.

The KNBS and the CBK analyze the large differences between the results of this survey and the financial account data disseminated in its balance of payments statistics, obtained from the ITRS, in order to explain the revisions that are expected to be taken in the balance of payments statistics. The results could also be used to develop an IIP statement consistent with the revised balance of payments.

II. Data Standards and Quality

Kenya participates in the Fund's GDDS and the EDDI project for Anglophone Africa. A Data ROSC was conducted in October 2005.

III. Reporting to STA

The data for the budgetary central government, submitted for publication in the *GFS Yearbook,* have been reported in *GFSM 2001* format, albeit with a significant lag. Monthly and quarterly GFS data are regularly reported for inclusion in the *International Financial Statistics (IFS)*. Monetary data for the central bank and ODCs are regularly reported for inclusion in the *IFS*. Annual balance of payments data, following *BPM5* classifications, are regularly reported to STA.

Table of Common Indicators Required for Surveillance

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items:[8]	
						Data Quality – Methodological soundness[9]	Data Quality – Accuracy and reliability[10]
Exchange rate	8/28/14	8/28/14	D	D	M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]							
Reserve/Base Money	8/28/14	8/28/14	D	D	M	LO, LO, LO, LO	LO, LO, O, O, NO
Broad Money	6/30/14	7/31/14	M	M	M		
Central Bank Balance Sheet	7/15/14	7/31/14	M	M	M		
Consolidated Balance Sheet of the Banking System	6/30/14	7/31/14	M	M	M		
Interest Rates[2]	8/28/14	8/28/14	D	D	M		
Consumer Price Index	7/30/14	7/31/14	M	M	M		
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]			NA	NA	NA	LNO, LNO, LNO, LO	LNO, LO, LO, LO, NO
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	6/31/14	7/31/14	M	M	Q		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	5/31/2014	7/25/14	M	M	M	LO, LO	LO, LO
External Current Account Balance	5/31/14	7/31/14	M	M	M	O, LO, O, LO	LNO, LO, LO, LO, LO
Exports and Imports of Goods and Services	5/31/14	7/31/14	M	M	M		
GDP/GNP	31/12/13 (A) 31/3/14 (Q)	5/14/14 6/30/14	Q,A	Q,A	Q,A	O, LO, LNO, LO	LNO, LO, LNO, LO, LNO
Gross External Debt	5/31/14	7/25/14	M	M	M	LNO	LNO
International Investment Position[6]	31/12/12	...	NA	NA	NA		

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

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

[3] Foreign, domestic bank, and domestic nonbank financing.

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

[5] Including currency and maturity composition.

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

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

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

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

JOINT WORLD BANK-FUND WORK PROGRAM, 2014

Title	Products	Provisional timing of missions (if relevant)	Expected delivery date
A. Mutual information on relevant work programs			
Key elements of World Bank work program in next 12 months	Kenya economic update (bi-annually)		December 2014
	The World Bank continues to lead and facilitate the Public Expenditure Review (PER) process in Kenya with government.		December 2014
	Governance and public sector (including PFM)		Ongoing
	Report on revenue sharing; technical assistance on revenue enhancement and conditional grants;		Ongoing
	Conference on Sub-national borrowing		September 2014
	Oil and gas management (including revenue management)		Ongoing
	Financial sector innovation (financial products for SMEs with a focus on factoring and mobile technology)		Ongoing
	Infrastructure/PPP project		Ongoing
	Value chain analysis in manufacturing		June 2015
IMF work program in next 12 months	Program negotiations for a precautionary arrangement	October 2014	December 2014
	First Review	March 2015	June 2015

B. Requests for work program inputs			
Fund requests to Bank	1. Assessment of key infrastructure projects and sectoral programs.		Continuous
	2. Inputs on the design of a social protection framework.		Continuous
	3. Inputs on sources of growth for private sector development and job creation.		Continuous
Bank requests to Fund	1. Monitoring of government contracting of non-concessional borrowing.		Continuous
	2. Monitoring of steps to strengthen corporate governance of the CBK		Continuous
	3. Sharing macro-framework updates.		Continuous
	4. Statement of fiscal risk and contingent liabilities.		Continuous
C. Agreement on joint products and missions			
Joint products in next 12 months	1. Collaborate on a joint DSA	August 2014	September 2014
	2. Enhancing PFM systems at national and sub-national level		ongoing
	3. Support to development of regulatory framework, fiscal regime, and macro-fiscal management for oil and gas		ongoing

INTERNATIONAL MONETARY FUND

KENYA

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS

September 8, 2014

Approved By
Roger Nord and Chris Lane (IMF) and John Panzer (IDA)

Prepared by staffs of the International Monetary Fund and the International Development Association

Kenya's debt outlook is favorable. Improvements in PV terms since the previous Debt Sustainability Analysis (DSA), published in 2013, reflect a higher discount rate. Kenya's risk of external debt distress remains low, while overall public sector debt dynamics continue to be sustainable.[1] *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.*

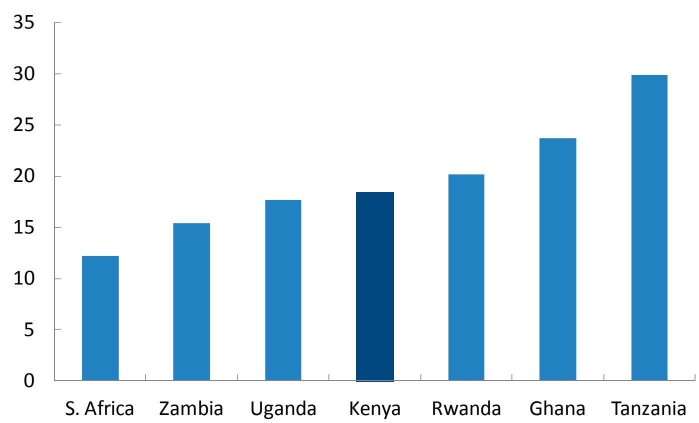
[1] The World Bank in 2013 upgraded its classification of Kenya to "strong performer" in terms of the quality of its policies and institutions as measured by a three-year average of the World Bank's Country Policy and Institutional Assessment (CPIA) Index. The relevant indicative thresholds for this category are: 50 percent for the NPV of debt-to-GDP ratio, 200 percent for the NPV of debt-to-exports ratio, 300 percent for the NPV of debt-to-revenue ratio, 25 percent for the debt service-to-exports ratio, and 22 percent for the debt service-to-revenue ratio. These thresholds are applicable to public and publicly guaranteed external debt.

BACKGROUND

1. **Kenya's overall public debt has been stable in recent years.** At end-2013, gross public debt totaled 41 percent of GDP, and has remained stable at around 41–42 percent of GDP since 2010. A little under half of Kenya's public debt is owed to external creditors. The DSA consists of two parts: external and public. The external DSA covers external debt of the central government and the central bank, as well as of the private sector; stress tests apply to public and publicly guaranteed by the government. The public DSA covers total debt—external and domestic—incurred or guaranteed by the central government. Public domestic debt comprises central government debt; government finance statistics are to be expanded to cover the newly created county governments. 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).

2. **Most of Kenya's external public debt remains on concessional terms, but its commercial component is increasing in 2014 with Kenya's first sovereign bond issuance.** Nominal public external debt as at end-2013 was USD 10 billion (text table), equivalent to 18 percent of GDP—broadly in line with comparable SSA countries (text chart). Multilateral creditors continued to account at end-2013 for more than 60 percent of external credit to Kenya. The share of debt from private creditors is set to increase in 2014, reflecting Kenya's successful inaugural

Figure 1: External Public Debt in Selected SSA Countries
(percent of GDP, 2013)



Sources: Country authorities, and IMF staff estimates.

Kenya: External Public Debt

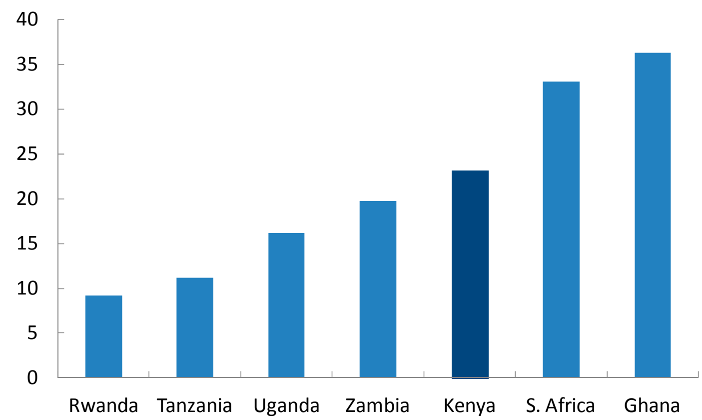
	2011		2012		2013	
	Billion USD	Share	Billion USD	Share	Billion USD	Share
Multilateral creditors	4.97	61.7	5.56	57.6	6.47	60.5
Bilateral creditors	2.29	28.4	2.71	28.1	2.84	26.6
Commercial banks	0.00	0.0	0.68	7.0	0.69	6.5
Others (supplier credits)	0.26	3.2	0.18	1.9	0.18	1.7
Total (excluding guarantees)	7.52	93.4	9.13	94.6	10.18	95.2
Publicly guaranteed debt	0.53	6.6	0.52	5.4	0.51	4.8
Total (including guarantees)	8.05	100.0	9.65	100.0	10.69	100.0

Source: Kenyan National Treasury.

sovereign bond issuance in June 2014. The USD 2 billion issuance comprises a 5-year bond totaling USD 500 million a 10-year bond totaling USD 1.5 billion. Kenya previously obtained commercial debt in 2012 through a two-year syndicated loan of about USD 600 million. In addition, in May 2014 Kenya signed an agreement with China featuring USD 3.8 billion in semi-concessional loans to finance construction of a regional railway. The authorities expect these loans to be disbursed over the next four years. Kenya did not seek debt relief under either the HIPC or MDRI initiatives.

3. **Kenya's gross domestic public debt[1] was around 23 percent of GDP at end-2013.** Domestic debt is issued mostly in the form of Treasury bonds (68 percent of domestic debt) and Treasury bills (27 percent). Commercial banks and nonbanks now hold roughly the same share of domestic debt (47 percent each); the central bank holds most of the remainder. The nonbank share has increased significantly over the past few years, reflecting greater diversification of the domestic investor base. Despite the relatively large size of the domestic debt (text chart), and some modest shortening of its maturities over the past two years, rollover risks remain moderate: the average maturity of Kenya's domestic debt was 5 years at end-2013, albeit down from 5.8 years in June 2011.

Figure 2: Domestic Public Debt in Selected SSA Countries
(percent of GDP, 2013)



Sources: Country authorities, and IMF staff estimates.

UNDERLYING ASSUMPTIONS

4. **This DSA is based on macroeconomic assumptions that are consistent with the framework outlined in the Staff Report for the 2014 Article IV consultation.** Notable revisions compared with the April 2013 DSA include (text table):

- Real GDP growth is weaker in short term but higher in the long term (Table 2), reflecting both the short-term impact of lower terms of trade but also sustained higher growth rates in the services sector.

  The primary fiscal deficit is projected to be around 2 percent of GDP wider in the short term owing largely to significant spending needs associated with devolution. In the medium term,

[1] Net domestic debt—gross domestic debt less government deposits at the central bank and at commercial banks, and government advances to parastatals—was slightly lower, at 21 percent of GDP at end-2013.

Kenya: Selected Macroeconomic Assumptions

	2012	2013	2014	2015	Long term
Real GDP Growth					
Current DSA 1/	4.5	4.6	5.0	5.8	7.0
Previous DSA (April 2013)	4.7	5.8	6.1	6.3	6.0
Primary Fiscal Deficit (percent of GDP)					
Current DSA	2.8	3.5	3.2	2.3	0.9
Previous DSA (April 2013)	2.2	2.0	1.6	1.4	1.1
Non-interest Current Account Deficit (percent of GDP)					
Current DSA	8.2	8.4	7.3	8.1	5.8
Previous DSA (April 2013)	8.7	7.1	7.8	7.1	3.9

Source: IMF staff estimates.

1/ Fiscal-year basis. The authorities expect to release upwardly revised GDP statistics in September 2014.

the authorities' commitment to regional integration implies a policy of deficit reduction.[1] In the long term, the primary deficit would be kept close to its previously projected level.

- The GDP deflator is projected to be higher in the medium term, reflecting pass-through from past falls in the terms of trade, though the terms of trade is projected to recover in subsequent years.

- Abstracting from the upward revision of GDP, the projected current account deficit is substantially wider reflecting larger historical deficits, current imports associated with oil exploration-related investment, and higher longer-term investment needs. The baseline does not include recent oil discoveries, pending confirmation that these will be commercially viable.

- The discount rate used to calculate the present value (PV) of external debt, now uses the unified rate of 5 percent, compared with 3 percent in the previous DSA. As flagged at the Sixth Review under the ECF (November 2013), the use of the revised (higher) discount rate results in a more favorable debt profile in PV terms.

- Indicative thresholds for debt are higher, owing to Kenya's improved CPIA rating.

[1] The EAC Monetary Union Protocol provides for fiscal convergence criteria including a ceiling on the fiscal deficit including grants of 3 percent of GDP; and a ceiling on the gross public debt of 50 percent of GDP in net present value terms. The other macroeconomic convergence criteria include a ceiling on headline inflation (8 percent) and a floor on reserve cover (4.5 months of imports). The fiscal plans outlined in the authorities' budget policy statement are consistent with Kenya meeting the EAC convergence criteria by 2021.

EXTERNAL DEBT SUSTAINABILITY ANALYSIS

5. **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:

- **Under the baseline scenario, the debt burden remains sustainable over the 20-year projection period (Table 1a).** As a result of the issuance of the sovereign bond and railway-related loan package, the NPV of external debt would rise to 16 percent of GDP at end-2014 and stabilize at 16–17 percent (well below the 50 percent indicative threshold). The NPV of the debt-to-exports ratio would plateau at 90–95 percent in the medium term, remaining well under an indicative threshold of 200 percent.

- **Standard stress tests do not reveal significant vulnerabilities (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 17 to 26 percent in 2033, but still well below the relevant threshold.

- **The current account balance could improve significantly if recent resource discoveries are confirmed as profitable.** Kenya is currently a net oil importer. However, an oil company has reported estimated discovered resources of at least 600 million barrels of oil equivalent, and oil and gas exploration activities are continuing. If recent discoveries are confirmed as commercially viable, Kenya could become self-sufficient in 3–5 years and a net exporter in 5–10 years. This represents significant upside potential for the medium to long term.

PUBLIC DEBT SUSTAINABILITY ANAYLISIS

6. **Public debt peaks in 2015 and subsequently remains on a downward trend in the baseline scenario.** In 2014, overall public debt is projected to rise to 45 percent of GDP. The sovereign bond issuance and railway loan disbursements lift public debt to around 46 percent of GDP in 2015 (Table 2a). In subsequent years, on the basis of a primary deficit kept to 3 percent of GDP in 2016 and gradually brought down thereafter, public debt eases below 46 percent of GDP by 2018. In PV terms, the public debt-to-GDP ratio would remain stable around 41–42 percent through end-2018 (Table 2b), falling thereafter. The PV of public debt-to-revenue ratio gradually would decline from around 200 percent in 2014–15 to 191 percent in 2018.

7. **The alternative scenarios and bound tests indicate that the projected paths for all debt indicators remain under the relevant thresholds (Table 2b and Figure 2).** The shock with the highest negative impact on debt dynamics is real GDP growth one standard deviation below the historical average.

This shock pushes the ratio of PV of debt-to-GDP to 49 percent in 2018 compared with the baseline 41 percent; the PV of debt-to-revenue ratio to 229 percent from 191 percent, and the PV of debt service-to-revenue ratio to 30 percent from 26 percent by 2018. An unchanged primary balance from 2013 would have similar results. However, the authorities plan to reduce the primary balance in the medium term, consistent with the fiscal convergence deficit and debt criteria of the East African Community (EAC) monetary union.

8. **The devolution process has made concrete progress, but is also presenting challenges that—if left unaddressed—could have important medium-term fiscal implications.** Significant central government powers were devolved to 47 newly created county governments during the current fiscal year. Transitional challenges have emerged, as evidenced by capacity constraints at county level and problems in establishing adequate coordination between the two levels of government. From a general government perspective, underspending by counties could result in a lower budget deficit in the near term. However, staff cautions, and the authorities agree, the transitional challenges, together with devolution-related wage bill issues, the issue of the debt inherited from previous local authorities, and potentially imminent county borrowing, could—if left unaddressed—hamper efforts to reduce the primary balance in the medium term (even at the general government level).

9. **Contingent liabilities represent an additional fiscal risk.** Contingent liabilities in Kenya include publicly guaranteed debt of public entities, which reached KSh 43.5 billion (1 percent of GDP) at the end of 2012/13. About 15 percent of this guaranteed debt has been called. Public Private Partnerships (PPPs), mostly in the energy sector, represent an additional source of contingent liabilities that are yet to be fully assessed.

MAIN FINDINGS AND CONCLUSIONS

10. **This DSA finds that Kenya continues to face low risk of external debt distress.** Institutional improvements in recent years have increased the safety margin between Kenya's projected debt and the related indicative thresholds, though the use of a higher discount rate also contributes significantly to the more favorable dynamics. Upward revisions to GDP time series are also lowering the ratios of debt to GDP.

11. **Standard stress tests suggest scenarios in which debt would increase, but remain within sustainable bounds.** Exchange rate shocks and less favorable terms on new public sector loans represent the largest upside risks to external debt. Overall public debt would increase most in the event of significantly lower than anticipated economic growth. A scenario of this type could be triggered by the following adverse developments:

- a return to drought would reduce agricultural production and hydro-power generation, and would in turn reduce economic growth, increase food and oil-related imports and lead to a widening of the current account deficit.

- a deterioration in security conditions would weaken earnings from tourism, and dampen FDI inflows.

- 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), and reduce remittance and FDI inflows, with a significant impact on economic growth. However, in the external balances, these effects would be mitigated by an associated decline in oil prices.

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

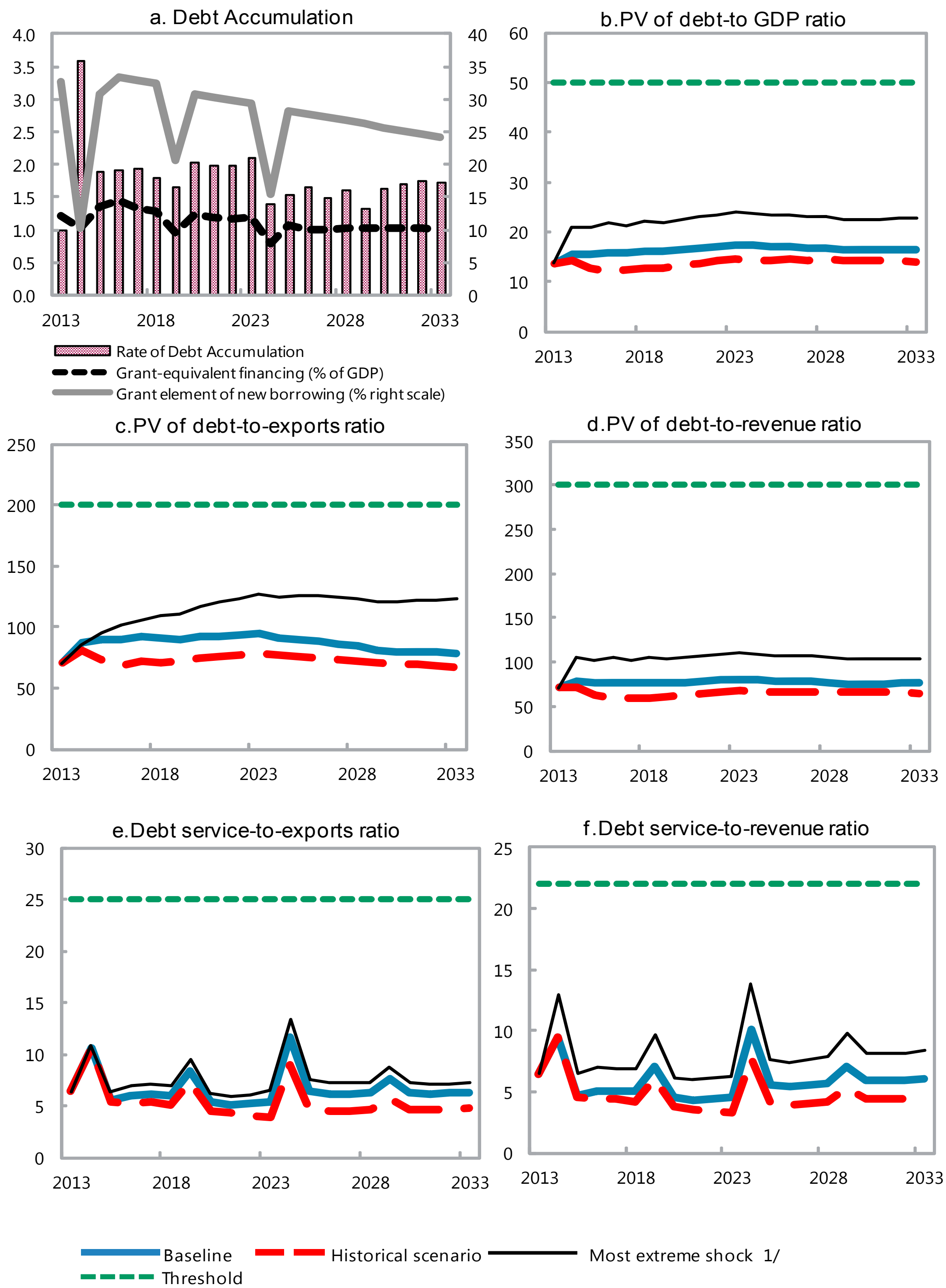
At the same time, Kenya has strong market foundations and long-standing sound macroeconomic policies—absence of price controls, flexible exchange rate and interest rates, limited budget subsidies—which give it scope to respond to shocks.

12. **The arrangements for the devolved institutions are only now being tested in practice.** The transitional problems of devolution could translate into fiscal risks for the central government if left unresolved, potentially affecting this year's budget outturns and creating pressures for the design of next year's budget. This makes it important for the authorities to maintain their efforts to reduce the primary deficit in the medium term, consistent with meeting the fiscal convergence criteria for the EAC monetary union.

13. **But natural resource discoveries represent upside potential for the medium to long term.** If confirmed, resource exports could significantly improve Kenya's external prospects. This puts a premium on appropriate design for policies to manage Kenya's natural resources.

14. **The authorities agree with the conclusions of this DSA.** They concur that Kenya is at low risk of external debt distress. They see Kenya's successful debut sovereign bond issuance in June 2014 as helping to diversify the country's funding sources and more broadly as a stepping stone in the path towards emerging market status. The authorities recognize specific fiscal risks in their medium-term budget policy statement, and have identified and are seeking to address the emerging challenges in the devolution process. The government has also initiated institutional and legal reforms for extractive industries.

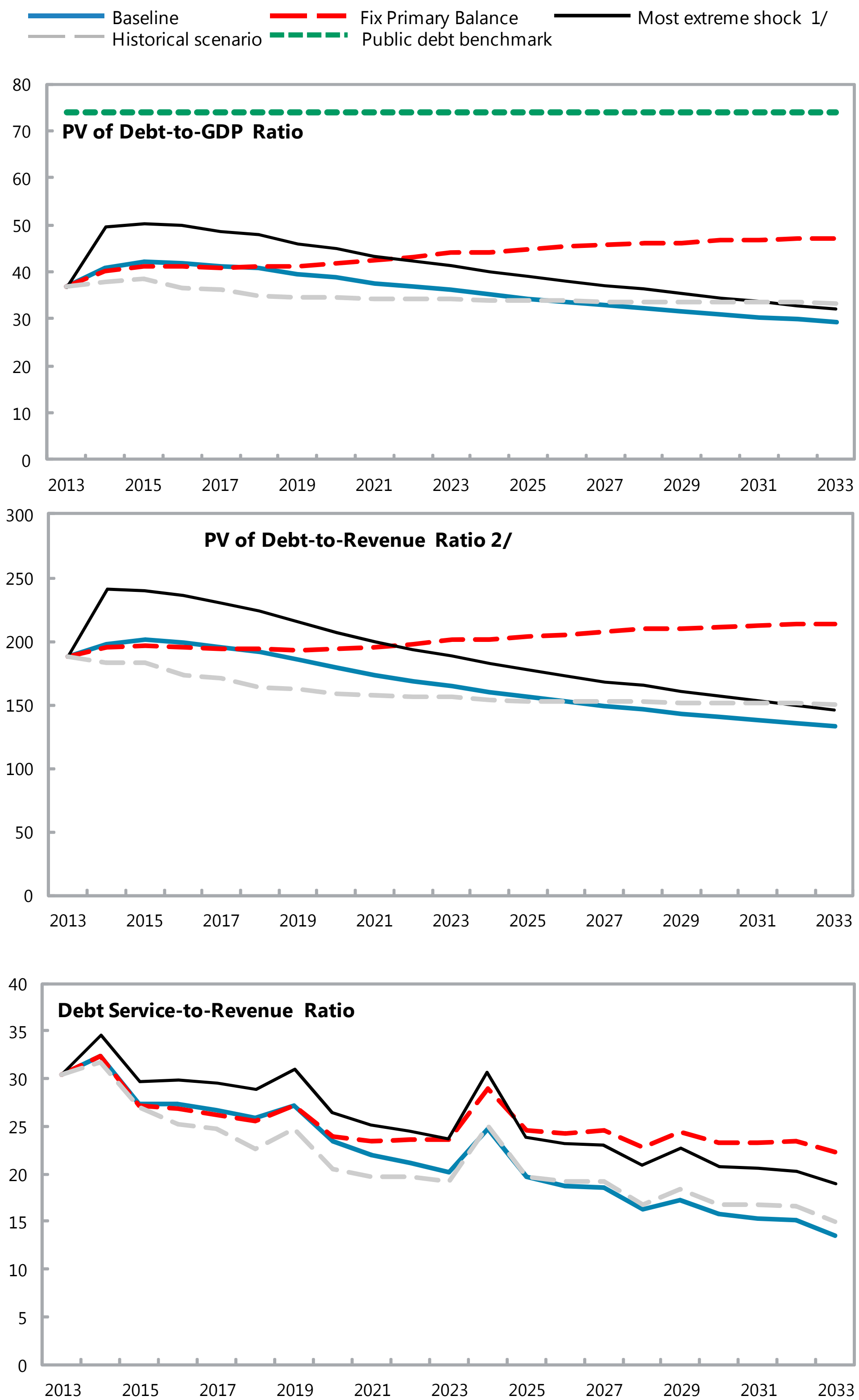
Figure 1. Kenya: Indicators of Public and Publicly Guaranteed External Debt under Alternative Scenarios, 2013-2033 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 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 an Exports 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 on or before 2023.

2/ Revenues are defined inclusive of grants.

Table 1a. Kenya: External Debt Sustainability Framework, Baseline Scenario, 2010-2033 1/
(In percent of GDP, unless otherwise indicated)

	Actual				Historical 6/ Average	Standard 6/ Deviation	Projections								
	2010	2011	2012	2013			2014	2015	2016	2017	2018	2014-2018 Average	2023	2033	2019-2033 Average
External debt (nominal) 1/	**26.9**	**29.3**	**30.7**	**30.7**			**33.0**	**33.9**	**35.3**	**35.7**	**37.1**		**41.8**	**43.1**	
of which: public and publicly guaranteed (PPG)	18.5	20.8	18.5	17.7			19.5	19.7	20.3	20.7	21.1		23.3	22.2	
Change in external debt	0.0	2.4	1.5	-0.1			2.3	0.9	1.4	0.4	1.4		1.1	0.3	
Identified net debt-creating flows	2.8	6.4	3.9	5.7			5.2	3.9	4.1	2.1	2.7		2.3	2.7	
Non-interest current account deficit	**5.2**	**8.7**	**8.2**	**8.4**	**4.6**	**3.2**	**7.3**	**8.1**	**6.7**	**6.2**	**5.6**		**5.8**	**5.9**	5.8
Deficit in balance of goods and services	11.3	15.0	13.8	13.7			13.2	14.0	13.0	12.4	11.8		11.8	11.1	
Exports	22.3	23.0	22.0	19.4			17.8	17.3	17.6	17.1	17.7		18.5	21.0	
Imports	33.6	38.0	35.8	33.1			31.0	31.4	30.6	29.5	29.5		30.3	32.0	
Net current transfers (negative = inflow)	-5.8	-6.2	-5.6	-5.7	-6.1	0.6	-6.3	-6.1	-6.0	-5.7	-5.8		-5.4	-4.8	-5.2
of which: official	-0.5	-0.4	-0.4	-0.4			-0.1	-0.1	0.0	0.0	0.0		0.0	0.0	
Other current account flows (negative = net inflow)	-0.3	-0.1	0.1	0.4			0.4	0.1	-0.2	-0.5	-0.4		-0.5	-0.3	
Net FDI (negative = inflow)	**-0.4**	**-0.8**	**-0.5**	**-0.9**	**-0.5**	**0.6**	**-1.8**	**-2.0**	**-1.9**	**-1.8**	**-1.9**		**-1.7**	**-1.0**	-1.5
Endogenous debt dynamics 2/	**-2.0**	**-1.5**	**-3.9**	**-1.8**			**-0.4**	**-2.2**	**-0.8**	**-2.3**	**-0.9**		**-1.9**	**-2.2**	
Contribution from nominal interest rate	0.2	0.2	0.3	0.3			0.4	0.4	0.5	0.5	0.5		0.6	0.6	
Contribution from real GDP growth	-2.1	-1.9	-0.4	-2.1			-0.8	-2.6	-1.3	-2.7	-1.5		-2.5	-2.8	
Contribution from price and exchange rate changes	-0.1	0.2	-3.7	-0.8			...	...	...	...	...		...	...	
Residual (3-4) 3/	**-2.8**	**-4.0**	**-2.4**	**-5.7**			**-2.9**	**-3.0**	**-2.7**	**-1.7**	**-1.3**		**-1.2**	**-2.4**	
of which: exceptional financing	0.1	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.3		-0.1	0.0	
PV of external debt 4/	...	...	26.5	26.6			29.0	29.8	30.8	30.9	32.0		35.9	37.5	
In percent of exports	...	...	120.5	137.0			163.1	171.8	174.6	180.8	180.9		193.9	178.5	
PV of PPG external debt	**...**	**...**	**14.2**	**13.6**			**15.6**	**15.6**	**15.8**	**15.8**	**16.0**		**17.5**	**16.5**	
In percent of exports	**...**	**...**	**64.7**	**70.1**			**87.4**	**89.9**	**89.7**	**92.8**	**90.7**		**94.3**	**78.7**	
In percent of government revenues	**...**	**...**	**75.6**	**71.4**			**77.5**	**76.0**	**76.4**	**76.3**	**76.3**		**80.9**	**75.9**	
Debt service-to-exports ratio (in percent)	**4.8**	**11.4**	**14.3**	**18.9**			**24.9**	**20.9**	**22.1**	**22.7**	**22.7**		**23.1**	**23.6**	
PPG debt service-to-exports ratio (in percent)	**3.9**	**3.7**	**3.9**	**6.4**			**10.6**	**5.6**	**5.9**	**6.1**	**5.9**		**5.3**	**6.3**	
PPG debt service-to-revenue ratio (in percent)	**4.5**	**4.6**	**4.6**	**6.5**			**9.4**	**4.7**	**5.1**	**5.0**	**5.0**		**4.6**	**6.1**	
Total gross financing need (Billions of U.S. dollars)	3.4	5.8	7.0	8.8			9.3	10.4	10.9	12.1	12.8		23.2	70.2	
Non-interest current account deficit that stabilizes debt ratio	5.2	6.3	6.7	8.5			5.0	7.2	5.3	5.8	4.2		4.7	5.7	
Key macroeconomic assumptions															
Real GDP growth (in percent)	8.6	7.6	1.7	7.5	5.1	3.0	2.8	8.8	4.1	8.9	4.4	5.8	6.6	7.2	7.0
GDP deflator in US dollar terms (change in percent)	0.4	-0.6	14.5	2.7	7.2	6.9	9.6	3.3	4.5	5.8	2.8	5.2	2.9	2.9	2.9
Effective interest rate (percent) 5/	0.9	1.0	1.0	0.9	1.3	0.5	1.3	1.5	1.5	1.5	1.5	1.5	1.6	1.5	1.5
Growth of exports of G&S (US dollar terms, in percent)	21.7	10.3	11.3	-2.7	12.0	11.1	3.3	9.4	10.6	11.6	11.2	9.2	11.2	11.2	11.3
Growth of imports of G&S (US dollar terms, in percent)	20.1	20.8	9.6	2.2	16.3	12.0	5.5	13.6	6.0	11.0	7.4	8.7	10.5	11.0	10.6
Grant element of new public sector borrowing (in percent)	...	...	...	32.7	...	...	10.3	30.8	33.4	32.9	32.4	28.0	29.3	24.2	26.2
Government revenues (excluding grants, in percent of GDP)	19.1	18.5	18.8	19.1			20.1	20.5	20.7	20.8	21.0		21.6	21.8	21.6
Aid flows (in Billions of US dollars) 7/	0.2	0.2	0.2	0.8			1.3	1.5	1.8	2.0	2.1		3.1	6.9	
of which: Grants	0.2	0.2	0.2	0.3			0.3	0.3	0.3	0.3	0.3		0.5	1.3	
of which: Concessional loans	0.0	0.0	0.0	0.6			1.0	1.2	1.5	1.7	1.8		2.6	5.6	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...	1.2			1.0	1.4	1.5	1.3	1.3		1.2	1.0	1.0
Grant-equivalent financing (in percent of external financing) 8/	...	...	...	44.7			18.6	40.5	40.7	39.5	38.9		36.1	31.8	33.7
Memorandum items:															
Nominal GDP (Billions of US dollars)	40.2	43.0	50.1	55.3			62.2	70.0	76.1	87.7	94.1		151.5	394.1	
Nominal dollar GDP growth	9.0	6.9	16.5	10.4			12.6	12.4	8.7	15.2	7.3	11.3	9.7	10.3	10.0
PV of PPG external debt (in Billions of US dollars)			7.0	7.5			9.5	10.7	12.0	13.5	15.1		26.4	65.0	
(PVt-PVt-1)/GDPt-1 (in percent)				1.0			3.6	1.9	1.9	1.9	1.8	2.2	2.1	1.7	1.7
Gross workers' remittances (Billions of US dollars)	1.0	1.4	1.9	2.3			2.5	2.8	3.0	3.4	3.7		5.6	12.9	
PV of PPG external debt (in percent of GDP + remittances)	...	...	13.7	13.1			15.0	15.0	15.2	15.3	15.4		16.8	16.0	
PV of PPG external debt (in percent of exports + remittances)	...	...	55.3	57.8			71.2	73.1	73.2	75.7	74.2		78.6	68.1	
Debt service of PPG external debt (in percent of exports + remittanc	...	...	3.4	5.3			8.6	4.5	4.8	5.0	4.9		4.4	5.5	

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt. For private sector debt, actual for 2010-11 and estimates for 2012-13.

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)

	Actual	Projections						
	2013	2014	2015	2016	2017	2018	2023	2033
PV of debt-to GDP ratio								
Baseline	14	16	16	16	16	16	17	17
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2013-2033 1/	14	14	13	12	12	13	15	14
A2. New public sector loans on less favorable terms in 2013-2033 2	14	15	16	18	18	19	23	26
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2014-2015	14	15	16	17	16	17	19	18
B2. Export value growth at historical average minus one standard deviation in 2014-2015 3/	14	16	17	17	17	17	18	17
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014-2015	14	17	17	18	17	18	20	19
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014-2015 4/	14	17	19	19	19	19	20	17
B5. Combination of B1-B4 using one-half standard deviation shocks	14	17	20	21	20	20	21	19
B6. One-time 30 percent nominal depreciation relative to the baseline in 2014 5/	14	21	21	22	21	22	24	23
PV of debt-to-exports ratio								
Baseline	70	87	90	90	93	91	94	79
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2013-2033 1/	70	80	73	69	72	71	79	67
A2. New public sector loans on less favorable terms in 2013-2033 2	70	85	95	101	105	109	126	123
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2014-2015	70	86	88	89	90	90	94	78
B2. Export value growth at historical average minus one standard deviation in 2014-2015 3/	70	90	108	109	109	109	110	88
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014-2015	70	86	88	89	90	90	94	78
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014-2015 4/	70	97	110	110	109	109	106	81
B5. Combination of B1-B4 using one-half standard deviation shocks	70	90	106	107	106	105	104	80
B6. One-time 30 percent nominal depreciation relative to the baseline in 2014 5/	70	86	88	89	90	90	94	78
PV of debt-to-revenue ratio								
Baseline	71	78	76	76	76	76	81	76
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2013-2033 1/	71	71	62	58	60	60	68	65
A2. New public sector loans on less favorable terms in 2013-2033 2	71	76	80	86	87	92	108	119
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2014-2015	71	76	80	82	79	82	86	81
B2. Export value growth at historical average minus one standard deviation in 2014-2015 3/	71	78	82	84	81	83	85	77
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014-2015	71	83	84	86	83	86	91	85
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014-2015 4/	71	86	93	94	90	91	91	78
B5. Combination of B1-B4 using one-half standard deviation shocks	71	87	99	100	96	97	98	85
B6. One-time 30 percent nominal depreciation relative to the baseline in 2014 5/	71	105	102	105	102	105	111	104

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	11	6	6	6	6	5	6
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2013-2033 1/	6	11	5	5	5	5	4	5
A2. New public sector loans on less favorable terms in 2013-2033 2	6	11	5	6	6	7	8	9
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2014-2015	6	11	6	6	6	6	5	6
B2. Export value growth at historical average minus one standard deviation in 2014-2015 3/	6	11	6	7	7	7	7	7
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014-2015	6	11	6	6	6	6	5	6
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014-2015 4/	6	11	6	7	7	7	7	7
B5. Combination of B1-B4 using one-half standard deviation shocks	6	10	6	7	7	6	6	7
B6. One-time 30 percent nominal depreciation relative to the baseline in 2014 5/	6	11	6	6	6	6	5	6

Debt service-to-revenue ratio

Baseline	6	9	5	5	5	5	5	6
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2013-2033 1/	6	9	5	4	4	4	3	5
A2. New public sector loans on less favorable terms in 2013-2033 2	6	9	4	5	5	6	7	9
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2014-2015	6	9	5	5	5	5	5	7
B2. Export value growth at historical average minus one standard deviation in 2014-2015 3/	6	9	5	5	5	5	5	6
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014-2015	6	10	5	6	6	6	5	7
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014-2015 4/	6	9	5	6	6	6	6	7
B5. Combination of B1-B4 using one-half standard deviation shocks	6	10	5	6	6	6	6	7
B6. One-time 30 percent nominal depreciation relative to the baseline in 2014 5/	6	13	6	7	7	7	6	8
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	22	22	22	22	22	22	22	22

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						Projections								
	2010	2011	2012	2013	Average 5/	Standard Deviation 5/	2014	2015	2016	2017	2018	2014-18 Average	2023	2033	2019-33 Average
Public sector debt 1/	40.8	42.0	41.0	40.8			44.7	46.2	46.5	46.1	45.9		42.0	34.9	
of which: foreign-currency denominated	18.5	20.8	18.5	17.7			19.5	19.7	20.3	20.7	21.1		23.3	22.2	
Change in public sector debt	1.2	1.2	-1.0	-0.2			3.8	1.5	0.3	-0.4	-0.2		-0.5	-0.5	
Identified debt-creating flows	1.3	-2.1	0.9	1.0			1.8	0.4	0.4	-0.6	-0.4		-1.1	-0.9	
Primary deficit	2.2	1.6	2.3	2.8	0.9	1.6	3.4	3.3	2.8	2.4	1.9	2.8	0.8	1.2	0.9
Revenue and grants	19.7	19.0	19.3	19.6			20.6	21.0	21.1	21.1	21.3		21.9	22.1	
of which: grants	0.6	0.4	0.4	0.5			0.5	0.5	0.4	0.3	0.3		0.3	0.3	
Primary (noninterest) expenditure	21.9	20.6	21.5	22.4			24.0	24.2	23.9	23.5	23.2		22.7	23.3	
Automatic debt dynamics	-0.9	-3.7	-1.4	-1.9			-1.6	-2.9	-2.4	-3.0	-2.3		-2.0	-2.1	
Contribution from interest rate/growth differential	-1.7	-3.1	-0.3	-1.4			-0.7	-2.6	-1.6	-2.8	-1.6		-1.7	-1.8	
of which: contribution from average real interest rate	1.4	-0.3	0.5	1.5			0.4	1.0	0.2	1.0	0.3		1.0	0.5	
of which: contribution from real GDP growth	-3.1	-2.9	-0.7	-2.9			-1.1	-3.6	-1.8	-3.8	-1.9		-2.6	-2.4	
Contribution from real exchange rate depreciation	0.8	-0.6	-1.1	-0.4			-1.0	-0.3	-0.8	-0.2	-0.7		...	...	
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	-0.1	3.3	-1.9	-1.1			2.0	1.1	-0.1	0.2	0.2		0.7	0.4	
Other Sustainability Indicators															
PV of public sector debt	...	...	36.8	36.8			40.7	42.1	42.0	41.3	40.8		36.1	29.2	
of which: foreign-currency denominated	...	...	14.2	13.6			15.6	15.6	15.8	15.8	16.0		17.5	16.5	
of which: external	...	...	14.2	13.6			15.6	15.6	15.8	15.8	16.0		17.5	16.5	
PV of contingent liabilities (not included in public sector debt)	...	...	...	...			...	...	...	...	...		...	...	
Gross financing need 2/	12.8	12.2	13.4	14.8			16.3	15.6	15.6	14.9	14.2		10.5	7.7	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	190.9	187.9			197.9	200.6	198.9	195.6	191.4		164.7	132.4	
PV of public sector debt-to-revenue ratio (in percent)	...	...	195.3	192.7			202.9	205.2	202.7	198.8	194.3		167.1	134.3	
of which: external 3/	...	...	75.6	71.4			77.5	76.0	76.4	76.3	76.3		80.9	75.9	
Debt service-to-revenue and grants ratio (in percent) 4/	25.5	26.2	28.0	30.5			32.4	27.4	27.3	26.6	25.9		20.2	13.5	
Debt service-to-revenue ratio (in percent) 4/	26.3	26.8	28.6	31.3			33.2	28.0	27.9	27.1	26.3		20.5	13.7	
Primary deficit that stabilizes the debt-to-GDP ratio	1.0	0.5	3.3	3.0			-0.4	1.8	2.5	2.8	2.1		1.3	1.7	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	8.6	7.6	1.7	7.5	5.1	3.0	2.8	8.8	4.1	8.9	4.4	5.8	6.6	7.2	7.0
Average nominal interest rate on forex debt (in percent)	1.0	1.2	1.3	1.3	1.5	0.5	2.0	2.3	2.4	2.4	2.4	2.3	2.8	2.9	2.8
Average real interest rate on domestic debt (in percent)	7.6	-0.7	2.6	7.1	1.6	3.9	1.7	4.1	0.3	3.7	0.9	2.1	3.8	2.1	3.7
Real exchange rate depreciation (in percent, + indicates depreciation	4.8	-3.5	-5.6	-2.6	-4.4	6.8	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	2.8	11.4	9.0	4.6	8.4	3.9	9.2	5.4	8.6	5.0	7.9	7.2	5.0	5.0	5.0
Growth of real primary spending (deflated by GDP deflator, in percer	0.1	0.0	0.1	0.1	0.1	0.0	0.1	0.1	0.0	0.1	0.0	0.1	0.1	0.1	0.1
Grant element of new external borrowing (in percent)	...	...	...	32.7	...	...	10.3	30.8	33.4	32.9	32.4	28.0	29.3	24.2	...

Sources: Country authorities; and staff estimates and projections.

1/ Refers to gross debt of the central government.

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

	Actual	Projections						
	2013	2014	2015	2016	2017	2018	2023	2033
PV of Debt-to-GDP Ratio								
Baseline	37	41	42	42	41	41	36	29
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	37	38	38	36	36	35	34	33
A2. Primary balance is unchanged from 2013	37	40	41	41	41	41	44	47
A3. Permanently lower GDP growth 1/	37	41	43	43	43	44	44	52
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2014-2015	37	41	47	48	48	49	49	48
B2. Primary balance is at historical average minus one standard deviations in 2014-2015	37	40	41	41	40	40	35	29
B3. Combination of B1-B2 using one half standard deviation shocks	37	39	41	42	42	42	41	39
B4. One-time 30 percent real depreciation in 2014	37	46	47	46	45	44	39	32
B5. 10 percent of GDP increase in other debt-creating flows in 2014	37	50	50	50	49	48	41	32
PV of Debt-to-Revenue Ratio 2/								
Baseline	188	198	201	199	196	191	165	132
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	188	183	183	173	171	163	156	150
A2. Primary balance is unchanged from 2013	188	195	196	195	194	194	201	213
A3. Permanently lower GDP growth 1/	188	200	205	206	206	205	201	237
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2014-2015	188	200	222	226	228	229	222	217
B2. Primary balance is at historical average minus one standard deviations in 2014-2015	188	194	194	193	190	186	161	130
B3. Combination of B1-B2 using one half standard deviation shocks	188	189	195	198	199	198	187	175
B4. One-time 30 percent real depreciation in 2014	188	224	223	219	213	207	176	146
B5. 10 percent of GDP increase in other debt-creating flows in 2014	188	241	240	236	230	224	188	146
Debt Service-to-Revenue Ratio 2/								
Baseline	30	32	27	27	27	26	20	14
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	30	32	27	25	25	23	19	15
A2. Primary balance is unchanged from 2013	30	32	27	27	26	26	24	22
A3. Permanently lower GDP growth 1/	30	33	28	28	28	27	24	24
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2014-2015	30	33	29	30	30	30	26	23
B2. Primary balance is at historical average minus one standard deviations in 2014-2015	30	32	27	27	26	25	20	13
B3. Combination of B1-B2 using one half standard deviation shocks	30	32	28	27	26	26	23	18
B4. One-time 30 percent real depreciation in 2014	30	35	30	30	29	29	24	19
B5. 10 percent of GDP increase in other debt-creating flows in 2014	30	32	30	33	31	31	23	15

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

KENYA

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—EXTERNAL STABILITY ASSESSMENT

September 8, 2014

Approved By
Roger Nord and Chris Lane (IMF)

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

Kenya's external position is broadly stable: it has built up international reserve buffers, and external debt appears within sustainable bounds. The current account deficit is large at around 8 percent of GDP: while this appears to be broadly in line with medium-term fundamentals after accounting for capital imports, it also suggests continuing vulnerability to external shocks. The nominal exchange rate is largely market-determined. However, the real effective exchange rate has appreciated steadily in recent years. Several metrics now suggest modest real overvaluation, though results should be treated with caution owing to measurement gaps in external sector and productivity statistics. Measures of nonprice competitiveness indicate relatively well developed financial markets and flexible prices and labor markets, but also gaps in infrastructure, health and education, and governance.

RESERVE ADEQUACY

1. **Kenya has been rebuilding its international reserves buffer despite a challenging external environment.** Kenya's gross international reserves increased from USD 4.3 billion (2.9 months of next year's imports) at end-2011 to USD 6.4 billion (3.9 months of next year's imports) at end-2013 (text chart), and further to USD 7.5 billion (4.5 months of imports) at end-June 2014 following the successful inaugural sovereign bond issuance. Despite a challenging external environment—the current account deficit has been around 9 percent of GDP or more for the past three years, while the terms of trade has declined steadily—financial inflows to Kenya have been stable at around 10–11 percent of GDP annually. This has enabled the Central Bank of Kenya (CBK) to purchase enough official reserves in the interbank market to reach its desired minimum reserve coverage of 4 months of imports, even allowing for some sales of FX in May 2014.

2. **According to traditional rules of thumb, current levels of international reserves appear adequate:**

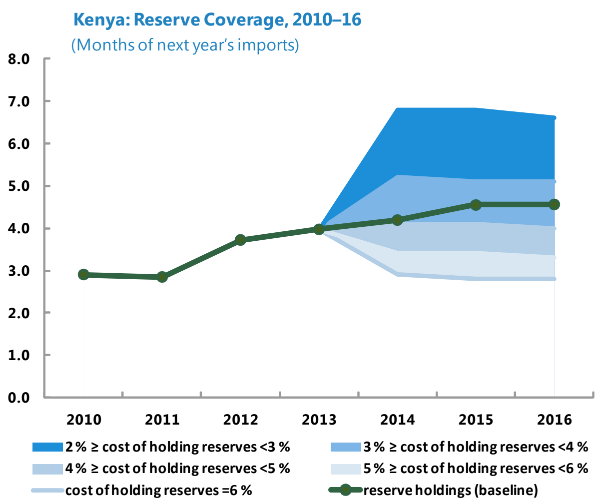
- Reserves of 4–4½ months of next year's imports are above the standard adequacy threshold of 3 months.
- End-2013 reserves were equivalent to 28 percent of broad money, well above the standard adequacy threshold of 20 percent.
- Although short-term external debt data are not available, the authorities report a lengthy average time to maturity on external debt, exceeding 11 years, and a high grant element.

3. **The current level of reserves appears broadly appropriate if the cost of holding reserves is moderate.** In a low-income country context, the probability of a drop in absorption—against which a country should hold reserves—can be estimated using a panel probit regression that includes the exchange rate regime, fiscal balance, institutional quality, and IMF program status.[1] This yields a range of "optimal" reserves that depends on the cost of holding reserves. In the case of Kenya, current reserve levels would be close to optimal if the annual cost of holding reserves is around 4 percent per year, and somewhat more than optimal if the cost of holding reserves is higher (text chart).[2] The model suggests that reserve needs will be higher in the absence of an IMF-supported program. In the short to medium term, Kenya's reserve needs are mitigated by its flexible exchange rate regime (below) and its gradual transition to an inflation targeting framework for monetary policy, subject to risks to balance sheets from a potential

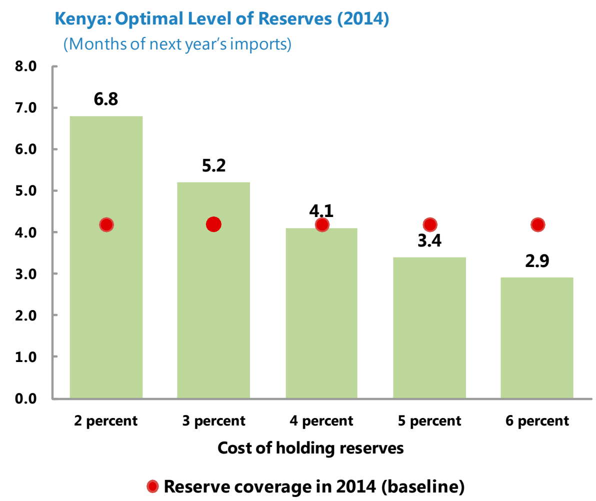
[1] The methodology is outlined in *Assessing Reserve Adequacy*, IMF Policy Paper, February 2011. Institutional quality is proxied by the World Bank's Country Policy and Institutional Assessment (CPIA).

[2] Follow-up analysis suggests that LICs face a marginal cost of holding reserves of around 4 to 6 percent, but at the lower end of the range for LICs that have accessed sovereign bond markets. See *Assessing Reserve Adequacy—Further Consideration*, IMF Policy Paper, November 2013.

exchange rate adjustment remaining contained.[3] In the medium to longer term, Kenya will need to maintain reserve cover of at least 4.5 months of imports in order to meet the macroeconomic convergence criteria agreed in the East African Community Monetary Union protocol.



Sources: Kenyan authorities and IMF staff estimates.



Source: IMF staff estimates.

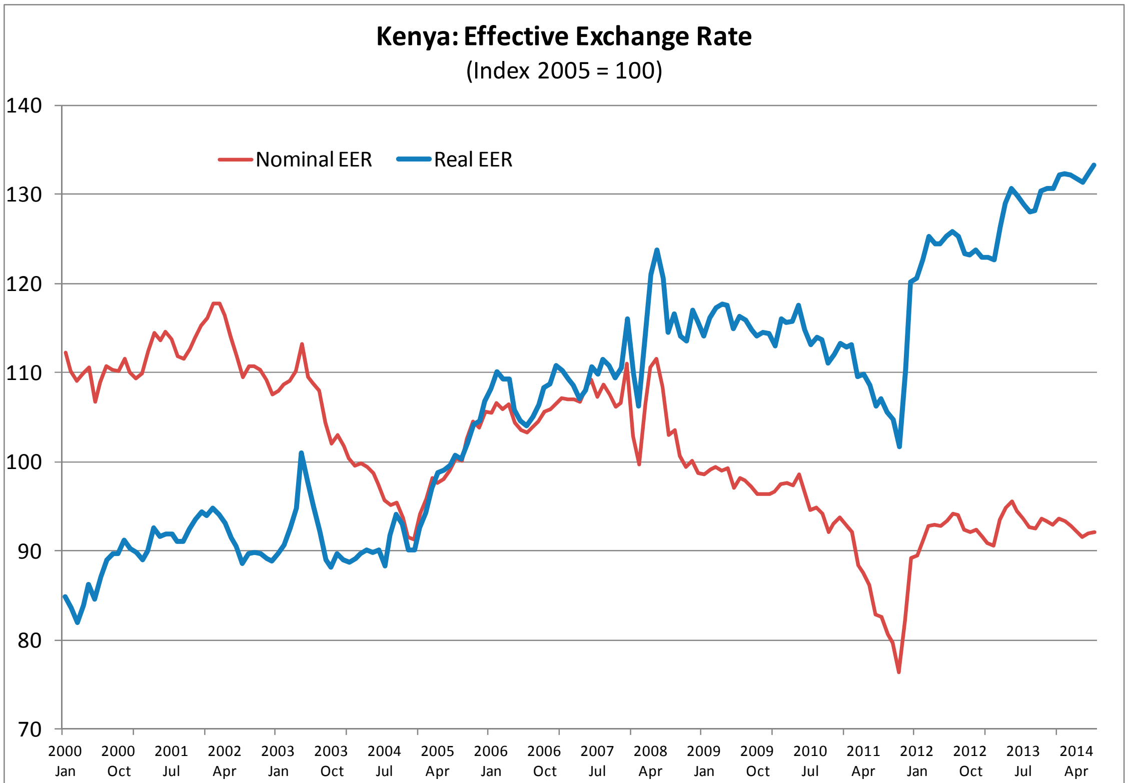
4. **But in the event of a large-scale reversal in portfolio inflows, reserves could fall below standard adequacy levels.** Based on fragmented data sources—including the authorities' Foreign Investment Survey for 2011, indirect data from creditors through 2012, and more recent net cash flow data from the Nairobi Securities Exchange—staff estimates the stock of portfolio liabilities at around USD 2–2.5 billion at end-2013, mainly in equity and investment fund shares. Experience in other sub-Saharan African countries suggests that episodes of portfolio reversals, when they occur, are nearly equally likely to be small or large. In a worst-case scenario, loss of the full stock of portfolio liabilities could bring reserves down below USD 5 billion, or below the standard threshold of 3 months of next year's imports. An additional uncertainty is the lack of timely information on private sector external debt.

EXCHANGE RATE ASSESSMENT

5. **Kenya maintains a de facto floating nominal exchange rate regime.** The nominal exchange rate is largely market-determined, although the CBK has been intervening moderately to build up its reserves buffer. The Kenyan shilling has remained broadly stable against major currencies since 2012, notwithstanding some largely seasonal fluctuations.

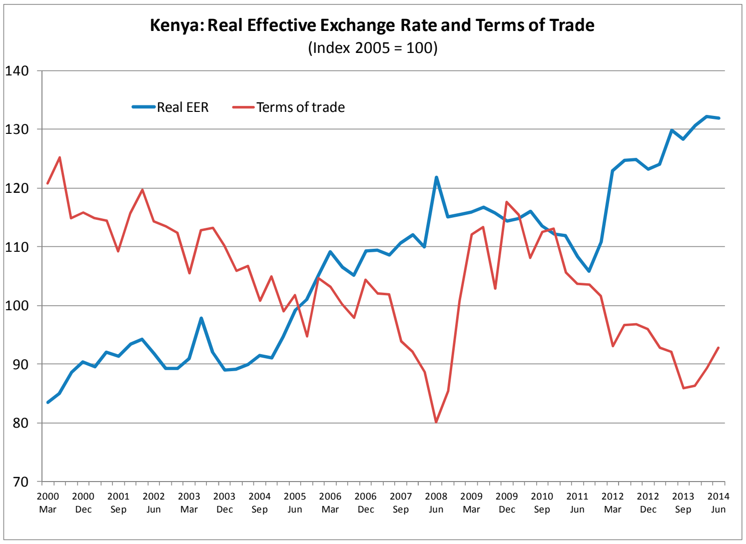
[3] Available data for the banking system suggest that dollarization in Kenya is modest, at around 16 percent of deposits and 24 percent of loans in June 2014. However, limited information is available on other sources of potentially significant foreign currency exposure; nonbank private external debt data is available only to 2011.

6. **However, Kenya's real exchange rate has appreciated steadily in recent years.** The CPI-based real effective exchange rate (REER) appreciated by 17½ percent from December 2010 to July 2014 (text chart). Even abstracting from crisis-related volatility in the REER in 2011, this represents a somewhat faster pace of real appreciation than the trend real appreciation of about 2½ percent annually since 2000.

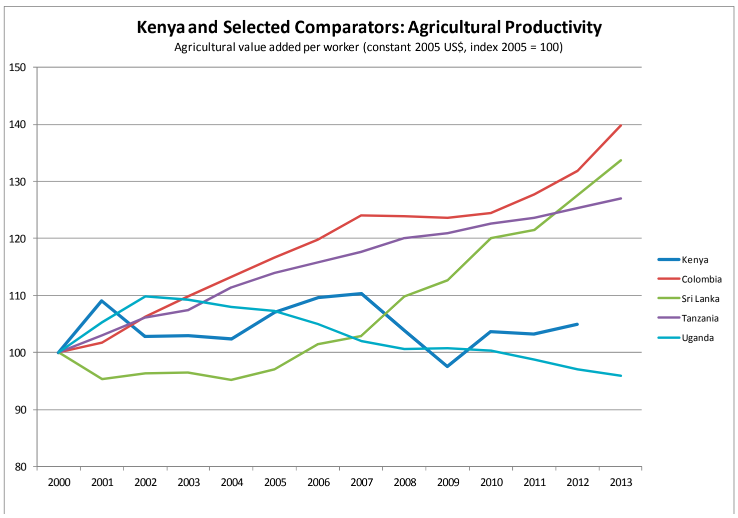


Source: IMF staff estimates.

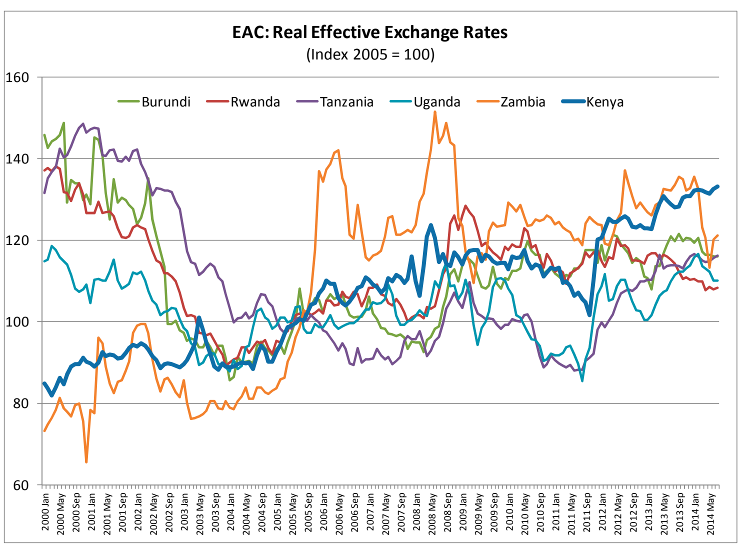
7. **The recent real appreciation is difficult to explain in terms of improved fundamentals.** The 2011 Article IV found that Kenya's real exchange rate was broadly in line with fundamentals. However, the subsequent real appreciation has occurred at the same time as a sharp decline in the terms of trade, which declined by some 18 percent from end-2010 to end-June 2014 (text chart). National accounts data do not provide evidence of productivity growth above that of trading partners, with the caveat that these data are now being revised (currently available data may underreport recent growth in the services sector). Agricultural productivity through 2012 was flat compared with growth in key export competitor countries (Colombia for coffee, Sri Lanka for tea; text chart). And, with the exception until recently of Zambia, Kenya's REER remains relatively appreciated compared with other countries in the region (text chart).



Source: IMF staff estimates.



Source: World Bank, *2014 World Development Indicators*.



Source: IMF staff estimates.

8. **Results from several methodologies differ, though on average they suggest a modest real overvaluation.** The underlying estimates—which range from -1 to 17 percent—need to be treated with caution (Table 1). The estimates are based on external sector ratios scaled to take into account forthcoming revisions to the GDP time series.[4] Annex I provides further details on the individual approaches.

Table 1. Kenya Exchange Rate Misalignment[1]

Method	
Macro Balance	-1
External Sustainability	9
Equilibrium REER	10
Purchasing Power Parity	17

[1] Positive numbers signify overvaluation

Source: IMF staff estimates.

- The **macroeconomic balance** (MB) approach indicates negligible undervaluation (1 percent), consistent with the current account deficit—currently wide, but projected to narrow to 6½ percent of GDP in the medium term—being in line with fundamentals. This "underlying" current account deficit compares with current account "norms" estimated at around 6½–7½ percent, which appear plausible given Kenya's investment needs.

- The **external sustainability** (ES) approach indicates overvaluation of some 9 percent, but is subject to high uncertainty because of major gaps in data on private external debt and the international investment position. Pending new data from the authorities—which could change the results significantly—the available time series estimates for net foreign assets (NFA) imply lower current account "norms" of around 4¾–5½ percent of GDP consistent with stabilizing NFA. A norm of 5½ percent would imply a current account gap of around 1½ percentage points of GDP, in contrast to the macroeconomic balance approach. This result should also be seen in the context of the accompanying Debt Sustainability Analysis (DSA), which finds that Kenya has a sustainable external debt position and is at low risk of external debt distress.

- The **equilibrium REER** approach indicates overvaluation of around 10 percent. However, results from this methodology need to be treated with particular caution, and are excluded from the overall average. The equilibrium REER result depends heavily on the estimated productivity differential between Kenya and its trading partners. This differential can be difficult to measure reliably, but uncertainties are exacerbated pending the release of full details of the rebased national accounts data. In addition, the estimated equilibrium is sensitive to changes in government consumption, which could be mismeasured in the current phase of devolution.

[4] The statistical bureau has flagged an upward revision of 20 percent, with details to be released in September 2014.

- The **purchasing power parity** (PPP) approach, in contrast, suggests overvaluation of 17 percent, calculated as the deviation of the current level of the REER from its long-term historical average.

9. **These results do not imply a need to adjust the nominal exchange rate adjustment—which has been market-determined—but are suggestive of structural bottlenecks that policymakers should address.** Survey evidence (Section III, below) points to bottlenecks that could be adding to domestic prices and eroding competitiveness.

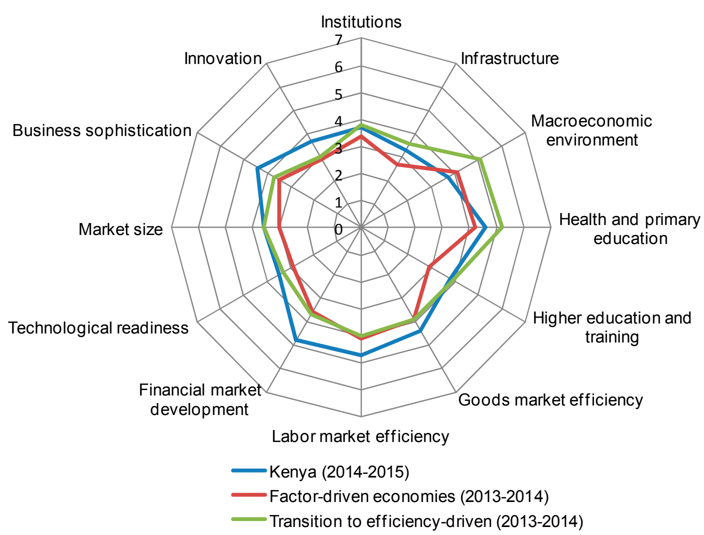
10. **Another caveat to these results is the upside potential from resource discoveries.** As discussed in the DSA (¶5), if recent oil and gas discoveries are confirmed as commercially viable, Kenya's medium and long-term current account balance could narrow substantially more than the current baseline indicates. This could reduce the current account gaps and implied exchange rate misalignments under the MB and ES methodologies, even allowing for an improved current account "norm" under the MB methodology.

SURVEY-BASED INDICATORS OF COMPETITIVENESS

11. **International surveys of competitiveness shed light on Kenya's structural strengths and weaknesses.** Survey data do not provide evidence of price or wage inflexibility, but do point to remaining weaknesses in other areas—infrastructure, health and education, and governance—that will require longer-term efforts to address.

Kenya and Comparator Economies: Structural Indicators

(Score, 1-7)

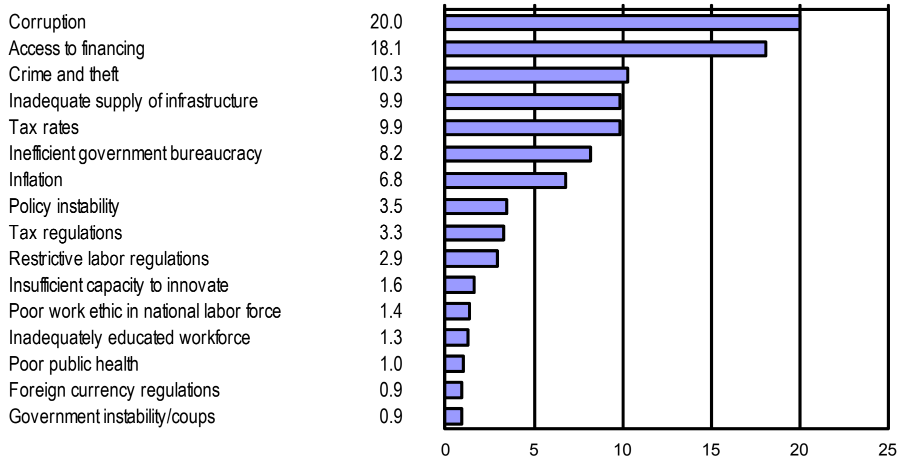


Source: *Global Competitiveness Report*, 2013–2014 and 2014–2015.

12. **Kenya's Global Competitiveness Index (GCI) ranking has improved over the past two years.** In the World Economic Forum's GCI for 2014–2015, Kenya's overall rank was 90 out of 144 countries. This is an improvement since 2012–2013, when Kenya's rank had slipped back to 106 out of 144. Kenya's rankings are better than average compared to other low-income countries (or "factor-driven" economies in GCI terminology), and roughly comparable

to economies in transition the next stage of development (text chart).[5] Kenya's most favorable sub-rankings in 2014–2015 were in financial market development and labor market efficiency (24 and 25 respectively). Kenya ranked less favorably on higher education and training (95), infrastructure (96), health and primary education (120), as well as (more counterintuitively) on macroeconomic environment (126). GCI respondents saw corruption as the most problematic factor for doing business in Kenya (text chart).

The Most Problematic Factors for Doing Business in Kenya

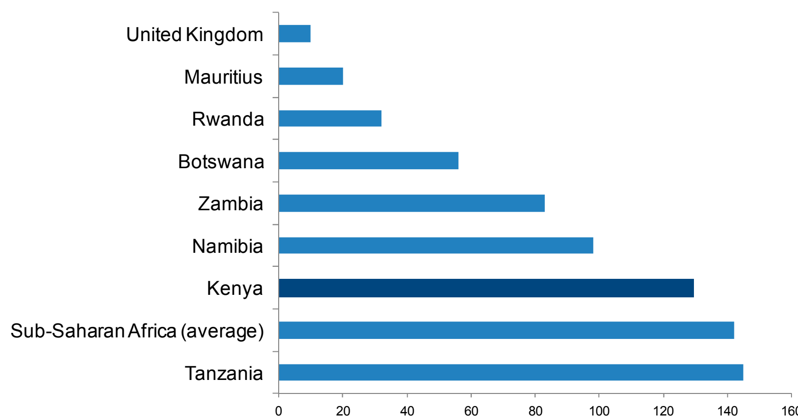


Source: *Global Competitiveness Report, 2014–2015.* (Percent of responses)

13. **Kenya's *Doing Business* ratings suggest a similar picture.** In the World Bank's *Doing Business* survey for 2014, Kenya's overall ranking was 129 out of 189 economies (text chart): somewhat above the average for sub-Saharan Africa (142), but below some other African economies (Rwanda, Botswana, Zambia, Namibia) and a decline of 7 places (Kenya ranked 122 out of 185 in 2013).

Kenya and Comparator Economies: Ease of Doing Business

Ranking out of 189 countries



Source: *Doing Business 2014*.

[5] The GCI groups economies according to three stages of development—*factor-driven*, *efficiency-driven*, and *innovation-driven*—as well as those in transition between these stages.

Annex I: Technical Comments on the Exchange Rate Assessment

Macroeconomic Balance (MB)

The MB methodology estimates the exchange rate misalignment as the current account (CA) "gap" divided by the CA elasticity, where:

CA gap = "underlying" CA balance minus "norm" CA balance;

Elasticity = percentage point change in the CA balance resulting from a one percentage point change in the real exchange rate

Results from the MB methodology (Table 2) are only as good as the underlying current account time series (historical data and projections); the econometric estimates of the CA norm (source: AFR); and the econometric estimates for export and import elasticity (using from two sources: CGER, and Tokarick Working Paper WP/10/180).

Table 2. Kenya: Macroeconomic Balance Approach [1]

	Variables	Coefficients		Coefficient*Variable	
	2017/18	Benchmark	with FDI	Benchmark	with FDI
	1	2	3	=1*2	=1*3
Old age dependency	-0.132	-0.103	-0.104	0.014	0.014
Population growth rate (rel. to trading partners)	0.016	-1.947	-1.694	-0.030	-0.026
Relative income	-2.254	-0.008	-0.007	0.018	0.015
Per capita GDP growth (rel. to trading partners)	0.009	-2.709	-2.071	-0.025	-0.019
Oil balance	-0.065	0.197	0.197	-0.013	-0.013
Fiscal balance (rel. to trading partners)	-0.026	0.269	0.270	-0.007	-0.007
Net foreign assets	-0.431	0.034	0.031	-0.015	-0.013
Aid inflows	0.026	-0.080	-0.075	-0.002	-0.002
Remittance inflows	0.045	-0.062	-0.026	-0.003	-0.001
Foreign direct investment	0.022	-	-0.324	-	-0.007
Constant	1.000	-0.013	-0.006	-0.013	-0.006
Current Account Norm (% of GDP)				-7.6	-6.6
Underlying Current Account (% of GDP)				-6.9	-6.9
Current account gap (underlying - norm)				0.7	-0.3
REER misalignment ('+'=overvaluation)					
CGER elasticity = -0.12				**-5.8**	**2.3**
Tokarick elasticity = -0.29				**-2.5**	**1.0**
MB Average				**-1.3**	

[1] All variables are expressed in decimals. The current account norm is converted to percent by multiplying by 100.

Source: IMF staff estimates.

External Sustainability (ES)

The ES methodology is similar to the MB, except that the CA norm is not estimated econometrically, but instead is calculated as the CA balance that stabilizes a country's net foreign assets (NFA) at a desired benchmark level (set as 2018 projected NFA).

- The estimates for Kenya need to be treated with particular caution because the methodology depends on incomplete data to derive estimates (historical and projected) of NFA. The Kenyan authorities recently released a Foreign Investment Survey (FIS) for 2011. However, a FIS has not yet been conducted for 2012 or 2013.

  In the absence of more timely official statistics—which could change the results significantly—time series estimates to 2011 are extended using flow projections for foreign assets and liabilities, i.e. adding the change in NFA of commercial banks, less public external debt and net FDI inflows.

- Without further adjustment, this methodology implies a CA deficit norm of 4¾ percent of GDP (Table 3), which is arguably low for a country with Kenya's investment needs, and well below the medium-term projected CA deficits of around 6½ percent of GDP.

- The FIS data to 2011 strongly confirm the finding of the ECF Sixth Review Staff Report that the BOP statistics substantially underreport FDI. To adjust for underreporting, the NFA series beyond 2011 is calculated assuming doubled net FDI inflows compared with official statistics. The resulting lower benchmark for NFA implies a CA deficit norm of 5½ percent, which is used to derive the CA gap and resulting estimate of overvaluation.

Table 3. Kenya: External Sustainability Approach

		2017/18		2017/18
Nominal GDP growth, %		13		13
Net foreign assets, % GDP	No FDI adj:	-43	FDI adj:	-49
NFA stabilizing CA norm, % GDP		**-4.8**		**-5.5**
Underlying Current Account (% of GDP)		-6.9		-6.9
Current account gap (underlying - norm)		-2.1		-1.5
REER misalignment ('+'=overvaluation)				
CGER elasticity = -0.12		**18**		**12**
Tokarick elasticity = -0.29		**7**		**5**
ES Average		**13**		**9**

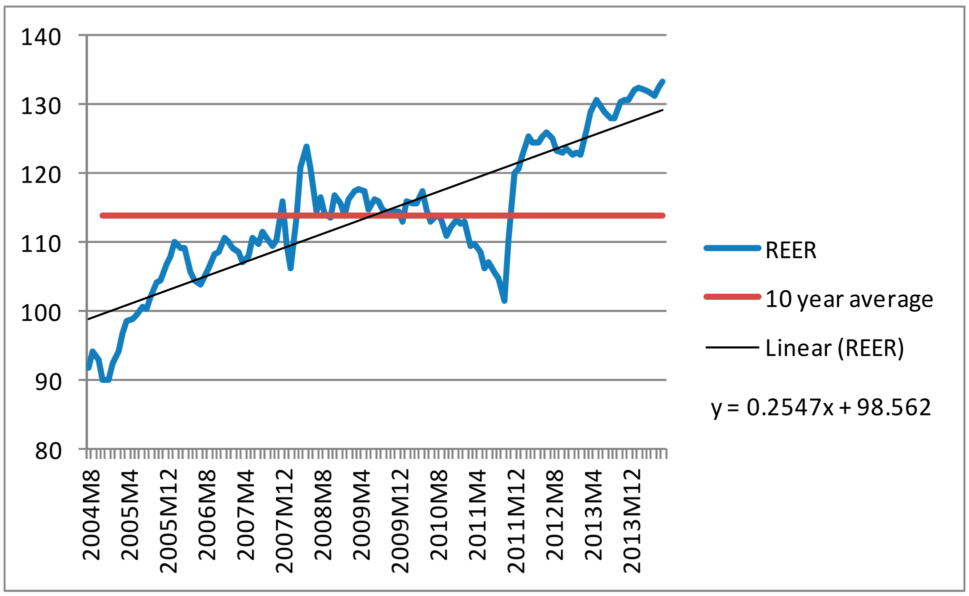
Source: IMF staff estimates.

PPP

This method compares the current value of the REER to its long-term average, assuming the REER is stationary in the long term.

The REER at July 2014 was 17 percent above its average for the previous 10 years (text chart). The result did not materially change if excluding the 2011 depreciation and its subsequent sharp unwinding.

The historical deviation is much less—3 percent—if compared to a long-term average around a secular trend increase (estimated at 3 percent annually). However, such a trend increase could not be explained by improvements in fundamentals (terms of trade and/or productivity).



Equilibrium REER

The equilibrium REER is estimated using a panel regression using country-specific fixed effects to obtain coefficients (source: AFR).

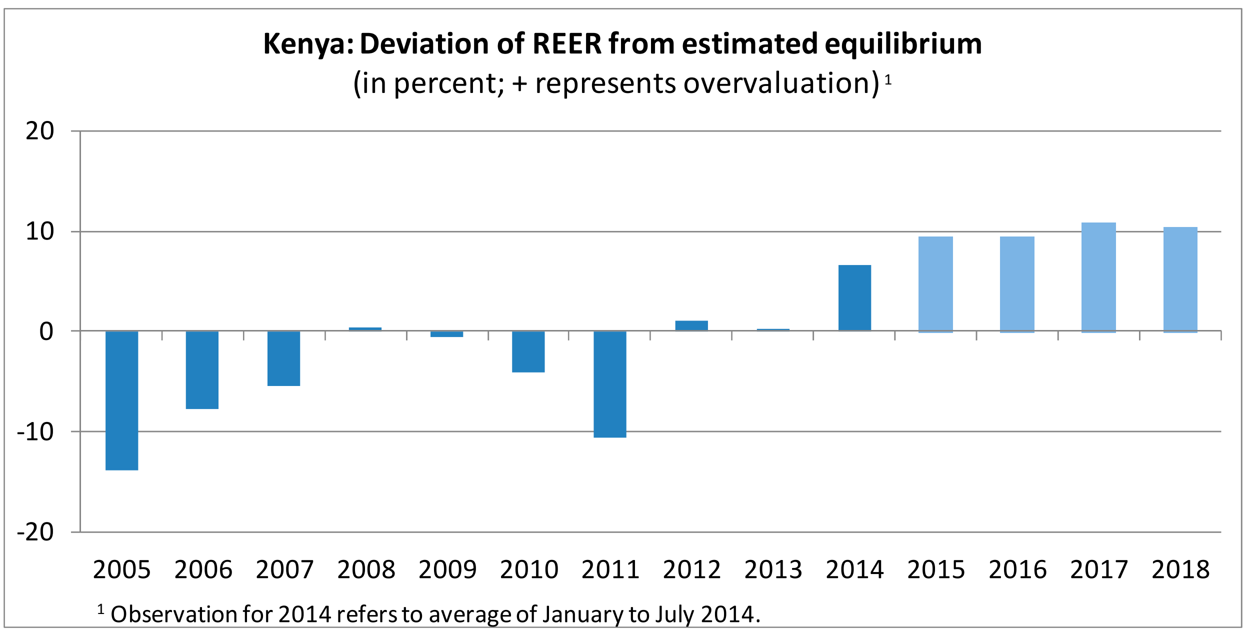
The two most important components of the estimate are the country-specific constant, and relative productivity. The negative productivity differential between Kenya and its partners implies a lower equilibrium REER.

Overvaluation is calculated as the gap between the current REER and its estimated equilibrium value.

Table 4. Kenya: Equilibrium Real Effective Exchange Rate Approach

	Variables 2017/18	Coefficients	Coefficient*Variable
	1	2	=1*2
Terms of trade	-0.150	0.181	-0.03
Relative productivity	-2.482	0.185	-0.46
Relative government consumption	0.000	2.123	0.00
Initial NFA	-0.431	-0.015	0.01
Aid inflows	0.026	-0.035	0.00
Remittance inflows	0.045	0.191	0.01
Constant	1.000	0.649	0.65
Equilibrium Real Exchange Rate (log)			0.18
Log(REER)			0.28
Deviation from Equilibrium %, (+ =overvaluation)			**10**

Source: IMF staff estimates.



Source: IMF staff estimates.

Press Release No. 14/455
FOR IMMEDIATE RELEASE
October 2, 2014

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2014 Article IV Consultation with Kenya

On September, 22, 2014, the Executive Board of the International Monetary Fund (IMF) concluded the 2014 Article IV consultation[1] with Kenya.

Kenya's economy has continued to expand in a stable economic environment. Credit to the manufacturing sector has picked up and foreign investor interest is growing, notably in the extractive industries. The economy's growth rate rose to 5 percent in 2013/14 and is expected to gain further momentum in 2014/15, driven by higher domestic and external investment. Inflation remains moderate, but rising food prices and rapid credit growth may fuel inflation expectations. The relatively high external current account deficit (around 8 percent of Gross Domestic Product (GDP) in 2013/14) reflects strong capital imports and a decline in agricultural exports. Following a successful first-time Eurobond issue (US$2 billion) in June 2014, international reserves reached some four and a half months of prospective import coverage. Kenya's financial sector remains robust, the process of financial inclusion is ongoing, and efforts to develop Nairobi into a regional hub have advanced with Kenya's recent removal from the Financial Action Task Force's watch list.

The 2013/14 central government deficit remained broadly unchanged compared to the previous year at about 5¾ percent of GDP. A stronger revenue performance was accompanied by a higher wage bill, rising security spending and the implementation of devolution, which was rolled out at a fast pace. A new quarterly reporting framework for budget execution by counties will help to address transitional challenges for public financial management posed by devolution. Kenya's debt remains broadly stable and sustainable. The authorities plan a gradual fiscal consolidation with a view to meeting the medium-term convergence criteria specified in the East African Community Monetary Union Protocol.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

Kenya's medium-term growth prospects are favorable, supported by rising infrastructure investment in energy and transportation; the expansion of the East African Community market; deepening financial inclusion, which fosters a more dynamic small and medium-sized enterprise sector; and the positive impact of large-size irrigation projects on agricultural productivity. Nonetheless, Kenya remains vulnerable to weather-related shocks, a further deterioration of security conditions, protracted slow growth in advanced and emerging economies, and difficulties in implementing devolution that could complicate public financial management.

Executive Board Assessment[2]

Directors commended the authorities for maintaining macroeconomic stability, introducing important market-friendly reforms, and for Kenya's successful debut Eurobond issuance. Kenya's economic outlook is favorable, although the country remains vulnerable to exogenous shocks. To mitigate downside risks, Directors encouraged stronger policy buffers and further structural reforms, including to strengthen the business climate and improve security conditions. They noted that this would help to consolidate the gains to date, contribute to poverty reduction, and promote more inclusive growth.

Directors called for continued commitment to fiscal discipline in the wake of challenges emerging from the ongoing process of devolution of government responsibilities. This process should lead to better delivery of services to help alleviate poverty and inequality across counties. Directors agreed that a prudent fiscal stance, consistent with Kenya's medium-term debt target, will create space for much needed infrastructure investment and priority social spending. Accordingly, Directors supported further revenue mobilization, enhancement of the quality and efficiency of public spending, and better control over the public wage. They also recommended full implementation of public financial management reforms, especially with regard to fiscal devolution and the recent introduction of the Treasury Single Account aimed at strengthening cash management. They supported the authorities' efforts to reduce fiscal risks by reforming government-owned agencies, and closely monitoring contingent liabilities from state-owned enterprises.

In view of the rise in headline inflation in recent months, Directors encouraged the authorities to monitor the accelerated pace of credit growth, and to stand ready to tighten monetary conditions to anchor inflationary expectations. They also recommended strengthening prudential oversight to prevent a deterioration in the quality of banks' loan portfolios. Continued efforts to modernize the monetary framework should also help lay the foundation for inflation targeting.

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[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summing ups can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Directors welcomed the rapid increase in financial inclusion, and the authorities' strong commitment to strengthening prudential and regulatory oversight. In light of the rapid expansion of Kenyan banks in East Africa and other SSA countries, they underscored the need for enhanced consolidated supervision of transnational banks and other systemic groups. Cross-border cooperation with regional supervisors in joint prudential oversight would also be important. Directors commended Kenya's removal from the Financial Action Task Force (FATF)'s monitoring process and encouraged sustained improvements in the country's Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) framework.

Directors encouraged the authorities to maintain the momentum of structural reforms and to continue their efforts to remove remaining infrastructure bottlenecks, in order to mitigate vulnerabilities to weather-related shocks and improve competitiveness. Looking ahead, they also underscored the need to put in place an effective framework for natural resource management, in light of recent oil and gas discoveries. While welcoming the ongoing revision of the national accounts statistics, Directors encouraged the authorities to further improve the quality and the scope of information on the balance of payments, social conditions, and the labor market.

Kenya: Main Economic Indicators, 2012/13–2018/19[1]

	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
	Act.	Prelim.	Projections				
National accounts and prices (percentage change; unless otherwise indicated)							
Nominal GDP (market prices, in billions of Kenya shillings)	4,497	5,051	5,734	6,525	7,420	8,416	9,504
Real GDP growth (market prices)	4.6	5.0	5.8	6.3	6.5	6.5	6.6
GDP deflator (average) [2]	6.7	6.9	7.2	7.0	6.7	6.4	5.9
Consumer price index (annual average) [2]	4.6	7.1	6.5	5.2	5.0	5.0	5.0
Consumer price index (end of period) [2]	4.9	7.4	5.3	5.0	5.0	5.0	5.0
Import volume growth, goods	6.8	3.6	8.3	11.2	7.6	8.8	8.8
Import value growth, goods	3.2	5.0	11.2	9.2	7.8	8.7	9.6
Export volume growth, goods	8.2	0.7	6.2	10.3	10.0	10.6	10.7
Export value growth, goods	2.8	-5.3	4.1	9.1	10.4	11.1	11.3
Terms of trade, goods, and services (Base year 2000)	-4.2	-6.2	-1.3	1.5	0.6	1.2	0.7
Ksh per US$ exchange rate (end of period)	85.8	87.6					
Nominal effective exchange rate (- depreciation; end of period)	1.2	-2.7		...	...	...	...
Real effective exchange rate (- depreciation; end of period)	3.6	1.9		...	...	...	...
Money and credit (percentage change; unless otherwise indicated)							
M3 (broad money and foreign currency deposits, end period)	14.2	21.4	...	...	...	...	...
Reserve money	11.7	16.0	...	...	...	...	...
Investment and saving (In percent of GDP; unless otherwise indicated)							
Investment	18.7	18.7	22.3	22.6	23.2	23.1	22.8
Central government	6.6	6.2	8.6	8.7	9.0	8.8	8.5
Other	12.1	12.5	13.7	14.0	14.2	14.3	14.3
Gross national saving	10.6	11.0	13.9	14.7	16.1	16.5	16.5
Central government	0.8	0.2	2.1	2.9	3.6	4.0	4.1
Other	9.8	10.8	11.8	11.7	12.5	12.6	12.5

Kenya: Main Economic Indicators, 2012/13–2018/19[1] (concluded)

	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
	Act.	Prelim.	Projections				
Central government budget (In percent of GDP; unless otherwise indicated)							
Total revenue	18.8	19.2	20.5	20.5	20.6	20.9	20.9
Total expenditure and net lending	24.8	25.4	27.2	26.4	26.1	25.8	25.3
Overall balance (commitment basis) excluding grants	-6.0	-6.2	-6.7	-5.9	-5.5	-4.9	-4.4
Overall balance (commitment basis) including grants	-5.5	-5.7	-6.2	-5.5	-5.1	-4.6	-4.1
Primary budget balance	-2.5	-3.0	-3.7	-3.0	-2.7	-2.2	-1.7
Net domestic borrowing	3.8	4.0	2.7	2.8	2.4	2.2	1.5
General government overall balance including grants [3]	-5.2	-4.7	-5.7	-5.4	-5.3	-4.8	-4.5
Balance of payments (In percent of GDP; unless otherwise indicated)							
Current account balance	-8.1	-7.8	-8.4	-8.0	-7.1	-6.5	-6.3
Current account balance, excl. capital imports and official transfers	-0.2	0.0	0.0	0.4	0.9	1.2	1.3
Exports value, goods, and services	20.8	18.8	18.1	17.9	17.8	17.8	17.9
Imports value, goods, and services	34.1	32.0	32.2	31.6	30.8	30.3	30.0
Gross international reserve coverage							
In billions of U.S. dollars (end of period)	6.2	7.5	8.3	9.3	10.3	11.2	12.5
In months of next year imports (end of period)	4.0	4.3	4.4	4.6	4.6	4.6	4.6
Public debt (In percent of GDP; unless otherwise indicated)							
Total public debt, gross (percent of GDP)	42.1	42.2	45.8	45.5	45.4	45.0	44.3
Of which: external debt	18.8	19.4	19.0	19.3	19.7	19.7	20.1
Of which: domestic debt, gross	23.4	22.8	26.8	26.2	25.7	25.2	24.2
Total public debt, net of deposits (percent of GDP)	37.6	38.2	40.7	41.3	41.4	41.1	40.5

Sources: Kenyan authorities and IMF staff estimates and projections.

[1] Incorporates Staff estimates for pending upward revisions to GDP, which the authorities expect to release in September 2014. Fiscal years are from July 1 to June 30.

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

[3] General government includes central government and county government, and excludes extra budgetary funds (EBFs) and central government units with individual budgets for which regularly published data are not available.

Statement by Mr. Saho, Executive Director for Kenya
September 22, 2014

Macroeconomic stability and growth has gained traction as structural adjustment and political reforms continue to be deepened in Kenya. This notwithstanding, the authorities continue to foster economic transformation to address the high poverty levels and youth unemployment. On behalf of my Kenyan authorities I thank staff for their constructive engagement with Kenya.

Economic performance and prospects

Although growth is resilient, the economy remains vulnerable to external and internal risks. Kenya's economy is projected to grow at a much slower pace than initially expected due to poor performance in the tourism sector as a result of the security problems that have threatened tourism with multiple issuances of travel advisories from major tourist destinations. This is despite various measures announced by the government to promote domestic tourism earlier in the year. As a result, the authorities have revised their growth estimates for 2014 to between 5.0-5.5 percent which is lower than the estimate of 5.8 percent in FY2014/15 budget.

Inflation has remained generally stable in the last two years averaging 6.0 percent. However, it increased from 7.7 percent in July 2014 to 8.4 percent in August 2014 reflecting base effect and increases in prices of some food and energy items. The Kenyan shilling is relatively stable against the major foreign currencies supported by foreign exchange inflows through remittances, increased foreign investor participation in the Nairobi Securities Exchange (NSE) and the successful issuance of the debut sovereign bond. Currently, the foreign reserves are about 4.2 months of import cover.

In FY2013/14 total government revenue surpassed its target with tax income making a 70 percent contribution. There was a noticeable increase in foreign debt mainly because of borrowing to finance development activities. In the current fiscal year, the authorities target to increase revenue collection by 15.5 percent, and increase development expenditure consistent with the objective of rebalancing expenditures towards development outlays. The authorities have also set a performance benchmark for absorption of the development budget of at least 80 percent.

The FY2014/15 budget continues implementing the Second Medium Term Plan of the Vision 2030 whose main theme is "*Transforming Kenya: Pathway to Devolution, Socio-Economic Development, Equity and National Unity*". To push this agenda forward, the authorities have as their key objectives to enhance the business environment for job creation; improve productivity and competitiveness in domestic and international markets; reduce the cost of living; protect the poor and vulnerable; reduce unemployment among the youth and women; and strengthen devolution.

Fiscal policy and reforms

The authorities are committed to fiscal prudence and debt sustainability. To strengthen revenue mobilization, efforts are ongoing to deepen tax reforms with a focus on the excise and income taxes to widen the tax base. In addition, to enhance efficiency in tax administration, as part of the reform initiative under the Revenue Administration Reform and Modernization Program, the Kenya Revenue Authority (KRA) has introduced a new online tax system that allows taxpayers access to various tax administration services such as updating registration details, filing tax returns, making payments, and monitoring the status of their tax ledgers. Further, to enhance the capacity of tax administration, the authorities are in the process of submitting to parliament, the Draft Inland Revenue Agency Bill and Customs and Border Services Bill to facilitate the reorganization of KRA. In addition, to rationalize expenditure and assure efficiency and value for money, the authorities are planning to roll out e-Procurement by making operational Procure-to-Pay module of the Integrated Financial Management System (IFMIS).

To address the growing wage bill, the authorities have launched the Capacity Assessment and Rationalization of Public Service (CARPS) initiative. The program aims to have a leaner, efficient and responsive public service covering both the national and county levels of government. On September 1, 2014, the biometric registration of civil servants was launched to verify staff on government payroll and their qualifications, and weed out ghost workers.

With the enormous development demands, the authorities are diversifying their financing of development. Recently, they successfully issued a debut sovereign bond to reduce the crowding out of the private sector in the domestic money market. In addition, the government has launched the Annuity Financing Mechanism for road development to provide sustainable means of funding road projects while ensuring faster turnaround in executions. This model is being pursued for roads that may not be viable for conventional tolling through public private partnership. It involves engaging a private entity to finance, design, construct and maintain a road based on an agreed payment modality by the government. This should take funding pressure away from the government to the private sector, and also incentivize contractors to improve the quality and efficiency of their service.

At the same time, the authorities are gearing to implement the parastatal reforms. The Presidential Task Force on Parastatal Reform has proposed mergers and dissolution of various parastatals that would reduce the number of parastatals from 262 to 187. However, to kick start the process two bills have to be passed by parliament; the Government Owned Entities Bill 2014 which is meant to ensure parastatals adopt a leaner and more efficient structure; and the National Sovereign Wealth Fund Bill 2014 that would revamp the government management of its shareholdings in listed companies, and address issues of managing the new found mineral wealth while also seeking to establish a wealth fund. These two bills have been published and are awaiting parliamentary debate.

The devolution process

Despite facing various challenges at the initial stages of implementing a devolved government system, my authorities are committed to making devolution work. For the challenges related to the PFM system, the authorities are committed to facilitate the county governments strengthen their PFM systems so that they can achieve value for money in the use of public resources. In addition, while the Constitution stipulates an allocation to county governments of not less than 15 percent, in the current financial year the national government is allocating 43 percent of the most recently audited revenues approved by parliament to ensure adequate financing of devolved responsibilities. Furthermore, the Division of Revenue Bill and County Allocation Bill have been assented to, allowing for timely disbursement of funds to the counties in this fiscal year.

Monetary and financial policies

The Central Bank of Kenya (CBK) continues to pursue prudent monetary policy to compliment fiscal policy in order to maintain price stability. Although overall inflation has remained above the 7.5 percent upper bound of the prescribed range for the second consecutive month, the Monetary Policy Committee (MPC) at its meeting on September 3, 2014 retained the CBR at 8.5 percent on the basis of the absence of any fundamental structural pressures on inflation. However, the CBK has undertaken to pursue a tightening bias in the money market through monetary policy operations to continue anchoring inflation expectations. It will also keep vigilant on any domestic or external developments that may impact on price stability and take timely action should shocks materialize.

To maintain monetary policy credibility, the authorities are committed to modernizing the monetary policy framework. It is important to note that Kenya is serving as a pilot project in the IMF project on "*Monetary and Exchange rate policies for LICs*" where the IMF is collaborating closely with the central bank to modernize the practice of monetary policy. The project has led to the training of CBK staff on Forecasting and Policy Analysis System (FPAS) which captures the authorities' views of the monetary transmission mechanism and shocks impacting on the economy in line with best practices in emerging markets. CBK is in the process of institutionalizing this framework.

As financial inclusion continues to deepen, efforts are being made to mitigate credit risks emanating from micro-loans. A mass education campaign has been launched, targeting the new users of mobile banking micro-loan facility (M-shwari). In addition, micro-loans issued under the M-Shwari facility are subject to Credit Reference Bureau Regulations, 2013. Section 50 of the Credit Reference Bureau Regulations (issued as Subsidiary Legislation in January 2014) provides the timeframe during which all non-performing loans must be reported to the credit bureau for listing.

Starting January 2015, all banks are required to maintain a minimum capital requirement (Tier II) of 14.5 percent from the current 12 percent. This follows the issuance of revised guidelines on prudential capital adequacy ratios by CBK in January 2013 to strengthen the regulatory framework for commercial banks. According to the guidelines, banks are required to hold a capital conservation buffer of 2.5 percent over and above the prevailing minimum ratios. This increases the minimum core capital to risk weighted assets and total capital to risk weighted assets requirements to 10.5 and 14.5 percent respectively. The main aim is to enable the institutions withstand future periods of stress. Further, in the recent Financial Stability Report, CBK has indicated its intentions to raise the minimum ratios further to make the banking industry move to the level of other markets in the region such as South Africa and Nigeria.

The Kenya Banks' Reference Rate (KBRR) became effective July 8, 2014. The CBK and Kenya Bankers Association are monitoring the implementation of the KBRR and the Annual Percentage Rate (APR) frameworks by commercial banks. So far there are indications that new and existing loans are benefiting from the KBRR framework. The average premium that commercial banks charge above the KBRR on commercial mortgages averaged 3.05 percent while that on corporate loans (1–5 years) was 4.09 percent by end August. These frameworks are designed to improve transparency in credit pricing and promote full disclosure of bank charges on new loans thereby supporting an increase in the supply of affordable credit to support investment.

NSE is now operating as a demutualized entity. This demonstrates commitment to transparency and good corporate governance.

Enhancing the business environment and regional integration

The authorities are focusing on enhancing the business environment to strengthen economic activity and create jobs. They have prioritized addressing security challenges. In this regard, they are building on the security modernization program initiated in the last financial year to strengthen the security system. They have in the FY2014/15 budget focused interventions to recruitment and training of police officers, security infrastructure development, and housing and medical scheme for security personnel. In addition, the authorities are working to improve productivity and enhance overall competiveness by investing in transport and logistics networks including, modernizing Jomo Kenyatta International Airport, improving efficiency of Port of Mombasa, increasing energy production, and widening the coverage of road networks.

Further, in the context of regional integration various joint infrastructure projects have been initiated to ease doing business in the East African region. Already Kenya, Uganda and Rwanda have put in place the singe tourist visa and a single customs territory. A standard gauge railway from Mombasa to Kigali and Juba through Kampala is being designed to facilitate regional trade and the financing of the first segment has been secured. In addition, to improve the efficiency of the Port of Mombasa, the Kenya National Electronic Single Window System has been launched. Further, the LAPPSET project that covers Kenya, Uganda, Rwanda, South Sudan and Ethiopia is expected to foster transport links and give the region a competitive edge in global maritime trade.

Conclusion

My authorities value the Fund's policy advice and technical assistance. Therefore, they will continue to engage with the Fund and also seek the support of development partners as they implement their ambitious economic transformation agenda. My authorities are committed to maintaining macroeconomic stability and deepening structural reforms to create a favorable business environment that will support strong and inclusive growth